1. Global assumptions: US driving recovery amid geopolitical risks

BY RICHARD GRIEVESON

- **The global economy is strengthening, with a nascent recovery in global manufacturing particularly encouraging. The US remains strong, and there have been better data out of China in recent months.**
- **The euro area economy is also starting to show some signs of recovery. Inflation is falling more quickly than we previously expected, boosting real incomes, with private consumption set to be the main driver of growth this year.**
- **Nevertheless, the euro area manufacturing sector is continuing to suffer from the competitiveness shock of higher energy prices. Tight financial conditions are also weighing on the recovery, with real interest rates now rising sharply as inflation falls. We expect the European Central Bank (ECB) to start loosening policy this year, but the positive impact of this on the economy is likely to be felt only in 2025-2026.**
- **The war in Ukraine will not end soon, but the impact on the euro area and global economy will be limited from here.**
- **The biggest risk to the recovery at present comes from geopolitics, specifically in the US, where the outcome of the next presidential election will be crucial, and in the Middle East, where heightened tensions involving a number of regional players risk causing a significant and prolonged rise in energy prices. If that happens, it will push global inflation back up, weighing on consumption, and will also delay monetary loosening by the major central banks.**
- **We view Donald Trump's possible return as US president as a significant risk in terms of both likelihood and impact. If he wins the election, we expect a negative impact on global trade, increased uncertainty about the US security commitment to Europe (which would be especially damaging for investor sentiment in the Baltic states), higher defence spending in Europe and a greater chance of instability in those areas of CESEE where NATO soldiers are currently stationed.**

1.1. GLOBAL OUTLOOK: GLOBAL ECONOMY STRENGTHENING

After two years in which inflation – which reached levels not seen for decades –hammered the global and especially the European economy, early 2024 offers some signs of improvement. The JP Morgan/S&P Global Composite Purchasing Managers' Index (PMI) rose to a nine-month high of 52.3 in March (anything above 50 indicates expansion), marking the fifth consecutive month of growth. Services output remained robust in March, while manufacturing – which has underperformed over most of the last two years – showed encouraging signs of catching up, with output expanding at its fastest rate for 21 months.

The March data also showed encouraging signs that global growth is becoming more balanced, and less reliant on the US. In March, the US (and the UK) continued to expand at a healthy rate; but the survey also noted improvements in Japan, the euro area (especially Spain and Italy), China, India and Russia.

The performance of the US economy in the face of the inflation shock and the sharp interest rate hikes of the past two years has been the latest version of American exceptionalism. While China and the euro area – the other two key pillars of the global economy – have struggled, the US has ploughed on regardless. Such is the strength of the US economy, with inflation recently surprising on the upside, that the Federal Reserve is only likely to make limited rate cuts this year. At the time of writing, market pricing indicated an expectation of only 50 basis points of cuts in 2024, meaning that the Fed is likely to cut less than the ECB. We do not expect this to have a material impact on the exchange rate, but there are downside risks to our forecast of USD 1.08/EUR during the period under consideration.

China, by contrast, faces a multitude of challenges and will not drive global growth as it did pre-COVID; yet there, too, the economic outlook is also improving gradually. Both services and manufacturing posted healthy growth in March, according to PMI surveys. China already saw export growth in January and February, benefiting from the upturn in the global economy.

A strong dollar will be a net negative for other major emerging markets in 2024. The scaling-back of expectations about Fed loosening has seen the dollar strengthen markedly against most emerging market currencies. This will increase imported inflation and may delay (or even reverse) monetary loosening by central banks, as they try to defend their currencies against the dollar. This is likely to weigh somewhat on the global recovery this year.

1.2. EURO AREA OUTLOOK: INFLATION DECLINE DRIVING CONSUMER REVIVAL, BUT INDUSTRY STILL STRUGGLING

The euro area economy is gradually returning to life, after a very difficult two years. The March Composite PMI for the single-currency area moved back above 50 for the first time since May 2023. Most encouragingly, the sub-component for business activity expectations reached its highest level since February 2022, the month in which Russia launched its full-scale invasion of Ukraine.

The March PMI showed services growing robustly in the euro area, with the fall in inflation having a positive impact on consumer purchasing power. Companies reported sales increasing in March for the first time in nine months. Services are being boosted by the sharp decline in inflation, which – in combination with nominal wage rises – is significantly expanding households' real spending power. Euro area inflation slowed to 2.4% year on year in March, compared with 6.9% in the same month a year earlier, its joint-lowest rate since July 2021.

By contrast, manufacturing remains very weak, and the March manufacturing PMI remained in negative territory, caused above all by problems in Germany. German industrial production – which has been struggling for some time – rose in monthly terms in both January and February. However, in February output was still 4.9% lower than a year earlier. Higher energy costs for industry and the consequent impact on international competitiveness, plus the weakness of Chinese demand (albeit with some recent signs of improvement), are still holding German industry back.

Despite the green shoots, we have made a small downward revision to our euro area growth forecast in 2024, caused by the weaker-than-expected end to last year. We continue to see the recovery gradually firming, led above all by domestic demand as falling inflation boosts real incomes. We also continue to expect the ECB to start cutting interest rates this year, although the positive impact of that on the economy will only be felt later in the forecast period. In 2025-2026 we expect a firmer recovery, with the euro area economy growing by 1.6% in both those years.

Table 1.1 / wiiw spring 2024 global assumptions

	Winter 2024			Change since autumn		
	2024	2025	2026	2024	2025	2026
Euro area real GDP growth, %	0.6	1.6	1.6	-0.2	0.0	0.0
Euro area HICP, %	2.5	2.2	2.0	-0.5	0.0	0.0
Euro area unemployment rate, %	6.7	6.6	6.6	0.1	0.1	0.2
Euro area current account, % of GDP	3.2	3.2	3.1	1.7	1.5	1.4
USD/EUR exchange rate, average	1.08	1.08	1.08	0.0	0.0	0.0
ECB refinancing rate, %, eop	3.50	2.50	2.00	0.0	0.0	0.0
Brent crude oil, USD per barrel, average	80.0	77.0	74.0	0.0	0.0	0.0

Source: wiiw forecasts. Cut-off date: 10 April 2024.

1.3. ASSUMPTIONS ABOUT THE WAR IN UKRAINE

Our assumptions about the future course of the war in Ukraine are broadly unchanged from our January update:

› The war in Ukraine is likely to last at least into 2025.

› There will be no major (i.e. nuclear) escalation.

› The further impact of the war on most European economies will be quite limited.

› US and EU military and financial support to Ukraine will continue, but with delays in disbursement and with a lot of political noise and uncertainty. Ukraine will get enough to fend off Russia, but not enough to go more decisively on the offensive. The US in particular will remain wary of ‘provoking’ Russia by delivering more long-range weapons.

› As long as the war continues, reconstruction cannot start properly, which will hold up Ukraine’s economic recovery.

› The European Parliament elections may well see a rise in support for far-right parties, but this will have no fundamental impact on EU support for Ukraine. The five biggest EU member states all have governments that have expressed unambiguous support for Ukraine. In terms of both the functioning of the Council and EU support for Ukraine, the 2023 election result in Poland is good news.

› If Trump does win, the outlook is much more uncertain, although even in this scenario we do not regard it as inevitable that the US will stop supporting Ukraine.

1.4. RISKS TO THE OUTLOOK

While the global and euro area outlook is improving, we see three key downside risks that could knock it off course.

First, while it is very difficult to predict what a victory for Donald Trump would mean in the upcoming presidential election,[1] we believe that the net impact on the global economy would be negative, for the following reasons:

- Trump would likely follow through on at least some of his pledges to impose tariffs on imports from Europe and China, which would hurt growth there and have a knock-on effect for CESEE countries. It is highly likely that Trump would take further steps to reduce the economic integration between the US and China in particular, including by erecting trade barriers and imposing restrictions on flows of investment into China.
- A victory for Trump would cast doubt on the US commitment to NATO, forcing European governments to spend more on defence – and therefore less on other things, thus accelerating the end of the peace dividend.
- An uncertain US commitment to NATO could cause serious problems in parts of CESEE, by emboldening revisionist actors in the Western Balkans or damaging investor confidence in other countries that Russia has previously threatened, especially the Baltic states.
- The US role in the world would be more unpredictable, leading to a security vacuum in global hotspots and increased regional competition and arms races. This could be the case particularly in the Middle East, where the Israel-Hamas war risks spreading into a broader regional conflict involving a number of players. There is a partial vacuum, which others are seeking – and will continue to seek – to fill, increasing the risks of instability. There is a very real chance that, under a second Trump presidency, the coming years will see a series of rolling geopolitical crises, much more frequent than in the past, with repercussions for the global economy and CESEE.

Second, even without a Trump victory, geopolitical and geo-economic tensions, especially between the US and China, pose a downside risk to global economic growth. Treasury Secretary Janet Yellen visited China in April to discuss US concerns about Chinese oversupply. The US is especially worried about China's practice of subsidising its green-tech industry, which is increasing the supply of solar panels, electric vehicles and batteries, and is concerned about the impact this will have on US producers, US workers and ultimately US politics. The Chinese March manufacturing PMI showed that the contraction in output prices deepened, indicating deflationary pressures that will have a knock-on effect globally. Under the current administration, the US has continued to attempt to restrict Chinese access to US inputs, which has been part of the weaker momentum in China (and thereby in the global economy). The general direction of US policy towards China seems set, irrespective of who wins in November.

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[1] The former president is currently favourite to win; but there are huge uncertainties, including the array of legal cases against Trump (meaning that he may not be able to stand for office at all); the age of both the main candidates (which makes it unusually likely that one or both will not be around to take office); and the impact of third-party candidates.

Third, inflation could start to rise again; if it does, it will weigh on the current revival in consumer spending and cause interest rates to stay higher for longer. Global commodity prices, including of energy, have risen sharply in recent months. In part, this reflects classic demand/supply fundamentals: the high global demand for oil as the economy recovers and the way OPEC+ is keeping a lid on production are both factors that push up prices. However, the oil price is also rising due to worries about the Middle East. At the time of writing, Israel's attack on the Iranian embassy in Damascus has been followed by Iran firing hundreds of missiles at Israel, most of which were intercepted and so caused no casualties. While the US and key regional players such as Saudi Arabia, Turkey, Iraq and Jordan appear to be very involved in keeping the lines of communication open with all players, given the range of actors involved and the heightened emotions on all sides, the risk of events spiralling out of control and leading to a regional war is non-negligible.