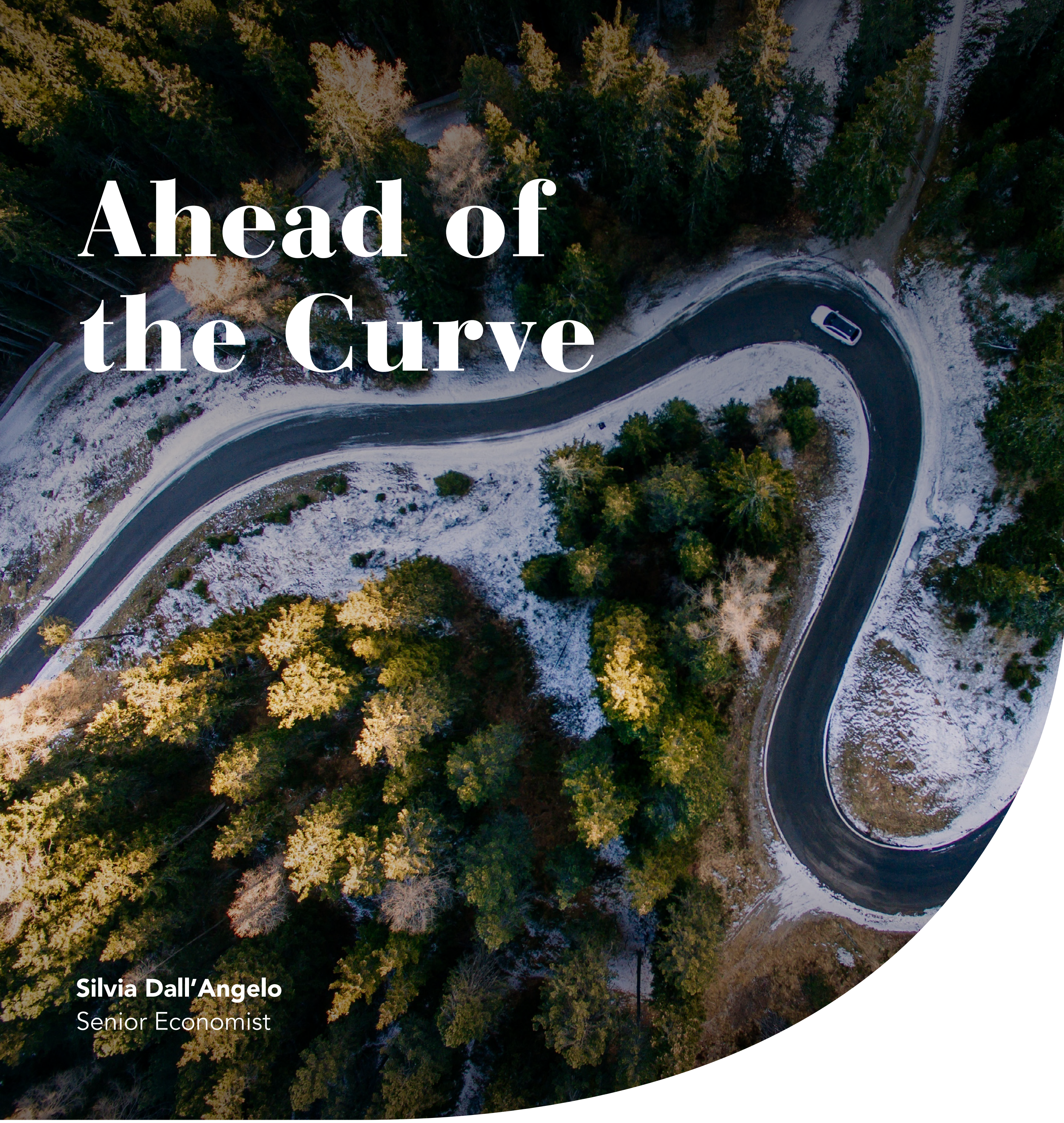

Ahead of the Curve

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Macroeconomic outlook

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As Senior Economist, Silvia is responsible for providing macroeconomic analysis and commentary, non-standard macroeconomic modelling, and developing relationships with key central banks and monetary authorities.

Economic outlook: Hope for the best, prepare for the worst

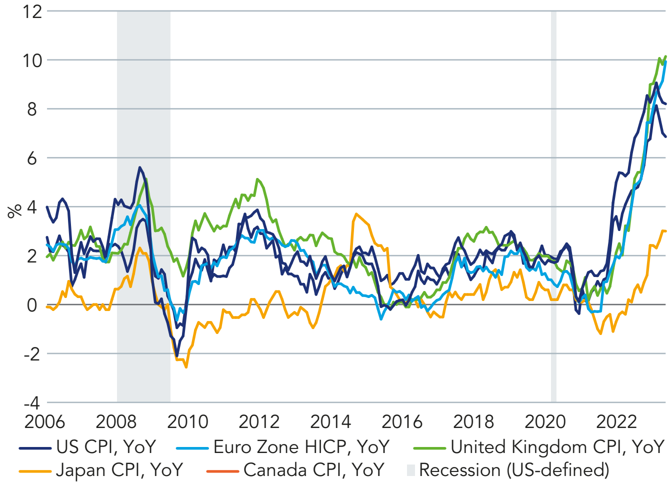
The most recent quarter has proven destructive for the broader economic picture.

The global economy continues to stagger under the weight of back-to-back supply shocks, although there are significant differences across regions. Earlier this year, as most countries were still in recovery-mode from the Covid-related recession, the Russian invasion of Ukraine imparted a new energy shock to the global economy, which has been particularly painful for net commodity importers.

More recently, the outlook has deteriorated further, largely reflecting three key drivers as outlined below:

- **First,** while the eurozone economy started the year on a strong footing, the Russian invasion of Ukraine and the related energy crisis quickly cast a shadow over the outlook for the balance of 2022 and into 2023.
- **Second,** inflation has continued to surprise to the upside across the board, proving even higher and stickier than expected a few months ago, as seen in Figure 1. This has resulted in a faster pace of monetary policy tightening – now likely to be maintained through to the end of the year – which will drag on aggregate demand, with a lag.
- **Third,** the Chinese economy has performed poorly due to the persistence of the Beijing government's zero-Covid policy and an ongoing correction in the property sector.

Figure 1: Inflation has continued to surprise to the upside across the board



Source: Refinitiv Datastream, as at October 2022.

Across the pond, the US economy has continued to outperform, probably reflecting the long-lasting impact from the outsized Covid-related fiscal stimulus on aggregate demand, while energy independence largely shielded the country from the war-related surge in energy prices. While the US labour market has continued to add jobs at a fast pace in recent months, several sectors of the economy have lost momentum, reflecting the impact of inflation on real incomes as well as intensifying monetary and fiscal tightening. In our base case, the US will experience a mild recession around the middle of next year.

Central banks grapple with supply-side constraints

More broadly, monetary and fiscal policies appear to be constrained in the current circumstances, which is a key component of the difficult outlook. Central banks are in aggressive tightening mode across the board as they focus on fighting elevated inflation. Their actions come as no surprise when considering the risk of a price-wage spiral against the backdrop of a tight labour market. Meanwhile, governments have limited fiscal space following large Covid-related stimulus and in an environment of raising rates.

Over the last year, inflation has proved higher and stickier than previously expected. More recently, it has also become more pervasive across expenditure categories, especially in the US. It all started as the result of the pronounced supply-demand imbalances created by the Covid-19 pandemic. As economies around the world reopened in an asynchronised fashion following the initial and most severe lockdowns, a surge in demand – fuelled by extraordinary fiscal and monetary stimulus – met insufficient and disrupted supply. A supposedly temporary shock from Covid turned out more persistent than expected as dislocations and bottleneck effects were mutually reinforcing, while the pandemic itself lasted for longer than initially expected.

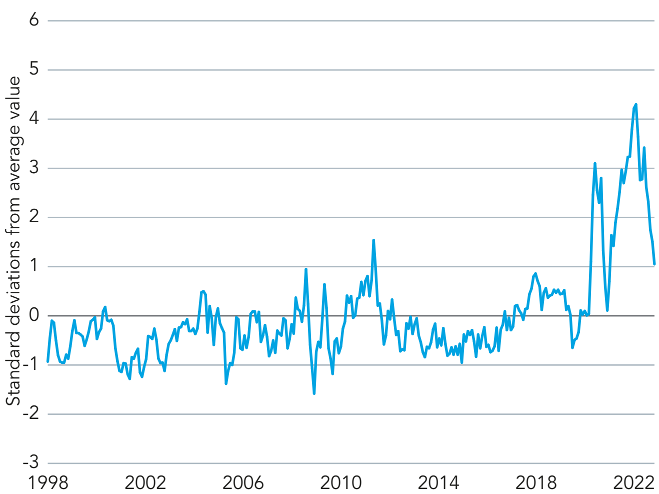
Labour shortages have been particularly acute in the US and the UK. The participation rate has not recovered after the Covid recession, especially for the age 55+ cohort and among women. We can identify several reasons behind this, and all to some extent can be linked back to the pandemic: early retirements (arguably the single most relevant driver), long-Covid/Covid fear, lack of childcare arrangements, more generous unemployment benefits, regional/skills/expectations mismatches. On top of that, Covid has also prevented migration, and in the UK, Brexit has further added strain in that regard.

In our base case, inflation globally is close to its peak. In the US, headline consumer price index (CPI) inflation has probably already peaked at 9.1% in June, but core inflation is still on the rise, largely reflecting domestic price pressures still in the pipeline – mainly pertaining the labour market. In Europe (both in the eurozone and the UK), inflation will likely peak at just north of 10% in Q4, mainly reflecting the impact from the energy crisis.

Inflation will likely trend down in 2023, reflecting stabilisation in commodity prices (and related base effects), a gradual easing of global supply chain disruptions (see Figure 2 below) and, crucially, a significant demand slowdown in coming quarters. Inflation should converge to target in 2024, although it is possible that it will stabilise somewhat above target in the medium-term (at the 3-5 years horizon).

Indeed, it is likely that the Covid-related shock accelerated some structural supply constraints that were already in the making. The impact of climate change might also contribute to a picture of supply constraints (e.g., food shortages), while an uncoordinated/mismanaged transition would certainly be inefficient and costly. It is possible we are heading towards a world dominated by supply constraints and slow-moving but relentless supply chain re-arrangements, implying a somewhat higher inflation rate (compared to the pre-Covid era) in the medium-term.

Figure 2: Supply chains disruptions have eased significantly but are still well-above norm



Source: Federal Reserve Bank of New York, Global Supply Chain Pressure Index, as at September 2022.

The geopolitics of high inflation

Secular trends – evolving in a non-linear fashion – and future policy decisions will determine inflation in the medium-term. While policy decisions are often the results of short-term pressures, recent geopolitical developments can provide some guidance with respect to some inflationary trends. They are part of ongoing structural change and have significant policy implications.

As mentioned in the previous section, international geopolitical tensions and domestic populist pressures point towards a partial reversal of globalisation going forward. Policymaking will be increasingly driven by national security considerations rather than economic rationale. The recent double shock from Covid and the war in Ukraine sharpened policymakers' focus on supply chain resilience, energy and food security. Those goals will develop over a long period of time and will come at a cost.

Food security

The current food crisis has been the result of a combination of factors, including reduced supply of agricultural products due to the war in Ukraine and supply chain disruptions, high energy prices making production and transportation more expensive, shortages of fertilisers (high energy prices have made production uneconomical, also disrupting ammonia production), constrained public finances following Covid, and droughts and extreme weather in Europe and Asia (irrigated agriculture accounts for 40% of global food production). According to the World Food Programme (WFP)[1], in 2021, more than 193 million people worldwide experienced acute food insecurity, an increase of 40 million people from the year before.

Going forward, food insecurity is likely to become much more acute over the next 10-20 years, as climate change and population growth impact both supply and demand dynamics. According to the UN Food and Agriculture Organization estimates[2], a 60% increase in today's food production will be needed to feed the 2050 global population of 9.3 billion.

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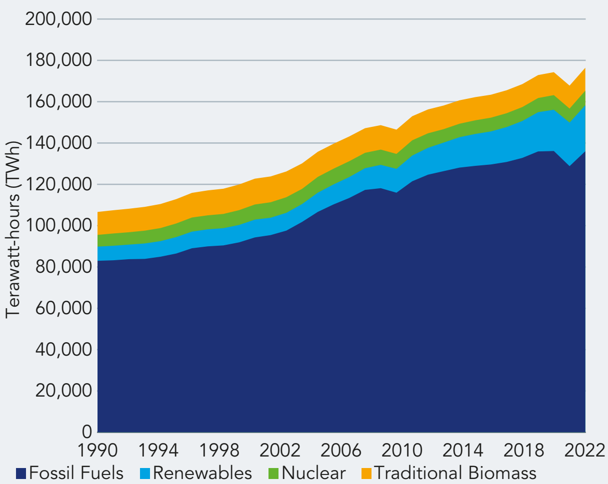
Energy security

The Covid crisis and subsequent recovery has likely exposed some brewing supply shortages in the Energy sector, reflecting underinvestment in the sector over the last decade. While fossil fuels still account for about 80% of the global energy mix (see Figure 3 below), there has not been much investment in the sector in the decade preceding the Covid recession, for good reasons, i.e., expected poor returns and regulatory risk. At the same time, there has not been enough investment in renewables and energy storage solutions. While renewable energy has increased almost three-fold (in absolute terms) over the last 30 years, its share in the global energy mix is still only slightly above 10% (going up to 20% adding traditional biomasses and nuclear). The pandemic and the conflict in Ukraine have underscored the need for Europe – and more generally for net importers of fossil fuels – to achieve energetic independence and security.

The transition to net zero offers a great opportunity in this regard; renewable sources offer the most promising solutions to achieving energy security, while also being a key element of the transition to net zero. The 27 countries in the EU got about a fifth of their total energy from renewables in 2020 and had planned to double that share to 40% by 2030 – in the wake of the war in Ukraine, the target was raised to 45%. Germany, which relied on Russia for the bulk of its oil, natural gas and coal, brought forward its goal of 100% renewable power by more than a decade to 2035. That will not come cheap nor immediately. In the next few years, the Next Generation EU economic recovery programme and, hopefully, other EU-level energy-focused initiatives (funded with joint bond sales), will support investments in green technologies. Public sector development banks and private investments also need to be heavily involved.

Figure 3: Our planet still largely relies on fossil fuels for energy – an ecological and security issue



Source: OurWorldInData.org, based on BP's Statistical Review of World Energy 2022.

[1] Global Report on Food Crises - 2022 | World Food Programme (wfp.org)
[2] Feeding the World Sustainably | United Nations

COP27: the North-South divide in sharper focus

The challenging geopolitical backdrop will likely drag on the proceedings and conclusions of the COP27 summit.

Climate change has slipped down the list of priorities in the global agenda as governments worldwide grapple with the fallout of the war in Ukraine on energy prices. In particular, European governments – typically the most ambitious with respect to climate change policies – have watered down their commitments in the very short term as they deal with the shock of higher energy prices and the threat of falling into a recession. Faced with the short-term pressures of surviving the winter, governments will be scrambling for supplies, putting their net-zero progress on hold. More generally, the existing multilateral architecture seems unfit to accommodate a more tense geopolitical context and a more fragmented world order, which would impair the Conference of the Parties (COP) process over the longer-term. Climate change action requires global coordination to be truly effective.

In this challenging context, the COP27 summit – which will be held in Egypt this year – will likely try to emphasise the view from developing countries, with the potential of a sharpening North-South divide. Developing countries have been responsible for a minor share of the stock of post-industrial CO_2 emissions, and are yet to achieve their development needs, which they legitimately see as a priority with respect to carbon intensity. At the same time, the Global South has been more vulnerable to the consequences of climate change – more frequent and more extreme weather events have already materially affected lives, health, and livelihoods in several developing countries. Accordingly, the focus of the discussions will likely be on adaptation and finance. Climate finance is a particularly contentious issue. The pandemic and the energy crisis have led to more fiscal spending in the north of the globe, while fiscal space for most emerging economies has remained constrained. That will significantly impact their leapfrog potential – opportunities to bypass carbon-intensive development need investment to have a chance to materialise – and their ability to adapt.

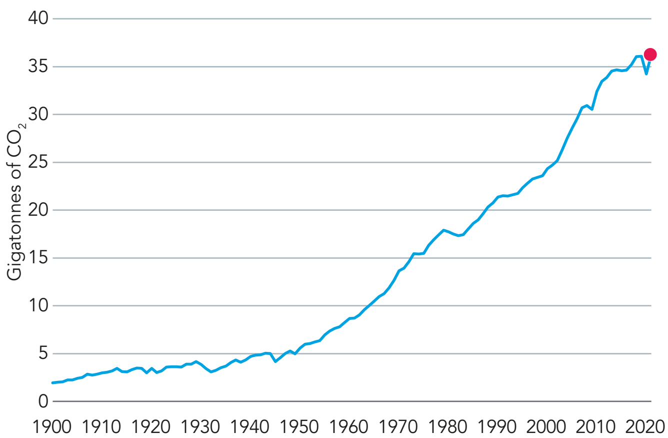
A fading just transition

At the same time, while developed economies have devoted large sums to shield domestic households and firms from higher energy prices, they have missed once again their annual €100bn target of climate finance to developing nations this year. The goal has now been postponed to 2023, amid reciprocal accusations – including lack of transparency of delivery and governance issues. Most likely, there will be a shift away from blanket finance pledges towards a set of country-specific plans, that should imply greater accountability at both ends and, accordingly, more effective implementation. Also related to finance, the issue of loss and damage will likely gain traction once again, with the emerging economies' request for a funding facility likely to prove contentious.

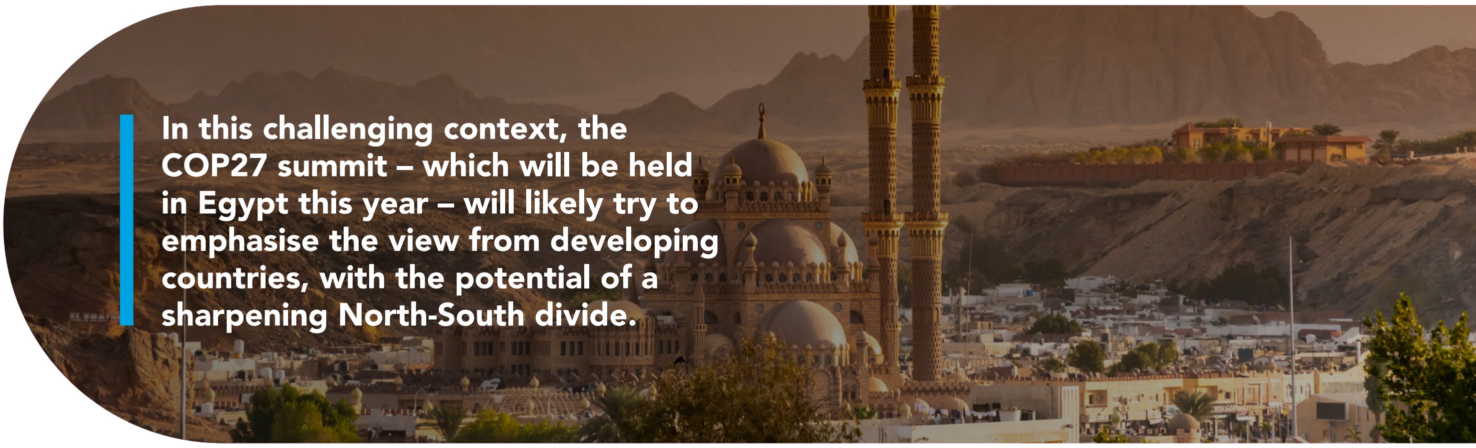
Overall, the set-up of COP27 works against the odds for significant progress. It does not help that the first global stocktake (GST) to assess progress towards the Paris Agreement's goals will take place in 2023. COP27 might be seen as an ancillary event, happening against an extremely challenging backdrop.

Figure 4: Global annual CO_2 emissions bounced back to a new record high in 2021

CO_2 emissions from energy combustion and industrial processes, 1900-2021



Source: IEA, Global Energy Review: CO_2 Emissions in 2021, as at March 2022.



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