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EIU Risk Outlook 2022

10 scenarios that could impact global growth and inflation

A report by EIU

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EIU Risk Outlook 2022

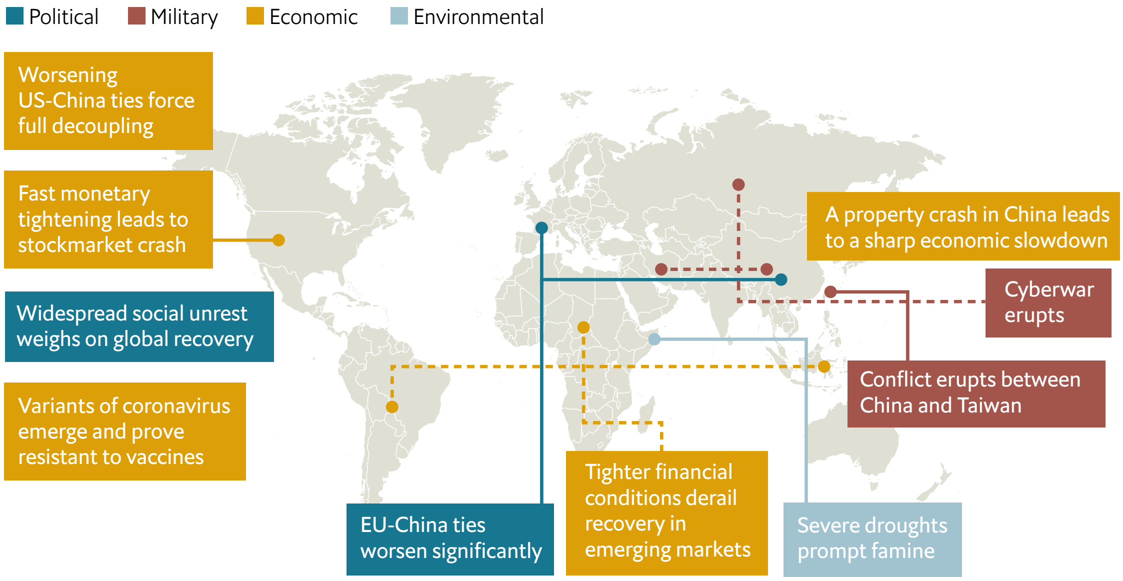
10 scenarios that could impact global growth and inflation

EIU produces macroeconomic forecasts, risk scores and economic, policy, politics and industry analysis to help our clients identify business opportunities and manage operating risks. We expect the post-pandemic recovery to continue in 2022, with global GDP expanding by 4.1%. However, this rebound will mask great variations in the pace of recovery across different regions. In addition to this baseline outlook, we are also tracking a host of scenarios that could derail the post-pandemic recovery and have an effect on global business operations. In this paper, we aim to summarise some of these key risks.

EIU's top ten global risk scenarios

1: Worsening US-China ties force a full decoupling in the global economy
2: An unexpectedly fast monetary tightening leads to a US stockmarket crash
3: A property crash in China leads to a sharp economic slowdown
4: Tighter domestic and global financial conditions derail the recovery in emerging markets
5: New Covid-19 variants emerge that prove resistant to vaccines
6: Widespread social unrest weighs on the global recovery
7: Conflict erupts between China and Taiwan, forcing the US to intervene
8: EU-China ties worsen significantly
9: Severe droughts prompt a famine
10: An inter-state cyberwar cripples state infrastructure in major economies

Global risk scenarios



Source: The Economist Intelligence Unit.

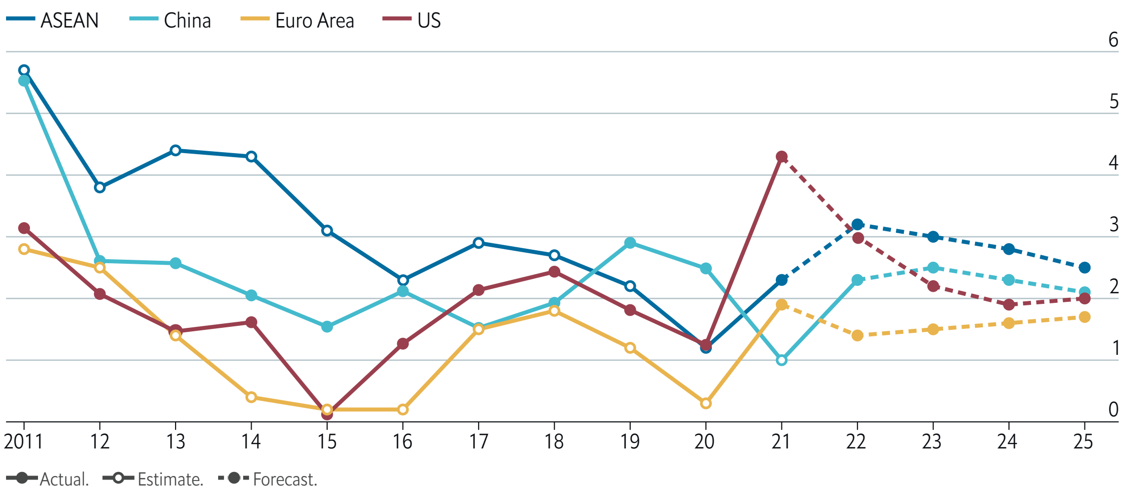
Scenario one: Worsening US-China ties force a full decoupling in the global economy

The US and China are vying for global influence. The US president, Joe Biden, is trying to convince "like-minded" (mostly Western) countries to collaboratively put pressure on China. This has included restrictions in the areas of trade, technology, finance and investment, along with sanctions, forcing some markets (and companies) to choose sides. Although most evident in the technology arena, there is a risk that this strategy will encompass industrial or consumer-facing sectors. In an extreme scenario, this could lead to a neutral stance becoming economically prohibitive for third countries, dividing China-supporting and US-supporting economies. Full global economic bifurcation would force companies to operate two supply chains with different technological standards. Implementation of 5G telecommunications networks could be postponed in some countries, and sanctions by China would heighten uncertainty surrounding global trade and investment.

Scenario two: Unexpectedly fast monetary tightening leads to a US stockmarket crash

Supply-chain disruptions, higher energy prices, ultra-loose monetary policy and a recovering real economy have all contributed to a sharp uptick in US inflation in 2021. Although many of these factors are likely to ease as the US economy rebalances post-pandemic—indicating that spiking inflation will not be long-lasting—they nonetheless give cause for the Federal Reserve (Fed, the central bank) to start tightening monetary policy gradually by tapering its asset purchases. However, if slow and clearly signalled monetary tightening fails to rein in inflation in the medium term, a rise in interest rates by mid-2022 may be necessary. Given that US stock price/earning ratios are currently higher than before both the 1929 and the 2007-08 crashes, accelerated interest-rate increases could be enough to initiate a sharp stockmarket adjustment. The high number of retail investors means that falling stock prices would weigh heavily on consumer spending, possibly halting the US economic recovery and risking a recession.

Consumer Prices - Core EIU Forecast
(% change pa; av)



Source: EIU.

Scenario three: A property crash in China leads to a sharp economic slowdown

A Chinese property giant, Evergrande, has already missed some repayments on debt totalling about US$300bn, and, given exposure to the company across much of China's economy, its potential default represents a serious risk of financial contagion. The state tightly controls China's financial markets, and its willingness to step in and bail out firms means that it has the tools to isolate financial distress, making a large-scale financial crisis unlikely. However, many of China's real estate firms are similarly overleveraged. If worsening real estate sentiment leads to a string of defaults across China's real estate sector, it will become much harder to contain. At the very least, this would lead to a collapse of property prices, with investment contracting, the government having to bail out overexposed banks and households, and in many cases household wealth taking a significant hit. This combination could drive China's real GDP growth to well below the 6-7% norm of recent years. Weak growth would, in turn, instigate a global economic downturn, with commodity exporters particular affected by a period of much weaker demand from China.

Scenario four: Tighter domestic and global financial conditions derail the recovery in emerging markets

Inflationary pressures stemming from rebounding commodity prices have already led some emerging markets, including Brazil, Mexico, Russia, Sri Lanka and Ukraine, to raise monetary policy rates in 2021. In a context where sovereigns have grown increasingly leveraged as a result of the pandemic, interest-rate normalisation will feed into higher debt-service costs for governments. This could ratchet up pressure for aggressive pro-cyclical fiscal consolidation that ultimately sets back the recovery of emerging countries. In particular, the potential for US bond yields to rise faster than expected in the coming months could drive higher emerging-market risk premiums, leaving them vulnerable to sudden drops in capital inflows. Risks will be especially elevated in countries where indebtedness in foreign currency is particularly high, for example in Argentina and Turkey, where bond sell-offs could trigger currency and/or debt crises.

Scenario five: New Covid-19 variants emerge that prove resistant to vaccines

The pace of vaccine rollout is the main variable behind economic forecasts. One of the main risks for the global recovery is that new, more aggressive Covid-19 variants prove resistant to current vaccines. Some—notably the Delta and Mu variants—appear to partly escape the protection offered by some vaccines. In addition, vaccines do not appear to block transmission of the Delta variant, raising the risk that asymptomatic people transmit the virus. The continued spread of Covid-19 in some parts of the world further heightens this risk. Manufacturers could therefore end up in a perpetual cycle of having to update their vaccines, creating a scenario whereby a variant proves highly resistant to vaccines; there are already several viruses for which no effective vaccine has yet been developed despite extensive research, such as HIV/AIDS.

Scenario six: Widespread social unrest weighs on the global recovery

Given the negative effect of the pandemic on incomes and quality of life, a spike in unrest is possible in 2021, including in traditionally stable Western states and long-standing authoritarian regimes. Countries where political tensions are already high appear to be especially at risk, but so are those whose economies were hit the hardest by the pandemic. Regions such as the Middle East, Africa and Latin America are particularly at risk. All three were already experiencing heightened social tensions, but many countries within them also underwent tough lockdowns and deep recessions; snowballing unrest could lead to a government collapse, panicking investors and leading to destabilising capital outflows. In the medium term, this trend could drive investor risk aversion and higher political risk premiums, stunting the global recovery.

Scenario seven: Conflict erupts between China and Taiwan, forcing the US to intervene

Increasing Chinese aggression against Taiwan since late 2020 has raised the risk of a military conflict in the Taiwan Strait. We expect China to refrain from purposefully initiating direct conflict with Taiwan, owing to concerns about US involvement. In addition, Taiwan's president, Tsai Ing-wen, has rejected declaring independence as an explicit policy goal. Nevertheless, the recent warming in US-Taiwan relations has prompted China to make regular incursions into Taiwan's air defence identification zone (ADIZ). These manoeuvres have raised the risk of a military miscalculation, such as an accidental collision between Chinese and Taiwanese fighter jets. 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 participation of the US, Australia and Japan, which could set the stage for a global conflict, with catastrophic economic consequences.

Scenario eight: EU-China ties worsen significantly

The imposition in March of EU sanctions against China over human rights abuses in Xinjiang, and retaliatory sanctions from China against ten EU individuals and four organisations, have led to a deterioration in EU-China relations. These developments may heighten European calls for EUUS cooperation over China, particularly as Mr Biden is seeking backing from allies. Our baseline forecast is that the EU will continue to pursue an independent approach to dealing with China, but there is a risk that the EU will decide to apply sanctions against Xinjiang-based companies, potentially mirroring existing US import and investment bans. This could also happen in response to Chinese policies in Hong Kong and Tibet (and potentially Taiwan). Under such a scenario, curtailed access to European financial flows would cause further operational disruption for the affected Chinese companies and leave EU companies operating in China vulnerable to retaliation (such as a boycott or being blacklisted).

Scenario nine: Severe droughts prompt a famine

Climate change models point to the risks associated with increased frequency of droughts. So far these have been sporadic events in different parts of the world, but they could—sooner than we think—start to happen more synchronously and for prolonged periods. Intense heatwaves have struck Canada and the US this year, and Greece, Turkey and Spain have suffered devastating fires in recent months; and volatile weather, including a drought in Brazil, has already contributed to rising prices for some foodstuffs. Extreme climate events are only one among many risks. Water shortages in southern Europe, the Mediterranean, the south-western US and southern Africa—the breadbaskets of the world—would have short- and long-term consequences for the global economy. Multiple crop failures would drive up global commodity prices, most likely of highly irrigated crops such as wheat, maize and rice. Such a situation would fuel global inflation and weigh on global growth and sentiment.

Scenario ten: An inter-state cyberwar cripples state infrastructure in major economies

As states battle for the upper hand in the wake of the Covid-19 pandemic, geopolitical competition will continue to heat up in the coming years. Given the much higher costs of direct military conflict and the difficulty in identifying perpetrators of cyber-attacks, any military escalation is most likely to take the form of cyber-warfare. This could be triggered by a complete diplomatic breakdown between major powers (for example between the US and either China or Russia), leading to an escalating string of tit-for-tat cyber-attacks ultimately targeting software that controls state infrastructure. In the current environment, with economies still feeling the negative effects of the coronavirus-induced global downturn, the shutdown of a national grid, for example, would severely disrupt business operations, creating uncertainty that would weigh on investor sentiment.

How worried should businesses be?

EIU's Risk Briefing product tracks global and country-level risks that could derail our core forecasts. We track these risks and score them in terms of probability (how likely are they to happen?) and impact (if they happen, how great is the impact on businesses?). We combine these probability and impact scores to produce an intensity rating to support our clients in their ongoing risk monitoring requirements, helping them to answer the question, "how worried should we be?". Below is a snapshot of scores for our ten global risk scenarios.

EIU's global risk scenario watchlist

Scenario	Probability	Impact	Risk intensity
Worsening US-China ties force a decoupling in the global economy	*High*	*Very High*	**20**
Unexpectedly fast monetary tightening leads to a US stockmarket crash	*Very High*	*High*	**20**
A property crash in China leads to sharp economic slowdown	*High*	*Very High*	**20**
Tighter domestic and global financial conditions derail the recovery in emerging markets	*High*	*High*	**16**
New Covid-19 variants emerge that prove resistant to vaccines	*Moderate*	*Very High*	**15**
Widespread social unrest weights on the global recovery	*Very High*	*Low*	**10**
Conflict erupts between China and Taiwan, forcing the US to intervene	*Low*	*Very High*	**10**
EU-China ties worsen significantly	*Moderate*	*Moderate*	**9**
Severe droughts prompt a famine	*Low*	*Moderate*	**6**
An inter-state cyberwar cripples state infrastructure in major economies	*Moderate*	*Low*	**6**

Very high probability = greater than 40% probability that the scenario will occur over the next two years; high = 31-40%; moderate = 21-30%; low = 11-20%; very low = 0-10%.
Very high impact = change to global annual GDP compared with the baseline forecast of 2% or more (increase in GDP for positive scenarios, decrease for negative scenarios); high = 1-1.9%; moderate = 0.5-0.9%; low = 0.2-0.5%; very low = 0-0.1%.
Risk intensity is a product of probability and impact, on a 25-point scale.

Intensity colour key: 1 to 4 5 to 8 9 to 12 13 to 16 17 to 25

Note: Intensity is a product of the probability and impact ratings, where 'very low' scores 1 and 'very high' scores 5.

Source: EIU, Risk Briefing

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