Economic Outlook for the Eurozone 2023-2025

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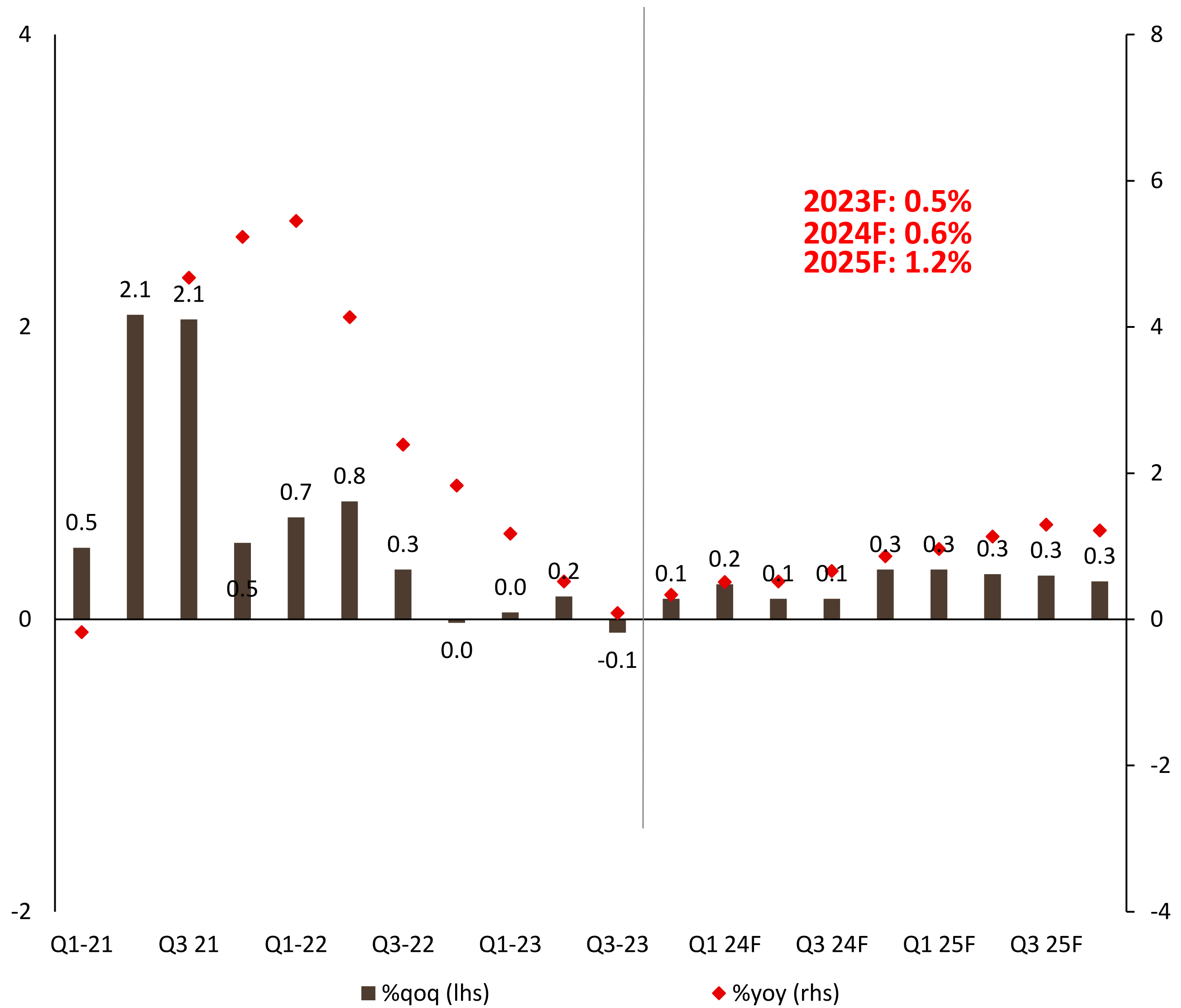
Eurozone outlook – key messages

- GDP growth: expected to stay modest, with downside risks
- Fiscal policy: Gradual consolidation after 4 years of flexibility & support
- Inflation: Declining, but return to 2% target will require more time
- ECB: Policy rate have peaked (4%), but likely to stay restrictive for longer
- Overall situation likely to remain challenging

Outlook for Eurozone GDP growth

- **Key message: EZ growth expected to stay modest, with downside risks**
  - GDP growth of 0.5% in 2023E, 0.6% in 2024E, 1.2% in 2025E
  - Q3 GDP: -0.1% q/q (+0.1% y/y)
  - Big picture: GDP currently broadly stagnating, with little leeway towards technical recession
- **Key headwinds:** ECB tightening, weak external environment, fiscal consolidation
- **Positives:** record-low unemployment, recovery in real wage growth
- **Key questions:** Will labour markets remain tight? How will US & China perform? Geopolitical risk?

Eurozone growth outlook



UBS forecasts for European GDP growth

			UBS forecasts			Consensus		UBS vs Consensus	
	2021	**2022**	**2023F**	**2024F**	**2025F**	**2023F**	**2024F**	**2023F**	**2024F**
Eurozone	**5.3**	**3.4**	**0.5**	**0.6**	**1.2**	**0.5**	**0.8**	0.0	-0.1
Germany	2.6	1.9	-0.3	0.7	0.9	-0.4	0.5	0.1	0.2
France	6.4	2.5	0.6	0.7	1.2	0.8	0.8	-0.2	0.0
Italy	7.0	3.8	0.8	0.7	0.9	0.7	0.6	0.1	0.1
Spain	5.5	5.5	2.2	1.5	1.8	2.3	1.4	0.0	0.1
Netherlands*	6.3	4.4	0.6	1.2	1.5	0.5	0.8	0.1	0.4
Switzerland	5.4	2.7	0.7	0.9	1.6	0.8	1.1	-0.1	-0.2
UK	7.6	4.1	0.2	0.6	1.5	0.4	0.4	-0.2	0.2

Source: Haver, UBS estimates, **Note: Forecast for the Netherland = IMF estimates, Oct 2023. Bloomberg consensus as of 27 Oct 2023

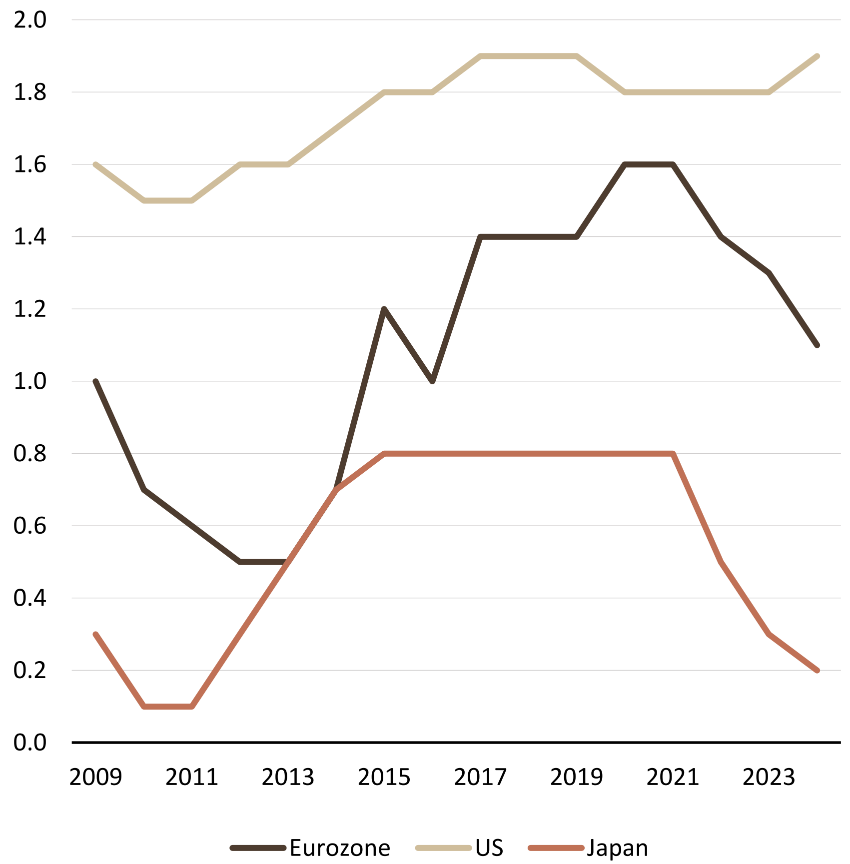
UBS forecasts for the Eurozone

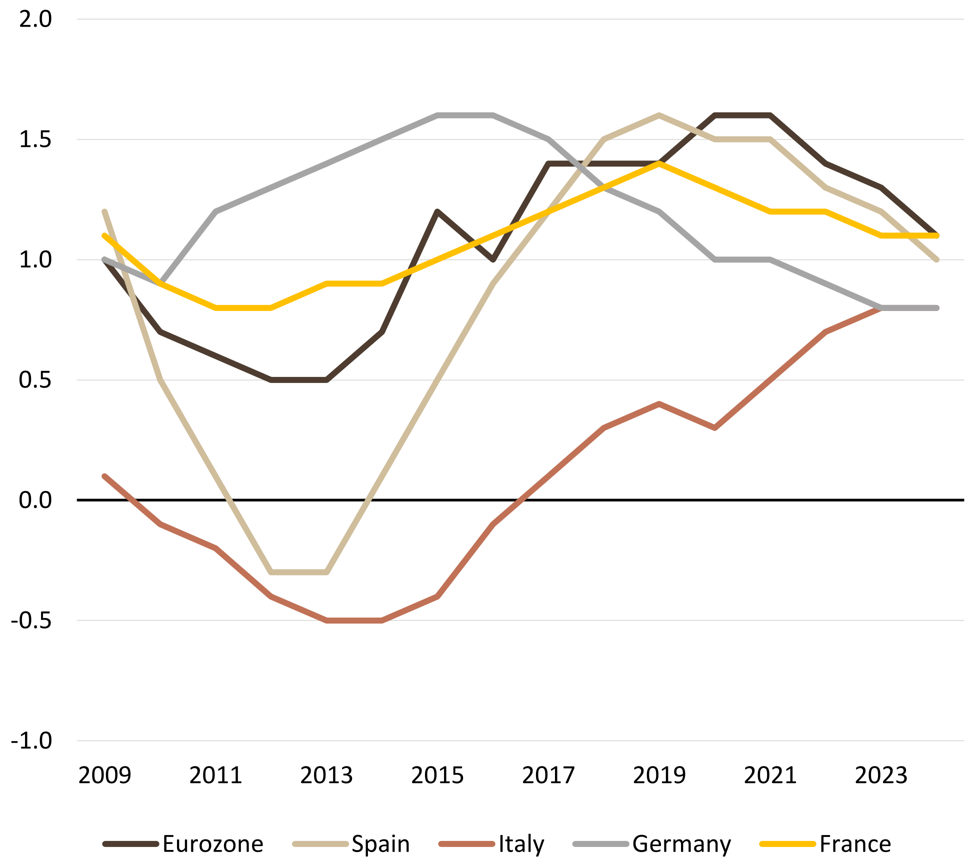
					2022				2023F				2024F				2025F			
% y/y, unless where stated	2022	2023F	2024F	2025F	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP, % q/q	**-**	**-**	**-**	**-**	**0.7**	**0.8**	**0.3**	**0.0**	**0.0**	**0.2**	**-0.1**	**0.1**	**0.2**	**0.1**	**0.1**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Real GDP	**3.4**	**0.5**	**0.6**	**1.2**	**5.5**	**4.1**	**2.4**	**1.8**	**1.2**	**0.5**	**0.1**	**0.3**	**0.5**	**0.5**	**0.7**	**0.9**	**1.0**	**1.1**	**1.3**	**1.2**
Private consumption	4.3	0.4	1.1	1.1	8.3	5.5	2.2	1.1	1.3	0.4	1.3	0.4	-0.4	0.6	0.8	1.2	1.3	1.3	1.2	1.1
Government consumption	1.4	0.0	0.4	0.7	3.4	1.7	0.6	0.7	-0.4	0.2	-0.4	0.2	0.4	0.0	0.6	0.3	0.4	0.5	0.6	0.7
Fixed Investment	2.9	1.1	1.3	1.9	3.5	2.2	4.6	0.9	1.9	1.4	1.9	1.4	0.2	0.7	0.7	1.0	1.4	1.6	1.8	1.9
Exports	7.2	0.3	0.9	2.4	9.0	8.4	7.7	4.6	2.9	-0.2	2.9	-0.2	-1.2	-0.8	-0.4	0.9	1.3	1.7	2.0	2.3
Imports	8.1	-0.4	1.7	2.7	10.1	9.0	10.2	3.2	1.9	-0.2	1.9	-0.2	-2.2	-0.8	0.8	1.6	1.9	2.2	2.4	2.6
Domestic demand*	3.7	-0.1	0.9	1.2	5.5	4.1	3.2	1.0	0.6	0.5	0.6	0.5	-0.3	0.4	1.1	0.8	0.9	1.0	1.1	1.2
Net exports*	-0.2	0.6	-0.1	-0.1	-0.1	0.1	-0.8	0.8	0.6	0.0	0.6	0.0	0.4	-0.1	-0.6	-0.3	-0.2	-0.2	-0.1	0.0
Nominal GDP (y/y)	8.2	6.3	4.2	4.0	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Employment (%)	2.3	1.3	0.7	1.5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Unemployment rate (%)	6.7	6.6	6.9	6.9	6.8	6.7	6.7	6.7	6.5	6.4	6.5	6.7	6.8	6.9	6.9	6.9	6.8	6.8	6.8	6.8
HICP	**8.4**	**5.5**	**2.4**	**2.0**	**6.1**	**8.0**	**9.3**	**10.0**	**8.0**	**6.2**	**5.0**	**3.0**	**2.6**	**2.6**	**2.2**	**2.1**	**1.9**	**2.0**	**2.1**	**2.1**
Core HICP	**3.9**	**5.0**	**2.4**	**2.1**	**2.7**	**3.7**	**4.4**	**5.1**	**5.5**	**5.5**	**5.1**	**3.9**	**2.9**	**2.5**	**2.1**	**2.0**	**1.9**	**2.1**	**2.2**	**2.1**
Budget balance (% GDP)	-3.6	-3.4	-2.9	-2.2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Primary balance (% GDP)	-1.9	-1.6	-1.0	-0.4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Cyclically-adjusted primary balance (% GDP)	-2.1	-2.1	-1.6	-1.3																
Public debt (% GDP)	93.2	90.9	89.8	88.3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Current account (% GDP)	1.7	1.9	2.2	2.4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
ECB deposit rate (end period)	**2.00**	**4.00**	**3.25**	**2.25**	**-0.50**	**-0.50**	**0.75**	**2.00**	**3.00**	**3.50**	**4.00**	**4.00**	**4.00**	**3.75**	**3.50**	**3.25**	**3.00**	**2.75**	**2.50**	**2.25**
3mth Euribor rate (end period)	2.06	4.04	3.29	2.29	-0.50	-0.24	1.01	2.06	2.91	3.54	4.04	4.04	4.04	3.79	3.54	3.29	3.04	2.79	2.54	2.29
German 10-yr bund yield (end period)	2.57	2.70	2.20	n/a	0.55	1.36	2.12	2.57	2.28	2.39	2.85	2.70	2.65	2.50	2.40	2.20	n/a	n/a	n/a	n/a

Source: Haver, national sources, UBS estimates. Forecasts as of 27 Oct 2023. * Effective policy rate (i.e. the rate that determines money market rates (EONIA)): refi rate until end-2011, since then deposit rate. ** percentage-point contribution to GDP growth.

Eurozone potential growth is declining

Potential GDP growth, % p.a.





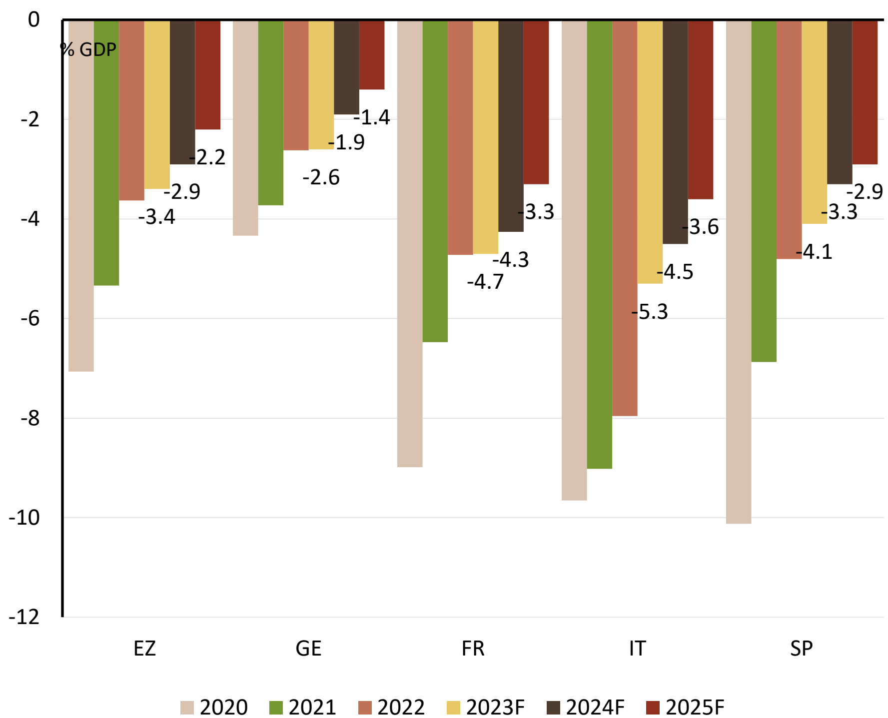
Source: Haver, UBS

Outlook for EU fiscal policy

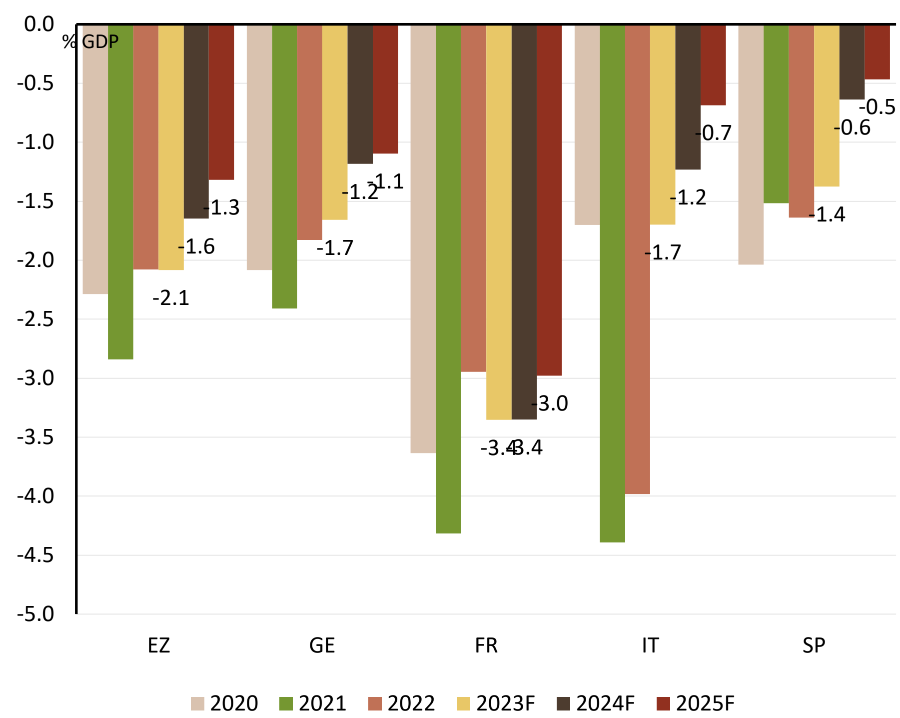
- **<u>Key message</u>: Slow consolidation of EU fiscal policy after 4 years of support**
- **Fiscal impact: broadly neutral in 2023E, moderate headwind in 2024E**
  - EZ budget balance: -3% of GDP in 2023, expected to improve to -2.3% in 2024E
  - Underlying fiscal stance (cyclically adjusted & excluding interest and one-offs) broadly neutral in 2023, moderately contractionary in 2024 (c. ½% of GDP)
- **Stability and Growth Pact (SGP) to apply again in 2024** (after 4 years of suspension) => Excessive Deficit Procedures (EDP) might be triggered again
- **Reform of fiscal rules ongoing**, effective as of 2025 at the earliest
- **Public debt: gradual decline, with upside risk**
  - Debt/GDP to fall from 90.7% in 2023E to 89% in 2024E (peak of 99.2% in 2020)
  - Support from high inflation to wane, further consolidation requires more effort
- **EU recovery fund (NGEU) – peak impact still ahead**
  - Biggest nominal payments to Italy, Spain, France, Germany, Poland
  - In terms of GDP: Bulgaria, Croatia, Greece, Romania, Latvia to benefit most

Fiscal policy in 2020-2025

Headline budget balances (% of GDP)

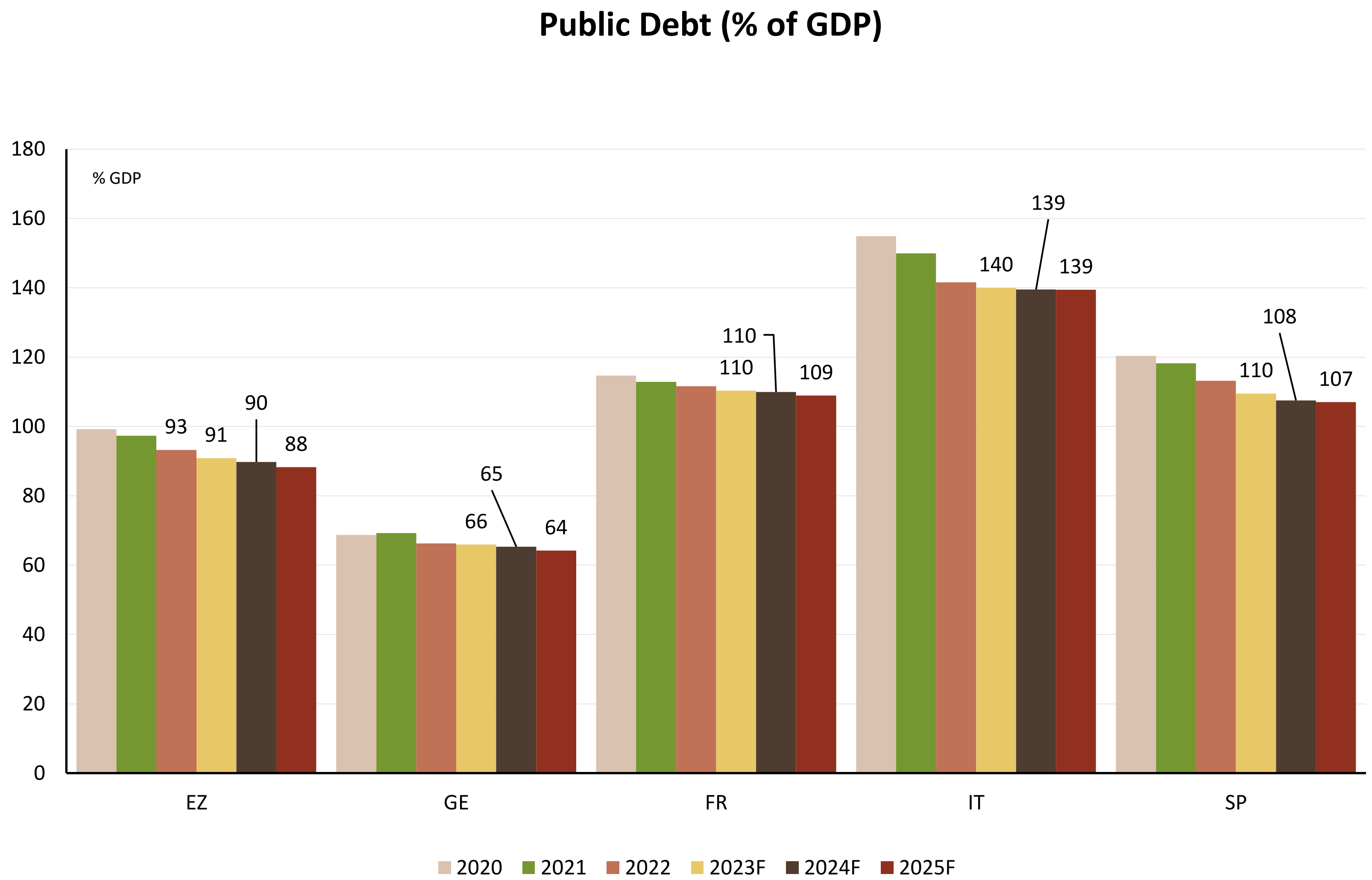


Cyclically-adjusted primary balances (% of GDP)



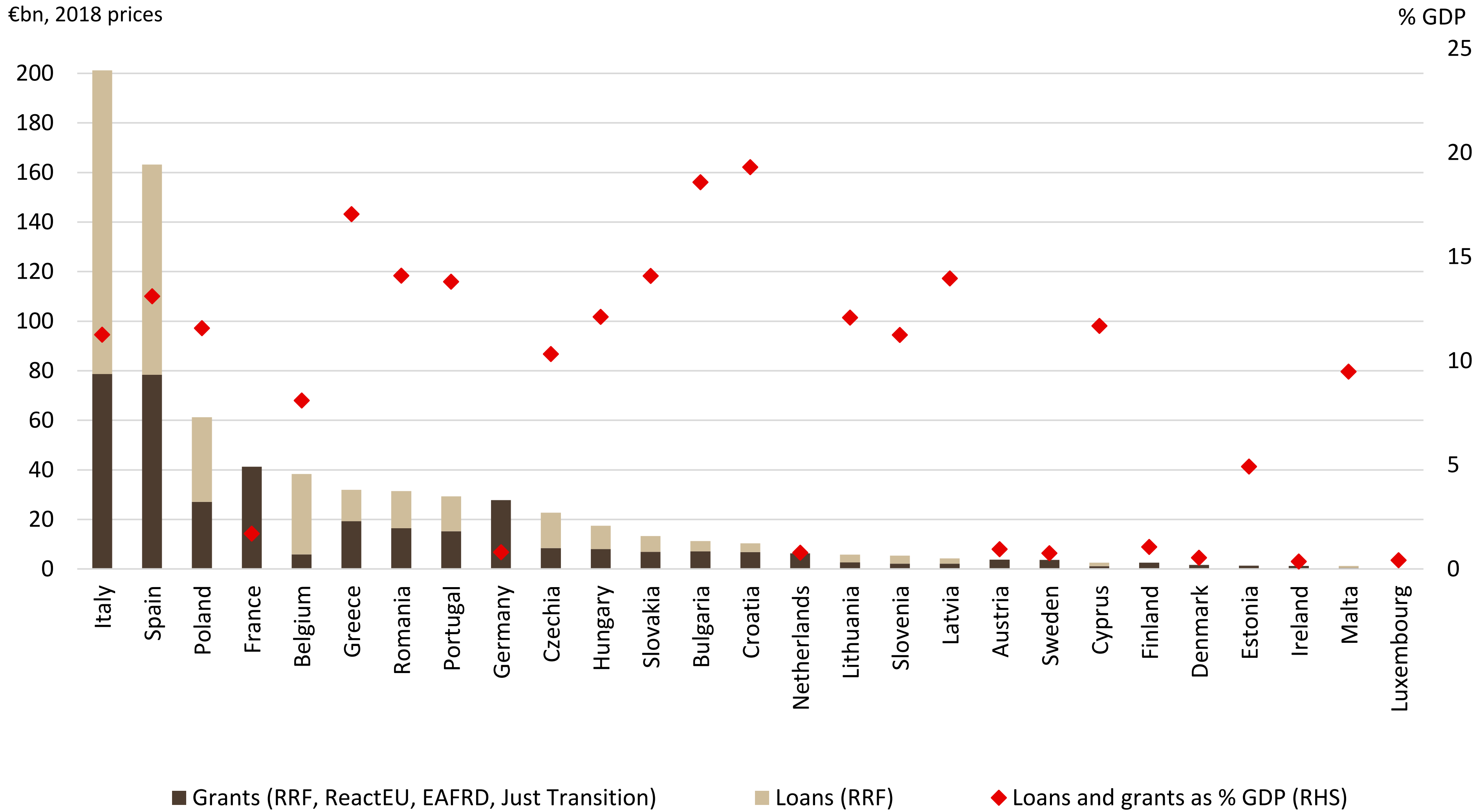
Source: Haver, UBS estimates

Public debt



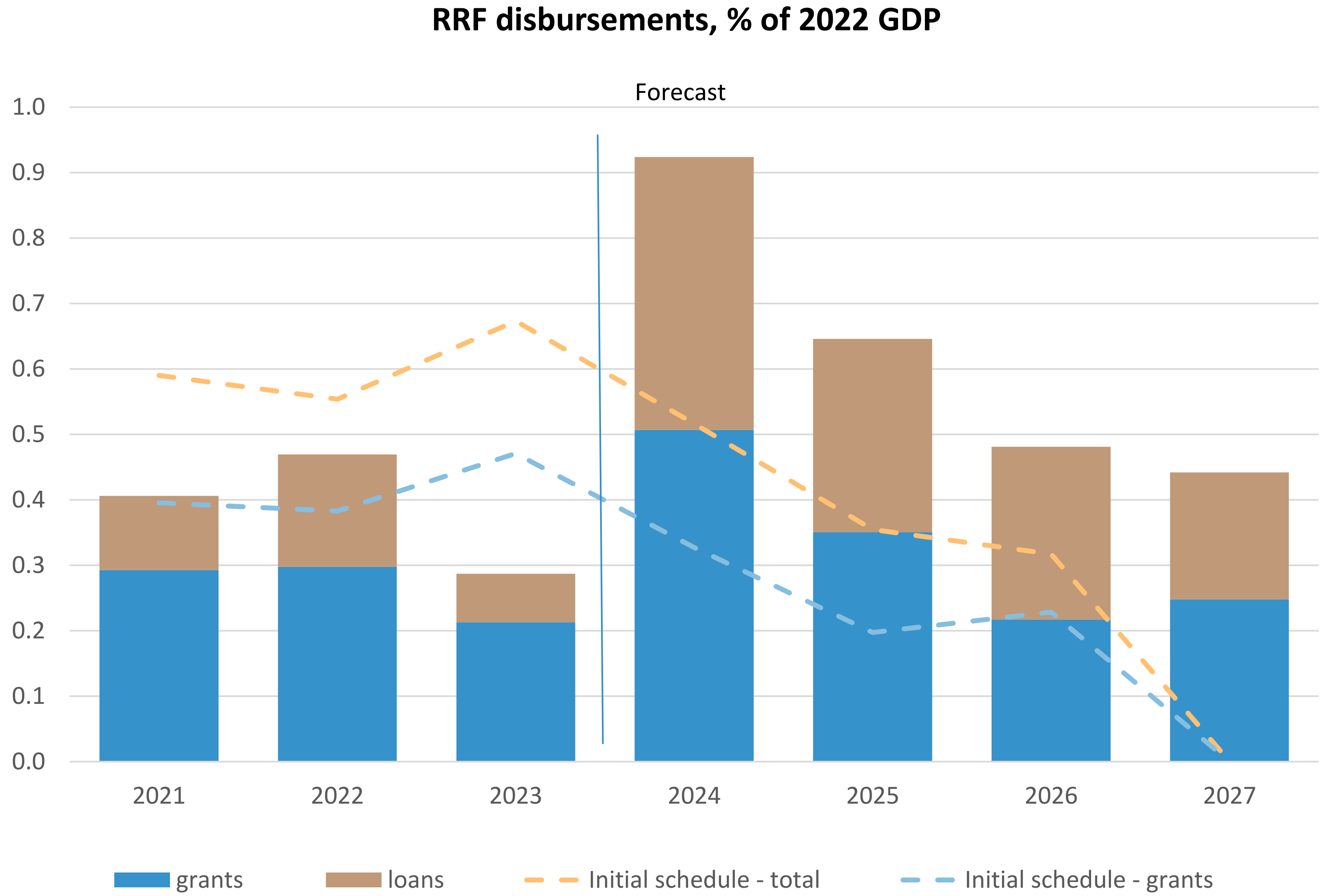
Source: Haver, UBS estimates

EU recovery fund: grants and loans (€750bn)



Source: [EU recovery fund: Where will all the money go?]() 14 June 2021, UBS. *Note: The allocation excludes grants from Horizon Europe, Invest EU, RescEU, which combined account for 1% of all NGEU funds.

EU recovery fund: the best is yet to come



Source: EC, NGEU country pages, UBS estimates. Note: The notes in the previous chart apply. Initial schedule is based on the operational arrangements that each country signed with the EC. The difference between bars and lines is explained by (1) delays in disbursements and (2) increases in disbursement requests due to the recent amendments to the Recovery and Resilience Plans by 5 countries, notably Spain.

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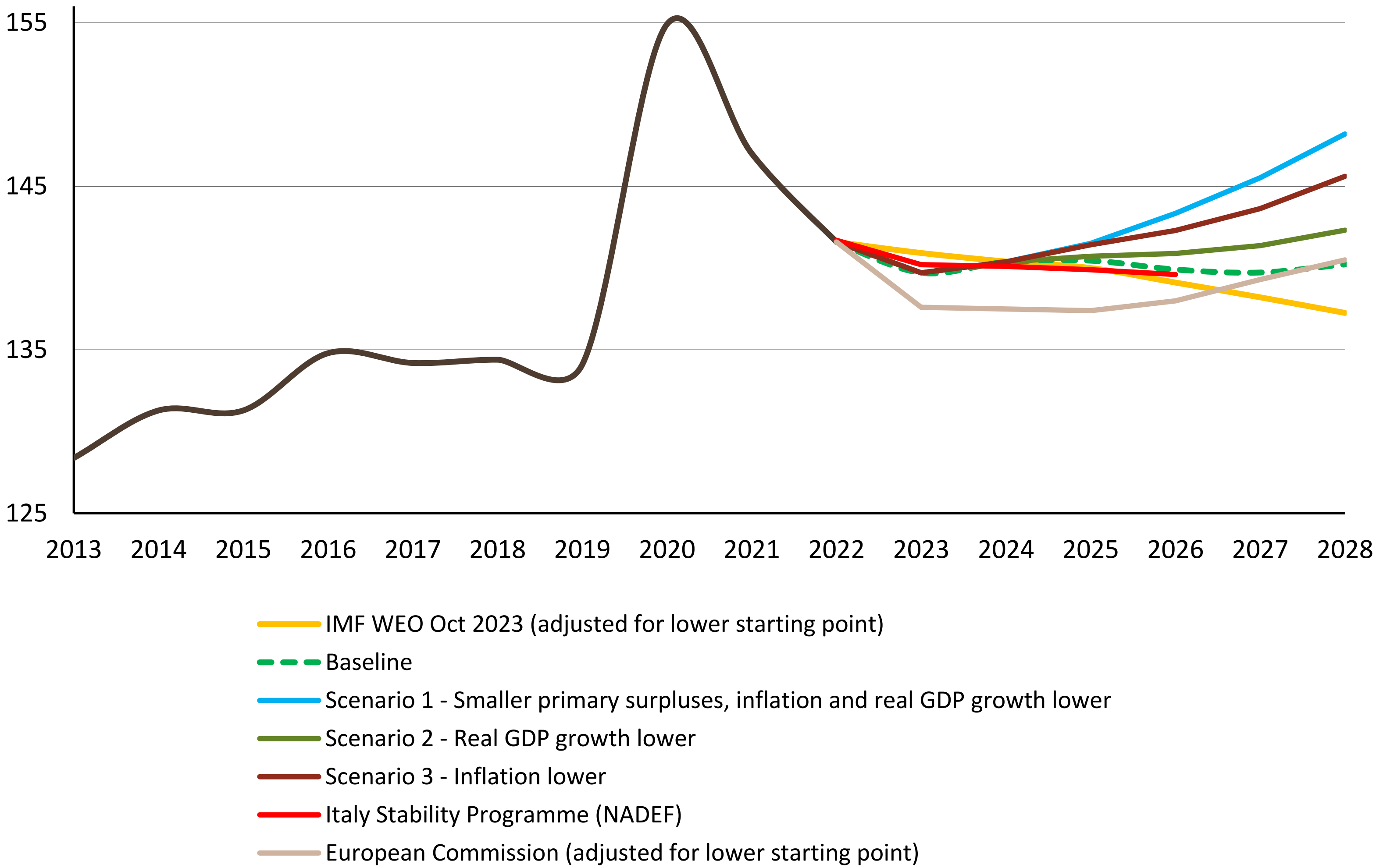
Italy’s public debt scenarios

Italian government debt under different macro scenarios



Source: IMF, Haver, UBS calculations. Note: We have adjusted the IMF and EC forecasts (which are based on a 2022 debt ratio of 144.4%) for downwardly revised figure of 141.6%. **Scenario 1** assumes that the primary budget stays in balance rather than moving into surplus as in the baseline, and that real and nominal GDP growth revert back to their lower pre-Covid averages. **Scenario 2** assumes that real GDP reverts back to its lower pre-Covid trend, but uses the same inflation and primary balance as in the baseline. **Scenario 3** assumes that inflation reverts back to its lower pre-Covid trend, but uses the same real GDP and primary balance as in the baseline.

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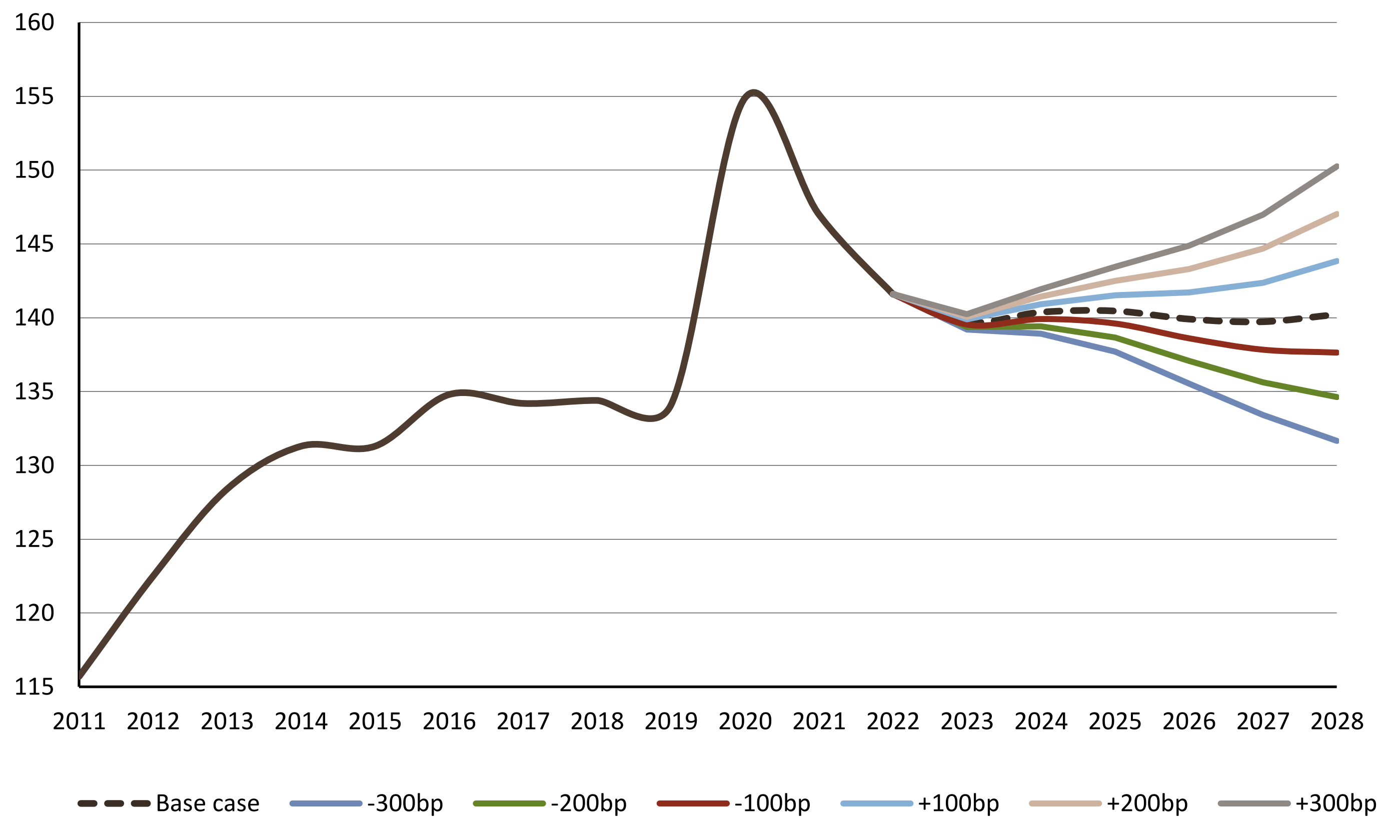
Italy's public debt scenarios (2)

Italian government debt under different assumptions for <u>market interest rates</u>



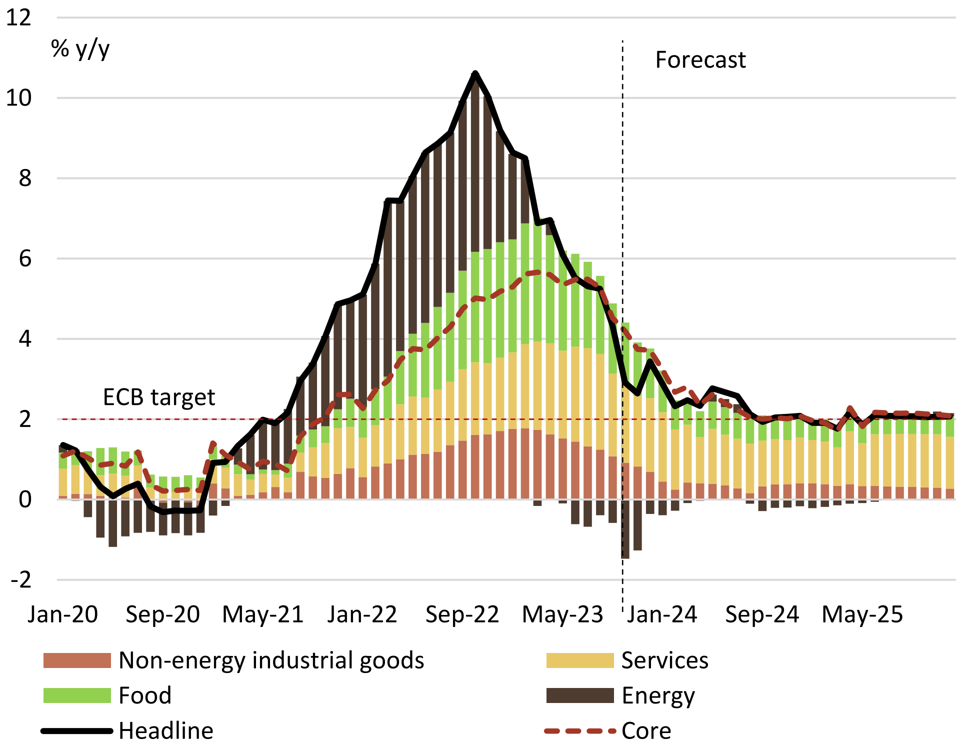
Source: IMF, Haver, UBS calculations.

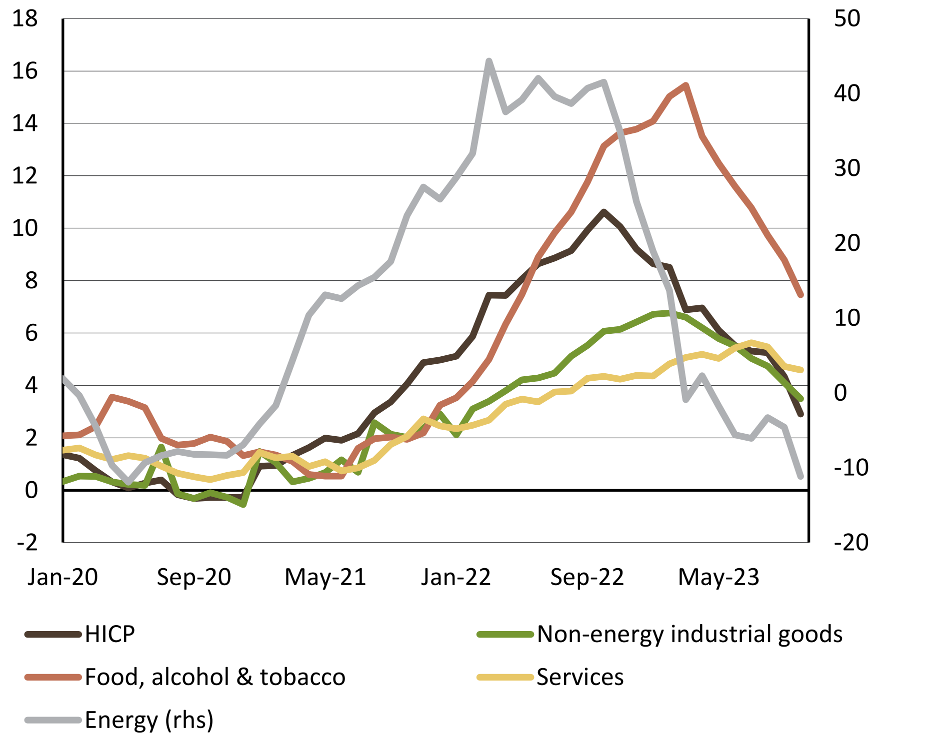
Outlook for Eurozone inflation

- **Key message: Disinflation underway, but return to 2% will take time (and require a relatively hawkish ECB)**
- **Structurally higher inflation pressure over the coming years**, due to tight labour markets & EU investment agenda (ESG, energy security, defence)
- **Return of inflation to ECB's 2% inflation target only in 2025**
  - Headline inflation: 5.5% in 2023E, 2.4% in 2024E, 2.0% in 2025E
  - Core inflation: 5.0% in 2023E, 2.4% in 2024, 2.1% in 2025E
  - Risks skewed to the upside
- **Labour markets will be crucial**
  - Eurozone labour markets are structurally tight
  - Unemployment at historical low of 6.4%, unlikely to rise by much
  - Elevated wage growth slowing down disinflation in services (43.5% of HICP)
  - Should labour markets weaken sharply, disinflation would accelerate and allow the ECB to deliver faster rate cuts

Inflation

- **Headline inflation:** 8.4% in 2022, 5.5% in 2023F, 2.4% in 2024F, 2.0% in 2025F
- **Core inflation:** 3.9% in 2022, 5% in 2023F, 2.4% in 2024F, 2.1% in 2025F



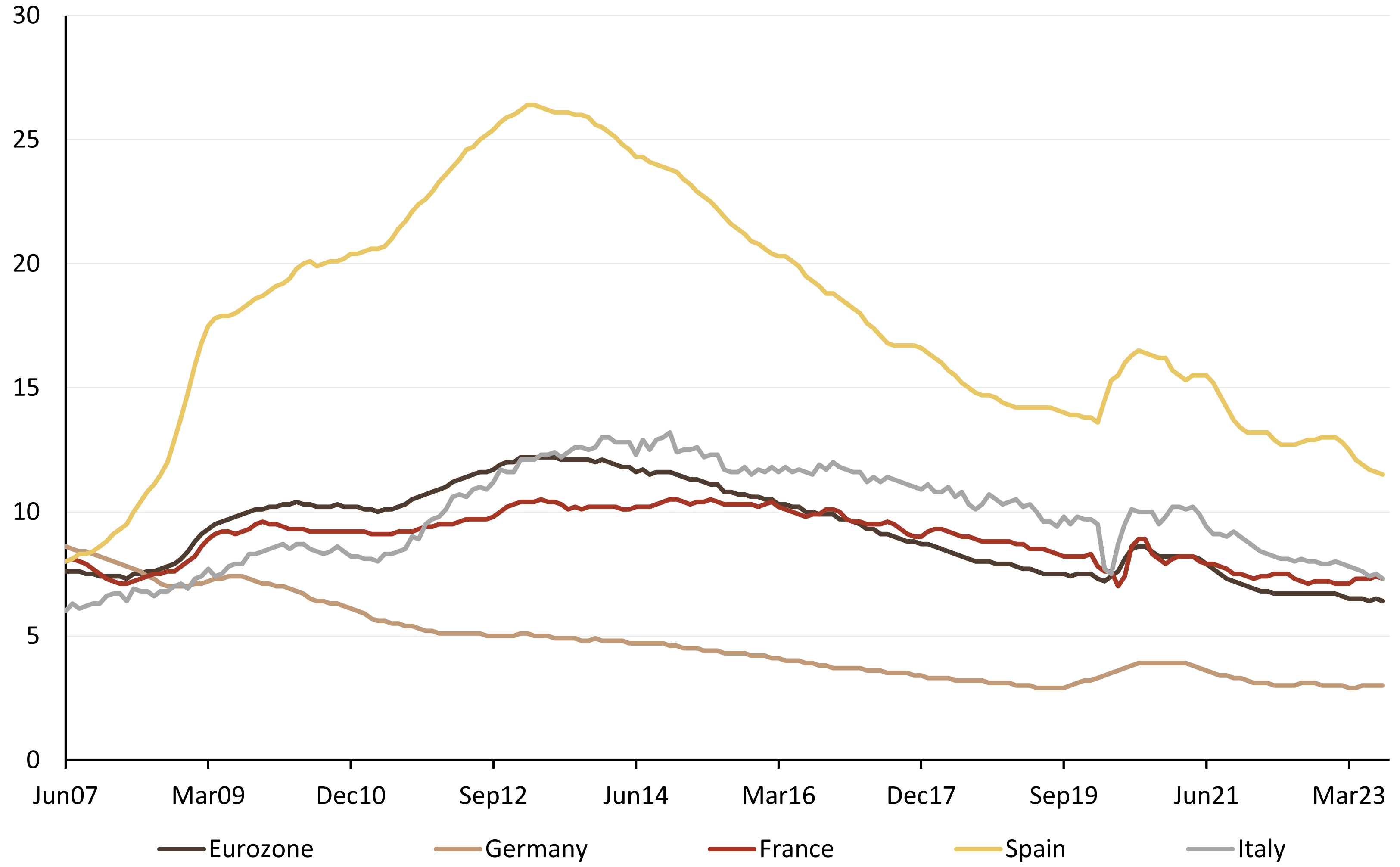


Measures of the broader inflation environment

	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23
HICP headline inflation (% y/y)	**8.6**	**8.5**	**6.9**	**7.0**	**6.1**	**5.5**	**5.3**	**5.2**	**4.3**	**2.9**
Non-energy industrial goods (% y/y; w.:26.2%)	6.7	6.8	6.6	6.2	5.8	5.5	5.0	4.7	4.1	3.5
Services (% y/y; w.:43.5%)	4.4	4.8	5.1	5.2	5.0	5.4	5.6	5.5	4.7	4.6
Food (% y/y; w.:20%)	14.1	15.0	15.5	13.5	12.5	11.6	10.8	9.7	8.8	7.5
Energy (% y/y; w.:10.3%)	18.9	13.7	-0.9	2.3	-1.8	-5.6	-6.1	-3.3	-4.6	-11.1
Exclusion measures of inflation										
Core (HICP excl. energy and food) (% y/y; w.:69.8%)	**5.3**	**5.6**	**5.7**	**5.6**	**5.3**	**5.5**	**5.5**	**5.3**	**4.5**	**4.2**
Core (% 3m/3m, saar)	5.4	5.3	5.6	5.6	4.9	4.3	3.7	3.8	3.6	3.2
HICP excl. energy (% y/y)	7.3	7.8	7.9	7.4	7.0	6.9	6.7	6.3	5.5	4.9
HICP excl.energy & unprocessed food (% y/y)	7.1	7.4	7.5	7.3	6.9	6.8	6.6	6.2	5.5	
HICP excl.energy, food, travel and clothing (% y/y)	5.4	5.6	5.6	5.6	5.3	5.4	5.3	5.2	4.5	
Measures of underlying inflation										
Trimmed mean (10%, % y/y)	8.1	8.2	7.4	6.8	6.5	6.0	5.4	5.2	4.9	
Trimmed mean (30%, % y/y)	7.5	7.6	6.8	6.5	6.1	5.8	5.4	5.2	4.9	
Supercore	6.2	6.3	6.3	6.2	6.0	5.7	5.6	5.3	4.8	
PCCI (% y/y)	4.2	4.2	4.0	3.9	3.3	2.9	2.6	2.6	2.6	
PCCI excl. energy (% y/y)	4.7	4.8	4.6	4.4	3.7	3.2	2.8	2.6	2.4	
Inflation expectations										
Consumer inflation expectations 1 year ahead (median)* (% y/y)	4.9	4.6	5.0	4.1	3.9	3.4	3.4	3.5		
Consumer inflation expectations 3 years ahead (median)* (% y/y)	2.5	2.4	2.9	2.5	2.5	2.3	2.4	2.5		
5y5y inflation forwards (% y/y)	2.3	2.4	2.4	2.4	2.5	2.5	2.5	2.6	2.6	2.5
SPF long-term inflation expectations** (% y/y)	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
SMA 2024 inflation expectations*** (% y/y)	2.3	2.5	2.5	2.5	2.7	2.7	2.7	2.7	2.7	2.7
Wage growth										
UBS monthly negotiated wage tracker (% y/y)	4.0	4.2	4.0	4.0	4.0	4.3	4.2	4.2		

Source: Haver, Bloomberg, ECB, UBS. Supercore is constructed using only those items of core items (headline inflation excluding energy and food) that are deemed sensitive to slack. Persistent and Common Component of Inflation (PCCI) is a measure of underlying inflation that aims to capture common developments across different items in the consumption basket representing the more persistent part of inflation. *ECB Consumer Expectations Survey; **ECB Survey of Professional Forecasters.

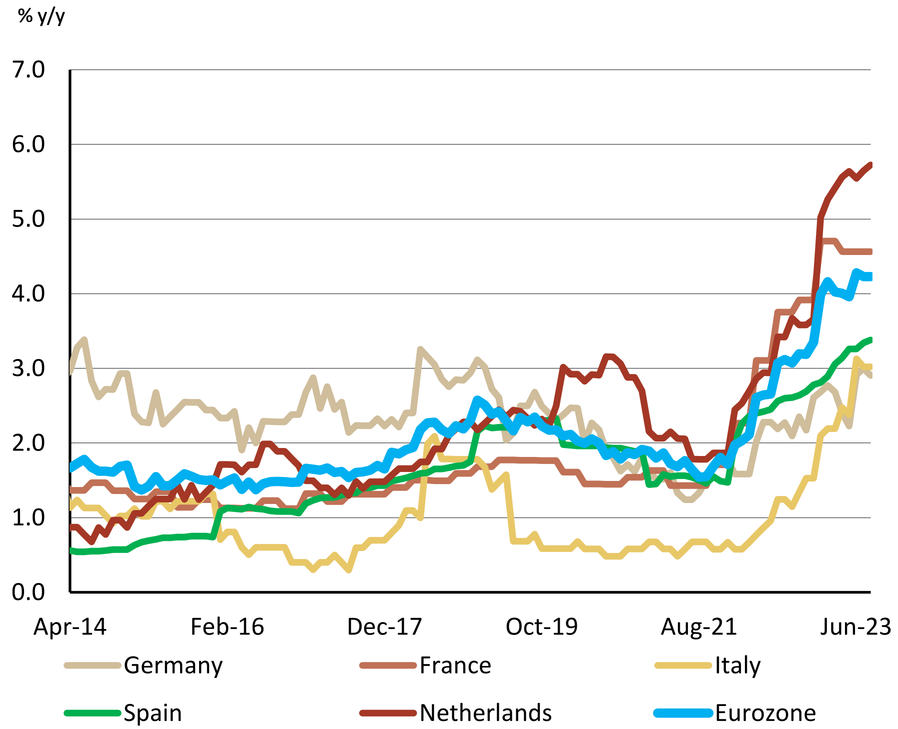
Unemployment (%)



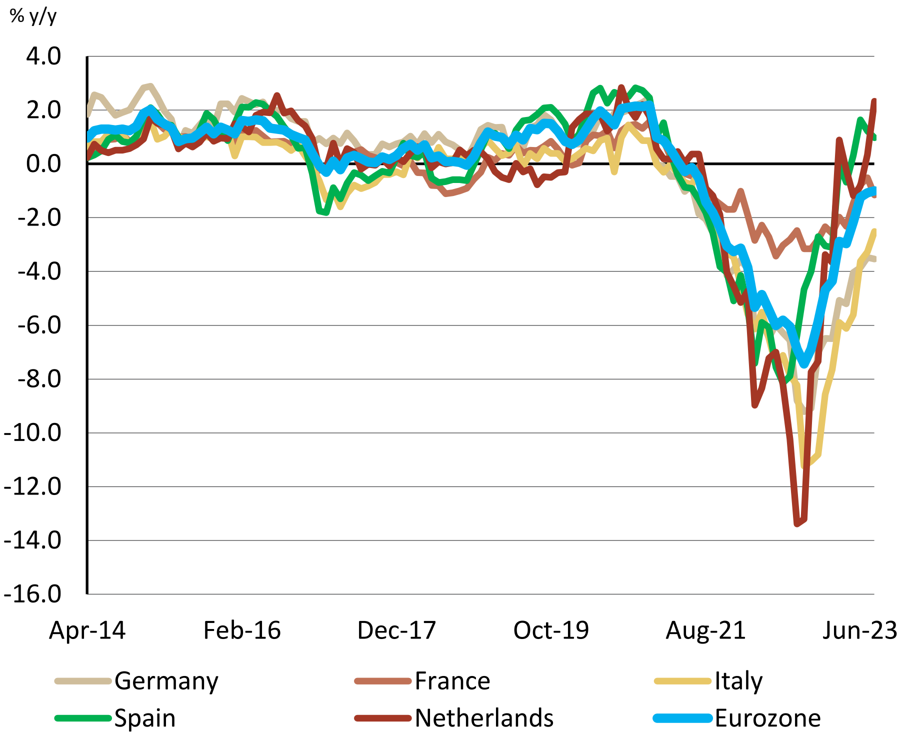
Source: Haver, UBS

Nominal and real wage growth

Negotiated wages, nominal (% y/y)



Negotiated wages, real (% y/y)



UBS Source: Haver, UBS calculations

Outlook for ECB monetary policy (I)

- <u>Key message</u>**: Restrictive ECB policy required to ensure return to 2% target; ECB framework for steering short-term rates (spring 2024) will be important**
- **Structurally higher inflation will require ECB to stay hawkish**
  - Rates have peaked at 4%, ECB to stay "restrictive" for as long as necessary
  - UBS sees first cut in June '24, 25bps per quarter, back to neutral (2%) in early '26
  - Market pricing more hawkish for 2025/26
- ECB likely to speed up quantitative tightening (QT) related to PEPP <u>if</u> markets are calm
- ECB might raise **minimum reserve requirements** (from 1%) to limit losses
- **Digital Euro**: ECB has started 2-year "preparation phase" of intensified preparations for a digital euro; ECB could then take a decision whether or not to launch a digital euro a few years later
- Spring 2024: ECB to present new **framework on steering short-term rates**

Outlook for ECB monetary policy (II)

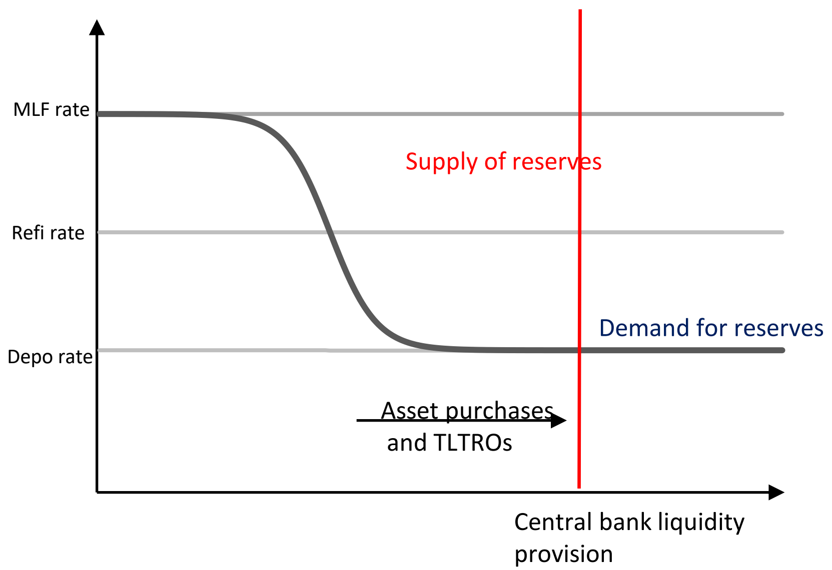
- **ECB** to present **new framework for steering short-term interest rates** in spring of 2024 and provide guidance on eventual size of ECB balance sheet **=>** crucial guidance for EZ money markets and liquidity conditions
- 1. Will ECB stick to **floor system** or return to **corridor system**?
- 2. Will Eurozone **liquidity** stay abundant (floor) or get tight again (corridor)?
- 3. Will **depo rate** stay key policy rate of will ECB return to **refi rate**?
- 4. Will **interbank market activity** remain modest (floor) or pick up again (corridor)?
- 5. How far can **QT** proceed?
- 6. How far will **Eurosystem balance sheet** shrink from current levels?
- **UBS expectation**: Current **floor system** to be maintained (= Fed & BoE), potentially complemented by **collateralised ECB lending operations**

Floor vs corridor system – key differences

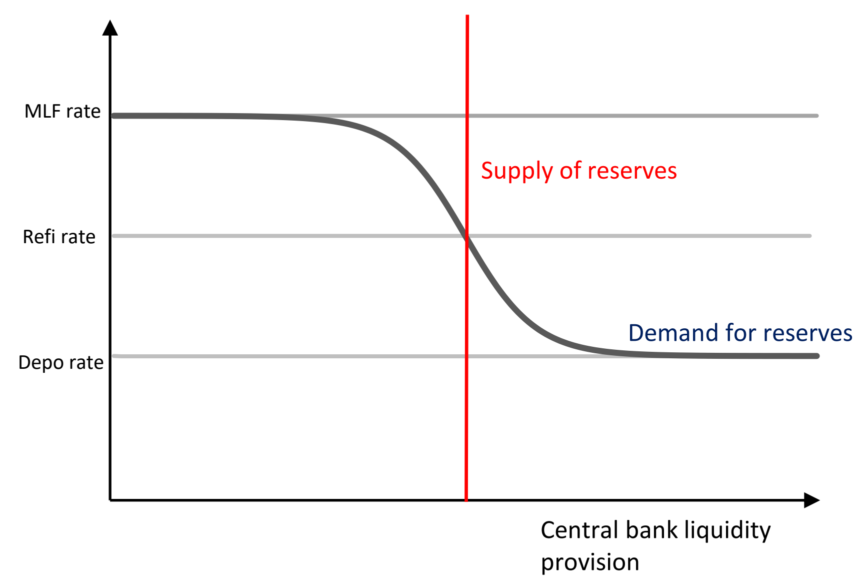
Key features of Floor and Corridor systems		
	Floor system	**Corridor system**
Quantity of liquidity and banks' (excess) reserves	Abundant	Limited
When will ECB balance sheet run-off /QT end?	Earlier	Later
Size of Eurosystem balance sheet	Larger	Smaller
Which interest rate will be the ECB policy rate?	Deposit rate	Refi rate
Effort required to steer short-term interest rates	Little	More
Activity in interbank markets	Less	More
ECB scope to support finanical stability	More	Less
Risk of ECB losses on its balance sheet	Higher	Smaller

Source: UBS

Supply of & demand for reserves in floor system

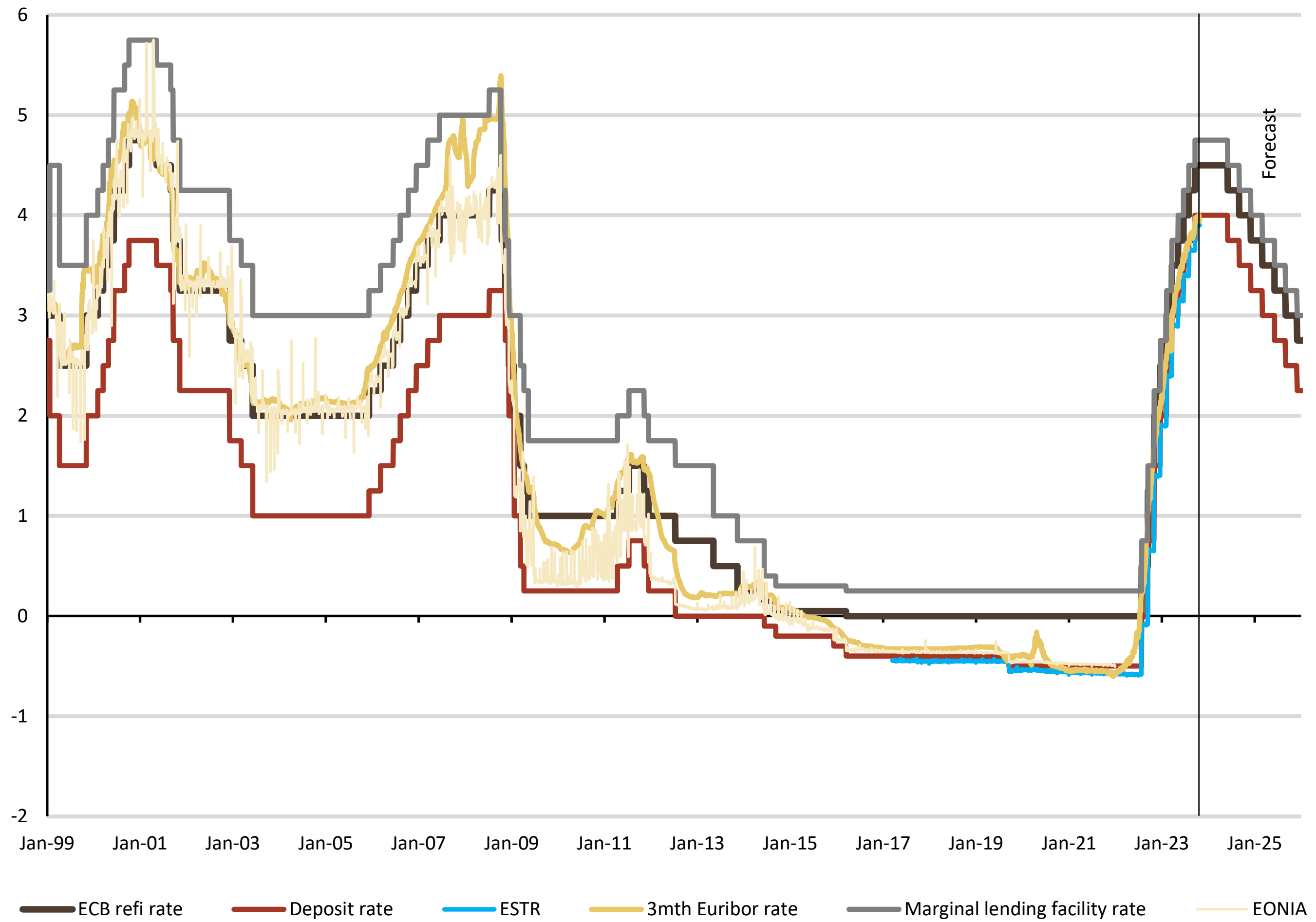


Supply of & demand for reserves in corridor system



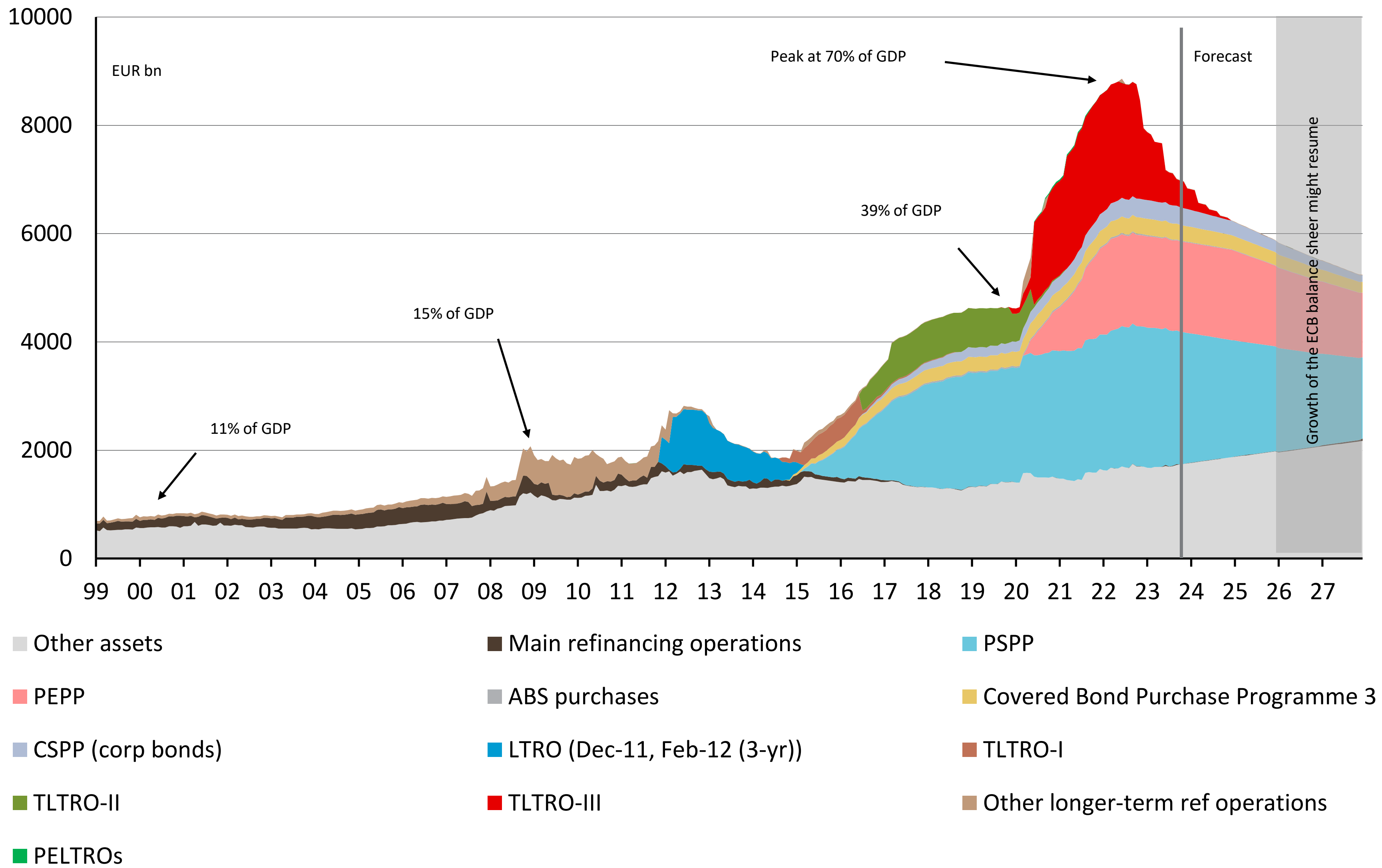
Source: ECB, UBS

UBS forecast for ECB interest rates



Source: Haver, UBS estimates

Eurosystem balance sheet



UBS Source: Haver, UBS estimates

Risks (negative and positive) & what to watch

- **Negative risks:**
  - Higher-than-expected inflation & tighter-than-expected monetary policy, with negative implications for growth and sentiment
  - Tight financial conditions to trigger new debt sustainability concerns
  - Sharp weakening of labour markets with negative impact on GDP growth
  - Weaker-than-expected external environment
  - Geopolitical risk
- **Positive risks:**
  - US avoiding a recession (US recession is UBS house view)
  - Faster-than-expected decline in inflation, lower energy prices to support growth and open door for faster-than-expected monetary easing
  - Reduced geopolitical uncertainty
- **Factors to watch:**
  - EU labour markets, wage growth and credit dynamics
  - How much energy-intensive production will leak out of Europe?
  - How will EU respond to US Inflation Reduction Act (IRA)?

Annex

UBS

Global economic outlook for 2023-2025F

	2019	2020	2021	2022	2023F	2024F	2025F
GDP growth							
World	**2.9**	**-2.8**	**6.5**	**3.4**	**3.1**	**2.7**	**3.1**
Emerging markets	3.8	-1.9	7.5	4.1	4.3	3.9	4.2
Developed markets	1.7	-4.1	5.3	2.4	1.6	1.1	1.7
US	2.5	-2.2	5.8	1.9	2.5	1.2	1.7
Euro Area	**1.6**	**-6.2**	**5.6**	**3.4**	**0.5**	**0.6**	**1.2**
Germany	1.1	-4.2	3.1	1.9	-0.3	0.7	0.9
France	1.9	-7.7	6.4	2.5	0.6	0.7	1.2
Italy	0.5	-9.0	7.0	3.8	0.8	0.7	0.9
UK	1.6	-10.4	7.6	4.1	0.2	0.6	1.5
Switzerland	1.2	-2.3	5.4	2.7	0.7	0.9	1.6
Asia	4.8	-0.7	7.5	4.1	4.8	4.5	4.7
China	6.0	2.2	8.4	3.0	5.2	4.4	4.6
EMEA	2.0	-2.4	6.6	3.2	2.0	1.9	3.0
Latam	-0.1	-7.0	7.1	3.9	2.0	1.9	2.2
Inflation							
US	1.8	1.3	4.7	8.0	4.2	2.7	2.0
Euro area	**1.2**	**0.3**	**2.6**	**8.4**	**5.5**	**2.4**	**2.0**
Interest Rates (eop)							
US Fed funds rate	1.75	0.25	0.25	4.50	5.50	2.75	2.00
US 10 year bond yield	1.92	0.93	1.52	3.88	4.40	3.00	-
ECB Depo rate	**-0.50**	**-0.50**	**-0.50**	**2.00**	**4.00**	**3.25**	**2.25**
Bunds 10 year	**-0.19**	**-0.58**	**-0.18**	**2.57**	**2.70**	**2.20**	**-**
Exchange Rates							
EUR/USD (eop)	**1.12**	**1.23**	**1.13**	**1.07**	**1.15**	**1.25**	**-**

UBS Source: UBS estimates as of 26 Oct 2023

Outlook for Fed, ECB, BoE, and SNB

- **US: Rates at 5.25-5.5% - we think the Fed is now “done”**
  - UBS expects first Fed cut in March 2024 and a US recession in Q2/Q3-2024
  - But: forecast risk skewed towards stronger US growth and later Fed cuts
- **ECB: Rates have peaked at 4.0% (depo); gradual cuts to start in June 2024**
  - Tight labour markets imply relatively slow return of inflation back to 2% target
  - We first ECB rate cut in June 2024, 25bps per quarter; rates back to 2% in Q1/26
  - ECB to unveil new framework for steering short-term rates in the spring of 2024
- **BoE: Rates at 5.25% and likely done**
  - BoE left rates on hold in September and is likely done amid falling inflation
  - We expect BoE to start cutting rates in May 2024 (to 2.5% by H2 2025)
- **SNB: We expect policy rate have peaked at 1.75%, first cut seen in Sept 2024**
  - Inflation has declined to <2%, but domestic price pressures will increase (rents)
  - SNB projects inflation to be (slightly) within target by 2025
  - SNB is selling FX reserves to support CHF

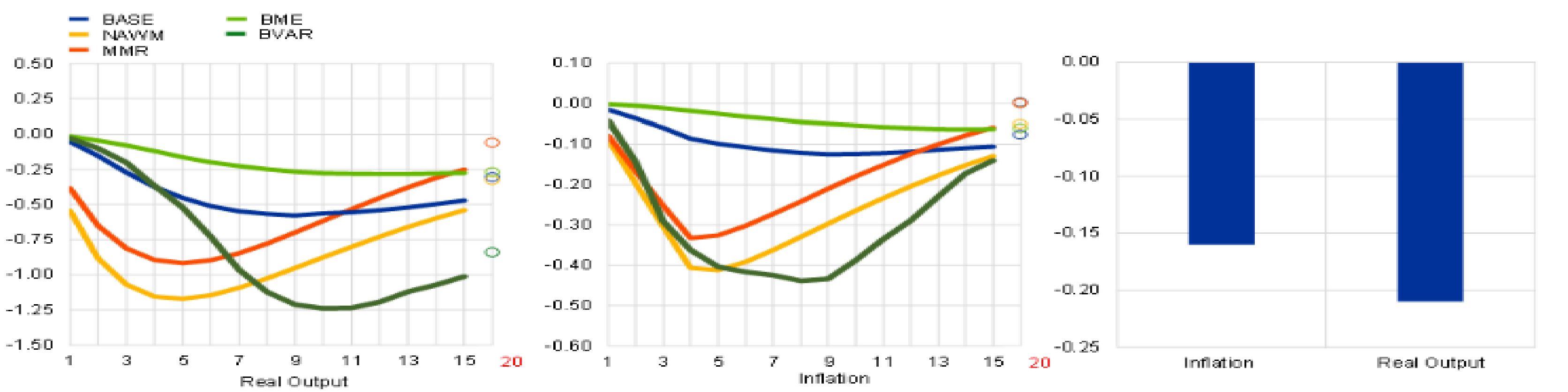
ECB research on monetary policy transmission

- **<u>Interest rates</u>: Effect of a 1pp interest rate hike:**
  - -0.3pp impact on average inflation
  - -1pp impact on output gap
- **<u>ECB balance sheet</u>: €500bn reduction over 12 quarters:**
  - -0.15pp impact on average inflation
  - -0.2pp impact on output

Chart 2

Macroeconomic impact of a 100 basis points monetary policy shock (left and middle panel), 12-quarter cumulative impact of a standardised €500 billion balance sheet reduction (right panel).

(deviation of output in per cent; year-on-year percentage points)



Sources: ECB staff calculations.

UBS

Source: [Philip Lane: Euro euro area hiking cycle: an interim assessment](), 16 February 2023

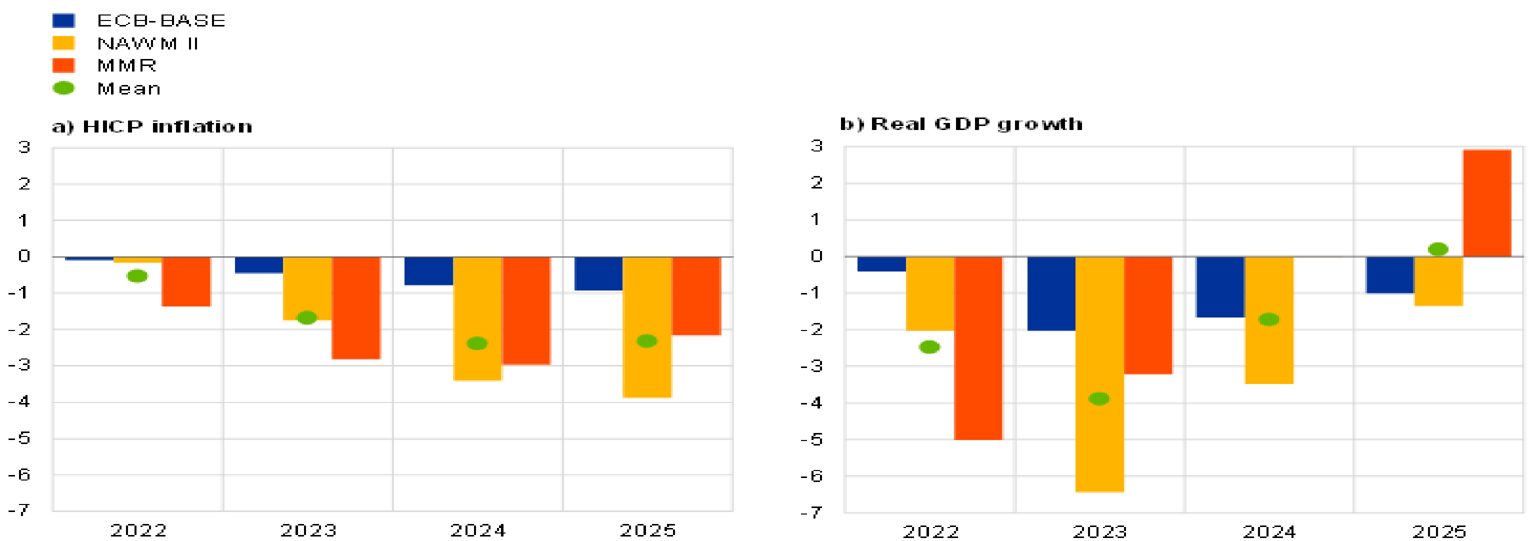
ECB research on monetary policy transmission

- **Impact of ECB policy tightening since December 2021:**
  - Increase in short-term interest rates of c. 270bps on average over the projection horizon 2022-2025; long-term interest rates up c. 230bps
  - **Inflation** lowered by 0.5pp in 2022; -2.0% in 2023-2025 (peak impact 2024)
  - **Real GDP growth** lowered by an average 2.0pp in 2022-2025 (peak: 2023)
  - => faster impact on growth than on inflation

Chart B

Impact of monetary policy tightening according to a suite of models

(percentage points)



Source: ECB calculations based on the NAWM II model (see Coenen et al., op. cit.), the MMR model (see Mazelis et al., op. cit.) and the ECB-BASE model (see Angelini et al., op. cit.).

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Source: A model-based assessment of the macroeconomic impact of the ECB's monetary policy tightening since December 2021, ECB Economic Bulletin, Issue 3/2023

Longer-term inflation outlook

- **Longer-term inflation outlook subject to <u>opposing forces</u>**
- **Anti-inflationary forces**
  - Automation, digitalisation, growing role of e-commerce
  - Secular stagnation ("Japanification"), ageing workforces, subdued productivity growth & GDP growth,
- **Pro-inflationary forces**
  - Increased investment into **energy transition, energy security & defence**
  - Worsening **structural shortage of qualified labour** (demographic change)
  - Shift to services (less room for productivity growth, e.g. health care)
  - De-globalisation and shortening of supply chains
  - The Great Demographic Reversal (Charles Goodhart)
    - Key thesis: China has added to the global pool of labour in the past 25 years, driving down global wage costs, but this era is now ending
- **Will ECB remain committed to 2% inflation target (rates higher for longer) or allow inflation to stay elevated? Will ECB consider raising its 2% inflation target (next ECB strategy review in 2025)?**

Inflation and growth sensitivity to oil and gas

		10% oil	10% wholesale gas prices	10% retail prices of fuel, gas and electricity
Impact	Inflation	0.25pp short term plus 0.15pp longer term	0.04pp (over 12 months)	1pp (immediate)
	GDP growth	0.1pp (over 12 months)	0.02pp (over 12 months)	0.2pp (over 12 months)*

Source: UBS estimates. *Does not include compensating effects from easier fiscal or monetary policy

Inflation as function of oil prices and EUR/USD

Impact on HICP	1% NEER		1% EUR/USD		10% oil	
	1 y	0.1pp	1 y	0.05pp	Direct	0.25pp
	3 y	0.2pp	3 y	0.1pp	Indirect	0.15pp

See An Interactive model for Eurozone inflation forecasting for a detailed discussion of the oil price and FX impact on Eurozone HICP.

Source: ECB, Monthly Bulletin, August 2010 (p. 91) and ECB Economic Bulletin, Issue 7/2016 – Article 'Exchange rate pass-through into euro area inflation, p42.

EU sustainability, energy security & industrial policy

- **European Green Deal (Dec 2019)**
  - Climate neutrality by 2050
  - Greenhouse gas emissions to be cut 55% by 2030 (relative to 1990)
- **European recovery fund (NGEU, €750bn), response to Covid-crisis (2020)**
  - 1/3 to be spent on the green transition
- **REPowerEU (May 2022), response to Russian invasion of Ukraine**
  - Saving energy, producing clean energy, diversifying energy supplies
  - Financial support from the RRF: €225bn of loans; €10bn of new grants
- **Green Deal Industrial Plan (Feb 2023), response to US IRA**
  - Ensuring access to "technologies, products and solutions that are key to net zero", via streamlined regulation, better funding, strategic trade policy
  - Looser state aid rules, REPowerEU, InvestEU (formerly Juncker-Plan), Innovations Fund, European Sovereign Fund (work in progress)
- **Carbon Border Adjustment Mechanism (CBAM), to start in 2026**
  - Initially covering: cement, iron/steel, aluminium, fertilisers, electricity

Bond yield forecasts

UBS Gobal Rates Forecast		2023	2024			
	Current	Q4	Q1	Q2	Q3	Q4
US 10 year Bond Yield	4.83	4.40	4.25	3.75	3.50	3.00
UK 10 year Bond Yield	4.70	4.40	4.30	4.00	3.80	3.60
German 10 year Bond Yield	2.82	2.70	2.65	2.50	2.40	2.20
Swiss 10 year Bond Yield	1.10	1.10	1.00	0.90	0.80	0.70
Japan 10 year Bond Yield	0.85	1.10	1.20	1.30	1.00	0.50
Australia 10 year Bond Yield	4.68	4.50	4.50	4.25	4.00	4.00
NZ 10 year Bond Yield	5.44	5.50	5.00	4.50	4.50	4.50

Source: Haver, UBS estimates as on 26 Oct 2023

UBS FX forecasts

G10 FX Forecast Table

	Spot	End-2023	End-2024
EUR/USD	1.06	1.15	1.25
USD/JPY	150	130	120
EUR/JPY	159	150	150
GBP/USD	1.21	1.35	1.51
EUR/GBP	0.87	0.85	0.83
EUR/CHF	0.94	1.00	1.05
USD/CHF	0.89	0.87	0.84
EUR/SEK	11.63	11.00	10.50
EUR/NOK	11.70	10.00	9.50
AUD/USD	0.63	0.75	0.80
NZD/USD	0.58	0.67	0.70
USD/CAD	1.37	1.28	1.22
XAUUSD	1989	2000	2100

Source: UBS forecasts as of 26 Oct 2023

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Risk Statement

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