RUSSIAN INVASION TESTS EU ECONOMIC RESILIENCE

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The outlook for the EU economy before the outbreak of the war was for a prolonged and robust expansion. But Russia's invasion of Ukraine has posed new challenges, just as the Union had recovered from the economic impacts of the pandemic. By exerting further upward pressures on commodity prices, causing renewed supply disruptions and increasing uncertainty, the war is exacerbating pre-existing headwinds to growth, which were previously expected to subside. This has led the European Commission to revise the EU's growth outlook downwards, and the forecast for inflation upwards.

1. Spring 2022 Economic Forecast: Russian invasion tests EU economic resilience

Slowdown in growth as war exacerbates pre-existing headwinds

EU GDP is projected to remain in positive territory over the forecast horizon, thanks to the combined effect of post-lockdown re-openings and the strong policy action taken to support growth during the pandemic. Namely, the post-pandemic re-opening of contact-intensive services, a strong and still improving labour market, lower accumulation of savings and fiscal measures to offset rising energy prices are set to support private consumption. Investment is set to benefit from the full deployment of the Recovery and Resilience Facility and the implementation of the accompanying reform agenda.

Real GDP growth in both the EU and the euro area is now expected at 2.7% in 2022 and 2.3% in 2023, down from 4.0% and 2.8% (2.7% in the euro area), respectively, in the Winter 2022 interim Forecast. The downgrade for 2022 must be read against the background of the growth momentum gathered by the economy in spring and summer last year, which adds around 2 percentage points to the annual growth rate for this year. Output growth within the year has been reduced from 2.1% to 0.8%.

Energy prices drive inflation to record highs

Inflation has been picking up momentum since early 2021. From 4.6% year-on-year in the last quarter of 2021 it went up to 6.1% in the first quarter of 2022. Headline inflation in the euro area surged to 7.5% in April, the highest rate in the history of the monetary union.

Inflation in the euro area is projected at 6.1% in 2022, before falling to 2.7% in 2023. For 2022 as a whole, this represents a considerable upward revision compared to the Winter 2022 interim Forecast (3.5%). Inflation is expected to peak at 6.9% in the second quarter of this year and decline gradually thereafter. For the EU, inflation is expected to increase from 2.9% in 2021 to 6.8% in 2022, and fall back to 3.2% in 2023. Average core inflation is projected above 3% in 2022 and 2023 in both the EU and the euro area.[1]

[1] Spring_2022_Economic_Forecast__Russian_invasion_tests_EU_economic_resilience_.pdf

2. Higher prices, exacerbated by the Russia-Ukraine war, weaken the recovery and increase global risks

Financial stability conditions have deteriorated

Energy and commodity price shocks, amplified by the Russian invasion of Ukraine, increase risks to post-pandemic growth, inflation and financial conditions in the euro area and globally.

Higher financial market volatility, although largely orderly, underscores risks of sharp corrections. Non-banks are most exposed to duration, credit and liquidity risks.

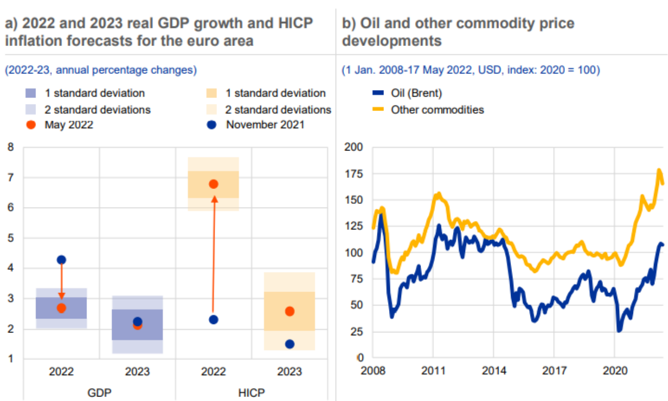
Euro area sovereigns, corporates and households face higher interest rates and cost pressures that could test debt sustainability for the more highly indebted entities.

Banks, which have remained strikingly resilient and able to support the economy, see increased credit risk and a weaker profit outlook.

Financial stability conditions have deteriorated, as the post-pandemic recovery has been tested by higher inflation and Russia's invasion of Ukraine. Since late 2021, rising inflationary pressures have threatened to slow the momentum of the recovery in 2022. Upside risks to euro area inflation and downside risks to growth rose sharply following the outbreak of the Russia-Ukraine war (Chart 1, panel a). In particular, large rises in commodity and energy prices (Chart 1, panel b) and ongoing global supply chain pressures are expected to prolong the period of elevated inflation. The course and consequences of the Russia-Ukraine war are still hard to predict. While peace could reverse some pressures, a protracted conflict could imply sustained higher inflation and even lower growth outturns than currently expected. Risks to inflation, growth and global financial conditions could also be triggered by other global events, such as a broader resurgence of the coronavirus (COVID-19), emerging market weakness or a sharper economic slowdown in China.

Chart 1

Risks of higher inflation and lower growth outturns in the euro area amplified by an intensified commodity and energy price shock



Sources: Consensus Economics Inc., Refinitiv, Hamburg Institute of International Economics and ECB calculations.
Note: Panel a: shaded areas display one and two standard deviations in Consensus expectations for euro area real GDP growth and HICP inflation. HICP stands for Harmonised Index of Consumer Prices. Panel b: other commodities include food (cereals, oilseeds/oils and tropical beverages/sugar) and industrial raw materials (agricultural raw materials, non-ferrous metals and iron-ore/scrap).

Higher inflation and lower growth could increase market volatility and challenge debt servicing capacity as financing costs rise. The consequences of the war and the shift to a lower-growth, higher-inflation environment affect virtually every aspect of economic activity and financing conditions. In turn, these developments might not only amplify, but could also trigger the materialization of pre-existing financial stability vulnerabilities identified in previous issues of the FSR. These include heightened debt sustainability concerns in non-financial sectors or the possibility of corrections in both financial and tangible asset markets.[2]

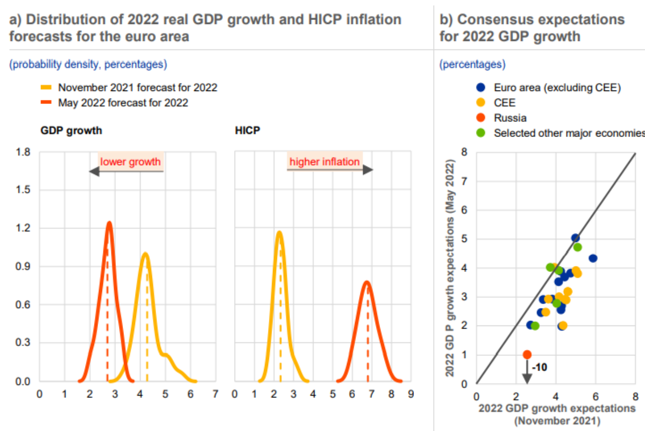
[2] Financial Stability Review, May 2022 (europa.eu)

3. Euro area economic outlook weakens on the back of global cost pressures and the war in Ukraine

Since the November 2021 Financial Stability Review, the economic outlook for the euro area has weakened, while inflation projections have been revised upwards. Private sector forecasters have downgraded their growth expectations significantly since the end of last year as the repercussions of the Russian war in Ukraine reverberate globally, likely slowing the economic recovery. The supply chain and cost pressures that built up during the coronavirus (COVID-19) pandemic have been amplified by the war, which has prompted further increases in commodity prices, affected supply chains and substantially weakened consumer confidence. As a result, consensus expectations for real GDP growth in the euro area in 2022 have been downgraded to 2.7% (down 1 percentage points since late February), while inflation expectations have been revised upwards to 6.8% (up 2.6 percentage points since late February) (Chart 1.1, panel a).[3]

Chart 1.1

Forecasters pare back growth prospects and raise inflation projections as sanctions slow the economic recovery and hit the Russian economy particularly hard



Sources: Consensus Economics Inc. and ECB calculations.
Notes: Panel a: HICP stands for the Harmonised Index of Consumer Prices measure of inflation. The dashed vertical lines represent the average forecast values. Panel b: selected other major economies include Australia, Canada, China, Japan and the United States. CEE stands for central and eastern Europe and includes Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia. CEE and Russia forecasts show April 2022 consensus GDP growth expectations.

4. North Macedonia Faces New Economic Headwinds Despite Strong Post-Pandemic Recovery

GDP growth in the region reached 7.4 percent in 2021, after a contraction of 3.2 percent in 2020. In North Macedonia, growth was driven by a strong rebound in consumption, helped by both fiscal stimuli and pent-up demand, as well as a relaxation in movement and travel restrictions. The unemployment rate reached a historical low in the country and poverty resumed its declining trend. However, the post-pandemic recovery has been cut short, as the war in Ukraine sends shockwaves across the region. Growth for the Western Balkans region is now forecast at 3.1 percent in 2022, and at 2.7 percent for North Macedonia. The downside risks to the region's economic outlook are daunting. An expanded conflict or prolonged war in Ukraine could trigger further disruptions to global trade and to energy and food prices. Refinancing risks could arise if external financial market conditions continue to tighten. Debt sustainability may become a concern if limited fiscal space is eroded by policy responses to higher energy and food prices amidst rising refinancing costs.[4]

[3] Financial Stability Review, May 2022 (europa.eu)
[4] North Macedonia Faces New Economic Headwinds Despite Strong Post-Pandemic Recovery (worldbank.org)