Group Economics | 20 May 2022

Global Monthly

Macro Research Team abn.amro.group.economics@nl.abnamro.com Bill Diviney: +31-6-4778-4657

Recession risk: How big is it?

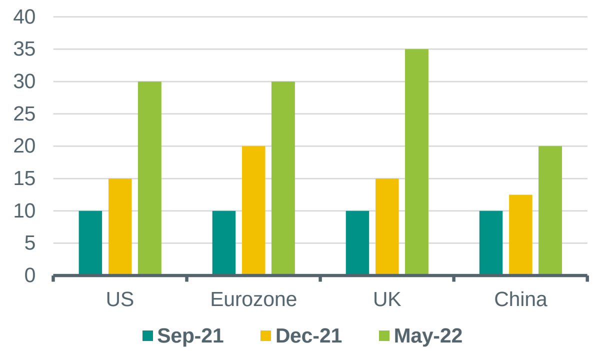
- **The risk of recession is arguably now the highest it has been since the start of the pandemic in 2020**
- **Inflation, the biggest fall in real incomes in decades, and central bank rate rises pose the biggest risk, with a potential Russian gas cut-off and China lockdowns adding to this**
- **The massive accumulation of excess savings during the pandemic, and significant services recovery potential, are crucial offsets. But they may not be sufficient to prevent growth going into reverse**
- **Regional updates: Increasing ECB worry over inflation in the *eurozone* means a rate hike looks likely in July. In the *Netherlands*, growth is expected to rebound in Q2 following a weak first quarter**
- **In *the US*, a surge in services inflation is piling pressure on the Fed to raise rates aggressively**
- **In *China*, the trade-off between pandemic control and safeguarding growth is hardening**

Global View: Recession risks are mounting

The cascade of shocks hitting the global economy has been relentless over the past half year. In advanced economies, the inflation shock is driving the biggest decline in real incomes for decades, while the monetary policy response of higher interest rates is adding to the squeeze on consumers and dampening business activity. Against this background, the war in Ukraine and unexpectedly prolonged and strict lockdowns in China have intensified the upside risks to inflation, and in turn interest rates. They also pose their own unique threats to global growth, with the ever-present risk of a cut-off in Russian gas supplies to Europe, and the risk of prolonged supply and demand shocks in China creating yet more turmoil for global supply chains. In the face of such threats, it would seem understandable for economists to forecast a global recession. We do not, at least not for now. Why is this? And how big is the risk of a recession over the coming year? The short answer is that there are crucial cushioning factors that should, with some luck, get the global economy through to the other side. These include the massive build-up of excess savings during the pandemic, strong labour markets, and a services sector that – for the most part – still has significant recovery potential. However, as we explain in this month's *Global View*, even these offsets might not be enough to keep global growth on track, and we now judge the risk of a new recession to be the highest it has been since the start of the pandemic.

Global recession risk is on the rise…

Probability of recession in the next 12 months, % (Bloomberg consensus)



Source: Bloomberg, ABN AMRO Group Economics

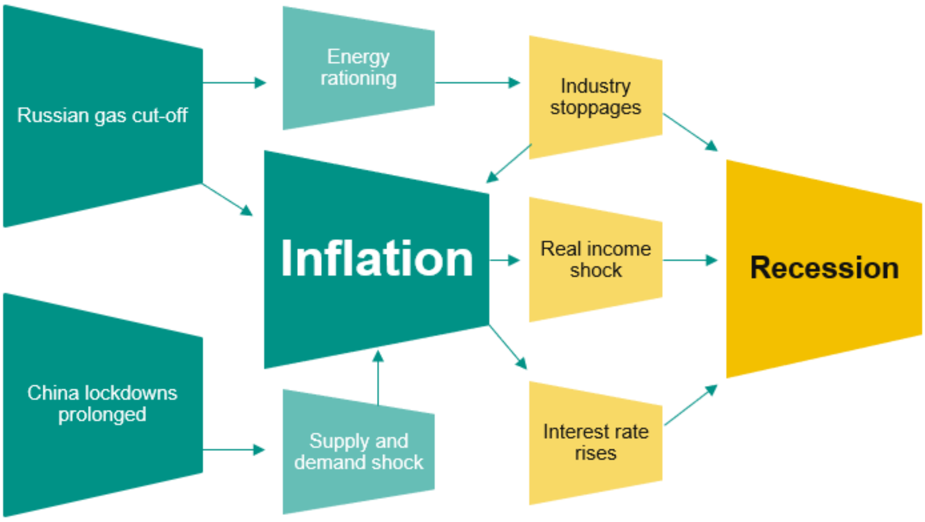
…as bottlenecks worsen again

Index (+6 = maximum bottlenecks)

Source: ABN AMRO Group Economics, Bloomberg, Refinitiv

Recession Watch: Three key risks, and three crucial cushioning factors

Broadly, we divide recession risk into three buckets, which we describe in more detail below: 1. A Russian gas supply cut-off to Europe; 2. China lockdowns becoming more prolonged; 3. Inflation becomes an even bigger problem. This can by itself trigger a downturn via the hit to real incomes, or alternatively, this process is helped along by central banks in their attempts to return inflation back to target. (Note, the first two risks could feed into this third one). In the below schema, we illustrate how each of these recession risks interact, and the various pathways to a recession. These pathways are not set in stone; they are only meant to illustrate the various ways a recession *could* happen.



Risk #1: Russia cuts off the gas (35-40% probability)

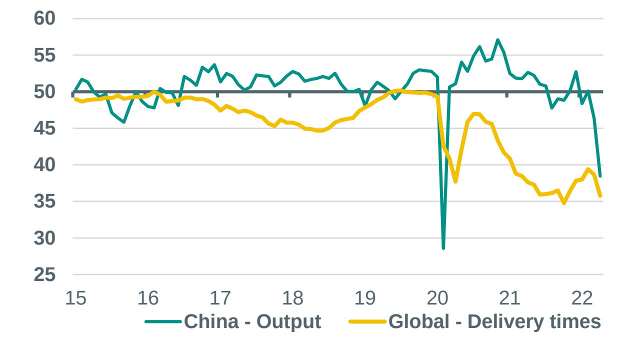
We start with arguably the biggest looming threat to the outlook – at least for Europe – which is the ongoing risk of an abrupt halt in Russian gas supplies. We analysed this risk in more detail in our March *Global Monthly*, but we judge this risk to have risen materially since then, from around a 25% probability to a 35-40% probability. In late April, Russia halted gas supplies to Poland and Bulgaria after these countries refused to settle gas payments in roubles. More recently, Russia halted gas supplies to Finland following its application to NATO. Currently, the risk of a broader stoppage rests largely on whether energy suppliers in other European countries would breach EU sanctions by complying with Russian demands to pay for gas in roubles. The European Commission has sent mixed messages on this topic, while Italian premier Draghi has said that the issue of sanctions compliance is up to member states to enforce. Ultimately, the issue is a political one, as the EU could agree on clarifications to sanction rules that enable continued purchases of Russian gas. In the meantime, the risk remains that other EU countries receive similar treatment to Poland and Bulgaria. Alongside this risk, the EU's proposed embargo on Russian oil – yet to come into force due to Hungarian opposition – could also trigger a retaliatory Russian block of gas exports, something Russian deputy premier Novak suggested in March. All told, while still not our base case, we see a significantly higher risk of a Russian gas cut-off. We judge that this by itself would likely trigger a recession in the eurozone and the UK, with further price spikes in energy and spillover effects to other goods adding to the real income shocks we already see, and energy shortages leading to government enforced rationing and industry stoppages. Such a decline in activity in Europe would naturally have spillovers to the global economy, raising recession risk elsewhere.

Risk #2: China lockdowns become more prolonged (25% probability)

A large swathe of China, covering approximately one quarter of the population as of mid-April, has been under some form of lockdown. While lockdown intensity varies significantly per city, and the overall intensity has declined somewhat of late, the impact is already becoming evident in the macro data. To start with the supply side, as analysed in our April *Global Monthly*, the broadening of lockdowns in March/April caused shortages of supplies and disruptions in production, alongside problems in truck transport and port congestion, particularly around Shanghai. This is also visible in recent macro indicators. The output and delivery times subindices of China's manufacturing PMIs dropped sharply in March/April, while China's industrial production contracted by 2.9% yoy and 7.1% mom in April. All of this is having a clear impact on global supply chains, with for instance global delivery times lengthening and a lack of materials and equipment hurting industrial production in the eurozone. Indeed, in the European Commission's Q2 survey of industrial companies, 52% of all companies reported that activity was limited by shortages of materials and/or equipment. These problems were probably aggravated by the drop in production in China in April, as China is by far the biggest single supplier of intermediate goods and machinery imports to Europe (see figure below). After easing somewhat in late 2021, our global supply bottlenecks indicator has risen again in recent months, driven largely by falling Chinese output relative to developed economy demand.

Supply bottlenecks in China add to longer delivery times

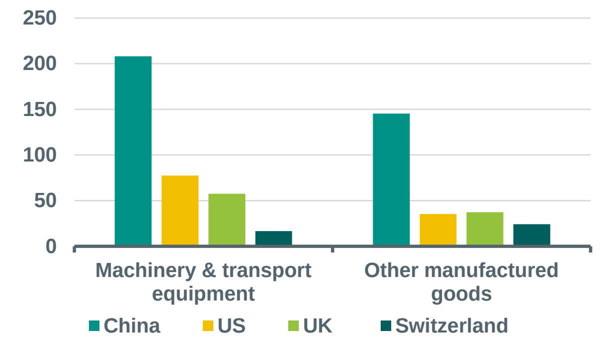
PMI subindices (China: Caixin)



Source: Refinitiv

China the main supplier of EU industrial goods

EU imports from… (EUR bn)



Source: ABN AMRO Group Economics, Bloomberg, Refinitiv

Chinese lockdowns also add to global recession risks from the demand side. All demand indicators (PMI order components, retail sales, property sales, imports, fixed investment) were very weak in April. Consumer confidence has deteriorated and the unemployment rate in urban areas (6.1%) is almost back to the peak seen just after the initial Covid-19 shock in Q1-2020. While a technical recession by the strict definition (two consecutive quarters of negative qoq growth) is not very likely, given that China is still an emerging, high growth economy, the economic indicators for April can be described as 'recession-like'.

Looking ahead, our base case assumes a gradual reopening of the Chinese economy (see Box p4), and government measures to alleviate bottlenecks in domestic transport and production. We also expect demand conditions to gradually improve compared to the trough seen in April, partly reflecting the further stepping up of targeted fiscal stimulus, monetary easing and a cautious relaxation in macroprudential policies including for real estate. As such, we expect growth momentum to improve in the second half of this year, although our 2022 growth forecast of 4.7% is almost 1pp below Beijing's 5.5% growth target. Meanwhile, there is a significant risk that strict lockdowns lead to more prolonged disruptions to both supply and demand in China. This would keep delivery times in global supply chains high for longer, with further upward pressure on industrial goods' prices. Chinese growth is estimated to be even lower (3.5-4.0%), adding to global recession risks from the demand side. That said, weaker Chinese growth would likely have a moderately downward impact on energy and other commodity prices, offseting upward effects on industrial goods' prices.

Risk #3: Inflation hit to incomes/interest rate shock drives fall in consumption (30-40% probability)

The first two risks outlined feed into the much broader problem of inflation, which even without these risks crystalising, could by itself push advanced economies into recession. Across developed economies, real incomes are falling at their fastest pace in decades, although the problem is more acute in the eurozone and the UK where the difference between inflation rates and wage growth is most stark: in the US, inflation is running around 3pp higher than wage growth, while in the UK and eurozone that difference is nearer 5pp. This reflects the fact that inflation is still largely an imported problem in Europe; put another way, Europe is facing a large negative terms of trade shock via the surge in gas prices. The bigger scale of the shock in Europe is one of the reasons we expect less aggressive rate hikes by the ECB and Bank of England compared to the Fed. However, negative real income growth will ultimately act as a dampener on consumption on both sides of the Atlantic – notwithstanding the various cushioning factors that we describe below – and this could by itself push the economy into recession.

Central banks could deliberately – or accidentally – cause a recession

At the same time, central banks are beginning to step on the brakes in an attempt to lower the risk of inflation becoming more entrenched, with the Fed and Bank of England having already raised interest rates in recent months, and the ECB expected to begin raising its policy rates in July. This is feeding through to a significant tightening of financial conditions, with equity markets falling, and bond yields and mortgage rates rising. All of this puts yet further pressure on household incomes and business activity, through negative wealth effects and higher borrowing costs. The risks here are twofold. The first is that cooling growth might not be enough to keep inflation expectations well-anchored, meaning that central banks have to step harder on the brakes to *deliberately* trigger a recession. Fed Chair Powell has repeatedly flagged this risk, by emphasising the priority the central bank places on achieving price stability. The second risk is of a policy mistake. Interest rate changes are a blunt instrument that affect the economy with 'long and variable lags', as Milton Friedman once famously said, and as a result, central bankers are to some degree flying blind. In other words, it will be difficult to know when they have reached the sweet spot of keeping inflation expectations well anchored, while minimising damage to the economy. The risk then is that central banks over-tighten, *accidentally* causing a recession.

Box: Will China stick to its strict Covid-19 stance? – Three scenarios

Beijing continues to pledge vigilance on the pandemic front

Last year, following the Delta outbreak, China tweaked its Covid-19 policy from a centralised "zero tolerance" to a decentralised "dynamic clearing". That meant that outbreaks were met with strict containment measures at the very local level, reducing the overall macroeconomic fallout. However, with the spread of the more highly contagious Omicron variant, this approach has become more difficult to maintain, illustrated by rising cases and a broadening of lockdowns in March/April. The central government has so far continued with pledging vigilance on the pandemic front, and pandemic policies seem to have been politicised. The CCP – who has profiled itself as a 'global champion of pandemic control' pointing to low mortality rates – looks reluctant to fundamentally ease Covid-19 policy at this stage. The reasoning is that relaxation may result in hospital capacity issues and a rising death toll in the run-up to the National Party Congress in November. While the overall vaccination rate has been ramped up, the elderly are lagging behind: just over 50% of the Chinese older than 80 years has received two doses and less than 20% has received a booster. The central government's hawkish stance is also affecting local governments, who are implementing restrictions at early stages of the pandemic; developments in large cities such as Xi'an and Shanghai have shown that dynamic clearing is not working if measures are taken too late.

The future of China's Covid-19 stance: three scenarios

China's nationwide lockdown intensity has started to ease somewhat in recent weeks, despite ongoing struggles in e.g. Shanghai and Beijing. In our base case, we expect a gradual reopening going forward, within the framework of 'dynamic clearing'. Given recent statements by the central government, we do not expect a fundamental easing of Covid-19 policy at short notice, nor a fast reopening, although some tweaking may be on the cards should the vaccination rate of the elderly population be significantly lifted. On the macro policy front, we anticipate a further stepping up of targeted fiscal support, piecemeal monetary easing and a cautious relaxation of macroprudential regulation including for real estate.

As uncertainty regarding pandemic developments in China and Covid-19policy remains high, with risks still tilted to the downside, we look at alternative scenarios as well. In a negative scenario, Omicron flare-ups in China combined with ongoing strict Covid-19 policies result in the overall lockdown intensity staying at relatively high levels. In a positive scenario, a re-allocation of public resources towards ramping up vaccination of the elderly population – combined with other measures to prevent an overburdening of the health system –facilitates a more rapid, fundamental easing of China's Covid-19 stance, similar to what has happened in other Asian countries.

China and zero Covid-19 policy: three scenarios

	Base case *Gradual reopening under dynamic clearing* ±60%	Negative scenario *Lockdown intensity remains high in 2022* ±25%	Positive scenario *Broader easing of covid-19 policy* ±15%
China: GDP growth 2022	4.7%	3.5-4.0%	±5.5%
China: Macro policy response	- Targeted fiscal stimulus - Piecemeal monetary easing - Relaxation macroprudential regulation incl. for real estate	More stimulus	Less stimulus
Global: Delivery times	Gradual improvement	Deterioration	Stronger improvement
Global: Industrial goods' prices	Moderately downward impact	Upward impact	Downward impact
Global: Energy/metal prices	Upward impact	Moderately downward impact	Strong upward impact

Source: ABN AMRO Group Economics

Excess savings, post-pandemic rebound, and fiscal policy are buffers against recession risk

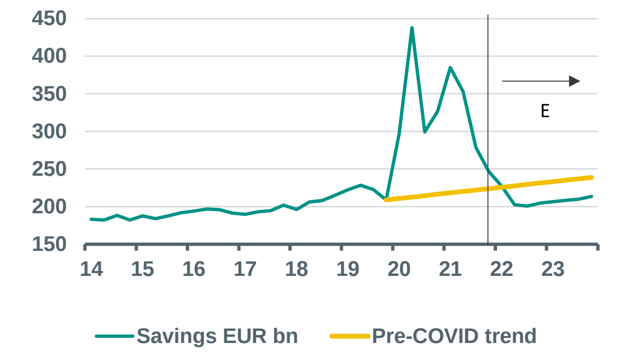
So far we have outlined the major risks facing the global economy, but there are also a number of offsetting factors that – in our base case – will prevent economies from sliding into a recession. These cushions are so crucial, that in their absence we likely would already forecast a recession on the back of the inflation shock to real incomes alone. Although these cushioning factors give some cause for comfort, we emphasise that our conviction level is no longer as strong that these will be sufficient to offset the growth risks.

Cushion #1: Excess savings and confidence in job prospects

The most important, and most cited reason to expect consumption to continue growing despite real income falls, is the significant build-up in excess savings through the pandemic. On both sides of the Atlantic, savings rates surged during lockdown periods, largely because consumers were unable to spend on services in the way they would normally, although in the US this was accentuated by fiscal stimulus that overcompensated for income losses. In the eurozone, around EUR 880bn in excess savings built up between the start of the pandemic and the end of 2021, which is equal to around 14% of 2021 consumption expenditure by households (in the US, the equivalent figure was $2.4tn, or 15.2% of 2021 spending). Some of this excess has begun to decline, with savings rates dropping back below trend, particularly as inflation began to pick up in the latter half of 2021. However, the bulk of it remains, suggesting there is still considerable room for consumers to compensate for the hit from inflation to real incomes.

EZ stock of excess savings expected to decline

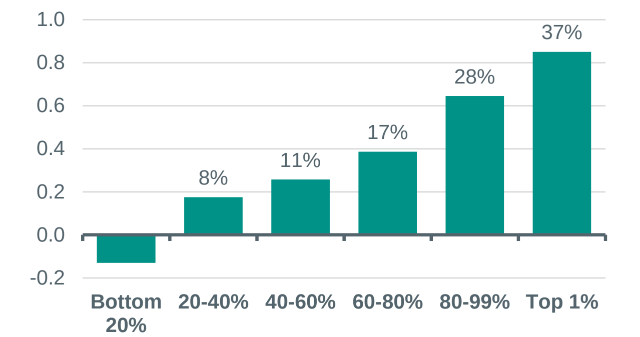
EUR bn



Source: Bloomberg, ABN AMRO Group Economics

Savings distribution skewed heavily to high earners

US excess savings distribution per income quintile, USD tn.



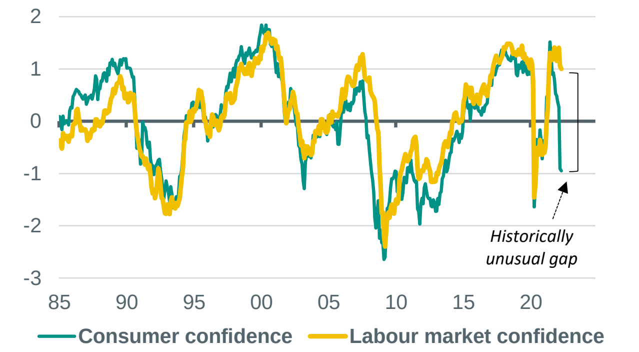
Note: Percentages refer to share of excess savings going to each group
Source: Federal Reserve, ABN AMRO Group Economics

How long can this buffer last? Perhaps a few quarters, on our estimates. ECB data shows that about half of the excess in eurozone household savings is held in liquid cash and bank deposits, meaning it is readily available to spend, but the data also shows that the accumulation of savings is concentrated among higher-income households. For instance, households in the top 10% of the income distribution accounted for around half of the total rise in deposit flows between the start of the pandemic and mid-2021. The distribution is even more extreme in the US, with nearly 40% of excess savings accruing to the top 1% of earners, and the bottom 20% actually seeing a net *decline* in savings. Higher income households are in any case not liquidity constrained, so there would not be the same need to dip into savings to maintain consumption growth as for lower income groups. The lowest income groups have very limited (if any) savings buffer to offset the real income hit. This leaves the middle income groups, and it is they who we expect to make the most use of the excess savings buffer in dealing with inflation. Assuming a further decline in savings rates to near historic lows, we think aggregate consumption growth can continue to withstand the inflation hit for much of 2022, but that this buffer will be heavily depleted as we move into 2023. For the eurozone specifically, this estimate is based on assumed disposable income growth of 3-3.5% in both 2022 and 2023, and our expectation for inflation to fall back next year.

Another key assumption for households to utilise these excess savings is their continued confidence in job prospects. Historically, consumer confidence strongly influences saving habits; the more confident people are in the future, the more willing they are to spend rather than save. While consumer confidence overall has plummeted over the past few months, this fall has been historically unusual in that it has been almost entirely driven by inflation, with worries about unemployment still at very low levels. This is consistent with the tight labour markets we are seeing across developed economies. Our base case assumes that labour markets will remain tight. In the eurozone we continue to expect falls in the unemployment rate. In the US, we expect unemployment to start rising later this year, as interest rate rises begin to weigh on demand for labour, but we do not expect a surge in unemployment such that it significantly weighs on consumer confidence. With that said, there are risks to this view, and should employment prospects darken, this would also reduce the degree to which consumers deploy excess savings to maintain consumption growth.

Confidence has plunged, but still high for labour market

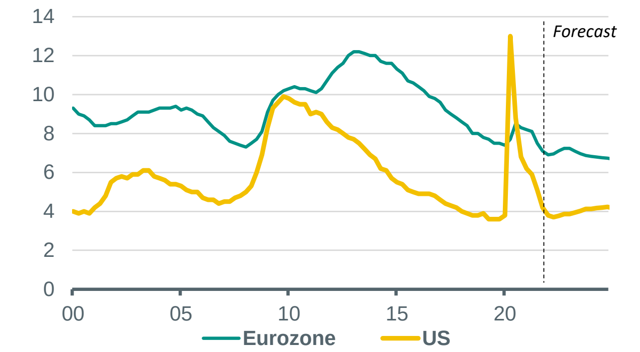
Consumer confidence, eurozone & US standardised average



Source: Refinitiv, ABN AMRO Group Economics

We expect labour markets to stay tight

Unemployment rate, %



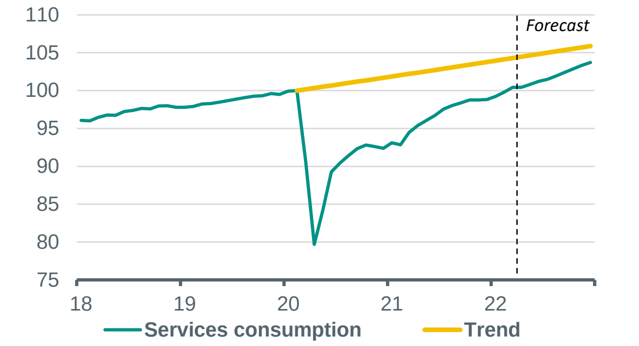
Source: Refinitiv, ABN AMRO Group Economics

Cushion #2: Catch-ups in services demand and industry supply

One of the lingering effects of the pandemic is the continued shortfall in services consumption, and in industrial output relative to demand. The flipside of this is that there remains significant potential for rebound in these areas, and we expect the recovery trend we have seen so far to continue. On services demand, we estimate consumption is currently around 3.7pp below trend in the US, and perhaps double that amount in the eurozone. The shortfall – and therefore recovery potential, particularly in leisure and travel services – is greater in the eurozone due to the recurrent lockdowns throughout the pandemic (in the US, there were no further widespread lockdowns following the early 2020 episode). The services recovery should be significant tailwind for growth given that services makes up the bulk (60-70%) of private consumption. Even in the US, where the impact of the services recovery will be partly offset by an expected decline in goods consumption from above-trend levels, total consumption growth should remain positive. Following the expected rebound in consumption in Q2-Q3 in the eurozone, we expect growth to slow, as most (deployable) excess savings will have been spent by then. Still, consumption should continue to grow solidly next year, as employment is expected to expand and the gap between inflation and wage growth should diminish. In the US, in contrast, we expect consumption growth to fall below trend next year, as much tighter monetary policy leads to a modest rise in unemployment.

Still significant room for services recovery

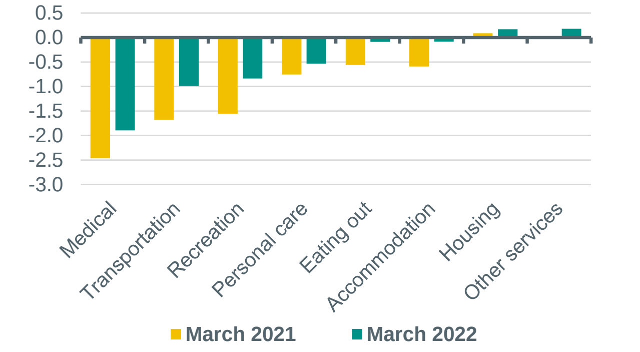
US services consumption vs pre-pandemic trend, Feb 2020 = 100



Source: Refinitiv, ABN AMRO Group Economics

Contributions to services shortfall

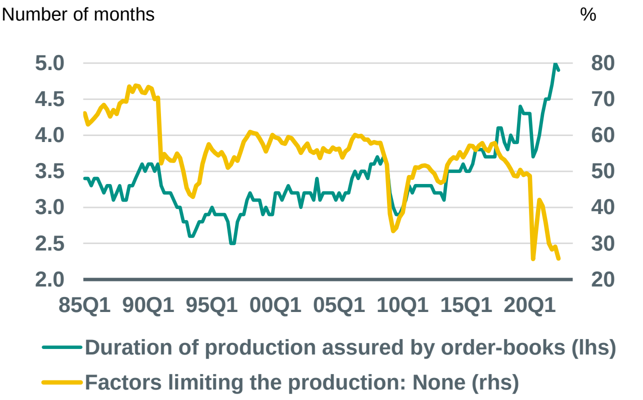
Percentage point contributions to US services consumption shortfalls vs trend



Source: Refinitiv, ABN AMRO Group Economics

Industry is also likely to make a positive contribution to growth in H2 2022, as despite signs of cooling goods demand, there remain large backlogs of orders that will continue to support activity over the coming quarters. This backlog has been due to supply chain bottlenecks and shortages of labour, bottlenecks that we expect to ease as a base case in the course of the year. The European Commission's recent survey of eurozone industrial companies showed that the volume of order books had reached the equivalent of 5 months of production in Q2 (see graph), which is the highest level since the start of the series in 1985. At the same time, the share of companies reporting that the level of production was not limited by any factors (eg. shortage of material and/or equipment or shortage of labour) dropped to an all-time low of 26. All told, in both the US and the eurozone, we expect industrial production and investment in machinery and equipment to bounce back as bottlenecks ease. However, subsequently, we expect the industrial sector and fixed investment growth to lose momentum again next year, as the global economy and world trade are expected to slow.

Industrial sector to rebound when bottlenecks ease



Source: European Commission, ABN AMRO Group Economics

Cushion #3: Fiscal policy is helping in Europe, but not in the US

Although fiscal policy is unlikely to be anywhere near as active a support for growth as it was during the pandemic, we have still seen significant moves by governments in Europe to limit the fallout from the surge in energy prices. This has largely taken the form of tax cuts to energy and cash handouts to lower income households struggling to keep up with energy bill payments. While not as generous as the support we saw during the pandemic, this is still an important offset to the hit to real incomes. According to recent reports in the press, the European Commission is likely to propose soon that the suspension of the EU rules for government finances will be extended in 2023. In the US, however, fiscal authorities have been much more cautious, given that the inflation there has been more domestically-driven, while a consensus has grown among politicians that excessive stimulus during the pandemic was likely one of the causes of the current surge in inflation. Given this, we see very little prospect for the government to offer even piecemeal support for households in dealing with inflation. Instead, government efforts have been focused on relieving supply-side bottlenecks, including efforts to relieve port congestion, and the release of strategic petroleum reserves as a means of capping gasoline prices.

Conclusion

The current macro-economic environment is highly unusual. With an income shock of the magnitude we are seeing, we would typically forecast a recession right now. The significant cushioning factors we have outlined are a major offset that prevent us from doing so at this stage. However, if the risk factors we have outlined crystalise – for instance, if Russia were indeed to cut off gas supplies to Europe – even these cushioning factors would be insufficient to prevent advanced economies from sliding into a recession. (Bill Diviney, Aline Schuilling, Arjen van Dijkhuizen)

Eurozone: Growth to slow after temporary pick up

Aline Schuiling – Senior Economist | aline.schuiling@nl.abnamro.com

- **After a weak start of the year, GDP growth should pick up somewhat in the next few quarters, but slow down again moving into 2023**
- **Further rises in inflation(-expectations) have raised the sense of urgency at the ECB to hike policy rates soon. We still expect a pause after the first two rate hikes as the economy slows down**

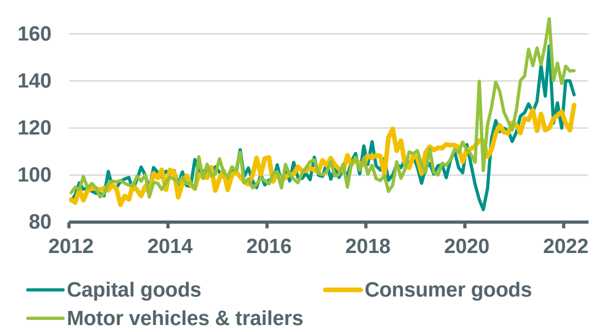
Eurozone GDP expanded by 0.3% qoq in 2022Q1. The details have not yet been published but it seems that a major factor behind the expansion in GDP was a rebound in the part of the services sector that had been in lockdown during winter. In contrast, consumption of goods probably contracted in Q1, with retail sales and new car registrations combined falling by more than 1% qoq in Q1. Serious shortages in supply seem to have been the main factor behind the drop in goods consumption. Indeed, the gap between orders and production for German consumer goods has soared to historically high levels (see graph). The gap between orders and production of capital goods suggests that similar supply shortages probably also weighed on fixed investment growth in Q1. Although the falls in consumer and producer confidence since the start of the war in Ukraine should limit growth in consumption and investment spending, we do not expect this weakness to show up in the actual growth numbers until around the end of the year. First, the easing of supply chain bottlenecks should result in a temporary bounce in production and spending in the second half of this year. As mentioned in this month's *Global View*, we expect consumers to spend part of the excess savings that they have accumulated during the pandemic, which means that the volume of consumption should continue to expand despite the high level of inflation. Moving into 2023, we expect GDP growth to slow to somewhat below the trend rate, as the temporary catch-up effects fade. In addition, we expect global growth to slow due to policy tightening by the main central banks, including the ECB.

Inflation stabilised at 7.4% in April. The rise continued to be driven by energy and food prices (see graph below). Moreover, core inflation was lifted by the post-COVID normalisation of holiday and leisure prices, and the pass-through of high energy inflation into transportation services. Finally, supply chain disruptions have raised the prices of industrial goods. Inflation is expected to remain elevated for a considerable time, but it should drop lower next year as the impact of past rises in energy prices dissipates. We expect inflation to be close to the ECB's 2% target by the end of 2023. The expected slowdown in growth implies that underlying inflationary pressures should remain contained.

The sense of urgency at the ECB to hike interest rates has however increased. We now expect a first 25bp rate hike in July and another in September. Although the risks are skewed toward a further rise in December, we have not pencilled in any rate hikes in the months beyond September. This is because we remain of the view that the window for rate hikes will close around the turn of the year. This mainly reflects that the hit to economic growth will increasingly become visible in the data, and we expect a weak outlook for 2023. In addition, the US Fed's rate hike cycle will probably also come to an end around the end of the year, which will ease downward pressure on the euro. Finally, we think headline inflation will be on a significant downward trend from early next year.

Supply shortages restrain spending

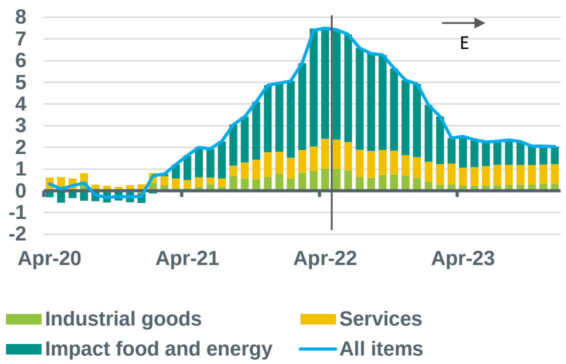
Germany: Ratio of industrial orders to industrial production, index, 2015 = 100



Source: Refinitiv, ABN AMRO Group Economics

Contributions to HICP inflation

pps yoy



Source: Refinitiv, ABN AMRO Group Economics

The Netherlands: Growth to pick up before inflation starts to bite

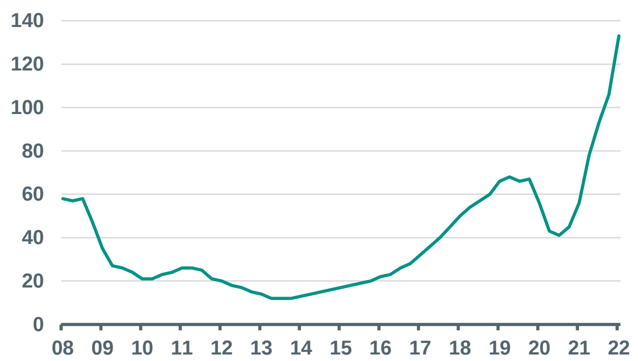
Jan-Paul van de Kerke – Economist | Jan-Paul.van.de.kerke@nl.abnamro.com

- **Growth was flat in Q1 but is expected to pickup in the second quarter**
- **Inflation in 2023 is expected to cool but stay elevated on the back of high energy prices**

The lockdown and the winddown of public Covid spending weighs on growth in the first quarter
Last Tuesday's Q1 GDP report showed a flat quarter compared to 4Q21. Despite headline GDP not moving, the subcomponents painted a different picture. Consumption – both private and public – declined. For government consumption (-4% qoq) this was anticipated. The ramping up of testing and vaccination capacity during the pandemic has boosted public spending. Now that more than 70% of the population is vaccinated and new infections are low this capacity has been wound down. Lower government consumption weighed heavily on growth (-1 pp). Private consumption also disappointed (-0.1% qoq), reflecting the lockdown in January and part of February, still, we expect the rebound in the remainder of the quarter to be stronger. On the upside, investment continued to expand, continuing a trend from 4Q2021. Investment has been lagging GDP growth since mid-2021 when supply-chain issues materialised. The same issues and the war in Ukraine have also contributed to a decline in exports (-0.5% qoq), while the details showed a rebalancing in export composition. Goods exports declined but services exports, which had been lagging behind through the pandemic, continued their catch-up.

Labour market tightness is a support for consumption

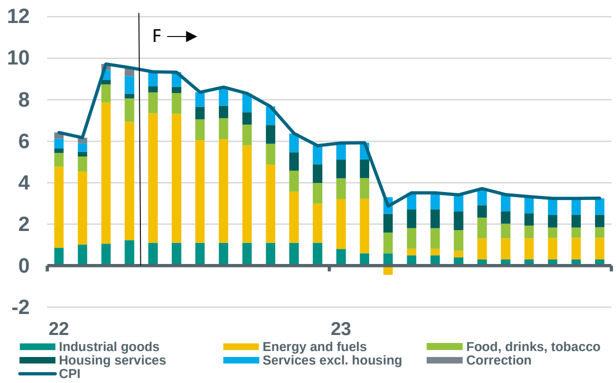
Vacancies per 100 unemployed.



Source: CBS, ABN AMRO Group Economics

Elevated energy prices until 2023 push up Inflation

Contributions to cpi inflation.



Source: CBS, ABN AMRO Group Economics

We expect a stronger second quarter before inflation starts to bite
As we expect a further recovery in global trade in the year ahead, Dutch exports should follow suit. In particular, the export of services is expected to normalise, boosting total exports in the near term. As for private consumption, our own transaction data point towards solid consumption growth in April and in the first weeks of May. We expect an expansion of private consumption in the second quarter. Services also plays a pivotal role here. Lockdowns left services consumption below trend. A further rebalancing in the composition of consumption is expected to drive consumption growth in the coming months. There are a number of other factors supporting domestic demand in the near term. Firstly, the significant stock of excess savings acts as an initial shield to price rises; secondly most households are currently not yet affected by energy price inflation as roughly 50% of Dutch households have longer term energy contracts with fixed prices. Thirdly, the tight labour market acts as a backstop for consumption. Indeed, most recent figures showed a new tightness record being set in the Dutch labour market: in 1Q22 there were 133 vacancies for every person unemployed, the highest on record.
All of this does not mean inflation will not affect growth. In the second half of 2022, as inflation broadens and more households become exposed to higher energy prices, we expect consumption to slow significantly. Similar to the broader eurozone, we currently do not expect a recession, however, and forecast 2022 growth at 3% and 1.3% in 2023.

The broadening of inflation and elevated energy prices cause inflation to stay high until the end of 2023
We expect CPI inflation to average 8% in 2022 and 3.8% in 2023. A major driver of this is elevated energy prices until the end of 2023, as the war leads to continued upward price pressure. Sustained elevated energy prices also adds fuel to second round effects, as more businesses pass-on higher energy and input prices to customers. The increase in core inflation from 2.1% in March to 3.5% in April signals this broadening and persistence of inflationary pressures.

US: Jump in services inflation piles pressure on the Fed

Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

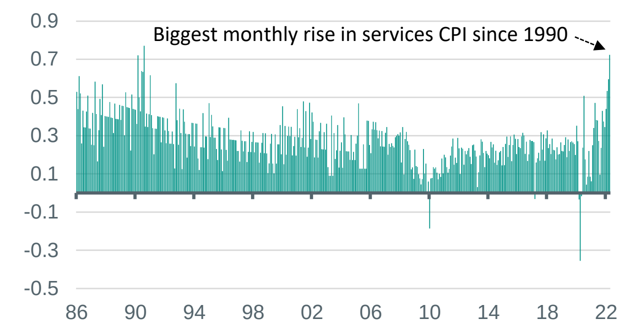
- **An expected fall in still-elevated retail volumes should help drive a cooling in goods inflation…**
- **…but this won't be enough to bring inflation back to 2%, given the surge in stickier services inflation**
- **This will keep pressure on the Fed to hike in 50bp steps in June and July – and perhaps for longer**

Equity markets in the US received a rude awakening over the past week, when major retailers reported a significant shift from high-margin discretionary consumption towards essentials, as consumers adapt to the surge in inflation. Retailers reported write-downs on excess inventory, suggesting there had been an expectation for the extraordinary growth in goods consumption seen last year to persist into this year. In contrast, our view has been that the above-trend goods consumption is unsustainable, and a correction would be vital to bring inflation back down. Despite falling in real terms for much of 2022 so far, goods consumption is still much too high in the US, and we expect the hit to real incomes to drive further modest declines in retail volumes over the coming months. This will likely help to drive a cooling in goods inflation, which has already fallen back somewhat, driven by declines in elevated used car prices. However, this will not by itself bring inflation back to the Fed's 2% target, given that stickier services inflation has become a much bigger driver over the past few months.

Indeed, while overall inflation cooled in April, services inflation registered the biggest monthly gain in over three decades. A significant driver of the strength in services came from airfares – a knock-on effect from the run-up in oil prices – but housing rents, medical and other services costs also continued to rise sharply, at around double the pace that we typically see in these categories. We view this as a spillover from on-going elevated wage growth, which although cooling a touch in recent months, remains elevated, with hourly earnings continuing to rise at around a 5% annualised pace. We significantly raised our inflation projections on the back of the April reading, with headline inflation now expected to average 8% in 2022 and 4.1% in 2023 (previous forecasts: 6.9% in 2022 and 3.3% in 2023). Alongside firming services inflation, energy inflation – a major drag in the April report – is set to rebound significantly in the coming months. Aside from higher oil prices, a shortage in refining capacity is raising the margin between crude oil and gasoline and jet fuel prices. Meanwhile, higher natural gas prices – something the US had been relatively immune from until recently – will also drive a rise in household energy bills.

Services inflation jumps the most in three decades

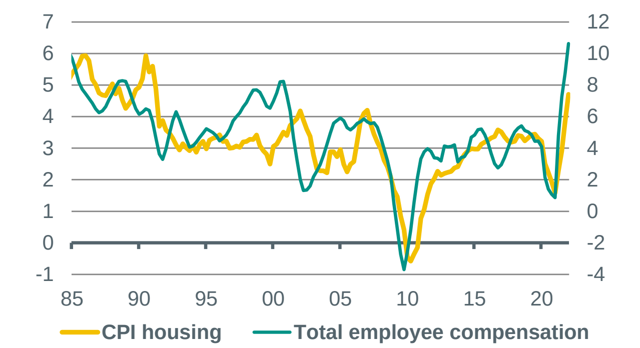
Services inflation, seasonally adjusted month-on-month change, %



Source: Refinitiv, ABN AMRO Group Economics

Surging wages pushing up housing rents

Quarterly change in participation, percentage points



Source: Bloomberg, ABN AMRO Group Economics

Continued upside inflation surprises all-but seal a 50bp hike taking place at both the June and July FOMC meetings, and raises the risk that the Fed continues hiking at this pace in subsequent meetings. A key question mark over the outlook remains the extent to which the hit to real incomes will drive a decline in demand, and the timing of this. While we have seen some decline in goods consumption of late, it is still not nearly to the extent that is likely necessary to bring demand back into balance with disrupted supply in the economy. The run-up in services inflation also suggests we will need to see a significant easing in labour market tightness to bring wage growth back down to more normal levels. The excess savings from the pandemic are providing some buffer to the real income hit for the time being (see this month's Global View), but this will not last forever, certainly for lower income groups. In the meantime, the risk is tilted towards the Fed stepping even harder on the brakes.

China: Something's gotta give

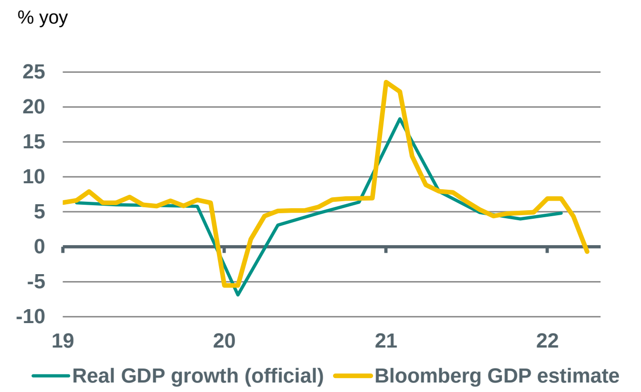
Arjen van Dijkhuizen – Senior Economist | arjen.van.dijkhuizen@nl.abnamro.com

- **Broadening of lockdowns in March/April hits economic activity and impacts sentiment**
- **We have cut our 2022 growth forecast further, to 4.7% from 5.0%**
- **We expect growth momentum to improve in 2H-22, but risks remain as trade-off is hardening**

The broadening of lockdowns in March/April is making itself felt, highlighting the rising costs from ongoing strict Covid-19 policies. In line with our expectations, the April data were even weaker than the March data. Industrial production contracted by 2.9% yoy (7.1% mom), with manufacturing hit by bottlenecks in production and transport, adding to distress in global supply chains. Retail sales shrank by 11.1% yoy (0.7% mom), with car sales and catering particularly weak. Property sales also plunged. Fixed investment slowed to 6.8% yoy ytd, with property investment contracting. The unemployment rate rose to 6.1%, close to the peak seen after the initial Covid-19 shock. The PMIs and foreign trade data for April also came in much weaker. Bloomberg's GDP estimate for April points to -0.7% yoy, the first negative reading since the -5.5% yoy in February 2020. We adjusted our near-term growth forecasts, and cut our annual growth forecast for 2022 to 4.7%, from 5.0%.

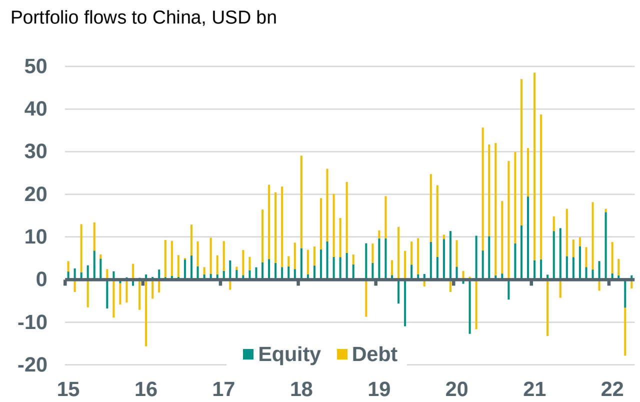
We expect growth momentum to improve in the second half of this year, but risks from Covid-19 policies remain
China's nationwide lockdown intensity started to ease in recent weeks, despite ongoing struggles in eg. Shanghai and Beijing. We expect a gradual reopening going forward, within the framework of strict 'dynamic clearing' Covid-19 policy. We also assume a further step-up of targeted fiscal stimulus, piecemeal monetary easing and a relaxation in macroprudential policies including for real estate. Recent State Council meetings hint in that direction too, with Beijing so far sticking to its 2022 growth target of 5.5%. Although we expect momentum to improve in 2H22, our 2022 growth forecast is around 1pp below Beijing's target. The government's pledge for vigilance on the pandemic front makes the recovery vulnerable to pandemic flare-ups and prolonged lockdowns. For this reason we are also looking at alternative scenarios (see main article).

Growth momentum battered by renewed lockdowns



Source: Bloomberg

Ukraine, lockdowns and Fed trigger portfolio outflows



Source: Institute of International Finance

The trade-off between maintaining strict Covid-19 policies and safeguarding economic growth is hardening
Last year, China tweaked its Covid-19 policy from centralised "zero tolerance" to decentralised "dynamic clearing". This meant that outbreaks were met with strict containment measures at the very local level, reducing the overall macro fallout. However, with the spread of the contagious Omicron variant, this approach has become more difficult, illustrated by rising cases and a broadening of lockdowns in March/April. The CCP – profiled itself as a 'champion of pandemic control' pointing to low mortality rates – looks reluctant to fundamentally ease Covid-19 policy at this stage, as that may result in hospital capacity issues and a rising death toll in the run-up to the National Party Congress in November. While the overall vaccination rate has been ramped up, the elderly are lagging behind. Beijing's stance is also affecting local governments, who are implementing restrictions at early stages of outbreaks; developments in large cities such as Xi'an and Shanghai show that dynamic clearing is not working if measures are taken too late. Although Beijing is keen to step up policy support, it has become clear that the trade-off between maintaining strict Covid-19 policies and safeguarding growth has hardened. This has also contributed to confidence issues among consumers, producers and (foreign) investors.

Key views on a page

The post-pandemic recovery is being hampered by the surge in inflation, the Russia-Ukraine conflict, and China lockdowns. Consumption growth is being weighed by the biggest fall in real incomes in decades, while industry faces headwinds from higher commodity prices and an intensification of supply bottlenecks. We still expect inflation to decline this year, but the jump in commodity prices and supply disruptions is delaying this. We expect energy prices to remain high over the next few years, with sanctions on Russia triggering a lasting trade realignment. Upside inflation risks mean the Fed is likely to continue raising rates rapidly at coming meetings. The ECB has signalled its intent to normalise policy, and we now expect rates to start rising in July. Europe will also continue to feel the global spill-over effects of tighter US monetary policy over the coming year, pushing bond yields higher, equity markets lower, and ultimately dampening growth.

Macro	Central Banks & Markets
Eurozone – GDP expanded by 0.3% qoq in Q1, mainly due to a rebound in services sector activity after lockdowns. Goods consumption and fixed investment currently are restrained by supply shortages. After a weak Q2, growth should pick up temporarily in 2022 H2 as supply bottlenecks ease and consumers spend excess savings. By the end of the year growth should slow down noticeably, falling below the trend rate in 2023. Inflation stabilised at 7.4% in April. It will remain elevated for a while, but will start declining from the middle of 2022.	**ECB** – The ECB has become more worried about inflation expectations. We have brought forward our expectation for the first rate hike from September to July, and now expect 25bp hikes in both July and September. After the deposit rate reaches zero in September, we expect policy rates to subsequently remain on hold for a while. This reflects that we expect economic growth to be sub-trend during 2023. Also, headline inflation will likely be on a significant downward trend from early next year.
Netherlands – First quarter growth in 2022 was flat, primarily due to the lockdown and the end of pandemic support measures. For Q2 we expect positive growth driven by private consumption. The war in Ukraine however is weighing on the growth outlook. While Q2-Q3 growth will be modest but positive, we expect Q4 growth to be flat. We expect the drag on growth stemming from inflation to fully materialise in the second half of 2022. The labour market continues to perform very well with a record 133 vacancies per 100 persons unemployed.	**Fed** – Given persistently elevated inflation in the US, and upside risks to the outlook, we expect the Fed to continue hiking rates in 50bp steps in June and July. Thereafter, we expect 25bp hikes until the Fed reaches our estimate of the terminal rate of 2.5-2.75% in December. Thereafter, we expect the Fed to pause, assuming inflation is moving back towards its 2% target. Risks are to the upside, both in the rate hike pace and in the terminal rate. The Fed will begin unwinding its balance sheet in June, initially at a $47.5bn monthly pace, doubling to $95bn from September.
UK – Inflation surged to over 9% in April following the rise in the household energy cap by Ofgem. At the same time, growth indicators remain broadly weak, as the inflation hit to real incomes weighs heavily on consumer confidence. We expect this to drive a contraction in the economy in Q2, before growth recovers (albeit modestly) in the second half of the year. The labour market remains strong for the time being, with the vacancy to unemployment ratio continuing to rise, and wage growth accelerating. As the year progresses we expect the labour market to weaken.	**Bank of England** – The MPC hiked a further 25bp at its May meeting, but the vote split and minutes showed a heavily divided Committee, reflecting the tight-rope the central bank is walking between keeping inflation expectations well anchored and preventing the economy from sliding into recession. We expect two further 25bp hikes, taking the policy rate to 1.5% by August. Thereafter, we expect the BoE to pause, as the risk of recession begins to weigh more heavily in policy deliberations than the risk of a drift higher in inflation expectations
US – Supply bottlenecks in Q1 led us to lower our GDP forecast for 2022 to 2.7% from 3.1% previously. Demand remains strong overall, despite the necessary cooling in goods consumption. There is still significant room for the services sector to recover, and we expect this to continue, albeit the pace of recovery is being weighed by the inflation hit to real incomes and – increasingly – tighter monetary policy. Inflation continues to be the biggest risk to the outlook. Services inflation accelerated in April, reflecting pass-through from elevated wage growth.	**Bond yields** – Both the US and the eurozone markets are well advanced with pricing in an aggressive rate hike cycle by the Fed and the ECB. We judge that markets are running ahead of themselves and expect a repricing of central bank hikes downwards in both the US and the Eurozone. This would in turn result in lower euro rates as well as US rates. Indeed, we expect the 10y US Treasury yield to drop from around 2.9% at the time of writing to 2.7% during the course of this year.
China – The broadening of lockdowns in March/April is making itself felt. April data were even weaker than in March, with domestic supply bottlenecks adding stress to global supply chains. Nationwide lockdown intensity started to ease in recent weeks. We expect a gradual reopening, within the framework of strict 'dynamic clearing'. Still, risks remain as the trade-off between pandemic control and safeguarding growth becomes more challenging. We adjusted our near-term growth forecasts, and have cut our annual growth forecast for 2022 to 4.7%, from 5.0%.	**FX** – The deterioration in investor sentiment initially resulted in investors taking some profit on US dollar longs. However, they later bought dollars again when sentiment deteriorated even further. We think that the upside for the US dollar versus the euro is limited, barring sharp risk off periods or even more aggressive rate hikes by the Fed. Going forward, more Fed rate hikes will only be a US dollar positive so long as investors don't fear a sharp slowdown or a recession in the US. We expect more weakness on sterling due to the deterioration in the economic outlook.

Main economic/financial forecasts

GDP growth (%)	2020	2021e	2022e	2023e	3M interbank rate	12-5-2022	19-5-2022	+3M	2022e	2023e
United States	-3.4	5.7	2.7	2.2	United States	1.41	1.50	2.00	2.70	2.70
Eurozone	-6.5	5.4	2.6	1.7	Eurozone	-0.41	-0.37	-0.28	0.22	-0.03
Japan	-4.6	1.7	1.9	1.8	Japan	-0.02	-0.02	-0.05	0.00	0.00
United Kingdom	-9.3	7.4	3.8	1.6	United Kingdom	1.24	1.33	1.25	1.50	1.50
China	2.2	8.1	4.7	5.3						
Netherlands	-3.8	5.0	3.0	1.3						
Inflation (%)	**2020**	**2021e**	**2022e**	**2023e**	**10Y interest rate**	**12-5-2022**	**19-5-2022**	**+3M**	**2022e**	**2023e**
United States	1.2	4.7	8.0	4.1	US Treasury	2.82	2.86	3.0	2.70	2.25
Eurozone	0.2	2.6	6.3	2.5	German Bund	0.87	0.94	1.1	0.75	1.15
Japan	0.0	-0.2	1.5	0.9	Japanese gov. bonds	0.24	0.24	0.2	0.20	0.30
United Kingdom	0.9	2.6	8.8	6.6	UK gilts	1.67	1.87	2.5	2.15	2.00
China	2.5	0.9	2.5	2.0						
Netherlands	1.1	2.8	8.5	4.3						
Key policy rate	**19-5-2022**	**+3M**	**2022e**	**2023e**	**Currencies**	**12-5-2022**	**19-5-2022**	**+3M**	**2022e**	**2023e**
Federal Reserve	1.00	1.50	2.75	2.75	EUR/USD	1.04	1.06	1.07	1.05	1.10
European Central Bank	-0.50	-0.50	0.00	0.00	USD/JPY	128.3	127.8	127	124	120
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.22	1.25	1.26	1.22	1.26
Bank of England	1.00	1.25	1.50	1.50	EUR/GBP	0.85	0.85	0.85	0.86	0.87
People's Bank of China	3.70	3.60	3.60	3.60	USD/CNY	6.79	6.72	6.60	6.60	6.60

Source: Refinitiv, ABN AMRO Group Economics.

Macro Research Team

Sandra Phlippen, Chief Economist | sandra.phlippen@nl.abnamro.com
Aline Schuiling, Senior Economist | aline.schuiling@nl.abnamro.com
Arjen van Dijkhuizen, Senior Economist | arjen.van.dijkhuizen@nl.abnamro.com
Bill Diviney, Senior Economist | bill.diviney@nl.abnamro.com
Jan-Paul van de Kerke, Economist | jan-paul.van.de.kerke@nl.abnamro.com
Nick Kounis, Head of Financial Markets Research | nick.kounis@nl.abnamro.com
Nora Neuteboom, Senior Economist | nora.neuteboom@nl.abnamro.com

FX & Rates Research

Georgette Boele, Senior FX & Precious Metals Strategist | georgette.boele@nl.abnamro.com
Jolien van den Ende, Senior Rates Strategist | jolien.van.den.ende@nl.abnamro.com