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European Economics Analyst

Euro Area Outlook 2024: Fading Headwinds

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- 2023 has been a mixed year for the Euro area. Initially, the economy showed surprising resilience to the energy crisis, defying expectations for recession. Growth has disappointed since the spring, however, reflecting ongoing negative effects from high gas prices, a large drag from monetary tightening and weak global industrial activity. As a result, Euro area growth underperformed the US notably this year.
- We expect 2024 to be a better year for the Euro area economy for three reasons. First, we look for growth to pick up as these headwinds diminish. Real disposable income is set for a notable boost as headline inflation slows sharply and nominal wage growth remains firm, supporting consumer spending. The negative credit drag should recede notably in H1 as the ECB holds rates steady. And we look for manufacturing growth to normalise, even though the upside is limited as the global industrial environment remains mixed.
- We expect these receding headwinds to more than outweigh a rising fiscal drag and look for area-wide growth of 0.9% next year, slightly ahead of consensus. Looking across countries, we expect 0.6% in Germany, 1.1% in France, 0.7% in Italy and 1.7% in Spain.
- Second, we expect underlying inflation to normalise in 2024. Core inflation has cooled more than expected in recent months—with sequential core inflation now running at around 2½%—and wage growth is showing clear signs of deceleration. We expect the labour market to remain broadly resilient—with only a modest increase in the unemployment rate—but look for the normalisation in wage growth to continue, as the effects of past high headline inflation fade. We lower our projection for core inflation over the next year and now expect core inflation to fall to 2.7%yoy by mid-2024 (vs 2.9%yoy before).
- Third, we look for a more supportive ECB next year. Given progress with underlying inflation, we now expect the first deposit rate cut in 2024Q3 (vs 2024Q4 before)—with the possibility of a Q2 cut if growth surprises to the downside—and expect the ECB to lower the deposit rate by 25bp per quarter until reaching 2.5% in 2025Q4. We maintain our view that the Governing Council will taper its PEPP reinvestments in Q2.
- Another spike in natural gas prices—caused by a cold winter and/or escalating geo-political tensions—could put renewed upward pressure on headline inflation

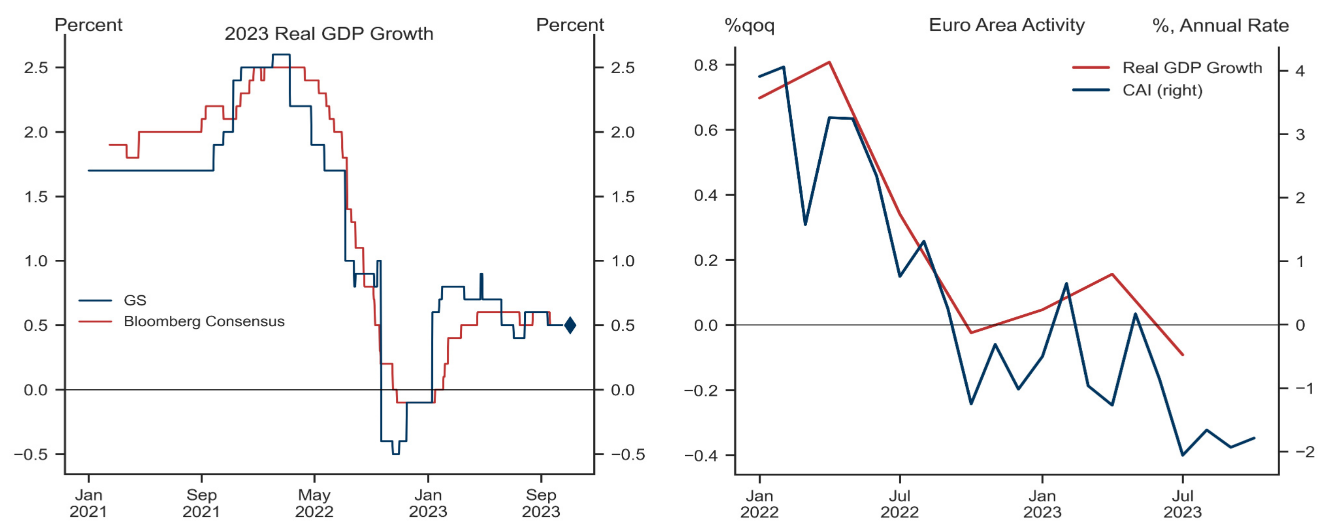
and mute the recovery in real household incomes. But we would expect only small spillovers to underlying inflation (given subdued demand and a high price level) and limited risks to gas balances (given high storage levels, lower demand and higher LNG imports).

- The more fundamental risk is that budget tensions in Italy could move back into focus given slowing nominal growth, higher interest rates and elevated deficits. Our central expectation is that any fiscal tensions remain manageable as Italian growth improves and the EU institutional backdrop remains supportive. But fiscal tensions could reappear and weigh on area-wide growth via tighter financial conditions and additional budget consolidation.

Fading Headwinds

The Euro area's 2023 economic performance has come in two parts (Exhibit 1). Initially, the economy showed surprising resilience to the energy crisis and defied expectations for a recession. This reflected significant fiscal support, substitution away from gas to other energy sources and new liquid gas supply routes.

Exhibit 1: Resilient First Half, Disappointing Second Half



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg

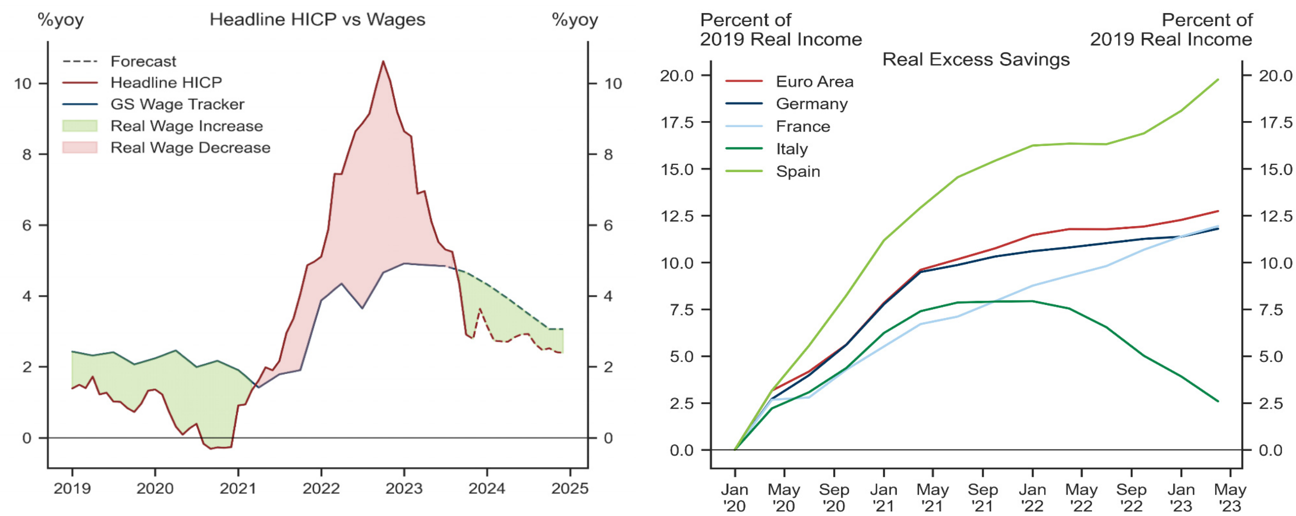
Since the spring, however, growth has disappointed given (1) ongoing negative effects from high gas prices, (2) a large drag from the ECB's tightening and (3) modest growth abroad, especially in China. As a result, Euro area growth underperformed the US notably this year and we look for continued subdued growth in Q4 at 0.1%qoq (not annualised).

Receding Headwinds

We see three main reasons to look for better growth in 2024.

First, household real incomes are likely to receive a significant boost from continued firm nominal wage gains and sharply falling headline inflation. Following a contraction until early 2023, we look for a 2.8% real disposable income gain in 2024. Rising disposable income combined with strong household balance sheets—households have still not unwound their pandemic savings, except in Italy—should provide a significant boost to consumer spending.

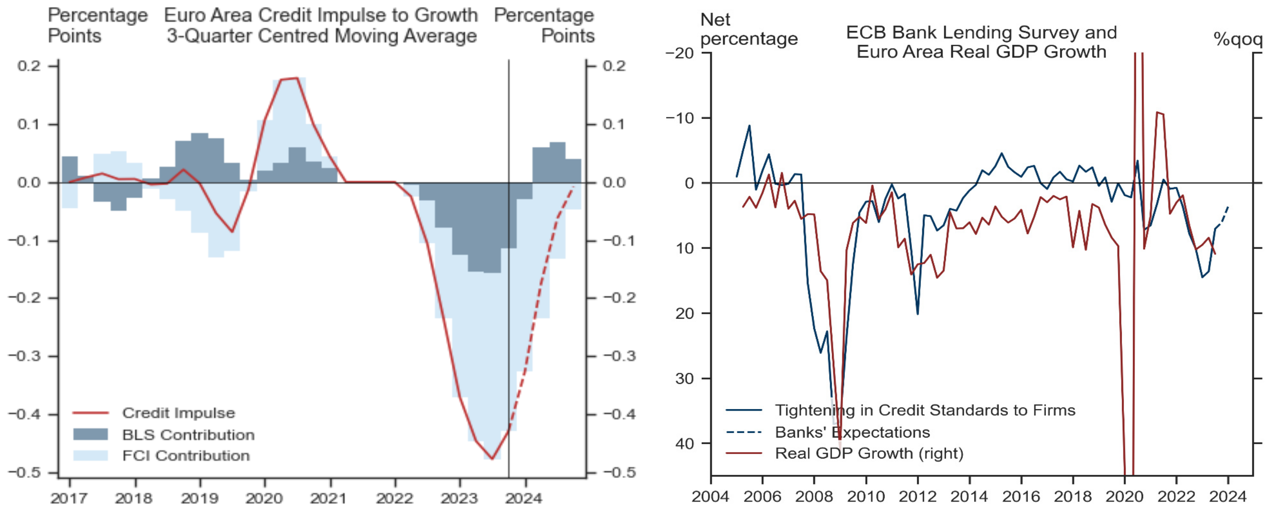
Exhibit 2: A Consumer Tailwind



Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, our analysis suggests that the credit drag on growth is likely to diminish rapidly in 2024. Combining our financial conditions index (FCI) with the ECB's Bank Lending Survey of lending conditions, we estimate that tighter credit conditions shaved almost 0.5pp off growth in Q3 (Exhibit 3, left). We find that the drag will remain elevated in Q4 but then diminish sharply in Q1 and Q2 next year. The intuition can be seen in Exhibit 3 (right), which shows that growth tends to respond to changes in credit conditions with a short lag.

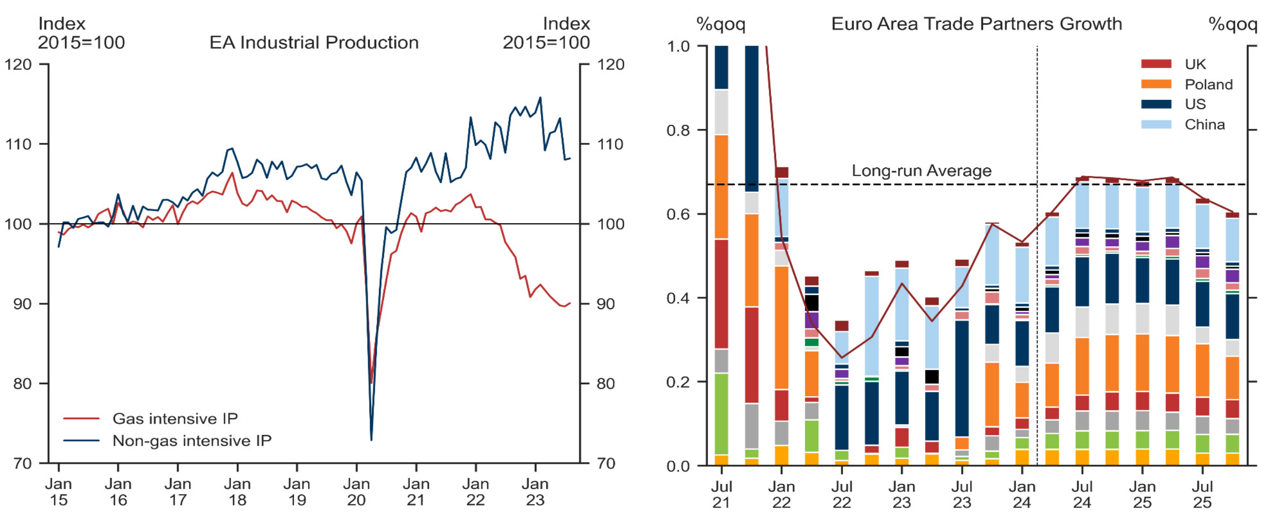
Exhibit 3: A Fading Credit Drag



Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

Third, we look for improvement in manufacturing activity over the next year. Some relief should come from energy-intensive sectors, where production looks to have bottomed as the adjustment to higher energy prices has advanced. And some relief should come from abroad as the global inventory drawdown comes to an end and the goods cycle picks up. That said, we do not look for the levels of European manufacturing activity to return to pre-covid levels, as energy prices remain much higher than before the pandemic and growth in China has slowed.

Exhibit 4: Some Manufacturing Relief

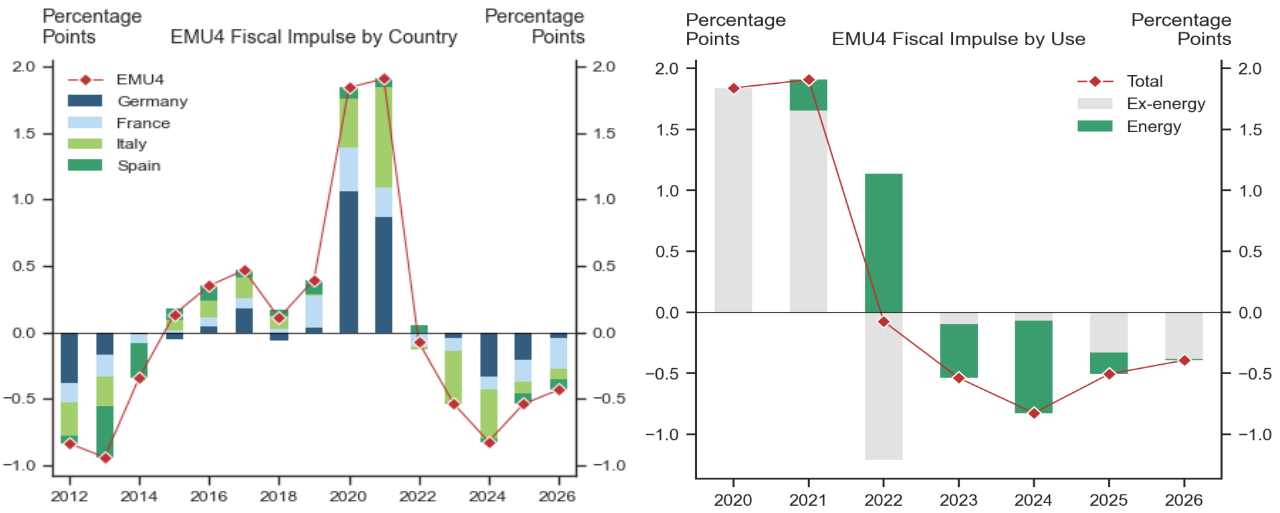


Source: Goldman Sachs Global Investment Research, Haver Analytics

The main headwind building into 2024 is fiscal policy, mostly reflecting the end of energy support measures and the normalisation of post-pandemic fiscal support. We estimate that the fiscal growth drag will build from 0.5pp in 2023 to about 0.8pp in 2024, and remain negative in 2025-26. The higher fiscal drag is largely due to Germany's removal of energy support policies and Italy's discontinuation of construction tax credits in 2024, with France and Spain providing a more backloaded contribution in 2025 and

2026.

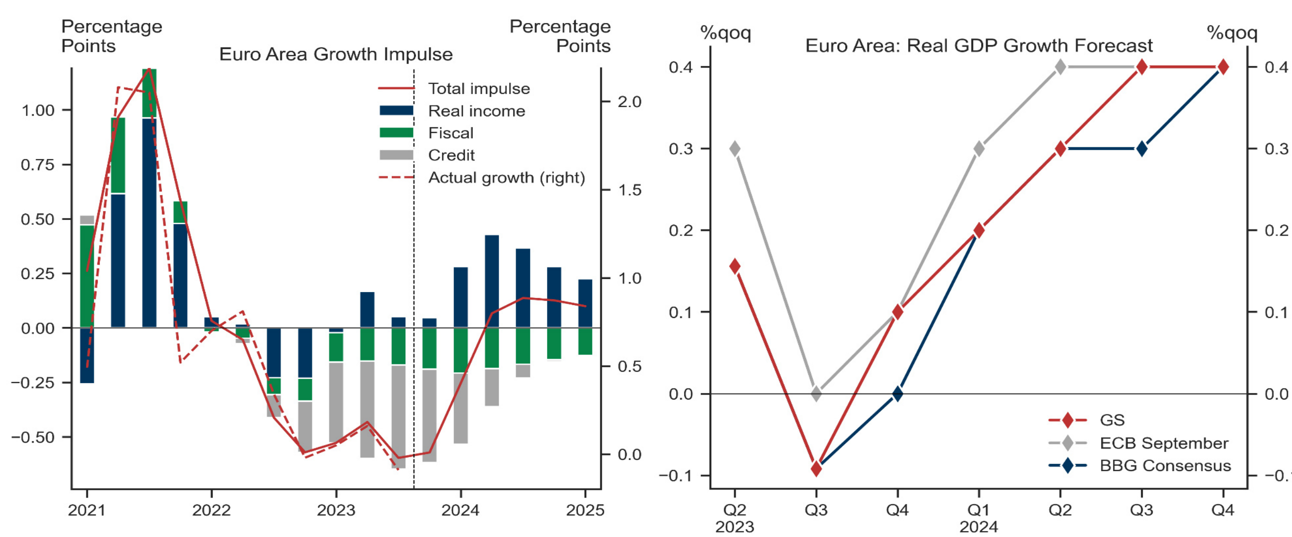
Exhibit 5: More Fiscal Drag in 2024, As Energy Support Measures Unwind



Source: Goldman Sachs Global Investment Research

On net, our analysis of the growth tailwinds and headwinds points to better growth next year (Exhibit 6, left). We estimate that the net impulse should remain significantly negative in Q4 but then improve notably in Q1 and Q2 as the credit drag fades and the boost from lower inflation comes through. Our analysis then points to a slightly above-trend growth pace in 2024H2.

Exhibit 6: A Growth Pickup in 2024

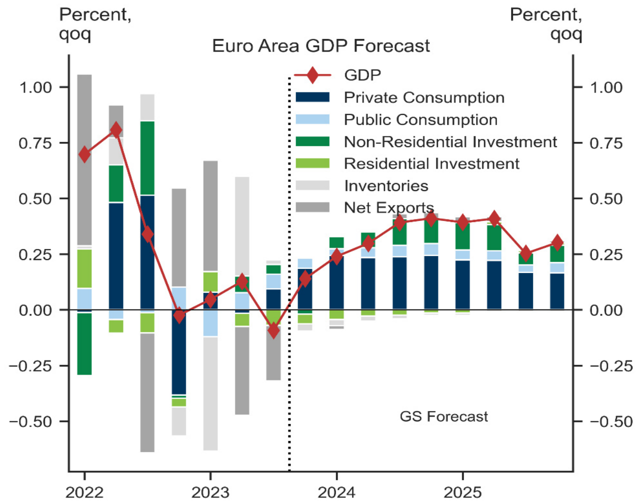


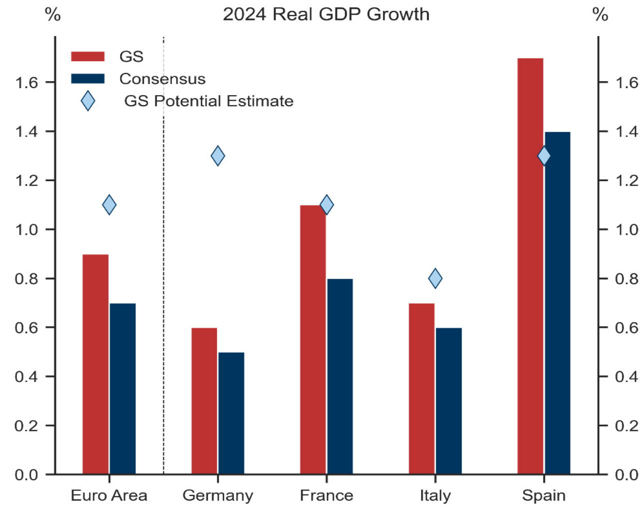
Source: Goldman Sachs Global Investment Research, Bloomberg, ECB

Consistent with this, we look for a significant growth pickup in H1, with 0.2% in Q1 and 0.3% in Q2, followed by 0.4% in H2 (Exhibit 6, right). Our forecast is below the ECB's September staff projections but slightly above consensus.

Looking across components, we expect consumer spending to drive the pickup in growth in 2024, outweighing a drag from trade and residential investment (Exhibit 7, left). We expect business investment to grow steadily in coming years, reflecting support from the Recovery Fund and energy-related initiatives. Looking across countries, we expect 0.6% growth in Germany, 1.1% in France, 0.7% in Italy and 1.7% in Spain (Exhibit 7, right).

Exhibit 7: Looking Across Components and Countries





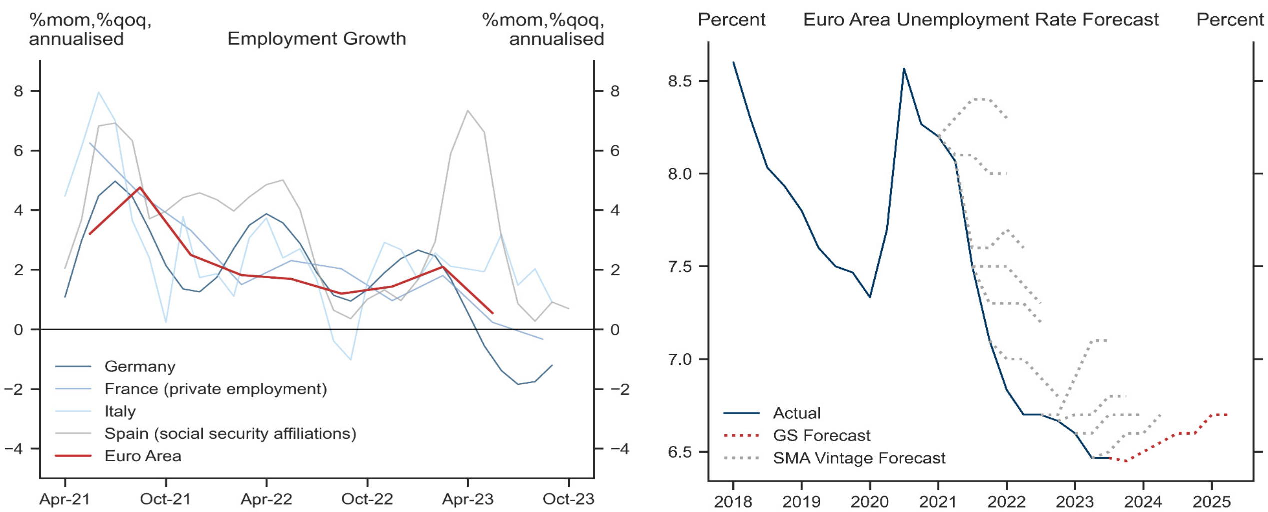
Source: Goldman Sachs Global Investment Research, Bloomberg

Next year's growth drivers are likely to vary a bit across Euro area countries. In Germany, we expect the consumer to drive the majority of the growth improvement, as real disposable income recovers despite the removal of government support, and the saving rate continues to normalise. In France, we see less scope for a rebound in real disposable income—which has been buffered by generous fiscal support—and instead look for a normalisation of the household saving rate, which has remained higher than in other countries in the region. We expect a more muted consumer boost in Italy (given some upward pressure on the saving rate) but the reacceleration in implementation of the Recovery Fund should support capital expenditure. Spain, by contrast, should benefit from both continued consumption resilience and elevated investment growth.

Continued Disinflation

Given below-trend growth this year, the labour market has started to slow and is likely to weaken gradually over the next year. We expect employment growth to stall in coming quarters and push up the unemployment rate over the next year. Given our expectations for somewhat better growth next year, we expect only a limited deterioration of the labour market, with the area-wide unemployment rate rising from 6.5% at the moment to 6.7% over the next year.

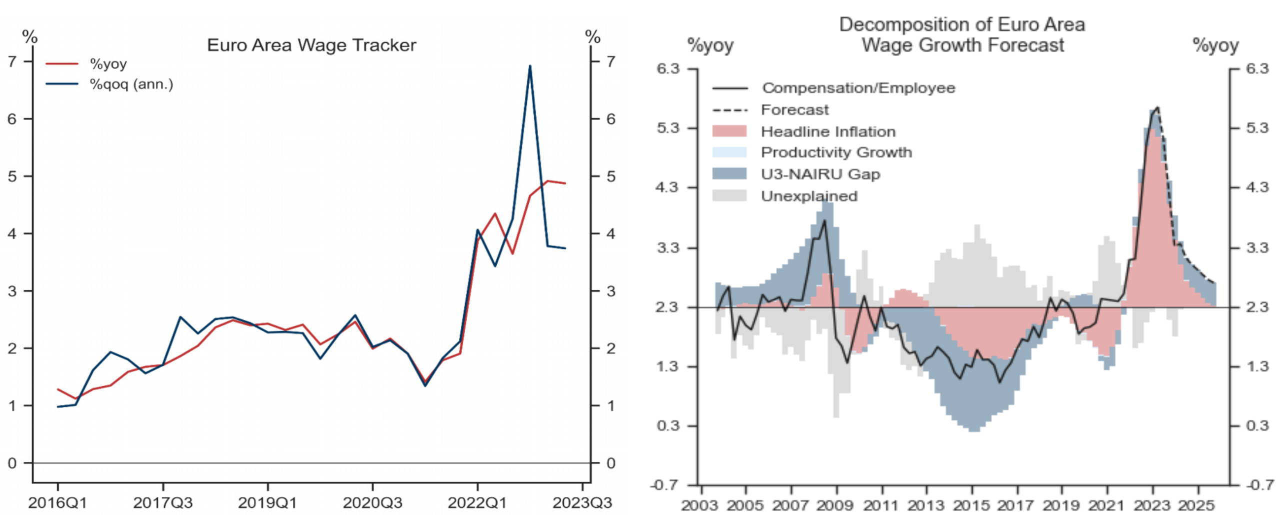
Exhibit 8: A Gradual Weakening of the Labour Market



Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

Wage growth, however, has already started to cool and is likely to normalise further over the coming year. This is because our analysis suggests that catch-up effects to past headline inflation have been the key driver of wage strength, and we look for pay growth to decelerate to around 4%yoy by end-2023 and almost 3%yoy by end-2024. The wage negotiations running from December to March—including hospitality services in Germany and public employees in Italy—will be a key guidepost to confirming the cooling of labour cost pressures.

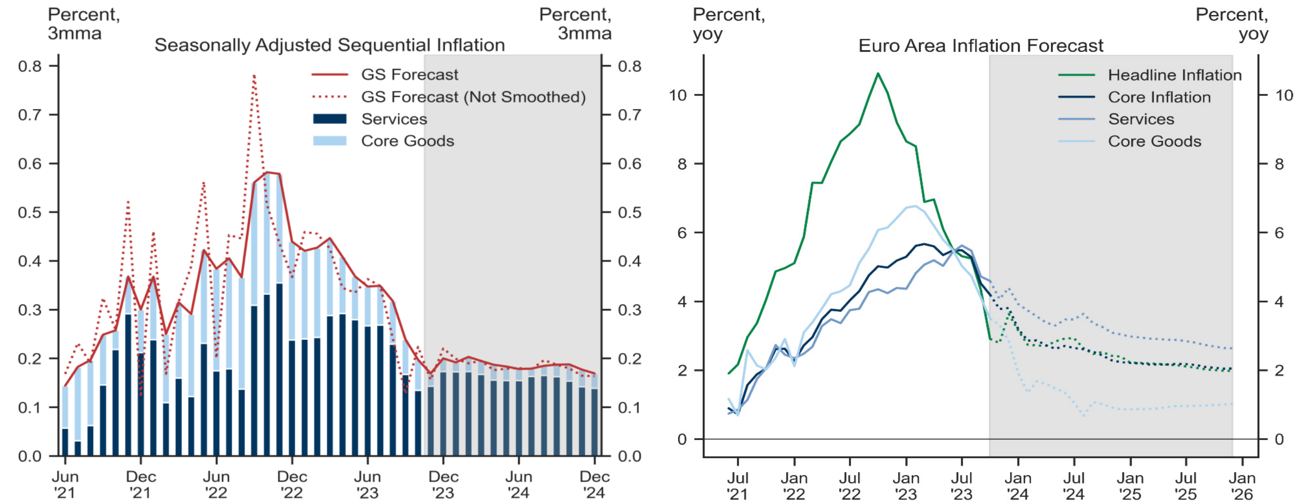
Exhibit 9: Cooling Wage Growth



Source: Goldman Sachs Global Investment Research, Haver Analytics

Underlying inflation measures have likewise shown significant improvement. In particular, we estimate that sequential core inflation has slowed from an annualised pace of 5½% in Q1 to about 2½% over the last three months. Most of the cooling so far reflects weaker core goods inflation, as energy prices have come down and global bottlenecks have eased. But sequential services inflation has slowed, too, and is likely to continue its deceleration as wage growth normalises.

Exhibit 10: More Progress with Disinflation



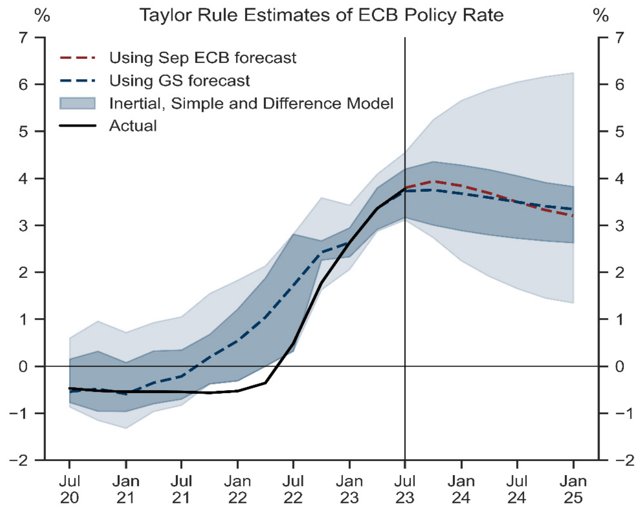
Source: Goldman Sachs Global Investment Research, Haver Analytics

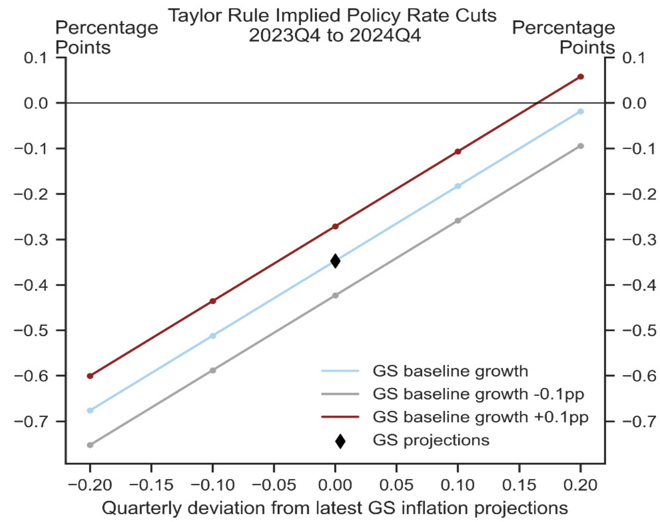
Given the better inflation news, we slightly lower our inflation forecast for the year ahead and look for core inflation to reach 2.7%yoy in mid-2024 (vs 2.9% before), 2.2%yoy in December 2024 (vs 2.3%yoy before) and 2%yoy at the end of 2025 (vs 2.1% before).

Earlier ECB Cut, Higher Long-Term Rate

Given the encouraging news on inflation, we expect the ECB to remain firmly on hold. While recent communication has left the door open for additional tightening, we see a high hurdle for more hikes, consistent with our estimated Taylor rule framework, which points to an extended period with the deposit rate at 4% (Exhibit 11, left). Recent commentary has emphasised the importance of the 2024 wage negotiations—most of which occur between December and March—to confirm that pay pressures are normalising as expected. This, we believe, signals that the hurdle for rate cuts is high until Q2.

Exhibit 11: ECB Now Firmly on Hold



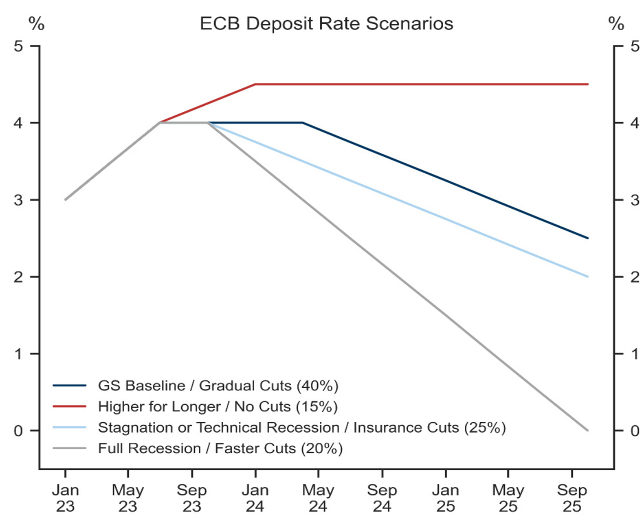


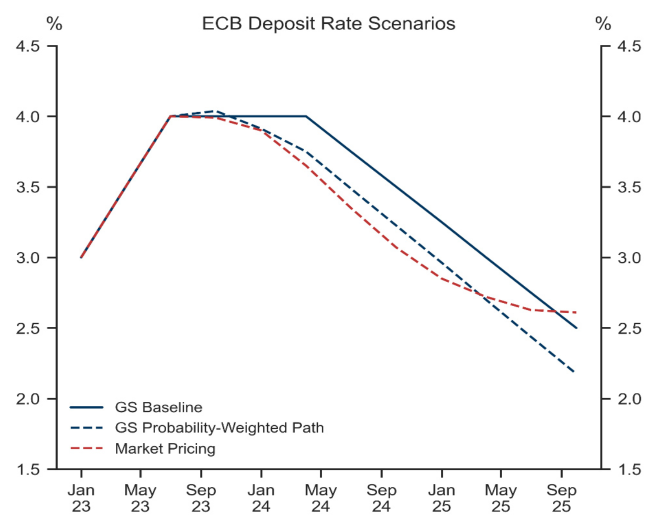
Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB

Given our forecast for weaker core inflation in 2024H1, we pull forward our forecast for the first cut from 2024Q4 to 2024Q3—consistent with the predictions from our updated Taylor rule—and now look for two 25bp cuts next year. That said, a Q2 cut is possible if growth and/or inflation surprise to the downside, and we would expect the Governing Council to lower the deposit rate more quickly if the economy slides into recession (Exhibit 11, right).

As a result, the risks around our central path for the deposit rate are skewed to the downside. Exhibit 12 presents stylised scenarios and shows that the GS probability-weighted path is significantly below our modal forecast but slightly above current market pricing.

Exhibit 12: Our Probability-Weighted Deposit Rate Forecast is Below Our Modal Baseline Forecast

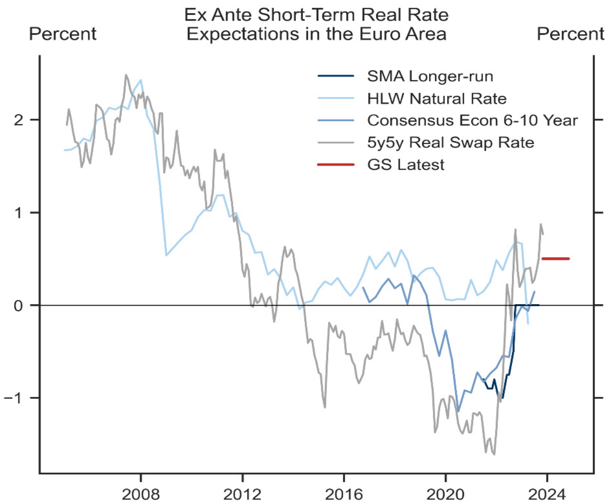


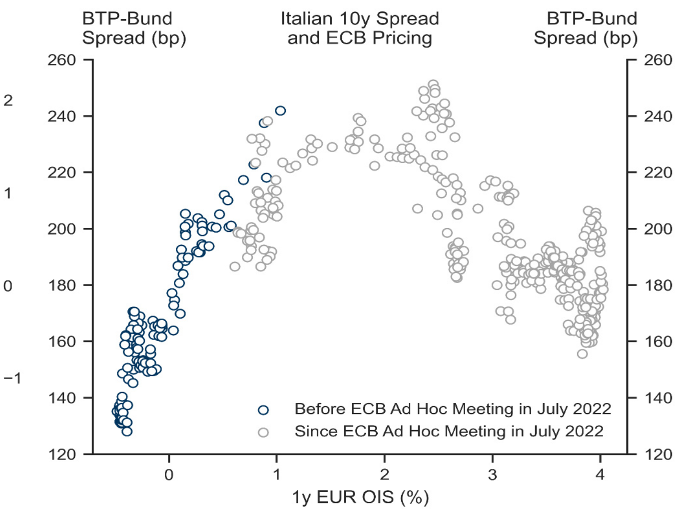


Source: Goldman Sachs Global Investment Research, Bloomberg

Looking further ahead, we raised our long-term deposit rate forecast from 2% to 2.5%. Recent estimates of the equilibrium rate point to an increase since the pandemic to a range of -1.5% to 0.5% in real terms (Exhibit 13, left). We see a number of reasons to believe that the equilibrium rate has increased and now stands at the upper end of this range, including changes in European fiscal policy, a strong co-movement between global rates and advances of the Euro area's institutional architecture, including the ECB's new anti-fragmentation tools. In particular, the more muted co-movement between policy rates and sovereign spreads points to the need for a higher terminal policy rate to ensure that inflation returns to 2% (Exhibit 13, right).

Exhibit 13: A Higher Equilibrium Rate

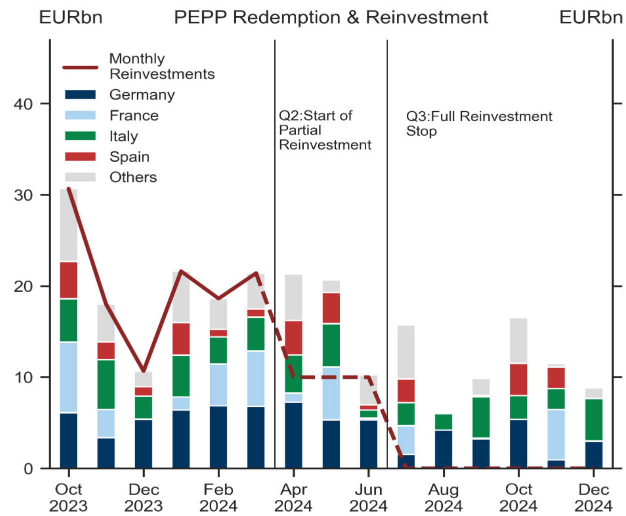


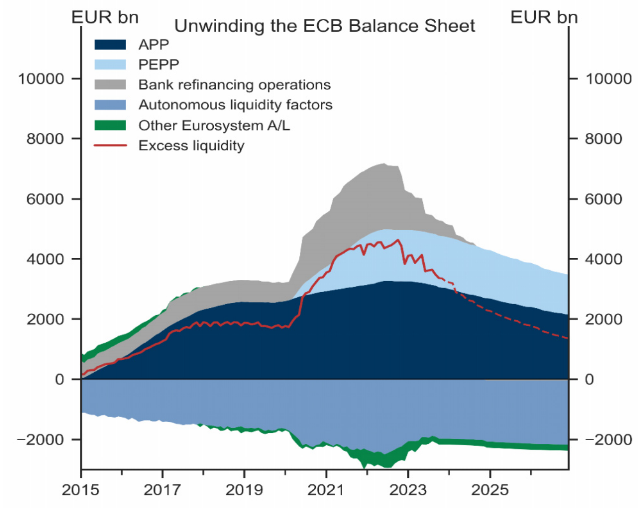


Source: Goldman Sachs Global Investment Research, Haver Analytics, ECB, Consensus Economics, Bloomberg

Turning to the balance sheet, we expect a gradual move towards ending PEPP reinvestments (Exhibit 14). In particular, we expect the Governing Council to limit PEPP reinvestments in 2024Q2 to EUR 10bn per month, before stopping all reinvestments from 2024Q3. But we expect ECB officials to proceed carefully, with a formal decision in Q1 and flexibility to amend the monthly target (across time and countries) depending on the dynamics of financing conditions. That said, a further rise in European bond yields or an earlier rate cut could push back the timeline for tapering PEPP reinvestments. We do not expect any changes to the ECB's reserve remuneration parameters until the operational framework has been concluded in the spring.

Exhibit 14: Partial PEPP Reinvestments from Q2, No Change to Reserve Remuneration until Spring





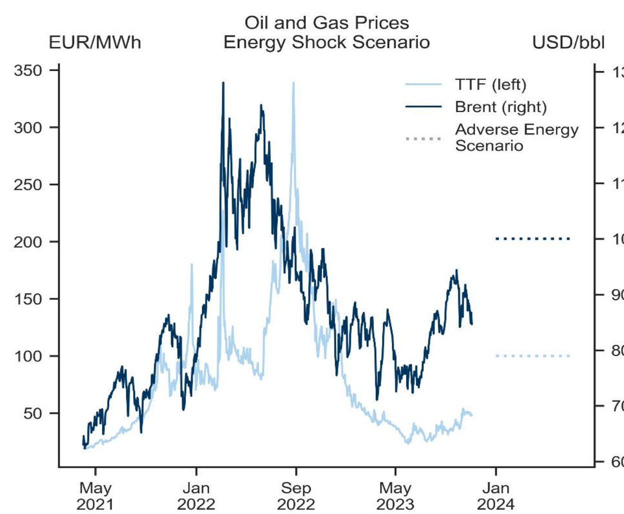
Source: Goldman Sachs Global Investment Research, Haver Analytics

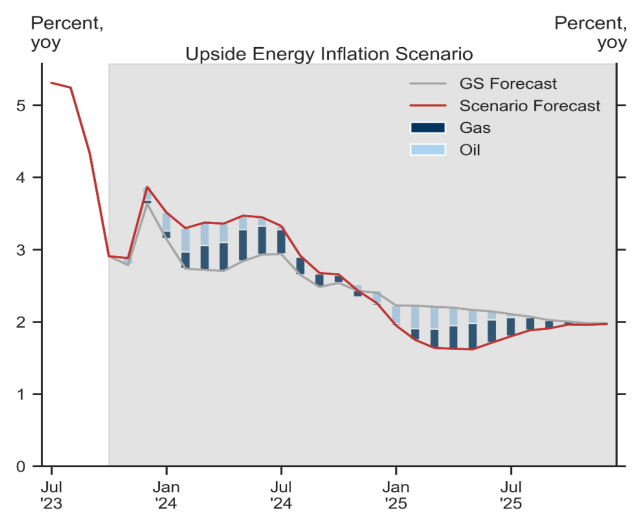
Sources of Uncertainty

The European economic outlook remains unusually uncertain and we will be focusing on two particular risk factors.

The first is a renewed spike in natural gas prices, caused by a cold winter and/or escalating geo-political tensions. Our commodity team laid out such a scenario in which oil prices rise to $100/bbl and European gas prices spike to 100 EUR/MWh. We estimate that higher energy prices in this scenario would put renewed upward pressure on headline inflation (up 0.7pp at the peak in March/April) and mute the expected recovery in real household incomes (lowering real GDP growth via consumption by 0.1-0.2pp in each of 2024Q1 and Q2).

Exhibit 15: Inflation Risks from Renewed Energy Pressures

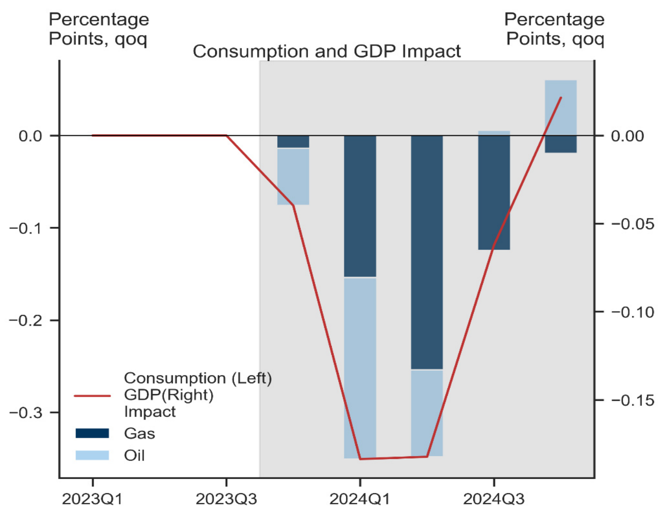


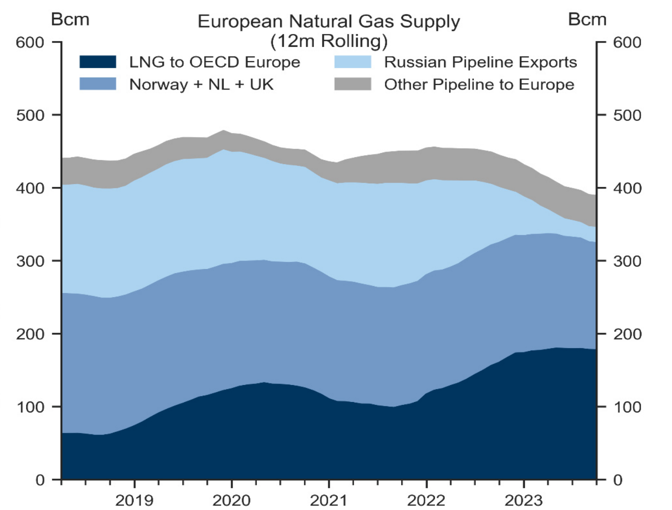


Source: Goldman Sachs Global Investment Research, Haver Analytics

But we would see only small effects on underlying inflation, as the propagation of the energy shock would likely be muted by subdued demand and contractionary monetary policy. Moreover, we see more limited risks to gas balances tightening than last winter given high EU gas storage levels, lower demand across the region and higher LNG imports.

Exhibit 16: But More Limited Risks to Activity

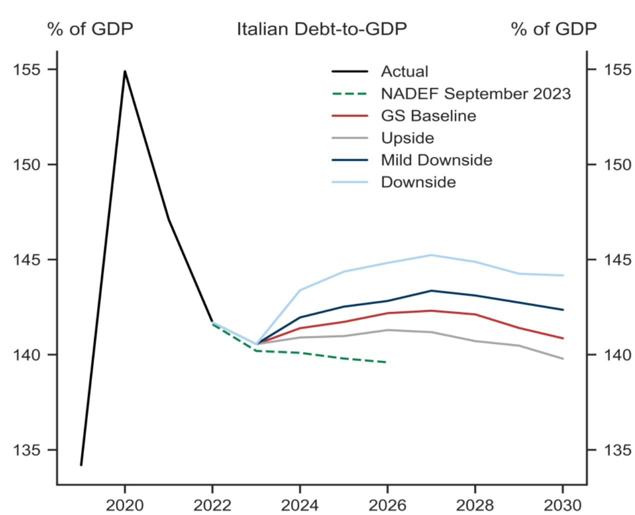


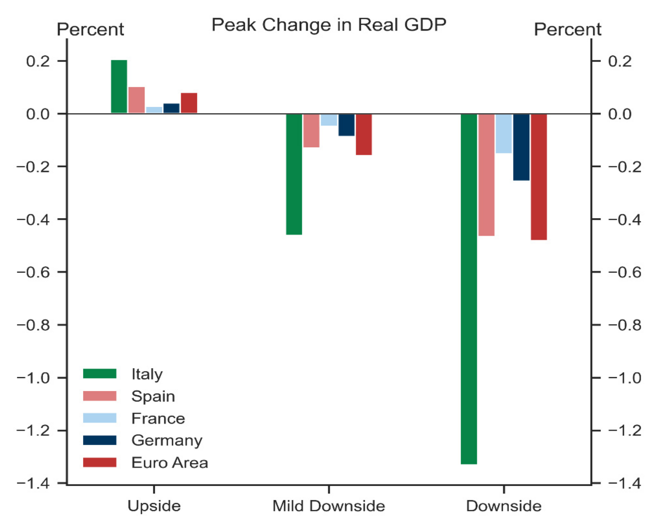


Source: Goldman Sachs Global Investment Research, Haver Analytics

The more fundamental risk is that budget tensions in Italy could move back into focus given slowing nominal growth, higher interest rates and elevated deficits. Our central expectation is that the BTP-Bund spread drifts moderately wider in coming months but that any fiscal tensions remain manageable as Italian growth improves, Recovery Fund implementation re-accelerates and the EU institutional backdrop remains supportive.

Exhibit 17: Potential Spillovers from Italian Budget Tensions





Source: Goldman Sachs Global Investment Research, Haver Analytics, Italian Ministry of Finance

More severe fiscal tensions could reappear and weigh on growth via tighter financial conditions and additional budget consolidation. Our scenario analysis points to an area-wide output cost of 0.2% in a mild downside scenario, where 10-year BTP-Bund spreads widen to 250bp and the debt-to-GDP ratio rises more notably, but additional fiscal consolidation in Italy and the EU institutional architecture anchor yields and limit the fallout for growth. We estimate that the area-wide GDP cost could rise to 0.5% in a downside scenario, where a 10-year BTP-Bund spread widening to 300bp calls into question the sustainability of Italy's debt and a sharper fiscal adjustment clears the way for the ECB to signal its willingness to activate the TPI. Ultimately, investors will likely focus on the ability of the Italian government to respond promptly to building tensions through fiscal adjustment, which is key to securing continued support from EU institutions, including the Commission and the ECB.

European Economics Team

Disclosure Appendix

Reg AC

We, Sven Jari Stehn, Filippo Taddei, Christian Schnittker, James Moberly, Alexandre Stott, Ibrahim Quadri and Katya Vashkinskaya, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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