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How resilient is the euro area economy?

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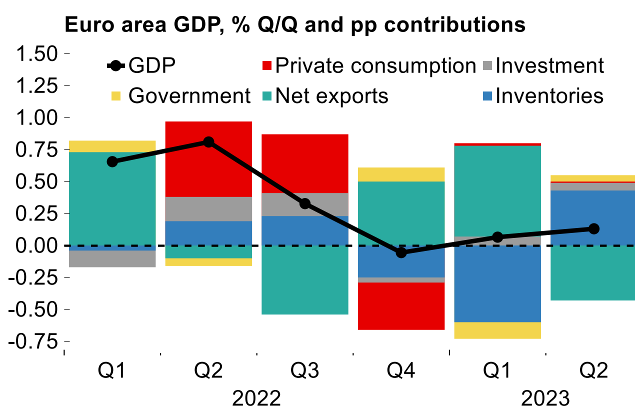
- The narrative of a resilient euro area economy is being challenged after a series of gloomy business surveys and a downward revision to the Q2 GDP estimate. Risks of a recession in H2 have clearly risen.
- The German economy looks particularly vulnerable as the industrial sector continues to struggle in the face of weaker external demand and structurally higher energy costs. It's hard to see much scope for a meaningful bounce.
- We look for GDP growth of just 0.6% in 2023 and 0.9% 2024. Risks are tilted to the downside. Our chief concern relates to the lagged effects of rapid ECB tightening and the withdrawal of energy-related fiscal support on activity.

Clear signs that the economy is flagging

The euro area economy navigated last winter's energy crisis without experiencing even a mild technical recession. The story seemed to be one of unexpected resilience and the hope was that rebounding sentiment and easing inflationary pressures would provide a foundation for stronger growth through H2 2023. That narrative is now being challenged. Growth is flat and rising energy costs are set to delay the disinflation process, which leaves the picture looking increasingly stagflationary.

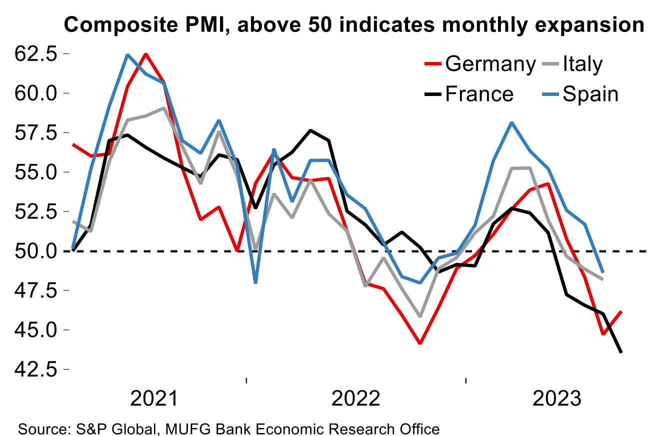
The sense of gloom has been compounded by a downward revision to the Q2 GDP numbers. Euro area growth was revised from a relatively healthy 0.3% Q/Q to just 0.1%. The main drag on the Q2 figures was from net exports (Chart 1) amid concerns about the effect of a slowing Chinese economy. This was offset by a positive contribution from inventories, but consumption and investment were both flat.

Chart 1: Three quarters of essentially flat GDP growth



Source: Eurostat, MUFG Bank Economic Research Office

Chart 2: Surveys are pointing to contraction



Source: S&P Global, MUFG Bank Economic Research Office

So there is little momentum into H2, and it could yet get worse with alarm bells now ringing again for recession. Survey data has weakened sharply through the summer

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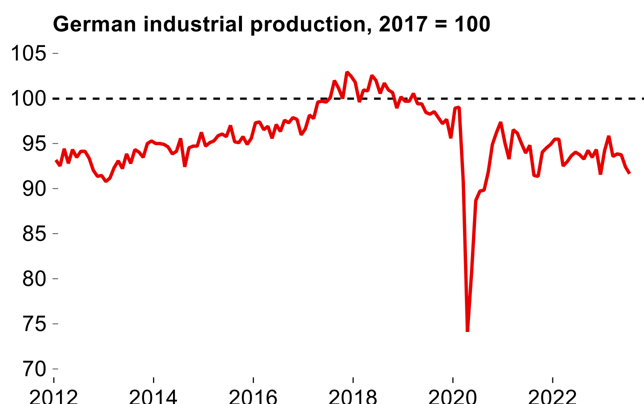
with the euro area composite PMI signalling a mild contraction in Q3. Both manufacturing and services are below the breakeven mark now. Weakness is especially pronounced in France and Germany (Chart 2).

The industrial sector's woes continue

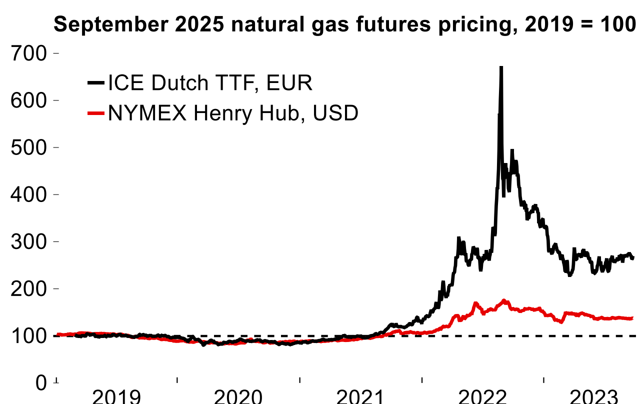
The outlook looks challenging for Germany in particular (in contrast to the post-GFC years it is the peripheral euro area countries which are now looking relatively stronger). Unlike the euro area as a whole, the German economy did not manage to avoid a winter recession. GDP in Q2 was 0.5% below the Q3 2022 mark. The signs are that things will get worse: factory orders plunged by 11.7% M/M in July and business surveys, including the reliable Ifo gauge, are pointing to an overall GDP contraction in Q3. It's not a shock that the German economy, with its export-orientated and capital-intensive manufacturing sector, is under cyclical pressures from a slowing China and rapid interest rate rises. But there are also longer-term issues at play. German industry is essentially stuck in a six-year recession (Chart 3). That's not just cyclical pressures: there are legitimate questions now on topics such as the automotive sector's struggles with the EV transition in the face of low-cost competition from China.

Chart 3: German industry is stuck in a six-year recession with no sign of a turnaround



Source: Destatis, MUFG Bank Economic Research Office

Chart 4: Structural rise in European gas prices will drag on European industry



Source: Macrobond, MUFG Bank Economic Research Office

On energy, it seems that Germany and the euro area as a whole will have to contend with structurally higher prices for years to come. With gas storage buffers looking healthy and the proven adaptability of the economy of last year behind us there is less nervousness going into this winter. However, gas futures point to prices remaining significantly higher than pre-crisis. This points to European industry, and countries such as Germany in particular, remaining at a comparative disadvantage to other countries such as the US (Chart 4). At this point it's hard to see much scope for a meaningful industrial rebound in the euro area over the medium-term.

Policy tightening is the main downside risk

As mentioned above there is less nervousness around energy costs going into the winter, despite recent upward moves in oil and gas prices. To our minds, the main downside risk now is that the euro area economy reacts more strongly than expected to policy tightening. Last week the ECB took the deposit rate to a record high of 4.0% (see here) and the speed of the tightening cycle has been unprecedented. It was a fairly dovish hike and may well be the peak in this cycle. However, looking at credit data it's clear that monetary policy has been in restrictive territory for some time. Christine Lagarde, ECB president, talked of “stronger” monetary policy transmission and noted that it is “effective”. The size and speed of the real economy's response to

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this sudden shift in financial conditions after years of lower-bound policy is hard to estimate and remains the key risk factor.

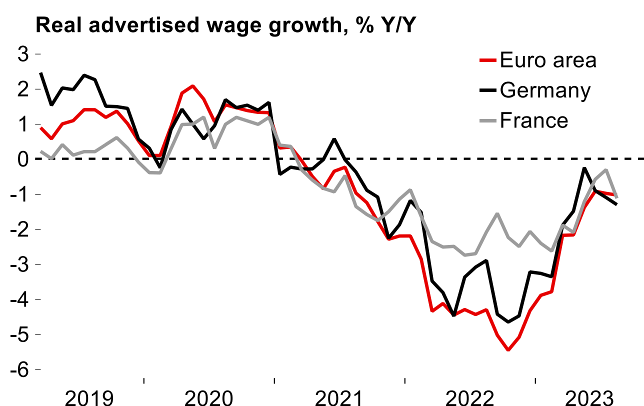
At the same time, the economy will also have to contend with tighter fiscal policy. Fiscal support related to the energy crisis in the euro area is around 1.8% of GDP this year. That will fall to 0.5% next year. Overall, we're moving to a more neutral setting for fiscal policy, but it's still a sudden and rapid shift from the expansionary government measures in place through 2022-23.

Will the euro area consumer come to the rescue?

After navigating the energy crisis, there was hope that the European economy would eventually benefit from recovering real income growth and stronger private consumption. This real wage recovery effect has not yet materialised – retail volumes have been broadly horizontal through 2023 – and may not provide such a boost as initially anticipated.

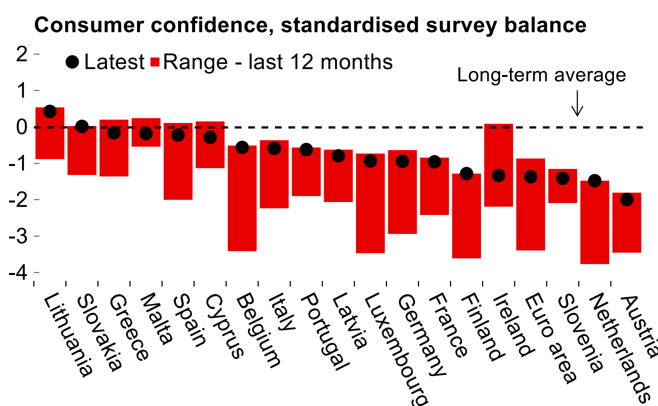
Headline inflation has now fallen 5.4pp from the peak of 10.6% recorded last October, but recent moves in energy prices could now delay the real wage recovery. There are signs that real income growth is now edging back into positive territory (Chart 5) but the outlook for headline inflation has deteriorated slightly. Last week the ECB raised inflation forecasts to 5.6% in 2023 (from 5.4% in June) and 3.2% in 2024 (from 3.0% in June), primarily on the back of higher energy costs.

Chart 5: There are signs now that real wage growth is edging back into positive territory



Source: Bank of Ireland/Indeed, Eurostat, MUFG Bank Economic Research Office

Chart 6: Consumer confidence has improved from last winter's lows, but remains weak



Source: European Commission, MUFG Bank Economic Research Office

Meanwhile, consumer confidence has improved markedly from the lows seen last year in most euro area countries, but is still languishing around one standard deviation below the long-term average (Chart 6). This *could* mean that there is scope for a sustained rebound in consumer spending – but some headwinds are likely to remain. The withdrawal of energy-related fiscal support measures through 2023 (see above), such as subsidised public transport, will be a drag. A lot will also depend on the euro area labour market. The unemployment rate is at an all-time low of 6.4% but survey evidence points to a slightly weaker outlook for jobs over coming months. Our base case is that the headline rate will edge slightly higher through 2024, but not to the extent that overall consumer spending will be meaningfully dented.

So, while we're somewhat optimistic that a degree of consumer resilience will continue, we don't completely buy into narrative that it could be a major growth driver through 2024. Overall, we look for euro area GDP growth to average 0.6% in 2023 and 0.9% in 2024. Risks to both those below-potential figures are tilted to the downside.

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