Is the Global Economy Heading towards a Recession?

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Abstract

Emerging Market Economies (EMEs) in general and India in our specific case, are vulnerable to both surges of capital inflows and episodes of outflows, with associated policy challenges in terms of managing the macroeconomic and financial consequences. While EMEs have fashioned responses to inflow booms by employing a combination of monetary and fiscal policies, macroprudential tools and capital-flow management measures, capital outflows are more daunting to deal with as they can lead to tightening of financial conditions and instability, with contractionary effects on growth. Changes in global uncertainty, as captured in the Volatility Index (VIX) of the Chicago Board Options Exchange (CBOE), affect the risk appetite of international investors which, in turn, results in sudden movements in capital flows as observed vividly during the GFC, the European debt crisis and COVID-19. Movements in the VIX are closely associated with the volatility of foreign portfolio investment (FPI) flows to and from India. A RBI paper[1] has found that Growth differentials and the term premium in India turn out to be the most influential variables in determining capital flows to India, indicating the predominance of pull factors.

Therefore, though EMEs have opened up their borders to international capital movements to exploit the well-documented benefits associated with these flows, they have become vulnerable to large swings, with attendant volatility, shocks and crises. The recent hike of the federal funds rate by the Federal Reserve by 75 basis points has also made FIIs cautious on EMEs and they have already started pulling out their exposure from EMEs including India. On the other hand, despite Janet Yellen's proposition that US might not fall into recession, rather a slowdown, the fear of recession in US and subsequent repercussion impact cannot be ruled out [further, to recall Yellen later declared that she was 'wrong" on inflation forecast, hence, similar probability for her recession forecast also cannot be ruled out.]. The Fed stress test this year shows the 2021 stress test envisioned a 4 percentage point jump in unemployment under a "severely adverse" scenario. In 2022, that increase is 5.75 percentage points, thanks largely to rising employment over the past year. In this backdrop, this paper critically reviews the global macroeconomic developments including of the Indian economy, and suggests certain policy options.

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[1] RBI June 2022 Bulletin.

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Introduction

We are back to an era, where panic igniting words like “stagflation”, “recession” are once again cropping up. Most of the central banks are struggling to contain inflation towards their target zone, including India and US. At a hearing before the U.S. Senate Banking Committee, U.S. central bank chief Jerome Powell acknowledged that a recession is "certainly a possibility". An important query in this regard is whether increasing policy rate (e.g. federal funds rate for the Fed, repo rate for the RBI) is a right policy to control inflation without any side effects? The inflationary situations and reasons thereof can be categorized largely into “demand-pull”, “cost-push” and “stagflation.” By raising policy rates, any central bank can control “demand-pull” inflation by increasing cost of borrowing. However, the current situation of inflation is a scenario which has emerged due to supply side bottlenecks, and largely it is a scenario of “stagnation” with “inflation.” In fact, an article published (17 June 2011)[2] highlighted that “inflation driven by "supply-side" considerations is still stronger, and that cannot always be effectively curtailed through monetary policy action. In fact, there's the risk of over-reliance on monetary policy to tackle overall inflation.”

Movements in the VIX are closely associated with the volatility of foreign portfolio investment (FPI) flows to and from India. A RBI paper[3] has found that Growth differentials and the term premium in India turn out to be the most influential variables in determining capital flows to India, indicating the predominance of pull factors. Therefore, though EMEs have opened up their borders to international capital movements to exploit the well-documented benefits associated with these flows, they have become vulnerable to large swings, with attendant volatility, shocks and crises. The recent hike of the federal funds rate by the Federal Reserve by 75 basis points has also made FIIs cautious on EMEs and they have already started pulling out their exposure from EMEs including India. On the other hand, despite Janet Yellen’s proposition that US might not fall into recession, rather a slowdown, the fear of recession in US and subsequent repercussion impact cannot be ruled out [further, to recall Yellen later declared that she was ‘wrong” on inflation forecast, hence, similar probability for her recession forecast also cannot be ruled out.]. The Fed stress test this year shows the 2021 stress test envisioned a 4 percentage point jump in unemployment under a "severely adverse" scenario. In 2022, that increase is 5.75 percentage points, thanks largely to rising employment over the past year. In this backdrop, this paper

[2] [https://www.firstpost.com/business/rbi-barking-up-wrong-tree-27285.html]

[3] RBI June 2022 Bulletin.

critically reviews the global macroeconomic developments including of the Indian economy, and suggests certain policy options.

The global economic outlook remains shrouded in uncertainty, with headwinds from multiple fronts.

Increased US inflation has posed a Global Challenge

Consumer Price Index (CPI) has surged to a 6.2 per cent for last 12 month in October 2021 due to higher fuel costs and disrupted supply chain. The inflation has increased to 0.9 per cent in October 2021 from September 2021 faster than the prior month's 0.4 per cent. It is also becoming a major challenge for the Fed that has committed maintaining 2 per cent annual inflation with maximum employment. The initial assurance that inflation is transitory is losing ground so much so that President Biden has stated that "Reversing this trend is top priority for me."

Rising energy costs in Europe is also posing challenge

High energy costs in Europe are posing challenges. For instance, at the Dutch Title Transfer Facility, Europe's leading benchmark, prices have escalated from €16 megawatt per hour in early January'21 to €88 by late October'21, a hike of more than 450% in less than one year. This, in turn, has sent electricity prices skyrocketing.[4] Another challenge is that the auto industry in Europe is still functioning at a sub-optimal level due to semiconductor issues.

Coking Coal prices have increased

Leading steel companies needed to enhance prices (hot-rolled coil or HRC) to offset coking coal price increase.[5] Global coking coal prices have increased substantially, e.g. Australian premium coking coal is facing certain price pressures on freight on board levels at recent times.[6]

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[4] "Why Europe's energy prices are soaring and could get much worse" (28.10.2021) https://www.euronews.com/2021/10/28/why-europe-s-energy-prices-are-soaring-and-could-get-much-worse

[5] "Steel Cos Hike Benchmark HRC Prices by up to 3,500a Tonne" (1 November 2021) Business Standard https://www.business-standard.com/article/companies/steel-firms-hike-prices-by-up-to-rs-3-500-a-tonne-on-input-cost-pressure-121110101245_1.html

[6] Eurometal.net (15 September 2021) https://eurometal.net/india-fears-rising-coking-coal-prices-increases-imports/?utm_source=dlvr.it&utm_medium=twitter&utm_campaign=india-fears-rising-coking-coal-prices-increases-imports

Policy Implications of major central banks

On the policy front, a distinct shift towards unwinding of pandemic-led stimulus is taking hold as inflation worries are rumbling more clearly than before. The US Fed, in its November meeting, announced the tapering of its asset purchases at a pace of US$ 15 billion per month beginning mid-November. From the current pace of monthly purchase of US$ 80 billion of Treasury securities and US$ 40 billion of agency mortgage-backed securities (MBS), the taper will be of US$ 10 billion in Treasury securities and US$ 5 billion in agency MBS. The Bank of Canada in its October meeting left its policy rate unchanged but ended its weekly bond-buying programme of C$ 2 billion. The Reserve Bank of Australia also dumped its policy of yield curve control as a signal to act against a post-pandemic surge in prices. The Monetary Authority of Singapore tightened its monetary policy by allowing the Singapore dollar (S$), in nominal effective terms, to appreciate mildly, while the Czech Republic effected its fourth rate hike at a much higher magnitude of 125 basis points (bps) lower pace in Q4 than Q2 and Q3, as was decided in its September meeting.

The Bank of England too, kept its policy rate and asset purchase programme unchanged in its November meeting, confounding market expectations of a rate hike. Among the EMEs, Brazil remains the most hawkish central bank, raising its policy rate for the sixth time since March and at a much higher magnitude of 150 bps – the highest hike in almost 20 years – taking the total cumulative increase in 2021 to 575 bps. Russia too, effected its sixth consecutive rate hike but at a lesser magnitude of 75 bps, for a cumulative increase of 325 bps in 2021.

Among other EMEs, Hungary raised rates by 15 bps, its fifth consecutive hike in 2021, while Chile effected its third consecutive rate hike at a higher magnitude of 125 bps in October. Poland increased rate for the second consecutive month in November by 75 bps. In a sharp departure, Turkey cut its policy rate by 200 bps, its second rate cut in a row, which took the total cumulative rate change for the year to (-)100 bps.

WPI inflation jumps to 5-month high of 12.54%

The wholesale price inflation has increased to a five month high of 12.54% in October'21 against 10.66% in September'21 as the rate of price rise in raw materials showed an upswing. The widely tracked non-food, non-oil inflation rate, i.e. 'core inflation' has increased to 11.9% in Oct'21. As demand is recovering, the high wholesale price inflation might push up the retail price or CPI inflation. The retail inflation has increased in October'21 though marginally to 4.48% from 4.35% in Sept'21.

The high rate of inflation in Oct'21 is mainly due to a rise in the prices of mineral oils, basic metals, food products, crude petroleum and natural gas, chemicals and chemical products etc.

Manufactured items as a group saw the inflation rate rising to 12.04% from 11.41% from the previous month. Processed food items in this category saw the rate rising to 12.74% from 12.65%.

Raw materials such as vegetable oil and animal fats, chemicals and chemical products, rubber and plastic products, cement, lime and plaster, basic metals, semi-finished steel have also experienced inflation increasing in Oct'21 over Sept'21.

Following trends in different items are discussed briefly:[7] (reproduction from a Business Standard newspaper):

Tomatoes: Tomato prices have increased sharply after standing crops were damaged in late rain in major growing states. Tomatoes were sown in about 2,47,000 hectares this khariff season . In that, the crop on about 4,000 hectares (less than 2 per cent) was damaged due to rain. Tomato prices are expected to be in the range of ₹30-80 per kg in retail markets during the next few weeks. But they may fall if new crops arrive.

Onion: The rates have increased sharply in October 2021 due to damage to standing khariff crops. Since then the prices have cooled slightly as the Centre released its inventories of stored onions and as on 6 November 2021 prices were almost 38 percent lower than in the same period last year in retail markets. An assessment by the Ministry of Food Processing a few weeks back shows onion prices are expected to be high at ₹30-60 per kg in retail markets.

Edible Oils: The prices of all major edible oils have been on the boil for the past few months. The prices have increased sharply after Feb'21, mainly due to a sharp rise in global rates (where part of the oilseed crop has been diverted towards biofuel) and also on account of low domestic stocks. The Centre lowered import duties as many as five times since Feb'21 to cool prices. On 13 October 2021, the government has abolished basic customs duty on crude varieties of plam, soyabean, sunflower oil and slashed agri cess on them till March 2022. The data sourced from the Department of Consumers Affairs on 6 November 2021 showed that the retail price of groundnut oil was still higher by 18.44% year-on-year, mustard oil 43%, Vanaspati 45%, soyabean oil 45%, sunflower oil 37%, RBD palmolein oil 37%.

Pulses: Pulses rates also hardened, to cool prices the Centre has adopted a multi-pronged approach of first allowing easier imports and then imposing stock-holding limits. The measures seem to have some impact as the prices of tur dal and moong dal were 1.32% and 2.37% lower as on 6 Nov'21 (YOY) but urad was up 0.33% and masur 21%. Gram dal was 4.21% costlier YOY. The retail price of masur rose sharply due to lower imports.

[7] This part is entirely a reproduction from the Business Standard newspaper.

Fuel prices: Fuel prices have been on the upswing for the past few months. However, the Centre's recent move to cut excise duty on petrol by ₹5 and on diesel by ₹10 a litre would ease the retail price inflation by 0.30% points, provided global crude oil price does not change. The Indian basket of crude oil increased to $82.11 a barrel in October 2021 from $73.3 a barrel in September 2021.

Petrol & Diesel Prices of Major States announced cut in VAT (in ₹ per litre unless specified)

	before VAT cut		after VAT cut		%change	
	Petrol	Diesel	Petrol	Diesel	Petrol	Diesel
Gandhinagar	106.88	106.33	95.35	89.33	-10.8%	-15.9%
Lucknow	106.96	98.91	95.28	86.8	-10.9%	-12.2%
Shimla	107.49	97.68	95.78	80.35	-10.9%	-17.7%
Patna	113.79	105.07	105.9	91.09	-6.9%	-13.3%

On the other hand, merchandise exports have increased for the eleventh consecutive month to $35.65 billion up 43% on year in October'21 as external demand condition has improved despite many challenges. The export growth is driven primarily by engineering goods, petroleum products, gems & jewellery as well as organic and inorganic chemicals.

Compared with pre-Covid levels of October 2019, growth in the value of goods exported was up nearly 36%. Exports have been increased with the value of exports hovering around $30 billion over the past eight months, amid gradual recovery in major western markets.

According to the MVIRDC, World Trade Centre, Mumbai; the export growth of –carpets, handicrafts, leather goods, spices, marine products, meat (including poultry and dairy products), plastics and electronic goods are likely to see further growth.

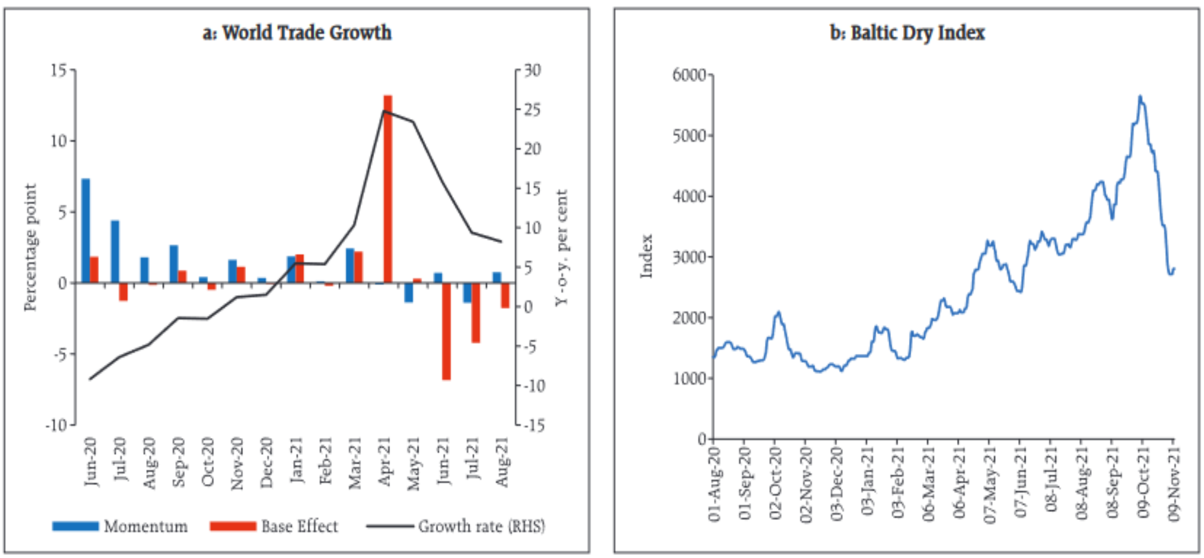
The time is opportune for India to expand its marine exports. At present, marine exports constitute only around 2 per cent of India's total exports. With the natural competitive advantage of having one of the longest coastlines suitable for fishing, India needs to seize the opportunity in the ocean economy. Moreover, India's marine exports have shown strong growth momentum in October'21. India's textile exports have recorded double-digit growth for the last two months over the pre-pandemic level.

The United Nations Conference on Trade and Development (UNCTAD) in its October release, highlighted that the global trade exhibited a strong recovery in H1:2021, surpassing its pre-pandemic level of 2019 and is likely to sustain the growth in H2:2021.

Accordingly, it projects the global trade value in 2021 to be about 20 per cent and 28 per cent higher than what was recorded in 2019 and 2020, respectively. The trade recovery, however, remains uneven with smaller economies struggling to catch up with the pace of exports growth in their larger counterparts. On average, goods exports of smaller economies are still 25 per cent below pre-pandemic levels. Granular data for monthly merchandise trade volume indicate that y-o-y growth decelerated for the fourth consecutive month in August, albeit at a slower pace, as monthly momentum turned positive post its decline in July'21.

The Baltic Dry Index, a measure of shipping charges for dry bulk commodities, scaled a 13-year high in early October'21, before sliding sharply by almost 50 per cent in November'21 so far, following losses in large and medium-sized vessel segments.

World Trade and Shipping Costs



Source: RBI Bulletin 15 November 2021.

The Bloomberg commodity price index maintained its uptrend in October'21, primarily mirroring soaring energy prices before exhibiting some corrections in November'21 so far. The World Bank's October edition of the Commodity Markets Outlook estimated average energy prices in 2021 to be 80 per cent higher than in 2020, and to remain elevated through at least the first half of 2022. Spurred by robust demand recovery and the early onset of winter, Brent crude oil price [nearly] hit a three-year high in October as persistent shortfall in supply amidst surging demand kept the oil market tight.

With the Organization of the Petroleum Exporting Countries (OPEC) plus sticking to its plan of gradual, monthly production increases of 400,000 barrels per day, crude prices extended gains in November. Also driving up the prices is a switch to crude oil from natural gas and coal for power generation as prices of the latter skyrocketed in recent months due to worsening supply crunch in Europe and Asia.

The global supply disruptions weighed on the domestic automobile sector, which continues to reel under supply shortages of semiconductor chips in October. The supply bottlenecks thwarted festival season sales, and in sync, retail sales of motor vehicles and vehicle registrations moderated. The decline in registrations was led by non-transport vehicles even as demand for transport vehicles improved on a y-o-y basis. Within the vehicles segment, tractor sales remained the lone bright spot with a robust growth of 8.2 per cent (over October 2019) in October. Sales of two-wheelers and motorcycles remained buoyant on a sequential basis. The construction sector is yet to catch up with its February 2020 levels as both steel consumption and cement production trailed below the baseline. Over the corresponding pre-pandemic month in 2019, however, cement production posted a robust growth while steel consumption growth stayed modest.

WPI and CPI inflation (%) 2021

Month	WPI(%)	CPI(%)
March	7.89	5.52
April	10.74	4.23
May	13.11	6.3
June	12.07	6.26
July	11.16	5.59
Aug	11.39	5.3
Sep	11.8	4.35
Oct	12.54	4.48
Nov	14.23	4.91

IMF raised concerns for Emerging Economies

Prices are rising at the fastest pace in almost four decades and the tight labor market has started to feed into wage increases. The new Omicron variant has raised additional concerns of supply-side pressures on inflation. The Federal Reserve referred to inflation developments as a key factor in its decision last month to accelerate the tapering of asset purchases.

These changes have made the outlook for emerging markets more uncertain. These countries also are confronting elevated inflation and substantially higher public debt. Average gross government debt in emerging markets is up by almost 10 percentage points since 2019 reaching an estimated 64 percent of GDP by end 2021, with large variations across countries. But, in contrast to the United States, their economic recovery and labor markets are less robust. While dollar borrowing costs remain low for many, concerns about domestic inflation and stable foreign funding led several emerging markets last year, including Brazil, Russia, and South Africa, to start raising interest rates.

India's benchmark yield increased to 6.59 per cent from 6.54 per cent in the backdrop of rising US Treasury yields. Decline in unemployment in US is expected to prompt the Fed to increase interest rate earlier than expected. There is continuous supply of State loans and G-Secs, but demand is less. As a result, bond prices have declined, and yields are rising. The Fed announcement of near-term rate hike is also a spoilsport. The rupee closed at 74.04; a record fund raise by Reliance Industries and other capital inflows are expected to keep the dollar under check.

There is also a negative outlook amid rising inflation with global oil prices firming up due to supply constraints arising out of the geo-political tension in Libya and Kazakhstan.

ADB Outlook

- The economic growth forecasts for developing Asia are downgraded slightly to 7.0% in 2021 and 5.3% in 2022, and the recent emergence of a highly mutated virus variant and a rise in infections globally indicate that the pandemic is far from over.
- East Asia's growth forecasts are revised down marginally for both 2021 and 2022 as the People's Republic of China is now expected to grow more slowly, by 8.0% in 2021 and 5.3% in 2022.
- The growth forecast for South Asia is revised down to 8.6% for 2021, while the forecast for 2022 is maintained at 7.0%. India's projection is lowered to 9.7% for fiscal 2021 but remains unchanged at 7.5% for 2022.
- After growth in Southeast Asia decelerated in the third quarter, the subregional forecast is revised down from 3.1% to 3.0% for 2021 but revised up to 5.1% for 2022.
- Central Asia's growth prospects are substantially upgraded from 4.1% to 4.7% for 2021 and then from 4.2% to 4.4% for 2022. The Pacific is still forecast to contract by 0.6% in 2021 before growing by 4.7% in 2022.
- Regional inflation remains manageable, with the inflation forecast revised down a notch to 2.1% for 2021 and unchanged at 2.7% for 2022.