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# Economic Update

NBK Economic Research Department I 12 December 2022

International Scene

# Signs of peak inflation means rate hikes will slow, but downturn risks persist

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## Highlights

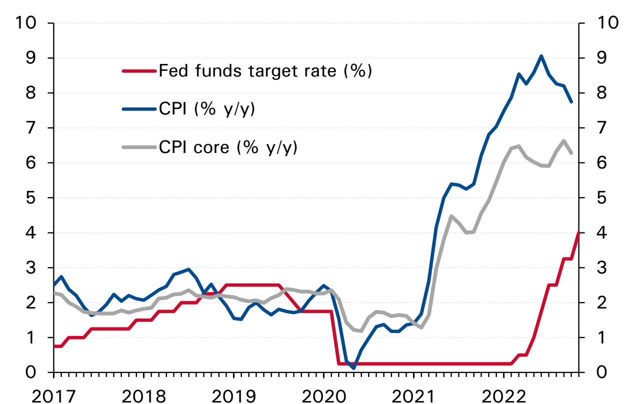
- **Inflation in developed economies has likely peaked albeit at high levels, helping pave the way for continued but smaller rate hikes by key central banks. However, recession risks persist.**
- **The US economy is showing mixed signals, with a still-strong job market but demand slowing across many sectors, including housing. Europe could still avoid a severe downturn this winter as gas unavailability woes ease.**
- **In Asia, Japan's struggle with a weaker yen continues, China's output remains subpar on Covid restrictions, while India appears as the lone bright spot on robust domestic demand despite a weak external sector.**

Although still historically elevated, inflation appears to have started easing in many markets, raising hopes that the peak inflationary phase is finally behind us. However, the easing is due primarily to softening energy prices, with core inflation remaining stickier. As such, more interest rate hikes by key central banks are still very much on the table, but the pace of hikes should start to moderate from recent outsized increases. Meanwhile, elevated cost-of-living pressures and higher interest rates have dampened the demand outlook. A shallow or narrow recession is becoming increasingly likely in western developed economies (Table 1, at the end of the document.) However, the job market continues to be resilient, cushioning against a harder landing. Expectations of smaller rate hikes by the US Fed have fueled a sharp relief rally in global currencies versus the US dollar (the dollar index fell 8% since late-September), which should help central banks fight inflation in some markets. China's approach to Covid restrictions will be keenly watched, with its widespread ramifications for the country's economy as well as for global supply-chains and commodity prices, including oil.

## US activity signals mixed amid policy tightening

The US economy seems to be still performing in a satisfactory way, despite the headwinds of elevated inflation, rising interest rates, and a weak global macroeconomic backdrop. After dropping for two consecutive quarters, GDP rebounded by an annualized 2.9% q/q in 3Q22, but given the aforementioned risks, momentum is likely to slow in Q4. The ISM indices in November painted a mixed picture, with manufacturing falling below 50 (49) for the first time since May 2020 but services expanding to 56.5, recovering from an over 2-year low of 54.4 in October. Headline consumer price inflation has most likely peaked with the y/y rate retreating to 7.7% through October from 9.1% in June and is set to continue dropping going forward. (Chart 1.) Core inflation might be more tricky; still, the latest (October) data delivered a positive surprise, with prices rising by a lower-than-expected 0.3 m/m, with goods prices deflating by 0.4% m/m after being flat in September. Mainly due to higher mortgage rates, home prices have now decreased for three consecutive months (July through September), something that last happened around ten years ago. Home prices are expected to remain under pressure, which will help moderate shelter inflation, a key component of services inflation.

**Chart 1: US inflation and policy interest rates**




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

The Fed carried on with its tightening policy as it increased rates by a fourth consecutive 75 bps (to a range of 3.75% to 4%) in its November meeting, bringing cumulative hikes to 3.75% since March. However, it is almost certain that the Fed will downshift to a 50 bps hike in the upcoming December meeting. Recently, the Fed chair Powell mentioned that the terminal rate would

likely be "somewhat higher" than the committee's view at the September meeting (upper range of 4.75%), a more dovish tone than previously. With an upper range of 4.5% already priced-in by year-end, going into 2023, the interest rate hiking cycle would be close to being done. In this context, the November CPI print (to be released on December 13) carries significant importance, and a better-than-expected outcome (similar to October) will likely further shorten the rate hiking cycle and lower the market's current projection of the terminal rate of 5%.

Finally, the labor market continued to be broadly resilient delivering decent job gains, though on a slowing trend and with expectations of further softening in the months ahead. The latest non-farm payrolls (November) showed an increase of 263k, still solid given the sharp rise in interest rates, but also the lowest level since April 2021. The unemployment rate ticked up to 3.7% from 3.5% (the pre-pandemic rate of February 2020 and the lowest in more than 40 years) in September. Labor participation remains a negative factor, ticking down for three straight months to stand at 62.1%, only slightly higher than at the start of the year and materially lower than the pre-pandemic rate of 63.4%.

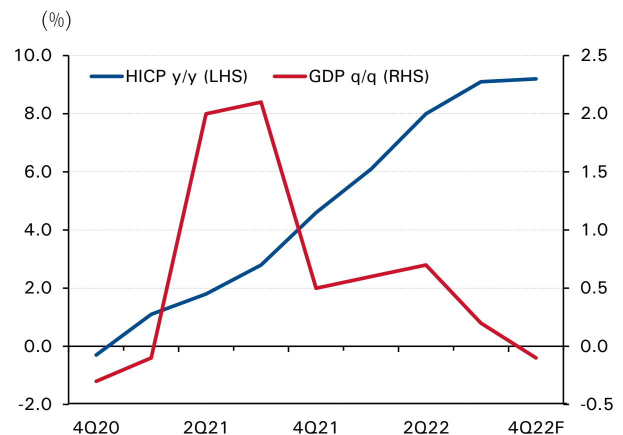
## Europe faces gloomier outlook on steeper price hikes

The odds of a winter recession in the Eurozone are increasing, albeit a short/shallow one, for now. The possibility of gas unavailability during the peak winter season has somewhat receded given milder weather thus far and sizeable gas stocks, mitigating the risks of widespread energy rationing in the coming months. That said, energy prices are still elevated, and the ongoing uncertainty in the market will be a key challenge for the economy amid increasing interest rates and high food prices. GDP growth in Q3 slowed to 0.2% q/q from 0.8% in Q2, resulting in weaker growth y/y of 2.1% from 4% in Q2. Economic sentiment is weak as recent PMIs remained in the contraction zone in November. The composite PMI came in at 47.8, easing the pace of deterioration from 47.3 in October, driven by an uptick in manufacturing (47.3 from 46.4), but services was flat (48.6). The European Commission recently downgraded the bloc's GDP growth forecast for 2023 to 0.3% (1.4% earlier) with 6.1% inflation. Despite the ongoing economic challenges, the job market continued to be tight, with the unemployment rate falling to 6.5% in October from 6.6% the previous month, the lowest on record.

Eurozone HICP inflation in November slowed for the first time in 17 months to 10% y/y (-0.1% m/m) from 10.6% in October on softer energy and services prices, but it remains historically very high. (Chart 2.) The core rate, however, was unchanged at 5%. Amid steep inflation, a weaker euro, and a tighter job market, the ECB in October raised its benchmark deposit rate by 75 bps, the second successive such hike, taking the rate to 1.5% from -0.5% in June. Further hikes are in the pipeline: the market currently expects a 50 bps rate hike in the ECB's meeting this month. So far, the adverse aftershocks of higher interest rates in peripheral countries such as Italy are contained. Italy's 10Y bond showed signs of relative calmness off late, with spread over Germany narrowing to around 190 bps from the peak of 264 bps in September. As expectations of Fed hawkishness shifted, the euro also recouped some losses, trimming the YTD drop against the US dollar to around 8% from the peak of 16% as of late September. If the trend is sustained, it could help partially offset inflationary pressures on imported goods, including energy products, in the coming months.

**Chart 2: Eurozone GDP and average HICP inflation**

(%)




Source: Haver Note: 4Q22 forecasts are from the ECB

Meanwhile, the UK stares at a deeper downturn, facing headwinds from decades-high inflation, fiscal tightening, and rising interest rates. GDP growth lost momentum in Q3 and contracted 0.2% q/q versus +0.2% in Q2, slowing y/y growth to +2.4% from +4.4%. The composite PMI in November stayed in a slump at 48.2 (unchanged from October), the lowest reading since January 2021, with weak manufacturing (46.2) and services (48.8) activities. CPI inflation rose 11.1% y/y from 10.1% the previous month, with the core rate flat at 6.5%. In November, the Bank of England raised the bank rate by 75 bps to 3%, and it looks set to hike the rate by 50 bps this month. Earlier sharp volatility in currency and bond markets has faded after the previous budget's loosening measures were rolled back, and supported by recent softness in the US dollar and US treasury yields. The pound has gained almost 18% against the dollar since its late September low, cutting the YTD loss to 10%.

The UK's new Chancellor of the Exchequer unveiled in November a budget that aimed to fill a £55 billion fiscal gap by raising taxes and squeezing/freezing public spending. Much of the fiscal consolidation is scheduled after 2024, cushioning the near-term impact on the economy. Nevertheless, amid fiscal tightening and higher interest rates, the Office for Budget Responsibility downgraded its outlook and now projects GDP to shrink by 1.4% next year with inflation of 7.4%.

## Japan's economy losing momentum on weaker yen

The yen's unprecedented slide this year (around -17% YTD against the US dollar) raised import costs and adversely impacted Japan's trade balance in Q3, hurting GDP momentum.

Japan's economy contracted by an annualized -1.2% q/q in 3Q22, against forecasts for a 1.2% gain. However, Q2 GDP was revised higher to 4.6% q/q from a preliminary estimate of 3.5%. Net exports were the main drag on economic output in Q3, although housing investment also fell. Private consumption and business spending slowed, but remained in growth territory.

Meanwhile, Japan's trade deficit widened in October as imports rose 54% y/y against export growth of 25% y/y. High global energy and commodity prices and the much weaker yen were the main drivers of the high import growth. The manufacturing PMI reading in November contracted for the first time in two years at 49 from 50.7 in October, due to a global slowdown and tepid local demand. The services PMI also slowed to a three-month low of 50.3 from 53.2. Moreover, core inflation reached a 40-year high of 3.6% y/y in October, dampening demand and staying above the Bank of Japan (BoJ)'s 2% target for a seventh straight month. Despite this, the BoJ remains steadfast in keeping long-term interest rates around zero to achieve wage growth and sustainable and stable inflation, as it believes inflation could fall back to below 2% next year. The authorities also continued to intervene in the FX markets in October, spending up to $65 billion.

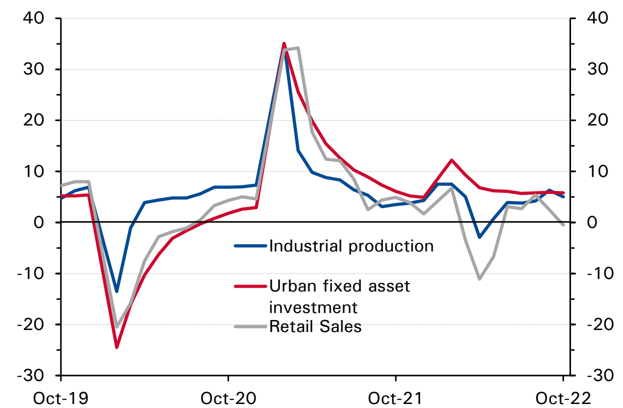
The government recently approved a fiscal stimulus package (worth $200 billion, about 5% of GDP) to boost growth and help households and businesses cope with surging prices, with the bulk of the package financed by new borrowing. In addition, the recent reopening of Japan's borders should allow for fresh incoming spending by foreign tourists. The outlook appears slightly positive in the near term with a rebound in GDP growth expected in 4Q22. Looking into 2023, however, prospects are uncertain. An impending global economic slowdown may hamper Japan's export prospects, while a weaker yen alongside elevated energy prices continue to elevate the import bill.

## China's recovery falters on Covid restrictions

The economy grew 3.9% y/y (3.9% q/q) in 3Q22 on a robust recovery in industrial and service activities amid a slight relaxation of Covid-related restrictions. However, data that are more recent have been trending weaker amid rising Covid cases and spreading lockdowns. The official PMIs in November tumbled deep into contractionary territory, with both manufacturing and services indices falling to 7-month lows at 48 and 46.7, respectively. The property sector, already under stress amid a loss of confidence, saw declines in activity and prices. Exports, which earlier provided an impetus to the economy when domestic demand slowed, shrank 8.7% y/y in November, as the downturn abroad intensified and Covid restrictions disrupted output at home. Growth in industrial production and fixed asset investments eased, while retail sales decreased 0.5% y/y in October. (Chart 3.) Moreover, tepid consumption in October led to softer growth in consumer prices (2.1% y/y) and the first decline in producer prices (-1.3% y/y) in almost two years.

**Chart 3: China industrial output, fixed assets and retail sales**

(y/y %)




Source: Haver

The government continues to provide measured monetary and fiscal stimulus to support the economy. The People's Bank of China recently slashed rates on 14-day reverse repo agreements and the reserve ratio requirement by 10 bps and 25 bps, respectively, following interest rate cuts in August. The central government has also stepped in to ease the burden on the troubled property market, announcing a rescue package and ramping up funding support amid a liquidity crunch that exacerbated challenges for the sector. However, the output of the overall economy remains below its potential disrupted by ongoing and sometimes intensifying lockdowns. Moreover, popular disapproval of the strict Covid-zero policy has been rising, causing rare protests from a growing section of the population. Recently, the government has cautiously relaxed part of its Covid-zero approach, fueling hopes for a gradual return to normality, but actual implementation and the resulting impact of such relaxation are yet to be seen.

## India's GDP growth normalizes, inflation easing

India's GDP growth slowed to a more normal level of 6.3% y/y in 2Q FY22/23 (from 13.5% in Q1) as the benefit of the pandemic-induced favorable base faded. Importantly, the more recent data have been robust, suggesting an improving business climate and resilient domestic demand despite the deteriorating global outlook. The manufacturing PMI reading in November expanded for the seventeenth successive month to 55.7 (from 55.3 in October). Gross goods and services tax (GST) collections – a key indicator of domestic demand and business activities and a significant source of government revenue – rose 18% y/y in the three months to November. Consumer price inflation meanwhile eased to 6.8% in October from its five-month high of 7.4% in the previous month, on a slower rise in food prices, while wholesale price growth also softened to a 19-month low of 8.4% from 10.7%. However, given this year's erratic monsoon rains and the ongoing volatility in food and oil prices, a sharp fall in overall inflation may be elusive. The Reserve Bank of India (RBI) has steadily raised the repo rate by 225 bps to 6.25% since May this year to restore price stability. With the peak of the

inflationary phase being behind, as per the RBI governor, further hikes could be more moderate. Nonetheless, continued global monetary tightening and elevated prices should keep policy rates high.

The Indian rupee has fallen by 10% YTD versus the US dollar on the widening trade deficit, capital outflows from the financial markets (around $16 billion YTD), and general dollar strength. However, the rupee is relatively flat (-3%) YTD on a trade-weighted basis. For FY22/23, GDP is expected to grow at 6.8% on sustained private consumption and improved business outlook. However, downside risks arising from potential disruptions to cheaper supplies of Russian crude, volatile food prices, and weakening exports remain.

**Table 1: Real GDP growth rate**

y/y %

| | 2021 | 2022f | 2023f |
|---|---|---|---|
| US | 5.9 | 1.8 | 0.4 |
| Eurozone | 5.2 | 3.2 | -0.1 |
| UK | 7.4 | 4.3 | -0.9 |
| Japan | 1.7 | 1.7 | 1.2 |
| China | 8.1 | 3.2 | 5.0 |
| India* | 8.7 | 6.8 | 6.2 |

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

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