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Mercurius Advisory Services

Global Economic Outlook

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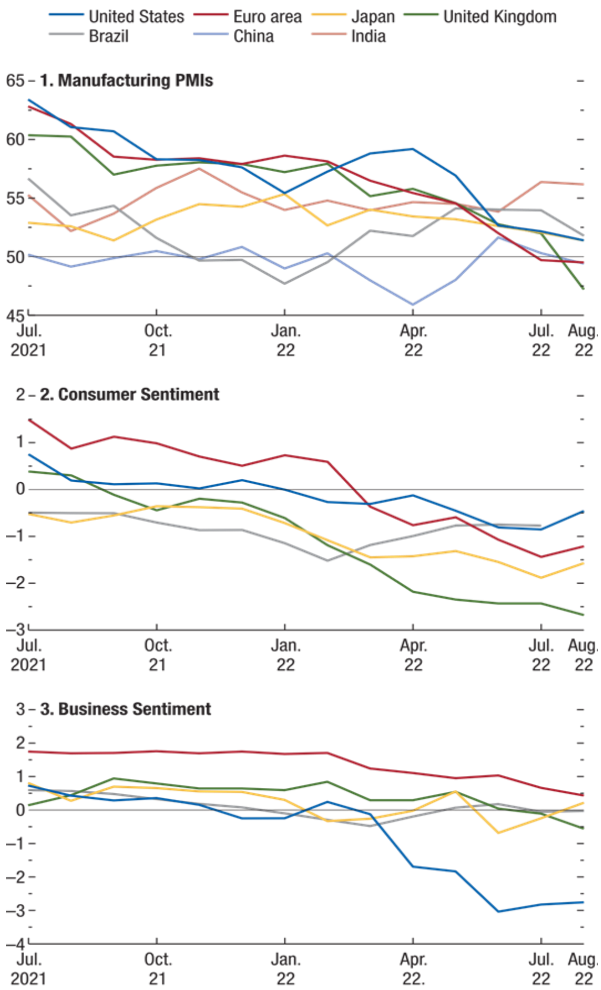
Inflation and Indecisiveness

The global economists as well as the policymakers are now required to keep a steady hand as the global economy continues to face steep challenges, majorly influenced by the powerful forces - such as the Russian invasion of Ukraine, and a cost-of-living crisis caused by the inflation pressures across the globe.

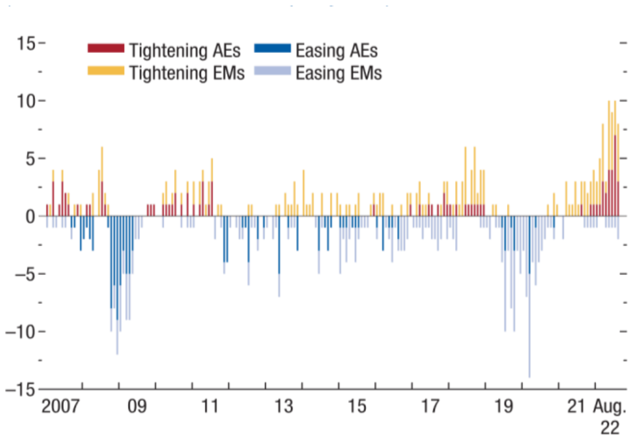
The latest forecasts project global growth to be consistent in 2022 at 3.2% and diminish to 2.7% in 2023—0.2% points lower than the July forecast—with a 25% probability that it could fall below 2%. It is believed that more than a third of the global economy will contract this year or by the next one, while the three largest economies—the United States, the European Union, and China—will continue to suffer. In short, many people should be prepared for 2023 as it will definitely feel like a recession.

The second quarter of 2022 saw global real GDP modestly contract, with negative growth in China, Russia, and the US, as well as sharp slowdowns in eastern European countries most directly affected by the war in Ukraine.



Sources: Haver Analytics; and IMF staff calculations.
Note: For panel 1, purchasing managers' indices (PMIs) greater than 50 denote expansion. In panels 2 and 3, values are normalized *z*-scores.

There have been observations with some indicators showing output weakness amid labour market strength. The major factor influencing the slowdown in the first half of this year is the rapid removal of monetary accommodation as many central banks seek to moderate persistently high inflation.

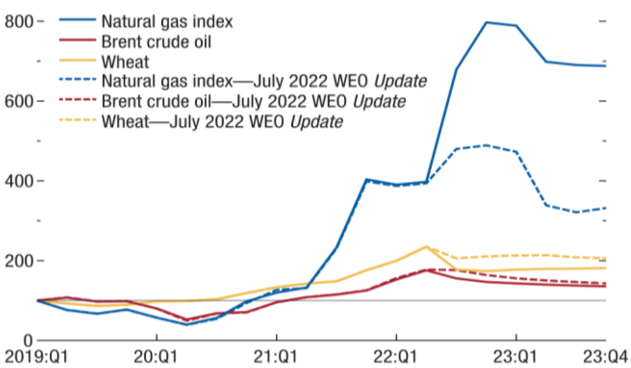


Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: AEs = advanced economies; EMs = emerging market economies.

The world seems to be pushing toward a global recession in 2023 as central banks across the world simultaneously hike interest rates in response to inflation. Higher interest rates and the associated rise in borrowing costs, including mortgage rates, shows the earliest and most evident signs of slowdown in the global economies.

Food prices have been a prime driver of global inflation so far this year. Russia and Ukraine are extremely critical to the world's food supply chain. These countries together export about 30% of the world's wheat, 60% of the world's sunflower oil (the third-most-traded seed oil after palm and soy), and about 20% of the world's corn. It has provided a rare slice of good news, with future prices falling and the Black Sea grain deal giving some hope of improved supply in coming months. There have been evident signs which show that commodity prices might be starting to ease off as global demand slows, helping to moderate inflation.

(Index, January 2019 = 100)



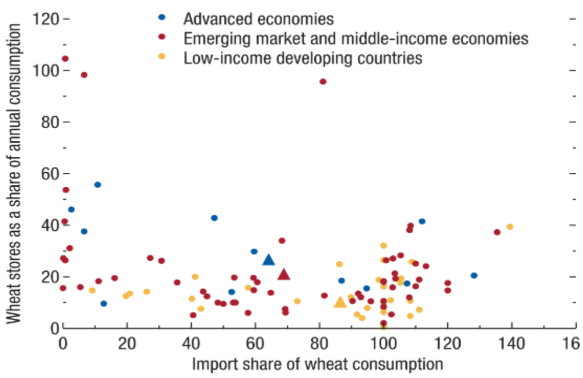
Source: IMF staff calculations.
Note: Natural gas index comprises European, Japanese, and US natural gas price indices. WEO = *World Economic Outlook*.

Central Banks’ strategy to undertake Inflation

Inflation has been rising at a faster and more persistent rate since 2021. In 2022, inflation in advanced economies broke all its previous records and reached its highest rate since 1982 (10.24%).

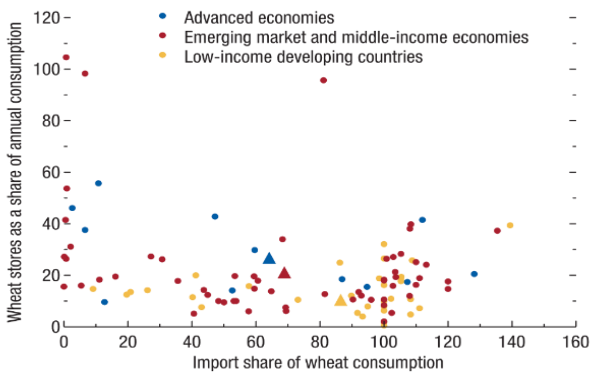
Although inflation is a vast phenomenon, affecting almost every economy across the world, it has the most severe impact on lower-income groups in developing economies. Such countries, which have up to half of household consumption expenditure on food, are seen to have intense effects on health and living standards.

(Percent, 2022)



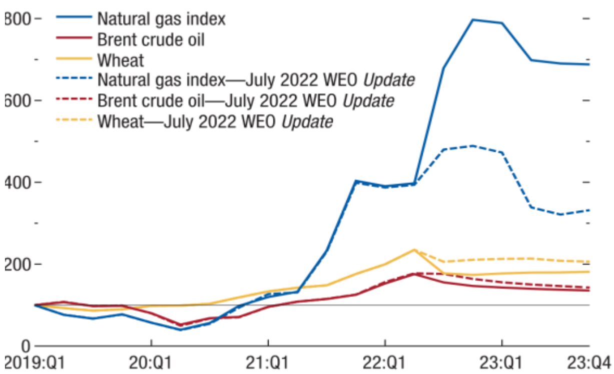
Sources: Food and Agriculture Organization of the United Nations; US Department of Agriculture, Foreign Agricultural Service; and IMF staff calculations.
Note: Data reflect storage-level estimates at the end of the first quarter of 2022 and projected consumption levels for 2022. Import share can exceed 100 becaus of stock building and reexport. Triangles show country group averages.

(Percent, 2022)



Sources: Food and Agriculture Organization of the United Nations; US Department of Agriculture, Foreign Agricultural Service; and IMF staff calculations.
Note: Data reflect storage-level estimates at the end of the first quarter of 2022 and projected consumption levels for 2022. Import share can exceed 100 because of stock building and reexport. Triangles show country group averages.

(Index, January 2019 = 100)



Source: IMF staff calculations.
Note: Natural gas index comprises European, Japanese, and US natural gas price indices. WEO = *World Economic Outlook*.

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In the utmost synchronised manner, central banks from all around the world are rushing to raise their key interest rates in a bid to tame high inflation, which, much to their disappointment, continues to break monthly records. They have been keeping an eagle eye on the global inflation and have been trying to combat with the ever increasing inflation rates in the best conceivable way:

- Central banks have rapidly lifted nominal policy rates in order to condense the inflation.
- The federal funds target rate has been increased by 3% by the Federal Reserve since the beginning of 2022 and is likely to increase further.
- Despite projecting weak growth, the Bank of England has raised its policy rate by 2.25%.
- The European Central Bank has raised its policy rate by 1.25% in 2022.
- The Federal Reserve has also raised interest rates in comparison to the European Central Bank due to differences in underlying inflation dynamics and economic conditions.
- Several countries have increased the interest rates to induce the volatility in financial markets.

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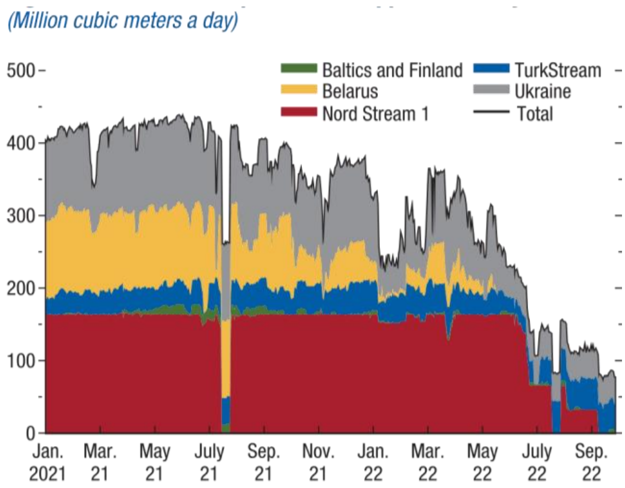
Russia-Ukraine War Impact

The invasion of Ukraine by Russia has been severely destabilizing the world economy. Let alone the intensified and merciless destruction of lives as well as livelihoods, it has also led to a severe energy crisis in Europe, resulting in sharply increasing the livelihood cost and hampering economic activity. According to the reports, the gas prices in Europe have seen a quadruple increase since 2021, with Russia cutting deliveries to less than 20%, raising the possibilities of energy shortages over the next few months. The fossil fuel trade has also been affected due to reduced gas exports from Russia, with the flow of Russian pipeline gas to go down to about 20% of its level one year ago.



Sources: European Network of Transmission System Operators for Gas; Gas Transmission System Operator of Ukraine; and IMF staff calculations.
Note: Latest data available are for September 18, 2022. Recent data are provisional. Gas flow volumes are measured at EU border crossing points; Belarus excludes flows to Kaliningrad (Russia). EU = European Union.

Furthermore, the conflict has also pushed up food prices on world markets, despite the recent easing after the Black Sea grain deal, causing serious hardship for low-income households worldwide, and especially so in low-income countries. The continuous inflation pressures have triggered a rapid and synchronized tightening of monetary conditions, parallel to a strong appreciation of the US dollar against most other currencies. The financial experts suggest that only with tighter global monetary and financial conditions, we will work our way through the economy by weighing the demand down and helping to gradually subjugate inflation.

Overall, international inflation has moved higher, driving to the significant increase in food prices, as the war has led to a broadening of inflationary pressures. Countries with diets tilted toward foods with the largest price gains which have suffered the most are

- those whose staple diet is dependent on wheat and corn
- those who are more dependent on food imports

Low-income countries which were already experiencing acute malnutrition and excess mortality before the war have suffered a particularly severe impact.

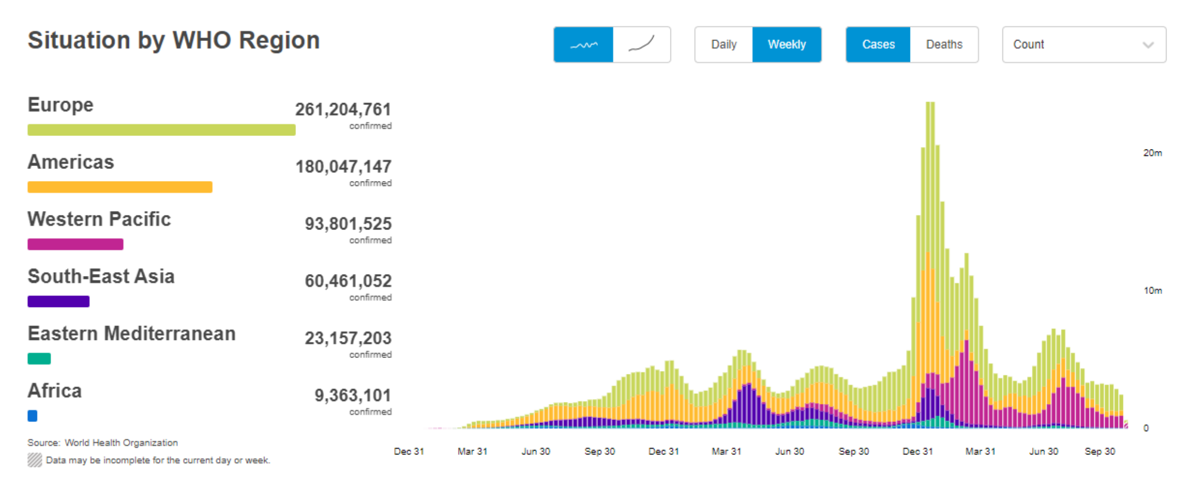
Covid-19 affecting Economic Progress

The impact of Covid-19 is still prominent in the major countries such as – China and Africa. Pandemic-related forces have been particularly crucial in China, wherein second-quarter shrinkage contributed to slower global activity. The recurrent lockdowns under its zero COVID policy has taken a massive toll on the global economy, especially in the quarter two of 2022.

Even the property sector, which is proven to represent about one-fifth of economic activity in China, is seen to have lost its due contribution. Given the size of China's economy and its direct influence on global supply chains, it is clearly visible that the lockdown has laid a direct impact on global trade and activity. There have been significant data which authenticates the slowing economic activities in China. The manufacturing industry is slowed to less than 76% in the quarter two of 2022. It was the lowest recorded in five years, except during the grave phase of the pandemic.

China had to face the impact of such turmoil not just in its domestic market but internationally as well since lower demand implies fewer exports for foreign suppliers. And the limitations in production and logistics delay has been keeping global supply pressure and eventually inflation, on a higher side.

Not just China, but the resurgent variants of the COVID-19 continue to intimidate economic recovery in Africa too. Limited vaccinations make sub-Saharan Africa more susceptible to ongoing illness and increase the risk of exposures to new variants. The low vaccination rate has moderately contributed to sub-Saharan Africa's real per capita GDP growth lagging behind that of advanced economies in 2022. Pandemic-induced damage has also slowed human capital build-up as a result of learning losses from lack of schooling and on-the-job skill acquisition.



The Forecast

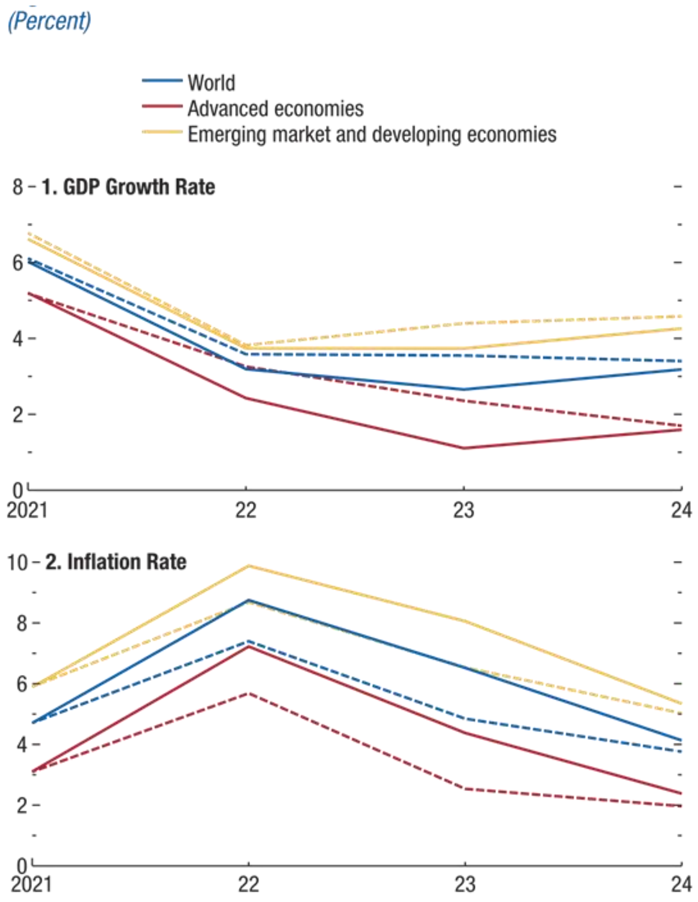
Uncertainties continue to cloud forecasts of global growth and inflation. The baseline forecasts described by the IMF are established on several assumptions that plausibly may fail to hold such as:

✓ Russia does not imply any sharp reductions in flows of natural gas to the rest of Europe in 2022, over and above the current 80% reduction compared with 2021.

✓ The long-term inflation expectations remain stable.

✓ Monetary policy imposed by Central Banks should be implied in a manner that its tightening does not induce widespread recession.

Global growth and Inflation forecast



Source: IMF staff calculations.
Note: Solid lines = October 2022 *World Economic Outlook*; dashed lines = April 2022 *World Economic Outlook.*

Global Outlook

United States of America

In the US, the overall economic growth has seen to be taken a hit in the year 2022. Although the GDP contracted for the first two quarters of the year; a phenomenon usually associated with a recession. However, according to the esteemed economists, the U.S. is not in a recession yet. Few facts supporting the same are that employment surged by 2.8 million jobs in the first six months of the year where the consumer spending slowed, but it did not collapse. This clearly means that the losses US endured did not meet the criteria of losses associated with a recession by the National Bureau of Economic Research (NBER), the official arbiter of business cycles.

- Rate hikes and the collapse in housing are expected to take a larger toll on consumer spending by the turn of the year.
- Business investment is expected to contract after playing catch-up to supply chain delays over the summer.
- Spending on intellectual property, automation and cyber security is expected to remain buoyant.
- A strong dollar and weaker growth abroad suggest that the trade deficit will reverse course and widen by the year end.
- Imports should continue to outpace exports and the trade deficit is expected to widen in 2023.

The war in Ukraine contributed in moving up the inflation. Heightened dollar value accompanied by drop in prices at the gas pump and some easing of supply chain disruptions have alleviated the upward pressure on the prices of some goods. Used vehicle prices are again depreciating after mounting above the sticker price of new vehicles in 2021. The policymakers are still contemplating on how long energy prices can remain low as it depends upon the substantial supply constraints, and how far the Russian government is willing to go to weaponize its oil reserves.

Cost of Labour has proven to be a major issue in service sector inflation. The factor increasing the labour costs are - high wages, high turnover rates and a doggedly high level of Covid infections, which is impairing staffing shortages. It is expected that a surge in long Covid cases shall add to labour shortages and will make those shortages more chronic. According to the expert, an additional two to four million US workers are estimated to be suffering from Long Covid considering the ever mutating variants. Unpredictably, this is happening at the same time as the boost to productivity growth triggered by working from home; employees are using more of the time they saved by not commuting to engage in leisure activities and up skilling themselves. Even the foreign students, are looking for guarantees that they can continue to work in the U.S. once they relocate.

Undeniably, long periods of high inflation tend to change the behaviours and have a direct impact on households as well as businesses. Workers demand wages to move up considering the inflation, whereas firms start imposing price hikes to cover elevated costs. The Federal Reserve recently addressed the recession. Federal authorities may either run the risk of strengthening the inflation to disrupt the recession, or elicit the continued recession and face the smaller increase in the unemployment. The Fed can’t grow food or pump oil. It can reduce demand to better balance with what is becoming a more chronically undersupplied world.

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China

The GDP of China grew by 2.5% year-over-year (yoy) in first half of 2022 which was apparently below its 5.5% annual growth target that was set in March. China's economy grew 0.4% in Q2 and was the second lowest quarterly growth but was higher than the first quarter of 2020 when the pandemic emerged (i.e. -6.9%). The growth was basically slowed in Q2 due to a resurgence of the Omicron variant of Covid between March to May of 2022, resulting in lockdowns in some areas and causing logistic disruptions.

Economic activity showed a recovery in June as the Omicron outbreak came under control. However, growth in industrial production slowed and manufacturing purchasing manager index (PMI), a leading indicator, fell into contraction territory again in July.

The natural calamities also played an important role. The severe heat wave hitting many areas this summer, sent electricity usage up 6.3% in July. The drought caused a shortage of hydropower production in some places, weighing on industrial production. Besides the pandemic, household expectations for job security and income growth are important drivers to consumer spending. The government of China has taken numerous measures to stabilise the job market. The overall unemployment rate dropped to 5.4% in July from 6.1% in April and is expected to average at 5.4% in 2022.

Meanwhile, the real estate market faces continued pressures while the government continues to take necessary actions to stabilize the same. On the demand side, many local governments have relaxed limitations on property purchases, lowered down-payment ratios, and cut mortgage rates. On the supply side, the authorities of some cities are setting up relief funds to aid developers with liquidity issues. The Central Bank, too, plans to provide credit support to distressed developers to ensure delivery.

Export trade in China have remained irrepressible. Driven by strong external demand, China's exports were up 18% in July and increased 14.6% in the first seven months of the year. Exports of new energy products such as solar cells and lithium-ion batteries also saw strong momentum. We expect China's fiscal and monetary policy to remain as supportive as it has been so far. On the monetary side, the Central Bank reduced the policy rate (medium-term lending facility, MLF) in August again, after cutting it in January. It also used special relending facilities to provide direct credit support to small and medium enterprises (SMEs), green investment and the transportation sector.

Inflation has remained low in China compared to many parts of the world, however it is expected to see some pressure in second half of the year. Food is responsible for nearly 30% of China's consumer price inflation (CPI) and the fluctuation of pork prices is an important factor behind inflation. The overall inflationary pressure is expected to remain in check in 2022. Meanwhile, producer price inflation (PPI) continued to moderate from a high base, slowing from 6.1% in June to 4.2% in July. As Hong Kong has adopted a pegged exchange rate with the USD, the government raised its interest rate to 2.75% in lockstep with the U.S. Federal Reserve's rate hikes. Monetary tightening and a global economic slowdown may weigh on Hong Kong's recovery. Looking ahead, the Hong Kong's economic growth is expected to continue to recover in H2, but challenges also remain.

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India

India has witnessed the tremors of the ever shaking global economy anguishing with inflation, slow GDP growth across all major countries, and tightening of monetary policy. Reopening of the private sector has proven to improve the private consumption, and thus, resulted in country's economic growth by 13.5% in Q1 of Fiscal Year 2022-23.

RBI has projected the growth of 7.2% for the fiscal year 2022-23. Such stats depict that the country is seemingly emerging as the fastest growing economy globally. It has replaced UK and is now fifth largest economy of the world.

An up rise in the domestic economic activity is apparent, with:

- Considerable improvements in domestic air travel; consistently increasing demand from urban and rural areas for automobile sales, consumer durables manufacture, etc.
- Positive movement in domestic demand is distinct from the import requirements for non-oil and non-gold commodities.
- Rising consumer optimism, improved corporate performance, and enhanced demand for contact-intensive services are expected to drive consumption.
- Investments are also rising in the country, and factors such as a capex push by the government, improvement in capacity utilization and widening of bank credit will contribute to ramping up investment activity. In addition, Foreign Portfolio Investors poured over INR 56,000 crore (~US$7.1 billion) in August 2022 after nine months of continued outflows, indicating improved enthusiasm of foreign investors for the Indian equity market, which became the fifth largest recently in terms of market capitalization.

The alarming factor for the country has been its Unemployment rates which surged to 8.3% in August 2022. Agricultural job opportunities to increase at the end of monsoon season and the most of the rural unemployment had been affected by factors such as erratic rainfall. However, the leading economists show concern around the trajectory of urban unemployment that seems to persist in the immediate future.

The government's reduction of excise duties on fuel in May, coupled with three interest rate hikes by RBI this year to 5.4% have helped moderate inflation, which was one of the highest in April 2022 (nearly 7.8%) due to the high prices of commodities such as food and fuel.

Given all the facts, the Central Bank expects inflation to remain high in Fiscal Year 2022-23 at 6.7%, due to effects of the global geopolitical situations. Furthermore, the appreciation of the U.S. dollar is a prominent factor contributing to inflationary burdens. The government is also introducing various production-linked incentive (PLI) schemes are correspondingly promoting domestic manufacturing as well as job creation, with investment commitments of INR 2.34 lakh crore (~US$29.53 billion) as of April 2022.

In the forthcoming period, India is expected to continue on its path of economic growth and may become a US$5 trillion economy by 2027. However, the uncertainties of geopolitical situations along with inflationary pressures and monetary tightening in economies like the U.S. or anywhere across the globe, are cautionary factors that could affect growth estimates.

UK

The UK endures high levels of inflation this year and even reached at 10.1% in July 2022 and then declined to 9.9% in August. Supply chain disruptions, arising during the global recovery from the effects of the pandemic, caused the initial pick-up in inflation in 2021.

Russia's invasion of Ukraine spiked up the prices for natural gas and elevated the food price. Majority of inflation has come from higher energy prices in UK. Because of the interruptions of supplies from Russia, the European and UK gas markets have been extremely volatile throughout the past 12 months. UK domestic energy bills have already risen by 73.2% by August, 2022 in comparison to the last 12 months. The UK Government's decision to cap domestic energy bills at £2,500 from October 2022 has limited further increases to 27%, avoiding the expected series of sharp rises that could have seen bills rise by another 235% by April 2023.

In contrast to natural gas, the prices of other commodities, such as oil, metals and food fell back from peaks reached in the aftermath of Russia's invasion in February. In August alone, the fall in global oil prices helped ease UK inflation to 9.9%, as the prices of automotive fuels fell by 6.8% between July and August. This, in addition to a fall in global food prices which took place between May and July this year, and which is yet to feed into UK consumer prices, should help in bringing inflation down towards the Bank of England's 2% target over the next 6 to 12 months.

The Bank of England have accelerated the policy rate by 2.25% and we expect Bank Rate to reach around 3.5% early in 2023. The bank seems to have more aggressive approach to the need to counteract upon the inflationary impact. The UK Government announced a large package of fiscal relaxing amounting to around £160 billion over the next 2 years, equivalent to 3.2% of GDP per annum. The same includes £45 billion of permanent tax cuts, funded by higher borrowing.

The UK economy seems to be in recession since the second quarter of 2022 which is expected to last for the three preceding quarters. The steep curb in domestic demand has led to a dwindling of growth momentum that the economy witnessed after a post-pandemic recovery in early 2022. The potential shrinkage in output among some of the UK's main trading partners could see further slowdown in export growth this year. Nonetheless, compared to past downturns, the scale of the current downturn might be relatively mild, with the level of GDP falling by 1% between Q1 and Q4 of this year. And in spite of this, GDP growth is expected to reach 3.2% this year, immensely improved by weaker GDP in 2021 due to pandemic-related restrictions. Further out, a picture of uneven growth in 2023 could lead to a full year fall in GDP of 0.2% compared to 2022. The UK labour market has sustained with the upside in the year 2022. The unemployment rate has fallen from a Covid peak of 5.2% at the end of 2020 to 3.6% in the three months to July, its lowest level since 1974. Around three quarters of that fall were due to a rise in employment rate, as slowing population growth has not kept up with the pace of hiring against the backdrop of a tight labour market.

Unemployment rate in the UK has been consistently low because of fall in the participation rate influenced by the long term sickness. We expect these factors to continue to dampen labour supply over the medium term. We then expect the economic slowdown to gradually filter through to the labour market, with lower demand putting less pressure on employers to recruit new staff. Although the job vacancy rate is still around record highs, there are tentative signs that the market could soon begin to slacken. The forecast for 2023 now sees the unemployment rate averaging 4.3%, slightly lower than during the Covid pandemic.

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Germany

The Russian invasion of Ukraine and its consequences continue to significantly affect Germany's economic outlook. The German economy grew by 1.7% in comparison to the second quarter of 2022. Real GDP grew by 0.1% in the second quarter of 2022, in comparison to Q1. Real GDP for Germany has now reached pre-Covid levels. As the government of Germany lifted the Covid restrictions by the end of Q1 of 2022, private consumption, for leisure and travelling, increased by 0.8% compared to the first three months of the year.

Consequently, Germany experienced an inflation rate of 8.2% in Quarter 2, while wages for the employees could only witness the increase of 2.9% compared to Quarter 1.

Supply chain disruptions as well as China's zero-Covid strategy implications are the main challenges for several industries for German. Unfortunately, these disruptions are expected to continue well into 2023.

Japan

Japan relatively had a slow start to 2022 with GDP rising by less than 0.6% in the last six months. Commercial activities supported by the continued relaxation of Covid restrictions eventually has enabled a solid rebound in consumption. However, the momentum is expected to ease over the rest of 2022, as household budgets are squeezed due to increase in inflation. It is expected for Japan's economy to grow by 1.6% this year and then by 2.2% in 2023. After recovering through Q2, the latest activity data suggests that momentum in Japan's economy is now easing.

The Bank of Japan's commitment for ultra-loose monetary policy seems promising given the lack of domestic inflationary pressures.

Australia

Supply chain disruptions, elevated commodity prices, and rising interest rates are all weighing on economic activity to some extent. Inflationary pressure easing but still elevated Oil prices have eased in recent months, but overall energy prices remain very high. The war in Ukraine has also put pressure on food prices globally and those pressures have been exacerbated in Australia due to the floods disrupting agricultural activity.

RBA increased the rates rapidly to cool domestic inflation pressures. The steep rise in inflation and tight labor market has forced the RBA to accelerate its hiking cycle.

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Contact us:

Ankit Jain
+91 98106 61322
ankit@ajsh.in
ankit@mas.net.in

Siddhartha Havelia
+91 98113 25385
siddhartha@ajsh.in
siddhartha@mas.net.in

Address:A-94/8,Wazirpur Industrial Area, Main Ring Road, New Delhi-110052
T:+91-11-45596689