European Economic Outlook

(Abridged Version)

EY Economic Analysis Team

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In Europe, economic activity is about to pick up...but recovery will be sluggish

- The European economy has been slowing since mid-2022 and in recent quarters has stagnated. High inflation continuing to exceed nominal wage growth and tightening financial conditions weigh on consumer spending and private investment.
- On the positive side, despite some cooling, labor markets remain strong, with employment continuing to grow and reaching record highs in many countries and unemployment rates at or near historical lows. In the coming quarters, declining inflation will bring some respite to consumers. Real wage growth, after bottoming at -4.9% in 2022 Q3, is accelerating and is expected to turn positive in 2023 Q3 in the euro area. As a result, vast majority of European economies will avoid full-year GDP contraction in 2023.
- We anticipate GDP growth in the euro area decreasing from 3.5% in 2022 to 0.7% this year, but while performance will vary between European economies, the majority will avoid full-year GDP contraction. Southern European economies will be among the best performers, with Portugal and Spain seeing the strongest growth in the EU in 2023, exceeding 2%. Economic activity in these countries will be supported by the tourism industry returning to pre-pandemic levels and increasing government investment financed from the EU Recovery Fund.
- By contrast, countries more reliant on manufacturing and most vulnerable to the previous increase in natural gas prices (Germany, Czechia, Hungary) will see a full-year decline in GDP. This is due to: (1) destocking of previously accumulated inventories, (2) the impact of earlier increases in energy prices on energy-intensive industries, (3) higher interest rates that manufacturing activity is particularly sensitive to, (4) spending rotation from goods to services and (5) weak consumer demand.
- Looking ahead, we anticipate economic activity in Europe will pick up throughout 2023 H2 and 2024, as significantly lower inflation supports recovery in real incomes and consumer demand. Additionally, government investment will increase on the back of absorption of the EU Recovery Fund, while a gradual increase in external demand and lower energy prices will stimulate manufacturing sector activity. However, the recovery will be sluggish, because the effects of monetary policy tightening are increasingly feeding through to the real economy and the withdrawal of fiscal measures introduced in response to the pandemic and the energy shock will also weigh on demand. Therefore, we expect only modest acceleration of GDP growth in the euro area to 1.2% in 2024 and 1.4% in 2025. The balance of risks continues to lean to the downside.
- Economic activity remains subdued also in the UK, with ongoing strikes and an extra public holiday hindering output in recent months. Elevated inflation will continue to erode household income and pressure the Bank of England to tighten monetary policy aggressively, thus constraining consumer spending and business investment. Tighter financial and credit conditions together with increased fiscal headwinds will likely constrain GDP growth to 0.4% in 2023 and 0.8% in 2024.
- Compared to Western Europe, we forecast a much stronger rebound in Central and Eastern European (CEE) countries that will realize their much higher potential growth, supported by rapid disinflation. Despite this, almost all European economies will remain well below pre-Covid trends over the projection horizon, pointing to the long-term negative effects of the pandemic and the war in Ukraine.

Inflation has passed its peak and is quickly declining … but core inflation is showing persistence, reflecting tight labor market conditions and high nominal wage growth

- Inflation in European countries has peaked and is quickly declining. In the euro area, inflation nearly halved from 10.6% in October 2022 to 5.5% in June 2023, initially driven by declining energy prices and base effects. More recently, however, receding supply bottlenecks, slowing demand and declining commodity prices have also begun to filter through to core and food prices. Disinflationary pressures are therefore broadening. Inflation will continue to decelerate in the coming months, which is also reflected in companies' business outlook across the majority of sectors, although to a lesser degree in services.

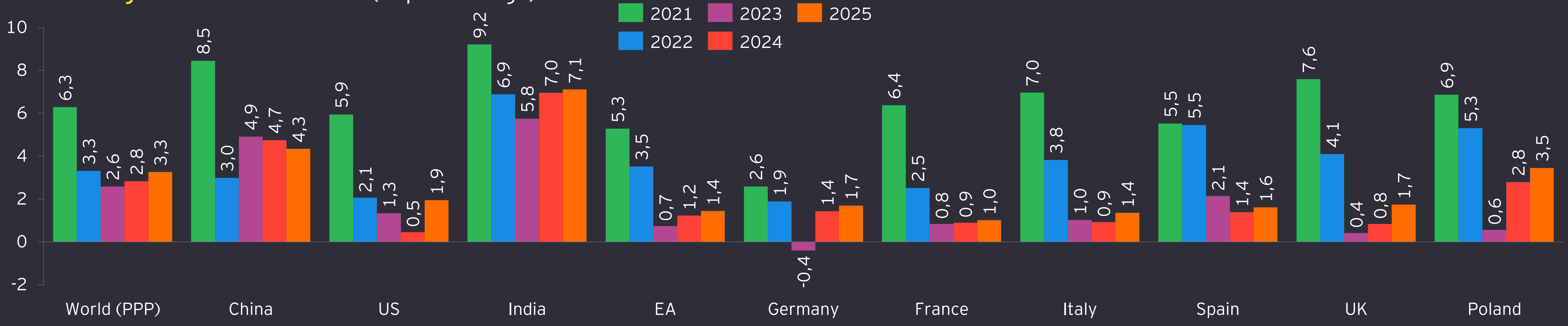
- As the indirect effects of past energy and other supply shocks gradually fade, "free lunch" disinflation will peter out and labor costs will become a dominant driver of inflation. With tight labor markets, workers are using their bargaining power to recoup lost income which will maintain upward pressure on wage growth and prices, especially in the services sector where wages represent double the share of direct input costs in manufacturing. The risk of sticky inflation is reflected in elevated core inflation (excluding food and energy) which is cooling only slowly in Europe. Therefore, while we anticipate that inflation in the euro area will reach the ECB target of 2% in the first half of 2024, core inflation will stay above the target throughout next year.

- Trends in inflation are similar across European economies, but inflation levels vary significantly, primarily due to differences in the sensitivity to the experienced commodity price shocks as well as differences in labor market tightness. The highest inflation rates, often well in double-digit territory, are in CEE countries due to their fossil fuel-based energy mixes, higher shares of food and energy in inflation baskets, tight labor markets and past exchange rate depreciation. Southern Europe (incl. Italy, Spain, Portugal and Greece), on the other hand, exhibits the EU's lowest inflation as labor slack, while declining, remains relatively significant. Despite these differences, we anticipate that most EU countries will see inflation near or at central bank targets in 2024. Two clear exceptions are Poland and Hungary, where tight labor markets, expansionary fiscal policy and the phasing-out of temporary indirect tax cuts will keep inflation elevated for longer.

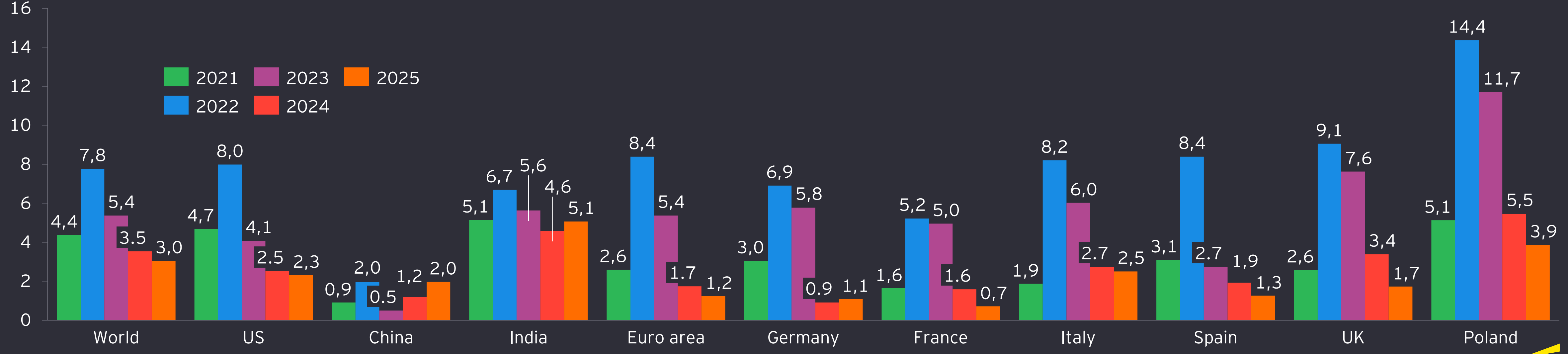
- The balance of risks remains tilted to the upside for inflation.

GDP and inflation forecasts

GDP growth in 2021-2025 (in percentage)



Inflation in 2021-2025 (in percentage)



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

Persistent inflation and strong wage growth signal that central bank rates may stay higher for longer

- While we forecast that inflation in the euro area will reach the ECB target of 2% in the first half of 2024, core inflation will remain more persistent and elevated. Following a hike in July, we anticipate that sticky services inflation and strong wage growth will embolden the ECB to continue its tightening cycle, with one more final 25bp interest rate increase in September.
- The ECB will maintain a data-dependent approach and will refrain from providing guidance on the future interest rate path. However, in our view, most policymakers consider the costs of protecting the economy from upside risks to be much lower than the costs of reacting only after upside risks to inflation have materialized. Therefore, a rapid decline in headline and core inflation indicators may not be sufficient stimulus for a policy rate cut in 2024 Q1. In particular, if nominal wage growth remains high and is not sufficiently absorbed by firms in their profit margins, the ECB may hold rates steady even until June 2024. Therefore, in our baseline, monetary policy in the euro area is overtightened and businesses should be prepared for a "higher for longer" scenario.
- With headline inflation cooling to 7.9% in June and core inflation moderating slightly to 6.9%, the BoE is likely to favor a 25bps rate hike in July after a 50bps rate increase in June. With forward-looking indicators suggesting inflation will fall further in the second half of 2023, and the labor market now decisively cooling, we expect one more final 25bp hike, to 5.5%, and a first rate cut in 2024 Q2. This makes our BoE monetary policy forecasts more dovish than implied by market expectations.
- With the ECB tightening policy further and core inflation remaining above the target, we expect the central banks of Switzerland, Sweden and Norway each to raise rates twice more and we do not anticipate rate cuts in these countries before the second half of 2024. In contrast to advanced economies, CEE central banks ended the hiking cycle many months ago and have either already begun the easing cycle (Hungary, though from a very high level of 18%) or are expected to start cutting rates in 2023 Q4 (Czechia and Poland), despite inflation remaining close to 10%. Given its continuing heightened inflation, we anticipate the easing cycle to be gradual in Poland. By contrast, the Czech central bank is likely to cut interest rates much faster next year as inflation quickly approaches the 2% target.
- While we consider both upside and downside scenarios for the inflation outlook and monetary policy path, in either case the era of "low for long" interest rates is over and business models should account for a higher cost of capital compared with the pre-pandemic period.
- On one hand, private indebtedness is historically high in Europe, which can greatly heighten the sensitivity of the private sector to higher interest rates. The effects of monetary policy tightening have already become apparent in the overall negative loan growth in the euro area. On the other hand, the pass-through from higher interest rates to debt service burdens has been delayed, as companies lengthened maturities of their debt during the period of low inflation. In addition, in many countries, more people have moved to longer-term fixed-rate mortgage contracts, which reduces the direct effect of interest rate changes on homeowners' mortgage costs. However, a growing proportion of owners and companies have already or will soon need to refinance at much higher interest rates.

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

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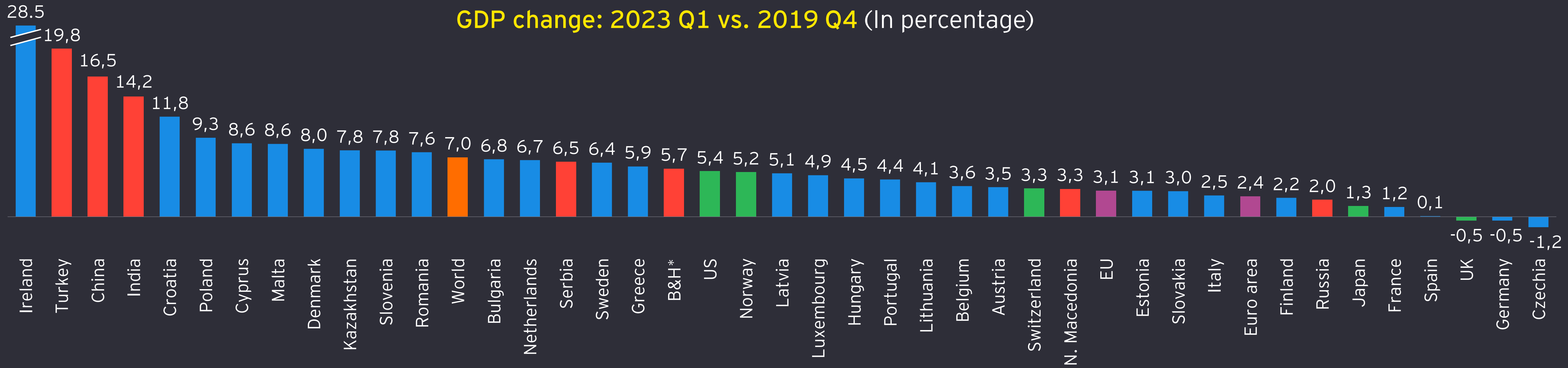
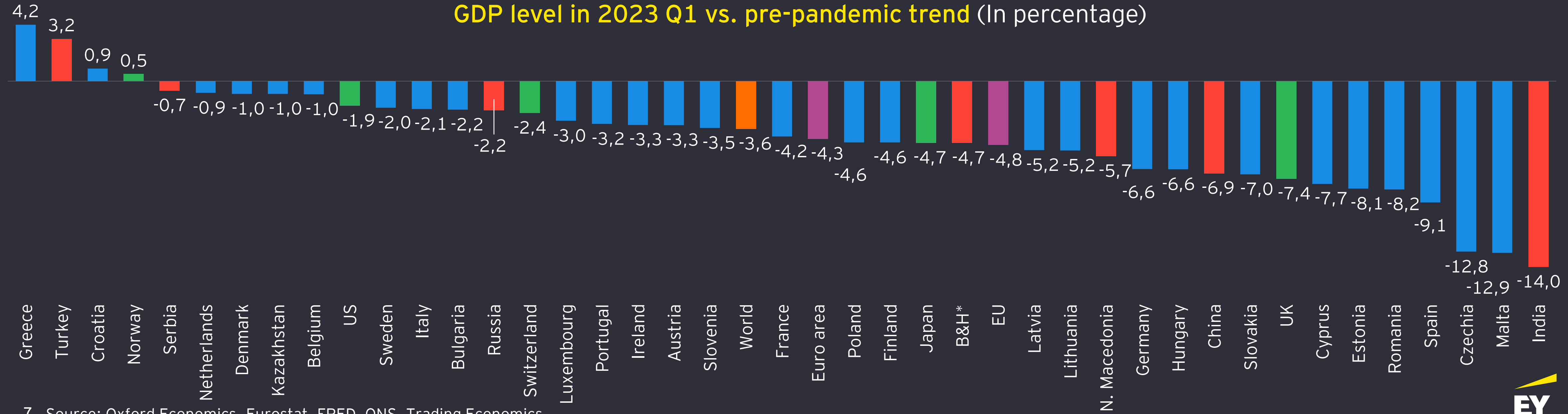
Most countries are significantly above the pre-pandemic levels of their economic activity, but well below the pre-pandemic trend


GDP change: 2023 Q1 vs. 2019 Q4 (In percentage)

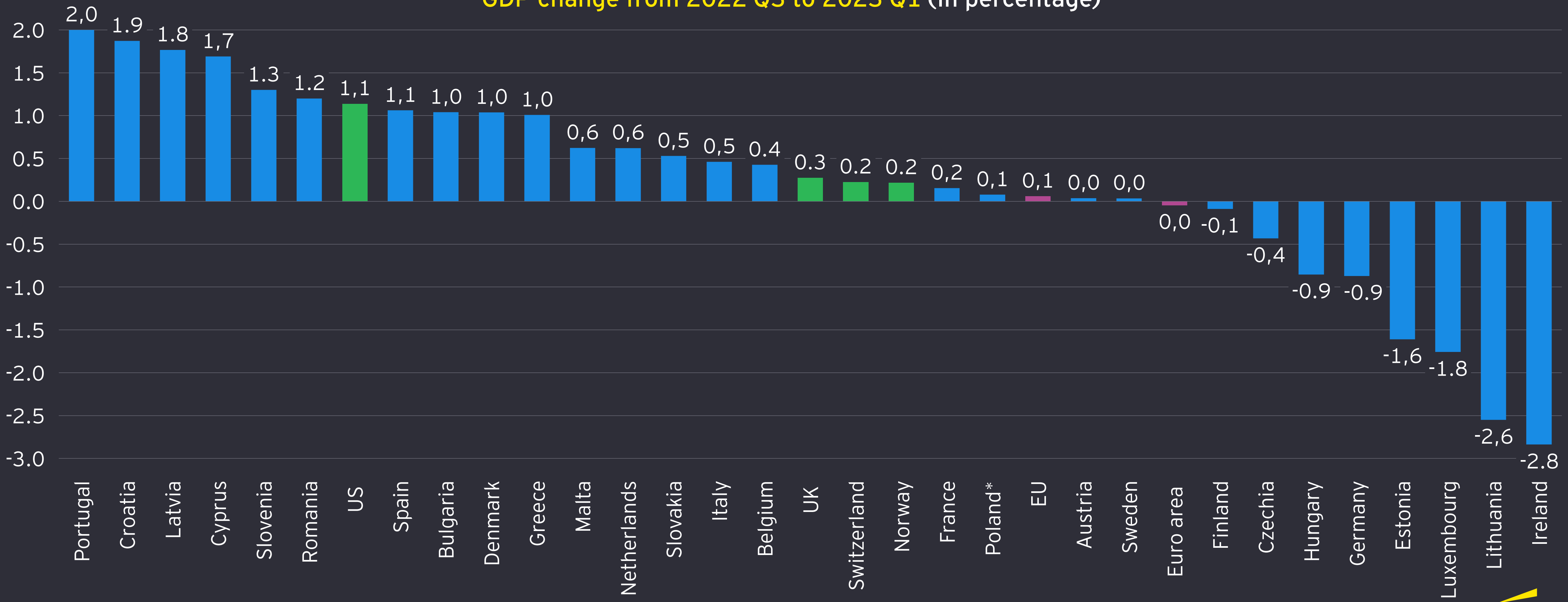

GDP level in 2023 Q1 vs. pre-pandemic trend (In percentage)

Source: Oxford Economics, Eurostat, FRED, ONS, Trading Economics.
Pre-pandemic trend is a logarithmic trend over 2014 Q1 – 2019 Q4. For Poland, data seasonally adjusted by EY.

The European economy stagnated over the 2022-23 winter, proving more resilient to the energy crisis than previously expected

- Most countries avoided a GDP decline. The exceptions included Lithuania and Estonia – countries with closest links to Russia pre-war – as well as Germany, Czechia and Hungary – countries highly vulnerable to elevated natural gas prices and the slowdown in manufacturing. Irish GDP continued to be highly volatile on the back of distortions caused by tax-related transactions of multinational corporations
- On the other side of the spectrum, GDP continued to expand at a healthy pace in Southern Europe and the Balkans

GDP change from 2022 Q3 to 2023 Q1 (In percentage)



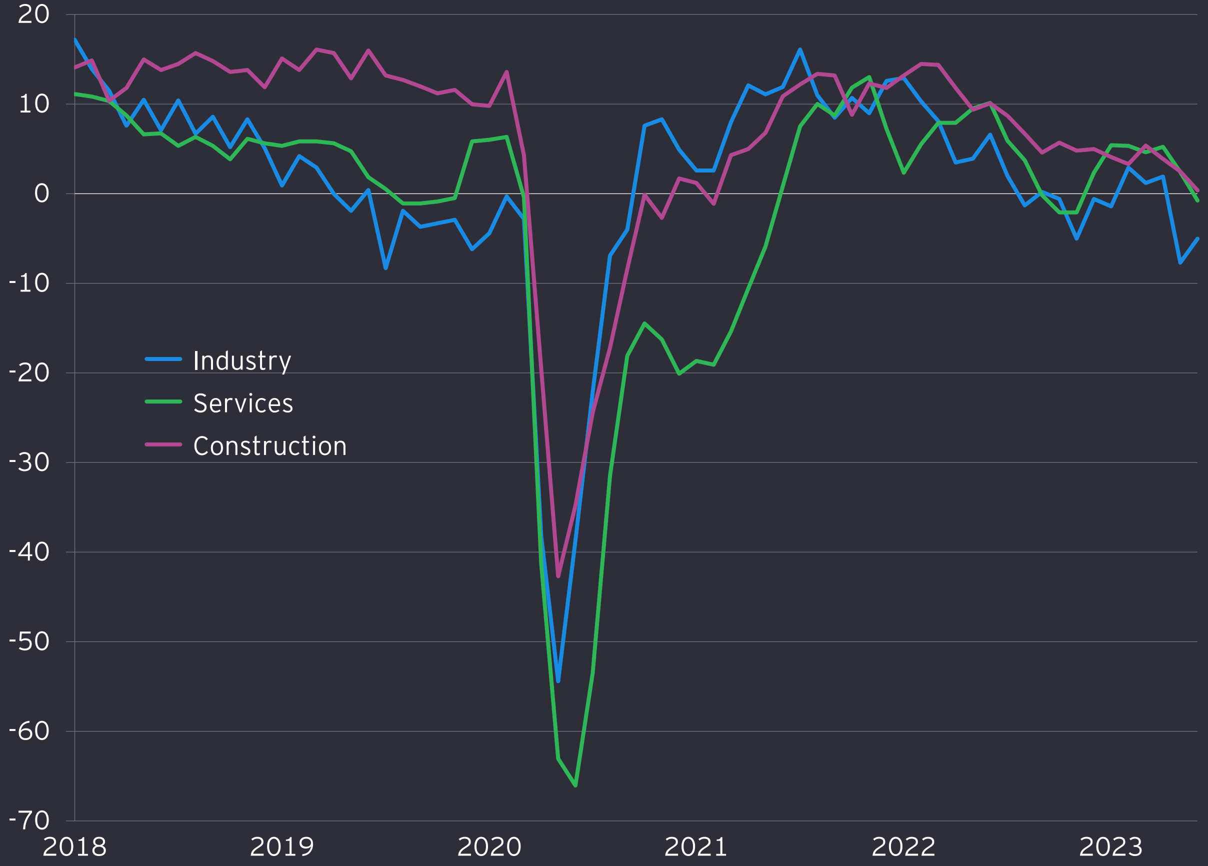
Source: Eurostat, Oxford Economics.

* For Poland, data seasonally adjusted by EY.

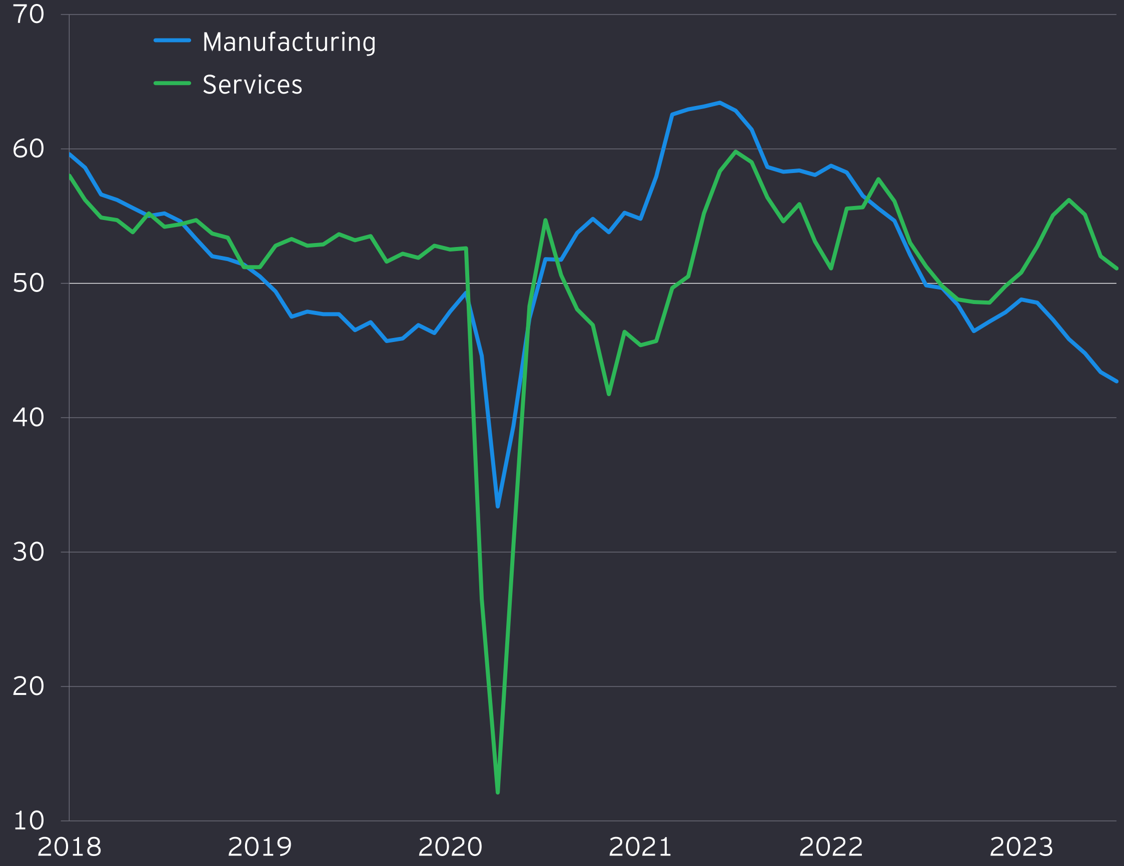
Business sentiment has again deteriorated in recent months, suggesting that the economy remains in stagnation, with a large discrepancy between industry and services

- Services are supported by the recovery of tourism to pre-pandemic levels, while industry has been held back by rebalancing of spending towards services, weak external demand, past increases in energy costs and destocking of inventories

Survey indicators of current production in the euro area (long-term average = 0)



PMI in manufacturing and services in the euro area (no change in activity = 50)

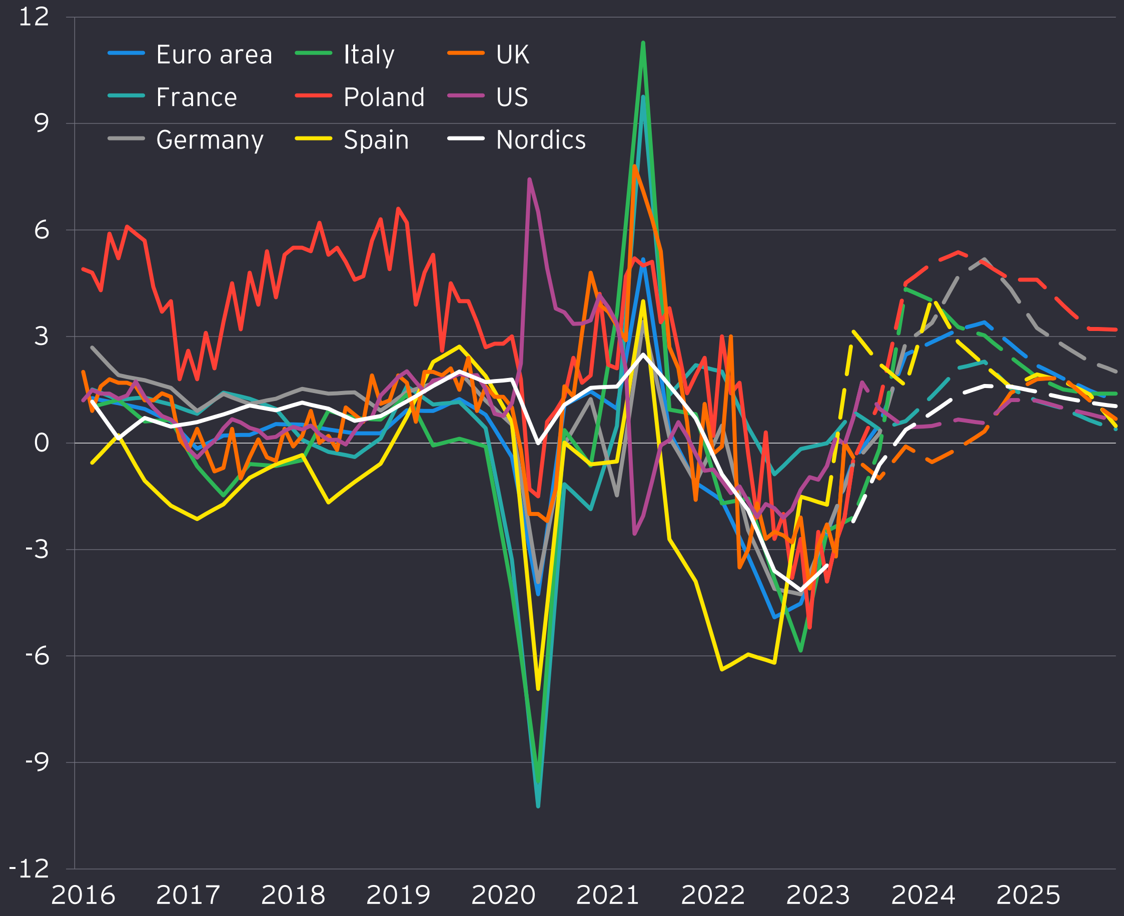


Source: Eurostat; Trading Economics.

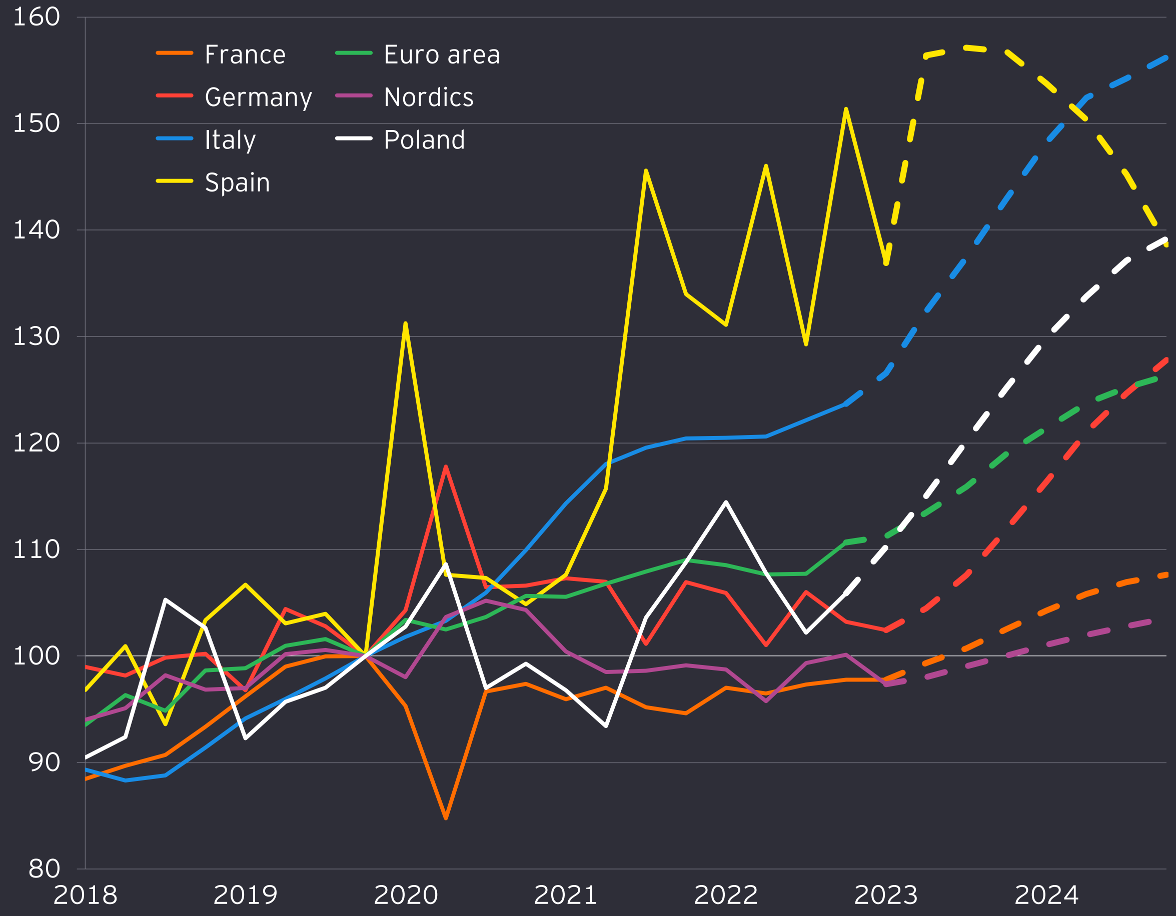
Notes: For services, evolution of demand over the past 3 months; for industry and construction, production development observed over the past 3 months. Long-term average since April 1995.

Nevertheless, there are reasons to be cautiously optimistic about the European outlook for the coming quarters. Real wage growth is accelerating on the back of rapid disinflation, supporting consumption, and government investment is set to increase on the back of the EU Recovery Fund and needs related to the green transformation

Real wage growth (y/y, in percentage)



Government investment (index, 2019 Q4=100)

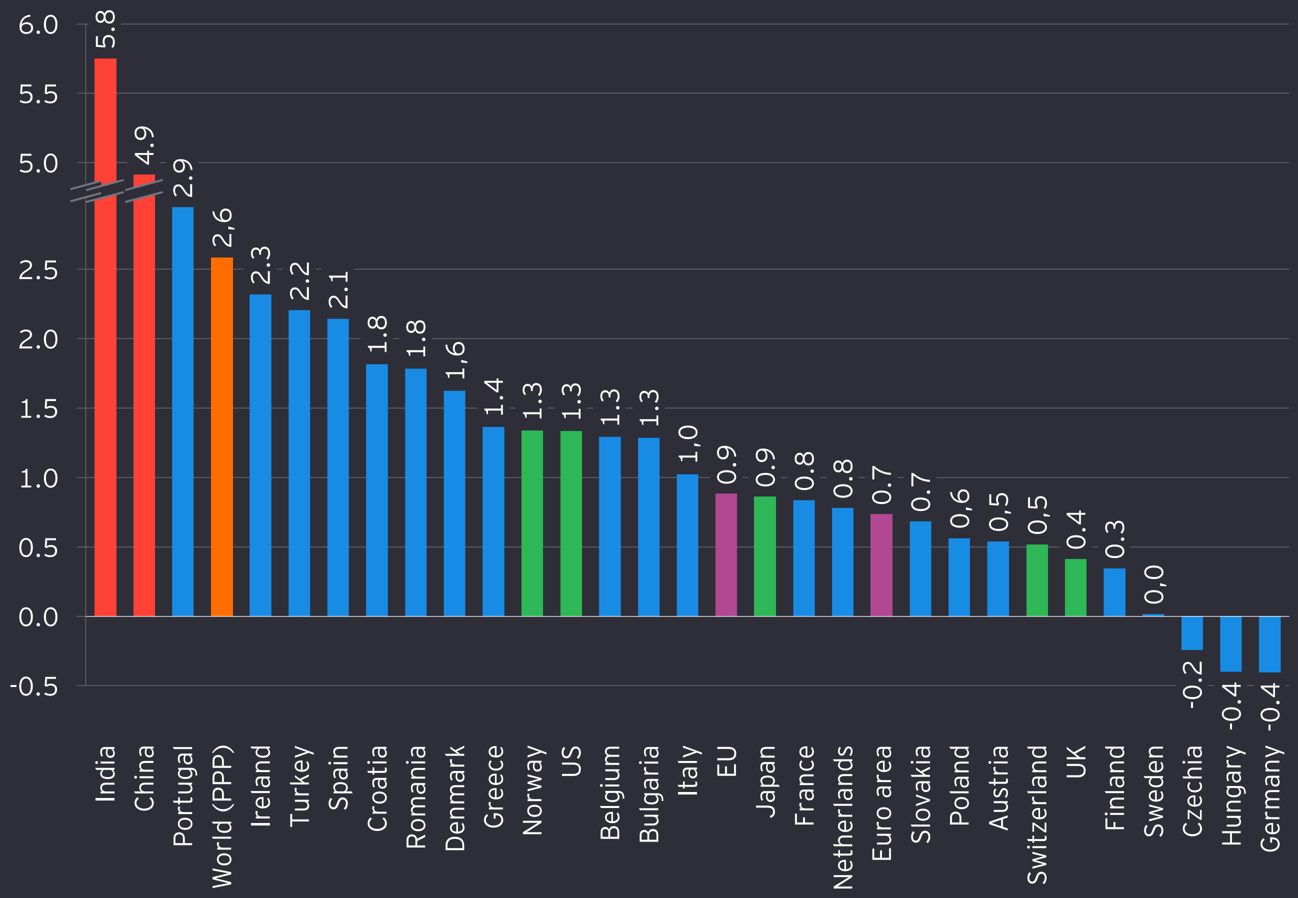


Source: Statistics Poland ,ONS, FRED, Oxford Economics, EY EAT forecast.
Notes: for the UK, average weekly earnings in the whole economy, total pay (monthly data); for the US, average hourly earnings of the production and nonsupervisory employees (monthly data); for Poland, wages in the enterprise sector. Real wages deflated with CPI. Nordics as average of Norway, Sweden, Finland and Denmark.

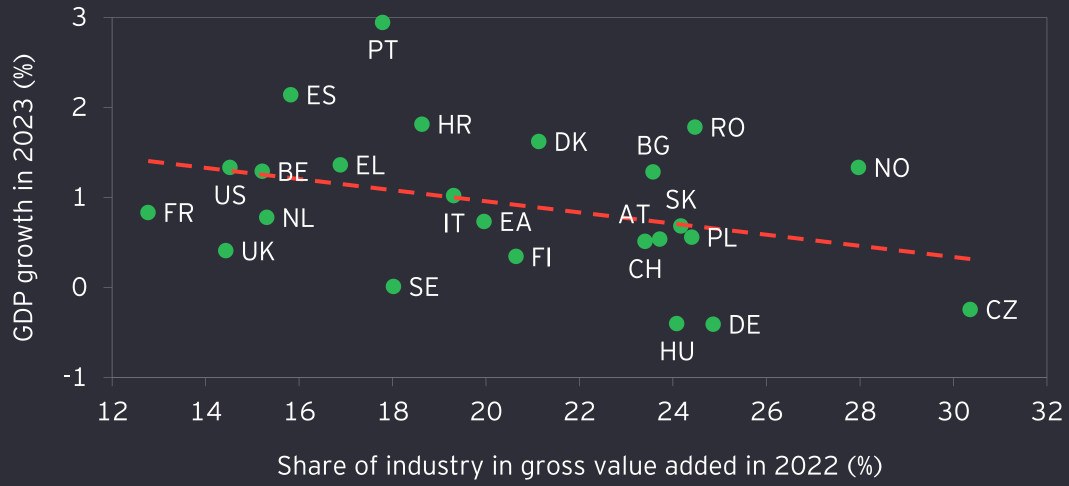
These factors should translate to modest but positive GDP growth in 2023 in most countries, despite ongoing monetary policy tightening

- Growth will be strongest in tourism-intensive Southern Europe, while most industry-heavy countries (Germany, Czechia, Hungary) will see a full-year decline in GDP in 2023

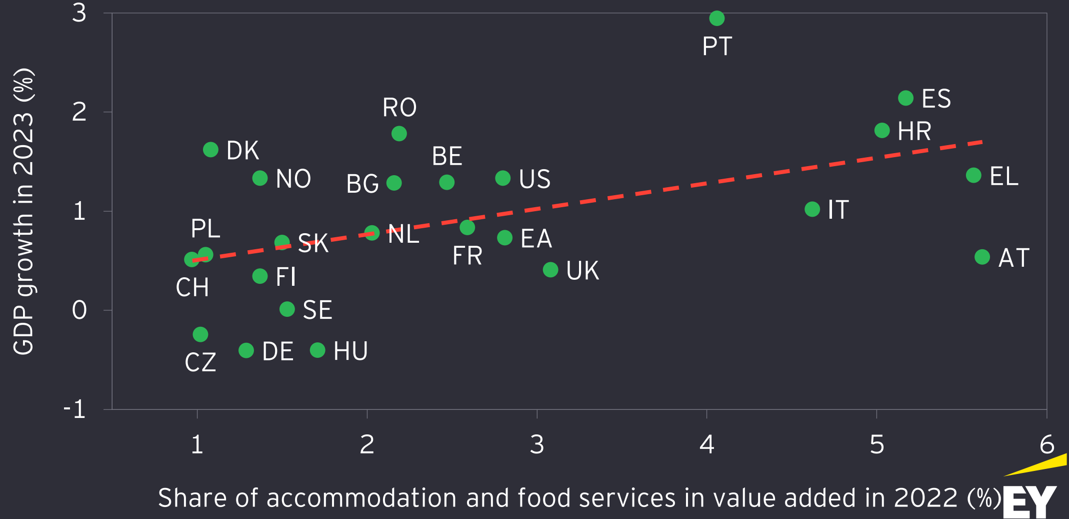
GDP growth in 2023 (In percentage)



GDP growth in 2023 vs. share of industry in value added in 2022



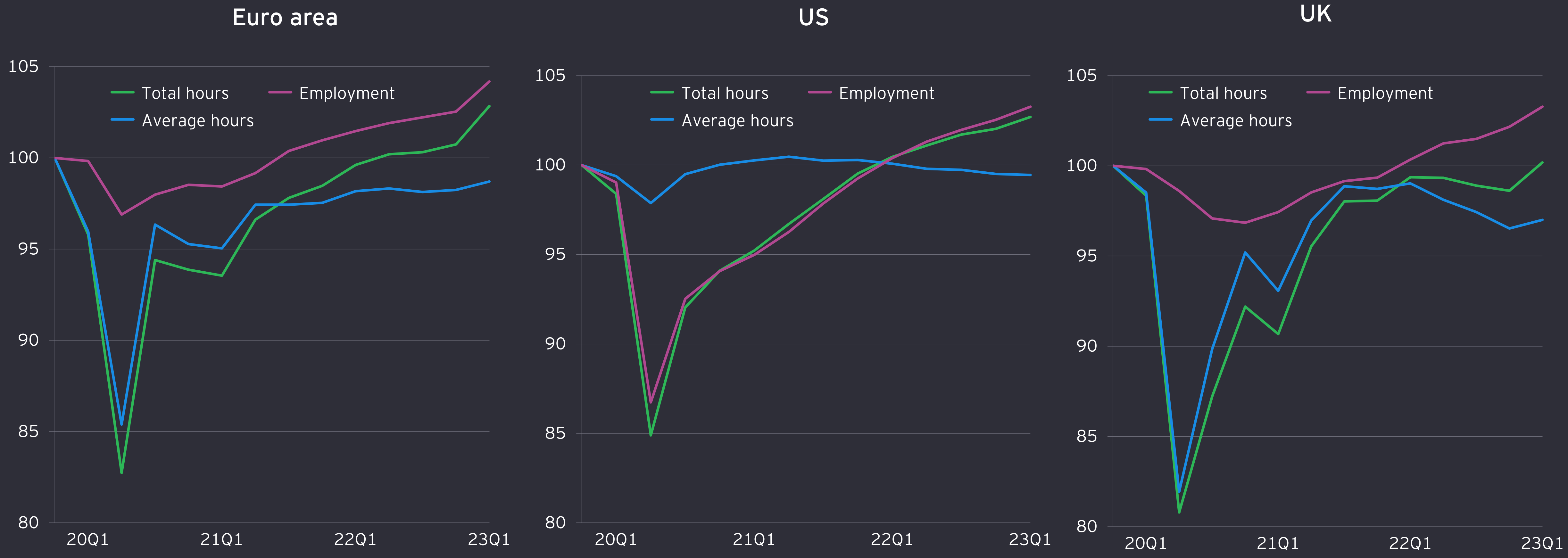
GDP growth in 2023 vs. share of accommodation and food service in value added in 2022



Source: EY EAT baseline forecast.

Economic growth in Europe is supported by resilient labor markets, with employment continuing to grow. Said that, labor input has not increased as much as employment as average hours worked are below pre-pandemic levels, especially in the UK

Employment, total and average hours worked
(2019 Q4=100)



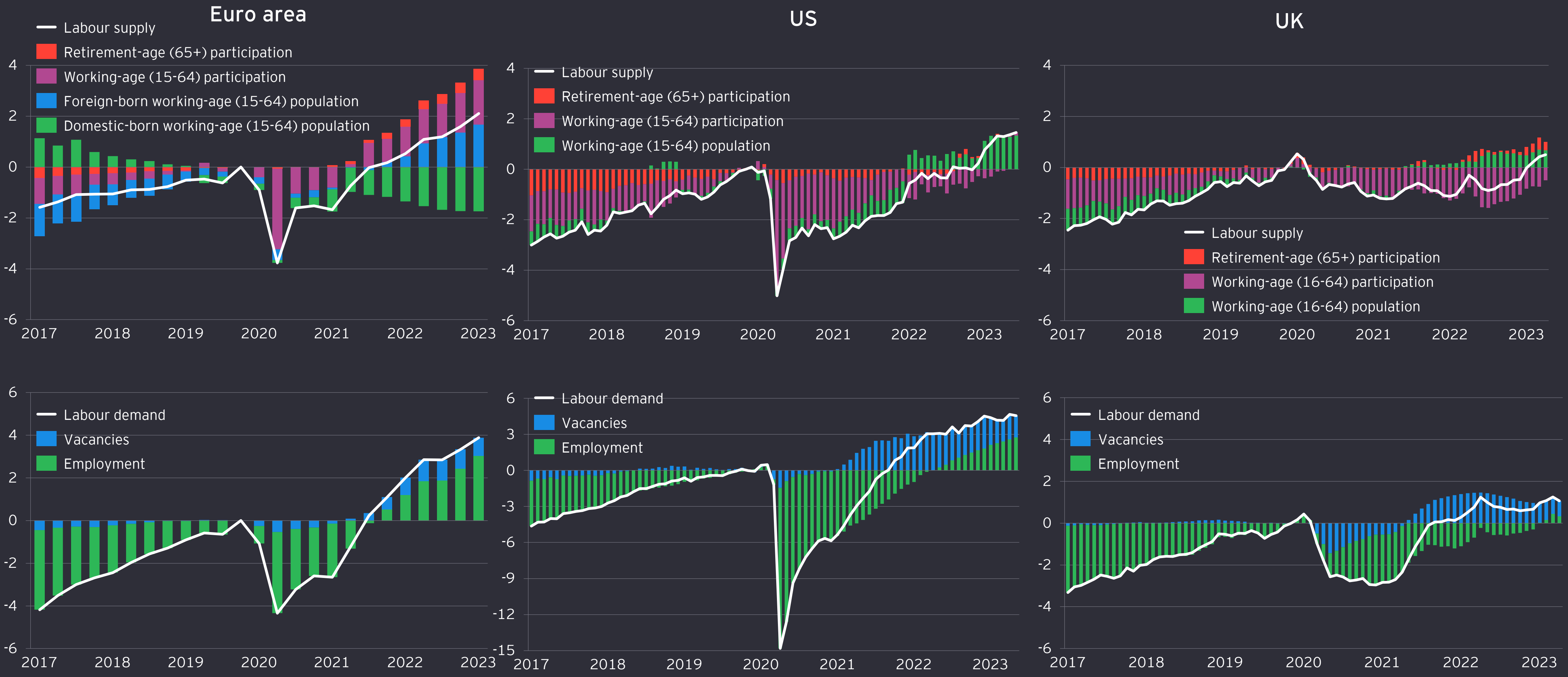
Source: Eurostat, FRED, ONS, EY calculations.

While labor demand has increased relative to pre-pandemic levels, labor supply has usually increased less, contributing to labor market tightening. Unemployment rates are at or near historical lows

- Said that, labor markets have recently been rebalancing, mainly due to an increase in supply on the back of increased immigration and labor force participation

Labor supply change compared with 2019 Q4 (in percentage)

Labor demand change compared with 2019 Q4 (in percentage)

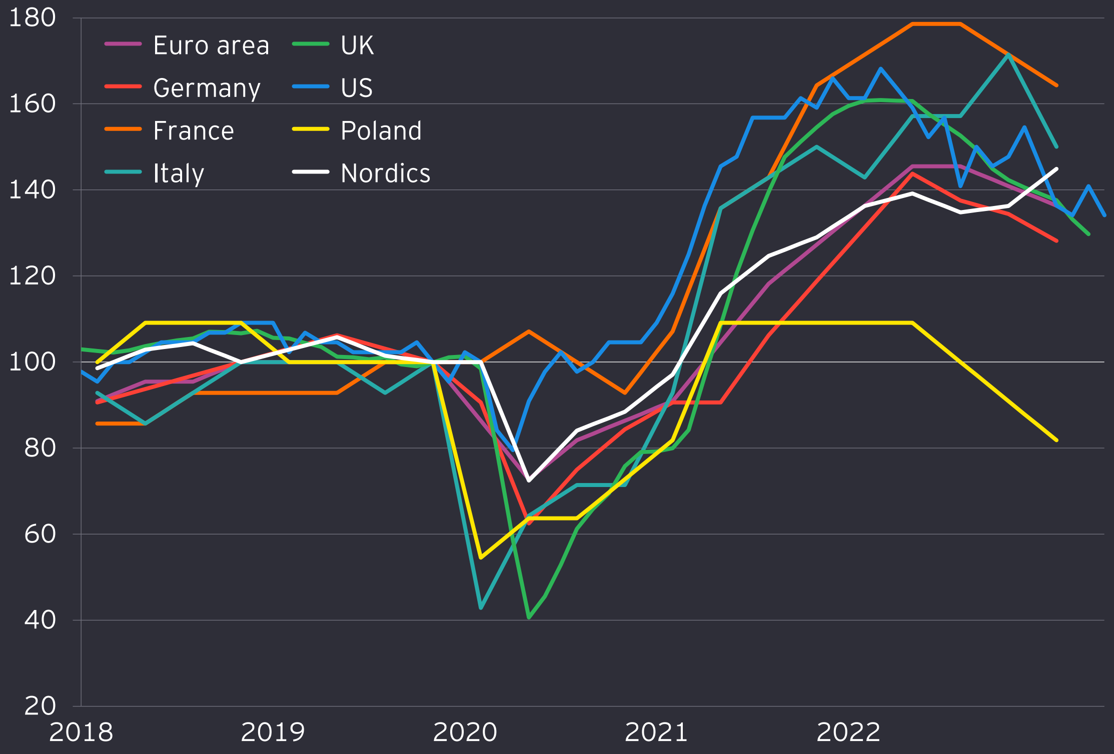


Source: Eurostat, BLS, FRED, ONS.

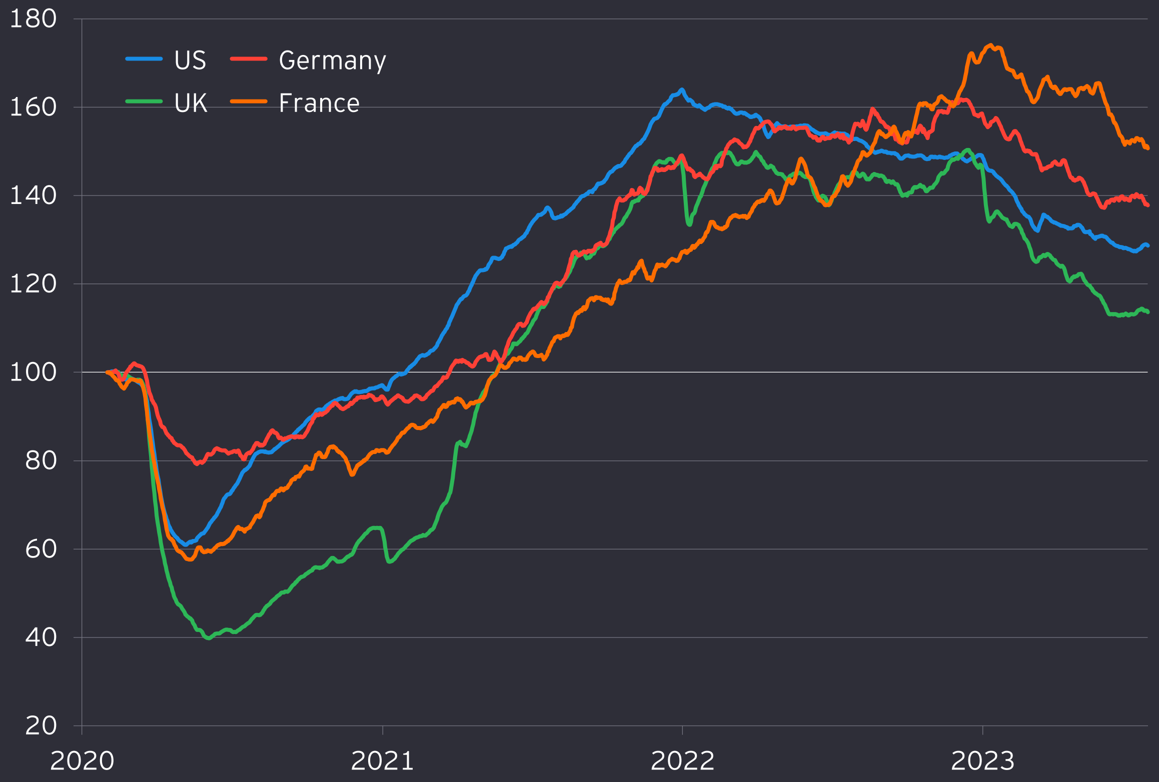
Labor market

Due to economic slowdown, demand for labor has softened a bit, but remains high

Vacancy rate [1] *
Index, 2019 Q4 =100



Indeed Job Postings Index[2],
(Index, Feb 01 2020 = 100)

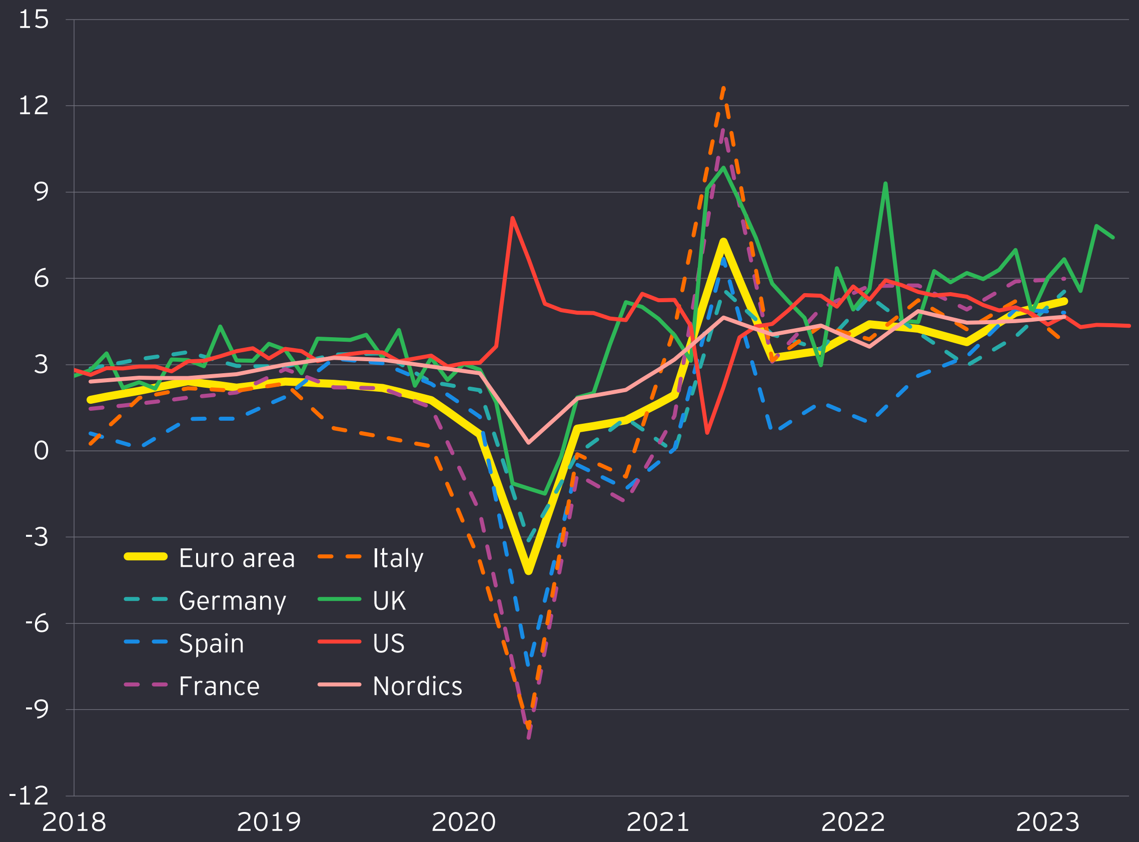


Source: [1] Eurostat, ONS, FRED, EY EAT calculations. [2] Data on online job postings is based on GitHub - hiring-lab/job_postings_tracker: Regularly updated data series for external use.
Notes: Vacancy rate is the number of vacancies divided by the total number of filled positions (for the UK, total 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. Nordics is an average of vacancy rates in Sweden, Finland and Norway.

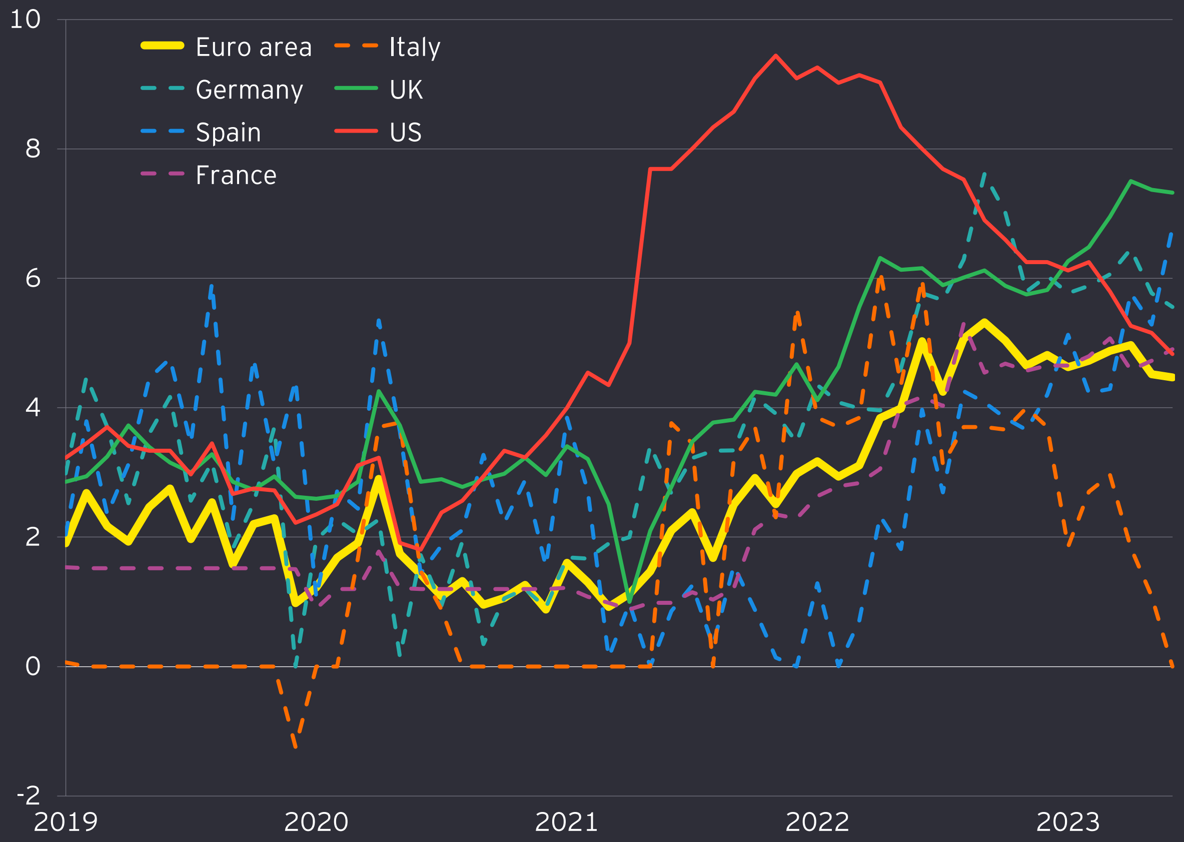
Despite economic slowdown and some labor-market cooling, nominal wage growth in the euro area has accelerated on the back of elevated inflation. Data on wages offered in job postings signal that wage pressures have stabilised in recent months

- 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

Wage growth (y/y, in percentage)



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



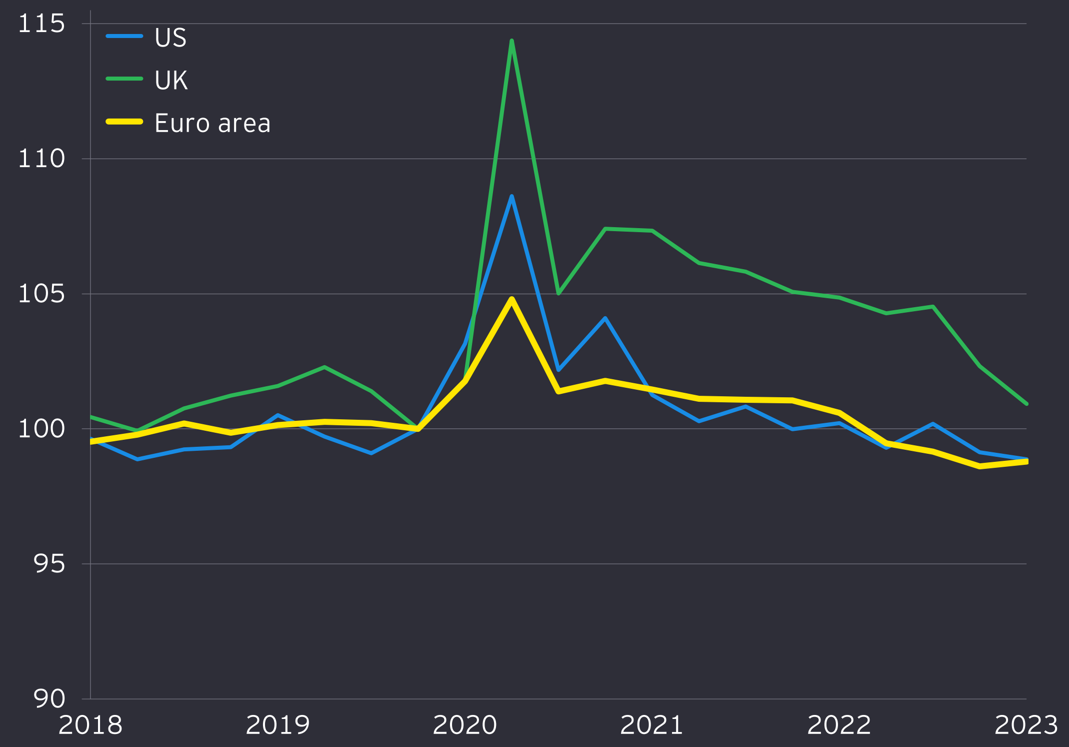
Source: [1] Eurostat, ONS, FRED, Oxford Economics
For the European area countries, Total Earnings (quarterly data); for the UK, average weekly earnings in the whole economy, total pay (monthly data); for the US average hourly earnings of All Employees, Total Private (monthly data). Nordics as Norway, Sweden, Finland and Denmark arithmetic average.
[2] Source: Indeed wage tracker

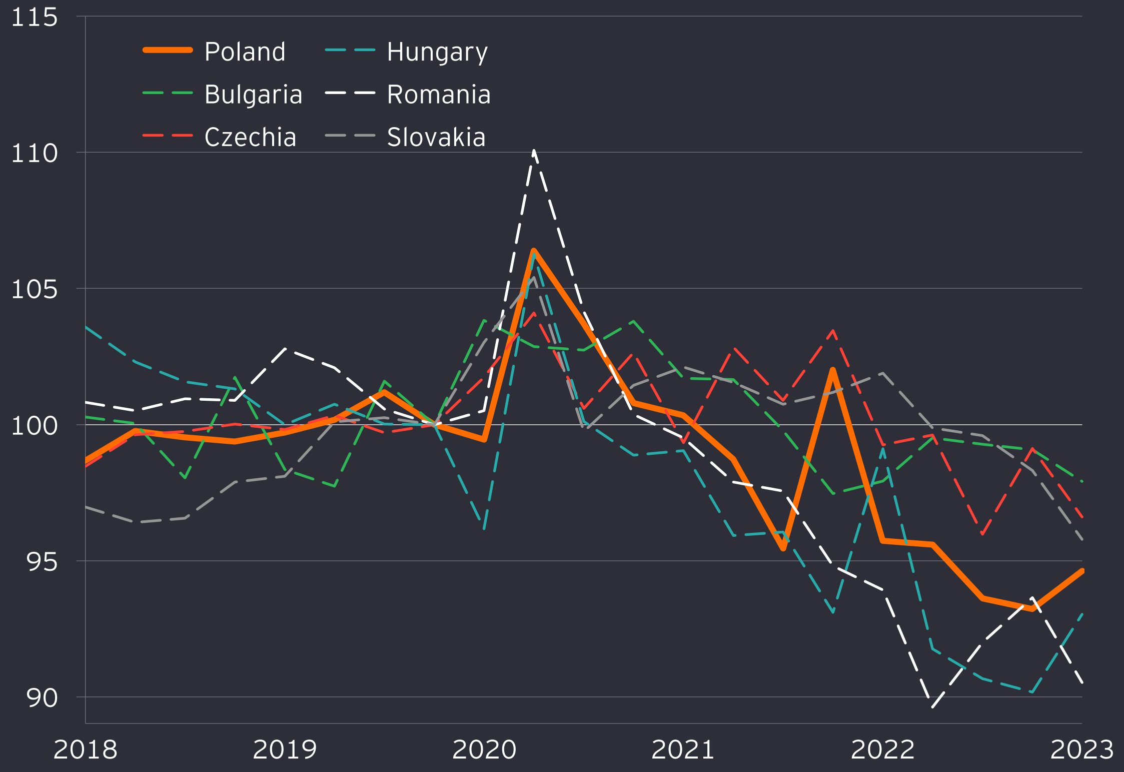
Despite acceleration in nominal wage growth, in most European countries, real wages are below the pre-pandemic levels. The share of compensation in gross value added has also declined, especially in CEE countries. With a tight labor market, workers may use their bargaining power to recoup lost income

- 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 in manufacturing

Compensation of employees as a share of Gross Value Added

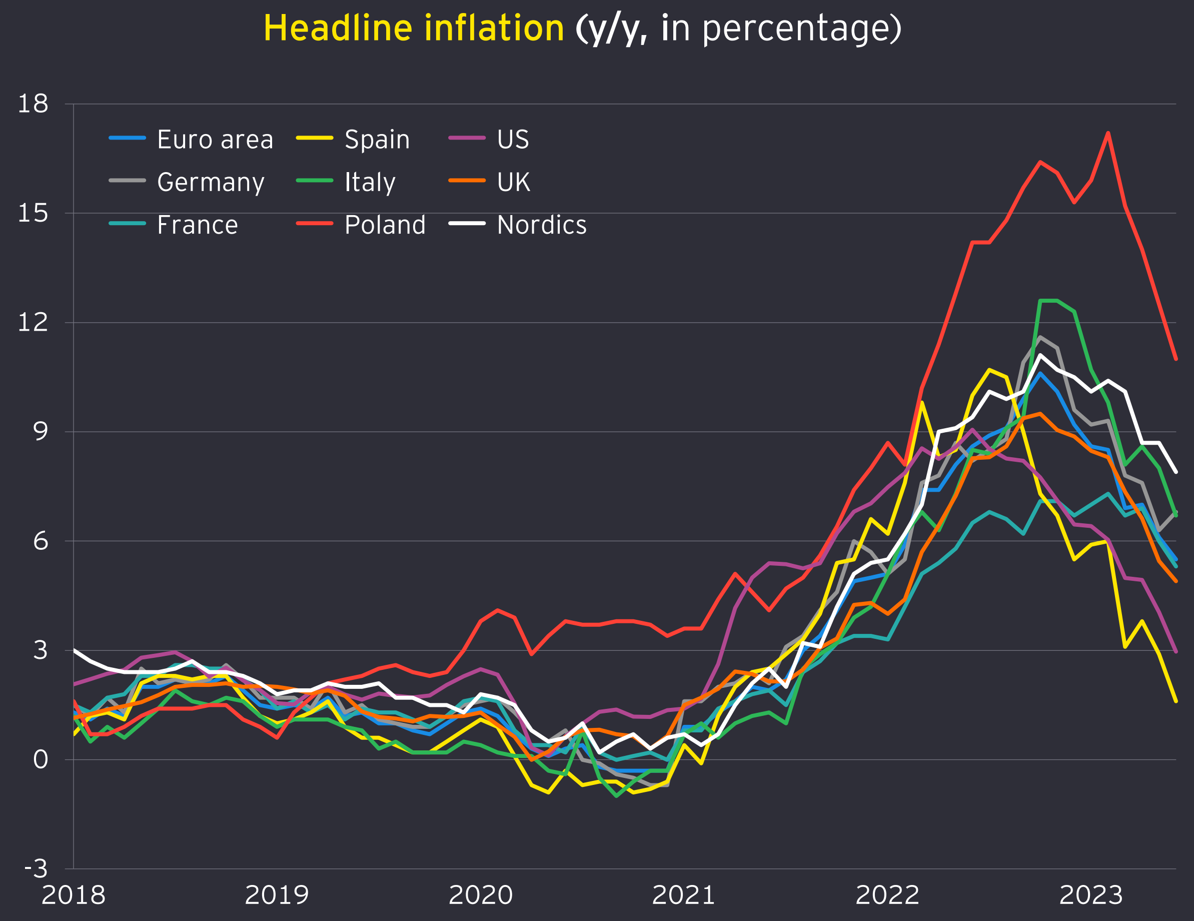
Index, 2019 Q4 =100

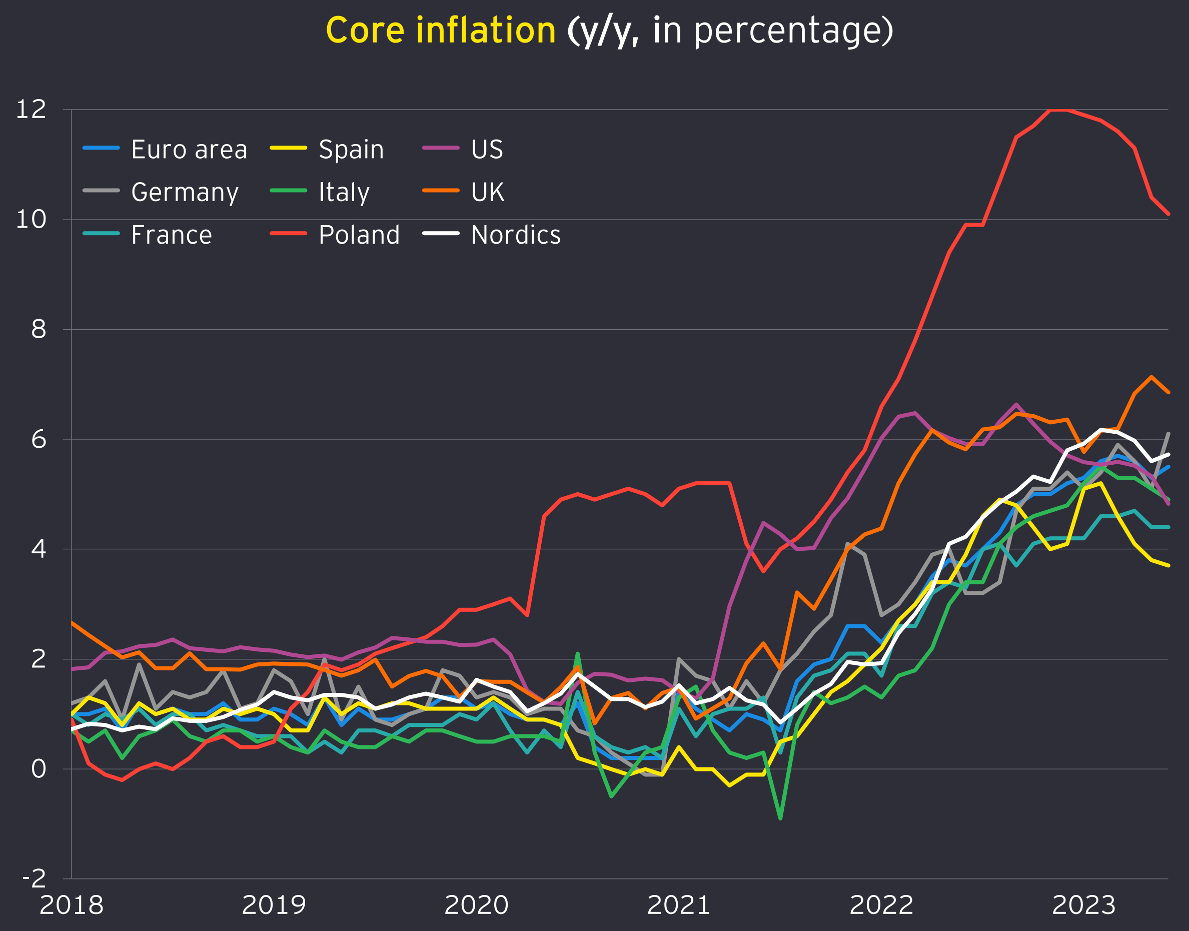




Source: Eurostat, ONS, FRED.

Despite tight labor markets and strong nominal wage growth, headline inflation has been decelerating quite rapidly. Core inflation also seems to have passed its peak in most countries but shows more persistence





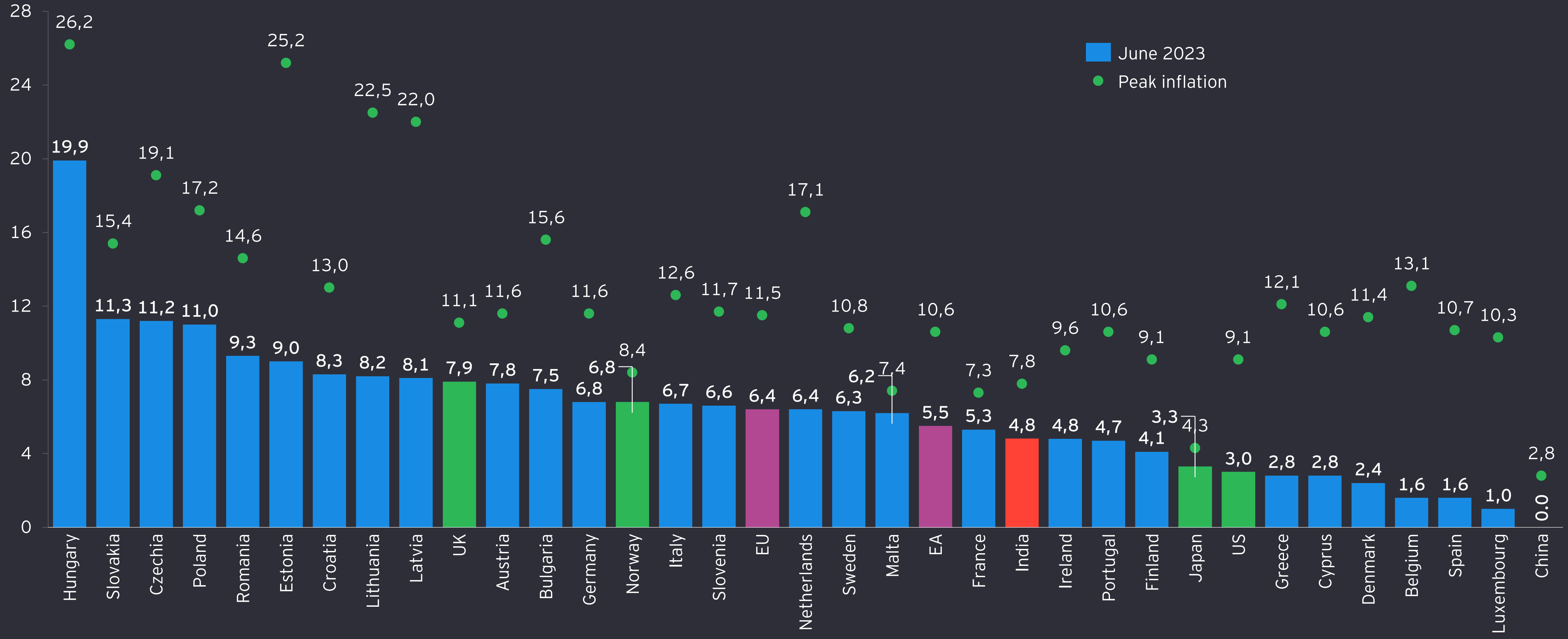
Source: Eurostat; ONS, FRED.

Notes: Nordics as arithmetic average of Norway, Sweden, Finland and Denmark.

Inflation

While inflation has declined significantly from its peak, it remains elevated, although its level varies widely across Europe, with highest rates recorded in CEE countries

HICP inflation in June 2023 (y/y, %)

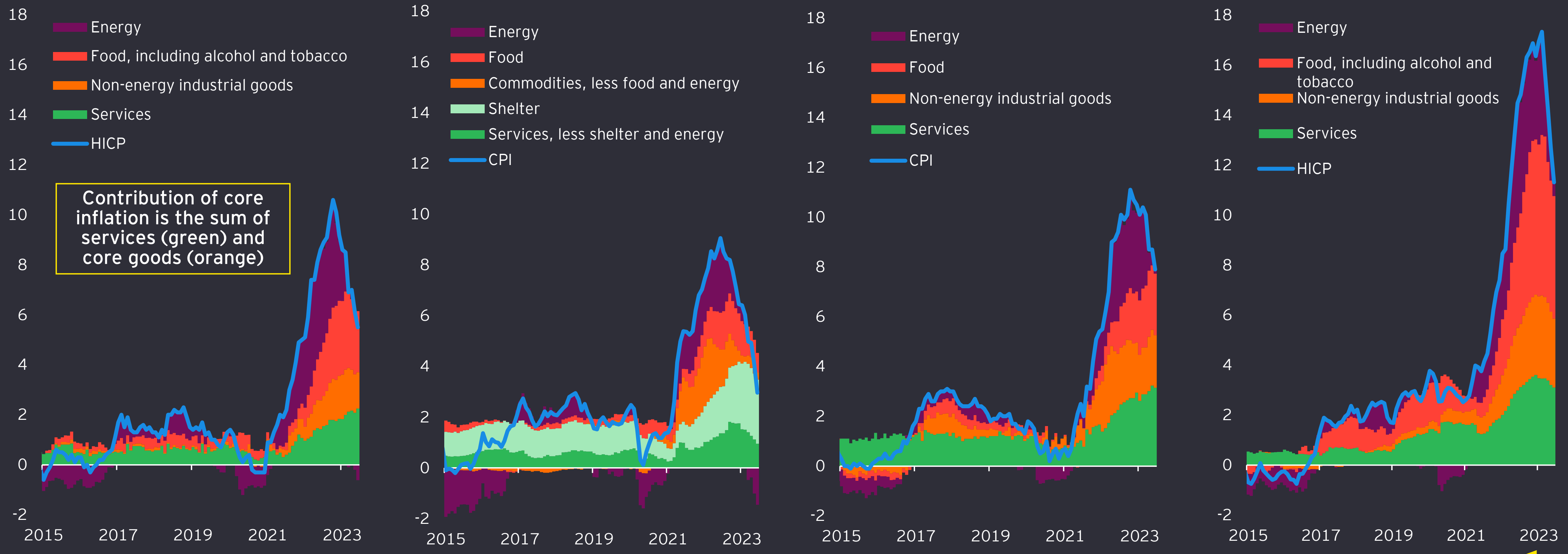


Source: Eurostat, FRED, ONS, national statistical bureaus.
Note: For non-EEA countries, CPI inflation.

While initially inflation in the euro area has been coming down exclusively on the back of declines in energy price inflation, more recently, food and core goods pressures have begun to subside as well

- In the UK, price pressures are more persistent due to stronger nominal wage growth and the consequences of Brexit and the pandemic
- In CEE, inflation has been much higher due to stronger pass-through from commodity price shocks and stronger demand. Core inflation began to ease earlier than in the euro area, though

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



a) Euro area

b) US

c) UK

d) CEE

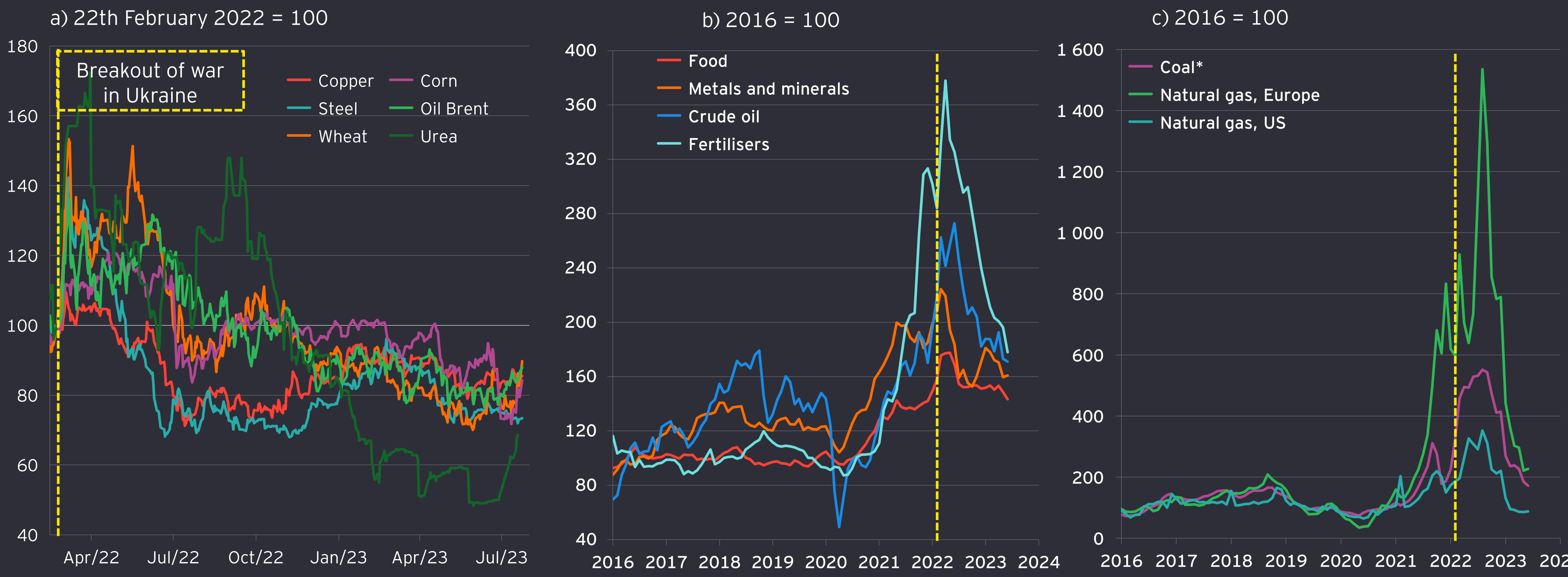
Contribution of core inflation is the sum of services (green) and core goods (orange)

Source: Eurostat; FRED; BLS; ONS; EY EAT calculations.
Note: CEE includes Czechia, Hungary, Poland, Romania and Slovakia.

Energy and food inflation is going down not only due to base effects (elevated prices a year before) but also thanks to the decline in commodity prices well below the pre-war levels

- Some commodities have even returned to pre-pandemic levels, though many, especially food and metals, still remain above them.

Global commodity prices (index)

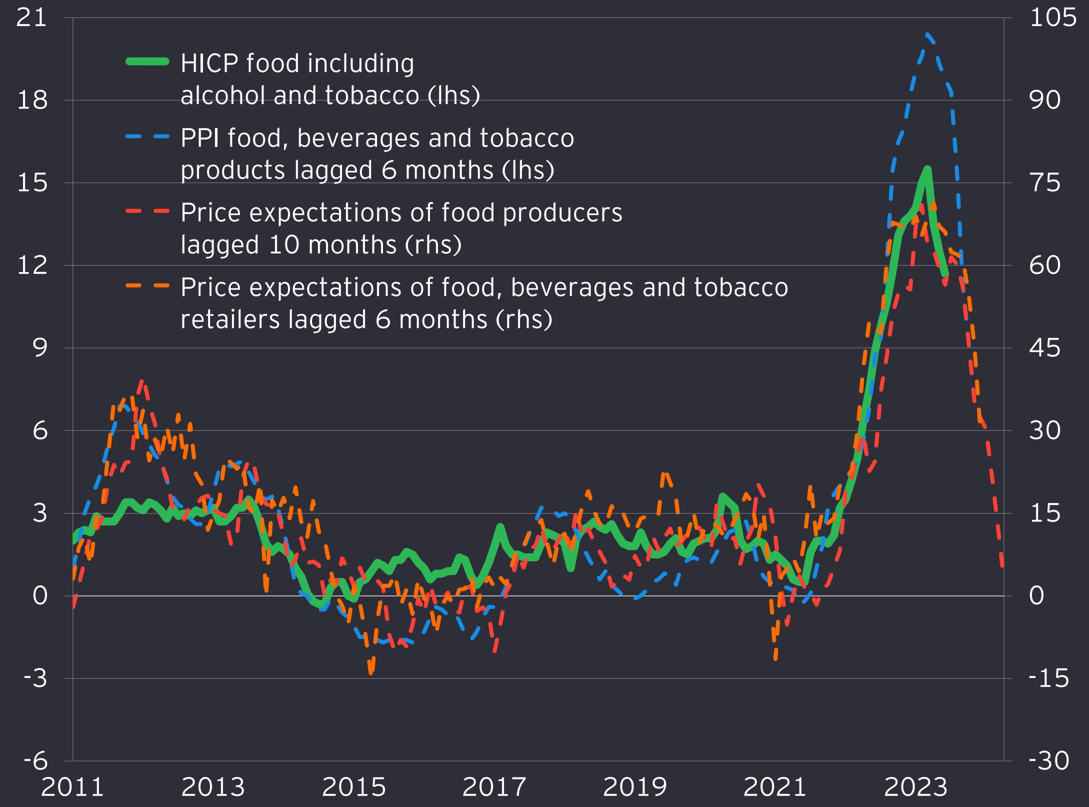


Source: World Bank Commodity Prices; stooq.pl.
* ICE Rotterdam coal price.

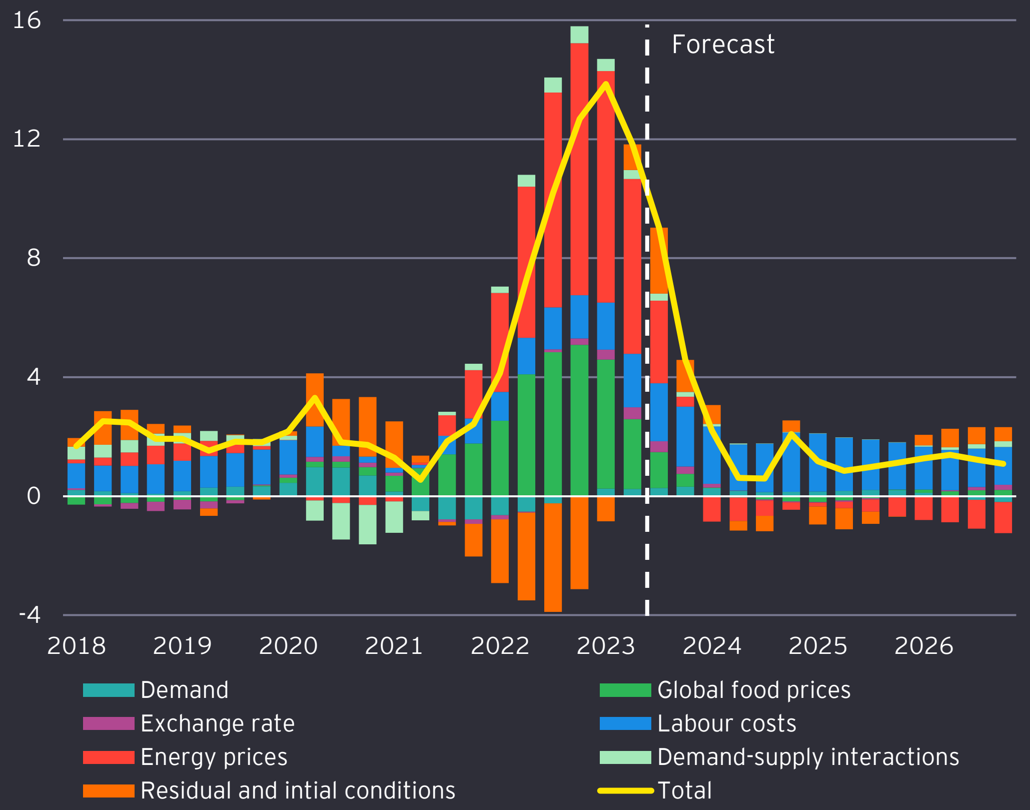
Euro area food price inflation has begun to decelerate. Leading indicators signal further rapid disinflation in the coming months, though upside risks linger

- Food prices react with a long lag and in a strongly non-linear fashion to global food and energy commodity prices. We expect food inflation to rapidly decelerate towards ~1% in the euro area as past declines in commodity prices filter through to food prices
- The risks are tilted to the upside though, given extreme weather conditions in many countries (e.g., very high temperatures in Southern Europe and arrival of the El Niño weather pattern) and policy decisions such as Russia quitting the Black Sea Grain deal and India, as a top rice exporter, banning some shipments of the commodity to reduce domestic price pressures

Food HICP and its leading indicators in the euro area



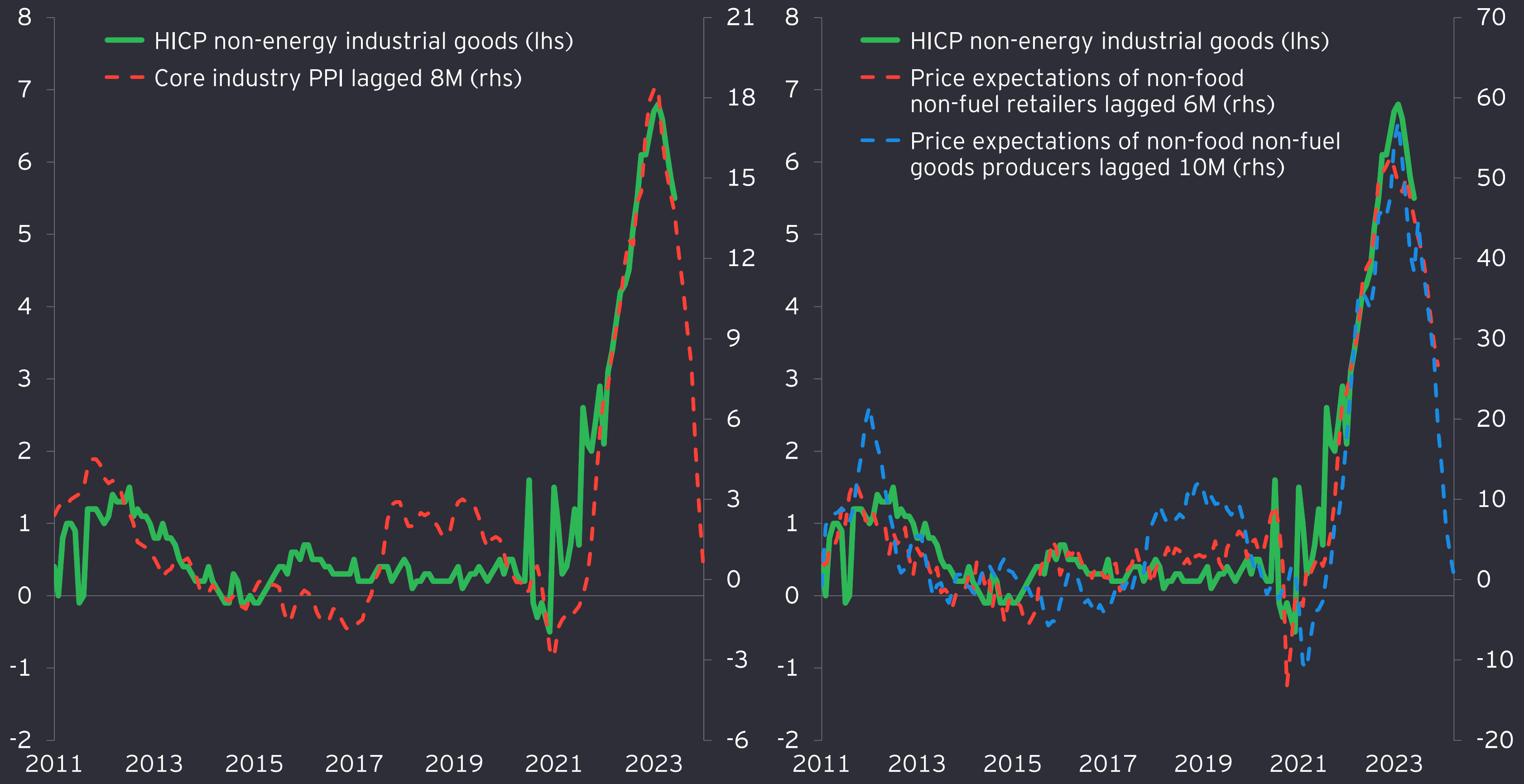
Model-based decomposition of food inflation in the euro area (y/y, in log points)



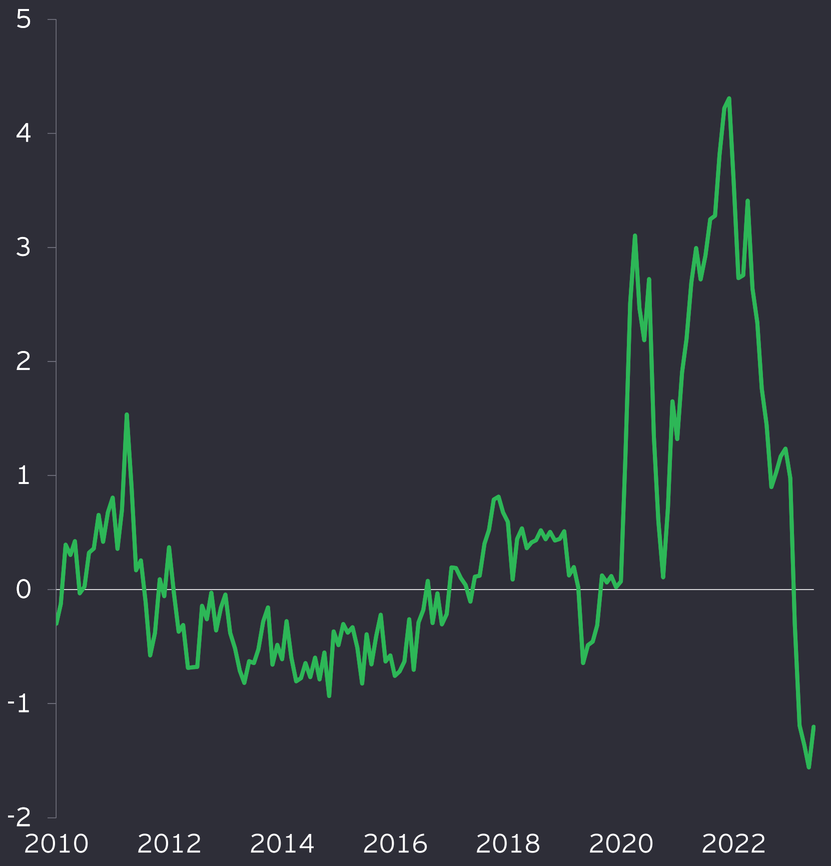
Source: Eurostat, European Commission, Oxford Economics, EY calculations.
Demand includes output gap and y/y consumption growth; exchange rate is NEER; Energy prices are country-specific demand-weighted averages of oil, natural gas, coal and electricity prices; global food prices is World Bank food commodity price index denominated in local currency; labour costs include average nominal wages in the whole economy and unit wage costs in manufacturing; demand-supply interactions are interactions between output gap and energy or global food prices.

Inflation of non-food non-energy (core) goods has also begun to decline on the back of easing supply bottlenecks, weaker demand, declining shipping costs and falling energy prices. Leading indicators point to a further rapid disinflation in the coming months

Core goods HICP and its leading indicators in the euro area



Global Supply Chain Pressure Index (GSCPI)*

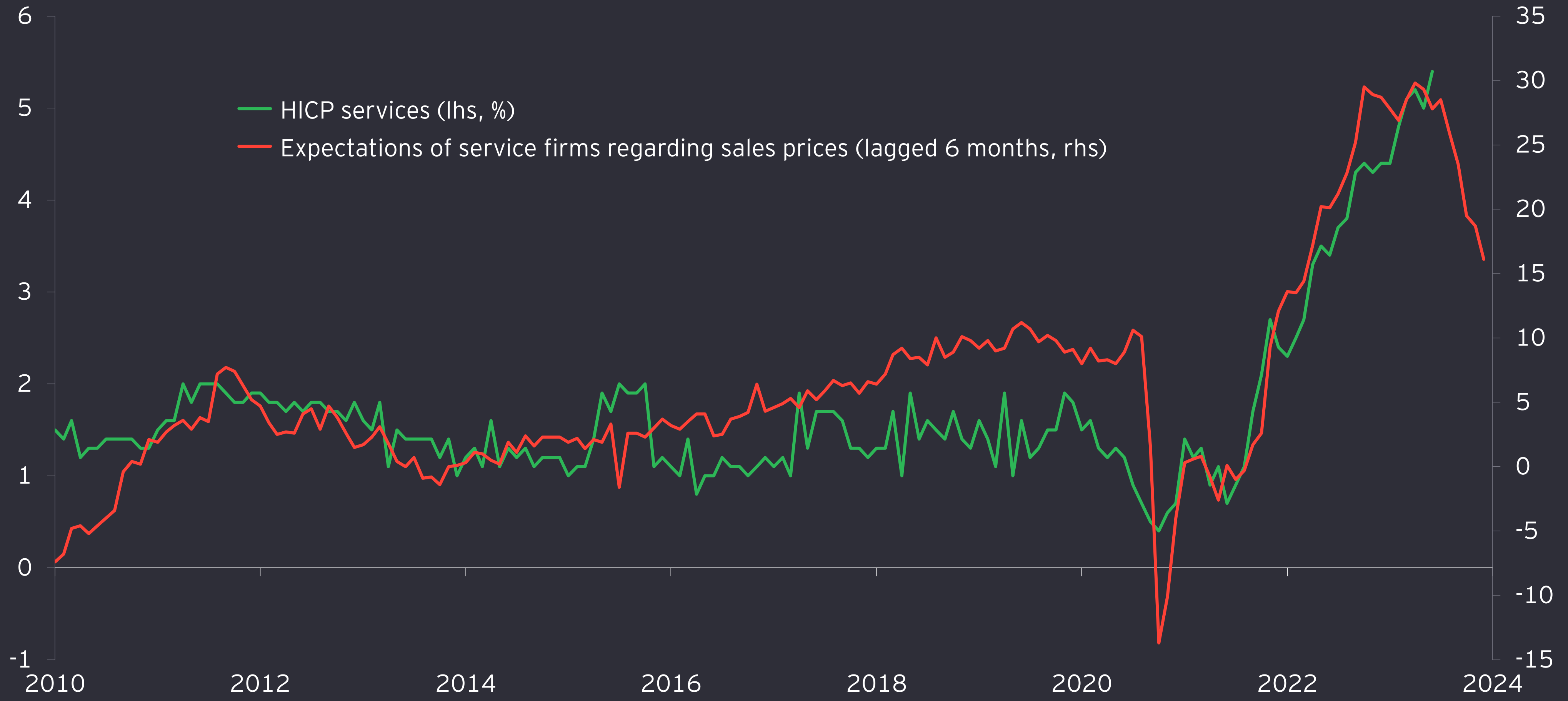


Source: Eurostat; European Commission; Federal Reserve Bank of New York Liberty Street Economics; EY calculations.
Note: Core industry PPI includes mining and quarrying; manufacturing (except MIG energy), except food, beverages and tobacco. Price expectations of non-food non-fuel goods producers is an arithmetic average of price expectiations in NACE sections 13-18 and 20-32.
* Index scaled by its standard deviation (0=average value).

Services inflation remains elevated, driven by strong wage growth. However, firm expectations suggest that it should also begin to decline in the coming months on the back of easing commodity prices and receding supply pressures as well as weakening demand

- In June 2023, services inflation accelerated purely on the back of a strong base effect in Germany (introduction of a cheap universal transport ticket in June 2022). Abstracting from that, services inflation shows signs of stabilisation in the last 3 months, while surveys indicate that price pressures are easing

Y/y HICP services vs. expectations of service firms regarding sales prices in the euro area

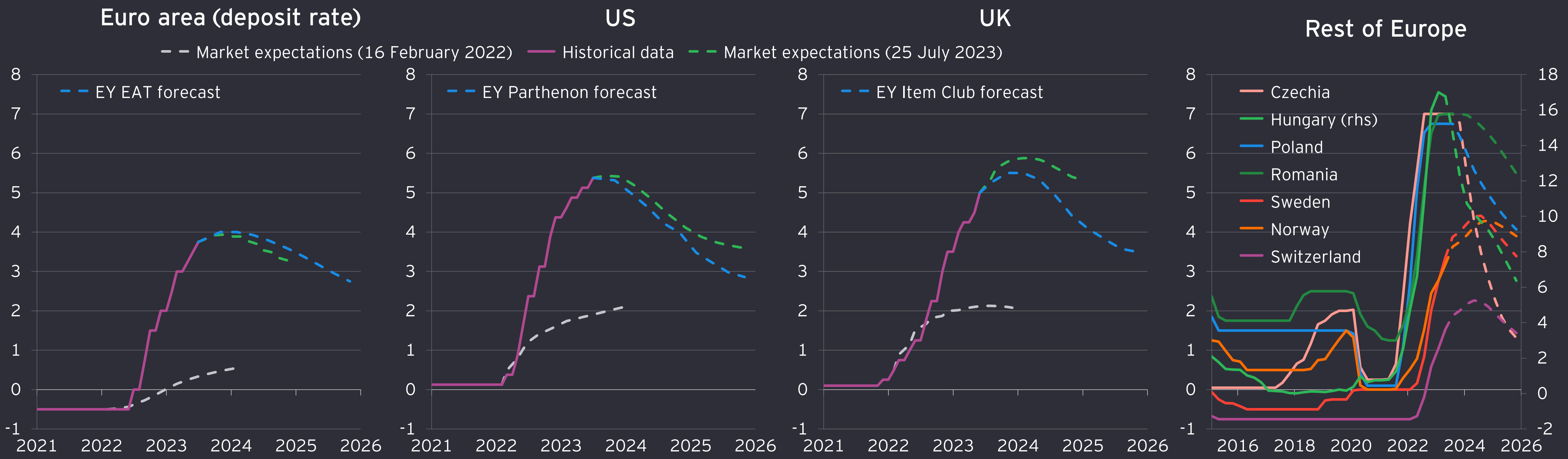


Source: Eurostat.

Despite falling inflation and the strongest tightening cycle in the euro area's history, the ECB retains a hawkish rhetoric. With major central banks viewing inflation risks as tilted to the upside, they are likely to err on the side of overtightening and businesses should be prepared for a "higher for longer" scenario.

- We anticipate one more final 25bp rate hike by the ECB in September. A rapid decline in headline and core inflation indicators may not be sufficient stimulus for a first policy rate cut in 2024 Q1. In particular, if nominal wage growth remains high and is not sufficiently absorbed by firms in their profit margins, the ECB may hold rates steady even until June 2024
- Given upside surprises to inflation and wage growth in May, the Bank of England hiked interest rates by 50 bp to 5.0% in June. We expect two more rate hikes in upcoming meetings and a first rate cut in 2024 Q2
- CEE central banks have already started to cut rates (Hungary) or will do so by the end of the year (Poland, Czechia). Given pressures on their currencies, above target core inflation and ECB tightening, Sweden and Norway are likely to raise interest rates at least twice more, with first rate cuts no earlier than 2024 H2.

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



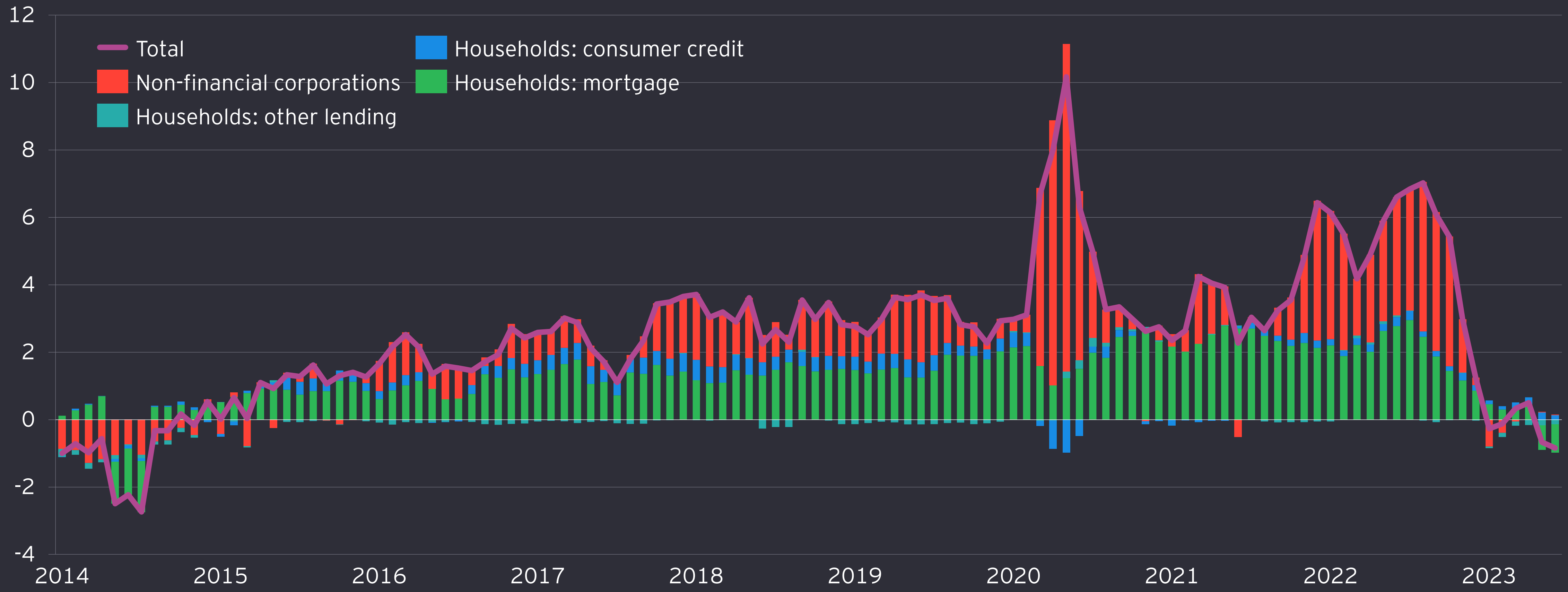
Source: ECB; Fed; BoE; Refinitiv; Eurostat; Oxford Economics; EY EAT forecast.
* For the euro area and the UK on 16 February 2022 and 25 July 2023 and for the US on 16 February 2022, expected interest rates from Refinitiv; for the US on 25 July 2023, expected interest rates from Atlanta Fed Market Probability Tracker. For expectations from 16 February 2022, the curve was prolonged using data on instantaneous government bond forward yield curves. For Hungary, 1-month interbank rate.

The effects of monetary policy tightening have become apparent in the slowing credit growth. In recent months, it has stabilised close to zero, though

- While consumer credit keeps growing, loans to firms have stagnated and mortgage credit is contracting
- However, one has to remember that the value of money has dropped considerably due to elevated inflation and the same amount of credit can buy much less now than before the pandemic

Monthly growth in loans to households and non-financial corporations in the euro area

(in percentage, annualised and seasonally adjusted, 3-mth moving average)

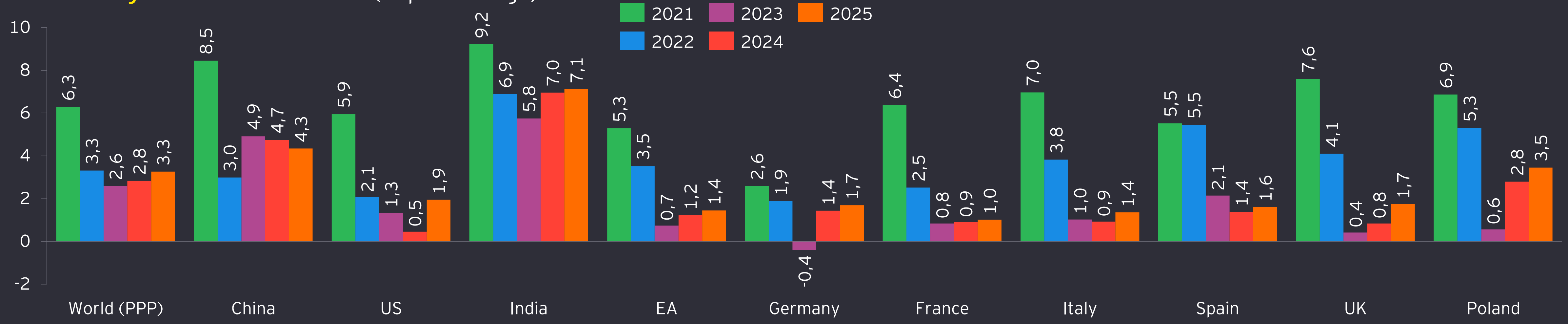


Source: ECB, EY calculations.
Note: Series for households include NPISH.

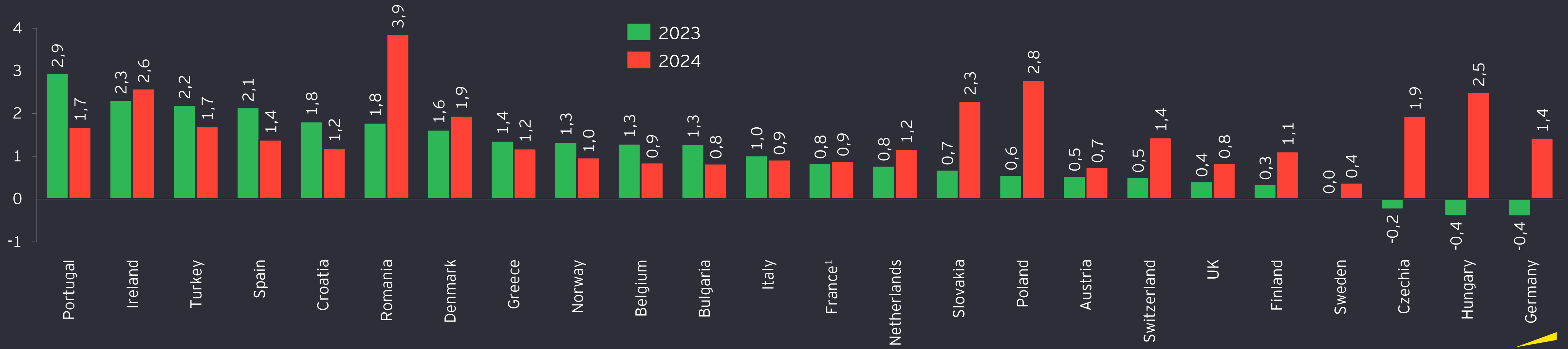
Outlook

Monetary policy tightening and subdued global demand will weigh on economic growth, which will accelerate only modestly next year. In 2024, growth in industry and services should be similar, and so will GDP growth across major euro area economies. CEE will stand out as it returns to its (much higher) potential growth

GDP growth in 2021-2025 (in percentage)



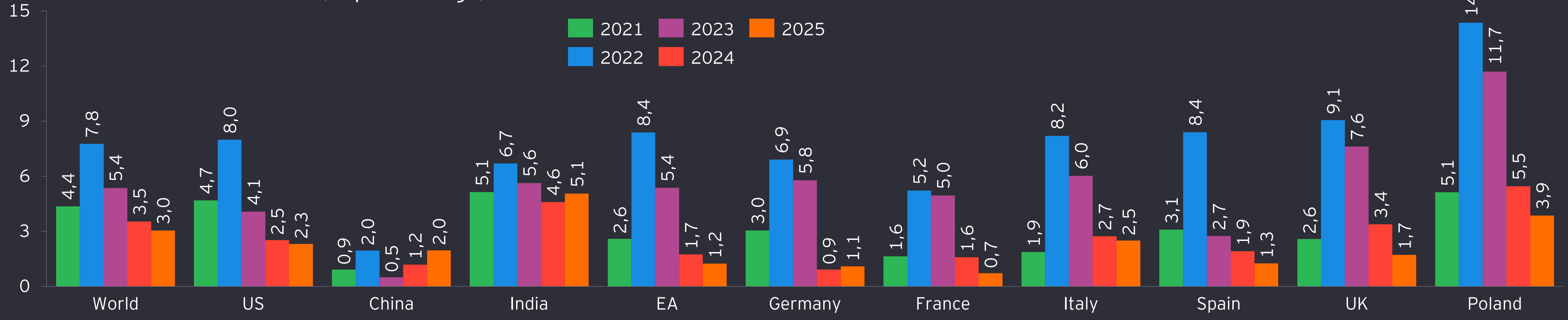
GDP growth in 2023 and 2024 (in percentage)



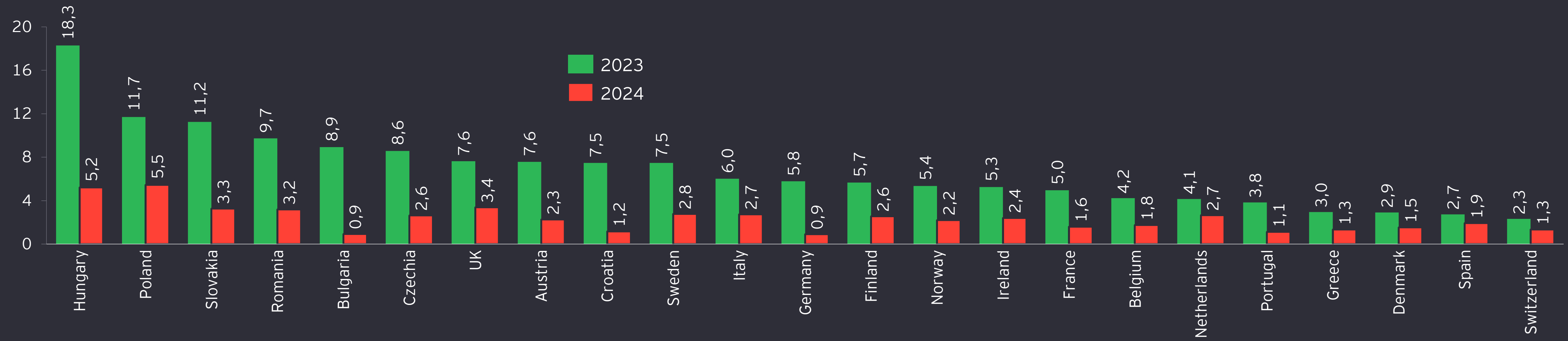
Source: Oxford Economics, EY EAT forecast (baseline scenario).

We expect inflation to fall below the 2% target in 2024 in many countries as the effects of supply shocks partially revert and food and energy price inflation bring down headline inflation. Poland and Hungary are major exceptions where inflation is likely to remain elevated for longer

Inflation in 2021-2025 (in percentage)



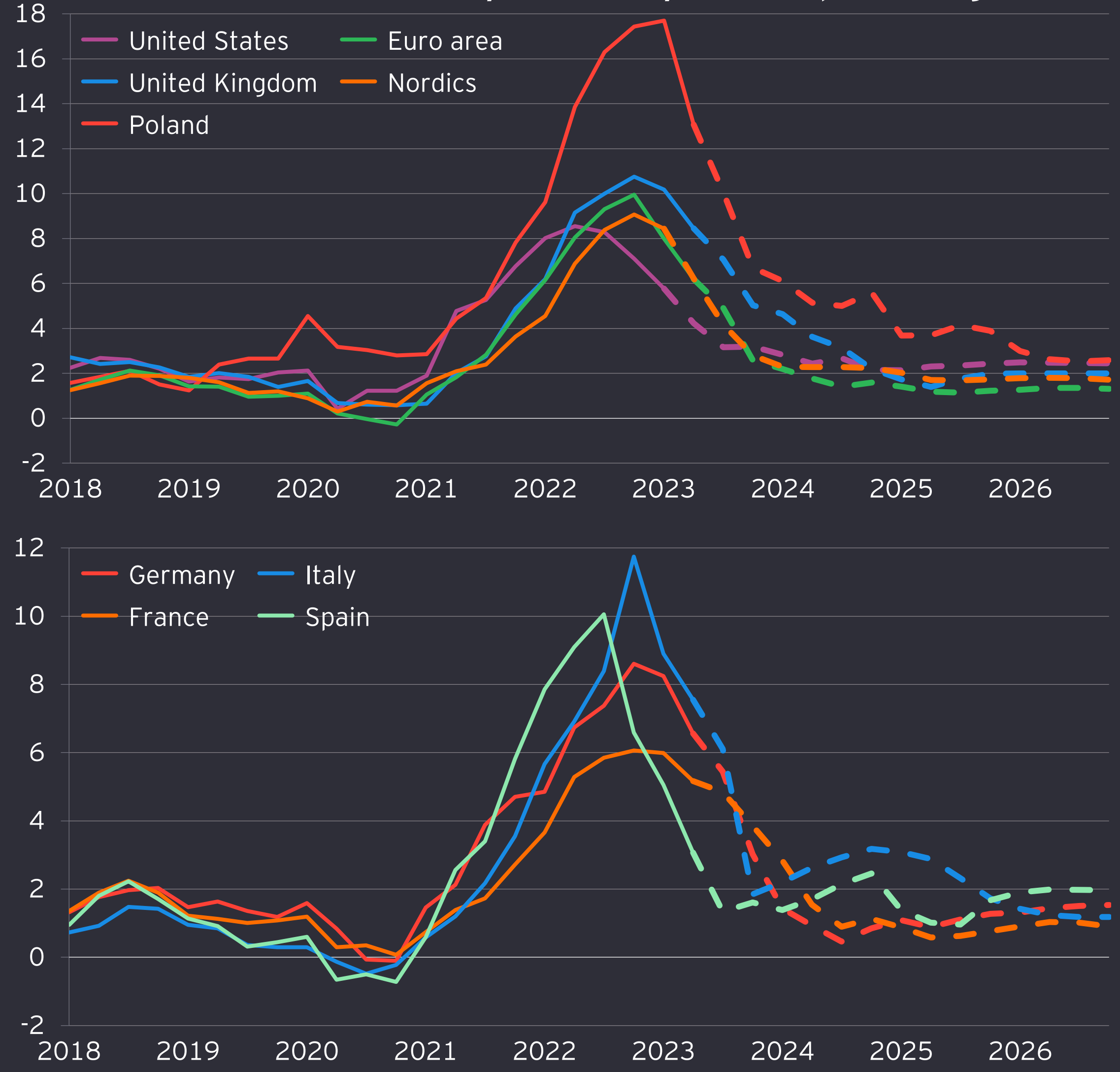
Inflation in 2023 and 2024 (in percentage)



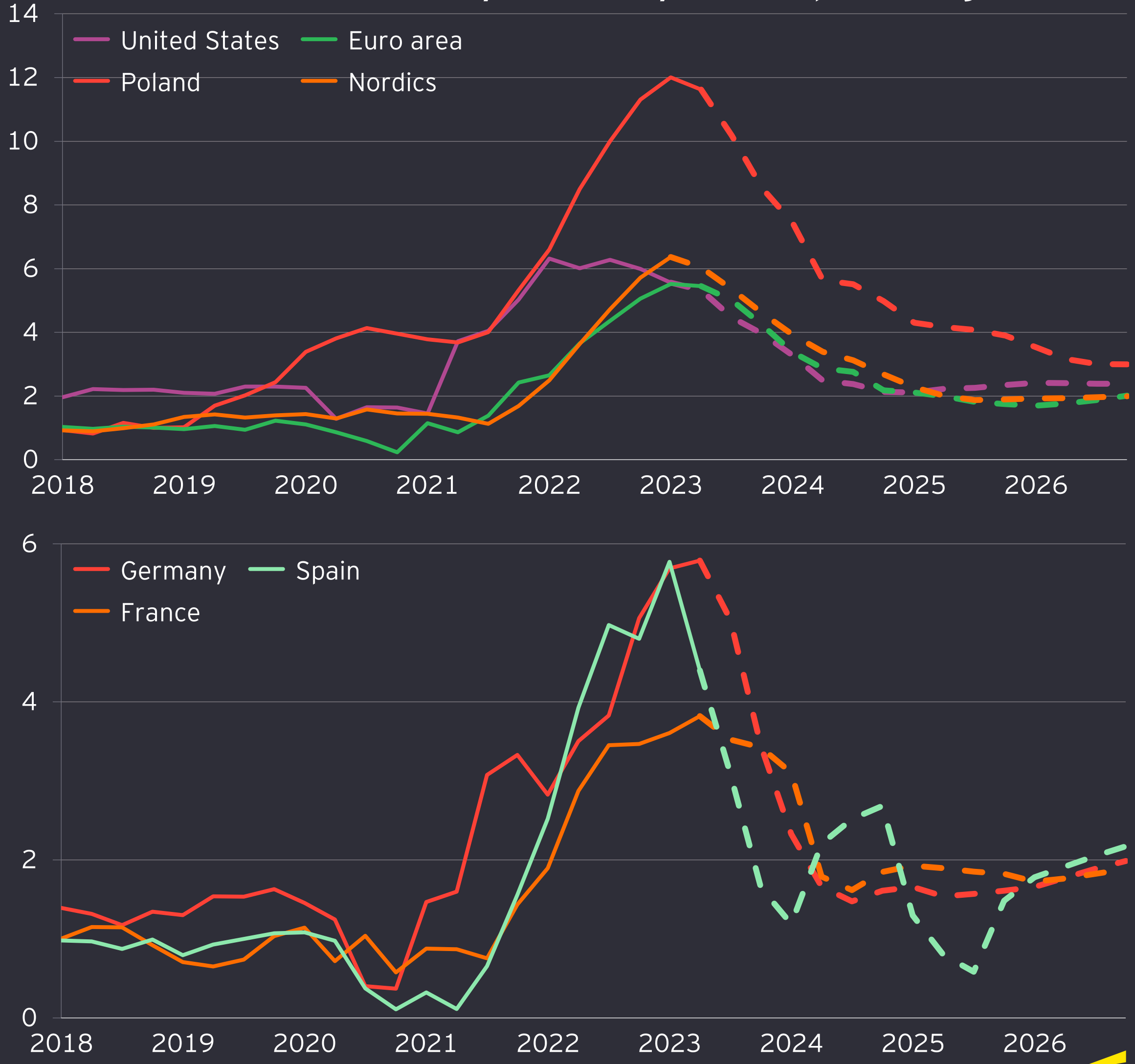
Source: Oxford Economics, EY EAT forecast (baseline scenario).

Inflation will fall relatively quickly over 2023 H2. In the euro area, headline inflation should reach the ECB target already at the beginning of 2024 and later decline below 2%. However, core inflation will remain above the target throughout 2024. In many CEE countries, inflation will stay above central bank targets until 2025-26

CPI inflation (year-over-year) (In percentage)



Core CPI inflation (year-over-year) (In percentage)



Source: Eurostat; FRED; ONS, Statistics Poland, EY EAT forecast (baseline scenario).
*Nordics as average of CPI: Denmark, Finland, Norway, Sweden.

Economic outlook remains highly uncertain. The balance of risks has improved, but remains tilted to the downside for growth and to the upside for inflation

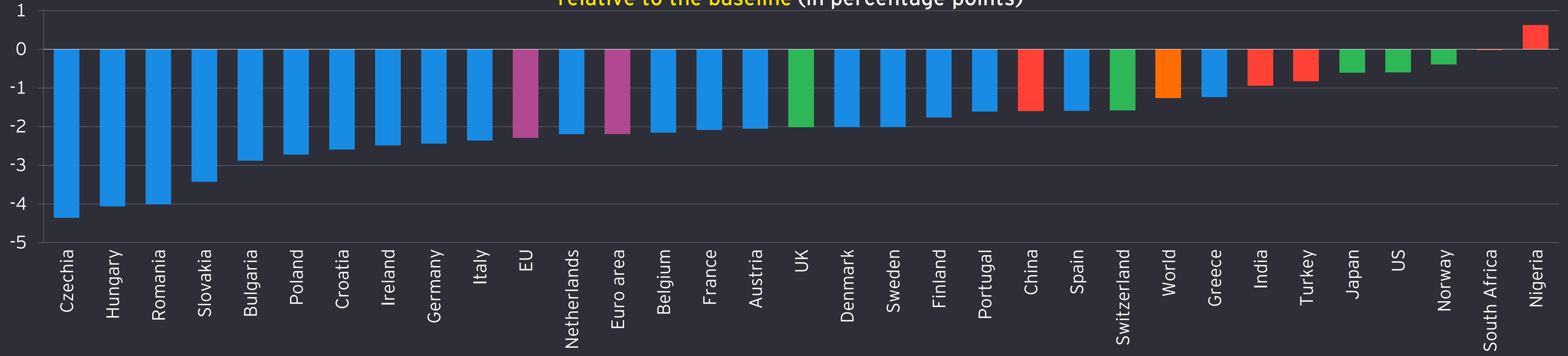
- Risk of inflation proving more persistent.
  - Strong labor market continues to be a major source of upside risks to the inflation outlook.
  - Geopolitical tensions, including the war in Ukraine, continue to be a key risk and if they intensify, could lead to more energy and food price spikes.
  - Unfavorable weather conditions (El Niño, droughts, heat waves, harsh winter 2023-24) can reduce global food production and increase food prices, as well as exacerbate imbalances in energy markets, leading to renewed energy price spikes.
  - Another upside risk to food prices stems from policy decisions such as Russia quitting the Black Sea Grain deal and India, as a top rice exporter, banning some shipments of the commodity to reduce domestic price pressures.

  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, including the ECB, that prefer to err on the side of caution.
- While the turmoil in the banking system seems to have subsided, excessive monetary policy tightening can lead to a resumption of banking sector stress.
- Elevated debt levels increase vulnerability to financial market turbulence, especially among emerging markets and developing economies. They also limit the fiscal space to offset new negative shocks and their impact on households and businesses.
- Un upside risk to the outlook stems from a faster disinflation than currently expected which may turn into deflation for some components of inflation as previous supply shocks partially revert. In such a scenario, inflation could fall well below the target and central banks might pivot earlier and more decisively, cutting interest rates sooner and faster than currently anticipated.

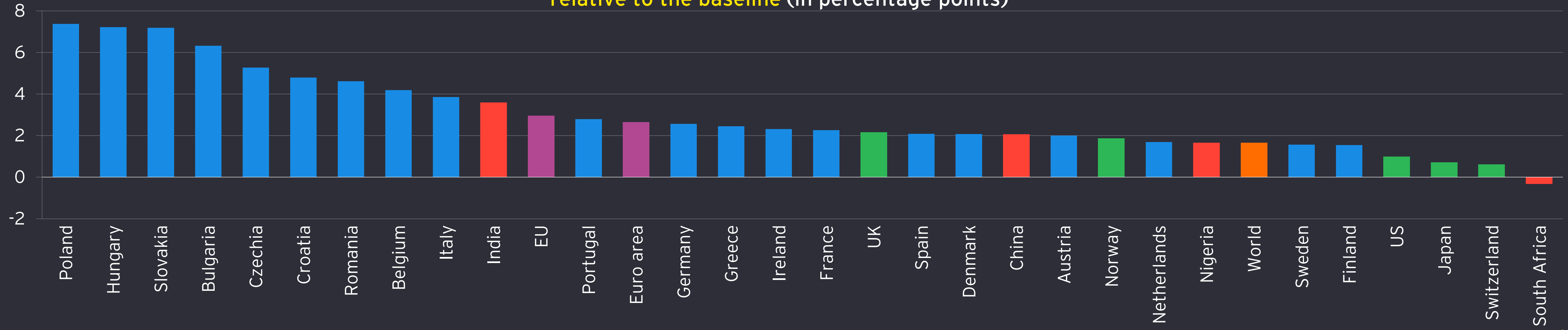
Another sharp spike in energy and food prices is not included in our baseline, nor is faster disinflation and a lower interest rate path. However, on next pages we consider alternative scenarios and their effects on European and selected major economies.

If the risk of a renewed increase in energy and food prices materialised, Europe would be impacted more than other major economies. CEE countries would be most vulnerable

Cumulative GDP growth over 2023-25 in the higher commodity prices scenario relative to the baseline (in percentage points)



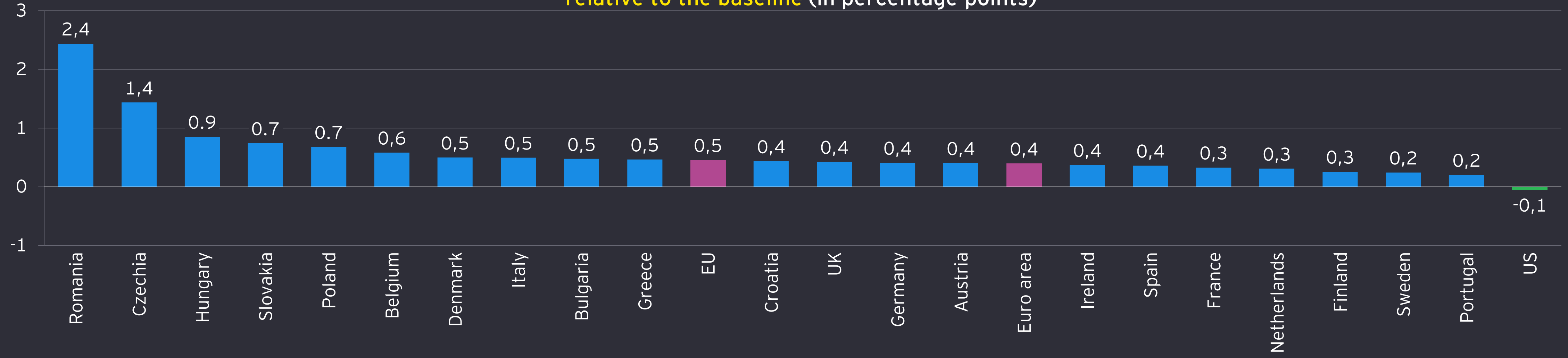
Inflation in 2024 in the higher commodity prices scenario relative to the baseline (in percentage points)



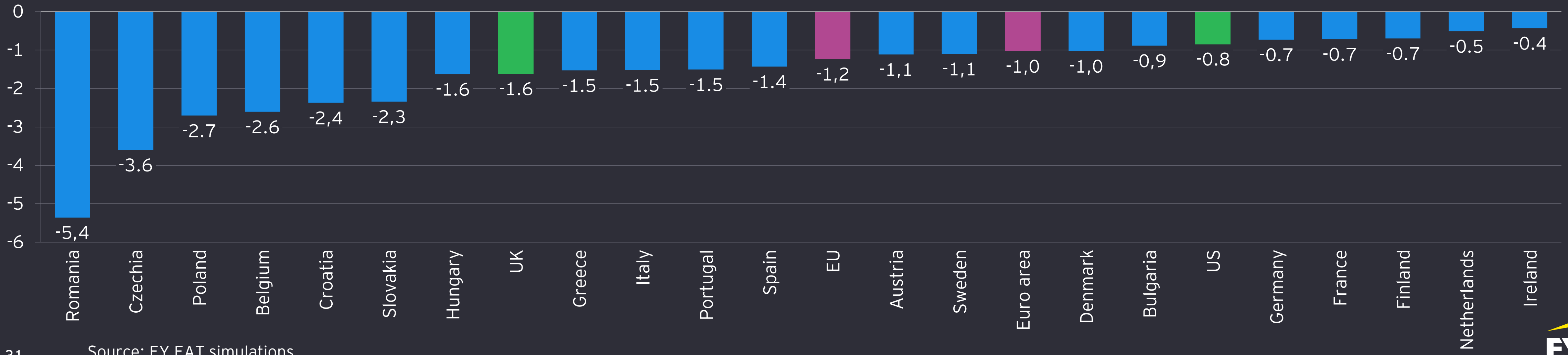
Source: EY EAT simulations.

In the faster disinflation scenario, inflation rates decline the most in CEE countries, particularly Romania and Czechia. Apart from these two countries, the impact on GDP is likely to be rather modest, though

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



Inflation in 2024 in the faster disinflation prices scenario relative to the baseline (in percentage points)



Source: EY EAT simulations.

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Forecast and country-specific outlook 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, China and Japan 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
- Country-specific outlooks for Germany, Italy, Spain and the UK have been provided by economists listed on the previous page

EY Global Economic Outlook

Explore our bi-annual EY 'Global economic outlook', developed in partnership with various EY economics teams and experts from around the globe.

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EY article summarizing the key findings of the latest report can be accessed here.

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Week of July 17, 2023

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