Banc Ceannais na hÉireann
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Box A: QB 4 – October 2022

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The International Economic Outlook

By the Monetary Policy Division

The Russian war in Ukraine continues to take its toll on global economic activity, with high energy and food prices weighing on households' disposable incomes and on their and business confidence, while supply bottlenecks arising after the pandemic, although slowly fading, are still present. The monetary policy measures taken in most major economies to counter the rise in inflation are also starting to tighten financing conditions and point to further slowdowns in investment and economic activity in the coming years.

The OECD September economic outlook predicts the world economy to significantly slow down in 2022 and 2023 (seeing global GDP growth rates of 3.0% and 2.2%, respectively), and attributes a large part of this slowdown to the Russian war in Ukraine and its effects on world energy and food markets, and the tightening of monetary policy worldwide to counter the global rise in inflation. Compared to forecasts made before the Russian aggression, the OECD sees global GDP to be 2.8 trillion US dollars lower in 2023. The Chinese economy is also experiencing a significant slowdown due to its zero-Covid policy and weaknesses in the property market, weighing down on global activity.

In its July World Economic Outlook, the IMF forecast global GDP growth of 3.2% in 2022 and 2.9%, a significant reduction compared to its previous forecast, mentioning weaker growth in China due to successive lockdowns and the crisis in the property market, lower growth in the US due to deteriorating household purchasing power and tight monetary policy, and the effects of energy price rises particularly in Europe. The further slowdown in 2023 compared to 2022 partly also reflects the dampening effects of tighter monetary policy in a number of economies.

For the euro area, the ECB forecasts GDP growth to reach 3.1% this year, and then to fall to 0.9% in 2023, recovering to 2.3% in 2024. The forecast for 2022 is slightly higher than in the July exercise as growth in the first two quarters of the year surprised upwards, however in 2023 it falls strongly from 2.1% predicted in June. In a downside scenario with a complete cut-off of Russian gas as well as seaborne oil flows into the euro area, with little scope for accessing alternative gas supply sources,

and higher commodity prices and uncertainty, the ECB predicts growth rates of 2.8%, -0.9% and 1.9% in 2022, 2023 and 2024 respectively, thus envisaging the possibility of a recession next year. The inflation forecast for the euro area has been further revised upwards, with ECB staff now expecting inflation to average at 8.1% in 2022, 5.5% in 2023 and 2.3% in 2024. The decline in inflation is seen as a result of energy and food inflation gradually declining over the next two years, while core inflation remains elevated into 2023 and start declining thereafter.

Euro area quarterly GDP rose robustly in the second quarter of 2022 as euro area economies continued to recover from the pandemic shock and entered the quarter with strong growth momentum. GDP rose by a further 0.8 per cent on a quarterly basis, after a 0.7 per cent rise in Q1; compared to the same quarter of 2021, euro area GDP grew by 4.1 per cent in Q2 2022, by which time GDP levels in the euro area were 1.8 per cent higher (in volume terms) than in the fourth quarter of 2019, before the pandemic. After this robust rebound in the first half of the year, the effects of the energy crisis on euro area inflation, terms of trade, and consumer and business confidence are predicted to lead to a substantial slowdown in the second half. The euro area manufacturing Purchasing Managers' Index fell again in August to 49.6 (from 49.8 the previous month), indicating a contraction. The services index also further declined to 48.9 in the same month, while the European Commission indicator of Eurozone consumer confidence fell to -28.8 in September, one of its lowest ever readings.

The labour market remains very strong in the euro area, despite inflationary pressures and the slowing global and euro area economy. The euro area seasonally-adjusted unemployment rate stood at 6.6 per cent in July 2022, down from 6.7 per cent in June and 7.7 per cent in July 2021. It represented a new record low level for the euro area. In Q2 2022, the annual growth rate of employment in persons for the euro area was 2.7 per cent, with a quarterly growth in employed persons of 0.4 per cent compared to Q1 2022. Employment in hours worked increased by 0.6 per cent quarterly and 3.7 per cent annually in Q2 2022.. Job vacancy rates stood at 3.2 per cent in the euro area in Q2 2022, significantly up from 2.3 per cent a year before.

Euro area annual HICP inflation continued to rise in August. It increased to 9.1 per cent, up further from 8.9 per cent in July and 3.0 per cent only a year earlier. The monthly increase in prices stood at 0.6 per cent. While inflation has been driven primarily by energy and food prices, the relative contribution of energy prices to inflation has declined (from 4.19 percentage points in June and 4.02 in July to 3.95 in August), while the contributions of non-energy industrial goods, and services have increased. Underlying inflation (HICP excluding energy, food, alcohol and tobacco) accelerated further to 4.3 per cent (from 4.0 per cent), with monthly inflation at 0.5 per cent. Services inflation rose to 3.8 per cent from per cent in July, with a monthly rate of 0.4 per cent.

In light of developments in inflation in the euro area, at its September 2022 meeting, the ECB Governing Council decided to raise all three key ECB interest rates by 75 basis points; this followed a previous 50 basis point increase in all three rates at the July Governing Council meeting, which had represented the first rate rise in over a decade. This brought the deposit facility rate, the main refinancing operations rate and the rate on the marginal lending facility at a level of, respectively, 0.75, 1.25, and 1.50 per cent. To ensure the return of inflation towards the ECB's 2 per cent target in the medium term, the Governing Council expects to continue rising rates in the near future but has confirmed it will follow a meeting-by-meeting approach to policy decisions. Principal payments from assets purchased under the PEPP and APP programmes continue to be reinvested in full, with PEPP reinvestments being made flexibly to counter risks to monetary policy transmission related to the pandemic.

In the United States, quarterly GDP decreased by 0.1 per cent in the second quarter of 2022, after another 0.4 per cent fall in the first quarter. In annual terms, GDP growth slowed down to +1.7 per cent in Q2 from +3.5 per cent in Q1. The labour market, however, remains strong, with the unemployment rate falling to 3.5 per cent in July from 5.4 per cent a year earlier. US inflation declined to 8.3 per cent in August from 8.5 in July and 9.1 in June. After a number of consecutive and large interest rate rises at previous meetings, in September the Federal Open Market Committee (FOMC) of the US Federal Reserve further increased the target range for the Federal Funds Rate to 3 to 3.25 per cent, an increase of 75 basis points. The FOMC also expects that ongoing increases will be appropriate at future meetings, and is continuing to reduce the size of the Federal Reserve balance sheet.

In the United Kingdom, quarterly GDP declined by 0.1 per cent in the second quarter of 2022 (+2.9 per cent relative to Q2 2021), a significant slowdown from the first quarter, when it had grown by 0.8 per cent in quarterly terms. Between May and July 2022, unemployment stood at 3.6 per cent. Inflation in August declined slightly to 9.9 per cent from 10.1 per cent in July. At its September meeting, the Bank of England's Monetary Policy Committee voted to increase the Bank Rate by a further 50 basis points, to 2.25 per cent, after a similar sized increase at the previous meeting. The Committed decided to reduce the stock of UK Government bonds in its balance sheet by £80bn in the next twelve months. Although the strong monetary policy tightening in the United States by the Federal Reserve relative to other central banks has led to a significant appreciation of the US dollar against most major currencies (including the euro, which is now below parity to the dollar), recent fiscal developments in the United Kingdom have put additional strong downward pressure on the pound sterling, which recently fell to record lows against the dollar. In light of risks to financial stability arising from disorderly conditions in the UK gilt market, on 28th September the Bank of England announced a temporary programme of purchases of long-dated UK government bonds, of up to £5bn per week day from 28th September to 14th October, with a total envelope of £65bn.