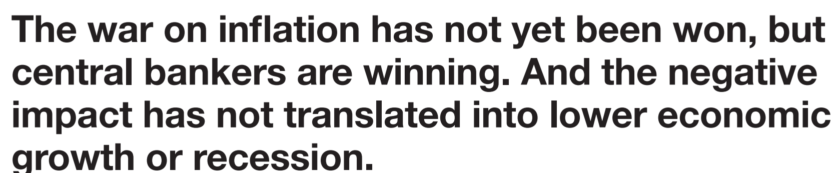
MACRO VIEW | By Tiziana Barghini

Forecast: Unsettled



The war on inflation has not yet been won, but central bankers are winning. And the negative impact has not translated into lower economic growth or recession.

Through 2022 and 2023, many central banks raised their benchmark interest rate multiple times. The European Central Bank increased rates nine times. Since March of last year, the US Federal Reserve has increased its key interest rate 11 times, reaching from the 5.25% to 5.5% range, the highest in 22 years. Also, Canada and the UK had a cycle of heavy monetary tightening.

There were some notable exceptions to the tightening trend: Japan, China and Russia in particular. Chile, one of the pioneers in initiating monetary tightening in 2021, began reducing its reference in July, and has since cut it a total of 175 basis points. Paraguay followed with its own rate cut in late August. China, facing economic woes, made two reductions in its key interest rates in recent months.

As of now, the mix of rate hikes and cuts seems to have gently slowed economic activity without kicking off a global recession. That has been a pleasant surprise for some. "Many people thought that a recession was relatively likely, because it was a statistical regularity of the postwar period," says Giorgio Primiceri, professor of economics at Northwestern University. "When the [US] Federal Reserve has raised interest rates to lower inflation, a recession has very often followed. The fact that it hasn't so far this year is somewhat surprising."

The International Monetary Fund (IMF), in its July World Economic Outlook Update, anticipates an easing of growth worldwide, dropping from an estimated 3.5% in 2022 to a projected 3% for each of 2023 and 2024. Yet no one is ready to break out the champagne just yet. Economic observers continue to spotlight widespread risks, including aging populations and swelling debt loads. Geopolitical tensions also threaten sustained long-term growth. And the investment boom in artificial intelligence (AI) is inspiring only limited optimism.

> **"The risks of a deep recession have come down."**
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> ***—Elena Duggar, Moody's***

Consensus in the business, banking, and investment communities is that the tightening cycle is nearing its conclusion. A common forecast for the US has been a modest recession or a cyclical slowdown in economic growth (a "soft landing") with flat or slightly positive growth over the full year. But some large banks have reviewed their expectations and do not see a recession upcoming.

"There's no sign of a deceleration in the [US] economy," says Aditya Bhave, senior US economist at Bank of America. "If you look at the final demand component of GDP, it's accelerated. Looking at that, we decided we've seen enough; and we'll be able to avoid a recession."

According to a newly coined term, the US could be in a rolling recession, with different

industries slowing up in succession. The automobile sector, for example, has rebounded significantly as supply recovers, offsetting weakness in other parts of the manufacturing sector. "All in all, it's really been a rolling recession across both autos and housing."

The US is not the only economy facing cloudy expectations. "Over the next 12 months, we anticipate a period of sluggish growth in the US and Europe, although the risks of a deep recession have come down," says Elena Duggar, chair of Moody's macroeconomic board. "The US is likely to experience a soft landing. Germany is currently experiencing contraction, and Italy is also facing challenges. Meanwhile, France is showing slightly better performance. Overall, the euro area may achieve a modest growth rate, albeit at a notably slow pace."

China, which enjoyed a boost at the beginning of the year when authorities in the world's second-largest economy abandoned their strict lockdown policies, is again causing serious concern. In addition to the two recent rate cuts, commercial banks in China have lowered their rates to support private consumption and mitigate the ongoing real estate crisis.

Manufacturing and consumption earlier rebounded, and net exports "contributed strongly to sequential growth in February and March as supply chains normalized and firms swiftly put backlogs of orders into production," the IMF noted in its July Update. "Nonetheless, continued weakness in the real estate sector is weighing on investment, foreign demand remains weak, and rising and elevated youth unemployment (at 20.8% in May 2023) indicates labor market weakness." Since then, Beijing stopped publishing data on youth unemployment in August, after it had reached a record high, topping 21% in June.

Peterson, Conference Board: Europe has already had its weakest point, and it's going to see a modest recovery from now onwards.

The IMF forecasts China's growth at 5.2% for this year and 4.5% for the next. However, this growth is expected to be primarily driven by consumption, while investment is likely to be hindered by the real estate downturn.

China's economy faces a significant challenge—and the lack of reliable economic data is making things more difficult to understand. The country appears to be stuck in a critical situation within its real estate sector, which has historically been a key driver of its development.

Financial troubles at Country Garden, a major player in the real estate industry, raised concerns similar to what was witnessed during the Evergrande collapse in 2021. Issues in the real estate sector have ripple effects, impacting savings, investments, and ultimately consumption—potentially disrupting a growth model that has sustained the Asian giant for the past decades, prompting China's central bank to take action.

India offers the flipside of China's picture. The IMF projects Indian GDP to grow 6.1% this year. Any anticipation that India's

COST-OF-MONEY CONCERNS

It takes money to make money, the saying goes; and on top of longer-term trends, the primary concern for most companies looking to build their business is the cost of money itself. A key benchmark in this respect is the real interest rate, sometimes called "r*" or "r-star," the level of the cost of money that economists consider neutral: low enough that it doesn't cause recession and high enough that it doesn't cause inflation.

Some observers see a radical increase in the short-run natural rate of interest as the only explanation for the US economy's strength in the face of a federal funds rate more than 500 basis points higher than it was a little more than a year ago. In the past, demographic elements such as an older population and a higher level of savings were thought to move the natural rate lower. Now, some economists think that higher debt and possibly higher productivity might factor in as well.

The latest assessment of r* by the Federal Reserve Bank of New York suggests that a federal funds rate of approximately 2.5% could potentially be considered a neutral setting, but there is a lot of uncertainty surrounding this issue.

Reduced demand for US debt could be another contributor of a future higher r*, says Northwestern University's Primiceri. "In the second part of the 1990s and the first part of the 2000s, Asian investors, in particular Chinese investors, wanted to buy US safe assets—and in particular, US government bonds," he notes. "Now, to the extent that the appetite for this type of asset is decreasing, or at least not increasing as fast as it was 15 years ago, these are all reasons to conjecture that r* is going to increase a little bit."

economy will overtake China's (as its population has) would be premature, however. Its GDP remains notably smaller—just a a fifth of China's.

Other emerging economies, like Vietnam's, show potential but remain minor as engines of economic growth in the global context. Germany, previously the engine of European growth, is sputtering; and some economists expect it to enter recession. The UK is suffering a period of high inflation and poor growth in the wake of Brexit and the pandemic shutdown. The sum total of this mixed picture, however, seems to be the hoped-for slowdown without a crash.

"We do not expect a global recession because you'd need the US, Europe and China all going into a recession at the same time; and we don't anticipate that happening," says Dana Peterson, chief economist and center leader of economy, strategy and finance at the Conference Board, "We expect the US to experience a mild and brief recession. Europe has already had its very weakest point, we think; and it's going to see a modest recovery from now onwards."

LONG-TERM GROWTH FACTORS

Economists who earlier projected higher inflation and lower GDP growth still argue that significant structural changes underway will hinder global expansion going forward. Long-term factors that might push inflation higher include decarbonization and deglobalization.

"Both elements tend to push prices up," says Marcelo Carvalho, global head of economics at BNP Paribas. That might prompt central bankers to review their inflation goals. Toward the end of August, Richmond Federal Reserve President Thomas Barkin warned that the Fed could lose credibility if it were to consider changing its 2% inflation target rather than pressing on to achieve it.

Other important changes are taking place in the job market. The retirement of America's baby boom generation is likely to create labor shortages, the Conference Board's Peterson warns. "The largest companies that we survey continue to say they expect a recession," she says, "but they're still hiring—40% are hiring and 40% are holding on to their workforces—because they believe if there is a recession, it'll be short and shallow."

Innovation and technology will also significantly impact workers. Kweilin Ellingrud, director and senior partner at the McKinsey Global Institute, anticipates a need to rescale and upskill for some 12 million positions in the US alone between now and 2030.

According to a McKinsey study of automation trends, around 30% of hours worked in current activities such as food services, in-person sales, and office support could be automated by 2030. "Eventually we will have more jobs than we do today, and better-paid jobs," she predicts, "but the path to get there is complicated and filled with some disruption."

Some industries will be more negatively affected than others, says Ellingrud. Positions in the science, technology, engineering and math (STEM) fields as well as healthcare will grow, while overall, low-wage workers earning less than $40,000 per year—disproportionately women and workers of color—will be hit hardest.

China's pullback from US bonds speaks to the tensions that have contributed to reshaping global trade. Escalated tariffs and Covid-related supply chain difficulties have encouraged a move toward some "nearshoring" and "friendshoring." Digitalization, meanwhile, is also reshaping trade dynamics.

"It's essential to delve beyond the surface trade figures," says Moody's analyst Dima Cvetkova, "This reveals a significant acceleration in digital trade." She points to digital services like software, cloud computing, e-learning, and social media. "These digital services experienced a fourfold increase from 2005 to 2022 and now constitute some 12% of total trade volume," she adds, "equivalent to slightly over 50% of commercial services exports."

As economies continue to digitalize, digital trade will expand and impact merchandise trade. "Data indicates that about 70% of global digital-services trade is concentrated in 16 developed economies, spearheaded by the US (17%), the UK (9%), and Ireland (8%)," says Cvetkova. "However, we anticipate spillover benefits and gradual advantages for countries in Africa, which currently represents less than 1% of global trade in digital services."

Carvalho, BNP Paribas: Both decarbonization and deglobalization tend to push prices up.

Adding it all up—demographic factors, interest rate shifts, digitalization, and other innovations—and the future remains frustratingly murky, however. Some economists see the US, the eurozone, and China heading into a period of paltry growth while others expect AI and innovation to bring a new burst of productivity gains.

McKinsey's Ellingrud believes that between generative AI automation and other things, 3% to 4% GDP growth could be achieved annually, with a horizon of seven years up to 2030. Most companies, however, are still concerned about what happens between now and then. ■

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