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The start of the consumer recession?

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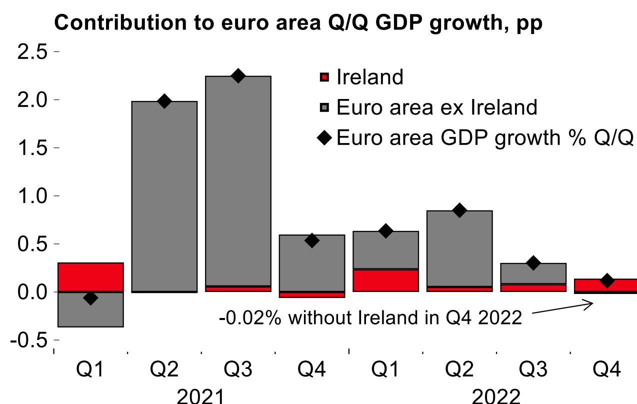
The latest GDP estimates show that the euro area may have avoided a technical recession. However, weaker consumer spending provides clear evidence that households are now feeling the pinch from higher inflation. The fall in energy prices points to some relief later this year but the ECB will continue its efforts to dampen demand through higher interest rates.

No recession yet – but consumers are being squeezed

We wrote last week that the euro area economy is not yet out of the woods despite some clear signs of resilience (see here). The initial Q4 2022 GDP estimates provided further evidence of an economy that is only just about managing to stave off recession. The euro area as a whole eked out growth of 0.1% Q/Q. However, strong growth in Ireland (+3.5% Q/Q), with the usual distortion from multinational activity there, may have made the difference between expansion and contraction (Chart 1).

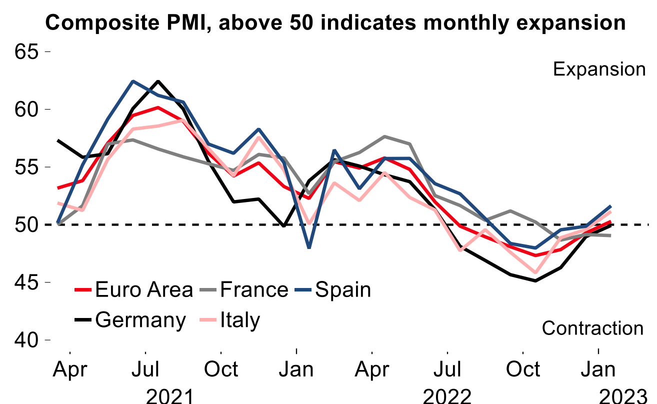
Germany, the bloc's largest economy, contracted by 0.2% Q/Q in Q4. There was also a contraction in Italy (-0.1%) and only weak growth in France (0.1%) and Spain (0.2%). This is consistent with the survey evidence which showed all the major euro area economies are teetering close to contraction territory, albeit with perhaps a little more momentum into 2023 than previously feared (Chart 2).

CHART 1: IRISH GROWTH SUPPORTED THE EURO AREA



Source: Eurostat, MUFG Bank Economic Research Office

CHART 2: SURVEYS STRENGTHENED IN JANUARY



Source: IHS Markit, MUFG Bank Economic Research Office

The breakdown by expenditure component is not yet available for the euro area as a whole, but we can infer the general picture from the available national data: households are under pressure from the real income squeeze, but the drag from this on the economy as a whole has been offset by an improving situation for net exports.

It was hard to predict when exactly the real income shock for households would appear in the data given the extent of accumulated savings and pent-up demand from the pandemic, but there are now clear signs of a slowdown. Household

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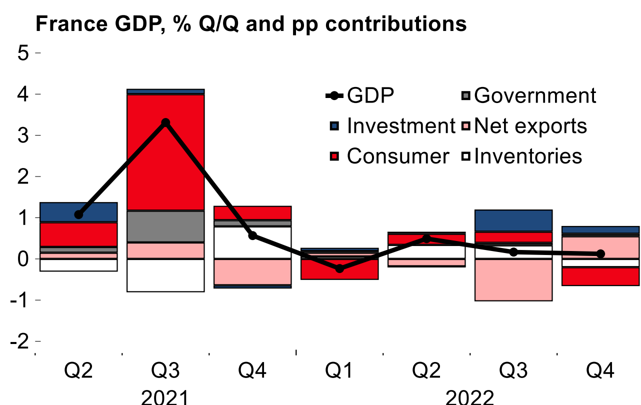
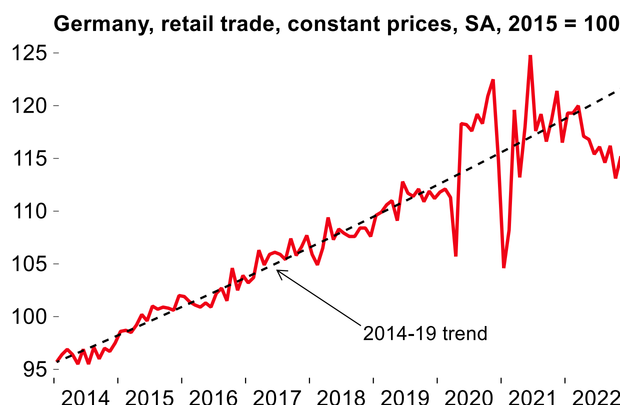
consumption fell by 0.9% Q/Q in France and 1.8% Q/Q in Spain (Chart 3 shows the contribution to French growth by component). The German expenditure breakdown is not yet available but the national statistics agency noted that private consumption "was lower than in the previous quarter" and German retail sales plunged by 5.3% M/M in December (Chart 4).

CHART 3: CONSUMPTION DRAG IN FRANCE



Source: INSEE, MUFG Bank Economic Research Office

CHART 4: GERMAN RETAIL SECTOR WEAKNESS



Source: Destatis, MUFG Bank Economic Research Office

The drag from consumer spending has been countered by better trade data. Wholesale energy costs have eased significantly over recent months while demand reduction efforts have been successful. The resilience of manufacturing has also been clear for some time as supply chain issues have improved. The result is likely to be a positive contribution to overall euro area GDP growth from net exports.

In the absence of any energy price shocks, the trend is likely to continue into 2023, with China's reopening set to help with both external demand and lingering bottleneck issues. It's hard to see how the picture for consumers can improve rapidly, however. Real income growth remains firmly in negative territory and ECB policy will continue to weigh on aggregate demand (see below). Our view is that the Q4 data probably marked the start of a domestic demand recession in the euro area.

Inflation has probably peaked

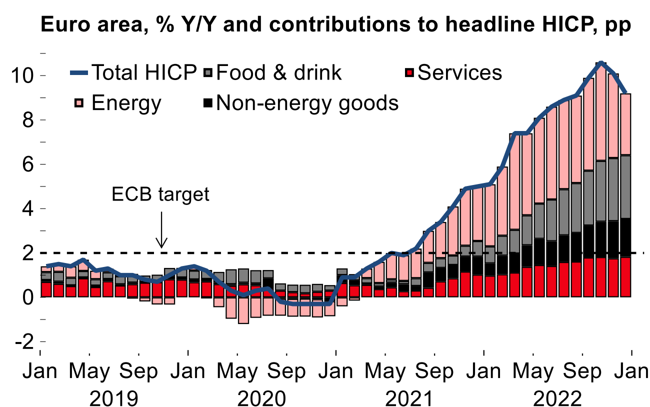
The preliminary flash estimate for euro area inflation was 8.5% in January, down from 9.2% in December (Chart 5). This may be subject to more revision than usual in the final release: Eurostat used a model-based estimate for German inflation for this euro area aggregate after the German statistical agency has postponed the release of the January estimate "due to a technical data processing problem". (The numbers imply that Eurostat estimated a sizeable fall in the German HICP rate from 9.6% in December to somewhere below 9%).

The 0.7pp fall in euro area headline inflation was largely driven by energy. Core inflation remained stable at 5.2%, despite risks that it could surprise higher. In December, ECB president Lagarde said that there were "good reasons" to believe that inflation would move higher in January due to annual repricing effects. In fact, our own seasonal adjustment of the data shows a lower M/M rate of core inflation.

Looking ahead, euro area inflation is likely to fall quickly through H2 2023 as the effect of last year's energy and food price shocks slip out of the annual calculation, providing some relief to households. There have been clear signs recently that global inflationary pressures are easing. Wholesale gas prices have plunged in recent months (Chart 6), and international food prices have fallen lower too. As mentioned above, there are also ongoing signs of improvements in global supply-chain

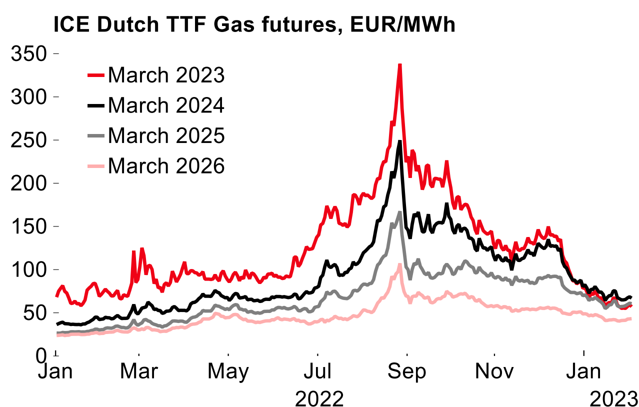
bottlenecks, with scope for further positive developments as the Chinese economy continues to reopen. As things stand, the door may even be open to euro area inflation falling below the ECB's 2% target by the end of the year. This is mostly due to energy price developments, so adverse shocks could change the outlook quickly. There will also be distortions from changes in national government policy as various energy support schemes are changed through the year, and it's hard to estimate the lagged effects of tighter monetary policy. So, while we can say with more confidence that the peak for inflation has been reached, it could still be a bumpy path ahead.

CHART 5: FOOD AND ENERGY STILL THE KEY DRIVERS



Source: Eurostat, MUFG Bank Economic Research Office

CHART 6: WHOLESALE GAS PRICES HAVE FALLEN

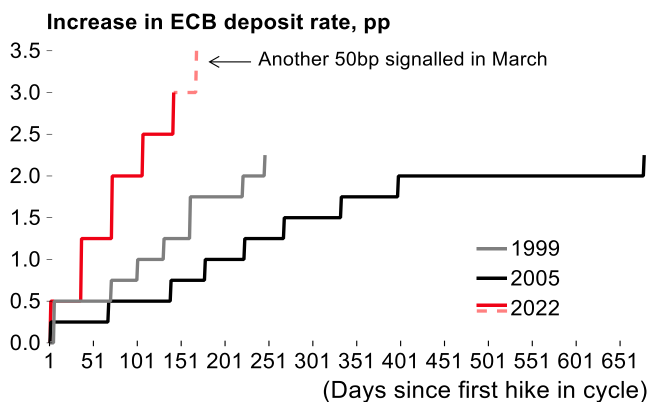


Source: ICE, MUFG Bank Economic Research Office

Still more work for the ECB to do

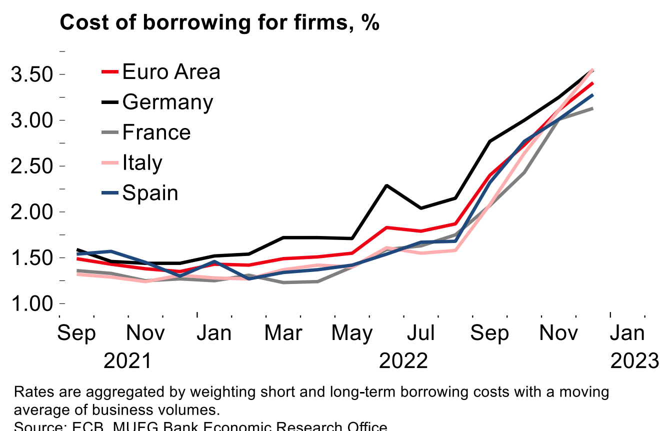
The ECB followed up its hawkish December meeting with another 50bp hike this week, as expected. This takes the deposit rate to 2.5% and means there has been a cumulative 3pp of rate hikes since the ECB belatedly starting tightening policy in July last year (Chart 7). There's more to come – the ECB indicated a strong intention to raise rates by another 50bp at the next policy meeting in March (despite also stating that it will "follow a meeting-by-meeting approach"). That would take the deposit rate to 3%, which we had previously estimated would be the peak of the hiking cycle. There are now clear upside risks to that assessment – it could be that there's a shift down to 25bp hike at the May meeting before the ECB reaches for the 'pause' button (see here). In the meantime, the transmission of tighter policy to the real economy is set to continue (Chart 8), weighing on aggregate demand.

CHART 7: THE ECB CONTINUES TO TIGHTEN RAPIDLY



Source: ECB, MUFG Bank Economic Research Office

CHART 8: BORROWING COSTS ON THE RISE



Rates are aggregated by weighting short and long-term borrowing costs with a moving average of business volumes.
Source: ECB, MUFG Bank Economic Research Office

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