Euro Area Outlook: Waiting on the World to Change

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Highlights

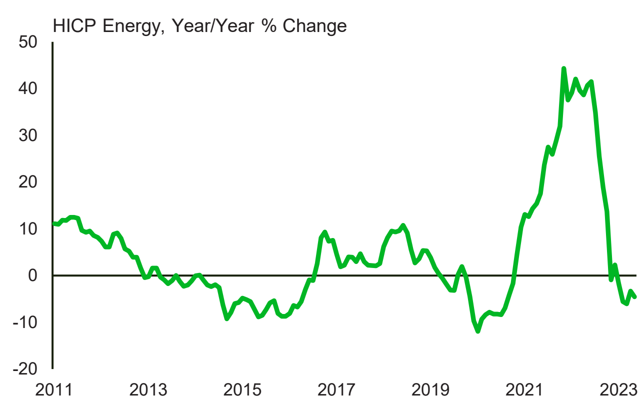
- The euro area's subdued economic performance is set to continue through 2023 and into 2024.
- The good news is that cooling inflation and a tight labor market will support real wage growth – helping to restore consumers' purchasing power.
- However, a challenging external landscape complicates the outlook. Growth in most advanced economies is expected to slow over the coming quarters, but the rumored fiscal supports in China present an upside risk.

Geopolitical events and China's economic challenges currently dominate the headlines, but the euro area's economy is still a very important piece of the global puzzle. We wish we had better news, but the euro area's subdued economic performance is likely set to continue through 2023 and into 2024. Our view is that the combined weight of elevated energy prices and high interest rates will continue to weigh on economic activity. A material upswing in growth is expected in the latter part of 2024, as interest rates start to fall, helping the economy expand by 1.2% in 2025.

The European economy has had a tough few years. Russia's invasion of Ukraine in early 2022 meant that the lift from reopening after the pandemic was relatively short-lived. The war saw consumer sentiment and real wages collapse thanks to supply chain challenges and surging energy prices. The staggering inflationary shock continued to hammer private consumption through the first half of this year with real household expenditures virtually unchanged since the third quarter of 2022. The European Central Bank (ECB) also started raising interest rates mid-2022 to fight high inflation, helping further tighten financial conditions. Thankfully, growth (tepid as it may be) is set to return to the consumer sector in 2024.

Some of the headwinds are now set to start relaxing. First, the inflationary impulse is dissipating (Chart 1) as energy prices come off their highs amid downbeat growth expectations. True, prices are still above pre-pandemic norms, but another shock on the scale of last year's is unlikely given the new composition of natural gas supplies and current stockpiles above historical ranges. Moreover, in response to inflation emerging in core goods and services, the ECB raised its deposit rate to a record high. This has helped cool aggregate demand and take some wind out of the sails of price gains (Chart 2).

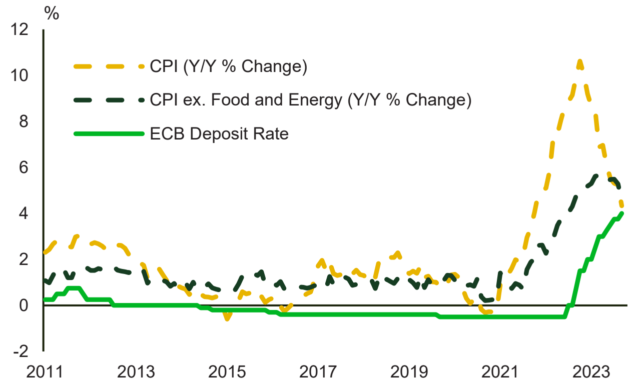
Chart 1: Europe's Energy Shock Abates



Source: Eurostat, TD Economics. Last Observation: September 2023.

With inflation fading, a tight labor market will support real wage growth. Unlike the U.S., labor force participation in the euro area is above pre-pandemic levels. The declines in real wages are going

Chart 2: Rising Rates and Falling Energy Prices Cool Inflation

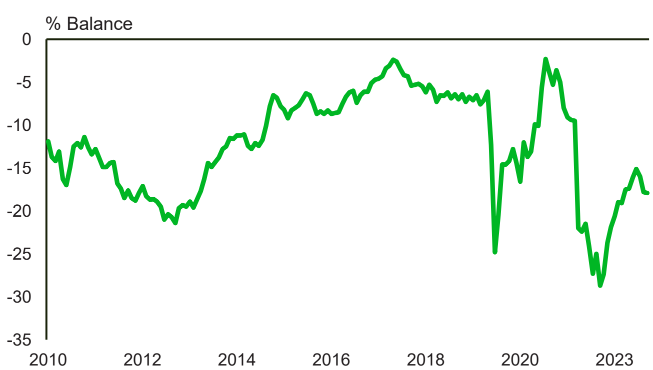


Source: Eurostat, European Central Bank, TD Economics.

to flip to growth as purchasing power is restored. Notably as inflation has abated, and the shock of the war dissipates, consumer confidence has come off the floor (Chart 3). There is still a long way to go, and conditions cannot yet be described as good, but the outlook for households is improving, and private consumption growth is expected to pick up from 0.5% in 2023 to 0.7% in 2024 and 1.4% in 2025.

Inflation is expected to cool slowly, so the ECB is likely to keep policy rates high well into next year – the first cuts are not expected until mid-2024. This period of elevated policy rates at a time of falling inflation means inflation-adjusted borrowing costs should continue to rise in the near-term and weigh on new investment, at a time that business sentiment is already downbeat thanks to tepid domestic and international demand.

Chart 3: Euro Area Consumer Confidence Remains Depressed



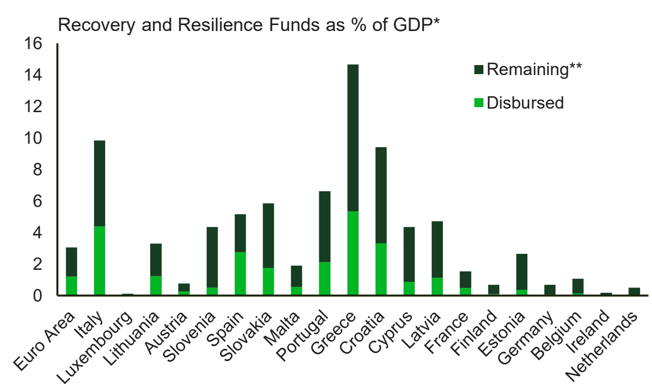
Source: European Commission, TD Economics.

Yet, even among these challenging conditions there are bright spots. During the pandemic European Union member states banded together to borrow funds collectively and create the Recovery and Resilience Facility (RRF) to finance the recovery. The benefits from the RRF will carry over into the coming years as funds amounting to roughly 2% of GDP have been allocated but not yet disbursed (Chart 4). This spending by member states should help hold off outright declines in investment, but growth in capital expenditures will still be tepid at roughly 0.6% in 2024.

However, apart from the borrowing that has already happened, governments are going to be gradually rolling back their fiscal accommodation. Deficits that widened during the pandemic and energy shocks are going to continue narrowing. Moreover, rolling over debt at higher rates leaves less money available for new expenditures. The result is that the fiscal boost will shift to a fiscal drag, removing a tailwind to growth.

The external landscape could also pose challenges. Sluggish expected growth in the U.S. and China – which absorb roughly a quarter of euro area goods exports – would sap a key source of external demand. In addition to the direct trade, euro area multinationals are also exposed to activity abroad. For instance, revenues of multinationals in China are equivalent to roughly 3.4% of euro area GDP, compared to 2.5% for U.S. firms. Moreover, this figure masks the relatively higher exposure of key economies like Germany (6.3%) and France (4.1%). With global GDP expected to register below trend growth in 2024, the outlook

Chart 4: Significant Disbursements Still To Come From Common Borrowing



*2022 GDP. **Funds allocated but not yet disbursed.
Source: European Commission, Eurostat, TD Economics.

for export growth is a still tepid 2.1% expansion in 2024, and 2.6% in 2025.

That said, China presents an upside risk for the outlook heading into 2024. The prospect of a deficit expansion next year to support growth present an upside to the outlook[1]. An upswing to China's growth trajectory would work to buoy energy prices at a time that the market remains supply constrained, while simultaneously boosting demand for industrial products.

Bottom Line

2024 is set to be another challenging year for the euro area. High interest rates and energy prices have drastically adjusted the cost structure of firms and households. Not surprisingly given these relentless challenges, sentiment is depressed relative to historical levels. The recovery will take time, and a material revival in growth isn't expected until the latter part of 2024. Our outlook for GDP growth is 0.6% in 2023 and 2024, and 1.2% in 2025.

Endnotes

1. Yao, K., (October 23, 2023) "Analysis: China to Choose Fiscal Muscle Over Big Reforms to Revive Economy" https://www.reuters.com/world/china/china-choose-fiscal-muscle-over-big-reforms-revive-economy-2023-10-24/ Reuters

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