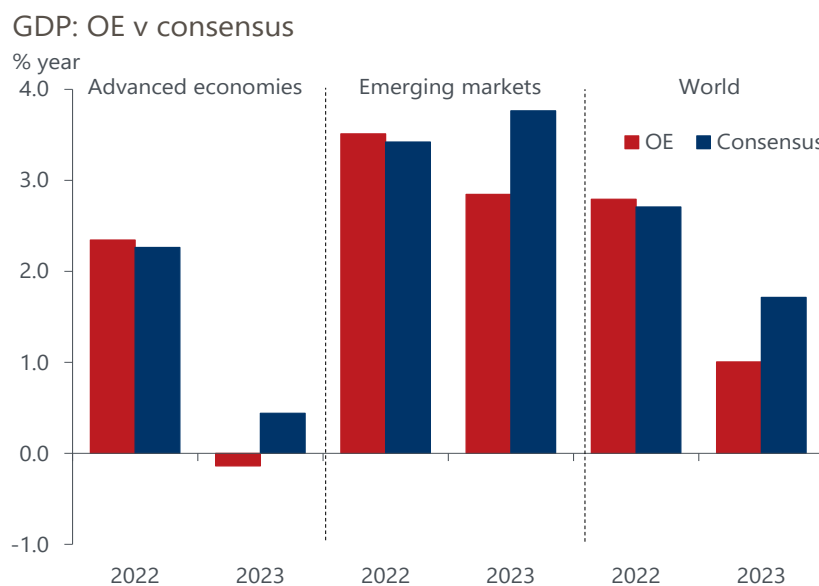


## Research Briefing | Global

# Key themes 2023 - Mild recessions and a cheerless recovery

- We anticipate most advanced economies will fall into recession in 2023 and global growth will be weaker than the consensus expectation. In that context, we have identified three themes that we think will dominate the economic outlook and financial markets.
- **1. Supply shocks will ease but won't fade completely.** Lockdown related supply-chain disruptions show clear signs of abating, which is good news for industry and inflation. But this won't end supply-side problems and uncertainties. Advanced economies' relationships with China and Russia will remain strained and may trigger changes in the way firms do business, raising costs and clouding the picture for central banks.
- **2. Inflation will fall sharply but a fast central bank pivot is less likely.** We expect inflation to fall back sharply for most economies as weaker commodity prices, slowing growth, and easing supply chain issues feed through to prices. But in the US, where demand factors have played a bigger role, inflation may fall back more slowly. While we expect eurozone inflation to be below the consensus expectation next year, US inflation is more likely to surprise to the upside.
- If inflation is close to target by late 2023, economies are growing again, and the labour market shakeout isn't too severe, central banks may be wary of doing anything that could trigger a renewed pick-up in inflation. So they may resist policy pivots next year. A substantive policy shift would likely need a bigger deterioration in the economic outlook than the consensus currently expects.
- **3. Recessions will be mild, but the subsequent recoveries disappointing.** The key shocks that have taken the wind out of the sails of global economies in 2022 should dissipate next year. But it will take more than negative shocks fading to generate a strong rebound. With China unlikely to act as spender of last resort, prior rate hikes in advanced economies still rippling through the system, and aggressive fiscal loosening off the table, a strong growth rebound seems improbable to us.

Chart 1: Our 2023 GDP forecasts are well below consensus



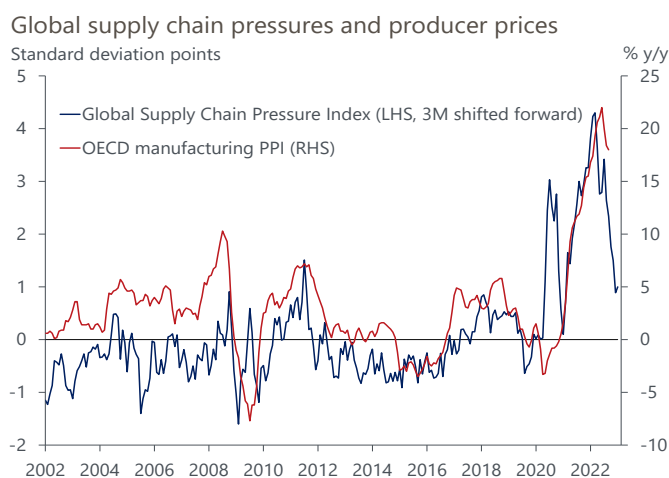
Source: Oxford Economics/Refinitiv

## 1. Supply shocks will ease but won't fade completely

Some [evidence suggests](#) that the success of inflation targeting in the 1990s and early 2000s was to a larger degree than initially appreciated due to an absence of adverse supply shocks. Monetary policy is more effective at managing demand rather than supply shocks, so the spate of negative supply shocks through the pandemic has placed a huge strain on the inflation targeting framework. If supply shocks ease from here, downside inflation surprises might start to coincide with upside revisions to GDP growth, making policymakers' jobs easier. But is this likely?

Encouragingly, there is growing evidence that the severity of global supply chain bottlenecks is easing markedly and the situation is likely to continue to improve, which may dampen price pressures over time (**Chart 2**). But it's too early to conclude that global supply woes are over.

### Chart 2: Supply bottlenecks are lessening



Source: Oxford Economics/Haver Analytics

First, it's still hard to pin down the extent to which easing pressure on supply chains is due to expanding supply or shrinking demand. If central banks assume it's mainly the former when it's the latter, any related policy pivot could quickly rekindle inflation pressures if demand growth picks up again.

Second, after a long period of turbulence, fully restoring just-in-time supply chains will take time and there will be volatility in the interim. As binding constraints on production are resolved, others may appear.

Third, other non-pandemic supply chain uncertainties still loom large over businesses. Russia's invasion of the Ukraine and geopolitical uncertainties surrounding China have forced many firms and governments to rethink how they manage international relationships, while highlighting the importance of managing supply chain weak spots via measures such as diversification.

True, we don't think that we are in the midst of a widespread phase of [deglobalisation](#). At the same time, though, we see some evidence of a decoupling with China via trade restrictions and reduced technological transfers, both of which may intensify. Along with other events over the past few years, all this has prompted some firms to reassess their production decisions. For instance, German firms, which are reliant on Chinese firms for key inputs, are finding they are [unable to bid for international business tenders](#), prompting some diversification.

Meanwhile, although mild autumn weather has raised hopes that Europe might avoid energy rationing this winter, the outlook for next year remains unclear. Rationing next winter is [far from inevitable](#), but uncertainty over the price and availability of energy could trigger some deindustrialisation in Europe. Energy rationing could also disrupt supply chains globally.

Overall, we expect problems on the supply-side of the global economy to fade through 2023, but it may be overoptimistic to assume that the upward impact on inflation from the supply side will fade completely.

## 2. Inflation will fall sharply but a fast central bank pivot is less likely

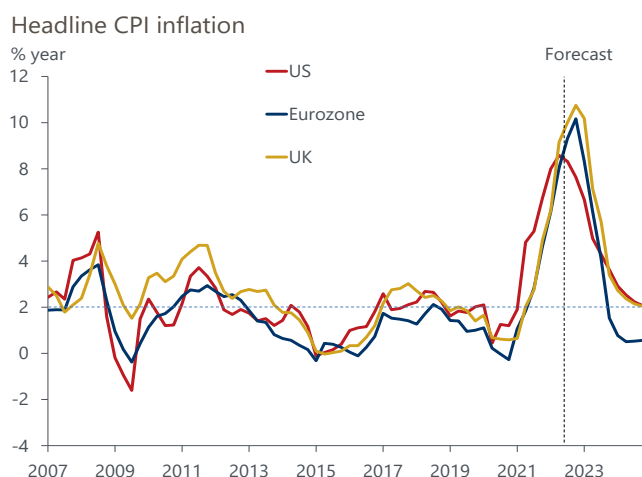
We remain optimistic that headline CPI inflation rates will fall back sharply over the course of 2023. By the end of next year, inflation should have returned to rates that are close enough to target to ease concerns about high inflation becoming entrenched.

Recent falls in commodity prices, container shipping rates, and other easing supply chain tensions suggest that a fall back in food, energy, and some goods inflation to well below 'normal' rates is [more likely than not](#) in 2023. Although services inflation in many economies is trending higher, softer growth may start to stifle inflation from early next year.

However, it's not clear how quickly these forces will push inflation back to target rates. This reflects a high degree of uncertainty over the extent to which constrained supply or strong demand have been dominant and the degree to which events in the past year or two have prompted fundamental shifts in the inflation generation process.

As we have [previously noted](#), observed inflation developments over the past couple of years can't be used to infer the extent to which the rise in inflation reflects demand or supply factors. Demand appears to be a relatively more important factor in the US than Europe. Accordingly, as supply problems ease, inflation in Europe could fall much more quickly than in the US, where upside demand effects will linger for longer (**Chart 3**). More generally, we think that CPI inflation will fall a bit less sharply than the consensus expectation in the US, but more sharply in the eurozone.

### Chart 3: Europe likely to see faster falls in inflation than the US in 2023

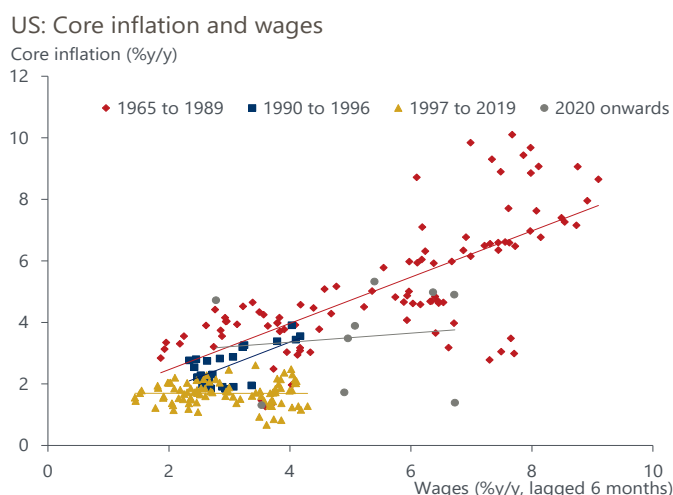


Source: Oxford Economics/Haver Analytics

High inflation [could linger longer](#) if the way inflation responds to shocks has changed. But while the overwhelmingly disinflationary structural forces of the 2010s might have waned, it seems unlikely that there has been a sudden flip back to the conditions of the 1980s or the 1970s. Shifts from a low inflation environment to a high one typically require a series of shocks [spread over several years](#). Events of the past year or two could mark the start of a de-anchoring of inflation expectations, but we don't think it will be enough on its own to do so.

If anything, the aggressive policy tightening by central banks and decreasing likelihood of major fiscal stimulus from here have lessened the risk of inflation expectations becoming de-anchored. Note too that [even during the 1970s](#), inflation fell as economies fell into recession. We believe that the weak relationship between wage growth and future core inflation that we've seen for the best part of the last 30 years will not crumble overnight (**Chart 4**).

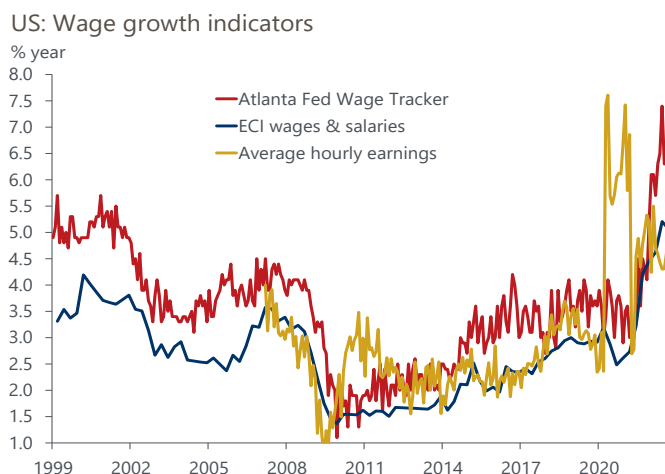
**Chart 4: We expect core inflation to remain unresponsive to wage growth**



Source: Oxford Economics/Haver Analytics

At the same time, the scale of the increase in inflation this year means that workers and firms won't expect inflation to be around target over the next 12 months – a potential departure from the experiences of past, smaller inflation spikes during the inflation targeting era. In the US, nominal wage growth remains high (**Chart 5**) and there is a risk in labour-intensive sectors that these costs are at least partly passed on to customers. More generally, in the US there is [evidence](#) that firms are placing more weight on economy wide inflation trends than in the past when deciding their own prices. All this may lead to a slower fall in inflation than say 2008, meaning a lower likelihood of a substantial inflation undershoot. That said, central bank credibility is better than in the early 1980s, so it should be easier than it was then to bring inflation down.

**Chart 5: Strong wage growth in the US adds to the risk of a gradual drop in inflation**



Source: Oxford Economics/Haver Analytics

By the middle of next year, we expect policy rates in most advanced economies to be above their likely neutral rates, as it becomes clear that inflation is falling back to near-target levels. So pressure to continue hiking rates should ease or cease. But a key question is when will central banks pivot towards policy loosening?

The Goldilocks scenario is for inflation in H2 2023 to be on a firm downward trend, the global economy to be emerging from recession, and central banks either beginning to cut interest rates or preparing the ground for some policy loosening. But we are sceptical that central banks will be quick to cut against this kind of backdrop. Uncertainty about the extent to which inflation expectations and the inflation generation process have changed, and a reluctance to see a further period of above target inflation will prompt central banks to be cautious about loosening monetary policy prematurely. Indeed, since changes in inflation

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regimes typically occur due to a series of shocks, keeping inflation low over the coming years will be as important as the initial job of bringing it down to target.

Our baseline forecast assumes that the peak to trough falls in advanced economies' GDP are small and unemployment rates will remain low by historical context, and that from mid-2023 economies will begin to expand again. If this turns out to be correct, we suspect that central banks' reactions won't be to swiftly move to cut rates. Factors such as relatively tight labour markets, particularly in the US, will still be a potential inflation threat.

In addition, if economies already have resumed growth by late 2023, as our baseline assumes, pressure to cut rates to support the economy should ease. True, central banks could try and cut to engineer a slightly more favourable combination of growth and inflation. But after the past year or so, we expect central banks to err on the side of keeping inflation low rather than looking to fine-tune policy. A resumption of growth when policy rates are high could be used as evidence that the neutral rates are higher than widely thought.

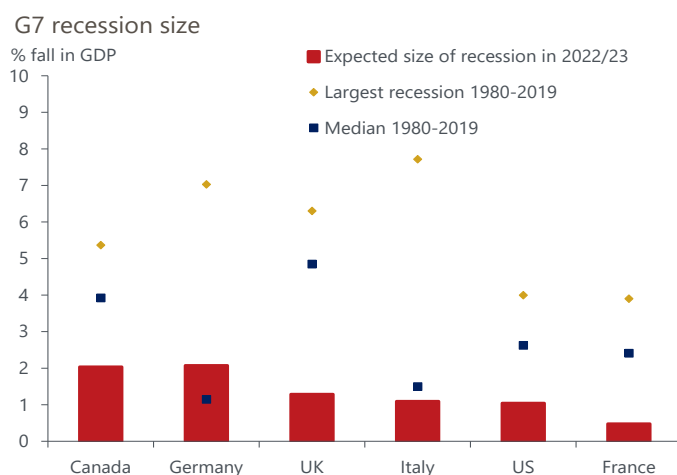
If widespread and significant rate cuts materialise next year, the most likely reason for this would be a longer and deeper recession than our baseline forecasts assume – in this context it's worth noting that our global forecasts are already notably weaker than the consensus (**Chart 1**). Relatedly, financial stability issues could force a central bank pivot. But so far at least, the [tightening in financial conditions](#) doesn't look particularly disorderly. This could change, but the likely initial response to pockets of stress will be targeted support measures. Policy rate cuts are likely to be reserved for severe, tail-risk scenarios.

In our view, hopes for speedy and significant monetary policy pivots next year will more likely than not be dashed. And if we are wrong, it's unlikely to be a cause for celebration.

## 3. Recessions will be mild but subsequent recoveries disappointing

Although our expectation that advanced economy recessions are expected to be mild in an historical context (**Chart 6**) may assuage the worst concerns, we would caution against concluding that GDP growth will rebound rapidly in H2 as economies begin to recover.

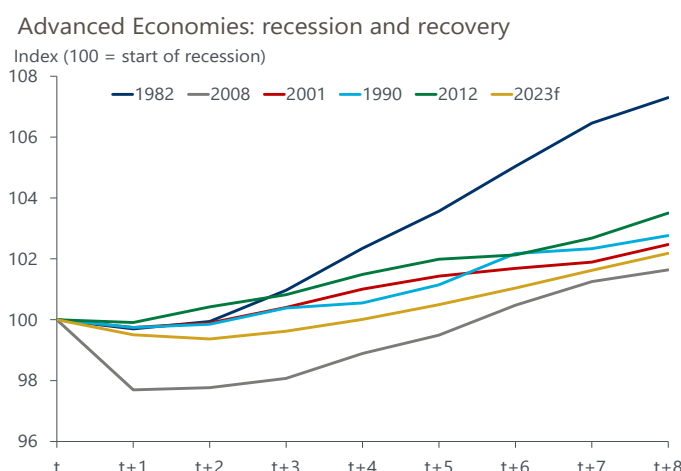
**Chart 6: Peak-to-trough falls in GDP are expected to be small in an historical context**



Source: Oxford Economics/Haver Analytics

Though we expect the recovery to be solid, it's likely to be unspectacular (**Chart 7**) and will mainly reflect fading adverse shocks, such as falling inflation. A much stronger recovery would probably need a big positive stimulus to materialise. But the typical go-to drivers – China and advanced economy policymakers' interventions – don't appear to be likely candidates this time around.

Chart 7: The economic recovery won't be robust in an historical context



Source: Oxford Economics/Haver Analytics

China has already stepped back from its post-global financial crisis role as spender of last resort. The effectiveness of China's traditional policy levers has diminished as China's debt has surged. In addition, concerns about growing imbalances and vulnerabilities have made the authorities less willing to pull the policy lever hard. Attempts to boost growth via other channels, such as through [increased household spending](#), have been largely unsuccessful. Despite 2022 being a problematic year for China, we expect the average quarterly pace of GDP growth in 2023 to be barely any higher.

Advanced economy governments and central banks don't seem primed to take decisive action to support growth either. While we do expect monetary policy tightening to end in H1 2023, the lags in the transmission mechanism mean past rate hikes will continue to weigh on growth through next year. And even if cuts begin in late 2023, their impact won't be felt straight away. The most plausible scenario for a substantial loosening would be a much deeper recession or major financial stresses. But this would reduce rather than increase the likelihood of a strong H2 growth rebound.

Neither do advanced economy governments look a likely catalyst for a more robust recovery. Despite a steady narrowing in their structural deficits over the past couple of years, we expect advanced economy governments will aim to keep these deficits [broadly steady](#) as a share of GDP in 2023, meaning the fiscal stance will be broadly neutral after two years of being contractionary. This is one reason why we expect the recession to be relatively mild.

But this year's rise in bond yields, the UK's recent fiscal debacle, and concerns about stoking inflationary pressures suggest that few, if any, advanced economy governments are likely to consider borrowing more to unveil spending hikes or tax cuts designed to super-charge nearer-term growth. Unexpected fiscal policy loosening is mostly likely to come in the form of measures to dampen the impact of further adverse economic shocks, rather than to generate robust recoveries.

## Another grinding year ahead

Overall, 2023 is shaping up to be another lacklustre year for the global economy. We anticipate recessions in H1 across swathes of the advanced economies, followed by unspectacular growth in H2. For now, we think the consensus is too optimistic about global growth prospects.

The end of the ultra-low interest rate era may be desirable, but it will inevitably be painful for some asset markets that until recently appeared to have priced-in interest rates remaining close to zero in perpetuity – most notably housing markets and real estate. Our baseline view is that these pockets of pain, won't be enough to cause the anticipated growth slowdown to morph into something rather more malign. But stickier inflation in the near term would be cause for concern. Not only would it likely prompt central banks to create a deeper downturn to lower inflation, it would also increase the risk of central banks straining vulnerable sections of the financial system to breaking point.