Europe Bends (2022), A Tightrope Walk (2023)

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For the final edition of our Essential Economics newsletter this year, we asked each of our chief economists to share their insights about following questions:

- What was the biggest surprise for you in 2022 and what are the takeaways?
- What will you be watching most closely in 2023, and why?

Here are the answers to those questions from our EMEA Chief Economist.

2022: The European economy is bending, not breaking

Against many odds, Europe's economy has surprised by its strength this year. Realized GDP growth (3.3%) so far this year is just moderately lower than our forecast of 4.4% made a year ago when the economy was supposed to rebound from pandemic lockdowns. We could not have predicted that a geopolitical shock would send Europe's energy bill soaring 4 percentage points of GDP.

In other words, Europe would have boomed this year--if not for the Russia-Ukraine war. What's more, the Continent's resilience is also striking compared with peers. The U.S. economy grew less (1.8%), despite greater distance from the geopolitical earthquake and relative immunity against rising energy and food prices.

Takeaways. How to explain the ruggedness of the European economy so far? Let's start to make a list of supporting factors: A catchup in consumption after the lockdowns. A rebound in production as supply chain bottlenecks eased. A strengthening of the labor market even as economic growth moderated. A relatively late start to hike rates by the European Central Bank. And let's not forget Europe's united front in handling the energy crisis, which helped avoid the dire risk of gas rationing this winter.

Next year might be another matter. That's because the European economy hasn't completely adjusted to the shock this year--especially corporate margins. We'll see evidence of that in 2023, a year when we expect the European economy to stagnate and the hiring cycle to turn.

2023: The fiscal and monetary tightrope

Next year is likely to be shaped by sticky inflation and developments in the Russia-Ukraine war, plus a possible reversal of the supporting factors we mentioned above. Above and beyond that, what will draw most of our attention is macroeconomic policy.

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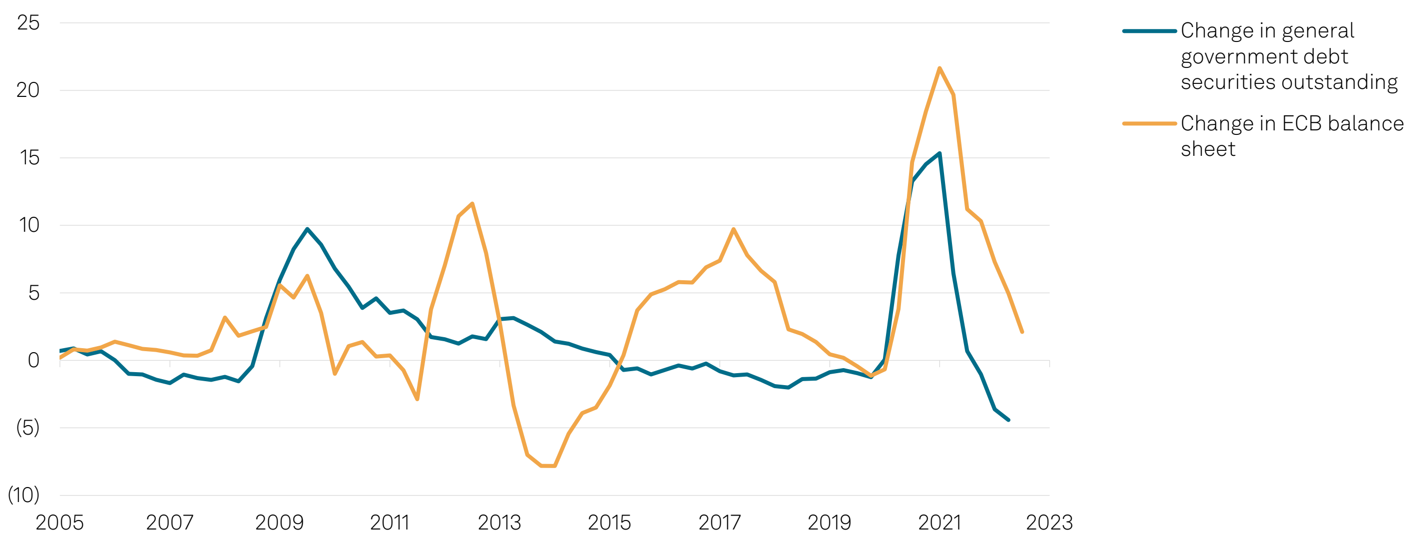
What to watch. Since the beginning of the pandemic, fiscal and monetary policies in the eurozone have never been better coordinated (see chart). Can that last? That's far from certain. Monetary policy will turn restrictive in 2023. The ECB is likely to raise rates until February or March next year, to bring the deposit rate above the neutral rate at 2.25%-2.5% and start reducing its bondholdings. Almost €300 billion of bonds will mature under the ECB's asset purchase program (APP) portfolio next year, and markets do not expect the ECB to reinvest them in full. Signs are that it will do so with care, but the risk of withdrawing liquidity too quickly should not be overlooked. At the same time, fiscal policy will remain accommodative, according to the latest IMF Fiscal Monitor, and European governments will have to agree on new budget rules. Whether the new fiscal rules might be tighter and more credible than the previous ones or not, might also shape market sentiment in 2023.

Events in the U.K. showed how an imbalance between fiscal and monetary policy can upset bond markets and tighten financing conditions. Europe will have to avoid this pitfall in 2023.

Chart

Fiscal and monetary policies have been well coordinated in the eurozone since the pandemic. Can that last?

Percentage of GDP (%)



Sources: ECB, S&P Global Ratings Economics.