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Economic prospects call for high inflation and slowing global growth

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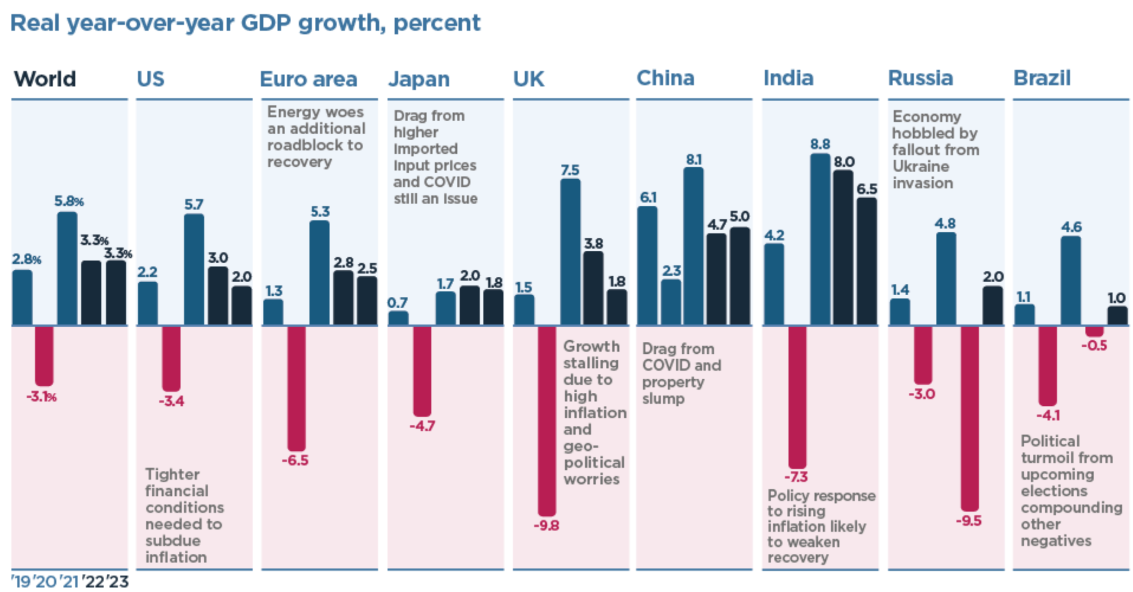
REUTERS/Andrew Kelly

Inflation has climbed sharply in most economies since the middle of 2021, increasing the imperative to remove monetary support faster than previously expected. This monetary policy shift is important among the factors that will moderate economic growth this year in most countries. Global economic growth is projected to decline from a brisk 5.8 percent in 2021 to 3.3 percent in both 2022 and 2023. In addition to monetary policy tightening, episodes of resurging COVID-19 and disruptions from the war in Ukraine —including higher prices for energy, food, and other commodities—are weighing on the outlook for countries around the world.

In 2021, US economic growth more than reversed the pandemic contraction the previous year, as seen in figure 1. Other large advanced economies also rebounded to varying extents but did not fully make up for their pandemic losses. Despite the scope for further rebound in some countries, all the large advanced economies are projected to grow only moderately in 2022 and to weaken further in 2023.

Figure 1

Growth slows across the global economy after a year of recovery



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Note: Purchasing power parity weights used to calculate global GDP. Data refer to annual-average-over-annual-average growth rates.

Sources: Consensus forecasts for 2019-2021; PIIE forecasts for 2022-2023.

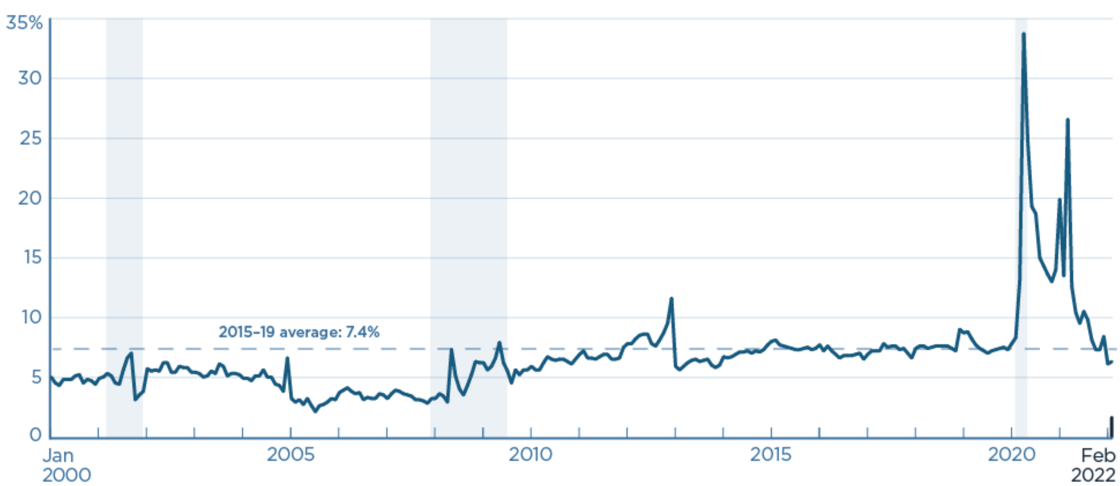
The outlook for large emerging economies is more divergent. India's economy is projected to have the strongest performance over the next two years, with ongoing (albeit slower) recovery from its particularly large contraction during the pandemic. China has been grappling with severe COVID-19-related shutdowns and is experiencing a major downturn in its property sector that will weigh on growth into next year. Meanwhile, the Brazilian recovery is being dampened by political turmoil related to upcoming elections, and the Russian economy is hobbled by economic repercussions from its invasion of Ukraine and sanctions imposed in response.

The US economic outlook is much less robust than was expected last fall. US GDP growth in 2021 pushed the economy beyond its productive capacity, and inflation reached its highest level since the early 1980s. Although waning fiscal stimulus is now a drag on growth, consumers have significant pent-up demand in some categories and plenty of accumulated savings to finance spending, as seen in figure 2. Against this backdrop, the labor market remains very tight, with job growth showing no sign yet of slowing down, a low unemployment rate, and a rate of job openings per unemployed worker that is 50 percent higher than in the robust economy of the late 2010s as seen in figure 3.

Figure 2

Consumers have plenty of built up savings to finance pent up demand

Monthly share of disposable personal income



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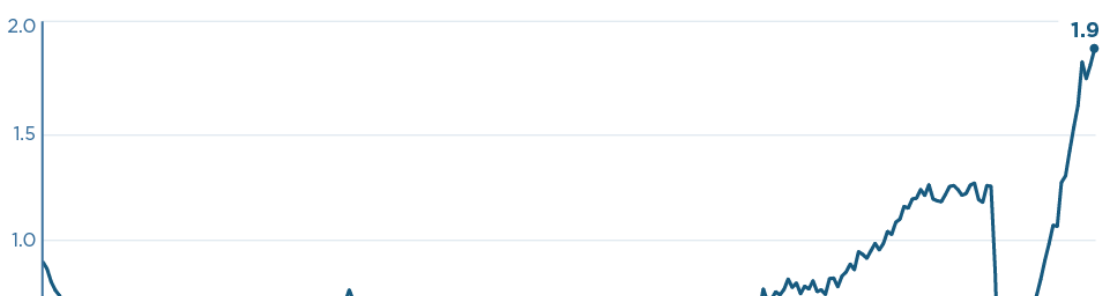
Note: Shaded areas denote recessions.

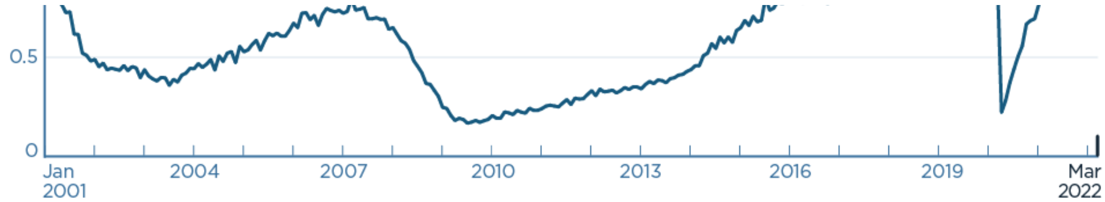
Sources: US Bureau of Economic Analysis via FRED and author's calculations.

Figure 3

Job openings have soared as the economy recovers from the pandemic and vastly outnumber unemployed workers

Number of job openings per unemployed worker





Note: Job openings for March 2022 are estimated based on Indeed Hiring Lab job postings.

Sources: Bureau of Labor Statistics via Macrobond, Indeed Hiring Lab, and authors' calculations.

Underlying demand in the US economy will need to be restrained by a tightening of financial conditions for inflation to moderate substantially. For this to happen, the Federal Reserve will need to remove monetary accommodation by significantly raising the federal funds rate and reducing the size of its balance sheet.

The pace at which the Fed tightens will depend on the evolution of inflation. Gradual increases in labor supply as people continue to return to the labor force should increase slack a bit and reduce inflationary pressures. The supply chain problems that caused demand to acutely outstrip supply in some categories appear to have slightly abated, but the jump in oil prices this year represents a new inflationary supply shock. The limited rise of long-term inflation expectations may temper the increases driven by businesses setting prices and workers negotiating wages. However, both businesses and workers are probably also looking backward to the strikingly high inflation of last year when making their decisions. While it is difficult to know how these forces will add up over the rest of 2022 and 2023, the lack of a material moderation in incoming inflation data so far suggests that high inflation will persist without significant Federal Reserve action.

In the absence of a material tightening of financial conditions from exogenous forces, the Fed will need to raise interest rates aggressively to subdue inflation in the next couple of years.

Accordingly, the federal funds rate is likely to rise to more than 4 percent by 2023. This policy change should reduce underlying demand and contribute to some labor market cooling. Importantly, the Federal Reserve should signal that it is seriously committed to bringing inflation back to its target, which will help prevent long-term inflation expectations from becoming unanchored and thereby curb price increases. With this policy change in place, worker shortages are projected to diminish and the unemployment rate is forecast to rise to 4.5 percent, about ½ percentage point above its natural rate. Core personal consumption expenditure (PCE) inflation is projected to moderate from a pace of 4.6 percent over the four quarters of 2021 to 4.1 percent in 2022 and then fall further to 3 percent in 2023.

While this "soft landing" scenario is the baseline forecast, we cannot count on it. Uncertainty is higher than usual and recession risks are elevated given geopolitical developments and the possibility that inflation may continue to surprise to the upside. An even more abrupt tightening of monetary policy that causes asset prices to fall sharply and consumers to pull back, perhaps combined with a greater slowdown in China than currently expected, could push the economy into recession by the end of this year.