

## **Informal ECOFIN, 9 and 10 September 2022 in Prague, working session I**

### **Presidency issues note**

#### **Russia's war of aggression against Ukraine: handling economic and financial consequences for Europe**

**The debate on the economic and financial impact of the Russian aggression includes the topic of Ukraine's financial needs discussed by Ministers at the informal lunch.** Addressing the economic and financial consequences of the war is key to ensuring sustainable growth and financial stability in the EU and, indirectly, adequate EU support to Ukraine.

**Shortly after the pandemic-induced economic crisis, the EU economy is experiencing another major negative shock.** Russia's invasion of Ukraine has not only precipitated a humanitarian catastrophe - with thousands of civilians killed and millions more displaced - but has also resulted in a deep contraction of the Ukrainian economy, the risk of a significant downturn for the EU and euro area and substantial negative spillovers at global level. The overall economic impact cannot yet be quantified, but it is clear that, at least in the short term, the war is causing economic growth to slow down significantly and is intensifying inflationary pressures. Other consequences include possible additional refugee flows. This comes on top of the COVID-19 legacy in terms of already existing supply bottlenecks and a constrained fiscal space.

**While growth continued in the first half of 2022 in the EU, the inflationary and economic outlook has worsened.** As presented in the summer 2022 European economic forecast, real GDP in the EU is forecast to grow by 2.7 % in 2022 and 1.5 % in 2023. The seemingly high annual growth rate for 2022 is propped up solely by the past momentum of last year's recovery and a stronger first quarter 2022 than previously estimated. In 2023, economic growth is expected to benefit from some positive factors, on the back of a resilient labour market, moderate inflation, support from the Recovery and Resilience Facility and a still large amount of excess savings. However, on an annual basis there is a downward revision of almost one percentage point compared to the spring forecast. Inflation in the euro area is projected to peak at a new record high of 8.4 % in the third quarter of 2022. As the pressures

from energy prices and supply constraints fade, inflation is expected to decline steadily thereafter to below 3 % year-on-year by the end of 2023. Still, the overall annual rates of 7.6 % in 2022 and 4.0 % in 2023 imply upward revisions of euro area inflation by more than one percentage point from the spring forecast. Moreover, recent data signal a broad-based and rapid deterioration of the outlook.

**While most EU countries do not have strong trade links with Russia or Ukraine, the economic impact is mainly due to Russia's and Ukraine's important role as commodity suppliers.** In particular, for certain raw materials, EU countries are heavily dependent on imports from Russia. Russia is using restrictions on the supply of commodities, especially gas, as a means of retaliation against the EU, which has imposed sanctions on Russia. EU unity in imposing and enforcing sanctions, as well as in acting together against Russia's counter-sanctions, is essential to cushion the impact of Russia's restrictions and press for an end to the war. A shortfall in the supply of commodities, accompanied by a rise in their prices, are the main drivers of the economic slowdown. In addition, the indirect effects of increased interest rates and a decline in consumer and business confidence have led to a further decrease in economic activity. Food security is also a major issue, which may have a delayed impact on the EU as a result of additional refugee inflows following potential food shortages or steep food price increases in countries neighbouring the EU.

**The effects of the invasion have also caused a further reduction in policy space, which is now much more limited than at the onset of the pandemic.** Amid surging commodity prices and supply disruptions, inflation has soared in the EU, exacerbating the exceedingly difficult trade-off faced by policymakers between supporting growth and keeping prices in check. Financial conditions have started to tighten and borrowing costs have increased. This reflects monetary policy responses to inflationary pressures, elevated uncertainty and heightened geopolitical risks.

**Looking ahead, the EU is facing serious challenges that require the attention of policymakers to ensure sustainable growth and financial stability.** Under the current conditions, the main policy priority is to restore price stability and protect the most vulnerable groups. The appropriate mix of monetary, fiscal, and structural policies aimed at reducing inflation differs across economies depending on the origin and extent of price pressures. As a consequence of monetary policy measures, tighter credit conditions may affect financial institutions. As interest rates rise, financial institutions may gain from higher net income but

may also suffer losses as loan origination declines and default rates rise. The balance between these factors will affect the profitability of the financial sector and the appropriate selection of macroprudential tools. Beyond general inflation, the spike in energy and food prices has resulted in specific mitigating policy measures across EU Member States. The increase in energy prices may even warrant an EU-wide coordinated response. The volatility of energy and food prices may further lead to a need to ensure a continuing supply of key food and energy commodities while avoiding export and import restrictions within the EU that would further magnify the rise in prices.

**While the national support measures to mitigate the effects of elevated food and energy prices are mostly legitimate, they may have unintended effects and spillovers that warrant further scrutiny.** The number and volume of support measures at national level is considerable. Member States are applying various measures, including taxation, social support or price caps. The measures represent a major challenge for the preservation of the integrity of the internal market and for public finances. With a view to the functioning of the internal market and to limiting the negative impact on public budgets, it may be worthwhile to monitor and coordinate support measures to avoid undue pressure on neighbouring countries. Therefore, a focus on evaluating the impact and effectiveness of individual measures should be considered in order to share good practices between countries and influence future policy actions. Finally, it is necessary to consider dealing with soaring energy prices urgently. The current extremely high energy prices call for immediate action at the European level. In particular, we should carefully consider all possibilities including capping all-time high prices of electricity and their decoupling from gas prices.

Against this background, the Presidency invites Ministers and Governors to exchange views on the economic and financial impact of the Russia's war of aggression against Ukraine on the EU and the policy response thereto.

**Questions for discussion:**

- *In view of the current macroeconomic conditions and the constrained policy space, what are the views of Ministers and Governors on the existing monetary, fiscal and structural policy and its future direction?*
- *In order to inform future policy actions and possibly to adjust those of the past, and without prejudice to possible EU-wide steps taken in other fora, do Ministers and Governors see a need for an initiative to evaluate the impact and effectiveness of support measures, in particular those in the energy sector? If so, where and how should such an initiative be carried out?*
- *What are views of Ministers and Governors on the impact of the spike in energy prices on the EU's economy? Without prejudice to possible EU-wide steps taken in other fora, how can high energy prices best be curbed to safeguard growth and social cohesion in the EU and how can they be leveraged as an accelerating driver for the twin transition?*