Insights from Elsewhere

ECONOMICS | THE WORLD

The inflation fight is pushing the world economy closer to recession

- **The general mood:** The annual meetings of the World Bank, the International Monetary Fund (IMF), and the Institute of International Finance (IIF) started on a gloomy note. In their October update of the World Economic Outlook, the IMF warned that the risks of global recession, sovereign defaults in some developing countries, and financial market instability have increased significantly. The Fund stressed that world growth is already losing momentum, but the worst is to come, with about a third of the world economy estimated to slip into recession in 2023.
- **On world growth prospects:** The IMF left its 2022 global growth forecast unchanged at 3.2% but tweaked its global inflation forecast up again to 8.8% from its previous estimates of 8.3% in July and 7.4% in April. Clearly, the IMF and others have persistently underestimated global inflationary pressures, and therefore also the pace of monetary policy tightening in the US and many other countries. While the IMF expects inflation to recede next year, the downward force is likely to take time to develop. As a result, the IMF still expects world inflation to average an elevated 6.5% in 2023. Persistently high inflation and the rapid rise in interest rates are expected to erode household disposable income, wealth, and savings, dampening consumer spending and aggregate demand. This toxic combination is forecast to weigh on growth in most advanced and developing countries. The IMF expects US growth to slow to a pedestrian 1% in 2023 from a downwardly revised 1.6% in 2022. On top of the cost-of-living crisis and rising interest rates, the Eurozone faces the burden of acute energy shortages due to its sanctions on Russia and Russia's retaliation by manipulating energy supplies to the bloc. Within this context, the IMF forecasts a severe loss of momentum in Eurozone, with growth stalling to a dismal 0.5% in 2023, which implicitly assumes a brief recession, down from the relatively resilient 3.1% forecasted for this year.
- **On US inflation, interest rates and recession risk:** The overwhelming consensus among all attendees and panellists at the IIF meetings (the representative body for the private financial sector) was that US inflation is unlikely to recede quickly. It is more likely to stay elevated, propped up by elevated wages due to persistent labour shortages. The causes of these shortages are complex and often structural in nature, including ageing populations, changed attitudes to work, and the clamp down on immigration over the past decade. Labour shortages are also widespread, manifesting in the manufacturing, travel, hospitality, food services, and high-skills gig industries. Professor Larry Summers, former US Treasury Secretary, pointed out that wages are growing at a pace of around 5% to 6% depending on the specific measure, while productivity is declining, pushing up operating costs and aggravating inflationary pressures. As one of the attendees explained, the US does not need to legislate cost-of-living adjustments, acute shortages are driving wages higher in any case. The best possible outcome is that the US Fed manages to slow growth down sufficiently to eliminate the labour shortage, leaving employment largely unscathed. However, most felt that it would be impossible to fine-tune monetary policy with such precision or impeccable timing. The more likely outcome is that the central bank overtightens, tipping the US economy into recession and driving unemployment up. JP Morgan Chase CEO Jamie Dimon predicted the US would enter recession over the next six to nine months, while Bank of America CEO Brian Moynihan also predicted recession but remained upbeat about US consumers. Summers believed that underlying inflation in the US is running at about 5% and it will not go away without slack or put differently without a meaningful recession. He concluded interest rates must rise further, and it was essential that the Fed does not throw in the towel when the going gets tough. All the speakers and attendees at the IIF admitted that Fed will be tested once the US economy enters recession, but most expected the central bank to hold its nerve and stay the course on policy tightening. The 68% of attendees polled at the conference expected the Federal Funds Target Rate to peak between 4%-5% in H1 2023.
- **On Eurozone inflation, interest rates, and the risk of recession:** At the IIF, all the speakers distinguished between conditions in the US and the Eurozone economy. On balance, most still consider the US the best bet because it is energy- and food-independent, the US dollar remains king despite all the talk of its demise, and US consumers have healthy buffers in the form of relatively high savings rates. In contrast, the prospects for Eurozone growth and inflation are clouded by the energy shortage triggered by Russia's war on Ukraine. The energy shortage is expected to keep inflation elevated while tipping the economy into recession. Many believed that the Eurozone already entered recession. However, Christine Lagarde, the President of the ECB, hit back by pointing out:
    - Europe is not in recession and the bloc turned out positive GDP numbers over the past two quarters compared with the US which entered a technical recession, however shallow.
    - The unemployment rate was at record lows. She added that, unlike the US, the Eurozone was not experiencing acute labour shortages. Labour participation rates were back to pre-Covid levels in most industries and below pre-pandemic levels in some industries. The upward pressure on wages was therefore less severe than in the US.
    - Interestingly, she stressed that second-round inflationary effects were not significant. Negotiated agreements averaged around 3.5%, which was 'quite' compatible with central bank targets. Almost all price pressures were emanating from fuel and food prices.
    - Europe was moving quickly to address the energy shortage. The region is rapidly shifting to LNG (liquefied natural gas), with new sources secured, ports and production facilities altered, and inventories expanded to cope with the upcoming winter. The ECB president noted that all this happened in nine short months. It will be a tight winter, but not catastrophic.

Lagarde reiterated that the ECB remains committed to restoring price stability. She noted that it is very difficult to determine exactly where the peak in interest rates should be to ensure a soft landing given the long lags involved in the monetary policy transmission mechanisms in most countries. The best the ECB could do was to focus on not stimulating the economy and anchoring inflation expectations around the target. She stressed that fiscal policy has a different mission. Its focus needed to be on shielding the most vulnerable against the worst of the cost-of-living crisis. However, she was very specific about the nature of this support – emphasizing that spending must be 'targeted, limited, and temporary'.

- **Markets likely to face a unique macroeconomic environment in 2023**: In an IIF session called. '*Navigating global shocks and inflation*', Atsi Sheth of Moody's Investor Services made an interesting observation. She highlighted that next year the global macroeconomic environment will be one where growth decelerates while interest rates either increase further or stay high around their peaks. She stressed that the world has not encountered this environment for several decades, noting that most analysts, traders, and investors working in the markets today have never experienced this combination in their careers. During the emerging market crisis of 1997/98, the global financial crisis of 2008/09, and the pandemic of 2020, global growth slowed or contracted and interest rates in the US and other advanced countries declined sharply. So, for many, this will be uncharted territory. As a result, she believed that risk-off sentiment will persist despite the sharp sell-off of risky assets over the past few months.
- **Everyone everywhere sounded the alarm on emerging market economies (EMEs):** The IMF and the World Bank stressed that EMEs are already and would continue to bear the brunt of the pain caused by elevated energy and food prices, the aggressive increases in the US policy rate, the resultant surge in the US dollar, and the anticipated global economic downturn. At an IIF session of chief investment officers from Long Biased Strategies, Invesco, and NWI Management, the panel noted that the markets were in the process of a risk rerate. There was consensus that the bulk of the shocks has probably been priced into emerging market currencies, bonds, and equities. However, it was unlikely to materialise in market pricing over the near term. The outlook for EMEs was dependent on US monetary policy, the extent of the slowdown in China's economy, and each country's fiscal situation. The panel agreed that there was too much uncertainty surrounding the outlook for all three of these drivers and therefore too much doubt about the growth differentials between emerging and developed markets, and these uncertainties were paralyzing the EME market. The panel felt that EMEs will remain under pressure until the US policy rate peaks regardless of country-specific fundamentals or the extent to which EMEs as a collective may appear oversold. Once US monetary policy tightening ends, EMEs will be more attractive. Even then, investors will increasingly distinguish between EMEs based on their growth outlook, their funding needs given current account and budget balances, the composition of corporate and government debt, particularly exposure to dollar-denominated debt, and the extent of their fiscal buffers (if any). The panel also stressed that geopolitical affiliations of EMEs would become more important to investors in the year ahead.
- **Some EME central bank governors critical of the pace of US policy tightening:** At an IIF panel of EME central bankers consisting of the deputy governors from the central banks of Indonesia, Mexico, and Hungary, all three officials stressed that inflation in EMEs was almost entirely caused by supply shocks and mostly not complemented by demand pressures. The deputy governor of Indonesia felt that monetary policy is not the right medicine for supply-side inflation, which he believed required capacity expansion and productivity gains to reduce inflation. Although undoubtedly true, neither production capacity nor productivity can be lifted rapidly over the short to medium term. He did not explain how central banks should prevent sharp and persistent supply shocks from lifting inflation expectations and undermining central bank credibility over the medium-term horizon. The Hungarian and Mexican officials had different perspectives. Both emphasized that central banks need to be vigilant because inflation is a complex phenomenon, which quickly spreads and feeds on itself even if the original source of inflation was isolated to supply shocks The underlying message is that once inflation is high, it is almost impossible to reduce it without significant costs to growth and employment. The policy advice was to act early and boldly. All three deputy governors emphasized that the job of EME central banks was much more complicated in the current environment as the US Fed's fight against inflation was exporting financial instability, inflation, and recession to emerging markets. Rising US interest rates and the strong US dollar were fuelling capital outflows and placing significant pressure on EME currencies. EME central banks are therefore increasingly forced to hike interest rates more aggressively than would otherwise be necessary. The panel added an interesting perspective to the inflation debate by revisiting some of the forces that contributed to the long period of low and steady inflation prior to the pandemic and lockdown. According to the panel, the key drivers were:

    - Positive global supply shocks due to globalisation including the emergence of low-cost manufacturing hubs in numerous developing economies and increased migration of labour.
    - Relatively low energy prices
    - Relatively low food prices

  In assessing recent developments, the underlying feeling was that these three pillars of low and stable inflation will fall away in the years ahead. Anti-globalisation sentiment will result in higher-cost production, logistics, and transportation systems. The world's labour markets will remain tight as populations age, not only in the West but also increasingly in the East. The mounting political resistance to migration in many countries will worsen labour shortages, especially in low-to semi-skilled positions in manufacturing and services in advanced countries. The panel was uncertain how the new 'configurations' of global supply chains will evolve but suspected that these were not optimal and would lift production costs to structurally higher levels over the medium to longer term. The transition to sustainable energy and transport systems was expected to be messy and expensive, while the fossil-fuel industries would not be able to fill the gaps due to persistent underinvestment in new production capacity. Finally, food prices were expected to remain elevated, with more frequent spikes in prices due to the devastating impact of climate change and extreme weather events. The panel concluded that the world was entering a new era of structurally higher inflation and therefore by implication structurally higher interest rates.

- **Sobering thoughts on the commodity markets:** The IIF panel on energy security and the outlook for mineral-based economies consisted of experts from RBC Capital Markets, Abu Dhabi Commercial Bank, and Morgan Stanley. This panel of commodity experts forecasted oil prices to remain high, with upside risks over the short term. A key point made by RBC Capital Markets and Morgan Stanley was that the recent decline in crude oil prices from its peak in early March to below $100 per barrel was only possible because Russian oil was still reaching the market. If the US and Europe's new measures succeed in meaningfully reducing Russian supplies, prices would spike as the Gulf and other OPEC+ members would not be able to meet demand. The US is restricting exports to lower domestic gas prices. Saudi Arabia and the United Arab Emirates have significant spare capacity. However, they can only sell more oil to Europe by giving up market share in China to Russia. To some extent, this is already happening. The panel did not expect that sanctions on Iran will be lifted amid widespread domestic protests against the brutality and oppression of women by the country's morality police. Venezuela was only likely to add meaningful quantities to global supply over the medium to longer term. This meant that only a handful of countries can fill the gap left by Russia in the energy market. However, the panel neatly avoided the likely impact of a global economic slowdown or global recession on crude oil prices. So far, the downward trend in oil prices suggests that recession fears are outweighing any supply concerns.

Table 1: Global growth forecasts

Real GDP growth (%)					Forecast			
	2018	2019	2020	2021	2022	2023	2024	2025
World	**3.6**	**2.8**	**-3.0**	**6.0**	**3.2**	**2.7**	**3.2**	**3.4**
Advanced economies	**2.3**	**1.7**	**-4.4**	**5.2**	**2.4**	**1.1**	**1.6**	**1.9**
United States	2.9	2.3	-3.4	5.7	1.6	1.0	1.2	1.8
Euro Zone	1.8	1.6	-6.1	5.2	3.1	0.5	1.8	1.9
Germany	1.0	1.1	-3.7	2.6	1.5	-0.3	1.5	2.2
France	1.8	1.9	-7.9	6.8	2.5	0.7	1.6	1.8
Italy	0.9	0.5	-9.0	6.6	3.2	-0.2	1.3	1.1
Spain	2.3	2.1	-10.8	5.1	4.3	1.2	2.6	2.7
Japan	0.6	-0.4	-4.6	1.7	1.7	1.6	1.3	0.9
United Kingdom	1.7	1.7	-9.3	7.4	3.6	0.3	0.6	2.3
Canada	2.8	1.9	-5.2	4.5	3.3	1.5	1.6	2.3
Other advanced economies	2.8	2.0	-1.7	5.3	2.8	2.3	2.6	2.3
Emerging and developing economies	**4.6**	**3.6**	**-1.9**	**6.6**	**3.7**	**3.7**	**4.3**	**4.3**
Developing Asia	6.4	5.2	-0.6	7.2	4.4	4.9	5.2	5.3
China	6.8	6.0	2.2	8.1	3.2	4.4	4.5	4.6
India	6.5	3.7	-6.6	8.7	6.8	6.1	6.8	6.8
ASEAN 5	5.4	4.9	-3.4	3.4	5.3	4.9	5.3	5.2
Emerging and developing Europe	**3.4**	**2.5**	**-1.7**	**6.8**	**0.0**	**0.6**	**2.5**	**2.3**
Russia	2.8	2.2	-2.7	4.7	-3.4	-2.3	1.5	1.0
Latin America and the Caribbean	**1.2**	**0.2**	**-7.0**	**6.9**	**3.5**	**1.7**	**2.4**	**2.5**
Brazil	1.8	1.2	-3.9	4.6	2.8	1.0	1.9	2.0
Mexico	2.2	-0.2	-8.1	4.8	2.1	1.2	1.8	2.1
Middle East and North Africa	**1.4**	**0.8**	**-3.0**	**4.1**	**3.7**	**2.8**	**2.9**	**NA**
Saudi Arabia	2.5	0.3	-4.1	3.2	7.6	3.7	2.9	2.9
Sub-Saharan Africa	**3.3**	**3.2**	**-1.6**	**4.7**	**3.6**	**3.7**	**4.1**	**4.2**
Nigeria	1.9	2.2	-1.8	3.6	3.2	3.0	2.9	2.9
Kenya	5.7	5.1	-0.3	7.5	5.3	5.1	5.5	5.6
South Africa	1.5	0.3	-6.3	4.9	2.1	1.1	1.3	1.4

Source: IMF World economic Outlook October 2022

Table 2: Inflation forecasts

Average consumer inflation (%)	2018	2019	2020	2021	2022	2023 (Forecast)	2024	2025
World	**3.6**	**3.5**	**3.2**	**4.7**	**8.8**	**6.5**	**4.1**	**3.6**
Advanced Economies	**2.0**	**1.4**	**0.7**	**3.1**	**7.2**	**4.4**	**2.4**	**2.0**
United States	2.4	1.8	1.2	4.7	8.1	3.5	2.2	2.0
Euro Zone	1.8	1.2	0.3	2.6	8.3	5.7	2.7	2.2
Germany	1.9	1.4	0.4	3.2	8.5	7.2	3.5	2.6
France	2.1	1.3	0.5	2.1	5.8	4.6	2.4	1.8
Italy	1.2	0.6	-0.1	1.9	8.7	5.2	1.7	2.1
Spain	1.7	0.7	-0.3	3.1	8.8	4.9	3.5	2.3
Japan	1.0	0.5	0.0	-0.2	2.0	1.4	1.0	1.0
United Kingdom	2.5	1.8	0.9	2.6	9.1	9.0	3.7	1.8
Canada	2.3	1.9	0.7	3.4	6.9	4.2	2.4	1.9
Other Advanced Economies	1.6	1.1	0.5	2.4	5.6	4.0	2.3	2.1
Emerging and Developing Economies	**5.0**	**5.1**	**5.1**	**5.9**	**9.9**	**8.1**	**5.3**	**4.6**
Developing Asia	2.7	3.3	3.1	2.2	4.1	3.6	2.8	2.8
China	2.1	2.9	2.4	0.9	2.2	2.2	1.9	2.0
India	3.4	4.8	6.2	5.5	6.9	5.1	4.4	4.1
ASEAN 5	2.9	2.1	1.4	2.0	4.7	4.4	2.8	2.9
Emerging and Developing Europe	**6.4**	**6.6**	**5.3**	**9.5**	**27.8**	**19.4**	**10.0**	**7.6**
Russia	2.9	4.5	3.4	6.7	13.8	5.0	4.0	4.0
Latin America and the Caribbean	**6.6**	**7.7**	**6.4**	**9.8**	**14.1**	**11.4**	**8.1**	**6.5**
Brazil	3.7	3.7	3.2	8.3	9.4	4.7	3.9	3.0
Mexico	4.9	3.6	3.4	5.7	8.0	6.3	3.9	3.3
Middle East and North Africa	**11.4**	**10.0**	**9.6**	**8.8**	**8.4**	**8.2**	**8.2**	**NA**
Saudi Arabia	2.5	-2.1	3.4	3.1	2.7	2.2	2.0	2.0
Sub Saharan Africa	**8.3**	**8.2**	**10.2**	**11.1**	**14.4**	**11.9**	**8.6**	**7.3**
Nigeria	12.1	11.4	13.2	17.0	18.9	17.3	12.6	11.5
Kenya	4.7	5.2	5.3	6.1	7.4	6.6	5.1	5.1
South Africa	4.6	4.1	3.3	4.6	6.7	5.1	4.7	4.5

Source: IMF World Economic Outlook October 2022

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