S&P Global Ratings

Global Credit Conditions Downside Scenario

Recession Risks Deepen

Oct. 12, 2022

Editor's note: On Sept. 28, 2022, we published the macro base case (see "Global Macro Update: Many Routes To The Bottom," published Sept. 28, 2022), which underpins the forecasts for rated entities, as part of our quarterly Credit Conditions Committee review (see "Global Credit Conditions Q4 2022: Darkening Horizons," published Sept. 29, 2022). In this quarterly report, we also underlined the increase in likelihood and severity of downside risks. Today's publication is aimed at providing the market with a sensitivity analysis if things were to deteriorate further compared with the estimates underpinning our base case.

This report does not constitute a rating action

Key Takeaways

- S&P Global Ratings sees a significant risk that the Russia-Ukraine military conflict drags on, exacerbating Europe's energy crisis, while at the same time interest rates in developed markets may have to rise even more sharply than in our base case to mitigate broadening inflation pressures. This could result in a deeper-than-expected recession in Europe and, to a lesser extent, the U.S., with a concomitant rise in unemployment from historically low levels.
- Considering increasing risks and the potential for materialization, we have developed a downside scenario--with a roughly one-in-three likelihood of occurring--based on a consistent set of downside projections presented for key regional economies for the period 2022-2025.
- In Europe, this downside scenario would see high energy prices and rationing. The European Central Bank would be forced to follow the Federal Reserve because of the depreciation of the euro against the U.S. dollar, fueling imported inflation. This will lead to eurozone recession, with GDP contracting by 1.3% in 2023--and Germany suffering the largest impact.
- In the U.S., it would result in GDP contracting by 0.3% in 2023, compared with a shallow recession in the first half of the year in our baseline, with marginal growth of 0.2% for the year.
- Growth in the large Asia-Pacific economies--China, India, Japan, and Indonesia--would be less affected by the downside scenario, because these economies are more domestically oriented, yet slower global growth and external demand will still weigh on economic activity.
- Among emerging markets (EMs), our downside scenario sees Mexico feeling the greatest impact among Latin America's developing economies, while Poland would be the hardest-hit among Europe's EMs, largely because of its direct exposure to energy supply disruptions.

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Global Credit Conditions Downside Scenario

On Sept. 28, 2022, we published the macro base case (see "Global Macro Update: Many Routes To The Bottom," published Sept. 28, 2022), which underpins the forecasts for rated entities, as part of our quarterly Credit Conditions Committee review (see "Global Credit Conditions Q4 2022: Darkening Horizons," published Sept. 29, 2022). In this quarterly report, we also underlined the increase in likelihood and severity of downside risks. Today's publication is aimed at providing the market with a sensitivity analysis if things were to deteriorate further compared with the estimates underpinning our base case.

Several Factors Pile Further Pressure On A Stumbling Global Economy

The potential for a prolonged period of rising inflation and low economic growth is increasing. Many factors could weigh increasingly on the already-waning economic prospects. If the Fed's ongoing efforts to curb inflation fail, the U.S. economy could face a hard landing, and monetary tightening beyond current expectations could lead to a deeper-than-expected recession. Moreover, higher rates will further strengthen the U.S. dollar, aggravating inflationary pressures for commodity importers and capital outflows from emerging markets (EMs). In Europe, the spillovers of the Russia-Ukraine military conflict could create a severe energy crisis, if compounded by a cold winter and a failure to replenish gas reserves in 2023 and beyond. At the same time, energy price caps could weigh on fiscal positions and, along with higher borrowing costs, this could cause a widening of spreads of more-exposed sovereigns (fragmentation).

Conditions remain fluid, and over recent weeks the U.K. and Germany have announced hefty support measures that could affect both our baseline and downside assumptions. However, at this point, neither S&P Global Ratings' baseline nor the downside scenarios we outline in this report consider those measures, because specifics on how these support packages will be rolled out are yet to be detailed. Furthermore, while support packages could help limit the economic impact of even-higher energy prices, we expect prices to remain high through 2025. The additional fiscal support could extend inflationary pressures, which would force central banks to further increase monetary tightening.

Our downside scenario was designed to illustrate the sensitivity of key global economies to higher-than-expected policy rates and a prolonged energy crisis in Europe. Our global downside scenario is not aimed to be one of severe stress, but rather within a reasonable probability of materialization, and it is based on the realization of two key potential events:

- The military conflict in Ukraine drags on, with Russia using all kinds of measures to create political discord and economic pain in the West. The energy markets remain tight through 2023 and 2024 as the EU embargos oil and its price caps on gas take effect, Russia cuts off all supplies of remaining gas to Europe, and Russian oil production is scaled back moderately; and
- U.S. high inflation proves more persistent, along with labor and certain goods shortages. The Fed responds even more aggressively than already anticipated, and U.S. equities decline meaningfully.

With these potential events in mind, we are working with the following key assumptions:

- The Fed raise rates beyond our expectations to at least 5%-5.25% by mid-2023, and rates remain higher for longer;
- The U.S. stock market declines by 14.5% by mid-2023;
- Higher interest rates could further strengthen the U.S. dollar. This surge poses several problems for both advanced and emerging economies, including higher imported inflation and the potential for higher rates, capital flow volatility, and higher debt service on U.S. dollar liabilities.

- The Bank of England (BoE) and European Central Bank (ECB) are forced to raise rates even faster, moving well above neutral, to also support weakening currencies (particularly through 2023). The BoE's bank rate rises to 4.25%, the ECB's to 3.5%--both 1 percentage point (ppt) above baseline;
- European gas prices (Title Transfer Facility or TTF) remain elevated for longer, up to $55 per million Btu (mmBtu) throughout winter 2023/2024, before declining thereafter--still 40% above our current baseline assumption;
- In a tight global liquefied natural gas (LNG) market, additional LNG sources of supply will not be available until at least 2025, even though regasification facilities in Europe will be available earlier;
- Global oil prices remain elevated at about $100 a barrel (/bbl) in 2023, declining in 2024 to an average price of $90 a barrel; and
- The EU introduces gas rationing through winter 2022-2023 and 2023-2024, primarily targeting industry, to cut overall demand to 15% below the average winter demand over the last five years.

Eurozone / U.K.

Extended Rationing And Higher Inflationary Pressures Drag Europe's Economy

For Europe, this new downside scenario largely borrows from the one we published in August, in which we examined the impact of a complete cut-off of the European economy from Russian gas (see "Europe Braces For A Bleak Winter," published Aug. 29, 2022). In addition, since it is now clear that Russian gas will not be flowing back to Europe anytime soon and that the energy supply for winter 2023/2024 remains uncertain, we have extended the period in which the EU is likely to impose gas rationing by one year, from fourth-quarter (Q4) 2022 to Q1 2024, instead of Q1 2023. Indeed, this updated scenario assumes that European gas prices will remain elevated for longer, up to $55/mmBtu-$60/mmBtu right through winter 2023-2024 (40% above S&P Global Ratings' baseline) before declining, albeit remaining 40% above our baseline until the end of 2025. The price of a barrel of Brent is seen plateauing for even longer than gas, at about $100/bbl and $90/bbl on average through 2023 and 2024, respectively: 15%-20% above futures levels.

Gas rationing and higher energy prices for longer are not the only shocks to the European economy we consider in this new exercise. We also add 100 basis points (bps) to central bank policy rates in comparison to our current baseline. This leads the ECB's repo rate to reach 3.5% in mid-2023 and the BoE's bank rate to 4.25% by Q3 2023. Tighter monetary policy results from higher inflation pressures, also arising as consequence of the fiscal support packages recently announced by European governments, as well as the need to stabilize the exchange rate in the context of a more hawkish Fed and outsized dollar strength (see "Economic Research: No Easy Way To Correct Outsized Dollar Strength," published Oct. 6, 2022).

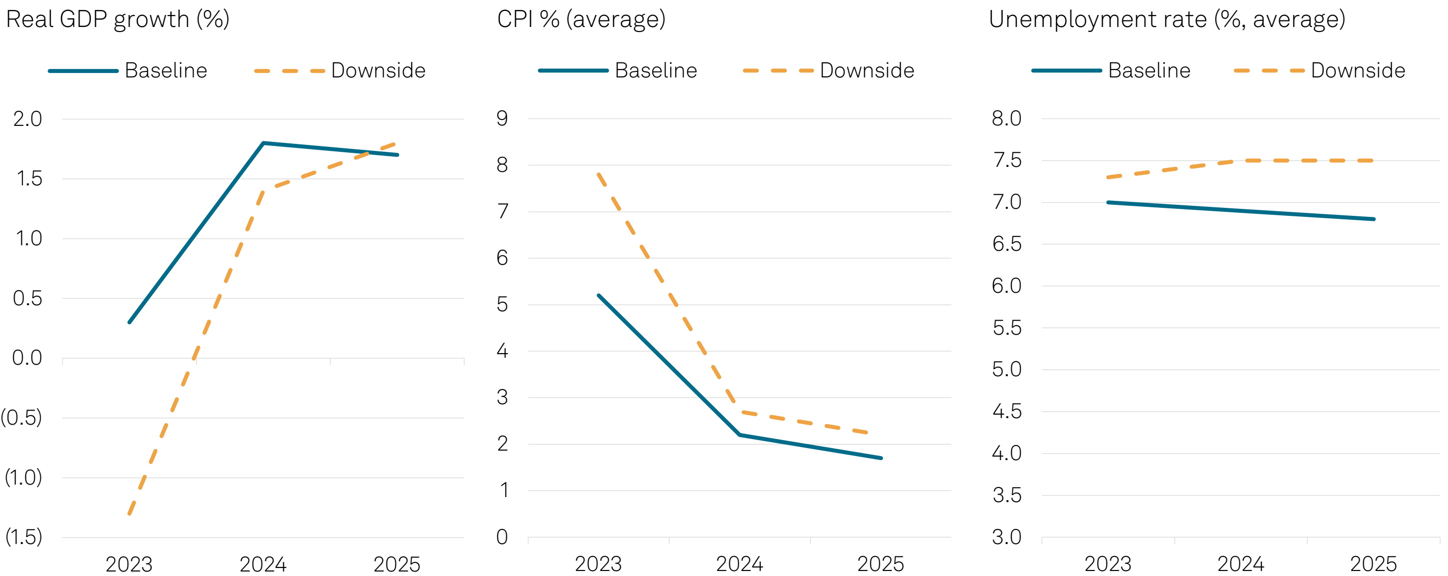
We keep the same harsh assumptions on German retail gas and electricity prices as in our previous gas cutoff scenario. This projected retail gas prices to jump by 200% in Q4 2022 and only gradually decline from the end of 2023. In the meantime, the German government's proposed tax package is designed to subsidize households and companies for a certain amount of basic consumption, but to let the market mechanism play in full on prices to encourage energy savings.

Finally, the new scenario factors in a weaker international environment, with U.S. GDP growth in 2023 half a point lower than in the baseline. This has a negative impact on European economies whose foreign trade depends more heavily than others on U.S. demand, such as Germany and the U.K. The depreciation of the pound and the euro may increase the export competitiveness of these economies (outside the energy-intensive sectors) in the medium term, but it does not fully offset the effect of lower foreign demand in the short term.

This new set of assumptions leads to a slightly more severe impact on eurozone GDP: a 1.6% decline from the baseline in 2023, compared with 1.4% in the first gas cut-off scenario. Given that our baseline has darkened, the result is a deeper recession across the region in 2023. The impact on Germany is the biggest, as the production side faces longer gas rationing, declining competitiveness, and more headwinds for exports. Otherwise, the closer to the epicenter of the shock (Russian gas), the bigger the impact is. This is why, behind Germany, Poland and Italy are more affected than France or Spain, and why the U.K. economy is less affected. For the U.K., the rapid deterioration in financing conditions is affecting economic growth. Inflation in the U.K. suffers less from higher wholesale energy prices than Europe because of the unit energy price cap introduced by the U.K. government and the low dependency on Russian gas.

Chart 1

A deeper recession across the region in 2023

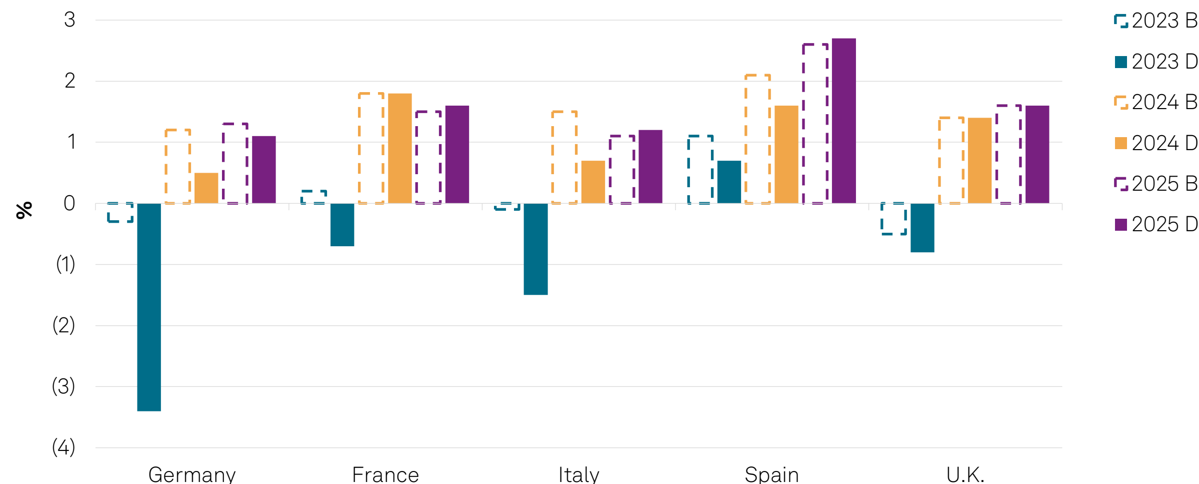


CPI--Consumer price index. Source: S&P Global Ratings Economics

Chart 2

Germany suffers the largest impact from the energy shock

Real GDP growth baseline versus downside



Note: Dotted bars show our baseline forecasts. B--Baseline. D--Downside. Source: S&P Global Ratings Economics

U.S.

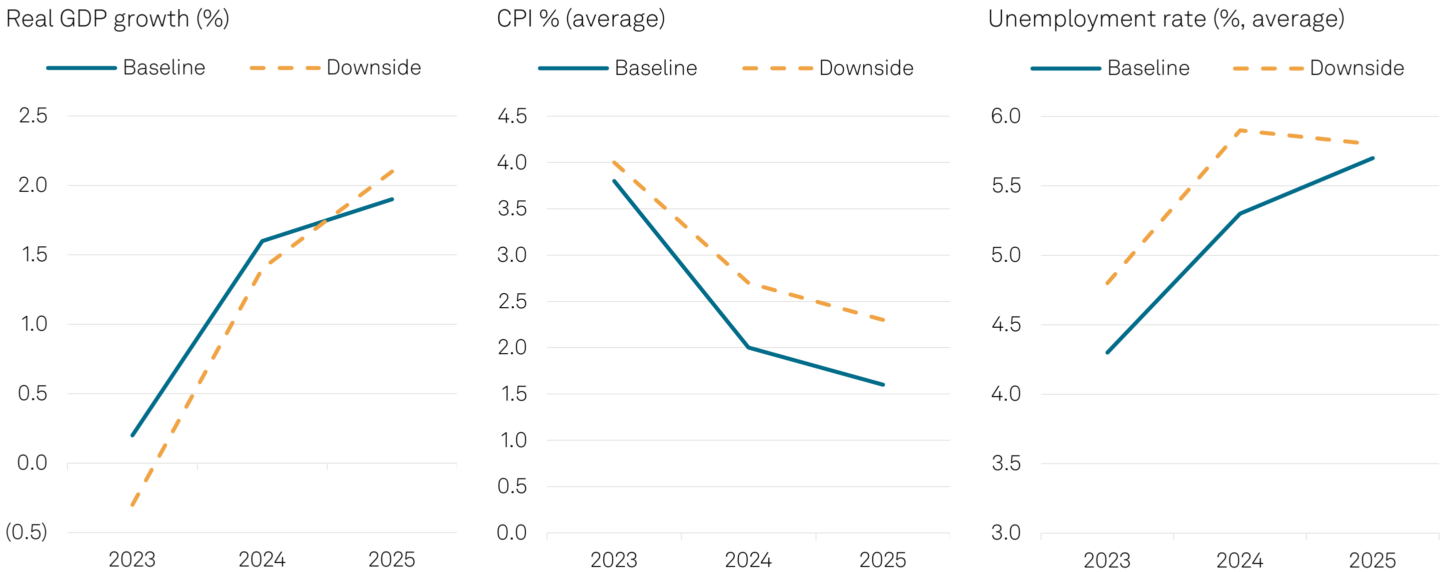
Fed Rate Hikes Take Hold And Deepen U.S. Recession

In our U.S. downside scenario, high inflation persists, along with shortages of labor and certain goods, forcing the Fed to tighten policy even more aggressively. While wage gains remain high, overall price gains climb even higher. With inflation continuing to outpace wage gains (as it has for 17 consecutive months), purchasing power deteriorates further. Any savings cushions left from pandemic-related stimulus are quickly depleted, and consumer spending declines further in mid-2023 into early 2024. Interest rate-sensitive sectors of the economy suffer first, with residential investment, for example, falling further. As cumulative Fed rate hikes take hold, our shallow baseline recession deepens and lasts longer.

This pushes full-year 2023 GDP growth below our base-case forecast of 0.2%--with a shallow recession in the first half of the year--deeper into negative territory. At the same time, depressed demand and lower profits prompt businesses to reduce staffing from the middle of 2023, with the unemployment rate jumping close to 6% in 2024. As inflation then falls near policymakers' target, but economic activity remains weak, the Fed corrects its overshoot and starts lowering interest rates in mid-2024. The economy eventually stabilizes in early 2025, with the unemployment rate (as a lagging indicator) finally falling below 5.5% by 2026. Additionally, still-high borrowing costs at a time when unemployment is rising and Americans' "wealth effect" is diminishing, by stock market declines, could further pressure home prices, which are already declining in many U.S. regions.

Chart 3

A shallow recession in the first half of the year, deeper into negative territory



CPI--Consumer price index. Source: S&P Global Ratings Economics.

Asia-Pacific

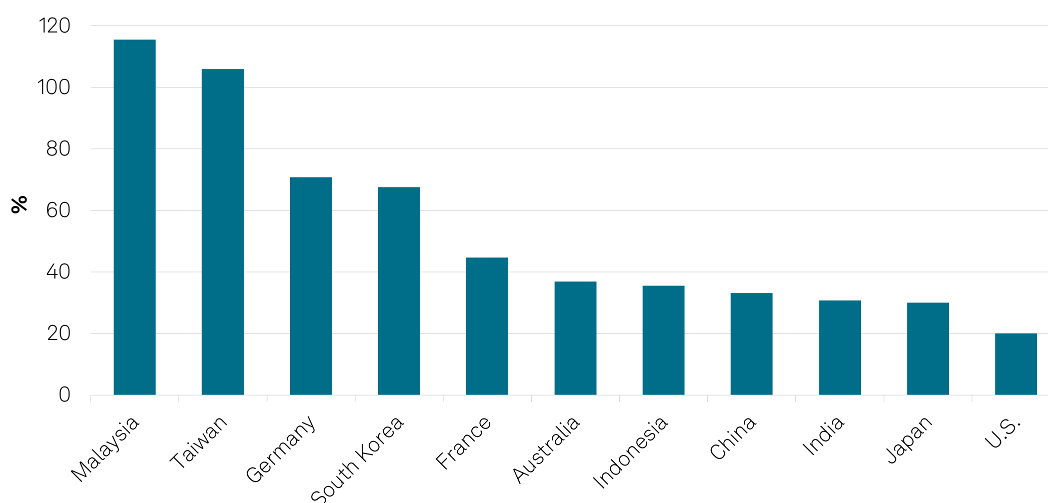
Slower Global Growth And External Demand Will Weigh On Economic Activity

In the large Asia-Pacific economies--China, India, Japan, and Indonesia--the downside scenario would have less effect on growth compared with the global average, given that these economies are more domestically oriented. That said, slower global growth and external demand will still weigh on economic activity. In addition, private sector confidence would be weaker amid tighter domestic and global monetary policy along with higher inflation and high energy prices. These channels would lead to weaker growth in Asia by about 30 bps on average in 2023 relative to our baseline. The growth impact would then dissipate gradually over the forecast horizon.

Chart 4

The impact on large Asia-Pacific economies is lower, because they are domestically driven

Total trade % of GDP



Source: S&P Global Rating Economics.

We expect higher inflation in the Asia-Pacific region, because of the stronger U.S. dollar and higher energy prices together with their second-round effects--a scenario along similar lines to that of 2022. The influence of imported inflation will be mixed, with lower levels of inflation in some manufacturing centers, such as China, but higher inflation in Europe.

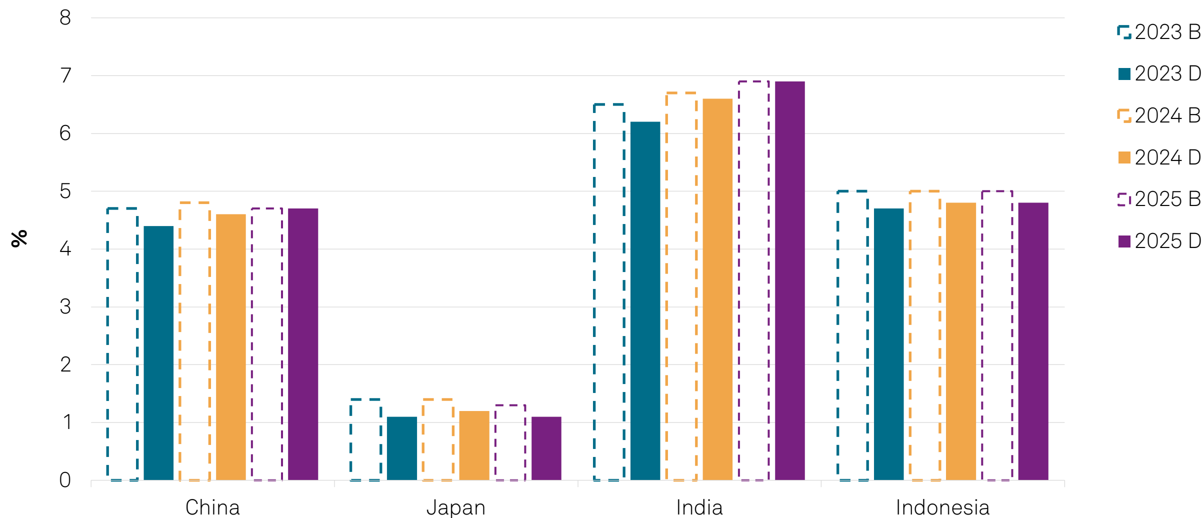
Overall, inflation is likely to rise the most in India, which is a net energy importer and faces higher inflationary pressures to begin with. In India, the downside scenario features inflation higher by 1.6 ppt in fiscal year 2024-fiscal 2025, compared with our baseline. We expect lower inflation increases in Japan and China where inflationary pressures are currently lower.

Meanwhile, in some Asia-Pacific economies, higher energy prices would increase the cost of energy subsidies, impairing the fiscal strength of governments. Central banks in India and Indonesia will look to tighten monetary policy further. Domestic inflation will be accelerating, more global monetary policy tightening would lead to more capital outflow pressures, and central banks will look to lean against these forces. The downside scenario features an additional 50 bps of interest rate hikes out of India and Indonesia by 2024. The Bank of Japan, however, does not change its policy response in the downside scenario, because inflation remains below the 2% target despite the price increases.

Chart 5

Slower global growth and external demand will still weigh on economic activity

Real GDP growth baseline versus downside



Note: Dotted bars show our baseline forecasts. B--Baseline. D--Downside. Source: S&P Global Ratings Economics.

Latin America (Brazil, Chile, and Mexico)

Mexico Could Suffer The Largest Impact Given Its Ties With The U.S. Economy

In our downside scenario, Mexico's GDP would be hit hardest in 2023, given its significant economic ties with the U.S. (Mexico's good exports to the U.S. are 28% of its GDP). After Mexico, Chile would feel the greatest impact (it has a small open economy mostly exposed to China), then Brazil (a medium closed economy, but reliant on Chinese demand for commodities). A more aggressive Fed would increase capital outflow pressures in the region, weakening exchange rates (roughly 5% weaker in 2023 versus our baseline) and pushing central banks to match Fed tightening. We would expect policy rates in the region to be roughly 100 bps higher than in our baseline. Higher oil prices would also imply higher inflation, further pressuring central banks to keep a tightening bias for longer than we assume in our baseline.

- **Brazil**: We would expect the Brazilian economy to experience near flat GDP growth in 2023 (0.2% versus our 0.6% baseline), mainly because of weaker Chinese demand for commodities, as well as the expected confidence shock. Under these adverse economic conditions, pressure to extend fiscal stimulus would be high under the incoming new administration, keeping concerns high over the government's commitment to its fiscal spending ceiling. This higher spending would in turn increase upward pressure on interest rates, keeping domestic borrowing costs elevated, and consequently, investment growth rates low. We would expect growth to remain weak in 2024 (1.7% versus our 2.0% baseline) and return to its potential growth rate in 2025.
- **Chile**: The main channel of transmission to the Chilean economy would be via lower commodity exports to China (about 10% of its GDP). We would expect GDP growth to contract 0.2% in 2023 (versus our 0.3% growth baseline). Higher energy prices would hit the Chilean economy more than its peers, given its status as a net energy importer (net energy imports are about 4% of GDP). This means that inflation would jump the most in Chile (relative to Brazil and Mexico), and consequently the central bank would be the most aggressive among its peers in tightening monetary policy (150 bps greater than our baseline in 2023). Tighter monetary policy would keep domestic demand subdued in 2024. The economy would then slowly recover and return to its potential growth rate (about 3%) in 2025.

- **Mexico**: Exports to the U.S. would likely contract in 2023, driving the Mexican economy into a recession that year, with average flat 0% GDP growth for the full year (versus our 0.8% baseline). The Mexican central bank would follow the Fed closely, which would imply that its policy rate would remain close to 10% throughout 2023. Higher energy prices would likely prompt the government to continue to subsidize gasoline, which would cushion the blow to consumption but at the expense of weaker fiscal dynamics. The economy would slowly recover as the U.S. also recovers toward the end of 2024 and into 2025, returning to its roughly 2% GDP growth potential by 2025.

Emerging Markets In EMEA (Poland and South Africa)

Energy Supply Disruption Could Hit Poland Significantly

Direct exposure to energy supply disruptions and higher European gas prices, as well as close economic ties with developed European economies make Poland's economy the most affected in 2023 among a sample of key EMs in our downside scenario. Exports to the eurozone and the U.K. account for about 30% of Poland's GDP. The shock spreads to the economy via trade, energy supply, financial channels, and confidence, resulting in a downward revision of 1.5 ppt to the baseline GDP growth rate, implying that the Polish economy would contract by 0.3% in 2023 in the downside scenario. The scenario envisages a broad-based decline across all GDP components, including exports, fixed investment, and consumption.

Higher oil and gas prices reverse the trend of slowing energy inflation, and add to broad-based inflationary pressures in the economy. While Poland is less reliant on gas than other central and eastern Europe (CEE) economies, because coal dominates its energy mix, its dependency on energy imports is significant, with imports covering almost half of the country's energy needs. What's more, the share of energy expenses in the consumer basket is the highest among key EMs at close to 15%. The government will likely increase energy subsidies, partially mitigating the impact. Still, higher energy prices, which will also spill into core prices, will push up headline inflation, so that consumer price index (CPI) inflation remains at above 13% in 2023. These developments sharpen the dilemma for the central bank, caught between worsening growth prospects and rising inflation, in an environment where global interest rates are rising fast. We expect interest rates will go beyond 8% in 2023, but acknowledge the uncertainty around the central bank's reaction; it may choose to be more cautious to prevent a sharp downturn.

We expect that flows from EU funds will support a Polish economy that has a strong catch-up potential, allowing it to get back to about 3% GDP growth in 2024-2025. Delays or reductions in EU transfers to Poland could lead to lower-than-anticipated public investment and negatively affect our outlook for private investment.

Higher inflation and funding costs could weigh on South Africa's economy

In our downside scenario, an increasingly higher inflation and cost of funding environment will severely drag on South Africa's consumer and business spending for the next two years. We assume that significant interruptions in electricity supply (load shedding), which started in Q2 2022, will continue through 2023, not only weighing on electricity generation (which is a direct input to GDP) but also handicapping agriculture, mining, and manufacturing sectors (all significant users of electricity). Although South Africa's energy import dependency is lower than most EMs, its energy intensity in the total output is among the highest (see "What Higher Energy Prices Mean For Emerging Markets," published March 3, 2022). Export growth is slower compared with our baseline, given weaker external conditions, but imports are also tempered on the back of softer domestic demand for the next couple of years.

In such an economic environment, real GDP barely grows in 2023 at 0.6% (versus 1.6% in our baseline), with consumer price inflation averaging 7.5% for the year, its highest since 2009. Limited by fiscal space, countercyclical government measures are far from sufficient to avoid contraction for the full year on a per capita basis. Meanwhile, the fight against inflationary and

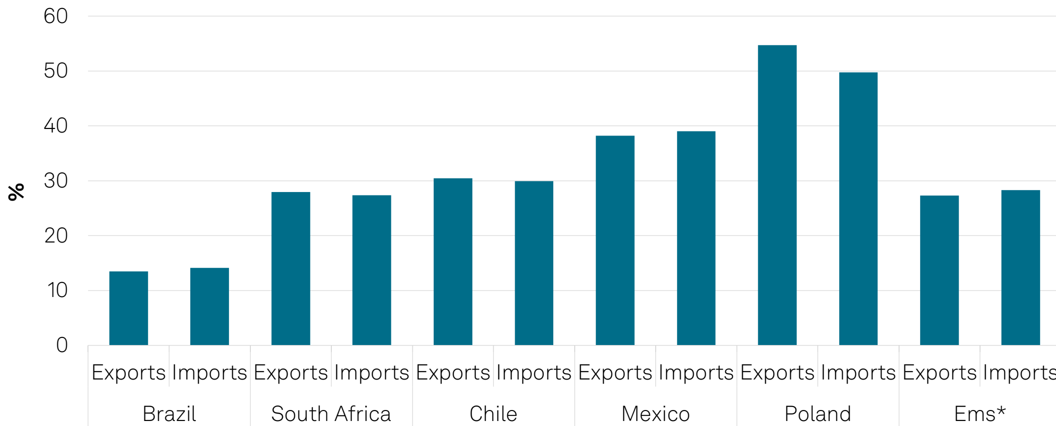
exchange rate pressures means that the South African Reserve Bank (SARB) is more hawkish in its policy guidance and actions--somewhat in lockstep with the Fed. The SARB's policy rate averages 7.3% in 2023 (versus 6.7% in our baseline), the highest since 2009 for the benchmark interest rate, despite weak domestic demand and a relatively large negative output gap. Although higher interest rate in tandem with the Fed provides some support to the South African rand (ZAR) exchange rate, it is not enough to avoid a gradual depreciation against the dollar, as a significant increase in the South African inflation rate widens inflation and growth differentials with the U.S. beyond our baseline expectations. The rand breaches ZAR18/$1 again by the beginning of 2023 and ZAR19/$1 by the end of 2025.

The pass-through effect of persistent elevated energy prices and a depreciated exchange rate on domestic core inflation keeps inflation near the upper bound of the central bank's target range (3%-6%). The SARB responds by lowering interest rates only gradually. Recovery in 2024, at 1.1%, remains below long-term potential and is underwhelming to say the least, before moving back above trend at 2% in 2025. Ultimately, by 2025, the South African economy--which was already 3% short of the pre-pandemic path in our baseline forecast--will be 1.4% smaller in this downside scenario compared with the baseline.

Chart 6

Many emerging markets are highly vulnerable to slower global trade

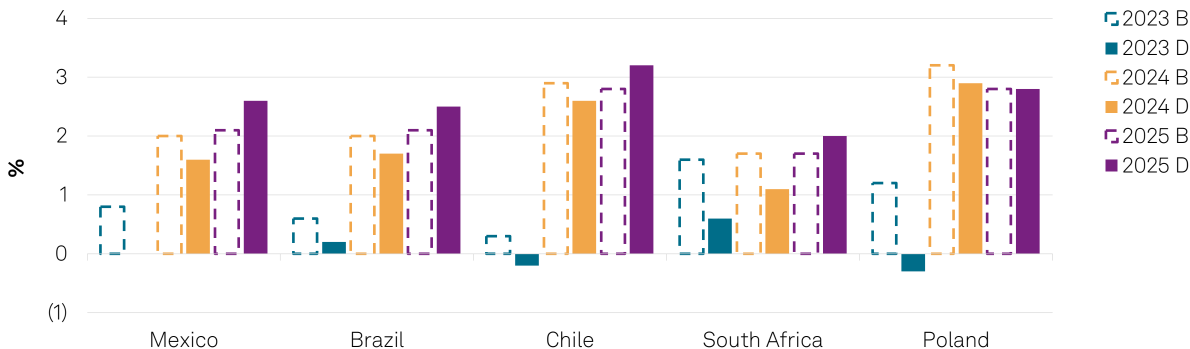
Total trade % of GDP (2013-2022)



Note: Data showing median value of 2013-2022. *Emerging markets (EMs) calculated as a median of Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, Thailand, Vietnam, Hungary, Poland, Nigeria, Saudi Arabia, and South Africa. Sources: Oxford Economics, S&P Global Ratings Economics.

Chart 7

Mexico and Poland suffer the largest impact under our downside scenario



Note: Dotted bars show our baseline forecasts. B--Baseline. D--Downside. Source: S&P Global Ratings Economics.

Appendix

Table 1

Downside GDP forecasts

Annual percentage change

	Downside			Changes from our baseline		
	2023	2024	2025	2023	2024	2025
U.S.	(0.3)	1.4	2.1	(0.5)	(0.2)	0.2
Europe						
Eurozone	(1.3)	1.4	1.8	(1.6)	(0.4)	0.1
Germany	(3.4)	0.5	1.1	(3.1)	(0.7)	(0.1)
France	(0.7)	1.8	1.6	(0.9)	--	0.1
Italy	(1.5)	0.7	1.2	(1.4)	(0.8)	--
Spain	0.7	1.6	2.7	(0.4)	(0.4)	--
U.K.	(0.8)	1.4	1.5	(0.4)	--	(0.1)
Asia-Pacific						
China	4.4	4.6	4.7	(0.3)	(0.2)	--
Japan	1.1	1.2	1.1	(0.3)	(0.2)	(0.2)
India*	6.2	6.6	6.9	(0.3)	(0.1)	--
Indonesia	4.7	4.8	4.8	(0.3)	(0.2)	(0.1)
Other emerging economies						
Mexico	0.0	1.6	2.6	(0.8)	(0.4)	0.5
Brazil	0.2	1.7	2.5	(0.4)	(0.3)	0.4
Chile	(0.2)	2.6	3.2	(0.5)	(0.3)	0.4
South Africa	0.6	1.1	2.0	(0.9)	(0.6)	0.3
Poland	(0.3)	2.9	2.8	(1.5)	(0.3)	--

*Fiscal year beginning April 1 in the reference calendar year. Source: S&P Global Ratings Economics.

Table 2

Downside consumer price index forecasts % (average)

Annual percentage change

	Downside			Changes from our baseline		
	2023	2024	2025	2023	2024	2025
U.S.	4.0	2.7	2.3	0.2	0.7	0.7
Europe						
Eurozone	7.8	2.7	2.2	2.6	0.5	0.5
Germany	12.0	2.8	2.2	5.0	0.6	0.6
France	4.5	2.8	2.2	1.1	0.8	0.3
Italy	5.7	2.9	2.6	1.4	1.0	0.9
Spain	3.8	2.1	1.2	1.2	0.6	0.1
U.K.	6.3	2.6	2.6	0.5	1.0	0.8
Asia-Pacific						
China	2.7	2.8	2.4	0.3	0.6	0.2
Japan	1.9	1.6	1.2	0.3	0.6	0.2
India*	5.6	6.1	5.4	0.7	1.6	0.9
Indonesia	6.6	4.6	4.2	0.4	0.9	0.6
Other emerging economies						
Mexico	6.6	5.1	4.0	0.5	1.0	0.5
Brazil	5.5	5.1	3.3	0.4	0.7	0.2
Chile	8.6	5.3	3.5	0.6	0.8	0.2
South Africa	7.5	6.0	5.0	1.1	1.5	0.7
Poland	13.2	5.2	2.9	1.5	0.8	0.4

*Fiscal year beginning April 1 in the reference calendar year. Source: S&P Global Ratings Economics.

Table 3

Downside unemployment forecasts % (Average)

Annual percentage change

	Downside			Changes from our baseline		
	2023	2024	2025	2023	2024	2025
U.S.	4.8	5.9	5.8	0.5	0.6	0.1
Europe						
Eurozone	7.3	7.5	7.5	0.3	0.6	0.7
Germany	3.9	4.6	4.7	0.5	1.0	1.2
France	7.8	7.7	7.7	0.1	0.1	0.2
Italy	9.0	8.9	8.5	0.2	0.4	0.4
Spain	13.1	13.5	13.5	0.2	0.4	0.4
U.K.	4.6	4.4	4.0	0.1	0.2	0.2
Asia-Pacific						
China	5.2	5.2	5.2	--	--	--
Japan	2.5	2.6	2.6	--	0.1	0.2
Indonesia	5.6	5.5	5.5	--	--	--
Other emerging economies						
Mexico	4.2	4.1	3.7	0.3	0.3	0.1
Brazil	10.7	10.3	10.0	0.2	0.2	0.1
Chile	8.9	8.3	7.6	0.3	0.2	0.1
South Africa	34.7	34.7	34.7	0.2	0.4	0.5
Poland	3.7	3.2	3.0	0.2	0.1	--

*Fiscal year beginning April 1 in the reference calendar year. Source: S&P Global Ratings Economics.

Editing: **Madeleine Corcoran**. Digital Design: **Joe Carrick-Varty**.

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