Box 3. Risk scenario for the impact of the Russia-Ukraine war on the domestic macroeconomic framework

Since the publication of the May 2022 *Inflation Report*, the effects of Russia's invasion of Ukraine have continued to intensify at multiple levels, resulting in adverse influences on all European economies. Although some of the risks associated with this conflict and reviewed in the previous *Report* materialised, the level of uncertainty surrounding economic, geopolitical and social developments continued to increase, in spite of its being already assessed as unusually high. Thus, tensions in energy markets lingered on, agri-food commodity prices rose above expectations, the investor sentiment in financial markets deteriorated, bottlenecks in global value chains persisted, while actual inflation and economic agents' inflation expectations posted new increases, in most cases significantly above the inflation targets adopted by central banks. Against this background, the medium-term macroeconomic outlook for both the external environment and the domestic economy worsened.

The Box in the previous *Report* highlighted Romania's low trade and financial exposures from bilateral relations with Russia and Ukraine, therefore anticipating a contained direct impact of the military conflict on domestic economic developments. Nevertheless, the indirect effects, passed on especially via the activity of Romania's main trading and financial partners, were assessed as likely, with their magnitude depending on the extent and duration of the conflict.
The statistical data that have become available since the publication of the previous *Report* reflected, to a certain extent, the initial assessments of the direct effects. Thus, the domestic economic activity in the first quarter of this year surprised significantly to the upside and, even in the event of considerably more modest developments in the economic activity as of Q2, real GDP growth rate is expected to remain robust for 2022 overall. The continuing military conflict and the escalation of the related geopolitical tensions led, however, to an unfavourable revision of the projections on the external macroeconomic environment, adversely impacting medium-term domestic forecasts. The main channels through which the detrimental effects of the Russia-Ukraine war may affect the domestic economy refer to the trade channel, the financial channel, investor confidence and migration[1].

Under these circumstances, the partial materialisation of the risks previously pointed out suggests also a higher likelihood for risks related to the projection interval to materialise, calling for an update of a risk scenario in which the evolution and implications of the war are more severe compared to those assumed in the baseline scenario.

Effects on the main domestic macroeconomic coordinates in the event of more severe developments associated with the economic implications of the war

The risk scenario for the economic impact of the Russia-Ukraine war foresees its step-up (compared to the assumptions in the baseline scenario), *inter alia* in the event of a possible protraction of the conflict over the coming year. In this

[1] For details on how Romania's economy is exposed through these channels, see the Box entitled "Current assessments of the impact of the war in Ukraine on the Romanian economy" in the May 2022 *Inflation Report*.

context, the sanctions imposed on Russia are anticipated to be tightened, whereas the Russian energy exports to European countries are seen to be cut off across the board, causing the rationing of natural gas consumption, especially in those countries that are heavily dependent on energy imports from Russia (such as Germany and, to a lesser extent, Italy – Romania's main trading partners). At the same time, such an evolution would lead to new inflationary bouts in commodity markets[2], as well as to more pronounced bottlenecks in global production and supply chains. Thus, both crude oil and natural gas prices are assumed to stand significantly above the values in the baseline scenario, by up to 65 percent in the case of oil, while natural gas prices are expected to double by year-end; the tensions in the market are anticipated to ease subsequently, but only at a gradual pace. In addition, agri-food commodity prices are seen to rise further, reaching levels of up to 30 percent higher than the current ones.

In light of these assumptions, the impact on economic activity is assessed to be significant in terms of EU effective GDP as well as domestically, causing a lower real GDP growth rate this year and a negative rate of change in 2023 (the cumulative impact in 2022-2023 on economic activity is seen to hover around -5 percentage points compared to the baseline scenario, for both the EU effective growth and domestic GDP dynamics). Under this scenario, the economic activity would fall for several quarters in a row. Although in the case of Romania direct effects are expected to be lower given its lower energy dependence on Russia compared to its main trading partners, the influences passed along through indirect channels, primarily trade and financial relations with the EU and economic agents' confidence, are projected to be more substantial. In addition, domestic vulnerabilities associated with the twin deficits (budget and current account deficits), which built up in the Romanian economy over the last years, would lead to rises in the sovereign risk premium, in the context of higher uncertainty and more restrictive financial conditions, causing a weakening of the leu against the major currencies.

Table A. Annual CPI inflation rate in the risk scenario versus the baseline scenario

	Baseline scenario		Risk scenario	
	2022	2023	2022	2023
Annual CPI inflation rate (%, end of period) *of which:*	13.9	7.5	15.2	11.2
– adjusted CORE2 (pp, contribution)	7.1	3.4	7.6	4.3
– energy (pp, contribution)	4.6	3.2	5.3	6.0

Turning to the CPI inflation rate, the significant and persistent hikes in energy commodity prices will fuel domestic inflationary pressures, its elevated double-digit levels lingering for a longer period of time, throughout the coming year (the cumulative impact in 2022-2023 on the inflation rate is foreseen to hover around +5 percentage points compared to the baseline scenario – Table A). At the same time, the core inflation rate will come under additional pressures from agri-food prices and bottlenecks in production and distribution chains, *inter alia* via the inflation expectations channel. In this context, the indicator is forecasted to run significantly above the baseline scenario by the end of next year, despite stronger disinflationary pressures via the demand channel.

2 Although shocks are assumed to have slightly lower magnitudes in the short run than those considered for the risk scenario in the Box presented in the previous *Inflation Report*, given that some of the risks referred to therein have already materialised, they are seen fading out more slowly in the medium term.