1. Global overview: Inflation up, growth down

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1.1. BASELINE SCENARIO: DOWNGRADES, BUT THE SHOW REMAINS ON THE ROAD

Russia's invasion of Ukraine will have substantial negative impacts for the global economy, and these are likely to last throughout the forecast period. The invasion has created a humanitarian crisis and has led to the mass destruction of physical infrastructure in Ukraine, but it has also had ripple effects that touch almost every country in the world. The decision by many Western and other countries to impose sweeping sanctions on Russia, combined with the systemic importance of both Russia and Ukraine in several global commodity markets, means that the economic and financial fallout will be significant and lasting.

Given the war, our spring 2022 forecasts come at a time of almost unprecedented global uncertainty. This stems from three main factors. First, the course of the war itself, which is impossible to predict. It is very difficult to say how long the conflict will last; whether the affected territory will expand or shrink; whether the intensity of the conflict will increase or decline; and whether a ceasefire will be reached soon. And all these factors will determine the economic fallout from the war. Second, the sanctions response, which continues to evolve. The truly 'nuclear' option in terms of sanctions – an EU decision to stop importing gas from Russia – has so far not been taken. If the EU opts for this, the consequences will be much more significant. The third main factor of uncertainty is the role of China. Although allied with Russia, and having so far largely kept quiet (including not joining sanctions), China remains something of a wildcard in the conflict. The extent to which it decides to help Russia deal with the fallout from existing and possible future sanctions, and the response that this elicits from the US, will both have a major bearing on the global economy in the coming years.

Our baseline scenario – which is subject to huge risks – is that there will be some kind of ceasefire by the middle of 2022. Such a ceasefire would come about because of a stalemate, with neither side able to advance further. This scenario assumes that Ukraine –thanks to an evidently very capable army, supplied with Western weapons – is able to fend off Russian forces, but not to defeat them entirely. Russia would control parts of the south and the east, but Ukraine's forces would hold the rest of the country. Such a ceasefire would end major combat operations and leave the Zelensky government in power in Kyiv. Talks, probably under Turkish mediation, could proceed along the lines that already seem to be broadly established (for example, with a Ukrainian commitment not to join NATO, in return for security guarantees). Nevertheless, this would be an uneasy truce, and we refrain from calling it 'peace'. Russia would continue its various unconventional warfare methods against Ukraine, while for its part Ukraine would seek reparations and war crimes trials. Most sanctions would remain on Russia for years, but not be materially increased from their current level.

For the global economy, this would not be the worst-case scenario, but clearly the situation requires a downgrade of projections vis-à-vis our previous, winter update. The euro area will be materially affected, primarily via a spike in inflation that will eat into real incomes, but also by a hit to confidence, which will weigh on investment and consumer spending. We project real GDP growth of 2.5% this year, 1.7 percentage points lower than we were anticipating in January (Table 1.1). Meanwhile we expect average inflation in the single currency area of 6%, up 2.8 percentage points from three months ago.

Table 1.1 / wiiw spring 2022 global assumptions

	Spring 2022			Changes since winter		
	2022	2023	2024	2022	2023	2024
Euro area real GDP growth, %	2.5	2.7	2.1	-1.7	-0.7	0.3
Euro area HICP, %	6.0	3.0	2.0	2.8	1.7	0.8
USD/EUR exchange rate, average	1.12	1.12	1.12	-0.02	-0.02	-0.02
USD per barrel Brent oil, average	105.0	90.0	90.0	27.0	17.0	22.0

Source: wiiw spring 2022 projections.

In the background, various other things will affect the global economy. On the positive side, the recovery from, and adaptation to, COVID-19 is continuing in large parts of the world, including the US and Europe. This will boost economic momentum this year. However, this is (probably more than) offset by negative effects from other sources, with two in particular standing out. First, even before the war began, global inflation was rising, driven by increasing commodity costs and supply-chain problems. In response, major central banks had started to tighten policy, most importantly the US Federal Reserve. As the Fed moves towards a more aggressive pace of tightening, this will weigh on economic activity in the US; but it also risks causing more serious financing difficulties in large parts of the developing world (World Bank, 2022). Meanwhile the second major negative for the global economy is the likelihood that China's zero-COVID policy – which is leading to massive restrictions on economic life across the country – will dampen economic growth.

1.2. ADVERSE SCENARIO: MUCH HIGHER ENERGY PRICES AND A RECESSION

Given the almost unprecedented level of uncertainty for global and CESEE economies in the current context, as part of our Spring Forecast we have also produced a second set of projections, this time for an 'adverse' scenario. We have conducted this exercise for the euro area and all 23 CESEE countries. For the latter, we have produced a second set of forecasts for all three years, for the consumer price index (CPI) and inflation (reference to CESEE table).

In this scenario, the war continues, and ever more evidence of war crimes by Russian forces emerges, leading to a ban on Russian energy imports by the EU (rather than the existing gradual phasing-out approach). While many are already calling for this step, some EU member states – most notably Germany – have demurred. Excuses offered for resisting this step include the likelihood that the economic impact for the EU would be quite severe. Many in the EU – and again perhaps especially in Germany – are worried about the impact of a sudden cessation of imports on key parts of the bloc's industry. In this scenario, the scale of atrocities committed by the Russian forces in Ukraine becomes so great that the heightened public pressure to increase sanctions outweighs the concerns outlined above.

This scenario would mean a substantial increase in energy prices in the euro area from their current levels, and a material further negative impact on growth. In addition, risk premia would rise, and confidence and investment would fall. There would also be lower demand from Russia for EU exports. According to this scenario, we model a doubling of energy prices in 2022, and continued effects on energy prices in 2023-2024 (albeit by then the effects would be less severe, relative to the baseline scenario).

In this scenario, the euro area would face a recession, albeit a fairly mild one, and a spike in inflation. Our results show a real GDP decline of 0.9% in 2022, 3.4 percentage points lower than the baseline (Table 1.2). In 2023 and 2024, real GDP in the euro area would be 0.4 and 0.7 percentage points lower than the baseline (respectively).

Table 1.2 / Adverse scenario and differences versus baseline

	Spring 2022 adverse scenario			Difference versus baseline		
	2022	2023	2024	2022	2023	2024
Euro area real GDP growth, %	-0.9	1.8	1.4	-3.4	-0.4	-0.7
Euro area HICP, %	9.5	4.0	2.7	3.5	-0.5	0.2

Source: wiiw.

BOX 1.1 / METHODOLOGY FOR THE ADVERSE SCENARIO SHOCK

Key assumptions

- Key shock: energy price increase:
  - Energy shock reduces GDP in the adverse scenario, compared to the baseline
  - Full weight of the shock in 2022. In 2023 and 2024, the shock values are smaller, depending on the speed of replacement of Russian energy supplies under the REpowerEU plan
- Energy shock derivation and assumptions:
  - We model the impact on GDP and inflation via energy price increases (oil and gas)
  - Energy prices double in 2022
  - Thereafter, energy prices decline, according to the European Commission's REpowerEU replacement plan: the EU replaces 72% of Russian gas by the end of 2023 and 79% by the end of 2024
- Other policy changes:
  - Monetary policy: no differentiation from the baseline scenario
  - Fiscal policy: neutral, no stimulus, no austerity

Modelling process

- Estimate one-year adverse impact (i.e. for 2022) of the energy price increases on German GDP and CPI, using a vector autoregression (VAR) estimation
- Model euro area GDP growth and inflation from bivariate regressions on German GDP and CPI, respectively, and predict changes in GDP and CPI for the euro area
- From the predicted values, generate shock values for 2022: add shock values to the baseline growth/inflation values in full for 2022
  For 2023, apply only 28% of the shock and 21% of the shock for 2024: 28% and 21% reflect the remaining deliveries of Russian gas to the EU, compared to 2021.

Method for estimating shocks to the German economy

- Time-series analysis using non-structural VAR, with two lags for the endogenous variables (GDP and CPI), and present values and one lag for the exogenous variables: gas and oil prices, European Central Bank rate, US GDP, Fed rates, time trend, and trend changes after 2008 and 2014
- Estimations performed in first differences
- The period of estimation is from Q1 2011 until Q4 2021
- Estimated on quarterly data from International Monetary Fund's International Financial Statistics and Investing.com
- Shock values generated from cumulative dynamic multiplier functions

Further details on the estimation results are available in Astrov et al. (2022).

REFERENCES

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