1. Global overview: German and Chinese weakness weighing on CESEE outlook

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- **The war in Ukraine is likely going to last for much or all of our forecast period. However, the direct economic fallout from the war for most of CESEE will be limited.**
- **The outlook for Germany in particular and for the euro area economy has deteriorated, and next year's recovery will be weaker than we had previously expected.**
- **Inflation has peaked in the euro area and will trend downward. The ECB has finished its tightening cycle and will start to cut next year. Some CESEE central banks will cut faster than the ECB, and that will exert downward pressure on regional currencies.**
- **The global economy is mixed, with China struggling, while the US remains impressively resilient to monetary tightening and external headwinds. For CESEE, the combined negative impact of weakness in the euro area and China is a major headwind for growth.**

1.1. ASSUMPTIONS ABOUT THE WAR

Predicting when and how the war in Ukraine will end is impossible. At times, it has seemed as though Russia was about to take the whole of Ukraine; at others, as though Ukraine was about to fully liberate all of its territory. At the time of writing, the Ukrainian summer offensive has gained some ground, but it is hardly decisive.[1] The Ukrainian army is coming up against manpower and equipment constraints.[2] Meanwhile, Russia's army has built itself defensive positions and the country's president, Vladimir Putin, appears to believe that time is on his side and that Russia is better placed to handle a war of attrition. Russia's military industry also seems to have been effective at circumventing sanctions.[3]

The Ukrainians will not give up, even as Russia continues to indiscriminately target civilians. But without more soldiers, equipment and weapons, it will be very hard to win. The US remains the key player, and at least as long as the Biden administration is in office, US support will remain steadfast. However, even the US has not been able to supply Ukraine with everything it needs, and at the speed that it needs it. Our assumption is therefore that the war will last into next year at least; neither side is capable of landing a decisive knock-out blow, but neither is close to giving up either.

A more extensive assessment of the future course of the war is provided in section 2. We see only a 20% chance of a decisive breakthrough by either side. Much more likely are either a stalemate or a more modest advance by Ukraine in the south: to both of those possibilities we assign a 40% probability. The implications of this for the economies of the two countries is important; but for the rest of the region,

1 https://www.reuters.com/world/europe/ukraine-retakes-more-territory-east-south-counteroffensive-2023-09-18/
2 https://www.bbc.com/news/world-europe-66542065
3 https://www.nytimes.com/2023/09/13/us/politics/russia-sanctions-missile-production.html

the future economic impact of the war is likely to be limited. The initial shock of the war, including its impact on energy prices, has been digested by the region's economies. However, the region is now undergoing a major energy transition (see *section 3*) and Europe as a whole faces an end to the peace dividend, which will matter economically.[4]

1.2. ECONOMIC OUTLOOK FOR THE EURO AREA

Table 1.1 / wiiw autumn 2023 global assumptions

	Autumn 2023			Changes since summer		
	2023	2024	2025	2023	2024	2025
Euro area real GDP growth, %	0.5	1.2	1.6	0.0	-0.6	-0.1
Euro area consumer price inflation, %	5.7	3.2	2.5	0.0	0.2	0.2
Euro area unemployment rate, %	6.6	6.6	6.6	0.0	0.0	0.0
Euro area current account, % of GDP	1.0	1.5	2.5	0.0	0.0	0.0
USD/EUR exchange rate, average	1.08	1.08	1.08	0.0	0.0	0.0
ECB refinancing rate, %, end of period	4.50	3.50	2.00	0.5	0.5	0.0
USD per barrel Brent oil, USD, average	82.0	77.0	73.0	2.0	2.0	2.0

Source: forecasts by wiiw. Cut-off date: 21 September 2023.

Our forecasts rest on the following main assumptions:

› There will be no quick end to the war in Ukraine, but also no major escalation, such as the use of tactical nuclear weapons.

› The humanitarian tragedy of the war will continue, but the fallout for the rest of Europe's economies will be limited.

› The European Central Bank (ECB) has finished tightening and the Fed is close to the end. Both will start to cut again next year.

› The US economy will continue to demonstrate impressive resilience, whereas the Chinese economy will continue to struggle.

We expect the euro area economy to expand by 0.5% this year, unchanged from our previous forecast. However, we have revised downward our projection for 2024 by 0.6 percentage points, to 1.2%; and for 2025 by 0.1 percentage points, to 1.6%. The downgrades reflect the weakness of recent data, indicating that Germany in particular is continuing to struggle, and that the recovery will not be as rapid as we had previously thought. Germany's travails reflect partly structural issues that will not disappear soon. The euro area economy grew by 0.1% quarter on quarter in both Q1 and Q2 2023, after a 0.1% decline in the final three months of 2022; this indicates that the bloc's economy is more or less flatlining. Most worryingly for CESEE, the German economy again failed to grow in Q2, while other key economies – such as those of Italy (-0.4%) and Austria (-0.7%) – contracted.

While the easing of supply bottlenecks and falling energy prices were tailwinds for growth in the first half of the year, this was offset by higher interest rates and the weakness of the global economy, which hit exporters hard. Purchasing managers' indices (PMIs) show that the euro area manufacturing sector in

[4] https://www.ft.com/content/93207193-c40d-495c-8b73-0a96a05768e7

particular is struggling badly, with particular relevance for Germany and large parts of CESEE. Moreover, although the euro is not especially strong by historical standards, it has rallied quite significantly since its lows against the dollar a year ago; that has made goods prices in euros more expensive, and thereby dented demand (Figure 1.1). As inflation moderates and monetary easing begins, economic activity should pick up by 2024.

Figure 1.1 / EUR per USD

Source: Investing.com

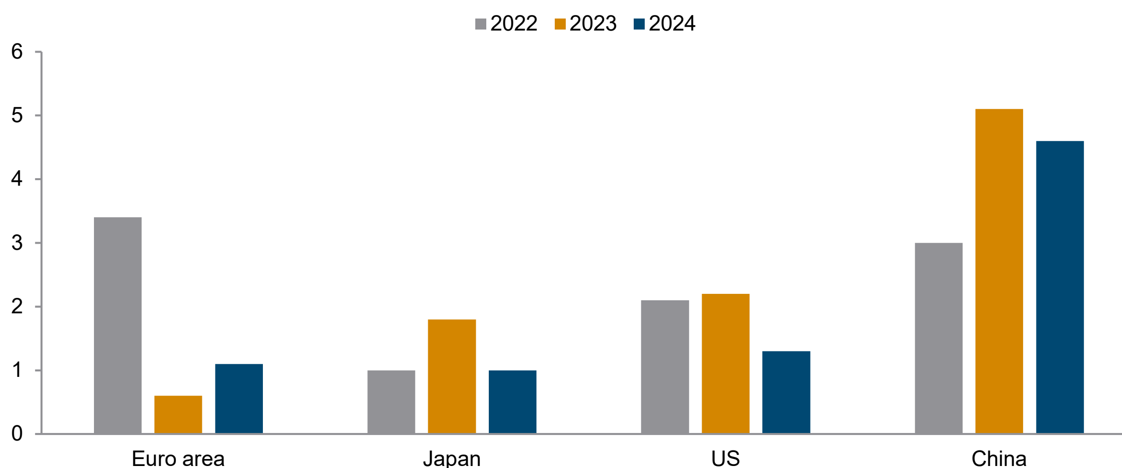
Inflation also seems to have peaked in the euro area, and should continue to trend down. Consumer prices in the euro area rose by 5.2% year on year in August, 0.1 percentage points lower than in July, and down from 9.1% in the same month last year. This is linked to the easing of supply bottlenecks and the pass-through from previous monetary tightening, while the much-feared wage-price spiral has so far failed to materialise. Oil prices have risen markedly recently, but gas storage levels in the EU are high, which bodes well for the winter. We have made small upward revisions to our oil price forecasts for 2023-2025, and now see consumer prices rising by 3.2% next year and by 2.5% in 2025, both 0.2 percentage points higher than our previous forecast. Inflation will therefore take some time to get back to the ECB's target of just below 2% (probably not until the second half of 2025), but will be well below the levels of the last 18 months. We are sticking with our view that the euro will hover at around USD 1.08 throughout the forecast period. The ECB has now finished its tightening cycle, but the Fed will likely also stop soon.

1.3. CONDITIONS IN THE GLOBAL ECONOMY

The story for the global economy as a whole is very mixed. In its most recent projections (released on 19 September), the Organisation for Economic Co-operation and Development (OECD) revised its global GDP forecast up by 0.3 percentage points to 3% for this year, while revising the figure for 2024 down by 0.2 percentage points to 2.7%. It noted that tighter monetary policy, weaker consumer and business confidence, and the fading impact of China's reopening were all weighing on the global economy. Of the main pillars of the global economy, the OECD expects only the euro area to do better in 2024 than this year; but this primarily reflects almost no projected growth in the single currency area for this year.

Otherwise, it expects a slowdown in the US, Japan and China in 2024 (Figure 1.2). The OECD noted that high-frequency indicators from the world's biggest economies generally point to a loss of momentum in the second half of the year, especially in the output and new order components of manufacturing PMIs, while service-sector indicators – although stronger –have also weakened recently.

Figure 1.2 / Real GDP growth, %



Source: OECD projections.

The US is still showing a remarkable degree of resilience, considering the external headwinds and the degree of domestic monetary tightening. In September, the OECD increased its 2023 US real GDP growth projection by 0.6 percentage points to 2.2%, and now expects the economy to expand by 1.3% next year – a 0.3 percentage point upward revision. Despite widespread predictions of a hard landing at the beginning of the year, the Fed seems to have pulled off a 'no landing' scenario, getting inflation under control without causing a recession – something that the *New York Times* economist Paul Krugman has called 'a minor, or maybe not so minor, miracle'.[5] This resilience reflects a combination of a fairly closed economy, large-scale domestic energy production and loose fiscal policy. However, the nature of the inflation also seems to have been important, with a recent paper finding evidence that inflation in the US was primarily driven by supply bottlenecks linked to Covid, and therefore that the main driver of falling inflation has been supply expansion linked to reopening, rather than the impact of Fed tightening.[6]

By contrast, the Chinese economy is struggling by its own standards, reflecting a nasty combination of a property slump, weak confidence and the fact that there is less fiscal space than in the past to boost the economy. The full reopening of the economy from Covid restrictions has not had the significant positive impact on growth that many had hoped for this year. Meanwhile the attritional grind of years of US sanctions also seems to have adversely impacted foreign investment. The weakness of the Chinese economy has negative implications for the whole global economy, but much more so for Europe than the US.

[5] https://www.nytimes.com/2023/09/11/opinion/inflation-unemployment-phillips-recession.html

[6] https://rooseveltinstitute.org/publications/supply-side-expansion-has-driven-the-decline-in-inflation/

1.4. RISKS TO THE OUTLOOK

There are risks to the outlook in both directions. On the positive side, the prospect of lower inflation and a coordinated global monetary easing cycle will provide a tailwind for growth next year; and if inflation and interest rates fall quicker than is currently expected, economic growth could surprise on the upside. However, the downside risks are currently more prevalent. First, the weakness in Germany and the euro area could intensify, leading to a recession in the bloc, with major negative knock-on effects for CESEE. Some recent high-frequency indicators show very weak sentiment in the euro area, implying that a recession is a possibility. Second, geopolitical factors could damage the economic outlook, such as an escalation of the war in Ukraine following the use of nuclear weapons by Russia, or the onset of a full-blown EU-China trade war. Third, inflation could yet take longer to come down than is currently expected. The sharp increase in global oil prices since June provides one possible sign of this. Fourth, Donald Trump (or a Trump-like candidate) could win next year's presidential election in the US, which could lead to a reduction in, or withdrawal of, US support to Ukraine; an end to the war there on more favourable terms for Russia than currently looks possible; a much larger outflow of refugees to the EU; and a deterioration in investor sentiment towards large parts of CESEE.