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Independent Thinking

Recession Watch: spotting European risks

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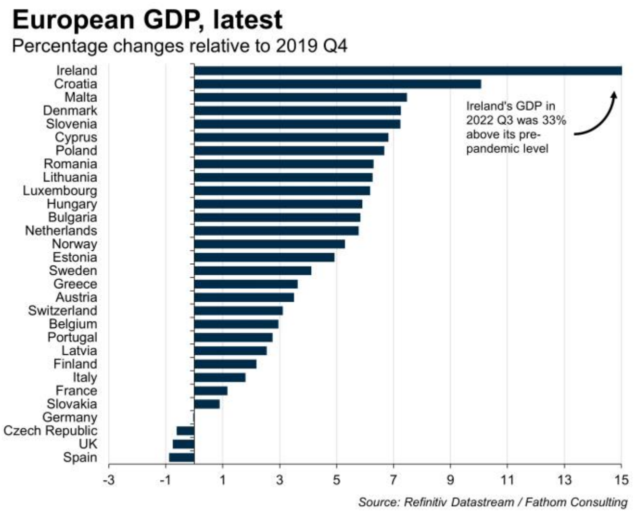
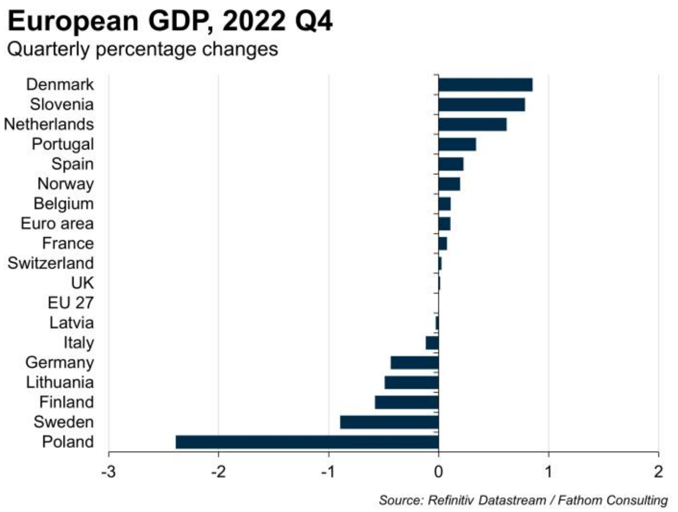
Headlines

- Current data show that Europe avoided a contraction in Q4, but output fell in some industry-intensive economies
- Consumer confidence is recovering, but is generally lagging in Nordic countries
- The full impact of rate hikes on house prices has not yet been felt — we think the banking systems of Sweden and France look especially vulnerable to this
- Excess savings remains a cushion for most countries, but are dwindling in Eastern Europe where inflation and currency risks are high
- Overall, while the European economy defied expectations in 2022, we still think a recession is on the cards this year

Most European economies have now recovered their pre-pandemic levels of output. While this took far longer than for China and the US, the other major economic hubs, it is nevertheless an impressive feat when compared to previous recessions. This recovery has been fairly broad-based across the region with only three countries — the Czech Republic, Spain and the UK — still producing less than they did at the end of 2019. By contrast, in 15 of the 30 economies shown in the first chart below output is at least 5% greater than it was prior to the pandemic.

However, while the first-round impacts of the pandemic may now be behind us, last year saw European economies face a different set of headwinds — namely fiscal and monetary tightening, higher inflation, falling real incomes and the prospect of gas supply shortages. Momentum has undoubtedly slowed as a result, with GDP growth falling to zero by Q4, and some of the region's more industry-intensive economies (e.g., Poland, Lithuania, and Germany) experiencing outright contractions. The key question now is whether the region will slip into recession and, if it does, where and when is this likely to happen? That is the topic of this week's *Recession Watch*.





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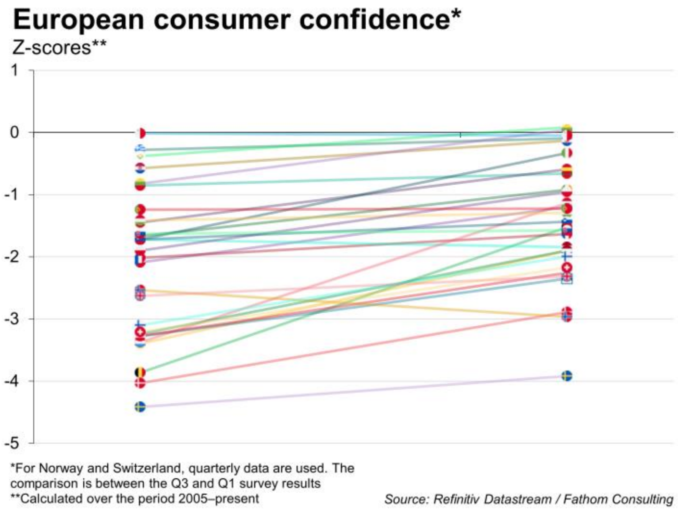
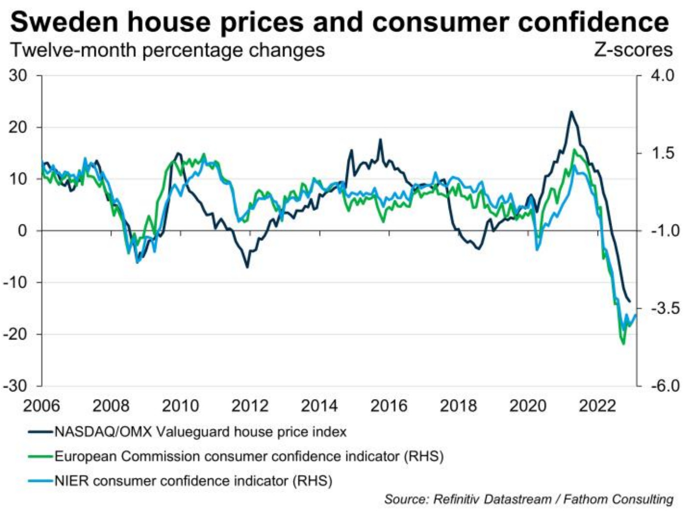
We, along with many others, had expected the euro area to contract in 2022 Q4. It did not.[1] Moreover, while core inflation remained more stubborn than policymakers would like, there were persistent downside surprises to headline inflation for the first time since 2020. What's more, consumer confidence rose after its trough in September for all bar one of the countries shown in the chart below. That said, household sentiment remains weak by historic standards, with the Nordic countries appearing particularly pessimistic about the economic situation.

Swedish households appear to be the most downbeat overall, with confidence four standard deviations below normal. It is also telling that Sweden is suffering one of the most severe house price corrections in the region. While the two are likely to be closely linked, it is unclear conceptually which way round the causality runs — i.e., do lower house prices erode confidence as they reduce the value of households' assets, or does lower confidence reduce the demand for housing and therefore lower house prices, or are both true simultaneously? Empirically, we can say that lower confidence tends to lead to lower house prices in Sweden, but there is little sign that lower prices feed back into weaker confidence.





We have not seen such dramatic house price corrections in the rest of Europe, but Fathom's Global Economic and Strategic Allocation Model (GESAM) suggests that the current rate hikes may be sufficient to chalk about 15% off UK house prices, roughly equal to the recent falls in UK residential REITs. Policymakers are likely to try to alleviate some of this pain. But, even so, rising rates also imply higher debt-servicing costs, and increase the likelihood of defaults. If the price of the underlying asset (i.e., the house) falls by too much, this could impose significant losses on the banking system. A forthcoming update from Fathom's Financial Vulnerability Indicator (FVI) will discuss these issues in greater detail.

1 It should however be noted that revisions to GDP data tend to be negative when an economy is slowing — as the region currently is. For more, see [Recession Watch: identifying recessions with uncertain data]

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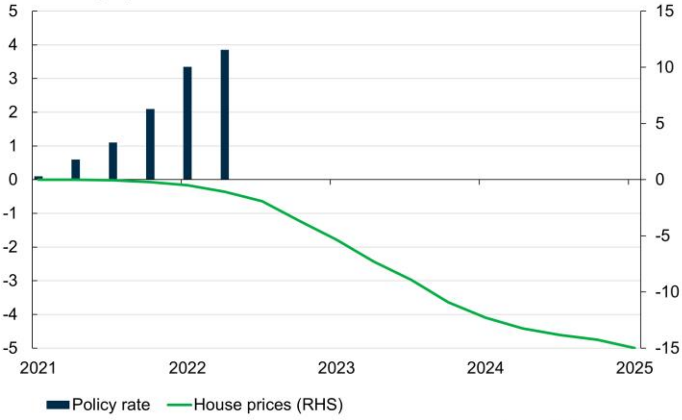
UK residential real estate investment trusts

Price index, 01/01/2020 = 100

Source: Refinitiv Datastream / Fathom Consulting

UK impact of higher policy rates

Percentage points, deviations* Per cent, deviations*



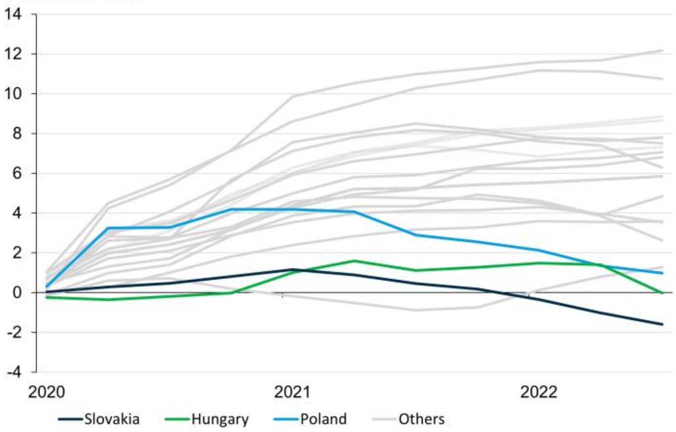
*From baseline

Source: Fathom Consulting

As we have stressed for some time, the size of pandemic savings pots and how those pots are spent could well dictate whether countries enter recession this year. Generally, these savings pots were smaller in Europe than in North America, although the UK and Spain stand out as being particularly generous. However, while US households have dipped into a significant proportion of their savings already (we estimate as much as one third have already been spent), European consumers have generally been far more conservative, with savings remaining largely unspent in many of the region’s major economies. This cautious behaviour may mean that consumer spending remains weak, but it may also provide a reserve of cash for households and cushion them if the economic situation deteriorates further. However, the picture is slightly different in Eastern Europe, with several economies appearing already to have exhausted their pool of savings. The picture is doubly worrying as the FVI is flagging this part of the continent as particularly vulnerable to a currency crisis, something which has the potential to lead to yet higher inflation and a further deterioration in real incomes.

European pandemic savings pots

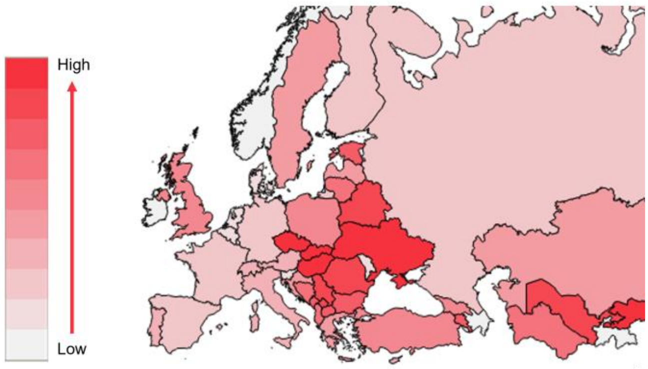
Per cent of GDP



Source: Refinitiv Datastream / Fathom Consulting

Europe and Central Asia Currency FVI scores

Probability of a crisis in 2023 Q2, per cent



Source: Fathom Consulting

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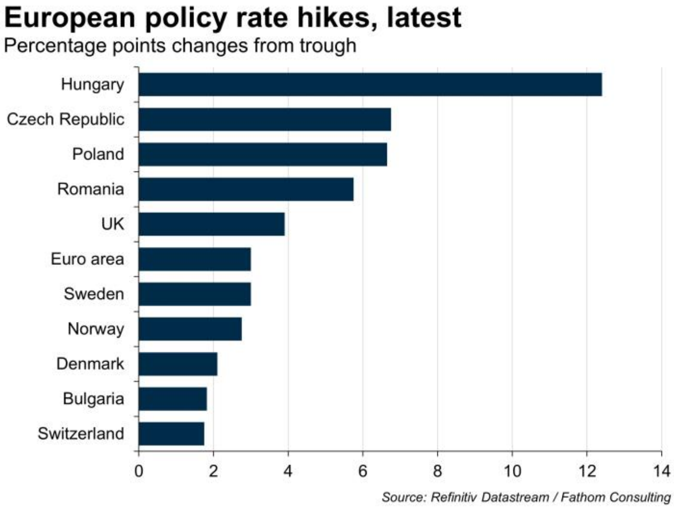
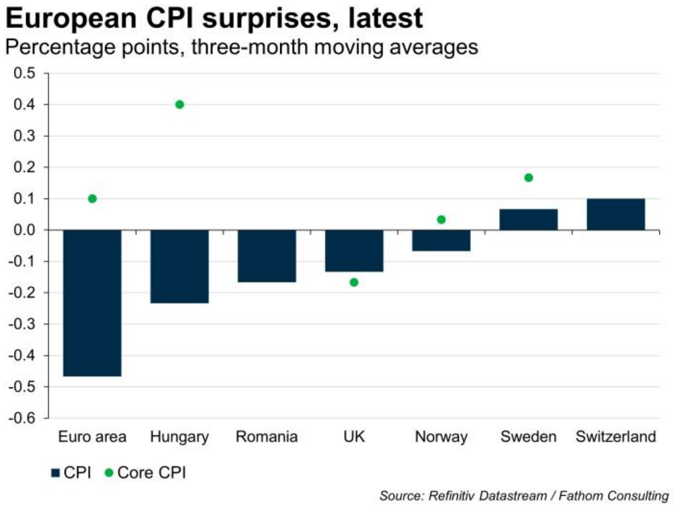
The problems facing Eastern Europe are somewhat intertwined — higher inflation and falling currencies are to some extent self-reinforcing and both are combining to erode nominal household savings faster than elsewhere. National central banks (at least, those outside the euro area) do have the power to prevent this, and we have seen a number of aggressive rate hikes. The further these rate hikes go, the greater the recessionary risks will become. For now, it seems likely that central banks will continue to hike rates until they are confident that inflation is falling back towards target. The good news is that inflation has started to surprise to the downside. The bad news is that core inflation is remaining stickier than hoped.





Further reading

- [Recession Watch: no landing… for now]
- [Recession Watch: the pause for breath]
- [Recession Watch: US doing all it can to avoid recession]
- [China's incredibly accurate GDP statistics]

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