Global Economic Outlook

A rocky recovery

EDC Economics

June 29, 2023

Insights on the world's key economies, GDP growth, commodity prices, interest rates and exchange rates.

Canada

EDC

Executive summary

Global Economic Outlook: A rocky recovery

By Stuart Bergman
Vice-President and Chief Economist

We came into spring with the wind at our backs as first quarter results were surprisingly strong across the United States, China and Canada. Even Europe, which slipped into recession early in the year, performed better than feared late last year. But as we move through 2023, the impacts of a series of one-off events—be it the unseasonably warm weather that dampened energy demand in Europe, a bumper crop in Brazil, the rundown of excess savings in North America, or China's post-reopening normalization of activity—aren't likely to continue to provide much additional support for the global economy.

To be clear, we're not expecting Global Financial Crisis-type patterns, but perhaps just a whole lot of nothing through the rest of this year, and into early 2024. In our summer *Global Economic Outlook*, we expect a significant drag on some of the key drivers behind the consumer activity that's been powering much of the momentum up to now. Interest rate hikes have already led to steep declines in real household wealth over the last six months and higher borrowing costs have taken their toll on the housing market. This will impact consumers' mood and spending behaviours, through what economists like to call the negative wealth effects.

Additionally, while consumers in the U.S. and in Canada dipped into excess pandemic savings to help finance their spending amid rising costs, much of that cash stash has now been depleted. And what's left of it is concentrated among the higher income brackets, where the tendency to spend each additional dollar that comes through the door is lowest. In fact, in Canada, if you look at the lower income brackets, where the marginal propensity to consume is highest, they're actually worse off than before the pandemic.

EDC Economics is also starting to see some deterioration in the labour market, with certain sectors, like consumer discretionary, showing outright declines in employment. This means that job growth should start to pull back as well, especially as higher costs, softening demand, and tighter credit conditions hit corporate earnings. If not, and if employers somehow manage to defy the historical precedent of higher rates leading to higher unemployment, central banks will have no choice but to make it happen. Wage growth in much of the developed world is still running ahead of rates consistent with central banks' target inflation range.

Executive summary (continued)

Global Economic Outlook: A rocky recovery

While we do expect inflation to come back to target range by 2024, thanks to the lagged effects of interest rate increases, fiscal consolidation, shrinking central bank balance sheets, weaker global demand and the moderating impact of year-over-year price comparisons, prices remain high. And so, elevated wages, and stubbornly high shelter and services costs have forced almost all major central banks to continue to tighten lending conditions, with the notable exception of the People's Bank of China.

This poses a real challenge for central bankers, given the need to ensure price stability on the one hand, while simultaneously ensuring that they're not pushing their economies into recession, or igniting financial meltdown. Faced with this policy trilemma, we continue to believe that central bankers are likely to deprioritize growth, even if it means an uptick in unemployment. As a result, we expect the U.S. Federal Reserve and the Bank of Canada to hike rates once more by the fall. The European Central Bank is expected to more than keep pace, under the cover provided by better-than-expected growth in the region.

These moves will weigh on the outlook for the second half of 2023 and into 2024 in advanced economies, especially when combined with the credit impacts of the recent banking turmoil. The anxiety that set into markets earlier this year because of a number of highly publicized bank failures has made lenders more cautious about lending, especially since we don't know what might trigger the next wave of panic. Together with the steepest hiking cycle in a quarter of a century, this will reduce the flow of credit into the system over the next several quarters and could even bring about contraction in certain economies.

We expect business to ease up on investment and hiring in this environment, as insolvencies increase, thanks to the end of more than a decade of cheap money. As a result, EDC Economics expects U.S. growth to fall to 1.3% in 2023 and just 1% in 2024. Canada's heavily indebted households will also dial back spending, to service higher debt costs, hitting overall activity and bringing gross domestic product (GDP) growth to 1.2% in 2023 and 1.4% in 2024. In Europe, we expect growth to fall to 0.9% this year and 1.1% in 2024.

Executive summary (continued)

Global Economic Outlook: A rocky recovery

China will continue to struggle with the lingering effects of a property slowdown, reduced levels of confidence, record youth unemployment and soft export demand. Authorities there will lean heavily into the economy, but remain constrained by already high levels of local government debt, managing growth of just 5.5% this year and 4.7% in 2024. And with China accounting for 32% of global growth over the last decade, and a big driver of activity in developing markets, this will constrain growth across developing countries, many of which are already suffering from rising debt-servicing costs, weak export demand, and limited room for governments to stimulate growth. Add it all up and we expect a global economy that manages growth of just 2.9% this year and 3% in 2024.

A weaker global demand outlook will weigh on commodity prices. We forecast West Texas Intermediate crude oil prices to average $77 this year and $73 in 2024, as spare capacity and weak demand keep prices in check. Copper prices will also remain subdued, as China's demand outlook more than offsets growing electrification demand. This, together with the interest rate dynamics described above, will combine to see the Canadian dollar average US$0.74 over our forecast horizon.

The bottom line

Following two solid years of post-COVID-19 catchup, the global economy has hit a soft patch. While we don't anticipate a return to the lows of the pandemic period, we expect to see a drag on activity over the next 12 months, before economies stabilize later in 2024. What's more, downside risk prevails as policy-makers look to skilfully balance the risks in efforts to steer us into open waters.

Outlook overview

- Stronger-than-anticipated growth in the first quarter led EDC Economics to revise up its global growth forecast for 2023 (2.9%), followed by similar growth in 2024 (3%). Weakness is expected in the second half of the year, and early in 2024, as consumers in developed markets work through excess pandemic savings and the interest rate hikes of the past year have their intended effect.
- Following a post-reopening surge in activity, China's growth has moderated due to weakness in the real estate sector and struggling consumer and business confidence. This will dampen growth across developing economies, which are also having to contend with the impact of higher interest rates in developed economies and a stronger U.S. dollar, increasing debt service costs and pressuring fiscal sustainability.
- Headline inflation is moderating in most economies, as prices for the more volatile components pull back, and the impact of year-over-year prices comparisons fall out. Core measures have been harder to tame in certain economies, helping to keep rates above central banks' preferred target range.
- Central banks are committed to taming inflationary pressures, even if it means keeping rates higher for longer. Recent banking sector volatility will further restrict credit conditions, reducing the flow of credit to businesses and consumers.

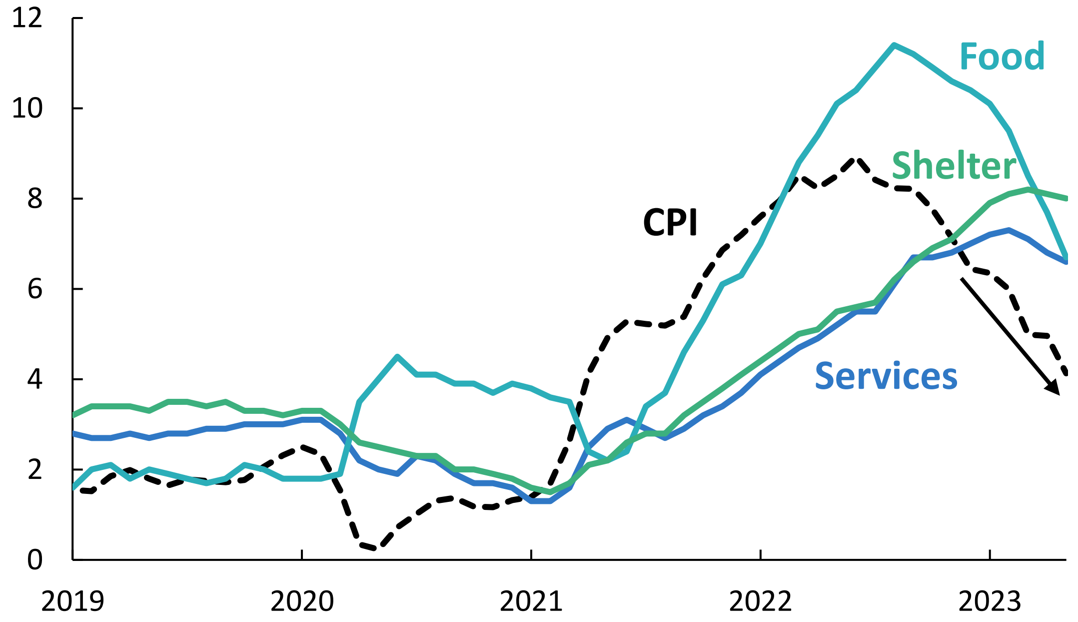
Macroeconomic context

Inflation is dropping, but core components proving more difficult

Inflation in many advanced economies is coming down as economic activity slows due to higher interest rates and volatile components, like energy, drop. But, some categories are keeping core inflation well-above normal levels of growth. As consumers shift spending to services, inflation has stayed persistent. The European context is still impacted by the Russia-Ukraine war, keeping food price inflation in double-digits.

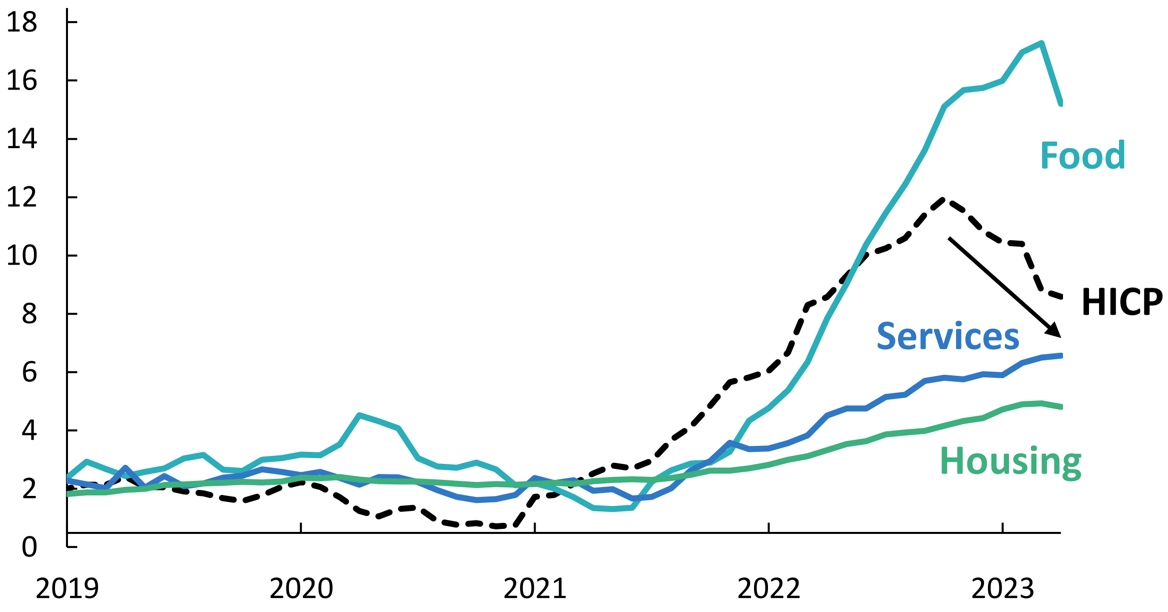
U.S. inflation growth and components

y/y % change in inflation and select components, SA



Euro Area inflation high due to Russia-Ukraine spillovers

y/y % change in inflation and select components, NSA



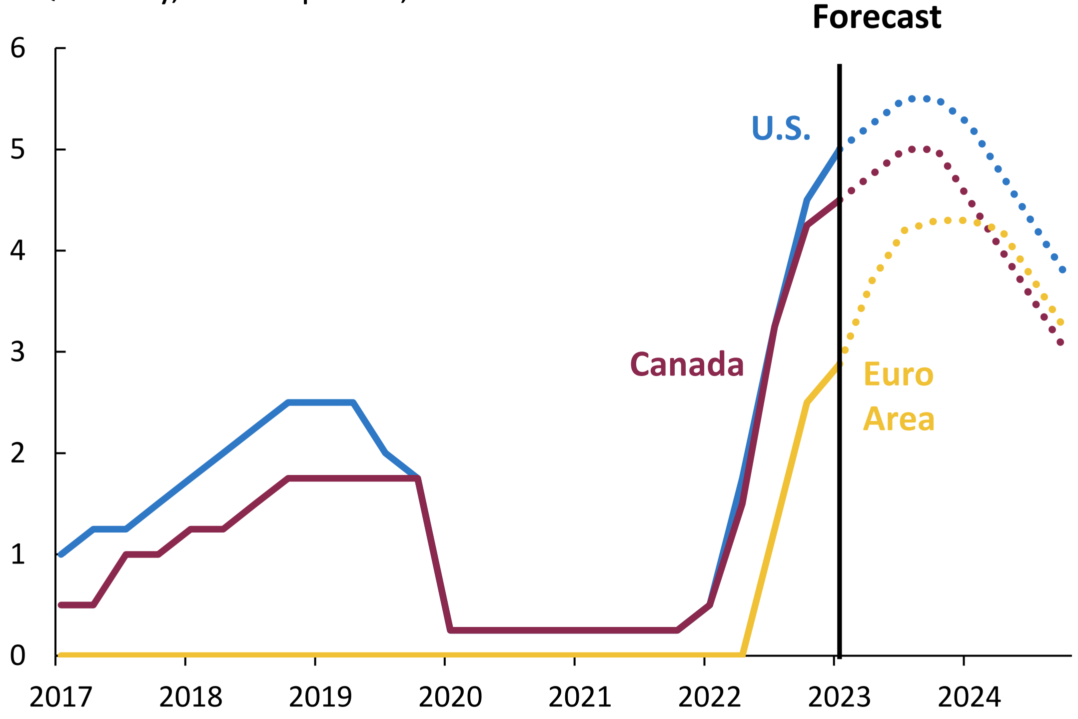
Note: Last data point is May 2023, SA: Seasonally adjusted. NSA: Not seasonally adjusted. Consumer Price Index (CPI). Harmonized Index of Consumer Prices (HICP). Euro Area food inflation includes tobacco and alcohol.
Sources: Haver Analytics, EDC Economics

The end of the monetary tightening is near, but rates remain high

While most central banks remain in their tightening cycle, the pace of interest rate increases has slowed. Yet, high interest rates have led to more expensive credit, as banks have swiftly increased lending rates. Tighter lending standards, in particular, have restricted access to credit for consumers and businesses.

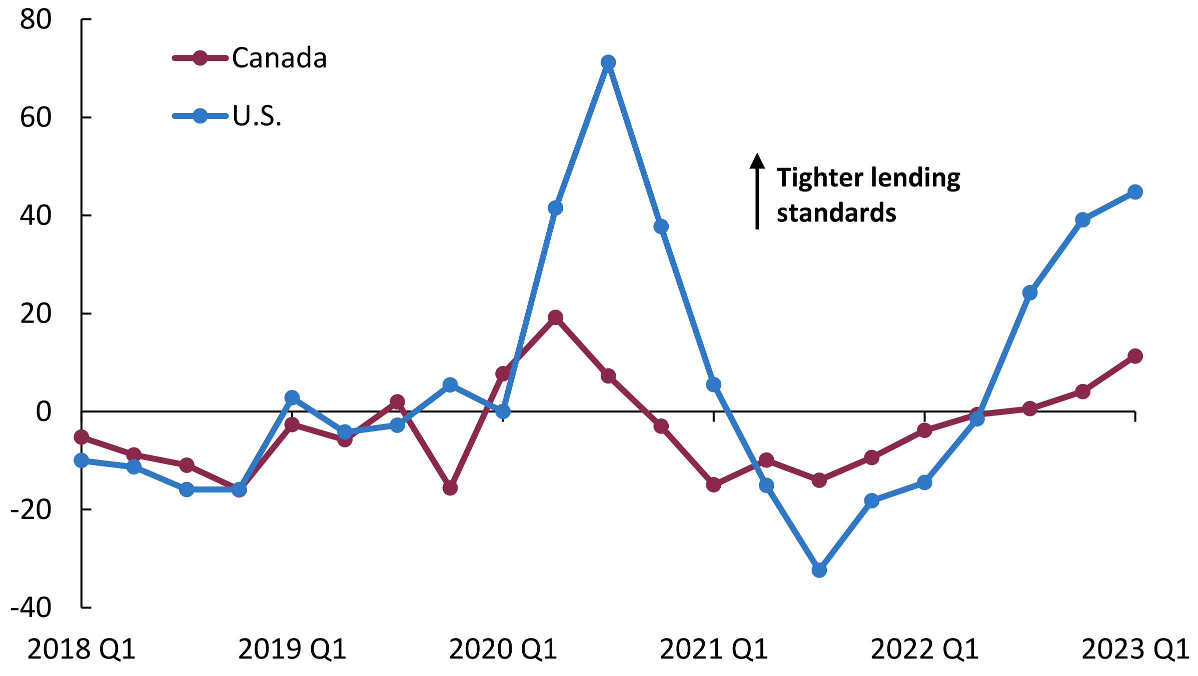
Policy interest rates

Quarterly, end-of-period, %



Senior loan officer survey: Canada & U.S.

Quarterly, Overall business lending conditions; Balance of opinion (%)



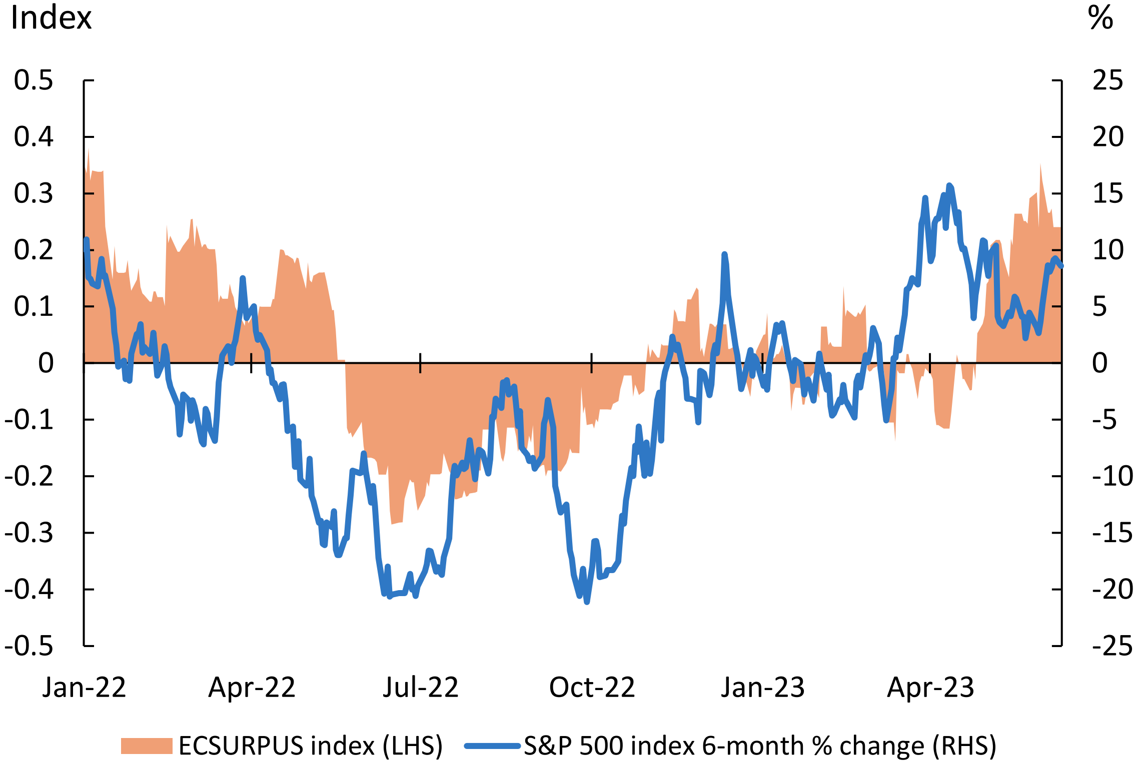
Note: Higher ratios in current cycles indicates that credit is becoming more expensive.

Sources: Haver Analytics, Organisation for Economic Co-operation and Development (OECD), EDC Economics

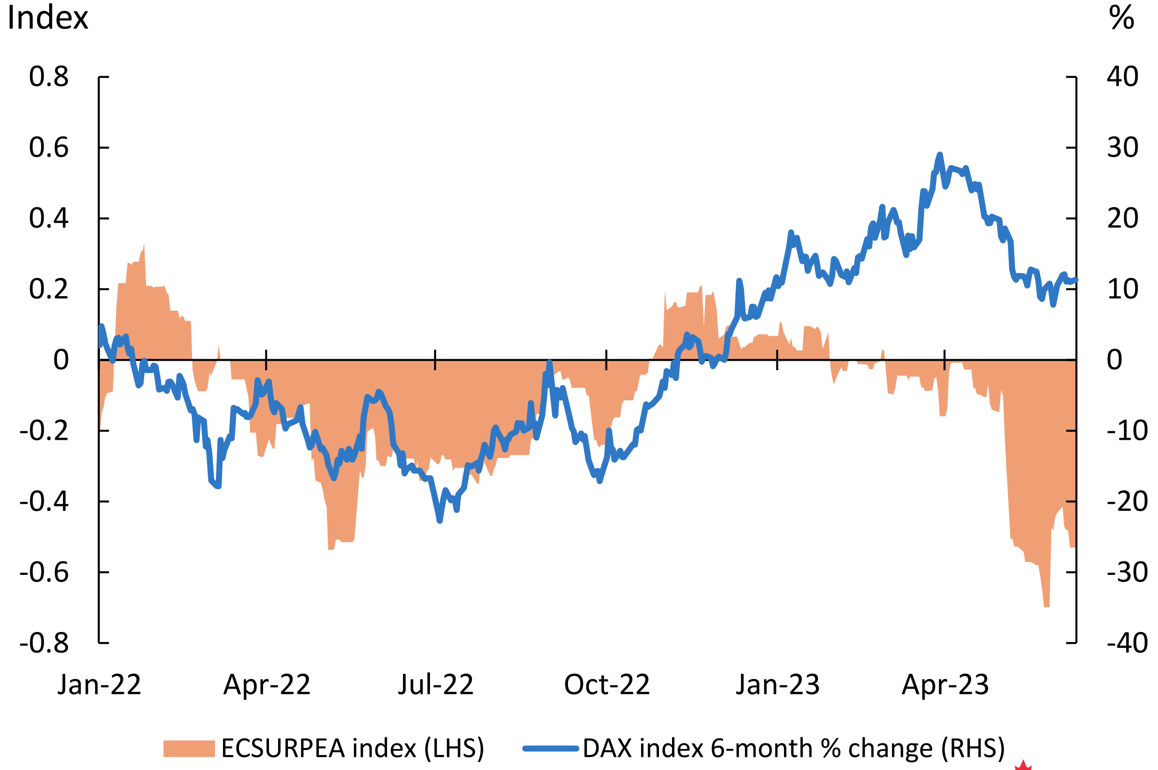
The U.S. and EU fared better in the winter, but upside surprises appear to be waning in Europe

The U.S. and the European Union (EU) experienced surprise upside events starting early last fall—such as energy crisis avoidance and robust labour markets. These pressures pulled economies upwards, but the EU's surprise index has recently fallen. Without further positive surprises, global growth is expected to trend downward.

U.S. economic surprise index



EU economic surprise index



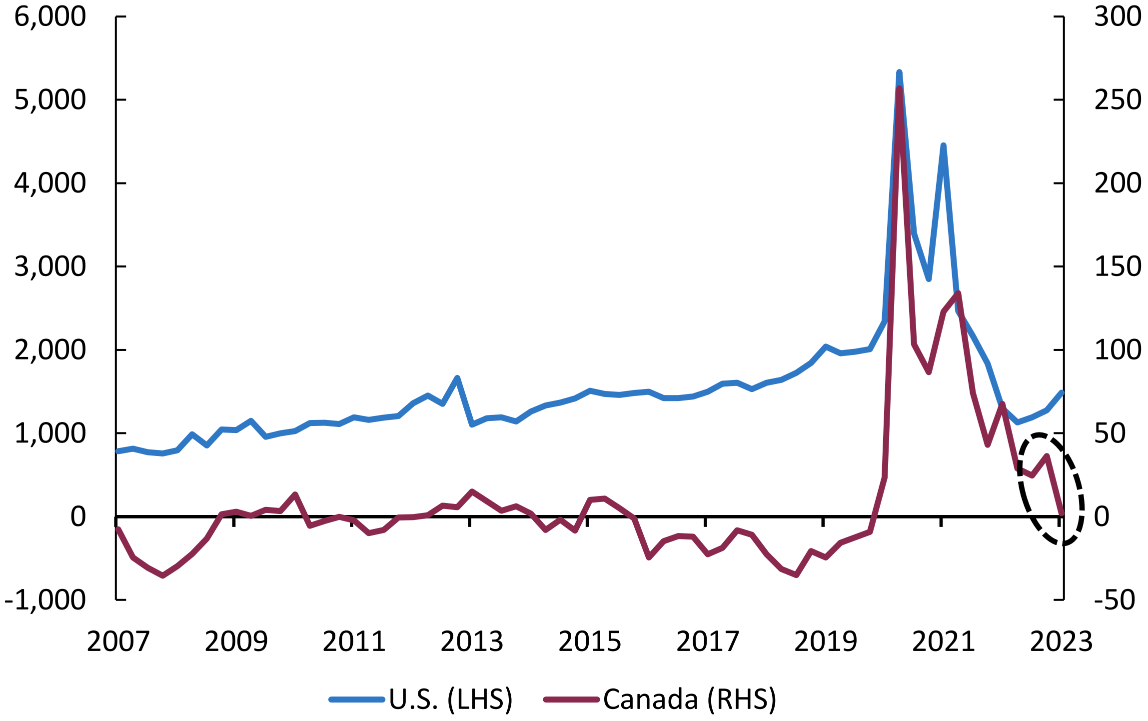
Note: Data as of June 12, 2023
Sources: Haver Analytics, EDC Economics, World Economics, Financial Times, Bloomberg Economics

Canadian consumers are running out of resources

Canadian cash-on-hand plummets in Q1-2023, while lower-income Canadians are now worse off than before the pandemic. The continual tightening of consumer resources has diminished expectations for Canadian consumer demand through year-end. The U.S. consumer has surprisingly increased cash-on-hand, but levels are still down from their post-pandemic peaks.

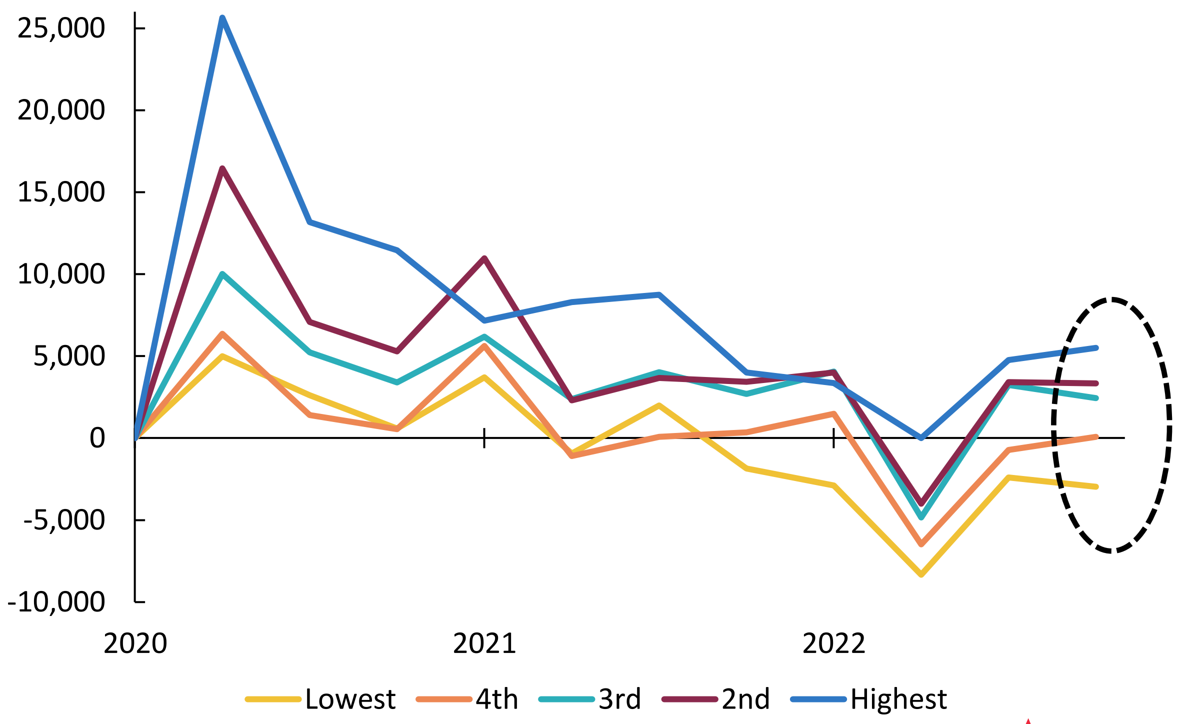
Cash-on-hand

Quarterly, USD billions



Change in Canadian cash-on-hand by income quintile*

Quarterly, CAD millions change from Q1 2020



Sources: Haver Analytics, Statistics Canada, EDC Economics

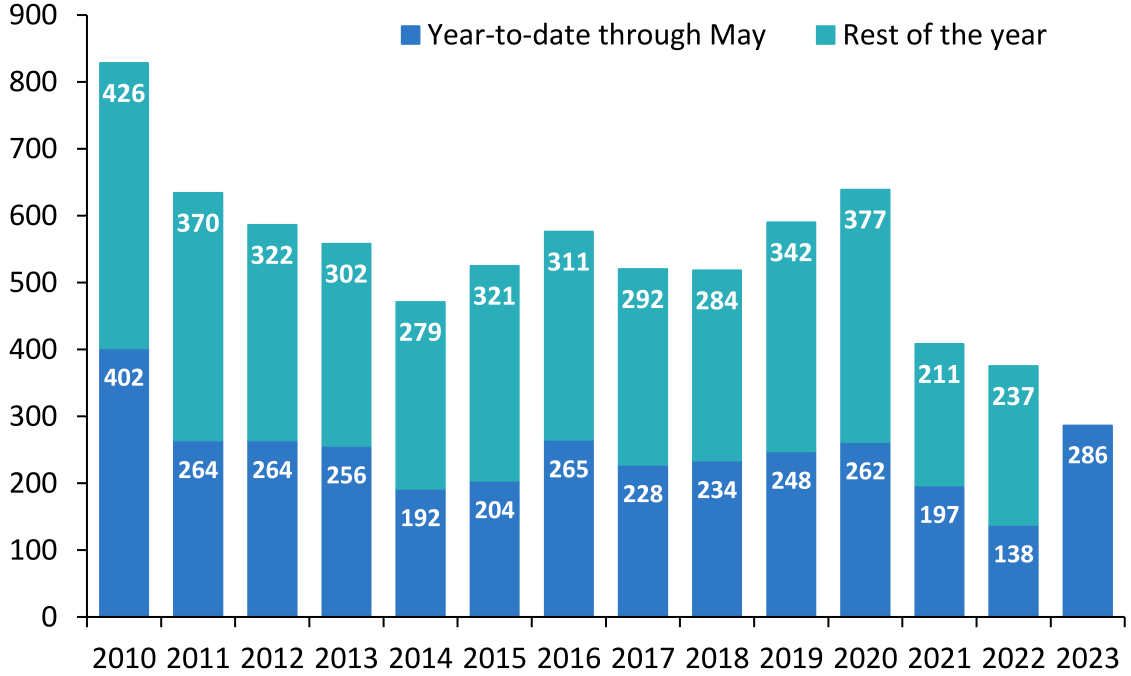
*Note: The cash-on-hand by income quintile data is lagging behind the other cash-on-hand series by one quarter. Quintile divides income groups into 5 categories, from the lowest 20% to the highest 20% earners.

Tightening lending standards threaten to expose financial vulnerabilities

High interest rates are beginning to expose more vulnerable financial institutions and businesses.
Asset price volatility will impact liquidity conditions in Canada and the U.S.

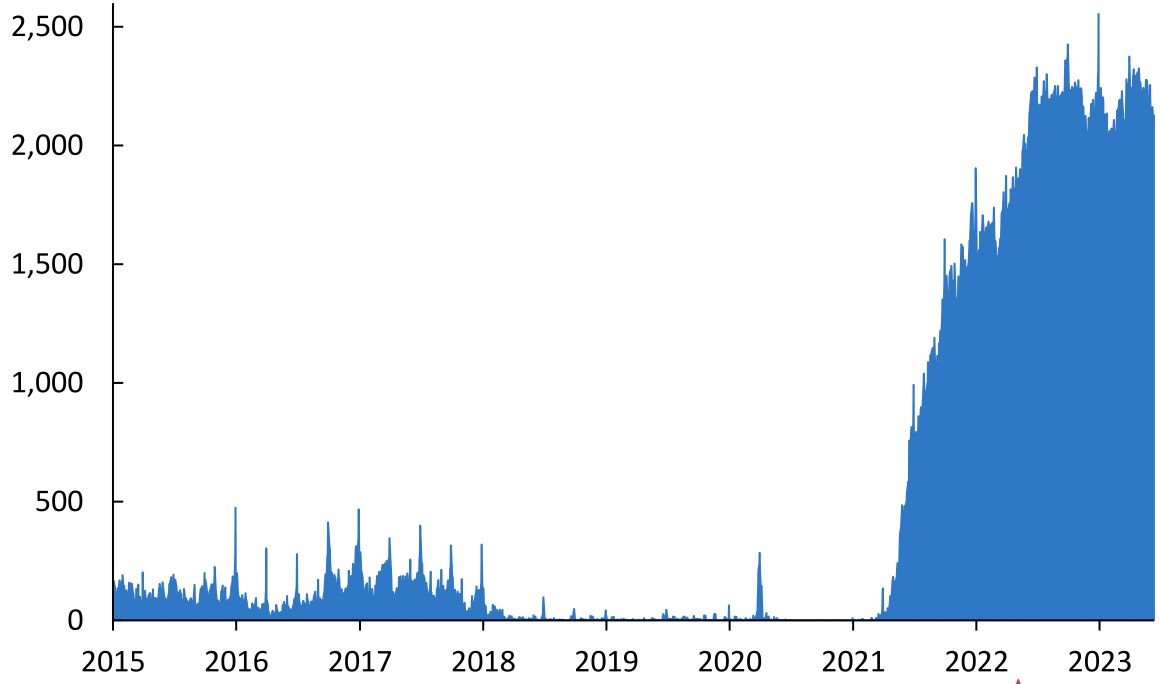
U.S. bankruptcy filings

Annual; 2023 data through May



Overnight reverse repurchase transactions at Federal Reserve

Billions of U.S. dollars, NSA



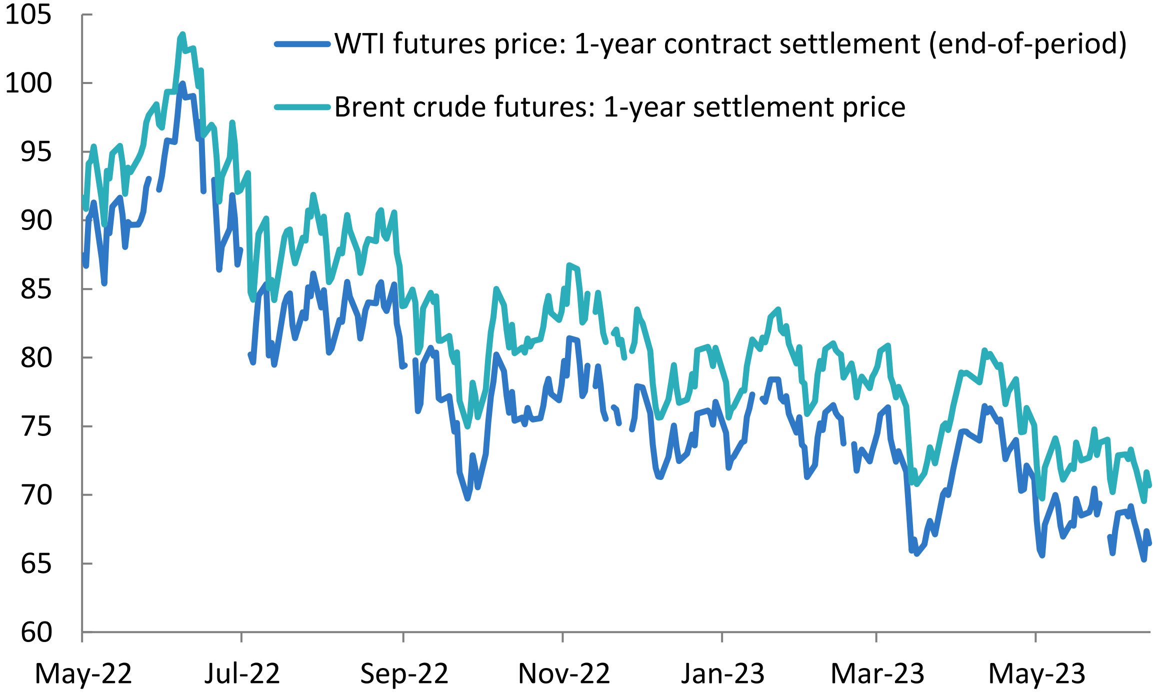
Sources: S&P Global Market Intelligence, Federal Reserve Bank of New York

Global oil and natural gas prices continue their downward trajectory

Despite the OPEC+ decision to extend crude oil production cuts through 2024, oil prices are expected to fall in line with global demand. As U.S. natural gas inventories and production rise to record levels, natural gas prices are also expected to continue their downward trajectory in the near term. Overall, key commodity prices will be subdued given the global macroeconomic environment.

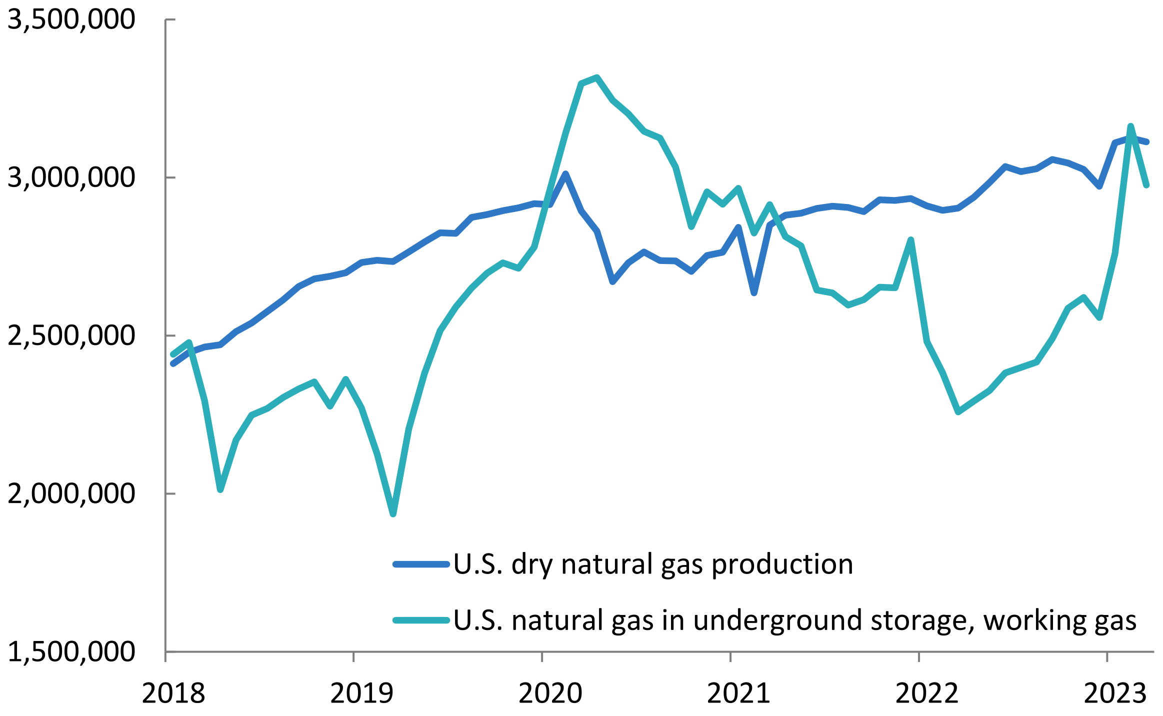
Crude oil futures

US$ per barrel



U.S. natural gas production and storage

Million cubic feet, SA

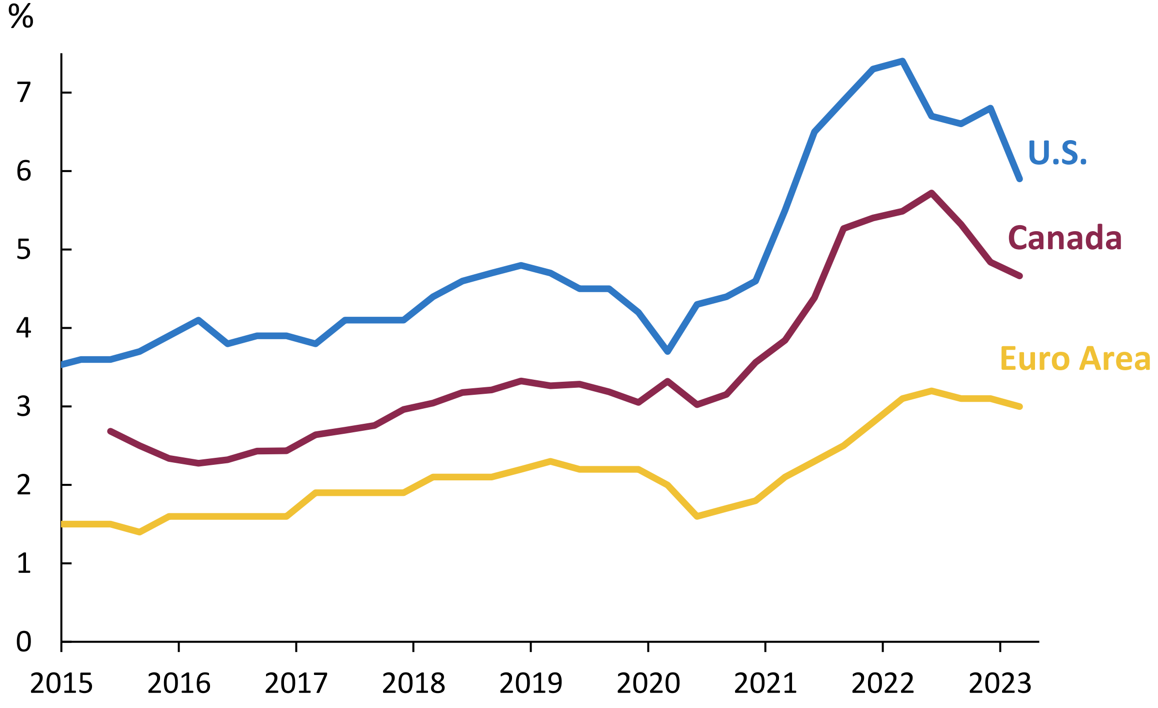


 Source: Haver Analytics

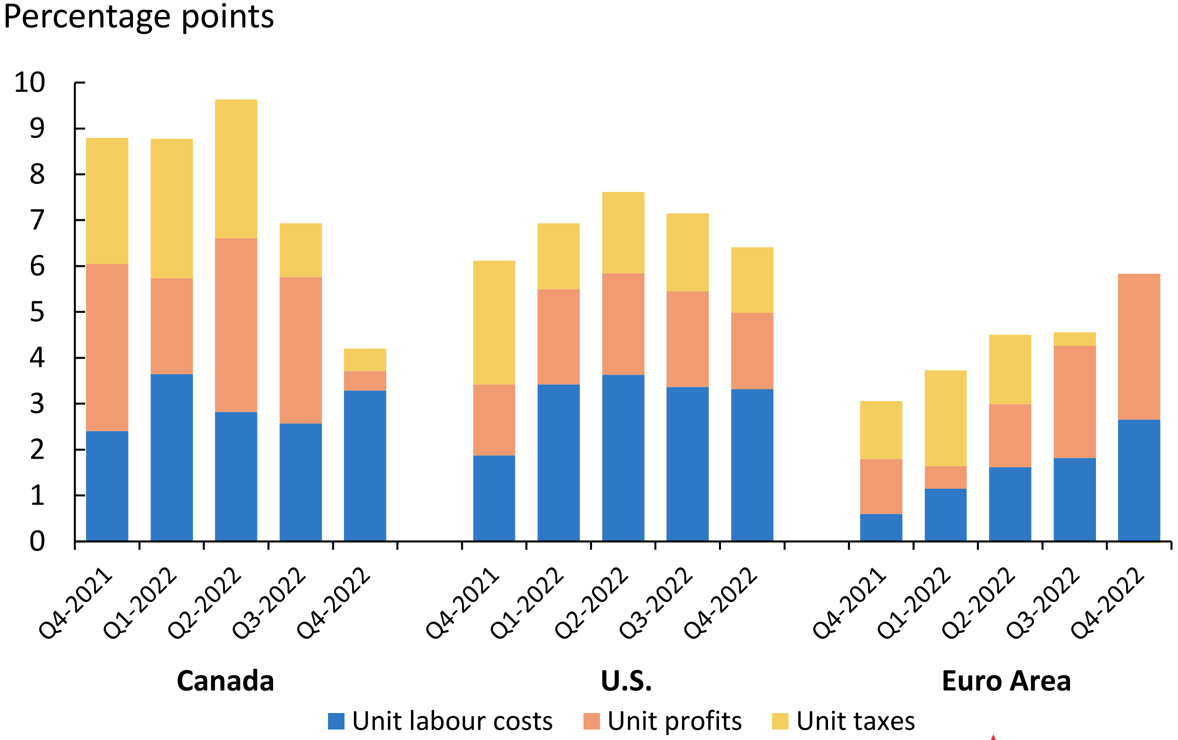
Wage-price spiral divergence

Tumbling job vacancy rates are an early indication of loosening labour markets in North America, where conditions never seemed to translate into a dreaded wage-price spiral. In the Euro Area, job vacancy rates have stalled, and labour costs have begun to stoke inflation pressures, highlighting the unique economic challenge the region is facing.

Job vacancy rates



Contribution of labour costs to inflation



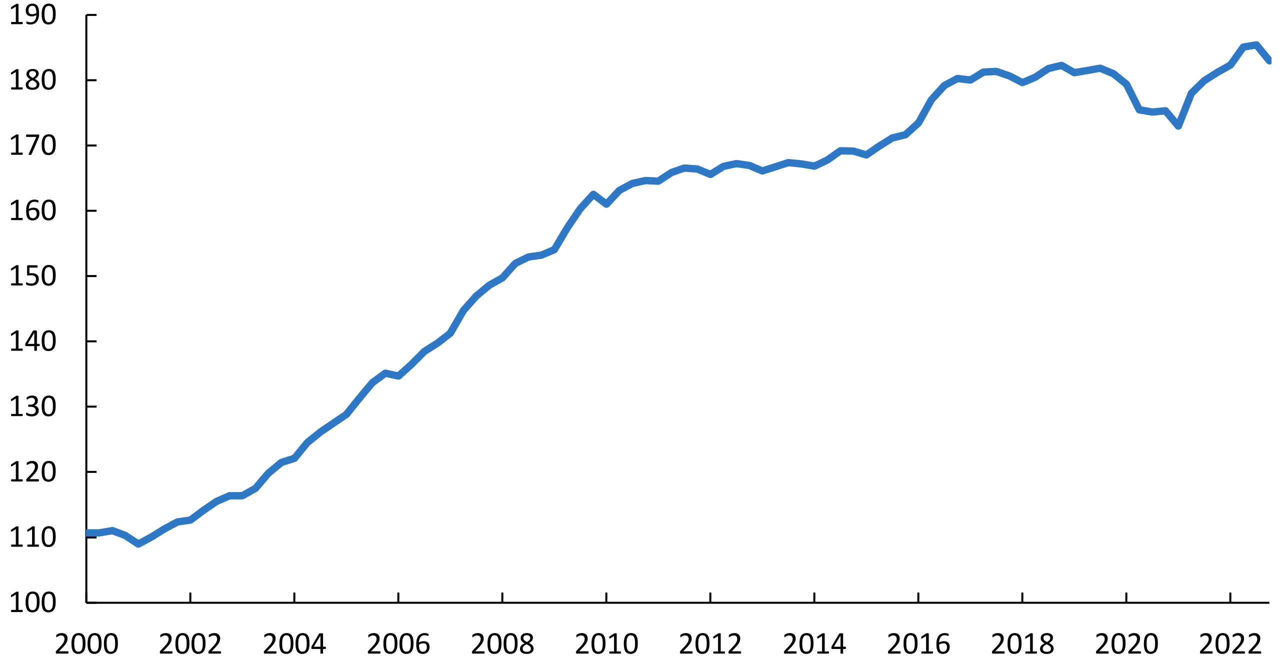
Sources: Haver Analytics, OECD, EDC Economics

Country outlooks

Canada

Indebted Canadian households are sensitive to this higher rate environment

% share of disposable income



Sources: Haver Analytics, EDC Economics

Canada expects below-average economic performance this year at 1.2% growth, and 1.4% in 2024, likely avoiding a recession.

Business and government investment as well as exports are expected to keep the economy afloat for the balance of the year. Strong pandemic-induced profits will support businesses to continue to invest in their operations.

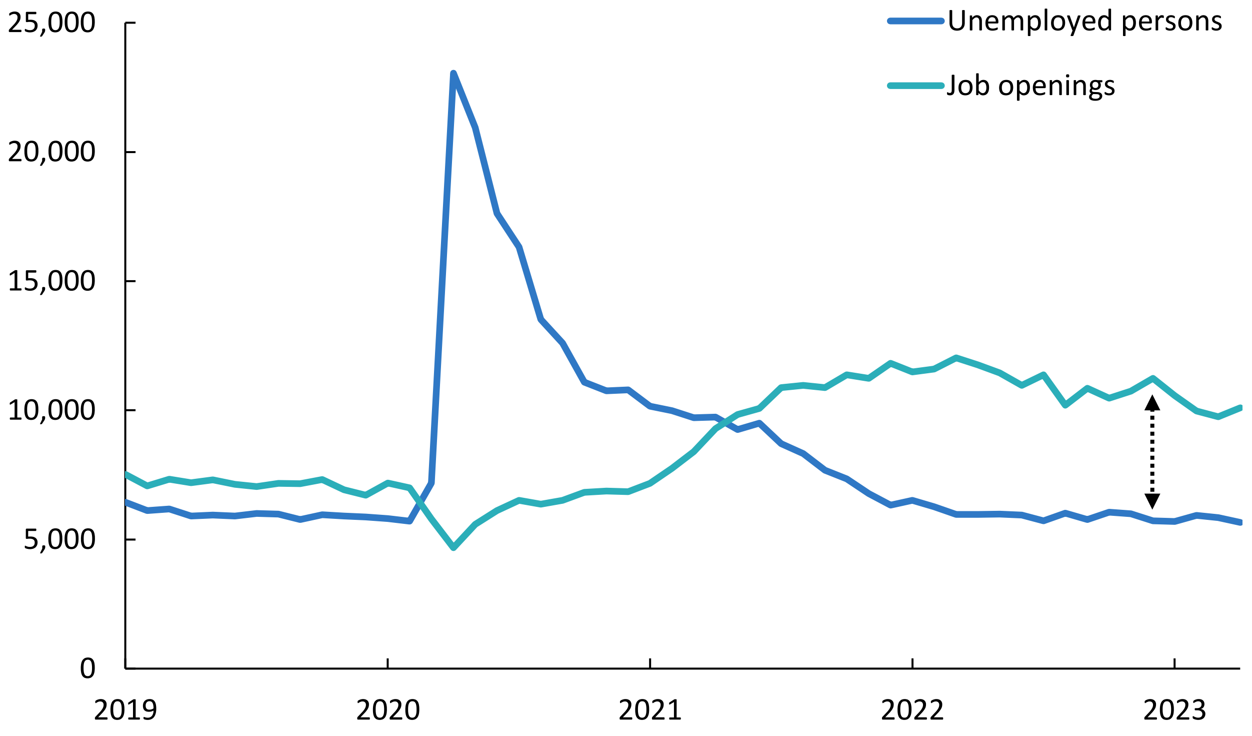
Demand for Canadian exports remains strong for autos, consumer goods, energy and minerals as well as agri-food products. North American auto inventories are low while global demand for agri-foods remain high given the Russia-Ukraine war. Canada's unsold crops from last year will continue to be shipped, while easement of chip bottleneck will help boost auto and parts exports to the United States.

While the Canadian economy has surprised on the upside in the first three months of this year, there are challenges for domestic consumption heading into the second half of this year. The consumer remains fragile under a heavy debt load as a chunk of household income goes to interest payments, while elevated inflation eats into the amount of goods and services they can buy. Thanks to a strong labour market, Canadian consumers have been able to keep their heads above water and given tight labour supply, the domestic economy should chug along.

United States

U.S. labour market tightness

Number of postings and people



Sources: Haver Analytics, EDC Economics

The United States is expected to defy the recession-currents sweeping across the world's other major economies, with a modest 1.3% growth expected in 2023, and 1% in 2024. U.S. consumers have shown remarkable resilience against domestic and global headwinds as they continue to power the world's largest economy.

Strong pandemic-induced profits have allowed businesses to increase wages to hold onto their valued talents in a tight labour market, even as they face slower demand for their products. Plentiful jobs, wage growth and high pandemic-induced savings have allowed the U.S. consumer to weather a double whammy of high interest rate and elevated inflation. While there are signs of waning strength of the U.S consumer, as long as the labour market remain steady, the consumer is unlikely to pull back. Businesses aren't likely to cancel their long-term plans as they deem current economic environment as transient. Major projects in advance manufacturing technologies, health care and mining are currently progressing, thanks to the government's recent industrial policy that's incentivizing businesses to invest. Government spending has played a significant role in supporting the economy during the pandemic, but will decelerate going forward. International trade has yet to fully recover, but there are plenty of opportunities for U.S. exporters as the mighty dollar loses some steam from its recent accent.

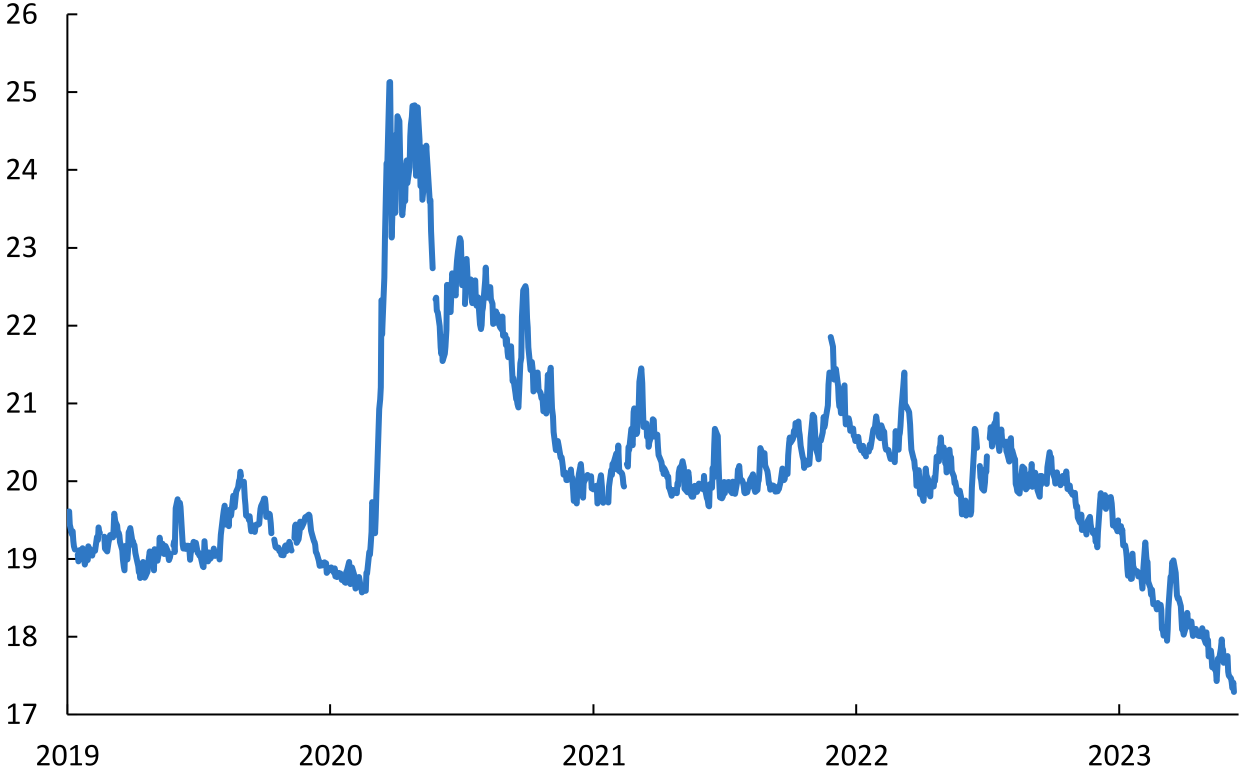
The U.S. outlook could surprise on the upside if there's a sharp improvement in the inflationary trend that triggers the Fed to reduce interest rates, which could engender stronger domestic spending.

The main downside risk to the U.S. outlook is the likelihood of reduced consumer spending due to a higher-for-longer interest rate environment.

Mexico

Higher interest rates and inward investment boost peso

Peso per U.S. dollar



Sources: Haver Analytics, EDC Economics

Mexico's economic prospects look bright over the next two years as capital inflow and a vibrant service sector powers the economy. Real gross domestic product (GDP) is forecast to advance 2.2% this year and 1.8% next year.

The post-pandemic, supply-chain snags and geopolitical risks elsewhere have created opportunity for Mexico as a nearshoring destination. Given its relatively stable political environment, businesses looking to de-risk their production and supply-chain processes and to have geographic advantage to the larger North American market are increasingly choosing Mexico to set up new operations.

In addition to manufacturing nearshoring, U.S. filmmakers are increasingly relying on Mexican talents to cut productions cost. Nearshoring, film production and tourism are drawing in foreign exchange inflows that have helped boost the Mexican peso to a level not seen in more than five years.

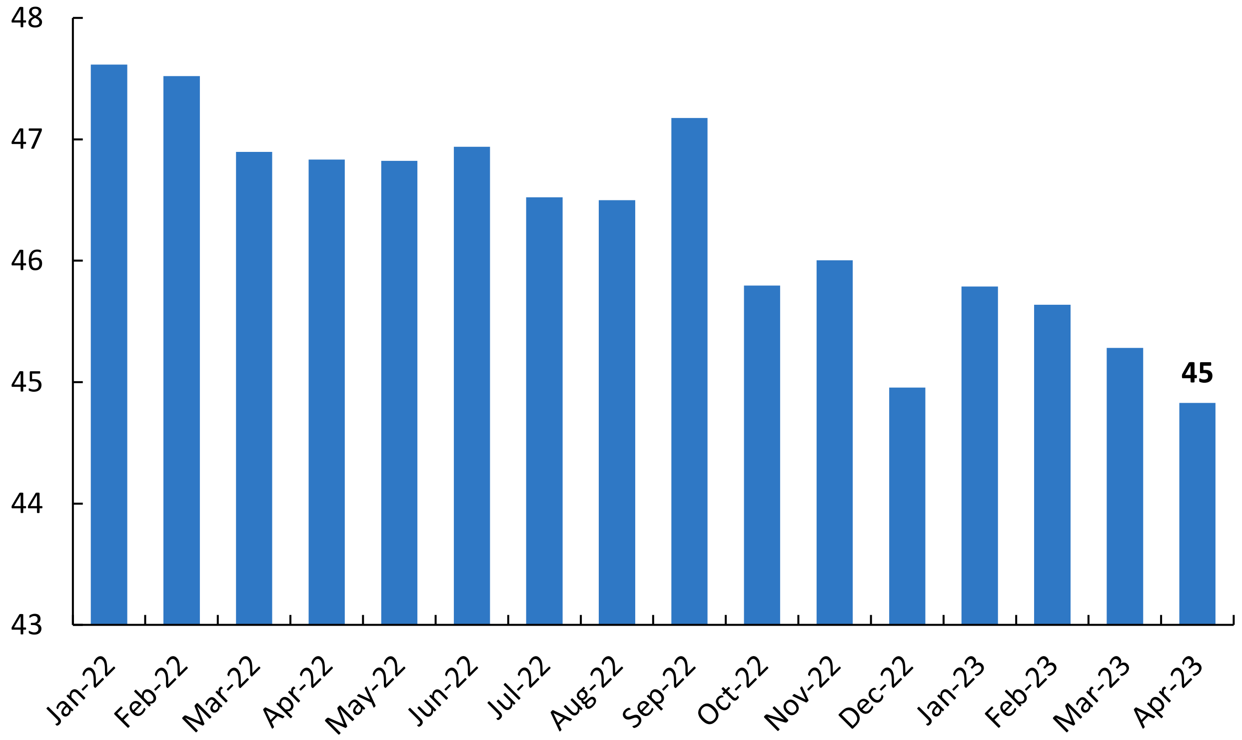
The jobs and incomes arising from foreign capital inflows and the government's fiscal measures for social programs are helping support domestic consumption. The increased consumption has fuelled inflationary pressure in the economy. In response to the inflationary pressure, Mexico’s central bank has raised the policy rate 725 basis points to 11.25% to help slowdown demand and to push inflation down.

Inflation, which reached 8.7% in August 2022, is on its way down and now sits 5.8% in May. Given the progress so far made on fighting inflation, the Central Bank paused rate hike in May and isn't likely to hike interest rate for the balance of this year.

France

French consumption has been declining since late 2022

Real total household expenditure, millions of 2014 euros



Sources: Haver Analytics, EDC Economics

France is expected to grow 0.6% in 2023, and further expanding 0.9% in 2024.

With consumption driving nearly half of gross domestic product (GDP) in France, weakness in the French consumer will always translate into weakness in French and European economic data. While the economy is expected to dodge a recession in 2023—a forecast growth of 0.6% indicates that 2023 will remain a challenging year.

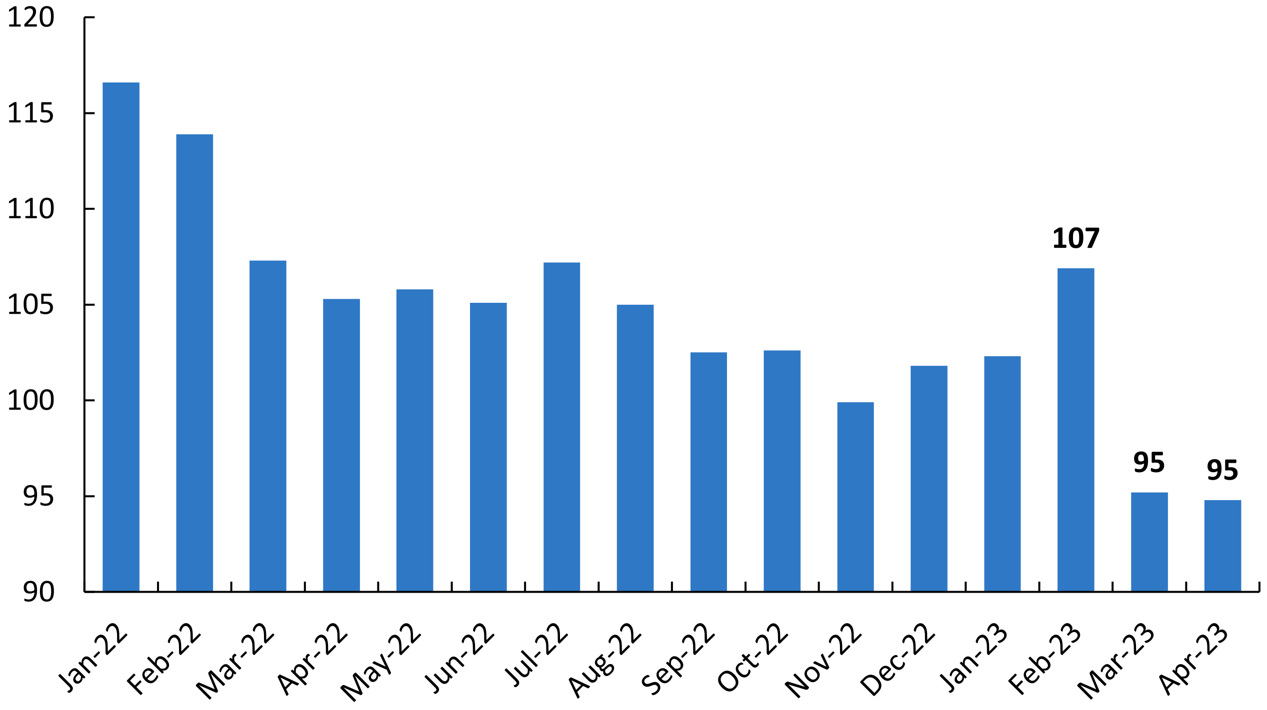
The French government is on a structural mission to reduce the role of government in the economy. The government has lowered budget deficit targets for 2023 and is working towards reduction in public spending as part of its 2027 medium-term goals. While exports have lifted growth in the first half of 2023—this performance is unlikely to be repeated given the one-off nature of exports increasing after supply chain normalization.

French consumers were shielded from energy bills in 2022 by government support measures. They'll deal with higher inflation and energy prices in 2023 as these support measures are phased out.

Germany

Manufacturing order books are thin despite supply chain normalization and Chinese reopening

2015 = 100



Sources: Haver Analytics, EDC Economics

Germany enters 2023 in a state of technical recession with the economy contracting by 0.3% in the first half of 2023 after a 0.5% contraction in the latter part of 2022. The economy is expected to contract by -0.1% in 2023 followed by growth of 1.3% in 2024.

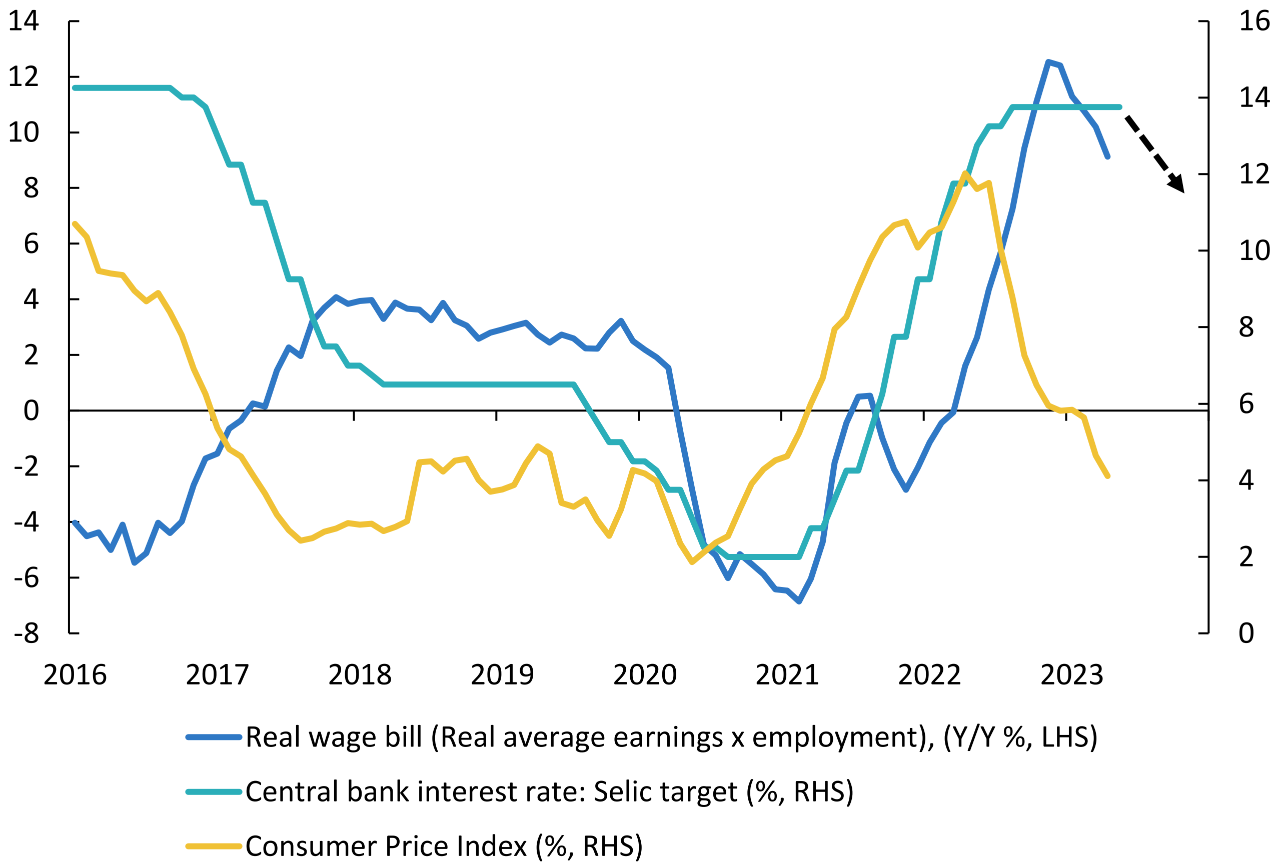
While the anticipated energy crunch following the Russian invasion of Ukraine failed to materialize last winter, consumers and businesses continue to grapple with a "stagflationary" environment, which has dampened household spending, curtailed business investment with limited benefits coming from Chinese reopening. Structural challenges remain in terms of finding an alternative to cheaper Russian gas imports, as well as a reliance on the Chinese market for exports.

The slow death of the internal combustion engine also poses challenges to the automotive sector, which has been an important pillar for German economic growth.

Brazil

Lower inflation and interest rates will support demand resilience

Percent



A record bumper crop, lower inflation, solid labour market, and boosted social transfers will support economic resilience amid the challenging demand fundamentals, with growth of 2.6% in 2023 and 1.6% in 2024.

Brazil's economy continues to surprise on the upside. The large agricultural harvest represents a significant supply shock that'll turbocharge this year's growth. Positive spillover effects to the broader economy and associated disinflationary effects, as well as lower-than-expected inflation prints, will also fuel resilience in what was otherwise slowing domestic demand dynamism due to the high interest rate environment. As a result, private consumption and exports will be key drivers of economic activity. Brazil's central bank—which hiked its interest rate sooner and faster than most—is now expected to bring forward its easing cycle of gradual rate cuts given the improved inflation backdrop and the virtual removal of fiscal sustainability tail risks following the approval of the new fiscal framework. Amidst tight financing conditions, lower interest rates will be a welcome development to the sovereign, consumers, and businesses.

Upside risks to Brazil's outlook include a faster pace of interest rate cuts, approval of the long-awaited tax reform, renewed strength in China's economy spurring demand for Brazilian commodities, and better-than-expected global growth fuelling investment and terms of trade tailwinds.

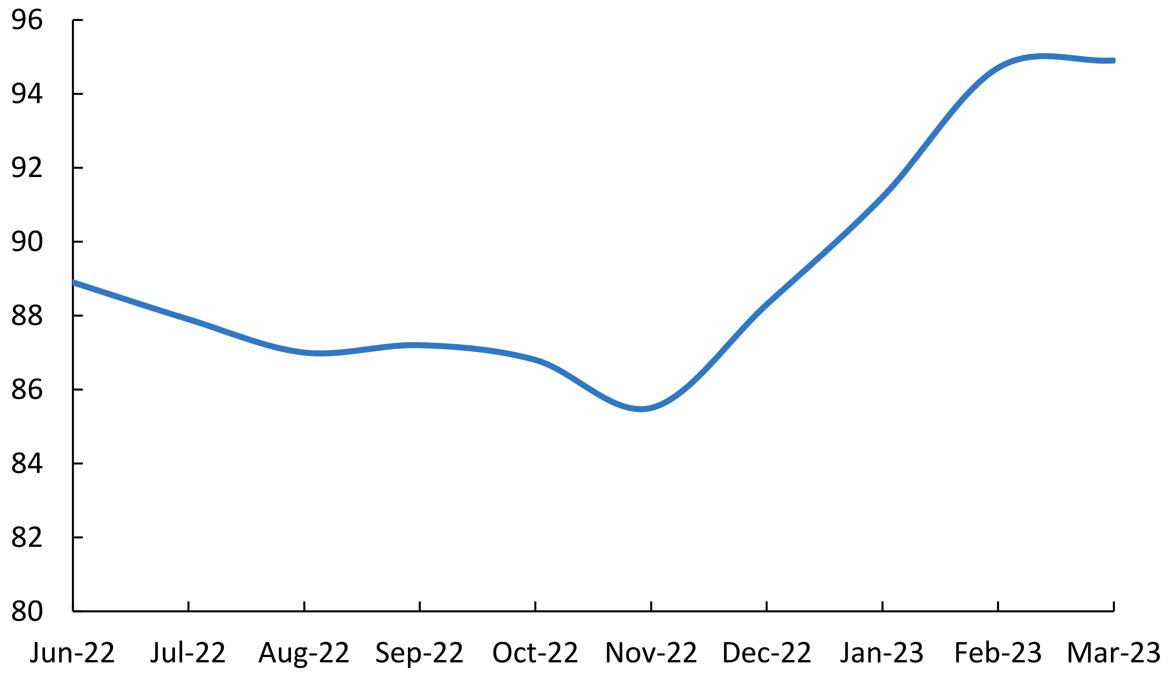
The main downside risks include rebounding inflation expectations or fiscal policy shocks that delay the central bank's monetary easing cycle, political volatility leading to legislative gridlock on key reforms, and lagging Chinese and global growth.

Sources: Banco Central do Brasil, Instituto Brasileiro de Geografia e Estatística, Haver Analytics, EDC Economics

China

Consumer confidence has temporarily improved, but still weak

100+ = optimistic, NSA



Sources: Haver Analytics, EDC Economics

China is forecast to grow by 5.5% this year on the back of a consumption-led recovery following the end of its zero-COVID-19 policy in 2022. Gross domestic product (GDP) growth is expected to moderate to 4.7% in 2024.

The frontloaded consumption-led recovery (mostly services) is expected to continue into Q2 as consumer confidence is still buoyant, but is likely to lose momentum as we enter the second half of the year—as has been the pattern for most markets following a post-pandemic reopening.

Automotive exports remain the bright spot amid an otherwise weak export outlook. We expect exports to remain soft for 2023 amid ongoing weak global demand. Overall, the economic recovery remains uneven as it's primarily focused on consumption. Industrial profits remain weak, and the property sector is still struggling as developers focus on finishing existing projects rather than new construction. With youth unemployment at almost 20%, the government is looking to support consumer and private sector confidence in the economy, to keep the recovery on track.

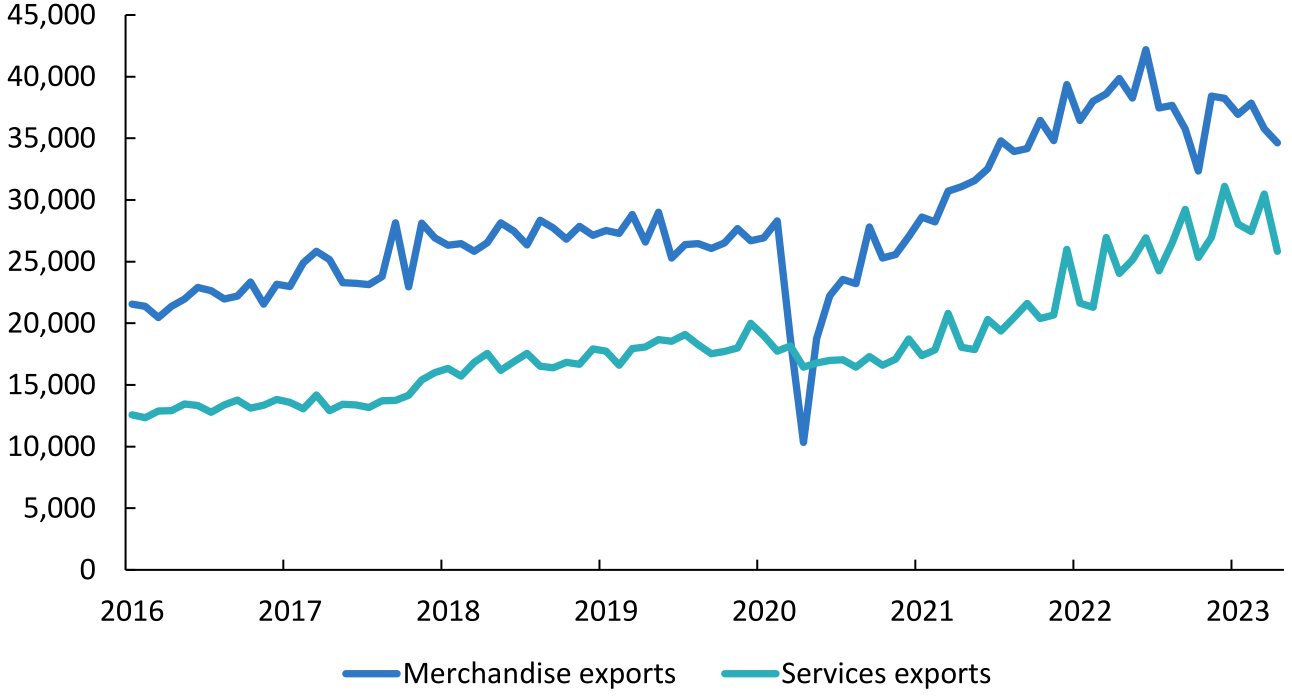
Upside risk is a strengthening of the global outlook, which would support stronger exports.

The main downside risk is escalating geopolitical tensions over Taiwan coupled with rising U.S.-China tensions impacting trade.

India

Exports leading the way

Millions, USD



The Indian economy continues to keep momentum and is set to be the fastest-growing major market in the world, with expectations of 5.3% growth in 2023 and 7% in 2024.

While performing below its own growth targets for this year and next, India is still outperforming its peers amidst a challenging global backdrop. Consumption has been measured to date in 2023, but will likely pick up speed as we head into 2024 with inflation softening and the Reserve Bank considering a rate cut later in the year.

Indian exports continued to grow by 12.1% in the first quarter and maintained their meteoric ascent since 2021, driven by growing global demand for Indian services. Investment has stayed strong and will drive the economy forward, even under tighter credit conditions, with major capital-intensive societal shifts underway and India's deepening importance in global supply chains driving its attractiveness with major multinationals.

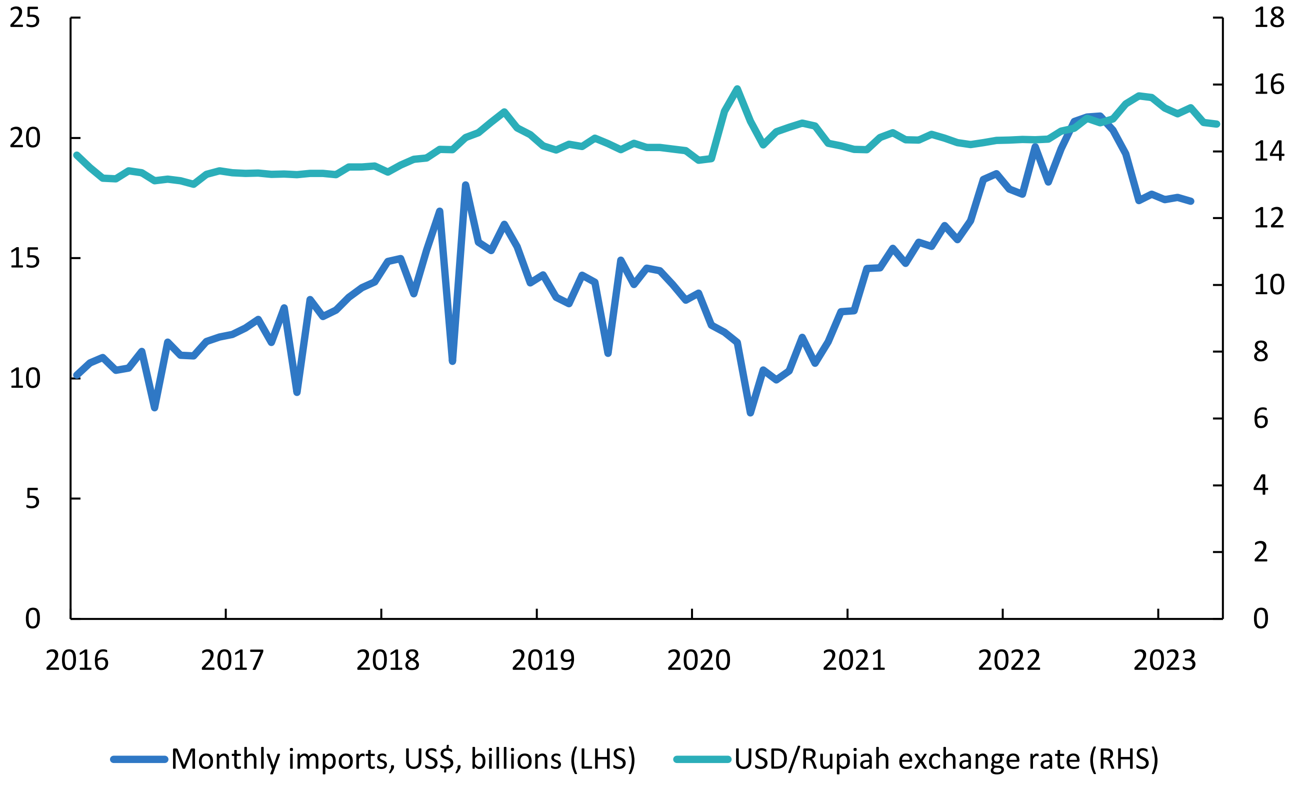
A protracted global downturn or recession that drags further on demand and investment is the main downside risk.

Upside risk to India’s outlook is better-than-expected inflation readings in coming quarters and a faster credit-easing cycle.

Sources: Haver Analytics, EDC Economics

Indonesia

Stable prices supporting consumer demand



Sources: Haver Analytics, EDC Economics

Indonesia continues to benefit from strong pricing and demand for its major exports and is set to grow at a considerable rate over the outlook period, by 4.8% in 2023 and 5.1% in 2024.

Unlike several other emerging markets, Indonesia has been spared the worst of softening global demand, inflation and the pressures from rising interest rates. Soaring goods exports and a trade surplus have allowed for the market's currency—the rupiah—to avoid the major volatility and depreciation from a strong USD, which in turn has supported domestic consumption and imports. With inflation readings remaining stable so far into 2023, consumers and manufacturers are optimistic that the Bank of Indonesia will begin easing credit conditions before long. Investors, too, are feeling bullish on Indonesia as an increasingly desirable market with tremendous growth and diversification potential, even if investment has plateaued under current conditions.

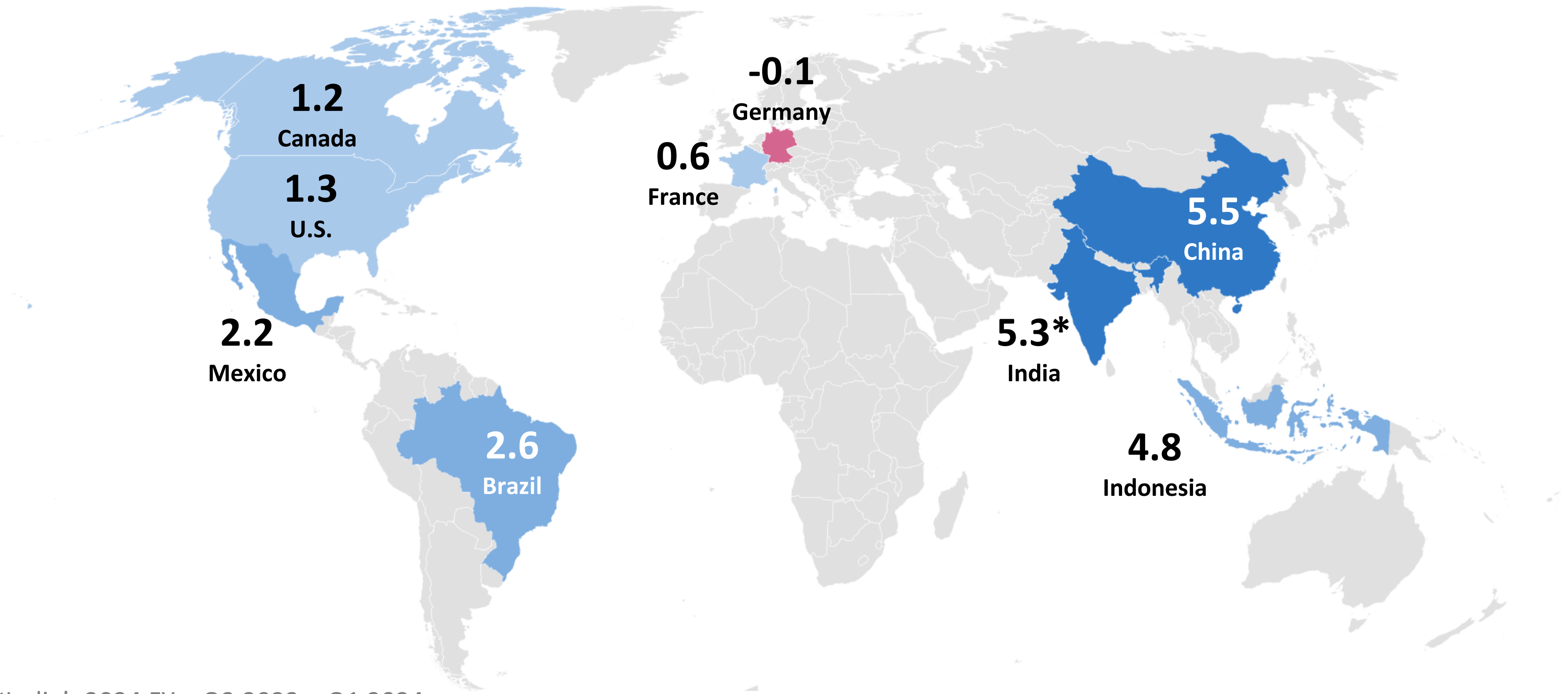
Downside risk is a faster and more acute carbon transition in the global economy, that reduces demand and pricing for Indonesia's principal exports: coal and palm oil.

Upside risk is a more sustained global reconfiguration and diversification of existing supply chains and investment in Asia.

Forecast

2023 growth outlook

Real GDP growth, %



2.9%
World

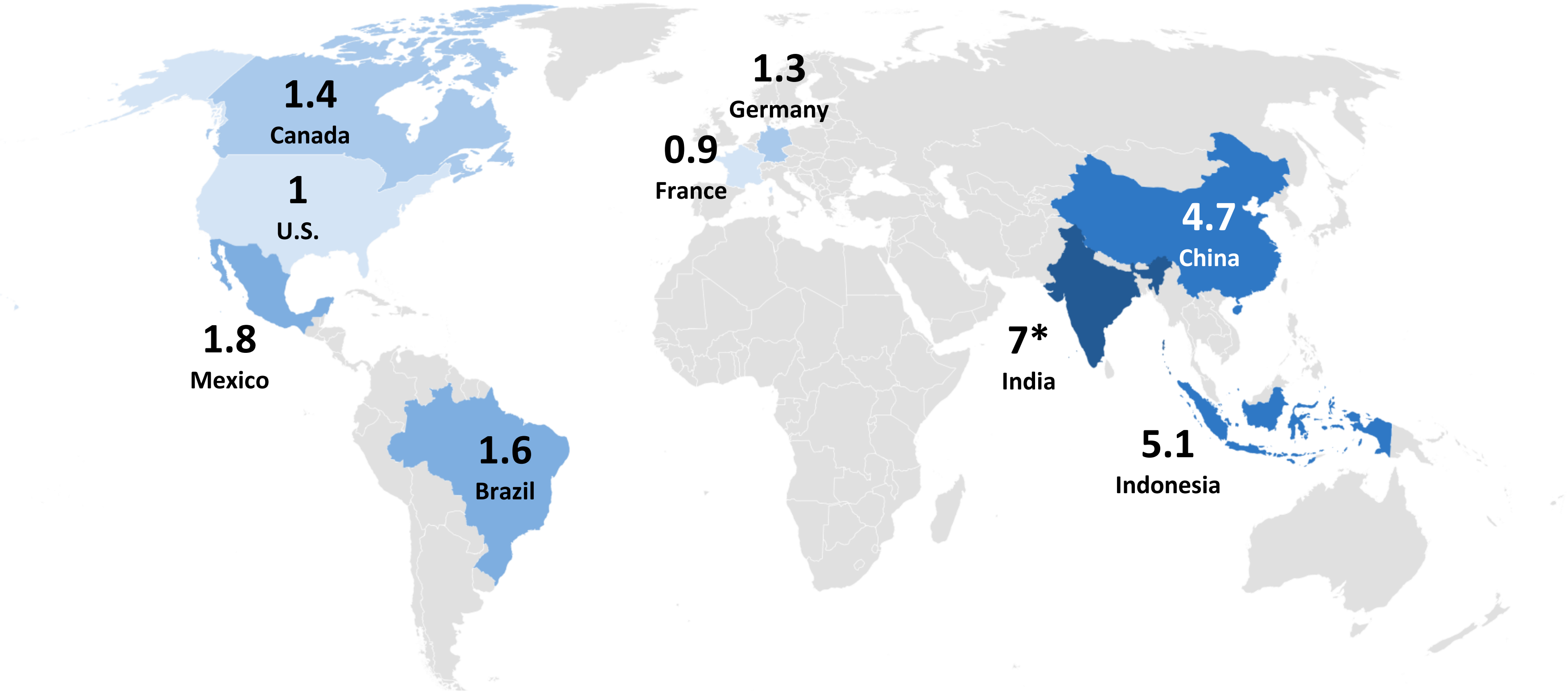
1.1%
Developed

4.3%
Developing

*India's 2024 FY = Q2 2023 – Q1 2024
Note: Red shading indicates a recession
Source: EDC Global Economic Outlook, June 2023

2024 growth outlook

Real GDP growth, %



3%
World

1.2%
Developed

4.4%
Developing

* India's 2025 FY = Q2 2024 – Q1 2025
Note: Red shading indicates a recession
Source: EDC Global Economic Outlook, June 2023

Real GDP growth

Global Economic Outlook (Annual % change)	2022	2023*	2024*
Developed countries	**2.7**	**1.1**	**1.2**
Canada	3.4	1.2	1.4
United States	2.1	1.3	1
Eurozone	3.5	0.9	1.1
Germany	1.9	-0.1	1.3
France	2.6	0.6	0.9
Developing countries	**4**	**4.3**	**4.4**
China	3	5.5	4.7
India	7.3	5.3	7
Indonesia	5.3	4.8	5.1
Brazil	3	2.6	1.6
Mexico	3	2.2	1.8
World	**3.4**	**2.9**	**3**

Note: * denotes the forecast period. India’s forecast based on fiscal year (2024 FY = Q2 2023 – Q1 2024, 2025 FY = Q2 2024 – Q1 2025)
Source: EDC Global Economic Outlook, June 2023

Changes from previous forecast

Global Economic Outlook Real GDP growth (percentage point change)	2023*	2024*
Developed countries	**0.3**	**-0.2**
Canada	1.1	-0.3
United States	0.3	-0.2
Eurozone	**0.3**	**-0.1**
Germany	-0.1	-0.1
France	-0.1	-0.4
Developing countries	**0.6**	**-0.1**
China	0.5	-0.1
India	-0.8	-0.7
Indonesia	-	-
Brazil	1.8	-0.3
Mexico	1	-0.1
World	**0.5**	**-0.1**

Note: * denotes the forecast period. Green shading represents upward adjustments; red shading represents downward adjustments;
Source: EDC Global Economic Outlook, June 2023 relative to March 2023.

Currencies and interest rates

Global Economic Outlook		2022	2023*	2024*
Currencies	**Exchange rate**			
U.S. dollar	**USD per CAD**	$0.77	$0.74	$0.74
Euro	**USD per EUR**	$1.05	$1.09	$1.10
Euro	**CAD per EUR**	$1.37	$1.48	$1.48
Interest rates, annual average				
Bank of Canada, *Overnight target rate*		1.94	4.74	3.99
U.S. Federal Reserve, *Fed Funds Target Rate (Upper limit)*		1.86	5.19	4.71
European Central Bank, *Policy interest rate*		0.58	3.74	3.85

Note: * denotes the forecast period.
Source: EDC Global Economic Outlook, June 2023

Commodity prices

Global Economic Outlook	2022	2023*	2024*
Brent Crude Spot, *USD / barrel (bbl)*	$100.78	$81.89	$77.4
West Texas Intermediate, *USD / bbl*	$94.6	$76.75	$72.97
Western Canada Select, *USD / bbl*	$75.02	$59.91	$58.47
Natural gas, *USD / MMBtu*	$6.37	$2.49	$3.02
Gold, *USD / troy ounce*	$1,801	$1,912	$1,801
Copper, *USD / tonne*	$8,813	$8,654	$8,829

Note: * denotes the forecast period.
Source: EDC Global Economic Outlook, June 2023

Key forecast assumptions

1. Monetary policy

While the pace of inflation is slowing, most countries will remain above central bank targets in the very near term. As such, interest rates are likely to be higher (more restrictive) than otherwise would be the case in a low-growth environment, before gradually returning to long-term rates. Beyond inflation, central banks will be monitoring recent U.S. banking sector stress and high levels of indebtedness, which are exacerbating the effects of higher interest rates. There's increased room for divergence between interest rates in the U.S., Canada and Europe. In developing markets, China will likely keep accommodative measures in place while other markets will be forced to keep rates elevated in the face of weak domestic conditions.

2. Financial conditions

While Economics' baseline outlook doesn't anticipate a systemic financial crisis, as households and corporations draw down their savings and adjust to high interest rates, stresses are building up in segments of the economy. This is further complicated by financial market turbulence caused by ongoing U.S. banking sector issues. Insolvencies could reach multi-decade highs (excluding the Global Financial Crisis) in particular, for corporations and sectors that are highly leveraged or more exposed to variable interest rates. Sovereign defaults and balance of payments crises are occurring in a growing number of markets, now expanding beyond frontier markets to larger emerging markets. Economic conditions are increasingly dependent on financial conditions. An ensuing recession would largely be driven by feedback between monetary policy and broader financial market conditions.

3. Russia-Ukraine war

The basecase sees the Russia-Ukraine war settling into a stalemate. Fighting will continue but armed conflict isn't expected to spillover beyond Ukraine. Western sanctions against Russia will remain in place beyond the forecast period with increasing risk of secondary sanctions to target non-U.S. and non-European Union (EU) companies or persons involved in commercial activities with Russia. Despite these sanctions, Russia continues to export a significant amount of commodities to other countries. Despite prices being heavily discounted—which impact the Russian economy—the availability of supply has reduced risks of a supply crunch. Supply chain adjustments have limited the impact on key commodities.

4. U.S.-China relations

The rise of China in relation to the U.S. is slowly changing the balance of power. EDC Economics expects the U.S., EU, and other bilateral relations with China to continue to be constrained and susceptible to increased uncertainty. We don't foresee a material improvement in relations between the U.S. and China with each increasing influence in key sectors.

5. Global fiscal policy

Fiscal policy will serve as a headwind to economic growth. As monetary policy conditions tighten, there's an increasing strain between monetary and fiscal authorities. For some markets, exchange rate depreciation, large deficits and higher borrowing costs are putting pressure on governments to rebalance public finances. Fiscal policy manoeuvring will be even more restrictive for countries who face deteriorating risk ratings. In the long term, most economies are expected to face pressures to increase spending due to aging populations, as well as increasing spending to areas around health care, defence and climate policies.

Disclosure

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