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Global Monthly

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Will tight labour markets make inflation sticky?

- **In this monthly, we challenge our view that peak policy rate is in sight and pivots are on the cards later this year**
- **Labour market developments present the most proximate risk to our monetary policy view. We assess the likelihood of wage-price spirals emerging from current tight labour markets and wage developments.**
- **In the Euro area, short term wage acceleration is probable, but from employment growth is set to weaken, while unemployment will increase, reducing the risk that wage acceleration will be persistent, though the ECB will need to see evidence of these trends materialising before changing tact**
- **In the US, temporary tightness from sectoral mismatches and worker shortages since the pandemic create upside risks to wages and inflation, which might make the Fed decide to go further than in our current base case.**
- **A weakening economy should see labour markets turning down convincingly during the course of this year, which together with sharply lower inflation, should see central banks pivot**
- **Regional updates: European economies show resilience to the energy crisis, with growth in Q4-2022 coming in stronger than expected. Still, for the Eurozone we expect moderate GDP contractions in the coming quarters, as interest rate hikes start to bite. For the Netherlands, we also expect weak growth in early 2023, but the Dutch economy will continue to outperform the eurozone in 2023-24.**
- **In the UK, we view risks to inflation and Bank Rate tilted to the upside, reflecting industrial action.**
- **Finally in China, the way is paved for a staged recovery in domestic demand and economic growth.**

Global View: Over the last few weeks financial markets have been upwardly revising their view on where the peak in central bank policy interest rates will be, as well as how long they will remain in restrictive territory. This reflects recent better than expected macro data and decidedly hawkish commentary from central bank officials. These trends have been challenging our view that the peak is within sight and that a pivot towards rate cuts will follow by the end of the year. For such a scenario to play out, we would need to see very clear signs that inflation – especially the core – is coming down. While that is a necessary condition, it is not a sufficient one. We would also need to see signs that the labour market is materially weakening and hence that inflationary pressures will come down sufficiently over the medium term.

In this monthly we reassess the strength of labour markets as well as the pass-through channels to inflation. In what follows, we first take stock of labour markets by looking at various indicators to assess tightness, wage pressures and the passthrough of wages to inflation. Whether firms are willing and able to refrain from passing higher labour costs through to prices depends on competitiveness (willingness) and corporate profitability (ability). Finally, we consider global supply chain pressures to inflation. The final section presents the monetary policy implications.

Europe: short term tightness but cooling ahead

While all labour markets we consider are tight, it matters whether that tightness springs from exceptionally high demand, a lack of supply, or sectoral shifts since the pandemic. It matters for determining how much wage pressure it is generating and where wage growth will go over the course of the year.

Below trend demand with above trend supply of labour

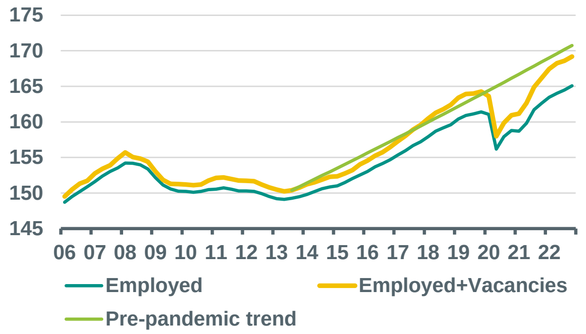
Starting with labour demand (total employment plus vacancies), the chart below shows that labour demand is above the pre-pandemic level, but it is below the pre-pandemic trend. Together with above trend labour participation, our judgement is that the Eurozone labour market is not that tight to start with on aggregate.

In addition, we see that in the first three quarters of 2022 the demand for labour slowed, from 0.8% qoq in 2022Q1, to 0.5% in Q2 and 0.2% in Q3.

The percentage of people between 20-64 who are at work or actively looking for work - has surpassed pre-pandemic levels (78.4%) in the 3rd quarter (79.4%). In comparison with the US, the Eurozone did not see its active population decrease as much, but rather saw its hours worked collapse during the pandemic on the back of job retention schemes. Since then, the number of hours worked per employee has bounced back. In 2022Q3, it still was below the pre-pandemic level, but roughly back in line with the downward trend of the last two decades.

Eurozone: labour demand at pre-pandemic trend

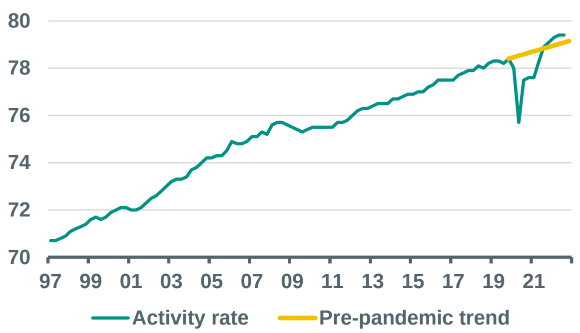
In millions



Source: Refinitiv, ABN AMRO Group Economics

EZ: Activity rate above pre-pandemic trend

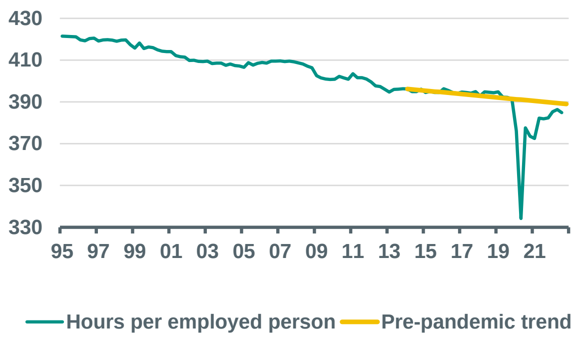
Active population / total population 20-64 years



Source: Refinitiv, ABN AMRO Group Economics

EZ: Hours per employee on downward trend

Level



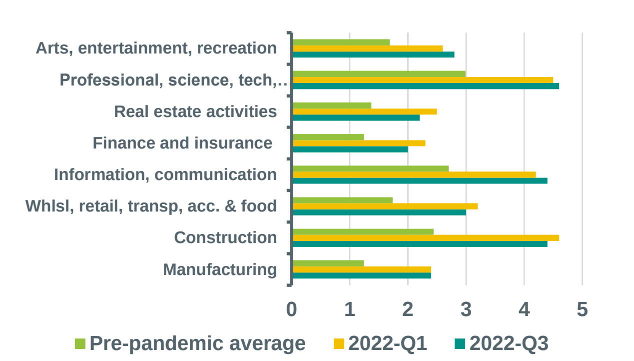
Source: Refinitiv, ABN AMRO Group Economics

Interest rate sensitive sectors start to unwind

Based on the number of vacancies, most segments of the eurozone labour market still seem very tight, although tightness has moderated in some sectors during the course of 2022. The job vacancy rate for the whole economy declined in Q3, to 3.1%, down from 3.2% in 2022Q2 (pre-pandemic average is 1.8%). At the sector level, the job vacancy rate for the contact intensive parts of the services sector (e.g. accommodation, recreation, entertainment) increased between 2022Q1 and 2022Q3, whereas the job vacancy rate for the sectors where activity is most sensitive to monetary policy and developments in the housing market (e.g. finance and insurance, real estate), declined during those quarters. The vacancy rate in manufacturing stabilised between 2022Q1-Q3.

EZ: Job vacancy rate various sectors

No. of job vacancies / (employment + no. of job vacancies)

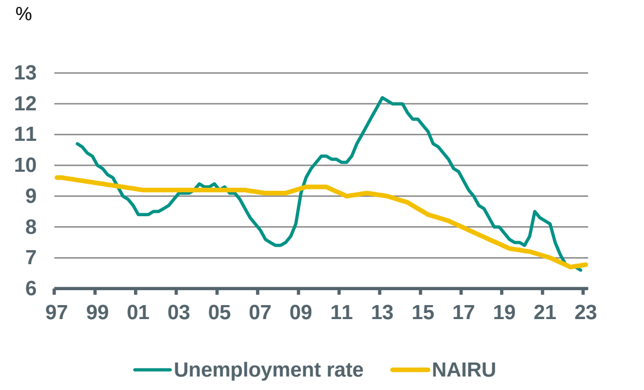


Source: Refinitiv, ABN AMRO Group Economics

Unemployment rate close to (but not below) NAIRU

While unemployment has moved to a historic low of 6.6 percent in December 2022, the equilibrium unemployment (that estimates when unemployment levels become inflationary) has been moving down along with it since the eurozone crisis, as countries implemented labour market reforms and reforms to the social security and pension systems. These have helped to increase the activity rate in the Eurozone. According to estimates by the European Commission the unemployment rate was very close to the NAIRU at the end of 2022. This means that unemployment is almost at the level where it is inflationary. However, it is possible that the NAIRU has fallen below those estimates given that the impact of reforms continues to feed through.

EZ: NAIRU* and unemployment



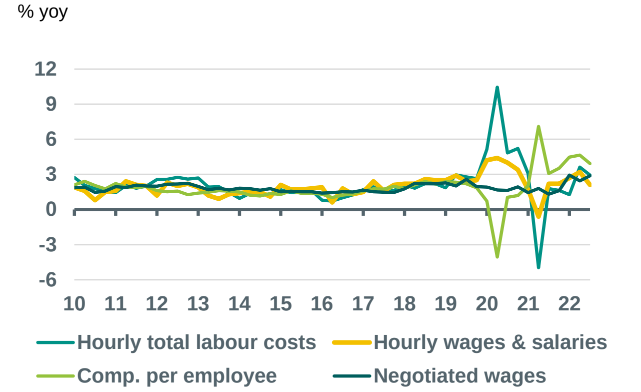
Source: Refinitiv, ABN AMRO Group Economics

* The non-accelerating inflation rate of unemployment (NAIRU) is the specific level of unemployment that is evident in an economy that does not cause inflation to increase. In other words, if unemployment is at the NAIRU level, inflation is constant. NAIRU often represents the equilibrium between the state of the economy and the labour market.

3 reasons for accelerating wages in the short term

Wage growth in Europe has been on the rise since the end of the pandemic. Negotiated wages accelerated from 1.3 percent before the energy crisis to 2.9 percent in the third quarter of 2022. An alternative real-time measure for new jobs published by Indeed has moved substantially higher, to a recent peak of 5.5 % y-o-y in August 2022 which is well above the (3%) level consistent with 2% inflation. But even this measure suggests that wages inflation has started to ease in the last quarter of 2022.

EZ: Labour costs and wages



Source: Refinitiv, ABN AMRO Group Economics

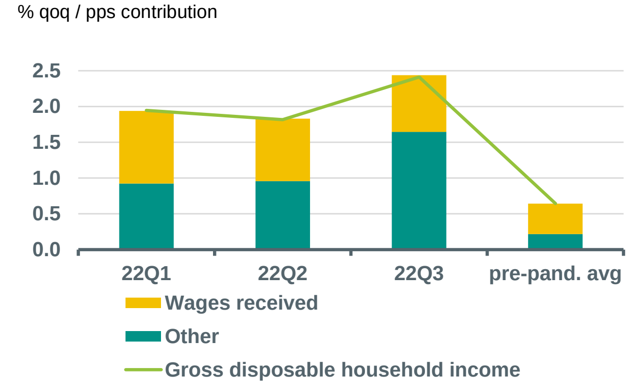
EZ: Indeed's short term wage tracker has slowed

Source: GitHub, Hiring Lab, ABN AMRO Group Economics

While cooling of the European labour market is on the cards, in the short run, there are three factors that may still push up wage growth in the first few months of 2023 in specific sectors.

First, sectoral re-allocations - away from and then towards the leisure sector for example - raised churn-related vacancies and has created temporary sectoral tightness.
Second, a number of other income sources such as government support or income from the housing market have been boosting gross domestic household income. While government compensation is planned to be phased out in the coming months and housing prices have started to come down, these additional income sources may explain why services stayed remarkable resilient up until now. February services PMIs improved slightly to 53, indicating expansion. This resilient demand for services, could keep labour market tightness high and as such lead to an acceleration of wages in the coming months.
Third, as government compensation schemes are unwinding, labour unions might look at employers to compensate a larger share of the inflation burden of workers. This could create some temporary upside wage pressure as long as inflation is still high.

EZ: Household income and contributions



Source: Refinitiv, ABN AMRO Group Economics

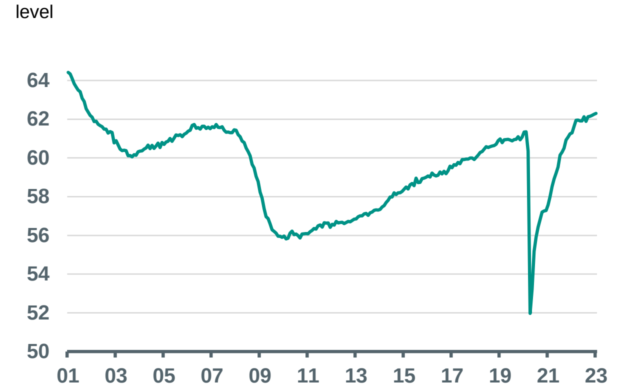
For the industrial sectors, the opposite holds. February's manufacturing PMI signalled contraction (48.8) and the ECB reports easing labour shortages and lower demand for temporary staff by employment agencies. Indeed, the European Commission business and consumer survey shows that labour shortages have ceased to be the major worry for manufacturing firms.
While all three arguments for upward wage pressure are temporary and sector specific, negotiated wage growth is expected to accelerate in the next few quarters (i.e. 2023 H1), from 2,9 % in Q3 2022 to around 3.5-4% before starting to come down.

Eurozone wage growth to slow back to level consistent with inflation target by 2024
On the back of a moderate recession in Europe, a not that tight labour market to start with, early signs of cooling in manufacturing, already contracting fixed investment and the effects from past monetary tightening still coming down the line, employment is expected to come down while unemployment is to accelerate in the second half of 2023. Short term wage acceleration is expected to diminish during the course of next year. As a result, wage growth should slow down again from 3.5 to 4% in the first half of 2023 to 3% over the course of 2024. A level consistent with the ECB's medium term inflation target.

US: stubborn worker shortages on top of sectoral mismatch

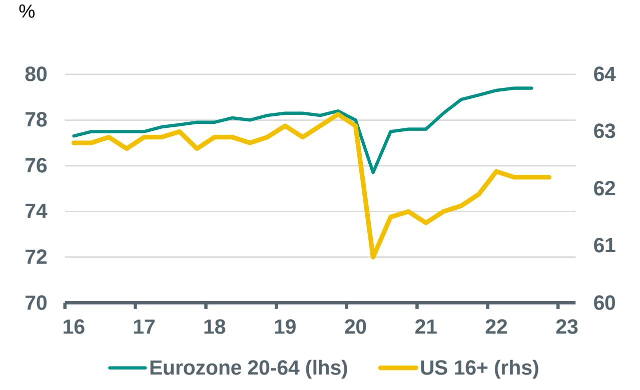
Supply shortages persist
Tightness in the US labour market is not so much coming from the demand side. Total Employment plus vacancies have moved back to the pre-pandemic trend but not beyond. Moreover, the vacancy rate is declining. The tightness is mainly coming from supply shortage. In contrast to the Eurozone, participation in the US has remained well below pre-pandemic levels. Early retirement of older American workers is often mentioned as a reason for the low participation rate, but there also is a striking difference between the US and EU in the post pandemic rebound of activity amongst younger people. Whilst in Europe, younger workers returned back to the labour market at a pace beyond the pre-pandemic trend, in the US it even remained slightly below the pre-pandemic level.

Total demand for labour US



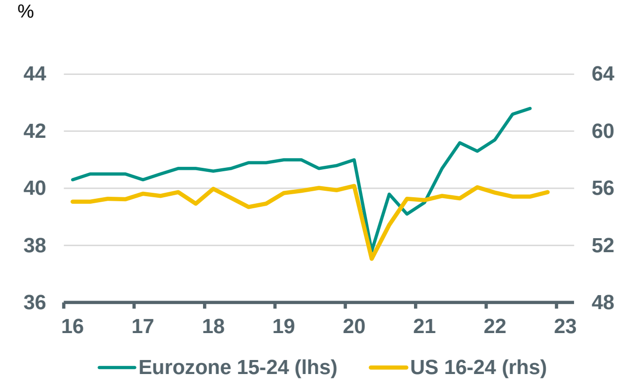
Source: Refinitiv, ABN AMRO Group Economics

Participation rate US and Eurozone



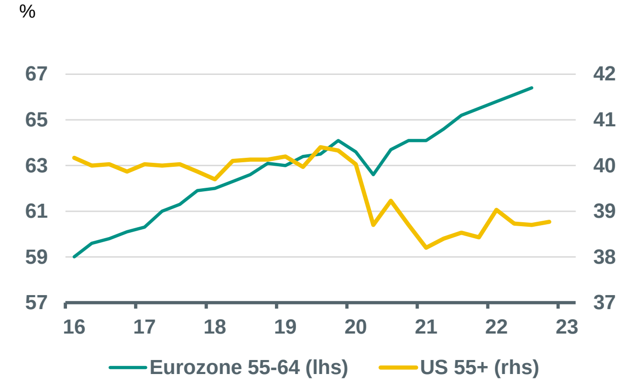
Source: Refinitiv, ABN AMRO Group Economics

Participation rate US and Eurozone- under 24



Source: Refinitiv, ABN AMRO Group Economics

Participation rate US and Eurozone – over 55

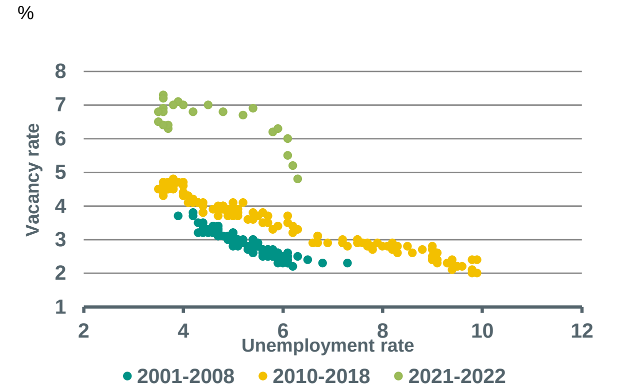


Source: Refinitiv, ABN AMRO Group Economics

Massive sectoral mismatch created temporary wage pressure

To assess potential sectoral mismatches the Beveridge curves is a useful tool. It plots the unemployment vis-à-vis vacancies. Close to peak tightness, the labour market swings to the upper left corner of the curve (with high vacancies and low unemployment). If the curve moves sideways to the right, this indicates sectoral mismatch, as vacancies stay open while unemployment is higher. The Beveridge curve of the US shows that de pandemic led to massive frictions in the labour market, as the green dots show that the curve is shifting sideways. Labour market frictions increased on the back of shifting consumer demand, which drove temporary shifts in labour demand (for instance from services to goods, and now back to services). While these labour market frictions are temporary as wages will eventually reallocate workers to the sectors with demand, it can in the short run drive wage increases.

US: Beveridge curve



Source: Refinitiv, ABN AMRO Group Economics

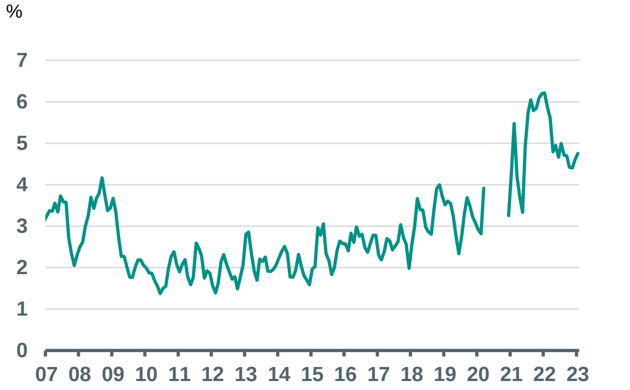
With unemployment at a 5-decade low of 3.4%, the Congressional Budget Office estimates that unemployment has fallen below the threshold where it can easily become inflationary.

Medium term wage growth likely to come down

Our take is that the US labour market is now at the turning point. Wage growth has already come down significantly and layoffs are picking up. We expect wages to cool further in the next months. From its peak of over 6% (3m/3m saar), average hourly earnings were growing at a 4.4% (3m/3m annualised) pace as of January. This is only a little higher than the pre-pandemic peak. Moreover, given US long term productivity growth of 1.5 %, a cooling of wage growth to around 3.5% should suffice to be consistent with the Fed achieving its 2% inflation target.

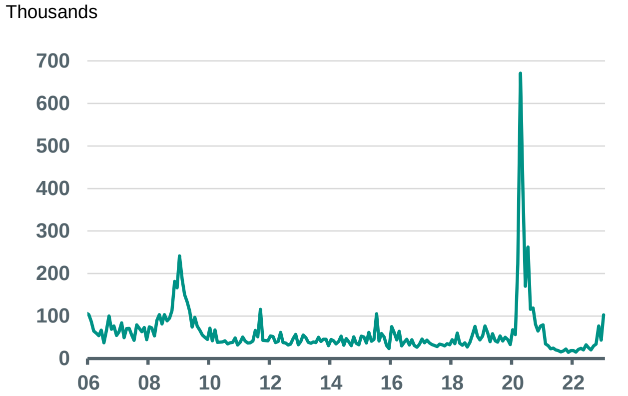
Our base case is that despite resilient labour demand, the labour market has reached its turning point as investments are contracting, consumption is cooling and layoffs have started to tick higher. This also means that labour demand will slow, unemployment will begin rising and vacancies continue falling over the coming months.

US: wage growth



Source: Refinitiv, ABN AMRO Group Economics

US: layoffs



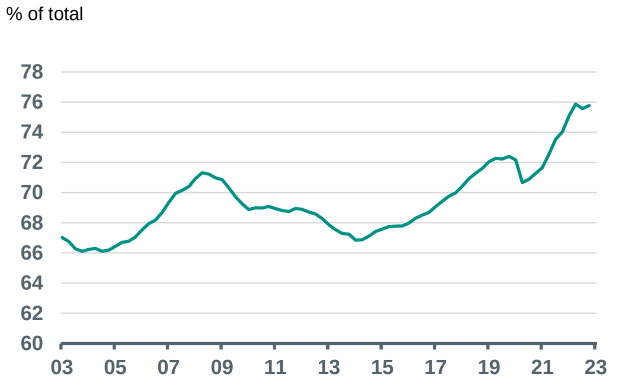
Source: Refinitiv, ABN AMRO Group Economics

The upside risk to this view is that if persistent labour hoarding occurs despite a cooling economy, demand could remain more resilient and wage growth could reaccelerate on this persistent tightness. There is however also a downside risk. The labour market could unwind more rapidly once a tipping point in layoffs is reached, which could set of a self-reinforcing dynamic of weaker employment driving lower consumption and hence weaker employment. This could then push down further on wage growth over the medium term.

Netherlands: extreme tightness is cyclical on top of structural

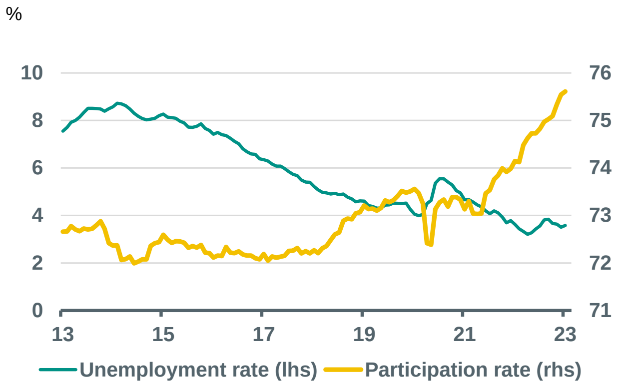
Dutch labour market tightness looks rather extreme to us, with unemployment deeply below the non-inflationary level of unemployment. In December 2022, unemployment decreased even further to 3.5%. The demand for labour is far beyond pre-pandemic trend, though participation rose to 75.6% in January 2023, preventing even more tightening.
Besides temporary factors that are expected to unwind this year - such as the pandemic support that is keeping demand high and bankruptcies at a historic low – it is the structural tightness that could make employers reluctant to let go of workers even if revenues go down. To assess whether sectoral mismatches explain part of the tightness we analysed the Beveridge curve in the same way as we did for the US. This shows that there is no outward movement of the curve, suggesting that temporary tightness from a sectoral mismatch does not seem to play a large role.

Netherlands: Total demand for labour



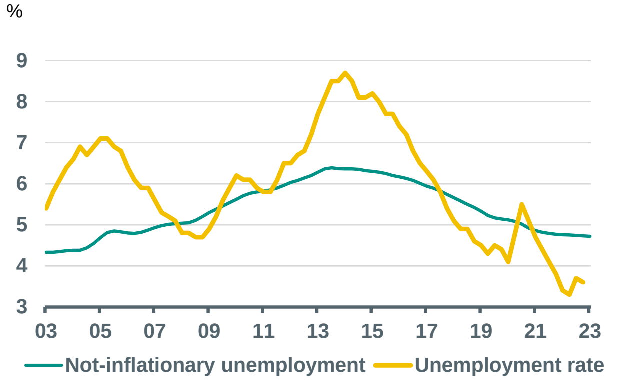
Source: Refinitiv, ABN AMRO Group Economics

Netherlands: Participation rate



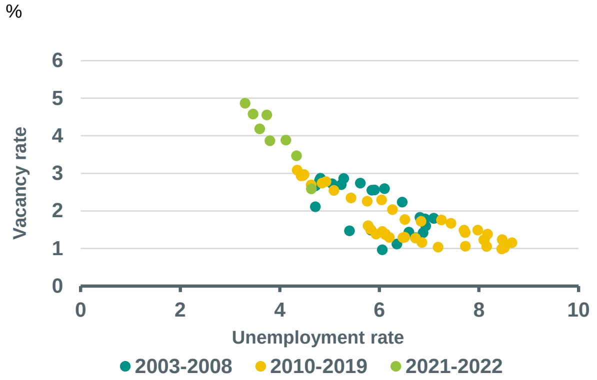
Source: Refinitiv, ABN AMRO Group Economics

Netherlands: Unemployment vs NAIRU



Source: Refinitiv, ABN AMRO Group Economics

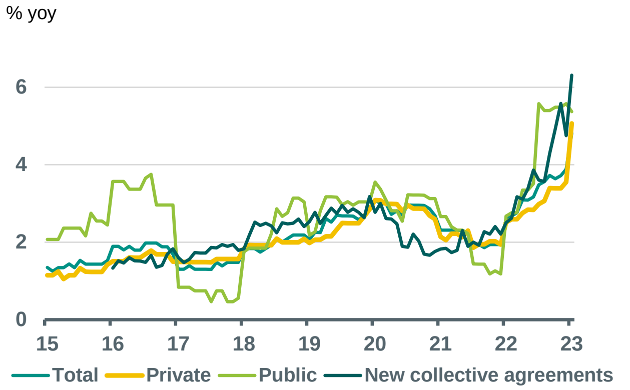
Netherlands: Beveridge curve



Source: Refinitiv, ABN AMRO Group Economics

All these factors above make wage growth acceleration likely this year. Labour unions are asking for large increases, such as the FNV transport wage demand of 14,6%. While these wage demands do not appear likely, negotiated wage growth has already increased to 5 percent, which is well above historic levels. It is worth noting that wage growth was muted in the past even when unemployment fell to levels below the NAIRU (in 2019 for example).

Netherlands: Wage development



Source: Refinitiv, ABN AMRO Group Economics

Something else than tightness is playing into wages

Two other factors are playing into current successful wage growth negations: the first is inflation itself. Consumer Price Inflation peaked at 14.5% in September 2022 (versus 10,6% in the eurozone). While the Dutch CPI figure was partly distorted (see here why), it encouraged labour unions to ask for much more compensation than they had in previous years. A second factor that played its part in the wage negotiations is government support. Throughout Europe gross disposable household income was massively supported by various government support schemes. For the Netherlands, these compensations schemes were in place as well, but the combination of extreme labour shortages and exceptionally high CPI figures has dominated negotiations.

Higher wages for longer in the Netherlands

In the Netherlands, wage growth of around 5% and new agreements closing above 6%, is way above the historic bandwidth of 1 to 3%. Given the structural tightness on the labour market, the long-term structure of labour agreements and the inflation figure itself pushing up the trend in new agreements, we expect wage growth to stay elevated for longer. This is rather remarkable, given the culture of wage moderation in the wage setting process that has kept wage growth confound to 3% even at times of very high labour shortages. The Dutch labour market looks therefore much more overheated that the Eurozone labour market. At the same time monetary policy is aligned with the Eurozone aggregate, which means that an easing of the Dutch labour market (over and above that expected from the eurozone) will have to come from fiscal unwinding of demand stimulating measures, such as the energy compensation schemes for households and for firms.

The pass-through of wages to inflation

With wage growth as high as 4.4% in the US, 5% in the Netherlands and 2.9% but rising in the Eurozone, the pass through to inflation and the re-emergence of a wage price dynamics has become relevant again. In the decade between the GFC and the pandemic, wages in Europe have been growing faster than productivity, resulting in higher unit labour costs, but this did not lead to much consumer price inflation. According to a study by the IMF, the disconnect between unit labour costs and inflation was due to 3 channels: subdued inflation and better anchored inflation expectations, more exposure to competition (either domestically or abroad), and higher aggregate corporate profitability (including when supported by access to cheaper inputs). Given the substantial changes that happened in recent years in these channels, we need to reassess whether such an outcome is likely this time around.

Inflation expectations add no munition to wage price spirals

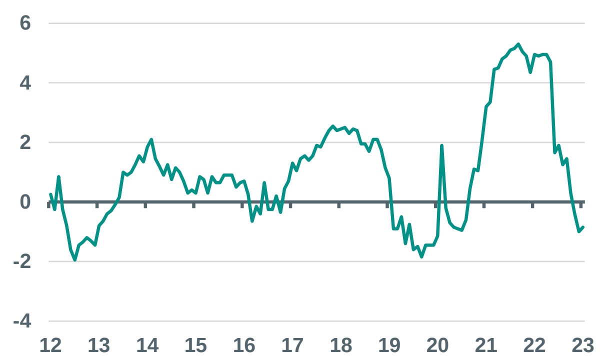
If inflation expectations de-anchor, both firms and workers are likely to try and increase prices and wages. Looking at short- and medium-term inflation expectations for the US and the Eurozone, these seem well anchored. 1- and 2-year expectations rose substantially, but have eased towards the long run. Medium term inflation expectations have remained broadly in line with long run average. Inflation expectations thus do not pose a risk of a revival of the passthrough of wages to prices.

Supply bottlenecks resolved increasing competition

After the massive supply chain disruptions from the pandemic and the reopening, our ABN AMRO supply bottleneck indicator that combines many variables that capture these pressures, has eased back to pre-pandemic levels. This suggests that competitive pressures from global trade are back and are posing downside risks to the pass through of wages to prices. The broader trend of deglobalisation could in the longer run lower competitive pressures.

Bottlenecks have eased considerably

ABN AMRO supply bottleneck indicator



Source: ABN AMRO Group Economics

Profit margins signal competitive pressures still alive

Apart from construction and retail sectors, corporate profit margins did not substantially increase in 2022 compared to their long-term average. This indicates that only in retail and construction firms have been able to raise prices more than their costs. Even for these sectors the recent turbulence in supply chains may have justified for example firms in the construction sectors to add some buffers to their profits in case of shortages. Moreover, equity market pricing suggests that these profit margins will not be sustained. An important caveat to keep in mind is that SME's make up a large part of the European economy and are not included, although recent ECB research suggests that European SMEs financial resilience is rather strong.

Difference (pp) between EBITDA margins for 2022 per European sector and the long-term (2012-2019) averages

Source: Refinitiv, ABN AMRO Group Economics

Conclusion and monetary policy implications

On balance, we see no clear evidence of wage growth passing through to prices more easily than before. Most important is that medium term inflation expectations remain well-anchored. With our assessment that wages are already cooling in the US and that in the second half of 2023 wage growth will start to come down in the Euro area as well, we think that the danger of wage-price spirals keeping inflation from coming down is not very high. That said, the risks that temporary frictions or government compensation take more time to subside are present. Moreover, central banks may judge that the risks of doing too little to bring down inflation and having to step on the breaks even harder as a consequence, is something they are keen to avoid.

Advanced economy central banks have already taken their policy rates into levels that are restrictive, meaning that they would persistently bear down on demand if kept at these rates. In addition, we almost certainly see another round of rate hikes next month. A retreat of inflation and in particular core inflation is a necessary condition to see rate hikes ending, it is likely not a sufficient condition. Given tight labour markets, it is clear that central banks want to see convincing signs that the economy is turning down and subsequently that unemployment will turn up. Our base case is that these signs will be visible before long, but the risk is that they take longer to materialise, meaning that the peak in rates maybe somewhat higher than we forecast for both the Fed and the ECB. Having said that, we continue to see a pivot towards rate cuts later this year. The cumulative rate hikes over the last few months are still largely to hit the advanced economies. This will likely take shape over the next few months, with modest but protracted recession and higher unemployment. Second, we see inflation coming down more sharply than central banks expect. Core inflation ex shelter has already slowed markedly in monthly terms in the US, while real time data suggest shelter will tumble in coming months. The eurozone is further back in this process, but core inflation has mainly been drive up by energy-sensitive items and with energy inflation now collapsing, the core should follow with a lag. Finally, monetary policy will be at restrictive levels, and against the changing macro backdrop, the beginning of a normalisation process would be a reasonable step.

Eurozone: Weakness under the surface

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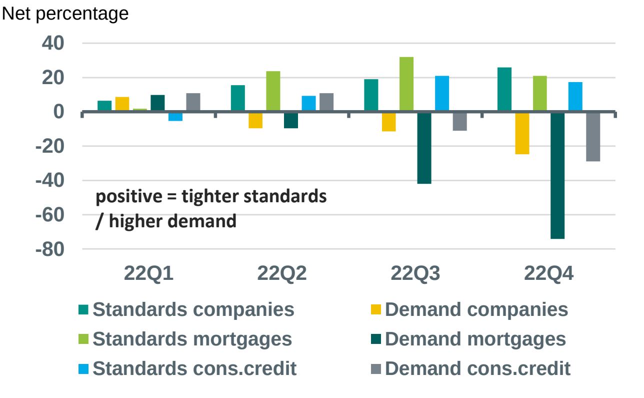
- **The eurozone economy grew by 0.1% qoq in 2022Q4, but we think that moderate contractions are on the cards for the next few quarters, as the impact of interest rate hikes will increasingly be felt**
- **There will be at least one more 50bp rate hike by the ECB in March, but the risks are skewed toward additional hikes in the short term.**

Eurozone GDP came in stronger than expected in 2022Q4, growing by 0.1% qoq versus the expectation of a modest contraction. That said, Ireland's GDP is notoriously volatile and grew by 3.5% qoq. Excluding Ireland, eurozone GDP would have contracted slightly. Another temporary push factor for GDP in Q4 was a rebound in motor vehicle production (+14% qoq) and new car registrations (+12.5% qoq), following the easing of supply bottlenecks that had hampered the sector since the start of the pandemic. No details of Q4 GDP have been published yet, but it seems that private consumption and private investment contracted somewhat, whereas net exports and government spending contributed positively to growth.

Looking forward, we expect GDP to contract moderately during most of 2023. This will mainly result from monetary policy tightening by the main central banks, which is expected to have a stronger downward impact on global growth than the potential positive impact from China's reopening. The impact of monetary policy tightening works with long and variable lags and we judge that most of the cumulative impact of past and upcoming rate hikes, and the tightening in financial and bank lending conditions, is still very much to be felt on the economy. Indeed, further evidence of the negative impact of interest rate hikes by the ECB on the eurozone economy was provided by the ECB's Bank Lending Survey (BLS) for 2022Q4. Banks tightened credit standards for all types of loans sharply again in Q4 and expect to tighten them further in 2023Q1. The BLS also showed that loan demand by companies for fixed investment dropped lower again in Q4, while loan demand by households for house purchases fell to its lowest level since the start of the series in 2003.

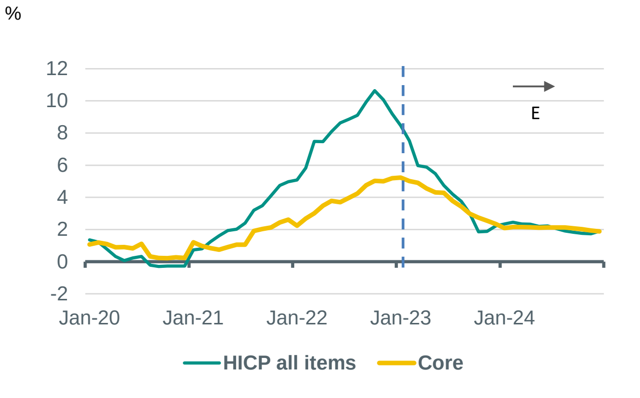
Headline inflation fell to 8.5% yoy in January, down from 9.2% in December 2022 and a peak-level of 10.6% in October 2022. Core inflation was more sticky and stabilised at 5.2% yoy in January. We think that headline inflation will continue to drop lower in the coming months and be around 2% by the end of the year. Core inflation (excluding food and energy) is expected to be more sticky and decline more gradually. As a result, core inflation should be higher than the headline rate in the final months of this year. We see core inflation falling gradually towards 2% in the second half of 2024.

BLS: tighter credit standards and lower credit demand



Source: Refinitiv, ABN AMRO Group Economics

EZ headline inflation to fall faster than core rate



Source: Refinitiv, ABN AMRO Group Economics

At its February meeting, the ECB hiked its key policy rates by 50bp and also pre-signalled another 50bp hike in March. We have maintained our forecast that the deposit rate will peak at 3%, implying that the March hike would be the final one and that rates will be kept on hold for a while after that. Meanwhile, we have pencilled in a pivot by year end, with rate cuts beginning in the fourth quarter. The risks to our view are skewed toward a more aggressive path on the 3-month horizon, although it seems likely that the pace of the hikes will be reduced to 25bp in case the central bank decided that rates should move further into restrictive territory.

The Netherlands: Resilient consumers drive solid Q4 print

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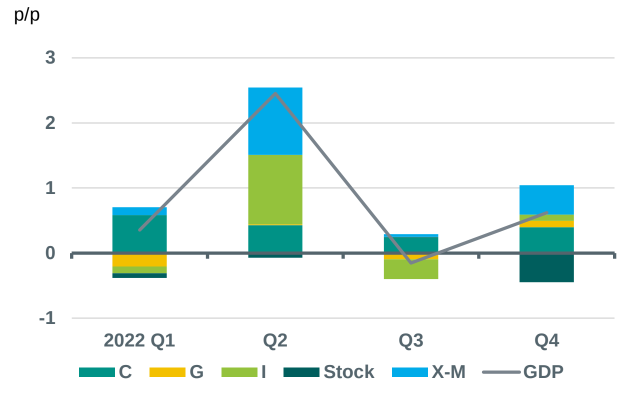
- **Q4 GDP growth of +0.6% qoq surprised to the upside and reflects an easing energy crisis, government support and strong employment growth;**
- **We expect further cooling of headline inflation but ongoing broadening of price pressures to core**
- **We raised out annual average inflation forecasts (HICP) to 4.6% in 2023 and 4.1% in 2024**
- **The labour market is expected to soften a touch, but overall tightness is here to stay**
- **Given still elevated inflation, softening external demand and increasing monetary headwinds, we expect annual growth to slow to 1.2% in 2023 (from 4.5% in 2022)**

As pointed out in our previous monthly, private consumption was remarkably sturdy in the final months of 2022. The fourth quarter upward surprise was mostly driven by solid consumer spending, investment and exports, pushing GDP growth to 0.6% qoq. Particularly in light of inflation (HICP) averaging 13% yoy in Q4 and low consumer confidence, this resilience in spending is remarkable. There are three reasons for this. First, ever growing employment – the net participation rate climbed to an all-time high of 72.9% in December – supported aggregate spending, and lasting labour market tightness also supports expectations of future job security. Second, the savings rate is on a downward trend since the pandemic. While still being higher than in 2019 we still see larger shares of income funnelled to consumption. Third, government support cushions the blow to disposable income from high (energy) inflation, especially in lower parts of the income distribution. The energy allowance of EUR 1300 granted to the minima, for instance, is roughly the equivalent of an extra month's income.

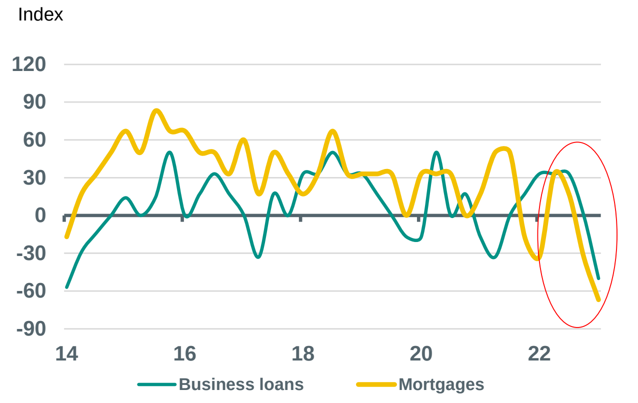
Decomposing net exports, the positive contribution to growth was primarily driven by goods and re-exports, whereas services exports declined qoq. Weakness in services exports likely contributed to declining value added qoq of the export heavy financial services sector. Investments expanded compared to the previous quarter. Our calculations suggest that public investment was driving this expansion. We expect strength in exports and investment to be temporary and fade over the course of the first quarter, as eurozone demand is already softening and higher interest rates hamper private investments.

Consumers leading broad-based Q4 GDP surprise



Source: CBS, ABN AMRO Group Economics

Loan demand points to weakening investment



Source: ECB, ABN AMRO Group Economics

We expect growth to be lacklustre in the first quarters of 2023 as inflation remains elevated, external demand cools and the lagged impact of monetary policy tightening will increasingly be felt over the course of this year. Higher interest rates have already caused a clear correction of the housing market and the first signs of slowing loan demand in the broader economy are visible. Still we expect growth to pick up over the year as wage growth intensifies, making up some lost ground in purchasing power, the labour market continues to be a bright spot from the point of view of households, and the government supports growth with the price ceiling and other targeted measures as well as an ambitious investment agenda. Based on these factors, we continue to expect the Dutch economy to outperform the eurozone throughout the year and grow by 1.2% in 2023 and 1.3% in 2024.

UK: Labour market remains resilient, despite weak growth

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- **The UK escaped a technical recession in 2022H2, but the growth outlook remains challenging**
- **Wage and price pressures remain elevated, despite the economic slowdown**
- **Risks to inflation and Bank rate tilted to the upside, because of ongoing industrial action**

Sluggish growth ahead

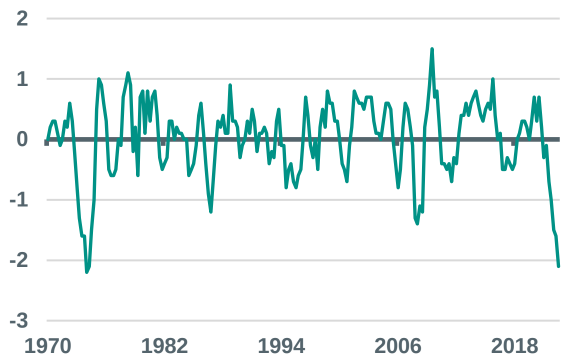
The UK escaped a technical recession in 2022H2 by the tiniest of margins, with GDP flat in 2022Q4 after an upwardly revised -0.2% q/q print in 2022Q3. The better-than-expected GDP growth outturn follows welcome developments in the wholesale gas markets, where prices have dropped to levels similar to the period immediately before the war in Ukraine. Set against this positive news are a number of headwinds that will continue to bear down on the economy in 2023. The most important of these is monetary policy, which is within the restrictive territory range. Second, fiscal policy is set to turn restrictive as taxes rise. Finally, the external environment is challenging, with weak economic growth in the eurozone and the US. Taken together, we expect annual GDP growth at -0.8% in 2023 and 1.2% in 2024 (after 4.1% last year), with growth particularly weak in the first half of this year and a sluggish recovery thereafter. More structurally, the key challenge for the UK remains low labour productivity, with output per worker some 16% below the G7 average (excluding Japan and UK) in 2021 and productivity growth (output per hour) averaging just 0.7% per annum between 2014-19.

Strikes pose a material risk to our inflation and monetary policy forecast

Headline CPI inflation fell for the third month in a row in January to 10.1% yoy (from 11.1% in October). Inflation is expected to fall further, as the sharp increase in imported commodity and energy prices from last year drop out of the index. The overall price level will nevertheless remain high, even after the reduction in commodity and energy prices, reflecting the permanent adverse terms-of-trade shock suffered by the UK (the largest since the 1970s).

UK facing largest terms-of-trade shock since 1970s

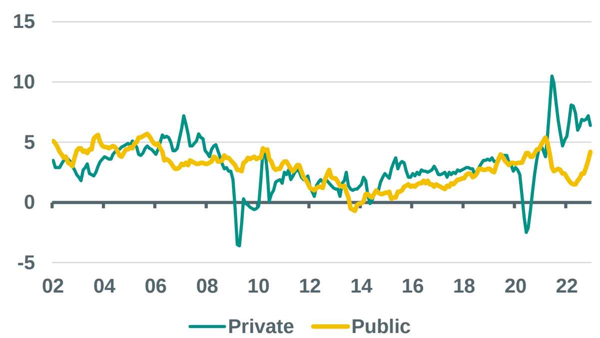
PP difference in 4-quarter growth rate of GDP and GDI



Source: ONS, ABN AMRO Group Economics

Wide pay gap between public and private sector

Annual 3m/3m %



Source: CBS, ABN AMRO Group Economics

The main uncertainly to the inflation outlook however, relates to core or service sector inflation, which is closely linked to developments in the labour market and more particularly, to wage growth and productivity. The labour market in the UK remains tight, despite the recent slowdown in economic activity. The unemployment rate rose marginally to 3.7% in 2022Q4, as did average total pay which, at 5.9%, is the strongest outside the coronavirus period and well above the level consistent with inflation at 2%. In our view, employment and wage pressures will ease over the course of the year in response to sluggish economic growth, but the risks to wages are tilted to the upside because of ongoing industrial action by workers in key sectors of the economy – health, transport and education (See UK wage-price spiral?)

The Bank of England raised its policy rate by 50 basis points earlier this month, to 4%. The current rate hiking cycle which started in December 2021 with Bank Rate at 0.1% is the most aggressive since the BoE was granted operational independence in 1997. In our view Bank Rate has peaked, but the risks to our inflation and monetary policy forecast are tilted to the upside because of labour strikes. We estimate that inflation could be around 0.2-0.8pp higher over the next 2-3 years if the government negotiates higher public sector pay, with an upside risk to Bank Rate to the order of 25-100 bps.

China: Recovery underway

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- **LNY holiday travel period does not look to have brought serious renewed pandemic disturbances**
- **The way is now paved for a staged recovery in domestic demand and economic growth**
- **Corporate lending picks up, household lending still subdued; early signs of bottoming out real estate**

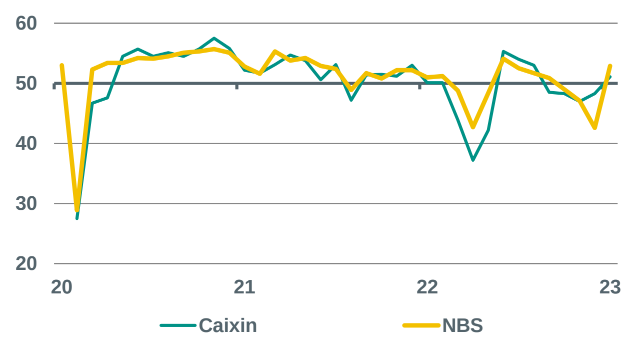
The initial effect of the U-turn in Covid-19 policy made in December (from the strict Zero-Covid to *laisses-faire*) was a spiralling of Covid-19 cases adding to disruptions on the supply and demand side, and deepening China's slowdown in late 2022. However, in line with our view and our 2023 growth upgrade (see our previous monthly update, ***Goodbye Zero-Covid, Welcome Recovery***) the picture has started to improve from January onwards. With no signs of overwhelming public health concerns and related disturbances following the LNY holiday, we think the way is paved for a staged recovery in domestic demand, with GDP growth strengthening from Q1-2023 onwards.

2022 ended weak, but 2023 started strong

As always around the Lunar New Year, there are fewer Chinese macro data published, as data on industrial production, retail sales, fixed investment, exports/imports and unemployment will be combined for January and February and published in March. That said, the data over January that have been published so far point to a meaningful improvement in activity and sentiment on China's 'reopening'. After three years of heavy restrictions, the Chinese were finally able again to travel freely to their hometowns during the Lunar New Year (LNY) period end-January. This had an immediate impact, particularly on 'fast moving' services such as transport, tourism and entertainment. The January PMIs also showed an impressive rebound, particularly the services PMIs. After sharp declines in late 2022, the official non-manufacturing PMI jumped by almost 13 points to a 7-month high of 54.4, while Caixin's services PMI rose to a five-month high of 52.9. The manufacturing PMIs also edged up, but not as spectacular as their services counterparts. With both services and manufacturing PMIs improving, the composite output indices from both NBS and Caixin are now back in positive territory for the first time since summer 2022.

January composite PMIs back in expansion territory

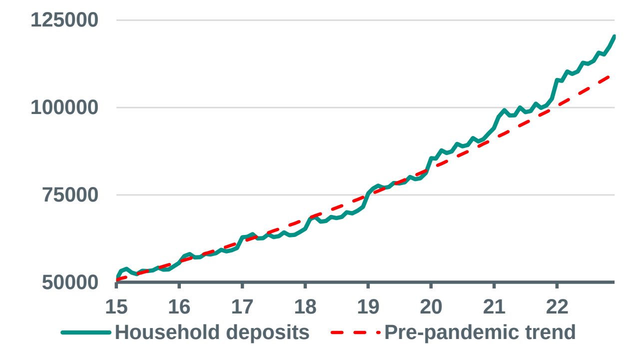
PMI composite output indices, 50 = neutral mark



Source: Refinitiv

Deposits overestimate excess savings ready for consumption

Household deposits held at Chinese financial institutions, CNY bn



Source: ABN AMRO Group Economics, Refinitiv

Corporate lending picks up, household lending still subdued – yet some early signs of bottoming out real estate

Bank lending data for January came in much stronger than in previous months, partly reflecting government policies to bolster lending to the property sector and to SMEs. The acceleration in corporate lending and an improvement of business sentiment as illustrated by the PMIs does bode well for private investment, which was very weak last year. By contrast, household demand for mortgage loans was still subdued, suggesting that it takes more time for consumer confidence to recover and home sales to get growing again. Consumer confidence edged up marginally in December (from 85.5 to 88.3), but remained at relatively weak levels. While household deposits held by Chinese financial institutions suggest the built-up of excess savings accelerated last year, part of this reflects movements out of financial assets such as wealth management products; hence, these deposits are overestimating excess savings that are 'ready for consumption'. All in all, with Zero-Covid behind us, and with more property support filtering through, trust in the real estate sector should gradually return. January home price data already signal a bottoming out of real estate, at least in the largest cities. All of this could help shaping a broader rebound in private consumption, with GDP growth gaining momentum from Q1-2023 onwards.

Key views on a page

The easing energy crisis in Europe is leading to more shallow expected recessions in the eurozone and UK, while the US is also entering a moderate downturn. In the near term, consumption will continue to be weighed by falling real incomes, and the impact of monetary tightening – with housing markets clearly correcting on the back of the surge in mortgage rates. China's exit from Zero Covid is offsetting the slowdown in the advanced economies to some extent, but may also slow the global disinflation process. While inflation has begun to trend lower, upside risks to the medium term inflation outlook mean the Fed, ECB and BoE are likely to continue raising rates at coming meetings, with risks to our policy rate views more and more tilted to the upside.

Macro	Central Banks & Markets
Eurozone – 2022Q4 GDP came in stronger than expected, at +0.1% qoq. Still, there is weakness under the surface and growth was supported by a number of temporary factors. The impact of past and upcoming interest rate hikes on the economy will increasingly be felt. We expect GDP to contract moderately during most of 2023. A drop in energy price inflation has lowered headline inflation since October. Core inflation is more resilient and will decline more slowly than the headline rate this year. There still is no evidence of a longer lasting sharp acceleration in wage growth.	**ECB** – The ECB has raised the deposit rate by 50bp in February and has pre-signalled another 50bp hike in March. We have maintained our forecast that the deposit rate will peak at 3%, implying that the March hike would be the final one. We expect the ECB to pause after March, as the economy is contracting moderately, inflation falls and unemployment rises. We see a first rate cut in 2023Q4. The risks to our view are skewed toward a more aggressive path on the 3-month horizon. The ECB also is gradually ending reinvestments under its APP bond portfolio, but will continue them under the PEPP.
Netherlands – GDP growth of +0.6% qoq surprised to the upside and reflects an easing energy crisis, government support and strong employment growth. We expect further cooling of headline inflation but ongoing broadening of price pressures to core. We raised our annual average inflation forecasts (HICP) to 4.6% in 2023 and 4.1% in 2024. The labour market is expected to soften a touch, but overall tightness is here to stay. Given still elevated inflation, softening external demand and increasing monetary headwinds, we expect annual growth to slow to 1.2% in 2023 (from 4.5% in 2022).	**Fed** – The FOMC raised the fed funds rate by 25bp in February, as was widely expected. We expect another 25bp hike in March. Subsequently, we expect the Fed to pause, assuming inflation continues to move lower and the labour market deteriorates. We think further rate hikes will ultimately prove unnecessary, and that by September, the Fed will be ready to start pulling back from the current highly restrictive policy stance. Our base case is for a total of 125bp in rate cuts in late 2023, which would leave the fed funds rate at a still-restrictive level of 3.50-3.75% by year end. The risk to near-term rates is still to the upside.
UK – While the easing energy crisis will soften the blow to household real incomes, the tax burden is set to rise significantly over the coming year. We expect a shallow recession in the first half of this year and a tepid recovery thereafter. The medium term outlook will critically depend on the evolution on labour productivity which remains weak. CPI inflation has eased, but wage inflation remains elevated. The risk to inflation is skewed to the upside because of a structural shortage of workers and public sector unrest.	**Bank of England** – The continued risk of a wage-price spiral in the UK led the MPC to hike Bank Rate by a further 50bp at the February meeting to 4%. The policy rate is close to neutral levels and as a result, MPC decisions over the next few months are highly sensitive to incoming data. In our view, the economic weakness that is evident in the activity and employment data will start to exert downward pressure on wage growth. We believe that the MPC will pause at this level and reverse course towards the end of this with the year-end policy rate at 3.5% .
US – The US consumer exhibited surprising resilience for much of 2022, but the twin headwinds of falling real incomes and dwindling excess savings are now exerting a bigger drag on consumption. Investment is also expected to remain weak in the near term. This will help inflation along its downward-sloping trend, while labour hoarding is likely to give way to a rise in the unemployment rate. This will lead to the NBER likely declaring a recession. Inflation is expected to fall significantly this year on the back of sharply easing pipeline pressures, and be within touching distance of 2% by the end of the year.	**Bond yields** – Given our economic and central banks outlook, we think both the 10y US and Bund yields currently are at peak levels. The recession will weigh on EZ rates this year, with the 10y Bund yield expected to fall below 2%. A similar path (albeit at a higher level) is expected for US rates. Both Treasury and Bund curves are expected to remain inverted until around the middle of 2023, as elevated core inflation will keep short-term rates higher for longer. Thereafter, we expect both curves to bull-steepen in the second half of the year on the back of monetary easing, with 125bp and 50bp in rate cuts pencilled in for the Fed and ECB rates respectively.
China – After three years of heavy restrictions, the Chinese were finally able again to travel to their families around Lunar New Year (LNY). With no signs of over-whelming public health concerns and related disturbances following the LNY holiday, we think the way is paved for a staged recovery in domestic demand, with GDP growth strengthening from Q1-2023 onwards. January data published so far point to a meaningful improvement in activity and sentiment. Bank lending to corporates did clearly pick up, although household lending is still subdued.	**FX** – Earlier in the month EUR/USD cleared the psychological level of 1.10. Since then there has been some profit taking on the back of Fed commentary, with EUR/USD moving back towards 1.07. As long as EUR/USD is above 1.0325 the long-term trend is positive. We think there is more upside in EUR/USD for 2023 and 2024. This is mainly driven by a narrowing of the difference in policy rates and government bond yields between the US and the eurozone as a result of more the more aggressive rate cuts we expect for the Fed compared to the ECB at the end of 2023. Our forecast for the end of 2023 for EUR/USD is 1.12 and to 1.16 end of 2024.

Main economic/financial forecasts

GDP growth (% yoy)	2021	2022e	2023e	2024e	Inflation (%)	2021	2022	2023e	2024e
United States	5.9	2.1	0.7	2.0	United States	4.7	8.0	3.4	2.1
Eurozone	5.3	3.5	-0.2	0.9	Eurozone	2.6	8.4	4.5	2.1
Japan	2.2	1.0	↓ 1.2	1.2	Japan	-0.2	2.5	2.0	1.0
United Kingdkom	7.6	4.0	-0.8	1.2	United Kingdkom	2.6	9.1	6.4	2.0
China	8.4	3.0	5.2	5.2	China	0.9	2.0	2.5	2.5
Netherlands	4.9	4.5	↑ 1.2	↑ 1.3	Netherlands	2.8	11.6	↑ 4.6	↑ 4.1
Policy rate	**20/02/2023**	**+3M**	**2023e**	**2024e**	**10Y interest rate**	**20/02/2023**	**+3M**	**2023e**	**2024e**
Federal Reserve	4.75	5.00	3.75	2.50	US Treasury	3.83	3.20	3.00	2.75
European Central Bank	2.50	3.00	2.50	1.50	German Bund	2.46	2.05	↑ 1.80	↑ 1.70
Bank of Japan	-0.10	-0.10	↓ -0.10	0.00	Japanese gov. bonds	0.50	0.50	0.50	0.50
Bank of England	4.00	4.00	3.50	2.75	UK gilts	3.47	3.00	2.60	2.20
People's Bank of China	3.65	3.60	3.60	3.60					
Natural resources	**20/02/2023**	**+3M**	**2023e**	**2024e**	**Currencies**	**20/02/2023**	**+3M**	**2023e**	**2024e**
Brent - Oil USD/barrel	84.1	90	↓ 90	100	EUR/USD	1.07	1.08	1.12	1.16
WTI - Oil USD/barrel	76.3	85	↓ 85	95	USD/JPY	134.2	131	128	124
TTF - Gas EUR/MWh*	59.1	65	↓ 75	↓ 65	GBP/USD	1.20	1.23	1.25	1.28
					EUR/GBP	0.89	0.88	0.90	0.91
Gold - USD/oz	1,841	1,900	1,900	1,900	USD/CNY	6.85	6.80	6.70	6.50

Source: Refinitiv, Bloomberg, ABN AMRO Group Economics

* Brent, WTI: avctive month contract; TTF: next calender year

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