GLOBAL INFLATION WATCH

Inflation back to target by end-2024

- **Overview** – Global headline inflation has fallen sharply from its peak a year ago and, despite a temporary setback due to higher fuel inflation, we expect it to fall a lot further over the coming year. The huge drag from energy inflation is now largely in the past and the Israel-Gaza conflict means there are now upside risks to energy inflation. But lower food and core inflation will now play a bigger role in bringing inflation back to targets, especially in advanced economies. Meanwhile, as the lagged impacts from monetary tightening causes activity to weaken and labour markets to loosen, services inflation should fall in both DMs and EMs. But while DM headline inflation will be back at 2% by the end of next year, the decline in EM inflation will slow from here. (See Chart 1.)

- **Demand and Capacity** – As the lagged impacts of monetary tightening take effect, we expect output in DMs to fall below potential for a few quarters, which should weigh on price pressures. (See page 5.)

- **Labour Markets** – While wage growth is falling in the US, it remains uncomfortably high in Europe. But as activity weakens and unemployment rises, wage growth and services inflation should slow. (See page 6.)

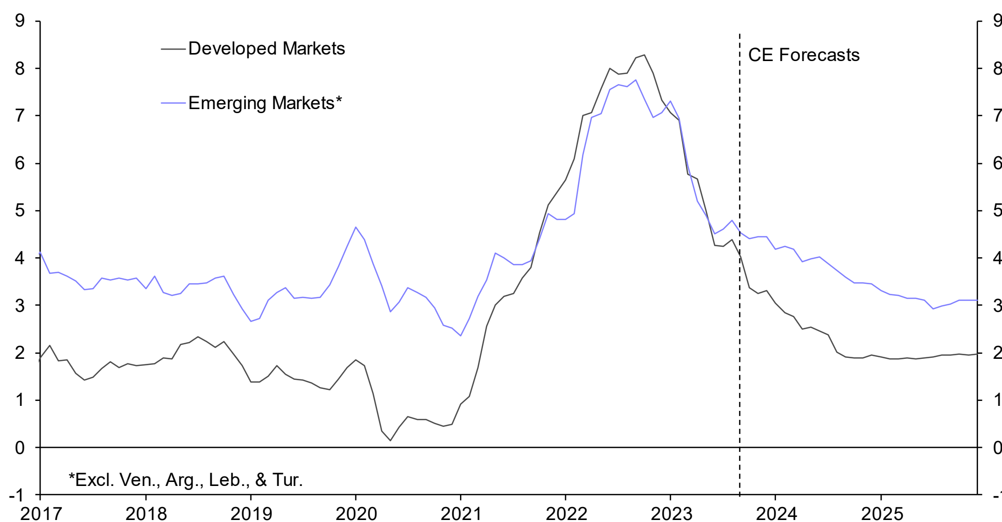
- **Commodity Prices** – Lower food inflation should weigh more heavily on headline inflation in the coming year, but higher energy commodity prices pose an upside risk. (See page 7.)

- **Monetary Conditions and Policy** – Previous monetary policy tightening will weigh more heavily on demand and ultimately core inflation in the coming year. (See page 8.)

- **Inflation Expectations** – With only a few exceptions, surveys of inflation expectations have continued to trend lower. (See page 9.)

- **Emerging Markets** – The decline in EM inflation has stalled, and won't resume until next year, at which point several central banks in Asia will join the EM monetary easing cycle. (See page 10.)

Chart 1: Headline CPI Inflation (%)



Sources: Refinitiv, Capital Economics

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Forecast Summary

Table 1: Key Forecasts

Year avg. unless o/w stated	Average 2015-2019	2020	2021	2022	Forecasts 2023	2024	2025
Headline CPI Inflation							
World [1]	2.7	2.4	3.5	6.9	5.2	3.3	2.7
Advanced economies	1.2	0.7	3.2	7.5	4.6	2.2	1.7
Emerging economies [1]	3.7	3.3	3.8	6.6	5.5	3.9	3.2
US	1.5	1.3	4.7	8.0	4.2	2.3	2.4
Euro-zone	1.0	0.3	2.6	8.4	5.6	2.5	1.8
Germany	1.2	0.4	3.2	8.7	6.0	2.8	2.0
France	1.0	0.5	2.1	5.9	5.8	2.3	1.8
Italy	0.6	-0.1	1.9	8.7	6.0	1.8	1.5
Japan	0.5	0.0	-0.2	2.5	3.0	1.6	0.4
UK	1.5	0.9	2.6	9.1	7.5	2.0	1.2
Canada	1.7	0.7	3.4	6.8	3.7	2.2	1.8
China	2.0	2.5	0.9	2.0	0.5	1.0	1.0
India	4.1	6.6	5.1	6.7	5.8	4.7	5.3
Russia	6.7	3.4	6.7	13.8	5.7	7.3	4.8
Brazil	5.7	3.2	8.3	9.3	4.8	4.8	4.0
Core CPI Inflation							
US	1.4	1.7	3.6	6.1	4.7	2.6	2.4
Euro-zone	1.1	0.7	1.5	3.9	5.1	2.9	2.3
Japan	0.6	0.2	-0.5	1.1	3.9	2.1	1.1
UK	1.7	1.4	2.4	5.9	6.3	3.4	1.8
Real GDP							
World [2]	3.5	-3.5	6.9	2.0	3.1	2.4	2.9
Advanced economies	2.0	-4.4	5.5	2.6	1.3	0.5	1.5
Emerging economies [2]	4.4	-2.9	7.8	1.6	4.1	3.5	3.6
US	2.4	-2.2	5.8	1.9	2.1	0.8	1.8
Euro-zone	2.0	-6.3	5.6	3.4	0.3	0.0	1.0
Japan	0.8	-4.3	2.3	1.0	2.0	0.7	0.9
UK	2.1	-10.4	8.7	4.3	0.2	0.2	1.7
Canada	1.9	-5.1	5.0	3.4	1.1	0.7	2.8
China [2]	6.2	0	11.5	-2.5	7.0	4.5	3.0
India	6.9	-6.0	8.9	6.7	6.3	5.5	6.5
Russia	1.0	-2.7	5.6	-2.1	2.5	1.5	1.3
Brazil	-0.5	-3.3	4.9	1.7	1.3	2.0	2.8
Commodity Prices [3]	*Latest*						
Oil (Brent $/b)	81	52	78	85	85	85	70
Gold ($/oz)	1,998	1,898	1,822	1,816	1800	1925	1800

(1) Excludes Venezuela, Argentina, Turkey & Lebanon; (2) China estimates based on our China Activity Proxy; (3) End-year, not year average.

Overview

Fuel inflation has risen again…

- Global inflation has nearly halved since its peak a year ago, and we expect it to fall further over the coming year, albeit at a more gradual pace. Food, goods and services inflation will replace energy inflation as the most important drivers of the fall in headline rates, which should return to pre-pandemic levels by the end of 2024.

- We do not think that the small uptick in inflation in July and August, due to higher fuel inflation, marks the end of the downward trend. Indeed, global inflation has generally come in *below* consensus expectations from the start of the year. And by our estimate, it fell again in September, to 4.4%. (See Chart 2.)

- For the past year, the sharp decline in inflation has been almost entirely due to big falls in energy inflation. But this has largely come to an end. We have made only a small revision to our forecast for Brent crude, which we expect to stay at $85pb until the end of 2024. But the potential for energy commodity prices to rise further due to the conflict in the Middle East means that the risks from energy CPI are now firmly to the upside. (See Chart 3.)

- Accordingly, non-energy inflation should be responsible for the bulk of the fall in DM headline inflation going forwards. (See Chart 4.)

- There are several reasons why we expect DM inflation to fall further over the coming year. For one thing, food inflation has finally turned a corner in major advanced economies apart from Japan. (See Chart 5.) And given the sharp falls in agricultural commodities prices we have seen over the past year, further falls in food CPI inflation are already in the pipeline.

- Lower core goods inflation will also weigh on DM inflation in the coming months, especially in the UK and euro-zone where the easing in shortages has lagged the US by several months.

Chart 2: Headline CPI Inflation (%)

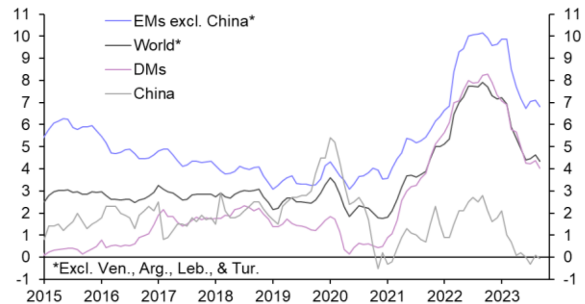


Chart 3: Oil Price & Percentage-Point Contribution of Fuel Inflation to Average DM Headline Inflation Rate

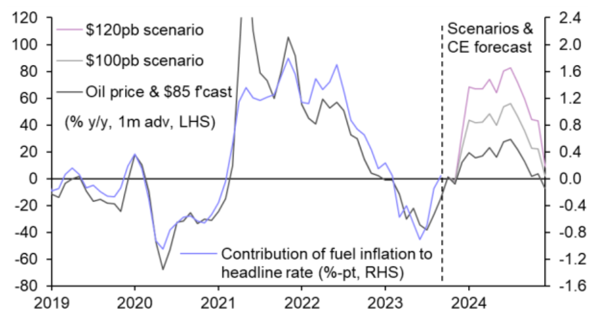


Chart 4: Contributions of Energy and Non-Energy Inflation to Average DM CPI Inflation (%-pts)

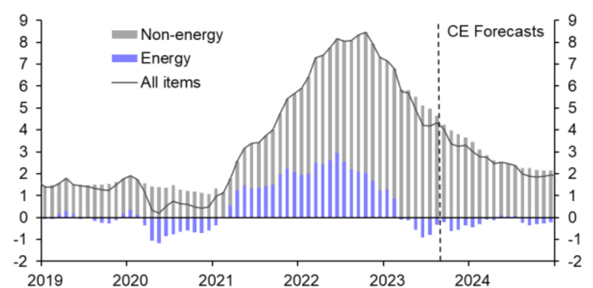
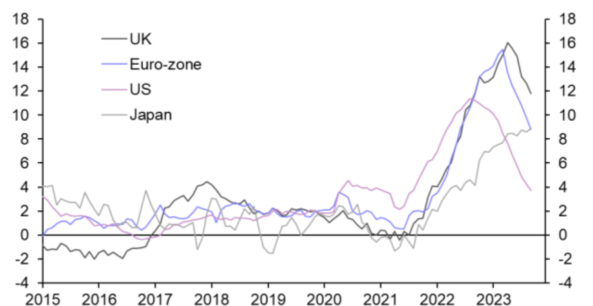


Chart 5: Food CPI (% y/y)



Sources: Refinitiv, S&P Global, Capital Economics

Overview (continued)

… but lower food and core inflation in the pipeline

- At the same time as supply constraints ease, weaker demand in advanced economies will start to bear down more heavily on underlying inflation. Financial conditions have tightened significantly over the past year, which is already weighing on money and credit growth. And we expect most major DMs to experience mild recessions, or at the very least a period of weak GDP growth in the coming quarters.

- One of the biggest uncertainties continues to be how fast and to what extent services inflation – which has been particularly sticky – will ease. In the US, a large part of this stickiness is due to rent inflation, which is a notoriously lagging indicator and for which surveys point to sharp falls ahead. (See Chart 6.) Excluding rent, core services inflation has been falling sharply in the US.

- But core services ex. rent inflation remains high in the UK and euro-zone. We think this is largely due to the fact that wage growth is still much higher there than in the US, which is fuelling price pressures in the labour-sensitive components of services CPI. As recessions take hold in the coming quarters, we expect unemployment to edge up and wage growth to moderate. This should help reduce core services ex. rent inflation, albeit more slowly than in the US.

- As core inflation falls sharply in the coming year (see Chart 8), central banks will turn to *cutting* policy rates in 2024. With the clearest signs of disinflation in the US, we expect the Fed to cut rates in H1 2024, whereas the Bank of England and ECB probably won't be in a position to loosen policy until later in the year. Meanwhile, the recent stickiness in inflation in some EMs (see Chart 9) means that we have pushed back our forecasts for the start of easing cycles in some Asian economies to 2024.

Chart 6: US CPI Rent of Shelter & New Rents (% y/y)

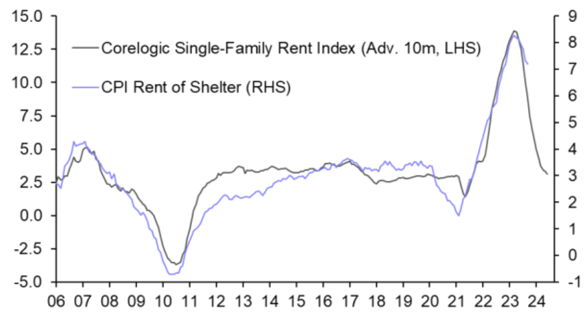


Chart 7: Core Services ex. Rent CPI* (% y/y)

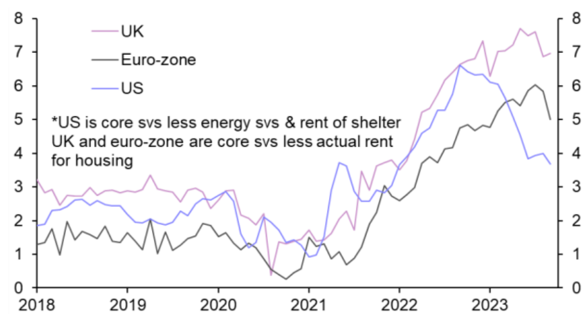


Chart 8: Core CPI Inflation (%)

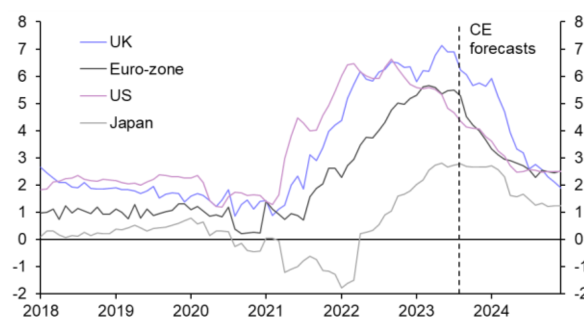
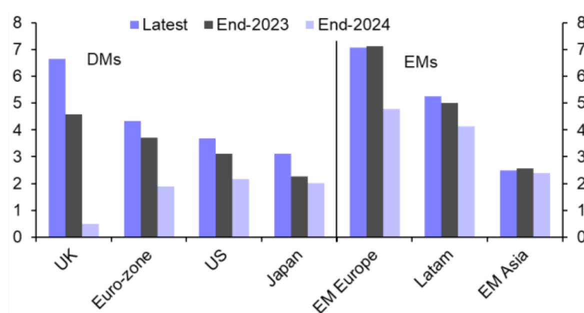


Chart 9: Headline CPI Inflation (%)



Sources: Refinitiv, Capital Economics.

Demand and Capacity

Weaker demand to weigh on price pressures

- Although demand has remained resilient so far this year, we still forecast mild recessions, or at the very least a couple quarters of weak GDP growth in most major advanced economies. And with product shortages no longer an issue, the combination of improved supply and weaker demand should free up capacity further and hence weigh on underlying price pressures.

- The fact that DMs have managed to dodge recessions so far this year despite a backdrop of much tighter financial conditions has been the result of two factors. First, product shortages have eased significantly, meaning that firms have finally been able to work through their large backlogs of orders. And second, consumer demand has been resilient, in part supported by households in some DMs dipping into their large stock of savings built up during COVID.

- But this resilience now seems to be fading. The PMI surveys suggest that output is now *contracting* in DMs, while new orders have been falling for a few months. (See Chart 10.) Meanwhile goods consumption has continued to normalise (see Chart 11), and should weaken further given that spending on goods tends to be fairly interest rate-sensitive.

- Weaker demand for goods should lead to some spare capacity emerging in industry. A majority of UK firms already seem to be operating below capacity. And while capacity utilisation is higher in the US and euro-zone, it has been inching down. (See Chart 12.) This should reduce core goods inflation, especially in Europe.

- As the lagged impacts of higher interest rates feed through, we expect output in advanced economies to fall below potential. (See Chart 13.) This should free up capacity more broadly and reduce underlying price pressures. A key upside risk to inflation would be if demand remained stronger than we expect, perhaps due to households reducing savings further in order to continue supporting spending on services.

Chart 10: DM Composite PMIs: Output & New Orders

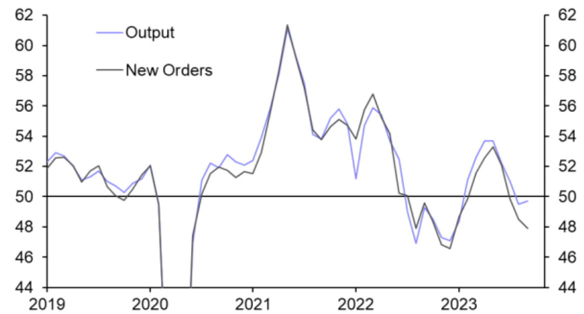


Chart 11: G7 Real Private Consumption (Q4 2019 = 100)

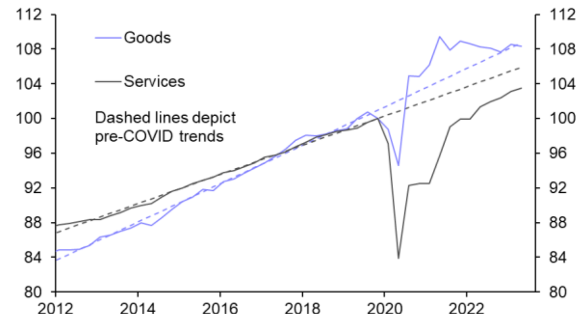


Chart 12: G7 Industry Capacity Utilisation

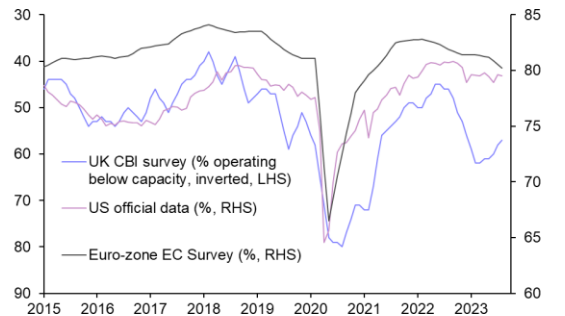
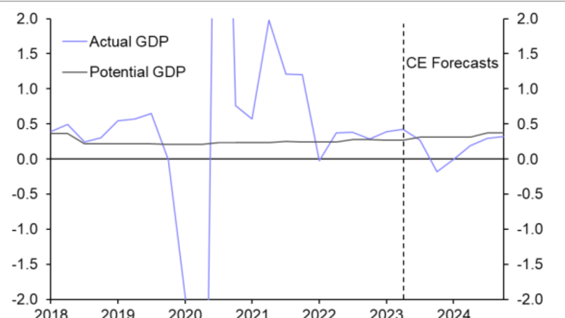


Chart 13: G4 Average Real GDP vs. EC Estimate of Potential (% q/q)



Sources: Refinitiv, Capital Economics

Labour Markets

Wage growth to slow, but upside risks dominate in Europe

- While a loosening labour market is contributing to slower wage growth in the US, in Europe it is still too high for central banks' comfort. This explains why core services ex. rent inflation has barely fallen in the latter. But as a period of weak economic activity takes hold and unemployment rates gradually rise, core inflation should fall back towards targets.

- There has been a clear divergence in wage growth between advanced economies. In the US, wage growth fell to a two-year low of 4.2% 3my/y in September. On the other hand, while wage growth looks to have finally peaked in the UK, it was still 8.1% 3my/y in August. And in the euro-zone, the available data showed wage growth was still rising in Q2. (See Chart 14.)

- Wage growth in the US has fallen thanks to a loosening labour market. Despite some recent upside surprises in the headline employment figures, other indicators seem to suggest wage growth will ease further. The job vacancy rate has fallen significantly. And the fall in the private quits rate suggest that wage growth will slow to just over 3.5% y/y. (See Chart 15.)

- A key reason why wage growth hasn't fallen yet in the euro-zone is that the labour market is still very tight, with the unemployment rate at a record low. However, the fact that wage growth remains so high in the UK is slightly more puzzling, given that job vacancies have fallen sharply and the unemployment rate has risen. Higher inflation expectations and lingering worker mismatches may be the cause.

- There is already some evidence that wage growth will moderate in Europe. Surveys point to slower or even *negative* employment growth. (See Chart 16.) And we think mild recessions will trigger a modest rise in unemployment rates. (See Chart 17.) As these feed through to weaker wage pressures, core inflation should return to targets by 2025. But a key upside risk to our inflation forecasts is that wage growth remains stubbornly high, especially in Europe.

Chart 14: Headline Average Earnings (% 3my/y)

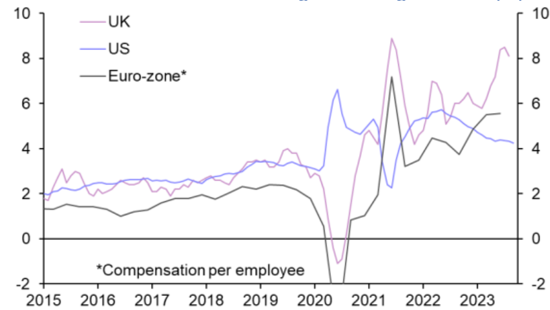


Chart 15: US Job Quits & ECI Wages & Salaries

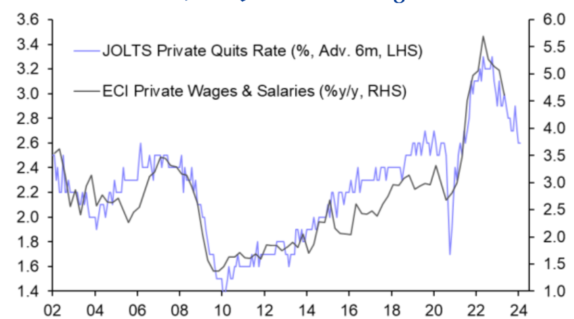


Chart 16: Composite PMIs: Employment

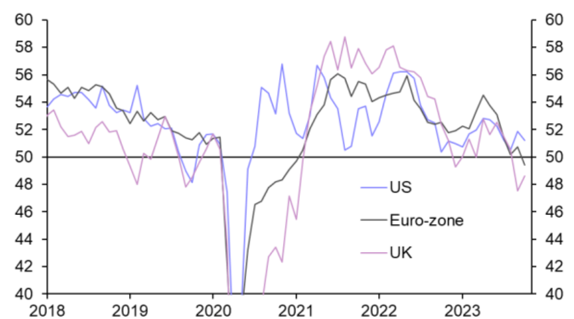
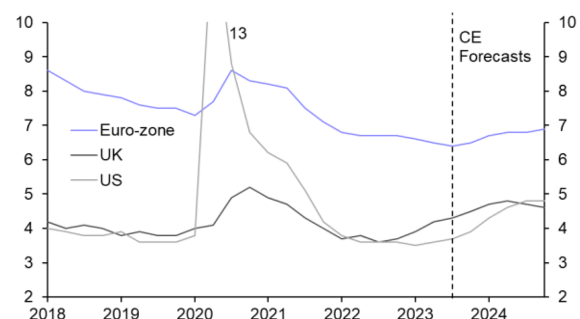


Chart 17: Unemployment Rates (%)



Sources: Refinitiv, S&P Global, Capital Economics

Commodity Prices

Higher energy commodity prices now an upside risk to inflation

- Energy effects are no longer exerting much downward pressure on DM headline inflation. And the potential for oil and gas prices to rise further due to the conflict in the Middle East poses an upside risk to our inflation forecasts. That said, lower food inflation should weigh on DM inflation in the coming year.

- Although commodity prices have come down a long way from their peaks, supply concerns have caused energy prices to rise again in recent months. (See Chart 18.) We have revised up our end-2024 forecast for the price of Brent oil to $85pb from $75pb previously.

- Fuel inflation has been responsible for a large portion of the fall in DM headline inflation this year, but this has come to an end. We expect fuel's contribution to headline inflation to turn positive again, reaching about 0.4%-pts by the end of the year. And as things stand, our higher oil price forecasts won't have a major impact on our DM inflation forecasts. (See Chart 19.)

- Meanwhile, past falls in natural gas prices suggest that household energy inflation still has a bit further to fall. But this should knock only about 0.2%-pts off DM inflation by the end of the year. (See Chart 20.)

- However, the Israel-Gaza conflict presents significant upside risks to our oil and gas price forecasts. If the conflict broadens out to the wider region, thereby threatening supply, energy prices could rise sharply. (See Chart 19.)

- As the effects from lower energy inflation fade, food inflation will become a bigger driver of the fall in DM inflation. The past falls in agricultural commodity prices are feeding through to lower food inflation. And we expect food to knock a further 1%-pt off DM inflation by end-2024 . (See Chart 21.) But there are upside risks to our agricultural commodity price forecasts too, including the potential for a severe or prolonged El Niño event, which could slow the decline in DM food inflation.

Chart 18: Select Commodity Prices (Dec. 2022 = 100)

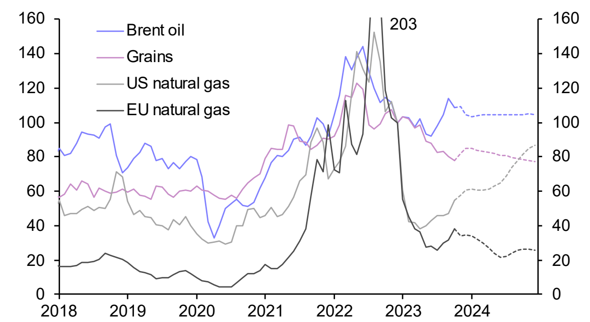


Chart 19: Oil Price & Percentage-Point Contribution of Fuel Inflation to Average DM Headline Inflation Rate

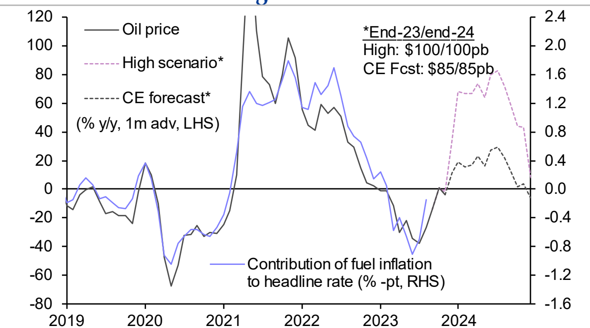


Chart 20: Nat. Gas Price & %-Pt Contrib. of Household Energy Inflation to Average DM Headline Inflation Rate

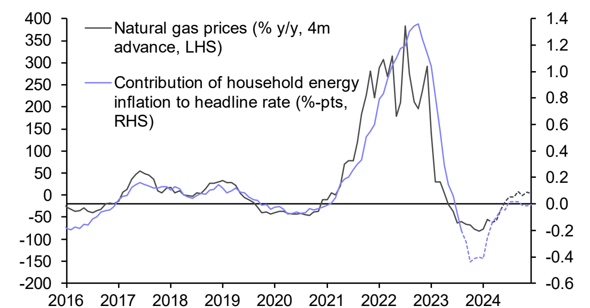
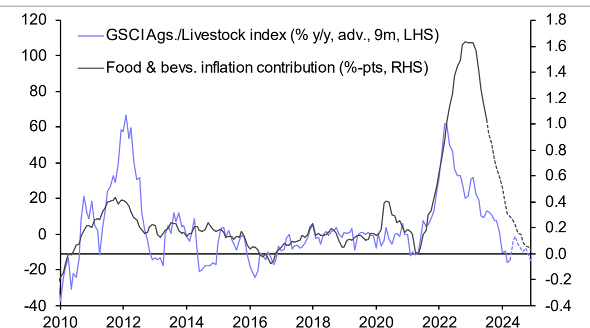


Chart 21: GSCI Agriculturals & Livestock Index & %-Pt Contribution of Food & Bevs. Inflation to DM Inflation



Sources: Refinitiv, Capital Economics

Monetary Conditions and Policy

Previous policy tightening will weigh further on activity and inflation

- Policy tightening is clearly taking a toll on the global economy, with market rates rising and bank lending stagnant. This will weigh more heavily on activity and inflation over the coming quarters as more borrowers have to refinance at higher interest rates. Since policy is likely to remain tight until 2025, monetary conditions should bear down on price pressures for most of next year.

- M1 narrow money is now falling at a near double-digit annual pace, as higher interest rates are reducing demand for liquid deposits. Broader money growth is not faring as badly, since higher rates are also boosting demand for savings deposits and money funds. Nonetheless, our measure of M3 broad money growth is close to zero. (See Chart 22.) Net bank lending has stopped rising in the US and UK and has fallen outright in the euro-zone. (See Chart 23.) Historically, such trends have been consistent with deep recessions. What's more, banks have continued to tighten their lending criteria. (See Chart 24.)

- Many *existing* borrowers have been shielded from the effects of higher interest rates because a higher share of loans have been taken out at long-term fixed interest rates over recent years. But effective interest rates on outstanding loans are now following the rates on new loans up. (See Chart 25.) In the extreme scenario where long-dated yields stayed at their current levels for several years, the effective interest rate on household debt would rise close to 6%, causing debt interest costs to rise by about 50% from Q2 levels, on average.

- Our own expectation that the US Fed will cut interest rates quite aggressively next year should mean that benchmark bond yields and hence market interest rates start to decline. But policy rates are set to remain above their "neutral" levels until 2025 and central banks intend to continue disposing of assets through their quantitative tightening programmes, which will limit the decline in yields.

Chart 22: DM Average Money Growth (% y/y)

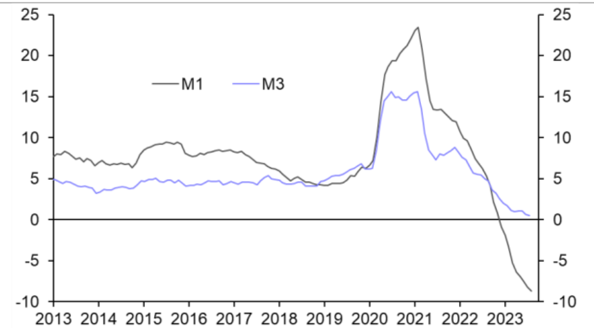


Chart 23: Net Bank Lending to The Private Sector (3MMA)

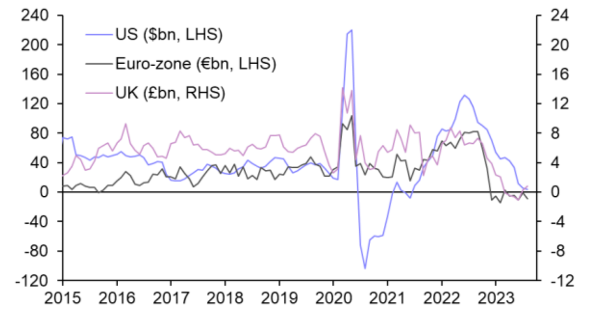


Chart 24: Net % of Banks Tightening Lending Standards for Households & Corporates

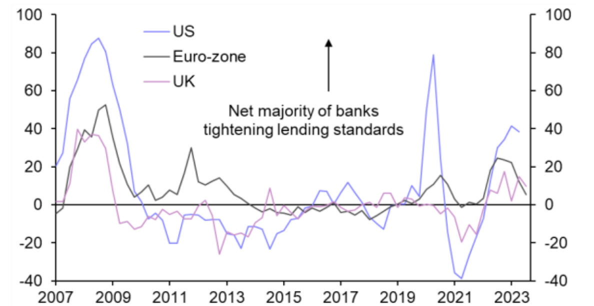
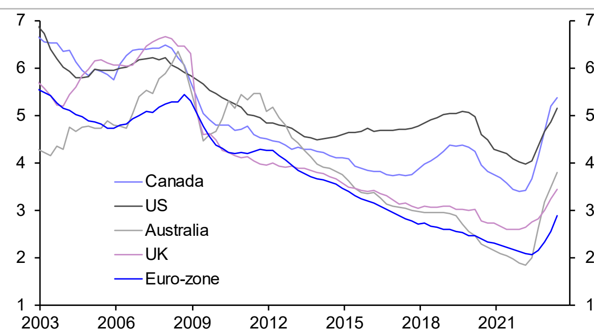


Chart 25: Effective Interest Rates on Household Debt (%)



Sources: Refinitiv, Capital Economics

Inflation Expectations

Inflation expectations gradually easing

- Surveyed inflation expectations have for the most part continued to trend lower. Firms still expect to raise selling prices at a historically high rate in the near-term, but by much less than a year ago. And the further moderation in households' inflation expectations means that the risk of expectations becoming de-anchored and inflation becoming entrenched is low.

- In the manufacturing sector, the combination of a significant easing in product shortages and weaker demand for goods has prompted firms to lower their selling price expectations a lot from their peaks. (See Chart 26.) Admittedly, firms in the US expected to raise prices by more than usual over the coming quarters, perhaps due to the ongoing resilience in consumption. But firms' expectations for price rises have continued to fall in the UK and are back below historical average rates in the euro-zone.

- Meanwhile, given that demand for services has only recently started to weaken, firms still expected to raise prices by more than usual. (See Chart 27.) But even there, selling price expectations have generally fallen.

- Households' inflation expectations have also continued to normalise. Although DM households still expected inflation to be above central banks' targets in a year's time, especially in the UK, short-term inflation expectations have come down a long way from their highs. (See Chart 28.) And the rise in the share of households in the euro-zone expecting prices to increase next year probably reflected the recent rebound in energy prices.

- Unlike short-term inflation expectations, households' longer-term inflation expectations didn't rise that much after the pandemic. And considering that 3- to 5-year ahead inflation expectations are back below 3% in the US, UK and euro-zone, central banks probably won't be too worried about an inflation expectations-driven wage price spiral developing.

Chart 26: Manufacturing Firms' Expected Change in Selling Prices 3-6 Months Ahead (Z-Scores)

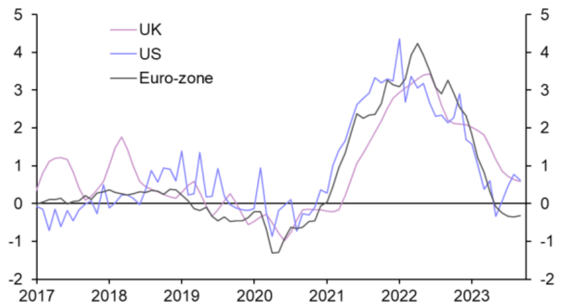


Chart 27: Services Firms' Expected Change in Selling Prices 3-6 Months Ahead (Z-Scores)

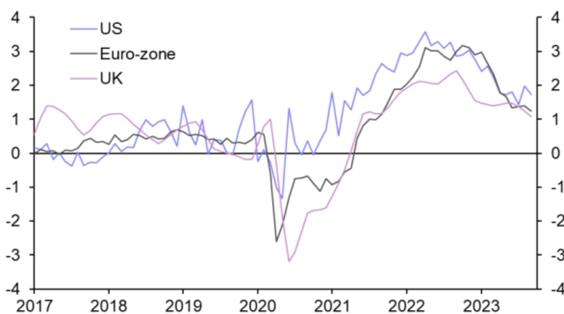


Chart 28: Households' 1Y-Ahead Expected Inflation

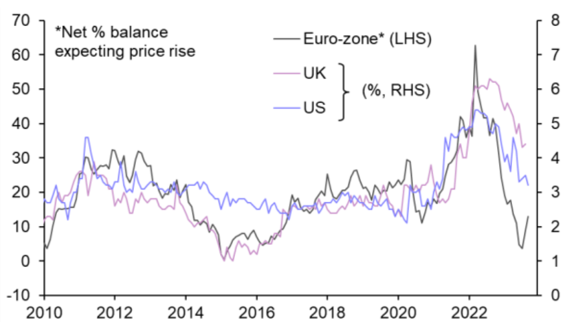
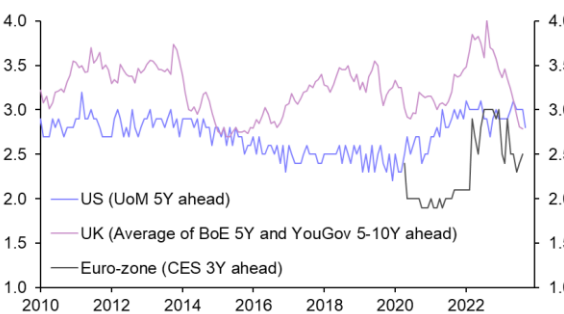


Chart 29: Households' 3Y+ Expected Inflation (%)



Sources: Refinitiv, Capital Economics

Emerging Markets

Temporary setback, but inflation to resume falling next year

- Inflation in emerging markets has fallen sharply this year but, similar to the case in advanced economies, it has stabilised over the past few months. And whereas DM inflation should continue to fall sharply, high food inflation will prevent EM headline inflation from falling for the rest of this year. Services inflation has finally turned a corner though and will drag on core rates, allowing the EM monetary easing cycle to broaden out next year.

- The decline in EM inflation has stalled over the past few months. By our estimate, aggregate EM headline inflation came in at 4.5% in September, while core inflation was slightly higher at 4.7%. (See Chart 30.)

- Similar to the case in DMs, higher fuel inflation was partly to blame for the recent pause in EM disinflation. But higher food inflation has also been responsible, particularly in Asia, where prices have been driven up by speculation over El Niño's potential impacts. A strong El Niño poses a significant upside risk to EM inflation in the coming year, as it has historically coincided with higher food inflation. (See Chart 31.) And given that food accounts for a larger share of CPI baskets in EMs than in DMs, upside risks to inflation are more prominent in the former.

- Nonetheless, we expect EM inflation to resume its decline next year, as core inflation softens on the back of weak economic activity. Services inflation has been sticky, but appears to have finally turned a corner. (See Chart 32.)

- Several central banks in Emerging Europe and Latin America have already started loosening policy. But sticky wage growth and hence core inflation means it will take longer for policy rates to reach neutral levels than in other EMs. Meanwhile, although inflation in Asia is much lower (see Chart 33), we have pushed back our forecasts for the start of easing cycles in some economies to 2024.

Chart 30: Aggregate EM Consumer Prices (% y/y)

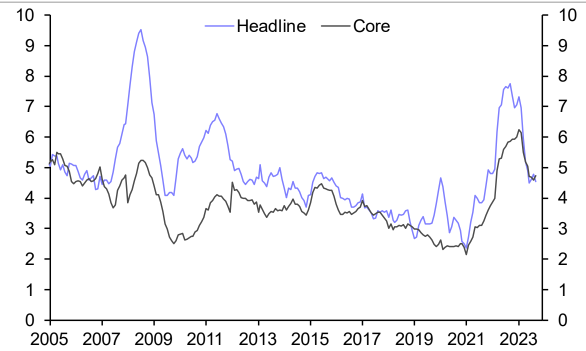


Chart 31: Aggregate EM Food Inflation (%)

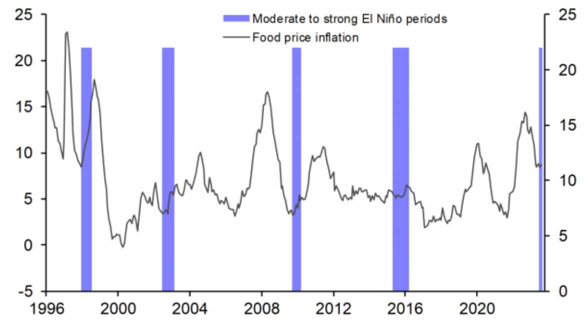


Chart 32: EM* Services Inflation (%)

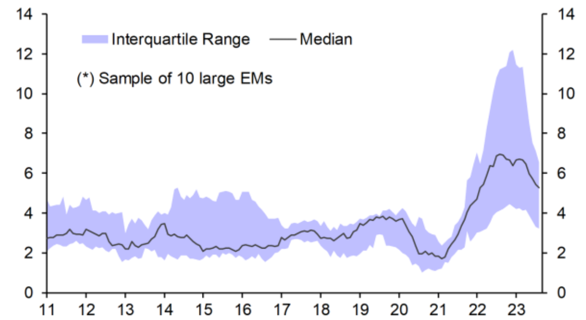
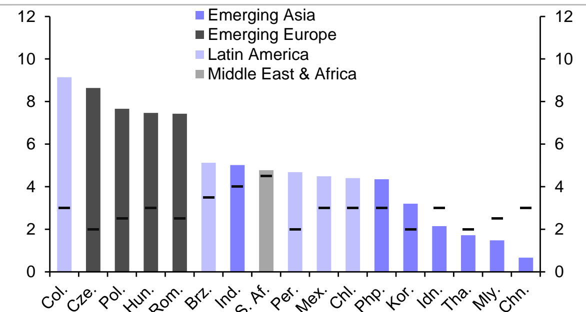


Chart 33: CE Headline Inflation Forecast and Mid-Point of Inflation Targets (End-23, % y/y)



Sources: Refinitiv, Capital Economics

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