European Economic Outlook

EY Economic Analysis Team

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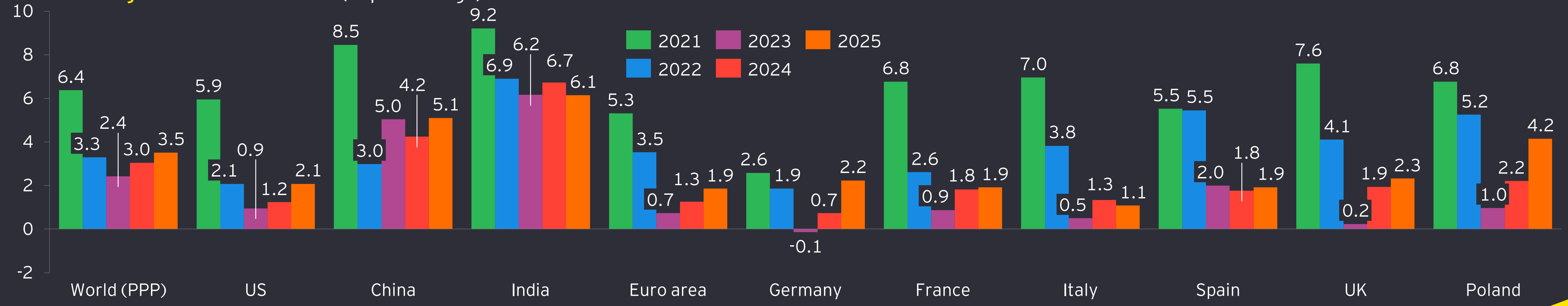
Topics

European economy shows resilience … but the recovery will be sluggish

- The European economy has been slowing since mid-2022, with inflation continuing to exceed nominal wage growth and acting as a drag on consumption. While rising interest rates have also taken their toll, economic growth surprised on the upside, with stagnant GDP in Q4 2022 and likely modest growth in Q1 2023, quelling previous expectations of an imminent recession.
- Considerable budgetary support measures for households and firms helped weather the energy crisis, assisted by a mild winter and ample natural gas storage at European facilities, which kept a lid on energy costs. Resilient labor markets continue to support consumer income and China's reopening has contributed to the global demand recovery.
- In coming quarters, declining inflation will bring some respite to consumers. Real wage growth, after bottoming at -4.9% in Q3 2022, is accelerating and is expected to turn positive in Q4 2023. Despite the banking stress that hit financial markets during March 2023, recent data suggest that financial tensions have so far made little impression on consumers and businesses. As a result, most European economies are expected to avoid GDP contraction in 2023.
- Prolonged elevated energy prices and inflation, compounded by monetary policy tightening, will continue to impact household consumption and economic growth. In our baseline scenario, in which we assume that the recent financial sector turmoil is contained, GDP growth in the euro area should decrease from 3.5% in 2022 to 0.7% this year, recovering to 1.3% in 2024 and 1.9% in 2025. European economies will remain well below pre-Covid trends, pointing to the long-term negative effects of the pandemic and the war in Ukraine.
- The slowdown in global trade (from 5.0% in 2022 to 1.1% in 2023 and 2.5% in 2024) will weigh on Europe's exports and thus on manufacturing. Faced with slower demand, many companies will adjust inventories, which will amplify the adverse cyclical impact on the industrial output. In some sectors (aerospace, automotive), easing supply bottlenecks allows them to realize solid order backlogs that outweigh, at least in the short term, the negative effects of demand slowdown.

GDP growth in 2021-2025 (in percentage)



Source: Oxford Economics, EY EAT forecast (baseline scenario).

Despite decline in energy prices, elevated inflation can prove more sticky

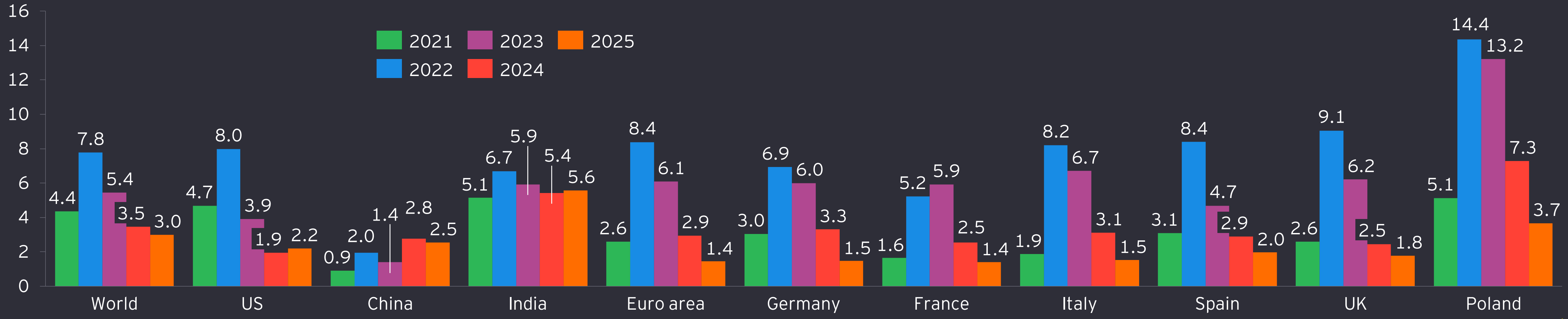
- Euro area inflation has passed its peak (10.6% in October 2022) and begun to decelerate, driven by falling energy prices and base effects. Supply bottlenecks are receding quickly, which allows supply to recover. That, coupled with slowing demand and reversal of the previous shifts in consumption patterns (away from services towards goods after the outbreak of the pandemic), should lead to lower industrial margins. Moreover, declining commodity prices, particularly energy costs, will gradually filter through to other prices. This should support disinflation of industrial and consumer goods. It's already reflected in companies' business outlook, especially in energy-intensive sectors.
- Downward inflationary trends could be counterbalanced by a strong and sustained wage growth, which has accelerated in the euro area. Moreover, previous increases in core goods PPI in Europe have been only partially passed on to consumers. Consequently, core goods HICP inflation (excluding volatile energy and food components) may not fall as quickly as some might anticipate due to declining PPI inflation. There is also little sign of abating price pressures in services, though they are no longer intensifying.
- The risk of sticky inflation seems to be confirmed by recent data indicating higher than expected core inflation that has not yet peaked in numerous European countries. Underlying price pressures are therefore proving more persistent, particularly with tight labor markets in many economies. The economic slowdown has caused some softening of demand for labor, as confirmed by the recent decline in job postings data, and firms report some reduction in labor market tensions. However, these remain much tighter than before the pandemic and employment continues to growth, activity rates are above pre-pandemic levels, while unemployment rates are at or near historical lows.
- On one hand, the ongoing economic slowdown reduces employees' bargaining power, while on the other the still-tight labor market, indexation to past inflation and minimum wage hikes in many countries are likely to maintain wage growth momentum in the coming quarters. Moreover, since Q4 2021 nominal wage growth in the euro-area has been lagging behind inflation, resulting in a contraction of real wages, which is unlikely to continue for much longer. With a tight labor market, workers may use their bargaining power to recoup lost income. As headline inflation decelerates, we expect growth in nominal wages in the euro area to remain near current levels in 2023, resulting in real wage growth turning positive in the last quarter of this year.
- In terms of inflation, this poses a risk of a more prolonged cost-push shock coming from wage growth. This is unlikely to prevent goods disinflation, but would imply more persistent inflation in services, which are on average much more labor-intensive and in which wages represent double the share of direct input costs than that in manufacturing. The strong labor market is therefore a major source of continued upside risks to the inflation outlook.

EY

Persistent inflation signals that central bank rates may stay higher for longer

- While we forecast inflation in Europe to fall relatively quickly during the course of 2023, in annual average terms, it will remain elevated. In the euro area, inflation will reach 6.1% and some CEE countries, especially Hungary, Czechia, Poland and Slovakia, will continue to see double-digit figures in 2023.
- In the euro area, inflation should reach the European Central Bank (ECB) target of 2% in the second half of 2024, but core inflation may remain higher until the second half of 2025. For many EU countries, price growth will remain above central bank targets until 2025 and for some even longer. Moreover, in the environment of tight labor markets and continued very high inflation, the risk of another surge in price pressures due to new supply shocks remains significant. Therefore, central bank rates may stay higher for longer.
- The ECB will maintain a data-dependent approach and, due to increased uncertainty over the effects of the recent financial-sector turmoil on credit conditions, will refrain from providing guidance on the future interest rate path. However, given that core inflation in the euro area has recently hit another record and labor markets remain very strong, in our view, for most ECB policymakers further rate hikes will be warranted. We expect the ECB deposit rate to be raised by another 75bps up to 3.75%. The effects of monetary policy tightening have already become apparent in the overall negative loan growth in the euro area for the first time since 2014 and a slowdown in new home construction in many countries. Moreover, the full impact of interest rate hikes is yet to be felt fully.
- Following the latest rate increase (by 25bps to the 4.75-5% range), the Fed has turned significantly more dovish as a result of the turmoil in the US banking sector. Still, another 25bps hike in May 2023 seems likely and we also expect the Bank of England to raise its base rate once more, to a peak of 4.50%.

Inflation in 2021-2025 (in percentage)



Source: Oxford Economics, EY EAT forecast (baseline scenario).

The 2023 economic outlook has improved, but the balance of risks leans to the downside

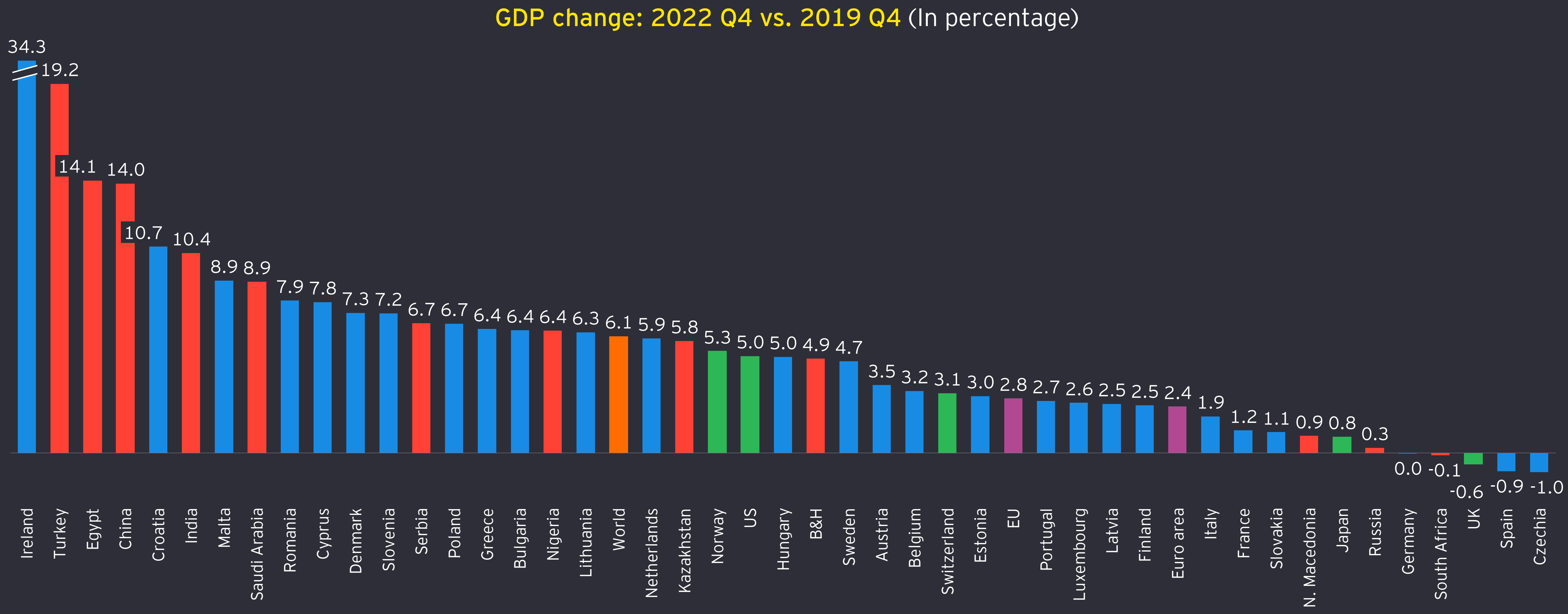
- KEY RISK FACTORS
  - Persistent elevated inflation would squeeze household budgets for longer and weigh on private consumption, in addition to increasing the risk of excessive monetary policy tightening by major central banks that may prefer to err on the side of caution.
  - The recent turmoil in the banking system, beginning with the failures of some US banks, is a new cause for concern. However, in Europe, the chances of similar situations occurring are more limited due to financial supervision covering much smaller banks than in the US. Moreover, the most recent assessment conducted by the European Banking Authority confirms the strong position of European banks. However, pockets of vulnerability may exist not only in the banking sector, but also in non-bank financial institutions, the role of which has been growing in global markets for many years.

    The latest financial tensions may make banks even more reticent in lending, but in our baseline scenario, the banking turmoil will be contained, without significant impact on the European economy. However, volatility in market sentiment could continue, together with hunting for weakness. In an alternative scenario, in which we assumed that the current turmoil leads to an additional tightening of credit conditions (a third as large as during the global financial crisis), by 2025, GDP in the euro area would be almost 2% lower than in the baseline.
  - Geopolitical tensions, including the war in Ukraine, continue to be a key risk and if they intensify, could lead to more energy and food price spikes (especially if the Black Sea Grain Initiative is not renewed), pushing inflation up. China's reopening, while easing supply bottlenecks and supporting global growth, will add to price pressures through increased demand for energy commodities, especially natural gas. Potential harsh weather conditions could exacerbate imbalances in energy markets, particularly ahead of the 2023-24 winter. The decision of OPEC+ members on 2 April 2023 to cut oil output only adds to the growing concerns over energy prices and economic outlook.

    Our analysis shows that Europe is more vulnerable to a renewed increase in energy prices than other major economies, in particular the US. In the event of another spike in energy costs, the most adversely impacted European economies would include: Romania, Hungary and Czechia.
  - Elevated debt levels increase vulnerability, especially of emerging markets and developing economies, to potential financial market turbulence. They also limit the fiscal space to offset new negative shocks and their impact on households and businesses.

It is essential to remember that the energy crisis and many other disturbances, including those driven by changes in the geopolitical landscape, are not transitory shocks. We should get used to an extended period of uncertainty and volatility. It is crucial for businesses and policymakers to remain vigilant and be prepared for any further risks to materialize.

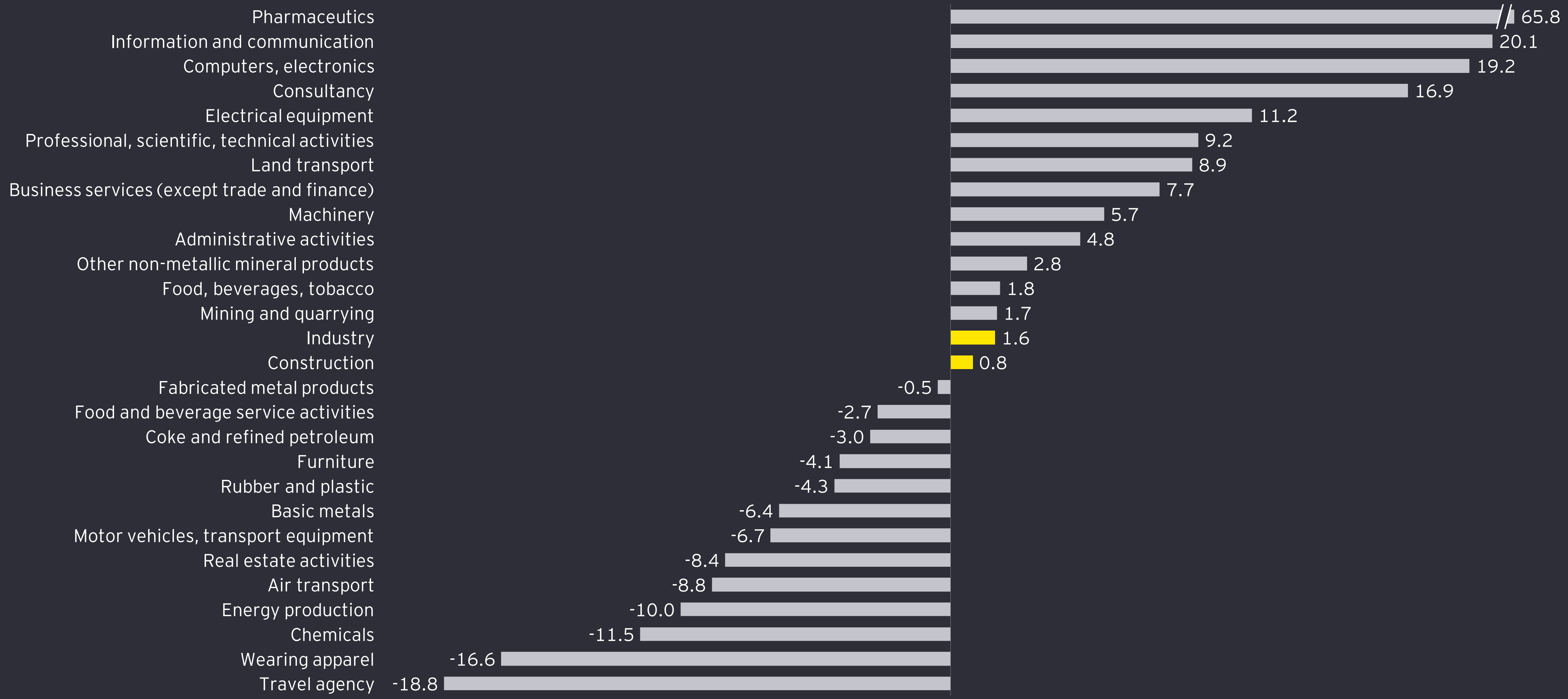
Most countries are significantly above the pre-pandemic levels of their economic activity



Source: Oxford Economics, Eurostat, FRED, ONS, Trading Economics.

In the euro area, pharmaceutical sector, IT, electronics production and consultancy are the best performing industries. By contrast, automotive, energy-intensive sectors (metals, chemicals), tourism and apparel production remain well below the pre-pandemic levels

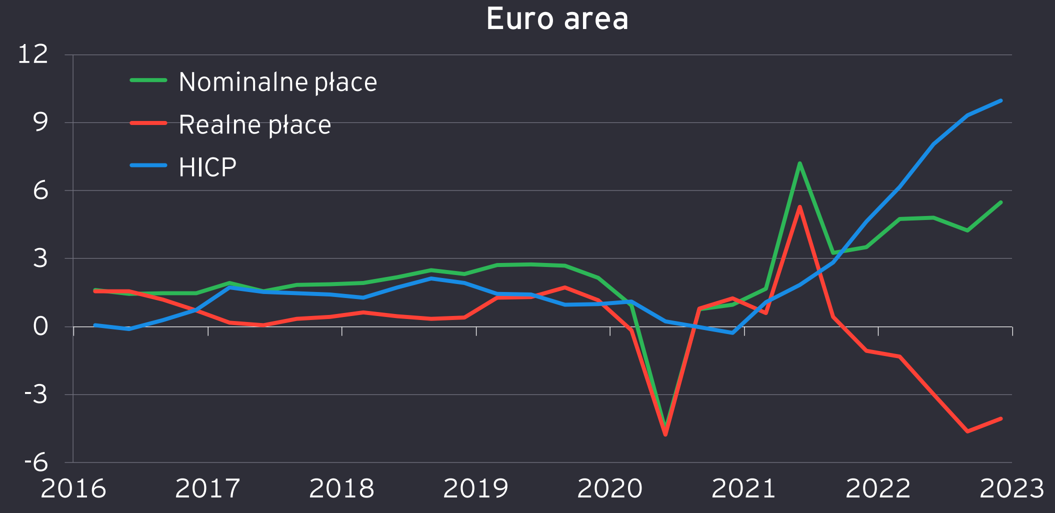
Production in the euro area, 2022 Q4 vs. 2019 Q4 (In percentage)

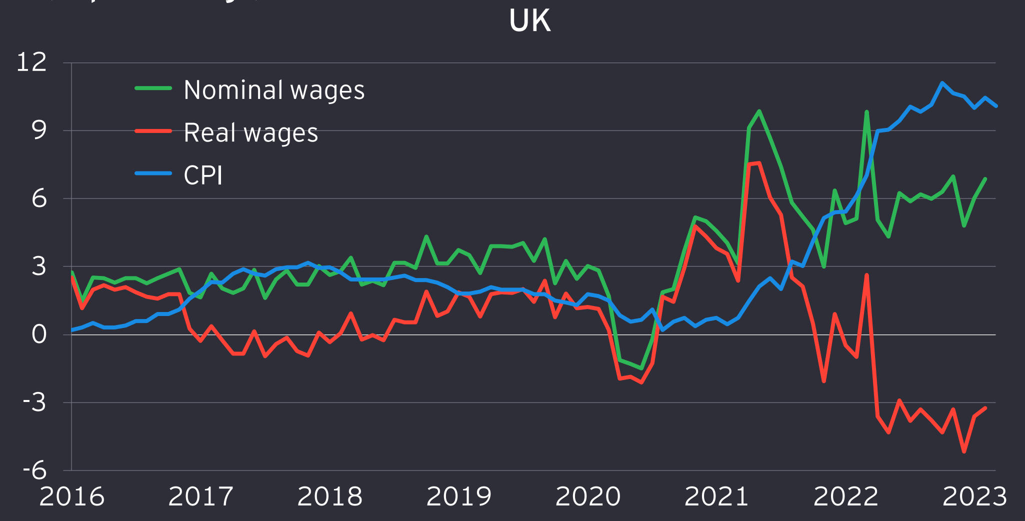


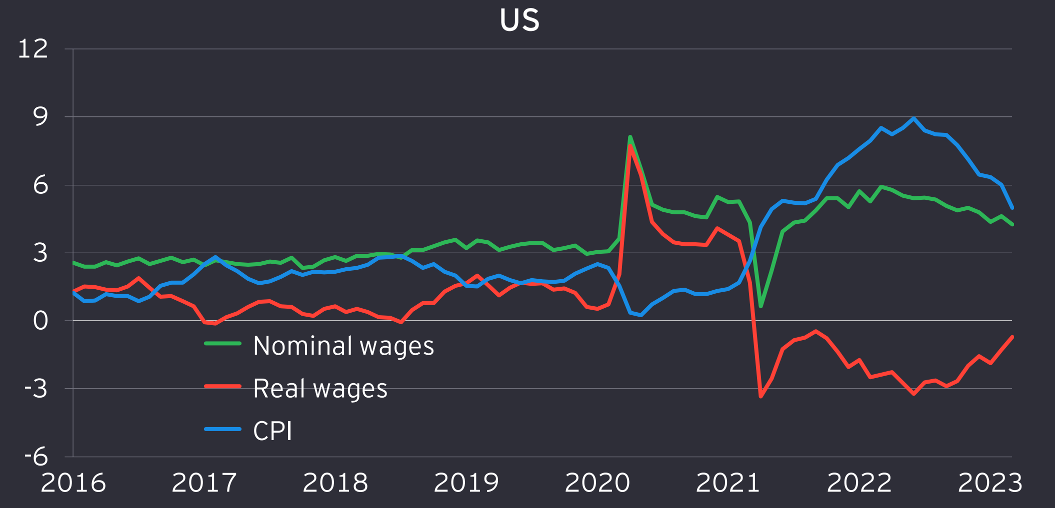
Source: Eurostat.

Most OECD and European countries are now facing slowdown. Economic activity is weakened primarily by high inflation, which exceeds nominal wage growth and puts a drag on consumption. Rising interest rates take their toll too

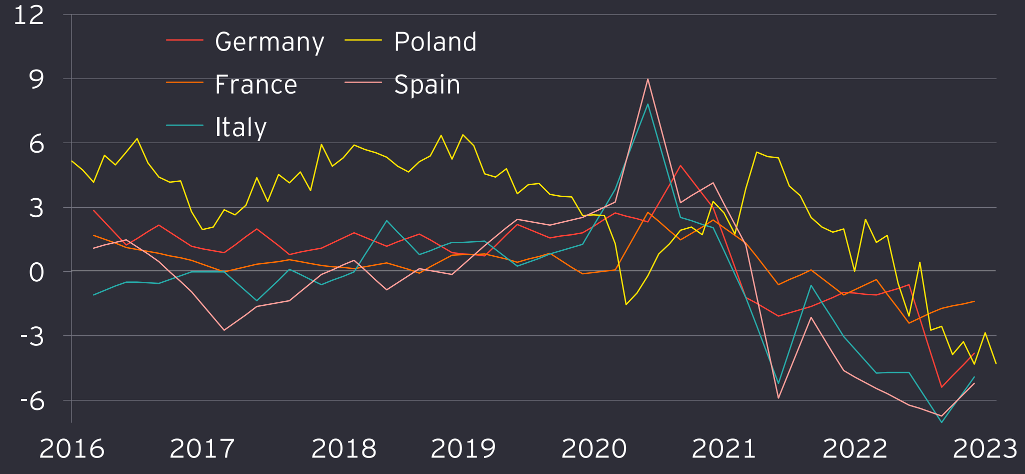
Nominal and real wage growth, YoY* (in percentage)







Real wage growth in selected EU countries, YoY (in percentage)

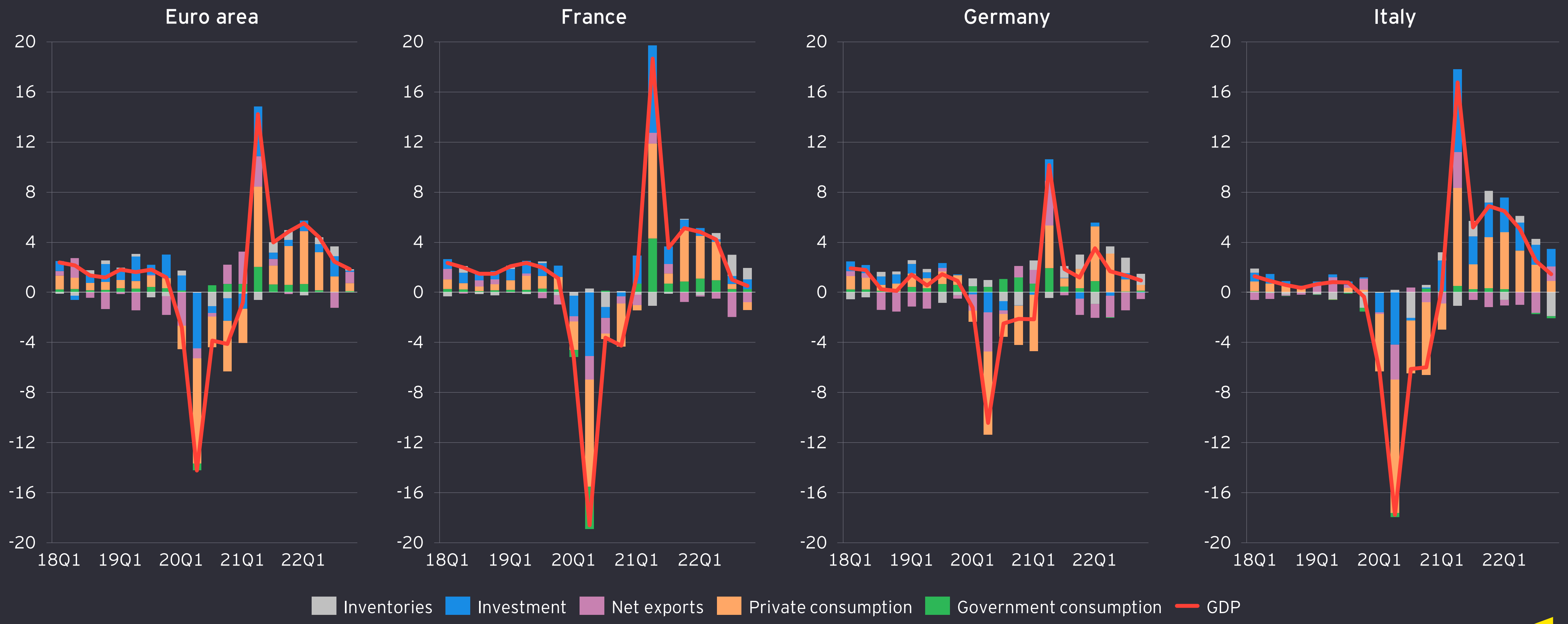


Source: Eurostat, Statistics Poland ,ONS, FRED, Oxford Economics.
* For the the euro area, wages and salaries per employee based on national accounts; for the euro area countries, labor cost index (quarterly data); for the UK, average weekly earnings in the whole economy, total pay (monthly data); for the US, average hourly earnings in the private sector (monthly data); for Poland, wages in the enterprise sector. Real wages deflated with CPI.

Consumption is the main driver of economic slowdown

- With high inflation reducing the real disposable incomes of households, consumer spending has been slowing down.

GDP growth decomposition (year-over-year, in percentage)

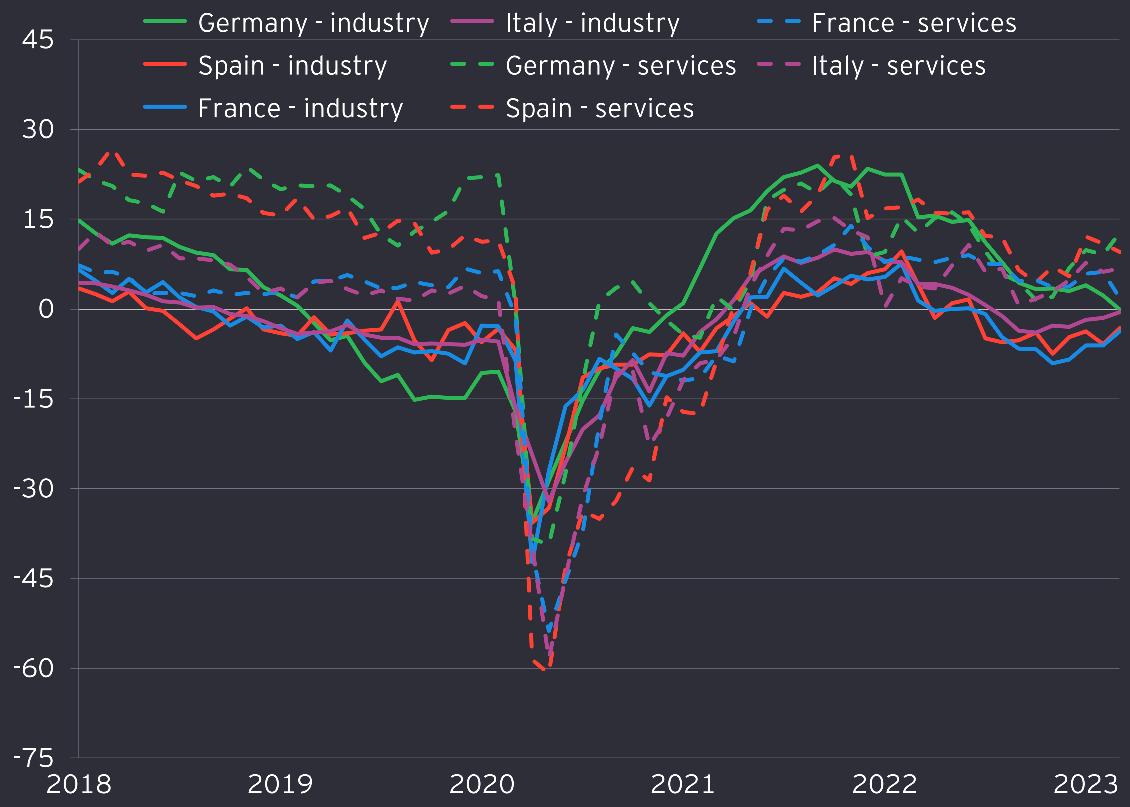


Source: Oxford Economics.

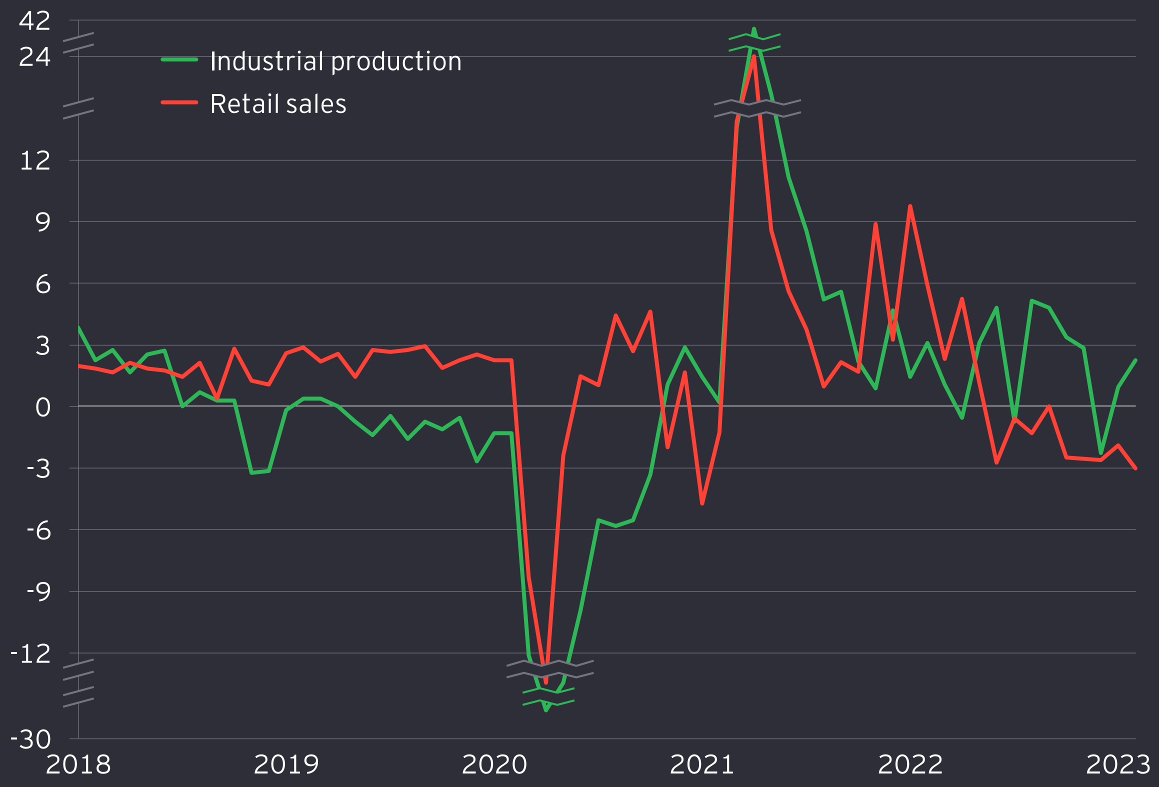
However, the European economy is proving more resilient than many expected: economic activity seems to have picked up slightly in 2023 Q1, quelling previous expectations of an imminent recession

- Considerable budgetary support measures for households and firms helped weather the energy crisis, assisted by a mild winter and ample natural gas storage at European facilities, which kept a lid on energy costs.
- Despite the banking stress that hit financial markets during March 2023, recent data suggest that financial tensions have so far made little impression on consumers and businesses, as indicated by confidence and sentiment indicators pointing to an ongoing gradual recovery.

Confidence indicators



Industrial production and retail sales in the euro area
(YoY, in percentage)

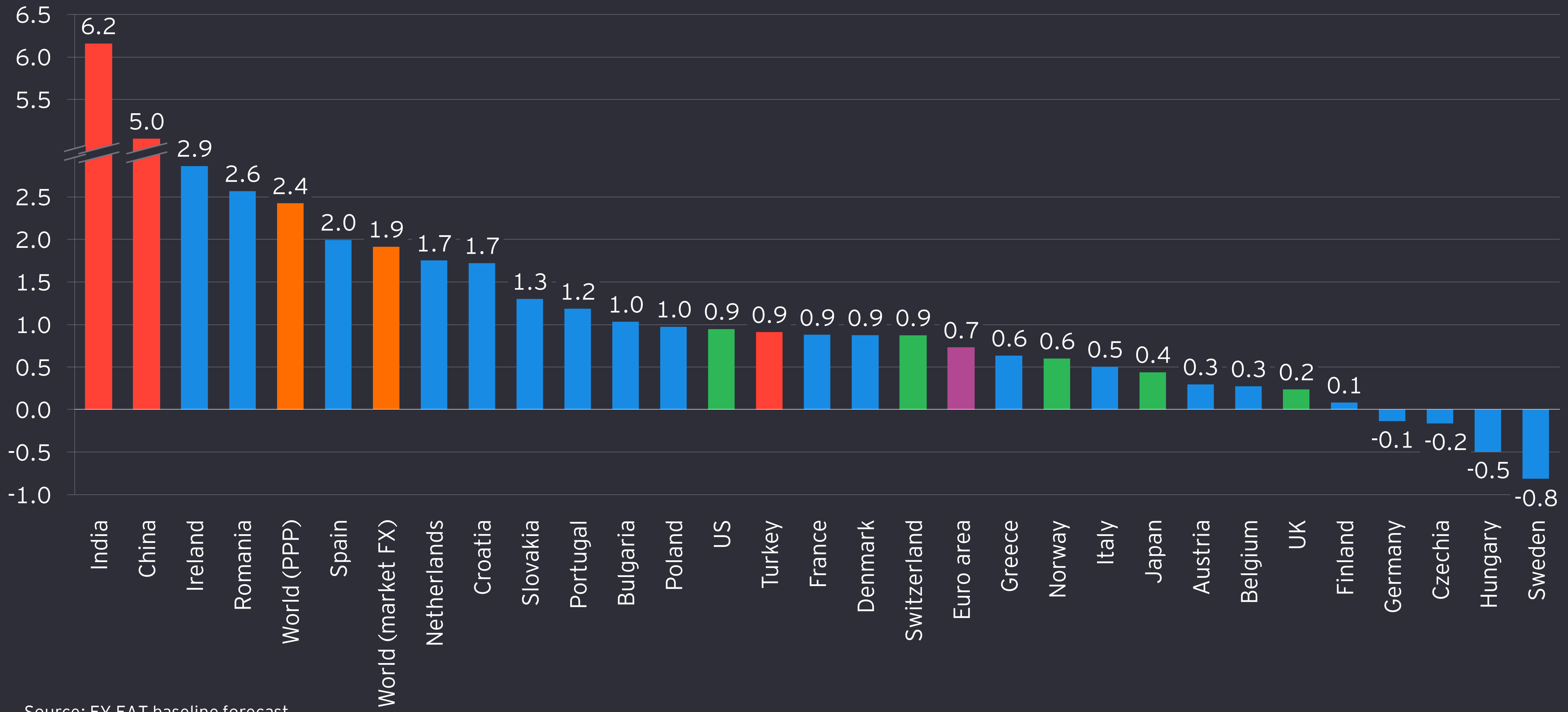


Source: Eurostat; ONS.

The slowdown in most European countries has already bottomed out and we expect most economies to avoid GDP contraction in 2023

- In coming quarters, declining inflation will bring some respite to consumers, even though monetary tightening will continue to put a drag on activity.
- Resilient labor markets continue to support consumer income and China's reopening has contributed to the global demand recovery.

GDP growth in 2023 (In percentage)

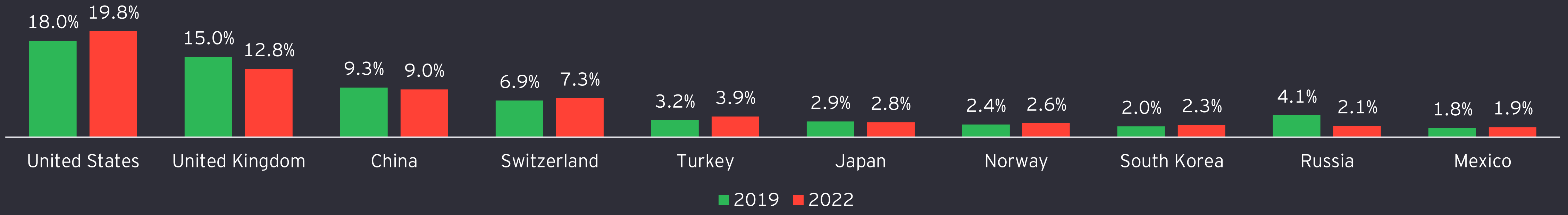


Source: EY EAT baseline forecast.

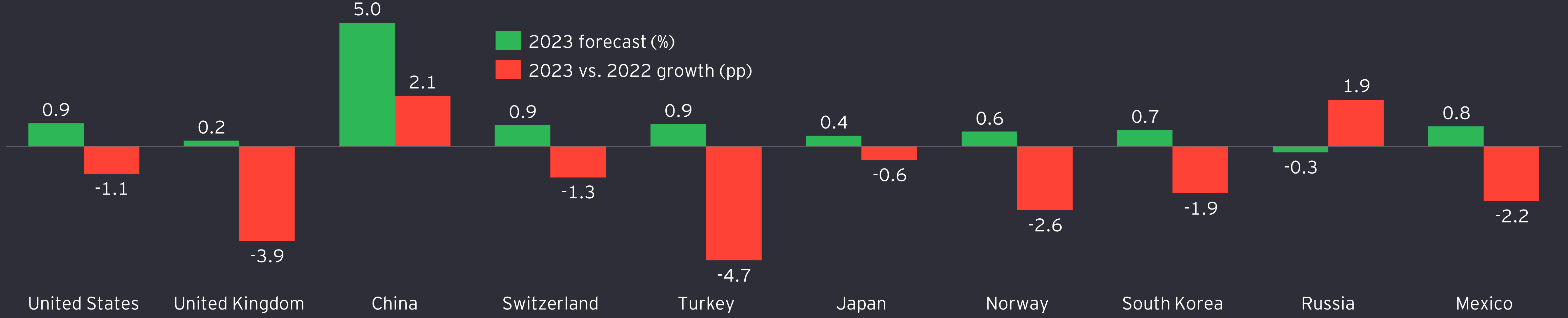
The slowdown in global trade (from 5.0% in 2022 to 1.1% in 2023 and 2.5% in 2024) will weigh on Europe's exports and thus on manufacturing

- The recovery in the US, UK and China will be of key importance, since these represent, in descending order, the EU's biggest trading partners.
- The role of the UK and Russia as trade partners of the EU has declined significantly since 2019, while the importance of the US has increased.

Top 10 export partners of EU in 2022 vs. 2019 (% of total exports of goods to extra-EU countries)



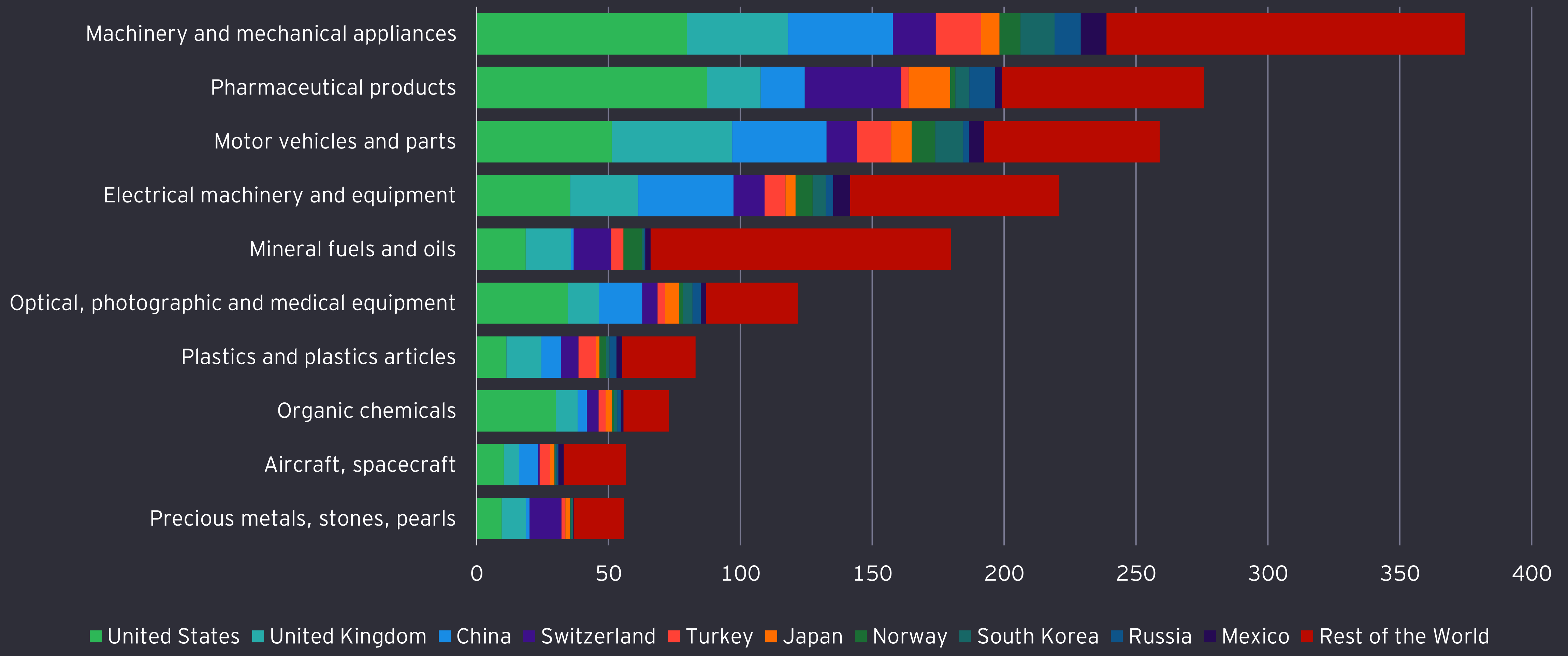
2023 real GDP growth forecast vs. 2022 observed growth (percentage change YoY and percentage point difference)



Source: Eurostat, EY EAT baseline forecast.

Key goods exported from the EU include machinery and medical appliances, pharmaceutical products and motor vehicles, in each case the US being the biggest customer

Top 10 goods exported from the EU in 2022 (EUR bn)

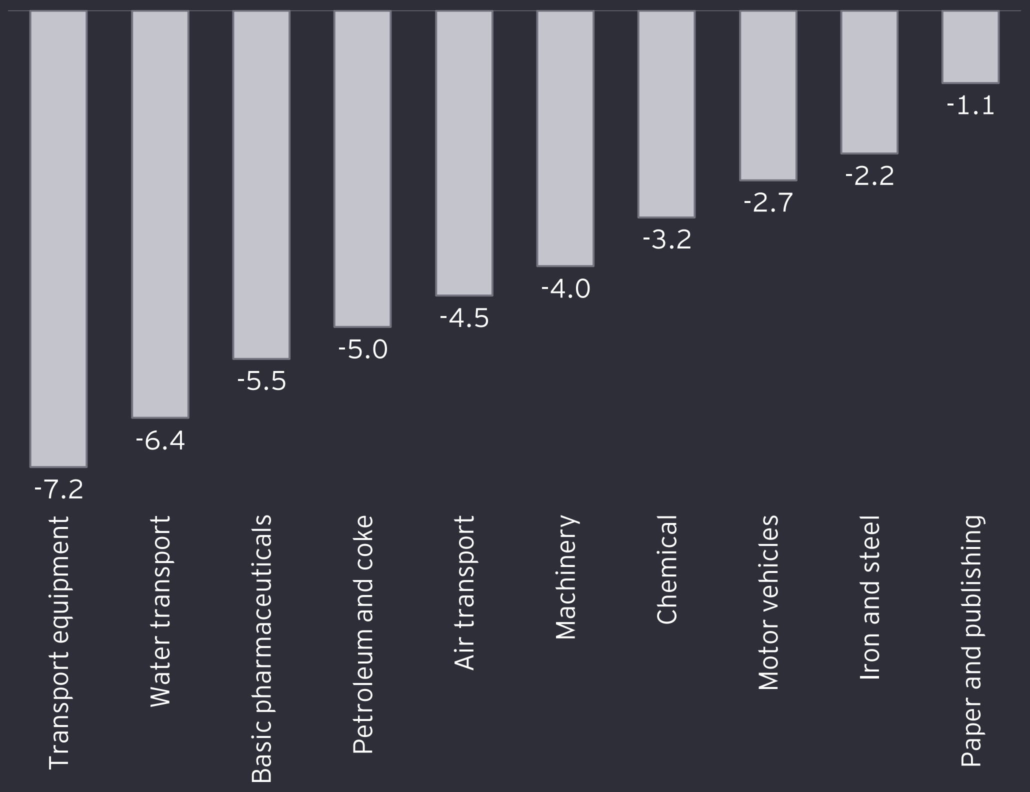


Source: Eurostat.

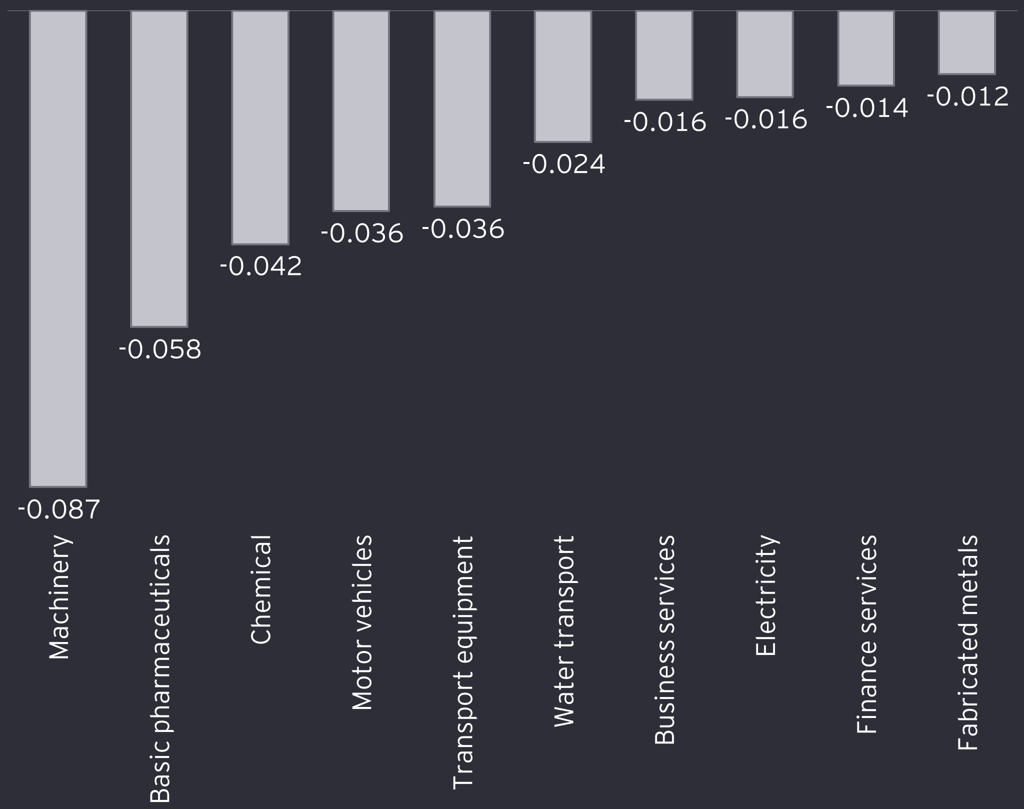
Intensified trade tensions might have a substantial impact on EU production in several sectors

An example simulation of a change in EU production by sector due to a 10 p.p. increase in export and import tariffs between the West[1] and the rest of the world

a) Top ten EU sectors in terms of the deepest decline in production (in percentage)



b) Top ten sectors in terms of the most adverse impact on EU GDP (in percentage)

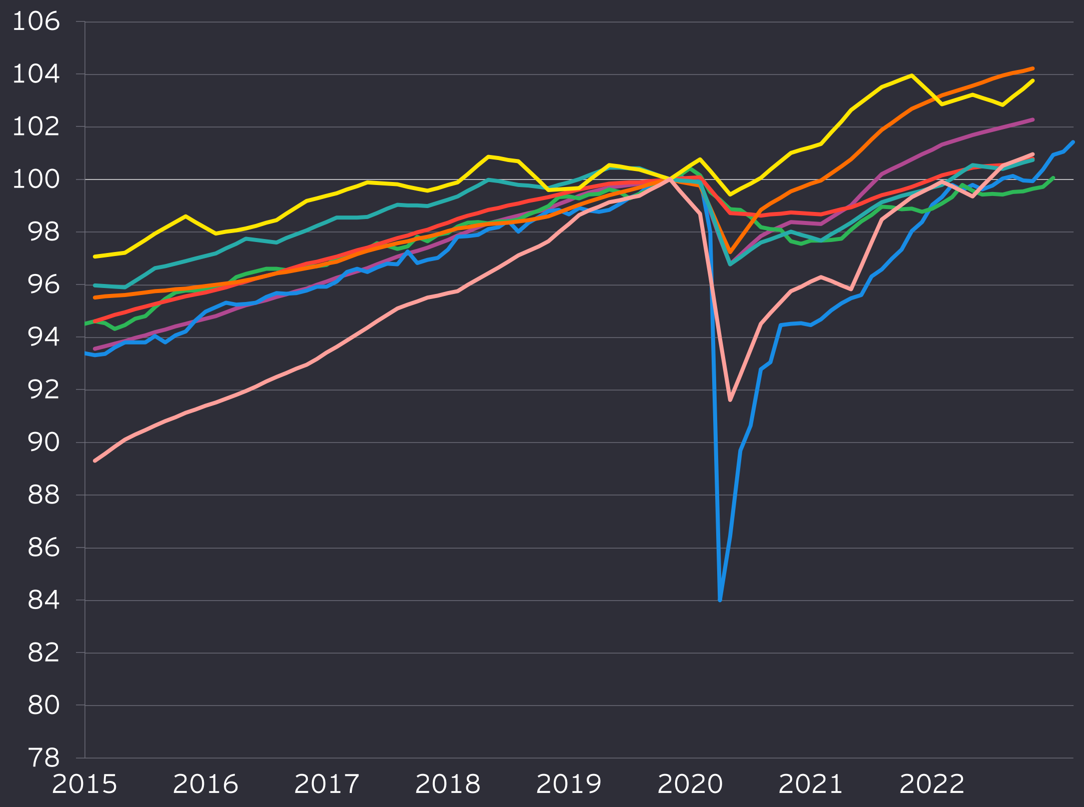


Source: EY calculations based on the CGE model.
[1] The West aggregate consists of the EU and the following countries: US, Australia, New Zealand, Japan, Korea, Taiwan, Singapore, UK, Canada, Switzerland, Norway and Ukraine. We consider a scenario where import and export tariffs are imposed between the West and the rest of the world, while there are no additional restrictions within trade blocks.

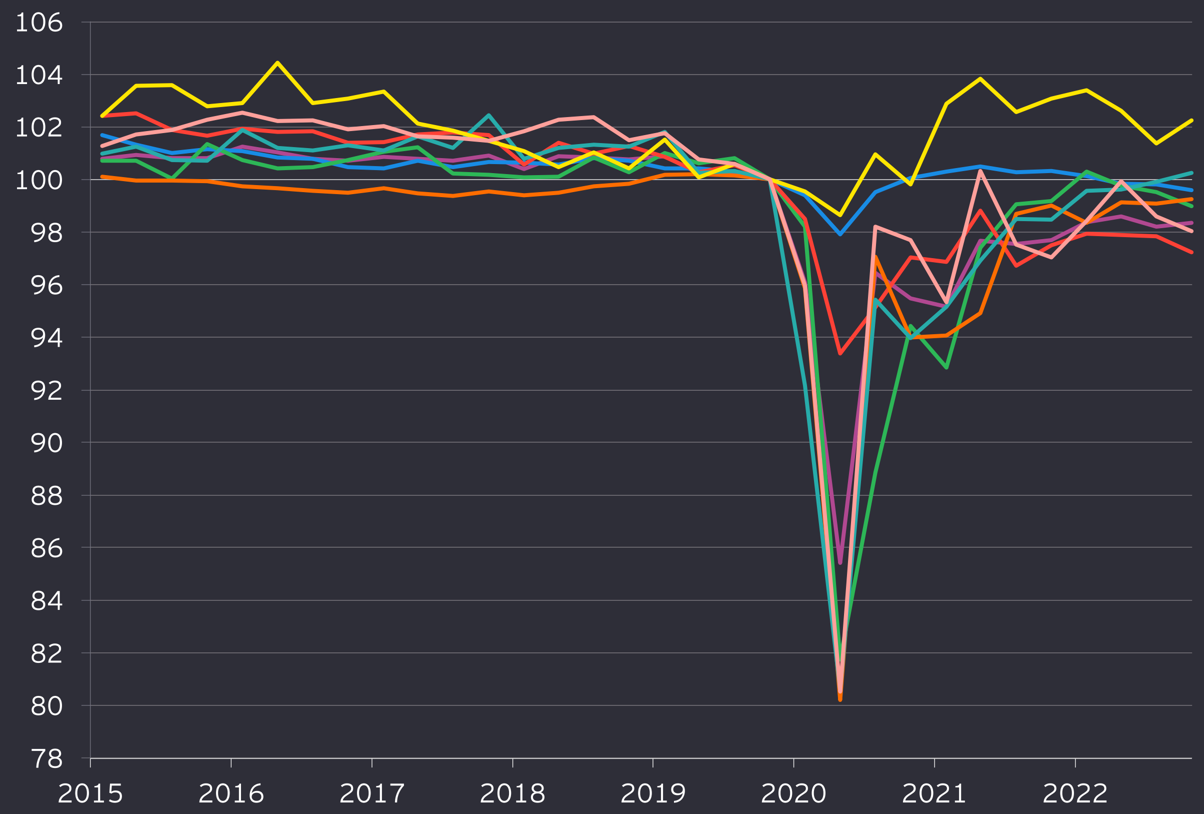
EY

Robust labor markets make this time different: despite economic slowdown, employment continues to grow reaching record high levels in many OECD economies

Employment*
(Index, Q4 2019 = 100, seasonally adjusted data)



Hours worked per employed
(Index, Q4 2019 = 100, seasonally adjusted data)



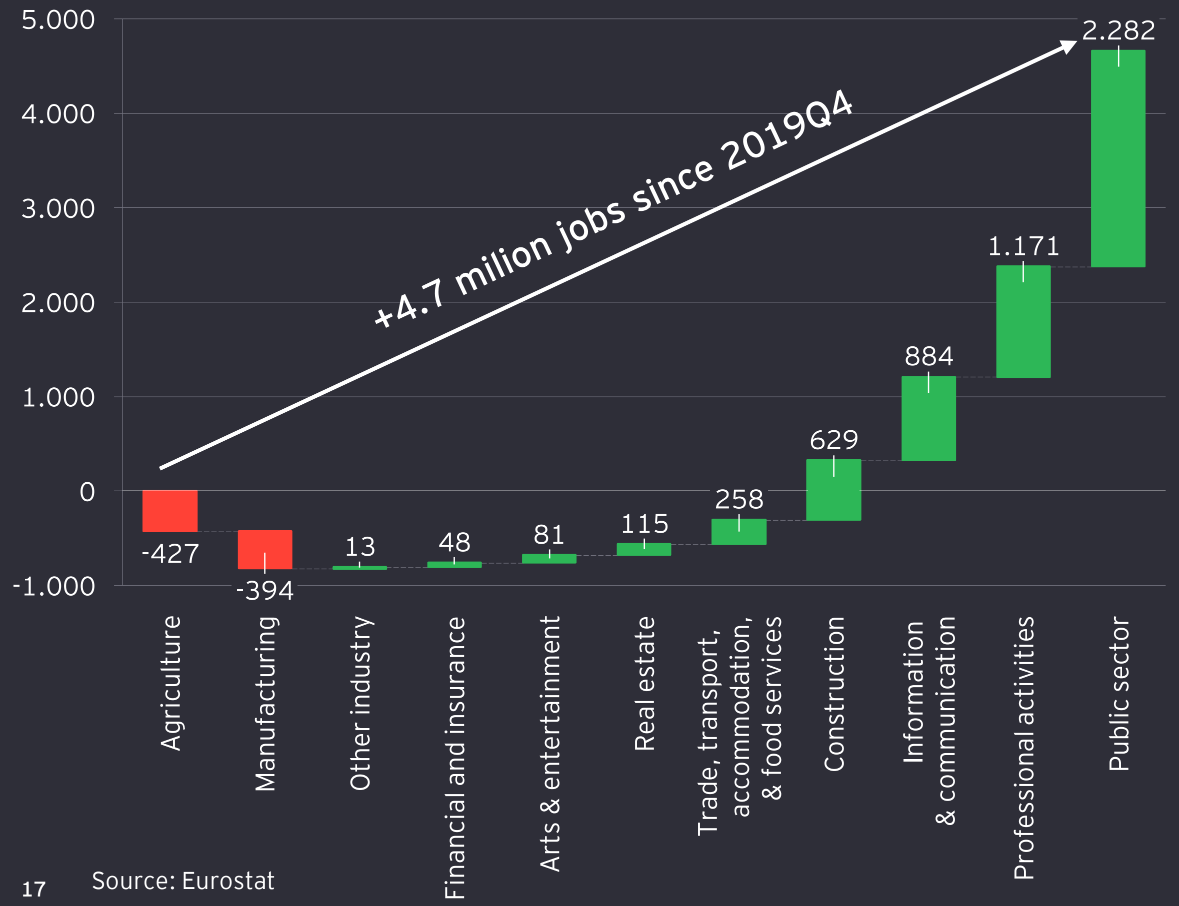
Euro area — US — UK — Germany — France — Italy — Poland — Spain

Source: Eurostat, FRED, ONS,
* For USA employment by the household survey, for UK number of employed persons, for Euro area and EU countries total employment by national accounts.

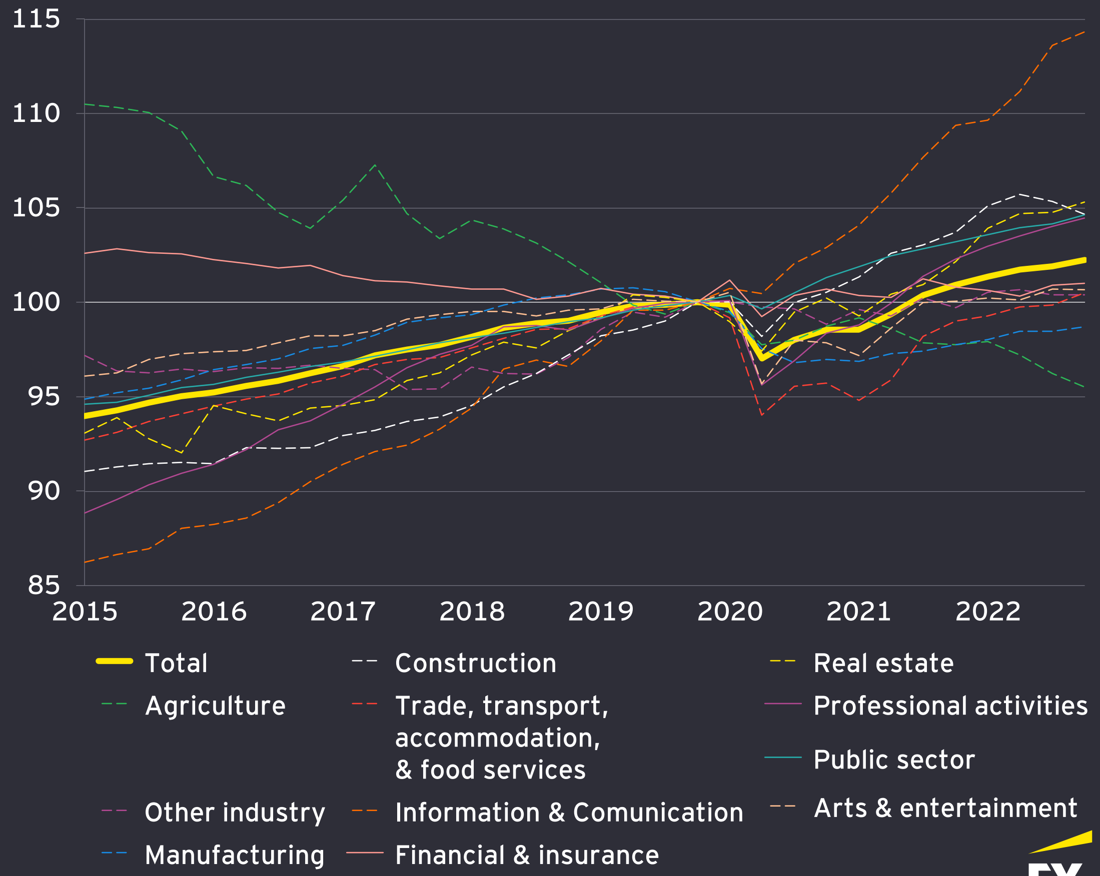
The post-pandemic recovery in the EU labor market has been asymmetric across sectors

- In absolute terms, employment increase was the highest in the public sector. It was aligned with the pre-pandemic trend.
- In relative terms, the highest employment increase has been observed in information and communication.
- Employment in manufacturing is still below pre-pandemic levels.

EU 27: employment by industry
(change in thousands, 2022 Q4 vs 2019 Q4)



EU 27: employment by industry
(Index, 100 = 2019 Q4)

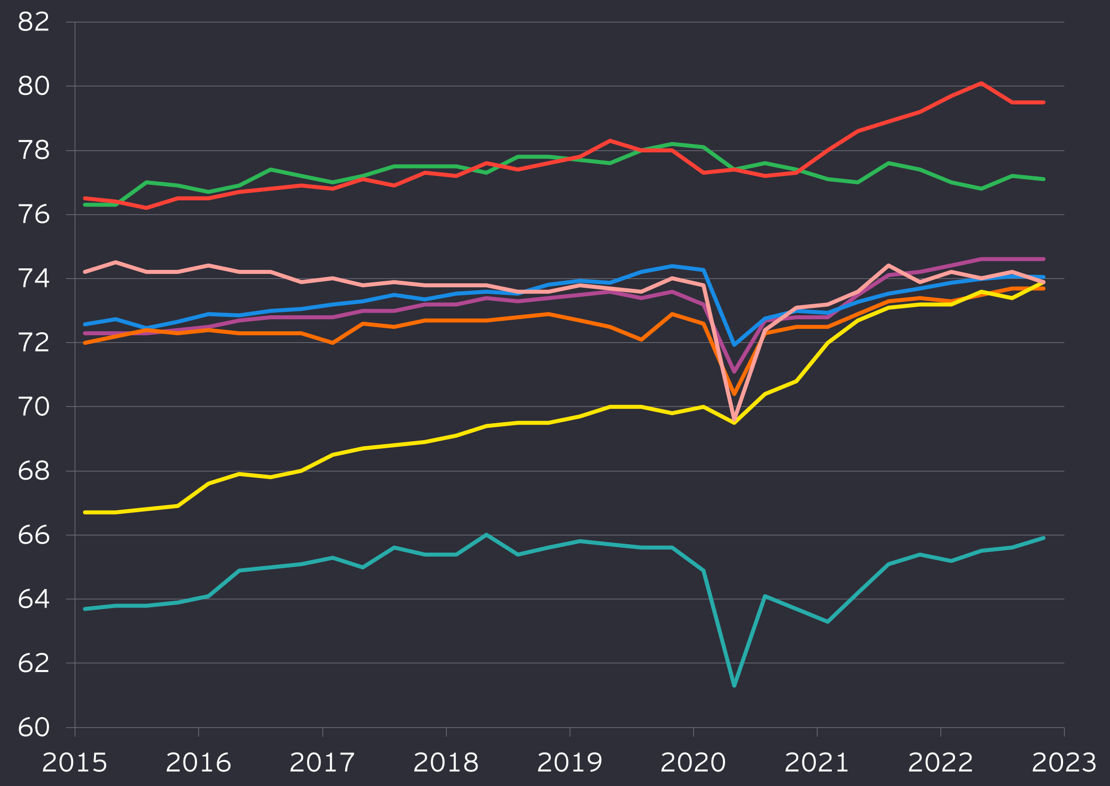


Source: Eurostat

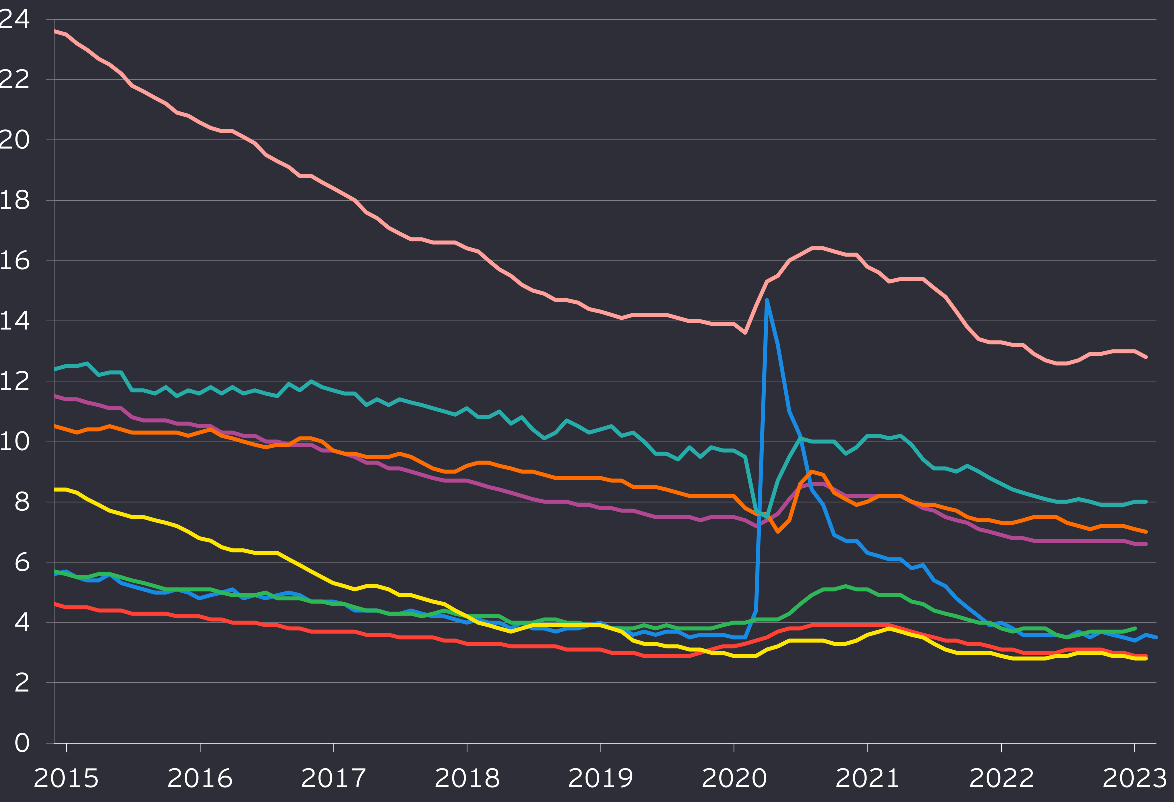
Activity rates have reached pre-pandemic levels in many OECD countries while unemployment rates are at or near historical lows

- Economic slowdown should lead to deceleration in wage growth, but without a significant surge in layoffs and with only a limited increase in unemployment. This is partly due to structural labor shortages that make companies 'hoard' staff more often than during past economic downturns.

Activity rate
(15-64 years old, in percentage, seasonally adjusted)



Unemployment rate
(in percentage)



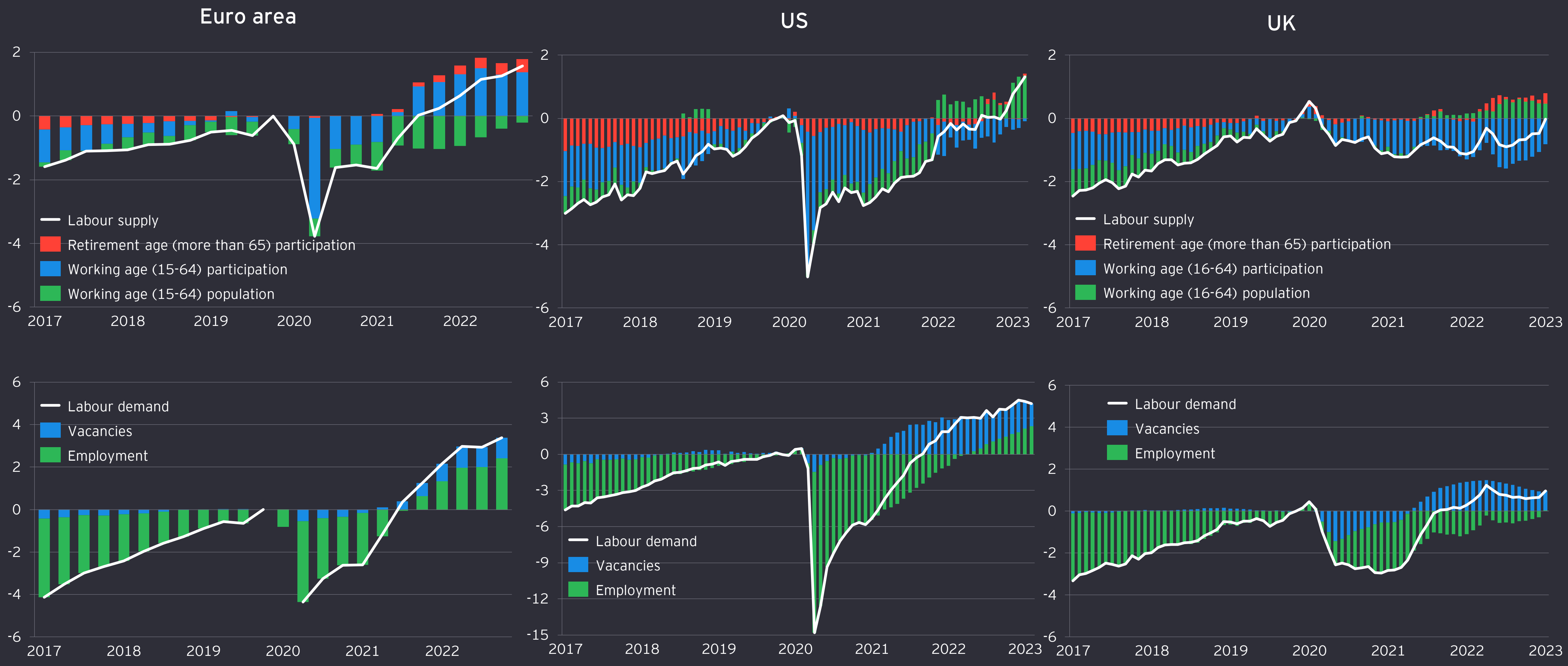
Euro area | US | UK | Germany | France | Italy | Poland | Spain

Source: Eurostat, FRED, ONS.

While labor demand has increased relative to pre-pandemic levels, labor supply has usually increased less, contributing to labor market tightening

Labor supply change compared with 2019 Q4 (in percentage)

Labor demand change compared with 2019 Q4 (in percentage)



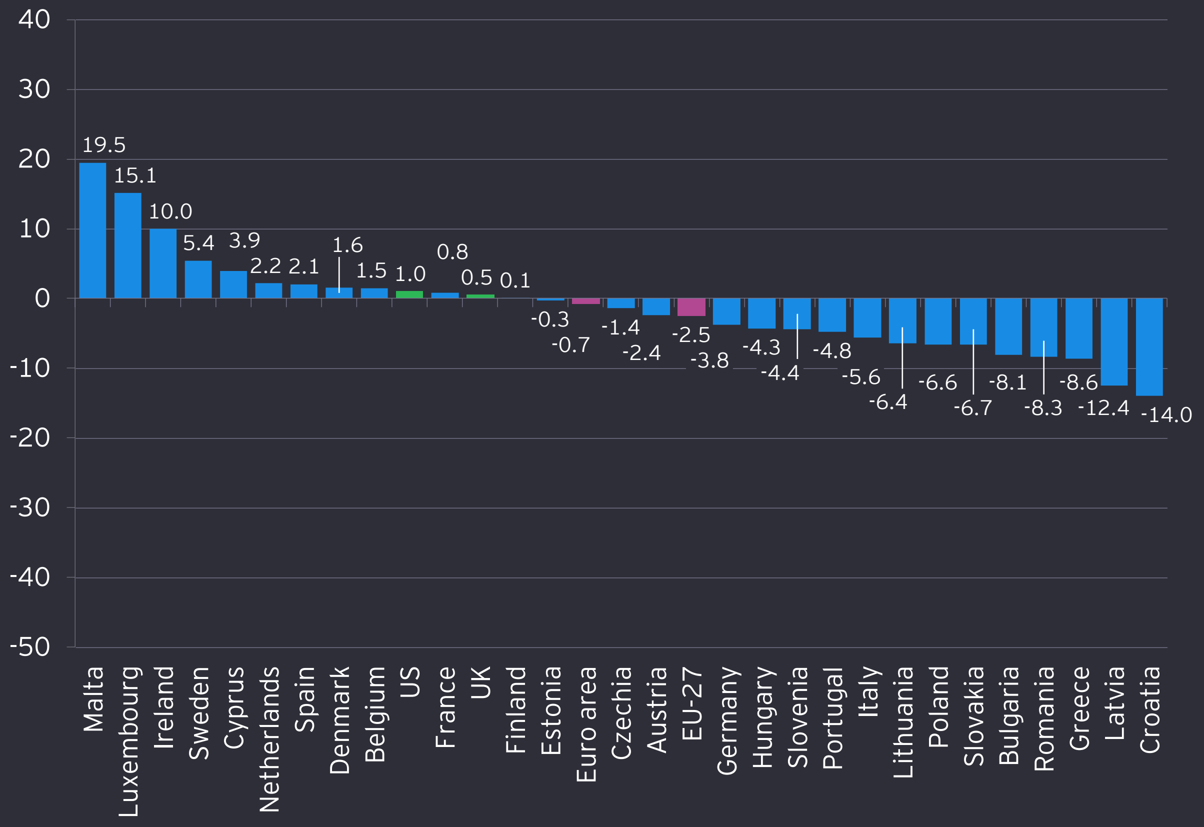
Source: Eurostat, BLS, FRED, ONS.

This is partly due to demographic issues, which are more acute in CEE countries

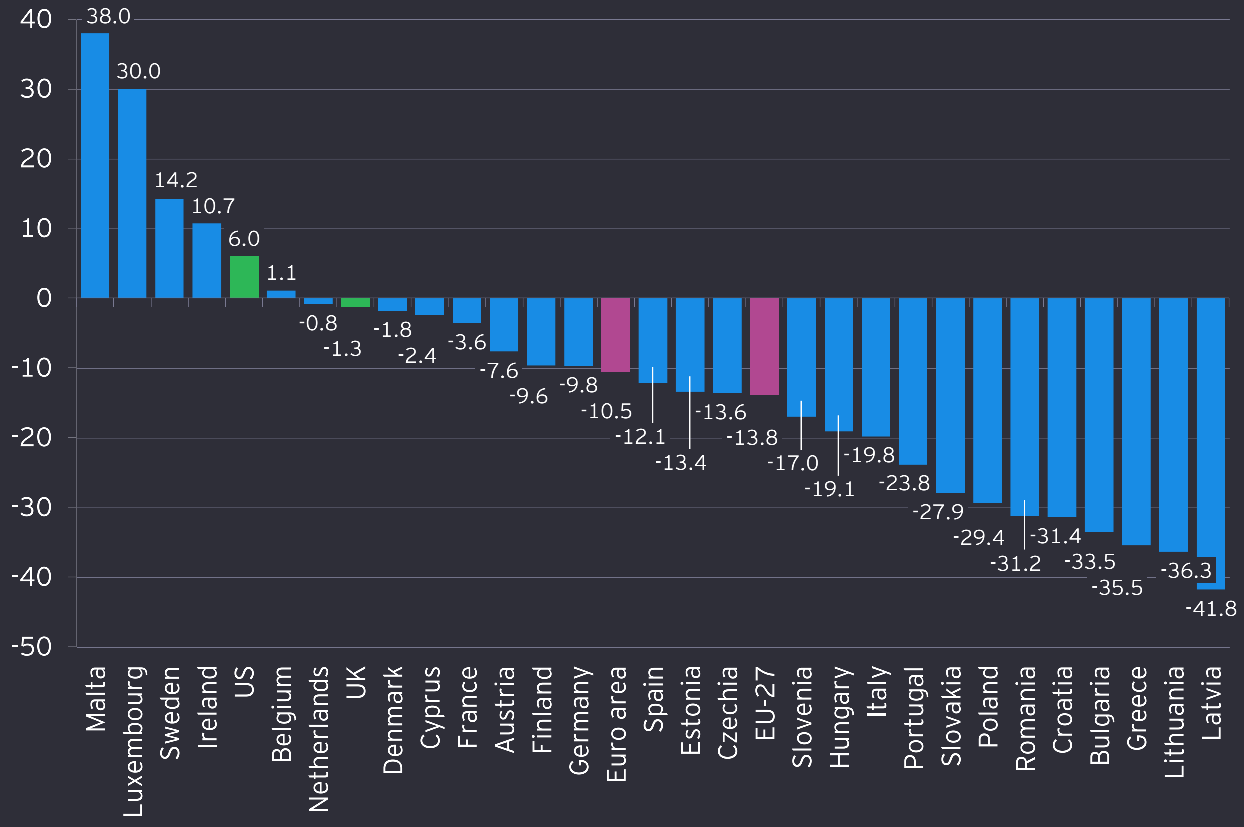
- Labor shortages and population aging increase the role of reskilling, upskilling, automation and AI solutions.

Projected change in the working-age population (20-64) in the EU, US, and UK (in per cent)

a) between 2020 and 2030



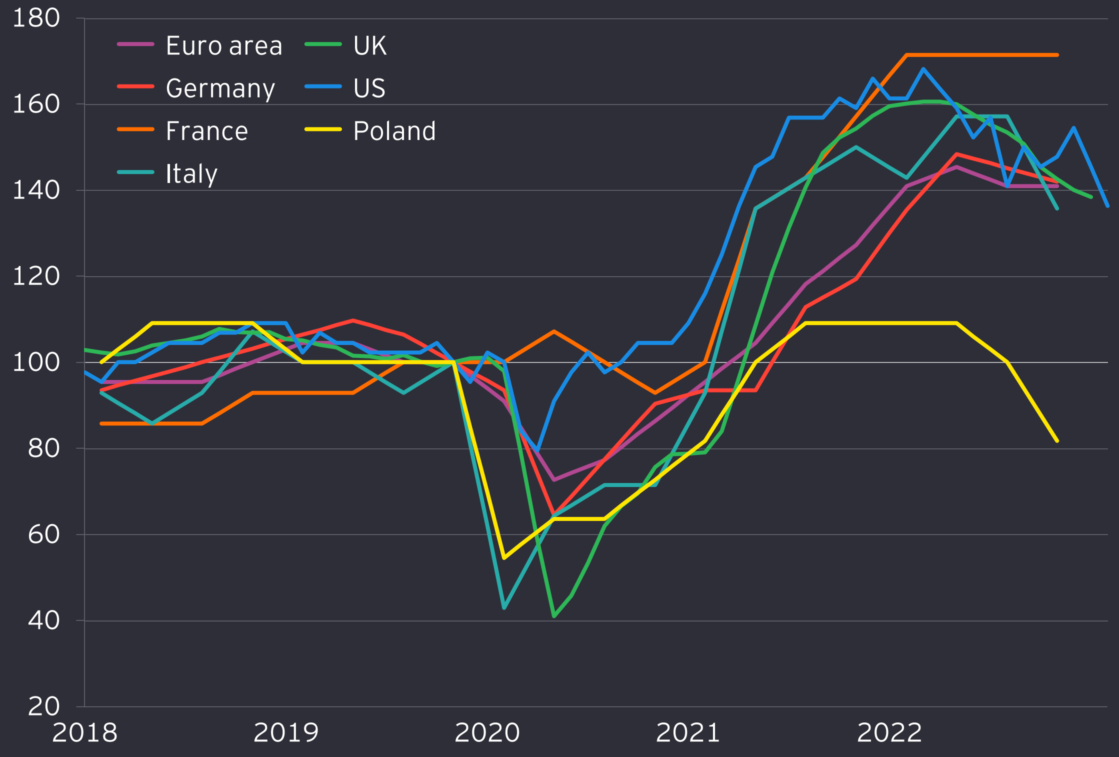
b) between 2020 and 2060



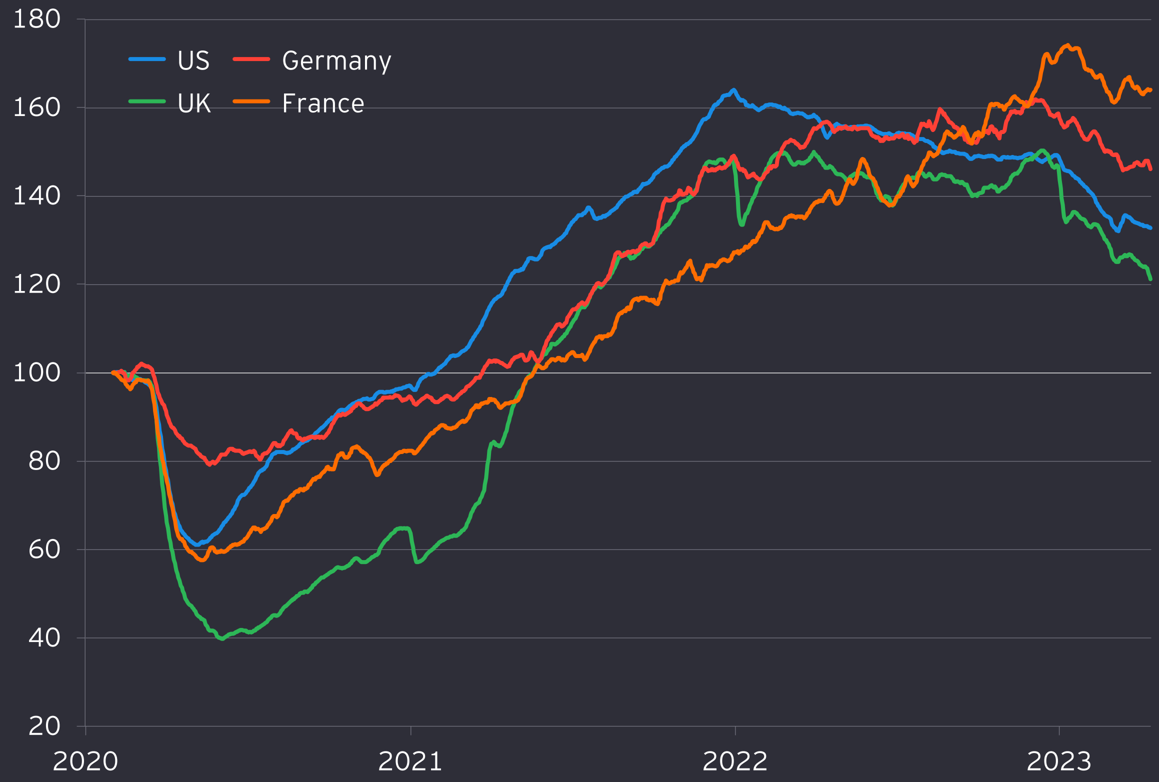
Source: Eurostat (2023 baseline projection); US CBO (Jan 2023); ONS (2020-based).

Due to economic slowdown, demand for labor has softened a bit, but remains high. The recent decline observed in job postings data is rather cyclical

Vacancy rate [1] *
Index, Q4 2019 =100



Indeed Job Postings Index[2],
(Index, Feb 01 2020 = 100)

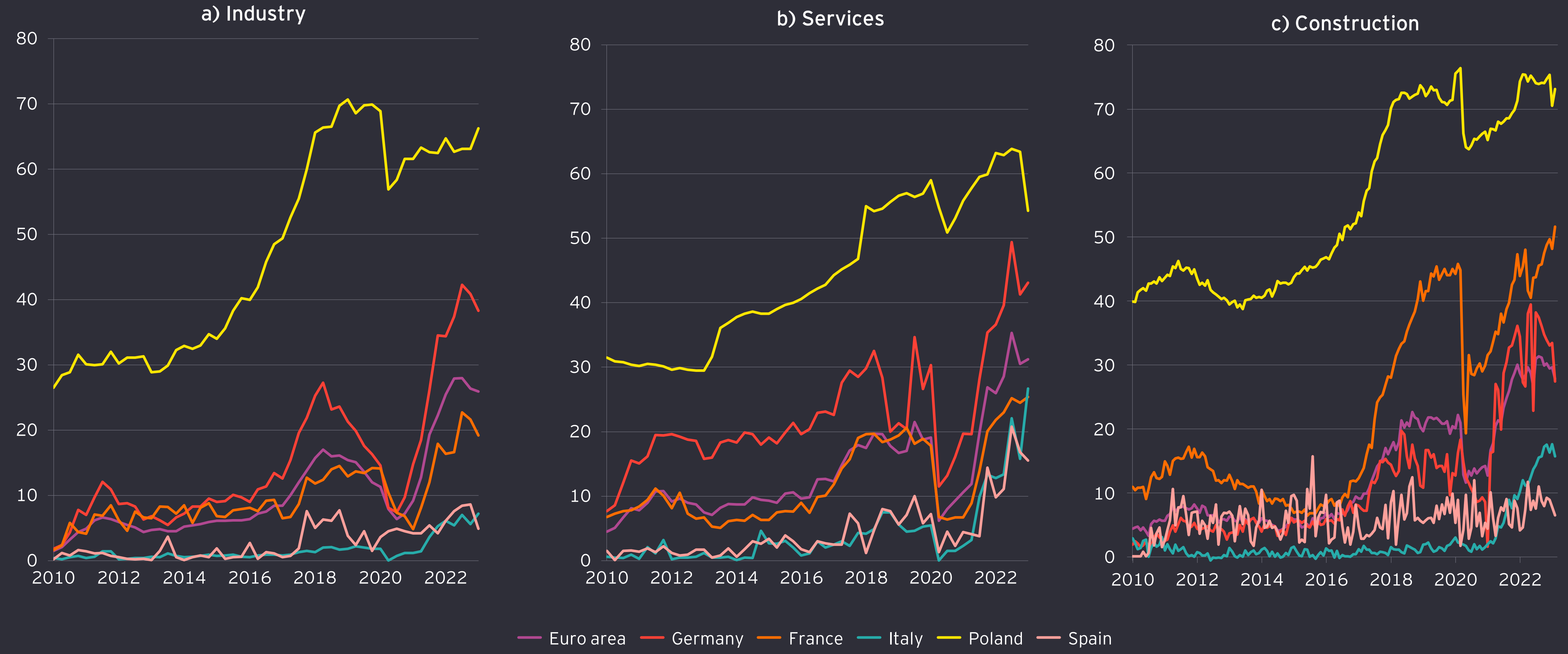


Source: [1] Eurostat, ONS, FRED, EY EAT calculations. [2] Data on online job postings is based on GitHub - hiring-lab/job_postings_tracker: Regularly updated data series for external use.
[3] Eurostat, EY EAT calculations, VA per worker based on 2021 data on sector VA and total employment.

* Vacancy rate is the number of vacancies divided by the total number of filled positions (for the UK, total number of people employed). For the EU countries, quarterly data; for the UK and the US, monthly data. For France, vacancies reported by firms employing at least 10 employees.

Firms report some reduction in labor market tensions, but in most countries the labor market remains much tighter than before the pandemic

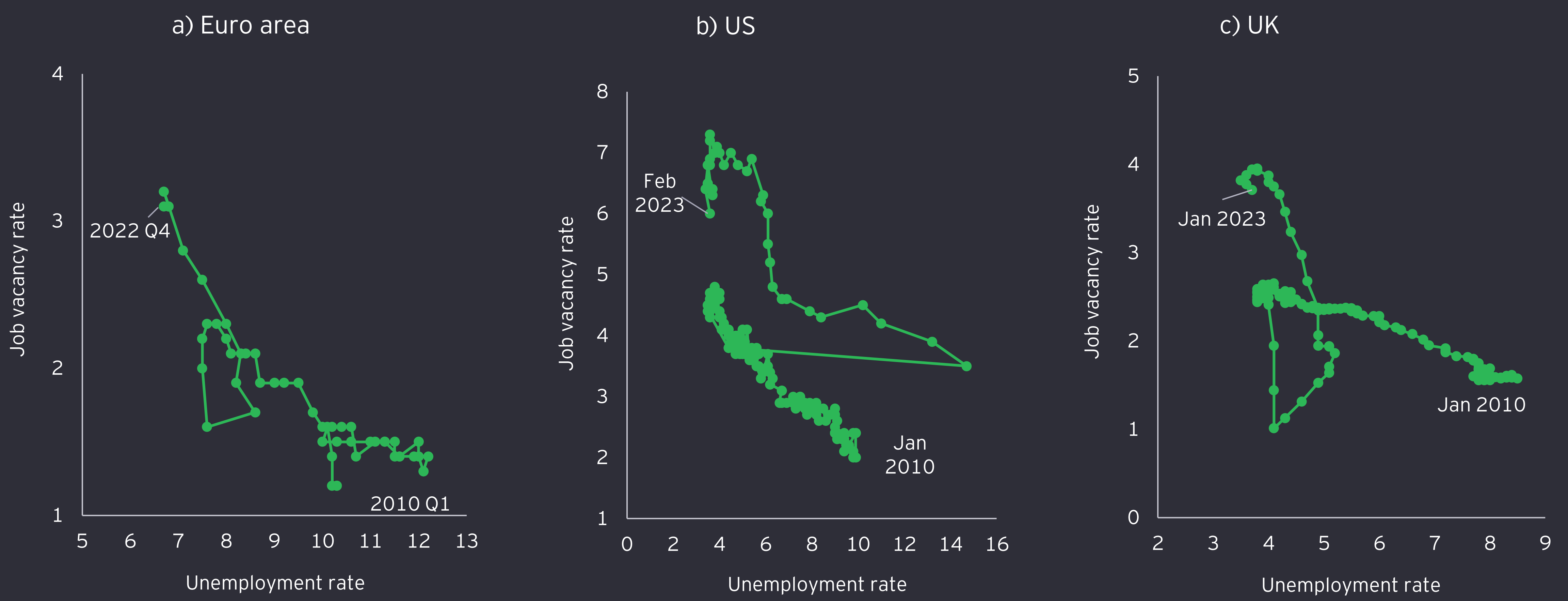
Factors limiting the production – Labor
(in percentage, seasonally adjusted)



Source: Eurostat.

Despite some recent cooling, labor markets in major economies remain very tight, especially in the US

Beveridge curve (vacancy rate vs. unemployment rate, percentage of labor force)

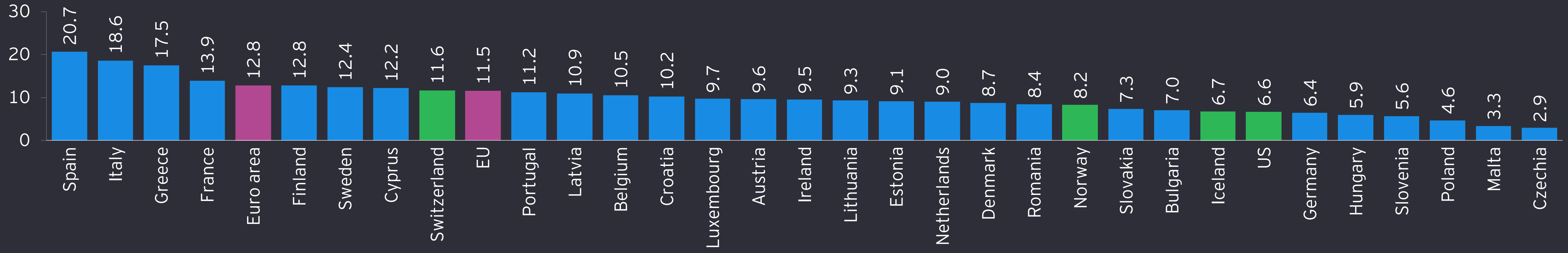


Source: Eurostat, Fred, ONS.
Notes: For euro area, persons unemployed aged 15-74 (quarterly data). For the UK, persons unemployed aged 16-64 (monthly data). For the US, unemployed persons aged 16 and over (monthly data).

Even though it reached a record low, labor market slack remains substantially higher in the euro area (particularly in Southern Europe) than in the US, UK or CEE

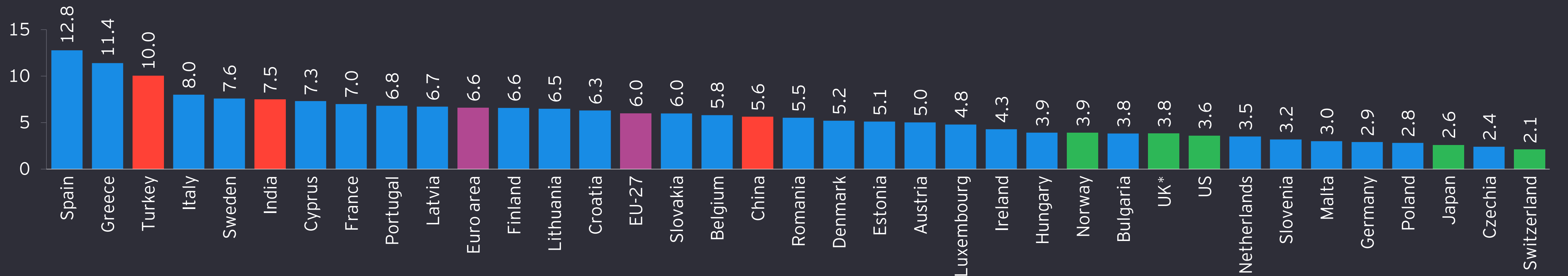
Labor market slack, Q4 2022

Percentage of the extended workforce aged 20-64



Unemployment rate in February 2023

Percentage of population in the labor force



Source: Eurostat; ONS; BLS

Note: Labor market slack includes four groups:

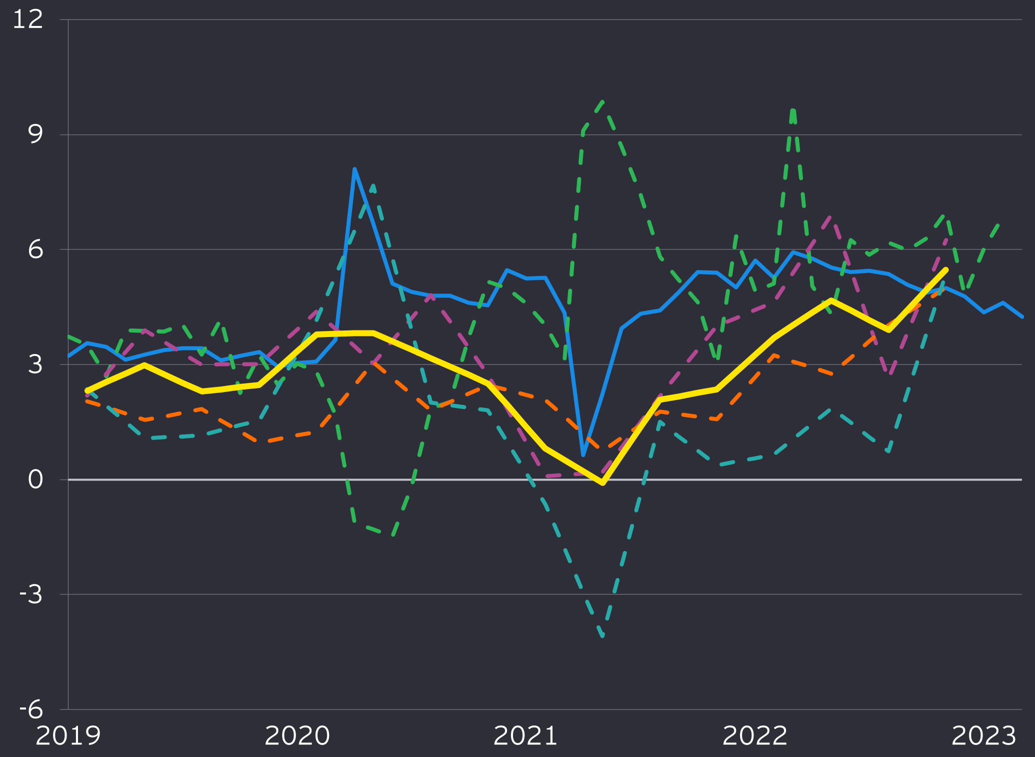
1. Unemployed persons, as defined by the ILO
2. Underemployed persons working part-time
3. Persons available to work but not seeking
4. Persons seeking work but are not immediately available

While the first two groups count as part of the labor force, the other two, also referred to as potential additional labor force, are outside the labor force. For this reason, the 'extended labor force,' consisting of both the labor force and the potential additional labor force, has been used for this analysis. For the US, the labor slack is the U-6 unemployment rate. For the US and UK, the unemployment rate for those aged 16-64.* Unemployment rate for December 2022 to February 2023.

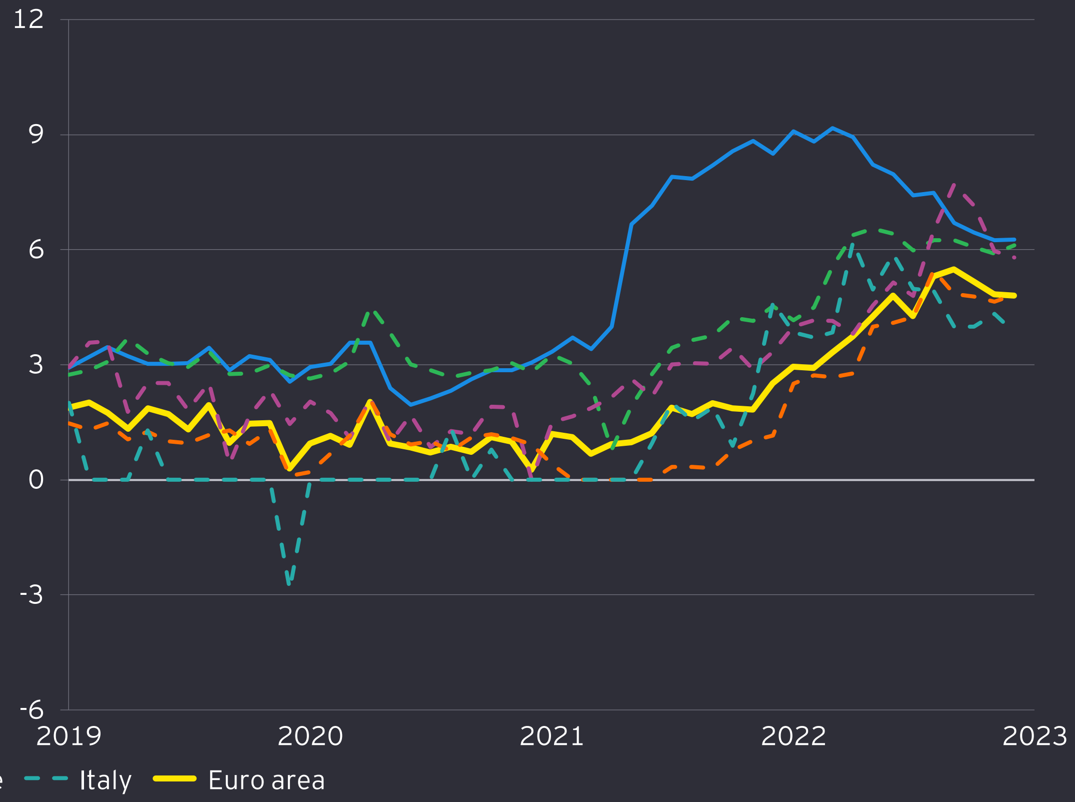
Despite this, on the back of elevated inflation, nominal wage growth in the euro area has accelerated and caught up with the US and UK. However, data on wages offered in job postings signal that wage pressures are no longer intensifying

- On one hand, the ongoing economic slowdown reduces employees' bargaining power, while on the other the still-tight labor market, indexation to past inflation and minimum wage hikes in many countries are likely to maintain wage growth momentum in the coming quarters.

Labor cost index[1], nominal
(YoY, %)



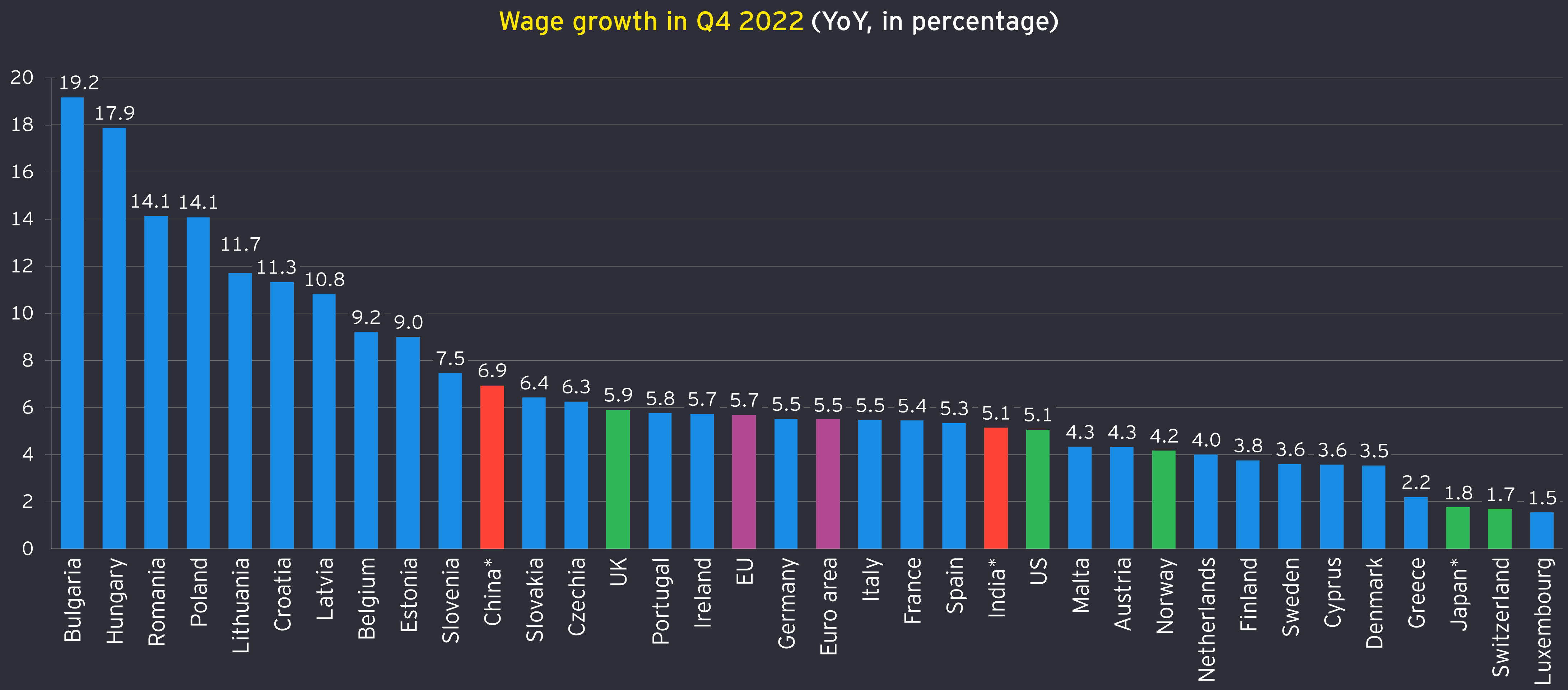
Wage growth in job postings[2]
(YoY, %)



Source: [1] Eurostat, ONS, FRED, Oxford Economics
For the European area countries, labor cost index (quarterly data); for the UK, average weekly earnings in the whole economy, total pay (monthly data); for the US, average hourly earnings in the private sector (monthly data). Real wages deflated with CPI.

[2] Data on nominal wage growth in job postings is based on "Wage growth in euro area countries: evidence from job ads" – P. Adrjan & R. Lydon, Economic Letter, Central Bank of Ireland, Vol 2022, No. 7. The latest observations are for December 2022.

At the same time, in many CEE countries wages continue to grow at a double-digit pace



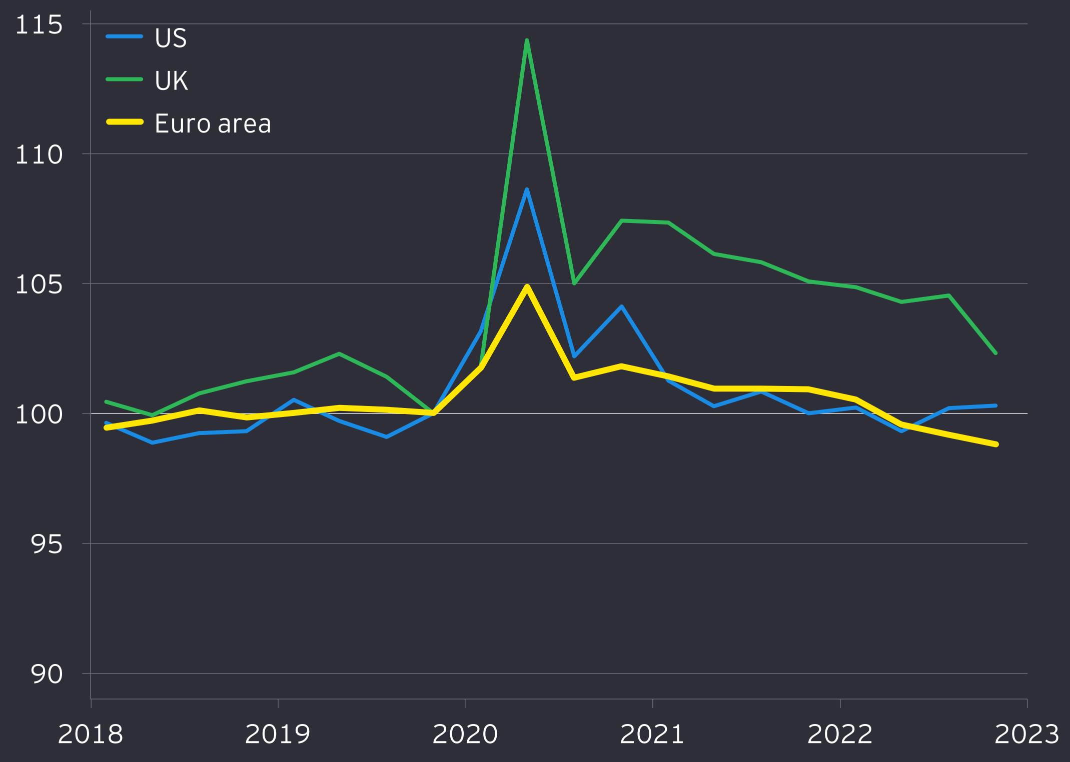
Source: Eurostat; FRED; ONS; Oxford Economics.
Notes: For EU countries, wages per worker from national accounts were used; for the US, the Employment Cost Index, and for the UK, the total wages in the national economy.
* Oxford Economics estimates.

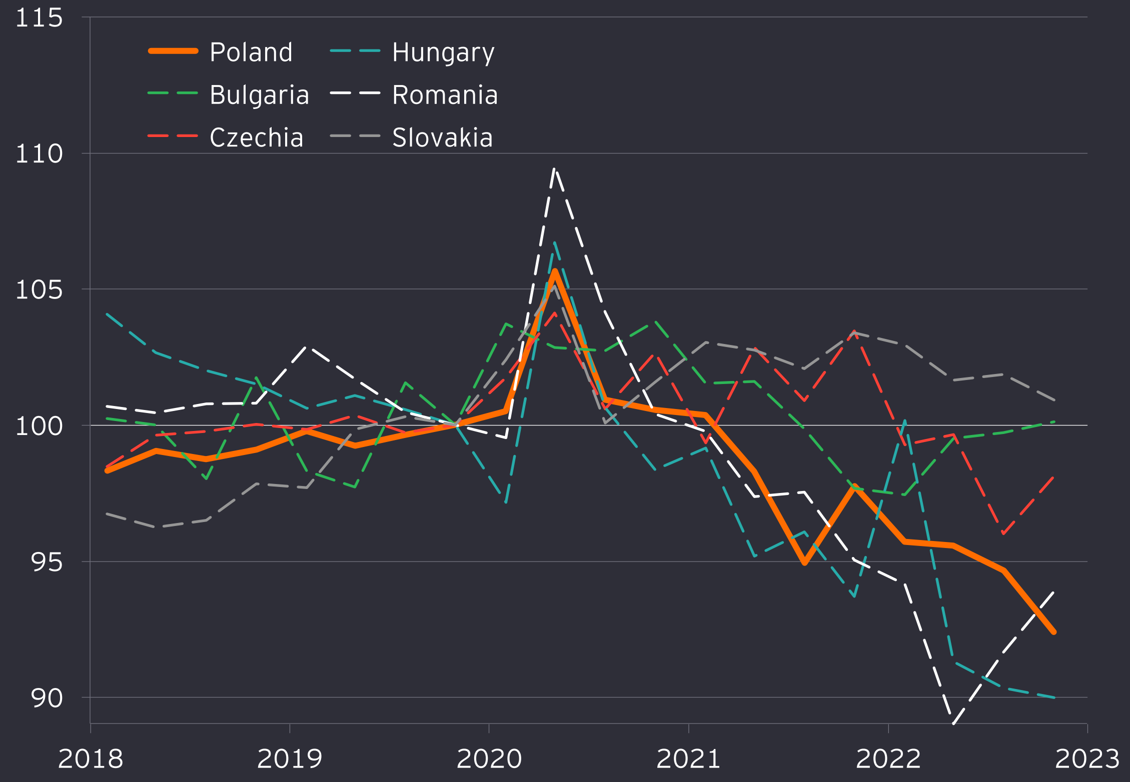
In many countries, real wages have decreased substantially and in most CEE economies, the share of compensation in gross value added has declined significantly since the pandemic outbreak. With a tight labor market, workers may use their bargaining power to recoup lost income

- A more robust wage growth is unlikely to prevent goods disinflation, but would imply more persistent inflation in services, which are on average much more labor-intensive and in which wages represent double the share of direct input costs than that in manufacturing firms.

Compensation of employees as a share of Gross Value Added

Index, Q4 2019 =100

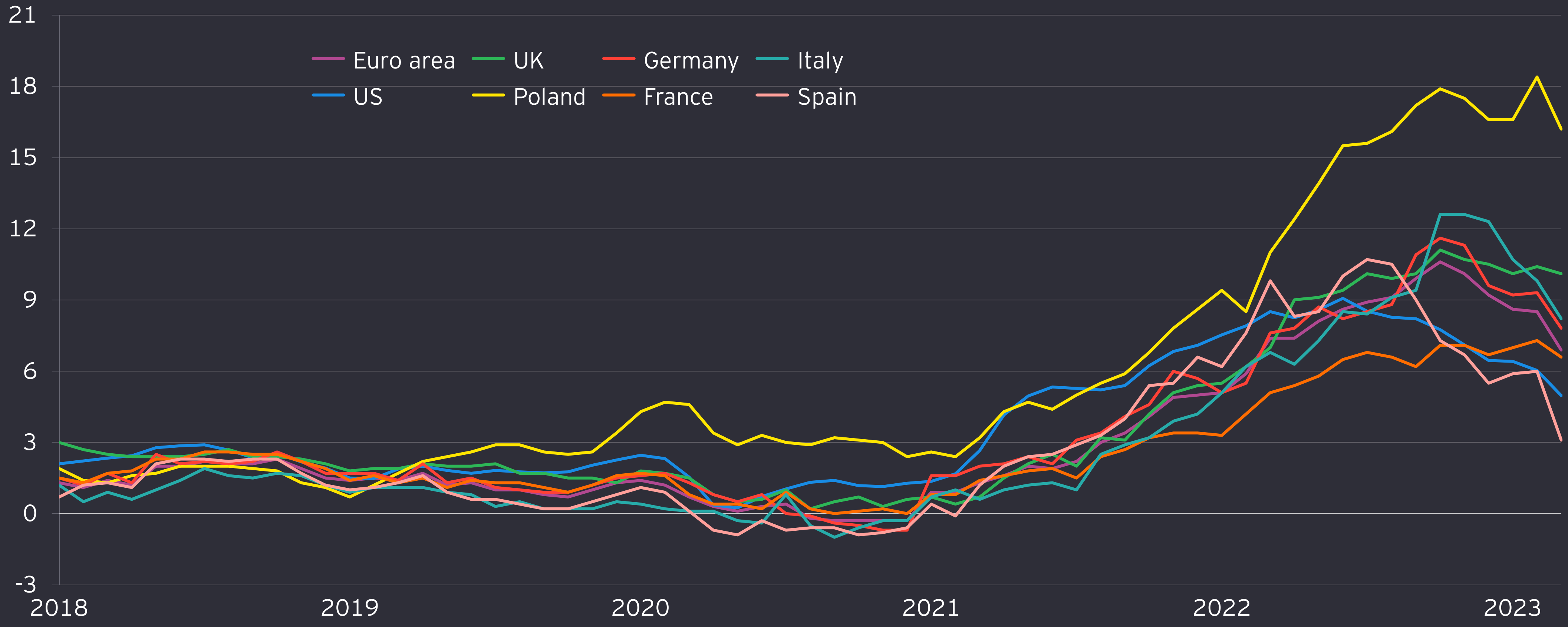




Source: Eurostat, ONS, FRED.

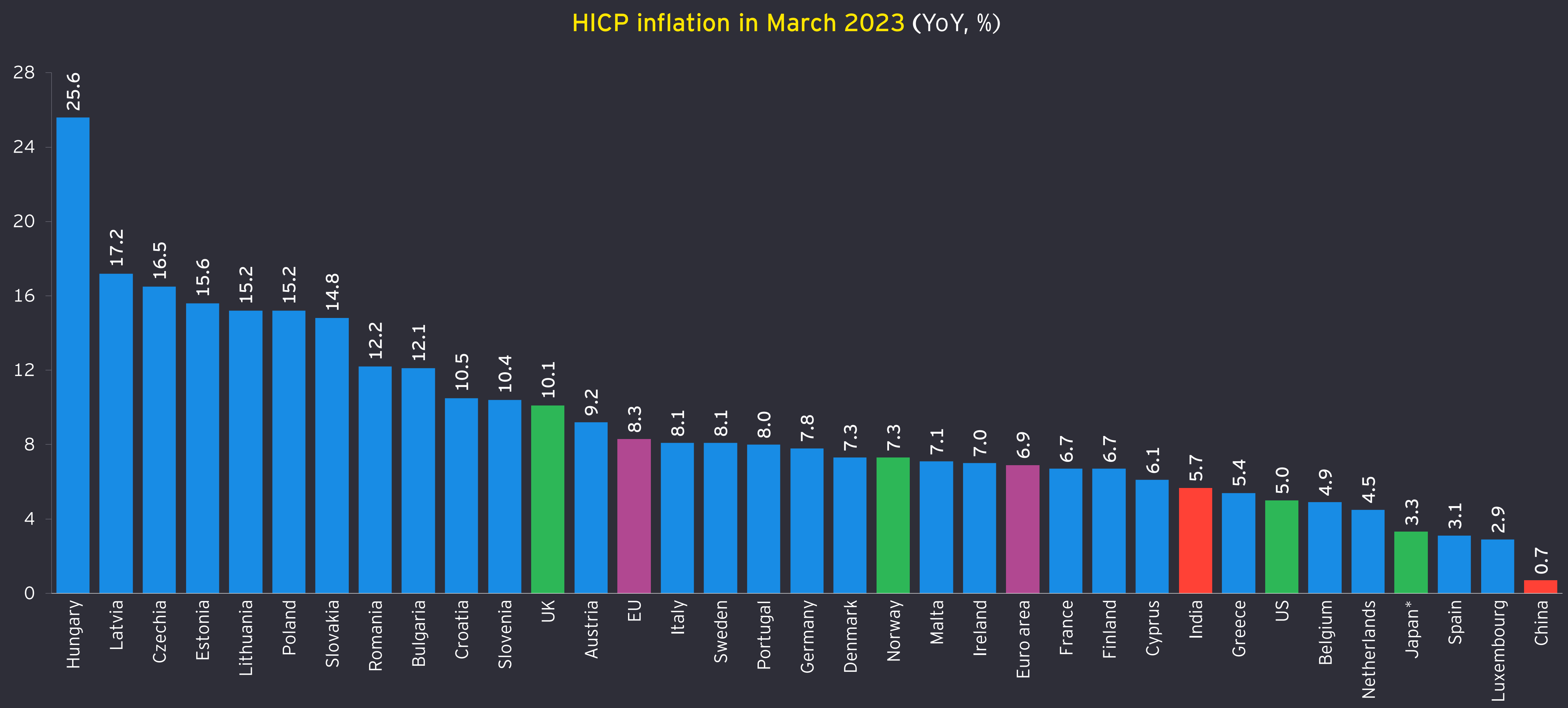
Despite tight labor markets and strong nominal wage growth, inflation has passed its peak and begun to decelerate in most countries

Inflation (YoY, in percentage)



Source: Eurostat; FRED.
Notes: For the euro area. For Poland, the US and the UK, CPI inflation. Flash estimate for March 2023.

Inflation remains elevated, although its level varies widely across Europe, with highest rates recorded in CEE countries

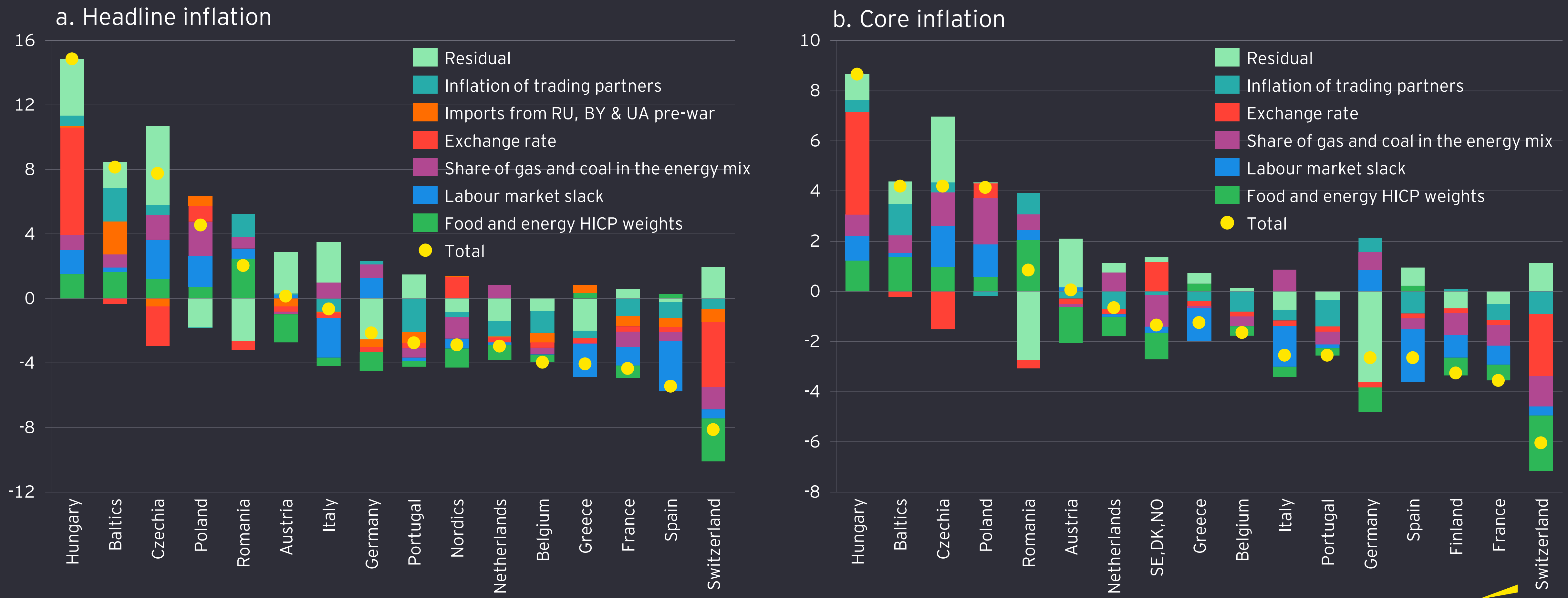


Source: Eurostat, FRED, ONS, statistical bureaus.
Note: For non-EEA countries, CPI inflation.
* Inflation rate in February.

Inflation tends to be higher in countries with tighter labor markets, fossil-fuel-based energy mix, higher shares of food and energy in the consumer basket, exchange rate depreciation, stronger trade linkages with Russia before the war in Ukraine and higher inflation among trading partners

- At the same time, consumer demand, wage growth, pre-pandemic inflation volatility, spending to combat the energy crisis, energy intensity, money supply, inflation expectations and agricultural production do not seem to be correlated with cross-country differences in inflation.

Model-based decomposition of cross-country differences in HICP inflation in January 2023 (deviations from unweighted average, in percentage points)

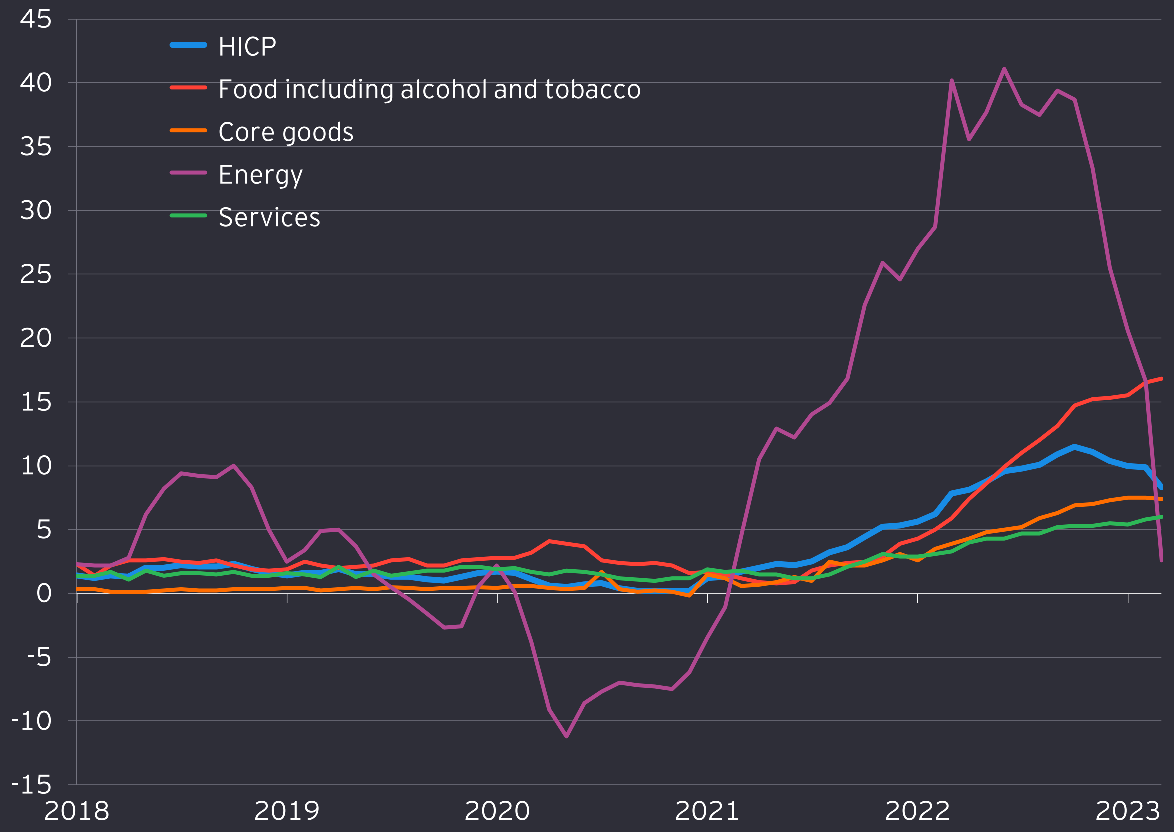


Source: EY calculations based on Eurostat, Bruegel, Our World in Data, ECB and Oxford Economics data.

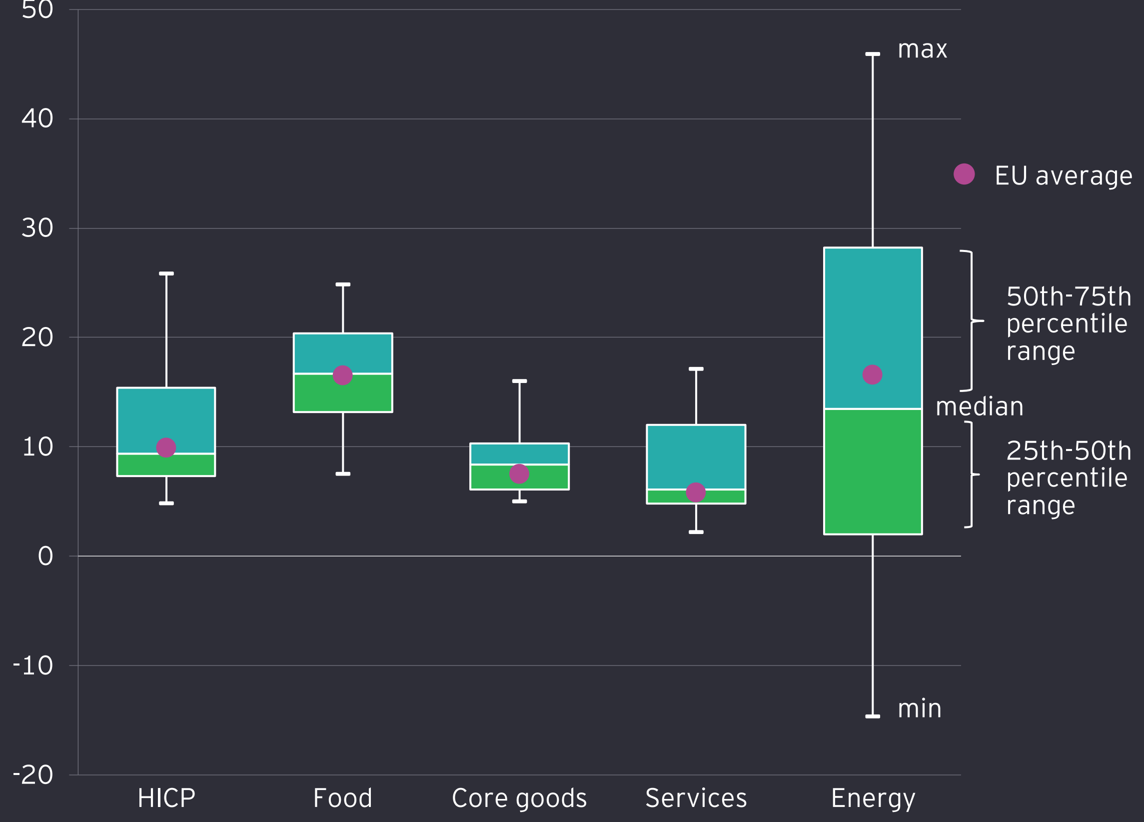
In the EU, the recent decline in inflation is driven by energy price disinflation, while core goods and, especially, food price pressures continue building up

- At the same time, energy price inflation differs widely across countries due to differences in energy mix and regulations, including support measures for households and firms to help them weather the energy crisis.

HICP inflation in EU-27 (YoY, in percentage)



Distribution of HICP inflation in EU countries in February 2023 (YoY, in percentage)

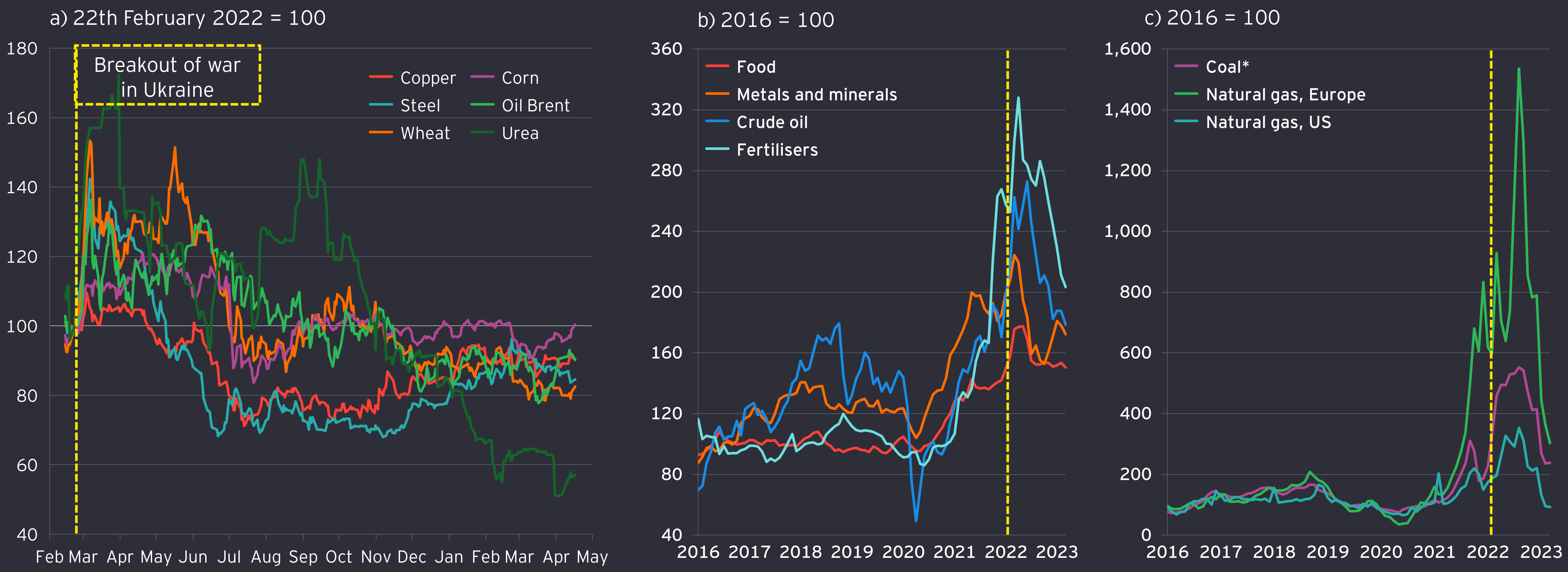


Source: Eurostat.

Energy inflation goes down not only due to base effects (elevated prices a year before) but also thanks to the decline in prices of energy commodities below pre-war levels

- Commodity prices remain above pre-pandemic levels, though.

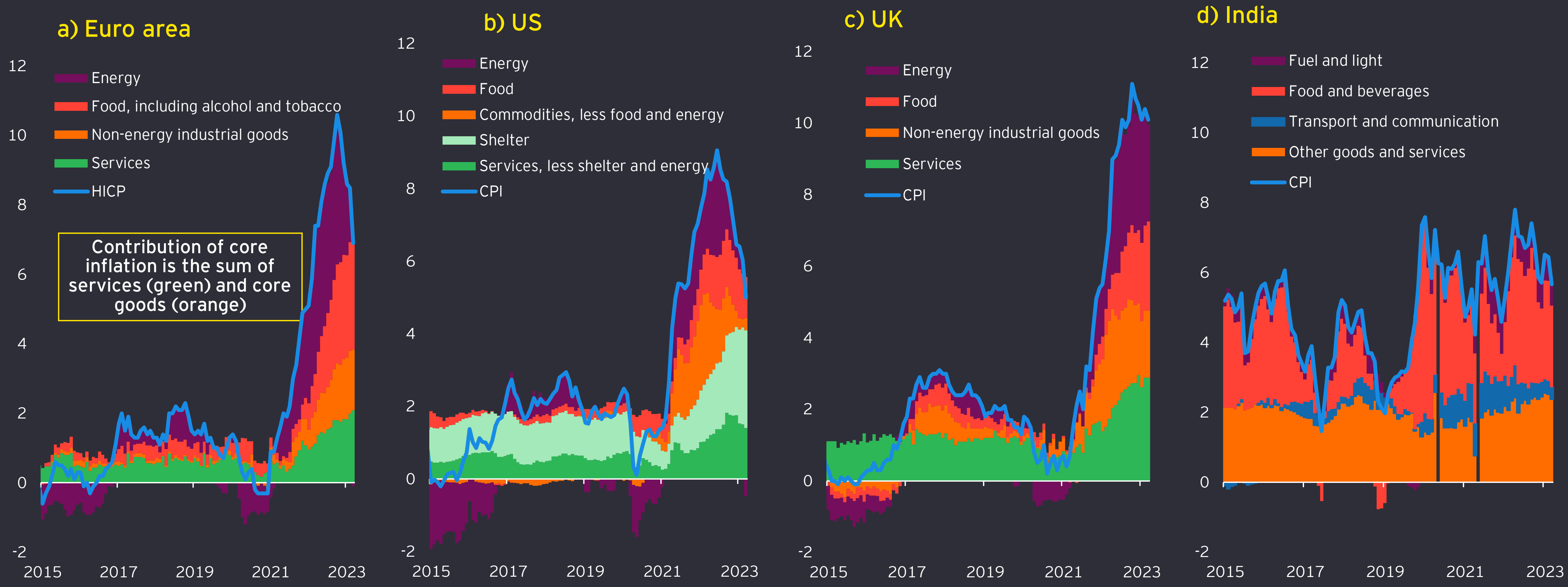
Global commodity prices (index)



Source: World Bank Commodity Prices; stooq.pl.
* ICE Rotterdam coal price.

While inflation in the euro area has so far been coming down exclusively on the back of declines in energy price inflation, in the US, disinflation is more broad-based

Statistical decomposition of year-over-year inflation (in percentage)

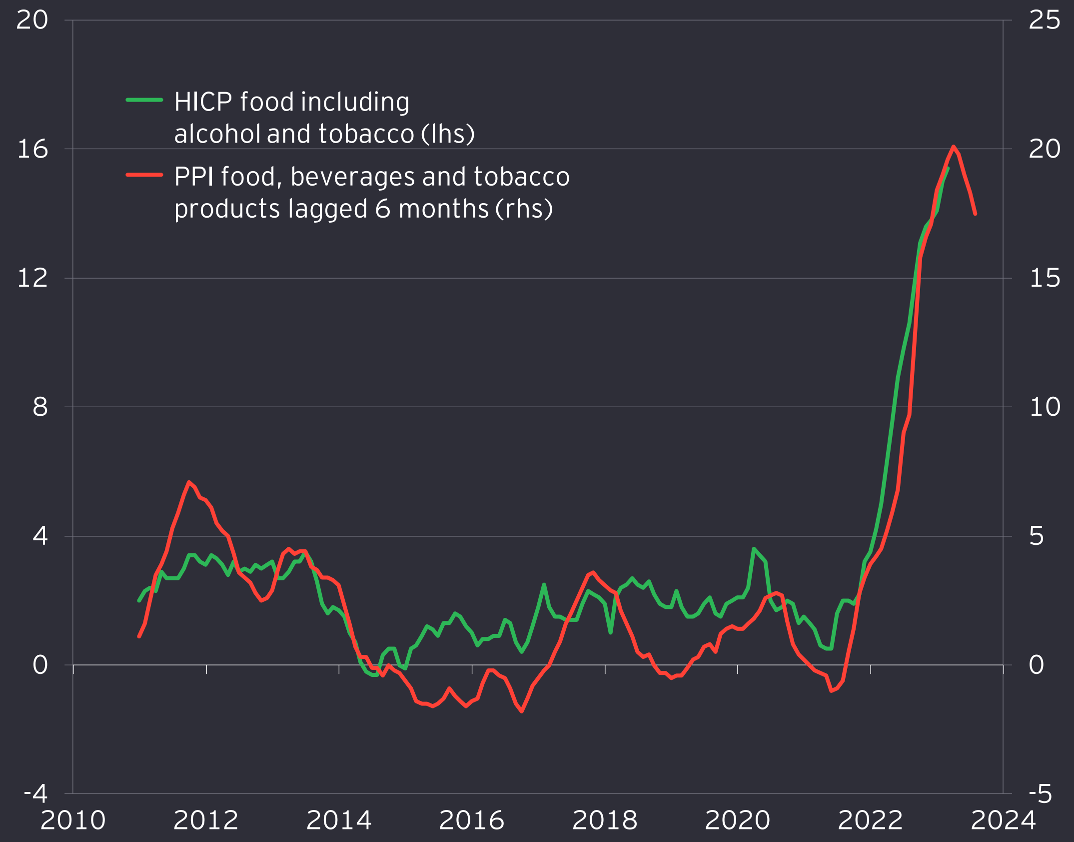


Source: Eurostat; FRED; BLS; ONS; RBI; EY EAT calculations.

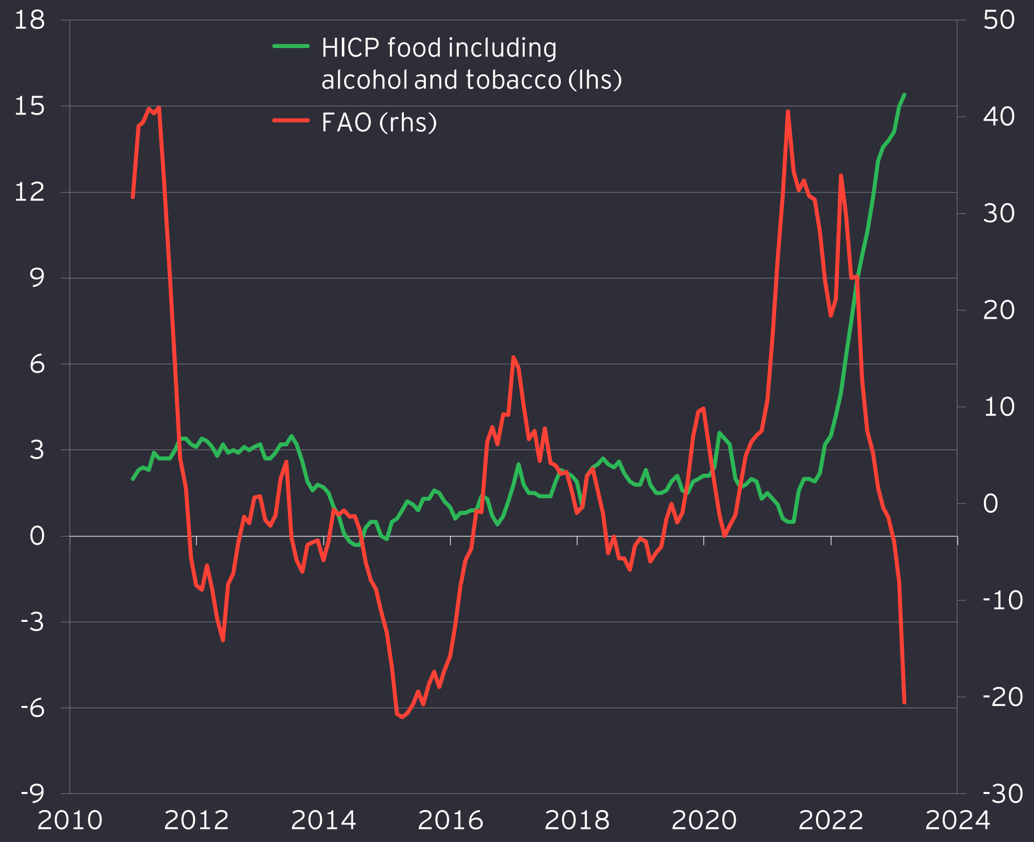
Euro area food price inflation continues to accelerate on the back of earlier increases in energy and food commodity prices and euro depreciation. However, PPI inflation suggests that it should turn the corner soon

- A decline in global food commodity prices will support food CPI disinflation, though this factor has a delayed and muted impact on CPI inflation as food prices are also influenced by a plethora of other factors (energy prices, wage costs, local weather conditions and crops).

Food HICP and PPI in the euro area (YoY, in percentage)



Food HICP in the euro area vs. FAO index (YoY, in percentage)

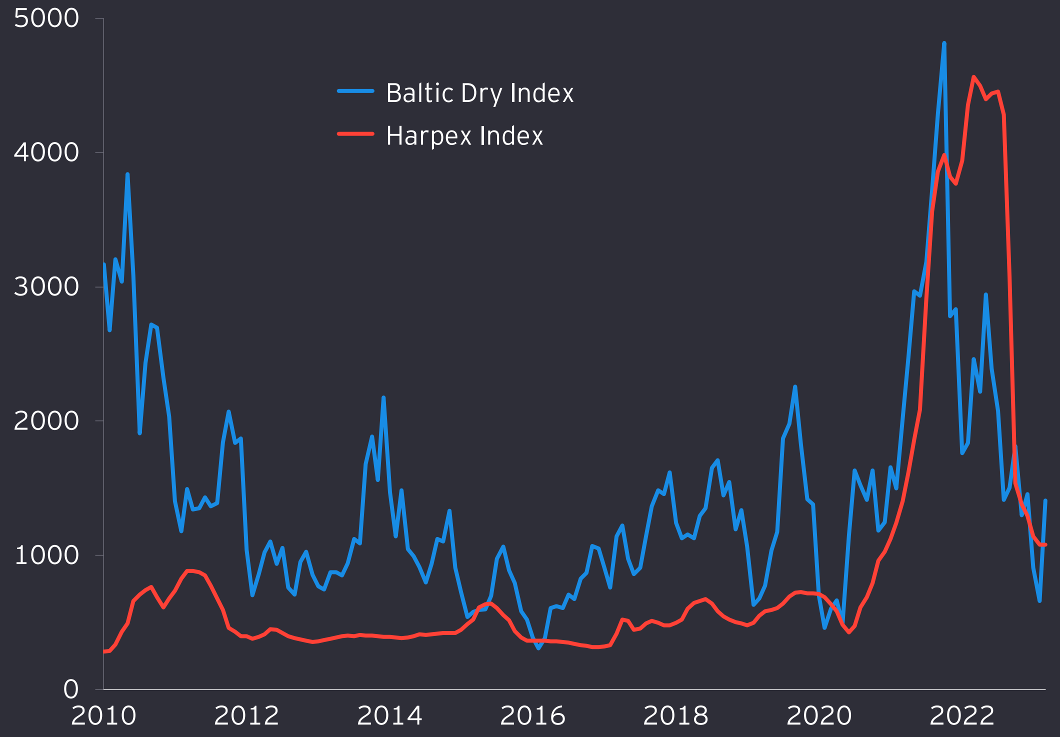


Source: Eurostat, FAO.

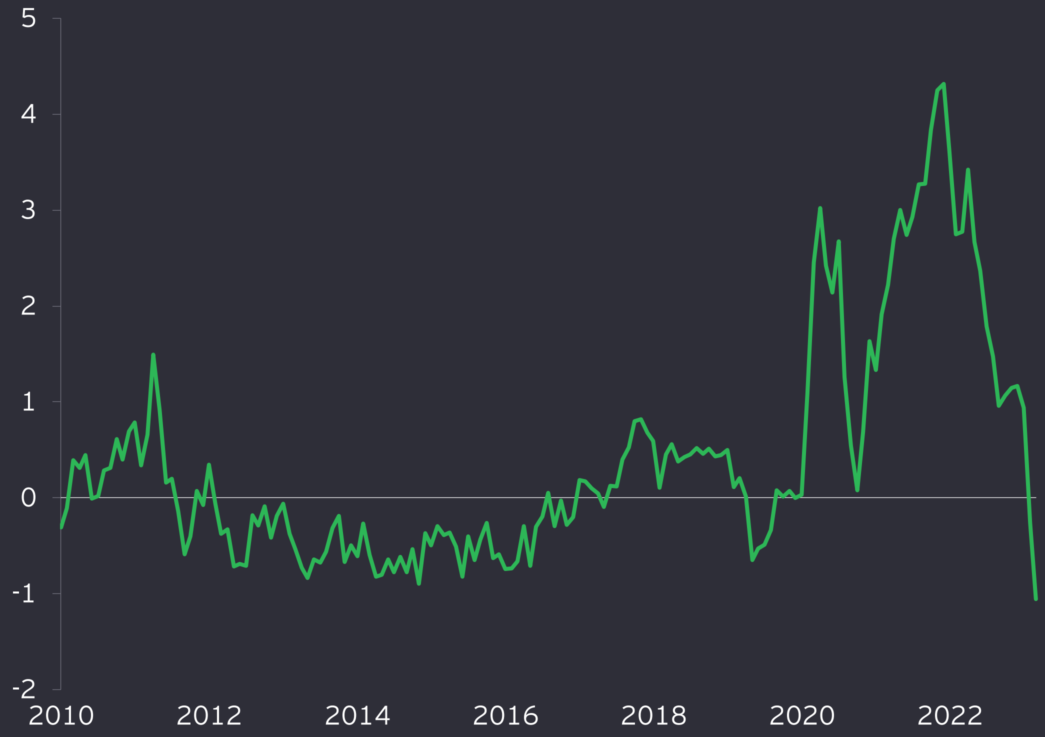
Receding supply chain issues (partially due to weaker global demand) and declining commodity (particularly energy) prices should gradually filter through to goods price disinflation also in Europe

- In some sectors (aerospace, automotive), easing supply bottlenecks allows them to realize solid order backlogs that outweigh, at least in the short term, the negative effects of demand slowdown.

Shipping costs of dry bulk and container ships



Global Supply Chain Pressure Index (GSCPI)*

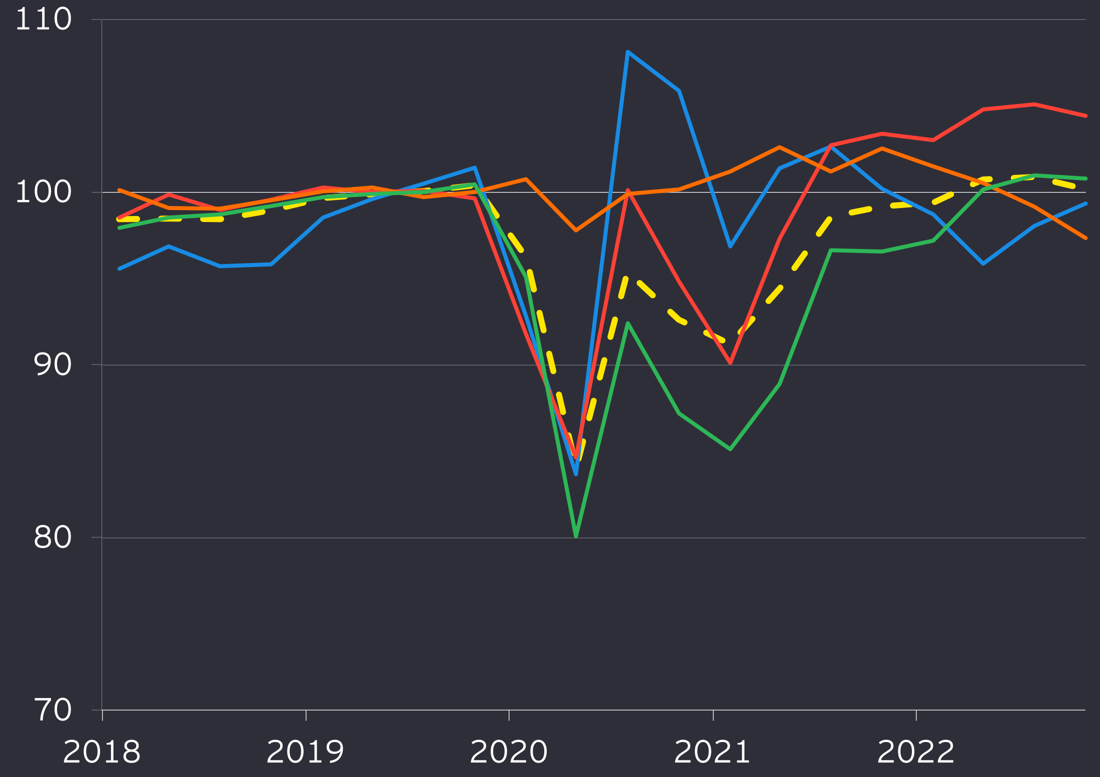


Source: Federal Reserve Bank of New York Liberty Street Economics; Investing.com; Refinitiv Eikon.
Notes: Baltic Dry index is a shipping freight-cost index for dry bulk cargo. Harpex Index reflects the worlwide price development in the charter market for container ships.
* Index scaled by its standard deviation (0=average value).

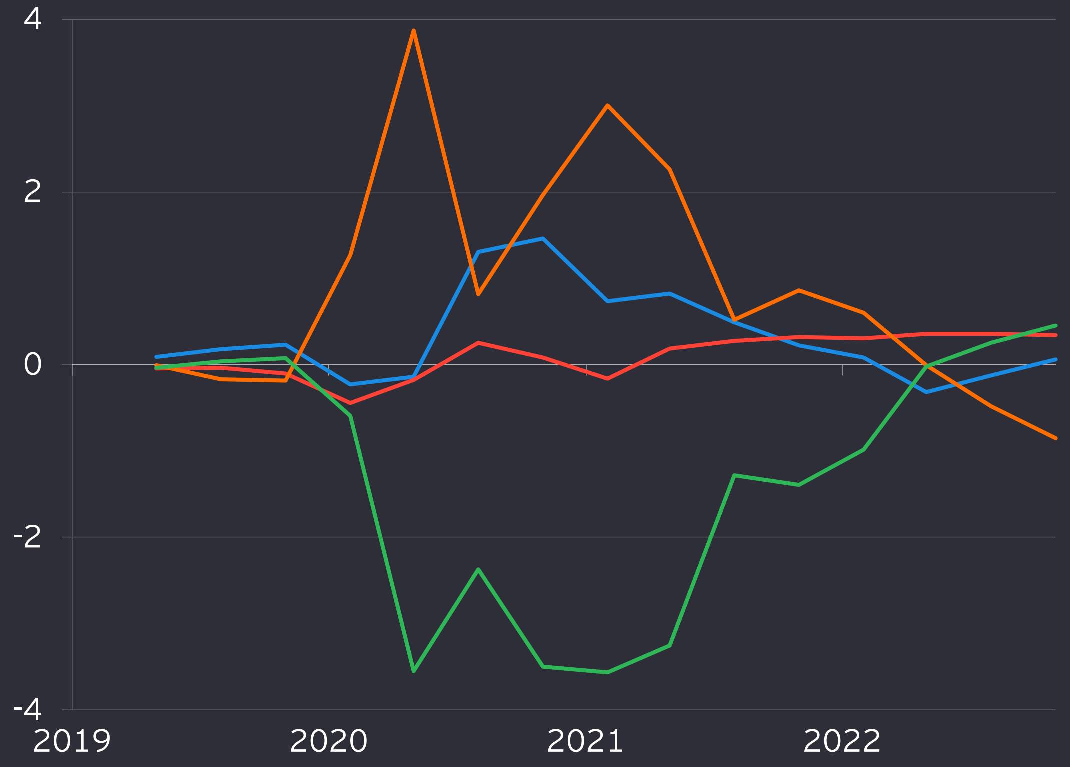
Pandemic-era shifts in consumption patterns (away from services towards goods) have reversed, which should also support disinflation of industrial and consumer goods …

- Following pandemic-era disruptions, the structure of consumption largely returned to normal in 2022, with services reaching pre-pandemic levels.

Households' expenditure on goods and services in the EU* (index, 2019 = 100, seasonally adjusted)



Change of shares of households' expenditure on goods and services in the EU* from 2019 Q1 (pp., seasonally adjusted)

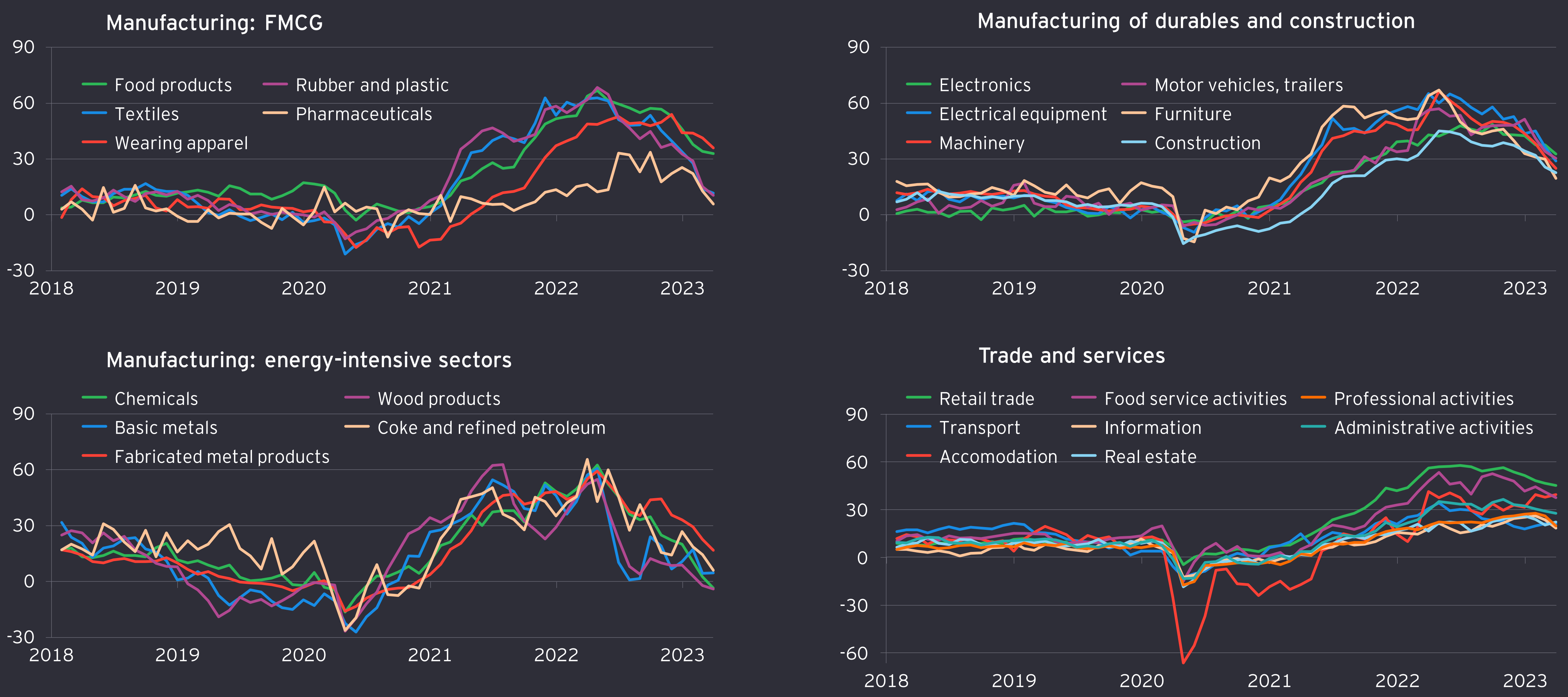


Source: Eurostat

* EU aggregate of 17 countries which account for around ¾ of final consumption expenditure in the EU.

… which is already reflected in companies' business outlook (especially in energy-intensive sectors) …

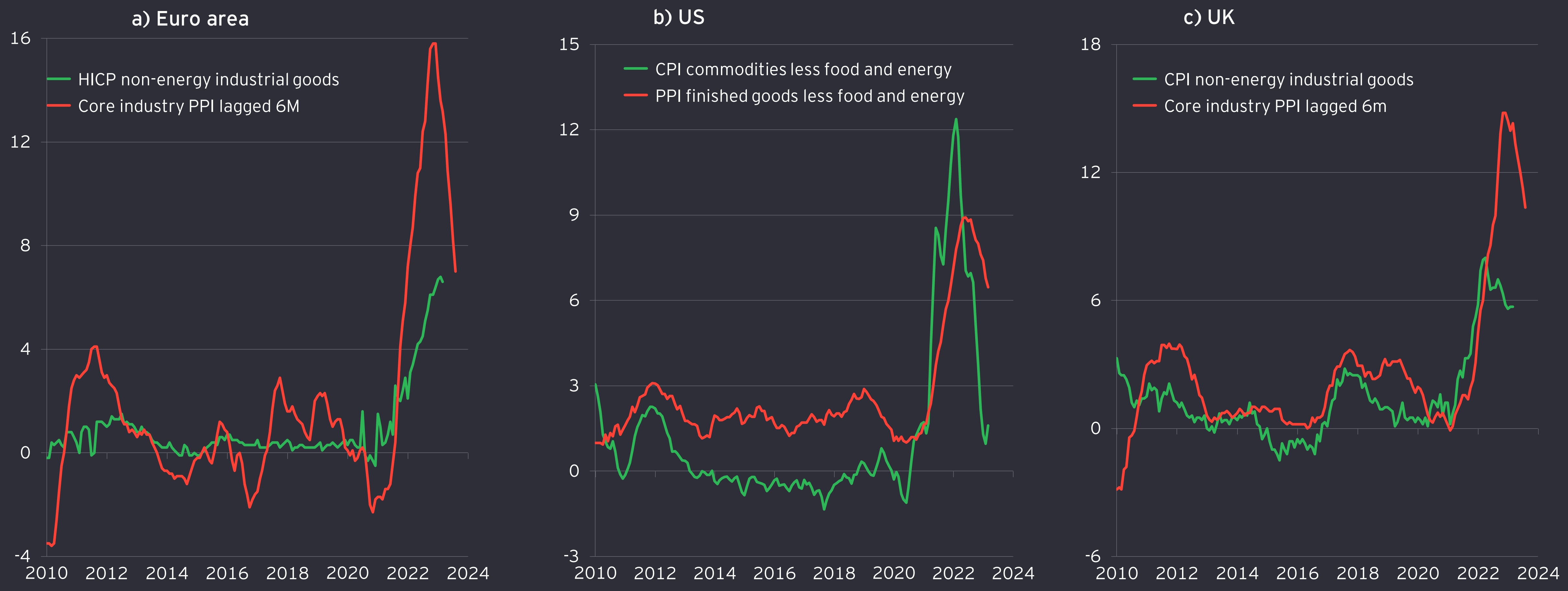
Expectations of the prices over the next 3 months in the EU (balance seasonally adjusted)



Source: European Commission.
Notes: Balance is the difference between the percentages of respondents giving positive and negative replies, e.i. an-above-zero balance means that more firms expect price increase than decrease. Retail trade except for motor vehicles.

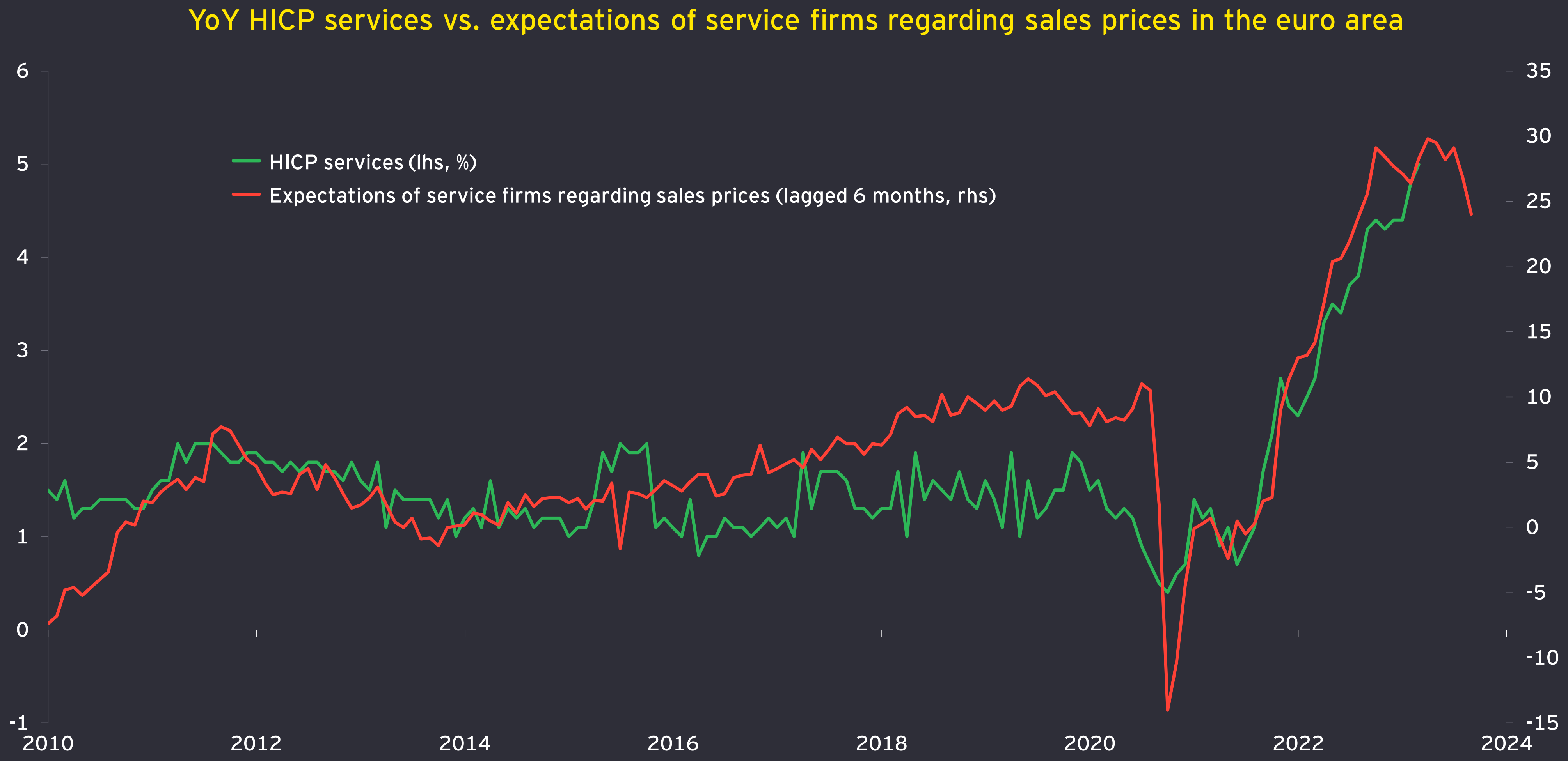
… and falling PPI dynamics. However, previous increases in core goods PPI in Europe have been only partially passed on to consumers. Consequently, core goods HICP inflation may not fall as quickly as some might anticipate due to declining PPI inflation

Core PPI in industry vs. core goods CPI (YoY, in percentage)



Source: Eurostat; FRED, ONS.
Note: Core industry PPI includes mining and quarrying; manufacturing (except MIG energy), except food, beverages and tobacco.

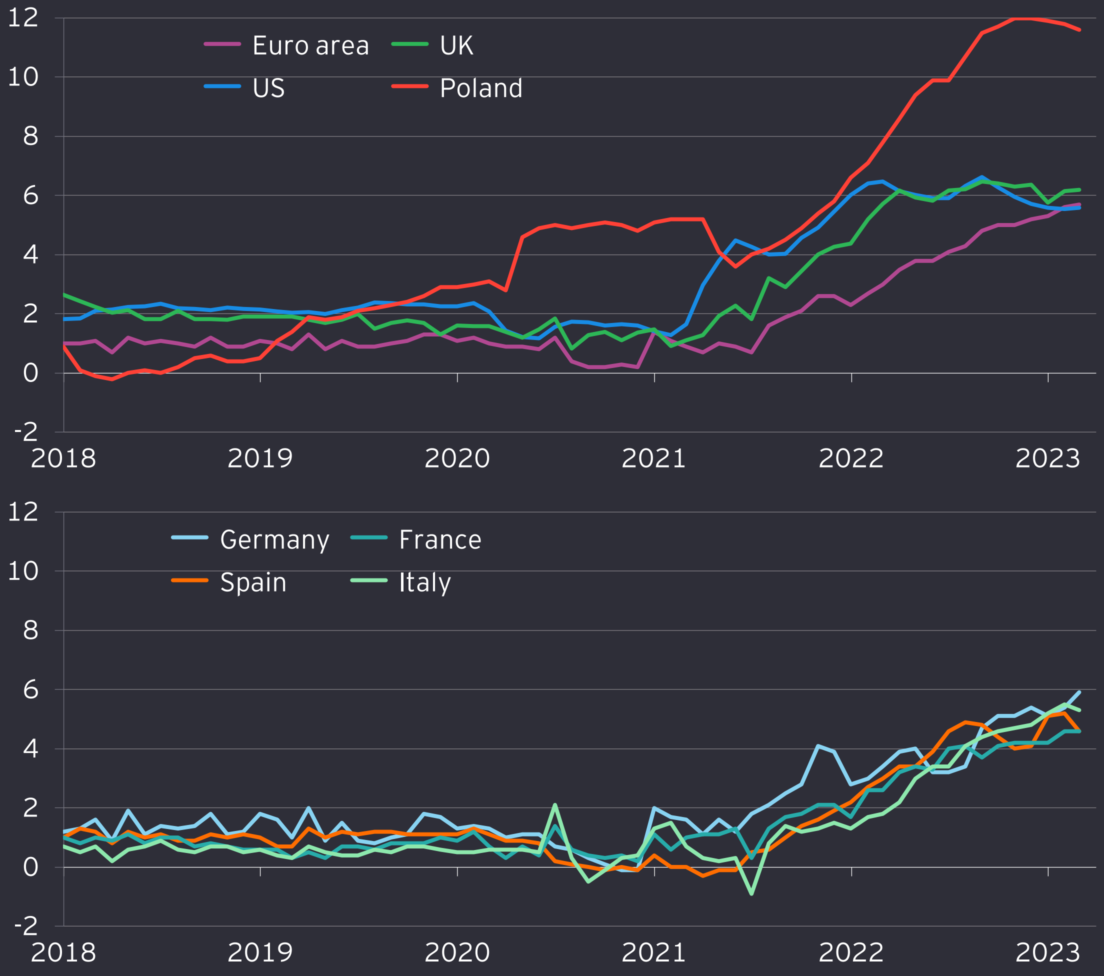
There is also little sign of abating price pressures in services, though they are no longer intensifying



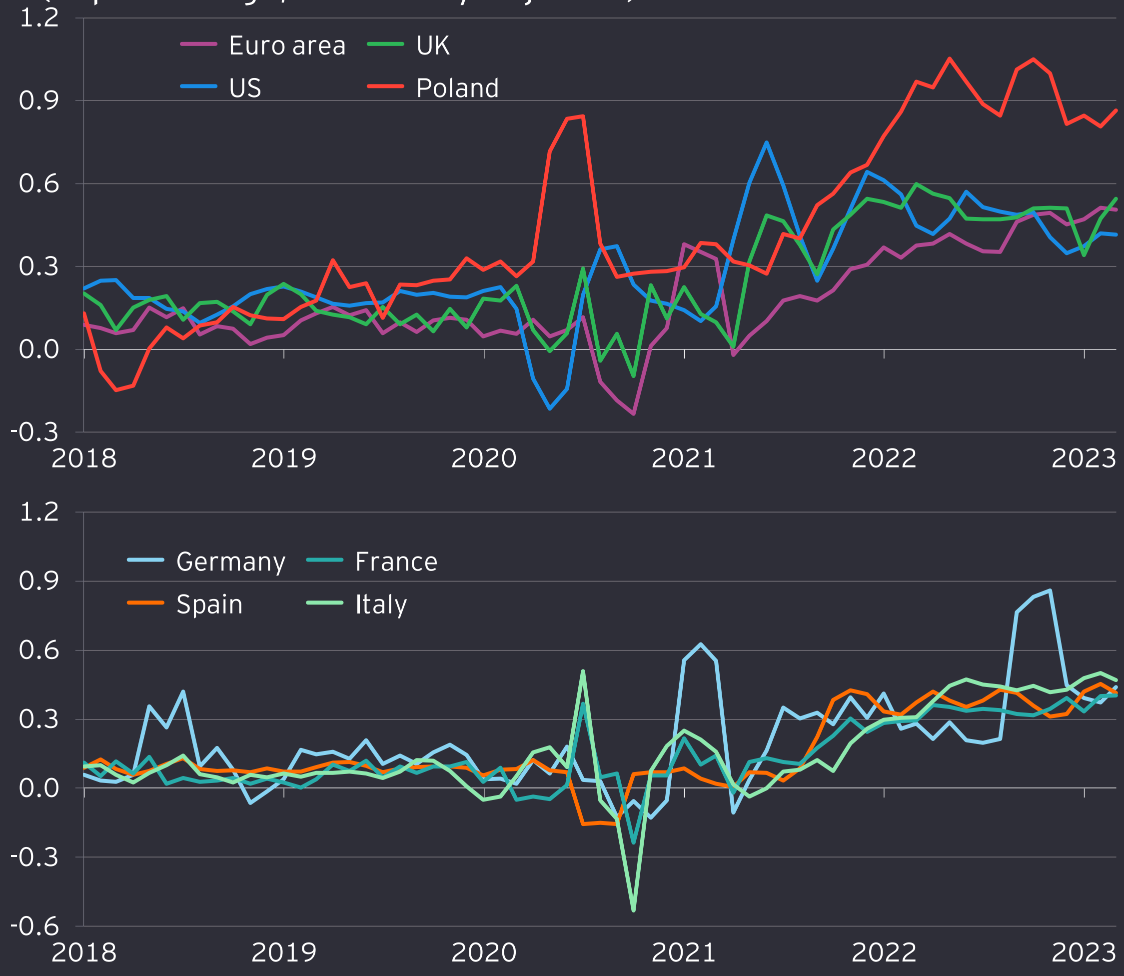
Source: Eurostat.

The risk of sticky inflation seems to be confirmed by recent data indicating higher than expected core inflation that has not yet peaked in numerous European countries

Core inflation YoY (in percentage)



Core inflation MoM, 3-month moving average (in percentage, seasonally adjusted)

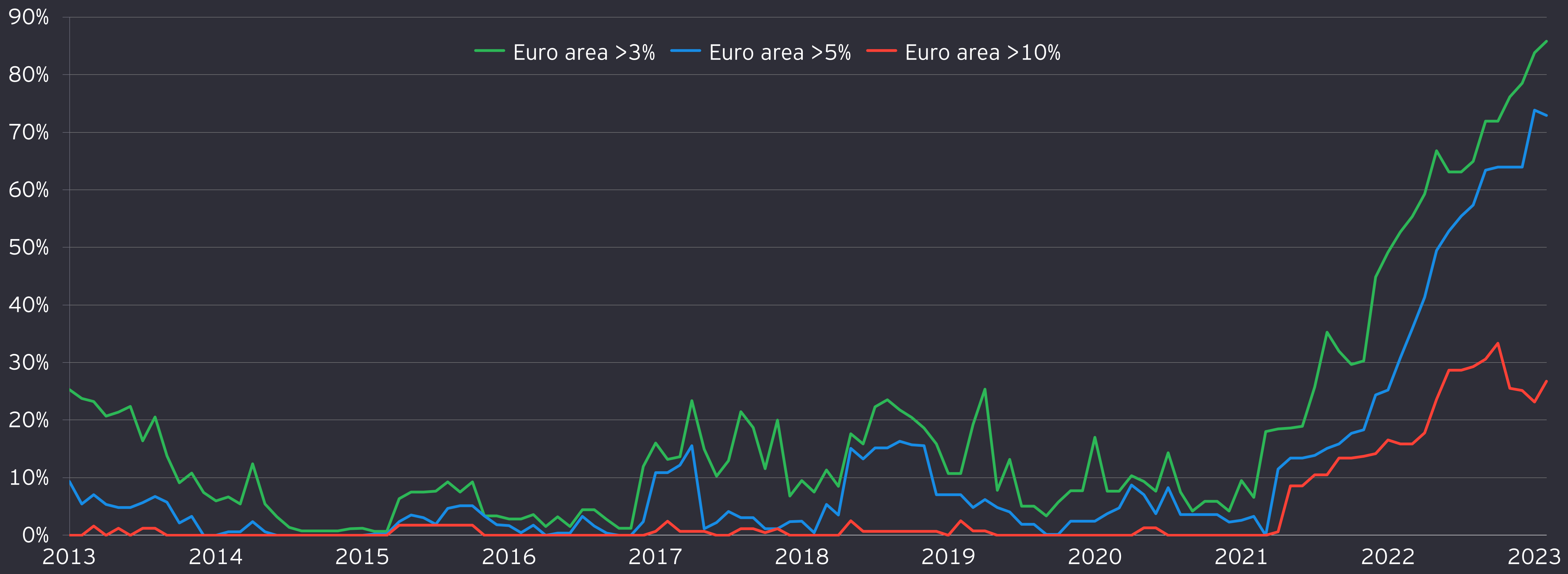


Source: Eurostat; FRED; ONS.
Notes: For euro area and EU countries, HICP. For the US and the UK, CPI inflation. Core inflation measured as price index less food and energy.

With increasing food and core inflation, price pressures in the euro area are getting more broad-based

- The recent decline in energy price inflation has been reflected in the decrease in the share of categories whose prices grow faster than 10%.

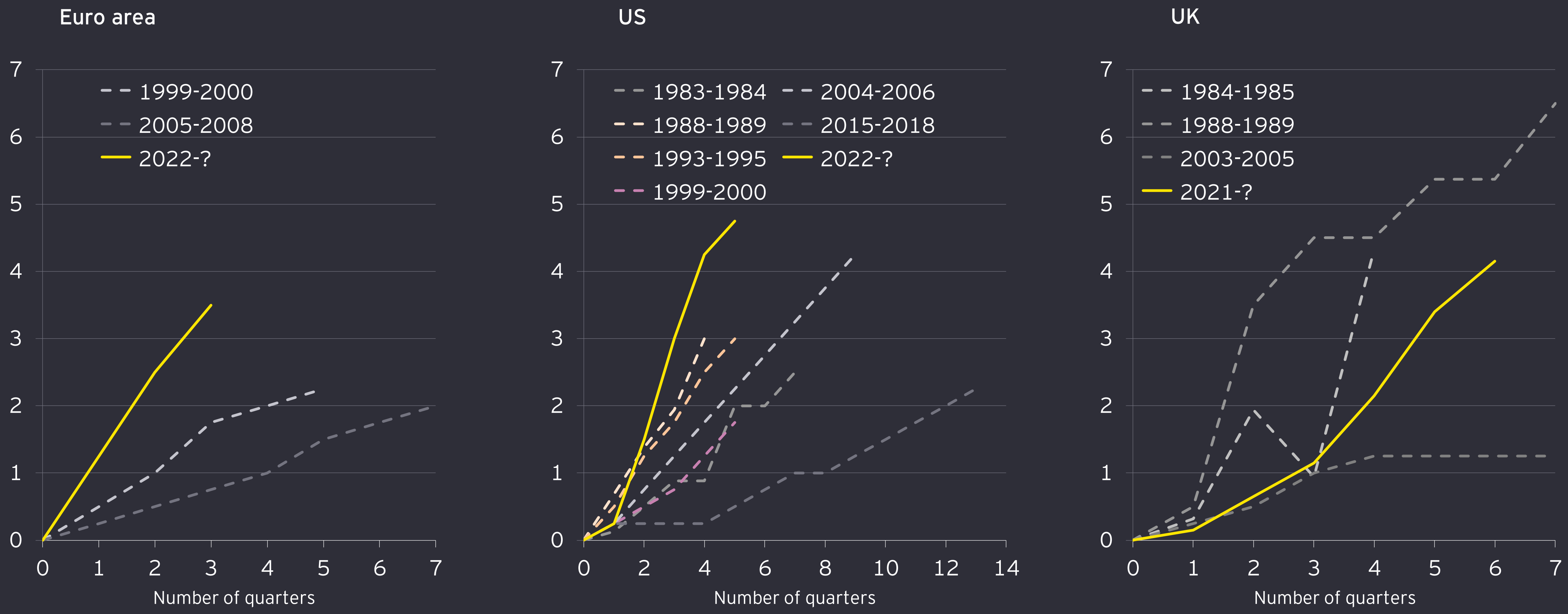
Share in the consumption basket of categories with an annual price growth exceeding 3%, 5% and 10% in the euro area
(in percentage)



Source: Eurostat, EY EAT calculations.

With inflation reaching multidecade highs, major central banks have embarked on the most rapid tightening cycle in decades

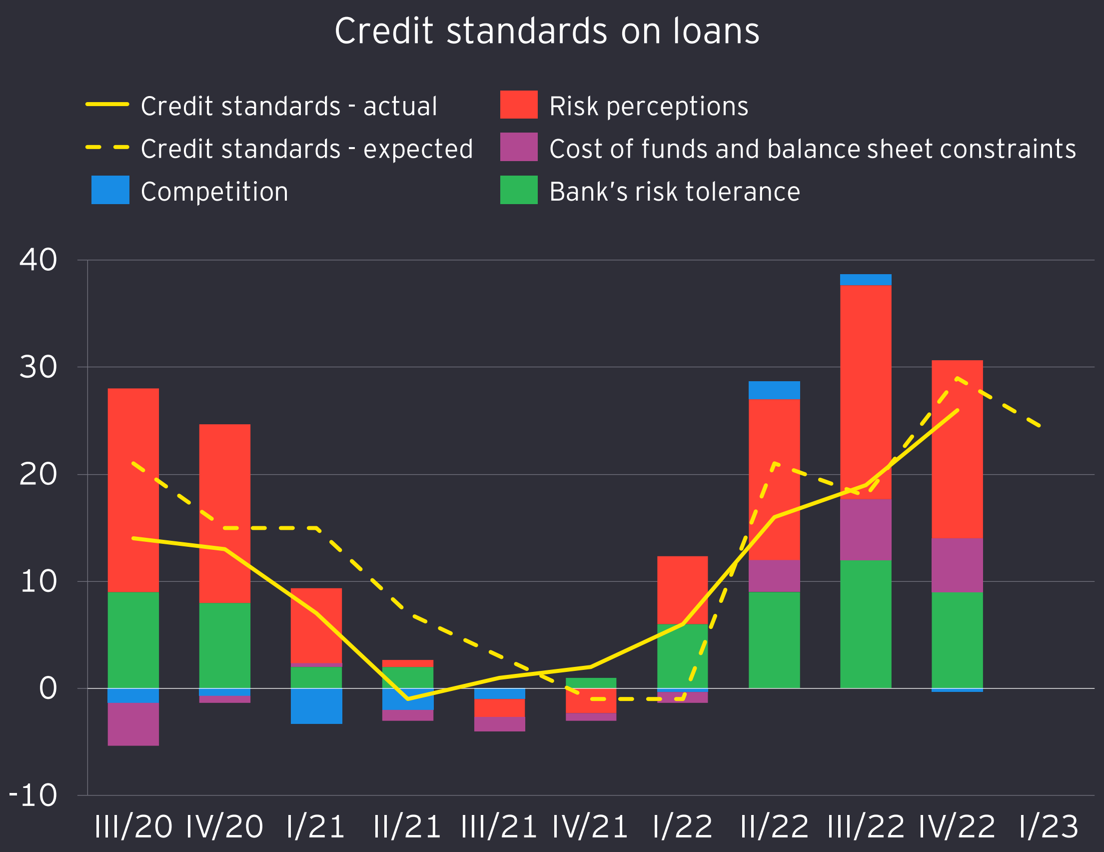
Monetary tightening cycles in the euro area, the US and the UK (in percentage points)

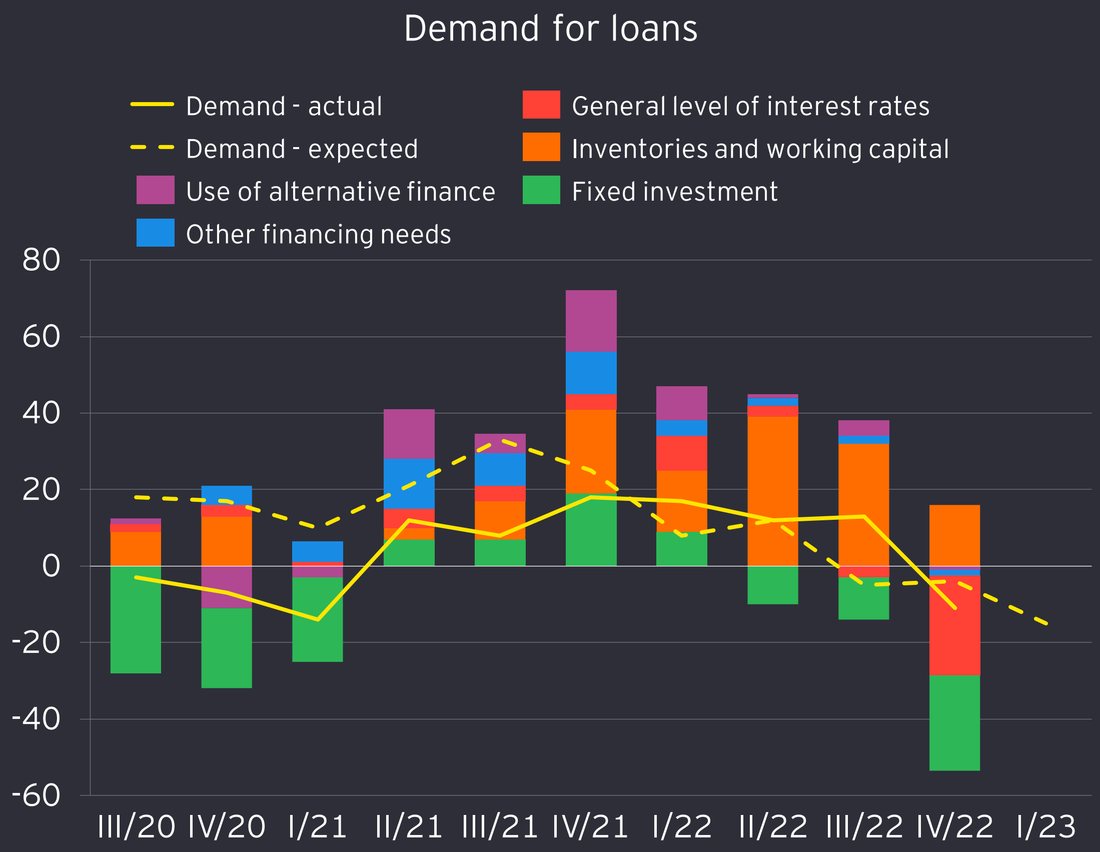


Source: Fred; Oxford Economics.

The euro area credit environment was tightening already before the recent banking turmoil. Enterprises' demand for loans held stable for a few quarters but eventually plummeted in Q4 2022

Firms: credit standards on loans and demand for loans in the euro area (net percentages)

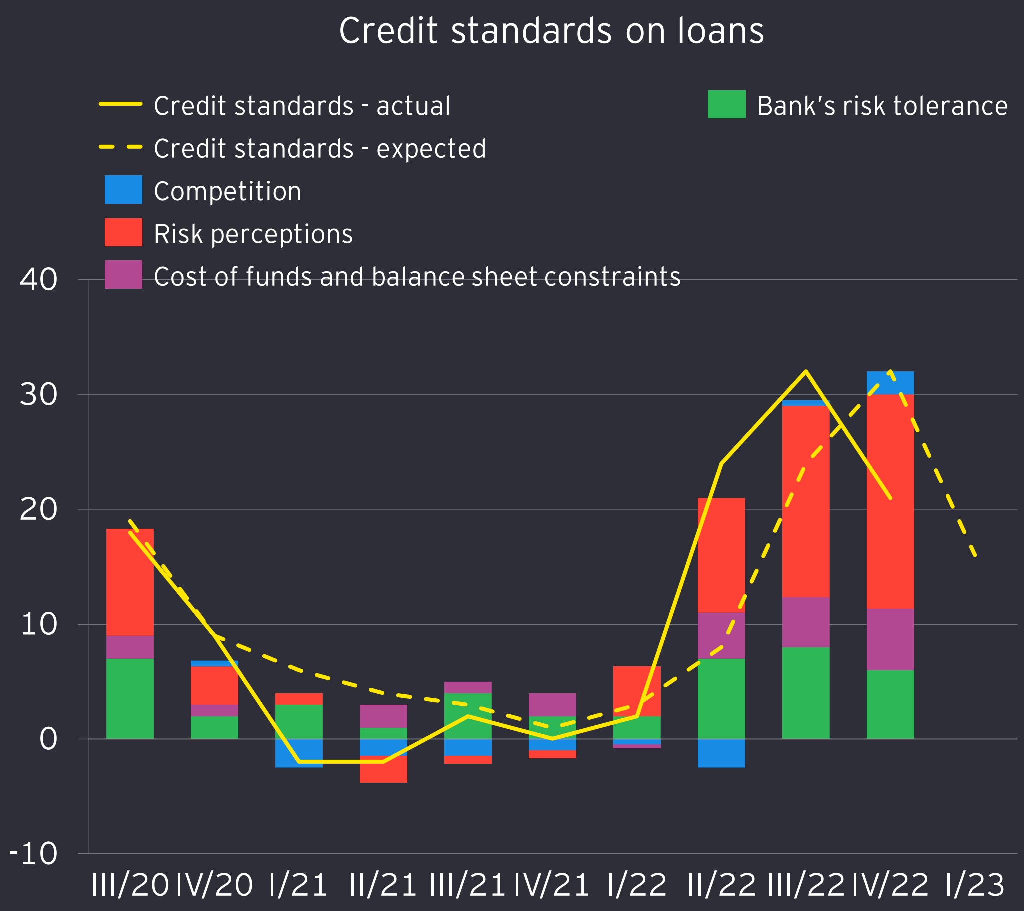


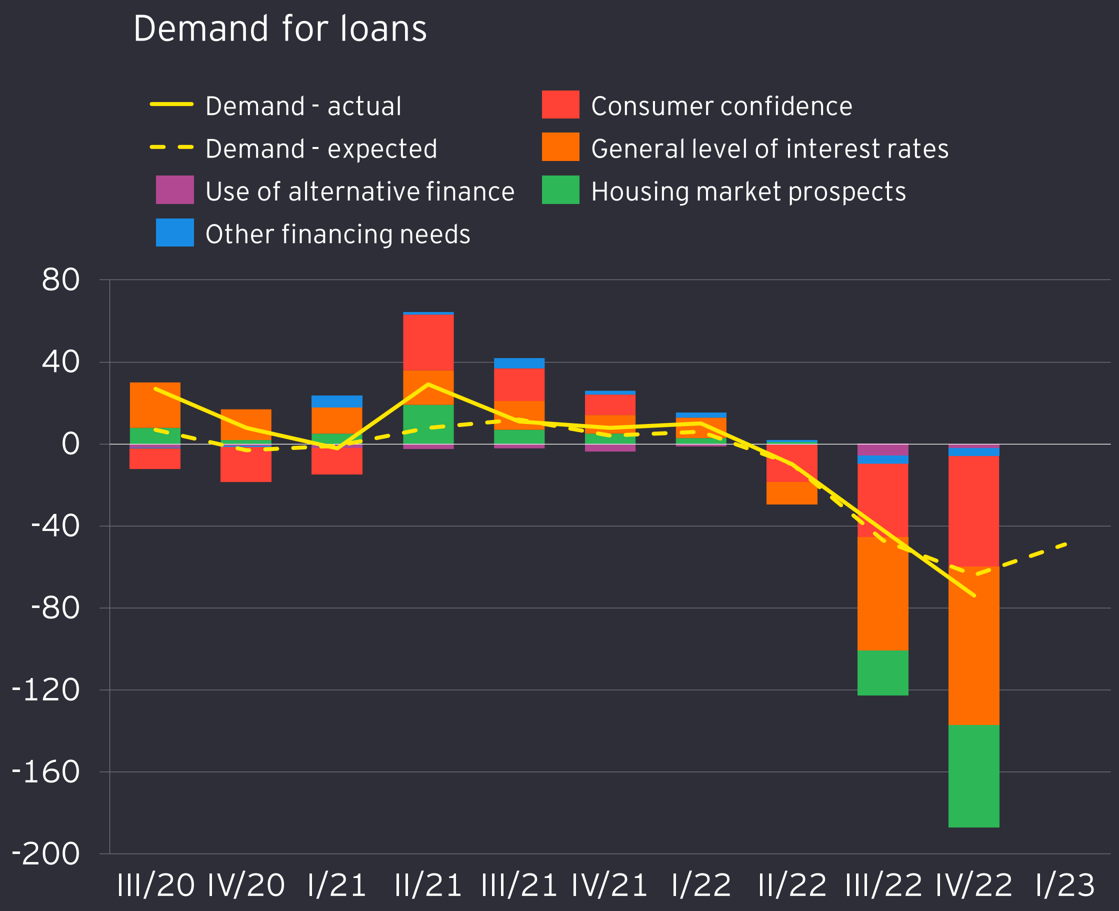


Source: ECB.
Notes: "Actual" values are changes that have occurred, while "expected" values are changes anticipated by banks. Net percentages are defined as the difference between the sum of the percentages of banks responding "tightened considerably" and "tightened somewhat" and the sum of the percentages of banks responding "eased somewhat" and "eased considerably". "Cost of funds and balance sheet constraints" is the unweighted average of "banks' capital and the costs related to banks' capital position", "access to market financing" and "liquidity position"; "risk perceptions" is the unweighted average of "general economic situation and outlook", "industry or firm-specific situation and outlook/borrower's creditworthiness" and "risk related to the collateral demanded"; "competition" is the unweighted average of "competition from other banks", "competition from non-banks" and "competition from market financing". "Other financing needs" is the unweighted average of "mergers/acquisitions and corporate restructuring" and "debt refinancing/restructuring and renegotiation"; "use of alternative finance" is the unweighted average of "internal financing", "loans from other banks", "loans from non-banks", "issuance/redemption of debt securities" and "issuance/redemption of equity".

Tighter credit conditions and higher interest rates have led to a steep decline in household demand for mortgage loans, beginning in 2022 H1

Households: credit standards on loans and demand for loans for house purchase in the euro area (net percentages)

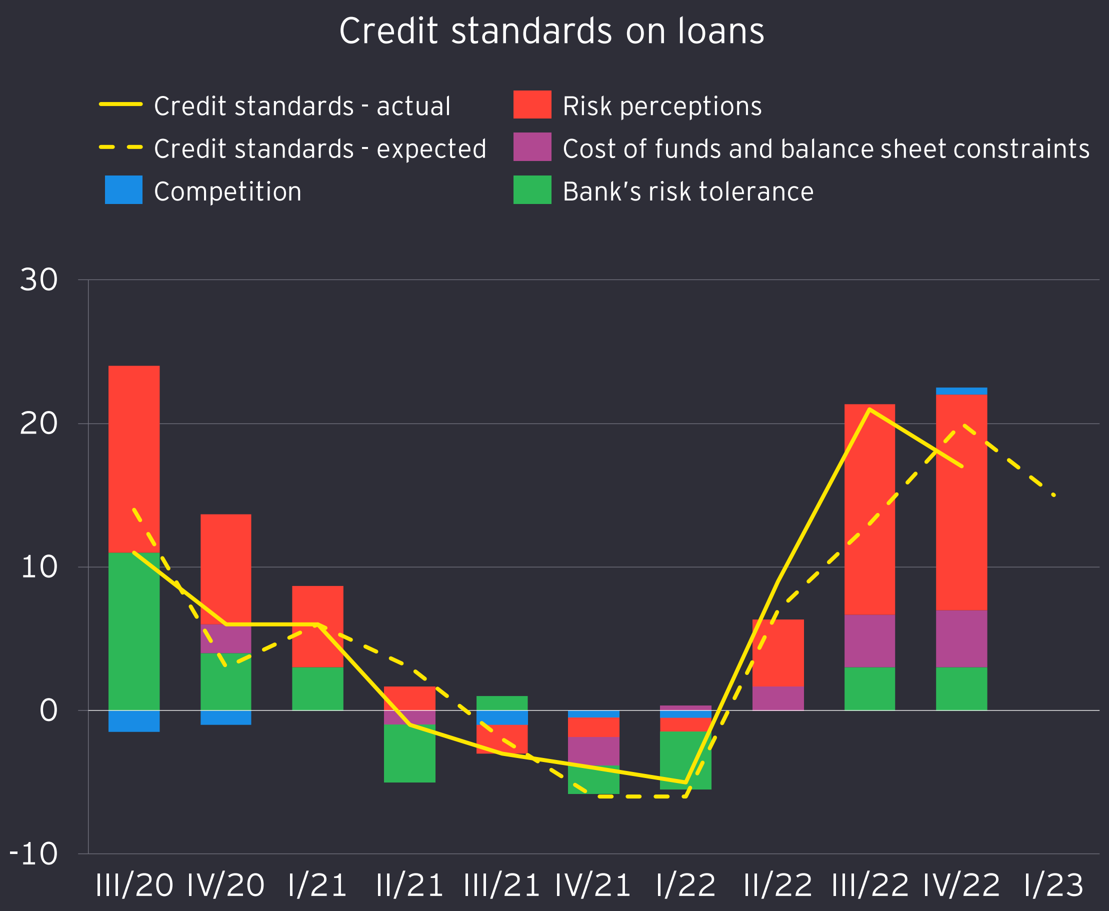


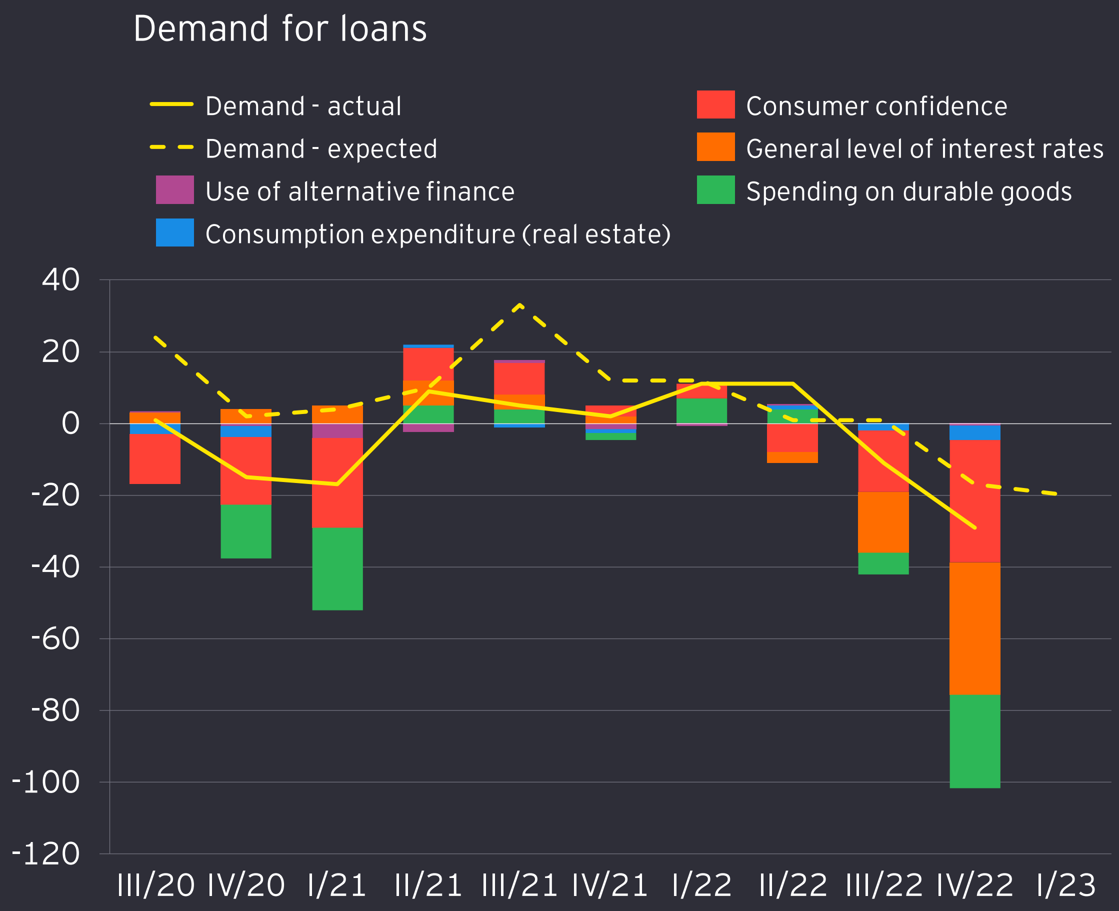


Source: ECB.
Notes: "Cost of funds and balance sheet constraints" is the unweighted average of "banks' capital and the costs related to banks' capital position", "access to market financing" and "liquidity position"; "Risk perceptions" is the unweighted average of "general economic situation and outlook", "housing market prospects, including expected house price developments" and "borrower's creditworthiness"; "competition" is the unweighted average of "competition from other banks" and "competition from non-banks". "Other financing needs" is the unweighted average of "debt refinancing/restructuring and renegotiation" and "regulatory and fiscal regime of housing markets"; "use of alternative finance" is the unweighted average of "internal finance of house purchase out of savings/down payment", "loans from other banks" and "other sources of external finance".

Demand for consumer credit has declined and credit standards in this segment have been tightened to a similar degree as for mortgage loans

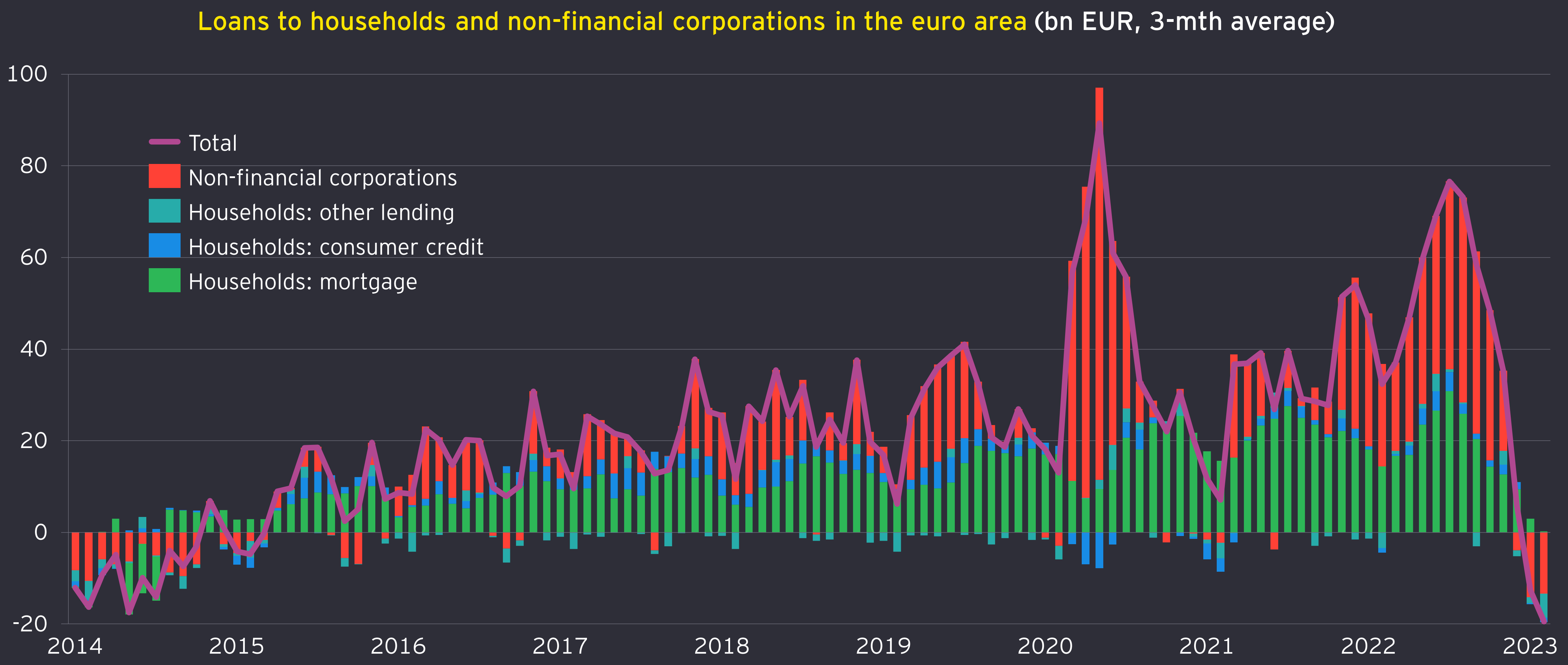
Households: credit standards on loans and demand for loans for consumption in the euro area (net percentages)





Source: ECB.
Notes: See the notes on the previous page. "Consumption expenditure (real estate)" denotes "consumption expenditure financed through real estate-guaranteed loans".

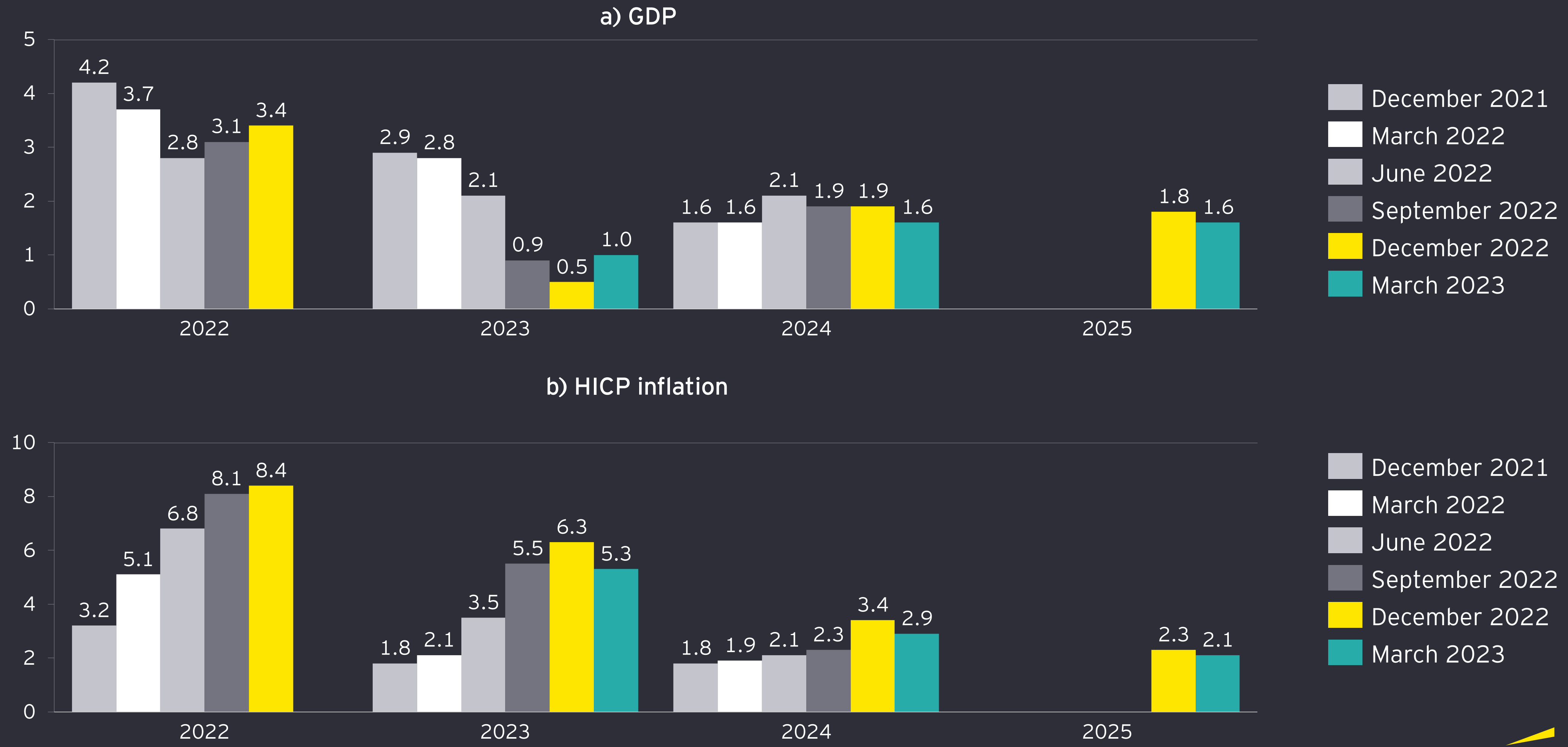
The effects of interest rate hikes and tighter credit standards have already become apparent in the overall negative loan growth in the euro area for the first time since 2014



Source: ECB.
Note: Series for households include NPISH.

Despite monetary policy tightening, the ECB continues to expect inflation to run above the 2% target in the medium term, supporting the view that further interest rate hikes are warranted

ECB staff projections for the euro area (in percentage)



Source: ECB

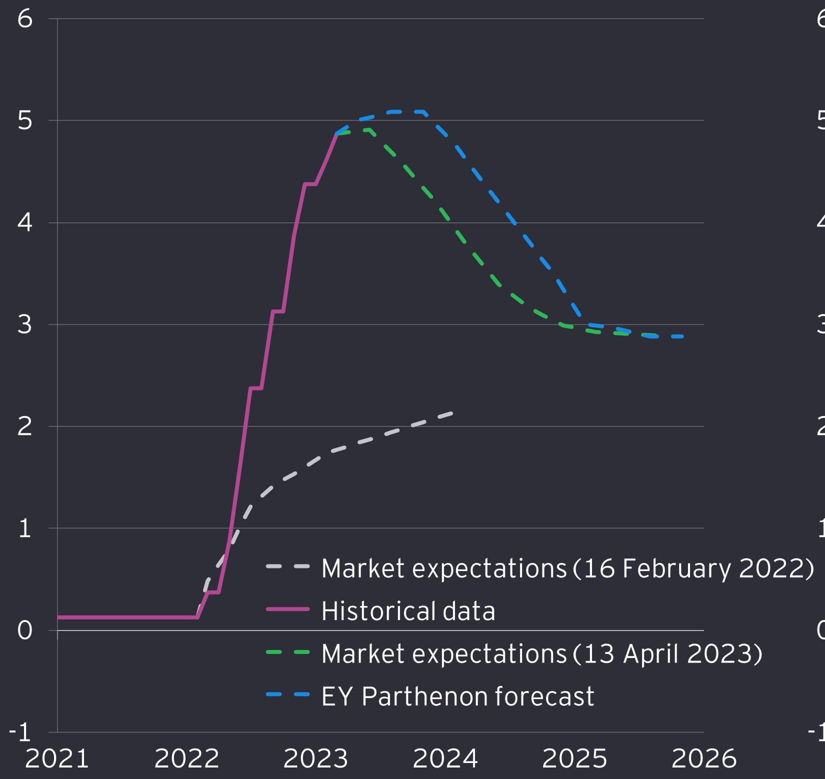
Given ECB forecasts and that core inflation in the euro area has recently hit another record and labor markets remain very strong, we expect more tightening from the ECB. The Fed and the BoE are likely to end the cycle after one more hike

- We expect the ECB deposit rate to be raised by another 75bps up to 3.75%.
- Following the latest rate increase (by 25bps to the 4.75-5% range), the Fed has turned significantly more dovish as a result of the turmoil in the US banking sector. Still, another 25bps hike in May 2023 seems likely and we also expect the Bank of England to raise its base rate once more, to a peak of 4.50%.

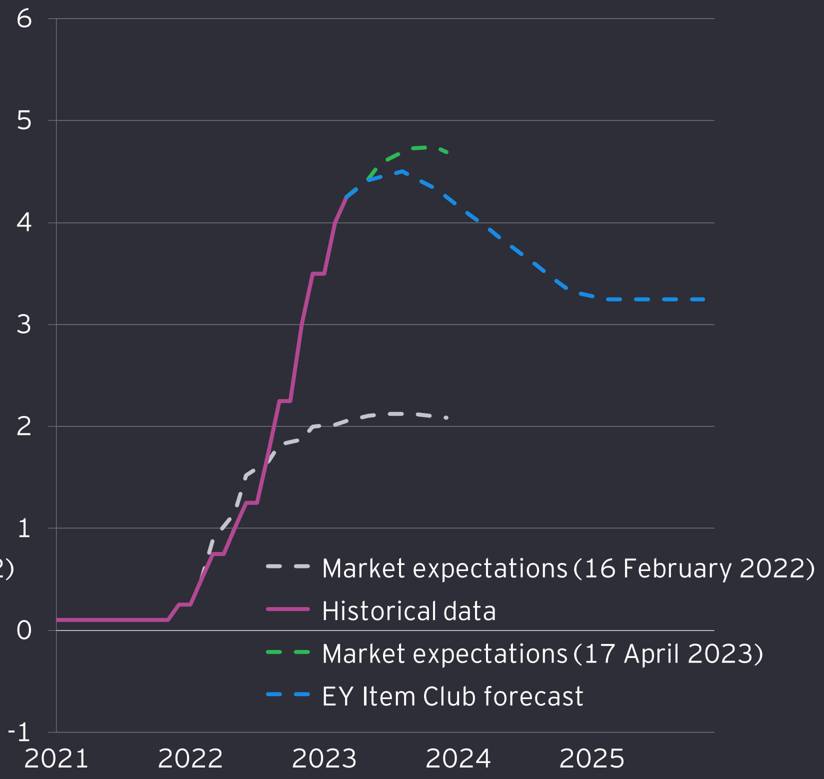
Historical and expected* central bank interest rates (In percentage)

Euro area (deposit rate)

US

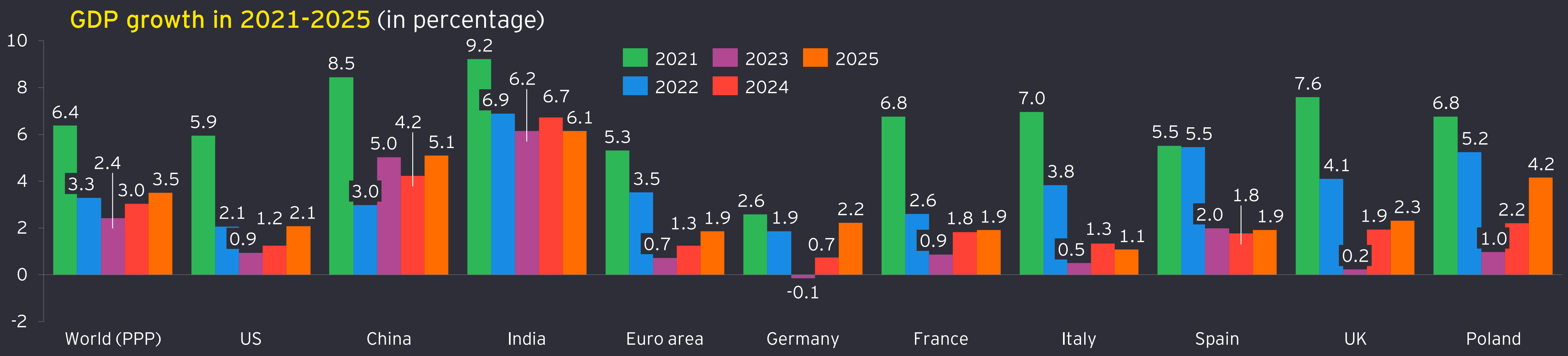


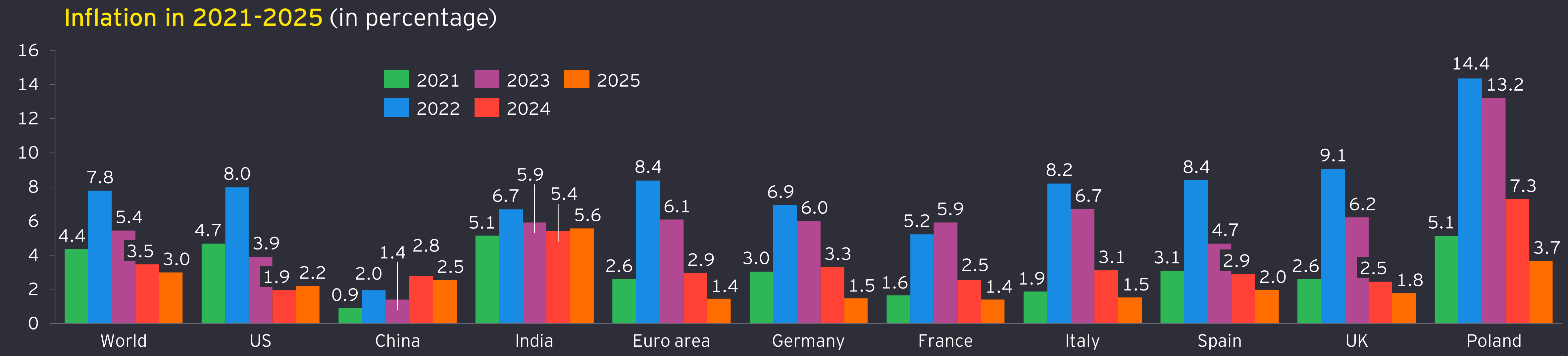
UK



Source: ECB; Fed; NBP; Refinitiv; Eurostat; EY EAT forecast.
* For the euro area, UK and US on 16 February 2022, expected interest rates from Refinitiv; for the US on 13 April 2023, expected interest rates from Atlanta Fed Market Probability Tracker. For expectations from 16 February 2022, the curve was prolonged using data on instantaneous government bond forward yield curves.

Monetary policy tightening, alongside still elevated energy prices and inflation, will continue to weigh on household consumption and economic growth. Thus, the recovery will be sluggish

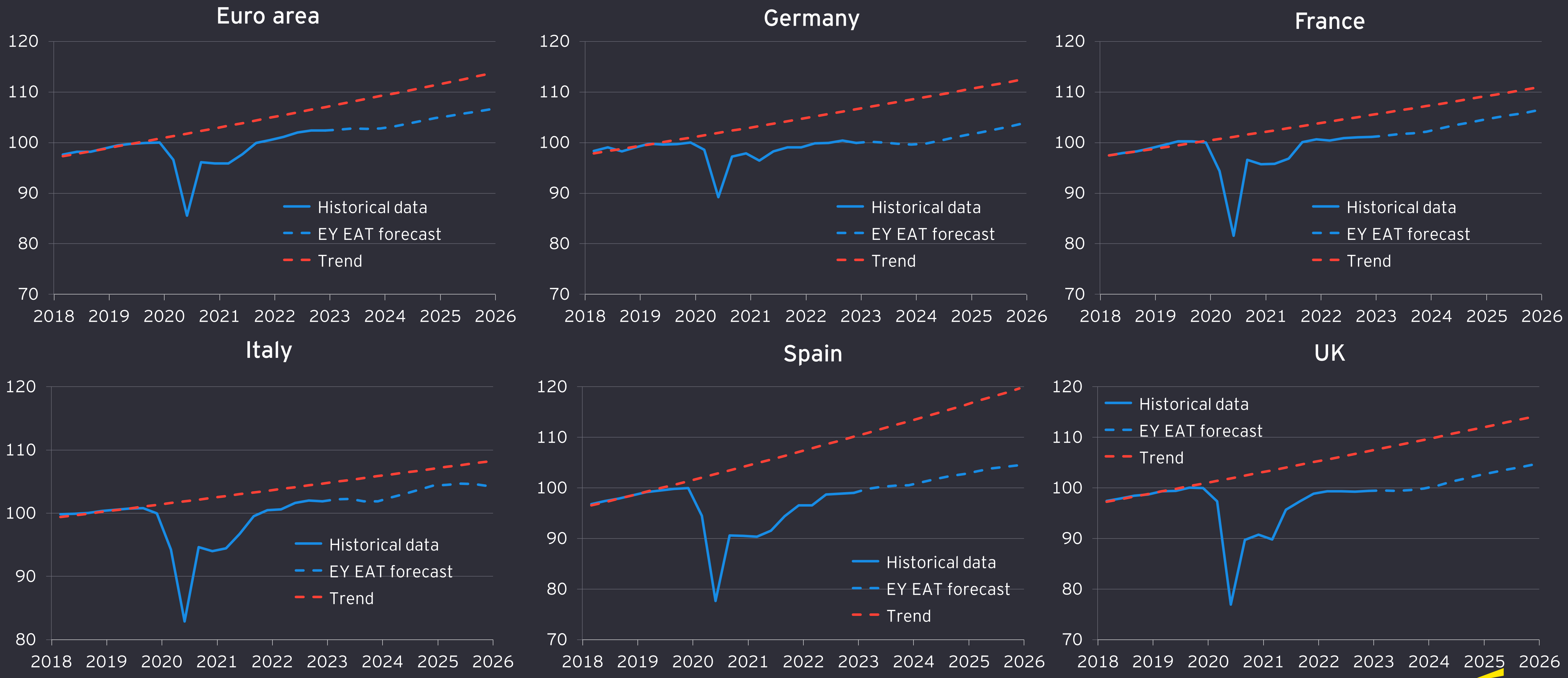




Source: Oxford Economics, EY EAT forecast (baseline scenario).

European economies are expected to remain well below the pre-pandemic trend, pointing to the long-term negative effects of the pandemic and the war in Ukraine

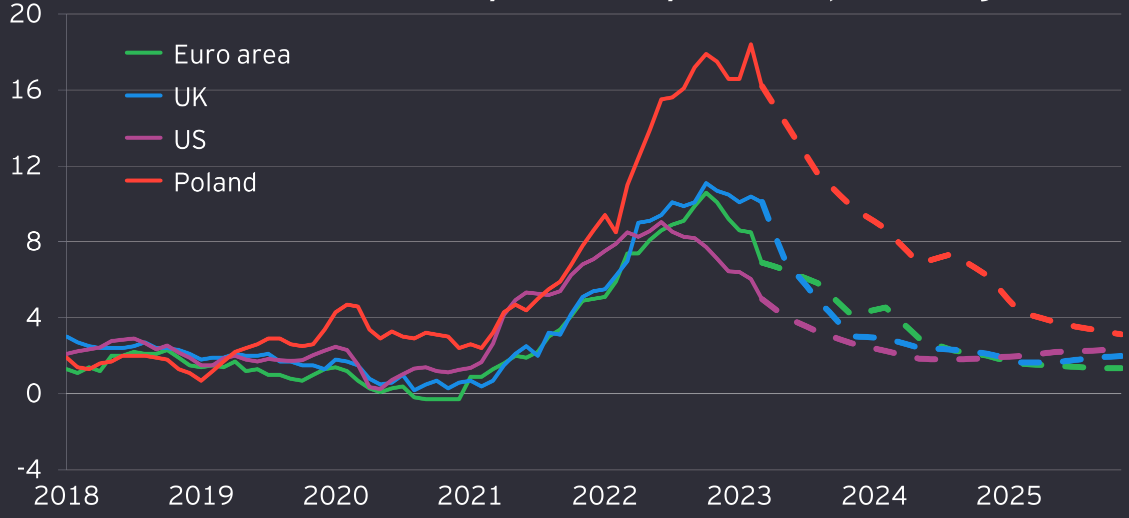
GDP level vs. the pre-pandemic trend* (index, 2019 Q4 = 100)

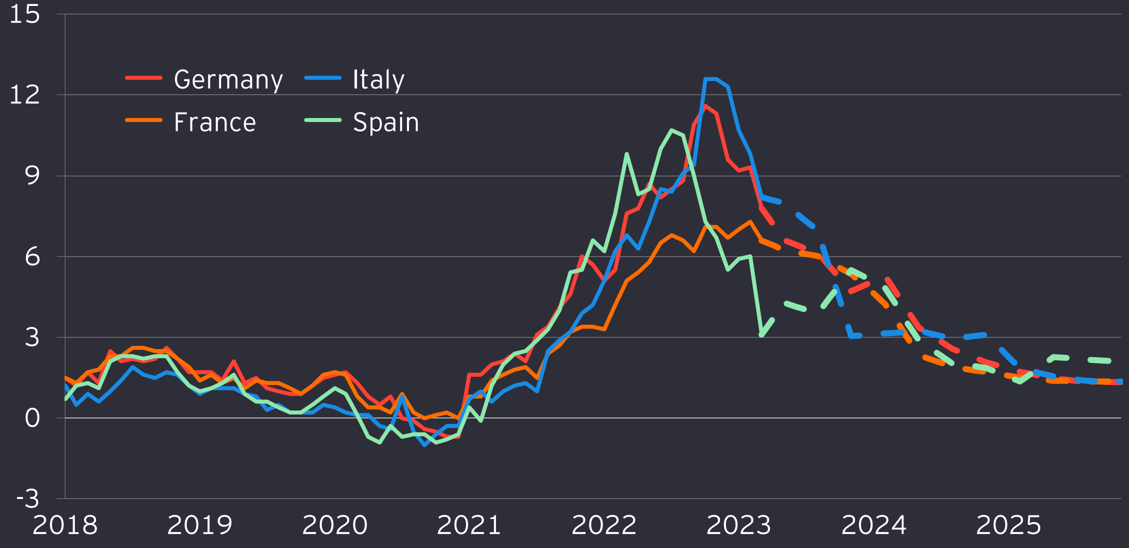


Source: Oxford Economics, EY EAT forecasts.
* 2014 Q1 – 2019 Q4 trend.

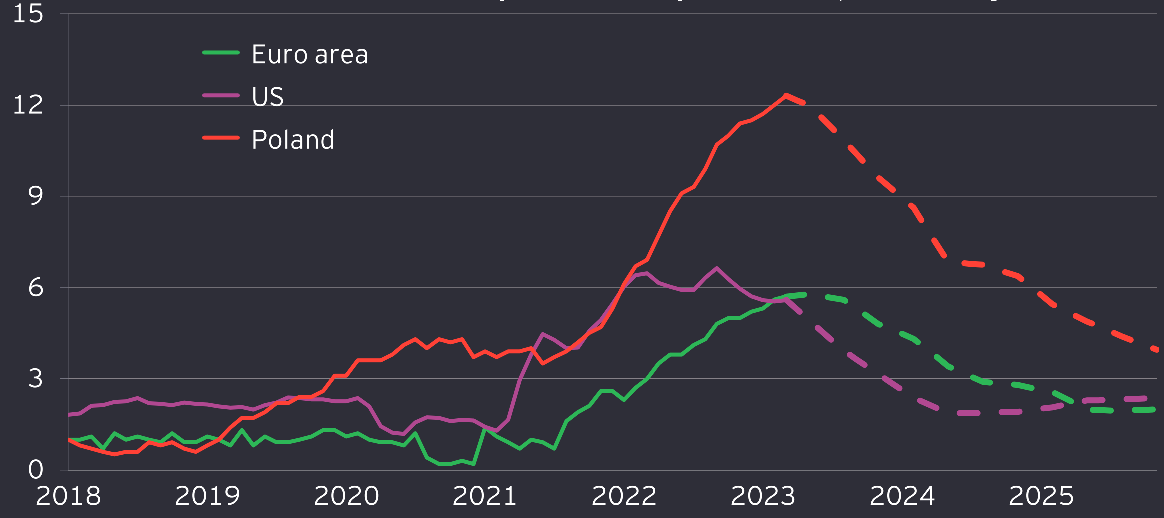
Inflation will fall relatively quickly during the course of 2023. In the euro area, UK and the US, it should reach the target in the second half of 2024, but core inflation in the euro area may remain higher until the second half of 2025. In CEE, inflation will stay above central bank targets until 2025-26

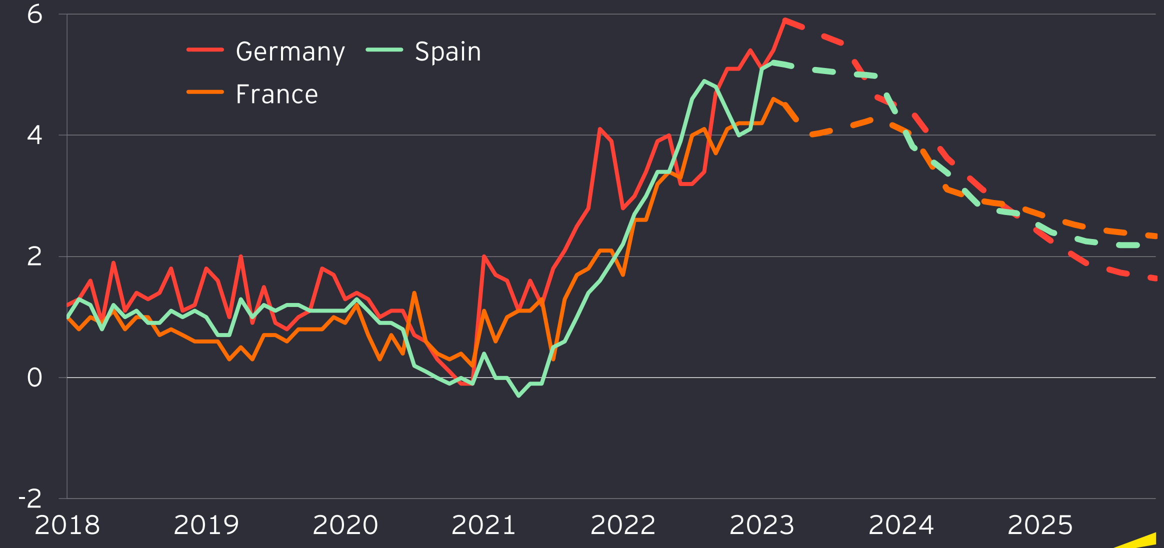
CPI inflation (year-over-year) (In percentage)





Core CPI inflation (year-over-year) (In percentage)

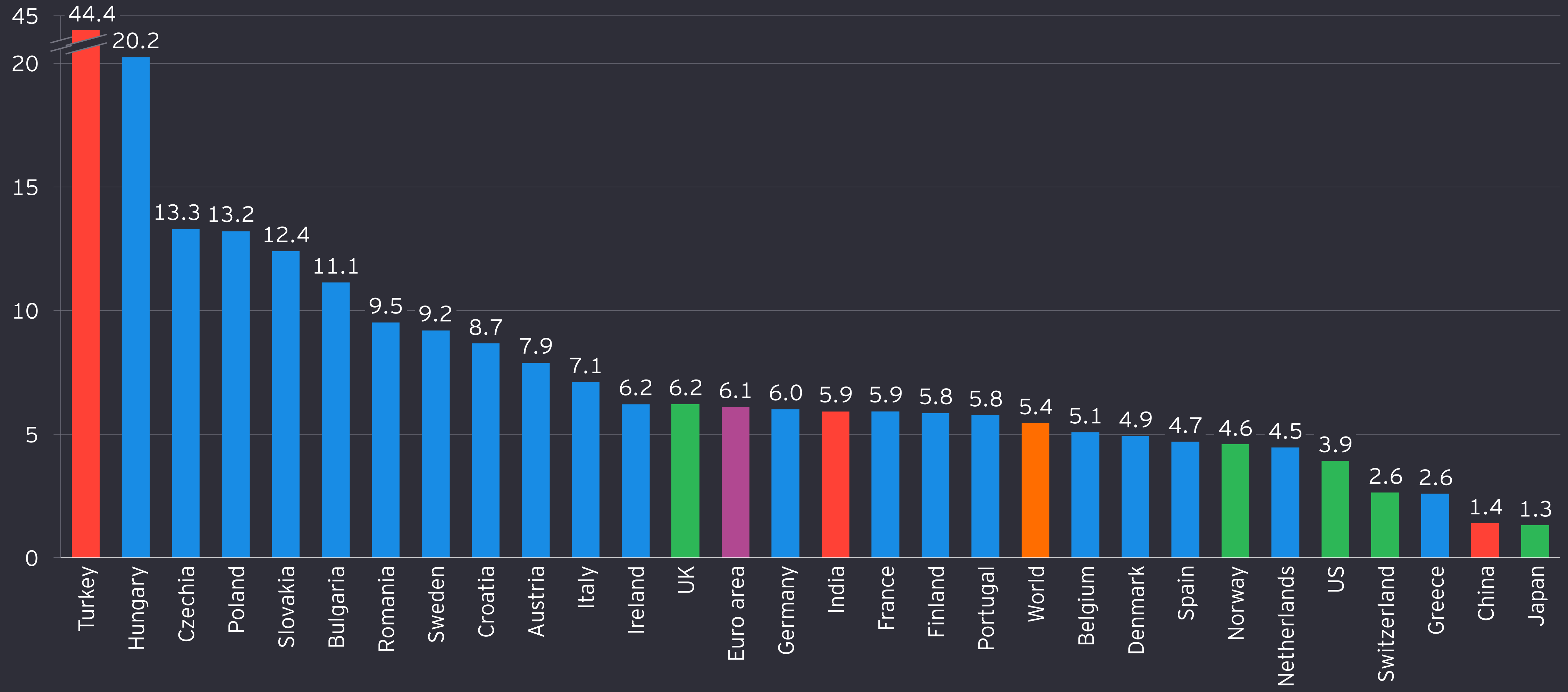




Source: Eurostat; FRED; ONS, Statistics Poland, EY EAT forecast (baseline scenario).

In annual average terms, in 2023, inflation will remain elevated all over Europe, particularly in CEE, while the US will see a significantly lower inflation

Annual inflation in 2023 (in percentage)



Source: EY EAT forecast (baseline scenario).

Economic outlook remains highly uncertain, with the balance of risks tilted to the downside for growth and to the upside for inflation

- Risk of inflation proving more persistent.
  - Strong labor market continues to be a major source of upside risks to the inflation outlook.
  - Geopolitical tensions, including the war in Ukraine, continue to be a key risk and if they intensify, could lead to more energy and food price spikes (especially if the Black Sea Grain Initiative is not renewed), pushing inflation up.
  - China's reopening, while easing supply bottlenecks and supporting global growth, will add to price pressures through increased demand for energy commodities, especially natural gas.
  - Potential harsh weather conditions could exacerbate imbalances in energy markets, particularly ahead of the 2023-24 winter.
  - The decision of OPEC+ members on 2 April 2023 to cut oil output only adds to the growing concerns over energy prices and economic outlook.

  Sticky high inflation would squeeze household budgets for longer and weigh on private consumption, as well as increase the risk of excessive monetary policy tightening by major central banks that may prefer to err on the side of overtightening.

- The recent turmoil in the banking system, beginning with the failures of some US banks, is a new cause for concern. Financial tensions may make banks even more reticent in lending. Moreover, pockets of vulnerability may exist not only in the banking sector, but also in non-bank financial institutions, the role of which has been growing in global markets for many years.
- Elevated debt levels increase vulnerability, especially of emerging markets and developing economies, to potential financial market turbulences. They also limit the fiscal space to offset new negative shocks and their impact on households and businesses.

Another sharp spike in energy costs is not included in our baseline. Moreover, we assume that the banking turmoil will be contained, without significant impact on the European economy. However, on next pages we consider alternative scenarios and their effects on European and selected major economies.

Recent turmoil in the banking sector is a new source of risk to financial and economic stability. Rapid increase in interest rates has increased vulnerability of banks to a sudden deposit outflow…

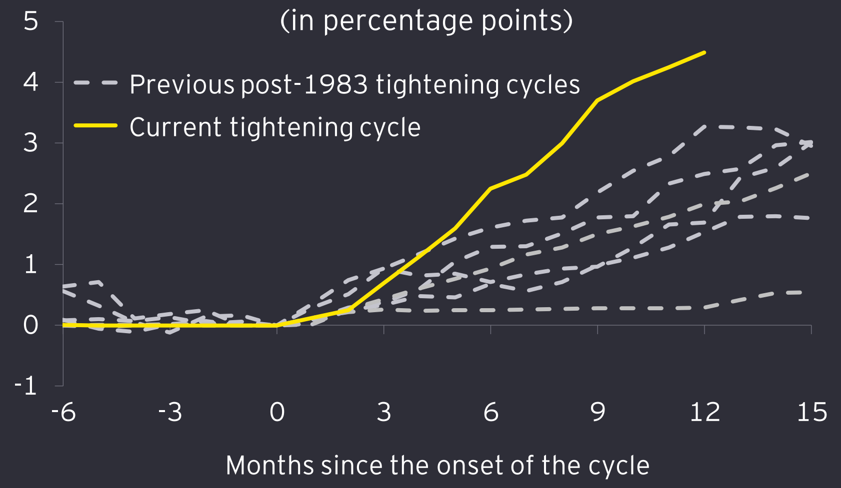
Interest rate hikes lead to unrealised losses on bank balance sheets…

- With inflation reaching levels unseen since early 1980s, central banks have embarked on the most aggressive monetary policy tightening cycle in decades.
- Though higher interest rates increase banks' interest rate margins and thus their profitability, they also reduce bond prices, leading to substantial unrealised losses on the banks' balance sheets.
- This increases banks' vulnerability to deposit outlows that may force banks to sell assets, especially bonds that lost a substantial portion of their value.

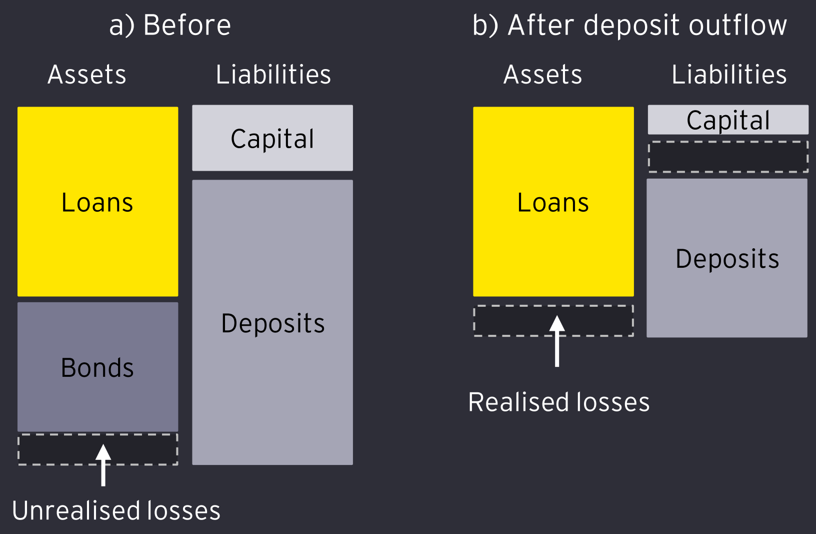
… increasing their vulnerability to deposit outflows

- This was the main reason for the collapse of some US banks, which were particularly vulnerable as their bond portfolio was large and the deposit base was highly concentrated among venture-backed startups whose funding dried up following monetary policy tightening.
- The failure of some US banks initiated hunting for weakness in the banking sector, including in Europe, leading to deposit outflows from institutions troubled also for other (past) reasons.
- This was the case of a major Swiss bank, which had to be acquired by its competitor to avoid a collapse.

Monetary policy tightening cycles in the US



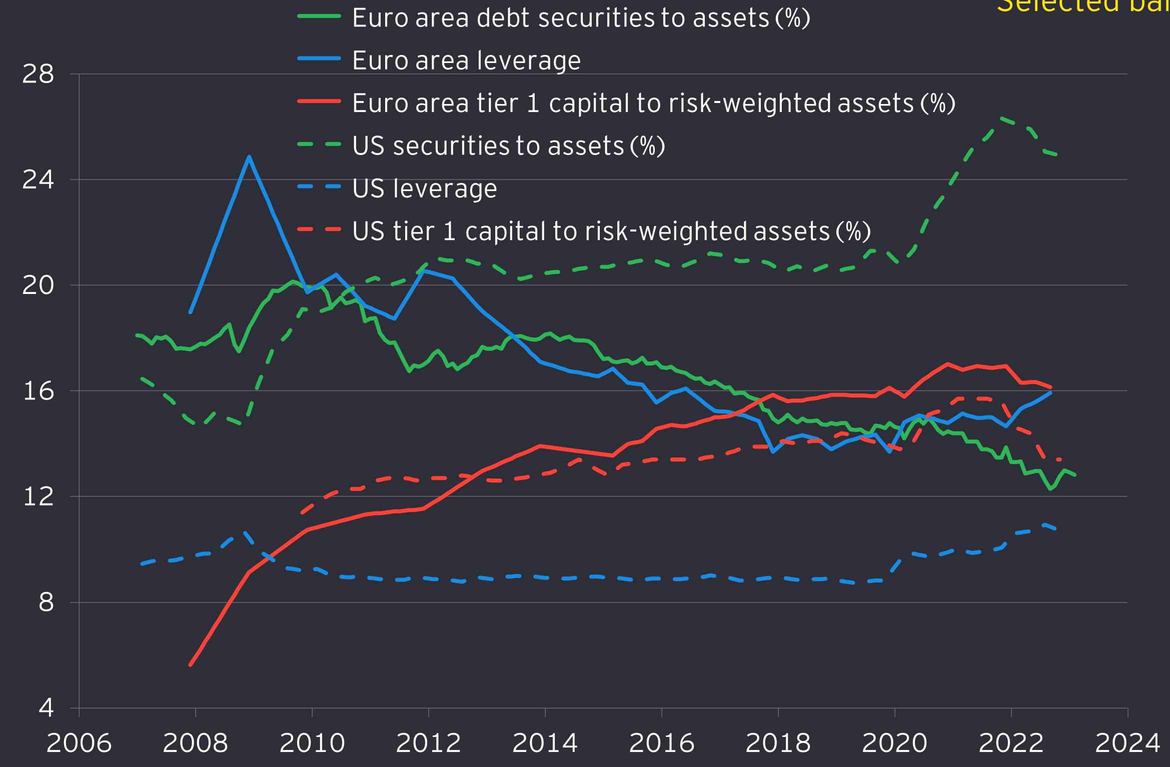
Stylised bank balance sheet

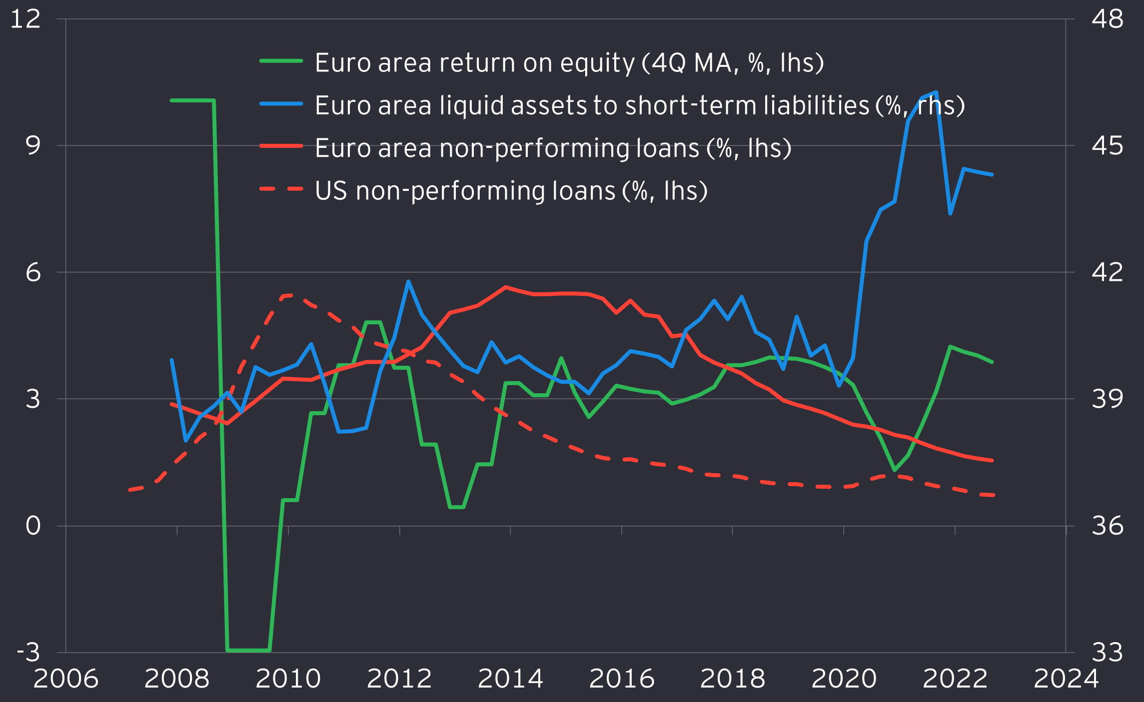


… but quick responses by policymakers, as well as stronger capital and liquidity position of banks than before the global financial crisis, reduce the risk of a wider crisis

- Following the collapse of two US banks, all deposits held at those banks were guaranteed and the Fed has allowed banks to exchange bonds for liquidity at par, reducing the risk of another bank bankruptcy in the US.
- Swiss authorities also reacted swiftly to the run on one of the major banks, organising and partially funding the acquisition by the main competitor.
- At the same time, the banking sector is in a much stronger position than before the global financial crisis, especially in Europe – capital ratios have increased, leverage has fallen, liquidity has improved, the share of bonds in assets has fallen, non-performing loans are record low and profitability, supported by higher interest rates, is solid.

Selected banking sector statistics



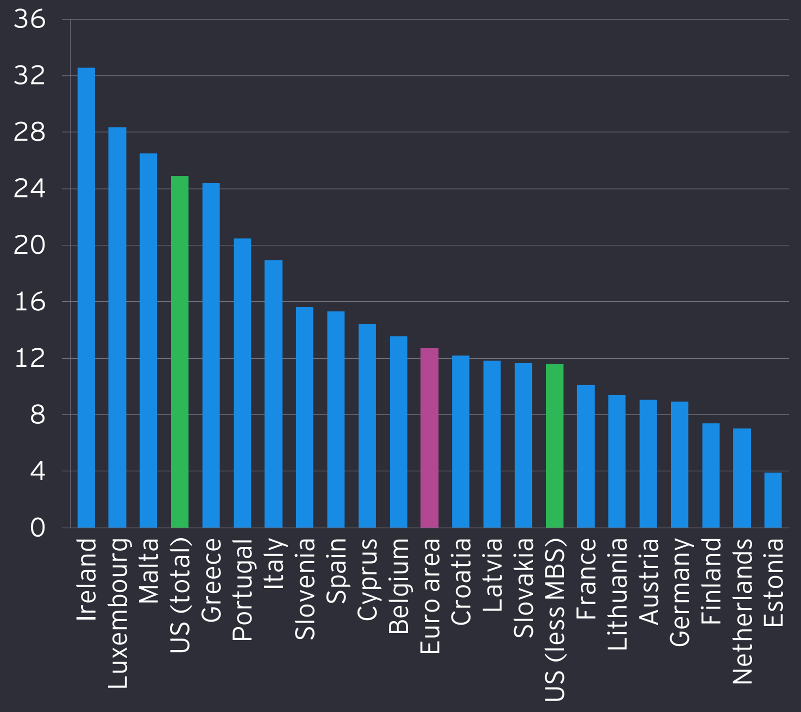


Source: ECB Warehouse, FRED.
Notes: Leverage is a ratio of assets to own funds, which are the sum of Tier 1 and Tier 2 capital (in other words, leverage is a reciprocal of a capital to assets ratio).
Tier 1 capital is a higher quality capital, comprising mostly of common shares, retained earnings and preferred stock.

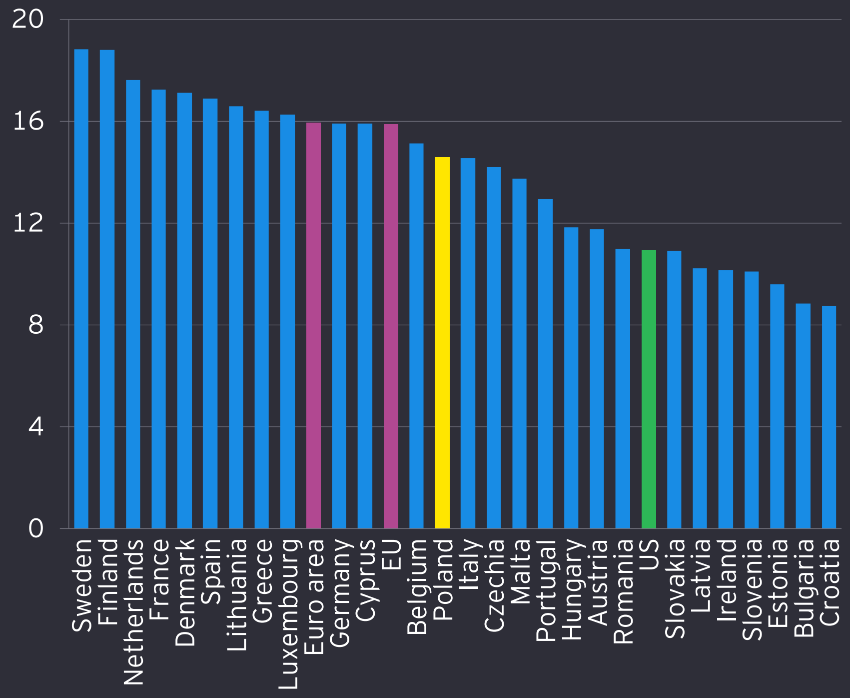
European banks are less likely to experience the problems that plagued some US banks

- European banks generally do not have such concentrated deposit bases nor invested so much of their assets into bonds as the failed US banks. More stringent regulations of non-systemic institutions in Europe play a part in explaining this.
- On average, European banks have a smaller exposure to long-term securities than US and are thus less vulnerable to interest rate hikes. At the same time, they tend to have higher leverage and thus smaller capacity to absorb potential losses, even though regulatory capital ratios (Tier 1) tend to be higher.
- Said that, banking sector vulnerability varies widely across Europe - banks in Ireland, Luxembourg and Southern Europe are most exposed to long-term securities; Baltic countries tend to have lowest exposure and best capital ratios.

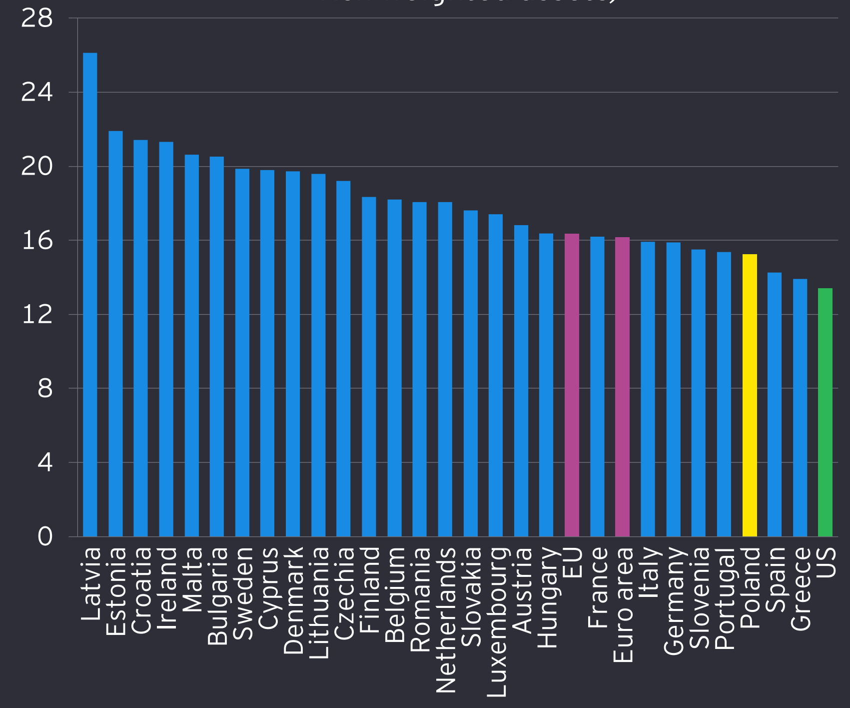
Debt securities to total assets in 2022 Q4 (in percentage)



Leverage in 2022 Q3 (total assets over total equity)



Tier 1 capital ratio in 2022 Q3 (in percentage of risk-weighted assets)

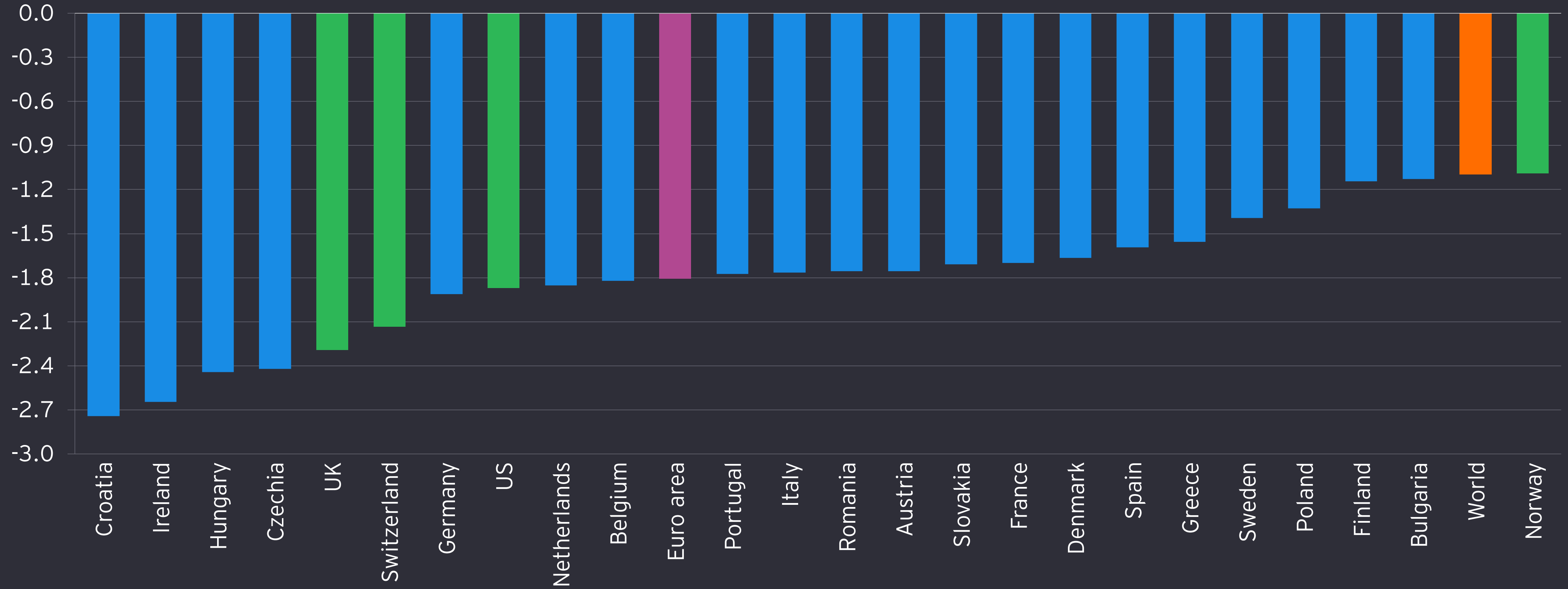


Source: ECB Warehouse, FRED.

In our baseline scenario, the banking turmoil will be contained, without significant impact on the European economy. In an alternative scenario of an additional tightening of credit conditions (1/3 as large as during the global financial crisis), by 2025, GDP in the euro area would be almost 2% lower than in the baseline

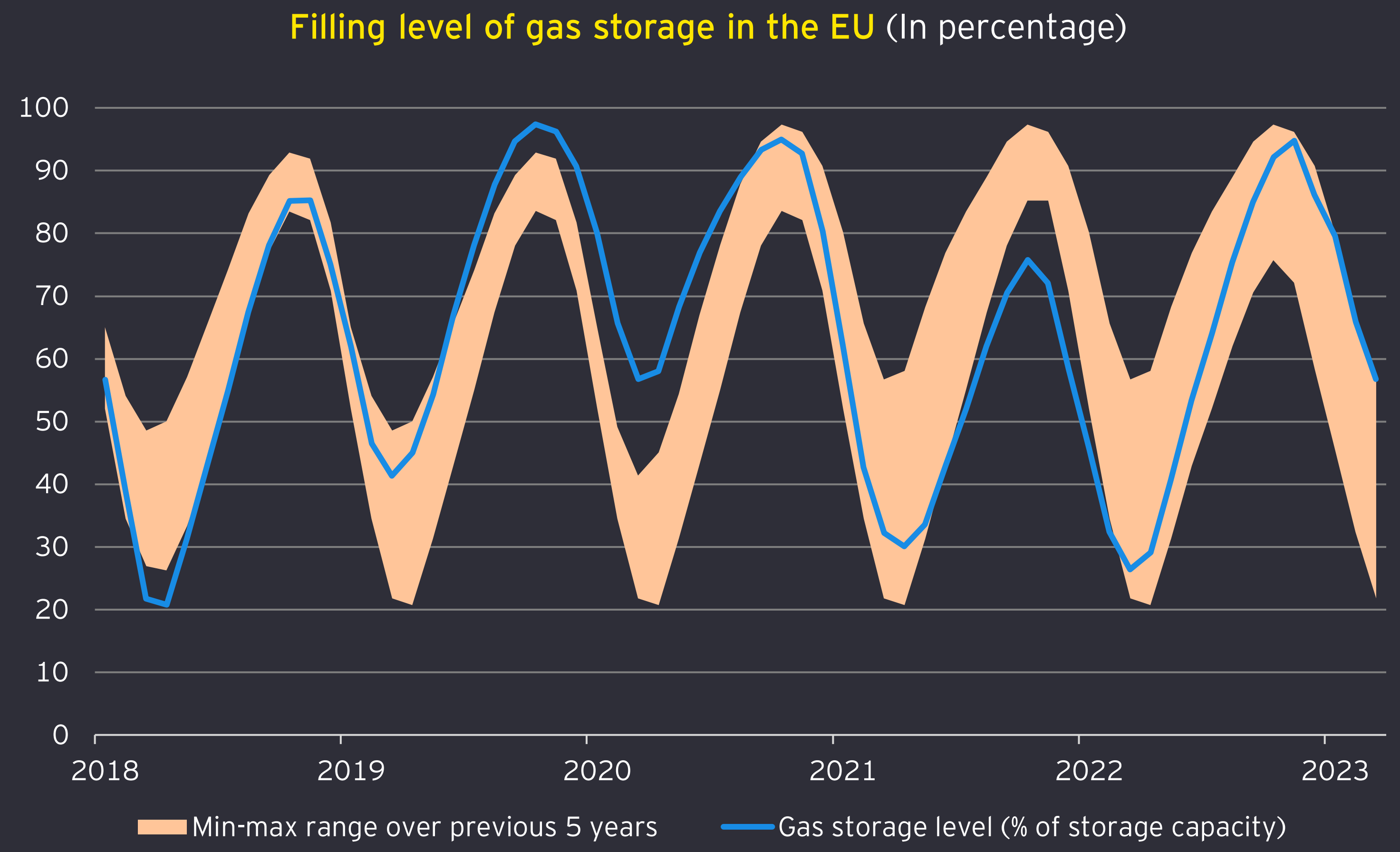
- Even though we assumed CEE countries are less exposed to the current turmoil, and thus would see a smaller tightening of credit conditions than Western Europe, several CEE countries (Croatia, Hungary and Czechia) would still be among the countries suffering from the largest hit to GDP, alongside bank-heavy Ireland, UK and Switzerland.
- On the other side of the spectrum, Nordic countries would be among least vulnerable countries, alongside Bulgaria and Poland.

Cumulative GDP growth over 2023-25 in the credit tightening scenario relative to the baseline (in percentage points)



Source: EY EAT simulation.

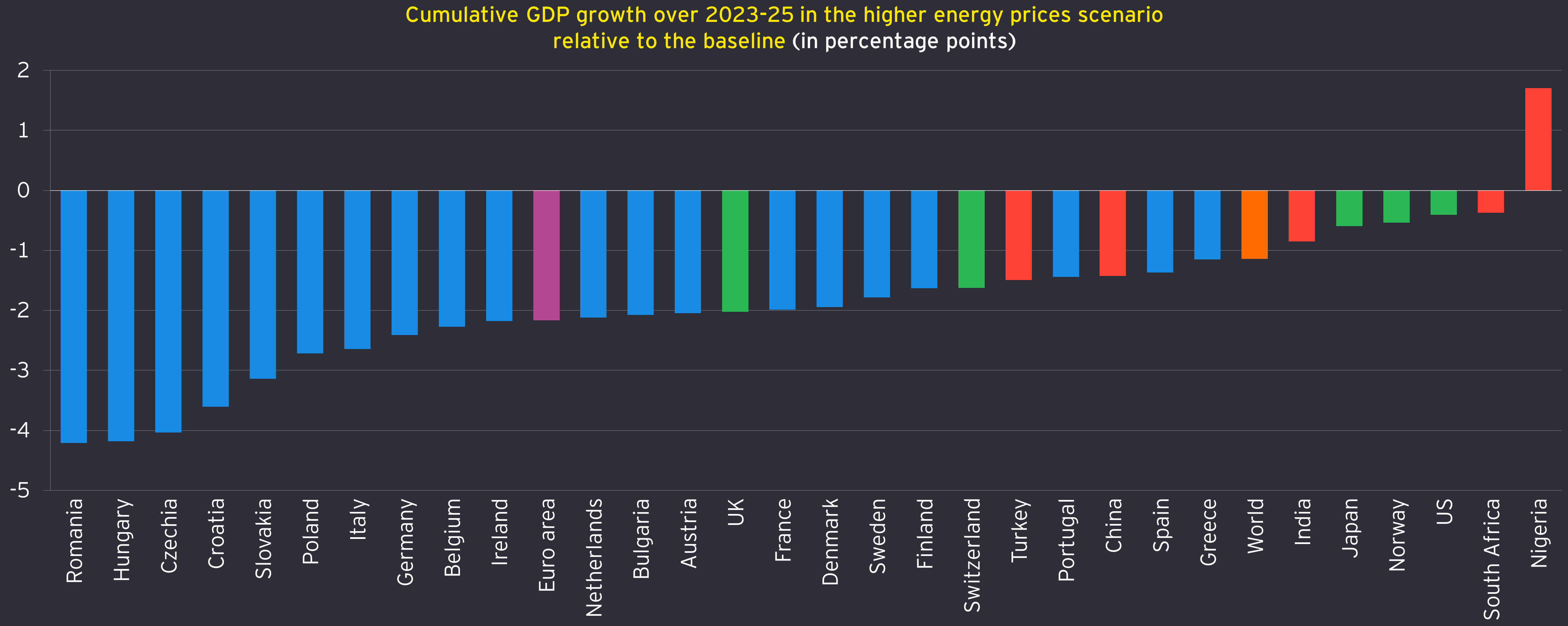
While a mild winter in Europe and ample natural gas storage at European facilities have helped keep a lid on energy prices …



Source: Gas Infrastructure Europe; EY EAT calculations.

… the risk of rising energy costs remains significant and, if occured, it might have a huge impact on economic activity and inflation

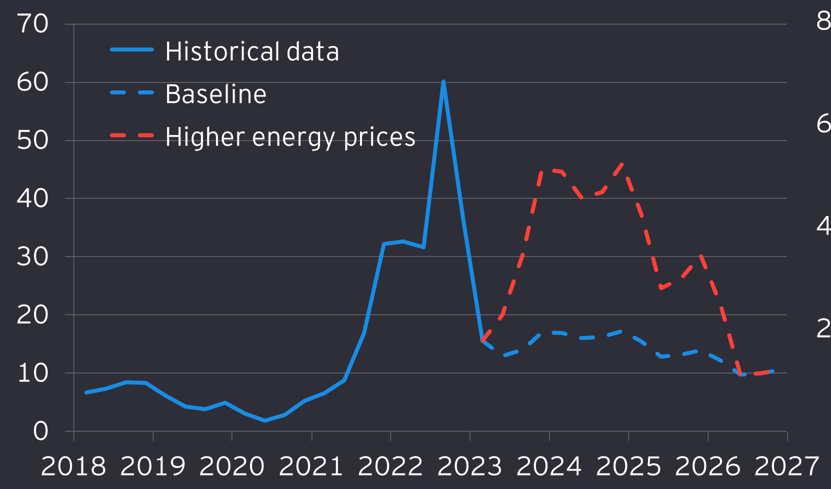
- Europe is more vulnerable to a renewed increase in energy prices than other major economies, in particular the US.
- CEE countries, in particular Romania, Hungary and Czechia, would be most adversely impacted by another sharp spike in energy costs.



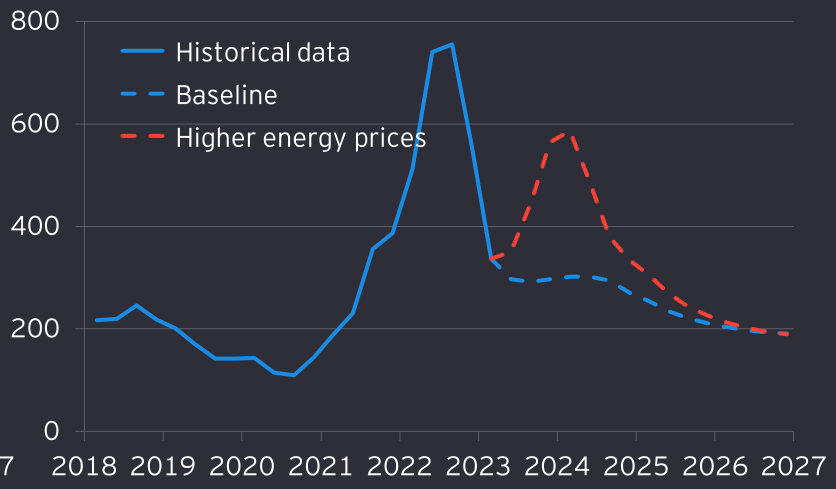
Source: EY EAT simulations.

Scenario assumptions

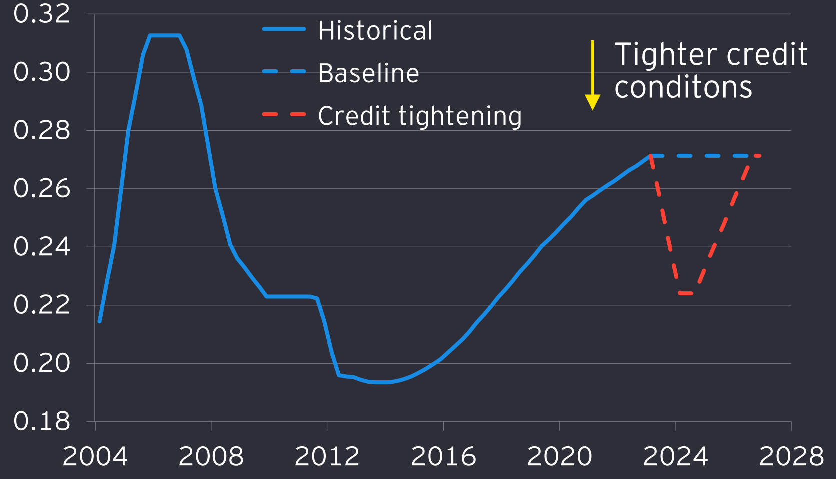
European natural gas prices (USD/Mil.BTU)



Global coal prices (index, 2005 = 100)



Credit conditions in the euro area



Baseline scenario

- Energy prices in line with futures curves
- No additional (i.e. above monetary-policy-implied) tightening in credit conditions

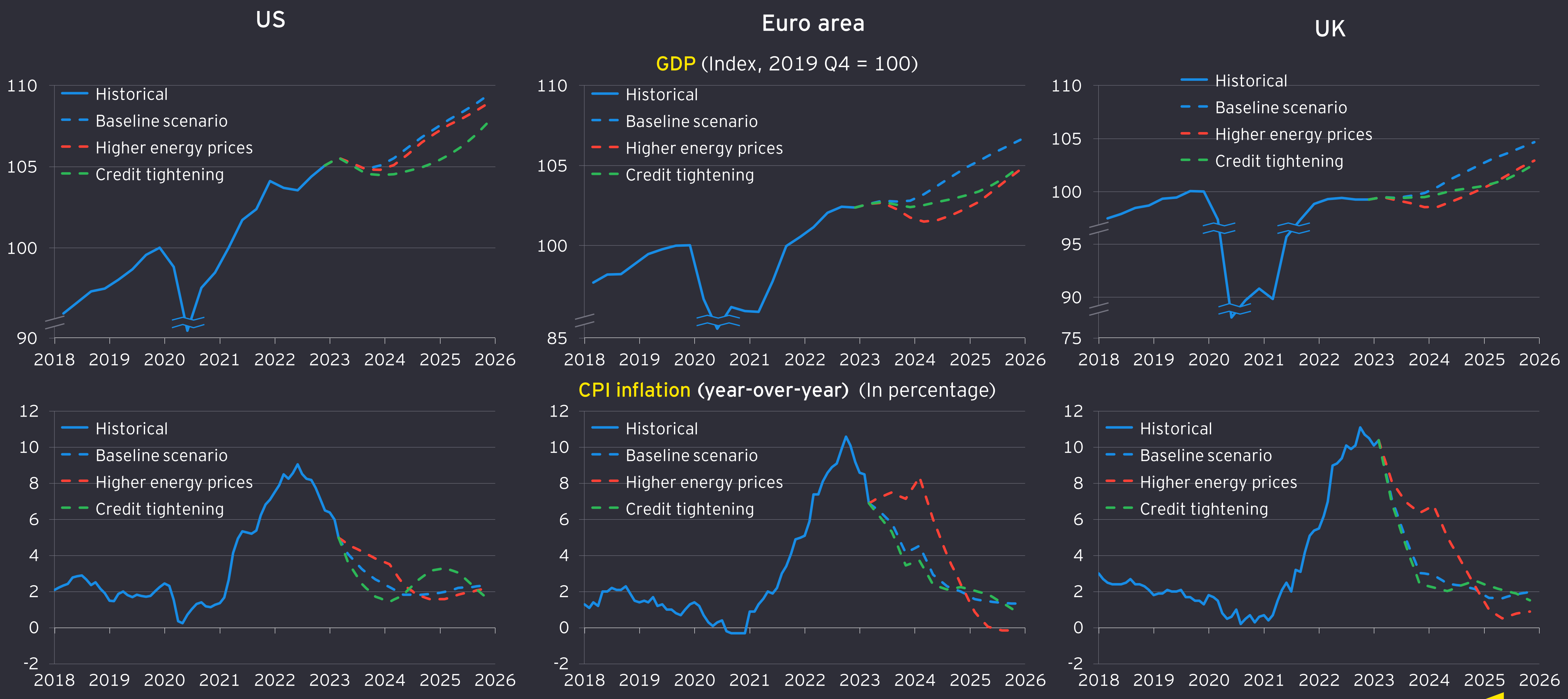
Higher energy prices scenario

- By winter 2023/24, natural gas in Europe and the US and coal prices around the world increase by approx. 2/3 from the current levels towards the summer 2022 peaks and decline gradually afterwards
- Central banks tighten monetary policy further and/or keep interest rates high for longer
- Euro appreciates against the US dollar, CEE currecies depreciate against the euro
- Business confidence in Europe deteriorates

Credit tightening scenario

- Credit conditions in the US, EU and EFTA countries tighten, on average, by 1/3 of the average tightening observed during the global financial crisis
- Credit conditions tighten more strongly than average in the US and Switzerland and less than average in the CEE countries
- Volatility in capital markets increases, sovereign and corporate credit spreads widen
- Business confidence deteriorates around the world

GDP and inflation outlook by scenario

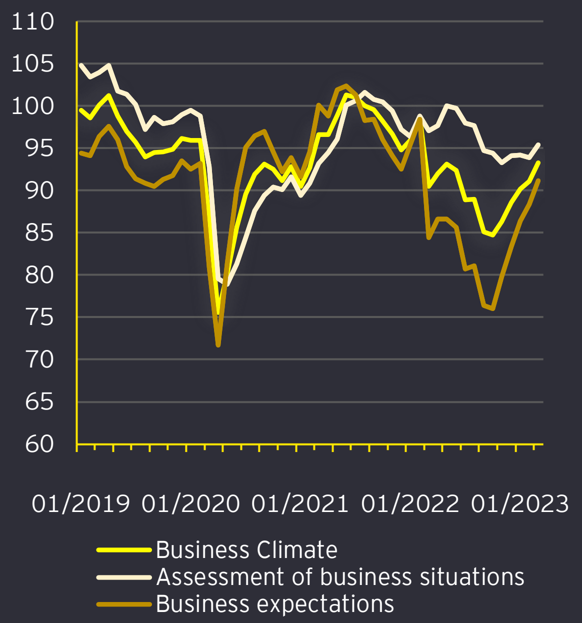


Source: Eurostat; FRED; Oxford Economics; EY EAT forecast.

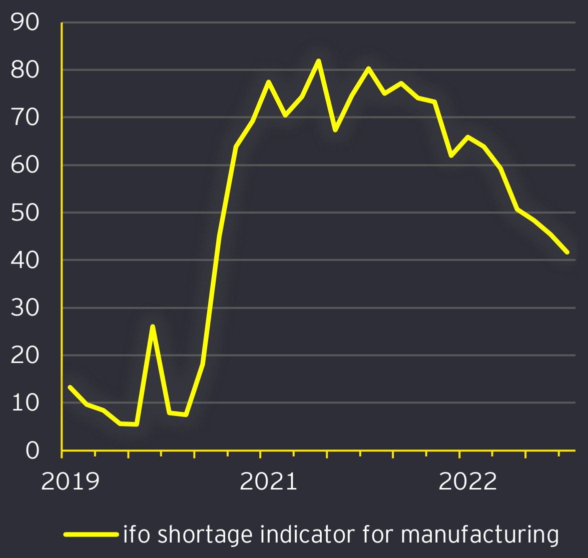
Germany: outlook better than previously expected, but still worse than euro area average i.a. due to a strong impact of high energy prices and ongoing disruptions in the manufacturing sector

GDP	Inflation	Exports	Unemployment Rate
-0.1%	+6.0%	+2.1%	2.9%
Real GDP growth, 2023	CPI Inflation, 2023	Volume growth, 01/2023	LFS unemployment rate, 2023
Source: EY EAT Forecast	Source: EY EAT Forecast.	Source: Destatis	Source: EY EAT Forecast.

ifo Business Climate indicators (2015=100)



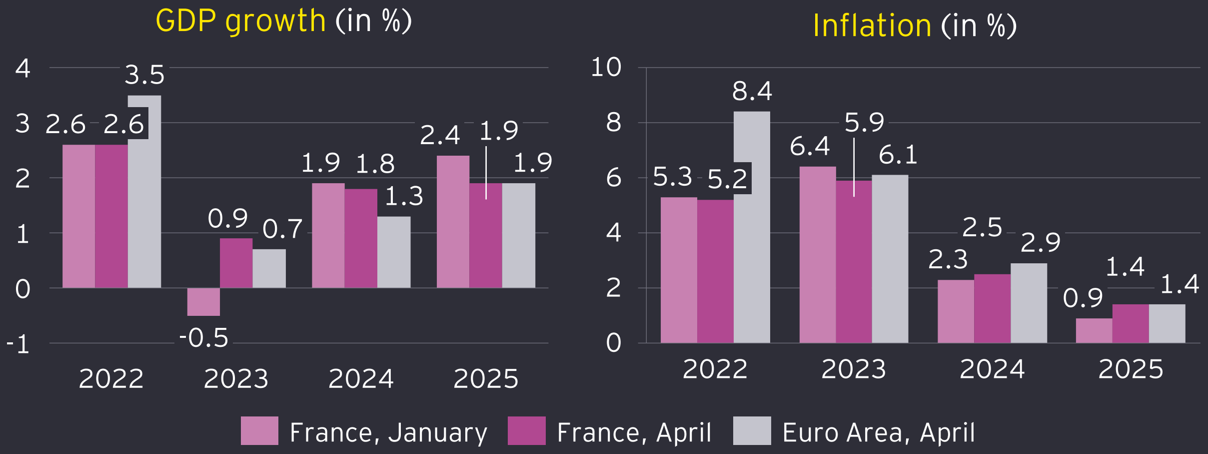
ifo shortage indicator(2015=100)



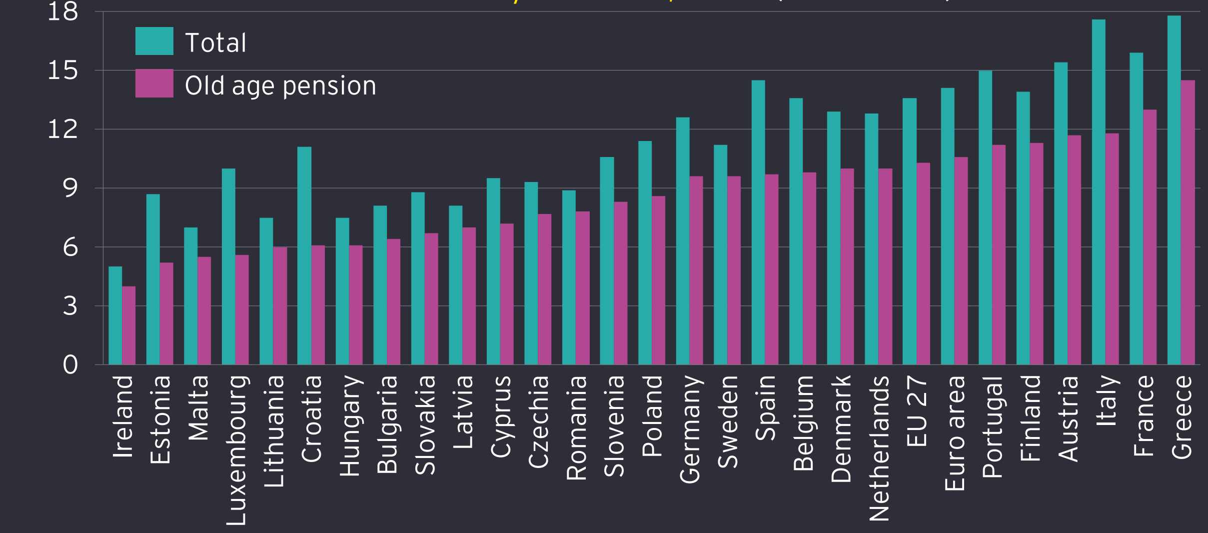
- Declining wholesale energy prices and China's departure from its zero-covid policy mitigate the decline in economic growth expected for Germany in 2023. High inflation, however, will dampen growth until well into 2024. The German economy continues to be burdened by high energy prices, but proved quite resilient to the energy crisis in the 2022-23 winter.
- Due to high energy costs, the German economy is exposed to a worse competitive situation compared to companies, for example, in the US.
- China's softer approach to its zero-covid policy has led to a reduced shortage in the manufacturing sector, though the ongoing war in Ukraine is still causing disruptions in global supply chains.
- The amendment to the climate protection law (November 2022) requires accelerated transformation of the German economy. Germany has continued to increase its share of renewable energy sources to 46% in its electricity sector and is targeting a share of at least 80% by 2030.
- Sentiment in key sectors, such as the automotive industry, chemicals, electrical engineering and mechanical engineering, has improved significantly.
- Despite the turbulence at some international banks, the German economy is stabilizing.
- Positive expectations for the Business Climate continued to rise for the fourth month consecutively.
- Currently in plan is a faster depreciation of corporate investments.

France: short-term outlook has improved and is slightly better than the euro area average. Social tensions around the pension system reform are a source of downside risks in the short term, but the reform should raise growth potential and limit fiscal risks in the long term

January and April EY EAT forecasts



Pension system cost, 2020 (in % of GDP)

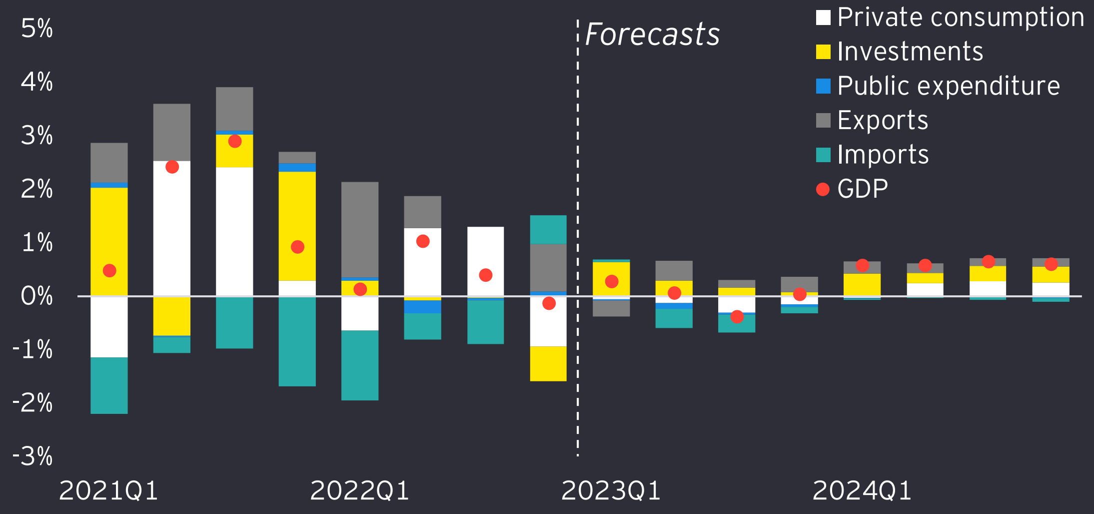


- On the back of the continued resilience, we have revised our 2023 GDP forecast for France from -0.5% to 0.9%. Relatively strong employment growth (see page 16) and lower than euro area average inflation in 2022 limited the hit to household real incomes, thereby supporting consumption. Fiscal policy remains loose, with 5.5% of GDP deficit expected in 2023 – an increase from 4.7% in 2022. These factors support the 2023 and 2024 GDP outlook, which is slightly above the euro area average.
- Due to a high share of nuclear power in the energy mix, the French government was able to limit the increase in energy prices, keeping a lid on inflation at 5.2% in 2022 – much below the euro area average, with core inflation also more muted. However, due to similarly strong underlying wage pressures, we expect core inflation to catch up with the euro area average in the latter part of 2023 (see page 51). Coupled with weaker base effects in energy prices, this makes inflation outlook for 2023 and following years very close to the euro area average.
- The retirement age reform has led to social tensions which constitute a downside risk to the short-term outlook. Protest disruption may lead to the downward revision of the Q2 forecast but this effect should largely be offset in the following quarters. The reform implies that the minimum legal retirement age will increase from 62 to 64 by 2030. It will help to reduce the cost of the pension system, which now is among the highest in the EU, leading to a reduction in the public debt to GDP ratio by 3.5pp by 2035 (according to Oxford Economics). By raising the labor force, it will also increase potential output by 1.1% by 2035.

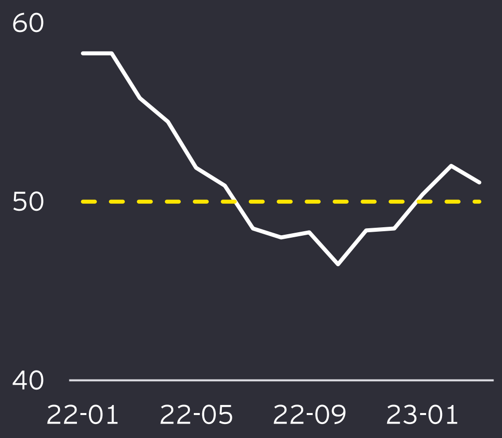
Source: French plan to raise retirement age by two years to 64 - BBC News; Eurostat; Oxford Economics; EY EAT forecast.

Italy: growth in 2023 will be mainly driven by investment and net exports, also thanks to the strong impulse provided by the resources of the National Recovery and Resilience Plan (NRRP). A positive contribution to growth from private consumption is expected in 2024.

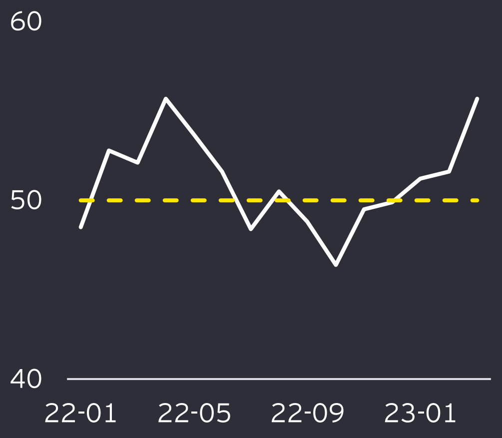
GDP growth decomposition in Italy
(quarter-over-quarter, in percentage points)



PMI Manufacturing in Italy



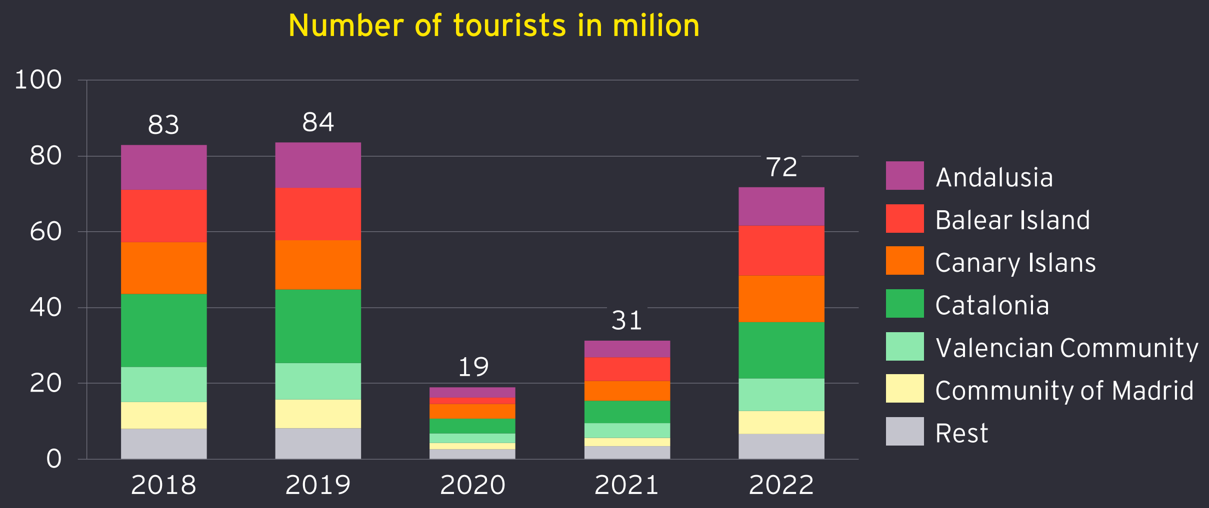
PMI Services in Italy



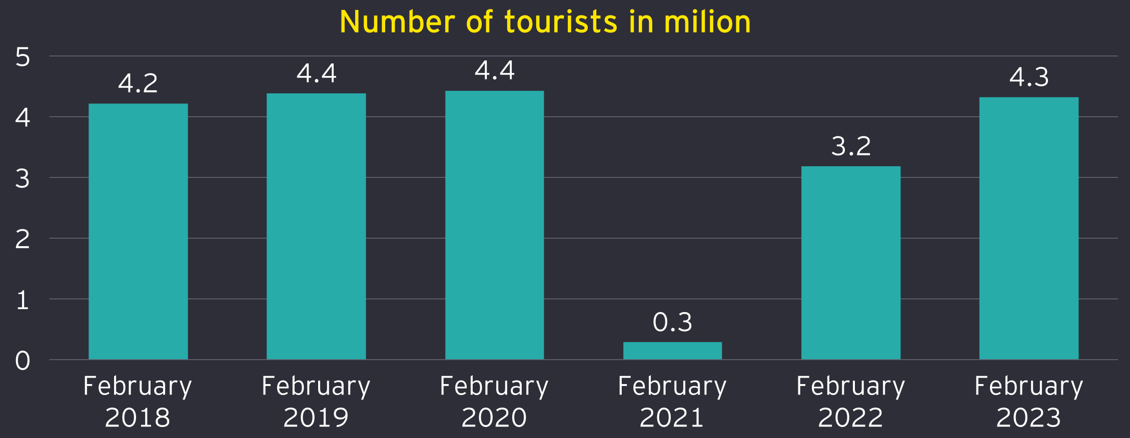
- EY forecasts a 0.5% real GDP growth for Italy in 2023 and 1.3% in 2024 (slightly below the euro area average), while inflation rate should fall from 6.7% in 2023 to 3.1% in 2024 (somewhat above the euro area average).
- The last quarter of 2022 was characterized by a strong reduction in household consumption (-1.6%) and an even stronger retreat of investment (-3.3%). Domestic demand was partly replaced by external demand as reflected in the rebound of exports.
- After a marginal contraction of economic activity 2022 Q4, mainly due to weak household consumption, we estimate that 2023 Q1 saw a modest growth.
- This was mainly driven by a positive contribution of investment, with consumption almost flat after its decline in the previous quarter.
- In the following quarters, Italian GDP growth will benefit from the positive contribution of net exports, mainly due to a slowdown of imports in 2023, and then driven by a recovery in global trade in 2024.
- External demand and investment will represent the engine of the Italian growth also in the coming years. The investment component will be supported mainly by public investment and by the NRRP resources.
- Recent figures of manufacturing and services PMIs for Italy show positive signs, although it is also important to consider the dynamics in other close countries such as Germany, where PMI manufacturing has been below the reference threshold since mid 2022 and shows no sign of recovery. This might negatively affect the Italian industry, highly connected with the German one.

Fonte: ISTAT, S&P Global and forecasts from EY Italy's Macroeconometric Model, 'HEY-MoM'.

Spain: economic outlook is strong. Post-pandemic tourism rebound, public spending increase associated with elections and NextGenEU funds support growth in the short term. Fiscal deficit constitutes a downside risk in the mid-term.



In February 2023, the number of tourists exceeded the 2018 level. The total number of tourists in 2023 is expected to be above pre-pandemic levels.

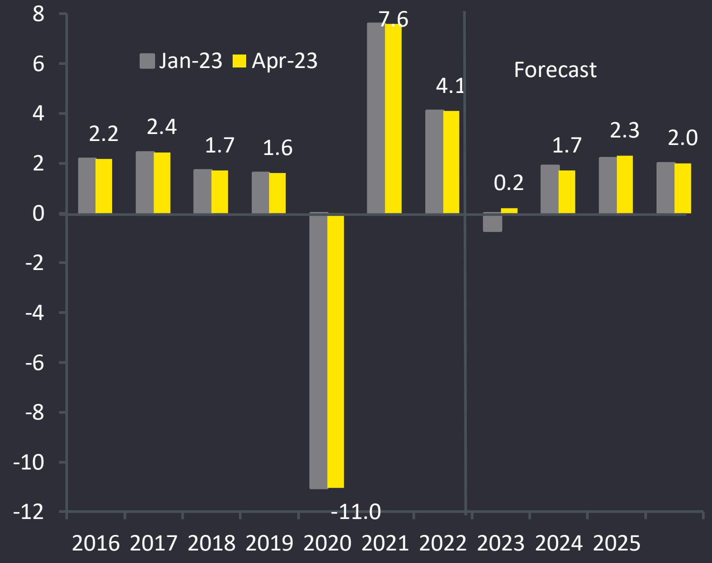


- Spain's growth forecasts are among the highest in Europe – EY EAT expects Spanish GDP to grow by 2.0% this year against the euro area average of 0.7%. There are several factors contributing to the resilience of the Spanish economy.
- The adverse effects of pandemic restrictions were particularly acute in Spain (i.a. due to a high share of services in value added) and reduced Spanish GDP more than in the rest of Europe. This impact was reversed fully at the turn of 2022 and 2023.
- Tourism rebound due to the end of pandemic restrictions is leading to employment increase, higher income, and stronger private consumption. Foreign tourism, due to Spain being considered a safe destination, is also improving current account figures.
- Savings accumulated during the pandemic are helping private consumption to remain healthy, supported by an accelerating payroll increase in Q1 2023.
- Recent data from PMI surveys for Spain are well above the rest of Europe, reaching almost 60 in PMI services. Composite PMI is the highest among Europe's leading economies, driven by the dynamic service sector.
- Local elections in May 2023 and general elections in November 2023 are also supportive of growth, leading to higher public expenditure in Spain. NextGenEU funds provide additional push for private and public CAPEX. Fiscal policy in Spain remains expansionary, including government measures to shield households and buisnesses from the energy crisis and pension reforms that increase the fiscal deficit in the short and medium term.
- Lower energy prices in Spain and other government measures to contain inflation are helping to keep Spanish CPI below the rest of Europe – EY EAT expects 2023 inflation to reach 4.7% against the euro area average of 6.1%. Core CPI remains high, though, reducing the expectations of headline CPI going back to 2% in the near future.

Source: Instituto Nacional de Estadística

UK: the outlook is highly uncertain, but our base case is that the economy will avoid a recession, inflation will fall sharply and attention will turn to rate cuts

UK GDP Forecast (in percentage)

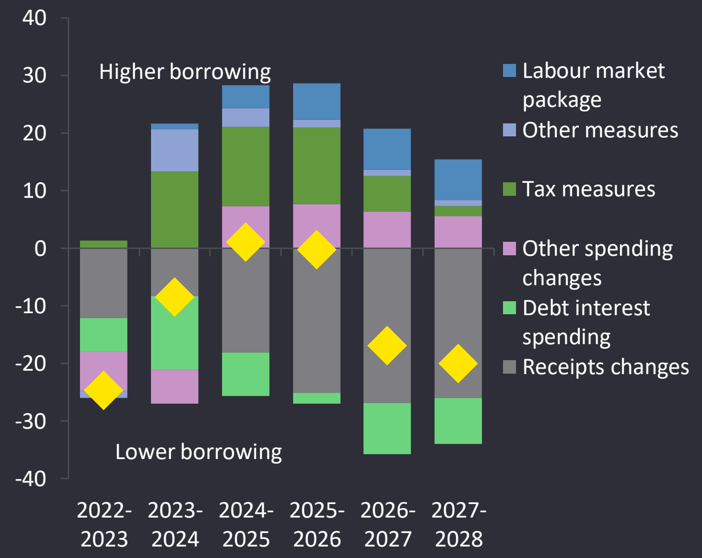


- The EY ITEM Club now expects the UK economy to grow by 0.2% in 2023, up from the -0.7% contraction projected in January's Winter Forecast.
- The UK economy is forecast to flatline in the short term and avoid two consecutive quarters of contraction – before better growth later in 2023.

UK CPI inflation (in percentage)

- House prices are expected to fall by around 10% peak-to-trough, although a serious correction is unlikely and the impact on the economy will be limited.
- Historically high inflation should fall quickly in the coming months, with cheaper energy having a significant effect.
- Against this backdrop, we expect the BoE to raise Bank Rate only once more in this cycle, to a peak of 4.50%. Thereafter, we expect the policy rate to remain on hold for much of this year, and for the first cut to be delivered in Q4 2023.

Changes in public borrowing (GBP bn)



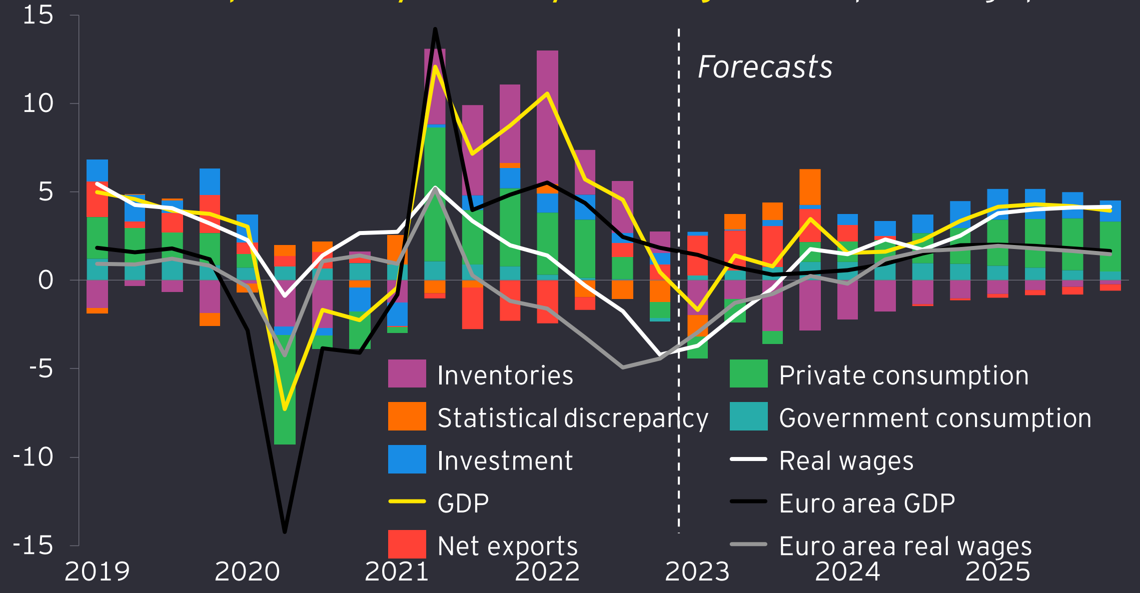
The Budget included supply-side reforms aimed at boosting long-run growth:

1. Incentivising business investment: for three years from 2023-24, firms will be able to fully offset investment spending on plant and machinery against taxable profits in the first year.
2. Measures to promote growth in the workforce and correct some of the shrinkage observed since 2020: this included broadening free childcare, imposing greater requirements to look for work and train for those in receipt of out of work benefits, and reforming rules around pension contributions to discourage early retirement.

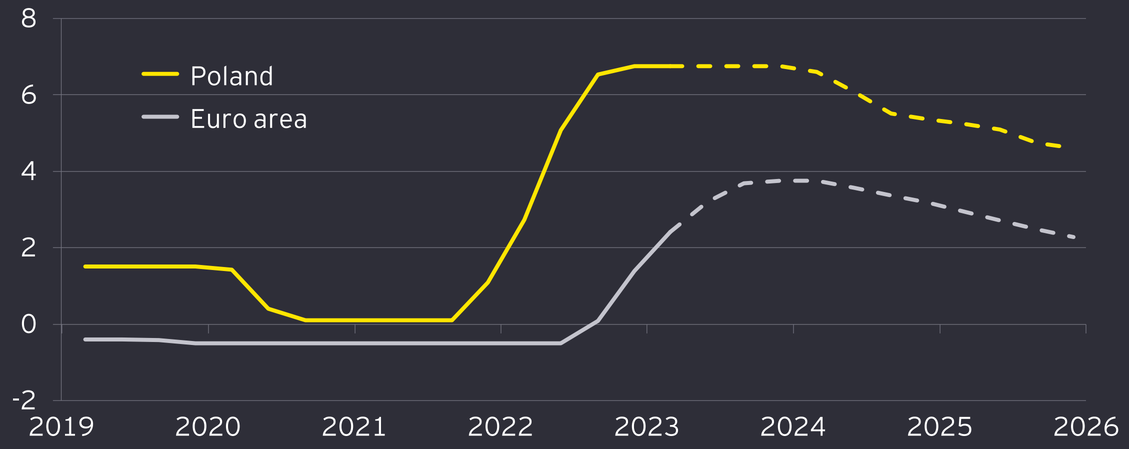
Source: EY ITEM Club/Haver Analytics

Poland: persistently high inflation, tight labor market, sharp growth deceleration in 2022 and muted growth in 2023

Decomposition of year-over-year GDP growth (in percentage points)



Central bank interest rates (in percentage points)

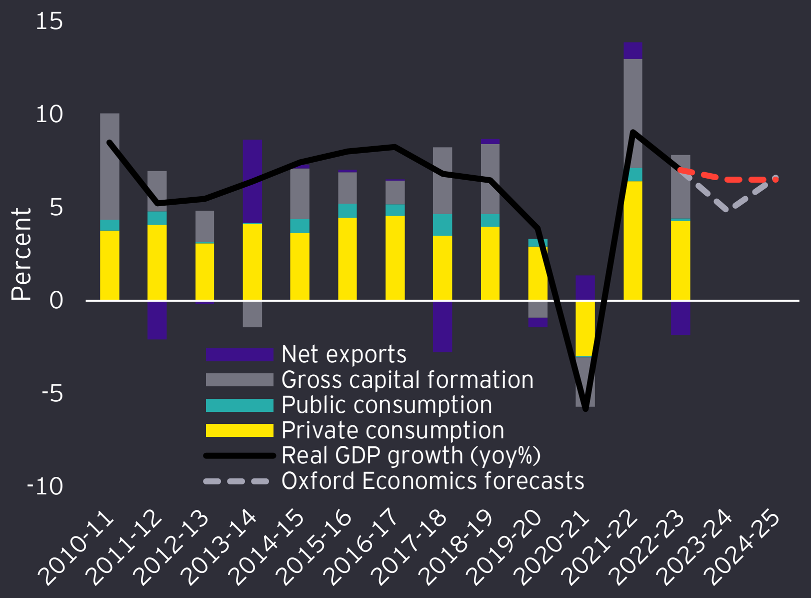


Source: Oxford Economics, EY EAT forecast.

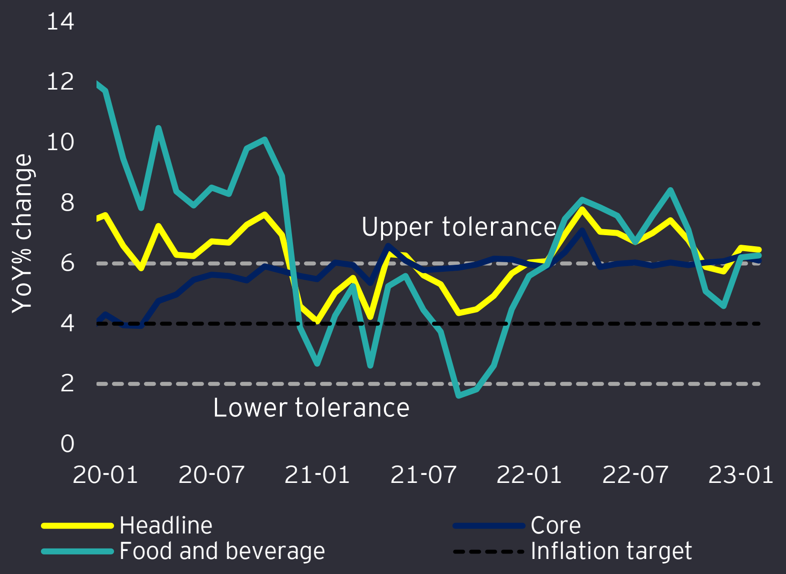
- Poland, similarly to most other CEE countries, has experienced much higher inflation than the euro area average, peaking at 18.4% in February 2023.
- Stronger impact of supply shocks (due to fossil-fuel-based energy mix, higher share of energy and food in the CPI basket and FX depreciation) has been the main culprit. Tight labor market, as well as relatively easy monetary and fiscal policies before and during the pandemic, have also contributed to inflation, especially by putting upward pressure on wage growth and services inflation (see page 30).
- GDP swiftly rebounded to the pre-pandemic trend by early 2022, but the recovery was characterised by a particularly large build-up of inventories, making the economy vulnerable to the reversal of the inventory cycle.
- After the outbreak of the war in Ukraine, economic conditions deteriorated more sharply than in the euro area, with GDP declining after 2022 Q1. Slower build-up of inventories and a relatively steep deceleration in consumption were the main culprits. Relatively limited excess savings accumulated during the pandemic and more abrupt monetary policy tightening (from 0.1% to 6.75%) contributed to the consumption slowdown, even though disposable income was supported by high wage growth, expansionary fiscal policy and refugee inflow.
- While we expect inflation to fall, it will remain stickly due to strong nominal wage growth and a (partial) reversal of food VAT cuts and energy price freezes in 2024. Consequently, we do not expect inflation to return to the 2.5% target before 2026 (see page 51).
- Muted growth in real disposable incomes and external demand, the reversal of the inventory cycle and a negative carry-over effect will cap 2023 GDP growth at 1.0% – similar as in the euro area, despite Poland's much higher growth potential. Growth will pick up in the following years, though it will be slightly lower if NextGenEU funding is not approved (we expect it to be approved in 2023 Q4).
- The central bank (NBP) concluded the tightening cycle at 6.75% already in Sep 2022. We expect that a gradual easing cycle will commence in early 2024.

India: the central bank delivers a hawkish pause in its latest policy meeting, emphasising it is “a pause and not a pivot”

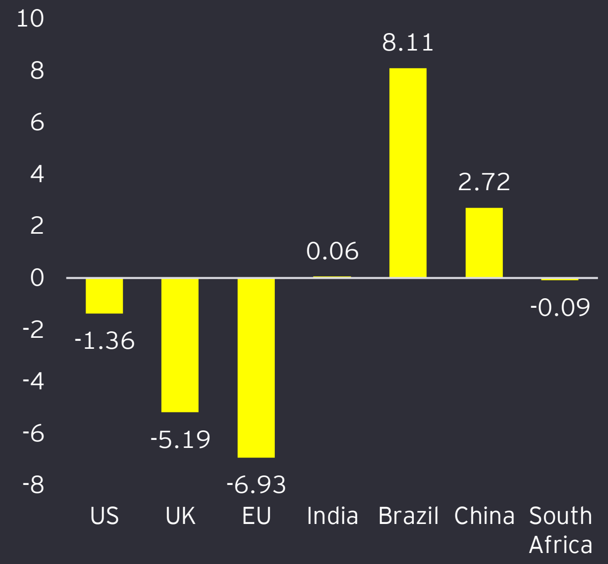
Decomposition of real GDP growth (year-over-year)



CPI inflation (year-over-year)



Real policy rate (in percentage)



- The Indian economy remains one of the fastest growth major economies, exhibiting fair degree of resiliency to spill-over from global geopolitical developments and accelerated monetary policy tightening by major central banks. After an estimated 7% YoY growth in FY23, India’s real GDP is projected to moderate slightly to 6.5% in FY24 and FY25 as per the RBI’s latest forecasts. With risks of recessionary pressures in major advanced economies and tentative signs of moderation in domestic economic activity, economic growth is likely to be lower around 6% in FY24.
- India’s inflation trajectory is proving to be sticky with the headline CPI inflation (6.4% in Feb’23) persisting above the upper tolerance limit of the central bank’s target range of 4% (+/-2%) in 10 of the past 12 months impacted by global supply constraints, domestic food supply pressures and lagged pass-through of input costs. As per RBI, it is projected to fall within the target range but remains elevated around 5.2% in FY24.
- In its April’23 meeting, the central bank (Reserve Bank of India, RBI) unexpectedly kept the key policy rate (repo rate) at 6.5% after raising it by a cumulative 250 basis points since May 2022. The RBI maintained a hawkish tone, emphasising “it’s a pause not a pivot” keeping the door open for future rate hikes. We believe the central bank is near the end of rate hiking cycle and another 25-50bps rate hikes are conditional on inflation trajectory persisting above RBI’s projection.

Sources: Reserve Bank of India, Oxford Economics, Haver, EY Analysis.
Note: Real GDP growth numbers are for Financial year e.g 2010-11 refers to April’2010 to March’2011.

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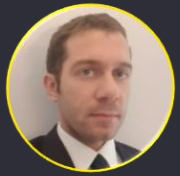

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Forecast and country-specific outlook sources

- Baseline forecasts for most economies and alternative scenarios for all countries have been prepared by EY Economic Analysis Team (EY EAT) using the Oxford Economics Global Economic Model (OE GEM)
  - EY EAT have adjusted OE GEM equations, assumptions and data inputs
- Baseline scenario for the US has been prepared by EY-Parthenon Macroeconomics Team
  - Contact: https://www.ey.com/en_us/strategy/macroeconomics
- Baseline scenario for the UK has been prepared by EY ITEM Club
  - Contact: parnold@uk.ey.com
- Baseline scenario for Italy in 2023-24 has been prepared by EY Italy
  - Contact: alberto.caruso@it.ey.com
- Country-specific outlooks for Germany, Italy, Spain and the UK have been provided by economists listed on the previous page. We also thank Pramod Chowdhary for his contribution to the outlook for India

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