GROWTH MUTED AS HIGHER INTEREST RATES IMPACT CONSUMPTION AND INVESTMENT

ECONOMIC SITUATION

- The European economy continued to grow sluggishly in the first half of 2023 as the impact of higher interest rates curbed demand against a backdrop of continuing geopolitical tensions, a slowing global economy, and increasing long-term competitiveness challenges.
- Industrial production levels have declined since the start of the year, although this hides the divergence in growth between sectors, with, in particular, energy-intensive industries remaining under exceptional pressure.
- We expect economic growth to recover moderately in 2024 as household spending recovers and international trade activity picks up. High interest rates continue to put a drag on investment growth and will make it more difficult to meet the investment needs of the green and digital transitions.
- Our central forecast is for growth to slow down to 0.7% in the EU in 2023, before increasing to 1.4% in 2024. This is a small downward revision of 0.2 pp. for 2024 compared to our Summer Economic Outlook.

POLICY RECOMMENDATIONS

- In face of continued above-target inflation, the ECB and other European central banks have rightly acted to bring inflation down, and in particular, ensure that long-term inflationary expectations do not rise.
- With wages now rising in some Member States faster than inflation and productivity growth combined, it remains crucial that social partners engage responsibly in collective bargaining on wages and help avoid a self-defeating wage-price spiral.
- It is important that the more restrictive monetary policy stance is complemented by Member States' fiscal policy stances. Given high debt and deficit levels in some countries, agreement on new fiscal rules is urgently needed to provide a credible and respected framework to maintain public finance sustainability in the EU.
- As global competition intensifies, a comprehensive strategy aimed at enhancing the long-term competitiveness of the European economy will be key to improving Europe's business environment.

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.

We are grateful for the contribution of Gloria Paggiaro to this Outlook.

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OVERALL FORECAST

Table 1: BusinesssEurope Economic Forecast

	EU		Euro Area	
Main Variables	**2023**	**2024**	**2023**	**2024**
Real GDP (annual % growth)	0.7	1.4	0.7	1.2
Inflation (%)	5.8	3.4	5.5	3.2
Unemployment (%)	6.0	6.0	6.2	6.1
Government net lending (% of GDP)	-3.2	-2.6	-3.2	-2.5

Source: Member federations

The European economy continued to grow sluggishly in the first half of 2023 as the impact of higher interest rates curbed demand against a backdrop of continuing geopolitical tensions, a slowing global economy, and increasing long-term competitiveness challenges. After a contraction of 0.1% quarter-on-quarter in the final three months of 2022, the EU economy grew by 0.2% in the first quarter of 2023, was unchanged in the second quarter and grew by 0.1% in the third quarter.

Our central forecast is for growth to slow down to 0.7% in the EU in 2023, before increasing to 1.4% in 2024. This is a small downward revision of 0.2 pp. for 2024 compared to our Summer Economic Outlook. Euro Area growth is projected to reach 0.7% in 2023 and 1.2% in 2024, following a downward revision of 0.1 and 0.4 pp. respectively for 2023 and 2024. These revisions follow a slight weakening of the global economy, particularly the Chinese economy, compared to earlier projections.

Higher interest rates and persistently elevated levels of inflation continue to impact businesses, both dampening investment and, weighing on disposable income and hence consumer spending. On a global scale, tightening monetary policy has weakened global demand, reducing export demand for European companies.

Production expectations for the coming months improved notably across all sectors, indicating potential for a return to growth toward the end of the year.

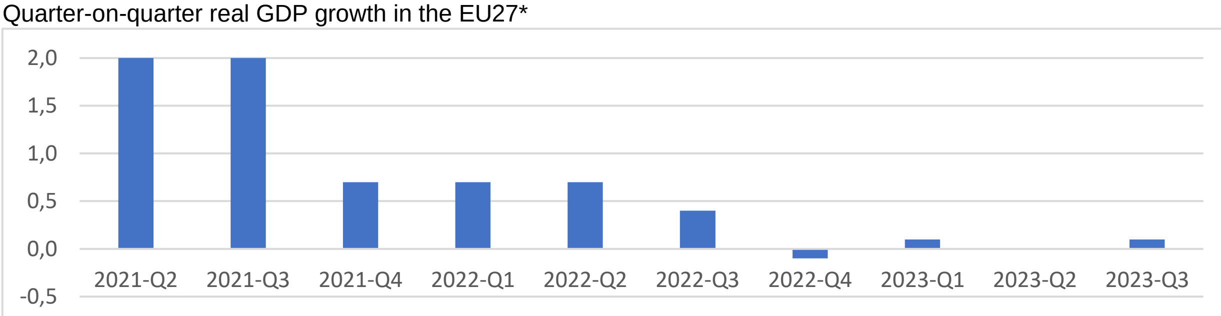
Growth is expected to pick up in 2024 as real disposable incomes recover, inflation moderates and global trade activity picks up.

Nevertheless, downside risks to our growth projection continue to predominate and include renewed volatility in commodity prices, an escalation of geopolitical tensions, a more pronounced and longer downturn in China, as well as more severe effects of competitiveness losses on European exports following a decline in price competitiveness caused by high energy prices in Europe and the depreciation of Asian currencies such as the renminbi and Japanese Yen relative to the Euro A rapid recovery of sectors particularly affected by high energy prices and high interest rates, such as construction and energy-intensive industries, and a faster decline of inflationary pressures may be causes for an upward revision of our forecast.

Growth to be muted as higher interest rates impact consumption and investment

After a contraction of 0.1% quarter-on-quarter in the final three months of 2022, the EU economy grew by 0.1% in the first quarter of 2023, was unchanged in real terms in the second quarter and grew by 0.1% in the third quarter as seen in chart 1.
Compared to the same quarters last year, the first quarter saw an uptick in household consumption and exports, which were heavily affected by sanctions and the terms of trade shock following Russia's invasion of Ukraine in February 2022. Industrial production and exports still benefited from major order backlogs as a consequence of supply chain pressures, which have now been broadly normalised.

Chart 1: Growth is down to a minimum
Quarter-on-quarter real GDP growth in the EU27*



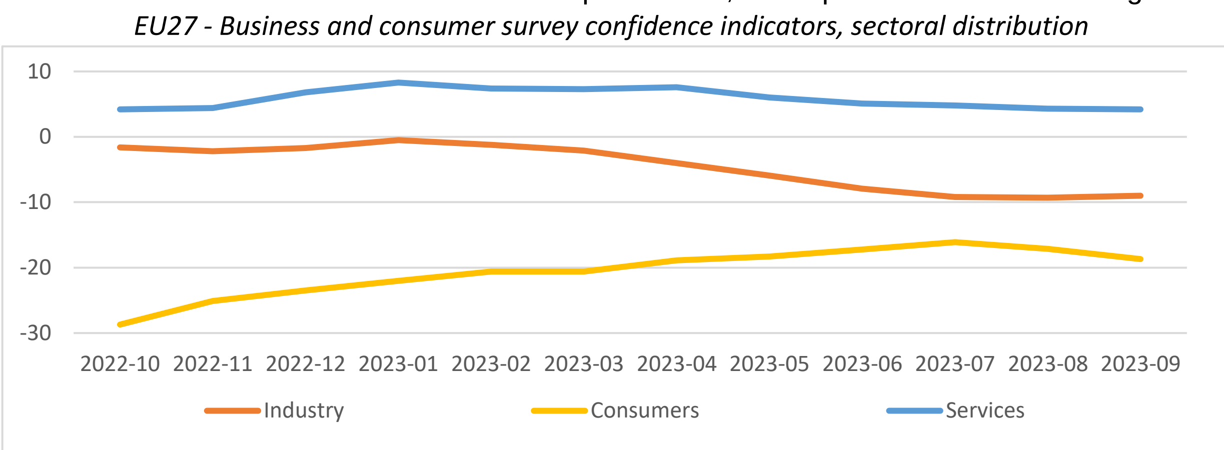
Source: Eurostat
*2023-Q3 data based on flash estimate

Quarter-on-quarter performance has however been weak, as consumption stagnated in the first quarter of 2023 and only grew by 0.1% in the following quarter as real incomes declined due to high inflation levels while the economy slowed down further. The decline in real incomes and low consumer confidence is reflected in the volume of retail trade, which has broadly stagnated since the beginning of the year.

The most recent survey data show a sustained decline in economic sentiment since Q2-2023, with a broad-based decline in business and consumer confidence across all sectors. Though the services sector remained a positive exception to the negative sentiment, it's trending well below its long-term average. Chart 2 shows that consumer confidence showed a positive upward trend until July when consumers became more confident about their financial situation and the general economic situation while lowering their expectations of future price increases as headline inflation declined. This trend reversed in summer as inflationary pressures remained sticky and the effects of tightened monetary policy manifested themselves.

Confidence in industry and the services sector has declined by 8.5 and 4.1 pp. since the start of the year, though the decline bottomed out over summer in a positive sign for the coming period. Though the services sector remained a positive exception to the negative sentiment, it’s trending well below its long-term average. Production expectations for the coming months improved notably across all sectors, indicating potential for a return to growth toward the end of the year.

Chart 2: Consumers and businesses remain pessimistic, but expectations are stabilising



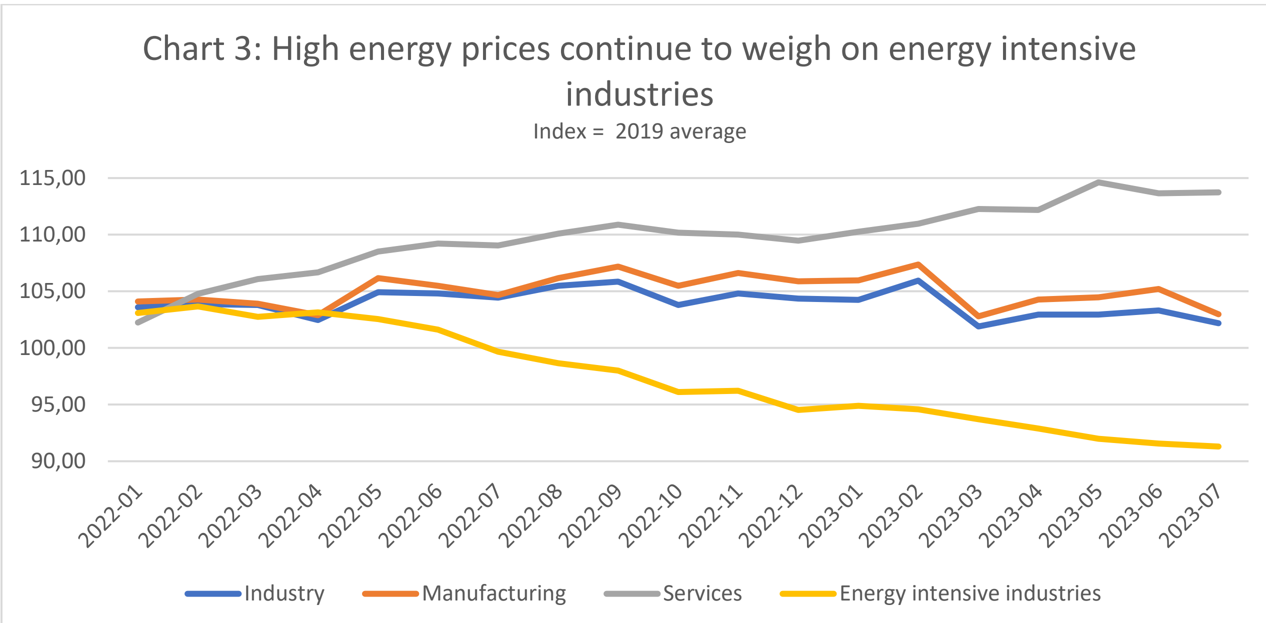
Source: DG ECFIN via Eurostat

Cyclical and structural challenges weaken industrial activity

Businesses are increasingly pessimistic about the current business climate as output is declining or stagnating in most sectors due to cyclical and structural challenges. BusinessEurope member federations indicate that European businesses continue to suffer from higher input prices, especially energy, as well as increasing labour costs, while muted domestic and foreign demand reduce opportunities to grow and compensate for this cost increase.

Overall industrial production levels, including manufacturing, have declined since the start of the year. But this hides the divergence in growth between sectors as shown in chart 3, with, in particular, energy-intensive industries remaining under exceptional pressure. Industrial production has struggled to return to a sustained growth trajectory after the pandemic. By July, industrial production was down around 3.6% compared to the peak in February 2023 as domestic and foreign demand dampened.

The services sector has to date appeared largely unaffected by low consumer confidence and the decline in real income faced by households in the first seven months of 2023. After a decline in the final quarter of 2022, the output in the services sector has grown steadily, increasing by 3.9% since the start of the year but slowing down after a peak in May. Nevertheless, we would expect higher interest rates to gradually eat into services sector demand over time as an increasing number of households have to negotiate new mortgage deals and begin to run down savings accumulated during the Covid crisis.



Source: BusinessEurope Staff calculations based on Eurostat

A particular point of concern for the European economy is the weak dynamic in energy-intensive industries (particularly metals and chemicals), as well as cyclically sensitive sectors (notably construction), which are disproportionally affected by the combination of high interest rates relatively and high EU energy prices.

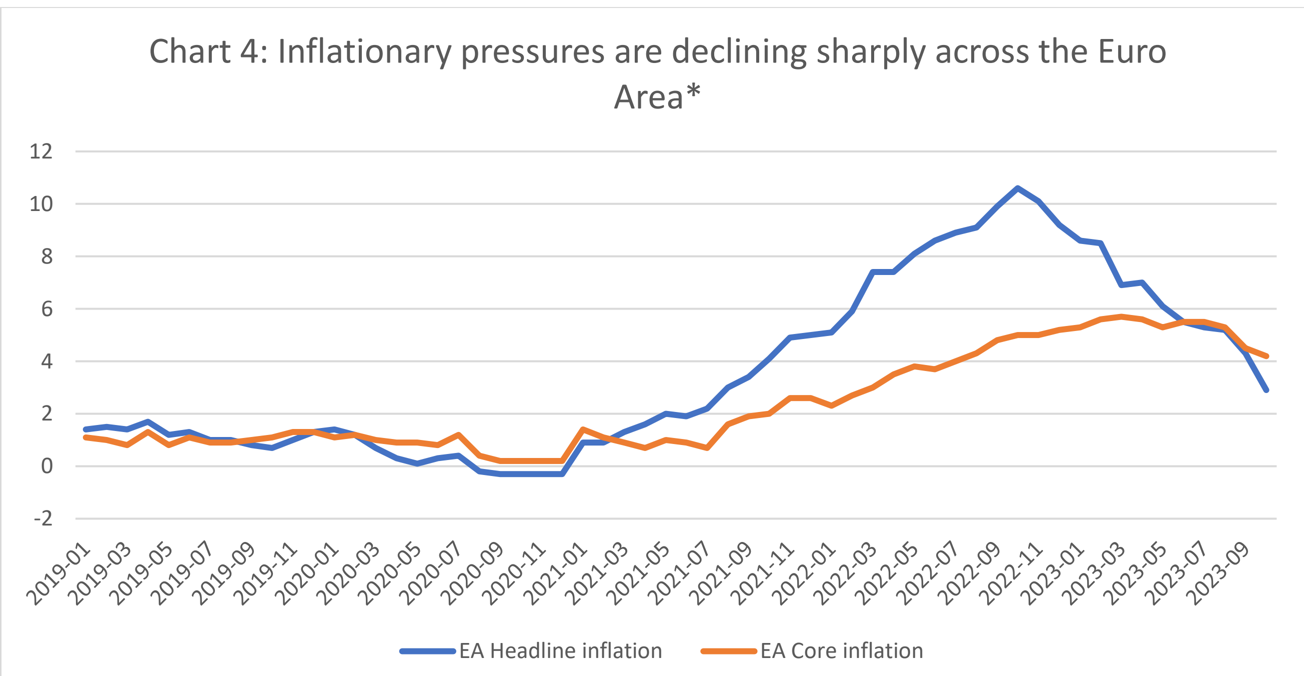
More recently, aggregate output in the Euro area declined at its fastest rate for almost three years in August according to S&P's Purchasing Manager Index[1]. Whilst businesses were able to continue producing to meet order backlogs developed as a result of covid era supply chain issues, these backlogs offer only temporary support for output, which may further decline in the absence of a pickup in demand. The downturn across the services and manufacturing sector in August 2023 represented the largest downturn since March 2013 when excluding the pandemic period and may represent a turning point for the services sector after remaining resilient despite an overall economic slowdown.

[1] https://www.pmi.spglobal.com/Public/Home/PressRelease/382c7872528a4f48bf03911ae648e7f1

Over the last months, the mood in the industrial sector deteriorated considerably, as 75% of BusinessEurope member federations are more pessimistic about the current business climate in industry compared to six months ago, compared to the 28% observed in our Spring Economic Outlook. BusinessEurope member federations foresee a slowdown in the services sector as 58% view the situation of the services sector more negative compared to six months, versus 20% observed in BusinessEurope's Spring Economic Outlook.

Fiscal policy must support the ECB's more restrictive monetary stance

In face of continued above-target inflation, the ECB has rightly acted to bring inflation down, and in particular, ensure that long-term inflationary expectations do not rise. September 14th's ECB Governing Council raised key ECB interest rates by 25 basis points, noting that, 'the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target'. But with both headline Euro Area inflation and (more significantly), core inflation falling in September and October, expectations have now increased that interest rates may have peaked in the EU, albeit with the expectation that they may remain at their relatively high levels well into 2024.



Source: Eurostat

*Data for October 2023 based on Eurostat flash estimate

The evolution of wages will be important for both inflationary pressures and firms' competitiveness. The ECB expects compensation per employee to increase by 5.3% in 2023, while labour productivity is projected to decline by 0.5%, clearly putting significant pressure on many businesses where wages represent the largest input cost.

It thus remains crucial that social partners engage responsibly in collective bargaining on wages and help ensure that temporary price rises do not give rise to a self-defeating wage-price spiral, which would force a more aggressive monetary policy response than otherwise necessary and weaken medium-term growth and employment prospects.

Given the negative impact of higher interest rates on investment, and hence, long-term growth it is important that the more restrictive monetary policy stance, appropriately adopted by the ECB, is complemented by Member States' fiscal policy stances.

Research by the IMF suggests that last year's fiscal support for households and businesses reduced euro area inflation by 1 to 2 percentage points[2]. ECB research shows a similar result yet expects fiscal policy to contribute 0.5 percentage points to inflation in 2024[3].

With government debt in the Euro Area averaging over 90% of GDP, and with the Commission estimating the EU will have a small but positive output gap (i.e., output above its long-term potential), it will be important that Member States step up their efforts to undertake fiscal consolidation. Whilst Member States will need to prioritise public investment to support the green and digital transitions, they will also need to phase out of generic support programmes introduced in response to volatile increases in price levels last year

Investment increasingly constrained by higher interest rates

Businesses are already feeling the impact of tightening monetary policy, as credit standards and financing costs have increased, resulting in a significantly decreased loan demand. In particular, we have seen:

- The October ECB Bank Lending Survey showed a decline in Euro area firms' net loan demand of 36% in Q3-2023, following a 42% decline in the second quarter of the year. SMEs are particularly affected, as the decline in their net loan demand is among the strongest on record.

[2] https://www.imf.org/en/Publications/WP/Issues/2023/08/31/Unconventional-Fiscal-Policy-in-Times-of-High-Inflation-537454
[3] Proper reference required.

- With many firms, particularly SMEs facing higher borrowing costs, increased operating costs, and reduced consumer demand it was no surprise that bankruptcies reached their highest point since records began in 2015. Bankruptcies increased by 10% in Q2-2023 compared to the final quarter of 2022. Whilst broad-based, the accommodation and food service activities (+16%), construction (+15.2%), and logistical (+13.8%) sectors were particularly affected.

- Gross fixed capital formation increased by 0.4% in the second quarter, after stagnating in the first three months of 2023.

Rapid agreement on the revised Economic Governance Framework remains essential

As noted in the section on inflation, it is important that the more restrictive monetary policy stance, appropriately adopted by the ECB, is complemented by Member States' fiscal policy stances.

With the General Escape Clause of the Stability and Growth Pact no longer in place in relation to Member States' budget for 2024, the Commission has provided guidance[4] as to how the rules will be applied. With 14 member states, including the four largest economies, projected to maintain a government debt-to-GDP ratio of over 60% in 2023 and 15 member states projected to have a budget deficit of 3% or higher in 2023, and governments facing significantly higher debt servicing costs in the coming years, difficult choices will need to be made.

Businesses still see opportunities for further fiscal tightening in a number of member states. 42% of BusinessEurope member federations currently consider fiscal policy to be too expansive for their country, while only 21% find fiscal policy to be too restrictive and 38% find their national fiscal policy stance to be appropriate. This reflects the differences in inflation rates, debt sustainability, and sectoral developments in the EU's national economies.

Agreement on new fiscal rules is urgently needed in this context. Given high debt and deficit levels in some countries, a credible and respected framework is essential to maintain public finance sustainability in the EU. In particular,

- It is important that, as the Commission proposes, the reference values of 3% of GDP for government deficits and 60% for government debt continue to be at the basis of the Economic Governance Framework.

[4] https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1410

- The Commission's simplified proposals, including greater ownership by Member States, can potentially enhance the enforceability of the rules. Greater flexibility must go hand in hand with a stronger and more credible enforcement framework, linked to the possible withdrawal of Commission funding.
- We welcome the proposal to support Member States undertaking growth-enhancing reforms and public investment through a longer fiscal adjustment path. But proper implementation needs to be ensured with flexibility only granted if Member States present credible reform and investment programs that support sustainable growth and debt sustainability.

Opportunities to grow through trade limited in the short term

Table 1: Growth projections for EU trade

	2023	2024
Exports	1.2%	2.2%
Imports	-0.2%	2.0%

Source: BusinessEurope Member Federations

Businesses are unlikely to be able to rely on a strong boost in export demand in the coming months given continuing geopolitical tensions, competitiveness concerns and weakened global demand. Whilst export volumes of European goods declined by only 1.1% overall since December 2022, compared to import volume declines of 3.9% over the same period, this to a large extent driven by falling volumes and prices of energy imports, rather than a structural competitiveness improvement.

Table 1 shows that BusinessEurope Member Federations nevertheless expect a small pick-up in trade activity in the EU in 2024, with export growth increasing from 1.2% to 2.2% in 2024, and imports to grow by 2% in 2024 after a decline in 2023.

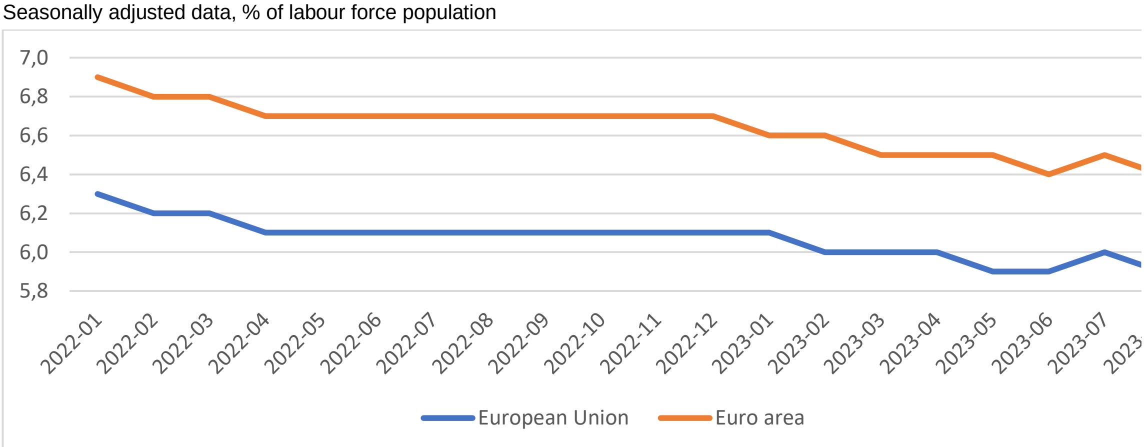
The spillovers of a deeper slowdown of the Chinese economy represent, just one of a number of potential downside risks to our forecast. Recent data by the ECB indicates that such a scenario would reduce EU GDP growth in 2024 and 2025 by 0.2%, while the correlating disinflationary effects would cut 0.1% off the Euro Area inflation projections over the next two years[5].

[5] https://www.ecb.europa.eu/pub/projections/html/ecb.projections202309_ecbstaff~4eb3c5960e.en.html

Labour market

Unemployment remains historically low across the European Union despite sluggish economic growth and a slowing down of activity in multiple sectors. Chart 5 shows the EU unemployment rate fell to 5.9% in August, down from 6.0% in July and 6.1 from August 2022. Alongside this, it is important to recall that the main source of employment growth has been the strong inflow of people joining the labour force rather than a sharp decline in the number of unemployed[6].

Chart 5: Unemployment rate since January 2022
Seasonally adjusted data, % of labour force population



Source: Eurostat

Nevertheless, signs are emerging that momentum in the labour market may be slowing down:

- The job growth rate has reached near-stagnation and employment in the manufacturing sector has declined for four months in a row[7].
- The job vacancy rate in the EU has declined by 0.1 pp in the first and second quarter of 2023 after its peak at 3% in Q2-2022.
- The European Commission’s Employment Expectations Indicator has declined by 5.5 pp. since the start of the year but remains in positive territory for now.

Despite the slowdown however, many firms still face sourcing difficulties and the skilled workers that will be vital for the green and digital transitions, and for the EU’s companies to remain competitive in new and emerging technologies.

[6] https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202306_03~631ad61075.en.html

[7] https://www.pmi.spglobal.com/Public/Home/PressRelease/382c7872528a4f48bf03911ae648e7f1
https://www.pmi.spglobal.com/Public/Home/PressRelease/a068624fcdde4a06b7b68d0afe07bdc3

Country differences

The overall projected growth rates continue to vary significantly across member states. The economies of Malta (4%), Ireland (3.2%), Romania (2.8%), Spain (2.4%), Croatia and Cyprus (2.3%) as well as Greece (2.2%) continue to lead in growth this year, and are, for the most part, projected to do so in 2024. A number of economies such as Estonia (-2.2%), Sweden (-0.9%), Lithuania (-0.6%), Hungary (-0.5), Germany (-0.4%), and Finland (-0.4%) are however facing a difficult situation. Unemployment is expected to remain stable with minor changes in most member states, with the exception of Estonia (+1 p.p. in 2024) and Greece (-1.1 pp. in 2024).

	Real GDP Growth		Unemployment	
Country	2023 (difference from summer forecast)	2024 (difference from summer forecast)	2023	2024
Austria	0.5 (0.2)	1.4 (0.4)	5.2	5.0
Belgium	0.9 (-0.1)	1.0 (-0.7)	5.6	5.5
Croatia	2.3 (1.3)	2.0 (0)	6.5	6.0
Cyprus*	2.3 (-0.7)	2.7 (-0.3)	6.9	6.4
Estonia	-2.2 (-0.7)	1.4 (-1.6)	7.0	8.0
Finland	-0.3 (0.0)	0.8 (-0.4)	7.2	6.8
France	0.9 (0.7)	0.4 (-0.2)	7.1	7.4
Germany	-0.4 (-0.6)	1.2 (-0.3)	3.4	3.2
Greece	2.2 (-0.4)	3.0 (1.5)	11.5	10.4
Ireland	3.2 (-2.0)	3.3 (-2.5)	4.1	3.7
Italy	0.4 (0.0)	1.2 (0)	8.2	8.0
Latvia*	1.4 (0.9)	2.8 (-0.9)	6.8	6.5
Lithuania	-0.6 (-1.1)	2.1 (-0.6)	6.7	6.5
Luxembourg*	1.6 (0)	2.4 (0.0)	4.8	5
Malta	4.0 (0.3)	3.8 (0.2)	3.0	3.1
Netherlands	0.7 (-0.9)	1.5 (0.1)	3.6	4.0
Portugal	2.2 (0.4)	1.5 (-0.5)	6.4	6.3
Slovakia	1.3 (0.0)	2.7 (-0.5)	6.0	5.9
Slovenia	1.6 (-0.2)	2.8 (-0.3)	3.6	3.5
Spain	2.4 (1.1)	1.4 (-0.6)	12.2	12.0
Euro Area	**0.7 (-0.1)**	**1.2 (-0.4)**	**6.2**	**6.1**
Bulgaria	1.5 (-0.1)	3.2 (0.7)	3.7	3.2
Czechia	0.1 (0.0)	3.1 (-0.3)	2.7	2.8
Denmark	1.7 (1.5)	1.3 (-0.2)	4.8	5.2
Hungary	-0.5 (0.0)	2.5 (0.3)	3.9	3.8
Poland	0.8 (0.0)	2.4 (0)	3.3	3.1
Romania	2.8 (0.0)	4.2 (-0.6)	5.4	4.9
Sweden	-0.9 (0.0)	0.0 (-0.9)	7.7	8.2
EU27	**0.7 (0)**	**1.4 (-0.2)**	**6.0**	**6.0**

Source: BusinessEurope Member federations, BusinessEurope Staff calculations. European Commission for data marked with an asterisk.

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.

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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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