BUSINESSEUROPE

ECONOMIC OUTLOOK AUTUMN 2022

7 November 2022

# BUSINESSES FACE A DIFFICULT WINTER AS SENTIMENT FALLS AND COSTS RISE

## ECONOMIC SITUATION

- After a strong first half year driven by post-covid service sector reopening, business sentiment has declined rapidly in recent months. **Soaring energy bills** and **continuing supply chain disruptions** mean costs for businesses are rising much faster than consumer inflation. With margins falling and the prospect of consumer demand also declining, many businesses are cutting production.

- Our central forecast is for the EU economy to **grow by 2.8% between 2021 and 2022**. But we now expect **EU growth of only 0.6% in 2023**, compared to the 2.1% in our Summer Economic Outlook. We expect **euro area inflation of 8% in 2022, falling moderately to 5% in 2023**. But even this disappointing outlook will depend upon no further increases in energy prices, a further easing of supply chain pressures, and policies that respond to the energy price shock in a timely, comprehensive, and well-balanced way.

## POLICY RECOMMENDATIONS

- EU leaders need to agree urgently on new measures to alleviate energy costs for businesses. In particular, policymakers should consider EU-wide measures to temporarily decouple electricity prices from gas prices and grant governments the necessary **flexibility to support businesses while maintaining a level playing field in the single market**.

- In view of limited fiscal space in many Member States, measures to support consumers and businesses with energy costs must be **temporary** and **well-targeted**. Rapid agreement **on the reform of the Stability and Growth Pact can support Member States in ensuring that the long-term strengthening of public finances is not unduly delayed.** Effective use of public funds, notably the EU's Recovery and Resilience Facility, is essential to boosting long-term investment growth.

- Any further normalisation of monetary policy through interest rate rises is likely to act as an additional drag on growth but may nevertheless be essential to help ensure inflation expectations remain well-anchored. **Social partners** can play an important role in helping **to continue to prevent the emergence of a damaging wage-price spiral**.

- In light of rising interest rates, policymakers should carefully monitor rising borrowing costs and **facilitate the access to alternative financing sources for businesses**, for example equity financing, whilst not coming at the expense of debt-financed instruments. Calibrating the Basel III rules must maintain the **ability of businesses to access bank lending** and **safeguard their competitiveness** vis-à-vis international competitors.

## ABOUT THE ECONOMIC OUTLOOK

BusinessEurope publishes a biannual Economic Outlook that provides business insight into recent and projected economic developments in Europe.

In producing our economic projections and assessing current challenges and developments in the international and regional economy, BusinessEurope works closely with its member federations and draws on their specialist expertise and detailed knowledge of their national economies and ongoing interactions with business.

In particular, our EU27 and euro area forecasts are a reflection of the GDP-size weighted economic forecasts from each member state from the economic research departments of our national member federations. Our economic projections are therefore informed by leading country experts with in-depth knowledge and day-to-day monitoring of the economic situation in every EU member state.

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# OVERALL FORECAST

The prospects for the EU economy, much in line with other regions, have significantly deteriorated since our Summer Economic Outlook. Soaring energy bills and ongoing supply chain disruptions are strongly impacting businesses who are seeing margins reduced and are struggling to avoid production cuts. Both business and consumer sentiment fell sharply during the summer. Macro and micro policies that address concerns around energy prices, inflation, growth, and long-term investment in a timely, comprehensive, and well-balanced way, will be essential to support the EU economy in the coming pivotal months.

**Table 1: BusinessEurope economic forecast**
*Forecast based on analysis of each EU27 Member State*

| | EU | | Euro area | |
|---|---|---|---|---|
| **Main variables** | **2022** | **2023** | **2022** | **2023** |
| **Real GDP (annual % growth)** | 2.8 | 0.6 | 2.9 | 0.3 |
| **Inflation (%)** | 8.8 | 5.6 | 8.0 | 5.0 |
| **Unemployment (%)** | 6.1 | 6.2 | 6.5 | 6.6 |
| **Government net lending (% of GDP)** | -3.5 | -2.8 | -3.2 | -2.5 |

*Source: member federations*

Our forecast is for the EU economy to grow by 2.8% in 2022 compared to 2021, supported both by growth in the first half of the year driven by the post-covid reopening of the service sector, and technical 'carry-over' effects from growth in the latter part of 2021. But both rising costs and associated falls in consumer confidence are weighing strongly on the outlook and we now anticipate GDP growth in the EU of only 0.6% in 2023, a downward revision of 1.5 percentage points since our Summer Economic Outlook. Our forecast for the euro area is for 0.3% GDP growth in 2023, with the energy shock particularly impacting the large industrial sectors in some of the euro area's larger economies.

Euro area inflation is expected to reach 8.0% by the end of 2022 (slightly down from the 10.7% at present) and to fall gradually to 5.0% by the end of 2023.

But achieving even this relatively weak growth outcome will depend on no further increases in energy prices, a further easing of supply chain pressures, and policies that respond to the energy price shock in a timely, comprehensive, and well-balanced way. For example, the IMF shows how in a scenario characterised by a hard winter and a complete cut-off from Russian gas, GDP could contract by up to 3% in some Central and Eastern European economies.

**Table 2: Growth expectations fall as consumption and investment weakens**
*Percent growth expected by European business in 2022 and 2023*

| | 2021 | | 2022 | | 2023 | |
|---|---|---|---|---|---|---|
| | Euro area | EU 27 | Euro area | EU 27 | Euro area | EU 27 |
| **GDP** | 5.4 | 5.4 | 2.9 | 2.8 | 0.3 | 0.6 |
| **Private consumption** | 3.5 | 4.0 | 3.5 | 3.3 | 0 | 0.3 |
| **Public consumption** | 3.8 | 3.6 | 1.4 | 1.3 | -0.3 | 0.1 |
| **Investment** *(Gross Fixed Capital Formation)* | 6.1 | 5.5 | 4.1 | 3.9 | 0.8 | 1.1 |
| **Exports** | 11.2 | 11.1 | 6.9 | 6.3 | 2.5 | 2.6 |
| **Imports** | 10.1 | 10.6 | 7.7 | 7 | 2.5 | 2.6 |
| *Net trade* | *1.1* | *0.5* | *-1.2* | *-0.7* | *0* | *0* |

*Source: BusinessEurope calculations from member federations*

Table 2 presents the main components of aggregate demand in the euro area and EU economy. The table shows clearly that the major driver behind the fall in GDP growth is private consumption, with many consumers' disposable income under pressure amidst significantly increased energy and food costs as well as increased uncertainty, particularly the prospect of increased mortgage costs as interest rates rise.

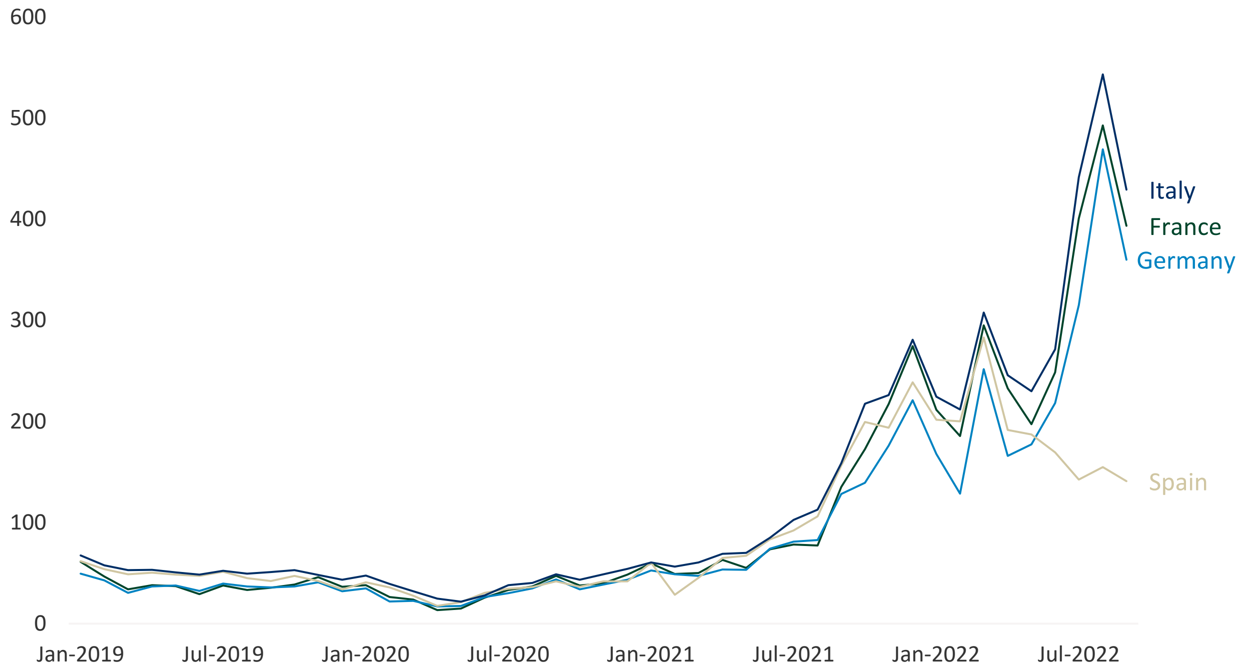
As we explore later, investment growth is also expected to fall as uncertainty plays on business confidence, alongside rising costs of capital.

## 1. High input prices are putting a strain on companies' margins and output

Rising input costs and the extraordinarily high volatility of energy prices put an additional pressure on industry confidence, are driving inflation, reducing firms' margins, and in many cases forcing firms to reduce output levels, particularly in energy-intensive sectors, as an increasing number of companies fight for survival.

Whilst businesses continue to deal with supply chain disruptions and temporarily very high commodity prices, high energy costs are the main factor driving input cost increases for companies. For example, the monthly average wholesale electricity price in Germany, the EU's largest economy, was 1,300% higher in August 2022 than in August 2020 (figure 1), and the European benchmark wholesale natural gas price increased by 1,800% between the end of 2019 and August 2022.

**Figure 1: Wholesale electricity prices remain at historically high levels despite recent falls**
*Average monthly spot prices in €/MWh in selected Member States*




*Source: Ember*
*Last observation: September 2022*

**Businesses are facing even larger price rises than consumers bills**

The rise in energy prices, whilst placing an unbearable burden on many households, has nevertheless been much larger for businesses. For example, quarterly market reports on EU gas and electricity markets prepared by the Commission's Directorate General for Energy estimate that average annual retail gas prices for EU industrial consumers (including taxes) have increased by 126% annually in Q2 2022, more than twice the increase experienced by households (+62%) during the same period. Similarly, retail electricity prices for high-demand industrial consumers increased by 60% annually in June 2022 compared to June 2021, twice as much as for households.

**Many businesses are reducing activity as margins are reduced or turn negative**

Recent studies conducted by our member federations show how businesses are absorbing a growing share of input costs. For example, evidence from Portugal shows that 53% of surveyed companies were passing on less than half of their cost increases to customers. In Germany, energy prices pose an existential threat to 34% of companies from the sample. In Italy, operating margins in the manufacturing sector have decreased by 3.6% between Q4 2020 and Q2 2022 due to the inability of companies to match rising input costs.

Such surveys are in line with official data showing that prices charged to businesses by (intermediate) producers in the EU have increased more strongly than consumer inflation, suggesting that businesses at the latter stage of the supply chain are absorbing such cost increases (producer prices in the EU rose by 43% annually in August, compared to 10.1% consumer inflation over the same period).

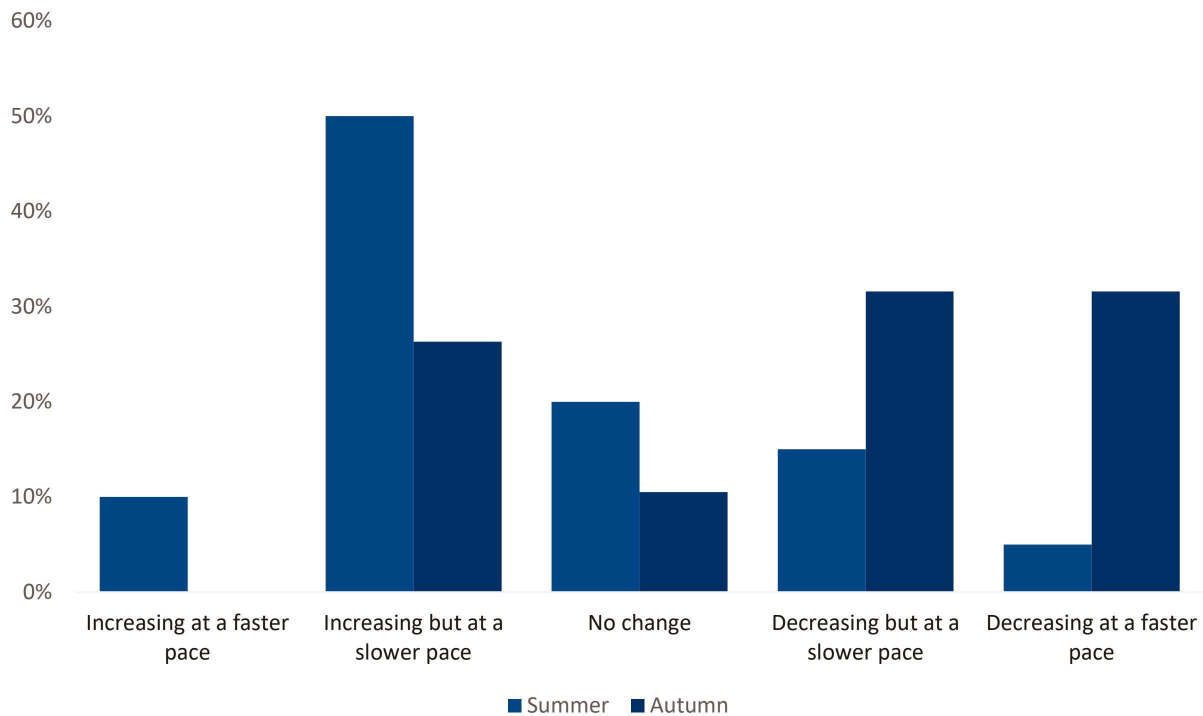
EU industrial gas demand contracted by 25% year-on-year in the third quarter of 2022, no doubt reflecting both a decline in production and moves to increase energy efficiency. Production expectations for the months ahead have taken a strong hit in September. As a result, the transmission of the supply-side shock has been eroding industry confidence for seven consecutive months, according to the European Commission's business and consumer surveys.

Similarly, a survey with our member federations shows that two thirds of federations expect the currently high energy prices to lead to temporary closures and output reduction in high-energy sectors in their countries, while all respondents expect strong financial pressures on all or most businesses. In the survey, none of our members expected the impact of high energy prices to be only little or limited to high-energy sectors only. At a sectoral level, estimates show that 70% of Europe's fertilizer production has been shut or slowed down, while 50% of total aluminium capacity has been lost.

**Uncertainty around energy costs, weakening consumer demand and rising interest rates are weighing on investment expectations**

With heightened uncertainty around energy prices and consumer demand, it is not a surprise that all our member federations expressed a much more negative view on the investment prospect for the coming six months (figure 3).

**Figure 3: European businesses expect a strong slowdown in investment**
*Member federations' view on the most likely investment trend (Industry/Services) over the next 6 months*

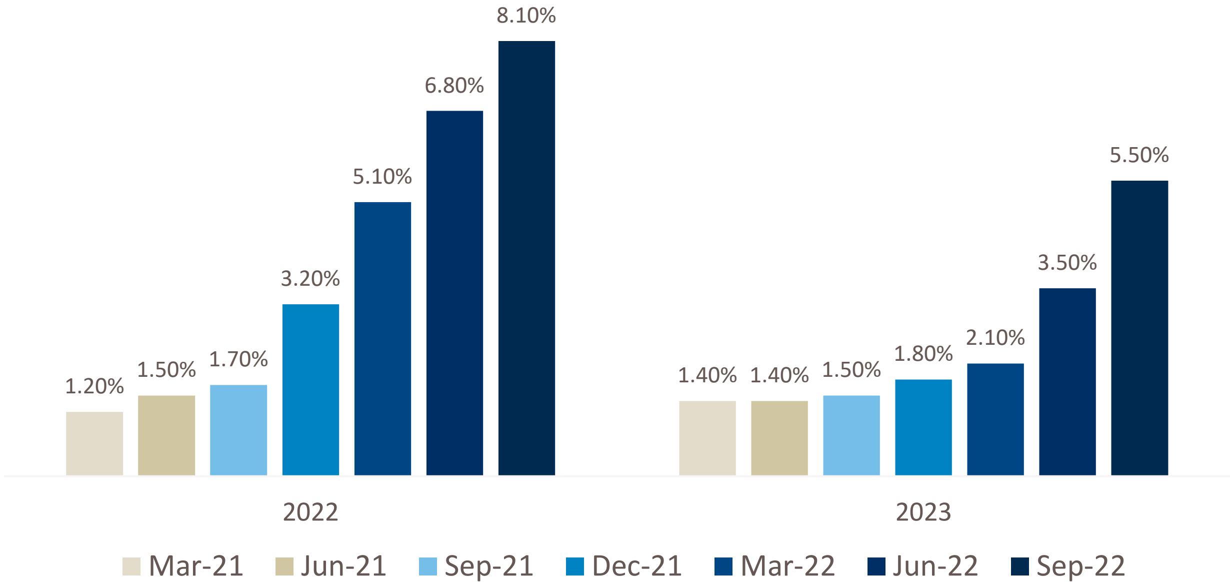



*Source: member federations*

## 2. The risk of further inflation pressures remain despite some easing of supply chain disruptions

Following the impact of ongoing supply chain disruptions and the war in Ukraine, inflation in the euro area increased to double digits in September 2022 and reached 10.7% as of October 2022. In recent months we have continued to see the ECB increase its official forecast for inflation in both 2022 and 2023 (figure 4).

**Figure 4: the ECB's forecast for inflation displays strong upwards corrections**

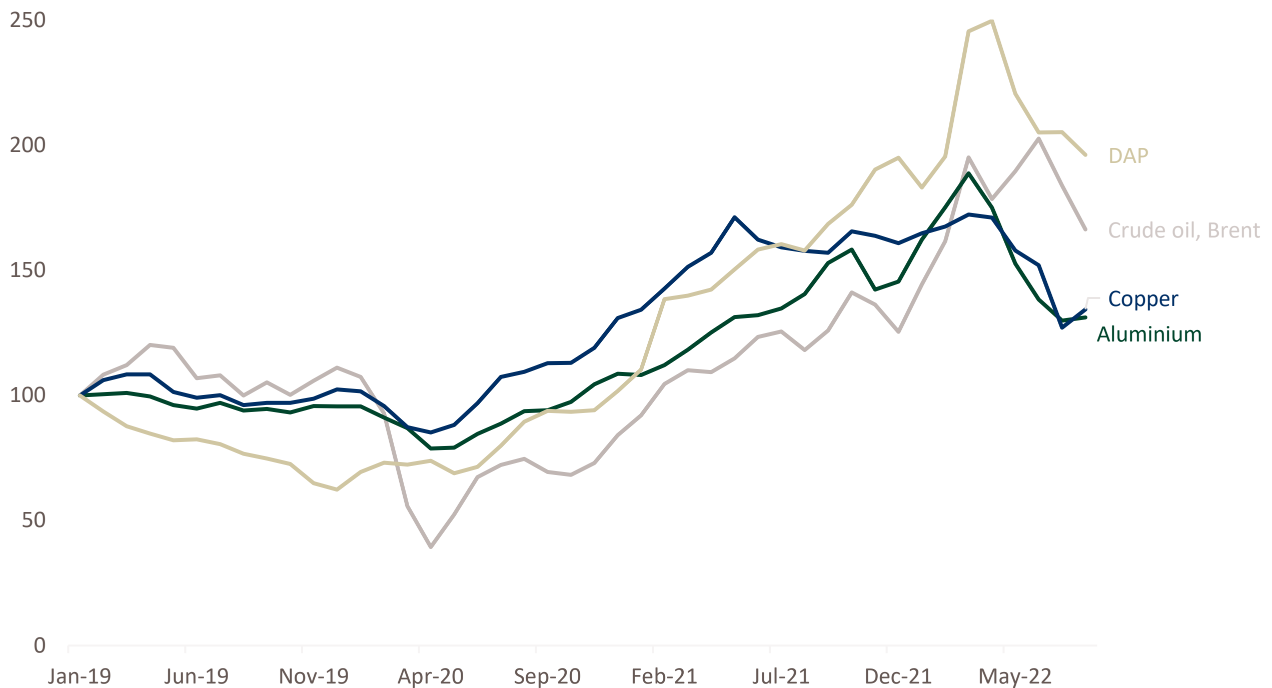



*Source: European Central Bank*

**Global supply chain disruptions are beginning to ease**

On a more positive note, there are tentative signs that some of the global pressures have gradually begun to ease. For example, whilst energy prices are currently still at high levels, they have recovered from the peak in August (figure 1) and commodity prices are decreasing from the heights seen at the beginning of 2022 (figure 5). Similarly, we have seen falls in raw material prices such as copper and aluminium from their spring peaks.

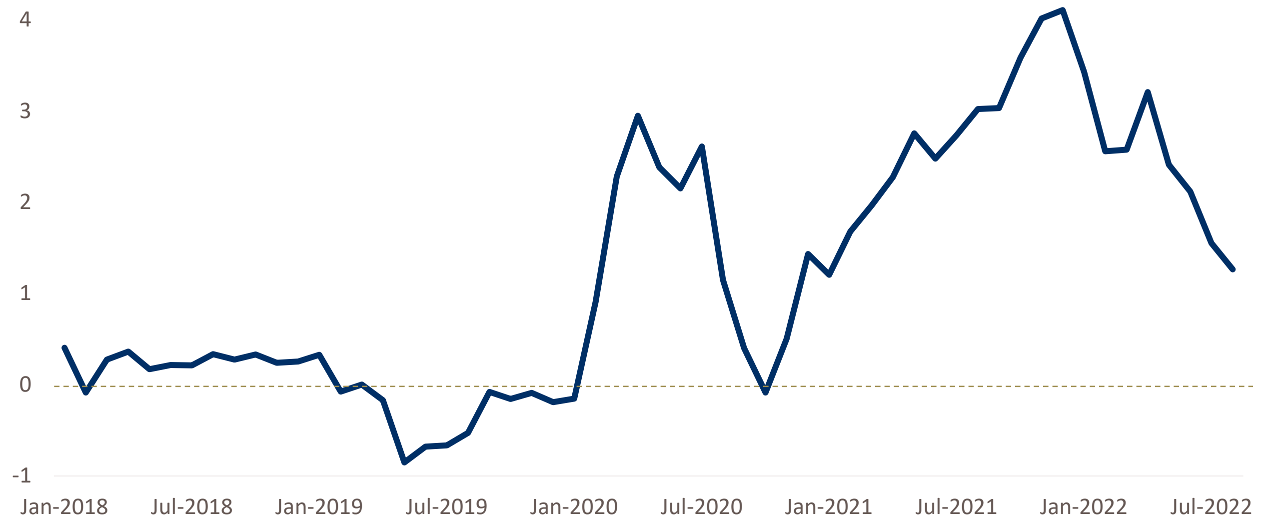
**Figure 5: major commodities' prices are recovering from peak seen earlier in 2022**
*January 2019 = 100*




*Source: OECD, own calculations*
*Last observation: August 2022*

More broadly, there are signs that global supply chains, whilst still far from fully functioning, may be seeing some easing of the severe disruptions observed during the pandemic. For example, the US Federal Reserve's global supply chain pressure index, which captures the state of international supply chain pressures and disruptions (figure 6) has decreased significantly through the year, whilst remaining above its long-term average. Likewise, freight prices from China to Europe have decreased by two thirds since the start of the year with schedule reliability and average vessel delays having also improved further in recent months.

**Figure 6: the global supply chain pressure index shows an easing of supply chain disruptions**
*Standard deviations from average*




*Source: Federal Reserve Bank of New York*
*Last observation: August 2022*

**But companies cannot keep absorbing cost increases indefinitely**

A particular concerning development since the Summer Economic Outlook has been the broadening of inflation. Core inflation, excluding energy, food, alcohol, and tobacco, has increased from 2.9% in March 2022 to 5% in October 2022. This process, as ECB chief economist Philip Lane has noted in more detail[1], reflects the process whereby higher energy costs are absorbed and incorporated into prices across the economy, given that all businesses are to some extent users of energy.

The pass-through of rising input prices into final consumer prices is likely to continue in the coming months, as businesses who have up to now absorbed much of the input cost rises are likely to increasingly be forced to pass them on through the supply chain. Thus, we may see a further increase in core inflation in coming months as costs pass through the economy, even if headline inflation declines.

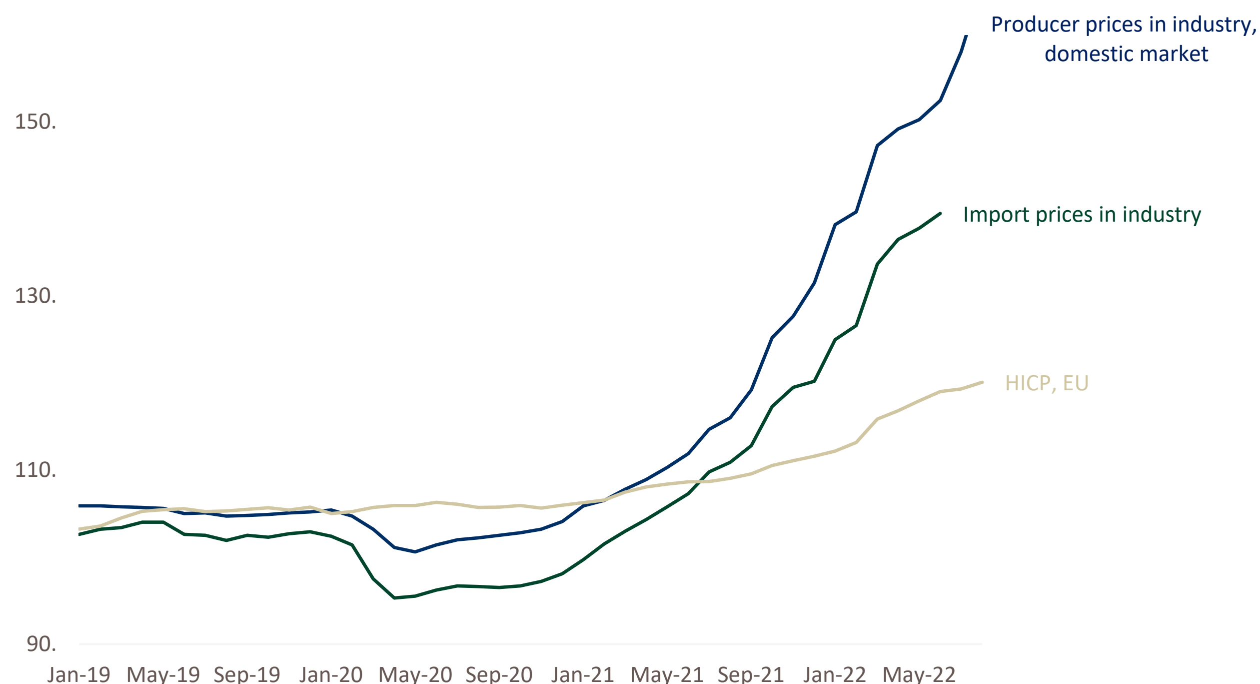
For example, we have seen producer prices in the EU rise by over four times as much as consumer inflation, growing by 43% annually in August 2022 (figure 7). The biggest share of the increase stems from the energy sector with 115.4% annual growth, but prices for intermediate goods (+20.1%) and in

[1] Lane suggested that as of May 2022, 'about one percentage point in the current inflation rate for non-energy industrial goods can be attributed to the indirect impact of elevated energy costs and the contribution of bottlenecks', noting the process 'may still have some distance to run'.
https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220505~dcbd30ecb6.en.html

manufacturing also rose at double-digit rates. In many production lines, a large or complete pass-through is not viable, either due to contractual rigidities or simply because of price competitiveness vis-à-vis non-European companies facing a much lower energy bill.

The ECB notes in this regard that "the stronger and more sustained producer price developments are in intermediate goods industries that are further upstream in the production and pricing chain, the greater the likelihood is that they may be passed through to producer prices in non-food consumer goods industries". Moreover, imported prices in industry are still at record high levels (+30% annually in June), signalling that cost pressures upstream remain elevated.

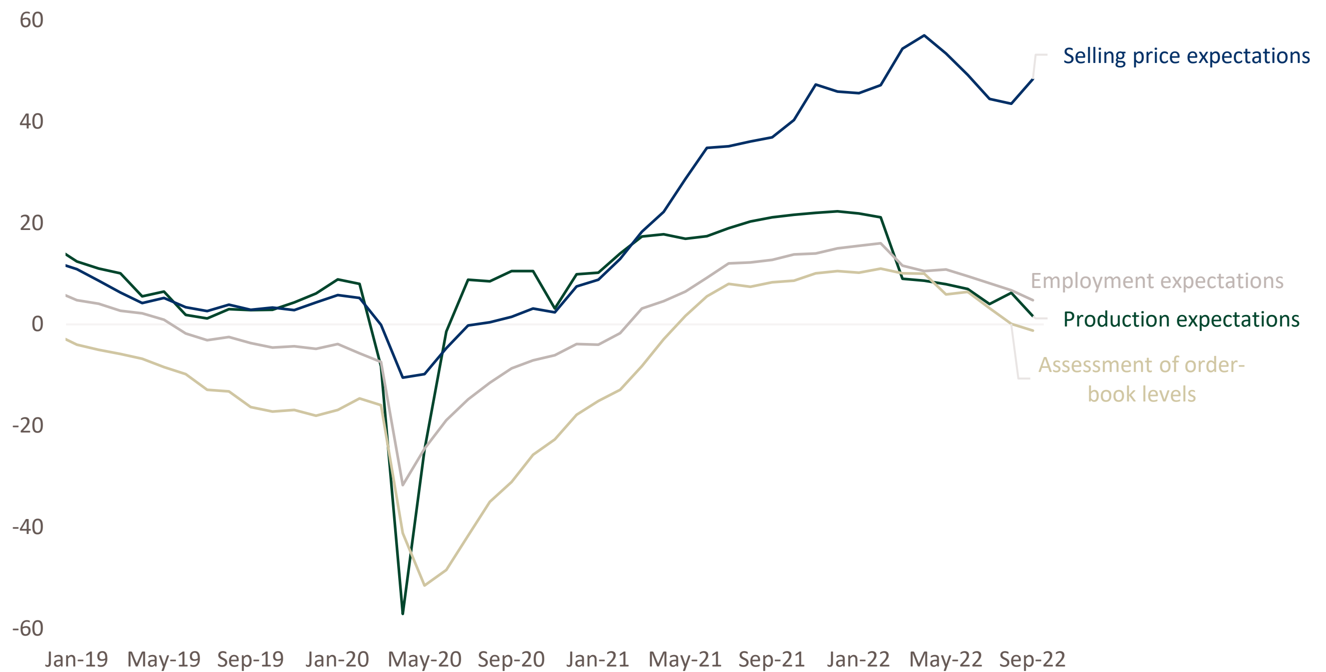
**Figure 7: evolution of producer prices and import prices in the EU**
*2015 = 100*




*Source: Eurostat and own calculations*
*Last observation: August 2022*

Similarly, the European Commission's business and consumer surveys show that a majority of companies are still expecting to increase prices, although the net percentage has decreased since April 2022 (figure 8). In September 2022, the selling price expectations for the next three months rose again across all sectors of the economy. While the magnitude of price rises is not quantified, it is a strong indicator of higher input cost pressures at earlier stages of the value chain. This result is consistent with the input Purchasing Managers' Index for the euro area, which remains at historically sharp levels overall and rebounded strongly (+5 points) in September 2022.

**Figure 8: the majority of companies are still planning to increase prices**




*Source: European Commission*
*Last observation: September 2022*

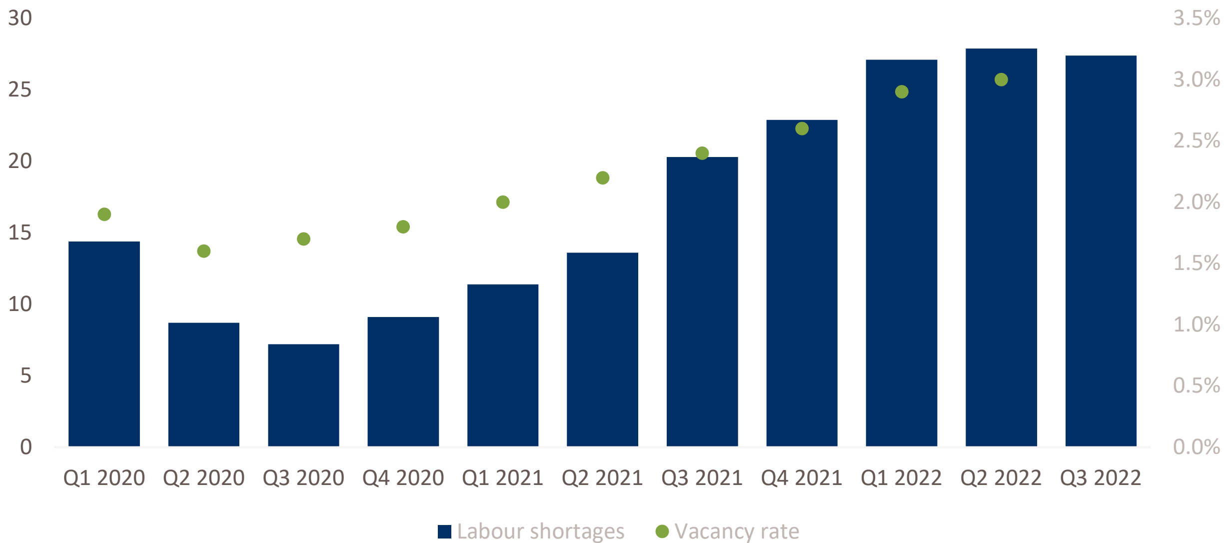
## 3. Labour markets are still historically tight

Wage developments in the coming months will be pivotal for the prospect of inflation, given wages represent a major share of costs for businesses, and up to 40% of firms' total cost of production in the services sector.

Labour markets have tightened further since our last Economic Outlook. The vacancy rate in the EU reached 3% and the unemployment rate stood at 6%, both levels not seen since statistical records. In line with these figures, the share of businesses stating labour as factor limiting production remains at elevated levels (figure 9).

**Figure 9: labour shortages are persistently high**

*Percentages of companies declaring shortage of labour as limiting production (LHS), job vacancy rate in % (RHS)*




*Source: European Commission, Eurostat*

**Responsible engagement in collective bargaining must avoid a wage-price spiral**

The risk remains that tight labour markets could lead to increased nominal wage growth in the months ahead. Nominal compensation per employee has increased to the highest levels since the introduction of the euro, but wages have not yet been a strong contributor to inflation, as wage agreements in the euro area increased below inflation at 2.5% annually in Q2 2022.

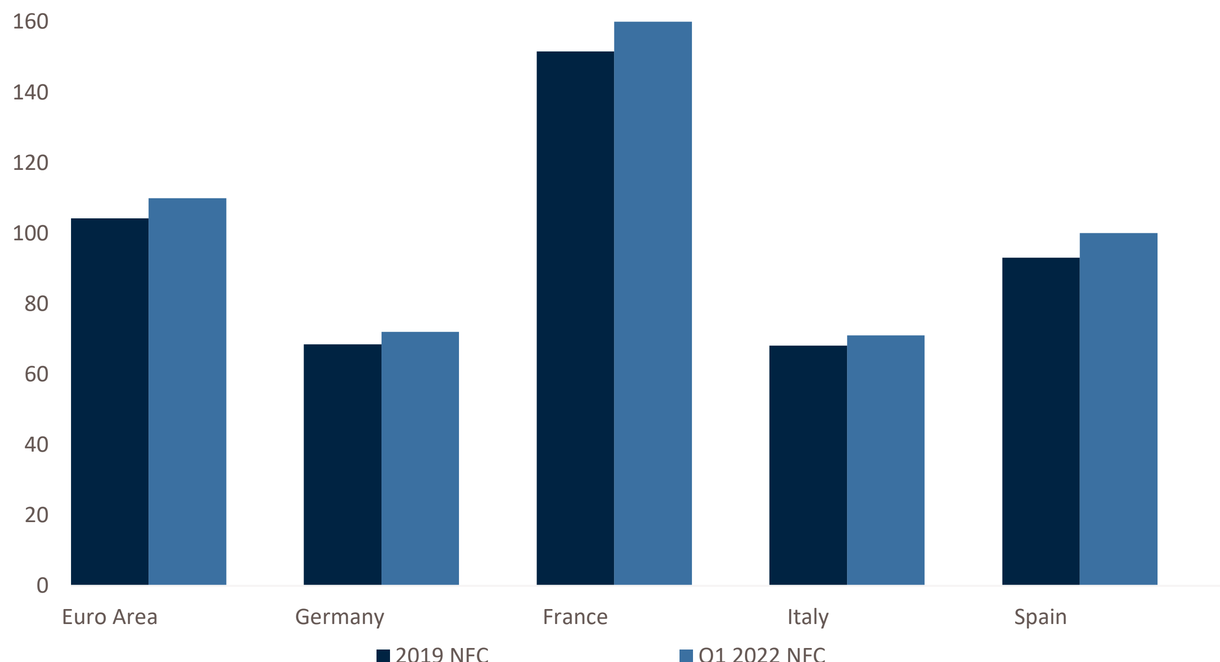
It will be important that wage agreements remain moderate in the coming months, despite the fact that quantitative price expectations from consumers for the next months reached a historical high in September 2022, with the ECB observing a "steady and sustained rise in medium and long-term inflation expectations in parts of the population".

Falling demand may also contribute to a moderate weakening of labour market pressures in coming months. Nevertheless, with increases in nominal wages only likely to increase prices (and hence leave real wages at best unchanged, but in a higher inflation environment), it remains imperative that all relevant actors engage responsibly in the wage-setting process to avoid triggering a damaging wage-price spiral.

## 4. Companies' borrowing costs are rising following the end of accommodative monetary policy

In recent years we have seen companies take on increased levels of debt in response to the pandemic (figure 10).

**Figure 10: total credit to non-financial corporations (NFCs) increased significantly during the pandemic**
*% of GDP*



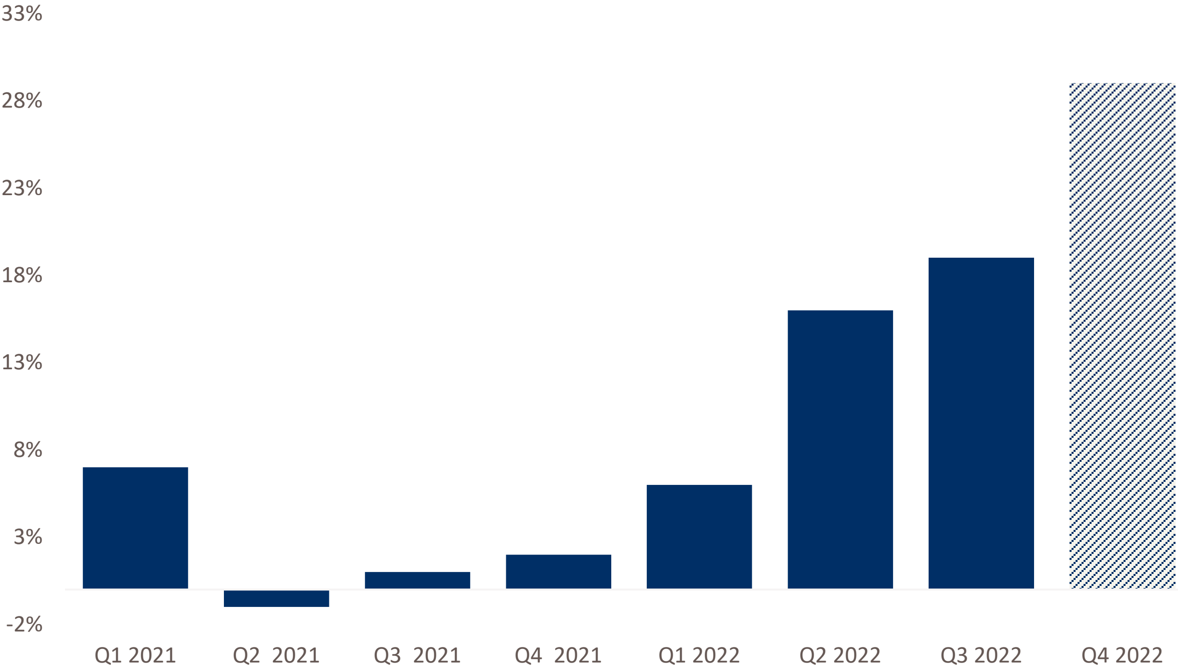

*Source: Bank for International Settlements*

Such increased leverage raises the risk associated with higher borrowing costs as the ECB raises its own lending rates, which are the basis for borrowing costs across the economy. The ECB's composite cost of borrowing indicator has expanded by 37% since the start of the year, whilst credit standards for loans to enterprises have tightened (figure 11) over the last months, as per the latest ECB bank lending survey. Hereby, these developments are influenced mostly by banks' negative risk perceptions and risk tolerance, rather than balance sheet constraints or bank funding costs.

So far, these dynamics have not yet affected bank lending to businesses, which increased strongly in July while the share of firms reporting financial constraints as limiting production stagnates at historically low levels. The trajectory for the number of declarations of bankruptcies has turned negative in the first two quarters of 2022, although this was expected following the sharp decline in bankruptcies during the pandemic. Nevertheless, access to finance will be a key area to observe in the coming months, particularly after the two further interest rate increases by the ECB in September and October.

Looking more broadly, we have seen corporate bond yields also rise considerably in recent months, whilst falling equity prices have considerably increased the cost of raising equity, for the very small number of larger companies presently seeking to use this financing route.

**Figure 11: ECB lending survey shows tightening credit standards**
*net percentage of banks reporting a tightening of credit standards*




*Source: ECB and own calculations*
*The figure for Q4 2022 represents the expected value by banks*

## 5. Macroeconomic policy makers face tough choices going forward

Since the publication of our Summer Economic Outlook, the ECB has further accelerated the normalisation of monetary policy. In line with other major central banks, the ECB has raised its main policy rates by 200 basis points in three steps. Moreover, as comments made following the ECB's governing council meeting on 27th October made clear, the likelihood remains of further interest rate raises.

Monetary policy makers face a difficult balancing act with the normalisation through higher interest rates and the gradual reduction of the ECB's stock of assets (quantitative tightening), clearly likely to slow the economy and raise borrowing costs for businesses and households alike. Economist also note the difficulty of calibrating monetary policy, given the long lags associated with such levers. For example, the IMF is stating that "Monetary policy seems to have its peak impact on real variables after about one year, but on inflation after closer to three to four years".

There remains a risk that central banks leave rates significantly above so-called neutral levels longer than is required to reduce inflation, but as the IMF noted in its Autumn 2022 World Economic Outlook, the risk of too accommodative policy allowing inflationary expectations to build is presently the more significant, arguing that "central banks must stay the course to ensure that inflation durably declines. Yielding to pressure to slow the pace of tightening will only undermine credibility, allow inflation expectations to rise, and necessitate more aggressive and painful policy actions later. By reversing course, monetary policymakers will deliver only the pain of tightening, with none of the gain".

It will also be important that fiscal policy in the EU does not counteract the efforts to tame inflation made by the ECB. BusinessEurope believes that, to mitigate the impact of energy prices, policymakers should consider EU-wide measures to decouple electricity prices from gas prices. In order to achieve this, we will need to grant governments the necessary flexibility to support businesses while maintaining a level playing field in the single market.

Nevertheless, in view of the limited fiscal space in many Member States and the need for coherent overall macroeconomic policy, measures to support consumers and businesses with energy costs must be temporary and well-targeted, as noted in the Eurogroup conclusions of 3rd October 2022[2].

Rapid agreement in the Council on the reform of the Stability and Growth Pact (SGP), with detailed proposals now expected from the Commission on 9 November, can also support Member States in ensuring that the long-term strengthening of public finances is not unduly delayed. We hope that the Commission's proposals on economic governance will simplify the SGP, provide a greater focus on productive investment, whilst at the same increasing the enforceability of the pact.

## 6. Country differences

**Table 3: GDP and unemployment for each EU Member State according to member federations**

| | Real GDP growth | | Unemployment | |
|---|---|---|---|---|
| **Country** | **2022** | **2023** (Difference from summer forecast) | **2022** | **2023** |
| Austria | 3.8% | -0.7% (-0.7%) | 4.6% | 4.7% |
| Belgium* | 2.3% | 1.3% (-0.5%) | 6% | 5.6% |
| Bulgaria | 1.9% | 1.7% (-1.4%) | 4.7% | 4.6% |
| Czechia | 1.9% | 0.9% (-2.6%) | 2.6% | 2.9% |
| Estonia | -0.5% | 1.1% (-1.3%) | 6.5% | 8.6% |
| France | 2.6% | 0% (-0.3%) | 7.3% | 7.5% |
| Germany* | 1.2% | -0.7% (-3.1%) | 3.2% | 3.1% |

[2] https://www.consilium.europa.eu/en/meetings/eurogroup/2022/10/03/

| | | | | |
|---|---|---|---|---|
| Greece* | 4% | 2.4% (-0.7%) | 13.7% | 13.1% |
| Hungary | 4.5% | -3.5% (-6.5%) | 3.5% | 4.3% |
| Luxembourg* | 2.6% | 2.1% (-0.6%) | 5.2% | 5.1% |
| Malta | 5.2% | 4.5% (-0.8%) | 3.1% | 3.1% |
| Netherlands | 4.6% | 1.5% (-0.2%) | 3.4% | 3.9% |
| Slovenia | 5% | 1.4% (-1.6%) | 4.2% | 4.1% |
| Spain | 4.3% | 1.5% (-1.7%) | 13% | 12.7% |
| Sweden | 1.9% | 0.5% (-1%) | 7.6% | 7.8% |
| Italy | 3.4% | 0% (-1.6%) | 8.1% | 8.7% |
| Croatia | 5.3% | 2.1% (-1.4%) | 6.2% | 5.7% |
| Ireland | 7% | 3.6% (-0.1%) | 5% | 4.5% |
| Denmark | 2% | -0.1% (-1.6%) | 3.8% | 4.2% |
| Finland* | 1.8% | 1.2% (+0.2%) | 6.8% | 6.7% |
| Portugal | 6.7% | 1.2% (-1.6%) | 5.6% | 5.3% |
| Poland | 1.5% | 2.3% (-0.7%) | 2.9% | 3.5% |
| Cyprus* | 3.2% | 2.1% (-1.7%) | 7.1% | 6.4% |
| Latvia* | 3.9% | 2.2% (-1%) | 7.1% | 6.0% |
| Lithuania* | 1.9% | 2.5% (-0.2%) | 7.2% | 7.2% |
| Romania | 3.5% | 3.7% (+0.1%) | 5.4% | 5.3% |
| Slovakia | 1.8% | -1% (-4.6%) | 6.2% | 6.7% |
| **EU 27** | **2.8%** | **0.6% (-1.5%)** | **6.1%** | **6.2%** |
| **Euro area** | **2.9%** | **0.3% (-1.6%)** | **6.5%** | **6.6%** |

*Source: BusinessEurope and member federations*

**in cases where our member federations were not able not publish their forecast, we based our estimation on the latest OECD and European Commission estimates*

Table 3 presents the forecast for each Member State and shows how differently the current developments have affected our estimations. Clearly, the countries most exposed to Russian gas supply and with the strongest industrial sector have seen the strongest downward revisions to GDP growth.

# BUSINESSEUROPE

**BusinessEurope** is the leading advocate for growth and competitiveness at the European level, standing up for companies across the continent and campaigning on the issues that most influence their performance. A recognised social partner, we speak for all-sized enterprises in 35 European countries whose national business federations are our direct members.

| | | | | | |
|---|---|---|---|---|---|
| Austria | Belgium | Bulgaria | Croatia | Cyprus | Czech Republic |
| Denmark | Denmark | Estonia | Finland | France | Germany |
| Germany | Greece | Hungary | Iceland | Iceland | Ireland |
| Italy | Latvia | Lithuania | Luxembourg | Malta | Montenegro |
| Norway | Poland | Portugal | Rep. of San Marino | Romania | Serbia |
| Slovak Republic | Slovenia | Spain | Sweden | Switzerland | Switzerland |
| The Netherlands | Turkey | Turkey | United Kingdom | | |

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