Recession, soft landing or a period of low-to-no-growth?

Like the US, the EU is at an economic crossroads. Where is the EU economy heading - into recession, a soft landing, or a period of low-to-no-growth?

Looking beyond the headline numbers for growth, inflation and unemployment, the EU has been struggling with fallen productivity and higher unit labour costs since the mid-2010s.

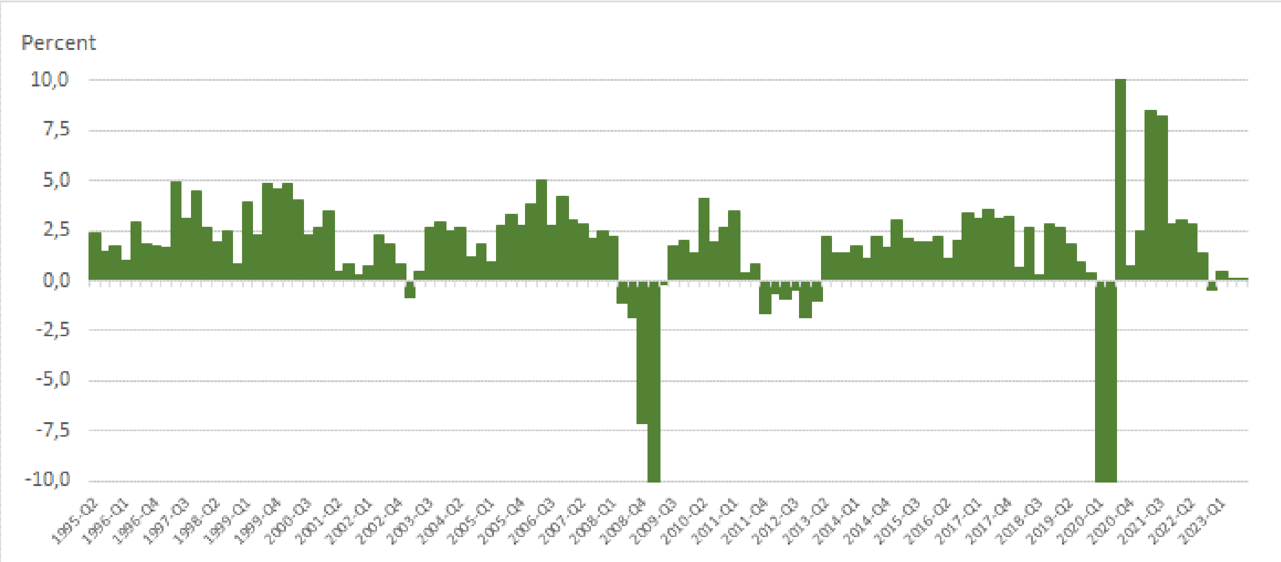
Down which path will these structural problems lead the European economies over the coming years?

GDP – status after Q3 2023

Eurostat has just released the first figures for EU growth in Q3 2023, and they are rather flat. Real GDP grew by an annualised 0.1% in Q3 2023, making it the fourth successive quarter without any real growth in GDP (see Figure 1, below).

Over the last almost 30 years, that is quite an unusual development; during that time, there has either been growth or recession, but growth has not ever remained unchanged for four consecutive quarters.

Figure 1 EU annualised growth in real terms *source Eurostat*



So are we in a recession? Or will we see a soft landing that many in the market are hoping for? Or is low-to-no-growth a phenomenon that we should get used to?

Recession, soft landing or no growth

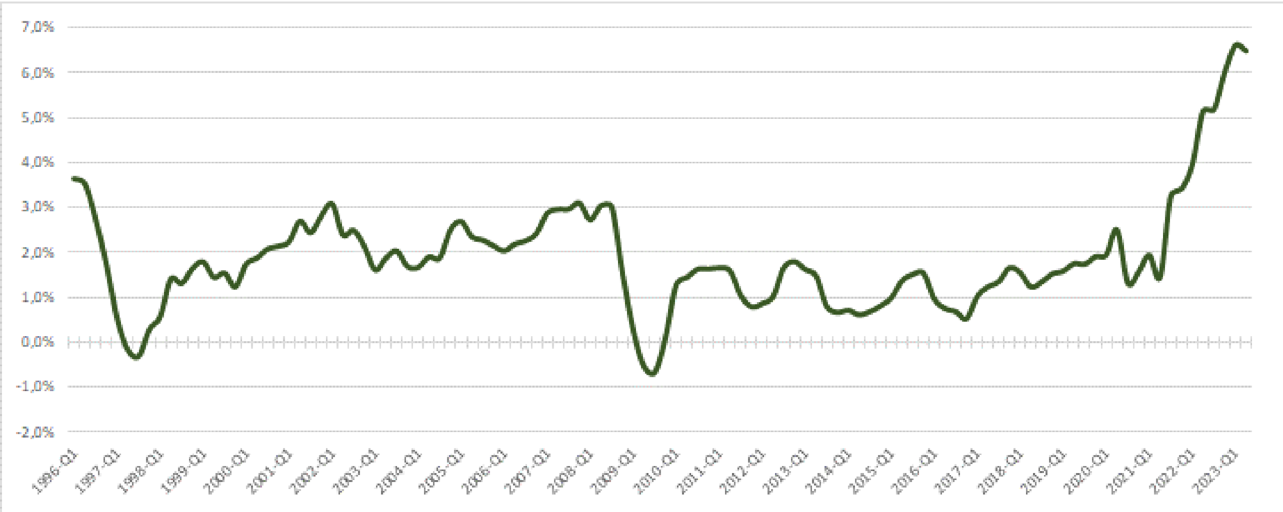
During the last 15 months, the ECB has hiked interest rates very aggressively. Normally, such a tightening of monetary policy should have caused a recession. Growth is low, but employment remains high, and unemployment has not really increased as rates have risen.

Therefore, it is difficult to argue that the EU is in a severe recession that would force the ECB to lower interest rates quickly, even if one considers the “normal” lack of impact to changes in monetary policies.

Engineering a soft landing is very difficult. Coordinating fiscal and monetary policy, and timing every policy move to perfection in order to bring real growth back up to over 2% and inflation down to under 2%, seems far-fetched - especially, when one examines some of the underlying economy series.

Figure 2, below, clearly illustrates the difficulties for policy makers. The implicit price deflator for GDP, which in layman’s term can be considered a “weighted average” of all prices in the economy, has reached a level not seen since 1996.

Figure 2 EU - GDP Implicit price deflator percentage change over previous year
source Eurostat



Having a severe recession would reduce the price deflator to zero, as it was during the financial crisis. If we have entered a soft-landing scenario, the price deflator should more likely be trending down towards the 1% area.

While we still have not received the implicit GDP price deflator for Q3 2023 at this point in time, it is unlikely that it will fall 5%-points in Q3 2023 or in the coming quarters.

The underlying inflation problem for the ECB is illustrated in Figure 3, which shows the growth in unit labour cost per hours worked.

Figure 3 EU - Unit labour cost per hour worked year-on-year growth *source Eurostat*

In a "normal" recession, such as that caused by the financial crisis, unit labour costs spike because output falls faster than the economy can adjust for labour costs. This can also be seen in the recessions of 2011 and that of Covid-19-

induced 2020. However, unit labour costs normally retreat quickly as adjustments in the economy take place and unemployment rises due to layoffs.

When the recession ends, unit labour costs begin to climb again.

Since 2016, unit labour costs per hours worked has grown steadily from around 0% to more than 7% in Q2 2023 - the highest level for the entire period. (COVID-19 basically caused only a "blip" on the radar.)

The unusual thing about the current economic situation is that, even with low growth or borderline recession, unit labour costs per hours worked have grown at increasing rates, which is alarming because it indicates underlying pressures in the labour market.

Of course, increasing unit labour costs per hours worked can be justified if productivity is also increasing. Unfortunately, however, productivity per hours worked displays a long-term downtrend in the EU, as seen in Figure 4.

Figure 4 EU - Real labour productivity per hours worked year-on-year growth *source Eurostat*

If productivity in the EU is falling, we cannot expect high GDP growth going forward. Real growth in the economy can only arise from two factors: high productivity or more hours worked.

Given the highest level in employment and lowest unemployment level for decades, along with falling productivity, it is difficult to envision anything other than a structural slow-growth path ahead for both the EU and the eurozone.

A structural problem with implications

The EU faces a structural problem in that it will be difficult to generate growth and simultaneously keep unit labour costs under control.

This will not be made easier by the demographic challenges facing the EU.

German Chancellor Olaf Scholz addressed this issue in an interview with Der Spiegel on 21 October 2023. In Germany, around 13 million baby-boomers will be retiring over the coming years, leaving a massive gap in the workforce that needs to be filled.

Many EU countries are facing a similar problem - one which can only be solved by structural labour market reforms or migration.

For the financial markets, a long-term low-to-no-growth period with relative high inflation is the worst possible scenario, and a long way from the current very optimistic expectations for high growth, low inflation and lower interest rates.

Such an optimistic view on the economy would, given the challenges mentioned above, require several massive structural reforms in many of the largest EU countries.

If such reforms are not implemented, financial asset classes will need to be repriced to a low-to-no-growth scenario with underlying inflation and wage pressures.

In our assessment, the latter is unfortunately more likely than the former, which will lead to even more volatility in the financial markets going forward.