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After A Decent Start To The Year, Eurozone Growth Will Moderate In H222

27 May 2022 | Eurozone | Economic Activity

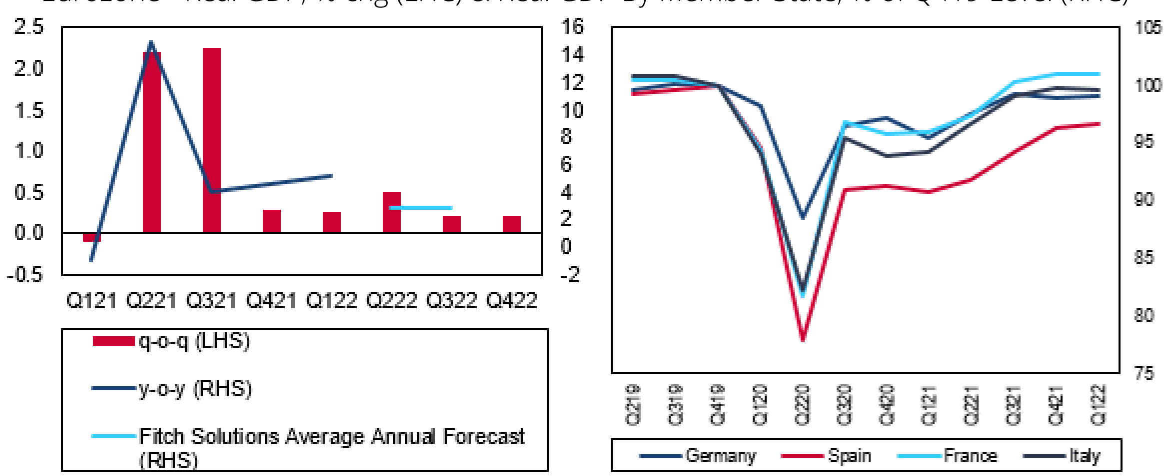
Key View

- We at Fitch Solutions continue to forecast a 2.8% rise in eurozone real GDP in 2022, to be followed by a 2.1% expansion next year.
- After a modest 0.3% q-o-q expansion in Q122, growth should pick up somewhat this quarter, with the removal of remaining Covid-19 restrictions set to boost activity in the tourism sector in particular.
- Growth will slow in H222, as consumer spending runs out of steam once the boost from the release of pent-up demand fades and as supply chain issues weigh on both business investment and exports.

We at Fitch Solutions continue to forecast a 2.8% rise in eurozone real GDP in 2022, to be followed by more modest growth of 2.1% next year. The eurozone economy had a decent start to 2022, expanding by 0.3% q-o-q (+5.1% y-o-y) despite a fairly adverse macro backdrop. A breakdown of GDP is not yet available, but national data suggest that activity was supported by strength in fixed investment, while both net trade and consumer spending acted as drags. Growth was strongest in Spain (+0.3% q-o-q) and in Germany (+0.2%), while activity stagnated in France and contracted outright in Italy (-0.2%).

Eurozone Growth To Ease As The Year Progresses

Eurozone - Real GDP, % chg (LHC) & Real GDP By Member State, % of Q419 Level (RHC)



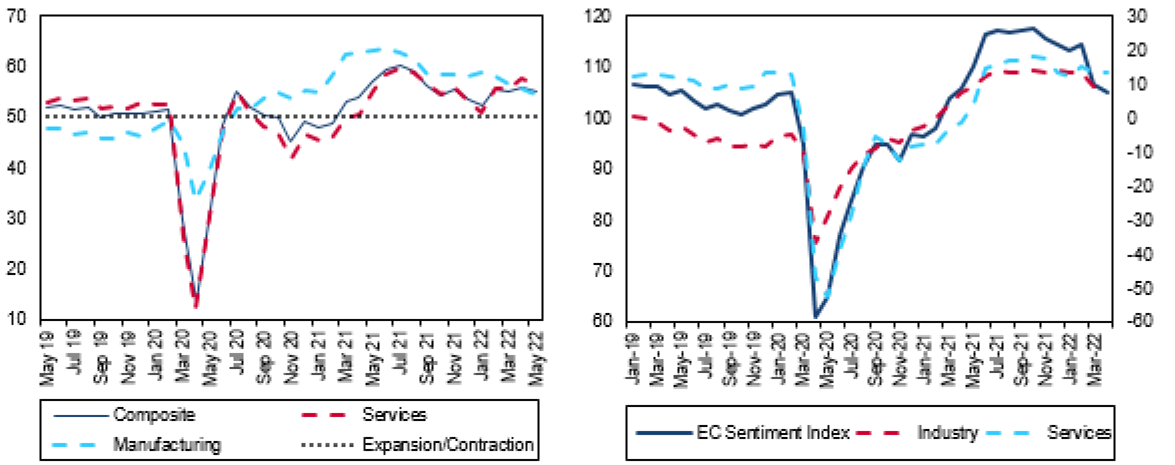
Source: Eurostat, Fitch Solutions

Early indications suggest that activity likely accelerated in Q222 despite the outbreak of war in Ukraine and renewed lockdowns in China, an important trading partner. Indeed, the purchasing managers' indices (PMIs) and the European Commission (EC) sentiment indices in the quarter-to-date are consistent with growth of around 0.5% q-o-

q. Driving this burst in activity has been the release of pent-up demand following the easing of restrictions introduced in response to the Omicron wave of Covid-19 over the winter of 2021/2022. This burst has been further supported by a tightening labour market (the unemployment rate fell to a record low of 6.8% in March), a modest pick-up in wage growth (2.8% y-o-y in Q122 from 1.6% in Q421) and the existence of a significant stock of excess savings worth around EUR907bn (8.0% of GDP) per the IMF.

Services Sector Support Growth In Q222

Eurozone - PMIs, balance of responses (LHC) & EC Sentiment Indices, balance of responses (RHC)

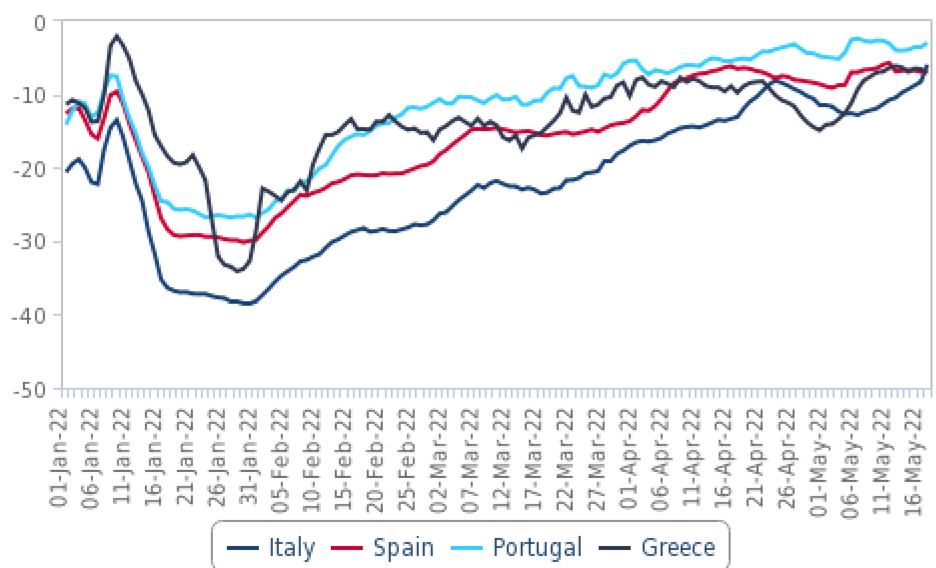


Source: Bloomberg, Eurostat, Fitch Solutions

The pick-up in activity has been concentrated in the services sector, with the tourism industry in particular benefitting from the removal of the last remaining major hurdles to travel within Europe. Daily flights data have effectively returned back to pre-pandemic levels, while Spanish overnight hotel stays hit 94% of their 2019 level in April. This strength in services will help to offset weakness in industry, which is more exposed to the supply chain issues caused by the war in Ukraine and China's zero-Covid policy. Indeed, we expect that industrial production will contract on a q-o-q basis in Q222, given these headwinds and the negative carryover impact from a 1.8% m-o-m plunge in output in March.

Flights Data Have Rebounded To Near 2019 Levels

Selected Economies - Flights As % Of Same Day 2019 Level, seven-day moving average

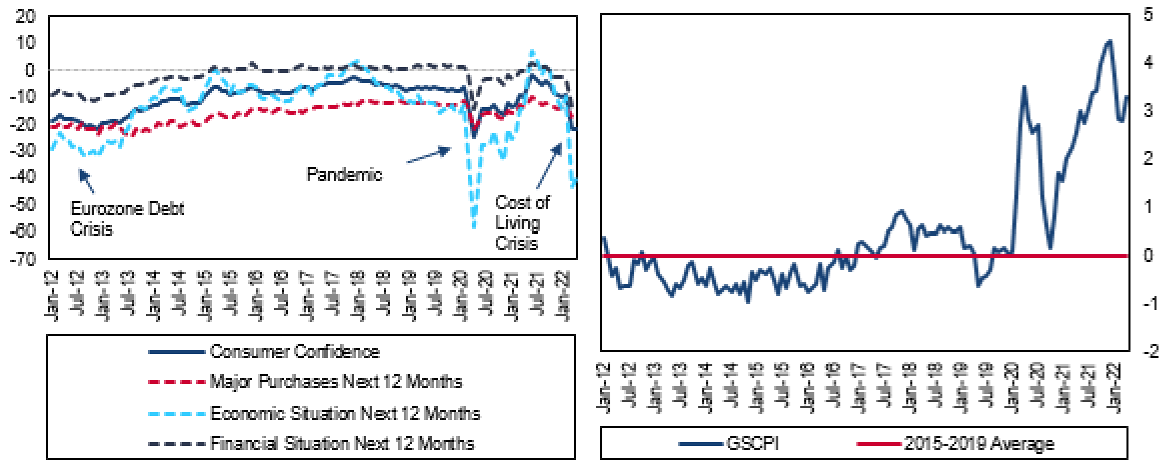


Source: EUROCONTROL, Fitch Solutions

Looking ahead to H222, the outlook is increasingly gloomy. Our forecasts assume that growth will ease well below trend (roughly 0.4% q-o-q), with some potential for a minor contraction come the final quarter of the year. Central to our more downbeat view is the plunge in consumer confidence to record lows in recent months as inflationary pressures have remained acute, in turn suggesting spending may run out of steam after pent-up demand is released in Q222. Several mitigating factors should, however, prevent a more pronounced downturn. These include: the availability of fiscal subsidies worth between 1.0-2.0% of GDP, a still tight labour market (survey data remain consistent with continued solid employment growth) and a projected partial easing of inflationary pressures as the year progresses.

Consumer Confidence Has Plummeted, While Supply Chain Issues Remain Pressing

Eurozone Consumer Confidence & Subcomponents, balances of responses (LHC) & New York Fed Global Supply Chain Pressure Index, standard deviations from average value (RHC)

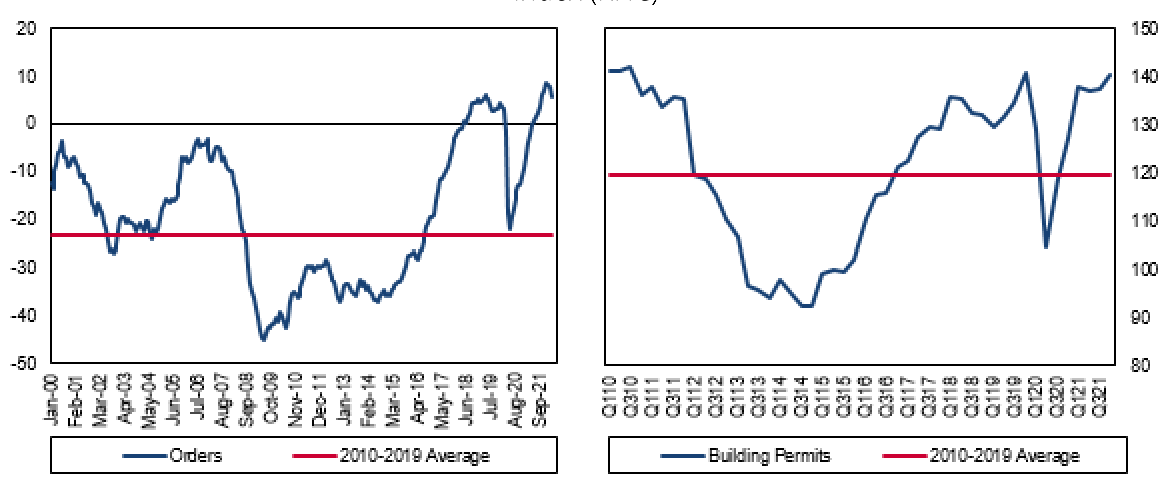


Note: GSCPI - higher score implies more pressure on supply chains. Source: Eurostat, New York Fed, Fitch Solutions

Faced with a combination of rising borrowing costs and weaker demand, we also anticipate that business investment expectations will weaken somewhat in the coming months. That said, the demand picture for construction-related investment in particular remains positive, with new orders growth aided by a structurally strong backdrop (despite rising interest rates) for housing and governments' ambitious infrastructure spending plans. Granted, supply chain issues are clouding the outlook for the sector somewhat, though national data suggest that they did not weigh heavily on activity in Q122.

Construction Sector Leading Indicators Remain Positive

Eurozone - Construction Sector Assessment Of Order Books, balance of responses (LHC) & Residential Building Permits, index (RHC)



Source: Eurostat, Fitch Solutions

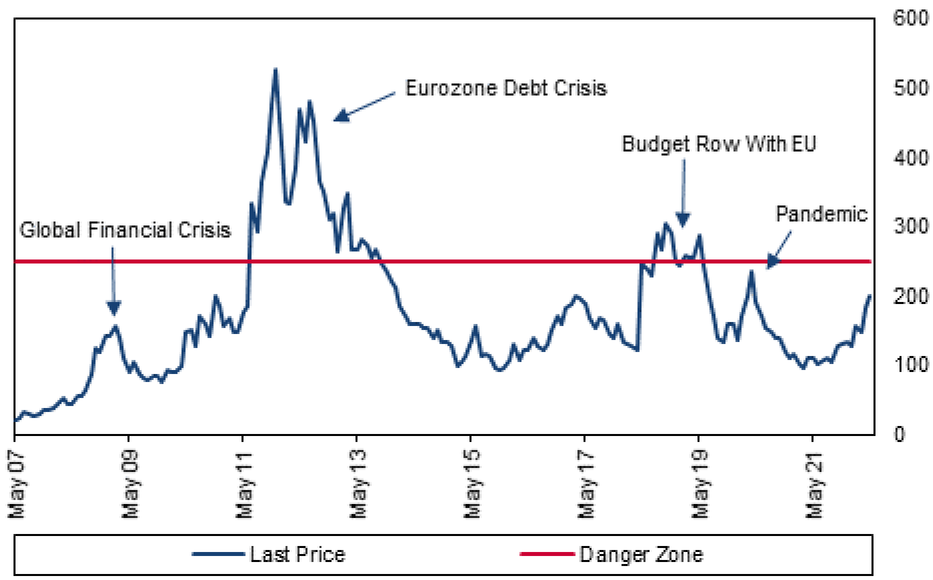
In terms of the external side of the economy, however, supply chain issues will represent a more pressing issue. As we have flagged for some time, order books remain at healthy levels. However, parts shortages have prevented firms from fulfilling these orders. Difficulties have centred around the semiconductor issues afflicting Europe's crucial auto sector, which our Autos Team do not expect to be resolved until H123 at the earliest. The situation has been worsened by China's commitment to its zero Covid policy and Russia's invasion of Ukraine, with Russia a key source of industrial metals and Ukraine also playing an important role in the manufacturing of wire harnesses. Persistent weakness in goods exports will only be partially offset by the stronger outlook for the eurozone service exports linked to the rebound in the tourism industry.

Risks To The Outlook

Risks to our forecasts are tilted firmly to the downside. In our view, the two most prominent threats relate to external factors: (1) the potential for disruptions, temporary or otherwise, to Russia's westward supply of energy and (2) a prolonging of China's zero Covid policies. Should either risk materialise, we would expect that private sector sentiment would deteriorate further on the back of the associated supply side disruptions, as well as due to an intensification of inflationary pressures.

Periphery Yield Spreads Widening As ECB Pushes Ahead With Policy Normalisation

Eurozone - 10-Year Italian And German Yield Spread, bps



Source: Bloomberg, Fitch Solutions

Domestically, concerns centre on the potential for a marked widening of periphery-core yield spreads as the European Central Bank presses ahead with its plans to tighten monetary policy into a weakening economic environment. While we anticipate that the central bank will ultimately intervene to prevent the emergence of another debt crisis, any sharp widening of spreads and associated pick up in financial market volatility would nonetheless represent a major headwind for growth.