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2023 KIEP World Economic Outlook: Suppressed Recovery amid Tightening and Fragmentation

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The world economy is in a shaky state following the Russia-Ukraine crisis, which broke out just as the world was adapting to the COVID-19 pandemic. It wasn't long before we understood the significance of supply chains, but as the segmentation of the global supply chain continues, we are confronted with higher prices. Resources, notably raw minerals, are increasingly being used as weapons, driving up the cost of goods and services throughout the economy and causing inflation to rise. It will be some time before a period of low prices and low interest rates will return, as expectations for inflation continue to rise as well.

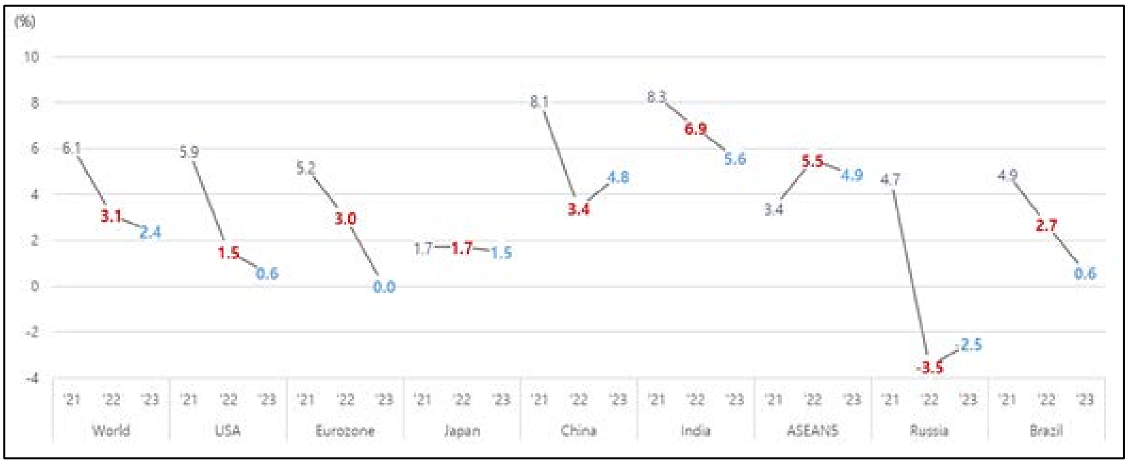
The world economy is anticipated to expand by 3.1% this year and 2.4% in 2023, according to the KIEP 2023 World Economic Outlook published in November. From the 3.6% prediction put forth in May, the growth rate for next year was lowered by 1.2%p. Global economic damage is mounting as a result of the protracted Russia-Ukraine situation. Because of the region's extensive economic and commercial ties to Russia, against which multiple sanctions have been imposed, economic growth rates are predicted to slow or even reverse in Europe in 2023. The U.S. will record 0.6%, the Euro area 0%, Japan 1.5%, China 4.8%, India 5.6%, ASEAN-5 countries 4.9%, Russia –2.5%, and Brazil will be 0.6%.

This 2023 World Economic Outlook is based on the following assumptions. First, additional health crises such as COVID-19 will not have a devastating impact on the economy. Second, the monetary policies of major countries such as the U.S. will remain hawkish up to the first half of next year. Third, the current state of the Russia-Ukraine war will remain unchanged for the time being, though behind-the-scenes negotiations are under way. Fourth, there will be no sharp change in investors' risk aversion, and we are unlikely to see rapid capital transfer from emerging countries to developed countries. Fifth, China's economic growth rate will remain within the target range of the Chinese government, but set somewhat lower. Sixth, the strong dollar will continue for the time being, and finally, the average annual oil price based on WTI in 2023 will remain at around $91.6. However, there is a possibility that certain risk factors will be realized, which will be mentioned later.

The global economic situation this time can be concisely described by "suppressed recovery amid tightening and fragmentation." The forecasts so far have implied these key words. In the area of "tightening," we need to be careful about the unintended negative effects of such policy due to the pressures of monetary tightening caused by the global inflation, and the constraints of additional fiscal capacity after implementing massive fiscal spending due to the COVID-19 pandemic. On the other hand, regarding "fragmentation," international cooperation continues to fragment as the global supply chain undergoes segmentation, slowly progressing due to the COVID-19 pandemic and the U.S.-China strategic competition, and coinciding with geopolitical changes since the Russia-Ukraine crisis. While a quick and short-term economic recovery will require a smooth implementation of expansionary policies and international cooperation, this recovery is being suppressed and delayed due to restrictions on these attempts. As economic problems combine with security problems, it is becoming more difficult to find a solution.

There are three related risk factors which might possibly lower the main projections even further. The first one is a sharp rise in interest rates and increasing private debt burden. The massive liquidity released to overcome the COVID-19 crisis flowed into the asset market, expanding the debt of households and companies as well as the government. The problem is that the process of reversing monetary easing is proceeding too fast and intense in pace compared to that following the global financial crisis, and combined with supply-side factors is triggering an economic downturn. If combating inflation takes longer than expected, concerns about adverse asset effects, increased difficulties for individuals and marginal companies, and financial crunch could increase. The second problem is the dilemma of fiscal policies. During the COVID-19 pandemic, major countries responded to the health and economic crisis by increasing fiscal spending faster compared to the trend. Today, governments are often constrained by budget constraints with huge additional spending and higher interest rates. Fiscal soundness is important, but the global economic situation is very complicated. The recent move by the British government shows the sensitivity of financial markets. Though intended to boost long-term growth, an unagreed announcement of expansionary fiscal policy could go against market expectations and develop quickly into a sense of crisis. The third is geopolitical risks such as the Russia-Ukraine crisis and the U.S.-China strategic competition. The era of globalization over the past 30 years, which began with China's accession to the WTO and the collapse of the former communist countries, is coming to an end, and a new era of disconnection and competition between blocs is coming. China's cross-strait problems and the recent threat from North Korea can also spread to global risks, which requires special attention.

Figure 1. KIEP 2023 World Economic Outlook



Notes: 1) Based on PPP, 2) ASEANS refers to Indonesia, Malaysia, The Philippines, Thailand, and Vietnam.
Source: KIEP World Economic Outlook (November, 2022)

Now let us review the outlook for major countries. For the U.S. economy, we lowered the growth rate by 1.6%p from 2.2% in May to 0.6% this time for 2023. Inflation and interest rate burdens are expected to dampen economic activities in the private sector and limit fiscal policy. The U.S. Fed is showing a willingness to control prices even at the cost of economic slowdown, so the high-interest rate trend is not expected to shift easily. In addition, as policy restrictions due to the political process become more complicated after the midterm elections, it will be difficult to implement new large-scale fiscal policies.

The euro area has been drastically lowered from 2.4% to 0%. The prolonged Russia-Ukraine crisis is expected to directly affect energy supply and demand. In addition, the fiscal burden is increasing as major European countries seek countermeasures against the supply chain disruption, with additional room limited along with the trend of interest rate hikes.

For Japan, we have lowered our forecast 0.1%p from 1.6% to 1.5%. While it is difficult to expect export expansion due to the possible global economic slowdown, the Japanese economy is expected to continue low growth centered on domestic demand thanks to high savings rates of households and corporate profits. It will maintain its expansionary monetary policy stance at least until the new governor of the Bank of Japan is appointed in April 2023. Inflationary pressure is slowly rising, but the core CPI remains in the 1% range.

Regarding China, we have downgraded 0.5%p from 5.3% to 4.8%. The economy is expected to recover with the possible containment of COVID-19 in China and the support of the economy through active monetary-fiscal policies after the 20th National Congress of the Chinese Communist Party. However, internal and external Chinese economic uncertainties are high, such as falling real estate investment and related risks, the possibility of re-proliferation of COVID-19 in China, intensifying conflicts with the U.S., and the prolonged Russia-Ukraine crisis. As China's fiscal income continues to decline and monetary policy capacity continues to weaken due to the U.S. interest rate hike, uncertainties over the effects of economic stimulus measures in 2023 are also high.

We cut 0.9%p from 6.5% to 5.6% for India. Foreign direct investment is on the rise due to the Indian government's steady efforts to improve the investment environment and the search for investment destinations other than China. But external conditions such as high inflation, monetary tightening in major countries, and geopolitical instability are the downside factors.

For Russia, we have reduced our forecast by 2.2%p, from -0.3% to -2.5%. This is because of the effects of prolonged war and strengthened sanctions from Western countries. Lastly, Brazil is expected to grow 0.6%. Rising raw material prices have a positive impact on exports, but the accumulation of fiscal deficits and a contraction in investment and consumption due to high interest rates will have a negative impact. Former President Lula winning the recent presidential election is expected to gradually boost environmental and fiscal policy following a centrist pledge.

Several implications, including policy ones, should be noted to deal with the current and future economic hardships. First, we have to give more attention to the possible realization of risk factors. Risk factors such as price pressure, supply chain disruptions, geopolitical crises, and policy capacity exhaustion are complex and intertwined, meaning even a small impact could expand to the entire system. Second, it is necessary to pay attention to the damage caused by the rapid reduction of liquidity. During the global financial crisis, liquidity rollback proceeded over a long period of time, allowing households and companies enough time to adapt, but the current liquidity reduction and interest rate hikes are much faster and wider, which could lead to postponement or cancellation of various investment projects, exit of marginal companies, and increased volatility in the asset market. Therefore, governments must carefully design their fiscal and financial policy priorities as they cope with constrained resources. Third, it should be recognized that blockization and localization of global supply chains are a long-term trend, not a short-term issue. As barriers for production have been created, securing and reorganizing the supply chain system becomes a challenge at additional costs. This will have a profound impact on the overall economy, and particularly on production activities, consumption, and prices. It also means that the market could shrink for companies. Finally, it is important to prepare for future changes in the structure of the economy. In the long run, it is necessary to keep an eye on newly growing industries and productivity improvements that combine existing industries and new technologies. Also, the investments made for irreversible trends, such as IT and green transformation, to enhance sustainability and potential output level even during recession times should not be ignored.