Five Key Questions for 2024

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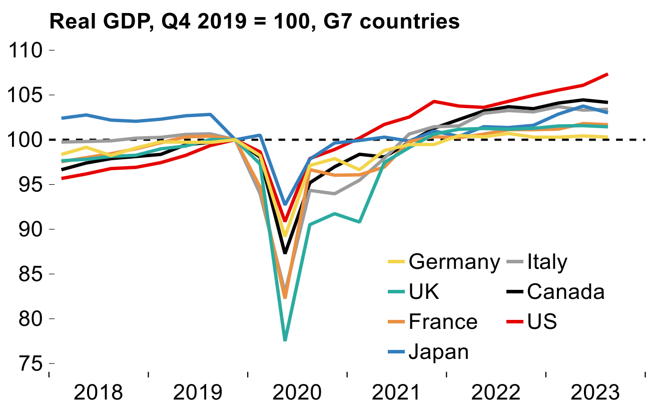
- 2023 can be summarised as a year of resilience as advanced economies avoided sharp downturns despite rapid monetary policy tightening. The US economy was a particularly bright light with buoyant domestic demand driving an upswing through the year. The Japanese economy also expanded strongly in H1 2023, before losing steam in the second half of the year. It's been tougher going in Europe with the euro area economy now teetering close to a mild technical recession against a broader backdrop of stagnation.

- This tees up some key questions for the year ahead from a macro perspective, the most important of which relates to the durability of the US expansion. As it stands, a so-called US 'soft landing' seems increasingly plausible, although we still look for a cyclical slowdown. The European economy, starting from a position of relative weakness, may be able to catch up a little ground in the second half of the year. We are also cautiously optimistic about the outlook for the Japanese economy.

- 2023 was also a year of disinflation as energy base effects weighed on headline rates, but we have now moved into what has been dubbed the hard 'last mile' with the focus shifting to underlying price growth. Our view is that core dynamics are favourable in developed economies and overall headline inflation should continue to ease in 2024.

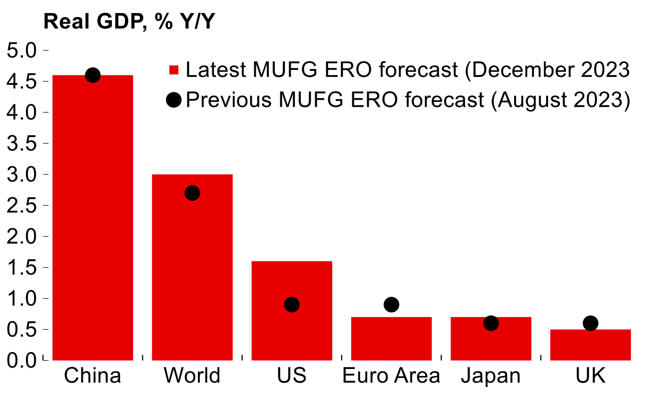
- Despite this, we suspect that markets are currently pricing in too much in the way of rate cuts given our US soft landing/no imminent recession call, although we do expect easing from the Fed, ECB and BoE this year. Meanwhile, the BoJ is likely to be swimming against the global monetary policy tide as it will look to raise interest rates back to positive territory.

Chart 1: The US economy performed strongly in 2023



Source: Macrobond, MUFG Bank Economic Research Office

Chart 2: We have upgraded our 2024 global forecast



Note: GDP growth figures for Japan are on a FY basis.
Source: MUFG Bank Economic Research Office

1. Is a soft landing for the US economy conceivable?

The US economy is poised for a slowdown in first half of this year, but a contraction may be avoided. We expect real GDP growth to weaken in the first half of 2024, but for consumers to have enough strength, bolstered by a strong labor market, to keep consumption growth in positive territory. Core PCE inflation has already hit the Fed's 2% target on a six-month annualized basis, with core goods prices in deflationary territory (-2.3%). Annual price growth is also expected to approach 2% in 2024. In our view, the upside potential for no recession outweighs downside risks, making a soft landing the most plausible scenario as it stands. See our full US forecasts here.

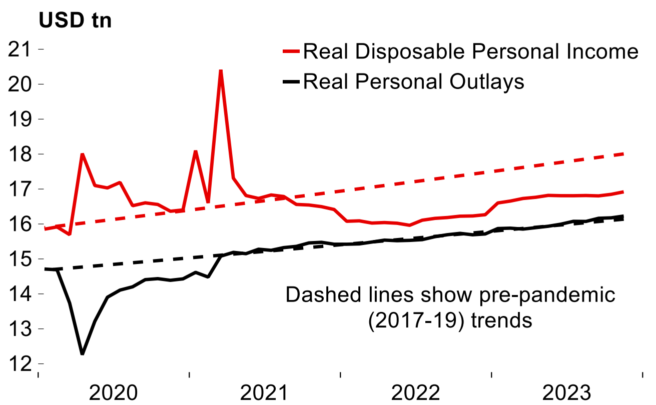
Upside potential – Accelerating growth in real personal income will likely prevent a contraction in personal consumption. It's true that excess savings have largely been depleted, making the narrow gap between real disposable income and outlays unsustainable for US households (Chart 3). But wage growth is outpacing inflation, bringing real incomes higher in recent months and helping to restore domestic savings. We expect that ongoing labor shortages will keep employment levels high and wage growth elevated. Better labor productivity growth is also set to limit the passthrough of wage growth into prices.

On the labor front, we expect the unemployment rate to remain relatively low. Deviations around the current rate of 3.7% have largely been a result of improvements in labor supply, but it remains well below the pre-pandemic trend and current demand levels (Chart 4). Participation rates are trending downward, especially for prime-age workers, and immigration growth has slowed. Slow growth in labor supply is likely to continue, suppressing the unemployment rate with fewer new entrants into the labor force. Ongoing labor shortages supports our expectation of only a modest increase in unemployment as economic activity slows.

Given our no recession scenario, we think that the Fed is unlikely to cut rates before this summer. If growth remains positive and unemployment remains low there will be little justification to cut sooner. MUFG Economic Research has pencilled in the first rate cut to occur in June 2024, and for economic growth to accelerate a little thereafter.

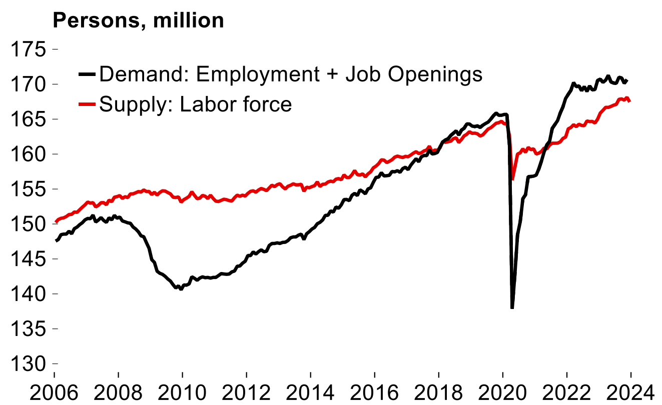
Downside risks – From a domestic perspective, lagged effects of monetary policy remain the clear threat to the soft landing, or no recession scenario. Restrictive monetary policy is working its way through the economy, impacting lower income households and less creditworthy businesses first. However, delinquency rates for consumers and businesses remain relatively low, and household debt service ratios are lower now than they were in 2019. The US economy has been able to absorb higher rates so far, and our base scenario is that will remain the case through 2024.

Chart 3: Real income is beginning to trend upward, which will support continued, but slower, consumption growth



Source: BEA, MUFG Bank Economic Research Office

Chart 4: Labor shortages are likely to stay as growth in labor supply slows

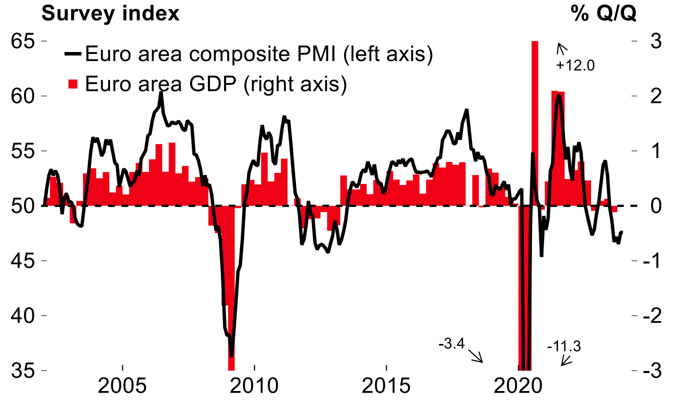


Source: BLS, MUFG Bank Economic Research Office

2. Will Europe be able to close the gap?

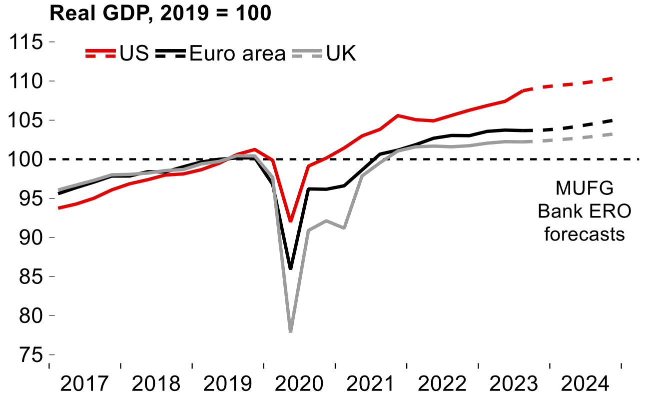
Unlike the US, nobody is talking about 'landings' for the euro area or the UK, soft or otherwise, simply because neither economy has managed to take off in the first place. The US economy has expanded by 3.5% since the start of 2022. The UK has grown by just 0.3% over the same period. The euro area as a whole has eked out slightly more respectable growth of 1.8%, supported by stronger figures from peripheral members, but Germany, its largest economy, has shrunk by 0.2% since Q1 2022. While the US has arguably been booming, Europe has been stagnating (see here).

Chart 5: The euro area economy is carrying very little momentum into 2024



Source: S&P Global, Eurostat, MUFG Bank Economic Research Office

Chart 6: We expect European growth rates to pick up slightly through the year



Source: Macrobond, MUFG Bank Economic Research Office

The near-term outlook remains challenging for Europe. The final euro composite PMI for December (47.6) is consistent with another contraction in Q4 after GDP fell by 0.1% the previous quarter, which would place the economy in a technical recession (Chart 5). Consecutive quarters of contraction can't be ruled out in the UK, either. However, business surveys in both economies now point to a degree of improvement in cyclical momentum, with tentative signs that firms are now expecting better conditions ahead.

We are slightly above consensus on annual average GDP growth for both euro area (0.7%) and UK (0.6%) in 2024. It's important to note that the carryover effect from 2023 activity into these figures is likely to be negligible. On a quarterly basis, we expect both UK and euro area growth will pick up through 2024 (Chart 6) and approach potential rates following an improvement in households' real purchasing power. In the euro area, negotiated wages reached 4.7% in Q3, and our view is that inflation will remain on a generally downward slope despite the 0.5pp uptick in December (see here). UK inflation has been more persistent, primarily due to the energy component, but rates are also now falling and we expect the disinflation process will continue in the UK too.

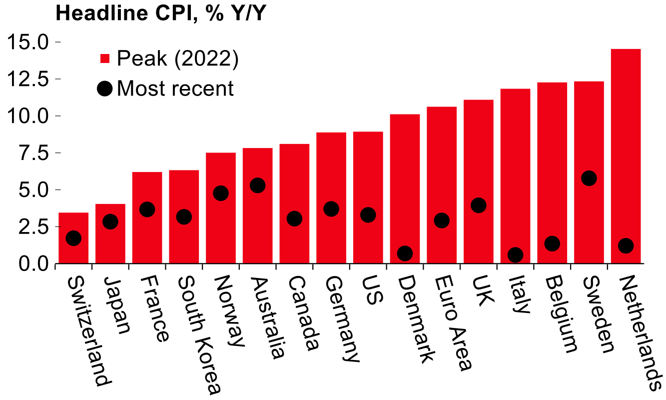
This better news on inflation means that central bank rate cuts no longer seem like a distant prospect. We have pencilled in the first ECB rate cut in April. Despite somewhat sticky UK inflation, we doubt the BoE will want to be too out of kilter with other major central banks and expect a UK rate cut at the end of H1. This reduces the chances that monetary policy overtightening will push the euro area and UK into recession.

The bottom line is that we're doubtful that Europe will be able to close the gap, but we do expect the narrative of divergence to fade through 2024 with European growth accelerating slightly and the US economy to experience a cyclical slowdown. That said, we do acknowledge that the risks to our European growth forecasts remain tilted to the downside given lingering uncertainty about the lags and effect of monetary policy tightening on the economy.

3. Just how hard will 'the last mile' of the disinflation process prove to be?

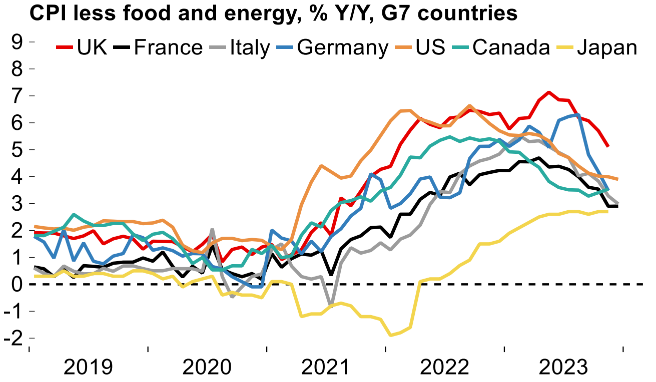
As inflation started to rise in early 2021 the initial debate was whether it would prove to be 'transitory'. That definition has been stretched: the OECD average CPI rate has remained above 2% for almost three years now. However, the path downwards since the peak in 2022 has been mostly smooth. Headline inflation fell steadily in 2023 as earlier energy price surges fell out of the annual calculation. These base effects are no longer as relevant, and we are now in what has been dubbed the hard '*last mile*' of the disinflation process (see here). The focus has shifted to 'underlying' inflation – and particularly the second-round effects of earlier supply shocks on wage growth.

Chart 7: Well past the peak for headline inflation…



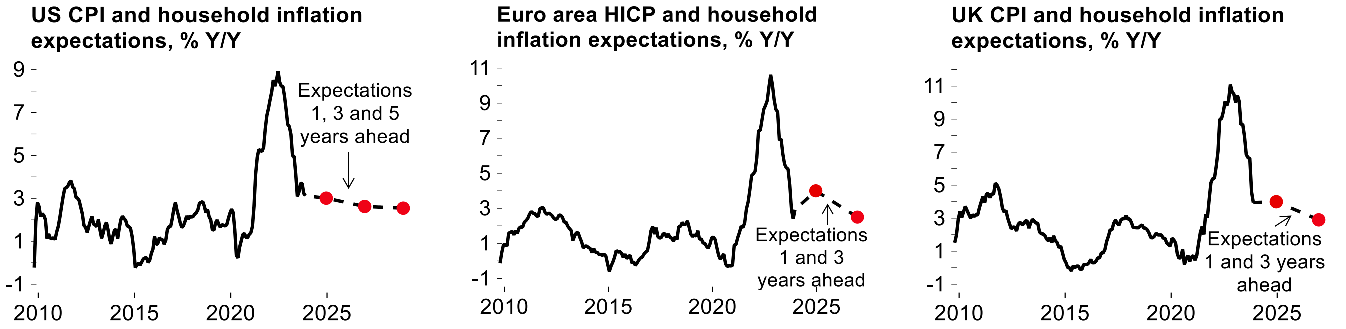
Source: Macrobond, MUFG Bank Economic Research Office

Chart 8: …and underlying pressures are also easing



Note: Chart shows HICP for EU countries. The series for Japan excludes all food.
Source: Macrobond, MUFG Bank Economic Research Office

Chart 9: Household inflation expectations have remained fairly well-anchored despite the surge in price growth



Source: BLS, Federal Reserve Bank of New York, MUFG Bank Economic Research Office

Source: ECB, Eurostat, MUFG Bank Economic Research Office

Source: ONS, BoE, MUFG Bank Economic Research Office

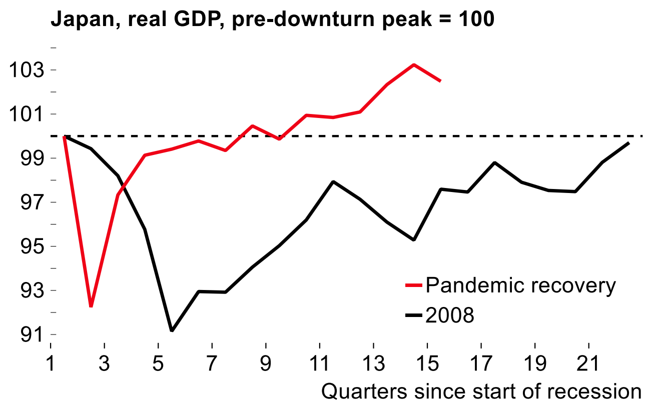
Our view is that this so-called last mile may prove to be more straightforward than some expect, with core inflation dynamics still looking favourable. Household inflation expectations, which can become self-fulfilling if workers have enough bargaining power over wages, have remained relatively well-anchored in developed economies (Chart 9). After some signs of cracks appearing in labour markets in 2023 we expect wage growth in developed markets will slow more noticeably this year. Central banks have tightened aggressively into restrictive territory and rate hikes will continue to pass through to the real economy with a lag. It's unlikely to just be a core story: we also expect global food prices will continue to contribute negatively to headline inflation, while oil prices have started this year around 3.5% below the 2023 average.

All told, we expect inflation in advanced economies will continue to fall through the year, from a 4.7% annual average in 2023 to 3.4% in 2024. The path might be a little bumpy in the absence of strong downward base effects (the latest US and euro area CPI prints being a case in point) but our view remains that inflation will remain on a generally downward slope towards central bank target rates.

4. How robust is the Japanese recovery?

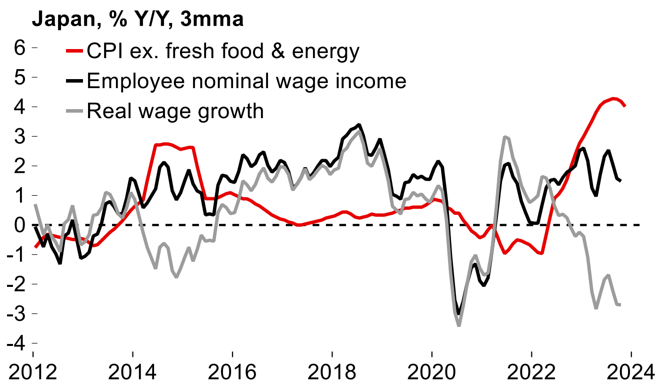
The Japanese economy fared comparatively well during the pandemic, contracting by less than other developed economies and recovering back to around the pre-COVID level in good time. A period of stagnation then followed but strong growth in H1 2023 changed the picture (Chart 10). There was notable impetus provided by net exports in Q2 on the back of easing global supply constraints and inbound tourism. However, GDP contracted by 0.7% Q/Q in Q3 when this boost from net exports faded. Domestic demand growth has remained lacklustre, which has raised questions about the durability of the recovery. It has become increasingly clear that the squeeze on real household disposable incomes (Chart 11) and associated weakness in consumer confidence has weighed on overall consumer spending.

Chart 10: The economy recovered quickly from COVID



Source: CAO, MUFG Bank Economic Research Office

Chart 11: Household real incomes have been squeezed



Source: Japanese Statistics Bureau, Japanese Cabinet Office, MUFG Bank Economic Research Office

We expect some improvement in the outlook. The disinflation process in Japan is set to continue this year (as is the case in other developed economies – see above). This will be good news for real incomes. While firms are likely to remain cautious about raising base wages, which are historically very rigid, we judge that there is scope for this year's spring wage negotiations to result in higher raises than last year. This recovery in real incomes should provide something of a tailwind to consumer spending. At the same time, a better corporate profit environment, supported by yen weakness, is likely to support business investment. The Tankan survey shows appetite for investment remains robust, while a better external environment (with a US soft landing now feeling more plausible) could provide a further tailwind for business confidence.

There is likely to be some moderate monetary policy normalisation during the year with the BoJ set to end its NIRP policy (we look for the first move in April, raising rates to 0.1%, with another hike to 0.25% in H2). With other central banks poised to cut rates, the BoJ is likely to be swimming against the global monetary policy tide. However, while the exit from the negative interest rate policy is symbolically important, these rate hikes would be relatively small and our view is that the Japanese economy should be able to absorb a degree of monetary tightening at this stage without significant hiccups.

All told, we are cautiously optimistic about the outlook for 2024. Our view is that the general trend will be one of a gradually recovering Japanese economy through 2024 as households' real purchasing power improves. The tragic New Year's Day earthquake has not significantly changed this outlook. Quarterly growth rates are likely to be slightly above potential (we look for ~1% annualised growth by year-end).

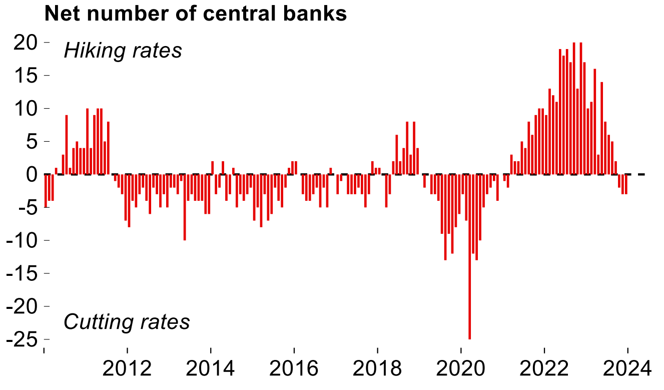
This section is based on MUFG Bank Economic Research Office Tokyo's latest Outlook document (see here) which was released 1 December 2023.

5. Are markets expecting too much in the way of rate cuts?

The Fed, ECB and BoE stopped raising rates in Q3 last year and have since attempted to maintain a holding pattern with policy in restrictive territory. While inflation rates slid lower in 2023, central banks were determined not to sound confident about the disinflation process to avoid looser financial conditions from market participants pricing in an interest rate pivot.

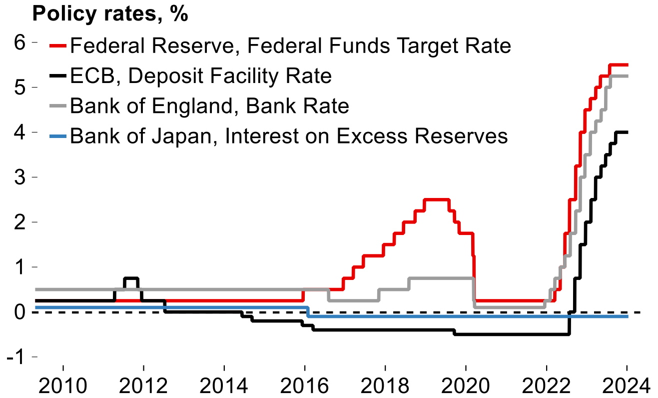
While it remains too early to definitively declare victory over inflation, it proved to be a slow process for this hard-pushed 'higher for longer' narrative to gain credibility with observers – and a lot of the work was undone following a surprisingly dovish Fed meeting in December. Markets are currently pricing in around 150bp of easing from the Fed and ECB this year, or six cuts, and almost that many from the BoE.

Chart 12: The global tightening cycle has turned



Note: Chart counts rate hikes/cuts relative to previous month, with 51 central banks included.
Source: Macrobond, MUFG Bank Economic Research Office

Chart 13: The Fed led the way with hikes since 2022



Source: Macrobond, MUFG Bank Economic Research Office

Our view in MUFG Bank Economic Research (*not the MUFG House Global Markets Research view*) is that current pricing for rate cuts is excessive: we currently look for three to four 25bp cuts from the Fed this year. As noted above, we are slightly above consensus on the outlook for US growth – a soft landing looks increasingly plausible – and we also expect inflation to prove a little stickier than some expect. Against that background, the current market-priced six cuts would be hard for the Fed to justify in the absence of a recession or shock, even with some of the groundwork for the pivot already laid at the December meeting and some signs now of cooling labour demand.

Meanwhile, our view remains that monetary policymakers in Europe have probably done too much in the way of interest rate rises given that inflation has been mostly supply-side driven (see here for recent ECB research on this topic) with monetary tightening providing a clear drag on growth. However, central banks will still be cautious about the risks to underlying inflation while labour markets remain tight (the euro area unemployment rate reached a new historic low of 6.4% in November). We look for four rate cuts from both the ECB and BoE this year – again, this is fewer than currently priced by markets, but slightly more than we expect from the Fed due to the weaker demand backdrop in Europe.

Lastly, as noted above, the BoJ is likely to be swimming against the global monetary policy tide in 2024. We expect that the Japanese central bank will raise interest rates back to positive territory in April after the spring wage negotiations, with another small hike to come in H2. This would be symbolically important after eight years of negative interest rate policy but is likely to have only a minor impact on the economy.

MUFG BANK ECONOMIC RESEARCH OFFICE FORECASTS

		Real GDP (% Y/Y)			Consumer Prices (% Y/Y)		
		2022	2023F	2024F	2022	2023F	2024F
World	**World**	3.4	3.2	2.9	6.4	4.7	3.4
	Advanced economies	2.5	1.5	1.3	7.2	4.6	2.5
	Emerging economies	4.3	4.9	4.5	5.5	4.8	4.3
Asia and Oceania	**Japan (FY)**	1.4	1.5	0.7	3.0	2.7	2.2
	Asia (11 economies)	4.2	5.1	4.8	3.6	2.3	2.5
	China	3.0	5.3	4.6	2.0	0.4	1.5
	India (FY)	7.2	6.6	6.3	6.7	5.3	4.7
	NIEs 4 economies	2.1	1.3	2.6	4.3	3.3	2.4
	South Korea	2.6	1.2	2.2	5.1	3.6 (A)	2.6
	Taiwan	2.4	1.0	3.1	2.9	2.5 (A)	2.0
	Hong Kong SAR	-3.5	3.4	3.4	1.9	2.0	2.1
	Singapore	3.7	1.2 (A)	2.8	6.1	4.8	2.8
	ASEAN 5	6.0	4.5	5.1	4.5	3.5	2.8
	Indonesia	5.3	5.0	5.0	4.2	3.7 (A)	3.0
	Thailand	2.6	2.5	4.0	6.1	1.3 (A)	1.7
	Malaysia	8.7	4.2	4.4	3.4	2.7	2.3
	Philippines	7.6	5.4	5.8	5.8	6.0 (A)	3.8
	Vietnam	8.0	5.1 (A)	6.5	3.2	3.2	3.1
	Australia	3.8	1.7	1.4	6.6	5.7	3.8
Americas	**United States**	1.9	2.5	1.6	8.0	4.1 (A)	2.7
	Latin America (6)	3.7	1.9	1.8	15.6	18.0	13.5
	Brazil	3.0	2.8	1.2	9.3	4.7	4.5
	Mexico	3.1	3.2	2.0	7.9	5.5	3.8
Europe	**Euro area (20)**	3.4	0.5	0.7	8.4	5.5 (A)	2.3
	Germany	1.8	-0.3	0.6	8.6	6.1 (A)	2.4
	France	2.5	0.7	0.8	5.9	5.7 (A)	2.2
	Italy	3.7	0.8	0.8	8.7	6.0 (A)	2.1
	UK	4.3	0.5	0.6	9.1	7.4	3.0

Note: Figures show annual average growth rates. The global aggregate is a PPP-weighted measure of 41 economies. Figures for Japan and India are on a fiscal year basis (April-March the following year). Consumer prices refers to a composite measure excluding fresh food for Japan; for euro area countries it is the HICP. The Latin America aggregate includes Argentina, Columbia, Chile and Peru as well as the countries shown. Forecasts first published on 1 December 2023. '(A)' indicates actual official figures rather than forecasts.

Source: National statistics offices, MUFG Bank Economic Research Office

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