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Twelve Themes for the Year Ahead

Summary

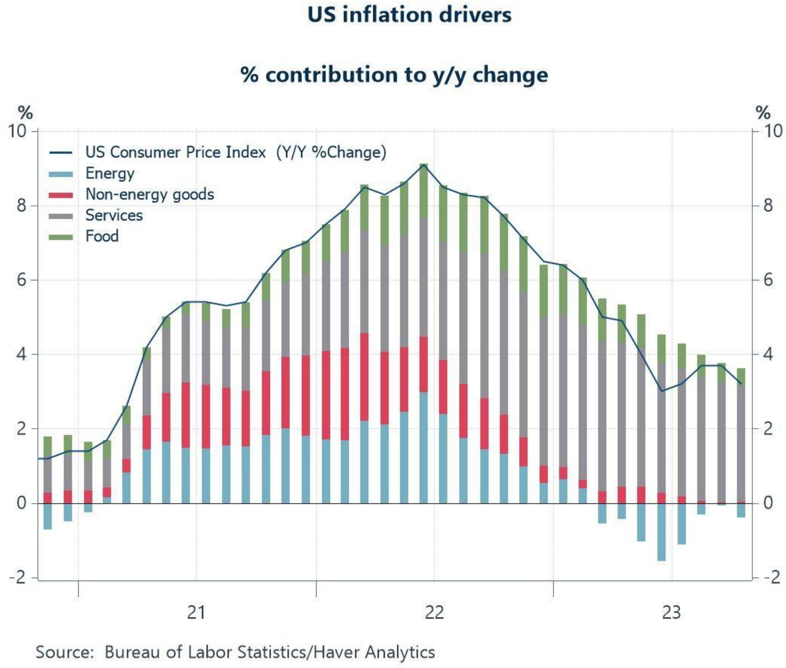
In our final Charts of the Week publication for 2023, we turn our attention to 2024, and highlight twelve themes that are poised to influence the economic and financial market landscape in the year ahead. These include several cyclical themes that concern, for instance, inflation, monetary and fiscal policy settings (see charts 1 to 4). The outlook for China's economy and India's economy could also remain significant (charts 5 and 6). We then turn our gaze to more structural matters such as the advance of AI (chart 7) and ageing demographics (chart 8). Politics, however, will also be critical next year with more than half of the world's population destined to vote in elections, including of course the US (chart 9). The latter, in turn, though could have profound implications for trade (chart 10) and geopolitical stability (chart 11). Our final theme is climate change and the energy transition which will also never remain too far from the headlines (chart 12).

Global Disinflation

A cyclical theme that's been in vogue now for several months is disinflation. Headline inflation rates have been declining in most major advanced economies over the past 12 months. And surveys of economic forecasters suggest that trend should persist in 2024. Looking at the drivers of that decline in the US suggest that much of this disinflation can be traced to weaker energy prices (see chart 1) and, to a lesser extent, to slower goods price inflation, including food. Service sector inflation, in contrast, has remained quite sticky (in the US as well as elsewhere).

This, in turn, has left policymakers concerned about still-tight labour markets. That being said, evidence is also now emerging that suggests labour market activity may have started to weaken. In the US, for example, job openings have declined sharply, continuing claims have been trending higher, and payroll growth has slowed. If that slowdown persists and spills into weaker wage inflation that will likely further fuel speculation that the Fed could begin an easing cycle in the early half of next year.

Chart 1: US inflation drivers

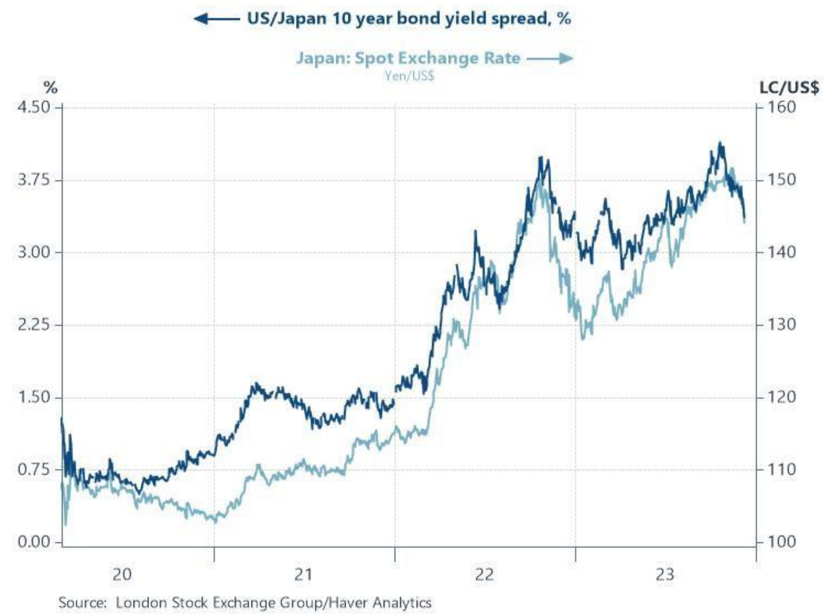


Normalisation in Japan?

While easing cycles are anticipated in a broad range of advanced economies in 2024, that's not the case for Japan. Above-target inflation coupled with recent tweaks to its yield curve control policy have been fuelling speculation instead about when the BoJ might now start lifting interest rates and thus commence a normalization of its monetary policy. However, there is still much uncertainty about the timing of this, in part because the economy has recently been floundering. Latest GDP data, for example, revealed a much bigger contraction in the economy than had been expected in Q3, and specifically a decline of 0.5% q/q.

Still, if the BoJ does lift interest rates next year it could generate big spillovers for global financial markets. For example, Japanese investors, who have been seeking higher yields abroad due to low domestic interest rates, could repatriate their funds, affecting both global bond markets and the value of the yen.

Chart 2: Japan's 10-year JGB yield and the USD/JPY exchange rate

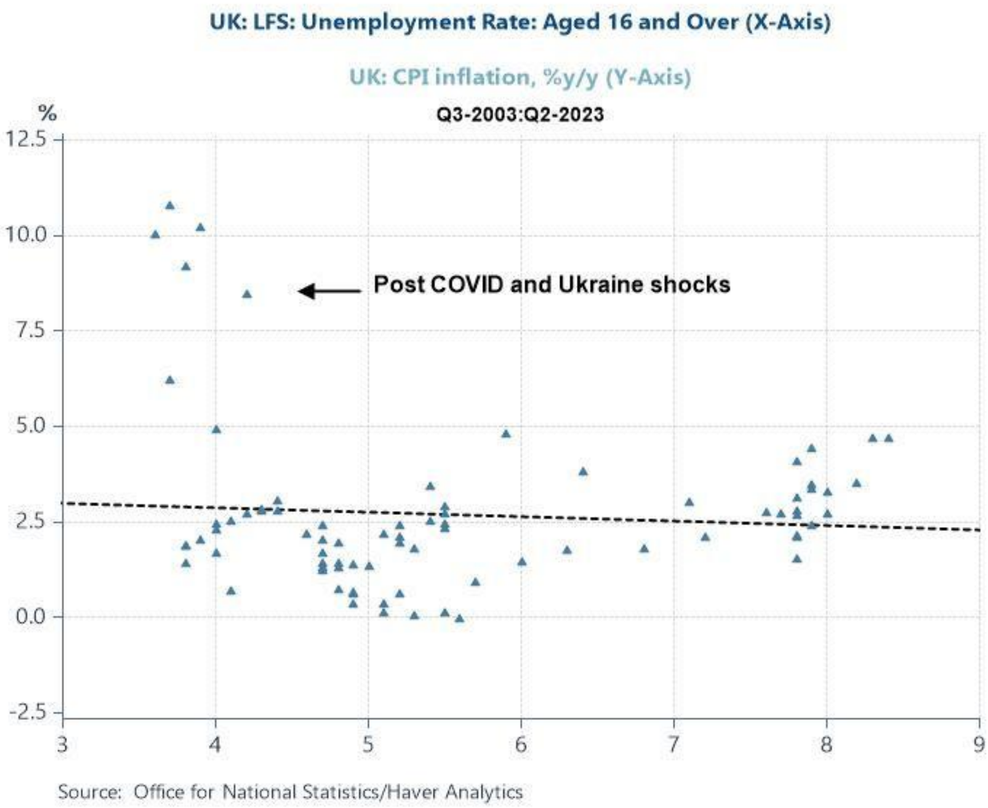


The Potency of Monetary Policy

Another theme that could circulate next year concerns the potency of monetary policy. As discussed above, the trend toward disinflation that has engulfed most major economies over the past 12 months has been largely driven by falling energy prices and weaker goods price inflation. The latter can be largely traced to the repair of global supply chains that had previously been choked by the COVID pandemic and the subsequent war in Ukraine. However, the impact of tighter monetary policy on this disinflationary trend is more debatable, especially given the hitherto tightness of labour markets in the US and Europe.

The relationship between unemployment and inflation, known as the Phillips curve, has been a subject of intense scrutiny even before the pandemic. This debate has intensified in the post-pandemic era, as we have witnessed fluctuations in inflation rates amidst consistently low unemployment rates (see chart 3 below for the UK). There are several caveats, such as monetary policy's outsized influence on asset prices compared with consumer prices as well as the role of balance sheet policies (e.g. quantitative easing) compared with interest rate settings. Fiscal policy implementation (see below) and the influence of global supply side shifts (e.g. globalisation) have further complicated the picture. Nevertheless the debate about the role of monetary policy could intensify in the coming months and potentially pose a challenge to central bank policy credibility as well.

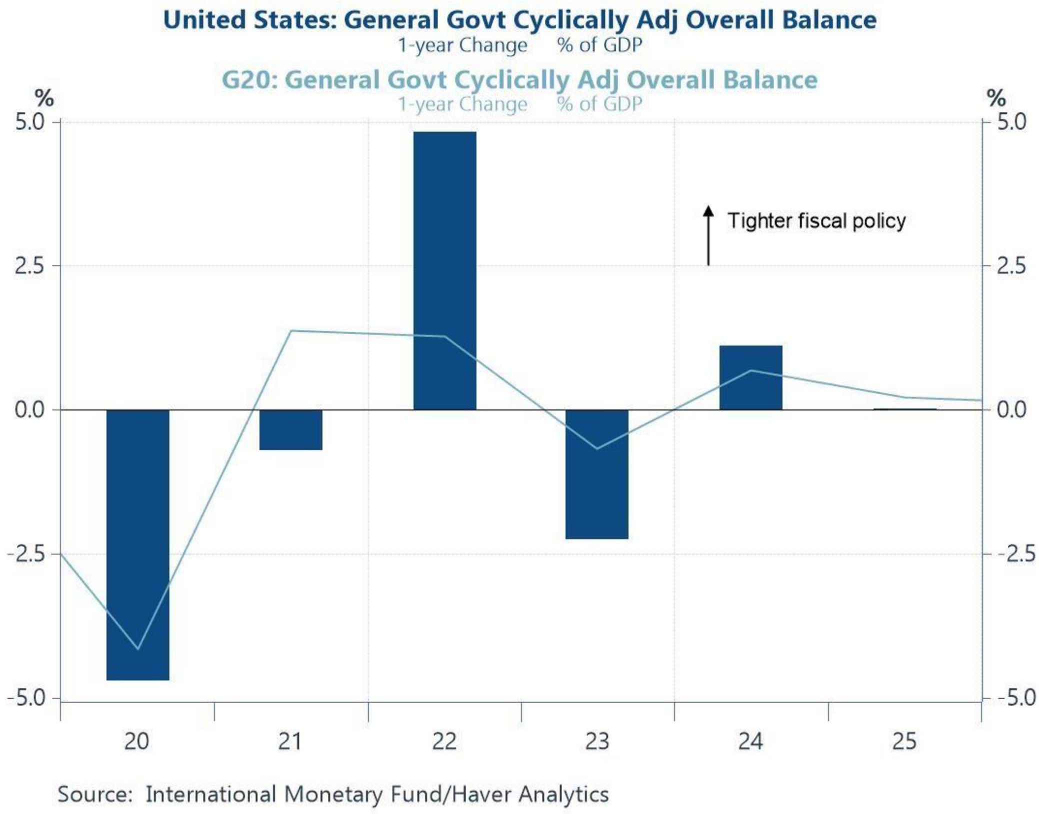
Chart 3: UK unemployment versus CPI inflation (a Phillips curve relationship)



Tighter Fiscal Policies

One contributing factor to the relatively robust performance of the US economy – as well as the relative impotency of monetary policy - compared to other major economies, could concern fiscal policy. As indicated by the IMF's estimates for the cyclically-adjusted budget balance in 2023, shown in chart 4 below, the US adopted a significantly looser fiscal policy than most other major advanced and emerging economies, many of which tightened their fiscal policies. However, this dynamic is expected to shift in 2024. According to IMF projections, US fiscal policy is likely to become considerably more restrictive. This shift is notable both in absolute terms and relative to other major economies. The implications of a tighter fiscal policy for the US economy are significant. It could potentially accelerate a shift towards more accommodative monetary policy, with impacts on financial markets, including a potential further weakening of the US dollar.

Chart 4: IMF estimates of the thrust from fiscal policy in the US and broader G20 economies



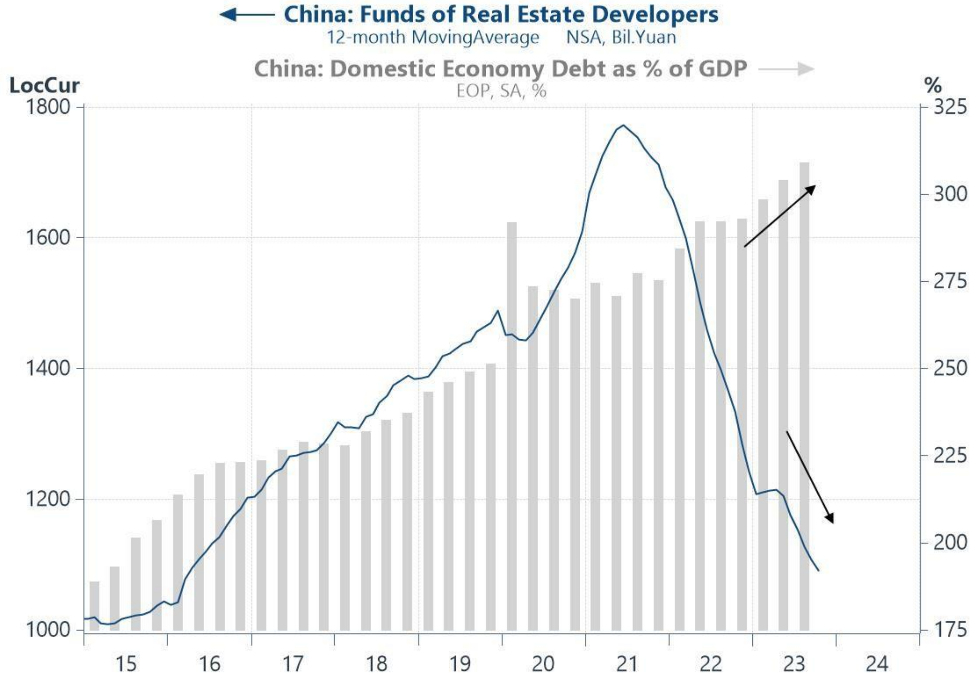
The China Brake

China’s economy will likely draw continued scrutiny going into 2024, as pockets of vulnerability look set to persist. Questions relate to China’s sources of growth for the coming year, as favourable pandemic-era base effects dissipate. Additional challenges concern China ability to achieve its new growth targets while facing continued property sector drags, and as indebtedness levels continue to rise.

For one, China’s property sector looks set to be an enduring investor concern, with the risk of additional defaults still running high amid ongoing liquidity woes. Specifically, developers will have to continue grappling with upcoming debt payments even as available funds dwindle further (see chart 5). All eyes are on what the authorities may choose to enact next to stem the fallout in a sector that was once a key growth driver of the Chinese - and broader world - economy.

In addition to the property sector, another key focus for investors as we enter 2024 will be China's escalating debt levels. By the third quarter of 2023, China's domestic debt had risen to approximately 309% of GDP. This increase was driven in part by household debt, which reached 63%, and nonfinancial corporate debt, which climbed to 149%. There has been a notable rise in concerns over default risks, especially among individuals, highlighted by a surge in the number of people blacklisted due to missed payments. Concerns also extend to local government debt, particularly off-balance sheet debts, which, according to IMF estimates, amounted to about RMB 66 trillion (around $9 trillion) in 2022. While China is likely to persist in stimulating growth through debt-financed local government projects, the growing pressure of debt sustainability issues might soon necessitate addressing these challenges, especially as investor perceptions evolve.

Chart 5: China’s domestic debt and funds available to property developers

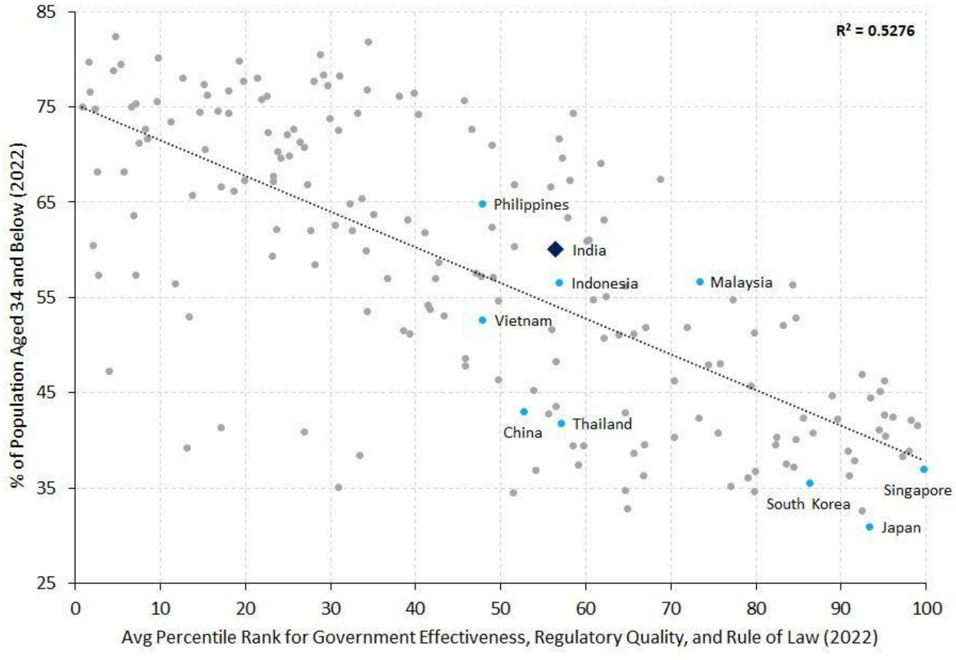


Sources: CNBS, CNBS/H/Haver

India's Promise

Some investors will likely continue looking favourably upon India as we head into 2024, given its relative structural advantages. Over recent years, India has implemented numerous reforms aimed at enhancing its business environment's appeal. A key advantage is its youthful population, with over 60% under the age of 34, positioning the country as an attractive investment hub (see chart 6). This demographic advantage, coupled with ongoing reforms, has made India an appealing destination for foreign investment. In fact, foreign investors have significantly increased their investments in Indian assets recently, seeking to capitalize on the country's economic potential. To date, they have purchased a net cumulative of $21 billion in portfolio assets this year, with equity and debt inflows amounting to $15 billion and $6 billion, respectively.

Chart 6: Various economies' proportion of young vs. governance metrics



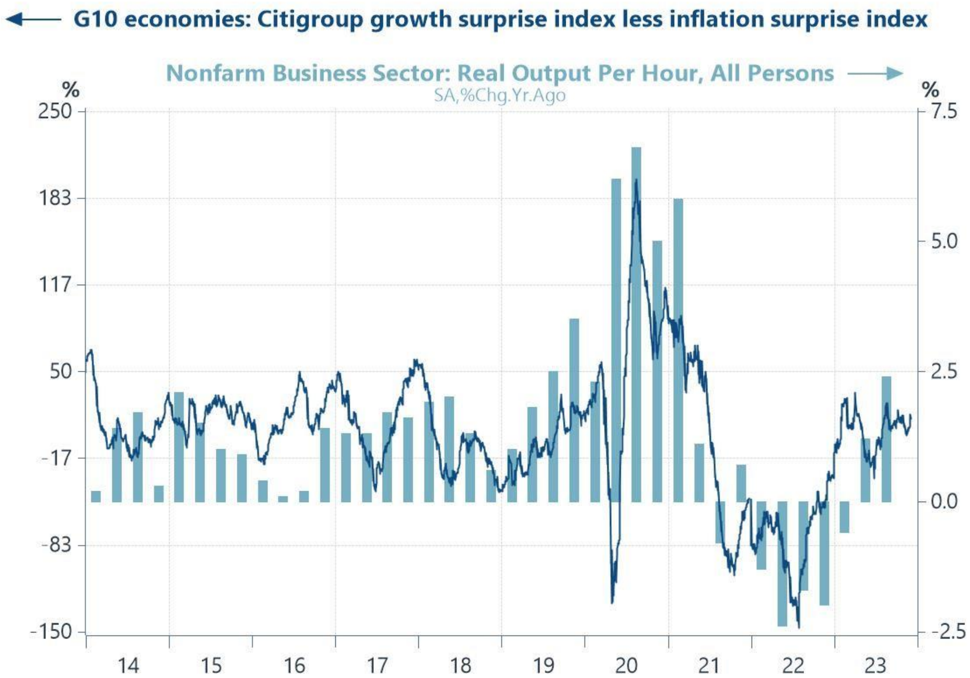
Sources: World Bank, NGRI, Brookings/Haver Analytics

The Advance of AI

Shifting focus, the progress of Artificial Intelligence (AI) is expected to continue drawing significant attention in 2024. A prevalent question in macroeconomic discussions, which remains largely unanswered, revolves around AI's potential to enhance productivity growth. AI holds considerable promise in this regard. For example, when we consulted ChatGPT about how AI could foster productivity, it detailed various efficiencies that could be achievable through the automation of mundane tasks, data analysis, predictive maintenance, customer service, healthcare diagnostics, supply chain optimization, energy efficiency, and notably, research—the very point we aim to illustrate. However, quantifying these potential benefits and their diffusion through the economy presents a greater challenge.

It may be interesting to note, however, that US productivity has picked up pace over the past year. Additionally, high-frequency data on economic growth, especially in the US, have shown surprising resilience in recent months. Correspondingly, and in line with the earlier discussion, it's also notable that inflation outcomes have been unexpectedly low. And this is notable because if the trend in productivity growth is indeed increasing, it might manifest as positive growth surprises coupled with negative inflation surprises.

Chart 7: US productivity growth versus G10 growth and inflation surprises

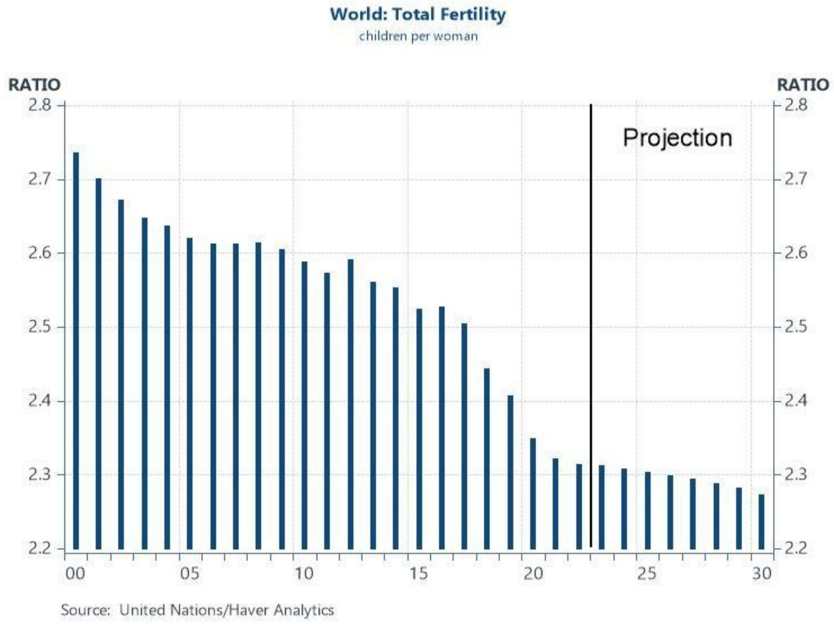


Source: Bureau of Labor Statistics/Haver Analytics

Demographic Change

Another structural theme is the demographic shift towards an aging population, a trend that is likely to continue influencing the year ahead. This shift has been gaining momentum in many economies, driven partly by increased longevity and, more notably, by declining fertility rates. Indeed the latter has accelerated recently, contributing significantly to ageing demographics (see chart 8 below). For instance, China witnessed a record low in births, falling below 10 million in 2022, a 10% decrease from the previous year. Assessing the long-term economic impact of this trend is challenging, as much depends on respective policy responses. However, it is clear that declining fertility rates could shrink the potential workforce, potentially leading to higher wage inflation unless mitigated by immigration. This brings us to a pivotal challenge and a key topic for the upcoming year. As discussed below, many countries facing elections next year have seen immigration become a highly contentious issue. And the political discourse around this matter could significantly influence election outcomes and their subsequent policy implications.

Chart 8: The global fertility rate

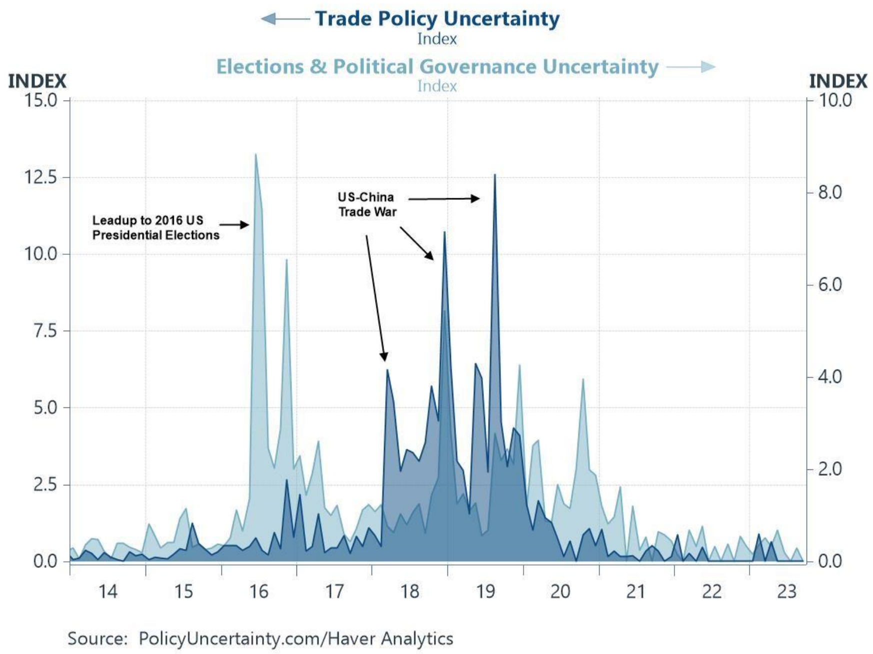


Politics

As noted in the previous discussion politics will also take centre stage next year, with over 50 countries and regions facing elections and with more than half of the world's population eligible to vote. The US Presidential Election will likely be the key focus, given the potential uncertainties and global ramifications that may follow (chart 9). At present, it seems likely that current President Biden and former President Donald Trump will compete once again for the presidency. Both candidates have performed similarly based on recent polling numbers, with their campaign positions so far not too dissimilar from the ones they have adopted before. For instance, Trump has called for the "Trump Reciprocal Trade Act", where he promised to implement the same tariffs that other countries have imposed on the US. In contrast, Biden continues to pursue closer trade ties with the world, including in the Asia Pacific region, via the Indo-Pacific Economic Framework for Prosperity.

The US aside, political watchers will likely keep an eye on the EU election (in June) and on general elections in other parts of the world, including the UK. The outcome of Taiwan's presidential elections – to be held in mid-January – will likely be closely watched too, given its influence on Taiwan's future path of relations with mainland China.

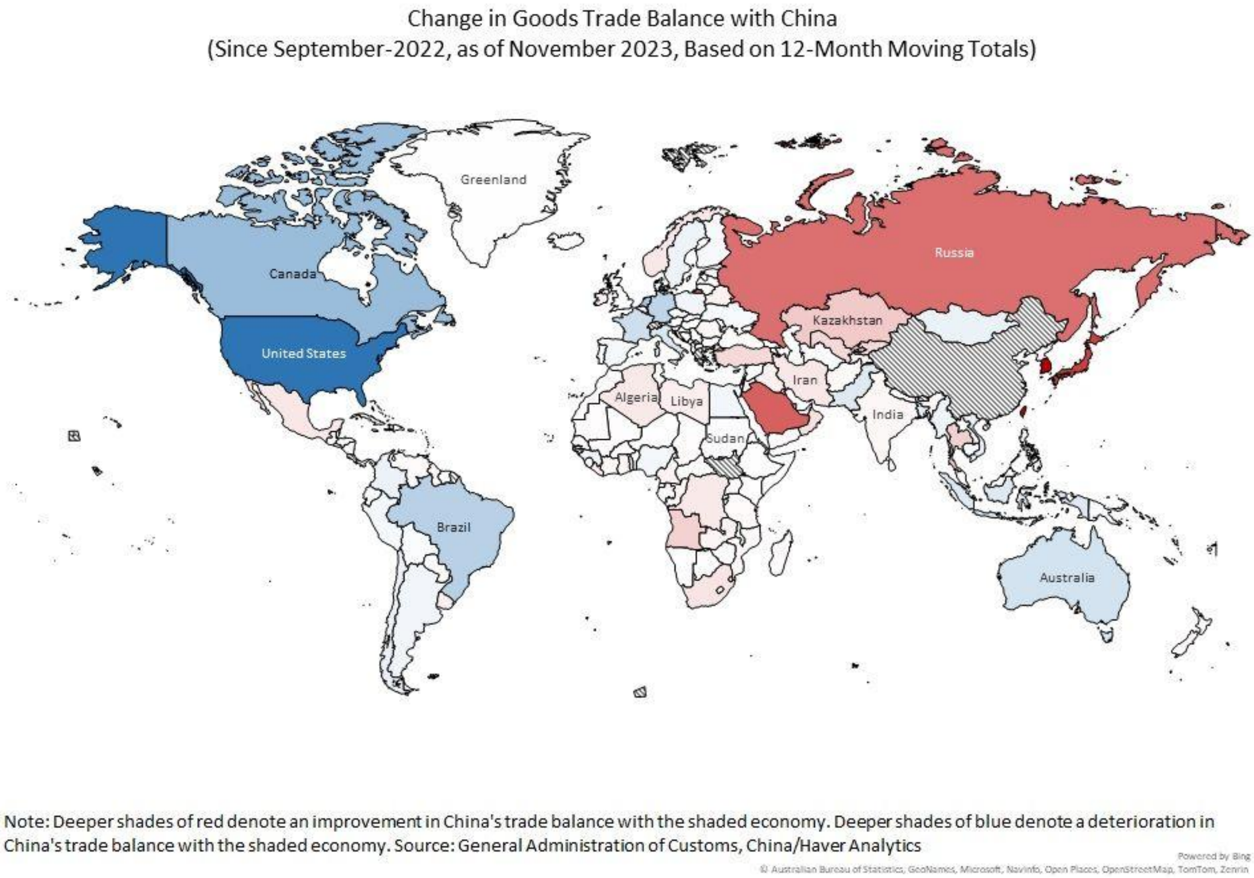
Chart 9: Trade and political uncertainty indexes



Lingering Trade Tensions

Trade is expected to remain a critical issue in the coming year, with its trajectory likely influenced by ongoing shifts in supply chain dynamics and the fluid nature of geopolitical developments. Although US-China relations have shown signs of improvement recently, the durability of these improvements is uncertain, especially with key forthcoming events such as the 2024 US Presidential Elections. Nevertheless, there have been significant changes in bilateral trade patterns over the past year, particularly concerning China. Notably, China's trade balance with advanced Asian economies (including South Korea, Taiwan, Japan, and Singapore) has seen considerable improvement.

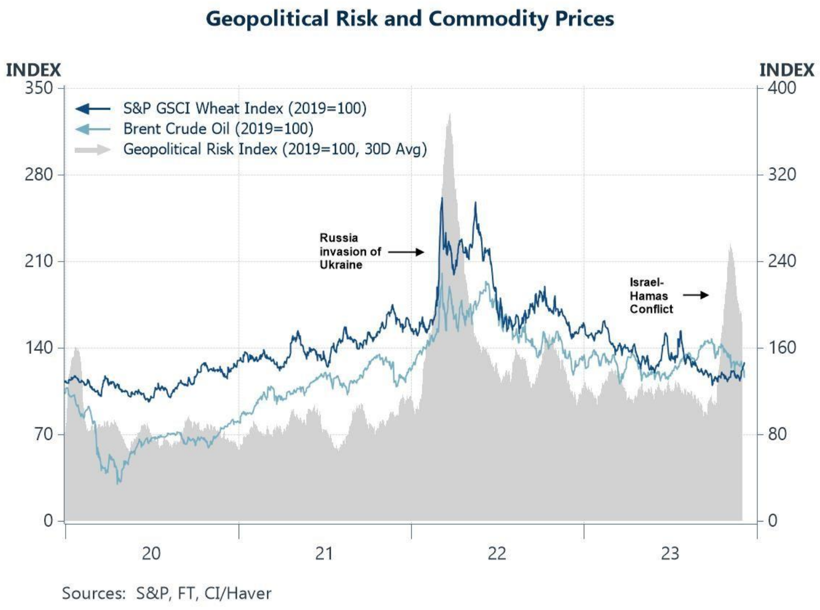
Chart 10: Change in goods trade balance with China



Geopolitical Conflict

Ongoing conflicts in Russia-Ukraine and between Israel and Hamas are likely to remain in the spotlight next year due to their potential impact on market sentiment and global supply chains. Following Russia's invasion of Ukraine in February 2022, fears of a supply crunch led to a surge in energy and wheat prices (chart 11). These initial spikes were eventually mitigated as market sentiment stabilized. Despite the conflict, Ukraine's wheat production has been resilient, but the future of its exports remains uncertain, especially after the expiration of the Black Sea Grain Initiative in July. In addition to the Russia-Ukraine conflict, the Israel-Hamas situation has also influenced commodity prices, though to a lesser extent. However, there is a high risk that this conflict could escalate into broader geopolitical instability in the Middle East.

Chart 11: Geopolitical risk and commodity prices

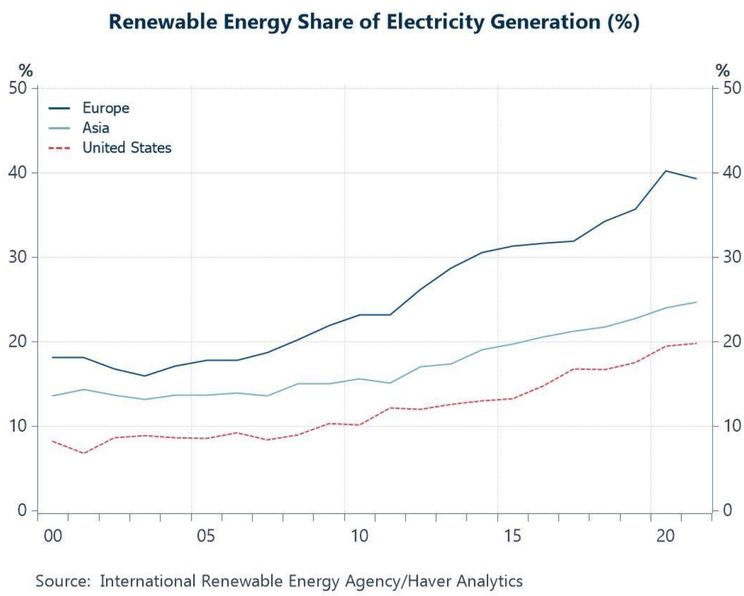


Climate Change

Lastly, climate change is set to remain a pivotal concern in the coming year, particularly in light of the recent COP28 discussions held in Dubai. A key focus is the global energy transition from non-renewable sources like natural gas and coal. Despite some progress in reducing dependence on non-renewables over past decades, the pace of this transition has been slow. For instance, renewable energy's share in global electricity generation was around 27.8% in 2021. Notably, Asia and the United States have lagged behind in this regard, while Europe has shown a better performance (see Chart 12).

Beyond energy sources, the world is also shifting from internal combustion engine (ICE) vehicles towards electric vehicles (EVs), with China leading this transformation. Thanks to significant advancements and strong sales growth, China dominated the global EV market in 2022, contributing about 60% of the 10 million electric car sales worldwide, as reported by the International Energy Agency. Europe followed as the second-largest market, contributing 2.5 million cars, while the United States ranked third with nearly one million car sales. With that said, while EVs have seen explosive sales growth in recent years, they are still nowhere near displacing internal combustion engine vehicles, which still dominate the roads.

Chart 12: Renewable energy share of electricity generation



ABOUT THE AUTHORS

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.

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