PICTET

Euro area 2024 macro outlook

Walking a thin line

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SUMMARY

- As we move towards 2024, fears the euro area economy will slide into recession remain rife. For our part, we expect the euro area to move sideways until mid-2024 before a modest recovery in H2 2024, with euro area GDP growth averaging 0.6% in 2024 after an estimated 0.5% in 2023. But the risks remain tilted to the downside, with geopolitical uncertainty and fiscal policy (in particular in Germany) posing the major risks to our growth outlook.
- HICP inflation is expected to fall quickly in the coming months amid subdued growth and base effects. We see headline inflation falling to the ECB's medium-term target of 2% by the end of 2024, with headline HICP inflation averaging 2.4% in 2024 (down from 5.5% in 2023) and core inflation also averaging 2.4% (down from 5.0%).
- With inflation falling faster than it projected, the ECB is coming around pressure to lower interest rates. We see the first cut coming in June 2024. We have pencilled in a total of 100 bps in rate cuts in 2024, bringing the deposit rate down to 3.0% by the end of the year. Given risks to the growth outlook, risks are tilted towards an earlier cut (i.e. in March). In the background, the ECB will likely continue to reduce its balance sheet at a steady pace, with risks of some tapering in the Pandemic Emerging Purchase Programme (PEPP).

GROWTH: SLUGGISH UNTIL MID-2024

This has been a year of mixed outcomes for the euro area. The region managed to avoid a recession last winter, demonstrating resilience amidst the energy crisis, thanks in part to significant fiscal support from governments. However, since spring, growth has fallen short of expectations due to subdued foreign demand, the weak performance of energy -sensitive industries and the strong impact of monetary tightening. The services sector has held up better thanks to continued impetus from

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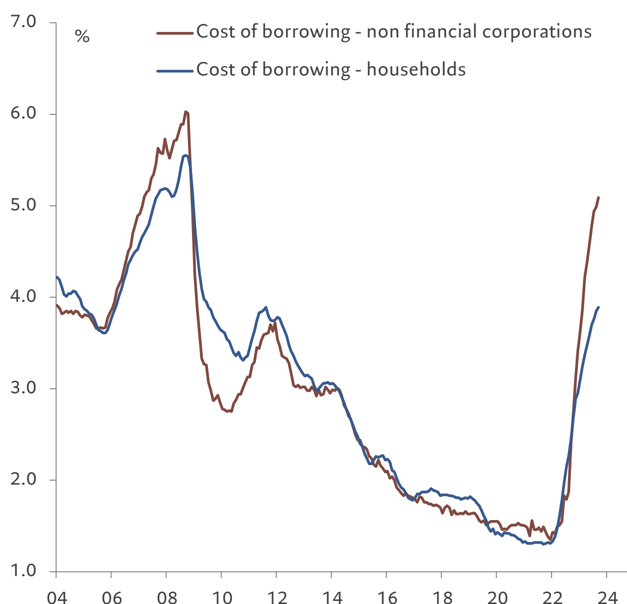
post-covid reopening, but the effect is fading and weakness in manufacturing is spreading.

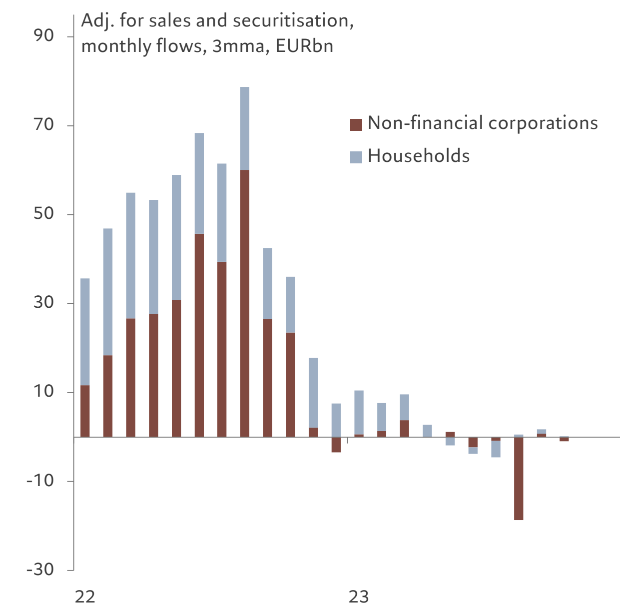
Looking ahead to 2024, concerns persist that the euro area will slip into recession. Our own analysis suggests that the euro area may narrowly avoid a recession, as we anticipate certain headwinds to gradually diminish. First, the impact of volatile energy prices is likely to decrease as real disposable income improves thanks to falling inflation, increasing wages and a resilient (albeit weakening) labour market. Second, the relatively fast transmission of European Central Bank (ECB) rate hikes has jacked up funding costs and lowered bank lending *(see chart 1 and 2)*. But we expect the drag from rate policy to gradually diminish as the ECB stays on hold and begins to lower rates towards the end of H1. Finally, we expect manufacturing activity to improve as inventories fall—although limited global demand may constrain the upside potential.

Chart 1: Euro area – cost of borrowing



Source: PWM, ECB, as of 1 December 2023

Chart 2: Euro area – bank loans to private sector



Source: PWM, ECB, as of 1 December 2023

More stringent fiscal policy (notably in Germany) poses a significant risk to our growth forecast for 2024. The euro area's overall fiscal stance is projected to be contractionary in 2024 due to the almost complete withdrawal of remaining covid-19 and energy-related measures. While Next Generation EU (NGEU) grants are likely to continue to bolster investment, especially in peripheral countries, the recent German Federal Constitutional Court decision to declare the 2021 supplementary budget[1] unconstitutional has major ramifications and could further intensify fiscal tightening in Germany.

Overall, we anticipate **euro area growth to remain subdued until mid-2024**, followed by a modest recovery as the US economy rebounds from a significant

[1] The 2021 supplementary budget had shifted unused funds from the central government to the Climate and Transition Fund to finance future investment plans for the green transition. The ruling was explicitly only for the Climate and Transition Fund, but the government meanwhile assumes that it would also apply to the Economic Stabilisation Fund, set up in 2022 to finance the electricity and gas price brakes in 2023/24.

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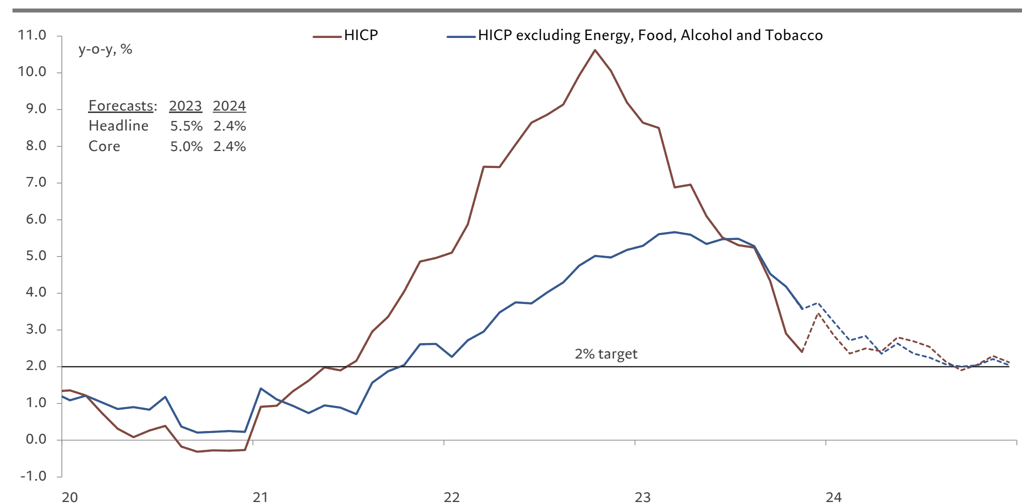
slowdown and the ECB begins to relax its monetary policy. **We project euro area GDP growth to average 0.6% in 2024**, slightly up from an estimated 0.5% in 2023. However, **risks are skewed to the downside**, particularly if geopolitical uncertainty impacts economic sentiment and fiscal policy.

INFLATION: HEADLINE BACK TO TARGET BY THE END OF 2024

Inflation has been falling fast in the euro area. Indeed, headline inflation declined to an annual rate of 2.4% in November 2023 from 10.6% a year before, mostly thanks to energy and core goods (to a lesser extent). There is increasing evidence that underlying inflation has turned the corner too. But most of the cooling so far reflects weaker core goods inflation as supply chain disruptions have eased and energy prices have come down. Services inflation remains stickier, but has also started to ease and is likely to continue to do so, as wage growth normalises.

Given weak demand and base effects, we expect gradual disinflation to continue. We see headline inflation falling to the ECB's medium-term target of 2% by the end of 2024 (see *chart 3*), with headline HICP inflation averaging 2.4% in 2024 (down from 5.5% in 2023) and core inflation also averaging 2.4% (down from 5.0%). This would be a faster decline in prices than ECB staff has been expecting. We think inflation could be even lower given the risks to our growth outlook.

Chart 3: Euro area HICP inflation



Source: Pictet Wealth Management, ECB, as of 1 December 2023

MONETARY POLICY: DECLINE IN INFLATION PUTS PRESSURE ON THE ECB TO PIVOT

The ECB's next move is very likely to be a rate cut. The question is when. The ECB will want to make sure that inflation is returning to its target, although recent data have confirmed that disinflation is well under way. Indeed, inflation is decreasing much faster than the ECB projected in its September forecast, thus increasing the pressure on it to cut rates. The ECB will seek further evidence in (other) data, with a particular focus on wage increases. According to 'a recent speech by Executive Board member Isabel Schnabel slowing wage growth is crucial for reducing (core) inflation

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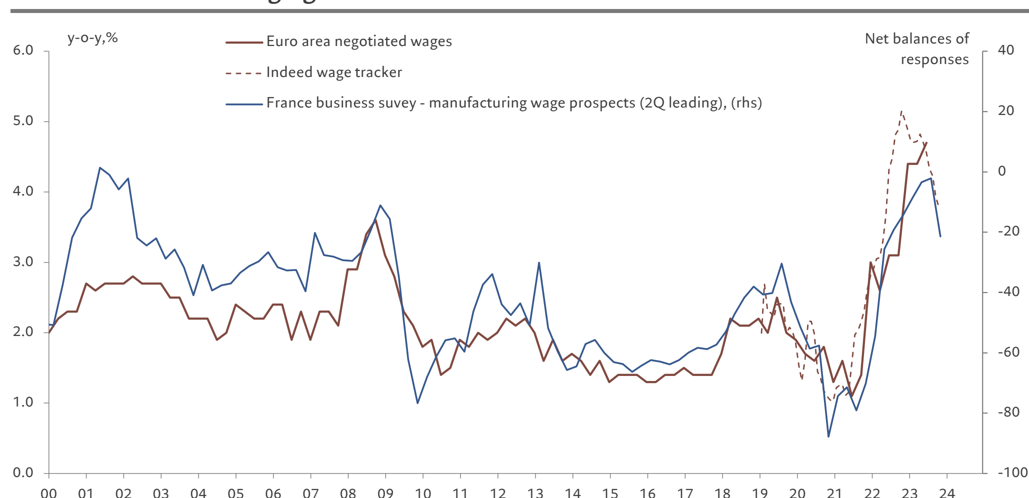
from its current level to the 2% target, a phase she termed "the last mile". For our part, we believe that wage growth (see *chart 4*), a lagging indicator, has peaked in the euro area given the slowdown in the labour market and the decline in inflation.

All things considered; **we expect the ECB to start cutting rates in June 2024**. We see it to reducing rates by 100 bps over 2024 as a whole, bringing the deposit rate down to 3.0% by year's end (see *chart 5*). **Importantly, rate cuts could come earlier given the downside risks to the growth outlook and the potential for disinflation to continue at a fast clip**. Either way, the ECB will likely justify lower policy rates as a way to recalibrate the monetary stance in an environment of slowing inflation (keeping real rates broadly stable) rather than a proper easing cycle.

Chart 4: Euro area wage growth measures



Source: Pictet Wealth Management, ECB, INSEE, Indeed, as of 1 December 2023

We expect the ECB to steadily reduce its balance sheet. Repayments of targeted longer-term refinancing operations (TLTROs) will conclude next year, while the reduction of the asset purchase programme (APP) will continue as bonds mature. We believe outright sales of APP bonds are unlikely. Meanwhile, the ECB is expected to adhere to its current policy of fully reinvesting maturing pandemic emergency purchase programme (PEPP) bonds until the end of 2024.

Some hawkish policymakers might advocate for a quicker reduction of the balance sheet. Thus, **some tapering of the PEPP in 2024 in Q3 or even Q2 cannot be completely dismissed** and could help forge a consensus between the hawks and doves when it comes to rate cuts. Nonetheless, there are few advantages to speeding up the tapering of the PEPP. Even if the amounts involved are relatively small, such a move could draw undue attention to the transmission protection instrument (TPI), especially as several countries risk being subject to an excessive deficit procedure in spring next year and losing their eligibility to the TPI. In any case, the ECB is likely to proceed carefully to avoid unwarranted fragmentation.

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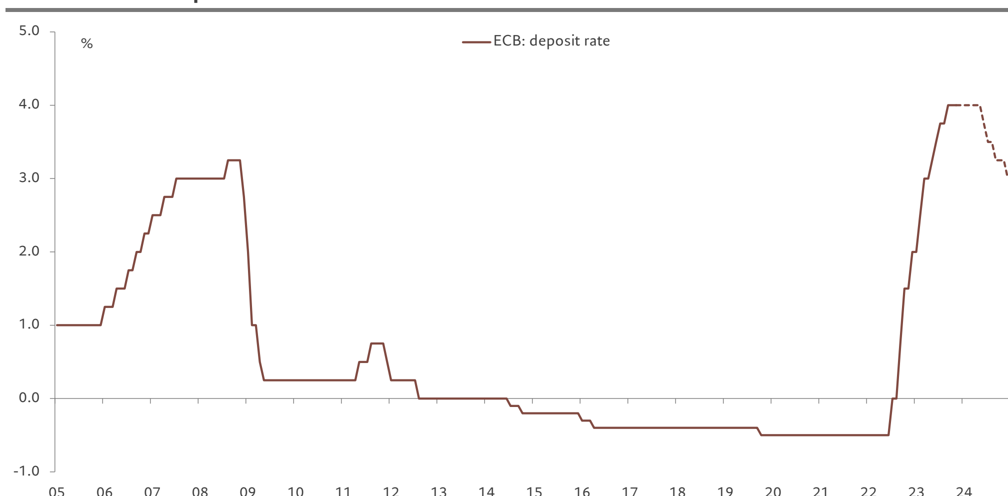
Chart 5: ECB deposit rate



Source: Pictet Wealth Management, ECB, as of 1 December 2023

COUNTRIES: MIXED FORTUNES, GERMANY TO REMAIN THE WEAKEST LINK

We expect growth in Germany to remain weak next year given shaky export demand, tighter fiscal policy and the impact of monetary tightening on investments. At the same time, we expect consumer spending to gradually recover thanks to rising disposable income and a resilient, albeit weakening, labour market. Following the constitutional court ruling, there is a big risk that fiscal policy is tightened more than expected. We expect German GDP to expand by 0.3% in 2024, up from -0.1% in 2023.

The French economy has performed better than Germany's over the past two years This can be explained by France's generally more domestic demand-driven economy, its lower exposure to China and the auto sector as well as a different energy mix, including a lower dependence on natural gas. Next year, consumer spending is expected to be a key contributor to French GDP growth, but a lot will depend on how savings are mobilised. Investment could remain subdued until the second half of the year due to the lingering effects of restrictive monetary policy. Fiscal tightening in France in 2024 is set to be very modest. We expect French GDP growth of 0.6% in 2024, down from 0.9% in 2023.

In Italy, weak global demand, the impact of high interest rates and the gradual phasing out of tax credits (the so-called 'Superbonus') are the main risks for the Italian economy. At the same time, consumer spending should benefit from rising real household incomes while disbursements from the EU recovery fund should still support economic activity. We expect Italian GDP to expand by 0.8% in 2024, slightly up from 0.7% in 2023. Fiscal policy will remain a key focus next year amid risks of fiscal slippage. Any delays in payouts from the EU's recovery fund could hurt the growth outlook and raise worries about debt sustainability in a context of still-high interest rates.

Spain's economic performance has been relatively robust. It has outperformed the euro area's three larger economies throughout 2023, not least thanks to the rebound

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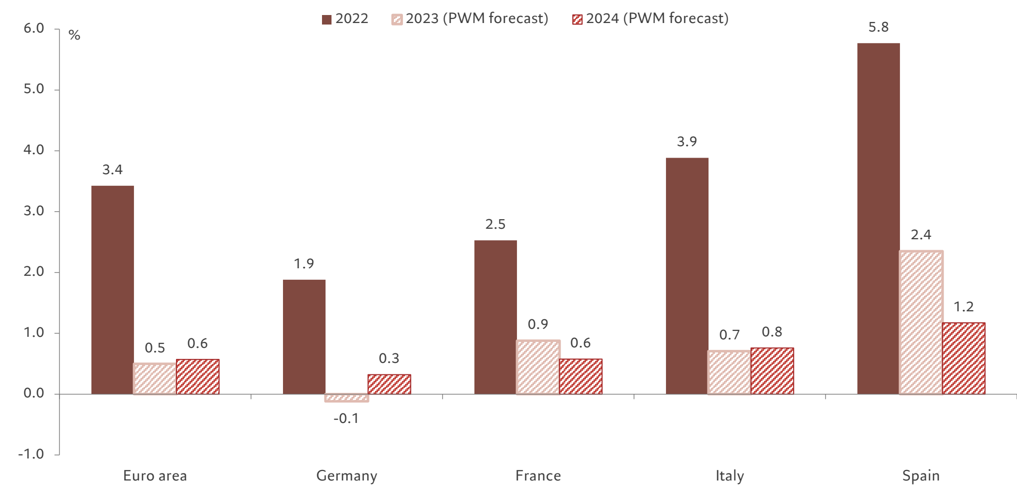
in tourism, solid household spending and payments from the EU recovery fund. We expect household spending resilience to extend into 2024. The EU recovery fund, recently scaled up, will remain an important driver for Spain's growth next year. The newly re-elected Socialist-led government is planning to reduce the fiscal deficit to 3% of GDP in 2024 but thanks to the recovery fund, fiscal policy in Spain is set to be modestly expansionary in 2024. We expect Spain's GDP to expand by 1.2% in 2024 compared with 2.4% in 2023.

Chart 6: Euro area GDP growth forecasts



Source: Pictet Wealth Management, Eurostat, as of 1 December 2023

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