European Economic Outlook
(Abridged Version)

EY Economic Analysis Team

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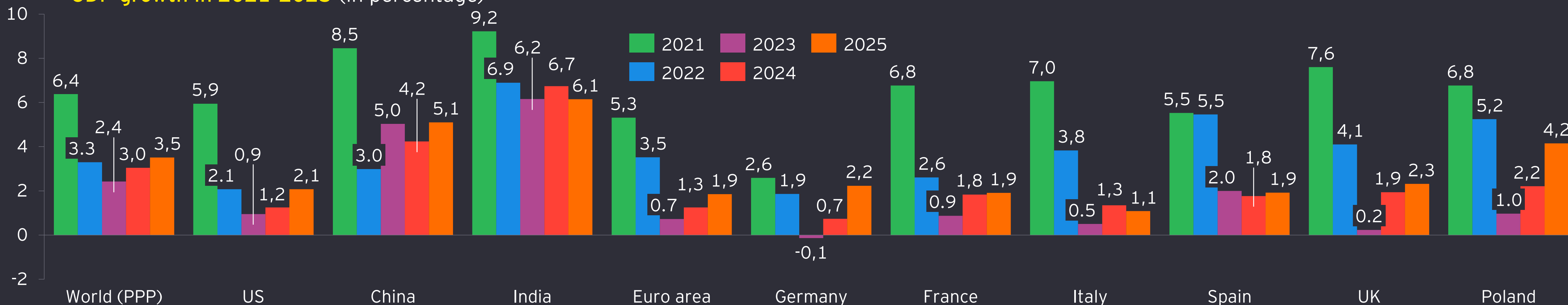
European economy shows resilience … but the recovery will be sluggish

- The European economy has been slowing since mid-2022, with inflation continuing to exceed nominal wage growth and acting as a drag on consumption. While rising interest rates have also taken their toll, economic growth surprised on the upside, with stagnant GDP in Q4 2022 and likely modest growth in Q1 2023, quelling previous expectations of an imminent recession.
- Considerable budgetary support measures for households and firms helped weather the energy crisis, assisted by a mild winter and ample natural gas storage at European facilities, which kept a lid on energy costs. Resilient labor markets continue to support consumer income and China's reopening has contributed to the global demand recovery.
- In coming quarters, declining inflation will bring some respite to consumers. Real wage growth, after bottoming at -4.9% in Q3 2022, is accelerating and is expected to turn positive in Q4 2023. Despite the banking stress that hit financial markets during March 2023, recent data suggest that financial tensions have so far made little impression on consumers and businesses. As a result, most European economies are expected to avoid GDP contraction in 2023.
- Prolonged elevated energy prices and inflation, compounded by monetary policy tightening, will continue to impact household consumption and economic growth. In our baseline scenario, in which we assume that the recent financial sector turmoil is contained, GDP growth in the euro area should decrease from 3.5% in 2022 to 0.7% this year, recovering to 1.3% in 2024 and 1.9% in 2025. European economies will remain well below pre-Covid trends, pointing to the long-term negative effects of the pandemic and the war in Ukraine.
- The slowdown in global trade (from 5.0% in 2022 to 1.1% in 2023 and 2.5% in 2024) will weigh on Europe's exports and thus on manufacturing. Faced with slower demand, many companies will adjust inventories, which will amplify the adverse cyclical impact on the industrial output. In some sectors (aerospace, automotive), easing supply bottlenecks allows them to realize solid order backlogs that outweigh, at least in the short term, the negative effects of demand slowdown.

GDP growth in 2021-2025 (in percentage)



Source: Oxford Economics, EY EAT forecast (baseline scenario).

EY

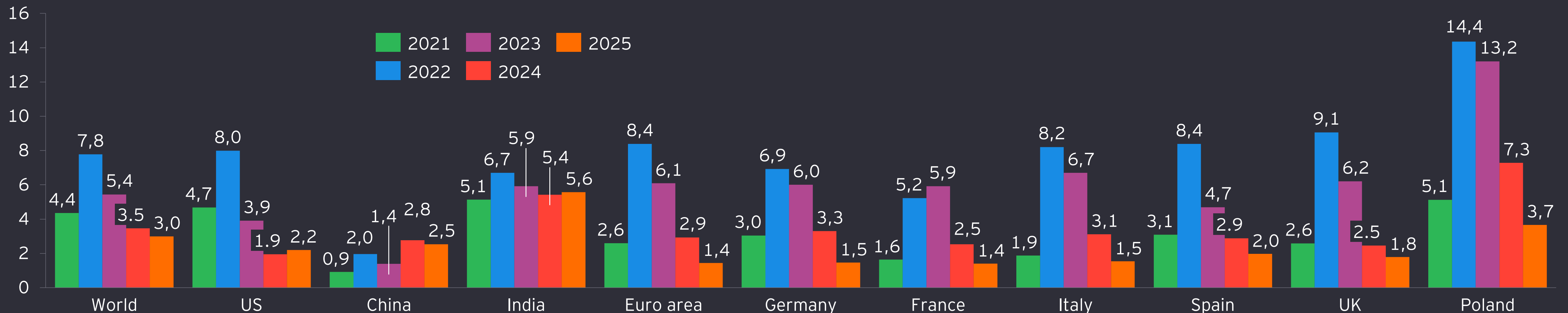
Despite decline in energy prices, elevated inflation can prove more sticky

- Euro area inflation has passed its peak (10.6% in October 2022) and begun to decelerate, driven by falling energy prices and base effects. Supply bottlenecks are receding quickly, which allows supply to recover. That, coupled with slowing demand and reversal of the previous shifts in consumption patterns (away from services towards goods after the outbreak of the pandemic), should lead to lower industrial margins. Moreover, declining commodity prices, particularly energy costs, will gradually filter through to other prices. This should support disinflation of industrial and consumer goods. It's already reflected in companies' business outlook, especially in energy-intensive sectors.
- Downward inflationary trends could be counterbalanced by a strong and sustained wage growth, which has accelerated in the euro area. Moreover, previous increases in core goods PPI in Europe have been only partially passed on to consumers. Consequently, core goods HICP inflation (excluding volatile energy and food components) may not fall as quickly as some might anticipate due to declining PPI inflation. There is also little sign of abating price pressures in services, though they are no longer intensifying.
- The risk of sticky inflation seems to be confirmed by recent data indicating higher than expected core inflation that has not yet peaked in numerous European countries. Underlying price pressures are therefore proving more persistent, particularly with tight labor markets in many economies. The economic slowdown has caused some softening of demand for labor, as confirmed by the recent decline in job postings data, and firms report some reduction in labor market tensions. However, these remain much tighter than before the pandemic and employment continues to growth, activity rates are above pre-pandemic levels, while unemployment rates are at or near historical lows.
- On one hand, the ongoing economic slowdown reduces employees' bargaining power, while on the other the still-tight labor market, indexation to past inflation and minimum wage hikes in many countries are likely to maintain wage growth momentum in the coming quarters. Moreover, since Q4 2021 nominal wage growth in the euro-area has been lagging behind inflation, resulting in a contraction of real wages, which is unlikely to continue for much longer. With a tight labor market, workers may use their bargaining power to recoup lost income. As headline inflation decelerates, we expect growth in nominal wages in the euro area to remain near current levels in 2023, resulting in real wage growth turning positive in the last quarter of this year.
- In terms of inflation, this poses a risk of a more prolonged cost-push shock coming from wage growth. This is unlikely to prevent goods disinflation, but would imply more persistent inflation in services, which are on average much more labor-intensive and in which wages represent double the share of direct input costs than that in manufacturing. The strong labor market is therefore a major source of continued upside risks to the inflation outlook.

Persistent inflation signals that central bank rates may stay higher for longer

- While we forecast inflation in Europe to fall relatively quickly during the course of 2023, in annual average terms, it will remain elevated. In the euro area, inflation will reach 6.1% and some CEE countries, especially Hungary, Czechia, Poland and Slovakia, will continue to see double-digit figures in 2023.
- In the euro area, inflation should reach the European Central Bank (ECB) target of 2% in the second half of 2024, but core inflation may remain higher until the second half of 2025. For many EU countries, price growth will remain above central bank targets until 2025 and for some even longer. Moreover, in the environment of tight labor markets and continued very high inflation, the risk of another surge in price pressures due to new supply shocks remains significant. Therefore, central bank rates may stay higher for longer.
- The ECB will maintain a data-dependent approach and, due to increased uncertainty over the effects of the recent financial-sector turmoil on credit conditions, will refrain from providing guidance on the future interest rate path. However, given that core inflation in the euro area has recently hit another record and labor markets remain very strong, in our view, for most ECB policymakers further rate hikes will be warranted. We expect the ECB deposit rate to be raised by another 75bps up to 3.75%. The effects of monetary policy tightening have already become apparent in the overall negative loan growth in the euro area for the first time since 2014 and a slowdown in new home construction in many countries. Moreover, the full impact of interest rate hikes is yet to be felt fully.
- Following the latest rate increase (by 25bps to the 4.75-5% range), the Fed has turned significantly more dovish as a result of the turmoil in the US banking sector. Still, another 25bps hike in May 2023 seems likely and we also expect the Bank of England to raise its base rate once more, to a peak of 4.50%.

Inflation in 2021-2025 (in percentage)



Source: Oxford Economics, EY EAT forecast (baseline scenario).

EY

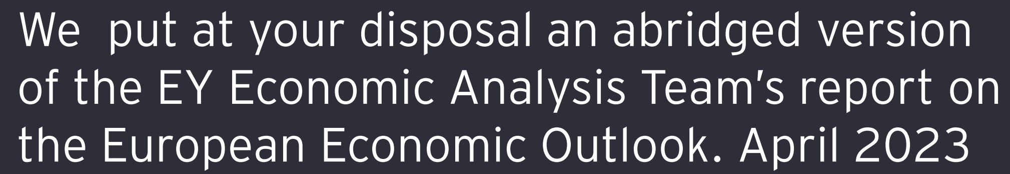
The 2023 economic outlook has improved, but the balance of risks leans to the downside

- KEY RISK FACTORS
  - Persistent elevated inflation would squeeze household budgets for longer and weigh on private consumption, in addition to increasing the risk of excessive monetary policy tightening by major central banks that may prefer to err on the side of caution.
  - The recent turmoil in the banking system, beginning with the failures of some US banks, is a new cause for concern. However, in Europe, the chances of similar situations occurring are more limited due to financial supervision covering much smaller banks than in the US. Moreover, the most recent assessment conducted by the European Banking Authority confirms the strong position of European banks. However, pockets of vulnerability may exist not only in the banking sector, but also in non-bank financial institutions, the role of which has been growing in global markets for many years.

    The latest financial tensions may make banks even more reticent in lending, but in our baseline scenario, the banking turmoil will be contained, without significant impact on the European economy. However, volatility in market sentiment could continue, together with hunting for weakness. In an alternative scenario, in which we assumed that the current turmoil leads to an additional tightening of credit conditions (a third as large as during the global financial crisis), by 2025, GDP in the euro area would be almost 2% lower than in the baseline.
  - Geopolitical tensions, including the war in Ukraine, continue to be a key risk and if they intensify, could lead to more energy and food price spikes (especially if the Black Sea Grain Initiative is not renewed), pushing inflation up. China's reopening, while easing supply bottlenecks and supporting global growth, will add to price pressures through increased demand for energy commodities, especially natural gas. Potential harsh weather conditions could exacerbate imbalances in energy markets, particularly ahead of the 2023-24 winter. The decision of OPEC+ members on 2 April 2023 to cut oil output only adds to the growing concerns over energy prices and economic outlook.

    Our analysis shows that Europe is more vulnerable to a renewed increase in energy prices than other major economies, in particular the US. In the event of another spike in energy costs, the most adversely impacted European economies would include: Romania, Hungary and Czechia.
  - Elevated debt levels increase vulnerability, especially of emerging markets and developing economies, to potential financial market turbulence. They also limit the fiscal space to offset new negative shocks and their impact on households and businesses.

It is essential to remember that the energy crisis and many other disturbances, including those driven by changes in the geopolitical landscape, are not transitory shocks. We should get used to an extended period of uncertainty and volatility. It is crucial for businesses and policymakers to remain vigilant and be prepared for any further risks to materialize.



We put at your disposal an abridged version of the EY Economic Analysis Team's report on the European Economic Outlook. April 2023

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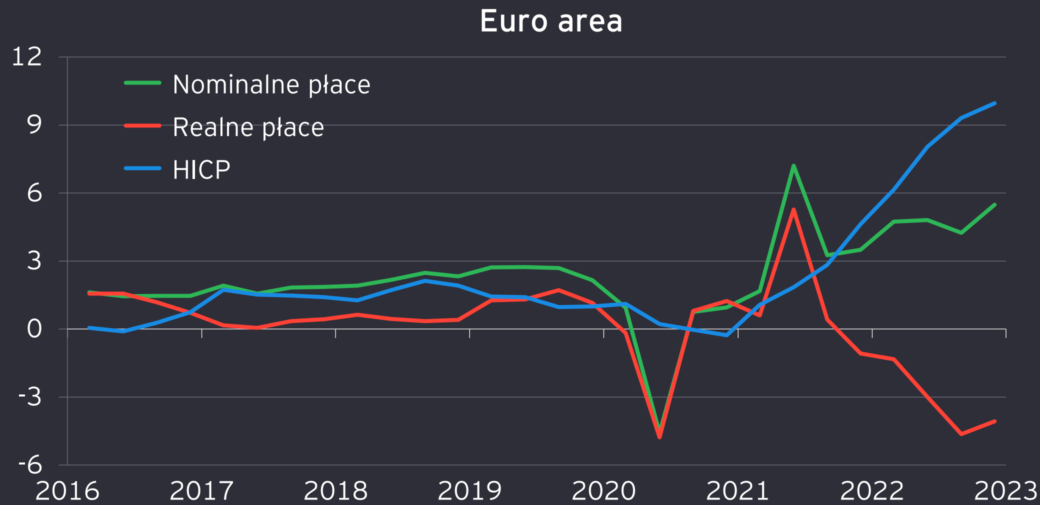
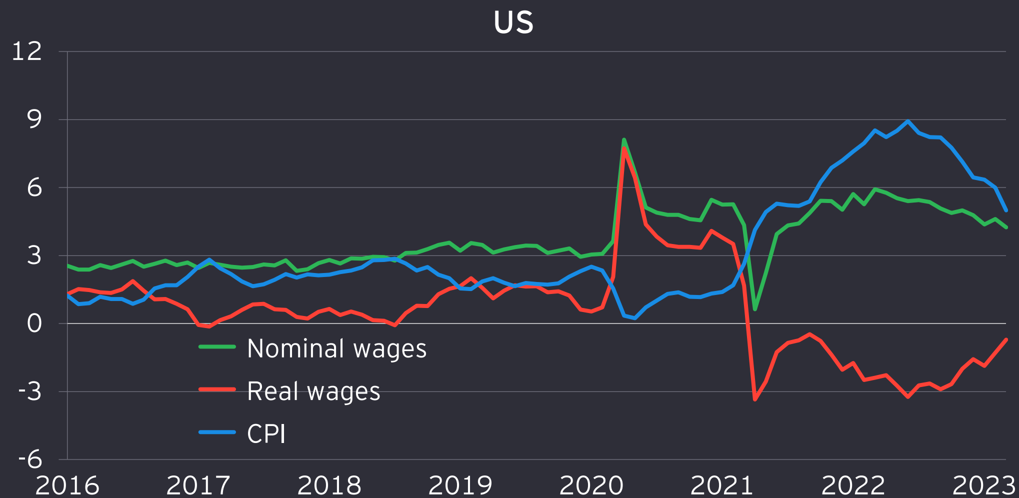
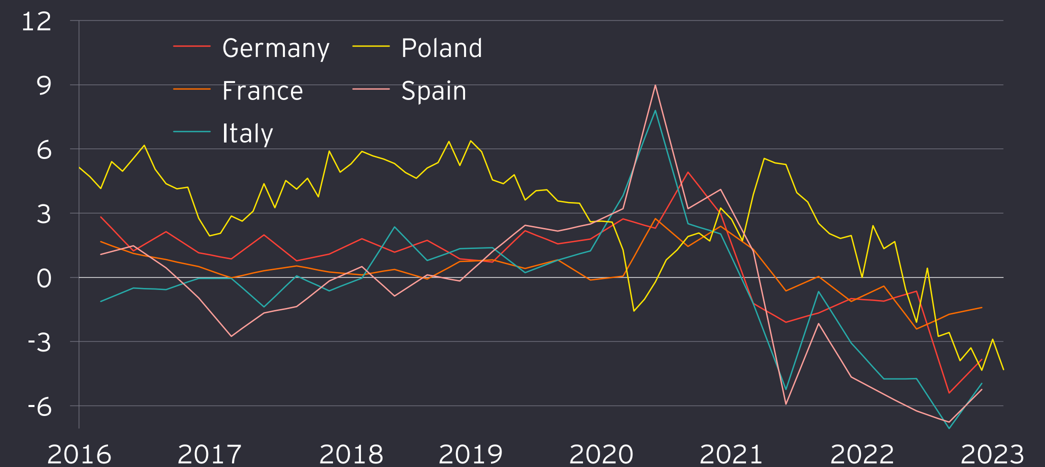
Most OECD and European countries are now facing slowdown. Economic activity is weakened primarily by high inflation, which exceeds nominal wage growth and puts a drag on consumption. Rising interest rates take their toll too

Nominal and real wage growth, YoY* (in percentage)





Real wage growth in selected EU countries, YoY (in percentage)



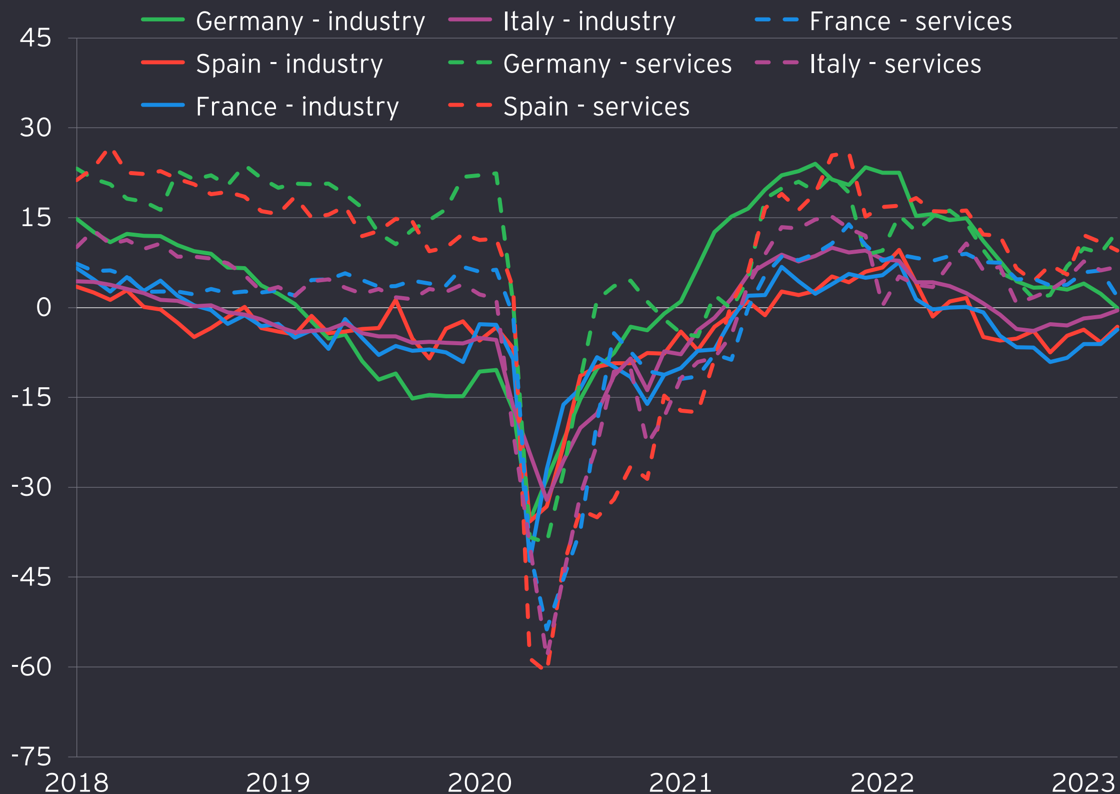
Source: Eurostat, Statistics Poland ,ONS, FRED, Oxford Economics.
* For the the euro area, wages and salaries per employee based on national accounts; for the euro area countries, labor cost index (quarterly data); for the UK, average weekly earnings in the whole economy, total pay (monthly data); for the US, average hourly earnings in the private sector (monthly data); for Poland, wages in the enterprise sector. Real wages deflated with CPI.

EY

However, the European economy is proving more resilient than many expected: economic activity seems to have picked up slightly in 2023 Q1, quelling previous expectations of an imminent recession

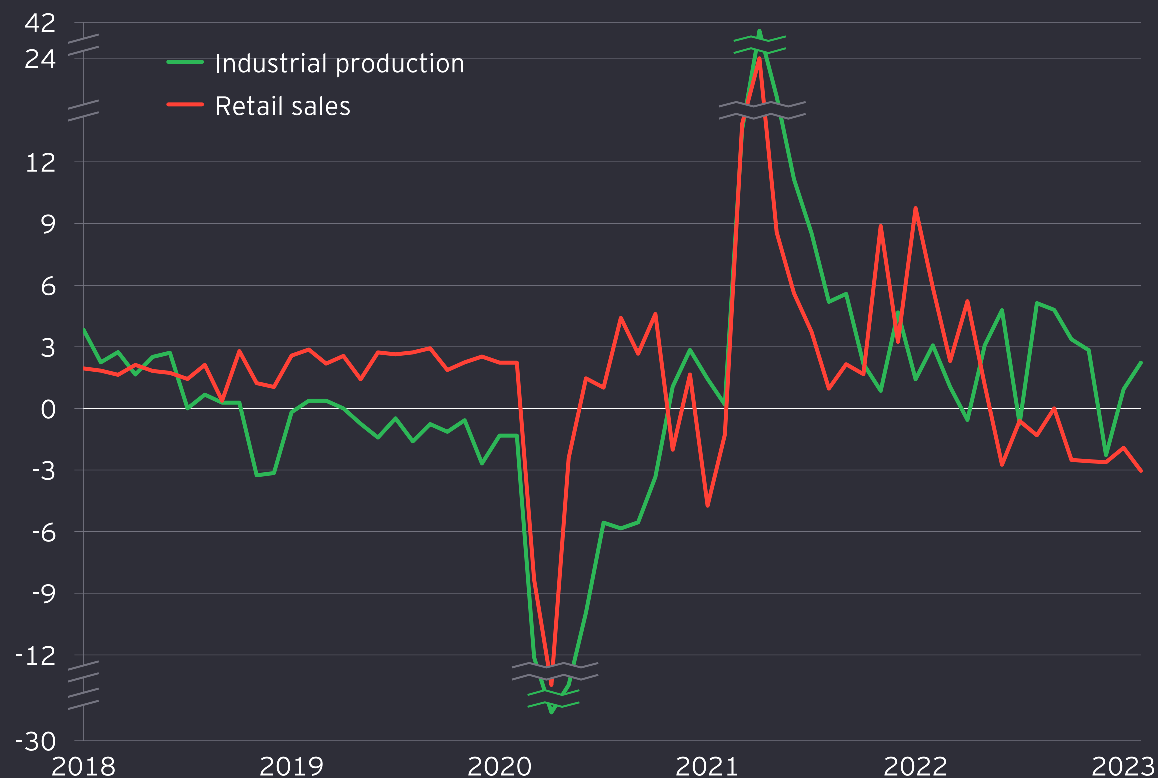
- Considerable budgetary support measures for households and firms helped weather the energy crisis, assisted by a mild winter and ample natural gas storage at European facilities, which kept a lid on energy costs.
- Despite the banking stress that hit financial markets during March 2023, recent data suggest that financial tensions have so far made little impression on consumers and businesses, as indicated by confidence and sentiment indicators pointing to an ongoing gradual recovery.

Confidence indicators



Industrial production and retail sales in the euro area

(YoY, in percentage)

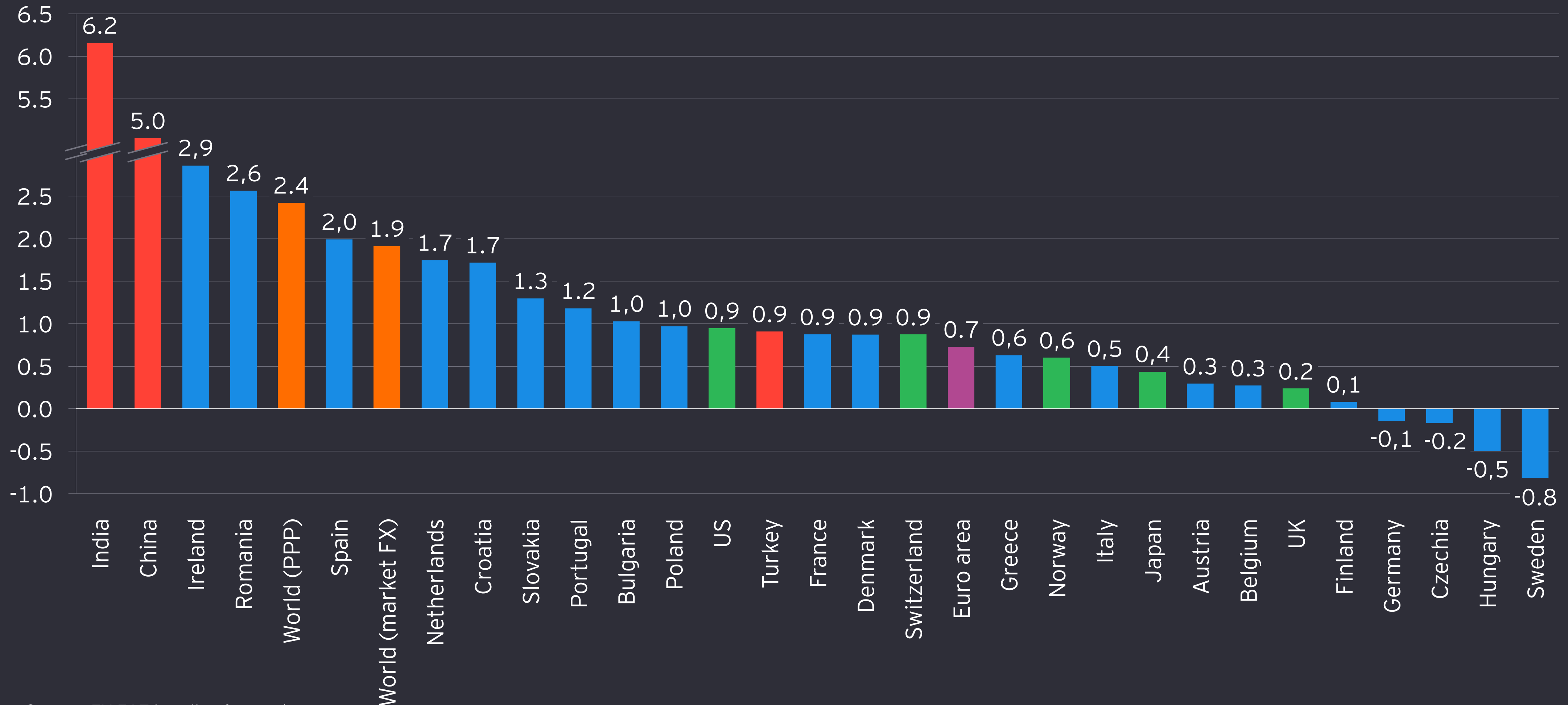


Source: Eurostat; ONS.

EY

The slowdown in most European countries has already bottomed out and we expect most economies to avoid GDP contraction in 2023

- In coming quarters, declining inflation will bring some respite to consumers, even though monetary tightening will continue to put a drag on activity.
- Resilient labor markets continue to support consumer income and China's reopening has contributed to the global demand recovery.



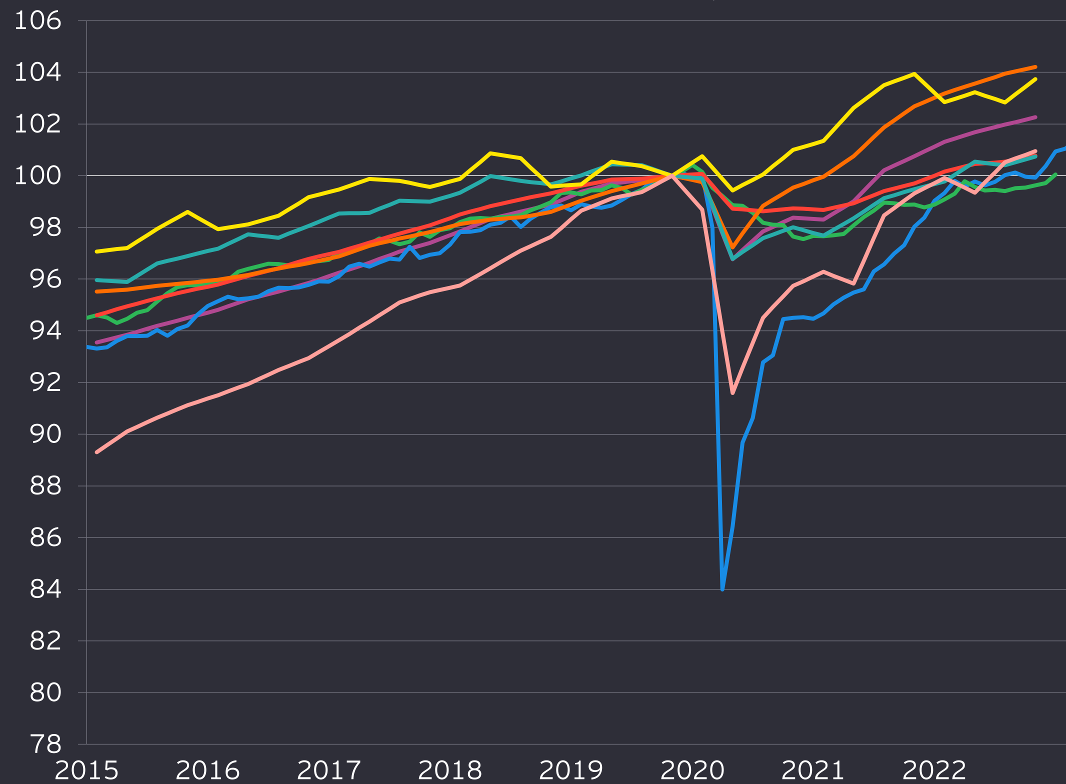
Source: EY EAT baseline forecast.

EY

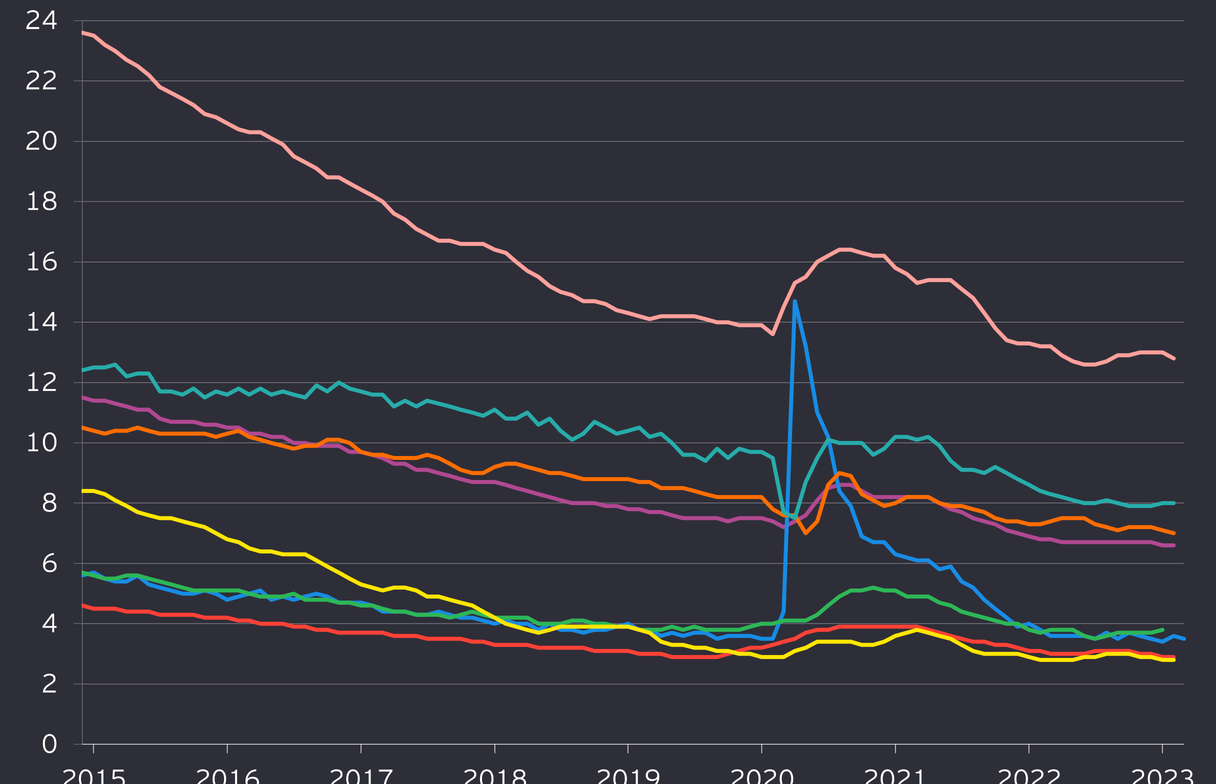
Robust labour markets make this time different: despite economic slowdown, employment continues to grow reaching record high levels in many OECD economies, while unemployment rates are at or near historical lows

- Economic slowdown should lead to deceleration in wage growth, but without a significant surge in layoffs and with only a limited increase in unemployment. This is partly due to structural labur shortages that make companies 'hoard' staff more often than during past economic downturns.

Employment*
(Index, Q4 2019 = 100, seasonally adjusted data)



Unemployment rate
(in percentage)



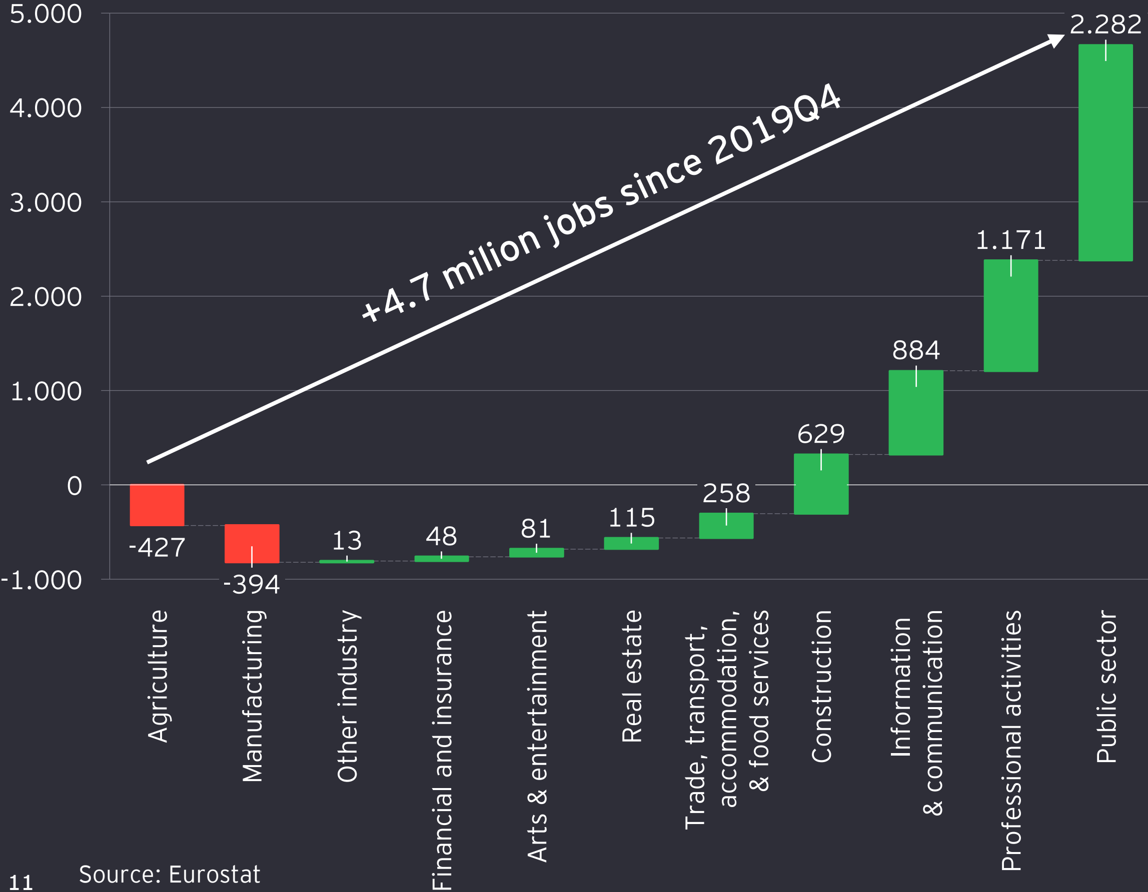
Euro area — US — UK — Germany — France — Italy — Poland — Spain

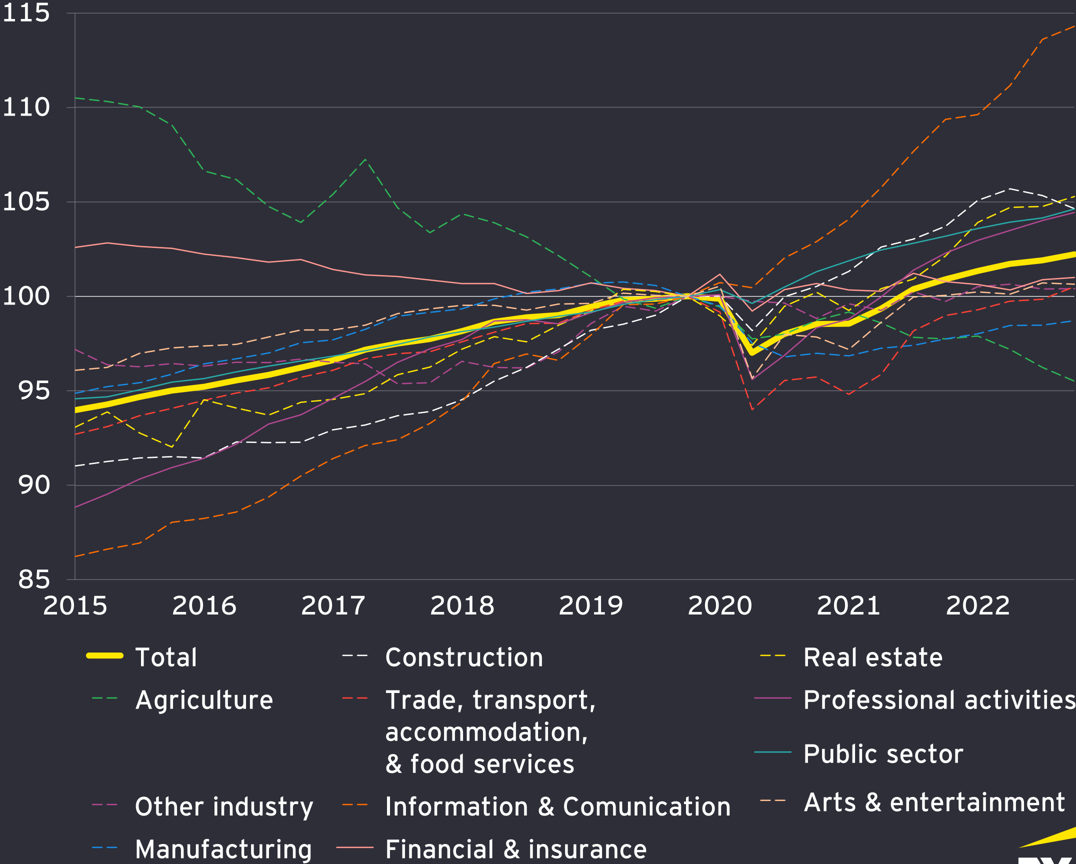
Source: Eurostat, FRED, ONS,
* For USA employment by the household survey, for UK number of employed persons, for Euro area and EU countries total employment by national accounts.

EY

The post-pandemic recovery in the EU labor market has been asymmetric across sectors

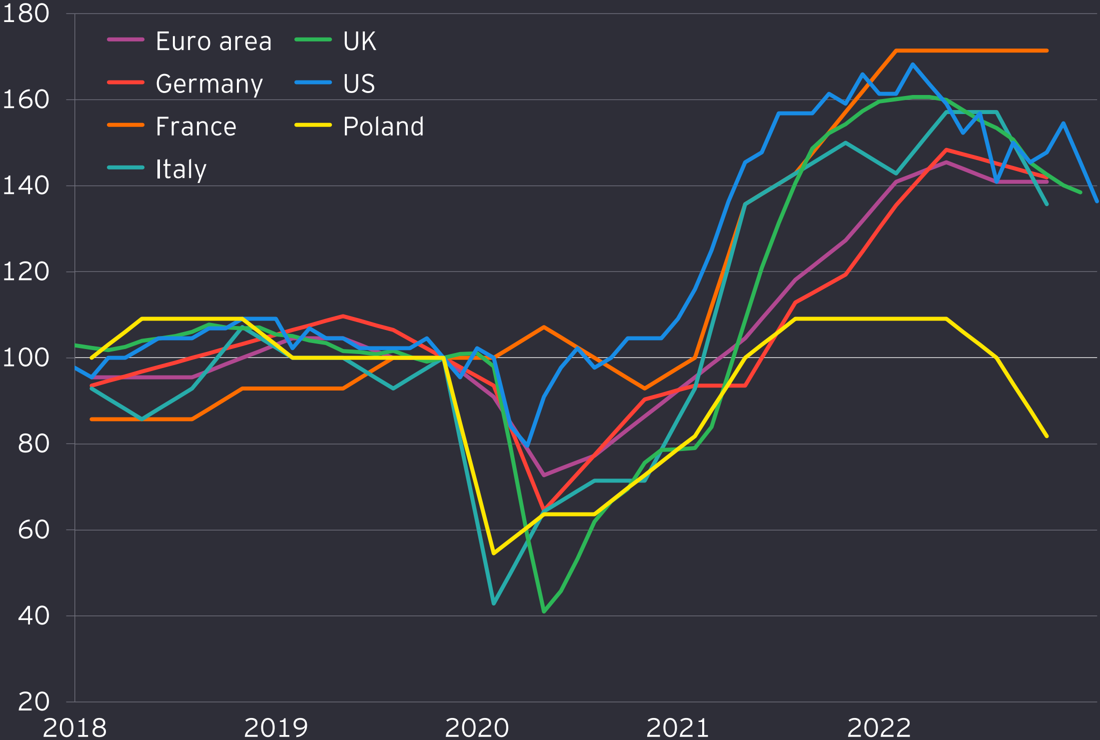
- In absolute terms, employment increase was the highest in the public sector. It was aligned with the pre-pandemic trend.
- In relative terms, the highest employment increase has been observed in information and communication.
- Employment in manufacturing is still below pre-pandemic levels.

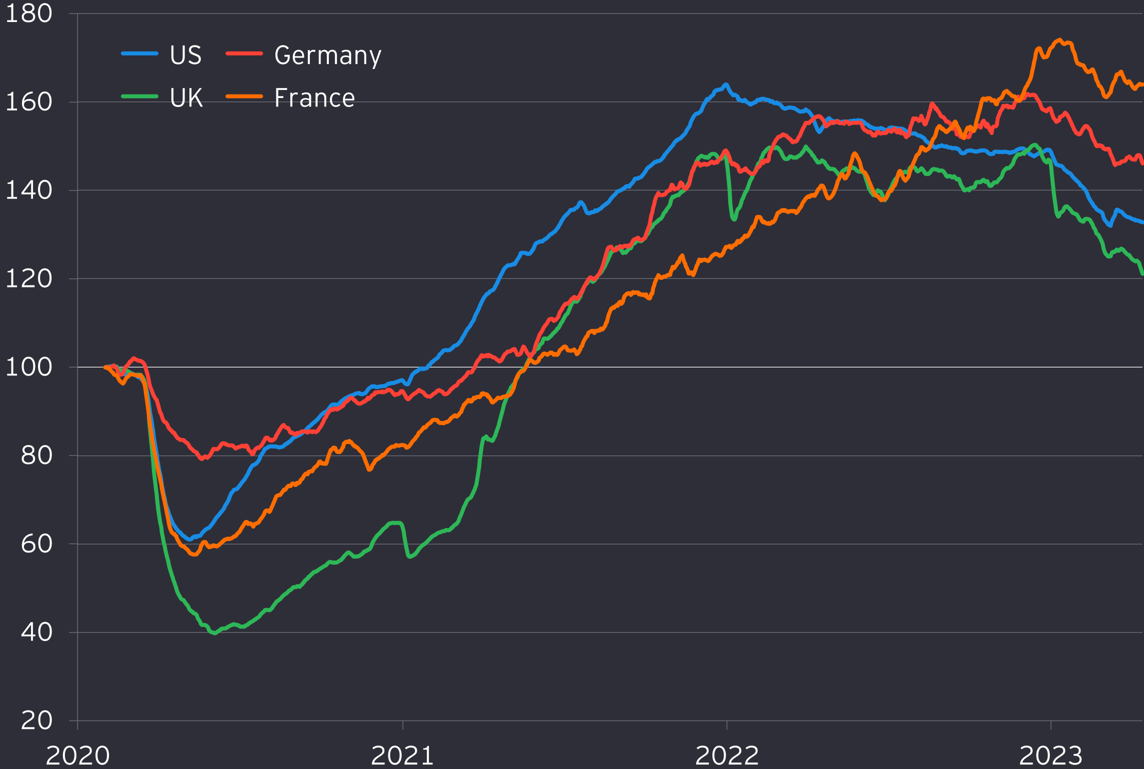




Source: Eurostat

Due to economic slowdown, demand for labor has softened a bit, but remains high. The recent decline observed in job postings data is rather cyclical





Source: [1] Eurostat, ONS, FRED, EY EAT calculations. [2] Data on online job postings is based on GitHub - hiring-lab/job_postings_tracker: Regularly updated data series for external use.
[3] Eurostat, EY EAT calculations, VA per worker based on 2021 data on sector VA and total employment.

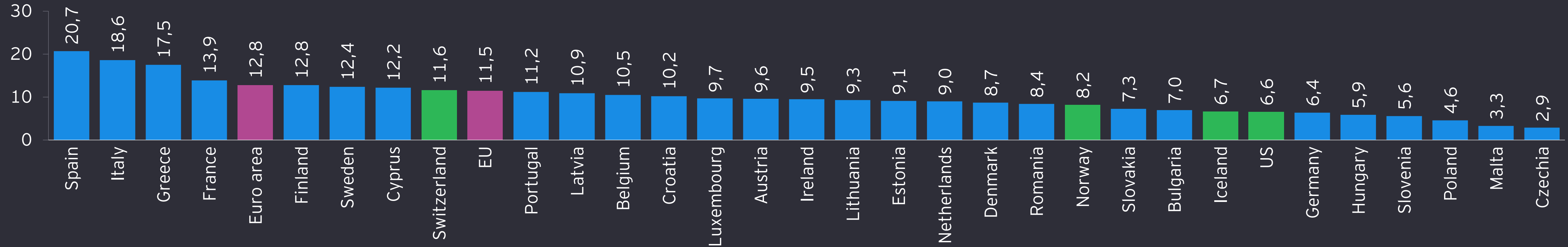
* Vacancy rate is the number of vacancies divided by the total number of filled positions (for the UK, total number of people employed). For the EU countries, quarterly data; for the UK and the US, monthly data. For France, vacancies reported by firms employing at least 10 employees.

EY

Even though it reached a record low, labour market slack remains substantially higher in the euro area (particularly in Southern Europe) than in the US, UK or CEE

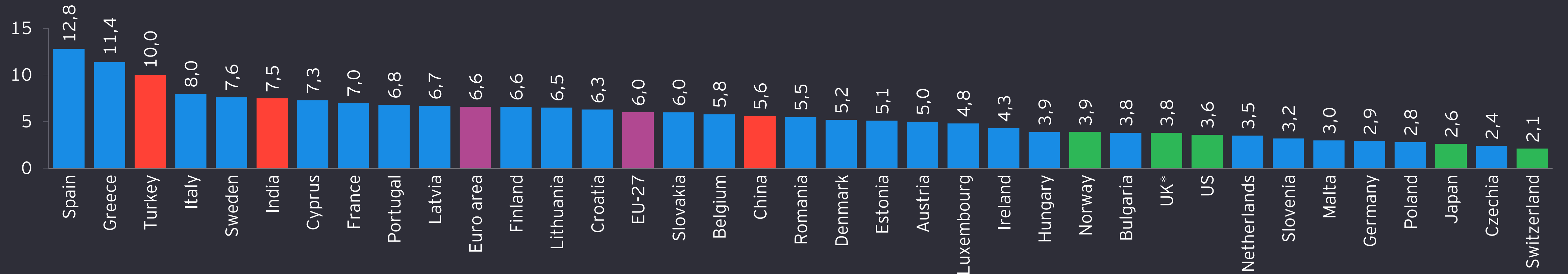
Labour market slack, Q4 2022

Percentage of the extended workforce aged 20-64



Unemployment rate in February 2023

Percentage of population in the labour force



Source: Eurostat; ONS; BLS

Note: Labour market slack includes four groups:

1. Unemployed persons, as defined by the ILO
2. Underemployed persons working part-time
3. Persons available to work but not seeking
4. Persons seeking work but are not immediately available

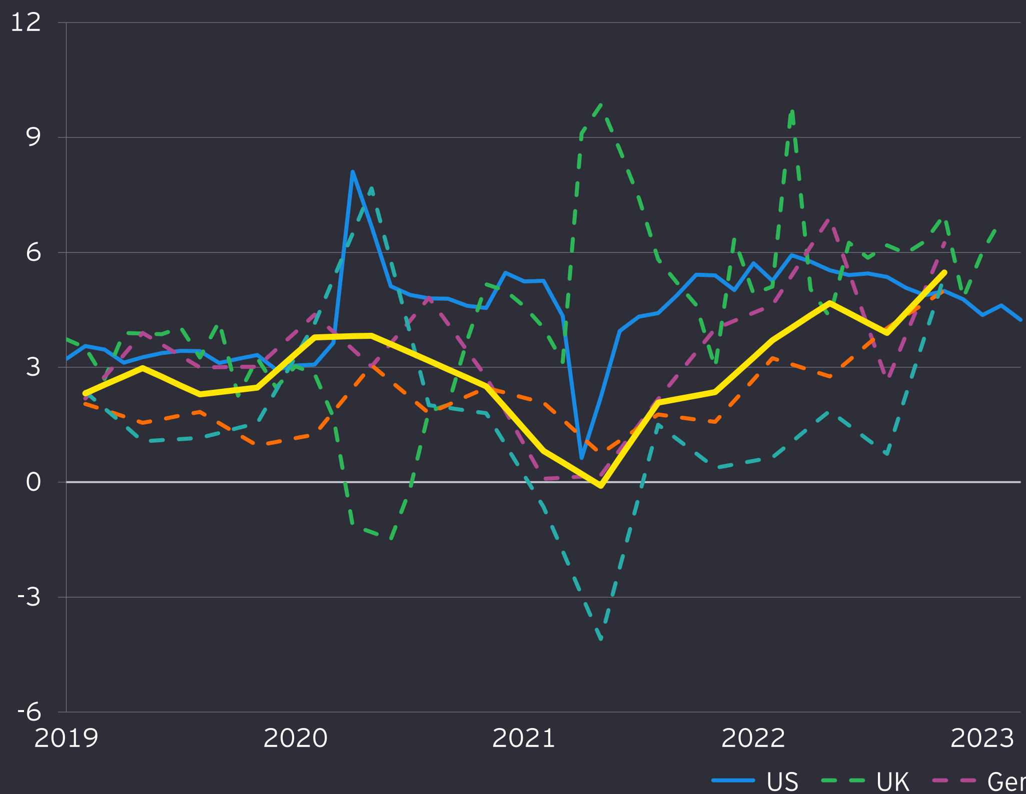
While the first two groups count as part of the labour force, the other two, also referred to as potential additional labour force, are outside the labour force. For this reason, the 'extended labour force,' consisting of both the labour force and the potential additional labour force, has been used for this analysis. For the US, the labour slack is the U-6 unemployment rate. For the US and UK, the unemployment rate for those aged 16-64.* Unemployment rate for December 2022 to February 2023.

EY

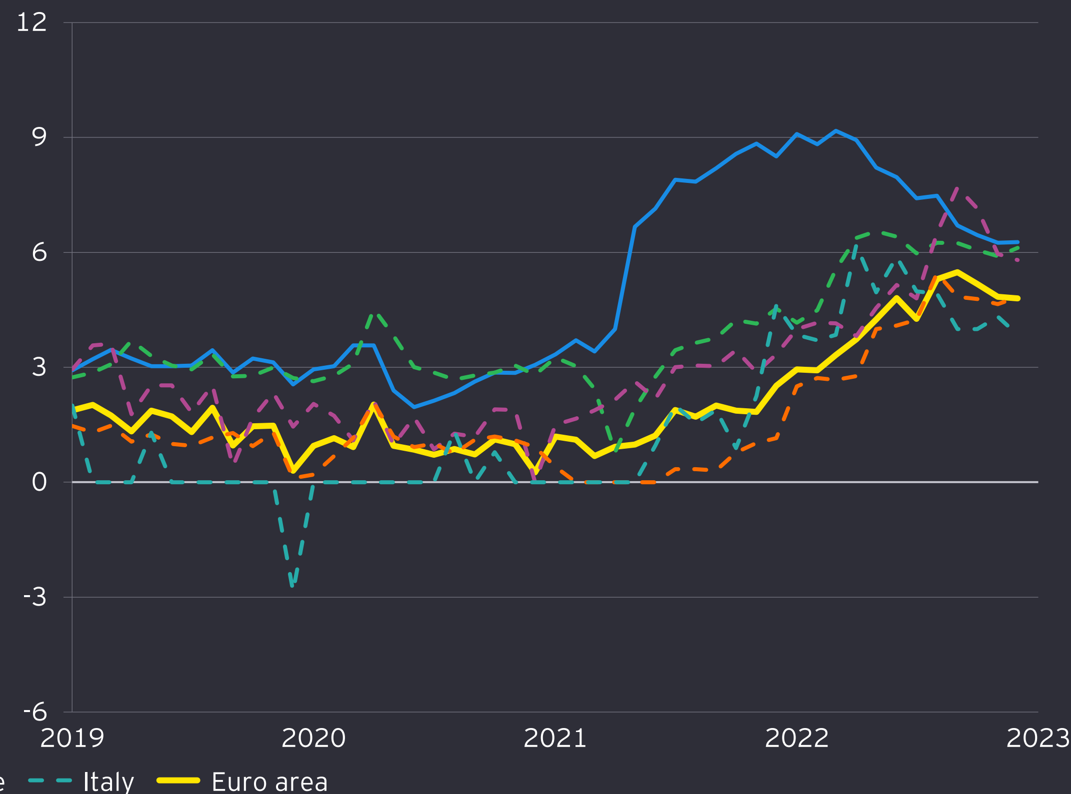
Despite this, on the back of elevated inflation, nominal wage growth in the euro area has accelerated and caught up with the US and UK. However, data on wages offered in job postings signal that wage pressures are no longer intensifying

- On one hand, the ongoing economic slowdown reduces employees' bargaining power, while on the other the still-tight labor market, indexation to past inflation and minimum wage hikes in many countries are likely to maintain wage growth momentum in the coming quarters.

Labor cost index[1], nominal (YoY, %)



Wage growth in job postings[2] (YoY, %)



US UK Germany France Italy Euro area

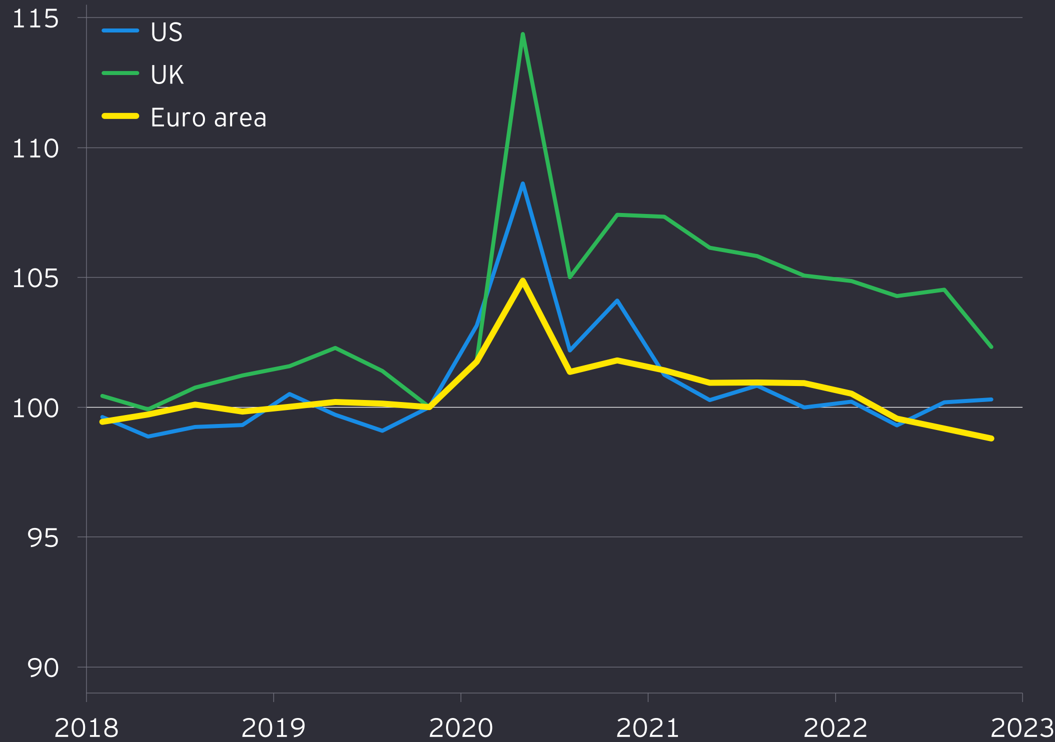
Source: [1] Eurostat, ONS, FRED, Oxford Economics
For the European area countries, labor cost index (quarterly data); for the UK, average weekly earnings in the whole economy, total pay (monthly data); for the US, average hourly earnings in the private sector (monthly data). Real wages deflated with CPI.

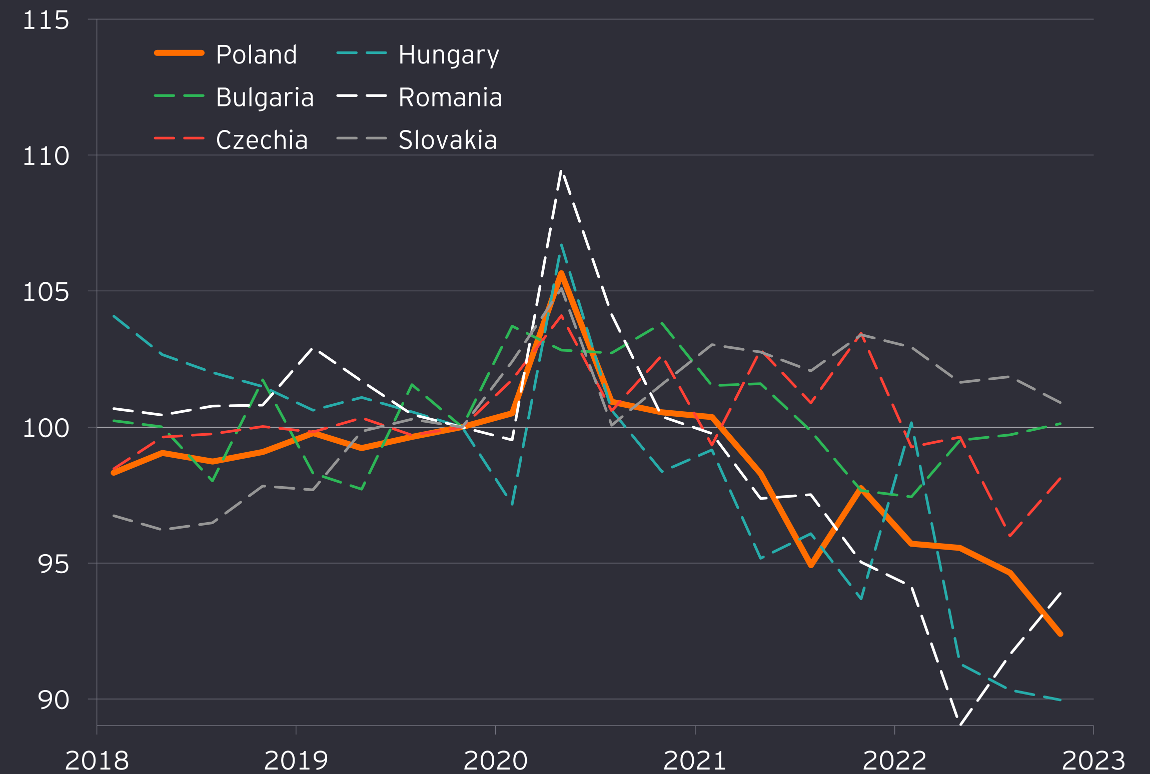
[2] Data on nominal wage growth in job postings is based on "Wage growth in euro area countries: evidence from job ads" – P. Adrjan & R. Lydon, Economic Letter, Central Bank of Ireland, Vol 2022, No. 7. The latest observations are for December 2022.

In many countries, real wages have decreased substantially and in most CEE economies, the share of compensation in gross value added has declined significantly since the pandemic outbreak. With a tight labor market, workers may use their bargaining power to recoup lost income

- A more robust wage growth is unlikely to prevent goods disinflation, but would imply more persistent inflation in services, which are on average much more labor-intensive and in which wages represent double the share of direct input costs than that in manufacturing firms.

Compensation of employees as a share of Gross Value Added
Index, Q4 2019 =100

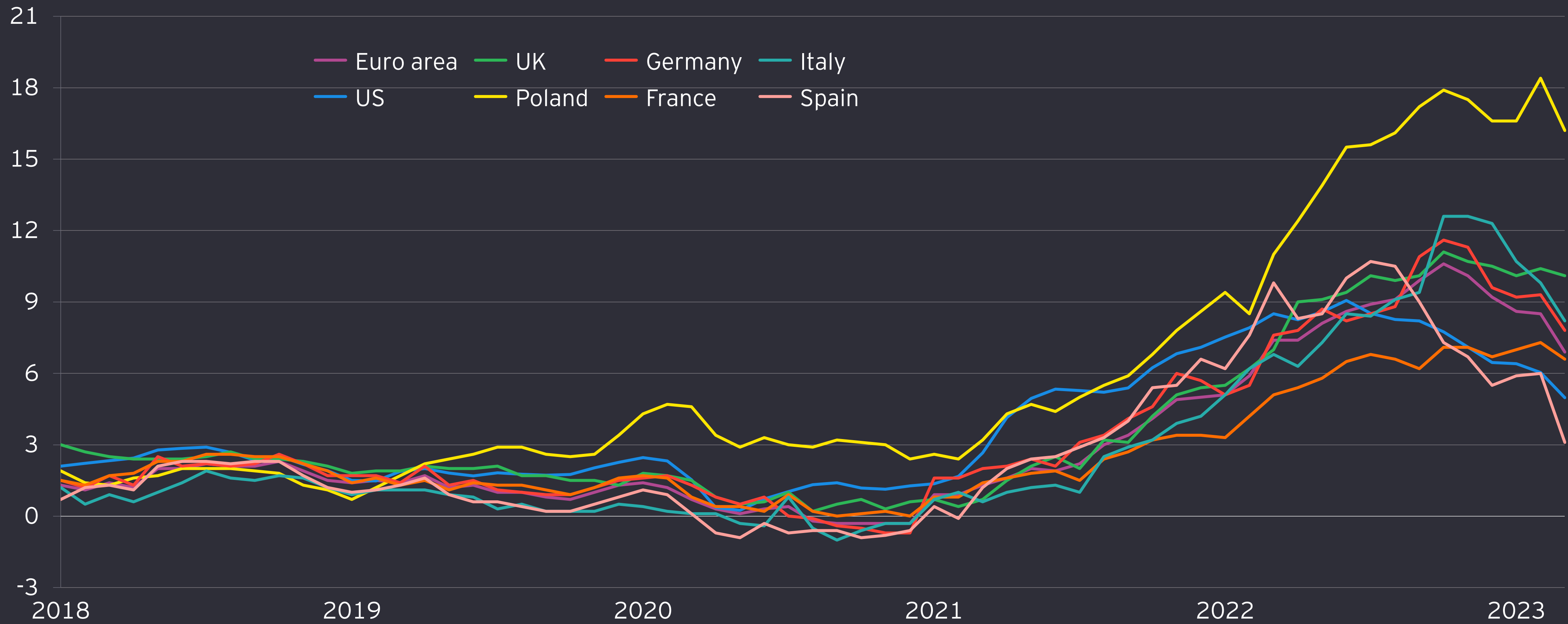




Source: Eurostat, ONS, FRED.

EY

Despite tight labor markets and strong nominal wage growth, inflation has passed its peak and begun to decelerate in most countries



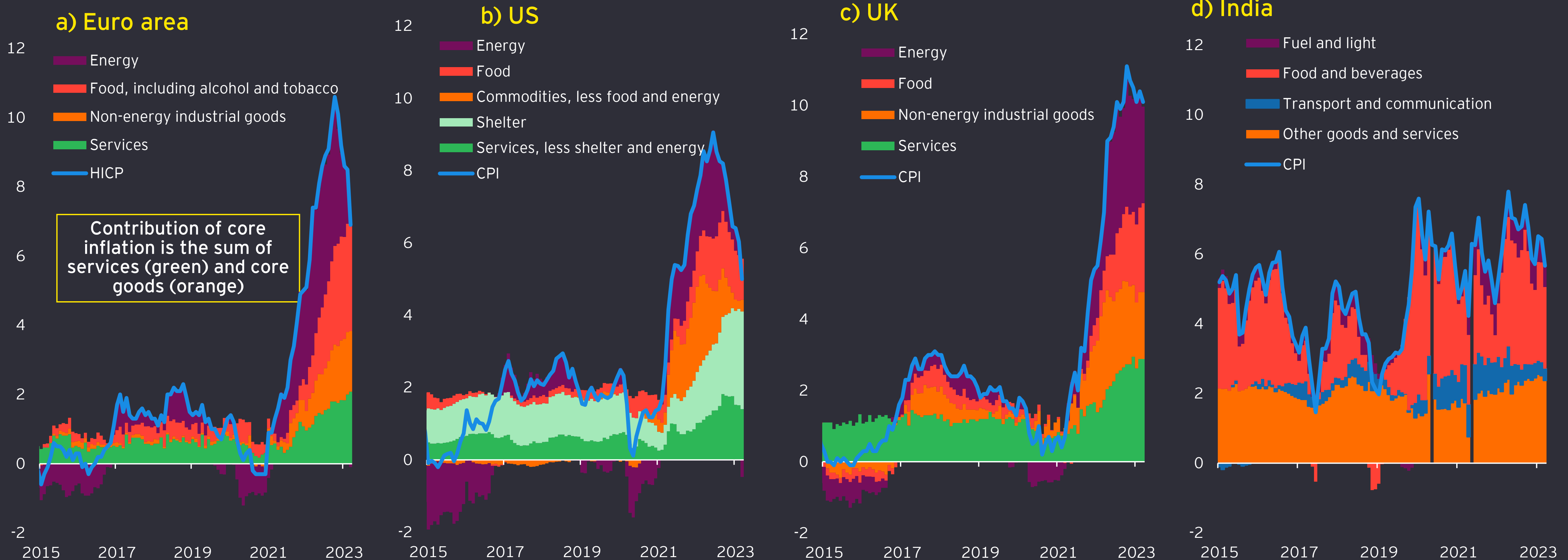
Source: Eurostat; FRED.
Notes: For the euro area. For Poland, the US and the UK, CPI inflation. Flash estimate for March 2023.

EY

In the euro area, the recent decline in inflation is driven by energy price disinflation, while core goods and, especially, food price pressures continue building up. In the US, disinflation is more broad-based

- Energy inflation goes down not only due to base effects (elevated prices a year before) but also thanks to the decline in prices of energy commodities below pre-war levels.
- Food price inflation continues to accelerate in the euro area on the back of earlier increases in energy and food commodity prices and euro depreciation. However, PPI inflation suggests that it should turn the corner soon.

Statistical decomposition of year-over-year inflation (in percentage)

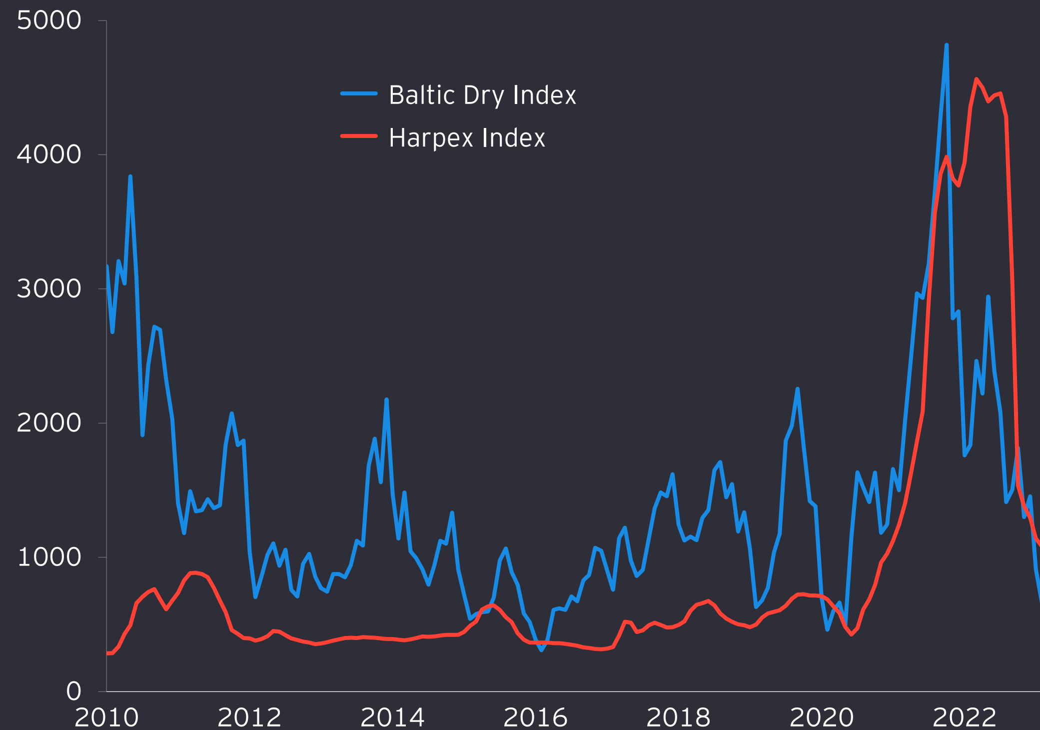


Source: Eurostat; FRED; BLS; ONS; RBI; EY EAT calculations.

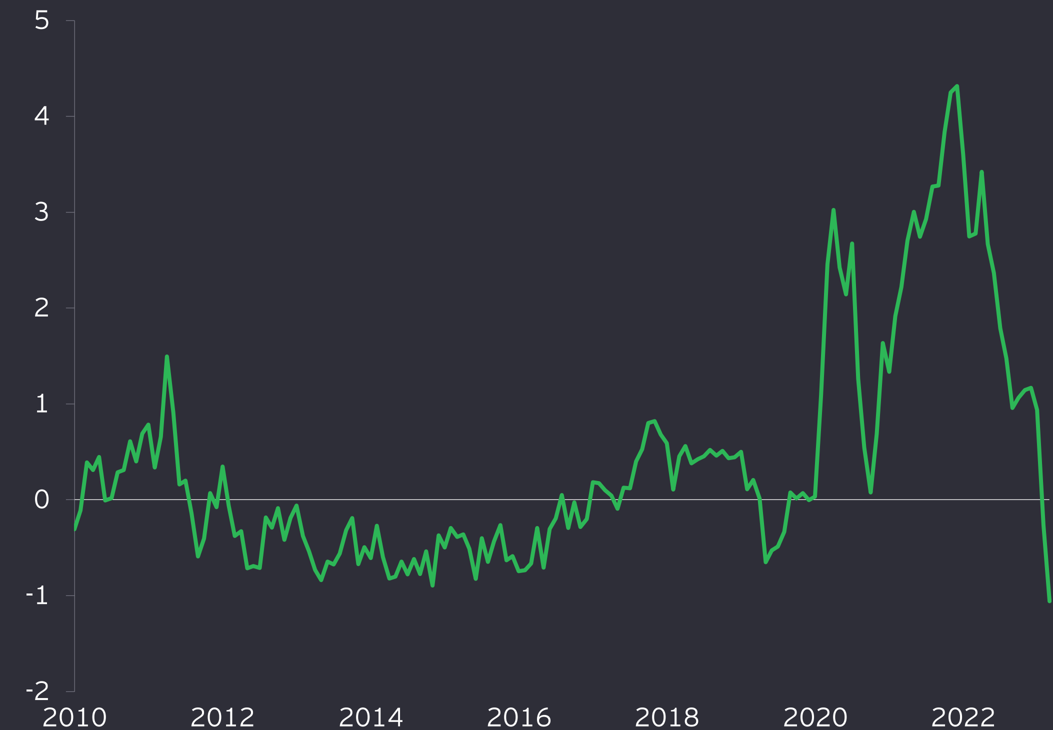
Receding supply chain issues (partially due to weaker global demand) and declining commodity (particularly energy) prices should gradually filter through to goods price disinflation also in Europe

- In some sectors (aerospace, automotive), easing supply bottlenecks allows them to realize solid order backlogs that outweigh, at least in the short term, the negative effects of demand slowdown.

Shipping costs of dry bulk and container ships



Global Supply Chain Pressure Index (GSCPI)*

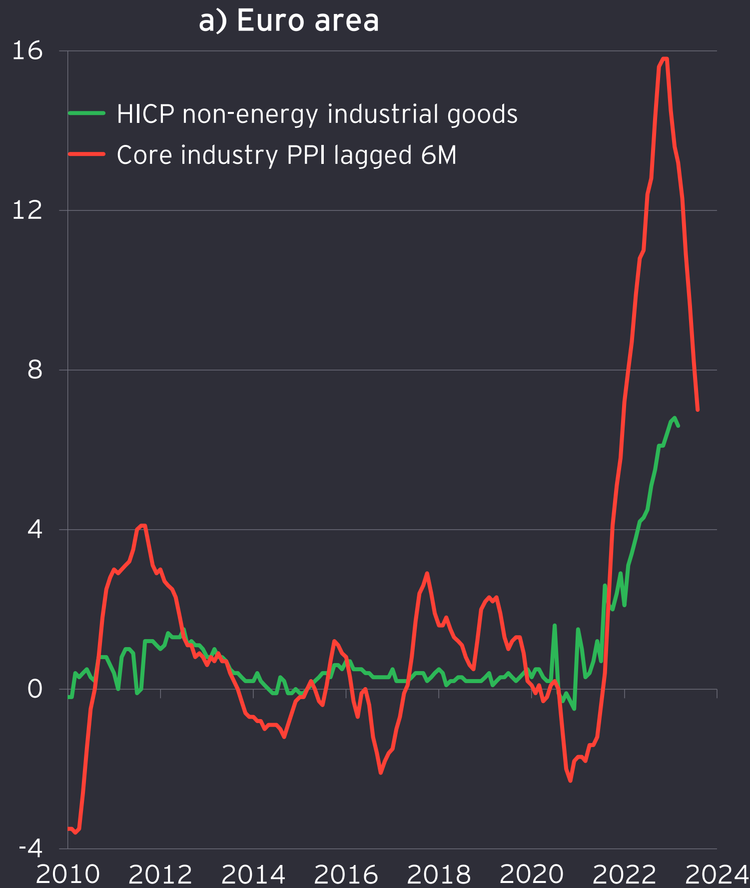


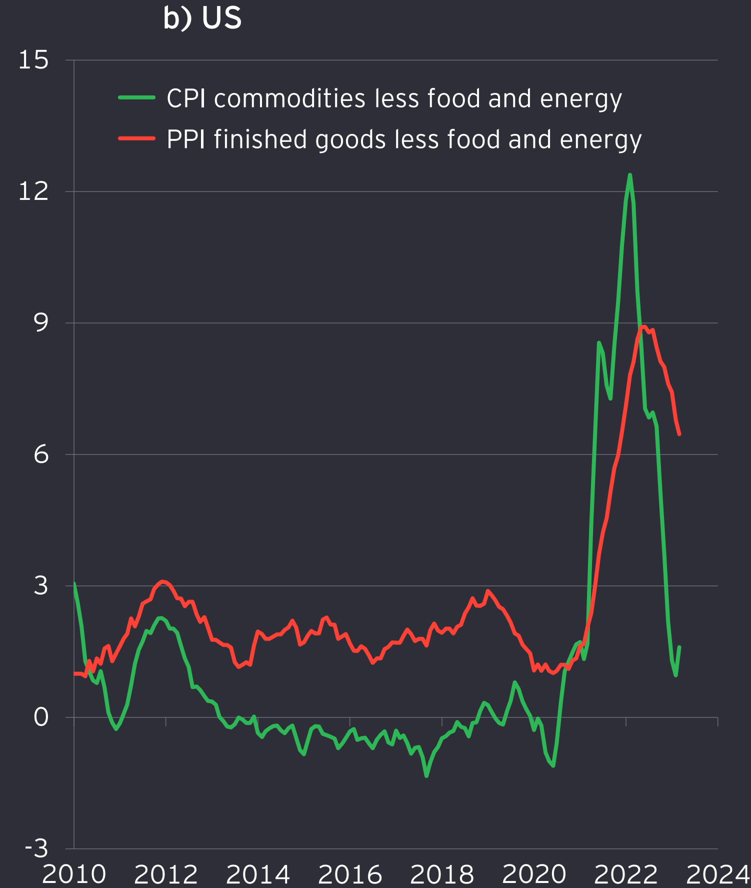
Source: Federal Reserve Bank of New York Liberty Street Economics; Investing.com; Refinitiv Eikon.
Notes: Baltic Dry index is a shipping freight-cost index for dry bulk cargo. Harpex Index reflects the worlwide price development in the charter market for container ships.
* Index scaled by its standard deviation (0=average value).

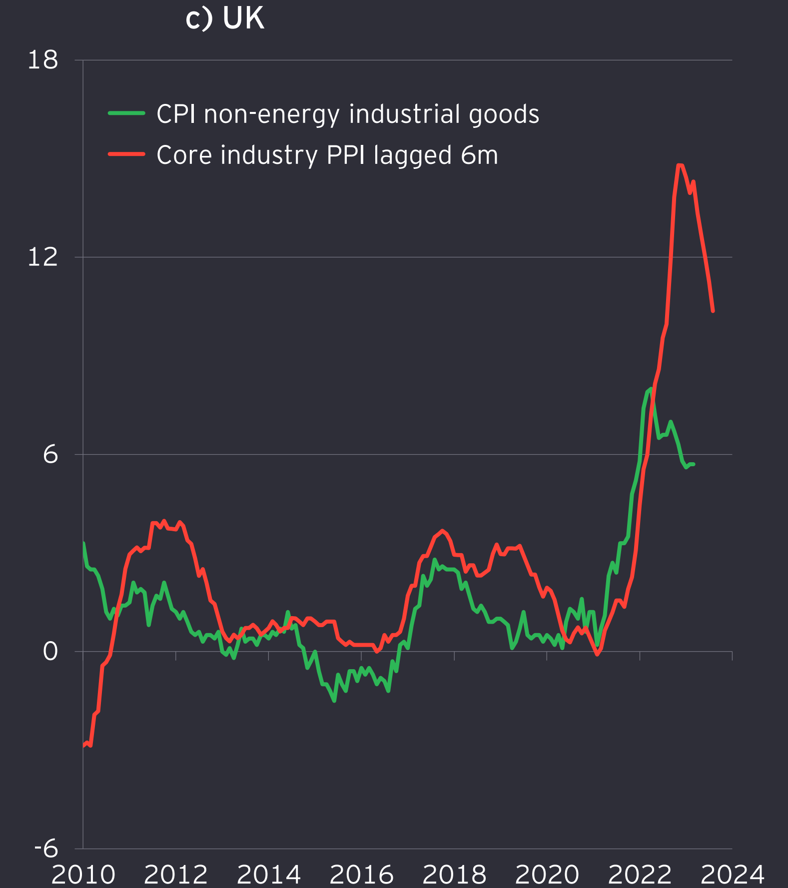
EY

However, previous increases in core goods PPI in Europe have been only partially passed on to consumers, unlike in the US, where the impact was greater. Consequently, in Europe, core goods HICP inflation may not fall as quickly as some might anticipate due to declining PPI inflation

Core PPI in industry vs. core goods CPI (YoY, in percentage)



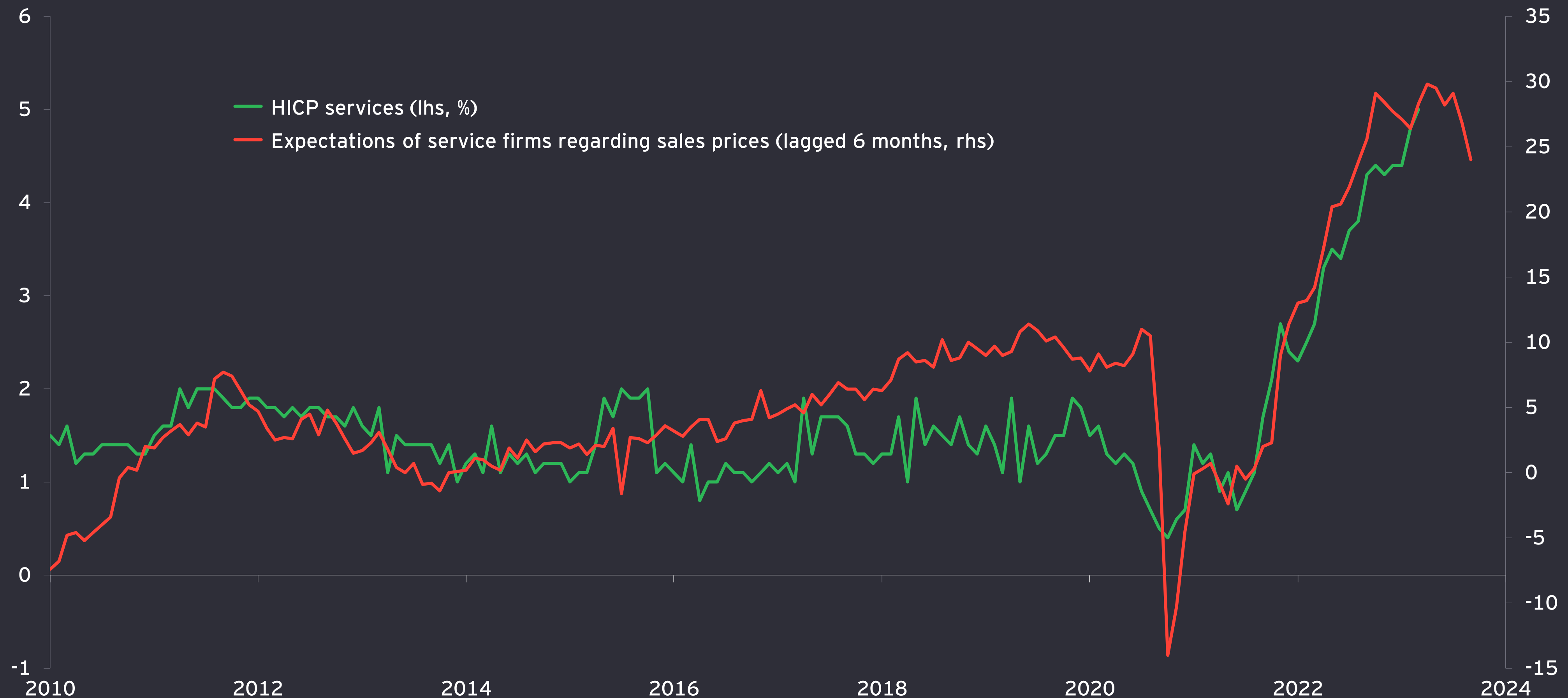




Source: Eurostat; FRED, ONS.
Note: Core industry PPI includes mining and quarrying; manufacturing (except MIG energy), except food, beverages and tobacco.

EY

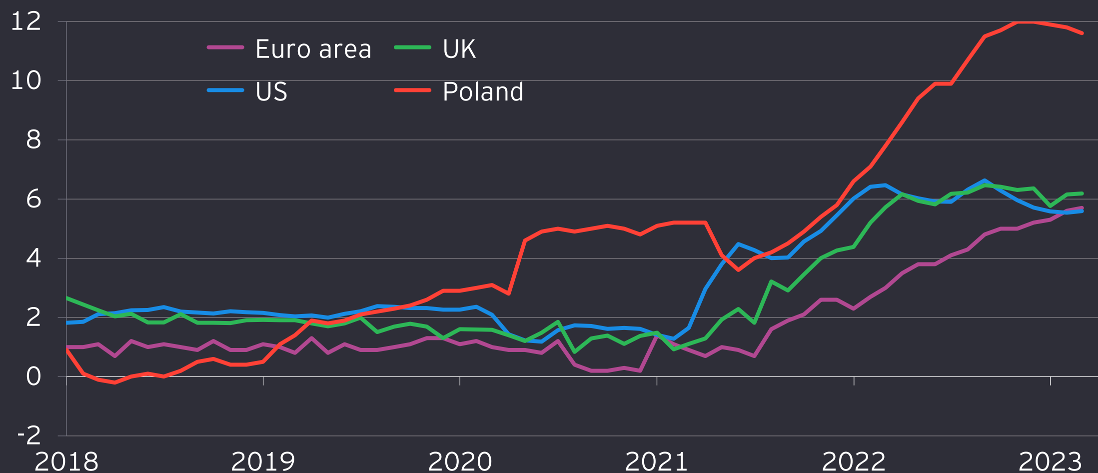
There is also little sign of abating price pressures in services, though they are no longer intensifying

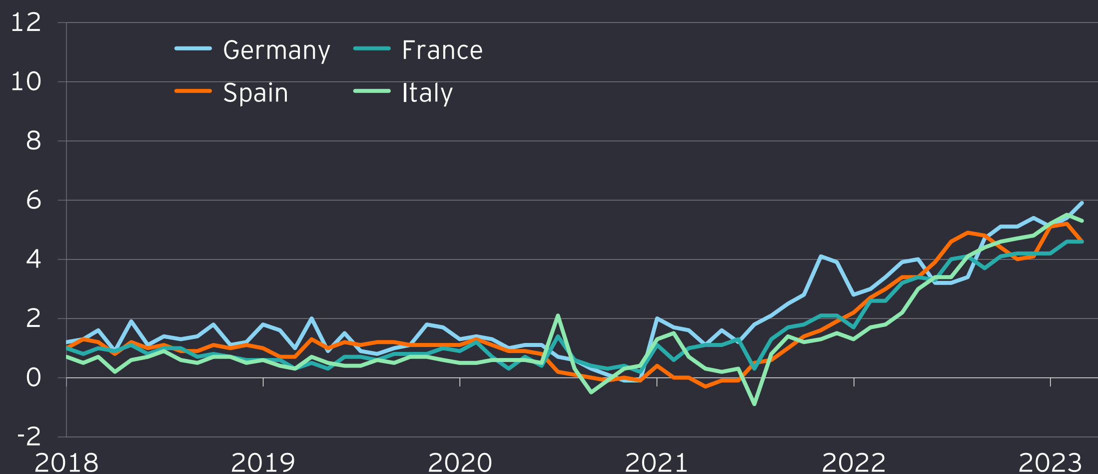


Source: Eurostat.

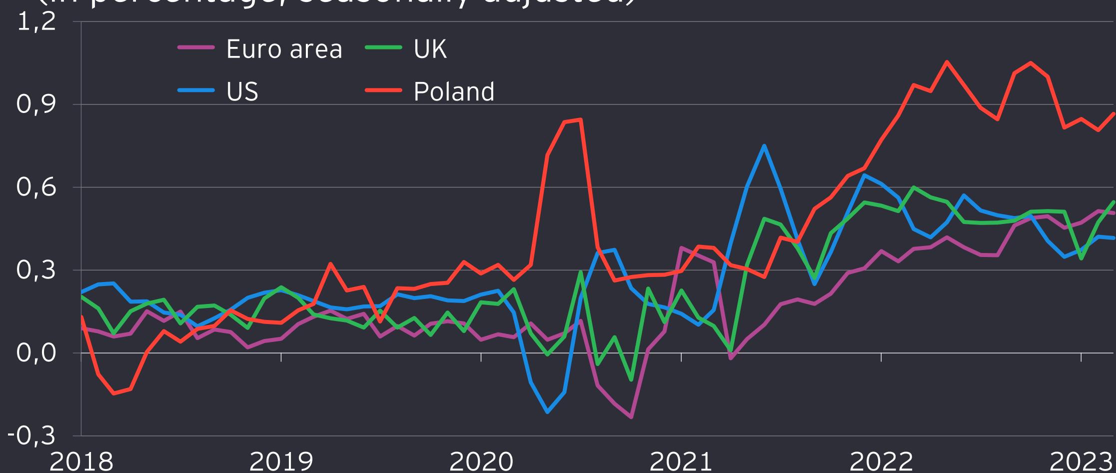
The risk of sticky inflation seems to be confirmed by recent data indicating higher than expected core inflation that has not yet peaked in numerous European countries

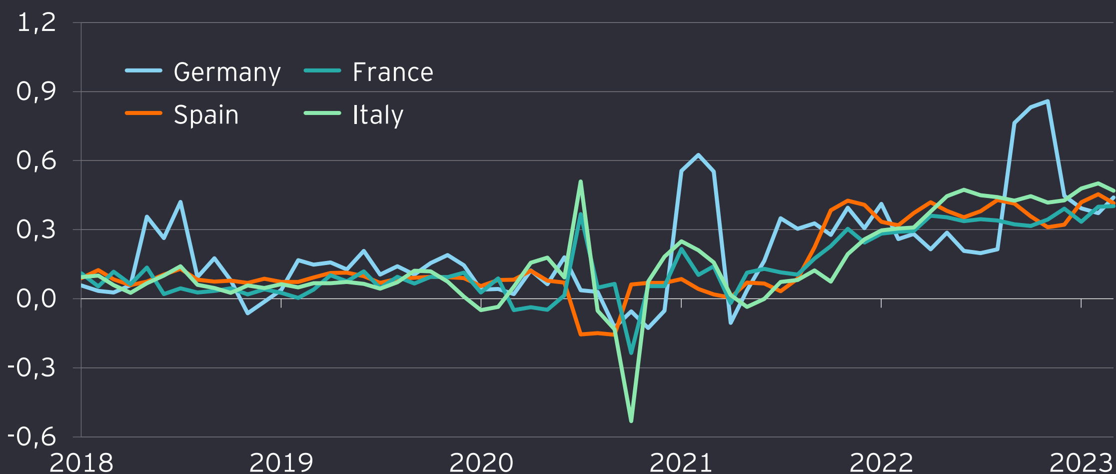
Core inflation YoY (in percentage)





Core inflation MoM, 3-month moving average
(in percentage, seasonally adjusted)





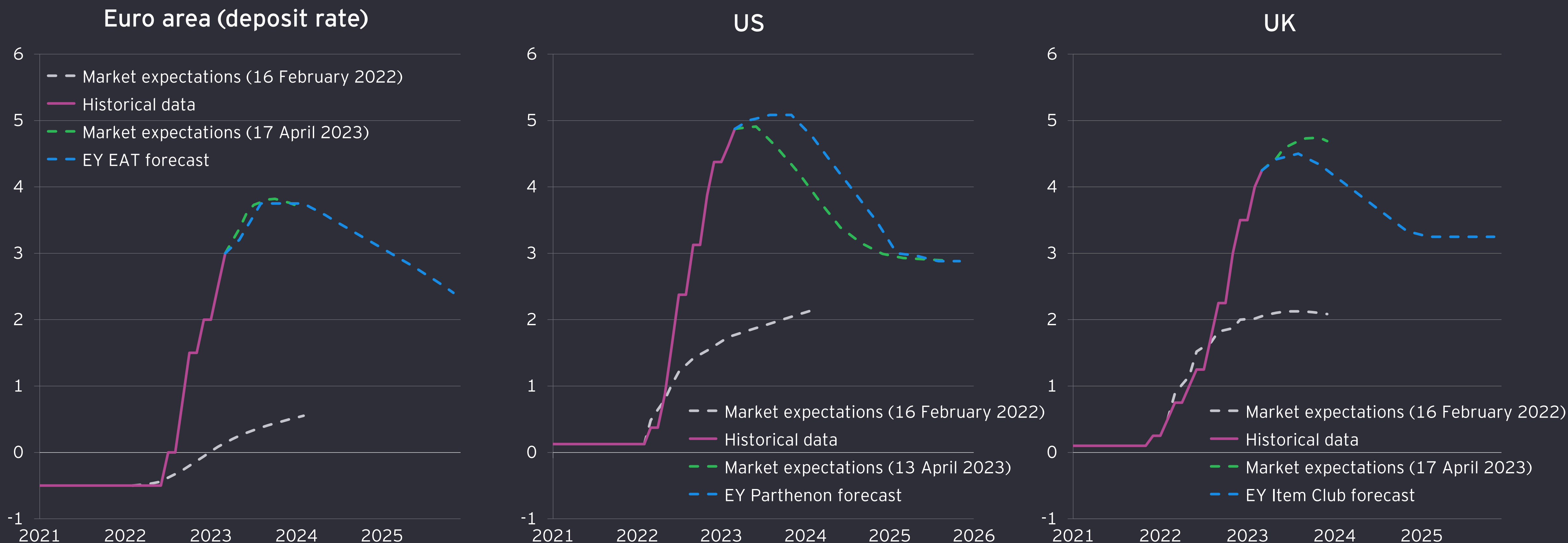
Source: Eurostat; FRED; ONS.
Notes: For euro area and EU countries, HICP. For the US and the UK, CPI inflation. Core inflation measured as price index less food and energy.

EY

Given that core inflation in the euro area has recently hit another record and labor markets remain very strong, we expect more tightening from the ECB. The Fed and the BoE are likely to end the cycle after one more hike

- We expect the ECB deposit rate to be raised by another 75bps up to 3.75%.
- Following the latest rate increase (by 25bps to the 4.75-5% range), the Fed has turned significantly more dovish as a result of the turmoil in the US banking sector. Still, another 25bps hike in May 2023 seems likely and we also expect the Bank of England to raise its base rate once more, to a peak of 4.50%.

Historical and expected* central bank interest rates (In percentage)

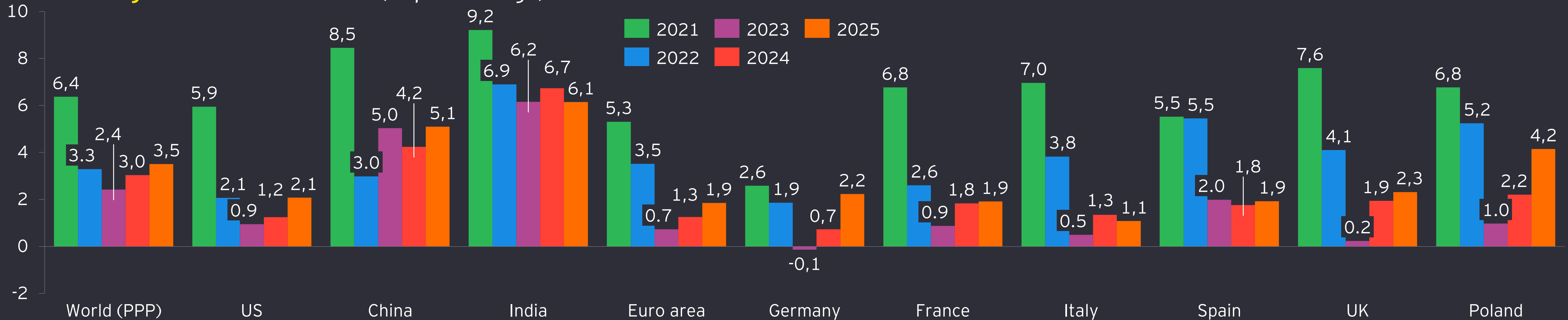


Source: ECB; Fed; NBP; Refinitiv; Eurostat; EY EAT forecast.
* For the euro area, UK and US on 16 February 2022, expected interest rates from Refinitiv; for the US on 13 April 2023, expected interest rates from Atlanta Fed Market Probability Tracker. For expectations from 16 February 2022, the curve was prolonged using data on instantaneous government bond forward yield curves.

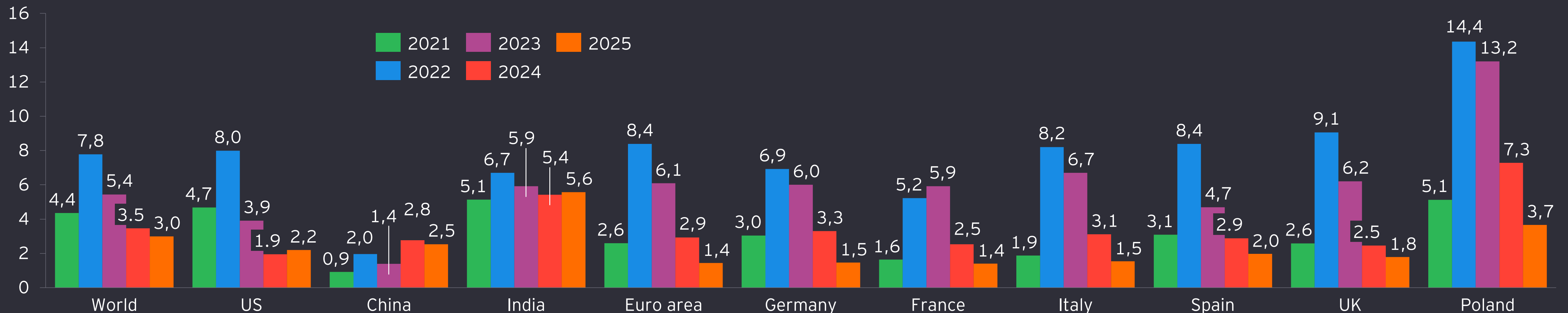
EY

Monetary policy tightening, alongside still elevated energy prices and inflation, will continue to weigh on household consumption and economic growth. Thus, the recovery will be sluggish

GDP growth in 2021-2025 (in percentage)



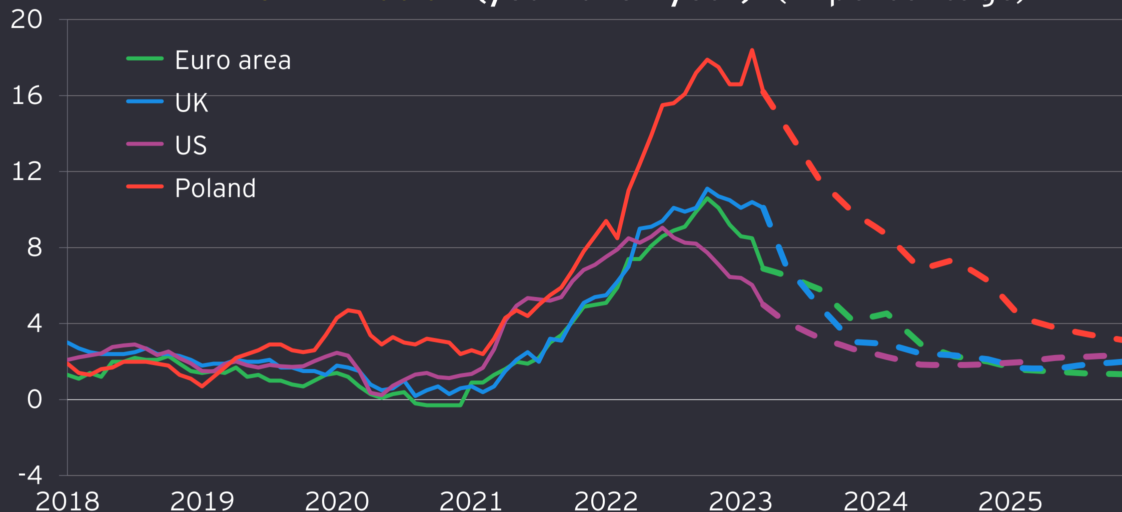
Inflation in 2021-2025 (in percentage)

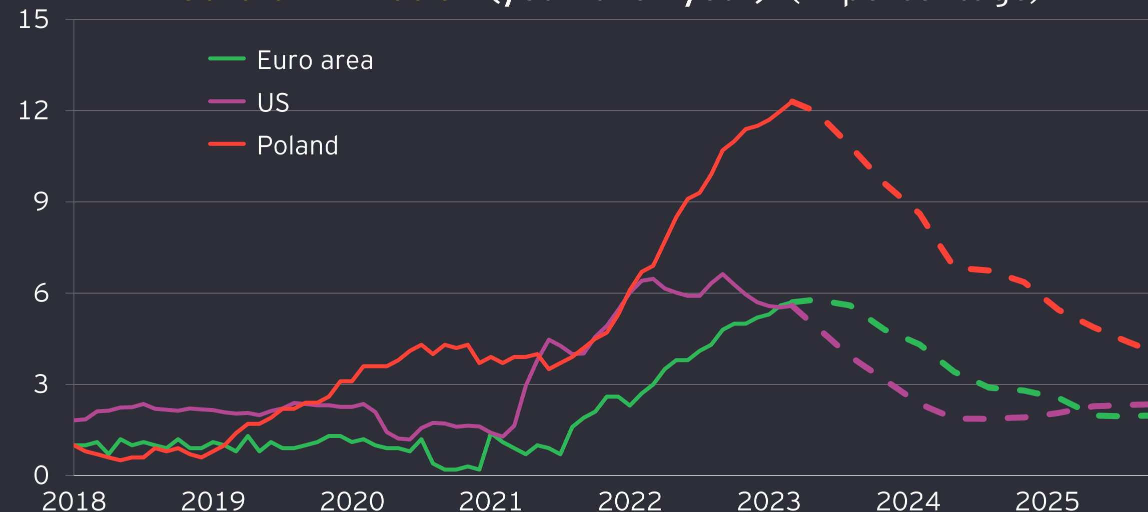


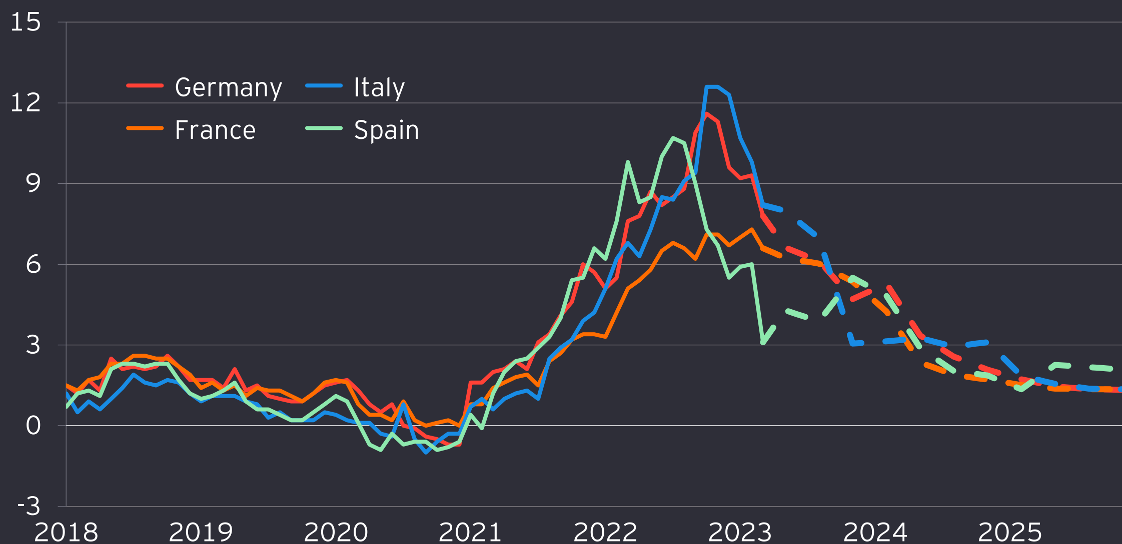
Source: Oxford Economics, EY EAT forecast (baseline scenario).

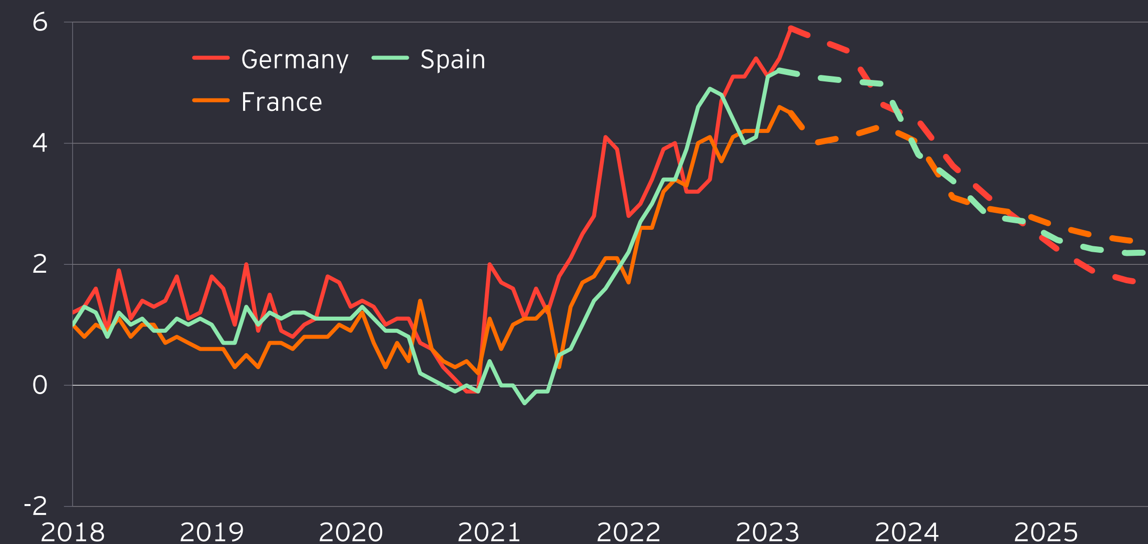
EY

Inflation will fall relatively quickly during the course of 2023. In the euro area, UK and the US, it should reach the target in the second half of 2024, but core inflation in the euro area may remain higher until the second half of 2025. In CEE, inflation will stay above central bank targets until 2025-26





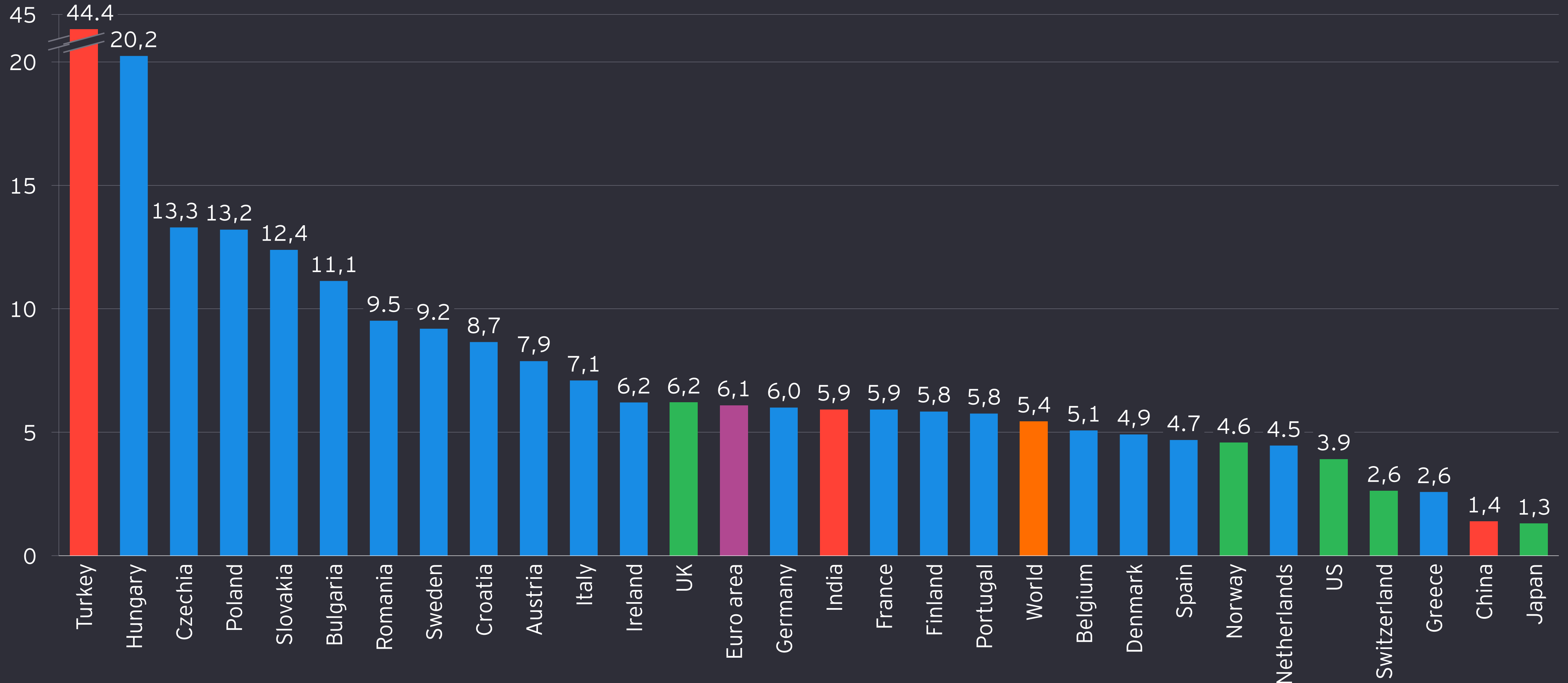




Source: Eurostat; FRED; ONS, Statistics Poland, EY EAT forecast (baseline scenario).

EY

In annual average terms, in 2023, inflation will remain elevated all over Europe, particularly in CEE, while the US will see a significantly lower inflation



Source: EY EAT forecast (baseline scenario).

EY

Economic outlook remains highly uncertain, with the balance of risks tilted to the downside for growth and to the upside for inflation

- Risk of inflation proving more persistent.
  - Strong labor market continues to be a major source of upside risks to the inflation outlook.
  - Geopolitical tensions, including the war in Ukraine, continue to be a key risk and if they intensify, could lead to more energy and food price spikes (especially if the Black Sea Grain Initiative is not renewed), pushing inflation up.
  - China's reopening, while easing supply bottlenecks and supporting global growth, will add to price pressures through increased demand for energy commodities, especially natural gas.
  - Potential harsh weather conditions could exacerbate imbalances in energy markets, particularly ahead of the 2023-24 winter.
  - The decision of OPEC+ members on 2 April 2023 to cut oil output only adds to the growing concerns over energy prices and economic outlook.

  Sticky high inflation would squeeze household budgets for longer and weigh on private consumption, as well as increase the risk of excessive monetary policy tightening by major central banks that may prefer to err on the side of overtightening.
- The recent turmoil in the banking system, beginning with the failures of some US banks, is a new cause for concern. Financial tensions may make banks even more reticent in lending. Moreover, pockets of vulnerability may exist not only in the banking sector, but also in non-bank financial institutions, the role of which has been growing in global markets for many years.
- Elevated debt levels increase vulnerability, especially of emerging markets and developing economies, to potential financial market turbulences. They also limit the fiscal space to offset new negative shocks and their impact on households and businesses.

Another sharp spike in energy costs is not included in our baseline. Moreover, we assume that the banking turmoil will be contained, without significant impact on the European economy. However, on next pages we consider alternative scenarios and their effects on European and selected major economies.

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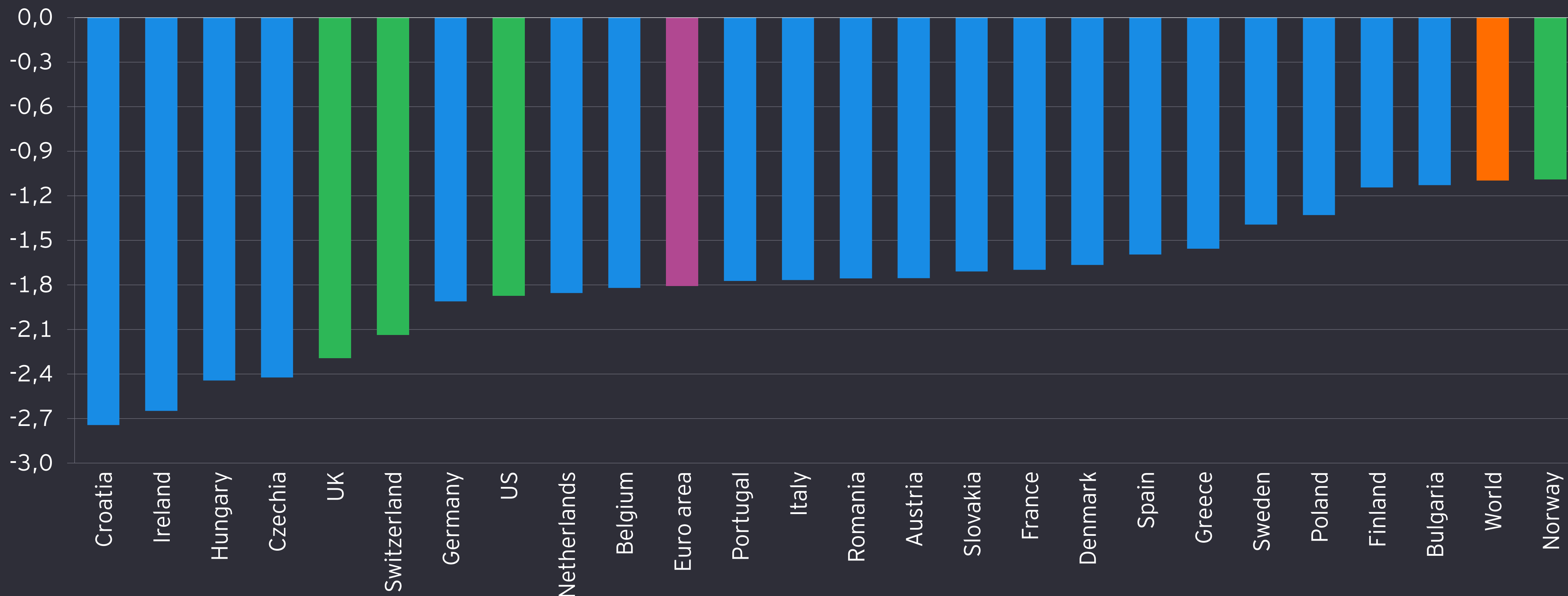
In our baseline scenario, the banking turmoil will be contained, without significant impact on the European economy. In an alternative scenario of an additional tightening of credit conditions (1/3 as large as during the global financial crisis), by 2025, GDP in the euro area would be almost 2% lower than in the baseline

- Even though we assumed CEE countries are less exposed to the current turmoil, and thus would see a smaller tightening of credit conditions than Western Europe, several CEE countries (Croatia, Hungary and Czechia) would still be among the countries suffering from the largest hit to GDP, alongside bank-heavy Ireland, UK and Switzerland.
- On the other side of the spectrum, Nordic countries would be among least vulnerable countries, alongside Bulgaria and Poland.

Cumulative GDP growth over 2023-25 in the credit tightening scenario relative to the baseline (in percentage points)



Source: EY EAT simulation.

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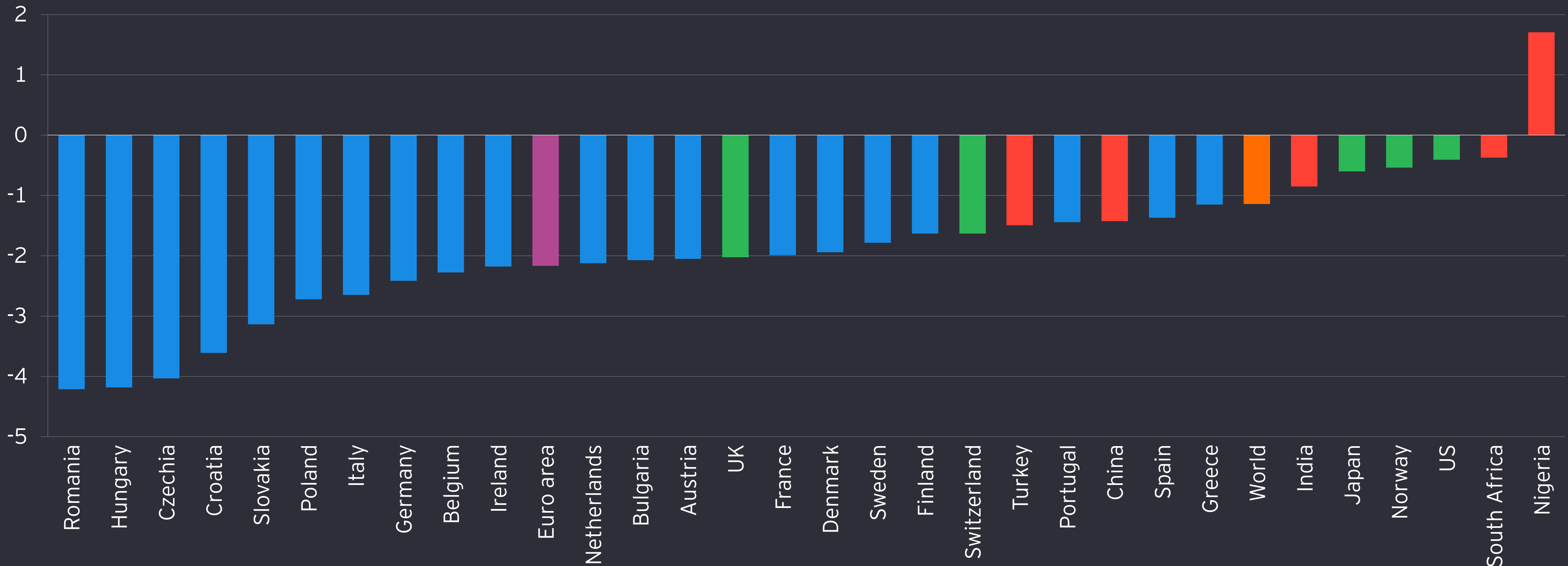
The risk of rising energy costs remains significant and, if occured, it might have a huge impact on economic activity and inflation

- Europe is more vulnerable to a renewed increase in energy prices than other major economies, in particular the US
- CEE countries, in particular Romania, Hungary and Czechia, would be most adversely impacted by another sharp spike in energy costs



Source: EY EAT simulations.

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Forecast sources

- Baseline forecasts for most economies and alternative scenarios for all countries have been prepared by EY Economic Analysis Team (EY EAT) using the Oxford Economics Global Economic Model (OE GEM)
  - EY EAT have adjusted OE GEM equations, assumptions and data inputs
- Baseline scenario for the US has been prepared by EY-Parthenon Macroeconomics Team
  - Contact: https://www.ey.com/en_us/strategy/macroeconomics
- Baseline scenario for the UK has been prepared by EY ITEM Club
  - Contact: parnold@uk.ey.com
- Baseline scenario for Italy in 2023-24 has been prepared by EY Italy
  - Contact: alberto.caruso@it.ey.com

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