GLOBAL ECONOMIC UPDATE

FEBRUARY 2023

The storm clouds are receding

The shocks that buffeted the global economy in 2022 and sent global inflation to a near three-decade high above 9% should dissipate in the year ahead. However, many economies will suffer the after-effects this year, with household incomes being squeezed and interest rates having risen sharply. With signs that activity slowed sharply late last year inflation risks are giving way to growth concerns, but recent data has also eased recession fears. Global growth is likely to remain subdued in the near-term, with a sustained recovery unlikely until later this year.

One trend dominated the global economy last year: rising inflation. Pressure on prices was already evident in advanced economies in early 2022, as the recovery of demand following the pandemic was met with bottlenecks in global supply chains and in labour markets. Inflationary pressures intensified dramatically following Russia's invasion of Ukraine, particularly for food and energy. Predictions that the inflation shock would prove transitory gave way to concerns that it would prove more persistent, as price rises affected more and more goods and services, and wage growth picked up. As a result, central banks aggressively stepped up the pace of interest rate rises from the middle of last year, leading to cumulative increases of 4.5% points in the US, 3.75% points in the UK and 3% points in the euro area by early February 2023.

Global inflation has peaked

The good news is that the peak of global inflation has probably passed. A combination of higher interest rates, slower growth, lower commodity prices (especially energy) and some easing of supply chain disruption has fed through to consumer prices. Inflation in the US, euro zone and the UK has fallen from peaks of around 10% in the second half of last year (see the charts, below). But it's notable that core inflation hasn't eased to the same degree (5.6% in the US, a record 5.2% in the euro zone and 6.3% in the UK). The experience of other regions has been more mixed, though many emerging markets (including China) have seen lower inflation.

Global inflation is expected to fall back further in 2023, but the pace of decline will depend in part on the relative importance of supply and demand factors that have driven prices higher over the past two years. The US economy has most clearly been facing a situation of excess demand and an extremely tight labour market, with more job vacancies than unemployed workers to fill them and strong wage growth. The labour market remained in rude health through to January, with jobs growth topping 500k and the unemployment rate inching down to 3.4%, the lowest since 1969. Wage growth has eased (4.4% y/y), and though this remains higher than is consistent with the Fed's inflation target, it has slowed enough to allow the Fed to shift down a gear at its February meeting, when it announced a 25bps hike (versus 50bps previously). Further hikes are likely in March and May, before the Fed pauses to assess whether the labour market has cooled.

By contrast there have been fewer obvious signs of excess demand in Europe. Although labour markets on the Continent are historically quite tight, with unemployment rates close to structural lows, the average vacancy rate in the euro area has been half that in the US (at around 3% of the labour force at the peak last year vs 7%, respectively), and nominal wage growth has generally been more moderate (2.9% in Q3). The outlier in this story is the UK, where the jobs market looks more like that of the US: unemployment is low (3.7), wage growth strong (over 6%), and the UK and the US are among a small group of countries in the OECD that have seen an increase in labour market inactivity since the start of the pandemic.

For most European countries, however, the main driver of inflation was the substantial energy supply shock following Russia's invasion of Ukraine. In 2022, household energy prices rose by 25% in the US, compared with 37% in the euro area and 47% in the UK. Moreover, these figures just capture the direct impact for households of higher prices for electricity, gas and transport fuels. Business energy bills have risen even more quickly, which has fed through to the cost of non-energy goods and services (particularly for energy intensive services such as hospitality).

The risk to the European inflationary outlook is that higher energy bills are feeding through with a lag. Wholesale energy prices have fallen sharply recently, as a warm European winter has curbed energy demand, helping to lower headline inflation. But the fact that wholesale energy prices are still double the level they were just a couple of years ago suggests that many European businesses could continue to see their costs go up in 2023 as fixed-price contracts expire and are renewed at higher levels. With wage pressures trending up too, this is likely to keep core inflation elevated in the near-term. In its February press conference, the ECB noted that underlying pressure "remained firm". And having raised rates by a further 50bps, the ECB signalled a similar rise was on the cards for March, with a further hike possible in May.

Growth likely to remain subdued in H1

While central banks are not yet ready to declare victory over inflation, the focus for policymakers is likely to turn to growth in the coming months, as central banks try to gauge how much of the effects of the recent monetary tightening have yet to be felt. Economic indicators have been sending mixed signals. On the one hand, global sentiment indicators remain weak. The S&P global composite PMI output index slipped below the 50 no change mark in August, reaching a trough of 48.2 in December, consistent with slowing activity, before edging up to 49.8 in January. While this points to more stable conditions at the start of the year, with new orders still falling in many key markets through to the beginning of this year (notably the US, euro area, UK and Japan), this loss of momentum seems set to persist well into the first half of 2023.

On the other hand, hard economic data has held up better than these sentiment indicators imply, which has raised confidence that downturns will be mild or may even be avoided. In Europe, GDP in Germany and Italy contracted in Q4 (by 0.2% and 0.1% respectively), but the euro zone economy as a whole kept its head above water, with GDP edging up by 0.1%. And with the euro zone composite PMI pointing to stable output in January, the euro zone may now avoid a recession early this year—an upgrade from our December forecast, which assumed a mild contraction at the start of this year. Growth is nonetheless likely to remain subdued in the near-term. Sticky inflation will weigh on real household incomes and consumer spending, while the latest credit data shows a sharp fall in the demand for loans by firms and households, pointing to weakness in business and residential investment. Meanwhile, new export orders remain deep in negative territory, but should begin to improve as global demand revives later in the year.

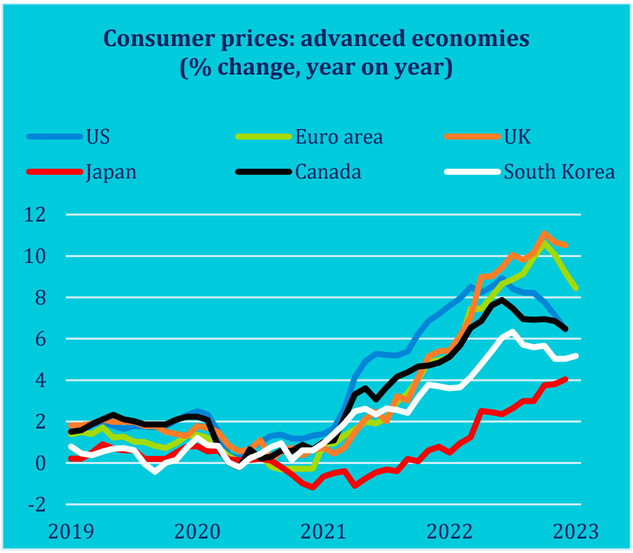
The US economy also avoided a downturn in Q4 year, growing by superficially impressive 0.7% over the quarter, though inventory building accounted for half of this, which could point to weaker growth in Q1. Meanwhile, consumption rose only moderately and investment contracted (with residential investment dropping sharply). As with the euro zone, growth was a little stronger late last year than we had assumed in our December forecast, but US consumers are facing significant headwinds going into 2023. Inflation will continue to outstrip wage growth, which together with the ongoing rate rises by Fed, tight financial market conditions and a weak global economic backdrop is likely to cause activity to slow in the coming months. It's possible the US could still avoid a recession this year and experience a "soft landing", thanks in part to the resilience of the labour market, but this will require US consumers to draw on already depleted savings or raise borrowing to keep on spending, despite the pressure on their incomes.

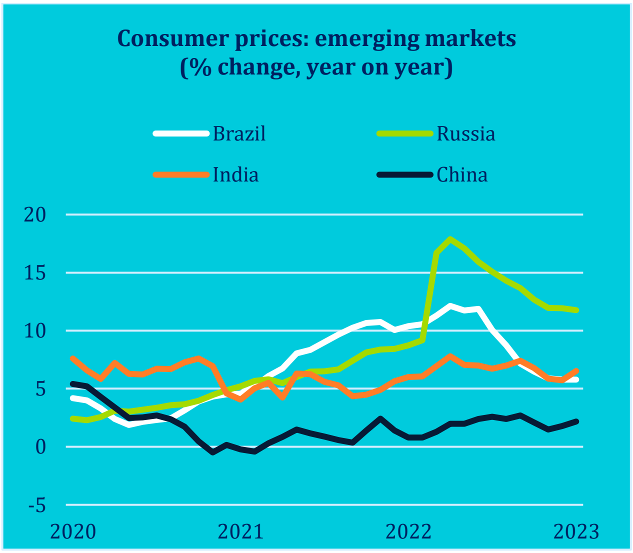
China's re-opening should support global demand

A major uncertainty over the near-term outlook is what China's rapid relaxation of COVID restrictions will mean for the Chinese and global economy. Almost three years since the start of the COVID pandemic, China lifted the majority of its restrictions and reopened its borders late last year. Having surged around the turn of the year, COVID infections appear to have peaked and activity indicators improved across the board in January, with particularly strong gains services sectors.

China's recovery is likely to be bumpy, but pent-up consumer demand and a recovery in investment should more clearly support global demand this year, especially for other Asian economies, while helping to further ease global supply chain pressures. The one sting in the tail is that China's re-opening could add to global price pressures, particularly if China experiences the kind of post-COVID boom in consumer demand seen in developed countries. Growth-sensitive metal prices have rallied in recent months and some forecasters now see oil prices rising above US$100 again later this year. For Europe in particular, rising competition from China for liquid natural gas (LNG) shipments could add to energy supply pressures next winter. A renewed upward spurt in prices for energy and non-energy commodities could stoke inflationary pressures again, and prompt further tightening by central banks.

On balance, however, the outlook for the global economy has brightened in recent months, given improvements in Europe's energy supply situation and China's re-opening. Incoming economic data has generally surprised to the upside. Although growth has clearly slowed in response to the sharp tightening of financial conditions last year, which will continue to feed through to real economy in the first half of this year, the drag on growth should gradually diminish through 2023.





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