

European Economic Outlook (*Abridged Version*)

EY Economic Analysis Team

October 2024



Marek Rozkrut
EY Chief Economist - Europe & Central Asia
Head of EY EMEA Economists Unit



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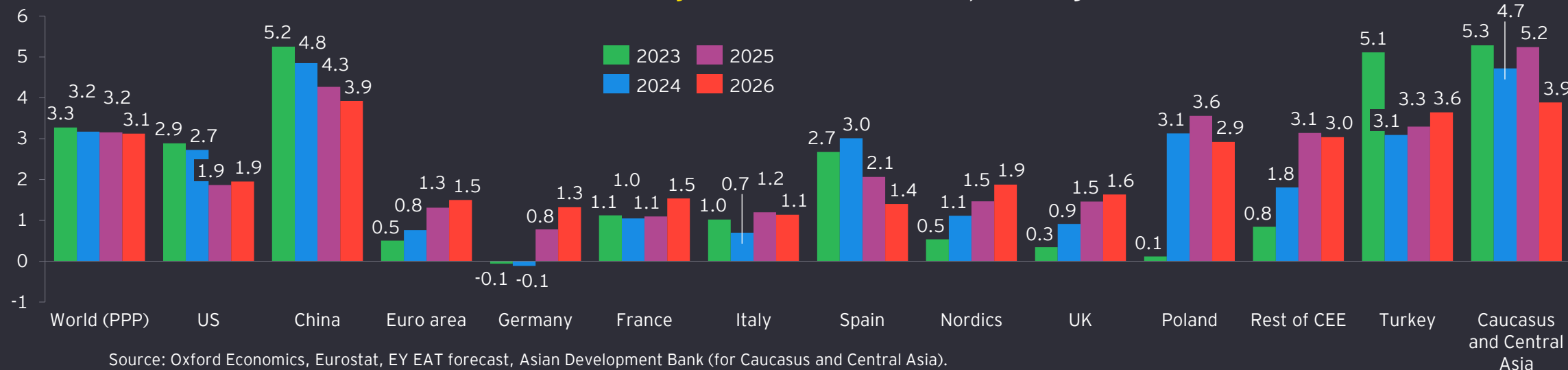
The European economy is recovering at a modest pace, with Southern Europe and CEE showing positive trends, while Germany and the Nordics lag behind

- ▶ **The euro area economy has been expanding at a modest rate of 0.2-0.3% q/q so far in 2024, primarily driven by a recovery in external demand and exports.** Despite rising real incomes, consumer spending has been increasing sluggishly, while firms have become more reluctant to invest amid decreasing profit margins and capacity utilization, elevated real interest rates, and negative business sentiment.
- ▶ **Sectoral economic performance is mixed, with the services sector outperforming much of manufacturing.** Tourism, especially in Southern Europe, and activities in ICT and professional services are on the rise. The pharmaceutical sector has returned to growth, but other manufacturing areas face challenges-activity in energy-intensive industries has stabilized at a low level, while sectors related to housing and investment (furniture, domestic appliances, machinery), as well as the automotive industry are in a recession.
- ▶ **Growth rates across Europe show significant variation,** with Southern, Central and Eastern Europe maintaining relative strength. In contrast, Germany, its neighboring countries (Austria, Netherlands), and the Nordic economies continue to stagnate. **This disparity in growth is influenced by differences in sectoral structure, fiscal and monetary policies, housing market dynamics, and potential growth rates.** Southern Europe enjoys the benefits of a robust tourism industry, while Central and Eastern Europe's (CEE) vigorous performance is largely due to continued convergence with Western Europe, additionally supported by fiscal expansion and monetary stimulus in certain countries. Denmark and Switzerland are leveraging their dynamic pharmaceutical sectors to surpass their neighbors. Conversely, the Nordic countries are contending with the repercussions of significant housing market contractions.
- ▶ **The labor market,** which previously outperformed during the Covid-19 pandemic and the energy crisis, **has seen a softening trend in recent quarters, despite modest GDP growth improvements.** Employment expansion is decelerating-we estimate a 0.1% q/q increase in euro area employment for 2024 Q3, the slowest pace since 2015 Q1, excluding the pandemic period. This deceleration is due to both a slowing demand for labor, as evidenced by falling vacancy rates, and declining labor supply growth, exacerbated by lower immigration inflows and intensifying demographic pressures. Consequently, the unemployment rate in the euro area has stabilized close to 6.5%, although there are notable disparities between countries: while unemployment continued to fall in the South (Italy, Spain, Greece), it increased in the Nordics. The labor market's cooling and the decline in inflation have led to a gradual slowdown in nominal wage growth, which fell in the euro area from close to 6% in early 2023 to 4.4% in 2024 Q2. Wage growth continues to diverge across countries, with a significantly higher pace observed in CEE on the back of tighter labor market conditions as well as higher inflation and productivity growth.

We anticipate a slight acceleration in growth in the upcoming quarters, with growth becoming more uniform between Southern and Northern Europe, while CEE will continue to outperform the West

- ▶ **From 2025, we expect a marginal acceleration in the euro area's GDP growth towards 0.3-0.4% q/q, driven by an increase in consumption growth and a revival in investment, despite the tightening of fiscal policies.** The recovery in real incomes is anticipated to eventually translate into more robust consumer spending, even if wage growth experiences a slight deceleration. Monetary policy easing will support this uptick in consumption by encouraging a reduction in savings rates. Lower interest rates and stronger consumer demand should bolster investment, particularly in the housing sector. However, the recovery in investment is likely to be relatively slow, as the economy continues to operate slightly below its full capacity, lessening the urgency for investment. Fiscal policy tightening, aimed at reducing fiscal deficits, will also act as a break on growth. Consequently, **we forecast a modest increase in the euro area GDP growth, from 0.8% in 2024 to 1.3% in 2025, and 1.5% in 2026.**
- ▶ **CEE countries are expected to lead the way in GDP growth in 2025, with projections ranging from 2.5% to 4.0%** as still-strong nominal wage growth amid sub-5% inflation continues to drive consumption, absorption of EU funding and monetary policy easing support investment, and the recovery in Western Europe aids exports. **For the rest of Europe, we anticipate GDP growth to gradually converge towards 1-2% over 2025 and 2026.** In the South, the momentum from tourism, public investment, and employment is expected to wane gradually, while Germany and Northern Europe are likely to see a steady recovery in consumption and investment.
- ▶ Facing mounting demographic pressures, we forecast the euro area to see employment growth limited to around 0.1% q/q. However, such growth should be sufficient to achieve a modest reduction in the unemployment rate, which is expected to approach 6% by 2027. Nominal wage growth is anticipated to continue its gradual decline in the upcoming quarters before stabilizing at 3% y/y, which is higher than pre-pandemic levels due to structurally tighter labor market conditions. We expect wage growth to remain higher in CEE, although it should gradually decrease to around 5-7% in most countries.

Real GDP growth in 2023-2026 (in percentage)



Source: Oxford Economics, Eurostat, EY EAT forecast, Asian Development Bank (for Caucasus and Central Asia).

Nordics include Denmark, Finland, Norway and Sweden; rest of CEE includes Estonia, Latvia, Lithuania, Czechia, Slovakia, Hungary, Romania, Bulgaria, Croatia, Slovenia; Caucasus and Central Asia includes Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan, Tajikistan, Azerbaijan, Armenia and Georgia.

Inflation in the euro area has temporarily dipped below the 2% target. Price pressures are set to remain elevated in CEE, whereas the Nordics are expected to experience the lowest inflation rates in 2025

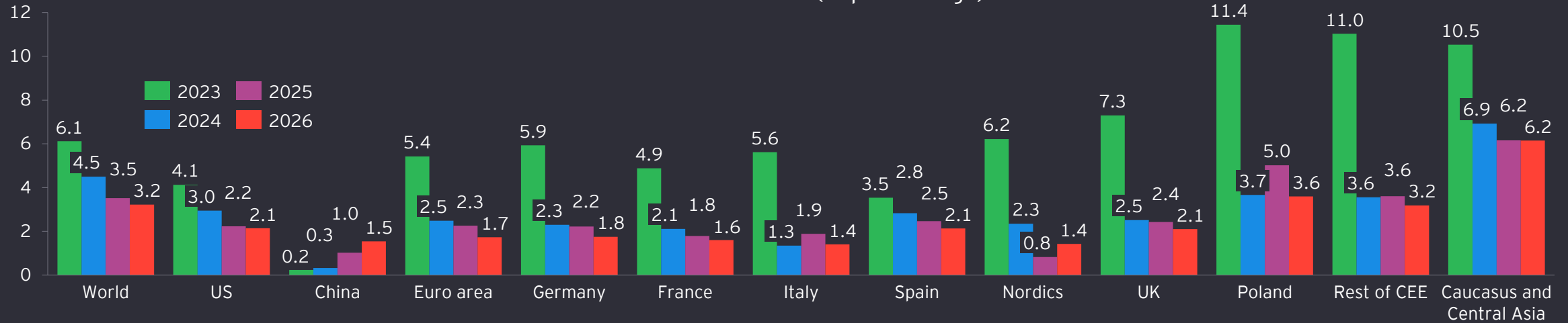
- ▶ **Euro area inflation fell below 2%, but underlying price pressures remained persistent.** After fluctuating around 2.5%, headline inflation in the euro area fell to 1.7% in September, primarily due to a drop in energy inflation caused by lower oil prices and base effects. However, price pressures in other areas have stabilized: services inflation remains close to 4%, driven by elevated wage growth, food inflation fluctuates around 2.5%, and core goods inflation stays close to 0.5%, as disinflationary trends in the goods markets (falling commodity prices, normalizing supply conditions) have largely dissipated. Core inflation, excluding food and energy, has settled just below 3% (2.7% in September).
- ▶ The impact of energy prices on inflation is expected to diminish quickly, as favorable base effects are excluded from the calculation, bringing inflation back above the ECB's 2% target. We project services inflation to remain around 4% until the end of 2024 before gradually decreasing towards 3% over the course of 2025 and 2026 as nominal wage growth slows. Core goods inflation is expected to gradually rise above 1% as increased shipping and wage costs put an upward pressure on prices. As a result, core inflation is likely to stabilize around 2.5% in 2025 before decreasing to closer to 2% in 2026. We expect food inflation to remain around 2.5% in 2025 due to tax hikes and labor cost pressures, before dropping to 2% from 2026 onward, while energy inflation will hover near 0%. Overall, **headline inflation is expected to remain slightly above the target in 2025, averaging 2.3%, before falling slightly below the target in subsequent years, averaging 1.7% in 2026 and 1.8% in 2027.**
- ▶ **Although the degree of divergence has lessened as inflation has declined, price growth continues to vary across Europe due to differences in wage growth and price regulation.** HICP inflation continues to be the highest in Romania (4.8% in September 2024), where 15% nominal wage growth and strong domestic demand keep core inflation above 6%. Other CEE countries, such as Hungary, Croatia, Slovakia, and Poland, also experience strong price pressures, particularly in services, due to wage growth exceeding 10%. However, declining energy prices have brought headline inflation below 3.5% in most of these countries. On the other end of the spectrum, headline inflation has fallen below 1% in Ireland, Italy, and Switzerland, with core inflation also dropping below 2%.
- ▶ **Moving forward, CEE countries are expected to have the highest inflation rates, while the Nordics and Switzerland should experience the least price pressure.** In 2025, we project Poland to exhibit the highest inflation in the EU, averaging 5%, as energy prices are deregulated, and core and food price pressures remain elevated due to strong wage growth and demand. Inflation in Hungary, Romania, and Slovakia is expected to exceed 4% for similar reasons. CPI inflation should be lowest in Sweden and Finland, at approximately 0.5%, due to methodological factors—mortgage interest payments are included in the CPI calculation in these countries, and thus, central bank interest rate cuts will significantly reduce inflation. Price growth is also expected to drop below 1% in Denmark, where core inflation has been particularly low, and remain below 1% in Switzerland.

Monetary policy easing across Europe has accelerated following a decline in economic sentiment and the Fed's 50 bp rate cut

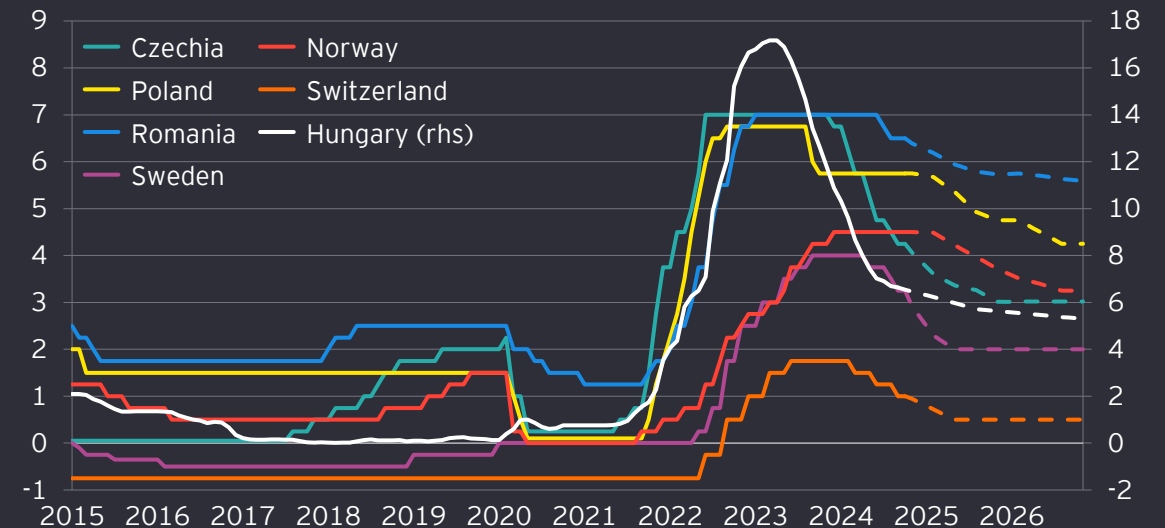
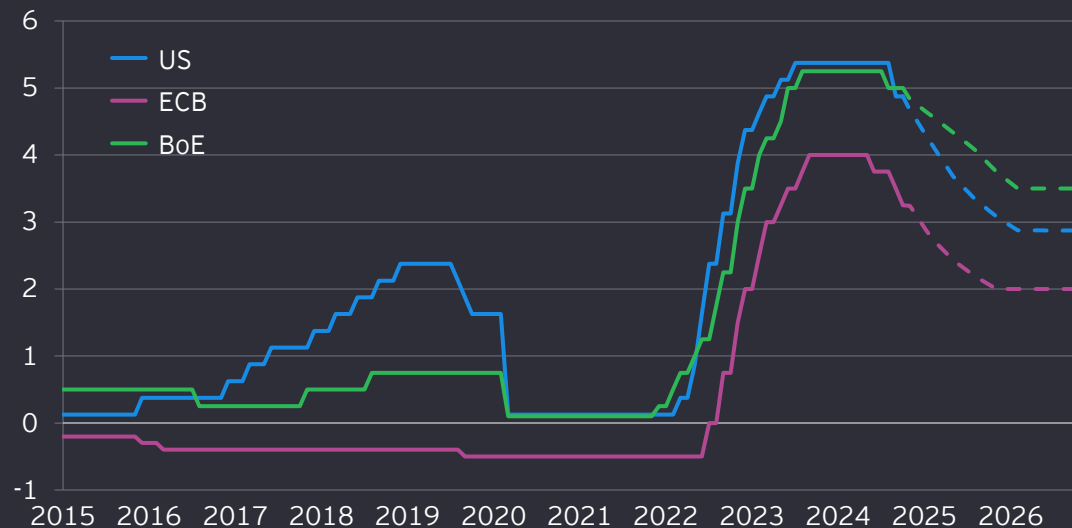
- ▶ With lower inflation than in previous years and relatively subdued economic activity across most of Europe, central banks have been reducing interest rates, although the pace and timing of easing vary significantly across jurisdictions.
 - ▶ The ECB began a gradual easing cycle by cutting rates by 25 basis points at every other meeting in June and September, balancing sluggish growth and near-target headline inflation against elevated wage growth and services inflation. However, after a more aggressive 50 bp cut by the Fed and worsening economic sentiment indicators, the ECB has accelerated the pace of easing with an additional rate reduction in October. We expect three more consecutive 25 bp cuts by March 2025, as growth falls below the ECB's previous projections and the balance of risks to growth remains tilted to the downside, while the risks to inflation seem to have shifted towards lower price growth. Given that inflation is forecast to remain slightly above the target and growth is expected to pick up gradually, the ECB is likely to slow the pace of easing afterward, with two more rate decreases in June and September, leaving the deposit rate at 2%. Risks lean towards a faster pace of easing and a lower terminal rate if growth continues to disappoint, and inflation turns out lower than expected.
 - ▶ The Bank of England is expected to take a more cautious approach, continuing to ease monetary policy at every other meeting after cutting rates from 5.25% to 5.0% in August, as it faces higher wage growth and services inflation amid a stronger economic recovery. We expect the terminal rate of 3.5% to be reached by the end of 2025.
 - ▶ The Swedish Riksbank is reducing rates most aggressively among advanced economies, given rapidly declining inflation and stagnant economic activity. After beginning the easing cycle in May, it is set to implement a significant 50 bp cut in November and reach the terminal rate of 2% by March 2025. Norges Bank is more cautious, with the first rate reduction expected in March 2025, followed by rate decreases at every other meeting.
 - ▶ While the pace and timing of easing differ significantly across CEE, all central banks are expected to cut rates by additional 100-150 bps by 2026. Central banks in Czechia and Hungary have been aggressively easing monetary policy since 2023 and are approaching the end of their cycles. Due to stronger price pressures, the terminal rate in Hungary (5.25%) is projected to be much higher than in Czechia (3%). On the other end, Romania began easing in July and is forecast to cut rates gradually before reaching 5.5% due to elevated inflation. Finally, Poland's central bank has paused since late 2023 and signals that the easing cycle will restart in March 2025. We expect rates to stop at 4.25% in 2026, above the neutral rate due to strong economic activity.

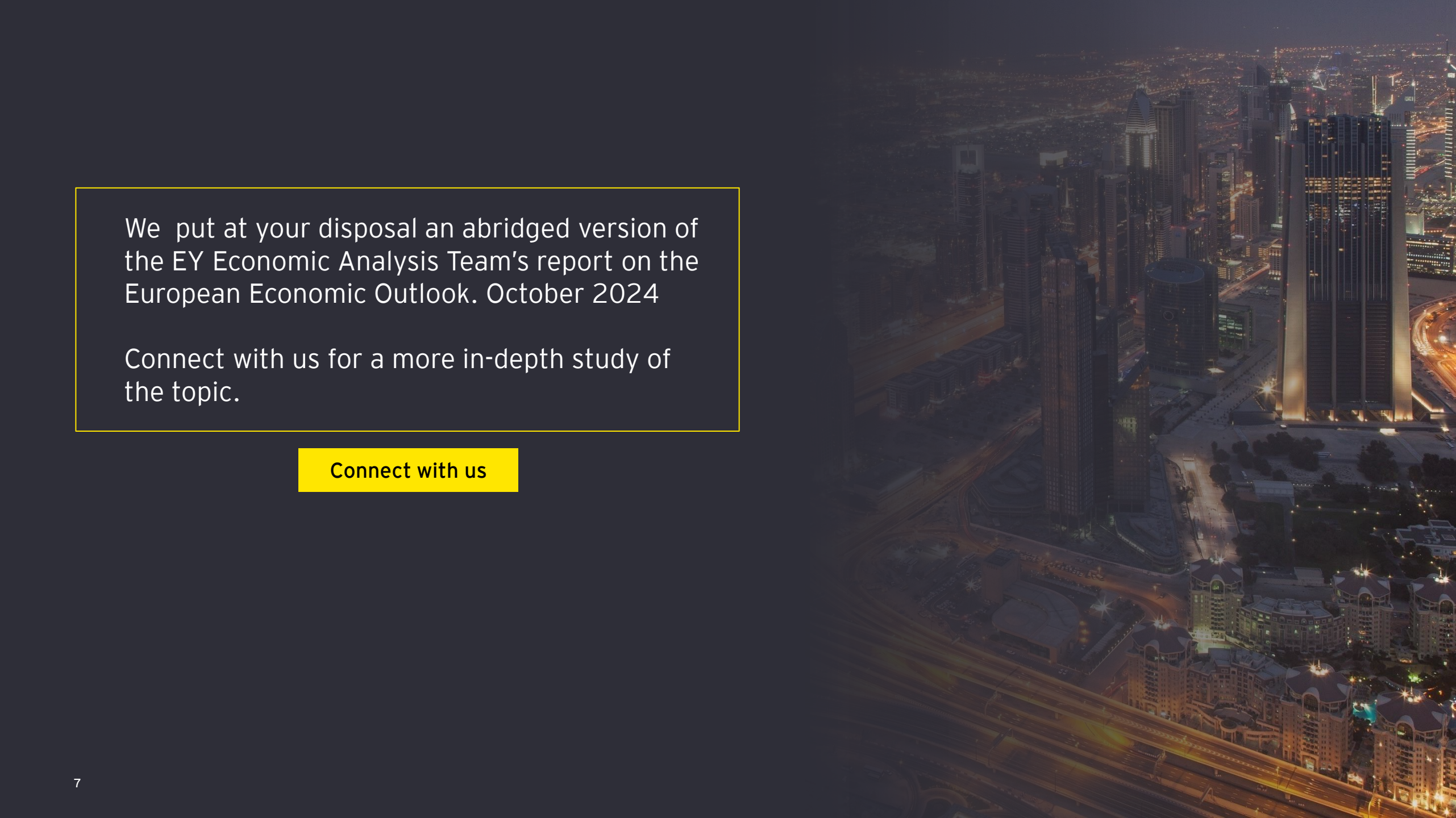
Inflation and interest rate forecasts

Inflation in 2023-2026 (in percentage)



Central bank interest rates (In percentage)





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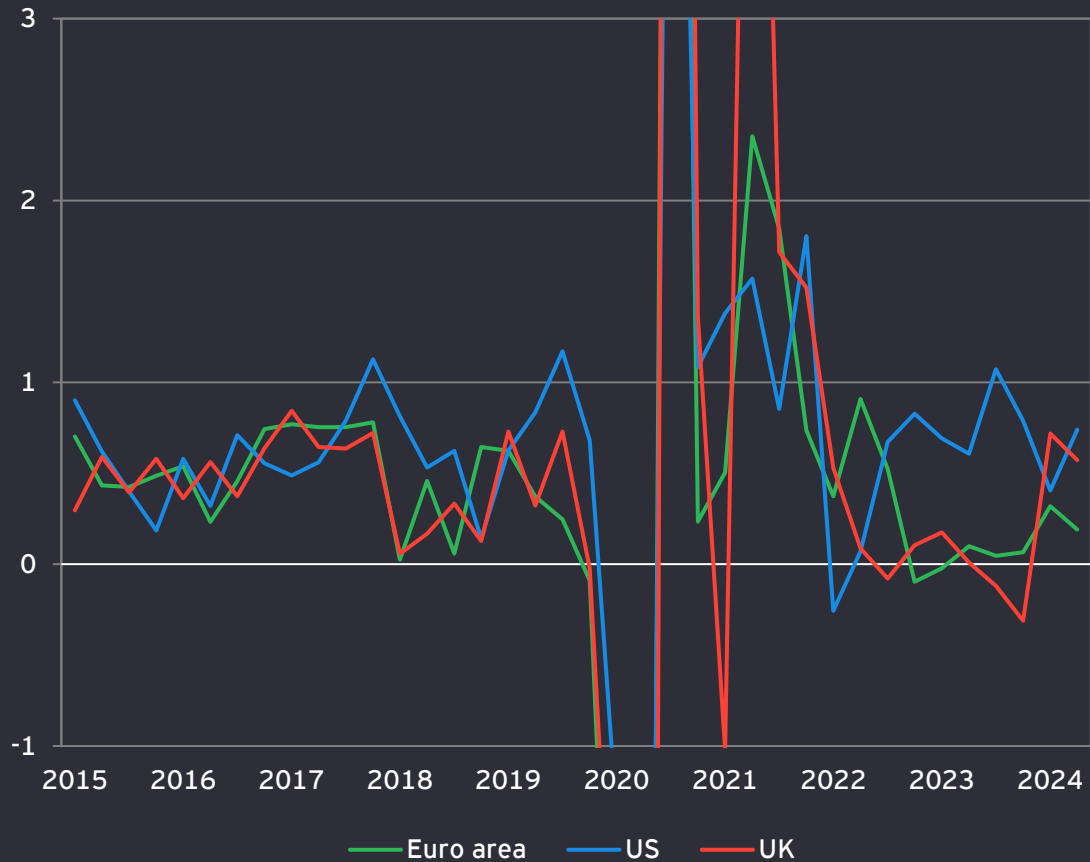
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Economic Growth

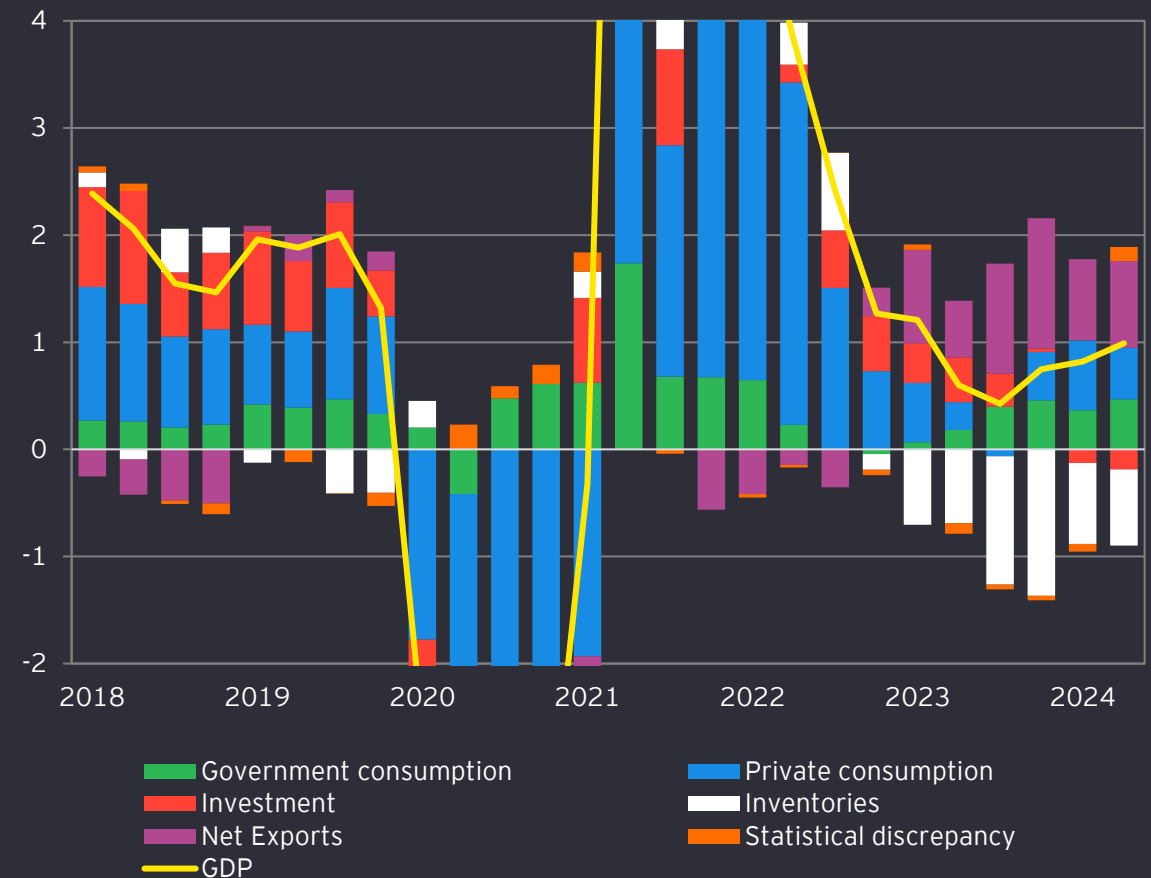
In 2024H1, the euro area's economy grew at a modest 0.2-0.3% quarterly rate, indicating a gradual recovery from 2023's stagnation and remaining notably lower than US growth rates

- Euro area GDP growth has been driven by export rebound. Consumption continues to grow modestly, government consumption supports growth, but investment falls and inventory reduction persists

Q/q real GDP growth (in percentage, seasonally adjusted)



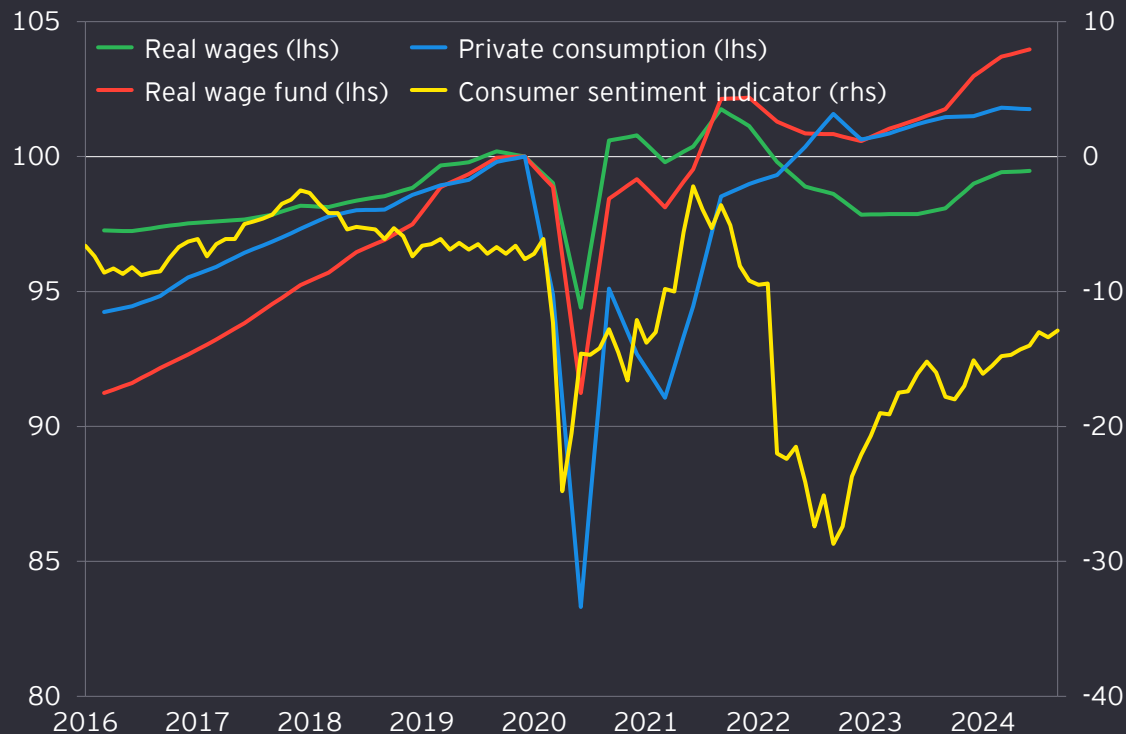
Decomposition of y/y GDP growth in the euro area less Ireland (in percentage)



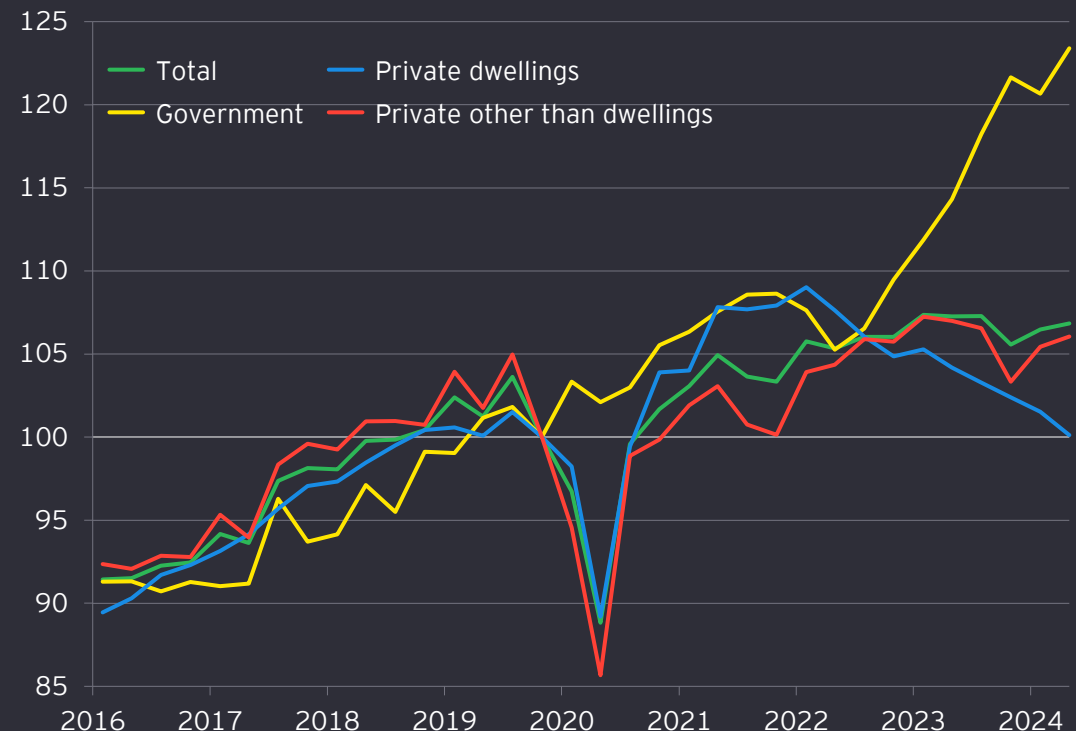
Real incomes rise substantially, yet consumption growth remains meager. Investment has shown resilience throughout the energy crisis but recently exhibits a slight downturn

- ▶ Consumer pessimism and elevated interest rates only partially explain this underperformance, suggesting that the current weakness in consumption is likely temporary
- ▶ Housing investment continues to decline due to elevated interest rates. Non-residential private investment additionally faces pressure from diminishing profits, reduced capacity utilization, negative business sentiment, and subdued external demand, beyond the impact of high interest rates.
- ▶ Conversely, government investment has experienced a rapid uptick, bolstered by NextGenEU-related expenditures.

Real wages, real wage fund, consumer sentiment and real private consumption in the euro area (2019 Q4 = 100)



Real fixed capital investment by type in the euro area less Ireland* (2019 Q4 = 100)

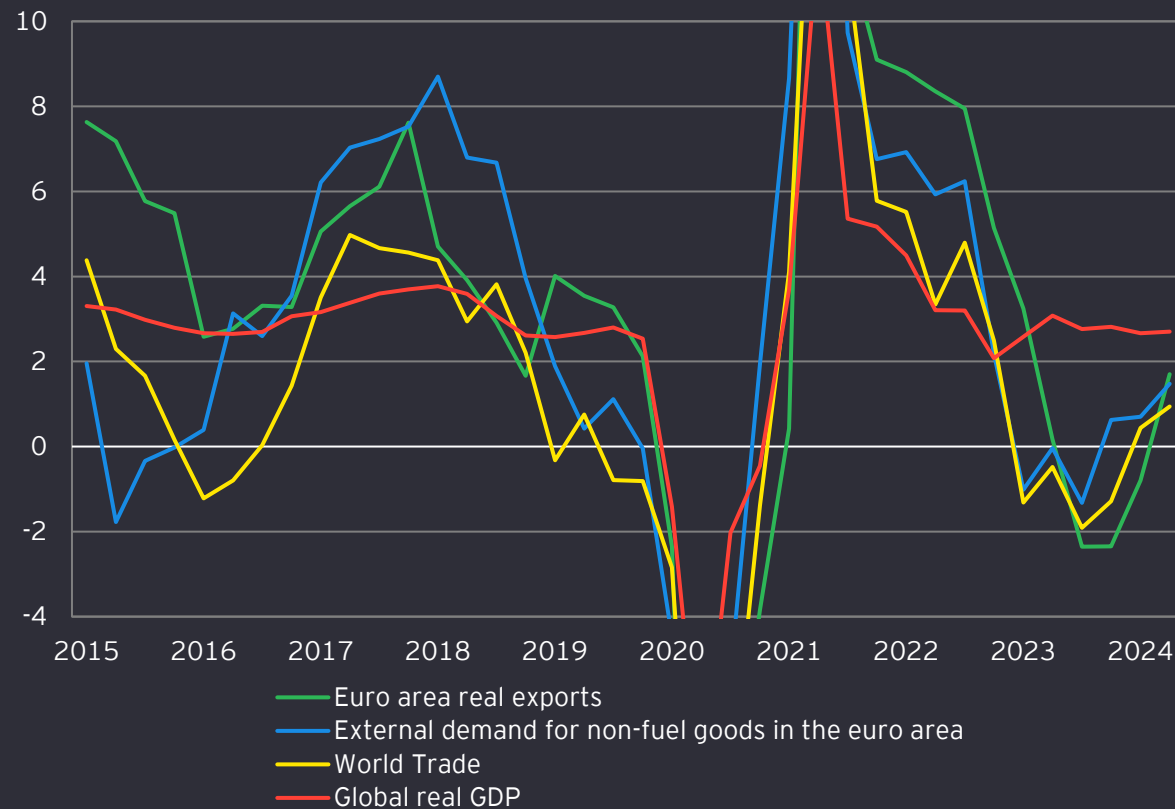


Source: Eurostat, Oxford Economics.

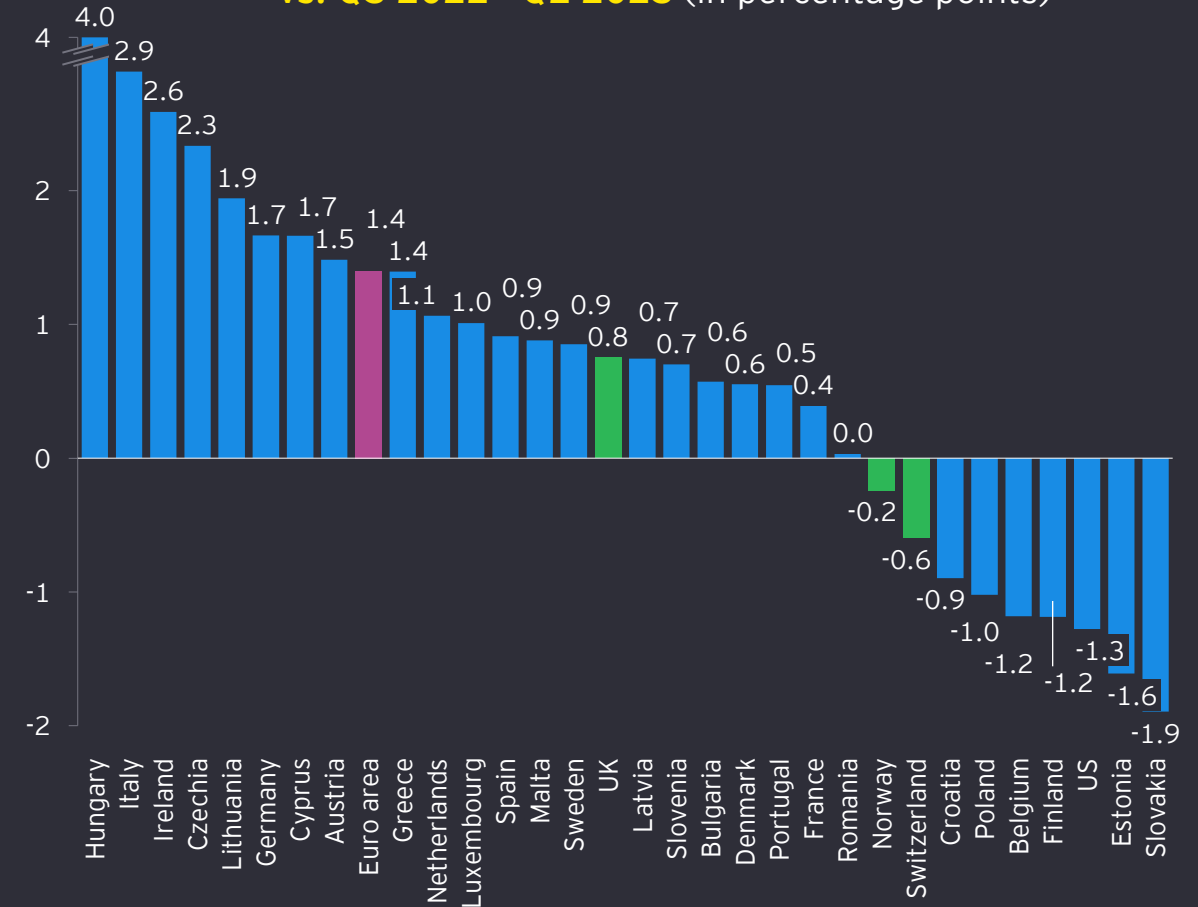
* Investment in Ireland excluded since it is very volatile, heavily distorted by activities of multinational corporations and does not appropriately reflect the underlying investment activity in the Irish economy.

Exports are experiencing a modest rebound, coinciding with a slight recovery in global trade. While government consumption and investment continue to contribute positively to growth, broader fiscal policy is constraining activity

Global real GDP, world trade, external demand for non-fuel goods in the euro area* and euro area real exports
(y/y, in percentage)



Change in structural balance to GDP: Q3 2023 - Q2 2024 vs. Q3 2022 - Q2 2023 (in percentage points)

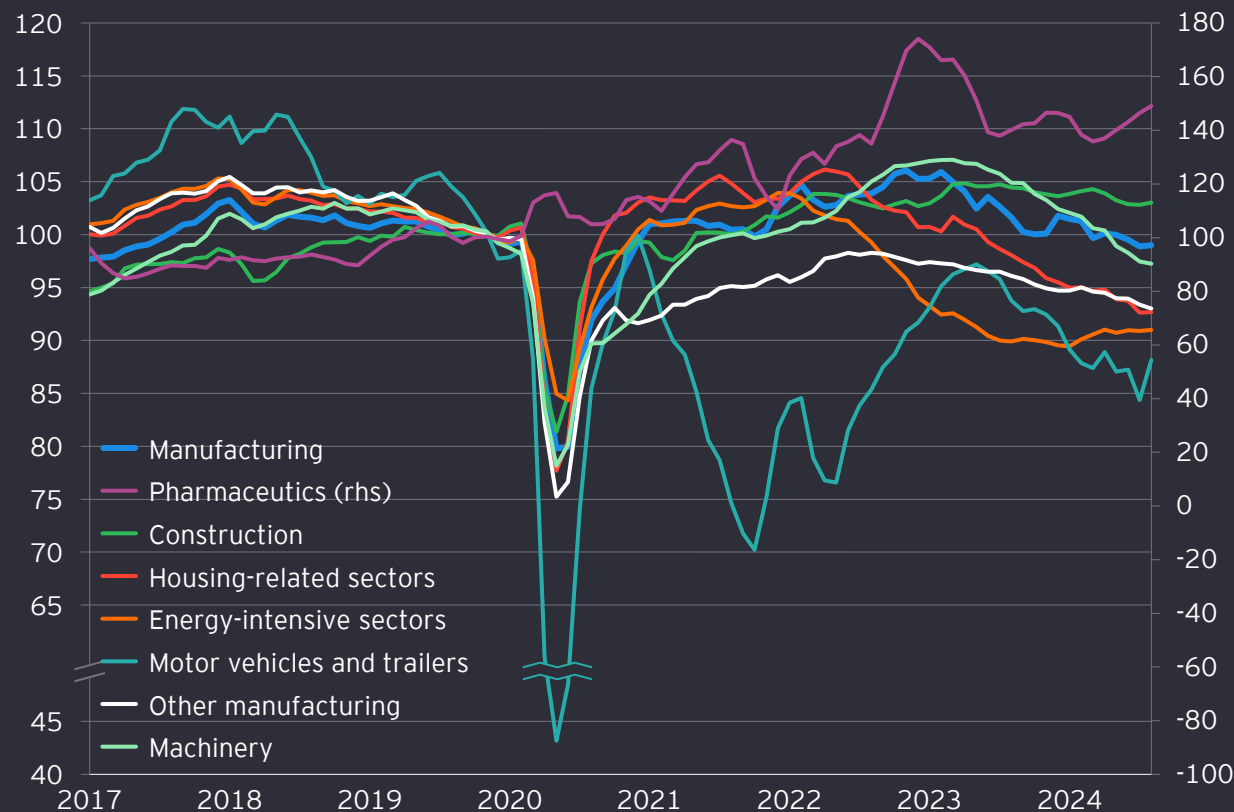


Manufacturing activity continues to contract, especially in sectors related to housing and investment. In contrast, activity in services has continued to grow, particularly in ICT and professional services

- ▶ The contraction in manufacturing is due to a mix of factors: relatively weak—albeit slightly improving—external demand, sluggish domestic demand, an inventory downturn, and high interest rates
- ▶ The pharmaceutical sector has emerged as a standout performer, returning to growth in recent months after a period of normalization in 2023.
- ▶ The tourism sector continues to grow, particularly in international travel.

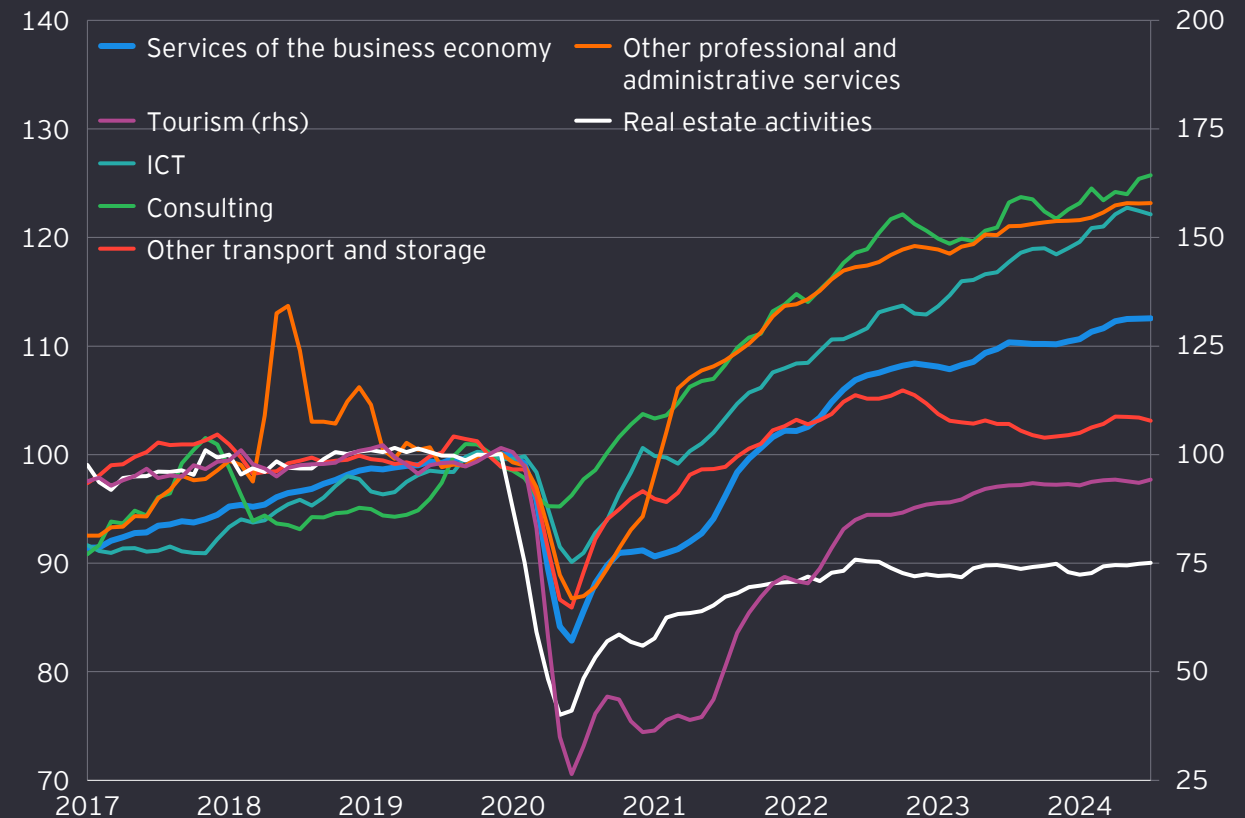
Manufacturing production in the euro area

(3-mth moving average, index, 2019 Q4 =100, seasonally adjusted)



Services activity in the euro area

(3-mth moving average, index, 2019 Q4 =100, seasonally adjusted)



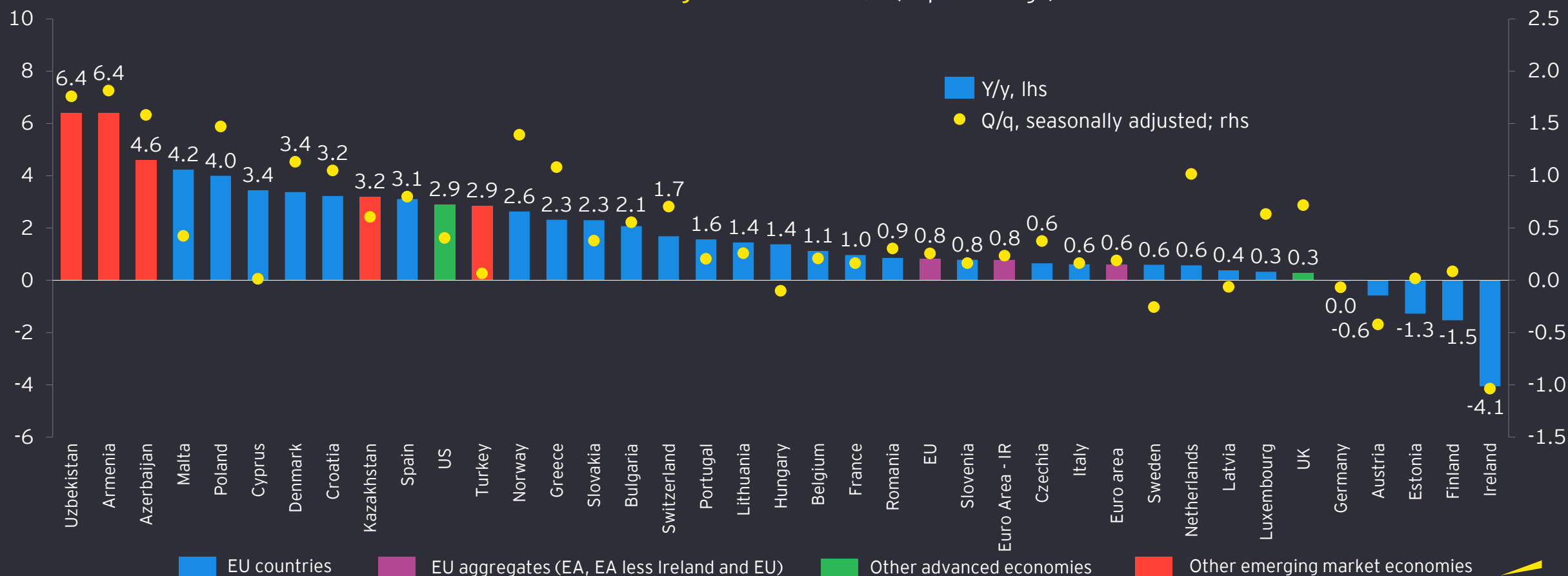
Source: Eurostat.

Notes: Energy-intensive sectors: paper, chemicals, basic metals and non-metallic mineral products. Housing-related sectors: wood, furniture and electric equipment. Other manufacturing is an arithmetic average of the remaining manufacturing NACE divisions. Services of the business economy except for trade and financial activities. Tourism includes accommodation and food service activities, air transport, travel agencies and related activities.

Growth remains uneven: UK has grown above potential in 2024 H1, Southern Europe sustains robust rates, and Germany's activity stays stagnant

- Southern Europe enjoys the benefits of a robust tourism industry, while Central and Eastern Europe's (CEE) vigorous performance is largely due to continued convergence with Western Europe, additionally supported by fiscal expansion and monetary stimulus in certain countries. Denmark and Switzerland are leveraging their dynamic pharmaceutical sectors to surpass their neighbors. Conversely, the Nordic countries are contending with the repercussions of significant housing market contractions.

Real GDP growth in 2024 Q2 (In percentage)



Germany has been the key laggard, with its underperformance stemming from multiple sources that extend well beyond high energy prices and challenges in the automotive industry

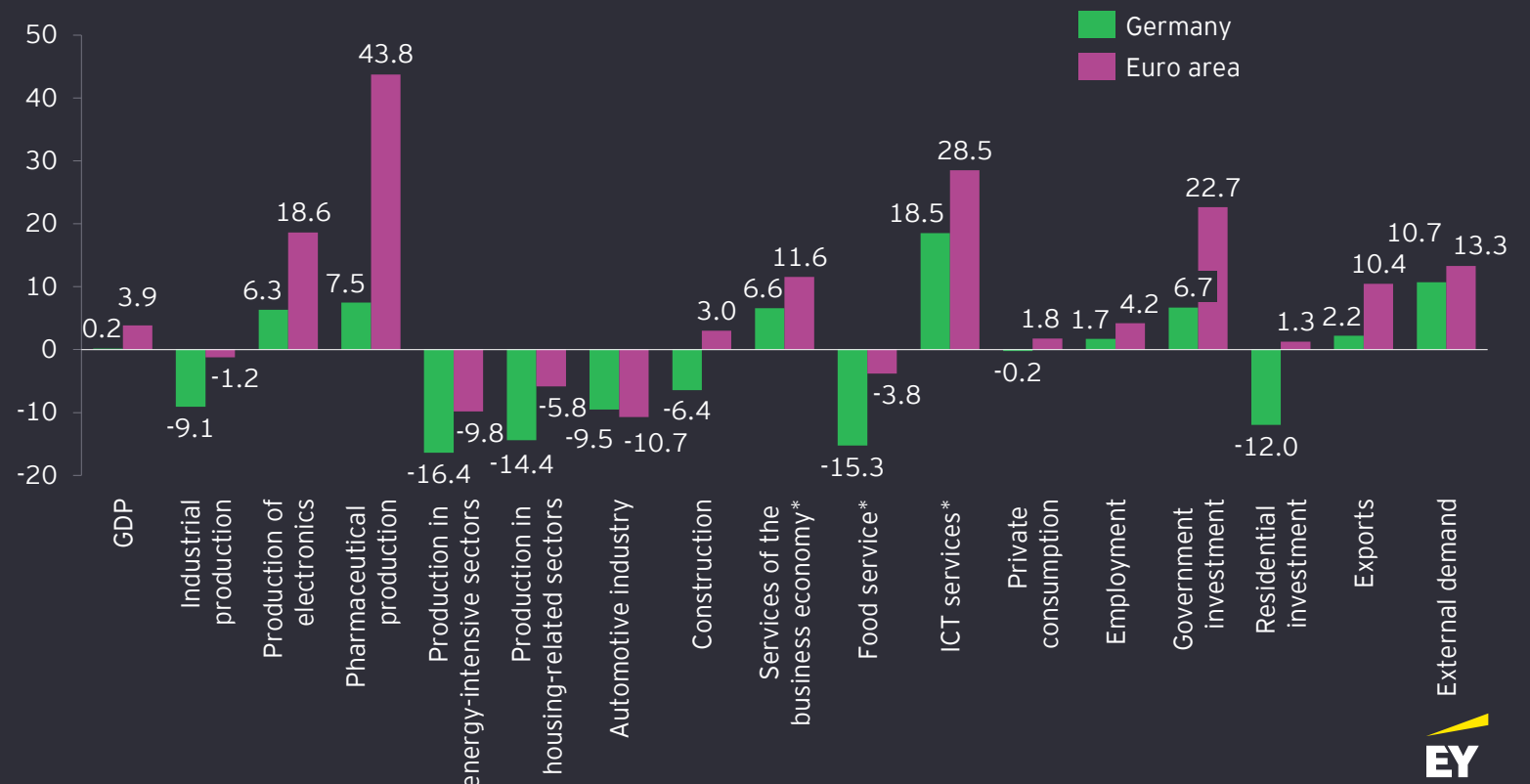
The underperformance of the German economy can be attributed to several factors:

- ▶ A constrained labor supply has led to subdued growth in employment and consumption.
- ▶ Before the war in Ukraine, there was significant reliance on energy imports from Russia, exacerbated by an energy mix that is relatively unfavorable.
- ▶ Emerging sectors, including ICT and pharmaceuticals, have experienced lackluster expansion.
- ▶ Fiscal policy has been notably stringent, with a limited allocation of funds from the NextGenEU program.
- ▶ The export structure is proving disadvantageous, affected by reduced global demand, particularly from China.
- ▶ The economy's structure is not supportive in current conditions, with a relatively high importance of manufacturing and a low importance of tourism
- ▶ There has been a significant downturn in the housing market.

Germany as a percentage of the euro area real GDP



Real change from 2019 Q4 to 2024 Q2
(In percentage)



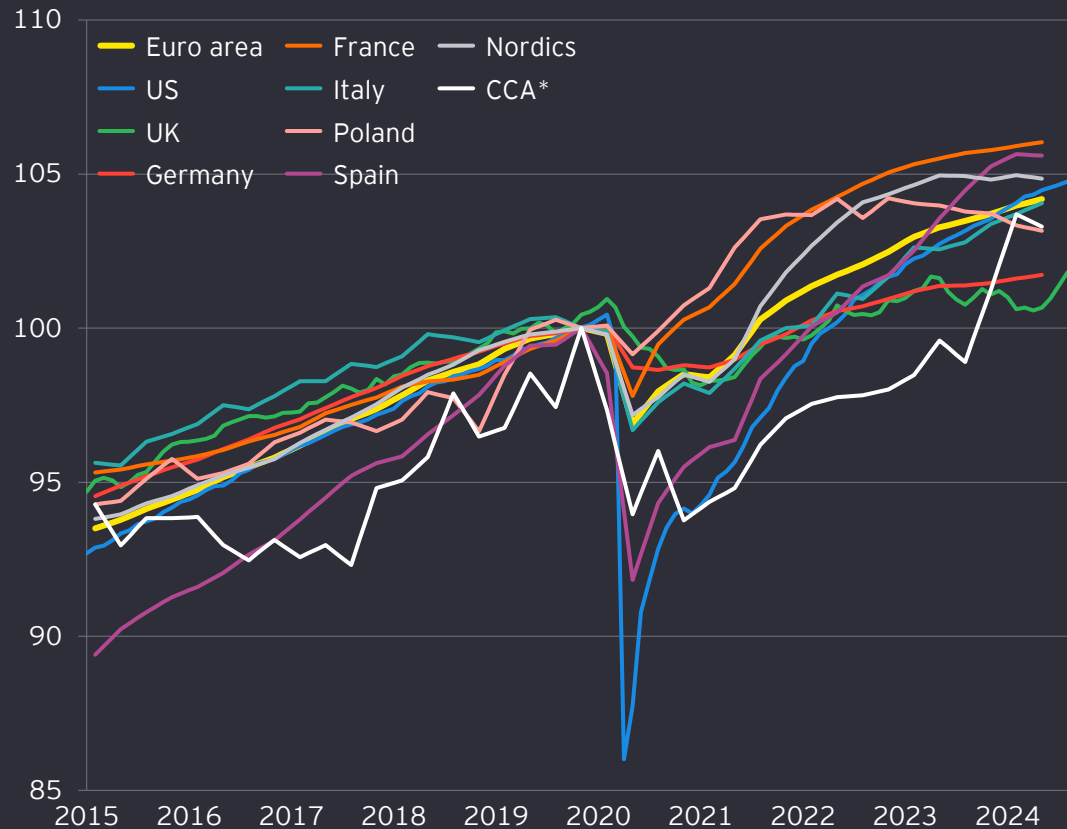
Source: Eurostat, Oxford Economics, EY EAT forecast.

* Q1 2024

Employment growth has gradually slowed down, except in the Caucasus and Central Asia. Declining vacancy rates also indicate a moderating demand for labor

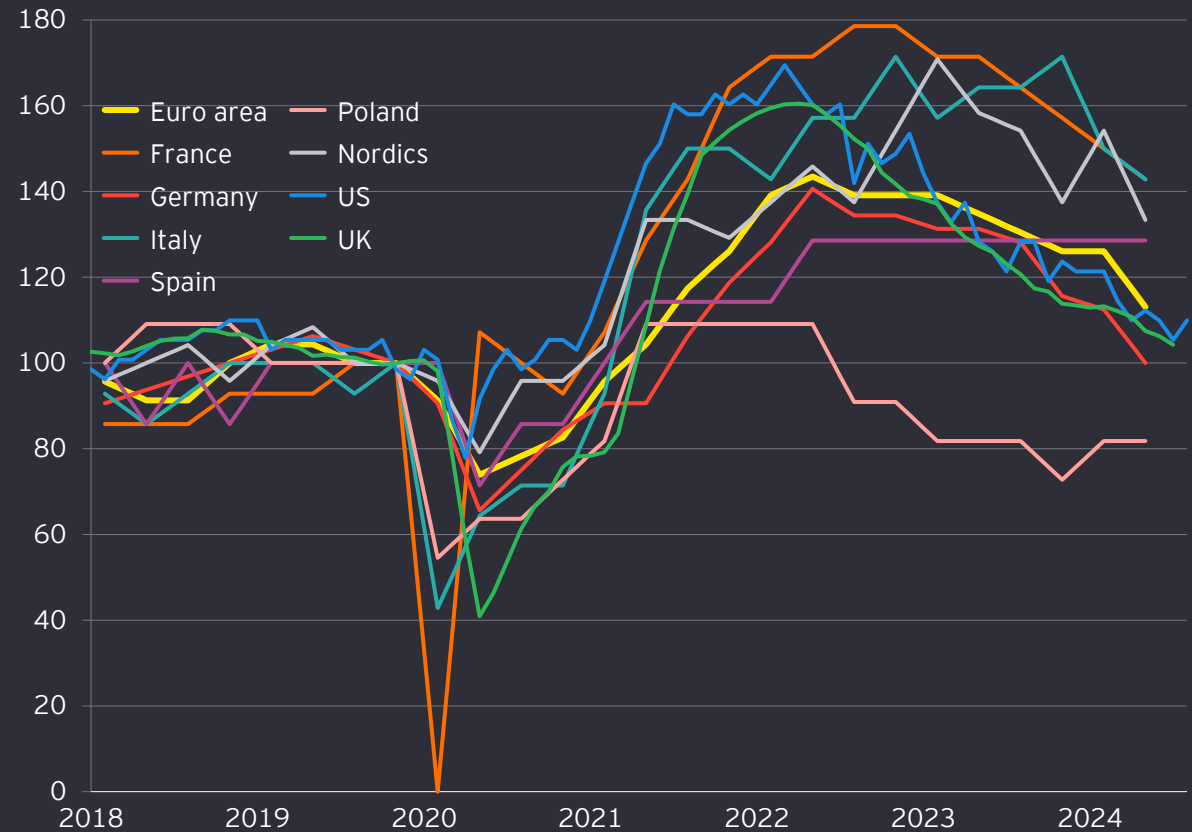
Employment

(Index, Q4 2019 = 100, seasonally adjusted data)



Vacancy rate ^[1] *

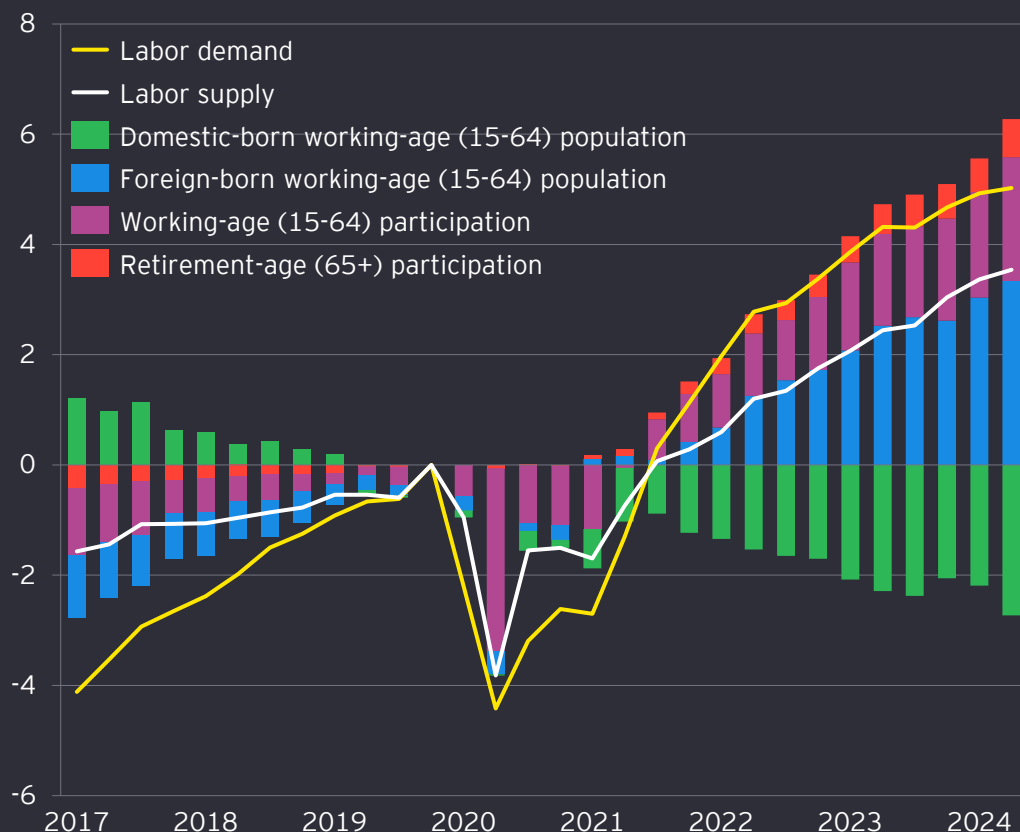
(Index, 2019 Q4 = 100)



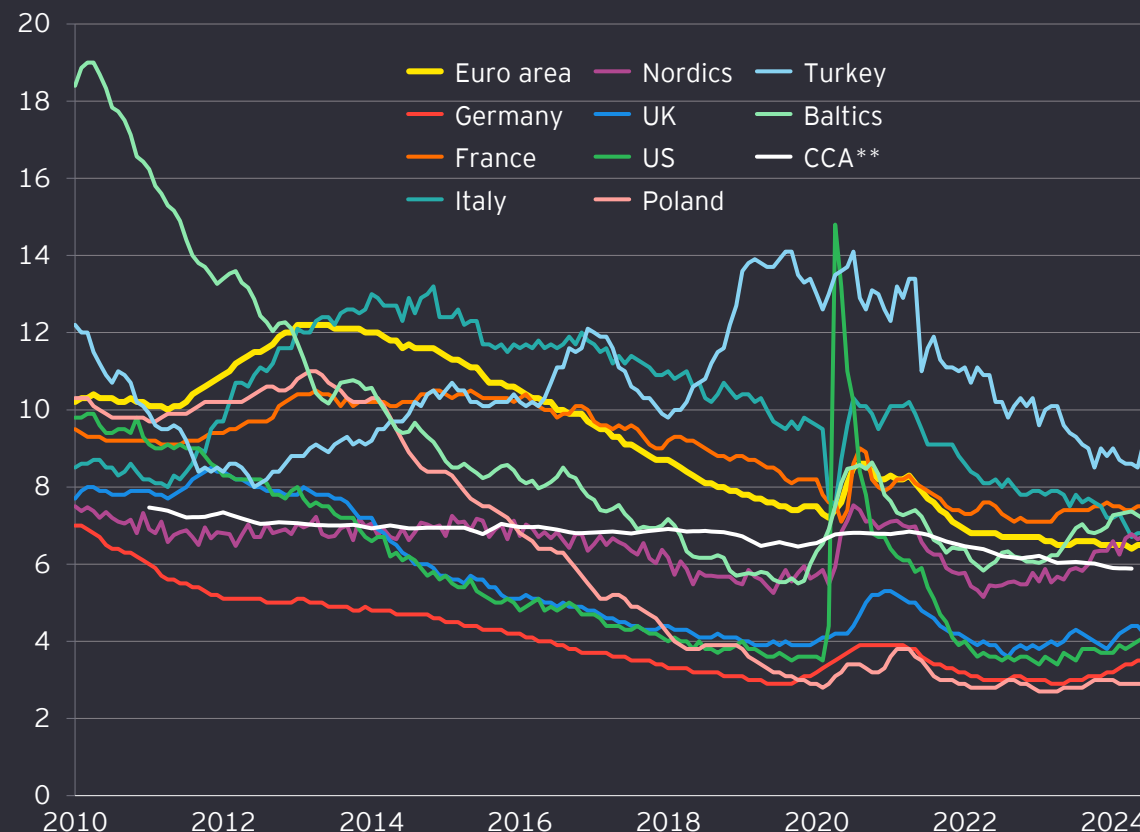
In parallel, labor supply growth has slowed slightly due to reduced immigration inflows. As a result, unemployment has stabilized near historical lows, despite the slowing pace of employment growth

- ▶ However, this masks variations between countries: unemployment continues to fall in Southern Europe, while it has begun to rise in Germany and has seen more significant increases in the Nordic and Baltic countries

Labor supply and demand change in the euro area compared with 2019 Q4 (in percentage)



Unemployment rate (in percentage)



Source: Eurostat, BLS, FRED, ONS.

Notes: Labor demand is a sum of supply employment and vacancies.

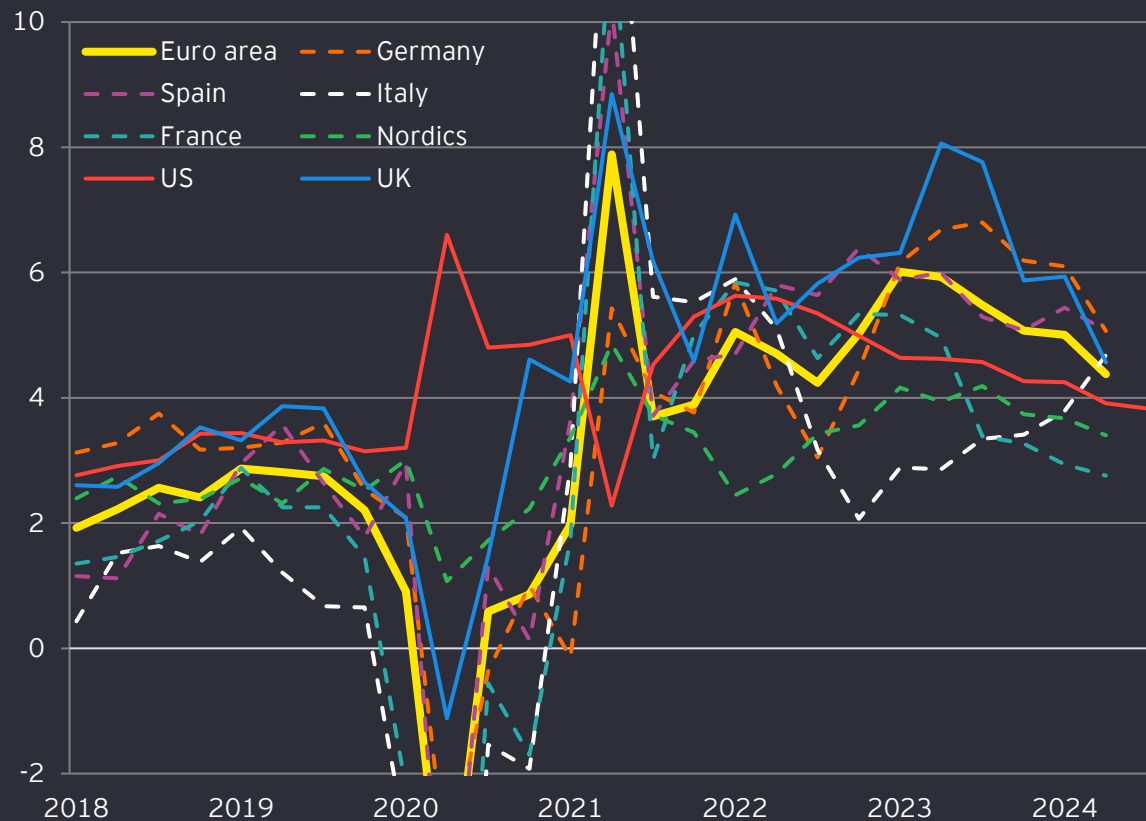
* For the UK and the US there is no division between domestic-born and foreign-born, instead replaced by a working-age (16-64) population category.

** CCA is an average of unemployment rates for Armenia, Georgia, Kazakhstan and Kyrgyzstan, weighted by GDP.

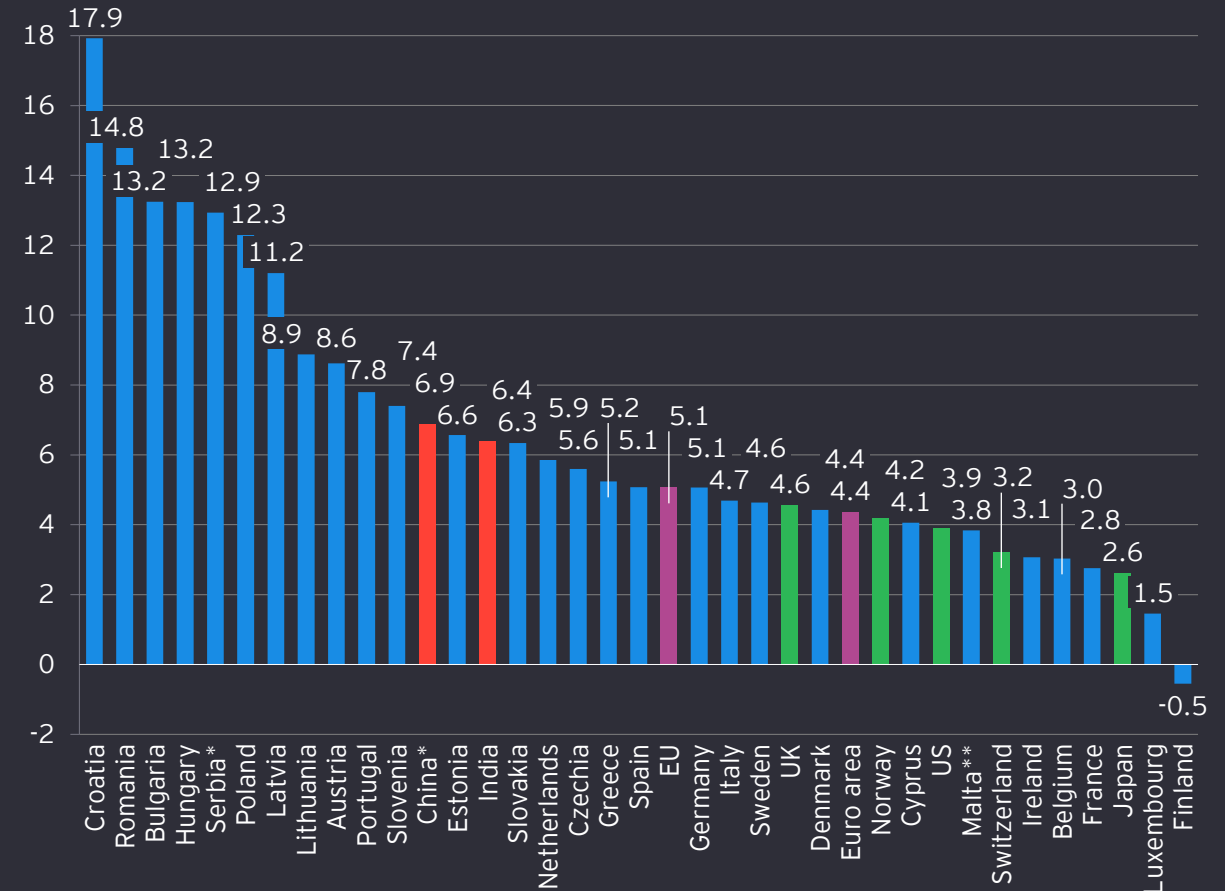
Nominal wage growth has gradually slowed, yet it continues to exceed levels consistent with the 2% inflation target

- ▶ Lower inflation is the primary reason for the slowdown in wage growth, while tight labor market conditions—despite some softening—and real wages catching up with productivity are keeping it elevated
- ▶ Significant disparities in wage growth persist among countries. CEE countries show much higher growth than Western and Southern Europe due to tighter labor markets, sizeable hikes in minimum and public sector wages, higher inflation, and stronger underlying productivity growth

Wage growth (y/y, in percentage)



Wage growth in 2024 Q2 (y/y, in percentage)



Source: Eurostat, ONS, FRED, Oxford Economics

For the euro area countries, wages and salaries per employed person; for the UK, average weekly earnings in the whole economy, total pay; for the US average hourly earnings of All Employees, Total Private. Nordics as Norway, Sweden, Finland and Denmark arithmetic average.

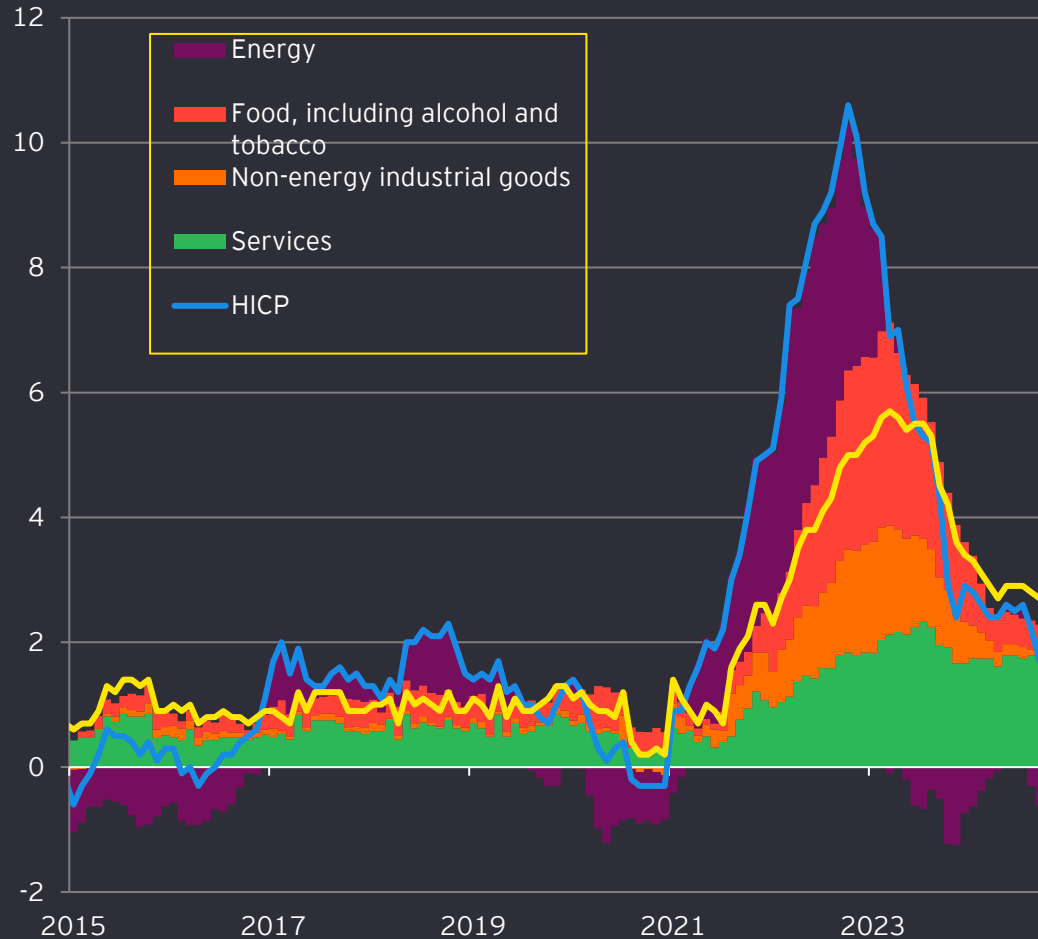
* Oxford Economics estimates.

** Q1 2024

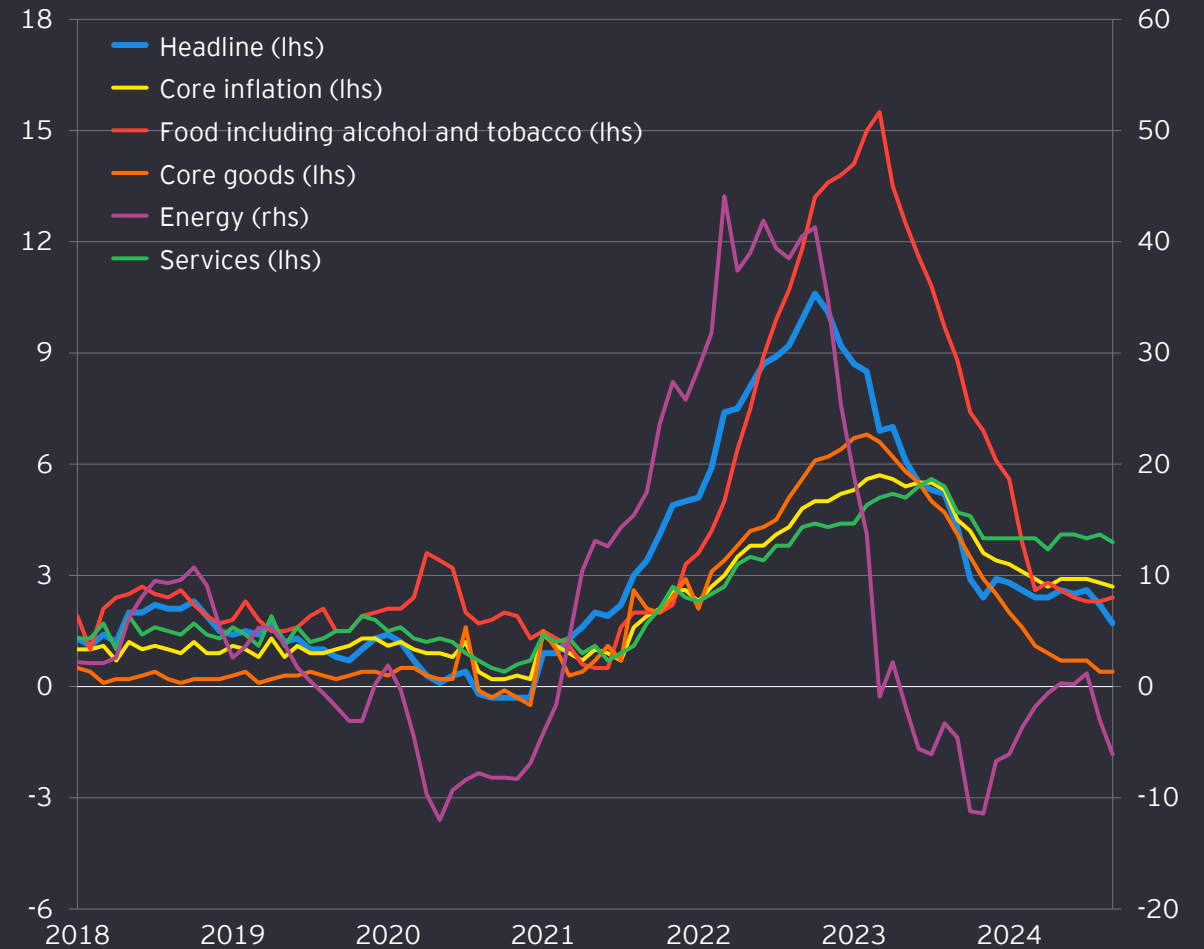
Inflation

In the euro area, inflation has fallen below 2%, primarily due to a drop in energy inflation caused by lower oil prices and base effects, but core inflation remains close to 3% due to persistent price pressures in services

Statistical decomposition of y/y HICP inflation in the euro area
(in percentage)



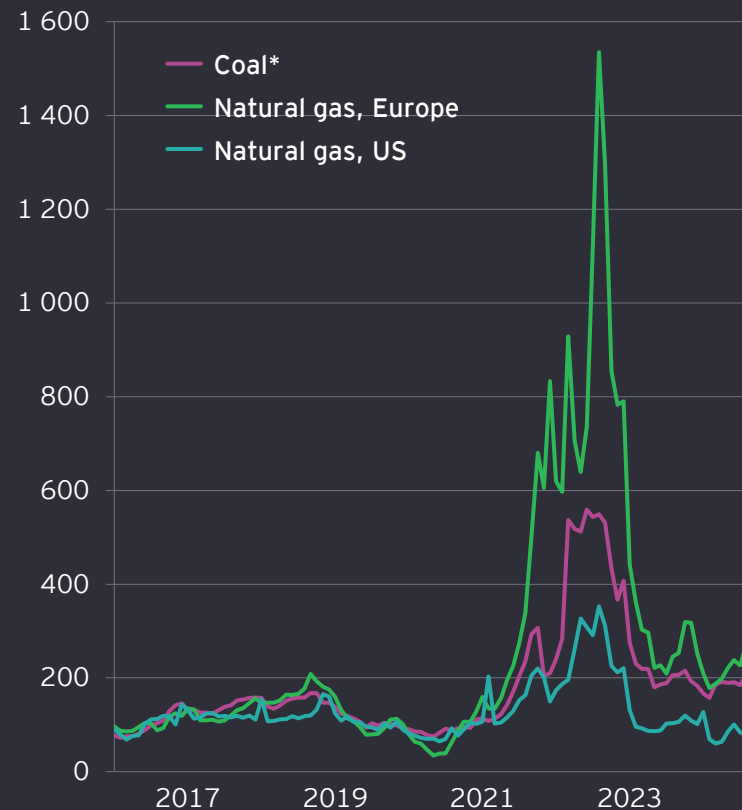
HICP inflation in the euro area
(y/y, in percentage)



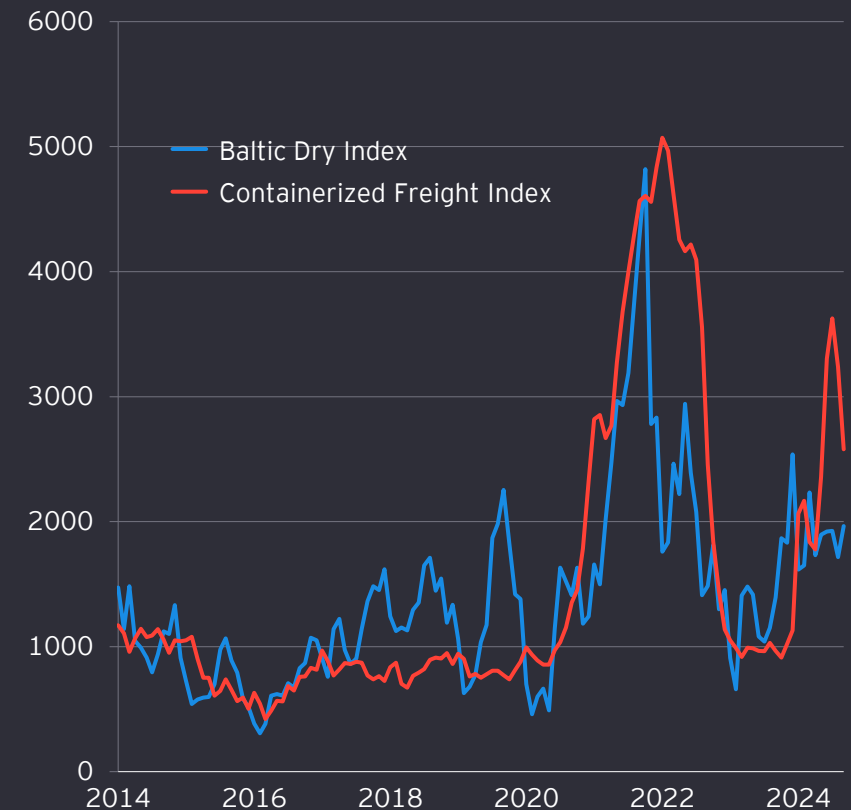
Commodity prices have been relatively stable over the past 18 months, staying below pre-war but above pre-pandemic levels, which has allowed the impact of past energy and food price shocks to fade

- ▶ That said, oil prices have decreased throughout Q3 2024 and are significantly lower than they were a year ago, exerting downward pressure on energy and headline inflation figures
- ▶ Elevated shipping costs, resulting from tensions in the Red Sea, have not yet led to a significant increase in supply bottlenecks or core goods price pressures, likely due to weak demand

Global commodity prices (index 2016 = 100)



Shipping costs of dry bulk and container transport



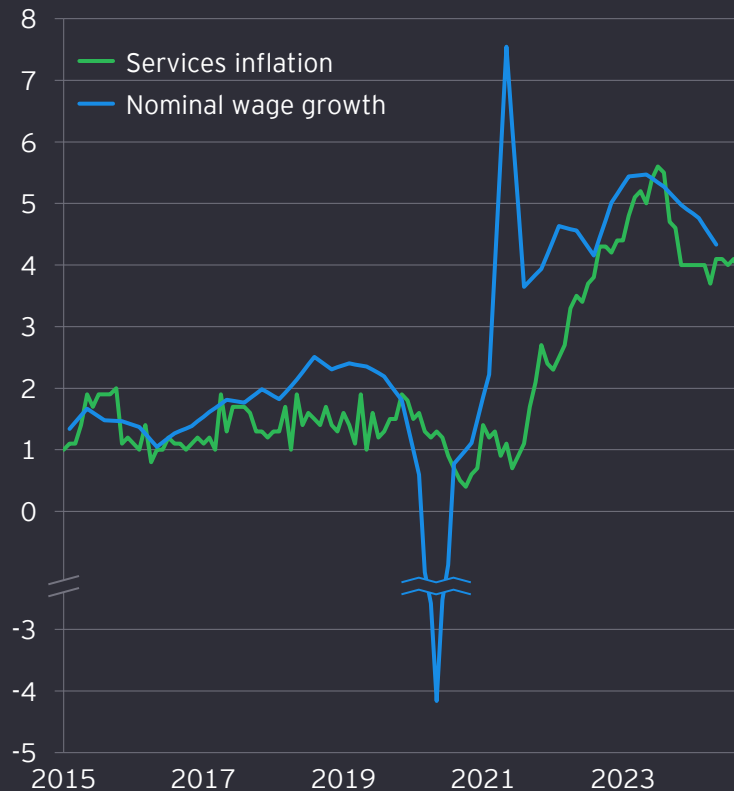
Source: World Bank Commodity Prices; stooq.pl; Investing.com; Trading Economics.

* ICE Rotterdam coal price.

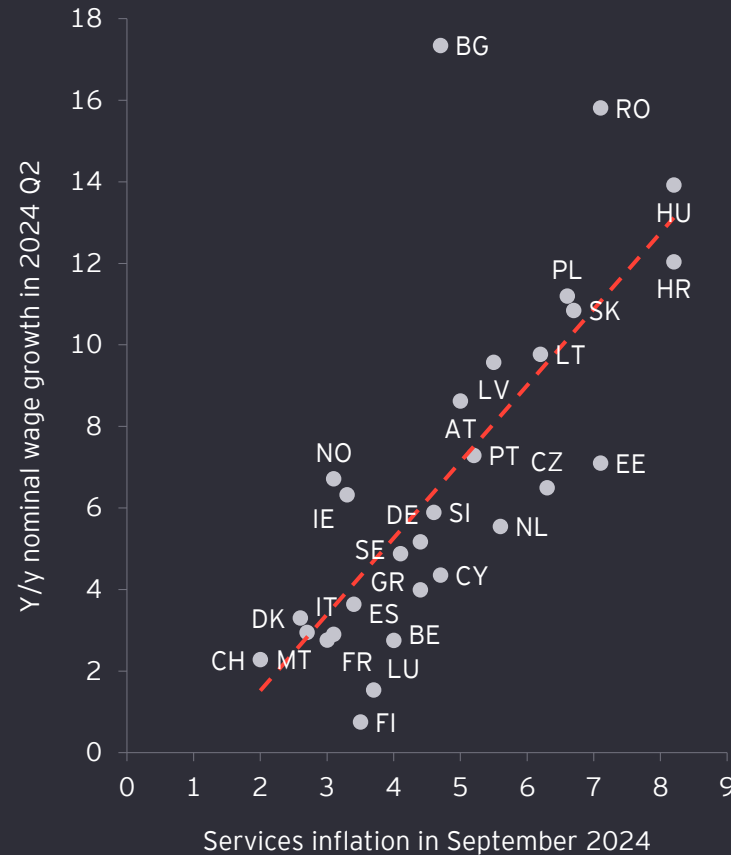
Services inflation remains persistent due to elevated wage growth and an ongoing catch-up with goods prices

- ▶ The labor share in services costs is twice as high as in manufacturing, creating a strong link between wage growth and services inflation
- ▶ Additionally, services prices may be catching up with goods prices due to cost pressures from energy, food in restaurants, and equipment, as well as efforts by services firms to preserve their relative pricing

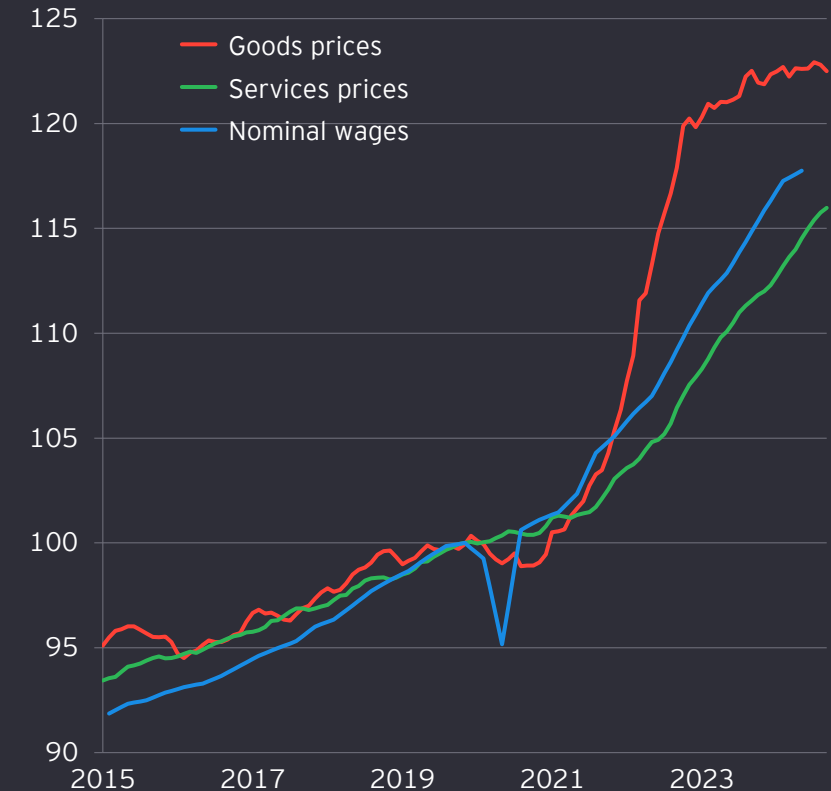
Y/y services inflation vs. y/y nominal wage growth in the euro area
(in percentage)



Y/y services inflation vs. y/y nominal wage growth by country (in percentage)



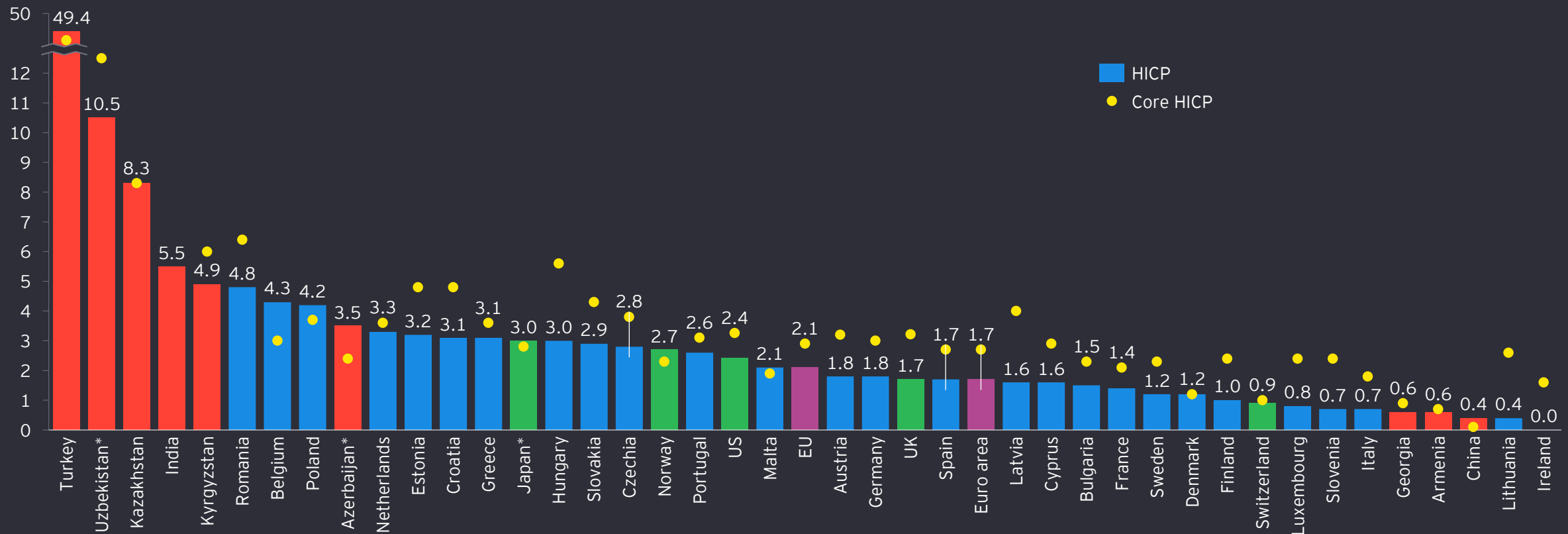
Services price level vs. goods price and nominal wage levels in the euro area
(index, seasonally adjusted, 2019 Q4 = 100)



Although the degree of divergence has lessened as inflation has declined, price growth continues to vary across Europe due to differences in wage growth and price regulation

- ▶ HICP inflation continues to be the highest in Romania (4.8% in September 2024), where 15% nominal wage growth and strong domestic demand keep core inflation above 6%. Other CEE countries, such as Hungary, Croatia, Slovakia, and Poland, also experience strong price pressures, particularly in services, due to wage growth exceeding 10%. However, declining energy prices have brought headline inflation below 3.5% in most of these countries. On the other end of the spectrum, headline inflation has fallen below 1% in Ireland, Italy, and Switzerland, with core inflation also dropping below 2%.

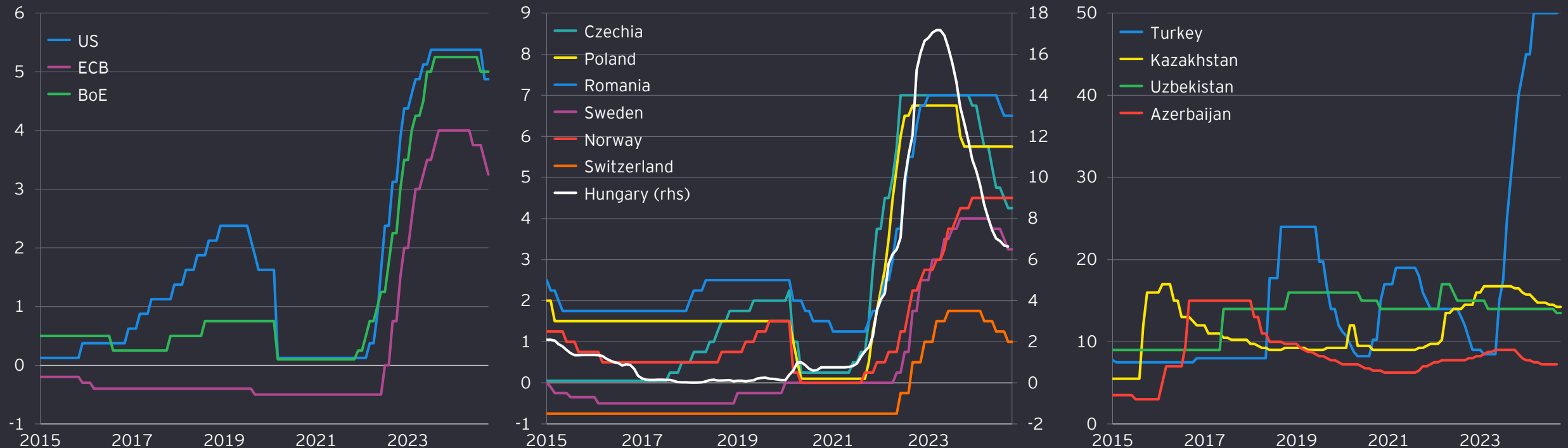
HICP inflation in September 2024 (y/y, in percentage)



Central banks have been reducing interest rates, although the pace and timing of easing vary significantly across jurisdictions

- ▶ The ECB began a gradual easing cycle by cutting rates by 25 basis points at every other meeting in June and September, balancing sluggish growth and near-target headline inflation against elevated wage growth and services inflation. However, after a more aggressive 50 bp cut by the Fed and worsening economic sentiment indicators, the ECB has accelerated the pace of easing with an additional rate reduction in October.
- ▶ The Bank of England has been more cautious, cutting rates in August, but keeping them unchanged in September, as it faces higher wage growth and services inflation amid a stronger economic recovery.
- ▶ Given rapidly declining inflation and stagnant economic activity, the Swedish Riksbank became the first advanced economy central bank to cut rates in May. Conversely, the Norges Bank has yet to cut rates
- ▶ In CEE, monetary policy follows differing paths. In Czechia, where growth and price pressures are relatively weak, and in Hungary, which had high interest rates at the onset, the easing cycles are well advanced. Meanwhile, Romania, faced with higher inflation, only began cutting rates in July, and Poland has kept rates unchanged throughout this year.

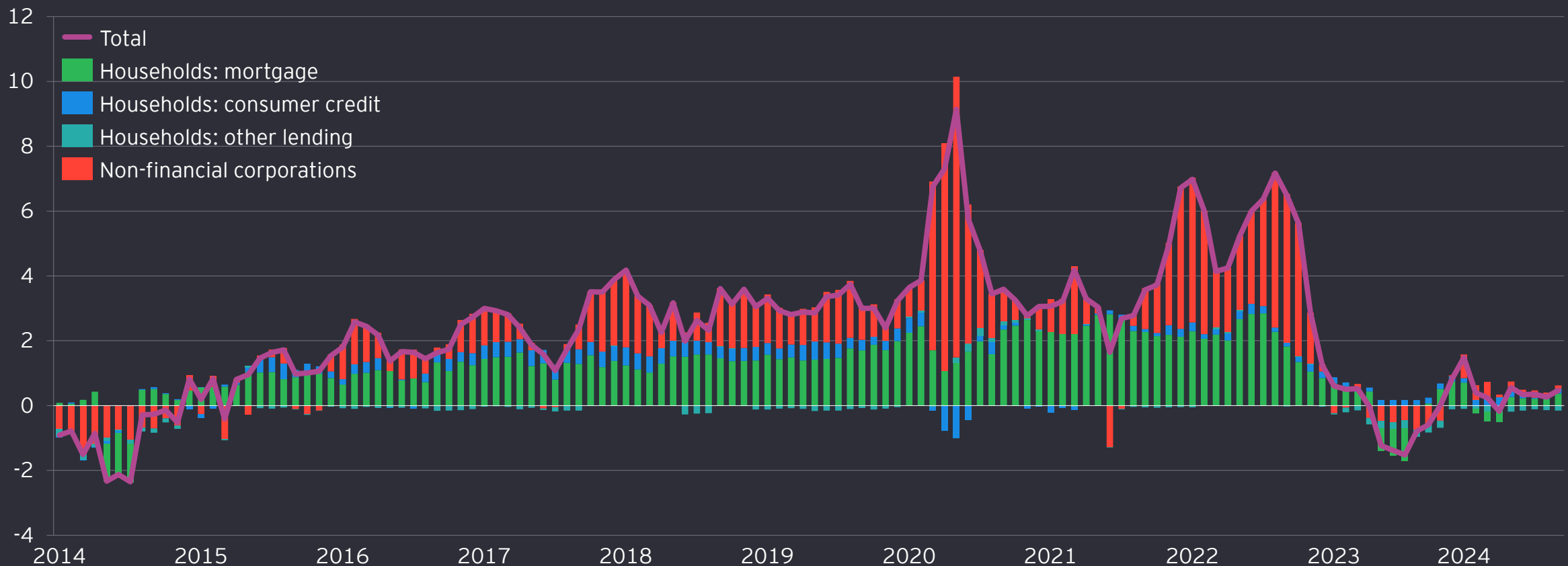
Central bank interest rates (In percentage)



Amid subdued demand and tight credit conditions, bank lending continues to grow at a very modest pace

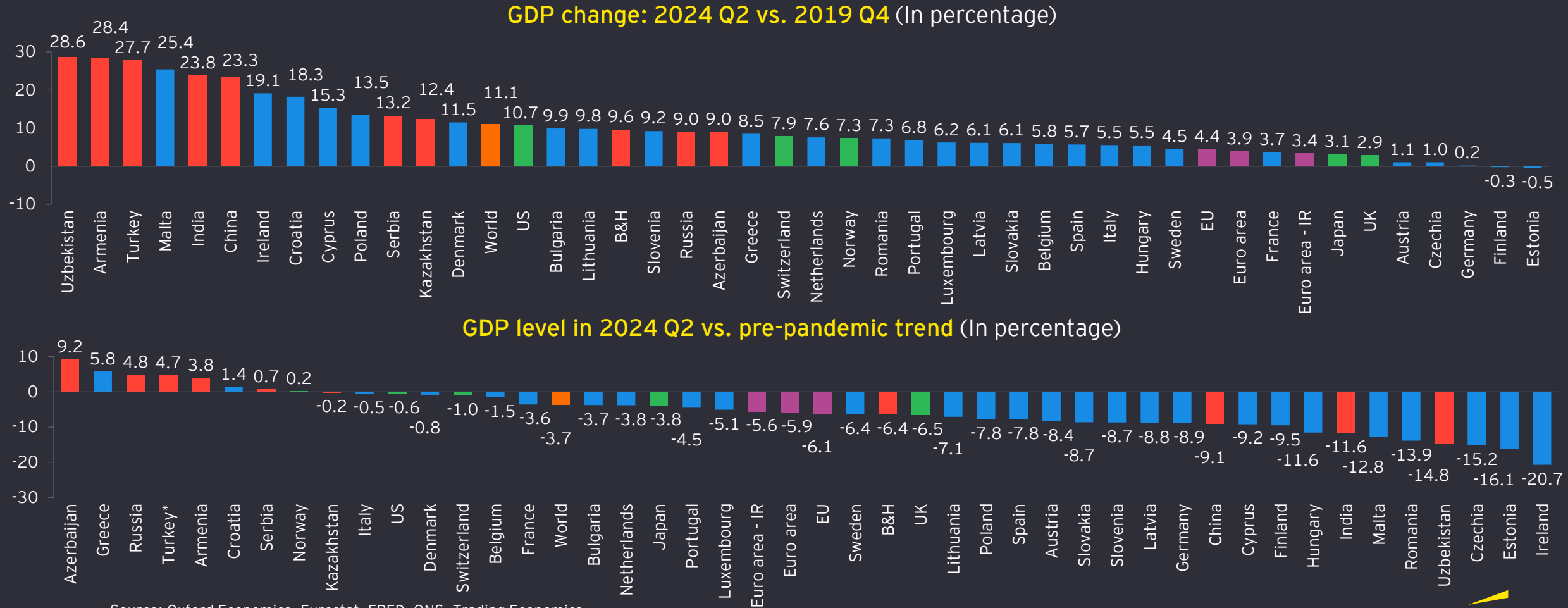
- ▶ Lending to firms remains stagnant, mortgage credit is increasing slowly, and consumer credit continues to expand at a modest pace

Monthly growth in loans to households and non-financial corporations in the euro area
(in percentage, annualized and seasonally adjusted, 3-mth moving average)



Most countries are significantly above the pre-pandemic levels of their economic activity, but well below the pre-pandemic trend

- ▶ Germany, Austria, Czechia, Finland, and Estonia are exceptions where GDP remains close to pre-pandemic levels, impacted by a high reliance on manufacturing, a housing downturn, and the consequences of the war in Ukraine
- ▶ Conversely, GDP in countries such as Italy, Greece, Turkey, and Croatia is close to or above the pre-pandemic trend, largely due to a tourism boom. Switzerland, Belgium, and Denmark, with their large pharmaceutical sectors; Norway, benefiting from high energy prices; and most notably, the US, driven by strong consumer demand and productivity growth, are also on the positive end of the spectrum.



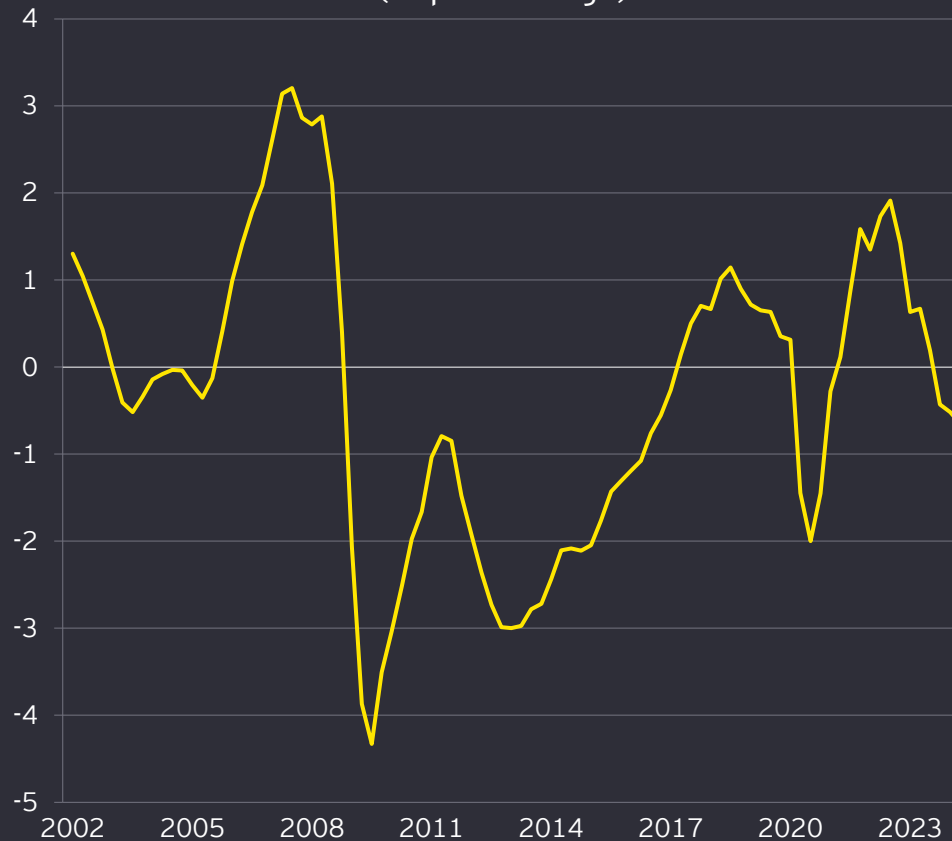
Source: Oxford Economics, Eurostat, FRED, ONS, Trading Economics.

Pre-pandemic trend is a logarithmic trend over 2014 Q1 - 2019 Q4. For Poland, data seasonally adjusted by EY. "Euro area - IR" stands for euro area less Ireland. Ireland is excluded as its GDP tends to be very volatile and artificially inflated by tax-related activities of multinational corporations.

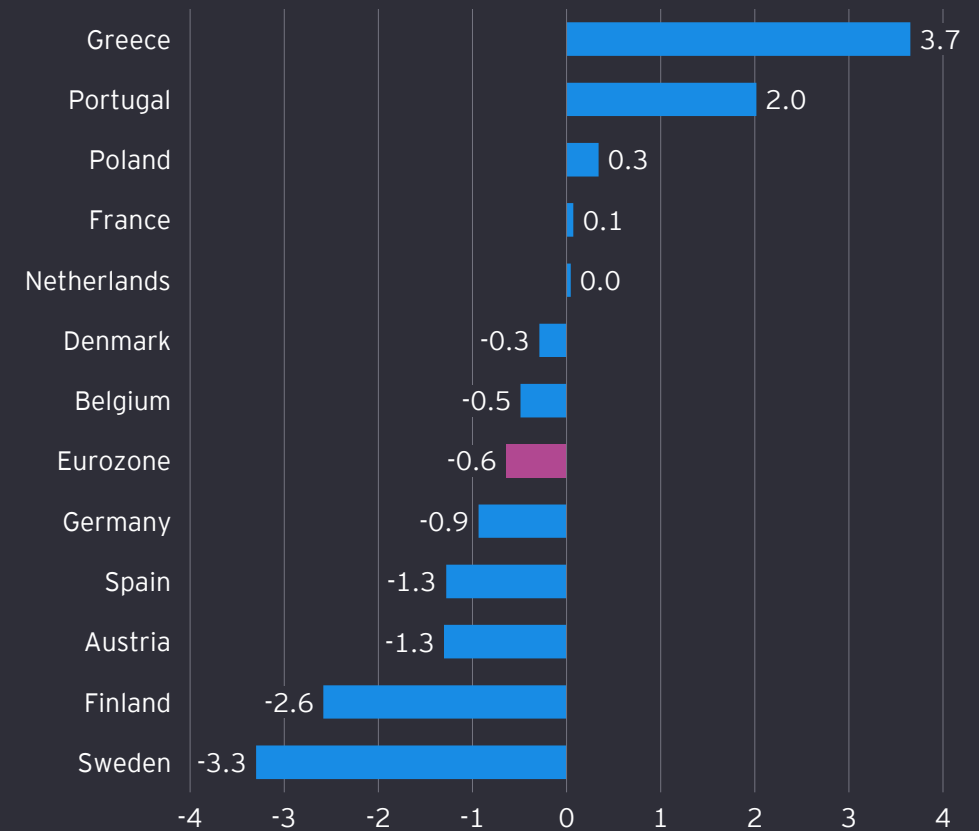
We estimate that the euro area's economy operates only slightly below capacity, suggesting limited potential for a cyclical recovery

- We estimate the output gap as a principal component from three indicators: the fraction of firms indicating demand as a factor limiting activity, the unemployment rate, and the inventories to GDP ratio

Output gap in the euro area
(in percentage)

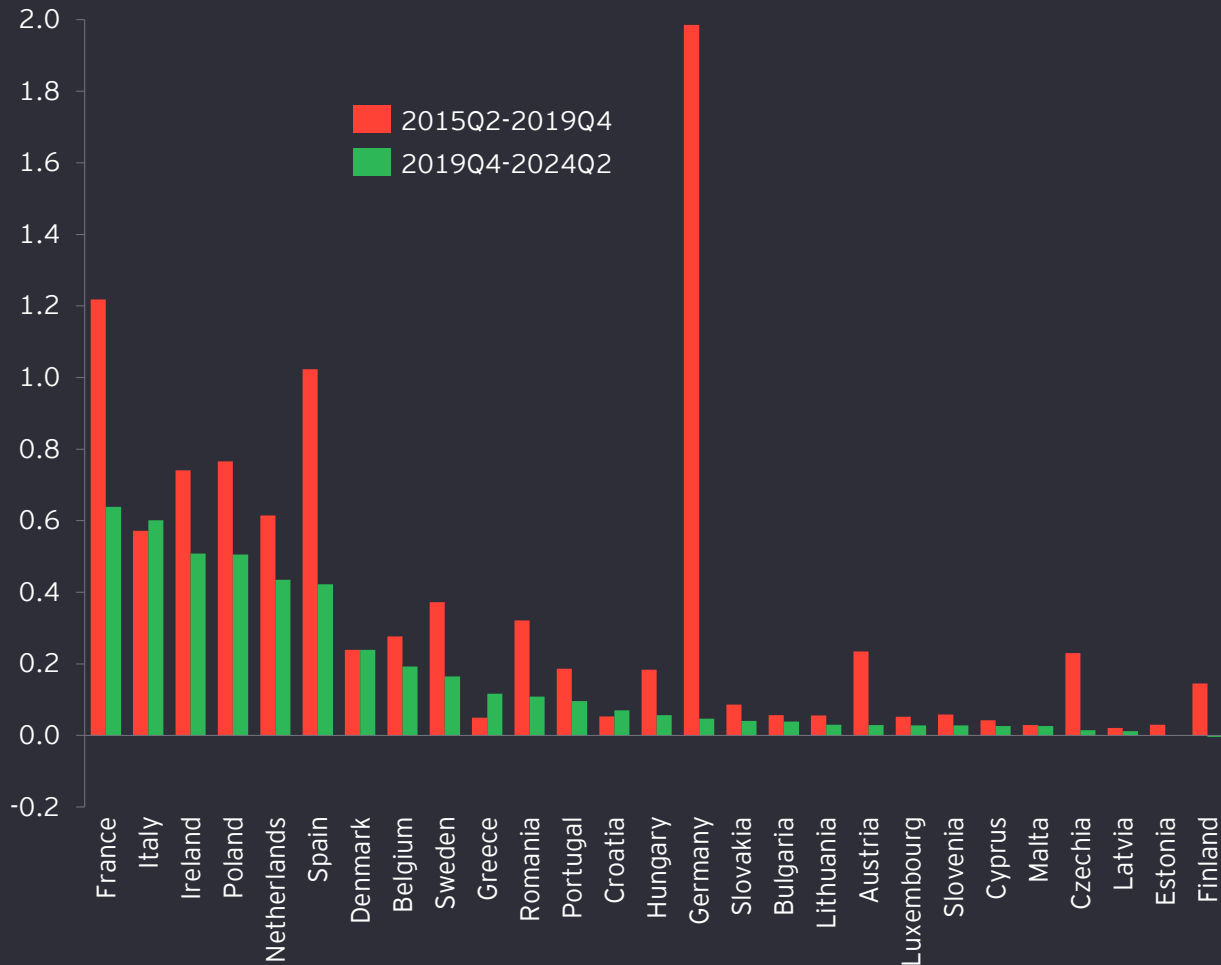


Output gap in 2024 Q2 by countries
(in percentage)

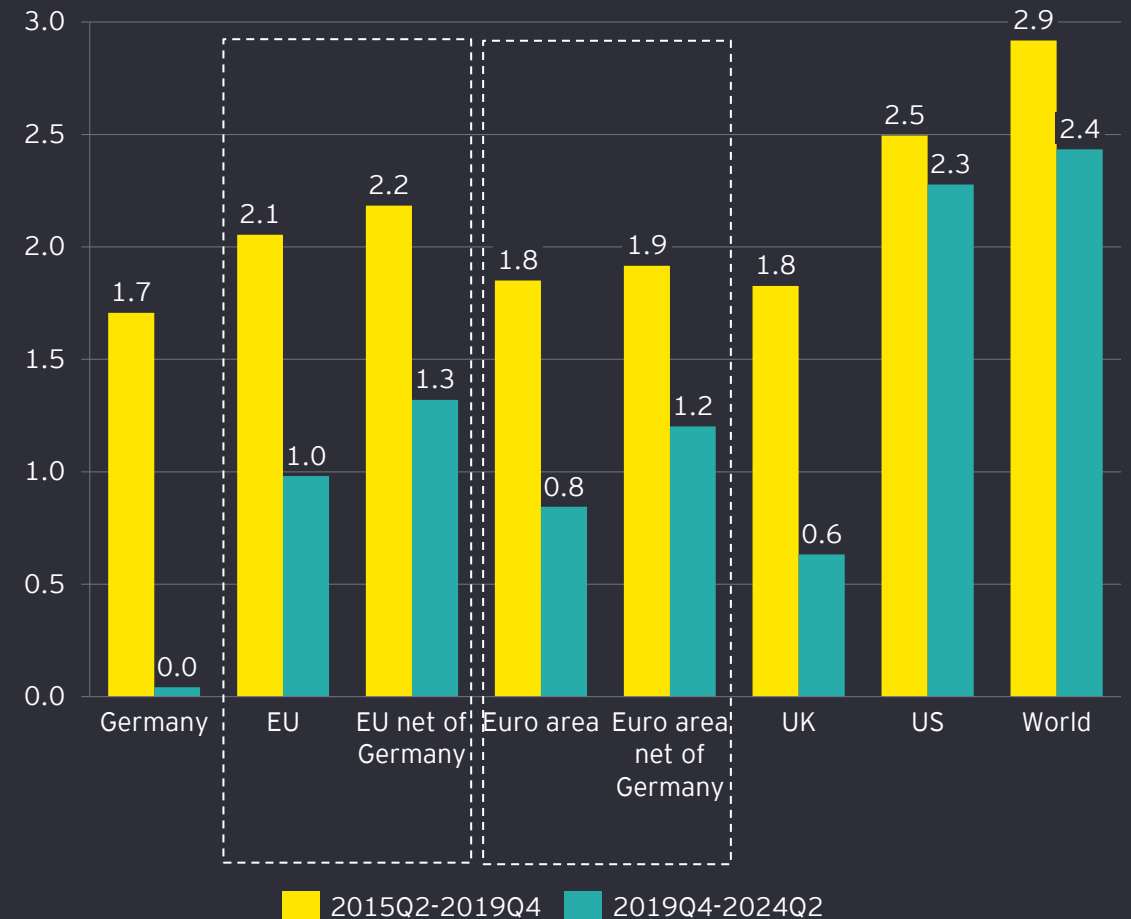


Stagnation in Germany is an important reason why the European economy has been underperforming compared to the pre-pandemic trend

Contributions to EU real GDP growth per country, post-pandemic vs. pre-pandemic (in percentage points)



Annualized real GDP growth before and after the pandemic (in percentage)

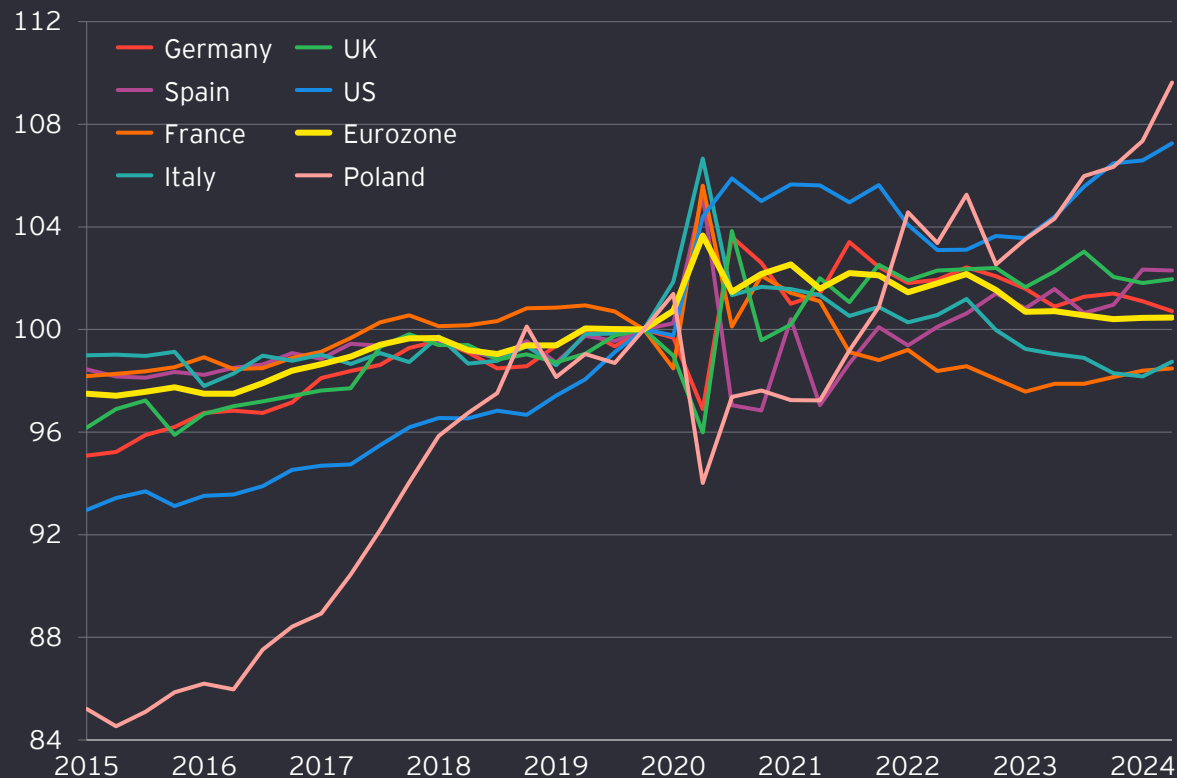


Longer-term perspective

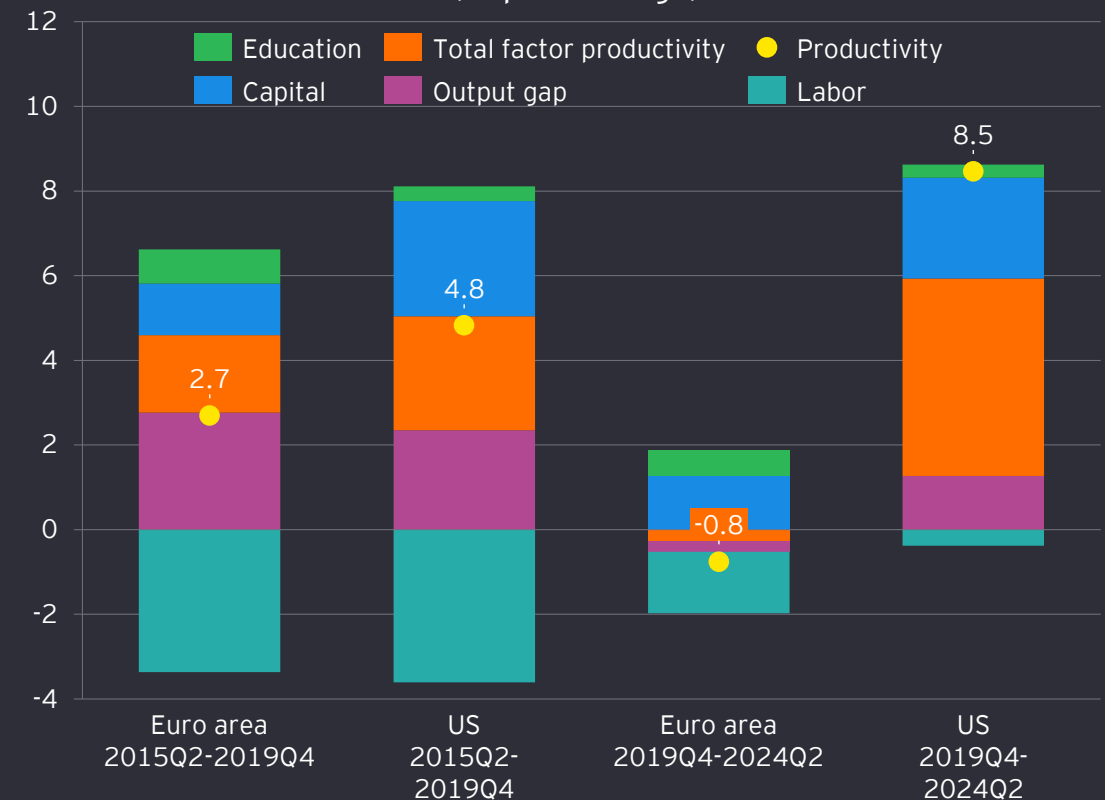
Lack of productivity growth is another reason for Europe's underperformance, in stark contrast to the US. The slowdown in the euro area productivity growth relative to the pre-pandemic period stems from a less favorable cyclical position and slower total factor productivity growth

- ▶ That said, productivity has continued to increase at a solid pace in most CEE countries
- ▶ In the US, productivity growth has accelerated post-pandemic due to faster growth in TFP
- ▶ The euro area's gap to the US has primarily resulted from much slower TFP growth, though lower investment in physical capital and a less favorable cyclical position have also contributed

Real GDP per hour worked
(Q4 2019 = 100)



Decomposition of productivity growth*
(in percentage)

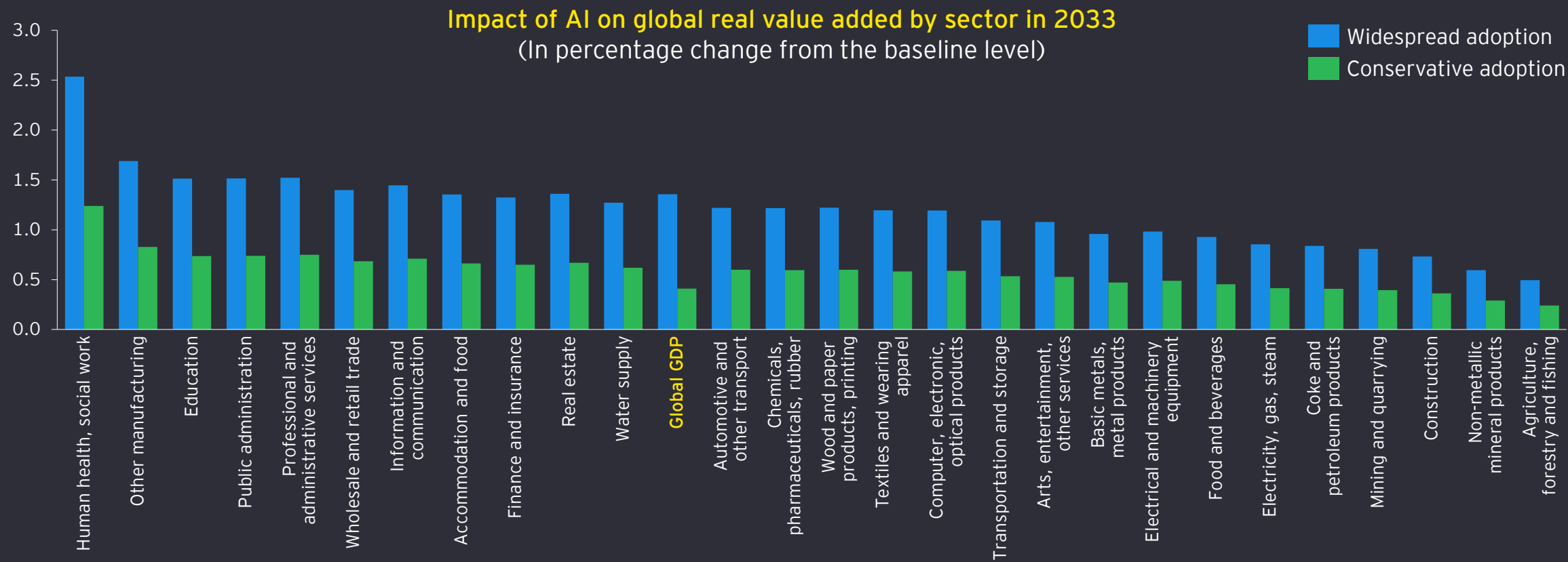


Source: Eurostat, ONS, FRED, Oxford Economics, EY calculations.

* Real GDP per hour worked. Labor is a sum of (positive contribution) of the increase in potential hours worked (employment at NAIRU (non-accelerating inflation rate of unemployment, i.e., equilibrium unemployment rate) times average hours worked) and a (negative contribution) of the change in actual hours worked.

AI is expected to increase TFP growth in the medium term. We explore AI’s economic impact, including sectoral effects, in a series of articles

- ▶ Here we briefly describe the results of the yet-to-be-published fifth article that utilizes the EY UPGRADE CGE model to study AI’s effects on sectoral developments and international competitiveness, drawing from our previous articles that estimate AI’s impact on the labor market, investment, TFP, and GDP growth
- ▶ AI is set to deliver significant TFP and output enhancements across sectors, with healthcare and advanced manufacturing expected to lead the way



Note: In [our study](#), we examine four distinct scenarios characterized by varying levels of AI adoption (conservative or widespread) and degrees of international capital mobility (high or low). Presented figures correspond to a high international capital mobility scenario. In our paper, we also study a low international capital mobility scenario where investors are not responsive to changes in rates of return across regions (e.g., due to home bias, significant domestic public support, etc.). The widespread AI adoption scenario assumes that AI is adopted at a similar pace as information and communications technology (ICT) during the 1990s and 2000s. The conservative scenario assumes 60% slower integration (based on existing relationship between AI and ICT adoption).

Source: EY EAT, EY UPGRADE CGE model

27

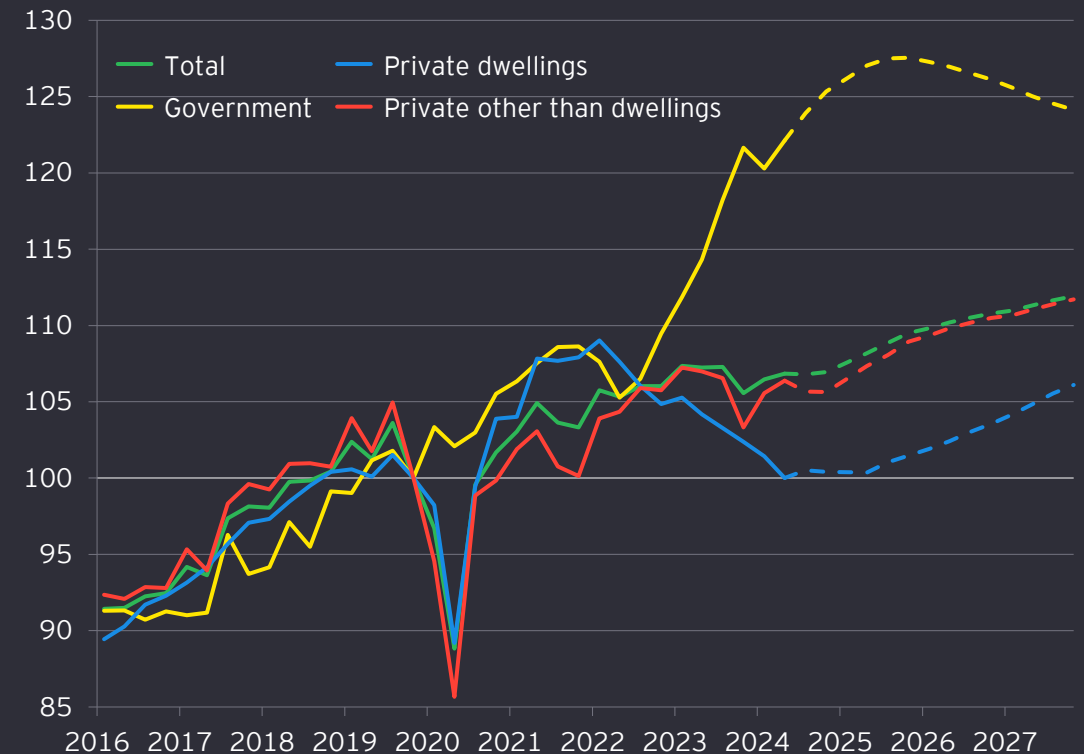
Looking ahead, the recovery in real incomes is anticipated to eventually lead to more robust consumer spending, while lower interest rates and stronger consumer demand should bolster investment

- ▶ Consumption recovery will also be supported by falling interest rates and improving consumer sentiment
- ▶ The recovery in investment is likely to be relatively slow as the economy continues to operate slightly below its full capacity

Y/y growth in real wages, real wage fund and real private consumption in the euro area
(In percentage)



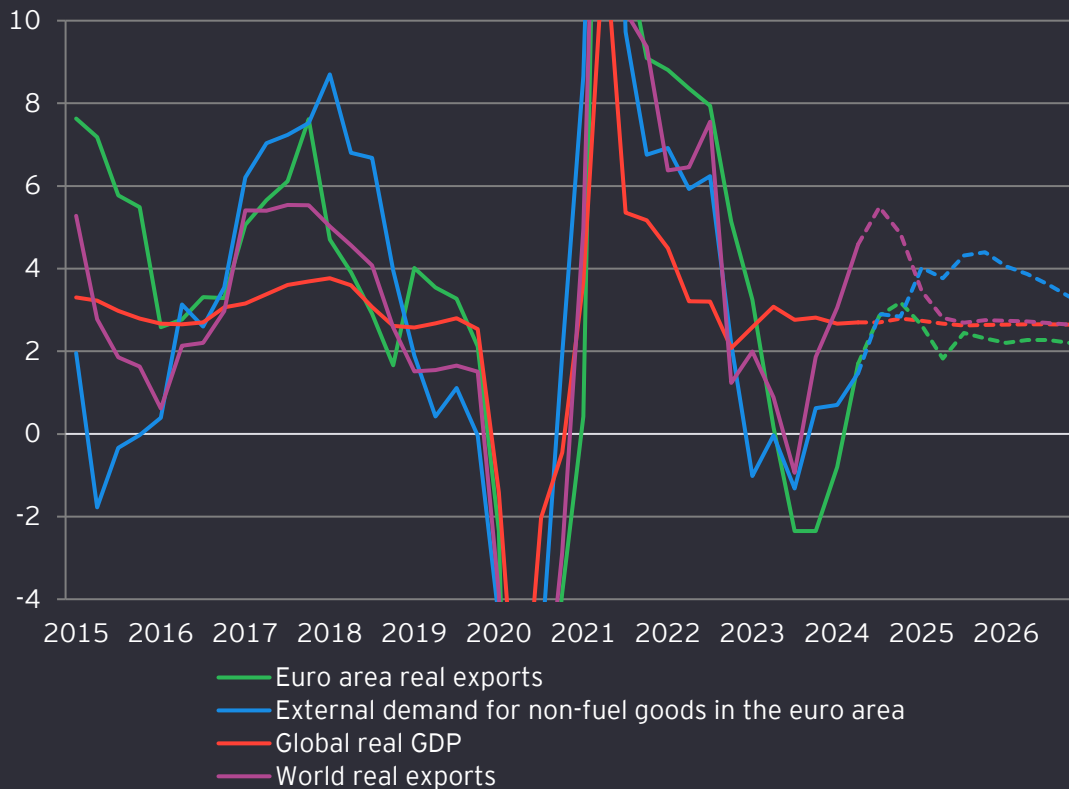
Real fixed capital investment by type in the euro area less Ireland (2019 Q4 = 100)



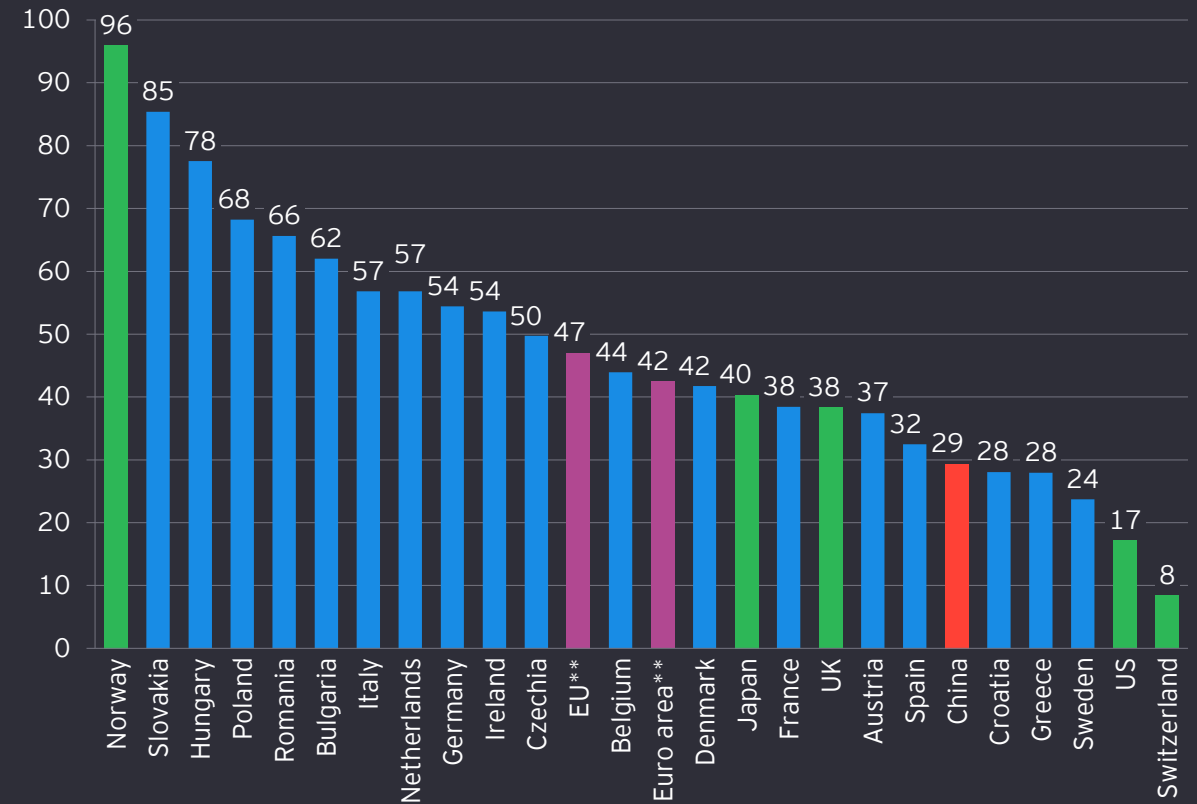
Exports are expected to continue growing, albeit at a slower pace than external demand, as the competitiveness of European producers has declined

- ▶ The competitiveness of European producers has been reduced, among other factors, by a stronger-than-elsewhere increase in energy prices, which remain much higher than before the pandemic.

Global real GDP and world exports, external demand for non-fuel goods in the euro area* and euro area real exports (y/y, in percentage)



Change in energy prices*: 2024 Q2 vs. 2019 Q4 (in percentage)**



Source: Oxford Economics, EY EAT forecast.

*External demand is equal to imports of trading partners, weighted by shares of those trading partners in the euro area exports.

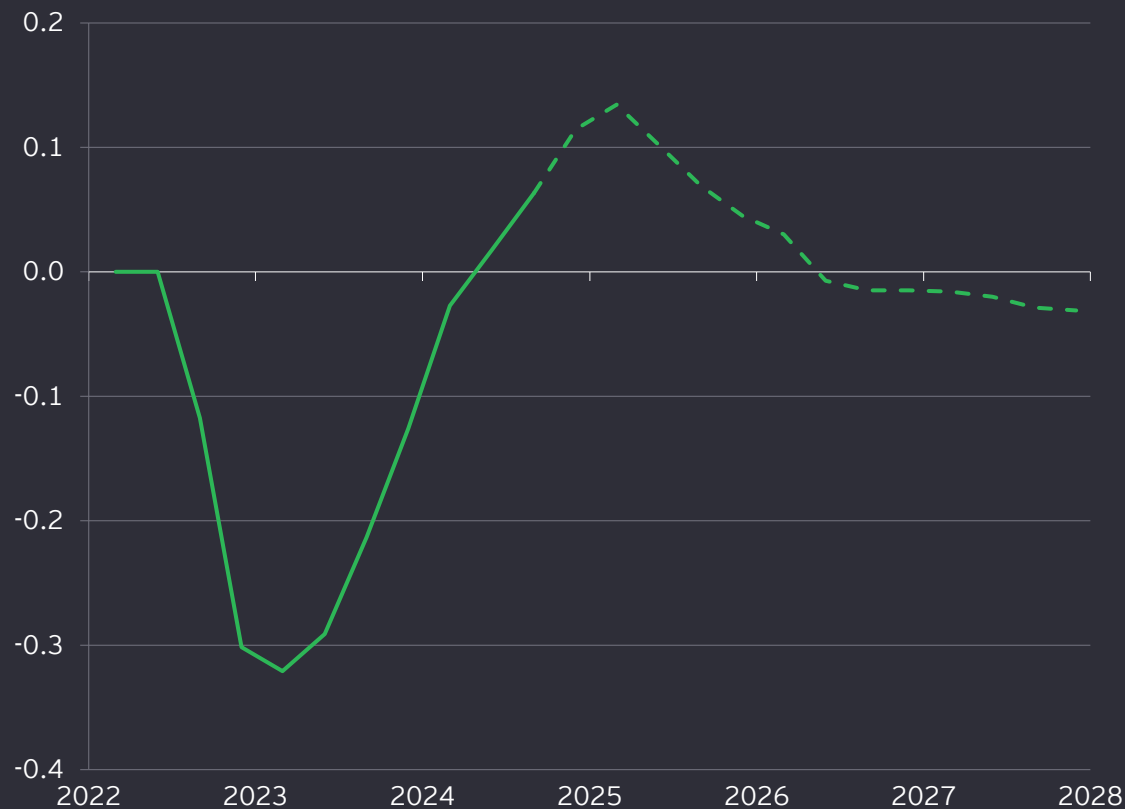
**Country average for EU and euro area excluding Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia.

*** Energy prices are the final price average of coal, natural gas, petroleum products and PPI for electricity weighted by consumption.

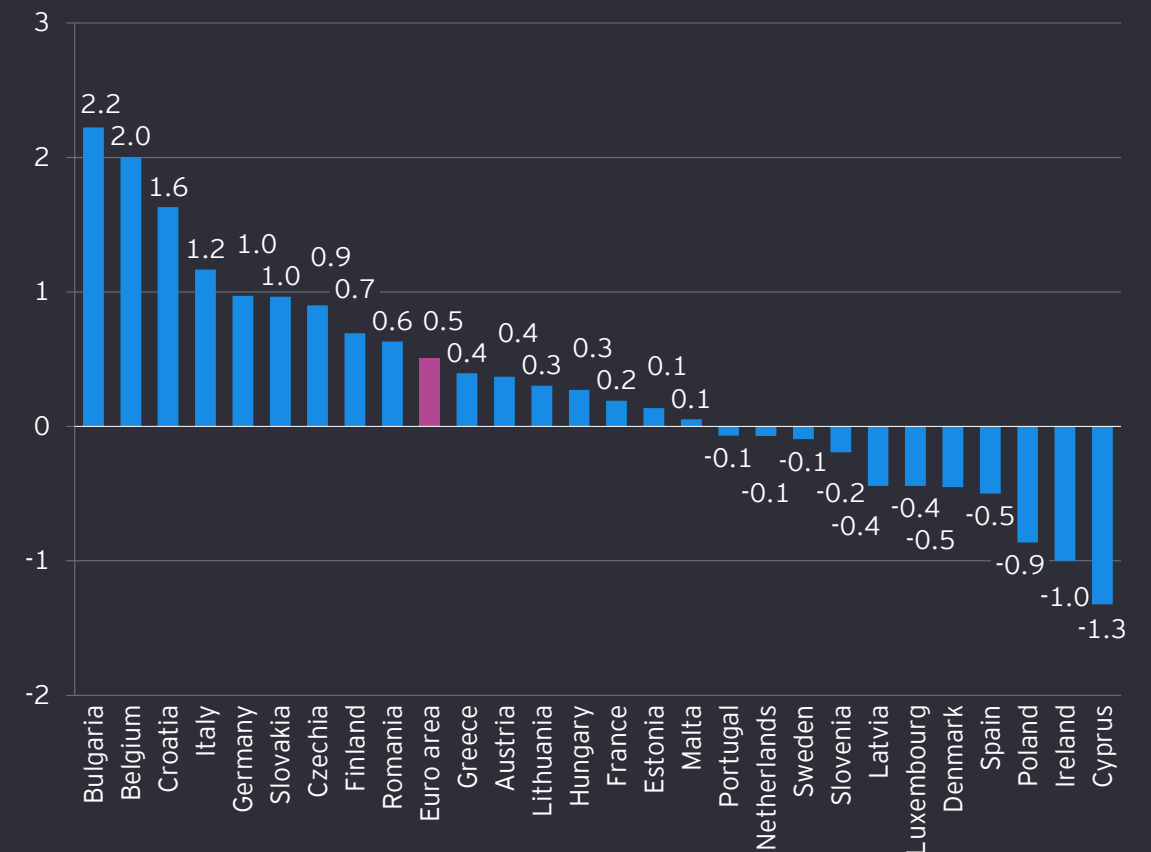
Dashed lines denote forecasts.

Economic policy is expected to have a mixed impact on growth, with monetary policy supporting activity, while fiscal policy is being tightened in most EU countries

Impact of monetary policy on the euro area real GDP q/q growth (in percentage)

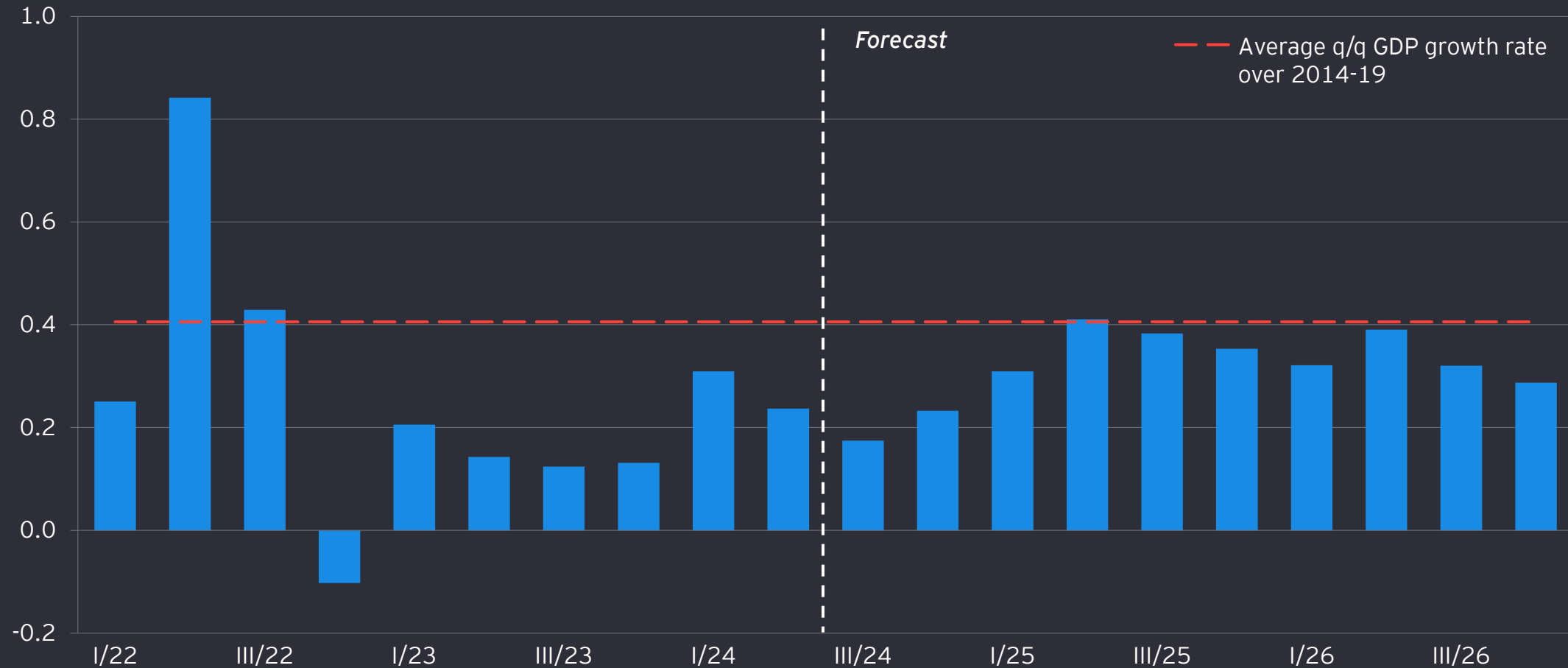


Expected change in structural fiscal balance excluding interest in 2025 (In percentage of potential GDP)



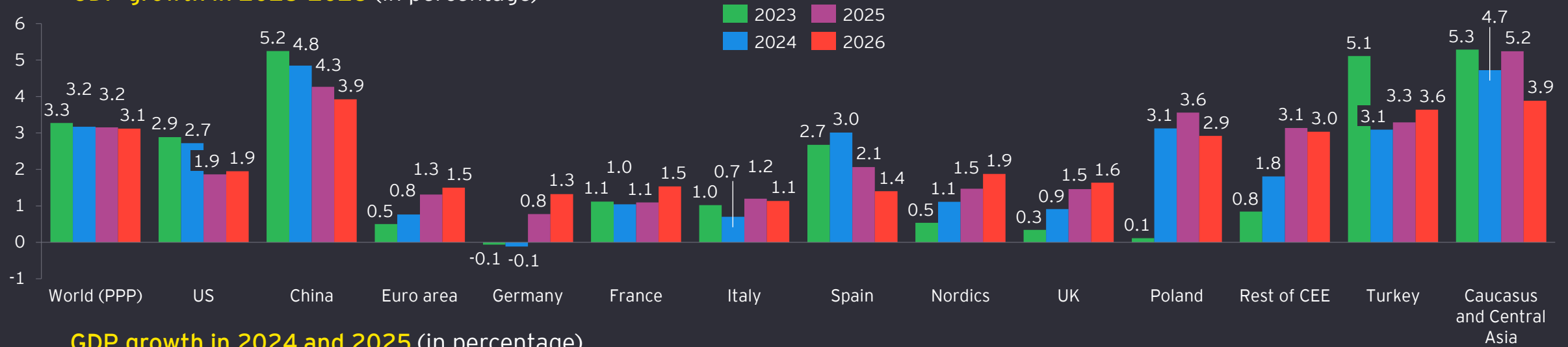
Consequently, we forecast a modest increase in euro area GDP growth, from 0.8% in 2024 to 1.3% in 2025, and 1.5% in 2026 - below the pre-pandemic pace

GDP growth in the euro area less Ireland
(q/q, in percentage)

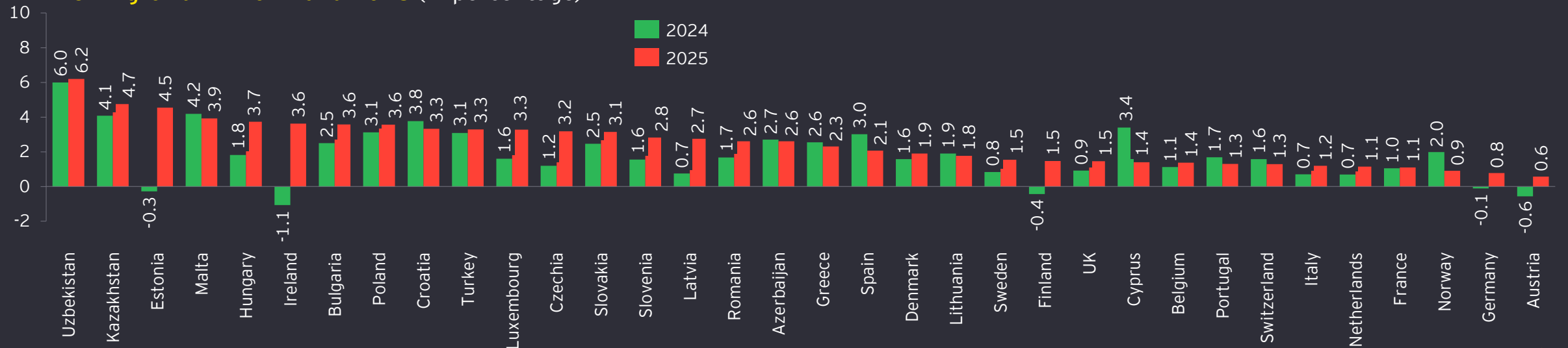


Major EU economies are expected to gradually converge in terms of GDP growth rates, while CEE countries will continue to stand out

GDP growth in 2023-2026 (in percentage)



GDP growth in 2024 and 2025 (in percentage)



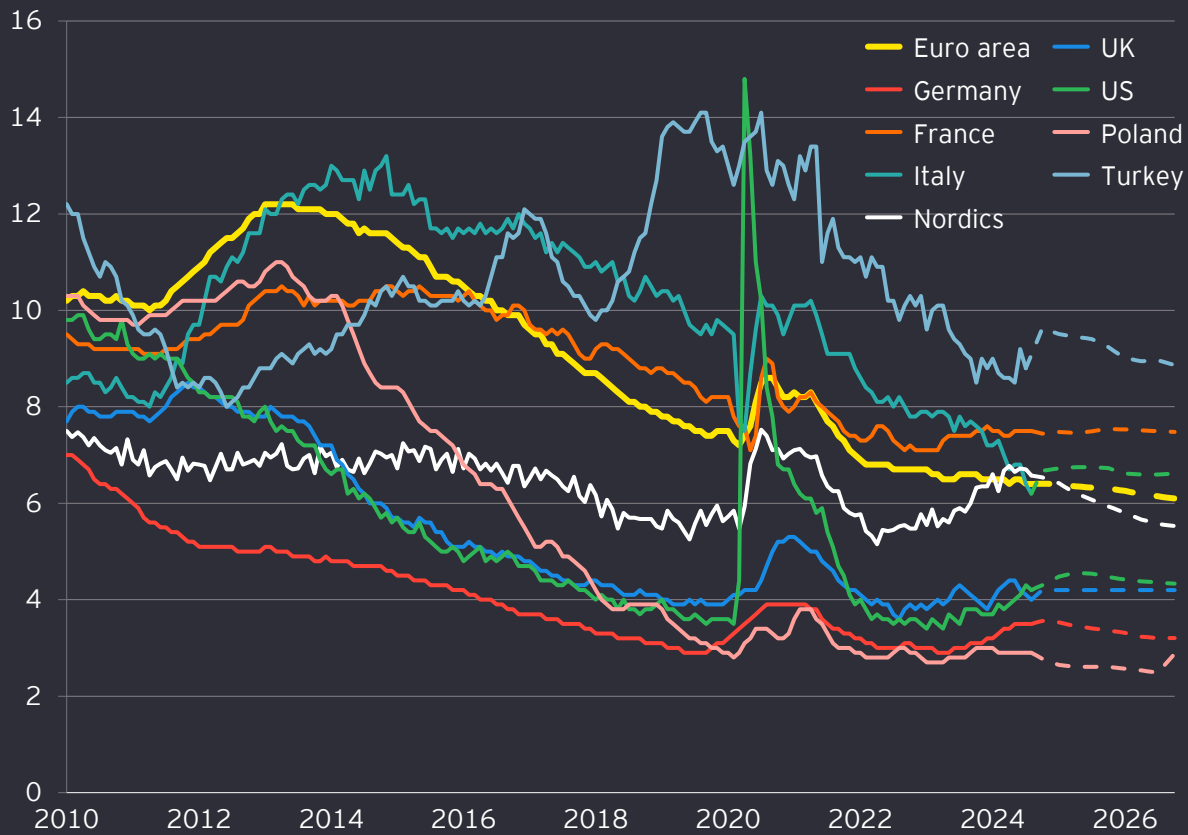
Source: Oxford Economics, EY EAT forecast; Asian Development Bank (for Caucasus and Central Asia).

Nordics include Denmark, Finland, Norway and Sweden; rest of CEE includes Estonia, Latvia, Lithuania, Czechia, Slovakia, Hungary, Romania, Bulgaria, Croatia, Slovenia; Caucasus and Central Asia includes Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan, Tajikistan, Azerbaijan, Armenia and Georgia.

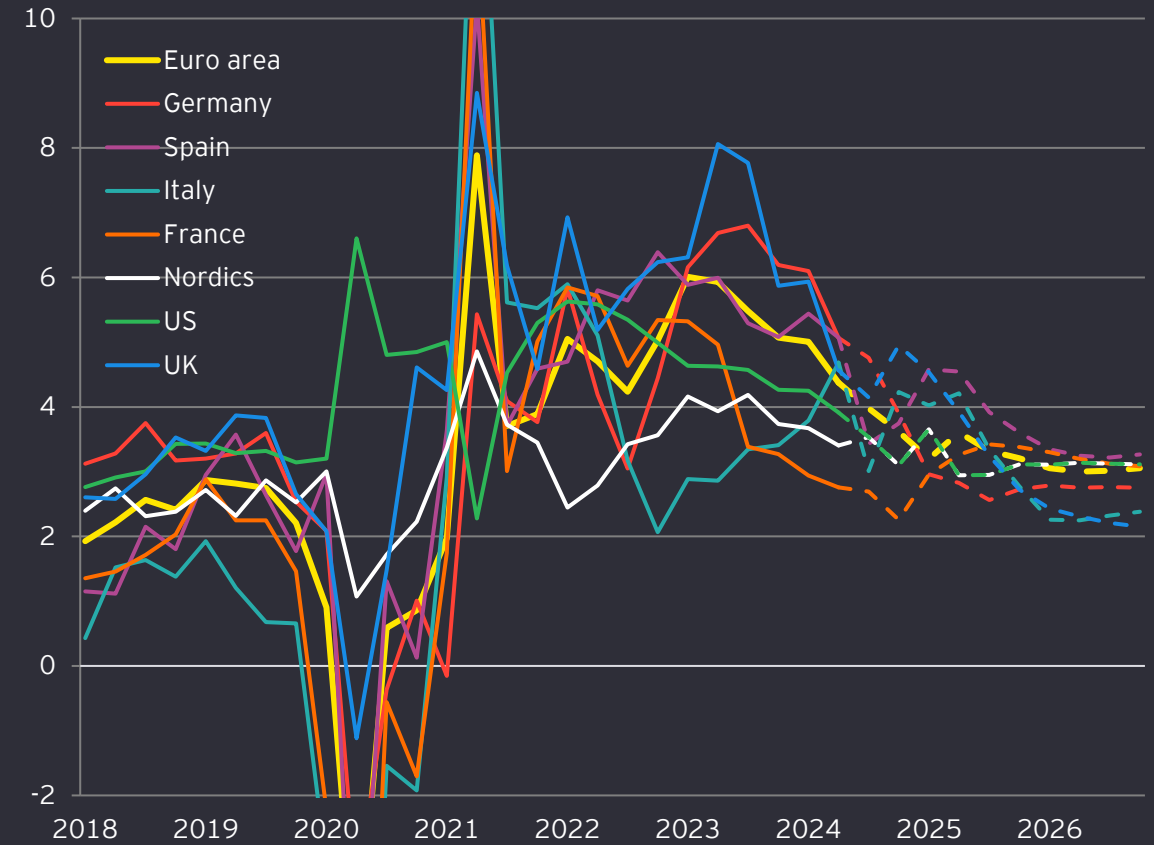
Labor market conditions are expected to largely stabilize, with wage growth in the euro area gradually declining towards 3%—a pace higher than before the pandemic due to a structurally tighter labor market

- Amid slightly faster GDP growth and increasingly binding demographic constraints, employment growth is expected to stabilize at approximately 0.1% q/q. This will be sufficient for the euro area unemployment rate to modestly decline towards 6%

Unemployment rate (in percentage)



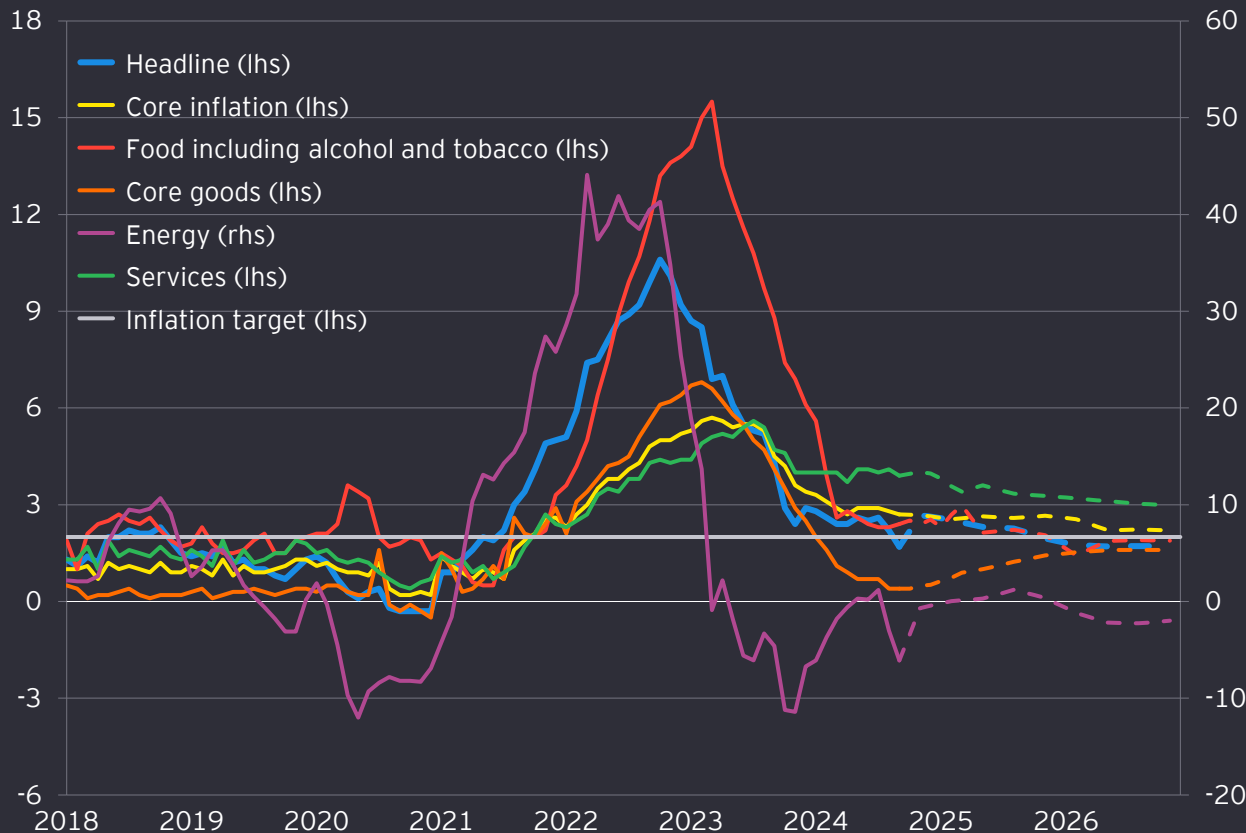
Wage growth (y/y, in percentage)



We anticipate headline inflation in the euro area to stay slightly above 2% through most of 2025 before declining to 1.7-1.8% in the following years. Core inflation will be somewhat more persistent

- We project services inflation to remain around 4% until the end of 2024 before gradually decreasing towards 3% over the course of 2025 and 2026 as nominal wage growth slows. Core goods inflation is expected to gradually rise above 1% as increased shipping and wage costs put an upward pressure on prices. As a result, core inflation is likely to stabilize around 2.5% in 2025 before decreasing to closer to 2% in 2026. We expect food inflation to remain around 2.5% in 2025 due to tax hikes and labor cost pressures, before dropping to 2% from 2026 onward, while energy inflation will hover near 0%.

HICP inflation in the euro area (y/y, in percentage)



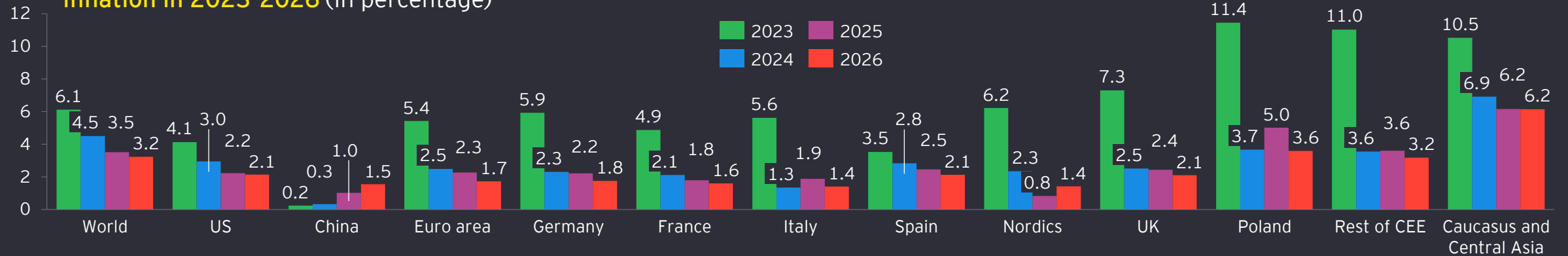
Y/y HICP services vs. nominal wage growth in the euro area (in percentage)



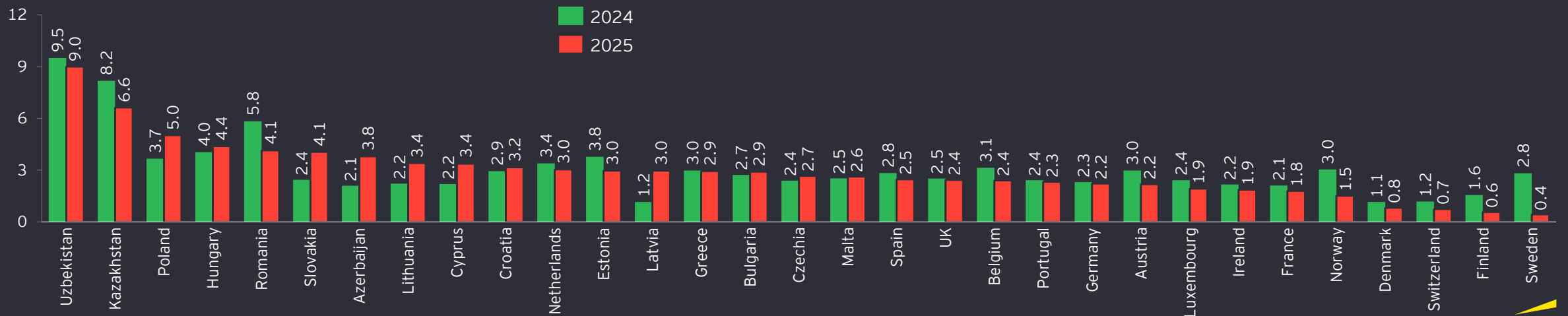
CEE countries are expected to have the highest inflation rates, while the Nordics and Switzerland should experience the least price pressure

- In 2025, we project Poland to exhibit the highest inflation in the EU, averaging 5%, as energy prices are deregulated, and core and food price pressures remain elevated due to strong wage growth and demand. Inflation in Hungary, Romania, and Slovakia is expected to exceed 4% for similar reasons. CPI inflation should be lowest in Sweden and Finland, at approximately 0.5%, due to methodological factors-mortgage interest payments are included in the CPI calculation in these countries, and thus, central bank interest rate cuts will significantly reduce inflation. Price growth is also expected to drop below 1% in Denmark, where core inflation has been particularly low, and remain below 1% in Switzerland.

Inflation in 2023-2026 (in percentage)



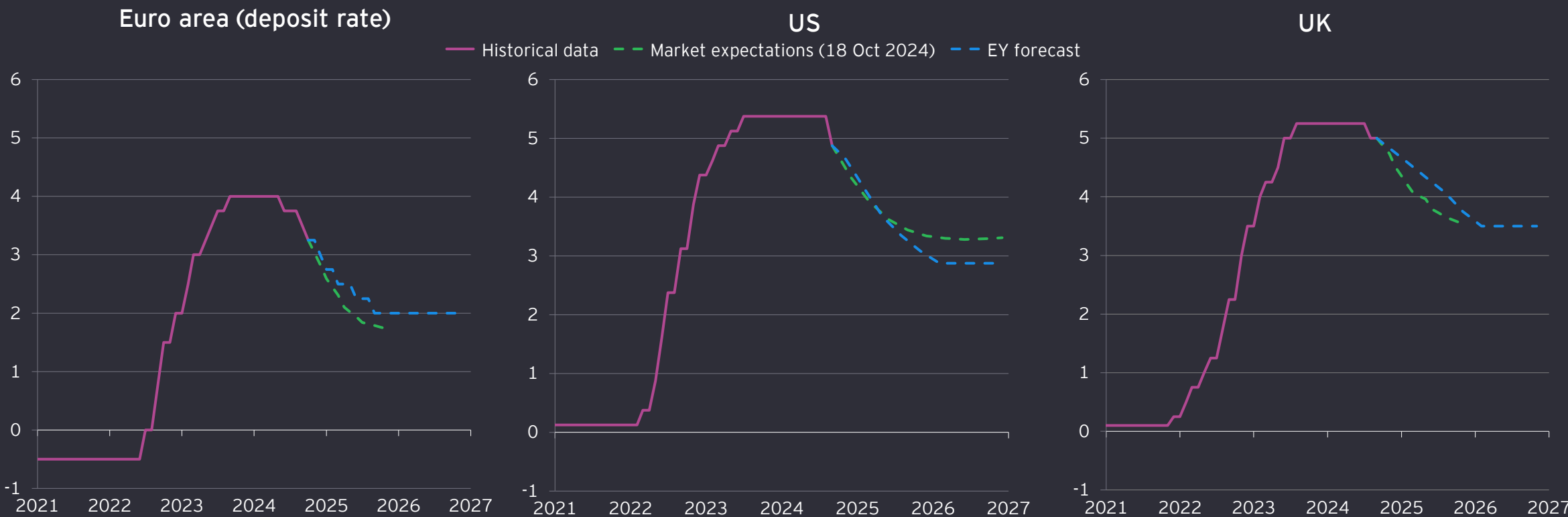
Inflation in 2024 and 2025 (in percentage)



We expect the ECB to cut rates at every meeting until March before slowing down the pace of rate reductions. The Bank of England will proceed at a slower pace given higher wage growth and services inflation, as well as a stronger recovery

- ▶ Following the recent shift in policymakers’ rhetoric and back-to-back cuts in September and October, we expect three more consecutive 25 bp cuts by March 2025, as growth falls below the ECB’s previous projections and the balance of risks to growth remains tilted to the downside, while the risks to inflation seem to have shifted towards lower price growth. Given that inflation is forecast to remain slightly above the target and growth is expected to pick up gradually, the ECB is likely to slow the pace of easing afterward, with two more rate decreases in June and September, leaving the deposit rate at 2%. Risks lean towards a faster pace of easing and a lower terminal rate if growth continues to disappoint, and inflation turns out lower than expected.
- ▶ The Bank of England is expected to take a more cautious approach, continuing to ease monetary policy at every other meeting after cutting rates from 5.25% to 5.0% in August, as it faces higher wage growth and services inflation amid a stronger economic recovery. We expect the terminal rate of 3.5% to be reached by the end of 2025.

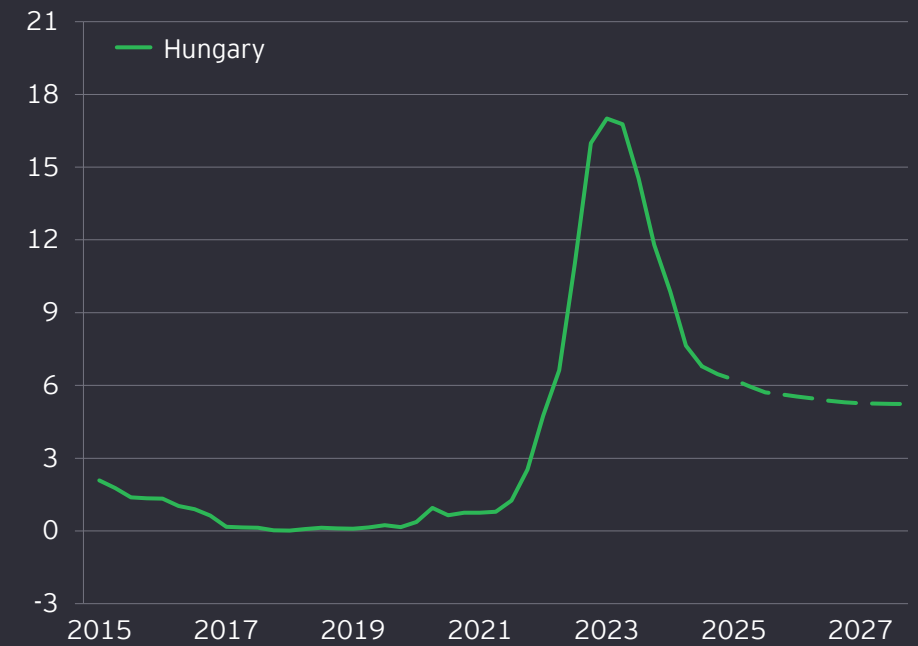
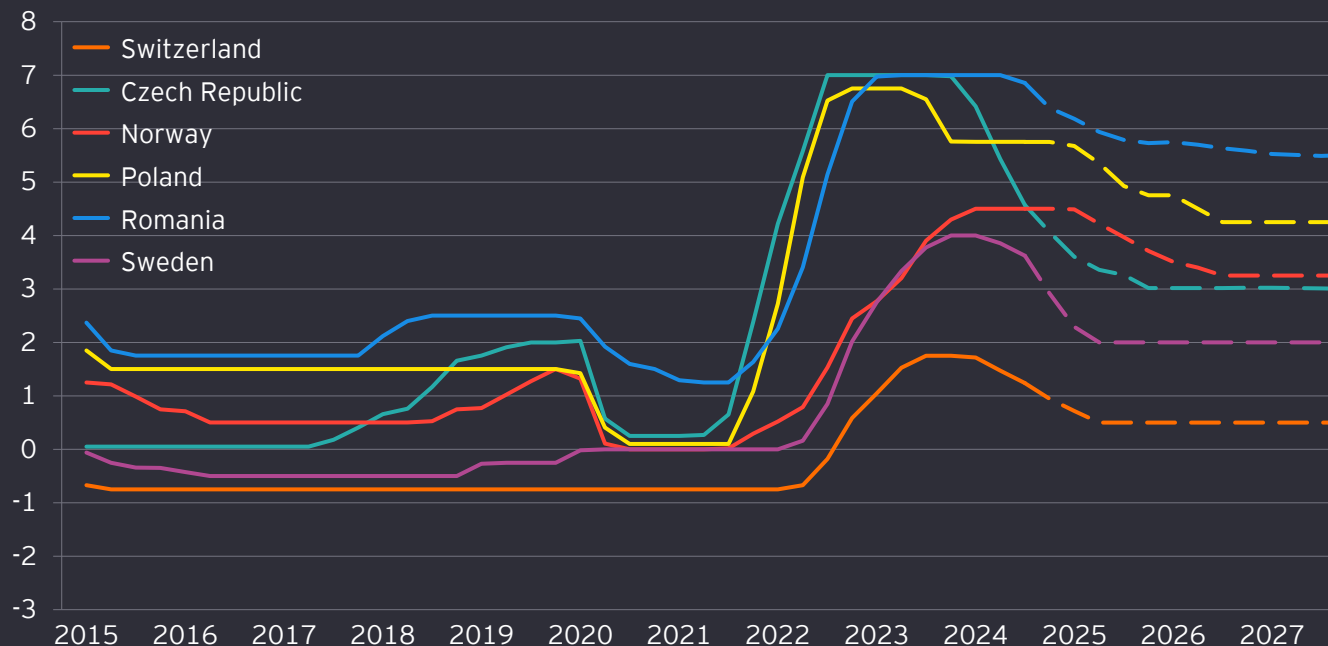
Historical and expected* central bank interest rates (In percentage)



Sweden is expected to continue cutting rates, Poland and Norway are likely to initiate easing cycles in early 2025, while Czechia and Hungary are anticipated to conclude their easing cycles soon

- ▶ Since the first rate cut in March 2024, the Swiss National Bank has systematically cut rates by 25bp every quarter. We expect the SNB to continue this trend and cut rates by 25bps at two more meetings.
- ▶ The Swedish Riksbank is set to implement a significant 50 bp cut in November and reach the terminal rate of 2% by March 2025. Norges Bank is more cautious, with the first rate reduction expected in March 2025, followed by rate decreases at every other meeting.
- ▶ While the pace and timing of easing differ significantly across CEE, all central banks are expected to cut rates by additional 100-150 bps by 2026. Central banks in Czechia and Hungary are approaching the end of their cycles. Due to stronger price pressures, the terminal rate in Hungary (5.25%) is projected to be much higher than in Czechia (3%).
- ▶ Romania is forecast to cut rates gradually before reaching 5.5% due to elevated inflation. Finally, Poland's central bank signals that the easing cycle will restart in March 2025. We expect rates to stop at 4.25% in 2026, above the neutral rate due to strong economic activity.

Historical and forecast central bank interest rates* (In percentage)



The balance of risks to GDP growth continues to lean to the downside, particularly in the short term

The economic outlook remains uncertain, with the balance of risks continuing to be tilted towards lower GDP growth in Europe, while inflation risks appear to have shifted towards more restrained price increases.

Key risk factors include:

- ▶ **Prolonged downturn in manufacturing** - in our baseline scenario, we expect a modest recovery in European manufacturing, driven by recovering domestic demand, continued improvement in external demand, falling interest rates, and a reversal in the inventory cycle. However, risks are skewed to the downside as the structural loss of competitiveness by European producers, not least due to higher energy prices and increasing competition from China, may be more significant than currently anticipated.
- ▶ **Delayed consumer recovery** - consumption has been weaker than expected in recent quarters, despite rising real incomes. We anticipate this to change as we move into 2025, but there is a risk of further downside surprises, especially if consumers remain pessimistic about the economic outlook.
- ▶ **Subdued investment** - although we already expect a modest to moderate pace of investment recovery, driven by lower interest rates and improving demand, there is a possibility that investment will be even more sluggish, particularly if company profit margins continue to erode. The recovery in housing investment may also be more protracted than expected, given that interest rates will remain well above pre-pandemic levels.
- ▶ **US elections and tariffs** - the direction of US policy following the upcoming presidential election is a significant source of uncertainty for the European economy. Specifically, the potential introduction of broad-based tariffs on imports from the EU and changes in policy towards the war in Ukraine could significantly impact exports and raise the perceived level of geopolitical risks, reducing consumption and investment.
- ▶ **Geopolitical tensions** - an escalation in the war in Ukraine or further conflict in the Middle East could lead to spikes in commodity prices, further increase in shipping costs, and renewed bottlenecks in global trade. This could lead to a resurgence in inflation and adversely affect global economic activity, particularly in Europe, which is more vulnerable to global shocks due to its openness.
- ▶ **Energy and food prices spikes** - unfavorable weather conditions or local political unrest could also reduce the supply of or increase demand for energy and food commodities, leading to higher inflation and reduced economic activity.
- ▶ **Sovereign bond market stress** - with inflation no longer driving revenue growth or helping to reduce debt-to-GDP ratios, the risk of renewed stress in emerging economies' sovereign bond markets, or those in Southern Europe, remains elevated.

Despite these significant downside risks, there are factors that could positively impact growth.

- ▶ **Lower than expected inflation** - inflation may turn out lower than expected if services inflation declines faster, core goods inflation remains subdued at close to 0%, or positive supply shocks reduce food inflation. Lower inflation would enhance household disposable incomes and consumption. Simultaneously, it would enable central banks to cut interest rates more rapidly to levels below current expectations, providing an additional boost to investment and consumption.
- ▶ **Stronger rebound in consumption, supported by accumulated excess savings** - with improving sentiment and declining interest rates, European consumers may also decide to utilize some of their substantial excess savings accumulated during the pandemic, resulting in stronger GDP growth.
- ▶ **Stronger productivity growth, due in part to AI** - productivity growth, which has been particularly weak over the past decade, presents another upside risk to the outlook. Tight labor markets should encourage firms to invest more in productivity-enhancing and labor-saving technologies, including automation, robotization, and the potential of generative AI. In a recent series of EY articles, we have shown that AI has significant potential to transform the labor market, boost investment, total factor productivity, and GDP growth, with uneven effects across sectors, but it may also increase inflation and interest rates.
- ▶ **Strong immigration flows alleviating demographic pressures and supporting potential growth** - our baseline scenario predicts that labor supply in Europe will plateau after 2025 and decline after 2027, driven by demographic trends, with several countries, particularly in CEE, experiencing earlier and more acute reductions. However, tight labor markets in Europe and ongoing global population growth present an upside risk that immigration could at least partially offset these gaps. This scenario appears more plausible in CEE, which had not seen significant immigration before the large-scale influx from Ukraine, making immigration projections typically conservative.

EY Economic Analysis Team (EAT) – Macroeconomic Insights Unit



Marek Rozkrut, PhD

EY Chief Economist – Europe & Central Asia
Head of EY EMEIA Economists Unit

Contact:

marek.rozkrut@pl.ey.com

Economic Analysis Team

EMEIA Macroeconomic Insights

SharePoint

Economic Analysis Team



Maciej Stefański

Senior Economist
Economic Analysis Team



Maciej Zdrolík

Senior Economist
Economic Analysis Team



Konrad Bochniarz

Economist
Economic Analysis Team



Matteo Mariotti

Economist
Economic Analysis Team



For more information on specific countries or regions, reach out to economists from across the EY network

US



Gregory Daco

EY-Parthenon Chief Economist

Contact

gregory.daco@ey.com

[Website](#)

UK



Peter Arnold

UK Chief Economist

Contact

parnold@uk.ey.com

[Website](#)

Germany



Ferdinand Pavel

Director, Economic Advisory

Contact

ferdinand.pavel@de.ey.com

Italy



Alberto Caruso, PhD

Senior Manager,
Strategy and Transactions

Contact

Alberto.Caruso@it.ey.com

Spain



Jose Miguel Perez Gil

Socio / Associate Partner,
Strategy and Transactions

Contact

JoseMiguel.PerezGil@es.ey.com

Turkey



Cem Camli

Partner, EYP-Strategy

Contact

cem.camli@parthenon.ey.com

Africa



Angelika Goliger

Africa Chief Economist
Strategy and Transactions

Contact

angelika.s.goliger@za.ey.com

MENA



Armando Ferreira

MENA Leader
Economic Advisory

Contact

armando.ferreira@ae.ey.com

Canada



Mauricio Zelaya

National Economics Leader

Contact

mauricio.zelaya@ca.ey.com

Oceania



Cherelle Murphy

Oceania Chief Economist

Contact

cherelle.murphy@au.ey.com

[Website](#)

ASEAN



Bingxun Seng

Economic Advisory Leader
Singapore

Contact

bingxun.seng@sg.ey.com

Forecast and country-specific outlook sources

- ▶ Forecasts for most economies have been prepared by EY Economic Analysis Team (EY EAT) using an amended version of the Oxford Global Economic Model (GEM)
 - ▶ EY EAT have adjusted GEM equations, assumptions and data inputs
- ▶ Forecasts for the US have been prepared by EY-Parthenon Macroeconomics Team
 - ▶ Contact: https://www.ey.com/en_us/strategy/macroeconomics
- ▶ Forecasts for the UK have been prepared by EY ITEM Club
 - ▶ Contact: parnold@uk.ey.com
- ▶ Forecasts for Italy in 2024-25 have been prepared by EY Italy
 - ▶ Contact: alberto.caruso@it.ey.com
- ▶ Country-specific outlooks for Germany, Italy, Spain, the UK and Turkey have been provided by economists listed on the previous page

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