ODDO BHF

MACROECONOMIC *view*

September 12th, 2022

Bruno Cavalier
Chief Economist ODDO BHF

Europe: a recession is inevitable

Key highlights:

- The Russian gas embargo and the ECB's tightening monetary policy make a recession this winter unavoidable.
- The European inflation peak is yet to come, expected slightly above 10%.
- The policy mix is inconsistent, with the ECB aggressively tightening while governments multiply their household support schemes.

●○●

What do Vladimir Putin and the ECB have in common? Both are firmly pushing the European economy into recession, albeit not for the same reasons.

For Vladimir Putin, it is about inflicting as much pain as possible on an adversary imposing heavy sanctions on its economy. By cutting off gas supplies to Europe, he is driving up energy prices, which could lead to a social crisis in our countries and weaken our governments, with the hope of forcing them to lift the sanctions or reduce their support for Ukraine. This is blackmail, pure and simple.

For the ECB, weakening the European economy is not an end in itself, but a means to ease inflationary pressures. In that sense, a recession is seen as a necessary evil. The ECB is openly talking about a "sacrifice" between growth and inflation. It is tightening its monetary policy at a pace never-before-seen in its history, with a 50-basis point rate hike in July, followed by a 75-basis point increase in September. It has warned that it will continue to raise rates at a sustained pace over the next three or four meetings.

As a result, pressures on the European economy further increased over the summer. Here, we look at the implications for the inflation, growth and economic policy outlook.

As far as inflation is concerned, the risks are still to the upside. While there are signs of inflation easing in the US and China, that is not the case in the eurozone. In August, price inflation reached a new record high of 9.1% year-on-year. **There is every reason to believe the peak is yet to come, as a double-digit inflation is expected by the start of 2023**.

First of all, wholesale gas and electricity prices have exploded to between 10 and 20 times the normal level. Even though retail prices are regulated and much less responsive, they are still on an upward trend, especially as consumer protection measures are likely to be reduced in the coming months.

Other prices seem to be accelerating as well, such as food and some services. The weakness of the euro is making imports paid for in dollars more expensive. As a counterpoint, it should be noted that the global supply chain is less stressed.

The demand for manufactured goods that surged in periods of lockdown is easing, now that mobility has returned to near normal levels (with the exception of China). There is less traffic in international trade, so less congestion, and some prices have fallen sharply: freight, industrial raw materials, oil. **However, it takes time for production prices to be passed on to consumer prices, whether upwards or downwards**.

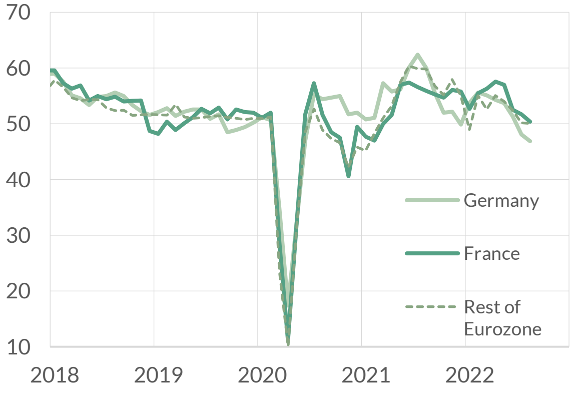
As far as growth is concerned, the risks are to the downside. Business climate indicators have been falling since the invasion of Ukraine began last February, but the decline has deepened over the summer. In many eurozone countries, these indicators have now crossed the recession-entry threshold (graph). Compared to 2019, the trade balance in energy products has deteriorated by around 4 GDP points. **There is no precedent for such a shock to real incomes without a contraction in activity and demand**.

For some companies, it is indeed preferable to reduce capacity rather than produce at a loss. That is the case for the most energy-intensive activities such as chemicals, metallurgy, paper and glass manufacturing. In Germany, these branches account for 20 % of the industrial sector's added value and 80 % of its energy consumption. The disappearance of Russian gas is disrupting their business conditions. The risk of shortages and blackouts will be greatest during the coming winter.

There are many other sources of weakness: consumers suffering a heavy loss of purchasing power, a real estate sector weakened by the rapid rise in interest rates, and banks that have become cautious in their distribution of credit. In fact, the only area where the European economy is still showing strength is the job market. After six months of continuous decline in business morale, there has been no reversal in hiring intentions.

As far as economic policy is concerned, an entirely new problem is arising. Inflation shock and the risk of a recession call for diametrically opposed reactions: restriction on the one hand, easing on the other. This is a major difference from the pandemic crisis. At that time, fiscal and monetary policies were eased together because there was no inflationary risk. Nothing like that in the face of the current energy crisis. The ECB will do everything, perhaps too much, to show it is adamant in its anti-inflationary mandate. For their part, governments are, in a scattered order, trying to limit the shock. Cumulatively, these emergency plans amount to around 2.5 points of GDP to date. **This division of labour is precarious and does not bode well for a quick rebound once the winter is over**.

PURCHASING MANAGERS' COMPOSITE ACTIVITY INDEX
(50 POINTS = RECESSION-ENTRY TRESHOLD)



Sources : S&P/Markit

Disclaimer

ODDO BHF
12, boulevard de la Madeleine - 75440 Paris Cedex 09 France - Phone: 33(0)1 44 51 85 00 - Fax: 33(0)1 44 51 85 10 – www.oddo-bhf.com ODDO BHF SCA, a limited partnership limited by shares with a capital of €70,000,000 - RCS 652 027 384 Paris – approved as a credit institution by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and registered with ORIAS as an insurance broker under number 08046444. - www.oddo-bhf.com