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Not out of the woods yet

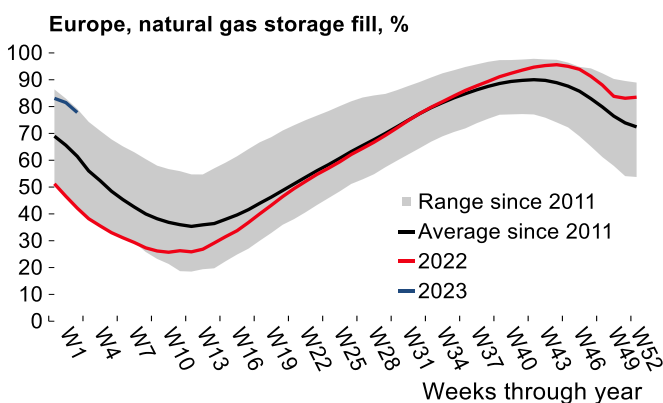
26 January 2023

The euro area has managed to dodge the worst-case energy scenarios, and supply chain problems related to war and the pandemic are also receding. Sentiment has gradually improved through the winter and now this is being reflected in actual output data. However, the economy is not out of the woods quite yet. Consumers are still being squeezed by high inflation, and the ECB's monetary policy tightening will have a lagged effect. We continue to expect a euro area recession – but it's likely to be shallow as national fiscal policy continues to cushion the blow from the energy price shock.

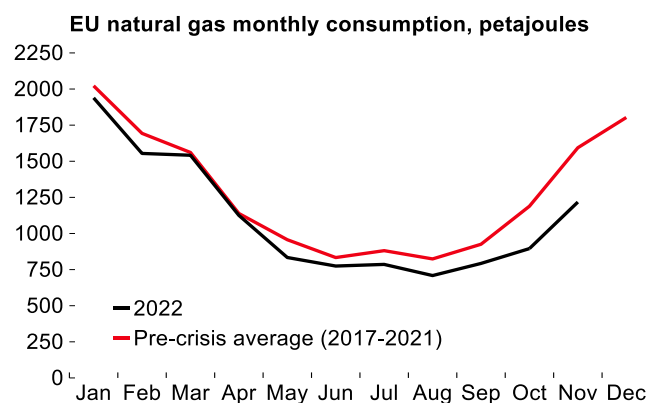
Energy risks have fallen significantly

The European economy is on a relatively firm footing in what could have been an extremely challenging winter. The most significant development has been the sharp reduction in downside risks related to the energy supply. After a successful scramble for LNG imports, gas storage buffers are in extremely good shape for this time of year (Chart 1). This has been helped by a reduction in consumption. EU states committed to reducing gas demand by 15% between August 2022 and March 2023, which now looks very achievable. Price-driven demand destruction and effective public policy have combined with a dose of luck: it was an exceptionally mild autumn in most of Europe, so heating needs were relatively low. The result is that EU gas consumption was down by over 20% in August-November compared to the average of the same months in the five years to 2021 (Chart 2).

Front-month natural gas prices are now below the levels seen in the months before the 2022 Russian invasion of Ukraine, and seemed unaffected by a recent period of below-average temperatures in much of Europe. The fall in energy prices is reflected by the euro area current account moving back into surplus (Chart 3).

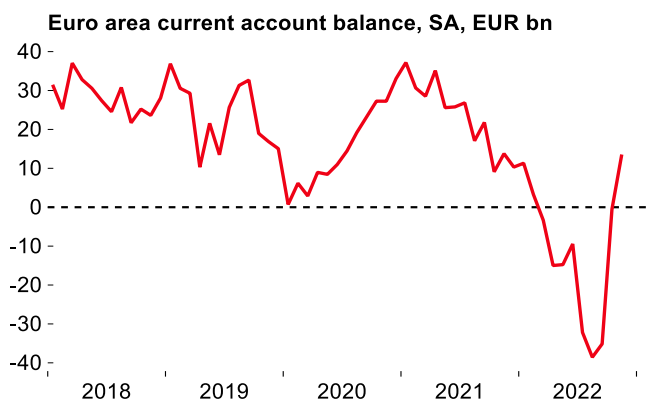
CHART 1: GAS STORAGE IN GOOD SHAPE AT THE START OF 2023

Source: GIE, MUFG Bank Economic Research Office

CHART 2: GAS CONSUMPTION FELL SIGNIFICANTLY IN H2 2022

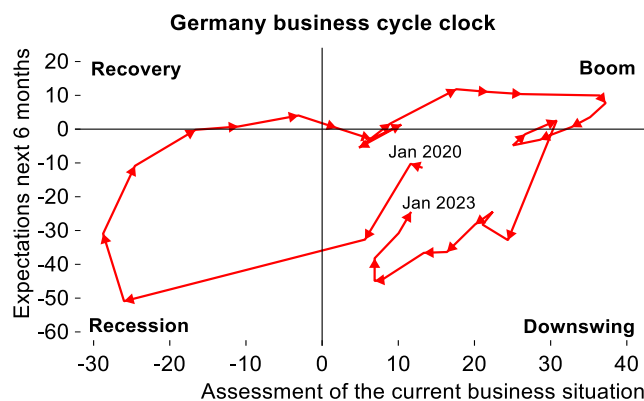
Source: Eurostat, MUFG Bank Economic Research Office

CHART 3: CURRENT ACCOUNT BACK INTO SURPLUS AS ENERGY PRICES EASE



Source: Eurostat, MUFG Bank Economic Research Office

CHART 4: THE 'IFO CLOCK' IS NO LONGER CHARGING TOWARDS RECESSION TERRITORY



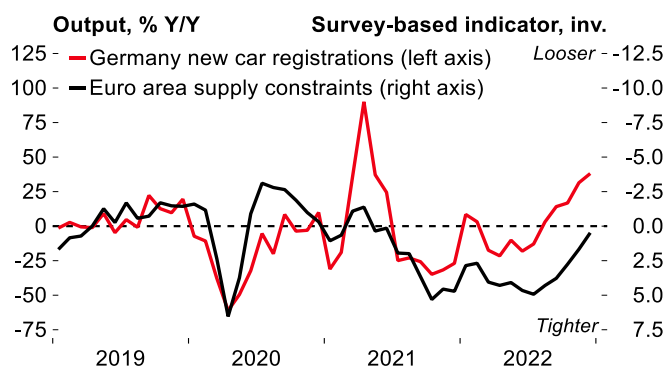
Source: ifo, MUFG Bank Economic Research Office

Economic activity has proved to be surprisingly resilient

Economic survey data has duly improved as it became clear that Europe will avoid the worst-case scenarios of blackouts and energy rationing. National surveys are no longer charging into clear recession territory (Chart 4). In fact, the composite PMI survey for the euro area as a whole has now moved above the breakeven mark for the first time since June.

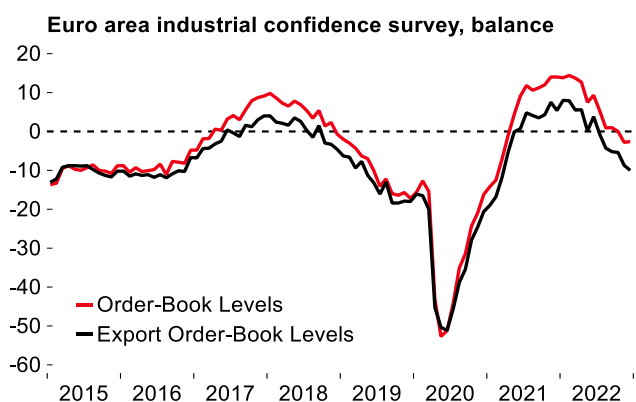
Output data is now starting to confirm indications from the soft data that the economic slowdown through Q4 was indeed milder than expected. The German statistical agency estimates that annual GDP growth in 2022 was 1.9%. This is significantly above our last forecast (1.4%), with the implication that Q4 growth may have been flat (like most forecasters, we expected a contraction). Meanwhile, industrial production for the euro area as a whole increased by a healthy 1% M/M in November. Industry has been remarkably resilient in the face of soaring energy costs. It seems there were relatively easy efficiency gains to reduce energy needs for many firms (consistently cheap gas for many years may have reduced incentives to look for these prior to the price shock). Some sectors have also benefitted from improving supply-chain constraints, such as the auto industry (Chart 5).

CHART 5: THE AUTO INDUSTRY HAS BENEFITTED FROM EASING SUPPLY-CHAIN CONSTRAINTS



Note: Supply constraints indicator based on Chart 2.3 of November 2021 BoE MP report. Source: KBA, BoE, IHS Markit, MUFG Bank Economic Research Office

CHART 6: SURVEYS ARE SUGGESTING THAT ORDER BACKLOGS ARE FALLING



Source: European Commission, MUFG Bank Economic Research Office

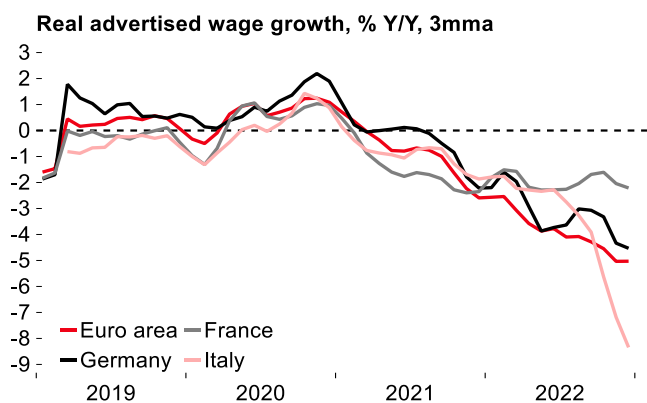
On the consumption side, it's now clear that national fiscal measures (e.g. retail price caps, direct grants, subsidised transport) have cushioned the blow from higher energy prices. Retail sales bounced back in November to around the level seen in July and August. Consumer confidence, while still extremely weak by historical standards, has now improved for four straight months to reach the highest mark since the Russian invasion of Ukraine.

A shallow recession remains our base case

The data flow has been encouraging relative to the gloomy expectations going into the winter, but it's still consistent with an economy hovering close to recession. There is a range of factors that will continue to drag on the economy. Euro area inflation has peaked and is poised to fall fairly quickly through the year, but the hit to real household disposable income will remain a challenge for months to come. Euro area negotiated wages rose by just 2.9% Y/Y in Q3 2022, while CPI inflation averaged 9.3% over the same period. More timely advertised wage data (Chart 7) shows how the squeeze on consumers is set to continue into the start of this year.

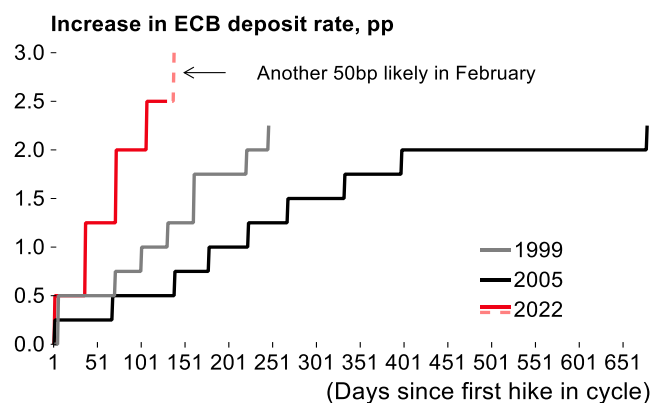
We're also dubious that the industrial sector can remain quite so resilient. Survey data suggested that backlogs were high through the summer but may now be falling as these older orders are fulfilled (Chart 6, above). In Germany, factory orders plunged by 5.3% in November. Our suspicion is that initial resilience in some areas will not be able to offset weakness in energy-intensive sectors indefinitely.

CHART 7: REAL WAGE GROWTH REMAINS FIRMLY IN NEGATIVE TERRITORY



Source: Bank of Ireland/Indeed, Eurostat, MUFG Bank Economic Research Office

CHART 8: AFTER STARTING POLICY NORMALISATION, THE ECB HAS MOVED FAST TO RAISE RATES



Source: ECB, MUFG Bank Economic Research Office

The shift in monetary policy is also significant. After years of rates close to the lower bound, and, it's fair to say, a slow start to tightening policy, the adjustment is now rapid (Chart 8). Higher borrowing costs will continue to pass through to the real economy with a lag, dampening aggregate demand. And the ECB's not done yet – markets are currently pricing in almost 150bp of further hikes by the summer.

So our baseline remains that the euro area will slip into a recession, but it's likely to be a relatively shallow downturn. Fiscal policy will pull in the opposite direction to the ECB. A range of national support measures will continue to support demand through 2023, and sometimes beyond (the German energy price brake scheme will run until April 2024). The introduction of fiscal buffers has been expensive: the euro area budget deficit widened to 3.3% of GDP in Q2 2022. However, if energy prices remain low through 2023 then governments may be afforded some more leeway to support the economy if conditions deteriorate again, which further reduces the downside risks.

External factors may become increasingly significant by H2

The external environment will remain hugely relevant to the outlook. The gas price crisis has been mostly Europe-specific, which leaves the continent out of kilter with the cycles of other economies. While European data has surprised on the upside recently (albeit against low expectations), recent figures in the US have started to disappoint (Chart 9). US recession risk has risen sharply (Chart 10) and a downturn across the Atlantic could delay the euro area recovery.

News out of China has been relatively encouraging, on the other hand. There are some early indications that post-reopening waves of COVID infections are not shuttering all economic activity. This points to further improvement in supply-chain issues, which could help European manufacturers. Pent-up demand and accumulated savings in China could also result in significant tourism flows (Chart 11), but may in turn add to headline inflation through the travel services component.

There are also implications from China reopening for the European energy supply picture. Re-filling gas inventories for next winter without Russian gas, which continued to flow until June 2022 before falling to a trickle, is set to remain a huge challenge. More competition for LNG shipments looks likely as the Chinese economy reopens (Chart 12). With this in mind, our overall sense is that it's still premature to declare that Europe has successfully managed to navigate the energy crisis.

CHART 9: EURO AREA DATA IS SURPRISING ON THE UPSIDE, IN CONTRAST TO THE US

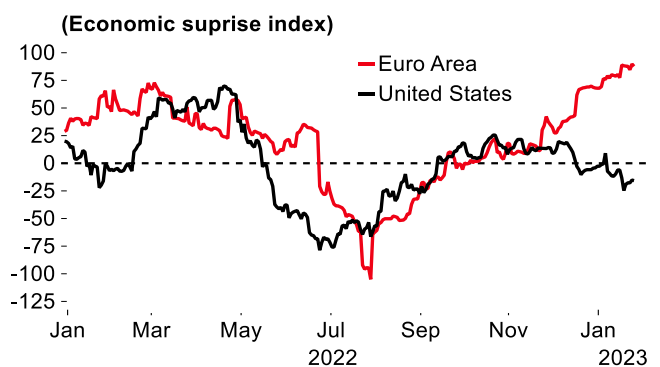


CHART 10: US RECESSION RISKS HAVE RISEN SHARPLY

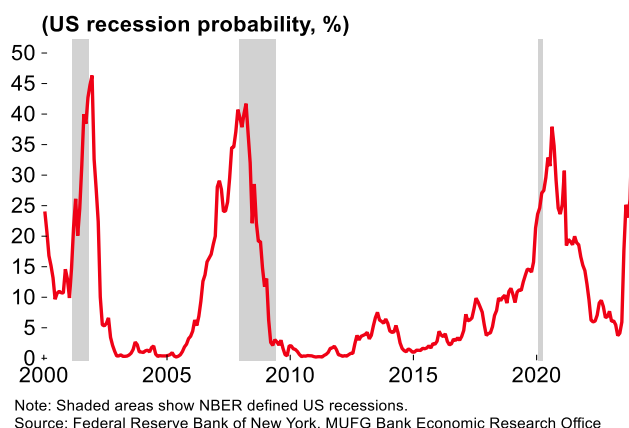


CHART 11: THE EUROPEAN TOURISM SECTOR COULD BENEFIT SIGNIFICANTLY FROM CHINA REOPENING

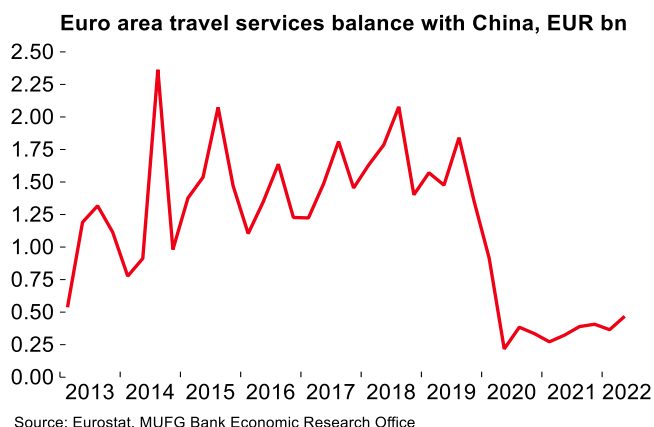
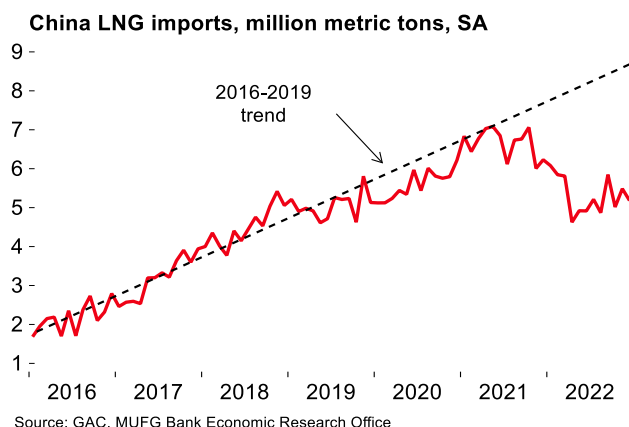


CHART 12: COMPETITION FOR LNG MAY SOON INCREASE



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