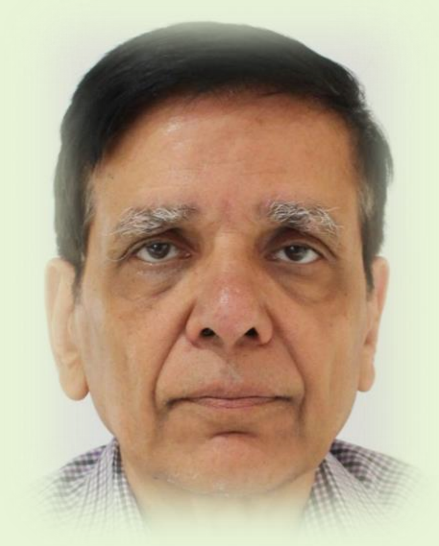
Recession Matters: Labour Market, Trade And The Role Of Geopolitics



By

Prof. Raghbendra Jha,

Emeritus Professor of Economics,

Australian National University

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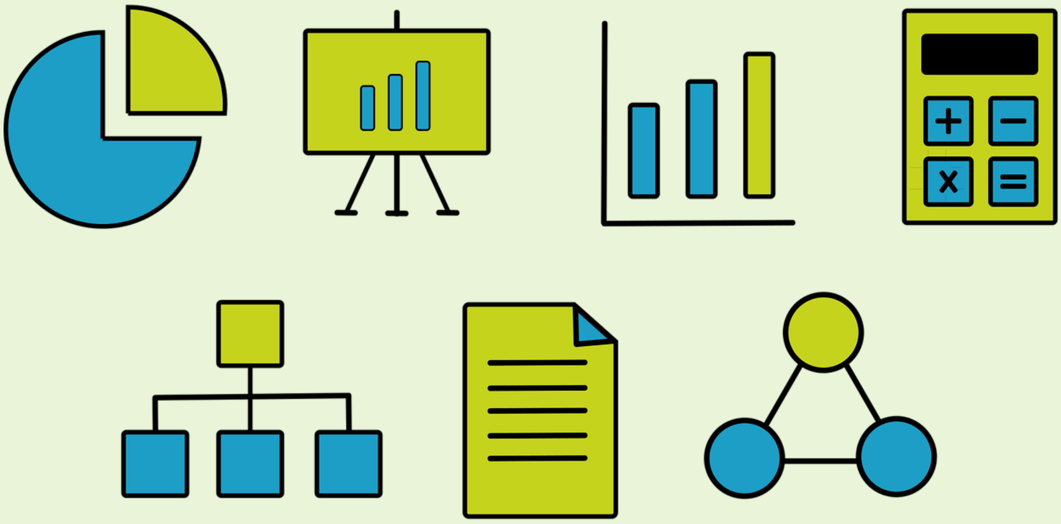
The global economy had started to recover from the pandemic in 2021. However, the recovery has stalled with little room for optimism for the foreseeable future. This has been made abundantly clear by the July 2022 update of the World Economic Outlook (WEO) published by the International Monetary Fund (IMF). https://www.imf.org/en/Publications/WEO/Issues/2022/07/26/world-economic-outlook-update-july-2022. Compared with the estimates provided in the April 2022 edition of the WEO most countries are expected to record lower rates of economic growth in both 2022 and 2023.

For 2022 the predicted real GDP growth rate in 2022 (change from the April 2022 forecast) was 3.8 % (-0.4%) for Australia, 3.3% (-1.1 %) for China, 2.3% (-0.6%) for France 1.2 % (-0.9%) for Germany, 7.4 % (-0.8%) for India, 1.7% (-0.7%) for Japan, -6% (25%) for Russia, 3.2% (-0.5%) for UK and 2.3 % (1.4 %) for the US. Corresponding figures for 2023, again in comparison to the April 2022 WEO figures are 2.2 % (-0.3%) for Australia, 4.6% (-0.5%) for China, 1% (-0.4%), 1.0 % (-0.4%) for France, 0.8% (-1.9%), for Germany, 6.1 % (-0.8%) for India, 1.7 % (-0.6%) for Japan, -3.5 % (-1.2%) for Russia, 0.5% (-0.7%) for UK and 1.0 % (-1.3%) for US.



Quarterly data indicates that the drop in growth rate has been particularly sharp in some countries, to the extent that the US, the largest economy in the world, may already be in a recession. In the US real GDP decreased at an annual rate of 0.9 % in the second quarter of 2022 after a decline of 1.6 % in the first quarter. The smaller decrease in the second quarter primarily reflected an upturn in exports and a smaller decrease in federal government spending. In the Euro area real GDP growth was 0.5% in the first quarter of 2022 and 0.7% in 2022. The Bank of England is anticipating a recession in the UK.

This general slowdown is the result of several factors. The pandemic represented both an adverse demand shock (collapse of demand in the face of the pandemic as workers were laid off and economic activity came to a near halt) and adverse supply shocks in the form of the huge public health challenge. Central banks and governments all over the world responded with strong stimulative measures including record low interest rates, quantitative easing, fiscal transfers and tax cuts. However, commensurate policy initiatives on the supply side could not be undertaken. Indeed, with widespread lockdowns supply chains were disrupted and considerable protectionist measures were undertaken to protect own markets and domestic supply chains. Hence the abundance of liquidity with businesses and consumers was matched by a disruption in supply whence the recovery in 2021 was accompanied by high and rising inflation. The supply chain breakdown has persisted and even been exacerbated in 2022 with repeated lockdowns in China (the most crucial link in a large number of global supply chains) as the country pursues a zero Covid policy.

The larger than anticipated slowdown in China has only served to worsen the impact of the slowdown. The war in Ukraine along with sanctions on Russia have had particularly strong impacts on food and fuel inflation – two critical components of the Consumer Price Index. Whereas food inflation has stroked fears of incipient food insecurity in the developing world, fuel inflation by its various nature filters into most prices – directly and/or indirectly – and exacerbates the conundrum of supply side inflation.

Supply side measures to combat inflation take time to have effect and short-term solutions are needed. Most central banks following inflation targeting raised interest rates substantially lest inflationary expectations get unhinged and price rises become difficult to control.

At the same time, governments all over the world built up large debt stocks even as their capacity to service such debts was being curtailed because of weak levels of economic activity. The rise in interest rates has only served to exacerbate the burden of debt servicing. No wonder markets are gloomy and no early relief from the mix of economic slowdown and inflation can be seen on the horizon.

However, it is imperative to break this vicious cycle, lest expectations of a prolonged recession even stagflation (a combination of high inflation and economic stagnation) get entrenched. In the Australian case one factor that softens the impact of supply side factors on inflation is the rise of the nominal wage rate substantially below the rate of inflation. This will mean that the wage price nexus typical of spells of high inflation has not yet become operative. The flip side is that with falling real wages household incomes are falling and inequality rising.

What does the future hold in store? There is little room for optimism. It is possible that the war in Ukraine could lead to a sudden stop or substantial drop in the supply of Russian gas to Europe. This would further stoke supply side inflationary pressures. In the face of the existing tightness in labour markets wage price spirals could develop in key economies whence inflationary expectations could become unhinged. All this could make the task of inflation control harder. The debt overhang and tight global financial conditions could lead to debt distress in many developing countries, e.g. Sri Lanka and Pakistan among several others.

The global economy is clearly in troubled waters. The best antidote at present should involve **four policy measures. First, efforts to control inflation should continue unabated. Second, supply enhancing measures such as enhancing labour market participation and flexibility should be pursued. Third, global supply chains should be strengthened through freer trade and investment. Finally, vaccines against newer strains of the corona virus need to be developed urgently.** These vaccines should prevent transmission in addition to providing protection for the person being vaccinated. One can only hope for a quick end to the Ukraine war and a substantial drop in the price of fuel.

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