ABN·AMRO

Global Monthly

Group Economics | 29 May 2024

What's up with eurozone productivity?

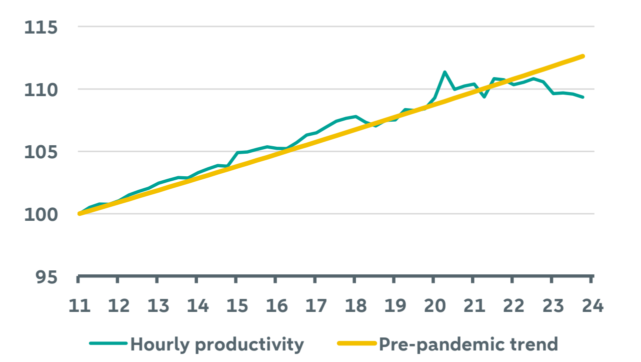
- The eurozone has long faced a productivity problem, but recent years have been particularly worrisome
- Structural headwinds, from weaker technology diffusion to the imperfect single market, are expected to continue weighing on the medium term productivity outlook
- However, the easing energy crisis – which is responsible for the bulk of the weakness recently – is likely to drive a cyclical improvement in the near term
- This should help close some of the growth gap with the US over the coming year
- Spotlight: The European Parliament election next week is likely to result in greater fragmentation
- Regional updates: With the ECB kicking off rate cuts next week, we are cautiously optimistic on the eurozone recovery, while in the Netherlands, a coalition agreement has finally been struck
- Hawkish Fed comments and firm US inflation make us less confident there will be near-term rate cuts
- Beijing is taking a new approach to stabilising China's property market

Global View: The easing energy crisis should give some lift to eurozone productivity

The ECB looks almost certain to kick off its easing cycle next week Thursday, in what must be one of the most heavily telegraphed policy pivots in recent history. At the same time, financial markets seem to have already got used to the idea that the Fed and ECB policy paths are about to diverge – a prospect that looked unlikely only a few months ago, before US inflation sprang an unwelcome return. The reason markets are digesting this development so well are twofold. First, markets continue to think the Fed will not be all that far behind the ECB in lowering rates. In other words, the divergence is not expected to last very long. And second, there are good reasons for the policy divergence. Despite tentative signs of a recovery so far this year, the eurozone economy continues to be in a much weaker state than that of the US economy, and combined with the further falls in inflation we have seen, this gives the ECB a greater urgency to lower rates than the Fed. But will the eurozone continue to significantly underperform the US this year? We have long expected 2024 to be a year of transatlantic convergence in growth trends, with the US economy coming back down to earth, and the eurozone recovering from a prolonged period of stagnation. This view hinges on a recovery in eurozone productivity, which has been so poor recently that it is drawing the attention of not just one, but two former Italian prime ministers. In this month's *Global View*, while acknowledging the structural challenges the eurozone faces, we make the case for the further easing in the energy crisis – alongside reduced labour hoarding – to drive a partial recovery in productivity this year.

Labour hoarding & weak demand have hit productivity

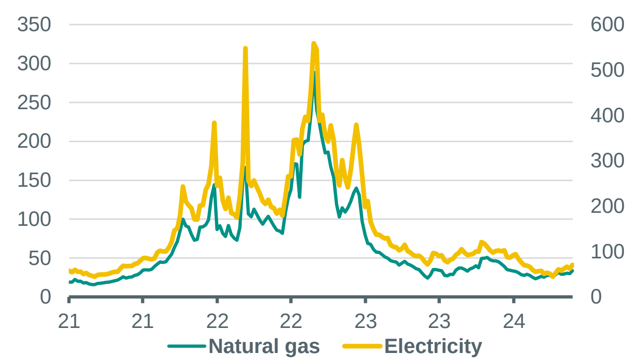
Eurozone hourly productivity, 100 = Q4 2015



Source: LSEG, ABN AMRO Group Economics

The easing energy crisis will help

TTF gas, +1m, EUR per MWh NL baseload, +1m, EUR per MWh



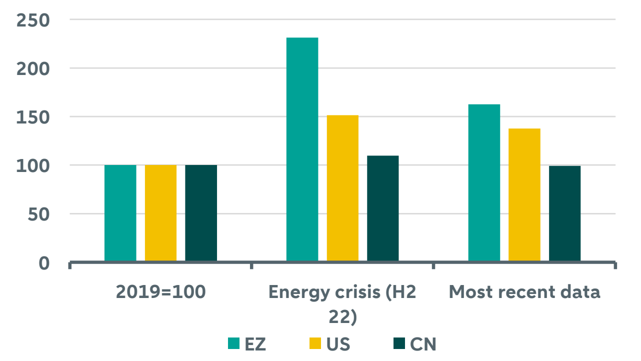
Source: Bloomberg, ABN AMRO Group Economics

Eurozone productivity: Bad track record aggravated by the energy crisis

The eurozone does not have a great track record when it comes to productivity. While productivity growth has slowed globally, long term productivity growth in the eurozone has lagged the US since the start of this century. Some of the reasons for this are specific for the eurozone; others are global in nature. To name a few: 1) changing sector compositions (increasing share of low productive services); 2) low investment due to opaque capital markets in the eurozone, and from lack of scale for eurozone businesses; 3) slower technology diffusion across businesses 4) an imperfect single market. Together, these factors help explain the 'missed ICT revolution-theory', which argues that the eurozone, compared to the US, has failed to reap the full efficiency benefits of ICT technology, or as Nobel Prize winner Robert Solow once famously put it: '*Computers are everywhere except in productivity statistics*'.

Receding energy prices still put EZ at disadvantage

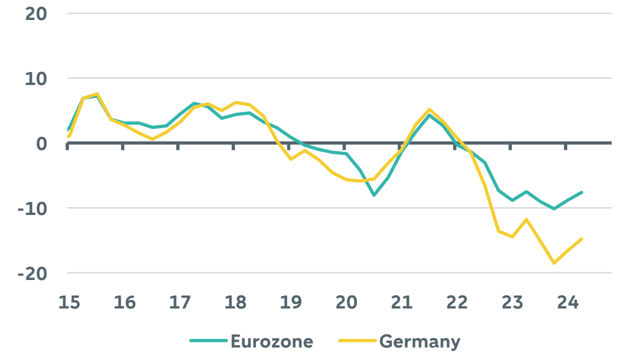
PPI Energy; index average2019=100



Source: LSEG, ABN AMRO Group Economics

EZ businesses report a weaker competitive position

Non-EZ competitive position, 6 month average



Source: EC, ABN AMRO Group Economics

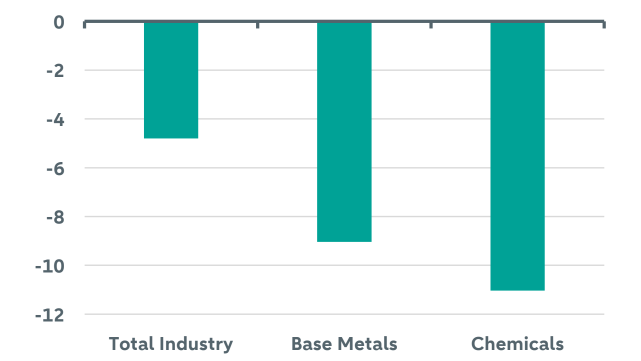
With a long term track record that is already subpar, recent crises – including the energy crisis and possible scarring from pandemic policies – have made things worse. Starting with the energy crisis, despite recent declines, eurozone energy output prices are still around 60% higher than pre-crisis, while in the US they are 35% higher and in China they are broadly unchanged. Next to energy prices, investment needs in grids – partly linked to the energy transition, but also due to the shift to LNG from pipeline gas – also pushed up costs. Elevated energy prices have hit countries with large industrial sectors particularly hard, like Germany and Italy. Of those two, as energy-intensive industrial subsectors such as chemicals and base metals are concentrated in Germany, the story of the energy crisis is to a large extent a German story. As a result of elevated energy prices, German producers in particular report that their competitive position on the global market has slipped, as input costs have risen more compared to global competitors.

Elevated energy prices: Short- and medium-term effects

The link between energy prices and productivity is more complicated than meets the eye. The straightforward effect runs via capacity utilization. As energy prices rose, businesses shut down energy-intensive production. Examples of this over the past years are plenty: from the closing of a zinc smelter in the Netherlands to chemical conglomerate BASF scaling down production in Germany. Indeed, capacity utilization in Germany fell the most in energy intensive sectors when energy prices spiked back in 2022. While falling energy prices have since driven a pickup in energy-intensive output, these sectors bore the brunt of industrial production declines, and output remains well below the pre-crisis

Lower capacity utilisation in energy intensive sectors...

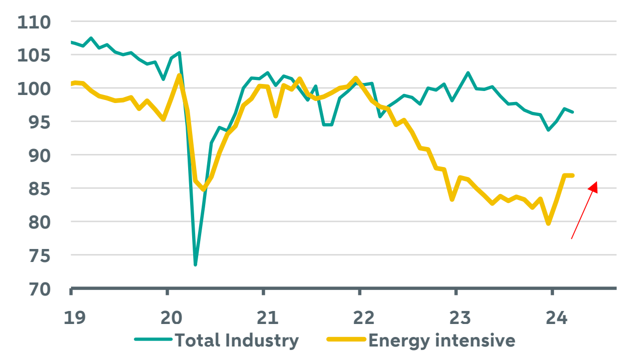
%, Capacity utilisation Germany, Difference 2021 and H1 2024



Source: LSEG, ABN AMRO Group Economics

...meant sharper production declines

Index, Industrial production Germany



Source: LSEG, ABN AMRO Group Economics

level. This could not have come at a worse time for the broader industrial sector, which already faced headwinds from the global manufacturing slump (linked to the shift in consumer demand from goods back to services).

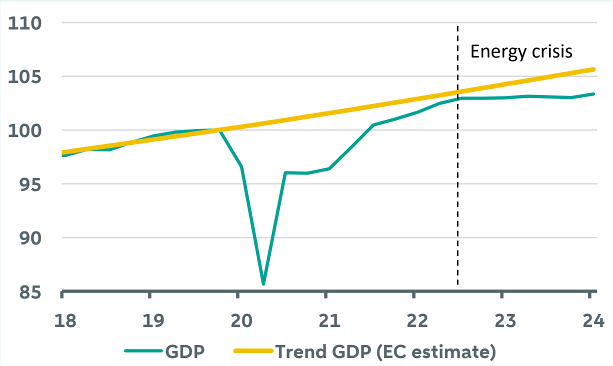
As energy-intensive firms on average have a higher level of productivity, the hit to output has had an outsized impact on aggregate productivity figures. Furthermore, high energy prices have led to increased uncertainty over the viability of business models, which in turn can lower investment and thereby medium term productivity growth. It is too early to give definitive answers, but investment survey results by the EIB suggest that energy costs are a major obstacle for investment for 60% of German firms.

The US-eurozone growth gap: It's the energy crisis, stupid

As of Q1 24, Eurozone GDP is running 2.3pp below trend according to the latest European Commission estimates. The bulk of this gap opened up at the onset of the energy crisis in Q2 22: at that time, the eurozone was well on its way to a return to trend output, with a gap at the time of only 0.6pp. Aside from the direct hit to production and net exports of energy intensive goods, a much bigger hit came to consumption via the real income shock from the surge in inflation, with private consumption and goods consumption hit particularly hard (goods consumption remains around 6pp below trend – see chart on p5). The US also saw some increase in its energy prices as a spillover effect from Europe's crisis, but the inflation shock to real incomes was much smaller. Ultimately, because the US is a net exporter of energy, Europe's loss proved to be the US's gain: since the crisis, net exports have made a 0.7 percentage point (pp) contribution to US GDP growth, partly on the back of higher LNG exports to Europe. This followed nearly a decade of persistently negative net export contributions to US GDP. In contrast, net exports subtracted 0.1pp from eurozone GDP; in more normal times net exports typically makes a positive contribution to eurozone GDP.

Energy crisis drove the eurozone stagnation...

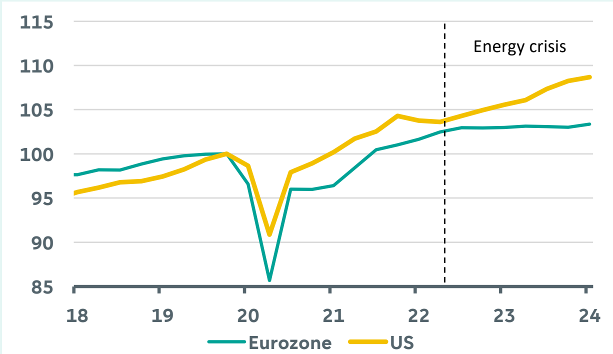
Index, Q4 2019=100 (GDP was in line with trend at this point)



Source: LSEG, ABN AMRO Group Economics

...explaining most of the growth gap with the US

GDP; index, Q4 2019=100



Source: LSEG, ABN AMRO Group Economics

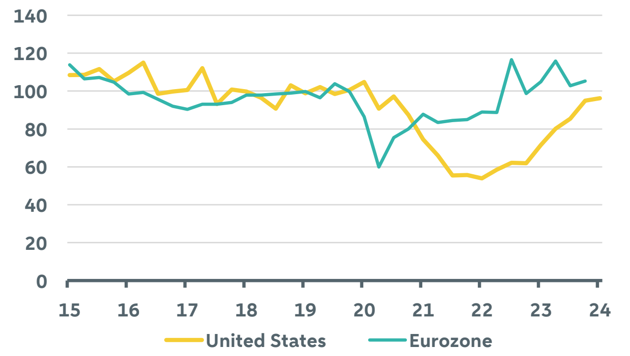
Pandemic hangover: A blow to allocative efficiency?

Productivity is traditionally viewed as having 1) a within-firm component, i.e. how productive is the firm, and 2) a between-firm component, i.e. can resources be allocated more efficiently between firms and thereby raising productivity? High energy prices primarily impact the within-firm component[1], but as suggested recently by Dutch Central Bank Governor Klaas Knot, the pandemic may have impacted the between-firm component of productivity. Mr. Knot highlighted the differences in Covid support and the detrimental impact that may have had on labour and capital reallocation. Where the US supported workers directly as businesses laid people off, European governments favoured support via businesses (wage subsidy schemes). As a result, the supply side in Europe was 'frozen' temporarily, keeping employer-employee relations intact. Whereas government support in the EZ and in the US both lowered bankruptcies, labour mobility (looking at the unemployment rate) in the US was generally higher. While there is no clear evidence yet of any productivity effects of this, in the past, labour reallocation has been productivity enhancing. Judging from historical evidence, it is likely that increased labour reallocation in the US has also raised productivity this time – a benefit that the eurozone may have missed out on.

[1]Should firms default or exit due to higher energy prices, the between-firm component comes into play, see here for instance

Bankruptcy rates fell in both EZ and US...

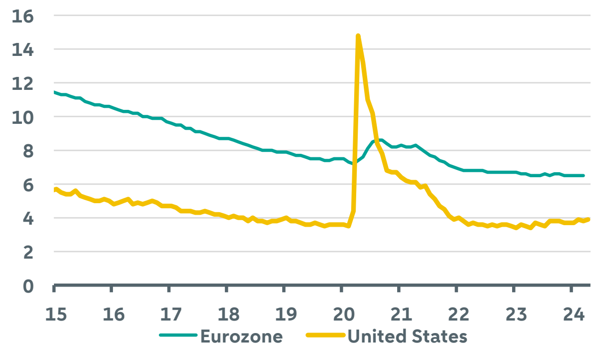
Index average 2019=100, Bankruptcies



Source: Bloomberg, LSEG, ABN AMRO Group Economics

...but the US experienced much more labour mobility

%, Unemployment rate



Source: Bloomberg, LSEG, ABN AMRO Group Economics

We expect a near-term bounce in productivity...

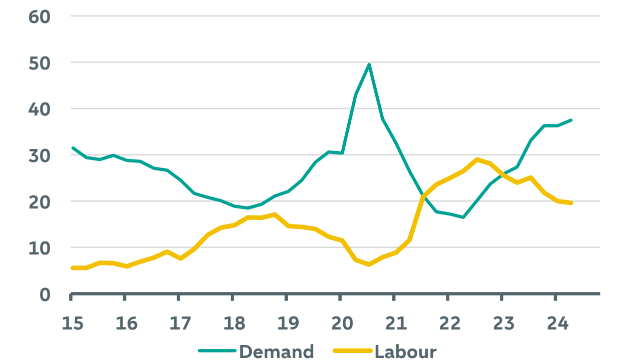
Productivity is often discussed as a longer run concept, but it also has a strong cyclical component. One of the main reasons productivity has been particularly weak over the past 18 months is that consumer and investment demand has stagnated, while employers – likely in anticipation of a recovery – have maintained or even expanded workforces. This combination has mechanically pushed down on productivity, and indeed it has surprised us the degree to which employers have held on to workers despite the weakness in demand (we had expected a decline in employment that has yet to materialise). Now that demand is recovering, we expect businesses to accommodate this by better utilising existing workforces rather than by further expanding employment or hours – both of which are already at historic highs. The catch-up in nominal wages with inflation – which is now weighing on profit margins – is likely to be an important factor that keeps employment growth in check. Our base case for the labour market therefore sees employment broadly holding at current levels, with GDP growth expected to continue recovering as the year progresses. This should raise productivity from a cyclical perspective.

...as businesses make better use of existing spare capacity

A clear sign that the existing workforce is not being fully utilised is the low level of capacity utilisation, which – at 78.9% as of Q2 – is the lowest rate since Q4 2020, when the economy was still recovering from the first lockdowns of the pandemic. While US capacity utilisation has also fallen back, reflecting tight monetary policy and the global shift in demand from goods to services, the fall in the eurozone has been much larger (-3.9pp vs -2.5pp in the US). We attribute much of this difference to the impact of the energy crisis, which has hit energy intensive industry particularly hard, as well as consumption more broadly via the shock to real incomes. The outsized decline in capacity utilisation in the eurozone suggests significant room for demand to increase without a corresponding rise in employment, which should partly reverse the recent decline in productivity. Another factor that should help is that the improved supply-demand balance for labour should lead to less labour hoarding behaviour on the part of employers. Indeed, the European Commission's business survey on factors limiting production continues to rank weak demand higher than lack of labour as the main factor, and this gap has widened further in recent months.

Demand now a bigger impediment than labour

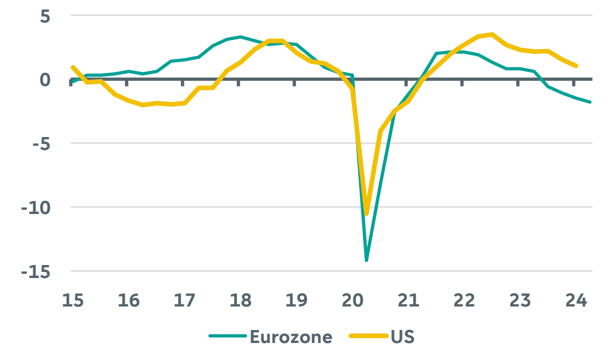
EC business survey on factors limiting production; response %



Source: LSEG, ABN AMRO Group Economics

Capacity utilisation drop is bigger in the eurozone

Capacity utilisation, % difference with long-run average (2000-2024)



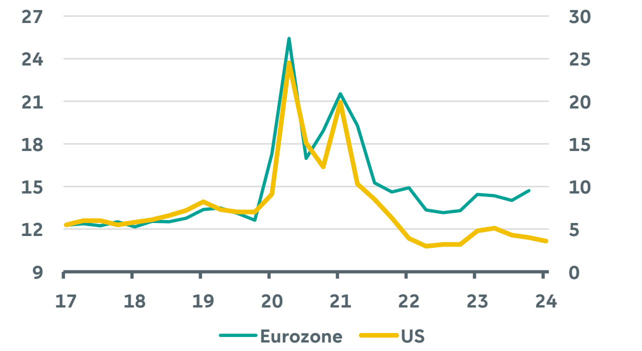
Source: LSEG, ABN AMRO Group Economics

Demand recovery to be driven by rising real incomes and reduced consumer caution

What will drive the recovery in output and demand? First, energy prices – while remaining higher than before the energy crisis – have fallen to more normal levels, and this is already driving some recovery in energy-intensive industry (see bottom right chart on page 2). Second, rising real incomes, driven by the aforementioned fall in energy prices as well as higher nominal wage growth, should support a recovery in goods consumption, which remains well below the pre-pandemic trend. Consumption is also likely to see support from a decline in the savings rate, which – in contrast to the US – has been higher than before the pandemic, suggesting eurozone consumers have been significantly more cautious. Rising real incomes and falling interest rates are likely to drive an improvement in consumer confidence, leading to a lower savings rate and therefore stronger consumption.

Cautious eurozone households...

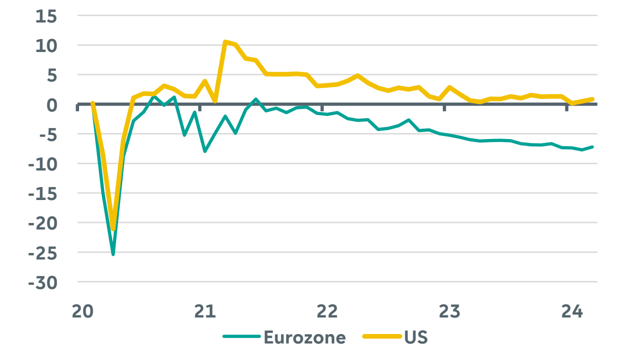
Savings rate, % (lhs = eurozone / rhs = US)



Source: EC, ABN AMRO Group Economics

...have more room to raise consumption

Real retail sales, % difference with pre-pandemic trend (2016-2019)



Source: LSEG, ABN AMRO Group Economics

Still, we do not expect a dramatic rebound

Taking a step back, the energy crisis had a much milder impact on the economy than most forecasters (including ourselves) predicted at its onset. The eurozone economy has flatlined over the past 18 months, but it avoided a deep recession. And a silver lining is that high energy prices provided a spur to the energy transition. By accelerating the shift away from fossil fuels and investing in energy efficiency savings, European countries frontloaded some of the transition pain that will ultimately contribute to future-proofing the economy[2].

Still, while the easing in the crisis means we are likely to see some cyclical improvement in productivity, the same factors that weigh on the broader growth outlook are also likely to prevent a full return to the pre-pandemic/pre-energy crisis trend in productivity in the near-term. There is likely to be some scarring impact from higher energy prices (see page 2), and the structural move away from energy-intensive industry may create labour market frictions that take time to resolve (workers who lose their jobs in energy intensive industry may take time to re-train for other jobs). And it is not only energy-intensive industry that faces problems: the European car industry faces a major challenge from the shift to EVs, given the stronger competitive position of Chinese manufacturers. The expected raising of tariffs on Chinese EV imports by the European Commission – expected imminently – may guard against an existential threat to the European car industry, but this will not boost productivity, and may come with its own costs, for instance in the form of potential retaliatory tariffs on European car exports.

Meanwhile, though the policy proposals of Enrico Letta and the upcoming proposals of Mario Draghi show promise, the structural headwinds weighing on productivity mentioned at the beginning look unlikely to be resolved quickly. And though interest rates are expected to fall, rates are expected to remain at a level that continues to restrain demand for at least the coming year. Given these factors, we continue to expect near-term eurozone growth to remain below trend at 0.2-0.3% q/q, and even with above-trend growth expected next year, output is likely to remain below potential for some time yet.

[2]Research by the OECD even suggests that short-term pain in this regard may even prove to be a long-term gain.

Spotlight: Fragmentation to make European Parliament less vigorous

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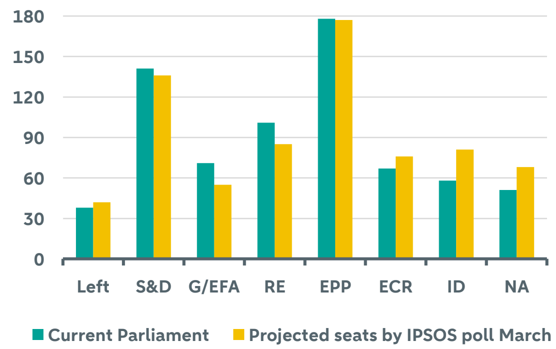
- Polls predict a shift to the right, and a more fragmented European Parliament after the elections
- Fragmentation will hinder coalition-building: a policy-poor period lies ahead
- The shift to the right is a prelude to restrictive immigration policies and a more gradual green transition
- A stronger national focus will make it more difficult to reap the benefits of the common market

European Parliament elections take place on 6-9 June

This summer Europe goes to the ballot box to vote for the European Parliament. From 6- 9 June more than 400 million eligible voters can choose the members of the European Union's only directly elected institution for the tenth time since 1979. Originally the European Parliament functioned as an advisory board. However, this has changed. Nowadays, it functions more like a normal national parliament. Its 720 parliamentarians are directly elected by their respective 27 national populations. It has co-legislative power in nearly all policy areas. It has the power to approve the European Union's budget, and the future European Commission. An important distinction though is that the European Parliament lacks the right to submit laws, a right which is almost entirely reserved for the European Commission. In that sense, the European Parliament is an important institution within the European Union, but not necessarily the most powerful one.

Polls indicate a marked shift to the right

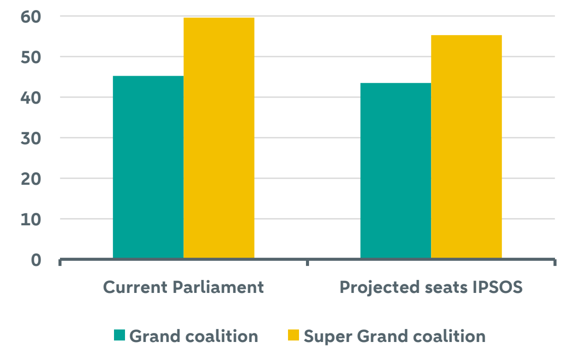
European Parliament seats



Source: IPSOS

'Grand' and 'Super Grand' coalition shares lower

Percentage share of European Parliament seats



Source: IPSOS

Radical right set to win seats

At the next elections, the Christian Democratic European People's Party (EPP) looks set to remain the largest and most powerful group in Parliament. If the EPP remains the largest party it will likely provide the next president of the European Commission. Therefore chances are that Ursula von der Leyen will be continue to be president. This would contribute to stability in turbulent times.

Traditional mainstream parties such as the Socialist and Democrats (S&D) and the centrist/liberal Renew Europe (RE) are expected to lose seats, as are the Greens/European Free Alliance (G/EFA). Many polls predict significant gains for the radical and extreme right. The most right-wing group, the Identity and Democracy Group (ID) is expected to gain between 10 and 30 seats and could overtake RE as the third largest group in Parliament. The European Conservatives and Reformists Group (ECR) is also projected to gain 5 to 15 seats. Some national parties that are currently non-attached to a European political group (NA), such as the Dutch Farmer-Citizen Movement (BBB), are negotiating to join ECR, which would enable ECR to potentially take third place instead of the Identity and Democracy Group (ID).

As a result of the expected shift, 'left' (S&D, G/EFA and The Left) and 'centre-left' (S&D, G/EFA, The Left and RE) coalition minorities will shrink in size. The 'grand coalition' of EPP and S&D, which lost its majority in 2019, continues to shrink to 43% of the seats according to the latest IPSOS poll. The majority of the 'super grand coalition', that also includes RE, would shrink to 55% of the seats. Reaching voting majorities in Parliament with only 55% of the seats will prove difficult though. The EPP, S&D and RE each consist of national parties, among which opinions and voting behaviour may diverge. Therefore, the 'super grand coalition' will increasingly have to seek support from non-attached Members of Parliament to secure majority votes.

Policy-poor period ahead

The expected political shifts mark a change in both policymaking and policy focus. With regards policymaking, European politics tends to be about creating coalitions. Coalitions on policy issues in the European Parliament tend not to be the result of formal agreements. Instead, political groups decide how to vote issue by issue. Research by the European Council on Foreign Relations shows that in the past, centre-left (S&D, RE, G/EFA and The Left) coalitions tend to push through legislation on social issues and the environment, centrist parties (EPP, S&D, usually also RE) do so on economic, fiscal, and monetary affairs, and the centre-right (EPP, RE, ECR and sometimes ID) does so rural development, agriculture, and fisheries. However, creating coalitions will become difficult in a more fragmented Parliament. Hence, the current polls could well be the harbinger of a relatively policy poor period.

Regarding the policy focus, we must recognize that Europe is enduring various crises. The economy has gone consecutively through a financial, a euro, a health, and an energy crisis. Covid shocked the health system and tested social cohesion. Wild fires and floodings due to climate change are causing financial damage. The arrival of refugees is stirring social unrest. The post-Cold War peace dividend seems to have ended after the first Trump presidency and the Russian invasion of Ukraine. The wars in Ukraine and Gaza stoke feelings of insecurity. According to polls conducted in September October last year European citizens are affected by these crises to different degrees, depending on their nationality, age, gender, and education. These differences explain the growing divide and the increase of political fragmentation. Not necessarily along the left-right divide, as in the past, but along the lines of the various crises.

Voters' main concerns differ between countries

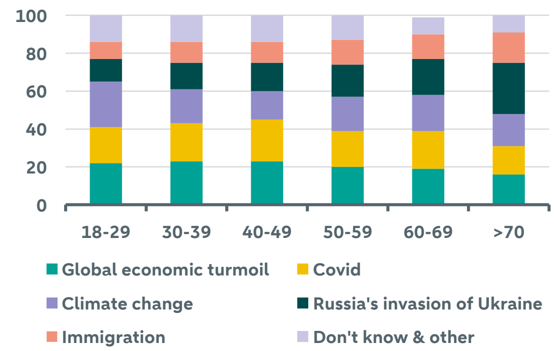
Concern ranked on top of list of concerns

Climate change	Denmark
	France
Immigration	Germany
Covid	Spain
	Romania
Russia's invasion of Ukraine	Estonia
	Poland
Global economic turmoil	Italy
	Portugal

Source: ECFR

Various age cohorts rank major concerns

Major concerns (percentage of respondents, by age)



Source: ECFR

Migration and climate change are in the limelight

The June elections will be shaped by competing worries about climate change, migration, military conflict, and the economy. In contrast to 2019, when concerns about climate change prevailed, the next elections seem to concentrate on migration. After June, a majority in the European Parliament will likely be supportive of restrictive immigration policies. In April the European Parliament voted in favour of the Pact on Migration and Asylum, which – despite legal difficulties – includes fast-tracking of asylum claims at external borders and sending people to third countries.

Another shift is expected on the environmental policy front. The green agenda hardly resonates with right wing parties that are, on the contrary, trying to scale down climate policy ambitions. Even the EPP and RE, which used to be proponents of the Green Deal, are becoming less ambitious on the environment. They have already indicated that environmental policies will not be a priority in the next legislative period. The majority of the new Parliament will probably advocate for a more gradual transition, raising the risk that the transition pathway moves away from an 'orderly Net Zero' scenario towards a 'delayed transition' scenario, triggering a sharper bend in climate policies after 2030. In a delayed transition scenario, climate litigations will increase, calling governments to comply with and implement their own legally binding mitigation commitments to the Net Zero target.

Though the radical parties lack a common program, they are united in their dislike for centralized European policies. Progress on implementing a capital markets union and a common industrial policy strategy may be complicated if national interests become more dominant. Lack of progress on these fronts could hinder competitiveness and productivity growth, which isn't helpful in the context of growing risks of international trade spats. A more national focus will also affect negotiations on the budget ahead of the upcoming seven-year period starting in 2028. An extension of the budget is required if enlargement plans progress, and if military expenses rise in response to international security threats. Another important budget-related topic is linking cohesion funds to reforms and investment targets, an idea that is gaining support.

Eurozone: Towards cautious optimism

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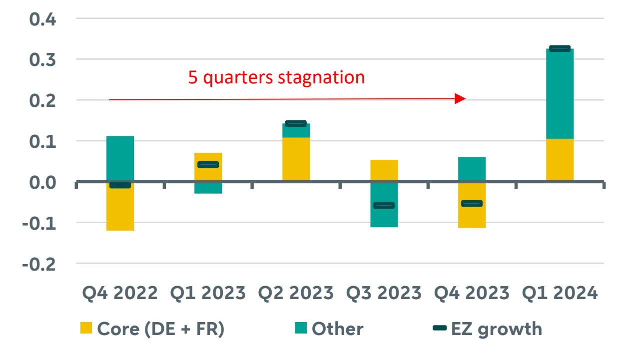
- Q1 GDP (+0.3% qoq) surprised to the upside. We raise our 2024 GDP forecast from 0.4% to 0.7%
- Growth is expected to remain slightly positive in Q2 as the outlook improves further, but remain below the trend rate
- Disinflation in the eurozone is still on track, but services inflation remains firm due to high wage growth
- The first rate cut by the ECB looks to be a done deal next week on 6 June, with attention shifting already to the pace of rate cuts that is likely to follow

Q1 GDP data gave us reason for cautious optimism over the bloc's economic activity in 2024. After a weak 2023 with a technical recession in H2, the eurozone surprised to the upside and expanded by 0.3% qoq in Q1. Growth was driven by net exports, spending from the European recovery fund and temporary factors such as higher services consumption due to an earlier easter as well as stronger construction activity – particularly in Germany – due to mild weather conditions. With tourism spending and recovery fund investment providing particular support to activity in southern eurozone countries, the periphery continued to outperform the core. Despite upbeat signs, a strong recovery this year is not expected as the bloc's industrial sector is still very much in recessionary territory, as confirmed by May's manufacturing PMIs, and although industrial demand seems to be stabilising, a strong pick-up is required for the sector to stop being a drag on overall GDP. Also, the loss of purchasing power and uneven recovery of real incomes across the eurozone combined with low consumer confidence and an elevated savings rate means private consumption is set to increase but remains very weak for the time being. As support from the temporary factors such as high construction activity and higher services consumption falls away, we expect a slight pullback in growth in the second quarter. Still, in the middle of the second quarter, the May PMI's, confirmed that the recovery is continuing, driven by the services sector. We expect the recovery to pick up momentum in H2 of 2024, as high wage growth across the euro area supports real incomes and rate cuts start to give some stimulus to demand and lending.

April inflation data were in line with our expectations, with disinflation still broadly on track to reach 2% in Q3 of this year. In year-on-year terms inflation in the coming months will likely rise a bit as favorable base effects from energy unwind. With regards services inflation, the April figure was flattered by the earlier Easter, helping it to dip clearly below 4% for the first time in nearly two years. Going forward, services inflation will take longer to normalise given still strong wage growth in the eurozone. This also means core inflation will take longer to return to the 2% target.

Q1 growth in core and periphery ends period of

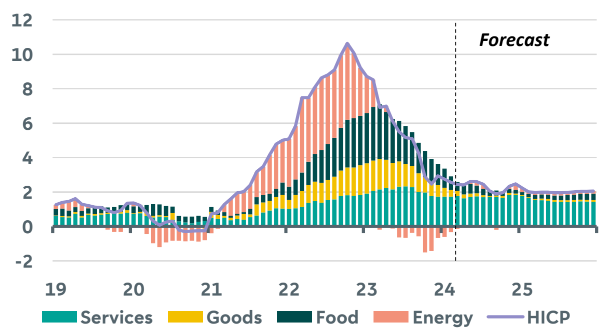
Country contributions to EZ growth



Source: LSEG, ABN AMRO Group Economics

Disinflation remains on track despite headline bumps

Contribution to headline inflation, pp/% Y/Y



Source: LSEG, ABN AMRO Group Economics

With disinflation on track and the near-term bounce in annual inflation likely fully expected by the ECB, the June start to rate cuts is unlikely to be derailed. The path after the June meeting is more uncertain, and some ECB officials have tried to play down expectations for back-to-back rate cuts. However, as the three conditions set by the ECB during the April meeting – the inflation outlook, the trend of underlying inflation and the strength of monetary policy transmission – are still largely met, and given the policy rate after the June cut will still be deep in restrictive territory, the rationale for rate cuts after June remains in place. Our base case continues to see the ECB cutting rates at each meeting from June onwards, for a total of 125bp of rate cuts over the course of 2024.

The Netherlands: A story of domestic demand

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- First quarter GDP showed an unexpected contraction by 0.1% q/q
- We have revised our growth forecasts to 0.5% (was 0.7%) in 2024 and 1.3% (was 1.2%) in 2025
- Growth will be driven by internal demand. Later in 2024, as financial conditions ease and external demand increases, growth is set to normalize further
- The coalition parties came to an agreement, with spending shifting away from longer term investments towards short-term spending and purchasing power increases

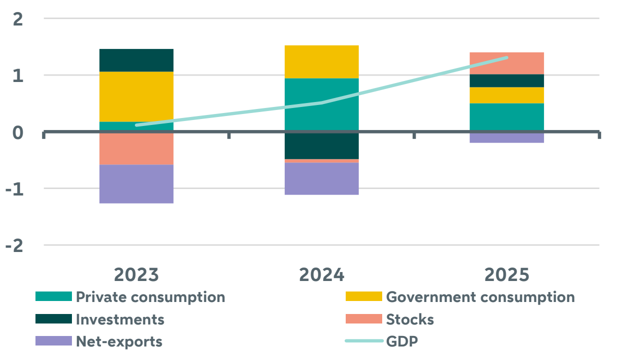
The Dutch economy unexpectedly contracted by 0.1% q/q in Q1 (ABN: +0.2%, consensus +0.3%). This contraction contrasts with figures from neighbouring countries. The German economy grew by 0.2% q/q and the eurozone as a whole grew by 0.3% q/q. The contraction in the Netherlands was largely driven by a decline in net exports and further stock depletion. Goods exports contracted (-1.3% q/q), while services exports grew (+4.7% q/q). The contraction in goods exports was driven by weakness in the manufacturing sector. The sharp decline in inventories also hurt growth, but the cycle of stock depletion seems to be reaching its end, in line with the bottoming-out of the industrial sector.

Despite the downside surprise, the published figures support our view of the 2024 growth outlook, as the domestic subcomponents did increase on a quarterly basis. For instance, private consumption rose by 0.7% q/q as households benefited from a recovery in real incomes on the back of further declining inflation and strong wage growth. Government consumption also increased by 0.6% q/q. Despite formation talks, the caretaker government continues to contribute to growth through spending on healthcare, education and defence. Finally, investments surprised to the upside, growing 0.4% q/q, even though weak growth prospects and high interest rates limit the rationale for investments. Indeed, investments mainly increased due to replacement investments, for instance in transportation and machinery, and not due to capacity-increasing investments.

Looking forward, the outlook for 2024 remains positive but weak. Growth will be driven by domestic demand, both from households and the government. Later in 2024, as financial conditions ease and external demand increases, growth will pick up further. Taking into account the Q1 realisations we have revised our growth forecasts to 0.5% in 2024 (was 0.7%) and 1.3% for 2025 (was 1.2%), up from 0.1% in 2023.

Private and public consumption drive growth in 2024

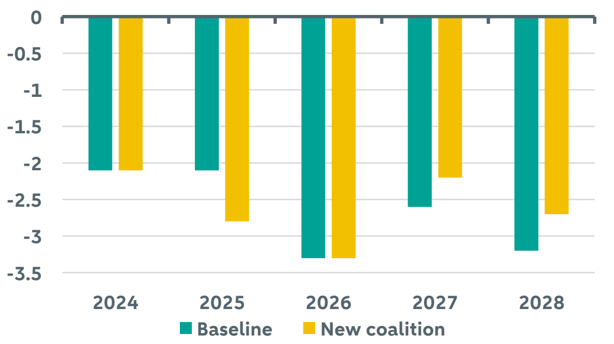
P.p. growth contribution



Source: CBS, ABN AMRO Group Economics

Deficits of new plans versus baseline

EMU-balance as % of GDP



Source: CPB, ABN AMRO Group Economics

The coalition parties reached an agreement (read more here), with limited macroeconomic effects. The plans focus on curtailing migration, lower taxation, the business climate, the agricultural sector and housing construction. The plans are expected to marginally increase economic growth in de short-term, mostly through consumption and investment. Consumption benefits from increased real incomes by measures such as lower income taxes, the extended decrease of fuel taxes, and higher rental allowances. Investment is for instance increased through higher housing investments, as the coalition prioritises new housing sites. The coalition parties plan to shift spending away from longer term investments and goals (such as climate) towards more short-term goals, which increases the budget deficit compared to the baseline in 2025 and 2026. The agreement states spending will be cut in 2027 and 2028, but we argue that these spending cuts are uncertain and unlikely to succeed, which puts upward pressure on the deficit in those years.

US: How much patience and confidence is needed?

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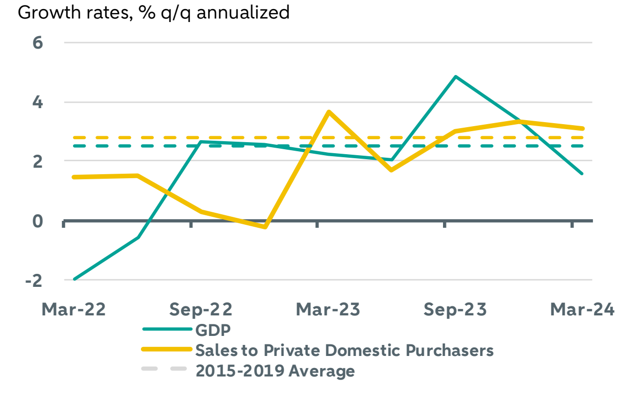
- Weak headline Q1 GDP growth hid more solid underlying fundamentals
- We continue to expect inflation to come down this quarter…
- … but we have less confidence that this will be enough for a July rate cut

GDP growth in Q1 disappointed at 1.6% annualized, but strength in consumption and investment - which grew 3.1% annualized - suggest underlying demand remains strong, with the main drag on GDP coming from higher imports. Nonfarm payrolls in April similarly disappointed at 175k, down from an average of 276k in Q1, but a large part of that decline can be attributed to virtually zero growth in government jobs. Unemployment remains low and the labor market is still strong. The ratio of unemployed to job openings has cooled to values near the pre-pandemic level. We expect headline GDP to rebound 2.5% annualized in Q2, reflecting an unwind of the drag from net exports on Q1 GDP. However, we still expect a slowing of the economy to 1.5% annualized growth per quarter in the second half of the year, on the back of weakness in the interest-sensitive parts of the economy, and a depletion of pandemic excess savings. In 2025, we continue to expect a return to trend growth as falling interest rates start to boost activity again.

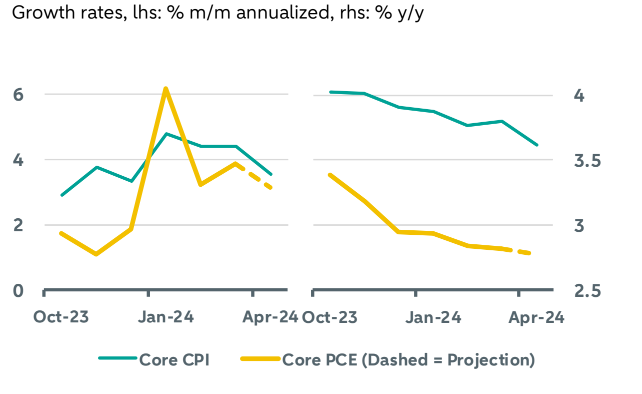
Such interest rate cuts depend crucially on inflation developments in the coming months. After unexpectedly hot readings in Q1, the headline and core inflation readings of 0.3% m/m in April brought a welcome relief after three months of no progress. In the absence of weakening labor markets, we will need stronger evidence of disinflation in the coming months for the Fed to start cutting rates in July. The April reading was an important first step for at least two reasons. First, it was sufficiently low for y/y inflation to restart its disinflationary trajectory, and second, it crucially showed a slowing in the all-important housing inflation component. As previously flagged in our coverage of the 1 May FOMC meeting (link), we think we will need to see three benign inflation readings for the Fed to have the confidence to start lowering rates in July. As we go to publication, the core PCE inflation data for April is expected to come in at 0.3% m/m, but – consistent with the CPI data for April – the details are likely to show reduced pressure from transportation services such as car insurance, and a continued pass-through of disinflation in housing. Our base case still sees such a number as consistent with a rate cut at the 30-31 July FOMC meeting, assuming the May and June data show further progress, but our view is increasingly challenged by commentary from Fed officials suggesting this might not be enough for the Committee to move so soon.

Weak growth but robust demand



Source: LSEG, ABN AMRO Group Economics

April inflation data points in right direction



Source: LSEG, ABN AMRO Group Economics

What would it take to derail a July rate cut? Not much. Since the May FOMC meeting, officials have revealed a more hawkish reaction function, consistently calling for patience due to reduced confidence in the outlook for inflation. Minutes from the latest meeting revealed that a number of members took a strong signal from the surprisingly strong Q1 inflation readings, even suggesting openness to further raising rates. Doubts were also raised over the degree of restrictiveness of current policy, given how resilient the economy has been. Likewise, some said that signs of weakness in activity or labor market data would be a prerequisite to start easing. Against this backdrop, even a small upside surprise in either the May or June inflation data would likely delay the start of the easing cycle to at least September. Barring idiosyncratic spikes in sub-components of inflation, the main source of such a surprise is still likely to be housing rents, where inflation has remained high, despite various leading indicators pointing towards an imminent decline (see our March Global Monthly). Big picture, the cooling labor market, benign wage growth and solid anchoring of inflation expectations remain consistent with inflation returning to 2% over the coming year in our baseline scenario.

China: A new approach to stabilising property

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- Domestic demand side remains weak, with property sector still in the doldrums
- Beijing comes with new approach to break the negative feedback loop in the property sector
- Upside/downside risks still 'in balance': property support versus new trade spats on excess supply

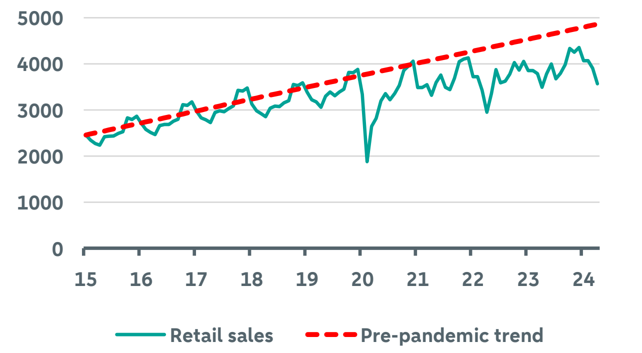
Macro data continue to show a divergence between strong supply and weak domestic demand, still dragged down by property sector woes. Beijing is trying something different now to break the negative feedback loop in property. At the same time, external risks are rising, as China's overcapacity contributes to a broadening of trade spats with the West.

Domestic demand remains weak, with property sector still in the doldrums

China's April data clearly point to ongoing macroeconomic imbalances, with the supply side stronger than the (domestic) demand side and the property sector remaining the largest drag. On the supply side, industrial production growth accelerated to 6.7% yoy (March: 4.5%), and by 1.0% mom (a post-pandemic rebound high). This partly rests on improving external demand (despite trade spats), with the export components of both manufacturing PMIs back in expansion territory since March. By contrast, the domestic demand side remains weak. Retail sales slowed to a meagre 2.3% yoy in April (March: 3.1%), falling even further below its pre-pandemic trend (see chart). Fixed investment slowed to 4.2% yoy ytd in January-April (Jan-March: 4.5%), with private investment growth still very weak (+0.3% yoy ytd). April data also show that, despite all kinds of previous targeted measures, the property sector is not out of the woods yet. In April, annual growth of property investment and residential property sales (see chart) fell even deeper into contraction territory, and home prices showed the sharpest monthly drop since 2015.

Private consumption still lagging

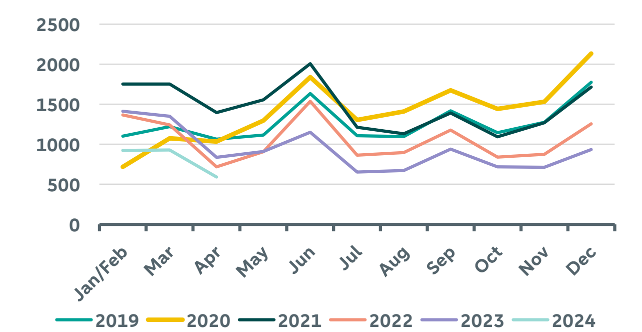
Nominal retail sales, CNY bn



Source: ABN AMRO Group Economics, LSEG

Housing sales have weakened even further

Sales of residential buildings, CNY bn



Source: ABN AMRO Group Economics, Bloomberg

Beijing's new attempt to break the negative feedback loop in property

Earlier this month, Beijing took further measures to stabilise the stumbling property sector. Floors for mortgage rates were removed, and minimum downpayment ratios for homebuyers lowered. Moreover, the PBoC introduced a CNY 300bn (± EUR 38bn) relending facility, through which local SOEs can buy completed, unsold property from developers and turn these into affordable housing. And another CNY 500bn (± EUR 64 mln) – aimed at urban reconstruction – will be made available through the Pledged Supplementary Lending facility. In addition, by means of special bonds, local governments are entitled to buy land from developers. The idea of these measures is to mitigate the financing distress of property developers, so that they can focus on the completion of projects. That should bolster confidence amongst potential homebuyers, and boost new home sales. That said, the facilities are small compared to the total outstanding stock of unsold homes, and there are many implementation issues and trade-offs at local government levels. While it is uncertain whether these measures will bring a 'quick-fix', they signal Beijing's increasing sense of urgency to tackle the biggest domestic drag to the Chinese economy, while (implicitly) supporting developers. All told, it remains to be seen whether this will be enough to break the negative feedback loop; if not, more targeted support will likely follow. All in all, we leave our growth forecasts for 2024 (5.1%, slightly above consensus) and 2025 (4.5%) unchanged for now. We still think risks to our growth forecasts are more or less balanced at the moment, as 'upside risks' from (more) property support are being (partly) offset by downside risks from the broadening of trade spats – with the US and the EU taking additional measures to shield their (strategic) industrial sectors from Chinese oversupply (also see here and here).

Key views on a page

Growth indicators are bottoming out in the eurozone and China, while the US economy is gradually cooling. Big picture, the global economy is slowly converging towards a more trend-like pace of growth, and this remains our base case for the second half of 2024. Global trade and industry are beginning to recover, but a sharp rebound is unlikely while rates remain restrictive. On the positive side, inflation has fallen significantly, although progress towards the 2% target has slowed in the US. The impact of the conflict in the Middle East has receded and the inflation impact is likely to be minimal. Further falls in inflation will enable central banks to pivot to rate cuts by mid-2024, and financial conditions have eased in anticipation of this. Still, interest rates will stay high for some time yet, and this will keep a lid on the recovery.

Macro	Central Banks & Markets
Eurozone – Q1 GDP for the eurozone came in above expectations (+0.3% qoq) ending a 5 quarter period of roughly stagnation. This provides cautious room for optimism about the bloc's economic performance this year. As growth was driven by some one-offs, Q2 activity is likely lower. Growth should expand moderately during the rest of the year, as trade and industry bottom out, which will support EZ exports. Domestic spending is expected to increase on the back of high wage growth and lower inflation but deteriorating labour market conditions and fiscal retrenchment prevent a strong recovery.	**ECB** – The ECB is expected to start cutting rates in June, in a widely telegraphed move. The ECB has said that if the inflation outlook, underlying inflation and the strength of monetary policy transmission were according to expectations, it would be appropriate to cut the policy rate. We believe these three conditions have been largely met already. ECB officials have so far played down expectations of a follow-on July cut, reflecting a general tendency to avoid forward guidance. Our base case sees rate being cut at each meeting after June, for a total of 125bp rate cuts in 2024.
The Netherlands – First quarter GDP showed an unexpected contraction of 0.1% qoq. We have revised our growth forecasts to 0.5% in 2024 (was 0.7%) and 1.3% in 2025 (was 1.2%). Growth will be driven by internal demand from households and the government. Later in 2024, as financial conditions ease and external demand increases, growth will pick up further. Inflation is continuing its downward trend. Although the price trend of products with a large wage component – such as labour-intensive services – cause the path down to take longer. We expect inflation to average 2.5% in 2024 and 2.1% in 2025.	**Fed** – We expect rate cuts to start in July, with a pause in September as the Fed waits to gain confidence in the inflation outlook. We expect consecutive rate cuts from November on. Hawkish Fed communication suggests the start of the easing cycle will be delayed in case of upside surprises to inflation this quarter. Monetary policy is expected to remain restrictive throughout 2024 and into 2025. We expect the upper bound of the fed funds rate to reach 4.75% by end-2024, and 3% by end-2025. Starting in June, the Fed will reduce the pace of QT, which has no implications for its monetary policy stance.
UK – Disinflation is continuing, providing some relief to the Bank of England, but upside inflation risks remain significant given that wage growth is still elevated and well above levels consistent with the 2% target. The economy is recovering from a prolonged period of stagnation, having been weighed by high rates and weak confidence. Wage growth is coming down, which should help to bring down services inflation. But the normalisation in inflation may take longer in the UK than in other advanced economies, due to historically higher inflation expectations, and stickier wage growth.	**Bank of England** – The MPC has kept policy on hold since last August. We think Bank Rate has peaked at 5.25%. The BoE is in full data-dependent mode, and UK macro data has been erratic over the past year. Our base case continues to see the BoE starting to cut rates in August. However, sticky wage growth – which poses upside risks to medium-term inflation – is likely to keep rate cuts at a more gradual pace than for the ECB and Fed; we expect only two rate cuts (total 50bp) in 2024, and four rate cuts (total 100bp) in 2025.
US – Following a surprisingly low growth reading in Q1 of 2024 on the back of higher imports, we expect a reversal with above trend growth for Q2. Still, weak bank lending and pockets of financial stress among households are likely to contribute to a slowdown in growth in the second half of the year, before returning to trend next year. Inflation has come in on the firm side in recent months, but pipeline pressures – particularly benign wage growth – continue to point to disinflationary progress resuming over the coming months.	**Bond yields** – Uncertainty about the number and timing (at least for the Fed) of rate cuts remains the key driver for markets. Recent macroeconomic data has once again reduced the number of cuts priced in for this year. However, our view remains that rates will fall going forward as we expect markets to reprice the estimated terminal rate lower once rate cuts start. The ECB is widely expected to start first (in June) and is likely to trigger such a move. Downward pressure is expected particularly on short-term rates, leading the yield curve to steepen in the second part of the year and beyond.
China - Divergence remains between strong supply and weak domestic demand, dragged down by real estate woes. Partly on the back of improving external demand, industrial production remains solid. Still, China's overcapacity leads to a broadening of trade spats with the West. Meanwhile, Beijing started a new approach to break the negative feedback loop in property – by facilitating local governments to buy homes from developers and turn them into affordable housing. While it is uncertain whether these measures will bring a 'quick fix', they signal an increasing sense of urgency to tackle the biggest macro drag.	**FX** – EUR/USD has been rangebound. EUR weakness from current levels will materialize in the coming months as long as the cut expectations on the ECB run ahead of rate cut expectations of the Fed. As soon as the Fed begins the easing cycle and markets start to anticipate a larger number of rate cuts in 2025, the dollar will probably decline. Our forecasts for Q2 and Q3 are 1.05 and for year-end 1.07. Our forecast for end 2025 stands at 1.10.

Main economic & financial market forecasts

	GDP				Inflation				Policy rate			
	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025
Eurozone	3.5	0.5	0.7	1.6	8.4	5.5	2.4	2.0	2.00	4.00	2.75	1.50
Netherlands	4.3	0.1	0.5	1.3	11.6	4.1	2.5	2.1				
UK	4.3	0.1	0.6	1.1	9.1	7.4	2.9	3.1	3.50	5.25	4.75	3.50
US	1.9	2.5	2.5	2.0	6.5	3.8	2.5	2.0	4.50	5.50	4.75	3.00
China	3.0	5.2	5.1	4.5	1.9	0.2	1.0	1.8	3.65	3.45	3.25	3.25

	2023	27/05/2024	Q3 24	2024	2025	Energy	2023	27/05/2024	Q3 24	2024	2025
US Treasury	3.88	4.47	3.90	3.75	3.25						
German Bund	2.02	2.55	2.10	1.90	1.75	Brent - USD/bbl*	77.04	83.1	85	90	80-85
EUR/USD	1.10	1.09	1.05	1.07	1.10	WTI - USD/bbl*	71.65	77.72	80	85	75-80
USD/CNY	7.10	7.25	7.15	7.10	6.80	TTF Gas - EUR/MWh*	35.25	39.23	35	40	35-40
GBP/USD	1.2731	1.28	1.26	1.28	1.30						

* Brent, WTI: active month contract; TTF: next calender year

	2023				2024				2025			
GDP (qoq)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone	0.0	0.1	-0.1	-0.1	0.3	0.2	0.2	0.4	0.4	0.5	0.5	0.5
Netherlands	-0.4	-0.4	-0.3	0.3	-0.1	0.5	0.3	0.4	0.3	0.3	0.3	0.4
US (saar)	2.2	2.1	4.9	3.4	1.6	2.5	1.5	1.5	2.0	2.0	2.5	2.5
UK	0.2	0.0	-0.1	-0.3	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.4
China (yoy)	4.5	6.3	4.9	5.2	5.3	5.6	4.9	4.7	4.3	4.4	4.7	4.7
Inflation	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone	8.0	6.2	4.9	2.7	2.6	2.5	2.1	2.2	2.1	2.0	2.0	2.0
Netherlands	7.2	6.3	2.7	0.4	3.0	2.5	2.4	2.3	2.2	2.1	2.1	2.1
US (PCE)	5.0	3.9	3.3	2.8	2.6	2.6	2.4	2.6	2.2	1.9	1.9	1.9
UK	10.2	8.4	6.7	4.2	3.5	2.3	2.7	3.1	3.4	3.2	3.0	2.8
China	1.3	0.1	-0.1	-0.3	0.0	0.5	1.3	2.2	2.1	1.9	1.7	1.6
Unemployment	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone	6.6	6.5	6.5	6.5	6.4	6.4	6.6	6.8	6.8	6.8	6.8	6.6
Netherlands	3.5	3.5	3.6	3.6	3.6	3.8	3.9	4.0	4.0	4.0	4.0	4.0
US	3.5	3.6	3.7	3.8	3.8	3.9	4.0	4.0	4.0	4.0	3.9	3.8
Policy rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone	3.00	3.50	4.00	4.00	4.00	3.75	3.25	2.75	2.25	1.75	1.50	1.50
US	5.00	5.25	5.50	5.50	5.50	5.50	5.25	4.75	4.50	3.25	3.00	3.00
UK	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.25	4.00	3.75	3.50
China	3.65	3.55	3.45	3.45	3.45	3.35	3.25	3.25	3.25	3.25	3.25	3.25

Source: LSEG, Bloomberg, ABN AMRO Group Economics

(saar = season adjusted annual rate)

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