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World Economic Outlook in Spring 2023: The Economy Reaches Its Trough

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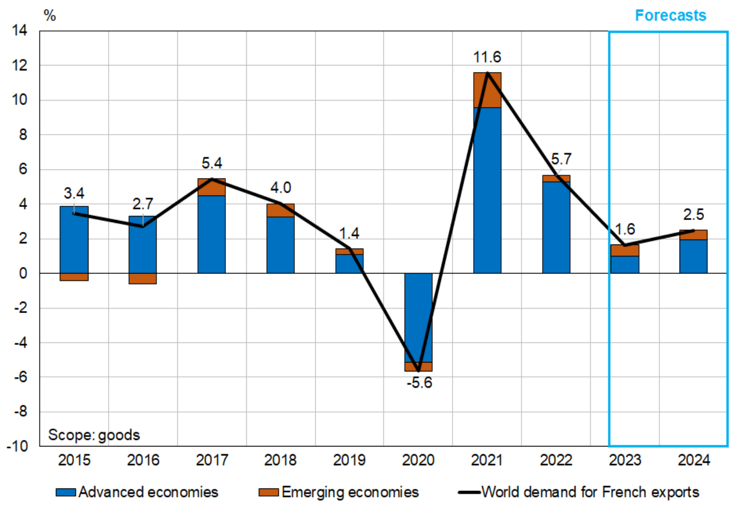
- The world economy is expected to grow by 2.8% in 2023, down markedly from 3.4% in 2022 due to the effects of high inflation and substantial key rate hikes by the major central banks, despite support from the reopening of China's economy. A slightly higher 3.0% is projected for 2024 as monetary policies ease.
- Positive growth is forecast for advanced economies in 2023, with the exception of the United Kingdom, which is set to enter a recession brought on by 2022's strong inflation and persistent Brexit-related weaknesses in its economy. Over our forecast horizon (2023 and 2024), European economies should continue to be supported by the NextGenerationEU recovery plan, particularly Italy and Spain. In 2024, we expect the United States to benefit from a rebound in investment fuelled by a revival of industry policy.
- In emerging economies, strong economic growth is expected overall, led by China and India, with slowdowns in Brazil and Turkey. China is set for a rebound in 2023, driven by a faster than-expected reopening of its economy and a recovery in household spending. In Turkey, the aftermath of the 2023 earthquakes is likely to put a damper on growth.
- World trade is expected to slow significantly in 2023 due to weaker economic activity, before rebounding in 2024. Growth in world demand for French exports (see Chart on this page) should follow the same pattern but is projected to lag behind global trade growth over the two-year period.
- The main downside risks to this scenario include inflation developments, financial risks, the war in Ukraine and potential natural disasters.

Growth in global demand for French exports



Source: DG Trésor.

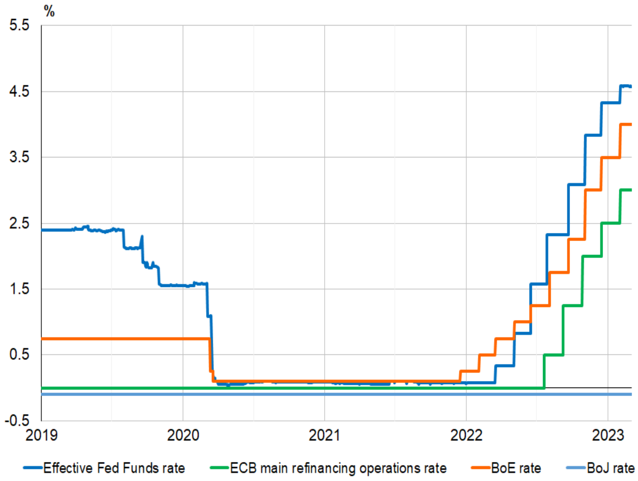
1. The effects of monetary tightening on the world economy

Our international projections rely on assumptions about future financial conditions, commodity prices and fiscal policy, with a cut-off date of 17 February 2023.

2022 was a year of aggressive monetary tightening in the world's major advanced economies, with the exception of Japan, which held its key policy rate steady. In addition to key rate hikes, central banks also began quantitative tightening, reducing the size of their balance sheets.[1] In our scenario, we make the assumption that the US Federal Reserve (Fed), the Bank of England (BoE) and the European Central Bank (ECB) will slowly start cutting rates in mid-2023.[2] Most emerging economies, particularly India and Brazil, also saw monetary tightening in 2022 in response to inflationary pressures and the Fed's rate tightening. In contrast, China trimmed several of its policy rates to support investment and mortgage lending. Turkey's central bank further eased its accommodative policy stance, lowering rates from 12.5% to 9.0% in 2022.

Central banks' monetary tightening announcements were met with a sharp rise in long-term yields. The 10-year sovereign yields of major advanced economies moved up significantly in the final quarter of 2022,[3] when inflation and rate hike expectations were at their highest. In early 2023, sticky core inflation and uncertainty about future monetary policy continued to put upward pressure on long-term yields, which remain at historical highs. Our forecast assumes that sovereign yields have already priced in the information communicated by central banks and will not rise significantly between now and 2024.

Chart 1: Main key rates



Sources: US Federal Reserve, Bank of England, European Central Bank, Bank of Japan.
Latest data points: 9 March 2023.

Fiscal policy, on the other hand, is expected to continue supporting growth in most advanced economies, with the exception of the United Kingdom. In Europe, planned spending under national recovery and resilience plans (NRRPs) should give a boost to investment in Spain and Italy in particular, while the anti-inflation measures announced by European governments should continue to support household purchasing power and business activity in 2023. As inflation drops significantly, we expect these supports to be gradually withdrawn in 2024. In the United States, the Biden administration's major fiscal initiatives (the Infrastructure Investment and Jobs Act, the CHIPS and Science Act and the Inflation Reduction Act), which are focused on industrial sovereignty and the green transition, will only begin to have an impact on the

(1) The Fed began tapering its asset purchases in November 2021, ending them completely in March 2022 before starting to reduce its balance sheet in June 2022. The ECB stopped growing its balance sheet in June 2022 and began quantitative tightening in November. The Fed reduced its balance sheet by $532bn (2.1% of GDP) between its April 2022 peak and February 2023, starting from an April 2022 balance sheet totalling $8,965bn (35.2% of GDP). The ECB reduced its balance sheet by €952bn (7.1% of euro area GDP) between June 2022 and February 2023, starting from a June 2022 balance sheet totalling €8,826bn (66% of GDP).

(2) Our scenario has the Fed's key rate topping out at 4.9% in June 2023 and falling to 3% by the end of 2024, and the BoE rate hitting 4.5% in August 2023 before gradually being cut to 3.5% at the end of 2024. The ECB's deposit facility rate (the interest rate banks receive for depositing money with the central bank overnight) is projected to peak at 3.5% in September 2023 and end 2024 at 3.25%.

(3) Italian, UK and US yields hit their peaks in October 2022, in connection with national political events (the mini-budget in the UK and elections in the US and Italy), before coming back down. French, German and Spanish yields hit their peaks later, in December 2022.

American economy in the second half of 2024, mainly through non-residential investment. As for the United Kingdom, our scenario includes a medium-term fiscal consolidation strategy that involves increasing gas and electricity price caps and raising corporation tax rates from 19% to 25% in the first half of 2023.

Oil prices skyrocketed in the first half of 2022 after Russia invaded Ukraine. Although in sharp decline since mid-June, they remained particularly volatile in the second half of 2022 due to major uncertainties on both the geopolitical front (intensity of the war in Ukraine, Russian oil sanctions, COVID restrictions in China, etc.) and the economic front (high inflation, pace of monetary tightening, world growth outlook, etc.). January 2023 saw new pressures put on oil prices as the Chinese economy reopened, and expectations of a slowdown in monetary tightening emerged after inflation showed clear signs of slowing. For the purposes of our forecast, we set the price of a barrel of Brent (North Sea benchmark) at $83.40 (€78.20) and the euro exchange rate at $1.08.

2. International scenario: a sharp slowdown in economic activity

Table 1: World growth forecasts

	2015-2019 average	2019	2020	2021	2022[a]	2023	2024	Cumulative since 2019[b]		
					(forecasts, working-day ajusted)			2022	2023	2024
Global growth	**3.4**	**2.8**	**–3.0**	**6.2**	**3.4**	**2.8**	**3.0**	**6.5**	**9.4**	**12.7**
Advanced economies[c]	**2.1**	**1.7**	**–4.3**	**5.4**	**2.7**	**1.0**	**1.4**	**3.6**	**4.6**	**6.1**
Euro area[d]	2.0	1.6	–6.3	5.3	3.5	0.8	1.5	2.1	2.9	4.5
Germany	*1.7*	*1.1*	*–4.1*	*2.6*	*1.9*	*0.2*	*1.3*	*0.3*	*0.5*	*1.7*
Spain	*2.8*	*2.0*	*–11.3*	*5.5*	*5.5*	*1.3*	*1.8*	*–1.3*	*–0.1*	*1.7*
Italy	*1.0*	*0.5*	*–9.1*	*6.7*	*3.9*	*0.7*	*1.3*	*0.8*	*1.6*	*2.9*
United Kingdom	2.1	1.6	–11.0	7.6	4.0	–0.7	0.5	–0.4	–1.1	–0.6
United States	2.4	2.3	–2.8	5.9	2.1	1.0	1.1	5.2	6.2	7.3
Japan	0.9	–0.4	–4.3	2.2	1.1	1.1	1.3	–1.2	–0.1	1.2
Emerging economies[c]	**4.3**	**3.7**	**–2.0**	**6.6**	**3.9**	**3.9**	**4.1**	**8.5**	**12.7**	**17.3**
Brazil	–0.5	1.2	–3.9	4.6	2.8	1.1	1.6	3.4	4.5	6.2
China	6.7	6.0	2.2	8.1	3.0	5.3	4.5	13.8	19.9	25.2
India[e]	6.6	3.7	–6.6	8.7	6.9	6.0	6.5	8.5	15.0	22.5
Turkey	4.1	0.8	1.9	11.4	5.0	2.8	2.9	19.2	22.6	26.1
World trade in goods[f]	3.0	0.8	–4.7	12.7	5.2	2.2	3.1	12.9	15.3	24.8
World demande for French exports	3.4	1.4	–5.6	11.6	5.7	1.6	2.5	11.3	13.1	22.8

a. The 2022 figures for advanced economies and China are estimates based on the available data as of the forecast cut-off date (17 February 2023). Emerging economy and world growth figures are projections.
b. Cumulative growth rates between 2019 and each year from 2022 to 2024.
c. Aggregate forecast figures for advanced economies and emerging economies are based on IMF projections adjusted using DG Trésor projections covering the countries in the table above, with past figures adjusted for revisions to national accounts. The forecast for global demand for French goods no longer includes forecasts for the Russian economy given the collapse in bilateral trade flows after sanctions were imposed on Russia.
d. Aggregate figures for the euro area are calculated using quarterly accounts, adjusted for working days. Forecast figures are estimated based on European Commission projections adjusted using DG Trésor projections for Germany, France, Italy and Spain.
e. Growth figures for India are on a fiscal year basis. On a calendar year basis, they are 6.9% for 2022, 4.7% for 2023 and 7.5% for 2024.
f. World trade, calculated as the sum of imports, covers 40 countries representing 85% of world imports.

Sources: IMF January 2023 World Economic Outlook; European Commission February 2023 Economic Forecast; DG Trésor calculations and projections.

2.1 A lull in economic activity and world trade

After returning to a level near its pre-crisis average[4] in 2022 (3.4%), world growth is expected to slow to a moderate 2.8% in 2023 (see Table 1). This is essentially due to the effect of tightening monetary policy and prices remaining high, giving rise to less favourable financing conditions, lower real income and a deterioration in consumer and business confidence. A lack of any major negative shocks in Asia's major emerging economies, which are less exposed to inflation and the war in Ukraine, is expected to accentuate the differences in growth between advanced and emerging economies. We predict growth will remain strong in emerging countries (3.9%), driven by the rebound in Chinese activity, and slow significantly in advanced economies (1.0%), dragged down by weak activity in the euro area and the UK in particular.

In 2024, world growth is expected to see a moderate recovery (3.0%), primarily supported by emerging economies (4.1%). Activity should also pick up in advanced economies (1.4%), driven by a faster pace of real income growth and the start of monetary easing as inflationary pressures gradually dissipate.

Despite easing supply chain pressures, world trade in goods is expected to slow considerably in 2023 (2.2% vs 5.2% in 2022), in line with global economic activity. With advanced economies set to experience a marked economic slowdown, we estimate emerging economies will account for more than half of world growth, compared to less than a quarter in 2022. World trade should then return to a pre-crisis pace of growth (3.1%) in 2024.

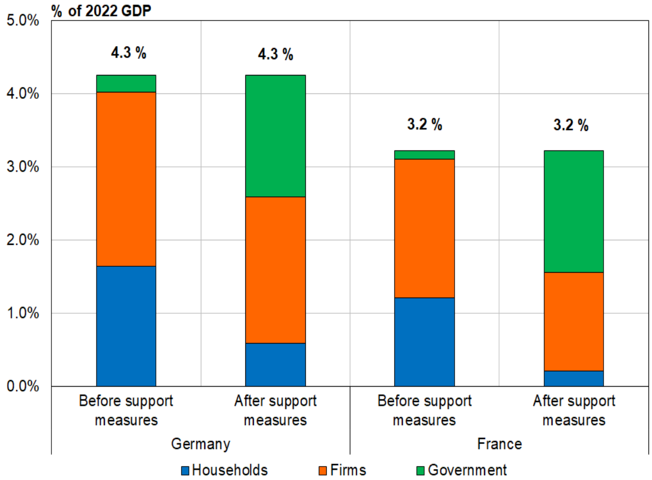
Growth in global demand for French goods is expected to lag behind global trade growth in 2023 (1.6%) and 2024 (2.5%) due to weak import demand from advanced economies, France's main trading partners.

Box 1: The high cost of commodity price increases for the German economy in 2022

The high level of inflation experienced in Europe in 2022 was primarily driven by rising energy prices.[a] Like all European economies, Germany had to contend with a sharp jump in wholesale energy prices: between 2019 and 2022, Germany's benchmark market price for natural gas saw an eightfold increase, the price of coal quadrupled, and oil doubled. In 2019, Germany's trade balance for natural gas, oil and coal stood at ?€65bn (1.9% of 2019 GDP), a figure comparable to France's in terms of percentage points of GDP (–€47bn, or 2.0% of GDP).

In France, rising oil and gas import prices resulted in an estimated €85bn in lost income, around 3.0% of GDP.[b] The same estimation methodology can be applied to Germany, adding coal to the list of energy commodities, which the country uses to produce a significant share of its electricity.[c]

Chart 2: Distribution of income losses associated with a deterioration in the terms of energy trade between 2019 and 2022



Source: DG Trésor.

a. In 2022, energy accounted for 40% of total inflation in France as measured by the Harmonised Index of Consumer Prices (HICP), and 47% in Germany.
b. For the analysis for France and details of the methodology that was used, see Clavères G. (2022), "The Distribution of Losses Caused by the Energy Terms of Trade Shock", *Trésor-Economics*, no. 318.
c. According to initial estimates from the German federal statistics office, Destatis, nearly one-third of the electricity produced in Germany in 2022 was from coal.

(4) Defined for our purposes as the average for the years from 2015 to 2019.

In so doing, we estimate the income lost by Germany as a direct result of higher imported energy prices to be more than €160bn, or 4.3% of GDP. As in France's case, the loss is mainly attributable to natural gas (€115bn), which saw the biggest price jump, and to a lesser extent oil (€33bn) and coal (€16bn). The reason Germany experienced a larger impact is the steeper increase in natural gas prices on the German benchmark index[d] and the rise in the cost of coal. Our estimate should be understood to be a static *ex ante* analysis; it does not account for any adjustments that might have offset the effects of the increase, such as firms being able to pass on the higher production costs to export prices or a decrease of import volumes compared to 2019. Furthermore, our analysis does not account for the dampening effect of procurement strategies, which may have partially and temporarily protected some firms from price increases. Other indicators suggest less substantial losses for Germany: the energy balance, for instance, did not deteriorate to the same extent (–€73bn, or 2% of GDP).

In terms of sector distribution, before factoring in government support, firms would have borne the brunt of losses, followed by households, in a breakdown close to what has been estimated for France. Germany's public finances absorbed a large part of the shock, but firm and household losses remained substantial. As in France, Germany's government introduced measures in response to rising energy prices. After factoring in support measures, German households and firms are still estimated to have borne 14% and 47% of total income losses, respectively, which is higher than in France (6% and 42%).

d. French and German suppliers can buy either at the Dutch Title Transfer Facility (TTF) price or at national hub prices: the *Point d'Echange de Gaz* (PEG) in France and the Trading Hub Europe (THE) in Germany. On average, the THE has a higher benchmark price than the PEG.

2.2 Advanced economies on track for a significant slowdown

We expect advanced economies will feel the pinch of rising interest rates and the gradual pace of the reduction in inflation, giving rise to a sharp economic slowdown in 2023 (growth of 1.0%) followed by a slight pickup in 2024 (1.4%). On an average annual basis, we do not forecast a recession, except for the United Kingdom in 2023.

In the United States, we anticipate low growth over the forecast period (1.0% in 2023 and 1.1% in 2024).[5] In 2023, the US economy will likely experience a slowdown in household spending as excess savings built up over the pandemic, which had so far offset the reduction in real wages, are depleted. The property slump caused by monetary tightening is set to affect economic growth (i) directly via private investment, particularly in residential housing, which is projected to slow in 2023, and (ii) indirectly via a decrease in spending in response to negative wealth effects (see Box 2). In 2024, economic growth will be driven by investment, thanks to improved financing conditions as the Fed lowers its key rate, as well as fiscal incentives in future-oriented sectors (semi-conductors, batteries, renewable energy, electric vehicles, minerals).

In Germany, growth is projected to slow sharply in 2023 (0.2%).[6] Investment, particularly in construction, will probably continue to be undermined by high input and financing costs. Consumer spending is expected to be dampened by an inflation rate above the euro area average. 2024 should bring an uptick in growth (1.3%), driven by improved purchasing power from wage growth and receding inflation. As uncertainty wanes and global trade picks up, we should see German industry make up lost ground, particularly the automotive sector.

The United Kingdom is expected to see a contraction in growth in 2023 (–0.7%). Although down sharply compared to 2022, rising prices are likely to eat into household purchasing power in 2023 and cause consumer spending to fall. Investment is also expected to decline due to monetary and tax policy tightening and lingering Brexit-related uncertainties. Although we forecast a moderate rebound (0.5%) in 2024, the UK economy is unlikely to return to its pre-pandemic level of growth. Consumer spending is projected to pick up only slightly in 2024, with weak purchasing power keeping it well below its 2019 level.

(5) Owing to a significant carry-over effect on 2023 growth from Q4 2022, the relative uniformity in the annual growth rate indicates stagnant quarterly growth in 2023 and stronger growth in 2024.

(6) Destatis published a new GDP estimate for Q4 2022 on 24 February, after our cut-off date. The revised quarterly growth rate (down 0.2 percentage points to –0.4%) does not affect our forecast for Germany's 2023 growth.

Italy is forecast to see a sharp slowdown in growth in 2023 (0.7%) and a rebound in 2024 (1.3%). In both years, growth is expected to be driven by consumer spending and investment, and we expect exports to be hit hard by the slowdown in world trade in 2023, but not so hard as to see a contraction. Consumer spending should pick up in 2023 thanks to easing inflation and strong wages. Investment, which received a major boost from the "superbonus" tax incentive scheme for energy-saving home improvements, is expected to remain strong and support economic activity in 2023 and 2024 as fresh European recovery plan funding comes in.

While Spain's economic growth is set to slow significantly in 2023 (1.3%) and 2024 (1.8%), it should continue to benefit from significant catch-up room after seeing a less pronounced post-pandemic rebound than its European neighbours. We expect consumer spending to stay strong, with inflation having dropped sharply since the end of 2022. The national recovery and resilience plan should continue to support investment, which is projected to remain solid over our forecast period, despite tightening financing conditions.

Japan should see continued moderate economic growth in 2023 (1.1%) and 2024 (1.3%), primarily driven by a catch-up in domestic demand. Even after a small key rate rise from the Bank of Japan, investment is projected to gradually return to its pre-pandemic level. We anticipate households will continue spending excess savings built up over the pandemic in spite of strong inflationary pressures. Although much lower than in other advanced economies, Japan's inflation rate, which hit 4% in Q4 2022, is at a more than 30-year high.

Box 2: The US housing sector has been detracting from GDP growth since Q2 2022

2020 and 2021 saw strong growth in the US residential housing market, driven by massive fiscal support and key rate cuts from the Fed. When the monetary tightening cycle began in March 2022, borrowing costs shot up and mortgage applications declined. As a result, building permits and housing starts have been falling since April 2022. Residential property prices began to drop in June 2022,[a] dragging US GDP growth down by 0.5 percentage points in 2022.

The non-residential segment,[b] which is more procyclical, was already slowing in 2020 and 2021, since a slowdown in economic activity meant that firms had less capacity to invest in construction spending, industrial sites and retail spaces. The segment has remained depressed, detracting from GDP growth (–0.2%) in 2022, mainly due to lower demand for office space as remote work has taken off. Overall, property investment, which has also been suffering from limited supply due to a construction materials shortage and a labour shortage, sapped 0.7 percentage points from GDP growth in 2022 (for observed GDP growth of 2.1%).

Property investment will likely continue to put a drag on economic growth in 2023, with things looking less certain in 2024.

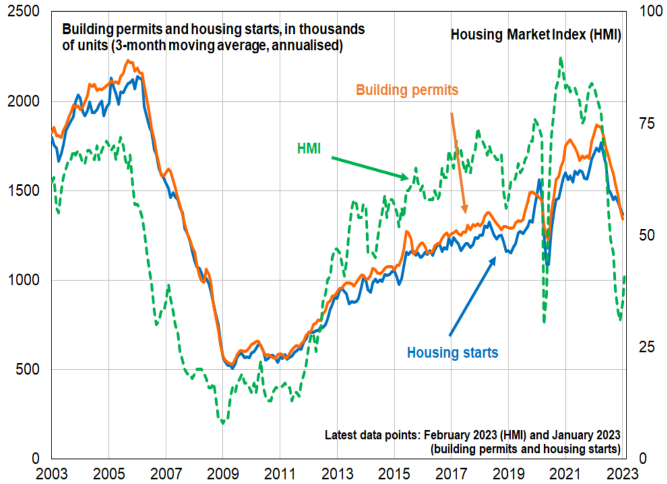
- In the residential segment, we anticipate investment will continue to detract from growth in 2023 as interest rates remain high and prices fall.[c] In 2024, the property sector's impact on growth will depend on the monetary policy direction taken by the Fed. If it cuts rates in December 2023 in line with market expectations, we would only see a rebound in the residential property sector and support for growth starting in mid-2024, which would entail a neutral contribution to growth for the year. Rising rates also pose a risk to the financial position of

a. The decline in property prices is due to two opposing forces: on the one side, demand is lower due to high mortgage rates; on the other, the low supply of homes for sale has been keeping prices relatively high. According to the S&P Case Schiller index, prices in the country's 20 largest cities fell by 4% between June and November 2022, a figure the Federal Housing Finance Agency index puts at 1% nationally.
b. Non-residential investment includes construction spending by firms on office buildings, industrial sites, warehouses and retail spaces.
c. In addition to the direct impact via investment, the property sector has an indirect impact on growth via household spending from a wealth effect caused by a rise in property prices: when prices fall, it causes agents' wealth to decline, and therefore their ability to take on debt to finance spending (academic studies estimate that every additional dollar of property wealth increases household spending by 2 to 9 cents). See: (i) Caceres C. (2019), "Analyzing the Effects of Financial and Housing Wealth on Consumption Using Micro Data", International Monetary Fund; (ii) Aladangady A. (2017), "Housing Wealth and Consumption: Evidence From Geographically Linked Microdata", American Economic Review, 107(11); and (iii) Cooper D. (2013), "House Price Fluctuations: The Role of Housing Wealth as Borrowing Collateral", Review of Economics and Statistics, 95(4).

property companies, which could have trouble refinancing, and to general financial stability. That said, there is less risk of a 2007/2008-style crisis because (i) borrowers are in a more sustainable financial position; (ii) the proportion of variable-rate mortgages is much lower; and (iii) stronger regulations have been introduced for the lending and securitisation markets.

- We expect the non-residential segment to hold steady in 2023 and resume contributing to GDP growth in 2024, as financing conditions improve and industrial policy measures aiming at increased economic sovereignty (the CHIPS and Science Act, the Inflation Reduction Act and the Infrastructure Investment and Jobs Act) spur the construction of new production plants.

Chart 3: Building permits, housing starts and the Housing Market Index (HMI)[d]



Sources: Census, NAHB.

d. How to read this chart: The Housing Market Index (HMI) is a seasonally adjusted index derived from a monthly survey of home builders. A reading above 50 indicates that more builders view sales conditions as good than poor.

2.3 Emerging market growth to be led by China and India

China, which saw economic growth slow markedly in 2022 to 3.0%, due to the government's zero-COVID policy and the property crisis, is expected to bounce back to 5.3% growth in 2023 thanks to a swift reopening of its economy. The end of pandemic restrictions is projected to drive a rebound in consumer spending. As evidenced by the lifting of zero-COVID rules and recent measures benefiting the property sector, the government is making economic support a priority for 2023, and Chinese monetary policy is also expected to continue easing. We project growth will then slow toward the potential growth rate, coming in at 4.5% in 2024, as traditional growth drivers such as property and investment lose steam. Without a rebalancing of domestic demand or policies to strengthen the social safety net, the sustainability of China's growth model is unclear.

In Turkey, growth is projected to slow to 2.8% in 2023, owing to the impact of the earthquakes and a necessary normalisation of economic policy. Although the 6 February earthquakes were the most destructive to ever occur in Turkey, the economic weight of the affected regions (9% of GDP) and their distance from the country's economic centre likely mean they will have a limited impact on growth. In 2024, we forecast growth of 2.9%, driven by strong investment in relation to rebuilding needs.

In India, we expect growth to remain strong in 2022/2023 at 6.9%, driven by a rebound in consumer spending and investment in the first half of the year and an infrastructure-focused recovery plan (2.7% of GDP in 2022/2023), primarily in railways, roads and telecoms. In the second half, however, a number of factors are likely to weigh on growth, including declining global demand, monetary tightening from the country's central bank to rein in inflation (with key rates up 250 basis points since May), and a less favourable labour market. Investment and infrastructure spending should continue to support growth, which we forecast will come in at 6.0% in 2023/2024 and 6.5% in 2024/2025.

We project Brazil will see growth slow to 1.1% in 2023 (down from 2.8% in 2022). The extent to which the economy slows will depend on how the government carries out reforms designed to support households (with consumer spending expected to remain a key growth driver) and improve the business environment and market confidence. We could also see exports benefit from the rebound in China's economy in early 2023 (see Box 3).

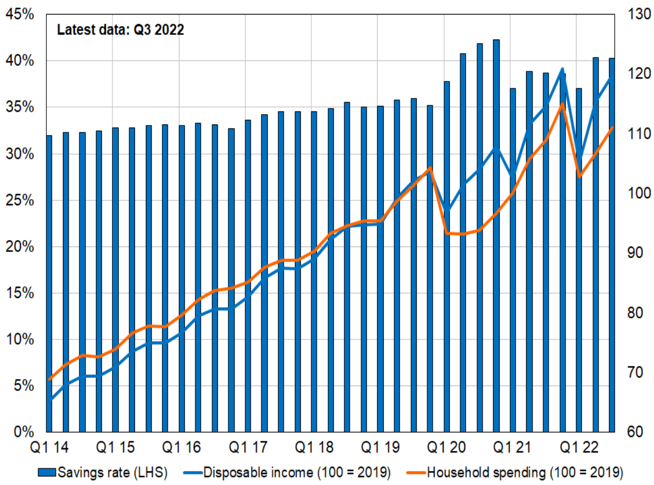
Box 3: What impact will a Chinese rebound have?

When China lifted most of its anti-COVID19 restrictions in early December 2022, it led to an unprecedented surge in COVID 19 cases, with the wave peaking in January 2023. At 21 January, the Chinese Center for Disease Control and Prevention estimated that some 1.2 billion people, or 80% of the population, had contracted the virus. The wave first peaked in the country's major cities, followed by rural areas in late January, due to travel between provinces over the New Year holiday period. The situation appears to have stabilised since February. Epidemiologists are not ruling out the possibility of another wave in four to six months, although infections are likely to be less severe on average due to a higher level of herd immunity.

The scrapping of zero-COVID restrictions caused Chinese economic indicators to deteriorate in December, but this was transitory and limited. Manufacturing output slowed to 1.3% year-on-year (YoY) in December (down from 2.2% in November), and retail sales fell by 1.4% YoY. Official manufacturing and non-manufacturing PMIs.[a] deteriorated further in December from already contraction-level readings. The massive COVID wave affected new orders and output as employees called in sick and supply chains were disrupted. After infections peaked in January, activity soon rebounded, with Shanghai container traffic rising at the end of December, for example, and PMIs bouncing back into expansion territory in January.

After slowing in 2022, we expect Chinese growth will rebound in 2023, coming in at 5.3%. But the size of the rebound remains uncertain, with the possibility of a new COVID variant, changes to demand from Western countries and tensions with the United States. Moreover the recovery in consumer spending could be delayed by weak growth in real wages in 2022, and will depend on the use of precautionary savings accumulated over the pandemic (see Chart 4).

Chart 4: Revenu disponible, taux d'épargne et consommation des ménages chinois



Source: NBS, calculations: DG Trésor.

We predict the rebound of the Chinese economy in 2023 will support global demand[b] and help further ease supply chain pressures, with fewer disruptions in manufacturing output and less shipping congestion.

However, the rebound could also put upward pressure on some commodity prices,[c] such as oil and nickel, which are highly sensitive to Chinese demand.[d] The International Energy Agency (IEA)[e] projects that world demand for oil will grow by 1.9 million barrels per day (mb/d) in 2023, with more than half of that increase coming from China. In terms of global supply, the IEA estimates growth of 1.2 mb/d in 2023, even though OPEC+ has not adjusted its production quota of 41.9 mb/d since November 2022, and Russia announced on 10 February that it would cut its exports by 500,000 barrels per day beginning in March in response to sanctions.

Overall, the net effect of a Chinese rebound on global GDP should be slightly positive, mainly benefiting commodity exporters (Brazil in particular) and China's main trading partners (ASEAN countries, the EU, Taiwan, South Korea and Japan).

a. Purchasing managers' indexes (PMIs) measure the level of confidence of purchasing managers. A reading above 50 indicates that purchasing managers are confident and expect an economic expansion. A reading below 50 indicates expectations of an economic recession.
b. A positive supply or demand shock would be transmitted directly via trade. China accounted for nearly 11% of world imports of goods and services in 2019.
c. A 1.0% increase in Chinese demand would result in a 2.2% rise in commodity prices, as estimated by William L. Barcelona, Danilo Cascaldi-Garcia, Jasper J. Hoek, Eva Van Leemput (2022), "What Happens in China Does Not Stay in China".
d. China accounts for nearly 14.5% of global oil demand.
e. IEA (2023) Oil Market Report – February 2023.

3. Inflation is the main risk to our scenario

What happens with inflation is key to our scenario. While headline inflation has started to come down due to lower energy prices, core inflation continues to rise as past energy price increases make their way through the entire economy. What happens next will depend on the outcome of opposing forces, which is difficult to predict. On the one hand, falling prices on a number of commodities and leading indicators such as production prices suggest that inflation is indeed waning. On the other, the knock-on effects of past increases – particularly wage increases – threaten to keep inflation high. The size of these increases is uncertain, but the risk of a wage-price spiral seems low for now: recent real wage growth is still negative, long-term inflation expectations remain anchored very close to central bank targets, and automatic indexation mechanisms are not as common as they once were. Pulling in the other direction, however, are the tight labour markets currently seen in advanced economies, which tend to drive up wages.

As with inflation, future monetary policy developments are also uncertain. If inflation persists longer than anticipated, we could see central banks pick up the pace of monetary tightening or keep rates high for longer, which would stoke recession risk in advanced economies, via tougher financing conditions and a decline in investment affecting economic growth and employment. Additional tightening would also affect emerging economies, via capital flows, currency crisis risks and a higher cost of dollar-denominated debt service. Conversely, if inflation were to come down faster than anticipated, it would drive a stronger recovery and see monetary easing come sooner.

At the current point in the monetary tightening cycle, there are risks to financial stability. Since early 2023, receding recession risks and announcements of further rate hikes have supported risky assets and driven sovereign yields up, although without spreads between euro area Member States widening significantly – in other words, without a resurgence of financial fragmentation risk. Despite a strong start to 2023 on the markets, financial institutions remain under pressure. Higher borrowing costs affect firms' and households' ability to meet their payment obligations, increasing default risk for the banking system.

What happens with inflation also depends on the international environment. Energy prices, particularly oil prices, are volatile, with opposing forces at play: the reopening of China's economy (see Box 3) and Russian restrictions on oil exports are exerting upward pressure on oil prices, while the release of US strategic reserves and restrictive monetary policy is pulling them down. Other commodity prices (natural gas, industrial goods, food), which have largely started to drop already but remain above 2021 levels, could fall further. High natural gas inventories in Europe, combined with cooperation on energy supply, could help reassure markets and further relieve price pressures. Furthermore, the reopening of the Chinese economy and a stronger-than-expected rebound in household spending in China could support growth in both emerging and advanced economies via trade.

If current protectionist tendencies develop further, we could see fragmentation in global value chains, which would drive up trading costs for firms and threaten security of supply.

A military escalation of the war in Ukraine would dampen the long-term investment outlook in Europe and spell sustained uncertainty for the oil and gas markets. Conversely, a ceasefire or peace agreement between Ukraine and Russia would reassure the financial and oil markets and could cause some commodity prices to come back down.

Climate change presents a major short-term risk due to the resulting natural disasters that could cause supply disruptions for both advanced and emerging economies. The summers of 2021 and 2022 saw Europe hit by unprecedented flooding and wildfires, respectively, with a loss of human life as well as infrastructure.

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