1 OVERVIEW

The Russian invasion of Ukraine amounts to a very severe economic shock, of highly uncertain duration and intensity. In the first few weeks of 2022, before the outbreak of the war, the global economic recovery from the pandemic was expected to continue, against a background of vaccination progress and supportive economic policy. In fact, fiscal policy and, in particular, monetary policy had been beginning to show the first signs of normalisation, after the surge in inflation rates resulting from the recovery in demand during 2021, the emergence of global supply chain bottlenecks and the rise in the prices of numerous commodities, including energy ones.

The war is having an adverse impact on economic activity and pushing up prices, through various channels. These worldwide impacts are hitting Europe harder than other regions, owing to Europe's greater links with the countries at war.

The most important channel runs through the commodity markets. Russia and, to a lesser extent, Ukraine account for a very large share of world production of oil and gas, and of certain metals and agricultural commodities. In particular, Russia supplies approximately a third of the gas consumed in the euro area and a fifth of the oil, these proportions being considerably lower in the case of Spain. The prices of many of these commodities, which had already increased as a result of heightened geopolitical tensions before the war, climbed considerably higher when the war started. Moreover, a hypothetical decrease or cut in the supply of Russian gas to Europe would probably hit economic activity in the continent very hard, given the difficulty of substituting these inputs in the short term.

The war is drastically reducing trade between Europe and Russia, but may also affect world trade if it leads to a slowdown in global growth. The West's coordinated sanctions against Russia place restrictions on the financial and non-energy trade flows with that economy. The direct impact of these restrictions, along with the indirect effects associated with the fall in economic activity in Russia owing to the war, have led to a sharp decline in Russia's foreign trade. From the standpoint of the European economies, these developments reduce the growth of their export markets, a decline that could be more pronounced if, as seems likely, the war also leads global economic growth to slow somewhat.

The war has also significantly reduced agents' confidence. The extraordinary uncertainty surrounding the current economic and geopolitical situation will tend to have an adverse impact on the spending decisions of households and firms. In the financial markets, the outbreak of war triggered a flight to safety, an increase in

Table 1
MAIN SPANISH MACROECONOMIC AGGREGATES (a)

		2020			2021				2022
	2021	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
National Accounts									
Quarter-on-quarter rate of change, unless otherwise indicated									
Gross domestic product	5.1	-17.7	16.8	0.2	-0.5	1.1	2.6	2.2	0.9
Contribution of domestic demand (b)	4.7	-15.2	15.4	-0.1	-0.7	2.5	0.8	1.2	0.8
Contribution of net external demand (b)	0.5	-2.4	1.4	0.3	0.2	-1.4	1.8	1.0	0.1
Year-on-year rate of change									
Employment: hours worked	7.0	-25.3	-6.3	-6.1	-2.7	29.7	3.3	2.7	4.9
Price indicators									
Harmonised index of consumer prices	3.0	-0.6	-0.6	-0.8	0.5	2.3	3.4	5.8	7.9
Harmonised index of consumer prices excluding energy and food	0.6	0.9	0.1	-0.1	0.1	-0.2	0.7	1.6	2.5

SOURCES: INE and Banco de España.

a Information available to 31 March 2022. The shaded figures are Banco de España projections.
b Contribution to the quarter-on-quarter rate of change of GDP, in percentage points.

volatility and a deterioration in financing conditions. Although this initial market reaction has been partially reversed in recent weeks, in such an uncertain environment these developments may lead to a rise in the cost of credit.

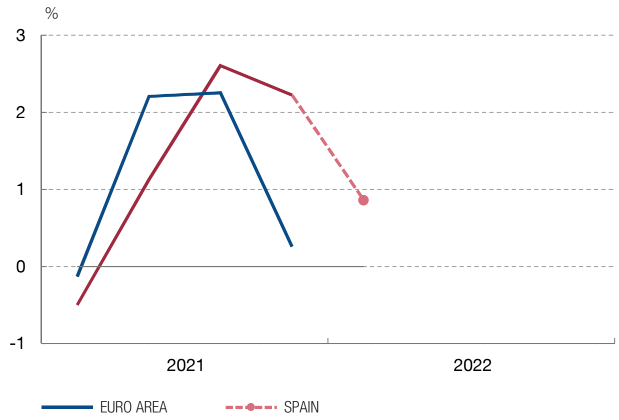
The precise magnitude of the effect of the war on activity and inflation is highly uncertain. The main source of uncertainty is the course of the armed conflict itself. Against this background, the ECB's March macroeconomic projections for the euro area – the cut-off date for which was a few days after the war broke out – involve a fall in GDP growth in 2022 (to 3.7%) and a sharp increase in the average headline and underlying inflation rates for this year (with upward revisions of 1.9 pp and 0.7 pp, respectively, to 5.1% and 2.6%). The ECB considered two additional scenarios in which GDP growth falls this year to 2.5% and 2.3%, respectively, while headline inflation rises to 5.9% and 7.1%. For its part, the OECD estimated in March that the war would have a negative impact of 1.4 pp on euro area GDP growth in 2022 and that it would raise the rate of inflation by 2 pp.

In Spain's case, the war is also having a significant impact on activity and prices. The Spanish economy is less directly exposed to some of the above-mentioned transmission channels than other European economies. Specifically, its dependence on Russia for the supply of gas is relatively low. It also has relatively little non-energy trade with Russia. Yet this has not prevented a worsening of the cost increases, especially in the case of energy inputs, to which our economy is particularly sensitive. Moreover, these increases, which seem to have started to be passed through, with some intensity, to the final prices of other goods and services

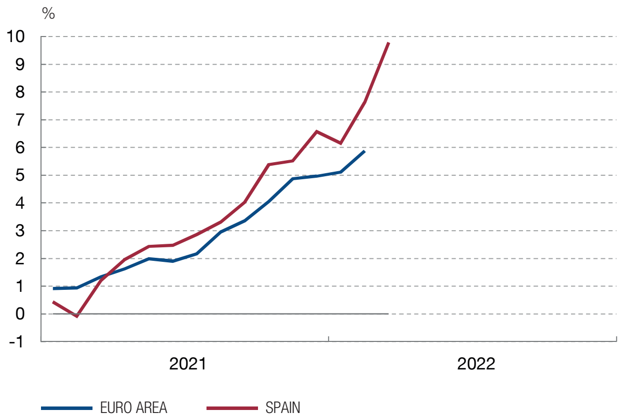
Chart 1
ACTIVITY HAS DETERIORATED AT THE END OF THE QUARTER AS A RESULT OF THE INVASION OF UKRAINE, AGAINST A BACKDROP OF SUSTAINED INFLATION GROWTH (a)

Activity continued to recover in the first half of the quarter, at a pace that was tempered by the surge in inflation and the continuation of pandemic-related restrictions. But the invasion of Ukraine changed these dynamics by giving rise to a highly significant increase in uncertainty and a notable rise in energy and non-energy commodity prices.

1 GROSS DOMESTIC PRODUCT (b)



2 HARMONISED INDEX OF CONSUMER PRICES



SOURCES: Eurostat, INE and Banco de España.

a Quarter-on-quarter rates of change based on the seasonally adjusted series in the case of GDP, and year-on-year rates of change in the case of the consumer price index.
a The Q1 data are Banco de España projections.

(thus reducing households' purchasing power), have also led to industrial stoppages in some sectors, such as transportation, compounding supply chain disruptions as a result.

The Banco de España's latest macroeconomic projections, presented in Box 1, envisage an average GDP growth rate of 4.5% this year. This downward revision of 0.9 pp from the December projections would actually be even more marked were it not for the 2021 H2 activity data (released since the publication of the December projections) being better than projected, which has raised the GDP growth rate for 2022 by 0.8 pp. The new projections foresee activity maintaining a high degree of momentum in the following two years, such that the Spanish economy will grow by 2.9% in 2023 and 2.5% in 2024. Under this scenario, it will return to its pre-pandemic level of activity in 2023 Q3.

Inflation will stand at 7.5% on average in 2022. Energy futures markets anticipate prices moderating somewhat from July this year. A crucial assumption underlying the projections is the small magnitude of the second-round effects, i.e. limited feedback effects between inflationary pressures and wages. Under this assumption, inflation will fall to 2% in 2023 and 1.6% in 2024.

Figure 1

RECENT GLOBAL ECONOMIC DEVELOPMENTS, OUTLOOK AND MAIN SOURCES OF UNCERTAINTY

<table>
<tr><th></th><th>MAIN RECENT DEVELOPMENTS</th><th>SHORT-TERM OUTLOOK</th><th>SOURCES OF UNCERTAINTY</th></tr>
<tr><td>ACTIVITY</td><td>Global economic growth slowed in 2021 Q4, weighed down by new COVID-19 variants and persisting bottlenecks in global value chains</td><td>Set against buoyant activity in the first half of Q1, the outbreak of the armed conflict in Ukraine and the economic sanctions imposed on Russia will foreseeably have a severe impact on the growth outlook for the coming quarters</td><td rowspan="3">— Duration and intensity of the armed conflict in Ukraine, and the persistence of the possible geopolitical fallout
— Energy prices and the possible indirect and second-round effects on inflation
— Global production and supply chain bottlenecks
— Global financing conditions and financial stability amid the normalisation of monetary policy around the world
— The nature and magnitude of the fiscal response to contend with the war's adverse consequences
— The pandemic</td></tr>
<tr><td>PRICES</td><td>Prior to Russia's invasion of Ukraine, inflation rates continued to rise worldwide, driven, above all, by persisting bottlenecks in global value chains and rising energy prices</td><td>The war in Ukraine has constituted a considerable shock to commodity prices. While these developments could contribute to the current inflationary spike lasting longer, it will remain temporary</td></tr>
<tr><td>OTHER</td><td>In response to the current setting of high inflation, central banks in developed economies have continued to normalise their monetary policy stances</td><td>The course of the armed conflict and changes in investors' expectations about monetary policy in the main global economies will have a significant bearing on international financial market developments</td></tr>
</table>

SOURCE: Banco de España.

Amid such volatility, the risks are predominantly tilted to the downside in the case of economic activity and to the upside in that of inflation. On this occasion, a particularly high degree of uncertainty surrounds the projections under the baseline scenario. In this regard, Box 1 presents, by way of illustration, several hypothetical exercises that highlight the considerable sensitivity of the projections envisaged under the baseline scenario to different assumptions relating to future developments in energy prices, trade with Russia, second-round price-wage effects and the path of household consumption and saving. As with the baseline scenario, the scale of the impacts estimated in these counterfactual exercises – which are not independent of each other, so that their impacts cannot simply be added together – should be interpreted with great caution given the enormous degree of uncertainty.

The economic policy response will also affect the scale of the war's economic impact. In recent weeks, many European governments have unveiled measures to alleviate the effects of higher energy prices on the most vulnerable consumers and the hardest-hit productive sectors. As public finances emerged from the pandemic significantly weakened, the design of these measures has had to strike a fine balance between their effectiveness and their budgetary cost. The set of measures adopted in Spain on 29 March will mobilise around €6 billion in the form of direct assistance and tax cuts, and a further €10 billion via an Official Credit Institute (ICO) guarantee facility. Future price and activity developments both in Europe and in Spain will partly depend on the ability of these measures (and of others that could be deployed in coming weeks) to attain their goals.