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Economic and Strategy Viewpoint

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War in Europe adds another twist of stagflation

– As we were finalising this document, Russia launched a full scale invasion of Ukraine and brought war back to Europe. We have updated our forecasts, but in a fast moving and dangerous situation uncertainty is particularly high.

– From a trade and finance perspective Russia is not significant enough to derail the world economy. However, the links through commodity prices are key and Russian aggression looks set to keep energy and food costs elevated. The fall in asset prices if sustained will also dampen global activity as will higher uncertainty.

– In this respect events in Ukraine add a further stagflationary twist to the outlook by pushing up inflation and weakening growth. The tightness of labour and product markets means that we were already heading in this direction.

– We now expect global growth of 3.7% this year and CPI inflation coming in at 4.7%. In our previous forecast last November these figures were 4% and 3.8% respectively. Significant downgrades to the Eurozone and UK account for the weaker growth forecast whilst inflation is revised up across the board.

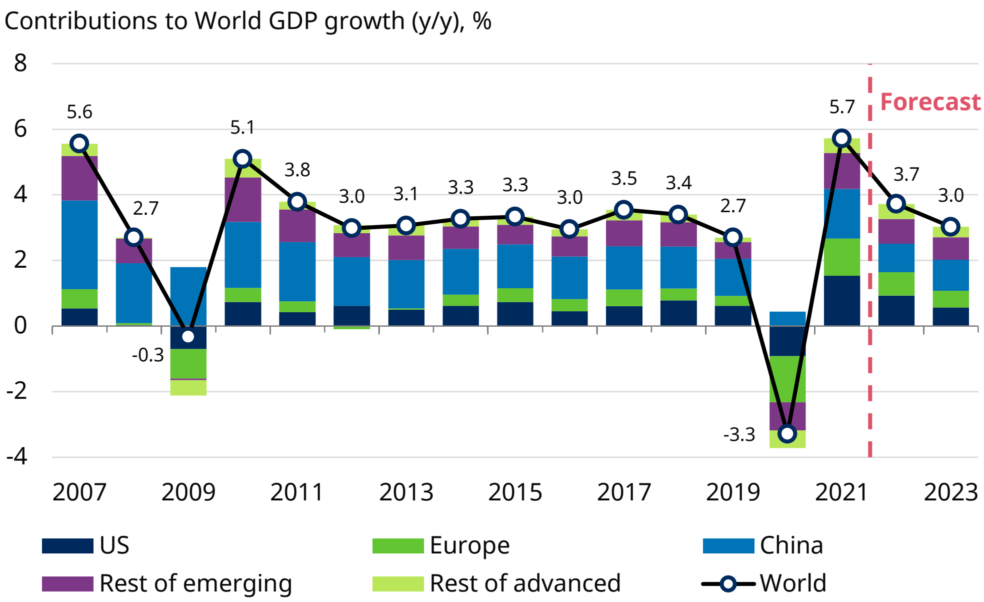
– We still expect pent up savings to provide a cushion for consumers against the increase in living costs to maintain spending and growth. An easing of supply chains and peaking in commodity price rises should also help ease inflation, as will a moderation and rebalancing in consumer demand as fiscal stimulus fades.

– The Fed is still expected to tighten with lift off in March, but to move more gradually with four hikes this year. Recent events reinforce our dovish stance on the European Central Bank, who are not expected to move until later in 2023.

– We continue to expect growth in emerging markets to slow and have trimmed our forecasts to 4.2% for this year and next. High inflation continues to impede activity and while we expect price pressures to ease in the months ahead, substantial interest rate hikes during the past year will increasingly weigh on growth.

– Despite the changes to the global forecast, the risks are still skewed toward stagflation either through a wage-price spiral or an even greater escalation of the Ukraine crisis. The chances of rising prices triggering another recession, as in earlier cycles, have clearly risen especially as central banks have limited room for manoeuvre given the high level of inflation and lack of economic slack.

Chart: Global growth forecast



Source: Schroders Economics Group. 25 February 2022. Please note the forecast warning at the back of the document.

War in Europe adds another twist of stagflation

As we were finalising this document Russia launched a full scale invasion of Ukraine and brought war back to Europe. We have updated our forecasts, but in a fast moving and dangerous situation we recognise that uncertainty is particularly high.

Inflation has been persistently high and central banks are responding

Inflation has been more persistent than expected in recent months following a series of upside surprises. Prices are now rising at their fastest rate for more than 30 years in the US, Eurozone and UK. US Federal Reserve (Fed) chair Jerome Powell has publicly retired the use of the word 'transitory' to describe the inflation outlook and the US central bank has turned significantly more hawkish.

Inflation risks have been increased by developments in Ukraine where Russian aggression has driven up commodity prices. Our central assumption is that after taking control of the Ukraine and installing a puppet government a new 'Cold War' equilibrium is reached with NATO reinforcing its borders around Ukraine and Belorussia. Sanctions remain in place or increase, and Europe starts to ween itself off Russian energy. The risks are that a continued Russian expansion and further sanctions exacerbates tensions and drives commodity prices even higher (see scenario section).

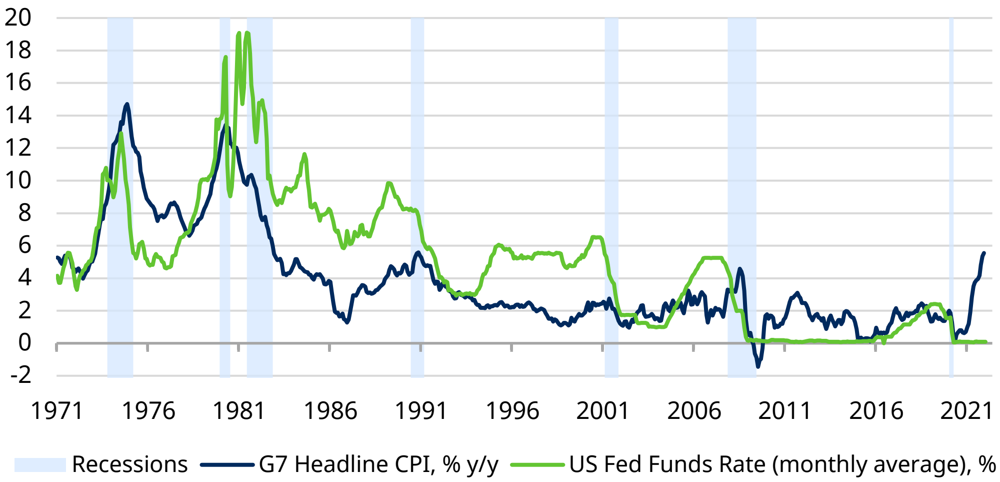
Interest rates have yet to rise in the US, but are still expected to lift-off in March. In the UK, the Bank of England tightened in December and February. The European Central Bank (ECB) has not moved, but President Lagarde is no longer ruling out a rate hike this year. This follows tightening moves in most emerging markets.

Meanwhile, monetary policy in China is on a different tack as inflation is running at 1% and the authorities have been easing to counter the downturn in the housing market. The challenges for China are more domestic: how to achieve a soft landing in the property market and lift its zero Covid policy.

The path of inflation is critical to the outlook for the world economy as it will determine the scale of the monetary response from central banks. Should inflation remain elevated the risk of a significant tightening and a recession would clearly rise.

In this respect the cycle could play out more like those from the past where central banks had to cool economic activity and create slack in the economy to bring inflation down. The recessions of the 1970s, 80s and 90's were all preceded by a pick-up in inflation and monetary tightening (chart 1). Recent developments seem to be pushing us in that direction once again.

Chart 1: Inflation, interest rates and recessions



Source: Refinitiv, Schroders Economics Group. 25 February 2022.

Inflation – recent developments

Omicron outbreak has exacerbated the unbalanced recovery

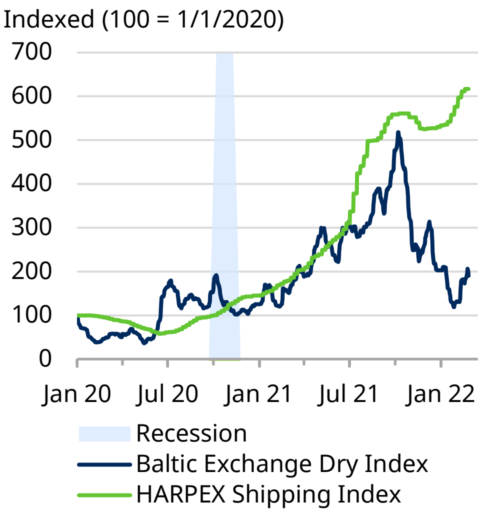
Looking at the current period, there are three factors behind the pick-up in prices. The first, and most immediate is Covid with the latest Omicron outbreak delaying the re-balancing of the world economy. The reintroduction of restrictions in many economies has hampered supply chains and meant the return of working from home for many. These factors exacerbate the imbalance between supply and demand by slowing the former and skewing the latter further toward the overheated goods sector. The unbalanced recovery, which we highlighted in our last viewpoint, persists.

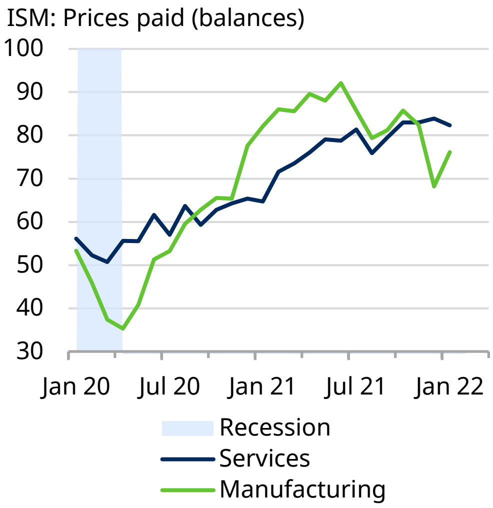
Going forward, although large parts of Asia are currently struggling with Omicron, elsewhere there are signs that the outbreak is easing off with cases falling in Europe and the Americas where restrictions are being lifted.

Supply chains remain stretched, but some indicators of supply pressures are beginning to fall back, such as the Baltic freight index (which tracks the cost of shipping raw materials) and prices paid in the purchasing manager surveys. Semi-conductor shortages are becoming less acute and there was a significant increase in retail inventory in the US in Q4 which suggests firms have been able to restock.

Its not all going in the same direction though as the Harpex index (which tracks the chartering cost of container shipping) has moved up sharply this year and there are ongoing concerns in China where the zero Covid policy can bring abrupt disruptions to international trade as restrictions are often imposed at short notice on whole cities.

Charts 2 and 3: Supply chain indicators





Source: Refinitiv, Schroders Economics Group. 25 February 2022.

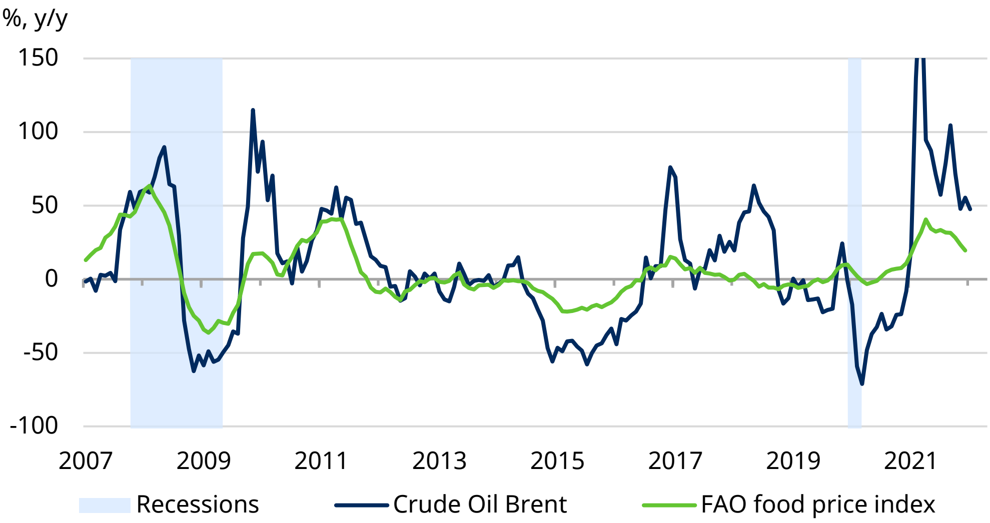
Geo-political tensions are boosting energy prices and the cost of food continues to rise

The second factor is commodity prices. Tensions between Russia and Ukraine and the subsequent invasion have significantly raised oil and gas prices. The EU relies on Russia for 40% of its natural gas supply and 25% of oil, leaving the bloc strategically vulnerable.

Food prices have also been buoyant as fears of disruption to Ukrainian and Russian exports have seen prices of wheat and fertiliser rise sharply. The increase in wholesale food prices is less headline grabbing than oil, but food carries more weight in CPI baskets and was up nearly 20% year-on-year (y/y) in January. The lags from wholesale inflation to retail prices are long and indicate that more pain is to come for consumers. The low income emerging market economies are particularly vulnerable to higher food prices which have often been a harbinger of political unrest in the past.

Despite these concerns food and energy prices are beginning to decelerate on a y/y basis (chart 4). Our forecast is based on futures prices which, although higher than at the time of our last forecast, are set to make a smaller contribution to annual inflation as we move through this year and next.

Chart 4: Oil and food price inflation high, but moderating



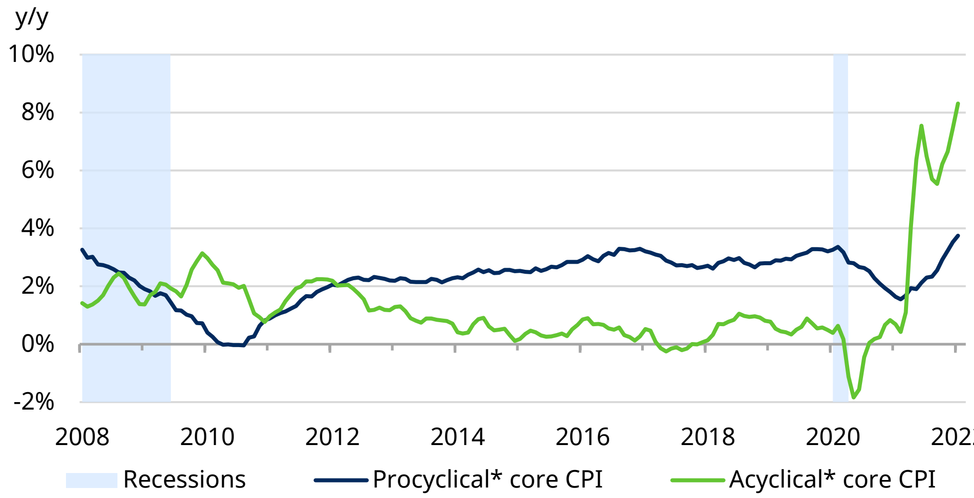
Source: Refinitiv, Schroders Economics Group. 25 February 2022.

Broader price increases

Price increases are broadening out

The third factor is the broadening of the rise in prices. Initially the rise in inflation in 2021 was led by the re-opening sectors such as airlines, hotels and restaurants, however more recently we have seen a pick-up in the cyclical areas such as housing in the US where shelter prices have accelerated sharply (chart 5). Overall, 80% of the US CPI basket components are now rising at over 4% y/y. This suggests it is not just one off supply bottlenecks which are driving the acceleration in inflation with cyclical prices also reflecting excess demand.

Chart 5: Both cyclical and acyclical prices are increasing



*If a core CPI category shows a positive and statistically significant relationship (5% interval level) with real GDP growth, we categorize the item as procyclical. If it does not satisfy this criterion, we categorize it as acyclical. Source: Refinitiv, Schroders Economics Group. 25 February 2022.

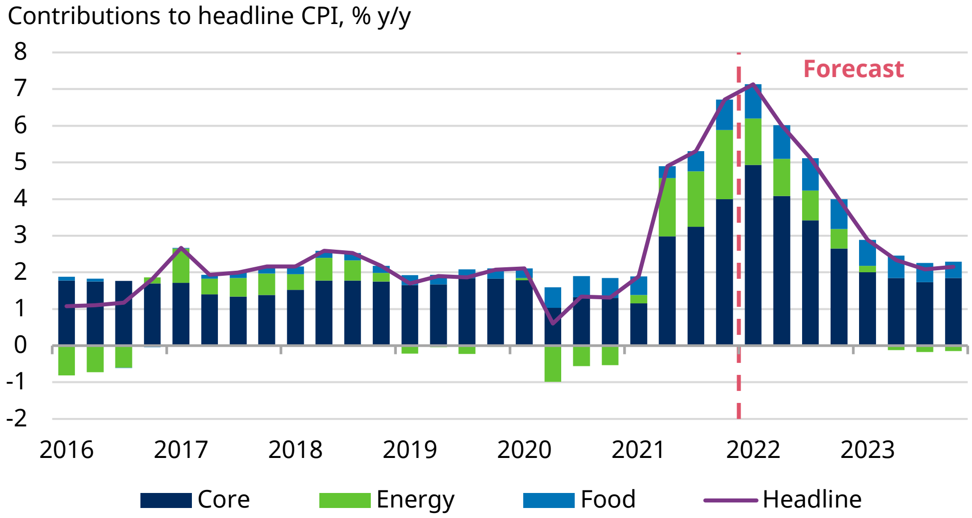
Inflation – the outlook

Looking ahead the picture is mixed: of these three factors we are optimistic on supply chains gradually returning to normal in the course of 2022 and can see scope for a moderation in commodity prices should the situation in Ukraine stabilise (see below). However, the broadening of inflation into the cyclical areas of the US economy is a concern as trends in this area can persist and may feed a wage-price spiral.

Falling inflation requires moderating commodity prices and slower growth

Our models take these factors into account alongside others such as wage pressures and the dollar. Not surprisingly they are forecasting higher inflation compared to our previous forecast with US CPI inflation expected to average 5.6% this year an increase of 1.1 percentage points (pp) compared to our previous forecast. Nonetheless, we continue to expect inflation to ease over the course of 2022 and into 2023 (chart 6).

Chart 6: US inflation forecast by component



Source: Refinitiv, Schroders Economics Group. 25 February 2022. Please note the forecast warning at the back of the document.

This is driven by a declining contribution from the commodity component and a moderation in the core rate. The decline in the latter is critical and is driven by a slower pace of real GDP growth and the lagged effects of dollar strength. On the pace of growth, our forecasts are below consensus for the US as we have doubts about the speed with which households will run down their excess savings.

Consumer spending and growth now depends on ability and willingness to spend savings

The household sector still has considerable firepower and the consumer is likely to be the mainstay of economic growth in 2022. Household balance sheets are strong and employment growth is robust. Furthermore, households have a cushion to absorb the impact of higher energy costs with the excess savings built up during the pandemic, which we estimate at around $2 trillion in the US and a similar figure in Europe.

This is a key difference with past cycles where higher inflation has invariably triggered a collapse in consumer spending and a recession (see chart 1 above). This time we are looking for consumer spending to hold up as people run down their savings.

There are two risks to this view. The first is simply that bottlenecks prevent spending from taking place. Big ticket items such as cars are in short supply and travel is still restricted in many regions, particularly Asia. This could create another air pocket for the economy where activity dips until supply can respond.

The second is that people choose not to spend their savings after all. Excess savings are concentrated amongst wealthier households who have lower marginal propensities to consume and can choose when to spend. On this the recent drop in the University of Michigan consumer confidence index for February does not bode well as it was entirely driven by households with incomes above $100,000. Now that fiscal support has run its course (we do not expect President Biden's 'Build back better plan' to get through Congress) this suggests some caution and highlights the downside risk to consumer spending.

Policy

In our baseline forecast we look for four rate rises from the Fed this year taking rates to 1.25% by December. Thereafter we see rates rising to 2% by mid 2023 where they peak. For the UK, we expect further rate hikes May, November and February (2023), taking the policy rate to 1.25%. But then, we expect the Bank of England to go on hold as the hit from higher energy and taxes takes its toll on the consumer. We also expect the ECB to tighten during the forecast with rate rises in 2023, the first since 2011. Meanwhile, China is expected to ease policy in response to the weakness of domestic demand with the People's Bank of China further trimming its policy rate.

Forecast and scenario update

The forecast has become more stagflationary

Overall our forecast is moving in a more stagflationary direction with global growth expected to register 3.7% this year and CPI inflation coming in at 4.7%. In our previous forecast last November these figures were 4% and 3.8% respectively. Significant downgrades to the Eurozone and UK account for the weaker growth forecast whilst inflation is revised up across the board. For 2023 both growth and inflation moderate to 3% and 2.8% respectively (previously 3.2% and 2.7%).

A broadening of the Ukraine crisis and uncertainty over consumer spending are the new risks

On the scenario side we have already mentioned two key uncertainties: where the Russia-Ukraine situation goes next and the behaviour of consumers with excess savings.

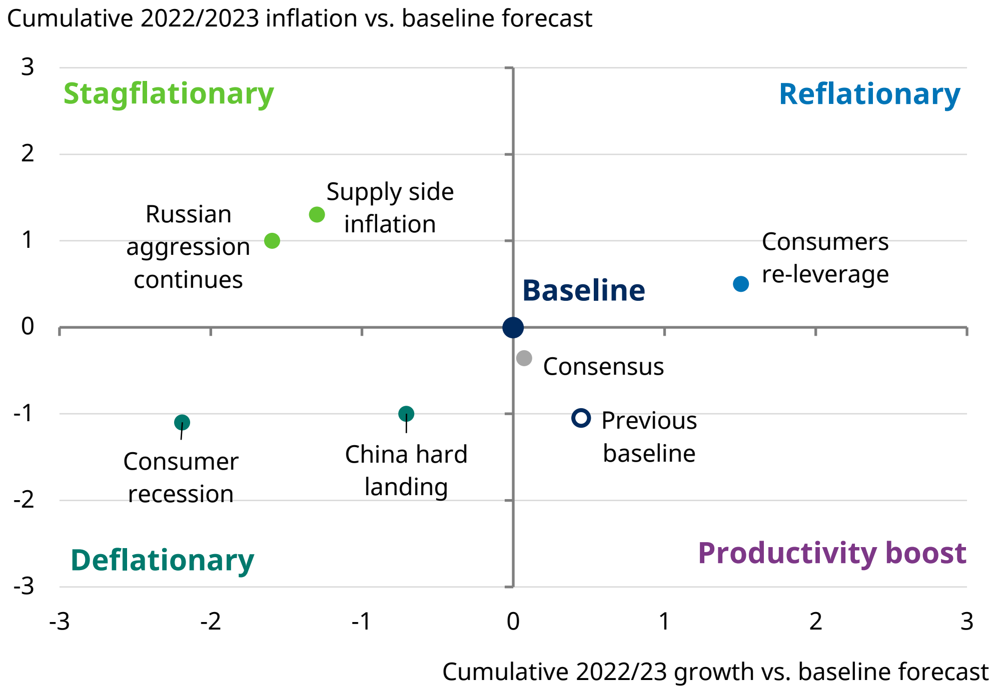
We capture the first in a 'Russian aggression continues' scenario where Russia continues to occupy Ukraine and turns its attention to its new neighbours prompting tensions with Eastern Europe (Poland, Romania, Hungary, Slovakia) and the Baltic states. NATO members respond and there is a build-up of troops which keeps tension and the risk of conflict high. Oil prices rise to $150/ barrel and stay there for much of 2022 whilst food prices also rise further. Significant disruption to Eastern European economies and Russia and an extended refugee crisis ensues.

The rise in commodity prices drives inflation even higher putting a major squeeze on consumers and business. Economic activity slows significantly: directly through disruption to trade and finance and indirectly as business confidence slumps and firms put their plans on hold. The result is an even more stagflationary outcome with global growth weaker and inflation higher this year and next. The risks beyond this are clearly huge given the potential for conflict between nuclear superpowers.

On the consumer side we introduce two scenarios: an upside consumer revival where households not only spend a significant proportion of their savings, but also re-leverage, and a downside consumer recession. The former is reflationary and elicits a stronger response from central banks with the Fed raising rates above 3%, whilst the latter takes the world economy in a deflationary direction with lower growth, inflation and interest rates than in the baseline.

Otherwise we retain our China hard landing and supply side inflation scenarios with their deflationary and stagflationary outcomes. For full descriptions of the scenarios please see page 18.

Chart 7: Scenario grid – growth and inflation deviations from baseline

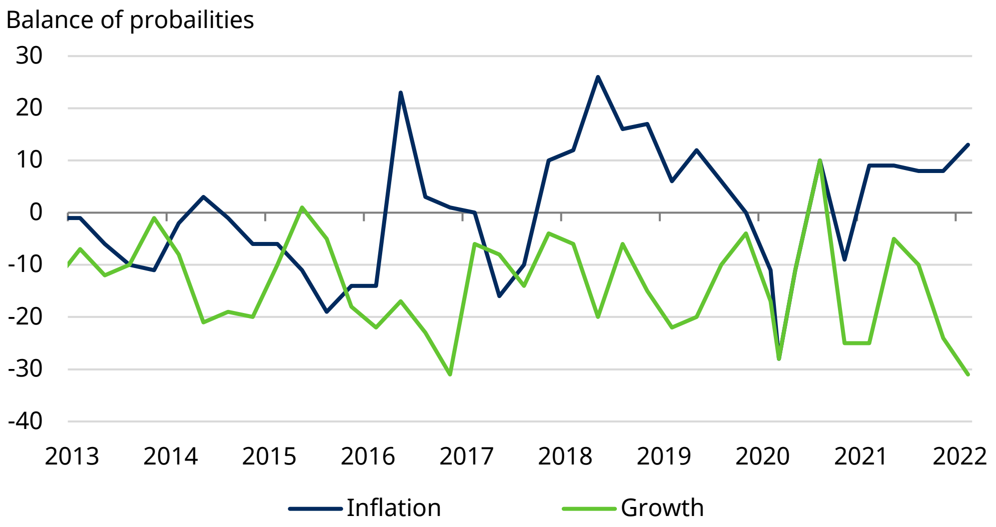


Source: Schroder Economics Group. 25 February 2022. Please note the forecast warning at the back of the document.

Risks still skewed toward stagflation despite the changes in the baseline

Despite the changes to the global forecast, the risks are still skewed toward stagflation (chart 8) either through a wage-price spiral or an even greater escalation of the Ukraine crisis. The chances of high inflation triggering another recession, as in earlier cycles, have clearly risen especially as central banks have limited room for manoeuvre given the high level of inflation and lack of economic slack.

Chart 8: Probability weighted growth and inflation



Source: Schroder Economics Group. 25 February 2022. Please note the forecast warning at the back of the document.

Regional views

Eurozone: Interest rates to rise, but not just yet

Eurozone growth slowed sharply due to Omicron, but not by as much as feared by the consensus

The eurozone economy slowed sharply in the final quarter of last year as concerns and restrictions related to the spread of the Omicron variant of Covid-19 hit activity. Real GDP growth slowed from 2.3% quarter-on-quarter (q/q) in Q3 to just 0.3% in Q4, but not by as much as feared by the consensus. Overall, the latest figures mark the return of GDP to its pre-pandemic peak, though compared to the Schroders baseline forecast prior to the pandemic, output remains 2.4% below where GDP was expected to have been.

Within member states, though all saw a deterioration in output, most managed to beat consensus expectations and continued to grow. Spain was the star of the quarter, generating 2% q/q growth compared to 2.6% growth in Q3. France saw GDP growth slow from 3.1% to 0.7%, while the Italian economy slowed from 2.6% to 0.6% over the same period. Germany was the only major member state to see growth fall, contracting by 0.3% (initially estimated at -0.7%, but later revised up).

While services were the most impacted in recent months, underlying weakness in Germany's manufacturing sector explains its lacklustre recovery so far. Firms are continuing to struggle with supply-chain bottlenecks, causing backorders to rise. Higher input costs haven't helped either, and firms have had little choice but to raise their prices, which in turn appears to have hurt demand, and the prospects for a sharp rebound.

Nevertheless, the flash estimates from the Purchasing Managers Indices (PMIs) for February show a solid rebound in growth, especially for services activity. Contact services such as restaurants, bars, hotels and entertainment services saw significant disruption over the festive period. The PMIs suggest the removal of restrictions have been followed with a surge in demand and activity (chart 9).

With restrictions lifted, service sector activity has rebounded sharply

Chart 9: Services PMIs

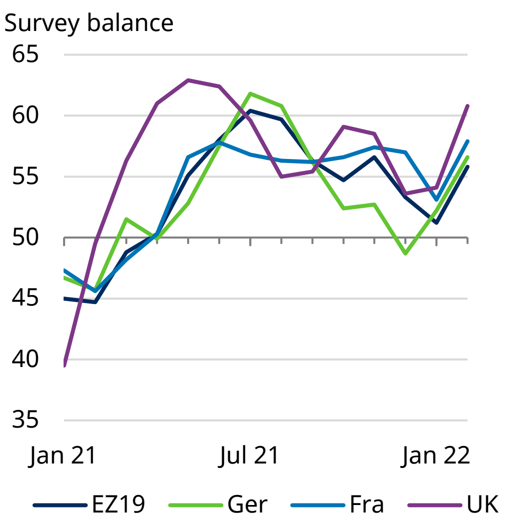
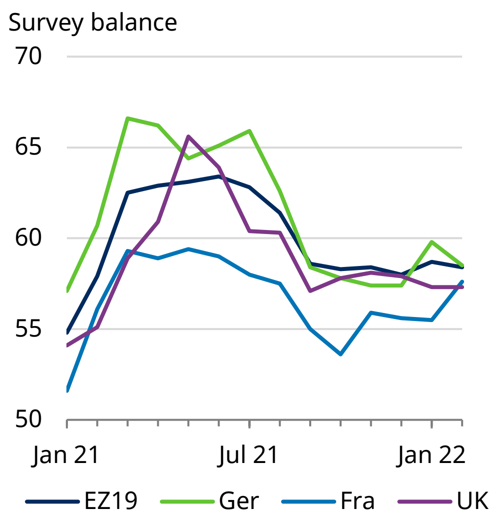


Chart 10: Manufacturing PMIs



Source: Eurostat, Refinitiv, Schroders Economics Group. 25 February 2022.

The manufacturing sector continues to perform well according to the PMIs, and appears to have been largely resilient to disruptions in recent months. That said, the momentum of the recovery, seen in the first half of last year has clearly faded (chart 10).

Meanwhile, inflation across the monetary union has surprised to the upside since our last forecast update. This was mainly driven by the continued rise in wholesale energy prices, but also the ability and willingness of firms to pass on more costs through increased prices. Headline Harmonised Index of Consumer Prices (HICP) inflation reached 5.1% y/y in January, though core inflation (excluding food, energy, alcohol, and tobacco) remains well contained at 2.3% y/y. Note, the equivalent measure for core inflation stands at 6% in the US, and 4.2% in the UK.

Eurozone growth has been downgraded owing to higher inflation pressures

Looking ahead, the eurozone growth forecast has been revised down from 4.6% to 3.3% for 2022. Most of the downgrade is caused by the impact of Omicron, as while we had downgraded near-term growth during the last forecast update, the impact turned out to be more severe. The other major cause for the downgrade is the higher energy inflation, which has recently been exacerbated by events in Ukraine. The war is also expected to knock household and businesses confidence in the near-term, especially in the east, but the impact is expected to be temporary.

Higher energy inflation will reduce households' spending power and therefore consumption, but should fade by 2023. The forecast for HICP inflation has been raised from 3.5% to 4.2% for 2022, and from 1.5% to 2.1% in 2023.

The forecast for growth in 2023 has been raised to 2.6%, as many of the headwinds mentioned already are expected to abate by the end of this year. Our forecast is both slightly above consensus, and above historical trend growth.

The unemployment rate, which has just reached a new low of 7% (since the creation of the euro), should continue to fall, and eventually generate more meaningful wage growth. This helps change the mix of inflation from being mostly driven by food and energy, to mostly being driven by domestic pressures through the core measure.

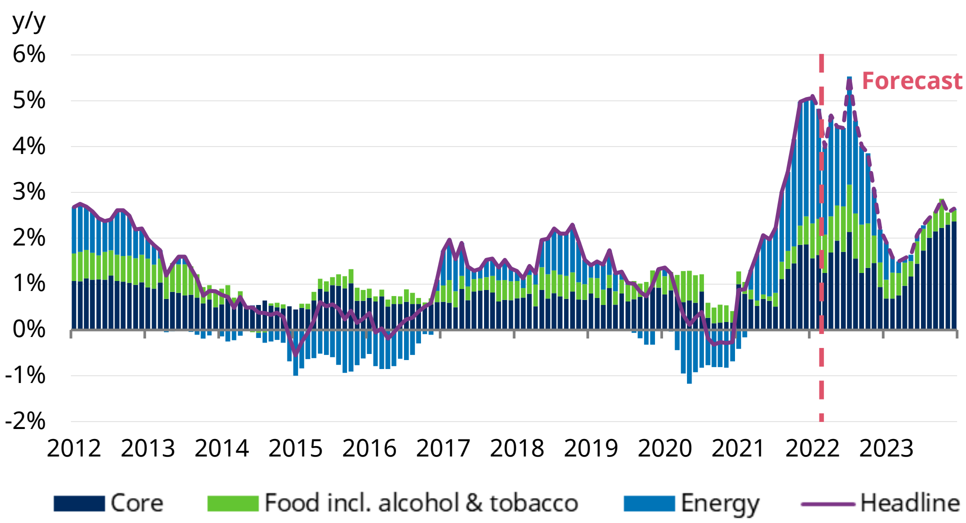
Above trend growth, tight labour markets and a recovery in domestic inflation should eventually persuade the European Central Bank (ECB) to tighten monetary policy. In recent communications, President Lagarde refused to rule out a rate increase later this year, but did re-issue the tough conditionality for the tightening of policy. Specifically, that inflation has to be above 2% by the middle of the forecast, must not dip below 2% during the forecast period, and must be trending upwards.

The ECB is now expected to hike in 2023, but by less than markets expect

At present, inflation is forecast to dip below 2% in 2023, and so these conditions are not satisfied in our view (chart 11). However, they should be by the second half of 2023. As a result, the updated forecast now has the deposit rate rising from -0.50% to zero in two steps, in Q3 and Q4 2023. The main refinancing rate is forecast to rise to 0.25% in Q4, and a 25bps corridor will then be (re)established moving forward. Before this, we expect the ECB to announce the end of traditional Quantitative Easing (QE) in Q1 2023. This is consistent with the guidance the ECB has provided on sequencing. Note, the forecast is more dovish than market expectations, as forward curves show just over two hikes priced by the end of 2023 (assuming the refi rate, over four if using the depo rate).

In any case, the war in Ukraine should ease the pressure on the ECB to tighten policy in the near future, but the language from the central bank is likely to remain cautious.

Chart 11: Schroders eurozone HICP inflation forecast



Source: Eurostat, Refinitiv, Schroders Economics Group. 25 February 2022. Please note the forecast warning at the back of this document.

UK: Slowing growth, rising inflation and tighter fiscal and monetary policy

The UK economy grew by 1% in Q4, slightly below our previous forecast (1.1%) and consensus estimates. However, upward revisions to data for the first half of last year and a downgrade to Q3 meant that momentum does not look as strong heading in to this year as it did a quarter ago.

Like most of Europe, Omicron related restrictions were light compared to those in response to the Delta wave of infections. Those restrictions have been lifted, and the evidence suggests that activity has started to rebound as a result (see PMIs in charts 7 and 8 above).

The forecast for UK GDP growth has also been downgraded owing to higher inflation pressures

In terms of the UK forecast, GDP growth has been revised down from 5.2% to 4.3% for this year, and from 3.1% to 2.2% for 2023. The downgrade is triggered by the continued rise in energy prices, most of which has so far not been passed on to households thanks to the government's energy price cap. The UK energy regulator, Ofgem, recently announced that the cap on variable tariffs for typical home energy consumption will rise by 54% in April. The planned increase is broadly in line with our previous forecast, however, continued wholesale price increases are likely to result in a further 42% rise in October – the next energy fixing – versus a small fall that was previously assumed.

The government has announced that it will help households by cutting energy bills in October by £200 per household (which otherwise would have meant a 52% rise) in the form of a compulsory loan, which is then repaid over the following five years. Moreover, lower valued properties will receive an additional smaller rebate through their local authority tax bills to help further (not repayable).

Though fiscal support for households is welcomed, the government could have done more by delaying the planned increase in national insurance contributions, due in April. The increase of 2.5 percentage point (10% effective) on the hiring of workers is a significant increase in a very distortionary tax. Then again, with the labour markets so tight at the moment, increasing cost of labour relative to capital (robots/automation) could help boost productivity through business investment.

Moreover, the government's energy subsidies are limited to households. Firms are not being offered any support, and will have to deal with higher energy costs themselves. The assumption in the new forecast is more firms will pass on these cost increases to households in the form of higher prices. To make matters worse, the government is pressing ahead with its previously announced increase in corporation taxes, which again, could force more price increases.

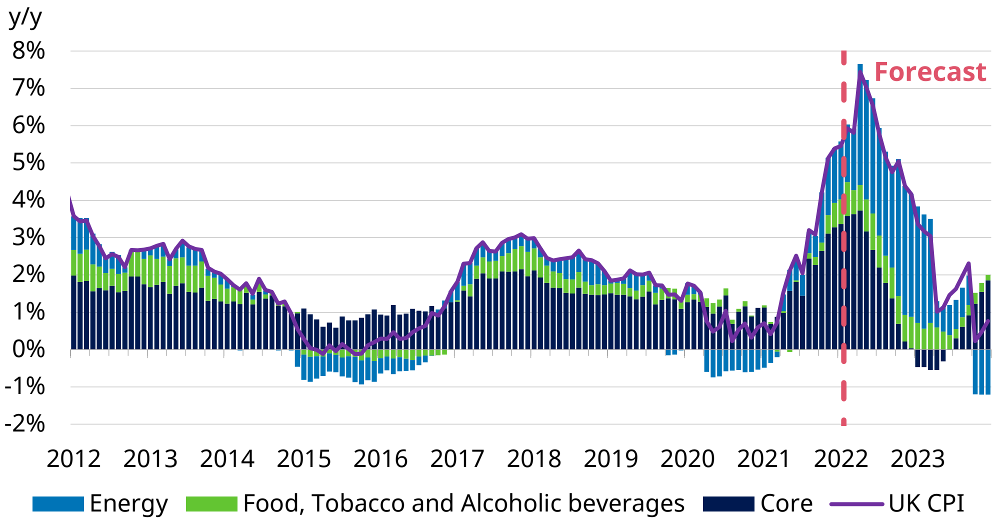
Finally, on the growth front, its is worth mentioning that the government has just announced that it is ending all legal restrictions and the vast majority of support related to Covid. Though individuals who catch Covid are encouraged to self-isolate, it will no longer be a requirement. This is a risky strategy for the Prime Minister, but one wonders if his recent political turmoil has forced him to appease the more sceptical wing of his party in order to avoid a vote of no confidence.

On the one hand, removing the legal requirement to self-isolate means less disruption to businesses. This of course assumes that people will still go to work when infected, which they are officially encouraged not to. On the other hand, the government is not only withdrawing income support scheme for those self-isolating on low incomes, but it is ending the provision of free testing and other support mechanisms. These will reduce Covid related spending for the government, but will also reverse most of the boost from the healthcare sector for the economy.

Turning to inflation, the forecast has been pushed up from 3.8% to 5.6% for this year, and from 1.1% to 1.7% for next (chart 12). CPI inflation is forecast to peak at 7.4% in April, before steadily falling back, bottoming out below 0.2% in Q4 2023. Core inflation (excluding food and energy) is forecast to decline over the course of the year, as households are forced to spend more of their disposable income on higher food and energy bills. Lower priority goods and services are likely to see lower demand, and may therefore struggle to pass on their respective higher costs.

UK CPI inflation is forecast to rise above 7% as the energy price cap is raised in April

Chart 12: Schroders UK CPI inflation forecast



Source: ONS, Refinitiv, Schroders Economics Group. 25 February 2022. Please note the forecast warning at the back of this document.

BoE to hike further, but is expected to disappoint hawkish markets

BoE is expected to hike again, but then pause until H2 2023

Meanwhile, the Bank of England (BoE) has already raised interest rates twice to 0.50%, and announced the end of the reinvestment of maturing bonds from its QE programme. This should mean that if the Bank passively manages its portfolio, it will shrink its £875 billion holding of gilts by just over £70 billion over 2022 and 2023, and a further £130 billion over 2024 and 2025. The UK government will almost certainly be running a budget deficit, and so this should increase the stock of free-floating debt on the market, therefore potentially increasing yields (reducing prices).

The forecast has the BoE hiking again in May, then again in November and February (2023). Despite current security concerns, these hikes are warranted given the state of the economy and elevated inflation. However, unlike financial markets that have priced interest rates to reach just over 1.75% by the end of this year, we expect the Bank to pause at 1.25% at the start of next year as inflation falls back sharply. A continuation of the hiking cycle is then expected only when inflation starts to head back towards 2%. This is unlikely to occur before 2024.

Emerging markets

EM have withstood the hawkish pivot in Fed policy, but growth is still set to slow

Most Emerging Markets (EMs) have so far taken the hawkish pivot in global monetary policy in their stride, and solid external positions coupled with relatively high interest rates should continue to offer some buffer as the Fed tightens the screws.

However, while these solid fundamentals should prevent an EM crisis, growth is still set to slow as fading impetus from exports to developed markets and higher domestic interest rates start to bite. We forecast aggregate GDP growth to slow from 6.7% in 2021 to 4.2% both this year and next.

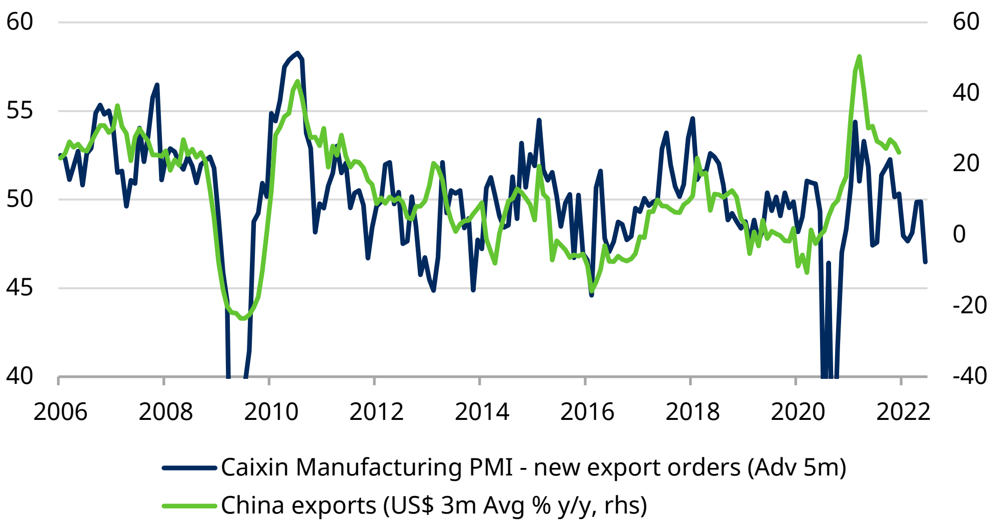
The good news is that softer demand conditions, coupled with some reversal of the impact of higher food and energy costs, should ensure that inflation peaks in the first half of this year before trending down. That should eventually allow EM central banks to bring tightening cycles to an end, perhaps presenting opportunities in local markets.

China

Growth in manufactured exports to slow, but the economy should stage a shallow recovery later this year

Most of the evidence suggests that China's economy has made a soft start to the year. In particular, as chart 13 shows, PMI surveys continue to indicate that manufactured exports, which have been the key driver of economic growth during the past couple of years, will slow in the months ahead. And there is little sign of a meaningful recovery in domestic demand to take up the slack as the real estate sector remains mired in a crisis of confidence which, along with the government's continued zero-tolerance approach to outbreaks of Covid, appears to have also dampened consumer activity.

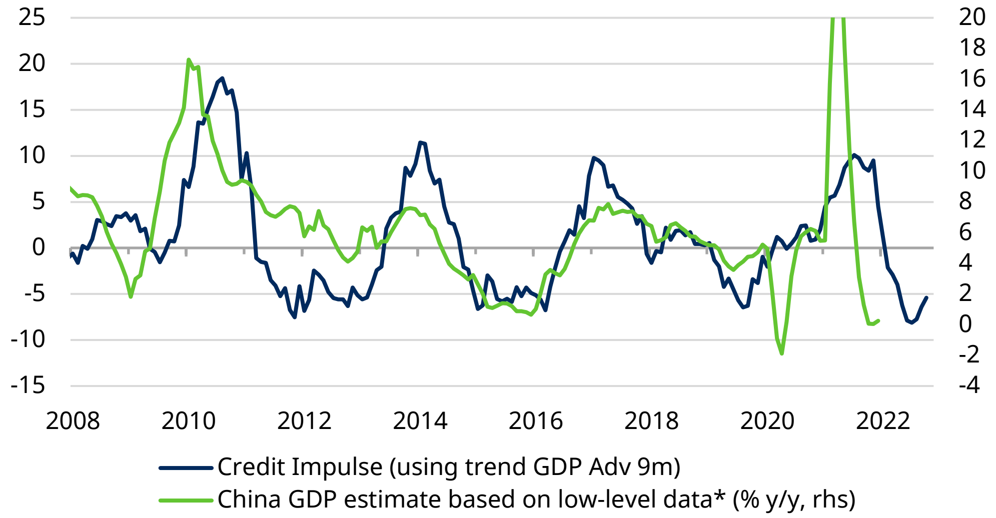
Chart 13: China's exports look set to slow during the course of 2022



Source: Refinitiv, Schroder Economics Group. 17 February 2022.

The good news is that as chart 14 shows leading indicators such as the credit impulse have begun to turn up in recent months, driven by an increase in government and corporate borrowing as the authorities have loosened the purse strings. This suggests that, while activity is likely to remain soft in the near term, signs of a cyclical improvement will begin to emerge later this year.

Chart 14: Leading indicators point to some recovery later this year



Source: Refinitiv, Schroder Economics Group. 17 February 2022.

All told, we expect GDP growth to slow to around 4.6% this year, from 8.1% last year, with a shallow recovery to 5% in 2023.

India

India's economy should register decent growth after a stop-start recovery

The stop-start recovery in India's economy has continued after the another wave of Covid infections forced the reintroduction of restrictions in order to contain the spread of the virus around the turn of the year. That is likely to have held back activity during the first quarter and ensured that GDP remained below pre-pandemic levels.

In light of this, policymaking remains geared towards supporting the economy. The government announced a pro-growth budget in February and while delivering public investment efficiently will remain a challenge this, along with low interest rates, should help to drive a further recovery.

That being said, inflation has been persistently above the central bank's 4% target in recent years and is unlikely to fall as the economy reopens again. As such, having been one of the few EM central banks to keep interest rates unchanged in 2021, the Reserve Bank of India (RBI) will probably begin to tighten policy later this year.

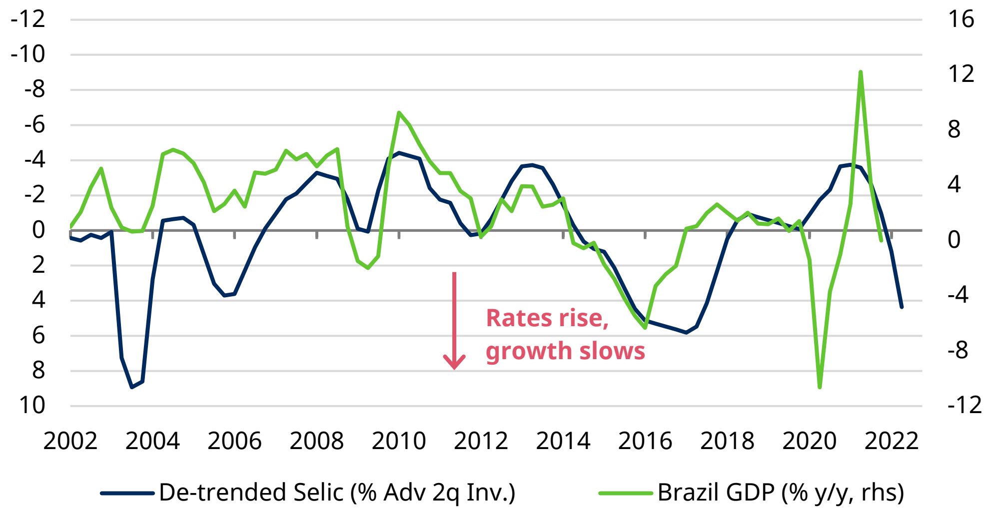
Brazil

Economy stuck in a rut ahead of October's general election

Financial markets in Brazil have made a roaring start to the year, but the economy remains on a soft footing. After falling into a technical recession in the middle of last year, the government's official activity indicator suggests that output may have marginally shrunk again in the fourth quarter.

Better news appears to be emerging on the inflation front. Despite an uptick in January, inflation has probably peaked and we expect it to trend down during the course of 2022. That will alleviate some pressure in real incomes, but we doubt it will signal the start of a strong rebound in growth as large interest rate hikes increasingly weigh on activity (chart 15).

Chart 15: Interest rate hikes point to another soft year in 2022



Source: Refinitiv, Schroder Economics Group. 17 February 2022.

As a result, policies to reinvigorate Brazil's economy are likely to take centre stage during the campaign ahead of the general election that is due to take place in October. After all, despite huge political upheaval in recent years, Brazil's economy is only marginally bigger than during Luiz Inácio Lula da Silva's second term in 2011.

Russia

Geopolitical tensions cloud the outlook

The incursion of forces into Ukraine means that the outlook for Russia's economy is extremely uncertain. A de-escalation of tensions would see Russia continue to benefit from high oil prices, since it accounted for around 12% of world crude exports in 2020 equivalent to around 10% of GDP.

However, such a benign scenario now seems unlikely and so a combination of disruption stemming from military action, along with the imposition of strong sanctions by NATO members, are likely to take their toll. Russia has accumulated large foreign exchange reserves sufficient to cover around two-years of imports, but GDP growth would still probably be stunted around 1% over 2022-23.

That being said, there is clearly risk of a more severe scenario where Russia begins to press up against NATO borders. Economic forecasts would probably seem irrelevant in such a situation, but it seems fair to assume that Russia's economy would suffer a deep recession, much higher inflation and significant Russian ruble depreciation.

Schroders Economics Group: Views at a glance

Macro summary – Q1 2022

Key points

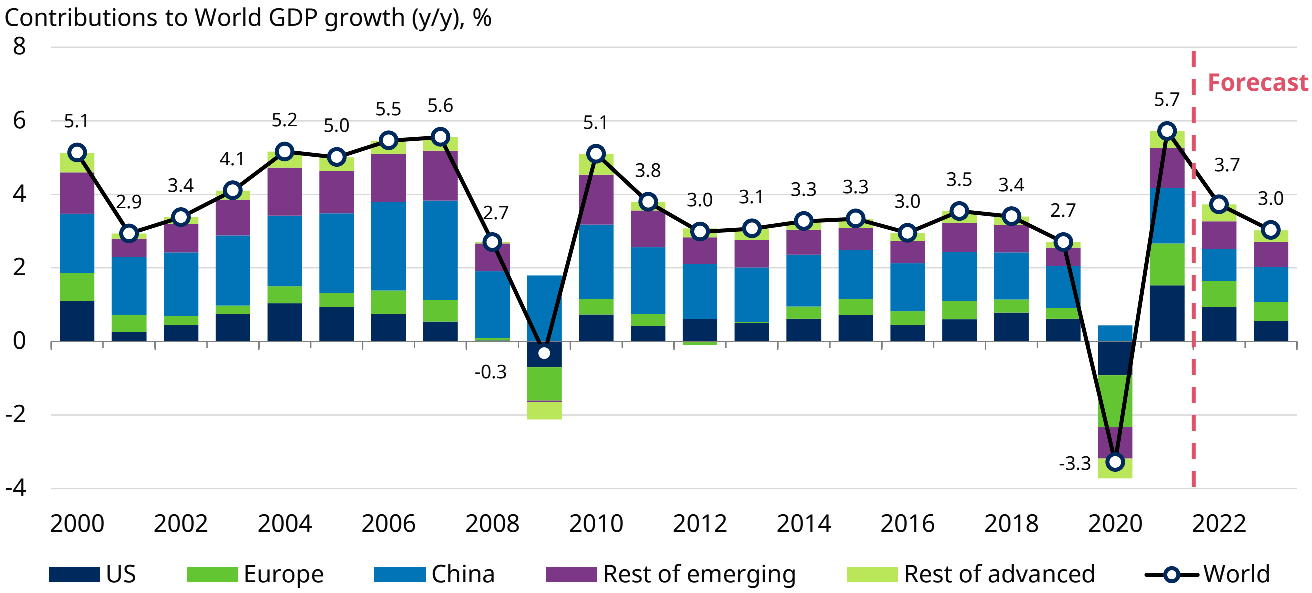
Baseline

- **US:** A slowdown in the US is inevitable after rapid GDP growth of 5.7% in 2021, but buoyant labour market conditions and further run-down of excess savings should still ensure that the economy registers a robust expansion of 3.5% this year and 2.3% in 2023. Inflation has continued to overshoot expectations and with the risk of second round effects refusing to go away, the Fed is set for lift-off in March. We expect it to raise rates four times this year, to 1.25%, with another 75bp of hikes to a terminal rate of 2% in 2023. The Fed is also likely to start shrinking its balance sheet in the fourth quarter of this year.
- **Eurozone:** Growth is forecast to slow but remain high at 3.3% for 2022 and 2.6% in 2023. Households are expected to reduce their savings rate to more normal levels, and activity gets a boost from government spending as the EU recovery fund kicks in. Annual inflation is forecast to rise from 2.6% in 2021 to 4.2% in 2022, before falling back to 2.1% in 2023. However, the ECB remains dovish, ending PEPP in Q1 2022, but maintaining pre-pandemic QE until Q1 2023, and only raising rates in H2 2023.
- **UK:** Growth should slow from 7.5% to 4.3% in 2022 as the boost from re-opening the economy begins fade. Household spending remains high as excess savings are reduced, but inflation reduces purchasing power. CPI inflation is forecast to rise from 3.6% in 2022 to 5.6% in 2023, mainly driven by higher energy prices. Inflation is then forecast to fall back to 1.7% over 2023. Meanwhile, a strong labour supports the BoE in to continuing to hike, taking the base rate to 1.25% by Q1 2023. Lower inflation and fiscal tightening lead to a pause for the rest of the forecast.
- **Emerging Markets:** Most EMs have so far taken the hawkish pivot in global monetary policy in their stride, and solid external positions coupled with relatively high interest rates should continue to offer some buffer as the Fed tightens the screws. However, while these solid fundamentals should prevent an EM crisis, growth is still set to slow as fading impetus from exports to developed markets and higher domestic interest rates start to bite.

Risks

The balance of risks is tilted in a stagflationary direction as four of our five risk scenarios bring weaker output and three have higher inflation. We still see the largest risk of supply side inflation though also place a high weight on the stagflationary Russia-Ukraine war and the deflationary Consumer recession scenarios.

Chart: World GDP forecast



Source: Schroders Economics Group. 25 February 2022. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2021	2022		Prev.	Consensus	2023		Prev.	Consensus
World	100	5.7	3.7	↓	(4.0)	4.0	3.0	↓	(3.2)	2.9
Advanced*	61.1	5.1	3.4	↓	(3.8)	3.7	2.3	↓	(2.5)	2.4
US	26.9	5.7	3.5	↑	(3.2)	3.7	2.1	↓	(2.2)	2.5
Eurozone	16.8	5.2	3.3	↓	(4.6)	3.9	2.6	↑	(2.4)	2.5
Germany	5.0	2.8	2.0	↓	(4.3)	3.5	2.8	↑	(2.3)	2.7
UK	3.6	7.5	4.3	↓	(5.2)	4.3	2.2	↓	(3.1)	2.0
Total Emerging**	38.9	6.7	4.2	↓	(4.4)	4.3	4.2	↓	(4.3)	3.6
BRICs	26.2	7.5	4.4	↓	(4.7)	4.7	4.6		(4.6)	3.6
China	19.0	8.0	4.6	↓	(4.7)	5.0	5.0		(5.0)	5.2

Inflation CPI

y/y%	Wt (%)	2021	2022		Prev.	Consensus	2023		Prev.	Consensus
World	100	3.4	4.7	↑	(3.8)	4.5	2.8	↑	(2.7)	2.7
Advanced*	61.1	3.2	4.4	↑	(3.6)	4.1	2.0	↑	(1.8)	2.0
US	26.9	4.7	5.6	↑	(4.5)	5.2	2.3		(2.3)	2.6
Eurozone	16.8	2.6	4.2	↑	(3.5)	4.0	2.1	↑	(1.5)	1.7
Germany	5.0	3.2	4.3	↑	(3.5)	3.4	2.3	↑	(1.8)	1.9
UK	3.6	2.6	5.6	↑	(3.8)	5.4	1.7	↑	(1.1)	2.7
Total Emerging**	38.9	3.8	5.3	↑	(4.1)	5.0	4.1	↓	(4.2)	3.8
BRICs	26.2	2.4	3.5	↑	(3.1)	3.0	3.3	↑	(3.2)	2.9
China	19.0	0.9	2.0		(2.0)	2.2	2.3	↓	(2.7)	2.3

Interest rates

% (Month of Dec)	Current	2021	2022		Prev.	Market	2023		Prev.	Market
US	0.25	0.25	1.25	↑	(0.50)	1.62	2.00	↑	(1.50)	2.06
UK	0.50	0.25	1.00	↑	(0.50)	1.78	1.25	↑	(1.00)	2.06
Eurozone (Refi)	-0.50	0.00	0.00		(0.00)	-0.11	0.25	↑	(0.00)	0.64
Eurozone (Depo)	-0.50	-0.50	-0.50		(-0.50)		0.00	↑	(-0.50)	
China	3.70	3.80	3.50	↓	(3.65)	-	3.50	↓	(3.65)	-

Other monetary policy

(Over year or by Dec)	Current	2021	2022		Prev.	Y/Y(%)	2023		Prev.	Y/Y(%)
US QE ($Tn)	8.8	8.8	8.7	↓	(9.3)	-1.1%	7.7	↓	(9.3)	-11.5%
EZ QE (€Tn)	2.8	2.8	3.2	↓	(3.4)	14.3%	3.3	↓	(3.6)	3.1%
UK QE (£Bn)	875	875	845	↓	(875)	-3.4%	805	↓	(875)	-4.7%
China RRR (%)	11.50	11.50	11.00		11.00	-	11.00		11.00	-

Key variables

FX (Month of Dec)	Current	2021	2022		Prev.	Y/Y(%)	2023		Prev.	Y/Y(%)
GBP/USD	1.33	1.37	1.33	↓	(1.37)	-0.9	1.37	↑	(1.35)	-1.8
EUR/USD	1.11	1.22	1.09	↓	(1.15)	-7.1	1.10	↓	(1.13)	-4.2
USD/JPY	115.6	103.2	120	↑	(115)	11.4	120		(120)	4.3
EUR/GBP	0.84	0.90	0.82	↓	(0.84)	-6.2	0.80	↓	(0.84)	-2.4
USD/RMB	6.32	6.54	6.50	↑	(6.45)	-2.5	6.80		(6.80)	2.0
Commodities (over year)										
Brent Crude	99.1	43.3	95.1	↑	(71.9)	63.5	84.2	↑	(79.2)	34.2

Source: Schroders, Thomson Datastream, Consensus Economics, February 2022
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 24/02/2022
Previous forecast refers to November 2021
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Cumulative 2022/23 global vs. baseline: Growth	Inflation
Baseline	We expect global growth to slow from 5.7% in 2021 to 3.7% in 2022, and to 3% in 2023. This is as global activity moderates from the strong post covid bounce. Pent-up demand helps support growth in 2022 as policy stimulus is withdrawn. However, high inflation is expected to reduce the spending power of households, though capex should continue its recovery. Global supply chain disruptions are expected to ease in 2022, though this has taken longer than expected. Inventory rebuilding appears to have begun in the US, but stocks remain low in the UK and eurozone, with Germany particularly struggling to catch-up with demand. Meanwhile, events in Ukraine have driven global energy prices significantly higher than in our previous forecast and this has contributed to a higher inflation forecast. We continue to use forward curves for our commodity price assumptions and these assume some easing in oil prices going forward. This would be consistent with Russia taking control of Ukraine and risk premiums remaining elevated in 2023, but no further escalation. Overall, the outlook moves in a stagflationary direction, as we make broad based upgrades to inflation, mainly driven by higher energy prices and ongoing cost pressures stemming from supply bottlenecks. We still expect pent-up demand to help support consumption but this results in downgrades for growth in almost all regions. The US is the exception for 2022, but this is caused by base effects due to the better outturn for the end of 2021.	Despite the geo-political situation, with inflation elevated and the economic cycle advanced, the Fed is expected to raise interest rates in March by 25bps. However, the pace of tightening is more gradual given geo-political tension and the weakness of equity markets and we only see three more rate moves over the course of the year. In 2023, we see two more quarter point increases in rates in the first two quarters, as the Fed stops at 1.75%. QT is progressively stepped up through 2023, settling at $100bn per month by the second half of the year. Meanwhile, the BoE is expected raise the interest rate to 0.75% in Q2, before pausing its hiking cycle. Fiscal tightening coupled with a forecast of falling inflation prompt a pause in hikes, which resume in Q4 2022, taking rates to 1.25%. Having just ended PEPP, but boosted pre-pandemic QE, the ECB tapers QE through 2022, and ends it in Q1 2023. This paves the way for rates to rise in H2 2023, with the depo rate returning to zero, and the refi rate reaching 0.25%. China is set to continue to ease monetary policy cutting the RRR and one year loan prime rate (to 11% and 3.50%, respectively, by the end of next year). Elsewhere in the emerging markets, with inflation above target and rising almost everywhere, additional upward pressure on energy costs is likely to force central banks to raise interest rates a bit further than we had previously expected. Rates in Brazil and Russia are likely to reach a peak of 12.75% and 10.50% respectively in Q2. India's central bank continues to lag behind, but will probably have to deliver significant rate hikes by year-end.	59%	-	-
1. Russian aggression continues	Russia continues to occupy the Ukraine and turns its attention to its new neighbours prompting tensions with Eastern Europe (Poland, Romania, Hungary, Slovakia) and the Baltic states. NATO members respond and there is a build up of troops which keeps tension and the risk of conflict high. Oil prices rise to $150/ b and stay there for much of 2022 whilst food prices also rise further. Significant disruption to Eastern European economies and Russia. Extended refugee crisis across Europe.	Stagflationary: The rise in commodity prices drives inflation even higher putting a major squeeze on consumers and business. Economic activity slows significantly: directly through disruption to trade and finance and indirectly as business confidence slumps and firms put their plans on hold. Europe is particularly badly impacted, as not only is the localised gas market hit, but security concerns prompt households and businesses to retrench. Net exporters of oil gain from the terms of trade shock and raise production. Russia falls into this category, though loss of businesses with Europe leads to a worse outcome for its growth than in the baseline. Central banks hold back on tightening monetary policy and re-focus on providing liquidity, despite the high rate of inflation.	9%	-0.8%	+0.7%
2. Consumers re-leverage	Strong labour markets put households in a buoyant mood, encouraging not only the spending of excess savings accumulated during the pandemic, but also a period of increased leverage.	Reflation: This results in stronger household consumption and GDP growth, but also higher inflation as companies re-discover their pricing power. The service sector recovers more quickly, as old patterns of spending return. Central banks realise that they are very behind the curve, and raise interest rates faster, taking rates above neutral. For example, the Fed funds rate reaches 3.25% at the end of the forecast.	5%	+0.7%	+0.1%
3. China hard landing	Relatively small stimulus measures already in place fail to arrest the slump in China's domestic economy. In particular, new housing sales and starts continue to fall sharply, forcing more developers into default, while negative spill overs on confidence drag on consumption. GDP growth slows to just 1.9% in 2022 and the renminbi depreciates to 7.15/$. Fiscal and monetary policy is loosened, driving a rebound in growth to 6.5% in 2023.	Deflationary: Lower growth in China presents a demand shock for the rest of the world who take a hit to their exports with commodity producers being particularly affected. Inflation is also lower as a result of lower growth and lower commodity prices. The PBoC respond by cutting the one year Loan Prime Rate (LPR) to 3% and the Reserve Requirement Ratio (RRR) to 8% by the end of next year. The Fed and BoE still raise rates in 2022 and 2023, but by less than in the baseline.	5%	-1.0%	-0.6%
4. Consumer recession	Supply bottlenecks delay households from spending their pent-up savings and rising food and energy inflation shock them into saving more, causing a slump in consumption. Companies suddenly realise that they have over-produced, and start to cut back output and hiring, which re-enforces the negative sentiment building amongst households. As inventories build, retailers start to compete again, offering greater discounts to clear excess stock.	Deflationary: As households slash spending, economies fall into a technical recession in the middle of this year. Household consumption stabilises by the end of the year, but the recovery is slow, as households maintain an elevated savings rate as the labour market weakens. Weaker demand and slowing production causes oil prices to fall back, which combined with retailers clearing inventories, helps inflation fall back sharply. US inflation sinks to 1.7% for 2023. Emerging markets also struggle as they see a big fall in demand for exports, of both finished goods and commodities. Central banks end the forecast with looser policy than in the baseline. The Fed reverses course, taking fed funds rate back to 0.5%, while the ECB extends QE and foregoes hikes.	9%	-1.1%	-0.5%
5. Supply side inflation	The current bottlenecks in the industrial sector last for longer than expected and have knock on impacts through global supply chains. Commodity markets also struggle with supply shortages. Meanwhile, wages accelerate by more than in the baseline in response to tight labour markets. The labour participation rate in the US does not improve, whilst mismatch between worker skills and jobs in the post covid economy means the NAIRU rises and available slack is less than in the baseline.	Stagflationary: Commodity prices continue to rise due to shortages in supply. This adds to inflation and energy price base effects do not wash out. Meanwhile, this feeds through to underlying inflation, which is also pushed up from supply side constraints and higher costs through global supply chains. Even though growth slows through 2022, demand still outpaces supply in the labour market and wages rise. This results in persistent inflation, averaging 6.2% in the US in 2022. This leaves the Federal Reserve hiking interest rates to 2.25% by the end of 2022 and 4% by the end of 2023. All other central banks also hike rates faster in this scenario.	13%	-0.6%	+0.6%
6. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

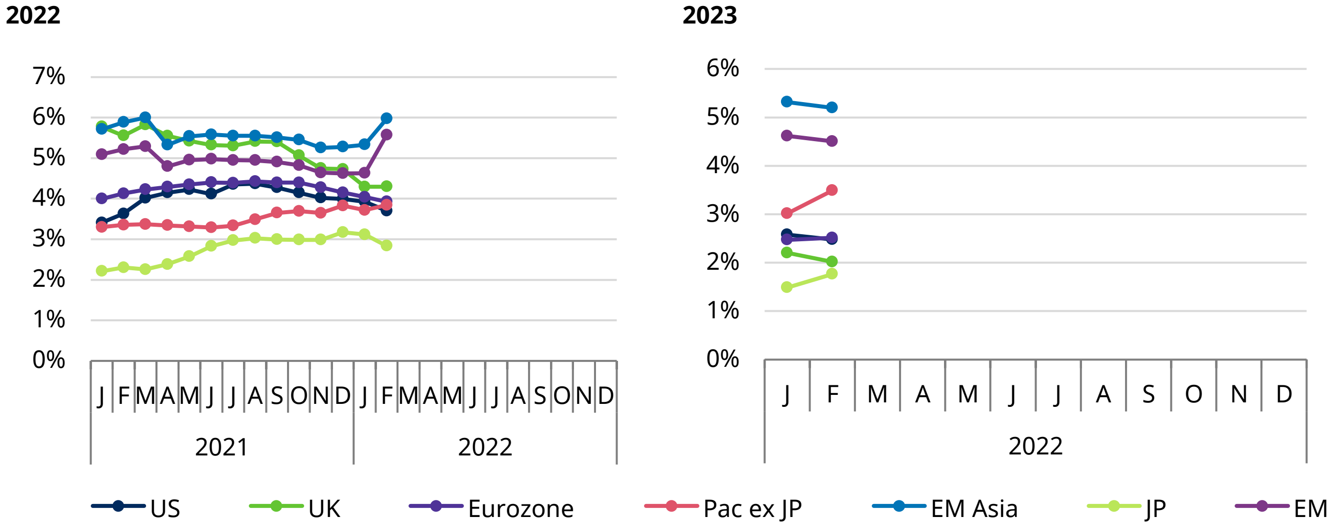
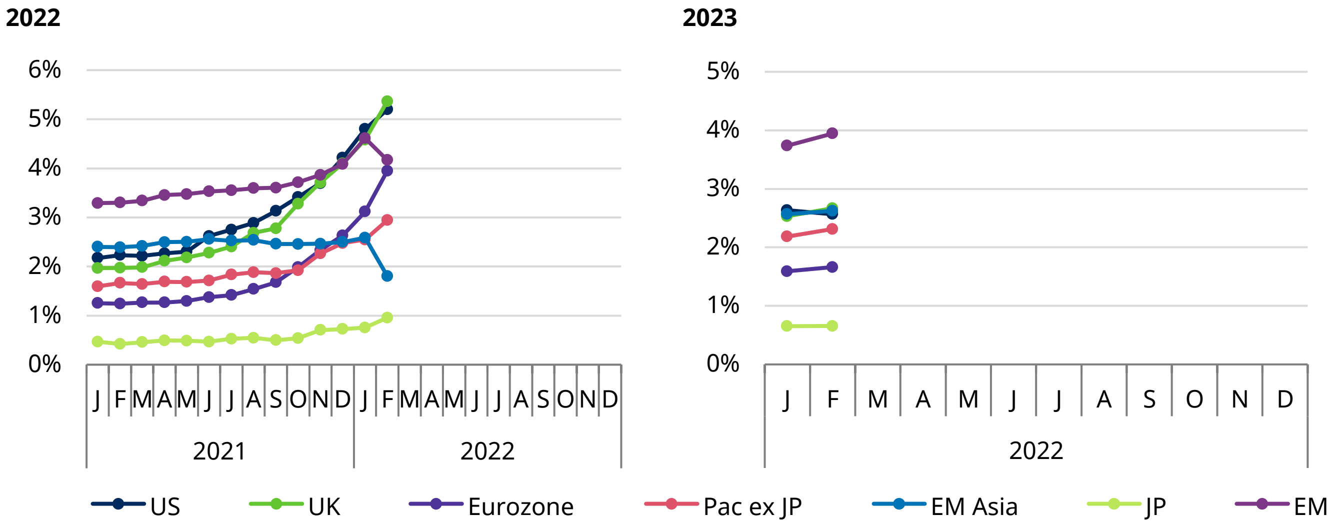


Chart B: Inflation consensus forecasts



Source: Consensus Economics (February 2022), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

Schroders