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Global Economic Outlook: Q2 2023

Of resilience and recessions

abrdn Research Institute

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Global Overview

Of resilience and recessions

The resilience of economic activity and the strength of underlying inflation at the start of 2023 imply that central bank policy rates – especially the fed funds rate – need to rise higher. However, rather than undercutting our forecast for an eventual US and broader developed market recession, we think that this combination actually underscores the necessity of that recession, even as it pushes it further into the future. The subsequent interest rate cutting cycle that we forecast is not yet priced into markets.

By contrast, the Chinese economy is rebounding rapidly and has the spare capacity to keep that strong growth going through our forecast horizon. Indeed, we expect growth in China to exceed consensus expectations this year. While the spillover from a strong China into broader emerging markets (EMs) will be smaller than it has been in the past, all this adds up to a global economy that should look increasingly divergent later this year.

Our overarching assessment continues to be that a US recession is "necessary" to unwind the overheating in the labour market and bring underlying inflation back to target-consistent rates. The US is in a state of excess demand with an unemployment rate below the natural rate. In our baseline, we don't think that correcting this imbalance can occur benignly, for example via lower job openings. Instead, we think it has to happen more painfully through a higher unemployment rate. Moreover, we believe that the Federal Reserve (Fed) will be willing to bear this cost to restore price stability. This has long been the thinking behind our US recession call.

Resilient US – and indeed global – activity data and upside inflation surprises at the start of 2023 at first appear to be at odds with this forecast. However, they actually increase our conviction that a recession is necessary, because they add to the evidence of overheating. What they do change is our assessment of whether the "sufficient" conditions for a recession are in place. The feed-through from monetary policy tightening is yet to be fully felt, or has simply not been sufficient to slow activity and inflation enough.

The strength of incoming activity data is clearest in the global composite PMI, which rose to 52.1 in February, back into expansionary territory for the first time in eight months (see Figure 1). This strength is broad-based.

In the US, the PMI business survey returned to expansion in February, while the alternative ISM survey remains robust. Crucially, the US consumer had a good start to 2023, with personal consumption strong in January and the labour market adding a very large number of jobs. Even industrial production, goods orders, and homebuilder confidence have been a little better. This improvement in part reflects seasonal distortions. However, it is clear that, having slowed into the back-end of last year, the US economy has picked up pace.

The corollary of better activity data has been still-elevated inflation prints. Revisions to the US CPI series mean that what previously looked like a gradual cooling in core inflation over 2022 is now much less convincing. And core PCE inflation rose to 4.7% in January 2023. Stripping out falling energy prices and globally-generated goods disinflation, services inflation remains far too hot.

The Eurozone economy is also proving relatively resilient. The economy avoided a deep winter recession, while the composite PMI rose to 52.3 in February. This better picture reflects the sharp fall in gas prices. However, core inflation is still rising, reaching 5.6% in February, an all-time high.

Meanwhile, China's reopening rebound is gathering pace. Despite the lack of hard data at the start of the year, surveys and high frequency proxies point to a sizeable recovery, and our activity index is strengthening. This is consistent with a V-shaped growth surge driven by consumption and services. We are a bit more cautious on the extent of any pro-growth policy pivots above and beyond reopening itself. And we expect the spillovers of Chinese growth into emerging markets (EMs) to be weaker than usual given the less import-intensive nature of the rebound. But we are above consensus on Chinese GDP growth in 2023 and think it will comfortably exceed the 5% target policymakers have set.

The implication of a recession still being "necessary", but the "sufficient" conditions not yet being in place, is that central banks have more work to do. Our terminal interest rate forecasts are rising, and we now expect the fed funds rate target range to reach a peak of 5.5-5.75% in July. We think the European Central Bank (ECB) will hike to at least 3.75%, and the Bank of England (BoE) to 4.5%.

In Japan's case, the near-term monetary policy outlook is more uncertain. There is substantial market pressure on the Bank of Japan's (BoJ) yield curve control (YCC) framework amid speculation about an end to the peg. Unlike in the US and Europe, we are not convinced about the fundamental macroeconomic need for tighter monetary policy. However, market distortions are so large that incoming Governor Ueda may use a narrow window of opportunity to change the policy.

Our baseline expectation is for a widening of the tolerance band on 10-year Japanese government bond yields to +/-75bps. A complete abandonment of YCC is unlikely but possible, especially if any tweaks are not seen as credible by financial markets. Either way, BoJ monetary policy is set to de facto tighten.

The EM rate cycle is closer to a turning point, given that hiking generally began sooner and core inflation is coming off the boil. But the credibility of policy pivots varies considerably. The most credible EM central banks include Brazil, Chile and Czechia. They are the most likely to follow the Fed in cutting before the end of the year. The likes of Mexico, the Philippines and India could face currency pressures if they ease too early, given the persistence of their underlying inflation. Finally, inflation pressures are still very strong in much of Eastern Europe, especially Poland and Hungary, where we expect more rate hikes.

The upshot of what we ultimately expect to be a cumulative 550 basis points of US fed funds rate tightening over 18 months is a recession. We've pushed back our forecast start date for this recession to Q3 2023. But we are still expecting a three quarter contraction that takes about 2% off US GDP. Adjusted for lower trend growth, this is a relatively mild US recession. But it is still a meaningful shock, with negative global spillovers that we don't think are fully discounted into financial markets.

The Eurozone, the UK, Japan, Brazil and Russia also fall into recessions this year or next in our forecasts. That said, we would not characterise the outlook as a global recession given the strength of China and divergence between the developed markets and parts of the EM complex. And by mid-2024 and into 2025 we would expect sequential global growth to be very strong coming out of earlier weakness.

Headline inflation is already falling sharply almost everywhere and should continue to decline over 2023 due to energy base effects. However, it is the recession and associated rise in unemployment that ultimately brings down underlying inflation to – and for a period of time, below – central bank targets.

But that also means that, by late-2023 and through 2024, central bank rate cuts are likely. Indeed, we have the out-of-consensus view that a Fed rate-cutting cycle back to the effective lower bound is possible, and would be in line with the historical response to recessions. Interest rates around the lower bound are also what a variety of policy rules suggest as appropriate given our growth and inflation projections. That said, we expect cutting cycles to be slightly less deep in the Eurozone, UK and many EMs.

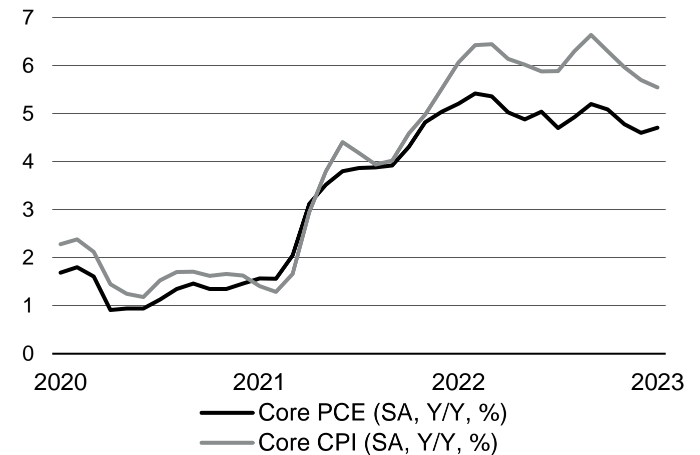
As always, all this is only one of several plausible scenarios. Our most likely alternative scenario is still "Fed walks the tightrope", which is a form of soft landing. A lot would have to go right for the Fed to pull this off, and it would buck historical precedent. Nevertheless, a period of below-trend but above-zero US growth, the labour market adjustment occurring through lower openings rather than higher unemployment, and a continuation of the recent moderation in wage growth, would make it possible.

Also on the upside, Chinese policy could be much more stimulative over the next few years than we are factoring in to our already-strong growth forecasts. This motivates our "China turns on the policy taps" scenario.

However, on the downside, we maintain our "sticky inflation" scenario in which monetary tightening triggers a recession but underlying inflation proves much more persistent for longer. The rate-cutting cycles that we are expecting in the baseline would be much shallower in this scenario.

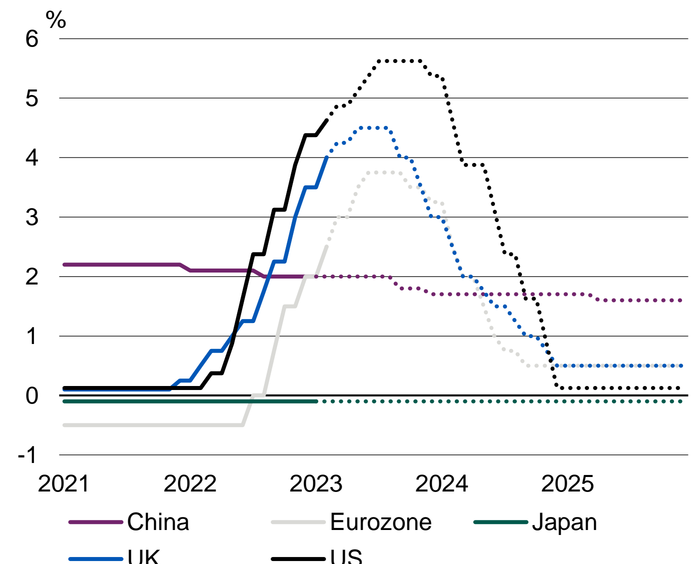
Finally, we've introduced a new "Fed has two bites of the cherry" scenario. This starts of as a form of so-called 'no-landing', in which, even with the additional rate hikes we forecast in the baseline, there is no moderation in growth and inflation. But a no-landing is unsustainable, and the Fed would ultimately be forced into significant additional rate hikes, perhaps to 7%. This would in turn push the economy into a later but deeper recession.

Figure 1: Activity and inflation resilience, for now



Source: Haver, abrdn (March 2023)

Figure 2: Rates to get higher, but then fall sharply



Source: Haver, abrdn (March 2023)

Global Forecast Summary

Of resilience and recessions

Figure 3: Growth and inflation forecasts in our baseline

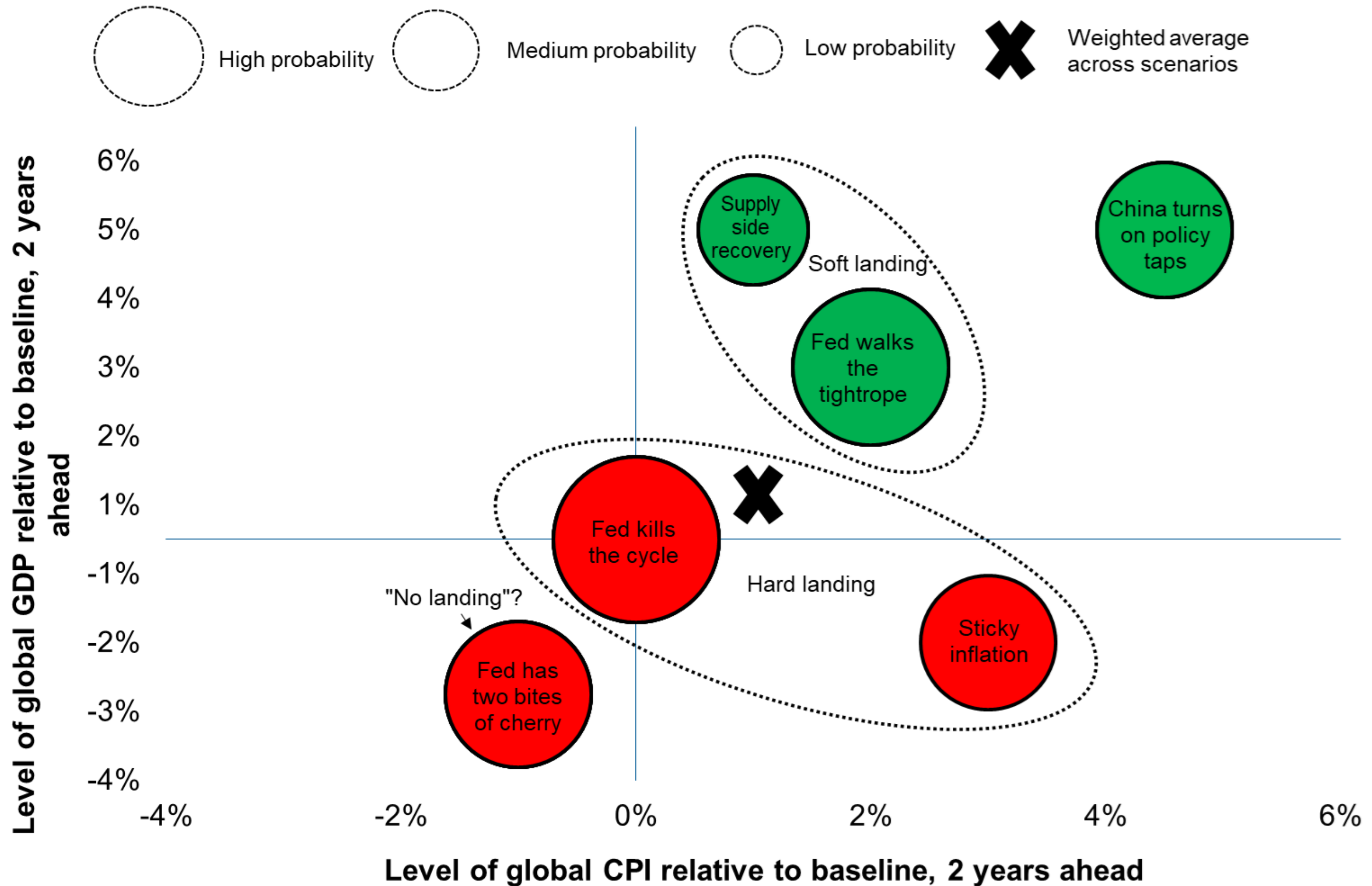
	GDP growth					CPI inflation				
	2021	2022	2023	2024	2025	2021	2022	2023	2024	2025
Global	**6.1**	**3.1**	**2.5**	**1.7**	**3.7**	**4.7**	**8.8**	**6.7**	**4.0**	**3.8**
DM	**5.4**	**2.7**	**0.8**	**-0.1**	**2.4**	**3.1**	**7.3**	**4.8**	**1.6**	**1.6**
US	5.9	2.1	1.1	-0.7	3.1	4.7	8.0	4.2	1.3	1.6
UK	7.6	4.0	-0.7	0.5	1.9	2.6	9.0	6.2	2.2	1.8
Japan	2.2	1.0	0.4	-1.1	0.6	-0.1	2.5	1.8	0.0	0.6
Eurozone	5.3	3.5	0.5	0.5	2.0	2.6	8.4	6.4	2.0	1.5
EM	**6.6**	**3.3**	**3.6**	**2.9**	**4.6**	**5.9**	**9.9**	**8.2**	**5.6**	**5.2**
Brazil	5.3	3.0	0.5	-0.8	2.1	8.3	9.3	4.4	4.8	5.2
Russia	4.7	-2.5	-1.2	-0.6	1.2	6.7	13.8	5.5	3.6	4.7
India	9.0	6.8	4.3	3.7	6.0	5.1	6.7	5.3	3.6	5.9
China	7.8	2.0	5.7	4.2	5.0	1.0	2.0	2.5	2.9	2.8

Source: abrdn (March 2023)

Scenario Overview

The baseline scenario contains a US recession. Across the full distribution, a hard landing is more likely than a soft landing. However, probability weighted outcomes are skewed to higher global growth and inflation than in the baseline.

Figure 4: Global activity and price level in alternative scenarios, relative to baseline, 2 years ahead



Source: abrdn (March 2023)

United States

Good news is bad news

The good news is that data in early 2023 suggest the US economy is not sliding towards an imminent recession. The bad news is that we think this will be a temporary reprieve. Strong short-term activity is prolonging the overheating of the US economy and by extension keeping inflation high. The upshot is the Federal Reserve (Fed) will have to tighten even more to tackle this inflation overshoot. We think this adjustment will trigger a recession starting in Q3 this year.

US activity data rebounded in early 2023, following signs of slowing late last year. This volatility in part reflects seasonal distortions as well as particularly mild weather However, even accounting for this, it seems pretty clear that the economy is not standing on the precipice of recession. This assessment is made especially clear by the still very strong labour market. (For more detail, see our Insight note *This labour market won't quit*, here.)

Inflation has also been stronger than expected, while revisions to past data suggest there has been little progress in tackling underlying price pressures. Indeed, when we strip out falling energy prices and global goods disinflation, services inflation is still far too hot. This remains the case even after removing shelter prices, which are likely to moderate around the end of the year following a turn in the housing market (see Figure 5).

Elevated labour costs are part of the story. While wage growth has cooled, it is still running well above rates that are consistent with the Fed's inflation target. In any case, we are sceptical that wage growth will continue to slow while the labour market remains exceptionally tight.

Despite the pick-up in short-term growth, there are signs that underlying activity is starting to creak. This is clearest in the property sector, with both house prices and housing market activity falling, while mortgage rates have resumed their move higher. The goods sector is also under strain, with production and orders contracting. Consumer spending has slowed somewhat, and the savings buffers that have underpinned household consumption are much lower than coming out of the pandemic. That said, it will likely take a weakening in the labour market to really hurt consumption growth.

The Fed has raised interest rates by 450bps over the past 12 months, and we continue to expect a significant drag to the economy resulting from this hiking cycle. (For more detail, see our Insight note *Can the US avoid recession?*, here.) Admittedly, market based financial conditions have eased somewhat and don't currently look like a big weight on growth. But the ongoing tightening in bank lending standards supports the view of a lagged effect from earlier tightening through the credit channel.

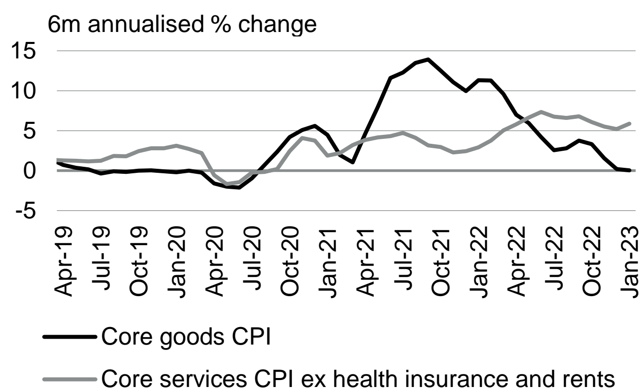
However, further tightening looks necessary to slow activity and bring inflation to heel. We continue to expect a 25bps hike at the Fed's March meeting, but we now think this is likely to be followed by similar moves in May, June and July. This would push the fed funds rate target range to a peak of 5.5-5.75%. We then envisage the hiking cycle ending in Q3 amid the recession.

The risks are tilted towards an even more aggressive Fed, especially if growth and inflation continue to hold up in the face of tighter policy. This could indicate that the level of interest rates needed to slow activity has increased, perhaps due to strong private sector balance sheets. Alternatively, the markets' benign pricing of the outlook may have prevented financial conditions from tightening sufficiently, requiring a more aggressive Fed.

The recession that we forecast in our base case lasts three quarters, takes 2% off GDP and pushes the unemployment rate up from below 4% to 6%. This shock would lead to a rapid slowdown in inflation, as labour costs moderate, margins are cut, core goods prices continue to correct and energy prices fall. We expect the core PCE inflation rate to bottom in late 2024 at 1%, before bouncing back to 2% by of the end of 2025.

In turn, we think that the Fed would ease policy during the recession itself. Our analysis of plausible cutting cycles points to a possible return to the lower bound by the end of 2024. While seemingly a long way off, a big cutting cycle is the logical consequence of a big negative growth and inflation shock.

Figure 5: Core services inflation yet to slow



Source: Haver, abrdn (March 2023)

Figure 6: US forecasts

	2021	2022	2023	2024	2025
GDP (%)	5.9	2.1	1.1	-0.7	3.1
CPI (%)	4.7	8.0	4.2	1.3	1.6
Fed Funds (%)	0.13	4.38	5.38	0.13	0.13

Source: Haver, abrdn (March 2023)

China

Fastest growing major economy in 2023

China's economic recovery appears to be occurring almost as fast as its abrupt policy pivot away from zero-Covid. Having only lifted restrictions in December, it seems the economy also began rebounding in the same month as households made the most of their newfound freedoms. High frequency data suggest that China's rebound continued in Q1. Our forecasts envisage China as the fastest growing major economy this year.

We have now entered the seasonal data black hole, so will need to wait until mid-March before receiving any more hard data to gauge the pace of activity. But survey data and high frequency proxies point to a sizeable rebound. The Baidu migration index suggests that travel exceeds its pre-pandemic norms, for example.

This is consistent with a fast, 'V'-shaped, growth surge driven by a recovery in consumption and services activity. We think this will more than offset drags from net trade, the real estate sector, and fiscal retrenchment. Our 2023 GDP forecast is an above-consensus 5.7%.

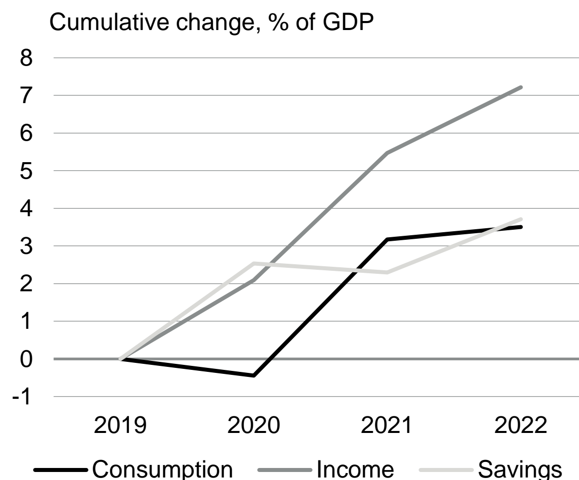
Moreover, the spending of excess savings built up during lockdowns means that the risks are to the upside (see Figure 7). But one does not need to appeal to households tapping excess savings to get to our already strong forecast. Simply returning the savings rate to prior norms should be enough to push nominal consumption growth to 14%. (For more detail, see our Insight note *Rebounding consumption growth to drive China's GDP in 2023*, here.)

Policy rhetoric has also turned 'pro-growth'. But we think it is unlikely that the authorities will really increase stimulus when the economy is rebounding. Local governments have large fiscal holes to fill, while the authorities will be wary of losing progress made on de-risking the economy. That said, we also do not expect support to be withdrawn and policy to be tightened too quickly.

The impulse from China's reopening to the rest of the world is unlikely to be as large as the pick-up in growth would normally imply. The changing composition of growth towards less import-intensive activity implies spillovers will be relatively modest (see Figure 8).

But China is well placed to withstand the US recession, even if it cannot fully offset the shock. Services inflation is likely to rise as China reopens, but inflation should not be a major constraint on policymakers. Chinese policy could then offer some modest shelter from the storm for its closest trading partners as stimulus reverts to more import-intensive activities, such as infrastructure spending.

Figure 7: Pandemic savings being spent are an upside risk to consumption growth



Source: Haver, abrdn (March 2023)

Figure 8: However, China's rebound will not help its trading partners as much this time around

Source: OECD, Haver, abrdn (March 2023)

Figure 9: China forecasts

	2021	2022	2023	2024	2025
aRI GDP (%)	7.8	2.0	5.7	4.2	5.0
Official GDP (%)	8.9	3.1	6.0	4.4	5.3
CPI (%)	1.0	2.0	2.5	2.9	2.8

Source: Haver, abrdn (March 2023)

Eurozone

A good start to the year, but the full impact of monetary tightening has yet to be felt

Our forecasts envisage the Eurozone economy contracting later this year. A deep winter recession has been avoided and the very near-term growth outlook has improved. But core inflation is still very strong, meaning the European Central Bank (ECB) will need to hike interest rates further. As the full effects of tighter monetary policy and spillovers from recession in the US are felt, we expect the economy to enter a mild recession in the second half of 2023.

The Eurozone economy has proved relatively resilient over the past few quarters. GDP growth in Q4 2022 was 0.1% q/q, which was better than expectations. That said, some of this outperformance was driven by very strong Irish GDP, which has more to do with multinationals' accounting practices than domestic economic conditions. Underlying Eurozone growth was probably mildly negative, but that's still much better than the deep recession that was at one point feared.

Activity growth appears to have improved over Q1 2023. The Eurozone composite PMI rose to 52.3 in February. On past form, that is consistent with decent GDP growth (see Figure 10). Consumer and investor confidence has also risen at the start of the year, but remains subdued relative to longer-term norms. This improvement reflects the avoidance of winter energy rationing and the fall in European gas prices below the levels they were at the start of Russia's invasion of Ukraine.

The corollary of better activity data has been still-elevated inflation prints. Eurozone headline inflation stood at 8.5% in February. While this is still extremely high, it is down from the peak above 10% late last year, and headline inflation should continue to fall as energy base effects moderate.

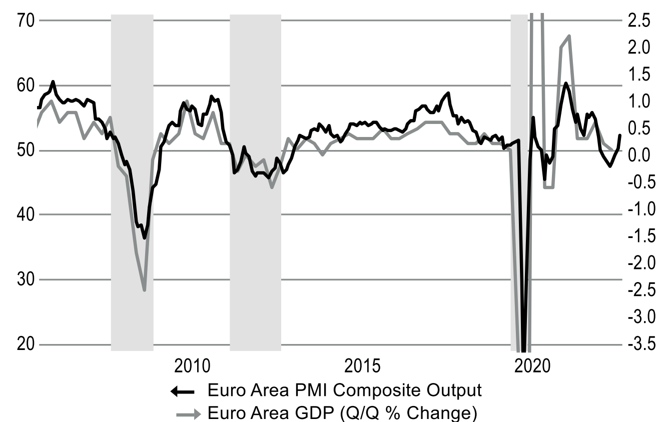
However, core inflation is still rising, and hit 5.6% in February, an all-time high. Admittedly, global disinflationary forces in the goods market may soon take Eurozone core good prices back down. But the strength of core services inflation generated by the tightness of the labour market is striking, and unlikely to return to target-consistent rates without an eventual rise in unemployment.

Indeed, the combination of better activity data and still well-above-target inflation means that we have revised higher our expectations for the ECB policy rate. The ECB hiked to 2.5% in February, and strongly signalled an additional 50bps hike coming in March. We are also now expecting a 50bps hike in May and a final 25bps rise in June. This would take the terminal deposit rate to 3.75%, a 15-year high. Moreover, the risks to this forecast lie to the upside, with a terminal rate of 4% or higher plausible.

In turn, we expect the cumulative 425bps of monetary policy tightening the ECB would have delivered over the course of just one year to exert a significant drag on the economy later this year. This tightening is even larger reviewed through the lens of the shadow rate. Moreover, layered on top of tighter domestic monetary policy will be the spillovers of a recession in the US, the Eurozone's largest trading partner. We are forecasting a relatively mild 1.5% peak-to-trough contraction during H2 2023. Sequential growth should then rebound strongly in 2024, although this doesn't show up in the year-average growth rates until 2025.

The onset of recession should ultimately take inflation and indeed policy rates down again. Headline inflation falls back below the 2% target in mid-2024 in our forecasts. We also think that the ECB could be cutting rates through 2024, an expectation that is not in the current market pricing.

Figure 10: Growth improving at the start of 2023, but expected to weaken later in the year



Source: Haver, abrdn (March 2023)

Figure 11: Eurozone forecasts

	2021	2022	2023	2024	2025
GDP (%)	5.3	3.5	0.5	0.5	2.0
CPI (%)	2.6	8.4	6.4	2.0	1.5
Depo Rate (%)	-0.50	2.00	3.25	0.50	0.50

Source: abrdn (March 2023)

Japan

Losing control of yield curve control?

The Japanese economy held up well in Q4 2022, but is likely to struggle through 2023. Tightening financial conditions from the uncertainty surrounding the future of yield curve control (YCC) will weigh on investment decisions, while a sluggish external environment will impact H2 growth.

Japan's preliminary Q4 GDP data showed the economy was grew 0.2% q/q at the end of last year. The breakdown shows that consumption and service exports were strong following the return of foreign tourists. Meanwhile business investment was weak. Overall this leaves GDP 0.9% below its 2019 pre-pandemic level, which is weaker than the US and Europe's post-Covid recoveries.

The global outlook will weigh heavily on Japanese growth in 2023 and 2024. Indeed, we think that spillovers from a US recession will drag Japan into recession too.

Savings buffers can support consumption for a while. However Japanese consumers may spend cautiously, especially as concerns over the US recession, energy supply, and the longer term demographic drag all weigh on consumer sentiment.

Meanwhile, Kazuo Ueda has been announced as the new head of the Bank of Japan (BoJ). The 71-year-old academic was a surprise announcement, but Ueda is considered to be one of Japan's foremost experts on monetary policy, and was a BoJ board member between 1998 and 2005. He had voted against ending zero interest rate policy in August 2000.

Given the uncertainty about the future of YCC, investors have been scrutinising his academic and policy record and his recent communication. His comments at the parliamentary confirmation hearings for the BoJ governor role were very carefully worded. He did however acknowledge that some policy shifts were needed, and seemed to signal a bias toward a surprise policy shift ahead.

'Overall, we believe the fate of YCC is finely balanced, but we think there is a 60% chance that a change will be made to it of one form or another once Ueda takes over as governor. We think the most likely change is widening the tolerance band for the 10-year JGB trading range to +/- 75bps. Targeting the yield level of shorter maturity bonds - perhaps the 5-year sector – is also a possibility, as the BoJ may find it has more control over shorter maturity bonds. (For more detail, see our Insight note *BoJ: battling inflation or investors?*, here.)

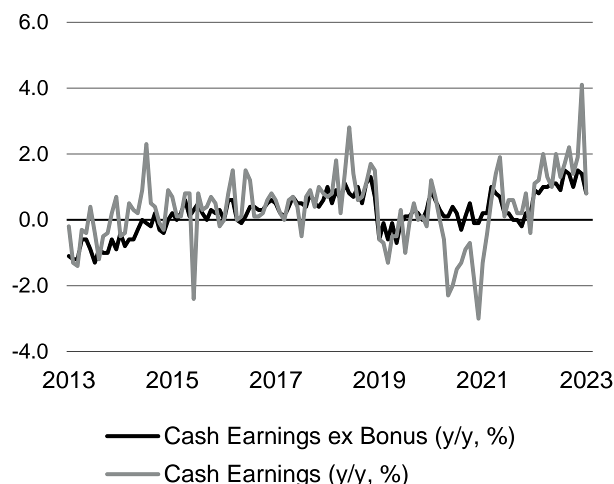
However, the window of opportunity to make any changes to YCC is very narrow. The BoJ's March meeting is close to the end of the fiscal year, making it a bad time for any market turbulence stemming from a policy change. But by July the macro backdrop will have shifted markedly and may no longer justify a de facto tightening in policy.

Inflation is set to decelerate quite sharply as energy base effects take hold and the global economy weakens from Q3. Moreover, the results of the Spring "Shunto" wage negotiation round will be in by then and are likely to indicate limited underlying inflation pressure.

The BoJ thinks that wage growth in excess of 3% is necessary to achieve the inflation target of 2%. However, the overall wage hike for spring 2022 was 2.2%, well below target-consistent levels (see Figure 12). Estimates suggest that for the economy as a whole to register wage growth of around 3%, the Shunto base pay increase would need to exceed 3.2% and the scheduled wage hike exceed 4.8%. This would be the largest increase since the early 1990s. We think wage growth is likely to come in well below this level.

As such, any policy changes are likely to come between March and July. The BoJ may hope that widening the 10-year target range helps to restore market functioning at a new, credible target. However, the risk is that any new target once again falls under speculative attack, and the BoJ finds itself adopting a de facto crawling yield peg.

Figure 12: Core earnings growth remains within the recent range



Source: Haver, abrdn (March 2023)

Figure 13: Japan forecasts

	2021	2022	2023	2024	2025
GDP (%)	2.2	1.0	0.4	-1.1	0.6
CPI (%)	-0.2	2.5	1.8	0.0	0.6
Key rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1

Source: Haver, abrdn (March 2023)

United Kingdom

Recession delayed but not averted

Despite narrowly avoiding a technical recession in the second half of 2022, the UK economy is set to endure recession-like conditions for much of 2023. The combination of a sustained decline in real incomes, tighter financial conditions, and the spillovers from a US downturn will be significant headwinds to growth.

Headline UK inflation has begun its long march downwards, with January CPI coming in at 10.1% after a peak of over 11% in October. Powerful base effects will continue to pull inflation lower through 2023.

Despite the fall in wholesale energy prices, the Ofgem price cap is in principle set to rise again in April. But it is likely that the government will extend its Energy Price Guarantee to effectively cancel this increase for many households, in part because the scheme has become much less expensive for the government to deliver. This would put further downward pressure on inflation.

Also promising is the fact that January core inflation fell to 5.8% from 6.3%. Services inflation, which is most closely linked to domestic demand, declined to 6% from 6.8%. However, it is plausible that weaker headline inflation through lower energy prices ends up boosting core inflation pressure through strong consumer demand.

Meanwhile, there are some very early signs that the labour market is starting to cool. Vacancies continue to decline, pointing to slowing labour demand and possibly a slight improvement in the job-matching function of the economy (see Figure 14) and labour force participation has started to recover, picking up slightly in early 2023.

However, with the unemployment rate at 3.7%, the labour market remains extremely tight. Indeed, the participation rate is still well below the pre-pandemic level.

Reflecting this tightness, private sector wage growth is running above 7% y/y, well in excess of a productivity-adjusted inflation target consistent rate. Moreover, there is little sign in wage surveys that any meaningful slowdown is in the pipeline.

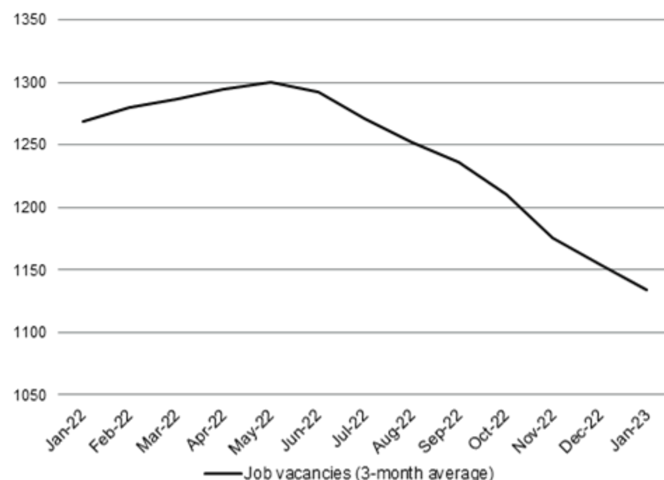
Labour force participation is unsurprisingly getting significant attention from policymakers. The upcoming Spring Budget is likely to contain measures to boost participation, especially among early retirees and parents. Anything that helps tackle the UK's huge childcare costs and boost the supply side more generally is welcome. But it is likely these measures will be marginal at best, and it is very difficult to see how they will help resolve the labour supply issues facing the economy *right now*.

As such, the burden of economic rebalancing will need to be shouldered by weaker labour demand. This means that further monetary tightening will be required even as the economy enters recession. We see rates peaking at 4.5% in May this year, below recent market pricing which points to a peak rate of around 5%. We now expect Bank Rate to remain elevated for longer than originally anticipated to bear down on price pressures. However, we still see a rate cutting cycle beginning by the end of 2023, with a sustained fall through 2024.

The government is loath to ease fiscal policy this year, in part because of the underlying inflation pressures, but also because of the political imperative to save tax cuts for 2024 in order to boost the government's electoral prospects. This 2024 fiscal easing should boost 2025 growth, helping the economy deliver a sustained recovery.

The UK-EU deal on the operation of the Northern Ireland protocol – the Windsor Framework – does little to move the needle on the short-term growth outlook, but does remove the tail-risk of a damaging trade-war. The bigger prize the deal represents is the possibility of a more constructive relationship between the UK and EU, which could begin a process of managed convergence to many EU standards.

Figure 14: Job vacancies continue to decline



Source: Haver (March 2023)

Figure 15: UK forecasts

	2021	2022	2023	2024	2025
GDP (%)	7.6	4.0	-0.8	0.5	1.9
CPI (%)	2.6	9.0	6.2	2.2	1.9
Bank rate (%)	0.25	3.75	3.00	0.5	0.50

Source: Haver, abrdn (March 2023)

India

The Reserve Bank of India will lag behind the US Federal Reserve as imbalances persist

The Reserve Bank of India (RBI) will have to hike rates further to tackle the country's underlying inflationary pressures. Only the US downturn unfolding will allow an easing cycle to begin. However, we think that market pressure in the initial phase of the US recession will cause the RBI to wait until 2024 to cut.

Indian domestic economic activity appears resilient. Strong credit growth has helped ease some of the impact of higher inflation on households, while wage growth ended 2022 on a high note.

Trouble at Adani Group– a major conglomerate – is a reminder of the concentration of economic power within an increasingly small group of 'champion' firms. The financial sector is seemingly well placed to deal with any negative fallout, implying that Adani Group is unlikely to prove a major drag on growth. However, it highlights the growing risks to India's corporates, and in turn broader economic growth, from tightening financial conditions.

While Adani Group's long-term investment plans (worth almost 3% of GDP) could be dampened, public investment is still set to get a significant boost (3.5% of GDP) from the upcoming budget. Measures include attempts to boost India's attractiveness as a hub for manufacturing and foreign investment, which could mean India indirectly benefits from US-China tensions.

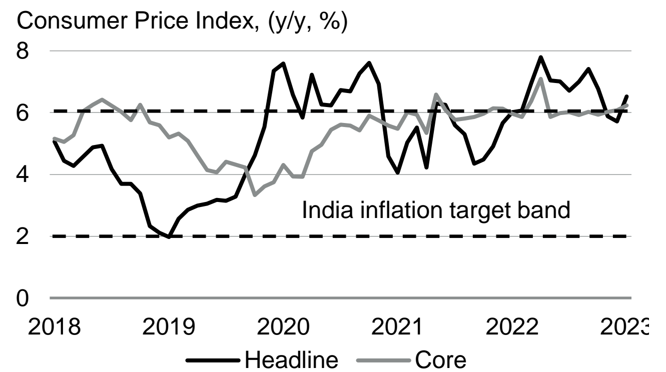
Though positive for growth, the resilience of domestic activity creates further challenges for the RBI. Core inflation has proved sticky, running above 6% y/y (see Figure 16). And headline inflation will also take longer to abate than we previously thought. A sharp rise in cereal prices will slow the disinflation process in the near term, and we expect that China's reopening will push up global oil prices as domestic and international travel resumes. As such, we expect that the RBI will increase its key policy rate to 6.75% in April.

Energy price base effects, the lagged effect of the RBI's tightening, and a worsening of external conditions as the US recession unfolds should bring headline inflation back within its target range in H2 2023. This will raise the real policy rate to above the RBI's neutral estimate of 0.8% to 1.0%, giving the RBI scope to pause.

But amid the early phase of the US downturn - in which we expect market risk aversion to rise for all EMs - we believe the RBI's ability to deliver monetary easing will be limited.

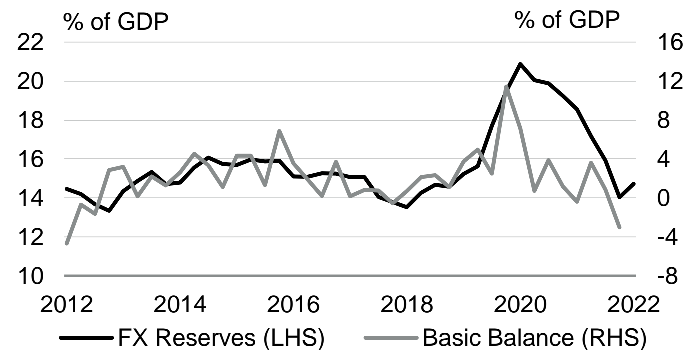
The RBI may engage in some bond market interventions under the guise of financial stability to keep government borrowing costs from surging. And it will have some scope to use FX reserves to offset capital outflows. But reserves are not as ample as they once were, and the RBI will be conscious that India's basic balance has deteriorated (see Figure 17). As such, we think the RBI will hold-off cutting until early 2024, but then ease rates over the course of the year down to 4.5%.

Figure 16: Core inflation still a problem



Source: abrdn, Haver (March 2023)

Figure 17: Curbing imbalances



Source: abrdn, Haver (March 2023)

Figure 18: India forecasts

	2021	2022	2023	2024	2025
GDP (%)	8.8	6.8	4.5	3.7	6.0
CPI (%)	5.1	6.7	5.3	3.6	5.9
Policy rate (%)	4.0	6.3	6.8	4.5	5.8

Source: Haver, abrdn (March 2023)

Brazil

Brazil's central bank to move cautiously

Sticky core inflation, further hikes from the US Federal Reserve (Fed), and concerns around Lula's policy agenda will constrain the Brazilian Central Bank's (BCB) ability to ease in 2023. Indeed, we think it will take the US recession tipping Brazil's economy into contraction for the BCB to begin cutting. Elevated market pressures will make the easing cycle tentative at first, but Brazil is relatively well-placed compared to other emerging markets, having hiked aggressively early on in its recovery from the pandemic.

The 0.2% q/q contraction in Brazilian GDP in Q4 provided further evidence that the BCB's prior tightening has slowed the economy. We expect that growth will be tepid in H1 2023, despite some additional support for exports from China's reopening and President Lula's social welfare spending.

Headline inflation has at least come down substantially from its peak, and will likely fall further over the course of the year as base effects from energy prices feed through. This should allow the BCB to remain on hold, even as the Fed delivers further tightening.

However, the reinstatement of fuel taxes in March will slow the downtrend in headline inflation. More concerningly, the moderation in core inflation has stalled recently, leaving it above target-consistent rates. The January m/m print showed core inflation running at almost 6% annualised, with core services also running hot (see Figure 19).

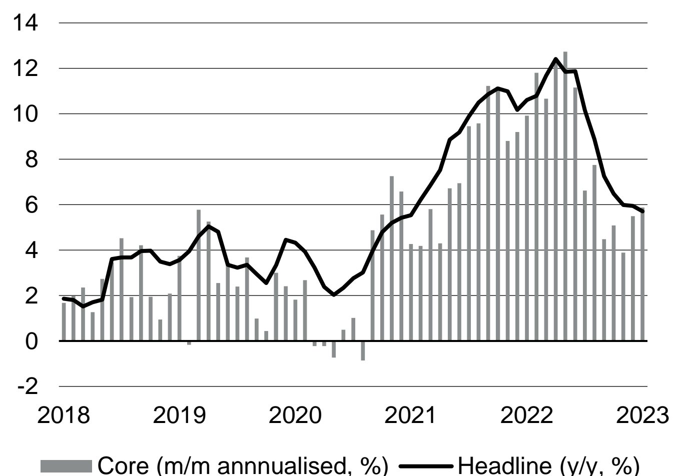
Further complicating the job for the central bank, market pressures on Brazilian assets are set to remain elevated due to concerns around Lula's commitment to BCB independence and fiscal prudence. On the former, Lula has repeatedly called for the BCB to ease its monetary stance and there are now concerns he could appoint more pro-growth members to the MPC over the coming months. There is also a possibility that the inflation target is raised from 3.25% to 4-4.5%, which could damage the BCB's credibility.

Concerns about Lula's fiscal stance and the risk of sliding towards populism are nothing new. However, Brazil's unique public debt structure acts as a pillar of institutional strength: the high share of inflation and policy rate-linked debt is a deterrent against running a loose fiscal policy for a prolonged period (see Figure 20). (For more detail, see our Insight note *Brazilian fiscal: here's what to expect*, here.)

As the US recession takes hold later this year, bringing global energy prices lower and dragging the Brazilian economy down, this should provide the catalyst for the BCB to begin tentatively cutting.

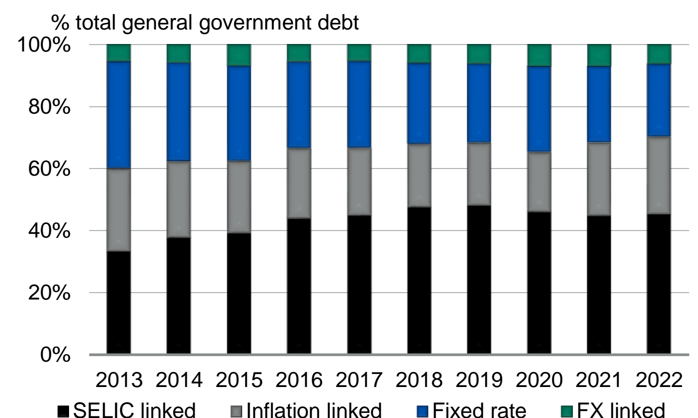
In the initial phases of the US recession, market volatility will likely climb, putting pressure on the currency and the country's financial conditions. Consequently, the BCB will likely hold-off cutting its policy rate more meaningfully until the Fed has delivered significant easing. The BCB is at least relatively well placed among EM central banks, having hiked aggressively early on. So it is likely to be one of the first movers. As the wider-EM cutting cycle begins in early 2024, the BCB could cut to 6.0% by Q2.

Figure 19: Core inflation proving stubborn



Source: Haver, abrdn (March 2023)

Figure 20: Debt structure leans against fiscal splurge



Source: Haver (March 2023)

Figure 21: Brazil forecasts

	2021	2022	2023	2024	2025
Brazil GDP (%)	5.3	3.0	0.5	-0.8	2.1
CPI (%)	8.3	9.3	4.4	4.8	5.2
Policy rate (%)	9.25	13.75	12.75	6.25	7.00

Source: Haver, abrdn (March 2023)

Emerging Markets Overview

In the waiting room

EM central banks will have to wait longer to loosen policy as near term resilience in the US forces the Federal Reserve (Fed) to hike rates further. A more resilient external backdrop will put pressure on those EM central banks which pivoted early. Ultimately, policy-induced DM recessions will cause EM growth to slow sharply, but a systemic EM crisis is unlikely.

At face value, a better-than-expected global growth backdrop as the Eurozone avoids a winter gas crunch, the US economy remains resilient, and China recovers at pace, should be positive for EMs.

However, the services-led rebound in China is likely to have a low import-intensity, muting the typical link from China to its trading partners. Moreover, the external environment remains tough: global trade continues to deteriorate as the composition of global demand moves away from goods, and new exports orders remain close to levels associated with manufacturing recessions (see Figure 22).

Most importantly, stronger growth delays the resolution of imbalances across the major economies. Markets have already re-priced a somewhat higher path for the Fed. Alongside a more aggressive hiking cycle from the European Central Bank (ECB), this implies that global financial conditions will limit the ability of EM central banks to ease.

The good news for EM central banks is that base effects from energy should help to bring down headline inflation. Supply chains also continue to normalise, while core inflation has shown signs of easing since the summer (see Figure 23). Inflation downside surprises have also increased, particularly in APAC, allowing many EM central banks to signal that the rate hiking cycle is at (or is close to) an end.

The credibility of policy pivots remains the key issue. Several Eastern European central banks, in particular those in Poland and Hungary, can no longer rely on a deep Eurozone recession to help unwind their imbalances. With core inflation running at around 10% and 25% annualised in the two countries respectively, their pivots look increasingly misguided.

The likes of Mexico, the Philippines, and India could still face currency pressures if they pause too early, given the persistence of their underlying inflation.

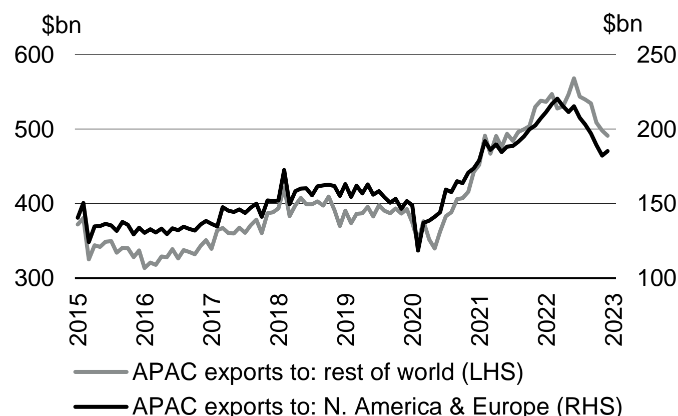
The most credible central banks, such as those of Brazil, Chile and Czechia, will still face a longer wait to begin meaningfully cutting their policy rates. But they are the most likely to follow the Fed in cutting before year-end.

The onset of the US recession will eventually usher in a pan-EM easing cycle, but it will also cause a deterioration in EM crisis vulnerabilities and put many EMs under considerable market pressure in the early phases.

Many frontiers are either already in the middle of crises or teetering on the brink, including Sri Lanka, Zambia, Pakistan, El Salvador, Ghana, Egypt, Tunisia and Lebanon. The drop in global risk appetite and capital flows will only further complicate debt restructuring.

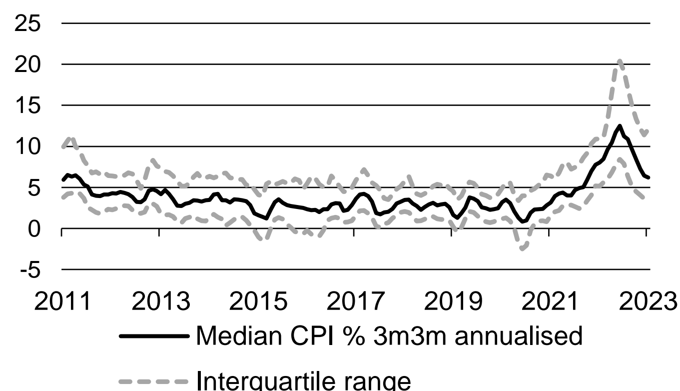
Those with large current account deficits such as Colombia and the Philippines may face currency pressures as the Fed waits for core inflation to abate during the initial stages of recession. The "original sin" vulnerabilities in frontiers – low FX reserves, large short-term FX debts and fiscal indiscipline – are generally absent, or less acute, in more mainstream EMs, suggesting pressures will fade, allowing policy easing to begin more conclusively in 2024.

Figure 22: External demand has weakened



Source: Haver, abrdn (March 2023)

Figure 23: Core inflation has come off the boil, but remains too hot for comfort in most EMs



Source: Haver, abrdn (March 2023)

Quantitative Indicators

Strength in activity may prove short-lived with recession risks still high

Over the past three months, our indicators have signalled two key changes: first, activity is holding up better than expected in the near term; second, financial conditions have loosened. The combination of these two things leaves our nowcasts for Q1 above consensus, our US financial stress index around neutral, and our models' implied recession risks a touch lower.

Across a number of regions, activity has held up better than expected in early 2023. In Europe, the big fall in natural gas prices below pre-Ukraine invasion levels has led to a much less sharp slowdown in growth than may have otherwise occurred. In the US, the slowdown in activity at the end of 2022 seems to have reversed, with near term activity data stronger than expected. And in China, the economy has rebounded from zero-Covid extremely rapidly. The upshot of all this is that our nowcasts for the current quarter suggest upside risks to growth compared to consensus (see Figure 24).

However, beyond the very near-term, our US recession probability modelling framework continues to signal high risks of a recession. The probability of recession is around 60-70% within six to 12 months, while the 24-month model estimates the recession probability to be as high as 96% (see Figure 25).

In particular, debt servicing costs, consumer confidence, residential investment and the manufacturing PMI are still signalling high risks of a recession.

Additionally, the resilience in demand now actually implies greater excess demand relative to trend, which signals a *higher* risk of recession over a longer horizon.

Similarly, the continued strength of the labour market implies a similar imbalance. This is captured in our recession framework by the unemployment gap, which is well into levels consistent with an eventual recession. (For more detail, see our Insight note *Can the US avoid recession?*, here.)

The other key area of change is the loosening in financial conditions since the end of 2022. Indeed, our US financial stress index has recently dipped below zero, consistent with below-average levels of stress. This is the first time financial stress has fallen to these levels since the onset of the pandemic. The loosening is being driven by stronger equity markets, lower volatility, and an improvement in macro factors, with the 30-year fixed mortgage rate moderating at the margin. Fed communication has so far done relatively little to push back on this loosening in financial stress. (For more detail, see our Insight note *Powell's half-hearted hawkishness drives market rally*, here.)

However, we would caution against an over-interpretation of the macroeconomic implications of this loosening into medium-term recession risks. The tightening in financial conditions in 2022 likely hasn't been fully felt in the US economy, and there is also an increased likelihood of a higher terminal rate from the Federal Reserve (Fed) which would increase the risk of a resurgence in financial stress through H1 2023.

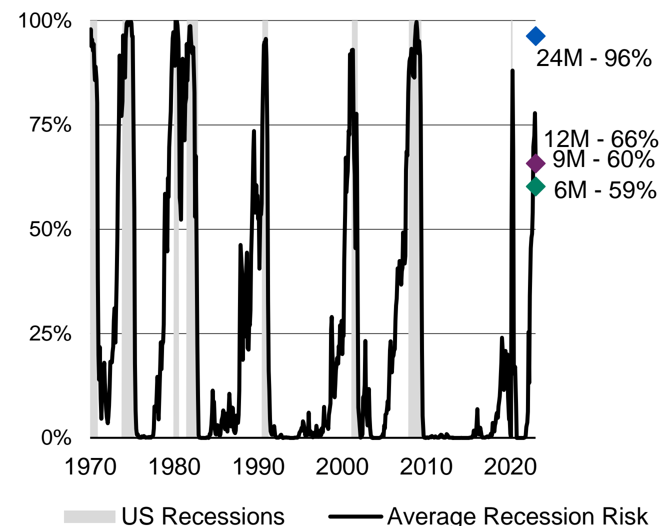
We will be updating our suite of indicators weekly as data for the quarter is released on our macro tools page, here.

Figure 24: Nowcasts suggest upside risks to activity in the near term

	Q1-23
US	1.1 (0.5)
UK	-1.8 (-1.2)
Eurozone	0.5 (-1.2)
Japan	1.2 (1.5)
EM*	3.3 (2.6)
*measured as y/y, all others q/q ann.	

Source: FRED, Haver, abrdn (March 2023)

Figure 25: Recession risks lower at the margin but still very elevated



Source: Bloomberg, Haver, abrdn (March 2023)

Inflation

China reopening versus US recession

Many of the pandemic and war-related factors pushing inflation higher over the last two years are unwinding rapidly. However, the reopening of China has fuelled speculation of a further rally in commodity prices that could lead to another surge in inflation. We think that the impact of a US recession later in the year will offset this China reopening effect, with commodity prices falling over the year.

The composition of China's growth will be a decisive factor in the outlook for commodities. Because the services sector is expected to be the primary beneficiary of China's reopening, the impact on commodity prices will be more limited than during previous Chinese growth surges.

However, two years of intermittent lockdowns and a strict zero-Covid policy mean that there is pent-up demand for travel. This will likely support diesel and gasoline in the first instance as domestic travel recovers.

Looking beyond this reopening effect, it is important to note that much of the end use for oil is driven by industrial demand. And the US recession we expect this year will weigh heavily on this source of demand, as it has done previously. As such, we expect energy prices will be dragged lower this year (see Figure 26).

Scarcity of intermediate inputs, such as semi-conductors, disrupted a broad range of products through 2021 and 2022. Combined with the strength of post-pandemic goods demand, this pushed core goods prices to multi-decade highs. But inflationary forces from these channels are moderating swiftly as consumer demand rotates towards services.

Freight costs and port congestion have stabilised. The backlog of goods and delivery times have improved. The gap between work in progress and finished goods has closed and some sectors even signal a supply glut. Indeed, the Federal Reserve's global supply chain pressure index signals a very sharp decline in producer prices and CPI goods prices over the coming months.

However, services inflation is proving much more persistent in some countries, and will likely take longer to stabilise. And while there are signs of improvement across wage measures and turnover data, labour markets in US and UK remain excessively tight.

The evolution of service sector inflation holds the key to how quickly underlying inflationary pressures will dissipate over the next 1-2 years. Our baseline is that recessions will put substantial downward pressure on core services inflation. Inflation expectations will play a crucial role.

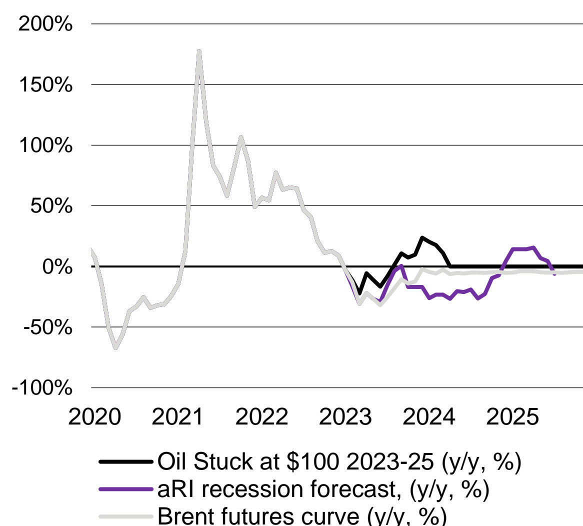
Consumer, business, and market inflation expectations are higher now than they were before the pandemic, but remain well-anchored at longer tenors. That said, with persistently high inflation, there is a risk that households and firms acclimatise to the higher inflation environment and begin to change price and wage setting behaviour accordingly.

If firms anticipate continued price rises, but can only change their prices infrequently, then they may set their own prices in a way that overshoots the current price level. This mechanism gives inflation an upwards momentum which may make it stickier even in a recession. (For more detail, see our Insight note *Inflation persistence and expectations*, here.)

Central banks may hope that the same Phillips curve steepness that meant inflation rose rapidly holds as the economy cools. In this case, there will be a low "sacrifice ratio", which means relatively fewer jobs need to be lost to tame inflation. However, if price and wage setting behaviour has become anchored on the recent high inflation experience, then the economy may be on a flatter point of the Phillips curve as unemployment rises. In this case, the sacrifice ratio would be higher. This means policy has to be much more restrictive to restore price stability.

We continue to think that most policymakers are willing to make this sacrifice. But political and societal pressures on central banks may rise during the recession. The cost of pausing or pivoting too early could take many years to repair. A deeper unwillingness to accept the economic costs of controlling inflation could become a gateway into our alternative, permanently higher, inflation paradigms.

Figure 26: Base effects from oil prices will contribute to disinflation despite the China boost



Source: abrdn (March 2023)

Monetary policy
Whatever does it take?

Two key judgements underlie our economic forecasts: first, that a US recession is necessary to restore price stability; and second, that the Federal Reserve (Fed) is willing to pay the price of this recession to deliver on its inflation target. Therefore, the crucial question for the outlook for monetary policy in the near term is how high interest rates need to go to slow the economy sufficiently to deliver this recession.

The impact of monetary policy on the economy famously occurs only after "long and variable" lags, reflecting the changing structure of the economy over time. And so, it is difficult to know how much of the impact of the very rapid tightening cycle in the US and elsewhere has already been passed through to the economy and how much is still to come.

The true stance of policy is judged by comparing interest rates against an ever-changing equilibrium rate. This complicates the assessment as the equilibrium rate is unobservable, making it very difficult to know how tight policy truly is in real time.

What's more, the transmission of monetary policy occurs not just through policy rates but also via its impact on broad financial conditions and financial stress. Our modelling suggests that the peak economic impact is felt after four quarters.

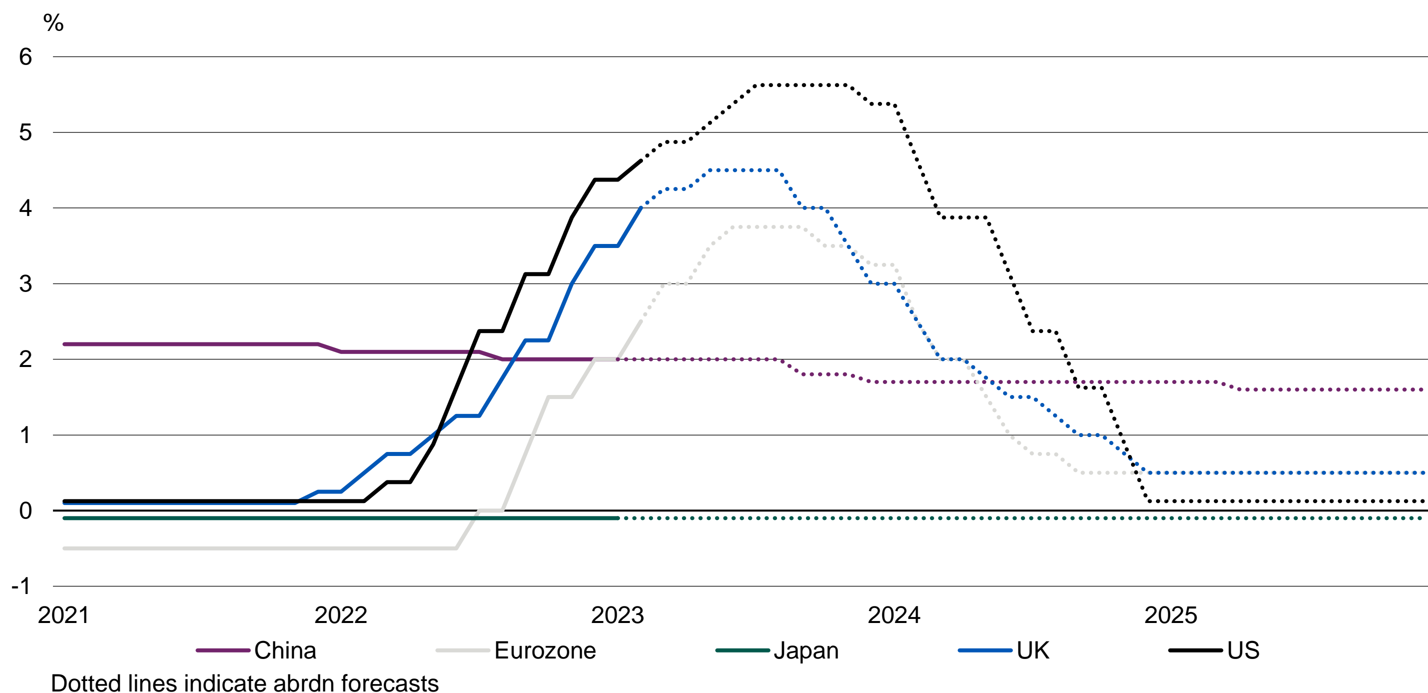
Given the movement of asset prices last year, this would imply that the peak impact of monetary tightening on the US economy will be around July this year.

This suggests that reasonably limited additional rate hikes are necessary to bring about the recession, with a significant further drag from past tightening still to be felt. That is why our base is for the US economy to fall into recession in Q3, and for the Fed to deliver four further 25bps hikes through to July, taking the fed funds target range to 5.5-5.75%.

However, US activity and inflation data at the start of 2023 have been strong and even accelerating. This could be a sign that the economy is already past the peak impact of policy tightening, perhaps because the transmission of monetary policy to the economy has sped up relative to the past.

This acceleration might be the result of several factors. First, central banks have become more transparent about the likely path of policy, allowing markets to discount much earlier into a hiking cycle the likely path of policy. This might bring forward to the present some of the impact of higher rates. Second, credit allocation in the economy has become increasingly driven by capital markets rather than banks, which would accelerate the impact of tighter financial conditions on economic decisions.

Figure 27: Policy rate forecasts



Source: Haver, abrdn (March 2023)

If the US economy has already weathered the peak impact of the recent monetary tightening, then not nearly enough rate hikes have been delivered to bring about the recession. This in turn would imply that the short-term equilibrium interest rate is higher than anticipated.

We have recognised the risk of this outcome in our analysis, introducing a new “Fed has two bites of the cherry scenario”. In this case, sustained US economic growth and inflation means that the Fed needs to return later this year to much more rapid monetary tightening, with rates peaking around 7%.

Once the economy falls into recession, we expect the Fed to pivot towards easing policy. To calibrate our forecasts for the size of this easing cycle, we consulted a variety of monetary policy rules. While these are far from an infallible guide to policy, and don’t take into account all the discretionary judgements policy-making involves, they are a good way of systematically gauging the trade-off policymakers face between activity and inflation.

In particular, we experimented across a variety of smoothed and unsmoothed policy rules, and also explored the evolution of policy should the short-term equilibrium interest turn out to be even higher than expected. A higher equilibrium rate has implications for the shape of the putative cutting cycle because it means that the policy rate becomes net stimulative at a higher level, which could mitigate the need to cut rates as much.

However, we find that even assuming a plausibly higher r*, the unsmoothed policy rules point to rates returning to the lower bound. Unsurprisingly, inertial policy rules involve a less dramatic cutting cycle, but still see the appropriate policy rate falling below the neutral rate. Overall we continue to see this easing cycle involving rates returning to zero in the baseline, but without the use of asset purchases which marked previous lower bound episodes, when the “appropriate” policy rate was in deeply negative territory.

We expect the Bank of Japan (BoJ) to tweak the parameters of its yield curve control (YCC) framework in the coming months, perhaps by widening the tolerance bound on 10-year JGB yields to +/- 75bps. Given market dynamics, it is likely yields will immediately settle at the top of this new range.

The dilemma facing the BoJ is that underlying domestically generated inflation pressures remain weak, and so the macro fundamentals do not justify a tightening in financial conditions. But bond market functioning has deteriorated so much that the current policy is very difficult to sustain.

If the tweak is successful, the BoJ will be able to re-anchor yields at a new, credible level, improving market functioning and reducing the need to intervene in the market. The central bank may be helped in this objective by falling global bond yields in the context of a US recession later this year.

However, the risk is that speculators will attack the new peg, with the BoJ losing rather than gaining credibility in tweaking the policy, in which case the economy will end up with tighter financial conditions without any commensurate improvement in market functioning. (For more detail, see our podcast *Losing control of yield curve control*, here.)

The European Central Bank (ECB) is unusual among the major central banks in continuing to provide quite explicit guidance about the near-term path of policy, including a further 50bps rate hike in March. We then expect another 50bps increase in May, followed by a final 25bps move in June, taking the deposit rate to 3.75%. This ongoing rapid tightening reflects the increasing risk that underlying inflation pressures are becoming more entrenched, especially now the Eurozone economy looks to have avoided a severe downturn over the winter.

In the UK, the Bank of England (BoE) has removed the tightening bias from its policy guidance and it is clear that at least some policymakers think the BoE has reached the end of its tightening cycle. Moreover, Bank communication has been focussed on resisting any potential read-across by investors from the near-term US policy outlook to the UK. We agree that recent market pricing that saw Bank Rate reaching a peak of around 5% is excessive. However, we also think the Bank may once again be underestimating the degree of underlying inflation pressure in the economy. That is why we expect a further 50bps of monetary tightening, taking bank rate to 4.5% by mid-year.

A higher terminal fed funds rate will keep the pressure on EMs in the near-term, limiting their ability to draw rate hiking cycles to a close.

We expect most EM central banks to hold-off monetary easing until the Fed moves, keeping monetary conditions very tight through the initial phases of the global recession and ultimately aggravating economic downturns. Bouts of volatility, increased risk premia and higher debt burdens could also limit the extent EMs can implement fiscal support. That said, outside frontier markets, major EMs are well placed to avoid crises.

China is not constrained in its ability to ease monetary and fiscal policy and should offer some shelter for its nearest trading partners when the global downturn unfolds. Policy may rotate back to infrastructure and investment, which has a higher import intensity. But its desire to hold the line on its de-risking campaign implies that this time round it will provide only a partial offset to the shock emanating from DMs.

Politics

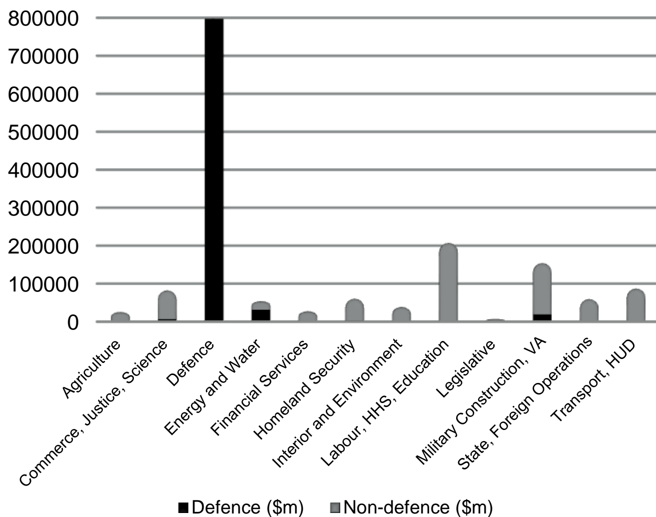
US debt ceiling risks are very high amid a dysfunctional Congress

A political crisis over raising the US debt ceiling is about to loom into view. Deep political divisions between Democrats and Republicans mean a last-minute agreement brought on by a negative market reaction is the most likely outcome. Faced with gridlock at home, Biden will focus on foreign policy, driving greater competition with China through the fusion of national security and trade.

The midterm elections in the US resulted in a split Congress, with the Republicans taking the House with a majority of only four. Both a split Congress and a narrow Republican lead in the House introduce additional risk factors around raising the debt ceiling. Republicans are clear that they will seek to exact spending concessions from Democrats in exchange for raising the ceiling and avoiding a US default. But Republicans will also need to reach agreement among themselves about exactly what these concessions are.

Current estimates for the X-date - the point at which the US will no longer be able to meet payments in full and on time – are between late June and early September. April tax revenues will be a key indicator of when it will fall. Higher revenues would enable the US Treasury to continue extraordinary measures for longer, pushing the X-date further into Q3. If any debt ceiling-induced market stress occurs around the July Fed meeting, it could potentially lead to delayed rate increases.

Figure 28: Republicans will focus on cuts to discretionary non-defence spending



Source: Consolidated Appropriations Act 2023

Our base case is a late resolution in which Congress suspends or raises the debt ceiling very close to the X-date. This makes a negative market response more likely.

Early voting activity in the House has demonstrated that Speaker McCarthy's leadership is relatively weak. He lacks authority with the right of the Republican party, who are likely to employ brinkmanship to secure concessions from both him and Democrat negotiators.

The two parties are extremely far apart in their negotiating positions. Democrats are seeking a 'clean' increase with no concessions on fiscal policy, which is not a realistic proposition. Republicans are struggling to coalesce around a set of negotiating asks that can win majority support. But they broadly advocate for cuts of over $100 billion to government spending. Republicans will not seek cuts to defence spending, Medicare or social security due to the high political costs, instead focusing on the remaining discretionary spending to fund cuts. This amounts to a relatively small area of government funding, limiting the likelihood they will succeed in achieving cuts of the scale requested (see Figure 28). Total non-defence discretionary spending amounts to $793 billion against projected total government spending in 2023 of $6.2 trillion. (For more detail, see our Insight note *Is a US debt ceiling crisis on the cards*, here.)

Faced with few prospects of legislative wins at home, Biden will focus his attentions abroad. One of the few areas of policy that enjoys broad bipartisan support are the Administration's approaches to China and Russia.

A core feature of the Biden Administration has been the fusion of industrial policy and national security, with a particular focus on accelerating the US lead in advanced manufacturing over China. The US is focusing on encouraging the growth of domestic industry while also expanding use of executive orders to introduce export controls, investment screening and scrutiny of US Foreign Direct Investment (FDI) into China. This has significant implications for US manufacturers of strategic assets like advanced semiconductors, while also creating additional risk factors in the US-China relationship. (For more detail, see our Insight note *Hopes of a thaw in US-China relations deflate*, here.)

Major legislative efforts passed in 2022 continue to shape US policy as they are rolled out, marking a shift towards a significantly more interventionist industrial policy. The CHIPS Act aims to support the growth of the US advanced semiconductor industry with $52 billion in subsidies and tax credits. Newly released details of the funding programme show companies receiving more than $150 million will be required to share excess profits with the US government and commit to building facilities in the US rather than overseas. This effectively requires manufacturers to pick a side in US-China competition, while domestic manufacturing capabilities (partially) guard against the risk that conflict over Taiwan disrupts supply.

EU fiscal reform will struggle to pass in 2023, but cohesion is improving

Detailed proposals for new EU fiscal rules will be presented in April, but implementation is unlikely before 2025 given the opposition of some 'frugal' states. Despite divisions on fiscal policy, delivery of substantial recovery funding will continue to incentivise EU cohesion. In the UK, Prime Minister Sunak is unlikely to provide meaningful solutions to the UK's structural challenges before the next general election.

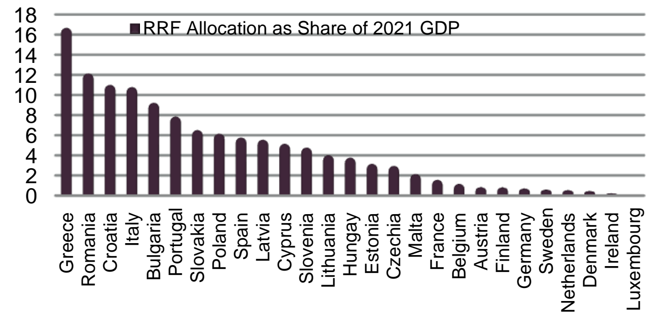
New European fiscal rules that would give member states more room to do counter-cyclical fiscal policy are now unlikely to be introduced before 2025. Detailed European Commission proposals will be published in April 2023, with a view to ending the sort of enforced austerity seen during the sovereign debt crisis in favour of promoting investment and long-term growth. The new framework would be a very positive macro overhaul, but faces opposition from some 'frugal' member states.

An aversion to additional borrowing among these states will also limit the ambition of the EU response to the US Inflation Reduction Act (IRA) and a potential joint weapons-purchasing programme. Instead, funding to respond to the IRA by introducing financing for green economy investments will be drawn from unused Recovery and Resilience Funding (RRF), while the joint weapons purchases will likely be made using €7 billion of remaining European Peace Facility Funding.

Widespread delays to member states distributing €720 billion in RRFs (principally due to bureaucratic challenges) may result in an extension of the fund beyond 2026. 16 member states have yet to receive any funds, while almost all others are falling behind on launching investment programmes and implementing reforms to secure future funding. As funding is conditional on completing investments, these delays will put pressure on the EU to extend the fund to allow all of it to be distributed.

Despite these delays, distribution of RRFs will continue to strongly incentivise member states to meet EU governance and fiscal expectations. The Italian government has maintained its conciliatory approach towards the EU, confounding early concerns. This is in part a recognition of the importance of RRFs for the Italian economy (equal to early 11% of GDP) and consequently for the fortunes of its government. Maintaining access to RRFs will also provide significant incentives for Poland and Hungary to continue with rule of law reforms. That said, the likely delay in Poland receiving its first round of funding, caused by outgoing President Duda's personal disagreement with the negotiation process, will have a negative impact on the incumbent government's election prospects this autumn.

Figure 29: Recovery and Resilience Funding acts as a substantial incentive for EU cohesion

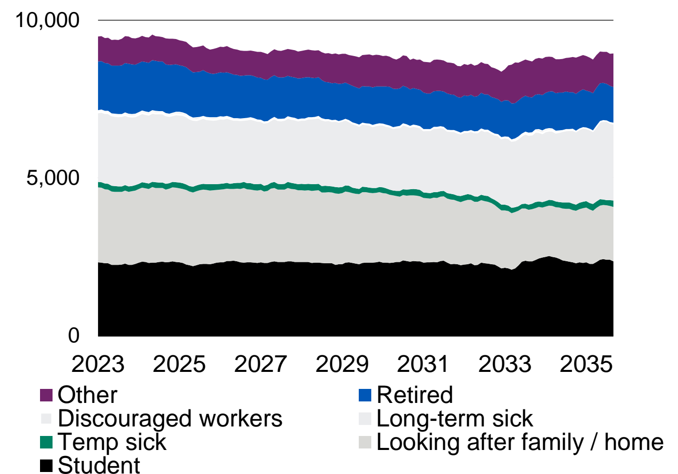


Source: European Commission (March 2023)

In the UK, the forthcoming March Budget will focus on ending the strike action that has persisted over the past year. Sunak is likely to use the bulk of the government's fiscal headroom to set out increased pay offers. 'Aside from the continuation of the energy price guarantee scheme, this will leave little funding for other major priorities.

As a result, it is likely that the government will focus on cost-neutral tweaks to labour market policy aimed at improving economic participation. Substantive reform will be framed as manifesto commitments, avoiding near-term spending increases or tax cuts, despite demands from backbench MPs.

Figure 30: UK government commitments to reduce economic inactivity may have marginal impact



Source: Office for National Statistics (March 2023)

Sunak's approach will mean little progress in addressing structural issues affecting the UK economy over the next two years. Poor economic performance and low poll ratings will likely result in ongoing momentum behind the Labour Party ahead of the next general election in 2024.

Scenario: Fed has two bites of the cherry

US growth and inflation fail to moderate sufficiently over coming months, meaning the Fed has to tighten policy much more significantly than expected (probability 17.5%)

In this scenario, near-term activity indicators recover while inflation remains elevated. Policy has not become sufficiently restrictive and the economy passes through the peak impact of tighter financial conditions quicker than expected.

However, such a “no landing” is unsustainable because policymakers remain committed to restoring price stability.

As the Federal Reserve (Fed) realises that underlying inflation is showing little sign of returning to target, a further round of rapid monetary policy tightening begins. This then pushes the economy into a later but deeper recession.

Waymarks:

The tentative pick-up in US economic activity at the start of 2023 becomes a more durable improvement, with the rest of the economy catching up to the strength of the labour market.

While y/y headline inflation continues to fall, underlying pressures show no sign of moderating, and indeed start building up again. Wage growth in particular ceases to slow, consistent with the labour market remaining extremely tight.

Fed policymakers begin to sound increasingly concerned about the easing in financial conditions and the outlook for inflation. Discussion turns to the possibility of a higher short-term r*, and so the need for an even higher fed funds rate.

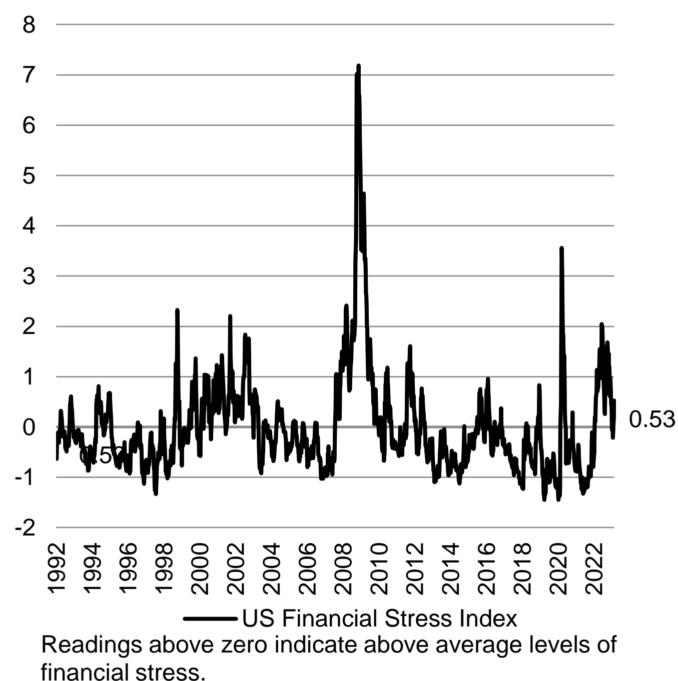
Around the middle of the year the Fed returns to large incremental rate increases, taking the policy rate to around 7%. This eventually tips the economy into a deep recession, but perhaps only by 2024.

Global economic forecasts relative to baseline, 2 years ahead:

Growth: -2.3%; Inflation: -1%

With a higher terminal rate and a delayed recession, rates remain elevated for much longer in this scenario than in the base case. Given the ultimate recession is deeper, a sharp cutting cycle at that point is likely, but its distance in the future means it is less important in shaping near-term market dynamics.

Figure 31: The recent easing in financial conditions may mean the US economy avoids a “necessary” recession, at least temporarily



Readings above zero indicate above average levels of financial stress.

Source: abrdn, Bloomberg, Haver (March 2023)

Scenario: Sticky inflation

Monetary tightening causes a recession in line with the base case. However, underlying inflation pressure is more persistent, causing a shallower cutting cycle (probability 15%)

This scenario starts off on a broadly similar path to the baseline, with monetary tightening by the Federal Reserve (Fed) causing a US recession starting in Q3.

However, underlying inflation pressures prove more persistent than expected, as the inflation-generating process is less responsive to slack.

The Fed faces a more acute trade-off in the pursuit of its dual mandate, with rising unemployment but still high inflation. This results in rates being kept on hold for longer, and then falling as low in the eventual cutting cycle.

Waymarks:

The economy shows signs of slowing sharply through Q2 with the economic impact of past financial condition tightness continuing to build.

Core inflation proves stickier than expected even as the economy slows, with unit labour costs adjusted for productivity continuing to run too hot relative to the inflation target.

Inflation expectations fail to fall back to target-consistent levels despite the rapid slowing in the economy.

The Fed signals its inflation fighting intent as the economy weakens, insisting that it needs to see convincing evidence of inflation moderating before it starts to cut.

When the Fed eventually starts to cut as a result of rising unemployment, it delivers a less rapid and deep cutting cycle.

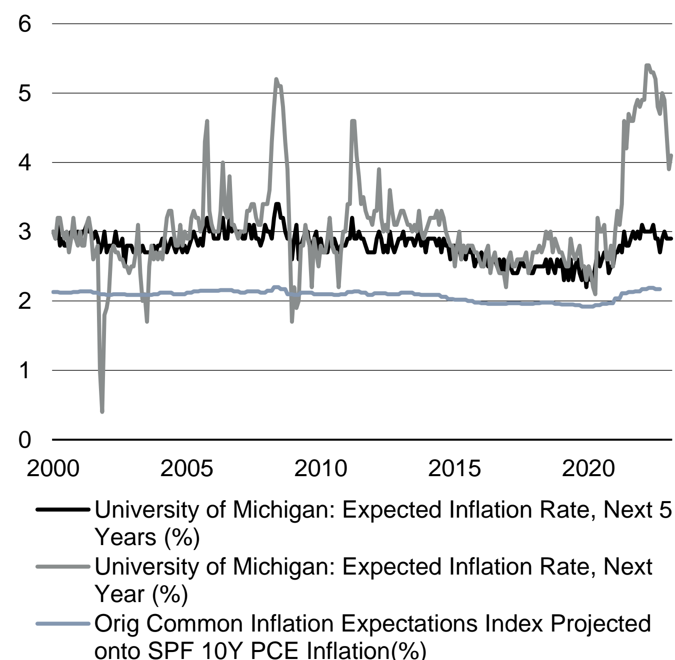
This tighter stance of policy means the economy does not recover as quickly as in the baseline.

Global economic forecasts relative to baseline, 2 years ahead:

Growth: -1.5%; Inflation: +3%

Rates stay elevated for longer than the baseline, with the cutting cycle less dramatic. The Fed remains committed to keeping the economy within the existing price stability framework, reinforcing our "back to new normal" paradigm.

Figure 32: Elevated inflation expectations would make inflation less responsive to unemployment



Source: Haver, abrdn (March 2023)

Scenario: Fed walks the tightrope

The Fed slows the economy enough to tame inflation without causing a recession, engineering a form of "soft landing" (probability 20%)

In this scenario, US and global growth slows to below trend levels, but the economy avoids falling into recession. Instead, inflation is brought back under control more benignly.

The Phillips curve retains its recent steepness, with inflation falling sharply on the back of a relatively modest increase in unemployment.

This is in turn due to broader supply side improvements, which cause a natural moderation in inflation pressures. Anchored inflation expectations also help to keep inflation contained, with a credible policy from the Federal Reserve (Fed) sufficient to stop the Phillips curve shifting outwards.

Waymarks:

Growth slows to below trend-consistent levels but avoids falling into "stall speed" dynamics and recession.

Labour force participation improves. Vacancies fall sharply but unemployment only ticks up modestly. Wage growth cools with unit labour costs falling to target-consistent levels.

Tentative evidence that underlying inflation pressure has started to cool is sustained, with a series of lower-than-expected inflation prints.

Inflation expectations stay well-anchored, with medium-term expectations falling back closer to long-term averages.

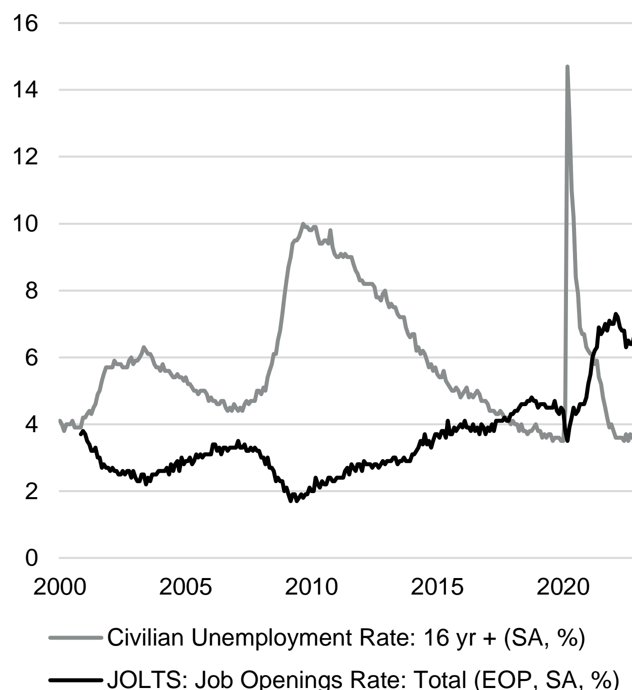
Fed rhetoric shifts away from a tightening bias towards neutral. Financial stress remains relatively subdued.

Global economic forecasts relative to baseline, 2 years ahead:

Growth: +2.5%; Inflation: +2%

Policy interest rates are above the neutral level but not as high as in the "Fed kills the cycle" scenario. As underlying inflation pressures recede, debate switches towards cutting rates back to neutral, rather than more aggressively through neutral.

Figure 33: Falling vacancies without a large increase in unemployment would help deliver a soft landing



Source: Haver, abrdn (March 2023)

Scenario: Supply side recovery

The supply side recovers significantly, reducing near-term inflationary pressure and meaning policymakers do not need to slow growth to restore economic balance (probability 10%)

In this scenario, a significant and rapid recovery in the supply side of the economy means that price stability is restored without a sustained period of below-potential growth.

This supply recovery would be much broader than the ongoing recovery in global supply chains. Crucially, it would also involve labour supply picking up; the labour matching function improving, with the Beveridge curve returning to its pre-Covid shape; and productivity growth picking up.

The strength of the supply side means headline and underlying inflation falls back quickly, with less policy tightening required despite stronger growth. Nevertheless, this scenario generates less disinflation than the recessionary baseline, as the growth environment is stronger.

Waymarks:

Supply chains continue to recover quickly, boosted by the lifting of zero-Covid in China.

Labour supply rises as workers return to employment and increase their hours rapidly. This dynamic is reinforced by cost-of-living challenges incentivising a return to work.

Frictions in the labour market reduce as demonstrated by the Beveridge curve shifting back towards its pre-pandemic level.

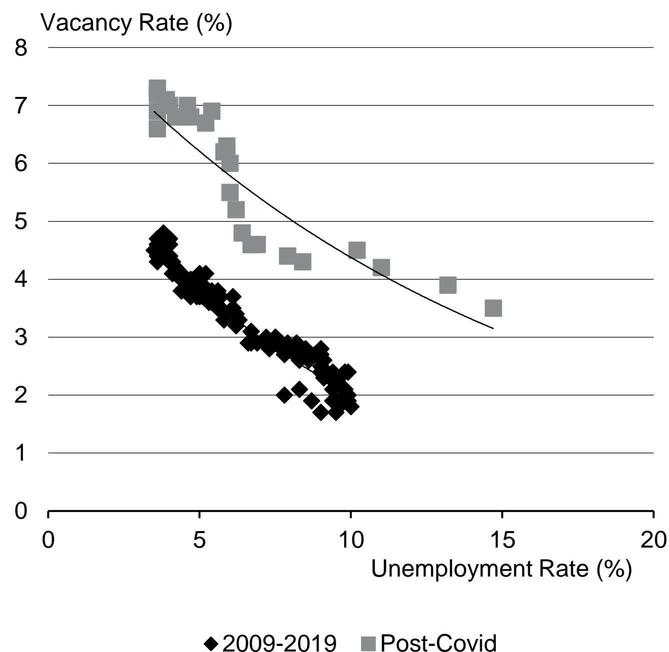
Monetary policy responds to the more subdued inflationary environment with a less pronounced tightening cycle, with no need for the economy to suffer a recession to restore price stability.

Global economic forecasts relative to baseline, 2 years ahead:

Growth: +4.5%; Inflation: +1%

In the short-term, a stronger supply side generates faster growth but lower risk of unanchored inflation expectations, and hence a less aggressive monetary policy path. In the long run, equilibrium real and nominal policy rates rise, giving central banks more room to meet inflation targets.

Figure 34: A supply side recovery involves the Beveridge curve shifting to its pre-pandemic level



Source: Haver, abrdn, (November 2022)

Scenario: China turns on the policy taps

China eases fiscal, monetary, and regulatory policy to supercharge growth. This significantly increases global inflation pressures (probability 15%)

In this scenario, Chinese authorities double down on growth after ending zero-Covid by significantly easing macroeconomic policy.

Credit is significantly expanded to the private sector and various regulations are eased further. Simultaneously public infrastructure spending accelerates, motivated by a desire to boost green investment, consistent with net-zero aims.

Waymarks:

Policymakers announce a concrete plan to shore up real estate developers, end the liquidity squeeze and ensure construction of pre-sold housing is completed.

Official sector communications emphasise that financial de-risking is to pause, while pro-growth statements dominate.

Consumer confidence and business investment snap back powerfully, aided by the move away from zero-Covid and reduced uncertainty from the property sector.

Financial market spreads narrow, while ample liquidity helps to lift credit growth, as measured by Total Social Financing.

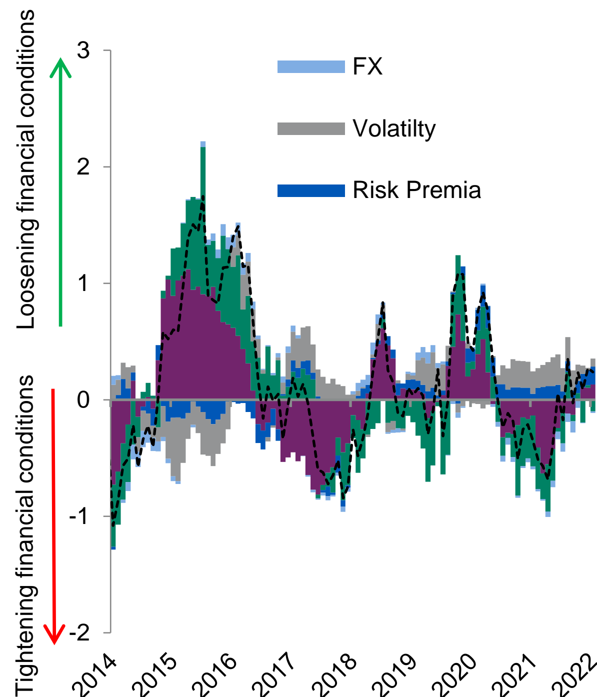
This growth model is much more inflationary for the global economy than a reopening boom alone, as it boosts commodity demand significantly and adds demand to an already supply constrained environment.

Global economic forecasts relative to baseline, 2 years ahead:

Activity : +3.5%; Price level : +4%

Looser Chinese policy would drive stronger global goods trade and push commodity prices higher. Both of these channels would push headline inflation higher around the world. EM policymakers may welcome stronger trade flows but would find their jobs complicated by inflation pressures.

Figure 35: China's policy stance has historically oscillated between extremes, with a swing back to easing possible



Source: Haver, abrdn (March 2023)

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