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Economic and Strategy Viewpoint

Q1 2023

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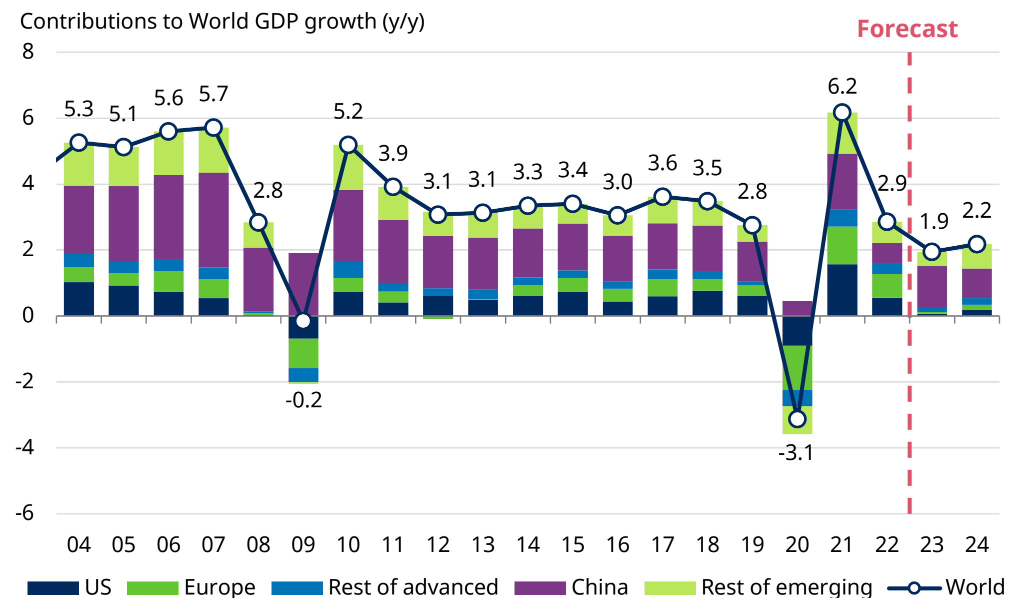
China to the rescue?

- The outlook for China has clearly improved since the zero-Covid policy was abandoned. Activity is normalising and we think a recovery driven by services could drive GDP growth of 6.2% in 2023 and 4.5% next year.
- China's sheer size means that stronger activity will mechanistically lift global GDP growth, which we have revised up to 1.9% this year, from 1.3% previously.
- However, it is not clear that a services-led recovery in China will offer much support to the rest of the world. Small Asian economies will benefit from the return of holidaymakers. However, prior strong investment and soft external demand means that the recovery is unlikely to spur a renewed investment cycle in manufacturing that sucks in imports from Europe and the rest of the world.
- Commodity exporters may receive some support if prices rise, but the playbook may be different this time. Whereas past recoveries driven by construction have buoyed the prices of industrial metals, a recovery in services may be more supportive of energy which could fire up global inflation again. Some emerging markets would thrive in this environment, but most face a period of sluggish growth as higher interest rates and subdued external demand bite.
- We have become less pessimistic on the outlook for developed markets, but more for domestic reasons. Despite most warning signs flashing red, the US has continued to defy gravity. We still think that higher interest rates, which we now expect to peak at 5.25% in the second quarter, will lead to a recession. But it is likely to be relatively short and shallow. A period of below-trend growth should still bring inflation down over the forecast horizon, allowing the Federal Reserve (Fed) to pivot back to rate cuts in late 2023 to a trough of 3.25% by mid-2024.
- The eurozone is set to avoid recession after some respite from the energy crisis. Inflation should fall back more quickly, relieving some of the pressure on real incomes. The economy is likely to be largely stagnant meaning that while the ECB may raises rates a bit further in the near term, it is also likely to cut next year.
- By contrast, the UK still faces a recession as higher inflation and interest rates, along with austere fiscal policy, dampen the outlook. We think GDP will contract by 0.8% this year. Interest rates may have already peaked with cuts likely in 2024.

Chart: Global growth forecast



Source: Schroders Economics Group. 21 February 2023.
Please note the forecast warning at the back of the document.

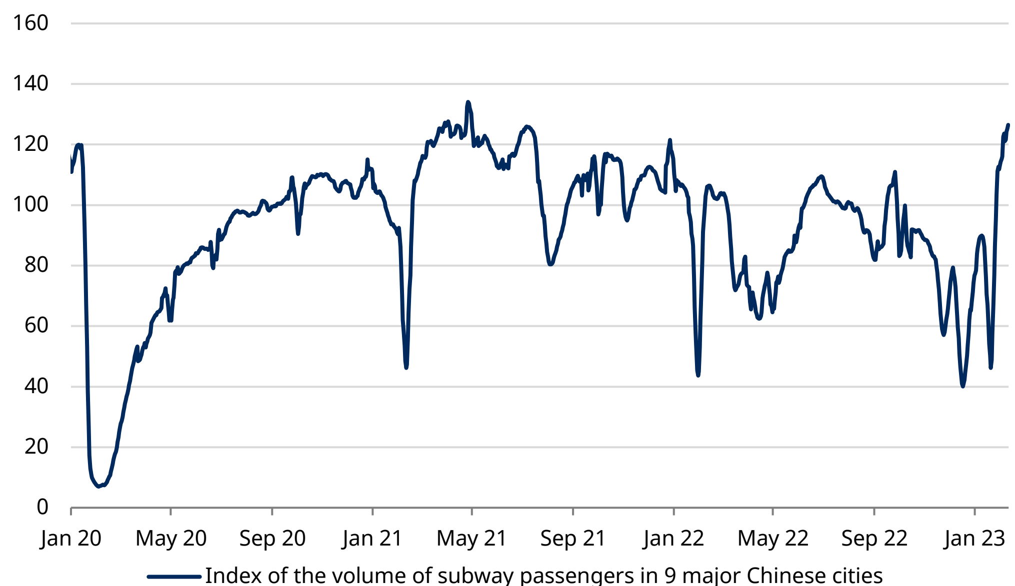
China to the rescue?

Upgrade to global growth as developed markets hold up and China reopens

After what has felt like a constant period of negative economic shocks and forecast downgrades as the world has lurched from one crisis to another, we have become less pessimistic about the outlook for the global economy. During our latest forecast round we have revised up our projection for global GDP growth to 1.9% in 2023, from 1.3% previously, with a slight pick-up to 2% in 2024. Inflation has peaked decisively and we have lowered our projections at the global level to 4.7% in 2023, down from 7.6% last year, and expect further gradual declines towards target in 2024. Better growth means that interest rates in the US and Europe may rise a bit further in the near term. However, we continue to anticipate rate cuts through 2024.

The outlook is decisively better for China after the government's pivot on zero-Covid policy (ZCP) late last year. Measures to control the spread of the virus have been abandoned far more quickly than anyone assumed possible, and the "exit wave" of infections appears to have been similarly rapid. The authorities no longer publish case numbers, but a prominent government scientist stated that 80% of the population were believed to have already had Covid by mid-January. The early indications are that mobility and activity began to rapidly normalise once restrictions were lifted (chart 1).

Chart 1: High frequency indicators point to a rapid rebound in China



Source: Macrobond, Schroders Economics Group. 17 February 2023.

The total abandonment of ZCP raises a lot of questions: how strong and long will the recovery be? Will it save the rest of the world by raising growth or will it cause inflation to come roaring back? Who will win and lose?

Recovery in China to be driven by services

While clearly not our base case at the time, we did at least in the previous *Viewpoint* consider the possible implications of an abrupt move away from ZCP in the "China rapid reopening" scenario. That saw a large upgrade to growth in China and gave a reflationary jolt to the world economy. With that scenario now reality, it is worth considering the implications in more detail.

When it comes to the domestic economy, the early indications from high frequency data and the January PMI surveys are that service sector activity rebounded strongly after the release of ZCP. By contrast, the positive impact on manufacturing was capped by weak external demand while housing transactions have only muddled along after some initial improvement.

This is likely to set the tone for the shape of the recovery. After all, it is China's service sector that has really been hampered by ZCP over the past couple of years as restrictions curbed travel. "Revenge spending" on services has been observed in most economies around the world that have transitioned away from measures aimed to contain the spread of Covid, and China is likely to experience the same release of pent-up consumer demand.

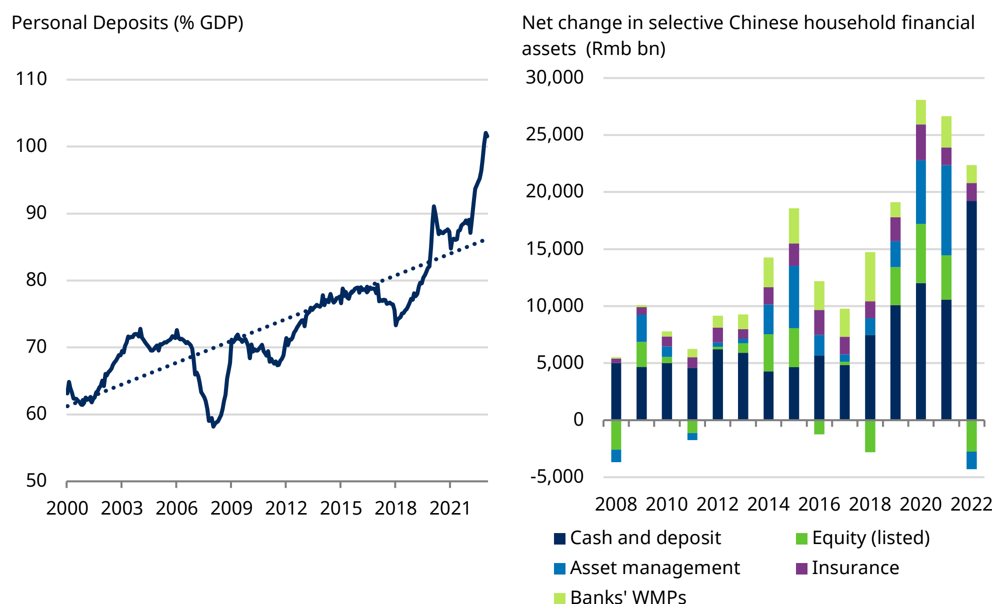
"Revenge spending" won't last forever

Chinese households do not appear to be sitting on a huge pot of savings

However, a key difference to other economies – certainly major developed markets – is that households in China do not appear to be sitting on huge stock of savings that can be drawn to fund a prolonged period of rampant consumption.

Admittedly, there has been a sharp increase in household deposits which, at first sight, appears to be evidence of large excess savings. But while deposits have increased by somewhere in the order of 10% of GDP over the past year, much of this hoarding of cash appears to have simply been due to a reluctance to invest in other, riskier assets such as equities, wealth management products and indeed property where prices have been falling (charts 2 & 3).

Charts 2: Personal deposits have risen... Chart 3: ...but this is not excess saving

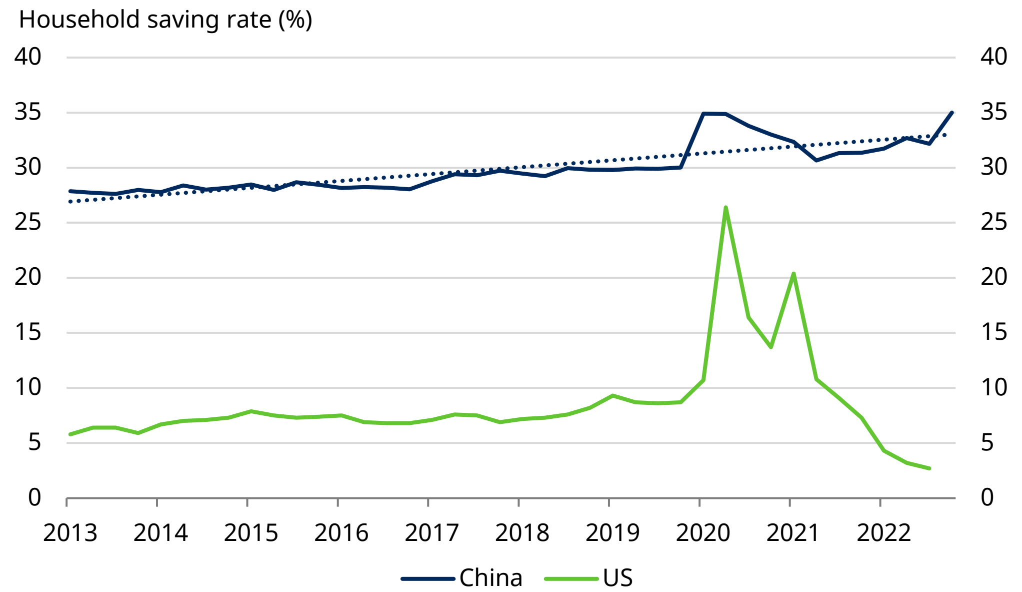


Source: Refinitiv, CLSA, Schroders Economics Group. 17 February 2023.

If these cash holdings were spent on consumption then there would clearly be scope for consumers to sustain stronger demand for longer. However, household surveys suggest that it is more likely that these cash holdings will be moved back to other, riskier investments as economic activity and confidence recovers. That would lend support to the performance of local financial markets, but not necessarily real activity in the wider economy.

Viewed another way, whereas the household savings rate in the US ballooned during the initial phase of the pandemic as the government sent out cheques, there has not been such a noticeable jump in China's savings rate (chart 4). The savings rate has trended higher over time, while fiscal support has focused on helping the supply side of the economy rather than direct transfers to households.

Chart 4: China has not seen a savings glut like that in the US



Source: CEIC, Refinitiv, Schroders Economics Group. 17 February 2023.

Housing to recover from a low base, but long term outlook still poor

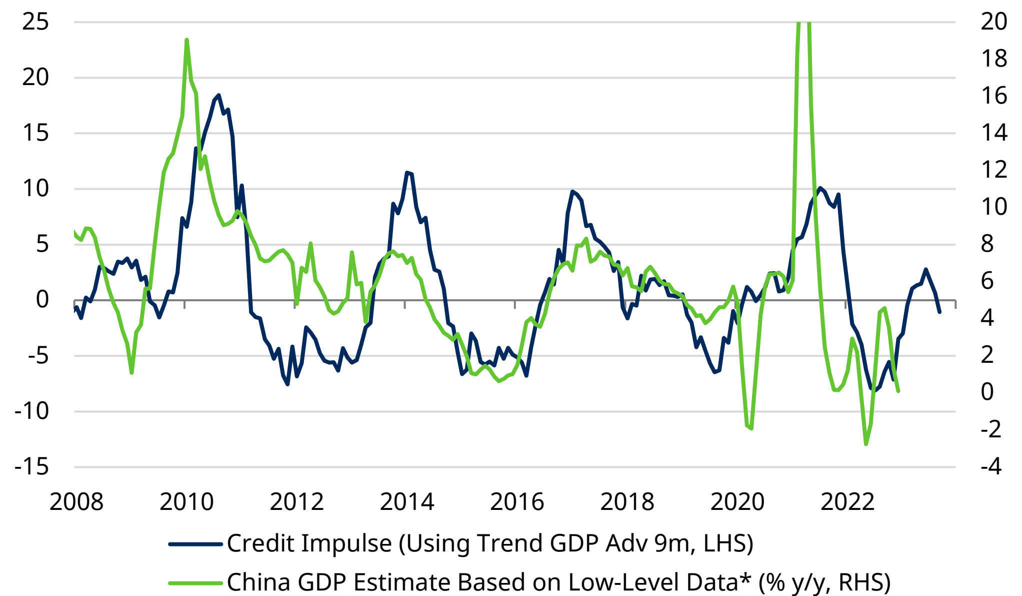
The housing market may also receive some boost. Real estate activity was extremely weak in 2022, meaning that base effects alone are likely to ensure the sector adds to the annual rate of GDP growth this year. Part of the weakness in 2022 may have been due to ZCP. To the extent ZCP prevented people from visiting properties and the negative impact on sentiment in general from weak economic activity halted purchases, there is likely to be some pent-up demand. The government has also provided policy support for housing and relaxed some restrictions on the sector. But while housing should see some recovery, in the absence of further policy support and a pivot back to allowing large-scale speculative purchases, we doubt it will be strong. And demographic trends point to a long term, structural decline in demand.

"Sugar high" recovery likely to fade into 2024

"Sugar high" of relatively strong growth to lose momentum into 2024

Pulling all of this together, our baseline forecast for China now assumes three consecutive quarters of above-trend growth starting in Q1 2023 skewed towards services. We think that will lift GDP growth from our previous forecast of 5% to around 6.2% in 2023. However, the "sugar high" will probably fade as the release of pent-up demand is exhausted, savings are spent and cyclical forces turn less favourable. Indeed, as chart 5 shows some leading indicators such as the credit impulse have already begun to decline, consistent with a loss of momentum in late summer. As such, barring another round of stimulus or rapid credit growth sufficient to drive a turnaround in leading indicators, we think GDP growth will ease back to 4.5% in 2024.

Chart 5: The recovery in China will probably lose momentum in late-2023



Source: Refinitiv, Schroders Economics Group. 17 February 2023.

Stronger China will raise global growth, but the spill-over may be limited

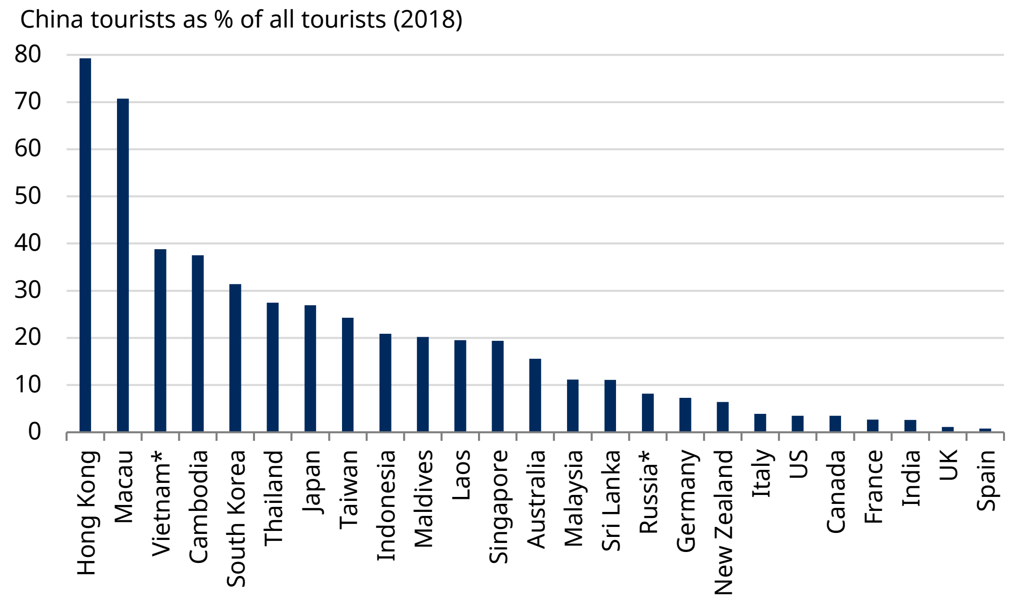
Faster growth in China mechanistically raises our global forecast. After all, China accounts for roughly one-fifth of global output, meaning that every 1 percentage point increase in GDP growth automatically adds 0.2 percentage point to the world aggregate.

However, the positive spill-overs to other economies may be quite limited. The fact that China runs persistent, large external surpluses makes clear that, in contrast to other major economies such as the US, it is not a major source of final demand. And while fiscal stimulus packages focused on the construction of real estate and infrastructure did help to save the world in the wake of the global financial crisis and domestic slump in 2015, we expect the recovery this time to be geared more towards services. In other words, the playbook is likely to be different this time.

The return of Chinese tourists will boost other parts of Asia

Tourism is an obvious first port of call when thinking about how China's services-driven recovery may benefit the rest of the world. Travel within Greater China has already recovered very strong since ZCP was abandoned. Outbound tourism should also pick up rapidly during the course of the year which will boost growth in those economies that rely heavily on Chinese tourism (chart 6). But while the return of holidaymakers will be good news for those countries, they are generally small Asian economies that account for only a fraction of world GDP. In other words, Chinese tourists are unlikely to offer any meaningful support to overall global growth.

Chart 6: The return of Chinese tourists will boost some economies



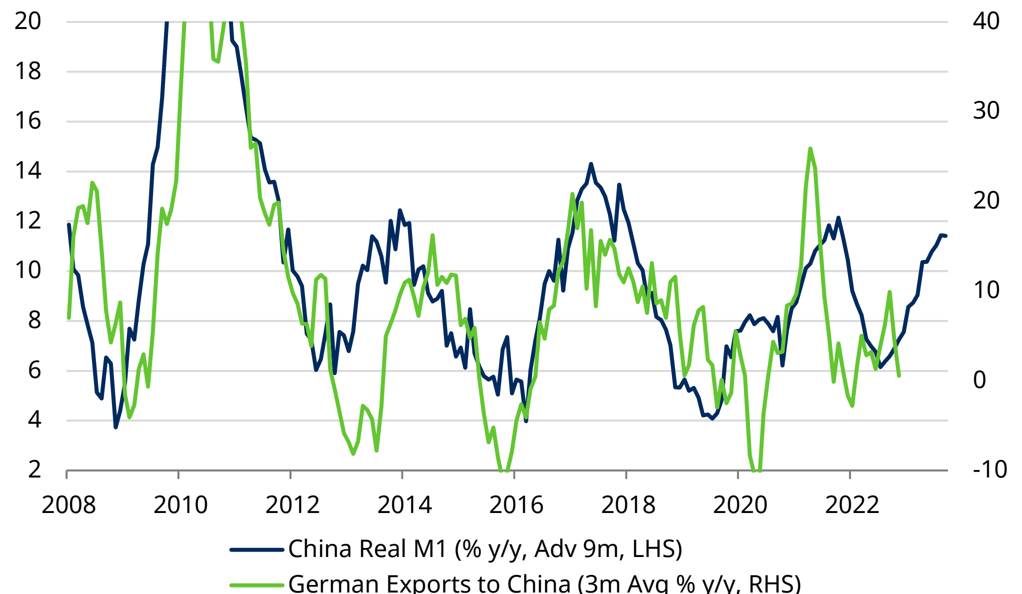
Source: Refinitiv, Oxford Analytica, Schroders Economics Group. 17 February 2023.

On the goods side, in net terms China is only a major source of final demand for commodities such as mineral fuels and industrial metals, and a slight consumer of some manufacturing equipment and machinery.

Services-driven recovery unlikely to drive capex boom in manufacturing

Europe would usually benefit from an upturn in China's economic cycle as stronger growth stimulates investment by manufacturers in response to an increase in demand for goods. For example, German exports, and more so corporate earnings, are well correlated with the leading indicators of activity in China (chart 7). This suggests that Germany is on course for double-digit growth in exports to China in the months ahead.

Chart 7: European exports may not benefit as much as in the past



Source: Refinitiv, Schroders Economics Group. 17 February 2023.

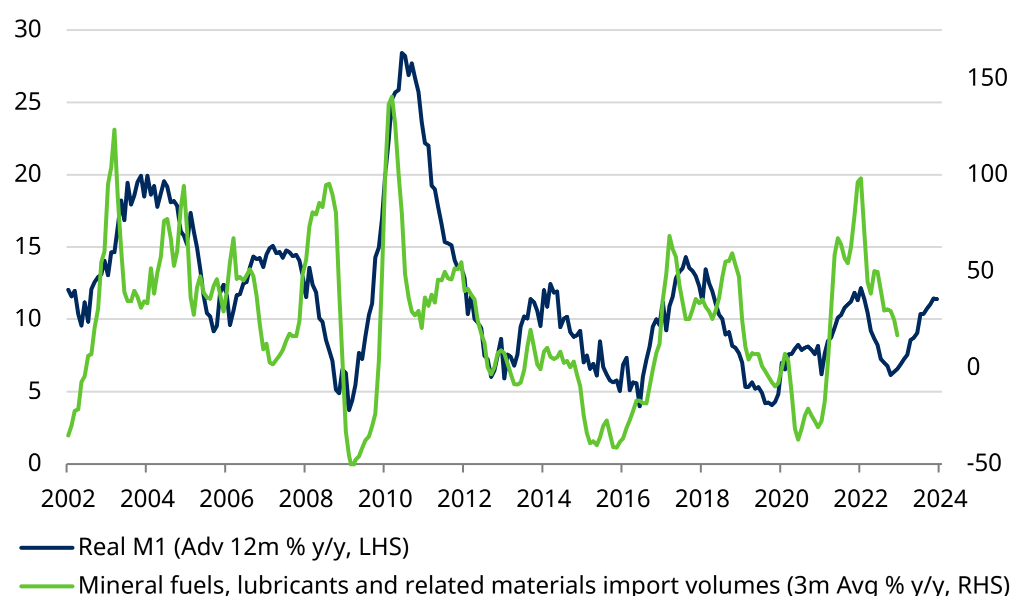
However, it is not entirely clear that this channel will be as fruitful as in the past, for at least three reasons. First, we expect the recovery to be skewed towards services. Second, while consumption of manufactured goods in China should increase as confidence recovers, it is not clear that it will create the kind of capacity constraints that would require further investment. After all, investment in manufacturing has

already been strong in recent years as Chinese firms scrambled to meet rampant global demand for goods during the initial phase of the pandemic. But with global inventories now rebuilt and external demand much softer, there is some slack in the manufacturing sector. This should at least anchor manufactured goods prices. Third, while ZCP may have delayed foreign direction investment (FDI), it is not clear if multinationals will increase investment in China at a time when geo-political pressures are pushing for supply chain diversification.

Demand for commodities likely to increase, particularly energy

The impact through the commodities channel is also likely to be different. China's heavy reliance on imports means there should be more spill-over to the rest of the world. However, a recovery skewed towards services ought to be less commodity-intensive than a construction boom, with demand geared more towards energy rather than metals as mobility increases. So, whereas past recoveries in China have benefitted metals exporters in regions such as Latin America and Africa, it may be energy producers than are the winners this time as import volumes pick up (chart 8).

Chart 8: Energy import volumes will probably recover

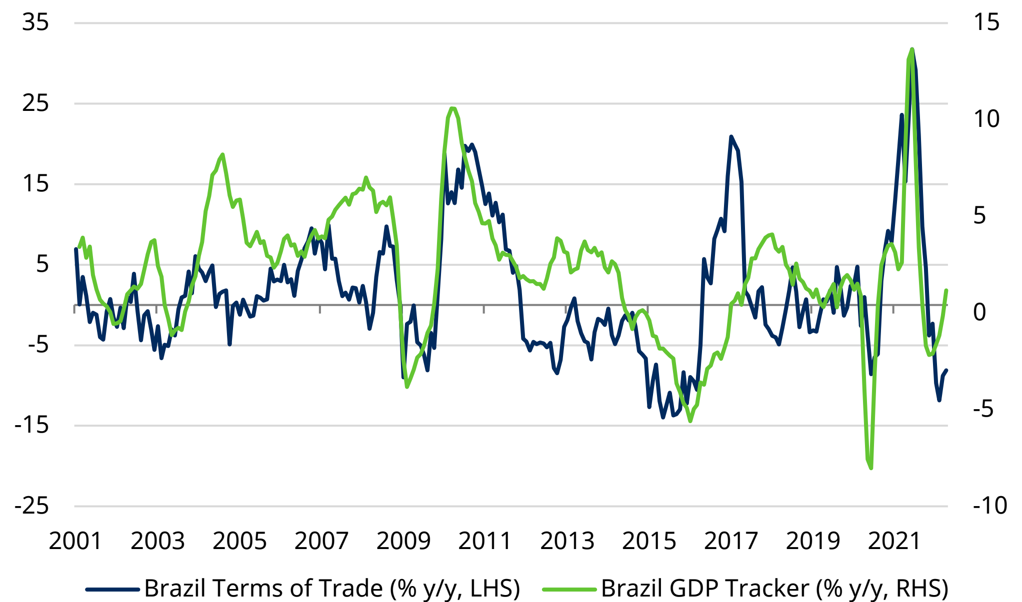


Source: Refinitiv, Schroders Economics Group. 17 February 2023.

Commodity exporters will benefit if Chinese demand pushes up prices

The degree to which the commodities channel will impact the rest of the world will depend in large part on what happens to prices. As chart 9 shows, commodity producers such as Brazil rely on price increases to generate faster economic growth as an improvement in their terms of trade funds an increase in domestic demand. However, the unusually desynchronised global cycle during the Covid pandemic means that it is not guaranteed that commodity prices will increase if stronger demand from China is offset by less demand from elsewhere.

Chart 9: EM commodity producers rely on higher prices to drive growth



Source: Refinitiv, Schroders Economics Group. 17 February 2023.

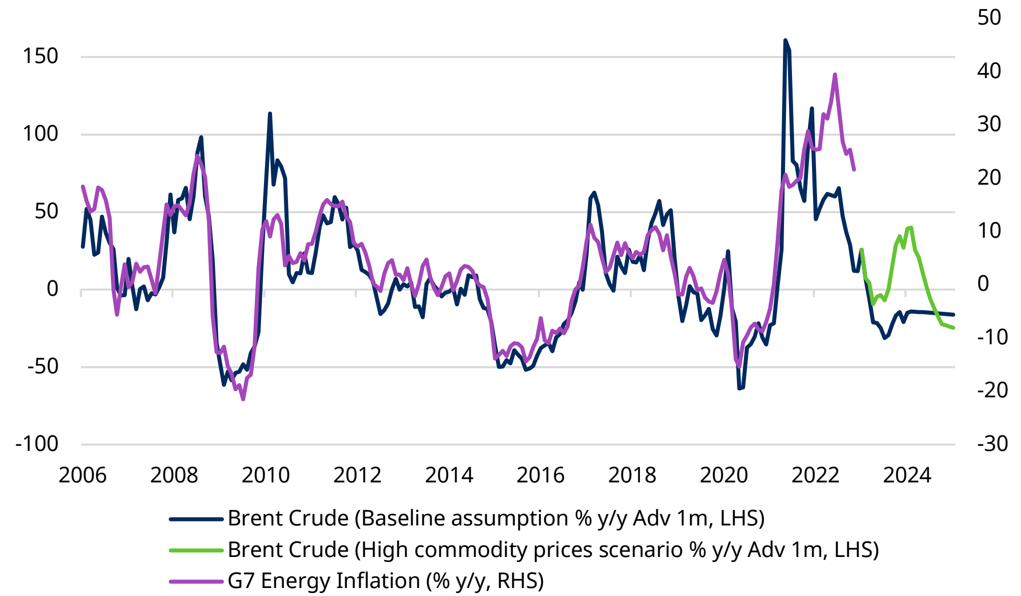
Our baseline forecast uses forward curves for food and energy prices, which are in backwardation and therefore assume that commodity prices will drift lower over time. Indeed, the prior terms of trade growth for emerging markets such as Brazil has faded away and this, coupled with the lagged impact of aggressive interest rate hikes, points to relatively sluggish growth.

Risk that inflation will return

But higher commodity prices could see inflation return

In any case, higher commodity prices would on balance probably be negative for the global economy. While some exporters of natural resources would benefit from an improvement in their terms of trade, our "higher commodity prices" scenario shows that there would be a negative overall impact on the global economy. After all, higher commodity prices could fire up inflation again. An increase in oil prices would cause energy inflation to rise again around the turn of the year (chart 10). And if, as has often been the case, rising energy costs were to pass through to higher food prices then the longer lags mean there could be a lasting increase in global inflation during the course of 2024. Manufactured goods inflation is likely to remain well anchored now that supply chains have normalised and inventories have been rebuilt. However, the return of commodity price inflation would put real incomes back under pressure and leave less room for central banks to lower interest rates in 2024.

Chart 10: Higher commodity prices would be an upside risk to global inflation



Source: Refinitiv, Schroders Economics Group. 17 February 2023.

The upshot is that while abandoning ZCP has clearly improved the outlook for China this year, the rest of the world may not benefit much if at all. Indeed, while we have also revised up our expectations for growth in the US and eurozone this year, the upgrades are due to domestic factors rather than a boost from China.

US – resilient labour market to trigger more rate hikes

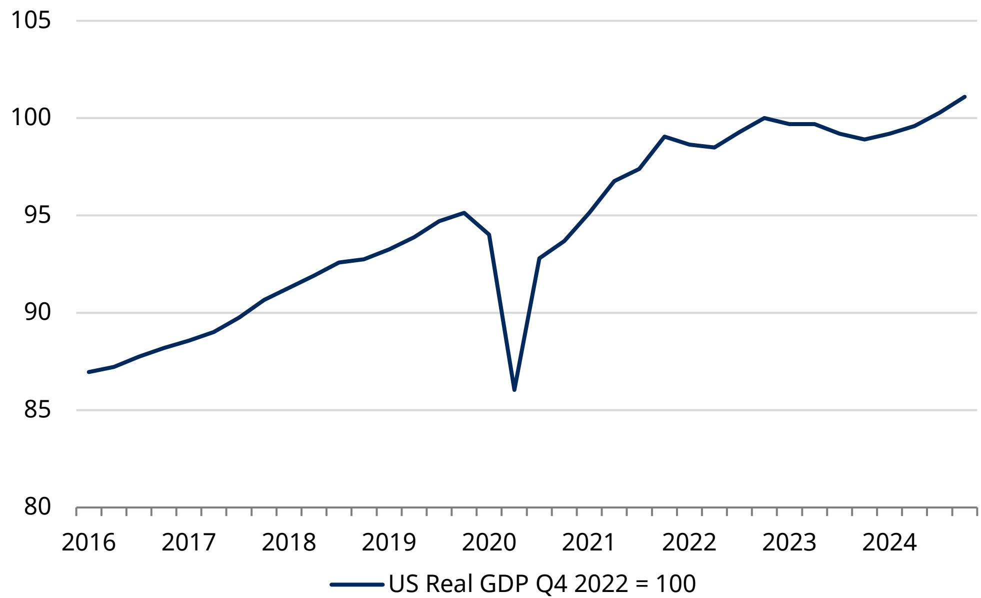
US economy still defying gravity

In the US, the various warning signs that have been flashing red for some time are yet to translate into recession. Indeed, the economy appears to have started 2023 on a relatively strong footing as the resilient labour market continues to underpin activity. Leading indicators such as rising layoffs continue to suggest that employment conditions will worsen during the course of this year. However, the unemployment rate remains at historic lows and this will probably encourage the Fed to lift rates further than we had previously assumed. We have pencilled in 25bp hikes in both March and May to lift the upper bound of the Fed funds target rate to 5.25%.

Additional rate hike still likely to lead to recession

We still think that tighter monetary policy will cause the economy to fall into recession in the second half of this year, but it will probably be shallow, short-lived and a bit later than we previously assumed. The carry-over from better-than-expected activity in the fourth quarter of last year means that even if output contracts later this year, the US economy may still eke out positive growth of 0.3% in 2023 as a whole. That is a significant improvement from our previous forecast that output would contract by 1% this year. But it is not all good news. A better outturn this year comes at the cost of a weaker growth next year as even higher interest rates bite. We have marked down our forecast to just 0.7% in 2024, from 1.4% previously. Output is set to be largely stagnant and unlikely to return to the Q4 2022 peak until the middle of next year (chart 11).

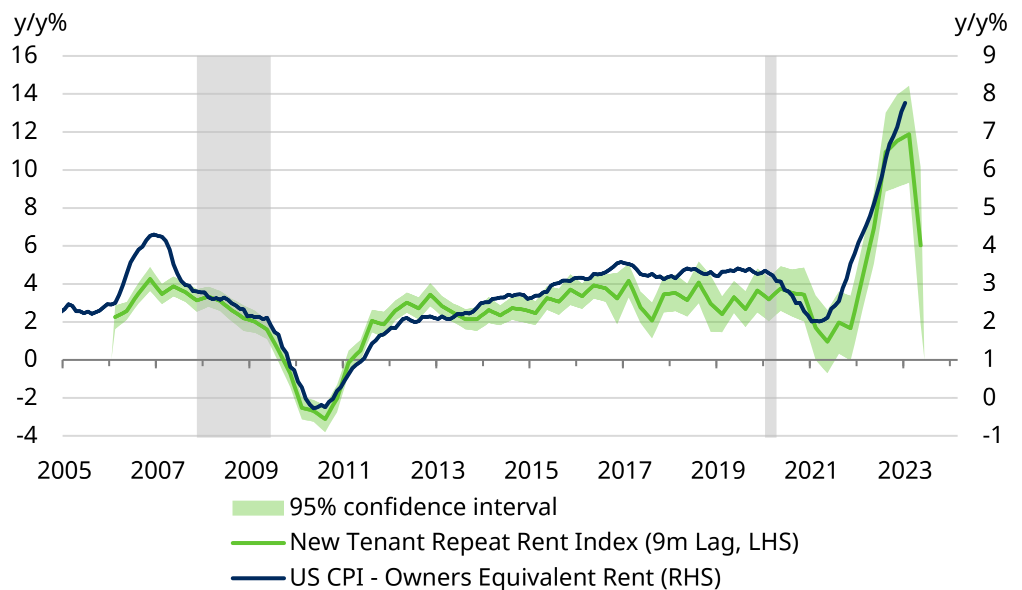
Chart 11: Strong performance of the US economy is hitting the buffers



Source: Refinitiv, Schroders Economics Group. 17 February 2023.

Inflation may also a be a bit firmer in the near term, but we continue to expect a period of below-trend growth to ensure that it will decline towards target over the forecast horizon. Much will depend on core inflation, which remains elevated due to housing-related components. Relatively strong fundamentals mean that price pressures here may persist a while longer, but a broad range of leading indicators continue to point to a significant easing of shelter price pressures (chart 12).

Chart 12: Shelter inflation should eventually decline

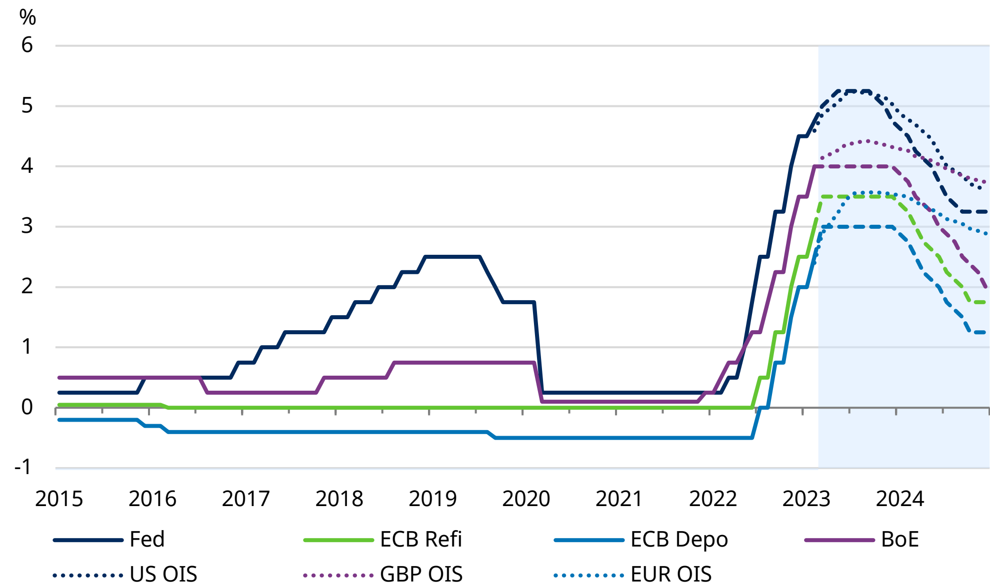


Source: Refinitiv, Schroders Economics Group. 17 February 2023 OER: Owner Equivalent rent, NTRR: New Tenant Repeat Rent index.

Fed pivot still likely before year-end

A mild recession and fading inflation pressures should still give the Fed confidence to pivot back to interest rate cuts later this year. However, the first cut is now unlikely to come until the fourth quarter of 2023, with 50bp of easing to 4.75% by year-end. More sizeable easing should follow thereafter, with rates finding a floor at 3.25% in the second half of 2024 (chart 13).

Chart 13: Interest rates are likely to rise a bit further before cuts into 2024



Source: Refinitiv, OIS data from GS (17 February 2023). Schroders Economics Group. 22 February 2023.

Recession risks reduce in Europe

Relief from energy crisis improves the outlook for the eurozone

Forward planning by governments, and good fortune in the form of warm weather, have helped to improve the outlook for European economies.

Reductions in demand for energy, partly enforced, but also partly in reaction to higher prices, helped boost storage levels of gas to highs not seen since winter 2019/20. At the start of this winter (December), German gas storage facilities reached 97.6% of capacity (chart 14). However, inventory levels at the end of January only fell back to 78.6%, compared to the average over the previous seven years of 63.3%.

Chart 14: Germany's gas inventories

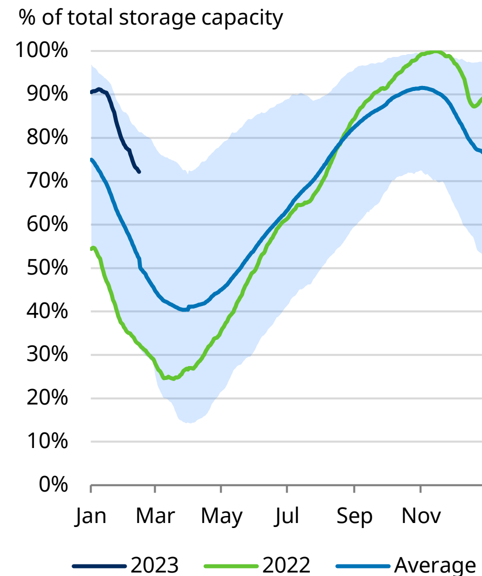
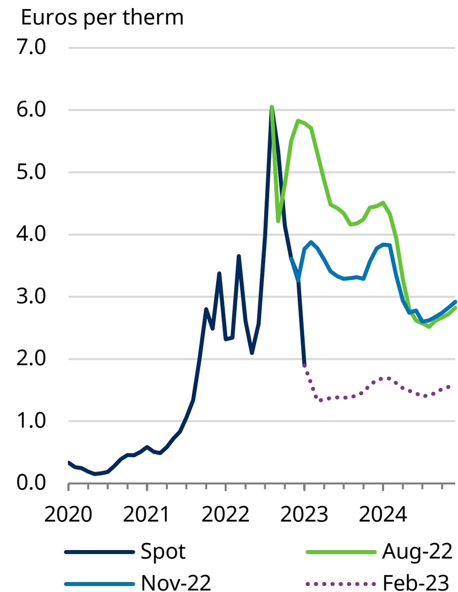


Chart 15: European gas prices



Source: Gas Infrastructure Europe – AGSI, Refinitiv, Schroders Economics Group. 17 February 2023.

Reduced demand and near-full storage facilities meant that the wholesale price of natural gas across Europe had to fall (chart 15). Compared to the time of our last forecast in November, the price for the December 2023 contract has fallen by 56%.

This will not help households in the very near term, but it should mean that combined with fiscal support, energy bills will fall significantly by the summer.

Inflation to fall back more quickly and economy may avoid outright recession

The fall in wholesale energy prices has helped lower the inflation forecast substantially. HICP inflation is forecast to fall from 8.4% in 2022 to 4.2% in 2023, compared to the previous forecast of 5.1%. Lower inflation will help boost the disposable income of households, which have so far proven to be very resilient through this period. This was supported by excess savings that were built up during the pandemic, which still remain.

Activity in general has continued to surprise to the upside as eurozone GDP growth beat the consensus once again in the last quarter of 2022. The economy grew by 0.1% compared to expectations of a contraction, and the start of a technical recession. The odds of a recession have now reduced significantly, although our revised forecast still assumes a largely stagnant year.

ECB to hike rates to 3.5% in Q1 before pivoting back to cuts in 2024

Rate hikes by the European Central Bank (ECB) are likely to start to bite by the second half of the year, dampening any recovery after the fall in energy prices. Indeed, the ECB is now expected to take the terminal rate to 3.5%, after it announced that a further 50 basis point rate rise in March should be expected. ECB president Christine Lagarde stated that staff would re-assess the outlook for the next meeting, which we see as an opportunity to conclude that inflation conditions will have improved sufficiently to warrant a pause.

Inflation should fall back below 3% by the start of 2024, allowing the ECB to start cutting rates. Core inflation (excluding food, alcohol, tobacco and energy) will remain a concern, but we expect domestic inflation pressures to ease by the end of 2024. The main refinancing rate is forecast to end 2024 at 1.75%, with the deposit rate 50bps lower.

At its last meeting, the ECB also announced the start of quantitative tightening (QT), which is forecast to be accelerated progressively over the forecast horizon. This increases the risk of an accident in sovereign debt markets, but if volatility does rise the ECB is likely to halt QT.

As the eurozone economy continues to recover in 2024, growth is forecast to average 0.8%, although by the end of the year, quarterly year-on-year growth is forecast to rise back to a trend rate of 1.4%.

UK recession delayed, not avoided

UK faces recession as high inflation and interest rates cause consumers to retrench

The latest GDP figures for the UK showed the economy narrowly avoided a technical recession at the end of 2022. A rebound in activity in October, after the additional bank holiday to mark the Day of National Mourning in September, stopped the fourth quarter as a whole contracting. However, the half a percentage point fall in GDP in December shows that the economy is losing momentum fast.

Like mainland Europe, the UK is struggling with higher energy bills, along with rising interest rates. Fiscal policy was initially set to be very generous; however, the gilts and sterling crisis which followed the expansionary fiscal package forced the government to cancel or pare back the help. National insurance contributions (a form of income tax) were not cut, and a cap of the average cost of home energy bills was lifted in January to pass on more of the costs to households.

By the end of the financial year, energy support for businesses will end, along with some super-deductions for business related to capex. Meanwhile, with a tight labour market, businesses are under pressure to accept higher pay settlements, or risk losing staff to competitors. There are more unfilled job vacancies than unemployed individuals, and so while wage growth is currently running below inflation, it remains a significant burden for businesses.

Over 2023, more households will see their fixed rate mortgages expire, forcing them to accept interest rates that are multiples of those they would have enjoyed in recent years. Naturally, this will reduce disposable income and hit household demand for goods and services and ultimately contribute to a recession over the first half of the year.

The forecast for UK GDP growth has remained at -0.8% compared to 4% in 2022. By the end of 2023, the economy should begin to bottom out, and start its sluggish recovery over 2024. Against this backdrop, inflation will remain relatively high, although it has been significantly downgraded from November. CPI inflation is forecast to slow from 9.1% in 2022 to 6.5% in 2023, before falling back to 3.8% in 2024.

Rates may have already peaked, BoE could also cut in 2024

The Bank of England's (BoE) minutes following its February monetary policy committee meeting said that the 50bps rise in rates "...would address the risk that domestic wage and price pressures remained elevated even as external cost pressures waned." In addition, "The MPC would continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wage growth and services inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required." This suggests that the UK interest rates may now be at their peak for this cycle.

The BoE is forecast to remain on hold until early 2024, and the begin to cut. Inflation will have fallen back significantly by then, allowing the BoE to forecast a path back to target, even if it fails to reach it. The forecast has the BoE cutting to 2% by the end of 2024, though QT continues at a steady pace through the period.

Scenarios analysis: Stagflationary risks remain, but upside scenarios emerge

Stagflationary scenarios remain the biggest risk

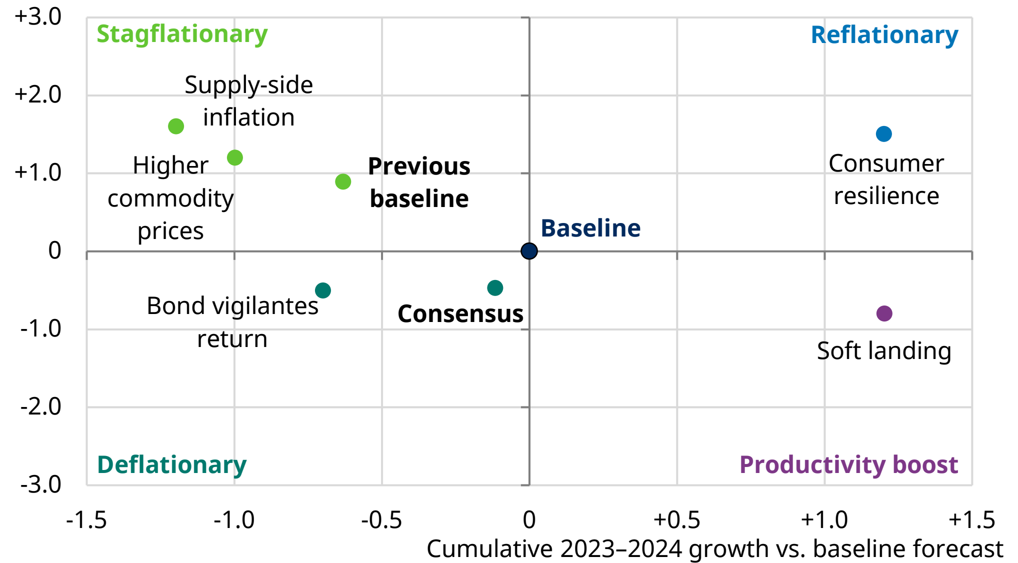
We assign the greatest probability to a new scenario of **Higher commodity prices**. Our above-consensus forecast for growth in China this year implies that demand for natural resources could be stronger than is generally expected. Meanwhile, a colder winter in 2023/24 would increase European demand for gas. Supply problems could also return in such a fraught geo-political environment. Higher commodity prices would fire up inflation again through the forecast horizon, putting a renewed squeeze on real incomes, forcing central banks to raise interest rates further and reducing growth.

We also continue to assign a relatively high probability to another, long-standing stagflationary scenario of **Supply-side inflation**. Concern stems from evidence that labour markets remain in rude health, running the risk of higher-than-expected wage settlements, driving up inflation further through second-round effects. This requires even more aggressive monetary tightening to reverse inflation pressures.

Battle over the US debt ceiling could lead to tighter global financial conditions

The other major downside risk comes in the form of another new scenario: **Bond vigilantes return**. The polarised political landscape in Washington raises a clear risk of government shutdown, ratings downgrades and even default as the US government approaches its debt ceiling. A buyers' strike in the Treasury market could cause huge volatility in global financial markets and see bond vigilantes go after other governments around the world that are running unsustainable fiscal policies. Governments may be forced to retrench, while an abrupt tightening of financial conditions would be bad news for those emerging markets that rely on capital flows. Global growth is markedly slower, although weaker demand does at least bring inflation down making this a deflationary scenario.

Chart 16: Scenario grid – growth and inflation deviations from baseline



Source: Schroders Economics Group. 22 February 2023. Please note the forecast warning at the back of the document.

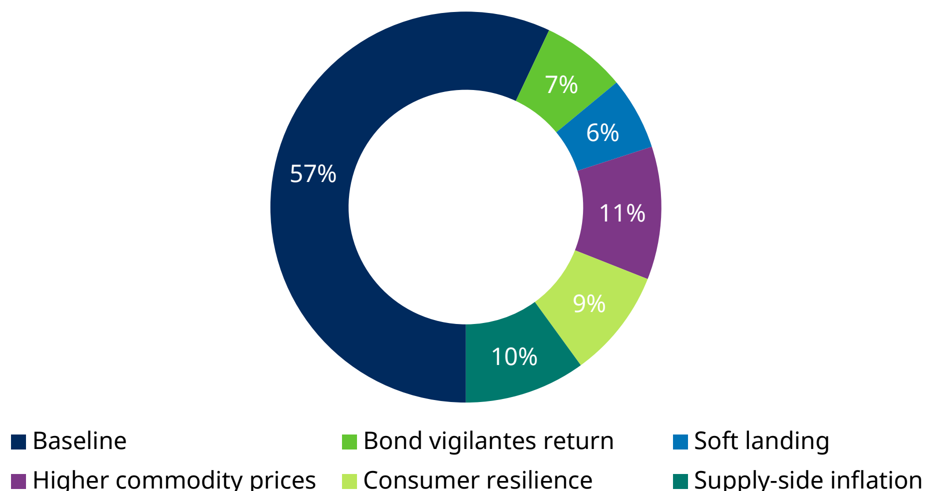
Upside risks come in the form of resilient consumers and soft landing

It is not all bad news, though, and we include two new upside scenarios with a combined probability of 15%.

The first is the reflationary **Consumer resilience** scenario. Consumer activity has held up well in several economies, notably the US, supported by buoyant labour market conditions and pent-up savings. With hiring difficulties post-pandemic still fresh in the minds of firms, labour hoarding may prevent a major increase in unemployment which, combined with a still large stock of savings, could see consumers brush off concerns about recession. Stronger aggregate demand would cause inflation to remain higher for longer, leading to more aggressive interest rate hikes that would eventually set the scenario for recession in late-2024.

The second upside scenario comes in the form of a **Soft landing**. Missing workers return to the labour force, helping to cool labour market conditions. Improvements on the supply side of the economy help to bring down inflation without the need for recession. Central banks are also able to run looser monetary policy giving the global economy a growth boost relative to our baseline forecast.

Chart 17: Scenario probabilities



Source: Schroders Economics Group. 22 February 2023. Please note the forecast warning at the back of the document.

Schroders Economics Group: Views at a glance

Macro summary – Q1 2023

Key points

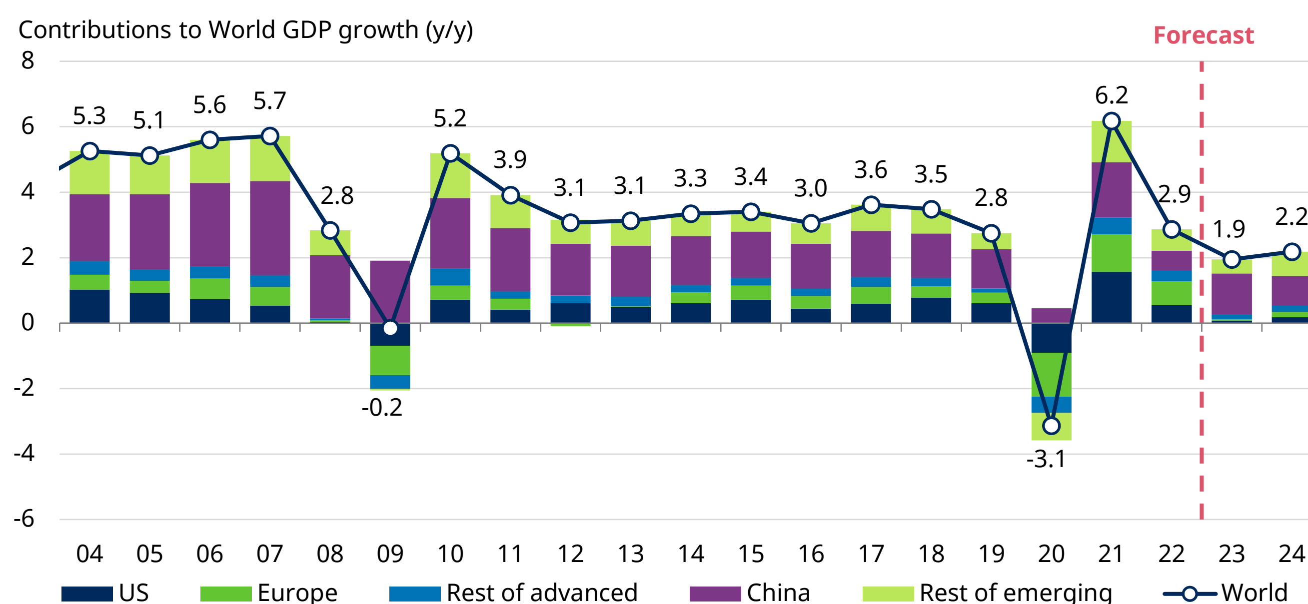
Baseline

- **US:** The US has so far avoided recession despite most early warning signs flashing red. Robust labour market conditions have helped to sustain growth, while core inflation remains elevated. Against this backdrop, the Fed is likely to raise rates further to a peak of 5.25% in Q2. Higher rates are still likely to lead to a recession, albeit a mild one that could still see GDP expand by 0.3% in 2023 as a whole and 0.8% in 2024. But with below-trend growth sufficient to ensure that inflation will trend down towards target in 2024, signs of a slowdown are still likely to see the Fed pivot before year-end, cutting rates to 3.5% in 2024.
- **Eurozone:** The eurozone economy has held up better than expected and after a reprieve from the energy crisis. Energy inflation remains the key concern, but headline HICP inflation is forecast to fall from 8.4% in 2022 to 4.2% in 2023 and 2.2% in 2024. The relief on household incomes means that the economy may avoid recession altogether and we have pencilled in GDP growth, albeit subdued, of 0.5% in 2023 rising a touch to 0.8% in 2024. Less concern about the energy crisis should embolden the ECB to raise its refinance rates to 3.5% in order to ward-off the threat of second-round effects from buoyant labour market conditions. But like the Fed, we doubt it will be long until the ECB pivots, lowering rates by 175bp to 1.75% in 2024.
- **UK:** We continue to expect the UK economy to underperform and suffer an outright contraction of 0.8% in 2023. The economy faces a toxic cocktail of high energy bills, shortages of labour and disruption to supply chains. Meanwhile, rising mortgage costs will increasingly sap demand. In addition, fiscal policy has turned more austere. The good news is that inflation is likely to be lower, at 6.8% in 2023 and 3.8% in 2024. As a result, the Bank of England is likely to end its hiking cycle, holding rates at 4% through 2023 before cutting them to 2% in 2024. That should support some pick-up in GDP growth to 0.8% in 2024.
- **Emerging Markets:** The removal of the government's zero-Covid policy is likely to release pent-up demand that will lift GDP growth in China to 6.2% in 2023. We expect three quarters of above-trend growth, but that momentum will fade into 2024 causing GDP growth to ease back to 4.5% in 2024. However, the spill-overs from the recovery in China will be limited and most other EMs face slower growth as soft global demand and the lagged effect of aggressive rate hikes hit activity. Brazil may grow by only 0.5% in 2023, while India may disappoint expectations. Inflation should trend down over the forecast horizon and central banks may start to lower rates before their counterparts in developed markets, brightening the outlook for 2024.

Risks

Stagflation remains the greatest threat to the global economy. Of our five risk scenarios, three are predicated on weaker output and two assume inflation will be higher. We see the greatest threat as being higher commodity prices followed by supply-side inflation, while the return of bond vigilantes is another downside risk. The three scenarios have a combined probability of almost 30%. Of the remaining risks, we see a roughly similar likelihood of either a soft landing or consumer resilience leading to a better outcome.

Chart: World GDP growth – history and forecast



Source: Schroders Economics Group. 22 February 2023. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2022	2023		Prev.	Consensus	2024		Prev.	Consensus
World	100	2.9	1.9	↑	*(1.3)*	1.9	2.2		*(2.2)*	2.4
Advanced*	59.7	2.7	0.4	↑	*(-0.2)*	0.6	0.9	↓	*(1.4)*	1.2
US	26.5	2.1	0.3	↑	*(-1.0)*	0.7	0.7	↓	*(2.0)*	1.1
Eurozone	16.6	3.5	0.5	↑	*(-0.1)*	0.4	0.8		*(0.8)*	1.2
Germany	4.8	1.9	0.1	↑	*(-0.4)*	-0.1	0.6		*(0.6)*	1.4
UK	3.6	4.0	-0.8		*(-0.8)*	-0.8	0.8	↑	*(0.3)*	0.7
Total Emerging**	40.3	3.1	4.2	↑	*(3.5)*	3.8	4.1	↑	*(3.5)*	4.1
BRICs	27.6	3.1	5.2	↑	*(4.1)*	4.6	4.6	↑	*(4.2)*	4.7
China	20.2	3.0	6.2	↑	*(5.0)*	5.2	4.5	↑	*(4.2)*	5.1

Inflation CPI

y/y%	Wt (%)	2022	2023		Prev.	Consensus	2024		Prev.	Consensus
World	100	7.6	4.7	↓	*(4.9)*	5.1	3.2	↓	*(3.9)*	3.3
Advanced*	59.7	7.4	3.9	↓	*(4.5)*	4.4	2.1	↓	*(2.6)*	2.4
US	26.5	8.0	3.6	↓	*(4.1)*	3.9	2.0	↓	*(2.2)*	2.5
Eurozone	16.6	8.4	4.2	↓	*(5.1)*	5.5	2.2	↓	*(2.5)*	2.4
Germany	4.8	8.6	4.8	↓	*(5.7)*	6.2	2.4	↓	*(2.6)*	2.7
UK	3.6	9.1	6.5	↓	*(9.3)*	6.7	3.8	↓	*(4.1)*	2.9
Total Emerging**	40.3	7.9	5.9	↑	*(5.6)*	6.1	4.8	↓	*(5.8)*	4.6
BRICs	27.6	3.9	3.0	↑	*(2.8)*	3.4	3.3	↑	*(3.0)*	3.0
China	20.2	2.0	2.3	↑	*(2.0)*	2.4	2.7	↑	*(2.3)*	2.3

Interest rates

% (Month of Dec)	Current	2022	2023		Prev.	Market	2024		Prev.	Market
US	4.75	4.50	4.75	↑	*(3.50)*	5.07	3.25	↑	*(2.50)*	3.55
UK	4.00	3.50	4.00		*(4.00)*	4.34	2.00		*(2.00)*	3.76
Eurozone (Refi)	3.00	2.50	3.50	↑	*(3.00)*	3.56	1.75	↑	*(1.50)*	2.86
Eurozone (Depo)	2.50	2.00	3.00	↑	*(2.50)*		1.25	↑	*(1.00)*	
China	3.65	3.65	3.65	↑	*(3.60)*	-	3.65	↑	*(3.50)*	-

Other monetary policy

(Over year or by Dec)	Current	2022	2023		Prev.	Y/Y(%)	2024		Prev.	Y/Y(%)
US QE ($Tn)	8.6	8.6	7.7		*(7.7)*	-10.5	7.0		*(7.0)*	-9.1
EZ QE (€Tn)	2.9	2.9	2.7	↓	*(2.8)*	-6.9	2.4	↓	*(2.6)*	-11.1
UK QE (£Bn)	831	831	733		*(733)*	-11.8	628		*(628)*	-14.3
China RRR (%)	11.00	11.00	11.00		*11.00*	-	11.00	↑	*10.00*	-

Key variables

FX (Month of Dec)	Current	2022	2023		Prev.	Y/Y(%)	2024		Prev.	Y/Y(%)
GBP/USD	1.21	1.20	1.18	↑	*(1.14)*	-1.9	1.22	↑	*(1.15)*	3.4
EUR/USD	1.09	1.07	1.11	↑	*(0.99)*	4.0	1.16	↑	*(1.00)*	4.5
USD/JPY	131.0	131.9	125	↓	*(146)*	-5.3	120	↓	*(140)*	-4.0
EUR/GBP	0.90	0.89	0.94	↑	*(0.87)*	6.0	0.95	↑	*(0.87)*	1.1
USD/RMB	6.75	6.95	6.60	↓	*(7.30)*	-5.1	6.40	↓	*(7.00)*	-3.0
Commodities (over year)										
Brent Crude	80.0	99.0	82.2	↓	*(100.8)*	-17.0	77.5	↓	*(91.3)*	-5.7

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data taken as at 03/02/2023. Previous forecast refers to November 2022
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan SAR, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Growth	Inflation
			Cumulative 2023/24 global vs. baseline		
Baseline	Global GDP growth is forecast to slow from an expected 2.9% in 2022 to 1.9% in 2023, with only a slight recovery to 2.2% in 2024. The outlook for developed markets remains challenging, with the US and UK experiencing recessions, while the eurozone stagnates. Developed markets growth falls from 2.7% in 2022 to just 0.4% in 2023, before rising to 0.9% in 2024. High energy prices and rising interest rates remain a concern in Europe, although recent falls in prices have helped negate the previously forecast recession. Meanwhile, a more robust US economy is likely to mean a delay to the recession to the end of 2023. In contrast to developed markets, we expect GDP growth in the emerging world to accelerate from 3.1% in 2022 to 4.2% in 2023. However, the improvement is driven almost entirely by China, with growth topping 6% after Covid restrictions were abandoned. Most other EMs face slower growth as past rate hikes and soft external demand bite. EM growth is then set to ease back to 4.1% in 2024.	Inflation in most of the advanced countries appears to have peaked, as energy inflation starts to fall back. Food inflation remains sticky through 2023, but is expected to ease, while core inflation, particularly for services will be the main challenge for central banks. The robust US labour market is expected to push the Fed to raise rates a little further to 5.25% by the Q2 2023. Meanwhile, QT continues at a steady pace. As the recession is confirmed, the Fed is forecast to cut rates at the end of 2023, eventually taking rates down to 3.25% by the end of the forecast. The forecast has no more interest rate rises in the UK, but the Eurozone has potentially one more 50bps hike in March. Both BoE and ECB are then expected to pause, before cutting rates through 2024, down to 2% and 1.75% respectively by the end of next year. Inflation has peaked in most emerging markets and should decline as price pressures from food and energy continue to ease. Past aggressive rate hikes and sluggish growth should bring core inflation down and make space for central banks to start lowering interest rates from high levels.	57%	-	-
1. Bond vigilantes return	As US government borrowing approached the debt ceiling, negotiations to lift the cap appear to hit an impasse as hard-liners refuse to negotiate without major concessions. The government is forced to close down many services to allow for more time for talks, but politicians start to openly talk about a default which spooks markets. US Treasury yields spike up as rating agencies take their turn to downgrade sovereign paper. Investors, especially those overseas, rush for the exit, pushing the US dollar down by 20% against the yen and by 15% against the euro. Contagion start to spread as other vulnerable debt markets, including the UK, Southern Europe start to see higher yield and a greater probability of default being priced in. In emerging markets, spreads widen across the board, but the hardest hit of the larger economies are Turkey, Hungary, Colombia and Chile. After some time, an agreement is reached to raise the debt ceiling, but the damage to the US's reputation is done, and a risk premium remains going forward.	**Deflationary:** Higher term premiums across the global economy raises the cost of financing debt, and reduced disposable income. The volatility in markets and currencies also reduce corporate confidence, who cut CAPEX, and consumer sentiment, prompting a rise in pre-cautionary savings. In the US, government shutdowns hits federal spending and activity. The economy enters an earlier recession, which in turn causes inflation to fall faster than in the baseline. The Fed is forced to stop QT and cut rates in an effort to lower yields. Elsewhere, the ECB and BoE cut rates more aggressively than the Fed, while policy rates in most of EM remain elevated to defend their currencies. Some EM central banks are forced into large emergency rate hikes to stem capital outflows, plunging economies into recession.	7%	-0.7%	-0.5%
2. Soft landing	The trade-off between growth and inflation improves as companies see costs fall back. Higher living costs encourage more workers to return to the labour force, boosting the participation rate. This helps ease wage pressures, and provides firms more resources to generate growth, with less inflation.	**Productivity boost:** Economies that have been hampered by supply constraints – notably the US, Europe and UK – see an increase in growth while inflation pressures subside a little. This relieves some of the pressure on the central banks to tighten policy, meaning that policy rates peak at lower levels than in the baseline.	6%	+1.2%	-0.8%
3. Higher commodity prices	Stronger-than-expected growth in China raises demand. Ongoing intense fighting in Ukraine coupled with an escalation in tensions in the Middle East between Iran, Saudi Arabia and Israel threatens energy supply, pushing the price of oil to over $120 p/b. The price of natural gas in Europe returns to highs not seen since Autumn 2022, as global competition for LNG shipments intensifies.	**Stagflationary:** Some of the higher energy prices will be offset by fiscal support, but ultimately, households and firms see a sharp rise in costs, which reduce disposable income, spending and CAPEX. Central banks diverge somewhat in their response. Although inflation is higher in the US compared to the baseline. The Fed initially takes rates up to a higher peak than in the baseline, but the deeper recession leads it to cut rates more aggressively. QT is also paused temporarily. The BoE and ECB both hike more aggressively, and due to more sticky inflation, are forced to keep rates higher than in the baseline.	11%	-1.0%	+1.2%
4. Consumer resilience	Thanks to the build-up of savings during the pandemic, households maintain regular spending patterns, despite rising cost pressures and interest rates. This in-turn bolsters the outlook for corporate profitability, encouraging greater CAPEX and the passing on of costs through higher prices.	**Reflationary:** Demand remains robust through 2023, leading to higher core inflation, and headline inflation falling back more slowly than in the baseline. Central banks respond by raising interest rates more aggressively. The Fed funds rate reaches a peak of 6.5% by the end of 2023, while the ECB reaches 4.5%. Eventually, higher interest rates cause activity to slow, and the US experiences a technical recession in the middle of 2024. At that stage, central banks start to cut rates again, but over the two-year horizon, growth and inflation are both higher than the baseline.	9%	+1.2%	+1.5%
5. Supply-side inflation	Bottlenecks in the industrial sector re-emerge and prevent goods inflation from falling back, while commodity markets also struggle with supply shortages. Meanwhile, wages accelerate by more than in the baseline in response to tight labour markets. The labour participation rate in the US does not improve, whilst mismatch between worker skills and jobs in the post covid economy means the NAIRU rises and available slack is less than in the baseline.	**Stagflationary:** Supply shortages cause commodity prices to climb further, pushing food and energy inflation higher. Supply constraints and higher commodity prices see goods inflation increase again and tight labour markets ensure that price pressures endure as wages increase. This results in persistent inflation, which does not get back down to target over the forecast horizon. This forces the Fed to raise rates all the way to 6.5%. Other central banks also step up the pace of tightening. Higher inflation, along with tighter monetary policy, chokes off demand leading to shallower recoveries from deeper recessions in 2023.	10%	-1.2%	+1.6%
6. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

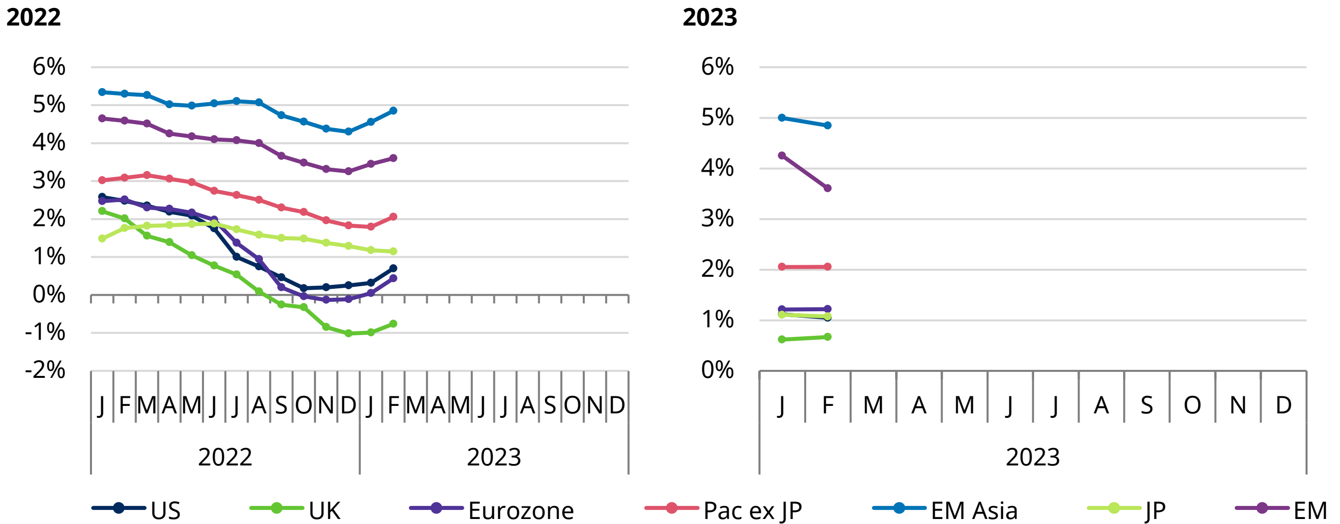
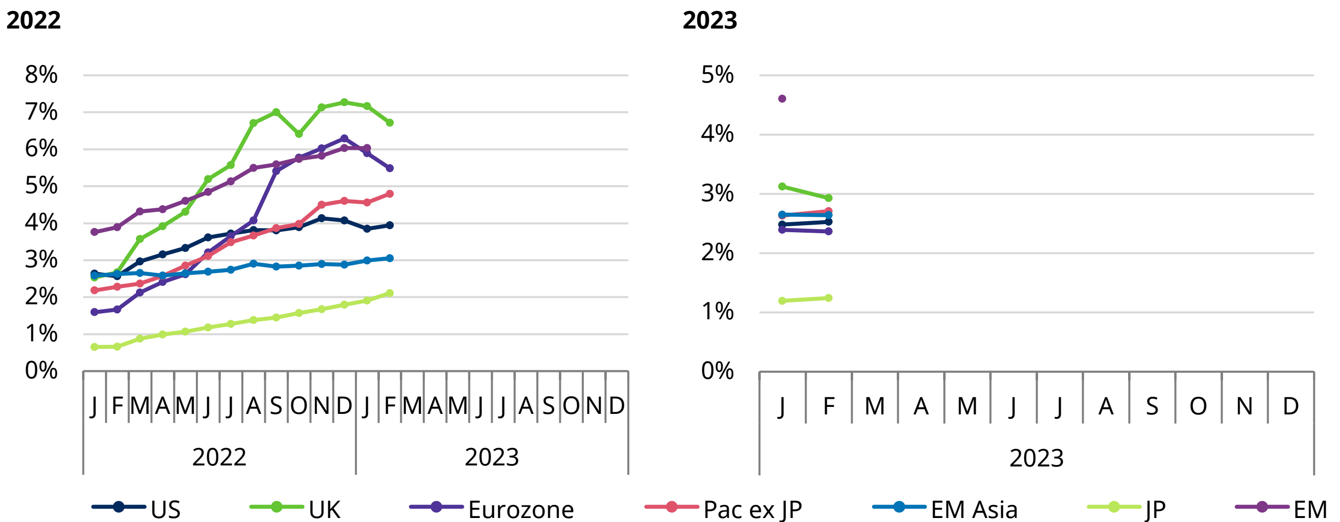


Chart B: Inflation consensus forecasts



Source: Consensus Economics (February 2023), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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