Global Economy

THE LOOMING RECESSION FEAR

The threat of a recession looks more real now as major economies, notably US, China, India and EU, sputter amidst a challenging macro environment.

The major economies are heading into a new slump in production, investment, and income in 2023. International agencies such as the International Monetary Fund (IMF), World Bank, and the Organisation for Economic Co-operation and Development (OECD), as well as private forecasters, all agree that global growth will slow significantly this year. The IMF, for example, reckons that global real gross domestic product (GDP) growth in 2023 will be just 2.7% after increasing by 6% in 2021 and 3.2% in 2022. The World Bank is even more pessimistic, with a forecast of 2.3% for 2023. In fact, it even warns that in case there is any "financial-market stress," global GDP growth would crash to 0.5% in 2023—or a 0.4% contraction in per-capita terms that would meet the technical definition of a global recession. The OECD forecasters project an even lower growth rate at a mere 2.2%, while expecting global inflation to average 6.6%. According to the Paris-headquartered organization, "the global economy is facing significant challenges. Growth has lost momentum, high inflation has broadened out across countries and products and is proving persistent. Risks are skewed to the downside."

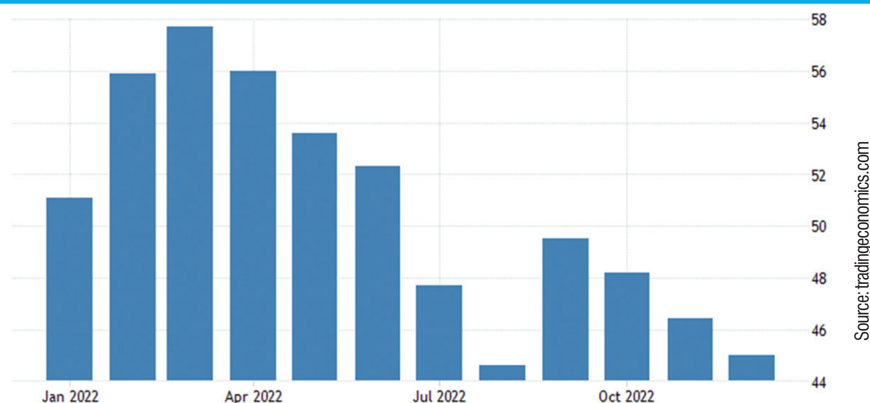
On their part, private sector forecasters paint, in fact, an even gloomier picture. For instance, the Institute for International Finance (IIF), a research body funded by major international financial institutions, forecasts an outright recession. "We forecast a global recession in 2023. Adjusted for base effects, which are likely around +0.3% next year—global growth will be only +1.3%. That's as weak as 2009. Another "Great Recession". And make no mistake, these forecasts also include faster-growing economies like India and China (as well as East Asia). If that's not enough, the prospects for the top G7 economies are even worse. Already, it looks as though the Eurozone (EZ) is in recession, with the European Central Bank (ECB) openly forecasting that EZ output will have contracted in the last quarter of 2022 and will again in Q1 2023. The central bank of the 19-member trading bloc whose common currency is the euro, however, hopes the recession will be "relatively short-lived and shallow."

Even if that were the case—which I doubt—EZ real GDP growth is expected to be 0.5% next year, with annual growth remaining below 2% for the foreseeable future. It's even worse for UK. Preliminary data showed that Britain's economy contracted at the end of 2022. And the Bank of England predicts 2023 will be the beginning of the country's longest recession since records began, lasting well into 2024. Citibank predicts that all major economies will contract next year, albeit at different times and for varying lengths.

China's economy, which has been losing steam for some time, is not likely to recover any time soon and faces prospects of weak growth this year as well. The end of the zero-Covid policy of the government under pressure to revive the economy is leading to a new wave of infections that could damage any economic recovery. Unlike the 2008-09 recession, when the Chinese economy continued to boom and helped the

Michael Robert
Economist
London

The United States Composite PMI



global economic recovery as a result, this time Mainland China will be contributing to the downturn in 2023. But what about the United States? Will the world's most powerful economy be able to avoid a contraction of output, investment, and employment this year? The Federal Reserve is currently forecasting a real GDP growth increase of just 0.5% in 2023. But in December, US business activity was contracting at its fastest rate since the depth of the pandemic in 2020. The US composite PMI, which surveys business activity, fell to 44.6 in December from 46.4 in November; anything below 50 means contraction, and the lower the figure, the faster the fall!

This is a sign that the US economy may not avoid the fate of Europe and many other regions in 2023. Even Fed Chair Jay Powell was not confident that US would avoid a recession in national output. At the December Fed monetary policy press conference, he remarked, "I wouldn't say that a soft landing is no longer achievable ... I don't think anyone knows whether we'll have a recession or not, or if we do, whether it's going to be a deep one or not. It's not knowable."

What is adding to the recessionary environment?

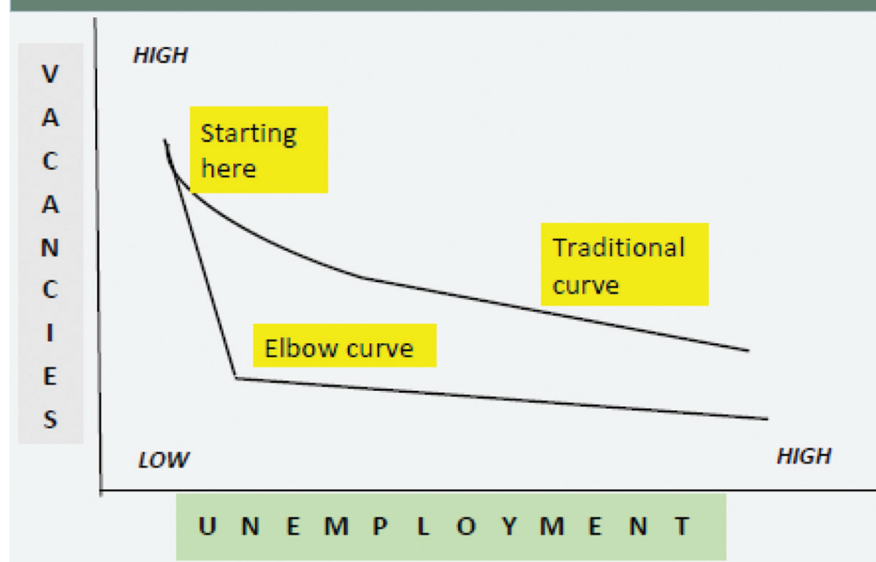
Why are the major economies heading into a new slump only three years after the pandemic slump of 2020? There are several reasons. First, it is the emergence of new levels of inflation in the prices of goods and services in all the major economies after they came out of the lockdowns of 2020 and opened up. Pent-up demand held back during the lockdowns could not be matched by supply, thanks to the broken supply chains, which revealed spillover damage to international trade and transport from the pandemic. This was particularly the case for energy and food production, where prices rocketed. The supply squeeze was then exacerbated by the Russian invasion of Ukraine and the subsequent sanctions on Russian oil and gas exports.

Indeed, economies have suffered permanent 'scarring' from the Covid pandemic, weakening productivity growth to new lows. As US Fed member Lisa Cook points out, "Over the first three quarters of 2022, productivity in the business sector has recorded a disappointing decline of 3¾% at an annual rate. Payroll employment in the private sector has continued to increase, yet GDP has done little more than move sideways, resulting in an outright decline in labor productivity." According to Lael Brainard, the Vice Chair of the Board of Governors of the Federal Reserve, this low productivity, high inflation scenario will continue despite the monetary efforts of the Fed. "It is the relative inelasticity of supply in key sectors that most clearly distinguishes the pandemic- and war-affected period of the past three years from the preceding 30 years of the Great Moderation ... A combination of forces—the deglobalization of supply chains, the higher frequency and severity of climate disruptions, and demographic shifts—could lead to a period of lower supply elasticity and greater inflation volatility," he reckoned.

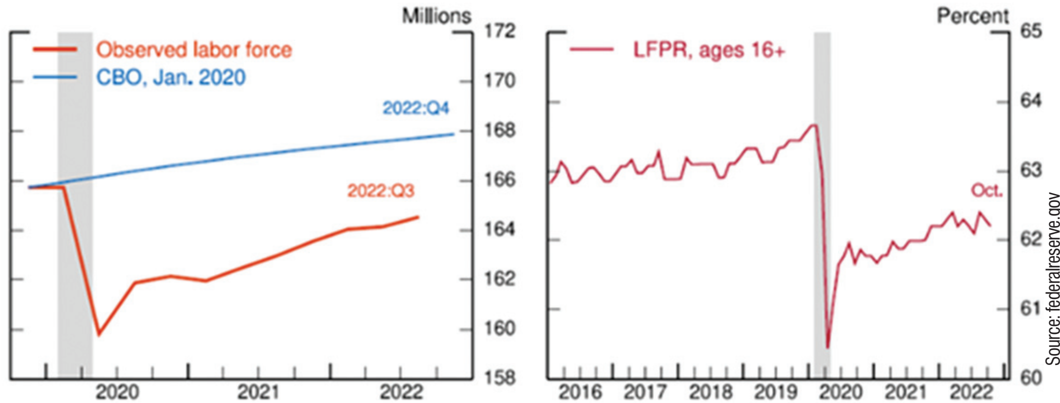
The supply side of the price equation is mainly driving inflation. As Philip Lane of the ECB showed, it is rising non-labor input costs and higher profit markups that have generated accelerating inflation in the food, goods, and services sectors over 2021-2022. "It seems clear that both the energy shock and the pandemic cycle (at both domestic and global levels) have exerted upward pressure on input costs and, in some categories, also facilitated an increase in markups." So there are raw material costs and profit mark-ups.

And what could cause further trouble for the economies, is that global

The Beveridge Curve: Traditional vs. Now



Labor Force Shortfall and Labor Force Participation Rate Gap



Source: federalreserve.gov

corporate profits are heading south for the first time since 2016—in an environment where the cost of borrowing is rising fast (mortgage rates, bond yields, loan charges, etc.). As economies enter 2023, this will slow investment and result in layoffs. It is another factor in the recipe for a slump in 2023.

The curious case of Beveridge curve

Two reports by regional Federal Reserve banks suggest a recession is coming. According to the St. Louis Fed, more than half of the 50 US states are exhibiting signs of slowing economic activity, breaching a key threshold that often signals a recession is in the offing: if 26 states have falling activity within their borders, that offers enough hint that the nation, as a whole, stares at what looks to be an impending recession. But as per the San Francisco Fed, which argues that the jobless unemployment rate is a reliable predictor of recessions, it almost always shows a turning point shortly before recessions but not at other times. Its success in predicting recessions is on par with the better-known slope of the yield curve, but at a shorter horizon. Hence, it performs better for predicting recessions in the near-term and says that currently this data and related series analyzed using the same method are not signaling that a recession is imminent, although that may change in the coming months.

Much is made of the US labor market still being very tight, thus justifying the forecast of no US recession and also the continued hikes in interest rates by the Fed to control inflation. For example, IMF Deputy Managing Director Indian-American Gita Gopinath, a former financial adviser to Kerala's Chief Minister and recipient of Indian President's Pravasi Bharatiya Samman, believes that US inflation has yet to "turn the corner," despite the Federal Reserve's historic monetary policy tightening campaign. Gopinath urged the US central bank to press ahead with rate rises this year despite a recent moderation in headline inflation. The reason is, according to her, "if you see the indicators in the labor market and if you look at very sticky components of inflation like services inflation, I think it's clear that we haven't turned the corner yet on inflation." She added that the fund's advice to the Fed was to "stay the course." Chief among Gopinath's concerns for the US economy, she said, is the continued resilience of the labor market, which on average is adding roughly 400,000 jobs each month.

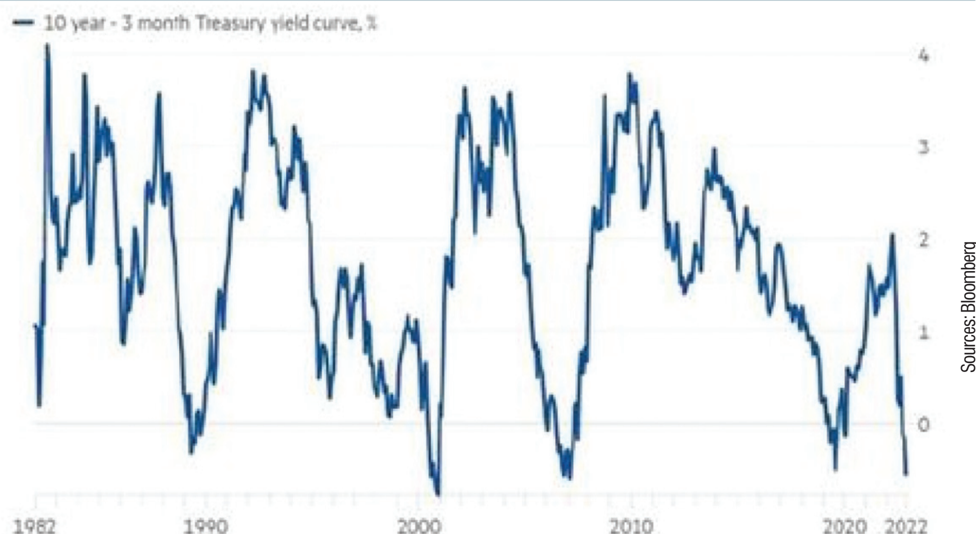
Last July, Federal Reserve officials Andrew Figura and Chris Waller argued that a 'soft landing' was likely for US because even if job vacancies fell over time, it would not lead to a significant rise in unemployment. That would mean a radical break with what is called the Beveridge curve, where there is a statistical trade-off between job openings and unemployment. The 'curve' would 'dog-leg' this time, keeping unemployment low. "We find that a soft landing is a plausible outcome for the labor market going forward." Wikipedia defines the Beveridge curve, or UV curve, as a graphical representation of the relationship between unemployment and the job vacancy rate, the number of unfilled jobs expressed as a proportion of the labor force. Named after William Beveridge, it typically has vacancies on the vertical axis and unemployment on the horizontal. The curve, is hyperbolic-shaped and slopes downward, as a higher rate of unemployment normally occurs with a lower rate of vacancies.

But is it true that there is a tight labor market and it will stay tight? The latest headline employment figures for US suggest so, as net new jobs in November were much higher than forecast. But the rate of monthly job gains has been falling since April. And Fed Chair Powell had to admit in a recent speech that employment was still millions below its level on the eve of the pandemic. "Looking back, we can see that a significant and persistent labor supply shortfall opened up during the pandemic—a shortfall that appears unlikely to fully close any time soon."

Comparing the current labor force with the Congressional Budget Office's pre-pandemic forecast of labor force growth reveals a shortfall of roughly 3.5 million Americans.

So it's not so much a 'tight' labor market caused by strong demand for labor but instead caused by a large number of working-age people not returning to the 'labor market.' Some of the 'participation gap' reflects workers who are still out of the labor force because they are sick with Covid-19 or continue to suffer lingering symptoms from previous covid infections ("long Covid"). However, recent research by Fed economists found that the participation gap is now primarily due to excess retirements, i.e., retirements that exceed what would have been expected

Trend in US Yield Curve



based solely on population ageing. These excess retirements account for more than 2 million of the 3.5 million shortfall.

Moreover, there is a weird discrepancy between US monthly job increases measured by the so-called establishment survey and the household survey, the latter asking people if they have a job or not. According to the establishment survey, there has been an increase of 2.7 million jobs since last March, but according to the household survey, the increase is just 12,000! Something is wrong here.

And when we look at other employment surveys, like the ADP measure of private sector employment, we find that there was a fall of 100k jobs in manufacturing and construction in November, while the official establishment survey claims an increase of 35k. But there is a catch: the new jobs are mostly part-time. Since last March US has lost 398k full-time employees, offset by a modest gain of 190k part-time employees, while a whopping 291k workers were forced to get more than one job over the same period. So there has been no change in the number of people employed in the past eight months, but due to the deterioration in the economy, more people are losing their full-time higher-paying, jobs and being forced into much lower-paying work.

Then there is the monetary policy of central banks. The reaction of central banks has been to hike interest rates sharply in an attempt to 'fight inflation.' However, this has only exacerbated the impact on the supply side of economies. As Powell admitted in a recent speech, "Slowing demand growth should allow supply to catch up with demand and restore the balance that will yield stable prices over time, (but) restoring that balance is likely to require a sustained period of below-trend growth." The words "below trend" hint at the recession and rising unemployment.

Hiking interest rates adds to the recipe for recession. And this is revealed by one of the most reliable indicators of an oncoming recession: the so-called inverted bond yield curve. That's where the rate of interest on long-term bonds (ten years) falls below the rate of interest on short-term loans (3 months or 2 years). That should not happen if an economy is growing 'normally'. Then the interest charged on long-term bonds would be higher because you get the loan for a longer time. The yield curve inverts only when central banks raise short-term interest rates and investors rush to buy long-term bonds because they fear a recession is coming. Right now, the US yield curve remains strongly inverted and has been for some time. Without fail, the inverted yield curve has foretold an ensuing slump about 12 months later or so.

According to IMF Managing Director, Kristalina Georgieva, one-third of the global economy will be hit by recession this year. US, EU, and China are all slowing simultaneously. For the first time in 40 years, China's annual growth is likely to be at or below global growth, Georgieva said, meaning it could drag down worldwide economic activity rather than propel it.

"That has never happened before." She observed that US "may avoid a recession" because its unemployment is so low," adding, "If that resilience ... holds (in 2023), US would help the world to get through a very difficult year."

"The US economy is remarkably resilient." But Gopinath reckons there is a "very narrow path" for US to avoid a recession this year. Indeed, in late January, the IMF will probably lower its economic forecast for 2023 yet again.

However, other forecasters appear to be less optimistic about the US economy this year than IMF. According to Capital Economics, a private forecaster, there is a 90% chance that the US will enter a recession within the next six months. "While the US recession is likely to be mild, the EZ will suffer a larger downturn due to the huge hit to its terms of trade caused by the Ukraine war."

According to Michael Gapen, Bank of America's Chief Economist, the risk of a US recession was "high," but any recession "may not be a deep and prolonged one."

To summarize, most major economies are likely to enter a recession this year, albeit with varying degrees of depth and duration, only three years after recovering from the worst slump since the pandemic. ■

Reference # 20M-2023-02-09-01