

PRESS RELEASE

A recession to avoid stagflation? The world economy at a crossroads *Coface Barometer Q2 2022*

Paris, 21 June 2022 – Four months after the start of hostilities in Ukraine, first lessons can be drawn: the conflict, which is set to last, has already upset the global geo-economic balance. In the short term, the war is exacerbating tensions in a production system that has already been damaged by two years of pandemic and is heightening the risk of a hard landing for the world economy: while the latter seemed to be facing the threat of stagflation a few weeks ago, the change in tone of the central banks, faced with the acceleration of inflation, has resurrected the prospect of a recession, particularly in the advanced economies.

In this complex environment, Coface revised downwards the evaluation of 19 countries, including 16 in Europe – Germany, Spain, France and the United Kingdom in particular – and made only 2 revisions upwards (Brazil and Angola). At the sectoral level, the number of downward revisions (76 in total, as opposed to 9 upward revisions) highlights the spread of these successive shocks across all sectors, both energy-intensive ones (petrochemicals, metallurgy, paper, etc.) and those that are more directly linked to the credit cycle (construction).

As the horizon continues to darken, the risks are naturally bearish and no scenario can be ruled out.

The slowdown in activity and the risk of stagflation are becoming clearer

Q1 growth figures were below expectations in most developed economies. In addition, GDP in the eurozone grew only very weakly for the 2nd consecutive quarter, with even a decline of -0.2% in France. This was due to a drop in household consumption against a backdrop of declining purchasing power. Activity also declined in the United States, hampered by foreign trade and the difficulties experienced by the manufacturing sector in replenishing its inventories. These figures are all the more worrying as the economic consequences of the war in Ukraine were just starting to bite.

Considering the acceleration in inflation, the deterioration in agents' expectations, and the tightening of global financial conditions, activity in Q2 does not look much better in the advanced economies, and considerably less favourable in the emerging economies. While it is probably too early to say that the global economy has entered a stagflationary regime, the signals are consistent with this view.

Commodity price pressures are building

Although commodity prices have stabilised recently, they remain at very high levels. For example, oil prices have not fallen below USD 98 since the beginning of the war, as fears of a potential supply shortage have remained significant.

This context is favourable to commodity exporters, and more particularly of oil. Coface's only two upward revaluations concern Brazil and Angola, and the sectoral reclassifications mainly concern the energy sector of producing countries, whereas the sectoral downgrades target the energy sector in countries where companies are located downstream in the production chain (mainly in Europe).

Similarly, industries whose value chain are energy-intensive in their production processes, such as paper, chemicals and metals, have their risks reassessed upwards. Agri-food is one of the sectors with the highest number of downgrades this quarter, with almost all regions affected.

Finally, it is likely that companies that had not fully passed on the increase in their production costs to their sales prices will continue to do so. Thus, price increases will continue in sectors with significant pricing power. This is the case for the pharmaceutical sector, where a small number of companies dominate the global market. Already identified as one of the most resilient, it is the only sector with 'low risk' ratings in our barometer.

Central banks with both feet on the brake

The ECB has gradually tightened its stance, following the example of the Fed and the Bank of England, to the point of pre-announcing its future rate hikes. Like the other major central banks (except the Bank of Japan), the ECB has no other choice, within the strict framework of its mandate, but to tighten its guard significantly, despite the fact that this could trigger a brutal slowdown in activity and rekindle fears of a fresh European sovereign debts crisis.

In this environment of tightening credit conditions, the construction sector appears to be as one of the most vulnerable. Rising borrowing costs are expected to affect the housing market and, ultimately, construction activity. This has started in the US where housing sales are declining rapidly.

Clouds are gathering for 2023

With the economic and financial environment deteriorating rapidly, Coface has downgraded the rating of 16 countries on the European continent, including all the major economies – with the exception of Italy, already rated A4.

Our central scenario suggests a significant slowdown in activity over the next 18 months, allowing inflation to decelerate gradually. Our growth forecasts are particularly poor in the advanced countries. There are many downside risks to the global economy, while the upside risk to inflation remains. To curb inflation, central banks seem tempted to push the economy into a recession, which they hope will be milder than if prices continue to slide, forcing them to implement a more violent monetary shock later. The risk, which cannot be ruled out, would be that demand would fall and inflation would remain high, due to commodity prices that would struggle to ease due to a chronic supply shortage.

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