November 2024

Fiscal tightening expected in the eurozone

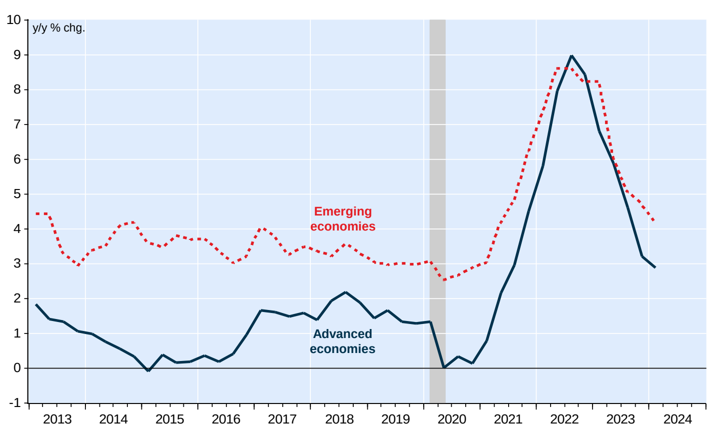
By Jocelyn Paquet

Summary

- Inflation continues to fall worldwide, allowing central banks to consider cutting interest rates. However, real rates remain restrictive in many places, limiting the immediate acceleration of the economy.
- China is facing unique challenges, with the weakness of the consumer price index reflecting weak domestic demand. Foreign demand, meanwhile, does not appear to be much stronger, as evidenced by low producer prices that are weighing on industrial profitability. These data merely confirm that the monetary stimulus measures already announced are not enough on their own to boost the economy
- After years of government profligacy in Europe, the IMF expects fiscal consolidation by 2025. Some are skeptical about the chances of this happening, but fears of disruption to the bond market could prompt some discipline. The recent rise in bond yields in the UK and France shows that investors are keeping a close eye on governments at the moment.
- With headwinds in China and Europe, global growth is expected to reach 3.2% in 2024 and 2.9% in 2025.

New data published by the IMF suggests that progress in the global fight against inflation has continued in recent months. Although not quite back to pre-pandemic levels, CPI inflation has continued to fall in both advanced and emerging economies.

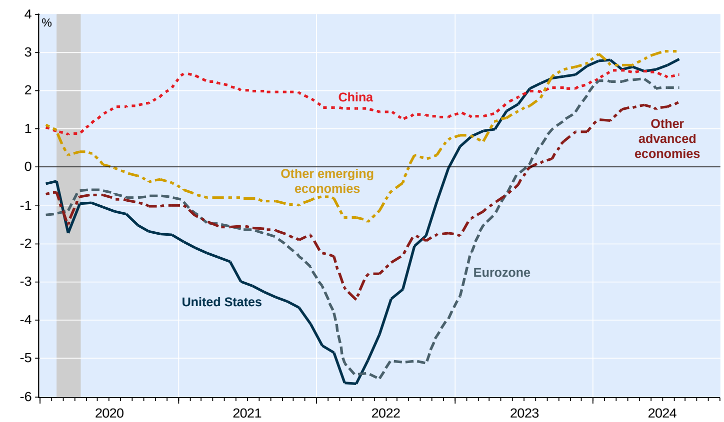
World: Progress on the inflation front has opened the door to rate cuts
Median CPI inflation



NBC Economics and Strategy (data via the IMF)

This setback is undoubtedly good news, as it now allows central banks to ease the pressure by reducing their policy rates. However, it will be some time before this easing translates into an acceleration in global growth. For, although they have fallen slightly, policy rates remain restrictive in many parts of the world, particularly in real terms.

World: Lower inflation dampens the effect of monetary easing
Real policy rates



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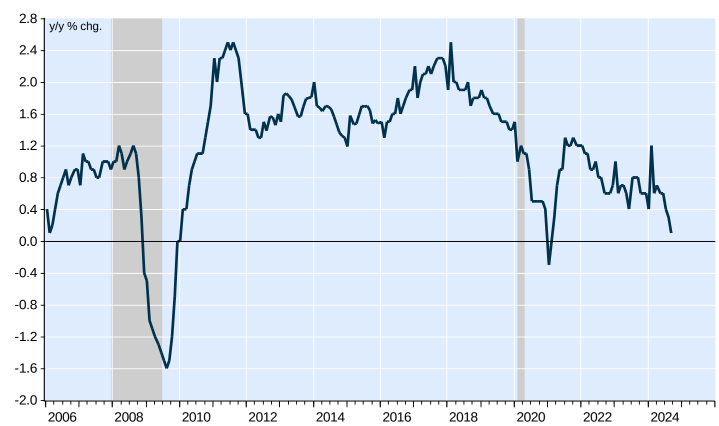
China is one of the regions where the positive impact of rate cuts has been largely cancelled out by weakening inflationary pressures. Weighed down by weak domestic demand, core inflation fell to just 0.1% on an annual basis in September, one of the lowest figures ever recorded.

China: An economy on the verge of deflation
Consumer Price Index excluding food and energy



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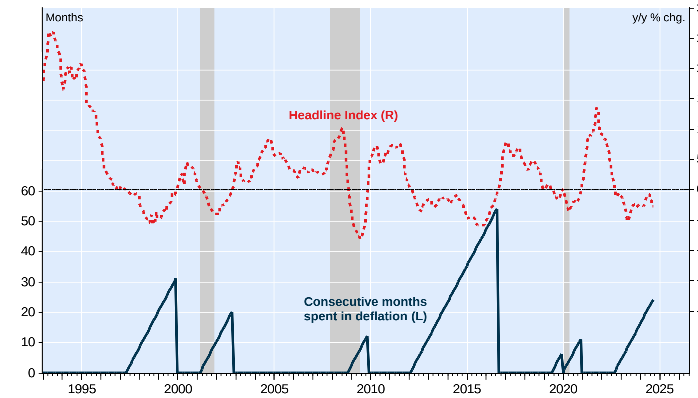
The producer price index, meanwhile, remained in deflation for a 24th consecutive month, the third longest such sequence since these data started being compiled in the early 1990s.

China: Two years of wholesale price deflation
Producer Price Index



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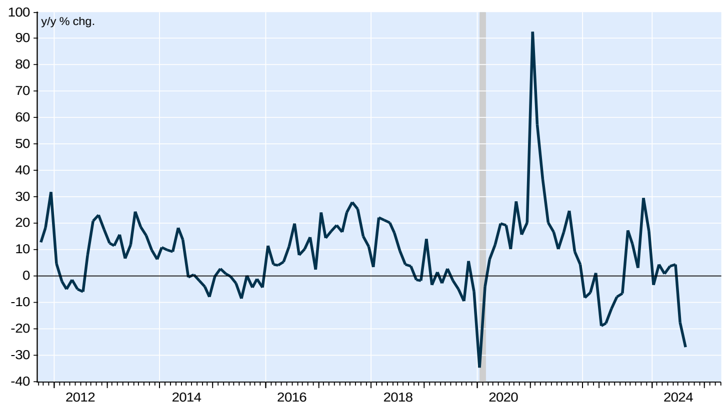
As well as keeping real interest rates higher than they otherwise would have been, the fall in prices has also hurt the profits of industrial companies, which fell by no less than 27.1% year-on-year in September.

China: Lower prices also take a toll on profits
Industrial profits



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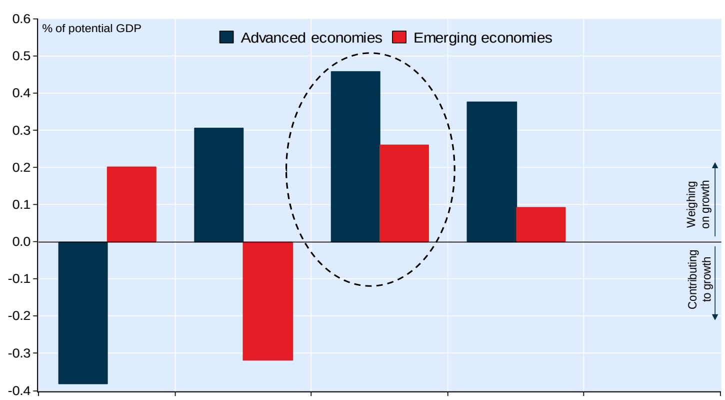
These data merely confirm that the monetary stimulus measures already announced are not enough on their own to boost the economy. All eyes will be on the Chinese authorities, who will unveil a fiscal stimulus plan in early November. For the time being, this forces us to maintain our growth forecasts below consensus expectations for the world's second-largest economy.

In addition to relatively weak Chinese growth on a historical basis, the emerging economies could also suffer from fiscal consolidation in 2025. This, at least, is the view of the IMF, whose most recent forecast assumes an improvement in the structural balance of public administrations in these countries.

World: Fiscal consolidation to weigh on growth in 2025
Projected change in the cyclically adjusted primary fiscal balance of general governments



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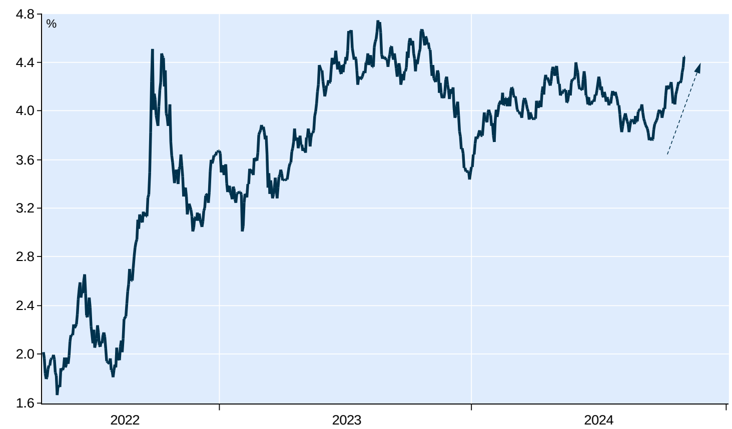
Fiscal policy could be even more damaging to growth in the advanced economies, where the structural budget balance of general government needs to improve even more than in the emerging economies by 2025. Of course, this will require policies to reduce deficits in several European economies. And after years of profligacy, our readers would be forgiven for thinking that the chances of this happening are pretty slim. To this, we would reply that it is the fear of disruption in the bond market (and the fear of rapidly rising borrowing costs) that is likely to bring governments back onto the path of sounder fiscal management, not any desire to be better stewards of the public purse. In a world of shrinking central bank balance sheets, it is likely that fundamentals such as fiscal management will take on greater importance in decisions about the allocation of public funds. Any doubts about the sustainability of public finances could therefore translate into greater volatility in bond yields than in the past.

The budget unveiled by the British government can serve as a warning in this respect. Although it provided for significant tax rises, these were largely offset by a substantial increase in spending. The result was a sharp rise in bond yields, which even reached their highest level in a year at the long end of the curve.

United Kingdom: Watch out for the bond vigilantes
Yields on 10-year government bonds



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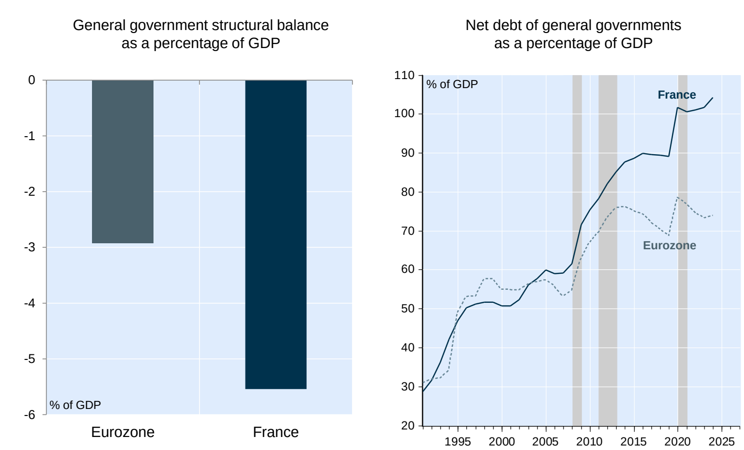
A similar situation can be observed in France, where the government has announced its intention to significantly reduce the budget deficit by the end of next year. There is an undeniable need to tighten the reins in France, where the deficit as a share of GDP is well above the 3% limit imposed by the Maastricht Treaty, and where public debt levels are well above the average for eurozone member countries.

France: Public finances in need of a shake-up...



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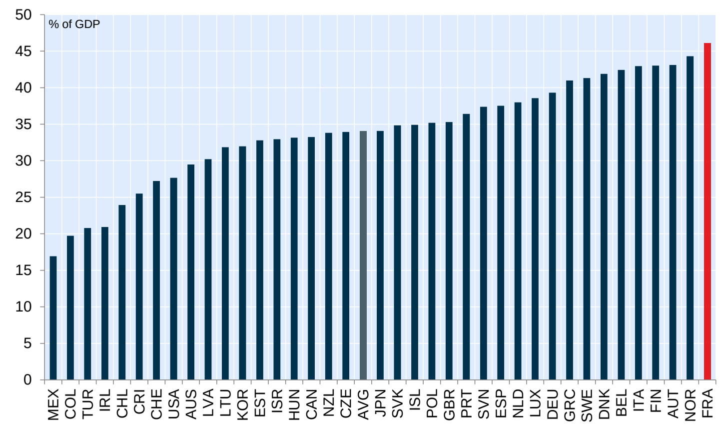
However, the markets are wondering how the government intends to achieve its objectives. While the new Prime Minister, Michel Barnier, seems to think that *temporary* tax hikes on big business will be enough to get public finances back on track, many commentators are pointing out that, given France's already high tax rate, deeper spending cuts will also be needed.

… but will raising taxes be enough to put them back in order?
Tax revenues as a percentage of GDP (as of 2022)



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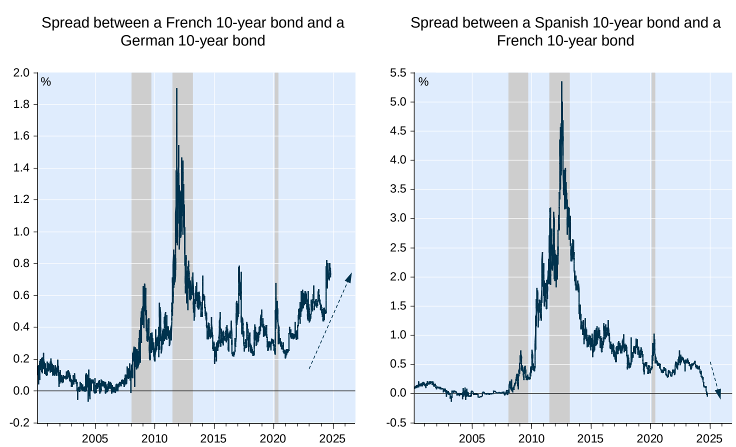
In the absence of clarification on this last point, French bonds have lost ground. Not only have the spreads between German and French bond yields widened, but French bond yields have even exceeded those of Spanish bonds for the first time in over 15 years.

France: Fiscal uncertainty spreads to the bond market



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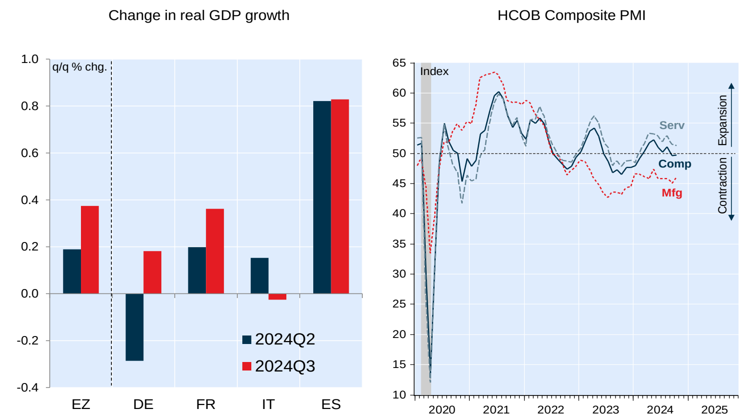
The choice therefore seems clear for the eurozone economies: consolidate public finances or risk paying the price of inaction on the bond markets. And since even the slightest effort on the fiscal front will be detrimental to growth, we continue to believe that growth in the eurozone will remain below potential for some time to come. Despite the positive surprise on the economic growth front in Q3, we still see a loss of momentum as the likely scenario in view of the most recent PMI report published by HCOB, which signaled a second consecutive contraction in private sector activity in October.

Eurozone: Q3's surprise unlikely to be repeated in Q4



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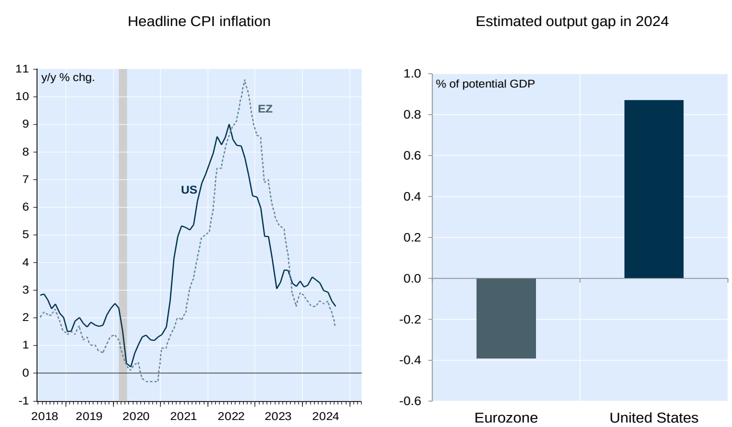
It is only in the second half of 2025 that we expect a significant acceleration in growth in the eurozone. Even then, this scenario depends on a significant easing of monetary policy by the European Central Bank. Fortunately, the context seems favourable for such an easing, as inflation has slowed considerably in recent months. The fact that the eurozone is operating below potential also allows the ECB to bring policy rates back to neutral more quickly than in the United States, where the positive output gap makes rate cuts more likely to rekindle inflationary pressures.

Eurozone: Rate cuts carry little risk as economy operates below potential



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With growth in China and the eurozone set to remain relatively weak for a few more quarters, we have decided to leave our global growth forecasts largely unchanged this month. The world economy should grow by 3.2% in 2024 and 2.9% in 2025.

World Economic Outlook

	2023	2024	2025
Advanced Economies	**1.7**	**1.7**	**1.2**
United States	2.9	2.7	1.3
Eurozone	0.4	0.8	0.8
Japan	1.7	0.2	0.9
UK	0.1	1.1	1.3
Canada	1.2	1.0	1.3
Australia	2.0	1.2	1.9
Korea	1.4	2.5	2.0
Emerging Economies	**4.2**	**4.2**	**4.1**
China	5.2	4.7	4.6
India	6.3	7.0	6.3
Mexico	3.2	1.5	1.2
Brazil	2.9	3.0	1.9
Russia	3.6	3.5	1.5
World	**3.2**	**3.2**	**2.9**

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