ECONOMIC CONSEQUENCES TURNING GRIMMER

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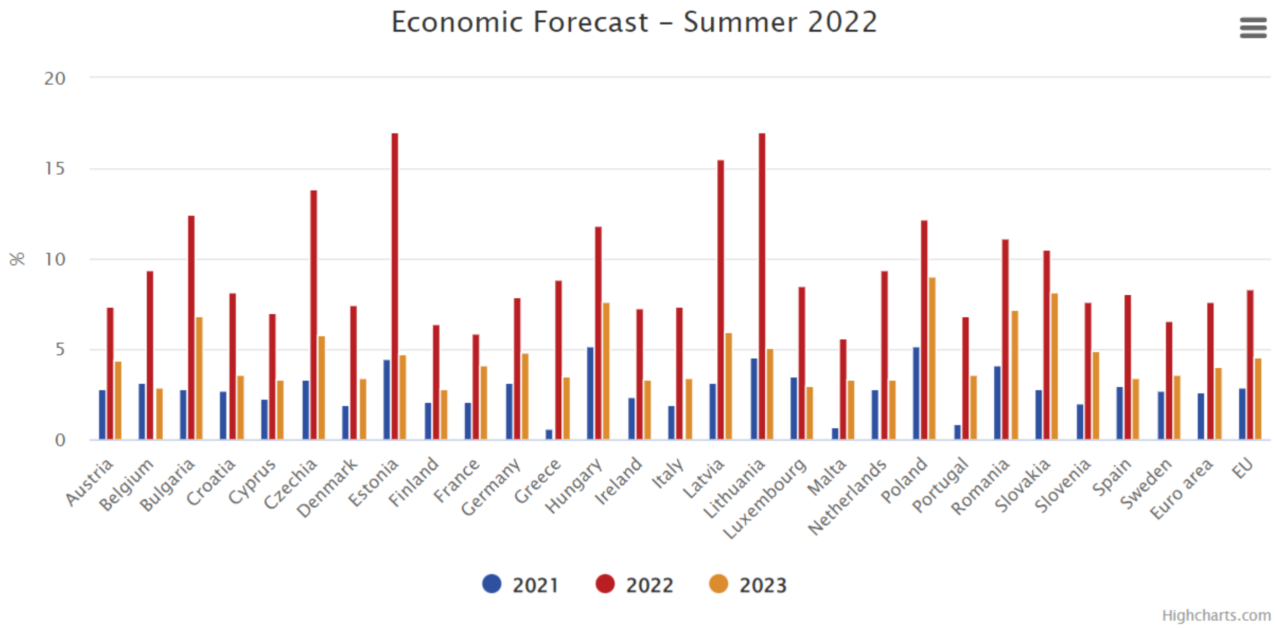
As the reality of a protracted Russian invasion of Ukraine sinks in, the assessment of its economic consequences for the global economy is turning grimmer. The shocks unleashed by the war are hitting the EU economy both directly and indirectly, setting it on a path of lower growth and higher inflation. The rapid increase in energy and food commodity prices is feeding global inflationary pressures, eroding the purchasing power of households and triggering a faster monetary policy response than previously assumed. Furthermore, the deceleration of growth in the US is adding to the negative economic impact of China's strict zero-COVID policy.

1. European Economic Forecast - Summer 2022

Whereas prices of some commodities are retreating from recent peaks, the EU economy remains vulnerable to developments in energy markets due to its high reliance on Russian fossil fuels. With gas prices nearing all-time highs energy inflation is on the rise. Food inflation is also surging, but pressures are broadening further as higher energy costs are passed-through to services and other goods. Lower income households are especially hit by the protracted rise in prices. Whereas businesses still eye an expansion of economic activity, they are less optimistic about the future, which will weigh on investment. Households are just as negative about the future as they were at the onset of the pandemic, which is set to drag on the recovery of private consumption.

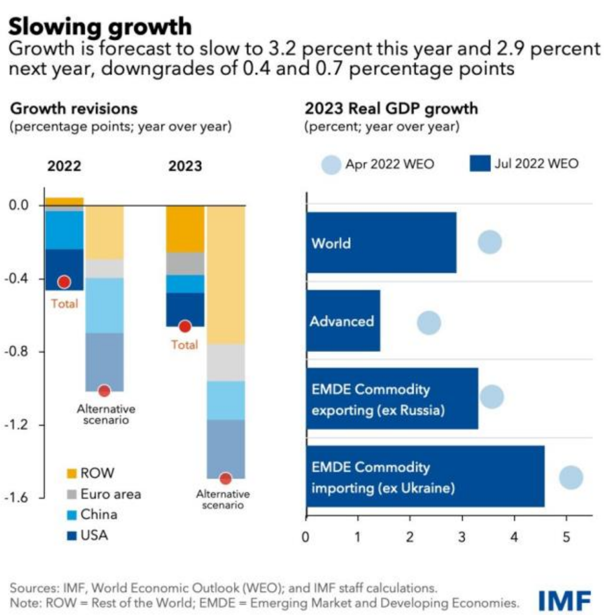


Overall, real GDP is forecast to grow by 2.7% in 2022 and 1.5% in 2023 in the EU and by 2.6% in 2022 and 1.4% in 2023 the euro area. The projected annual growth rate for this year is propped up by the momentum gathered with the recovery of last year and a stronger first quarter than previously estimated. Both bring acquired growth at the first quarter of this year to a solid 2.7% for the EU and 2.4% for the euro area. Economic activity is expected to have weakened in the second quarter, but should regain some traction during summer, thanks to a promising tourism season. In 2023, economic growth is expected to gather some momentum, on the back of a resilient labour market, moderating inflation, support from the Recovery and Resilience Facility and a still large amount of excess savings. However, on an annual basis there is a downward revision of almost one percentage point compared to the Spring Forecast.

Inflation in the euro area is projected to peak at a new record high of 8.4% in the third quarter of 2022. As the pressures from energy prices and supply constraints fade, inflation is expected to decline steadily thereafter and to fall below 3% by the end of 2023. The annual rates of 7.6% in 2022 (8.3% in the EU) and 4.0% in 2023 (4.6% in the EU) imply upward revisions by more than one percentage point from the Spring Forecast.[1]

2. Global Economic Growth Slows Amid Gloomy and More Uncertain Outlook

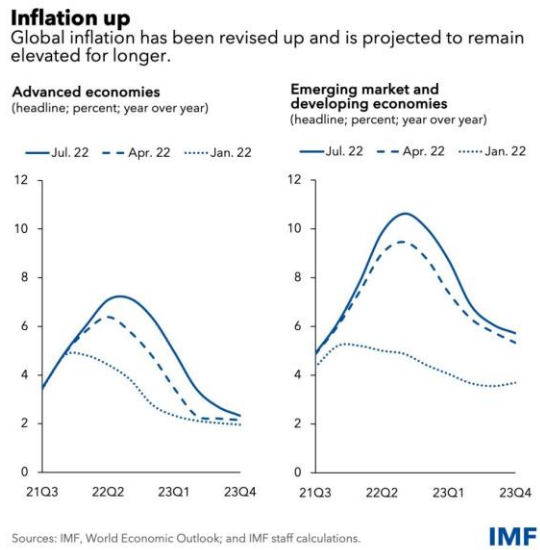
Higher-than-expected inflation, especially in the United States and major European economies, is triggering a tightening of global financial conditions. China's slowdown has been worse than anticipated amid COVID-19 outbreaks and lockdowns, and there have been further negative spillovers from the war in Ukraine. As a result, global output contracted in the second quarter of this year.



Under IMF 's baseline forecast, growth slows from last year's 6.1 percent to 3.2 percent this year and 2.9 percent next year, downgrades of 0.4 and 0.7 percentage points from April. This reflects stalling growth in the world's three largest economies—the United States, China and the euro area—with important consequences for the global outlook.

[1] Summer 2022 Economic Forecast: Russia's war worsens the outlook (europa.eu)

In the United States, reduced household purchasing power and tighter monetary policy will drive growth down to 2.3 percent this year and 1 percent next year. In China, further lockdowns, and the deepening real estate crisis pushed growth down to 3.3 percent this year—the slowest in more than four decades, excluding the pandemic. And in the euro area, growth is revised down to 2.6 percent this year and 1.2 percent in 2023, reflecting spillovers from the war in Ukraine and tighter monetary policy.



Despite slowing activity, global inflation has been revised up, in part due to rising food and energy prices. Inflation this year is anticipated to reach 6.6 percent in advanced economies and 9.5 percent in emerging market and developing economies—upward revisions of 0.9 and 0.8 percentage points respectively—and is projected to remain elevated longer. Inflation has also broadened in many economies, reflecting the impact of cost pressures from disrupted supply chains and historically tight labor markets.[2]

Latest World Economic Outlook Growth Projections

(real GDP, annual percent change)	2021	PROJECTIONS 2022	2023
World Output	6.1	3.2	2.9
Advanced Economies	5.2	2.5	1.4
United States	5.7	2.3	1.0
Euro Area	5.4	2.6	1.2
Germany	2.9	1.2	0.8
France	6.8	2.3	1.0
Italy	6.6	3.0	0.7
Spain	5.1	4.0	2.0
Japan	1.7	1.7	1.7
United Kingdom	7.4	3.2	0.5
Canada	4.5	3.4	1.8
Other Advanced Economies	5.1	2.9	2.7
Emerging Market and Developing Economies	6.8	3.6	3.9
Emerging and Developing Asia	7.3	4.6	5.0
China	8.1	3.3	4.6
India	8.7	7.4	6.1
ASEAN-5	3.4	5.3	5.1
Emerging and Developing Europe	6.7	-1.4	0.9
Russia	4.7	-6.0	-3.5
Latin America and the Caribbean	6.9	3.0	2.0
Brazil	4.6	1.7	1.1
Mexico	4.8	2.4	1.2
Middle East and Central Asia	5.8	4.8	3.5
Saudi Arabia	3.2	7.6	3.7
Sub-Saharan Africa	4.6	3.8	4.0
Nigeria	3.6	3.4	3.2
South Africa	4.9	2.3	1.4
Memorandum			
Emerging Market and Middle-Income Economies	7.0	3.5	3.8
Low-Income Developing Countries	4.5	5.0	5.2

Source: IMF, *World Economic Outlook Update*, July 2022

Note: For India, data and forecasts are presented on a fiscal year basis, with FY 2021/2022 starting in April 2021. For the July 2022 WEO Update, India's growth projections are 7.4 percent in 2022 and 5.3 percent in 2023 based on calendar year.

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The outlook has darkened significantly since April. The world may soon be teetering on the edge of a global recession, only two years after the last one. Multilateral cooperation will be key in many areas, from climate transition and pandemic preparedness to food security and debt distress. Amid great challenge and strife, strengthening cooperation remains the best way to improve economic prospects and mitigate the risk of geoeconomic fragmentation.

[2] Global Economic Growth Slows Amid Gloomy and More Uncertain Outlook – IMF Blog

3. The macroprudential challenge of climate change

Climate risk shocks could spread throughout the financial system, notably in the event of a disorderly green transition.
Financial market losses from abruptly repricing climate risks could affect investment funds and insurers as well as trigger corporate defaults and credit losses for banks.

Meanwhile, interdependent natural hazards – such as water stress, heat stress and wildfires – can amplify physical climate risk, as they can cluster together and exacerbate each other. Market dynamics can also magnify the financial impact of physical risks. For example, a climate shock could lead to a sudden reassessment of climate risk pricing, thereby causing fire sales, where financial institutions – especially those with overlapping portfolios – quickly sell a large number of exposed assets at the same time at distressed prices.

Climate risks might take shape in the financial system in a specific order. First, unforeseen climate shocks could have an abrupt impact on market prices, initially hitting the portfolios of investment funds, pension funds and insurance companies. Second, this sudden repricing could cause companies to default, resulting in losses for exposed banks. In a disorderly transition scenario, marked by an immediate and substantial increase in carbon prices, respective market losses of insurers and investment funds could potentially amount to 3% and 25% on stress-tested assets in the near term. An orderly transition towards net zero by 2050 could soften such shocks and alleviate the fallout for companies and banks, reducing the probability of corporate defaults by around 13-20% in 2050 compared with today's policies. It would also lessen credit losses for banks.[3]

[3] Climate shocks can put financial stability at risk, ECB/ESRB report shows (europa.eu)