The Big Picture

2023 Economics & Country Risk Outlook

A look ahead to the key strategic trends and opportunities expected to drive the Economics & Country Risk narrative through 2023 and beyond.

S&P Global
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Introduction

Going into 2022, the question on many minds was the pace of the pandemic recovery. The Economics & Country Risk team expected to see countries traverse different pathways even as the critical drivers of risk (climate agenda, supply chain disruptions, migration) became increasingly intertwined. Businesses would find themselves navigating a global economy in transition – around the COVID-19 pandemic, fiscal policy and the energy transition.

Russia's invasion of Ukraine dashed all optimism of a smooth recovery. Instead, the year brought commodity price runs, historic inflation rates, monetary tightening, additional supply chain disruptions, a refugee crisis at the center of Europe and renewed worries around energy security.

The invasion of Ukraine also hastened confrontation with a host of geopolitical risks that we were following in a post-Afghanistan conflict, post-Brexit world. The interconnected challenges of global security partnerships, financial integration, supply chain resilience and migration are no longer simmering in the background. They are now top of the agenda and will likely continue to stay there in the year ahead.

The Take

The interconnected challenges of global security partnerships, financial integration, supply chain resilience and migration are no longer simmering in the background, they are now top of the agenda and will likely continue to stay there in the year ahead.

With Ukraine's fall counteroffensive and given its position to recover the territory Russia has annexed since 2014, the conflict looks set to continue deep into 2023, with few politically palatable off-ramps available for Russian President Vladimir Putin.

Entering 2023, much depends on the severity of the European winter, on likely further sanctions, and on prospects for global measures being considered to cap the price of Russian oil. Economic and energy security concerns will drive short-term mitigation strategies in Europe, increasing fiscal, social and political challenges for governments - especially those facing scheduled elections in 2023.

Tightening financial conditions will lead to a further slowdown in global economic growth, putting expansions in vulnerable regions at risk and deepening anticipated recessions in Europe. The combination of subpar economic growth, rising unemployment and improving supply chain conditions will eventually cause inflation to subside over the next two years.

Russia’s invasion of Ukraine

Soundbite

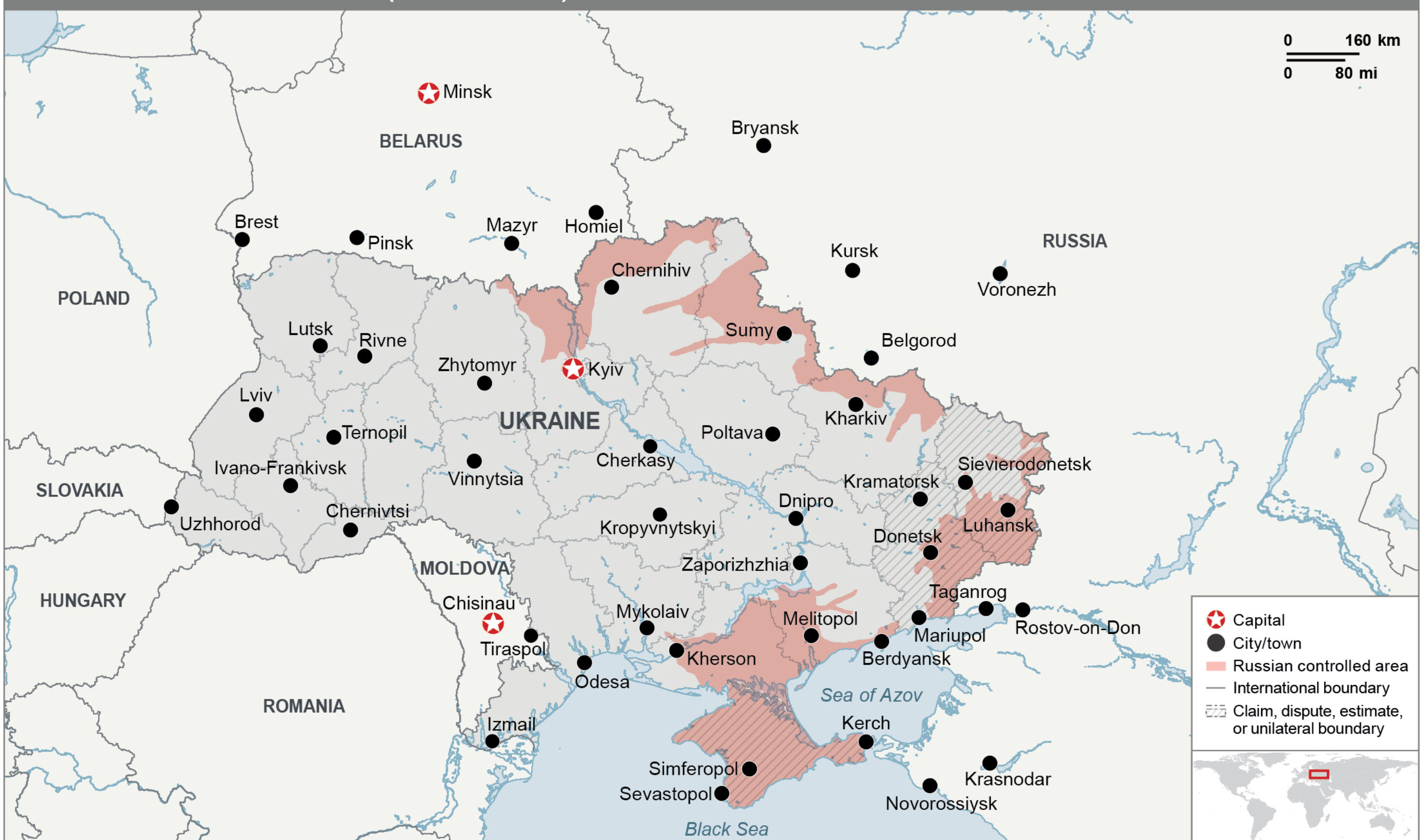
Russia’s regional ambitions represent a longstanding open test. The invasion of Ukraine has precipitated a confrontation with a host of geopolitical risks and transformed the near-term security and economic picture.

How did we get here?

Following years of simmering stresses, we noted in October 2021 that Russian objections to the Ukraine-North Atlantic Treaty Organization (NATO) cooperation elevated conflict risks. A key indicator was tripped when Russia formally recognized the Donbas breakaway entities on Feb. 21, with the Russian invasion following only days later. Together, the Russian invasion and the response from Ukraine’s allies quickly impacted supply chains and global energy markets, as the Russian forces made rapid gains on the ground and blockaded Ukraine’s Black Sea ports. Russian actions sparked a shift in the EU’s Russia policy, signaled both through sanctions and defense support to Ukraine. Commitments to NATO have strengthened and defense budgets amongst Russia’s neighbors were boosted, indicating a long-term shift in posture. In 2022, hard security interests clearly became more important than commercial relationships with Russia for the first time in many years. For other big global players, the response has been more nuanced, with many opting to preserve neutrality.

As the ground war developed in its early stages, with Kyiv and other major cities coming under attack and at risk of capture, we assessed, in March 2022, escalation pathways including incursions into neighboring countries and the potential use of nuclear and other non-conventional weapons. The economic war intensified, through Russian leverage of gas supplies on one side, and Western sanctions on the other. In parallel, the use of cyberattacks threatened critical national infrastructure not just in the combatant nations but also in allied nations,

Russia’s invasion of Ukraine (2 March 2022)



Source: Various data sources/IHS Markit: 2005718 raising wider concerns in markets and governments about their vulnerability to hybrid warfare impacts. Additionally, more than 1,000 multinational firms opted to exit the Russian market, even in cases where their operations were not directly impacted by the sanctions.

As United States' and European allies quickly ramped up weapons supply and training support to Ukraine, and Russia's military deficiencies became increasingly evident, Russia's advance slowed. Our risk intelligence experts noted the likelihood of Russia increasingly employing tactics similar to those it had used previously in Syria and Chechnya, with mass shelling of civilian population centers attempting to break Ukraine's resolve. But by early autumn 2022, Ukrainian counteroffensives had changed the battlefield dynamics so significantly that Russia had introduced military conscription and has not ruled out the use of nuclear weapons.

The takeaway

With Ukraine's fall counteroffensive, and given its position to recover the territory Russia has annexed since 2014, the conflict looks set to continue deep into 2023, with few politically palatable off-ramps available for Russian President Vladimir Putin. Only a major escalation, such as the use of chemical, biological, radiological and nuclear defense (CBRN) by Russia, is likely to bring NATO directly into the conflict in Ukraine or the Black Sea. With neither side seemingly able to produce a conclusive victory in the immediate term, a stalemate and an ongoing intense sanctions regime, becomes more likely.

Signposts

- Russian efforts to mobilize more conscripted troops fail to improve the effectiveness of their ground forces in Ukraine.
- China and other major non-aligned powers proactively lobby against Russian use of nuclear or other CBRN defense in Ukraine.

Russia's invasion of Ukraine (26 October 2022)

Source: External data sources/ data taken from IHS Markit ECR/midstream content (EDIN): 2007709

Energy security in focus

Soundbite

Russia has leveraged energy security as a second front in the conflict with Ukraine to destabilize Europe. Ongoing disruptions to natural gas supplies to Europe remain key for governments, markets, and companies, with impacts felt globally on prices and supply chains. With the trajectory of the war in Ukraine potentially leading to more sanctions and disruptions, markets and governments face ongoing challenges to effectively mitigate the consequences of Russia's use of gas supplies as a strategic lever.

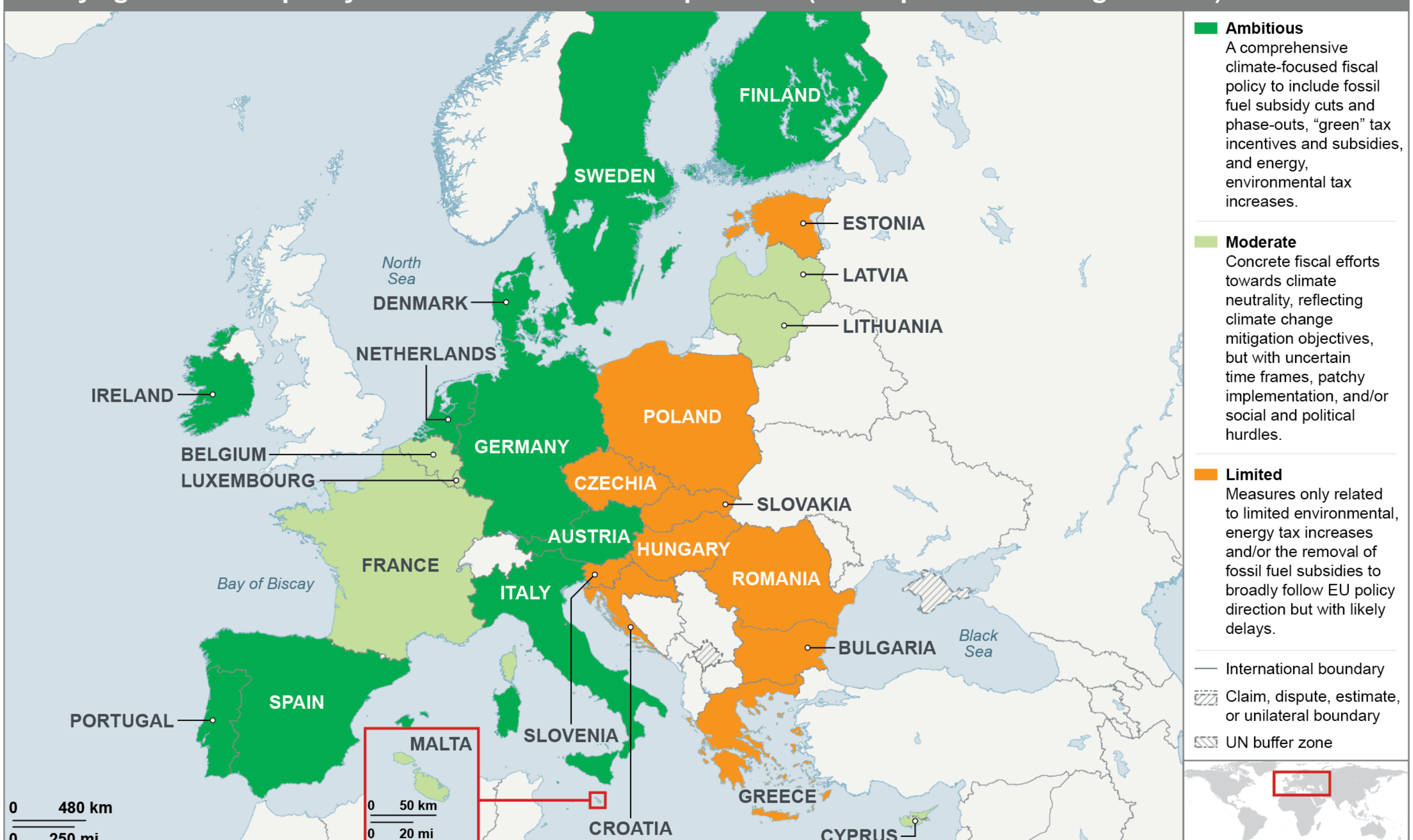
Russia's strategy, though, is not without serious downside risk. Its short-term gamble to drive up energy prices and with great effect in Europe is precipitating a longer-term reorganization of energy infrastructure and energy markets - laying the groundwork for Russia to potentially play a smaller role in the global economy.

How did we get here?

Concerns about the energy security of Europe due to the potential opening of the Nordstream 2 subsea gas pipeline were high well before Russia's Feb. 24 invasion of Ukraine, and energy prices were already becoming a European political concern pre-invasion. But the invasion directly shocked global energy markets and wider supply chains. The response from the EU, U.S. and allies through sanctions and other measures increased that global shock. As Ukraine and the Black Sea became an established hot conflict zone, global economies rushed to ensure their own supplies, and energy prices soared to new peaks, causing multi-sector impacts.

By the fall, high energy prices across Europe, the main upside risk to our eurozone inflation forecasts in the short-term, pushed the cost-of-living crisis front and center across the region. Alongside EU institutional efforts, national-level governments across Europe (including outside the EU) are pursuing measures of their own including tax cuts, subsidies and consumer price caps to mitigate household burdens as

Likely "green" fiscal policy initiative across the EU up to 2024 (assumptions as of August 2021)



Source: IHS Markit: 2007525

well as introducing greater government interventionism and protectionism in regional energy markets. The success, or otherwise, of these measures through the European winter 2022/23 will be a key factor shaping not only energy markets but also political stability and electoral outcomes across Europe in 2023.

European vulnerability to Russia's dominant position as regional gas supplier after the Feb. 24 invasion reinforced the EU's ambition to move quickl y on energy transition. However, as we observed in early October, high energy prices have already muted that ambition in the two-year outlook. While the phasing out of fossil fuel subsidies has slowed significantly as governments seek to shield consumers from the effects of high energy prices, other EU measures – such as the Energy Taxation Directive – are unlikely to be adopted before 2024/25.

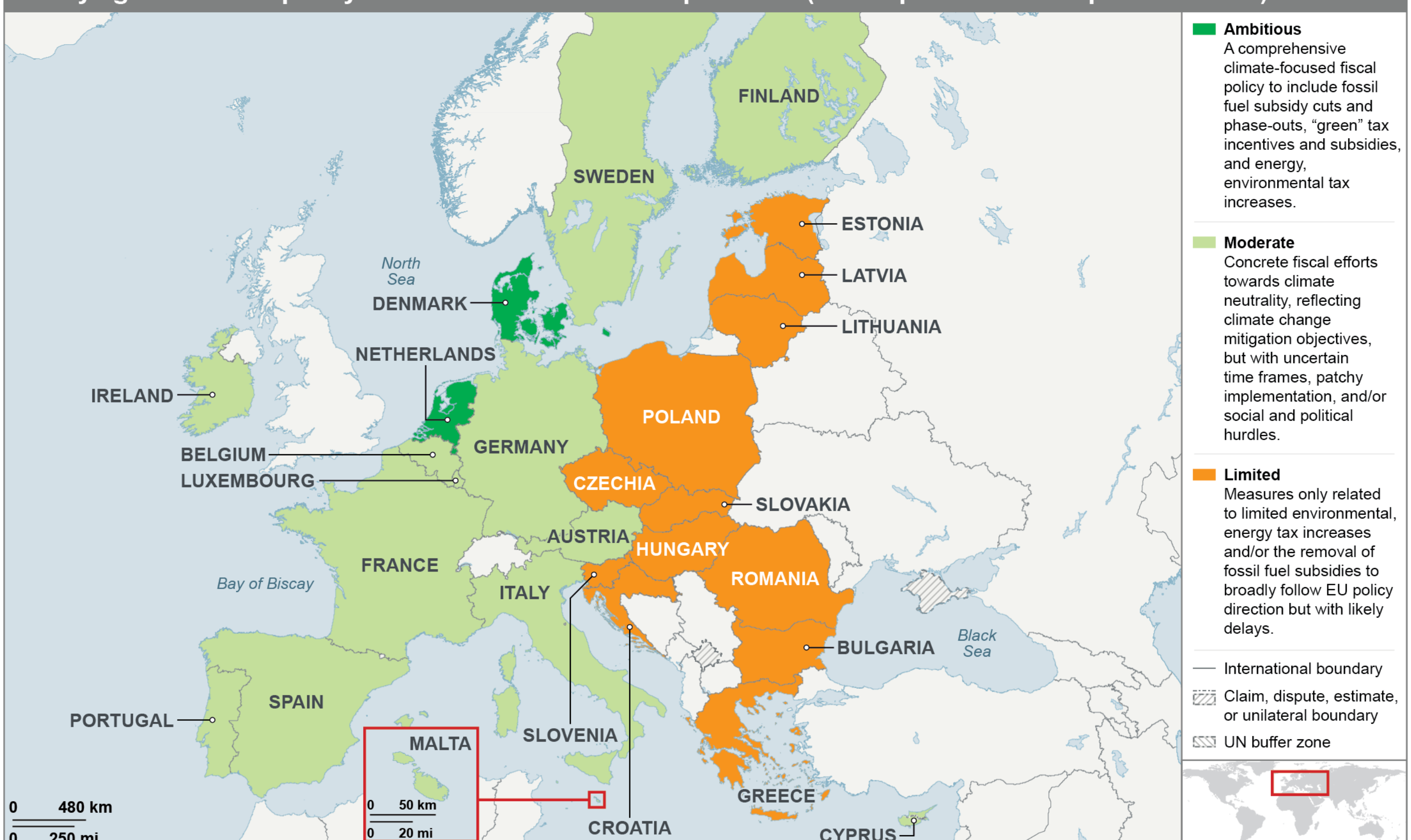
The takeaway

Entering 2023, much depends on the severity of the European winter, on likely further sanctions, and on prospects for global measures being considered to cap the price of Russian oil. Stress in energy markets plays a pivotal role in our view that the eurozone will enter a recession around the turn of the year. Economic and energy security concerns will drive short-term mitigation strategies in Europe, increasing fiscal, social and political challenges for governments - especially those facing scheduled elections in 2023 (Poland, Finland, Estonia, Greece). We expect ongoing market intervention, especially in energy and other sectors deemed "economically strategic" in respective countries; heightened risk of policy delays or reversals, negatively impacting government stability and longevity (e.g., United Kingdom, Slovakia); as well as a rising trend of social unrest, especially labor strikes, in the region in 2023. The impacts of low gas flows and prices for oil from Russia will also continue to ripple globally.

Signposts

- Russian gas stops flowing through Ukraine to Europe, either due to unresolved contractual issues or a change in tactics by Moscow, to further increase economic and political pressure on the EU.
- EU governments struggle to respond effectively to the cost of living crisis, increasing social and political pressure from voters to soften some member states' Russia policy.

Likely "green" fiscal policy initiative across the EU up to 2024 (assumptions as of September 2022)



Source: IHS Markit: 2007526

Economies in transition

Soundbite

Inflation, rising interest rates and recessionary risk are on everyone's mind. Will monetary policy tightening – now a near global trend – be able to deliver a soft landing or at least a path to avoid global recession? If not, when will we enter a recession, how long will it last and how deep will the contraction be, are key questions ahead.

How did we get here?

According to the S&P Global Purchasing Managers' Index™ (PMI) survey conducted just ahead of Russia's invasion of Ukraine, there were signs of optimism. The invasion, Western nations-led sanctions and a follow-on wave of corporate self-sanctions dislocated Russia from the global economy, dimming its economic outlook for 2022 and 2023.

The casualties, property damage, infrastructure disruption and mass population exodus in Ukraine prompted by the conflict has also sent Ukraine's real GDP into massive contraction in 2022, with reconstruction tied to the trajectory of the conflict.

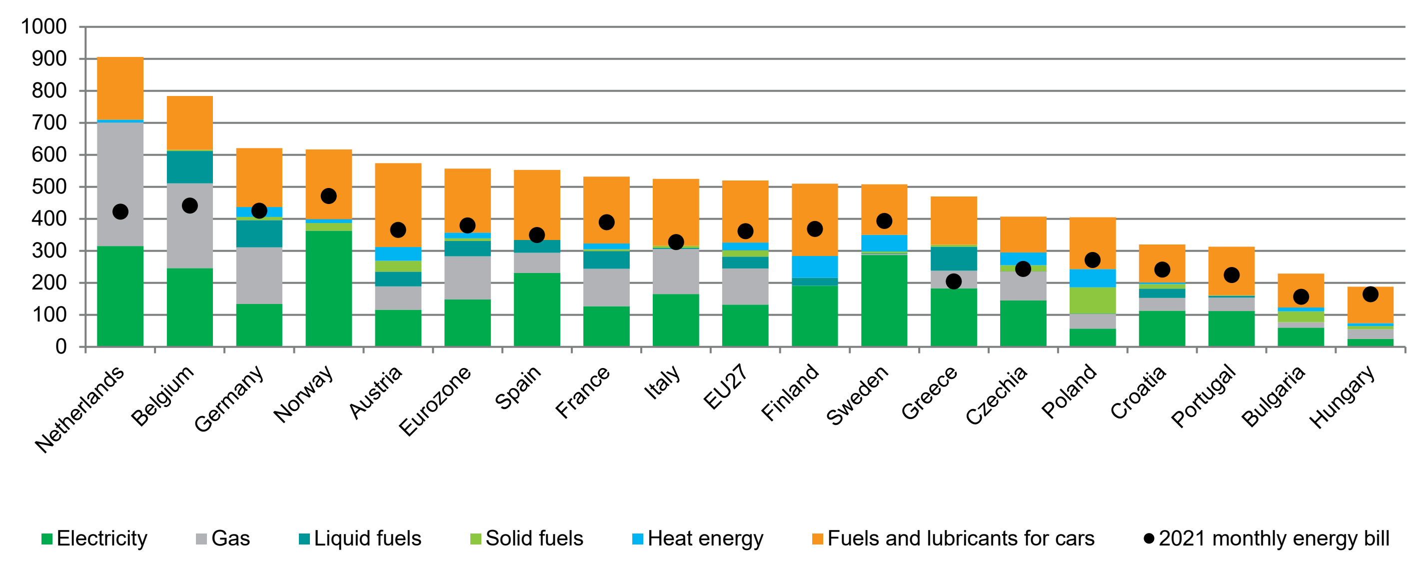
In addition to the direct effects of the invasion on the economies of Russia and Ukraine, the conflict has been threaded into the global economy through supply chain disruptions and commodity price surges, particularly across metals, agriculture and energy. In March, Economics & Country Risk was calling this the "everything rally", when our Materials Price Index (MPI) hit a record high for the four weeks ended 11 March, increasing by 21.5%. By mid-October, the MPI had fallen 30% from this early March peak.

Commodity price volatility and concerns over commodity supply – particularly energy security – have also affected global consumer prices. Our inflation forecast for 2022 represented the highest estimate since 1995.

Recognizing that high inflation will not quietly go away, the world's major central banks have embarked on a project to toughen their policies. By late 2022, gradualism had given way to super-sized interest rate increases and clearer resolve to restrain actual and expected inflation, despite the potential for adverse economic consequences.

High inflation and energy supply constraints are creating headwinds for growth. We now project global real GDP growth to slow from 5.9% in 2021 to less than 2.0% in 2023. The period of weakest growth and highest vulnerability will be late 2022 and early 2023, when a new major shock could tip the world economy into recession.

Monthly energy bill per household between Sep-22 and Mar-23 (EUR, highest value over period)



Source: IHS Markit

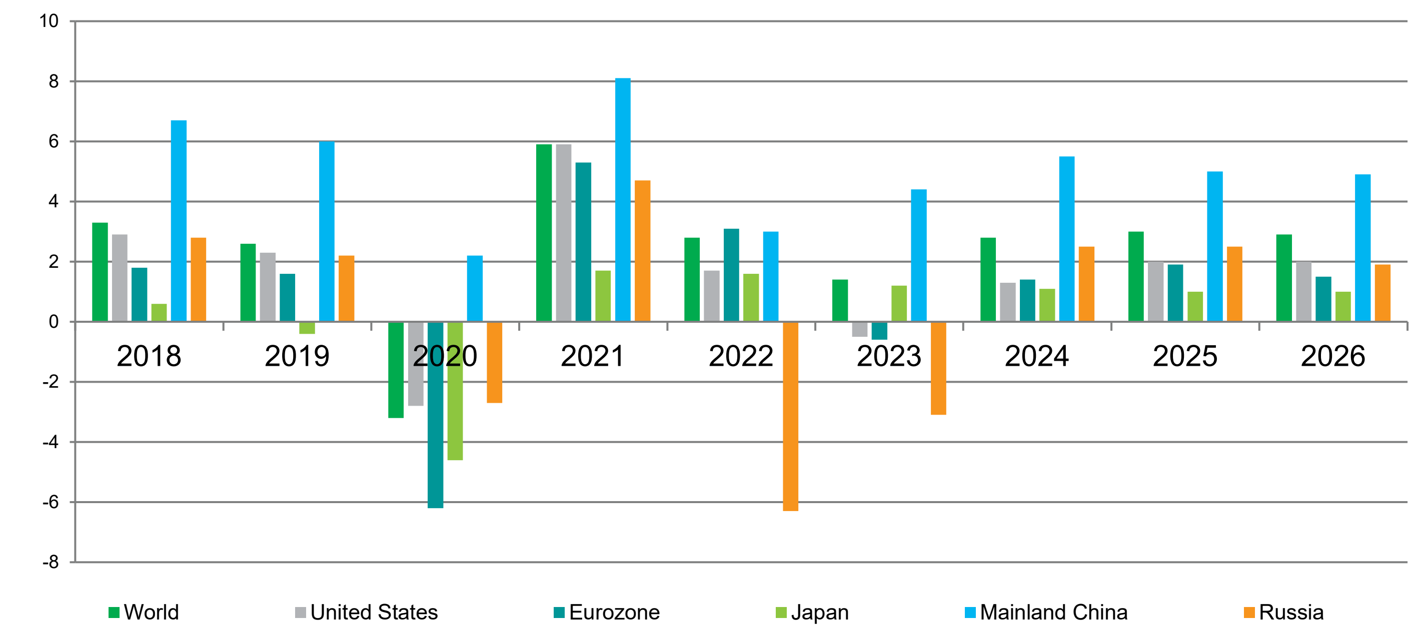
The takeaway

Tightening financial conditions will lead to a further slowdown in global economic growth, putting expansions in vulnerable regions at risk and deepening anticipated recessions in Europe. The combination of subpar economic growth, rising unemployment and improving supply chain conditions will eventually cause inflation to subside over the next two years.

Signposts

- The pace of the European Central Bank's interest rate hikes, currently forecast by Economics & Country Risk to reach a high of 2.75% by February 2023.
- The US labor market tilting towards sustained loosening (multiple cycles of labor market cooling), indicating the US economy is tipping into recession.
- Any easing in mainland China's dynamic zero-COVID policy, currently forecast by Economics & Country Risk to not happen before early 2023.

A quick look at the numbers: Real GDP growth (percent change)



Source: IHS Markit

Further reading and listening

Critical minerals: Illuminating the path to an electric future

What Europe's gas curtailment plan will do to industries and regions

Energy prices and availability as winter approaches

Mexico's nearshoring potential

Inflation and inventories: Two trends shaping US holiday sales

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