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Economic Update

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International Scene

Economic indicators improved recently but US bank turmoil triggers alarm

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Highlights

- **Financial markets reeled in March following the collapse of US banks, making the pace of further policy tightening in the US and Europe much less clear. Still-hot inflation and robust job markets would normally support a few more hikes.**
- **The recovery in Japanese GDP growth disappointed in 4Q22. Although inflation has hit a 40-year high, a rapid removal of ultra-loose monetary policy now appears unlikely, especially given latest international pressures.**
- **China's activity post-Covid reopening is rebounding but the government has set only a modest growth target of 5% for 2023. Growth in India should outstrip that in China this year, though momentum is slowing.**

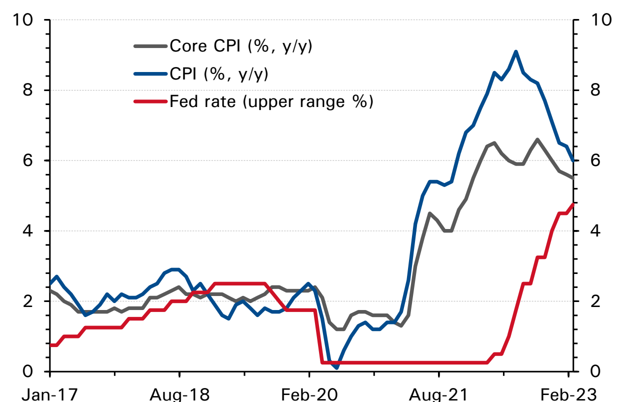
Fallout from the recent US bank failures sent shockwaves across the global financial industry, making for a more cautious and complicated outlook regarding central bank policy tightening. Before this turmoil struck, recent encouraging economic data had suggested that the chances of a deep recession in developed economies have receded considerably while price pressures, although easing, remain relatively sticky – both of which argued for further interest rate hikes. But this more bullish view is now less certain. Economic growth across key countries was already expected to decelerate this year versus 2022, with China the main exception. (See table 1 at the end of the document.) China's post-Covid re-opening and the resulting revival of consumer and industrial demand initially fueled a commodity rally, though gains have since partially reversed. The pace of demand recovery in China is still key for the global growth and inflation outlook this year.

US economy slowing but may escape recession

The US economy rebounded in 2H22 after two consecutive quarters of contraction in H1, resulting in full-year 2022 GDP growth of 2.1%, slowing from 5.9% in 2021. In 4Q22, GDP grew 2.7% (annualized), down from 3.2% in Q3, with underlying demand indicators such as personal consumption (+1.4% from +2.3%) and gross private fixed investment (-4.6% from -3.5%) weakening compared to the previous quarter. Yet the latest indicators are better than earlier projections, helped by sustained strength in the labor market and tentative improvement in consumer confidence (the University of Michigan consumer sentiment index hit a 13-month high of 67 in February). The February ISM services PMI was solid at 55.1, though the manufacturing equivalent remained in contraction for the fourth consecutive month at 47.7. Meanwhile, retail sales have been strong this year, despite a decline in February (-0.4%) following a large spike of 3.2% in January.

Underpinning much of the recent upbeat activity data, the labor market remains robust, with non-farm jobs in February increasing a very solid 311k even after a bumper January figure. The unemployment rate ticked up to 3.6%, but is not far from the 40-year low of 3.4% recorded in January. Meanwhile, inflation, although off its peak, continues to run relatively hot despite CPI inflation in February easing to 6% y/y, the lowest since September 2021, and the core rate ticking down to 5.5%. While moderating housing rents will likely help lower services inflation in the coming months, stubbornly high core services (ex housing) prices will contribute to inflation remaining well above the Federal Reserve's 2% target this year.

Chart 1: US inflation and policy interest rates



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

Fed policy has been on an up-and-down ride through 1Q23. The bank dialed back the pace of rate hikes to 25 bps in January, taking the policy rate range to 4.5-4.75%, acknowledging the start of a disinflationary process. But subsequent strong inflation and job data led chair Powell to signal that the door to faster rate hikes remains open.

However, sharp and unexpected signs of fragility in the banking system in mid-March have seen rate expectations shift again – this time in a more dovish direction. Start-up-focused Silicon Valley Bank (SVB), with total assets of around $210bn, collapsed after a deposit run amid sharp marked-to-market losses in its US treasury holdings, linked to previous Fed rate hikes. Within days, another US-based bank, Signature Bank ($110bn of assets) was closed by regulators for similar reasons. SVB was the largest US bank failure since 2008 and appeared at least partly triggered by its outsized exposure to an already cash-strapped start-up industry. The Treasury and the Fed made emergency funds available to the banking sector, including SVB and Signature, to help stem possible contagion. Still, the development rattled financial markets and led to previous expectations for 75 bps of further Fed rate hikes this year being reined in.

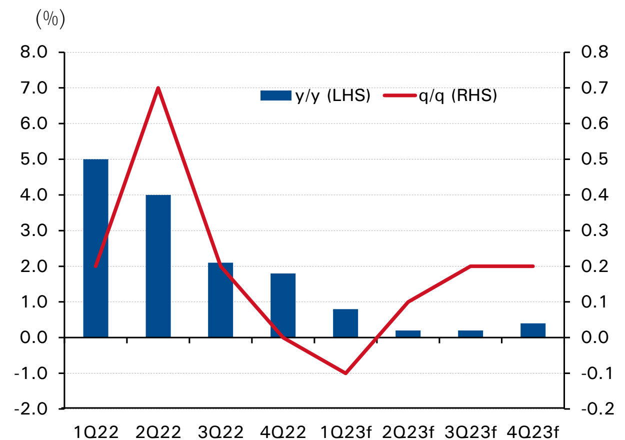
This is not the only financial challenge on the horizon. The US government hit its debt ceiling of $31.4 trillion in January, and Treasury secretary Yellen began funds management measures to buy time until this summer, delaying a government default by a few months. But with the Republican-controlled House seeking spending cuts, a political accord on raising the ceiling is unlikely to be easy.

Europe showing stronger signs of economic recovery

The Eurozone is off to a good start this year, with signs of a steady economic recovery continuing in the past few months. A relatively mild winter season, gas availability, and falling energy prices have helped. Even though the last GDP print (4Q22) was weak, other key data like the PMI, inflation, and unemployment signal a better-than-initially-expected outcome. GDP growth was flat q/q in Q4 from +0.2% in Q3, resulting in weaker growth y/y of 1.8% from 2.1% in Q3. (Chart 2.) Recent PMI figures have been more encouraging. The composite PMI rose significantly above the 50-mark at 52 for February from 47.8 in November, mainly driven by the services sector (52.7). But manufacturing remained in contraction (48.5).

Eurozone HICP inflation in February continued its deceleration, coming in at 8.5% y/y from its peak of 10.6% in October 2022 on softer energy and services prices. Still, this was higher than expected and well above the ECB target of 2%. Core inflation picked up to 5.6% versus 5.3% in January. The ECB in February raised its benchmark deposit rate by 50 bps to 2.5%, with further hikes in the pipeline – likely including another 50 bps this month. The euro has been relatively flat YTD against the US dollar after gaining around 10% during 4Q22; the large gain in 4Q22 should support the inflation outlook on imported goods, including energy products.

Chart 2: Eurozone GDP growth



Source: Haver, Refinitiv; Note: Forecasts are from Refinitiv (third party)

The UK has also surprised positively over the past few months as it narrowly missed the widely expected technical recession, while PMI and inflation figures project a better outlook than initially feared. GDP in Q4 grew by 0.4% y/y (flat q/q) versus 1.9% (-0.2% q/q) for the previous quarter. The composite PMI rebounded to 53.1 in February versus 48.5 in January, with services (53.5) again the main driver. GDP in January grew by a better-than-expected 0.3% m/m, recovering from a drop of 0.5% in December on stronger growth in the services sector, while the manufacturing sector slumped. On the fiscal side, the UK's Chancellor of the Exchequer is discussing possible tax breaks to spur economic activities.

CPI inflation has continued to edge down at 10.1% y/y for January from a peak of 11.1% in October, with the core rate also dropping, to 5.8%. In February, the Bank of England (BoE) raised the bank rate by 50 bps to 4%, and looks set to hike by a further 50 bps this month, too. However, the latest comments from the BoE hint that rates are not far from peaking.

Slow exit seen from Japan's ultra-loose monetary policy

Japan's economy rebounded less than expected in the final quarter of 2022. GDP growth was revised down to an annualized 0.1%, better than Q3's -1.1% given the reopening of the country's borders but weaker than expectations for a 0.5% rise. Tepid consumer spending dragged down the headline figure. Data for 1Q23 has been mixed, with industrial production falling in January, but retail sales stronger than expected and the composite PMI unchanged at 50.7 in February (preliminary reading), signaling modest growth.

Meanwhile, consumer price inflation accelerated to a new 40-year high in January at 4.3% y/y, while core inflation rose to 3.2%. High inflation has pushed real wage growth into negative territory for ten consecutive months, and the upcoming "shunto" spring wage negotiations will likely deliver higher growth in nominal pay for workers. Kazuo Ueda is set to replace the existing BoJ governor Kuroda in April. The BoJ's existing yield curve control (YCC) and ultra-loose monetary policies are unlikely

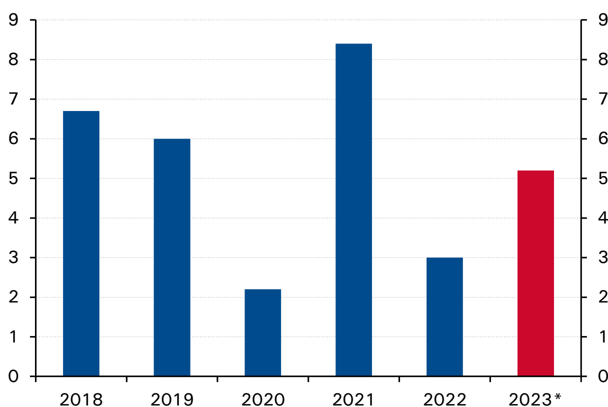
to be removed quickly, with Ueda keen on seeing inflation sustained at 2%, rather than fall below. Moreover, fallout from the US bank failures saw upward pressure on Japanese government bonds (JGB) ease, with the 10-year yield falling to around 30 bps, significantly below the current 50 bps YCC ceiling. Besides, Japanese banks' large unrealized losses on US treasury holdings (although the exposure is less significant than their JGB portfolio) may also support the BoJ's ongoing liquidity boosting measures.

China's outlook cautiously optimistic

Chinese GDP growth slowed to 3% in 2022, missing the official target of 5.5%, weighed down by the restrictive Covid-zero policy and property market weakness. The outlook for 2023 appears brighter as an abrupt exit from strict lockdowns in December last year has seen economic activity rebound. Official PMI readings expanded for the second consecutive month in February, with the composite measure jumping to its highest level on record (56.4). Growth in outstanding loans accelerated to 11.3% y/y in January, indicating an increased appetite for borrowing amid improving business sentiment. Meanwhile, mobility indicators have shown a robust recovery this year, including increased flight and traffic activity.

Chart 3: China real GDP growth

(y/y %)



Source: Haver; Note: 2023 forecast is from the IMF

Nonetheless, there are downside risks. The government has set a growth target for 2023 of "around 5%", the lowest in its history, potentially signaling only measured fiscal and monetary support. Although the IMF sees higher GDP growth at 5.2%, global macroeconomic headwinds and subdued exports could offset a rebound in the domestic economy. Weak trade figures reveal the still sketchy nature of the demand revival. Exports, which supported the economy before Covid restrictions were lifted, slumped 6.8% y/y in January-February, while imports fell 10.2%, partly reflecting weaker domestic consumption. The property market remains under pressure following government crackdowns and developer insolvencies. New home prices dipped a further 1.5% y/y in January.

Additionally, inflation slowed to 1% y/y in February from 2.1% in January, while producer prices fell 1.4% y/y. The monthly drop in consumer prices after the lunar new year holiday exposes the fragility of the recovery.

India's GDP growth eases, further RBI rate hikes expected

India's GDP growth further eased to 4.4% y/y in 3Q FY22/23 from 6.3% in Q2 (lower than the forecast of 4.6%) on a higher base and fading pent-up demand. The Indian government has retained its forecast of 7% GDP growth for FY22/23, slowing from an upwardly revised +9.1% the previous year, with the latest economic survey projecting a 6-6.8% growth in the next fiscal year. Most recent indicators have been decent but point towards slowing momentum, with elevated interest rates and a deteriorating global outlook starting to weigh on activity. The manufacturing PMI slipped to a four-month low of 55.3 in February, though the services measure expanded to a 12-year high of 59.4. Gross goods and services tax (GST) collections – a key indicator of domestic demand and business activities and a significant source of government revenue – rose 13% y/y in the first two months of 2023, slowing from 14% growth in 4Q22.

Consumer price inflation eased less-than-expected to 6.4% in February from 6.5% in January as food inflation stayed high. Given the unusually warm weather of late, chances of a weaker monsoon season this year have increased, potentially hitting food supply and pushing up prices. The Reserve Bank of India (RBI) has steadily raised the repo rate by 250 bps to 6.5% since May last year to restore price stability. Sustained inflationary pressures may keep the door open for the RBI to continue with its hawkish monetary policy, albeit at moderated levels due to softening economic growth.

Table 1: Real GDP growth rate

y/y %

	2022	2023f	2024f
US	2.1	0.7	1.2
Eurozone	3.5	0.5	1.2
UK	4.0	-0.8	0.8
Japan	1.3	1.0	1.1
China*	3.0	5.2	4.5
India**	6.9	6.0	6.4

Source: Refinitiv (third party forecasts), IMF Note: * forecasts from the IMF. ** fiscal year ending March of the following year

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