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European Economics Analyst

2023 Europe Outlook: Milder Recession, Higher Terminal Rate (Team Europe)

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- We maintain our long-held view that the energy crisis will push the European economy into recession this winter, as surveys and production data point to a sizeable slowing in energy-intensive industries, and high inflation will reduce real household incomes. But we now see a shallower recession as the hard data have remained surprisingly resilient, the rebalancing of the gas market has reduced the risk of energy rationing and governments have provided significant fiscal support. We forecast that the Euro area economy will contract by only 0.7% from 2022Q4 to 2023Q2 (vs 1.1% before).
- That said, Europe's gas supply situation remains fragile, fiscal policy will probably slow growth in 2023-24 as the energy support winds down, and the gas crisis is likely to leave substantial supply-side damage. We therefore see a muted recovery and shave our growth forecasts for 2023H2 and 2024Q1. We now look for area-wide growth of -0.1% for 2023 and 1.4% for 2024, close to consensus over the next two quarters but slightly below for the remainder of 2023 and early 2024.
- Looking across countries, we expect Germany and Italy to be more affected by the energy crisis than France and Spain. Rising sovereign yields, high debt and weak growth leave Italy's new government on a narrow fiscal path, highlighting medium-run fiscal vulnerabilities. The French government struggled to build a majority around its 2023 budget and political uncertainty (including the chance of early elections) remains.
- Although gas prices have fallen significantly, we expect Euro area inflation to peak in December given continued energy pass-through and strong underlying momentum. Core inflation is likely to ease gradually over 2023 as goods price inflation cools, but we see sticky services inflation due to continued labour and energy cost pressures. We look for core inflation to end 2023 at 3.1% and 2024 at 2.2%.
- We expect the ECB to step down the pace of hiking to 50bp in December as the deposit rate approaches the neutral rate, the ECB staff cut their growth projections and the Fed slows its pace of hiking. But given a shallower recession and ongoing inflation pressures, we now look for the Governing Council to take the deposit rate to 3% with a final 25bp hike in May 2023. We expect ECB officials to decide in Q1 to start a passive unwind of its asset purchase

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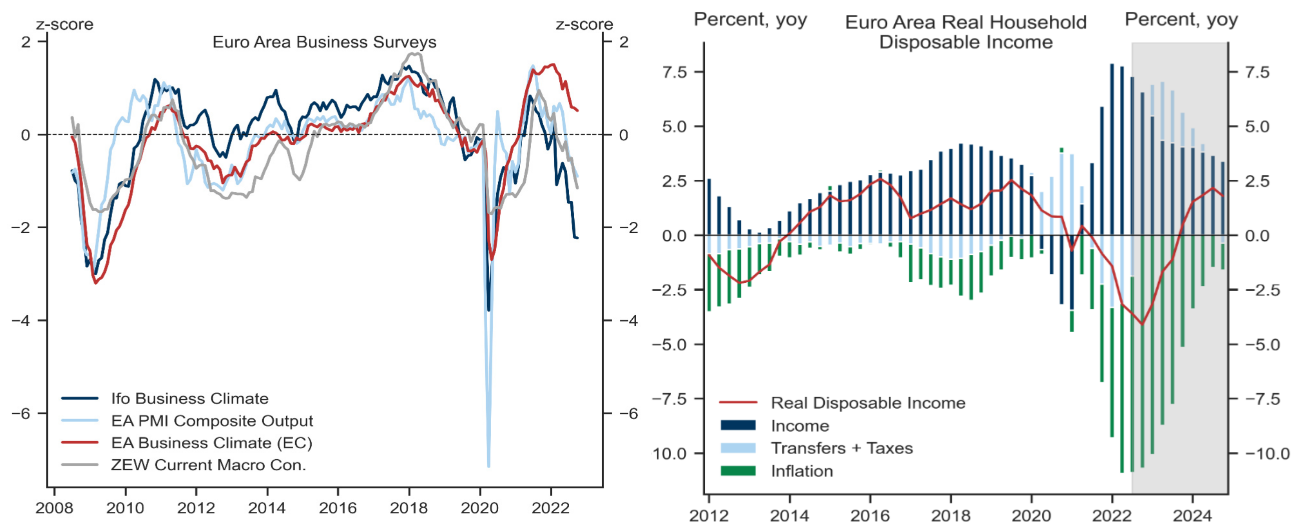
programme (APP) in Q2.

- While data revisions now suggest a slightly smaller UK contraction in H2, we continue to look for a deeper recession in the UK than in the Euro area given weak momentum, less fiscal support and supply-side constraints. The labour market has remained firm despite the slowing of the economy, pointing to persistent wage and inflation pressures ahead. Although we expect the BoE to step down the pace of hiking to 50bp in December, we think the BoE needs to take Bank Rate into significantly restrictive territory despite its dovish rhetoric and maintain our forecast for a terminal rate of 4.5% in May 2023.

Milder Recession, Higher Terminal Rate

We expect the energy crisis to push the Euro area into recession this winter. The surge in energy prices is likely to weigh notably on industrial activity and forward-looking indicators point to sizeable production cuts ahead, especially in gas-intensive industries (Exhibit 1, left). At the same time, we expect high inflation to reduce real household incomes sharply, which will likely push down consumer spending over the winter (Exhibit 1, right).

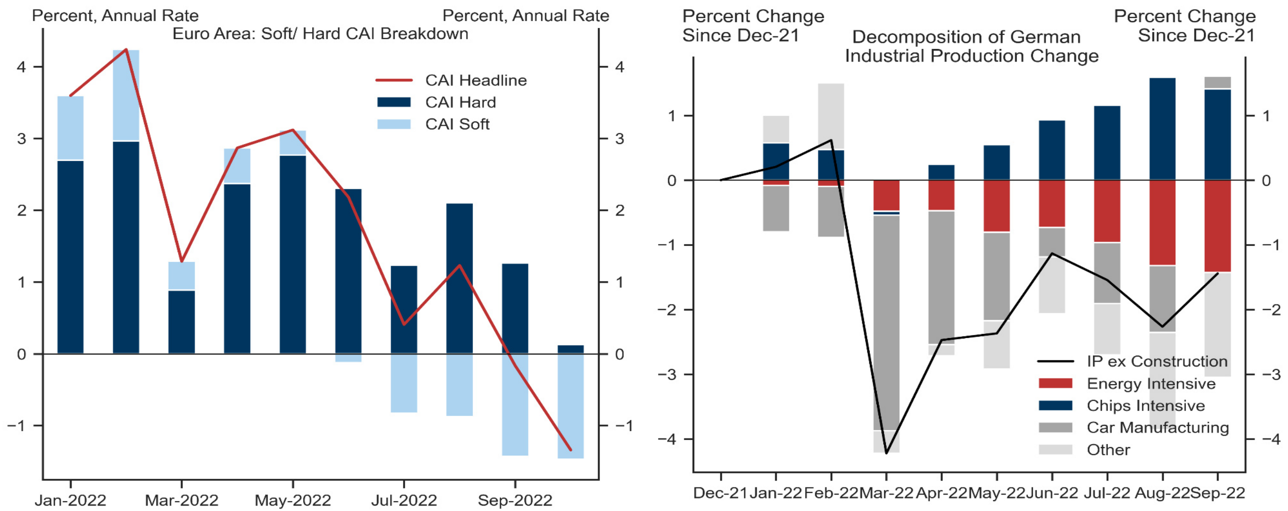
Exhibit 1: A Challenging Outlook for the European Economy



Source: Goldman Sachs Global Investment Research, Haver Analytics

That said, we now expect the Euro area recession to be shallower. First, the incoming data have remained more resilient than expected (Exhibit 2). Real GDP in Q3 surprised to the upside and the hard data coming into Q4 (September industrial production and retail sales) showed continued growth. While some of the resilience in industrial production likely reflects the easing in supply bottlenecks, European manufacturing has (so far) adjusted remarkably well to higher energy prices.

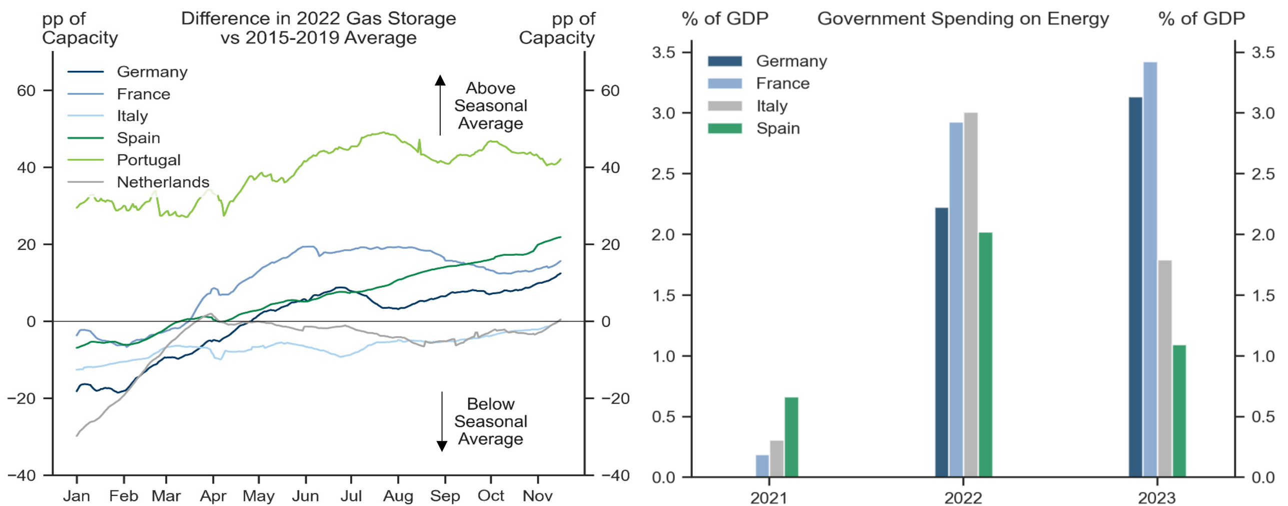
Exhibit 2: The Hard Data Remain Resilient



Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, the rebalancing of the gas market—with a build-up of significant gas storage and sharp declines in gas prices—has reduced the risk of energy rationing this winter (Exhibit 3, left). While a cold winter remains a risk, our estimates suggest that the Euro area should make it through the winter without running out of gas, avoiding costly energy rationing as a result.

Exhibit 3: Gas Storage and Fiscal Support to Cushion the Recession



Source: Goldman Sachs Global Investment Research, Haver Analytics

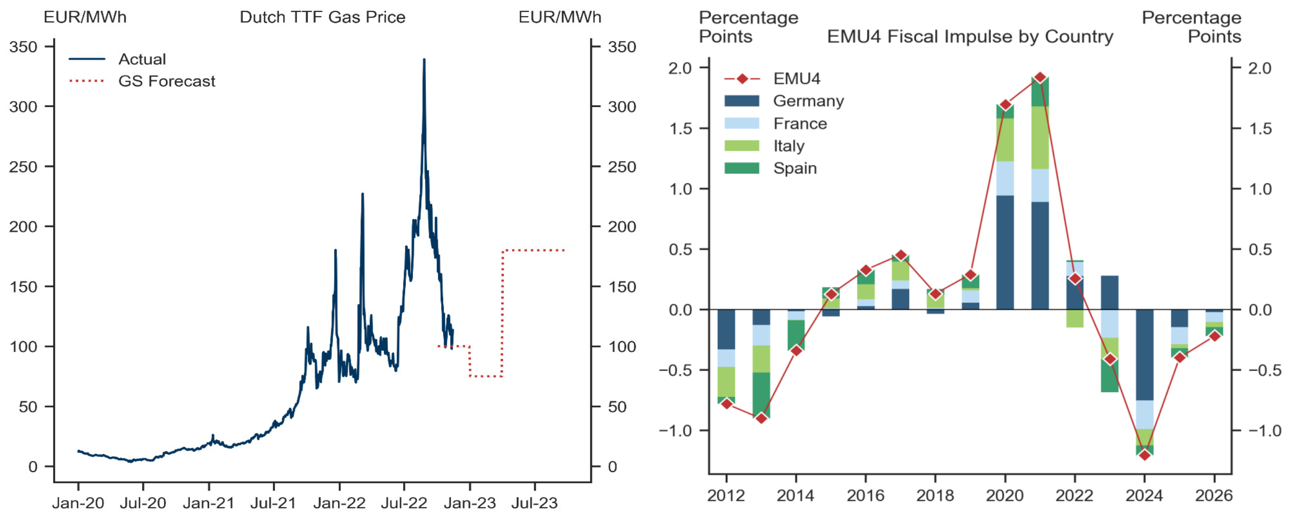
Third, governments have provided significant fiscal support to cushion the growth hit (Exhibit 3, right). Taken together, Euro area governments provided energy support of about 2.5% of GDP in 2022, which we expect to be extended to 2023. These measures—mainly focused on household support—are likely to provide significant offset to the contraction in real incomes.

We therefore revise up Q4 and Q1, pointing to a shallower recession, with a cumulative decline in real GDP of 0.7%. We now expect the Euro area economy to contract by

0.2% in Q4 (vs 0.4% before), 0.4% in Q1 (vs 0.6%) and 0.1% in Q2 (unrevised).

That said, we see several reasons for a muted recovery from the recession. First, Europe's gas supply situation remains fragile and we expect tensions in the gas market to re-intensify after the winter (Exhibit 4, left). Gas storage is likely to be low after this coming winter and the Euro area will struggle to fill the gas tanks for next winter, especially if China reopens as expected in Q2. While our commodity team has lowered its summer 2023 gas price forecast to EUR180 (vs EUR235 before), they maintain the view that gas prices will have to rise again after the winter to attract sufficient liquid gas to Europe.

Exhibit 4: Drags on the Recovery

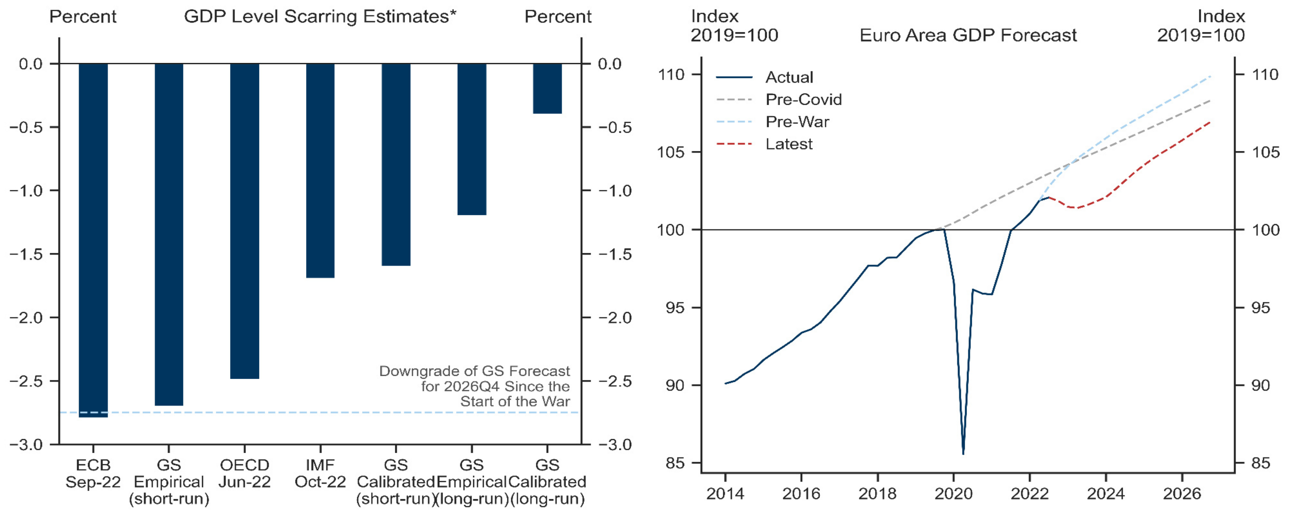


Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, fiscal policy will likely act as a significant drag on growth in 2023-24 as the emergency energy support comes to an end (Exhibit 4, right). While the Recovery Fund and off-budget funds help to cushion the extent of the fiscal drag, we now look for a negative fiscal impulse in 2023 (-0.4pp) and 2024 (-1.1pp).

Third, we see substantial supply-side damage from the energy crisis (Exhibit 5). Economic studies suggest that the reduction in gas supply implies a significant hit to potential output, although economies can lower this cost by substituting away from gas as an input into production over the medium term. Consistent with this, we expect a permanent hit of 2.4% to Euro area output, in sharp contrast to the V-shaped rebound seen from the pandemic.

Exhibit 5: The Permanent Cost of the Energy Crisis

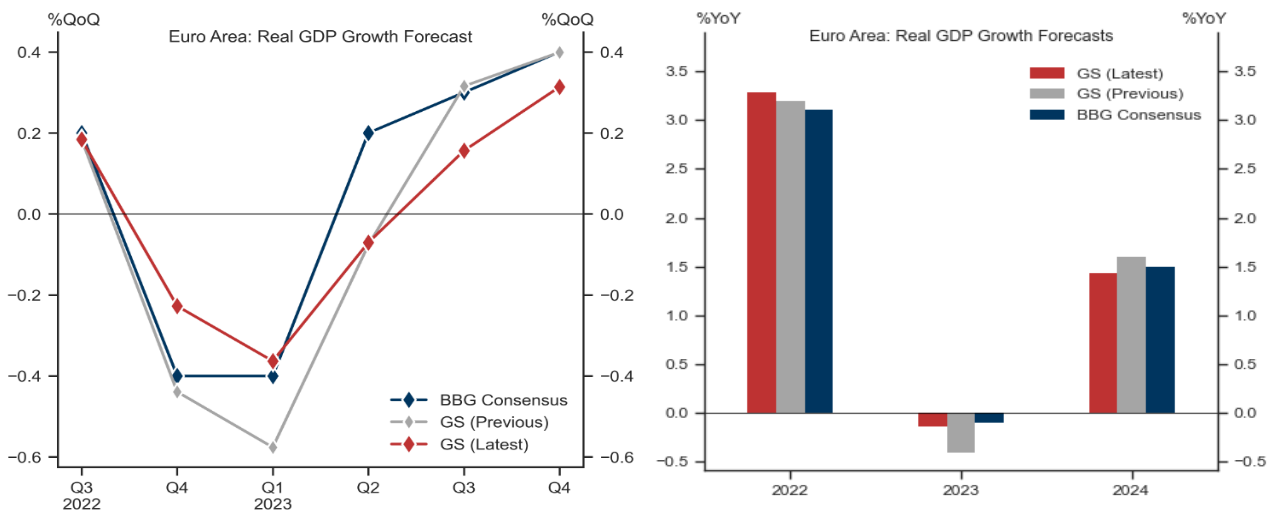


* Scarring estimates are proxied by the shortfall in the level of real GDP with respect to forecast preceding the start of the Russia-Ukraine war. We use the 2026Q4 horizon for the IMF and the OECD and 2024Q4 for the ECB.

Source: Goldman Sachs Global Investment Research, OECD, IMF, ECB

We therefore look for a sluggish recovery from the energy recession and nudge down growth in 2023H2 and 2024Q1. More specifically, we now forecast area-wide growth of 0.2%, 0.3% and 0.4% in 2023Q3, 2023Q4 and 2024Q1 (each down by 0.1pp). Our forecasts are now close to consensus for the next two quarters but slightly below other forecasters for the remainder of 2023 and early 2024. As a result, we now look for -0.1% growth in 2023 (in line with consensus) and 1.4% for 2024 (a bit below the 1.5% consensus). Given the potential for substitution away from gas over time, we now see slightly stronger growth in 2025-27.

Exhibit 6: Shallower Recession, Muted Recovery

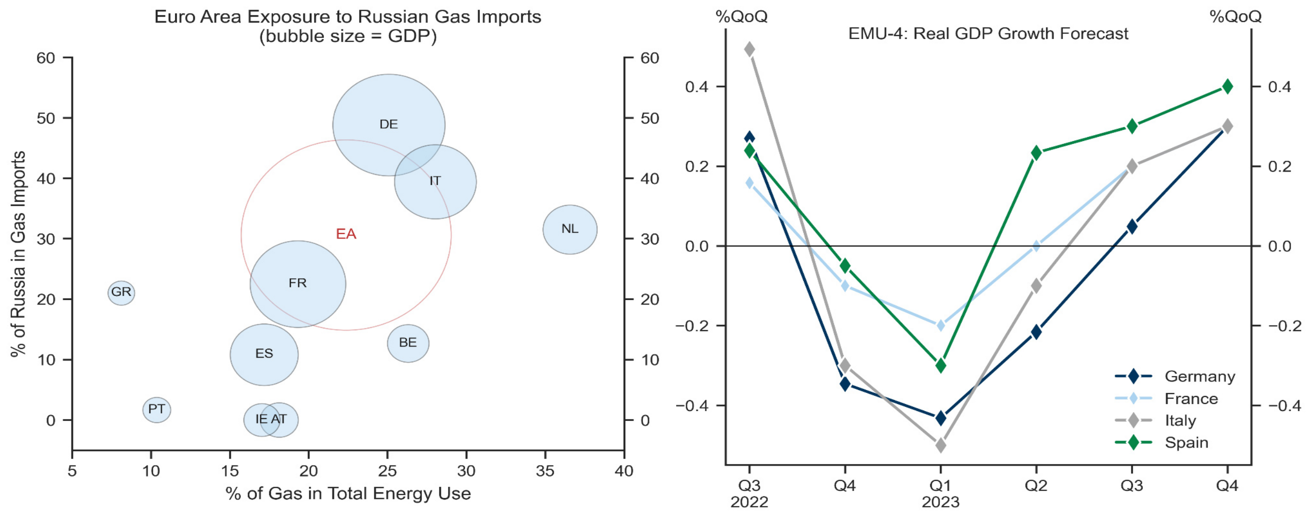


Source: Goldman Sachs Global Investment Research, Bloomberg

Looking across countries, we expect Germany and Italy to be more affected by the energy crisis than France and Spain (Exhibit 7). The most important reason is that Germany and Italy were more reliant on Russian gas imports, while France and Spain

have more diversified energy sources and are relatively more service-sector intensive. This is especially the case for Spain, which still has room to rebound from the covid crisis.

Exhibit 7: A New North vs South Divide



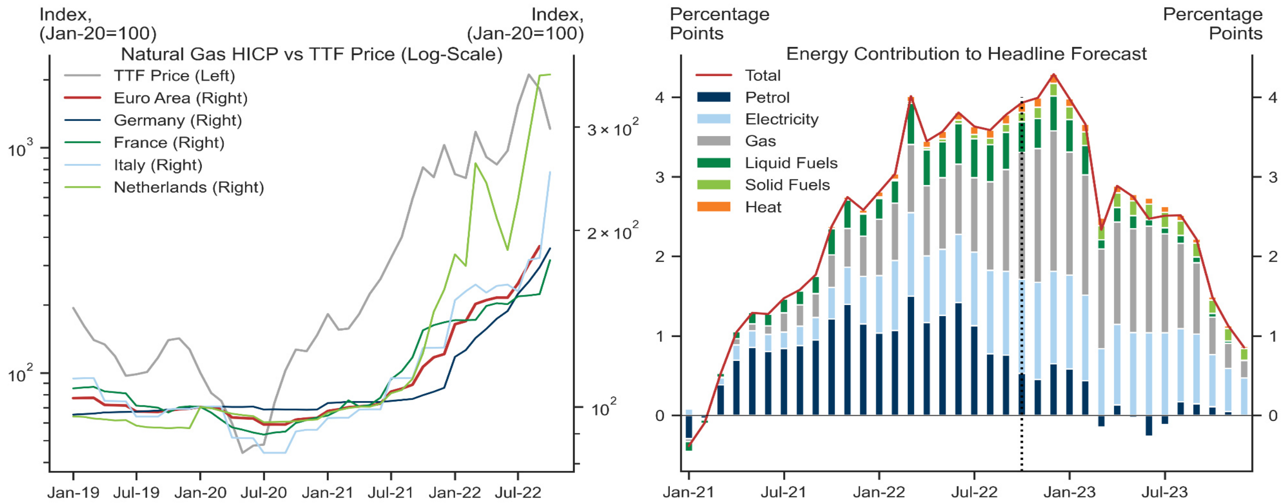
Source: Goldman Sachs Global Investment Research, Eurostat

Inflation Peak in Sight

Although gas prices have fallen significantly since their summer highs, we still see the peak in inflation ahead of us.

Starting with energy, we estimate that current spot gas prices are still above the wholesale gas price implied by the HICP gas component, even considering upcoming price caps. While our commodities team's lower TTF gas price forecast for the next year reduces our headline projection somewhat, we continue to look for elevated headline pressure (Exhibit 8). Regarding food prices, we see global, rather than local, factors as the predominant driver of Euro area food inflation, and these are unlikely to ease meaningfully in the near term.

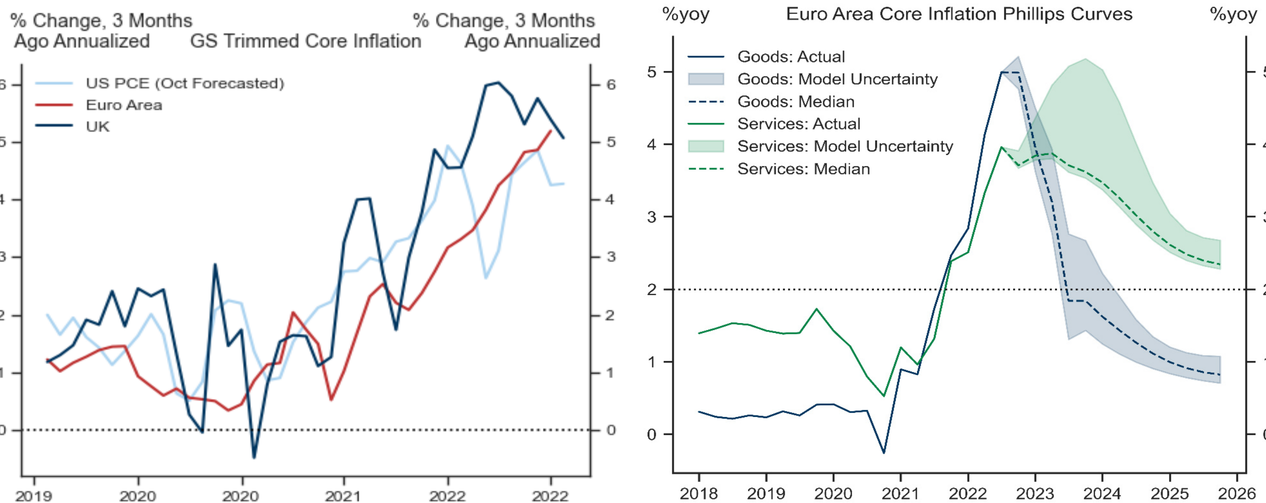
Exhibit 8: More Energy Inflation to Come



Source: Goldman Sachs Global Investment Research, Haver Analytics

Turning to underlying price pressures, we expect sequential core inflation pressures to ease gradually over coming months as goods price inflation weakens. But we find that there is still upward pressure on services inflation due to a delayed pass-through of rising energy and labour costs to consumer prices (Exhibit 9).

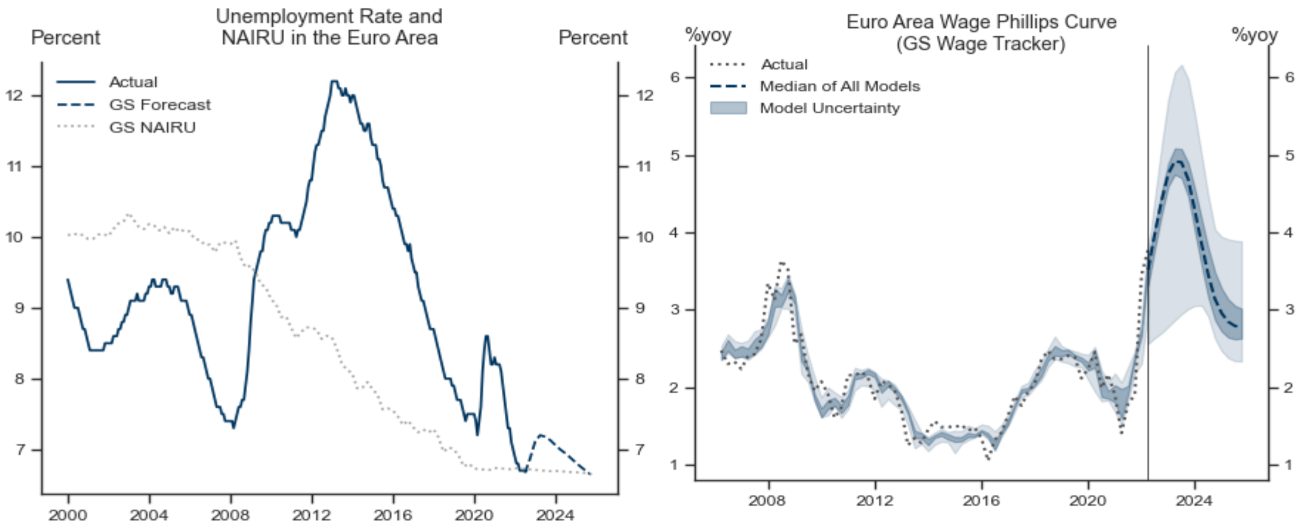
Exhibit 9: Persistent Core Pressures



Source: Goldman Sachs Global Investment Research

The key inflation issue to watch in 2023 is labour cost pressures. Euro area wage growth has picked up to almost 4%, and we expect the recession to push up the area-wide unemployment rate only slightly, from 6.6% to 7.2% in Q2. Combined with continued high headline inflation, we expect wage growth to average around 4.5% in 2023H1, before easing in late 2023 (Exhibit 10). While the stabilisation of long-term inflation expectations suggests that the risk of pronounced second-round effects remains limited, we expect firm wage growth to keep core inflation pressures elevated through 2023.

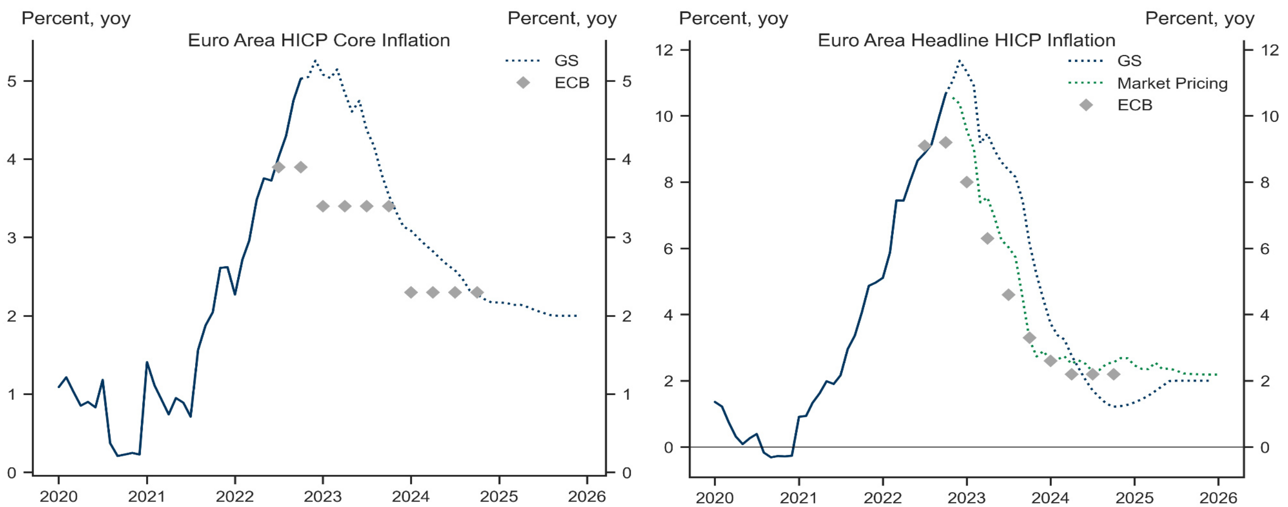
Exhibit 10: Watching Wages



Source: Goldman Sachs Global Investment Research, Haver Analytics

Taken together, we expect headline and core inflation to peak in December at 11.7% and 5.3%, respectively. We then expect inflation pressures to ease but see core inflation above the 2% target for some time, reaching 3.1%, 2.2% and 2% at the end of 2023, 2024 and 2025, respectively. Our inflation forecasts are thus notably above the ECB's latest projections, as well as current market pricing (Exhibit 11).

Exhibit 11: Inflation Peak in Sight



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

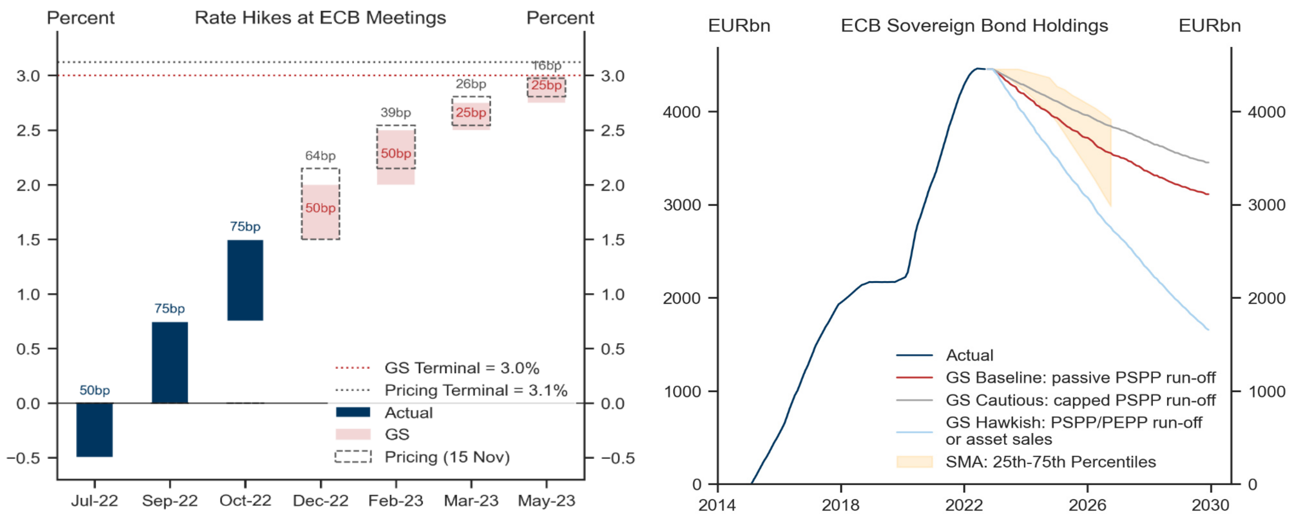
A Higher ECB Terminal Rate

Following rapid ECB hikes, we expect the Governing Council to step down the pace of hiking to 50bp in December. A smaller hiking increment seems likely given that the deposit rate has now approached levels that might be regarded as "neutral" for the inflation outlook, we are expecting a sizeable downward revision to the staff growth forecasts in December, and the Fed is likely to step down to a 50bp hike in December.

While another large upside inflation surprise in November could force the Governing Council into a third 75bp hike in December, a step-down to 50bp looks more likely.

Given our expectations for a shallower recession and ongoing inflation pressures, we now look for the Governing Council to take the deposit rate more clearly into restrictive territory, reaching 3% in May 2023. We look for another 50bp hike in February followed by two 25bp steps in March and May. The risks around our peak 3% ECB rate are two-sided, with (1) upside risk from potentially more persistent core inflation via more pronounced second-round effects, and (2) downside risk from a deeper recession or a possible flare-up in sovereign risk in Italy. We do not look for ECB rate cuts until 2024Q4, two quarters after the Fed and one quarter after the BoE.

Exhibit 12: Higher ECB Terminal Rate, Gradual Balance Sheet Unwind



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

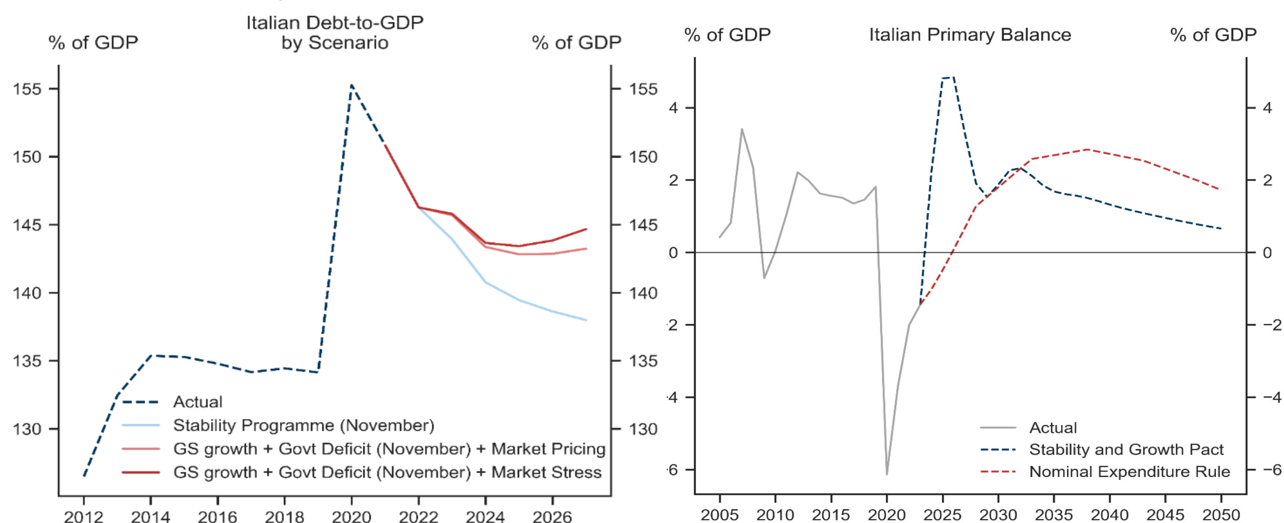
The Governing Council has signalled that it will lay out the principles for QT at the December meeting and we expect ECB officials to decide in Q1 to start a passive unwind of its asset purchase programme (APP) in Q2, which we believe bond markets should be able to digest. It is possible that the Governing Council will announce run-off as soon as December (together with the publication of the broad principles) but a delay between the decision to implement and the actual roll-off seems likely.

Keeping An Eye on Euro Area Political Risk

We will focus on three Euro area political risks in 2023, in addition to developments around the war in Ukraine. First, Italian PM Giorgia Meloni set out the fiscal deficit objectives for 2022 and 2023 (at -5.6% and -4.5% of GDP, respectively), notably higher than planned under the Draghi government due to the extension of energy-related fiscal measures in 2023. However, while the PM's party continues to gain ground in the opinion polls, some policy uncertainty remains in the run-up to the 2023 budget law. Lowering the effective retirement age would prove most costly, since Italy faces—along with Germany—one of the most difficult demographic outlooks. Rising sovereign yields, high debt and weak growth highlight medium-run vulnerabilities that leave Italy on a narrow fiscal path (Exhibit 13, left).

Second, the French government struggled to build a majority around its 2023 budget and pushed legislation through parliament without a vote (using Article 49.3 of the Constitution). The next legislative hurdle will likely be the pension reform at the start of 2023. The government could again make use of Art. 49.3 or look to build an absolute majority in parliament. The latter would imply either calling for early parliamentary elections or seeking an agreement with an opposition party. As such, we expect the government to seek to limit political uncertainty and look to build a broader majority in parliament to reaffirm its commitment to advancing structural reforms.

Exhibit 13: The Risk of Sovereign Stress Remains



Source: Goldman Sachs Global Investment Research

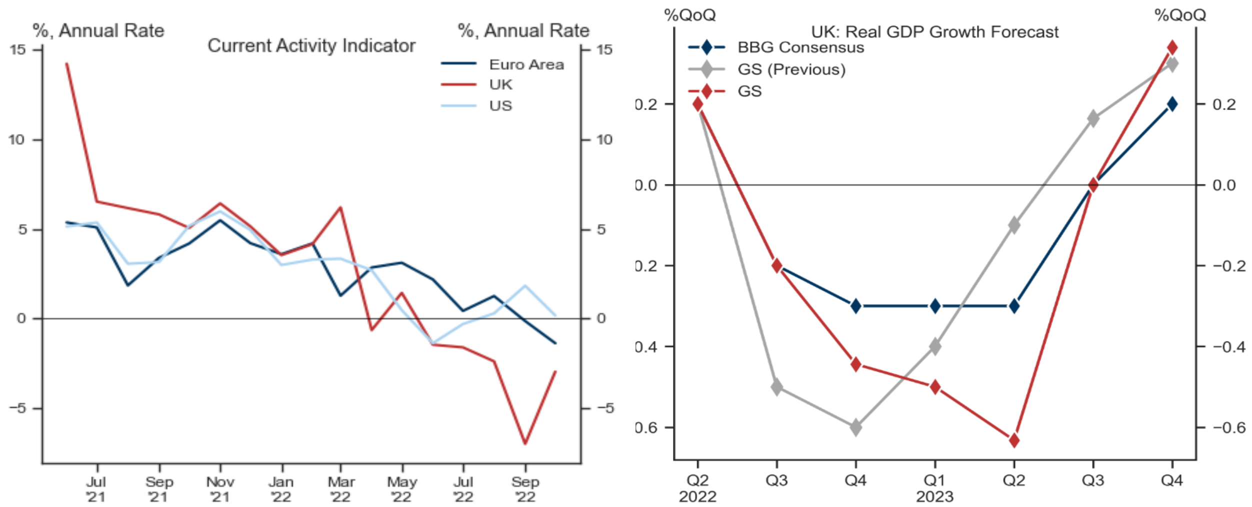
Third, European fiscal rules are coming back into focus after the suspension to accommodate a counter-cyclical fiscal stance during Covid-19. But the European fiscal framework will likely be reinstated in 2024 and, last week, the EU Commission officially started the reform process targeting a set of "simpler, more transparent and effective" rules. The EU communication presented a new three-step process. First, the EU Commission will put forward reference debt paths for every Member State. Then, each country will present its annual budget committing to a fiscal trajectory (a *net expenditure path*) consistent with its medium-term debt target. Finally, the EU Commission and Council will be provided with a richer enforcement toolbox to better achieve the desired growth and fiscal targets. A simple comparison, in the case of Italy, between the primary balance paths implied by the current *Stability and Growth Pact* rules and a nominal expenditure rule illustrates how the new framework could produce a more realistic, and backloaded, fiscal consolidation (Exhibit 13, right).

A Deeper UK Recession, Continued BoE Hikes

While data revisions now suggest a slightly smaller UK contraction in 2022H2, we continue to look for a deeper recession in the UK than in the Euro area through 2023Q2 (-1.7% contraction vs -0.7% in the Euro area). Despite the stronger than expected data flow, growth momentum remains weaker in the UK (Exhibit 14, left). Furthermore, tomorrow's Autumn Statement is expected to lead to less fiscal support both in the next few quarters and over the medium term. We look for the Energy Price Guarantee (EPG)

to be made less generous but more targeted, with subsidies provided to households in the bottom two income deciles. In addition, a broad freezing of tax thresholds is expected to weigh on growth from Q2 (Exhibit 14, right). Further out, we expect the large cuts to government spending and a sharper tightening in financial conditions to keep annual growth below trend through 2026.

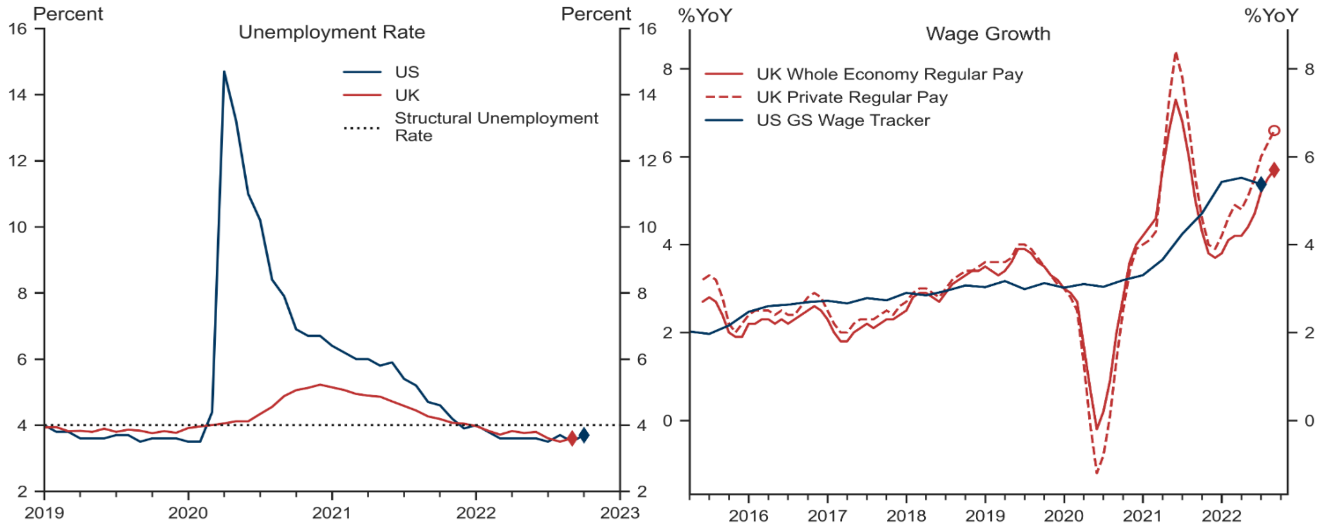
Exhibit 14: A Significant UK Recession



Source: Goldman Sachs Global Investment Research, Bloomberg

Despite the slowing of the economy, the news from the UK labour market has been firm. While the latest release showed a small increase in the unemployment rate, it remains very low and wage growth remains significantly above trend, surprising consensus expectations to the upside. As shown in Exhibit 15, the UK and US labour markets are similarly tight. A focus going forward will be whether the UK is facing greater supply-side issues given the impact of Brexit, and if the high incidence of long-term sickness remains the largest driver of economic inactivity, especially given pressures in the UK health system.

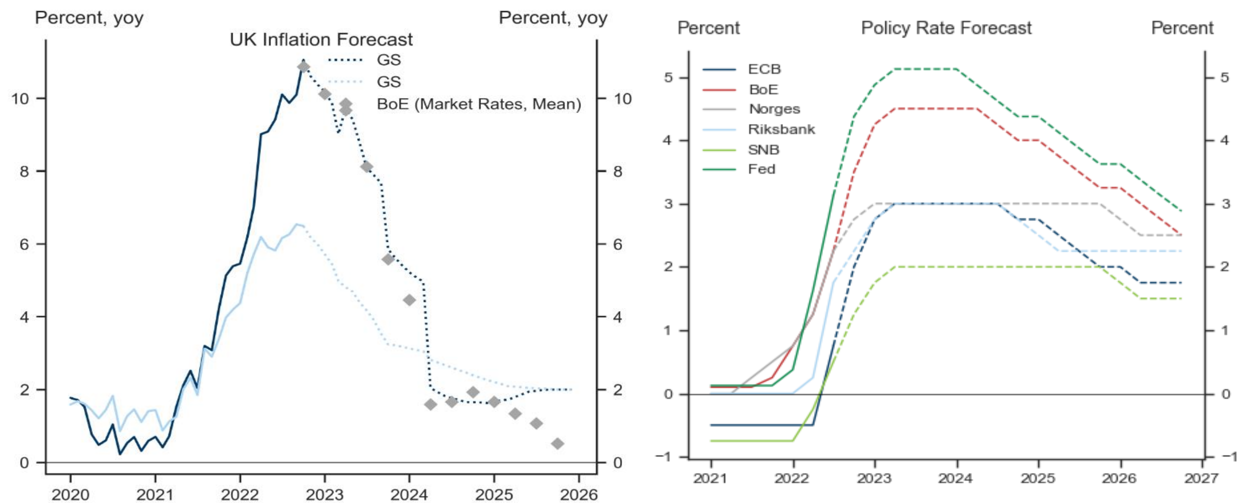
Exhibit 15: A Hot UK Labour Market



Source: Goldman Sachs Global Investment Research, Haver Analytics

Given the tight labour market, strong wage pressures and firm inflation momentum (Exhibit 16, left), we think the BoE needs to take Bank Rate into significantly restrictive territory despite its dovish rhetoric. The tone of the November MPC meeting supported our view that the BoE will more likely than not return to the previous 50bp pace in December. At that point, we see the economy clearly in recession, fiscal consolidation measures will be included in the forecast and other central banks (including the Fed and ECB) will likely also step down their tightening pace. Looking further ahead, we expect another 50bp hike in February, followed by 25bp hikes in March and May for a terminal rate of 4.5% (Exhibit 16, right).

Exhibit 16: More BoE Hikes to Come



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

Team Europe

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We, Sven Jari Stehn, Steffan Ball, Christian Schnittker, Filippo Taddei, Ibrahim Quadri and Alexandre Stott, 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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