Global economy update

July 2023

Global economic activity has remained reasonably resilient so far in 2023 in the face of persistently high inflation in many developed economies and rising interest rates. However, recent data suggest that global momentum was slowing by the middle of the year.

With headline rates of inflation now firmly on a downward path across developed markets, interest rates appear close to peaking. However, the resilience of activity and strong services inflation and wage growth have heightened central bankers' concerns around "second-round" inflation effects, particularly in Europe. Policymakers will be closely watching the dataflow in the coming months, with a risk that tightening cycles are extended further.

Lower inflation should help drive a recovery in real disposable incomes in the year ahead, but the cumulative rise in interest rates over the past 18 months will be a strong headwind for growth. Our latest forecasts for the global economy (published in June) assumes that global GDP growth will slow from 3.3% in 2022 to stand at 2.6% in 2023 and 3% in 2024, marking two consecutive years of subdued global growth.

What do recent data tell us?

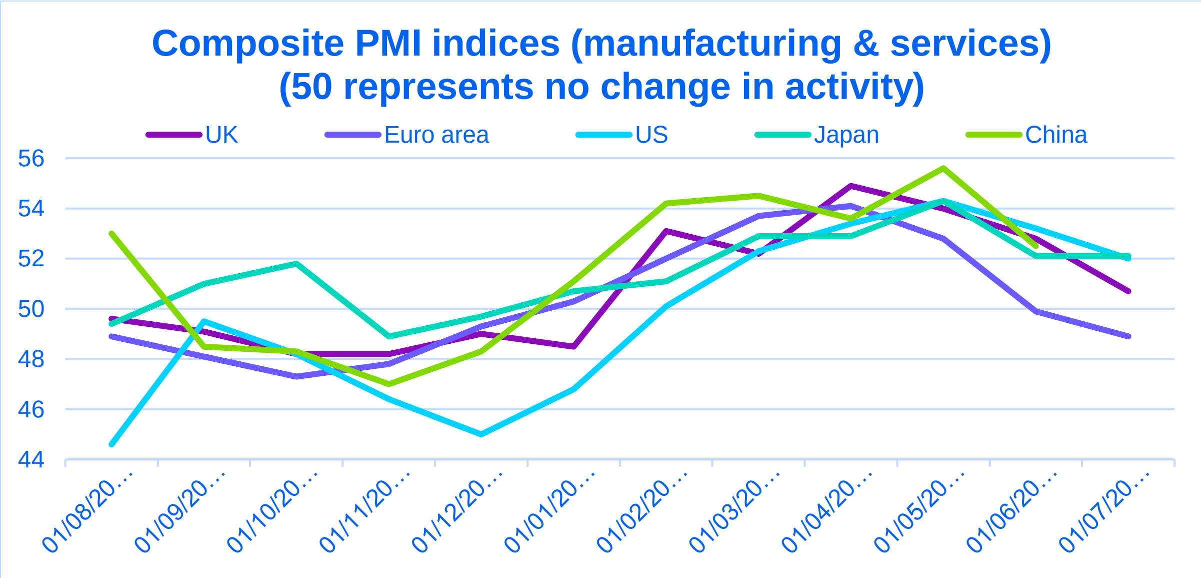
High frequency data have sent mixed signals over the strength of global economic recently. After seeing the strongest post-pandemic recovery in the G7, activity in the US is slowing down. In the first quarter of 2023 GDP growth slowed to 0.3% quarter on quarter, down from 0.6% in Q4, reflecting weaker capital expenditure and residential investment (likely a result of tighter financial conditions), as well as a continued unwinding of inventories.

However, there are still signs of resilience in the US economy. Despite high inflation, growth in consumer spending has been strong, supported by the tight labour market, a run-down in pandemic savings and limited direct impact from higher interest rates given the prevalence of 30-year mortgages. The US saw another solid expansion in Q2, with consumer spending still growing, confidence ticking up, and unemployment edging back down again in June. Nonetheless, survey data are sending a softer signal for the second half, with new orders in manufacturing and services pointing to weaker activity in the months ahead.

Revised data for the euro zone economy show that the region narrowly avoided a recession over the winter (despite a downturn in Germany), with growth flat in Q1 after a slight contraction in Q4 2022 (-0.1%). More recent indicators suggest growth may have been only slightly positive during Q2, however, with momentum fading again heading into the summer.

Weak industrial activity continues to weigh on the region's economy, reflecting a softening of demand for goods post-pandemic, an ongoing stock correction, high energy costs, and a limited boost from China's re-opening. The euro zone manufacturing PMI has remained in contraction territory (i.e., below the 50-mark) for 13 consecutive months as of July. Meanwhile, services activity, which had been holding up relatively well through the spring has also showed signs of softening. As a result, the euro area composite PMI sank back into contraction territory in June (at 48.9, an eight-month low), with activity in the region's two largest economies shrinking (48.3 in Germany and 46.6 in France). The Sentix and ZEW euro area surveys for July also suggest that sentiment has deteriorated this month. All this points to fading momentum through the summer as tighter financial conditions begin to bite (though services activity in Southern Europe could receive support from tourism).

A further sign that global GDP growth is slowing is provided by recent data from China, which suggested that the country's post-reopening recovery has already lost steam. After growth of 2.2% quarter on quarter in the first quarter of 2023, the Chinese economy expanded by just 0.8% in Q2, with annual growth of 6.3% flattered by the comparison with Q2 2022 (when Shanghai and other cities were locked down) and below market expectations (of 7.3%). China's difficulties reflect both domestic and external headwinds, with consumer confidence still historically weak, the property market sinking, industrial production softening and the value of exports (in dollar terms) down by 12% year on year in June. Additional monetary stimulus announced in June is expected to have a limited impact given weak credit demand, while global headwinds will remain as the impact of monetary tightening in developed countries continues to feed through in the second half of the year.



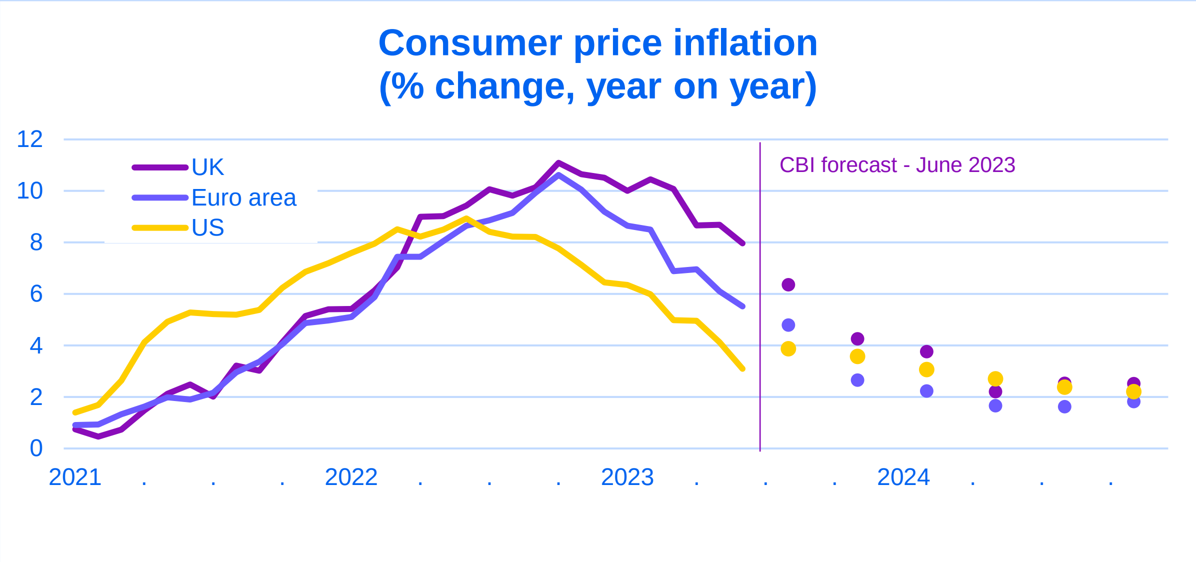
Source: Macrobond.

What's happening to inflation?

Recent months have brought encouraging news on the inflation front. A process of disinflation is now firmly underway across developed markets, reflecting base effects, weaker commodity prices, normalising supply chains and softer demand. But the pace of decline has varied, reflecting the different role of supply-side and demand-side factors in pushing up inflation since 2021. Across many developed economies headline inflation is unlikely to fall back to target until well into 2024 (and beyond, in the UK's case).

In the US, for example, headline inflation peaked earlier and lower than in either the UK or euro zone. US CPI inflation has now declined for 12 successive months to reach 3.1% in June, somewhat lower than we assumed in our June forecast (note this is only one measure tracked by the Fed). This reflected a diminishing contribution from food prices, with lower energy prices also making a large negative contribution (of -1.5% points in June). However, core inflation (excluding energy and food) was higher (4.8%), largely as a result of high service price inflation (6.2%, down from a peak of 7.3% in February). Rising services prices are now the main driver of US CPI inflation (contributing 3.4% points to the headline rate in June), which will likely keep core inflation above target until well into 2024.

Inflationary pressures in Europe have been more broad-based than in the US, with much larger contributions from energy and food in particular. While inflation in the UK and euro zone has also fallen from peaks, headline rates remained elevated at 7.9% and 5.5% in June, respectively. Weaker energy inflation will help pull headline inflation lower in the coming months, but food price inflation (though diminishing) will continue to make substantial contributions to headline rates across Europe. And as in the US, core inflation is also being sustained by rapidly rising services prices, largely reflecting strong wage growth. The enduring strength of food and services inflation is likely to ensure fairly moderate declines in headline rates in both the UK and euro zone over the year ahead.



Sources: Macrobond; CBI.

What's happening in labour markets?

A key issue for the inflation outlook is how wage growth evolves. There are signs that wage pressures in the US and some European countries are moderating as headline inflation falls back. But data continue to send mixed signals on underlying labour market conditions, with vacancy rates falling, but still elevated, and unemployment generally still very close to historic lows.

The news coming from the US has generally been quite encouraging, with signs that the labour market is adjusting smoothly amid a wider economic slowdown. Employment growth has slowed over the past year, but remains fairly robust (non-farm payrolls increased by an average 244k per month over the 3m to June, down from 329k a year earlier, but significantly stronger than an average 187k over the five years running up to the pandemic). Improving labour supply means that although the unemployment rate has edged up slightly recent months (to 3.7%), it remains close to historical lows. However, growth in average hourly earnings continues to slow (to 4.4% in June vs a peak of 6.9% in March 2022), easing concerns about labour market overheating. Our June forecast foresees earnings growth slowing to around 3% by the end of 2024.

In the euro zone, there are some indications that wage growth may be levelling off, though the picture is still mixed. According to Eurostat's quarterly labour cost index (LCI), the growth of wages and salaries slowed to 4.6% in Q1, from 5% in Q4 2022. By contrast, the ECB's preferred measure—the index of negotiated wages—increased to 4.3% in Q1, from 3.1% in Q4. By any measure, wage growth across the euro zone remains close to a 30-year high.

The drivers of the surge in wages have been the subject of disagreement on the ECB's Governing Council. Some members have pointed to evidence that wage growth has been strongest in countries with the highest inflation, suggesting a degree of catch-up that could fade as inflation begins to come down. Others are more concerned that rapid wage growth reflects tight labour markets, requiring further monetary tightening. Given a wide range of views on the ECB Governing Council, future policy moves are likely to depend very much on how the data evolves in the coming months. Our forecast sees earnings growth (which closely tracks the LCI) cooling to 3.1% in 2024 as unemployment edges up.

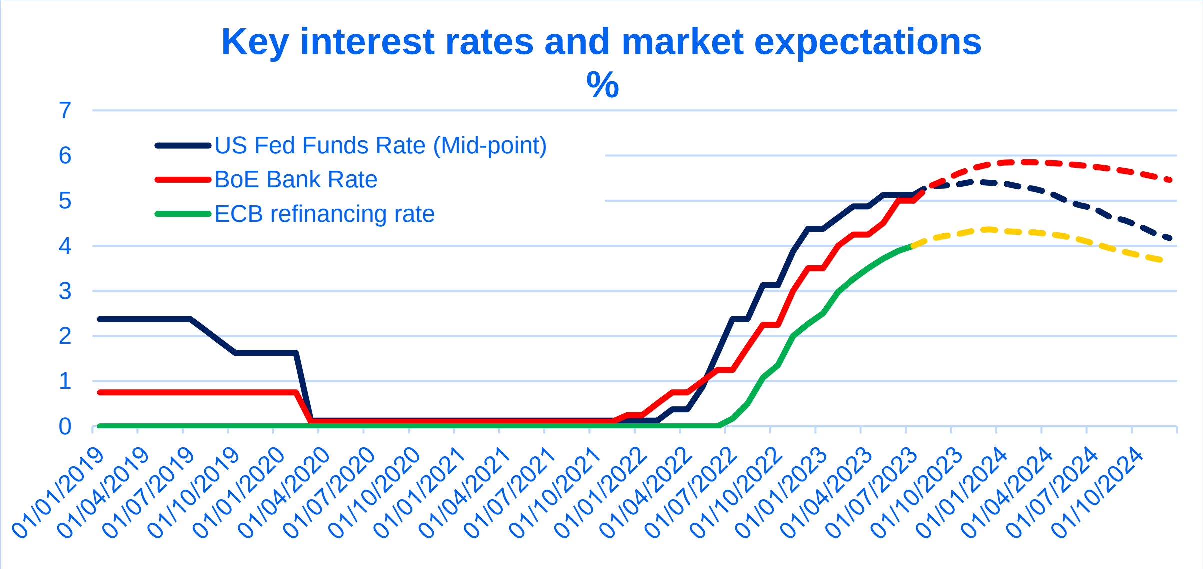
Meanwhile, UK wage growth remains above the rates in either the US or euro zone (though the different definitions used make direct comparisons difficult). In the three months to May, total average pay rose at the fastest pace on record outside of the pandemic (at 6.9%, up from 6.1% in the first quarter of 2023). While wage growth is expected to slow over the next 18 months, our June forecast assumed that it will remain higher in the UK than in its main competitors on average in 2024 (at 3.7% in the UK).

How much further will interest rates rise?

Following aggressive rate hikes over the past year-and-a-half, and with headline inflation now slowing, policy rates in most developed economies appear close to peaking. In the US, the latest inflation data has reduced market expectations for future interest rate hikes and increased investor confidence that the Fed is on course to deliver a "soft landing". A further 25 basis points (bps) increase in late July appears certain, which would take the Fed Funds rate to 5.25%-5.5% (slightly higher than we had assumed in our June forecast), but financial markets are pricing in a high probability that this will be the final hike in the current cycle. Rates are then predicted to remain on hold for the remainder of the year, followed by very gradual cuts to leave the Fed Funds rate a little above 4% by the end of 2024 (though the Fed is likely to tread cautiously and may keep policy tighter for longer).

In Europe, high rates of services inflation and wage growth have sharpened central bankers' concerns that "second-round" effects could slow the decline of inflation, meaning further tightening seems more likely in the coming months. This potential divergence with the Fed has already led to an appreciation of the euro (and to a lesser extent sterling) against the dollar in recent weeks, adding welcome impetus to the disinflationary process already underway in Europe. An expected 25bps rise by the ECB in late July would take the refinancing rate to 4.25%, but signs of slowing growth will make discussions about how much further to go more difficult. Recent comments from ECB officials have acknowledged weaker activity data, but left the door open to another rate hike in September.

Similarly, in the UK, while the softer inflation data for June has reduced the chances of another 50bps hike in August, markets are pricing for Bank rate to peak at just below 6% in early 2024 (from 5.5% currently). But it's worth remembering that market expectations can be quite fluid and adjust to the flow of economic data. Central banks are assuming that the full effect of higher interest rates has yet to be felt and that as unemployment creeps up in the months ahead, wage growth will slow to levels consistent with inflation targets. However, if growth proves more resilient and jobs markets remain tight, central banks may end up tightening monetary policy more than markets are currently pricing in.



Source: Macrobond.

What is the outlook for growth?

In our latest forecast (published in June) we assumed somewhat stronger global GDP growth this year, relative to our previous forecast in December, underpinned by China's economy re-opening, lower energy prices, and better consumer and business confidence. But 2023 will still be a challenging year in many economies, with high inflation expected to lead to annual falls in real household disposable incomes in many developed economies (notably including the UK, the euro zone and Japan, though not the US). As inflation falls back, disposable incomes are expected to recover in 2024, which drives an improvement in global growth next year. However, given sharp rise in interest rates over the past year or so and a long lag for monetary policy to influence activity and inflation, the cumulative rise in interest rates will weigh on growth and financial conditions throughout our forecast, ensuring a second consecutive year of fairly lacklustre global growth.

GDP growth, y/y% (Jun 2023 forecast)			
	2022	**2023**	**2024**
US	2.1	0.8	0.7
Eurozone	3.5	0.8	1.0
Germany	1.8	-0.3	0.9
France	2.6	0.5	0.8
Spain	5.4	2.1	2.2
Italy	3.8	1.2	0.9
UK	4.1	0.4	1.8
Japan	1.0	1.2	0.9
China	3.0	5.6	4.6
India	6.7	5.8	6.4
World (purchasing power parity)	**3.3**	**2.6**	**3.0**

Source: CBI.

If you have any feedback on this article or would like to share any insights into the trading conditions currently facing your business, please contact us at: Ben.Jones@CBI.org.uk