MOODY'S ANALYTICS

COMMENTARY
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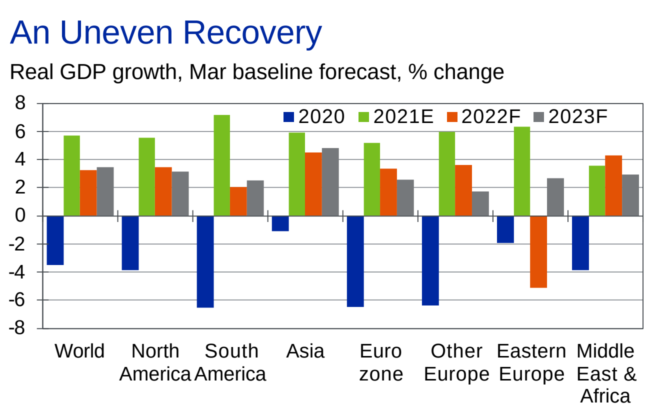
Global Outlook: Inflation Risks Intensify

Russia's invasion of Ukraine creates new negative supply shocks that will weigh on growth.

View the Moody's Analytics Global Forecast.

- Moody's Analytics projects that the global economy will grow 3.2% in 2022 and 3.5% in 2023, after a robust 5.7% in 2021.
- Russia's invasion of Ukraine has created new supply shocks in commodity markets that will weigh on the global expansion and reinforce stagflation risks.
- The Fed's rhetoric around a more aggressive withdrawal of monetary policy accommodation increases the chances of a policy mistake.
- Emerging markets excluding China remain vulnerable as higher food prices and erosion of consumers' purchasing power offset gains to net commodity exporters.
- The continuation of supply-chain disruptions related to factory and port closures will largely hinge on China's policy response to a resurgence of COVID-19.

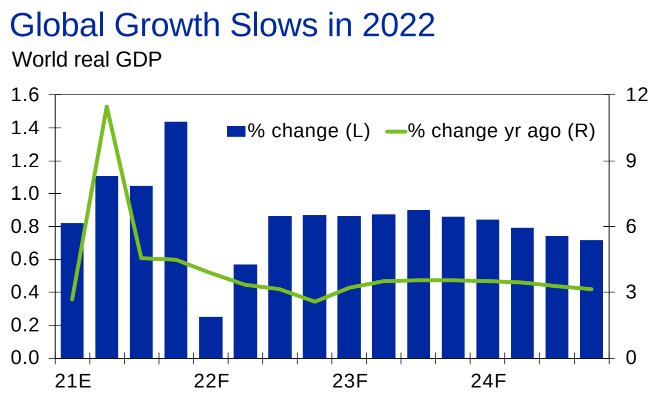
After unprecedented fiscal stimulus in the United States and China's trade-led growth pushed the world economy as a whole toward peak growth late last year, global economic activity has slowed more than expected in the first quarter of 2022. Rapidly rising inflation from ongoing supply shortages and surging commodity prices following Russia's invasion of Ukraine are weighing on the global expansion. While most of the globe is in an improved position relative to 2021, performance remains uneven.



Source: Moody's Analytics

Disparities in pandemic-era policy support, vaccination coverage, and exposure to supply-chain disruptions have highlighted a growing divergence among the world's major economies (focusing on the U.S., China, Japan, India, and the five largest economies in Western Europe) that will only widen this year due to differing trade and investment links to Russia and Ukraine. We project that most of the large European economies will join the U.S., China and India in recovering all pandemic-related real GDP losses in 2022, but Spain and Japan's economies will lag and fully recover over the next two years.

Moody's Analytics forecasts global real GDP growth, after peaking at 5.7% in 2021, will slow to 3.2% in 2022 and then accelerate slightly to 3.5% in 2023. The annual forecast for 2022 represents a full percentage point decrease since January, reflecting the widening economic effects of the war in Ukraine.

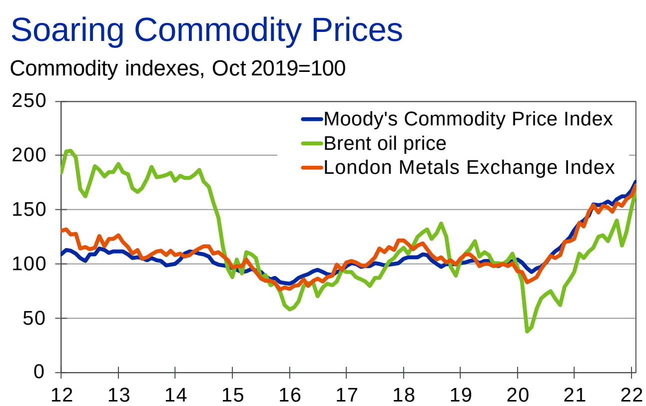


Source: Moody's Analytics

The U.S. will maintain its strong contribution to the global expansion; however, the fading fiscal impulse from more than $5 trillion in government spending will temper gains. U.S. real GDP growth will moderate to 3.5% y/y in 2022 and 3.1% in 2023, after a 5.7% pace last year, the strongest annual rate since 1984. At the same time, China, one of the fasting-growing economies in 2021 with an 8.1% gain, will experience a deceleration in annual growth this year to 5.1% before rebounding to 5.8% in 2023 as its aggressive zero-COVID policies, cooling property market, and buildup of risks in the financial sector weigh on activity.

Stagflation risks rise

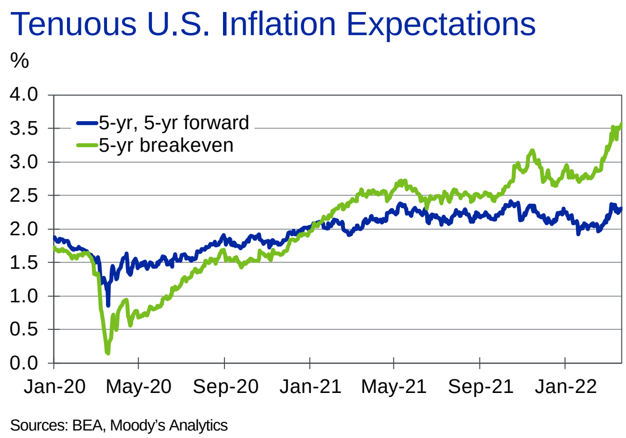
The Russia-Ukraine military conflict exacerbates both cost-push inflation and growth risks already present in the global economy from the residual effects of the pandemic. Oil and gas prices have soared, in addition to prices for other commodities such as wheat, fertilizers and metals.



Sources: Bloomberg, Moody's Analytics

Many of the supply issues triggered by the pandemic that were slowly resolving will now be reinforced, including the global shortage of semiconductors, the production of which relies on palladium and neon, two inputs supplied enormously by Russia and Ukraine. With supply shortages persisting, price pressures will strengthen and last longer worldwide.

Top-line consumer price inflation in the U.S. rose to 7.9% year on year in February to mark the steepest rise in 40 years. However, February's print preceded the Russian invasion of Ukraine, which will exacerbate disruptions in global supply chains. Concerned about the de-anchoring of inflation expectations, the Federal Reserve followed through on the hawkish tone at its January meeting and raised rates by 25 basis points in March.

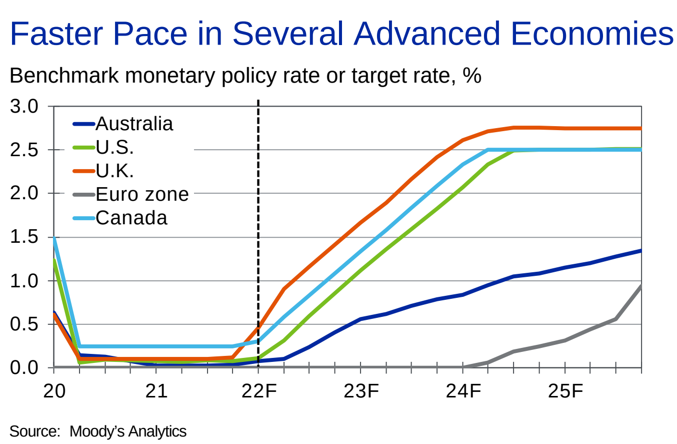


However, Fed Chair Jerome Powell's recent comments that the central bank is prepared to raise the target federal funds rate more aggressively at future meetings have sharply raised market expectations and increase the likelihood of a policy error.

The current U.S. Treasury futures curve now shows that the spread between the 10- and two-year Treasury yields will invert in the next three to six months, a harbinger of recession in the next two years. While an inversion in the yield curve does not directly cause a recession, the Fed is still in an enormous bind. Pausing the tightening cycle to avoid an inversion could itself increase the odds of recession by allowing the economy to overheat more quickly.

A more troubling development for global growth would be a steady rise in the unemployment rate, which has proven to be a more accurate predictor of recessions, and with a shorter lead time, than yield curve inversions. If the unemployment rate begins to steadily increase in the next 12 to 18 months, that would significantly increase the risk of stagflation in the U.S.

Inflation has also intensified in advanced economies such as the U.K., prompting the Bank of England to decrease its government bond purchases and hike the policy rate three times since November.



Despite rising prices, monetary policymakers in other developed economies are playing a balancing act and looking for ways to keep liquidity conditions easy. Given Europe's, and especially Germany's, close trade ties with Russia and Ukraine, the European Central Bank left its policy rate unchanged at -0.5% at its March meeting, with the only meaningful change focused on asset purchases under the regular Asset Purchase Program. As we expected, the ECB made the continuation of purchases after June data-dependent, opening the possibility for these purchases to wind down beginning midyear. In reaction to the meeting, markets increased their bets on a hike in September and are even suggesting the possibility of a hike in June, but we see this as an upside risk rather than a baseline outcome.

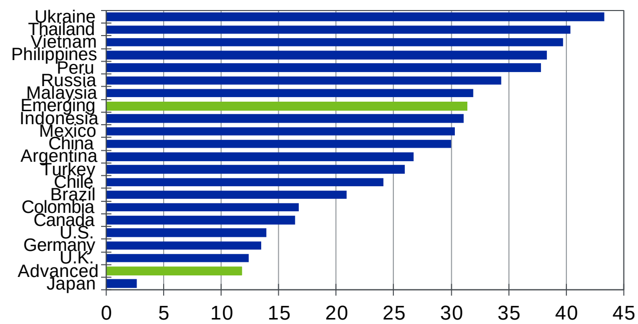
The Bank of Japan, meanwhile, left monetary settings unchanged at its March meeting, keeping its short-term interest rate target at -0.1% and the 10-year bond yield target at “around 0%.” Because of Japan’s stance as a large net energy importer, we expect the BoJ to keep major monetary policy levers unchanged in the short term.

Emerging market challenges

Emerging economies excluding China will face different challenges than usual this year. Despite rising global interest rates that have preceded many emerging-market crises, the current tightening cycle will remain largely on the margin for most emerging economies. This is because major EM central banks were quick to respond to inflation pressures caused by the reopening process and have been raising borrowing costs for almost one year ahead of the Fed’s March decision. Nonetheless, since food and beverage spending makes up an outsize share of the consumer basket across the emerging world, rising commodity prices, while benefiting net commodity exporters in Latin America, Southeast Asia and Africa, will be more than offset by higher inflation and the consequent erosion of consumers’ purchasing power.

Food Carries More Weight for EMs

Consumer price index, weight, food & beverages, %



Sources: Multiple statistical agencies, Moody's Analytics

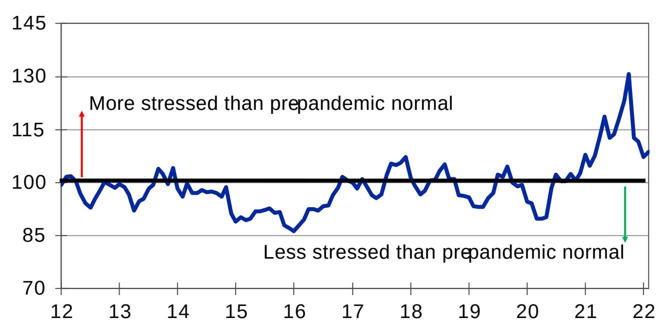
In addition, EM Europe economies that have significant export exposure to Russia and Ukraine such as Turkey, Poland, Czechia and Hungary will be particularly vulnerable to capital outflows stemming from the crisis through at least the first half of 2022.

Global supply-chain stress

The direct disruption to trade in key commodities due to Russia’s military assault on Ukraine has since replaced the Omicron variant as the leading source of supply-chain stress in the West as COVID-19 numbers have come down. However, the continuation of supply-chain disruptions related to virus-related factory and port closures will largely hinge on China’s policy response to its recent surge in Omicron cases.

Stress Dips Before Surge of Cases

China Supply-Chain Stress Index, Oct 2019=100



Sources: Multiple statistical offices, Moody’s Analytics

China so far has instituted short-term lockdowns to quell COVID-19 outbreaks and this policy will not have substantial impact to global supply chains if the lockdowns remain localized. However, it remains to be seen whether ports that are critical to the global logistics network will remain open if the growth in COVID-19 cases in China continues. While the disruption to global auto production caused by the semiconductor shortage likely has peaked, the difficulties of increasing supply or finding alternative sources for chips will keep conditions tight this year.