S&P Global Ratings

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Economic Research:

Eurozone Economic Outlook 2022: A Look Inside The Recovery

November 30, 2021

Key Takeaways

Will the new wave of COVID-19 infections derail the recovery? It may slow the recovery in consumption, especially for consumer-facing services. Therefore, we are maintaining our eurozone GDP forecast at 5.1% for this year and are lowering the 2022 outlook 0.1 percentage point to 4.4%, despite a surprisingly strong third-quarter uplift. That said, because the pandemic situation in Europe and elsewhere is fluid again, we see it as a risk to our macroeconomic baseline.

Will the eurozone continue to suffer from supply chain bottlenecks? These should ease gradually but extend well into next year. Germany has been the most exposed because of a larger industry and long supply chain. Thanks to more domestically oriented sectors and support packages, France and Italy are recovering more quickly than expected.

Which sectors are recovering the quickest? Employment and value creation have been stronger in information and communication and finance and real estate, while consumer-facing sectors still have some way to go, and bottlenecks are hindering industry.

Is above-target inflation here to stay? The rate should ease to about 2% next year, as the frictional mismatch between demand and supply eases and the end of tax breaks starts falling out of headline inflation. More structural drivers are set to lift consumer prices gradually only from the end of 2023.

Will the ECB tighten monetary policy as soon as next year? We think the ECB will wait until 2024 to hike rates. Yet, the central bank is likely to phase out net purchases under the PEPP in March 2022. Tapering the APP will probably not appear on the agenda before end-2023.

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Will the new wave of COVID-19 infections derail the recovery?

S&P Global Ratings believes the recent rise in COVID-19 cases in some European countries will somewhat slow the recovery in consumption but still allow the eurozone economy to surpass pre-pandemic levels of activity in fourth-quarter 2021. Some governments--such as in Austria, the Netherlands, and Belgium--are imposing some restrictions to economic activity, which are dampening consumer-facing businesses. Google retail and recreation mobility data for these countries is already down about 10% in recent weeks from pre-pandemic levels. Plus, even in countries less effected by the recent COVID-19 wave, governments have put travel restrictions in place. Yet, it is too early to call for a drop in output. First, it is still unclear whether the Omicron variant is resistant to vaccines and whether it is very deadly. Second, as the last lockdown shows, restrictions don't necessarily reduce aggregate demand. Businesses and consumers have learned to live with them, and governments can easily extend or reactivate support measures--such as furlough schemes and credit guarantees. What's more, the industry still has large unfilled orders to complete and real-time indicators (such as truck mileage) suggest that manufacturing activity resumed in the fourth quarter. Finally, a slowdown in the latter part of the fourth quarter might be offset by a stronger recovery in February or March 2022.

S&P Global Ratings believes the new Omicron variant is a stark reminder that the COVID-19 pandemic is far from over. Although already declared a variant of concern by the World Health Organization, uncertainty still surrounds its transmissibility, severity, and the effectiveness of existing vaccines against it. Early evidence points toward faster transmissibility, which has led many countries to close their borders with Southern Africa or reimpose international travel restrictions. Over coming weeks, we expect additional evidence and testing will show the extent of the danger it poses to enable us to make a more informed assessment of the risks to credit. Meanwhile, we expect the markets to take a precautionary stance and governments to put into place short-term containment measures. Nevertheless, we believe this shows that, once again, more coordinated, and decisive efforts are needed to vaccinate the world's population to prevent the emergence of new, more dangerous variants.

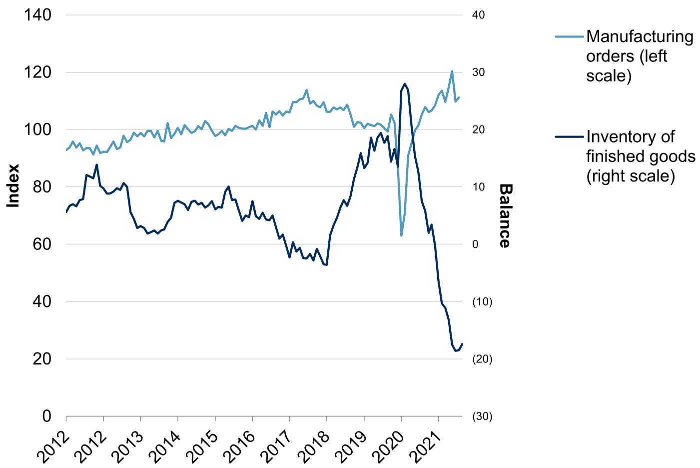
Will the eurozone continue to suffer from supply chain bottlenecks?

Our forecast for the eurozone economy is broadly unchanged from our September baseline, but we have modified our view of specific country trends. We are now more optimistic about growth prospects for France and Italy, and less so about Germany's and Spain's (see our forecast table at the end of this article). The reopening this summer benefited services-oriented economies like France much more than manufacturing-oriented economies such as Germany or tourist destinations in Spain.

Industry continues to face supply chain shortages, with September industrial production in Germany about 10% below its 2019 average, even though factory orders are 10% higher (see chart 1). Shortages are particularly acute for the automobile industry, where production in September was 42% below its 2019 average, close to its 2020 lows (see chart 2). Interestingly Italy, the eurozone's second industrial powerhouse, has suffered less from these shortages because of a slightly different specialization; industrial production there has been hovering close to its pre-pandemic levels since the summer (see chart 3).

Chart 1

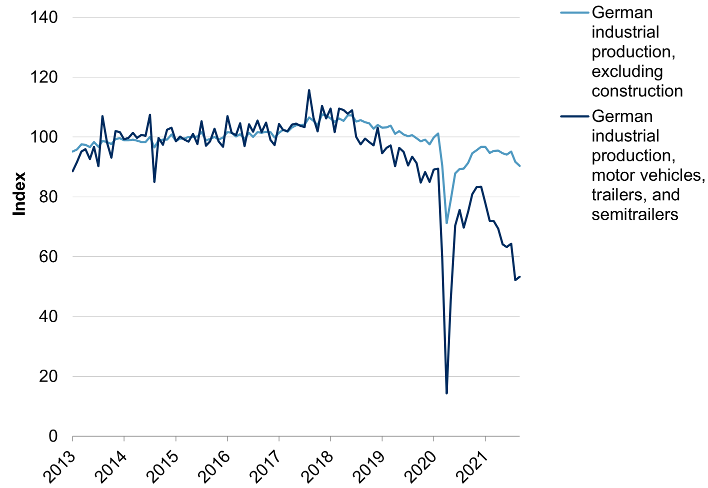
German Manufactures Run Down Inventories To Satisfy Higher Orders Because Of Supply Chain Bottlenecks



Sources: IFO, Destatis, S&P Global Ratings.

Chart 2

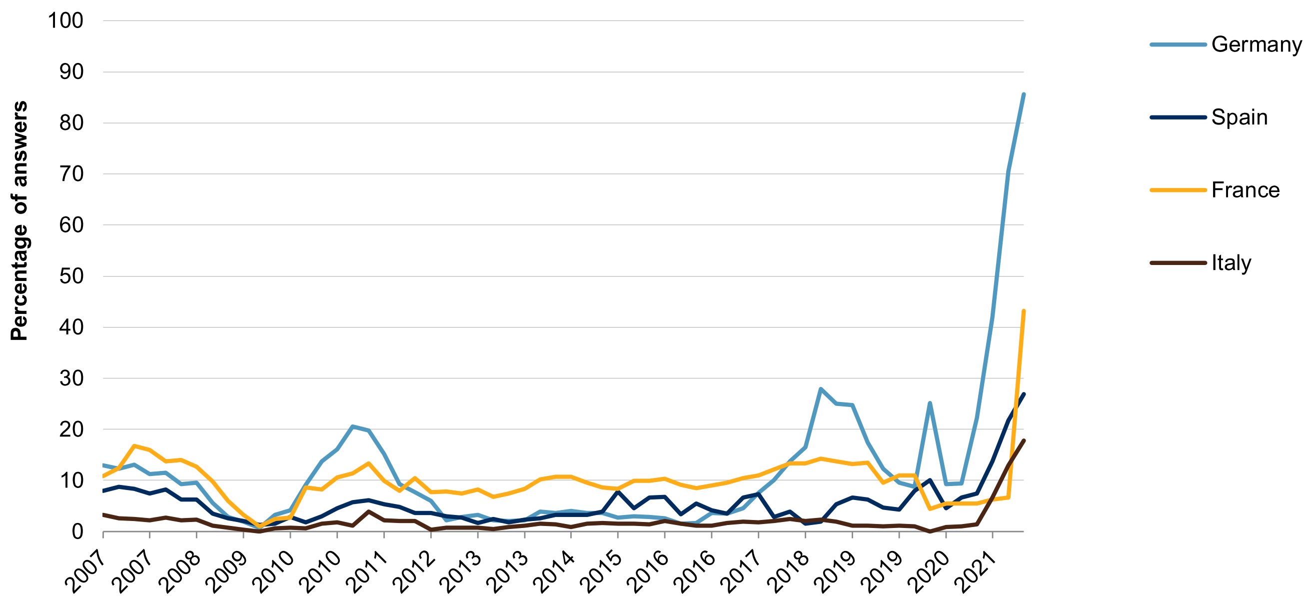
The German Auto Industry Is Suffering The Most From Supply Chain Bottle



Sources: Destatis, S&P Global Ratings.

Chart 3

Supply Bottlenecks Are More Acute In The German Industry
Equipment seen as main factor limiting production



Source: European Commission, S&P Global Ratings.

Supply bottlenecks should start to ease as we move into 2022. First signs of a reversal are already visible. Shipping costs, lumber prices, and a backlog of orders for Taiwan manufactures are now easing, suggesting that the peak in supply chain pressures may be behind us. Nonetheless, most businesses expect those constraints to hinder production until second-half 2022 (see "Global Corporates: Supply Chain Strains And Rising Costs Will Pressure Profitability in 2022," published on Nov. 18, 2021). What's more, a slightly less dynamic Chinese economy will also weigh on German exporters' prospects, which means that German GDP is set to recover to pre-pandemic levels only in first-quarter 2022, one quarter after the eurozone average.

Meanwhile, the slowdown in Spain cannot be explained by supply-chain bottlenecks but rather a high specialization in tourism. As travel takes time to recover to pre-pandemic levels, tourism-oriented economies are also set to underperform their peers in the recovery. In Spain, tourism arrivals in third-quarter 2021 were still one-half those for third-quarter 2019 because of travel restrictions.

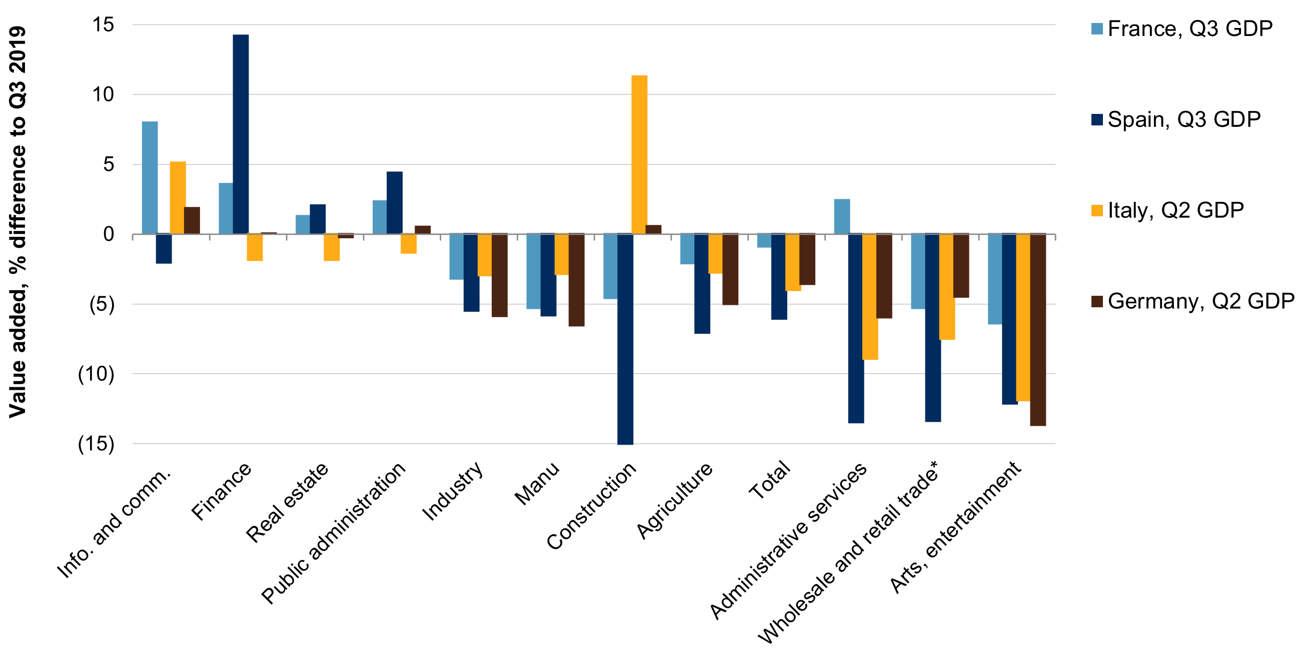
Finally, the rollout of recovery packages can also provide some support to the economy while bottlenecks continue (see "Next Generation EU Will Shift European Growth Into A Higher Gear," April 27, 2021). France had already disbursed close to half of its recovery stimulus this summer, helping companies restart the economy more quickly. In Italy, although some disbursements have already been postponed to next year--a bit later than originally expected--the start of the wide-ranging reform plan (notably for the judiciary, public administration, and taxation) has lifted consumer and business confidence to levels not seen since 2001 and seems to have given a positive impetus to investment as well.

Which sectors are recovering the quickest, and what does it mean for employment and productivity?

The post-pandemic economy so far looks much different than recoveries of the past. Sectoral data shows that the winners of this crisis have been in the information and communication sector, along with finance and real estate (see chart 4). Government services (public administration, health, and education) also make up a larger share of output because of the need to support the economy during the crisis and recovery. By contrast, consumer-facing activities still have some way to go--especially arts and entertainment, where employment has also dropped the most (see chart 5), but retail and wholesale are also still lagging behind the total aggregate, and manufacturing is also well below its pre-pandemic level because of continued supply chain constraints.

Chart 4

France And Italy See More Gains In Information And Communication Boding Well For The Digitalization Agenda



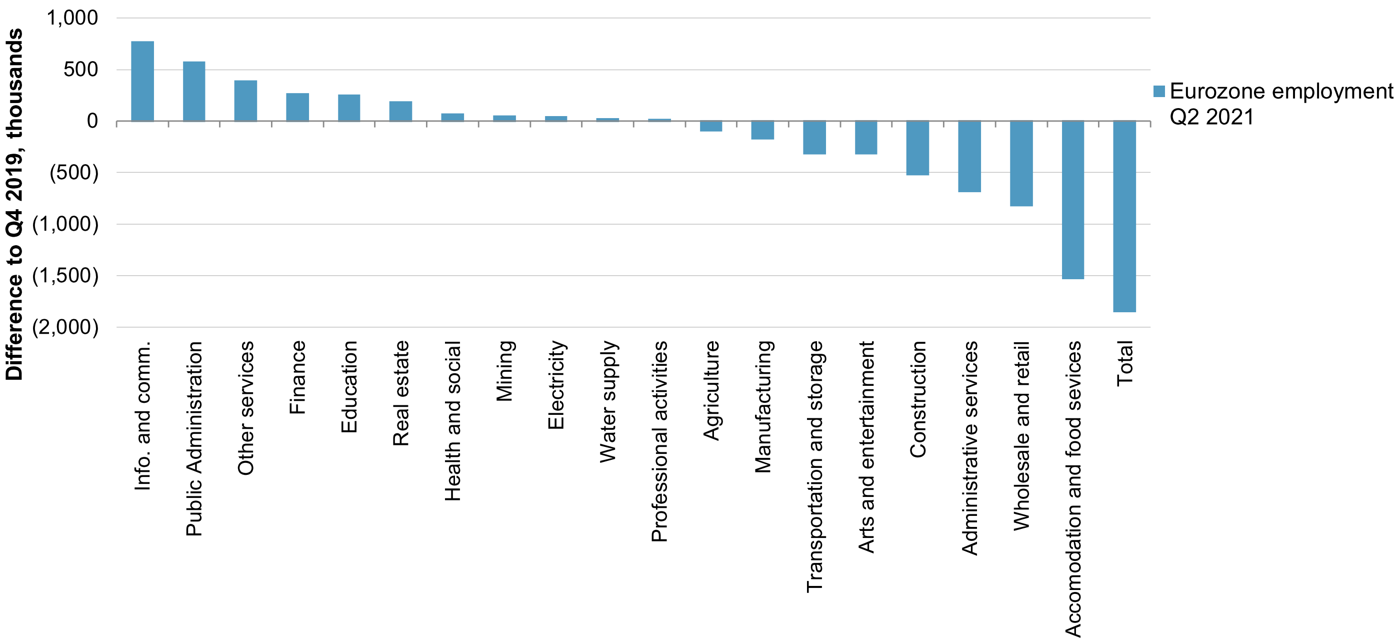
*Wholesale and retail trade, transport, accomodation, and food services.

Note: Q2 and Q3 indicates the latest available gross value-added data for 2021.

Sources: Eurostat, S&P Global Ratings.

Chart 5

Workers Went Into Information And Communication, Public Administration, And Finance, While Accommodation And Retail Services Are Still Recovering

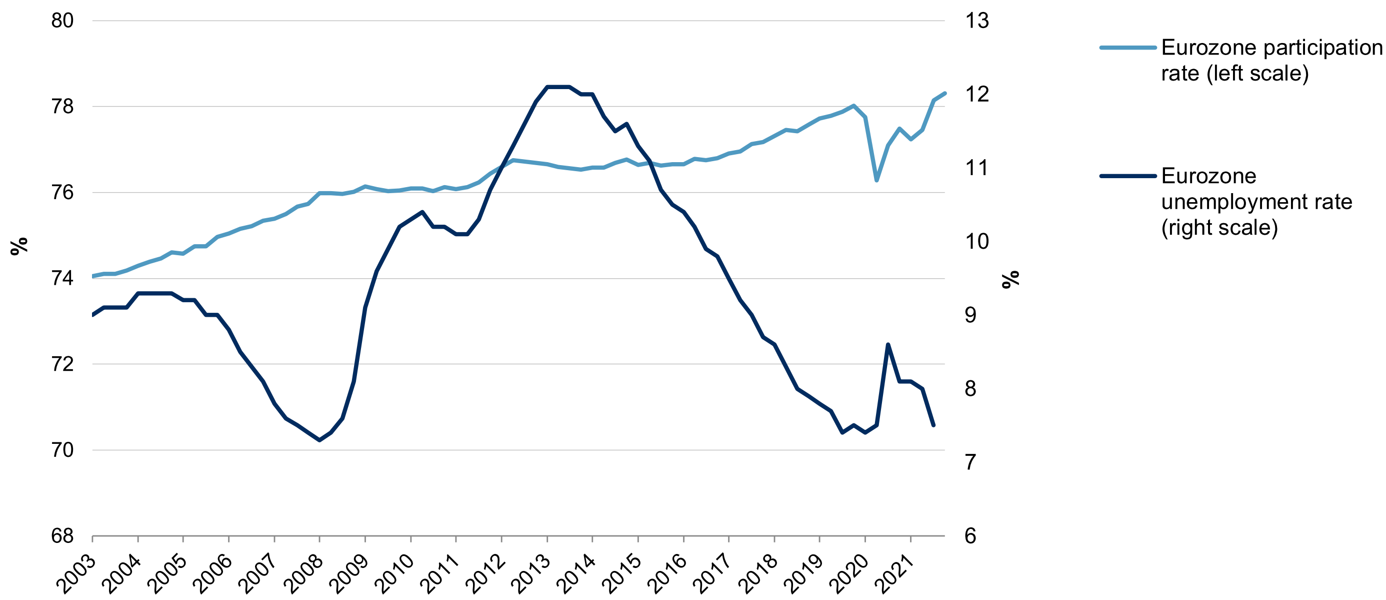


Sources: Eurostat, S&P Global Ratings.

Interestingly, this crisis has not featured the typical overall destruction of employment. Instead, before activity recovered jobs overshot pre-pandemic levels in France and Spain, which is unusual as job creation normally lags GDP growth. This can be partly attributed to furloughs, which preserved pre-pandemic jobs. Less than 1% of European workers are now on furlough and unlike in the U.S., European workers have not left the labor market (see chart 6 and see "Where Are The Workers? Three Explanations Point To An Answer," Nov. 4, 2021). As a result, labor shortages are just starting to appear and are mostly concentrated in the sectors where furlough schemes were less efficient at keeping jobs alive, such as the accommodation and food industry or retail trade sector.

Chart 6

Employment Has Recovered To Pre-COVID-19 Levels, And Few Workers Have Dropped Out Of The Labor Force



Sources: Eurostat, S&P Global Ratings.

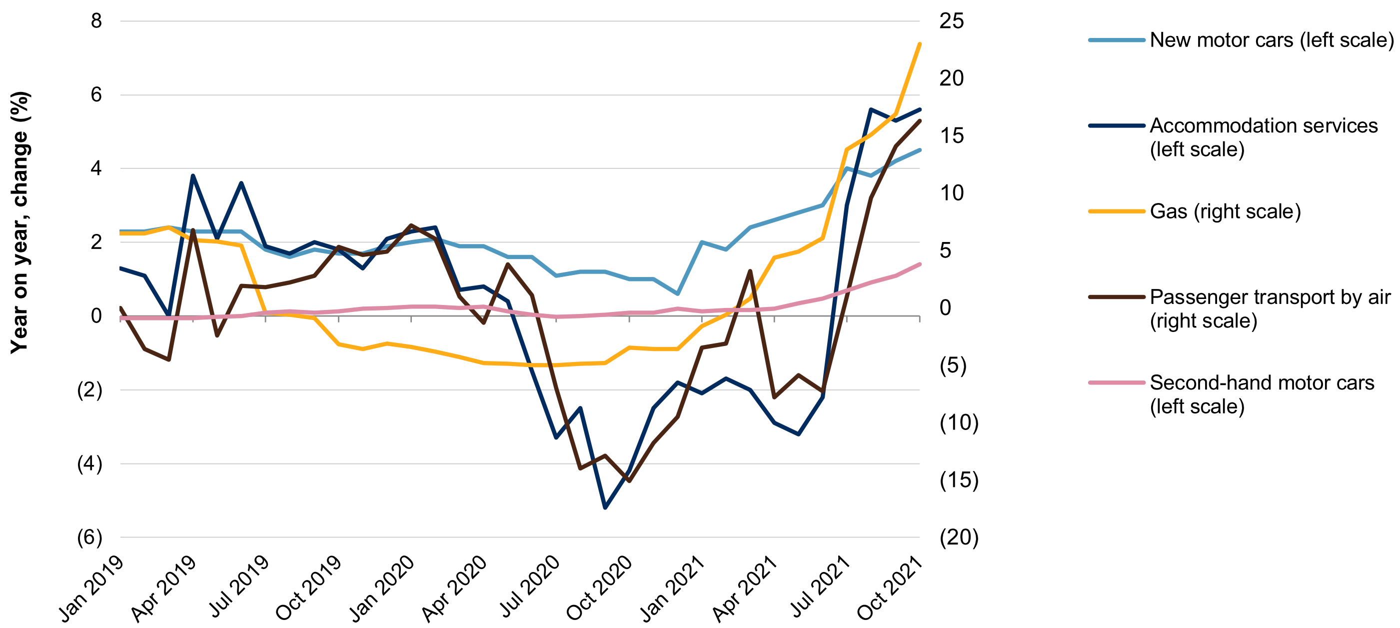
The reallocation of labor observable in the sectoral data points to some positive trends for productivity—but the use of savings points to a big negative one. Employment creation has been more dynamic in higher productivity-enhancing sectors (like information and communication) and for more highly skilled workers. While policy support to corporates has prevented much destruction of the economic fabric, many new businesses have been created since the outbreak of the pandemic. They might turn out to be more productive than existing firms. On the other hand, the sharp rise in nonproductive investments such as housing is a negative development for productivity. A large part of savings accumulated by consumers during lockdowns is going toward buying property (see "European Housing Market Inflation Is Here To Stay," Nov. 2, 2021). This is not only worsening housing affordability and inequality but also likely to act as a drag on total aggregate productivity.

Is above-target inflation here to stay?

We expect inflation to slow as we move into 2022 as temporary drivers start to fade. These were linked to the reopening of economies (for example, the end of tax cuts) and the mismatch between supply and demand globally, which sent energy prices higher and created supply chain bottlenecks (see chart 7).

Chart 7

Inflation Driven By Reopening, Base Effects, And Supply Chain Bottlenecks

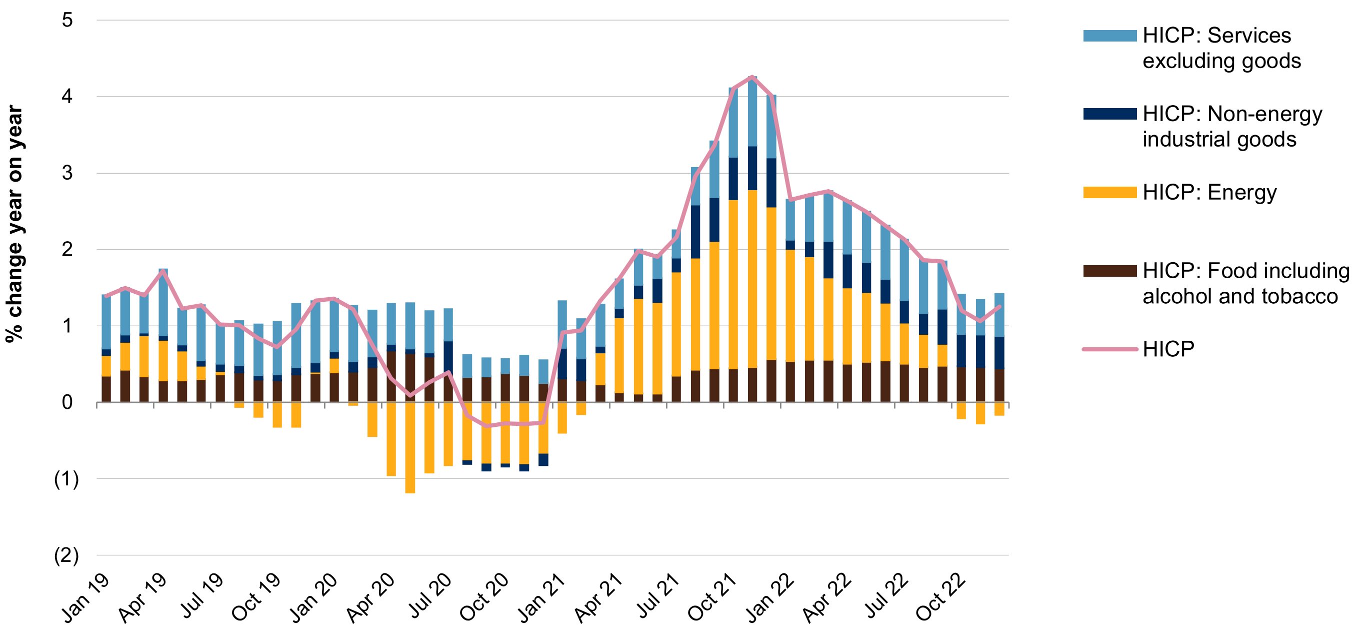


Sources: Eurostat, S&P Global Ratings.

As the year turns, base effects, such as the return of the German VAT to pre-pandemic levels or the spike in oil prices in 2021 (up 122% in November in euro terms), will start to fall out of the yearly inflation numbers (see chart 8). What's more, we estimate that government measures to limit the rise in gas and energy prices will have a sizable impact next year, reducing headline inflation 0.3 percentage points in Germany for 2022. What's more, inflation may fall at the start of 2022 if the Omicron variant leads to a drop in demand, because that will likely lower energy prices.

Chart 8

Temporary Drivers Will Drop Out Of Inflation Next Year



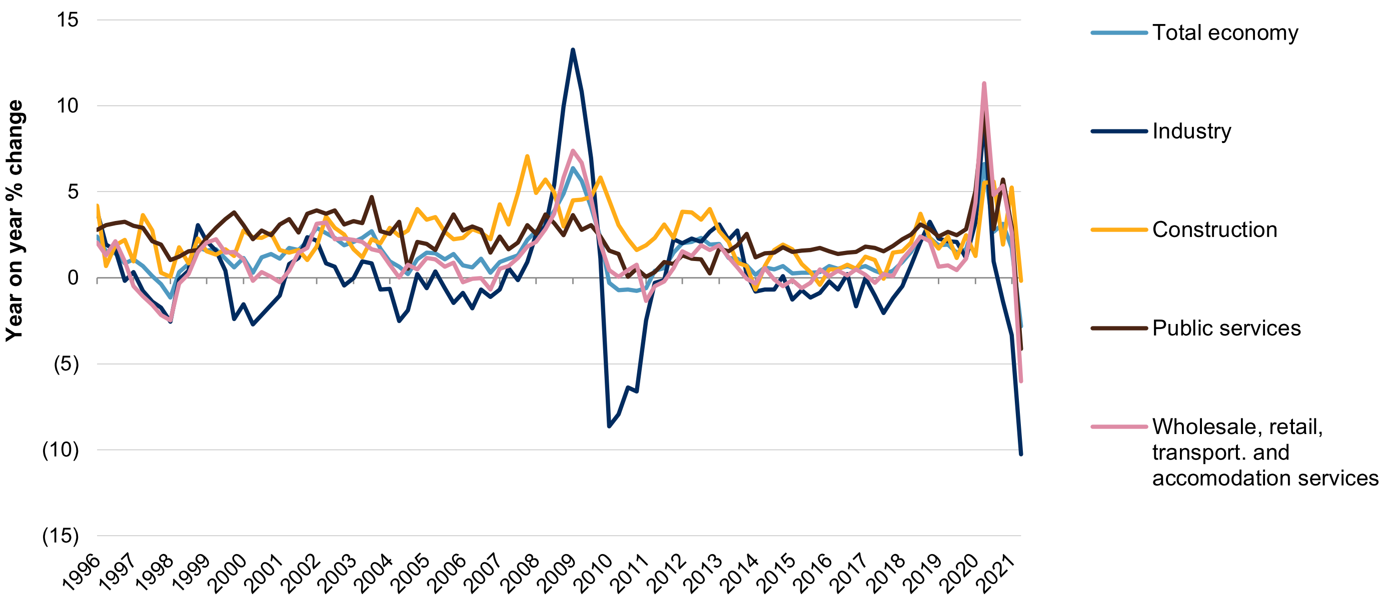
HICP--Harmonized Index of Consumer Prices. Sources: Eurostat, S&P Global Ratings.

At the same time, companies' non-energy input costs will start falling as supply chain bottlenecks start to ease in mid-2022, especially because they have tended to place larger orders than needed to rebuild inventories in the face of shortages, which could trigger some oversupply. This should lead to lower non-energy industrial goods inflation from 2023 as the current boost diminishes from producer prices, on the order of 0.3-0.4 percentage points for 2022.

The labor market and wages will take a bit more time to fuel higher prices. We expect that to happen only from the end of 2023. Job levels have recovered in some countries already and vacancy rates are now above pre-pandemic levels for the eurozone average. However, we expect more workers to enter the labor market as job prospects improve further (especially in countries like Italy and Spain, where participation rates have yet to recover), which would somewhat alleviate shortages. Second, we find that companies in Europe expect wages to rise only "a little" next year (see "Global Corporates: Supply Chain Strains and Rising Costs Will Pressure Profitability in 2022"). Adding to that, if higher wages are concomitant with productivity improvements, wages might not have an inflationary impact. Compensation per hour is expanding less than output per hour in most sectors of the European economy, which translates into falling unit labor costs, easing the pressure from non-labor costs for producers (see chart 9). As a result, we see the inflation rate falling to 2% in 2022 from 4.1% in November 2021, and decreasing to 1.5% in 2023 before rising to 1.7% in 2024.

Chart 9

Unit Labor Costs Are Falling In Almost All Sectors As The Economy Reopens
Unit labor costs are the difference in growth between output per hour and wage per hour



Source: ECB, S&P Global Ratings.

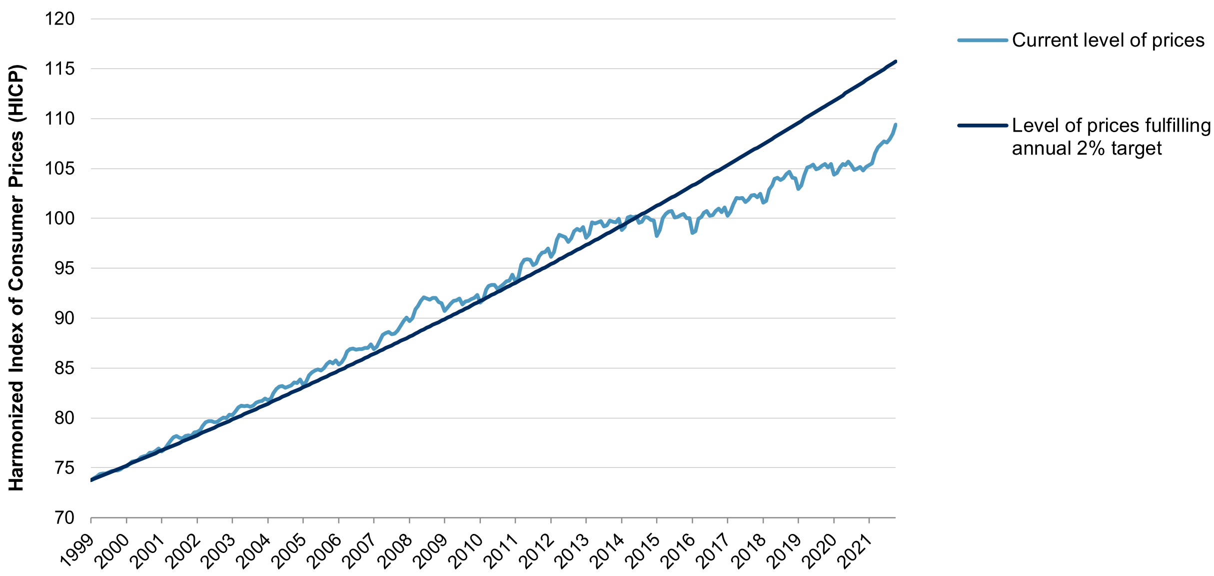
Will the ECB tighten monetary policy as soon as next year?

The European Central Bank in our view will wait until early 2024 to start raising rates, after tapering net asset purchases from the end of 2023. Even if inflation has risen above the ECB's 2% average inflation target, this was mostly temporary. Indeed, prices in October were just 3.7% higher than two years ago, so still below target (see chart 10). Meanwhile, the ECB is likely to wait for the U.S. Federal Reserve to tighten monetary policy first, as this will be a first source of upward pressure on eurozone long-term yields and trigger some tightening in eurozone financing conditions (see "How Long Can The ECB Yield Shield Last?" June 11, 2021).

Chart 10

The ECB Price Gap: Not Yet Back To Target

Current level of consumer prices in the eurozone compared with level if ECB had delivered 2% inflation each year

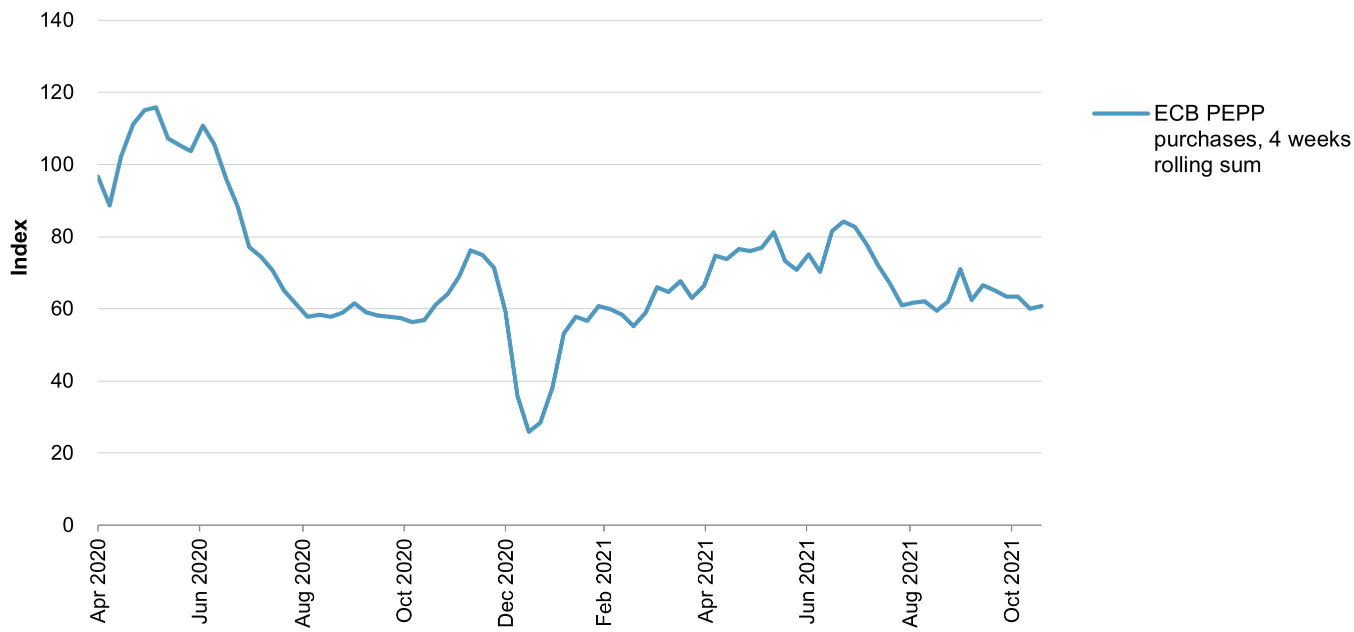


Sources: Refinitiv, S&P Global Ratings.

The ECB will provide more guidance about next steps at its December meeting, including for its quantitative easing (QE) programs. Unless the new COVID-19 variant proves resistant to vaccines and deadly, we expect President Christine Lagarde to clarify the phasing out of the pandemic emergency purchase programme (PEPP) from March 2022. Currently, monthly average purchases are about €65 billion, down from €90 billion in the summer (see chart 11). We expect the ECB to continue lowering its net purchases under the PEPP gradually until March 2022 to around €40 billion, so that it could easily stop them by then and carry on with slightly higher purchases under the asset purchase programme (APP)--perhaps about €40 billion a month instead of the current €20 billion. This would make it easier for the ECB to announce that it will taper in 2023. Meanwhile, we also expect the ECB to renew targeted longer-term refinancing operations (TLTRO) next year, to continue supporting credit growth during the recovery but with slightly less favorable terms, as a first step to normalizing its monetary policy as the economy moves closer to potential. That said, to give itself flexibility in case inflation worsens, the ECB could be tempted to adjust its two QE programs, announcing a phaseout of just the PEPP in December and waiting for March next year to announce a recalibration in size and redefinition of the guidelines for bond purchases under the APP.

Chart 11

The ECB Has Already Reduced Its Net PEPP Purchases



Sources: ECB, S&P Global Ratings.

S&P Global Ratings' European Economic Forecasts November 2021

GDP

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
2019	1.1	1.8	0.4	2.1	1.9	2.1	1.6	1.7	1.2
2020	(4.9)	(8.0)	(9.0)	(10.8)	(3.8)	(5.7)	(6.5)	(9.7)	(2.5)
2021	2.7	6.7	6.4	4.5	4.6	6.1	5.1	6.9	3.3
2022	4.3	3.8	4.7	7.0	3.9	3.3	4.4	4.6	3.3
2023	2.5	2.2	1.8	4.4	2.0	1.5	2.4	2.2	2.1
2024	1.5	1.6	1.0	2.4	1.8	1.4	1.6	1.9	1.6
CPI inflation									
2019	1.4	1.3	0.6	0.8	2.7	1.2	1.2	1.8	0.4
2020	0.4	0.5	(0.1)	(0.3)	1.1	0.4	0.3	0.9	(0.7)
2021	2.9	2.1	1.7	2.8	2.2	2.5	2.3	2.4	0.5
2022	2.2	1.9	1.7	2.2	2.0	2.0	2.0	3.4	0.7
2023	1.7	1.6	1.2	1.4	1.8	1.6	1.5	1.5	0.6

S&P Global Ratings' European Economic Forecasts November 2021 (cont.)

2024	1.8	1.8	1.5	1.6	1.8	1.8	1.7	1.9	1.0
Unemployment rate									
2019	3.2	8.4	10.0	14.1	3.4	5.4	7.6	3.8	4.4
2020	3.9	8.0	9.3	15.5	3.8	5.6	7.9	4.5	4.8
2021	3.6	8.0	9.6	15.1	3.3	6.4	7.9	4.6	5.2
2022	3.4	7.8	9.1	14.4	3.5	5.8	7.5	4.5	4.7
2023	3.3	7.7	8.9	14.0	3.4	5.7	7.3	4.3	4.5
2024	3.2	7.4	8.7	13.8	3.3	5.6	7.1	4.0	4.5
10-year government bond									
2019	(0.2)	0.1	1.9	0.7	(0.1)	0.2	0.4	0.9	(0.5)
2020	(0.5)	(0.2)	1.2	0.4	(0.3)	(0.1)	0.1	0.3	(0.5)
2021	(0.3)	(0.0)	0.8	0.4	(0.2)	(0.0)	0.1	0.8	(0.3)
2022	0.0	0.3	1.2	0.7	0.1	0.3	0.4	1.3	0.1
2023	0.3	0.6	1.6	1.1	0.3	0.6	0.7	1.9	0.2
2024	0.4	0.8	1.9	1.3	0.5	0.8	0.9	2.1	0.3

Exchange rates

	Eurozone	U.K.		Switzerland	
	USD per euro	**USD per GBP**	**Euro per GBP**	**CHF per USD**	**CHF per euro**
2019	1.1	1.3	1.1	1.0	1.1
2020	1.1	1.3	1.1	0.9	1.1
2021	1.2	1.4	1.2	0.9	1.1
2022	1.2	1.4	1.2	1.0	1.1
2023	1.2	1.4	1.2	1.0	1.1
2024	1.2	1.4	1.2	1.0	1.1

Policy rates

	Eurozone (ECB)		U.K. (BoE)	Switzerland (SNB)
	Deposit Rate	**Refi Rate**		
2019	(0.4)	0.0	0.8	(0.8)
2020	(0.5)	0.0	0.2	(0.8)
2021	(0.5)	0.0	0.1	(0.8)
2022	(0.5)	(0.0)	0.4	(0.8)
2023	(0.5)	(0.0)	0.6	(0.8)
2024	(0.3)	(0.0)	0.9	(0.6)

Source: S&P Global Ratings.

This report does not constitute a rating action.