Euro area

Double dip recession

- The economic challenges facing the euro area are not the same as in the US. Supply side shocks set the scene for an extended period of high inflation coupled with lacklustre growth. A recession seems difficult to avoid and we expect GDP to decline by 0.9% in 2023, followed by stagnation in 2024.

- Elevated inflation pressures coupled with the risk of de-anchoring inflation expectations will keep the ECB firmly in tightening mode. Rate cuts could be on the cards in 2024, but uncertainty remains high.

- Europe's biggest fragility stems from the (geo)political front, as well as a renewed flaring up of the energy crisis or new Covid-19 outbreaks next winter. Upside risks to the growth outlook arise from pandemic-related private savings buffers, fiscal measures and accelerated investment spending.

- 'Stagflation' does not have to be the new normal, but structural reforms to address low productivity and adverse demographic trends as well as securing a leading position in the green transition race remain key.

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Another winter, another downturn

With its geographical proximity to Russia and Ukraine, heavy reliance on energy imports and high integration in global value chains, the euro area economy is facing the perfect storm. The catch-up potential from the pandemic seems increasingly exhausted in many sectors. Consumers have turned historically gloomy and real spending is trending down. Waning demand and rising input costs are slowly taking their toll on production. A recession seems difficult to avoid and we now expect GDP to decline by 0.9% in 2023, followed by stagnation in 2024. Declining private consumption will be the main driver for the growth slowdown over the winter, as the real income squeeze exerts its full force in 2023. Following a temporary uptick in the growth momentum towards the summer, we expect another downturn in the second half of 2023, as both the lagged impact from ECB's monetary tightening and spill-overs from the US recession take effect through the export channel.

Downside risks mainly stem from the geopolitical front (see theme box) as well as a renewed flaring up of the energy crisis or new Covid-19 outbreaks next winter. On the other hand, pandemic-related private savings buffers, fiscal measures and accelerated investment spending on defence and the green transition remain upside risks for the growth outlook.

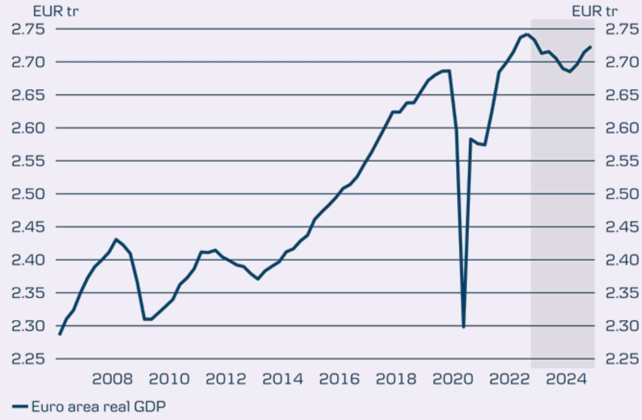
Balancing debt and productive investments

During 2022, governments have set up various programmes to help households and firms cope with higher energy prices. These programmes are costly and have often not yet been fully accounted in the 2023 budget plans. The recession is going to be a further drag on public finances, as are higher interest expenditures due to rising government bond yields. Overall, we think the fiscal stance will stay roughly neutral in 2023, but taking into account the large off-balance sheet spending, fiscal policy might end up being expansionary, especially if additional measures are rolled out during 2023.

Thanks to strong nominal growth, debt to GDP ratios will continue to fall in 2022, but start growing again from 2023 onwards, illustrating the fiscal sustainability challenges Europe faces. While the Stability and Growth Pact rules remain suspended during 2023, discussions about EU fiscal rules reform should gather pace in H1 23. Current proposals foresee individual member states getting a bigger say in their debt reduction plans, with extra time granted for justified investments and structural reforms, while also strengthening enforcement. In the coming years, governments will have to walk a fine line between managing their rising debt piles, while allowing for productive investments, especially fiscally vulnerable ones like Italy.

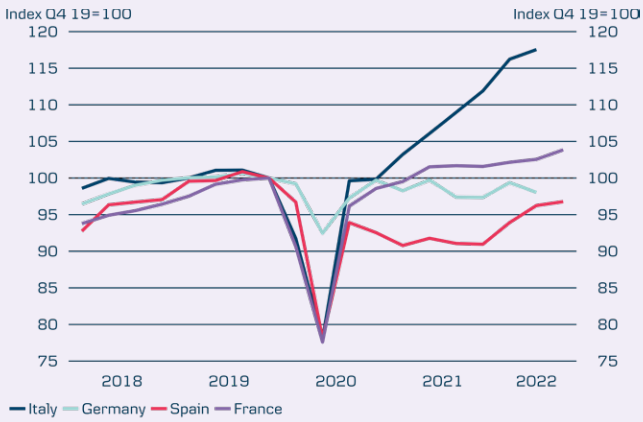
'Next Generation EU' (NGEU) funding will continue to play a key role in levelling the economic playing field between euro area countries and according to ECB estimates will boost euro area GDP by around 0.5pp in 2023 and 2024. Under its REPowerEU plan, the Commission has also outlined additional investment needs of EUR 210bn until 2027. But although there is now a drive to fast-track the approval and construction of renewable energy, the EU's electricity grid might not expand fast enough and blackouts and gas rationing remain a clear possibility also next winter.

Double dip recession



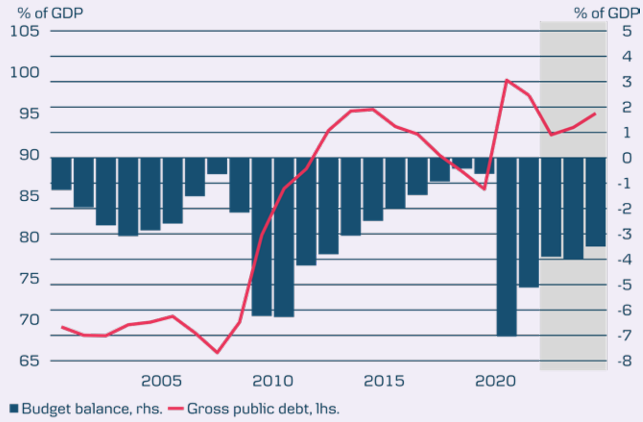
Source: Eurostat, Macrobond Financial, Danske Bank

Upside risks from NGEU-financed investments



Source: Eurostat, Macrobond Financial, Danske Bank

Fiscal sustainability challenges remain



Source: EU Commission, Macrobond Financial, Danske Bank

Inflation remains sticky…

Euro area labour supply was quicker to return to pre-pandemic levels than in the US, but labour shortages remain widespread. The economic downturn should cool labour demand and lead to a moderate uptick in unemployment on the back of rising bankruptcies and production relocations abroad. Nevertheless, we do not look for a large-scale labour market crisis, which should support ongoing wage growth.

Firms continue to pass-on higher input costs to consumers and in spite of the recession, we expect this process of cost-push inflation to extend into 2023, keeping price pressures elevated for longer. Despite the moderation in natural gas and electricity prices, delayed pass-through to household bills will mean energy price inflation will abate only gradually, while the downside risk from price caps seems limited. Core inflation will also prove sticky in our view, due to second round effects from higher energy, material, but also labour costs. Our forecasts are above current market pricing and show headline inflation returning to the ECB's target not before the end of 2024, with the green transition and higher than expected wage growth still presenting upside risks.

… with no monetary easing in sight before 2024

Elevated inflation pressures coupled with the risk of de-anchoring inflation expectations will keep ECB firmly in tightening mode, despite the growing recession risk. Monetary tightening will be achieved both through balance sheet normalisation and the policy rates channel. Following further rate hikes in the coming months, we expect the deposit rate to peak at 2.75% in early 2023 and remain in restrictive territory throughout next year. Rate hikes will be accompanied by quantitative tightening (QT) in early 2023, with Fed-style capped reinvestments of maturing bonds under the APP programme, as well as tightening liquidity conditions via maturing TLTROs.

Rising borrowing costs and tightening credit standards will take its toll on e.g. construction investment and a housing crisis remains a key downside risk for the growth outlook. The prospect of a double dip recession, combined with clear signs of easing underlying inflation pressures over the medium-term opens up the possibility of ECB rate cuts in 2024, with QT likely also being phased out, but uncertainty about the global central bank outlook remains high.

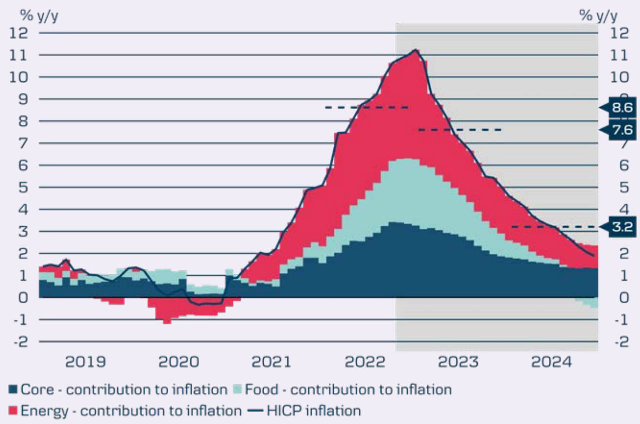
Political fragilities

The economic challenges facing the euro area are not the same as in the US. But on balance its supply side shocks are even more difficult to address with monetary tightening alone and will likely result in an extended period of high inflation coupled with lacklustre growth. Europe can, and eventually will, end its reliance on Russian energy, but the transition will be painful and take time. In the meantime, Europe's biggest fragility stems from the political side, not only from fragmented fiscal policies, but also growing divisions how to address long-term challenges such as climate change or global trade. 'Stagflation' does not have to be the new normal in our view, but structural reforms to address low productivity and adverse demographic trends as well as securing a leading position in the green transition race remain key.

Moderate uptick in unemployment

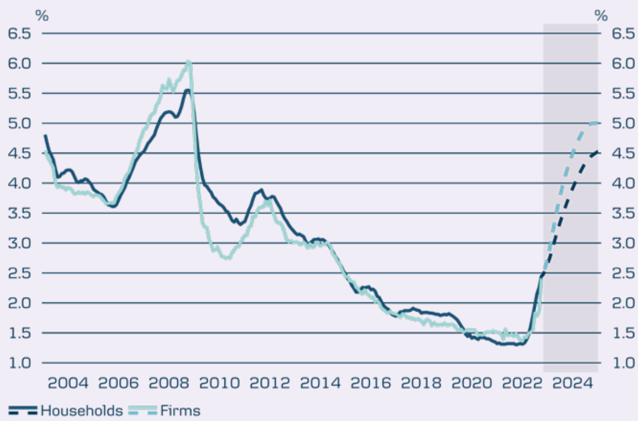
Source: Eurostat, Macrobond Financial, Danske Bank

Inflation to return to ECB's target not before 2024



Source: Eurostat, Macrobond Financial, Danske Bank

Rising borrowing costs will weigh on growth



Source: ECB, Macrobond Financial, Danske Bank

Macro forecasts - Euro area

% Change q/q	2023				2024				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2021	2022	2023	2024
GDP	-0.7	0.1	-0.4	-0.6	-0.2	0.4	0.7	0.3	5.3	3.3	-0.9	0.0
Private Consumption									3.7	3.9	-1.6	0.7
Fixed Investments									3.7	2.5	-1.0	-0.2
Public Consumption									4.3	1.0	0.7	1.7
Exports									10.5	6.6	2.0	1.2
Imports									8.3	6.4	2.1	2.7
Unemployment rate (%)	6.9	7.2	7.5	7.8	8.1	8.2	8.4	8.6	7.7	6.7	7.4	8.3
HICP (y/y)	10.4	8.1	6.6	5.3	4.4	3.5	2.9	2.1	2.6	8.6	7.6	3.2
Core HICP (y/y)	4.7	4.3	3.8	2.9	2.6	2.3	2.1	2.0	1.5	3.9	3.9	2.2
Public Budget[1]									-5.1	-3.9	-4.0	-3.5
Public Gross Debt[1]									97.2	92.4	93.3	95.0
ECB deposit rate[2]	2.75	2.75	2.75	2.75	2.75	2.50	2.25	2.00	-0.5	2.0	2.75	2.0

1. Pct. of GDP
2. End of period
Source: Eurostat, Danske Bank

Geopolitical tensions and the risk of hybrid attacks cast a shadow on Europe

Russia's war of aggression against Ukraine is going through a period of escalation following Ukraine's latest battlefield successes. Mobilisation of conscripts, 'scam' referenda and the illegal annexation of four Ukrainian oblasts are both acts of desperation, but also clear signals that the Kremlin's strategy remains one of doubling down, not backing off.

Currently, there is no room for diplomacy and we expect the war to drag on. Ukraine's leadership has been explicit about their goals: they are not only aiming to deter Russia, but also restore the borders that pre-date Russia's illegal annexation of Crimea back in 2014. Considering its remarkable advance, Ukraine has no reason to negotiate a ceasefire – neither does Russia, which is the underdog now. Russia's objectives remain unclear, but it has not given any signals that original goals have changed, despite the apparent underperformance. At this point, Russia would not be able to secure terms favourable enough through diplomacy, let alone spin its 'special operation' as a victory.

It is in Russia's interests to seek a stalemate. While the Russian economy and its army will be weakened by the sanctions in the long term, in short term time is on its side, with new conscripts soon joining the frontline. Russia is likely counting on Western interest towards Ukraine to fade over time. In terms of funding, the US remains the single largest contributor to Ukraine and its role in supporting Ukraine's military is crucial. For now, we expect no change in the US stance: though significant in absolute terms, as a share of US GDP, its contribution is only around 0.25%. We doubt it would be the first target on any Republican cost-cutting agenda.

Rising household energy bills will be a first test for European solidarity, with some polls already showing growing public support among European countries for renewed peace negotiations. But it is likely that Russia will aim to exert even more pressure on Europe by means of hybrid warfare: cyber-attacks are already common, but also the risk of sabotage against critical infrastructure should not be ignored. The European energy market has no leeway for the coming winter and any unexpected shocks would cause severe disruption, triggering higher prices and raising the risk of blackouts and rationing, with devastating consequences for the economy.

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Date of first publication

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