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Weekly Economic Briefing | Eurozone

War in Ukraine will hit Europe's economy

Economist

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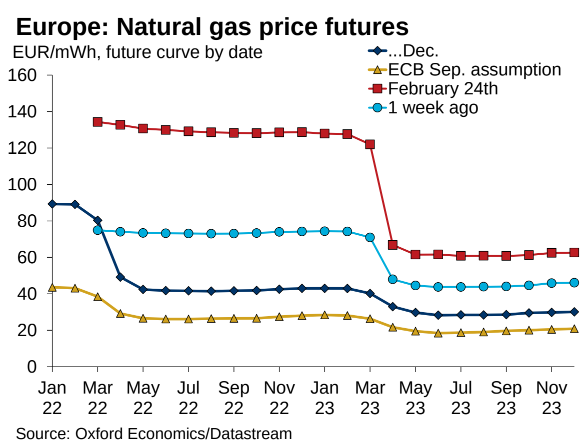
- **Russia's invasion of Ukraine means that the economic impact of the conflict on Europe will be larger than we previously assumed. Our new baseline sees higher gas, oil and food prices over the medium term, as well as increased disruption in financial markets and greater sanctions on Russia by the EU, UK and US. This means an even 'higher for longer' period of inflation in the euro area, with increased risks of it becoming entrenched and a larger impact on households' real incomes and industries' supply lines.**
- **While we do not yet incorporate a permanent occupation of all Ukraine by Russia in our base case, the severity of the conflict and the speed at which events are moving means that extreme scenarios such as a suspension of gas supplies to Europe are no longer unthinkable. A protracted period of severe tensions is still the more likely scenario, risking more permanent damage to the European economy, which means that risks to the outlook have now moved firmly to the downside.**
- **Although war means higher inflation, its negative impact on growth and financial conditions may prompt the ECB to reconsider its current plan to raise interest rates later this year and end asset purchases at an accelerated pace, instead taking a more flexible, data-dependent approach based on the evolution of the crisis. Our new baseline sees a small delay in the policy normalisation process, with the first interest rate hike postponed until Q1 2023.**

Russia invades Ukraine and Europe will feel the impact

Although only a few days ago we still expected that a full-scale conflict between Russia and Ukraine could be avoided, sadly our worst fears about a war in Ukraine were confirmed this week. The speed at which events are unfolding and the severity of the situation means that our new baseline for the conflict has moved to our scenario of a full-scale invasion. In addition to the obvious cost in human lives, this means that the economic impact on Europe will be larger than we had previously assumed.

Figure 1



Gas futures surged 40% yesterday in response to Russia's invasion of Ukraine but have moderated earlier this morning.

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War means higher energy prices for even longer than we had expected

The escalation in hostilities will translate into a large revision to our oil and gas price forecasts, which we now expect to remain higher for much longer, in line with what the futures market suggests (**Figure 1**). There will also be an additional impact on food prices given Russia's key role as a global exporter of grains and chemicals used in fertilisers and also some minerals. This will push eurozone inflation higher than we had expected and also means that the inflationary cycle will be longer, which poses increasing risks that higher energy costs permeate more permanently into broader goods and services.

As we have argued before, we still see the impact of higher inflation on household real incomes as the main transmission channel for the eurozone economy. However, the exacerbation of price tensions also poses risks for the industrial sector, which will continue to be put under enormous pressure, particularly in energy-intensive sectors. The imposition of strict sanctions by Western powers on Russia could make things even worse for the European industrial sector, as Russia is also a main producer and exporter of some key metals such as steel, aluminium or nickel, so any disruption to trade flows would cause further damage to already-stressed global supply chains.

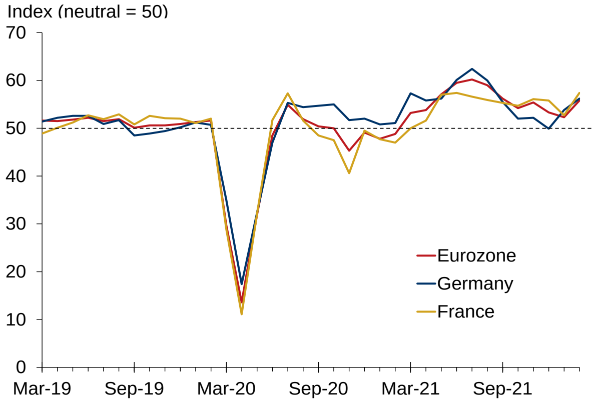
The invasion of Ukraine also means that extreme scenarios such as a cut in Russian gas supplies to Europe can no longer be considered unthinkable. While this is still a tail risk given the massive revenues that the Russian state obtains from selling gas to Europe, the impact of such a measure would deal a devastating blow to the European economy, which imports nearly 40% of all its gas from Russia, a number that goes up to 100% for some countries such as the Czech Republic and Latvia.

Positive data this week but upcoming releases will show impact of crisis

The invasion of Ukraine has completely overshadowed the positive economic data coming out of the euro area earlier this week. The PMIs rebounded strongly in February (**Figure 2**), boosted by a strong pick-up in services activity coinciding with the easing of Covid restrictions and a general improvement in sentiment regarding pandemic risks. The positive data was corroborated by a rise in the German ifo index, suggesting businesses were optimistic about the outlook in the coming months. However, the upcoming data releases are likely to start showing the impact of the escalation in the conflict, in line with the increased volatility already evident in financial markets. Our view still sees a robust recovery in GDP growth in Q2 and Q3 this year, but we will be lowering our forecasts in line with the worsening of the conflict. An improved medical situation and strong labour markets should still provide substantial tailwinds to the euro area economy this year, but there are now growing risks to our view that a rebound in private consumption will be the main engine of growth.

Figure 2

Eurozone: Composite PMIs



Source: Oxford Economics/IHS Markit

The latest data still point to a robust pick-up in activity in February, but upcoming releases will start to reflect the worsening geopolitical tensions.

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The week ahead

Next week brings a variety of hard economic indicators, the most important of which are the flash inflation readings released on Wednesday. We expect further increases in both headline and core inflation. Energy prices will continue to be the main driver of headline inflation, with the spike in food prices also contributing. But core inflation is also expected to edge up after a decline in January. But a new key development now enters the equation – Russia's invasion of Ukraine is set to push up commodity prices further, exacerbating already-high energy inflation. This will dent real incomes in the eurozone, erode the real value of households' excess savings and likely worsen consumer confidence as well.

Two backward-looking indicators, unemployment and retail sales for January, are released on Thursday and Friday respectively. We expect the unemployment rate to remain unchanged from its December value at 7.0%, testament to the resilience of the eurozone labour market throughout the pandemic. Further gains have been put on hold by the Omicron wave but, with infection rates now substantially below their peaks and firms' hiring intentions up substantially in February, the labour market should see further improvement in the near term.

Equally, we expect a bounce-back in retail sales following a weak December likely caused by the pandemic disrupting usual pre-Christmas shopping patterns. January will not see a full recoup of the December losses as the Omicron wave still weighed on spending, but the solid gains in retail trade sentiment in both January and February point to decent near-term prospects for the sector.

Europe Weekly Calendar

Europe Calendar: The week ahead

BST	Country	Events	Period	Unit	Previous data	Consensus*	OE forecast
		Monday 28 February					
08:00	Spain	HICP Flash y/y	Feb	Percent	6.2%	6.8%	7.1%
		Tuesday 01 March					
07:00	Germany	Retail Sales m/m Real	Jan	Percent	-5.5%	1.8%	1.0%
08:15	Spain	Manufacturing PMI	Feb	Index (diffusion)	56.2	56.2	56.0
08:45	Italy	Markit/IHS Mfg PMI	Feb	Index (diffusion)	58.3	58.3	58.0
08:50	France	Markit Mfg PMI	Feb	Index (diffusion)	57.6	57.6	57.6
08:55	Germany	Markit/BME Mfg PMI	Feb	Index (diffusion)	58.5	58.5	58.5
09:00	Euro Zone	Markit Mfg Final PMI	Feb	Index (diffusion)	58.4	58.4	58.4
10:00	Italy	CPI (EU Norm) Prelim y/y	Feb	Percent	4.8%	5.1%	5.5%
13:00	Germany	HICP Prelim y/y	Feb	Percent	5.1%	5.2%	5.4%
		Wednesday 02 March					
08:55	Germany	Unemployment Rate SA	Feb	Percent	5.1%	5.0%	5.1%
10:00	Euro Zone	HICP Flash y/y	Feb	Percent	5.1%	5.3%	5.9%
10:00	Euro Zone	HICP-X F,E,A&T Flash y/y	Feb	Percent	2.3%	2.5%	2.5%
		Thursday 03 March					
08:15	Spain	Services PMI	Feb	Index (diffusion)	46.6	51.6	52.0
08:45	Italy	Markit/IHS Svcs PMI	Feb	Index (diffusion)	48.5	52.2	52.5
08:45	Italy	Composite PMI	Feb	Index (diffusion)	50.1		53.6
08:50	France	Markit Serv PMI	Feb	Index (diffusion)	57.9	57.9	57.9
08:50	France	Markit Comp PMI	Feb	Index (diffusion)	57.4	57.4	57.4
08:55	Germany	Markit Services PMI	Feb	Index (diffusion)	56.6	56.6	56.6
08:55	Germany	Markit Comp Final PMI	Feb	Index (diffusion)	56.2	56.2	56.2
09:00	Euro Zone	Markit Serv Final PMI	Feb	Index (diffusion)	55.8	55.8	55.8
09:00	Euro Zone	Markit Comp Final PMI	Feb	Index (diffusion)	55.8	55.8	55.8
09:00	Italy	Unemployment Rate	Feb	Percent	9.0%		8.9%
10:00	Euro Zone	Unemployment Rate	Jan	Percent	7.0%	7.0%	7.0%
		Friday 04 March					
09:00	Italy	GDP Final QQ	Q4	Percent	0.6%	0.6%	0.6%
10:00	Euro Zone	Retail Sales m/m	Jan	Percent	-3.0%	1.5%	1.5%

*Reuters poll

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Key forecasts

Forecast for Eurozone

(Annual percentage changes unless specified)

	2019	2020	2021	2022	2023	2024
Domestic Demand	2.5	-6.3	3.9	4.1	2.8	1.4
Private Consumption	1.4	-8.0	3.5	5.7	3.7	1.6
Fixed Investment	6.7	-7.3	3.8	4.6	3.4	1.6
Government Consumption	1.8	1.2	3.7	1.0	0.8	0.6
Net exports (% of GDP)	3.4	3.3	4.4	4.1	4.0	4.1
GDP	1.6	-6.5	5.2	3.8	2.7	1.5
Industrial Production	-1.1	-7.7	8.0	3.7	3.9	1.5
Consumer Prices, average	1.2	0.3	2.6	3.9	0.9	1.3
Current Account (% of GDP)	2.4	1.9	2.5	1.5	1.9	2.3
Government Budget (% of GDP)	-0.6	-7.2	-5.4	-3.8	-2.6	-2.1
Short-Term Interest rate (%)	-0.36	-0.43	-0.55	-0.45	-0.01	0.26
Long-Term Interest Rates (%)	0.41	0.08	0.10	0.84	1.16	1.53
Exchange rate (US$ per Euro), average	1.12	1.14	1.18	1.15	1.19	1.22
Exchange rate (YEN per Euro), average	122.1	121.9	129.9	132.1	132.5	131.0

Quarterly forecasts for Eurozone

	2021				2022			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (% year)	-1.1	14.4	3.9	4.6	5.1	4.0	2.8	3.3
CPI inflation (% year)	1.1	1.8	2.8	4.6	5.0	4.6	3.7	2.4
3-month EURIBOR (%)	-0.5	-0.5	-0.5	-0.6	-0.5	-0.5	-0.5	-0.3
10-year yield, EZ average (%)	0.0	0.2	0.0	0.2	0.6	0.9	0.9	1.0
US$ per euro, average	1.20	1.21	1.18	1.14	1.14	1.15	1.16	1.17
Euro per £, average	1.14	1.16	1.17	1.18	1.20	1.21	1.21	1.20

Latest Country Economic Forecasts:

Eurozone: 10 February 2022

Germany: 10 February 2022

France: 18 February 2022

Italy: 15 February 2022

Spain: 10 February 2022

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