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Managing risk, enabling trade

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It's still about inflation

Atradius Economic Outlook

Atradius Economic Research

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Executive summary

The global economy is performing better than we expected at the start of the year, which means that a 'stagflation' scenario has been averted for now. The reopening of the Chinese economy after Covid along with resilience of the US and eurozone economies to high energy prices are bringing relief to global growth in 2023. However, the full effect of monetary tightening on demand is still to be felt, keeping our 2023 and 2024 outlook subdued. We consider a deepening of persistent inflation to be the main risk to our outlook. The further central bank rate hikes that would be necessary in such a scenario, would push GDP growth in the US and eurozone in or close to negative territory.

Key points

- Global GDP growth is forecast to slow to 2.2% in 2023 from 3.1% in 2022. Despite the slowdown, the 2023 forecast is significantly better than what we expected six months ago. There are two major reasons for this upgrade. First, the reopening of China after the sudden reversal of the zero-Covid policy that happened earlier this year. Second, the US and eurozone economy proved more resilient to 'stagflation' forces, such as the energy price shock and sanctions on trade related to the war in Ukraine. For 2024, we foresee 2.1% growth globally. This is a subdued growth rate in historical perspective, as the full effect of monetary policy tightening and sticky inflation are increasingly felt.
- As energy prices decline, headline inflation has moved past its peak. In major economic regions such as the eurozone and US, core inflation (inflation excluding energy and food) remains sticky however. Underlying this is the gradual normalisation of demand after the pandemic. Demand switching back from goods to services such as travel, hospitality and events is driving up price pressures in the services sector in particular. With monetary policy tightening gradually taking effect, we expect inflation to come down significantly over the forecast period.
- We forecast global trade growth to slow down to 1.9% in 2023, from 3.2% in 2022. The trade forecast for 2023 is better than previously expected as GDP growth in the US and eurozone turns out more resilient and China's reopening has a beneficial impact. For 2024 we predict a slight recovery of trade growth to 2.5%. Our forecast is in line with the prediction that the relationship between trade growth and GDP growth has settled down to 1:1.
- We project GDP growth across advanced markets to reach 1.0% in 2023, better than the stagnation expected at the beginning of the year due to consumer resilience. But as the effects of monetary tightening are increasingly felt, growth in 2024 remains very restrained at 0.9%.
- GDP growth in emerging market economies (EMEs) is forecast to stay in lower gear at 3.9% this year and 3.8% in 2024. Under the headline figure lies substantial heterogeneity. Emerging Asia is set to lead other regions again as China's economy rebounds from Covid lockdowns. Latin America, struggling with structural weaknesses and political uncertainty, will lag other regions.
- In our baseline scenario, inflation is expected to come down as monetary tightening has its effect on demand, compounded by stricter lending conditions. There is, however, the ongoing risk that inflation persists. If such a scenario plays out, central banks will have no choice but to hike rates further. This is then likely to push GDP growth in the US and eurozone in or close to negative territory.

1. The global macroeconomic environment

Weak, but not that bad

In our December 2022 Economic Outlook we made a case for a period of mild stagflation - economic stagnation in combination with high inflation. This was reflected in the title of the document: 'Stagflation light'. Six months on, it turns out that economic development is indeed weak, but not nearly as bad as feared back then. This improvement highlights the high level of uncertainty surrounding the global economy.

It is not that we had no good reasons to forecast a negative growth environment for the US and Europe, and very weak economic development for other parts of the world, including power house Emerging Asia. We had three, solid-looking reasons. First, inflation. This resulted from supply and demand imbalances inherited from the Covid-19 pandemic, leading to value chain bottlenecks and skyrocketing transport costs. It was subsequently aggravated by the war in Ukraine that induced commodity price rises. Inflation is supposed to put a brake on demand, especially household consumption, and thus restrain GDP growth. Second, monetary tightening by central banks. In order to fight inflation, these institutions, notably the US Federal Reserve (Fed) and by the European Central Bank (ECB), started hiking interest rates, stopped purchasing bonds, and later on even started selling bonds. Higher interest rates that come with this drive up financing costs and in that way restrain demand, more specifically investments by firms. Again, it puts a brake on GDP growth. Third, growth in China, the world's second largest economy, was held back. Zero tolerance Covid-19 policy, leading to testing, quarantining and lockdowns dominated the country even in late 2022. This, in combination with an evolving property crisis, had a negative effect on production as well as consumption, and thus on GDP growth.

So what changed to drive the improved outlook? Most prominently, of course, the reopening of China after the sudden reversal of the zero tolerance policy since December 2022. It is boosting Chinese consumption as well as production in 2023, positively affecting growth in China itself, but also in the rest of the world. Chinese supply chain disruptions are removed and import demand from the country will rise. This underlying stagflation force was therefore largely eliminated.

The other pleasant surprise came from Europe and the US, which have proven more resilient than expected to stagflation pressures. Economic activity in Europe has weathered the energy price shock and sanctions on trade related to the war in Ukraine relatively well so far. Governments put in large sums, to the order of 1.3% of GDP in the EU, to shield households and firms from the rise in energy prices. Helped by a relatively mild winter, energy consumption savings by households were higher than expected. Firms proved rather flexible in adjusting processes. This, in turn, dampened and later supported the decline in energy prices. The result was that consumption and investment held up better than expected. Finally, in the US monetary tightening did not bite as hard as initially envisaged. The US labour market remained very tight with unemployment below 4%. Not worried by unemployment and with large accumulated savings during the pandemic, the US consumer has kept up consumption. This was a stronger than expected impetus from GDP growth.

Here the positive news stops. The other two, strongly related and powerful, stagflation forces still linger. Inflation is coming down relatively quickly, helped by positive base effects and declining commodity prices.[1] But not as fast as hoped. Especially core inflation, that is inflation excluding the volatile food and energy price components, is proving stickier than expected. This as such is also not surprising, given the energy crisis resilience in Europe and ongoing spending by the US consumer. In reaction to this, monetary tightening has arguably been more aggressive than initially expected. That such tightening has side-effects became clear in early March, when the failure of Silicon Valley Bank (SVB) in the US sent a shockwave through global financial markets. The impact of this has so far been contained, but will clearly bolster the effect of tightening on demand as we will elaborate below. While China's reopening and consumer resilience in advanced markets improves growth prospects, the prevalence of elevated inflation and tight monetary policy keep the 2023-2024 outlook weak.

Moving away from stagflation

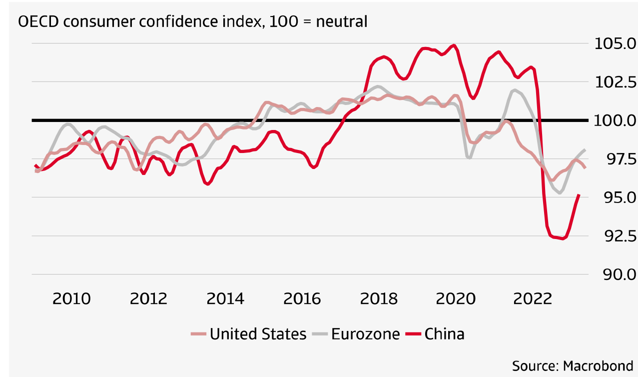
A more resilient Europe, a stronger-than-expected US economy and a reopening China imply that the impact of stagflation forces are less keenly felt in 2023. Indeed, the previously forecast neutral or negative growth in 2023,

[1] Energy price rises were at the heart of the surge in inflation during 2022. Had they remained constant, this would have had a downward effect on inflation; inflation is no more than a comparison between the price levels in two years. This effect is reinforced if, as happened, the energy prices decline.

especially in the US and Europe, is no longer on the cards. Sentiment indicators concur with this view.

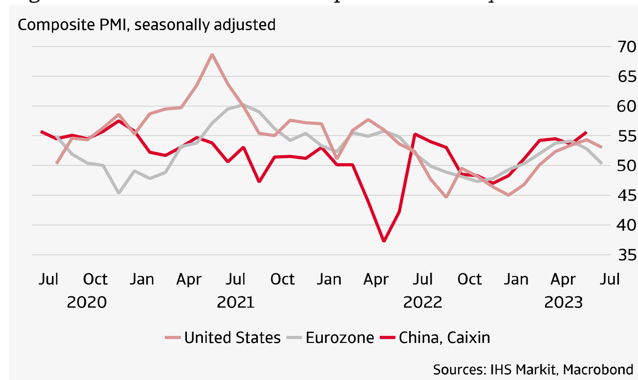
The negative trend in consumer confidence, still clearly visible in late 2023, has reversed. Yet all major global economies, the US, the eurozone and China remain in negative territory (below 100). This indicates that consumers will remain careful with spending decisions. For the US and the eurozone this is not surprising, given that inflation is still significantly above levels that consumers have been used to over the past decade. So is monetary tightening, that feeds back into consumer spending, directly via interest rate costs for borrowers, and indirectly via wealth effects for homeowners as well as asset portfolio holders. For China, the impact of abandoning the 'zero Covid' policy is a major factor for what now seems a recovery in consumer sentiment. However, the level of consumer confidence is still pointing at cautious consumer spending. Overall, a picture in line with a better but still weak GDP growth for the short term, in 2023.

Figure 1.1 Consumer confidence on the way up



Business sentiment indicators even go one step further. Purchasing managers' indices (PMIs) are not only improving in the US, the eurozone and China, but are also in positive territory. That is to say: all above 50, a level signalling growth in the order portfolio and thus GDP. It should be highlighted that this growth is determined by the services PMI, which is improving and robustly in positive territory, in all regions. Manufacturing PMIs are indeed painting a far less positive picture, with that of the eurozone still below 50 and those for the US and China only marginally above that benchmark.

Figure 1.2 Business confidence in positive territory



Several factors come into play that explain the difference in services and manufacturing PMIs. First, the recovery from the pandemic was led by services. This is the switch back from goods to services that we alluded to in previous Outlooks. For services, such as tourism, hospitality and the like, the pandemic had put a brake on demand. That was expected to be compensated for after the easing of pandemic restraints, to some extent at the expense of goods. Second, monetary tightening and the resulting increase in financing costs weighs heavier on manufacturing firms. These simply need more financing than firms in the services sector. Third, energy costs also weigh more heavily on manufacturing. This means that, though the energy crisis is fading, the remaining high energy costs weigh more on the manufacturing sector.

The analysis of the previous section as well as the development of the sentiment indicators all point to stronger growth in 2023. That is reflected in our baseline forecast which has been revised upward by 1.0 percentage point (ppt) globally. All regions contribute, with an above-average revision for the US by 1.7 ppt. Emerging Asia growth was upwardly revised by no less than 1.6 ppt, with the China reopening clearly playing a large role (1.3 ppt upward revision). Even Eastern Europe, including war-stricken Russia and vulnerable Turkey, faces an uplift For 2024 the picture, with the exception of Emerging Asia, points in the reverse direction. This should not come as a surprise. In the December forecast, 2024 was seen as a year of recovery. Our latest forecast foresees a better 2023, but a worse 2024 compared to six months ago. Moreover, the full impact of monetary tightening, which works with lags on demand, and stickier inflation is still to be felt.

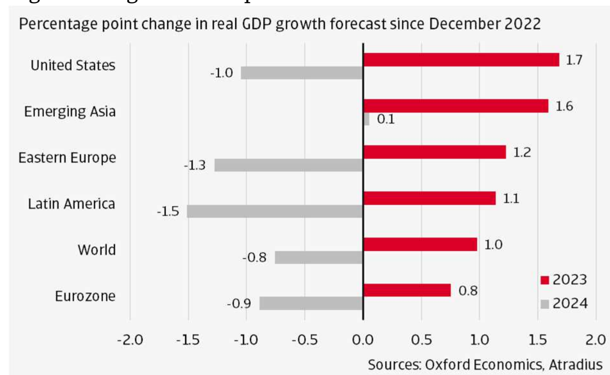
Global growth in 2023 is now forecast to be 2.2%, which is indeed weak, an improvement compared to what we expected six months ago. This conclusion can also be drawn for the US and the eurozone as well as Latin America and Eastern Europe. With 5.3% growth, Emerging Asia is again the global carthorse. For 2024 this growth pattern does not fundamentally change for the eurozone, Emerging Asia and Latin America. Significantly higher growth is expected though for Eastern Europe, driven by a recovery from a 2023 slump in Russia and Turkey. The resulting global growth, however, is a slight fall to 2023 at 2.1%.

Table 1.1 Real GDP growth (%) – global regions

	2021	2022	2023f	2024f
Eurozone	5.3	3.5	0.6	1.2
United States	5.9	2.1	1.3	0.4
Emerging Asia	7.8	3.8	5.3	4.9
Latin America	6.9	3.6	1.3	1.0
Eastern Europe	7.0	1.8	1.4	2.2
World	**6.2**	**3.1**	**2.2**	**2.1**

Sources: Oxford Economics, Atradius

Figure 1.3 Significant improvement in forecasts for 2023



Baseline assumptions fairly stable

Our forecast which we further develop in this chapter and beyond comes with a number of assumptions. While we have written them now somewhat more compactly, in essence they have not changed since the December 2022 Economic Outlook.

First, the timing of the end of the military conflict is highly uncertain. Whenever that may happen, the tensions between Russia and the western coalition led by the US, UK and EU are expected to last well beyond a ceasefire or peace deal. Therefore, the upward pressure of the war on commodity and food prices is expected to last and remain at the current level. It means we expect no new spikes in energy or food prices to arise. Gas rationing in Europe over the coming winter is likely to be avoided. Sanctions remain in place over the forecast horizon.

Second, the World Health Organisation (WHO) has formally declared the Covid-19 pandemic to have ended. China has abandoned its 'zero Covid' policy. If this virus, or any other, flares up again we assume no return to lockdowns and if so, they may be temporary and with much less impact on the economy and society in general. Pandemic-related supply chain tensions have abated, as has the exorbitant pressure on transport, airborne and maritime, and the related inflationary pressures, and will not return.

Third, supply restrictions during the pandemic and the unprecedented government support during the energy crisis led to excess savings. Excess savings were in the range of 5.1% to 9.2% of GDP for the eurozone, US, UK and Japan by the end of 2022.[2] The US consumer has so far been most prominent in spending these, with milder spending by UK and Japanese consumers, and very limited by the eurozone consumers. This pattern is expected to continue.

Fourth, the pandemic support programmes by governments have all ended now. The expected reduction in government deficits was slowed down by new support programmes intended to offset the rise in energy prices. As energy prices have calmed down, we expect the programmes to be scaled back now that their use is limited. That implies fiscal consolidation is likely to occur, if only gradually. This is also necessitated by the hikes in interest rates that will gradually start weighing on government budgets. Governments, especially in advanced economies, are nevertheless expected to continue using fiscal policy to mitigate the impact of economic shocks.

Fifth, inflation is expected to come down as the forecast period progresses, with speed and pace varying per economy. Our assumption is that no new shock to energy prices will occur, meaning that source of inflation will dry up. Inflation will be brought down by base effects. Another source of inflation, supply chain tensions, has also faded. Tightening of monetary policy will ultimately weigh in too, as will more fiscal policy restraint. The key assumption though is that wages will not rise as much as prices, so that a vicious wage-price spiral is avoided. To that end, anchoring of inflation expectations is key, and that is what we currently see and expect to continue as well. We see no switch to a permanently higher rate of inflation.

Sixth, whereas the forces that bring inflation down are strong, the process is delayed by more resilient economic growth. As a result, headline inflation is not expected to fall back to target until well into 2024 and perhaps later. But given the aggressive rate hikes in 2022 and 2023 so far, we think the end of monetary tightening is nearing. The tightening impact of turmoil in the US banking sector in the early spring has reinforced this point. Interest rate cuts cannot be expected this year in the major advanced economies, barring more weakness in the economy. Gradual balance sheet reduction of central banks, through redemption of bonds purchased during the crisis, will continue.

Seventh, the risk of deglobalisation and even regional fragmentation has clearly grown. China is not distancing itself from the Russian stance in Ukraine, which has reinforced the stress in its relationship with the US. The EU has awoken to a new reality. This puts pressure on existing supply chains that have just recovered from the pandemic and will increase the cost of trade, if only gradually. Still no decoupling is on the cards in our baseline in the relationship between the major economic powers. Neither is there any meaningful thawing in the relationship between the US and China. Tariffs and non-tariff barriers that have been erected over the recent years remain in place.

Eighth and last, 'scarring', meaning damage to the skill set of workers and productive capacity of capital owing to the pandemic has remained limited. Likewise its impact on productivity and potential GDP. This is due to the unprecedented government support during the pandemic. Meanwhile new technologies such as artificial intelligence create upward potential to productivity.

[2] See Excess savings can still deliver an upside surprise. Research briefing. Global. Oxford Economics, May 10 2023.

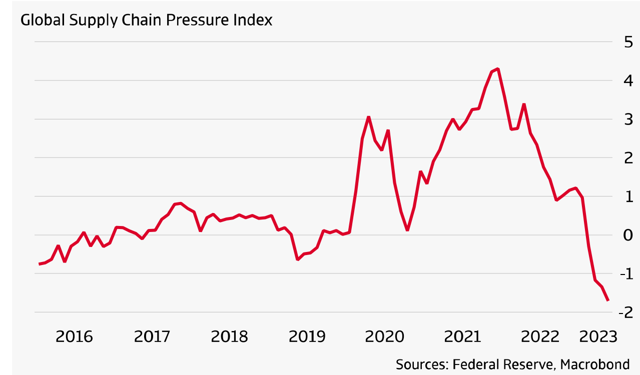
Trade growth slowdown less severe

Trade growth amounted to 3.2% for the full year in 2022, marking a significant decline in the growth path during the second half of the year. That was expected as the first half of 2022 contained lagged effects of the past pandemic trade recovery in 2021 (10.4% growth). The decline was expected to continue into 2023 given the weak economic environment. That weakness now turns out to be less severe. This is reflected in an upgrade, albeit limited, of our global trade growth forecast to 1.9% (from 1.5%) for 2023 and 2.5% for 2024.[3] This is confirmed by forward-looking indicators such as the global new export orders index (Figure 1.4). This has markedly improved, suggesting stronger growth over the summer and into the autumn. With this forecast, we stay in line with what we believe the relationship between trade growth and GDP growth has settled down to: 1:1.[4] Therefore, the trade slowdown is less severe than previously expected.

Figure 1.4 Export orders signal trade growth improvement

Let us look a little more closely at the drivers of our trade growth upgrade. The good news is, most obviously, that import demand will benefit from the better-than-expected GDP growth. As we saw, the US and eurozone look to be fending off negative growth in the full-year 2023. The reopening of China will also have a beneficial impact on import demand. Moreover, China's reopening has another beneficial impact on trade. During the period of zero tolerance and accompanying lockdowns, trade was diverted to other countries, notably in Southeast Asia. To the extent that this was driven by the zero tolerance policy, this trade diversion is temporary and more costly. That trade can now be recaptured by China, indeed lowering trade costs. This has a beneficial impact on trade growth. Finally, supply chain constraints have fallen significantly, also pointing to lower trade costs. The global supply chain pressure index (Figure 1.5) is now even below pre-pandemic levels.

Figure 1.5 Supply chain pressures below pre-pandemic levels



Other factors remain a drag on trade growth. First, higher financing costs as a result of monetary tightening have a negative impact on trade. Especially capital goods trade, requiring more finance, is affected. US, German and Japanese capital goods exports were down by around 2.5% y-o-y in the early months of 2023. Second, foreign direct investment flows are under pressure. The IMF signalled a decline from 4% to 1.7% of GDP since 2018. Whereas this also reflects the impact of tax driven moves by multinational firms and flagging mergers and acquisitions, the underlying trend in greenfield foreign direct investment is also negative. Third, GDP growth is largely determined by services growth, with manufacturing remaining weak as we saw above. This was largely expected during the post pandemic recovery, with demand swinging back to services. The trend is compounded by the energy price rises that hamper production in countries like Germany. Energy savings have supported mitigation of the impact, as have lower energy prices. But it is mitigation, not elimination of the impact. Goods production, including intermediary goods and therefore trade in goods, remains supply side constrained. Fourth, the EU and Russia trade collapse continued. Whereas exports of goods to Russia from the EU are now fairly stable at 50% of the pre-war level, the full effect of the ban on crude oil and petroleum products is still to be felt. Natural gas is unsanctioned but Russia minimised gas flows in 2022, now accounting for only 10% of the EU gas imports (previously this was around 40%). Pipeline flows are only 10% of the previous flows,[5] the rest comes from LNG imports. Trade lost between Russia and Europe will be diverted, but it will take time and comes at a higher cost: trade therefore becoming less efficient. For now, Russia is delivering oil to China and India. Fifth, whereas no signs of decoupling from China exist, a more cautious attitude does. This is reflected in trade figures, especially those between the US and China. US imports coming from China fell in the final quarter of 2022 to 13.9% of total imports, from 21% in 2018 before the Trump tariffs were imposed. In particular, electronic equipment slumped (40% to 27% of imports) as well as electronics and computers (50% to 30%). For now, China has maintained its

[3] We focus on trade in goods volumes.

[4] See for this WTO Global Trade Outlook and statistics, April 2023, Chart 1. That picture also highlights that trade growth is also moving mildly above GDP growth. In a downturn, trade growth is below GDP growth and vice versa.

[5] Notably through Ukraine.

share in Europe's imports. But upcoming restrictions on tech exports by countries such as the Netherlands signal pressure on trade.

Looking at various sectors, we see effects of unwinding of the pandemic and thus the switch from goods to services demand. This shows a success story in services, especially in travel and transport. These were precisely the sectors that were hit hard by the pandemic. Now, countries such as the UK, France, Spain and Italy have recovered their lost ground. The US, Japan, Australia and Thailand have not. It is here that the restrictions in China are still felt, but this will change now that China is reopening. Lingering effects of the pandemic will fade, thus creating upward trade potential in automobiles (8% below pre-pandemic), aerospace products (40% below) and tourism as they return to normal. Semi-conductors, however, flourished during the pandemic as consumer demand for electronics soared. This trend is now being reversed: demand in 2022 was 25% lower than in 2021 and back to the 2019 level. Advanced economies in Asia with stakes in these sectors, such as South Korea and Taiwan are bearing the brunt. Chinese semi-conductor exports also fell back, partly reflecting its zero tolerance policy. Overall, the sectoral winners of the pandemic are now losing, and vice versa.

Zooming in on regions, we see most regions recording trade growth to the tune of 5% in 2022.The major exceptions, dragging down the overall figure, are China (-2.5%) and Eastern Europe (-19%), which includes Russia (Figure 1.6). With the above sketch of developments of the factors underlying trade growth, this does not come as a surprise.

Figure 1.6 Trade growth continues to decelerate

Fossil fuel price slide halts

Energy prices have slid further. The oil price is a case in point. Since the June 2022 peak of USD 130 per barrel Brent after the shock of the Russian war it has embarked on a downward trajectory. It has now somewhat calmed down, hovering between USD 70 and USD 90. Russian oil kept flowing to the markets. A better than expected global economy, the reopening of China and the OPEC+ production constraints provided price support.[6] Gas prices, more precisely European gas prices, peaked in September 2022 at unprecedented levels amid fear of shortages after Russia cut its pipeline supplies to Europe. As European households and firms quickly adjusted, helped by a mild winter, prices started to come down rapidly. The same pattern, though far less pronounced, can be seen in US and Asian markets. The rapid decline of gas prices has outpaced those of coal, so that the latter has lost its competitive advantage as an input in the power sector.

This pattern of lowering prices is not expected to last. We think oil prices will remain within the current range as the forces on the supply side roughly balance. This is significantly higher than prior to the Russian war. A further gas price slide is also not on the cards. It has a bottom determined by the liquefied natural gas (LNG) price, which is a factor 2-3 higher compared to pipeline gas. Coal prices are expected to decline but remain higher than before the pandemic as well, helped by reduced demand and higher carbon prices. In short, fossil fuel prices are mostly expected to move sideward during the forecast period. Levels will remain higher than pre-war. Let us look in more detail at these markets now.

Oil. Various factors have determined the oil price movements in the said range during the first months of 2023. On the supply side, after the USD 60 price cap in December for crude oil sales to sanctioning countries last year, the G7 imposed a price cap on oil product exports of USD 100 and the EU an embargo and Maritime Services Ban,[7] both in February. The idea is to reduce crude oil and crude oil products revenue for Russia, while limiting the disruption to the market. So far it has worked out well, in a sense. Russia is selling its oil at a discount at an estimated value of USD 10-15 below the price cap, indeed restraining the revenues. Oil has also kept flowing to the market. Not to the sanctioning countries though, but rather to Asian markets, such as India and China. The maritime services ban is reportedly being circumvented by a 'shadow fleet' of aged oil tankers operating outside usual maritime channels. This comes at the cost of longer journeys and risk of spills. Meanwhile, other OPEC + countries' oil supply rose by 3 million barrels per day in 2022. But this is below the announced production targets. In the first part of 2023 that shortfall was about 2 million barrels per day (mb/d), especially in Angola and Nigeria. With this in mind, the announcement in April by OPEC+ to cut production by another 1.7 mb/d until end-2023 (including a Russian cut of 0.5 mb/d) came as a surprise. [8]Surprise it may be, it does provide support to the oil price. Meanwhile, US oil production, accounting for about 10% of global production, was slightly higher in the first months of 2023, but its upward potential is limited. The number of drilled but uncompleted wells is now lower than before and

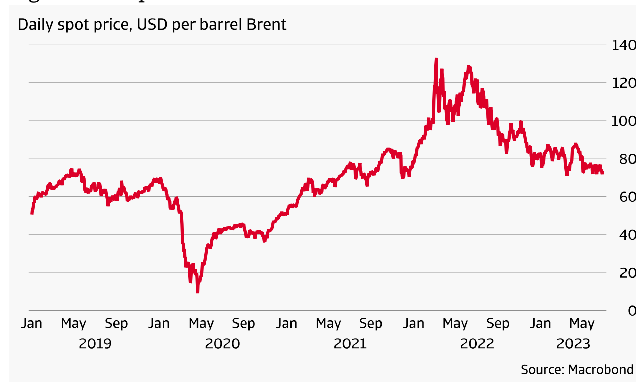
[6] OPEC+ includes Russia.

[7] These include a ban on insurance of ships carrying oil at purchase prices above USD 60.

[8] In June, Saudi Arabia added a voluntary reduction of 0.5 mb/d, while OPEC+ agreed to extend the production reduction into 2024.

there are labour shortages as well as high wage and other input costs.

Figure 1.7 Oil price slides

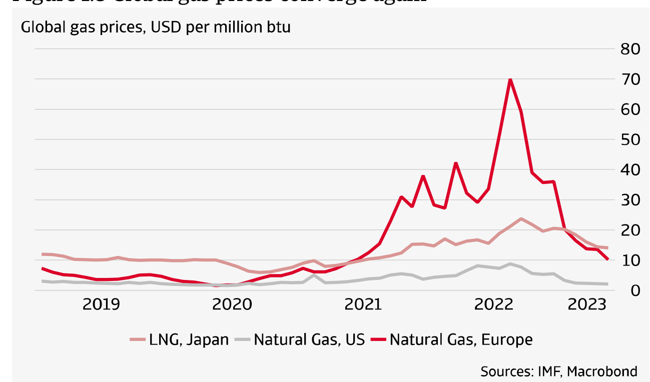


Moving to the demand side, while monetary tightening continued to rise, the economy weakened, albeit less than expected. This had an impact on oil demand, especially in the US and Europe. Q4 2022 oil demand in Europe was 0.7 mb/d lower y-o-y, especially from the manufacturing sector. Nevertheless, better-than-expected demand developments support the oil price. China plays an important role in this. It fell by 3% in 2022, and even 31% for aircraft fuels y-o-y in Q4 2022. China's reopening has led to expectations of rapid growth of demand for oil. The country is the second largest oil consumer after the US. In the meantime, as during the last months of 2022, demand exceeded supply and inventories were drawn on. This has now halted. In January commercial inventories rose to their highest level since September 2021, reducing that source of price volatility. Still, government stockpiles that were drawn on after the early phase of the Russian invasion have yet to be replenished. This process may take years.

Our forecast of an oil price moving sideways, while remaining volatile, is supported by an expected oil consumption rise of 2% to about 102 mb/d in 2023, which is a new all-time high. Demand is expected to peak in 2024, after which the energy transition will weigh in more heavily. This is supported by the expected recovery in China, covering about half of the expected demand rise. Other Asian countries will account for most of the rest of the surge. In the rest of the world, weak industrial activity and ongoing transition to a low carbon-emission economy will be reflected in sluggish demand growth. It is particularly the resurgence of travel and travel related activities that will contribute significantly to global demand growth. Production is anticipated to show a slightly smaller increase, to 101 mb/d, also an all-time high. The production expansion will mainly come from the US (adding 1 mb/d), Brazil, Guyana and Norway. OPEC + supply will remain flat, implying a mild decline compared to 2022. Russia's production is expected to decline by 0.4 to 0.8 mb/d. The now anticipated supply shortfall for 2023, and potentially 2024, will obviously have to be met, by drawing on inventories, or indeed, lower demand in combination with more supply. As we have mentioned in previous Outlooks, a major risk is a shortfall of investment, especially in upstream activity, to cover the longer term remaining oil demand. So far, there have only been muted signs of increased investment.

Gas. As global gas prices came down, large price gaps emerged between the three global markets. European and US prices plunged more than 50 % in Q1 2023 (versus Q4 2022), the Asian benchmark by almost 10%. As a result, the latter ended up twice above its pre-pandemic average, the European benchmark by a factor 1.3 above, but the US one was 16% below it. This narrowed the unusual price gap between the European and Asian benchmark existent since 2021. In particular, increased LNG trade to Europe supported this.

Figure 1.8 Global gas prices converge again



Global gas demand fell 2% in 2022. Particularly in Europe demand was lower, caused by high prices, a mild winter and government policies to save energy. European demand fell 8% in 2022 as compared to the pre-pandemic average. Demand from the power sector held up though as gas filled the shortfalls from hydropower and nuclear in Southern Europe. Asian demand was somewhat reduced as a result of high prices, mild weather and the impact of Covid-19, especially in China. Apart from reduced economic activity, it was also other energy supply (coal) that contributed to lower gas demand. LNG exports to China were 75% lower. The exception in this regional picture is North America, where consumption rose by 5%. Power generation in both the US and Canada contributed, as did residential demand in the US and industrial demand in Canada.

On the supply side, as Russia cut exports, other suppliers filled the gap. Production turned out stable in 2022. The Russian share in EU imports fell, from 43% in 2021 to 11% in Q42022. However, these exports were diverted, albeit partially, to (and via) China and Turkey. Predominantly Norwegian and Azerbaijani pipeline gas, and US and Middle East LNG covered Europe's gas needs. LNG price rises drove up US gas production. Inventories in Europe were filled when entering the 2022-2023 winter and have remained ample so far. In the US they are still also above five year average. Production has been relatively high against demand restrained by a mild winter and disruptions at the US export terminal.

As prices are forecast to move sideward from now, they will be significantly lower than in 2022. But they remain higher than prior to the energy crisis. There is also some downward pressure. In Europe, this is because LNG importing facilities

are coming on stream. Challenges will remain, as for the 2023-2024 winter there will be more fierce competition from LNG from Asia, notably China. For Asia there will be some downward pressure on prices. For US prices there will be some upward pressure in 2024 as demand will grow more quickly than production.

Global demand for gas will grow only marginally, with most growth coming from China. In the US and Europe, demand is expected to decline with the energy transition towards renewables weighing in. Heavy reliance on LNG imports is expected to continue in Europe. No significant overall gas production increase is expected globally. The picture of Russian gas production substituted by US (and to some extent Middle Eastern) LNG remains. A major risk is Russia cutting off the remaining gas pipe line (and LNG) supplies to Europe.[9]

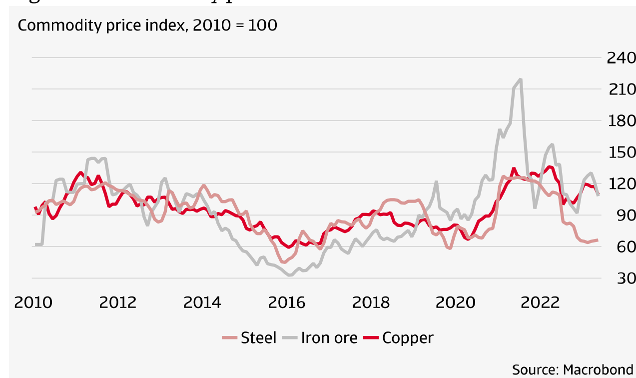
Coal. The situation for coal is somewhat different than that of oil and gas. Prices are expected to fall in 2023 and 2024 but remain higher than prior to the pandemic. After the peak in 2022, we have seen coal prices come down in Q1 2023 (q-o-q) accelerating a Q4 2022 decline. But natural gas prices have declined more significantly even to the extent that coal has lost its competitive advantage in power supply. Carbon emission price increases have contributed as well; coal is heavily carbon emission-intensive. Moreover, demand is down as inventories are up due to a mild winter. Meanwhile, production has started to increase, including in in Australia and China. This, as well as the ongoing energy transition away from fossil fuels, is setting the scene for further downward pressure on prices for coal.

Lower but still elevated commodity prices

In our December 2022 Outlook we already mentioned the pressure on metals prices coming from the weak economic environment and the fact that the Russian war had pushed them up to unsustainable levels. Now, despite upward growth revisions for 2023, a weak economic environment remains, as does the said underlying downward price pressures. In essence, the same story holds for prices of food commodities such as grain and oils.

Metals. Prices of metals rose in Q1 of 2023 on the back of optimism for a strong recovery following the end of the zero Covid-19 tolerance of China and a less-weak-than-expected economic environment. Prices of all metals, though not steel, were higher. But this is not sustainable, with prices expected to decline in 2023 y-o-y and mostly flattening in 2024. For steel, the outlook is even weaker. In the first months of the year we have seen prices declining significantly, with a bottom now likely to have been reached (Figure 1.9).

Figure 1.9 Commodity prices face weak demand



For an understanding of the steel price development, China is critical, and in particular the Chinese developments in construction and infrastructure. Demand from those sectors is expected to remain weak. China's reopening should lead to predominantly services-based growth. That does not seem to fit in well with steel production growth in the early months of the year (January 2% y-o-y growth) and its expected continuation. Hence the price pressure we have seen recently. At the same time steel prices will be supported by the Chinese production cap that the authorities have been imposing, for a third year in a row now. This concurs with our view that the worst may be over for steel prices.

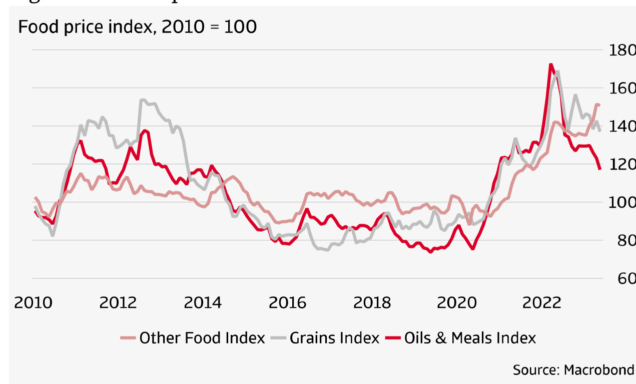
The price of iron ore, an input for steel, has increased which may not immediately look consistent with steel's weak outlook. Iron ore prices have risen by 27% q-o-q in Q1 2023 . This is unlikely to be sustainable, as that rise reflected - following the steel price rise - the initial optimism about China's reopening. As this fades, keeping in mind the Chinese government's control over steel output as well, so will optimism about demand for iron ore. Moreover, the supply side seems to aggravate matters. While shipments of iron ore were reduced due to weather disruptions in the past months, production is set to grow over the year. In the longer term, supply growth will come from new mines in Australia, Africa and Brazil, as Chinese production restraints are set to continue. Copper prices jumped 11% in Q1 2023 and are now significantly above their long-term average. Here as well, China's recovery hopes played an important part, with China accounting for 57% of global consumption. But that factor is now fading.. Moreover the slowdown in real estate sectors in some advanced economies matters. On the supply side, disruptions in mines in Chile, Peru and the Democratic Republic of Congo chipped in for price support. Again, this is unlikely to last, hence the price decline forecast. Longer term developments on the demand and supply side look more balanced. Supply growth coming from American countries and Russia as well as the Democratic Republic of Congo meets higher demand from the production of electric vehicles, renewable power and the power infrastructure.

Food. The grain price index eased almost 5% in Q12023 but it remains elevated, just like the broader food index. The Black Sea Grain Initiative, which helped most of Ukraine's grains

[9] Russian gas is not subject to sanctions.

and oilseeds reach the world, and good harvests in other major regions eased price pressures. Indeed, the oil and meal price index was more or less stable as the Russian war price rise had gradually unwound. Both indices are expected to slide further during 2023 and 2024 assuming the said initiative remains in place and harvests are good. The other food price index though, which includes oranges and sugar for example, rose in Q1 of 2023 as a reflection of the recovery in the global economy in conjunction with production decline in Spain and Italy (both oranges). Slight increases of the index are expected as Chinese demand increases after the reopening.

Figure 1.10 Food prices remain elevated



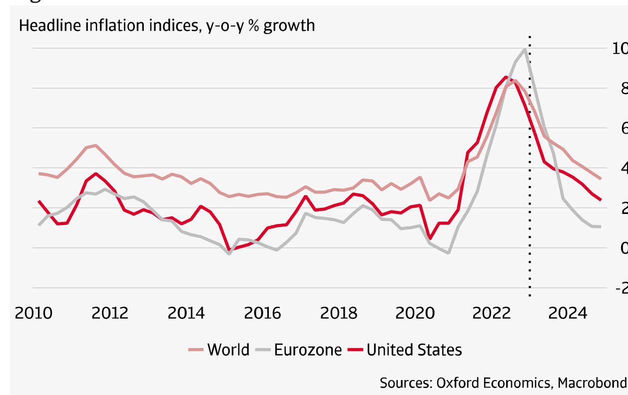
Inflation more persistent

In our December 2022 Economic Outlook we made a case that the high inflation levels seen at that moment were unlikely to persist. The reasons were the potential stagnation of GDP growth and numerous underlying factors such as moderation of energy prices, as well as lower food and commodity prices. The latter, as we have argued above, are indeed happening. The former, stagnation, now seems to have been staved off. What does this mean for our view on inflation? The answer is: fundamentally not much. Inflation is still expected to come down. But it is clear that the path of disinflation, as we call the decline of inflation, will be more protracted. In other words, inflation is more persistent. It may take us into 2024 before inflation is fully tamed.

Let us first look at the facts. On the back of lower energy prices, headline inflation is beyond its peak and has started to come down (Figure 1.11).

In the US, headline inflation reached a peak in June last year at 9.1%, fell back to 7.7% in October and was at 4.9% y-o-y in April. For the second consecutive month, energy inflation was negative. Food inflation stood at 7% y-o-y. US core inflation, which strips energy and food from headline inflation, is higher at 5.5% and declining slowly after the September 2022 peak at 6.6% y-o-y. Eurozone headline inflation peaked, later and higher than in the US: 10.6% y-o-y in October 2022 and is now back to 5.5% in June. Energy inflation in the latest two months was negative. Food (which includes alcohol and tobacco) was still very high at 11.7%, after peaking in March. Eurozone core inflation, which also strips non-energy industrial goods, is now stabilising at 5.4%.

Figure 1.11 Inflation on track to lower levels



While food inflation is still high we observe the persistence of inflation for both the US and Eurozone is particularly in core inflation. Underlying this is the gradual normalisation of demand after the pandemic. Demand switching back from goods to services such as travel, hospitality and events causes more price pressure in the latter sector, and less in the former. Services, moreover, are more labour intensive. That means more upward pressure on wages, from employees demanding compensation for the loss of purchasing power as well as employers having to lure employees into services in a tight labour market (in the US, and some of the eurozone countries such as the Netherlands).

Meanwhile, the larger emerging economies paint a rather divergent picture on inflation. China is at one end of the spectrum, with a March headline figure of 0.7% y-o-y, with low food inflation, and moderate non-food readings as a result of oil price weakness and even car price cuts. At the other end, we find Turkey where inflation reached 43.7% y-o-y in April, although it is the first reading below 50% in a year. Turkey is trapped in a range of country-specific issues, not least the unorthodoxy of its economic policy (see emerging economies section). In between are countries such as India where the economy is cooling, with inflation 5.7% y-o-y in March; Brazil where the economy is resilient, with inflation 4% y-o-y in mid-May; and South Africa which was plagued by power shortages, with inflation 7% y-o-y in February.

With the exception of Turkey, this picture of inflation compared to the US and eurozone suggests lower levels in the emerging economies compared to the advanced economies. This is indeed what research confirms.[10] There are several reasons for this. First, during the pandemic the emerging economies did not provide households with the stimulus package similar to advanced economies. As a result, there was less of a pandemic and post-pandemic demand push to inflation levels we saw in the US and the eurozone. Second, central banks in emerging economies hiked interest

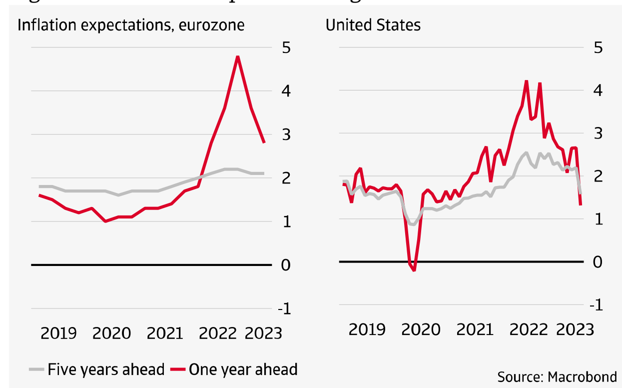
[10] Inflation looks set to drop sharply, Oxford Economics Research Briefing| Global, 16 March 2023.

rates earlier than in the advanced economies, and even before inflation started to run up due to energy and food price rises. Third, the monetary tightening in advanced markets such as the US and eurozone also helped to bring inflation down in emerging economies, due to positive spill-over effects. It kept money flows in the advanced economies, rather than what happens in a low-interest-rate environment, when money often flows to emerging economies, where it would have fuelled inflation.

The upshot is that inflation in the US and ECB is essentially a demand phenomenon. Conversely, as soon as demand starts to decline once monetary tightening really kicks in, inflation will come down. Just as it went up when governments splashed money over the economy.[11] As we have seen, demand is expected to be rather weak in the advanced economies as monetary policy tightens and government stimulus has stopped. This is consistent with our view that inflation is to come down significantly over the forecast period. Inflation may be more persistent, but it is ultimately not resistant to demand constraints.

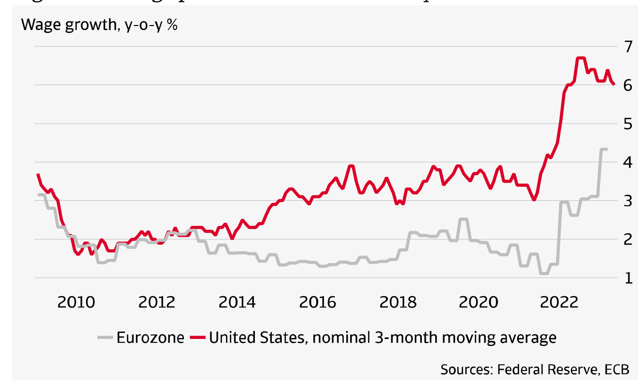
For this view to play out over the forecast period there are two conditions that should be met, focusing on the US and the eurozone. First, it is of paramount importance that inflation expectations remain well anchored. That is to say around levels close to the 2% mandate imposed by the central banks in several major advanced markets. This is an objective that should hold for the medium term. In other words, households and firms should remain convinced that the central banks are capable of 'killing the beast' over some period of time. They should be credible. What do surveys tell us in this context? (see figure 1.12) Whereas inflation expectations in the short term, being one year ahead, are declining but arguably still deviate from the 2% target this is not the case for longer term expectations. These have edged up somewhat since the crisis, but remain well anchored. Second, and in close connection with the inflation expectation argument, wage increases should be contained and clearly not surpass inflation. That would mean a vicious wage-price spiral, which could drive inflation out of control, is avoided.

Figure 1.12 Inflation expectations signal confidence maintained



What do current developments tell us here? (Figure 1.13) The fact that wage growth in the US is a lot higher than in the eurozone does not come as a surprise given the relative tightness of the US labour market (3.4% unemployment versus 7% in the eurozone). While stabilising at a high rate, US wage growth remains lower than inflation. Then for the eurozone, where data lag a bit, we still see increasing wage growth. But that growth is (very) far from the inflation levels the eurozone witnessed. With these two conditions arguably met, we feel sufficient support for our view.

Figure 1.13 Wage pressures far below worry levels



Further support for our view is found in the following factors of key relevance for inflation. First, elaborating on the demand story above, inflation as such has a limiting impact on purchasing power, and thus on demand and – ultimately indeed - on inflation itself. In countries where government support during the pandemic was generous this effect may be cushioned by the use of excess savings, but even that has its limits. Second, barring a new shock, energy and commodity prices are expected to move sideways or even slide as we have argued above. As we have argued in previous outlooks, even a sideward move of prices will have a dampening impact on inflation. That is because if the price of oil is at say USD 85 per barrel now and it is unchanged compared to last year, the inflation contribution of the oil price is zero. That is the so-called base effect. Third, as a result of the ongoing switch of demand away from goods to services, the pressure on manufacturing and supply chain diminishes. We have discussed that above: the supply chain pressure index is back to normal, or even below it. Precisely supply chain pressures as well as transport cost spikes contributed significantly to the rise of inflation. Then, we can expect inflation from that source to disappear as well.

Monetary policy right about inflation persistence

In our December 2022 Economic Outlook we made the case for monetary policy tightening to end and reverse, although we refrained from mentioning a time frame. There was still

[11] The US government topped the list with a 12% of GDP pandemic stimulus program.

some hint of the argument that inflation could be transitory in that judgement. That was based on the idea that if the underlying causes of the inflationary spike, such as surplus demand for goods during the pandemic and energy and food price spikes after the Russian invasion, were to disappear, inflation would fade as well. In such a context, the aggressive monetary policy tightening observed could only be explained by the central banks' worry about inflation persistence. Six months on, it is indeed exactly persistence that we are witnessing, and especially persistence in core inflation.

As we have become convinced, central banks, especially the Fed and the ECB that worried before us, have only become strengthened in their views. And they have continued to act in line with that. The Fed has further hiked its policy interest rates during all of the FOMC meetings,[12] from 4% in December to 5.25% in May. The pace has declined though, with the last four steps only 0.25 ppt hikes every meeting, in contrast to the giant steps of 1.25 ppt since June last year. Interest rate hikes are backed up by the reduction of the Fed balance sheet that ballooned to almost USD 9 trillion from USD 4.2 trillion during the pandemic. This reduction takes place by capping reinvestments of principal payment on securities, USD 80 billion for Treasury securities and 35 billion per month for mortgage-backed ones. Its pace is rather modest: after almost a year, the current stance of the balance sheet is USD 8.4 trillion. The Fed has to tread carefully here to avoid disruptions in the financial markets that are accustomed to ample liquidity.[13] While the balance sheet reduction is continuing, the Fed has indicated further rate hikes are now less likely, although incoming data, especially regarding the tight labour market, may trigger further action.

The ECB has continued on its tightening path, also slowing down the pace after two large steps in the autumn of 2022. Since December three steps of 0.5 ppt interest rate rises were announced, followed by two 0.25 ppt hikes in May and June to 4.0%. In contrast to the Fed, the ECB has indicated that its hiking, which started when the Fed rates were already at 1.75%, has not yet ended. Similar to the Fed though, the ECB terminated its net purchases under the asset purchase programs in July 2022. That neutralises the balance sheet growth. Balance sheet reduction started in March this year, as from that month there will only be partial reinvestments of redemptions.

Figure 1.14 Quantitative tightening restrained

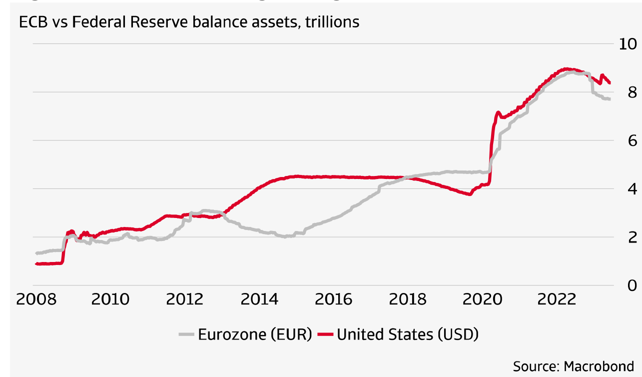
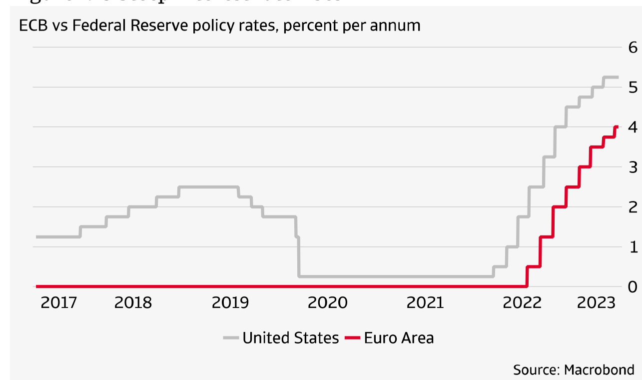


Figure 1.15 Steep interest rate rises

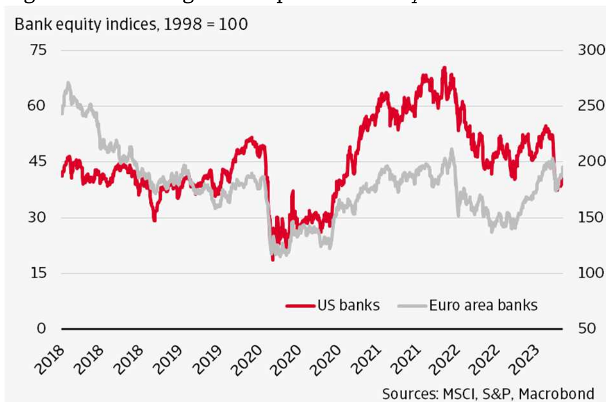


The overall picture is that monetary tightening is clearly slowing while the balance sheet normalisation continues. How should we interpret this policy development since last December now that inflation persistence, especially core inflation persistence, is still around? There are several points worth making. First, now that the persistence of inflation has become indisputable, central banks were right with their 'better-safe-than-sorry' approach of aggressive tightening by way of interest rate hikes during 2022. The fact that inflation expectations have not moved significantly, which is critical for inflation not to run out of control as we argued in the previous section, testifies that central banks have remained credible. Second, we estimate that current policy rates are actually sufficiently high to restrain demand (see box). Third, if the second point indeed holds we still have the question whether enough tightening is being done to bring down inflation and eliminate core inflation. In other words, have the central banks done enough and is the current slowdown justified? The situation became more complex when banking turmoil erupted. (see figure 1.16).

[12] FOMC stands for Federal Open Market Committee, the Fed body taking the monetary policy decisions.

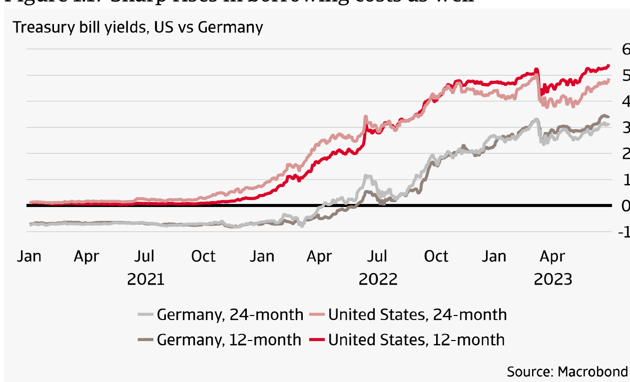
[13] During the banking sector turmoil of March the balance sheet reduction was indeed interrupted, even briefly reversed, for that reason.

Figure 1.16 Banking turmoil predominantly in US



In early March, Silicon Valley Bank of California came under stress, as did New York-based Signature Bank and later First Republic Bank. The US authorities quickly reacted and prevented contagion effects in the banking sector.[14] But the underlying issue became clear. Rapid monetary tightening has a price. It reduces the market value of bonds held by banks which for more vulnerable banks may lead to deposit runs and failure. While we do not see a new crisis on the horizon, the banking sector, especially in the US, may face some more failures.[15] What we do see, however, is that banks are becoming more careful, limiting lending to firms and households. In other words, the rapid tightening has a side-effect, or externality, in the sense that it limits the necessity of further tightening by the central bank. In fact, part of the heavy lifting of demand reduction is now being taking over by banks that restrain lending. That is what interest rate increases also attempt to achieve, and have achieved: a rise in financing costs (Figure 1.17). If one considers these points, the conclusion is that monetary policy by the Fed and the ECB is right about inflation persistence.

Figure 1.17 Sharp rises in borrowing costs as well



Box 1 Does the central policy rate actually restrain demand? In this context in the previous outlook we elaborated somewhat on the natural rate of interest, which is the interest rate that is neutral from a demand perspective. If the actual rate is below the natural rate, the policy stance is expansive, but contractionary if it is above it. The natural rate is not observable, it can only be estimated. Recent IMF research signals that this rate is just below 1% for the US and just above zero for Germany and France.[16] One should be aware that this is a real rate, meaning the nominal rate corrected for inflation expectations. If we then calculate the current real rate of interest for the US it is 5.25% and subtract the one year inflation expectation of 2.75%, we end up at 2.5%. This is above the natural rate, signalling a contractionary stance. For the eurozone, a comparable calculation gives 3.75% - 2.75% = 1%, also above the natural rate and thus contractionary if we apply this figure for Germany as well as France. Therefore, in this calculation we find some support for monetary tightening restraining demand. We point in this context to the confidence bands of the point estimates that are used for the natural rate. For the US it is between 2% and -0.5%, for France and Germany it is between 2% and -2.5% and 3% and 0.25% respectively.

Some government support for central bankers

As mentioned earlier in this chapter, during the pandemic, governments, especially in advanced economies, stepped in with large packages to soften the blow of the containment measures. That demand stimulus has kept the global economy going, but at the same time generated a side effect: inflation. First goods inflation and subsequently services inflation. But as stimulus packages are running down, so is their inflationary impact. But is this the case? The Russian war further pushed up inflation through energy inflation, creating a sense of energy crisis in Europe. It triggered government reaction to soften that blow, including announcements of plans to accelerate the energy transition.[17] This response was much softer than during the pandemic, but still has the same impact: inflation, or perhaps restraining disinflation. This raises the question: what are governments doing while the central banks are fighting inflation? Are they backing them up sufficiently?

To evaluate this we need to consider the development of the structural government balance.[18] From the very high level of 7% deficit in 2020, the figure for the advanced economies has

[14] By extending the deposit guarantee beyond USD 250,000, also for other banks, and providing liquidity support.

[15] See 'Fears of a banking sector crisis overdone'. Atradius Economic Research Notes, April 2023.

[16] The natural rate of interest: drivers and implications for policy. Chapter 2 of the World Economic Outlook, International Monetary Fund, April 2023.

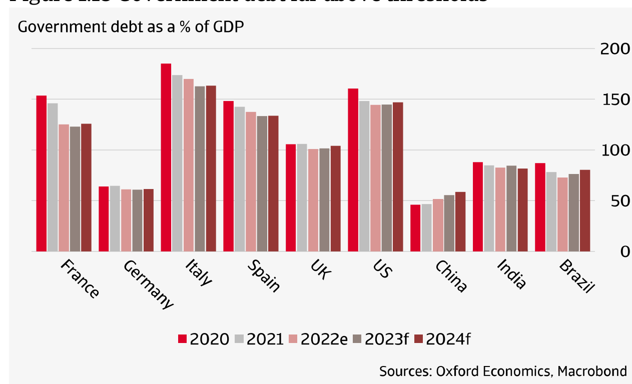
[17] See Atradius Energy Outlook, February 2023.

[18] It is the government balance divided by GDP, both adjusted for the business cycle.

come down to 4.5% in 2022. This is indeed what can be called fiscal tightening and is suggestive of governments that support a disinflationary process. At the same time, this seems to be it for now: the 2023 and 2024 forecast at 4.6% and 4.3% respectively signals only mild further tightening, and leaving a significant amount of stimulus in place. Indeed, the five-year average figure before the pandemic was at 2.4%.

Looking into the group of advanced economies, the picture is fairly heterogeneous (Figure 1.18). We make three observations. First, in 2022 very significant fiscal tightening took place, particularly in the US and UK, less so in the eurozone. Indeed, the US figure peaked at 11.4% in 2020 to be reduced to 3.7% in 2022, with a similar though slightly less pronounced pattern seen for the UK. For the eurozone, the figure came down from only 4% in 2020 to 2.8%. Second, the remaining levels imply that in 2022 there was a lot more stimulus from the government in the US and the UK than in the eurozone. This picture is not expected to change significantly over the forecast horizon, with the US and UK figures even edging up again. The eurozone structural balance figure only rises in 2023 and then falls somewhat, to 2.5%. Third, within the eurozone group of countries there is quite some heterogeneity. Spain has tightened significantly by reducing the structural deficit from 6.7% to 4.2% in 2022, a case that can also be made for Italy. Germany on the other hand has hardly tightened with figures of 2.2% and 2% respectively. This also signals that stimulus levels in the eurozone differ. Spain falls more in the range of the US and UK, whereas thrifty Germany seems a bit of an outlier in the eurozone. In 2023 and 2024, with Germany forecast to even bring back stimulus to only 1%, this conclusion is reinforced. In short, one can infer from this overview that the US and UK have been significantly more zealous in helping to reduce inflation than major eurozone countries, perhaps with the exception of Spain and Italy.

Figure 1.18 Government debt far above thresholds

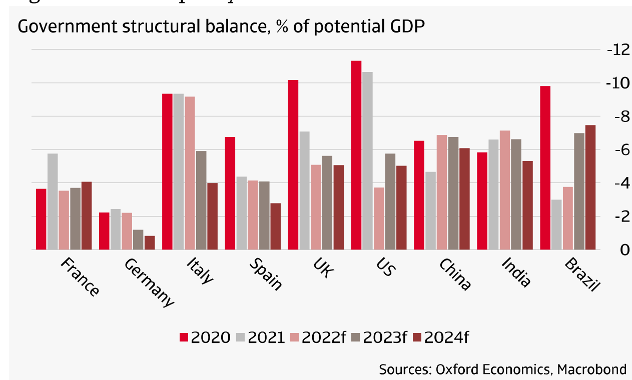


To further interpret this picture, the following remarks are relevant. First, fiscal tightening was inevitable after the large stimulus during the pandemic. Simply, with the pandemic and the accompanying healthcare measures affecting the economy disappearing over the course of 2022, the need to keep supporting the economy with large programs fell away. The energy crisis triggered support programmes in various eurozone countries, but these pale in comparison with the pandemic ones. Second, structural deficits seen during 2020, let alone those in the range of 9% to 11% for the US, the UK and Italy, are not sustainable. They have pushed up debt-to-GDP levels by an average of almost 20 ppt for the advanced economies that year, and for countries like the US and Italy to above 150% of GDP. For reference, the threshold level of the IMF for debt-to-GDP for the advanced economies is 90%. This will not be achieved by most of the countries (see figure 1.19). Third, and in close relation to the previous point, higher interest rates that come with monetary tightening will ultimately show up in the government balance as a cost. That will be a gradual process, as debt repayments on government bonds are usually spread over a number of years. It will allow governments time to adjust, with spending now naturally lower for a given government balance. Fourth, whereas fiscal tightening supports disinflation, inflation as such helps fiscal tightening as well. The point here is that as nominal GDP rises simply because of a rise in the price index, so do government tax revenues. Spending increases, on the other hand, are usually nominally fixed in advance. This means inflation reduces the government balance. It should be noted that this effect cannot create magic for government finances. It only works if there is an inflation surprise, as took place recently. Only in that case can investors be fooled as they do not properly account for inflation in the interest rate they demand. Similar for a parliament that sets limits for government spending. [19]

For the emerging economies, the picture is different in a number of ways. Large government programmes to support the economy during the pandemic were not rolled out, with Brazil a notable exception. As a result, the structural balance in 2020 in India and China did not markedly change compared to the pre-pandemic year. And thus neither did the inevitable fiscal tightening visible in the advanced economies after the pandemic occur. Yet, these countries, with the notable exception of China, are feeling the impact of inflation due to global developments particularly those sourced in energy, metals and food price rises. Monetary or fiscal policy tightening helps here. The former has happened and even started before the Fed hiking cycle. The latter, if one looks at the development of structural balances in China, India and Brazil, less so. They are relatively high as compared to the advanced economies, and will remain so over the forecast horizon (Figure 1.19).

[19] The other notable effect of inflation on government finances is that debt-to-GDP levels are pushed down. This is because debt is a nominal amount, unaffected by inflation, whereas the denominator, nominal GDP, includes inflation.

Figure 1.19 Fiscal policy remains lax



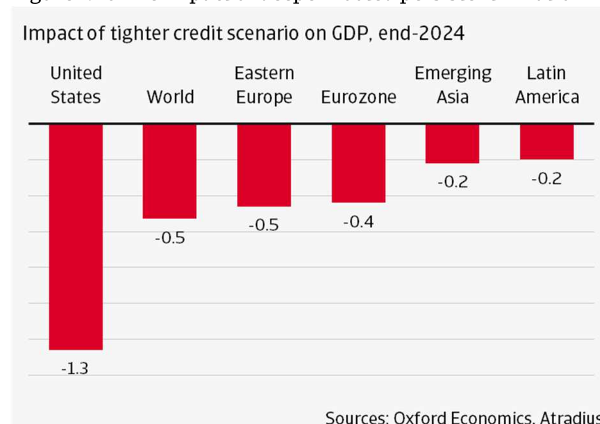
What if inflation persistence is deeper rooted

In the previous sections we have drawn the picture of a world in which inflation, and more in particular core inflation, is somewhat more persistent than initially envisaged. At the same time, this persistence is not expected to last, let alone surprise to the upside. Indeed, central bank rate hikes are now coming to an end, based on confidence that there is some lagged demand effect of the previous rate hikes that is still to work its way through the system. Banking sector turmoil, especially in the US, and its impact on lending conditions, compounds this effect. Inflation will come down to central bank mandate levels somewhere in 2024. GDP growth will be weak but gradually pick up.

But what if our forecast underestimates the pace at which these effects work out so that inflation remains higher for longer? Or even worse, if they stop working through and leave the inflation level, core inflation level for that matter, (much) higher than envisaged?

In such a case, central banks are no longer allowed to sit on their hands, a position they are now moving to. They will have to react with further rate hikes to root out inflation and in that way maintain their credibility. That may be one hike too far for the global economy, already weak because of inflation and the (monetary) policy reaction. Effects now seen in the financial markets will be exacerbated in the following scenario. Equity prices fall by more than 10% and start to generate adverse wealth effects, especially for the US consumer. Such a negative wealth effect is reinforced by perils in the housing market as mortgage costs will surpass threshold levels. The cost of capital for firms goes up further, with a negative impact on investments. Banking sector jitters will transform into real turmoil that may not be limited to the US banking sector, further reinforcing the impact of central bank tightening. Governments restrained by higher debt ratios, are not able to (and in fact should not) step in to keep the economy afloat. The US and eurozone economies enter a worse economic environment. Emerging economies are also not safe, as the continuation of US rate hikes triggers capital flows to the US. This can be countered by further rate hikes by the authorities in these emerging economies, with a negative impact on GDP growth, or they can accept the outflow of capital. In the latter case emerging economies will have to deal with the impact of imported inflation through currency depreciation, and indeed, will have to hike rates in the end as well. In short, this scenario means an even weaker global economy, in particular for the advanced economies (figure 1.20).

Figure 1.20 The impact of deeper-rooted persistent inflation



2. Developments in major economies

Advanced economies facing tighter credit conditions

While the resilience of consumers across advanced economies has continued to surpass expectations in H1 2023, it will fade in H2 as higher prices and borrowing costs increasingly impact their purchasing power. Decreasing energy prices have offered relief, helping turn consumer confidence around, but higher interest rates are finally feeding into a tightening of credit conditions. We project GDP growth across advanced markets to reach 1.0% in 2023, better than the stagnation expected at the beginning of the year due to consumer resilience. But as the effects of monetary tightening are increasingly felt, the growth outlook remains drab, with only 0.9% growth now forecast in 2024, compared to 1.8% expected at the beginning of the year.

Table 2.1 Real GDP growth (%) – advanced markets

	2021	2022	2023f	2024f
Eurozone	5.3	3.5	0.6	1.2
United States	5.9	2.1	1.3	0.4
United Kingdom	7.6	4.1	0.4	0.8
Japan	2.2	1.0	0.8	0.7
Australia	5.2	3.7	1.6	1.6
New Zealand	6.0	2.2	-0.6	2.9
Advanced economies	**5.4**	**2.6**	**1.0**	**0.9**

Sources: Oxford Economics, Atradius

Eurozone: upward revision to 2023 growth

Despite the challenging global context, the eurozone is on a stronger footing than we expected six months ago in the December Economic Outlook. A number of positive developments underpin the improved outlook. The European gas price has fallen significantly, helped by a sharp fall in gas consumption and continued diversification of supply sources. Labour markets have also continued to perform strongly. Finally, economic sentiment has continued to improve. Our latest forecast is for GDP to expand by 0.6% in 2023, 0.7 percentage point higher than six months ago. This growth revision takes place among all major economies (figure 2.1). The growth outlook for 2024, however, has been revised down due to lingering effects of high inflation and delayed effects of monetary tightening. In 2024, eurozone GDP growth is expected to come in at 1.2%, 0.9 percentage point below our expectation six months ago.

Figure 2.1 Positive growth revisions for 2023

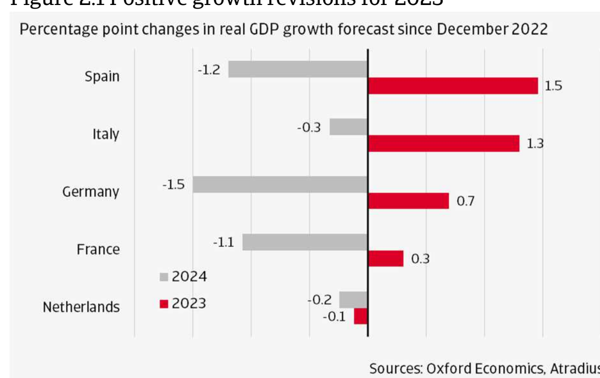


Table 2.2 Real GDP growth (%) – eurozone

	2021	2022	2023f	2024f
Austria	4.7	4.9	0.5	0.8
Belgium	6.3	3.2	1.3	1.0
France	6.4	2.5	0.5	0.8
Germany	2.6	1.9	-0.4	1.2
Greece	8.1	6.0	1.3	1.0
Ireland	13.4	12.1	0.5	4.4
Italy	7.0	3.8	1.2	0.9
Netherlands	4.9	4.5	0.7	1.4
Portugal	5.5	6.7	2.7	1.5
Spain	5.5	5.5	2.3	1.3
Eurozone	**5.3**	**3.5**	**0.6**	**1.2**

Sources: Oxford Economics, Atradius

Eurozone GDP declined by 0.1% quarter-on-quarter in Q1 of 2023. This was the second quarter of negative growth, meaning the eurozone is officially in a recession, though a very shallow one. There remains significant divergence across the region. In Q1 there were decent quarterly growth rates in some countries, such as Portugal (1.6% q-o-q growth), Spain (0.5%) and Italy (0.6%), but disappointing growth in others, such as the Netherlands (-0.7%) and Germany (-0.3%). Many indicators suggest the growth momentum remains weak in Q2. The European Sentiment Indicator (ESI) declined from 99.0 in April to 96.5 in May, remaining below the neutral level of 100.

The purchasing managers' index (PMI) was 52.8 in May, above the neutral level of 50, but with a clear divergence between the services sector and manufacturing. The services PMI (55.1) points to robust growth, while the manufacturing PMI (44.8) points to a contraction of activity. The manufacturing PMI has been showing a declining trend for several months, mostly because of worsening demand conditions. New orders, international demand, and backlogs of work are declining, the latter in clear evidence of rising spare capacity in the eurozone. The services PMI, on the other hand, was showing a positive trend, except in the last month (May). Services are benefitting from high demand and backlogs of work have increased. Companies have stepped up their efforts to boost capacity, with employment levels rising.

Export and investment growth slowing

In line with a cooling global economy, export growth in the eurozone is also slowing. The slowdown in export growth is somewhat inhibited by the good performance of the tourism sector. Falling energy prices also contribute to lower import growth, so that net trade contributes positively to GDP growth in 2023.

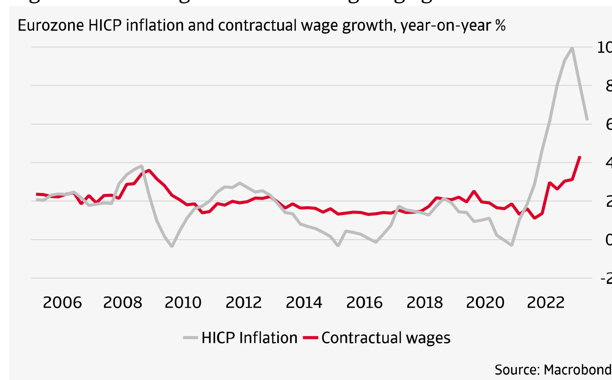
Tightening financing conditions and the global economic slowdown weigh on investment growth in 2023, but there are countervailing factors at play. Corporates still have an overall healthy balance sheet. Moreover, investment surveys still show that in both manufacturing and services companies overall expect more investments in 2023 compared to 2022. In 2024, we expect a broader recovery to take hold and to lead to higher investment growth.

Consumption growth cooling down

Private consumption remained roughly constant over the past two quarters, in contrast to the six quarters before that, when consumption grew robustly on the reopening of the economy after Covid. For 2023, we predict only very mild consumption growth of 0.2% y-o-y due to high inflation and tighter credit standards. As we expect inflation to come down in the second half of the year, the outlook for 2024 is slightly better (1.7%).

The labour market in the eurozone remains resilient. The latest unemployment figure (6.5% in April) shows that the labour market is still tight. Total employment in the eurozone increased by 0.6% on a quarterly basis in Q1 of 2023, following a 0.3% increase in Q4 and Q3 2022. Employment growth is coming mainly from business services and public services. Construction is making a mildly positive contribution. In industry, we see hardly any employment growth in recent quarters. For 2023, we predict an average unemployment rate of 6.6%.

Figure 2.2 First signs of accelerating wage growth

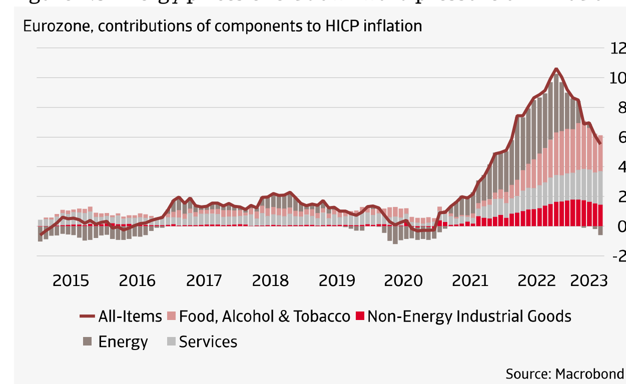


Finally, the first signs are appearing of accelerating wage growth: the indicator of negotiated wages increased by 4.3% year-on-year in Q1 of 2023, up from 3.1% in H2 2023 (figure 2.2). However, with inflation still elevated, real wages remain in negative territory (-3.7% in Q1 of 2023). Given the tight labour market, we still expect further wage pressure in the coming quarters. In combination with declining inflation, this should give support to consumers' purchasing power in H2 2023 and in 2024.

Inflation past its peak, but remains sticky

Headline inflation continued to decline in the first months of 2023 amid a sharp deceleration of energy prices (figure 2.3). The decline in inflation from 9.2% in December to 5.5% in June was driven by the energy component, which over the same period saw annual price growth decelerate sharply from 25.5% to -5.6%. Food inflation remained high in recent months, amounting to 11.7% in May 2023. Core inflation (excluding food and energy) increased slightly in June to 5.4%, from 5.3% in May. Core inflation thus remains relatively high.

Figure 2.3 Energy prices exert downward pressure on inflation



The rise in core inflation is mostly driven by services. Price pressure in services firmed in early 2023 particularly in contact-intensive services such as transport and package holidays. This suggests that reopening effects continue to play a role, particularly in sectors where persistently high demand interacts with supply-side challenges, including energy costs, labour shortages and accelerating wage growth. Inflation of non-energy industrial goods appears to have peaked in the early months of 2023 as impulses related

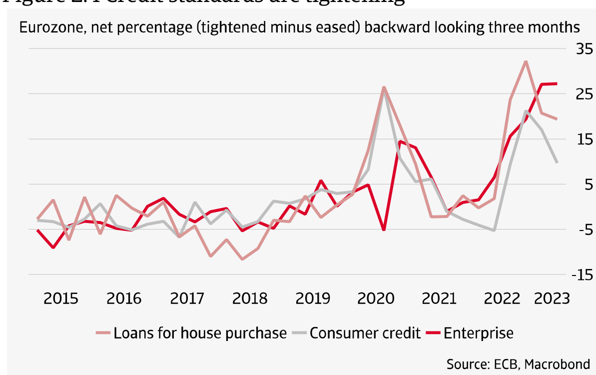
to pandemic shocks were fading out. We expect declining headline inflation in the second half of 2023, leading to an average inflation rate of 5.3% this year. In 2024, we expect inflation to be 1.4%.

Lending conditions tighten

The ECB continued its historically rapid tightening campaign at June's council meeting. It hiked the deposit rate by 25 bps, following a similar hike in May. This brought the main refinancing rate to 4.0%. The ECB will discontinue reinvestments under the Asset Purchase Programme (APP) as of July 2023. It does intend to continue reinvestment of principal payments of the pandemic emergency purchase programme until at least the end of 2024. On balance, these measures contribute to a winding down of the ECB balance sheet, which is still elevated compared to pre-pandemic levels. The ECB continues to follow a data-dependent approach to monetary policy. We expect one further rate hike in July, after which the ECB is likely to implement a lengthy pause in its monetary tightening cycle.

While the ECB still sees inflation as "too high for too long", it does acknowledge that the past rate increases are being transmitted to euro area financing and monetary conditions. This became very clear from the Q1 2023 bank lending survey. Credit standards for business loans tightened further substantially (with the net percentage of banks reporting a tightening standing at 27%) in the first quarter of 2023. Banks also reported a further tightening of their credit standards for mortgage lending and to a lesser extent for consumer credit (net percentages of banks at 19% and 10% respectively) (figure 2.4).

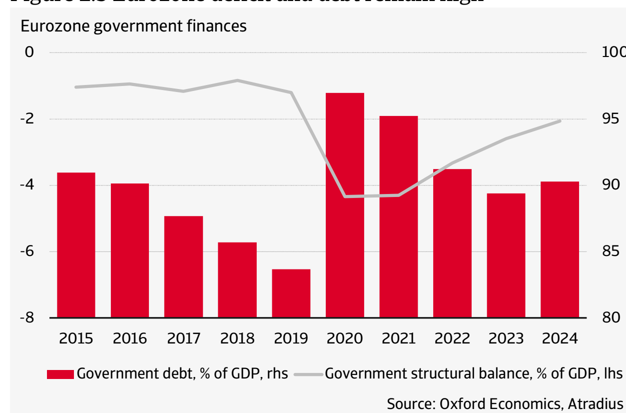
Figure 2.4 Credit standards are tightening



Fiscal policy remaining expansive

Adjusted for the business cycle, the government deficit declined in 2022 to 3.3%, from 4.3% in 2021. The deficit reduction was underpinned by the phasing out of pandemic-related temporary measures. The estimated net budgetary cost of energy support measures was 1.2% in 2022 (at the EU level). We expect a continued reduction of the structural deficit in the coming years, to 2.6% in 2023 and 2.1% in 2024 (figure 2.5). In 2023-2024, the deficit reduction is driven primarily by discretionary policy measures such as a phasing out of the pandemic emergency measures. The cyclical component is expected to contribute negatively to deficit reduction in 2023 and mildly positively in 2024. In this scenario, the budget deficit for the eurozone remains above the 3% target stated in the Stability and Growth Pact.

Figure 2.5 Eurozone deficit and debt remain high



Due to sustained fiscal stimulus measures, eurozone government debt also remains high: an estimated 91% of GDP in 2022, and an average of 90% in 2023 and 2024. At the same time, there are several member states with significantly higher debt, such as Italy and Greece. Although short-term debt sustainability risks are limited, several member states with high government debt cannot afford to do nothing about their budgetary policies in the long term.

United States: costlier credit squeezes economic growth

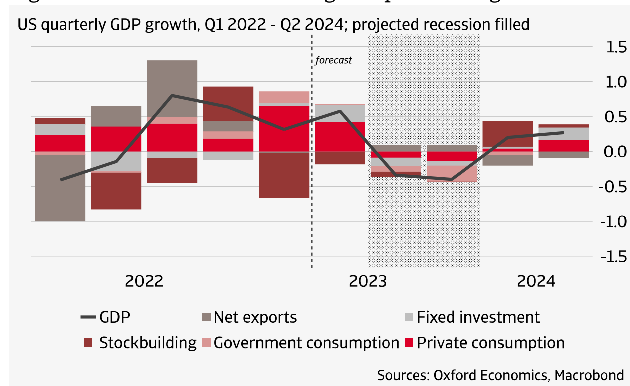
While the US economy has demonstrated resilience since the recovery from the pandemic, we expect a mild recession to take hold in H2 this year. Pent-up savings, high employment and increasing wage growth have helped consumers keep the economy afloat in the face of rising interest rates and banking sector jitters, motivating a substantial upward revision of our 2023 growth forecast to 1.3% from -0.4%. But this resilience has essentially postponed the inevitable slowdown to H2 2023, setting a weak starting point for 2024. Our forecast for 2024 has accordingly been revised substantially lower: 0.4%, compared to 1.4% six months ago.

Mild recession to begin in Q3

Annualised GDP growth fell to a modest 1.3 in Q1, a marked slowdown from the 2.6% expansion recorded in Q4 of 2022 (0.3% from 0.6% respectively in quarterly terms). Consumer spending grew robustly at 3.8% y-o-y, the fastest rate since the vaccine rollout in mid-2021. Consumers continue to benefit from a strong labour market and rising wages, which have driven resilience in the face of rising prices and higher borrowing costs. Unseasonably warm weather further helped. The remarkable strength of private consumption in Q1 was offset by weak investments. The slowing housing sector dragged fixed investment's growth contribution to nearly zero. Inventory investment remains very volatile as supply chains normalise and has been the largest drag on Q1 growth, with the wholesale trade sector seeing the sharpest

declines, followed by manufacturing, as businesses respond to slowing demand with slower stockbuilding.

Figure 2.6 US consumers set to tighten purse strings in H2



We expect that inventories continue to drag on economic growth in Q2, as businesses stay pessimistic concerning their expectations for consumer spending. Private consumption is likely to have slowed but continues to keep economic growth afloat. Payroll and wage gains continue to support disposable income growth as excess savings still underpin capacity to spend. Job creation keeps exceeding expectations, especially in construction, transport and business services sectors, bolstering continued spending prospects.

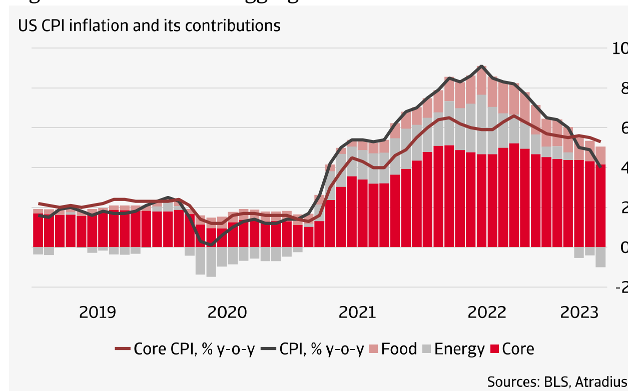
Cracks are beginning to show though and we expect consumption to drag on growth in H2, bringing the US economy into a mild technical recession (two consecutive quarters of negative quarterly GDP growth). Unemployment has ticked up to 3.7%. The personal savings rate has been gradually increasing, reaching 4.1% in April compared to a low of 2.7% in June 2022, signalling that US consumers are growing more cautious. The outlook for continued spending of excess savings also continues to dim as most remaining pandemic-era savings are held as wealth in higher-income households.

Government consumption will be the largest drag on economic growth in Q3 and Q4 as the fiscal stance turns contractionary. The pandemic-era fiscal stimulus was unprecedented in recent history (5.3% of GDP in 2021). In 2023, fiscal policy will likely be contractionary at -0.5% of GDP. With a divided Congress and spending controls imposed by the June debt-ceiling deal, the likelihood of government support to GDP growth is very slim.

Slowdown offers some relief for price pressures

The weaker demand outlook for H2 does bode well for inflation though, which remained more than double the Fed's target in Q1. The May figures have already offered some relief to consumers and policymakers as headline CPI inflation eased to 4.0% from 4.9% the month before. Energy price deflation is the culprit, however, and core CPI fell much less substantially to 5.3% from 5.5%.

Figure 2.7 US core CPI lagging headline disinflation

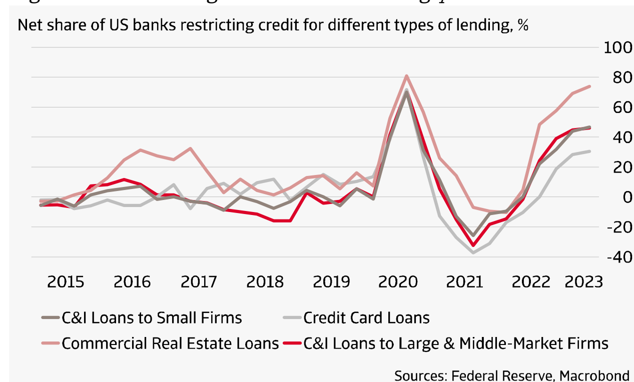


Similar to the consumer outlook, inflation data continues to offer a very mixed picture of the health of the US economy. The downward trend, however, has proven sufficient – in conjunction with early signs of lower consumer spending – to allow the Federal Reserve to pause its monetary tightening cycle. Headline inflation is likely to continue its decline in the coming months, supported by the normalisation of supply chains and falling commodity prices. The pace will remain steady due to base effects, given its peak was in the same time window in 2022. Core inflation on the other hand does not have the same base effect trend and is only expected to ease gradually as the impact of monetary tightening 6-12 months earlier feeds into demand. Concerns for stickiness in core inflation are also easing given the deceleration in wage growth underway.

Access to credit increasingly squeezed

One of the key drivers of our outlook for disinflation and a minor downturn in H2 is the significant tightening in credit conditions underway. The Fed's latest bank lending practice survey shows access to credit for both businesses and households has decreased. Figure 2.8 shows the net share in banks tightening their lending standards to companies and households to be increasing sharply in the first two quarters of 2023. Lending conditions for commercial real estate loans are the tightest, nearing 80% where they stood at the peak of the pandemic lockdown. Given the limited return to office work, investors are wary of commercial real estate and the Fed has increased monitoring of banks with high CRE concentration risk. Overall, banks cite expected deterioration of their credit quality amid an economic downturn and increasing bank funding costs to be behind their lower willingness to lend.

Figure 2.8 US lending conditions increasingly restrictive



This is essentially the desired effect of monetary tightening as more expensive borrowing should reduce consumer spending, company hiring and investment, in turn easing the pressure on price growth. Evidence of this, alongside some signs of easing demand in the real economy and disinflation, will allow the Federal Reserve to shift into wait-and-see mode now, as discussed in Chapter 1. This should allow the economy to absorb the current high rates without sparking a credit crunch. Healthy household balance sheets and a tight labour market should ensure the downturn will be shallow, reducing the need for the Fed to lower rates prematurely.

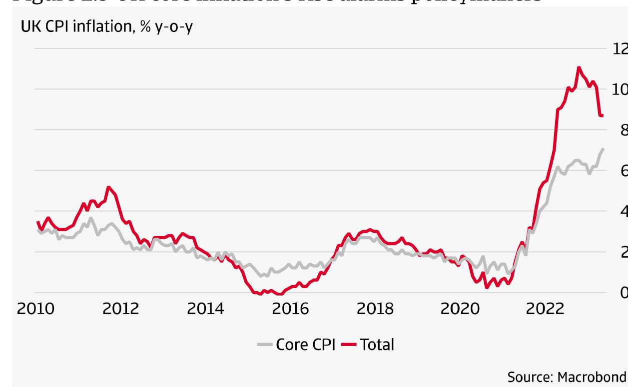
UK outlook clouded by higher-for-longer interest rates

The UK's economic fortunes have improved since December but its challenges remain uniquely elevated. At the start of the year, we expected the UK to contract 0.7% in 2023, the worst performance in the G7. Its consumption-dependent economy is grappling with rising costs of living and the effects of Brexit on international competitiveness. Consumer resilience has helped the economy avoid recession so far in 2023 though, and a positive shift in policymaking should help keep GDP growth in the black this year at 0.4%. Stickier-than-expected inflation is driving more aggressive monetary tightening which will keep growth low at 0.8% in 2024, compared to 1.8% expected six months ago.

Economic growth has lost some steam so far this year, weighed down by industrial disputes and some temporary drag from the King's coronation in May. But slowing headline figures mask the resilience of private consumption. Direct fiscal support to households to help pay energy bills helped bring consumer confidence to its highest level since Russia's invasion of Ukraine. The labour market is very tight with only 3.8% unemployment and total wage growth has picked up to 6.5%. In real terms, wage growth remains negative at -2.0% but is beginning to turn up as inflation eases.

Ongoing consumer resilience is forcing the Bank of England (BoE) to tighten its monetary policy more aggressively while other central banks have been slowing down or pausing their cycles. While headline inflation has cooled off slightly from its peak of 11.1% in October 2022, the May 2023 reading disappointed as it was unchanged from the month before. Of even greater concern, core inflation rose to a new 30-year high of 7.1% in May, showing the UK is not out of the woods yet (see figure 2.9). The BoE's Monetary Policy Committee (MPC) responded accordingly by hiking its official interest rate by 50 basis points to 5%, the highest level since September 2008.

Figure 2.9 UK core inflation's rise alarms policymakers

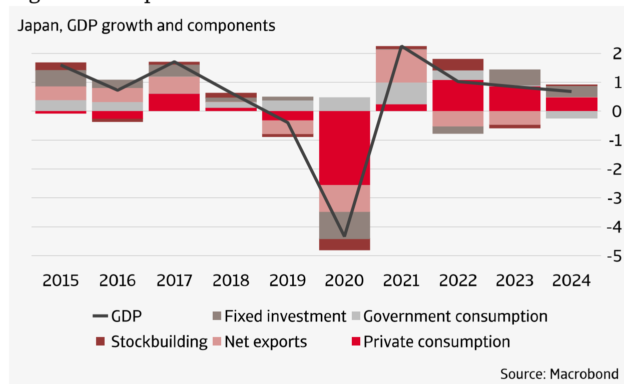


We expect the MPC to follow this with another 0.5 percentage point rate hike in its upcoming August meeting. Its latest policy statement has taken a hawkish tone, suggesting that tighter credit conditions for borrowers may be a price to pay to contain inflation - the top priority. With only one more month of inflation and labour market data coming in between, it's unlikely to sway this position. Beyond that, we anticipate another quarter-point hike in September before pausing, as the effects of recent tightening feed into the real economy. That would make a peak interest rate of 5.75%, compared to our previous expectation of 4% which will exert more of a drag on the UK economy, keeping growth sluggish over the forecast period.

Advanced Asia outlook weakens

We expect **Japan**'s economic growth to slow further to 0.8% in 2023, continuing the loss in momentum since H2 2022. Lacklustre growth will likely continue in 2024, with only 0.7% growth. Private consumption continues to be supported by the improving labour market, accumulated savings during the pandemic and transfers included in the latest fiscal package. The labour market remains strong, though unemployment went up a bit in March (to 2.8%, from 2.6% in the month before). Several factors continue to weigh on consumption growth, however, such as elevated inflation (by Japanese standards), high uncertainty and a fading impact of reopening. Both headline and core inflation remain elevated at 3.4% and 4.1% respectively. Core inflation is even at its highest level since 1981.

Figure 2.10 Japanese economic outlook remains lacklustre



Weak external demand is causing export growth to slow and drag on headline growth. Despite some gains in auto shipping in H1, overall exports have been dragged down by fewer capital goods demands which we expect to continue in the coming quarters. Fiscal policy remains supportive of growth this year following a large fiscal package announced in October 2022. The stimulus includes subsidising prices of electricity, gas, oil, and cash transfers to couples with children. This is likely to lead to keeping the fiscal deficit elevated at 5.8% in 2023, with prospects of a somewhat lower deficit in 2024 as some measures are phased out, resulting in a contractionary effect on next year's GDP growth.

Weakening domestic conditions are weighing heavily on Australia and New Zealand's economic prospects as well. **Australia**'s economic growth is slowing to 1.6% in 2023 and 2024, rates well below its long-term trend due to more persistent inflation and higher interest rates. Inflation appears to have peaked in Q4 2022 but remained high at 7.1% in Q1 2023. Disinflation will stay slow as services prices continue to rise, despite goods prices declining. The historically tight labour market is also supporting resilience in the face of current headwinds, ensuring only a gradual decline in prices. **New Zealand**'s economy entered recession in Q1 2023 as investment declined and consumer spending stalled. House price falls and tight monetary policy are being exacerbated by the devastation from Cyclone Gabrielle. While reconstruction efforts should boost construction and investment since Q2, the weak consumer outlook will continue to drag on activity in 2023.

Emerging economies staying in low gear

The outlook for emerging market economies (EMEs) is on average stronger than that for advanced economies, but it remains weak by historical standards. We expect GDP growth to stay in lower gear at 3.9% this year and 3.8% next, broadly flat with 2022 due to weak external demand and tightening global financing conditions. Under the headline figure lies substantial heterogeneity. Emerging Asia is set to lead other regions again as China's economy rebounds from Covid-19 lockdowns. Latin America, struggling with structural weaknesses and political uncertainty, will lag other regions.

Table 2.3 Real GDP growth (%) – major emerging markets

	2021	2022	2023f	2024f
China	8.5	3.0	5.5	4.6
India	8.9	6.7	5.6	6.4
Brazil	5.3	3.0	1.8	1.0
Mexico	4.9	3.0	1.8	1.0
Russia	5.6	-2.1	0.7	1.7
Turkey	11.4	5.6	2.1	1.5
South Africa	4.7	1.9	0.2	1.0

Sources: Oxford Economics, Atradius

Asia: China and India

We expect the **Chinese** economy to grow by 5.5% in 2023, which is 1.3 percentage points higher than our forecast from six months ago. Growth is supported by a rapid normalisation of consumer spending, after the economy reopened from the Covid lockdowns in early 2023. Even though the current surge in consumption will lose momentum once the level has broadly normalised to pre-pandemic times, we do think the rebound in household consumption still has legs into Q2 2023. We forecast GDP growth to weaken to 4.6% in 2024, on the back of weakening consumption prospects and lower investment growth.

The Chinese economy saw a sharp consumer-led rebound in Q1 2023. At 4.5% year-on-year, the Q1 GDP growth was above expectation. Consumer and services-related segments raced ahead. Retail sales in particular jumped 10.6% y-o-y, driven by dining out services and to a smaller extent automobile sales. Investments remained weak (5.1% y-o-y), with overall growth very much supported by state investments. Property investment remained sluggish at -5.9% y-o-y, in contrast to relatively buoyant property sales, reflecting caution among property developers.

Household consumption growth can likely keep momentum into Q2, given the recent savings trend. Beyond that, a more sustained consumption boost would require either higher confidence, or for consumers to dip into their excess savings. For 2023 overall, we forecast a very robust consumption growth of 9.3%, driven by the strong momentum at the start of the year and depressed activity in 2022. As the one-off effect from lifting Covid measures wears out, consumption growth is likely to weaken in 2024.

China continues to have relatively low and stable inflation. CPI inflation is expected to only slightly increase to 2.1% in 2023 and 2.6% in 2024, below the central bank's target rate of 3%. While the supply shock associated with the Russia-Ukraine war had driven up energy and food prices, the feedthrough to domestic inflation in China is still relatively modest due to its domestically administered pricing mechanism and its self-sufficiency in coal and food (staple grains). This means, compared to other EMEs, inflation is less of a brake on consumers' purchasing power.

We forecast fixed investment growth to pick up to about 6% in 2023. State-driven investments remain a key force behind the growth, even though they should gradually wind down as fiscal policy normalises in the rest of the year and the fiscal impulse turns negative. Offsetting this will be private investment, which we expect to pick up pace during the year. A weak spot remains the poor performance of the real estate sector. Despite a few positive developments, such as a rise in the amount of completed projects by 15% y-o-y in Q1 2023, investor sentiment remains weak. The commencement of new projects remains below par, after a 40% decline in 2022 and another 5% decline in Q1 2023.

Exports, after falling last year, are showing subdued growth in 2023, due to weak demand from key markets and the shift in global demand from goods back to services. Fiscal policy support is only making a mildly positive contribution to growth in 2023. The National People's Congress in March set conservative government spending targets, indicating its trust in a strong consumption recovery. Furthermore, the congress called for 'prudent' monetary policy, and maintaining stability. However, more targeted measures directed at the real estate sector or SOEs could be expected in case of market disturbances.

We expect that **India's** economy will grow by 5.6% in 2023 and 6.4% in 2024. The growth momentum is likely to fade after the first quarter of 2023, weighed down by the weakening trade environment and a delayed effect of earlier monetary policy tightening.

Price pressures eased in April, with headline CPI inflation dropping to 4.7%, from 5.7% in March. Cooling inflation was broad-based across food, fuel, and all major core categories. Lower inflation, together with more signs of a slowdown in economic activity, were reason for the central bank of India (RBI) to pause rate hikes in April. Policy committee members are taking a wait-and-see approach to assessing the lagged impact of monetary tightening since May 2022. We expect policy rates to stay on hold at the next meeting in June and for the rest of the year as inflation cools and the economy loses steam. Consumers are likely to turn more cautious due to tightened monetary policy and elevated price pressures. High inflation weighs on real income growth and is likely to drag down consumption growth in 2023.

The manufacturing Purchasing Managers' Index (PMI) survey continues to point to expansion, with a reading of 57.2 in April 2023, above the neutral threshold of 50. Despite positive sentiment, manufacturing production growth continues to weaken, which supports the view that investment growth is likely to remain lacklustre. We expect fixed investment growth to cool to 2.3% in 2023, from 10.5% in 2022. Furthermore, both exports and imports show weak dynamics. There is weak demand from India's major export markets, the US and EU, which is only partially compensated for by higher exports to China. We think the current account deficit can narrow slightly in 2023, to 1.3% of GDP, from 2.4% in 2022.

In the FY2023-24 budget, the government pledged fiscal prudency, targeting a smaller fiscal deficit of 5.9% of GDP, down from 6.5% in FY2022-23. Capital expenditure on energy and infrastructure is set to receive a boost, which should support private investment, though the effects will only be felt over the medium term. While we believe that the government's budget deficit target is ambitious, we do think the pledge of government consolidation is strong and will succeed in narrowing the deficit somewhat in the coming years. This is crucial for reducing government debt, which we estimate to reach 86% of GDP at the end of 2023.

Latin America: Brazil and Mexico

After a surprisingly robust performance since the pandemic, we project **Brazil**'s GDP growth to fall from 3.0% in 2022 to 1.8% in 2023 and to moderate further to 1.0% in 2024. The economy is steadily slowing down as the lagged effects of high interest rates increasingly weigh on demand. Brazil's central bank was one of the first to begin its post-crisis monetary tightening cycle, increasing interest rates from 2% in March 2021 to 13.75% in August 2022, the highest in the region. Lower external demand and policy uncertainty, which keeps inflation expectations elevated and will delay the start of the monetary policy-easing cycle (which we now expect by year-end 2023), are also weighing on Brazil's growth outlook. Policy uncertainty stems from the change in government at the start of 2023 after the left-oriented former president, Lula da Silva, narrowly won the presidential election against the right-wing populist, Jair Bolsonaro. Economic policy will be more state-driven with higher social spending. This raised concerns about the credibility and future of the spending cap, an important anchor for public finances. Political pressure on the central bank to cut interest rates added to policy uncertainty. This policy uncertainty contributes to higher inflation expectations which will delay the start of the monetary policy easing cycle to Q4 2023.

We expect macroeconomic policy to stay broadly orthodox and the central bank to remain independent, as pragmatism and a minority position in Congress will limit the risk of radical policies. Proposals for a new much-needed fiscal framework have just been passed by the lower house and are awaiting approval by the Senate. Additionally, the central bank has kept interest rates unchanged so far and although it acknowledged the proposals it also indicated that an interest rate cut is not imminent. Both the proposals and central bank actions largely reassured investors. The sovereign CDS price has fallen from 250 bps end-March to 183 bps mid-June. The real is among the world's strongest currencies this year and has appreciated by over 9% vis-a-vis the USD, illustrating Brazil's resilience. Nevertheless, to put government debt (73% of GDP in April 2023) on a firm downward trajectory, the new rules need to be complemented with tax reforms to lift tax revenues - expected to be sent to Congress later this year. And as always, the proof of the pudding will be in the eating. As the effects of policy uncertainty and high interest rates will only slowly fade, we expect a further moderation of GDP growth in 2024. A normalisation of agricultural output and weak investment demand will outweigh positive effects from rising consumer demand on the back of falling inflation and improving global demand.

After one of the slowest and still incomplete recoveries from the pandemic, we project **Mexico**'s real GDP growth to weaken from 3.0% in 2022 to 1.8% in 2023 and further to 1.0% in 2024. This is largely due to Mexico's close economic ties to the US. The US economy continues to lose momentum which will curtail Mexican exports and remittance inflows. Moreover, domestic policymaking is straining its economic growth outlook. The lack of fiscal support during the pandemic will leave lasting scars on Mexico's economy such as permanent business closures and lower quality jobs. Furthermore, business-unfriendly policies under President López Obrador, in power since December 2018, will continue to curtail private investment. Finally, still elevated inflation and the lagged effects of monetary policy tightening will restrain domestic consumer demand and business investment. Consumer price inflation peaked at 8.7% in August and September 2022 following Russia's invasion of Ukraine and a severe drought in Northern Mexico raised, both contributing to higher food and energy prices. In response, the central bank lifted interest rates from 4% in June 2021 to 11.25% in March 2023. Although inflationary pressures have eased to 5.8% in May, they remain well above the 2%-% to 4% target range of the central bank. Also, core inflation (excluding food and energy), remained elevated at 7.4% in May 2023. And with wage increases in the manufacturing sector being relatively high as well, we expect the central bank to remain very cautious. It also may take until 2024 the last quarter of 2023 before it starts an easing cycle. Combined with ongoing state intervention in the energy sector, this will continue to drag on the economy in 2024.

Eastern Europe: Russia and Turkey

We forecast that **Russia's** economy will grow by 0.7% in 2023, which is 2.7 percentage points higher compared to six months ago. Despite Western sanctions, Russia is still able to export large amounts of oil, which underpins economic growth. For 2024, we expect 1.7% growth.

There is still little clarity on the extent of Russia's oil output cut. The government announced it would cut production by 500,000 barrels per day in March in response to the EU embargo and oil price cap, but it remains unclear whether the full production cut has been implemented. The IEA estimates that Russian crude production fell by only 200,000 barrels per day in April compared to the February baseline. Other data show that Russian seaborne oil exports have been increasing gradually since the trough in December.

The Russian rouble quickly recovered after the first weeks of the war, due to the imposition of capital controls, the forced conversion of European payments for gas into roubles and strong import decreases. This year we see a gradual depreciation of the rouble due to FDI outflows, though the central bank has taken measures to prevent a sudden outflow of too much FX. Inflation decreased considerably in recent months, declining to 2.5% in May 2023. This compares to 11.8% at the start of the year, due to high base effects from 2022 and weak domestic demand.

We still expect 2.2% consumption growth in 2023, but much depends on the government's mobilisation plans. The adoption in April of new army draft legislation rekindled expectations of another wave of mobilisation. The central bank has reported a pick-up of household lending, which can provide a stimulus to consumer demand in Q2. Later in the year, when we expect some additional mobilisation, consumer demand growth is likely to wear off. Whether there will be additional mobilisation or not, people's propensity to save will remain elevated. The labour market is also expected to remain tight. The unemployment rate declined from 4.1% at the start of the war, to 3.3% in April this year.

The central bank of Russia cut the policy rate several times since the start of the war (when it sharply hiked the rate to 20%). Since September 2022, the policy rate was kept at 7.5%, although the central bank signalled that it might consider rises in the coming months depending on inflation dynamics. The federal government budget posted a sizeable deficit in April. Though they have come under pressure in recent months, oil and gas exports still bring in large revenues for the government budget. At the same time, expenditures rise as the government allocates more funds to the war in Ukraine. According to our estimates, the 2023 budget is on track to record a 3% deficit, followed by a 1.3% deficit in 2024.

In **Turkey**, in the second round of the presidential elections held on May 28, Recep Tayyip Erdogan was re-elected as president with 52.2% of the vote. The parliamentary elections held two weeks before resulted in Erdogan's AKP party remaining the largest party in parliament with 35.5% of the vote, though it did lose compared to the previous elections. In the aftermath of the elections, the lira fell by 2.3% to a new record low of 20.45 against the USD. The lira's decline is partly good news, as it shows a willingness by the authorities to bring the currency more in line with its underlying value. In recent years, attempts have been made to artificially prop up the lira's exchange rate through capital controls and FX interventions.

Economic activity is constrained by high inflation and a weak lira, weighing on consumer purchasing power. Moreover, global monetary tightening and a subdued external environment, which will constrain the external sector, will slow the pace of economic activity. We expect GDP growth of 2.1% in 2023, against 5.6% last year. February's earthquake has hit production in Turkey's southern and central regions. Despite the near term impact on GDP growth - the affected regions account for 9.3% of Turkey's GDP – we think that reconstruction efforts are likely to bring back economic activity relatively quickly.

Inflation slowed down for the sixth consecutive month to 44% in April, from 51% in March, owing to a supportive base effect and a round of electricity and natural gas price cuts. The pace of inflation will now likely stabilise at about 40% for the rest of the year. There is still a strong pass-through on inflation from a weakening lira. The lira lost one fifth of its

value in the past year as monetary policy remains very accommodative, with several interest rate cuts. Internal and external imbalances, unorthodox domestic policies, and recent policy tightening in the US and the eurozone continue to weigh on the lira in 2023.

Over the past couple of months, the central bank kept the policy rate constant at 8.5%. Given the high rate of inflation, this causes the real interest rates to be sharply negative and monetary policy to be far too accommodative. Net reserves (gross reserves adjusted for FX liabilities) of the central bank declined from USD 26 billion in January to around zero in May, leaving almost no space for the central bank to make direct interventions in the FX market.

Another vulnerability of Turkey's economy is its weak external position, characterised by structural current account deficits and high external debt. The current account deficit is forecast to be 4% in 2023, which is lower than in 2022 (5.7%), but still very high. The external debt stock is estimated to reach 52% of GDP in 2023. Short-term external debt repayments and the current account deficit are leading to high external financing needs.

We think that the current economic trajectory in Turkey is unsustainable. A change in direction of policy is needed to bring back confidence from financial markets. This includes a return to more conventional policy to get inflation under control and to reduce external imbalances. Two recent appointments by the Erdogan government – Mehmet Simsek as finance minister and Hafize Gaye Erkan as head of the central bank – are reassuring in this regard, as both are supporters of more rational economic policies.

Sub-Saharan Africa: South Africa

We predict that growth in **South Africa** will slow to 0.2% in 2023, on a weak global backdrop and serious domestic constraints. The unprecedented scale of power outages means that the economy is unable to produce any meaningful growth in the near term. Rising loan costs, tougher credit conditions and sky-high unemployment will squeeze household disposable income in 2023, heightening the risk of strikes and social discontent, although ebbing inflation will relieve some of the pressure. We forecast growth to recover modestly in 2024, to 1.0%, aided by a global uptick and an improvement in power supplies, led by new private-sector renewable energy projects.

Headline inflation has been on a downward trajectory in recent months. In May 2023, inflation was equal to 6.3%. Over the coming months, we expect to see further disinflation, helped by slack aggregate demand, spare industrial capacity, strong retail competition and rising interest rates. Our forecast sees inflation moving closer to the midpoint of the central bank's target rate (3%-6%). The central bank has raised the policy rate by 125 basis points to 8.25% since the start of the year. We expect that it is nearing the end of the monetary tightening cycle.

On the fiscal side, we estimate the budget deficit to equal 5.1% of GDP in 2023, with similar readings expected in the coming years. The budget for fiscal year 2023/24 underlines an improvement in revenue –restructuring at the South African Revenue Service (the tax agency) – and a cautious approach to spending. Fiscal consolidation is needed in the medium term, given the structurally high deficit, and the very rapid increase in the government debt level in recent years.

Looking forward, South Africa faces a variety of uncertainties. Structural economic risks include high unemployment, power supply constraints and logistics bottlenecks. Infighting in the ruling party, the African National Congress (ANC), and low confidence in the ANC and President creates further uncertainty within the country, especially in course to the elections in 2024. Other threats are climate-related, such as more intense droughts and floods, alongside water shortages, which would stifle growth in multiple sectors.

Appendix: macroeconomic forecasts – major markets

	GDP growth (% change p.a.)			Inflation (% change p.a.)			Budget balance (% of GDP)			Gross government debt (% of GDP)			Current account (% of GDP)			Export growth (% change p.a.)			Private cons. (% change p.a.)			Fixed investment (% change p.a.)			Government consumption (% change p.a.)			Retail sales (% change p.a.)			Industrial prod. (% change p.a.)		
	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024
Australia	3.7	1.6	1.6	6.6	5.9	3.2	-0.7	0.9	-2.4	55.9	53.3	56.3	1.1	2.5	0.4	3.4	8.5	6.6	6.5	1.8	1.8	1.1	2.1	2.7	5.1	-0.4	-2.0	5.4	-0.9	1.5	0.6	2.6	1.2
Austria	4.9	0.5	0.8	8.5	7.2	1.1	-3.2	-2.8	-1.0	112.0	108.8	108.7	0.7	1.9	2.4	13.0	2.4	1.4	4.9	-1.2	1.9	0.4	1.1	0.3	3.6	0.3	0.5	-0.8	-1.1	3.5	7.5	-0.6	-0.4
Belgium	3.2	1.3	1.0	9.6	4.1	1.8	-3.9	-3.8	-3.3	125.5	121.5	122.9	-3.6	-1.5	-0.9	5.1	-0.6	1.2	4.1	2.5	1.7	-0.8	2.6	-0.7	3.2	0.7	0.6	-3.8	-4.0	2.5	-0.7	-3.9	-1.5
Brazil	3.0	1.8	1.0	9.3	5.0	4.2	-4.5	-7.9	-7.7	72.9	76.4	80.3	-3.0	-1.5	-3.5	5.9	5.7	-0.2	4.3	1.1	0.2	0.8	-4.6	1.7	1.5	1.7	2.0	1.0	2.7	1.6	-0.7	1.0	3.5
Canada	3.4	0.6	0.5	6.8	3.7	2.2	-0.3	-1.8	-3.8	111.7	114.3	115.2	-0.3	-1.9	-2.4	2.8	3.7	0.8	4.8	1.6	0.6	-1.5	-3.0	1.0	2.0	0.0	-0.3	1.8	0.7	0.6	3.8	0.1	1.4
China	3.0	5.5	4.6	2.0	1.4	2.4	-7.3	-6.7	-6.1	51.8	55.6	58.6	2.2	2.2	0.6	-0.3	0.3	0.7	0.1	9.3	5.0	3.3	5.9	4.3	9.0	4.3	1.7	0.3	9.6	5.2	3.8	5.5	4.7
Denmark	3.8	1.3	2.2	7.7	3.7	1.6	3.3	2.0	1.0	49.7	42.4	39.9	13.0	11.8	12.2	8.6	3.9	1.1	-2.3	0.3	2.7	8.6	-5.9	2.8	-3.5	-1.3	1.8	-4.7	-2.3	1.2	15.1	7.3	2.3
Finland	2.1	-0.2	1.0	7.1	6.1	1.7	-0.8	-2.0	-2.3	73.4	72.5	73.4	-3.9	-3.0	-2.5	1.7	0.1	2.5	2.0	0.0	1.4	5.0	-4.4	2.2	2.9	2.8	0.2	-3.6	-1.4	1.9	4.1	-0.2	0.3
France	2.5	0.5	0.8	5.2	5.2	1.9	-4.7	-5.0	-5.0	125.1	122.9	126.0	-2.1	-0.8	-1.8	7.2	1.0	3.4	2.2	0.1	1.2	2.3	-0.4	0.2	2.5	1.0	1.6	3.2	-2.8	-1.1	-0.1	0.1	1.1
Germany	1.9	-0.4	1.2	6.9	5.2	0.2	-2.7	-2.3	-1.8	61.3	60.8	61.5	4.3	6.1	5.6	3.5	1.0	2.5	4.9	-0.9	3.0	0.5	1.1	2.3	1.2	-4.6	0.8	-0.6	-2.9	3.6	-0.5	0.8	1.4
Greece	6.0	1.3	1.0	9.6	3.6	2.1	-2.4	-1.4	-1.3	215.1	204.2	199.9	-9.6	-3.8	-3.7	4.9	6.2	2.2	7.9	2.6	0.3	11.6	5.0	5.1	-1.5	2.7	1.0	3.0	-1.1	1.2	2.2	0.7	2.0
Hong Kong	-3.5	4.4	2.5	1.9	2.5	2.7	-8.0	-3.3	-1.9	2.7	3.6	4.4	10.7	4.5	4.6	-12.6	-3.4	8.3	-1.2	8.0	2.4	-7.7	7.3	3.3	8.2	-2.4	1.5	-3.3	25.4	7.9	0.2	0.1	1.2
India	6.7	5.6	6.4	6.7	5.4	4.5	-6.9	-6.7	-5.5	82.6	84.4	81.7	-2.4	-0.8	-1.5	16.1	4.3	0.1	8.1	1.8	6.5	10.3	6.4	5.9	2.7	4.1	6.4	9.7	3.3	7.9	4.6	1.7	3.8
Ireland	12.1	0.5	4.4	7.8	4.4	0.8	1.6	1.8	1.2	36.5	33.9	30.5	8.9	13.0	14.2	15.2	1.5	2.6	6.8	3.9	1.3	26.3	-23.6	2.1	0.7	0.6	1.9	1.9	1.8	3.4	17.7	-0.1	2.6
Italy	3.8	1.2	0.9	8.2	5.9	1.8	-8.0	-4.9	-3.2	170.1	162.7	163.3	-1.3	2.4	1.5	10.2	1.6	3.3	4.6	0.9	0.4	9.7	2.0	1.1	0.0	1.0	-0.5	0.3	-1.7	2.2	0.4	-0.7	3.7
Japan	1.0	0.8	0.7	2.5	2.8	0.9	-6.2	-5.6	-4.5	####	241.7	243.2	1.9	1.9	2.2	5.1	-0.6	1.4	2.0	1.6	0.9	-1.0	2.3	1.5	1.5	0.1	-1.1	-0.2	3.2	0.8	0.1	-0.9	1.8
Luxembourg	1.6	0.7	2.8	8.2	3.2	1.7	1.0	0.6	0.8	21.6	20.7	19.5	5.0	3.1	5.9	-0.6	2.4	4.3	2.8	0.9	1.4	-1.1	0.7	2.3	4.1	-0.8	-0.7	2.6	-2.3	8.6	-1.2	-2.0	4.8
Netherlands	4.5	0.7	1.4	10.0	4.2	2.0	0.1	-3.0	-2.4	64.6	63.0	63.3	4.4	6.0	7.3	4.7	0.8	2.3	6.5	1.9	1.3	2.5	1.9	-0.4	1.6	2.6	1.5	0.6	-1.9	1.3	2.4	-4.7	1.5
New Zealand	2.2	-0.6	2.9	7.2	5.2	1.7	-5.3	-3.1	-0.9	45.5	47.5	46.1	-8.6	-5.9	-4.0	-0.7	18.6	7.3	2.8	-2.0	2.5	3.6	-7.6	2.6	4.5	-0.9	1.6	-0.3	0.7	3.6	-1.3	1.4	2.6
Norway	3.2	1.3	0.8	5.8	5.1	2.6	27.3	13.5	7.2	35.7	41.4	37.4	30.3	16.8	18.0	5.5	4.4	1.8	7.0	-0.1	1.1	4.3	1.3	1.5	0.0	1.9	0.7	-5.4	-3.0	2.2	2.6	-5.3	3.7
Portugal	6.7	2.7	1.5	7.8	4.6	2.5	-0.3	-0.4	-0.3	135.1	123.5	118.6	-1.4	1.3	0.3	16.6	7.7	0.3	5.8	1.0	1.0	3.1	1.9	4.6	1.7	0.9	1.2	4.8	1.1	-0.5	0.3	-2.3	2.1
Russia	-2.1	0.5	1.6	13.8	4.8	4.3	-1.1	-2.9	-1.0	14.8	16.5	18.3	10.9	3.6	3.6	-13.9	1.3	3.4	-1.4	2.2	1.9	3.3	2.5	2.4	2.8	7.2	1.1	-6.1	-3.1	1.9	-0.3	0.2	0.0
Singapore	3.6	0.4	2.3	6.1	4.0	1.8	-1.0	-0.5	0.4	167.8	172.1	156.7	19.3	15.6	13.4	-1.3	-1.5	2.0	9.7	1.8	3.6	1.6	0.9	5.4	-2.3	4.1	1.3	7.1	-5.6	4.2	2.8	-4.9	4.8
Spain	5.5	2.3	1.3	8.4	3.2	2.2	-4.8	-4.3	-3.1	137.6	133.6	133.7	0.6	2.4	1.7	14.4	4.6	0.9	4.4	0.8	2.2	4.6	-0.7	2.1	-0.7	1.2	1.1	0.9	4.9	1.2	2.8	0.9	0.7
South Africa	1.9	0.2	1.0	6.9	6.1	5.1	-4.9	-5.1	-4.7	71.1	75.9	78.4	-0.5	-2.9	-1.8	7.4	1.7	1.9	2.5	0.5	0.4	4.8	3.3	1.9	1.0	0.8	0.1	1.8	0.5	0.7	-2.4	0.9	2.3
South Korea	2.6	0.5	1.8	5.1	3.3	1.5	-3.0	-2.0	-0.2	47.9	51.2	50.4	1.7	1.4	2.9	3.4	-3.6	0.2	4.1	1.8	1.1	-0.5	-1.7	2.5	4.0	2.2	0.4	-0.3	2.5	3.0	1.3	-5.8	6.0
Sweden	2.9	-0.3	0.7	8.4	8.1	2.6	0.8	-1.5	-0.4	44.4	43.4	42.7	4.7	4.4	3.9	7.1	2.8	1.5	2.0	-2.4	1.3	6.2	0.0	0.5	0.1	1.9	2.0	-2.1	-5.1	3.3	1.9	-0.4	1.5
Switzerland	2.1	0.3	1.5	2.8	2.4	1.5	1.0	0.0	0.0	25.8	25.2	24.4	9.3	6.8	7.4	5.9	0.9	2.5	4.0	1.5	1.0	-0.3	1.3	1.1	0.1	-0.5	-0.8	-1.3	-1.8	1.1	7.6	1.9	1.3
Turkey	5.6	2.1	1.5	72.3	46.5	41.9	-0.5	-4.9	-3.2	26.9	29.0	24.9	-5.7	-4.3	-1.8	9.1	-0.9	4.2	19.6	6.0	-4.8	2.8	3.5	-1.8	5.2	2.7	-1.3	10.3	9.0	-4.8	6.2	0.3	2.3
United Kingdom	4.1	0.4	0.8	9.1	7.1	2.9	-5.2	-6.5	-6.0	101.0	101.4	104.2	-3.8	-2.6	-3.2	9.9	-3.0	2.4	5.3	-0.1	0.4	8.6	-0.1	-1.3	1.8	0.2	2.1	-3.7	-1.5	1.0	-2.8	-1.0	1.1
United States	2.1	1.3	0.4	8.0	4.4	2.9	-4.5	-6.7	-6.3	144.6	144.8	147.1	-3.7	-3.0	-3.0	7.1	1.2	3.0	2.7	1.9	0.5	-0.5	-0.3	1.3	-0.2	1.5	-1.9	0.2	0.9	0.7	3.4	-1.0	-1.0
Eurozone	3.5	0.6	1.2	8.4	5.2	1.3	-3.6	-3.3	-2.7	-	-	-	-1.1	2.2	2.0	7.4	1.3	2.4	4.5	0.3	1.7	3.8	-0.2	1.3	1.4	-0.4	0.9	0.9	-1.6	1.5	2.2	-0.3	1.8

Sources: Oxford Economics, Atradius

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