World economic scenarios and risks to 2025

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Gist

This paper examines the outlook for 2025 in the world economy and various possible risks.

It is highly unlikely that a steady world economic recovery will continue for the next 3 years up to 2025. As a basic trend in the macroeconomic environment, uncertainty has not abated, and in particular, for the foreseeable future of 2022 to 2023, it is necessary to anticipate stagflation (the coexistence of inflation and economic stagnation) and recession (deflationary conditions) to a reasonable degree.

Past examples of the world economy falling into stagflation and then returning to a recovery path after entering recession include the second oil shock in the late 1970s and early 1980s, and the experience in the late 2000s, when the U.S. housing bubble and emerging-market boom turned into the global financial crisis. In both periods, it can be seen that a cycle was followed in which stagflation lasted for about one to two years in real terms, followed by economic recovery through policy response and other measures after a recession of about one year. We assume that the basic scenario through 2025, will follow a similar cycle, albeit varying among countries and regions.

Factors that could affect the world economy exist in the economic, social, and political front. On the economic front, there is an inflation of which duration is longer than expected, and continued interest rate hikes in major economies. On the social front, there is the possibility of a new pandemic, and widening world economic disparities, through which lead to social unrest. On the political front, there is the complete division between Russia and the West economies, as well as the contingencies involving the U.S. presidential election and other issues. If these

factors materialize, the world economy could face compound risk scenarios, including a possible simultaneous recession.

On the other hand, as we move toward 2025, there are not only negative risks. In the next 3 years through 2025, the realization of risks such as the pandemic and high resource prices may accelerate the expansion of new investments and related businesses such as DX and GX in response to changes in economic, social, and industrial structures. In Japan, to realize Society 5.0, both the public and private sectors share the view that promoting investment in DX and GX is an important strategic investment to regain the growth potential that is being lost due to headwinds such as population decline.

It is hoped that these new investment flows and the accompanying progress in social and industrial structural reforms will transform the world economy in 2025 from a gloomy to a hopeful one.

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Introduction: Growing uncertainties

What will the world economy look like in 2025? Although it is only three years away, given the current extremely unstable world situation, it is, to be honest, an extremely difficult task to accurately pr edict the course of events. The uncertainty and instability surrounding the world economy appear to have intensified over the past three years.

Looking back, in 2019, trade friction between the United States and China from the previous year suddenly intensified, and the competition for hegemony between the two countries, including advanced technologies, raised concerns about decoupling between the United States and China and its impact on the world economy.

The first phase of the agreement between the two countries at the end of the same year was expected to ease the confrontation and the sense of uncertainty to some extent. But in 2020, due to the rapid spread of COVID 19 in China in the early spring, the world economy in the first half of the same year fell into a pandemic recession, which was said to have been the worst since the Great Depression, albeit for a short period of time. Although the world economy has generally recovered, thanks in part to the unprecedented speed of vaccine development and vac ci nation progress, the successive emergence of a series of mutant strains has made many regions face the challenge of balancing infection control with economic recovery.

In 2021, the supply shortage of various materials including semiconductors intensified due to the effect of tighter restrictions on activities aimed at controlling infections in Asia. In the United States, where domestic demand is particularly strong, labor shortages and logistical stagnation have played a role in the development of inflation at an unexpected pace, forcing the government to shift its monetary easing policy. The world has become aware of the increasing inflationary pressure and adverse effects on the economy caused by rising prices of natural resources such as crude oil and natural gas.

In 2022, the world economy outlook has become even more uncertain due to the emergence of a new geopolitical shock of the Russian invasion of Ukraine in late

February, new waves of COVID 19 in China since March, and the implementation of city lockdowns in Shenzhen, Shanghai, and other areas.

The following is Hitachi Research Institute's current world economic scenarios for 2025 and the risks to which special attention should be paid, taking into account the current uncertain political and economic situation.

1. The twists and turns in the world economy until 2025

1.1From stagflation through recession to recovery

The first thing we can say with considerable certainty about the world economic scenario for 2025 is that it is highly unlikely that a steady economic recovery will continue for the next 3 years or so. In the process, it is assumed that not only the economy but also policy responses such as to the environment and the development of new technologies such as AI will make significant progress. Against this backdrop, as will be described later in Chapter 4, there are some developments that are expected to contribute to the growth of the world economy, such as the expansion of new investments and related businesses, as exemplified by digital transformation (DX) and green transformation (GX). However, as a basic trend in the macroeconomic environment, uncertainty has not abated, and in particular, for the foreseeable future of 2022 to 2023, it is necessary to anticipate stagflation (the coexistence of inflation and economic stagnation) and recession (deflationary conditions) to a reasonable degree.

Past examples of the world economy falling into stagflation and then returning to a recovery path after entering recession include the second oil shock in the late 1970s and early 1980s, and the experience in the late 2000s, when the U.S. housing bubble and emerging market boom turned into the global financial crisis. Figure 1 shows the trends in global growth and inflation at that time. In both periods, the world economy showed increasing signs of stagflation due to the rising inflation rate centered on resource prices and the corresponding tightening policy, and then inflation subsided due to weak demand, resulting in economic depression. It can be seen that a cycle was followed in which stagflation lasted for about one to two years in real terms, followed by economic recovery through policy response and other measures after a recession of about one year.

Of course, we cannot conclude from past experience that we will follow a similar path this time, but as shown in the lower right of Figure 1, we assume that the basic scenario through 2025, will follow a similar, albeit varying, cycle.

1.2 Prospects for each country and region

The basic scenarios for selected countries and regions are as follows.

U.S.: The U.S. economy, marked by strong domestic demand and rising inflationary pressures, is expected to slow down to a certain degree in 2023 due to the effects of monetary tightening. However, the government does not anticipate a setback in the U.S. economy or a repeat of the financial crisis. The relative strength of the U.S. economy compared to other developed economies will not change until 2025. On the political front, it is unclear what will happen in the 2024 presidential election, but it is unlikely that the political and social divisions will be repaired.

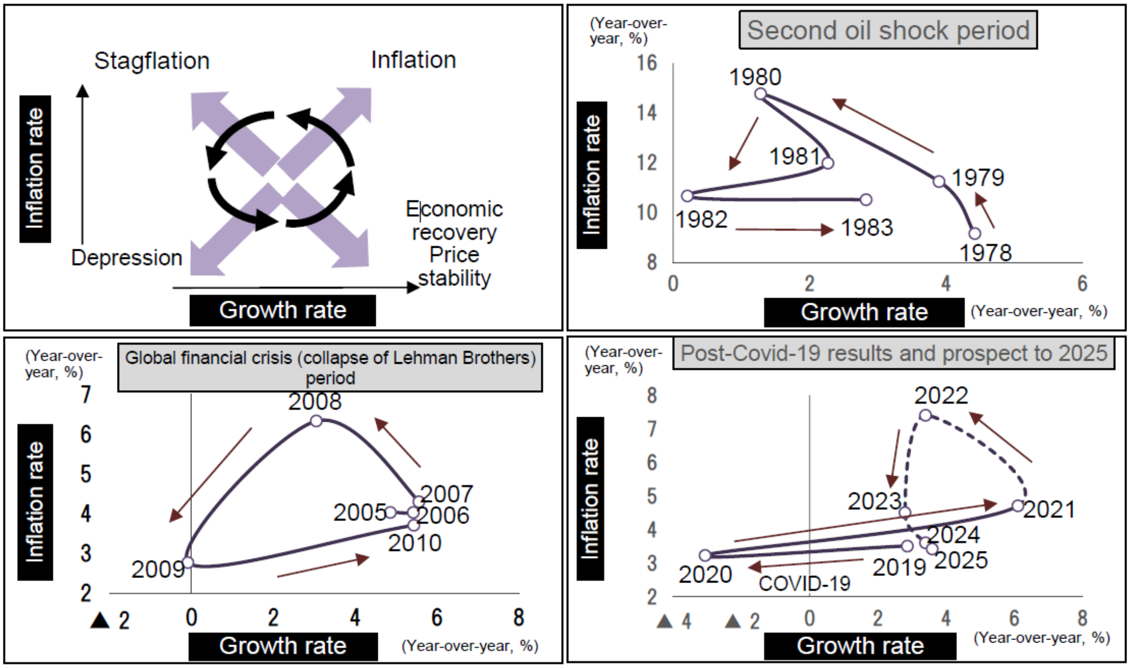
Europe: Although the European economy through 2025 is expected to receive financial support such as the reconstruction fund, the economy will be depressed especially from 2022 to 2023 due to an energy shortage caused by the Russia-Ukraine war. On the political front, the EU is expected to become more united in its policy toward Russia, but some countries such as Hungary are leaning toward Russia, which is a factor of uncertainty.

China: Although the economy will basically maintain stable growth by 2025, its growth potential is expected to gradually decline. Activity restrictions remain due to the zero-COVID policy in 2022, and growth may fall below 5%. Even after that, the basic assumption of growth potential toward 2025 is about 5%. Worsening real estate market conditions and the risk of deepening of the non-performing loan problem will remain a concern until 2025. In addition, China is expected to maintain the attractiveness of its domestic market by accelerating its dual circulation strategy amid the prolonged confrontation with the United States, and the inflow of foreign capital is expected to continue.

India: The Modi administration has pledged to reach an economy of $5 trillion (about ¥640 trillion) by 2025 ($2.7 trillion as of 2020). It will not be easy to achieve this goal, but if various policy measures, such as the integration of the electronics industry (making it a global hub) and investment incentives designed to promote domestic production, are successful, it is possible that they will have a certain effect on strengthening the manufacturing industry. Prime Minister Modi is likely to be re-elected in the 2024 general elections because he has no major rival.

Japan: The Kishida administration, which advocates a virtuous cycle of growth and distribution, has achieved a certain degree of success in curbing COVID-19, maintaining a stable approval rating and reducing the risk of a reversion to a short-lived administration. However, with the population continuing to decline, the policy hurdle for expanding the economic pie is high, and the potential growth rate is assumed to remain near zero.

Figure 1: World economic growth and inflation



Source: IMF, OECD, Hitachi Research Institute forecasts from 2022 onwards

Figure 1 World economic growth and inflation

2. Economic, social and political factors affecting the global economic outlook

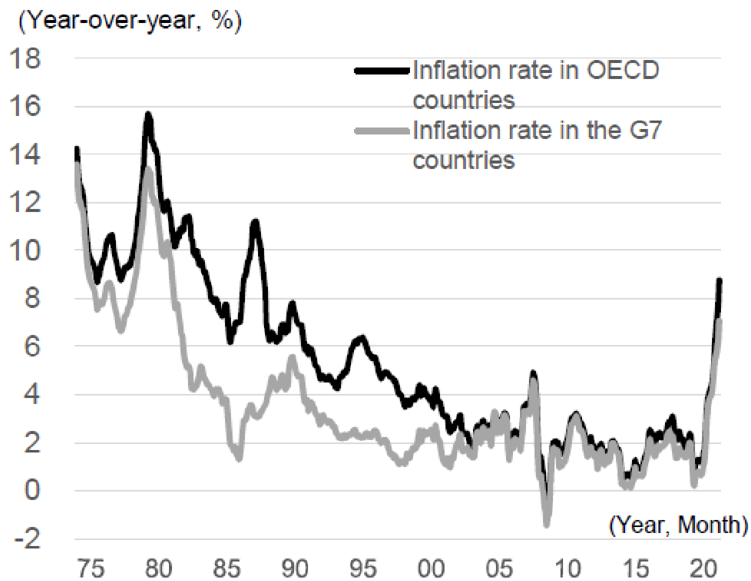
In this chapter, the factors that could affect the world economic base scenario up to 2025 outlined in the previous chapter are divided into economic, social and political factors, and the current assumptions and risks considered by Hitachi Research Institute are examined.

2.1Economic factors

2.1.1 High global resource prices and rising inflation

The first economic factor is inflation. As of March 2022, the consumer price index of OECD member countries increased by 8.8% from the previous year, the highest in about 35 years (Figure 2).

In addition to strong demand for goods generated in the process of recovery from the COVID-19 disaster, rising energy costs due to high resource prices and shortages of semiconductors and other materials caused by supply chain disruptions have strongly affected inflation[1]. In addition, wages are also rising in some developed countries, raising concerns about wider inflation and prolonged high inflation.



Source: Developed by Hitachi Research Institute from various sources

Figure 2: Inflation rates in OECD and G7 countries

Given that the current rise in inflation includes factors such as the impact of higher resources and a temporary surge in demand due to the recovery from COVID-19, it is unlikely that high inflation will continue for a long time like over the next two years or more. Hitachi Research Institute forecasts that the inflation rate will turn

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[1] According to an analysis by the Federal Reserve Bank of New York, there is a high positive correlation between the producer price indexes of OECD member countries. Federal Reserve Bank of New York (2022), "The Global Supply Side of Inflationary Pressures", Liberty Street Economics

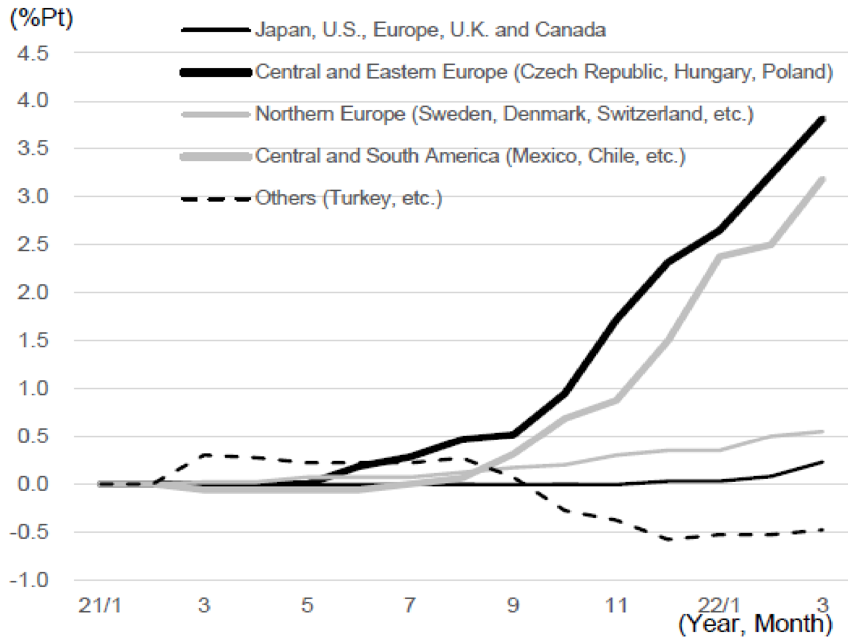
downward in 2023, based on the assumption of an economic slowdown in 2023.

The risk scenario, on the other hand, is a further sharp rise in inflation and a longer than expected duration. In other words, spiraling price increases and its prolongation results from, among others, rising commodity prices caused by rising energy and food prices, and a broad rise in service prices caused by rising wages.

2.1.2 FRB and central banks in other major economies raising interest rates

The second economic factor is monetary policy by developed countries. In response to the aforementioned increase in inflation, central banks around the world began raising interest rates in succession around the middle of 2021 (Figure 3). Interest rate hikes are accelerating in Central and Eastern Europe, such as Poland, and Latin America, including Brazil. In both regions, the average rate increase since January 2021 has already reached 3.5%pt.

In addition to the impact of high imports of natural resources, the hike reflects concerns about inflation caused by the depreciation of the currencies against the dollar and the euro. Furthermore, from the end of 2021 to the beginning of 2022, developed countries such as the United States, the United Kingdom, and Canada raised their interest rates one after another.



Note: When there is more than one policy rate, only the main one is used. The policy interest rates in each region are simply averaged and the difference from January 2021 is extracted.

Source: Developed by Hitachi Research Institute from various sources

Figure 3: Changes in OECD policy rates by region

Hitachi Research Institute forecasts that major countries such as those in Europe and the United States will raise interest rates in earnest from 2022 to 2023. The Eurozone, which has been cautious about raising interest rates, is likely to raise rates after the summer of 2022 due to higher than-expected inflation. Interest rate hikes in major Western countries and regions are likely to spread to smaller countries in the region in order to prevent currency depreciation, and interest rates will continue to rise in Northern Europe and Latin America.

The risk scenario in this regard is that the pace of rate increases between 2022 and 2023 will be faster than expected. It could become apparent when spiraling price increases occur. In this case, excessive interest rate increases will kill the economy, and the economic stagnation expected in 2023 will not end, so there is a high possibility that the recession will become severe and prolong into 2024.

2.2 Social factors

2.2.1 <u>Coexistence with COVID 19</u>

The first social factor is coexistence with COVID 19. Approximately 2 years have passed since the World Health Organization (WHO) declared a pandemic in March 2020.

As of April 2022, new infections of COVID 19 have continued, but the number of critically ill patients has decreased, and the impact on social activities has generally decreased. A major change in the economic structure during this period is the progress of digitization. In terms of working styles, telecommuting and online meetings have become widely used, and in terms of living, online medical care and online shopping have become even more popular. Social and industrial structural changes due to the progress of digitization are irreversible.

Hitachi Research Institute expects that COVID 19 will gradually become endemic due to continued vaccination and the development and dissemination of oral therapeutic drugs, normalizing coexistence with the coronavirus after 2023.

The risk scenario on the other hand, is new waves of more virulent variants before the development and dissemination of oral therapeutics. In particular, the resurgence of infection in China, which has adopted a zero COVID policy, is fear ed to have a greater impact on t h e world economy due to a sharp decline in demand and supply chain disruptions.

2.2.2 Widening disparities

The second social factor is the widening disparities. The debate over the relationship between inequality and economic growth has long been discussed and is not settled.

In recent years, however, as exemplified by the IMF (2014)2, the prevailing view has been that "Countries with smaller disparities t end to have higher economic growth rates and sustained economic growth" (Fukasawa,2015)3.

Hitachi Rese arch Institute does not foresee any major changes in income inequality through 2025. This is because many developed countries, including the United Stat es,

advocate inclusive growth in their recovery from the COVID 19 disaster and have adopted policies focusing on redistribution (of income). In Japan, the Kishida administration has emphasized "growth and distribution," and has proposed a shift from the economic growth path based on the trickle-down theory advanced by the Abe administration.

On the other hand, there is a n argument that the digitization of the economy caused by the COVID 19 disaster will lead to a decline in employment and a digital div ide, which will contribute to the widening of economic disparities. The risk scenario is a further increase in income inequality through the decline of the middle class due to

increased digitization and prolonged inflation. The widening disparities could raise criticism of existing political parties against the backdrop of rising job insecurity and could lead to social unrest such as a change of government.

2.3 Political factors

2.3.1 Complete division between Russia and Western economies

The first political factor is the complete division between Russia and Western economies. The international community, led by the United States and Europe,

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[2] Ostry et al (2014)., "Redistribution, Inequality, and Growth," IMF STAFF ISCUSSION NOTE, February 2014

[3] Fukasawa (2015), "H ow Should We Think about the Relationship between Inequality and Economic Growth," The Reference, February 2015

showed strong solidarity against Russia, and took effective measures in quick succession, such as banning Russian financial institutions from SWIFT, an international payments network, and reducing dependence on Russian crude oil and natural gas. The war between Russia and Ukraine is sending a permanent shock to the world economy.

Hitachi Research Institute assumes that sanctions against Russia will continue and

become normal regardless of whether the war is prolonged or not. The Russian and Western economies are completely divided, and Russia's grain and resources can no longer be counted on. Energy shortages in Europe will continue for at least 2022 to 2023.

The risk scenario, on the other hand, is the escalation of war. Russia's us e of weapons of mass destruction and other factors could raise the profile of war between Russia and

NATO, leading to confusion in financial markets due to rapid risk aversion.

2.3.2 Other political factors

Other political factors up to 2025 include events such as the U.S. presidential election in November 2024 and Taiwan's presidential election in the same year.

The 2022 U.S. midterm elections envisage a Republican sweep of the House and senate, but the risk is that Democrats will retain their majority in the House of Representatives, and congressional twists will further stall congressional operations and policymaking. It is also possible that former President Donald Trump, who implemented self-righteous policies and diplomacy, will come back to power in 2024.

Taiwan's presidential election is also drawing attention due to its relationship with China. The base scenario does not envisage China taking any military act ion against Taiwan by 2025. On the other hand, the risk scenario assumes that the Xi administration takes control of Taiwan's remote islands as a prelude to the reunification with Taiwan, and that economic sanctions by the United States and its allies will be implemented.

3. Compound risks of concern

Based on the risks contained in each of the factors mentioned in Chapter2, the following four scenarios are of concern as compound risks for 2025. The relationship between individual risks and compound risks is shown in Table 1.

Table 1: Compound risk scenarios

	Economic factors		Social factors		Political factors	
	Rise in inflation	Acceleration of interest rate hikes	New waves of COVID-19	Widening disparities	Deteriorating situation in Ukraine	Other political factors
Overkill and stagflation of the U.S. economy	○	○		○	○	○
Rapid slowdown of China's economy	○		○			○
Supply chain risk in Europe	○				○	
Japan's return to deflation and long-term stagnation	○			○	○	

Source: Hitachi Research Institute

3.1 Overkill and stagflation of the U.S. economy

The first compound risk is that the FRB's excessive monetary tightening will be regulatory overkill for the U.S. economy, further deepening global stagflation and subsequent global recession.

The acceleration of interest rate hikes in the United States triggered by rising inflation will lead to a plunge in stock prices and other asset prices, and the U.S. economy will stall. On the other hand, due to the deteriorating situation in Ukraine, energy prices continue to rise, and even if interest rates are raised, inflation will not resolve immediately. The Republican Party will win the U.S. midterm elections amid growing criticism of the widening income inequality, and the United States will not be able to implement aggressive fiscal policies. After the end of the rapid rate hike in 2023, risks will become more serious than expected and global stagflation will deepen. The point at which inflation will eventually subside due to a decline in demand is the same a s in the assumed scenario, but it will be as severe as or even worse than that after the global financial crisis, and the world economy will suffer a simultaneous recession.

3.2 Rapid economic slowdown in China due to political factors

The second compound risk is a sudden slowdown of the Chinese economy. Two political risks are assumed: the failure of the zero COVID policy and a contingency in Taiwan.

The former is a short-term risk. China will fail to contain the virus, and infections will spread further in major cities. However, the Chinese government cannot easily change its zero COVID policy and will continue to impose severe restraint measures such as city lockdowns, causing a sharp slowdown in economic activity. The rise in inflation will lead to small and midsize companies failing to repay their debts, increasing the number of nonperforming loans held by financial institutions.

The rapid slowdown of the Chinese economy will spill over into the world economy, including Japan and Europe. The problem of nonperforming loans is likely to arise around 2025.

If a progressive government continues in Taiwan’s 2024 presidential election, the Chinese government will seek to conquer Taiwan's remote islands as a prelude to reunification. In response, the United Stat es and its al lies will impose economic sanctions and China will take retaliatory measures. The world economy will slow sharply as the Chinese market becomes more fragmented.

3.3 Supply chain risk in Europe

The third compound risk is supply-chain risk in Europe with its epicenter in Central and Eastern Europe.

The intensification of the war between Ukraine and Russia will lead to increased political and social unrest in neighboring Central and Eastern European countries and

further currency depreciation in regions that have not adopted the euro. To cope with the depreciation of the currency, the authorities will raise interest rates further, but the effect will be limited, and the region will face a financial crisis along with capital outflow. In Central and Eastern European countries such as Poland, social disorder will be spreading due to the acceptance of refugees from Ukraine.

As a result, supply chains will be disrupted due to the closure of plants in Central and Eastern Europe, and production will be suspended mainly in the German manufacturing industry, which is heavily dependent on the region. Germany's sudden economic slowdown will spread not only to Europe but also to China and other countries.

3.4 Japan's return to deflation and long-term stagnation

The fourth compound risk is Japan's return to deflation and long-term stagnation. In the second half of 2022, while the negative impact of the COVID 19 pandemic will be mitigated, Japan will not be able to recover its consumption after the COVID 19 pandemic due to import inflation caused by high resource prices. After stagflation,

Japan will fall into deflation again as the United States and other overseas economies stall. Under zero interest rates, the fiscal deficit will widen further as monetary policy is hamstrung and forced to rely on fiscal policy. The Kishida administration's "virtuous cycle of growth and distribution" will end unsuccessfully, widening disparities and shortening the life of the administration.

4. Social and industrial structural reforms develop despite the crisis

So far, we have examined the base scenario and risk factors assumed by Hitachi Research Institute for the world economy up to 2025, and the compound risk materialization scenario that requires attention.

As mentioned at the beginning of this paper, the current situation is extremely uncertain, and it is quite possible that unexpected events may occur in addition to the risk factors discussed in this paper. They are the known unknowns (awareness that something will happen but not sure what it is).

On the other hand, as we move toward 2025, there are not only negative risks. As described in Chapter 1, in the next 3years through 2025, the realization of risks such as the pandemic and high resource prices may accelerate the expansion of new investments and related businesses such as DX and GX in response to changes in economic, social and industrial structures. Such moves are likely to be irreversible and not fundamentally reversed by the effects of the current crisis in Ukraine. In the very short term, there may be moves to replace natural gas in Europe, which used to depend on Russia, with oil and LNG from other regions, and there may be moves to reverse decarbonization efforts, such as the temporary release of oil reserves, but this will not change the t rend in the medium term.

Nor is the trend toward supply chain resilience likely to stop as the pandemic settles down. Rather, the development and provision of new technologies and services related to physical distance, such as contactless serv ices, the implementation of edge and digital infrastructure in social and industrial systems, and other new technologies in

response to the growing demand for enhanced business risk tolerance will be steadily progressing. Furthermore, from the perspective of “safety a n d security,” it is not difficult to imagine the emergence of ideas for various technologies and business services that respond to the growing demand for community healthcare and other forms of life security, as well as to new digital work life needs in the post pandemic era.

In the United States, the promotion of large-scale investments such as DX and GX in anticipation of the post COVID period is proposed in the U.S. Employment Plan, which was launched as a measure against the COVID 19, and in the EU, it is included in and promoted in the reconstruction and resilience plans of each country. China is also promoting DX and GX investments in new and critical infrastructures, which are called the "Two New and One Critical " investment areas, that contribute to the improvement of the civilian population and structural adjustment. In Japan, to realize Society 5.0, both the public and private sectors share the view that promoting investment in DX and GX is an important strategic investment to regain the growth potential that is being lost due to headwinds such as population decline.

It is hoped that these new investment flows and the accompanying progress in social and industrial structural reforms will transform the world economy in 2025 from a gloomy to a hopeful one.