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Europe: Still on the Road, Despite the Bumps

Following four extremely turbulent years, Europe urgently needs a year of recovery.

- Growth is likely to remain weak over much of 2024, held back by a beleaguered consumer and weak external demand.
- Inflation will decline to target this year, but there is a risk that it will rise into next year, especially in the U.K.
- Central banks will cut rates, but there is considerable uncertainty around the pace of cuts and the rate in the long run.

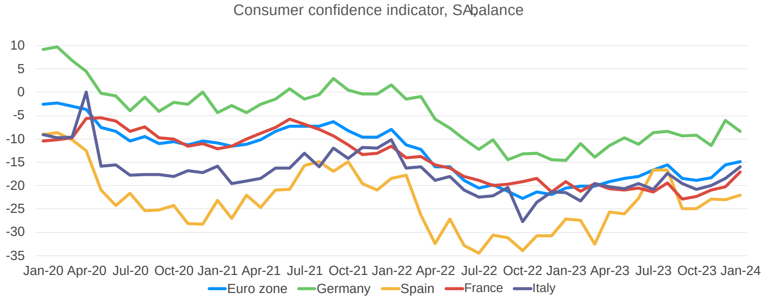
Europe has weathered a number of significant storms over the last four years, including pandemic-related lockdowns, supply-chain disruptions, an energy crisis, and a severe inflation shock. It is not surprising therefore to see Europe limping rather than sprinting towards what it hopes is a finish line that will mark the end of years of turbulence. Europe will have to spend this year addressing a number of fault lines.

Finding growth

Growth is somewhat less than tepid and likely to remain so at least for the first half of this year as confirmed by data for the fourth quarter of 2023. Euro zone GDP growth came in close to but just above zero, just about offsetting the mildly negative print in the third quarter. Both consumers and firms are hamstrung by weak confidence and high interest rates, and while consumers are also still reeling from the shock to real disposable income brought on by the spike in prices in 2022, firms are additionally suffering from weak global demand.

Fortunes may be turning for the long-beleaguered euro zone consumer. Wage increases over the course of last year and a gradual stabilization in prices have meant that the hole in the consumer's pocket is gradually closing, setting the stage for at least a gradual strengthening in consumer demand. It is worth bearing in mind that consumption, which ranges between 73% and 83% of GDP for major European economies, has had a rocky ride over the last few quarters, first recording the biggest fall ever in quarter-on-quarter terms outside of the pandemic years back in the fourth quarter of 2022 and then barely moving forward for the next couple of quarters before picking up a bit more in the summer of 2023, primarily because of the holiday season. The outlook for the next few quarters is weak because of continued headwinds from low confidence and high interest rates, but there is hope that having come so far, households will start to feel more able to spend thanks to continued wage growth and declining inflation.

Consumer Confidence is Weak

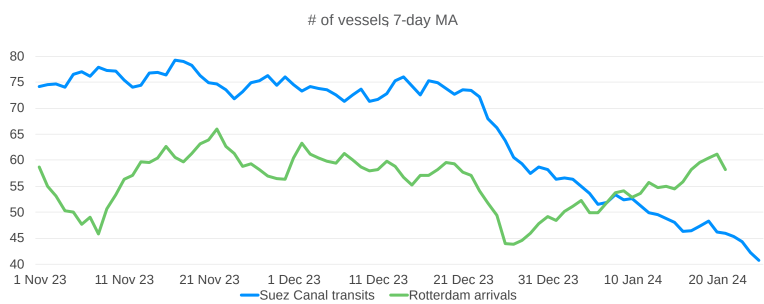


Sources: Eurostat, Moody's Analytics

Firms face a troubled future. Their confidence also is low, and while backlogs of production built up during the pandemic years continue to keep firms busy, an alarming absence of new orders suggests that more hard times await. To add to their woes, many euro zone firms now face further frictions in production due to disruptions to shipping in the Red Sea. The decline in vessels transiting through the Suez Canal since December 16 has led to concerns of stretched supply chains in Europe, as ships take the longer route around the southern tip of Africa to get to Europe.

European port data show that after an initial drop off in vessels, arrivals have since normalized, and while there are accounts of supply-chain disruptions, weak global demand, shipping capacity, and a better state of supply chains compared with 2021 suggest that the impact on growth will be negligible. Although the current situation in the Red Sea is manageable, an increase in tension and greater disruption cannot be ruled out.

Port Arrivals Recover in Europe



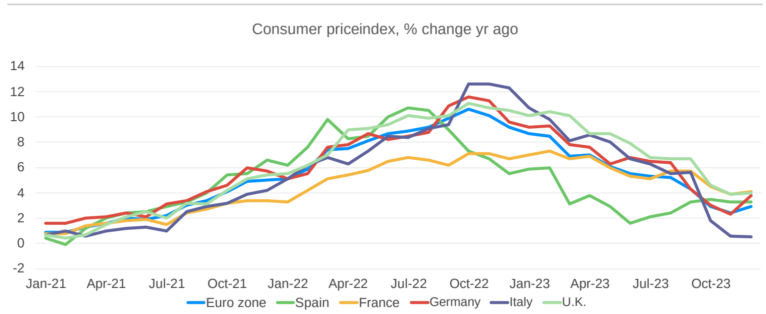
Sources: IMF PortWatch, Moody's Analytics

Firms also face structural headwinds. The European chemicals sector is in decline following years of aggressive Chinese investment, and European automotives face a loss of market share in China, where European cars are losing out to Chinese manufactured electric vehicles. Bidenomics is drawing investment away from Europe as it struggles to compete with the Inflation Reduction Act. Lower interest rates and a pickup in the global economy will benefit European firms, but longer-term structural problems won't go away.

Bringing down prices and wages

The incontrovertible good news is that prices are not only stabilizing but that price growth is rapidly heading towards something that central banks across Europe can deem as acceptable. We are all familiar with the events of 2022 that led to the sharp increase first in energy and food inflation and then rapidly broadened out to include other goods and services in the consumption basket. That was only to be expected as oil and gas affect every part of the economy either directly or indirectly. More worrying were the second-round effects of price increases that came into sharp focus as workers, whose consumption power was crimped by inflation, demanded offsetting increases in wages. Fear in central banking circles grew that aggressive wage demands would, a few months down the line, fuel further inflation as workers spent their newfound wealth, in turn sparking a vicious cycle of wage-price increases.

Inflation on a Declining Path



Sources: Eurostat, Moody's Analytics

There is an interesting contrast in inflation prospects between the euro zone and the U.K. There is a distinct possibility that inflation will not only decline swiftly to target in the former but that it will sink below 2% and stay there. In the U.K. on the other hand, while headline inflation is likely to return to target this year, the persistence of underlying inflation raises the distinct possibility that inflation will then rise again.

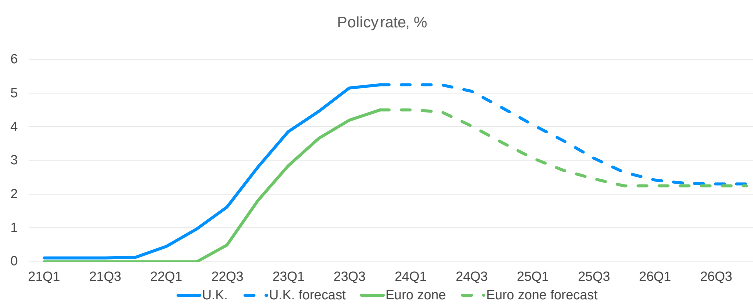
Wage growth is an important part of this story and the difference between the U.K. and the euro zone is that while wage growth is a fairly aggressive at 6.5% in the former, it is a much cooler 4% in the latter. Headline inflation is declining rapidly in the U.K. and will continue to do so, but core faces a more difficult path down. Second-round effects could arrest the recent decline in core and there is a risk that inflation could start to rise later in the year as a result. Brexit has also played a part in damaging the labour market, and resulting labour shortages play a structural role in keeping wages high. The latest CFO survey shows that firms expect wage growth to be running at 5% by the end of the year, posing upside risk to inflation.

Lowering interest rates

Having spent most of last year in tightening mode European central banks entered the year firmly on hold and with inflation clearly falling, attention turns to three important questions. When will central banks start to cut? How fast will they cut? What will the neutral rate be? The answers, in short order are: sometime this year, not very fast, and take a guess.

The contrast in inflationary pressures between the U.K. and the euro zone suggests there is a greater possibility that the European Central Bank will start to cut rates ahead of the Bank of England. Our baseline forecast targets June as the beginning of the easing cycle for the ECB and August for the BoE, but it is possible that the ECB will cut earlier and the BoE later. Much depends on the state of the economy by spring and the underlying strength in wages. A weaker economy will motivate an earlier cut, while strong wages will incentivize keeping rates on hold. A fear that second-round effects might arrest the decline in underlying inflationary pressure will also lead central banks to exercise caution on the way down. As long as the economy shows signs of life, caution will win out and rates will go down slowly.

Policy Rate Slow on the Way Down



Source: Moody's Analytics

Finally, the long-run equilibrium interest rate, which is the interest rate consistent with inflation at 2% and the economy running at its potential rate of growth, is a matter that leaves central bankers scratching their heads. It is notoriously difficult to measure and depends on a number of issues such as the long-run balance between investment and savings, which in turn is affected by fundamental factors such as demographics and returns on assets. Neither the ECB nor the BoE has articulated a clear view of where the policy rate might end up, and it is likely to be a matter of empirical determination. Given the caution expressed around the speed of rate cuts, we may also never get a chance to find out. Other shocks to the economy may move policy rates in either direction in the near future and leave central banks grappling with new problems.

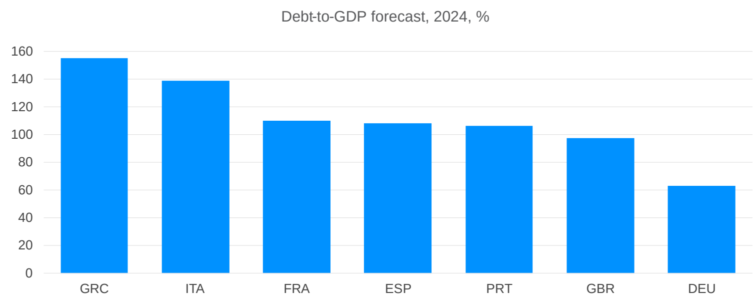
Managing politics and finances

There are a number of geopolitical issues that Europe watchers will be concerned about over the course of the year. Elections to the European Parliament take place in June with opinion polls suggesting increased support for populist, right-wing parties. The European Parliament is an important body which, in conjunction with national government representatives, co-decides on EU legislation, approves the EU budget, and is responsible for its implementation. If the election does indeed result in an increase in support for populist parties, not only does this risk increasing factionalism in the European Parliament, it also risks diluting or even overturning the course of EU policy in key areas such as climate change and fiscal rules. For climate, this could lead to implementation failures and significant backsliding on commitments.

The U.K. will also hold elections in 2024, most likely in autumn. Opinion polls suggest that the Tory Party, after more than 13 years in office, will fail to win the election. The Labour Party has been quite light on detail on fiscal policy, but whatever spending programme it unveils, it will have to operate within the tight constraints of a sovereign with a high debt load and limited spending headroom.

The need for extra spending on infrastructure, public services and defence is widely acknowledged but absent ambitious measures such as an increase in income tax or a broadening of the tax base, the only way to accomplish such spending is through further borrowing which markets might be less than willing to accept. A future chancellor will also have to bear in mind the need to adhere to fiscal rules that call for a declining debt-to-GDP ratio five years out. Other countries in Europe also need to undertake measures to stabilize debt. While markets have been sanguine about high debt loads over the last few years, such tolerance is likely to be tested if fiscal discipline is not forthcoming.

Countries Need to Stabilize Debt in 2024



Source: Moody's Analytics

Europe's difficult relationship with China continues. A recent EU proposal for extra screening of foreign investment has China in mind and requires member states to block investments and technological transfers that pose a security risk. There is also an ongoing investigation into uncompetitive Chinese practices in the automobile industry. For the EU, it is a difficult balancing act. China is an major trade partner, and the EU stands to lose significantly in a tit-for-tat war of retaliation. At the same time, the decline in relations is structural and the drift between these two major economic powers will continue.

Europe has managed to escape recession despite facing significant shocks over the past few years. However, the economy is struggling, and there are several fault lines. The economy urgently needs a period of calm during which it can not only recover but also increase its resilience ahead of the next bump in the road.