Fitch Solutions Europe Key Themes For 2022: Mid-Year Review

17 Jun 2022 | Europe (Region) | Economic Activity

At the end of 2021, we highlighted six key themes that we thought would emerge throughout 2022 across Europe. Among these were ongoing tensions between the European Union (EU) and Russia keeping political risks in the region elevated, while energy inequality was also set to become more acute. With the Russian invasion of Ukraine having impacted security and economic prospects across the region, we assess how our prior key themes have so far played out below.

HIT OR MISS? KEY EUROPE THEMES FOR 2022

VIEW	PLAYING OUT?	EXPLANATION
EU-Russia Tensions Will Remain A Key Driver Of Political Risk	Yes	Russia's invasion of Ukraine has been followed by a series of sanctions from the EU, with little sign of a resolution of the conflict this year
Green Transition Could Lead To Further Energy Inequality	Partially	Energy price inflation amid the war in Ukraine has led to a cost of living crisis that poses risks of public unrest
Above-Trend Growth In Eurozone, But Increased Headwinds In Emerging Europe	Partially	The Russia-Ukraine conflict has exacerbated headwinds to economic activity across both developed and emerging Europe
Inflation To Peak In H122, But Risks Tilted To The Upside	No	Energy prices increased markedly following Russia's invasion of Ukraine, with inflation looking set to peak in H222
Monetary Policy In Europe To Diverge	Partially	Eastern European central banks have tightened as anticipated. However, the European Central Bank has pivoted to a more hawkish stance than previously expected
Fiscal Policy Tightening Could Be Gradual Relative To Previous Economic Crises	Yes	Governments have implemented a range of fiscal support measures to shield households and firms from rising energy prices
Source: Fitch Solutions		

Theme: EU-Russia Tensions Will Remain A Key Driver Of Political Risk

Description: *Persistent tensions between the EU and Eastern Europe will weigh on policymaking on various fronts, particularly energy.*

Key Developments: This theme has played out beyond the expectations we held at the end of 2021, and has ruined prospects for improved ties between the EU and Russia over the coming years. The political and macroeconomic knock-on effects of Russia's invasion of Ukraine for Europe as a whole are multiple and diverse. The EU has shown a relatively unified response to Russia's actions, concentrated in a series of sanctions rounds. However, Hungary's persistent opposition to harsher measures has undermined the bloc's position and will remain a source of discord in Brussels. Managing rising energy costs and sourcing new energy suppliers will pose significant challenges to policymakers across Europe.

Russia Could Push Westward To Connect Donbas With Transnistria

Black Sea Region- Geopolitical Flash Points

Note: Contested territories and Russian invasion of Ukraine shaded in red stripes. Source: SIPRI, Fitch Solutions

In our view, the war in Ukraine will be protracted. We do not think a clear victor will emerge in 2022 and possibly not even 2023. In the meantime, European governments will continue supplying aid to Ukraine and imposing sanctions on Russia. We see a relatively limited risk that the conflict will spill-over into the Baltic states because this would bring Russia into direct confrontation with NATO, risking nuclear war. We see a greater risk of tensions erupting in areas of Central Asia and CIS where the Russian state has sponsored secessionist or breakaway regions, such as Nagorno-Karabakh or South Ossetia.

Theme: Green Transition Could Lead To Further Energy Inequality

Description: *Renewed emphasis on climate initiatives could make the energy crisis more acute and cause a backlash against the associated rise in living costs, particularly among lower income groups across Europe.*

Key Developments: Energy prices in Europe and globally have surged in the wake of Russia's invasion of Ukraine, with Brent crude trading at a year-to-date average of USD103.8/bbl (2021 average: USD71/USD) and UK NBP natural gas at GBP1.89/therm (2021 average: GBP1.17/Therm). Food prices have also faced considerable upward pressure, with eurozone food price inflation increasing to a record-high of 7.4% y-o-y in April. So far in 2022, we have seen instances of cost of living related protests in Spain, the UK, Albania, Bosnia and Kazakhstan and we believe that further unrest is likely in H222. In our view, rising stagflation risks could foment further social unrest across the continent in the months ahead. Energy transition measures have so far in 2022 been superseded by policies aimed at shielding households and firms from rising energy prices. Moreover, many countries in Europe have pledged to wind-down or end energy imports from Russia by end-2022, meaning that supply disruptions could arise in Q422 when demand is highest. We expect that governments will prioritise energy security and mitigating the cost of living crisis rather than the green agenda.

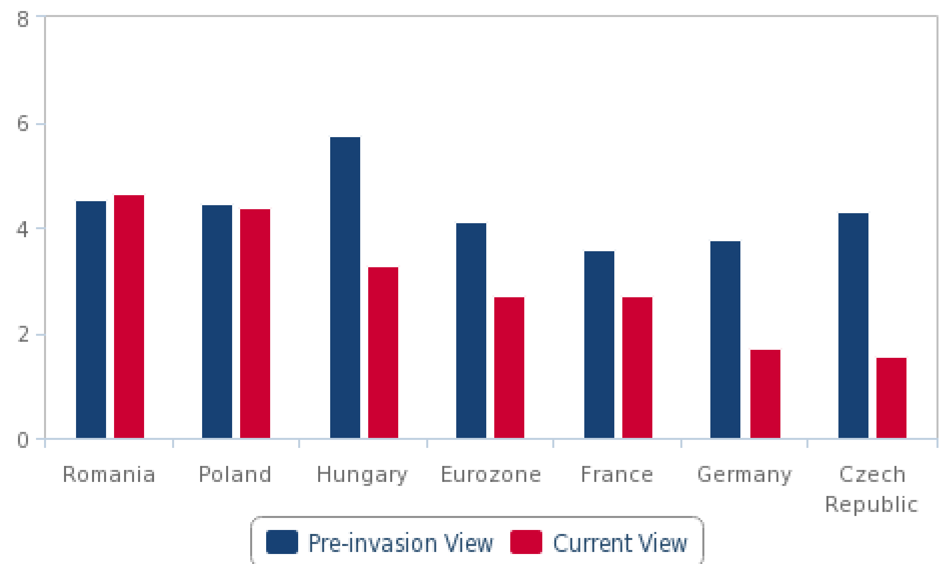
Theme: Above-Trend Growth In Eurozone, But Increased Headwinds In Emerging Europe

Description: *We expected broad based growth recovery in 2022 and above trend growth the Eurozone given positive dynamics in the manufacturing sector and pent-up demand for services.*

Key Developments: This view was formed before the invasion of Ukraine by Russia in late-February and as such the economic realities for Europe have been altered considerably. Since then we at Fitch Solutions have made a number of downward revisions to our growth forecasts for both the eurozone and major Central and Eastern European (CEE) countries. The Russia-Ukraine war has intensified a cost of living crisis that was already brewing in 2021 given continued supply chain disruptions caused by the Covid-19 pandemic. Energy security concerns have also increased as Russia itself has been sanctioned from the financial market and has used its role as a major energy supplier to reiterate its aggressive position against the rest of Europe.

Eastern European Markets Set To Grow Slightly Faster Than The Eurozone

Selected Economies - Real GDP Growth, % chg y-o-y



Source: Fitch Solutions

Our expectation that credit conditions would remain more supportive for longer in the eurozone relative to CEE has also been challenged, as inflation in the eurozone has risen to consecutive all-time highs over H122 that have forced the European Central Bank's (ECB) to adopt a more hawkish stance. Moreover, recent downward revisions to our growth forecasts for the US and China in June have led us to lower our 2022 growth forecast for Germany from 2.0% to 1.7%, with weak German activity set to weigh on the eurozone and wider region. As such, we do not expect this theme to play-out this year and remain cautious of a material recovery in 2023, given that our core view is for the war in Ukraine to remain a long-drawn out affair that will make the damages in ties between Europe and Russia, more permanent.

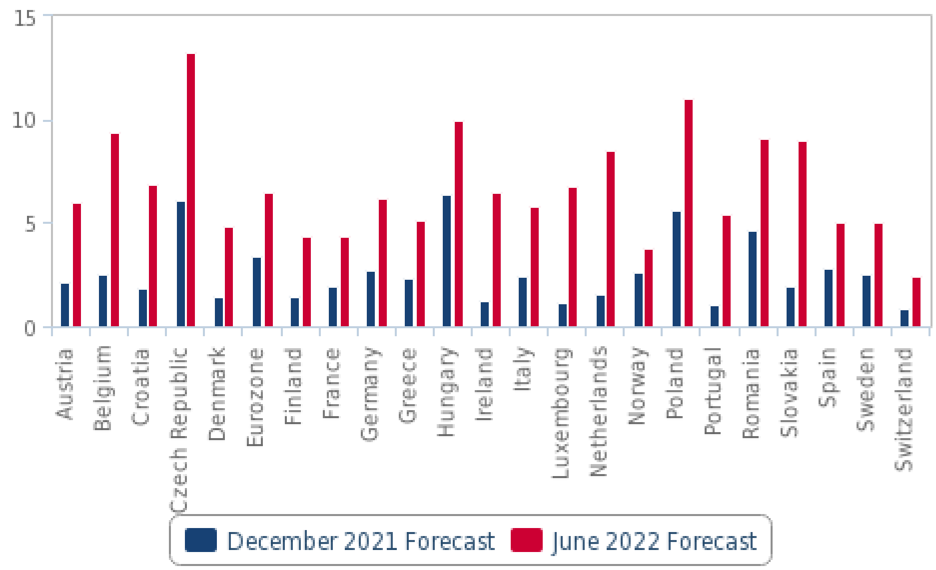
Theme: Inflation To Peak In H122, But Risks Tilted To The Upside

Description: *Price pressures will ease in H222 as base effects reverse and some of the supply chain issues that goods trade is currently facing ease.*

Key Developments: Price growth in H122 has risen beyond our prior expectations, and we now expect inflation to peak in H222. Inflationary pressures ratcheted up throughout Europe as Russia's invasion of Ukraine exacerbated supply side shortages, pushing up food, energy, and raw material prices throughout H122. Further consumer and producer price pressures stem from the continuation of China's Zero-Covid strategy preventing the resumption of supply for many final products and components. We anticipate a gradual moderation of inflation towards to the end of the year as significant base effects begin to take effect, most notably as gas does not repeat its 357.7% 2021 price increase (UK NBP figure). A slowing of economic activity across the continent (owing to lower consumer confidence, rising prices, and tighter credit conditions) will also moderate demand-side price pressures. We do note however that still rising producer price inflation indicates some upside is yet to filter through to consumer prices. Meanwhile, moderate second round effects are becoming evident, with services price growth (a salary proxy) having picked up in recent months. Our average inflation forecasts across the continent have all increased significantly since December (see chart below), and we now expect double digit average inflation in several Eastern European economies, which tend to run much hotter than their Western European counterparts.

Inflation Forecasts Have Been Raised Across Europe

Average 2022 Consumer Price Inflation Forecasts



Source: Fitch Solutions

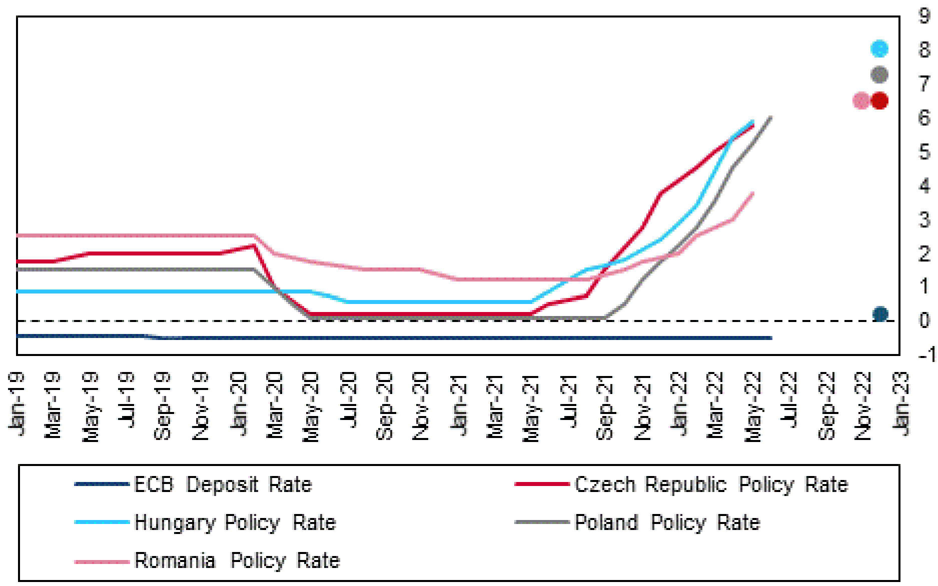
Theme: Monetary Policy In Europe To Diverge

Description: *Monetary policy between the eurozone and CEE countries will remain divergent given that inflation in the latter region will be sticky on the upside.*

Key Developments: This key theme has partially played out, but not for the reasons we flagged at the end of last year. Back then, we highlighted that stronger demand-side inflation in CEE than the in the eurozone would fuel further tightening in CEE, while the ECB would remain on hold. Though CEE did indeed continue to hike, the region's central banks did so because of supply-side inflationary pressures caused by the Russian invasion of Ukraine. These supply-side pressures will now also prompt the ECB to hike by at least 75 basis points (bps) this year, contrary to the rate stability view we held at the beginning of the year.

Inflation Has Pressured Central Banks To Become More Hawkish

Central Bank Interest Rates & End Of 2022 Forecasts, %

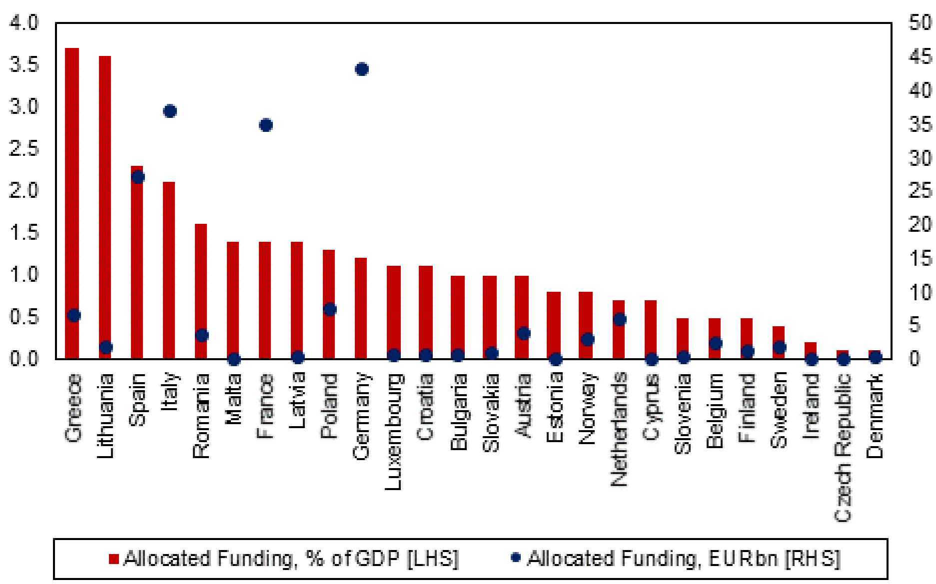


Note: Forecasts are Fitch Solutions forecasts. Source: Bloomberg, Fitch Solutions

Our view that monetary policy in Russia and Ukraine would see a year of two halves, with hikes in H122 and cuts in H222, also partly played out, but again not for the reasons we anticipated. In Russia, the central bank first aggressively hiked (from 8.50% to 20.00% in an emergency meeting in February) to ease financial market volatility following the invasion Ukraine, but then swiftly cut rates over April-June to 9.50% in order to support the sanctioned Russian economy. By year-end, we expect the Central Bank of Russia's key rate to stand at 6.50%, lower than the 8.50% we forecasted at the beginning of 2022. Meanwhile in Ukraine, the national bank's 1500bps hike to 25.00% in June renders our previous forecast for the policy rate to end the year at 10.00% impossible, as we now project rates to remain on hold throughout the rest of the year.

Support Measures Amid Energy Price Surge Will Weigh On Fiscal Balances

Government Expenditure Aimed At Shielding Consumers And Firms From Energy Price Increases (Sep 2021 - Jun 2022)



Source: Bruegel, Fitch Solutions

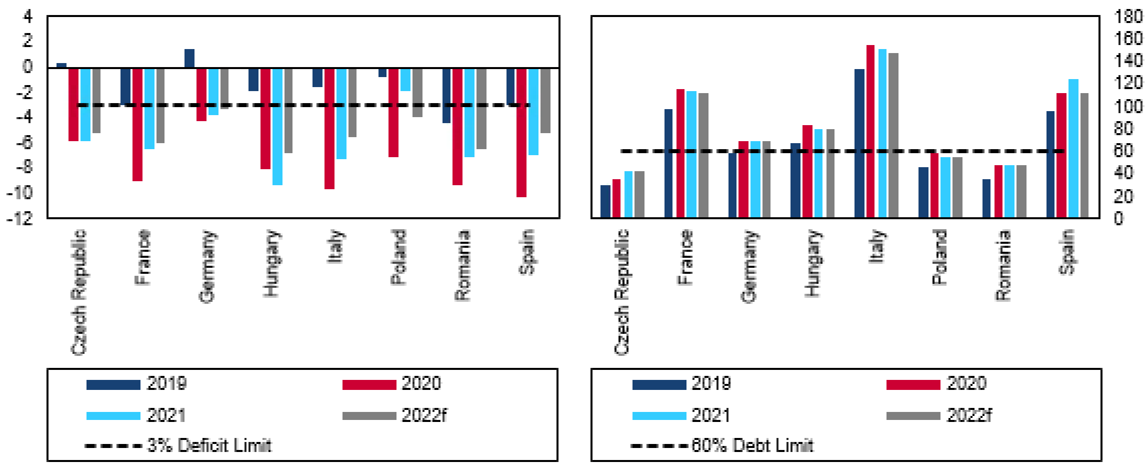
Theme: Fiscal Policy Tightening Could Be Gradual Relative To Previous Economic Crises

Description: *Government spending will be tightened, but severe austerity measures will not be put in place as the EU will allow debt levels to remain elevated for longer.*

Key Developments: We had previously anticipated that fiscal consolidation following the pandemic would be limited in 2022, and this key theme appears to be playing out. Our view was based on expectations for revenue gains from improved economic activity to be partly offset by pandemic-related support expenditures winding down only gradually, as policymakers would seek to preserve recovered growth momentum and avoid politically unpopular austerity measures. Since then, the macroeconomic impact of the war in Ukraine has further dampened prospects for fiscal consolidation over 2022. Several governments across the region had already begun implementing support measures such as energy price caps and transfers to vulnerable and low-income groups in late 2021. With policymakers having ramped up their support expenditures by varying amounts since Russia's invasion exacerbated inflation (see chart above), we see scope for further support expenditure to be put in place as energy prices are set to remain high for the remainder of the year.

Fiscal Consolidation Will Be Only Gradual In 2022

Selected Economies - LHC: Budget Deficits, % Of GDP; RHC: Public Debt, % Of GDP



f = Fitch Solutions forecast. Source: National sources, Fitch Solutions

Meanwhile, the outlook for fiscal revenues is mixed, but overall muted. Elevated inflation will prop up growth of revenues in nominal terms, informing our expectations for budget deficits and public debt to generally moderate as percentages of GDP compared to 2021. However, less favourable economic conditions will see revenue collection (particularly through indirect taxes) to slow overall in 2022. The EU's fiscal rules – with the Stability and Growth Pact requiring fiscal deficits below 3.0% of GDP and public debt below 60.0% - remain suspended for the third consecutive year, and the European Commission have proposed a further suspension for 2023 following the impact of the war. We therefore expect governments to maintain a more accommodative stance over the coming quarters compared to after the global financial crisis.