Global Economic Outlook

March 2023

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Introduction

We may only be part-way through 2023, but the phrase that has overwhelmingly dominated conversations – from boardrooms to political chambers and Main Streets – has been the cost-of-living crisis. In recent years, the world has faced waves of challenges, from the pandemic to the invasion of Ukraine, to the unfolding bank liquidity challenges amidst skittish depositors. The impact of such a lengthy period of uncertainty is being felt by everyone and that's reflected in KPMG's latest *Global Economic Outlook*.

How we get back to sustainable, long-term growth is the big question facing boardrooms and political chambers around the world right now. Some of the biggest inflationary fears – widely predicted late last year – have been mitigated by more direct, pro-active political action geared especially towards getting rising energy prices down. There are also signs that other commodities and food prices are finally starting to ease – helping consumers and business owners who've been facing a significant financial squeeze.

The actions taken over the coming months are likely to play a significant role in the pace and nature of the world's economic recovery. KPMG's analysis forecasts that employment levels should remain robust, even given recent tech layoff announcements – a sign that the tightness of the labor market faced post-pandemic shows no sign of easing. It's an indication of the complexities the world faces today. Strong employment figures are often held up as an example of buoyant market conditions, but they can also reflect the challenges central banks are facing as they attempt to juggle wage expectations, tightened credit conditions and the ever-present danger that any shift in the conflict in Ukraine could bring inflation back into the mix. The upside of a strong labor market, combined with relatively strong personal savings among consumers – especially in Europe and the Americas – means we could start to see a return to robust consumer spending, driving a return to slow-but-steady domestic growth in key markets.

KPMG's *Global Economic Outlook* is a forecast. It's based on detailed analysis of trends and models from KPMG firms' economic specialists across the world. Digging deeper into the numbers isn't an exact science, but it can offer a good indication of what may lie ahead and should help to equip business leaders with a greater understanding of what lies behind today's complex marketplaces, enabling them to develop more robust strategies focused on the ultimate goal of a return to sustainable, global growth.

Regina Mayor
Global Head of Clients & Markets
KPMG International

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The global outlook: Treading cautiously amid risks

Sharp falls in inflation will likely leave behind some of the recent challenges for the global economy.

Central banks approaching the end of the tightening cycle partly as a response to rising tensions in financial markets.

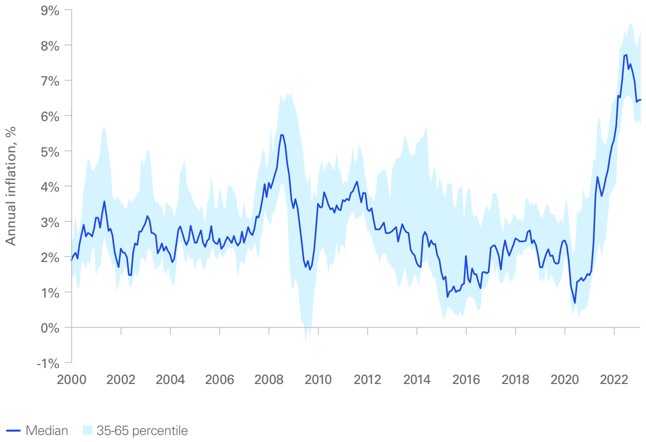
Easing supply chain pressures and resilient labor markets to support recovery but uncertainty about the outlook is on the rise.

Inflation no longer central stage

The outlook for the global economy took a positive turn early in the year. Inflationary pressures began to ease, with global energy prices back at levels last seen prior to the invasion of Ukraine. In addition, base effects from the rise in energy prices following the invasion are now coming off, putting further downward pressure on inflation for the rest of this year. Prices of other commodities as well as global food prices have also eased.

However, domestic inflationary pressures remain relatively elevated in a number of economies, in particular those with tighter labor markets, although even there inflation probably already passed its peak around the second half of last year (see Chart 1), with headline inflation expected to continue falling this year, and potentially reaching central banks' targets by 2024[1].

Chart 1: CPI inflation among G20 economies



Source: Refinitiv Datastream, KPMG analysis.
Note: The chart excludes Australia and the EU, as EU countries are covered individually.

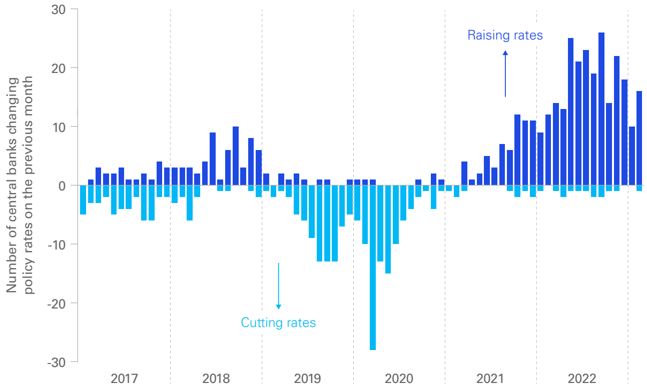
[1] See the Appendix for individual country forecasts.

Central banks face a trickier outlook

While the outlook for inflation has improved significantly, many central banks remained cautious at the start of the year. The concern was that the bout in inflation, as a result of the reopening of economies after Covid-19 restrictions followed by a commodity shock due to the invasion of Ukraine, has been embedded in inflation expectations and therefore pricing behaviors of firms and wage expectations of employees. The worry is that inflation could remain sticky, with core inflation (which excludes items such as food and energy) stubbornly high and price rises widespread across the economy due to a relatively tight economic environment in some countries.

Recent tensions in the banking system, which were triggered by the collapse of Silicon Valley Bank and Signature Bank in the U.S. may complicate matters for central banks. The uncertainty it unleashed will inevitably tighten credit conditions while exposing markets' fragility following an unprecedented period of monetary tightening. Last year saw a sharp rise in policy interest rates, with most central banks raising them significantly during the year (see Chart 2). While the tightening cycle almost reached its course in some economies, other central banks – notably the Fed and ECB – were expected to tighten further. However, latest developments in the banking sector and bond markets could see rates peak sooner and at lower levels.

Chart 2: Central banks have been tightening monetary policy



Source: Bank for International Settlements, KPMG analysis.

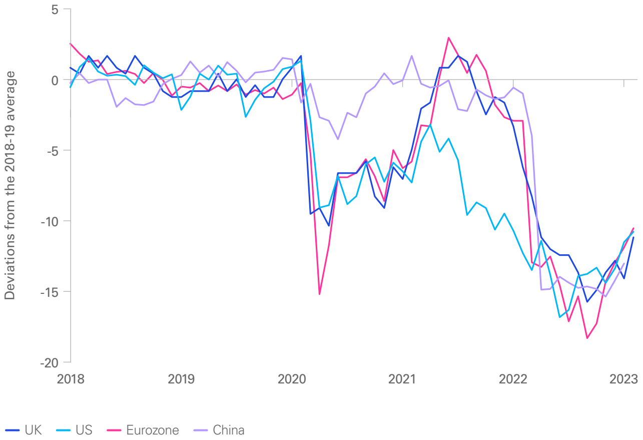
Room for growth

With monetary policy focused on moderating inflation while stabilizing financial markets, fiscal policy is left as the potential tool to boost economic growth. Unfortunately, the public finances have deteriorated significantly over the past three years. Governments have spent significant amounts on first shielding their economies from Covid-19 and subsequently on protecting households and businesses from higher energy prices. That left public debt at historically elevated levels, with less room for expansionary fiscal policy. Even in the U.S., federal spending is expected to slow despite the ramp up in infrastructure spending, although in China fiscal support is to be stepped up following the reopening of the economy. The rise in interest rates has made these larger debt levels more costly to service, putting further pressure on government finances.

Nevertheless, some positive growth momentum is expected this year from the relatively smooth reopening of the Chinese economy following the lifting of Covid-related restrictions in December last year. The pressure on global supply chains has eased significantly in recent months, while shipping costs have dropped too. This should help alleviate some inflationary pressures and improve supply capacity. Global trade remains relatively weak, although we would expect it to recover this year as trade flows normalize with the reopening of the Chinese economy and a recovery in global growth, while we expect geopolitical tensions to continue to exert some pressure on trade flows over the medium term.

Consumer demand is also expected to pick up this year, with excess savings – money saved during the pandemic when spending on certain services was not possible – still relatively high in China and Europe which could potentially be deployed once confidence returns. Indeed, consumer confidence has started to improve in Europe, although it remains at relatively low levels (see Chart 3).

Chart 3: Consumer confidence



Source: GfK, University of Michigan, European Commission, Refinitiv Datastream, KPMG analysis.

One lingering risk is that rising interest rates and tighter credit conditions would see further falls in house prices, particularly in the U.S. and some European economies where valuations are relatively high. That in turn could depress consumer confidence and spending again.

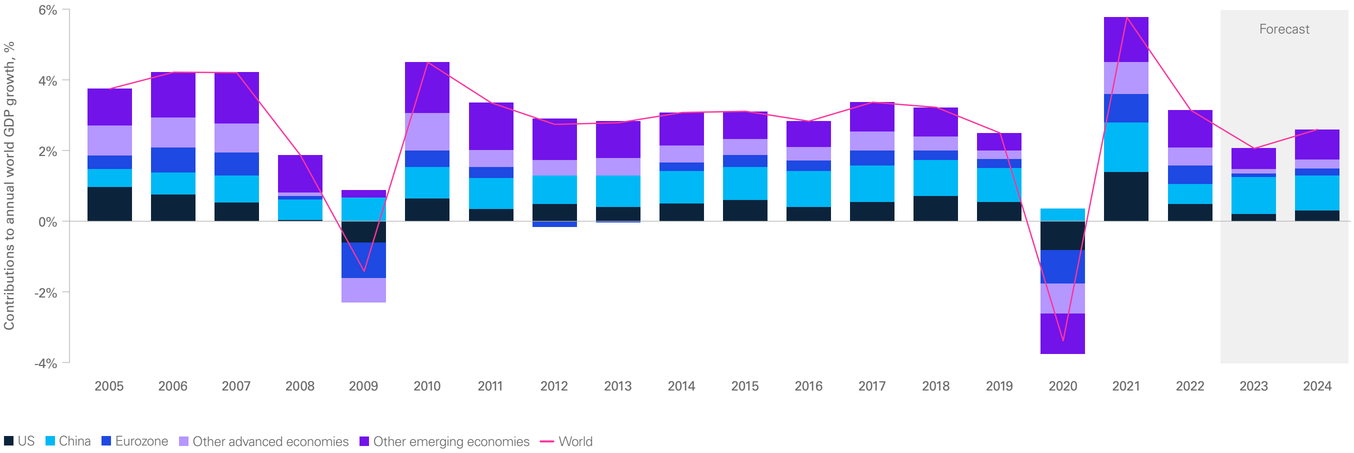
However, the labor market remains relatively tight across most countries, and we are not expecting any major rise in unemployment this year, as outlined in our forecasts for individual countries in the Appendix. This should provide an important support for households' incomes and consumer spending, even though real incomes are squeezed as a result of the high levels of inflation. Households' purchasing power is expected to recover gradually over the medium term as wage increases overtake inflation once more from next year.

Despite the resilience of the labor market and the improving inflation conditions, we expect global economic growth to be relatively modest over the next two years, and to stay below its long-term average (see Chart 4). Global growth is expected to be driven by the recovery of the Chinese economy and a relatively strong growth in some of the emerging markets, while the Eurozone and U.S. economies are expected to contribute less to global growth over the next two years.

Risks to our forecasts are broadly skewed to the downside given the volatility in financial markets. The global economy has been through a series of significant shocks over the past three years – the Covid-19 pandemic and the Russia-Ukraine conflict – and saw a major expansion to government debt and a significant hike in policy interest rates by central banks. The ramifications of some of that may not have surfaced yet and we are still to see their full impact and how they interact.

Yael Selfin
Chief Economist, KPMG in the UK

Chart 4: KPMG global growth projections



Source: IMF, KPMG projections.

United States: A tale of two economies

A tale of two economies is emerging: firms that benefitted most from the pandemic-induced boom are pulling back, while startups and firms that were late to the recovery are still ramping up. Labor shortages are more structural than cyclical.

A strong labor market, which feeds more directly into service sector prices, is upping the risk of a more prolonged and corrosive bout of inflation. Service sector inflation is getting sticky.

Recent efforts by regulators are hoped to eventually calm financial markets; that will not prevent a more systemic tightening of credit conditions. The Federal Reserve will weigh those shifts as they determine how far to go on rate hikes.

Growth in the U.S. is forecast to slow to a 0.9% pace in 2023, less than half that of 2022. After a solid start, the economy is expected to suffer a mild contraction mid-year. The unemployment rate is expected to rise, but only modestly. Prices in the service sector, where labor costs play a larger role in setting prices, are starting to look sticky. The Federal Reserve will continue to raise rates and keep monetary policy restrictive well into 2024.

A tale of two economies is emerging. Firms that benefitted most from the pandemic-induced boom are pulling back; tech, finance and manufacturing activity are hardest hit. Startups and firms that were late to the recovery are still ramping up.

The pace of high-quality business formation – firms that intend to hire, not the self-employed – were still nearly 40% above the pace of the 2010s in January. Our own analysis suggests that those firms accounted for more than half of the excess demand for workers since February 2020 (see Chart 5).

The most recent Job Opening and Labor Turnover Survey revealed that firms with less than 250 employees dominated net hiring and job postings since the economy reopened. That continued except for job openings for construction in late January, which plummeted. Employment gains actually accelerated at the start of the year as firms with less than 250 employees absorbed what is being shed at some larger firms.

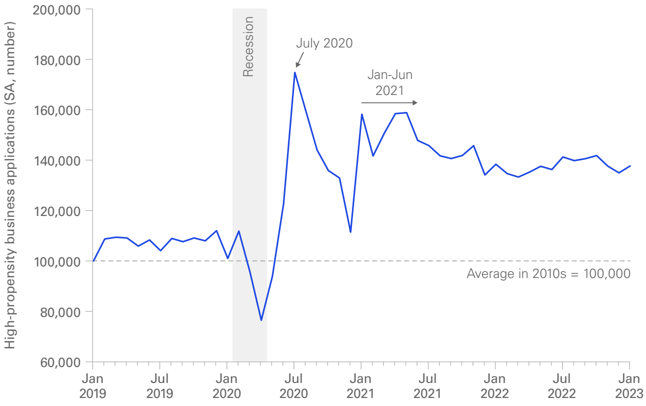
Table 1: KPMG forecasts for the U.S.

	2022	2023	2024
GDP	2.1	0.9	1.3
Inflation	8.0	4.3	2.4
Unemployment rate	3.6	3.6	4.3

Source: KPMG Economics, Bureau of Economic Analysis, Bureau of Labor Statistics.

Note: Forecasts are dated as of March 2, 2023. GDP and inflation are year-over-year % change. The unemployment rate is an annual average. Numbers are percentages.

Chart 5: High propensity business formation



Source: KPMG Economics, Census Bureau.

Anatomy of a slowdown

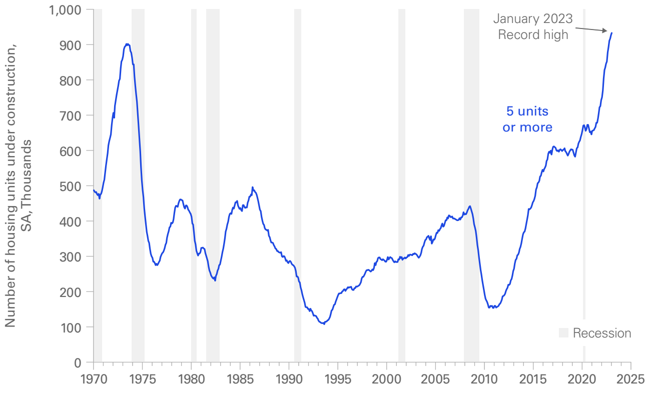
Consumer spending is expected to stall but not collapse. A healing of household balance sheets and a ramp up in saving is buoying demand. Tighter credit market conditions are eroding affordability and will take a toll on employment, especially among younger, smaller businesses that are more susceptible to the current tightening of credit market conditions.

Big-ticket items such as appliances and home furnishings are expected to be hit harder than services; goods purchases tend to get financed, while pent up demand for travel remains strong. Those out of work and unable to work due to vacations are hitting monthly records.

The recession in housing is expected to deepen, with higher interest rates dealing a larger blow to sales and construction than prices. An unusually high percentage of homeowners have either locked into an ultralow 30-year fixed mortgage rate or paid off their mortgages entirely.[1] That has provided a hedge against inflation for homeowners, not renters. The supply of homes for sale is near record lows, which is pushing more would-be home buyers to rent instead of buying single-family houses.

The multifamily market is facing greater headwinds. The pipeline on multifamily construction is at a record high and vacancies are rising (see Chart 6). Unaffordability has forced new college graduates to take on multiple roommates to make ends meet or work from their parents' homes.

Chart 6: Record pipeline for new multifamily construction



Source: KPMG Economics, Census Bureau.

As higher rates take a toll on plans to upgrade and expand existing infrastructure, business investment is expected to contract. The purchasing managers' surveys show that manufacturing activity remained in contractionary territory at the start of the year. The outlier is the vehicle industry, which is still playing catch-up due to earlier supply chain disruptions.

Investment in structures is expected to remain suppressed. Firms continue to shrink their office footprints due to hybrid work models with many existing office leases not being renewed. The exceptions are electric vehicles and chip plants, which are both benefiting from government incentives.

In late 2022, retail inventories ballooned more than those in manufacturing inventories. The liquidation of those inventories is expected to suppress production at home and abroad with imports making up a disproportionate share of retail inventories.

Government spending is poised to slow, despite a ramp up in infrastructure spending and the largest bump in Social Security payments in history. The politics surrounding the raising of the debt ceiling is expected to further slow the pace of government spending in fiscal 2024. The concern is Treasury markets, which remain much less liquid than they were pre-pandemic. The bond market has grown more skittish, which means we could see more volatility than many expect in response to the brinkmanship leading up to a package to lift the debt ceiling.

The trade deficit is expected to narrow. Exports are expected to hold up better than imports. Growth abroad has been surpassing expectations, while a sharp drawdown in inventories will take a toll on imports. Retail inventories are still bloated, with a large share of goods from abroad.

The wrinkle in the forecast for the trade deficit is the strong dollar, which works with a lag. That is undermining our competitiveness at home and abroad. During the global financial crisis, the dollar strengthened and trade came to a virtual standstill.

[1] https://www.dallasfed.org/research/economics/2022/1227

Inflation proves sticky

Escalating geopolitical tensions, a hardening of country borders, climate change and aging demographics have combined to make the economy more susceptible to supply shocks and prone to bouts of inflation. Core (excluding food and energy) inflation measures have become sticky and more resistant to rate hikes than hoped.

Energy prices have come off their highs, which should dampen inflation. The conundrum today is that it is fueling consumer demand elsewhere in the economy, which is setting a floor under inflation.

Inflation in the service sector, which is more dependent on the strength of labor, accelerated again at the start of the year, including everything from vacations to doctor's visits and accounting for more than half of all inflation. It is running above 4% on 3-, 6-, and 12-month measures -- double the Fed's inflation target.

A challenge for the Fed

The Federal Reserve is committed to derailing inflation, which requires a chilling of demand. Main Street picked up at the start of the year, with smaller firms absorbing high profile layoffs at larger firms.

The challenge for the Fed is to balance the need to cool the economy with the need for financial stability. Credit markets are now tightening across much of the economy even as financial markets front-run the Fed on rate hikes.

That tightening of credit conditions we are now experiencing is expected to hit smaller firms with less than 250 employees, residential real estate (builders) and a large chunk of consumer loans hardest. That tightening will eventually show up in a more dramatic pullback in both employment and demand.

The Fed was committed to cooling inflation via a rise in unemployment. The goal was to control that rise and slowly derail inflation, not trigger a deep and more scarring recession. That is a very fine line to walk.

We have consistently argued that the one thing that would stop the Fed from raising rates is a financial crisis. If the regulators have truly averted a crisis, then rate hikes should continue so that inflation is derailed. Otherwise, the Fed risks stoking a more persistent bout of inflation. Policy uncertainty and the risk of a deeper recession just rose.

Diane Swonk
Chief Economist, KPMG in the U.S.

Canada: Winding down to hit inflation target

A recent downward trend in inflation signals that Canada may reach the inflation target range of 1-3% by early 2024.

Canada's resilient labor market, especially for skilled labor, continues to support the economy.

A key downside risk resides in the potential need for further monetary tightening; however, risks are now more balanced.

Following the 2021 rebound, Canada's GDP growth began to experience a slowdown in 2022, in part due to the tightening of monetary policy through most of the year. While the estimated GDP growth for 2022 is closely aligned with the September 2022 forecast, expectations for 2023 have been revised down, reflecting more muted growth than expected in Q4 2022, as well as possible further rates increases this year.

The labor market remains strong, especially for skilled labor, and while inflation excluding mortgage servicing costs is back in line with the target range on a monthly basis, core inflation has moderated from its peak but still remains high. Our models show current momentum is positive for the Canadian economy, which is supported by a resilient U.S. economy and an upward revision to China's economic forecast, which would support demand for Canadian resources.

Table 2: KPMG forecasts for Canada

	2022	2023	2024
GDP	3.6	0.7	1.5
Inflation	6.8	3.6	2.2
Unemployment rate	5.3	5.8	6.1

Source: Statistics Canada, KPMG analysis.

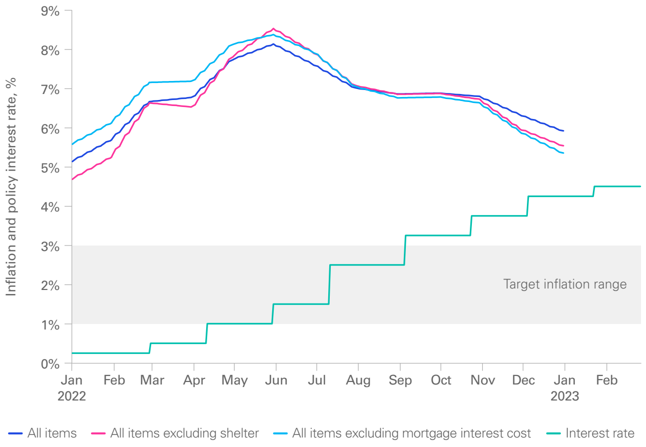
Note: Average % change on previous calendar year except for the unemployment rate, which is the average annual rate.

Despite remaining below potential, GDP growth is forecast to pick up slightly by 2024, signalling expectations that consumer confidence and investor sentiment will improve from anticipated lower inflation and Canada's resilience in its labor markets, amongst other factors.

In an effort to help steer inflation back to a 2% target and to cool down the economy overall, the Bank of Canada introduced eight consecutive interest rate hikes over the past 12 months, reaching 4.5% by January 2023, the highest value since November 2007. The 2022 annualized inflation rate for all items (6.8%) has decreased from its June 2022 peak of 8.1%. At the same time, the annualized inflation rate excluding mortgage costs currently sits below that of all items, hinting at a deceleration of inflation given that mortgage costs are intrinsically linked to interest rates.

Inflation has started to show some moderation, with a 5.9% headline rate in January 2023. While this headline number is still outside the 1-3% target range for inflation, there are other signs showing that inflation is moving in the right direction. Over the last three months, total changes to the CPI, when annualized, show inflation rate much closer to the target range. As this moderation may reflect interest rate increases from the early spring 2022, with later and sharper increases still to be felt, there is some room for inflation to continue moderating. As a result, following its January 2023 interest rate hike, the Bank of Canada's monetary policy stance has now changed from "increase by default, pause if warranted" to "pause by default, increase if warranted". Notably, as of the most recent interest rate announcement (March 8), this stance has been maintained, with the central bank holding this rate steady for the first time in a year. Based on these developments, inflation is expected to return within the target range of 1-3% towards the end of 2023 or early 2024.

Chart 7: Recent momentum in downward trend in inflation

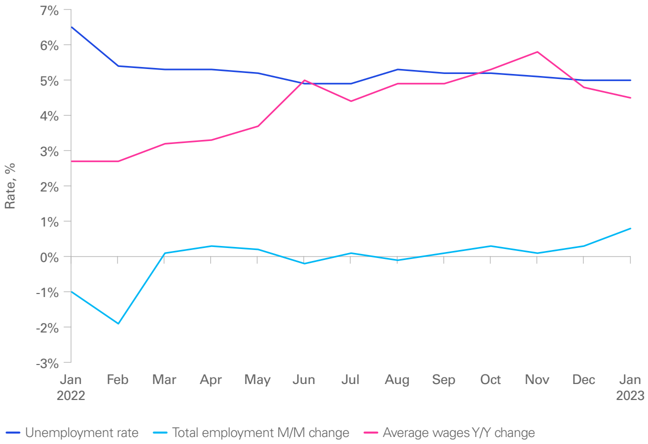


Source: Bank of Canada, Statistics Canada, KPMG analysis.

The labor market showed resilience in January with headline numbers coming up 10 times higher than market expectations. With a monthly gain of 150,000 jobs, this was predominantly concentrated in services sub-sectors, including wholesale and retail trade (+59,000), health care and social assistance (+40,000) and educational services (+18,000). In contrast, certain sectors that were more sensitive to interest rates, such as manufacturing (+7,000), had weaker employment gains. Overall, employment across all industries has seen positive growth since September 2022, with accelerated growth in December 2022 and January 2023.

Similarly, at a stable unemployment rate of 5.0%, close to its record low (4.9%), and an increase in average hourly wages (4.5%) in headline numbers, Canada's labor market remains strong despite the current economic environment. Labor demand is surpassing supply, particularly in the skilled labor category. In the most recent Canadian Survey on Business Conditions, nearly 40% of Canadian businesses reported upcoming challenges to recruiting and retaining skilled labor over the next three months.

Chart 8: Recent momentum in total employment and continued growth in average wages



Source: Statistics Canada, KPMG analysis.

Risks to the forecast are broadly balanced, a relative improvement from the September 2022 forecast which saw elevated downside risks.

The outlook for the global economy has improved, and the U.S. economy in particular is showing itself to be resilient. This improvement may lead the Federal Reserve to take additional actions to bring the U.S. economy "back into balance", which could have negative ramifications for Canada given the deeply integrated trading and economic relationship between the two countries.

Similarly, inflation may not return within the target range as expected, resulting in additional monetary tightening by central banks. Potentially higher interest rates could further reduce activity on some leveraged or rates exposed sectors, leading to greater employment loss and financial distress for some of the more leveraged households.

In other markets, the upward revision to China's GDP forecast for 2023 is set to provide support for global trade, including Canada's resources sector. Overall, increased demand for Canadian resources from one of its main trading partners may result in stronger economic activity and lead to an increase in employment opportunities and wage growth in certain sectors.

The current labor market momentum may also ease the expected effects of a mild recession or slowdown of the Canadian economy. Canada's labor market has shown to be resilient through the pandemic crisis, and recent numbers have demonstrated that the market is still experiencing sustained demand for labor and significant wage growth.

There may also be stronger economic growth through fiscal stimuli and investment in developed economies, including the dual phenomenon of a transition to a cleaner economy and a readjustment towards areas of geopolitical influence (i.e., reshoring), which could boost cross-border investment.

Karicia Quiroz
Manager, Economics & Policy at KPMG in Canada

Stefano Cimmarusti
Senior Consultant, Economics & Strategy at KPMG in Canada

Mathieu Laberge
Partner, Economics & Policy at KPMG in Canada

Caroline Charest
Partner, Economics & Strategy at KPMG in Canada

Brazil: New policies could stoke inflation

The Central Bank of Brazil was among the first central banks to hike rates to combat inflation, having raised them from 2% to 13.75%.

The reopening of China, Brazil's largest trading partner, is the biggest upside risk to growth.

Easier fiscal and monetary policies could fuel a higher and more destructive period of inflation down the road.

Real GDP growth is forecast to slow to 0.8% in 2023, less than a third of the 3% pace in 2022. Brazil is expected to narrowly avoid a recession. Growth has slowed in each successive quarter, finishing 2022 in the negative. President Luiz Inácio Lula da Silva, widely known as Lula, was elected on a left-leaning agenda.

This is the second time that Lula has led the country and he is pivoting from winning to governing this time round. The country remains deeply divided and politically polarized. For the moment, the President has leaned more to the left in his recent policy agenda than when he departed office in 2016 and those shifts are expected to keep consumption afloat in the near term but at the expense of higher inflation.

The President was able to extend pandemic-related fiscal stimulus. Wage and price subsidies and transfer payments are all expected to support growth in 2023, but not to the extent seen earlier in the recovery. The Brazilian government sets a target budget deficit based on expected growth (which was cut in November 2022), making it unlikely that the nation will improve upon last year's deficit. The stimulus package will add to consumer spending and increase already bloated government deficits.

China is Brazil's largest trading partner, accounting for nearly a third of the country's exports according to the Observatory of Economic Complexity (OEC), and its faster than expected reopening and lockdown-induced surge in the households' saving ratio are hoped to support growth. Final consumption expenditures in China tightened in 2022, so pent-up demand is expected to fuel Brazilian exports. In a distant second, the U.S. is also expected to play an albeit smaller role, given the forecast for a slowdown in growth there.

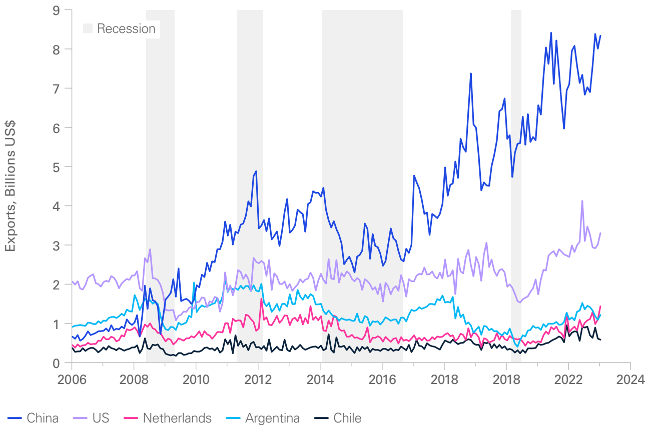
Table 3 KPMG forecasts for Brazil

	2022	2023	2024
GDP	3.0	0.8	2.2
Inflation	9.3	6.4	4.9
Unemployment rate	9.4	9.0	8.8

Source: KPMG Economics, Instituto Brasieiro de Geografia e Estatistica.

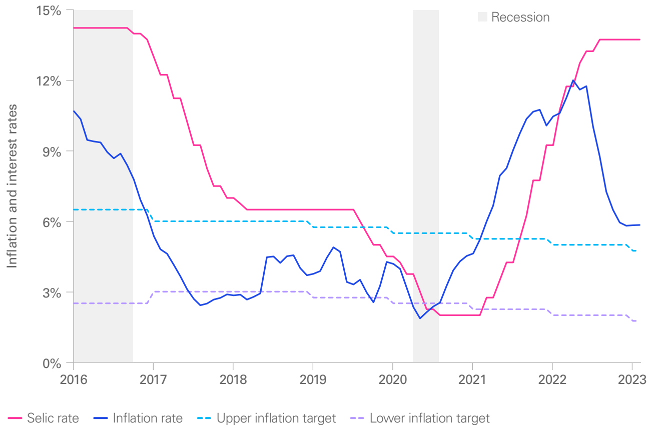
Note: Forecasts are dated as of March 6, 2023. GDP and inflation are year-over-year % change. The unemployment rate is an annual average. Numbers are percentages.

Chart 9: Exports to China are growing, while other destinations remain flat



Source: KPMG Economics, Instituto Brasileiro de Geografia e Estatistica, Banco Central do Brasil/Haver Analytics, OECD.

Chart 10: The BCB holds the Selic rate high while inflation retracts



Source: KPMG Economics, Instituto Brasileiro de Geografia e Estatistica, Banco Central do Brasil/Haver Analytics, OECD.

While environmentally controversial, Lula's pledge to refine oil domestically will allow the nation to lessen its reliance on imported refined petroleum. This should boost net exports over the long term but will not come to fruition soon.

Following nearly a decade of declines, foreign direct investment (FDI) into Brazil reversed in 2022. Those increased inflows were driven by tax incentives and a weak currency. The unemployment rate is far below pre-Covid-19 levels and approaching all-time lows since the measure started being tracked and subpar economic growth is expected to push the unemployment rate up again in 2023.

Business confidence remains suppressed. Capacity utilization trended down at the end of the year, in step with manufacturing PMIs; they closed out 2022 in contractionary territory. Services PMIs are hanging on to expansionary territory but have been weakening since early- to mid-2022.

The Central Bank of Brazil (BCB) was among the first to hike rates. It ratcheted up the Selic rate (Brazil's policy rate) from 2% to 13.75%, where it remains today. The central bank's policy rate increases and other risk factors have led to an inverted yield curve, which is seen as a leading indicator of recessions.

To counter risk of a recession, the President is pushing the BCB to cut rates instead of raising them and lift its inflation target from 3% to 3.5%. Those shifts would undermine the BCB's independence from political interference.

The risk is that shifts to stimulate growth will come at the expense of higher inflation, both in the near and long term. The President's decision to abandon fiscal rules and move away from reforms aimed at reducing borrowing costs, improving productivity and fostering competition could further undermine confidence in the country's economic policies.

Inflation decelerated from above 9% to below 6% at year-end 2022. Core inflation, which strips out food consumed at home deregulated prices, ended the year at 5%, which is still a long way from the BCB's 3% target. Inflation was formerly expected to return to its 3% target in 2024; however, this now seems a stretch.

Demand remains weak, the inflow of FDI could once again reverse and the Brazilian real could further depreciate. That could stoke inflation and balloon government deficits. Given the loss of confidence we have already seen in the business sector, the hope is that the government reverses some of its most extreme policies. Otherwise, borrowing costs for corporations and the government will remain high for a longer period which could raise the risk of default.

Ben Shoesmith
Research Economist, KPMG in the U.S.

Mexico: Policy headwinds make for muted growth

Stronger economic momentum at the end of 2022 slightly boosts growth prospects for 2023, but headwinds mount.

A mild recession is likely due to the interconnectedness with the U.S., Mexico's largest trading partner.

Inflation pressures are easing, while the peso's strength is expected to continue through 2024. Rate cuts are likely this year.

Mexico, Latin America's second largest economy according to the World Bank, is expected to grow at a 0.9% pace in 2023, a slowdown from 3.1% pace, as seen in 2022. Consumption – both by households and the public sector – is expected to drive growth, while investment and trade are set to provide some offset. The U.S., Mexico's largest trading partner, is set to suffer a mild contraction mid-year, according to our forecast. "Friend-shoring" investments are boosting Mexico's long-term economic growth prospects; policy uncertainty for foreign investors remains sand in the gears.

Consumer spending, which is about two-thirds of the overall economy, is forecast to rise by 0.3% in 2023. Rising minimum wages and record-high remittances have boosted consumption in recent years, but high inflation, record tightening of monetary policy and a loss in tourism due to the U.S. recession are expected to derail income gains.

Exports are forecast to be a drag on growth. This is largely in response to a slowdown in the U.S., which takes up about 80% of Mexico's exports.

Due to Mexico's proximity to United States-Mexico-Canada Agreement (USMCA) partners, it is benefitting from reduced investment in China. Legacy manufacturing, such as automobiles and textiles, is being supplemented by an increased desire to produce semiconductors and green energy components, such as batteries. There have been more announcements from companies on increasing their manufacturing presence, especially in the north of the country.

Foreign direct investment (FDI) rose by 12% in 2022 to a level of USD 35 billion (see Chart 11). Roadblocks to increased FDI include uncertainty over the outlook for the energy sector and more hostile government policies. The left-leaning government of Andrés Manuel López Obrador (AMLO) has yet to make its agenda for investment clear.

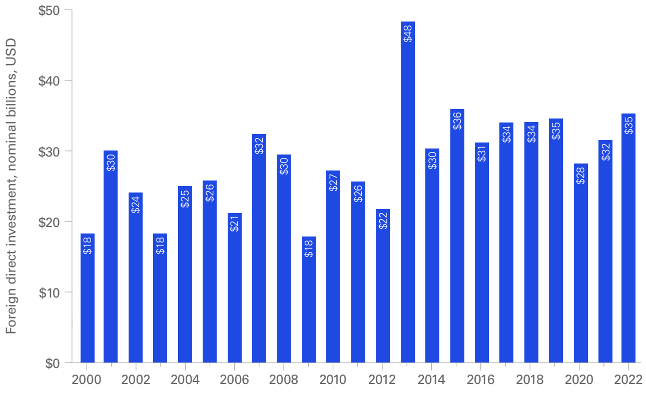
Table 4: KPMG forecasts for Mexico

	2022	2023	2024
GDP	3.1	0.9	1.6
Inflation	7.8	4.5	3.9
Unemployment rate	3.4	3.6	3.8

Source: KPMG Economics, Instituto Nacional de Estadística Geografía e Informatica (INEGI).

Note: Forecasts are dated as of March 6, 2023. GDP, inflation, & the unemployment growth rates are annual averages. Numbers are percentages.

Chart 11: Mexico FDI highest in seven years in 2022



Source: KPMG Economics, Banco de Mexico.

The U.S. and Canada are currently embroiled in a trade dispute with Mexico over restrictions of private investments in energy, which is in violation of their USMCA trade agreement. Increased demand for manufacturing translates into more energy needs, which Mexico cannot meet with its current infrastructure.

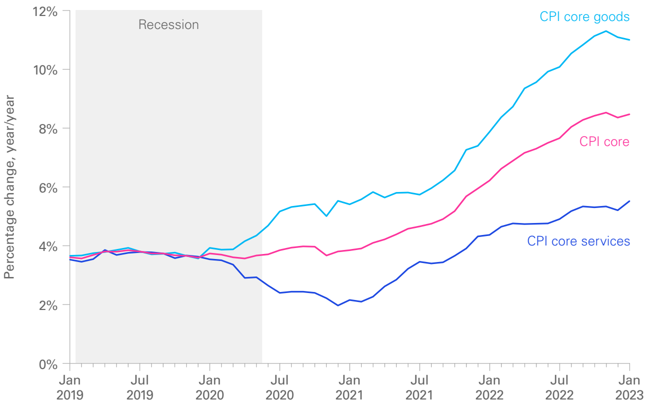
In the public sector, a positive current account balance and a below-50% debt-to-GDP ratio reduce the risks of sovereign default, even with a mild recession. The government deficit is expected to narrow to 0.2% of GDP in 2023. The expiration of food and fuel subsidies, which were used to counter escalating costs, will help reduce the deficit.

The unemployment rate is expected to rise to 3.6% by the end of the year, after hitting a multi-decade low of 2.9% in January 2023. A double-digit annual increase in the minimum wage level has boosted households' finances, but high inflation is taking a bite out of those gains.

Remittances (which make up about 4% of GDP) hit a record high in December of 2022 after rising sharply in 2020 and 2021. With many remittances coming from the U.S., an appreciation of the peso relative to the U.S. dollar has eroded the purchasing power associated with those transfers.

Inflation remains sticky; the drop in core goods inflation is slowing, while core services inflation is accelerating (see Chart 12). In response to aggressive rate hikes by Banxico, Mexico's central bank, overall inflation is expected to cool to 4.5% by the end of 2023.

Chart 12: Inflation remains sticky



Source: KPMG Economics, INEGI.

Banxico surprised markets in February by hiking rates by 50 basis points (instead of the expected 25), signaling that more hikes are on the table. Rising core inflation is a concern for the bank, with January data showing inflation rising at an 8.45% annual pace, significantly higher than the bank's 3% target. The bank has raised the short-term rate to 11%, or 700 basis points higher since the start of their hiking cycle in mid-2021. Banxico is expected to hit a peak in short-term rates of 11.5% by late spring and to cut rates at the end of 2023, earlier than the U.S. central bank.

Mexico is expected to lag many of its Latin American counterparts in 2023 and to rebound slightly in 2024. The growth trajectory remains below its potential. Policy missteps and a lack of clarity on investment policy by AMLO are expected to crimp growth in the private sector. Mexico's greatest asset is that it is seen as a safer bet for offshoring than China; evidence of "friend-shoring" is emerging. The USMCA trade pact, which Mexico ratified before its Northern neighbors, is playing a key role in those shifts.

Yelena Maleyev
Economist, KPMG in the U.S.

China: Domestic demand as the key for recovery

With a rapid exit from the zero-Covid policy, the re-opening last December has accelerated China's economic recovery, which we expect to continue this year.

Consumption is expected to be a key driver of growth this year, supported by improving income growth, consumer confidence, and mobility.

China is accelerating its establishment of a modern industrial system. We expect manufacturing investments, digitalization, and energy transition, to see rapid growth in 2023.

China's GDP grew 3.0% in 2022. Headwinds such as the highly transmissible Omicron variant of Covid-19, continued slowdown of the real estate market, rapid interest rate hikes by the U.S. Fed, and geopolitical uncertainty, weighed on the Chinese economy last year. Meanwhile, despite slower economic growth, the size of China's GDP reached RMB 121 trillion (USD 18 trillion), underscoring China's growing importance to the global economy.

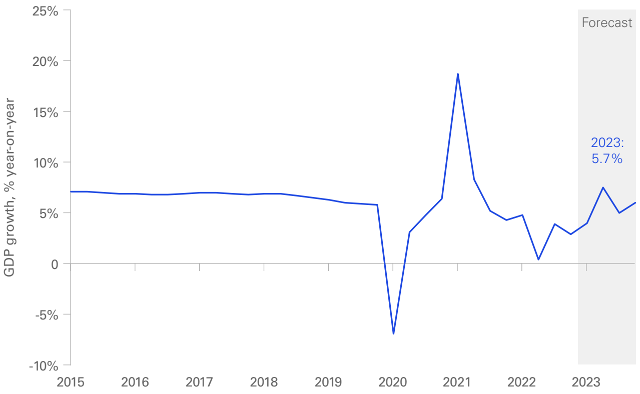
The country's annual Government Work Report (GWR), delivered at the 14th National People's Congress in March, set a GDP growth target at "around 5.0%" for 2023, slightly lower than market expectations. Although it was the lowest growth target set in several decades, it is still an ambitious goal considering the large size of the Chinese economy. The target is also still higher than the expected growth of many major economies. Looking ahead, after a rapid exit from the zero-Covid policy, China is shifting its priority to improving economic growth. We expect China's economy to continue to recover and grow by 5.7% this year. Meanwhile, the global economy is facing increasing headwinds. With China's growth rate accelerating from last year, we expect it to be a key engine of global growth again this year.

Table 5: KPMG forecasts for China

	2022	2023	2024
GDP	3.0	5.7	5.2
Inflation	2.0	2.4	2.2
Unemployment rate	5.6	5.3	5.2

Source: Wind, KPMG forecasts. Average % change on previous calendar year except for the unemployment rate, which is the average annual rate. Inflation measure used is the CPI, and the unemployment measure is the surveyed unemployment rate.

Chart 13: China's real GDP growth



Source: China's National Bureau of Statistics, Wind, KPMG forecast.

Employment stabilization is an important policy target and is critical for restoring market confidence. According to the GWR, China set a target of creating around 1,200 million new urban jobs this year, the highest target in history. And the target for the urban unemployment rate this year is "around 5.5%". With a record 11 million students graduating from colleges this year, the government is giving special attention to support the youth labor market. We expect the unemployment rate to average 5.3% in 2023.

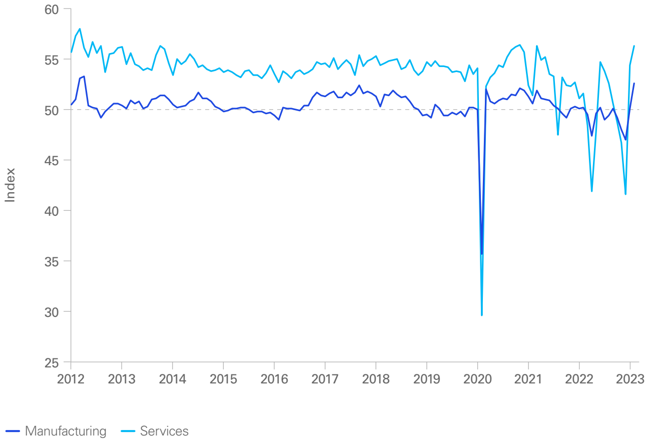
The relaxation of pandemic restrictions starting from December 2022 has accelerated China's economic recovery. Recent data showed a strong rebound after the Chinese New Year holidays. Road traffic saw more congestion than the same period in 2019 before the pandemic, reflecting normalization of economic activities. Meanwhile, the manufacturing Purchasing Managers' Index (PMI), a leading indicator of industrial production, returned to the expansionary territory and reached 52.6 in February, the highest reading since May 2012 (see Chart 14). Industrial activities are expected to continue to recover.

The government is prioritizing the recovery and expansion of domestic consumption. Consumption is expected to be a key driver for China's growth this year. Consumer spending, especially for services and discretionary, will likely see a stronger rebound. Holiday spending during the 2023 Chinese New Year holiday saw a solid recovery. Movie box office totalled over RMB 6.76 billion, the second highest in history[1]. Service PMI also saw a strong rebound, jumping 14.7 percentage points in February from the depressed level last December. As services account for nearly half of China's consumption, its recovery is important for the rebound in consumption.

In addition, we estimate that China's households have accumulated RMB 10 trillion of excess savings compared to the historical trend, as they became more cautious on spending and mobility restrictions also reduced consumption scenarios. The re-opening and economic recovery will help improve consumer confidence and some of the excess savings may be released, which should support the recovery in consumption.

On the investment side, we expect technology upgrading and green transformation to support manufacturing investment. Infrastructure investment should remain solid, but its growth will be limited by local government's fiscal conditions. Meanwhile, the real estate investment is expected to stabilize this year and become a lesser burden to overall growth.

Chart 14: Purchasing Managers' Indices



Source: Wind, KPMG analysis.

[1] https://www.chinafilm.gov.cn/chinafilm/contents/142/4507.shtml

Exports used to be China's key growth engine during the past three years, but the trend has started to reverse. China's exports have declined for five consecutive months since last October and the weakness is expected to continue as the global economy slows. Despite the slowdown, the product mix of China's exports is changing with increasing high-end manufacturing. Driven particularly by strong demand of new energy vehicles, China exported over 3 million vehicles last year, up by 54% and becoming the second largest auto exporter after Japan. Meanwhile, as the Regional Comprehensive Economic Partnership (RCEP) strengthening intra-region cooperation, China's exports to ASEAN economies still maintained robust growth, accounting for 15.8% of total exports in 2022, up by 1.4 percentage points from 2021. The trend of Asian Pacific economic integration is expected to continue to strengthen.

China is expected to maintain an accommodative policy stance to boost growth. Fiscal support measures will be stepped up and be more effective. The government set a fiscal deficit ratio at 3.0%, 0.2 percentage points higher than last year. In addition, RMB 3.8 trillion local government special bonds will be issued to supplement government spending, an increase of RMB 150 billion from last year. China will continue to adopt supportive monetary policy, particularly in targeted areas including expanding liquidity and applying special relending facilities to increase financial support to SMEs, green investment, technology, and elderly care. We expect China's CPI inflation to remain mild at 2.4% in 2023.

Despite multiple challenges, China's foreign direct investment (FDI) rose 8% in 2022. However, it may not be easy to keep up the momentum in light of slowing global growth and increasing geopolitical challenges. To attract FDI, the government strives to further increase market access and expand institution-based opening up. In the latest catalogue for encouraged FDI, effective this year, it added over 200 items to the list and gave special priorities to foreign investment in advanced manufacturing, modern services, energy efficiency and environment protection, and scientific innovations.

The Hong Kong (SAR) economy is also expected to recover in 2023. An expected strong rebound of tourism from the Chinese Mainland should support an acceleration of services consumption. While weak global demand will continue to pose pressure to Hong Kong's exports, the removal of cross-border travel restrictions and an expected faster growth of the Chinese Mainland economy should help Hong Kong's economy. We expect that Hong Kong's economic growth will return positive, after falling by 3.5% in 2022. Meanwhile, Hong Kong is accelerating its economic integration with the Chinese Mainland and the development of the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) continues to gain traction.

Kevin Kang, PhD
Chief Economist, KPMG China

Japan: Recovery stifled by rising prices and global headwinds

A weakening global economy and a slowdown in consumer spending weighs on economic recovery driven by pent-up demand.

Inflation expected to moderate from a peak early in 2023 as the influence of global factors on inflation recedes.

Bank of Japan is likely to maintain an ultra-loose stance of monetary policy.

Japan faces a mixed outlook as the ongoing recovery in the domestic economy is set against weaker global growth and consumers cutting back on spending plans in response to rising prices. Revised data for 2022 showed no GDP growth in the three months to December 2022, following on from a 0.3% contraction in the preceding quarter. We expect GDP growth to reach 1.1% in 2023, accelerating to 1.2% in 2024.

Japan's manufacturing sector has seen a steady deterioration in demand driven in part by weaker demand from a slowing global economy. In February 2023, the level of the Purchasing Manager's Index (PMI) for manufacturing fell to 47.7 (see Chart 15) indicating the fastest pace of contraction in the sector since September 2020. While we expect continued weakness in the first half of 2023, a partial recovery in the global economy as well as an easing of supply chain frictions early this year could provide a boost to Japan's manufacturing sector in the second half of 2023.

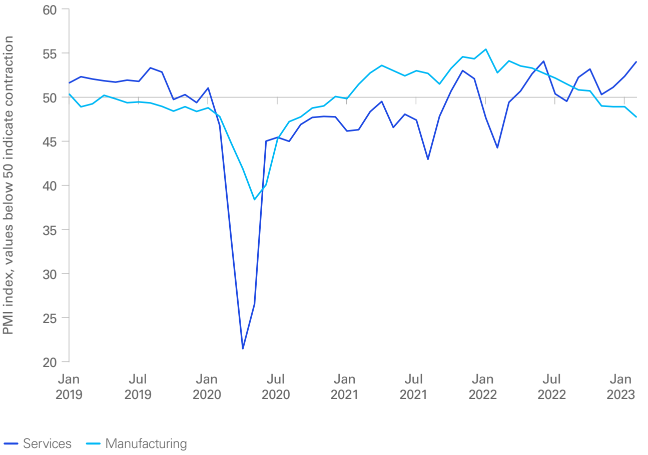
In contrast, sentiment in the service sectors has been more robust at the start of 2023, with the February PMI survey for services pointing to the fastest pace of expansion for eight months. The easing of Covid-19 restrictions in 2022 has also prompted a partial recovery in Japan's tourism sector, which saw January 2023 visitor numbers reach 56% of the average levels seen in 2019. While some restrictions of visitors from China remain in place[1], a complete recovery may take some time, but is nevertheless expected to support growth during 2023.

Table 6: KPMG forecasts for Japan

	2022	2023	2024
GDP	1.0	1.1	1.2
Inflation	2.5	2.9	1.0
Unemployment rate	2.6	2.4	2.4

Source: Cabinet Office of Japan, Ministry of Internal Affairs and Communications, KPMG forecasts.
Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is CPI.

Chart 15: Stronger service sector output is offset by weakening growth in manufacturing



Source: S&P Global.

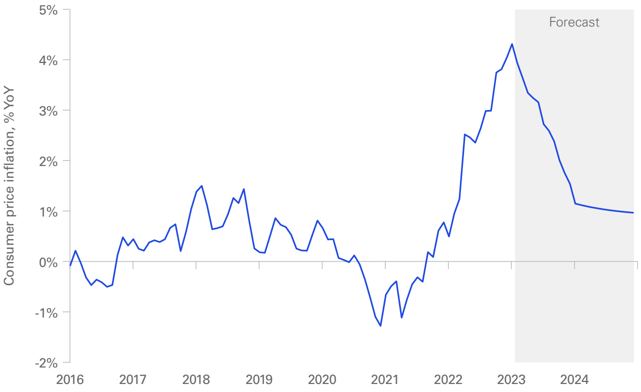
[1] Arrivals from China to Japan are required to show proof of a negative-PCR test as well as China's continuing ban on package tours.

In January 2023, Japan's consumer price inflation reached 4.3%, its highest level for more than 40 years. Rising costs of domestic energy and higher food prices were the main drivers. We expect the impact of both factors to diminish over the course of this year, leading to a steady decline in inflation this year (see Chart 16). Overall inflation is expected to average 2.9% this year, and 1% in 2024.

We expect base rates to remain at current low levels and the overall stance of monetary policy to stay accommodative throughout the next two years. While higher inflation offers an opportunity to exit the ultra-loose monetary policy regime, the Bank of Japan appears reluctant to do so, as an early tightening of monetary policy could risk inflation falling back to below its 2% target in the longer term. Historically, the Japanese economy has suffered from persistent weakness in domestic demand and low levels of inflation, while the Bank of Japan maintained a low level of base interest rates and engaged in unconventional monetary policies.

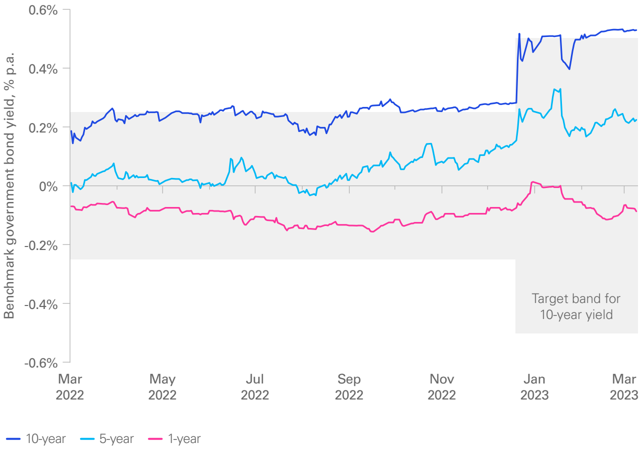
Some tweaks to monetary policy may be inevitable this year, in particular to Yield Curve Control (YCC), which could see a further increase in the target bands from their current level. This policy forms a part of "Quantitative and Qualitative Easing" under which the Bank of Japan intervenes in bond markets to ensure that the yields for 10-year government bonds are within a band of 0.5 percentage points from 0%. The current bands were set in December 2022, from a narrower band of 0.25 percentage points around the 0% level (see Chart 17). Long-term bond yields have consistently stayed at or above the upper targeting band for the past year and could prompt further increases in the target band in the future.

Chart 16: Outlook for Japan's inflation



Source: Ministry of Internal Affairs and Communications, KPMG analysis.

Chart 17: Japan's 10-year yield has remained at or above the cap imposed by the Bank of Japan



Source: Ministry of Finance of Japan, KPMG analysis.

A more comprehensive policy review is a distinct possibility, especially as the Governorship of the Bank of Japan passes from Mr Haruhiko Kuroda to Dr Kazuo Ueda in April 2023. A February survey of Bond Market participants showed 64% of respondents reporting a "low" level of market functioning as the Bank of Japan has taken on an increasingly larger stake of government bond ownership. The extent of the Bank of Japan's interventions has in some cases led it to increase its holdings of government bonds to over half of those issued and over 100%[2] for some recent issues of long-term bonds.

Japan's labor market remains tight with January's unemployment rate of 2.4% in line with 2019 averages. High inflation and increasing competition for talent have pushed annual increases in cash earnings to 2.24%[3] in the three months to January 2023. We expect the overall rate of unemployment to remain at 2.4% throughout this year and next.

Our overall outlook for the Japanese economy shows a modest pace of recovery alongside a slowing pace of inflation. While the Bank of Japan continues to pursue loose monetary policy, we judge that inflation in 2024 may undershoot the target of 2% and more policy action may be needed before it returns to sustainably to target.

Dennis Tatarkov
Senior Economist, KPMG in the UK

[2] Through securities lending aimed at enhancing market liquidity and repurchases.
[3] Ministry of Health, Labor and Welfare, establishments with five or more employees.

India: Cautiously shining amid global uncertainty

India's domestic demand expected to be a key driver for economic growth.

Strong capital expenditure push seen from the government to promote investments and job creation.

Global geopolitical tensions and a slowdown in the global economy remain a risk to the outlook.

The effects of the slowdown in global economic growth resulting from high inflation and the continuing war between Russia and Ukraine are also seen to be affecting India's economic performance. The country recorded muted growth of 4.4% in Q4 2022 compared to 6.3% in Q3 2022, with sluggish private consumption and exports being the major reasons behind that. The country's real GDP growth in the fiscal year 2022-23 is estimated at 7.0% in comparison to 9.1% in the prior year. However, some demand indicators such as record sales of 3.8 million in the passenger vehicles segment in 2022[1], strong growth in tractor sales, and a rise in domestic air travel, continue to support economic growth.

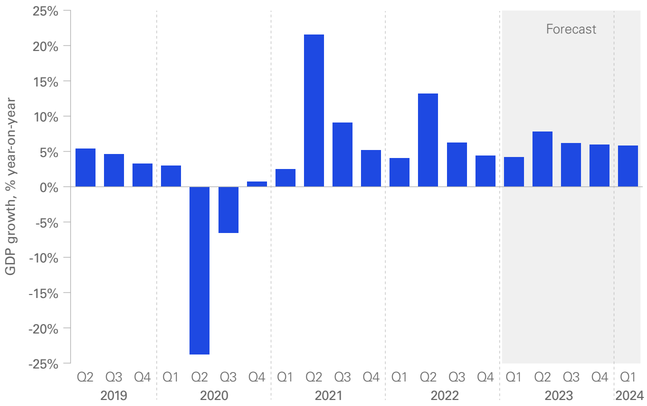
Table 7: KPMG forecasts for India

	2022	2023	2024
GDP	7.0	6.4	6.9
Inflation	6.5	5.3	4.4
Unemployment rate	7.5	6.0	5.4

Source: Ministry of Statistics and Programme Implementation, CMIE, KPMG forecasts.

Note: The years represent the April-March period, for instance, 2022 spans from April 2022 to March 2023.

Chart 18: India's quarterly GDP growth

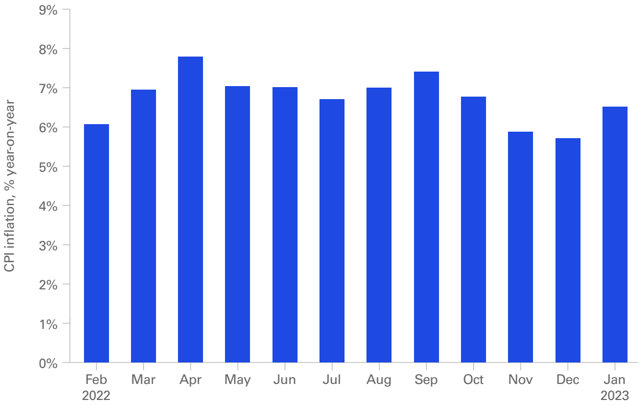


Source: RBI and National Statistical Office.

[1] "Auto Industry Sales Performance of December 2022, October - December 2022, April-December 2022 and January - December 2022", SIAM, 13 January 2023, as accessed on 1 March 2023.

Despite the sluggish growth in the latest quarter, we still expect India to be one of the major beacons of growth in 2023, driven by strong domestic demand and government expenditure. The efforts of the Union Budget 2023-24 to improve the disposable income of taxpayers in the country is expected to boost consumption via an increase in discretionary spending. In addition, the strong capital expenditure push provided by the Union Budget, with an increased outlay of 37.4% in comparison to the fiscal year 2022-23, is expected to drive growth, investments, and job creation. The government's reduction of over 39,000 compliances and decriminalization of over 3,400 legal provisions will also foster the ease of doing business in the country.[2] Strong credit growth and resilience in financial markets are further expected to create an environment that supports investments.

Chart 19: India's Consumer Price Index



Source: Ministry of Statistics and Programme Implementation.

Note: Inflation rate for the month of January 2023 is provisional.

A high unemployment rate, however, remains a concern for India, standing at 7.5% in February 2023. Inflation, which was falling since October 2022, spiked again to 6.5% in January 2023 driven by high food prices, breaking the Reserve Bank of India's (RBI) upper tolerance limit, though still below the elevated levels seen during the first half of 2022-23. The RBI is focused on the withdrawal of accommodation aimed at controlling inflation, with policy repo rates hiked six times since May 2022. The ongoing global geopolitical tensions and higher demand from various countries lifting Covid-19 related mobility restrictions are also expected to affect commodity prices. Core inflation is expected to be affected by the continued transfer of input costs to output prices, particularly in the services sector. However, input costs and output prices are expected to ease in the manufacturing sector. Taken together, the RBI projects inflation at 6.5% for 2022-23 and 5.3% for 2023-24.

A robust domestic demand and favorable government initiatives are expected to help India remain as one of the fastest growing major economies globally. However, external challenges, such as a slowdown in the global economy and monetary tightening in advanced economies, are factors that could affect the country's growth.

Preeti Sitaram
Director, Government & Public Services, KPMG in India

[2] Budget 2023-2024, Speech of Nirmala Sitharaman, Minister of Finance, Government of India, 1 February 2023, as accessed on 1 March 2023.

Germany: Europe's largest economy to escape recession

German economy to gradually recover in the second half of 2023.

Inflation rate to fall in the medium term.

Labor market to remain robust and stabilize private consumption.

The war in Ukraine, ongoing supply chain disruptions, and the energy crisis weighed on the German economy in 2022. Gross domestic product grew by 1.8%, thanks in particular to private consumption, which grew by 4.3%. Consumers spent almost as much as before the Covid-19 pandemic with people making up for what they could not do during the pandemic: travel, visits to restaurants, cultural experiences, celebrations, trade fairs, etc.

Despite the 0.4% contraction in GDP in Q4 2022, the slowdown in economic momentum is likely to be shorter and milder than originally expected. Relief packages from the German government, particularly in the form of the gas and electricity price brakes, could save the German economy from a recession in 2023. These subsidies will also have a dampening effect on the rise in consumer prices.

After reaching its lowest point in September 2022, business sentiment is brightening again. Companies have been more upbeat about both their business situation and expectations in recent months. This is on the one hand due to the lower producer prices in the manufacturing sector, which have a positive effect for the industry in purchasing. On the other hand, the energy price brakes announced and imposed at the turn of the year have provided some reassurance for companies.

The Russia-Ukraine war and the associated explosion in energy prices are estimated to have cost Germany around 2.5%, or EUR100 billion, in economic output in 2022. Germany is economically more affected by the crisis than other countries due to its high dependence on Russian energy, a high share of energy-intensive industry, and greater reliance on exports and global supply chains.

This is also reflected in the foreign trade figures. Due to the sharp rise in energy prices, Germany's trade surplus was lower last year than at any time since the turn of the millennium. Although more goods were again exported than imported, the foreign trade balance halved.

Table 8: KPMG forecasts for Germany

	2022	2023	2024
GDP	1.8	0.1	1.4
Inflation	6.9	6.1	2.2
Unemployment rate	3.0	3.1	2.8

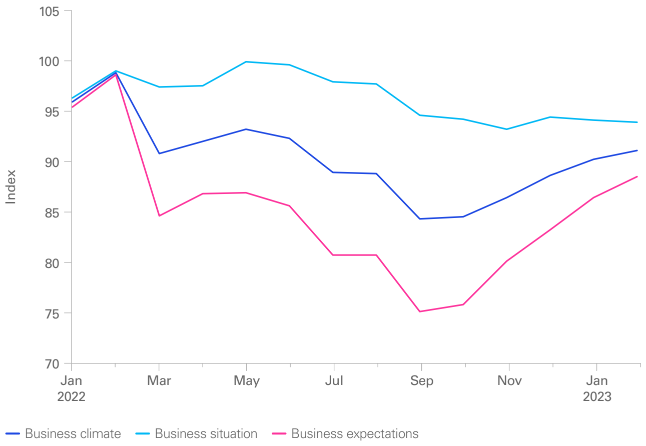
Source: Destatis, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the CPI.

DEM BAYERISCHEN HEERE

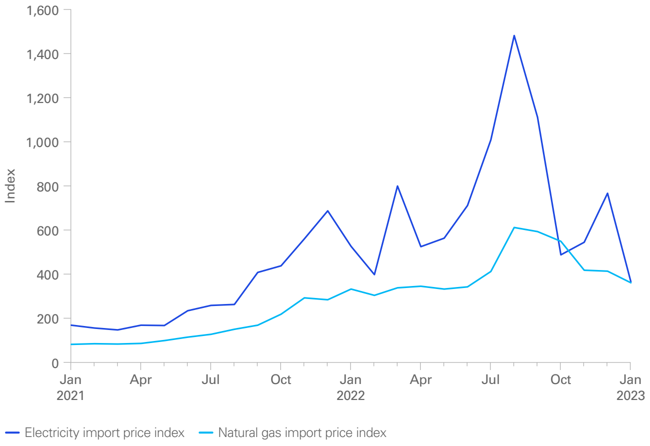
The energy crisis is also burdening the construction industry. Prices for building materials remain at historically high levels, especially those which are energy intensive. Other factors, such as rising interest rates, supply bottlenecks, and a lack of skilled workers, are also clouding the investment climate and slowing down new construction and renovation activities. The number of building permits is falling rapidly, and more and more companies are cancelling already planned construction projects. Although the order backlog in the construction industry remains high, there have been more and more cancellations recently. The construction industry is therefore pessimistic about 2023 and expects a real decline in turnover of around 7% for the year.

Chart 20: ifo Business Climate Index for Germany



Source: ifo Institute.

Chart 21: Electricity and natural gas import price index



Source: Destatis.

Set against that, consumer sentiment in Germany is on the road to further recovery. Recently lower prices for energy, a labor market that remains stable and the possibility that a recession in Germany could be avoided, are slowly bringing optimism back. Nevertheless, German consumers must cope with a hit to their real disposable incomes due to high inflation, which could also affect their propensity to spend. Real incomes fell by 4.1% in 2022, more sharply than ever before.

After inflation in Germany reached its highest level last year since the reunification, various effects are contributing to a gradual easing of the price pressures. These include the government's gas and electricity price brakes which provide relief for both industry and private households. In addition, base effects, which are taking effect from March, will also have a positive impact on inflation.

Manufacturers also lowered their prices in January for the fourth time in a row. Producer prices, which are currently driven primarily by expensive energy, are considered a precursor to the development of the cost of living. However, the inflation rate remains at a high level, and second-round effects from strong wage and salary increases are foreseeable.

The persistently high price level, geopolitical uncertainty, rising interest rates and disrupted supply chains continue to weigh on businesses and consumers. However, the absence of the feared gas shortage, coupled with a falling inflation rate, government subsidies, and stabilizing foreign trade paint an improved outlook for the German economy. Overall, we expect activity to gradually stabilize in 2023 and continue to grow in 2024.

Dr. Ventzislav Kartchev
Head of Business Intelligence/Markets, KPMG in Germany

Austria: Mild recession, slow recovery

After strong 2022 growth, the probability of entering a technical winter recession has risen.

Above-average fiscal support leads to well above-average Eurozone inflation.

Trade-off between further support and fiscal consolidation to dominate the 2023 outlook.

Following strong growth in the first half of 2022, the Austrian economy has slowed down significantly. High inflation has dragged on consumption and investment, causing GDP to stay flat in Q4 2022. Industrial production also came down significantly. As this decline is expected to have continued, the probability of Austria entering a technical recession remains high, with economic sentiment indicators as well as the Purchasing Managers' Index substantially below their long-term averages.

Despite the slowdown, Austria recorded above-Eurozone average growth of 5.0% in 2022. Looking ahead, although growth is set to benefit from a recovery in real disposable incomes as energy prices moderate and wages increase, the outlook remains mixed. Increasing labor shortages, combined with falling industrial production and generally low economic sentiment, are expected to weigh on the growth momentum.

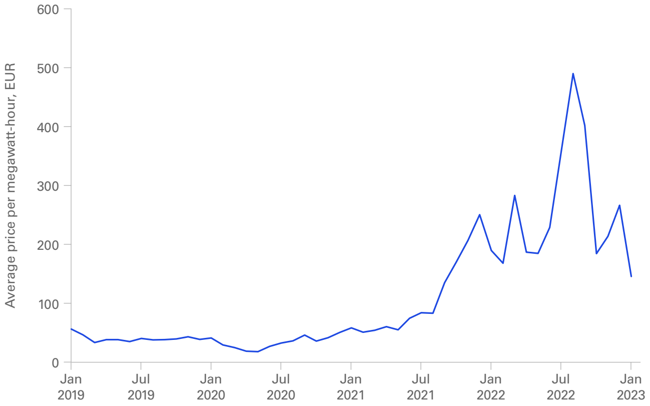
Table 9: KPMG forecasts for Austria

	2022	2023	2024
GDP	5.0	0.1	1.4
Inflation	8.6	6.3	2.8
Unemployment rate	4.8	4.9	4.6

Source: Bloomberg, Statistik Austria, KPMG forecasts.

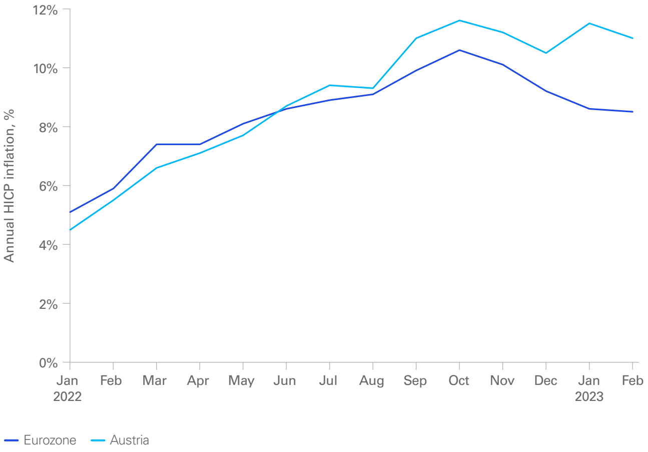
Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

Chart 22: Average monthly electricity wholesale price in Austria



Source: Statista.

Chart 23: Inflation rates in Austria and the Eurozone



Source: Eurostat.

Rising interest rates have turned out to be an additional dampening factor. Thanks to ongoing and strong fiscal support, as well as a resilient labor demand, we expect the recession to be mild, followed by a moderate upswing. While negative growth for full year 2023 seems unlikely, we forecast the Austrian economy to stagnate (0.1%). In view of the large number of economic policy challenges ahead, only a slight acceleration in economic activity to 1.4% growth in 2024 is anticipated.

Turning to inflation, Austria experienced the same pressures as other European countries with a strong dependence on Russian gas, driving up energy prices. Moreover, wage settlements in recent months have resulted in pay growth slightly above the inflation rate, leading to additional pressure on prices, resulting in an annual inflation rate of 8.6% in 2022. However, while heavy fiscal support has helped to hedge against a downturn, it has also pushed up inflation. While Eurozone inflation eased to 8.5% in February, Austria recorded a higher rate of 11% (see Chart 23).

We expect inflation to stay elevated over the forecast horizon, with significantly stronger price increases than Eurozone average. Nevertheless, with energy prices set to moderate throughout 2023, headline inflation is forecast to average 6.3%. In 2024, core price developments are set to moderate, with inflation projected at 2.8%.

Despite the slowdown in economic activity, the seasonally-adjusted unemployment rate remains low and was flat at 4.8% in January 2023. The high number of job vacancies counteracts the negative effects of the economic slowdown. After averaging 4.8% in 2022, we expect the unemployment rate to stabilize at 4.9% in 2023 amid cyclical fluctuations during the year. For 2024, despite the moderate pace of recovery, we expect a slight decline to 4.6% due to slower growth in the labor force.

Despite its inflationary side effects, the structure and size of the fiscal support measures are set to be reviewed in 2023. Rent ceilings and further measures to address purchasing power are on the table. The trade-off between further support and rising debt is expected to be in the focus of political debate in 2023, determining the longer-term growth path for the Austrian economy.

Dr. Stefan Fink
Chief Economist, KPMG in Austria

Switzerland: Testing the frontiers of resilience

Switzerland will not be able to escape the international trend of declining economic performance entirely in H1 2023.

A recession is likely avoidable due to the relatively high resilience of the Swiss economy, followed by moderate growth in 2024.

Price pressures are increasing, and – although inflation is far below its peers – monetary policy reaction is expected.

The Swiss economy lost steam in the last quarter of 2022 amid tighter monetary policy and a slowdown across major export destinations. GDP growth stagnated in Q4 (0.0%), after growing at 0.2% in Q3. The Swiss growth dynamic has therefore aligned with the big European picture. Potential stress in the banking system leaves the economy vulnerable to further uncertainty and shocks.

Slowing growth rates in the international environment in general, and core Swiss trade partners, dampened export dynamics, which had significant impact on the manufacturing sector, albeit coming from a very high level. Following strong data for manufacturing PMIs in early 2022, industrial dynamics slowed down, though still remaining in expansionary territory (see Chart 24). Strongest support came once more from the chemical-pharmaceutical industry. The Swiss industry left expansionary path in early 2023, where manufacturing PMI numbers started to worsen into a negative growth region (49.3 in January, with further slowdown to 48.9 in February).

Sectoral dynamics have not been homogeneous. While services PMIs in Q1 joined strong manufacturing figures (60.2 in March 2022), the drop came somewhat sooner, with 49.5 in December, consistent with negative services growth. However, the sector has recovered quickly, with services PMIs returning to positive territory in January and February 2023 (56.7 and 55.3, respectively).

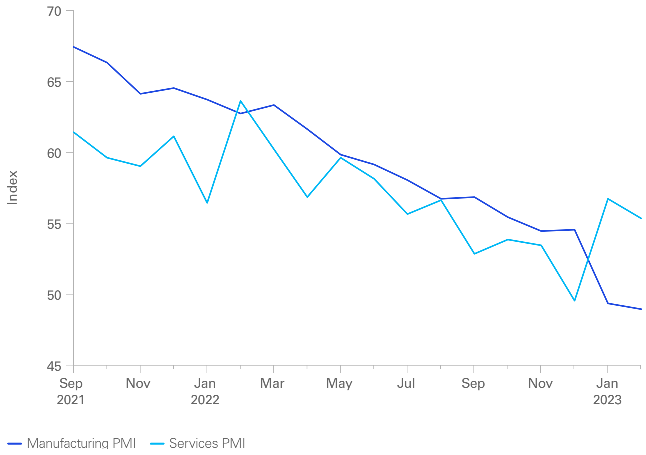
Table 10: KPMG forecasts for Switzerland

	2022	2023	2024
GDP	2.1	0.3	1.4
Inflation	2.8	2.3	1.3
Unemployment rate	2.1	2.4	2.3

Source: Eurostat, SECO, KPMG forecasts.

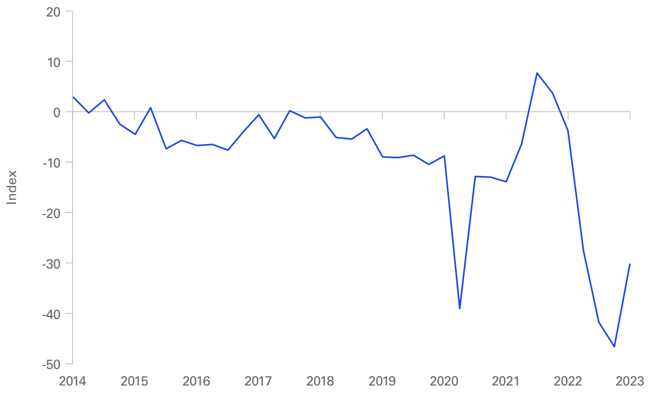
Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the CPI.

Chart 24: Purchasing Managers' indices for Switzerland



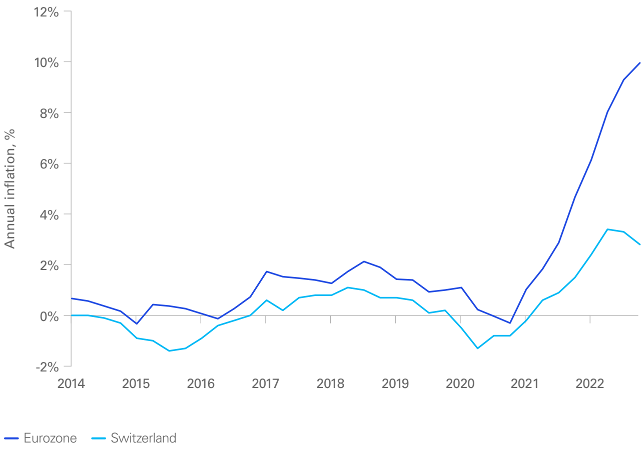
Source: procure.ch, Credit Suisse.

Chart 25: Consumer sentiment index in Switzerland



Source: SECO.

Chart 26: Inflation in Switzerland and the Eurozone



Source: Bloomberg.

The strong labor market is a supportive factor, although it could mask the structural issues of labor shortage, which turn out to be a central risk factor for the Swiss economy. 2022 saw the development of a labor market increasingly characterized by a shortage of workers and an unemployment rate of 2.1%. The unemployment rate fell in 2022 by 0.5 percentage points (from 2.6% in 2021) to its lowest in 20 years.

In Q4 2022, labor compensation increased slightly stronger than consumer prices (which were flat in Q4), while higher purchasing power supported private consumption. This is also reflected in consumer sentiment figures; although still being in negative territory, consumer sentiment improved from -47 in October 2022 to -30 in January 2023 (see Chart 25). That makes the Swiss consumption dynamic significantly stronger than in the Eurozone.

Nevertheless, price increases are a challenge for Switzerland as well. Energy price increases as well as the impact of supply chain shortages in Europe have both had an impact on the economy, although the Swiss inflation is still far below its European peers. The latest figures showed a reacceleration of inflation, with February CPI coming in at 3.4%, close to the peak of 3.5% in August 2022 and far above the Swiss National Bank inflation target.

This increases the pressure on the Swiss National Bank (SNB) for further interest rate hikes. The main refinancing rate, being at 1.00% at the beginning of March, is expected to rise further. Nevertheless, as Eurozone interest increases are expected to be higher, the interest rate differential between the Eurozone and Switzerland is expected to increase, lowering the pressure on the Swiss franc versus the euro.

In this environment, we forecast Swiss GDP growth of 0.3% in 2023, followed by a 1.4% increase in 2024.

Although the inflation rate is clearly above 2% in Q1 2023, average CPI inflation is expected to be 2.3% for 2023. Afterwards, we expect a deceleration to 1.3% on average in 2024.

The resilient labor market is expected to persist, with the unemployment rate only marginally rising in 2023. We expect an unemployment rate of 2.4% in 2023, followed by 2.3% in 2024.

Overall, the Swiss economy proves to be resilient to the different kinds of external headwinds, most likely avoiding recession in 2023. Nevertheless, it won't be able to fully escape the dampening impact from the international environment and geopolitical risks.

Dr. Stefan Fink
Chief Economist, KPMG in Austria

France: Economic outlook clouded by inflationary pressures

Recession avoided thanks to resilient business sentiment and government support.

Inflation to peak later on the back of delayed transmission of energy prices.

Tightness in the labor market set to ease from a weakening economy.

The French economy was resilient in 2022, despite the global headwinds from the war in Ukraine, rising energy prices, and supply chain disruptions. GDP grew by 2.6% compared to 2021, supported by broad-based expansion across the domestic demand, while net trade subtracted 0.8 percentage points from growth on the back of strong imports (see Chart 27). France has so far been relatively insulated from rising energy prices thanks to its reliance on nuclear energy, low dependence on Russian gas, and the government's measures to protect households and businesses from the immediate increase in utility bills.

Table 11: KPMG forecasts for France

	2022	2023	2024
GDP	2.6	0.4	1.1
Inflation	5.9	6.4	2.4
Unemployment rate	7.3	7.3	7.5

Source: INSEE, Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

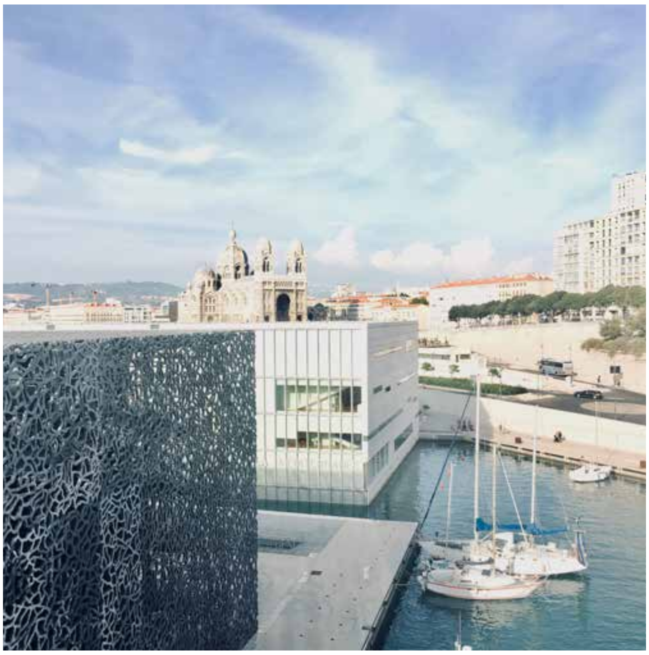
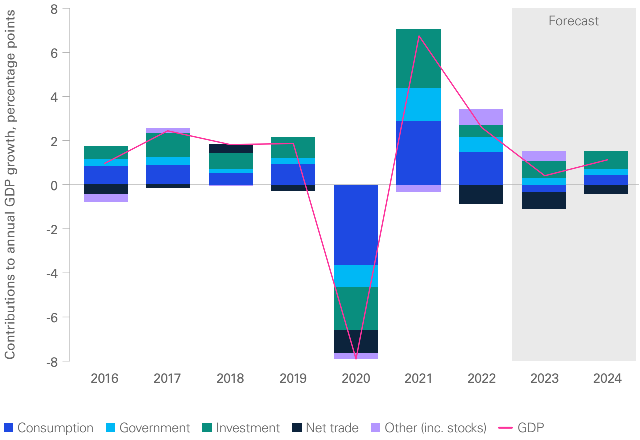
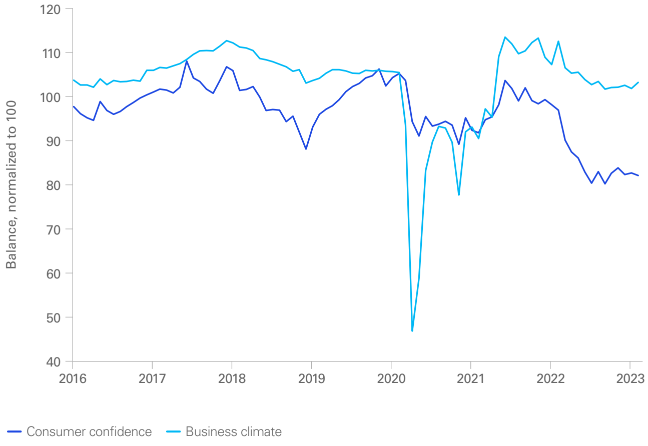


Chart 27: Outlook for the French economy



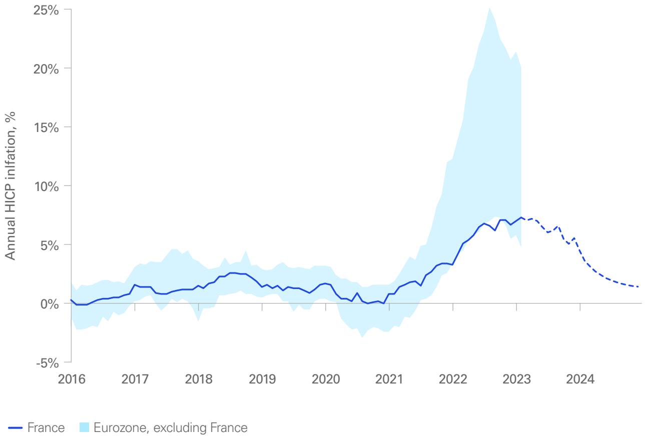
Source: INSEE, Refinitiv Datastream, KPMG analysis.

Chart 28: French business sentiment has held up better than consumer confidence



Source: INSEE.

Chart 29: French inflation set to peak lower but later than in the Eurozone



Source: Eurostat, KPMG forecast.

More recent data have been less encouraging. Growth slowed to just 0.1% in Q4 2022 following growth of 0.2% in Q3 2022. The slowdown was primarily driven by a deterioration in household consumption, which fell by 1.2%. Consistent with that, consumer sentiment remains close to its all-time lows, with weakness across households' perception of their personal financial situation, standard of living, and appetite for major purchases (see Chart 28).

Set against that, business surveys point to some short-term momentum at the start of 2023, which is likely to see the French economy avoid a recession this year. The composite PMI for February showed that France returned to growth for the first time since October, while the latest survey from the National Institute of Statistics and Economic Studies (INSEE) points to strong sentiment among firms (see Chart 28). Business sentiment has been bolstered by the recent fall in wholesale energy prices, the easing of supply chain disruptions, and the better-than-expected external environment.

The near-term outlook remains clouded by external risks, ongoing inflationary pressures, and diminishing government support. In addition, the impact of rising interest rates is set to gradually pass through to the economy. These will weigh on households' purchasing power and domestic activity. Overall, we expect the economy to grow by 0.4% this year, before picking up to 1.1% in 2024.

The path for inflation continues to be influenced by the timing of the government's energy support, which caused France to be an outlier in its inflation path last year compared to other European economies (see Chart 29). While this reduced the full impact of higher prices last year, the end of the fuel rebate and the increase in regulated electricity and gas prices (capped at 15%) in January 2023 have meant that inflation will likely peak later in France compared to its peers. Annual HICP inflation picked up in February to 7.3% (the highest rate since the adoption of the euro in 1999), with core inflation at 4.6%. Supermarkets are expected to hike prices amid a deadlock in negotiations with producers, with food prices likely to remain elevated throughout 2023. We expect HICP inflation to average 6.4% in 2023, before moderating to 2.4% in 2024.

The French labor market remains tight. The unemployment rate sits at 7.1%, which is below the pre-pandemic levels of 8-9%. Reflecting that, wage growth accelerated to 3.8% in Q3 2022, the highest rate outside of the pandemic since 2001. The positive sentiment around the labor market is corroborated by the INSEE's employment climate indicator, which remains significantly above its long-term average. We expect unemployment to remain steady at 7.3% in 2023, before gradually picking up as demand slows and hiring returns to more moderate levels.

Moustafa Ali
Economist, KPMG in the UK

Michal Stelmach
Senior Economist, KPMG in the UK

Italy: Cautious optimism as outlook brightens

Despite weaker growth, Italy, on the back of stronger than expected sentiment, looks likely to narrowly escape a technical recession in the first half of the year.

Strong growth in investment will be supported by the government's Resilience and Recovery Plan.

Large public sector debt burden may pose a risk if the ECB tightens monetary policy further.

As the sharp increase in food and energy prices eroded the value of household incomes, the Italian economy markedly slowed at the end of 2022. GDP fell by 0.1% in Q4 2022, driven by a decrease in consumption which fell by 1.6%. Italy was severely exposed to the energy crisis last year in large part due to its reliance on Russian gas, which accounted for 40% of total gas imports at the start of 2022. However, this number fell to just 10% by the end of the year as Italy increased imports from other sources.

There have been encouraging signs in business surveys since the start of the year. The composite Purchasing Managers' Index (PMI) for Italy stood at 52.2 in February, up from 51.2 in January and its highest level since June 2022. The PMIs for February showed continued growth in the manufacturing and services sectors, suggesting a broad-based recovery across most sectors of the economy in Q1 2023. Consumer and business sentiment have also improved since the start of the year, with the latest survey from the Italian Institute of National Statistics showing both at their highest levels since October 2022.

Business sentiment has also in part been bolstered by the Italian government's Resilience and Recovery Plan (RPP) worth EUR210 billion. The RPP, which was announced in 2021, will be financed by EU Next Generation funds and will run until 2026. Under this plan, the Italian government will invest across a range of sectors, including energy and infrastructure. This spending package is expected to drive growth in investment and the economy over the coming years.

With European energy prices and supply chain pressures easing since the start of the year, the Italian economy is now looking likely to escape a technical recession in Q1 2023. Despite this, the overall outlook for the year is set to be dampened by elevated consumer prices which will continue to squeeze household incomes and weaken consumption throughout 2023. We expect the Italian economy to grow by 0.5% this year, followed by growth of 0.9% in 2024 (see Chart 30).

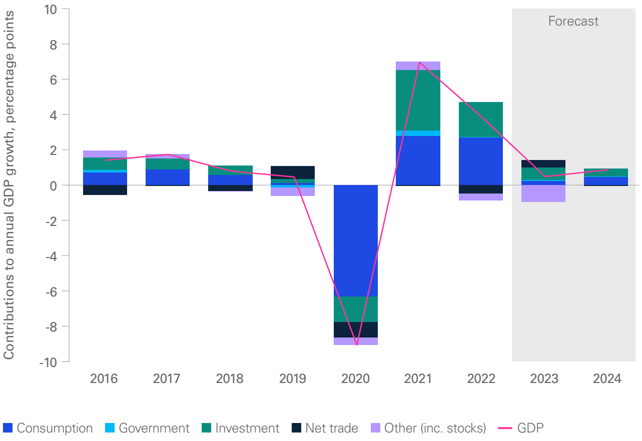
Table 12: KPMG forecasts for Italy

	2022	2023	2024
GDP	3.8	0.5	0.9
Inflation	8.7	7.7	1.4
Unemployment rate	8.1	8.2	8.7

Source: Istat, Eurostat, KPMG forecasts.

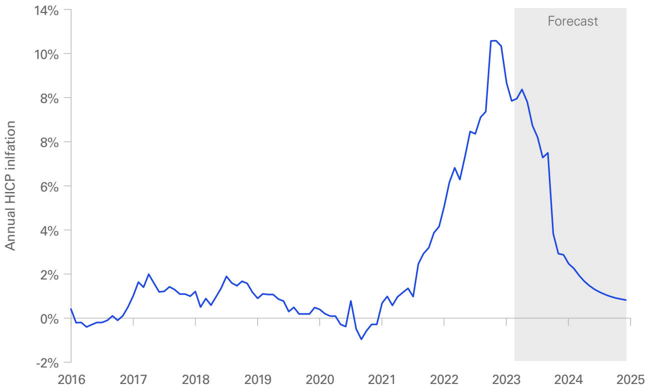
Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

Chart 30: Outlook for the Italian economy



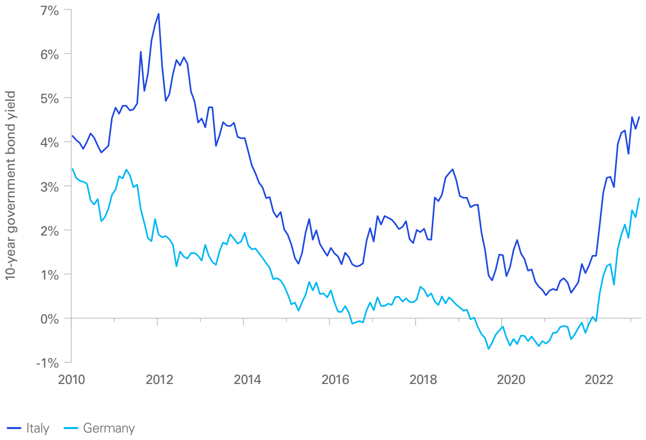
Source: Istituto Nazionale di Statistica, KPMG analysis.

Chart 31: Outlook for Italian inflation



Source: Eurostat, KPMG forecast.

Chart 32: German and Italian bond yields have both risen in tandem since last year



Source: Refinitiv Datastream.

As energy prices continue to fall back from their winter peak, the Italian economy is starting to see a deceleration in headline inflation. The latest data from Istat showed that annual inflation in domestic energy prices fell from 42.5% in January to 28.2% in February, while headline inflation slowed from 10.7% to 9.8% over that period. Despite the welcome fall in overall inflation, core inflation accelerated in February, suggesting that inflation may remain sticky this year. Services inflation also increased, to 4.4% in February, compared to 4% in January. Overall, we expect inflation to average 7.7% this year and 1.4% in 2024 (see Chart 31).

Higher ECB rates could challenge the sustainability of Italy's stock of public sector debt. Italy has a significant debt burden, the latest quarterly data from Eurostat show that the debt-to-GDP ratio stood at 147% in Q3 2022, the second largest in the Eurozone after Greece and significantly above the Eurozone average of 93%. Higher than expected Eurozone inflation since the start of the year has already raised market expectations for the ECB's terminal rate. As shown in Chart 32, the spread between Italian and German government yields has remained steady. However, continued increases in base rates could push up the cost of borrowing for Italy. While a debt crisis is unlikely, if Italian borrowing costs diverge sharply from Germany, it could potentially lead to the government being forced to tighten its fiscal stance.

The Italian labor market remains resilient despite the weakening in the economy, with the latest figures from Eurostat showing unemployment stable at 7.9%, while wages grew by 2.2% according to Istat. We expect the labor market to weaken as a result of the slowdown in economic activity this year, with unemployment forecast to rise to 8.2% on average in 2023 and 8.7% in 2024.

Despite the risks to the outlook, there are reasons to remain cautiously optimistic on the Italian economy. Improving global conditions coupled with continued support through the RPP will likely stave off recession this year. As energy prices continue to decline, Italy may see a quicker fall in inflation this year compared to its Eurozone peers. Natural gas accounts for over 40% of Italy's energy mix, significantly higher than the Eurozone average. The fall in global gas prices will provide relief for households and businesses. A pickup in Eurozone growth and the expected end of the ECB's hiking cycle will boost economic activity in 2024.

Moustafa Ali
Economist, KPMG in the UK

The Netherlands: Economy to remain resilient as fiscal deficit widens

Household support from government weights on the fiscal position.

Government expenditure to be the key driver of growth in 2023.

Core inflation to remain high in 2023 as inflationary pressures broaden.

The Dutch economy avoided a recession with growth of 0.6% in Q4 2022 (after a contraction of 0.2% in the previous quarter). Despite the slowdown in the second half of the year, the economy registered robust growth of 4.5% in 2022. Higher than expected net trade and strong household consumption, driven by a tight labor market and government support to fight the energy crisis, contributed to this positive outcome.

We forecast Dutch GDP to grow at 0.5% in 2023 and 1.3% in 2024, remaining below its average historical growth. The balance of risks remains tilted to the downside, but adverse risks have moderated as there are signs that inflationary pressure is already abating. Household consumption has remained resilient and could provide a positive surprise in 2023 as consumer confidence continues to slowly recover. Despite the weak growth outlook, we expect the unemployment rate to stay close to 4% in 2023-2024, given the extreme structural tightness in the labor market makes employers reluctant to lay off workers.

We expect elevated inflation, lagged impacts of monetary policy tightening and a slowdown on international trade to weigh on private sector growth. Government expenditure will be the key driver of GDP growth in 2023, reflecting the coalition government's sizeable packages to support households with the energy crisis as well as its ambitions to fight climate change.

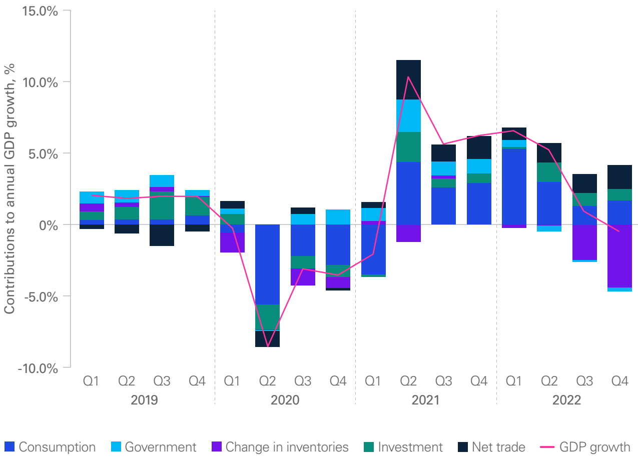
Table 13: KPMG forecasts for the Netherlands

	2022	2023	2024
GDP	4.5	0.5	1.3
Inflation	10.0	5.2	3.0
Unemployment rate	3.5	3.8	4.0

Source: Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation rate measure is the CPI.

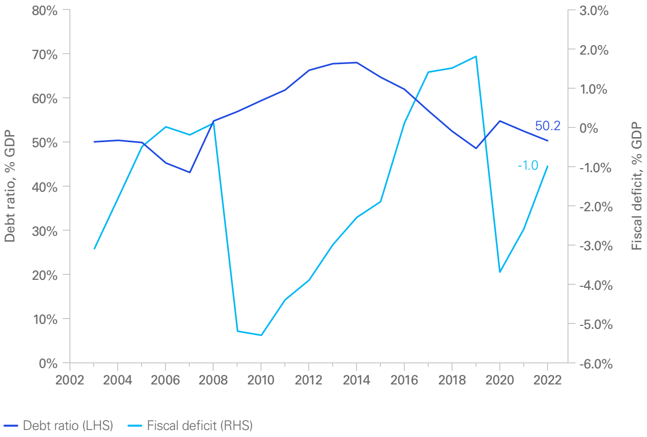
Chart 33: Economic growth by demand components



Source: Statistics Netherlands, KPMG analysis.

Annual CPI inflation peaked in September 2022 (14.5%) and has come down to 8% in February 2023, but we forecast inflation to remain high in 2023 at an annual average of 5.2%. The effects of higher inflation in 2022 will continue this year as higher costs of transportation, raw materials and energy are passed on to consumers. The contribution of energy prices to headline inflation will keep on decreasing, but higher labor costs and input prices will keep core inflation high. The latter implies the inflationary sources have broadened and high core inflation would be more persistent than previously expected. The key risk is tilted to the upside and linked to potential further increases in wages driven by lack of supply and sectoral shifts since the pandemic. Regarding household support, the government withdrew some measures at the end of 2022 (e.g. lower energy tax and VAT rate on energy, remaining Covid-19 measures), but an energy price cap was introduced in early 2023 and is expected to cushion the overall impact on consumers.

Chart 34: Dutch government debt and fiscal deficit



Source: Statistics Netherlands, DNB, KPMG analysis.

Note: 2022 values are DNB's estimates.

Government support measures are adding pressure to fiscal balances, and we expect the fiscal deficit to remain weaker in the next few years. According to government sources, purchasing power measures in the 2023 budget are worth EUR15 billion, including structural measures such as increasing the minimum wage by 10% and its corresponding knock-on effects on pension and welfare benefits payments. Additionally, the government introduced an energy price cap and subsidy scheme for energy-intensive SMEs; the cost of these packages will be dependent on future market prices and the Dutch National Bank (DNB) estimates it at EUR11 billion.

The government deficit would peak at around 3.5% in 2023 and fall gradually, remaining near 2% over the following few years. This reflects the government's sizeable medium-term investment plans including the climate and transition fund (EUR35 billion by 2035), nitrogen fund (EUR24 billion by 2035) and enhancement of the Dutch education system (EUR2.8 billion). The debt to GDP ratio is expected to fall below 50% in 2023-2024 (from 52.4% in 2021, and near 50% in 2022) as a consequence of higher nominal GDP (mainly driven by the price component).

Diego Vilchez Neira
Senior Manager, KPMG in the Netherlands

Ireland: Continued growth, comes with caveats

Economy strong throughout winter across all key macroeconomic indicators.

Budgetary surplus facilitated wide range of social transfers to mitigate cost-of-living challenges.

Infrastructure bottlenecks increasingly seen as hampering growth and competitiveness.

The Irish economy entered winter 2023 with a degree of momentum, in spite of the range of challenges facing the wider European and global economies. Over the course of 2022, the economy as measured by GDP grew by 12.2%, while the domestic economy, based on an alternative measure called Modified Domestic Demand (MDD), grew by 8.2%. These rates made the Irish economy the fastest growing economy in Europe in 2022.

The strong end to 2022 was driven by higher levels of investment by multinationals in intellectual property, continued robust growth in exports of both goods and services, higher private consumption (despite downbeat consumer sentiment), and a relatively mild winter.

But despite this broadly positive situation, a number of uncertainties remain: the global outlook (e.g. commodity markets and China), tighter ECB monetary policy, and a range of in-country dynamics between profits, margins, prices and wages.

Given some clear anomalies in Ireland's reported economic growth figures, it is difficult to identify the strength or robustness of the underlying economy. Many households and businesses may claim that they do not feel the economy growing by 8%-12%. Inflationary pressures have been eroding disposable incomes for many on lower incomes and a range of bottlenecks in infrastructure and services do not tally directly with the reported headline strength of the economy. Meanwhile, exceptional levels of tax receipts in 2022 facilitated a budgetary surplus, allowing the government to provide significant levels of social transfers to cushion households against more severe impacts to their disposable incomes.

Table 14: KPMG forecasts for Ireland

	2022	2023	2024
GDP	12.2	5.0	4.0
Inflation	8.1	5.0	3.5
Unemployment rate	4.5	4.5	4.5

Source: CBI, CSO, DOF, EC, ESRI, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

Inflation since the start of 2023 has been somewhat more persistent than had been anticipated. The headline rate stood at 8.1% in February, up from 7.5% in January. Effectively, while there has been a fall in the cost of heat and power, inflation rates in other sectors remain high. However, as 2023 evolves, we expect inflation to fall, potentially to 5%, on the back of falling energy prices. Consistent with that, recent sentiment indices suggest that consumers and businesses are becoming more optimistic through 2023, implying that the worst of consumers' concerns may be behind them.

Yet, while inflation may fall, the expected further monetary policy tightening from the ECB would cause issues for homeowners in Ireland, who will see mortgage and loan repayments increase and may act as a drag on overall growth.

On a wider level, another drag on potential growth may be a general retreat from globalization. However, rather than a retreat in 2022, multinationals in fact increased total employment numbers in Ireland by 9%, doubling down on the investments they have made in the country. In the Tech sector, on which Ireland relies for exports, jobs, and tax revenue, negative impacts of the recent slowdown have been modest. The sector in Ireland has remained relatively resilient, with total lay-offs to date accounting for around 1% of the sector's workforce in Ireland, compared to around 1.5%-2% in the sector's global workforce.

Similarly, some commentators and regulatory bodies fear that the Irish Exchequer is over-reliant on tax paid by multinationals. As a way to create a buffer against this risk, the government has been transferring several billion euros from its October budgetary surplus to a 'rainy day' reserve fund. While the government hopes that any feared risks never materialize, its overall approach has been prudent to date. At the same time, many representative groups have been encouraging the government to provide further social transfers now, rather than to withhold the spend for another point in the future.

On the whole, the outlook for Ireland remains positive in 2023 and beyond. Despite the improved outlook for inflation, high prices and rising interest rates are still expected to drag on growth, with GDP and MDD expected to respectively grow by 5% and 3% in 2023 and by 4% and 3% in 2024. Unemployment is expected to remain low and labor shortages in certain sectors may in fact hold back growth.

Taking account of these various dynamics, there is a degree of relief amongst Irish policymakers that many of the pre-winter economic downside risks did not materialize. In some cases, the feeling may be delight that some outturns have been as positive as they have been. Against the global backdrop of multiple negative risks, it would seem appropriate that the Irish approach is to prepare for a rainy day.

Dr. Daragh Mc Greal
Director, Strategic Economics, KPMG in Ireland

UK: Short-term momentum masks underlying headwinds

Although the likelihood of a recession has fallen, growth is expected to be negative in 2023 on the back of a squeeze on household real incomes and the impact of past interest rate increases.

The outlook for businesses remains mixed, with government measures aiming to boost investment likely to only have a temporary effect on growth.

Structural issues, including skills shortages, slowing workforce participation, and population ageing, dominate the longer-term risks to the outlook.

The UK economy at the end of 2022 has proved to be more resilient than expected. GDP was flat on the quarter, therefore avoiding a technical recession following the fall in Q3 2022, although these data are still provisional. A widespread industrial action during winter has led to 1.7 million working days lost, distorting the headline growth figures. We estimate that while the impact of strikes subtracted around 0.1 percentage point from underlying growth in Q4 2022, it would subsequently boost growth in the following quarter as the disruption unwinds and the impact on the volume of activity fades.

More timely indicators have been positive on balance. The composite PMI for February picked back above the 50.0 threshold for the first time since July 2022. Business confidence, measured by the Lloyds Business Barometer, is close to its pre-pandemic average, while consumer confidence has risen, albeit from a historically low level. The latest official data for January showed GDP growing by 0.3% on the previous month, of which we estimate that around a half was thanks to a fall in the number of days lost to industrial action.

Table 15: KPMG forecasts for the UK

	2022	2023	2024
GDP	4.0	-0.3	0.6
Inflation	9.1	6.3	1.8
Unemployment rate	3.7	4.1	4.6

Source: ONS, KPMG forecasts.

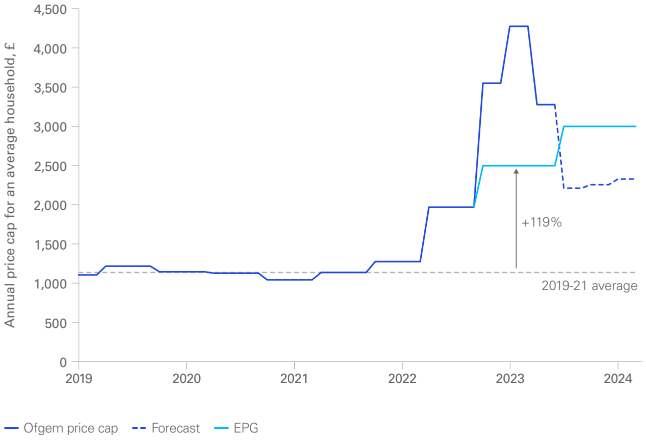
Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the CPI and the unemployment measure is LFS.

Although the likelihood of a UK recession has fallen, it has not dissipated entirely. We expect a major headwind to come via household consumption, with a fall of 0.4% in 2023. Elevated inflation continues to act as a drag on real incomes, and the evolution of energy prices – while having fallen in recent months – means that household utility bills remain historically high. To put this into perspective, despite the government's announcement to maintain the Energy Price Guarantee at the £2,500 level for a further three months from April, the average household energy bill remains some 120% higher than over 2019-21 (see Chart 35). Households' energy costs could fall further in July when the Ofgem price cap is expected to fall due to lower wholesale prices, but they would still remain around 93% higher than prior to the invasion of Ukraine.

Furthermore, higher interest rates and the ongoing correction in the housing market are set to negatively affect homeowners, especially those with a mortgage, which constitute just under a third of all households. The cost of fixed-rate mortgages remains 250-300 basis points higher than a year ago, despite a drop in recent months. Around 1.4 million households are therefore facing the prospect of significantly higher interest rates during 2023 when they roll onto a new contract. Set against that, house prices have now fallen by 3.7% since the peak in August 2022, according to Nationwide. We expect this to further depress consumer spending via lower collateral available for homeowners to borrow against and lower confidence.

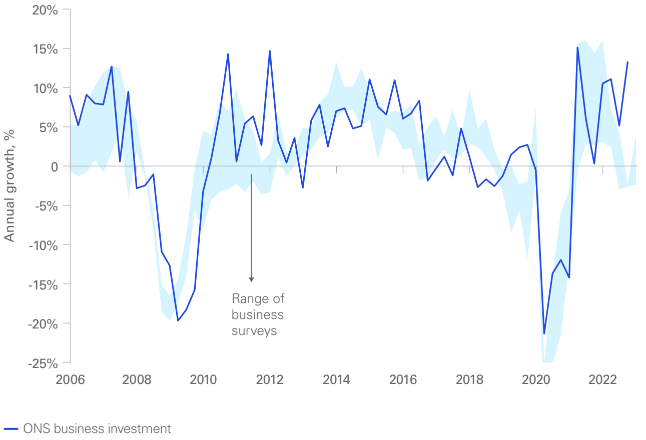
Higher costs of borrowing and slowing growth outlook are expected to lead to weakening business investment during the course of this year. Latest data show some strengthening in momentum, as business investment increased by 4.8% in Q4 2022, although survey evidence points to overall investment intentions remaining at subdued levels (see Chart 36). We judge that the stronger recent growth reflects the timing of investments ahead of the ending of the government's super-deduction scheme on March 31, rather than a more sustained increase. This points to an expected sharp reduction in investment from the second quarter of 2023, leaving overall investment to fall by 1.3% this year. The announcement of the full expensing policy at the Spring Budget provides some continuity for investment incentives, however the new scheme is less generous than the one it replaced and only remains in place on a temporary basis. This is likely to see business investment brought forward next year and to some degree the year after but not to increase the overall trend growth in business investment in the UK.

Chart 35: Energy Price Guarantee extended at £2,500 for a further 3 months



Source: Ofgem, OBR, KPMG analysis.

Chart 36: Business surveys are consistent with a slowdown in business investment



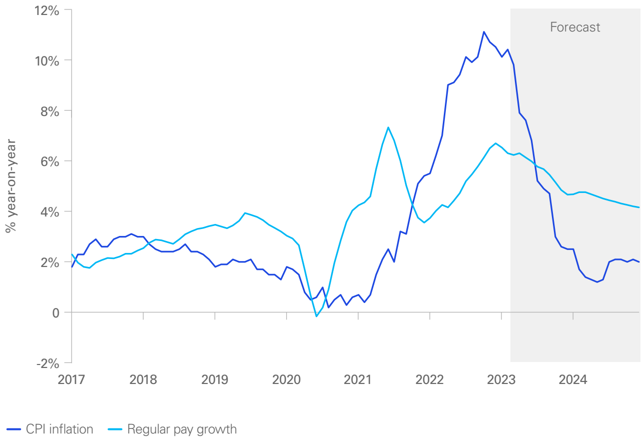
Source: ONS, CBI, BCC, Bank of England, KPMG analysis.

We expect UK exports to benefit from relatively stronger growth among the UK's main trading partners, with growth in exports outpacing that of imports. Despite this, the volume of overall UK exports has shown consistent weakness since 2020, with exports in January 2022 down by 4.1% compared to December 2019.

UK inflation is set to fall sharply this year after reaching its highest levels in over 40 years in late 2022 (see Chart 37). CPI inflation reached a peak of 11.1% in October 2022, driven by a combination of rising food prices, increases in energy costs, as well as building domestic cost pressures and strained global supply chains. We expect the recent fall in wholesale natural gas prices to cause a reduction in energy bills from July this year. In addition, global food prices continued to fall at the start of this year, with the Food and Agriculture Organization of the United Nations (FAO) Food Price Index reaching its lowest level since September 2021. As these changes in global food prices are gradually passed on to consumers, we expect this to lead to a slowdown in UK food price inflation during 2023.

We expect the Bank of England's base interest rate to remain at the current level of 4.25% throughout the rest of this year. This follows on from a series of hikes which saw rates increase by 415 basis points in a little over a year in response to higher levels of inflation. As the economy cools and inflation returns back to target, this may provide the Bank of England with an opportunity for a series of gradual rate cuts next year, bringing the base rate to 3.5% by the end of 2024.

Chart 37: Inflation and pay growth are set to moderate



Source: ONS, KPMG projections.

The fiscal position has been upgraded thanks to a slightly stronger and more tax-rich economic environment. Relative to the autumn, this has added around £25 billion a year of wiggle room over the next five years, of which the Chancellor decided to spend £16 billion a year on average (declining to £8.5 billion by 2027-28) as part of the Spring Budget. However, despite the relatively optimistic economic determinants from the Office for Budget Responsibility (OBR) which the forecast is based on, this still leaves the government with just £6.5 billion of headroom to meet the fiscal rule of falling debt, which is significantly less than in the past.

The labor market is at a turning point. While the unemployment rate has stayed relatively low, we expect this to reverse as employers adjust their headcount in light of rising costs and falling demand. Recent indicators show that demand for staff is losing momentum, with employers pivoting away from hiring permanent staff to temporary placements as they become more cautious over the economic outlook. Following another fall in February, vacancies are now 176,000 below their peak in May 2022 (a drop of 13.5%), while the redundancy rate is close to pre-pandemic levels. We expect the unemployment rate to peak at around 4.7% by the middle of next year. Nonetheless, the main pressure on the labor market still comes from structural challenges including slowing workforce participation and population ageing. The Spring Budget announced sizable giveaways to help tackle that but it remains to be seen how effective the government will be in increasing the participation rate.

Michal Stelmach
Senior Economist, KPMG in the UK

Dennis Tatarkov
Senior Economist, KPMG in the UK

Central and Eastern Europe: Not a uniform story

Inflation remains a core issue in Central and Eastern Europe (CEE), with inflation rates significantly above those in the Eurozone.

Elevated interest rates and poor external demand will weigh on 2023 growth, leading to an expected stagnation in the region.

Despite the fallback in energy prices, structural supply side issues still remain unresolved, with a potential re-emergence in 2023.

Although average 2022 growth figures came in robust for most of the CEE region, the outlook has started to weaken in H2 2022, notwithstanding the positive growth figures (Bulgaria: 0.5%, Romania: 1.1%, Slovakia: 0.3%, and Slovenia 0.8%, quarter-on-quarter). That said, growth in some larger countries has already turned negative (with the largest CEE economy, Poland at -2.4%, Hungary at -0.4%, and the Czech Republic at -0.3% after -0.2% in Q3, therefore already entering a technical recession).

Looking ahead, three major headwinds to CEE growth can be identified, starting with consumer price pressures. As can be seen from 2022 inflation numbers, CEE inflation rates were well above the Eurozone peers. Although immediate energy price pressures have moderated, inflation remains high and continues to weigh on activity. In most markets in the region, we believe that average inflation will remain in the double digits, well above wage growth expectations. This loss in purchasing power will in turn have impact on the propensity to consume as well as consumer confidence. Furthermore, input costs for firms are set to increase further. This mix is likely to require tight monetary policy for longer, and potentially force central banks to restrict policy further.

Tight monetary policies will continue to increase the cost of financing and further weigh on consumer and producer sentiment. Almost all central banks in the region performed a massive tightening cycle in 2021 and 2022, and it is expected that will take time to pass through to the economy; time lags of 18-24 months are common, which means that a big part of the real cost of the tightening cycle is yet to transpire, dragging on growth in 2023 and 2024.

Due to the strong export orientation towards Eurozone countries, the slowdown in many of the target markets will have strong spill-over effects to the CEE economies. As much of the pre-Covid years growth stemmed from being part of the Eurozone's supply chain network, the weak outlook represents a major risk.

Poland

It is likely that the Polish economy will enter a technical recession in Q1 2023. Although we expect positive growth to follow in H2 2023, uncertainty and downside risk of this recovery path is high. Germany is Poland's largest trading partner, and connections are tight.[1] GDP growth forecast is 0.7% for 2023, followed by 2.9% in 2024. Inflationary pressure is expected to remain high, with CPI inflation staying above 13% in 2023, followed by a 6.3% rise in 2024.

Czech Republic

The Czech economy has benefited from strong investment activity, while private consumption slowed down from the previous year. Investment growth is expected to remain the main driver of growth in 2023, despite its relative decline. Tight financial conditions are likely to dampen private financing demand. Although the fiscal stimulus is expected to prevail, the loss of purchasing power due to high inflation (15.1% in 2022) will weigh on private consumption, which is expected to stagnate in 2023. As prices are going to increase at a much lower pace in 2023 and 2024 (9.5% and 3.7%, respectively), household demand is set to support growth again in 2024.

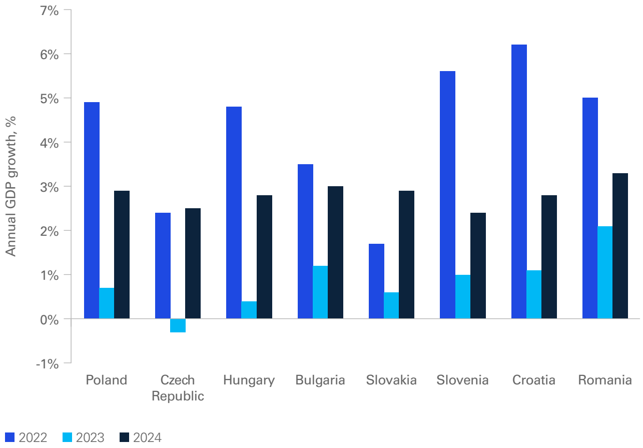
Hungary

Growth in 2022, especially in the second half, was induced by a large monetary and fiscal stimulus. We expect a significant reduction in government spending in 2023. From the monetary perspective, policy rates were kept at low levels despite galloping price increases, until a rapid hiking cycle began in spring 2022. This brought Hungary's base rate up from 0.60% in July 2020 to 13% in September 2022, resulting in a much slower loan growth. Higher interest rate payments, and an even stronger loss of purchasing power (with inflation expected to increase to close to 16% in 2023, from 14.5% in 2022), will weigh on growth. We expect growth of 0.4% in 2023.

Bulgaria

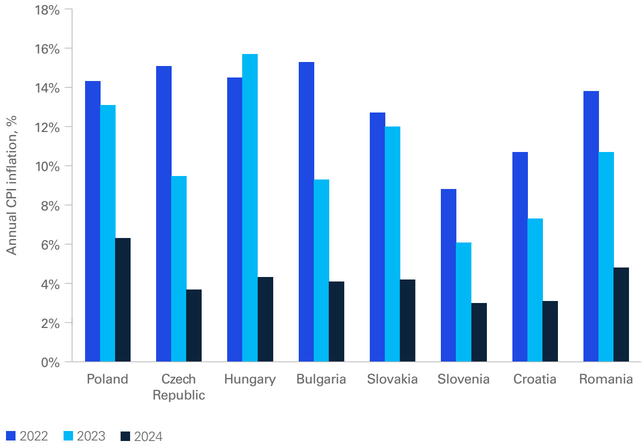
Despite the 1.2% GDP growth expected for 2023, the economic picture is mixed. While consumption proved to be quite resilient, investment rates have contracted for nine consecutive quarters. This will weigh on Bulgaria's growth potential, although not immediately. Political uncertainty is high, with uncertainties around future government support and the likelihood of structural reforms. Nevertheless, we expect growth of 3% in 2024. After the highest 2022 CPI inflation rate in the CEE (15.3%), we forecast single-digit inflation for 2023 and 2024 (9.3 and 4.1%, respectively).

Chart 38: GDP growth in the CEE



Source: Bloomberg.

Chart 39: CPI inflation in the CEE



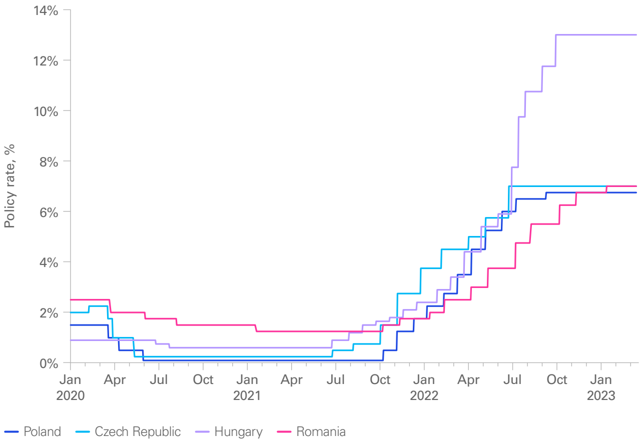
Source: Bloomberg.

[1] https://wits.worldbank.org/CountryProfile/en/Country/POL/Year/LTST/TradeFlow/EXPIMP

Slovakia

Though a technical recession appears less plausible, growth is nonetheless expected to continue to decelerate, with elevated inflation weighing on household consumption, coupled with weak external demand. Set against that, government measures to reduce the negative impact of rising energy prices should support households and businesses. However, real wage growth is expected to be negative in 2023, due to persistently high inflation (projected at 12% in 2023). As a consequence, we expect weak GDP growth of 0.6% for 2023, followed by 2.9% in 2024.

Chart 40: Policy rates in the CEE



Source: Bloomberg.

Slovenia

Growth in 2022 was mainly supported by strong carry-over effects from the previous year. Although it has weakened in H2 2022, a larger drop in activity was prevented by strong employment and resilient industrial production. Prospects for 2023 are pointing towards low, yet positive growth rates (1.0% in 2023, followed by 2.4% in 2024). Inflation is elevated, but somewhat lower compared to other CEE peers, with a forecast of 6.1% in 2023 and 3.0% in 2024.

Romania

Despite slowing down significantly compared to 2022, we expect Romanian GDP growth to be in positive territory in 2023, with an expected real growth rate of 2.1%. That said, energy price risk will remain an issue this year, as well as second round effects from inflation. Hence, inflation is expected to come in at 10.7% in 2023, after an already steep increase of 13.8% in 2022. This implies a significant loss of purchasing power which is weakening consumption. Overall private sector activity will face the headwinds from monetary tightening. The central bank already hiked policy rates by a cumulative 575 basis points, from 1.25% in October 2021 to 7.00% in January 2023.

Dr. Stefan Fink
Chief Economist, KPMG in Austria

South Africa: Lacking the power to grow

Economic growth halted by electricity supply constraints.

Monetary policy tightening close to peak.

Inflation set to trend back into target range.

South Africa is returning to pre-Covid-19 levels of economic growth and is currently facing the inflationary implications that arose as a direct consequence of the pandemic and the Russian invasion of Ukraine. Interest rates are rising and, as with the rest of the world, growth prospects are being reduced accordingly.

The South African policy rate has more than doubled from a low of 3.5% in 2021 Q3 to 7.25%, with an additional 25 basis points hike expected in March given that inflationary expectations remain above the anchor rate of 4.5%. This implies that the policy rate is at, or close to, its peak as inflation trends down towards the official target range of 3% to 6% (see Chart 41).

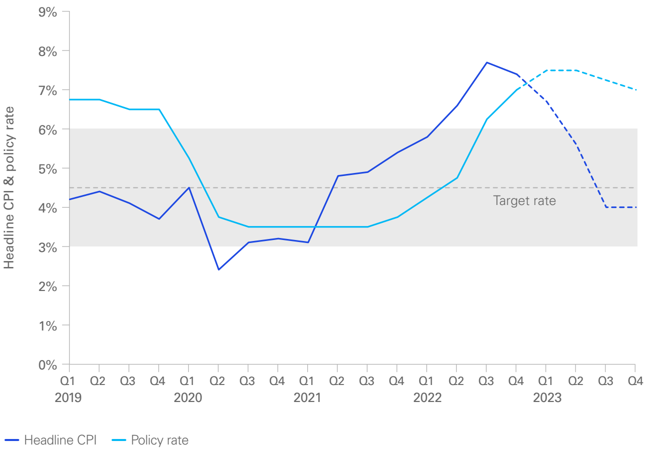
Monetary policy tightening achieved through rising interest rates has slowed the growth prospects for South Africa. However, it is primarily the insufficient and inconsistent supply of electricity from South Africa's monopolistic state-owned energy supplier, Eskom, that is severely dampening potential economic growth.

Table 16: KPMG forecasts for South Africa

	2022	2023	2024
GDP	2.0	0.5	0.9
Inflation	6.9	5.1	4.5
Unemployment rate	32.7	34.0	34.9

Source: Statistics South Africa, KPMG forecasts.

Chart 41: Inflation and the policy rate



Source: Statistics South Africa, South African Reserve Bank, KPMG analysis.

Consequently, GDP is set to grow by around 0.5% in 2023, led by contributions from the finance, real estate and business services sector, manufacturing as well as mining, agriculture and trade, catering and accommodation. Growth projections improve to around 0.9% in 2024 provided that the electricity supply stabilizes.

The slow rate of economic growth for 2023 and 2024 compared to a population growth rate of approximately 1.3% is not sufficient enough to reduce the high unemployment rate forecast at 34% for 2023. Therefore, a further rise in unemployment over the forecast period to an estimated level of 35.4% by 2025 is expected.

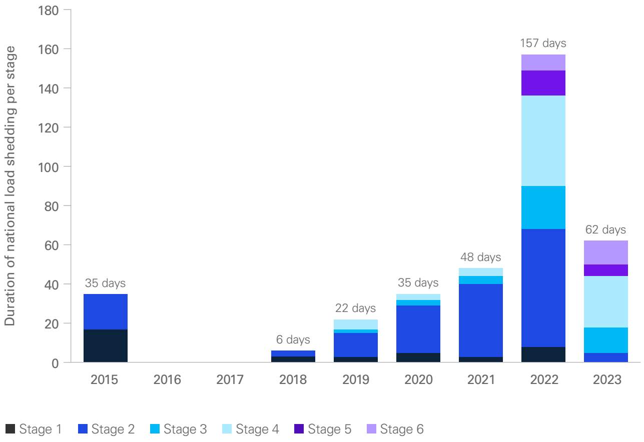
The inadequate and inconsistent supply of electricity from South Africa's monopolistic state-owned supplier and its detrimental impact on the prospects of the South African economy was highlighted as the main priority within both the State of the Nation Address and the National Budget in 2023.

In response to questions on how the electricity deficit may impact potential growth during the January Monetary Policy Committee (MPC) statement, the South African Reserve Bank stated that it is estimated to account for a two percentage point reduction in economic growth per year over the medium term.

The deficit in electricity supply is a combination of governance failures that resulted in inadequate levels of investment in additional electricity supply over the past three decades as well as an increase in the frequency and severity of breakdowns of the old, near-obsolete fleet of operational power stations.

As a result, demand for electricity generally outstrips the available supply, leaving no room for the down-time required to bring about much needed maintenance and upgrades to generation and transmission assets. To allow for maintenance to take place requires the rationing of already constrained electricity supply through planned outages ("loadshedding"), that vary in terms of severity between a reduction of 1,000 MW during stage 1 and 8,000 MW during stage 8, depending on the electricity generating capacity available.

Chart 42: Increasing trend of load shedding



Source: Eskom se Push, KPMG analysis.

South Africa has seen a steady increase in loadshedding over the past few years, spiking in 2022 and 2023 both in terms of the duration of loadshedding experienced as well as the severity in terms of MWs reduced (see Chart 42).

In response to the deficit in supply, the government has been under pressure to announce a host of initiatives, including the belated scrapping of license requirements for private power generation, expansion of private sector power procurement projects, as well as the provision of business and household incentives to invest in rooftop solar energy systems in a sweeping overhaul of the South African energy industry. However, given the lags associated with implementing large-scale energy projects, it will still take an estimated 18-24 months before the impacts of these policy changes are felt across the broader economy.

Until adequate supply is made available, South Africa will continue to experience economic growth far lower than its potential. As the primary determinant of the future prospects for the economy and the country, this current and additional supply activity will be the focus of both South African and international investors for some time to come.

Frank Blackmore
Lead Economist, KPMG in South Africa

Nigeria: Challenging macroeconomic fundamentals in a transition period

Growth set to be driven by continuous recovery in household consumption, sustained performance of the non-oil sector and a recovery in oil production.

Inflation to remain elevated, driven partly by persistent food supply shocks, foreign exchange illiquidity, and insecurity.

Unemployment to remain a major challenge due to the continuing inflow of job seekers into the job market in the presence of limited investment and low industrialization.

A new government is set to take over from the current administration in May 2023. It will, however, face a deeply rooted challenging environment, characterized by fragile and slow economic growth and challenges in the foreign exchange market. Additionally, government revenue remains inadequate to support much needed expenditure, leading to a high debt stock and high debt service payments.

The Nigerian economy ended the past year with a GDP growth rate of 3.52% in Q4 2022 compared with 2.25% in Q3 2022 (see Chart 43), with growth averaging 3.10% over 2022. This represents eight consecutive quarters of growth, following its exit from the pandemic-induced recession in Q3 2020. Growth in 2022 was driven by the non-oil sector, as continuous recovery in household consumption boosted spending, particularly in the finance and insurance services, telecommunications, and transportation and storage services. While the non-oil sector grew by 4.84%, the oil sector contracted by 19.22%, largely attributed to worsening oil theft, pipeline vandalization, underinvestment, and other operational challenges inhibiting oil production (see Chart 44). Accordingly, oil output (including condensates) declined from 2.07 million barrels per day in Q1 2020 to 1.34 by Q4 2022 (see Chart 45).

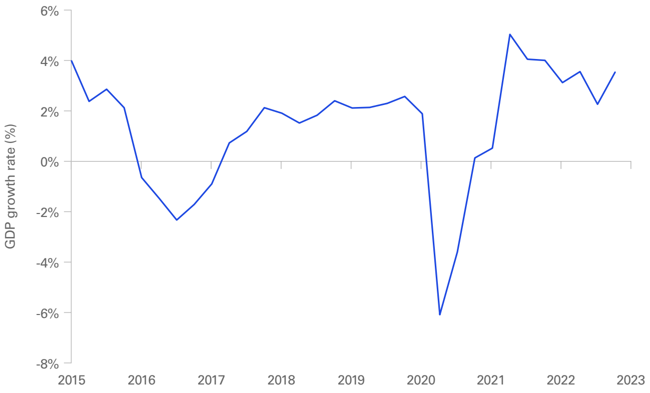
We expect Nigeria's GDP to continue to grow at a relatively slow pace of 3% in 2023 due to the slowdown in economic activity that typically characterizes periods of political transition in Nigeria. Furthermore, the spillover from an expected slowdown in the global economy in 2023 and its trade and financial flows implications are expected to drag on GDP. Additionally, growth will be negatively affected by the Naira Redesign Policy introduced in Q4 2022 and Q1 2023 and its implications on key non-oil sectors like manufacturing, trade, accommodation and food services, transportation and other services, further slowing down overall GDP growth in 2023.

Table 17: KPMG forecasts for Nigeria

	2022	2023	2024
GDP	3.1	3.0	3.0
Inflation	18.8	20.3	20.0
Unemployment rate	37.7	40.6	43.9

Source: KPMG forecasts.
Note: Unemployment rate figure for 2022 is a KPMG estimate.

Chart 43: GDP growth in Nigeria



Source: National Bureau of Statistics.

Nevertheless, we expect telecommunications, trade services, as well as an expected recovery in the oil sector, on account of measures being taken to tackle security issues, to drive our forecast of 3% growth in 2023.

Headline annual inflation maintained its upward trend throughout 2022, reaching its highest levels in almost two decades and closing the year at 21.34%, with food inflation and core inflation growing by 23.75% and 18.49%, respectively (see Chart 46). This was driven by persistent structural issues which impacted domestic food production and transportation such as insecurity, floods in key agricultural producing areas and rising international food and energy prices following the Russia-Ukraine conflict; and other policy-related bottlenecks which continue to impact the cost of doing business. Additionally, the expected fuel subsidy removal and the 2023 Fiscal Bill are also expected to keep pressure on domestic prices in 2023.

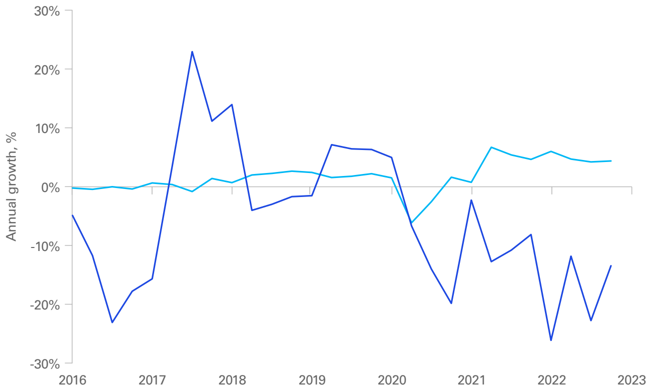
To combat rising inflation, the Nigerian Central Bank (CBN) raised the Monetary Policy Rate (MPR) by a cumulative 500 basis points in 2022, to 17.5%, and increased the Cash Reserve Ratio (CRR) from 27.5% to 32.5%. However, despite these aggressive rate hikes, inflation has remained stubbornly high and is predicted to remain above 20% in 2023 due to the persistence of the structural and policy issues.

Unemployment is expected to continue to be a major challenge in 2023 due to the limited investment by the private sector, low industrialization and slower than required economic growth and consequently the inability of the economy to absorb the 4-5 million new entrants into the Nigerian job market every year. Although lagged, the National Bureau of Statistics recorded an increase in the national unemployment rate from 23.1% in 2018 to 33.3% in 2020[1]. We estimate that this rate has increased to 37.7% in 2022 and will rise further to 40.6% in 2023.

Dr. Oyeyemi Kale
Partner and Chief Economist, KPMG in Nigeria

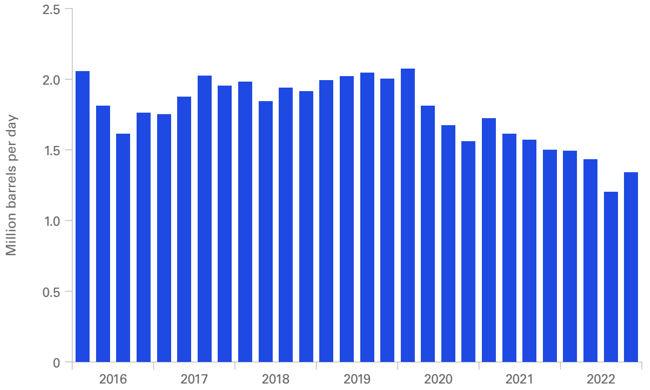
Oluwole Adelokun
Associate Director, Strategy and Economics,
KPMG in Nigeria

Chart 44: Real oil and non-oil growth in Nigeria



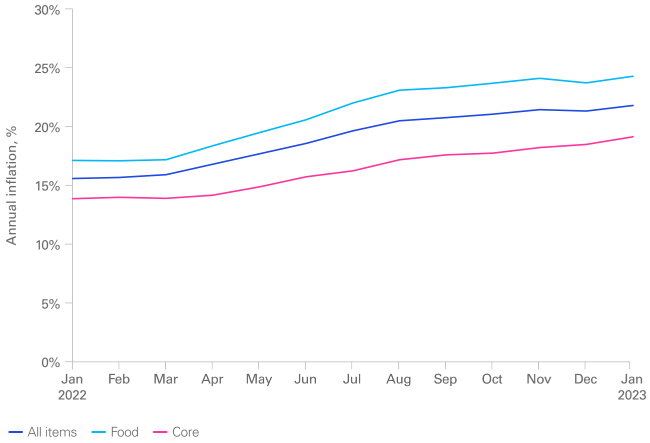
Source: National Bureau of Statistics.

Chart 45: Oil production in Nigeria



Source: National Bureau of Statistics.

Chart 46: Inflation rates in Nigeria



Source: National Bureau of Statistics.

[1] Nigeria uses an adjusted time based ILO methodology that divides employment into underemployment and unemployment. To be classified as employed, individuals in the labor market have to work for at least 20 hours a week. Using ILO standards, Nigeria's unemployment rate stands at 17.5% in Q4 2020.

Appendix: Summary of KPMG forecasts

	GDP			Inflation			Unemployment		
	2022	2023	2024	2022	2023	2024	2022	2023	2024
World	3.1	2.1	2.6	7.4	5.3	3.2	5.2	5.2	5.4
U.S.	2.1	0.9	1.3	8.0	4.3	2.4	3.6	3.6	4.3
Canada	3.6	0.7	1.5	6.8	3.6	2.2	5.3	5.8	6.1
Argentina	5.2	-0.6	0.2	94.8	94.5	78.0	6.9	6.9	6.9
Brazil	3.0	0.8	2.2	9.3	6.4	4.9	9.4	9.0	8.8
Chile	2.5	-0.9	2.1	12.8	4.7	3.2	7.7	7.9	7.6
Mexico	3.1	0.9	1.6	7.8	4.5	3.9	3.4	3.6	3.8
Colombia	7.5	0.9	2.4	13.1	7.9	4.2	11.1	11.7	12.6
Peru	2.7	2.0	2.9	8.5	4.0	2.9	7.6	7.5	7.4
Germany	1.8	0.1	1.4	6.9	6.1	2.2	3.0	3.1	2.8
Austria	5.0	0.1	1.4	8.6	6.3	2.8	4.8	4.9	4.6
France	2.6	0.4	1.1	5.9	6.4	2.4	7.3	7.3	7.5
Italy	3.8	0.5	0.9	8.7	7.7	1.4	8.1	8.2	8.7
Netherlands	4.5	0.5	1.3	10.0	5.2	3.0	3.5	3.8	4.0
Spain	5.5	1.3	1.8	8.3	4.1	1.5	12.9	13.2	13.4
Ireland	12.2	5.0	4.0	8.1	5.0	3.5	4.5	4.5	4.5
Eurozone	3.5	0.6	1.4	8.4	6.4	2.0	6.7	6.8	7.1
Norway	3.2	1.1	1.5	5.8	4.5	2.4	3.3	3.6	3.7
Sweden	2.7	-1.0	1.0	8.9	7.2	2.4	7.5	8.3	8.5
Switzerland	2.1	0.3	1.4	2.8	2.3	1.3	2.1	2.4	2.3
UK	4.0	-0.3	0.6	9.1	6.3	1.8	3.7	4.1	4.6
Poland	4.9	0.7	2.9	14.3	13.1	6.3	2.9	5.5	5.5
Turkey	5.6	2.1	3.0	72.3	42.2	27.6	10.7	10.3	10.0
China	3.0	5.7	5.2	2.0	2.4	2.2	5.6	5.3	5.2
Japan	1.0	1.1	1.2	2.5	2.9	1.0	2.6	2.4	2.4
India	7.0	6.4	6.9	6.5	5.3	4.4	7.5	6.0	5.4
Indonesia	5.3	4.6	5.0	4.2	4.0	3.1	5.5	5.3	5.2
Malaysia	8.7	3.7	4.5	3.4	2.8	2.3	4.5	4.3	4.2
Philippines	7.6	5.3	5.7	5.9	5.8	3.3	5.7	5.4	5.1
Singapore	3.6	1.7	2.5	6.1	4.7	2.6	2.1	2.1	2.1
South Korea	2.6	1.1	2.2	5.1	3.2	1.9	3.1	3.4	3.5
Saudi Arabia	8.7	3.0	3.0	2.5	2.5	2.2	5.8	5.8	5.8
Nigeria	3.1	3.0	3.0	18.8	20.3	20.0	37.7	40.6	43.9
South Africa	2.0	0.5	0.9	6.9	5.1	4.5	32.7	34.0	34.9

Source: National statistical agencies, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Figures for India represent fiscal years 2022-23, 2023-24 and 2024-25. Consumer price inflation measured as % change Dec-on-Dec for Argentina, Chile, Colombia and Peru.

Contacts

United Kingdom

Yael Selfin
Chief Economist, KPMG in the UK
yael.selfin@kpmg.co.uk

Michal Stelmach
Senior Economist, KPMG in the UK
michal.stelmach@kpmg.co.uk

Dennis Tatarkov
Senior Economist, KPMG in the UK
dennis.tatarkov@kpmg.co.uk

Moustafa Ali
Economist, KPMG in the UK
moustafa.ali@kpmg.co.uk

United States

Diane Swonk
Chief Economist, KPMG in the U.S.
dswonk@kpmg.com

Canada

Mathieu Laberge
Partner, Economics & Policy, KPMG in Canada
mathieulaberge@kpmg.ca

China

Kevin Kang, PhD
Chief Economist, KPMG China
k.kang@kpmg.com

India

Preeti Sitaram
Director, Government & Public Services,
KPMG in India
psitaram@kpmg.com

Germany

Dr. Ventzislav Kartchev
Head of Business Intelligence/Markets,
KPMG in Germany
vkartchev@kpmg.com

Austria

Dr. Stefan Fink
Chief Economist, KPMG in Austria
stefanfink@kpmg.at

The Netherlands

Diego Vilchez Neira
Senior Manager, KPMG in the Netherlands
vilchezneira.diego@kpmg.nl

Ireland

Dr. Daragh Mc Greal
Director, Strategic Economics, KPMG in Ireland
daragh.mcgreal@kpmg.ie

South Africa

Frank Blackmore
Lead Economist, KPMG in South Africa
frank.blackmore@kpmg.co.za

Nigeria

Dr. Oyeyemi Kale
Partner and Chief Economist, KPMG in Nigeria
oyeyemi.kale@ng.kpmg.com

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