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EUROZONE STAGFLATION: HOW LONG WILL IT LAST?

Berenberg Macro View

Tough luck. Since the Delta wave of the pandemic hit Europe last November, the Eurozone has been stuck in stagflation with hardly any growth at the highest rates of inflation of the last four decades. Just when economic data were turning up nicely again in February upon the fading of the Omicron wave, Putin launched his brutal onslaught on Ukraine, depressing consumer confidence to recession levels as energy and food prices surged. Following a moment of relief after Putin lost the battle for Kyiv, serial lockdowns in China and an – overdue – tightening of EU energy sanctions in response to Russian war crimes have dealt new blows to the Eurozone economy over the last six weeks. We expect real GDP to stagnate with inflation at close to 8% in Q2 before picking up momentum again in the second half of this year. The range of potential outcomes remains unusually wide, though.

Positive fundamentals: Since 2019, Eurozone data have followed a clear pattern. Whenever an external shock started to fade (receding trade tensions with the US at the end of 2019, ebbing waves of the pandemic), the Eurozone began to gear up for significant growth. The penchant to spring back to life after a shock reflects the mostly positive underlying fundamentals: Employment has risen to record levels, businesses would like to produce and invest more, inventories need to be replenished, corporate balance sheets are mostly in good shape and governments have turned from semi-austerity to additional spending on the physical and digital infrastructure, the energy conversion and – as a likely new trend – on defence. Thanks to excess savings built up during the pandemic worth 13% of 2019 (pre-pandemic) consumer spending, most households can cope with the energy and food shock that has raised the level of consumer prices by close to 6% relative to the previous price trend.

Consumers anxious, businesses still upbeat: The most recent shocks (energy and food prices) and supply chain dislocations have hit consumers and businesses very differently. Business confidence has softened. The inflow of new orders has slowed and expectations have taken a hit while supply disruptions hold back production. Nonetheless, business confidence remains well above average levels – see Chart 1. Order books are still full. In manufacturing, orders cover 4.9 months of production, down slightly from the record reading of 5.0 in January 2022 but well above the long-term average of 3.5 according to the European Commission's April sentiment survey. However, consumer confidence has plunged to recession levels – see Chart 1. As consumers expect their financial situation to worsen significantly in the next twelve months, their readiness to make major purchases at present (balance of positive and negative survey responses of -35.1 in April) is now closer to the trough of -47.5 at the depth of the Covid-19 crisis in April 2020 than to the long-term average of -17.0. The situation is highly unusual. In previous crises, business and consumer confidence usually plunged in tandem, sometimes with business confidence slightly in the lead. This time, businesses have a safety valve. Most of them can pass cost increases onto consumers. If critical inputs are in short supply, they often use the inputs they get for high-margin products to protect their earnings.

Supply disruptions versus a post-Omicron bounce: Within the business sector, the situation is also somewhat mixed. The purchasing managers indices show a pickup in activity in services versus a softening for manufacturing in the last few months – see Chart 2. For both sectors, the PMI readings are well above the expansion/contraction line of 50. The contrast between resilient services activity and depressed consumer confidence is particularly striking as many services are being sold directly to consumers. The fading impact of the Covid-19 pandemic probably explains the gap. The energy and food price shock makes consumers reluctant to spend money on goods. However, they are ready to enjoy the services they often had to forsake

while the pandemic was raging. If it had not been for the price shock, GDP would likely be recovering rapidly. Without the offsetting post-Covid rebound in spending on some services, the price shocks would likely have pushed the Eurozone into recession.

Stagflation until summer: On balance, the current data (very low consumer confidence at still fairly positive business confidence) point to stagnation rather than a major drop in activity in Q2. After a further fall in activity in April, cushioned somewhat by a rebound in car output as cable harnesses from western Ukraine became available again, we look for a stabilisation in May and the start of a significant recovery in June. For Q2 as a whole, some replenishing of inventories and additional government spending will probably offset a noticeable decline in private consumption. Thereafter, some easing of supply constraints and a bumper summer tourist season should help to return the Eurozone to significant growth again in Q3. Anecdotal reports on holiday bookings are encouraging. While consumers are holding back on purchases of durable goods, they seem eager to take vacations on the beaches again after COVID-19 had kept many of them away in the last two years. Our forecasts differ from the Bloomberg consensus in two major respects: we are more concerned about the near-term, projecting stagnation in Q2 versus a 0.4% qoq consensus. Thereafter, however, we look for a stronger rebound with growth of 1.0% qoq in Q3 and Q4, well ahead of the consensus of 0.6% qoq gains for both quarters. We see a stronger underlying dynamic than consensus and expect the positive fundamentals to re-assert themselves from mid-2022 onwards.

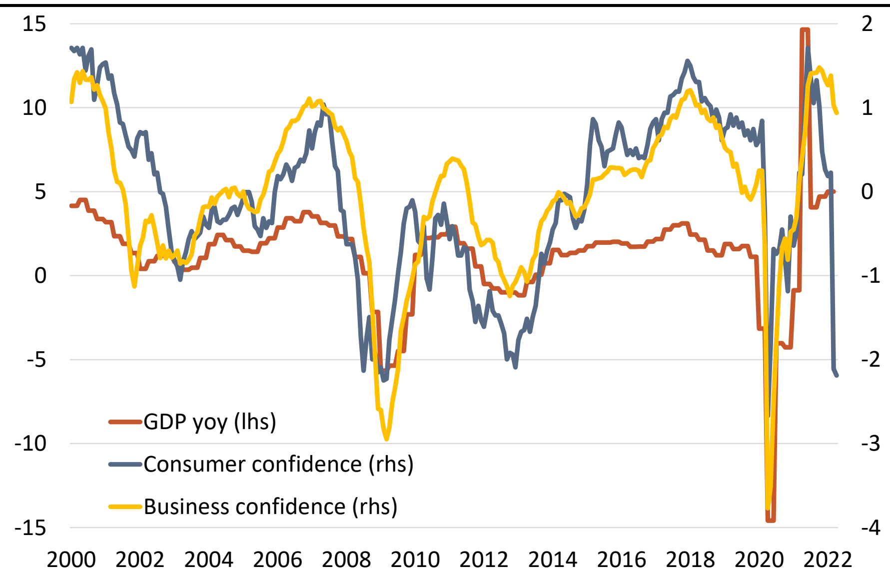
Near term, risks to growth are tilted to the downside. Worsening Chinese lockdowns and cautious consumer spending in reaction to high energy and food prices could easily cause a temporary contraction in Eurozone GDP in Q2. An immediate embargo on gas imports from Russia (highly unlikely) could turn that into a more serious recession. If the Fed gets it badly wrong and catapults the US straight from boom to bust (unlikely but not fully impossible), such a recession could last well into next year. But unless worst came to worst, the Eurozone should escape such a sorry fate.

Inflation: no reprieve – yet. After surging to a 40-year record of 7.5% in April, inflation looks set to rise a bit further in May and stay close to those levels until September. The contribution of energy prices to headline inflation has peaked at 4.4 percentage points in March (Chart 3) and will likely moderate slightly from June onwards. However, some inflationary pressure is still in the pipeline. It typically takes up to six months until higher grain prices have been passed on fully to consumers buying processed food. Supply-chain shortages and higher energy costs for producers will also hit consumers only with a lag. Government interventions into energy markets including the temporary German cuts in petrol taxes (June through August) will probably help to limit the rise of inflation in coming months. From October onwards, the base effects of the energy price surge that gathered pace last September and peaked in March 2022 will show up in a major decline in the year-on-year rate of headline inflation to a trough around 2% in March 2023 before settling around 2.5% thereafter.

ECB: time to get real. So far, Eurozone inflation reflects solely external shocks rather than any domestically generated price pressures. The ECB can neither influence energy and food prices nor alleviate supply shortages. Hiking rates rapidly to strengthen the euro exchange rate would have no more than a minimal impact on headline inflation relative to the gyrations caused by world market prices for energy, foodstuffs and other commodities. Unable to shape the near-term outlook much, the ECB should focus on the medium term. As we have argued for more than two years, mounting labour shortages and some restructuring of global supply chains away from the cheapest to more reliable suppliers will lift inflation pressures over time. As a result, the ECB should lean against it once the worst temporary shocks are over. We expect the ECB to end net asset

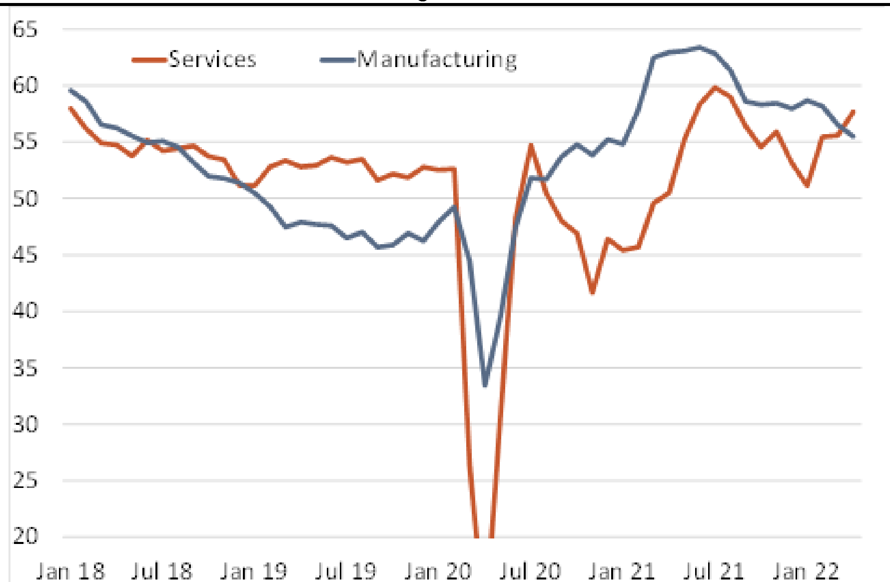
purchases in July and raise rates by 25bp each in September and December, with a probability of 40% that the ECB may start to raise rates in July already and thus deliver three instead of two hikes this year.

Chart 1: Business and consumer confidence – what will drive Eurozone GDP?



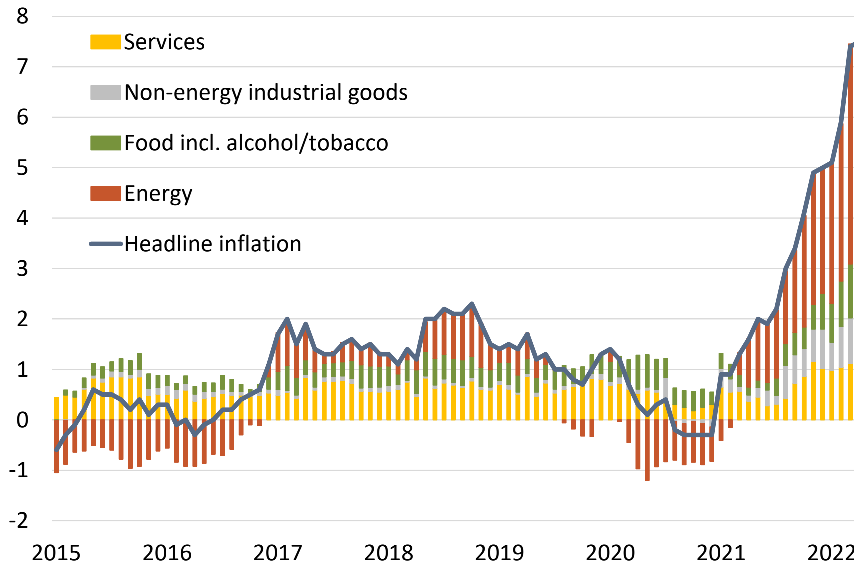
Real GDP: yoy change in %, left-hand scale; confidence indicators: difference from mean in standard deviations, business confidence as weighted average of industry (50%), services (37.5%), retail trade (6.25%) and construction (6.25%), right-hand scale. Sources: Eurostat, European Commission, Berenberg

Chart 2: Eurozone PMIs: manufacturing versus services



Eurozone purchasing managers indices, manufacturing and services activity. Values above 50 indicate growth. Source: Markit

Chart 3: Eurozone inflation: food and energy are the main drivers



Headline inflation (yoy change in HICP, in %), contributions to the yoy rate of headline inflation, in percentage points. Sources: Eurostat, Berenberg

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