Economic Update
NBK Economic Research Department I 21 June 2021

International Scene

Economic recovery gathers pace but fresh US inflation spike fuels concern

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Highlights

- **US economic indicators point to very robust growth and inflation spiked to 5.0% in May. The Fed left policy on hold in June, but may soon start to prepare financial markets for a reduction in asset purchases later this year.**
- **Economic activity in the Eurozone is at last gathering speed as virus pressures fade and restrictions ease. Notable ECB policy changes look unlikely before September, when the results of the bank's strategy review are due.**
- **In China, the economic recovery may be slowing but businesses are facing rising input costs. The move to a 3-child policy aims to address the country's ageing workforce, but may have only a limited impact on fertility patterns.**

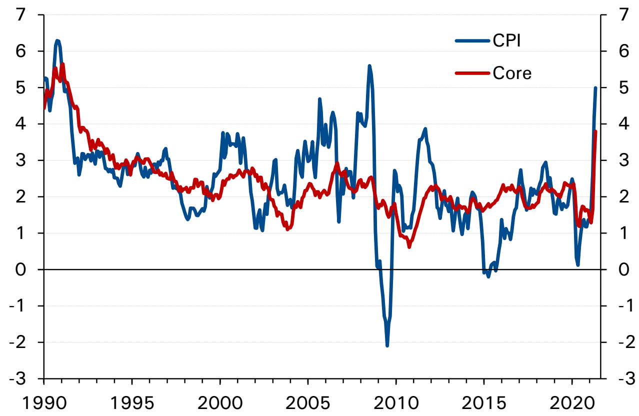
Global financial markets remained in upbeat mood over the past month, benefitting from continued reopening measures as pandemic pressures ease across both the US and Europe, generally upbeat economic data and signs that authorities are in no rush to scale back policy support despite inflation worries. The US S&P was up 1.9% in the month to mid-June, while the 10-year treasury yield remained below its March peak at 1.58%. Oil prices have also made strong gains, with Brent above $70/bbl on demand optimism and OPEC supply discipline. Despite the broad positivity, the global economy is not out of the woods on Covid and pressures on developing countries with less access to finance and vaccines remain severe. G7 countries promised to start addressing this with the pledge to supply low-income countries with at least 1 billion vaccine doses to try to end the pandemic next year, although this fell far below the 11 billion doses needed according to the international health community.

US recovery helps push inflation to multi-year high

Economic indicators continue to point to very robust growth, boosted by enormous fiscal stimulus and rising spending in particular on the services sector most leveraged to the economy's reopening. The ISM services activity index surged to a series record of 64.0 in May on strong orders and lengthening supplier delivery times, overtaking its manufacturing equivalent for the first time in the post-pandemic recovery. This data bodes well for another big GDP growth figure in 2Q21 of perhaps 9% (annualized) following the 6.4% recorded in Q1, which would leave the economy comfortably above its pre-Covid size. The recovery in the labor market – important both for policy and in sustaining consumer spending – continues to lag some way behind output however. Non-farm payrolls disappointed again in May, up just 559,000 and are still 7.6 million short of pre-pandemic levels, while the unemployment rate dipped to 5.8% helped by a fall in the labor force. Strong economic growth should see employment growth accelerate over coming months, though the true underlying state of the labor market may not become clearer until the phasing out of enhanced unemployment benefits (which may affect the incentive to work), which in some states is set to start in mid-June.

Meanwhile the debate over the inflation outlook and its implications for Fed policy continues to intensify. Consumer price inflation jumped to a near 13-year high of 5.0% y/y in May on a combination of surging demand, capacity shortages in key sectors and statistical base effects including from year-ago weakness in oil prices. (Chart 1.)

Chart 1: US Consumer price inflation
(% y/y)



Source: Refinitiv

The core rate hit a 29-year high of 3.8%. The Fed continues to see these pressures as mostly short term, and has some support for this view from the bond markets, with the 10-year treasury yield dipping below 1.5% (since reversed) after the release of the May inflation surprise.

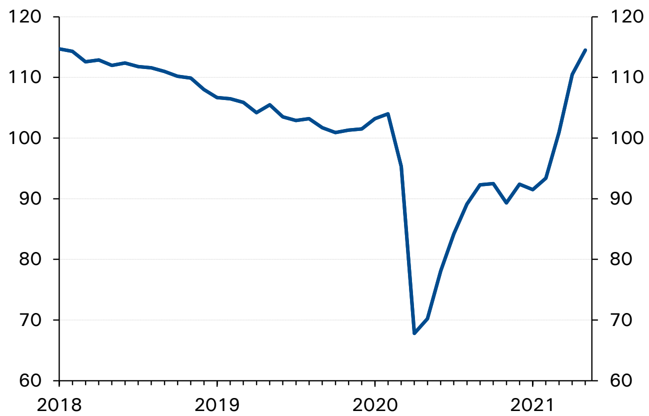
But while it looks possible that inflation may have peaked and will start to come down in coming months as year-on-year base effects fade, the year-end headline figure could still be above 4% and a persistently high rate could push inflation expectations and wage growth higher, causing longer-term effects. The Fed pushed up sharply its forecasts for PCE inflation in 2021 in June to 3.4% y/y from 2.4% in March, though still expects it to fall back next year, to 2.1%. The bank left policy on hold as expected, but may start soon to prepare financial markets for a reduction in asset purchases later this year. The majority of Fed officials now see the first interest rate hike coming in 2023, at least a year sooner than previously thought.

Eurozone recovery at last gathering speed

Economic activity in the Eurozone continues to pick up as the earlier virus wave fades and restrictions are eased. The composite PMI hit a more than three-year high of 57.1 in May, with the service sector (55.2) starting to close the gap on already booming manufacturing (63.1). Sentiment has also rebounded, with reopening steps boosting the prospects for travel and tourism over the key summer period. (Chart 2.) This should translate into a decent 1.5% q/q rise in GDP in 2Q21 (-0.6% in Q1), accelerating in the third quarter despite the potential for unemployment (8.0% in May) to edge back up as furlough schemes are unwound. Also helpful for the outlook is the imminent approval by the EU of the first country-level (for Spain and Portugal) spending plans under the group's €750 billion Next Gen pandemic recovery fund agreed last year. Worth 5% of GDP, spending will be spread over five years but front-loaded, and seen to benefit smaller countries the most.

Chart 2: Eurozone economic sentiment indicator

(index, 100=long-term average)



Source: European Commission

The European Central Bank as expected left policy on hold in June, but recommitted to maintaining PEPP asset purchases at the current elevated pace despite reports that multiple ECB members wanted to slow bond buying given the now visible economic recovery. Notable policy changes may now be unlikely before September, when the results of the Bank's strategy review – which could include a change in the inflation target – are due. Inflation stood at 2.0% y/y in May, its first month above the bank's 'below but close to 2%' target in more than two years. However the core rate stood at just 0.9% and comparatively less vibrant economic growth, smaller policy stimulus and more spare capacity mean that inflation concerns across the region are for now less acute than in the US.

In the UK, the government decided to delay by four weeks its full reopening measures scheduled for June 21st in light of rising – if still relatively modest – virus cases. This is to allow more full (i.e. double-shot) vaccinations seen as important to combat the delta virus strain. The economy has continued to bounce back strongly from strict restrictions in place earlier this year with GDP up 2.3% m/m in April and forecast to rise 5-6% q/q in Q2. The delay in opening could slow this improvement, however, and the Bank of England is unlikely to announce any shift towards tighter policy at its June 24 meeting.

Japanese economic activity weakens in May

The Japanese economy continues to grapple with the impact of a persistent pandemic and the extension of emergency measures designed to control it. Both the manufacturing and services sector PMIs weakened in May, with the former dropping to 53.0 in May from 53.6 in April and the latter to 46.5 from 49.5 in April. The decline in services sector activity was the 16th in a row, and came on the back of the extension of the anti-Covid emergency measures at home and the implementation of stricter measures in the country's main Asian export markets. Japanese wholesale prices in May notched up their fastest annual growth since 2008, climbing 4.9% y/y due to the broader increase in global commodity prices, which is itself a reflection of higher global demand and, probably more so, constrained supply chains caused by the pandemic.

However the economy did not perform as badly as initially thought in 1Q21, after the government revised up its initial GDP figure of -5.1% (annualized) to -3.9% on smaller cuts to plant and equipment spending. While this has eased somewhat concerns that Japan would have to endure a double dip recession, Prime Minister Yoshihide Suga is also reportedly planning another big economic stimulus package to stave off such a scenario, before calling for an election in September.

Chinese 3-child policy aims to address aging workforce

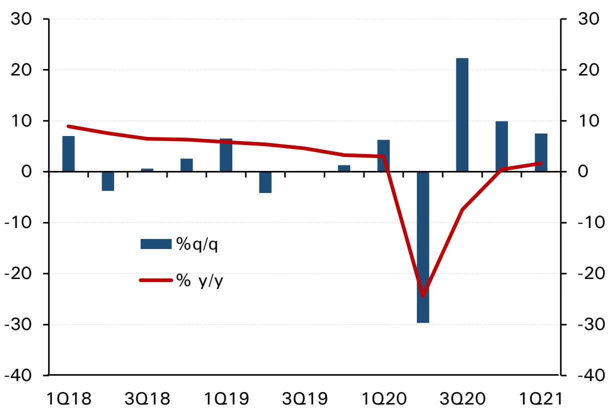
Following census results that highlighted China's rapidly-aging population, the government announced that the two-child policy would be adjusted to allow couples to have three children. This new policy aims to stop the ongoing decline in the country's working-age population and to support economic growth in the medium-to-long term. However, the new policy is not expected to make a major difference to fertility patterns, with recent surveys showing major concerns about the costs of bringing up children and accessing affordable childcare.

Meanwhile, some recent economic indicators revealed further signs of slowing demand and inflationary pressures. Credit growth eased to 12.2% y/y in May, the slowest pace since February 2020, as the authorities started to slowly unwind emergency measures and cool credit growth to contain debt risks. In addition, inflation jumped to 1.3% y/y in May from 0.9% a month earlier, the highest reading since September. Producer price inflation also accelerated from 6.8% y/y in April to 9.0% in May, recording the fifth straight month of increase and the steepest pace since 2008, amid a faster recovery in domestic production and rising commodity prices. The authorities remain concerned that the economic recovery is still not on a solid footing, and higher producer costs if not fully passed on to consumers could bite into business profitability.

India's GDP growth accelerated in Q1 but still modest

India's 1Q21 (4Q FY20/21) GDP expanded by a modest 1.6% y/y, helped by a pick-up in government spending (28% y/y) and investment (11% y/y) as the government continued its efforts to curb the adverse effects of the virus on the economy. (Chart 3.) This marks the second consecutive quarter of mild expansion (0.5% in 4Q20) despite the massive surge in virus cases seen March-May, which is now receding. More recent monthly data shows the economy still under pressure. The May services PMI fell sharply into contraction territory at 46.6 (55.4 in April), while the manufacturing PMI pointed to the slowest pace of expansion in ten months, at 50.8 (55.5 in April). On the policy front, the Reserve Bank of India kept rates unchanged (4% repo rate), but reaffirmed its commitment to revive growth by remaining accommodative, with $5.5 billion in asset purchases planned for June, followed by a larger $16 billion package for September. Additional support comes from a liquidity window for vulnerable sectors such as hotels & tourism, and a $2.2 billion credit line for micro, small, and medium enterprises.

Chart 3: India GDP



Source: Refinitiv

We expect the economy to regain momentum in subsequent quarters, given the low base levels of 2020, helped by a pick-up in government spending and private investment and perhaps a gradual recovery in the private sector as virus concerns ease amid concerted vaccine and social distancing efforts. Further support could come as foreign demand improves in line with the global economic recovery. However, given recent headwinds from the Covid resurgence, the World Bank has revised down its growth forecasts for FY21/22 to 8.3% from 10.1% before.

Oil prices above $70 as the economic recovery continues

Brent crude broke through the psychologically important $70 level on 1 June and then extended those gains to close as high as $72.9/bbl on 14 June. (Chart 4.) Price have been pushed up by expectations of stronger oil demand over the northern hemisphere summer and continued oil supply restraint by OPEC+, as well as the broader rally in commodities. On the demand side, economic activity, especially in advanced economies, has improved as the vaccination drive has accelerated and mobility restrictions eased. The International Energy Agency (IEA) now forecasts that global oil demand could surpass pre-pandemic levels by the end of 2022, an upgrade of its March assessment, with growth this year of 5.4 mb/d and 3.1 mb/d in 2022 following 2020's historic decline of 8.6 mb/d. Moreover, the IEA even went so far as to warn that unless OPEC+ brings on more supply in the coming months the market is at risk of overheating.

Chart 4: Brent crude oil price

($ per barrel, end of month*)

Source: Refinitiv * Latest figure is for June 14

OPEC+ reaffirmed at its early June meeting that output will rise incrementally, by 700 kb/d in June and 841 kb/d in July following May's 600 kb/d (these figures include the restoration of Saudi Arabia's additional production cuts). The tight demand/supply dynamics are worth watching over the coming months, and there is a good chance that with the market in deficit, OECD commercial oil stocks below the pre-Covid 2015-19 average and oil prices looking more likely to firm up rather than soften, that OPEC+ could open the taps further.

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