Euro Area Outlook:
Better Than Expected but Not Out of the Woods Yet

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Highlights

- An unseasonably warm start to the winter, falling energy prices, and government supports have helped offset the headwinds facing the common currency area, likely averting the worst-case scenario.
- The cost-of-living crunch continues, and sagging real incomes along with a rate hiking cycle that will continue well into 2023 will limit economic upsides in the coming year.
- Given the balance of risks, we anticipate euro area GDP to post virtually no growth in 2023 followed by a tepid bounce-back in 2024 (+0.9%).

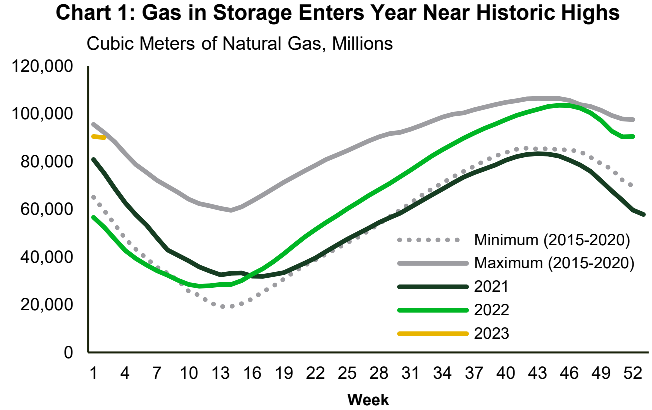
The euro area had been expected to fall into recession this winter, but it has started the year on a better footing. Better-than-expected data from Germany suggest that it may have avoided a contraction in the fourth quarter – and thereby avert a technical recession. An unseasonably warm start to the winter, falling oil prices, and gargantuan government supports have also helped offset the headwinds.

However, ample challenges remain that continue to weigh on the outlook. That is why the upgrade to the outlook will likely be relatively small. The risks facing the euro area include the ongoing struggles with inflation, rising interest rates, depressed consumer sentiment, and external demand that will rely on China's reopening to provide most of its strength. The near-term tracking suggests the euro area will likely record virtually no growth (+0.1%) in 2023, while 2024 growth will likely also be tepid.

The biggest influence on the growth outlook has been the crushing inflationary wave weighing on household budgets. Consumer price index (CPI) inflation in 2022 is expected to register 8.4%, most of which is a product of soaring energy costs. Various government subsidies are helping to offset some of the cost-of-living crunch. In total, some 600 billion euros have been allocated across the EU, including roughly 260 billion in Germany alone (almost 7% of 2022 GDP)[1]. The interventions and varying exposure to Russian gas supplies have resulted in a healthy wedge in inflation readings between economies – 6.7% year-on-year in France versus 21.4% in Lithuania as of December.

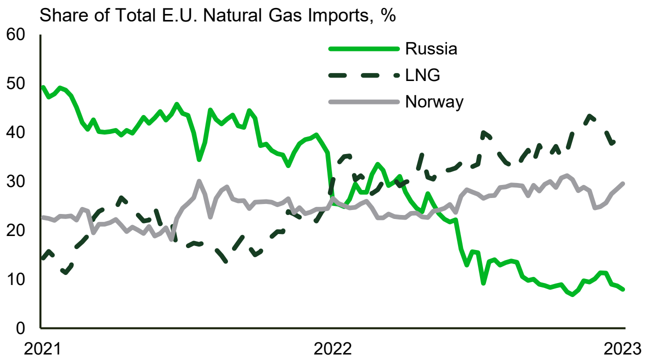
With energy costs, and natural gas in particular, playing such a large role in the hit to households, the positive developments thus far this winter have been substantial. Energy prices have been in decline since the summer, offering a reprieve heading into 2023. The European wholesale natural gas price, for instance, has fallen 81% from its peak in August, and over 50% since mid-December. In fact, the price is now lower than before the Russian invasion of Ukraine.

Chart 1: Gas in Storage Enters Year Near Historic Highs



Source: AGSI, Bruegel, TD Economics, McWilliams, B., G. Sgaravatti, G. Zachmann (2021) 'European natural gas imports', Bruegel Datasets, first published 29 October, available at https://www.bruegel.org/publications/datasets/european-natural-gas-imports/.

Chart 2: Declining Importance of Russian Pipeline Gas Supplies



Source: ENTSO-G, Breugel, TD Economics, McWilliams, B., G. Sgaravatti, G. Zachmann (2021) 'European natural gas imports', Bruegel Datasets, first published 29 October, available at https://www.bruegel.org/publications/datasets/european-natural-gas-imports/.

This is partly due to the fact that the potential shortages of natural gas that had been envisioned have failed to materialize. Courtesy of unexpectedly warm weather, stockpiles are running well above historic norms (Chart 1). Smaller than expected drawdowns through January mean less will be required for the 2023 filling season. This is crucial. Despite the eventual shutdown of the Nord Stream 1 pipeline, Russia had been a key supplier of gas both in the lead up to the war (January and February) and through the spring (Chart 2). The U.S. has since stepped in to increase liquified natural gas (LNG) exports and offset the shortfalls. But, with limited capacity to expand supplies (apart from the restart of the Freeport facility) and the gradual expansion of European import capacity, a bitterly cold winter would have meant supplies heading into the winter of 2024 could have been particularly tight.

The picture in January is much better, with stockpiles still at 98% of the max between 2015 and 2020. With additional import capacity set to come online this year, and U.S. LNG production set to ramp up after 2024[2], the outlook for energy security has greatly improved. However, a prolonged cold stretch, or a summer of exceptional heat and dry weather (like last year's) could put another dent in gas supplies. Things are good, but given the increased frequency of bouts of extreme weather, it is prudent to err on the side of caution.

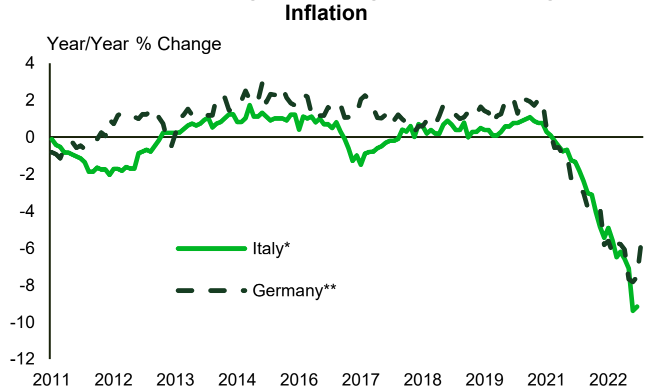
To improve resiliency, E.U. member states have greatly reduced gas consumption for both households and industry. December 2022 usage was down 12% compared to the 2019-2021 average for the month[3]. This is roughly in line with targets set out in the RePower EU framework for reducing reliance on Russian energy supplies. Curtailing demand through 2024 will be crucial as global output is not set to materially increase until then.

However, geopolitical events could also put renewed upward pressure on prices. For instance, a ban on diesel imports – the primary source of fuel for the transportation of goods – from Russia is set to take effect on February 5th. Moreover, China's wind down of zero-COVID will increase global demand for LNG in 2023 – amid relatively fixed supply conditions.

Despite the best efforts of policymakers, we expect euro area CPI inflation will register 7.0% in 2023. Part of the reason for sustained price gains is that second round effects from the energy shock have started to materialize in core goods and services. These will be harder to stamp out. For instance, negotiated wages, after two years of tepid growth, have started to rise sharply. Burgeoning wage pressures will help carry momentum in core inflation through 2023 and help keep CPI at an above-trend 2.3% in 2024.

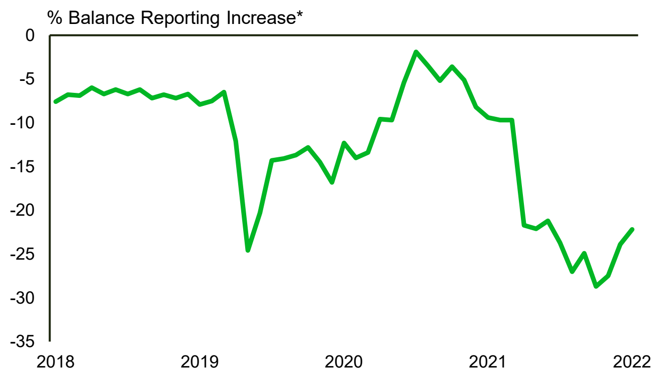
Despite some new momentum in wages, they have not kept pace with inflation. Real incomes have contracted sharply across the euro area (Chart 3). The erosion in purchasing power combined with a drastic decline in consumer confidence (Chart 4) are going to put pressure on discretionary spending. The ongoing rebound in tourism and services spending will provide some offsets, in addition to support from historically tight labor markets (Chart 5). However, high inflation will keep real activity restrained, and the labor market will soften over the next two years as the economy struggles to gain traction – lifting the unemployment rate to 8.0% by 2024.

Chart 3: Real Negotiated Wages Decline on High Inflation



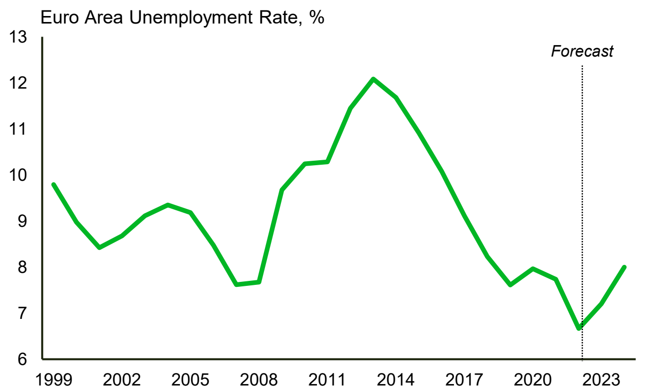
*Hourly Contractual Wage. Last Observation: November 2022.
**Gross Wage excluding Bonus and Overtime. Last Observation: December 2022.
Source: ISTAT, Bundesbank, FSO, TD Economics.

Chart 4: Euro Area Consumer Confidence Remains Depressed



*Calculated as average of responses to four sentiment indicators.
Source: European Commission, TD Economics.

Chart 5: Historically Tight Labour Markets Support Consumer Spending



Source: Eurostat, TD Economics.

Moreover, in response to sustained inflation, the European Central Bank (ECB) has begun raising interest rates rapidly to prevent higher inflation expectations from becoming entrenched. The main refinancing rate is now up 250 basis points since June. We anticipate another 150 basis points of tightening to come this year, substantially tightening financial conditions. The ensuing decline in property valuations amid stretched affordability will weigh on both real estate investment and consumer confidence.

Tighter financial conditions will also weigh on nonresidential investment by adding to the strains on corporate margins for firms that are already facing structurally higher energy costs and weaker consumer demand. Moreover, the steep reduction in natural gas demand this year has helped minimize the risk out outright shortages this winter, but the energy shock means some heavy industrial users may simply offshore operations going forward[3]. Lastly, despite recent improvements, uncertainty continues to weigh on business sentiment in the common currency area.

One silver lining for the investment landscape is the substantial volume of funds yet to be disbursed as part of the Next Gen EU scheme. The plan committed roughly 800 billion euros (5.5% of 2021 GDP) to a variety of schemes to, among other things, green and digitize the economy. Most of the funds (700 billion euros) will flow through the Recovery and Resilience Scheme where national level allotments vary greatly. For instance, major beneficiaries Italy (191.5 billion euros) and Spain (69.5 euros) are due to collect 10.7 % and 5.6% of 2019 GDP, compared to 0.7% in Germany.

What's crucial to the outlook is that although the funds have been committed, only 138.7 billion has been disbursed (as of December 2022). Italy and Spain have received roughly 35% and 45%, respectfully, of their allotments thus far. The lag, in part, reflects that nations still need approval from the European Commission before their allotments can be paid out. This is setting up 2023 and 2024 to be years where the money and investments really begin to flow.

Lastly, with global growth set to slow from 3.3% in 2022 to 2.3% in 2023, external demand won't be the source of growth euro area nations have come to rely on. The U.S. is still the euro area's largest export destination and domestic demand there is set to slow sharply over the coming year. Stronger growth in China – particularly starting in the middle of the year – because of the removal of COVID controls does provide some offset.

Bottom Line

The story for Europe remains one of depressed consumer sentiment and an erosion in purchasing power thanks to high inflation. Fiscal policy, together with unseasonably warm weather and downbeat economic expectations, have helped ease the effects of skyrocketing energy prices, but these effects could prove fleeting. Given the balance of risks, we anticipate euro area GDP to post virtually no growth in 2023 followed by a tepid bounce-back in 2024 (+0.9%).

Endnotes

1. Sgaravatti, G., S. Tagliapietra, G. Zachmann (2021) 'National policies to shield consumers from rising energy prices', Bruegel Datasets, first published 4 November 2021, available at https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices

2. Leibovici, F., J. Dunn (2022) "The Increased Tradability of Natural Gas", Economic Synopses, No. 32, 2022. https://doi.org/10.20955/es.2022.32

3. McWilliams, B., G. Zachmann, (Jan. 13, 2023) "European Natural Gas Tracker", Bruegel, available at https://www.bruegel.org/dataset/european-natural-gas-demand-tracker

4. Reuters (October 26, 2022) "BASF seeks 'permanent' cost cuts at European Operations" https://www.reuters.com/markets/europe/basf-says-european-operations-need-be-cut-size-permanently-2022-10-26/