1. Global overview: Euro area heading into recession

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- **We expect the war in Ukraine to last until at least the end of 2023. This will continue to have a negative impact on the euro area economy.**

- **Global economic conditions are increasingly gloomy, and the euro area is already facing the risk of stagflation, with a recession now almost certain over the winter. We expect a gradual recovery starting in the first half of 2023, but energy prices will stay high, preventing a rapid bounce-back.**

- **Inflation in the euro area is higher than we previously anticipated, and will remain at a historically elevated level during 2023. It should fall back towards target by 2024.**

- **The ECB, Fed and other major central banks are hiking aggressively to try to tame inflation. This risks exposing vulnerabilities in the financial sector, places heavy pressure on emerging markets with large dollar borrowing needs, and is driving a coordinated global monetary tightening that will weigh further on growth.**

- **The risks to the outlook are skewed heavily to the downside. In terms of likelihood and impact, the biggest risk is a full cessation of Russian energy supplies to Europe.**

Table 1.1 / wiiw global assumptions, autumn 2022

	Autumn 2022			Changes since summer		
	2022	2023	2024	2022	2023	2024
Euro area real GDP growth, %	3.1	0.2	1.9	0.9	-2.3	-0.2
Euro area consumer price inflation, %	8.5	6.0	2.3	1.0	2.5	0.3
USD/EUR exchange rate, average	1.03	0.99	0.99	-0.05	-0.09	-0.09
USD per barrel Brent oil, USD, average	101.0	97.0	90.0	-9.0	7.0	0.0

Source: forecasts by wiiw. Cut-off date: 3 October 2022.

1.1. THE WAR WILL CONTINUE, WITH NO DECISIVE VICTORY FOR EITHER SIDE

The Russian invasion of Ukraine and the sanctions response by a broad range of countries has had – and will continue to have – a major impact on economic activity, inflation, commodity prices and exchange rates across the global economy. While all countries are affected, the strongest impact is generally being felt by other European countries, given their proximity to the hostilities. The pre-war reliance of many key euro area economies on Russian gas has created a very powerful contagion channel, with effects on inflation and growth already visible. Assumptions about how

much longer the war will last, what the future fallout will be and how it will end are therefore crucial underlying elements in all our forecasts.

We assume that the war will continue in 2023 (see chapter 2). At the time of writing, the Ukrainian army is pushing its Russian adversary back in certain areas of the country, but neither side has the weapons needed to achieve a decisive victory. Geographically, we assume that the war will remain centred on particular areas of southern and eastern Ukraine and will not spread further. We assume that Russia will not use nuclear weapons or attack a NATO member state, and therefore that the war will not expand to become a NATO-Russia conflict. In terms of energy supplies, we assume that Russia will continue to heavily restrict flows to most of Europe over the winter.

Economically, this means a continuation of the status quo in the euro area, with energy prices very high by historical standards, huge uncertainty among investors and caution among consumers. Throughout our forecast period, inflation will be higher, growth will be lower and the euro will be weaker than would otherwise have been the case. If the war spreads to become a NATO-Russia conflict, the economic consequences are too drastic to quantify. If the war ends sooner, then economic growth in the euro area could be higher than we currently project. However, this will depend on *how* the war ends, something that at present is impossible to predict with any certainty.

1.2. RECESSION NOW, RECOVERY FROM SPRING 2023

The euro area performed better than expected in 2022, with reopening effects contributing to a robust H1, in particular. Both firms and consumers demonstrated impressive resilience in the face of sharply rising prices in the middle of the year. Growth was supported by the reopening after the COVID lockdowns, a rebound in tourism, continued consumer willingness to spend (possibly bringing forward big purchases in view of high inflation) and resilience in industry.

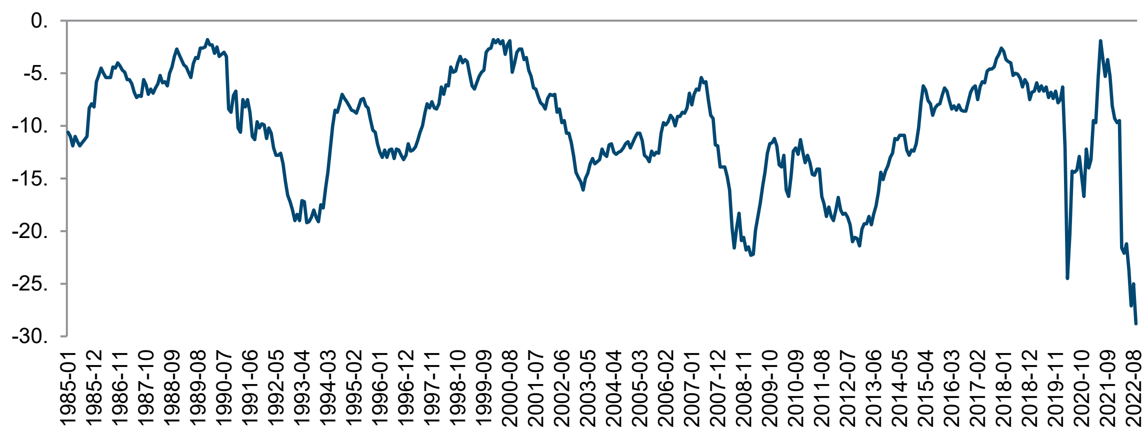
However, this resilience has faded, and the key global economies are all currently struggling. High-frequency indicators in the euro area indicate a major slowdown in the past couple of months, and we expect the single currency area to go into recession over the winter. Consumer confidence in the euro area is now weaker than in 2008 or 2020 (Figure 1.1). The latest industry sentiment data indicate a deep contraction in the manufacturing sector, especially in Germany. The negative fallout from higher energy prices and supply bottlenecks is really starting to become visible. Although gas storage tanks are filling up and governments are taking a variety of measures to reduce energy use, it looks as though it will be hard to avoid gas rationing in the euro area over the winter, which will mean further industrial shutdowns. At the time of writing, a gas price cap is being discussed by the EU, but details are scarce on how it will be implemented.

At the global level, the two key drivers of post-2008 economic growth – strong Chinese demand and loose US monetary policy – no longer exist. The latest OECD Economic Outlook, published in September, sees global growth at 2.2% next year, down 0.6 percentage points (pp) against the June forecast.[1] It expects the US to grow by just 0.5% in 2023, down 0.7 pp compared with the previous forecast. The sharp increase in US interest rates has caused a rapid tightening of financial conditions in

[1] https://www.oecd.org/economic-outlook/september-2022/

the global economy, which acts as a major brake on economic growth. Meanwhile, the crash in Chinese real estate has rippled out across the economy and, combined with the regular shutdowns due to China's zero-COVID policy, has resulted in much weaker growth there. The Chinese economy is also suffering from weaker export demand, owing to the slowdown in the US and the euro area.

Figure 1.1 / Euro area consumer confidence, balance of positive and negative responses, seasonally adjusted



Source: Eurostat.

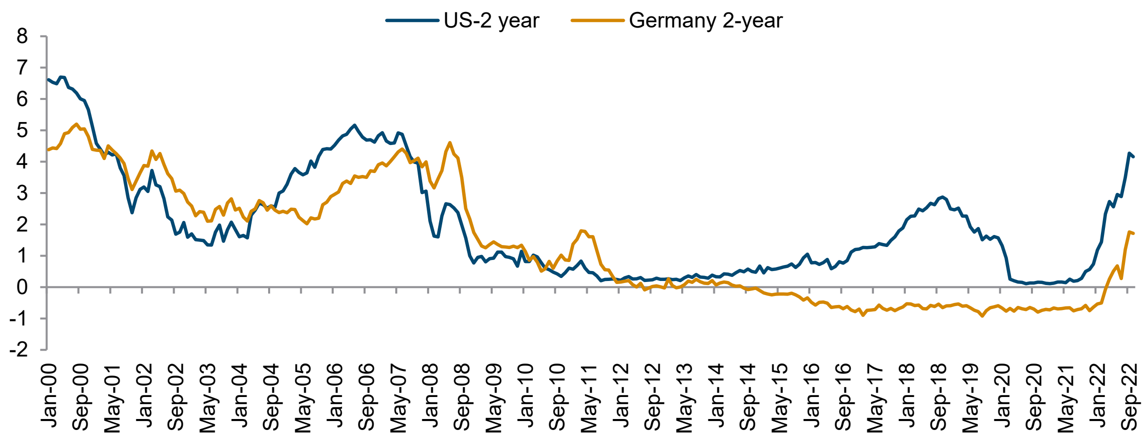
We expect the recovery in the euro area to begin in spring 2023, as the weather improves, thus easing the pressure on scarce gas supplies. Nevertheless, Europe's transition away from Russian gas – via a combination of diversification, a step back towards coal and other dirtier forms of energy, and an accelerated green transition – will take time. It is feasible that the gas supply will be tight by historical standards for many years, and it seems more than probable that gas prices will be very high in Europe next winter as well. Industry will continue to struggle with much greater input costs for some time to come. Meanwhile real wage growth will not return to positive territory any time soon, since we expect inflation to remain at a historically high level in the euro area (6%) next year as well.

1.3. INTEREST RATES HAVE BROKEN OUT OF THEIR DECADES-LONG DOWNWARD TREND

We have made upward revisions to our euro area inflation forecasts for all three years, but especially for 2023, as price growth has continued to rise. The original trigger for euro area and global inflation was a surplus of demand over supply for certain goods during the recovery from the pandemic, combined with surging energy costs from late 2021 on the back of rising Chinese demand for gas and cuts in Russian supplies to Europe. The Russian invasion of Ukraine and the sanctions response have, however, dramatically accelerated these trends, creating a further surge in both energy and food prices on the global markets. There is evidence that even in the euro area, this price growth is now increasingly broad based. Meanwhile, the weaker euro has contributed to higher import costs in the single currency area. The European Central Bank (ECB) expects all these factors to ease by the middle of next year, and inflation to fall back towards target by 2024. One of the main caps on inflation in the coming quarters will be the euro area recession, which will damp down demand-side pressures.

Inflation will also be somewhat tamed by much tighter monetary policy, with a fundamental change in monetary trends under way across the global economy. At their most recent meetings, both the Fed and the ECB increased their main policy rates by 75 basis points, both unusually big moves by historical standards. Any monetary tightening would be significant after over a decade of ultra-loose monetary policy by the major central banks. However, the scale of the recent interest rate increases indicates that a huge collective global monetary tightening is under way, in an attempt to put the brakes on inflation, which is way ahead of target. Short-term government bond yields, which are most sensitive to changes in monetary policy, have risen almost vertically in the last few months, as the markets have rapidly adjusted their interest rate expectations (Figure 1.2). One does not have to be a technical analyst to see a clear break in the multi-decade downward trend in long-term interest rates (Figure 1.3).

Figure 1.2 / Two-year government bond yields, %



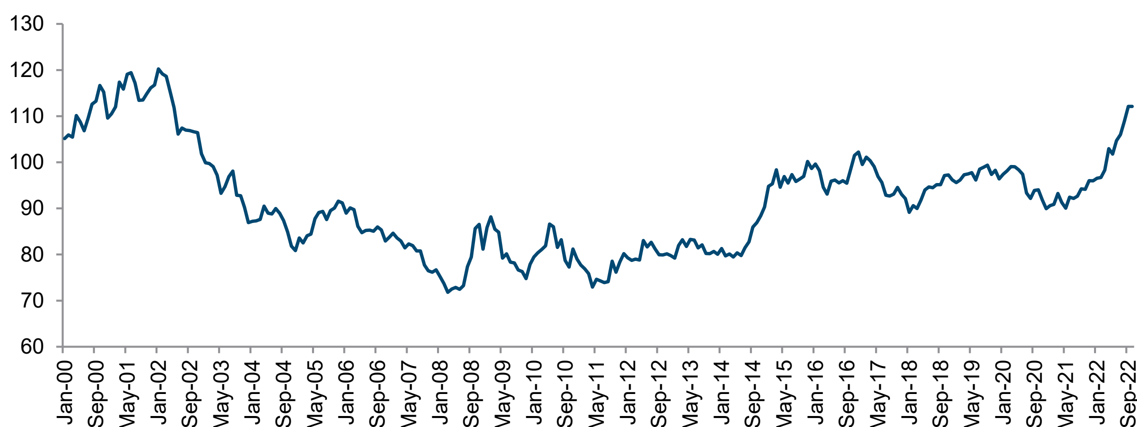
Source: Investing.com

Figure 1.3 / US 30-year bond yield, %

Source: Investing.com

Central banks are in an invidious position, both because it is not clear that tightening will solve the inflation issue and because higher rates could cause serious economic and financial problems. Especially in the euro area, the ECB is tightening into a recession; higher interest rates will not do anything to tackle the supply-side causes of inflation. Moreover, many (including us) have always feared that, after more than a decade of ultra-low interest rates, the euro area economy and financial sector may not be able to manage a significant tightening of policy. Recently, the crisis in the UK private pensions sector and the need for the Bank of England to conduct an emergency intervention provided a stark reminder of how ill-prepared pockets of the economy may be for higher rates. The US Treasury's Office of Financial Research recently flagged that its financial stress index was at its highest level since the peak of the pandemic sell-off in early 2020. There is a risk that, after a decade of low or negative rates, sharply higher interest rates will cause stress in a particular part of the financial sector that will spill over into a broader financial crisis. Fed tightening and general risk aversion have contributed to an extremely strong dollar (Figure 1.4), something that tends to go hand in hand with weak global economic conditions. Once again, the prophecies at the start of the Russian invasion about the end of the dollar have proved wrong; in fact, the dollar is as dominant as ever.

Figure 1.4 / US dollar index



Source: Investing.com

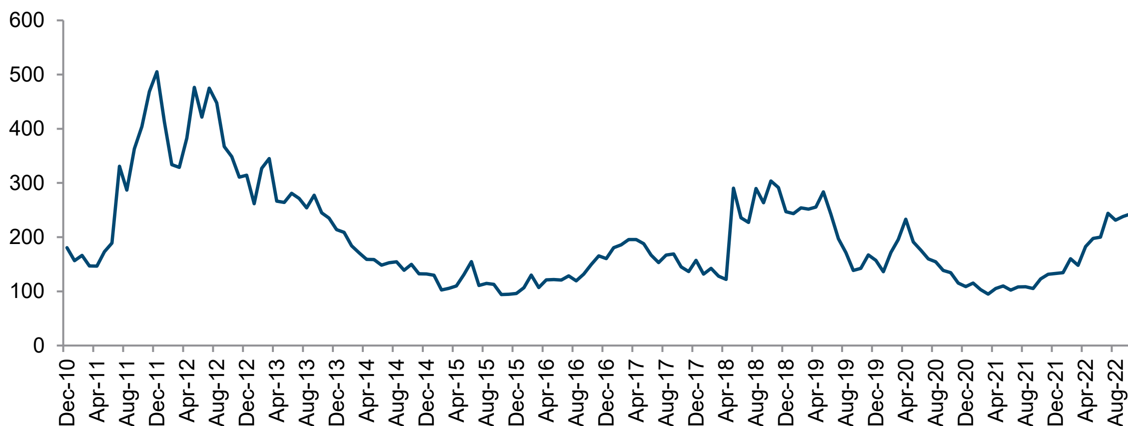
Across both the developed and the emerging world, central banks have been forced to respond to the Fed with their own aggressive hiking cycles. Currency weakness against the dollar (in which most commodities are priced) increases import costs and thus exacerbates already-high inflation. The strength of the dollar also presents clear risks for emerging markets with large dollar financing needs, of which Turkey is the clearest example in CESEE. The recent UNCTAD Trade and Development Report for 2022 noted that 'around 6 out of 10 low-income countries and 3 out of 10 emerging market economies are at or near debt distress'.[2]

There are various potential areas of stress in the euro area, not least the funding costs of peripheral euro area economies. Here, the spread over German yields has risen sharply in 2022, indicating increased wariness among investors. The difference between the yield on Italian 10-year sovereign debt and its German equivalent recently reached a higher level than at the start of the

[2] https://unctad.org/webflyer/trade-and-development-report-2022

pandemic, albeit still well below the levels of the euro area crisis of the early 2010s (Figure 1.5). For now, the ECB seems to have the situation under control; it has so far not had to use its new Transmission Protection Instrument (TPI) to cap Italian bond yields. As in previous cases of rising peripheral yields, it is possible that the existence (rather than the actual use) of such an instrument will be enough to calm the market. It is also possible that the new Italian government under Giorgia Meloni has not frightened the market in the way that perhaps many expected. Nevertheless, even if market panic is avoided, it is clear that much higher borrowing costs will limit fiscal space and dampen economic momentum across the euro area, including in Italy. Moreover, there are growing signs that higher rates are causing stress in European real estate markets.[3]

Figure 1.5 / Spread of Italian 10-year sovereign yields over German equivalent, basis points



Source: Investing.com

1.4. DOWNSIDE RISKS ARE PREVALENT

The risks to the outlook are strongly on the downside. In terms of likelihood, we see the most serious risk as stemming from a potential complete cessation of energy flows from Russia (Table 2). Medium-likelihood risks include global inflation staying higher for longer than expected, the emergence of a new and more dangerous COVID variant over the winter, an emerging markets debt crisis due to Fed tightening, higher interest rates causing a financial crisis in the developed world, and political gridlock in the US. Low-likelihood but high-impact risks are the use of nuclear weapons by Russia in Ukraine, a direct Russia-NATO conflict and a new euro area sovereign debt crisis.

[3] https://www.bloomberg.com/news/articles/2022-10-04/european-real-estate-s-decade-long-party-is-coming-to-an-end?sref=tvUbUFbg

Table 1.2 / wiiw risk matrix

		Impact		
Likelihood		**High**	**Medium**	**Low**
	High		› Russia cuts all remaining flows of energy to Europe	
	Medium	› Longer-than- expected period of high inflation	› New infectious, dangerous COVID variant › New stoppage of food exports from Ukraine › Stress in part of financial sector leads to broader financial crisis › Emerging markets debt crisis caused by Fed tightening	› Political gridlock in the US
	Low	› Nuclear 'incident' in Ukraine › Chinese invasion of Taiwan › Russia-NATO direct conflict › New euro area sovereign debt crisis	› Political gridlock in the euro area	