



What if the eurozone were to enter a recession?

Roland Berger Institute

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After having recovered from the recession caused by the COVID-19 pandemic, the eurozone is again facing economic woes – The bloc is headed for another recession

In the wake of steadily rising prices, ongoing supply shortages, and above all, severe energy supply disruptions, the eurozone economy is facing an economic slowdown.

A technical recession – defined as two consecutive quarters of negative GDP growth – appears certain already in the second half of this year.

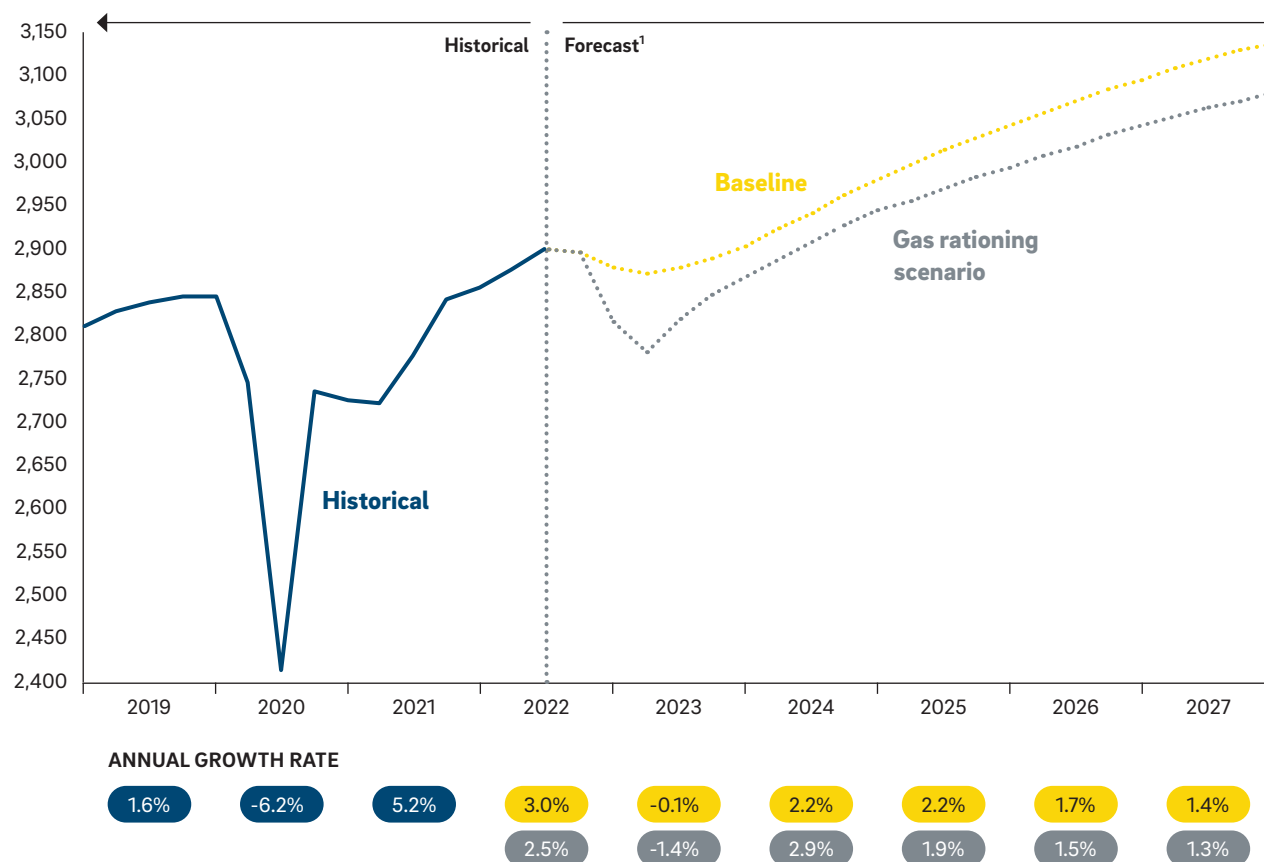
Most recent forecasts predict the impact to be strong enough to also cause a decline in annual GDP in 2023.

In a scenario where the eurozone runs into a gas shortage, with industry being forced to ration its use of gas, a recession would be significantly more pronounced.

Such damage would also substantially weaken the eurozone over the next few years, as higher costs would force some companies to either relocate or shut down their operations completely.

RECESSION EXPECTATIONS ARE GROWING – FORECASTS SHOW A CLEAR DECLINE IN GDP

Quarterly eurozone GDP, real [EUR bn, chained 2015 prices]



¹ Forecast begins as of Q2 2022

Sentiment indicators show that the economic cycle has very quickly moved from boom to recession in 2022, with worryingly low expectations

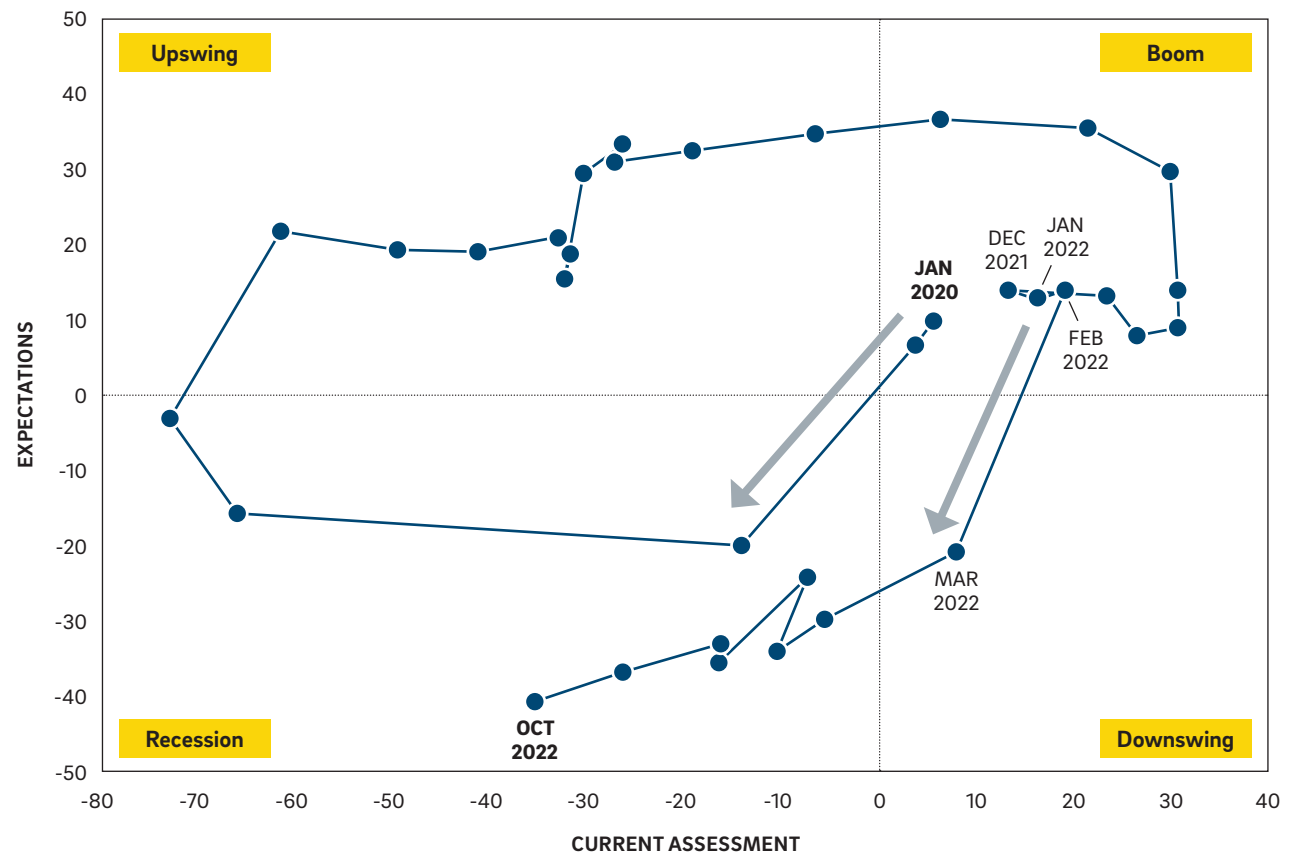
As part of the business cycle, economic downturns are natural features of an economy's development and are not a cause for concern per se.

But to put the current situation into perspective, we look at the Sentix survey's Business Cycle Index, which measures both investors' assessment of the current situation as well as their expectations.

The threat of the now impending recession is perceived to be particularly severe by market participants, expressed in their poor expectations.

With the negative experiences of the COVID-19 crisis in mind, market participants are now being hit by the new crisis, which darkens both the assessment of the current situation and expectations more considerably than the pandemic did.

DOWNSWING OF GREATER MAGNITUDE THAN DURING THE PANDEMIC Eurozone Sentix survey



Short-term sentiment indicators have reliably announced crises in the past – Fears of another recession hitting the eurozone are well founded

Following Russia's invasion of Ukraine, sentiment among consumers, producers, and stock markets plummeted.

Consumer confidence in particular has deteriorated sharply, falling to a new low.

Similarly, producer as well as investor sentiment has deteriorated significantly over recent months.

Since February, the PMI has fallen by 13% and the EURO STOXX 50 by almost 12%.

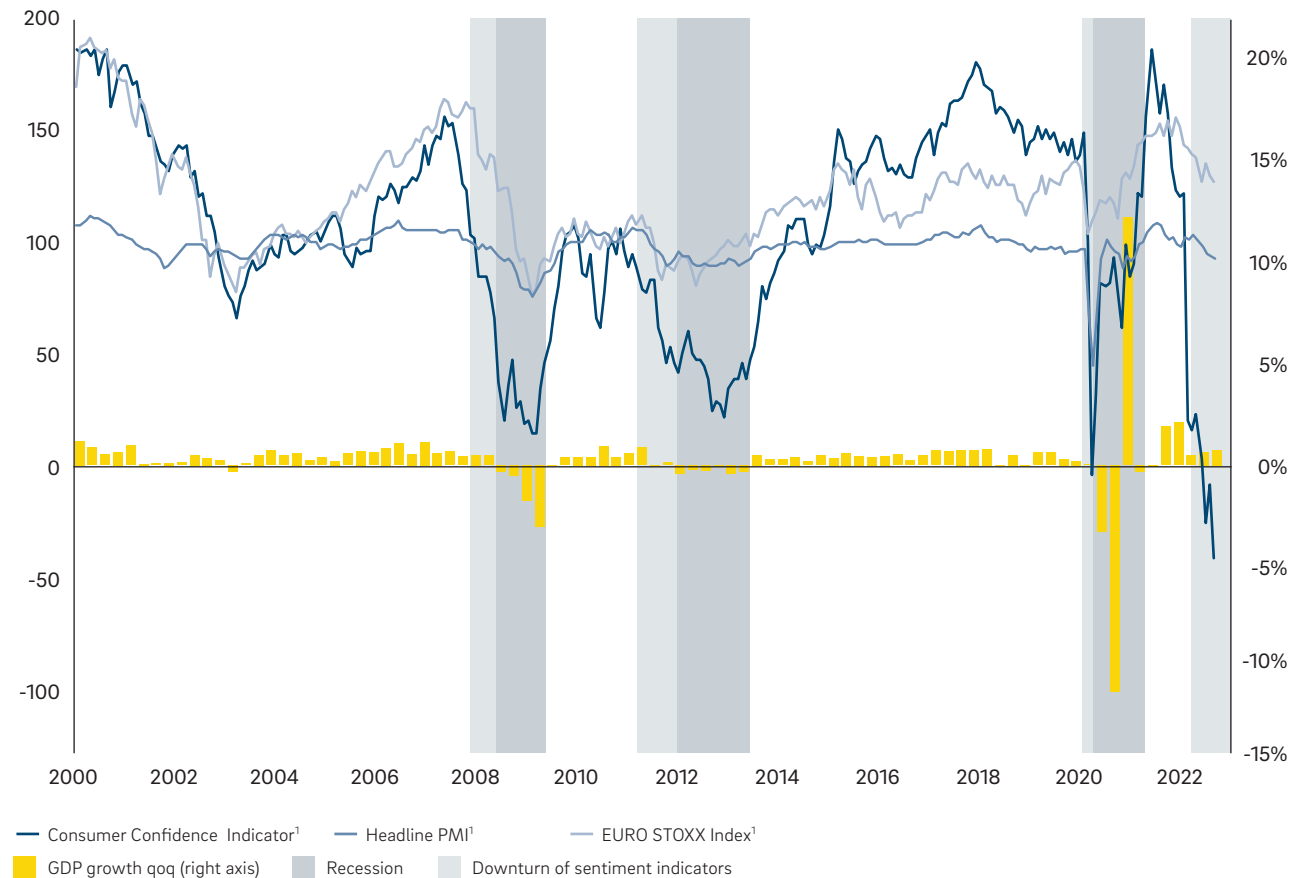
In the past, such significant drops in the three sentiment indicators were a reliable indication of a coming crisis.

But what happens in a recession and how would this new economic crisis develop?

To answer these questions, we look at data of past crises in combination with next year's forecasts in order to assess what to expect.

PRECEDING ECONOMIC DOWNTURN, CONSUMER, PRODUCER, AND INVESTOR SENTIMENT PLUNGE

Eurozone short-term sentiment indicators



¹ Indexed, 01/2010=100

When the economy contracts, companies do not only reduce production but cut investments, too

In the past, a recession has always been characterized by a decline in both investment and production levels. However, the key reasons underlying this decline are different for each crisis.

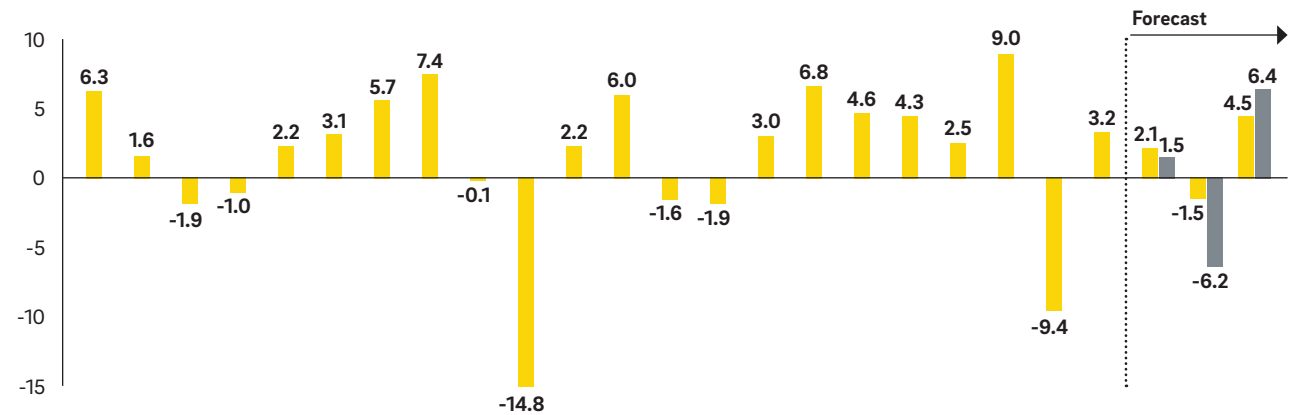
While the huge drop in investment and production during the global financial crisis was caused by a lack of financial resources, the main reason for low activity during the European debt crisis in 2012/13 was low demand caused by increased uncertainty.

Contrarily, during the COVID-19 crisis, low economic activity mainly resulted from lockdowns and disruptions to global supply chains.

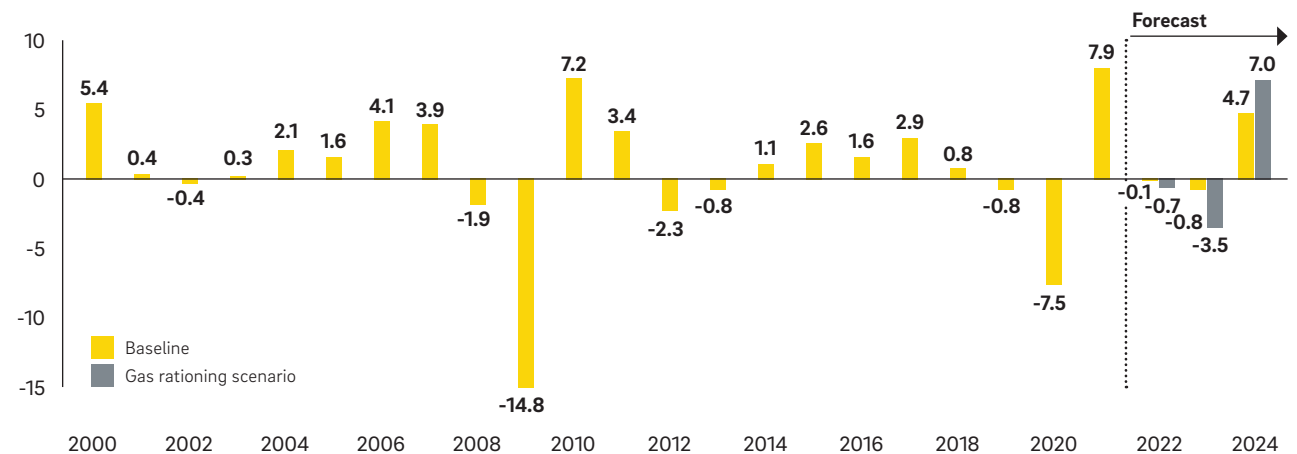
Now, the new crisis hurting businesses stems from four areas of concern: First, high inflation, fueled heavily by skyrocketing energy prices, and ongoing supply chain disruptions are likely to force companies to cut spending and, in some cases, even curtail production. Second, the high level of uncertainty about energy shortages and the global geopolitical situation will reduce incentives to invest. Third, the rate hikes of the ECB will harden companies' borrowing situation. And finally, falling demand due to high costs of living for consumers will reduce sales and thus production.

CAPITAL FORMATION AND INDUSTRIAL PRODUCTION VOLUMES DECLINE IN TIMES OF UNCERTAINTY

Private sector investment in the eurozone, real [% yoy change]



Industrial production index, eurozone, excluding construction [% yoy change]



Due to rampant producer prices, many companies are seeking ways to cut costs – However, layoffs are likely to be the last resort

Due to declining business activity and the resulting loss of revenue, more and more companies are forced to cut costs. In some cases, this also includes laying off employees.

In our baseline scenario, the impact on the unemployment rate would be similar to the effect seen during the coronavirus crisis, i.e. relatively modest.

However, should the gas rationing scenario materialize, we expect the impact on the labor market to be more pronounced compared to our baseline forecast.

Nevertheless, layoffs are likely to be among the last resort given tight labor markets at present as well as a shortage of skilled workers. Other measures, such as short-time work/furlough, have already proven useful during the pandemic and could be utilized again in this crisis.

PAST RECESSIONS AND THEIR EFFECT ON UNEMPLOYMENT

Eurozone unemployment rate [%]



High inflation and gloomy expectations for the future will dampen households' readiness to consume

Since the beginning of 2022, assessments of the financial situation of eurozone households deteriorated sharply, as can be gathered from the results of the European Commission's consumer survey.

In recent months, households have also reported that they are saving more, which further hints at a downturn in consumer appetite.

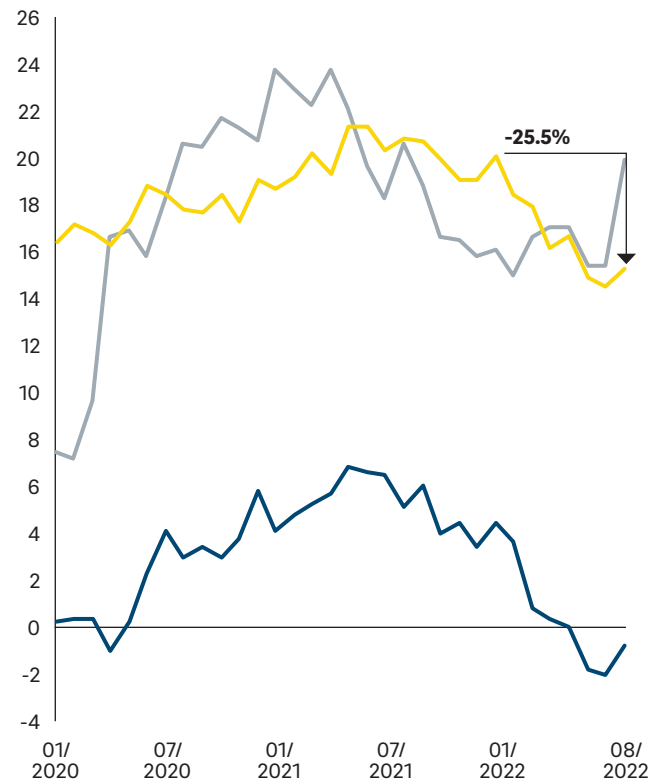
Looking ahead, households are expected to increase their savings in the short term to counteract rising uncertainty, high prices and fear of unemployment.

In the medium term, however, savings are likely to decline again, as high price levels – especially for energy and food – entail more household expenditure. Consequently, the financial situation of households in the eurozone is expected to worsen further next year.

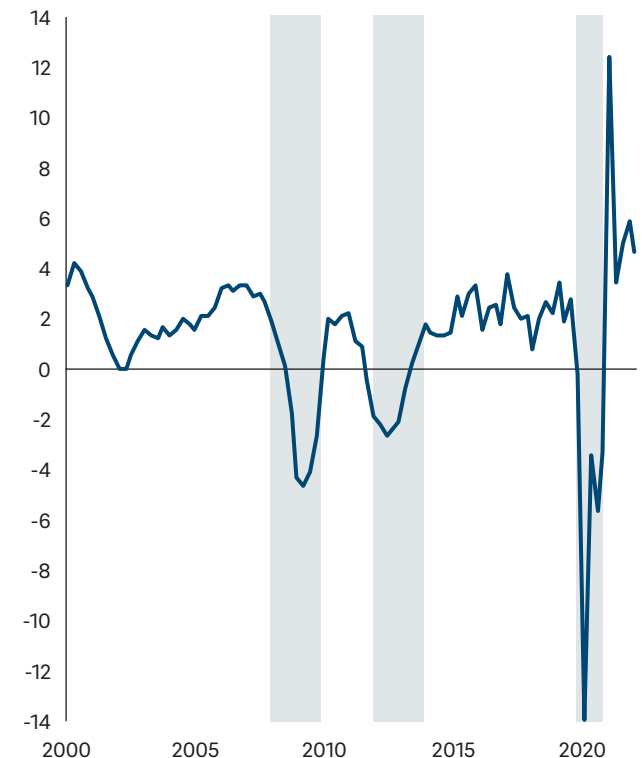
In total, the decline in disposable income is likely to lead to lower demand for non-essential goods and services in the medium term, affirming the fact that economic crises have a significant negative impact on demand.

CONSUMERS' WORSENING FINANCIAL SITUATION WILL PUSH DOWN DEMAND

Eurozone household self-reported savings and financial situation¹



Eurozone domestic demand, compared to previous year quarter [%]



— Savings over next 12 months — Savings at present — Financial situation

¹ As difference between the percentages of respondents giving positive and negative replies in the European Commission's consumer survey

To boost the economy and create financial security for households, governments will increase their spending, potentially leading to even higher inflation rates

In response to the economic downturn, governments typically increase spending.

The intention of increased spending is to boost economic activity in the short- to medium-term to stimulate demand and, thus, the economy.

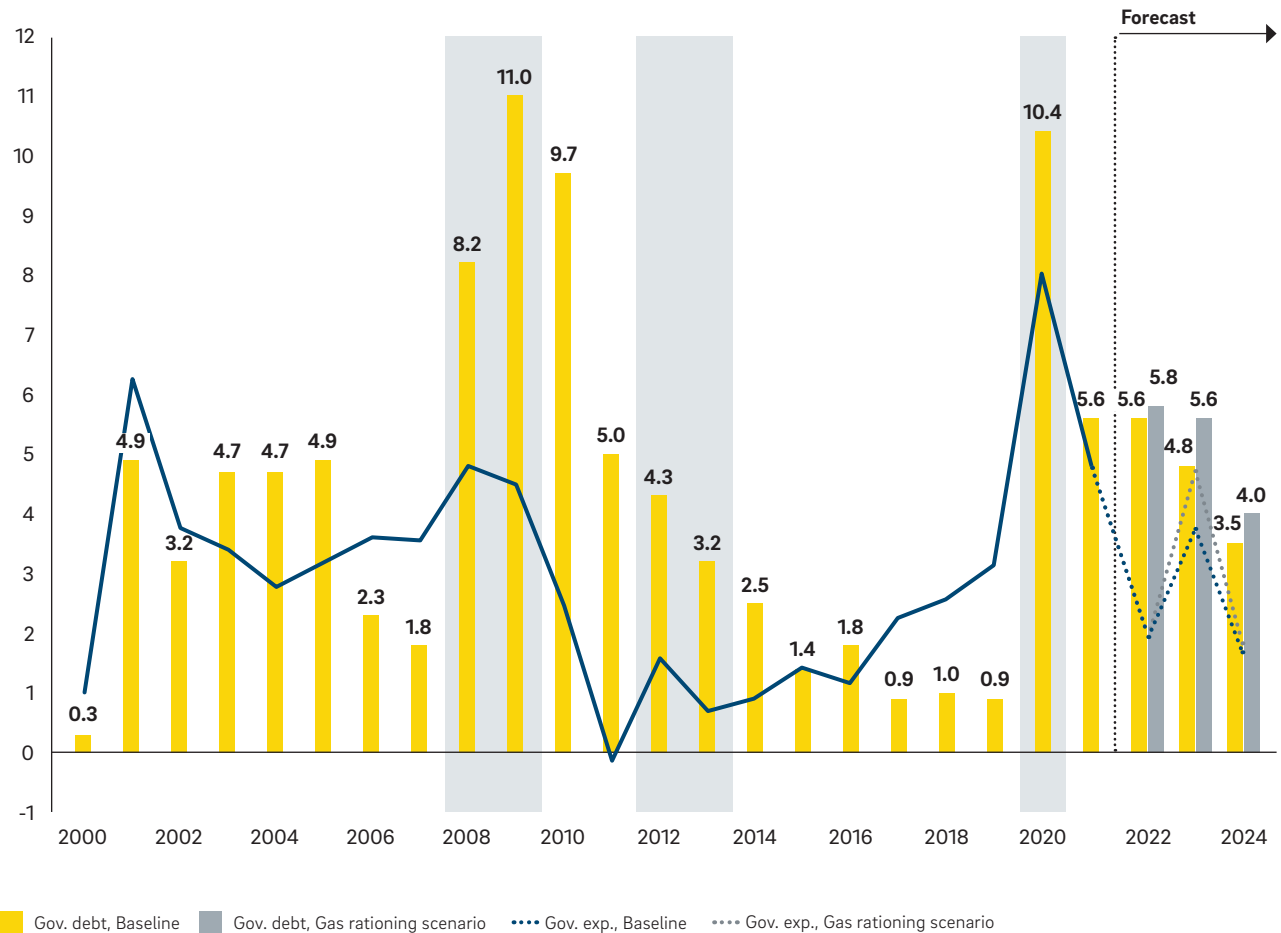
Since government interventions usually create additional direct or indirect demand, they risk fueling inflation further.

This is particularly perilous when the supply side is already facing major challenges.

In the current crisis, therefore, the finer points of market intervention matter a lot. If both supply and demand are supported by government measures, inflationary risks can be contained.

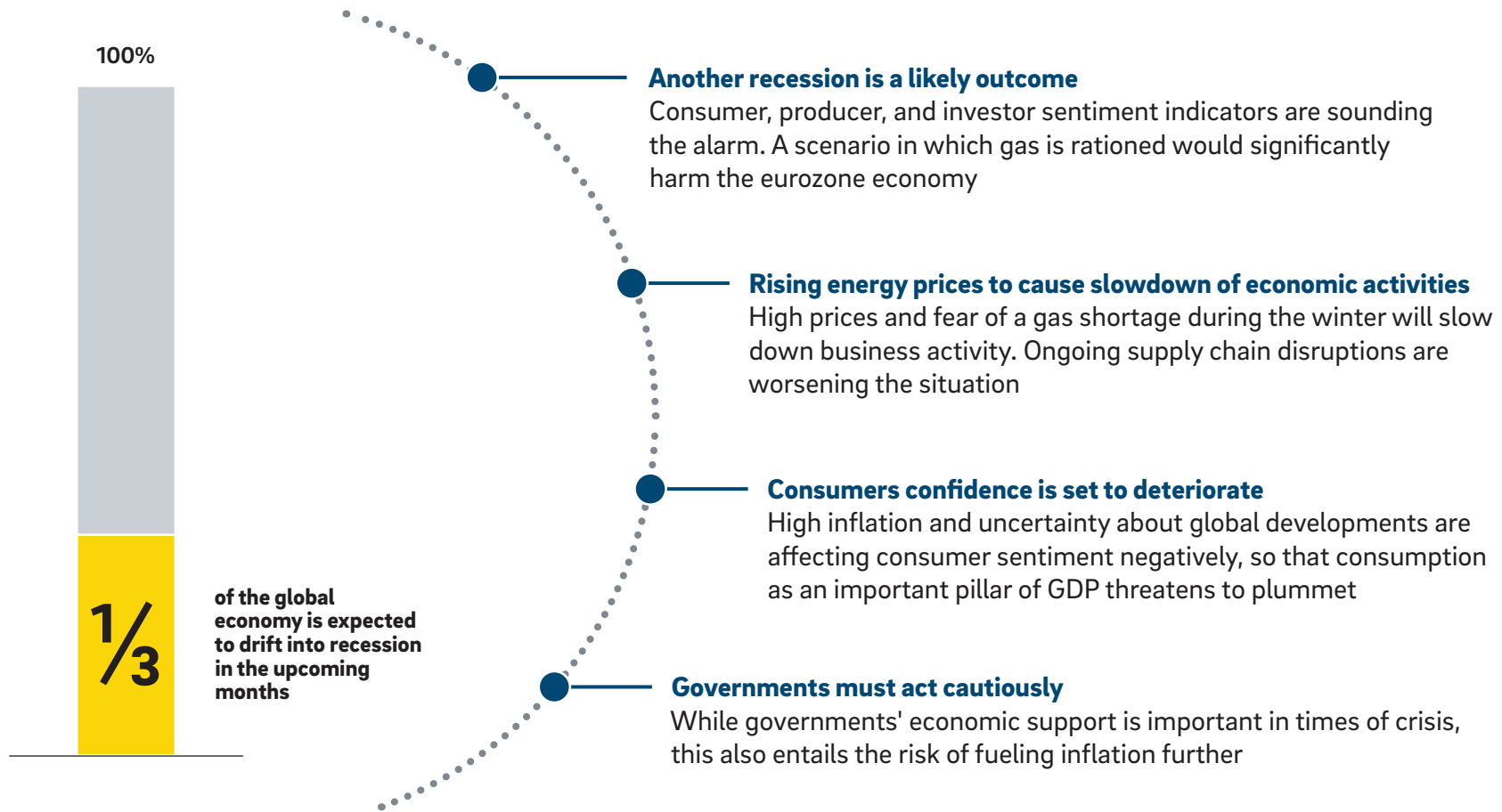
GOVERNMENT EXPENDITURE TO RISE IN RECESSION

Eurozone government expenditure and government debt [% yoy change]



A new recession will hit businesses as well as households and governments, yet would be relatively moderate if gas shortages do not materialize

SUMMARY AND OUTLOOK



Authors

Steffen Geering

+49 211 4389-2194

steffen.geering@rolandberger.com

Christian Kryz

+49 211 4389-2917

christian.kryz@rolandberger.com

David Born

+49 69 29924-6500

david.born@rolandberger.com

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WWW.ROLANDBERGER.COM

PUBLISHER

ROLAND BERGER GMBH

Sederanger 1

80538 Munich

Germany

+49 89 9230-0

www.rolandberger.com

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