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Economic Update

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International Scene

Central banks ratchet-up policy tightening to address high inflation

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Highlights

- **Major central banks are pushing up policy interest rates with increased urgency to address the ongoing spike in inflation. While justified, this policy is increasing the risk of recession in both the US and Europe.**
- **The US appears better placed than Europe, with employment still robust and energy prices relatively low. Eurozone GDP has held up quite well so far, but industry could be hammered by possible energy rationing this winter.**
- **Inflation rates in much of Asia remain comparatively mild. This is despite huge currency falls versus the US dollar, driven by policy interest rate differentials that could persist as the Fed pushes interest rates higher into next year.**

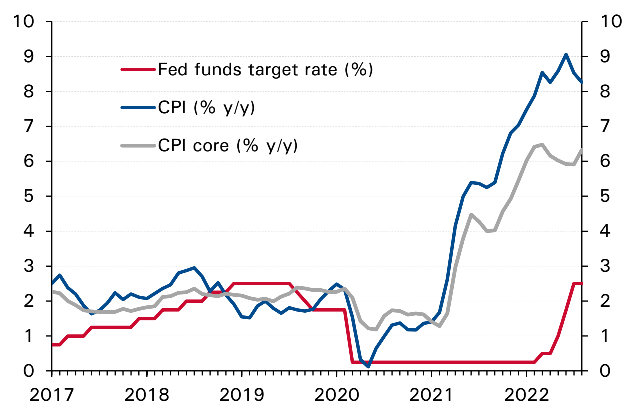
The rapid rise in the cost of living has prompted most central banks to turn more hawkish than previously. Benchmark interest rates are now at multi-year highs, with more hikes due through the remainder of 2022 and at least some of 2023. The US Fed was the first major entity to kick-start an aggressive tightening process, and others, especially the European Central Bank (ECB) and the Bank of England (BoE), are ramping up as higher inflation risks becoming ingrained. Swift Fed tightening has also seen a dramatic climb in the US dollar, putting other major currencies under tremendous stress and fueling the inflation problem by pushing import costs higher. This has also sparked bond sell-offs in Europe. The post-pandemic demand boom is fading as consumer wallets are squeezed, increasing risks for economic slumps in the US and Europe. The recent fall in commodity prices, if sustained, will be a welcome relief for policymakers and consumers alike.

Weaker economic activity in the US amid stubbornly elevated inflation and rising interest rates

The US economy continued to lose momentum in the past few months amid rising interest rates, ongoing elevated inflation, and a weakening global economic backdrop. While headline consumer price inflation seems to have peaked with broadly stable prices in July and August, translating into a softening in the y/y increase to 8.3% through August from 9.1% in June, this is not the case for core inflation (i.e. excluding food and energy). The core index increased by a higher-than-expected 0.6% m/m in August, driving up the y/y increase to 6.3% from 5.9% in July.

The Fed carried on with its tightening policy as it increased rates by 0.75% in its July 15 meeting (bringing cumulative hikes to 2.25% since March), with expectations of a 75 bps hike in its September 21 meeting and a further 125 bps before the end of the year. Balance sheet reduction commenced in June and the monthly cap increased from $47.5 billion to $95 billion in September. While further tightening is definitely warranted given where inflation is, there is also the risk that the Fed might be slow to respond to cooling inflation dynamics. For example, several market-based metrics are already indicating that inflation will moderate rather fast in the months ahead, and some indicators (commodity prices, ISM surveys, used cars prices, etc.) that typically lead hard CPI inflation data point to weakening price pressures going forward. Moreover, consumer inflation expectations (an important metric that the Fed looks at) have dropped from recent peaks.

Chart 1: US inflation and policy interest rates



Source: Haver Note: Upper bound of Fed Funds target rate

GDP decreased by an annualized 0.6% q/q in 2Q2022, dragged down by private investment while personal consumption growth remained in positive territory (+1.5%). This was the second straight quarter of negative growth (-1.6% in Q1), which is a widely accepted rule of thumb for a recession. However, positive growth is expected for Q3, though current projections point to a limited 1% to 2% expansion. Both manufacturing and services ISM indices (latest for August) have continued to trend lower on average, though remain above the 50 no-growth level.

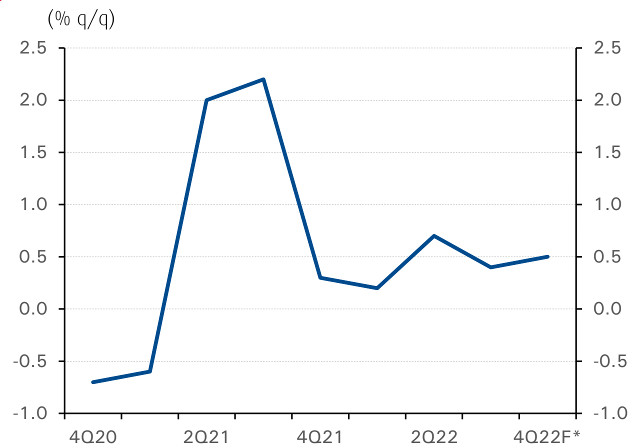
On the other hand, the labor market, continued to be favorable although likely beyond its peak-tightness. Job creation remains positive albeit on a slowing trend with expectations of further softening in the months ahead. The unemployment rate increased from 3.5% in July to 3.7% in August (the highest level since February), mainly driven by a relatively sharp increase in labor participation from 62.1% to 62.4%, tying with March as the second-highest since the pre-pandemic level of 63.4% in February 2020. This increase in labor participation is a positive development, implying a boost to labor supply. If this upward trend continues, that will most likely help cool down both wage inflation as well as consumer price inflation.

Europe stares at recession; central banks unleash aggressive policies to tame inflation

The looming energy crisis, stubbornly-high inflation, a tight job market, weakening currency, big ECB rate hikes and growing signs of impending recession sum up the ongoing mess for the Eurozone economy. Russian gas flows saw frequent disruptions, with Russia completely halting the discharges through one of the main pipelines, Nord Stream 1, exacerbating fears about gas availability and possibly a rationing of supplies. On top, president Putin threatened to stop all energy flows to the countries supporting any price cap on Russian oil. Although 2Q GDP was revised upwards to +4.1% y/y, the bloc's composite PMI for August remained in the contraction territory, at 48.9 from 49.9 in July. Significantly, the services sector, a bright spot on the post-COVID demand surge, also fell into the recessionary zone in August, to 49.8 from 51.2. Despite the ongoing economic challenges, the job market has remained rather tight, with the unemployment rate dropping to 6.6% in July from 6.7% in June.

Eurozone HICP inflation rose to 9.1% y/y in August from 8.9% in July, with the core rate jumping to 4.3% from 4%, implying a broad-based rise. Worse, the euro has depreciated by almost 12% YTD versus the US dollar (partly due to the gap in policy rates with the Fed), pushing the cost of dollar-based fuel imports higher. Amid no signs of easing inflation, a weakening euro, and a tighter job market, the ECB raised the benchmark deposit rate by 75 bps earlier this month, following a 50 bps hike in July, taking the rate to 0.75% from -0.5% in June. The adverse aftershocks of higher interest rates will likely be felt in peripheral countries, including Italy, where the yield spread over Germany widened to around 225 bps (on 10-year government bonds), near the post-pandemic high. As a mitigating mechanism, the ECB announced its so-called Transmission Protection Instrument, which aims to prevent spreads between Eurozone members from widening too much, though details are still evolving.

Chart 2: Eurozone GDP



Source: Haver Note: * Forecasts for 3Q22 and 4Q22 from the ECB

Meanwhile, in the UK, GDP recovered +0.2% m/m in July from -0.6% in June. But August's composite PMI tumbled to 49.6 from 52.1 in July, the first contractionary reading since February 2021. Headline CPI appears past its peak and unexpectedly eased to 9.9% in August (10.1% in July), but the core rate rose to 6.3% from 6.2%. The BoE delivered a 50 bps hike in July and looks set for another 50 bps (minimum) increase later this month. Like the euro, the pound has depreciated significantly (-14% YTD), against the US dollar and is hovering near multi-decade lows, feeding imported inflation. 10-year gilts were sharply sold-off, with yield rising more than 115 bps in the last few weeks to above 3.1%, the highest level since 2011.

Newly-appointed PM Liz Truss will cap a typical household's energy bill at current levels of around GBP 2,500 (due to rise above GBP 3,500 next month) and cut taxes to address cost of living pressures. This relief measure will cut the headline inflation sharply in the near term. Some concerns about the fiscal implications remain, estimated to be around GBP 150+ billion (3% of GDP and funded through additional borrowings) over two years. Although the BOE earlier projected five consecutive quarters of economic decline starting 4Q, PM Truss's measures could propel consumer demand and help the UK avert a prolonged/deep recession. Conversely however, interest rates could stay higher for longer, as the package's net impact will still be inflationary on the core components.

Japan policymakers at crossroads given weakening yen

Japan's GDP growth for 2Q22 was revised upwards to an annualized 3.5% q/q from 0.2% in 1Q22, regaining the ground lost during the pandemic. Private consumption, which makes up more than half of GDP, grew 4.8%, while capital spending rose 2.8%. However, robust growth seems unlikely to be sustained with continued supply chain disruptions weighing on production, elevated prices forcing consumers to limit purchases, and

concerns about levels of demand at home and abroad.

In August, the manufacturing PMI expanded at its slowest rate in almost a year, reaching 51.5 from a final 52.1 in July as the worsening global economic backdrop including falling demand from China and South Korea affected businesses. This could signal broader weakness in overall GDP growth in Q3. Meanwhile, inflation increased to 2.6% y/y in July from 2.4% in June, putting the rate higher than the 2% target of the Bank of Japan (BOJ). These prints indicate that, following a protracted period of deflation, Japanese businesses and consumers are witnessing a change in inflation dynamics they have not seen in a long time.

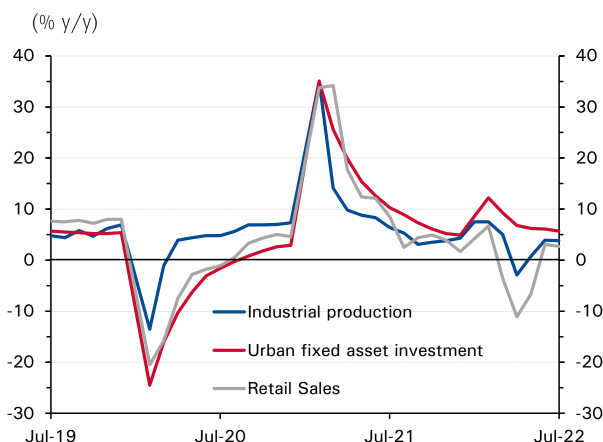
The yen has fallen to its weakest level against the US dollar since the Asian financial crisis in 1997/98, depreciating by over 25% YTD. It has raised concerns about Japan's ultra-loose monetary policy as opposed to ongoing tightening by the majority of central banks around the world. Nonetheless, Japan's inflation gains are still modest compared to those of Europe and the US, and the BOJ seeks to prioritize growth despite the widening current account deficit. Therefore, the BOJ appears unlikely to make a shift soon, further pressuring the yen.

China's economic activity well below potential

Economic activity continues to trend far below potential, barely escaping a contraction in 2Q22 (+0.4% y/y), weighed down by demand-sapping Covid-19 lockdowns, a real estate market downturn and a record-breaking heatwave. Domestic consumption remains weak, disrupted by continuous and scattered lockdowns spanning large cities. Consequently, retail sales growth edged down to 2.7% y/y in July, missing market forecasts of a 5% rebound. House prices (new and resales) also declined between May and July as demand for real estate slowed amid widespread mortgage boycotts on cash-strapped property developers. Business activity did not fare better, either. The official manufacturing PMI in August showed activity contracting again (49.4), for a fifth time in six months. Industry was badly affected in recent weeks by power shortages amid the network-straining severe heatwave.

Chart 3: China industrial output and retail sales

(% y/y)



Source: Haver

CPI inflation, however, remained fairly low and stable at +2.5% y/y in August, in contrast to the trend in advanced economies. Indeed, this has provided the People's Bank of China (PBoC) with space to ease monetary policy, moving rates in the opposite direction to advanced economy rates. The PBoC has cut both the one and five-year loan prime rates by 5 bps and 15 bps, respectively, and expanded the money supply at the fastest rate in five years (+12.2% y/y in August). The bank is, however, cognizant of the risk that the divergent policies could accelerate capital outflows. The government also rolled-out multiple stimulus measures, including a $146 billion package late in August, which raised limits on local municipalities' bond issuance, a major source for infrastructure investment, and pledged lower financing costs for private businesses.

Strong 1Q GDP growth, inflation appears easing in India

India's GDP grew 13.5% y/y in 1Q FY22/23 (from 4.1% in the previous quarter) on last year's low base as the services sector recovered sharply after Covid-related mobility restrictions eased. However, the growth was below the RBI's 16.2% forecast. The PMI readings for August were robust, with services and manufacturing indices at 57.2 and 56.2, respectively, and hiring activities within services soared to a 14-year high.

Inflation meanwhile eased to 7% in August from its multi-year high of 7.8% in April. But uncertainties remain, given this year's erratic monsoon rains and volatile food prices. The government recently imposed a curb on rice exports, following restrictions on wheat and sugar earlier. The Reserve Bank of India (RBI) in July raised the repo rate by 50 bps to 5.4% (taking the cumulative hike to 140 bps since May 2022). With the peak of the inflationary phase being behind, as per the RBI governor, further hikes could be more moderate. Nonetheless, global monetary tightening and persistently high food prices should continue to keep policy rates high.

The current account deficit continues to swell on elevated fuel import prices, and with global uncertainties hindering exports it could expand to a decade-high of 3.1% of GDP this year from 1.2% last year. The Indian rupee has fallen by 7% YTD versus the US dollar on the widening trade deficit, capital outflows from the equity markets (c. $35 billion YTD), and general US dollar strength. However, the INR is up 2% YTD on a trade-weighted basis. The RBI has been defending the INR through market interventions, triggering a 13% YTD drop in India's forex reserves to $553 billion (the lowest level in almost two years) as of early September.

Looking ahead, GDP could grow at a normalized rate of 6-6.5% in 2Q (July-September) and around 7% for the full year FY22/23 on sustained private consumption and improved business outlook. However, downside risks arising from potential weakness in the rural sector, elevated consumer and producer prices, and the external sector, remain.

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