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Global Outlook 2023

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Five key questions for 2023

- **Following a tumultuous 2022, we expect the energy crisis to continue to dominate next year**
- **European industry has exhibited resilience so far, with the crisis accelerating the energy transition**
- **However, recessions are now unfolding across advanced economies. Policy support will soften the blow, and the starting point of tight labour markets will limit the rise in unemployment**
- **On the downside, central banks will be tightening policy going into the downturn, potentially amplifying the risks to the outlook**
- **The silver lining is that inflation should come down, and the risk of a wage-price spiral should recede**
- **The Fed, ECB and BoE are expected to continue hiking rates in the near term, but we expect a shift to rate *cuts* in late 2023, once inflation comes down and given how weak economies will be at that point**
- **In this *Global Outlook*, we explore five key questions informing our calls and assumptions for 2023**
- **Regional Outlooks: We expect the collapse in real incomes to drive recessions in *the eurozone*, *the Netherlands* and *the UK*, with only a modest recovery likely in 2024**
- **The almighty *US* consumer is on borrowed time, but the recession will be milder than in Europe**
- ***China's* gradual exit from Zero-Covid will be another key 2023 theme, and the ride could be bumpy**

2022 has been a year of massive shocks to the economic system, starting with the war in Ukraine and the subsequent energy crisis, the broadening and surprising persistence of inflation, and now the most aggressive rate hike campaign by central banks in decades. Shocks by their nature are impossible to predict, and we do not attempt to do so for 2023, only to say that we have learned to be prepared for anything. What has become clear is that 2023 will be a year of recessions: if not driven by the energy crisis directly, then by the enormous pressure on households and business from high inflation and the jump in interest rates. While the coming recession is unlikely to lead to the kind of rise in unemployment we have seen in more recent downturns – given the position of extreme tightness in labour markets that we are coming from – a recession can nonetheless take on a life of its own once it takes hold, and the fact that central banks are continuing to tighten policy even as we enter a downturn could amplify the risk that it ends up being worse than we currently expect. At the same time, we should also acknowledge that the economy has in some respects exhibited surprising resilience in the face of the energy crisis – a key theme that we tackle in this *Global Outlook*.

Given the complex but deeply intertwined drivers of the outlook over the coming year, we once again look to our specialists in this *Global Outlook* to give their views on a range of topics, in the form of five key questions and answers. Starting with Europe's energy crisis, we then look at how the nature of the coming recession is likely to differ to previous downturns. Inflation naturally will remain a key theme, and so we also devote special attention to why we expect a significant decline next year. Finally, in our last two questions, we tackle the complex issue of monetary policy lags, and explain why we hold an out of consensus view for significant rate cuts in late 2023 by the Fed, ECB and Bank of England.

Wherever economic developments take us in 2023, we wish our readers a restful holiday period, and a happy new year!

Outlook 2023: Recession, declining inflation, and eventually rate cuts

The energy crisis is expected to remain the dominant theme in 2023, provided no new black swans along the lines of the Russia-Ukraine war enter the picture. We expect European industry to scrape through without major output losses next year, but the European economy will still be hit by the collapse in real incomes from high inflation, and the jump in interest rates. The silver lining is that inflation is expected to come down significantly, enabling rate cuts by central banks by the end of the year, setting the stage for a modest recovery in 2024.

In the below Q&A, we explore five questions informing our key judgment calls and assumptions for 2023.

1. What do falls in gas demand mean for the energy transition and for industry next winter?

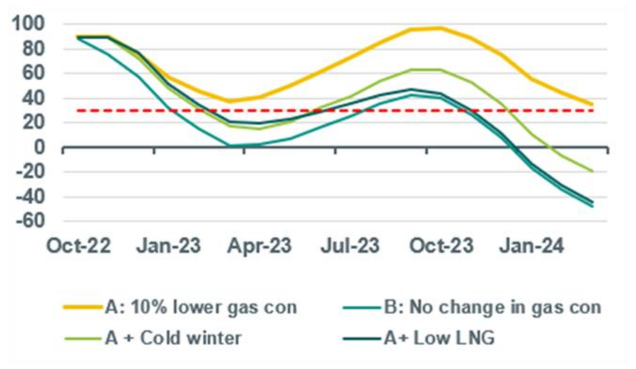
Russian gas deliveries via pipelines to the EU have dropped sharply, causing major increases and volatility in gas prices, and sparking fears over potential energy shortages. At the time of writing, however, EU gas storage is well filled at about 90% of maximum capacity – far better than perhaps even the most optimistic assumptions earlier this year. A combination of still-flowing Russian pipelines during summer, relatively low LNG demand from China, and unseasonably mild temperatures which delayed the start of the European heating season, have helped. At the same time, gas demand has seen massive reductions, while industrial output has been remarkably resilient. Will Europe still face the same benign scenario this time next year?

Gas savings: Better than expected…

Europe could still run into trouble refilling its inventories next year, according to a recent set of **OECD** scenarios, which assume a complete cut-off of Russian pipeline gas (currently, gas still flows through the pipeline via Ukraine). Even with a consumption reduction of 10%, storage levels could fall dangerously low, for instance if the winter is an especially cold one, and/or if LNG supplies are constrained. Thus far, however, gas consumption falls have been much bigger than expected, with around a 20% fall in consumption in the second half of 2022 compared with the 2019-21 average. In the right graph below we distinguish between the change in gas consumption by Local Distribution Zones (LDZ) and non-LDZ, where the former includes residential and commercial customers and the latter industry and Gas-to-Power. We have seen significant falls for both categories.

Europe could yet face supply disruptions…

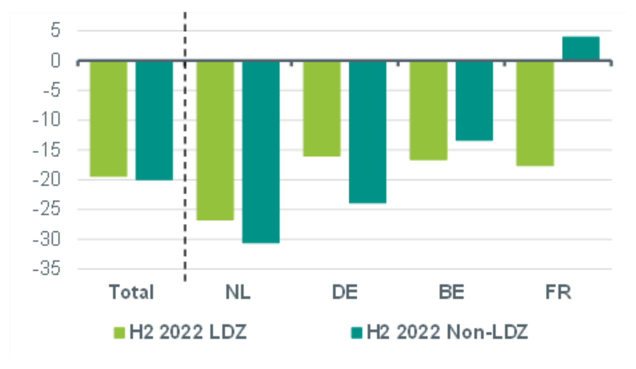
% gas storage filled; high risk of disruption below 30% (marked in red)



Source: OECD, ABN AMRO Group Economics

…unless significant demand destruction is maintained

% change in gas consumption vs 2019-2021 daily average



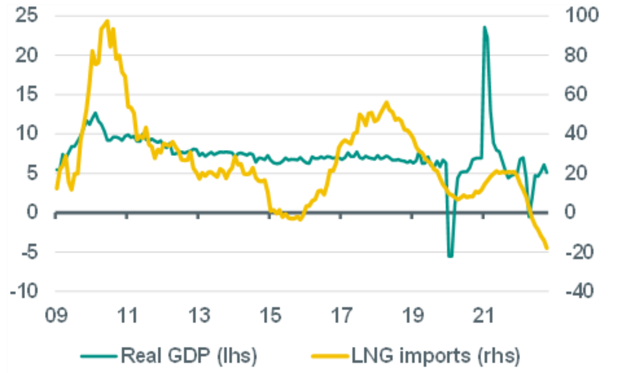
Source: Refinitiv, ABN AMRO Group Economics

…with a little help from Lady Luck

The upside surprise in gas savings is partly attributable to the mild autumn and better than expected access to LNG. Lower LNG demand from China was also an important contributor, partly due to recurrent lockdowns, but also due to increased domestic production and pipeline imports from Russia. Both of these factors cannot be counted on for next winter. A significant relaxation of Zero-Covid, with a sharp rebound in consumption, could mean that China's imports of oil and gas return to pre-Covid levels (or even beyond). Our base case assumes only a gradual exit from Zero-Covid, given issues with ICU capacity and vaccinating/boosting the elderly. Such a gradual exit could nonetheless reduce the number of gas flex contracts resold to European parties. Additionally, part of the current LNG supply is provided by Russia. This could also be at risk if Russia decides to cut these supplies as well.

Chinese LNG imports hit by recurrent lockdowns

Real GDP, monthly estimate, % / Imports (volume): 12m sum, % yoy



Source: Bloomberg, ABN AMRO Group Economics

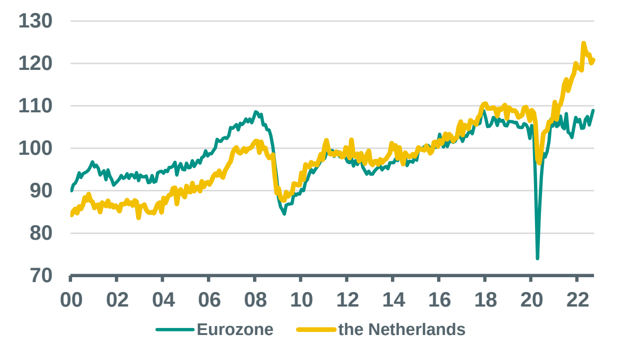
With that said, Lady Luck has not always been on Europe's side. For instance, France has suffered major nuclear reactor outages, leaving a shortfall in power supply that has had to be made up for with gas. As reactors are expected to be back online next year, this could prove to be a counterweighing factor to a China reopening or colder winter.

Could industry turn out to be more resilient?

Yet another positive surprise has been from industrial output, which has held up despite significantly lower gas use. Industry gas savings (non-LDZ in upper right chart) have been as high as 30%, while output increased or held steady throughout the eurozone. If these developments are maintained, industry could potentially avoid supply disruptions this winter and next, and the high price of gas could prove to be a push towards renewable energy substitution. While we indeed see some early indications of energy efficiency improvements and switching to renewables, there are also indications that industry could face some trouble ahead.

Industrial production not harmed by gas shortage

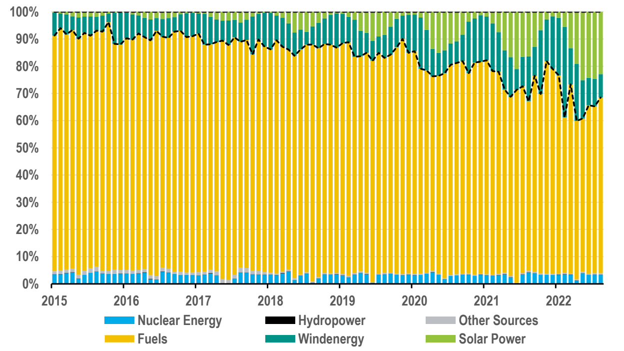
Industrial production in volumes, 2015 = 100, seasonally adjusted



Source: Refinitiv, ABN AMRO Group Economics

Share of renewable energy in the mix is increasing

% share in total electricity production

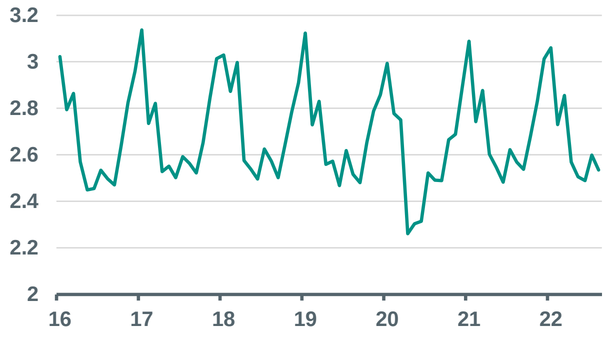


Source: CBS, ABN AMRO Group Economics

Sectoral output versus gas usage data for the Netherlands shows that even for the energy intensive sectors such as oil, chemicals and metals, output has so far not declined much. This is in line with survey results from the German Ifo institute on whether firms have been able to save gas without production loss. To some extent, it appears that fuel switching from gas to oil and even coal explains part of the resilience. The only slight increase in European oil consumption (1.4% y/y in September) conceals a bigger switch from gas to oil because car fuel consumption fell. In addition, Germany generated 82.6bn kWh of electricity from coal during the first six months of the year, which is 17% higher than the same period last year. While data on the European energy mix shows a steady increase in renewables, electricity consumption has not increased compared to last year. In fact, we see a small decline as of August (-0.9% y/y).

Electricity usage in line with historical trend

Final consumption of electricity; OECD Europe; x100,000



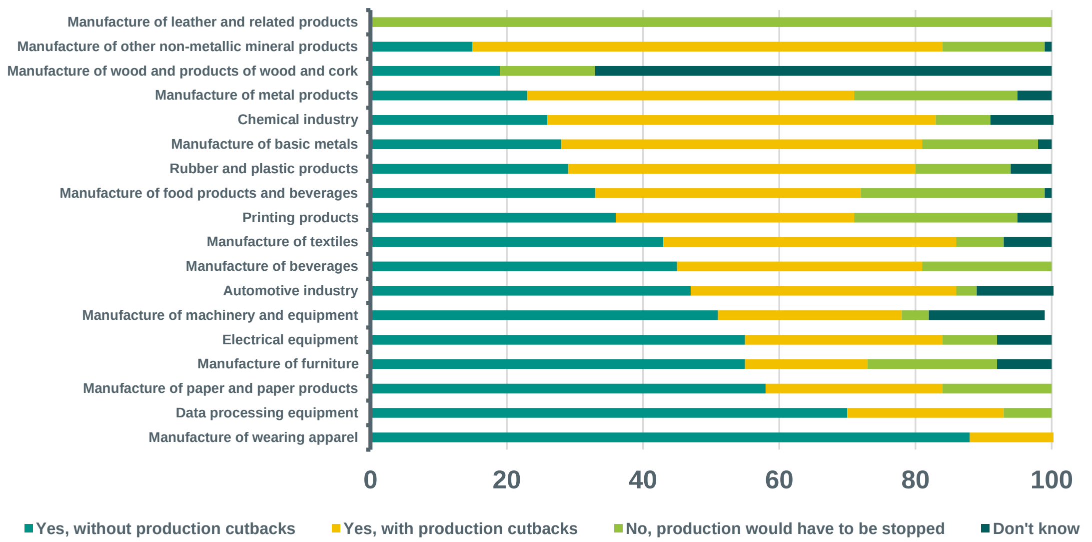
Source: IEA, ABN AMRO Group Economics

Further falls in gas consumption are likely to lead to production cuts

Despite the progress so far, German businesses have become much less optimistic about their ability to further reduce gas consumption without a production loss. The majority of energy intensive sectors expect production cutbacks in the next six months if faced with a need to further cut gas consumption (on top of existing cuts to consumption). With that said, one has to wonder whether firms would have responded to the survey the same way if asked this question six months ago; in other words, they may be underestimating the potential for savings. An additional factor, however, comes from the demand side. Despite significant government support for households via energy price caps, households will still face a significant real income hit that is likely to hit demand. By the winter of 2023, some output losses are then inevitable, unless external demand makes up for weaker domestic demand (not our expectation given recession conditions globally).

Further saving potential for natural gas in next 6 months less optimistic

Share in %; Survey taken October 2022



Source: Ifo Business Survey, ABN AMRO Group Economics

Could household gas savings prevent industry stoppages?

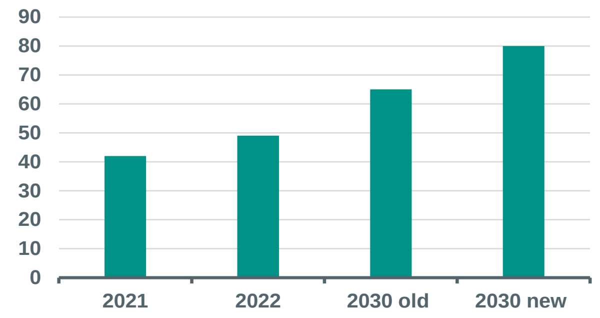
If household gas savings are the result of either switching to renewables and insulation or behavioural changes that have become routine, the pressure on industry to cut consumption is reduced. While the savings on the part of households so far have indeed been impressive, data from the last few weeks show that as the weather gets colder household savings in Germany have fallen back to 12% compared to the 2019-21 average for this time of the year. Moreover, price caps (particularly those without usage limits) lower the incentive to continue saving gas at the same rate we have seen over the past 9 months, as we explained in our **Global Monthly of September**.

Sustainability push for the longer term
The energy crisis has not enabled a sudden switch to fossil fuel-free alternative energy sources, but it has made households and firms acutely aware of their energy use and savings potential. In the short run, there has unfortunately been some switch to dirtier alternatives, but the crisis has set in motion a number of medium to longer term shifts that will accelerate the transition.

As the return period of private investments in renewables has about halved since the war (due to higher energy prices), insulation, solar panel and heat pump subsidy applications have increased quite dramatically, as well as spending on imported solar panels to Europe. In addition, governments have upped their ambitions for wind energy substantially.

Germany lifts ambitions to 80% renewables by 2030

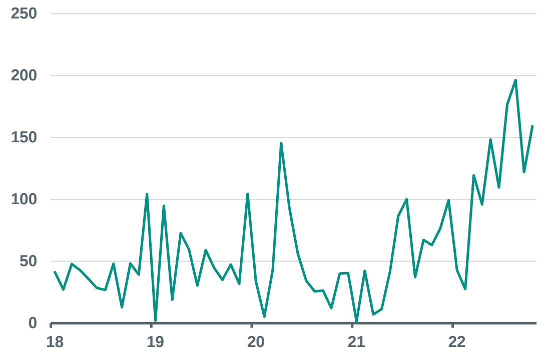
Renewable share in total power consumption, %



Source: EC, ABN AMRO Group Economics

Increase ISDE subsidies in the Netherlands

Index Jul 2021



Source: ABN AMRO based on anonymised transaction data

Besides increasing investment in renewable energy, equally important has been the decision to avoid fossil fuel lock-ins via LNG regassification terminal investments by choosing floating terminals rather than building permanent infrastructure. However, for economies with tight labour markets (e.g. Germany, the Netherlands, the US and the UK), the lack of available workforce in professions that are crucial for the energy transition is a **major hurdle** for speeding the transition. As major investment decisions made today will only pay off in perhaps 10-15 years, potential for fossil fuel use reductions this – and next – winter, will therefore depend mainly on behavioural changes and short-term investments, such as better insulating the existing housing stock. Also for residential real estate companies, **we judge** that investments in energy efficiency improvements will still pay off, despite higher financing costs from rising interest rates.

Large scale output losses are a tail risk
Whether all of this will be enough to avoid disruptions next winter ultimately also depends on how cold the weather will be and if potential problems in securing LNG will arise. However, with gas savings being higher than expected, and without showing clear signs of aggregate output losses, Europe is showing resilience, with an increasing likelihood that gas inventories will be refilled ahead of next winter. On balance, we judge that despite the challenges, European industry will continue to scrape through the energy crisis, with large-scale output losses now looking to be a tail risk scenario rather than a reasonable base case. *(Sandra Phlippen, Aggie van Huisseling, Jeannine van Reeken, Casper Burgering, Arjen van Dijkhuizen, Hans van Cleef)*

2. How will this recession differ from previous ones?

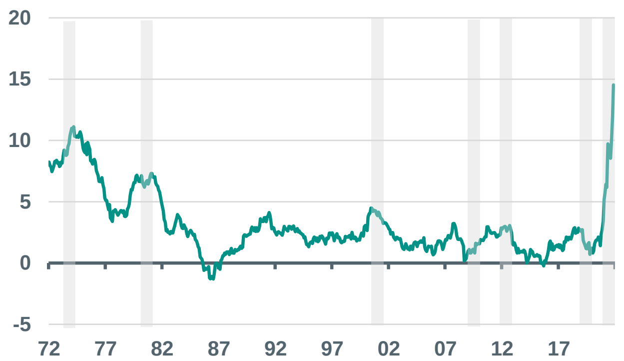
The unfolding recession contrasts with prior downturns in three main areas: 1) supply shocks are back as root cause, 2) financial resilience and tight labour markets mean a better starting point for consumers going into the recession, and 3) governments are more active in cushioning the blow (though their room for manoeuvre is more constrained than during the pandemic). The bottom line is that in many respects this recession is likely to be different than previous downturns, with less

of a rise in unemployment, and less risk in the banking sector than before. On the downside, high inflation means that central banks cannot provide the same support to economies as they would normally entering a downturn.
Coming from a period of very strong post-pandemic growth, Europe is on the brink of a recession. Contrary to most of the recent downturns, which were demand driven, this recession is driven by an energy supply shock resulting from the Russia-Ukraine war. Surging energy prices have led to record inflation in the eurozone. For households, this means higher energy bills and real income declines, whereas for businesses the supply shock is putting pressure on margins and constraining production.

Though this downturn is not being driven by the demand side of the economy, domestic demand still plays a big role in the dynamics of the recession. Frontloaded goods consumption during the pandemic and catch-up growth in services consumption after lockdowns meant that the energy supply shock hit the economy when supply and demand was already out of balance. This unbalanced starting point combined with the energy supply shock resulted in soaring inflation rates, which led to aggressive central bank policy tightening in order to bring demand back into balance with constrained supply.

Supply shocks back with a vengeance

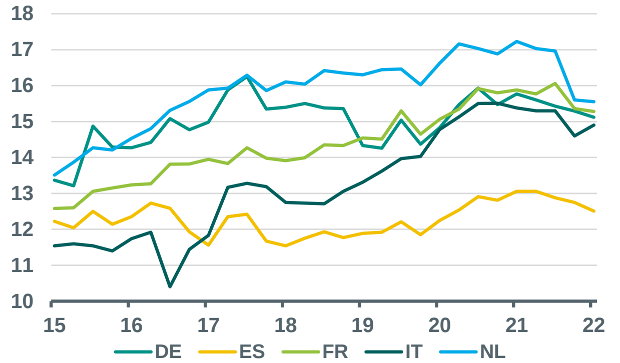
Dutch CPI inflation, % y/y; recessions in shaded area



Source: Refinitiv, ABN AMRO Group Economics

Greater resilience in key areas such as banking

CET1 ratio, %



Source: ECB, ABN AMRO Group Economics

The good news is that structural and cyclical aspects provide a better starting position going into the economic downturn than during previous recessions. In particular, the financial resilience of both businesses and households has much improved. Banks are far better capitalised and more capable of weathering a storm than during the 2008 global financial crisis or the eurozone sovereign debt crisis, which has reduced systemic risks to the wider economy stemming from the banking sector. The strong cyclical upswing moving out of the pandemic has contributed to a solid starting position as well. Strong catch-up growth has resulted in tight labour markets, and the pandemic had left households with significant excess savings, both of which have cushioned the real income shock. Although we expect a modest rise in unemployment, and excess savings to decline, these two factors mean the downturn is unlikely to be as deep as during most recent recessions.

The final crucial difference with previous recessions is the degree and speed of government support measures aimed at protecting households and companies against the impact of soaring energy bills. Governments have been much more pro-active in supporting domestic demand than for instance during the eurozone sovereign debt crisis, although the full compensation for income losses that we saw during the pandemic is unlikely this time. Given the inflationary environment and the impact on government finances from higher interest rates, we expect governments to be more prudent and target most support at the poorest households only.

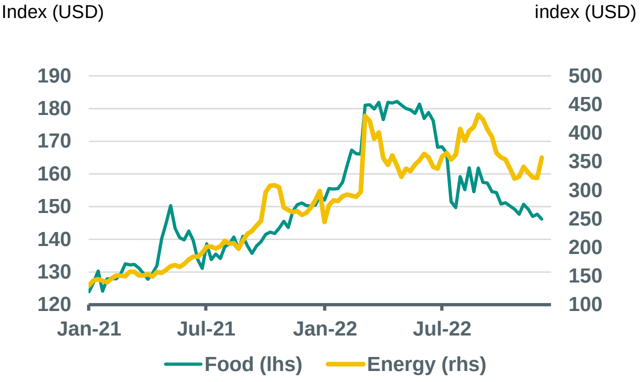
The bad news is that high inflation means that central banks cannot ease monetary policy moving into the downturn, as they have in the past. In contrast, central bank are expected to continue to tighten policy for the time being. Indeed, should governments go too far in attempting to ease the pain of the recession, this could backfire and require even higher interest rates to offset this stimulus (as we saw with the UK's *mini budget* debacle in September). *(Jan-Paul van de Kerke, Aline Schuiling, Bill Diviney)*

3. Why will inflation come down, even with energy prices staying high?

Inflation rates across advanced economies have all moved in the same direction in 2022: *higher*. Still, there have been wide differences between countries, which we describe in the Box on the next page. Looking ahead at 2023, while the factors driving inflation and where it ends up will still vary, we think that the global tendency for inflation in 2023 will be the same again across advanced economies: *lower*.

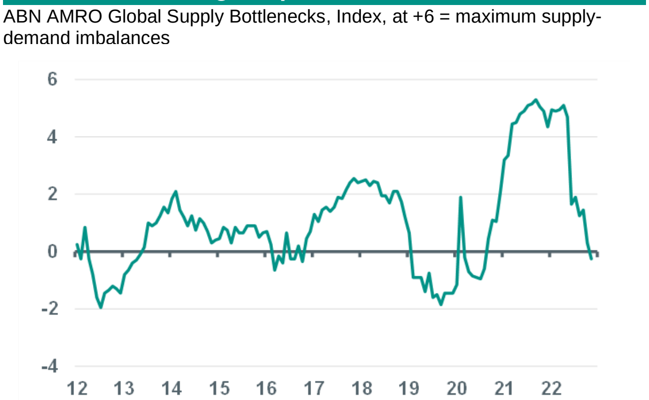
To begin with, inflation rates are measured by comparing the current price (or price index) of a good or service to the price one year ago. So, even if the level of the price (or price index) stays very high, yet stable, the inflation rate will drop to zero a year later. Therefore, even if energy prices were to remain at their current high levels, the inflation will rate will fall sharply during the course of next year. The same is expected to happen with food price inflation. In fact, food commodity prices have fallen sharply in the last few months (see graph below), meaning that global food price inflation could actually turn negative during the second half of 2023.

Food and energy commodity prices have declined



Source: Refinitiv, ABN AMRO Group Economics

Lower industrial good price inflation on the cards



Source: Refinitiv, ABN AMRO Group Economics

With regards to core inflation (excluding food and energy), a number of factors will probably also contribute to a global decline in 2023. To begin with, industrial goods price inflation and services inflation are currently still being lifted by companies passing on high energy costs to consumers. Although this process tends to be lagging and, therefore, could continue for a while, we think the impact of high energy costs on good and services inflation will diminish during the course of next year. The recessions we expect across advanced countries, with consumption contracting, should also limit companies' options to raise prices.

Another factor weighing on goods inflation is the unwinding of imbalances between global industrial goods supply and demand, which we think is in its final phase. This is illustrated by our global supply bottlenecks index (see graph above), which fell to a two-year low in November. The ratio between indicators for output in emerging markets and demand in developed markets has been an important driver of this, but other indicators of supply bottlenecks that are included in the index also point to a further easing. The benchmark for global container tariffs has fallen back by more than 75% compared to its peak reached a year ago. The components of our index that measure delivery times for manufactured goods, electronic equipment and semiconductors have also continued to normalise. All in all, our index suggests that imbalances between global goods supply and demand have diminished, thereby mitigating price pressures.

Finally, services and housing related inflation is primarily driven by domestic factors. Wage growth and changes in house prices in individual countries tend to have a large impact here. Wage growth is expected to pick up in the coming quarters as employees seek compensation for the loss of real income in 2022. However, as we describe in the various country chapters of this Global Outlook, all main developed countries are expected to experience recessions, with deteriorating labour market conditions. This should keep a lid on wage growth. Meanwhile, aggressive interest rate hikes by all major central banks are expected to result in house price corrections in a number of countries, which should result in lower housing rent inflation, particularly in the US (something we also discuss in our **Global Monthly of 26 October**). *(Aline Schuiling)*

Box: How has the inflation surge differed across countries?

Items in the CPI index and the weights these items have in the total index can vary widely across countries and regions. For instance, the eurozone HICP index only includes actual housing rents (with a weight of a little over 7% in the HICP index), whereas the US CPI index also includes the owners' equivalent rent (a part of shelter, which has a weight more than a third in the total CPI). The inflation rate of EZ housing rents (which are heavily regulated in many countries) accelerated from 1.1% (yoy) in November 2021 to 2.0% in November 2022; in contrast, the inflation rate of shelter in the US rose from 3.9% to 6.9%.

Moreover, the importance of imports versus domestic production of items in the inflation index and changes in import prices has differed between countries and regions. Changes in exchange rates have added to these differences. For instance, the relatively high dependency on imports of food and energy from Russia and Ukraine combined with the depreciation of the euro versus the US dollar have lifted EZ food and energy price inflation well above the US equivalents in 2022. Food price inflation in the EZ has been around 2.5 percentage points (pp) higher than in the US during the past six months, while EZ energy price inflation has been more than 11pp higher than in the US. In contrast, the US inflation rate has been fuelled much more than the eurozone's by the imbalances between supply and demand for non-energy industrial goods (particularly cars, which saw a stimulus-fuelled demand in 2021). Non-energy industrial goods price inflation was almost 5pp higher in the US than in the eurozone on average during the past twelve months.

Finally, the impact of policy measures aimed at protecting households from soaring energy costs and their impact on inflation has also varied widely. Direct price caps or changes in VAT rates do have a direct (yet temporary) impact on the inflation rate, whereas energy subsidies or cuts in other taxes do not – although the impact on real disposable income (and private consumption growth) could be similar. For instance, France capped prices for household energy already in the autumn of 2021, which is the main reason why France's inflation rate was 2.5 percentage points lower than the EZ total on average during the past twelve months.

4. Will rate hikes affect the economy more quickly than they did in the past?

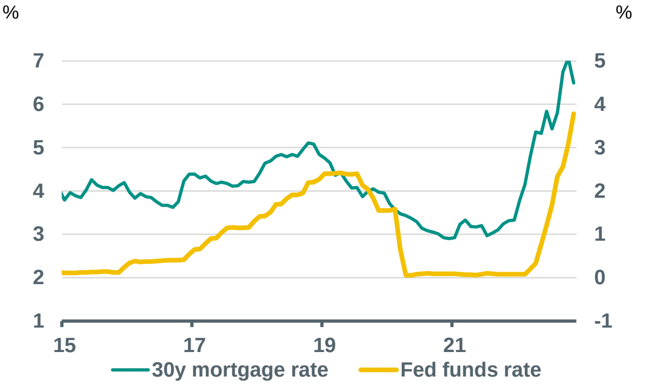
Milton Friedman once stated famously that changes in interest rates affect the economy with 'long and variable lags'. Historically, academic research suggests that the full effect of a change in interest rates takes 18-24 months to be visible. Are there reasons to think rate rises might now affect the economy more quickly than in the past?

In some respects, the lags do appear to be shorter. A change in policy now starts with central bank officials merely telling markets what they plan to do, with market interest rates rising and falling in response. Through communication alone, central banks now exert a powerful influence on long term interest rates, long before actual changes to policy. The Fed's communication shift in late 2021 was a prime example, when it became clear that inflation in the US was not as 'transitory' as most economists (us included) thought. This led to a surge in government bond yields, a rise that was so significant that it had global spillover effects – dragging European government bond yields higher, long before the ECB changed its communication to markets.

This rise in government bond yields then cascaded through the economy via higher borrowing costs for businesses and households. One of the most visible of these for households was higher mortgage rates, which began moving up in early 2022. Indeed, housing is one of the first areas of the economy to respond to shifts in monetary policy, and this is now visible in correction in house prices that is now unfolding across advanced economies. Weaker housing markets lead to lower housing investment, weighing on GDP growth. They also dampen consumer confidence as homeowners feel less wealthy. Finally – and important for the inflation outlook in the US in particular – this leads to a slower growth in rents. For this part of the economy, then, the lag appears to be relatively short – perhaps 3-6 months after the first policy rate rise (the Fed began raising rates in March; the ECB in July).

Then, there are the more indirect channels of impact. As interest rates dampen demand, they also raise recession risks. Higher recession risk makes banks more cautious with lending, further dampening demand and creating a self-reinforcing recessionary cycle. In the last major rate hike cycle in the eurozone – from 2005-08 – bank lending standards took much longer to tighten than in the current cycle. This partly reflects the impact of the energy crisis, which by itself has raised recession risks. But it arguably also reflects the greater degree of forward guidance deployed by central banks, which have sought to steer a tightening of financial conditions ahead of actual policy decisions in their attempt to get ahead of the curve in the inflation fight.

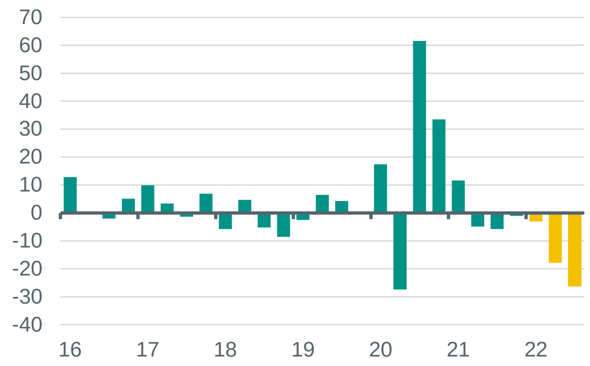
Mortgage rates rose long before the fed funds rate…



Source: Bloomberg, ABN AMRO Group Economics

…driving a decline in US housing investment in 2022

Housing investment, % q/q saar



Source: Datastream, ABN AMRO Group Economics

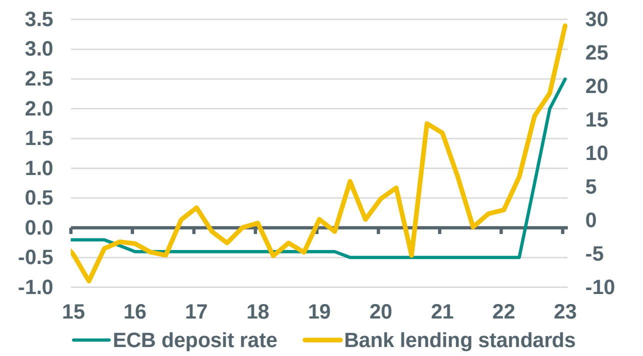
Labour markets again likely the last domino to fall

While it is clear that some of the policy lags are shorter in this cycle, it is the effect on labour markets and overall inflation where lags arguably do still fit the 'long and variable' description posed by Friedman. Inflation has been largely driven by supply/demand imbalances for goods and services up until now, and this component of inflation is already beginning to ease in the US. But the risk that tight labour markets in the US and many parts of Europe entrench high inflation is what keeps central bankers awake at night. Labour markets tend to be the most 'laggy' part of the economy, and this tightness will not evaporate overnight. Ahead of a rise in joblessness, consumption and investment typically slow sharply or contract. We have seen this to some extent, for instance with investment in the US contracting for much of 2022. Anecdotal reports suggest firms have been reluctant to let go of workers in the face of weakening demand, i.e. there has been an element of labour hoarding due to recent difficulties recruiting workers. However, this situation cannot be sustained for very long, and we are seeing some early signs of a rise in layoffs now in **the US**. In both the eurozone and the US, we expect unemployment to start rising in the first half of 2023, but do not expect unemployment to peak until 2024 – which would be consistent with the academic literature suggesting a policy lag of 18-24 month for the full effects to be felt.

Central banks are cognisant of these lags in their policy deliberations, and this became a key topic of discussion among FOMC members as the Fed raised rates well into restrictive territory in November. ECB president Christine Lagarde recently suggested that policy lags may require the central bank to act *even more* forcefully in the near term in order to achieve the desired dampening effect on demand. We judge that this significantly raises the risk of central banks going too far in their policy tightening, which is one of the main reasons we expect central banks to begin reversing course and cutting rates in late 2023. We explore this topic in our next question. *(Bill Diviney)*

Tightening in eurozone bank lending standards…

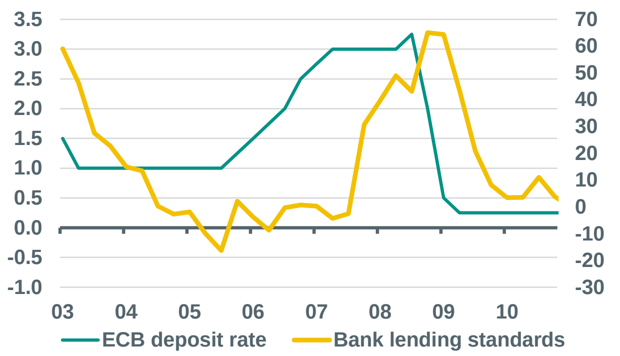
% banks reporting tighter lending standards, net balance



Source: ECB, Bloomberg, ABN AMRO Group Economics

…has been more rapid than in the past

% banks reporting tighter lending standards, net balance



Source: ECB, Bloomberg, ABN AMRO Group Economics

5. Why do we see central banks cutting rates later next year?

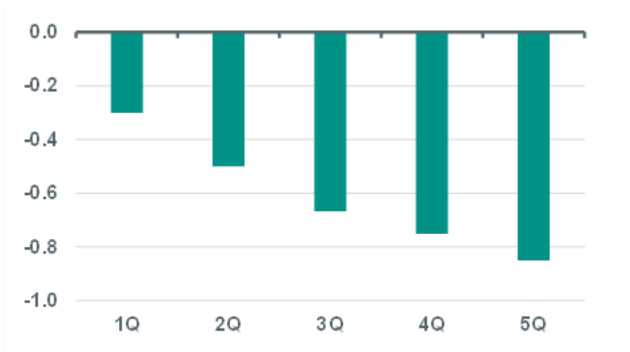
We think central banks are currently in the process of over-tightening monetary policy and will likely compensate for this by the end of next year by cutting rates, especially with macroeconomic conditions looking very different by then. The over-tightening of monetary policy is not an accident, but rather conscious risk management strategy.

Policymakers feel that the risks currently are asymmetric. If they raise interest rates too far, they can always re-adjust later, even though this might do more damage to economy than otherwise. This is seen as being the lesser evil. If they raise too little, and inflation becomes entrenched, they main need to step harder on the brakes later on, causing a longer and deeper recession.

The other element of the risk management approach reflects the anchoring of inflation expectations. They hope that the combination of language signalling their determination to control inflation coupled with large-front loaded rate hikes will convince households, businesses and investors that inflation will come down. This is important, as expectations of inflation are important driver of actual inflation. For instance, if businesses expect inflation to remain high, they are more likely to raise their prices to support their margins, while employees will be minded to ask for larger pay rises.

Monetary policy works with lags

Impact of 100bp of rate hikes on GDP, average of three ECB models, %



Source: ECB, Bloomberg, ABN AMRO Group Economics

US real rates will rise further as inflation falls

2y real yields, %

Source: Bloomberg, ABN AMRO Group Economics
Note: Projection assumes market inflation expectations move back to the 2017-19 average

Finally, the recent period of unexpectedly high inflation has also meant that central banks do not trust their forecasts as much. As monetary policy works with significant lags (see chart on left, and as discussed in Question 4) usually central bankers set interest rates with a view to where inflation will be 12-18 months ahead. However, given the uncertainty, policymakers have put more weight on recent inflation trends, and have been minded to continue raising interest rates until they are convinced that inflation has peaked and is clearly coming down. All of this means that there is considerable monetary tightening in the pipeline, which will increasingly weigh on the economy during the course of next year.

So let's try and imagine the circumstances that would emerge in the second half of next year. First, if our forecasts are correct, the major advanced economies would have experienced a recession. Second, unemployment would have risen and slack would have started to build. Third, inflation would have come down sharply and although still above central bank targets, there would be the prospect of a further downtrend in the months ahead.

Crucially, monetary policy would be restrictive and with inflation (expectations) coming down and real interest rates rising, the stance would become tighter even with no further rises in nominal rates (see chart on the right). Central bankers may return to a forward looking approach and will likely come to the conclusion that inflation could undershoot targets in 2024-2025 if policy were to remain restrictive. We therefore think that policy rates will be moved from above neutral levels back towards neutral levels. In that sense, our call for rate cuts is not a judgement that central bankers will push down on the accelerator, but rather that they will take their foot off the brakes. *(Nick Kounis)*

In the below table, we summarise our key judgment calls and assumptions for macro and financial market developments in 2023.

Theme	View
Energy crisis	• **Large-scale output losses now look to be a tail risk** rather than a base case scenario for European industry, but high energy prices and the risk of physical shortages of energy will remain a significant headwind • **The crisis looks to be accelerating the energy transition**, although this is constrained by tight labour markets and availability of materials
Recession	• **We expect recessions across advanced economies,** but the recession will be milder in the US given that it is relatively unaffected by the energy crisis • **Unemployment is unlikely to rise by as much as in previous recessions,** with current tightness in labour markets making employers reluctant to lay off workers • **Central bank tightening going into the downturn is historically unusual**, and this could amplify downside risks to the outlook
Inflation	• **Inflation to decline significantly in the course of the year** on easing pipeline pressures and base effects • **Core inflation to stay somewhat elevated**, but risk of a wage-price spiral to recede as labour demand weakens and workers become worried over job security
Interest rates and FX	• **Fed, ECB & BoE to hike a further 100bp by March**, with near-term risks to policy rates still somewhat to the upside • **Rate cuts are likely by the end of 2023,** led by the Fed in September and followed by the ECB & BoE in Q4 • **Bond yields to continue declining in the course of 2023**, with the euro strengthening as Fed-ECB policy rates converge
Emerging Markets	• **China to gradually exit Zero-Covid policy,** with a risk of a more disorderly exit • **China's recovery may give some respite to the global economy,** though the effect of this will be blunted by advanced economy recessions

Eurozone: Recession to limit underlying inflationary pressures

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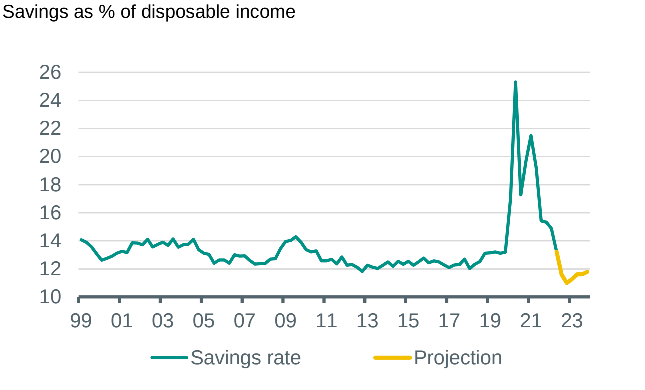
- **The eurozone economy grew solidly during 2022 Q1-Q3, despite the start of the war in Ukraine in February, which fuelled inflation and eroded real household income and corporate profitability**
- **Growth was supported by rebounding services consumption, and catch-up growth in industry that had been constrained by supply bottlenecks, which had led to significant order backlogs**
- **The stage is now set for contractions in GDP in 2022 Q4 and 2023H1. Firstly, because the factors that have driven growth in 2022 Q1-Q3 have largely vanished and, secondly, because financial conditions have tightened due to aggressive interest rate hikes, with further increases on the cards**
- **Inflation has soared to record-high levels in 2022, but should fall gradually in the course of 2023**
- **Headline inflation is expected to decline more rapidly than core inflation, which will be more sticky as companies will probably continue to pass on some earlier rises in input costs to consumers**
- **Wage growth is expected to pick up, but remain contained as the employment outlook worsens**
- **Government finances should deteriorate in 2023, with the debt ratios of the Big-3 EZ countries rising**

Final domestic demand to contract the next few quarters. Following surprisingly robust GDP growth in 2022 Q1-Q3, we expect GDP to contract in 2022Q4 and 2023H1, and to grow only modestly in the second half of 2023. Private consumption and private fixed investment are both expected to contract on average in 2023. Importantly, we think the potential for declines in the savings rate to fuel further private consumption growth has now been exhausted. The volume of private consumption expanded by 0.9% qoq in 2022Q3. Although data for household income in Q3 has not yet been published, real disposable income probably contracted, with rises in food and energy prices higher than the rise in nominal income.

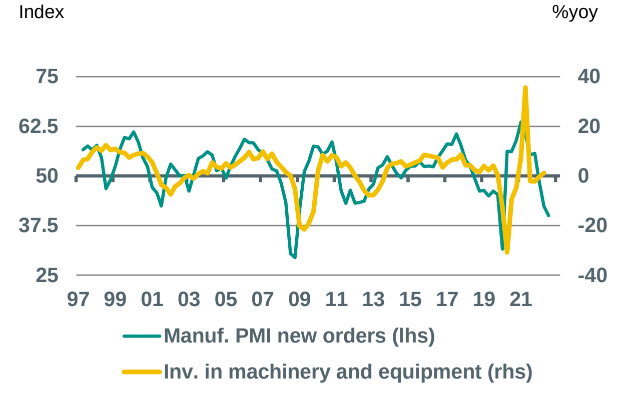
We think that the decline in the savings rate will come to an end around the turn of the year, as the outlook for the labour market deteriorates, and precautionary savings start rising. Indeed, the real value of net household wealth (including houses), which jumped higher during the pandemic, dropped sharply in 2022 according to research by the European Commission (see **here**), suggesting that potential tailwinds to consumption from changes in wealth and previously accumulated wealth have largely vanished. The worsened outlook for consumption, the slowdown in global trade, higher funding costs and tighter bank lending standards – combined with pressure on margins from the jump in energy prices and higher wage growth – should all contribute to declining private fixed investment in 2022Q4-2023H1. However, the extra investment support from the European RRF funds, estimated to be equal to roughly 0.5% GDP in 2023, should limit the contraction in total investment.

Household savings rate to stop falling



Source: Refinitiv, ABN AMRO Group Economics

Contraction in fixed investment on the cards



Source: Refinitiv, ABN AMRO Group Economics

Headline inflation to decline faster than core inflation in 2023. Inflation has soared to historically high levels during the course of 2022. The rise was mainly driven by energy and food price inflation jumping higher on the back of soaring global commodity prices. Still, during the year, the contribution from non-energy industrial goods and services price inflation also accelerated. This rise in core inflation was partly due to high energy prices being passed on into goods and services prices (the ECB estimates that about half of current core inflation is due to categories defined as higher-intensity users of energy inputs; see here). Moreover, high food inflation has also had an impact on core inflation, as it is an important component in hospitality and related services. On top of that, inflation was fuelled by the depreciation of the trade-weighted euro exchange rate in 2021 and in the first half of 2022, by the normalisation of the price of services that had been in lockdown during the pandemic, and by bottlenecks in global supply chains, which lifted industrial goods prices.

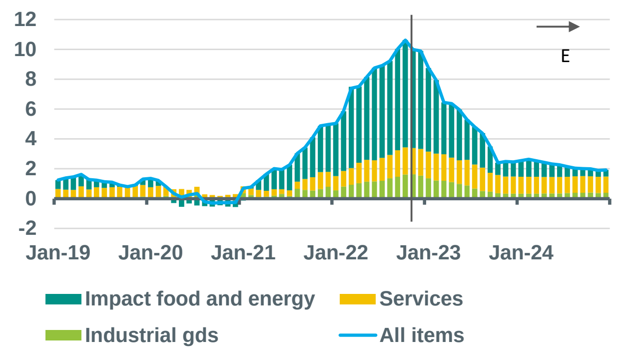
Looking ahead, recent drops in food and energy commodity prices already reduced inflation in November (to 10.0%, from 10.6% in October) and will result in further sharp declines in headline inflation in the coming months. Core inflation should also decline in 2023, but we expect it to fall more gradually than headline inflation. Although falling commodity prices should also reduce the inflation rates of food and energy-intensive goods and services, we expect this process to be slow, as past rises in food and energy prices still do not seem to have been passed on fully to consumers. Non-energy industrial goods price inflation should ease in the coming months, as these prices are mainly driven by global supply and demand for industrial goods, which have become more balanced. However, services price inflation is expected to remain more elevated. Services inflation is more domestically driven and more sensitive to wage growth, which is expected to rise in 2022H2-2023H1 and stay elevated in 2023H2. All in all, inflation should fall noticeably in the coming months. We expect inflation to return to levels close to the ECB target by the end of 2023, but the risks to this forecast seem to be tilted to the upside.

Deteriorating labour market to keep a lid on wage growth. We expect wage growth to pick up in 2023, as employees seek pay rises to compensate part of the loss in real wages they suffered in 2022. Labour market tightness in many countries after the pandemic will support wage growth in 2023. Still, we expect wage growth to remain contained by the recession that is about to hit the labour market, with unemployment to start rising from early 2023 onwards. With wage growth expected to remain well behaved, and inflation likely to fall back towards the ECB's 2% target around the end of 2023, we expect the ECB to start lowering interest rates again by end 2023. Before that, we first expect the central bank to hike interest rates by 50bp in December 2022 and by another 50bp in 2023Q1, something we discuss in more detail in our global outlook chapter.

Government debt to rise in 2023. Government finances had not yet fully recovered despite the phasing out of pandemic support measures, as large support packages were introduced to shield households and companies from soaring energy costs. The EC estimates that government support measures that directly impact the budget balance will amount to 1.2% GDP in 2022 in the eurozone as a whole. According to current plans, about 0.4pp of this will come to an end in 2023. Despite this decline in energy support measures, government budget balances are expected to deteriorate in 2023, due to the downturn and higher interest payments. Largely thanks to exceptionally high nominal GDP growth, government debt ratios will probably fall in 2022. However, we expect debt ratios to rise again in the Big-3 eurozone countries in 2023.

HICP inflation and contribution from main components

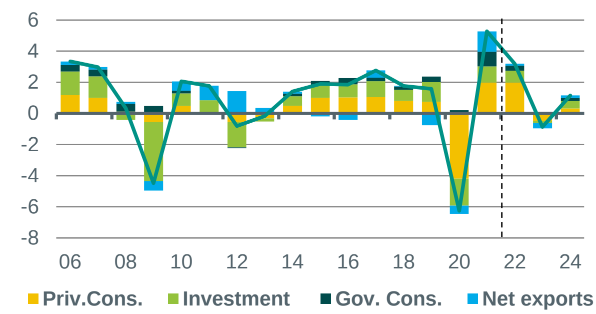
% / pps yoy



Source: Refinitiv, ABN AMRO Group Economics

GDP growth and contribution from main components

% / pps



Source: ECB, ABN AMRO Group Economics

The Netherlands: Recession knocking on the door

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- **The contraction in Q3 seals the deal for a recession in the second half of 2022. We expect GDP to contract slightly in Q4 2022 and Q1 2023 as well, after which growth is expected to resume. Following 4.2% growth expected in 2022, we see the economy expanding by just 0.5% in 2023**
- **Inflation will cool significantly on the price cap and receding global price pressures, but the pass-through of energy will persist and further push up core inflation. HICP will average 4.1% in 2022**
- **Monetary headwinds, a cooling housing market, the tight labour market, plus energy and environmental constraints will mean a tepid recovery, with below trend growth of 1.2% in 2024**

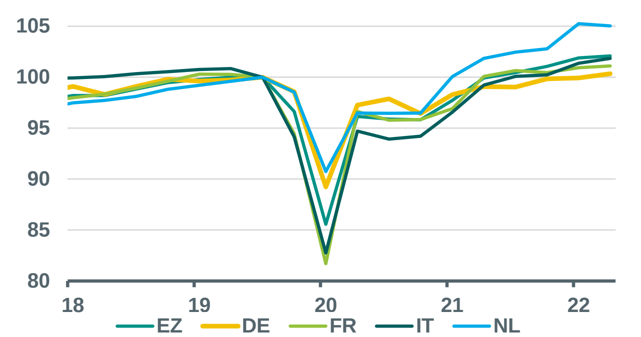
Q3 contraction to continue in coming quarters, with growth to resume later in 2023

With the energy crisis driving record high inflation in the Netherlands, we had already anticipated a recession at the end of 2022. However, with third quarter GDP growth already slightly negative (-0.2% qoq), primarily driven by investment, the recession is knocking on the door already. As high, primarily energy driven inflation weighs on domestic consumption, and weakening activity in the Eurozone does not bode well for external demand, we expect GDP to contract in Q4 2022 as well. This will tip the Dutch economy into a technical recession before the end of the year. We expect 2023 to start weak as well, with a small GDP contraction in the first quarter. From Q2 2023 onwards, growth will return, supported in part by generous government support such as the energy price cap – which dampens the real income shock – and above trend wage growth.

Consumption remained robust up until September. Although real goods consumption was already slowing, pandemic related catch-up spending in services kept total consumption afloat. Since September, however, we see this catch-up effect fade and total consumption slowing considerably. This supports our view that consumption will contract in Q4. True, still significant savings are bolstering household financial positions. These cannot, however, stop consumption from contracting, as households – with consumer confidence at historic lows – are reluctant to use these savings for consumption. Instead, we assume savings to flow into the economy at a more gradual pace over the coming years. For 2023 however, the unequal distribution of savings, mostly geared towards higher incomes, combined with a generous government package primarily supporting lower income groups, are supporting consumption.

After outperformance, NL is the first to contract

GDP; 2019Q4=100



Source: Refinitiv, ABN AMRO Group Economics

Catch-up in services is behind us

Index; 2021=100, 3m moving average

Source: CBS, ABN AMRO Group Economics

Investment is weak, despite ambitious government plans

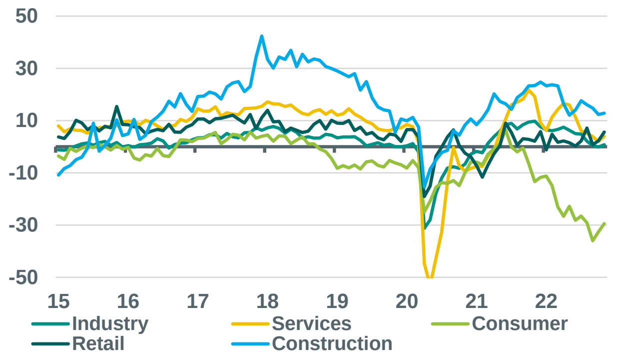
The weak outlook for demand, coupled with financial headwinds in the form of higher interest rates and the tightening of financial conditions, are not supportive of investment. Indeed, with roughly 20% of private investment being real estate related – and hence highly sensitive to interest rate changes – investment is set for a weak year. Public investment should limit the slowdown, as there is an ambitious public investment agenda. The government, however, also faces considerable constraints. The most prominent constraint comes from binding nitrogen limits which hampers construction, but also the tight labour market limits investment execution and has already led to underspending relative to government plans in 2022.

Still, businesses have been more resilient than expected in the face of the energy crisis. Bankruptcies are still well below pre-Covid levels, and Dutch industry, in particular, has achieved remarkable energy savings while keeping industrial production relatively stable. Whereas energy-intensive industries are already grappling with the full rise in energy prices, the pass-through to SMEs is still ongoing. This also means core inflation is likely to continue rising.

Price cap to push headline inflation lower; ongoing broadening of price pressure keeps core elevated in 2023
The November HICP inflation figure showed a step in the right direction (at 11.2% yoy). Inflation came down by over 5 pp compared to October, due to lower energy prices and base effects. For 2023, the planned cap on energy prices plays a dominant role in our forecast. Since roughly 90% of gas and electricity consumption falls under the price cap, household energy bills, and in turn energy inflation, will drop and push headline inflation down significantly. However, core inflation is expected to continue moving upward. Despite receding global inflationary pressures – stemming for instance from supply bottlenecks and lower commodity prices – the pass-through of energy into goods and services will continue well into 2023. This will keep core inflation elevated and above headline inflation, while exceeding the ECB target for the remainder of 2023. We expect HICP inflation to average 4.3% in 2023.

Business and consumer confidence is weakening

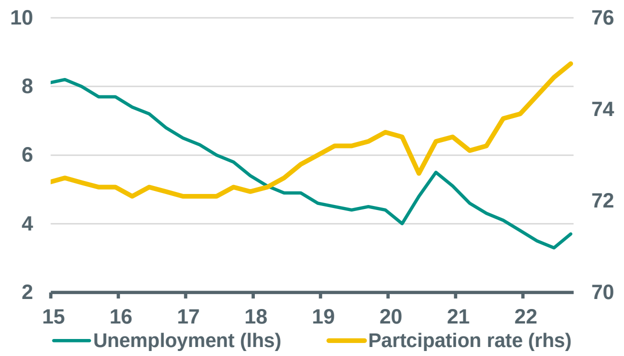
Index



Source: EC, ABN AMRO Group Economics

Unemployment slowly rising, participation very high

Unemployment rate and participation rate, both in %



Source: CBS, ABN AMRO Group Economics

Sizzling hot labour market starts cooling off
Tightness in the Dutch labour market peaked in the second quarter, with 1.4 vacancies for every unemployed person. Since then, unemployment has crept up, albeit slowly. Going forward, we expect the recession to reduce labour demand and put slight upward pressure on unemployment. The labour market, however, remains tight, as employers continue to hoard labour, public labour demand increases and demographics reduce labour supply. We expect unemployment to increase from 3.6% this year to 4.3% next year.

Energy support causes small increases in government debt ratio in 2023
Labour market tightness combined with other capacity constraints, such as nitrogen emission limits, have hampered government policy execution and have led to underspending, for example in infrastructure and military spending. As these constraints are structural, they will also limit government spending in 2023. Extra spending next year will come from the energy support package, which will contribute to a higher budget deficit. Public finance forecasts are subject to considerable uncertainty, as final spending related to this package will depend on energy market prices and whether the government succeeds in its ambition to fund the package mostly by cutting spending elsewhere. We expect the EMU budget balance to be -3.1% of GDP in 2023, and government debt to increase slightly to 50% of GDP.

2024 cyclical headwinds and structural constraints lead to below trend growth
Going forward, the current macro situation will remain uncertain. We expect growth to stay below trend. The further cooling of the housing market is a drag on consumption. The ECB is also not yet done with monetary tightening, and given the usual lags in the transmission of monetary policy, headwinds are expected to persist throughout 2024. Finally, structural issues, such as environmental and labour market constraints, will also limit growth.

US: On borrowed time

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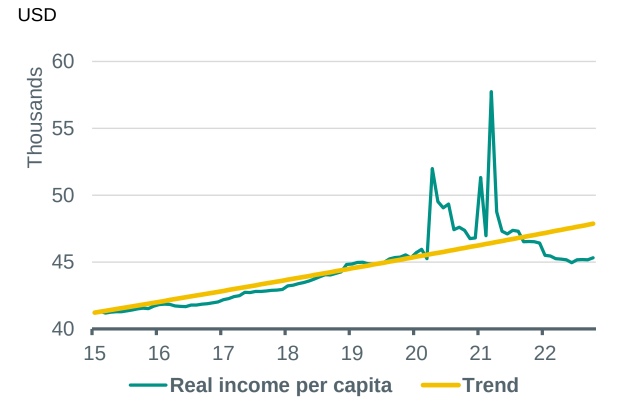
- **The US consumer has exhibited surprising resilience for much of 2022**
- **However, the twin headwinds of falling real incomes and dwindling excess savings are now expected to exert a powerful drag on consumption. This will help inflation along its downward-sloping trend…**
- **…while labour hoarding is likely to give way to a rise in the unemployment rate**
- **The Fed will continue raising rates in the near-term, but we expect 125bp in rate *cuts* by end-2023**

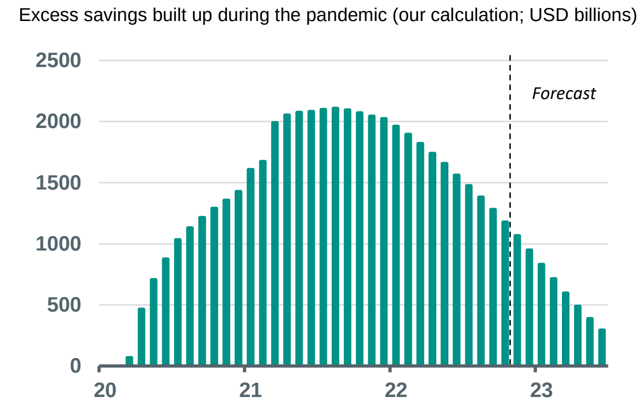
The reckoning is approaching for the almighty US consumer. From a lofty stimulus-fuelled peak in March 2021, real per capita incomes have been on a near constant decline ever since, and are now running around 5% below where incomes would have been absent the pandemic. For most of this period of falling real incomes, consumers have maintained above trend goods consumption by drawing on their extraordinary build-up of excess savings. For the bottom 20% income group, this excess had already been exhausted by the middle of 2022. For the remainder, we estimate excess savings have fallen to around half their peak as of October. With the savings rate now far below normal levels, at just 2.3% in October (the pre-pandemic normal was 7-8%), and surging interest rates pre-empting a credit binge, consumers are rapidly running out of room to accommodate still-elevated inflation. We don't expect a 'Wile E. Coyote'-style freefall in the economy that former Treasury Secretary Larry Summers recently suggested as a possibility, but we do expect a mild recession over the coming year, with stagnant domestic demand driving a rise in the unemployment rate to 5% by the end of 2023. Combined with an expected decline in inflation, this should give the Fed the confidence to take its foot off the brakes after an aggressive rate hike campaign, and we continue to expect significant rate cuts towards the end of 2023 and into 2024.

Real incomes are around 5% below trend…



Source: Datastream, ABN AMRO Group Economics

…while excess savings are being rapidly run down



Source: Datastream, ABN AMRO Group Economics

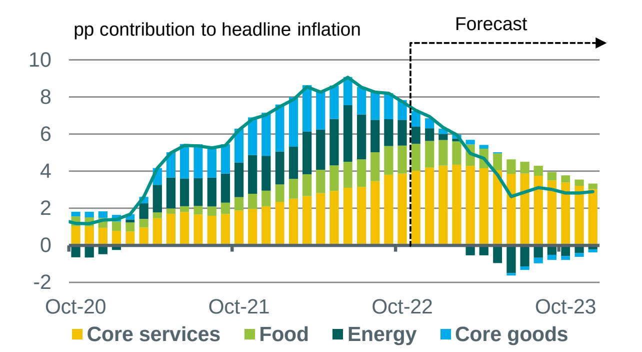
From a growth angle, 2022 has been a messy, mixed bag. Headline GDP stagnated over Q1-Q3, with an unexpected decline in the first half of the year followed by a modest recovery in Q3. For the most part, headline GDP growth was driven by a still heavily disrupted supply-side, with swings in inventories and net exports reflecting the difficulty businesses have faced in predicting both consumer behaviour and the availability of goods and other inputs. Underlying domestic demand has tracked our expectations more closely, with modest growth in the early part of the year followed by stagnation in Q2 and Q3. Where domestic demand has surprised has been in its composition: consumption has been remarkably resilient in the face of historically low consumer confidence and falling real incomes, while investment has been unexpectedly weak, driven by a rapid downturn in housing investment. Indeed, following the historical pattern as one of the most interest rate sensitive parts of the economy, the housing market is already now in a correction that is likely to persist well into next year.

How will the economy fare going forward? Consumption data for the start of Q4 suggests continued resilience for the time being. Net exports are also likely to remain a growth support, as the supply-side recovery comes alongside increased demand for US energy exports (particularly from Europe). However, as we move into 2023, we expect the twin consumer headwinds of depressed real incomes and a further rundown in excess savings to put increasing downward pressure on consumption, with an expected decline in goods consumption in particular offsetting a continued (though increasingly sluggish) services recovery. Business investment is also likely to remain relatively weak given high interest rates and recession worries. All told, we expect GDP growth to slow sharply from an expected 1.9% outturn in 2022, to 0.5% in 2023. For 2024, we expect rate cuts by the Fed to drive a rebound in consumption and investment, with growth to average 2%.

Naturally, a critical underpinning of this growth outlook is how inflation – and in turn monetary policy – evolves. Headline inflation marked a high point of 9.1% y/y in June, and we judge this to have been the peak. Since then, inflation has fallen back to 7.8% as of October, and we expect that declining trend to persist over the coming months. Almost all of the expected decline in inflation in the near term is expected to be driven by falling prices for energy and goods (particularly used cars and clothing). By contrast, core inflation is expected to remain elevated, reflecting continued pass through from earlier rises in housing rents, as well as strength in services, reflecting higher input costs and the tight labour market. However, here too we expect a significant cooling, but with most of that taking place in the second half of 2023. Real-time data on new leases suggests housing rents are now falling following a stunning rise over the past two years, but due to the CPI methodology, this likely won't show up in the inflation data for some months yet. The Fed, however, is fully aware of this and we do not expect these lags to be a barrier to rate cuts. All told, we expect the Fed's preferred PCE inflation measure to be within touching distance of the central bank's 2% target by the end of 2023, with both headline and core measures back at target in the course of 2024.

Inflation to continue its declining trend

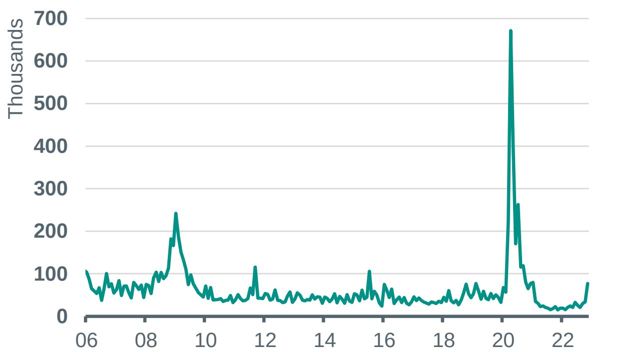
% y/y



Source: Refinitiv, ONS, ABN AMRO Group Economics

Job layoffs have begun to tick higher

Monthly announced job layoffs



Source: Refinitiv, ABN AMRO Group Economics

The key long-run determinant of inflation – alongside inflation expectations – is ultimately the labour market. The labour market has remained exceptionally tight this year, despite the general cooling in the economy, with 1.7 job vacancies per unemployed person as of October (in more normal times, this figure is below 1). However, there are cracks under the surface: job vacancies peaked in March and have since been on a declining trend, and we have also seen a modest rise in layoffs. According to the Fed's latest Beige Book report, contacts in November had expressed "a reluctance to shed workers in light of hiring difficulties, even though their labor needs were diminishing." This situation of labour hoarding is unsustainable, in our view, and as it becomes increasingly clear how weak growth is expected to be in 2023, we expect layoffs to accelerate, payrolls growth to turn negative, and the unemployment rate to start rising. A persistent rise in unemployment is likely to be sufficient for the NBER to declare a recession, even if headline GDP does not meet the technical recession definition of two consecutive quarterly contractions.

In the near term, the ultra-tight labour market and the ongoing risk of a drift higher in inflation expectations means the Fed is likely to continue raising interest rates at the coming three FOMC meetings. Following an expected 50bp hike in December, we expect two further 25bp hikes in February and March; this will take the upper bound of the fed funds rate to 5%. The risk in the near-term to rates remains to the upside, as labour market tightness could still put further upward pressure on wage growth, raising worries over the medium term inflation outlook. However, by Q3 2023, we expect monthly core inflation readings to be much closer to normal, and the unemployment rate to be on solidly rising trend. This, we think, will be enough to convince the Fed that monetary policy is too restrictive at that point, and as such we expect the first of a series of rate cuts to take place at the September FOMC meeting. Rate cuts should take the fed funds upper bound back down to 3.75% by the end of 2023, while the full expected normalisation in inflation in 2024 should lead to further rate cuts back to the estimated neutral level of 2.5%.

UK: Fiscal and monetary tightening to drive prolonged recession

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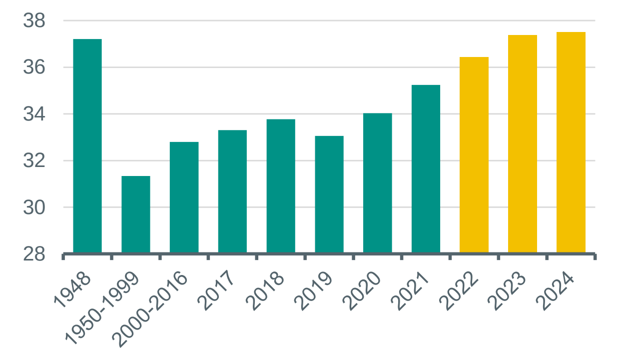
- **The new government has staved off a potential crisis, but it cannot prevent a recession**
- **A sharply rising tax burden will compound the challenges faced by households and businesses from high interest rates and energy costs, with the economy set for a year-long contraction**
- **Inflation risks will push the BoE to raise rates even further in the near term, but falling inflation next year combined with weak activity is likely to lead to rate cuts in late 2023 and into 2024**

The infamous 'mini budget' from September now feels like a bad dream, with the new government led by Rishi Sunak moving quickly to unwind proposals that triggered a period of extreme turmoil in UK financial markets. The episode illustrated how financial markets can be a powerful disciplining mechanism, preventing policy mistakes before proposals are implemented. As a result, while the risk of a snap election will remain high over the coming two years, any new (likely Labour) government is likely to be as fiscally hawkish as the current government. For now, though the new government has rescued the UK economy from a potential crisis, it is unable to prevent the unfolding recession. Hobbled by the same energy crisis as the rest of Europe, the UK also faces its own unique challenges from an especially tight labour market (partly stemming from Brexit), and therefore even higher interest rates to fight inflation than in the eurozone. Tighter monetary policy will be compounded over the coming years by increasingly tight fiscal policy. Although the government is stepping in to shield households from the worst of the energy crisis, from next April it will be raising significantly higher taxes on both businesses and workers, with the overall tax burden on the economy expected to reach the highest since the end of WW2. The combined forces of both fiscal and monetary tightening should work to push inflation sharply lower next year. In the meantime, the risk of a wage-price spiral – and high inflation becoming entrenched – remains significant.

Taxes are set to rise significantly…

Tax burden, % GDP; yellow = forecast (OBR)



Source: OBR, ABN AMRO Group Economics

…adding to the burden from higher interest rates

Bank Rate, %; yellow = ABN AMRO forecast

Source: Bank of England, ABN AMRO Group Economics

The government's new budget on 17 November contained few surprises, with most changes trailed some weeks before, in order to calm fragile market sentiment. Among the few – albeit most important – policies retained from the previous government was the Energy Price Guarantee (EPG), which caps energy bills for the average household at £2500 per year. This will remain in place until April 2024, with the cap raised to £3000 from next April. Similar to price caps elsewhere in Europe, much of the cost will be funded by the extension of a windfall tax on oil and gas companies, as well as a new tax on low carbon energy producers. The ultimate cost will naturally depend on energy prices, although the surprisingly steep fall in energy demand has kept prices sharply below their August peaks. Assuming wholesale energy prices follow futures pricing, we expect a budget deficit of 6.5% in 2023 – little changed from 2022, but significantly lower than the 13.1% deficit in 2020.

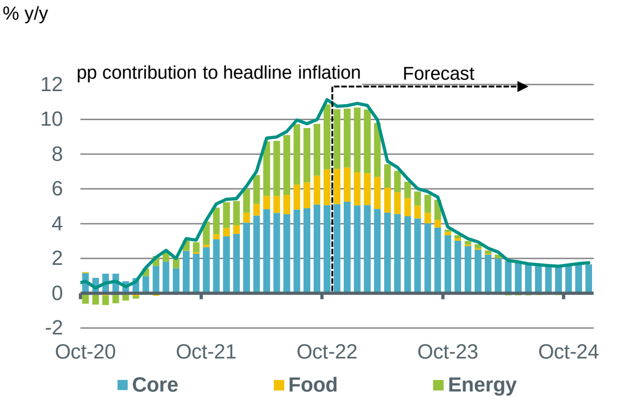
While the budget deficit is expected to remain large in 2023, there will be significant increases in taxation, and in the absence of the EPG this would have represented a major fiscal tightening. Specifically, the corporation tax rate is set to rise to 25% from next April, up from 19% at present. The upper rate of income tax will apply at a much lower income threshold, while all other tax thresholds will be frozen until 2028. Coming at a time of high inflation and wage growth, this will push increasing numbers of workers into higher tax brackets, and together with the rise in corporation tax, will raise the tax burden on the economy to 37.4% of GDP next year – sharply higher than the pre-pandemic level of c.33%. The tax rises come on top of the pressures from high energy prices and interest rates, and will further dampen activity both among households and businesses. As such, we expect declines in real consumption and business investment next year, and only a tepid recovery in 2024, as falling inflation enables the Bank of England to cut interest rates. GDP already declined in Q3, largely due to the additional public holiday related to the Queen's funeral, and our base case sees GDP declining over four consecutive quarters – comfortably meeting the recession definition.

The recession is also likely to fuel the ongoing housing market correction. As of November, house prices are down 3.6% from their August peak. Although mortgage rates have eased following the September surge, rates are still elevated at 5-6%, and UK households are particularly exposed to high rates with most mortgages fixed for relatively short terms (25% of mortgages are on variable rates and 50% on fixed rates due to expire within 2 years). The effect of higher mortgage rates is twofold: first, it lowers housing affordability, pushing down on prices; second, it further reduces the amount of household income available for consumption of goods and services, even for existing home owners.

Labour force stagnant despite rising population

Source: Refinitiv, ONS, ABN AMRO Group Economics

Reduced energy contribution to push inflation lower



Source: Refinitiv, ABN AMRO Group Economics

The silver lining of the unfolding recession is that it should help to bring inflation back to the BoE's 2% target. Inflation is expected to remain near the October reading of 11.1% until April, after which base effects should lead to a steep decline in the energy contribution. Core inflation is likely to remain somewhat elevated, but as 2023 progresses we expect rising slack the labour market to start bearing down on wage growth and in turn broader price pressures. The easing in global supply-side bottlenecks and falls in non-energy commodity prices should also help to significantly dampen goods price inflation.

For now, inflation risks continue to be to the upside. The latest BoE decision maker panel of CFOs showed businesses expect to raise prices by 5.7% over the next 12 months, with inflation at close to 4% in three years' time – double the BoE's 2% target (the BoE's consumer survey shows expectations rather better anchored, at around 3%). The labour market is also exceptionally tight, with the number of job vacancies continuing to outnumber the unemployed – a historically unusual situation. Although labour demand appears to have cooled, firms are so far reluctant to implement layoffs, perhaps due to the recent difficulties in finding workers. The worker shortage is partly due to increased long-term sickness, as well as Brexit, with net migration from EU countries persistently negative in recent quarters. This has not yet been alleviated by the influx of refugees from Ukraine – despite a sharp increase in the working age population this year, the labour force has barely grown.

The combination of a still-tight labour market and elevated inflation expectations means the BoE is likely to continue raising rates in the near term. We expect the MPC to hike Bank Rate by 50bp to 3.5% at the December policy meeting, with a further two 25bp hikes at the February and March meetings, taking rates to 4%. From here on, we expect the BoE to keep rates on hold as it assesses the impact of prior rate hikes, as well as the other pressures bearing down on inflation – namely the recession, and the significant fiscal tightening expected from April. We think that by later in the year, the economy will be sufficiently weak to have driven a rise in unemployment, while falling inflation will be driving rises in real interest rates even as nominal rates are unchanged. Given the weakness we are likely to be seeing in the economy at that point, we think this will push the BoE to start cutting rates modestly. Our base case is for two 25bp cuts in Q4 2023, which will likely be followed by further cuts in 2024, ultimately taking Bank Rate back to neutral levels by Q3 2024.

China: Headwinds to fade, but ride to remain bumpy

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- **Exit from Zero-Covid could be a bumpy ride, as the authorities face a difficult balancing act**
- **Beijing doubles down on property support, but restoring trust is key and may take time**
- **Growth should profit from these major policy shifts, but some downside risks remain**
- **All in all, we expect annual growth to pick up from 3.0% in 2022 to 4.8% in 2023, and 5.2% in 2024**

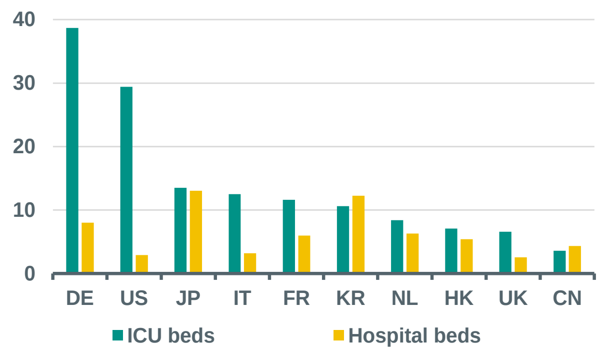
In 2022, China's economy faced major headwinds, some of which are self inflicted: Zero-Covid, the property sector slump, a slowdown in global growth and the flaring-up of tensions with the US on tech and Taiwan. Going forward, we expect some of these headwinds to fade, and annual growth to pick up from 3.0% in 2022, to 4.8% in 2023 and 5.2% in 2024.

Exit from Zero-Covid could be a bumpy ride, as the authorities face a difficult balancing act

Although Zero-Covid helped to keep the death toll extremely low, it has proven less effective in dealing with the highly contagious Omicron and related variants. Moreover, this policy had a large macro impact, depressing confidence and domestic demand, while adding to supply bottlenecks from time to time (particularly during the initial Covid-19 shock and the Omicron slump in early 2022). There is also a huge social impact, evidenced by unprecedented protests in late November. Although Beijing quickly stepped in to contain these protests, the sense of urgency to prepare for a relaxation of Zero-Covid has increased, even as new cases remain high (albeit falling). Both central and local authorities have started 'optimising' testing, quarantine and vaccination policies. With herd immunity still a distant prospect, the key to engineer an orderly exit is boosting the vaccination of the elderly while strengthening ICU capacity. Also crucial is a shift of Beijing's overall narrative and the launch of education campaigns to prepare the population for a different approach. Bolstering vaccination efficacy by developing or importing mRNA vaccines may also be needed, but using foreign vaccines remains politically sensitive. All in all, we expect Beijing to aim for a gradual but steady approach towards relaxation, aiming for an orderly exit without overburdening the public health sector. Still, the risk of a more disorderly outcome is high, with a bigger impact on public health that may backfire on the economy, and lead to renewed disruptions to both the supply and demand side.

China's vulnerable public health system

ICU beds per 100.000 people / Hospital beds per 1000 people



Source: Various (pre-pandemic numbers)

Zero-Covid has driven consumer confidence to record low

Consumer confidence index, 100 = neutral

Source: Refinitiv

Beijing doubles down on property sector support, but restoring trust remains key, and may take time

The property slump, initially triggered by tighter policies ('three red lines') and aggravated by Zero-Covid, intensified over the past year due to a vicious cycle of financing problems for developers leading to more projects being unfinished, depressing confidence and new home sales, even resulting in a mortgage boycott. The government's response was initially cautious, as it wanted to contain overall leverage and moral hazard. Still, in line with our expectations, support measures have been stepped up over time. A more direct support package was announced in November, including a PBoC relending programme, more room for property lending by banks, easier restrictions on shadow-bank and equity financing, government bond guarantees, and the extension of payment deadlines, with a wave of debt maturities due in the coming months. This policy is aimed at avoiding further defaults amongst property developers, with specific funds allocated to help finishing construction projects. These measures, together with a relaxation of Zero-Covid, should help to break the vicious cycle, but it may take a while to restore homebuyers' trust and revive property sales – particularly if the exit from Zero Covid is disorderly.

US-China tensions to remain, but Biden-Xi meeting last November should help to keep the situation under control

US-China tensions flared up over the summer after China responded with unprecedented military activity in the Taiwan Strait to Nancy Pelosi's visit to Taipei, and with the US imposing export restrictions on advanced chips and related machines. Some calm has returned after the first face-to-face meeting ever between Biden and Xi at the margins of the November G20-summit in Jakarta. Both leaders agreed to restart some working-level communication channels that were suspended, on climate and other areas. US Secretary of State Blinken will visit China in early 2023. That said, risks remain, also depending on political developments in the US and Taiwan (with presidential elections coming up in both countries in 2024). Meanwhile, there are more signs that multinational firms are diversifying their supply chains following geopolitical tensions and pandemic disturbances (from 'just in time' to 'just in case'), but this will be a gradual process given the interests at stake.

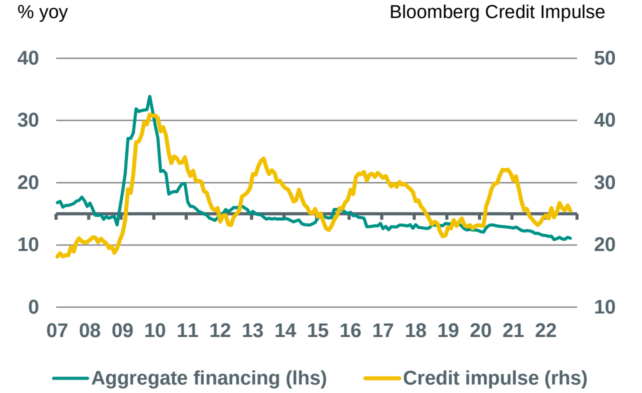
Inflation still relatively low, giving the PBoC room for manoeuvre

China does not face the same (largely energy-driven) inflation spikes as major developed economies. In line with our expectations, consumer price inflation has picked up in the course of 2022 (partly driven by pork prices), averaging around 2% yoy in 2022 (2021: 0.9%) . However, core inflation has fallen to 0.6% yoy in recent months, reflecting weak domestic demand and the lack of pipeline pressures – with producer price inflation even turning negative in Q4 2022. We expect headline (and core) inflation to pick up again in 2023, as domestic demand stabilizes, but to remain below the PBoC's 3% target. All of this means that the PBoC still has some room for manoeuvre in terms of piecemeal monetary easing. We anticipate modest additional cuts in banks' reserve requirement ratios and targeted mini cuts of specific policy rates (such as the 5-year Loan Prime Rate, which is used as a benchmark in mortgage lending). We do not anticipate a major monetary easing campaign, partly also for FX stability reasons (given further rate hikes expected in developed economies in early 2023). Indeed, the main shift in China's policy stance will come from the expected relaxation of Zero-Covid, and the more direct support of the property sector. These shifts will likely support a further turn in the credit cycle as well.

Growth should profit from Zero-Covid exit and property support, but some of the downside risks remain

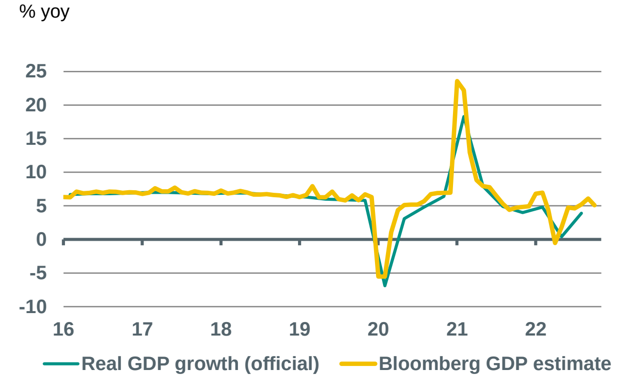
What does all this mean for the growth outlook? We expect the impulse from the Zero-Covid exit and more property sector support to materialise in the course of 2023, driving a rebound in consumption and private investment. However, after years of volatile quarterly growth numbers due to recurrent lockdowns, China's growth trajectory could remain bumpy in 2023, as the exit from Zero-Covid may well prove disorderly. Meanwhile, recent foreign trade data show that China's export strength is fading, reflecting the sharp slowdown in global growth and the rotation in global demand back to services. In addition, it will likely take some time before the property sector adds to growth again. All in all, we expect sequential growth to pick up particularly in the second half of 2023 and annual growth to rise from 3.0% in 2022 (revised down following the intensification of pandemic headwinds in Q4, as reflected in for instance the PMIs), to 4.8% in 2023, and 5.2% in 2024.

Turn in credit cycle has further to run



Source: Bloomberg

Real GDP growth volatile due to recurrent lockdowns



Source: Bloomberg

Country and region forecast tables

Key forecasts for the Eurozone				
	2021	**2022e**	**2023e**	**2024e**
Economic outlook (% yoy)				
GDP	5.3	3.2	-0.9	1.2
- Private consumption	3.7	3.8	-1.0	0.6
- Fixed Investment	3.7	2.7	-0.5	2.2
- Net exports (contribution pps)	1.3	0.1	-0.3	0.2
Inflation	2.6	8.5	5.1	2.2
- Core inflation	1.5	3.9	3.4	2.1
Unemployment rate	7.7	6.7	7.3	7.5
Interest and exchange rates (eop)				
ECB deposit rate	-0.5	2.00	2.00	1.50
3M Euribor rate	-0.6	2.25	2.05	1.65
10yr yield (Bund)	-0.2	2.00	1.50	1.70
EUR/USD	1.10	1.00	1.08	1.12

Key forecasts for the Netherlands				
	2021	**2022e**	**2023e**	**2024e**
Economic outlook (% yoy)				
GDP	4.9	4.2	0.5	1.2
- Private consumption	3.6	5.8	-0.2	0.9
- Fixed Investment	3.2	2.7	-0.2	1.4
- Exports	5.3	4.4	0.8	1.7
- Imports	4.0	3.5	1.0	1.7
Unemployment rate	4.2	3.6	4.3	4.2
Inflation (HICP)	2.8	11.6	4.3	4.0
Budget balance (% GDP)	-2.6	-1.1	-3.1	-2.2
Governerment debt (% GDP)	52.4	49.7	50.0	50.1

Source: ABN AMRO Group Economics

Key forecasts for the United States

	2020	2021e	2022e	2023e	2024e
Economic outlook (% yoy)					
GDP	-2.8	5.9	1.9	0.5	2.0
- Private consumption	-3.0	8.3	2.7	1.0	2.1
- Fixed Investment	-2.3	7.4	-0.1	0.0	2.2
- Net exports (pp contribution)	-0.2	-1.7	-0.7	0.3	-0.3
Inflation (PCE)	1.1	4.0	6.2	3.1	1.9
- Core inflation (PCE)	1.3	3.5	5.0	3.4	2.1
Unemployment rate (annual average, %)	8.1	5.4	3.7	4.4	5.2
Interest and exchange rates (eop)					
Fed funds rate (eop, upper bound)	0.25	0.25	4.50	3.75	2.50
10y yield	0.85	1.70	3.50	3.00	2.75
EUR/USD	1.18	1.14	1.05	1.08	1.12

Source: ABN AMRO Group Economics

Key forecasts for the UK

	2020	2021	2022e	2023e	2024e
Economic outlook (% yoy)					
GDP	-11.0	7.5	4.3	-1.3	1.0
- Private consumption	-13.2	6.2	4.7	-1.0	0.7
- Fixed Investment	-10.5	5.6	5.7	1.6	1.6
Inflation	0.9	2.6	9.1	6.7	1.9
- Core inflation	1.4	2.3	6.0	5.4	2.3
Unemployment rate (%)	4.6	4.5	3.7	4.3	4.8
Budget balance (% GDP)	-13.1	-8.1	-6.6	-6.5	-3.7
Government debt (% GDP)	98.9	101.5	99.5	103.2	104.2
Interest and exchange rates (eop)					
Bank of England Bank Rate	0.10	0.25	3.50	3.50	2.00
GBP/USD	1.37	1.35	1.15	1.20	1.27
EUR/GBP	0.89	0.84	0.87	0.90	0.88

Key forecasts for China

	2020	2021	2022e	2023e	2024e
Economic outlook (% yoy)					
GDP	2.2	8.1	3.0	4.8	5.2
CPI inflation	2.5	0.9	2.1	2.5	2.5
Unemployment rate (urban areas), %	5.6	5.1	5.6	5.2	5.0
Interest and exchange rates (eop)					
1-Year Loan Prime Rate	3.85	3.80	3.65	3.60	3.60
USD/CNY	6.54	6.37	7.00	6.70	6.50
EUR/CNY	8.00	7.24	7.35	7.24	7.28

Source: ABN AMRO Group Economics

Key views on a page

The energy crisis in Europe is tipping the eurozone and UK economies into recession, with the US entering a more moderate downturn. Consumption is being weighed by the biggest fall in real incomes in decades, housing markets are correcting on the back of the surge in mortgage rates, and industry is being hampered by sky-high energy prices. Governments are stepping in to help households and businesses, but high inflation means that central banks may need to tighten monetary policy even further to offset this. Upside inflation risks mean the Fed, ECB and BoE are in any case likely to continue raising rates at coming meetings, and as we enter the downturn, this raises the risk that recessions are worse than we currently expect. By late 2023, falling inflation and economic weakness are likely to drive rate cuts, but the recovery is expected to be tepid.

Macro	Central Banks & Markets
Eurozone – Soaring food and energy prices and rapidly tightening financial conditions have pushed the economy into recession. We have pencilled in contractions in GDP in 2022Q4 and also in 2023Q1-Q2. A modest recovery is expected in 2023H2. Inflation reached a new record high level of 10.6% in October, but eased to 10.0% in November. It should fall noticeably in coming months, mainly on the back of lower food and energy price inflation. Core inflation will be more sticky, but should also decline in the course of 2023. Wage growth is expected to pick up, but remain contained as the employment outlook worsens.	**ECB** – Following the two consecutive 75bp rate hikes in September and October, we expect a 50bp step in December. We expect another 50bp of hikes in 2023Q1. By then, the economy will be in recession and unemployment will be rising, allowing the ECB to pause. Subsequently, we expect the need for a restrictive policy stance to end in 2023Q4, when we expect 50bp of rate cuts. This would bring the deposit rate back to 2% - the estimated level of the neutral rate. The risks to our forecast for ECB policy are skewed to more rate hikes in the 3-6 month horizon.
Netherlands – The energy crisis has caused record high inflation, and an unfolding recession. 2022 Q3 GDP growth was already negative, primarily driven by investment. We expect 2022Q4 and 2023Q1 GDP growth to be negative as inflation weighs on domestic consumption, and weakening activity in the eurozone does not bode well for external demand. From 2023 Q2 onwards growth will return, supported in part by generous government support such as the price cap on energy, which dampens the real income shock, and above trend wage growth. 2024 growth is likely to be below trend as headwinds and constraints persist.	**Fed** – Given the persistent risk of high inflation becoming entrenched in the US, we expect the Fed to hike rates a further 50bp in December, and 25bp hikes in February and March, with the upper bound of the fed funds rate to peak at 5%. Subsequently, we expect the Fed to pause, assuming inflation continues moving lower and the labour market deteriorates. The risk to near-term rates is still to the upside. A higher near-term policy rate means a higher risk of over-tightening, and we expect significant rate cuts in late 2023. In the background, the Fed continues to unwind its balance sheet at a $95bn monthly pace.
UK – The new government has staved off a potential crisis, but it cannot prevent a recession. While the Energy Price Guarantee will soften the blow to household real incomes, the tax burden is set to rise significantly over the coming year. Demand has already weakened on the back of record low consumer confidence, and tightening fiscal policy will compound the impact of monetary tightening and the energy crisis. We expect a year-long recession, and despite weak demand, there is a continued risk of a wage-price spiral due to a structural shortage of workers.	**Bank of England** – The growing risk of a wage-price spiral in the UK led the MPC to hike rates by 75bp at the November meeting. We now expect a 50bp hike in December, with Bank Rate to peak at 4% in early 2023. Fiscal policy U-turns have significantly reduced the risk of more aggressive rate hikes, and market pricing for Bank Rate is now much closer to our own expectations. We expect the BoE to reverse course in late 2023 and start cutting rates, given expected falls in inflation and likely a very weak economy at that point.
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 expected to exert a powerful drag on consumption. Investment is also expected to remain weak. 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 next year. Inflation is expected to fall significantly in 2023 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 have peaked. The recession will weigh on EU rates in 2023 with the 10y Bund yield dropping as low as 1.35% in Q2 2023. A similar path is expected for US rates. We expect the Treasury yield curve to stay inverted until H2 2023, which is later than our expectation for the Bund curve (Q1 23). Both yields curves are expected to bear-steepen in the second half of next year on the back of monetary easing, with 125bp and 50bp in rate cuts pencilled in for the Fed and ECB rates respectively.
China – Unprecedented protests in November have triggered central and local authorities to speed up the exit from Zero-Covid. Given remaining public health challenges, this could prove a bumpy ride, with a disorderly outcome leading to renewed disruptions. Meanwhile, Beijing has doubled down on property support, but it may take time to restore trust and revive property sales. All in all, growth should profit from these major policy shifts, although some downside risks remain. We expect annual growth to pick up from 3.0% in 2022, to 4.8% in 2023, and 5.2% in 2024.	**FX** – In recent weeks, the US dollar has declined across the board. The long term uptrend of the US dollar has come to an end in most major currency pairs including in EUR/USD. We expect US dollar weakness to continue because of our view of more aggressive rate cuts by the Fed in the second half of 2023 than by other central banks. We also expect rate cuts by the Bank of England and the ECB in the second half of 2023, but the total amount of cuts will likely be less than the Fed. Our forecast for EUR/USD for the end of 2023 stands at 1.08.

Main economic/financial forecasts									
GDP growth (% yoy)	**2021**	**2022e**	**2023e**	**2024e**	**Inflation (%)**	**2021**	**2022e**	**2023e**	**2024e**
United States	5.9	1.9	0.5	2.0	United States	4.7	8.1	3.8	2.2
Eurozone	5.3	3.2	-0.9	1.2	Eurozone	2.6	8.5	5.1	2.2
Japan	2.2	1.3	1.5	1.2	Japan	-0.2	2.4	1.7	1.0
United Kingdkom	7.5	4.3	-1.3	1.0	United Kingdkom	2.6	9.1	6.6	2.0
China	8.1	3.0	4.8	5.2	China	0.9	2.1	2.5	2.5
Netherlands	4.9	4.2	0.5	1.2	Netherlands	2.8	11.6	4.3	4.0
Policy rate	**8-12-2022**	**+3M**	**2023e**	**2024e**	**10Y interest rate**	**8-12-2022**	**+3M**	**2023e**	**2024e**
Federal Reserve	4.00	5.00	3.75	2.50	US Treasury	3.49	3.75	3.00	2.75
European Central Bank	1.50	2.50	2.00	1.50	German Bund	1.82	1.65	1.50	1.65
Bank of Japan	-0.10	-0.10	0.00	0.00	Japanese gov. bonds	0.25	0.25	0.32	0.50
Bank of England	3.00	4.00	3.50	2.00	UK gilts	3.09	3.25	2.60	2.20
People's Bank of China	3.65	3.60	3.60	3.60					
Natural resources	**8-12-2022**	**+3M**	**2023e**	**2024e**	**Currencies**	**8-12-2022**	**+3M**	**2023e**	**2024e**
Brent - Oil USD/barrel	77.2	90	110	100	EUR/USD	1.05	1.02	1.08	1.12
WTI - Oil USD/barrel	72.0	85	105	95	USD/JPY	136.7	136	132	125
Henry Hub - Gas USD/mmB	5.72	6.0	6.5	5.0	GBP/USD	1.22	1.16	1.20	1.27
TTF - Gas EUR/MWh*	147.9	150	130	100	EUR/GBP	0.86	0.88	0.90	0.88
Gold - USD/oz	1,786	1,700	1,900	1,950	USD/CNY	6.97	7.00	6.70	6.50

Source: Refinitiv, Bloomberg, ABN AMRO Group Economics * Brent, WTI, Henry Hub: active month contract; TTF: next calender year

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