Fitch Solutions Europe Key Themes For 2023

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We at Fitch Solutions expect that the European economies will continue feeling the effects of the Russia-Ukraine war in 2023 while the energy crisis provoked by this event will continue to leave its mark. Economic recession is forecast for most countries in the European Union and this could weaken unity in the region on matters such as fiscal policy coordination, energy policy and support for Russian sanctions. The continuation of the war will also reorient geopolitical ties at the outer edges of the region with countries in the Commonwealth of Independent States finding themselves looking for new strategic partners for security and economic support.

Key Europe Macro Themes For 2023

Theme	Thoughts
Russia-Ukraine War Will Persist But Neither Side Will Achieve Their Objectives Fully	Even though resource constraints will intensify on both sides, we do not expect commitment towards the conflict to weaken on either side.
Europe Will Fall Into A Recession Which Will Be Followed By An Uninspiring Rebound	We believe that the energy crisis caused by the Russia-Ukraine conflict could worsen in 2023 thereby exacerbating growth weakness and weighing on hopes of a resilient recovery.
Fiscal Policy In Europe Will Diverge From Monetary Policy	Fiscal and monetary policy divergence will likely prove costly as governments are faced with expensive debt burdens to service beyond 2023.

Source: Fitch Solutions

European Union Unity To Come Under Pressure	We see cracks emerging both with regard to the commitment of member states towards supporting Ukraine and sanctions against Russia, and also in terms of domestic policy actions to offset the negative impact of the war.
Tensions Between The European Union And the United States To Rise	The European Union and the United States' geopolitical goals will be less aligned, especially on trade and industrial policy.
Russia's Sphere Of Influence In The Commonwealth of Independent States To Continue Receding	Countries like Kazakhstan and Turkiye will likely grow their influence in former Soviet countries as Russia's ability to provide security and economic partnerships abates.

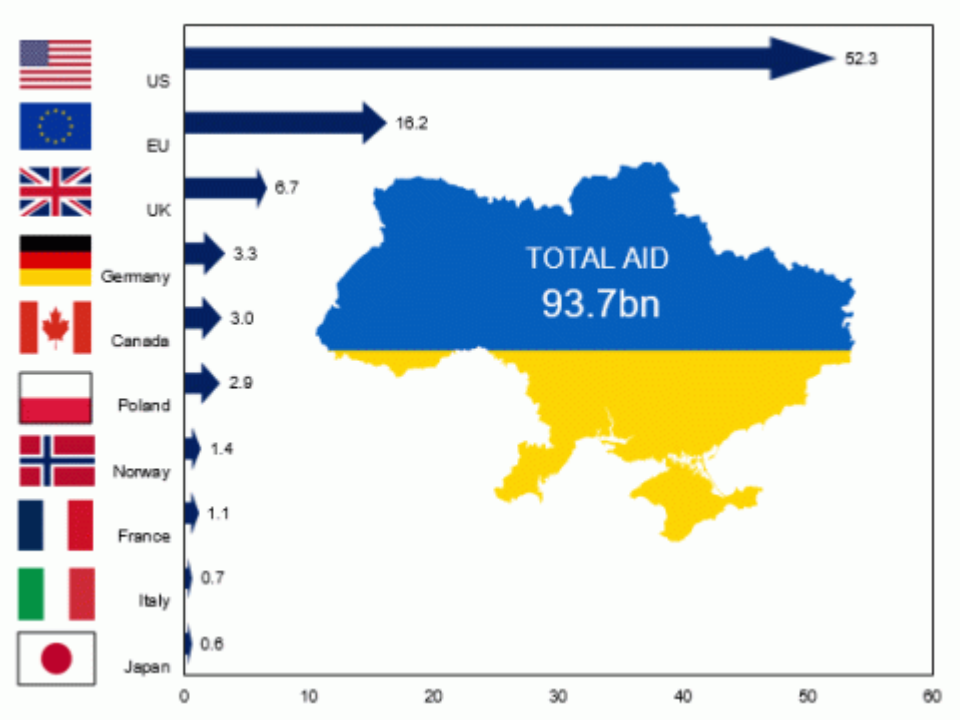
Source: Fitch Solutions

Theme 1: Russia-Ukraine War Will Persist But Neither Side Will Achieve Their Objectives Fully

We remain of the view that fighting in the Russia-Ukraine war will continue for most of 2023. While previously we had expected the conflict to enter into a *de facto* frozen conflict stalemate by the end of 2022, we now think fighting will continue at a more intense pitch throughout the year. Both sides remain committed to achieving their objectives, although this will prove difficult as neither side possesses sufficient personnel, weaponry and financing to fulfil them. On the Ukrainian side, fulfilling their war aims refers to the restoration of the country's 1991 borders. On the Russian side, this refers to the complete occupation of the annexed regions of Kherson, Zaporizhzhia, Donetsk and Luhansk. Ukraine in particular is faced with rising financing constraints while heavy sanctions against Russia will make it increasingly hard for that country to replenish its military resources. For Ukraine, we see the IMF stepping in as a major provider of its financing needs. On October 12, the IMF's Managing Director Kristalina Georgieva pledged to work with the Ukrainian authorities to establish an appropriate forum to facilitate Program Monitoring with Board Involvement (PMB). Georgieva confirmed that the PMB would pave the way towards an "upper credit tranche arrangement" hinting at a fully-fledged IMF programme.

Huge Inflows Of Financial, Military and Humanitarian Aid To Continue

Ukraine - Aid By Donor Country And In Total Up To October 3 2022, EURbn



Source: Kiel Institute For The World Economy, Fitch Solutions

For Russia, we expect the Kremlin to seek out ways of increasing the number of troops stationed in Ukraine without necessarily calling for a full-scale mobilisation of its armed forces. While a full mobilisation remains a possibility, we think the Kremlin's apparent reluctance to depart from the definition of 'Special Military Operation' for its activities in Ukraine suggests that it remains a last resort. Regarding financing, bumper hydrocarbon revenues from the first three quarters of 2022 will help sustain defence spending in 2023. Indeed, Russia's 2023 fiscal budget commits roughly a third of expenditures to defence and domestic security, totalling RUB9.4trn (USD15bn) at the cost of public amenities like healthcare, education and civil infrastructure. The Kremlin will finance a 2.0% budget deficit through borrowing on the domestic market, having held its largest ever OFZ bond auction in November 2022, selling government securities worth RUB823bn (USD13.7 billion). In our view, Russia's ability to finance the war without compromising stability at home will diminish as time goes on. We think any potential territorial gains in south and eastern Ukraine are unlikely to compensate for deteriorating living standards at home in the minds of ordinary Russians.

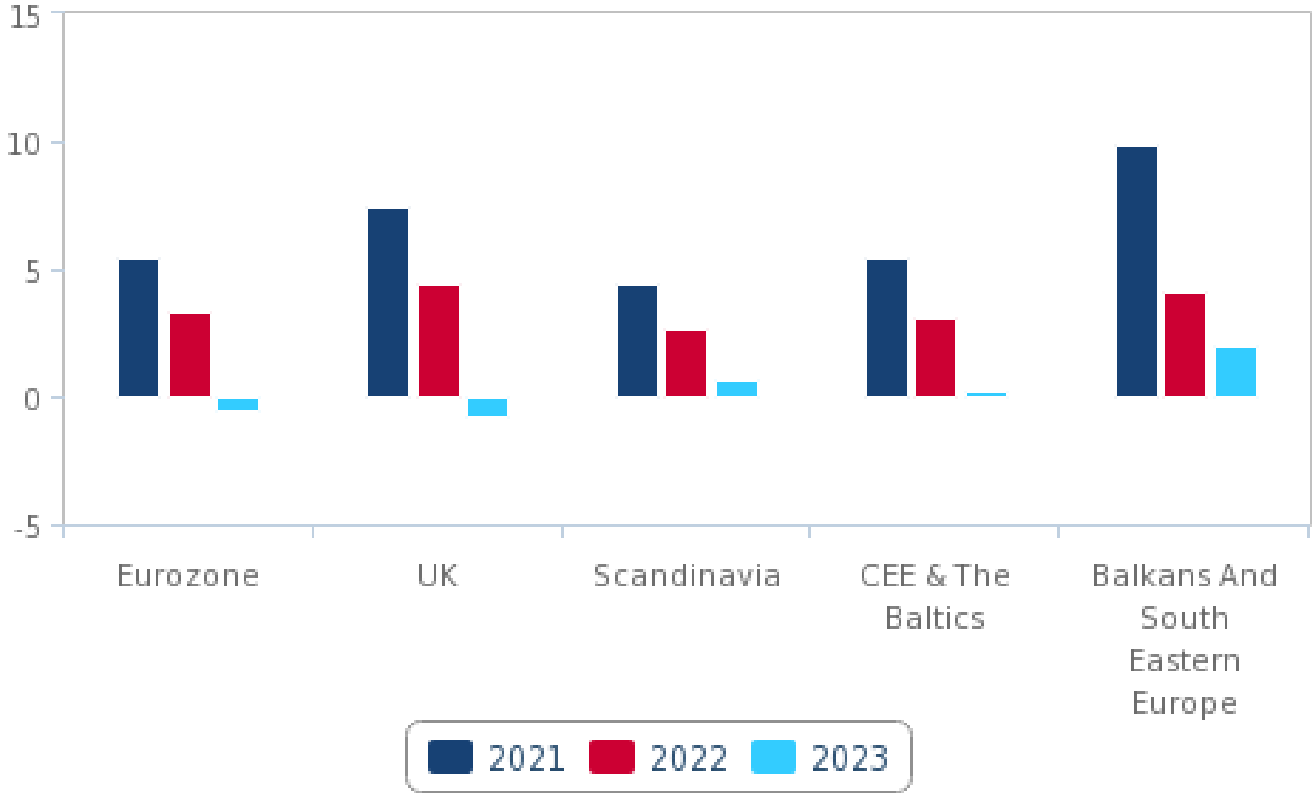
Theme 2: Europe Will Fall Into A Recession Which Will Be Followed By An Uninspiring Rebound

Europe's post-pandemic rebound will come to a halt in 2023, with the economy (ex-Russia and Ukraine) putting in its third worst performance since 2000. Growth will be weakest in developed markets, with the eurozone and the UK set to contract by 0.6% and 0.8%, respectively. We forecast full-year growth at a somewhat stronger 0.2% in Central and

Eastern Europe and the Baltics and 2.0% in the Balkans and South-Eastern Europe. However, we do anticipate that several important markets – including the Czech Republic, Hungary and Poland – will enter technical recessions in the coming quarters.

DM Europe Growth To Suffer

Europe - Real GDP Growth, Annual % Chg

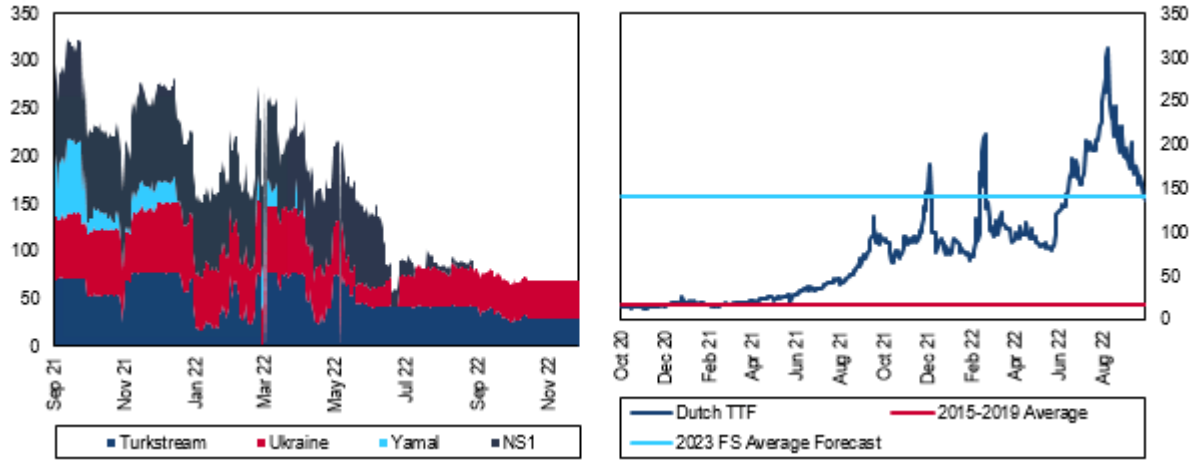


Source: Eurostat, Fitch Solutions

The European downturn will be largely linked to spill over effects from Russia's invasion of Ukraine, and in particular the ongoing energy crisis. Over the past year, Russia has meaningfully curtailed natural gas exports in an attempt to undermine Western support for Ukraine, which has pushed prices to seven-times their 2015-2019 average. Governments have rolled out significant support measures in an attempt to shield the private sector from this cost of living shock, but we nonetheless expect that much of the region will plunge into recession from Q422. Those economies with larger manufacturing sectors and where natural gas accounts for a larger share of energy consumption will struggle the most in the coming months, with Germany / Italy and CEE markets standing out as particularly vulnerable in developed and emerging Europe, respectively.

Energy Crisis To Remain A Constraint On Growth

Eurozone - Russian Gas Exports By Pipeline, mcm per day (LHC) & Dutch TTF Month Ahead, EUR per MwH (RHC)

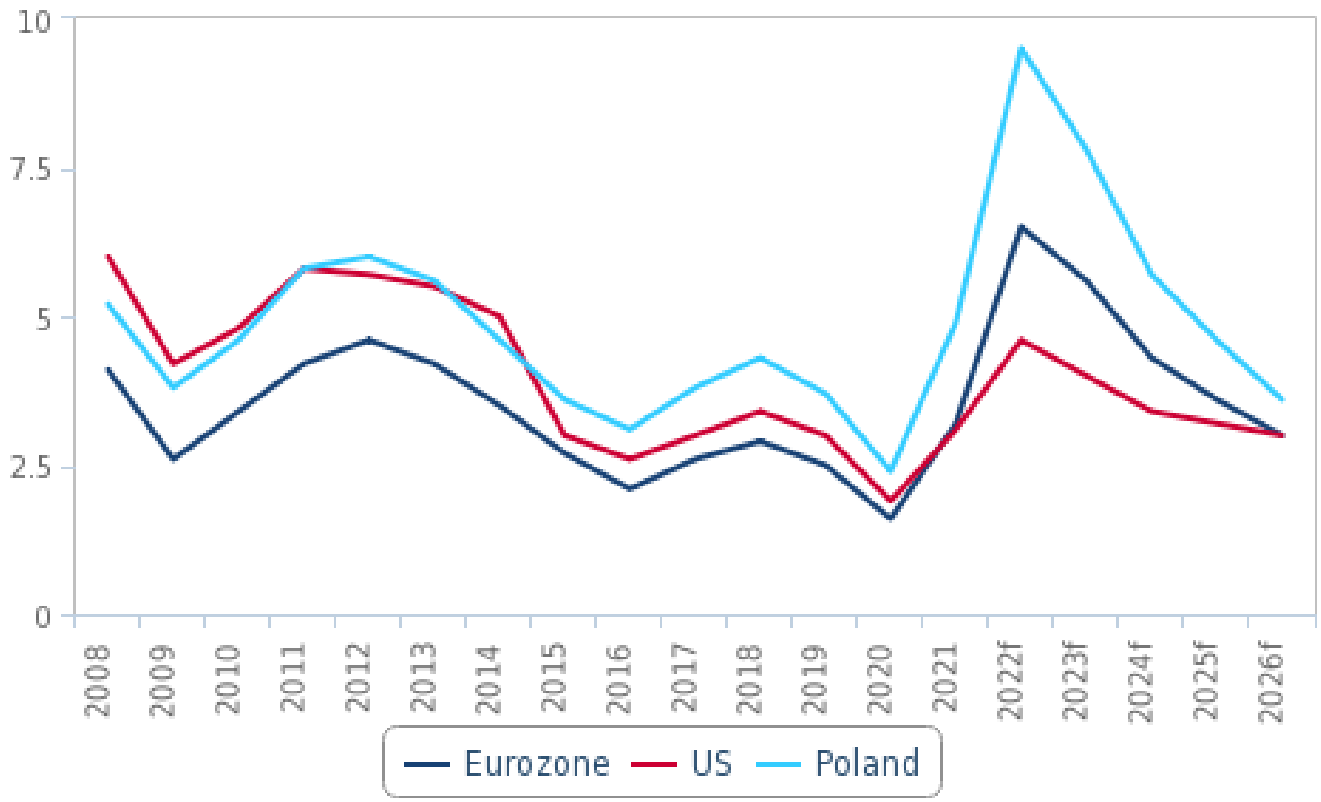


Source: Bloomberg, Fitch Solutions

Energy security will endure as a pressing matter for Europe throughout 2023, with rationing remaining a distinct possibility in the event of an unusually cold winter. Our Oil and Gas Team also estimate that the continent could be facing a shortfall of up to 30bcm of natural gas next year (roughly 10% of expected 2022 consumption), should Russia cut exports to zero. Against this backdrop, our industry analysts see little scope for natural gas prices to meaningfully fall back from current levels, which will see energy bills remain hefty throughout 2023.

A Long Road Back To Normal In Europe

US & Europe – Oil & Gas Consumption, % of GDP



Source: Fitch Solutions

Growth will be further constrained by central banks' hawkish policy stances as tighter financial conditions hit the economy with a lag. Interest rates have effectively returned to pre-Global Financial Crisis era levels across Europe over the past several months as the persistence of elevated inflation forced central banks into action. For the most part, we believe that tightening cycles will come to an end in the early part of 2023, but with price pressures likely to remain sticky we see little scope for central banks to begin meaningfully loosening next year in response to these growth concerns.

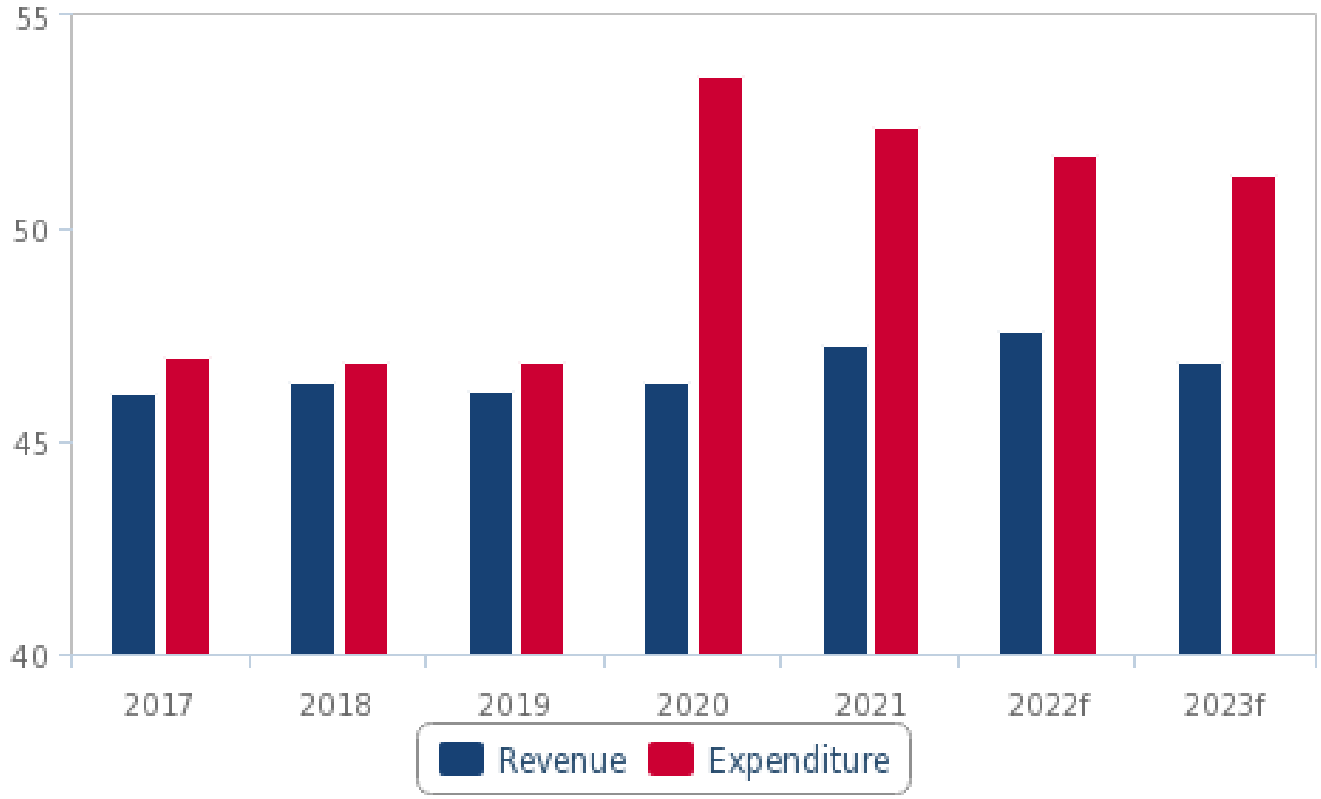
Theme 3: Fiscal Policy In Europe Will Diverge From Monetary Policy

We believe that the pace of fiscal consolidation will markedly slow across Europe as governments manage the effects of tighter monetary policy, cost of living challenges and the Russia-Ukraine war induced energy crisis. The improved epidemiological outlook across Europe allowed for budget deficits to narrow over 2021 and 2022. Despite inflation rising to multi-decade highs, post-pandemic demand has generally proven resilient through to Q322, thereby driving notable nominal revenue growth. However, the higher cost of living will increasingly stifle demand and revenue generation compared to 2022. Moreover, support measures that were announced in 2022 – including but not limited to subsidising energy bills, price caps and transfer payments to vulnerable groups – will keep expenditure high over the

coming year. Indeed, we project average expenditure relative to GDP across the eurozone to reach 51.3% in 2023, remaining well above the level of 46.9% of 2019 (see chart below) with a similar trend in non-eurozone economies.

Two Consecutive And Expensive Economic Crises

Europe - Weighted Average Revenue And Expenditure, % if GDP

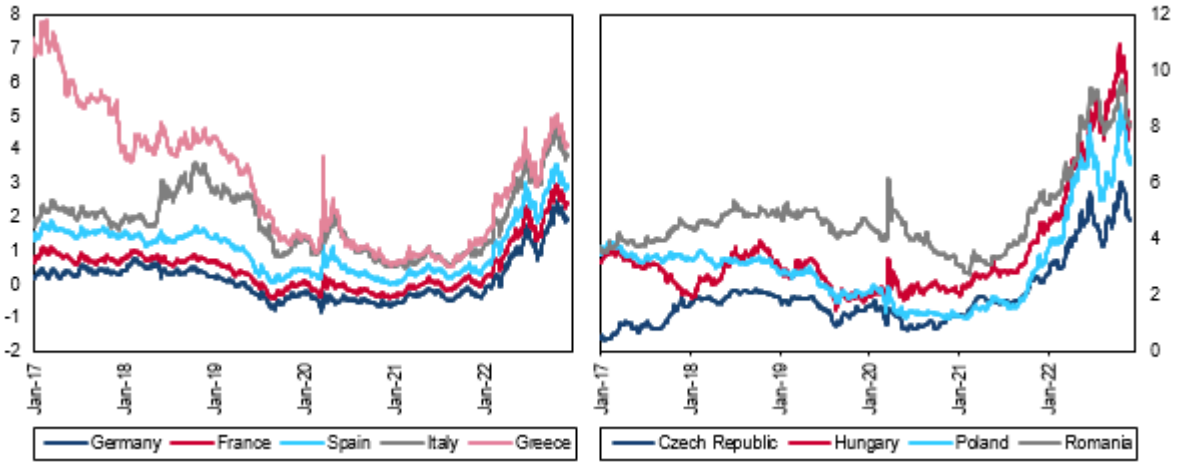


Source: Eurostat, Fitch Solutions

Revenue constraints and extensive support packages will lead European governments to continue borrowing significantly over 2023, and at a higher cost. Bond yields have risen sharply over 2022, owing to a combination of increased risk aversion alongside inflation which has spurred monetary tightening (*see charts below*). Still, even with higher borrowing and debt servicing costs, European governments will remain under considerable political pressure to support households and firms over the short term.

Cost Of Funding Generous Fiscal Packages Will Remain Elevated

Europe - Bond Yields For Selected EMs & DMs, %



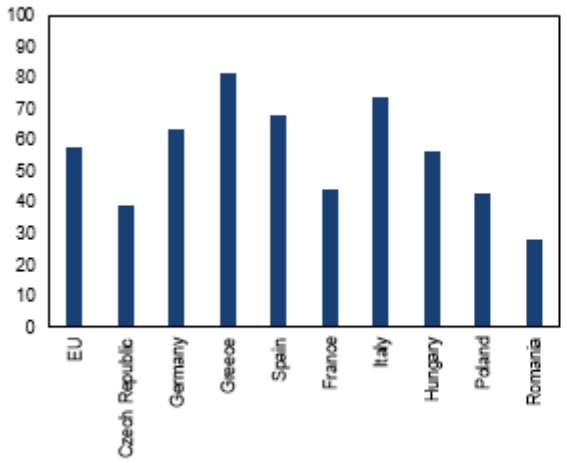
Source: Bloomberg, Fitch Solutions

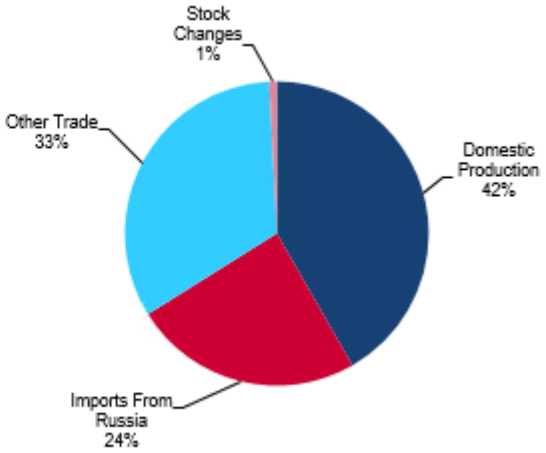
Theme 4: European Union Unity To Come Under Pressure

While the bloc managed to find consensus in 2022, maintaining a mostly united front against a tough macroeconomic backdrop, several strains have recently become evident. Even as the EU passed a swathe of sanctions on Russia, several member states undertook actions that deviated from the consensus. French President Emmanuel Macron was criticised for his early failed attempts at diplomacy with Russian President Vladimir Putin, while prior to the conflict, Germany was in the process of certifying the Nord Stream 2 pipeline (in spite of several vocal warnings from allies such as the US) which would have further entrenched Germany's dependence on Russian energy. Russian energy dependence is a theme for much of the continent's east and is the driver of red lines on sanctions laid down by governments inside the bloc such as Hungary or in applicant states such as Bosnia-Herzegovina and Serbia. Beyond the conflict, lawsuits threatening bloc funding for Hungary and Poland progressed as both markets allegedly continue to break bloc laws and values - the EU initiated article 7 proceedings (which would suspend certain membership rights upon conclusion) with both states over 2017-2018. Italy and Sweden elected right-wing governments in October, which will at best prevent further bloc integration and could present significant challenges in the worst case.

EU Russian Energy Dependence Presents 2023 Threat To Unity

Europe - Energy Imports Dependency (LHS) & Energy Availability By Source (RHS), %, 2020





Source: Eurostat, Fitch Solutions

Several challenges will emerge in 2023 which will further strain the bloc. While the EU is in a decent position to get through winter, the gas outlook for 2023 is more uncertain, and it is unlikely that pipelines from Russia will be flowing at capacity for the 2023 refilling season. This will keep prices elevated (perhaps encouraging a less hawkish stance on the conflict in some states) and may threaten the EU's borderless gas sharing system as markets prioritise their own energy consumption. Inflation may remain elevated, which could pose a dilemma for the European Central Bank. The Bank's overriding objective is price stability; however, monetary policy has a limited impact on supply side pressures whilst rising interest rates will significantly raise debt servicing costs for those member states with large debt burdens. **A showdown between the core and peripheral states within the EU over perceived fiscal laxity versus monetary tightness is a major risk in 2023.** Refugee inflows could pose another major threat, with Ukrainian migrants joining traditional flows from non-European countries. Coupled with a potential influx from Turkiye in a similar manner to 2015, this could trigger crises in several member states.

Theme 5: Competition Between The European Union And The US Will Rise

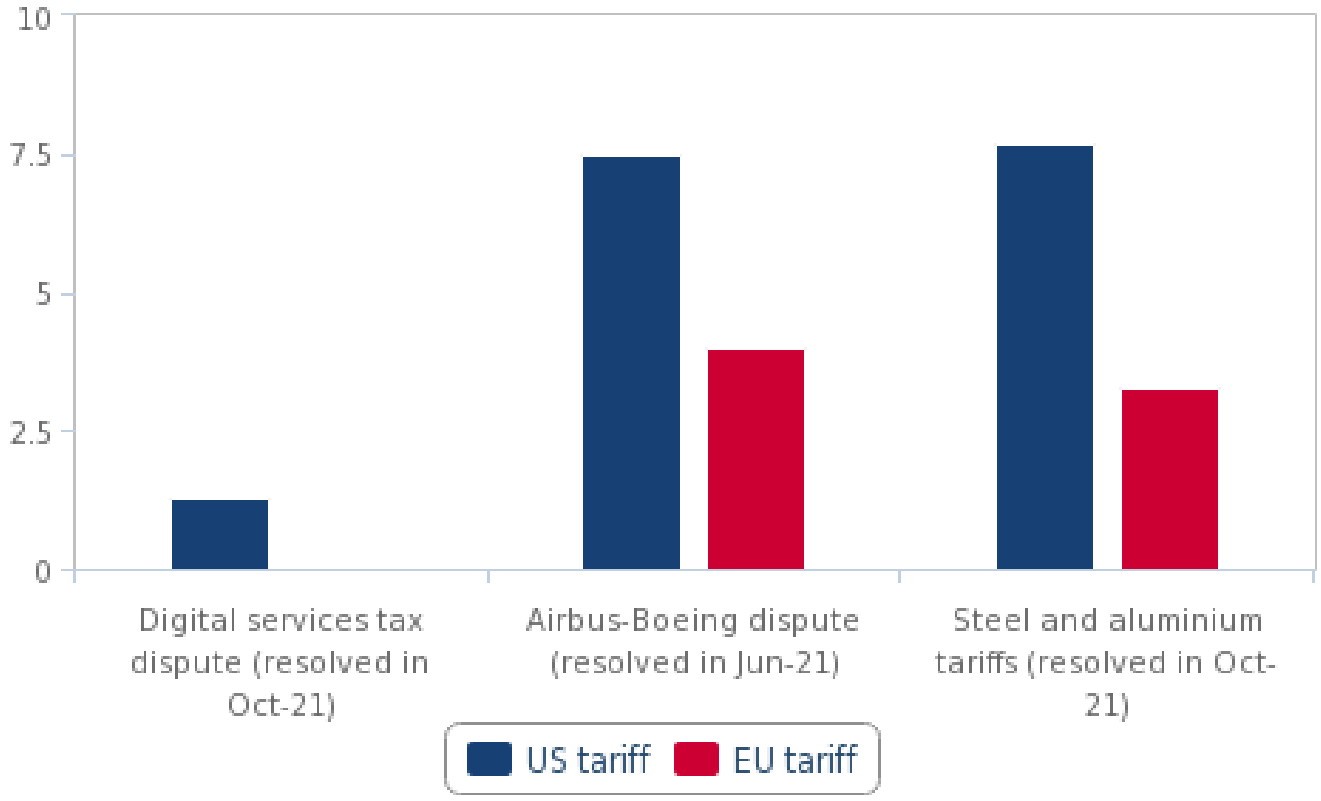
We expect relations between the US and the European Union (EU) will deteriorate in the coming 12 months and remain strained beyond that, compared to 2022. This is due to an increasing domestic focus of industrial, trade, and other policies in the US and the EU. In 2023, this will be manifested in several areas, such as industrial policy disputes (most visibly the US Inflation Reduction Act, which is due to provide generous incentives for investment in the US). Meanwhile, Washington will likely increasingly put pressure on EU states to follow US trade restrictions on Mainland China, which we expect will tighten further in 2023.

For its part, **the EU will likely prove divided on these questions, which will at best keep disagreements unresolved**, and potentially exacerbate tensions with the US and within the EU. In case of industrial policy disputes, the bloc will suffer from divisions between Germany

and France in particular, where Paris favours responding to US subsidies in kind (by adopting similar subsidies for EU firms), which Berlin rejects. This will impede an EU-wide response and potentially lead to some unilateral measures by individual EU governments. Even if the EU succeeds in pushing the US into making concessions on its subsidies, the risk of similar disputes will remain elevated as both sides increasingly intervene in key sectors via industrial policies.

Lifting Of US-EU Tariffs Helps, But Other Obstacles Are On The Horizon

US-EU trade volume facing tariffs due to selected disputes, USDbn



Source: Fitch Solutions

In terms of the impact on Europe of US export controls against Mainland China, these have so far been primarily focused on ASML, the Netherlands-based manufacturer of lithography systems. In response, the Dutch government has reportedly ceased issuing certain export licences to ASML in order to align with US export controls. However, further US pressure on Europe could follow in 2023 and beyond given tensions between US and Mainland China are likely to increase. European governments will prove reluctant to impose significant additional obstacles to trade that would further weigh on the bloc's already dismal economic growth outlook for 2023, potentially adding to US-EU tensions.

As a result, we expect greater industrial policy competition between the US and the EU in 2023, leading to a higher regulatory burden as firms navigate an increasingly diverse set of incentives and obstacles to trade and investment. **While not our core view, renewed US-EU competition will also raise the chances of retaliatory EU measures against US subsidies, which Brussels views as illegal, and of US secondary sanctions on European firms that are deemed to be bypassing US sanctions on Mainland China.** Such fears will be more pronounced over the medium term, particularly if the prospects of a Republican victory at the US presidential election in 2024 increase, for example due to a likely economic slowdown in the US in 2023.

Theme 6: Russia's Sphere Of Influence In The Commonwealth of Independent States To Continue Receding

In 2023, we believe Russia's standing in Central Asia and the Caucasus will decline further as the war in Ukraine diverts resources and attention away from the country's former 'sphere of influence'. Not only will Russia be in a weaker position to enforce its influence in the regions, Central Asian and Caucasus governments will make active efforts to reduce their reliance on Russian economic and security support. While for some of the larger, more powerful countries – like Kazakhstan – Russia's relative impotence offers an opportunity for greater independence, smaller states like Armenia might seek to replace Russia with new partners.

Turkiye's Geopolitical Role To Strengthen At Centre Of Trade Route

Europe, Middle East & Africa- BRI Map

Source: Asian Pacific Center, d-maps.com, Fitch Solutions

In our view, Russia's loosening grip on the region will be visible across Russia-led institutions (like the Collective Security Treaty Organisation) and in investment projects. In this vein, we expect to see greater investment in strengthening trade routes and infrastructure that circumvent Russia, as broad-based Western sanctions have significantly reduced Russian trade competitiveness. For example, on November 26, officials from Georgia, Turkey, Azerbaijan and Kazakhstan agreed to further develop the 'Middle Corridor', a trade route connecting Turkey to China. Similarly, we expect the Georgian government to revitalise the shelved Anaklia deep water port project on Georgia's Black Sea Coast. Previously, the project had been scrapped for a number of political reasons, including Kremlin opposition to the plan.

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