policy
hive

7 risk scenarios to the world economy

Policy briefing – 30 July 2022

The recent flagship reports by leading international forums – the IMF in April and in July, the WEF in May, the OECD, World Bank and BIS in June respectively – offer a fairly consistent picture of the years to come: in 2022, a peak in inflation and, in response, a gradual monetary tightening, followed by a "soft landing" in 2023, and in 2024 we would be back to business and to the Great Moderation.

The assumptions are more or less the same in economic forecasts for 2023-2024:

- Central banks are successful in engaging an orderly tightening of monetary policy to curb inflationary pressures;
- The war in Ukraine is contained to the eastern border, no further sanctions are made aside from those already implemented and no further disruptions to energy supply arise;
- The pandemic is over despite controlled outbreaks in a few countries while vaccination rates increase continuously;
- The bottlenecks in labour markets and in global supply chains are gradually resolved;
- Pandemic-related fiscal support measures are phased out and replaced by smaller but targeted support for the most vulnerable.

Whatever happens next, the recent events – disruptions in global supply chains and rise in inflationary pressures, the war in Ukraine, lockdowns in China – signal the end of an era from the past decade of accommodative monetary policy and low inflation. The fear of inflation becoming de-anchored, i.e. getting out of control because firms and households' own expectations, is reflected in the increasingly hawkish attitude of central bankers.

The mood is shifting from whatever-it-takes to support the economy, to whatever-it-takes to kill inflation. For the BIS "*the most pressing challenge for central banks is to restore low and stable inflation without, if possible, inflicting serious damage to the economy*". Almost half of the chief economists surveyed by the WEF "agree" or "strongly agree" that "*the risk for long-term growth due to higher inflation outweigh the risk from contraction due to monetary tightening*". The above assumptions are becoming increasingly improbable ones. That is true for monetary tightening being subtle and orderly, and for energy restrictions not increasing beyond those foreseen by the sanctions in April.

In their forecasts and projections, international organisations highlight a number of downside risks that could derail the baseline scenarios. What are those? A closer look helps single out seven scenarios.

policyhive.org
contact@policyhive.org

Paris, July 2022

A deepening of energy and commodity crisis: the war in Ukraine has a much more profound impact on energy and commodity supply due to the sanctions against Russia combined with a shutdown of gas exports to Europe. The OECD estimates that a full embargo scenario would push most European countries into recession or close to it in 2023. In its latest July forecast, the IMF suggests that such scenario would cut global growth from 3.2% to 2.8% in 2022 and from 2.9% to 2.6% in 2023.

Monetary tightening turns aggressive: inflation expectations get out of control, forcing central banks to engage in aggressively raising interest policy rates. The sudden rise in rates would help curb inflation pressures, but it would come at a severe cost for people and businesses, running the risk of a hard landing for the global economy. IMF projections under this scenario would see global growth forecasts shift from 3.2% to 3% in 2022 and from 2.9% to 2.3% in 2023.

The combination of the two downside risk scenarios – energy restrictions + aggressive tightening – would bring the global economy growth to a mere 2% in 2023, a level not seen for decades, and push the EU to the edge of recession with a -0.1% IMF forecast in 2023. As if prospects were not gloomy enough, international organisations are tabling five other downside risk scenarios for the next five years.

The pandemic continues combined with a Chinese slowdown: a new Covid-19 variant(s) emerge(s) and the pandemic is far from being over. The zero-covid policy in China turns into an economic disaster, which in turn exacerbates existing vulnerabilities of the Chinese economy and financial system: high levels of debt of local government, property developers, and households and a financial system that lacks transparency and regulatory checks.

Financial markets destabilised: aggressive monetary tightening not only kills growth in advanced economies but also triggers a major financial crisis of the magnitude of 2008. Massive capital flight destabilise emerging economies, while financial vulnerabilities accumulated throughout the past decade of monetary policy easing come to implosion. For the BIS, *"structural vulnerabilities in the form of hidden leverage and liquidity mismatches loom large in the asset management sector".*

A disorderly climate transition: fossil fuel energy shortfalls are not compensated by renewable energy while mispricing of carbon remains an issue. Such disorderly transition would cut down productivity, costing between 5–10% GDP point by 2040, with a higher impact for China and India. A recent report by French CEPII estimates that both countries would account for over 55% of world energy consumption by 2050.

A transition to war economies: geopolitical conflicts change scale and lead to a rearmament of Western Europe. In times of fiscal consolidation and competing public priorities, rearmament – reaching 3% of GDP – crowds out growth and sustainable development-oriented spending (education, health, infrastructure and climate transition) and does so with a much lower fiscal multiplier.

Leading economies go for re-shoring: geopolitical tensions also lead to re-shoring and "friend-shoring" strategies among advanced economies, most notably Western Europe and North America – prompting similar retrenchment policies by China. According to the World Bank, this scenario of "reshoring" by leading economies would have a negative impact across the board, including real income decreasing by 1.5% worldwide by 2030. The impact would be minimal for advanced economies and highest for China and for developing economies at large.

Paris, July 2022