EU economic resilience tested

The EU has revised growth forecasts down. Maarten Verwey, Laura Bardone and Kristian Orsini say the Russian invasion is exacerbating pre-existing headwinds to economic growth

Russia's invasion of Ukraine has led the European Commission to revise its EU growth outlook downwards, and the forecast for inflation upwards. As this column discusses, 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.

Nevertheless, the economy is expected to keep expanding, and inflation is set to gradually decline towards, though remain above, 2% throughout the forecast horizon. Should further disruptions in energy markets occur, the economy would not escape stagflation.

…but economic expansion in the EU is set to continue and inflationary pressures to abate…

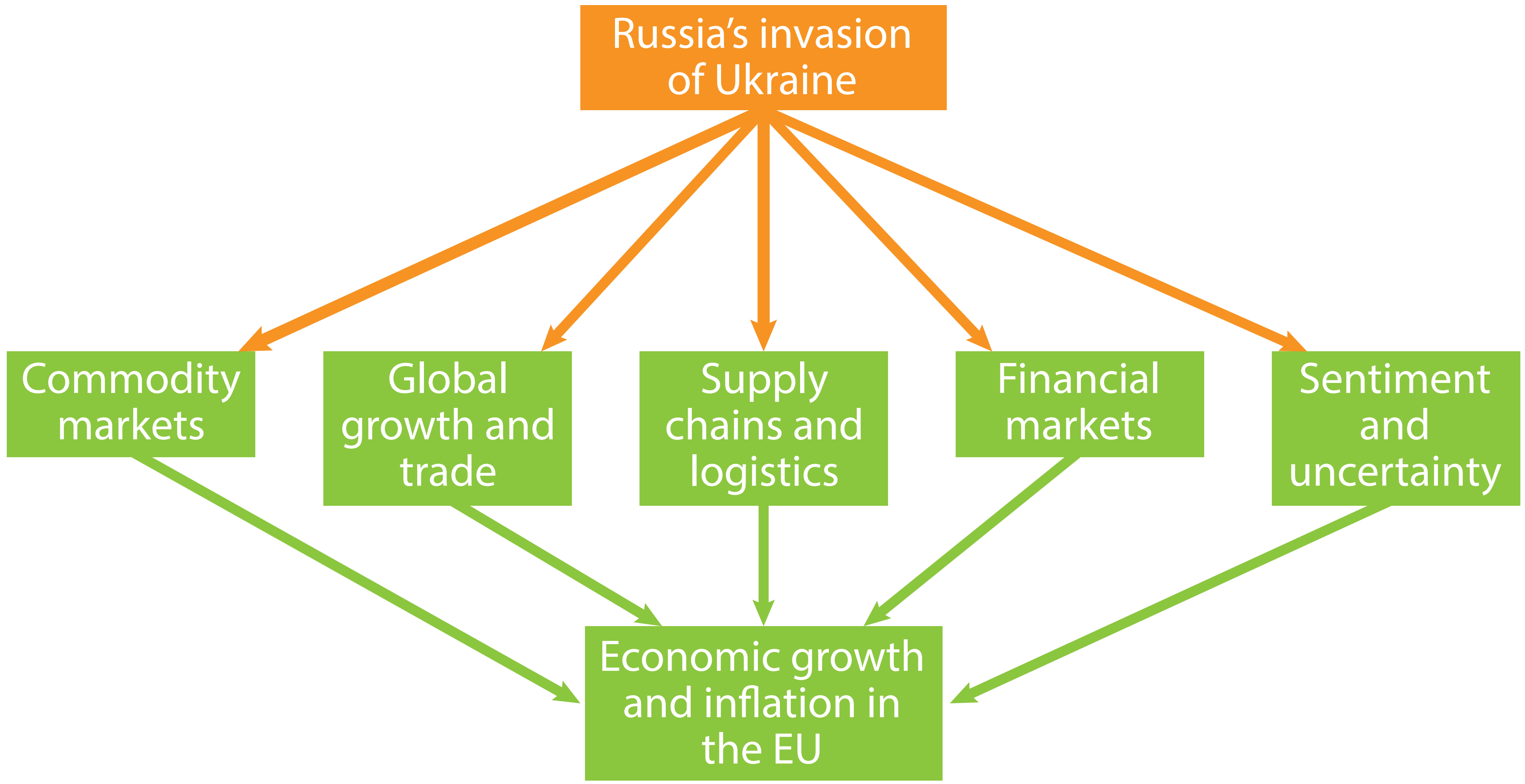
The current shock bears many similarities with that occurring in the 1970s, when oil prices skyrocketed as the Organization of Arab Petroleum Exporting Countries (OAPEC) curtailed supply in response to the Yom Kippur war in October 1973.

This alone has led observers to evoke the spectre of stagflation. Yet, similarities should not be overemphasised. First, at least so far, the magnitude of the energy commodity price increase has been smaller than in the 1970s (Ha *et al* 2022).

Admittedly, the price of gas is now around six times higher than the pre-pandemic benchmark, an increase that is even larger than the surge in oil prices between October 1973 and February 1974.

Yet, the increase in the price of oil – which still is the primary source of energy for the EU – has been more contained, at roughly 60% above pre-pandemic levels.

Figure 1. How Russia's invasion of Ukraine is affecting the EU economic outlook



Second, in the 1970s, OAPEC controlled nearly 60% of the world oil supply, whereas today Russia accounts for a much lower share of both oil and gas global supply (12% and 17%, respectively; British Petroleum 2022).

Third, four decades ago, production in advanced economies was much more energy-intensive than it is today, thanks to progress achieved in energy efficiency and a larger share of services (IMF 2022c).

Fourth, other structural characteristics of the economy also differ: back in the 1970s, widespread wage and price indexations, highly regulated and oligopolistic markets, and trade protectionism were key in propagating and prolonging price shocks.

Policymakers have to preserve incentives to diminish energy consumption and ensure public finances to remain on a track of long-term sustainability

Finally, prevailing demand management policies were slow to respond to the untested supply shock (ECB 2000).

Despite revising the projections for growth downwards and for inflation upwards, the European Economic Spring 2022 Forecast (European Commission 2022b) still projects the economy to keep expanding over the forecast horizon, and inflation to gradually converge towards – but remain above – target. This is not the full-blown stagflationary scenario of the 1970s.

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 (European Commission 2022c).

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 growth over this year ('carry-over effect'). Within-year growth has been reduced from 2.1% to just 0.8%.

In turn, the projection for inflation has been revised up significantly. In the EU, HICP inflation is now expected to average an all-time high of 6.8% in 2022, before declining to 3.2% in 2023. In the euro area, inflation is projected at 6.1% in 2022 and 2.7% in 2023. This compares with 3.5% and 1.7%, respectively, in the Winter 2022 interim forecast.

The economic expansion is upheld by residual tailwinds from the ongoing post-pandemic re-opening of contact-intensive services, as well as the resilience of the economy built through strong policy action at EU and national levels in response to the pandemic crisis.

A strong and still improving employment situation, high accumulated savings and the full deployment of the Recovery and Resilience Facility (RRF) and accompanying reform agenda are set to support private consumption and investment. Fiscal measures to offset part of the impact of rising energy prices on vulnerable households and energy-intensive firms are adding to this support.

Still, the unprecedented nature and size of the shocks ushered in by the war make the baseline projections of our forecast subject to considerable uncertainty, and the balance of risks surrounding them skewed towards adverse outcomes. Risks are heavily dependent on the evolution of the war and its consequences for energy markets.

The forecast is based on the assumption that geopolitical tensions do not normalise over the forecast horizon and that energy prices evolve in line with the indications from futures markets. It does not factor in large-scale interruptions in the supply of oil and/or gas commodities, which reflects the situation on the cut-off date of the forecast.

… still severe disruptions in energy markets could tip the EU into stagflation…

Shocks reverberating from an evolution of energy markets that depart from these key assumptions are assessed through model-based scenario analyses. A first adverse scenario assumes oil and gas prices 25% above the baseline throughout the forecast horizon. A second, more severe scenario considers an outright cut in gas supply from Russia.

Both scenarios are associated with further increases in risk premia and negative confidence effects. The results of the simulation exercise show that the shocks in energy markets strengthen the stagflationary forces at play, and result in lower growth and higher inflation than in the baseline.

Figure 2a. EU GDP growth forecast (Spring and Winter)

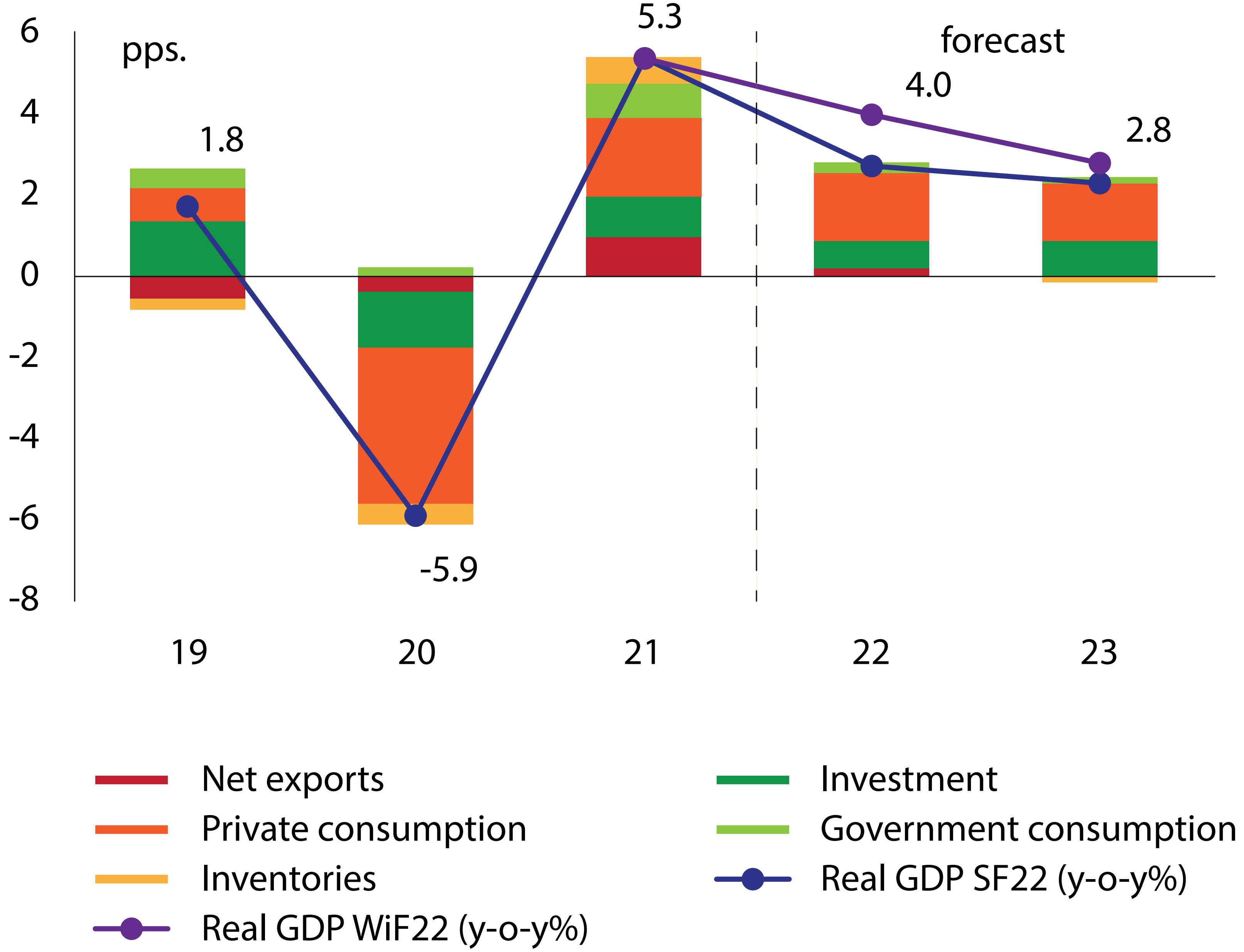
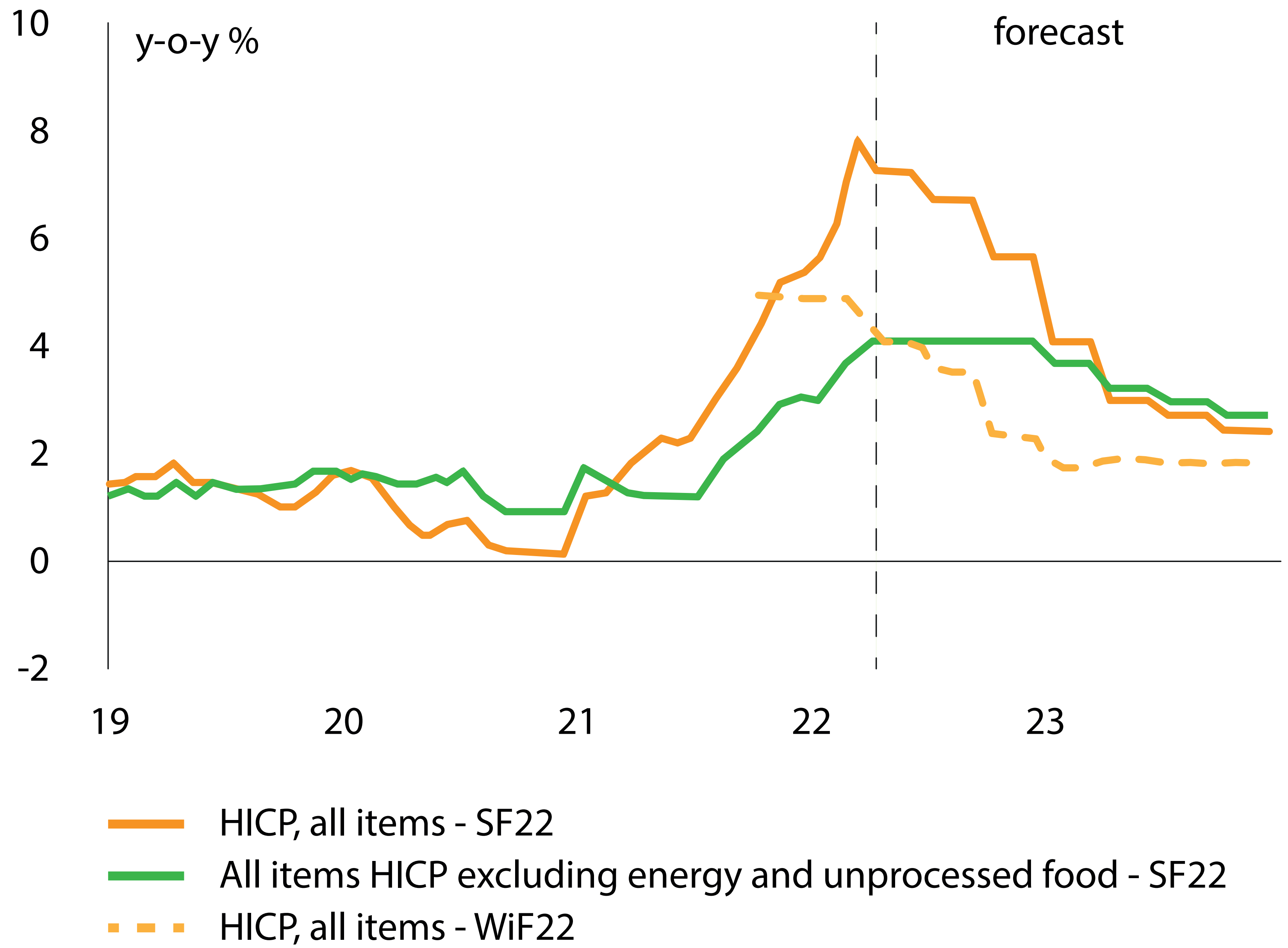


Figure 2b EU inflation forecast (Spring and Winter)



Thanks to the strong carry-over from 2021, the euro area economy would still manage positive annual growth rates in the two forecast years, but net of the carry-over effect from 2021, the economy would contract in 2022.

A sharp reduction in gas supplies from Russia would imply a substantial deterioration of the economic outlook: GDP growth rates would be around 2½ and 1pps. below the baseline in 2022 and 2023, respectively, while inflation, proxied by the private consumption deflator, would be 3 percentage points higher in 2022 and more than 1 percentage point above in 2023.

… reinforcing the need to frontload energy transition

Substantial macroeconomic risks stemming from the EU's high dependency on imports of oil and gas from Russia reinforce the case for an accelerated decarbonisation of the economy. Policy action should target both supply (eg. investing in renewables sources or LNG terminals) and demand (eg. facilitating energy efficiency or electric car charging stations).

It is crucial that the RRF can be counted upon to face this new challenge. The timely implementation of its investment and reform pillars is as relevant as ever to reduce fossil fuel dependency from Russia and enhance the long-term growth potential of the EU economy.

Within the framework of the REPowerEU plan (European Commission 2022d), the Commission stands ready to scale up its support projects and reforms that accelerate the energy transition. Projects completing the internal market in energy and those with a strong cross-border dimension should be privileged. Unused loans in the RRF can be an additional source of funding.

Figure 3a. Real GDP growth rates across scenarios, euro area

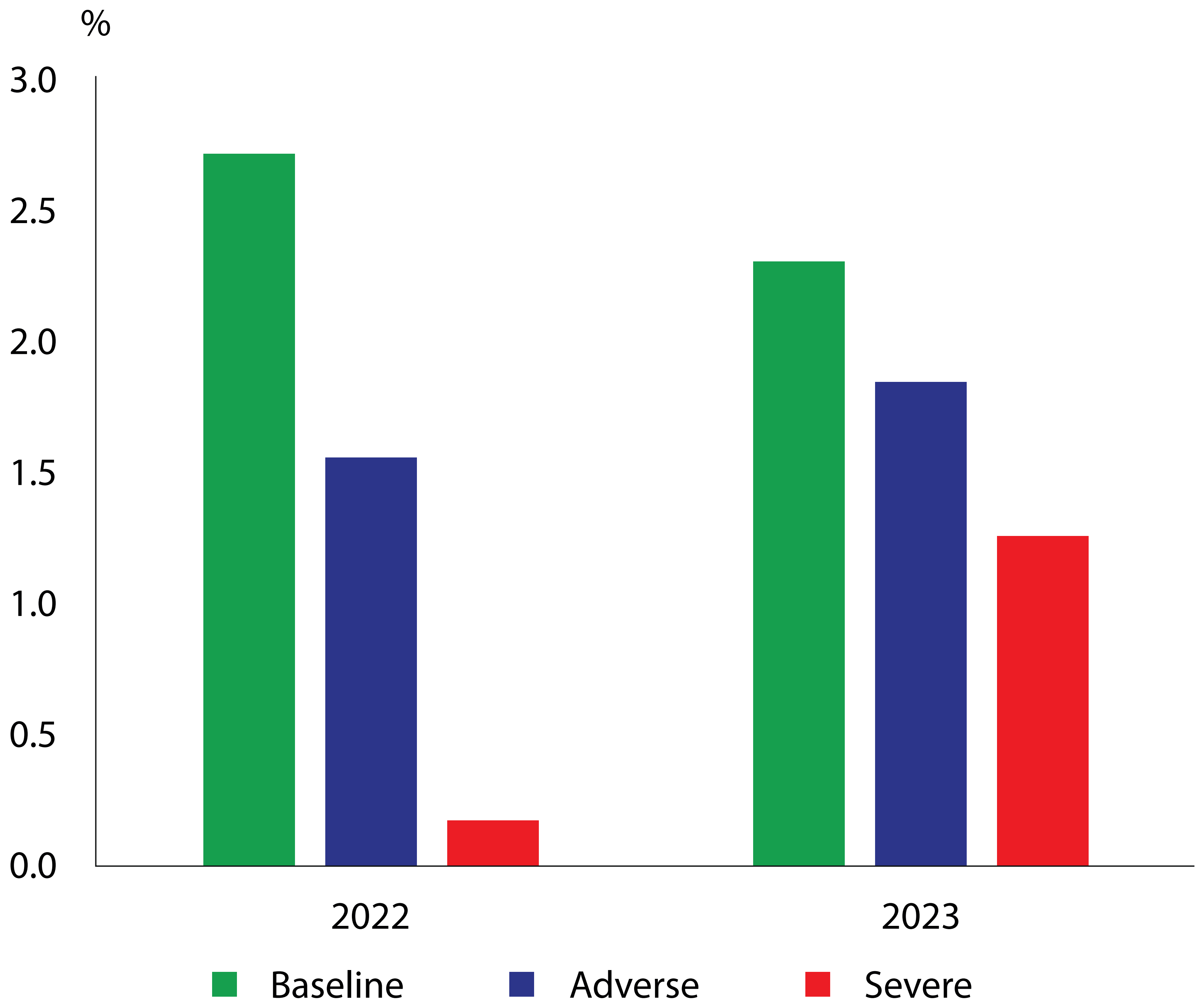
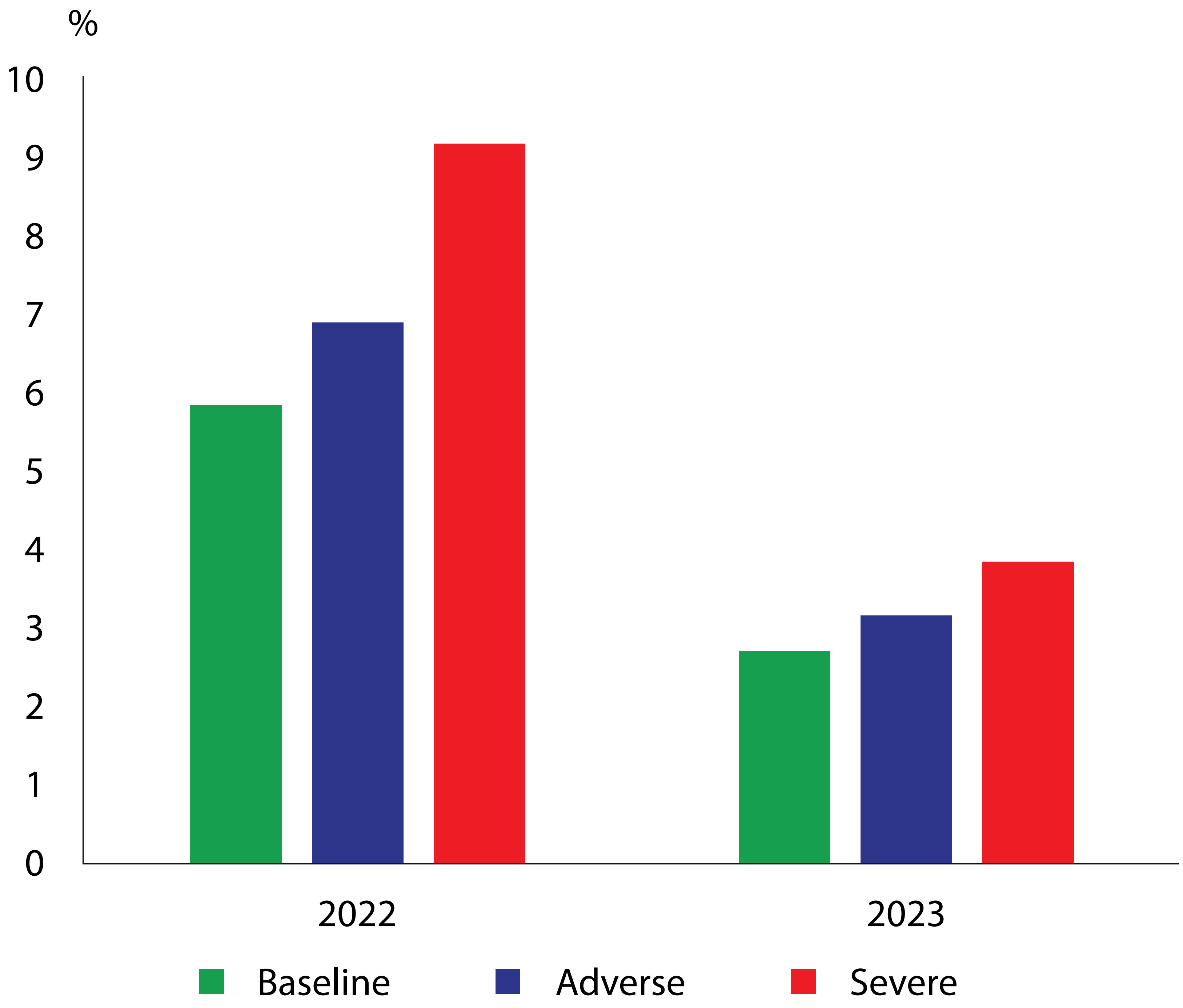


Figure 3b. Inflation rates across scenarios, euro area



Policymakers will have to recalibrate their policy tools deployed during the pandemic. Over the past couple of years, fiscal firepower was successfully mobilised to support aggregate demand and stabilise employment, thereby also safeguarding price stability in face of deflationary risks.

This response has proved highly effective in protecting EU citizens and preserving the economy's productive capacity in a context of a temporary shock, expected to have overall limited transformational consequences. Faced with a potentially permanent shock that largely weighs on the supply side of the economy, policy action should no longer aim at avoiding excessive dislocations but rather accompany and accelerate structural change.

In facing these new challenges, attention needs to be paid to distributional aspects. While softening the impact of rising energy prices on vulnerable households and energy-intensive industries, policymakers have to preserve incentives to diminish energy consumption and ensure public finances to remain on a track of long-term sustainability. ■

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