

Inflation, Geopolitics Are Twin Threats To Our Base Case

Dec. 8, 2022

Editor's note: This report is an update of "[Global Credit Conditions Downside Scenario: Recession Risks Deepen](#)," published Oct. 12, 2022.

This report does not constitute a rating action

Key Takeaways

- This paper lays out a downside scenario to S&P Global Ratings' recently published macro baseline. It is based on a set of alternate projections for 15 key economies and determines the effects on three key economic variables (growth, inflation, and unemployment) for 2023-2025. We estimate this scenario has a roughly one-in-three likelihood of materializing.
- The downside scenario is centered on two key assumptions. First, inflation pressures are more entrenched than in our baseline and require a stronger and longer policy response, particularly from the U.S. Federal Reserve. Second, the Russia-Ukraine conflict drags on, exacerbating the ongoing energy crisis and heightened risk-aversion.
- Europe would be hit the hardest. Growth in the eurozone would be 90 basis points (bps) weaker than in our base case in 2023. Germany suffers an extended recession, with growth 1.2 percentage points lower in 2023, and 90 bps lower in 2024. Inflation is 1-2 percentage points higher than in our baseline in 2023 and declines gradually, remaining above target until 2025.

We recently published our macro base case that underpins the forecasts for rated entities (see "[Global Macro Update: Surprising Resilience Unlikely To Last Into 2023](#)," published Nov. 30, 2022), as part of our quarterly Credit Conditions Committee review (see "[Global Credit Outlook 2023: No Easy Way Out](#)," published Dec. 1, 2022), in which we highlighted a number of downside risks. This publication is aimed at providing the market with a sensitivity analysis that shows what could happen if these risks materialize (see chart 1). The two main downside risks driving our scenario are:

The forecast path of federal funds rate hikes proves insufficient to curb demand. Despite a steep path of policy rate hikes this year, U.S. growth surprised on the upside in the third quarter and wage growth remains strong. Some measures of inflation are peaking but remain well above target, suggesting that the Fed will need to do more than is currently priced in. Our current base case estimate for the Fed's terminal rate (5.00%-5.25%) will be around 1.0% in real terms and near its historical average. If higher real rates (deflated by CPI) are ultimately required to cool demand sufficient to bring inflation back to target, then the Fed will need to go higher and stay there for longer.

The military conflict in Ukraine drags on. The mapping of the conflict to the macroeconomic sphere is imprecise, but the risk is that Russia will continue to create political discord and economic pain in the West. The implication is that energy markets remain tight through 2023 and

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2024 as the G7 ratchets up economic pressure on Russia via sanctions, the EU embargos Russian oil and its price caps on natural gas take effect, Russia cuts off all supplies of remaining gas to Europe, and Russian oil production is scaled back moderately.

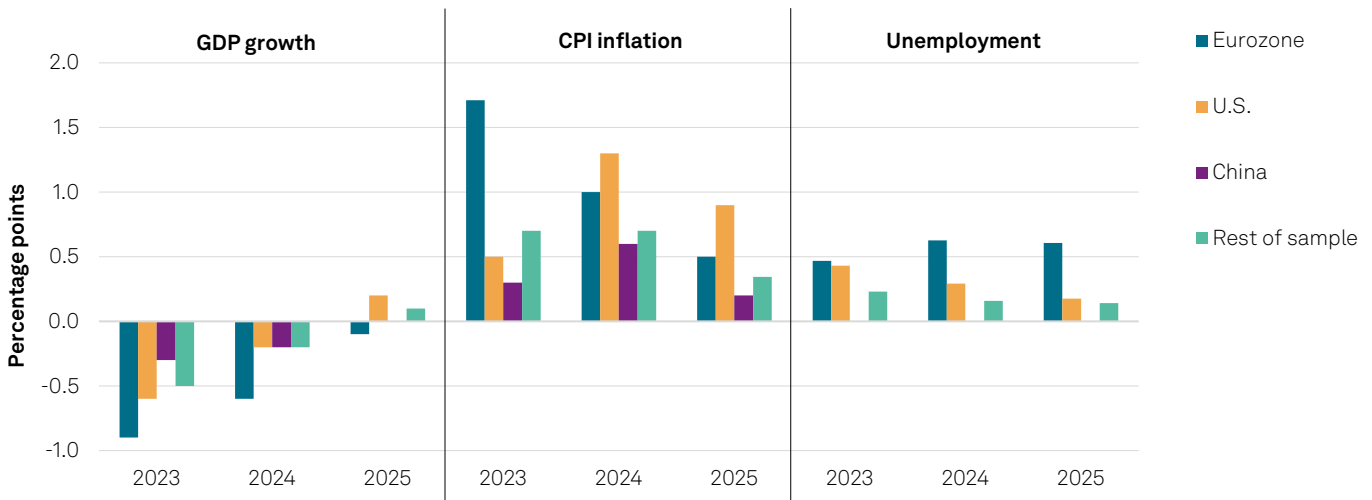
In the event these two risks materialize, we model the effects using the following assumptions:

- The Fed raises rates to least 6% by mid-2023, compared with 5% in our baseline, and rates remain higher for longer;
- The benchmark S&P 500 Index declines 14.5% by mid-2023;
- Higher interest rates further strengthen the U.S. dollar. This surge poses problems for both advanced and emerging economies, including higher imported inflation and the potential for higher domestic policy rates, capital flow volatility, and higher debt service on dollar-denominated liabilities;
- The Bank of England (BoE) and European Central Bank (ECB) are forced to raise rates further, moving well above neutral, to prevent weakening currencies from further fueling inflation (particularly through 2023). The BoE's policy rate rises to 4.5% and the ECB's repo rate to 3.75%--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 baseline assumption;
- In a tight global liquefied natural gas (LNG) market, significant additional LNG sources of supply globally won't be available until at least 2025, even though regasification facilities in Europe will be available earlier; and
- Global oil prices rise to \$110 a barrel (/bbl) in 2023-2024, before declining to an average price of \$85 a barrel in 2025.

Chart 1

Downside Scenario Macroeconomic Effects

Changes from baseline forecasts



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

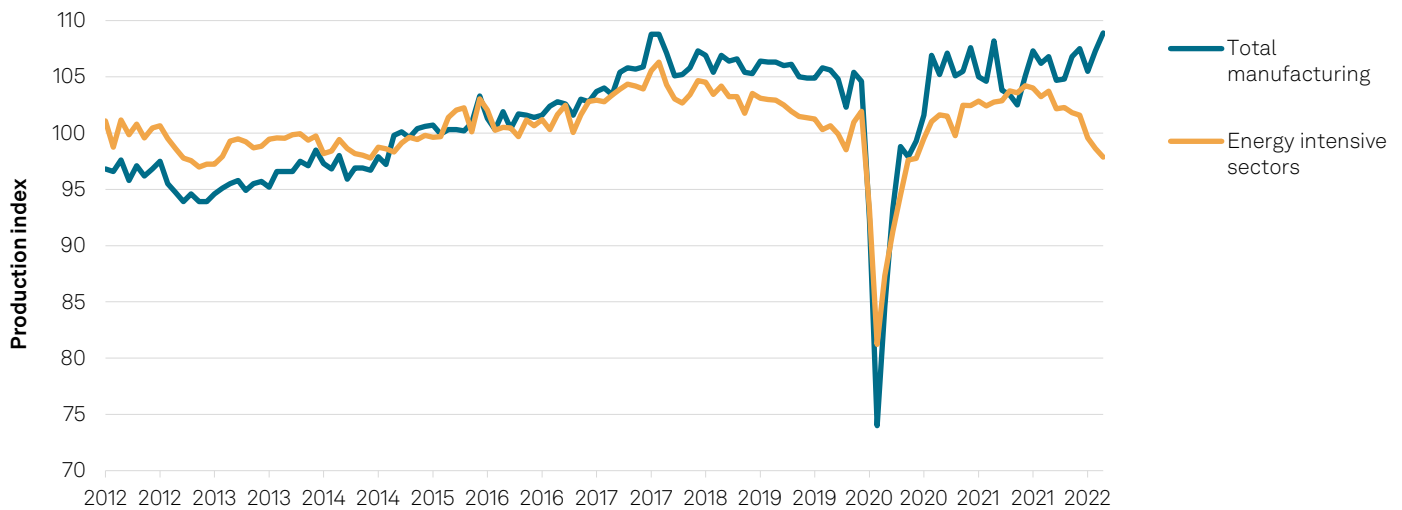
Eurozone / U.K.

We have recalibrated the assumptions for our downside scenario for Europe. This reflects recent progress in reducing demand for gas and power by energy-intensive sectors (see chart 2) as well as residential and commercial users, and the success in replenishing gas storage levels. Specifically, the likelihood of energy rationing later this winter in Germany, a key assumption in our previous report, has receded significantly, although it remains a meaningful concern for winter 2023-2024. Emergency government support measures have also reduced the near-term impact on consumers from higher gas and power prices.

Chart 2

EU Industrial Production Close To All-Time High Even As Energy-Intensive Sectors Suffer

High energy prices have seen energy intensive sector production fall 6% in 2022



Note: Energy intensive sectors are chemicals, metallurgy, coke and refined petroleum product manufacturing, and paper products. Sources: Eurostat, S&P Global Ratings.

Nonetheless, we expect the European gas and power markets to remain tight for several years.

This stress will prevail until additional energy capacity (either renewables or LNG) come on stream, providing the necessary supply buffers to stabilize prices at much lower levels. The implication is that energy prices could still move higher in certain circumstances such as a colder than average winter, a further curtailment in Russian gas supply to Europe, or even if Russia retaliates to the G7's imposition of a \$60 oil price cap by cutting production and exports of crude and distillates.

As a result of the recalibration, the 1.7% incremental impact on inflation in Germany in 2023 is more aligned with the other major countries in Europe. This also means the negative GDP growth impact is now more evenly distributed across the European economies. Specifically, it's now less pronounced for Germany and Italy, partly owing to more favorable carryovers into 2023, after Q3 GDP surprised on the upside and incoming data for Q4 suggests only a slight contraction in GDP. On the other hand, outcomes are worse in some cases, notably in the U.K., where they also reflect downward revisions in the baseline.

U.S.

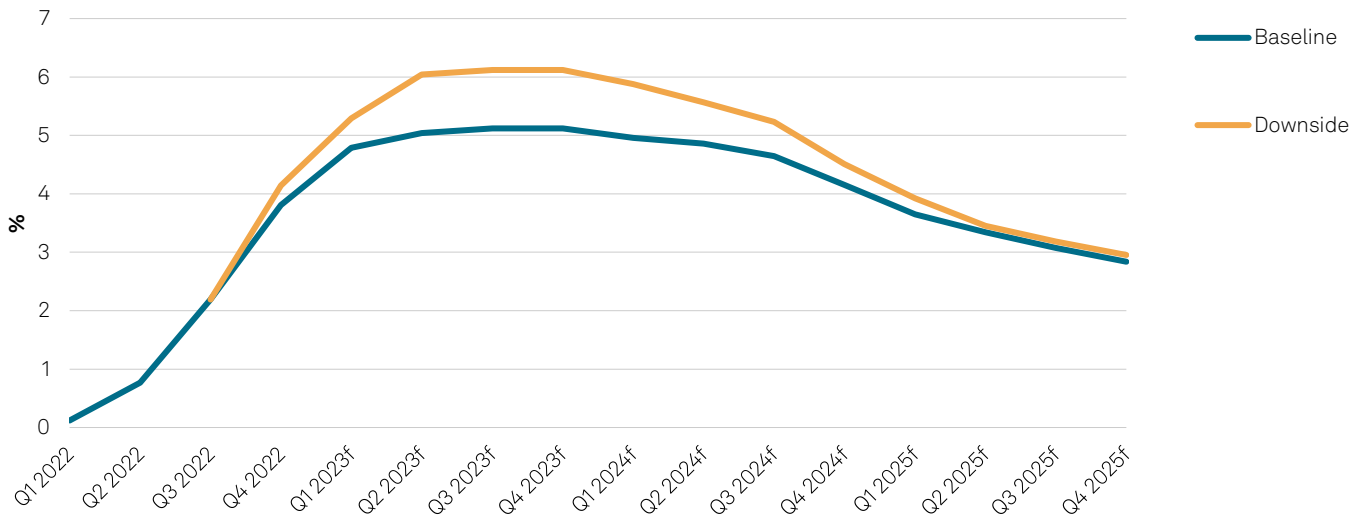
For the world’s biggest economy, the most pressing issue is the path of monetary policy. While the Fed has seen some good news in its battle against inflation, the most recent jobs report may complicate policymakers’ approach. The Fed’s preferred barometer of inflation, the personal consumption expenditures (PCE) index, has come off its highs. But the labor market remains tight, with November’s job gains outpacing forecasts and, more importantly, wage gains coming in at a much stronger-than-expected 0.6%—another two-year high and keeping year-over-year gains up an astonishing 5.1%. While Fed Chair Jerome Powell had indicated the central bank’s most aggressive rate-hiking cycle in decades could slow somewhat with inflation seeming to have peaked, stubbornly high wages have put another 75 basis-point rise back in play for the Federal Open Market Committee’s Dec. 13-14 meeting.

In our U.S. downside scenario, inflation remains high, pushing the Fed to continue to raise rates aggressively in December with another painful move early next year (see chart 3). Any savings cushions left from pandemic-related stimulus are exhausted, 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. At the same time, depressed demand and lower profits prompt businesses to reduce staffing from the middle of 2023, with the unemployment rate jumping to 5.6% in 2024, from the current 3.7%. As inflation eventually falls nearer policymakers’ target amidst weakening economic activity, the Fed reverses course and starts lowering interest rates in early-2024, but not fast enough for the U.S. recovery to gain momentum. The economy eventually stabilizes in early 2025, with the unemployment rate (as a lagging indicator) finally falling to 5%.

Chart 3

Fed Funds Rate: Higher And Higher

Fed funds rate, baseline versus downside estimates



f--Forecast. Sources: Federal Reserve Bank, S&P Global Market Intelligence, S&P Global Ratings Economics forecast.

Asia-Pacific

In the Asia-Pacific region, the downside scenario would have a moderate impact on growth, as the scenario's shocks don't directly impinge on the region. The impact would be especially modest in the large, mainly domestic demand-driven economies such as China, India, and Indonesia: they would on average see 30 bps lower growth in 2023 than in the baseline, with the impact dissipating gradually thereafter. But the combination of slower external demand and weaker confidence will have a larger impact on growth in economies such as South Korea and Taiwan, where exports matter more.

Higher energy prices and weaker currencies versus the U.S. dollar would lead to higher inflation. Consumer inflation is likely to rise the most in India, a significant net energy importer that would see a relatively pronounced depreciation. Meanwhile, in several Asia-Pacific economies, higher energy prices would increase the cost of energy subsidies, impairing the fiscal strength of governments.

Central banks would tighten monetary policy further, especially in India and Indonesia. Domestic inflation will be accelerating, more global monetary policy tightening would lead to more capital outflow pressures, and central banks will lean against these forces. The downside scenario features 50 bps higher interest rates in India and Indonesia by 2024, with smaller adjustments in China and Japan.

Other Emerging Markets (Brazil, Chile, Mexico, Poland, and South Africa)

A more pronounced global slowdown, tighter financial conditions, and higher energy prices mean a gloomier 2023 for emerging market economies (see "[Economic Outlook Emerging Markets Q1 2023: Hanging In There, But Growth Prospects Remain Tough](#)," published Nov. 28, 2022).

In the Latin-American countries and Poland, GDP will contract or stall (at best), while South Africa will eke out growth just under 1%. Relative to our baseline, Poland and Mexico would get hit the hardest in 2023 given their significant economic ties with the European economies and the U.S., respectively. The recovery prospects in 2024 and 2025 are tied to the regional industrial complex, as well. That said, for Poland, recovery also hinges on EU funds, which we assume to stay intact.

Higher inflation and funding costs will severely drag on South Africa's consumer and business spending for the next two years, while Chile's reliance on copper exports will deliver it a larger contraction next year. Brazil, on the other hand, will feel the least impact given a larger growth reliance on domestic demand.

The persistence of energy inflation will add to broad-based inflationary pressures next year and further erode the private sector's purchasing power and confidence. The governments of emerging market countries will likely increase energy subsidies, partially mitigating the impact, but are limited by fiscal space.

These developments heighten the dilemma for central banks, caught between worsening unemployment rate and rising inflation, in an environment where global interest rates are rising to a higher terminal rate. Higher domestic inflation will keep central banks' tightening bias intact for longer versus a reversal in 2023. Moreover, a more aggressive Fed could increase currency pressures in these countries and subsequent capital outflow from them, weakening exchange rates versus our baseline and prompting central banks to match Fed tightening.

Appendix

Table 1

Downside GDP Forecasts Annual percentage change

	Downside			Changes from our baseline		
	2023	2024	2025	2023	2024	2025
U.S.	(0.7)	1.1	2.0	(0.6)	(0.2)	0.2
Europe						
Eurozone	(0.9)	0.8	1.4	(0.9)	(0.6)	(0.1)
Germany	(1.7)	0.1	1.0	(1.2)	(0.9)	(0.3)
France	(0.4)	1.4	1.5	(0.6)	(0.2)	--
Italy	(1.1)	0.8	1.2	(1.0)	(0.6)	--
Spain	0.4	1.5	2.5	(0.4)	(0.4)	--
U.K.	(1.6)	1.1	1.4	(0.6)	(0.2)	(0.1)
Asia-Pacific						
China	4.5	4.5	4.6	(0.3)	(0.2)	--
Japan	0.9	0.9	1.1	(0.3)	(0.2)	--
India*	5.6	6.8	6.9	(0.4)	(0.1)	--
Indonesia	4.7	4.8	5.0	(0.3)	(0.2)	--
Other emerging economies						
Mexico	0.0	1.9	2.6	(0.8)	(0.1)	0.3
Brazil	0.3	1.9	2.2	(0.2)	(0.1)	--
Chile	(0.9)	2.8	2.8	(0.5)	(0.1)	--
South Africa	0.9	1.3	1.9	(0.5)	(0.4)	0.2
Poland	(0.3)	2.8	2.8	(1.2)	(0.4)	--

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

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Table 2

Downside Consumer Price Index Forecasts

Annual average percentage change

	Downside			Changes from our baseline		
	2023	2024	2025	2023	2024	2025
U.S.	4.7	4.0	3.2	0.5	1.3	0.9
Europe						
Eurozone	7.4	3.6	2.4	1.7	1.0	0.5
Germany	9.0	4.2	2.3	1.7	1.2	0.6
France	5.4	2.9	2.6	1.0	0.5	0.3
Italy	7.2	3.3	2.6	1.1	1.0	0.6
Spain	7.0	3.4	1.8	1.9	1.1	0.3
U.K.	7.9	1.5	2.1	0.9	0.6	0.5
Asia-Pacific						
China	2.9	3.0	2.4	0.3	0.6	0.2
Japan	1.8	1.8	1.4	0.3	0.6	0.2
India*	5.7	6.1	5.4	0.7	1.6	0.9
Indonesia	5.3	4.6	4.2	0.3	0.9	0.6
Other emerging economies						
Mexico	6.3	4.2	3.3	0.5	0.5	0.1
Brazil	4.7	4.6	3.5	0.4	0.3	0.1
Chile	8.5	4.4	3.1	0.6	0.2	0.1
South Africa	6.8	4.8	4.3	1.0	0.5	0.2
Poland	14.4	7.0	3.5	1.5	0.8	0.4

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

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Table 3

Downside Unemployment Forecasts

Annual average rate (%)

	Downside			Changes from our baseline		
	2023	2024	2025	2023	2024	2025
U.S.	5.3	5.6	5.0	0.4	0.3	0.2
Europe						
Eurozone	7.5	7.7	7.6	0.5	0.6	0.6
Germany	3.9	4.4	4.3	0.5	0.9	0.8
France	8.0	8.0	7.9	0.2	0.2	0.1
Italy	8.7	8.7	8.6	0.2	0.3	0.2
Spain	13.1	13.6	13.5	0.2	0.4	0.4
U.K.	5.0	4.8	4.3	0.4	0.3	0.3
Asia-Pacific						
China	5.3	5.1	5.0	--	--	--
Japan	2.6	2.6	2.6	--	0.1	0.2
Indonesia	5.4	5.3	5.3	--	--	--
Other emerging economies						
Mexico	3.9	3.7	3.6	0.2	--	--
Brazil	9.7	9.3	9.2	0.2	--	--
Chile	8.7	8.1	7.4	0.1	0.2	--
South Africa	33.6	33.1	32.5	0.7	0.6	0.5
Poland	3.3	3.0	2.8	0.2	0.1	--

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

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Related Research

- [Global Credit Outlook 2023: No Easy Way Out](#), Dec. 1, 2022
- [Credit Conditions Asia-Pacific Q1 2023: Still Above Water](#), Dec. 1, 2022
- [Credit Conditions Emerging Markets Q1 2023: Downturn Exacerbates Risks](#), Dec. 1, 2022
- [Credit Conditions Europe Q1 2023: Time To Face The Music](#), Dec. 1, 2022
- [Credit Conditions North America Q1 2023: Worse Before It Gets Better](#), Dec. 1, 2022
- [Global Macro Update: Surprising Resilience Unlikely To Last Into 2023](#), Nov. 30, 2022
- [Economic Outlook Asia-Pacific Q1 2023: Global Slowdown Will Hit, Not Halt, Growth](#), Nov. 28, 2022
- [Economic Outlook Emerging Markets Q1 2023: Hanging In There, But Growth Prospects Remain Tough](#), Nov. 28, 2022
- [Economic Outlook Eurozone Q1 2023: Reality Check](#), Nov. 28, 2022
- [Economic Outlook U.K. Q1 2023: A Moderate Yet Painful Recession](#), Nov. 29, 2022
- [Economic Outlook U.S. Q1 2023: Tipping Toward Recession](#), Nov. 28, 2022
- [Global Credit Conditions Downside Scenario: Recession Risks Deepen](#), Oct. 12, 2022

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