1. Global Overview: Hitting the limits

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We have further revised upward our forecasts since the last update, reflecting stronger-than-expected activity during the middle of the year (see Table 1.1). We now estimate full-year growth of 4.8% in the euro area in 2021, up from 4.4% at the time of our previous report. This projection is actually slightly on the conservative side: it includes an assumption that momentum will wane towards the end of the year, owing to both a renewed rise in coronavirus infections over the winter (leading to greater caution and – at least in some countries – heightened restrictions on economic life) and increasingly significant supply-side constraints. Nevertheless, our core assumption is that the recovery will continue.

We expect growth of 4.4% in 2022 – another strong performance by euro area standards. This projection relies on three core assumptions. First, that the current spike in inflation will indeed be transitory, as the major central banks continue to emphasise (see below), and that the current supply-side constraints do not generate a more serious upward spiral in costs that ultimately dampens (or even puts an end to) the current robust growth momentum. Second, that vaccines continue to work against COVID-19 and any possible future variants, and that vaccination rates continue to rise in the developing world. This second assumption is, naturally, subject to huge uncertainty in both directions. Our third core assumption is that the significantly expanded EU budget will really start to have a strong positive impact on growth in the euro area from next year.

Table 1.1 / wiiw autumn 2021 global assumptions

wiiw forecasts autumn 2021	Euro area			EU		
	2021	2022	2023	2021	2022	2023
Real GDP growth, % per year	4.8	4.4	2.1	4.9	4.5	2.5
CPI, % per year	2.1	1.6	1.4	2.3	1.8	1.6
Unemployment rate, %	8.1	7.8	7.3	7.3	7.0	6.5
Current account, % of GDP	2.5	2.5	2.5	2.5	2.5	2.5
Fiscal balance, % of GDP	-7.1	-3.4	-2.6	-6.9	-3.2	-2.5
EUR/USD	1.18	1.18	1.18			
Brent crude, USD per barrel	68	66	65			

Changes since summer 2021	*Euro area*			*EU*		
	2021	*2022*	*2023*	*2021*	*2022*	*2023*
Real GDP growth, % per year	0.4	0.2	0.0	0.4	0.3	0.0
CPI, % per year	0.2	0.1	0.0	0.2	0.1	0.0
Unemployment rate, %	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Current account, % of GDP	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal balance, % of GDP	0.0	-0.0	0.0	0.0	0.0	0.0
EUR/USD	-0.01	-0.01	-0.01			
Brent crude, USD per barrel	3.00	6.00	5.00			

Source: Forecasts by wiiw. Cut-off date: 5 October 2021.

While global momentum remains robust, at least in the US and China the current cycle appears to have peaked. Indicators of economic surprise have been trending down for some time in both economies. In the euro area, the sense of waning momentum is perhaps less stark, but – at least in part – this reflects the fact that the bloc's recovery came later, and has been less strong, than the other two pillars of the global economy. Put another way, the economy of the euro area still has some post-pandemic catching-up to do.

Global growth is coming up against increasing supply-side constraints – although for the time being these appear to be mostly manageable. Back in our Spring Forecast, we highlighted the rapidly rising price of commodities, and this trend has continued strongly (in year-on-year terms) in recent months. Although we mostly anticipated it, we have made a further upward revision to our oil price forecast for 2021. The recent gas crisis looks set to push up the cost of energy even further over the winter months, perhaps particularly in the euro area. Higher input costs are affecting industry around the world, with manufacturing surveys highlighting increased cost pressures; these can often only partly be passed on to consumers, which means that margins get squeezed. On top of this, firms are reporting increased waiting times for a host of inputs. Meanwhile, labour shortages – an important theme in pre-pandemic times –appear to have returned in many key markets, acting as a further check on the current strong momentum in the global economy.

We have made slight upward adjustments to our euro area inflation forecasts for 2021 and 2022, but we retain our baseline assumption that the current spike in prices will be transitory. Comparisons between the current era and the persistently high inflation of the 1970s, for example, seem to us to be very overblown: the oil price is not especially high by historical standards, and broader price pressures in the euro area do not look particularly strong. Among other factors, the relatively weak bargaining power of labour across much of the global economy today suggests that a wage-price spiral is quite unlikely to materialise. As commodity price inflation eases from next year (our baseline scenario), we expect headline consumer price inflation to do the same.

Given these assumptions about inflation, we do not expect any radical change in monetary policy either by the US Federal Reserve or by the European Central Bank (ECB) during the forecast period. We expect the Fed to start tapering its asset purchase programme before the end of the year, and to have fully wound it down by the end of 2022. We think the first hike will come from the Fed in 2023. By contrast, the ECB will remain in ultra-loose mode, and will not raise rates during the forecast period. The fact that the Fed will be making policy less loose more rapidly than the ECB (and at some point, also tightening it more quickly) will keep the dollar strong against the euro. The risks are certainly now weighted towards a quicker winding-down of asset purchases and tightening of policy (the most recent ECB minutes showed some support for quicker tapering, for example).

Our core assumptions surrounding fiscal policy are also that a fairly loose stance will be maintained throughout the forecast period, which will support headline economic expansion. In both the US and the EU, the fiscal response to the crisis has been huge. The harsh lessons of post-2008 austerity have been learned, as can be seen from the rather different (and much more fiscally dovish) fiscal policy recommendations of institutions such as the International Monetary Fund (IMF) over the past 18 months. Although public debt loads are high, in most major economies the real interest rates on government debt remain extremely low (by any historical standard), and this will not change dramatically during the forecast period.

The risks to this forecast are high and are primarily on the downside, reflecting the unusually large degree of uncertainty about economic projects in the context of the pandemic and its aftermath. There has been no comparable development in recent decades, and so there is no historical guide to how the modern economy will emerge from the pandemic. It is clear that, although the headline recovery looks strong, below the surface there is considerable variation in terms of how different sectors have been impacted, and in the shape and speed of their recovery. Labour market scarring almost certainly exists, although the extent and the implications remain hard to quantify at present. This also applies to different countries: even if the Western world looks well set to ride out the current challenges, this cannot be said so confidently of many emerging markets, where even inflation at its current level could cause serious macroeconomic dislocation, especially when combined with currency weakness. A stronger and/or more pronounced spike in inflation is a clear risk. Not only would that choke off the recovery (via a depression of real purchasing power), but it would also likely lead to considerably higher interest rates than we currently project. Europe could be facing a gas crisis over the winter, although recent noises out of Russia suggest that President Vladimir Putin is willing to allow increased production to avert this. The Evergrande affair in China has served as a reminder of underlying vulnerabilities in the economy that has done most to prop up global demand since 2008. Meanwhile the budget gridlock in Washington underlines the very real danger that partisan politics could limit (or even block) the major extra demand that the US is currently putting into the global economy. Should Chinese and/or US growth falter, there would be serious blowback for the European economies, too.

The implications of our baseline global outlook for CESEE are largely unchanged since our spring and summer updates. Given the euro area's central importance to CESEE as a source of export demand, remittances and foreign direct investment, the ongoing recovery in the bloc is good news. Continued ultra-loose monetary policy in the euro area will prevent CESEE central banks from tightening too quickly, not least because of concerns about the impact of exchange rate appreciation on exporters. Finally, the appreciation of the dollar and higher US rates could create difficulties for CESEE countries with large and especially short-term dollar-denominated external financing requirements.