NOT IF, BUT HOW

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Economic Outlook

Munich Re Economic Research
4 February 2022

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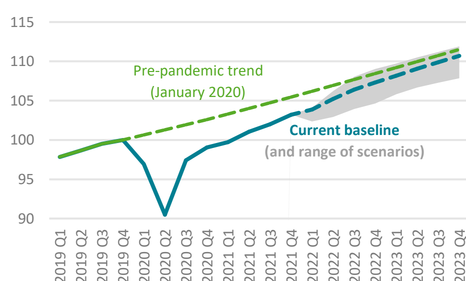
Global economy in 2022: Continued recovery amidst high inflation – downside risks dominate again

The continuing recovery of the global economy has to overcome a multitude of stumbling blocks. Corona infection rates have been surging in many countries. This has e.g. led to stricter pandemic containment measures in the euro area as well as to increased labour shortages. Global supply-chain pressures are still high and weigh on activity. Rising energy prices contributed to inflation hitting the highest rate in decades. For 2022, we expect above-trend global growth while inflation should gradually recede over the course of the year. But **uncertainties surrounding the outlook have significantly increased again in recent months.**

Fig. 1: World real GDP (index, 2019 Q4 = 100), pre-crisis trend, baseline forecast and distribution of plausible risk scenarios



Source: Oxford Economics, Munich Re Economic Research

1 Growth: The global recovery continues on a bumpy road

The **high GDP growth rates** we are projecting for 2022 (see Tab. 1) do not indicate a boom. **They show the ongoing recovery from the sharp recession of 2020** (see Fig. 1) and the setback especially of European economies in winter last year. While the US reached its pre-crisis GDP level already in Q2 2021, the euro area is only about to recover to its pre-pandemic GDP level in the current quarter, while Germany and the UK should be there in Q2 2022.

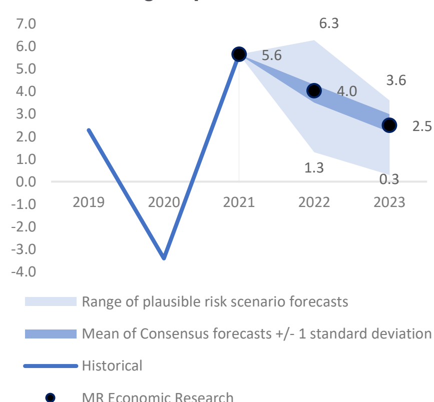
Private consumption in advanced economies, where a portion of unplanned savings of the past two years will be spent, will continue to be an important driver of global growth. A **crucial assumption for this forecast** is that though the **current Omicron wave** is leading to high infection rates, it will **not result in hard lockdowns or significantly more cautious consumer behaviour**. The mandatory and voluntary containment measures currently seem to be having a less

Tab. 1: Real GDP growth (in %), baseline forecast

	2020	2021e	2022f
USA	-3.4	5.6	4.0
Eurozone	-6.4	5.2	3.9
Germany	-4.6	2.7	3.7
China	2.3	8.0	5.0
Japan	-4.7	1.8	3.2
UK	-9.4	7.2	4.3

Source: Munich Re Economic Research

Fig. 2: US GDP growth (in %), baseline forecast, +/- 1 standard deviation of Consensus mean, and range of plausible risk scenarios



Source: Consensus Economics, Oxford Economics, MEAG Research, Munich Re Economic Research

negative effect on economic activity than during last winter (and significantly less compared to March/April 2020, as suggested by mobility indices, for example). Another substantial contribution to GDP growth is expected to come from fixed investment growth and inventory build-up by businesses. These factors should be strong enough to outweigh drags from less supportive fiscal policy, monetary policy tightening (especially in the US and in the UK, among the major central banks) and inflation effects on real incomes.

In aggregate, **advanced economies** are projected to **contribute slightly more than half of global economic growth** this year. This is different from pre-pandemic years (when the bulk of growth usually came from emerging markets) and not only due to the recovery momentum in advanced economies but also due to **weakness in several big emerging market economies**. For example, China's economy is grappling with a real estate market slowdown and regional lockdowns to eradicate infections, and Brazil's economic growth is stagnating in the face of a severe drought, high inflation and fiscal and monetary tightening.

The road ahead remains bumpy: The pandemic (i.e. Omicron), supply-chain disruptions and high energy prices are currently slowing growth dynamics. As these negative effects should diminish in the coming months, i.e. once pent-up orders in industrial production are processed and (self-imposed) restrictions are lifted, solid growth should return from Q2 onwards.

Risks to the growth outlook are clearly tilted to the downside. Two years into the pandemic, and the economic forecasts are still very uncertain (see Fig. 2). Back in the summer of 2021, we felt that GDP projections could be made with more certainty than in 2020 – after all, there had been great progress in the vaccination campaigns of many countries. But all of the aforementioned current stumbling blocks could actually be greater than previously thought. New coronavirus variants that challenge the effectiveness of vaccines could lead to renewed restrictions and consumer reluctance. The problems in the global supply chain could last longer than currently expected – e.g. if growth-disrupting effects of China's zero-Covid policy spread across the global supply chain. Energy prices could increase further and thus reduce consumers' purchasing power and/or affect energy-intensive industries more than expected. A geopolitical hotspot (e.g. Russia/Ukraine) could lead to problems on capital or commodity markets or impede international trade and investment. Finally, central banks could react faster or more strongly than expected to high inflation – which would likely worsen financing conditions and thus dampen economic growth.

2 Inflation rates are likely to decrease during 2022 – but there is a risk that inflation softening will take longer

In most economies, **inflation in 2021 was far higher than expected**. We did not expect inflationary pressures to remain for so long. Especially supply and demand imbalances related to the pandemic and the reopening of the economy contributed to the elevated levels of inflation. For example, prices for used cars in the US surged by around 25% in 2021. A shortage of semiconductors used in the manufacturing of new cars had resulted in shortages of used cars. About one percentage point of the 7% year-over-year inflation in December 2021 was due to higher prices for used cars. In the eurozone, the main culprit was energy. Higher oil prices and unprecedented increases in natural gas prices resulted in upside inflation surprises. In January 2022, energy prices accounted for more than half of the 5.1% (y-o-y) inflation rate in the eurozone.

Over the course of 2022, inflation in most advanced economies should gradually recede, although the peak might not have yet been reached (i.e. monthly published year-on-year inflation rates expected to decrease in the next months). This forecast is based on the following factors and **assumptions**:

- Global supply-chain bottlenecks (logistics, semiconductors) are expected to gradually ease.
- The exceptionally strong growth in demand for goods in the US is expected to normalise and shift back towards services.
- Developments in 2020 (e.g. the plunge in oil prices and the German value-added tax cut) contributed to the high year-on-year inflation rates published in 2021. These base effects will flatten or reverse in 2022.
- Energy prices will most likely not repeat their sharp rise (although some of the 2021 price increases will only be passed on to consumers in 2022).
- Labour force participation in the US will continue to recover and help to mitigate wage growth, while wage inflation in the euro area will remain moderate.
- Inflation expectations remain well anchored.

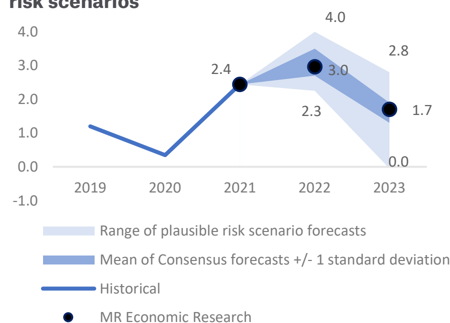
Tab. 2: CPI inflation (in %), baseline forecast

	2020	2021	2022f
USA	1.2	4.7	4.6
Eurozone	0.3	2.4	3.0
Germany	0.5	3.1	3.1
China	2.5	1.0	2.5
Japan	0.0	-0.2	0.8
UK	0.9	2.6	4.6

Source: Munich Re Economic Research

However, annual average inflation rates in 2022 will remain relatively high, similar to 2021 (see Tab. 2). And similar to 2021, the forecast is uncertain (see Fig. 3). In the case of weaker-than-expected consumption growth, inflation could even turn out lower, too. But we see the **risks for inflation clearly tilted to the upside**: Ongoing supply-chain disruptions (e.g. related to China's zero-Covid policy) and increasing commodity prices (e.g. escalation of Russia/Ukraine conflict) could result in continued elevated levels of price pressure. An outright consumption boom could prolong the demand-supply mismatch. "Second-round effects" (e.g. higher commodity lifting food prices) could be more pronounced than anticipated. Stronger-than-expected wage growth would push up costs for companies and inflation expectations could shift higher, thus prolonging inflationary pressures and affecting the medium-term outlook for inflation.

Fig.3: Euro area CPI inflation (in %), baseline forecast, +/- 1 standard deviation of Consensus mean, and range of plausible risk scenarios



Source: Consensus Economics, Oxford Economics, MEAG Research, Munich Re Economic Research

In any case, **we do expect inflation over the next few years to be higher than in the low-inflation decade** from the global financial crisis up to the Covid-19 recession. In addition – in contrast to the years prior to the pandemic when inflation on average was lower than central banks' targets – we consider it **more likely that inflation will be above central banks' targets in the future**. This is based on the assumption that structural forces such as digitalisation will continue to keep a lid on inflation. However, the decarbonisation of the global economy might increase energy price volatility. And with the European Central Bank (ECB), a major central bank is showing its intention to stick to announced strategies and tolerate elevated inflation if this is connected to energy price shocks, especially after a period with lower price pressure.

Other major **central banks** (especially the **US Federal Reserve** and the **Bank of England**) have shifted gear and started to address inflation concerns. The process of **monetary tightening** (i.e. the end of the unprecedented monetary expansion) will be delicate, as the risks of falling behind the curve (i.e. being too late to rein in inflation) vs. pre-mature tightening (i.e. choking growth) need to be balanced. The **ECB** seems to be still more concerned with changing course too early, although it now acknowledges that inflation risks are "tilted to the upside". Overall, we anticipate that there will be only **tentative monetary tightening in the euro area** in 2022. Nevertheless it should be kept in mind that the ECB's target is price stability for the entire euro area. For economies such as Germany, which have had higher inflation than the euro area average in the final months of 2021, this could mean another year of elevated inflation but scarcely any monetary policy reaction.

Bond yields have moved upwards markedly in recent weeks, reflecting inflation concerns and the shift in monetary policy. However, **government bond yields** are still at **historically low levels**, and most observers expect them to rise only gradually from current levels.

3 Focus risk scenario: supply-chain bottlenecks are more persistent, drive up inflation and drag growth down

As mentioned above, there are several risk drivers that could result in a downside scenario with weaker economic growth and higher inflation. In our view, for the immediate future, the most crucial of our baseline assumptions is that the negative impact of most supply chain issues (shipping bottlenecks, labour shortages) will gradually fade. Although semiconductor capacity might remain tight into 2023 (due to secular demand strength), we expect relief in the course of the year 2022, when Covid restrictions are lifted. However, the exceptionally high transmissibility of the Omicron variant has resulted in unprecedented infection waves in America and Europe. **The risks of major outbreaks in Asia are growing**. Even if individual health risks from Omicron seem to be less severe compared to previous virus strains, many governments in Asia could react to another infection wave with similarly stringent restrictions as in the past. **China** especially (where only a relatively small part of the population is immune to infections and the government is pursuing a **zero-Covid policy**) is at risk of **economic disruptions that might impact the global supply chain**.

Thus, as a prominent example to address uncertainties related to our baseline forecasts, we look at **a risk scenario where current supply-chain disruptions prove more persistent than assumed in the baseline forecast**. In this scenario, 2022 **GDP growth rates in several big economies would be significantly lower** (e.g. around 2 percentage points lower in the US and in the euro area), and **inflation rates** in advanced economies would be **about 1 percentage point higher**. Taking into account the sweeping restrictions related to China's zero-Covid policy, current high inflation readings, recent energy price increases and geopolitical tensions, we think that the implications of this scenario are currently the most relevant to focus on.

Notwithstanding the specific driver(s) of a such risk scenario, another year of price changes overshooting expectations **could result in more permanent shifts in the inflation environment**. Most importantly, wage growth could react and inflation expectations of households could become de-anchored, implying a wage-price spiral to build up. Central banks could then be in the uncomfortable situation of hiking interest rates despite a weaker-than-expected economy.

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