BUSINESSEUROPE SPRING ECONOMIC OUTLOOK

8 June 2023

RECESSION AVOIDED FOR THE EU ECONOMY - BUT CHALLENGES REMAIN

ECONOMIC SITUATION

- Whilst falling energy prices through the mild winter have helped steer the EU economy away from the recession, the situation remains challenging for many businesses.
- Our forecast is for growth of just 0.7% in the EU in 2023, with 1.6% growth in 2024, provided downside risks, particularly around continuing geopolitical instability don't materialise.
- We expect economic growth to remain subdued despite the decline of supply chain pressures. Energy prices remain significantly above their longterm average while falling consumer confidence and increasing borrowing costs will increasingly act as a drag on consumption and investment.

POLICY RECOMMENDATION

- A further normalisation of monetary policy may weaken short-term growth but remains essential to manage inflation expectations.
- With financing costs rising for businesses, and particularly given the investments required to meet the digital and green transition, policymakers must redouble their efforts to make it more attractive for businesses to invest in the EU.
- Swift agreement on the revision of the Stability and Growth Pact (SGP) is essential to assist Members States in strengthening their public finances and ensure they have the capacity to respond to future challenges. The revised rules must support growth-enhancing structural reforms and public investment, as well as increasing ownership of the plans in Member States. But the rules must not provide excessive flexibility in their interpretation. 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.

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

After a turbulent year characterised by soaring inflation and supply chain disruptions, it remains unlikely that we will see a return to 'business as usual' in 2023. Although energy prices and supply chain disruptions are declining as China re-opens to the world and Europe diversifies its energy supply, businesses continue to contend with high levels of uncertainty, as well as the consequences, in terms of increasing borrowing costs and lower demand, of the ECB's necessary efforts to reduce inflation. Thus, whilst national fiscal stimulus packages and a mild winter supported business activity through the winter, the medium-term outlook for EU economic growth and competitiveness remains challenging.

Based on input from member federations, we expect:

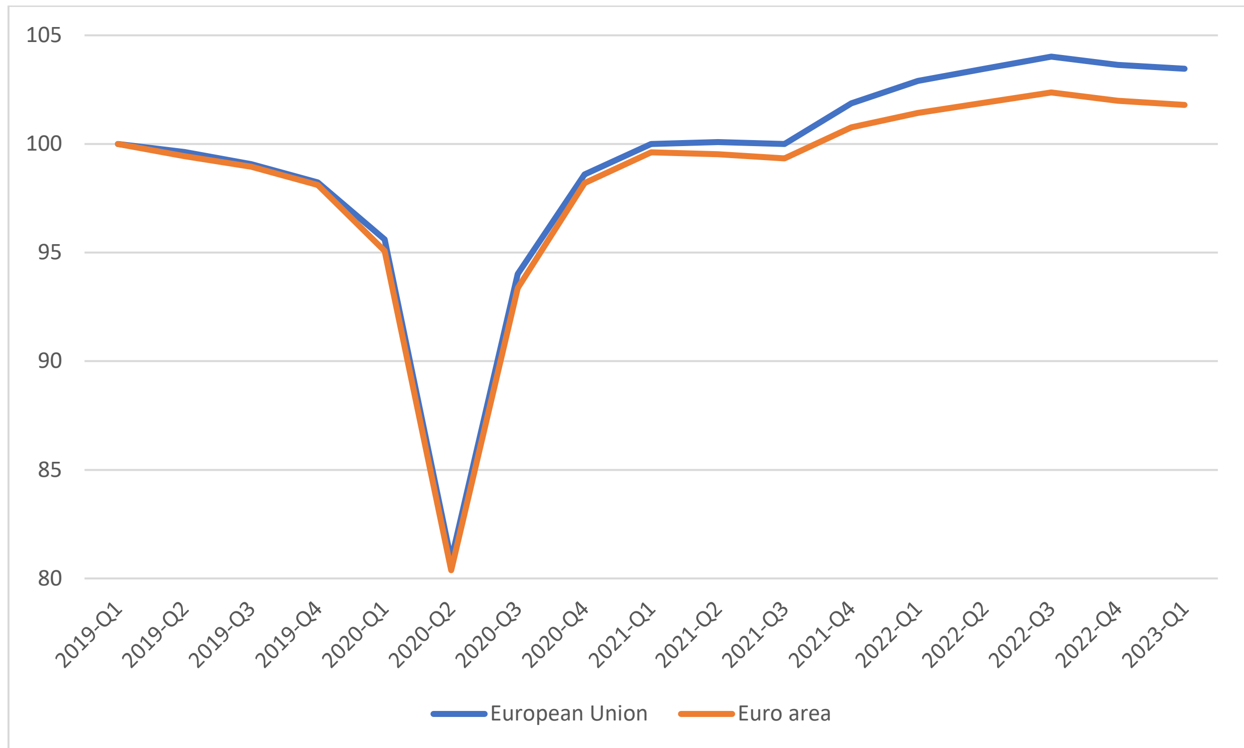
- The EU economy to grow by 0.7% in 2023, with EU growth increasing to 1.6% in 2024.
- Inflation is likely to remain relatively persistent, averaging 5.9% and 5.4% respectively in the EU and EA in 2023, before declining somewhat to 3.1% and 2.7% in 2024.
- Unemployment, already at relatively low levels, will broadly remain stable, at 6.1% across the EU in 2023 and 2024, and 6.4% and 6.3% in the Eurozone in respectively 2023 and 2024.
- Government lending is expected to decline slightly, particularly as Member States withdraw household support for energy (as prices fall from their exceptional peaks) and anticipate the full reapplication of the (revised) Stability and Growth Pact.

Table 1: BusinesssEurope Economic Forecast

	EU		Euro Area	
Main Variables	**2023**	**2024**	**2023**	**2024**
Real GDP (annual % growth)	0.7	1.6	0.8	1.6
Inflation (%)	5.9	3.1	5.4	2.7
Unemployment (%)	6.1	6.1	6.4	6.3
Government net lending (% of GDP)	-3.0	-2.4	-3.4	-2.6

Source: Member federations

Chart 1: industrial production is stagnating
Industrial output in the EU and EA, index=Q1-2019



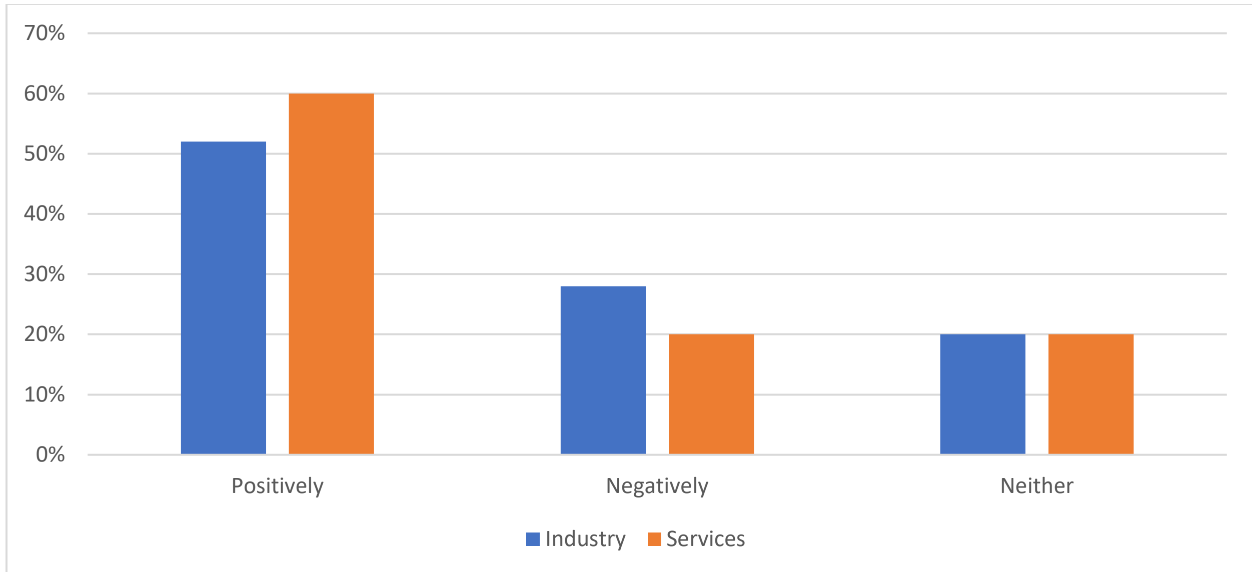
Source: Eurostat

European businesses continue to face considerably higher energy prices than their competitors, as energy prices remain far above early 2021 levels. The increase in energy prices and supply chain disruptions seen over the last years has contributed to relatively weak growth in industrial output (chart 1), with many companies, particularly in energy-intensive sectors, choosing to cut back production, whilst in other sector output has been constrained by supply chain disruptions.

Nevertheless, more than half of member federations view the overall business climate as generally better than the extremely uncertain outlook experienced in the autumn (chart 2),

Chart 2: More than half of member federations view the overall business climate as generally better than in autumn

Member federations' view on the overall business climate (Industry/Services) over the next 6 months



Source: Member federations

Our forecast is for the economy to grow by 0.7% in the EU27 in 2023, supported by China's re-opening and recent declines in wholesale energy prices gradually feeding through into the broader economy.

Private consumption is expected to increase substantially in 2024 compared to 2023. There is also some potential for increases in investment, particularly as funds from the EU's next generation EU programme increasingly come on stream

At the same time, a multitude of downside risks remain. Although, as noted by ECB Vice-President de Guindos[1], the current financial environment is very different from the situation in 2008, especially considering the increased resilience of the European banking system after previous financial crises, there remains a downside risk of further turbulence, beyond that seen in March. More broadly, we continue to see uncertainties relating to geopolitics, in particular, an increasing risk of fragmentation of the global economy. The April 2023 IMF World Economic Outlook for example notes that an increase in geopolitical fragmentation could see the EU lose over 2% of GDP in the long term. This uncertainty continues to weigh on business and consumer confidence, which remains at levels under their long-term averages.

[1] Introductory remarks by Luis de Guindos, Vice-President of the ECB, at the 34th edition of "The outlook for the economy and finance", organized by the European House – Ambrosetti

Table 2: Growth expectations improve though uncertainty remains
Percentage growth expected by European business in 2023 and 2024

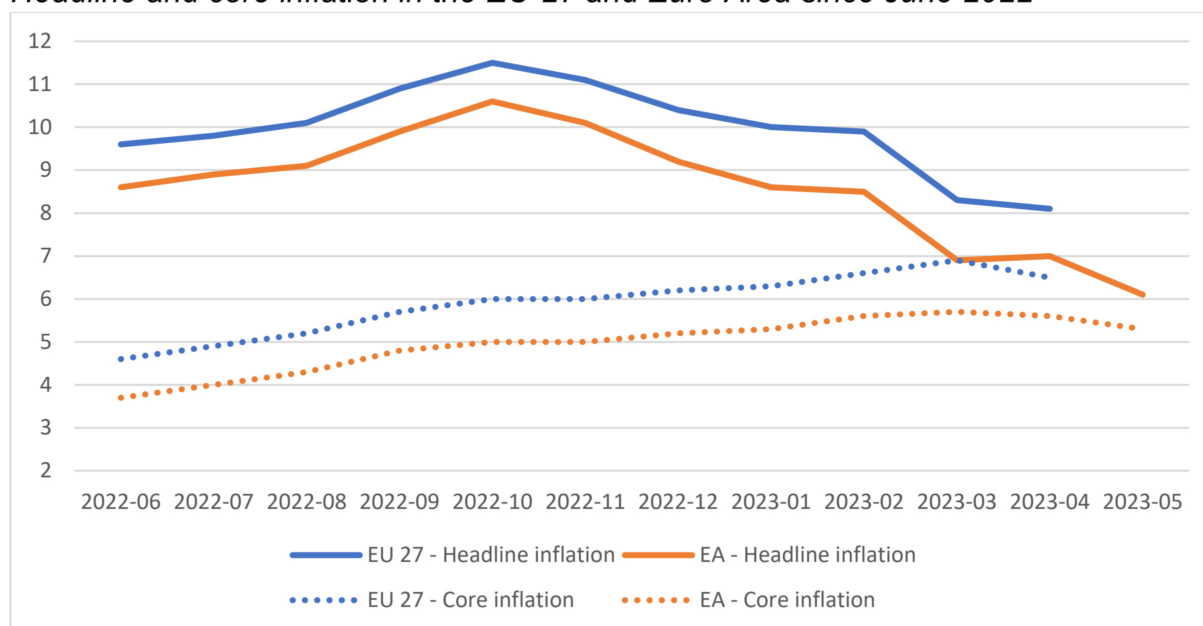
	2023		2024	
	EU 27	**Euro Area**	**EU 27**	**Euro Area**
GDP	0.7	0.8	1.6	1.6
Private consumption	0.2	0.3	1.7	1.6
Public consumption	0.7	0.7	0.9	0.8
Investment (*gross fixed capital formation*)	1.1	0.8	2.0	2.0
Exports	2.6	2.5	3.1	3.0
Imports	2.3	2.5	2.8	2.7
Net trade	0.3	-0.1	0.4	0.3

Source: Member federations

1. Inflationary pressures remain, despite easing supply chain disruption

Although headline inflation has fallen from its peak in October 2022, Eurozone headline inflation remains at 7.0%, well above the ECB's price stability target of 2%.

Chart 3: Headline inflation is declining, but remains above target
Headline and core inflation in the EU-27 and Euro Area since June 2022

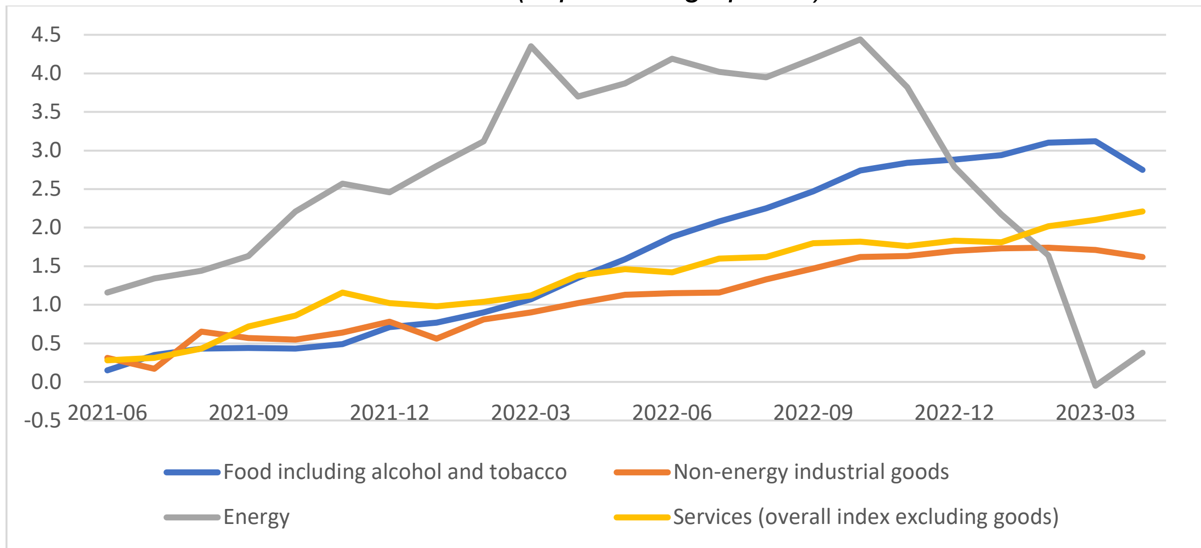


Source: Eurostat

The sectoral drivers of inflation are also changing, with energy prices contributing to a lower proportion of the increase, as the strong price rises of Spring 2022 drop out of the 12-month index (Chart 3). As a consequence, we have seen a limited fall in underlying inflation (defined as the changes in prices of goods and services excluding food and energy) in recent months, with Eurozone core inflation fluctuating between 5 and 5.6% since October 2022 as the initial inflationary pressures work their way through the broader economy, including into the service sector, both through the gradual dissipation of energy prices and through higher wage settlements.

Chart 4: Energy is no longer the key driver of Euro Area inflation

Contributions to EA annual inflation (in percentage points)

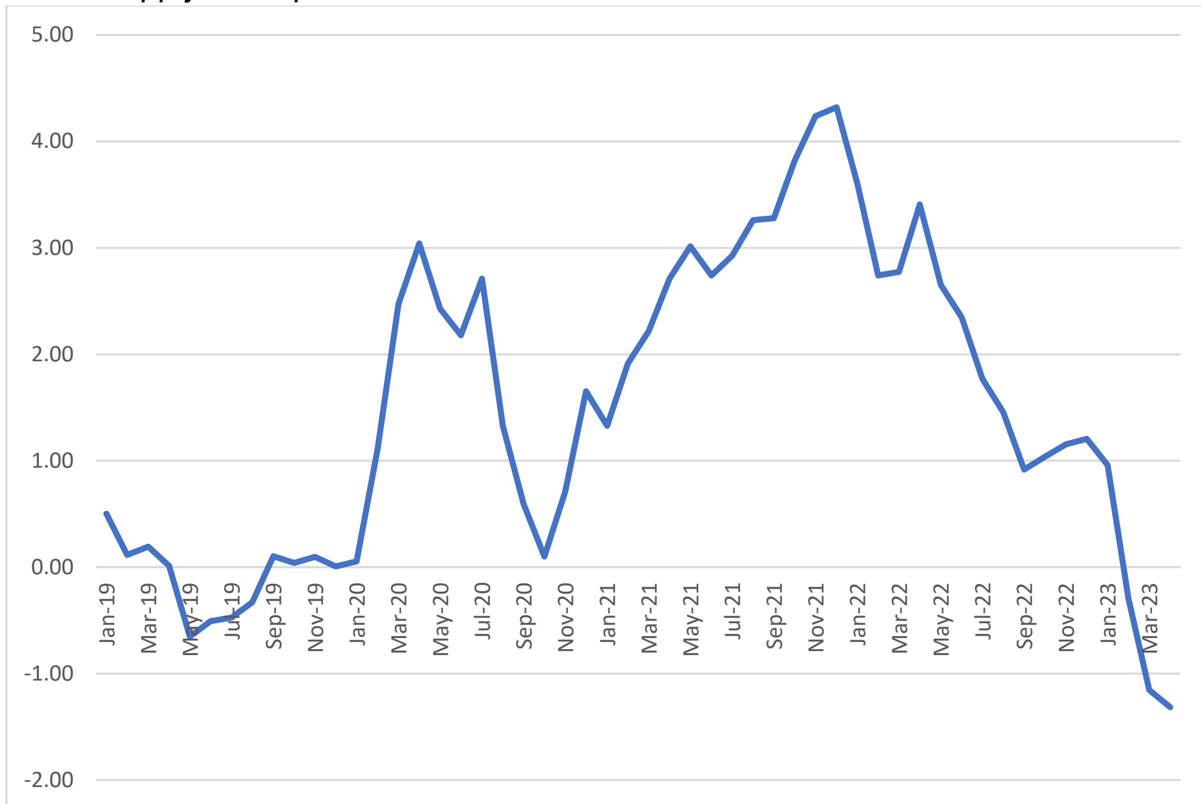


Source: Eurostat

On a more positive note, businesses are facing fewer supply chain bottlenecks as supply chain pressures are on the decline. China's abolishment of its restrictive covid policy in December 2022 contributed to this, and the re-opening is likely to significantly increase Chinese consumer demand for European goods. Chart 5 shows that the Global Supply Chain Pressure Index reached its lowest value since August 2009 in April 2023, indicating that global supply chains returned to their pre-pandemic state.

Chart 5: Supply chain bottlenecks disappear as pandemic-related measures are lifted

Global supply chain pressure index



Source: Federal Reserve Bank of New York

In chart 6, the Global Container Index shows a similar picture, as shipping prices declined to pre-pandemic prices, less than a seventh of their peak in September 2021.

China's post-pandemic re-emergence on the global economic stage will likely have a positive impact on global trade, as import prices for EU businesses decline and barriers to exports and business contacts in China fall away.

As global demand remains subdued, we expect commodity prices to remain stable or slightly decrease over the coming period. Global demand for Liquified Natural Gas has surged as Europe shifted away from Russian pipeline gas last year, and the continent will now have to compete with China over the limited supply of LNG on the global markets. The reduction in gas usage in the EU and the weaker than expected economic rebound of China may prevent another surge in global gas prices as seen last year. Though futures prices on the Dutch TTF gas exchange have declined over the last months, they remain above pre-2021 levels while forward natural gas prices for 2023 on the Dutch TTF gas exchange are trading at levels 5 to 6 times higher than at the US Henry Hub gas exchange.

Oil prices may similarly stabilise or mildly decline over the following months as the global economy remains fragile. A further tightening of monetary policy may further weaken global demand and reduce demand for commodities. This is however highly contingent on geopolitical developments.

Chart 6: Shipping prices returned to their pre-pandemic level
Global shipping costs, index=03-01-2020

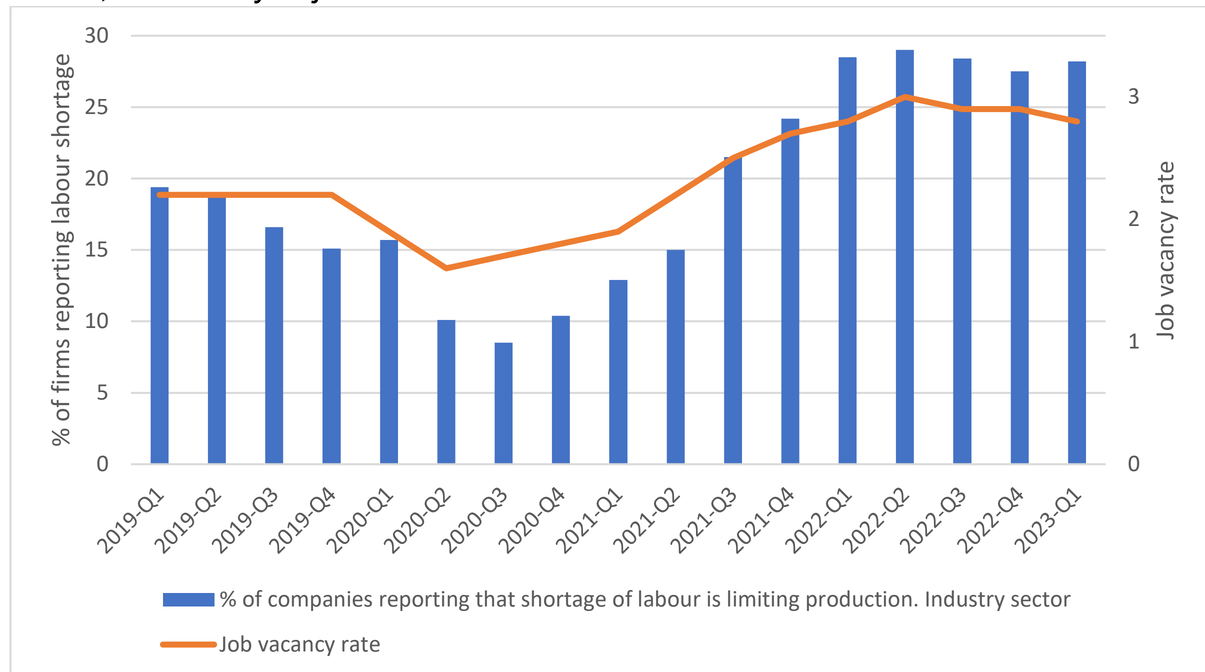
Source: Freightos Global Container Freight Index based on own calculation

2. Labour markets remain tight as labour costs are on the rise

With wages representing the largest input cost for most businesses, development in the labour market, and particularly around wages, will be a key determinant of inflation.

Despite low economic growth and difficult business conditions over the past years, the labour market remains extremely tight. The job vacancy rate across the EU stabilised at about 2.9% in Q4 2022, remaining significantly above the long-term average. Overall, we see that a shortage of labour continues to be a significant constraint on production (chart 7). This emphasises the need for structural reforms

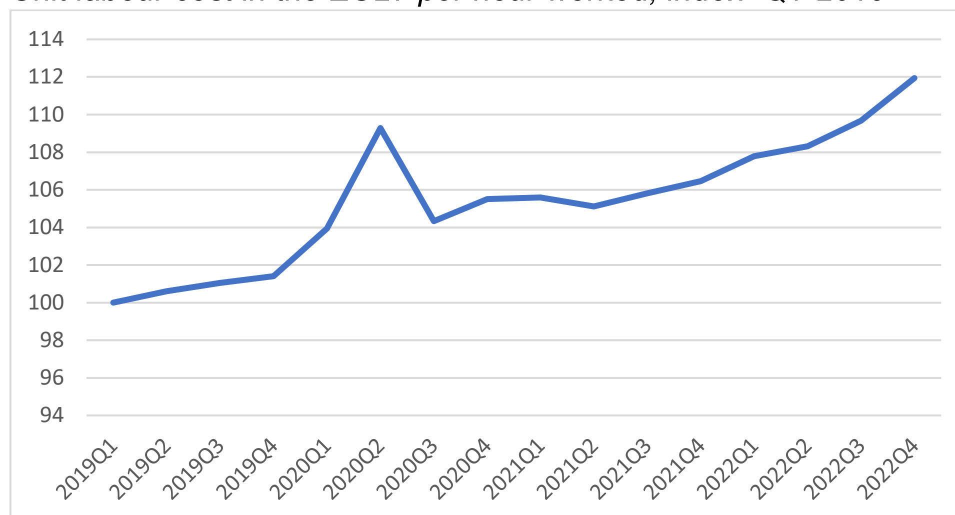
Chart 7: The European labour market remains stable but tight
EU-27, seasonally adjusted



Source: DG ECFIN and Eurostat

After being relatively restrained in many Member States through much of 2023, there are increasing signs that wage settlements may be increasing, which may slow a return to the ECB's notion of price stability. For example, nominal hourly labour costs across the economy increased by 5.8% in the EU in the final quarter of 2022, a significant increase from previous quarters.

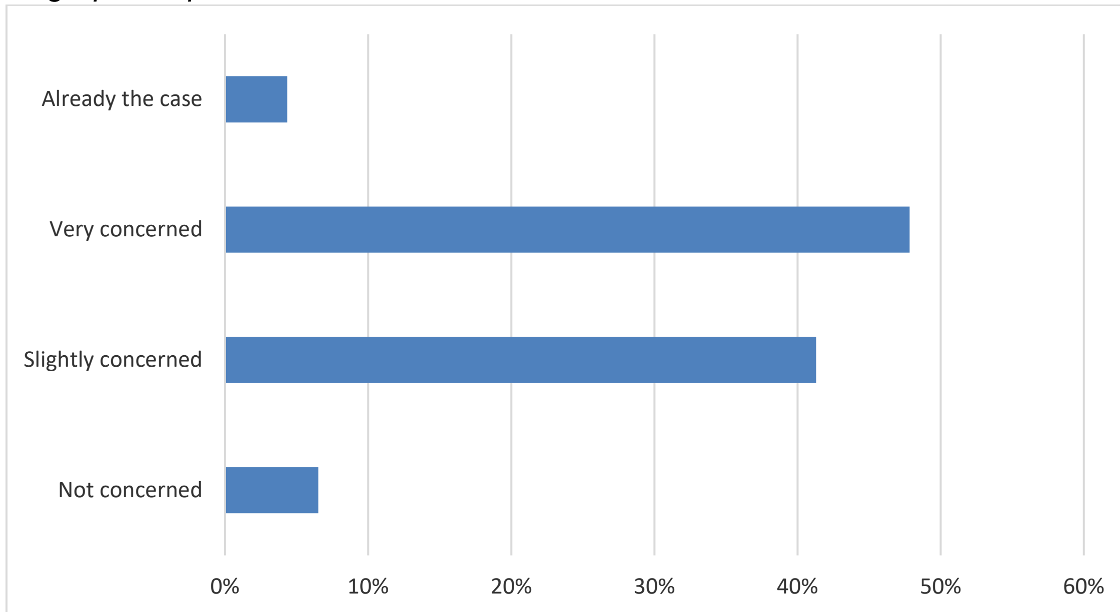
Chart 8: Unit labour costs have increased substantially in the final months of 2022
Unit labour cost in the EU27 per hour worked, index=Q1-2019



Source: ECB

Almost 90% of BusinessEurope member federations indicate they are concerned about current wage developments and the prospect of a wage-price spiral in particular.

Chart 9: Member federations remain concerned about a wage-price spiral.
Member federations' views on the prospect of current inflationary pressures leading to a wage-price spiral



Source: Member federations

We need to avoid higher expectations of inflation developing and feeding through into inflation through wages. Whilst profits in some sectors rose in 2022, most companies, have at best only seen a small rise in margins which can serve as a buffer for wage increases and facilitates employment and investment. This follows a weakening in their balance sheets during COVID, with high levels of bankruptcies underlining the challenges facing particular SMEs. In line with the ECB, we expect any rises in profits to prove only transitory and to decline over the next year.

In the coming months, social partners need to 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.

3. Bankruptcies are rising, whilst we have also seen access to finance tightening.

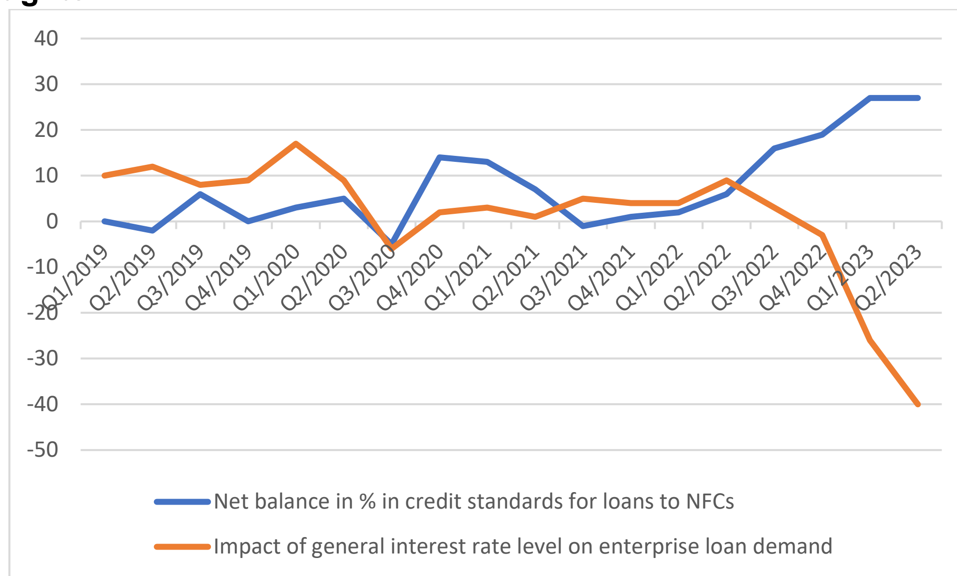
Both rising interest rates and tightening lending standards are increasingly impacting company borrowing and investment. Chart 10 shows how credit standards for loans to non-financial corporations increased significantly over 2022 while interest rate hikes

reduced lending volumes, with both indicators reaching levels last seen in 2012 during the European sovereign debt crisis. Combined with broader investment uncertainty, the ECB Quarterly Lending Survey of May 2023 shows net loan demand by enterprises decreased by 38% in Q1 2023; the largest net decline since Q4 2008.

There is a clear likelihood that lending will continue to become more costly in the coming months. For example, an ECB study[2] found that changes in credit standards for non-financial company (NFC) loans generally precede NFC loan developments by around a year. Moreover, policymakers are already re-examining regulatory and supervisory frameworks following the financial turbulence in March 2023, with the collapse of Silicon Valley Bank and the deposit run at Credit Suisse and the subsequent merger with UBS.

For businesses, it is essential that the regulatory framework for the banking sector is modern and able to respond effectively to new challenges as they emerge. Nevertheless, any strengthening of the framework in response to this turbulence should, if necessary, be targeted. Overhastened regulation risks putting further strain on banks' ability to provide credit and may thus negatively impact the European investment climate. The current increase in lending costs is already disproportionally affecting SMEs as they are particularly reliant on bank financing and don't usually have access to the alternative sources of credit available to larger firms.

Chart 10: Loans are becoming less attractive to companies as credit conditions tighten



Source: ECB Bank Lending Survey

[2] De Bondt, G., Maddaloni, A., Peydro, J.-L. and Scopel, S., "The euro area bank lending survey matters: empirical evidence for credit and output growth", Working Paper Series, No 1160, European Central Bank, 2010.

With access to finance tightening, combined with the cuts to margins experienced by many businesses, particularly SMEs, it is unsurprising that we have seen bankruptcy levels increase in recent months. Bankruptcy declarations increased significantly across the EU last year as shown in chart 11, reaching its highest level since 2016 in the first quarter of 2023. Part of this increase may be attributed to the phasing out of pandemic-related support measures, as loans must be paid back and pandemic-related tax relief measures end, though legislative changes in member states that facilitate debt restructuring may also temporarily elevate the number of bankruptcies. Some of the bankruptcies may be attributed to businesses that have utilised government support to survive the pandemic and energy crisis. These are at increased risk of bankruptcy now that support measures are halted and paid back. Nevertheless, low economic growth, the COVID-19 pandemic, soaring inflation, and tightening credit conditions have clearly taken a significant toll on the financial health of European businesses.

Chart 11: Bankruptcies soar across the EU

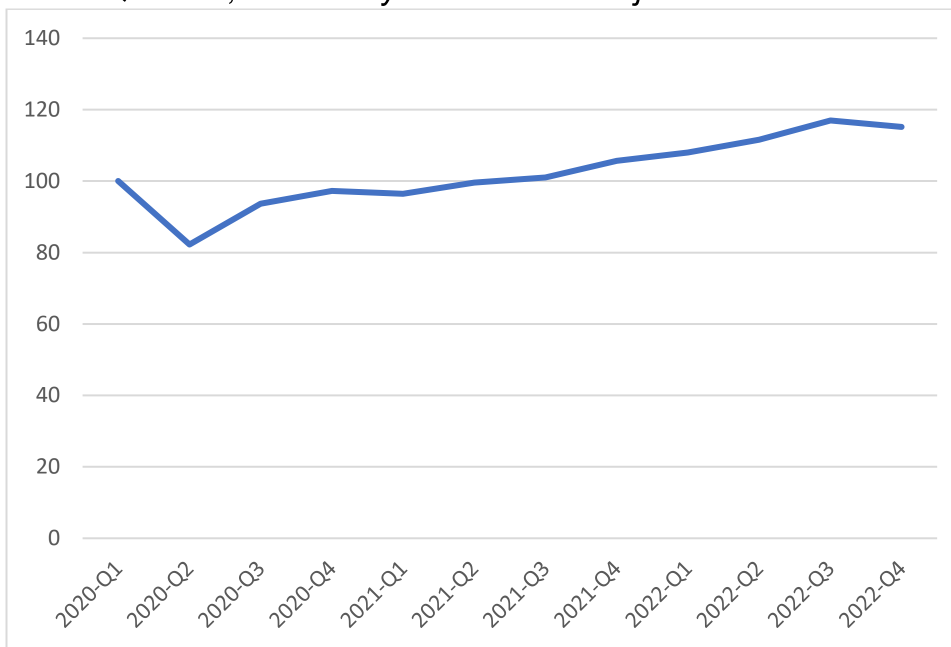
Bankruptcy declarations in the EU27. Seasonally and calender adjusted, index=Q1-2019

Source: Eurostat based on own calculations

4. Investment remains constrained amidst tightening financial conditions and global economic uncertainty

With financial conditions tightening amidst continuing global economic uncertainty, it is no surprise that business investment remains constrained. Table 12 shows that gross fixed capital formation growth continues to struggle post-pandemic, falling by 1.5% in the fourth quarter of 2022, showing a trend break compared to the steady quarterly growth of on average 3.3% since the second quarter of 2021.

Chart 12: Gross fixed capital formation declined in the second half of 2022
Index=Q1-2020, seasonally and calendar adjusted

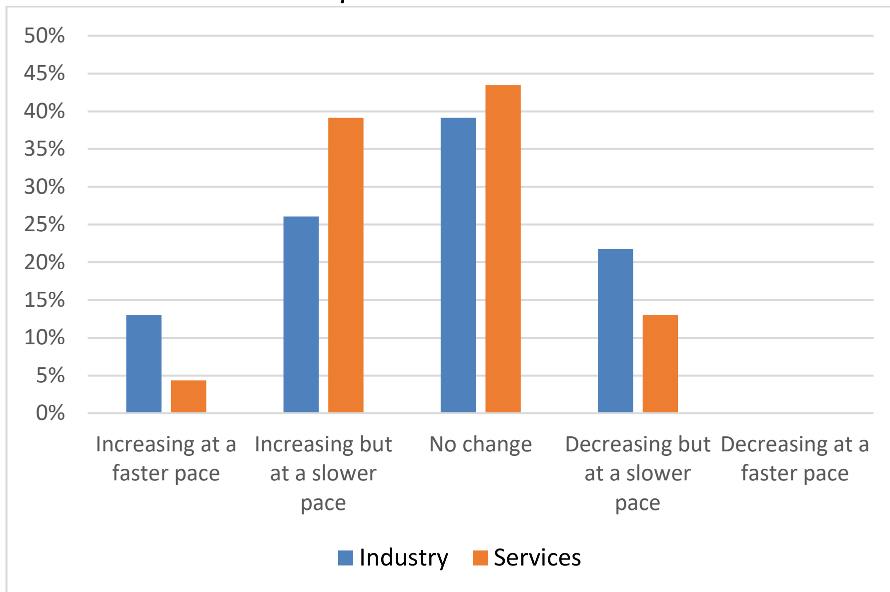


Source: Own calculations based on Eurostat

Just 13% of BusinessEurope member federations expect an acceleration of investment in the industry sector, with the figure even lower for the services sector (4%). Thus, the majority of member federations expect a stagnation or decline in investment in the short term, at a time when investment is crucial to businesses' economic recovery.

Chart 13: Investment is expected to grow more slowly or stagnate

Member federations' expectations for the investment trends in the next six months



Source: Member federations

Whilst global uncertainty is clearly weighing on investment, there is also a concern that the EU may be falling behind in terms of the attractiveness of its investment environment. Considering the investment needed in the framework of the green and digital transitions, policymakers should consider taking further measures to improve the investment conditions in the EU. This includes providing breathing space on regulatory and reporting requirements, and speeding permitting procedures, particularly for energy projects.

5. Long-term investment challenges

Despite the expected modest recovery of investment in the short term, a number of long-term investment challenges remain. Our members point in particular to two long-term challenges pushing investment away from the EU.

- Firstly, an increasing regulatory burden for EU companies means that almost half of our member federations see the regulatory burden here as significantly higher than in other developed nations.
- Secondly, EU businesses are facing the prospect of long-term energy price rises well in excess of major competitors, with wholesale gas prices for summer 2025 trading at over four times their pre-Covid level in the EU, compared to less than twice pre-Covid levels in the United States.

Alongside these factors pushing investment away from the EU, the support for industry seen in other major regions, most recently through the U.S.'s Inflation Reduction Act (IRA)

which seeks to provide up to $369 billion dollar to US-based businesses for industrial transformation, is acting as a significant pull factor to invest outside the EU. This remains a risk for the EU's attractiveness as an investment location.

On a positive note, member states continue their implementation of national Recovery and Resilience Plans (RRF). So far, the European Commission has disbursed €106.3 billion in grants and €47.1 billion in loans. The swift execution of the Recovery and Resilience Facility remains vital in 2023, as the structural reforms and investments related to the RRF will be key to increasing EU competitiveness and prosperity in the long term.

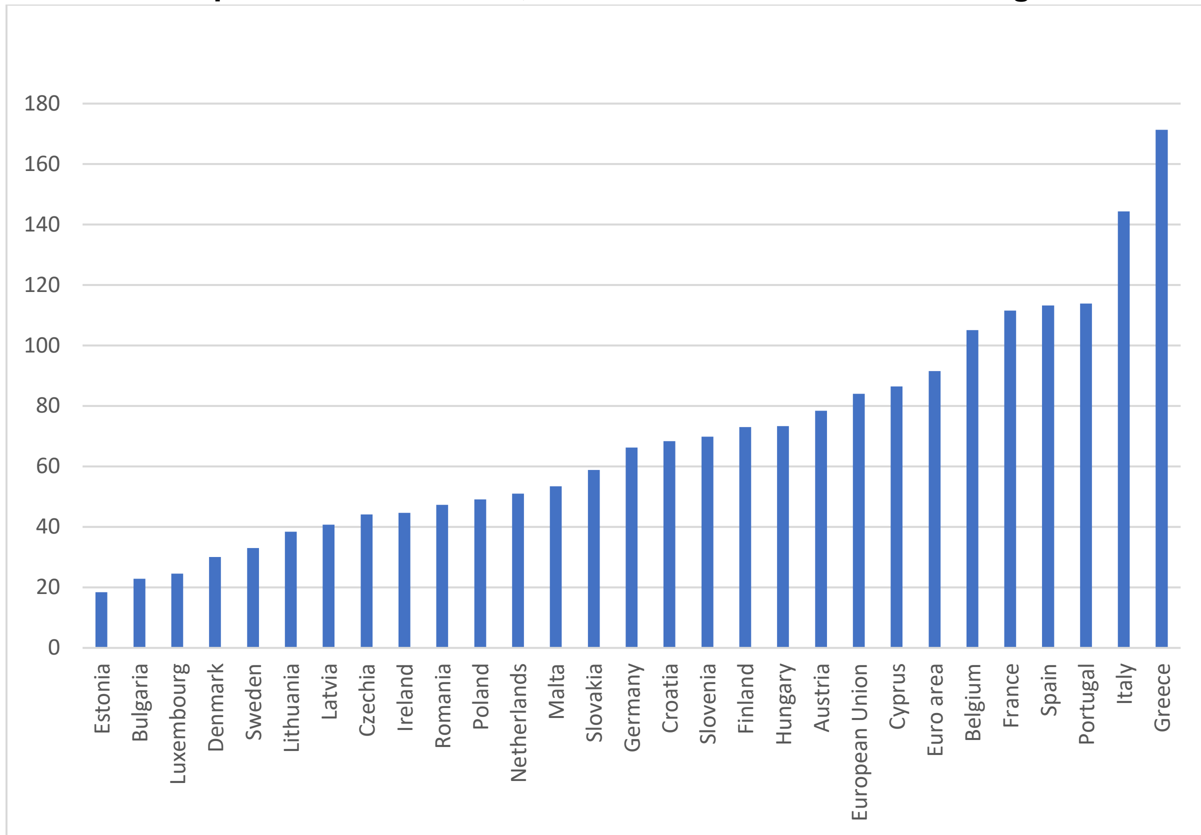
6. Macroeconomic policymakers face an uncertain way forward

The ECB continues to face a balancing act between ensuring that inflation returns to its 2% target, whilst avoiding an undue slowing of the economy. Recent financial turbulence has further complicated the dilemma, with the risk that monetary tightening, either through interest rate increases or through a more rapid reduction in the stock of debt held by the ECB, although merited by inflationary considerations may, contribute to further uncertainty in financial markets.

Whilst interest rate increases represent a challenge to businesses, through the impact on the cost of finance and therefore investment, and through lower household demand, BusinessEurope is also clear that, given the potential costs if higher inflationary expectations are allowed to develop, long-term growth is best served by the ECB taking appropriate action now.

Increasing borrowing costs should also remind us of the importance of governments taking appropriate action to strengthen public finances. Such action may include the implementation of growth-enhancing reforms, as well as national efforts to increase the efficiency of the public sector. The average debt-to-GDP ratio increased by 6.3% in Q4 of 2022, compared to the same quarter in 2019. Moreover, debt-to-GDP ratios of fifteen member states exceeded the 60% threshold of the Stability and Growth Pact. The average debt-to-GDP ratio also remains above target, amounting to 85.1% in the EU and 92.9% in the Euro Area in the third quarter of 2022. A failure to reduce budget deficits and high debt levels limits the fiscal manoeuvring space of governments and may leave them unable to respond promptly to new, unexpected crises.

Chart 14: Despite a recent decline, debt-to-GDP ratios remained high in Q4-2022



Source: Eurostat

The EU member states are in the process of revising the Stability and Growth Pact (SGP), with the Commission publishing a Communication in November 2022, and a legislative proposal in April 2023. As noted in our position paper, the Commission's November 2022 proposals, focussing on Member States' net primary expenditure can potentially simplify the rules and help Member States construct medium-term adjustment paths that are less sensitive to cyclical conditions, thus more credible. Efforts to support growth-enhancing structural reforms and public investment, as well as increasing ownership of the plans in Member States, are also helpful. But the rules must not provide excessive flexibility in their interpretation. 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.

7. Country differences

Overall projected growth continues to vary across the EU. High GDP growth is expected in a number of Southern European states such as Malta (3.7%), Cyprus (3%), and Greece (2.6%) as well as in Ireland (5.4%). Notably, Sweden (-0.9%), Estonia (-1.5%), Finland (-0.3%), and Hungary (-0.5%) expect their economy to contract. Unemployment is set to

decline slightly overall, with Slovakia (-0.6 p.p.), Greece (-0.8 p.p.), Romania (-0.5 p.p.), and Spain (-0.5 p.p.) all expected to see the most significant positive changes in unemployment rates.

Table 4: GDP and unemployment for each EU Member State in 2023-2024

	Real GDP Growth		Unemployment	
Country	2023 (difference from autumn forecast)	2024	2023	2024
Austria	0.3 (1.0)	1.8	4.7	4.5
Belgium	1.0 (-1.3)	1.7	5.7	5.5
Croatia	1 (-1.4)	2.0	6.8	6.5
Cyprus	3 (0.9)	3.0	6.4	5.7
Estonia	-1.5 (-2.6)	3.0	7.4	7.2
Finland	-0.3 (1.5)	1.2	7.1	6.8
France	0.2 (0.2)	0.6	7.4	7.8
Germany	0.3 (1.0)	1.5	3.4	3.2
Greece	2.6 (0.2)	1.5	11.2	10.4
Ireland	5.2 (1.6)	5.8	4.5	4.3
Italy	0.4 (0.4)	1.2	8.3	8.1
Latvia	0.5 (-1.7)	3.7	7.4	7.3
Lithuania*	0.5 (-2.0)	2.7	6.6	6.5
Luxembourg*	1.6 (-0.5)	2.4	4.8	5.0
Malta	3.7 (0.8)	3.6	3.3	3.2
Netherlands	1.6 (0.1)	1.4	3.9	4.1
Portugal	1.8 (0.6)	2.0	7.0	6.9
Slovakia	1.3 (2.3)	3.2	6.1	5.5
Slovenia	1.8 (0.4)	2.5	4.0	3.8
Spain	1.3 (-0.2)	2.0	12.9	12.4
Euro Area	**0.8 (0.5)**	**1.6**	**6.4**	**6.3**
Bulgaria	1.4 (-0.3)	2.5	4.2	4.0
Czechia	0.1 (0.8)	3.4	2.8	2.9
Denmark	0.2 (0.3)	1.5	4.5	4.5
Hungary	-0.5 (3.0)	2.2	4.2	3.7
Poland	0.8 (-1.5)	2.4	3.1	3.1
Romania	2.8 (-0.9)	4.8	5.3	4.8
Sweden	-0.9 (-1.4)	0.9	7.9	8.2
EU27	**0.7 (0.1)**	**1.6**	**6.2**	**6.1**

Source: Own calculations based on member federations and Eurostat. European Commission for data marked with an asterisk.

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