ECONOMIC FORECASTS FOR 2023 AGAINST THE BACKGROUND OF THE CURRENT GEOPOLITICAL CONTEXT

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Abstract*:*

The military conflict in Ukraine has induced globally relevant political, economic and social transformations. The year 2023 will be characterised by a global recession, with direct effects on the unfavourable development of economic indicators worldwide. The continuation of the conflict in Ukraine, including in 2023, will have negative repercussions on international economic relations and global political polarisation will influence economic indicators and the world economy in general.

In terms of the global economic downturn, this will directly affect the economy and the population and resilient measures are needed to overcome this economic crisis. From a social point of view, it is the low and middle income population that will suffer the most from the social impact, with soaring inflation and rising prices for utilities, fuel and basic goods, especially food.

In order to emerge quickly from the crisis, pro-active measures are needed based on identifying the best solutions to reduce inflation and measures to protect the vulnerable population by granting economic and fiscal incentives.

Keywords: *economy, global recession, military conflict, economic resilience.*

JEL: *F31, F41, F43*

1. INTRODUCTION

The war unleashed by the Russian Federation against Ukraine continues to negatively affect the economy of EU Member States, pushing it towards lower growth and higher inflation compared to the spring 2022 forecast.

Many of the risks associated with the spring 2022 forecast have materialised. The invasion of Ukraine by the Russian Federation has put additional upward pressure on prices, in particular for energy and food commodities. These factors are fuelling global inflationary pressures, eroding household purchasing power and leading to a faster monetary policy response than previously expected. The continued slowdown in US growth is adding to the negative economic impact of China's rigorous zero-COVID policy.

The EU economy remains particularly vulnerable to developments in energy markets due to its high dependence on fossil fuels from Russia, and the slowdown in global growth is reducing external demand. The momentum gained from last year's upturn and a slightly stronger-than-expected first quarter should support the annual growth rate for 2022. However, economic activity for the rest of the year is expected to be modest, despite a promising summer tourist season. Quarterly economic growth is projected to accelerate in 2023 on the back of resilient labour markets, moderating inflation, support from the Recovery and Resilience Mechanism, and still large amounts of surplus savings.

Overall, the EU economy will continue to expand, but at a much slower pace than expected in the spring 2022 forecast. According to the summer 2022 (interim) economic forecast, the EU economy will grow by 2.7% in 2022 and 1.5% in 2023. In the euro area, growth is expected to be 2.6% in 2022, with a more moderate pace of 1.4% in 2023. Average annual inflation is expected to reach historical highs in 2022 of 7.6% in the euro area and 8.3% in the EU, before falling to 4% and 4.6% respectively in 2023.

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As for Romania, in the first quarter of 2022, the economy surprised specialists with an upward trend, with real GDP growth of 5.2%. This positive result is explained by a significant increase in gross fixed capital formation and private consumption, while net exports made a negative contribution. This robust growth was supported by higher wages, which kept pace with inflation, and the gradual removal of COVID-19 restrictions.

Thanks to this positive first quarter for the economy, GDP growth for the full year 2022 has been revised upward to an estimated 3.9%. However, for 2023 a downward revision to 2.9% is warranted, in line with the slower global and EU economic growth outlook. Private consumption and investment will be the main drivers of growth this year and next, while net exports are expected to act as a drag on GDP, leading to a widening trade deficit.

2. THE IMPACT OF THE WAR IN UKRAINE ON ECONOMIC GROWTH

By June 2022, headline inflation has reached record levels as energy and food prices have continued to rise and price pressures have extended to services and other goods. In the euro area, inflation rose strongly in the second quarter of 2022, from 7.4% in March (compared with the same period a year earlier) to a new record high of 8.6% in June. In the EU, the increase was even more pronounced, with inflation rising sharply by a full percentage point, from 7.8% in March 2022 to 8.8% in May this year.

Inflation forecasts have been revised considerably upwards compared to the spring forecast. In addition to the strong price increase in the second quarter, a further increase in natural gas prices in Europe is expected to be passed on to consumers via electricity prices. Inflation is expected to peak at 8.4% (year-on-year) in the third quarter of 2022 in the euro area, before falling steadily to below 3% in the last quarter of 2023 in both the euro area and the EU as commodity price pressures and supply constraints ease.

3. RISKS REMAIN HIGH AND DEPEND ON THE EVOLUTION OF THE WAR

Risks to the economic activity and inflation forecasts depend to a large extent on the evolution of the war and, in particular, its implications for Europe's gas supply. Further increases in gas prices could lead to a further increase in inflation and dampen economic growth. Side effects could in turn amplify inflationary forces and lead to a further tightening of financial conditions, which would not only affect growth but also entail increased risks to financial stability. The possibility that the re-emergence of the pandemic in the EU could lead to further economic disruptions cannot be excluded.

At the same time, recent downward trends in oil and other commodity prices could intensify, leading to a faster decline in inflation than currently expected. In addition, thanks to a strong labour market, private consumption could prove more resilient to rising prices if households draw more on accumulatedsavings.

In this context, Valdis Dombrovskis, Executive Vice President for an Economy Serving the People, said: "Russia's war against Ukraine continues to cast a dark shadow over Europe and our economy. We face challenges on many fronts, from rising energy and food prices to a highly uncertain global outlook. We have a chance to start from a position of strength, having managed to overcome the previous crisis and revive growth strongly. In the second half of the year, economic growth will slow considerably, but will pick up in 2023. With high inflation and tightening financing conditions, it will be important to strike the right balance between moving to a more prudent fiscal stance and protecting the most vulnerable.

Paolo Gentiloni, Commissioner for Economic Affairs, said: "Russia's unprovoked invasion of Ukraine continues to send shockwaves throughout the global economy. Moscow's actions are disrupting energy and grain supplies, driving up prices and weakening confidence. In Europe, the momentum generated by the reopening of our economies is expected to support annual growth in 2022, but for 2023 we have revised our forecast considerably downwards.

Inflation, already extremely high, is now expected to reach a record high this year and then gradually decline in 2023. As the evolution of the war and the reliability of gas supply remain unknown, the forecast is clouded by a high degree of uncertainty and downside risks. To navigate these troubled waters, Europe must take the lead, with three defining watchwords for our policies: solidarity, sustainability and security."

4. THE GLOBAL ECONOMIC CONTEXT

The World Bank has warned that interest rate hikes by central banks around the world could trigger a global recession in 2023.

The international financial institution warned that central banks have been raising interest rates "with a degree of synchronisation not seen in the past five decades" to respond to rising prices, but higher rates make borrowing more expensive, which could slow economic growth. Also, interest rate hikes, which are likely to continue into 2023, may not be enough to bring inflation back to pre-pandemic levels.

The World Bank's warning comes ahead of the US Federal Reserve (Fed) and Bank of England (BoE) monetary policy meetings, which are expected to raise key interest rates. The European Central Bank has decided to raise its benchmark interest rate by 0.75%, the biggest-ever increase in the cost of borrowing by the Frankfurt-based institution, amid the explosion of inflation in the eurozone.

In the press release published at the end of the ECB Governing Council meeting, "The Governing Council decided to increase the ECB's three key interest rates by 75 basis points. As a result, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will increase to 1.25%, 1.50% and 0.75% respectively".

The world economy is experiencing its deepest slowdown since recovering from the 1970s recession, consumer confidence has fallen more than in previous global recessions, and the three largest global economies - the US, China and the euro area - are slowing significantly. "Under these conditions, even a moderate shock to the global economy in 2023 could lead to recession," a study published by the World Bank said.

The institution called on central banks to coordinate their actions and "communicate decisions clearly" to "reduce the degree of monetary policy tightening required".

"Growth in the global economy is slowing significantly, and a continuation of this trend is likely to cause recession in many countries," said World Bank president David Malpass, who expressed concern that these trends will persist, with devastating consequences for emerging market and developing countries.

He said authorities should focus on increasing production, not reducing consumption, and take steps to increase investment and productivity.

If supply chain disruptions and labour market pressures ease, headline headline inflation excluding energy could be around 5% in 2023, almost double the average of the last five years before the pandemic.

To bring inflation down, central banks would have to raise interest rates by a further two percentage points, but such an increase, coupled with the turmoil in financial markets, would slow the advance of the world economy to 0.5% in 2023, or a contraction of 0.4% on a per capita basis, which would meet the technical definition of a global recession, says the World Bank study.

The forecast for global economic growth in 2023 has been revised to 2.7%, compared with a 2.9% growth estimated in July, "with a 25% probability" that the economy could fall below 2%.

"The global economy continues to face major challenges shaped by the lingering effects of three powerful forces: the Russian invasion of Ukraine, the cost-of-living crisis caused by persistent and rising inflationary pressures, and the slowdown in China (...). More than a third of the world economy will contract this year, or next year, while the three largest economies - the United States, the European Union and China - will continue to stagnate," the IMF says in its October report on the global economic outlook.

The financial institution kept unchanged its estimate for global economic growth this year at 3.2%, but warned that "the worst is yet to come" and that "for many people, 2023 will feel like a recession".

5. ECONOMIC CONTEXT AT EUROPEAN UNION LEVEL

The summer 2022 economic forecast provides an update of the spring 2022 economic forecast, which was presented in May 2022, focusing on GDP and inflation developments in all EU Member States.

These forecasts are based on a number of technical assumptions about the evolution of exchange rates, interest rates and commodity prices, based on information available up to 30 June. For all other source data, including public policy assumptions, these forecasts take into account data available up to and including 5 July 2022.

The European Commission publishes each year two sets of detailed forecasts (spring and autumn) and two sets of interim forecasts (winter and summer). The interim forecasts include annual and quarterly GDP and inflation figures for all Member States for the current and the following year, as well as aggregate data for the EU and the euro area.

The European Commission's next forecast will be the autumn 2022 economic forecasts, due to be published in November 2022.

6. ECONOMIC SITUATION IN ROMANIA

Inflation has brought a new wave of price rises. According to data from the National Institute of Statistics (INS), it reached 15.9% in September. Gas, sugar, oil and potatoes top the list of price hikes.

According to analysts, the price ceiling has not been reached, prices will continue to rise in 2023. According to data from the NSI, sugar, oil and potatoes have almost doubled in cost, while other products have risen by 20-30%, which can be seen in your shopping basket. According to experts, the population is feeling inflation even harder, at around 35-40%.

Unfortunately, price increases will continue into 2023, with inflation expected to remain in the double digits. Simply put, we won't get away from high prices so easily, and living standards will continue to deteriorate.

"Basically, we have a big increase in bread. 26% increase in bread. It's never been so high," said economist Adrian Vasilescu.

Romanians are noticing ever higher price increases. Compared to September 2021, the increase in prices for food goods is 19%, for non-food goods 17%, and services have increased by 8%.

Romania will not be able to avoid technical recession in winter. This implies a fall in gross domestic product two quarters in a row. Economic activity will slow down due to rising energy prices. Already many companies have had to shut down production for limited periods. Another decisive factor is inflation, which reduces the purchasing power of Romanians and thus consumption. But Romania has a lifeline, economists say: European money.

High energy prices are already hurting industry. Major electricity and gas consumers have been operating at break-even levels this year. The fertiliser plant in Târgu Mureș, the main producer of fertilisers, has only been operating for a few months this year. "We produced about 150,000 tonnes of fertiliser in May, June and half of July. It's a very small quantity. We also imported fertilizers from the market and used Azomures as our packaging and distribution unit. 225 of our employees have been put on technical unemployment. We gave the opportunity to 150 employees to take jobs in other industries and we paid them the difference in salary", said Harri Kiiski - former general manager of Azomures.

Analysts at a financial institution also active in Romania expect economic activity to slow down towards the end of this year and early next year amid rising energy bills. In addition, they expect an increase in the number of unemployed in industry as a result of the closure of production capacity that will not be able to cope with high gas and electricity prices. Adrian Negrescu, an economic analyst, noted that "industry has slowed down significantly, industrial production is stagnating or even falling in some areas, and prices continue to rise. This is the worst-case scenario for Romania, and the effects are already being felt as more and more companies close and 2023 could bring a significant wave of unemployed".

Inflation is also contributing to the deteriorating economic outlook, outstripping the rate at which Romanians' incomes are growing and eroding their purchasing power and appetite for spending their money. The result is the seizure of one of the main drivers of the economy, consumption. But the country's economy may also be affected by a possible recession in other countries. Through two channels, the trade channel and the investment channel.

On the trade channel, Germany's economy enters a more serious recession, which is very likely, then trade orders to our industry will fall. The same goes for Italy, our main trading partners in the EU. Estimates show that Romania's economy will grow by 6.4% this year. However, this winter, we would inevitably enter a technical recession, after GDP shrinks in the last quarter of 2022 and the first quarter of 2023. What's more, next year Romania's economy is expected to grow by just 1 percent. But a technical recession does not necessarily mean an economic crisis. The latter is defined as a longer period of severe economic decline in which both production and consumption are affected. But economists say Romania has a lifeline: European money. There are tens of billions of euros that could flow into our economy through the implementation of reforms under the NRRP or by attracting funds from various European programmes.

Germany is Romania's main trading partner, and a contraction of the German economy will have a direct impact on our country's economy.

Germany's economy will fall into recession next year, with GDP shrinking by 0.4% compared to a previously forecast 2.5%, while inflation will remain high at 7%, which will curb consumption, according to the latest forecast published by the Berlin government on Wednesday.

Also for this year, growth estimates have been revised down from 2.2% to 1.4%, while the inflation forecast has been revised up from 6.1% to 8%.

German Economy Minister Robert Habeck said, "We are currently experiencing a difficult economic crisis, which is increasingly turning into an economic crisis". But he stressed that while the contraction in 2023 is serious, it is less severe than some experts expected, thanks to measures taken by the Berlin authorities to protect the economy.

7. SITUATION OF ROMANIA'S MAIN TRADING PARTNER

Germany unveiled at the end of September a €200 billion plan to subsidise the price of energy consumed by households and businesses by 2024, which will curb inflation in 2023. Before the announcement of this huge plan, Germany's main economic institutes had expected a new inflation peak of 8.8% next year.

The drop, and then the early September halt, in Russian gas supplies to Germany is affecting Europe's leading economy. Germany, which before the war in Ukraine imported about 55% of its gas needs from Russia, now has to source it from other sources at higher prices. These tensions have caused gas and electricity prices in Europe to explode, boosting inflation and production costs for industry, the engine of the German economy.

According to data from the German statistics institute, industrial production fell by 0.8% in August. Hardest hit were energy-intensive industries such as chemicals, metallurgy, paper and glass production. All these sectors have seen output fall by almost 9% since February.

Germany is Romania's main trading partner and, at the EU level, Germany is the main destination for goods exported by 17 Member States and one of the top three destinations for 22 Member States.

8. INFLATION LEVEL - RELEVANT INDICATOR FOR THE ECONOMIC FORECAST FOR 2023

The continuously rising level of inflation could lead to a recession in Romania in 2023, and the recovery will be more complicated than in the financial crisis of 2008-2009, a similar situation caused by inflation was also encountered in the 1970s during the oil crisis.

The co-founder of the Black Sea Fund, Matei Păun, says: "I see that we are operating in an increasingly cautious economy, I see purchase or investment decisions tending to be postponed, I see substantial inflation pressures. Things are complicated because these pressures have not yet materialised along the whole economic chain, but it is very clear that certain segments are operating under very high pressure. We are in a period of uncertainty, which leads to a tension. Whereas six months ago things were quite clear and predictable, and this created a solid foundation for investment, now that feeling is not so much there. It's not a case of panic, but it's clear that people have slowed down their decision-making, they've started to look more carefully. It is clear that the conditions for sustained growth are no longer in place, but we cannot yet speak of a clear decline."

According to this expert, it is likely that in a year's time we will be talking clearly about recession, and this time it could be a recession complicated by inflation.

Usually when you enter a recession you have some monetary levers you can activate, but in an inflationary context these levers are no longer available. Normally in a recession central banks seek to cheapen money so that it circulates faster. But hit by inflation, central banks will have to do the opposite. That is to say, to slow the velocity of circulation so that money becomes more expensive, which could accelerate the recession. So we are heading for a rather complicated situation where we will have two phenomena - recession and inflation - colliding head on. The fight against inflation being seen as paramount by central banks is bad news for economic growth forecasts. Low inflation is not necessarily a bad thing, but above a certain level it becomes a disease that needs to be treated.

This is the first crisis in decades that we cannot print our way out of. What is happening now last happened in the 1970s as a result of the "oil shock". It is the first crisis in decades that we cannot print our way out of. If you look at the economic crisis triggered by Covid-19, we got through it by generating huge amounts of cash, if you look at the 2008 crisis, we got through those years still printing huge amounts of cash. We always had this valve that governments and central banks used. This time we cannot do the same because we would add fuel to the fire, we would stir up more inflation, which can lead to hyperinflation, uncontrolled inflation. That is why there is a good chance that the major Western economies will soon be in recession.

In 2008, the biggest effects were unemployment and lack of economic activity. People lost their jobs, and the government imposed austerity measures that exacerbated job losses. Now, I think the biggest impact will be that money will lose its value. Prices will rise without wages rising as much. If you have a budget of 100 lei today, you buy a basket of food, and in three to six months you will buy less. Which means a veiled impoverishment of the population. Inflation has already been going on for several months, the population is certainly already feeling it. And, unfortunately, this may get worse before it gets better and comes with an economic crisis where people suffer not only from the devaluation of their money, but also find themselves thrown out of work. It is a far more dangerous and far more painful crisis for which I see no very clear, tangible way out.

Also, many things will depend on factors beyond our control. The more the situation in Ukraine worsens, the more we will feel economic consequences, inflation will increase. There are several issues for which I do not see a quick outcome and there may be quite adverse economic consequences for the West.

Things do not seem to be calming down any time soon in Ukraine, and the worse the situation gets, the worse the economic consequences might get. The more the energy supply from Russia stagnates, the greater the economic impact. Now we have some sanctions that have created quite a big economic impact both on the Russians and in the West, but if these events continue the economic consequences will increase. But beyond that we are left with the fundamental problem of inflation that can lead to crisis. By fighting inflation we are bound to create a recession.

There was a similar crisis in the 1970s and it lasted almost a decade. It was a crisis that generated very high inflation because of the embargo imposed on the West by the oil-producing countries.

This crisis was not solved in a year or two, but only in the early 1980s by Paul Volcker, the chairman of the Federal Reserve (the US central bank). He got rid of inflation in the US only with a period of very, very high interest rates. At that time interest rates were between 10-20%. It is very likely that the US economy will be in recession in six to eight months and I find it hard to believe that Romania will be spared.

In terms of openness to investment, there is still money, it's just that people's reluctance to use it has increased quite a lot, adding that this reluctance depends quite a lot on the geographical area, but both inflation and the situation in Ukraine have an impact here. Maybe in the US inflation is more important than the war, but for us the war is also quite important. In Central and Eastern Europe the situation could be more slippery because it is an area that is heavily exposed in terms of energy to Russia.

What has changed in the first months of this year compared to 2021 is related to the extent of inflation talk, the fact that entrepreneurs feel they have to raise prices. There is a sense of procrastination, of waiting to see how things develop before building a new hall, increasing production capacity or hiring five more people. And if more and more people are more cautious, that influences an economic downturn which validates the caution and you get into a vicious circle. For us as a fund it's not necessarily a problem. On the one hand it complicates our business plan and our job, but it creates interesting opportunities for us. Because we have the ability to think long term and if you understand what and why something is happening, what impact something has in a certain context, such a situation can become an opportunity.

Conclusions

Analysts warn that 2023 will be an even tougher year, as there will be an unprecedented economic crisis and food will become more expensive.

Experts are talking about a 50% increase in food prices compared to the same period last year, but the increase will be even higher in 2023.

As a result, although sugar, oil and potatoes have doubled in price, the increases will continue into the future. Most products have already risen by 30%, according to statistics from the last few months.

According to experts, although the inflation rate has reached 15.9%, people are feeling inflation at 35-40%.

The main victims of inflation are families with young children, pensioners and those on the minimum wage - more than 50% of the population. Financial experts predict that next year there will be an economic crisis, most likely a very big one, which will affect Romanians even more.

Some services and food will certainly increase due to the adoption of the new tax code, separate from the increases caused by the crisis or inflation. So from 1 January 2023, VAT will rise from 5% to 9% for every meal in a restaurant, as well as for catering and accommodation services.

The same goes for VAT on soft drinks, non-alcoholic beer or cider, where the increase will be from 9% to 19%. As a result, Romanians on average or low incomes are in for a very tough year, if they manage to get through this winter's price hikes in all areas, including energy.

The way out of the recession requires proactive measures that require sustained efforts from the Romanian Government and the economic environment, namely: identifying solutions to reduce the budget deficit, keeping the trade deficit under control, in particular by controlling and reducing budget expenditure.

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