Economic Forecast for the European Economy

Near-stalling growth in H1 and weak activity in Q3 pave the way for fragile recovery in 2023 and beyond.

Low PMI readings point to underlying weaknesses persisting in the economy.

Despite dodging a technical recession in early 2023, and even registering positive - albeit anemic- growth in Q2, underlying weaknesses persist in the European economy. The Euro Area's Purchasing Managers' Index (PMI), an indicator of short-term economic activity, fell from 48.6 in July to 46.7 in August, marking the third consecutive month of contraction in business output. Notably, activity in the services sector, a key source of business growth throughout 2023, fell below 50 and into contradictory territory for the first time this year. The deep contraction in manufacturing output also continued. Among leading European economies, activity in Germany declined at the steepest rate. Tighter financing conditions and weakening domestic demand are critical reasons behind the deceleration of business activity in Q3. Beyond the near-term, we expect activity to pick up as moderating inflation, a robust labor market, and strong wage growth that will support private spending will help the European economy to muddle through in the coming quarters. We project the Euro Area will expand by 0.7 percent in 2023, and experience moderate growth of 0.9 percent in 2024.

Despite an uptick in August, inflation is still set to moderate.

August inflation prints is a mixed bag of good and not-so-good news. Annual headline inflation remained unchanged from a month ago at 5.3 percent year-over-year. Despite price pressures for food, goods, and services rising at a slower pace than a month ago, a sudden increase in energy prices was the main reason keeping overall inflation unchanged from July. Core inflation on the other hand, which strips out energy and food prices from the headline figure and is a better way of gauging underlying price pressures in an economy, fell from 5.5 percent to 5.3 percent. Despite the August uptick, inflation is set to soften further in the coming quarters. Fast-falling producer prices and weak demand for goods hint goods inflation will come further down. Energy and food prices are also expected to ease further in coming months. As a result, we project inflation to fall from the record-high of 8.2 percent in 2022 to 5.9 percent in 2023 and then to 3.1 percent in 2024. However, as services inflation is likely to fall more slowly, due to stronger wage growth, we see core prices lingering above 5 percent in 2023, before falling to 3.1 percent in 2024.

The European Central Bank signals the end of its tightening cycle.

The European Central Bank (ECB) hiked its three key main rates by 25 basis points at its September meeting. Consequently, the deposit rate, the ECB's key monetary policy rate, increased from 3.75 to 4.0 percent. This is the tenth consecutive time the institution raises its main rate since July 2022, for a total of 450 basis points. Interestingly, according to the press release, it seems the September rate hike is likely the final one, assuming the ECB's objective is achieved, and inflation progressively returns to its medium-term objective of 2-percent in coming months. Looking forward, given already adverse financing conditions and a slowing economy, we expect the ECB to maintain rates at the current levels until the end of the year. However, assuming its monetary strategy does not materialize, and inflation is not tamed in a timely manner, future hikes in 2024 are possible.

The labor market will remain a bright spot to the economy.

The European labor market continues to provide a key source of strength to the European economy. Despite the recent economic slowdown, employment expanded by an additional 0.2 percent in Q2, while unemployment rate has stabilized at the historical low of 6.4 percent. Job vacancies in the region remain at historic highs and employment expectations are still positive and above their long-term average, according to latest data from the European Commission Business and Consumer surveys. All in all, we make no changes to our employment forecasts expecting the European labor market to maintain a strong and robust outlook in 2023 and beyond.

For more resources on the European economy, please see our monthly Economy Watch ***report*** *and annual long-term* ***outlook*** *(October 2022).*

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