EUROPEAN ECONOMY ON THE RECOVERY PATH?

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Abstract: *The sharp rise in energy prices in 2022 brought the recovery from the pandemic to an abrupt end. Following a robust expansion in 2021, the global economy has entered a period of moderate growth, while the European economy is near-stagnation. After a sluggish period during this winter, the European economy and the economies in Central and Easter Europe are expected to gradually regain momentum during the upcoming year. The decline in inflation is boosting real incomes. As the labour markets are also robust, consumer confidence should improve and this should be reflected in rising consumer spending. However, demand aggregates that are sensitive to interest rates, will continue to be affected by the tighter financial conditions and may slowdown economic growth.*

Keywords: *economic growth, global economy, interest rates*

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1. Introduction

After a robust expansion in 2021, the global economy has entered a period of moderate growth, while the European economy is near-stagnation. The sharp rise in energy prices in 2022 brought the recovery from the pandemic to an abrupt end. The end of the corona-related catch-up

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effects, high inflation, rising interest rates as a result of the restrictive monetary policy and the unfavourable international environment, particularly in the eurozone, are weighing on the economies of Central and Eastern European countries. High inflation is dampening purchasing power. The industry is suffering from a lack of orders and high-cost pressure. The rise in interest rates and sharp price increases are having a negative impact on the construction sector, particularly residential construction. After a sharp slowdown in 2023, will the European economy gradually recover in 2024? This publication attempts to give an answer to this question. The second chapter focuses on the global economy, while the third chapter examines the latest economic developments in Central and Eastern Europe and Russia. The fourth chapter presents arguments in favour of an economic recovery despite the risks.

2. Global economic headwinds are slow to subside

In 2023, the global economy experienced only moderate growth. In the emerging markets, the economies were generally more robust than in the industrialized countries, but development was also mixed within the industrialized countries (Table 1). The economy in Europe and Japan was sluggish, whereas it was remarkably robust in the United States of America (USA), despite the substantial tightening of monetary policy. According to data from the Netherlands Bureau for Economic Policy Analysis (CPB), global industrial production increased by 0.9% in the third quarter compared to the previous quarter. This was probably primarily a countermovement to the 0.5% decline in the spring. Considering falling incoming orders and restrictive financing conditions, there is no sign of a sustained overcoming of the industrial weakness. Momentum in the services sector slowed and approached the weak development in industry. The catch-up effects in some service sectors, particularly tourism, following the end of the pandemic-related restrictions are coming to an end. In addition, the delayed effects of interest rate hikes are becoming obvious in consumer services.

Global trade in goods has now been declining for four quarters on a seasonally adjusted basis. On average, it was 3.3% lower in the first three quarters than in the same period of the previous year. It increased slightly in August and September, particularly in Asia and most recently also in North America. In contrast, trade in goods in Europe remained weak. The RWI/ISL Container Throughput Index indicates that container throughput has largely overcome the effects of the energy price shock. However, there are currently no signs of a significant revival in global trade (RWI 2023).

According to the International Monetary Fund (IMF 2023), the decline in global industrial production and global trade is attributed to the shift in consumption towards services following the end of the coronavirus pandemic, a decrease in demand owing to high inflation, tighter financing conditions, and a rise in protectionism.

The energy crisis of last year and its corresponding escalating rise in electricity and natural gas prices significantly impacted Europe more severely than the United States, which, as an exporter of energy commodities, was able to achieve significant gains in terms of trade. Since the beginning of the year, inflation continues to fall, but the disinflation process is quite slow.

In the group of OECD countries, consumer prices rose by 5.6% in October. A year ago, the inflation rate was still around five percentage points higher, but the decline in overall inflation has recently slowed. Disinflation differs significantly between the major economies. While consumer prices rose by 4.7% in the UK in October, the increase was 3.2% in the USA and 2.9% in the eurozone. In Japan, inflation rose to 3.3% in October after falling to 3.0% in September. In China, consumer prices have barely risen since April and have even fallen year-on-year in some months. In the OECD countries in particular, the core rate excluding energy and food is still very high at 6.5%. According to the IMF (2023), the passing on of higher energy prices has pushed up core inflation in the eurozone, while the high core inflation in the USA is the result of a tight labour market. The pressure on food prices has eased recently, but is still at a high level. By contrast, energy prices are having a strong negative impact on inflation, as energy prices rose sharply a year ago. However, this base effect will soon come to an end.

Although the price of crude oil has fallen recently, it remained nevertheless high by the end of November considering the weak economy and industrial sector. This was mainly due to the production cuts by Saudi Arabia and Russia. At the end of November, some OPEC+ countries announced that they would further reduce production and extend the cuts into the first quarter of 2024. By contrast, the terrorist attack in Israel and the subsequent war in the Middle East have not yet driven up the oil price, although the region is responsible for around one third of global oil production according to the U.S. Energy Information Administration (Deutsche Bundesbank 2023a). One explanation for this is the significant rise in the oil reserves in the United States.

The central banks of the major economies, which have raised key interest rates sharply since spring 2022 – albeit at different speeds and to different degrees – have not tightened monetary policy any further recently. In their communications, the US Federal Reserve and the European Central Bank (ECB), for example, have announced that they will leave interest rates at their current level for a longer period of time and decide on the next interest rate hikes or cuts depending on the data. We assume that the ECB will not raise key interest rates any further and will begin to cut rates in summer 2024.

3. Central and Eastern Europe: a heterogenuous picture

In 2023, the economic development in the Central and Eastern European countries was uneven. In Poland, despite a sluggish first half-year, the economy rebounded in the third quarter, owing to a resurgence in private consumption and robust investments. In Hungary and the Czech Republic, on the other hand, economic development remained negative throughout the year due to a sharp decline in private consumption as a result of falling real incomes. In the Czech Republic, the reduction in inventories had additionally a negative impact on economic growth. In Croatia, Romania and Bulgaria, a moderate expansion in economic output continued during the whole year. In these countries, both private and public consumption were important growth drivers. Supported by funds from the European Union (EU), investments bolstered the economy almost everywhere. In Hungary, however, investment fell sharply as most government infrastructure projects were cancelled due to the urgent need to consolidate the budget. As imports declined, net exports made a positive contribution to gross domestic product (GDP) growth almost everywhere.

Inflation followed the downward trend of global food and energy prices and weakened continuously over the course of the year. Prices for services, on the other hand, fell only slightly. Inflation rates therefore reached single-digit levels in all countries in the region in October. However, rates remained well above the level in the eurozone. Inflation rates fell the most in Bulgaria and Poland, at 5.9% and 6.3% in October respectively. Due to the base effect, the slowdown in inflation is expected to continue in the coming months. Nevertheless, the increase in the administrative component of the electricity price announced in some countries and the strong growth in pensions and wages, including a sharp rise in minimum wages, are fuelling inflation. Inflation in many countries in the region is therefore expected to remain above the central banks' targets in the coming year.

Key interest rates were raised sharply over the course of the year to combat inflation. As inflation has weakened, some central banks have already begun to ease their monetary policy. Beginning in May, the Hungarian central bank cut the key interest rate a few times. Poland's central bank followed suit with interest rate cuts in September and October. In the Czech Republic and Romania, interest rate cuts are not expected until the course of next year.

Unemployment remains low as the labour market is tight everywhere. The lowest unemployment rates in October were recorded in Poland and the Czech Republic at 2.7% and 2.9% respectively, while Croatia had the highest at 6.5%.

To mitigate the effects of high inflation on private households and companies, the countries took numerous support measures in 2022. Many of these measures also had an impact in 2023 and are currently reflected in high budget deficits. The necessary budget consolidation measures may have a negative impact on economic growth in all countries in the region in the coming years.

It is to be expected that GDP in the Central and Eastern European countries will only expand slowly in the winter months. Weaker growth in the eurozone, particularly in Germany, is clouding the outlook for goods exports. In addition, higher interest rates are making loans for private households and companies more expensive. As inflationary pressure eases, real incomes rise and monetary policy is loosened, private consumption should pick up in the coming year. However, the continuing high cost of living and the high level of uncertainty could slow down the pace of recovery.

Investment growth is being fuelled by the continued inflow of EU funds, with the co-financing of investments by the “Next Generation EU” (NGEU) recovery plan being of particular importance. The additional inclusion of the REPowerEU chapter increases the funds available. These can compensate for the lower investment activity when switching to EU funding from in the current 2021 to 2027 budget period. In Poland and Hungary, the implementation of reforms in the area of the rule of law should facilitate access to EU funds. At the beginning of the forecast period, net exports will not make a significant positive contribution to gross domestic product, as exports are expected to be weak while import growth recovers.

In Russia, overall economic activity expanded in the first half of 2023 and the positive trend continued in the third quarter according to preliminary indicators. As a result, gross domestic product returned to its level before the invasion of Ukraine. A stronger than expected increase in government spending supported private consumption and investment. Real wages and social benefits, as well as consumer credit rose sharply. Investments increased considerably in connection with the rise in military spending and publicly subsidized projects.

Due to sanctions evasion and a sharp increase in Russian trade volumes with countries such as China, India and Turkey, production and exports of crude oil and oil products have almost returned to pre-war levels. However, gas production has suffered greatly due to lower exports of pipeline gas to Europe. To counteract the circumvention of sanctions, the EU Commission decided to tighten the conditions for Russian oil exports to third countries by the end of 2023. As many workers have been mobilized into the army or left the country to avoid military service since the start of the war, the labour market is increasingly facing bottlenecks. Unemployment reached a very low level of 2.9% in October. Furthermore, the robust rise in demand has resulted in the full utilization of capacity across numerous industries.

The strong production increase and the significant devaluation of the rouble have contributed to a renewed rise in inflation, which climbed to 6.7% in October. Due to a high government budget deficit and a drastic decline in the current account surplus, the rouble has lost around a third of its value against the US dollar and the euro since the beginning of the year. To counter this, the central bank has raised the key interest rate sharply, most recently in October to 15%. However, this is likely to slow down the growth rate of lending in the coming months. As the long-term economic consequences of the brain drain and the Western ban on high-tech exports are hampering Russia's longer-term growth prospects, the opportunities for a significant expansion of the Russian economy are limited (IHS 2023). Thanks to a robust performance in the first half of the year, the economy should grow moderately in 2023. After a drop last year, economic output in Russia could increase by 2.0% in 2023 and continue to rise in the next two years (Table 1). Forecasts for the Russian economy are subject to high uncertainty. Possible changes in the course of the war could have a significant impact on economic development in Russia.

4. Conclusions

After a sluggish period during the winter of 2023/2024, the economy in Europe is expected to gradually regain momentum during the upcoming year. The decline in inflation is boosting real incomes. As the labour markets are also robust, consumer confidence should improve and this should be reflected in rising consumer spending. On the other hand, demand aggregates that are sensitive to interest rates, such as residential construction, will continue to be affected by the tighter financial conditions. In addition, interest rate increases will hit those economies particularly hard in which companies primarily rely on bank loans and less on financial market financing (OECD 2023). This is one reason why economic growth in the EU is likely to be weaker than in the US in the forecast period.

This explains why global expansion this year and in the coming years is likely to be below the long-term average. With the robust economy in the United States and the revival in the EU, it is likely that the economy in the industrialized countries will return to the previous trend soon. In contrast, structural challenges are slowing growth in the emerging markets. In China, trend growth is slowing due to the problems in the property market and the high indebtedness of general governments. This is reducing the Chinese demand for commodities, which in turn is having a negative impact on commodity-exporting emerging economies (Deutsche Bundesbank 2023b). Furthermore, protectionist policies have intensified in recent times, stifling global commerce in merchandise and affecting the emerging economies that previously benefited greatly from the globalization process and integration into global supply chains.

However, the economy would develop weaker than assumed here if the conflict in the Middle East were to spread. If Iran or other oil-producing countries were involved, this would likely drive up the oil price. The price of gas could rise, especially in Europe, if gas supplies from Russia were to stop completely. Rising energy prices again would delay the disinflation process and thus interest rate cuts.

Further increases in interest rates could lead to a revaluation of assets. Falling asset prices could cause problems for banks. In addition, higher interest rates in industrialized countries could lead to capital outflows from emerging markets and increase inflation there. As a result of interest rate hikes, public debt servicing will also increase, which will primarily affect countries with high levels of foreign currency debt, which could have a greater negative impact on the economy than assumed here.

The high level of geopolitical uncertainty could affect companies' willingness to invest. In addition, further protectionist trade practices or efforts to shorten global supply chains would burden global trade and reduce specialization advantages. A stronger slowdown in growth in China would hit the global economy primarily via the trade channel.

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Table 1

GDP of major economies and Central and Eastern European countries, precentage change over previous year

	2020	2021	2022	2023*	2024*
Germany	−3,8	3,2	1,8	−0,6	1,1
Italy	−9,0	8,3	3,7	0,7	0,8
France	−7,5	6,4	2,5	0,8	1,2
United Kingdom	−10,4	8,7	4,3	0,3	0,8
Switzerland	−2,1	5,4	2,6	0,8	1,7
USA	−2,8	5,9	2,1	2,0	1,3
Japan	−4,2	2,2	1,0	1,8	1,0
China	2,2	8,4	3,0	5,0	4,6
Poland	−2,0	6,9	5,1	0,3	2,5
Slovakia	−3,3	4,9	1,7	1,0	1,8
Czechia	−5,5	3,6	2,4	−0,4	1,3
Hungary	−4,5	7,2	4,6	−0,8	2,5
Slovenia	−4,2	8,2	2,5	1,6	2,3
Bulgaria	−4,0	7,6	3,4	1,8	2,5
Romania	−3,7	5,8	4,7	2,0	3,3
Croatia	−8,5	13,1	6,2	2,6	2,5
Russia	−2,7	5,6	−2,1	2,0	1,0
Eurozone	−6,1	5,6	3,3	0,4	1,3
CEEC-5**	−3,3	6,2	4,4	0,4	2,5
EU-27	−5,6	5,7	3,4	0,4	1,4
OECD	−4,4	5,7	3,0	1,4	1,6
World	−3,1	6,1	3,3	2,7	2,8

Source: Institute for Advanced Studies, Herbst-Prognose der österreichischen Wirtschaft, October 2023.
**Forecast for 2023 and 2024. **CEEC-5: Poland, Czechia, Hungary, Bulgaria, Romania.*