**HENRY COOK**
*Senior Europe Economist*

Economic Research Office

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

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# Still slipping towards recession

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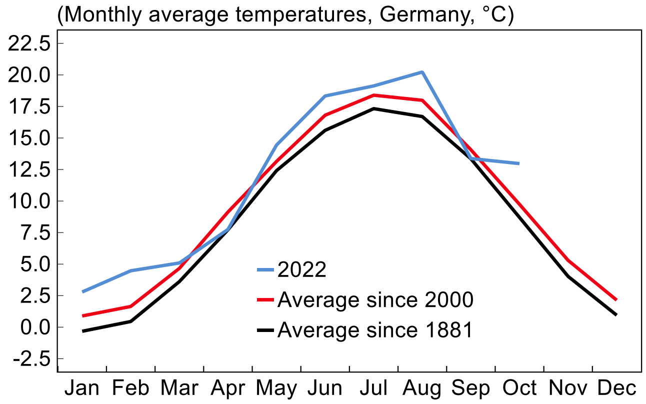
Mild weather and healthy gas storage levels are encouraging for the euro area economy, but high frequency data are still pointing to an imminent recession. Sizeable fiscal support and lower energy risks make it likely that any downturn will be moderate rather than severe, but medium-term challenges will remain.

### Near-term risks have fallen thanks to healthy gas storage

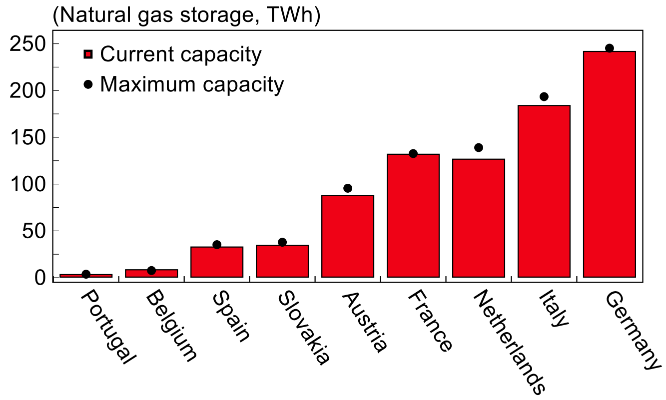
There has been good news at the start of Q4. Europe is now in the traditional 'heating season' when gas use rises to around 2.5 times the levels seen in the summer. However, it has been an unusually mild start to the autumn period (Chart 1). After a summer of LNG shipments and effective demand-reduction programmes, this has helped gas storage to essentially reach capacity in many places (Chart 2). Some longer-term forecasts are now suggesting that weather conditions may be slightly cooler than usual over the rest of the winter. However, the buffers now in place mean that Europe is well-placed to avoid the worst downside scenarios of blackouts and stringent rationing, unless temperatures fall to exceptional lows.

**CHART 1: A MILD AUTUMN HAS EASED ENERGY PRESSURES**




Source: DWD, Macrobond, MUFG Bank Economic Research Office

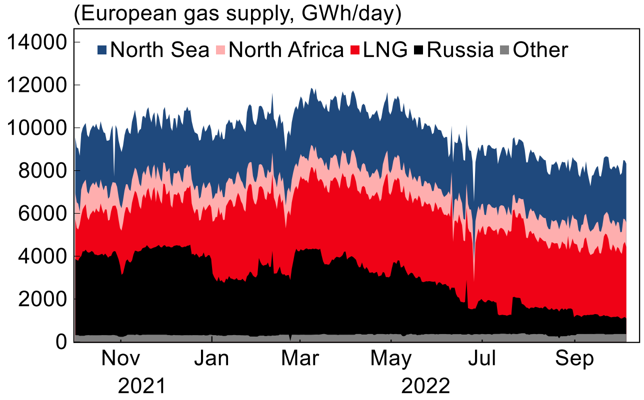
**CHART 2: GAS STORAGE SITES ARE CLOSE TO CAPACITY**




Source: Gas Infrastructure Europe, MUFG Bank Economic Research Office

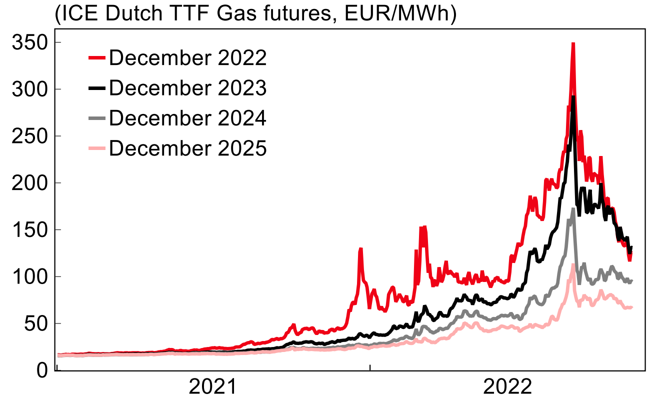
With gas storage now looking healthy, attention is increasingly turning to the 2023/24 winter. Russian gas flows supported the filling of storage sites in H1 (Chart 3). Despite the rush to construct LNG capacity, it will be a major challenge to return to the healthy fill levels we're seeing now without meaningful Russian gas supplies. Front-month gas prices may have fallen sharply in recent weeks but futures markets suggest that the European economy will continue to suffer from the negative terms-of-trade shock for some time yet (Chart 4). Two and three-year ahead gas prices haven't really shifted and remain well above pre-pandemic levels.

**CHART 3**: RUSSIAN GAS FLOWS HAVE BEEN REDUCED TO A TRICKLE




Source: ENTSOG, MUFG Bank Economic Research Office

**CHART 4**: ENERGY LIKELY TO REMAIN EXPENSIVE



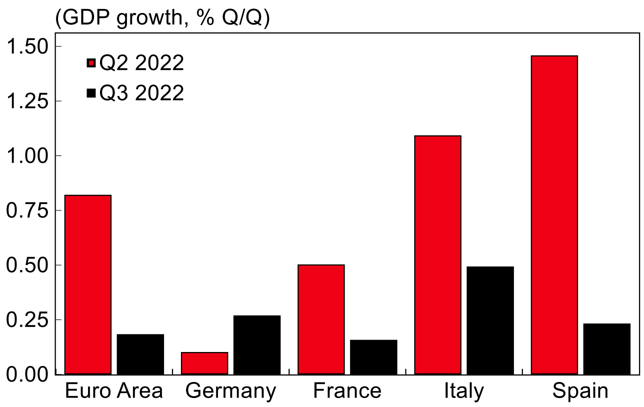

Source: ICE, MUFG Bank Economic Research Office

**A recession still looks inevitable**

The euro area economy eked out growth of 0.2% Q/Q in Q3. This above-consensus figure was supported by expansions in Germany (0.3%) and Italy (0.5%) as post-pandemic pent-up demand continued to boost to activity. There are also signs that improvements in supply constraints have helped the car industry.

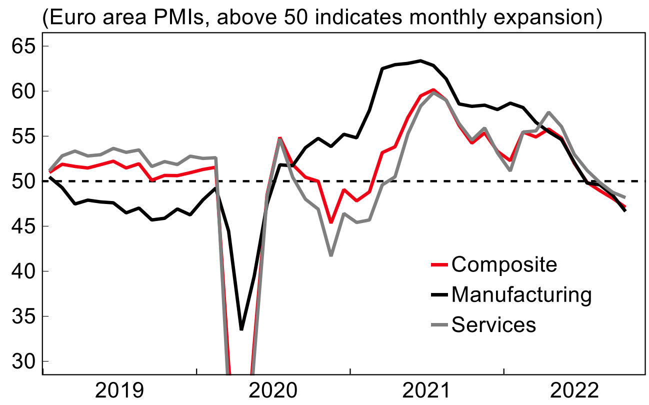
So, some encouraging news, but the small Q3 expansion doesn't change the broader picture. Growth is slowing and a euro area recession is still our base case. The latest survey data continues to paint a gloomy picture. The composite PMI has tumbled into contraction territory, mirroring developments in national survey indicators which show that the manufacturing sector is under particular pressure due to higher energy costs. The downturn in industry is likely to be deeper than that of the economy as a whole as energy- and gas-intensive firms curtail production.

**CHART 5**: NOT YET IN RECESSION, BUT GROWTH IS SLOWING SHARPLY




Source: Eurostat, MUFG Bank Economic Research Office

**CHART 6**:THE PMIS ARE SIGNALLING CONTRACTION



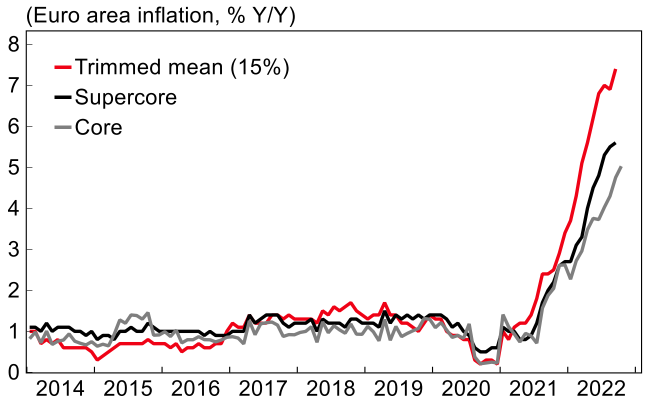

Source: IHS Markit, MUFG Bank Economic Research Office

Euro area inflation reached a fresh high of 10.7% Y/Y in October, as underlying pressures continue to rise (Chart 7). The headline rate may have further to go, despite recent moderation in commodity prices and easing supply-chain constraints, with producer prices and survey data suggesting that further rises are in the pipeline.

Overall, we expect HICP inflation will average around 5.5% in 2023. This means that pressure on households will remain. The euro area labour market is still strong and there are signs in surveys and settlements that wage growth is picking up, but we expect real growth will remain in negative territory through most of next year.

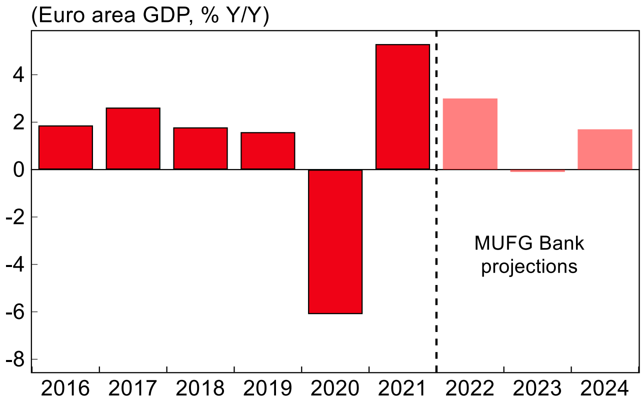
Tighter financial conditions will also be a drag as the ECB continues to tighten policy (it may have hinted at a dovish pivot at its last meeting but that high inflation print and upside GDP surprise will have given weight to the more hawkish arguments). The Q3 bank lending survey showed that credit standards have tightened significantly and this is set to weigh increasingly on household spending and firms' investment decisions. The recent UK experience also highlights how vulnerable markets may be to a new era of higher interest rates.

**CHART 7**: UNDERLYING INFLATION CONTINUES TO RISE




Source: Eurostat, ECB, MUFG Bank Economic Research Office

**CHART 8**: RECESSION LOOMS AHEAD




Source: Eurostat, MUFG Bank Economic Research Office

So, despite some encouraging news on the short-term energy supply front, the euro area economy will face a range of headwinds. A recession still feels inevitable – the only question is how deep it will be.

The accrual of gas buffers and introduction of significant fiscal policy support in recent months (most significantly from Germany) should prevent a severe recession, even if there is an unusually cold winter. Given that, our view is that the impending downturn is most likely to be 'moderate'. That is, we expect 2023 annual average growth will only be slightly negative for the euro area as a whole (although there are likely to be more severe contractions in Germany and Italy given their exposure to higher gas prices). However, energy challenges will remain for the euro area over the medium-term, and any subsequent recovery is likely to be muted (Chart 8).

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