

# Energizing Europe

Part 1

**Inclusive Growth:  
Inflation Chipping  
Away Income Gains**

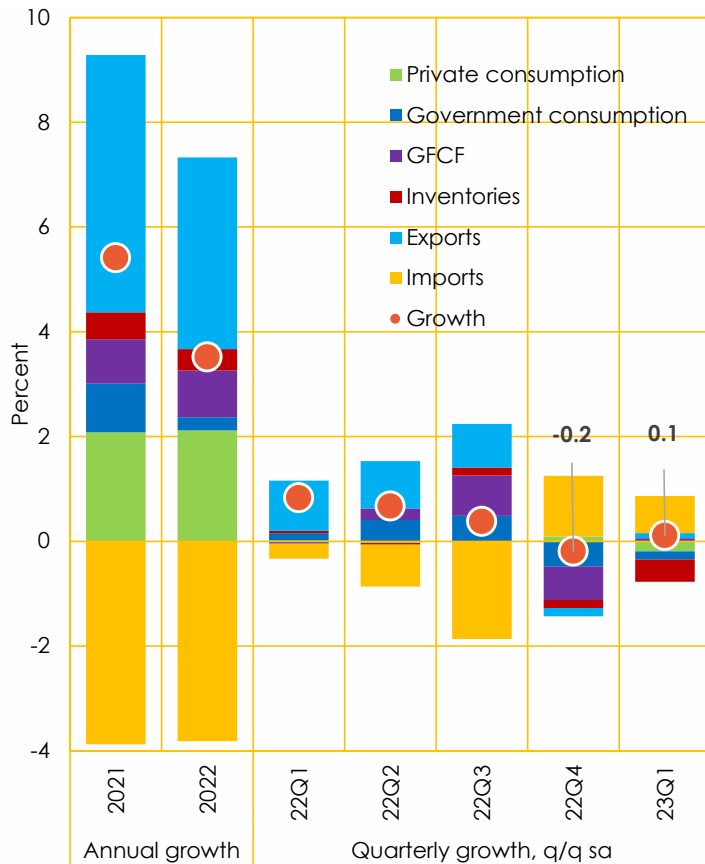


# EU Outlook

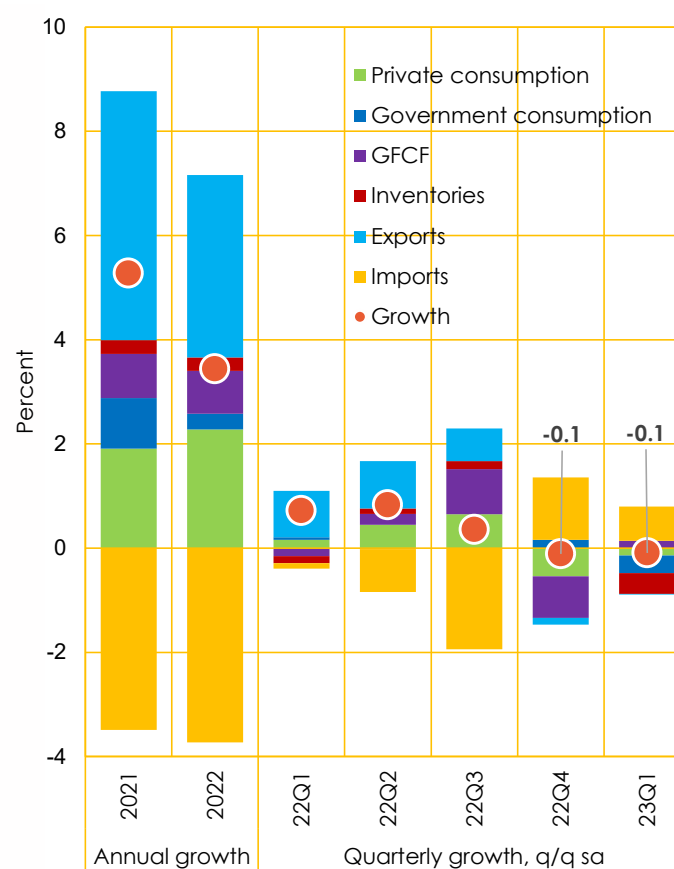
Fading resilience

# After weathering last year's storm, EU activity stalled in early 2023 amid ongoing macroeconomic headwinds

## EU: Contributions to Growth



## EA: Contributions to Growth



**Weak activity stemming from:**

- Monetary policy tightening
- Cost-of-living crisis
- Elevated uncertainty
- Challenging global environment

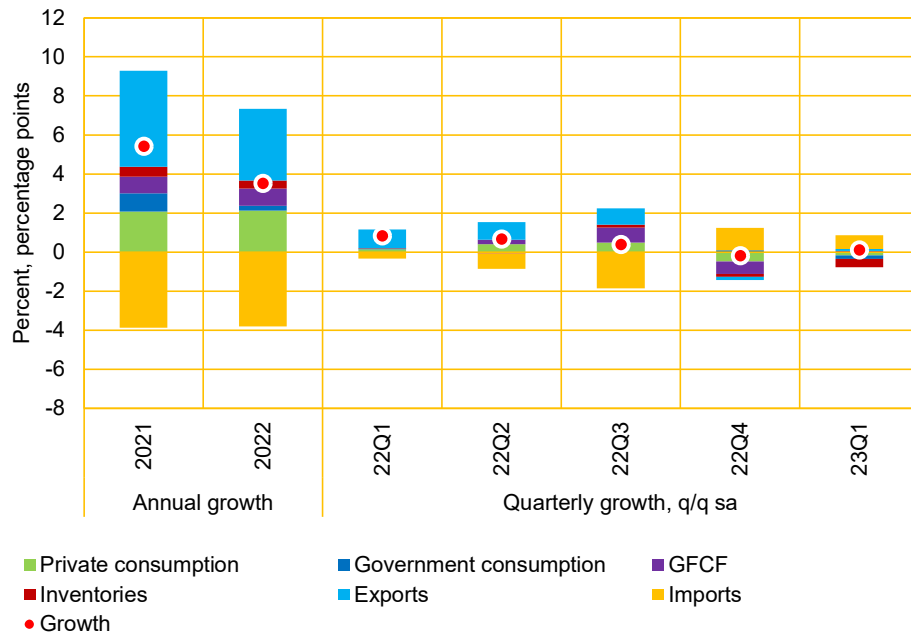
**In turn, output contracted in:**

- 44% of EU economies in 22Q4
- 30% of EU economies in 23Q1

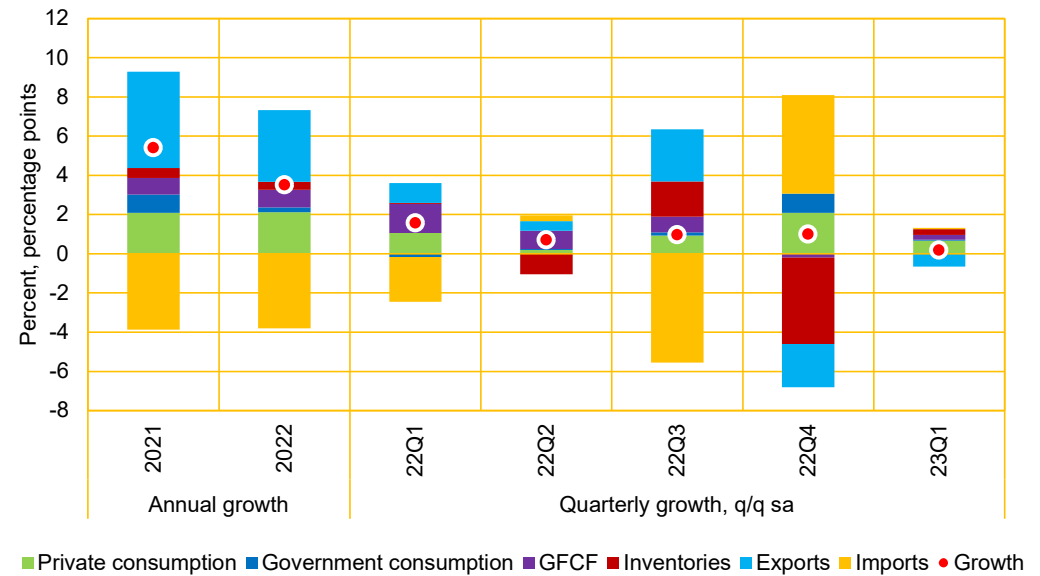
Source: Eurostat.

# Romania's growth has also slowed, falling to 0.2% in 23Q1—in tandem with weakening activity in the EU

**Modest, but better than expected 23Q1 performance as terms-of-trade benefits from declining energy prices**  
(EU27 GDP growth by expenditure component)



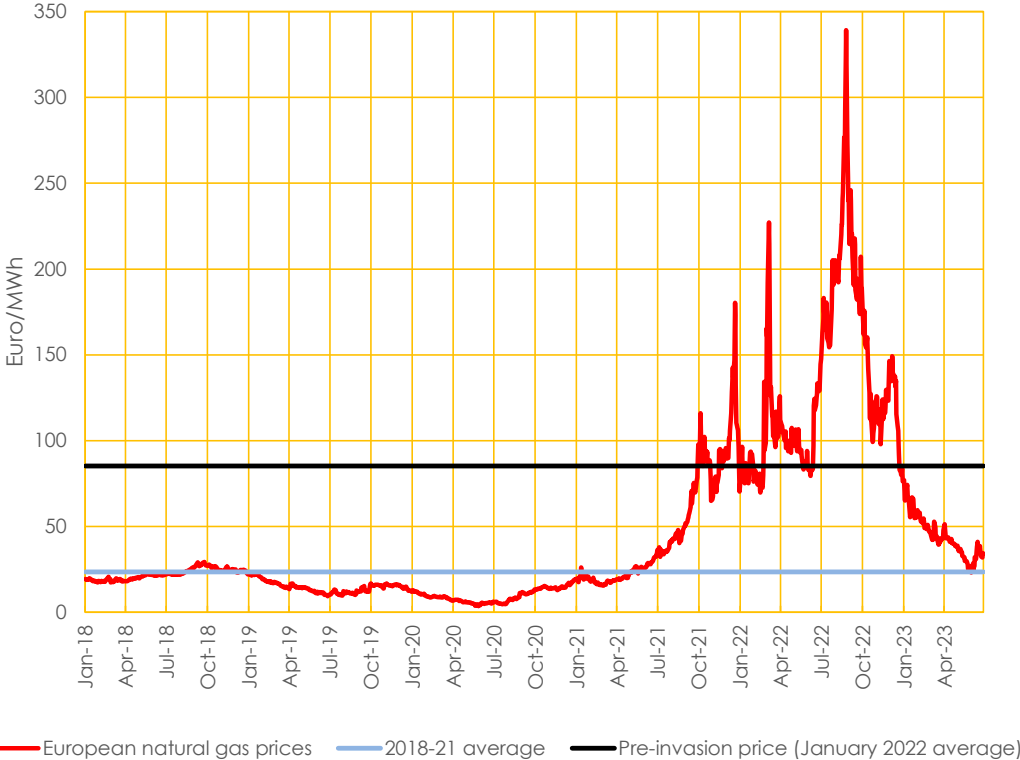
**Fading domestic demand as persistent core inflation squeezes disposable incomes**  
(Romania GDP growth by expenditure component)



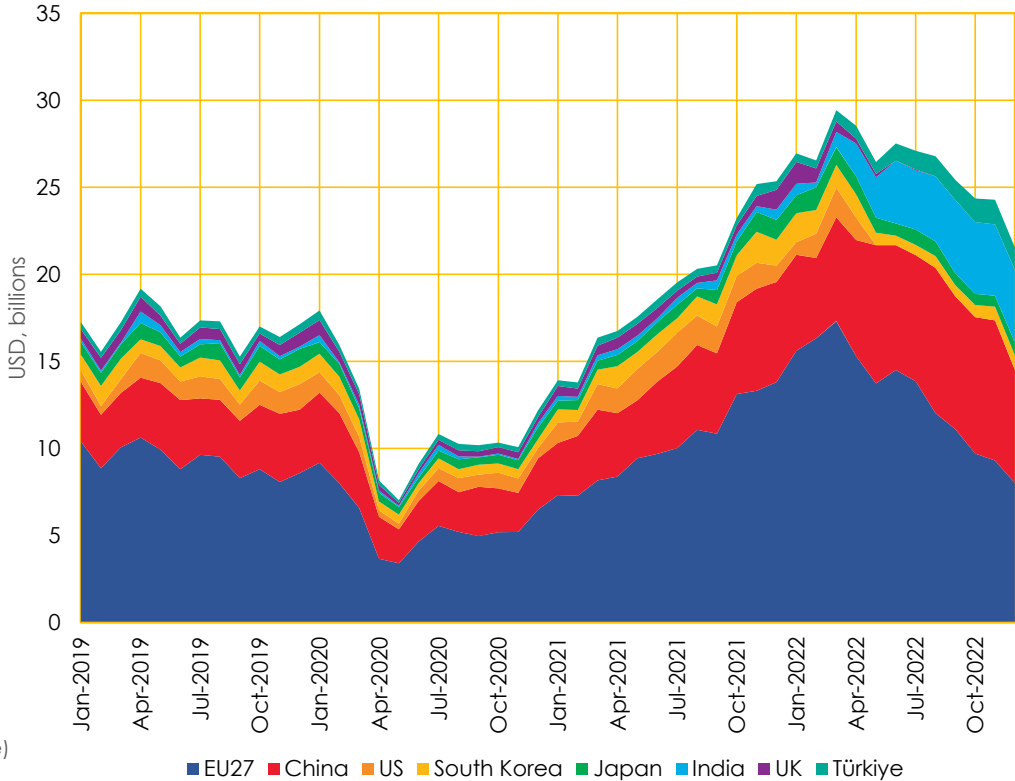
Source: Eurostat, Haver Analytics, World Bank.  
Note: Growth calculated using chained 2015 euros, seasonally and working day adjusted

# Energy prices have subsided since last year's spike, but remain 35% above 2018-21 average

## European Natural Gas Prices



## Destinations of Russia's Mineral Fuel Exports



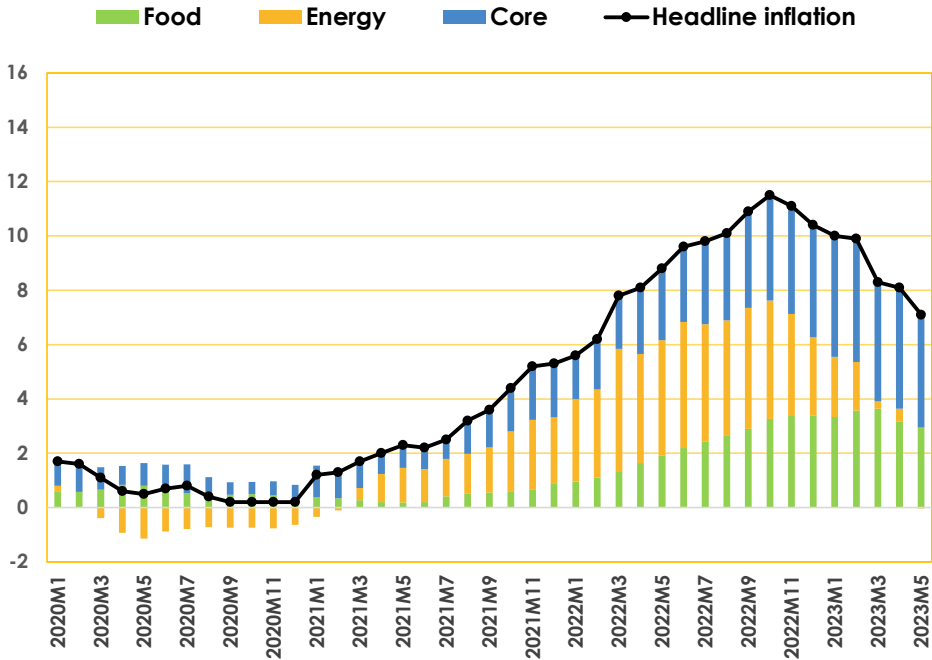
Source: Bloomberg.

Source: Bruegel based on Eurostat, General Administration of Customs - People's Republic of China, United States Census Bureau, Korea Customs Service, Ministry of Finance—Trade Statistics of Japan, Ministry of Commerce and Industry—Government of India, Office of National Statistics (UK), Turkish Statistical Institute.

# Inflation remains persistently high in the EU, including Romania, driven by core and food price pressures

## Persistent core inflation may prolong the monetary tightening cycle

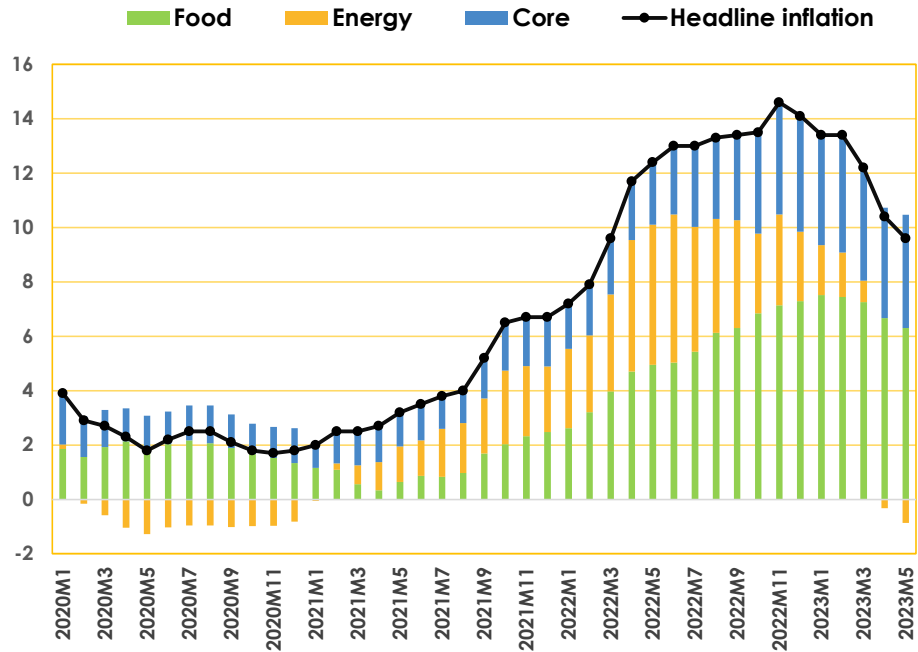
(EU27: Contribution to headline HIPC inflation, 2020M1-2023M5)



Source: Eurostat and WB staff calculations  
 Note: In percent, y/y

## Processed food prices higher in Romania than the EU27 average, putting pressure on core inflation

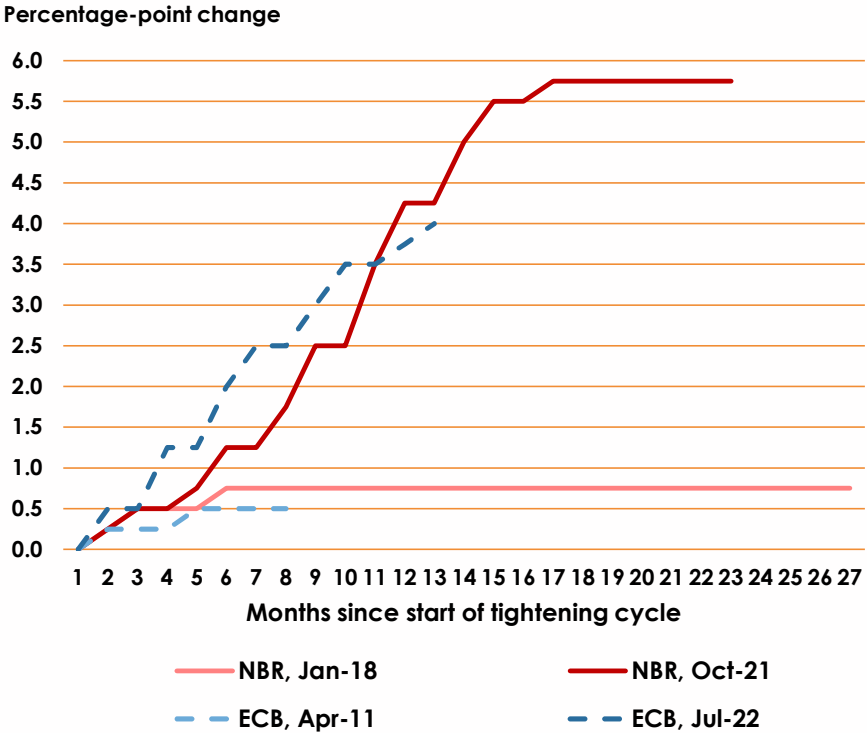
(Romania: Contribution to headline HIPC inflation, 2020M1-2023M5)



Source: Eurostat and WB staff calculations  
 Note: In percent, y/y

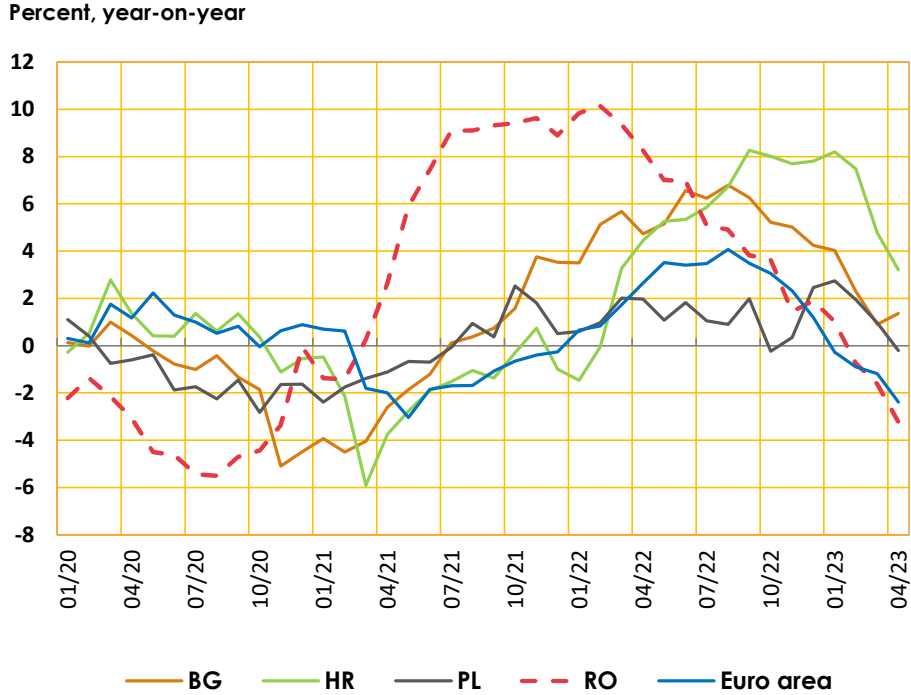
# Financing conditions have tightened alongside monetary policy rate hikes, including in Romania

ECB and NBR reacted more forcefully than in previous tightening cycles



Source: ECB, Haver Analytics.  
 Note: ECB – European Central Bank, NBR – National Bank of Romania. Last observation is June 2023 for the current tightening cycle

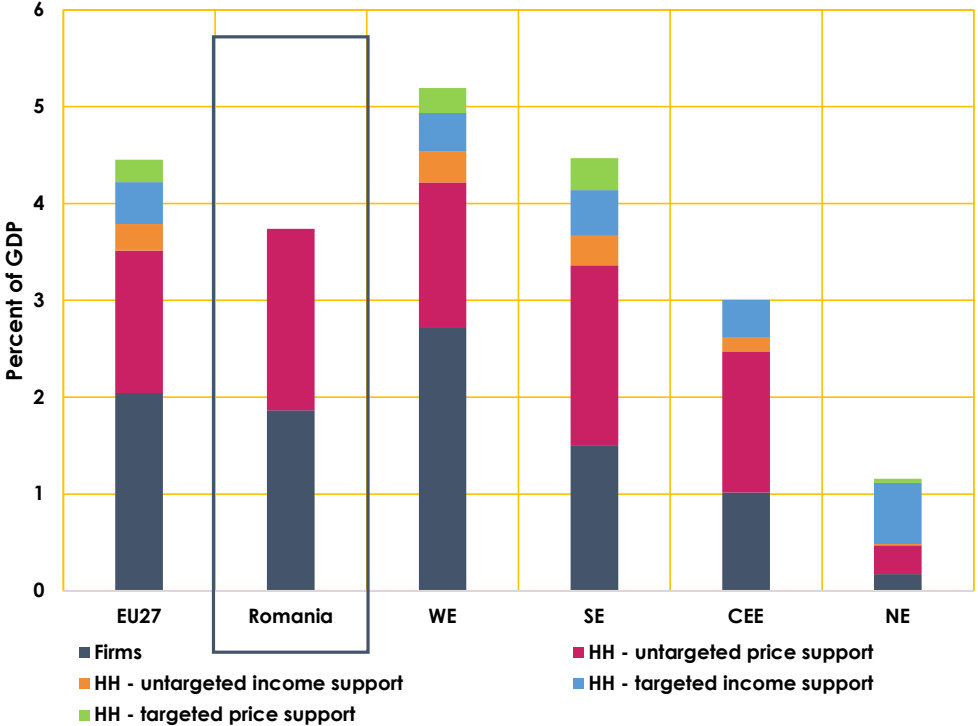
Credit growth remains positive, but has been decelerating after the initial post-pandemic recovery (Bank credit impulses)



Source: ECB, Haver Analytics.  
 Note: Change in credit growth rates.

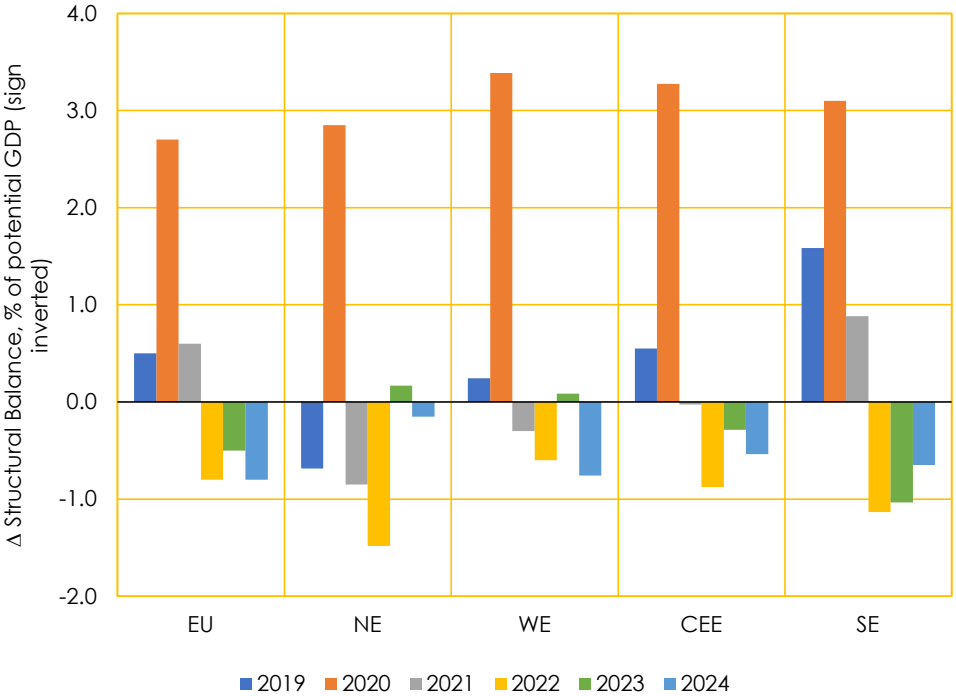
# Tighter fiscal policy is needed after sizable untargeted support, but fiscal consolidation will be a drag on growth

Total Fiscal Support Packages to Confront the Cost-of-Living Crisis, by EU Region, 2021M9-2023M3



Source: Adapted from data from Amaglobeli and others (2023), Eurostat, and WB staff calculations.  
 Note: In percent of 2021 GDP for relative size illustration.

Fiscal Impulses



Source: AMECO. Simple averages for regions.



# Risks remain tilted to the downside

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**Weak growth in baseline leaves the economy vulnerable to additional negative shocks—most downside risks are a worsening of the drags in the baseline.**

**The combination of slowing growth, persistent inflation, and tightening financial conditions amid high levels of debt increases the risk of economic downturn, financial strains, continued fiscal pressures, and weak investment:**

- **Higher for longer inflation**, especially in poorer EU countries, amid ongoing pressures in core, services, and food inflation.
- **Tighter than expected monetary policy**, as central banks may need to hike policy rates more than is currently expected to rein in inflation, with substantial uncertainty about the impact in terms of magnitude and timing.
- **Banking sector strains** could result from the combination of additional monetary tightening, softer growth, and falling confidence in an environment of elevated debt.
- **Heightened uncertainty** from the invasion could continue to dampen investment and sentiment.
- **Energy security and independence** continue to play a prominent role in the EU policy agenda, especially given ongoing energy supply cuts and volatile global commodity prices.
- **Trade and investment flows could further fragment** alongside an intensification in Russia's invasion of Ukraine.

# Romania's economy is facing several challenges

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The prospect of lower economic growth is exacerbating the challenges of addressing widening external imbalances and higher poverty rates.

- **Earlier growth resilience has faded in Romania—similar to global and EU developments.** Growth decelerated to 0.2 percent q-o-q in Q1, 2023 and is expected to slow to around 2.6 percent in 2023 (World Bank GEP).
- **Double-digit inflation** eroded households' purchasing power and led to poverty increases. Annual inflation shows signs of decelerating in recent months on the back of lower energy prices. However, food price dynamics remain elevated, disproportionately affecting poorer households.
- Higher inflation could lead to an increase in the **poverty rate** by 1.8 percentage points, as measured by the \$6.85 poverty line (2017 PPP). The poorest households experienced the largest relative welfare losses, with simulations pointing to real income losses of nearly 8 percent for the poorest income decile.
- Romania's **external imbalances** have increased in the recent past. Since 2018, the country has seen an increase in the twin deficits—fiscal and current account—coupled with expansionary fiscal policy. The two large external shocks, first the pandemic and then the war, have exacerbated these imbalances.

# EU Inflation Dynamics

**Model-based approach**

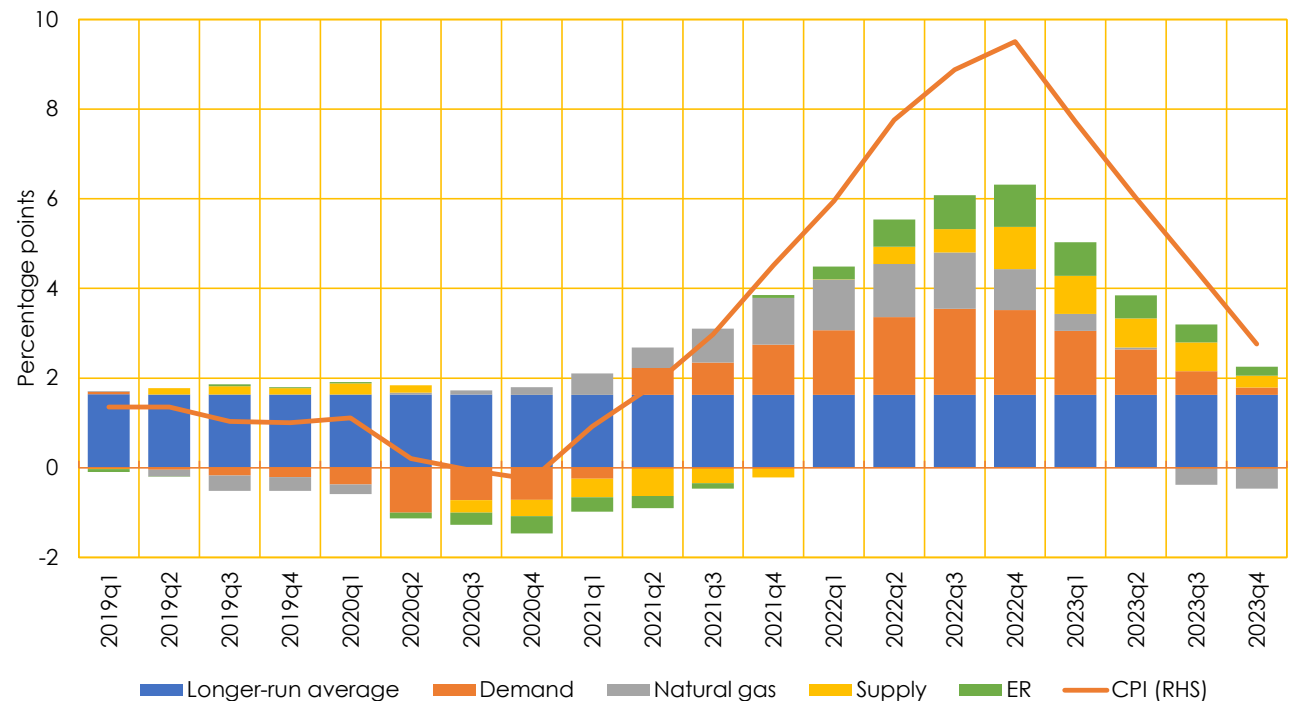
# Model-based approach suggests energy prices and external factors played a role in the inflation spike

## Euro area inflation driven by:

- Earlier resilience in demand
- Supply disruptions from pandemic and Russia's invasion of Ukraine
- Elevated energy prices
- The passthrough of exchange rate depreciation

By late 2023, euro area inflation expected to fall to around 3%--in line with ECB projections

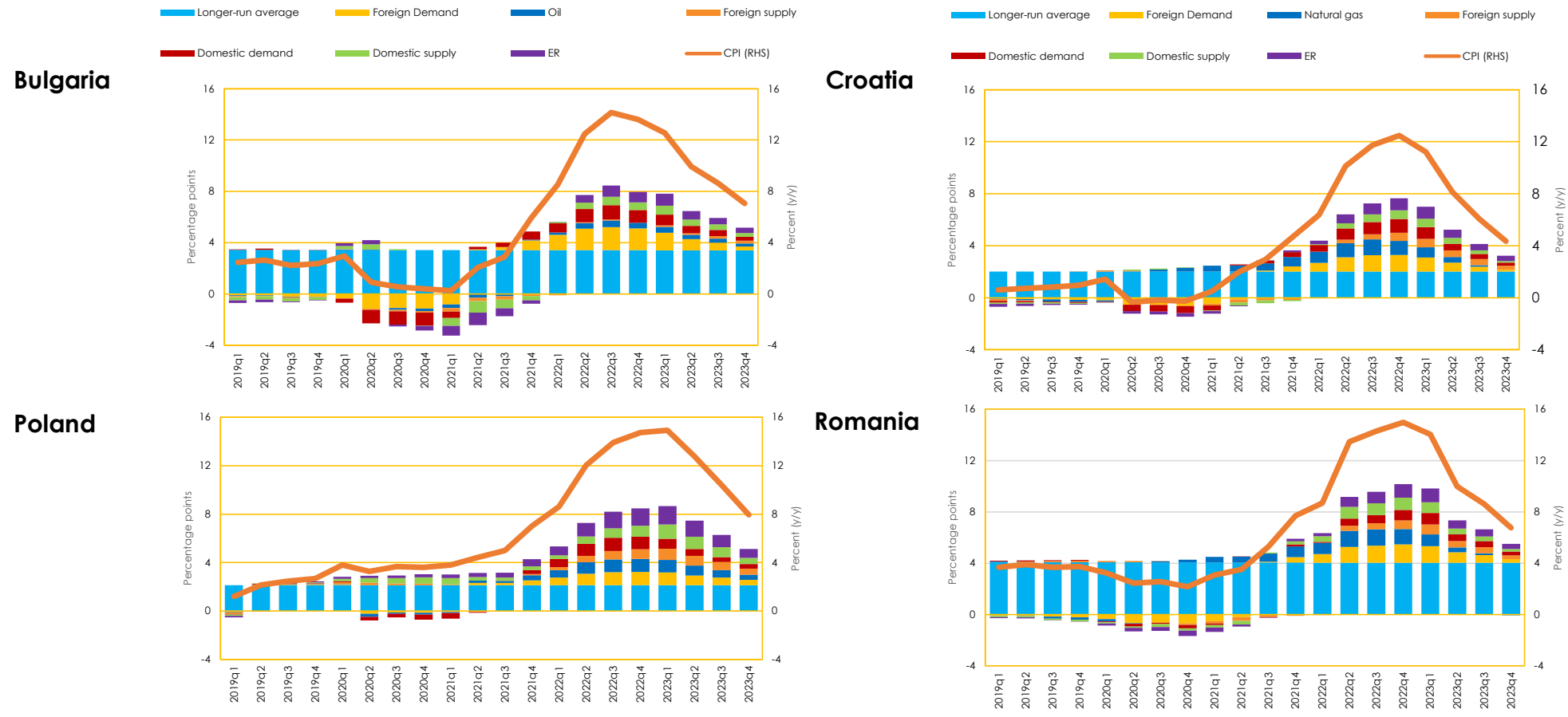
## Inflation Decomposition in Euro Area, model-based estimates of deviation from target/average



Source: Bloomberg, Eurostat, Haver Analytics, J.P. Morgan, World Bank.

# Model-based approach shows energy prices and external pressures played role in inflation spike

## Inflation Decomposition by Country, Model-based estimates of deviation from target/average



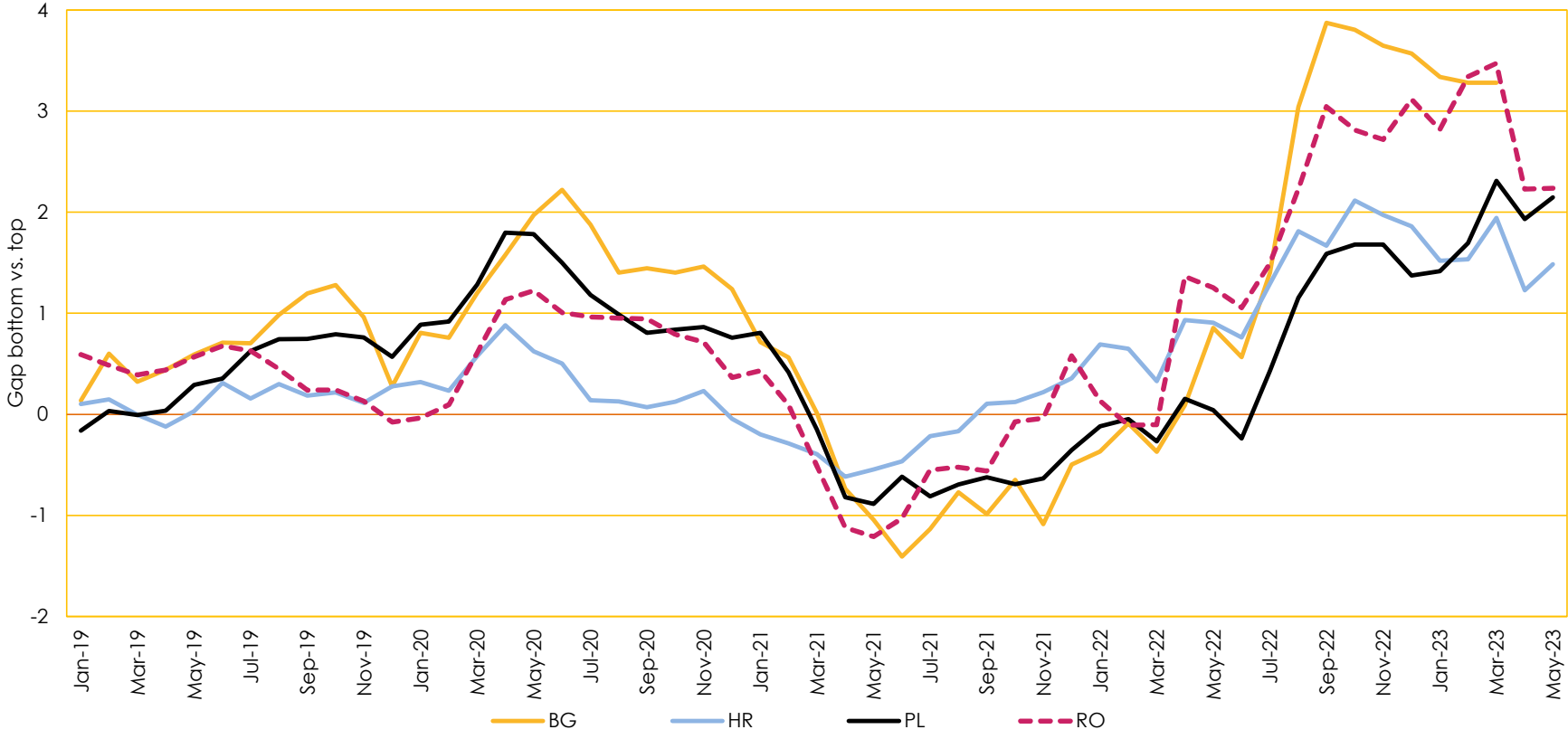
Sources: Bloomberg, Eurostat, Haver Analytics, Inc, World Bank.

# Inclusive Growth

Inflation eroding gains in inclusion

# Persistent inflation has disproportionately hit the poorest over the past year

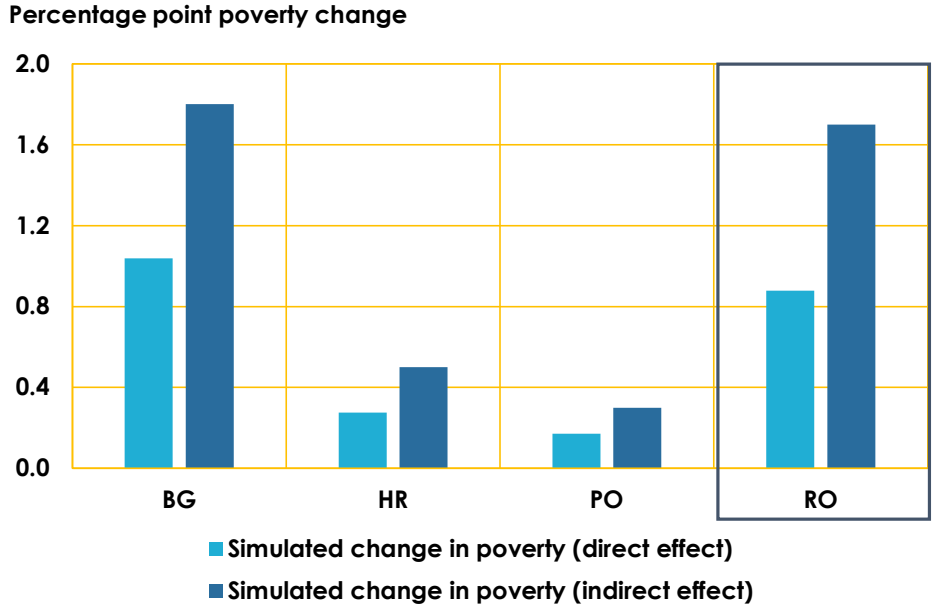
## Difference in the Inflation of bottom and top income quintiles by countries



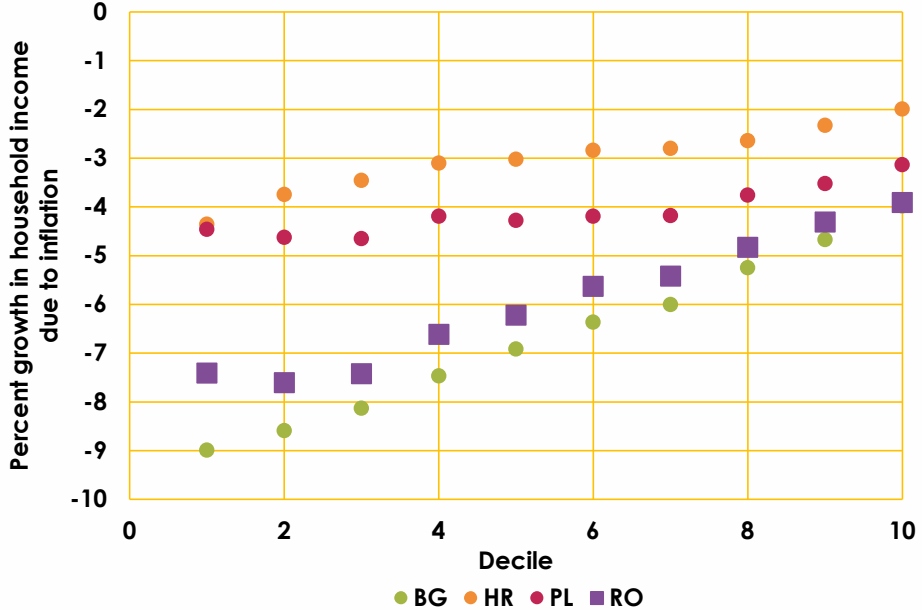
Source: Bruegel (<https://www.bruegel.org/dataset/inflation-inequality-european-union-and-its-drivers>), 2019M1–2023M05.

# Persistent inflation could lead to poverty increases, mainly through indirect channels

Simulated changes in poverty due to food and energy inflation, direct and indirect impacts, USD 6.85 poverty line (2017 PPP)



Simulated changes in household disposable income, by income deciles (direct effects)



Source: World Bank micro simulations based on Eurostat Harmonized Indices of Consumer Prices (HICP) and the latest consumption data available from the HBS and income data from the EU-SILC.

Note: Simulated changes in poverty represent the difference between baseline poverty rates, constructed from household income per capita in EU-SILC 2020 and 2019 for Poland, and simulated poverty, resulting from microsimulations. For the simulation of direct impacts, we use inflation changes from October 2022 relative to October 2019 and assume that the price elasticity of demand is the same for food and energy, but the price elasticity differs across the income distribution. For the simulation of indirect effect, we use the detailed price changes as a result of the energy shock in a CGE model.



# Policy recommendations

**Navigating cyclical and structural headwinds**

# Policy recommendations

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**Governments face the challenge of balancing competing demands and limited macroeconomic policy space after a series of negative shocks. Supporting growth will require an acceleration in structural reforms, which have taken a backseat given multiple crises.**

**Tighter macroeconomic policy must be calibrated to avoid worsening the economic slowdown, while structural reforms are needed for long-term growth.**

- **Fiscal policy support needs to be timely, targeted, time bound, and transparent** to eventually support gradual fiscal consolidation.
- **Strengthen social protection system to deliver aid to the poorest households**, supported by higher spending on poverty-targeted programs, better targeting and coverage, and leakage reduction.
- **Reduce cost of supporting firms** by fostering innovation that improve efficiency, making government support conditional on energy savings, and improving targeting by focusing on viable firms.
- **Green transition requires significant investments** in human and physical capital and technological advancements—requires increased participation of the private sector.
- **EU countries also need to spur productivity**, including by strengthening innovation policies, boosting R&D spending, and promoting entrepreneurship—which can be complemented by reducing product and labor market distortions and promoting a more competitive environment.

# Unlocking Romania' long-term growth potential requires renewed attention to reforms

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The National Recovery and Resilience Plan (NRRP) promotes key reforms and Investments, which can boost growth potential, facilitate the green and digital transitions, and fill infrastructure gaps.

## Aging

- **Pension reforms** to enhance equity and long-term fiscal sustainability

## Institutions

- **Tax policy and tax administration reforms** to bring more revenue to the budget
- **Budget reforms** to enhance spending discipline and efficiency
- **Public sector pay reforms** to strengthen performance and fiscal sustainability
- **SOE reforms** to improve corporate governance

## Inclusion

- **Social assistance reforms** to strengthen inclusion

## Green

- **Energy sector reforms** to reduce dependence on fossil fuels and improve efficiency

## Digital

- **Digitalization of the public sector** to boost productivity and quality of public services

The background of the slide is a vibrant, abstract pattern of diagonal brushstrokes in various shades of orange and red, creating a sense of movement and energy. The strokes are of varying lengths and thicknesses, some overlapping, giving it a textured, hand-painted appearance.

Thank you!