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JULY 14, 2023
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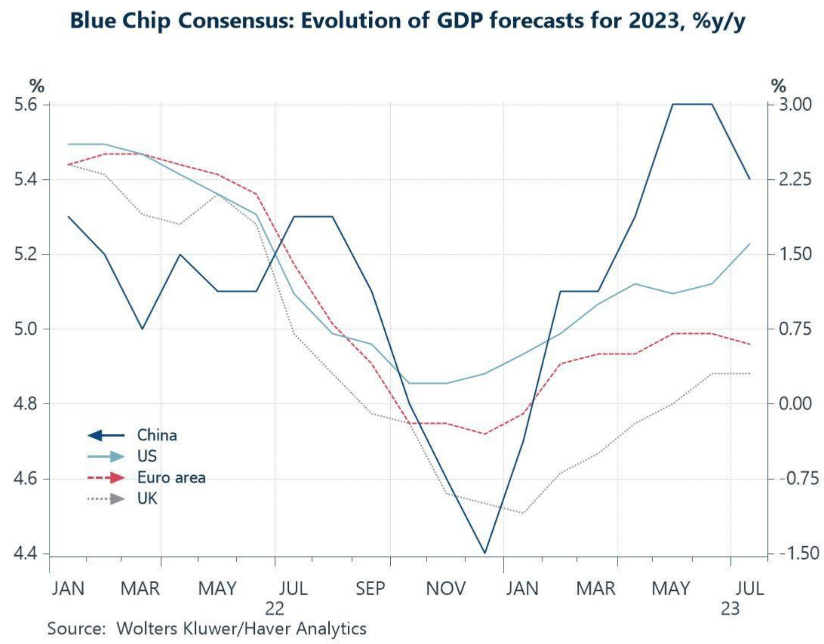
Summary

Incoming economic data that concern inflation and labour market activity have continued to dominate the financial headlines over the past few days with Wednesday's weaker-than-expected US CPI report a notable highlight. And this, coupled with evidence suggesting that labour markets may be cooling down, has driven soft landing scenarios into the ascendancy once again. In our charts this week we illustrate how the Blue Chip consensus for GDP growth and inflation in 2023 for some of the world's major economies appears to have decoupled from global influences in recent months (charts 1 and 2). Domestic drivers of the economic cycle, in other words, are taking on more importance compared with global drivers, such as energy prices (chart 3). Our second chart additionally suggests that UK inflation is unexpectedly high relative to global norms but, as suggested above, there was some helpful evidence of a slowdown in the labour market in this week's batch of economic data (chart 4). Calibrating monetary policy at present, however, remains hazardous, not least given acute uncertainties about prospective demand and supply patterns. Latest estimates from the New York Fed suggest the final destination for short-term interest rates is little different to where it used to be (chart 5). The same analysis, however, equally suggests that this destination could still be a long way off and with the road in between somewhat rocky and hazardous to say the very least (chart 6).

The Blue Chip growth consensus for 2023

Domestic factors are taking over from global factors as principal drivers of GDP growth in the world's major economies. This is one of the messages from the latest Blue Chip survey of economic forecasters. For example, although the outlook for the US economy in 2023 has been revised up over the past two months, GDP forecasts for China and the euro area have been revised down. This decoupling contrasts with the last 18 months or so, when forecast revisions to the outlook for 2023 were far more synchronized in both an upwards and downwards direction (see chart 1 below).

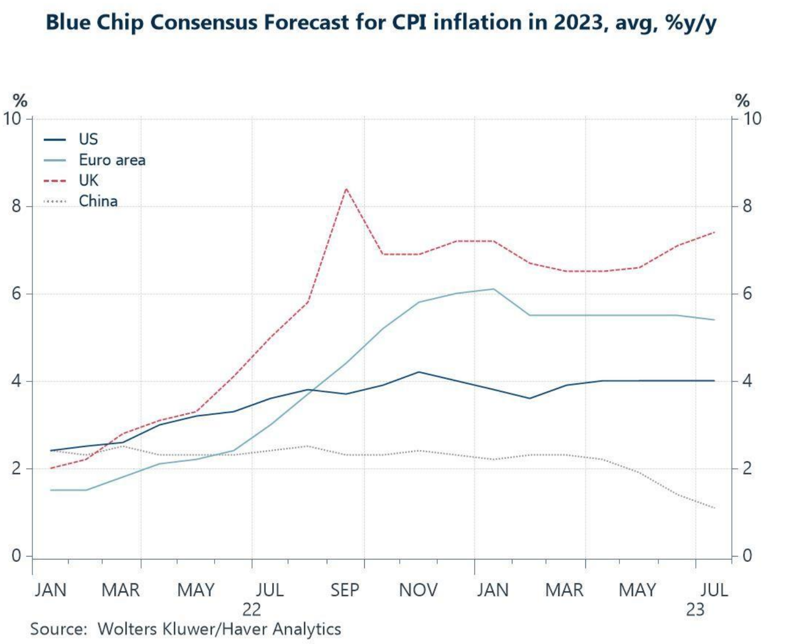
Chart 1: The evolution of the Blue Chip consensus for GDP growth in 2023



The Blue Chip inflation consensus for 2023

This decoupling applies to the inflation outlook in 2023 as well. The Blue Chip consensus for CPI inflation in China, for example, has been lowered quite sharply over the last few months. That contrasts with some stability in the inflation outlook for the US and the euro area. It contrasts even more starkly, however, with the large upward revisions that have been made to inflation forecasts for the UK (see chart 2 below).

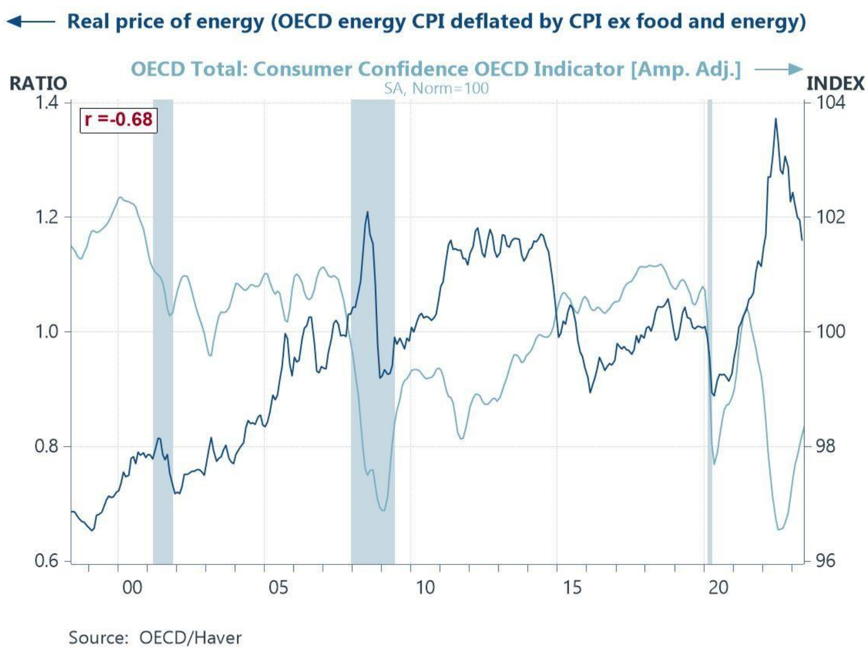
Chart 2: The evolution of the Blue Chip consensus for CPI inflation in 2023



Energy prices and consumer confidence

One of the key reasons for these fading global drivers of the economic outlook concerns energy prices. Negative supply shocks from the COVID pandemic and the war in Ukraine coupled with looser policy settings spawned big imbalances in key commodity markets in recent years, and most notably in the energy sector. The ripple effects from these imbalances for energy prices, broader inflation rates and for consumer confidence were profound (see chart 3 below). As these imbalances have unwound, however, these ripple effects have diminished leaving domestic growth and inflation drivers to now move into the ascendancy.

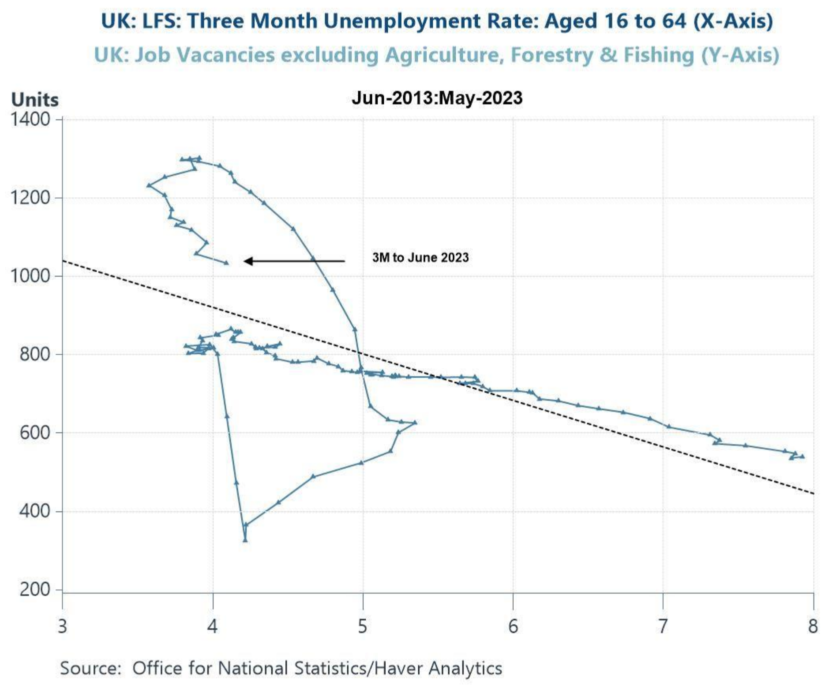
Chart 3: Real energy prices in the OECD versus consumer confidence



The UK labour market

Notwithstanding a more troublesome inflation outlook for the UK, this week's data offered welcome evidence of some loosening in the labour market. The unemployment rate rose from 3.8% to 4.0% in the three months to May, for example. In addition to this, vacancies continued to fall. That means that the vacancies to unemployment ratio – a good gauge of labour market dysfunction - has continued to normalise. This can be further illustrated via the Beveridge curve analysis shown in chart 4 below

Chart 4: The UK Beveridge curve



Estimates of trend GDP growth

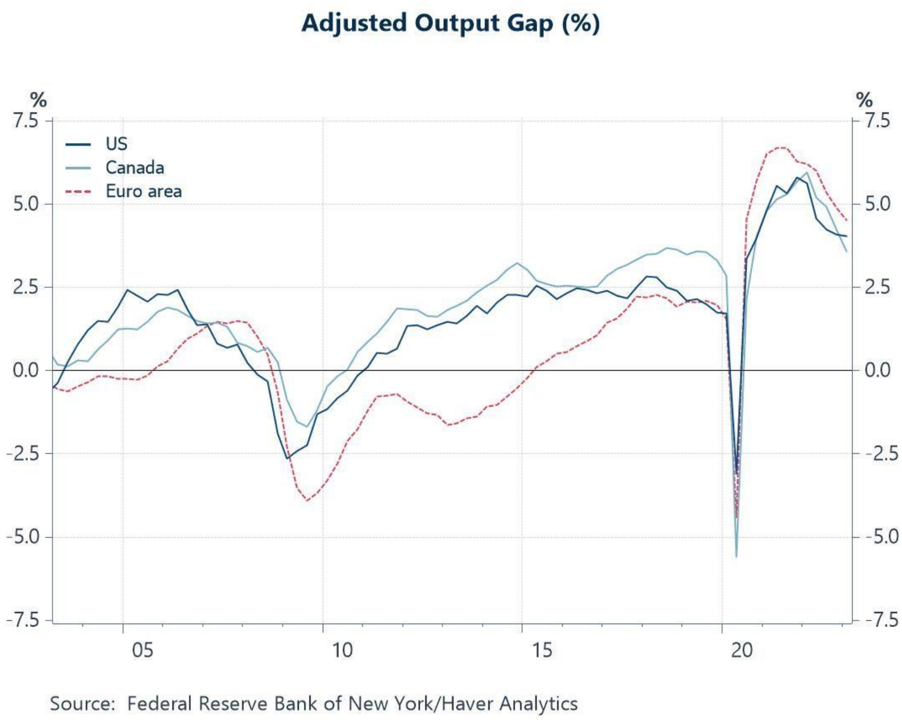
Key considerations – and uncertainties - for the calibration of monetary policy concern estimates of an economy's potential GDP growth and r-star (the real short-term interest rate that's expected to prevail when an economy is at full employment and inflation is stable). Some recently updated/resumed analysis from the Federal Reserve Bank of New York (FRBNY) sheds some light on this (see: [Measuring the Natural Rate of Interest, FRBNY](#)). A simple weighted aggregation of the FRBNY's estimates for the US, euro area and Canada imply that there has been little-change in r-star in those economies in recent years. Indeed, latest estimates for Q1 2023 specifically suggest a weighted average level of around 0.7%, which is more or less in line with where it stood prior to the COVID pandemic (see chart 5 below).

Chart 5: Estimates of trend GDP growth and r-star in the US, Euro area and Canada

Output gap estimates

This does not mean, however, that central banks can relax. Calibrating monetary policy also requires assessing an economy's underlying supply and demand imbalances and how these square with current inflation and central banks' target levels. And at present, the FRBNY's output gap estimates – which quantify that mismatch between demand and supply – suggest inflation could continue to climb in the period ahead (see chart 6 below). Putting that another way, a prolonged period of restrictive monetary policy may be required in order to keep economic growth below potential and, in doing so, close output gaps and quell inflationary pressures.

Chart 6: Output gap estimates for the US, euro area and Canada



ABOUT THE AUTHOR

Haver Analytics is pleased to bring Andrew Cates's commentaries on the state of the global economy to its clients.

Andy Cates has more than 25 years of experience forecasting the global economic outlook and in assessing the implications for policy settings and financial markets. He has held various senior positions in London in a number of Investment Banks including as Head of Developed Markets Economics at Nomura and as Chief Eurozone Economist at RBS. These followed a spell of 21 years as Senior International Economist at UBS, 5 of which were spent in Singapore. Prior to his time in financial services Andy was a UK economist at HM Treasury in London holding positions in the domestic forecasting and macroeconomic modelling units.

He has a BA in Economics from the University of York and an MSc in Economics and Econometrics from the University of Southampton.