ISSN: 2241-4851

Eurobank Research

EUROBANK

GLOBAL & REGIONAL MONTHLY

As evident in the latest PMIs surveys for 2022, the global economy is starting the new year on the back foot, as it continues to face several challenges. Meanwhile, though headline inflation has likely passed its near-term peak, it still remains above target, and labor market tightness contributes to strong wage growth, putting upward pressure on core services inflation. Several major CBs, thus, are under pressure to follow through with additional rate tightening as they remain resolute in restoring price stability, keeping open the option for continued large hikes early this year and restrictive policy for longer.

Macro Picture

USA: Growth still solid, but survey data continue to indicate slowing momentum

EA: The economy has likely slipped into a recession in Q4 2022, which however is expected to be short-lived and shallow

UK: Q3 GDP decline has likely marked the start of a prolonged recession as headwinds intensify

CESEE: Firm labor markets, high energy and food prices prevent inflation from pulling back

Markets

FX: The USD index nearly 10% down from September highs on slower Fed hiking, risk-on sentiment

Rates: Both EU and US short term yields consolidated at higher levels on continued hawkish rhetoric from the ECB and Fed

EM: Assets performed well due to weak dollar and expectations of lower Fed hikes

Credit: IG/HY decompression as narrative shifts from rates/inflation to fundamentals/recession

Policy Outlook

USA: The Fed is likely to maintain restrictive policy for longer to restore price stability

EA: The ECB to remain in a tightening mode given the risk of de-anchoring inflation expectations

UK: The BoE hiking cycle has further to run as wage growth continues to accelerate

CESEE: Subsidizing private consumption through capping prices or sharing costs continues

Key Downside Risks

DM: Enforced EU gas rationing, renewed uptrend in commodity prices, further deterioration in geopolitical tensions, over-tightening of monetary policy, more infectious Covid variants

EM: Further debt distress as financial risks mount, persistent energy price increases prolong disinflation and trim growth prospects for energy importers, spillovers from the slowdown of DM

Special Topic in this issue

→ Developed, emerging economies and commodities outlook for 2023

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January 2023

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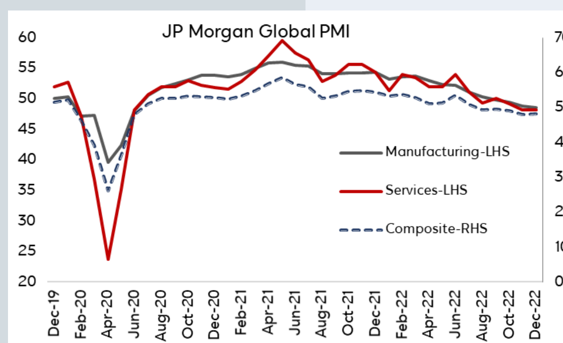
Macro Views

Latest world economic & market developments

The global economy is struggling to gain momentum, while inflation pressures remain elevated

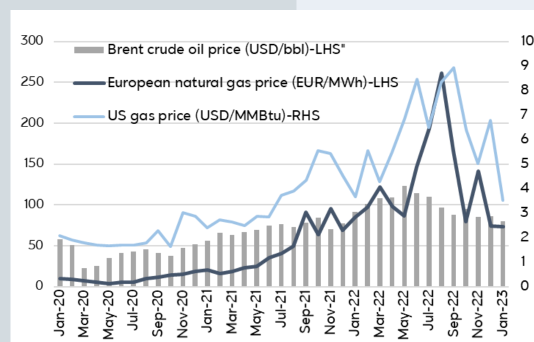
As evident in the latest PMIs surveys for 2022 from several major economies, the global economy is starting the new year on the back foot, as it continues to face several steep challenges. The J.P. Morgan Global Composite PMI (solely based on the output component within the manufacturing and services PMIs) edged up from November's 29-month low of 48.0 to 48.2 in December, though still among the lowest readings recorded in the last decade and still down near 7bps from its November 2021 peak. More importantly, although the December uptick signals a slower pace of contraction for the first time in the last three months fueling optimism that the downturn in global economic activity might have bottomed out, several closely watched forward-looking components remained in a downward trend, including new export orders which dropped for the tenth consecutive month at a pace close to October's 2 ½ year high, pointing, thus, to risks of more weakness ahead. The global manufacturing PMI fell further to 48.6 from November's 48.8, marking its fourth consecutive sub-50 reading, while the global services PMI remained unchanged at November's 29-month low of 48.1, with output contracting for the third month in a row. Encouragingly, broader inflation pressures continued to ease. The rate of increases in global input and output price indices, though still elevated, moderated further to a 24-and 22-month low (to 56.8 and 54.6), respectively, partly due to the continued improvement in global supply chain pressures, as indicated by a further recovery in the global delivery times PMI. Meanwhile, amid global growth concerns, oil prices have dropped sharply, with Brent remaining not far from early December one-year lows ($75.11/bbl). Similarly, the price of the European natural gas has declined by more than 50% since early December, as unusually mild weather at this time of year has reduced heating demand, keeping gas storages near 90% of their capacity compared to a five-year average of around 70%. Largely driven by falling energy prices, global headline inflation has likely passed its near-term peak. However, the deceleration is not sufficiently large, as it still remains unacceptably high relative to

Figure 1: Downtrend in global economic activity slightly moderated at the end of 2022



Source: Markit, Eurobank Research

Figure 2: Softer headline inflation momentum amid lower energy prices



Source: Bloomberg, Eurobank Research

the central bank target. Besides persistently high headline inflation, labor markets remain tight across most economies —in spite of early indications that they are probably starting to soften in the US and the UK— contributing to strong wage growth and exerting upward pressure on core services inflation. Obviously, cumulative rate tightening so far has only had a limited impact on labor markets, taking into account that the latter respond to tighter monetary policy with a time lag. Several major central banks, thus —with the exception of the BoJ— are under pressure to follow through with additional rate tightening, keeping open the option for continued large hikes early this year and restrictive policy for longer, as they remain resolute in preventing the de-anchoring of inflation expectations and a wage price spiral.

Developed Economies

US: According to the final estimate, US Q3 GDP was revised up by 0.3ppt to an annualized rate of 3.2% QoQ saar, marking a turnaround in economic activity after a 1.1%QoQ annualized GDP decline in H1. Looking into Q4, the majority of hard data have come in fairly strong, indicating continued solid GDP growth. In contrast, most of survey data continued to surprise to the downside, pointing to a deterioration in growth momentum and suggesting that the risk of a US slide into recession in the not-too-distant future is non-negligible, as the impact of tightening Fed policy will weigh more forcefully in economic activity in the period ahead. Meanwhile, both headline CPI and core CPI surprised to the downside in November for the second consecutive month, still remaining though elevated, and December's average hourly earnings growth still remained far too high to be consistent with the Fed's inflation target amid continued labor market tightness. With the Fed awaiting concrete signs of a sustained softening in labor market conditions and price pressures, expectations are for a further increase in interest rates, while restrictive policy will likely be maintained for longer so as for price stability to be restored on a sustained basis.

Euro area: Underlying inflationary pressures in the Eurozone remained elevated in December, as core inflation accelerated by 0.2ppt to a new all-time high of 5.2%YoY. However, headline CPI fell by a higher than expected 0.9ppt to 9.2%YoY — albeit still well above the ECB's target — mainly driven by lower energy prices. Nevertheless, a renewed uptrend cannot be ruled out in early 2023, due to, among others, delayed pass-through of past increases of wholesale energy prices to household bills, supporting the view that the ECB will remain firmly in a tightening mode in the coming months, to prevent a de-anchoring of inflation expectations. Meanwhile, as suggested by a string of hard data and sentiment indicators, faced with persistently high price pressures that erode consumer purchasing power and increase energy costs for businesses, the economy has likely entered a recession in Q4 2022 that may last until spring 2023. However, the expected downturn is likely to be shallower than earlier feared, with annual GDP near stagnating in 2023 after growing by an estimated 3.2% in 2022, mostly thanks to supportive fiscal policy, the reduced risk of gas rationing and a large consumer savings buffer.

Emerging Economies

EM: With the two major developed economies of the globe, the US and the EU, flirting with a recession or a GDP growth rate that points to a standstill mode of economic activity, this year's global growth rate will be almost fully fueled by the emerging world. According to the latest Global Economic prospects of the World Bank released on January 10, the global economy is projected to grow by 1.7% in 2023 with average growth in emerging market and developing economies (EMDEs) expected at 2.7% and 0.5% in the advanced economies (DMs). However, with EMDEs, diachronically, not ruling their own economic destiny but being strongly correlated with DMs performance, the outlook of the first is by no means rosy. Challenges persist resulting in an expected deceleration from 3.8% in 2022, 'reflecting significantly weaker external demand compounded by high inflation, currency depreciation, tighter financing conditions, and other domestic headwinds[1].' As the European emerging arm is the most exposed to geopolitical risks related to the war between the continental neighbors of Russia and Ukraine, and Latin America struggles with idiosyncratic political risks, the key contributors of the EMDEs economic growth in 2023 are geographically concentrated in Asia (*see EM Outlook p.13*). Russia and Ukraine are both expected to remain in recession in 2023 after falling in such grounds in 2022, spilling over the CESEE region economic deceleration in 2022 which will continue or even intensify in 2023 in the shape of skyrocketing energy costs and commodity prices.

CESEE: The drag on economic activity in the region due to the war in Q3 2022, with GDP growth decelerating to 3.3%YoY from 5.7%YoY in Q2 2022, a weakening stronger than the EU average (to 2.5%YoY from 4.3%YoY respectively) is expected to escalate in Q4 2022. The further slowdown will mainly stem from adverse external environment, tighter financial conditions and elevated inflation, weighing on disposable income and accordingly on private consumption. Besides, the rise of annual inflation during the war was more intense regionally than in the EU, as it escalated from 7.0% (excl. Turkey) in Q1 2022 (6.5% in the EU) to 12.6% in Q3 (10.3%). Local central banks have already procced with successive hikes of Key Policy Rates (Poland, Romania, Serbia etc.). The headwinds in Q4 2022 are reflected in the deteriorating activity of core economic sectors, such as industrial production, construction output, retail trade volume. The slowdown in European trading partners, albeit milder than initially expected in Q3 2022, will also escalate in the following months, especially in the first quarters of 2023, weighing on the current account balance. Idiosyncratic factors will affect economic activity in some economies (e.g. lingering political uncertainty in Bulgaria, implementation of the Stand-by Arrangement in Serbia). The World Bank, in its Global Economic Prospects released this week, downgraded its 2023 GDP growth for almost every regional peer compared to its previous review in June, sealing the worsening of economic prospects for the year ahead.

[1] https://www.worldbank.org/en/news/press-release/2023/01/10/global-economic-prospects

CESEE Markets Developments & Outlook

Bulgaria

The drivers behind the movements of local papers and Eurobonds during December broadly sum up to the continuing high inflation and the instability it brings to local markets. The ongoing conflict between Russia and Ukraine also weighs. Eurobond yields moved higher across all maturities. On the short-term spectrum, the 2023 title rose by 87 bps with the longer maturity bonds, namely the 2034 and 2035, posting increases of 24 bps and 35 bps, respectively. Local papers moved both ways. On the short-end the 2-year tenor rose by 22 bps, the 9-year tenor fell by 20 bps, while the 15-year tenor spiked by 24 bps.

Serbia

The National Bank of Serbia (NBS) does not seem to be affected by the new year's resolutions custom as it appears poised to continue ringfencing the dinar against both appreciating and depreciating dynamics. Therefore, the EUR/RSD is expected to fluctuate within the narrow margin of 117.35 – 117.80 for the whole year. Foreign currency reserves are strong enough to provide support in case of any economic or geopolitical instability, amounting to almost EUR14bn which is an all-time high level. The effort to keep dinar stable could be undermined by the sizable widening of the trade deficit which if not restrained any time soon, it could trigger additional macroeconomic imbalances such as an increase of the debt to GDP ratio, the fiscal deficit, diminished reserves and higher borrowing costs. According to official data by the NBS, the trade deficit amounted to EUR 9.64bn in 2022, widened by 58.9%YoY primarily due to the energy crisis and the collapse of the state electro-distribution network. However, tailwinds are expected from the inflationary front as price pressures are expected to ease. Towards that direction the next two monetary policy committees of the NBS could have some say on the matter as they look poised for a bit further tightening. Without a doubt, the pace of both the ECB and the Fed will determine the NBS's stance to a crucial extent regarding holding fire or not. Still, if the current account dynamics do not improve and the borrowing needs of the economy do not match with investors' appetite anytime soon, then the way could be paved for further tightening. Concluding with the fixed income space, the RSD bond curve continued to flatten as yields at the long end dropped by 50bps in December. The downward trend is anticipated to last in 2023, albeit at slower pace compared to the previous two months, amid the looming economic deceleration ahead.

Markets View

Foreign Exchange

EUR/USD: The pair is trading above 1.07 at the time of writing, after bouncing off from the 1.05 support level during the first week of the year. There is mixed consensus for the dollar at the moment, but the bearish case seems to prevail with US inflation expected to decline further and the Fed appearing closer to its terminal rate than the ECB. 1.10 is the next big level we expect to be tested after the current consolidation. A break of 1.05 is required to invalidate the bullish case for the par.

EUR/GBP: The bullish EUR sentiment and expectations that the BoE might be nearing the end of the current rate-hiking cycle, drove the pair higher, from 0.8540 low in December to 0.885 currently. We see the pair sliding down to 0.86 in the mid-term. A break of 0.8877 will open the way to 0.90.

Rates

EU: Short term interest rates increased in December post a hawkish ECB and are consolidating at these higher levels as the market has repriced the terminal rate higher, above 3%. The 10y Swap rate trading at 286bps up from 250bps low in December. The slope of the curve consolidated at the same levels, with 5s-30s trading at -65bps. Going forward we expect rates to continue their upward move as China's reopening, affecting Europe and Germany directly, will probably put extra pressure on the ECB to rein on inflation.

US: Swap rates remained volatile since our last issue driven primarily this time by a very hawkish ECB. The 10yr swap rate is trading at 350bps, a level similar to the beginning of December with the path going via 385bps. The slope of the 5s-30s part of the curve has consolidated close to -50bps. Looking forward, we expect the short end rates to move closer to 5% and remain there for a while as the market will price the end of Fed's hikes. Medium and long term rates are not expected to break last year's highs.

Emerging Markets Sovereign credit

A weaker USD, expectations of lower Fed hikes and the China reopening helped EM assets to advance further. The EMBI Global Index closed at 388 bps at the end of December, 14 bps tighter on the month, but this tightening is now fully reversed after the first week of the year. In CEEMEA, Romania continued trading strongly, while Hungary underperformed as the country still faces delays with the EU financing due to the rule of law conditionality process. In LATAM, the Mexican central bank hiked rates by 50bps, while in Brazil fear of fiscal slippage after the election of Lula along with turbulence caused by rioters supporting former president Bolsonaro has led to some underperformance. In Asia, Chinese sovereign bonds were little changed, while yields on Japanese government bond yields surged on the back of the surprising announcement of the BoJ that it will widen its yield curve control on 10-year bonds from 0.25% to 0.50%.

We remain cautious as volatility is still elevated, but we think that receiving EM rates is a rational trade as some countries will benefit from a US recession and lower US rates.

Corporate credit

Picking up where we left off in November, both Europe's Investment Grade (IG) and High Yield (HY) markets started the month on a risk-on tone amid strong buying interest. ECB's hawkish downshift at its December meeting led to a widening of spreads both in corporate cash and synthetics space but this faded quickly, especially in cash markets as they remained well bid. Notably, IG corporate cash spreads ended the month around -10/-15 bps tighter (outperforming US IG); Real Estate underperformed the move tighter (ended +20/+25bps wider) while Financials outperformed it (-18bps tighter). Volumes in Europe's primary market remained light amid seasonal year-end slowdown. EU CDS indices ended the month little changed underperforming cash. Noteworthy, iTraxx Crossover (HY) underperformed iTraxx Europe (IG), this IG/HY decompression indicates the focus shifting from rates/liquidity risks to fundamen-tal risks (iTraxx Crossover ended +15bps wider while iTraxx Europe -1bps tighter). On the other side of the Atlantic, both corporate cash and CDS indices underperformed their EU peers. More specifically, CDX IG ended the month +6bps wider while US IG corporate cash spreads were most-ly unchanged to -6bps tighter. A slow deterioration of the global economy in 2023 is expected and market's focus seems to be shifting from rates/liquidity risks to fundamental risk. Spreads are expected to move moderately wider while we expect IG to remain well bid outperforming HY both in cash and synthetics space.

Special Topic: Developed, emerging economies and commodities outlook for 2023

⇒ **Global economy:** After the global economy expanded by an estimated growth rate of 3.2% in 2022, less than half the pace in 2021 when it enjoyed a brink rebound from the Covid-19 crisis, expectations are for a further slowdown in 2023 as it continues to face steep challenges. The pandemic remains in place, the Ukraine war continues with no signs of resolution in the imminent future, Europe experiences an unprecedented energy crisis as supplies of Russian gas have been cut by more than 80% and major central banks pursue the most aggressive synchronized tightening cycle in decades in response to persistently high price pressures and labor market tightness as they remain resolute in bringing inflation back toward target, so as for price stability to be restored on a sustained basis. Against this backdrop, global GDP growth is seen slowing to around 2.0% this year, the third worst so far in the 21st century (after the pandemic year of 2020 and in the aftermath of the financial crisis in 2009), masked with substantial heterogeneity across economies.

Persistently high inflation eroding consumers' purchasing power and squeezing firms' profit margins, has probably already pushed both the Euro area and the UK into a recession before the end of 2022. Even so, the former is likely to climb out by mid-2023 as the hit from higher energy prices is slowly fading, but the latter is seen remaining in a recession by early 2024, as the economy is struggling with the rising cost of living, tighter BoE monetary policy, post-Brexit structural adjustments and weakening global growth. The US is also likely to slip into a recession around midyear as aggressive Fed tightening takes a toll on economic activity. However, consumer spending relative resilience to higher interest rates supports optimism that the recession will likely be milder than many market participants earlier feared. Noticeably, despite global headwinds, China, India and Japan are among the economies that are expected to fare significantly better than a number of major peers, partially offsetting global recessionary pressures mostly thanks to pent-up demand after post-Covid economic reopening.

However, growth risks are skewed to the downside. Importantly, energy rationing remains a key risk for Europe, especially if gas flows from Russia are reduced further in 2023 or/and this winter is unusually cold, depleting gas reserves, triggering natural gas shortages and production shutdowns. A renewed uptrend in commodity prices and a further disruption in global supply chains amid a further deterioration in geopolitical tensions, mainly as a result of the conflict in Ukraine and strategic competition between the US and China, could result in a further increase in commodity prices and supply chain disruptions, pushing central banks to hike rates further into restrictive territory. Last but not least, the resurgence of the pandemic through more virulent infectious variants and recurring lockdowns remains high on the risk agenda.

After reaching a peak in late 2022 driven by significant imbalances between supply and demand, global headline inflation is expected to decelerate in 2023, driven by negative base effects as energy and food prices inflation is expected to stabilize, lower aggregate demand amid an anticipated further slowdown in

global economic activity, and a further decline in commodity prices on the assumption that global supply bottlenecks will continue to dissipate. After rising sharply in 2021 and early 2022 due to expenditure-switching towards goods, core goods inflation is seen continuing to decline amid a post-Covid consumption shift away from goods towards services and reduced durable goods spending amid higher policy rates and increased economic uncertainty. Core services inflation pressures threaten, though, to decrease more slowly, especially in the US, given the expected lag from slowing aggregate demand to softening labor market conditions. Though price pressures are expected to fall back in 2023 after consistently surprised to the upside in the last two years, that process is seen to be rather slow with inflation remaining well above target throughout the year, forcing central banks to continue tightening policy aggressively before the expected slowdown in economic activity brings their hiking cycle to a halt.

US: GDP growth rebounded in H2 2022 from the technical recession of H1, almost exclusively driven by net exports amid declining imports, but the near-term outlook remains challenging. Private consumption growth, though still positive as a persistently tight labor market allowed households to continue whittling away excess savings, continues to moderate. Rapidly rising interest rates squeeze real incomes and weigh on investments, while tighter financial conditions continue to increasingly act as a drag on the interest rate sensitive sectors of the economy, including housing market activity. With the impact of the cumulative Fed monetary tightening expected to be mostly felt in the period ahead given the lags in the transmission of monetary policy on output, the US economy is seen remaining well below trend in 2023, with real GDP increasing by just 0.3% after a moderate recession begins around midyear and lasts around three quarters. Meanwhile, demand-driven inflation appears to have peaked and is expected to continue moving lower throughout this year, though still well above the Fed's target as wage growth, a lagging indicator, is seen slowing, but still remaining at a robust pace and too high to be consistent with the inflation target, on the back of a chronically constrained labor supply (reflecting an acceleration in retirements, long-term sickness and sluggish immigration). Mostly driven by weaker demand and a further gradual easing in supply chain constraints, core goods inflation is seen moderating further, while core services inflation is likely to be stickier, as it is not expected to show clear signs of moderation before end-H1 due to the tight labor market and elevated shelter inflation. After delivering a cumulative tightening of 425bps since March 2022 amid persistently elevated price pressures and a resilient labor market, the Fed is expected to continue hiking rates in the coming months, and likely retain them high for longer (the December median dots for 2023 were revised upwards at 5.1% from 4.6% previously).

Eurozone: Reflecting surprising resilience on supply chain disruptions and persistently high inflation, Eurozone GDP grew in 2022 by an average quarterly rate of 0.6% through Q3, twice the pace of potential growth, supported by government measures aiming to cushion the impact of higher energy prices, a strong labour market, a run-down in excess savings and a post-pandemic rebound in tourism and other services. Nevertheless, faced with persistently high price pressures that erode consumer purchasing power and increase energy costs for businesses, it seems difficult for the economy to avoid entering a recession in Q4 2022 that may continue until Q1 2023. Hopefully, the expected downturn is likely to prove less severe than earlier feared thanks to the reduced risk of potential gas shortages this winter (gas storages close to full capacity), expectations of a continued modest easing in global supply chains as demand is slowing, supportive government fiscal policy (and Next Generation EU funding), a relatively tight labor market, and

a large consumer savings buffer. However, the rebound from this recession, expected to start in Q2 as inflation is seen receding, is likely to prove modest due to the laggard impact of the ECB rate tightening, spillover effects from a US recession and a moderate fading in labor market resilience. For the whole 2023, GDP is expected to marginally decline, by 0.1%, after a significantly better than expected growth rate of around 3.2% in 2022. After surprised to the upside in 2022, headline inflation is seen entering a downward trend in 2023 mainly on the back of energy base effects, broad stabilization in commodity prices, reduced demand and a further easing in supply chain bottlenecks. That said, the expected easing will likely be very gradual, pointing to the risk of de-anchoring inflation expectations, mainly due to the delayed pass-through of past increases in natural gas and electricity prices to household bills and the continued pass-through of higher input costs to consumers. Core inflation is likely to prove stickier to come down as higher wage growth (even if unemployment is seen rising modestly) and services inflation are anticipated to offset a slowdown in core goods inflation on the back of global demand compression. Amid persistently above-target inflation, ECB policy rates are expected to move further higher despite a looming recession, accompanied by quantitative tightening (QT) starting in March through a gradual reduction of the APP portfolio at a monthly pace of €15bn.

Germany: While GDP surprised to the upside in Q3 2022 thanks to lagged effects on services consumption from the removal of Covid-19 restrictions, growth prospects remain gloomy, with the German economy expected to have slipped into a technical recession at the end of last year. The EU energy crisis and higher electricity prices weigh heavily on the economy, especially given its relatively high reliance on Russian gas and its large energy-intensive industrial base. Furthermore, private consumption and business fixed investment should increasingly feel the impact of tighter financial conditions and elevated price pressures, while slowing foreign demand should hinder activity in the export-dependent manufacturing industry. However, higher than expected government relief packages for households and businesses, the reduced probability of a gas rationing amid fully stocked gas storage sites and a modest easing in supply chain disruptions should help to mitigate the expected downturn before a modest recovery starts taking shape from Q2 2023 onwards, with annual 2023 GDP growth expected to shrink by 0.5% after an estimated rise of 1.9% in 2022., After rising again in the early months of the year as utility companies will adjust their prices to reflect the past increase in wholesale gas and electricity prices, inflation is seen decelerating thereafter, mostly thanks to the government's electricity and gas price caps that take effect in March and remain in force until at least April 2024. Though, the expected inflation moderation will likely be slow, with 2023 HICP averaging at a still high 6.5%, mostly due to a noticeable rise in negotiated wage growth that reflects fundamental robustness of the labour market.

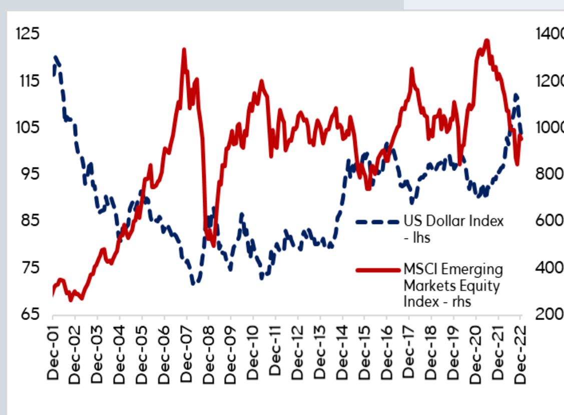
France: After rising by an estimated 2.5% in 2022, the French economy is expected to lose momentum, entering into a recession in H1 2023, as elevated inflation and higher interest rates take a toll on domestic demand, while lower global demand weighs on export growth. However, the recession is likely to prove moderate thanks to the measures taken by the government to caution the impact of higher energy prices, even though support will be less generous this year as it intends to reduce fiscal cost and provide incentives for a reduction in energy consumption (both regulated electricity and gas prices will increase by 15% in January and February, respectively — a larger rise than the 4% increase in 2022— and then be capped for the remainder of 2023, while rebates on fuel prices were abolished in end-2022 and were replaced with

more targeted support measures). The subsequent recovery, though, will probably be subdued, with 2023 GDP change expected at 0.2%, amid a combination of high economic uncertainty, tighter financing conditions and a weaker labor market. Meanwhile, after reaching a peak in early 2023 following the aforementioned changes in the so—called energy tariff shield, inflation is expected to start moderating thereafter, mostly driven by base effects on energy prices, but only very gradually as past rises in wholesale energy prices have not yet fully passed through. On the political front, the loss of the absolute majority in the National Assembly suggests that President Emmanuel Macron will likely face significant hurdles to pass crucial reforms, including a pension reform law, envisioning, inter alia, a gradual rise in the minimum retirement age by 2031.

UK: Inflation has likely marked a near-term peak in October as energy base effects should begin dragging the annual comparison lower, largely due to the government's Energy Price Guarantee that envisions a higher energy cap for the average household energy bill. Meanwhile, global supply chain disruptions continue to ease modestly, several commodity prices have turned negative in annual terms and aggregate demand is seen weakening amid an expected sharp downturn in economic activity. That said, price pressures should ease in the coming months, though slowly, remaining well above the BoE target throughout 2023, mostly owing to an expected continued strong momentum in food prices, the rise in the energy cap in April and continued strength in core services inflation amid wage growth acceleration on the back of persistent labor market tightness. Against this backdrop, the BoE is expected to continue raising interest rates in the first half of 2023 and be cautious about easing prematurely as wage growth is seen moderating slowly, despite a looming protracted recession, and remaining above levels consistent with its inflation target, as labor market tightness will likely prevail for longer amid a surge in economic inactivity due to long-term sickness (e.g., long Covid) and lower net migration, partially due to Brexit. The economy surprised to the upside in H1 2022 but the negative GDP print in Q3, the first one since the pandemic (Q1 2021), likely marks the beginning of a prolonged recession that is anticipated to last for four quarters, as headwinds are intensifying. In combination with the weakening global economic activity, tighter financial conditions amid rising BoE interest rates, real income squeeze on consumers and businesses on the back of persistently high inflation, weaker confidence, higher prices for imported goods after Brexit (especially for natural gas and goods), reduced fiscal stimulus following the UK government's Autumn Statement which entailed fiscal consolidation of £55bn per annum by 2027/28 (1.9% of GDP) and the slowing housing market amid much higher mortgage rates, should weigh on GDP growth which is expected to slow from an estimated 4.4% in 2022 to around -1.0% in 2023.

⇒ **Emerging Markets:** Either you name it BRIC[2] , CIVETS[3] or MINT[4], it is emerging markets and developing economies that will narrate 2023's growth story. With the two major developed economies of the globe, the US and the EU, flirting with a recession or a GDP growth rate that points to a standstill mode of economic activity, this year's global growth rate will be almost fully fueled by the emerging world. According to the latest Global Economic prospects of the World Bank released on January 10[5], the global economy is projected to grow by 1.7% in 2023 with average growth in emerging market and developing economies (EMDEs) expected at 2.7% and 0.5% in the advanced economies (DMs). However, with EMDEs, diachronically, not ruling their own economic destiny but being strongly correlated with DMs performance, the outlook of the first is by no means rosy. Challenges persist resulting in an expected deceleration from 3.8% in 2022, 'reflecting significantly weaker external demand compounded by high inflation, currency depreciation, tighter financing conditions, and other domestic headwinds.'[6] As the European emerging arm is the most exposed to geopolitical risks related to the war between the continental neighbors of Russia and Ukraine, and Latin America struggles with idiosyncratic political risks, the key contributors of the EMDEs economic growth in 2023 are geographically concentrated in Asia. Russia and Ukraine are both expected to remain in recession in 2023 after falling last year, spilling over the CESEE region economic deceleration in 2022 which will continue or even intensify in 2023 in the shape of skyrocketing energy costs and commodity prices. In the following lines we attempt a brief and concrete outlook of China and India with the two economies accounting to ca 20% of the global GDP, which could climb to 35% up to 2060[7], nearing the US and EU joint share currently.

Figure 3: Emerging markets and the US dollar in a diachronic reverse contango



Source: Bloomberg, Eurobank Research

China: While economic activity deteriorated markedly in 2022 due to Covid-19 related restrictions, rare heatwaves causing draughts and real estate sector imbalances, it is broadly expected to fare better in 2023 as the economy has embarked towards a pro-growth approach abandoning faster than expected the crisis management mandate it had served during the past three years under the recently abolished zero-Covid tolerance policy. From a GDP growth rate of 8.1% in 2021, the economic output is estimated to

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[2] Acronym coined by the economist Jim O'Neill in 2001 standing for the developing economies of Brazil, Russia, India, China https://www.goldmansachs.com/insights/archive/archive-pdfs/build-better-brics.pdf
[3] Acronym coined by Robert Ward of the Economist Intelligence Unit in 2009 standing for the developing economies of Colombia, Indonesia, Vietnam, Egypt, Turkey, and South Africa https://www.economist.com/the-world-in-2010/2009/11/26/brics-and-bicis
[4] Acronym coined by Fidelity Investments in 2014 referring to the developing economies of Mexico, Indonesia, Nigeria, and Turkey https://www.businessinsider.com/jim-oneill-presents-the-mint-economies-2013-11
[5] https://www.worldbank.org/en/news/press-release/2023/01/10/global-economic-prospects
[6] Global Economic Prospects, World Bank, January 2023
[7] https://www.jcer.or.jp/english/2060-digital-global-economy

have expanded by 3% - 3.5% in 2022 before rebounding close to 4.5% in 2023. We foresee an economic upturn through the return to normalcy and the pent-up demand entailed once the reopening stabilises. The exact time period this will happen in 2023 depends on dynamically changing factors such as the progress of vaccination, the continuing increase of ICUs and the massive access to anti-Covid medicine which is currently in the works. Taking into account the above, some serious decompression should be expected after Q12023 and from that point onwards, spillover from the improvement in the economic sentiment of consumers and the retreat of uncertainty over job losses could act supportively, among other sectors, to the real estate activity as pending decisions over the purchase of property and residential items could be routed back towards execution. Fiscal and monetary policy are expected to remain supportive during the transitory period of the reopening and stabilise thereafter, i.e., sometime after H12023. While fiscal stimulus will be provided more deliberately, albeit cautiously, monetary support will most probably come in the form of RRR cuts rather than interest rate cuts, when several major central banks in the rest of the globe, including the Fed and the ECB, remain clearly on a tightening mode.

India: The Covid-19 pandemic led India's economy into a contraction of 6.6% in 2020, despite the well-crafted fiscal and monetary policy support. However, in 2021, it bounced back, recording the strongest GDP rebound (+8.9%) among the G20. In 2022 the economy lost some of its momentum as inflation remain elevated due to rising global energy and food prices and global financial and economic conditions deteriorated. Having achieved a 5.5% average GDP growth rate over the past decade, 2022 is considered an above trend year, as based on the most recent forecasts by the OECD and the WB, with real GDP estimated to have grown by 6.9% in 2022, reflecting strong private consumption and fixed investment growth. The slowdown in the global economy and the rising uncertainty will weigh on export and investment growth in the running year, translated into a slight slowdown of GDP growth to 6.6%, which ranks among the fastest growth rates between the largest EMDEs. Looking over and beyond 2023, a lot has been written on how soon India is projected to take over, in terms of economic magnitude, large, developed economies. Indicatively, there are reports[8], according to which, India is on track to become the world's third largest economy by 2027, surpassing Japan and Germany thanks to global trends and key investments the country has made in technology. Namely, three megatrends—global offshoring, digitalization and energy transition—are setting the scene for unprecedented economic growth in the country of more than 1bn people, accounting for almost 18% of global population and ranking second with respect to that gauge, after China.

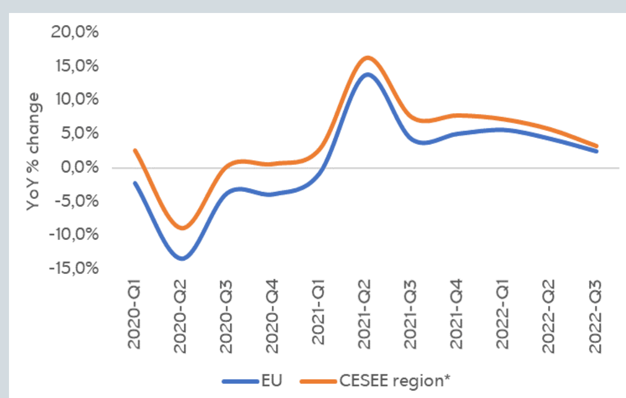
⇒ **CESEE:** Because of their proximity to Ukraine and their strong economic relationships also with Russia, many of the countries of the CESEE region are included among those which could be mostly affected by the Russo-Ukrainian war. That said, the strong growth momentum in 2021 in the CESEE countries (+8.3%, +6.2% excl. Turkey)[9] continued in H1 2022, as GDP spiked by another 6.5%YoY (6.1%YoY excl. Turkey)[10] against a 5.0%YoY average increase in the EU, mainly due to the GDP rise in Poland (+8.1%YoY). The drag on economic activity due to the war started becoming evident in Q3 2022, as growth decelerated to

[8] https://www.morganstanley.com/ideas/investment-opportunities-in-india
[9] Source: Eurostat, Eurobank Research. No data available for Albania
[10] No data available for Albania, Bosnia - Herzegovina, Montenegro, Kosovo

3.3%YoY (2.7%YoY excl. Turkey), with the weakening being stronger than that at EU-level (from 5.0%YoY to 2.5%YoY). In most countries of the region the slowdown, expected to continue in Q4 2022, is attributed to tighter financial conditions and elevated inflation, weighing on disposable income and accordingly on private consumption. Besides, the rise of the average annual inflation during the war is more intense than in the EU, as it climbed from 7.0% excluding Turkey in Q1 2022 (6.5% in the EU) to 10.2% in Q2 (8.8%) and 12.6% in Q3 (10.3%)[11].

Unfavorable financial conditions, heightened uncertainty due to the war and continuing inflationary pressures, albeit likely lower in most countries than in 2022, because of fiscal measures and price caps to mitigate the impact of high energy prices, are expected to dampen growth in 2023 in the CESEE region, before it gradually resumes from 2024 onwards. The resilience of public investments in the EU countries of the region will come from EU structural and RRF funds. Additionally, idiosyncratic factors will define economic activity in some of the biggest CESEE economies and countries of high economic interest.

Figure 4: GDP growth rate, EU and CESEE region*



*excl. Kosovo/Montenegro/North Macedonia
Source: Eurostat, Eurobank Research

Poland: A reversal in the inventory cycle following a period of strong restocking is expected to cause a significant drag on private investments and growth over the following quarters. That said, a rise in defense expenditure and local government investments spending will counterbalance or even outweigh the drop in private investments. Accordingly, the GDP growth is forecasted to narrow close to 1.0% in 2023 from ca 4.0% in 2022.

Bulgaria: The trend in inflation will be a key factor for economic developments in the new year, as food prices kept increasing up to late 2022 by an accelerating pace (26.1%YoY in November) despite the slowdown in the headline print and are expected to ease gradually in 2023, stressing household budgets. The impact of persistent inflation could be broader, as it can trigger setbacks for the euro adoption, a possibility clearly stated by both Fitch Ratings and S&P recently. The lingering political uncertainty after the Oct-22 elections and higher interest rates will be deterring factors to investment decisions, which are expected to be supported by higher absorption of EU funds, including the RRF. The deterioration of the

[11] Weighted average inflation, based on countries' shares to total household consumption in the region. No data available for Bosnia - Herzegovina, Montenegro, North Macedonia, Kosovo.

economic activity in Europe will negatively affect exports, one of the most significant drivers of the recovery in 2021. Consequently, growth will continue at a slower pace in 2023, ca 1.5%, against 3.1% in the previous year.

Serbia: The severe impact of the drought on agriculture and adverse developments in the energy sector are the idiosyncratic factors that weighed on growth in 2022 and dampen the country's economic outlook for 2023. The negative effects of the drought extend over food prices, exports of goods and hydro power generation. Higher than expected imported energy prices and electricity production problems led to the Stand-by Arrangement between the new government and the IMF in December, which succeeded the Policy Coordination Instrument (PCI) of Jun-21. To offset increased energy costs, the agreed program involves raising energy tariffs, which will put further pressures on real household income. On the other hand, the authorities have approved additional expenditure for 2023 to mitigate the high cost of living, without undermining fiscal sustainability. However, due to the mentioned unfavourable developments, growth will slightly decelerate in 2023, to 2.3% from 2.5% in 2022.

Turkey: The unconventional monetary policy that is being followed since Sep-21, with successive policy rate cuts (900bpts cumulatively up to Nov-22), is weighing on household consumption expansion and investment appetite, through soaring inflation and heightened uncertainty, mainly because of the extensive Turkish Lira (TRY) devaluation (-52.4% vis-à-vis USD during Sep-21 - Dec-22). Inflation is projected to decline in 2023, due to base effects and macroprudential measures deterring a significant further TRY devaluation, but remain above 40%, as another minimum wage increase (+54.6%) will be put in force in 2023 and expansionary fiscal policy will continue, in view of the presidential elections in June. Subdued growth in some of the main trading partners in Europe will weigh on exports. Weak business confidence and political uncertainty ahead of the presidential elections are expected to put a drag on investments. Overall, growth is forecasted to ease to ca 2.5% in 2023, from 5.2% in 2022.

Cyprus: The strong growth momentum in 2021 lost little pace in the next year, as tourist inflows from certain European countries increased sharply and investments expanded significantly. That said, the expected slowdown in the EU in 2023 will severely hamper tourism revenues. Credit expansion towards businesses decelerated significantly in H2 2022, impeding investments. This trend in credit supply will not be reversed as long as the loans foreclosure suspension is extended, a measure also inhibiting progress in the milestones related to the country's RRP. However, in 2023 the mobilisation of RRF funds will be higher than in 2022. Inflation already recedes, on the back of support measures, relaxing pressures on household consumption. Overall, Cyprus is expected to grow by ca 2.0% in 2023, albeit much slower than in 2022 (5.3%).

⇒ **Commodities:** Trends in the demand and prices of energy commodities and industrial metals in 2023 are expected to be driven mainly from Covid-19 developments in China, how the Russo-Ukrainian war will evolve, decisions by some of the major exporters globally, e.g., OPEC countries for petroleum products, China for aluminium production, Indonesia for coal.

Crude Oil: The major uncertainty in the oil markets in 2022 was how Russian supply would hold up after a number of countries banned the country's energy exports. Russian oil supply has held up better than most expectations, as India and China significantly raised their purchases, benefiting from steep discounts. That said, the impact of the EU ban on Russian crude oil from 5 December 2022 is expected to be felt in the course of 2023. As the ability of India and China to largely absorb another significant amount of Russian oil is considered limited, in combination with the fact that they are large producers of other materials used for energy production (e.g. coal), the country's supply will likely be reduced compared to 2022. OPEC+ decision to cut output targets by 2MMbbls/d (-4.6% of Oct-22 production) from November 2022 until the end of 2023, clearly states that the coalition is not willing to contribute to a widening of global oil supply. The response of US producers to war challenges significantly falls behind expectations, with US crude oil supply forecasted to grow by ca 5.4% in 2022 and ca 4.2% in 2023. The combination of lower Russian oil supply and OPEC+ supply cuts implies that the global oil market will most likely tighten over 2023, which suggests that oil prices will gradually trade higher from current levels. Indicatively, ICE Brent price is expected to average 20%-25% higher than the recent levels (≈US$80/bbl), however slightly below its Jan-Oct 22 average price (US$103.7/bbl).

Natural Gas: Milder than usual weather conditions in the early heating season, combined with demand destruction, due to skyrocketing gas prices, have helped Europe to build gas inventories, reaching nearly 96% of their capacity in mid-November, above the last five-year average of 88% for this time of the year. On the other hand, daily Russian gas flows to the EU in Dec-22 were down by ca 80%YoY and there is a clear risk that the remaining flows will be halted after the EU ban on Russian crude oil. Liquefied natural gas (LNG) imports to the EU contribute to inventory building (+58%YoY in 2022), however their share to total gas imports remains low. Given that global LNG export capacity is expected to grow by only 19bcm in 2023, expanding the average daily LNG global trade by approx. 0.1% in 2021 export terms, there is no ample space for a further LNG import increase in the EU this year, unless flows to some other major consumers decline sharply. The resurgence of Covid-19 in China could lead to such developments, depending on its implications for economic activity. The fact that 46% of total new export capacity will originate from Russia, which is already heavily sanctioned by the EU, limits the region's access to a significant part of new LNG resources. Therefore, Europe is likely to go into the 2023/24 winter with tight storage, leading gas prices much higher than recent levels, around €68/MWh. The outlook for US gas prices is more bearish, as US dry gas production is expected to hit record levels in 2023, growing by approx. 1.6%, to average 99.7bcf/day. On the consumption side, after strong demand in the summer of 2022 from the power sector, most of the forecasts for 2023 point to a fall back towards more normal levels.

Turning to expected price developments in basic metals and non-metallic ores in 2023, after the abrupt exit from zero-Covid policy in China and despite the unprecedented spike in coronavirus cases, **cooper** prices rebounded, with the 3-month price in the London Metal Exchange (LME) increasing by 5.6% from mid-December to early January and reaching a six-month high, above US$8700/t. Copper inventories available to withdraw from the LME warehouses fell in Dec-22 by the most in a month. As China has been for years the world's biggest importer of refined copper, a re-opening of its economy could push copper prices to levels such as those during the preparation of the 2022 winter Olympic Games in Beijing

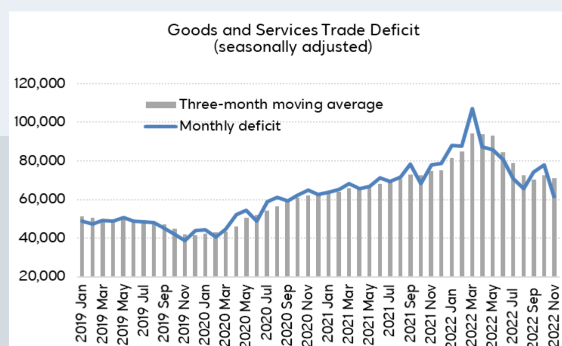
(≈US$9500/t). Copper longer-term prospects are supported by demand for the energy transition process. Concerning trends in **aluminium** prices, given that China's primary aluminium production hit successive monthly records in July and August, with the FY2022 output standing at 40.1 million tonnes (+4.1%YoY) and the fact that the LME decided in November not to ban the trading of Russian metals (aluminium, nickel, copper) in its system, a resurgence of economic activity in China will not boost prices significantly upwards from their current 19-month low levels in London and Shanghai. On the contrary, the subdued economic activity globally could push prices even lower, e.g., through softer demand from the automobile industry and the construction sector. The extension of the 2022 **coal** price cap in China in 2023, at a slightly lower level (675 yuan/t from 700 yuan/t), will deter a rise in coal prices. Although Indonesia and India have announced higher production targets for 2023, these are part of their goal to meet domestic needs internally. In case these strategies include bans of shipments for certain periods, as happened last year with coal in Indonesia, world's biggest exporter, market conditions will tighten, pushing prices higher than the current post-war low level of ca. $165/t (Argus/McCloskey's API2 CIF physical price).

US

Growth still solid, but survey data continue to indicate slowing momentum

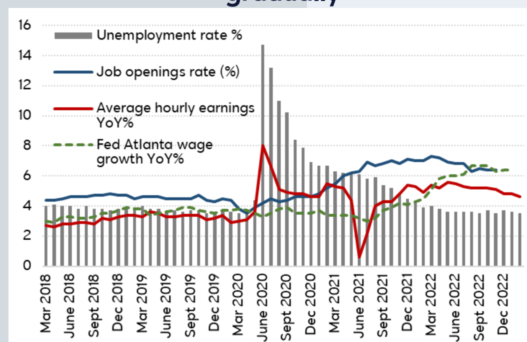
According to the final estimate, US Q3 GDP was revised up by 0.3ppt to an annualized rate of 3.2% QoQ saar, marking a turnaround in economic activity after a 1.1%QoQ annualized GDP decline in H1. The main driver was a sizable increase in personal consumption by 3.2%QoQ from 1.7%QoQ saar previously estimated. Looking into Q4, the majority of hard data have come in fairly strong, pointing to continued solid GDP growth. Inter alia, the trade deficit unexpectedly narrowed from October's $99.4bn to $84bn in November, the lowest in almost two years (nominal goods imports down 7.5%MoM vs. a 3.0%MoM drop in goods exports), inventories increased strongly (wholesale and retail inventories up by 1.0%MoM and 0.1%MoM, respectively) and construction spending rose by 0.2%MoM in November against expectations for a further decline. Against this background, as of January 10, the Atlanta Fed's GDPNow model projects an annualized growth rate of 4.1%, up from 3.7% in mid-December. In contrast to encouraging hard data which indicate that the economy still has enough momentum to withstand further Fed policy tightening, most of survey data continued to surprise to the downside, pointing to a deterioration in growth prospects and suggesting that the risk of a US slide into recession in the not-too-distant future is non-negligible, as the impact of tightening Fed policy will weigh more forcefully in economic activity in the period ahead (given the lags of monetary policy). Among others, the ISM manufacturing PMI fell further into contraction territory in December (-0.6ppts to 48.4) and the respective services index unexpectedly dropped below the threshold of 50 for the first time since May 2020 (-6.9ppts to 49.6). Meanwhile, both headline CPI and core CPI surprised to the downside in November for the second consecutive month (down to 7.1%YoY and 6.0%YoY, respectively), still remaining though elevated, while December's average hourly earnings growth, amid continued labor market tightness in spite of tentative signs of slowing, still remained far too high to be consistent with the Fed's inflation target (4.6%YoY from 4.8%YoY). With the Fed awaiting concrete signs of a sustained softening in labor market conditions and price pressures — a precondition for ending the current tightening cycle — expectations are for a further increase in interest rates in the coming months, while restrictive policy will likely be maintained for longer so as for price stability to be restored on a sustained basis.

Figure 5: Goods trade deficit unexpectedly narrowed to a 2-year low in November



Source: BEA, Eurobank Research

Figure 6: The labor market is slowing, but only gradually



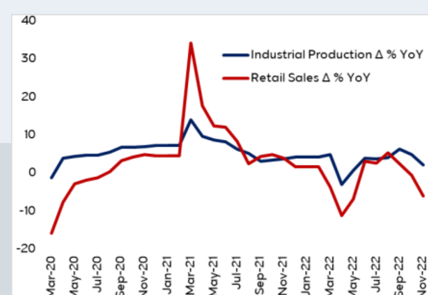
Source: BLS, Fed Atlanta, Eurobank Research

China

Embarking towards a pro-growth, still bumpy, 2023

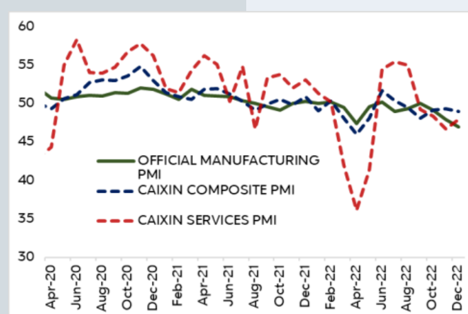
One month after the long-waited abandonment of the Zero-covid strategy, the current situation in the country is far from rosy but at the same time it is considered as transitory. The reopening is progressing faster than expected as if Chinese authorities and policy makers have decided to minimize the transitory period towards a Covid-endemic way of life during which a high social cost from increased infections will have to be paid. After the current stage, we foresee an economic upturn through the return to normalcy and the pent-up demand this will entail. The exact time period this will happen depends on dynamically changing factors such as the progress of vaccination, the continuing increase of ICUs and the massive access to anti-Covid medicine which is currently in the works. With an additional blow in infections expected from the two-week Lunar Year festivities that begin on January 22 and entail increased social mobility especially from cities to the provinces, some serious decompression should be expected after Q12023. Prior to this, specifically in mid-January, Q42022 GDP growth data will be released and while the consensus stands close to 2.0% YoY leading to a FY2022 headline growth rate just below 3.0%, in a pivot movement, President Xi, in a televised New Year's Eve speech, inferred that "China's economy grew at least 4.4% in 2022" which requires a GDP growth rate above 8% YoY in Q42022 for this to realise, unless some serious revision for the previous three quarters that average to a 3.2% YoY GDP growth rate intervenes. Looking ahead, 2023 is broadly expected to far better than 2022, even under the more optimistic view from the horse's mouth, as the economy has embarked towards a pro-growth approach abandoning faster than expected the crisis management mandate during the past three years. The most recently released economic data, either hard referring to November or soft as for December, are not suitable for extracting conclusions for what will follow in 2023. Nor the declining industrial production growth (+2.2% YoY, market consensus +3.5% YoY, +5.0% YoY in Oct) or the shrinking retail sales (-5.9% YoY, market consensus -4.0%, -0.5% YoY in Oct) in November have captured the ease of restrictive measures that followed, rather they could stand as proof of the necessity for ditching the zero-tolerance approach against Covid. Additionally, the latest PMIs, except the Caixin services which improved albeit remaining below 50, deteriorated, reflecting the transit status of the economy where things will have to get worse before they start improving.

Figure 7: Hard data underline the necessity for the zero-covid tolerance abolishment ...



Source: Bloomberg, Eurobank Research

Figure 8: while PMIs imply that things will get worse before they start to improve



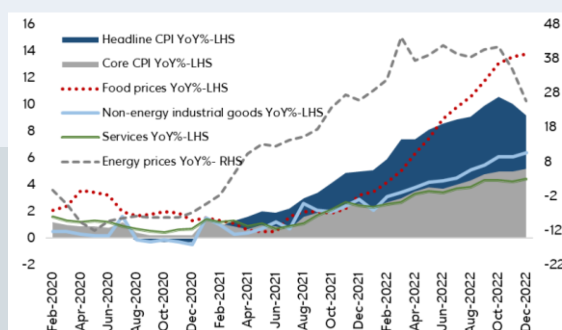
Source: Bloomberg, Eurobank Research

Euro area

The ECB to remain in a tightening mode amid persistently elevated inflation

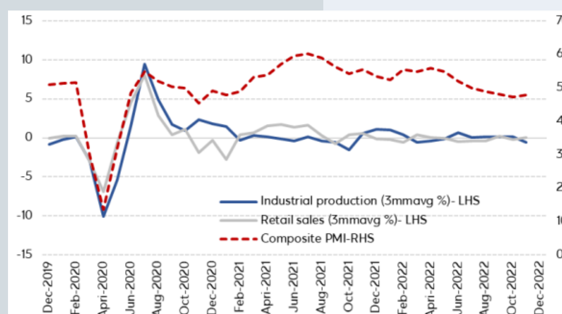
According to the flash estimate, underlying inflationary pressures in the Eurozone remained elevated in December, as core inflation accelerated by 0.2ppt to a new all-time high of 5.2%YoY, a move evenly split between core goods and services price inflation which rose by 0.3ppt and 0.2ppt, to 6.4%YoY and 4.4%YoY, respectively. However, headline CPI fell for the second consecutive month by a higher than expected 0.9ppt to 9.2%YoY — albeit still well above the ECB's target — mainly driven by lower energy prices (-9.2ppts to 25.7%YoY), while the German government's one-off payment of household energy bills, as part of a phased two-stage cap on energy prices, also had an impact. Nevertheless, a renewed uptrend cannot be ruled out in early 2023, before a sustained downward move begins thereafter, baring a renewed uptrend in energy prices. Though wholesale energy prices have retreated from their summer highs, there is still some delayed pass-through of past increases to household bills. In addition, many energy contracts will be renewed in January, some subsidies to pump prices will be phased out (e.g., France), regulated energy prices will rise by 15% in France (vs. 4% in 2022) and the effect from the German government's one-off gas relief payment will be fully reversed in January. Amid persistently elevated price pressures, the risk of de-anchoring inflation expectations prevails, as the relevant market-based measures remain elevated relative to post-GFC levels (5y5y at 2.3%). Against this backdrop, the ECB is seen remaining firmly in a tightening mode, with President Christine Lagarde clarifying at the December post-meeting press conference that interest rates will have to rise "at a steady pace" of 50bps "for a period of time" to reach levels that are "sufficiently restrictive" in order to bring inflation back to 2% in a "timely" manner. Meanwhile, as suggested by a string of hard data (e.g., retail sales, IP) and sentiment indicators (e.g., PMIs), faced with persistently high price pressures that erode consumer purchasing power and increase energy costs for businesses, the economy has likely entered a recession in Q4 2022 that may continue until spring 2023. However, the expected downturn is likely to be shallower than earlier feared, with annual GDP near stagnating in 2023 after growing by an estimated 3.2% in 2022, mostly thanks to supportive fiscal policy (and Next Generation EU funding), the reduced risk of gas rationing and a large consumer savings buffer (13.2% of disposable income in Q3 2022).

Figure 9: Headline CPI fell further in December, while core CPI accelerated ta o fresh record high



Source: European Commission, Eurobank Research

Figure 10: Data pertaining to Q4 2022 point to a recession, but likely a mild one



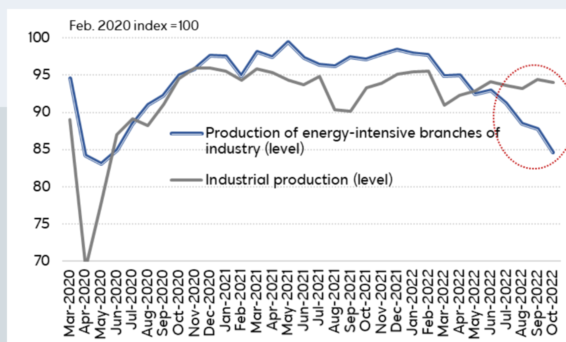
Source: Eurostat, PMI, Eurobank Research

Germany

The expected growth downturn is likely to be less pronounced than earlier feared

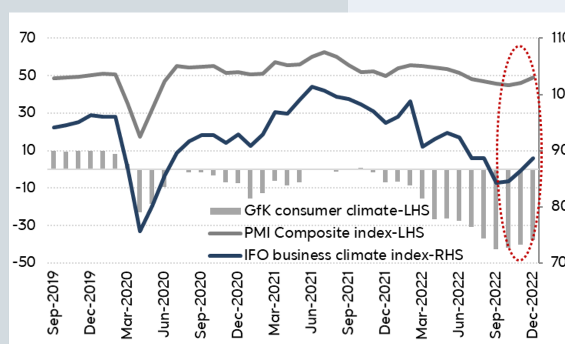
Defying earlier expectations of a recession amid sharply higher energy prices after Russia cut off gas supply exports via the Nord Stream 1 pipeline, the German economy managed to grow in Q3 by a healthy 0.4%QoQ from 0.1%QoQ in Q2. Reflecting lagged effects from the abolition of Covid-19 restrictions, private consumption was the main growth driver (+1.0%QoQ, +0.5ppt) amid strong pent-up demand for travel and contact-intense services, while investment in machinery and equipment was the second biggest positive contributor to GDP growth (+2.7%QoQo, +0.2ppt). However, growth prospects continue to look gloomy, and the positive Q3 GDP growth print has more likely delayed rather than postponed a looming recession. In spite of the ongoing resilience of the labor market that has started to exert an upward pressure on wages (unemployment stable at 5.5% in December for the fifth consecutive month) and a healthy household saving rate (up at 11% in Q3 from 10.8% in Q2), private consumption is unlikely to sustain Q3 growth momentum as it is expected to increasingly feel the impact of rising interest rates and persistently elevated price. After December's drop into single digits territory (9.6%YoY) for the first time since summer thanks to government's one-off payment of household energy bills, the headline CPI is seen rising again temporarily — notwithstanding the energy price caps that come into force in March but will be taken into account in the price statistics from January —as the price-fixed contracts of retail customers for gas and electricity that expired at the end of 2022 will be adjusted to reflect the past increases in wholesale prices. Adding to growth jitters, weakening external demand should weigh on net exports, while production in the energy-intensive sectors, which has dropped more than 13% since the outbreak of the Ukraine war —much higher than a -1.4% fall in industry as a whole —is likely to be cut further due to higher energy costs. That said, Germany may not avoid falling into a recession this winter. However, the anticipated downturn is likely to be shallower than earlier feared, thanks to reduced gas rationing risks amid high storage levels and the government's generous energy support measures. Overall, following the higher-than-expected Q3 GDP print, we forecast average growth for the full year at 1.7%YoY after a drop of 0.2%QoQ in Q4, followed by a 0.5% contraction in 2023.

Figure 11: Production of energy-intensive sectors has dropped more than in industry as a whole



Source: Federal Statistical Office, Eurobank Research

Figure 12: Leading indicators point to swaller than earlier expected economic downturn



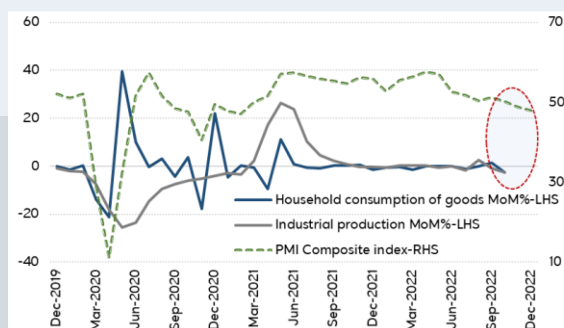
Source: IFO, Bloomberg, Eurobank Research

France

The economy likely to have entered recession in Q4, while inflation has yet to peak

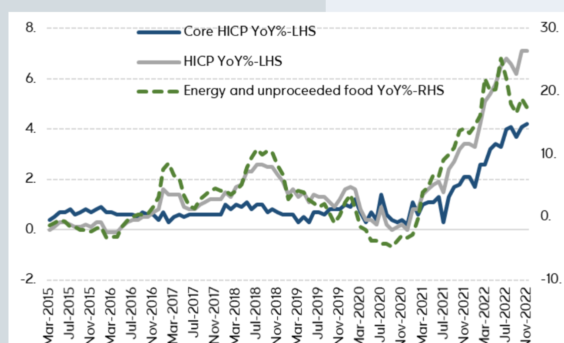
After having bounced in Q2 rising by 0.5%QoQ following a -0.2%QoQ contraction in Q1, GDP decelerated again in Q3 growing by a lackluster 0.2%QoQ. Private consumption declined (-0.1%QoQ) amid persistently high inflation and rising interest rates, while net trade was a drag on growth (-0.5ppt), partially reflecting a surge in electricity imports as more than half of the country's 56 nuclear reactors are closed due to planned maintenance or technical reasons (France generates roughly 70% of its electricity from its nuclear fleet of 56 reactors, the highest share in the world, and provides about 15% of Europe's total power through exports). Turning to Q4, most of the hard data and sentiment indicators suggest that economic momentum continued to ease, with GDP likely to have contracted for the second time in 2022. Coming at odds with the INSEE business climate which remained stable in December at 102 for the fourth consecutive month — 0.2ppt above its long-term average — the Q4 average composite PMI moved below the boom-or-bust level of 50 for the first time since Q1 2021, though the index edged up from November's 48.7 to 49.1 in December. In a similarly gloomy note, consumer spending on goods dropped in October by a hefty 2.8%MoM amid lower energy demand owing to the usually mild weather, and IP plunged by 2.6%MoM on the back of reduced energy production due to the October refinery strikes. The French statistical office (INSEE) forecasts a 0.2%QoQ GDP growth contraction in Q4 (lower than +0.1%QoQ projected by the Banque de France) that would take annual GDP for the whole year 2022 to 2.5% while for 2023, we expect a sharp slowdown to just 0.2%, as government support to cushion the impact of higher energy prices becomes less generous, high inflation dents domestic demand, rising interest rates weigh on investment, while lower global demand should hurt export growth. Meanwhile, after falling by 0.3ppts to 6.7%YoY in December, HICP is expected to rise again in early 2023, mostly due to changes in the tariff shield which foresees a 15% increase in the price cap for gas and electricity (compared to a 4% rise in 2022), before gradually falling in the remainder of the year largely due to base effects, averaging around 6.5% over the year, higher from 6.0% expected for 2022.

Figure 13: GDP growth has likely contracted in Q4 for the second time in 2022



Source: INSEE, Bloomberg, Eurobank Research

Figure 14: Inflation will likely rise again in early 2023 mostly due to changes to the tariff shield



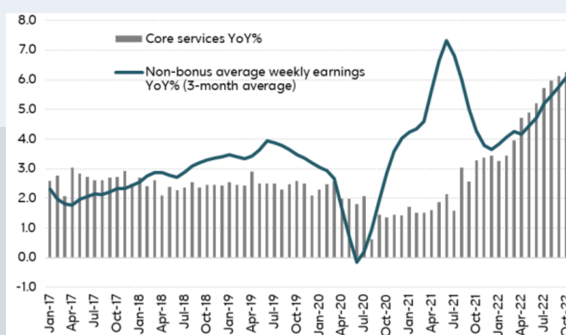
Source: Eurostat, Economic Research

UK

Inflation likely to remain elevated this year as wage growth continues to accelerate

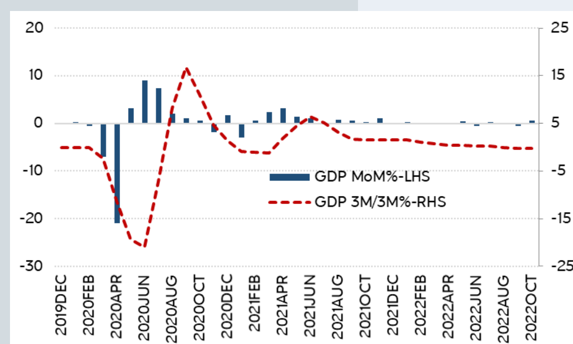
Headline CPI surprised to the downside in November, falling to a lower than expected 10.7%YoY from October's 41-year peak of 11.1%YoY, mostly driven by moto fuels on base effects (-1.7ppt to 7.2%YoY), while food and non-alcoholic beverage prices rose by 0.2ppt to 16.4%YoY, the highest since September 1977. Core inflation was also weaker than expected, falling from 6.5%YoY to 6.3%YoY on the back of a further decline in non-industrial goods (6.3%YoY from 6.7%YoY), reflecting lower commodity prices and easing global supply chain disruptions. However, services inflation remained unchanged from October at 6.3%YoY, a high level compared to historical standards, as wage growth continues to accelerate, in spite of some tentative signs of moderation in labor market conditions. Though the unemployment rate recorded the second consecutive increase rising to 3.7% in the three months to October following an increase in the inactivity rate, and the number of vacancies fell for the sixth consecutive month (-149k), though, at a still high level by historical standards, regular wage growth accelerated further, hitting a ½ year high of 6.1% 3m/y and pointing to a continued tight labor market. Against this backdrop, any further inflation deceleration in the coming months on energy base effects and a further decline in core goods inflation, will likely be gradual, staying well above the BoE target throughout the year, as food prices and services inflation are seen remaining elevated. That said, additional BoE rate tightening would be required to ensure a sustainable return of inflation to target. However, as persistently high pressures continue to erode consumer purchasing power and interest rates are expected to rise further, while external environment is weakening, the headwinds the economy is facing will likely intensify. Against this backdrop, we expect the economy to remain into recession until summer 2023, beginning in Q3 2022 when GDP dropped by a downward revised -0.3%QoQ. Notwithstanding GDP growth return to positive territory in monthly terms in October (+0.5%MoM) on a favorable base effect that may end up to a shallower than earlier expected decline in Q4, we see growth for the full year at 4.4%, following a contraction of 1.0% in 2023.

Figure 15: Persistent strength in services inflation driven by accelerating wage growth



Source: ONS, Eurobank Research

Figure 16: Though GDP growth returned to growth in October it continued to drop in 3M/3M terms



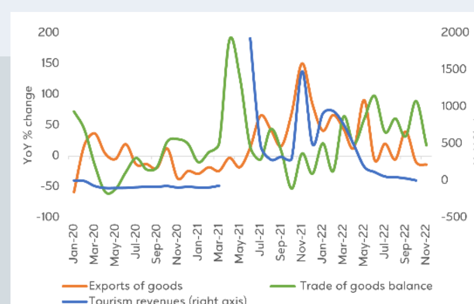
Source: ONS, Eurobank Research

Cyprus

Deterioration in exports urges for investment-boosting policies

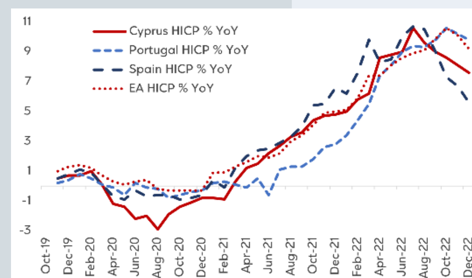
As mentioned in the previous issue, headwinds appeared in Q4 2022 in the main Q3 2022 growth drivers, tourism and investments. In line with the strong deceleration in tourist arrivals growth in Oct-22 to 2.3%YoY, from 37.6%YoY in Q3 2022, receipts from tourism eased to 3.1%YoY in Oct-22 from 43.7%YoY in the third quarter, with the stagnation in arrivals in November (+0.7%YoY) signaling a further weakening in revenues. Developments in exports of goods also point to the downside, with successive declines in October (-10.0%YoY) and November (-14.2%YoY) and the relevant deficit widening, especially in October (+89.3%YoY). On the investments side, the number of building permits fell in Sep-22 for a fourth consecutive month, by 12.8%YoY (4th highest fall in 2022), whereas in surface terms the decline reached 3.8%YoY. The continuous weakening of building activity is linked to trends in bank financing, with credit expansion decelerating since Jun-22, standing at 0.8%YoY in November -the slowest pace in 2022- from 3.3%YoY in May-22, the containment being stronger towards non-financial businesses (-0.1%YoY in November against +5.2%YoY in May) and moderate on households (-0.8%YoY from +0.9%YoY respectively). Given the protracted discussion on the foreclosure suspension for loans and its new extension in Nov-22 up to Jan-23, these developments were foreseen in the Dec-22 issue. Accordingly, a further contraction in the construction sector and a downshifting of investments in general is most probable for Q4 2022. The degree of continuation of these adverse dynamics in 2023 will depend on when the suspension will be withdrawn, as it also inhibits progress in the milestones related to the recovery and resilience plan and future RRF disbursements. The relevant uncertainty will not de-escalate prior to the formation of a new government after the Feb-23 presidential elections. Reforms in the labour market, education and taxation are also pending. On the other hand, publicly funded investments in 2023 will be higher than in the previous year, based also on the disbursement of the first RRF tranche in Dec-22. Inflation already recedes, on the back of support measures, relaxing pressures on household consumption. Still, the expected slowdown in the EU will severely hamper tourism revenues and exports of goods. Overall, Cyprus is expected to grow by ca. 2.0% in 2023, much slower than in 2022 (5.3%).

Figure 17: Deterioration in tourism receipts and exports of goods in Q4 2022, burdening the relevant balances*



*Due to the Covid ban in travels in Apr – May 20, the YoY increase a year after cannot be defined
Source: CYSTAT, Eurobank Research

Figure 18: Inflation easing in December for a fifth consecutive month, stronger decline of core inflation



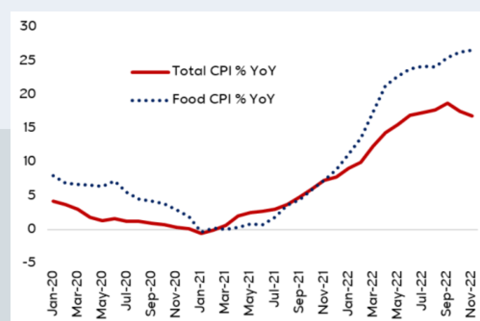
Source: Eurostat, Eurobank Research

Bulgaria

Despite the challenges, fiscal discipline remains cemented

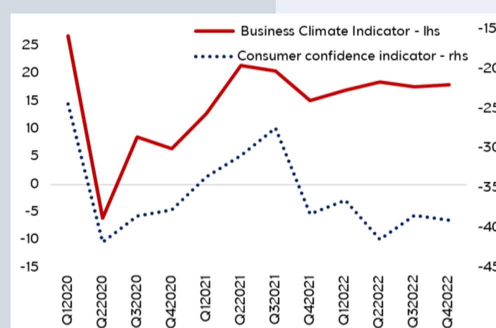
Inflation has started to show signs of slow decompression as it decelerated for a second consecutive month to 16.9% YoY in November, compared to 17.6% YoY and 18.7% YoY in October and September respectively. On a monthly basis, inflation eased by a tad, to 0.8% from 0.9% in the previous month. The slowdown in the annual headline print was broadly driven by fuel and services prices. Food inflation remained elevated, to 26.1%YoY from 26.3%YoY in October, with prices of vital goods such as meat, vegetables, milk and eggs continuing to accelerate. The mild improvement in the business confidence in both November and December, is broadly driven, in our view, by the said decrease in inflation, offsetting partially the uncertainty from heightened energy prices and the expectations of tightening financial conditions. An additional factor that may have weighed positively on the business sentiment is the disbursement of EUR.37bn of grants, excluding any prefinancing, as the country accomplished the 22 milestones and targets linked to the first instalment of the RRF. While the progress marked so far, apart from bearing tangible fruits such as the disbursement of RRF funds, also spurs optimism, fostering timidly the business climate, the disbursement of the second tranche is considered challenging as this is tied with 66 key measures and stages, out of which 22 must be approved by the parliament. Speaking of parliamentary necessity, the political impasse the country has hit since the latest elections in October 2022 is still lingering. In detail, with the first mandate given by President Rumen Raden in early December to GERB, the first winning party, for a government formation not having ended successfully, the second was handed in early January to WCC, the second largest party with no positive outcome also. As things stand, a political consensus among the elected parties is deemed as rather fragile and, hence, snap elections in the next couple of months should not be ruled out. Concluding with a positive development on the fiscal front, the 2022 budget execution appears to have overshoot the target for a 4.1% of GDP deficit as, based on preliminary data by the Ministry of Finance, the general government budget deficit, under the ESA 2010 standards, is estimated at 2.9% of the projected GDP. The result bodes well for the Stability and Growth Pact criteria that refer to the fiscal discipline and, as such, the perspective for Bulgaria's convergence assessment in the upcoming EC and ECB's reports on its readiness to join the eurozone is positively backed.

Figure 19: Dimly signs of inflationary retreat...



Source: National Statistical Institute, Eurobank Research

Figure 20: ... mirrored in the maigre uptick of the business climate



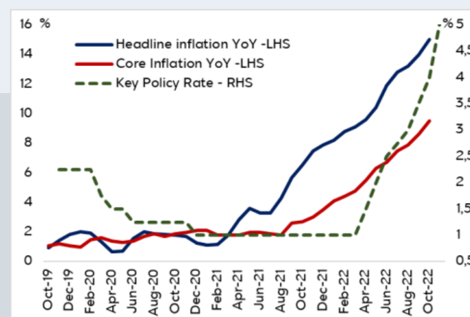
Source: National Statistical Institute, Eurobank Research

Serbia

Loss of steam in 2022 based on the preliminary growth estimate

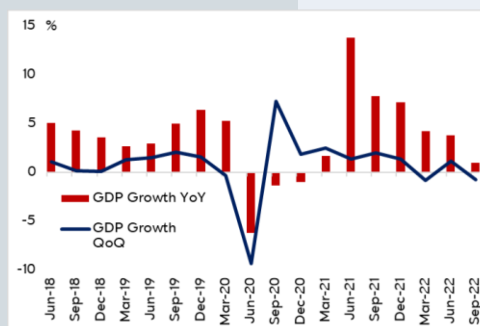
At the turn of the year, the Serbian statistics office released a preliminary estimate according to which GDP growth in 2022 cooled down to 2.3% from 7.5% in 2021. Assuming that the estimate will be verified in late February when the Q42022 growth data is due, the economy is estimated to have grown by 2.9%YoY in the last quarter after 1.0%YoY (Q3), 1.1%YoY (Q2) and 4.2% YoY(Q1) in the previous three, translated into an average of 2.1%YoY in 9M2022. The estimate bodes well with that of the Ministry of Finance at 2.5%, envisaged in the 2022 budget revision in November. Specifically, one of the key drivers of the revision for a 3.9% fiscal deficit as a percentage of GDP from the originally planned 3.0% was, among others, the downward revision of the GDP growth forecast to 2.5% from 3.0% previously. Doubtlessly, the soaring inflation took a big toll on the economy in 2022 as it trimmed the disposable income and private consumption in turn, which traditionally contributed the most in the headline GDP growth rate. However, the further breakdown of the national accounts for the last quarter is worth waiting as despite the evident cooling in the economy in Q2 and Q3, the latter two did not have a carryover effect in Q4 as broadly anticipated. On the contrary, from the annual flash estimate it can be inferred that the economy gained some pace in the latter period. On the steamy front of inflation, the annual prints are on a constantly increasing path since February 2021 with the January-November average rate standing at 11.6%. The behavior of the core inflation is identical, as it remained on an upward trend since August 2021, climbing to 9.70%YoY in November and bringing the January-November annual average rate at 6.82%. The rattling trajectory of inflation did not stop the S&P ratings agency from affirming the BB+ sovereign credit rating and keeping the outlook stable in mid-December. The fiscal and current account deficits are deemed as elevated in both 2022 and 2023, due to higher energy prices and domestic electricity production problems. Towards that end, the EUR2.4bn Stand-By Facility agreed with the IMF is rendered supportive to fiscal and external financing needs while providing an anchor for policy prudence and reforms. Additionally, it will assist the fiscal consolidation process as from a 3.9% of GDP deficit in 2022, the target for 2023 has been set lower at 3.3%.

Figure 21: Inflationary pressures impose continuing monetary tightening...



Source: National Bank of Serbia, Eurobank Research

Figure 22: ... despite the evident cooling in the economy...



Source: Statistics Office of the Republic of Serbia, Eurobank

Turkey

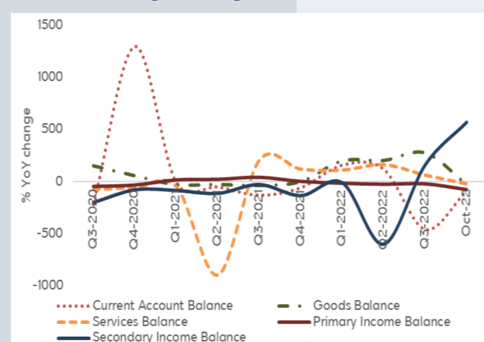
Macroprudential policies support the lira exchange rate and ease inflation, burdening banks' soundness

The CPI inflation in Turkey decelerated sharply in December, to 64.3%YoY, from 84.4%YoY in November and 85.5%YoY in October. The slowdown of inflation came from the decline in prices of energy goods globally during Nov-Dec and the stabilisation of the Turkish Lira (TRY) exchange rate in the last three months of 2022, mainly with means of the macroprudential measures on banks. The weakening of inflation in end 2022 is expected to strengthen the rise in the retail trade volume, which remained above 9.0%YoY in the Aug – Oct period, a trend to be reflected in household consumption in Q4 2022. The benefits of the TRY depreciation in the current account balance rebounded at least in October, mainly through the ease of the deficit in the balance of goods. That said, the financial account recorded at the same time the second highest monthly deficit in 2022, due to banks liquidating financial assets abroad, possibly also because of the macroprudential policies. However, the positive direct investment balance improved further, recording the highest surplus in the last four months, highlighting the gradual restoration of the confidence of investors to the prospects of the Turkish economy. Although the TCMB acknowledged that banks achieved the 50% liraization target over deposits for 2022, this target was revised to 60% for H1 2023 and stricter relevant macroprudential measures were adopted. Also, the scope of assets and liabilities of banks subject to the securities withholding practice was expanded in end-2022, with other financial institutions falling under it for the first time. Accordingly, an appreciation of the TRY is expected in the first months of 2023, easing inflation and boosting real household income, but also further increasing pressures on banks' balance sheets and deteriorating the current account through higher imports, as demand from abroad will be subdued. Expansionary fiscal policy in view of the presidential elections in June and another minimum wage increase put in force in Jan-23 (+54.7%) will hold back inflation decline. Still weak business confidence and political uncertainty ahead of the presidential elections are expected to put a drag on investments. Overall, growth is forecasted to ease from 5.2% in 2022 to ca 2.5% in 2023.

Figure 23: Deceleration of inflation in end 2022 from lower prices in transport and food & non-alcoholic beverages, with stagnant exchange rate

Source: Central Bank of Turkey (TCMB), Refinitiv Eikon,Eurobank Research

Figure 24: Rebound of the devaluation benefits for the current account balance in October, mainly through the goods balance



Source: Central Bank of Turkey (TCMB), Eurobank Research

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2021	2022f	2023f	2021	2022	2023f	2021	2022f	2023f	2021	2022f	2023f	2021	2022f	2023f
World	6.0	3.2	2.1	4.7	8.8	5.2									
Advanced Economies															
USA	5.9	1.9	0.3	4.7	8.0	4.0	5.4	3.6	4.6	-3.6	-3.9	-3.5	-10.8	-4.8	-4.4
Eurozone	5.3	3.2	-0.1	2.6	8.4	6.0	7.7	6.7	7.1	2.1	-0.2	0.6	-5.1	-3.8	-3.7
Germany	2.6	1.9	-0.5	3.2	8.6	6.5	5.7	5.3	5.6	6.7	3.6	4.1	-3.7	-2.6	-2.7
France	6.8	2.5	0.2	2.1	5.9	5.1	7.9	7.4	7.6	-0.9	-1.8	-1.9	-6.5	-5.1	-5.3
Periphery															
Cyprus	6.6	5.3	2.3	2.2	8.0	4.0	7.5	6.3	5.6	-7.2	-10.0	-8.0	-1.8	2.7	2.0
Italy	6.7	3.8	0.0	2.0	8.7	6.5	9.5	8.1	8.5	3.4	-0.2	-0.1	-7.2	-5.5	-4.9
Portugal	5.9	6.6	0.5	0.9	8.1	5.1	6.6	6.0	6.2	-0.7	-2.0	-1.7	-2.9	-1.8	-1.3
Spain	5.5	4.6	1.0	3.0	8.4	4.4	14.8	12.8	13.1	0.9	0.4	0.4	-6.9	-4.9	-4.4
UK	7.6	4.4	-0.9	2.6	9.1	7.2	4.6	3.7	4.6	-1.5	-5.4	-4.3	-7.3	-7.0	-5.5
Japan	2.3	1.4	1.2	-0.3	2.4	1.8	2.8	2.6	2.5	3.9	1.6	1.5	-5.5	-6.7	-4.8
Emerging Economies															
BRICs															
Brazil	5.2	3.0	0.8	8.3	9.3	5.0	13.5	9.6	9.3	-1.6	-2.4	-2.2	-4.3	-5.0	-8.2
China	8.4	3.2	4.9	0.9	2.1	2.3	4.0	4.1	4.0	1.8	2.2	1.5	-3.8	-5.7	-5.0
India	8.7	7.0	6.0	n/a	6.7	5.1		*NA*		-1.1	-3.4	-2.7	-6.2	-6.4	-6.0
Russia	5.6	-3.0	-3.0	6.7	13.8	5.7	4.8	4.2	4.7	6.7	11.2	6.1	0.4	-2.0	-2.5
CESEE															
Bulgaria	7.6	3.1	1.5	3.3	15.2	8.3	5.5	4.7	4.8	-0.5	-1.7	-1.5	-2.9	-3.7	-3.6
Serbia	7.2	2.5	2.3	4.1	11.9	8.7	10.1	9.9	9.7	-4.4	-8.7	-8.2	-3.9	-3.3	-3.1
Turkey	10.3	5.2	2.5	19.4	72.0	38.4	12.0	10.7	9.8	-2.2	-4.7	-3.6	-3.2	-4.0	-4.3

Sources: European Commission, World Bank, IMF, OECD, Bureaus of National Statistics, Bloomberg, Eurobank Research

Eurobank Fixed Income Forecasts

	Current	December	March	June	September
USA					
Fed Funds Rate	4.25-4.50%	4.77-5.00%	4.80-5.05%	4.70-4.95%	4.46-4.70%
3m SOFR	4.63%	4.92%	4.94%	4.76%	4.41%
2yr Notes	4.25%	4.51%	4.41%	4.14%	3.81%
10 yr Bonds	3.59%	3.85%	3.89%	3.68%	3.51%
Eurozone					
Refi Rate	2.50%	3.10%	3.15%	3.15%	3.10%
3m Euribor	2.28%	2.66%	2.72%	2.70%	2.64%
2yr Bunds	2.64%	2.32%	2.19%	1.98%	1.79%
10yr Bunds	2.29%	2.30%	2.19%	2.07%	1.90%
UK					
Repo Rate	3.50%	4.10%	4.15%	4.10%	4..05%
3m Sonia	3.85%	4.01%	3.95%	3.81%	3.73%
10-yr Gilt	3.59%	3.48%	3.39%	3.34%	3.18%
Switzerland					
3m Saron	1.04%	1.35%	1.41%	1.41%	1.41%
10-yr Bond	1.33%	1.42%	1.46%	1.39%	1.33%

Source: Bloomberg (market implied forecasts)

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