ENERGY CRUNCH WILL TRIGGER EUROZONE CONTRACTION IN 2023

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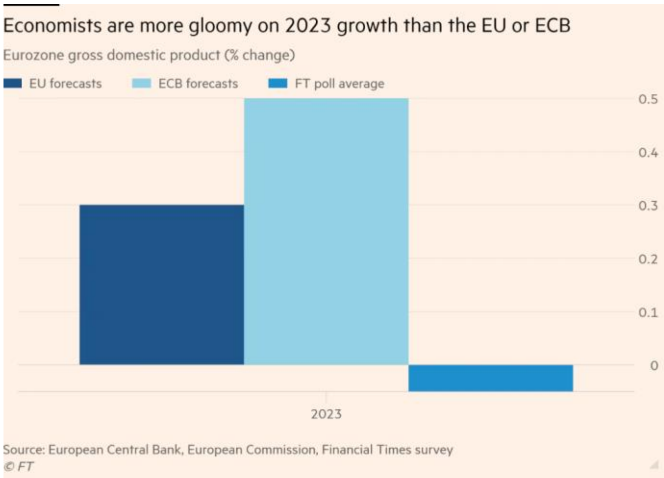
1. Is a Global Recession Really Around the Corner?

The world's leading economists spent most of 2022 convincing themselves that, if the global economy was not already in a recession, it was about to fall into one. But with the year's end, the global slump has been postponed to 2023. Europe, hit hard by soaring energy prices, is more likely to head into a recession, which conventional wisdom defines as two consecutive quarters of GDP decline. China, however, seems to be in even worse shape. It has the same problems as Europe, plus a collapsing property sector and a surge in COVID-19 cases, owing to the Chinese government's recent decision to reopen the economy without a sufficient vaccination push. While the OECD and International Monetary Fund expect global growth to plunge to 2.2-2.7% in 2023, from 6.1% in 2021, that still leaves the world economy unlikely to shrink for consecutive quarters.
Even if we adopt less strict measures of defining a global recession, such as a decline of GDP growth below 2.5%, a 2023 global recession is hardly a foregone conclusion.[1]

2. Energy Crunch Will Trigger Eurozone Contraction in 2023



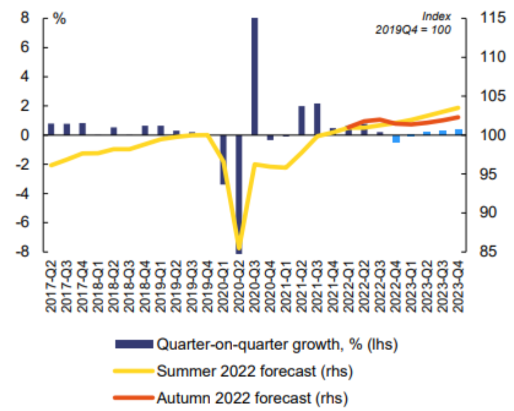
The eurozone economy is set to shrink next year as high inflation and potential energy shortages drag down output and trigger a reversal in the fortunes of the labour market, according to a Financial Times poll of economists. Almost 90 per cent of the 37 economists surveyed by the FT said they thought the single currency zone was already in recession and the majority forecast gross domestic product would contract over the whole of next year. Most economists said they thought Europe was past the worst of its energy crisis, sparked by Russia's invasion of Ukraine. A mild autumn allowed natural gas storage facilities to remain near to full capacity. However, many fear the prospect of energy rationing could return next year, particularly if this winter is unusually cold, depleting supplies, or if gas flows from Russia are reduced further during 2023. The downturn in the economy, combined with significantly higher mortgage costs across Europe, was also expected to trigger a sharp reversal in the region's housing market. The European Central Bank raised rates by 2.5 percentage points over the course of 2022 and is expected to increase borrowing costs further in 2023. On average, economists forecast eurozone residential house prices would fall 4.7 per cent next year. [2]

[1] Is a Global Recession Really Around the Corner? by Jeffrey Frankel - Project Syndicate (project-syndicate.org)
[2] Energy crunch will trigger eurozone contraction in 2023, economists warn | Financial Times (ft.com)

3. Macroeconomic Developments in the Euro Area

Economic developments in the euro area reflect the uncertain global and geopolitical environment. In the first half of 2022, economic activity in the euro area was supported by the positive momentum stemming from the re-opening of the economy following the COVID-19 pandemic. The improving labour market, the large household savings accumulated during the pandemic, favourable financing conditions, and the deployment of the Recovery and Resilience Facility (RRF) led to solid GDP growth. However, the increase in global energy prices, heightened uncertainty and renewed supply chain disruptions induced by Russia's war of aggression against Ukraine are set to result in a deceleration of economic activity in the second half of the year. Over the summer of 2022, the Commission's economic sentiment indicator dropped below its long-term average. In particular, consumer confidence plummeted to levels below those during the pandemic. Altogether, GDP for the euro area is expected to grow by 3.2 % in 2022 but with a much weaker growth outlook. The energy crisis has led to a downward revision of growth forecasts for 2023. Further gas and electricity price increases since the beginning of July, the technical recession in the US and the sharp drop in activity in China, together with deteriorated economic sentiment point to negative growth in the last quarter of 2022 and a weak recovery afterward. According to the Commission's autumn forecast, real GDP in the euro area is now expected to grow by 0.3% in 2023, with a stagnating private consumption, 0.5 % growth in investment, and only a negligible external sector contribution to GDP growth.

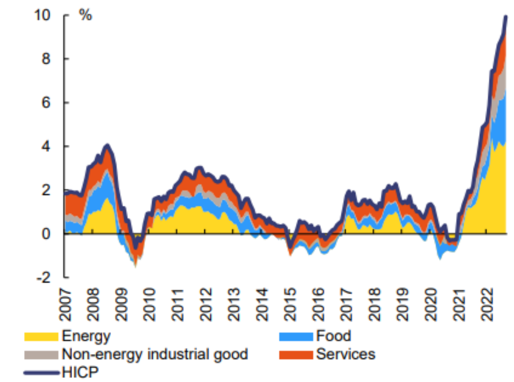
Graph 1.1: **GDP growth in the euro area**



(1) For Q2-2020 (-11.5) and Q3-2020 (+12.6) quarterly growth rate not visible. The light blue bars of quarterly growth based on the Commission's autumn forecast.
Source: Eurostat, European Commission.

Inflation has broadened across the economy and is expected to remain elevated in the coming months. Over 2022, inflation has repeatedly exceeded expectations. In October 2022, annual harmonised index of consumer prices (HICP) inflation stood at 10.7 %, its highest level since the euro was launched, a record breached every month over the last 12 months. As higher energy costs have gradually spread to other goods, price increases have been broadening across categories and HICP inflation is expected to average 8.5 % in 2022.

Graph 1.2: **HICP and its components in the euro area, 2007-2022 (annual changes; monthly data)**

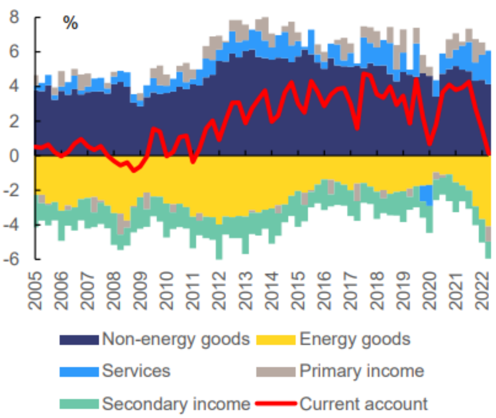


Source: Eurostat.

Inflation pressures are expected to ease gradually. The European Central Bank (ECB) has taken steps to start normalising monetary policy and thereby ensure that long-term expectations remain anchored. Despite record inflation rates, wage dynamics appear moderated so far. This weighs on spending power of workers but limits the persistence of high inflation. Mending global supply bottlenecks and the expected weakening consumption should remove some pressure from core inflation. Accordingly, price growth is expected to gradually decelerate, with HICP inflation projected at 6.1 % in 2023 and 2.6 % in 2024 (European Commission, 2022d).

The current account surplus for the euro area has receded. Over 2022, the deteriorating energy balance was the most relevant factor behind a reduction in the euro area current account surplus (Graph 1.3). Meanwhile, the strong variation in energy dependency across euro area Member States has translated in discrepancies in current account dynamics (see Section 3), in some cases increasing risks of external imbalances. Over the medium term, while measures taken to support investment, and in particular the RRF (IMF, 2022a), are set to reduce the surplus, current account developments remain uncertain and will be driven by dynamics on the energy markets.[3]

Graph 1.3: **Current account balance of the euro area, 2005-2022, % of GDP**



Source: European Commission.

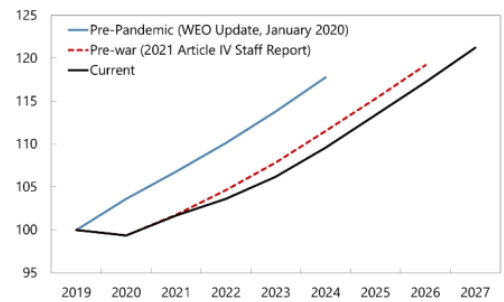
[3] 2023 Euro Area Report (europa.eu)

4. North Macedonia’s IMF Outlook

North Macedonia’s economy has been hit by two large external shocks. While recovering from the pandemic, the outlook deteriorated again following Russia’s invasion of Ukraine and sharply rising energy and food prices. Given high dependence on energy imports, the external financing need has increased, while at the same time, global financial conditions have tightened, increasing the cost of market financing. Economic activity is projected to slow going into 2023, driven by a combination of external and domestic factors. A modest recovery in late 2023 is projected to follow, as global energy and food prices start to subside. Risks are firmly to the downside, with slower external demand resulting from a global recession, a sharper rise in international energy prices, and a further tightening of financial market conditions being the main ones.

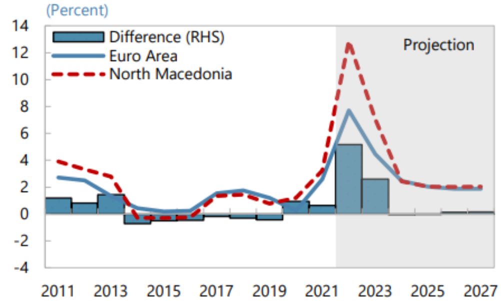
Real GDP growth is projected to remain subdued in 2022 and 2023. Higher commodity prices have significantly lowered households’ purchasing power and—along with high uncertainty and tighter financing conditions—will reduce domestic demand. Lower external demand from trading partners and a prolongation of the global supply disruptions are expected to dampen exports. At the same time, the milestone agreement to join the EU provides a strong positive signal. Moreover, the recovery from the pandemic is still incomplete. On this basis, growth is expected at 2.7 percent in 2022 and 2.9 percent in 2023—a 2½ percentage points cumulative downward revision relative to the forecast prior to the war in Ukraine. Over the medium term, growthwould rise above potential for a few years, as public investment is scaled up and reforms progress toward EU accession.

Potential Output
(Real Index, 2019 = 100)



Sources: Haver Analytics, SSO, IMF staff calculations.

Headline Inflation
(Percent)



Sources: Haver Analytics; World Economic Outlook; and IMF staff calculations.

Inflation is expected to peak in 2022, and come down in 2023 as global energy and food prices moderate. Inflation is projected at 12.9 percent on average in 2022. Still high inflation expectations, indexation, and high nominal wage growth are expected to create some domestic inflationary pressures in 2023, keeping inflation at 7.1 percent on average for the year. Over the medium term, inflation would gradually decline to around 2 percent by 2025, helped by the close link to euro area inflation under the de-facto peg.[4]

[4] Republic of North Macedonia: Request for an Arrangement under the Precautionary and Liquidity Line-Press Release; Staff Report; and Statement by the Executive Director for Republic of North Macedonia (imf.org)