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Economic Update

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International Scene

World economy faces growing headwinds as central banks tighten policy

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Highlights

- **Headwinds for the global economy have triggered a rout in financial markets. Challenges include high inflation, rapid monetary policy tightening and China's lockdowns. World growth could slow to 2.9% in 2022, barely improving next year.**
- **In the US positive growth is still expected for Q2, but recession risks have risen. 40-year-plus high inflation resulted in the Fed hiking rates aggressively by 75bps in June, with multiple further increases expected this year.**
- **The Eurozone is also at risk of a recession, and confronts an energy crisis given its sanctions on Russia. The ECB is being forced to speed up policy tightening but also faces emerging signs of stress across the region's debt markets.**

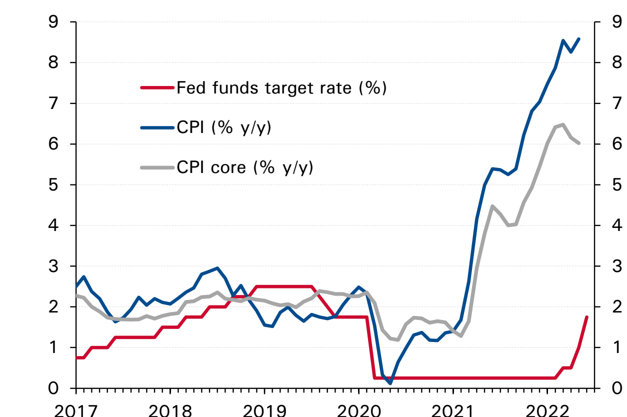
Growing worries about the global economic outlook have sparked a rout in financial markets, with key equity indices weak or entering bear market territory (-20% or more from peaks) in June and bond yields hitting multi-year highs. These challenges include continued fallout from the Ukraine war, soaring energy prices, high and persistent inflation especially in advanced economies, faster policy tightening by key central banks, lingering global supply chain disruptions and growth risks in China caused by the government's zero-Covid policy. Although a global recession is still expected to be avoided, the World Bank recently revised down its forecast for world growth in 2022 to 2.9% from 4.1% in January, highlighting the growing risk of stagflation with activity remaining soft in 2023 but inflation still above target in many countries. Part of the solution, it argues, must include increases in supply of food and energy and debt relief for developing countries.

Broadening US price pressures and rising recession odds

US economic prospects softened in the past few months amid elevated inflation, rising interest rates, a weaker global economic backdrop, and ongoing supply chain issues, with the likelihood of the economy dipping into a recession increasing. Consumer price inflation accelerated to a worse-than-expected 8.6% y/y through May (core rate at +6%), the highest reading since 1981. (Chart 1.) Price increases have been broad-based, casting a doubt on how close peak inflation is, and keeping the pressure on the Fed to carry on with its hawkish policy, especially given increasing inflation expectations.

In this context, the Fed carried on with its tightening policy as it increased rates by 0.75% in its June 15 meeting (bringing cumulative hikes to 1.5% since March) with the widely followed dot-plot indicating a further 1.75% increase by year-end. In addition, balance sheet reduction commenced in June at a monthly rate of $47.5 billion, which would then increase to $95 billion after three months although it remains to be seen if the Fed will be able to stick to that plan. The Fed now sees PCE inflation at 5.2% in 2022 (latest at 6.3% y/y) and 2.6% in 2023, compared with 4.3% and 2.7%, respectively, in their prior projection. Chair Powell continued to emphasize the strength of the US economy and that it is well positioned to handle tighter monetary policy. However, the Fed slashed 2022 GDP growth to 1.7% from 2.8% before and 2023 growth to 1.7% from 2.2%. The very high inflation led to a further plunge in consumer sentiment, with the University of Michigan's index hitting 50.2 in June (down from 58.4 in May), which is an all-time low.

Chart 1: US inflation and policy interest rates



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

GDP dropped by an annualized 1.5% q/q in Q1, dragged down by net exports and inventories, but with personal consumption growth holding up well at +3.1%. While positive growth is expected for Q2, projections point to a relatively limited 1-2% expansion, and more pessimistic forecasts indicate the economy is already on the brink of a recession. Meanwhile, the housing market continues to show several signs of weakening amid rising interest rates with, for example, new home sales hitting the lowest level in two years in April (-27% y/y) and mortgage demand dropping to levels unseen in more than 20 years.

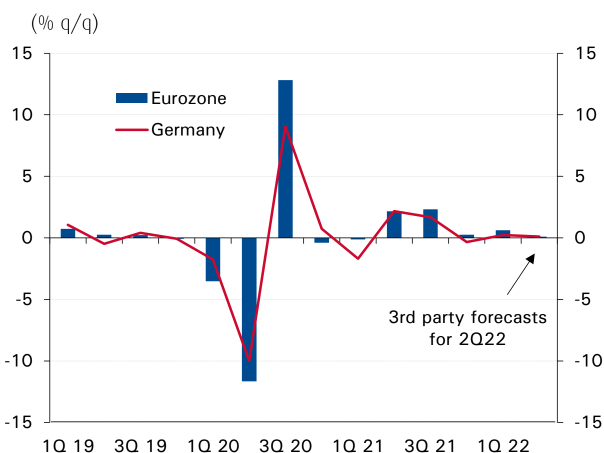
On the other hand, the labor market continued to improve with the unemployment rate down to 3.6%, a touch higher than the pre-pandemic 3.5% rate of February 2020, which was the lowest in at least 30 years. Nevertheless, job creation has been slowing with the May level (390K) being the lowest monthly gain since April 2021, re-affirming a trend that is expected to continue for the coming months.

Europe faces potential recession, energy crisis

The Eurozone economy is at risk of recession as fallout from the Ukraine war unfolds and steep price rises dent consumer and business activity, though so far indicators point more towards stagnation than outright contraction. GDP growth in 1Q22 was revised up to 0.6% q/q from 0.3% before, but figures much closer to zero are expected for Q2-Q4. (Chart 2.) The PMI slipped slightly in May to 54.8 from 55.8 in April, with services still holding up quite well (56.1) but at risk of weakening as the post-Covid reopening effect fades and as rising cost pressures bite. Conditions in the manufacturing sector are already much gloomier due to weakening overseas demand, supply chain disruptions and the impact of spiking energy costs. Things here could get worse as sanctions on imports of Russian oil are rolled out: the EU will stop most purchases by year-end, which risks stoking already near-crisis conditions in European energy markets. The next round of proposals could include cutting gas imports, but the severe implications for Europe's economy – winter energy rationing is already being discussed – could make agreement difficult to achieve without major caveats.

Chart 2: Eurozone GDP

(% q/q)



Source: Haver

Despite the risks to growth, the European Central Bank has been compelled to adopt a more hawkish stance due to higher than expected inflation, which stood at a record 8.1% y/y in May. The bank in June confirmed that it would end its asset purchase program in early July as planned, but went further by pre-committing to a 25 bps rate hike at its July 21 meeting to be followed by an even larger move in September if inflationary pressures persist. It also revised up its forecast for inflation in 2022 (to 6.8% from 5.1% in March) and down its forecast for GDP growth (to 2.8% from 3.7%). The steps were a tacit acknowledgement by the bank that it is behind the curve on tightening, with its policy deposit rate still negative at -0.5%. Still, it must tread carefully to avoid triggering a further widening of periphery country bond yield spreads, amid concerns about debt sustainability as interest rates rise. Indeed, the bank held an emergency meeting to discuss this issue in mid-June, as spreads on Italian and Greek 10-year debt hit their highest since early-to-mid 2020. No specific measures were announced, but the bank said it would accelerate work on a new 'anti-fragmentation instrument' to head off another debt crisis.

In the UK, the Bank of England raised interest rates by 25 bps to 1.25% in June, in line with expectations, but avoiding a larger hike. Like the ECB, the bank is trying to balance the need to bring down generationally high inflation – which hit a 40-year high of 9.0% y/y in April and is forecast to rise further – with a weak outlook for growth as high commodity prices, supply chain distruptions, a tight labor market, a weaker pound and rising interest rates push up business costs in turn generating a major cost of living squeeze for consumers. GDP fell 0.3% m/m in April, could contract in Q2 and remain weak through year-end and into 2023. Meanwhile, PM Boris Johnson is under pressure – narrowly winning a no confidence vote among his own MPs in early June. Johnson is still politically vulnerable and may look to shore-up support by cutting taxes, but room for maneuver is limited by a persistent fiscal deficit, forecast at 4% of GDP this year.

Japan's growth to benefit from easing Covid pressures

Japanese economic growth came in at -0.5% y/y in 1Q22, contracting at a slower pace than initially estimated (-1.0%). Private consumption held up relatively well, despite recurring Covid-19 infections, while inventory accumulation helped to offset a drop in corporate investment. Looking ahead, with pandemic-related restraints easing in the second quarter, consumption should rebound, although overall economic growth could face headwinds from the loss of economic momentum in China (due to Covid lockdowns), which is expected to have crimped trade with Japan, and from surging energy and commodity prices that could impinge on Japanese manufacturing activity. In May, the au Jibun Bank PMI did show an easing in manufacturing activity, at 53.2 from 53.5, with firms linking the slowdown to supply chain disruptions and higher costs. Services, on the other hand, benefitted from

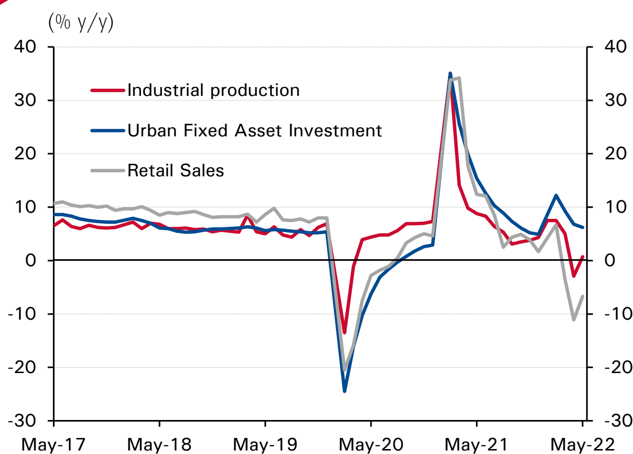
the stabilization of the Covid situation in Japan and ticked up (to 51.7 from 50.7). The reopening of Japan's borders on June 10 to certain package tourists after more than two years will be welcomed by the Japanese service sector.

In April, consumer price inflation reached 2.5%, above the Central Bank of Japan's 2.0% target for the first time since 2014. The core rate, which excludes fresh food and energy, rose at its fastest rate, 2.1%, since 2008. This is unlikely to result in a change in the BOJ's monetary stance, however, since the authorities view inflation pressures as being overwhelmingly supply-side driven and likely temporary.

Chinese activity indicators hit by Covid lockdowns

China's economy expanded 4.8% y/y in 1Q22 (4.0% in 4Q21) as strong fixed investment and retail sales in January-February set a good start to the year. However, activity measures have since been hit by the extended lockdowns imposed over several months in key economic centers including Beijing and Shanghai to control the spread of Covid-19. May's economic data showed a third consecutive month of declining retail sales (-6.7% y/y) and lackluster import growth (+4.1%) – although both improved versus April as some lockdown measures were finally eased. (Chart 3.) A contraction in activity was also evident on the production side, with the official NBS PMI reading coming in below the 50 no-change threshold in May at 48.4, while industrial production, which declined in April, grew at a marginal rate (0.7% y/y).

Chart 3: China industrial output and retail sales



Source: Haver

Nevertheless, exports continue to support economic activity, with annual growth averaging 11.1% in March-May. China has also so far escaped the worst of the high inflation that has become a fixture in advanced economies with inflation only at 2.1% y/y in May. Meanwhile, factory-gate inflation fell to a 14-month low of 6.4%, which should provide the authorities with the space to ease policy. Indeed, the People's Bank of China cut both the reserve ratio requirement for big banks by 25 bps in April and the five-year loan prime rate by 15 bps in May, aiming to inject liquidity and provide assistance amid softer economic activity. The central government, meanwhile, rolled-out in May a large package of 33 stimulus measures, including tax cuts and rebates, higher infrastructure spending, loan support, and other supportive policies. Nevertheless, given recent weakness and the lingering threat of fresh restrictions due to its 'zero Covid' approach, the government is unlikely to meet its own target of 5.5% GDP growth this year, with 4% more likely according to consensus forecasts.

RBI hikes interest rates amid high inflation

India's GDP grew by 4.1% y/y in the final quarter of FY21/22 (1Q22) from 5.4% y/y in the previous quarter, slowing for the third consecutive quarter on softer growth in private consumption and weaker net exports as the surge in Omicron cases and rising prices weighed down on business activity and demand. Despite the slowdown, the economy still expanded by a robust 8.7% for the full year. Of concern is the strong inflationary pressure from ongoing supply chain disruptions compounded by the Ukraine war, and leading to a global surge in food and fuel prices which have spilled over into the domestic economy. Inflation rose to an eight-year high of 7.8% y/y in April, while wholesale prices rose a record 15.1%. A higher import bill will add downward pressure on India's external deficit and the rupee, which currently stands at a near record low of just under IRP78/US$1. The government responded to rising domestic food costs by halting wheat exports, while the Reserve Bank of India raised its benchmark repo rate by 50 bps to 4.9% in June, following a 40 bps hike in May, measures which may help curb inflationary pressures.

Looking ahead, economic activity is set to strengthen in the current fiscal year (FY22/23) amid a much improved virus backdrop, higher budgeted spending and stronger business activity. Monthly data suggests a recovery is underway in the private sector, with the composite PMI reaching 58.3 in May, the highest since November 2021. The IMF forecasts GDP growth of 8.2% in FY 2022-2023, down from a previous estimate of 9% in light of the inflation risks.

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