European Economic Outlook
(Abridged Version)

EY Economic Analysis Team

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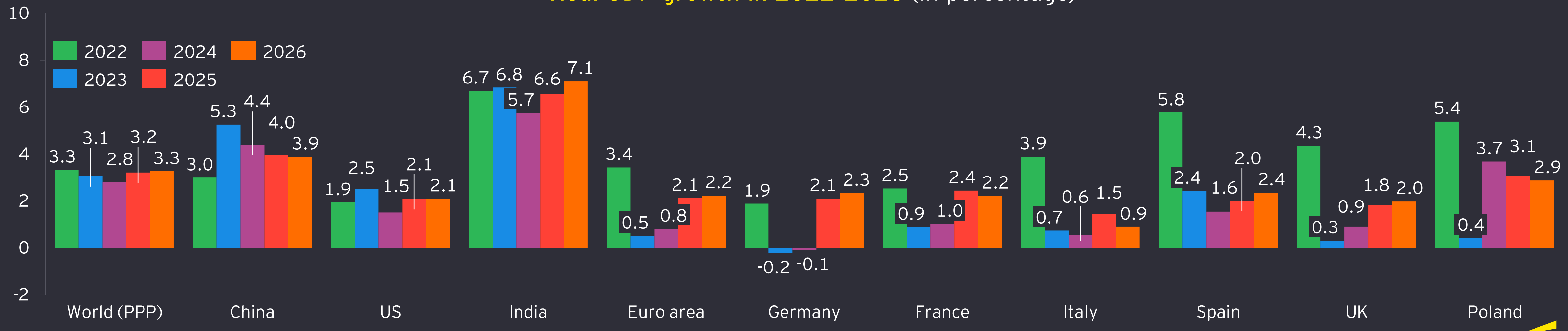
Although Europe's economic stagnation persists...

- **The European economy remains in stagnation – we estimate that euro area GDP remained unchanged in 2023 Q4, following a 0.1% contraction in Q3, as growth has been held back by supressed real incomes, weak international demand and monetary policy tightening.** Despite the decrease in inflation, prices remain elevated, keeping real wages well below their peak and limiting growth in consumption. While the cycle of monetary policy tightening has concluded, high interest rates continue to filter through to debt servicing costs and credit conditions, constraining consumer spending and business investment, particularly where linked to the housing sector. Against this backdrop consumers, both in Europe and globally, continue to prioritize spending on services, with resulting weak domestic and external demand for goods curbing manufacturing activity. These conditions occur at a time when the international competitiveness of European producers has been diminished by a stronger-than-elsewhere increase in energy prices.
- **The situation could have been bleaker if not for the resilience of the labor market and investment.** Uncharacteristic of previous slowdown periods and despite fastest monetary policy tightening in decades, non-residential business investment has remained steady in recent quarters. This stability is due to high company profits and investment needs related to supply chain restructuring, energy and digital transition. Concurrently, employment continues to grow, although at reduced rates, while unemployment has stabilized close to historical lows in most countries. This has prevented a pullback in consumer spending, as companies have been hesitant to lay off workers due to structural shortages.
- **Performance has continued to vary across sectors and countries.** Energy-intensive and housing-related manufacturing, in particular, has remained in recession, while most services, including tourism, have continued to grow, though at a slowing pace. As a result, most Southern European and Balkan countries have continued to outpace those in manufacturing-heavy Central Europe (Germany, Austria, Czechia). The Nordic countries have also underperformed due to their high sensitivity to interest rate hikes, fallout from the war in Ukraine and a slowdown in the pharmaceutical industry. Conversely, a recovery phase has begun in Poland and Hungary as rapidly declining inflation, in conjunction with strong wage growth, has boosted real incomes, thereby enhancing consumption.

… recovery is on the horizon

- **We still expect the European economy to recover gradually throughout 2024 as real incomes increase, activity in global manufacturing normalizes, the drag from tight monetary policy slowly fades with the help of rate cuts, and government investment continues to support economic activity.** While strong nominal wage growth continues on the back of indexation to past inflation and robust employee bargaining power, and while inflation is near the target, real wages are set to increase, thereby supporting consumption. Consumption may also be stimulated by a gradual reduction in household saving rates towards pre-pandemic levels as sentiment improves, and interest rates begin to fall. Simultaneously, we anticipate that government investment will continue to support activity as the absorption of NextGenEU funds is stepped up. Collectively, all these factors should outweigh the impact of fiscal policy that is on the course of tightening, most notably due to the progressive withdrawal of fiscal measures introduced in response to the pandemic and the energy shock.
- **Annual average growth will remain weak in 2024, though.** Due to weak carry-over from 2023 and only a gradual recovery in quarterly GDP growth, we anticipate annual average growth to accelerate only marginally in 2024 to 0.8% (vs. our 1.1% forecast in the October outlook) from an estimated 0.5% in 2023, which is significantly below the potential growth rate. The recovery is expected to reach full speed in 2025, with growth accelerating to 2.1% (vs. a 1.5% forecast in October).
- **Poland and Hungary will likely be standout performers in 2024** with growth rates above 3% as a rapid decline in inflation from very high levels, amid still strong nominal wage growth, provides a significant boost to real incomes and consumption. However, investment growth is expected to decelerate in these countries, as EU funding from the 2014–20 Multiannual Framework ends. In Poland, the outlook will also be supported by loose fiscal policy, with substantial increases in public sector wages and transfers to families.

Real GDP growth in 2022-2026 (in percentage)



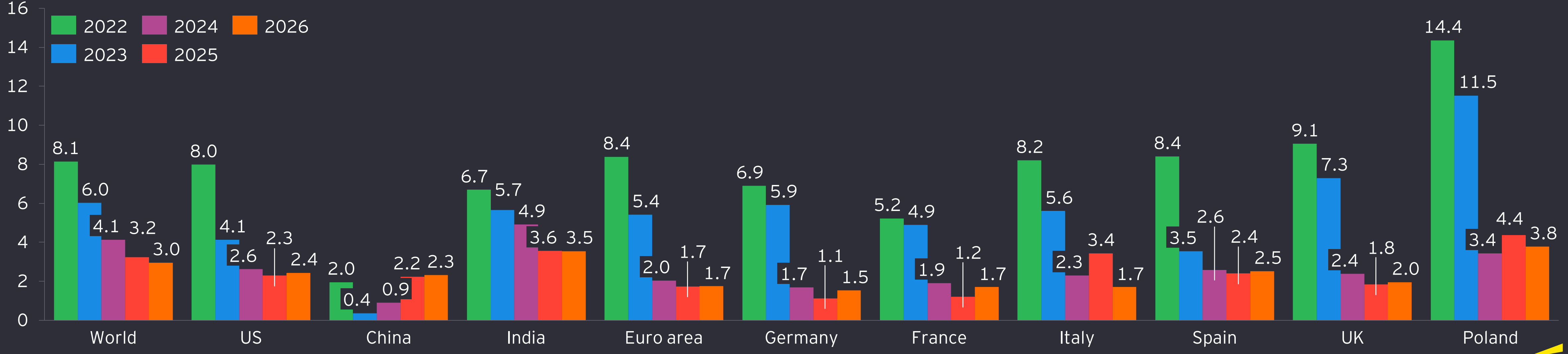
Disinflation continues, with headline inflation to reach the 2% target in 2024 Q2. However, core inflation may stay elevated for longer

- **Inflation has continued to decline, with the euro area noting 2.9% inflation in December 2023** due to the effects of earlier supply shocks gradually fading, supported by reduced supply bottlenecks, weak demand, pass-through from the drop in commodity prices, and falling inflation expectations. Disinflation has finally encompassed services, while both headline and core inflation have surprised to the downside in recent months.
- **We expect disinflation in the food, core goods and services components to continue in the coming months, while energy inflation is set to rise.** The inflation rates in food and core goods are predicted to fall below 2% around mid-year as the effects of earlier shocks partially unwind, though disruptions to Red Sea shipping constitute an upside risk to this forecast. However, service inflation may stabilize close to 3%, mainly as elevated wage growth continues to exert pressure on costs in labor-intensive sectors. Simultaneously, energy inflation is expected to gradually increase towards 0% from current negative levels, as substantial price falls recorded in 2023 H1 fall out of the calculation.
- **Taken together, we anticipate headline inflation in the euro area to reach the ECB's target of 2% in 2024 Q2** and subsequently fall slightly below this level. Concomitant to this, core inflation is expected to drop to 2.5% in 2024 Q2 from 3.4% in December 2023, but may linger slightly above 2% until mid-2025, given the persistent pressure on prices in services.
- **While inflationary trends are similar across European economies, inflation levels continue to vary, even though disparities are narrowing.** The highest inflation rates continue to be seen in Central and Eastern European countries (CEE: in the 5%-8% range, as of December 2023). These countries were most significantly impacted by the commodity price shocks of 2021–22 due to their fossil fuel-based energy mixes, higher shares of food and energy in inflation baskets, and tight labor markets. While inflation in the CEE has been declining rapidly on the back of weak demand and reversal of supply shocks, it remains high. In contrast, the lowest inflation rates, below 1%, are observed in the Netherlands, Italy, Denmark, and Belgium, where energy price spikes were highest and therefore price reversal is the strongest due to lesser regulation of energy prices and issues related to CPI measurement (the inclusion of only new energy contracts into CPI calculations).
- **We anticipate disparities between nations to dwindle – the 2024 headline inflation is expected to fall within the range of 1.5%–3.0% in most EU economies.** Two clear outliers will likely include Romania, where inflation is stickier due to robust domestic demand and thus we project it to exceed 5% in 2024. The other is Denmark, where price pressures have been particularly weak, leading to our forecast of inflation below 1% in both 2024 and 2025.

As a result, we expect the ECB to ease monetary policy, beginning in Q2, but to a lesser degree than markets expect

- **Given headline inflation approaching the 2% target, we expect the ECB, Fed, and the Bank of England (BoE) to initiate an easing cycle during April–June 2024,** with rates ending the year around 1 pp below current levels.
- **ECB to cut rates by 100 bp this year, starting in Q2.** Even though ECB communication has retained its hawkish tone, a faster-than-expected decline in inflation, which is already close to the target, economic stagnation, and cuts in the Fed's interest rates will likely bring about normalization of interest rates in the euro area, beginning in the second quarter. We predict cuts to ECB rates at every meeting until the deposit rate reaches 2.75%-3%. Rates may then stabilize for a while, considering that we forecast core inflation to stay slightly above the target until mid-2025.
- **Swiss and Nordic central banks have finished increasing interest rates, but first cuts are expected to come several months after the ECB begins reducing rates** (Sweden and Norway in Q3, Switzerland in December) due to weak currencies and more persistent price pressures in the Nordics and a lower inflation target of 0%–2% in Switzerland.
- **CEE central banks are ahead of the more advanced economies in their monetary easing cycle, although the pace of easing varies between countries.** We foresee that the Hungarian and Czech central banks will cut rates relatively quickly throughout 2024, by 4.75 pp and 3.25 pp, respectively. This is attributed to rapid disinflation, in addition to high interest rate levels in Hungary and very weak demand in Czechia. In contrast, Poland's rates may remain constant throughout the year, following earlier cuts. In Romania, the easing of monetary policy may be postponed until mid-year due to persistent inflation.

Inflation in 2022-2026 (in percentage)



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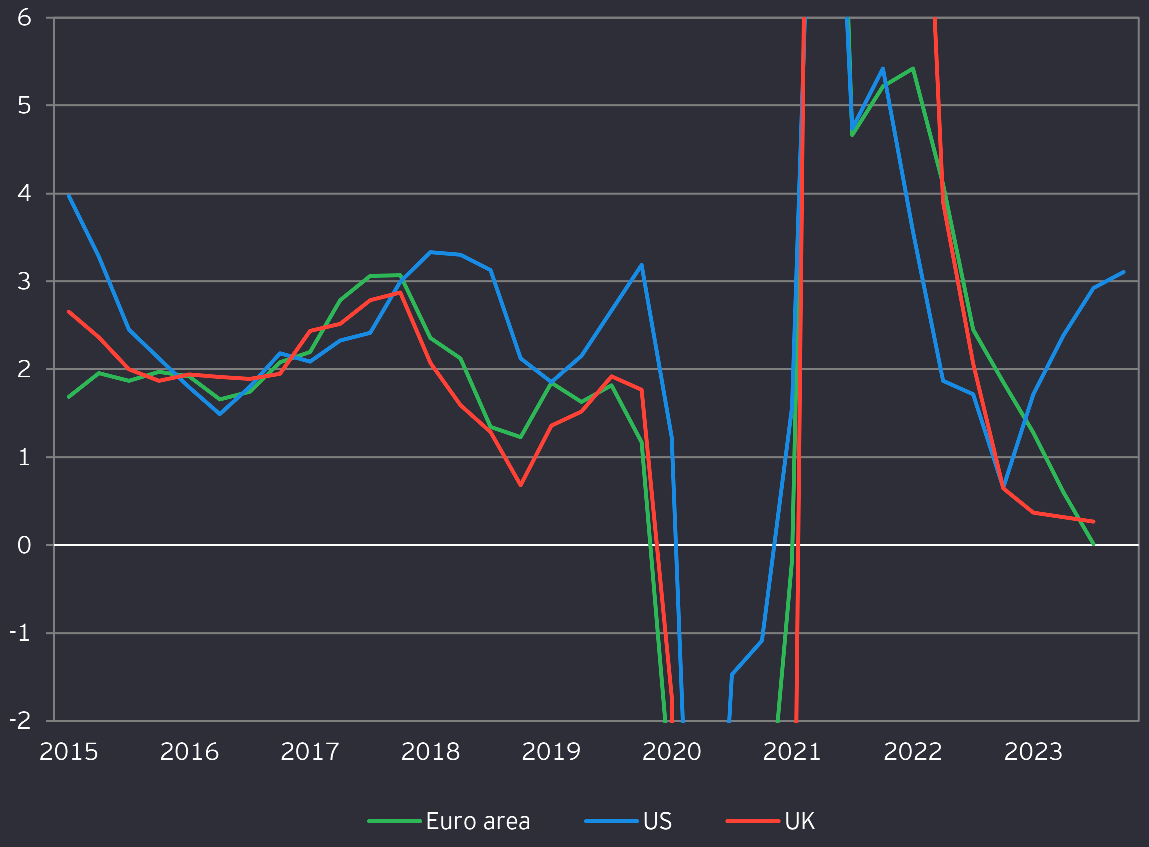
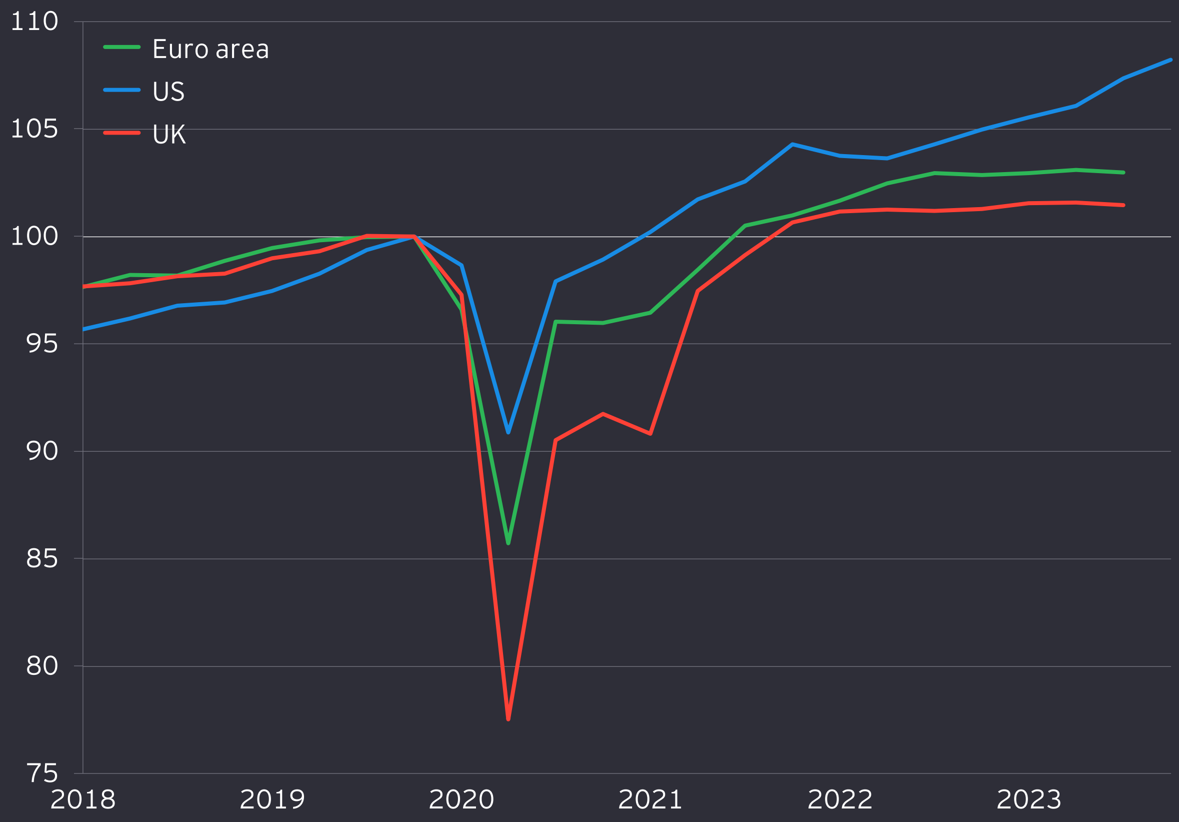
The European economy continues to stagnate...

Y/y real GDP growth (in percentage)



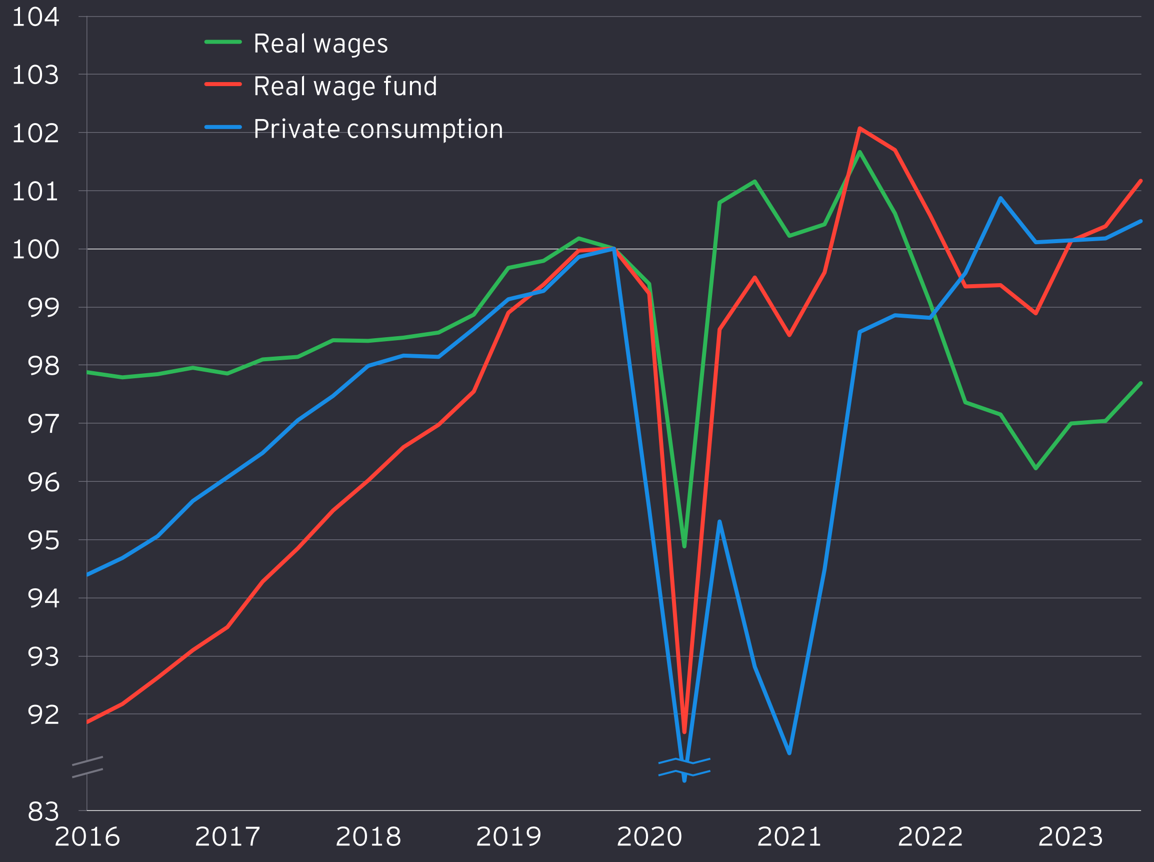
Real GDP (2019 Q4 = 100)



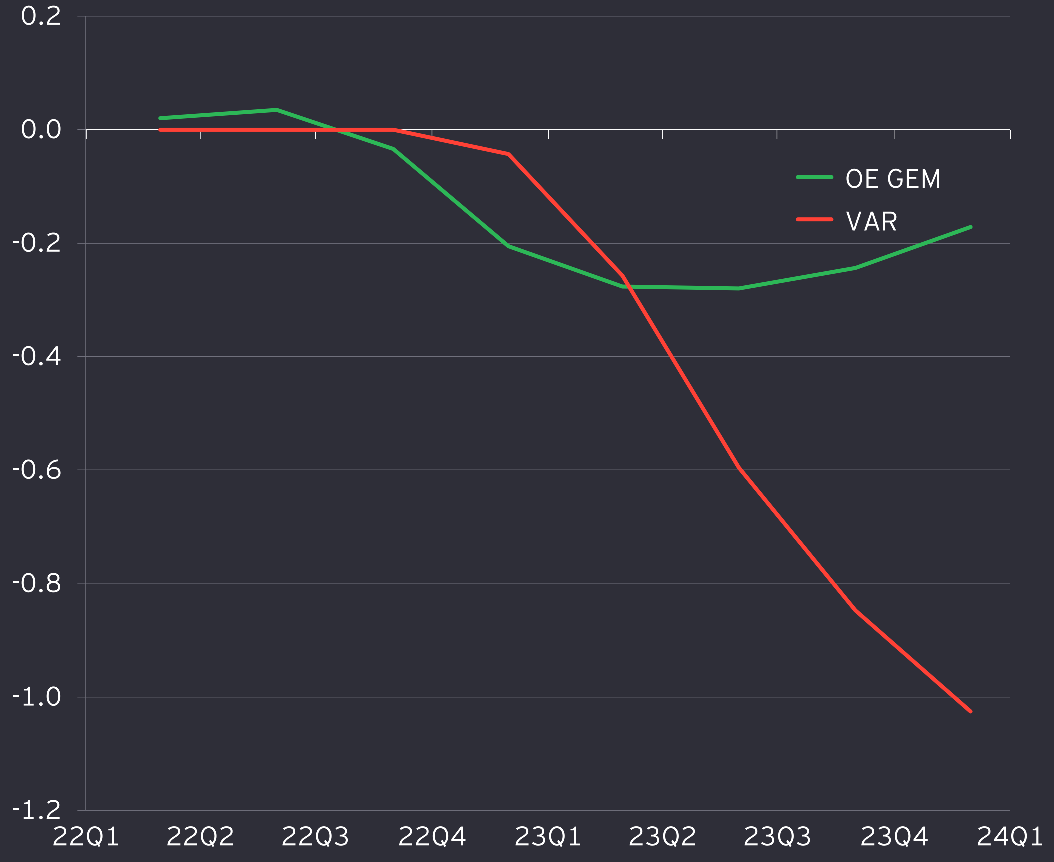
Source: Eurostat, Fred, ONS.

… held back by supressed real incomes, weak external demand and monetary policy tightening

Real wages and real wage fund in the euro area (2019 Q4 = 100)



Impact of monetary policy on quarterly real GDP growth in the euro area (in percentage points)

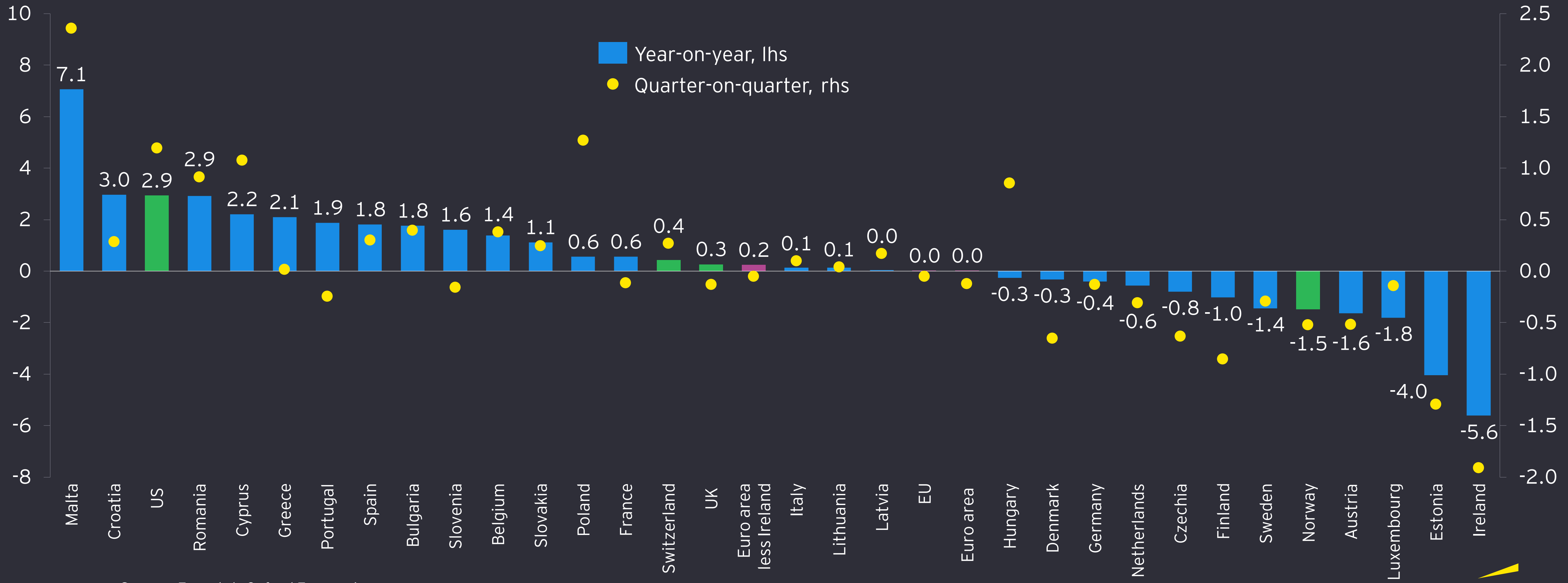


Source: Eurostat, FRED, ONS, Oxford Economics, EY calculations.
Notes: for EU countries, wages and salaries per employee based on national accounts deflated with HICP. For the US data Employment Cost Index: Total Compensation deflated with CPI. VAR model is a 14-variable VAR model for the euro area, estimated on a pre-pandemic sample using Bayesian methods, with shocks identified using Cholesky decomposition.
* 2023 Q2 vs 2021 Q4

Economic performance has continued to vary across sectors and countries. With manufacturing in recession and most services continuing to grow, most Southern European and Balkan countries have continued to outpace those in manufacturing-heavy Central Europe

- The Nordic countries have also underperformed due to their high sensitivity to interest rate hikes, fallout from the war in Ukraine and a slowdown in the pharmaceutical industry.
- Conversely, a recovery phase has begun in Poland and Hungary as rapidly declining inflation, in conjunction with strong wage growth, has boosted real incomes, thereby enhancing consumption.

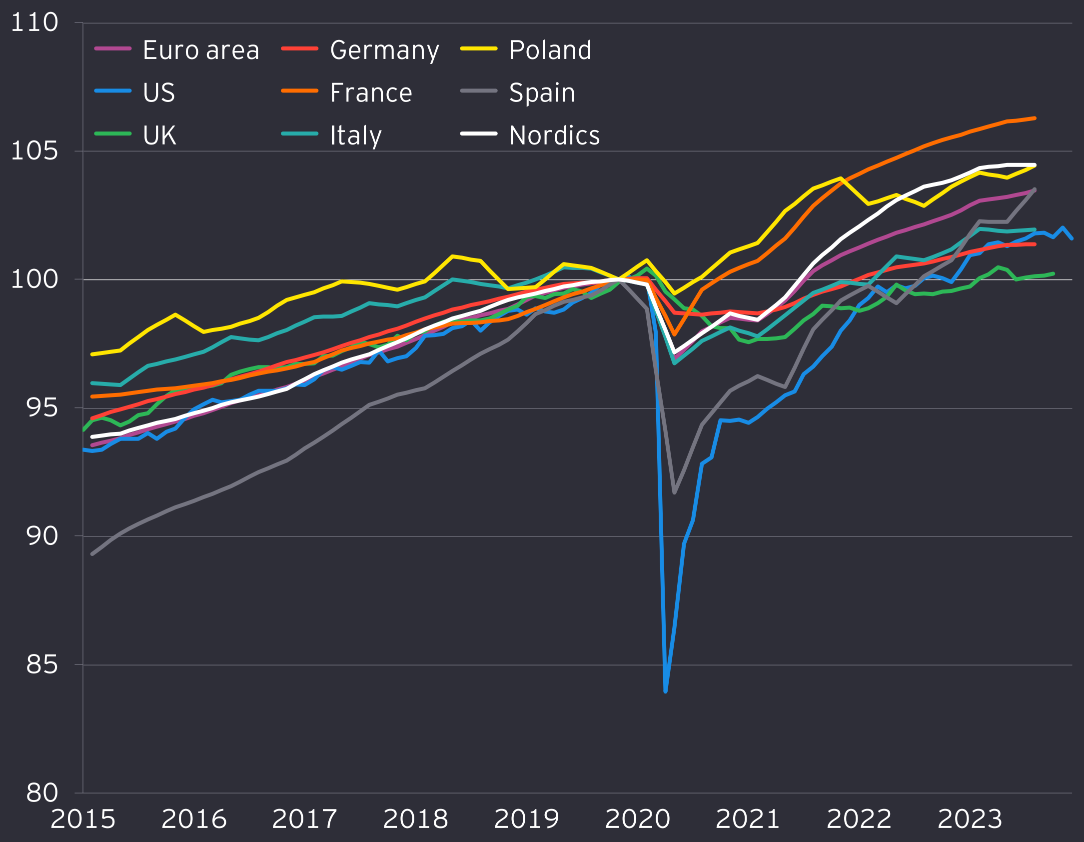
Real GDP growth in 2023 Q3 (In percentage)



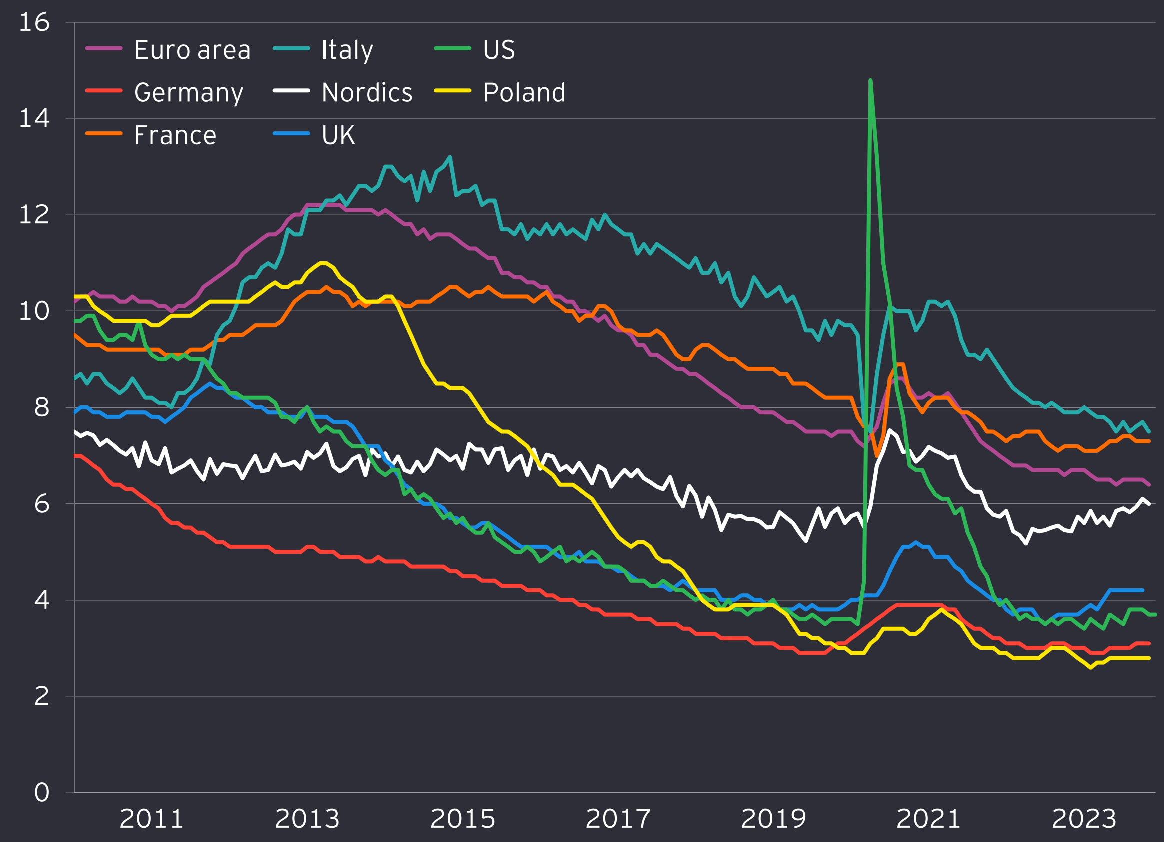
Source: Eurostat, Oxford Economics.
* For Poland, data seasonally adjusted by EY.

Stagnation has not turned into a recession thanks to resilient labor markets – despite the slowing pace, employment continues to grow, while unemployment and labor market slack have stabilized close to historical lows in most countries

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



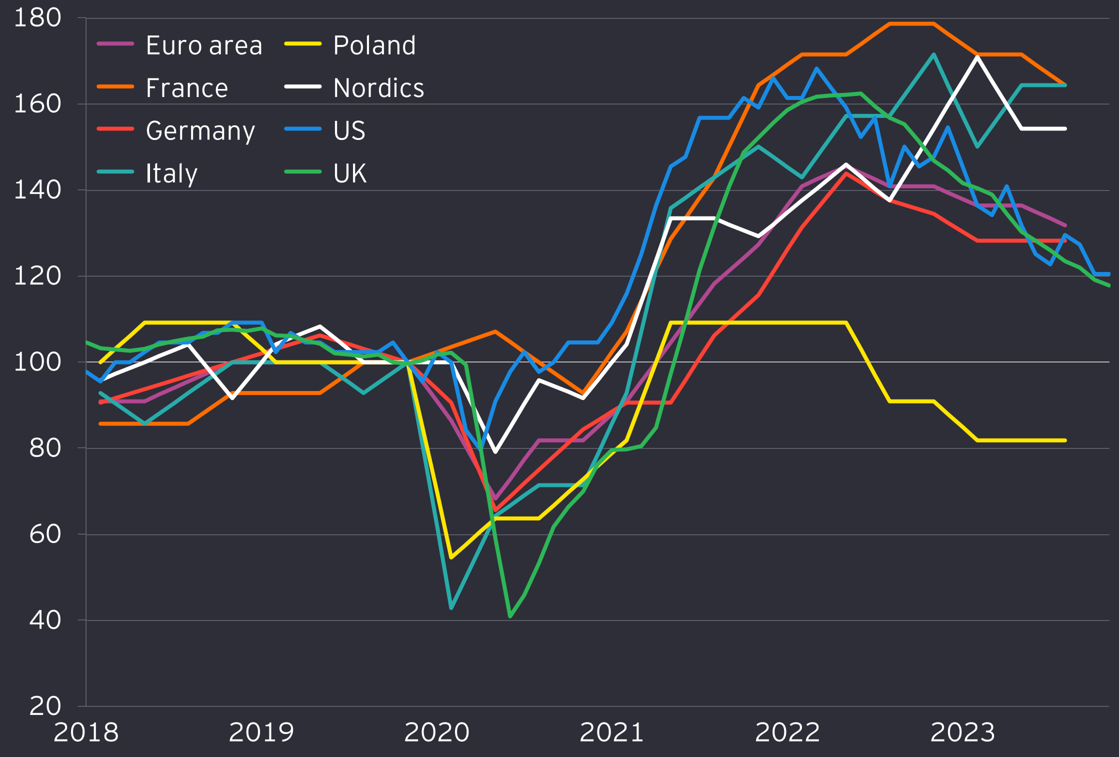
Unemployment rate (in percentage)



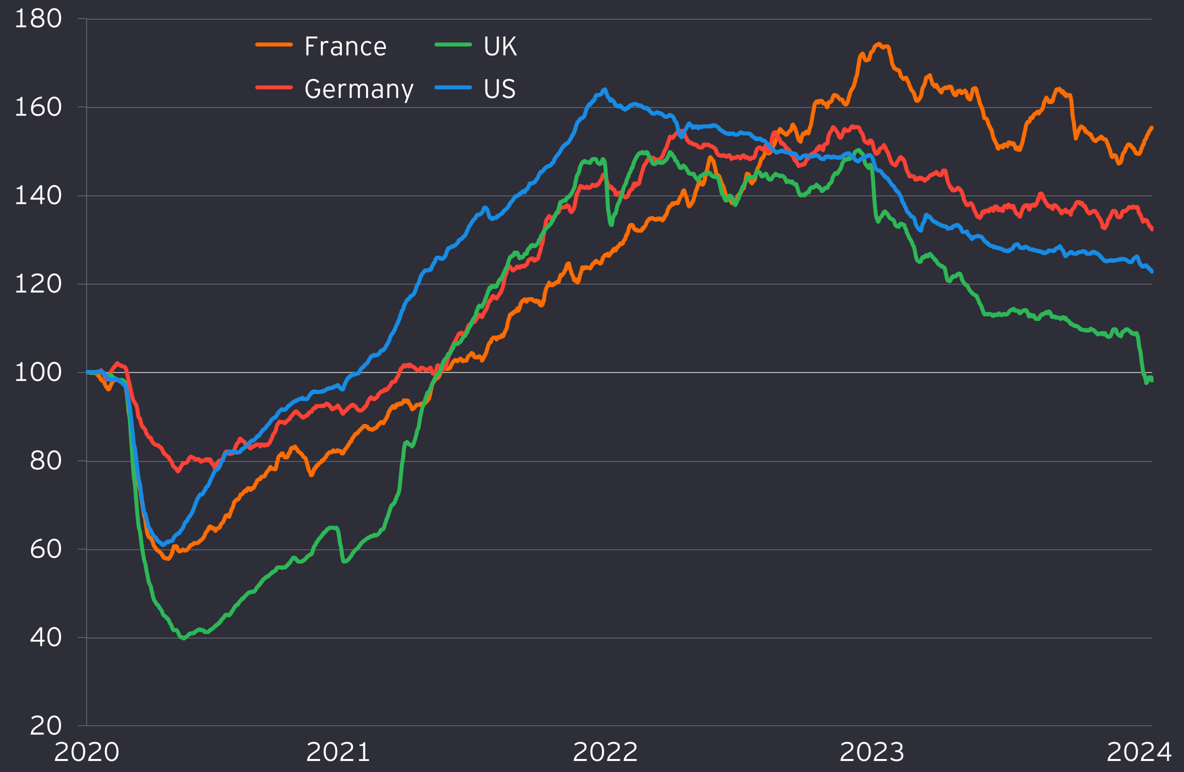
Source: Eurostat, FRED, ONS.

In the euro area, vacancy rates continue to be high and are decreasing at a slower pace compared to the US or UK. The demand for labor, while weakening due to slowing employment growth, remains robust

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



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

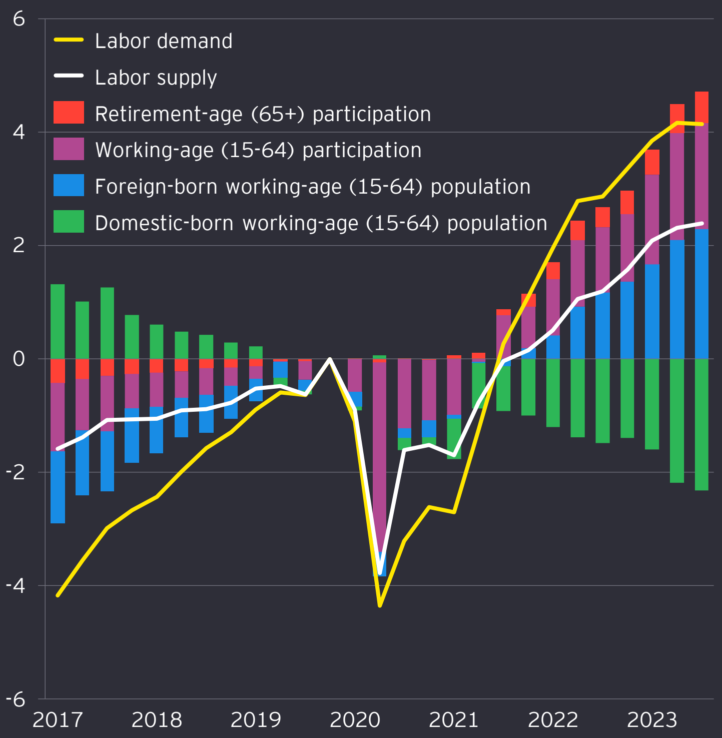


Source: [1] Eurostat, ONS, FRED, EY EAT calculations. [2] Data on online job postings is based on GitHub - hiring-lab/job_postings_tracker: Regularly updated data series for external use.
Notes: Vacancy rate is the number of vacancies divided by the total number of filled positions (for the UK, total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

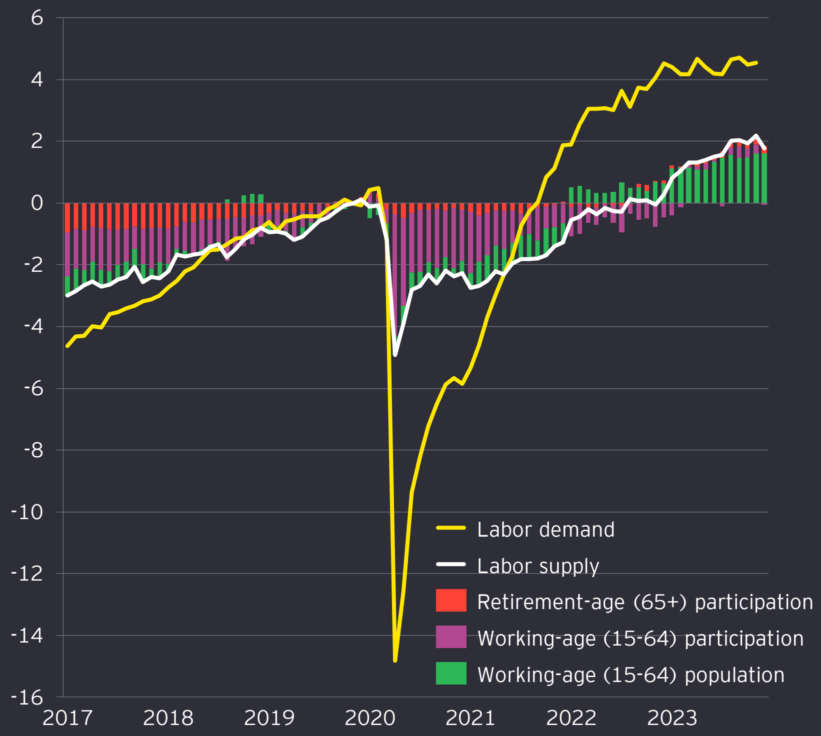
Consequently, the gap between demand and supply remains broadly stable in the euro area, unlike in the US or the UK, despite increasing labor supply on the back of rising immigration and labor force participation

Labor supply and demand change compared with 2019 Q4
(in percentage)

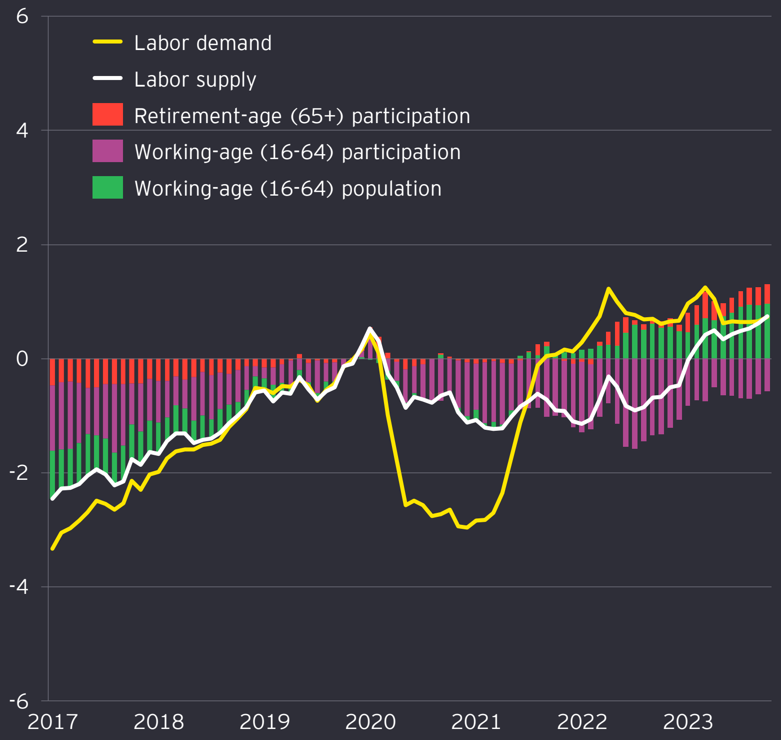
Euro area



US



UK

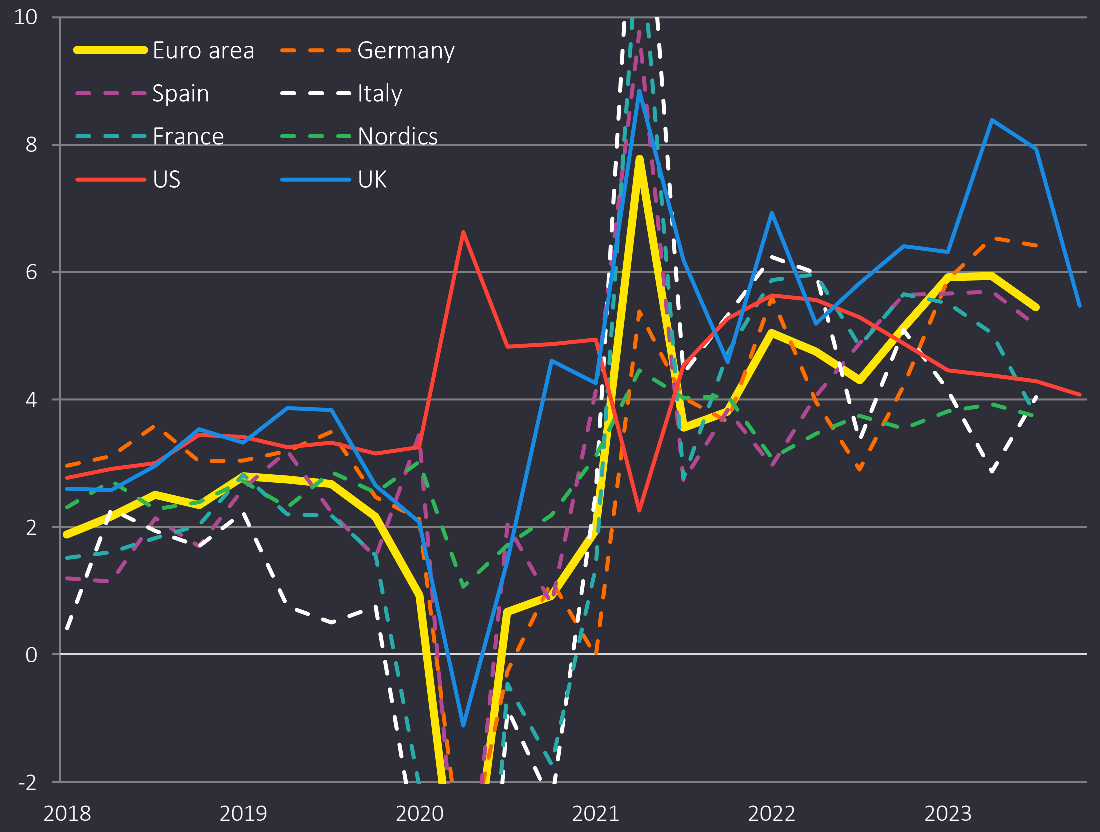


Source: Eurostat, BLS, FRED, ONS.
Notes: Labor demand is a sum of supply employment and vacancies. For the UK, ONS experimental statistics from June 2023 onwards.

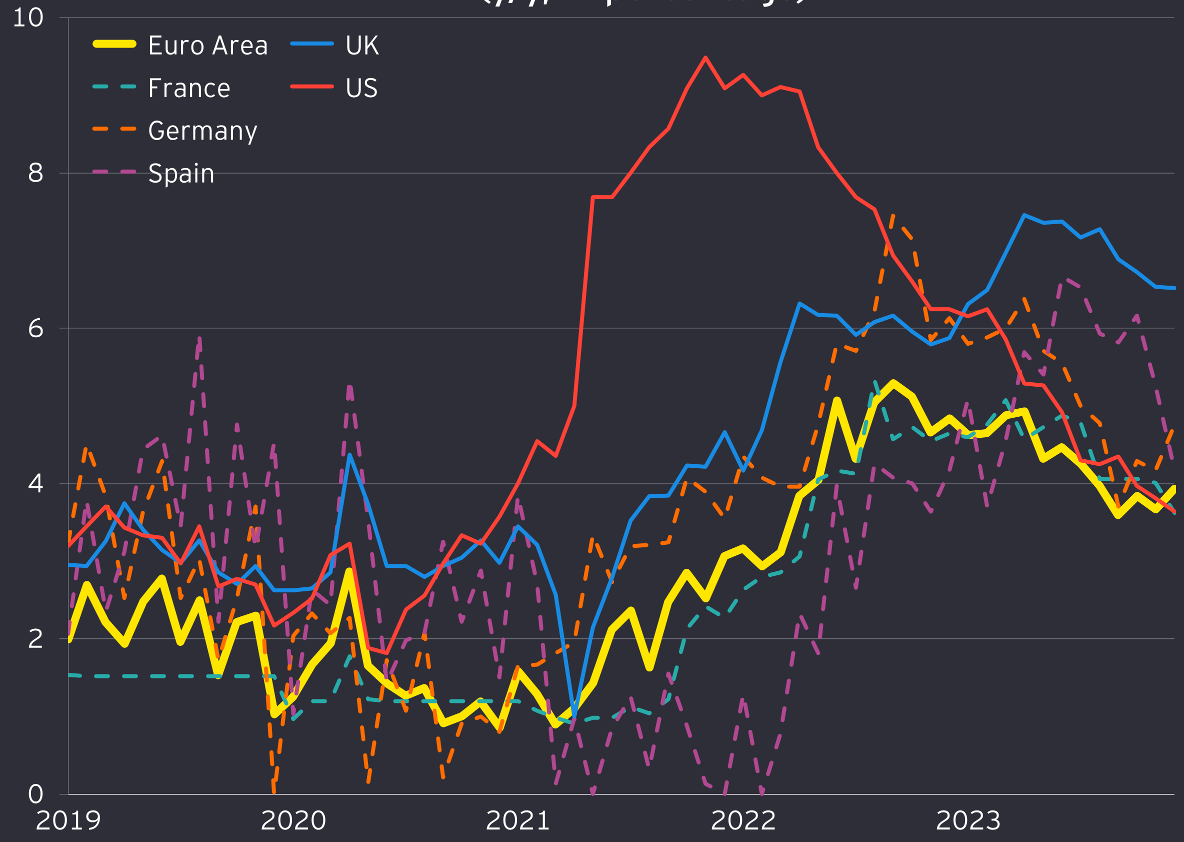
This leads to elevated nominal wage growth, which is additionally supported by wage indexation to past inflation and the high bargaining power of employees seeking to recoup lost real incomes

- On the one hand, the economic stagnation reduces employees' bargaining power, while on the other the still-tight labor market, indexation to past inflation and minimum wage hikes in many countries help maintain wage growth momentum.
- While job postings point to some deceleration going forward, wage growth remains above the levels consistent with the 2% inflation target.

Wage growth (y/y, in percentage)



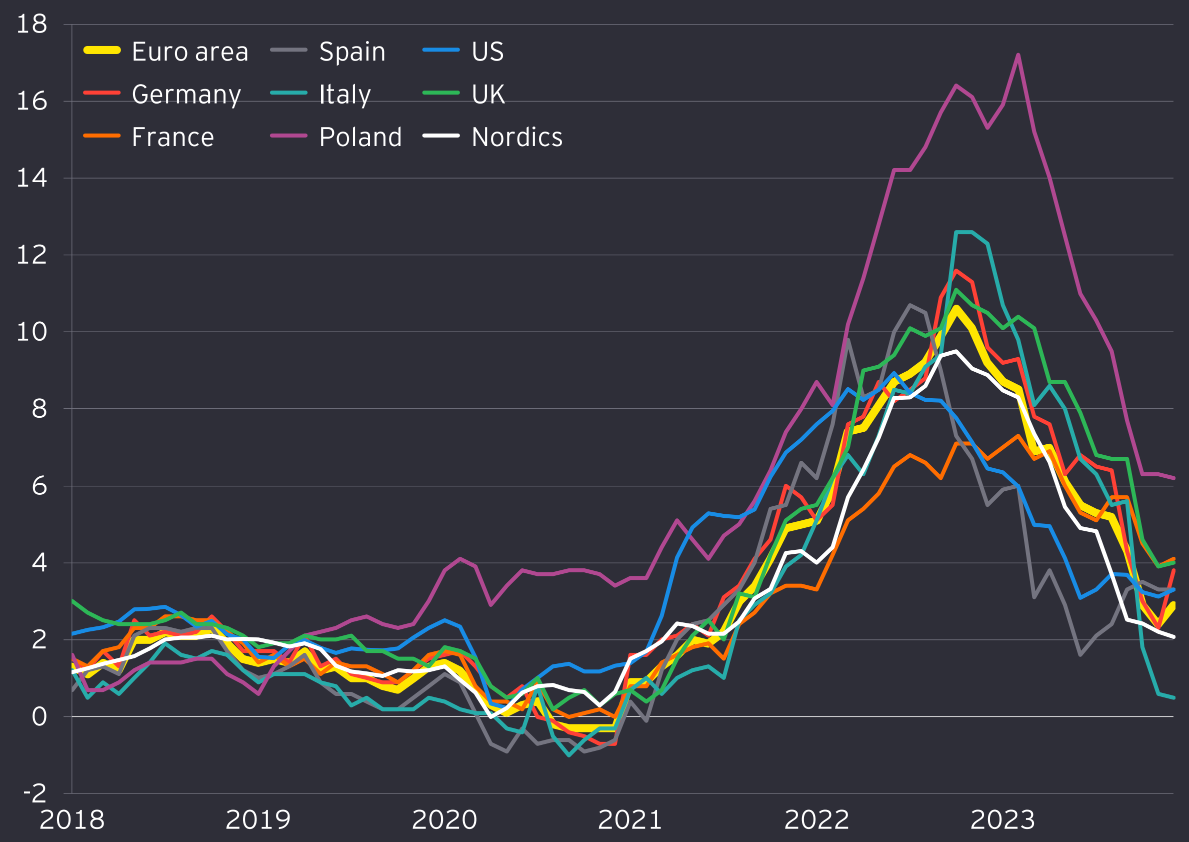
Wage growth in job postings[2] (y/y, in percentage)



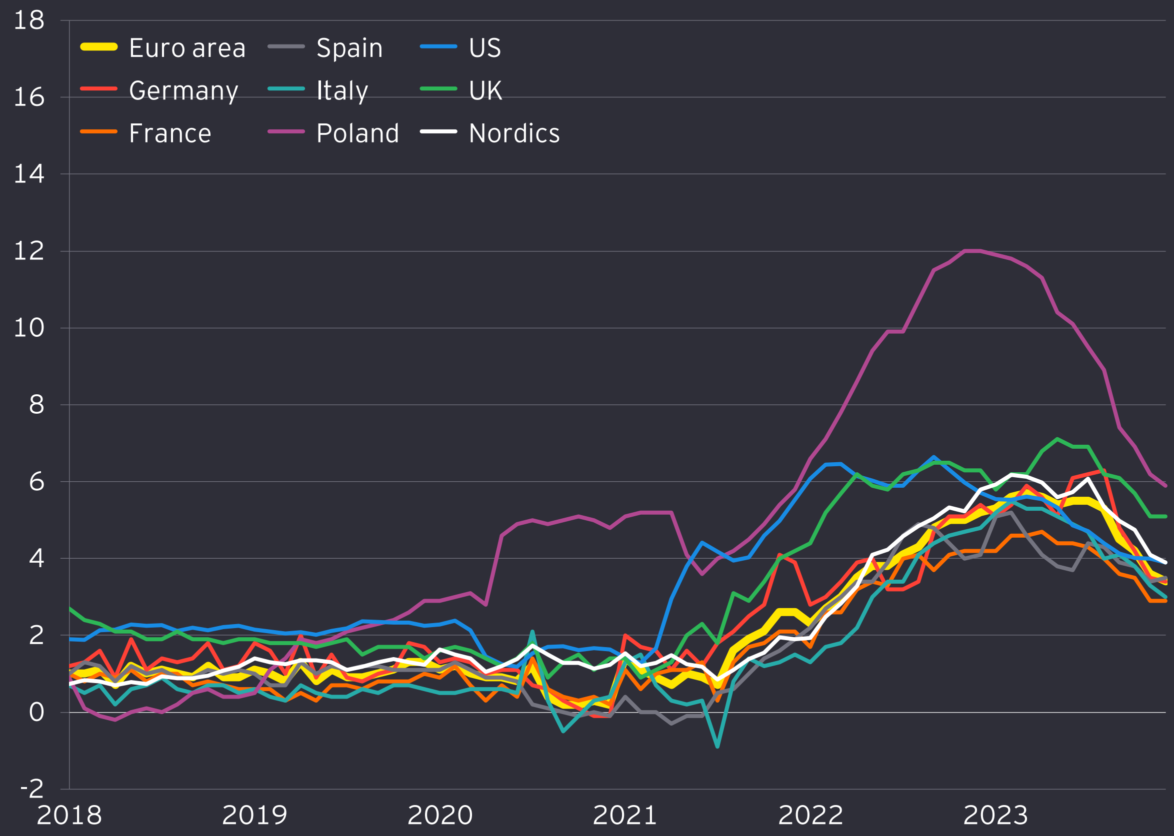
Source: [1] Eurostat, ONS, FRED, Oxford Economics
For the European area countries, Total Earnings; for the UK, average weekly earnings in the whole economy, total pay; for the US average hourly earnings of All Employees, Total Private. Nordics as Norway, Sweden, Finland and Denmark arithmetic average. For the UK in 2023 Q4, average for October-November.
[2] Source: Indeed wage tracker

Resilient labor markets and relatively strong nominal wage growth have not prevented rapid disinflation. Recently, core inflation has mirorred the trend of headline inflation, albeit declining at a slower pace

Headline inflation (y/y, in percentage)



Core inflation (y/y, in percentage)



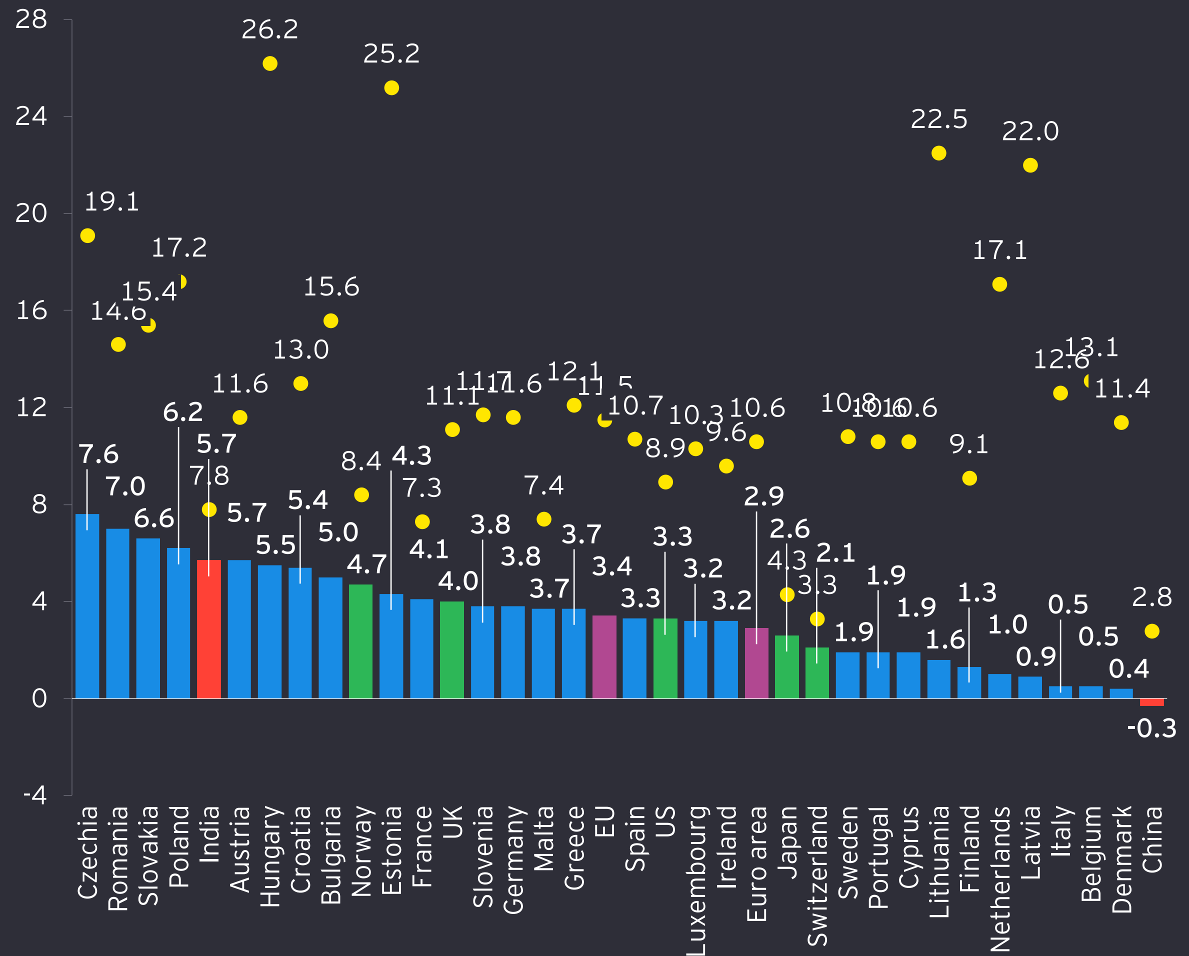
Source: Eurostat; ONS, FRED.

Notes: Core inflation excludes food, alcohol, tobacco and energy. For EU countries, HICP; for others, CPI. Nordics as arithmetic average of Norway, Sweden, Finland and Denmark.

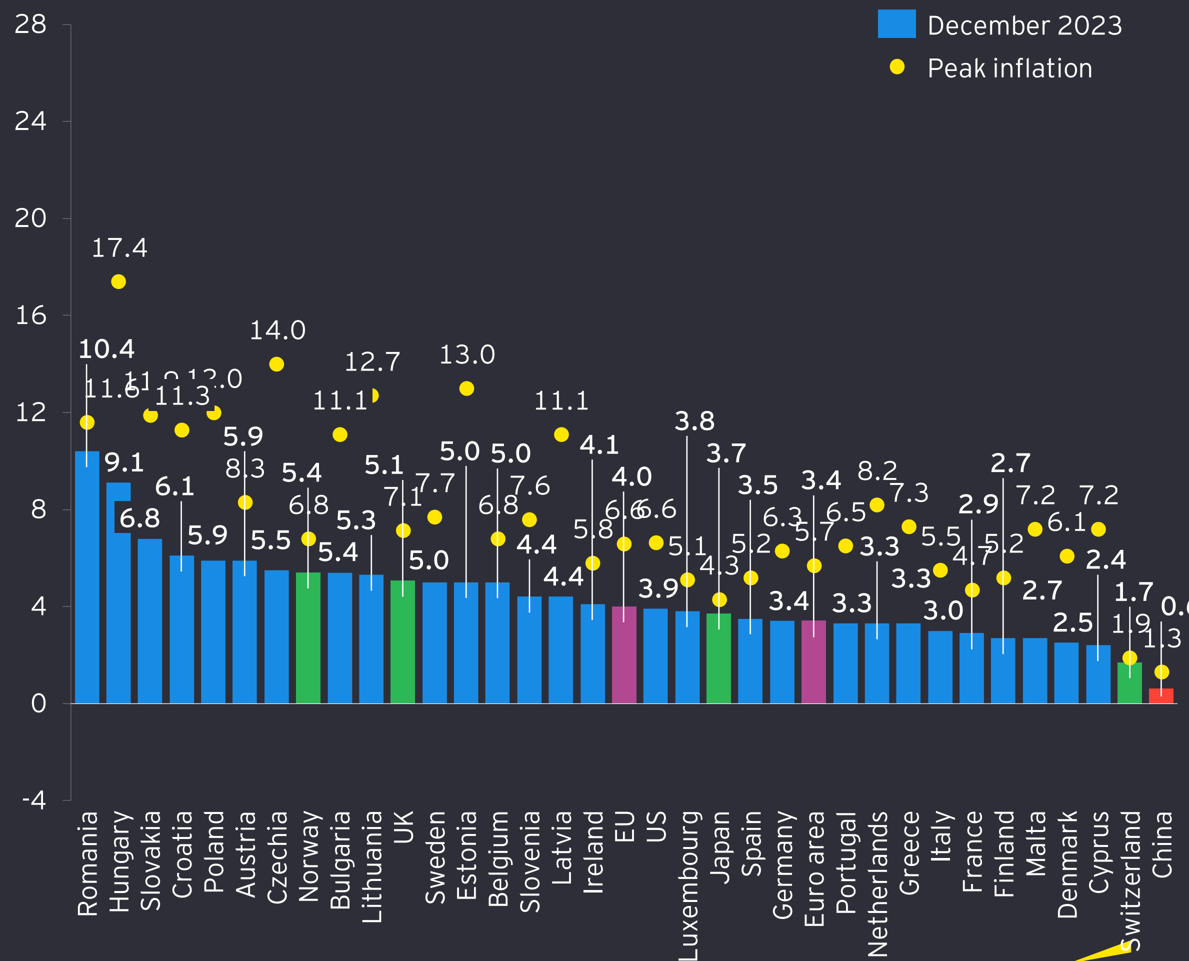
In many Western and Southern European countries, headline inflation is already close to the 2% target. However, in CEE, it continues to be higher. Core inflation remains above the targets in most countries

- Lowest inflation rates are recorded in the Netherlands, Italy, Denmark, and Belgium, where energy price spikes were highest and therefore price reversal is the strongest due to lesser regulation of energy prices and issues related to CPI measurement (the inclusion of only new energy contracts into CPI calculations).

HICP inflation in December 2023 (y/y, in percentage)



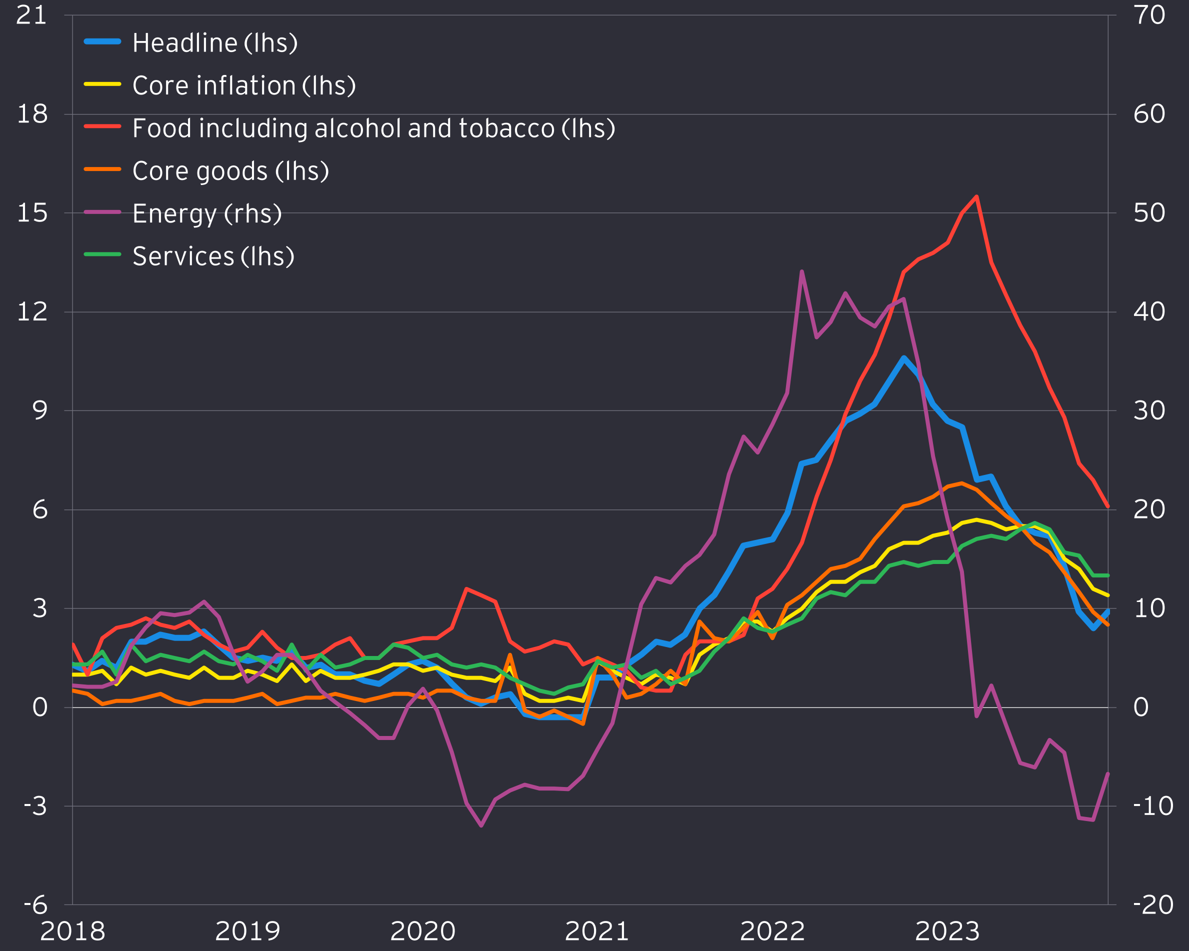
Core HICP inflation in December 2023 (y/y, in percentage)



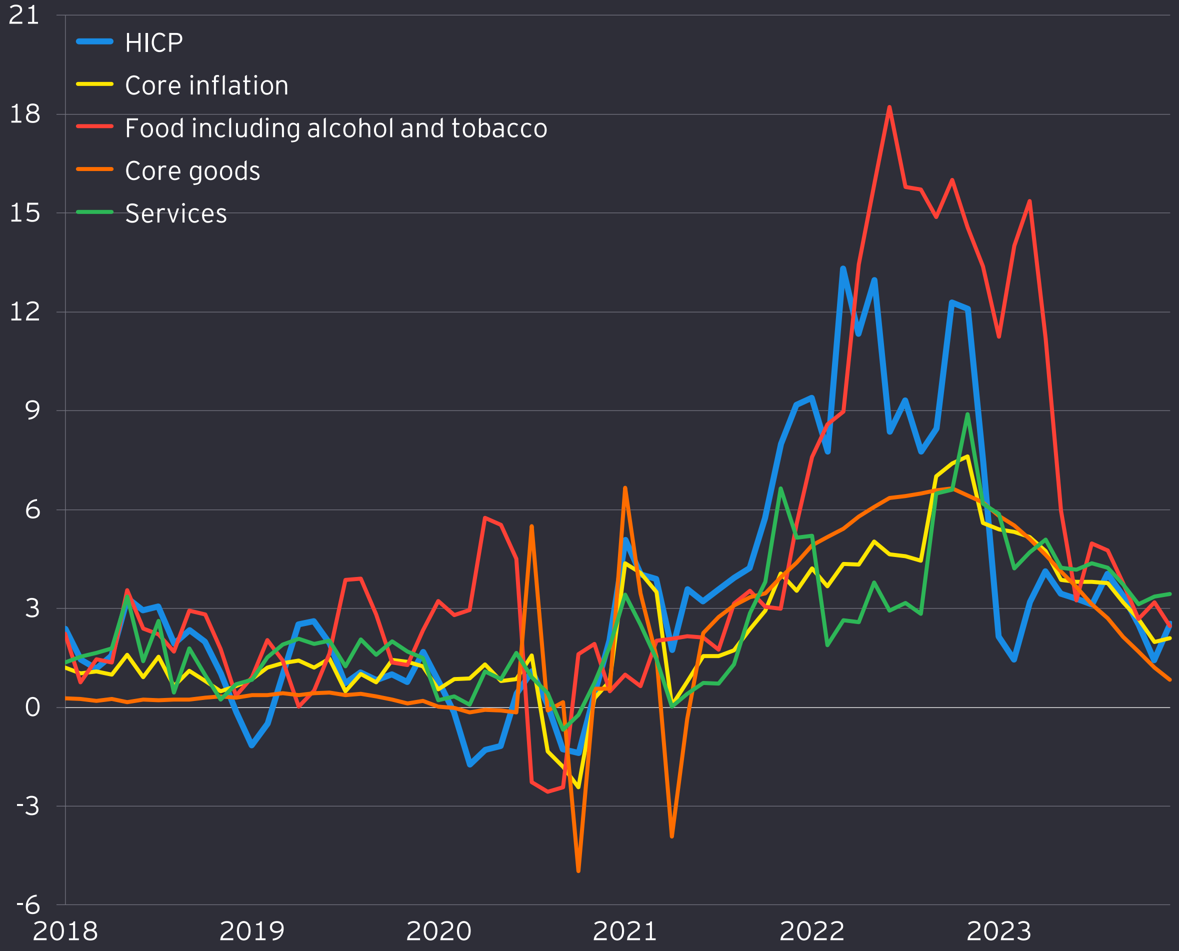
Source: Eurostat, FRED, ONS, national statistical bureaus.
Note: For non-EEA countries, CPI inflation.

Euro area non-food non-energy (core) goods inflation has already dropped below 3%, whereas food inflation remains elevated at close to 6%. Momentum* is below 3% for all the main components but services

HICP inflation in the euro area (y/y, in percentage)



HICP inflation in the euro area (m/m, seasonally adjusted, 3-month moving average, annualised, in percentage)

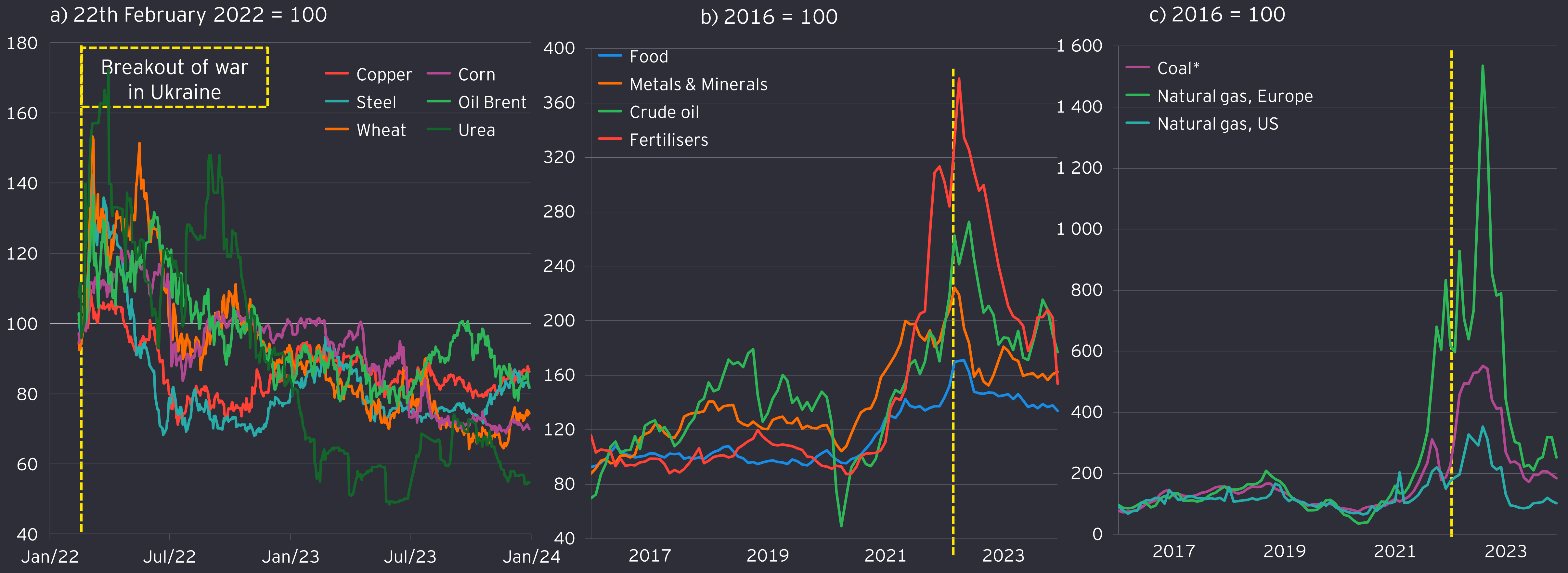


Source: Eurostat.
* Momentum is understood here as 3-month moving average of annualised and seasonally adjusted m/m inflation (as in the rhs chart).

Disinflation has been supported by a drop in commodity prices well below their 2022 peaks, which has had a direct effect on energy and food inflation while indirectly impacting core inflation components

- However, in most instances, commodity prices are still considerably higher than their pre-pandemic levels.
- Oil prices experienced a decline throughout 2023 Q4, fully reverting Q3 gains, thus reducing the short-term inflation outlook.

Global commodity prices (index)

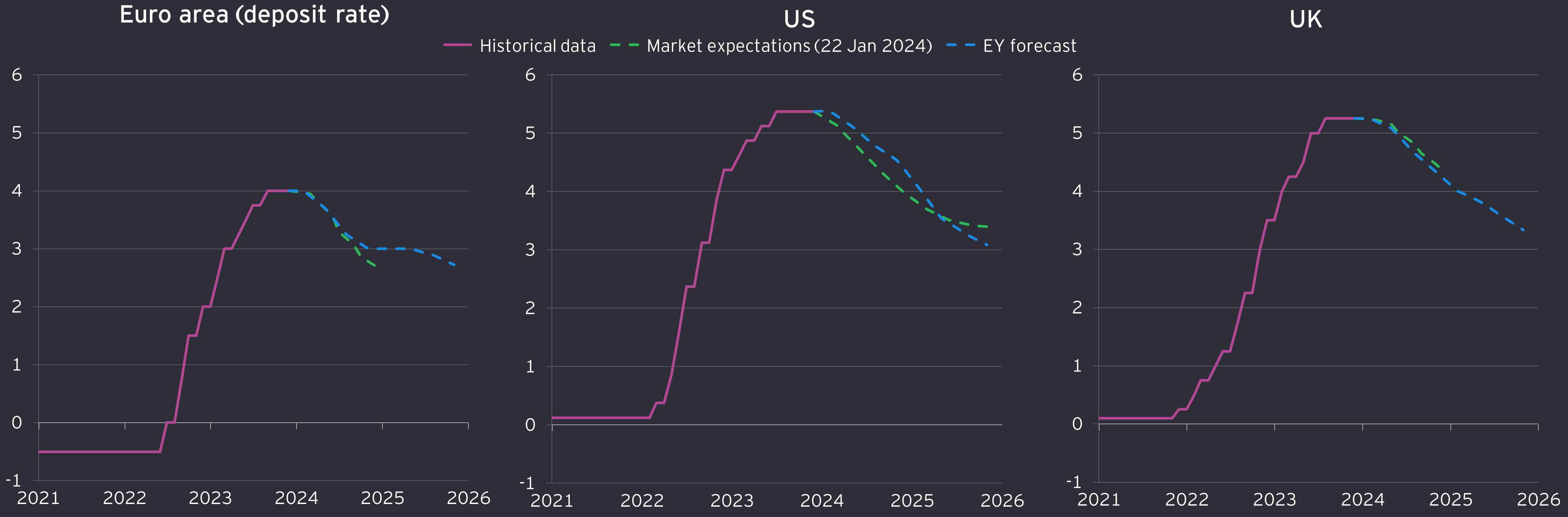


Source: World Bank Commodity Prices; stooq.pl.
* ICE Rotterdam coal price.

With rapid disinflation now affecting even services, it is clear that major central banks are done with their rate hikes. While the first rate cuts could arrive in spring, the pace of policy easing is likely to be slower than what the markets currently anticipate

- The Fed stayed put in throughtout 2023 Q4, but Chair Powell surprised many with his dovish tone at the December press conference. Consequently, we anticipate 100 bp of rate cuts in 2024, starting in May.
- The ECB kept rates unchanged throughout 2023 Q4. Even though ECB communication has retained its hawkish tone, a faster-than-expected decline in inflation, which is already close to the target, economic stagnation, and cuts in the Fed's interest rates will likely bring about normalization of interest rates in the euro area, beginning in the second quarter. We predict cuts to ECB rates at every meeting until the deposit rate reaches 2.75%-3%. Rates may then stabilize for a while, considering that we forecast core inflation to stay slightly above the target until mid-2025.
- The Bank of England also kept rates unchanged in 2023 Q4. We expect that it will begin rate reductions in June, with a total of around 100-125 bps of rate cuts this year.

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

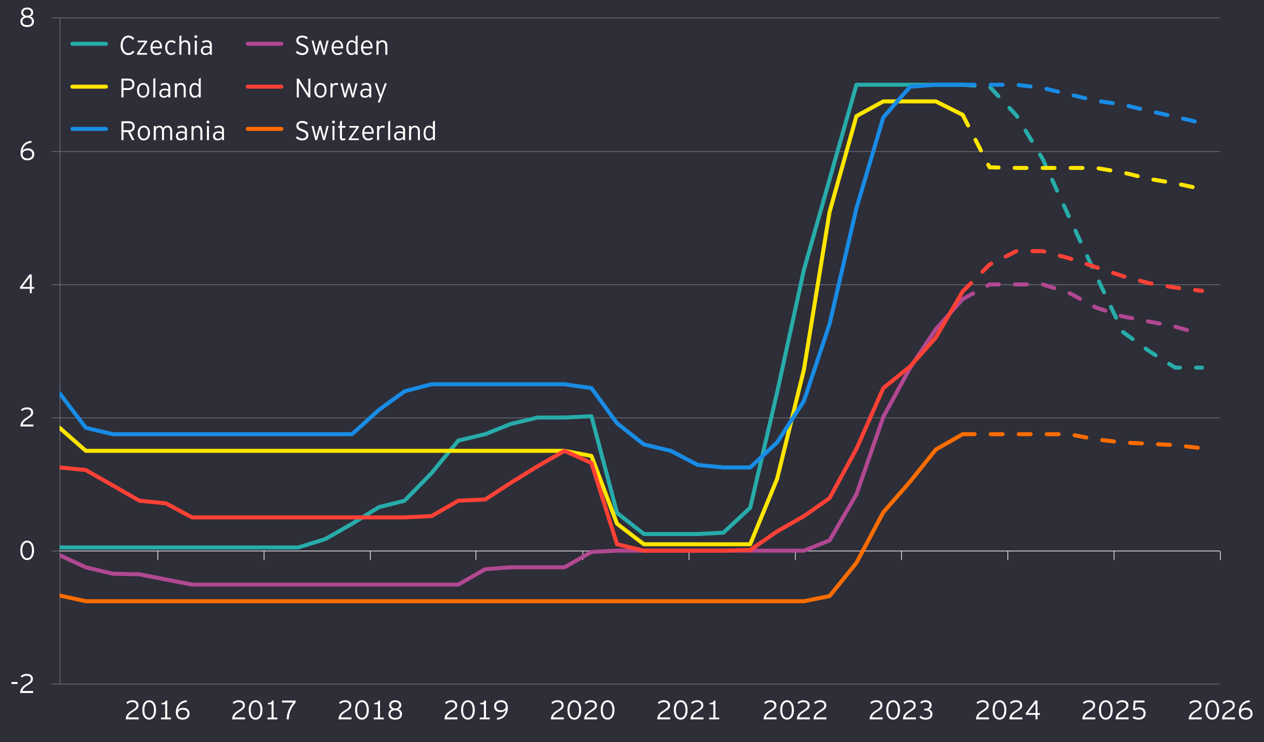


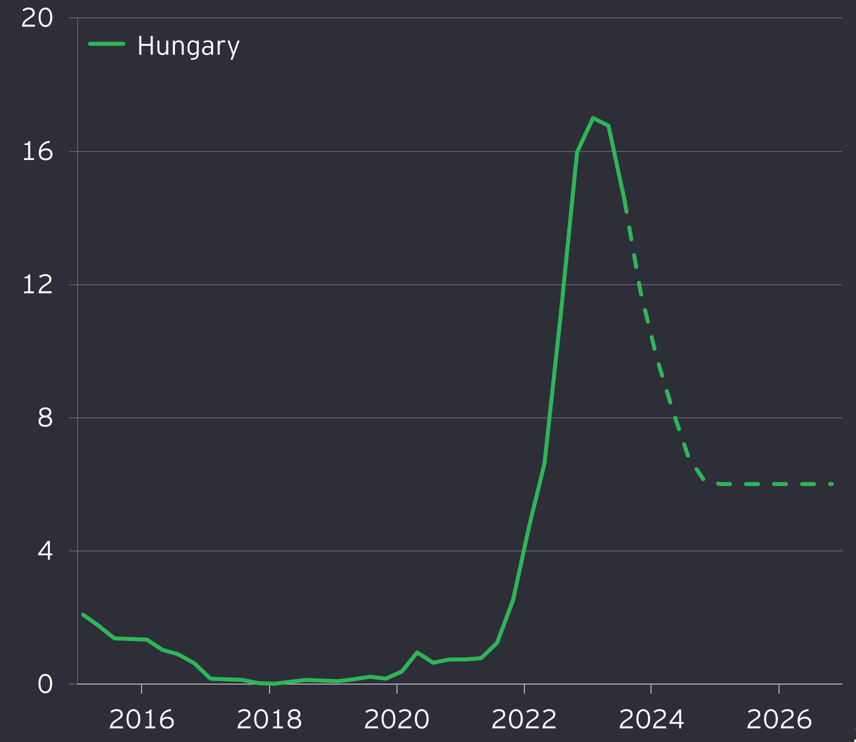
Source: ECB; Fed; BoE; Refinitiv; Eurostat; Oxford Economics; EY EAT forecast.
* For the euro area and the UK on 22 January 2024, expected interest rates from Refinitiv; for the US on 22 January 2024, expected interest rates from Atlanta Fed Market Probability Tracker.

Swiss and Nordic central banks have finished increasing interest rates, but first cuts are expected to come several months after the ECB begins reducing rates. CEE central banks are in easing mode, although the pace of easing varies

- The Swiss National Bank kept rates unchanged in 2023 H2 and is expected to continue doing so for an extended period, with the first cut no earlier than in December 2024.
- The central bank of Norway concluded the tightening cycle with a 25 bp hike in December 2023, while the Swedish Riskbank kept rates unchanged in November. We do not expect any further hikes. Given weak currencies and still elevated core inflation, first rate cuts are likely to occur in Q3, a few months after the ECB's first interest rate reduction.
- The Polish central bank (NBP) pivoted after the parliamentary elections of 15 October and we anticipate it to keep rates unchanged throughout 2024. The Hungarian central bank has continued normalising interest rates from very high levels and is expected to continue doing so. The Czech central bank (CNB) initiated the easing cycle in December 2023 with a 25 bp cut. We expect the easing will proceed at a fairly rapid pace given low price and demand pressures. In contrast, the Romanian central bank (BNR) has held its position at recent meetings and is anticipated to begin easing only around mid-year, given inflation persistence.

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

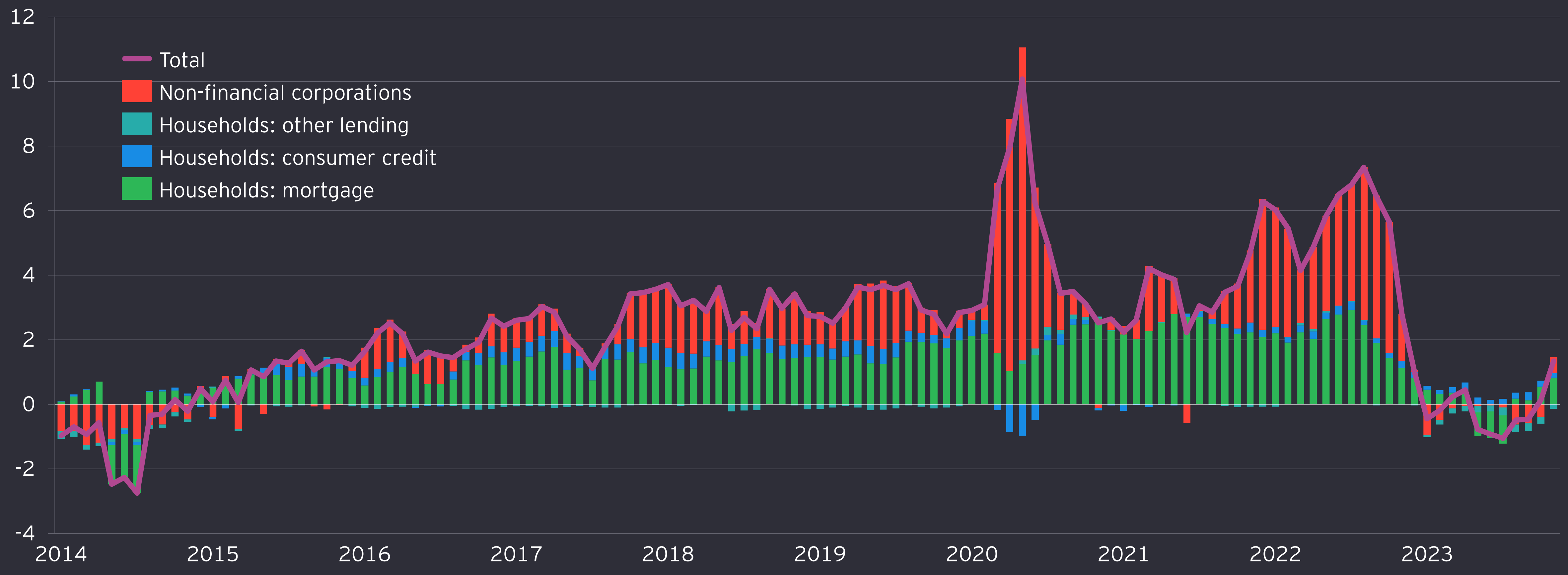




Source: Oxford Economics; EY EAT forecast.
* For Hungary, 1-month interbank rate.

In line with the decelerating rate of both decline in demand and credit conditions tightening, household and corporate credit growth seems to have bottomed out and started to pick up slowly

Monthly growth in loans to households and non-financial corporations in the euro area
(in percentage, annualised and seasonally adjusted, 3-mth moving average)

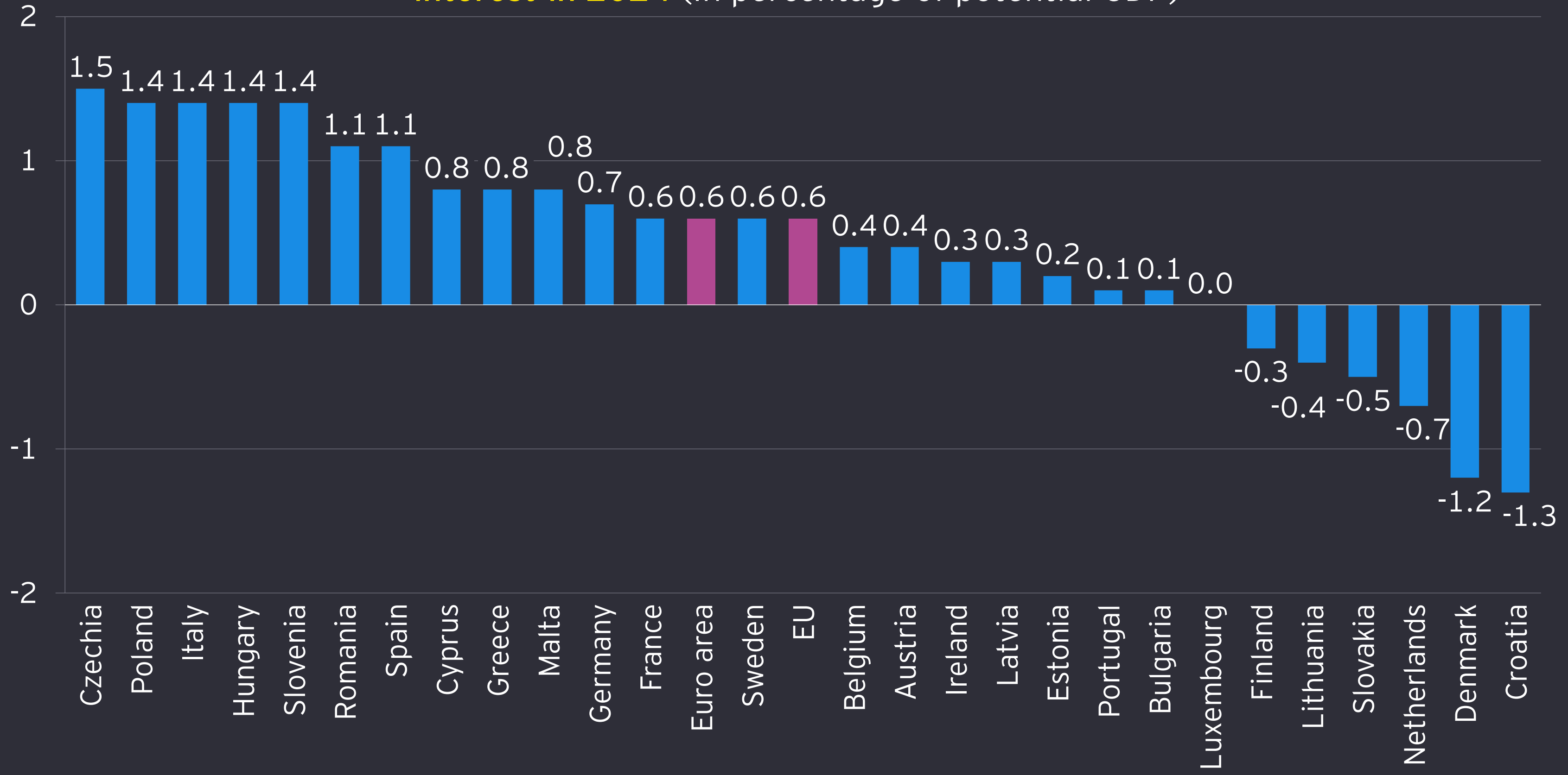


Source: ECB, EY calculations.
Note: Series for households include NPISH.

Fiscal policy in the EU is set to be moderately tightened this year as some of the energy crisis support measures are withdrawn, with strongest tightening in most of CEE and Southern Europe

- The below-shown forecasts were formulated by the European Commission in November 2023 and thus may not be entirely up to date. In particular:
  - In Germany, following the constitutional court's ruling against the use of leftover Covid-era funds to finance investment related to energy transition, the extent of fiscal tightening might be larger.
  - In Poland, due to a strong increase in public sector wages and the new government implementing new transfers, fiscal policy is likely to be broadly neutral in 2024.

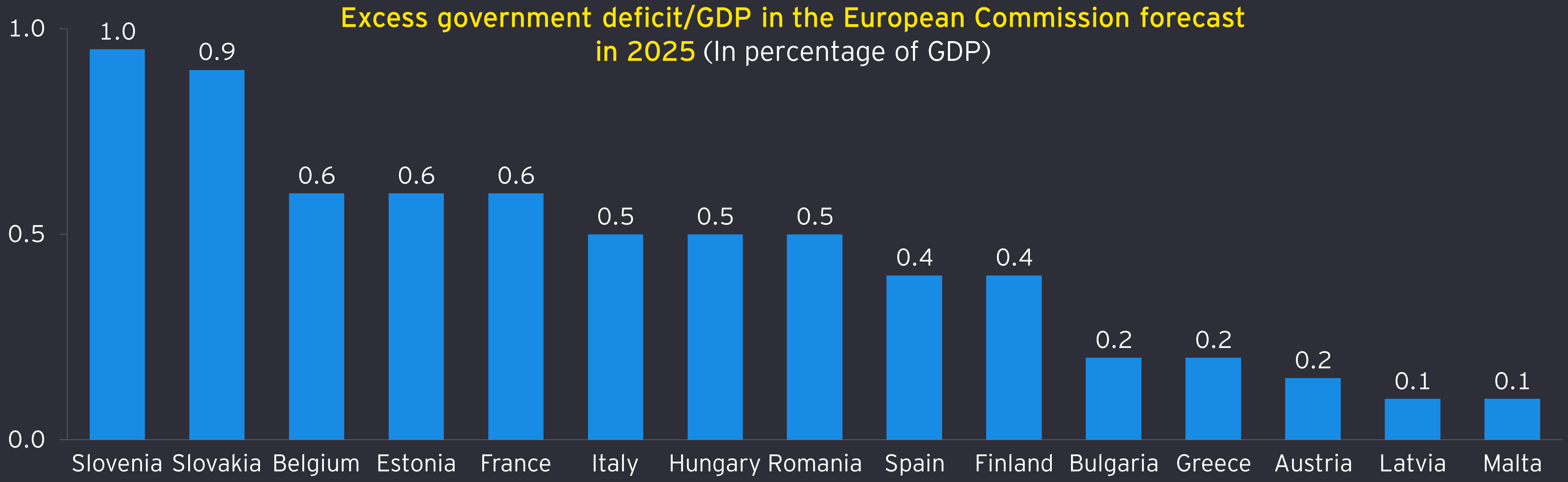
Expected change in structural fiscal balance excluding interest in 2024 (In percentage of potential GDP)



Source: European Commission.

While the newly-agreed upon EU fiscal rules reduce the risk of a sudden, obligatory fiscal tightening, they retain many weaknesses of the previous framework

- The key tenets of the EU fiscal rules have remained unchanged, including the 3% deficit and 60% debt thresholds. Structural deficit is still supposed to be reduced by at least 0.5% of GDP per year if deficit is above 3% of GDP. Nevertheless, several important amendments have been made, including:
    - If above 90%, the debt-to-GDP ratio should decrease by 1% of GDP per year, and it should decline by 0.5% per year if it falls within the 60-90% range. Previously, it was expected to decrease by 5% of the excess above 60%
    - The realisation of a 4-year fiscal plan can be prolonged to 7 years if substantial pro-growth reforms and spending are in place (incl. related to energy transition)
    - Governments with debt over 60% of GDP are now supposed to aim for structural deficits of 1.5% of GDP, reducing structural primary deficits by at least 0.25% of GDP annually on the way to achieving this objective.
- Key weaknesses of the rules have not been addressed, meaning that the rules only consider economic conditions to a limited degree and do not accommodate countercyclical fiscal policy. Moreover, the European Commission continues to have limited means to enforce compliance, especially when it comes to larger member states
- The rules will not have any impact on 2024 budgets. Additionally, the debt reduction rule will only be applicable once deficits are brought down below 3%, and until 2027, adjustments will be made for higher interest payments in the deficits.
- But even under these derogations, several countries, including France, Italy and Spain, are expected to violate the rules in 2025.

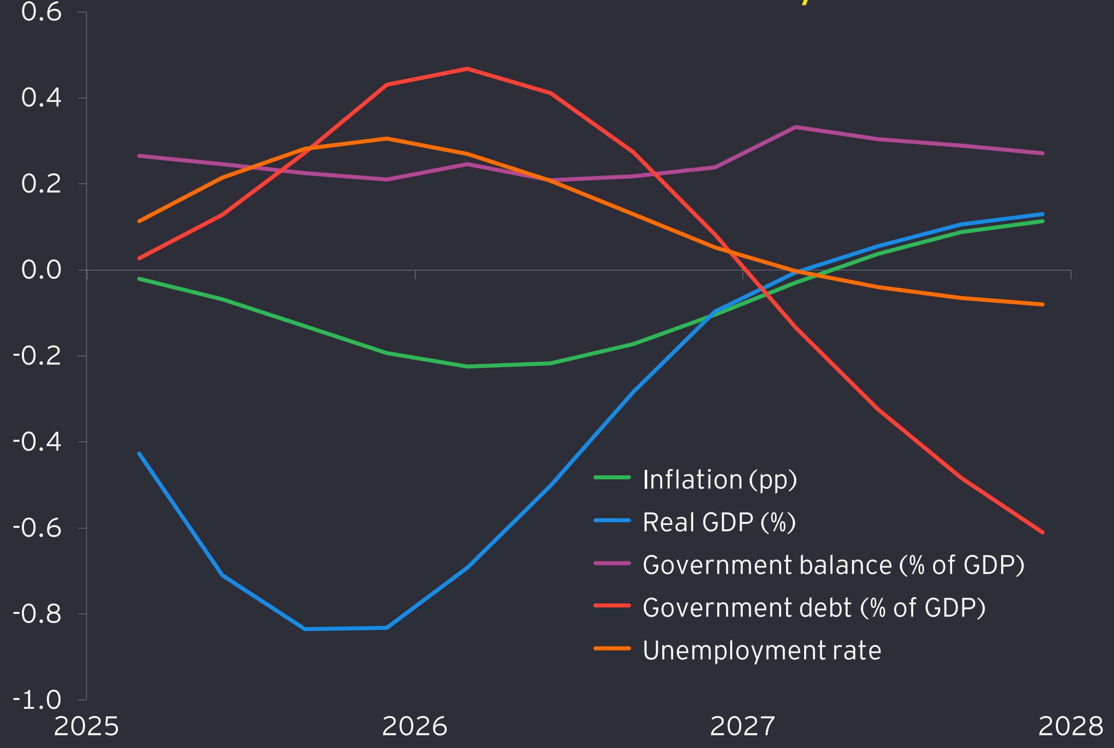


Source: European Commission, EY calcuations.
Notes: If deficit/GDP over 3% in 2024 or 2025, tightening such that structural balance improves by 0.5% of GDP or deficit falls to 3%. If deficit below 3%, but debt/GDP over 60%, tightening such that debt/GDP falls according to the debt reduction rule; if additionally structural deficit is above 1.5% of GDP, tightening such that primary structural deficit declines by 0.25% of GDP per year.

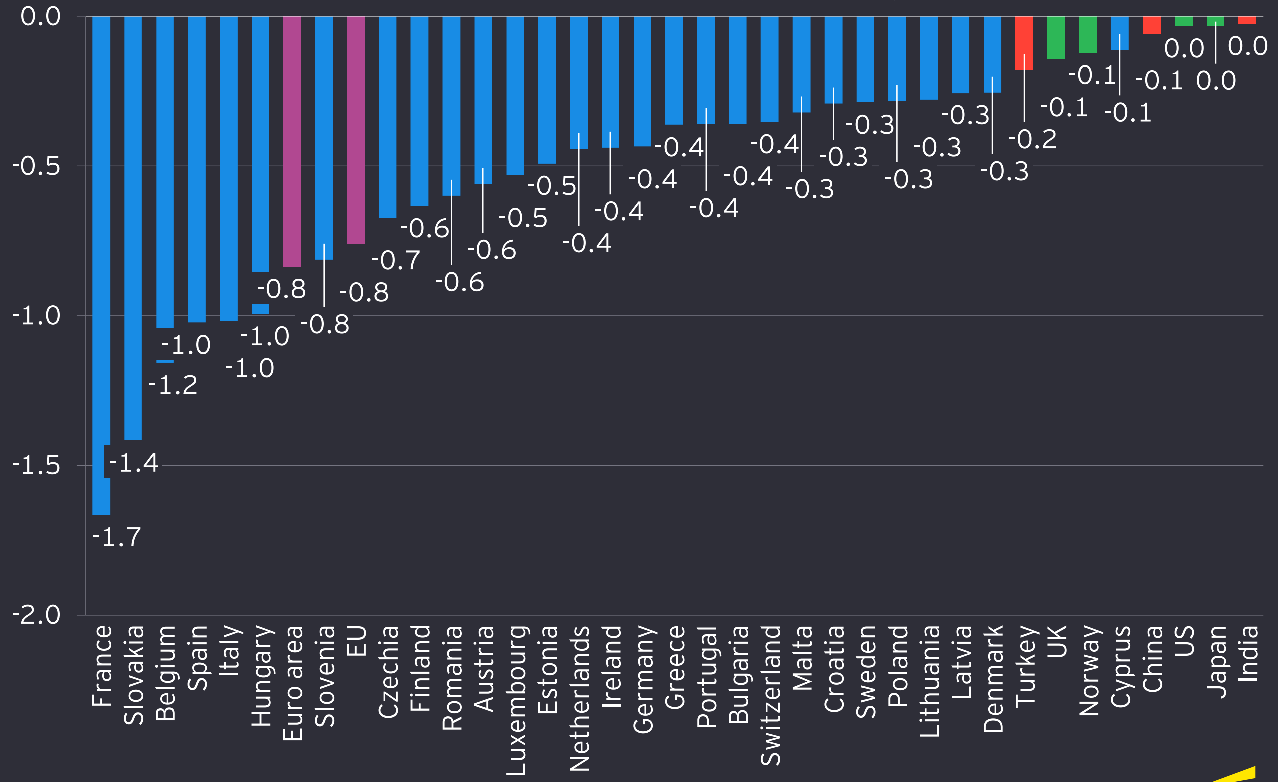
If Member States were to reduce their deficits in 2025 in accordance with the new EU fiscal rules, this would result in euro area GDP growth being 0.7 pp lower than the baseline, causing an initial increase in the debt to GDP ratio. The medium-term effects, however, would be positive

- We assume that Member States in breach of fiscal rules in 2025 reduce their deficits by an amount equal to the excess deficit (as shown on the previous page) through cuts in consumption expenditures and transfers to households.
- Consequently, the euro area government balance enhances by 0.2-0.3% of GDP, but GDP drops by 0.8% at its peak relative to the baseline. This initially leads to an increase in the government debt to GDP ratio. However, by 2027, GDP outperforms the baseline, and the debt to GDP decreases, indicating the positive medium-term effects of fiscal tightening.
- Countries subject to fiscal tightening would experience the most significant GDP drops (compared to the baseline), but other EU countries would also see GDP reductions relative to the baseline of up to 0.7%, driven by a decrease in external demand.

Impact of the fiscal compliance shock on the euro area economy



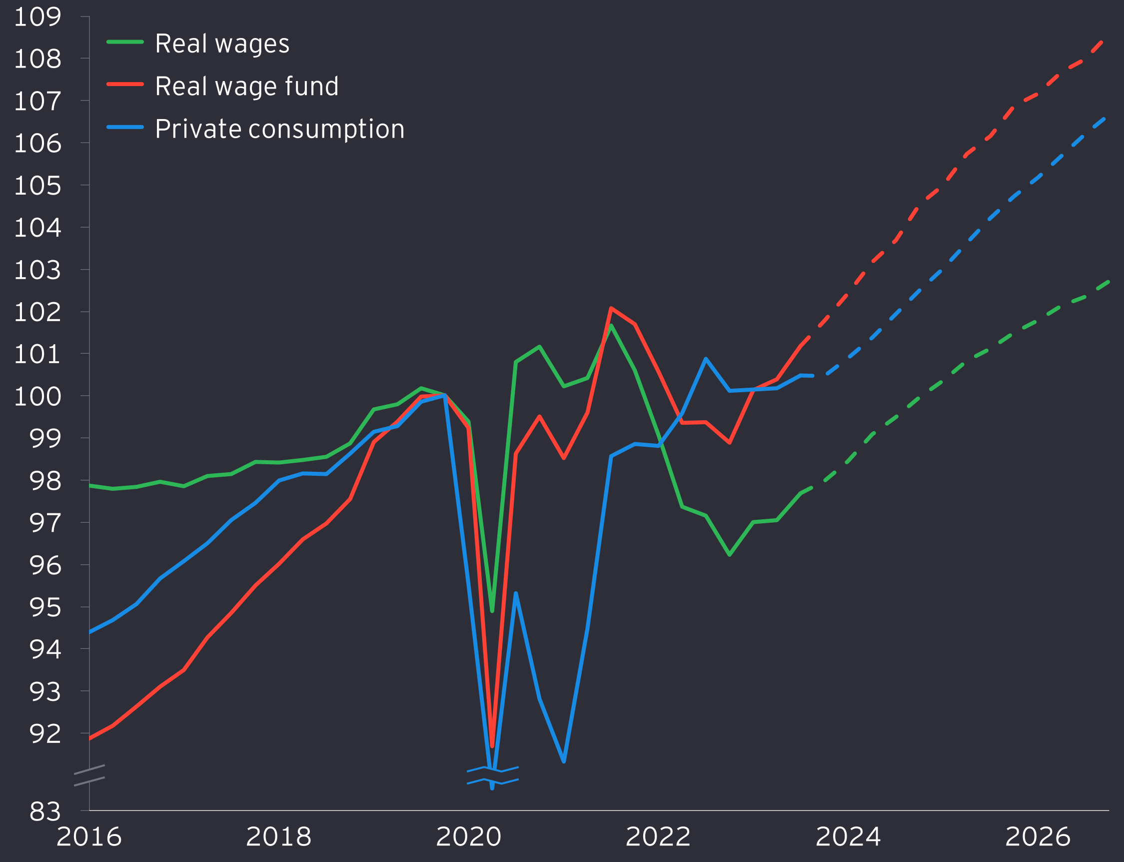
Peak impact on real GDP of fiscal tightening in line with the new EU fiscal rules (in percentage)



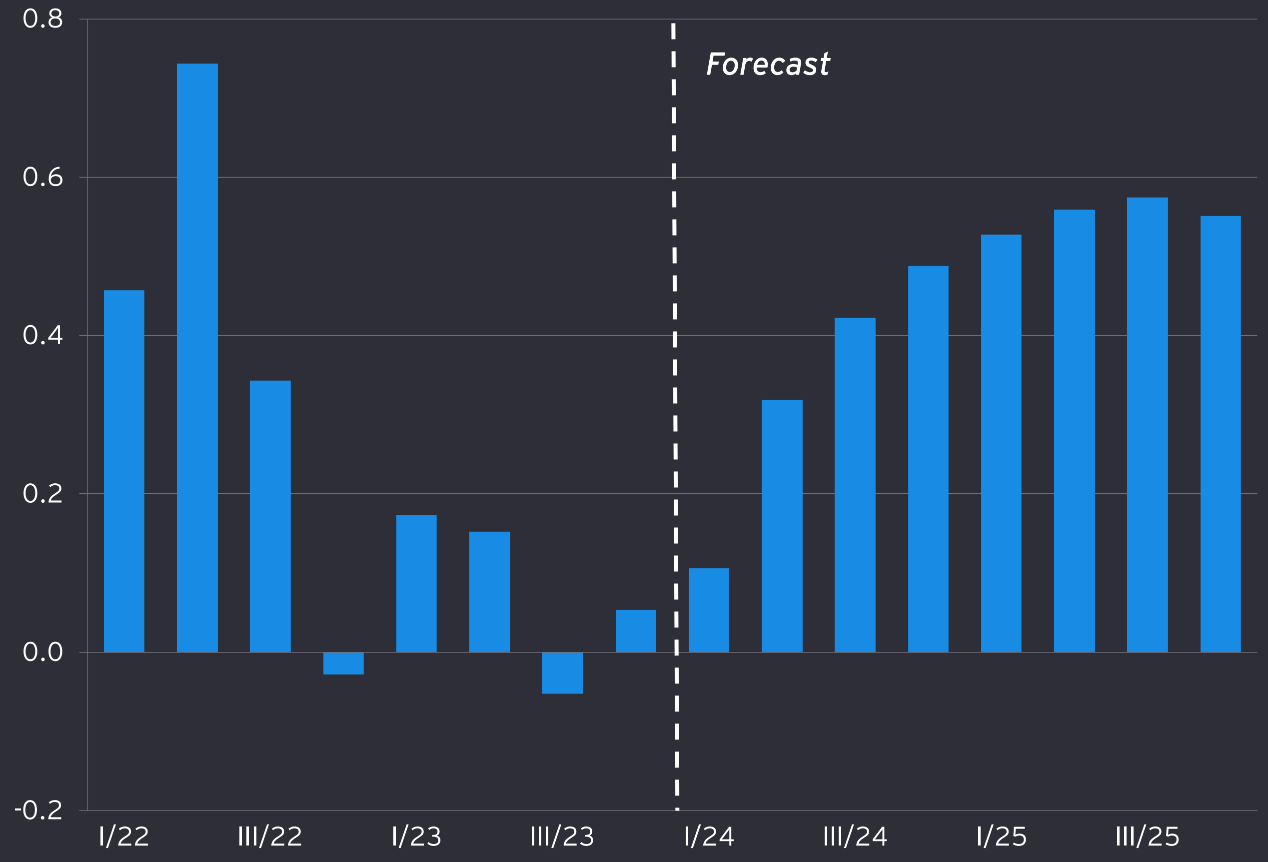
Source: EY simulation.
The degree of fiscal tightening differs across countries and is specified as in the chart on the previous page.

Looking ahead, we still expect the European economy to recover gradually throughout 2024 as real incomes increase, activity in global manufacturing normalizes, the drag from tight monetary policy slowly fades with the help of rate cuts and government investment continues to support activity

Nominal and real wage growth in the euro area
(2019 Q4 = 100)



GDP growth in the euro area less Ireland
(q/q, in percentage)

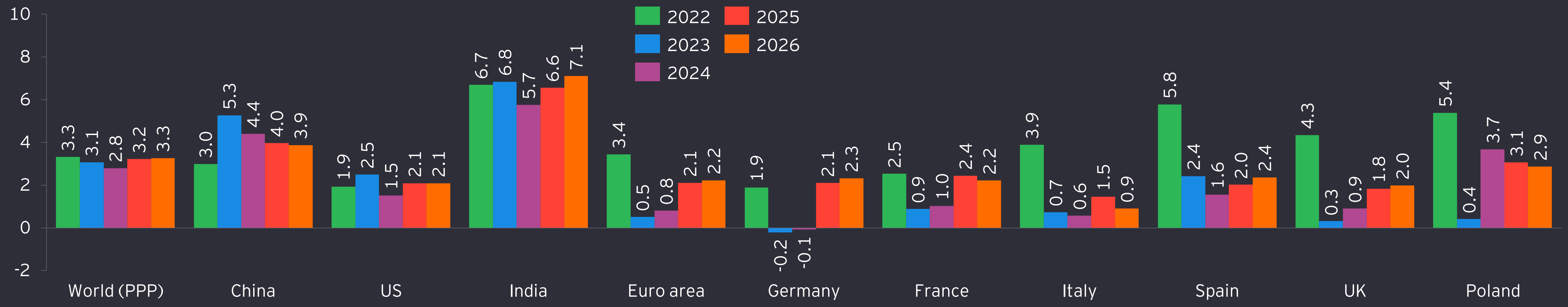


Source: Oxford Economics, EY EAT forecast.

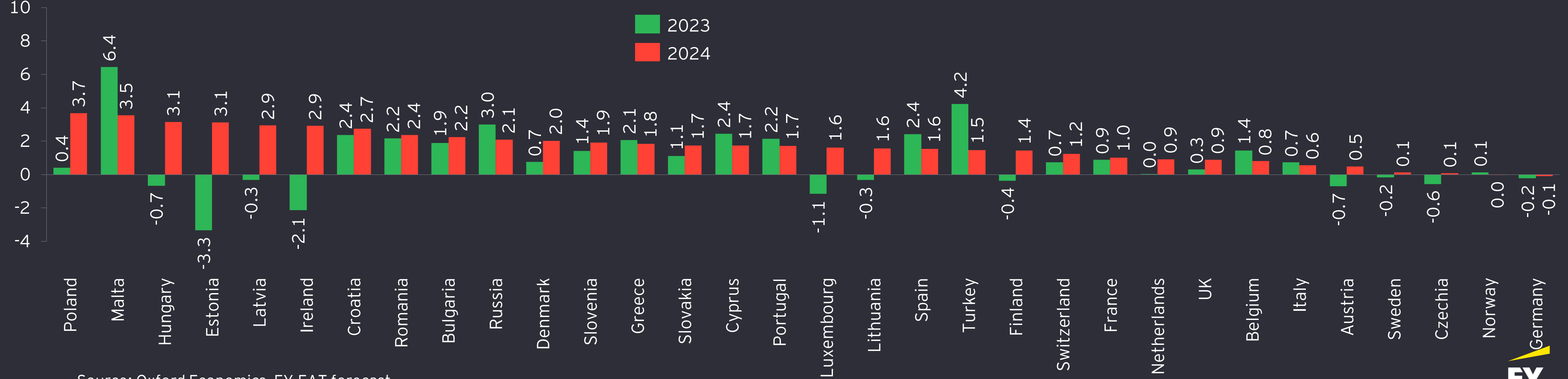
Notes: for EU countries, wages and salaries per employee based on national accounts deflated with HICP. For US Employment Cost Index: Total Compensation deflated with CPI.

We anticipate that GDP growth across major euro area economies will be converging over 2024. However, in annual average terms, Germany will likely continue to lag Southern Europe due to the carry-over effect. CEE countries should stand out as rapid disinflation amid strong wage growth will increase real incomes, thereby supporting consumption

GDP growth in 2022-2026 (in percentage)



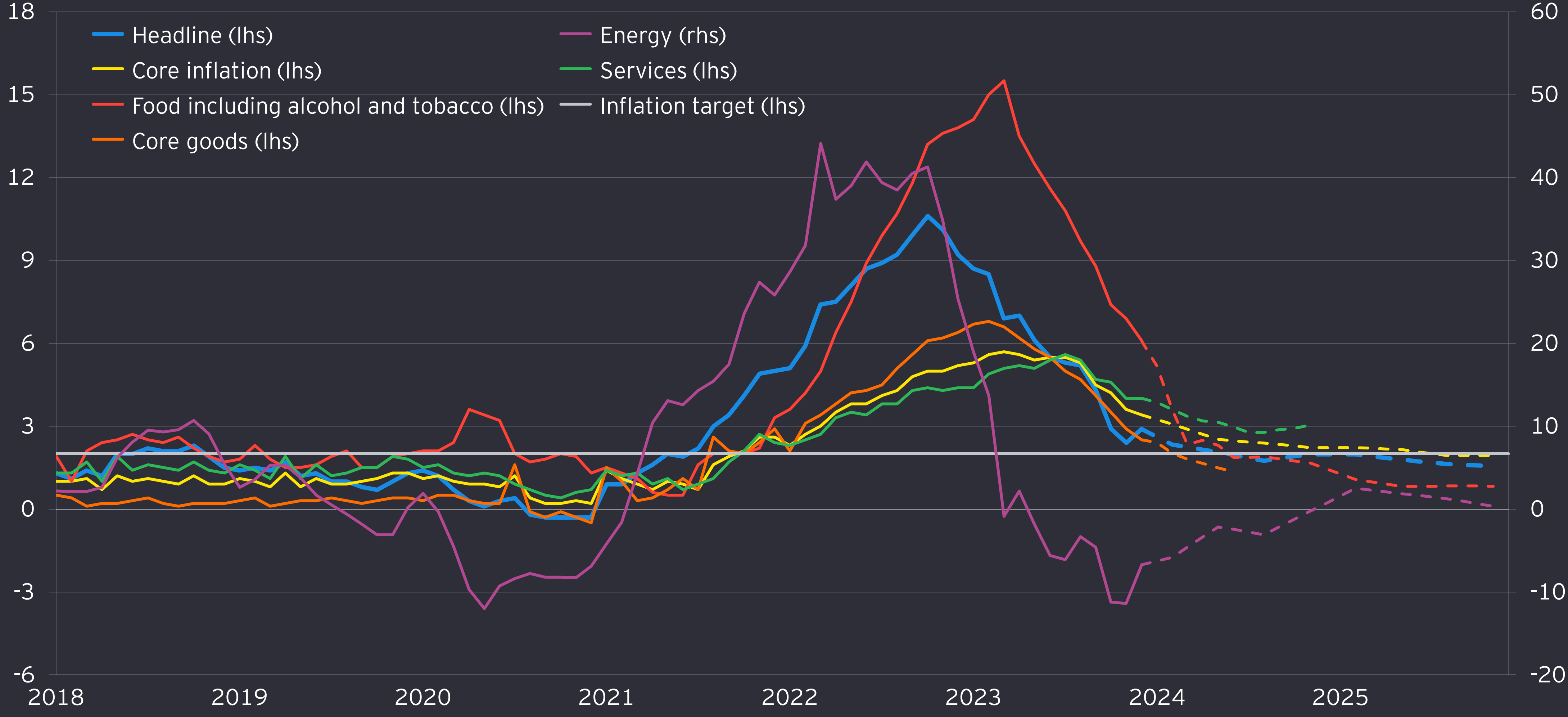
GDP growth in 2023 and 2024 (in percentage)



Source: Oxford Economics, EY EAT forecast.

We expect disinflation in the food, core goods and services components to continue in the coming months, although the latter is likely to remain elevated. Consequently, headline inflation is anticipated to reach the ECB's target in 2024 Q2, while core inflation should linger slightly above 2% until mid-2025

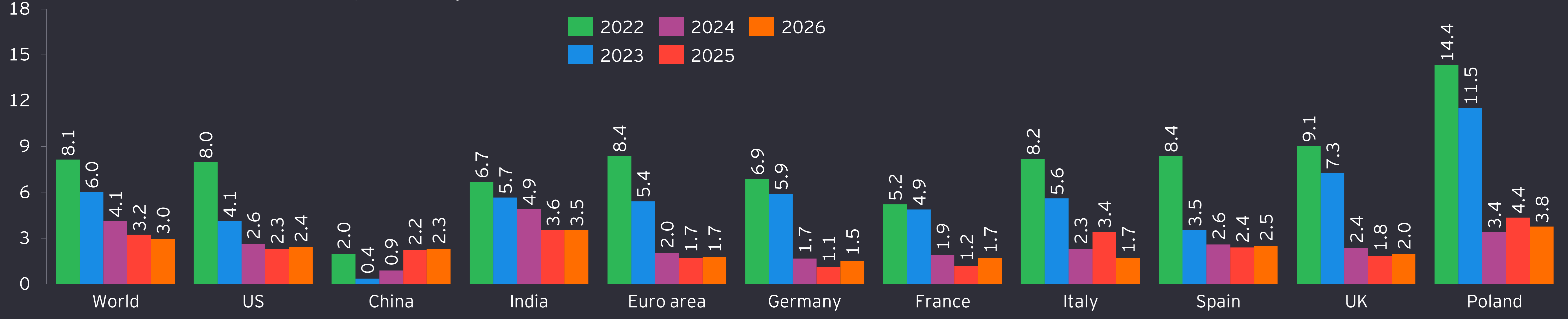
HICP inflation in the euro area (y/y, in percentage)



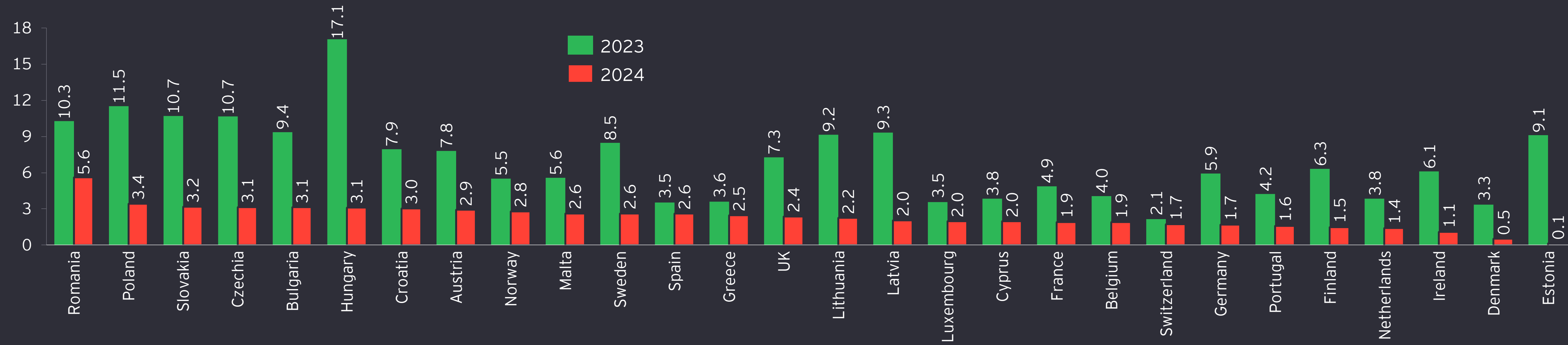
Source: Eurostat, EY EAT forecast.
Dashed lines denote EY EAT forecast.

We anticipate disparities between nations to dwindle – the 2024 headline inflation is expected to fall within the range of 1.5%-3.0% in most EU economies. Two clear outliers will likely include Romania, where inflation is stickier due to robust domestic demand, and Denmark, where price pressures have been particularly weak

Inflation in 2022-2026 (in percentage)



Inflation in 2023 and 2024 (in percentage)



Source: Oxford Economics, EY EAT forecast.

The balance of risks continues to lean to the downside

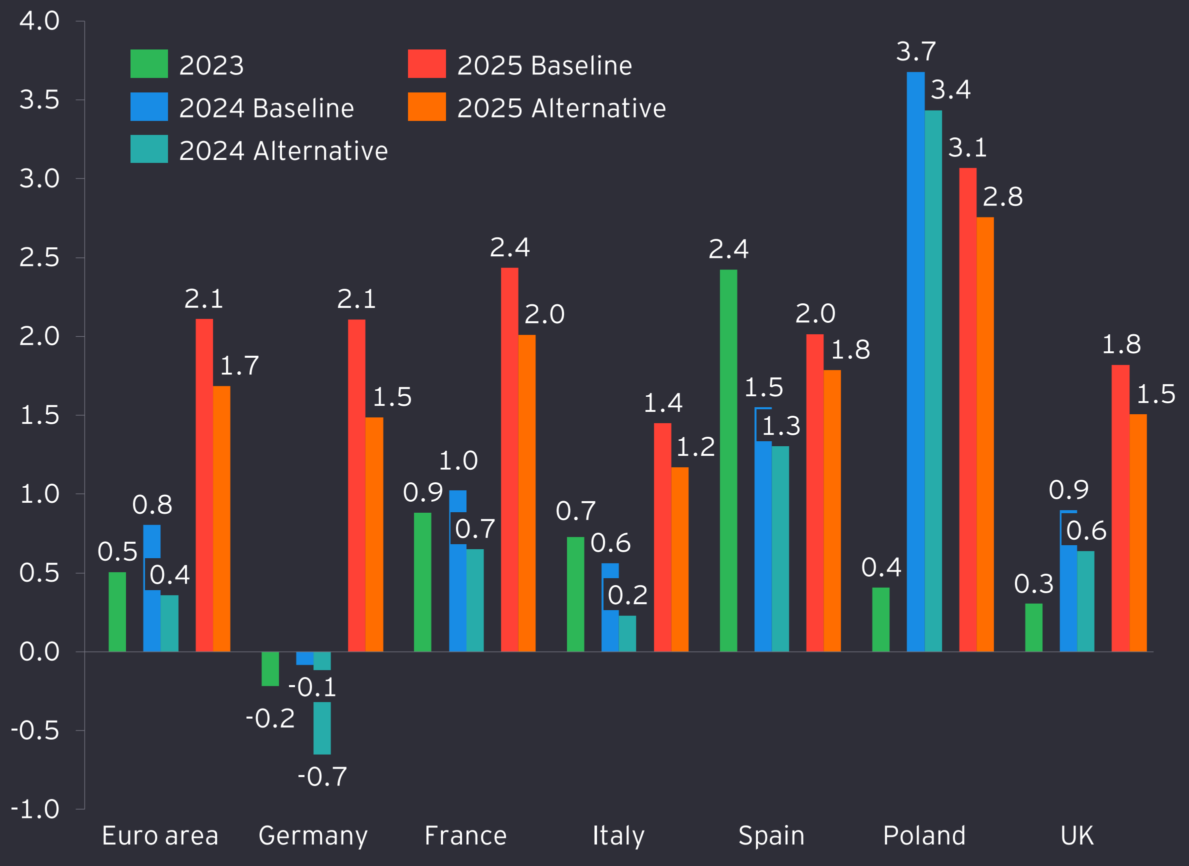
- **Prolonged downturn in manufacturing** – monetary policy effects and their lags are subject to substantial uncertainty and may prove to be stronger and more delayed than currently expected. As a result, the downturn in manufacturing and stagnation in world trade may continue longer than anticipated, leading to sub-trend economic growth and reduced labor demand. This, in turn, could trigger an increase in job losses and unemployment, further slowing economic activity.
- **Geopolitical tensions** – an increase in tensions related to the war in Ukraine, escalation of the conflict in the Middle East or strained China-Taiwan relations may generate spikes in commodity prices, further increase shipping costs, and create renewed bottlenecks in world trade. This might precipitate a renewed increase in inflation and adversely affect global economic activity.
- **Energy and food prices spikes** – unfavorable weather conditions or local political unrest could reduce the supply of or increase demand for energy and food commodities, prompting a resurgence in inflation and a reduction in economic activity.
- **Financial sector stress (banking sector, commercial real estate, sovereign debt)** – in a high-interest rate environment, there is a heightened risk of financial market turbulence originating from the banking sector, commercial real estate or sovereign debt markets. Specifically, with inflation no longer bolstering revenue growth or contributing to reducing debt to GDP ratios, and with spending on interest payments and other components, often indexed to past inflation, continuing to increase at an accelerated rate, the risk of renewed stress in emerging economies' sovereign bond markets, or those in Southern Europe, is on the rise.

Despite significant downsides, there are factors posing an upside risk

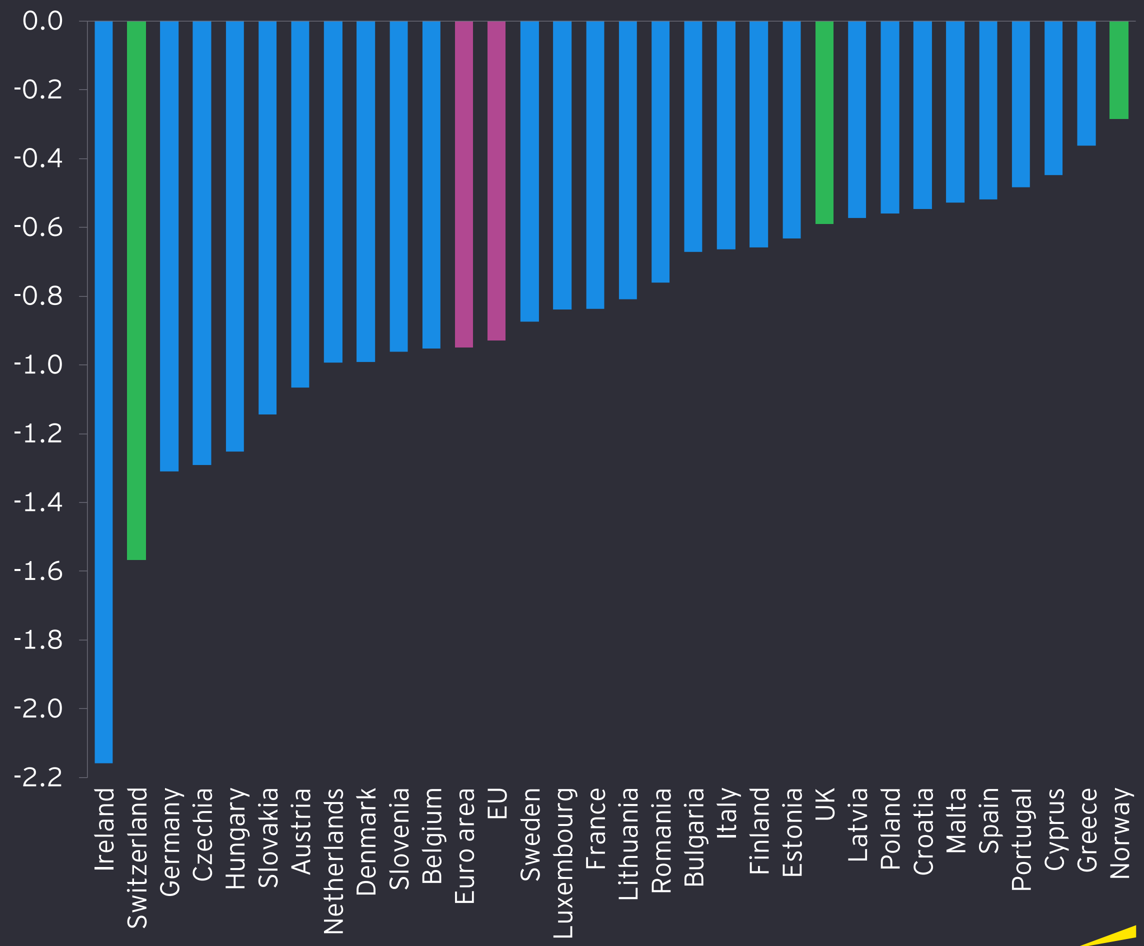
- **Faster disinflation, with inflation running below central bank targets for some time, leading to a faster and stronger cycle of monetary easing** – disinflation may continue faster than expected. Price levels may normalise following past spikes by growing at sub-target pace for some time. This could be facilitated by a further decline in commodity prices to pre-pandemic levels. Lower inflation and interest rates would support real incomes and spending, thereby stimulating economic activity.
- **Stronger rebound in consumption, supported by accumulated excess savings** – improving sentiment and declining interest rates, European consumers may decide to utilize some of their substantial excess savings accumulated during the pandemic. This would result in stronger GDP growth.

If global trade remained stagnant in 2024, so would the euro area economy. Switzerland, Germany, Czechia and Hungary would be among the most affected countries, with Southern Europe least impacted

Real GDP growth by scenario
(in percentage)



Peak impact on real GDP of lower external demand
(in percentage)

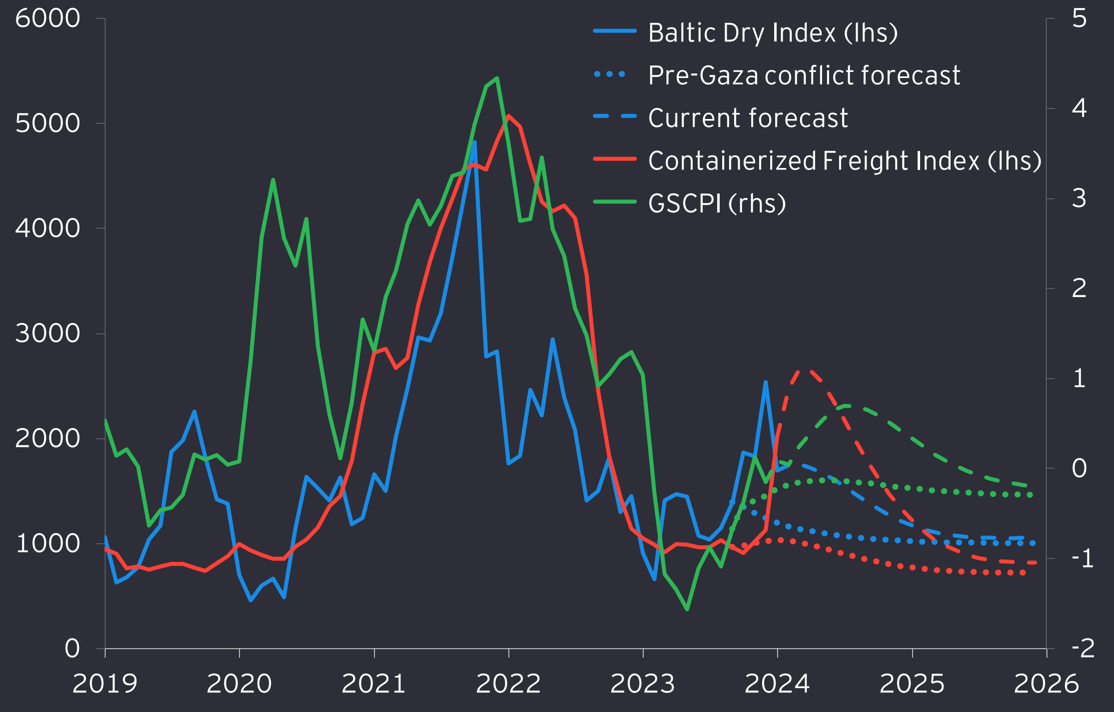


 Source: EY simulations.

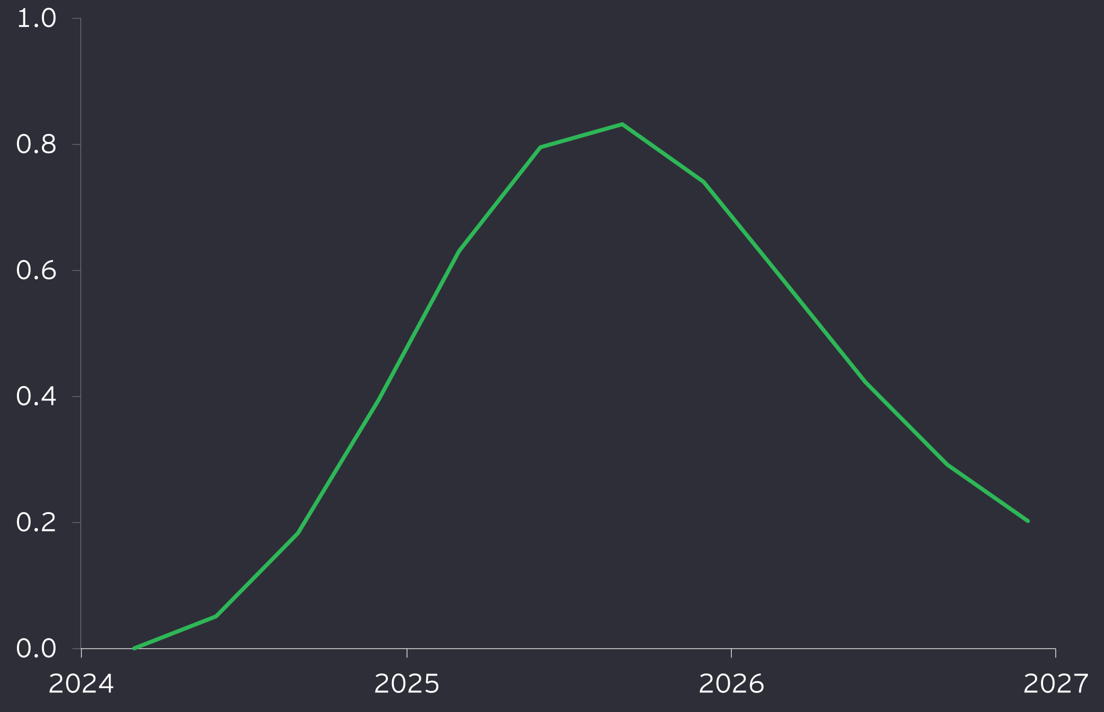
If sustained, the recent increase in shipping costs, due to tensions in the Red Sea, could lead to a 0.8 pp increase in headline inflation, with the peak effect delayed to 2025

- However, the impact may be smaller since, given the current weak demand conditions, the increased shipping costs may not lead to supply bottlenecks to the same degree as in 2021 and their pass-through onto the final goods prices may be weaker. Shipping costs may also decline more rapidly than projected if the tensions are resolved.

Shipping costs and Global Supply Chain Pressure Index (GSCPI)



Estimated impact of higher shipping costs on y/y HICP inflation in the euro area (in percentage points)



Source: Federal Reserve Bank of New York Liberty Street Economics; Investing.com; Trading Economics, EY calculations.
Notes: Baltic Dry index is a shipping freight-cost index for dry bulk cargo. Containerized Freight Index tracked by Trading Economics considers the most current freight prices for container transport from the most important ports in China.
Forecasts for Baltic Dry Index, Containerized Freight Index and GSCPI obtained from a VAR model that includes also the Covid Stringency Index and m/m growth in deflated orders in US manufacturing.
Estimated impact on inflation obtained from a 13-variable VAR model for the euro area specified so that it minimises forecast errors for inflation over 2015-19 and 2021-23. The model is estimated on quarterly data and log-differences and includes 1 lag of global GDP, external demand for non-fuel goods, US GDP, energy prices, US CPI, HICP, employment, consumption, GDP, general government balance, GSCPI, M3 and stock prices. The model is simulated under two alternative paths for GSCPI as in the LHS chart. The impact of higher shipping costs on inflation is the difference between these two scenarios.

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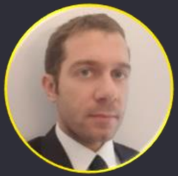

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Forecast sources

- Forecasts for most economies have been prepared by EY Economic Analysis Team (EY EAT) using an amended version of the Oxford Global Economic Model (GEM)
  - EY EAT have adjusted GEM equations, assumptions and data inputs
- Forecasts for the US, China and Japan have been prepared by EY-Parthenon Macroeconomics Team
  - Contact: https://www.ey.com/en_us/strategy/macroeconomics
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- Forecasts for Italy in 2023-24 have been prepared by EY Italy
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