

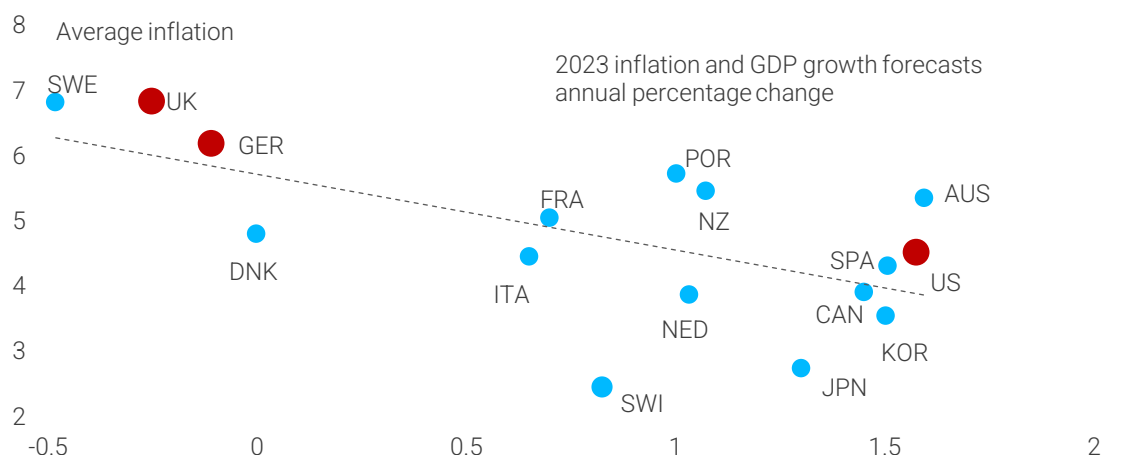
Macro Picture

POLICY TRADE-OFFS & MACRO DIVERGENCE

Dario Perkins

Much of the global economy is still struggling with a toxic combination of high inflation and deteriorating growth. Yet the underlying cause of this malaise is not the same in all parts of the world – which is why macro divergences are starting to emerge. The UK seems to be facing a more acute trade-off between inflation and recession than other major economies.

Chart 1: The stagflationary shock is not the same everywhere



Source: IMF forecasts, TS Lombard

SYNCHRONIZED DIMMING

Several forces have combined to produce a sour macro environment, namely: (i) a bullwhip manufacturing recession; (ii) a powerful squeeze on real incomes; (iii) tight monetary policy; and (iv) a deterioration in supply capacity. While these forces have given the whole world a tinge of stagflation, individual exposures vary – which could lead clearer divergences going forwards.

RESTORING BALANCE

Germany, already in “technical recession”, has been particularly vulnerable to faltering global trade. Also, German consumers are famously price-sensitive. While the US is faring better (so far), the Fed has engineered its own demand destruction through rapid monetary tightening. The good news is that neither the US nor Germany needs a deep recession to get inflation back down.

BRITISH EXCEPTIONALISM

The UK economy is in a more precarious situation, combining some of the worst problems of the euro area with some of the worst problems of the US. Further, Brexit and a decade of austerity have damaged supply potential, leaving the UK poorly placed to deal with these issues. The BoE faces an unenviable task, with an inflation-recession trade-off that seems starker than elsewhere.

POLICY TRADE-OFFS & MACRO DIVERGENCE

The world economy has had a distinctly stagflationary flavour over the past 18 months. Inflation has remained high while economic growth has slumped and [the risk of a global recession has continued to build](#). Several forces have contributed to this souring of the macro environment, namely: (i) a bullwhip contraction in global manufacturing and trade, which was an inevitable legacy of pandemic spending patterns and inventory mismanagement; (ii) a crunching squeeze on global consumers' real purchasing power; (iii) aggressive monetary tightening, which has destroyed demand through various "flow" and "stock" effects; and (iv) lingering supply-side problems associated with the pandemic, the war in Ukraine, and a number of idiosyncratic (country-specific) issues. On the surface, it seems much of the world has been suffering from the same stagflationary disease – certainly, that has been implicit in the way policymakers have tried to treat it (with synchronized monetary tightening). Yet, the reality is that exposures to the various underlying causes of this stagflation have varied considerably across countries. And as the lingering effects of the pandemic and the war in Ukraine wear off, this could lead to divergences in how different parts of the world perform. Not all economies face the same policy trade-offs.

We highlight these policy trade-offs by comparing the performance of Germany, the US and the UK – three economies that span the spectrum of current stagflationary dynamics. Germany, of course, has always been a leveraged play on world trade. Given its dependency on exports, it is not surprising the bullwhip contraction in global manufacturing has already swung the German economy into "technical" recession. Also, German consumers are famously price-sensitive, which has made domestic activity particularly vulnerable to surging energy costs. The good news is that these pressures are starting to unwind. Although Germany faces the threat of further energy problems next winter (and the potential loss of important export markets), the country's battle with stagflation is likely to prove rather fleeting. When it comes to the ultimate trade-off between inflation and recession, we see similar reasons to be optimistic about the outlook for the US, which is more insulated from global trade and energy prices. The US economy's most pressing vulnerability comes from the Fed's attempt to eliminate excess demand in the domestic labour market. The path [to a soft landing is narrow and treacherous](#), but there is every reason to think the US – like Germany – can get inflation down without a deep/sustained economic slump.

The UK is perhaps the DM economy with the most challenging trade-off between inflation and recession. On one level, this is because the UK currently combines some of the worst problems experienced elsewhere, overlaying a (European-style) "cost of living crisis" onto a tight (US-style) labour market. But at the same time the UK's macroeconomic vulnerabilities run deeper, as a result of a succession of domestic policy failures following the global financial crisis in 2008. A decade later, austerity, Brexit and a seriously stretched health system have interacted with the lingering pressures of COVID-19 to inflict persistent supply-side damage, while producing a domestic political climate that seems less conducive to sustained low inflation. While wage-price spirals have been rare outside the 1970s, the UK seems more susceptible to this sort of dynamic than many other developed economies (a point not lost on domestic policymakers). The Bank of England clearly wants to avoid such an outcome, but continued monetary tightening threatens domestic financial stability. So, both inflation and recession tail risks look fatter in the UK than elsewhere, leaving the Bank of England with the unenviable task of trying to reconcile competing demands on its mandate. UK policymakers are going to need considerable skill – and a lot of luck – to deliver an outcome as favourable as that which [other central banks can realistically expect](#).

1. SYNCHRONIZED DIMMING

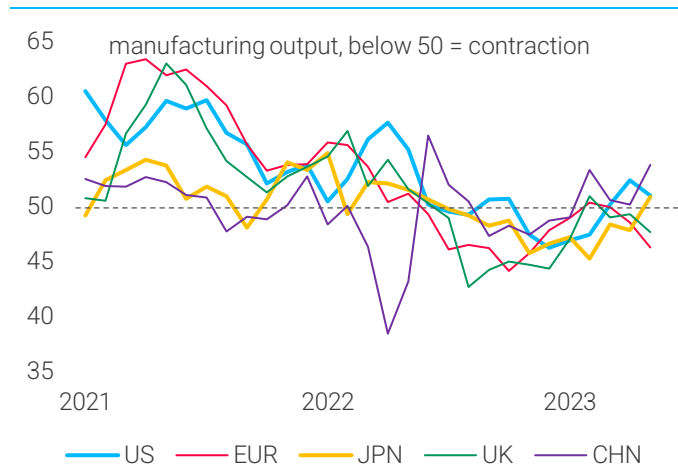
Most parts of the world continue to struggle with a decidedly unfavourable economic environment of high inflation and anaemic growth. Given the synchronization of these trends, it is tempting to assume the entire global economy is suffering from the same underlying disease. But a closer examination of what is ailing the global economy reveals a number of quite distinct and separate causes; and since country-level exposures vary considerably, it is possible that macroeconomic performance will start to diverge as some of these problems unwind. This is important in the context of the trade-offs now facing global policymakers. While some central banks (such as the Federal Reserve) will find it relatively easy to restore price stability without a deep recession, others (such as the Bank of England) face tougher policy dilemmas.

Chart 2: Global manufacturing still struggling



Source: Markit, TS Lombard

Chart 3: Bullwhip effect starting to fade



Source: Markit, TS Lombard

Causes of current stagflation

Two years into [the worst inflation outbreak in half a century](#), consumer prices continue to rise much faster than central banks' targets, real economic growth remains negligible, and a majority of investors continue to think the situation will get worse – with a global recession apparently imminent. But what is, in fact, ailing the global economy? As [we have explained elsewhere](#), several forces are working together to produce this souring macro environment, namely:

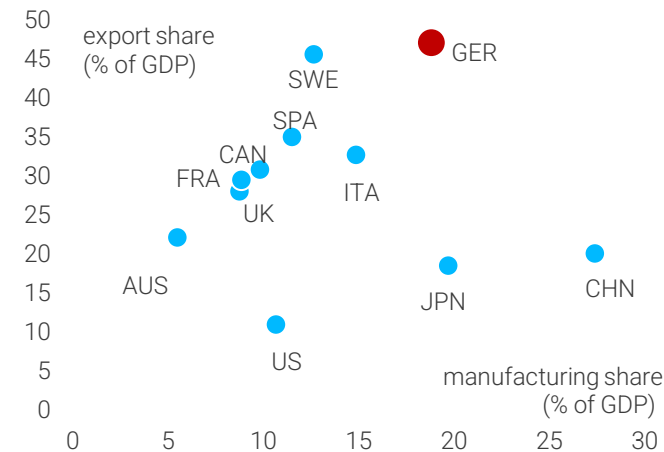
- (i) **The bullwhip recession in global manufacturing:** The reversal of pandemic spending patterns was always going to deliver a powerful downturn in manufacturing and world trade. No longer stuck at home buying goods from the internet, people have switched their consumption into the services sector, boosting areas such as hospitality, personal care, transport and tourism. Reduced demand for goods has not only eased the pressure on supply chains; it has also caused a reversal in the [bullwhip effect](#) that had stimulated manufacturing activity and lifted global goods prices in 2021-22. Wholesalers and retailers that accumulated inventories in anticipation of continued shortages now find they are stuck with excessive stock levels, which is creating a deflationary impulse through global manufacturing. For economists who have spent decades building “leading indicators” of the economy based on the inherent cyclicity of the industrial sector, this bullwhip effect has been a big part of the recession consensus that started last year. But the thesis has been

misleading because it ignored the concurrent strength of the global services sector. This was not a normal business cycle, so manufacturing was not a leading indicator.

- (ii) **A crunching squeeze on real incomes:** With nominal wages relatively subdued, the rapid rise in inflation from 2021H2 caused a dramatic reduction in household spending power. Real incomes have declined everywhere, with the squeeze becoming particularly intense in Europe after Russia's invasion of Ukraine sent food and energy prices soaring to historical highs. While US consumers were able to shield themselves by running down the savings they had accumulated during the pandemic (their so-called "excess savings"), there is less evidence of such behaviour in other parts of the world, where saving rates have often stayed above their pre-COVID levels. And even in the US, where nominal spending replaced "real" spending, there is no doubt the squeeze on real income curbed output and employment. (By selling fewer goods at higher prices, companies produced less and required fewer workers.) The good news is that squeeze on households' purchasing power is now coming to an end: inflation rates have dropped and nominal wages have accelerated.
- (iii) **Aggressive monetary tightening:** Most central banks have been increasing interest rates rapidly in an effort to destroy demand and force inflation back towards their targets. Monetary tightening has two effects on the economy: a "flow effect" and a "stock effect". The flow effect is where higher interest rates curb the demand for new loans, which, in turn, has a powerful impact on the most rate-sensitive sectors such as real estate and the auto industry. Transactions plunge, which is what we have seen across a range of housing markets. The stock effect, by contrast, captures the impact of tighter monetary policy on *existing debt holders*. When debtors need to refinance their borrowing at higher interest rates, they face an additional squeeze on their disposable incomes, which can cause further reductions in consumption and capex. There is a lot of cross-country variation in the impact of monetary policy, based on, among other things, differences in private leverage and the structure of mortgage markets.
- (iv) **Persistent supply-side damage:** Some economies seem to have suffered a permanent deterioration in supply capacity over the past three years. Immigration has slowed, trade barriers have increased, many older workers have dropped out of the labour force and productivity has gone down. With some parts of the world suffering both higher inflation and significant shortfalls in real GDP, it is likely that policymakers in those jurisdictions will continue to face a much less favourable macro environment, especially if the pandemic and/or the war in Ukraine have interacted with underlying structural vulnerabilities or exposed policy mistakes.

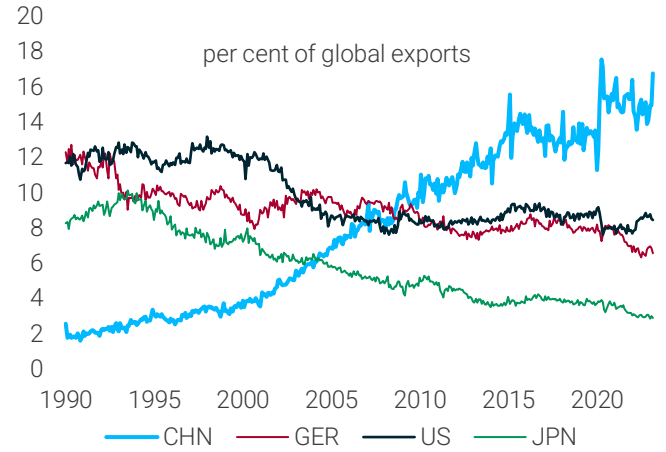
While all developed nations (and EMs) have suffered the effects of these four macroeconomic trends over the past 18 months, relative exposure to each has varied widely from country to country. We can illustrate this point by comparing the performance of three countries that span the spectrum of these stagflationary dynamics: Germany (which has been particularly exposed to global trade swings and imported goods prices), the US (where monetary tightening is now the dominant threat to the economy) and the UK (which has experienced some of the same problems as Germany and the US but is also experiencing its own idiosyncratic issues). Although the differences between these three economies have not really mattered over the past couple of years – since all central banks have been pursuing the same remedial actions – they could start to become more important, especially as policymakers consider their next steps.

Chart 4: Germany most exposed to bullwhip



Source: World Bank, TS Lombard

Chart 5: Germany struggles to defend market share

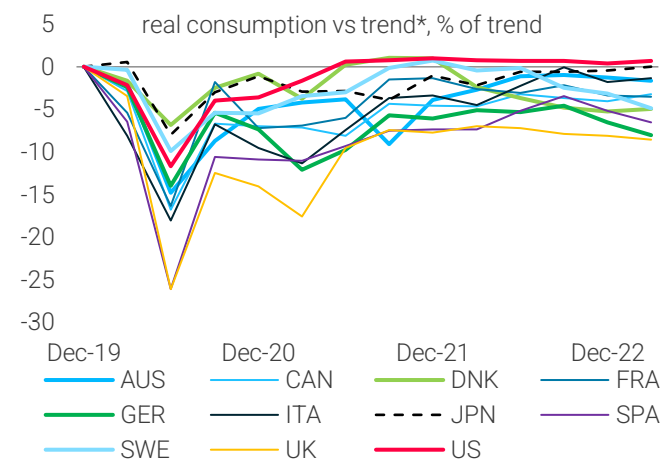


Source: IMF Direction of Trade, TS Lombard

Germany already in recession

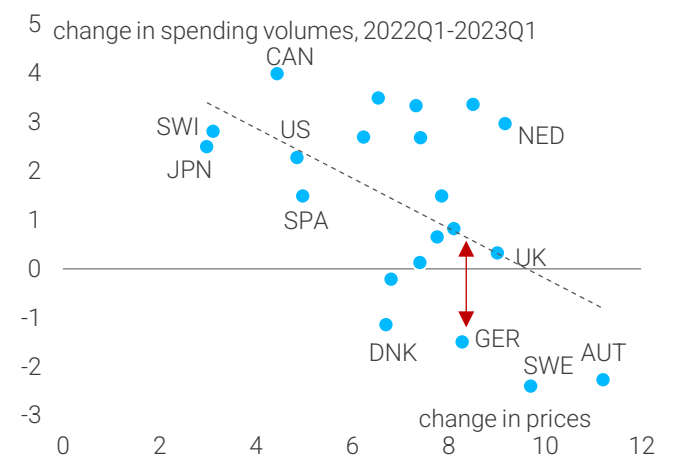
Germany's economy generated a lot of nasty headlines in May, when, following two consecutive quarters of negative GDP growth, the country entered "technical recession". On one level, this development is not, of course, as newsworthy as it might seem. Debating the "technicalities" of a recession is meaningless, especially for a nation where trend GDP growth is close to zero (which means "technical" recessions happen all the time) and companies have a strong propensity to hoard labour. As we have explained elsewhere, recession is a process – not an event – and a true recessionary dynamic kicks in only when employment starts to contract, because this is where nasty "reflexivity" tends to occur. When people lose their jobs, there is a decline in economy-wide confidence and spending, which leads to a reduction in corporate revenues and subsequently further rounds of redundancies. Yet, Germany's current technical recession is interesting because it is the result of macro pressures that are also being felt elsewhere – especially among countries that are most exposed to global trade and the IP cycle (China, Japan and many EMs).

Chart 6: Big squeeze on real spending power

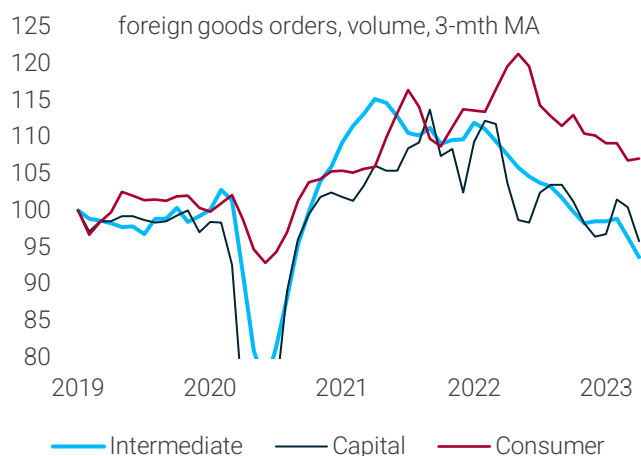


Source: OECD, TS Lombard

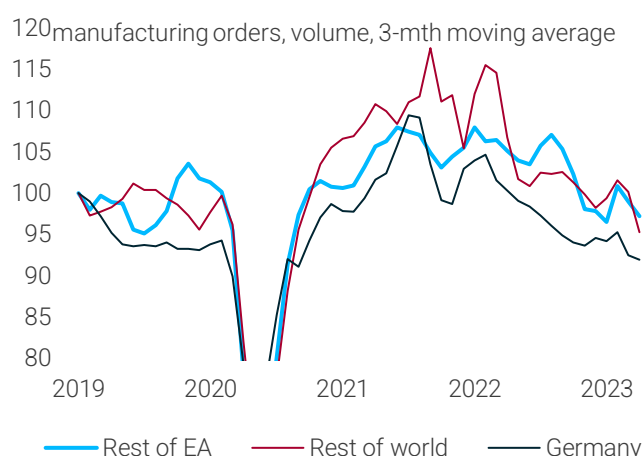
Chart 7: Price-sensitive German consumers



Source: OECD, TS Lombard

Chart 8: Bullwhip ripples through German industry


Source: Bundesbank, TS Lombard

Chart 9: Plunging demand for German industry


Source: Bundesbank, TS Lombard

Germany bullwhipped

Germany is more geared to the global industrial cycle than most other large, developed economies. Chart 4 shows that within the G20, it has the highest export and manufacturing shares. While this was an advantage during the pandemic, when spending patterns shifted from services to goods, it has become a serious vulnerability as those trends have reversed. Charts 8 and 9 show extreme swings in German factory orders over the past three years, with the bullwhip effect in global trade ripping its way through the domestic industrial sector. But it was not just Germany's reliance on external demand that left the country disproportionately exposed to the fake COVID business cycle. Germany was also at the epicentre of Europe's 2022 energy crisis, with the country's famously inflation-shy consumers particularly sensitive to falling real wages.

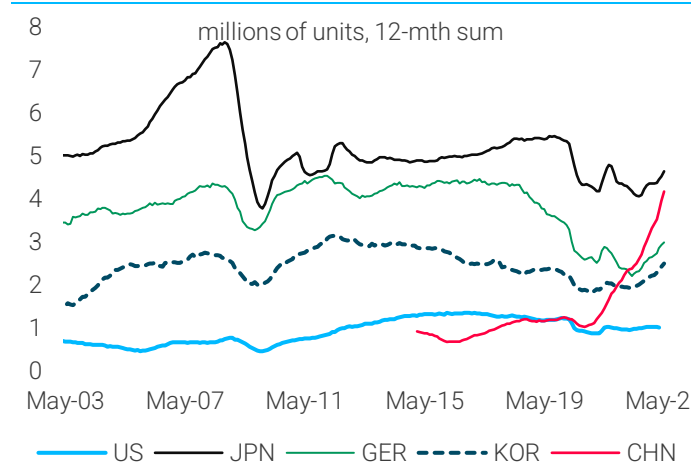
Consumption dysfunction

When Putin severed Europe's access to Russian natural gas, his actions had serious repercussions for Germany's economy, which had become increasingly dependent on cheap Russian energy in the decade preceding the Ukraine war. Even with massive fiscal support programmes, higher energy prices squeezed consumers' real spending power. As Chart 1 shows, German households suffered some of the most extreme price increases, while domestic wage gains were much more muted than elsewhere. But it was not just the reduction in real incomes that was a problem for Germany's domestic economy. German consumers are famously inflation averse, with a price elasticity of demand that is typically greater than elsewhere. While it difficult to isolate precise price elasticities in the aggregate spending data, we can get a sense of this dynamic from Chart 7. The German dot on that scatter plot is far below the average of the other economies, showing that higher prices caused additional demand destruction in Germany. Combine a large industrial base, highly price-sensitive consumers and a heavy reliance on Russian energy, and it is not surprising that Germany's economy is now performing so poorly.

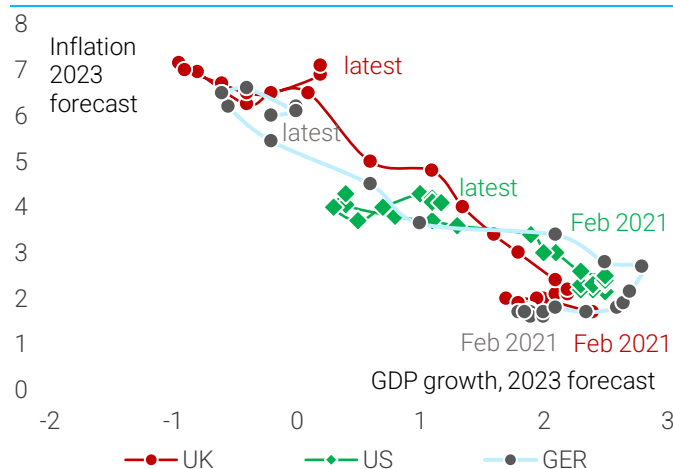
Threats from both energy and exports

Economists like to attach the word "inevitable" to the recessions they have been forecasting in 2023. And with Germany, there is a degree of truth to this. The country was always going to experience a downturn as a result of events largely beyond its own control – irrespective of domestic policy actions. The important point, however, is that Germany's recessionary impulse

should fade once the things that caused the downturn begin to ease. And with energy prices down significantly and global manufacturing showing tentative signs of stabilization, the worst of the slowdown could soon be over. That does not mean, however, that there will be no lasting damage to Germany's economy. We see two potential risks. The first is what happens next autumn when energy supplies could once again become inadequate. Europe survived its first winter without Russian gas partly because the weather was mild and partly because the China lockdown helped the continent secure large quantities of LNG. There is no guarantee that these favourable conditions will hold next winter. The second threat to Germany's longer-term health is from exports, where the recent gyrations in manufacturing demand may conceal a more serious loss of German-competitiveness. Auto producers should be particularly worried, given that Chinese EV exports are now making serious inroads into their market share (Chart 10).

Chart 10: China a problem for German auto sales


Source: CIEC, TS Lombard

Chart 11: UK breaks away – worse trade-off


Source: Bloomberg consensus forecasts

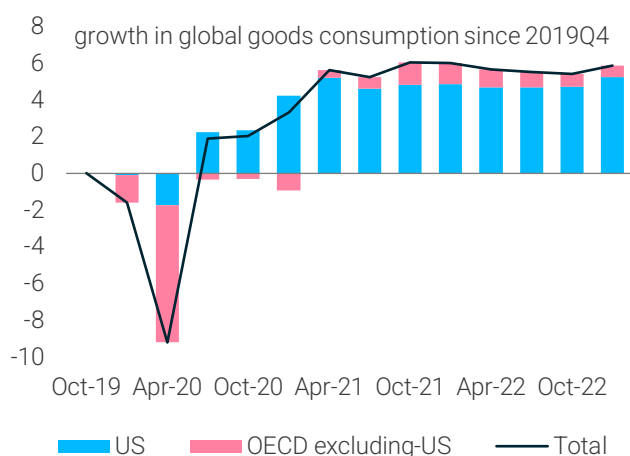
No policy trade-off

Persistently higher energy prices and a loss of global market share – if realized – would damage Germany's long-term growth. Real incomes would be permanently lower. But policymakers have no reason to expect either a stubborn inflation problem or a lasting deterioration in the trade-off between growth and inflation. There is no need for a monetary-induced recession on top of the downturn that has already taken place. Indeed, the only justification for tighter monetary policy is if workers and companies can be expected to resist the squeeze, producing second-round effects. This has clearly been the focus of the ECB, in part because it sets interest rates for the entire euro area, not just for Germany. But the case for a policy-induced economic downturn is far more compelling in other countries, especially those where domestically driven inflationary pressures are more acute. Sections 2 and 3 illustrate this point by focusing on developments in the US and the UK – economies with deeper underlying imbalances and where the main recession risk comes from domestic policy, not external events or large (but temporary) gyrations in trade.

2. RESTORING BALANCE

The combination of stinging energy costs and the bullwhip recession in global manufacturing has already delivered a significant downturn in Germany. Naturally, the same forces are contributing to the weakness we are seeing elsewhere, including in the US, which is less exposed to these

global pressures. But, in contrast with Germany, the main recession risk in the US is about domestic policy choices – specifically whether the Federal Reserve triggers a more serious domestic contraction as part of its effort to tame inflation. Our analysis suggests that while there is still a decent chance the US will avoid a recession altogether, the probability of a soft landing remains finely balanced. Since monetary policy is a blunt tool and it is hard for policymakers to assess the appropriateness of their actions in real time, we would not rule out a mild US recession over the next six to 12 months. important point, however, the US does not “need” a deep downturn to restore price stability. Like in Germany, it is doubtful US policymakers are seeing a serious or persistent deterioration in the trade-off between inflation and unemployment. That risk lies elsewhere.

Chart 12: US consumers inflated the world


Source: OECD, TS Lombard

Chart 13: US goods demand boomed


Source: OECD, TS Lombard

Chart 14: UK consumption has been weak


Source: OECD, TS Lombard

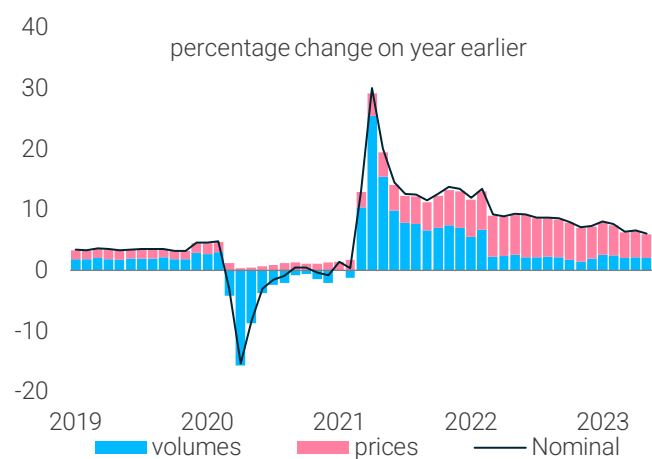
Chart 15: Euro-area consumption plunged


Source: OECD, TS Lombard

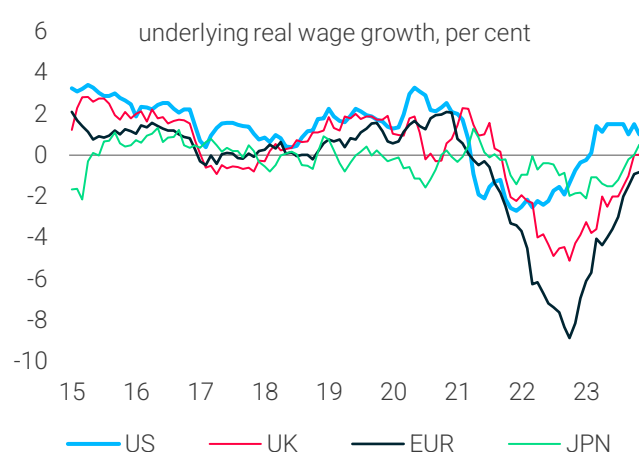
The US downturn

The US economy is obviously far less exposed to global developments than that of Germany. That said, the bullwhip contraction in global manufacturing has still had a notable impact on US

leading indicators – contributing to investor perceptions of near-term US recession risk – while US consumers have experienced a significant squeeze on their real spending power (Chart 16). But the good news is that these tensions are beginning to fade. Like in Germany, the pressure on domestic US manufacturing is starting to subside, while the worst of the squeeze on real wages appears to be over. US households, which have maintained their spending by running down the “excess savings” they accumulated during the pandemic, should now see their nominal wages rise faster than prices. This could be crucial for the resilience of consumption during the second half of the year, especially as those excess savings are set to disappear. If the US downturn were just about manufacturing bullwhips and real incomes, we might even expect an economic recovery. But the source of US recession risk has shifted – to tight monetary policy.

Chart 16: Higher US prices, lower volumes


Source: BEA, TS Lombard

Chart 17: The big real wage squeeze


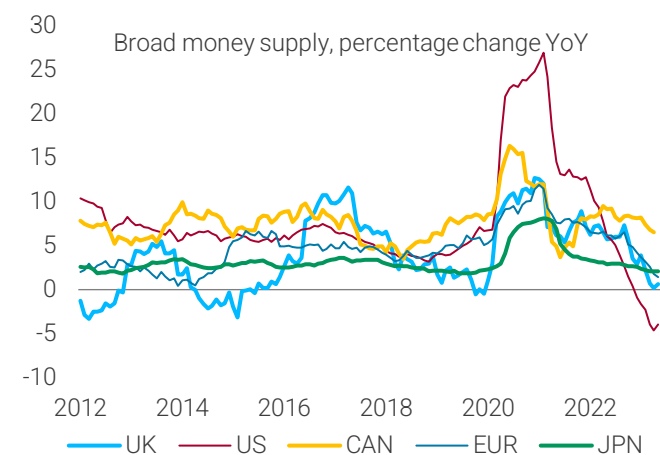
Source: national sources, TS Lombard

Tight US monetary policy

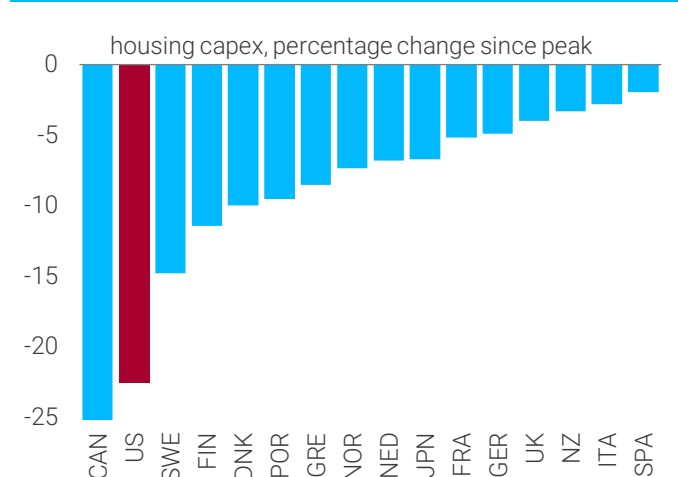
Rapid monetary tightening is causing genuine demand destruction in the US, over and above the “fake” recession associated with supply-chain normalization and the squeeze on real wages. The rationale for this development is that Fed policymakers want to address an underlying imbalance in the US economy, where the post-COVID boom has produced genuine and sustained overheating in the labour market. Officials believe it is their job to restore balance to the labour market by realigning demand and supply (i.e., by reducing demand for workers). In terms of the “stock” and “flow” effects we outlined above in Section 1, US monetary tightening has – so far – operated primarily through the flow effect (the impact on new lending). The cost of private-sector borrowing has increased dramatically, which has triggered a powerful decline in transactions across all the most rate-sensitive parts of the US economy. As Chart 19 shows, US housing investment has fallen dramatically, recording a much deeper contraction than many other parts of the world (except for Canada). This has been an immediate hit to GDP and employment.

As housing and auto demand deteriorate, US credit has naturally started to contract. Worse, following [the recent stress in the banking system](#), we are also seeing a notable reduction in the availability of loans, which adds a “supply” component to the monetary contraction. The only good news is that in contrast with some other parts of the world, the stock effect of monetary tightening operates only weakly in the US. Since most US mortgages are fixed over the very long term (30 years+), higher interest rates do not squeeze existing debt holders by the same degree as can be observed in economies that have a penchant for variable-rate mortgages. (Note, however, that this also explains why the US banking system has experienced more stress than

elsewhere – because it is the banks that suffer the squeeze from issuing fixed-rate mortgages.) Based on terminal interest rates, as priced into current yield curves, US household debt-servicing ratios are set to remain relatively low, both in historical terms and in comparison with other DMs.

Chart 18: Monetary contraction worse in US


Source: OECD, TS Lombard

Chart 19: Higher rates hurt US housing sector


Source: OECD, TS Lombard

Risks to corporate balance sheets

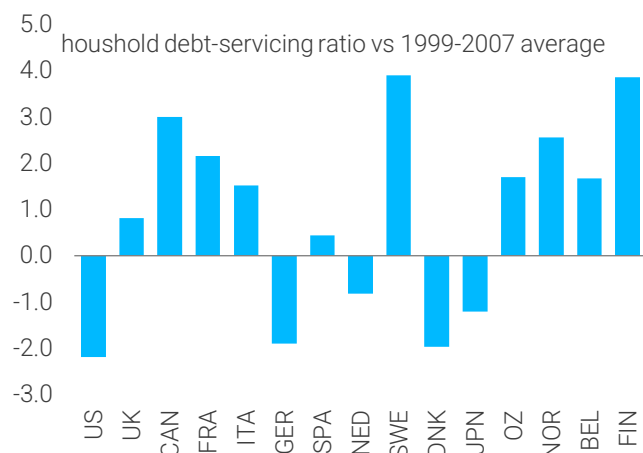
With regard to the stock effect of US monetary tightening, the greater recession risk is on the corporate side, where refinancing needs are greater and debt levels have increased over the past decade. Based on BIS data, our analysis shows that the US corporate debt-servicing ratio is set to rise to around 48% of income, which is above the historical average (43%) but still much less of a squeeze than we are likely to see in other countries. Still, as [recent analysis from the Fed points out](#), what matters is not just the overall hit to corporate debt servicing but also the distribution of vulnerabilities within the sector. When a large share of companies are in financial distress, contractionary monetary policy tends to have a much greater impact on aggregate investment and capital spending. This is worrying because in their latest research, [Ander Perez-Orive and Yannick Timmer](#) note that around 37% of US firms already meet their definition of financial distress, with their “distance to default” now below the 25th percentile of the historical distribution. As a result, Fed staff believe this could be one of the most contractionary periods of monetary policy since the Paul Volcker era (at least in terms of its impact on US corporates).

Is a US recession necessary?

If the US experiences a genuine recession – which, as always, we define by the reflexive process of employment contraction – and not a “technical” decline in GDP, monetary tightening will have been the primary cause. Not only is it difficult to assess the appropriateness of interest rates in real time, but continuing strains in the banking system mean policymakers are starting to lose control of their overall policy stance. Yet there is nothing “inevitable” about this threat of recession. And the US certainly does not need a deep recession to restore balance to its labour market, for the simple reason that much of the post-COVID gap between US labour demand and supply is “unrealized” – that is, companies have been trying to hire staff but the workers have not been available. This is an unusual situation, and one that is mainly the result of the pandemic. Many older workers dropped out of the labour force at a time when immigration slowed, which means companies have struggled to rehire the staff they lost during COVID-19 – as we see from the historically high levels of unfilled vacancies. The advantage of this situation, however, is that it [provides a realistic path to a soft landing](#). If the Fed can rebalance labour demand and supply by

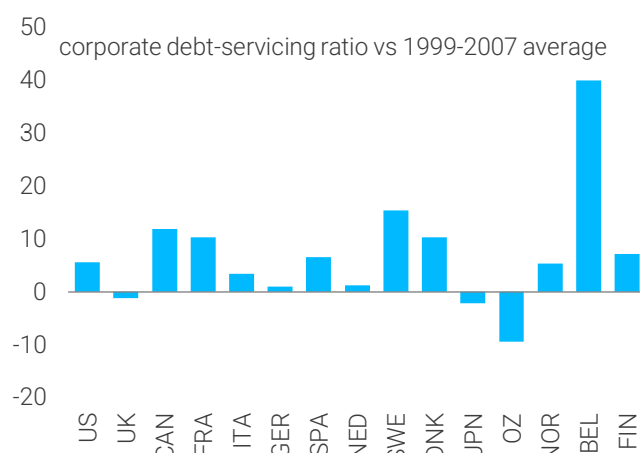
eliminating job openings – rather than putting people out of work – it should be able to generate a sustained reduction in inflation without causing a significant rise in unemployment.

Chart 20: Stock effects from higher rates



Source: BIS, TS Lombard

Chart 21: The corporate squeeze

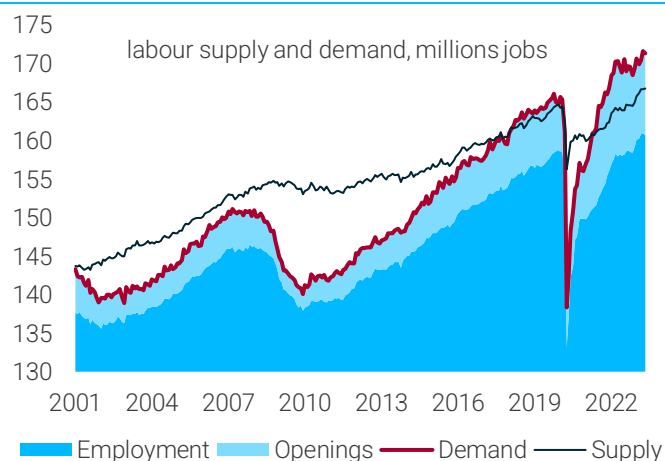


Source: BIS, TS Lombard

Supply improvement would help

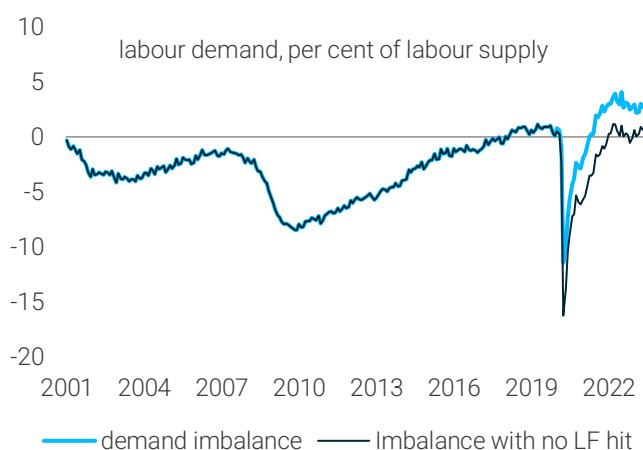
While there is definitely the prospect of a soft landing in the US, the margins are fine. Most of the demand destruction would need to come from reduced vacancies rather than layoffs, which is a big ask given that monetary policy is a blunt tool. There is no point, for example, making tech workers unemployed if all the staff shortages are for restaurant workers, carers and hairdressers; under such a scenario, we would end up simply with greater “mismatch” in the labour market, which would result in aggregate job losses and a classic recession. And a soft landing becomes even harder when banks are tightening lending standards because at the same time these institutions are likely cutting credit provision to the entire economy, not just the most rate-sensitive sectors (which is what tends to happen with ordinary rate hikes). Conversely, the Fed would stand a better chance of delivering a soft landing if the supply-side of the US labour market started to improve. And with immigration picking up and participation rates gradually recovering, there are some early signs of this happening. While it is premature to think a recovery in labour supply can save the Fed, US policymakers certainly have an advantage over some other central

Chart 22: The imbalance in US labour markets



Source: BLS, TS Lombard

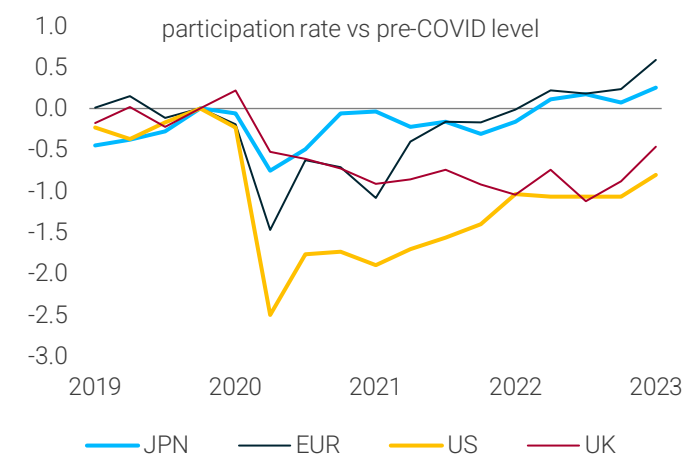
Chart 23: Weak supply contributed to US imbalance



Source: BLS, TS Lombard

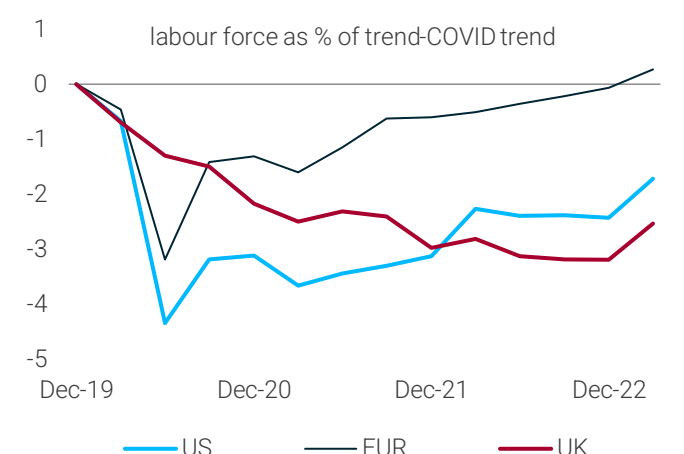
banks – especially the BoE – in whose economies the supply-side has turned decidedly less favourable since the pandemic.

Chart 24: Participation rates have diverged



Source: OECD, TS Lombard

Chart 25: UK labour force especially weak



Source: national sources, TS Lombard

3. BRITISH EXCEPTIONALISM

Germany's current economic malaise is mostly about weak global demand and high energy prices. In the US, by comparison, most of the recession threat now comes from aggressive monetary tightening. The important point, however, is that neither of these economies requires a deep recession to reduce inflation to tolerable levels. We see no major deterioration in the medium-term trade-off between economic growth and inflation. But there is one major economy that seems to be in a more difficult position – the UK. The British economy not only combines some of the problems experienced in Germany and the US, but its supply situation seems much bleaker than anything that has happened elsewhere. A decade of policy failure has left the UK economy fundamentally ill equipped to handle the challenges it faces today, resulting in much fatter tail risks for both inflation and growth. Ultimately, the Bank of England may have to tolerate higher inflation just to preserve the stability of the UK economy and its financial system. In other words, the BoE is going to need a great deal more luck than either the Fed or the ECB.

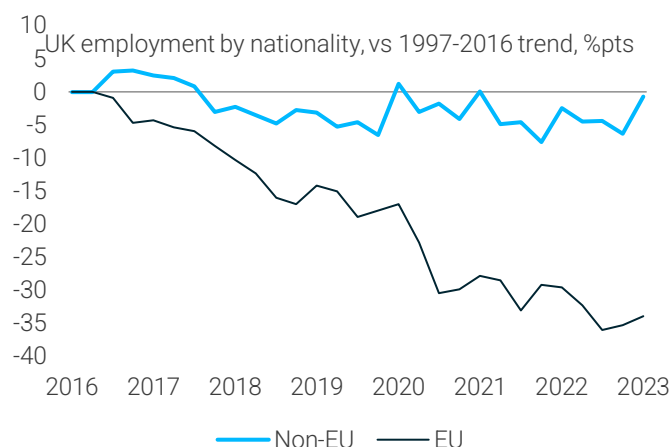
The UK – worst of both worlds

Like Germany, the UK was heavily exposed to the European energy shock following Russia's invasion of Ukraine. Inflation peaked at 11% – driven by energy, food and other imported goods – which caused a massive squeeze on consumers' real incomes. But unlike Germany, the UK has some of the most challenging aspects of the US post-pandemic environment, with an extremely tight labour market. Worse, a larger share of this tightness is the result of a decline in the labour force rather than a strong recovery in demand. The UK labour force has contracted over the past three years as participation rates have fallen and immigration slowed. Despite a decline in real GDP since the start of the pandemic, with output falling well short of its pre-COVID trend, the UK economy still shows signs of "overheating". Clearly, something has gone profoundly wrong on the supply-side of the UK economy. If we look across the DM world, it is hard to find an economy with a worse growth/inflation mix.

UK supply problems

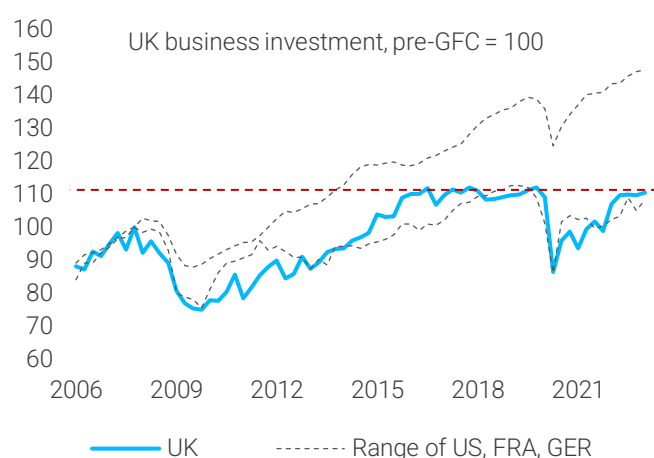
Most of the UK's supply-side problems can be attributed to the policy decisions that were made in the decade following the global financial crisis. Brexit is clearly one such decision: leaving the EU has had a significant negative impact on business investment and immigration. Chart 27 shows UK capital spending slowed sharply after 2016 as uncertainty about the country's trading relationships with the EU discouraged British companies from making large investments. Although the UK's poor investment record since 2016 is not unique, Britain has clearly underperformed most of its peers – including France and the US. Back in 2016, the hope among supporters of Brexit was that a weaker currency would offset some of the damage by providing a boost to UK exports. So far, however, these gains have not materialized. As in previous episodes of GBP weakness (Chart 28), the depreciation in the currency provided little more than a short-term boost, with the longer-term deterioration of UK competitiveness promptly resuming. It is impossible to restore exports through currency weakness when domestic manufacturers are part of long, complex international supply chains and when the authorities (both at home and abroad) are making it more difficult to trade with your nearest markets.

Chart 26: Brexit hit UK immigration



Source: ONS, TS Lombard

Chart 27: Investment weak since EU vote



Source: ONS, TS Lombard

Brexit and the pandemic

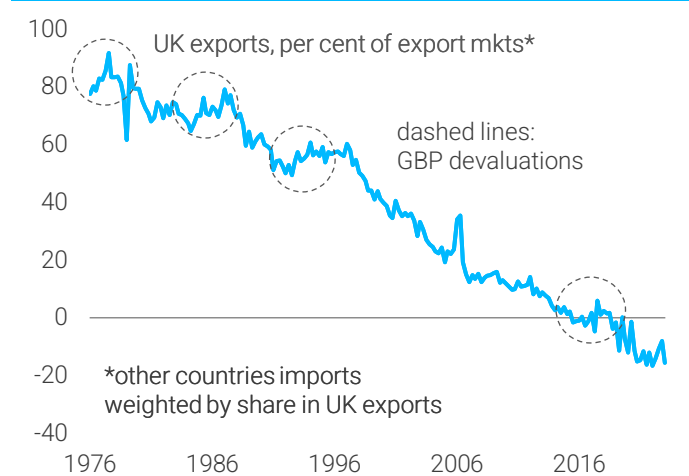
Yet, the greater macroeconomic problem of Brexit was how it interacted with the pandemic. The UK made itself less friendly to EU migrants just before an international health crisis that encouraged many non-British workers to return to their country of origin. Unsurprisingly, when the economy reopened from the pandemic, many of these people did not want to return. Chart 26 shows the loss of EU immigrants – numbers are currently running at around 30% below their pre-COVID trend – has had a significant impact on the UK labour force, contributing to the staff shortages we see across many sectors of the economy (particularly industries that were exposed to the pandemic, such as healthcare, hospitality and transport). While many economists warned about the long-term consequences of Brexit, the expectation was that any negative effects would play out gradually over time. But the pandemic accelerated this process. Even if the UK will eventually be able to rebuild its labour force through non-EU immigration – which should be easier outside the EU – that is not going to happen quickly. And UK politics are not particularly inclined towards rapid immigration.

Legacy of austerity

Brexit-related staff shortages have almost certainly contributed to the problems in the UK health system, which have become another source of supply-side weakness since the pandemic. Not

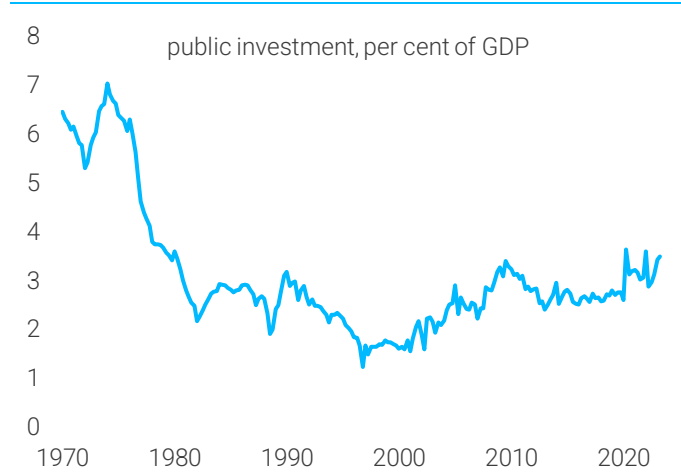
only is the NHS stretched beyond its limits, but there is clear evidence that poor health outcomes are creating an additional problem for labour supply – with a record number of people citing ill-health for their decision to drop out of their workforce (either because they are themselves unable to work or because they need to provide care for poorly relatives). While it is not surprising that people have dropped out of the workforce owing to ill-health during a pandemic – particularly with problems such long Covid – these issues appear to be worse in the UK than elsewhere. The reason for this is that a decade of austerity left the UK particularly badly equipped to handle the global health crisis. Government spending was cut drastically after the 2008 crisis; and although the NHS avoided deep cuts to its budget, net investment remained subdued. Waiting lists for UK healthcare trended higher throughout the 2010s, well before the pandemic made the situation much worse.

Chart 28: Weaker GBP doesn't really help



Source: OECD, TS Lombard

Chart 29: Austerity hurt UK investment



Source: ONS, TS Lombard

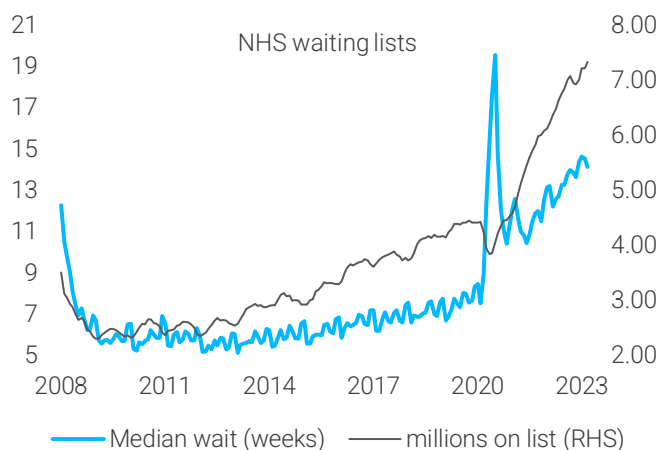
While the link between austerity and the problems in the UK health system seem direct and tangible, it is also likely that post-GFC cuts in public spending damaged UK growth potential in other, more subtle ways. Perhaps the most important factor is that UK workers have already suffered a decade of falling real wages, with public-sector employees particularly badly hit. Unsurprisingly, their tolerance for another squeeze on real incomes has been limited, especially in the context of severe labour shortages. Many UK workers are fed up with this situation, and the decline in the availability of the immigrant workers has greatly increased their bargaining power in wage negotiations. So, it is not surprising they many are ignoring the pleas of the Bank of England to exercise restraint in their pay demands – why should they accept a further decline in their real wages when they have already suffered the longest cost-of-living crisis since the Industrial Revolution? UK worker militancy – defined as the number of working days lost to strikes – has clearly picked up, even if it has a long way to go before it reaches the levels seen during the 1970s. While, in general, we think central banks tend to exaggerate the dangers of a classic wage-price spiral – something that has been extremely rare outside the 1970s – the risk of such a dynamic seems greater in the UK than in the US or many parts of the euro area.

Fatter tails

The Bank of England is clearly worried about this risk of such “second-round effects”. Recently, in fact, BoE officials have said they [can see early signs of a wage-price spiral](#), which is presumably why UK inflation has started to diverge from the unambiguously disinflationary trends of the US and the euro area. But it is not just inflation “tails” that seem fatter in the UK than in many other developed economies. The UK is also more exposed to the impact of monetary tightening – particularly the “stock” effect of higher interest rates – thanks to its heavy reliance on short-term (typically two- to three-year) fixed rate mortgages. So, the Bank of England faces a difficult

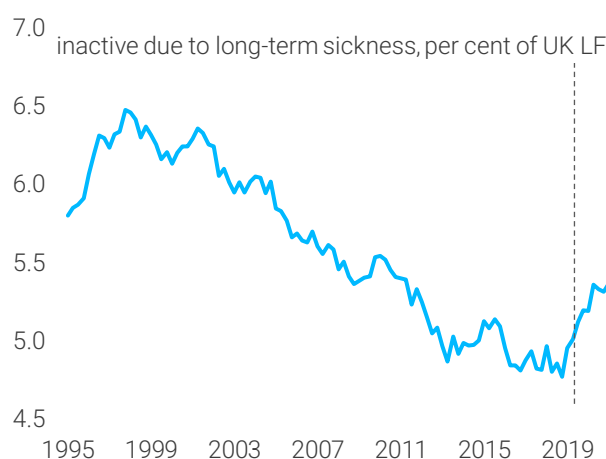
dilemma. Does it continue to raise interest rates aggressively to head off the danger of a wage-price spiral even when it knows such actions could trigger a deep recession and perhaps eventually threaten the stability of the UK financial system? Or does it tolerate higher inflation in the hope of limiting the damage to the real economy? This seems a starker choice than that faced by the Fed or the ECB, where better supply conditions mean slimmer tail risks. While we would not rule out a softish landing, even in the UK, the BoE is clearly going to need a lot more luck than other central banks.

Chart 30: Broken health system



Source: NHS, TS Lombard

Chart 31: Poor health has hurt UK labour force

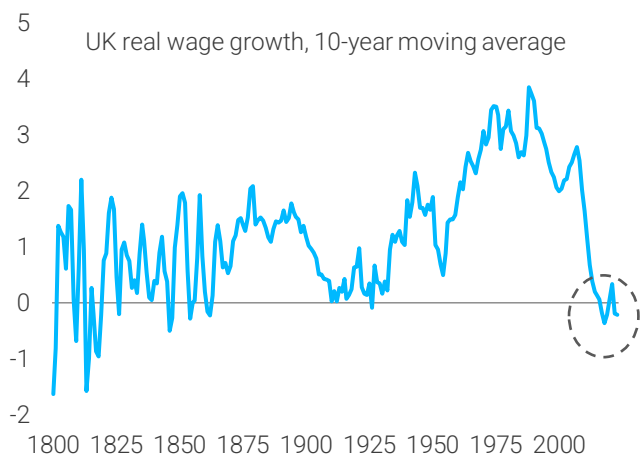


Source: ONS, TS Lombard

Bottom line

The world economy has had a distinctly stagflationary flavour over the past 18 months. Inflation has remained high while growth has slumped and the risk of outright recession has increased. Several forces have contributed to this souring of the macro environment, namely: (i) a bullwhip contraction in global manufacturing/trade, (ii) a crunching squeeze on consumers' real incomes; (iii) aggressive monetary tightening and (iv) lingering supply-side problems associated with the pandemic, the war in Ukraine and a number of idiosyncratic (country-specific) issues. While it is tempting to think all the world is suffering from the same stagflationary disease, a closer examination of individual countries reveals subtle differences in the nature of what is ailing them. Not only do these differences raise the prospect of divergence as some of the current strains in the world economy unwind, but they could ultimately create different trade-offs for central banks.

Chart 32: A decade-long cost-of-living crisis



Source: Bank of England, TS Lombard

Chart 33: Small uptick in worker militancy



Source: Bank of England, TS Lombard

We have illustrated this point by comparing recent developments in Germany, the US and the UK. Germany and the US are at different ends of the stagflationary spectrum; and while Germany's problems are all about world trade and energy costs, recession risk in the US is now much more contingent on what happens to domestic monetary policy. The good news is that neither the US nor Germany needs a deep recession to get inflation back down to tolerable levels. But the situation in the UK is more troubling. After a decade of policy failure that has undermined the supply potential of the UK economy, the tail risks for both inflation and economic growth seem higher than in other DMs. The BoE faces the trickiest policy dilemmas.