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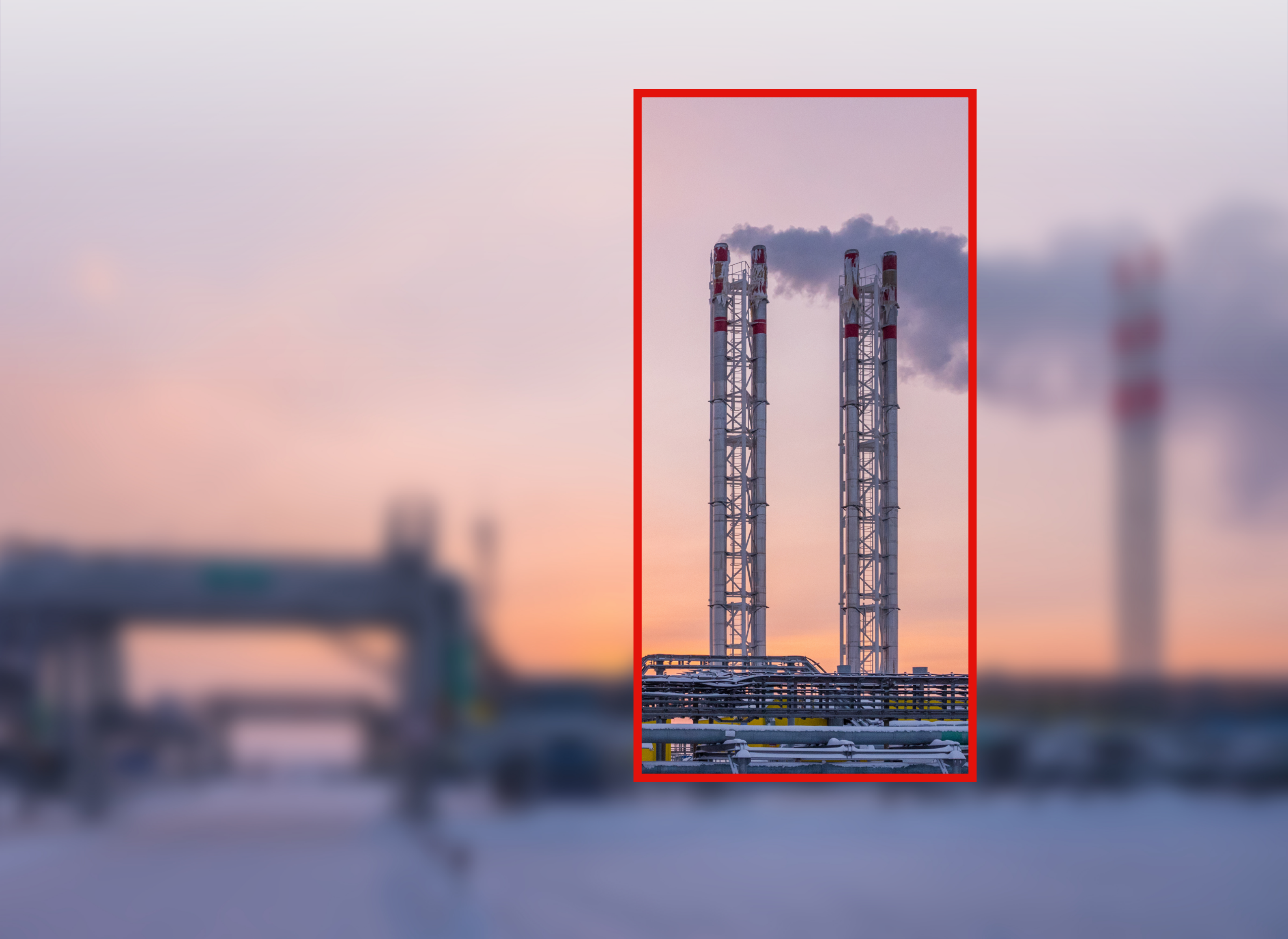
Risk outlook 2023

Ten risk scenarios that could reshape the global economy



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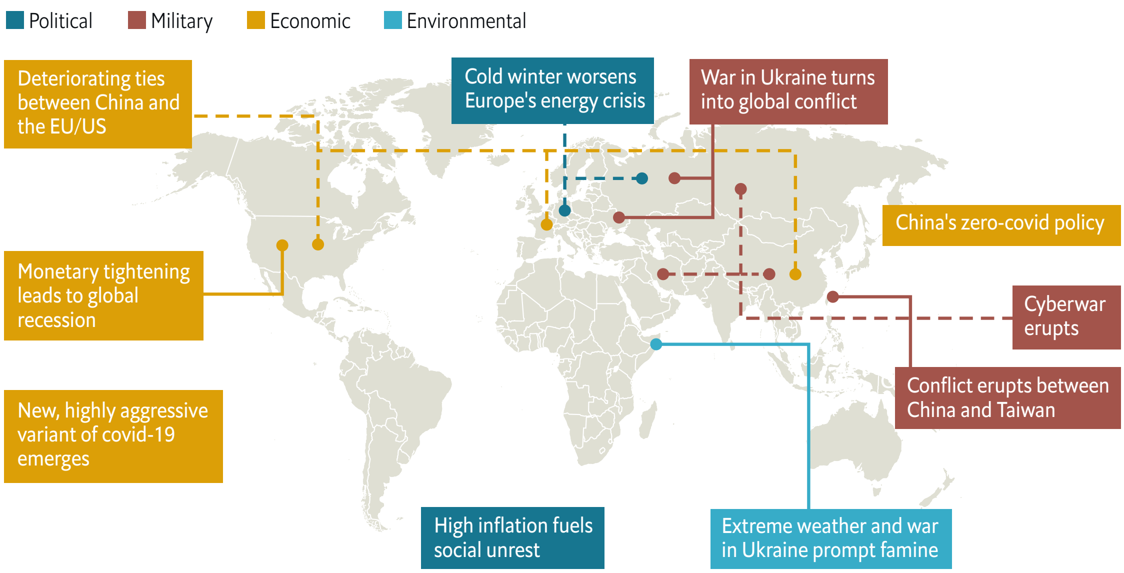
Risk Outlook 2023

Ten risk scenarios that could reshape the global economy

EIU produces a quantitative and qualitative assessment of economic, political and regulatory risks that help our clients evaluate potential shifts in a country's operating environment. In 2022 the global repercussions of Russia's invasion of Ukraine shifted global concerns away from coronavirus-related health issues and towards growing political, security and macroeconomic risks. We expect that ripple effects from the war in Ukraine, global monetary tightening and an economic slowdown in China will weigh on the economy in 2023, with global growth slowing to only 1.6%. This white paper explores some of the risks that could lead to even slower growth, or even, trigger a global recession.

Global risk scenarios



Source: EIU.

Scenario one: cold winter exacerbates Europe's energy crisis

High probability; Very high impact

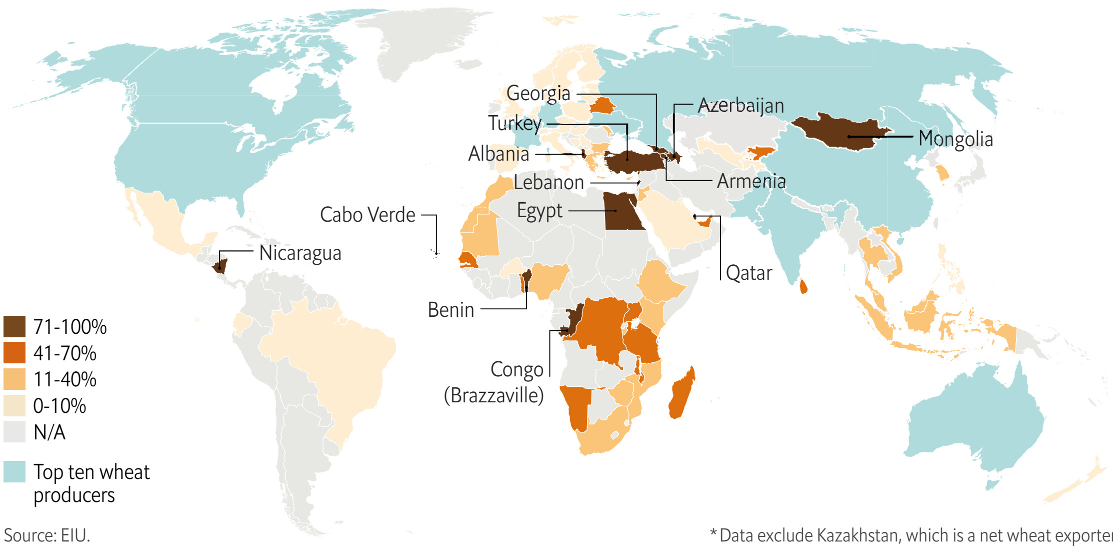
Russia has weaponised its energy supplies by completely or partially cutting off gas flows to 12 EU countries. If a cold winter in 2022/23 leads to above-average gas demand, Europe could exhaust its natural gas reserves early (and fail to replenish them), resulting in a recession that could drag into 2024 (our core forecast is for a mild recession, with the euro zone's GDP contracting by 0.4% next year). Major parts of the industrial sector would be forced to ration energy usage and reduce their workforces, ultimately bringing supply chains to a halt. High energy prices would lead to a surge in bankruptcies as firms become unprofitable. In an extreme scenario, governments could forcefully ration energy usage, leading to waves of blackouts. Governments could also halt price protections for households, increasing heating costs further and thus fuelling poverty and eroding consumers' purchasing power. A breakdown of EU solidarity is another risk, with member states possibly halting or reducing gas flows to their neighbours to prevent domestic shortages. Given their high level of dependency on Russian gas, central Europe, Germany and Austria would be the most exposed to a deep recession in such a scenario.

Scenario two: extreme weather adds to commodity price spikes, fuelling global food insecurity

High probability; High impact

Climate change models point to an increased frequency of extreme weather events. So far these have been sporadic and in different parts of the world, but they could start to happen more synchronously and for prolonged periods. Severe droughts and heatwaves in Europe, China, India and the US in 2022 are contributing to rising prices of some foodstuffs. In addition, the war between Russia and Ukraine (two of the world's largest agricultural exporters) has led to severe price spikes and risks creating global shortages of grains and fertilisers (which are crucial for harvests) in 2023. The world could face a prolonged period of crop shortages and skyrocketing prices, raising the risk of food insecurity (or even famine).

Over half a billion people live in countries that rely heavily on Russian and Ukrainian wheat
(% of total wheat imports from Russia and Ukraine, 2021)



Source: EIU.

*Data exclude Kazakhstan, which is a net wheat exporter.

Scenario three: direct conflict erupts between China and Taiwan, forcing US to intervene

Moderate probability; Very high impact

A direct conflict between China and Taiwan is unlikely, but tensions grew when China conducted "targeted military operations" following a visit to Taiwan by the speaker of the House of Representative (the lower house of the US Congress), Nancy Pelosi, in August. China's countermeasures have included live-fire military exercises in and around Taiwan's territorial waters. The US government has reiterated that its diplomatic approach towards Taiwan has not changed, but China is increasingly sceptical of US-Taiwan relations, particularly given the acute hostility towards China in the US Congress. The risk of a full military invasion is mitigated by China's reliance on Taiwan's semiconductors and concerns about the US's active response to Russia's invasion of Ukraine. However, recent military exercises by China and a more aggressive Taiwanese response raise the risk of a miscalculation, which could spiral into a wider conflict. Such a conflict would wipe out Taiwan's economy, including its semiconductor industry, on which global supply chains rely. It would also risk drawing in the US, Australia and Japan, starting a catastrophic global conflict.

Scenario four: high global inflation fuels social unrest

Very high probability; Moderate impact

Persistent inflationary pressures, caused by supply-chain disruptions and Russia's invasion of Ukraine, are pushing up global inflation, which is at its highest level since the 1990s. If inflation rises much higher than wage increases, making it hard for poorer households to purchase basic staples, it could spark social unrest. Such protest movements have arisen in India, Ecuador and Argentina. In an extreme scenario, protests could push workers in major economies and employed by large manufacturers to co-ordinate large-scale strikes demanding higher salaries that match inflation. Such movements, similar to those that have affected critical services in the UK (ports, postal services, barristers and railways), could paralyse entire industries and spill over to other sectors or countries, weighing on global growth.

Scenario five: new variant of coronavirus, or another infectious disease, sends global economy back into recession

Moderate probability; Very high impact

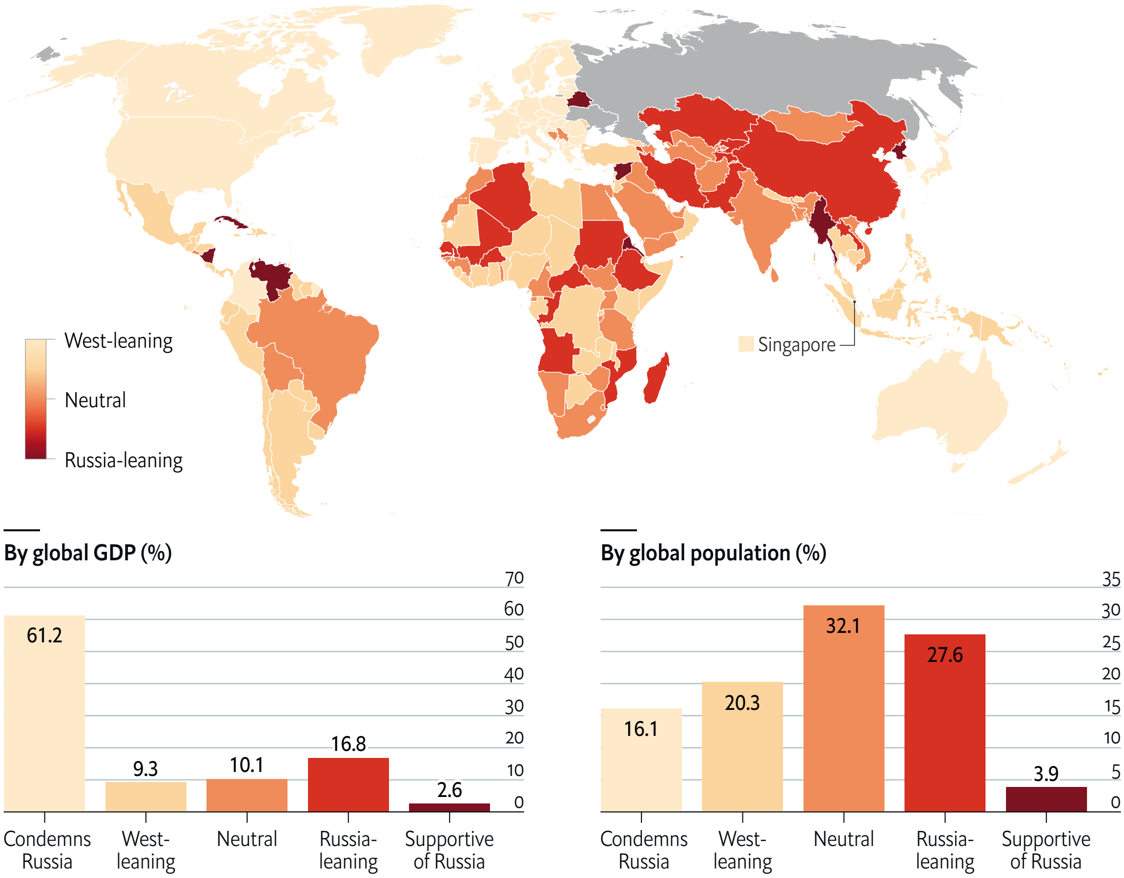
Amid global vaccine inequity, the relaxation of government policies and pandemic fatigue, we expect a new variant of covid-19 to emerge in late 2022 or early 2023. If it escapes immunity (despite a reformulation of vaccines), this could cause a repeat of 2020. Risks are not only related to the coronavirus—experts are warning that other infectious diseases will soon emerge (such as monkeypox). If another aggressive variant of the coronavirus materialises, developed countries may impose lockdowns. Consumer and investor sentiment would sink, leading to a downturn in financial markets, services and retail sales. Travel bans would return, dampening the tourism recovery. The vaccination drive would reset if vaccine producers have to start from scratch, and the global economy would go back into recession.

Scenario six: inter-state cyberwar cripples state infrastructure in major economies

Moderate probability; Very high impact

Russia's invasion of Ukraine and tensions surrounding Taiwan have increased the likelihood of major state-on-state cyber-attacks. Given the much higher costs of direct military conflict and the difficulty in identifying perpetrators of cyber-attacks, any military escalation is most likely initially to take the form of cyber-warfare. This could be triggered by a complete diplomatic breakdown, leading to an escalating string of tit-for-tat cyber-attacks ultimately targeting software that controls state infrastructure. The shutdown of a national grid, for example, would severely disrupt business operations.

Two-thirds of the world's population live in countries that are neutral or Russia-leaning regarding the war in Ukraine



Source: EIU.

Scenario seven: further deterioration in West-China ties forces full decoupling of global economy

Moderate probability; High impact

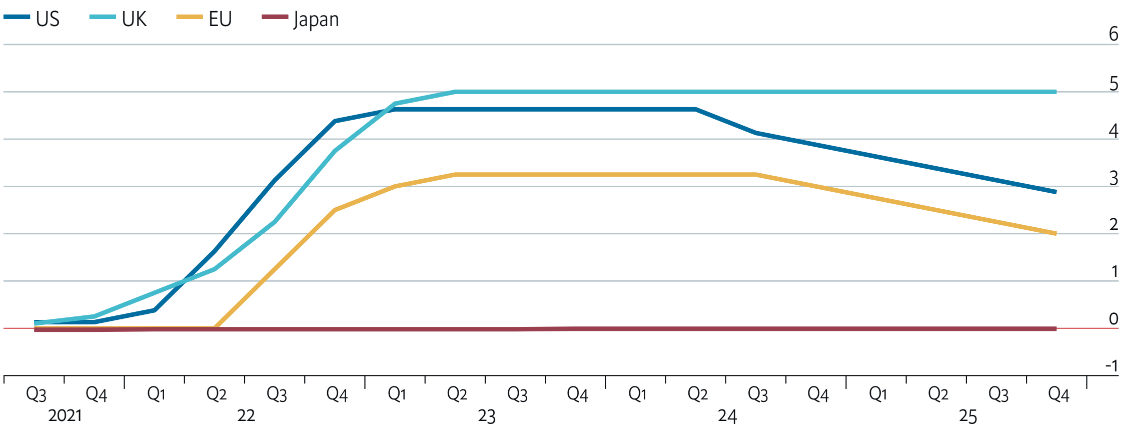
Western democracies, notably the US and the EU, are concerned about China's support to Russia following the invasion of Ukraine. In parallel, China is concerned about US-Taiwan relations and efforts by the US to convince other democracies to pressure it using restrictions on trade, technology and finance. The EU has also taken an increasingly confrontational stance towards China's human rights abuses in Xinjiang, unequal treatment of EU and Chinese firms, and its subsidy-led industrial model. In an extreme scenario, China could initiate military manoeuvres in the South China Sea (most likely in Taiwan), exacerbating tensions and pushing the West to unite in imposing sweeping trade and investment restrictions on China. This would force some markets (and companies) to choose sides. In retaliation, China could block exports of raw materials and goods that are crucial to Western economies, such as rare earths. This would have disastrous economic effects and force companies to operate two supply chains while fearing operational disruptions.

Scenario eight: aggressive monetary tightening leads to global recession

Moderate probability; Moderate impact

Major central banks are rapidly raising interest rates to try to tame rising inflation across most countries around the world (we assume that global inflation will stand at nearly 10% this year). These measures are fuelling a sharp increase in long-term interest rates, raising borrowing costs. A prolonged rise in inflation could prompt central banks to maintain aggressive policies that would undermine household purchasing power amid high energy and commodities prices. Amid other destabilising factors (for example the war in Ukraine, supply-chain disruptions, the strength of the US dollar and China's zero-covid policy), this situation could trigger a global recession. In developed countries, the economic slowdown could deepen, resulting in an asset market crash that would weigh on global growth. In emerging markets, interest-rate rises could prompt extreme currency depreciations and raise the risk of sovereign debt defaults (as happened in Sri Lanka in April).

Major central banks are rapidly raising interest rates
(main policy interest rate*; % end of period)



Source: EIU. *Data from Q4 2022 are EIU forecasts.

Scenario nine: China's zero-covid policy leads to severe recession

Low probability; High impact

China's government continues to believe covid-19 containment measures to be necessary. We therefore expect China's zero-covid policy to persist until mid-2023. With another coronavirus variant likely to emerge this winter, strict lockdown measures in China remain probable. These, combined with the persistent weakness in China's property sector, energy sector woes and a recent drought, could cause China's economy to contract severely. This would weigh on global economic activity, deteriorating already weak investor sentiment and dampening the performance of global financial markets. International companies could diversify their operations to non-China-based manufacturing and logistics hubs that have pivoted towards "living with the virus". However, this would be costly and would need to be carefully framed; Chinese authorities could retaliate, including via enhanced inspections of, or reputational attacks on, those firms that would be considered as "quitting the Chinese market".

Scenario ten: Russia-Ukraine conflict turns into global war

Very low probability; Very high impact

The war in Ukraine could become a global conflict, pitting Russia against NATO members. The war carries particular risks for NATO member states that border Ukraine and Russia, which could be drawn into the conflict inadvertently. Russia has readied its nuclear deterrence forces and could target critical infrastructure (such as gas pipelines or undersea telecommunications cables). In case of retaliation from NATO countries, the risk of a miscalculation cannot be discounted. Prospective and existing NATO member states such as Poland, Romania, the Baltic states, Finland and Sweden are the most likely trigger points. Moldova is another potential flashpoint. The consequences of a global conflict would be devastating. The global economy would fall into deep recession, with severe human consequences and large-scale fatalities. Such a confrontation could assume a nuclear form, with catastrophic consequences for major cities in Russia, the US and Europe.

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