**Energizing Europe**

Following a strong recovery after the onset of the COVID-19 pandemic, growth in the EU is expected to sharply decelerate in 2023 as high inflation and increasingly tight monetary policy dampen economic activity. Although the EU economy was more resilient than expected in 2022—owing to additional fiscal support and earlier strength in domestic demand—this momentum is expected to fade in 2023. Growth is set to slow further in 2023, as the drag from tighter monetary policy to combat inflation accumulates, external demand remains muted, and uncertainty remains high, especially after the recent banking turmoil. The outlook for the EU economy remains challenging as member states are confronted by strong headwinds from persistent inflation, weaker household disposable income, and tighter financing conditions. Despite ongoing fiscal support in many countries, the adverse impact of high inflation on real disposable income is expected to dampen private consumption. Despite considerable resilience, the EU economy is in a weakened spot following the string of overlapping crises since 2020, which have eroded macroeconomic buffers and left the economy vulnerable to additional negative shocks. Following the onset of the pandemic, Russia’s invasion of Ukraine, and the subsequent cost-of-living crisis, the EU economy faces significant macroeconomic challenges, heightened downside risks, and a volatile geopolitical environment. The negative spillovers from Russia’s invasion of Ukraine have propagated to the EU through multiple channels, including through higher food and energy prices eroding households’ purchasing power, and a weaker external environment. Russia’s invasion has arrived on the heels of the pandemic, which together with the cost-of-living crisis, has substantially reduced fiscal buffers in most EU member states. High inflation—driven initially by economic reopening, the release of pent-up demand, and pandemic-related supply bottlenecks and then by a surge in commodity prices and supply disruptions from Russia’s invasion of Ukraine—has prompted one of the steepest and most synchronous monetary policy tightening cycles in recent history (Figure ES.1). Given the ongoing need to contain above-target inflation, the space to cut monetary policy rates is limited. FIGURE ES.1 The EU outlook remains challenging after a series of negative shocks spurred steep increases in the cost of living and a rapid tightening in monetary policy a. European Central Bank policy rate change b. Decomposition of inflation in Euro area in 2022, modelbased estimates of deviation from target/average Sources: AMECO, Haver Analytics, Bloomberg, Eurostat, J.P. Morgan, World Bank. Percentage points Percent (y/y) Longer-run average Demand Supply Natural gas ER CPI (RHS) 10 | Energizing Europe Although the labor market remains strong, with unemployment rates near record-lows in the EU, the recovery in employment remains uneven, leaving some populations behind. Since the beginning of 2021, the labor market experienced a rebound in employment in line with the resumption of economic activity. Nevertheless, the headline figures do not accurately depict the differences in the labor market’s rebound across countries, workers or types of employment. Since much of the inequality prevalent throughout the EU is due to inequality in the labor markets, an uneven recovery there has implications for income inequality. Employment remains below pre-pandemic levels for those in more physically demanding jobs, part-time workers (particularly youth), and workers with lower education (Figure ES.2). Despite increasingly tight labor markets and partial nominal wage increases, real wages and households’ purchasing power have declined significantly due to rising inflation. While nominal hourly labor costs have been increasing in most countries in the EU since early 2021, real labor costs have been declining due to the acceleration in inflation since the third quarter of 2021. The fall in real wages has been particularly pronounced in Northern and Western Europe, where the gap between real and nominal labor costs widened in late 2022 as inflation surged. Most EU countries have increased or announced to increase their statutory minimum wages to soften the impacts of inflation on low-wage workers; nevertheless, these increases do not fully offset high inflation. Alongside an erosion of real minimum wages, the sustained fall in the labor share of GDP points to inequality challenges as the distribution of income shifts from workers to firms (Figure ES.3). High inflation has eroded real incomes, with the sharp rise in food prices hitting the poorest households the hardest—chipping away earlier gains in inclusion and likely leading to poverty increases. Rising food and energy prices over the last few years have left the poorest with less disposable income for essential needs and exposed their vulnerability to further shocks. While inflation has been showing signs of tempering across the EU, headline and especially food inflation has been high in some of the poorer EU economies. Although all households are affected by rising prices, the inflation gap between wealthier and poorer households has been widening recently as poorer households spend larger shares of their incomes on food items. In part because of high food and energy inflation, poverty could increase in some EU member states, as a result of direct effects, but also indirect effects.1 1. Direct effect, or first-order effects, refer to the loss in purchasing power in the short term as a result of the rising price of goods the household directly consume (i.e. energy and food). Indirect effects, or second-order affects, capture when households are affected indirectly through the consumption of other products that use energy as inputs, that is when rising input prices passed on to higher prices of final consumption goods. This capture more the medium term effects and adjustments through the economy. FIGURE ES.2 Employment growth index by education level, EU27 FIGURE ES.3 Labor share of income in GDP Source: Eurostat (lfsq\_epgais), 2019Q3–2022Q3. Governments have stepped in again to shield their economies and people from the cost-of-living crisis, but support measures have varied considerably, depending on the impact on the economy and policy buffers. Risks to the EU outlook remain firmly tilted to the downside, with most risks stemming from a worsening of the drags envisioned in the baseline projections. The uncertainty around forecasts remains elevated amid recent banking sector strains, persistently high core inflation pressures, tightening macroeconomic policy, and energy supply concerns. Growth could be weaker than expected if underlying inflationary pressures continue to surprise on the upside, prompting additional tightening by central banks, which would further tighten credit supply conditions and dampen activity. EU output could shrink from a number of downside risks materializing, including from a rapid deterioration in confidence following banking sector turmoil, which could trigger a full-scale banking crisis and years of weak investment. An intensification in Russia’s invasion of Ukraine could lead to additional cuts to Europe’s energy supply and renewed commodity price volatility, as well as further fragmentation of international trade and investment. Coordinated policy efforts are needed to mitigate the risk of recession, rebuild fiscal buffers, and support vulnerable households. Policy makers will need to pursue a carefully calibrated macroeconomic policy mix that continues to rein in inflation while avoiding additional financial market volatility or stress. Minimizing the probability of crisis and any potential impacts will also require a sound macroeconomic policy mix where fiscal policy does not add to inflationary pressures and prompt additional monetary policy tightening. This risk can be mitigated by ensuring that fiscal support is carefully targeted towards those most in need (firms and households). Eventually, EU member states will need to resume fiscal consolidation efforts to bring government debt levels within the levels outlined by the EU’s common fiscal framework. Monetary policy in the EU is expected to remain tight as slowing inflation causes real policy rates to gradually rise. After sharp rises in headline inflation, it has fallen in recent months and is expected to continue this trend over the next two years. The fall in inflation, combined with high policy rates, could shift real policy rates into positive territory absent policy rate cuts. As a result, monetary policy would assume a restrictive stance and weigh on economic activity, particularly investment, as the credit impulse tightens (Figure ES.4). A more restrictive stance, however, would help counter underlying inflationary pressures and be in line with closing positive output gaps. In some EU countries, if inflation remains too high for too long, authorities may have to continue tightening monetary policy to support macroeconomic stability and to prevent inflation expectations from becoming de-anchored. Fiscal policy support, going forward, will need to be timely, targeted, time bound, and transparent to eventually support gradual fiscal consolidation. Governments face the challenge of balancing competing demands and limited fiscal space. To this end, it will be critical for policy makers FIGURE ES.4 Bank credit impulses s Energizing Europe to better target fiscal support (Figure ES.5), including by identifying and prioritizing vulnerable groups. Better targeted fiscal support can also bolster efforts to realign spending with revenues, especially as fiscal policy makers embark on much needed and delayed fiscal consolidation. The challenge, however, is to ensure that the economic slowdown is not exacerbated by fiscal consolidation efforts—as was the case following the global financial crisis. Countries can balance these priorities by reducing untargeted tax cuts, strengthening tax administration, broadening the tax base and cutting subsidies on fossil fuels, which are costly and support demand for environmentally-damaging and carbon-intensive energy sources, which erodes the incentive for energy conservation and creates tension with longerterm climate goals.