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Global Outlook 2022

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Five key questions for 2022

- **Following a rapid, post-lockdown recovery in 2021, uncertainty has come back to cloud the outlook**
- **Unexpectedly persistent inflation, the resurgent pandemic, and a new threat to the recovery in the form of Omicron pose downside risks to growth, and raise the prospect of earlier interest rate rises**
- **Still, we expect growth to remain above trend in 2022, and inflation to ultimately moderate**
- **Upside risks to the US inflation outlook have led us to bring forward the timing of Fed rate hikes**
- **We do not expect the ECB to follow, but rising US rates will still push European bond yields higher**
- **In this *Global Outlook*, we explore five key questions informing our calls and assumptions for 2022**
- **We also devote special chapters to *Omicron* and alternative *pandemic and rates scenarios***
- **Regional Outlooks: We expect a resumption in above-trend growth in *the eurozone* and *the Netherlands* following a soft patch, with inflation falling back below the ECB target by end-2022**
- **In contrast, in *the US* excess goods demand and a tight labour market will keep inflation above target**
- **The *Brexit-pandemic supply crunch* could trigger rate hikes as soon as this month in *the UK***
- ***China's* zero-tolerance covid-19 policy and real estate pose ongoing growth risks in *Year of the Tiger***
- **The looming *Fed-ECB policy divergence* will pull eurozone bond yields higher, and weigh on the euro**

Uncertainty over the economic outlook is now arguably the highest it has been since the start of the pandemic in early 2020. While economic growth has been strong, as economies have largely opened up, the supply-side has struggled to keep up with resurgent demand, with the consequence being inflation. This has brought forward the likely timing of interest rate rises in the US, and while we do not expect the ECB to follow, given the very different macroeconomic circumstances in the eurozone, this will have global spill-over effects over the coming year. If that were not enough to contend with, many eurozone countries are now struggling to contain a new wave of pandemic infections, with potentially an entirely new challenge for policymakers looming in the form of the Omicron variant. We think it is too early to judge the precise impact of this new variant on our growth outlook, but our initial take is that the new inflationary environment means policymakers will struggle to provide the same kind of support for demand that we saw throughout much of the pandemic, and that there will be more focus on alleviating supply-side problems – which could well be exacerbated by the spread of Omicron. In grappling with these near-term challenges, we should not lose sight of the longer term big picture challenges of climate change and the energy transition. COP26 saw progress being made in terms of government pledges and targets. However, there remains a sizable gap between pledges and current policy, and we continue to think the window of opportunity to limit global warming to 1.5 degrees in an orderly manner is closing fast.

Given the varied drivers of the outlook over the coming year, in this *Global Outlook* we have asked our experts to give their views on a range of topics, in the form of five key questions and answers. We also devote special chapters to the Omicron variant, alternative pandemic and interest rate scenarios, and the impact of central bank policy on global financial markets. Finally, given that one of the dominant themes next year is likely to be *divergence* between key regions of the global economy, we invite readers to refer to our country and regional outlooks to get a more detailed view on a given economy.

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

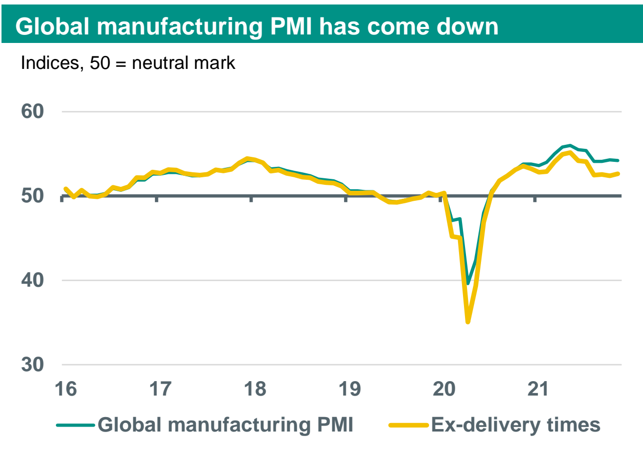
Outlook 2022: Continued above trend growth, but bottlenecks and Fed rate hikes are a dampener
In big picture terms, we expect the post-pandemic recovery to continue in 2022, with above trend growth in the eurozone, the US and China. However, growth will continue to be constrained by residual supply-side bottlenecks, and upside risks to US inflation will trigger Fed rate hikes, driving a global tightening of financial conditions. The spread of the new Omicron variant poses downside risks to growth, but upside risks to inflation.

In the below Q&A, we explore five questions informing our key judgment calls and assumptions for 2022.

1. When will supply bottlenecks resolve?
Pandemic-related disturbances have caused a wide range of supply-side bottlenecks over the past year, in areas such as raw materials, intermediate goods – including semiconductors – and freight transport (as well as in the labour market). Efforts by suppliers to build buffers, in reaction to the threat of scarcity of certain goods, has contributed to shortages, exposing the vulnerabilities of global 'just in time' supply networks. Meanwhile, supply-demand imbalances have been aggravated by a pandemic-related demand shift from services to goods, particularly in the US. These imbalances have not only formed a constraining factor in the global industrial rebound from the pandemic shock, but have also contributed to a pick-up in inflation. All of this is shown for instance by a decline in global manufacturing PMIs over the past months, certainly when corrected for record long delivery times (particularly in advanced economies). Other illustrations are the near-doubling of lead times for semiconductors (causing temporary production stops in high-tech industries, particularly in the car sector), a seven-fold rise in global container freight tariffs, and a sharp uptick in the global PMI subindices for input and output costs driven by a surge in commodity prices.

Global manufacturing PMI has come down

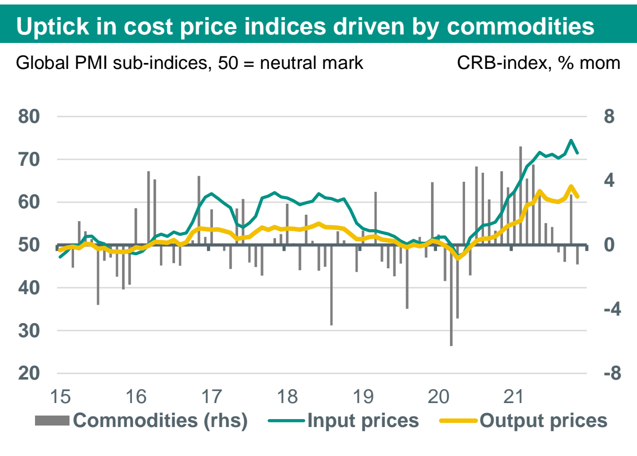
Indices, 50 = neutral mark



Source: Refinitiv, ABN AMRO Group Economics

Uptick in cost price indices driven by commodities

Global PMI sub-indices, 50 = neutral mark CRB-index, % mom



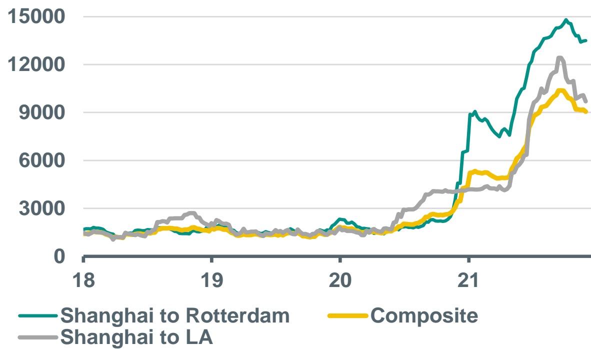
Source: Refinitiv, ABN AMRO Group Economics

A common factor driving these bottlenecks is the direct effect from pandemic flare-ups on labour supply and on production facilities and supply chains. For instance, earlier this year delta outbreaks in China caused a temporary partial closure of the country's second-largest port. Delta-related factory closures in Malaysia also added to a further lengthening of lead times for chips. Taken from this perspective, if one of the key assumptions for our outlook will prove correct – that 2022 will see less pandemic disturbances compared to 2021 – that should imply a fading of these supply bottlenecks in the course of next year. And if another key assumption – that reopenings will support a rotation in consumption from goods to services – will also hold, that would also help to reduce these supply-demand imbalances. Early indications of some easing of bottlenecks are visible in container freight tariffs (that have dropped by 10-20% over the past months), and in some easing in the monthly rise of lead times for semiconductors.

However, caution is warranted. First, we should be careful in generalising these supply issues. The dynamics behind for instance the rise in container freight tariffs, the scarcity in semiconductors and distortions in labour supply (which we cover in Question 2 and the regional outlooks) do have some commonalities, but also clear differences.

Container freight tariffs show some signs of easing

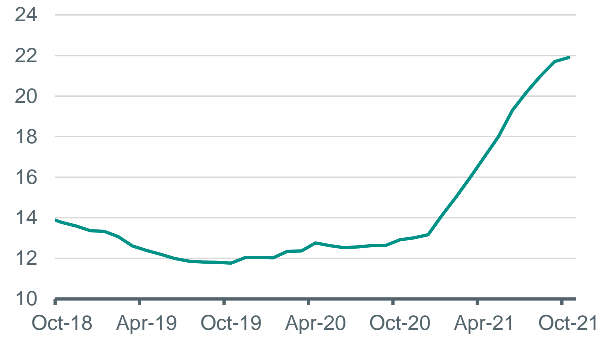
USD per 40ft container box



Source: Bloomberg

Lead times chips keep rising, but less aggressively

Number of weeks



Source: Susquehanna Financial Group

Second, some of these supply-side imbalances are driven by country specific factors, think of diverging demand conditions or different labour market circumstances. Third, the spread of Omicron and/or other new covid-19 variants may lengthen the process towards supply chain normalisation and hence make the supply bottlenecks even more persistent than they have already been so far. *(Arjen van Dijkhuizen)*

2. Why is the outlook for inflation – and therefore interest rates – so different in the US and eurozone?

Inflation has surged in both the US and in the eurozone over the past year, with US CPI inflation reaching a 30 year high of 6.2% y/y in October, and eurozone inflation hitting a record 4.9% in November, according to the flash estimate. Inflation in both regions has been boosted by surging energy costs, with a bigger contribution from petrol price rises in the US, and natural gas prices in the eurozone. Where inflation trends have differed significantly is in core prices. While core inflation has also risen in eurozone, at 2.6% in November it is nowhere near as elevated as the 4.6% reading from October in the US. Looking ahead, while core inflation is expected to fall back in both regions in 2022, in the US we expect core inflation to remain somewhat above the Fed's 2% target, while in the eurozone we expect inflation to fall comfortably back below target.

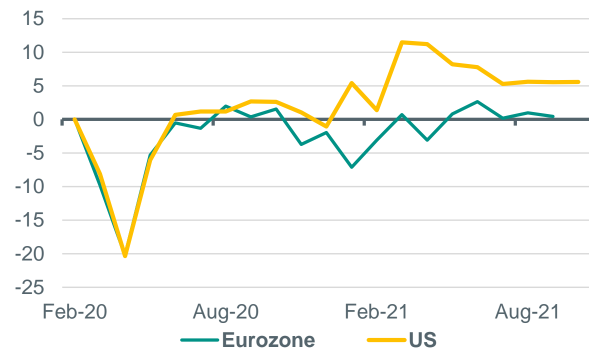
Core inflation is signficantly higher in the US…

% y/y

Source: Refinitiv, ABN AMRO Group Economics

…driven partly by excess goods consumption

Real retail sales, % vs pre-pandemic trend



Source: Refinitiv, ABN AMRO Group Economics

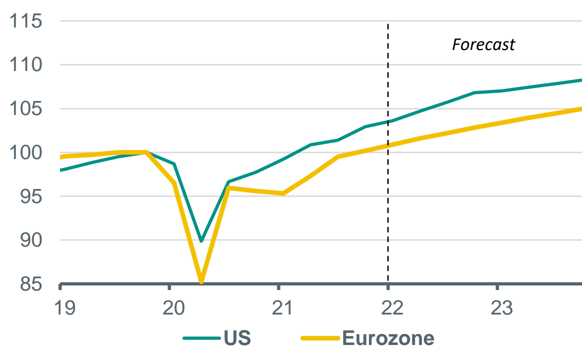
We see three key reasons for the divergent inflation trends in the US and the eurozone. First, while both regions have been affected significantly by supply-side disruptions, in the US this has been compounded by excess demand for goods, spurred by significantly more generous stimulus that overcompensated lost incomes from the pandemic (i.e. many workers were receiving more via fiscal transfers than when they were in employment). In the eurozone in contrast, the wage subsidy schemes merely sought to maintain employment and income levels rather than to stimulate demand. The result is a starkly different outcome for consumption in the two regions, which is clearly evident when comparing retail sales: in the US, retail sales have been persistently well above the pre-pandemic trend since early 2021, while in the eurozone there has been no

such excess demand – sales have been broadly in line with the pre-pandemic trend. This difference in demand has given producers and retailers in the US much greater confidence in passing on higher costs to consumers.
Second, the output gap is much bigger in the eurozone than in the US. The US economy has comfortably surpassed its pre-pandemic peak, and is on course to close the output gap from the pandemic entirely by Q2 next year; in the eurozone we do not expect this to happen until 2024. Nowhere is this difference more apparent than in labour markets. In the US, the labour market looks already to be near full employment, with a record quit rate and elevated wage growth, while in the eurozone – notwithstanding pockets of tightness in some northern economies – slack remains significant, and wage growth has actually slowed at the aggregate level, to 1.4% y/y in Q3, down from 1.8% in Q4 and 2.2% in 2019.

Third, aside from a greater degree of slack, one other reason for more subdued wage growth – and in turn inflation – in the eurozone is historically lower inflation expectations, driven by prolonged periods in which inflation has significantly undershot the ECB's 2% target. While inflation is above target now, it will likely take a much more sustained rise in inflation to meaningfully lift future expectations, and this should further restrain wage growth in the near term.

EZ will take longer to close the pre-pandemic gap

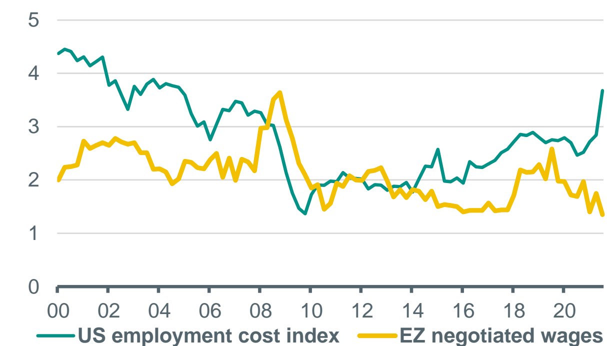
GDP, Q4 19 = 100



Source: Refinitiv, ABN AMRO Group Economics

Labour market is looking a lot tighter in the US

% yoy



Source: Refinitiv, ECB, ABN AMRO Group Economics

As a result of these significant differences between the US and eurozone, we expect a major policy divergence to open up between Fed and ECB policy over the coming years, with the fed funds rate rising to 2.5-2.75% by 2025, while the ECB is not expected to raise interest rates over our forecast horizon (to end-2023). Even so, European bond markets do not exist in isolation, and we expect spillovers from rises in US interest rates to put upward pressure on eurozone bond yields as well next year. For more, see our special chapter on **central banks and financial markets**. *(Bill Diviney, Aline Schuiling, Nick Kounis)*

3. Will Fed rate hikes trigger a major tightening in financial conditions, and might this stay the Fed's hand?

As the Fed begins to raise interest rates, financial markets tend to move pre-emptively to price in the tightening cycle – bond yields rise and this can trigger a deterioration in investor sentiment. Financial conditions are a key transmission channel for monetary policy – equity market moves have wealth effects and consumer confidence in the US is often heavily impacted by market moves, while mortgage rates tend to track long-term bond yields. As such, the Fed is mindful of the reactions in markets – globally as well as domestically – as these moves can do much of the tightening work for it. In other words, there is a risk of policy overshooting if the Fed continues to raise rates regardless of financial market developments. Indeed, in the past the Fed has shown flexibility in the face of a significant tightening in financial conditions, most notably in early 2016, just after the first rate hike of that cycle, when the S&P 500 rapidly corrected by around 13%, and also in early 2019, when equities declined by a much bigger 20% but over a longer period (see chart below, with reference to Fed policy statements from that time). On both occasions, the Fed paused rate rises (2016), or put an end to them entirely and even began reversing course (2019).

After bringing forward our expectation for the start of Fed rate hikes to June next year, from early 2023 previously, we also significantly raised our end-2022 forecast for the 10y Treasury yield, to 2.6% from 1.7% previously. Should our forecast for

the Fed and bond yields pan out, this raises the risk of a deterioration in investor sentiment (see our **Credit Crisp note**). Such a correction could well fit the parameters that in the past caused the Fed to pause in its policy tightening.

The Fed is responsive to financial conditions

US financial conditions index, >0 = easy conditions, <0 = tight conditions

Source: Bloomberg, ABN AMRO Group Economics

Our rates forecasts point to a major market correction

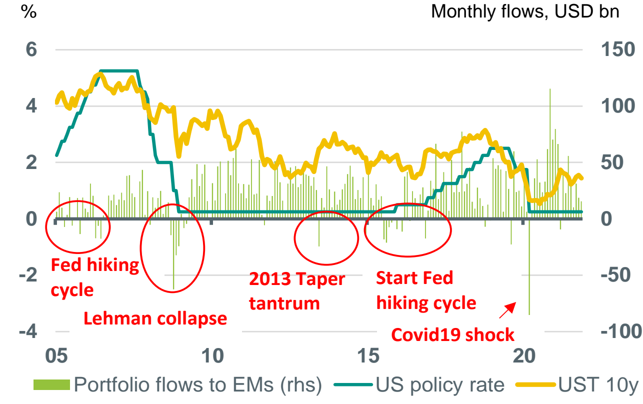
Source: Bloomberg, ABN AMRO Group Economics

However, we think the bar would be significantly higher this time around for the Fed to pause or reverse course, primarily because of the radically different inflation environment. In both 2016 and 2019, inflationary pressure was subdued and had been undershooting the Fed's target for some time; indeed, the Fed was hiking on the *expectation* that inflation would rise, rather than to bring down realised inflation. As such, although the Fed would still take into account a tightening of financial conditions, it would next time have to weigh this against likely continued upside risks to inflation. In that scenario, the Fed might well conclude that inflation is a bigger concern for the outlook than a major correction in equity markets. This suggests the hit to global growth could be larger than in previous Fed tightening cycles. *(Bill Diviney, Shanawaz Bhimji)*

4. Will EMs suffer from Fed tapering/lift-off and rising US rates?

A related question is to what extent a global tightening of financial conditions triggered by an earlier Fed lift-off will hurt a further post-pandemic rebound in emerging markets (EMs). History shows that Fed tapering and rising US policy and market rates are typically a negative factor for EMs. As 'risk free' rates rise and the dollar strengthens, investors will be less prone to a search for yield, reducing the relative appetite of the EM asset class. As the chart shows, previous periods of rising US rates typically coincided with periods of net portfolio outflows from EMs, putting pressure on EM currencies and other assets. We should add that the length and severity of such risk-off periods and their impact on net portfolio flows to EMs is impacted by many more factors than just US rates. What is more, following a surge in flows to EMs in late 2020 (partly driven by the outcome of the US presidential elections), portfolio flows to EMs have already started coming down sharply in the course of 2021, impacting relative valuations of EM assets.

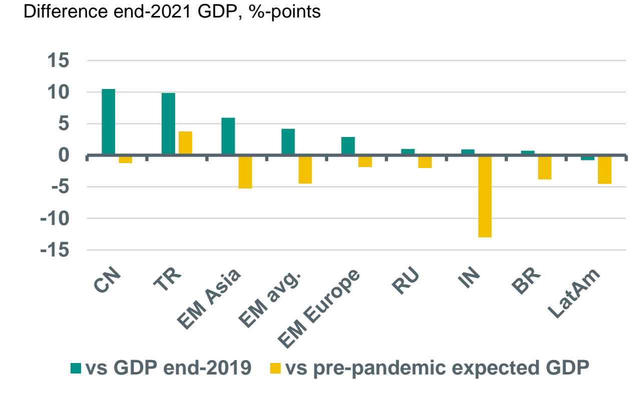
Rising US rates a negative for EMs



Source: Refinitiv, IIF, ABN AMRO Group Economics

Still some room for catch-up growth

Difference end-2021 GDP, %-points



Source: ABN AMRO Group Economics, EIU

Looking ahead, we expect tighter global financial conditions, rising US rates and US dollar strength to again trigger bouts of volatility and have a net negative impact on EM currency and asset markets and on EM growth. That will be particularly true for EMs with vulnerable fiscal and external metrics and high inflation. EMs will be faced with higher financing costs, while EM central banks – particularly those of the riskier ones – will likely be forced to raise domestic policy rates further to stem currency pressures and related inflationary pressures. As far as the most externally vulnerable EMs are concerned, all of this may even lead to a higher number of countries facing problems in servicing external debt obligations.

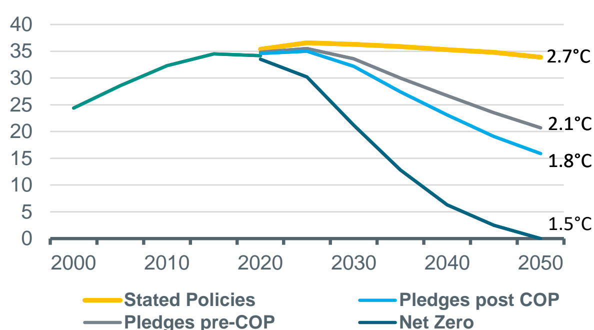
We have cut some of our EM growth forecasts on our updated Fed view. Still, for 2022, our global base case assumes continued above trend growth in developed economies, on the back of a normalisation in service sectors and industrial supply chains. This should be beneficial for EMs as well. Moreover, we still see some room for post-pandemic catch-up growth in many EMs, which generally have been lagging in terms of vaccination programmes. While overall EM GDP has surpassed pre-pandemic levels already, EM GDP per end-2021 will still be around 4.5 %-points below the level that was expected pre-pandemic. All in all, we expect EM growth to fall from around 6.5% in 2021 to around 4.5% in 2022. Obviously, a key downside risk stems from serious virus flare-ups of new variants like Omicron and resulting policy tightening (including the persistence of zero-tolerance COVID-19 policies in China and some other Asian countries), which would further delay a normalisation in services sectors and in industrial supply chains. *(Arjen van Dijkhuizen)*

5. How does COP26 impact the economic outlook?

COP26 saw progress made in terms of government pledges and targets. On this basis, the global temperature rise could be limited to 1.8 degrees. However pledges and targets are not policies, and on the basis of stated policies, warming is still projected to reach 2.7 degrees at the end of the century. Whether or not there is follow through on targets via policies and investment will be crucial in terms of likely outcomes. In thinking about the economic effects, it is therefore useful to assess the impact of both 1.8 and 2.7 degree scenarios. The first scenario – where policy action comes through but takes time – is one where transition risks predominate (the economic effects from policies implemented to reduce emissions), while the latter is one where physical risks (economic effects from actual climate change) come to the fore. Governments have committed to review and possibly enhance ambitions ahead of next year's COP, so a Net Zero scenario that limits warming to 1.5 degrees is still possible, but the window of opportunity to achieve that is closing fast, and we do not regard it as the most likely scenario. An orderly Net Zero scenario – that leads to immediate and smooth policy action and fast technological progress – would limit the impact of both transition and physical risks compared to the two other scenarios.

Scenarios for emissions and temperature rise

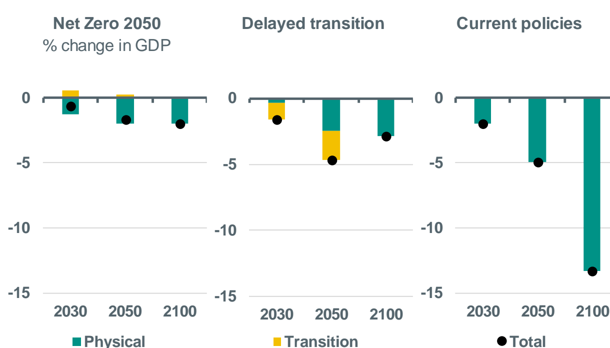
Gt CO2



Source: IEA, ABN AMRO Group Economics

Impact of different scenarios on economic outlook

GDP impact relative to trend



Source: NGFS, ABN AMRO Group Economics

The chart on the right above shows the projected economic impact of the three scenarios over the coming decades as estimated by the NGFS. In all scenarios, the economic effects materialise over many years and the impact on our regular 2-year business cycle forecasting horizon are modest. Negative transition shocks mainly emanate from higher carbon prices and energy costs, and heightened uncertainty in disorderly scenarios. The positive impulse comes from investment to facilitate the transition, and in the orderly Net Zero scenario carbon revenues are fully recycled to this aim as well as lowering employment taxes. The negative impact of climate change in the projections above is mainly factored in through

lower productivity. Other transmission channels – such as from severe weather, sea level rise and migration – are not yet captured. So it is quite likely that physical risks, especially in the higher temperature scenarios, are underestimated. (*Nick Kounis)*

In the below table, we summarise our key judgment calls and assumptions for macro and financial market developments in 2022.

Theme	View
Covid-19	• **The pandemic will remain a headwind in the first half of the year,** but will not cause further outright contractions in the eurozone or US economies • **This assumes that the Omicron variant does not cause more severe disease than prior variants**, and that vaccination and prior infection still affords some immune protection (see our special chapter on this)
Inflation	• **Supply chain bottlenecks will gradually ease in the course of the year**, with pandemic-related disturbances likely to be less significant in 2022 than in 2021 • **Inflation will fall significantly**, coming in below the ECB's 2% target by year-end in the eurozone, but remaining somewhat above target in the US
Interest rates and FX	• **The Fed will start raising rates from June**, with a total of three 25bp hikes during the course of the year. There will be a higher bar for the Fed to pause rate hikes in response to tighter financial conditions, given upside risks to inflation • **The ECB will maintain an accommodative policy stance**, with purchases under the APP continuing and policy rates remaining on hold. This will create a significant policy divergence with the Fed • **Rising US yields will put some upward pressure on eurozone bond yields**, and drive a weakening in the euro
Emerging Markets	• **Tighter global financial conditions could put significant stress on some emerging market economies**, but for EMs in aggregate, the impact of this will likely be significantly offset by strong external demand from advanced economies and a further catch-up recovery from the pandemic

Omicron: How might it impact the outlook?

Nick Kounis | Bill Diviney | Aline Schuiling

- **Omicron appears to be more transmissible, and could partially evade vaccine immunity. However, disease severity remains unclear – a crucial factor in determining its impact on the outlook**
- **In a negative scenario, Omicron could trigger renewed lockdowns and contractions in GDP, while exacerbating supply bottlenecks and posing further upside risks to inflation**
- **Given supply-side constraints, support from policymakers is likely to be much more modest**

The emergence of the Omicron variant has caused volatility in financial markets and raised uncertainty for the growth outlook. Health officials have expressed concern but have also stressed that it is difficult to make strong judgements at this stage. We therefore find it too early to make any changes to our key economic and market calls. However, below we give an insight into five of the key questions that arise and subsequently set out some stylised scenarios.

How dangerous will the Omicron strain be? Three factors will determine this: a) is it more transmissible? b) does it evade vaccine protection? c) does it cause more severe disease?

Our take from the reports and expert opinion so far is that Omicron looks likely to be more transmissible and resistant to vaccines, but the biggest question mark remains on the severity of the disease. The latter could prove to be crucial – if it is as severe or more severe, policymakers may need to reimpose lockdowns (see below). If the disease is less severe, the new variant could even be a positive development, as a more benign virus would supersede a more dangerous one (Delta).

To more specifically answer the above questions: a) The fact that Omicron so rapidly became the dominant strain in South Africa (now making up >75% of cases) suggests that it may be more transmissible than the Delta variant. b) The number of mutations suggests potential for significant vaccine evasion. An earlier study referenced by the ECDC involving a synthetic variant with 20 mutations showed almost complete vaccine evasion; Omicron has over 30 such mutations. c) It remains unclear whether Omicron causes more severe disease. Early anecdotal reports suggest mild disease, but most cases have been in young healthy adults.

How quickly could a new vaccine be put in place? One of the advantages of the modified mRNA technology that is used to build many Covid-19 vaccines is the ability to reprogramme the vaccines relatively quickly to counter dangerous new mutations. Indeed, Moderna's Chief Medical Officer Paul Burton asserted over the weekend that 'If we have to make a brand new vaccine, I think that's going to be early 2022 before that's really going to be available in large quantities'. Similarly, Pfizer and BioNTech expects 'to be able to develop and produce a tailor-made vaccine against that variant in approximately 100 days, subject to regulatory approval'.

It therefore seems that new vaccines would be available at some point during Q1, though rolling them out to a significant proportion of the public may take several more months. Even assuming speedy roll-outs across the richer economies, it must be noted that up until now, vaccination rates have been uneven and very low across much of the developing world. The emergence of Omicron adds to the case that 'nobody is safe, until everybody is safe'.

How would demand be impacted? The demand effects are likely to differ significantly between the eurozone and the US, and between goods and services. The eurozone is more likely to see a bigger hit to demand in a negative scenario than the US. In the eurozone, renewed lockdowns would trigger significant declines in services consumption, and likely a minimal impact on goods consumption. A technical recession is possible, depending on the length of lockdowns. In the US, lockdowns (and their recessionary effects) are likely only in a very negative scenario, where policymakers are much more reluctant to impose restrictions on activity, and healthcare capacity buffer appears to be greater. In the US, a bigger effect could be on the composition of consumption, with the services recovery facing a further delay, and goods consumption likely remaining above trend. Such an effect was observed during the Delta wave over the summer months; there were no new restrictions on activity, but consumers stayed at home more and goods consumption stayed well above trend.

Could Omicron exacerbate supply issues and therefore inflation? The supply side looks very likely to be adversely impacted if Omicron proves to be a more dangerous strain than its predecessors. Manufacturing and transportation could be impacted by a combination of direct restrictions and the disruption to labour supply. The zero tolerance policy of the authorities in China and some other Asian countries certainly points in this direction. Of course this would come at a time where the various supply-side bottlenecks globally are already severe, with long delivery times and a record gap between orders and output in major manufacturing economies such as Germany.

The overall impact on inflation will likely differ by sector and by country. A short-term significant disinflationary impact could come from oil prices. The quickest and most restrictive measures would likely be seen in travel, while any restrictions on mobility could also hurt demand for oil. On the other hand, it will be crucial how OPEC+ respond in terms of the supply side. Meanwhile, given resilient demand for manufactured goods, and forces to constrain supply, inflationary pressures could persist and even intensify in this sector. On the other hand, the demand shock may overwhelm the supply shock in services, leading to lower price pressures. Finally, countries that go into the 'Omicron shock' with stronger demand and close to full capacity (the US) are more likely to see more inflationary pressure, while those with weak demand and slack (the eurozone) could tend towards disinflation.

How would policymakers respond this time? The policy response is likely to be more restrained in terms of size and more focused on cushioning the supply side than fuelling another surge in demand. This follows from (a) the lessons from earlier policy measures (b) a different starting point in terms of inflation (c) limitations from using a lot of firepower over the last two years. For instance, the US government is unlikely to use the approach of sending significant transfers to households, while boosting unemployment benefits to levels that in some cases exceeded in-work income. This had the effect of both turbo-charging demand and limiting labour supply. The European approach of in-work support might be preferable, though it can have the side effect of creating rigidities. Meanwhile, the Fed will be constrained by worrisome inflation trends. High government debt levels, without a big buyer of Treasury securities may also restrain the extent of the fiscal response. In the eurozone, the ECB will likely be less constrained by inflation concerns, though it may not feel the freedom it did in 2020 where the starting point for underlying inflation was much lower. In addition, while the PEPP is not officially constrained by issuer limits, the 50% threshold may still provide some constraint.

Omicron: Three stylised scenarios		
Benign	**Negative**	**Very negative**
- Omicron causes more mild disease than existing variants (there is some anecdotal reporting of this). Its higher transmissibility therefore becomes a positive development, as it would supersede the Delta variant - Economy follows our base case, i.e.: -- Continued above trend growth in both the eurozone and US, aided by the services recovery and a gradual easing in suppy-side bottlenecks -- Upside inflation risks and an earlier attainment of full employment in the US to trigger Fed rate hikes from June 2022 -- ECB rates to stay on hold, PEPP ends but APP continues, with inflation likely to fall back below target by end-2022	- Omicron more transmissible, (partially) evades vaccine protection but disease and death rate is similar to Delta - Renewed restrictions in the eurozone, delaying the recovery. US unlikely to follow with restrictions, but consumers would be more cautious. Rotation from goods to services further delayed, raising upside inflation risks - Supply disruptions take longer to normalise, but still on an improving path - Policy response less generous than in previous waves. Wage subsidy schemes a backstop in the eurozone, unemployment benefits in the US (but without the generous top-ups and stimulus cheques of before) - Monetary policy still tightened in the US due to inflation risks, as long as financial conditions do not tighten too aggressively. ECB extends PEPP, which it uses flexibly to maintain easy financial conditions	- Omicron is more transmissible, evades vaccine protection and causes more severe disease - Strict lockdowns return to the eurozone until a new vaccine is rolled out, leading to a renewed recession. In the US, partial or full lockdowns in many states, but likely not as widespread - Supply disruptions intensify, pushing goods inflation even higher. This would be offset by sharp fall in oil prices and services disinflation - Policy response likely to have even less of a cushioning effect on demand, as inflation from supply disruptions reduces scope for stimulus - US monetary policy tightening delayed, but high goods inflation limits scope for additional easing. ECB puts in place larger PEPP envelope but scale of asset purchases still less than in first round

Scenarios: How could rates, the pandemic and climate interplay?

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- **The unusual uncertainties surrounding both the pandemic with Omicron, and financial conditions surrounding inflation, make it useful to think through some scenarios**
- **These do not represent our base case, but rather extreme situations that help us grasp how factors could interplay**

Scenario I: Pandemic ends, financial conditions stay loose	Scenario II: Pandemic ends, but financial conditions tighten severely
If the pandemic starts to fade in 2022 in a manner that prevents further economic restrictions, 2022 could see even stronger above trend growth than in our base case, which slowly normalizes as the reopening phase passes. Consumers shift their purchases back from goods to services which eases pressure on supply chains and cools inflation. Monetary policy will stay accommodative as long as global GDP is below its potential. This means that with discretionary fiscal spending on covid support no longer required, there is more leeway for public investments in decarbonisation. Also, households can spend their excess savings (in the Eurozone around 750 billion euro) on investments in energy efficiency of their homes.	A very different world emerges if we assume that the pandemic ends in 2022, but economies overheat. Consumers may switch their attention to services, but shortages of staff (caused by a large scale and permanent retreat of the labour force) force employers to raise wages dramatically. As services comprises large parts of today's economies, these wage increases can set in motion wage-price spirals – a dynamic not seen for decades. Global supply chain disruptions might also take longer to ease. For example, the zero- tolerance strategy of the Chinese government could lead to continued local lockdowns, despite few people being infected. In addition, freight capacity increases may cause new frictions in road transportation in destination economies that face labour shortages. Price pressures would then endure in both services and industry. Central banks slam on the brakes by raising rates, with a disorderly response by financial markets. Central banks have limited room to retreat from their tightening strategy until prices cool. Via currency exchanges and external financing, global financial tightening comes at a time when emerging economies have only started to recover. This triggers a global recession. Public debt issuance for climate spending becomes expensive, and carbon pricing politically unfeasible.
Scenario III: Pandemic endures, financial conditions stay loose	**Scenario IV: Pandemic endures and financial conditions tighten severely**
With the enduring pandemic, economically harmful restrictions remain. Governments switch to a more adaptive support scheme. Instead of balance sheet support (EU) or direct income support (US), workers are incentivised to move towards economic activities that continue during restrictions (health care, transport logistics, renewable energy). The adjustments cause large scale bankruptcies and unemployment which in turn lowers demand and cools inflation. Monetary policy stays ultra-loose, and fiscal spending on retraining further raises public debt. With the focus on worker mobility, a major hurdle for pro-active climate policy (labour shortages) eases. As a result, climate policy – although not the priority – gets a major boost.	Probably the most unlikely scenario, but worth considering. In this world, the pandemic drives continued lockdowns, with governments supporting the economy as until now. This means balance sheet support for European firms and large-scale stimulus checks for American consumers. Bankruptcies and unemployment stay low, but labour shortages in sectors that grow during lockdowns continue to increase. Consumers, particularly those in receipt of direct income support, raise their goods consumption driving supply shortages and higher inflation. Aggravating this situation is lengthy hard lockdowns in China, causing manufacturing output to drop significantly. All of this adds fuel to already high inflation, with central banks finding rate rises unavoidable. Financial markets panic, as not only rates rise steeply but also the pandemic endures. The combination of historic high public debt levels and severe financial tightening could trigger a debt crisis.

Eurozone: Soft patch to be followed by above-trend growth

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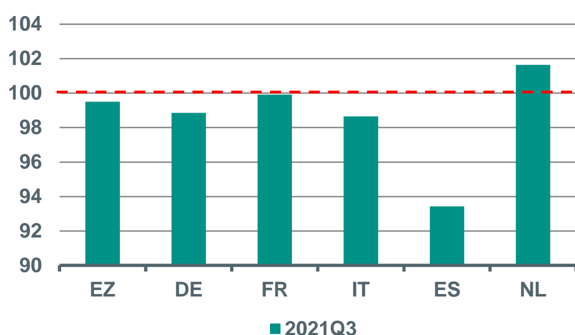
- **Economic growth has slowed markedly in the final months of 2021**
- **Supply side bottlenecks and high (energy price) inflation are restraining growth in industrial production and also reducing consumers' real disposable income, even as a new coronavirus wave is hitting the region**
- **Following this soft patch, growth is expected to go back above trend rates, supported by monetary and fiscal policy as well as a continued labour market recovery**
- **Inflation is likely to fall back in the course of 2022, and should end up below the ECB target in 2023**

Following a sharp rebound in growth in 2021 Q2-Q3, the eurozone economy has entered a soft patch, which could persist for a couple of months. Although, the spread of the Omicron variant clearly is a downside risk to our growth outlook, we do not expect new contractions in GDP, as high vaccination rates will allow containment measures to be more moderate than during earlier waves of the pandemic. We expect growth to return to above the trend rate during 2022Q1, and remain elevated throughout 2022. Indeed, there still is room for strong growth in consumption due to pent-up demand and a further recovery of the labour market, while growth will continue to be supported by fiscal and monetary policy.

Economic performance within the eurozone to converge. The level of eurozone GDP almost returned to its pre-COVID level in 2021Q3 (see graph). However, there were big differences among the largest member states. These growth differences can be explained by a large number of factors. Some related to the pandemic (e.g. spread of the virus and strictness of containment measures) and others to economic fundamentals (e.g. economic structure, competitiveness and flexibility of the labour market). We expect the gaps between the various countries to narrow when the economic impact of the pandemic wanes, which we expect to happen in 2022-2023. Part of this economic convergence will be due to the distribution of funds from the European Recovery and Resilience Facility (RRF), which will be skewed towards the countries that were hit hardest during the pandemic. For instance, Italy and Spain will receive relatively large amounts (equal to around 4% and 6% of GDP, respectively), whereas France will receive less than 2% and Germany and the Netherlands each less than 1%.

GDP versus pre-COVID, EZ Big-5

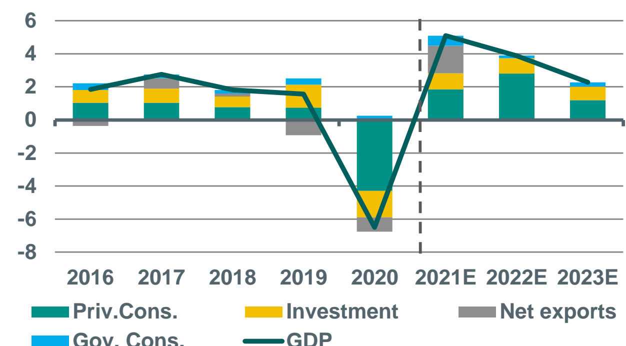
Index, 2019 Q4 = 100



Source: Refinitiv, ABN AMRO Group Economics

EZ GDP growth and main components

% / pps



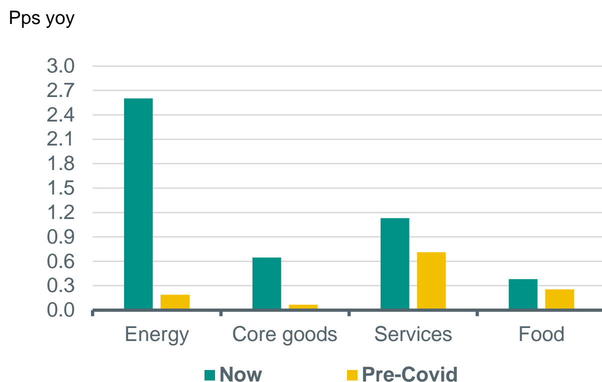
Source: Refinitiv, ABN AMRO Group Economics

Private Consumption the main contributor to growth next year. Looking at the main components of GDP, private consumption growth bounced back sharply during Q2-Q3. Despite this rebound, the volume of consumption was still around 3% below pre-pandemic levels in Q3, while the savings rate was still well above pre-pandemic levels. This suggests that there is room for pent-up demand going forward. However, monthly data for retail sales, new car registrations and Google Mobility data for visits to retail and recreation have indicated that consumption growth has slowed markedly in Q4. Consumer confidence fell in October and November, which was probably due to the rapid spread of the Delta variant in a number of member states, and the re-introduction of containment measures. On top of that, the ongoing rise in (energy

price) inflation has reduced real disposable household income and has probably also reduced consumers' propensity to carry out major purchases. We think the current weakness in private consumption will dissipate during the course of next year, when inflation is expected to decline noticeably, while the labour market recovery should continue. Indeed, we expect private consumption growth to outpace total GDP growth in 2022 as a whole.

Investment supported by RRF. Although private consumption will be the biggest contributor to GDP growth in 2022-2023, fixed investment is also expected to grow robustly. Both private as well as government investment will receive extra support from the RRF funds. According to the European Commission's (EC) assessment of the RRF spending plans that had to be submitted by the member states, in total more than 0.5% of EZ GDP will be spent in each of 2022 and 2023. In terms of composition of expenditure, the biggest allocation of the RRF funding by 2023 will go to capital transfers (44%), predominantly supporting private investment, followed by general government investment (32%), while the remainder would finance current expenditure and other costs. Member states have allocated almost 40% of the spending in their plans to climate measures and more than 26% on the digital transition.

Contributions to inflation now vs pre-pandemic



Source: Refinitiv, ABN AMRO Group Economics

Wage growth has slowed down

Source: ECB, ABN AMRO Group Economics

Labour market recovery faster than expected, but not yet complete. Thanks to the wide use of job retention schemes, the impact of the pandemic on household income has remained limited. Although these schemes might have created some frictions in the labour market, they have also reduced hiring and firing costs for companies. The overall adjustment of the eurozone labour market to the pandemic was smoother than expected. The eurozone unemployment rate returned to the pre-pandemic level in September 2021, albeit with large differences between countries and economic sectors. Nevertheless, there remains slack in the labour market, with employment (in persons as well as in hours worked) and the labour market participation rate still below pre-pandemic levels in Q3. Meanwhile, growth in negotiated wages has slowed. We expect wage growth to pick up in 2022-2023, but to remain below the levels that would create upward cost pressure on inflation.

Inflation at record high levels. Inflation rose to 4.9% in November, up from 4.1% in October. The main driver of the rise in inflation since the start of the pandemic has been energy price inflation. On top of that, services inflation is currently being lifted by (base effects due to) the normalisation of prices related to hospitality, entertainment and travel after the end of lockdowns in the spring of this year. Finally, a rise non-energy industrial goods inflation is due to surging global industrial goods prices on the back of supply-chain bottlenecks and higher commodity prices. Looking forward, recent producer price data as well as industry price expectation surveys indicate that the rise in non-energy industrial good inflation could continue for a while, but it should ease over time. We expect inflation to fall sharply from the start of next year (also because the upward impact of changes in VAT rates will fall out of the series) and end up comfortably below 2% by the end of the year and in 2023. Energy price inflation seems to have peaked now, and should fall back in the course of next year. Moreover, leisure and holiday-related inflation and hence services inflation is likely to ease, as we judge that the prices of these items have largely normalised. With inflation likely to fall back below target by the end of 2022, we expect the ECB to maintain an accommodative policy stance, something we go into more detail on in our *Central banks and markets* Outlook.

The Netherlands: Robust growth in 2022 but bottlenecks are a drag

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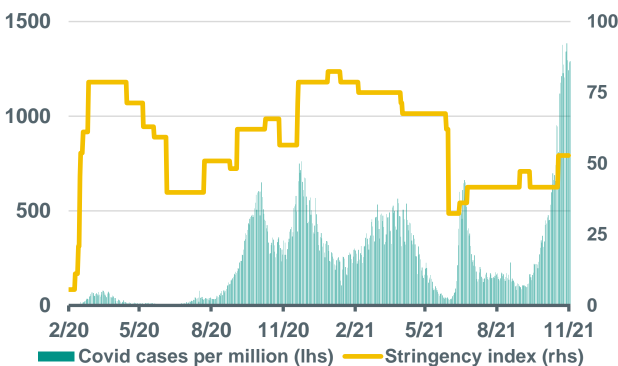
- **New restrictions are dampening activity in Q4, but growth in 2021 is still expected to reach 4.4%**
- **The Dutch economy has been resilient, and we expect this to drive above trend growth in 2022**
- **The pandemic, Omicron, and prolonged bottlenecks pose serious downside risks to growth**

With Q3 growth of 3.8% qoq, Dutch GDP bounced back above pre-pandemic levels, mainly led by a rebound in consumer spending after the reopening of the economy. Compared to eurozone peers, the Dutch economy has been remarkably resilient in 2020 and 2021. The initial drop in GDP was smaller, and each successive Covid wave has had less macroeconomic impact. This flexibility and resilience will be crucial for the economy going forward, as catch-up growth fades and uncertainty regarding Covid and supply-side bottleneck increases.

Daily cases are spiking, leading to new restrictions

Oxford Stringency index, Total confirmed cases of COVID-19 per 1,000,000 people



Source: ABN AMRO, CBS

Netherlands outperforms most Eurozone countries

GDP-index, 2019Q4=100

Source: ABN AMRO, CBS

In 2021 global trade expanded further, which benefitted Dutch exporters. In normal times this leads to a pick-up in investment, but in the second half of 2021 investment actually declined. With producer confidence and new orders at record highs, this is clearly not due to a lack of demand, but rather the result of bottlenecks; global supply issues and shortages in key components and the tight labour market have delayed the execution of investments plans.

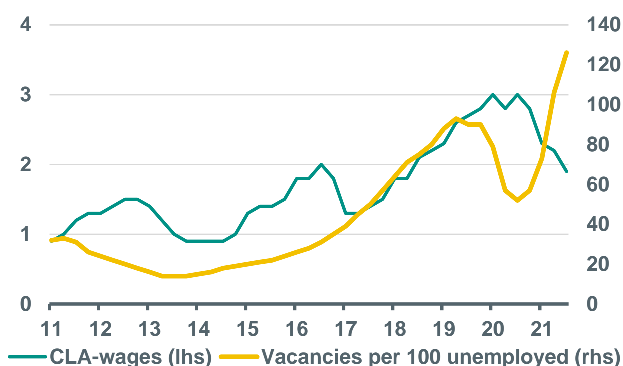
Recently, new infections have spiked, prompting the Dutch government to step up restrictions. The 'lockdown light' of previous waves in the pandemic has been replaced by an evening lockdown – where bars, cafés and non-essential shops close at 5pm – of three weeks. The direct impact of these restriction is estimated to be manageable, as it mainly targets bars, restaurants, cinemas and theatres, which comprise together only around 4.5% of total consumer spending. Moreover, in previous lockdowns, we witnessed large substitution effects, with spending redirected from bars and restaurants to takeaway venues, and from cultural activities to at-home activities. The subscriptions to on-demand video have surged as visits to theatres and cinemas were restricted. That said, it remains highly uncertain whether the new measures will be sufficient to relieve ICU occupancy, and therefore an extension and/or tightening of restrictions is a serious risk. The emergence of the new Omicron strain adds to these risks. All told, we expect restrictions to result in a contraction in private consumption in Q4, which followed an already declining growth trend due to the fading out of catch-up effects, in combination with declining consumer confidence due to inflation fears and uncertainty regarding the Covid outlook. Despite a weaker fourth quarter primarily due to Covid restrictions, we still expect growth of 4.4% in 2021.

Outlook for 2022: Covid uncertainty and nearing the limits of growth
As the economy is still in catch-up mode versus trend GDP, we expect above trend growth for 2022, primarily driven by a further recovery of private consumption. Despite higher inflation eroding purchasing power, consumption is being boosted by low levels of unemployment and high savings rates. On top of that, the government has announced to reintroduce the wage subsidy scheme given that Covid-19 restrictions have been tightened again. This will help to sustain consumption as well. Yet, the uncertainty regarding potentially tighter Covid restrictions and the Omicron variant is casting a shadow over the 2022 outlook. On our current forecast, we expect restrictions to remain in place until early 2022, with a rebound in consumption starting in the latter half of February, making 1st quarter consumption growth still positive.

As the economy grows, the constraints on supply are likely to weigh more heavily. The October business survey pointed to increased supply constraints, with firms reporting insufficient inventories to sustain production, and we expect these impediments to continue well into the first half 2022. In addition, thanks to the generous wage subsidy scheme (NOW) by the Dutch government, unemployment has only dropped slightly during the pandemic, and with the re-opening of the economy, the labour market has become historically tight. Currently, unemployment stands at 2.9%, and for every 100 unemployed, there are 126 vacancies. The EC business survey for the Netherlands shows that labour is as big a factor limiting production as the shortage of materials. We do however expect that, when the economy adjusts, these pressures will abate. All in all, while supply and labour market constraints will weigh on growth in 2022, we still expect some catch-up growth, especially in the first and second quarter of 2022. We expect GDP growth of 3.8% in 2022, slowing somewhat from 2021's 4.4%. The pandemic, however, continues to pose downside risks to the outlook.

Unprecedented tightness, but wage growth subdued

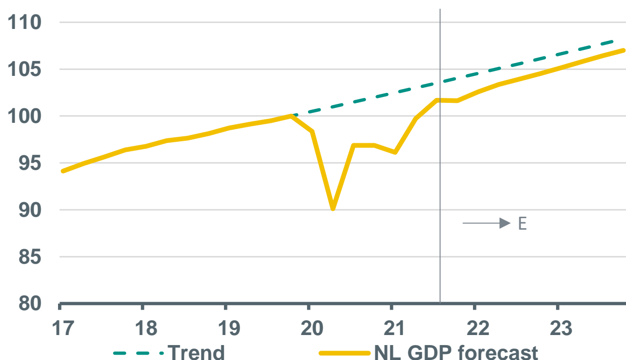
CLA-wages incl. special remuneration yoy, vacancies per 100 unemployed



Source: ABN AMRO, CBS

Above trend growth helping to close the output gap

GDP-index, 2019Q4=100



Source: ABN AMRO, CBS

Global demand outpacing supply has also driven prices higher in the Netherlands. CPI inflation for November (5.2%, core: 2.5%) showed a further acceleration in price growth. As the difference between headline and core shows, inflation is mainly driven by volatile components, particularly energy. Taking the latest figure into account, we expect inflation for 2022 to moderate to 2.6%. High energy prices, and pass-through effects into goods are expected to continue until mid-2022. Once high energy prices subside, the main source of upward inflationary pressure will fade and we therefore expect inflation to come back down.

Despite these price pressures and a scorching hot labour market, we see no effect on wages. Collective Labour Agreement (CLA) wage growth has declined slightly in Q3 of 2021. Due to the wage structure in the Netherlands – 75% of all wages are fixed in CLAs – a wage-price spiral is very unlikely at the moment. Incidental wages, including job-switches, promotions and bonusses, have been on a higher growth path lately, but are only responsible for a very small proportion on the total wages. For these reasons, we do not see reasons to change our view on inflation; i.e. we expect it to be elevated well into 2022, but driven primarily by base effects and energy prices, with a normalisation to just-below 2% levels from 2023 onwards. A delay in the easing in supply side disruptions and bigger second round effects are an upside risk to this view.

US: Inflation risks to drive earlier policy tightening

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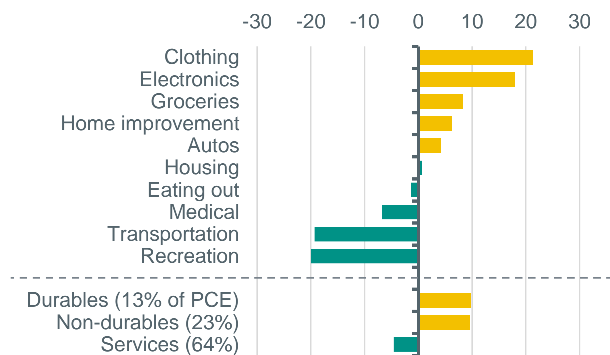
- **The economy grew strongly in 2021, and above trend growth should continue in 2022**
- **However, the continued tilt in goods vs services consumption is keeping inflation risks firmly to the upside. The spread of Omicron could – if anything – intensify those risks**
- **We expect this, combined with an unexpectedly tight labour market, to trigger rate rises from June**

Looking purely at headline growth figures, the US economy has performed remarkably close to our expectation laid out in February, following the crucial Democrat Senate majority win; GDP is likely to have grown 5.6% in 2021, just shy of our 5.8% estimate back then. GDP has comfortably surpassed its pre-pandemic peak, and will return to the pre-pandemic trend – i.e. the output gap will have closed – by Q2 next year. Where the economy has surprised is in the composition of growth, and the implications that this has had for inflation. Goods consumption, initially boosted by successive rounds of stimulus cheques and unemployment benefit top-ups, has stayed strong for far longer than we expected. At the same time, the rapid spread of the Delta variant over the summer months – while not leading to any meaningful new restrictions on activity – nonetheless put a dampener on the services recovery. The net result is that private consumption growth overall has actually outperformed our expectation from February, but this persistent excess goods consumption has conspired with unexpected supply-side bottlenecks to push inflation to the highest it has been in 30 years.

Consumption remains heavily tilted towards goods…

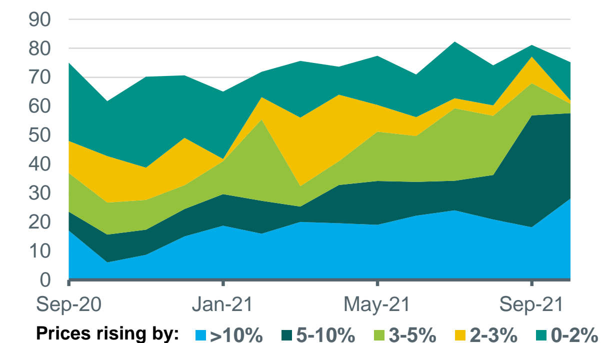
Private Consumption Expenditure (PCE), % vs pre-pandemic trend



Note: As of October 2021. Yellow bars = goods categories, green = services categories. Source: Refinitiv, ABN AMRO Group Economics

…driving a broadening in inflationary pressure

% distribution of inflation categories (weighted share) by price rise



Source: Dallas Fed, ABN AMRO Group Economics

When inflation initially began picking up in the spring, much of it could be explained as catch-up from the undershoot periods during lockdown in 2020. The next leg of acceleration was largely on the back of used car prices. Car production has been hampered globally by a shortage of semiconductors, but in the US this shortage in supply met a stimulus-fuelled surge in demand, and this drove astronomical rises in used car prices: as of October, prices are 43% higher than February 2020 levels. In recent months, inflationary pressure broadened well beyond used cars; according to Dallas Fed estimates, some 60% of weighted PCE inflation categories are rising by more than 5% annualised as of October, and half of those are rising at a 10%+ annualised pace. This rapid broadening of price pressures comes alongside historically unprecedented rises in pipeline producer prices, both in the US and globally, as well as wage growth driven by an unexpectedly tight labour market.

Outlook for 2022: Recovery to continue, aided by an easing in supply-side bottlenecks

While growth in the 2021 has been somewhat weaker than expected, this is not for lack of demand, but rather supply: the drags on growth have come mainly from an inventory drawdown, and weak investment on the back of component and labour shortages. On some measures – for instance, shipping freight tariffs and port congestion – some supply-side bottlenecks look to have peaked, but a full recovery of the supply side looks unlikely before end-2022, and the spread of the new Omicron variant could well prolong that process. Nonetheless, growth should still see support from a gradual easing in supply-side bottlenecks, and we expect a pickup in investment alongside a rebuild of inventories to be tailwinds for the economy in 2022. Fiscal policy is also likely to remain broadly supportive, with the recently-passed Bipartisan Infrastructure Deal and President Biden's upcoming Build Back Better plan set to lift investment in infrastructure and renewable energy.

On the consumption side, based on the experience of the Delta wave, we are unlikely to see a re-imposition of restrictions on economic activity, while consumers themselves also seem to be increasingly undeterred by the spread of new virus variants. As such, while Omicron could dampen near-term consumption growth, it looks unlikely to derail it.

Continued upside inflation risks are likely to trigger an early rise in interest rates

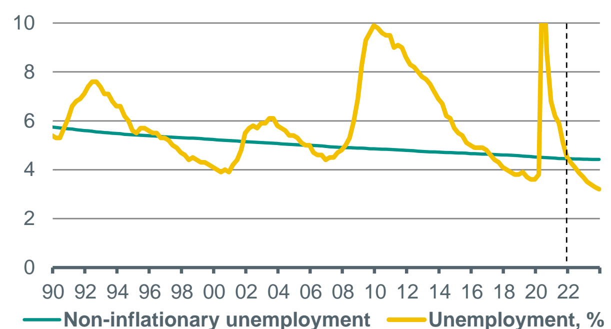
Perhaps a bigger implication of Omicron could be its impact on the composition of consumption rather than growth, i.e. it could further delay the shift from goods consumption back to services. This would add to already elevated risks to inflation. We still expect inflation to come down significantly in the course of 2022, with core CPI inflation expected to peak at just over 5% in February, falling to 2.4% by end 2022. However, there is significant uncertainty surrounding this forecast, and the risks are primarily to the upside. First, the broadening in inflation raises the risk that recent price-setting behaviour becomes entrenched, i.e. that inflation expectations rise more broadly. Recently, consumer survey-based measures of inflation have hovered around the top end of the range of the past decade or so. However, the longer that broad and elevated inflation persists, the bigger the risk that these expectations drift beyond recent historic ranges. Even more importantly, indicators of labour market tightness have risen to historically elevated levels, despite employment itself still being below the pre-pandemic level, with the quit rate at an all-time high of 3%, and some measures of wage growth at multi-decade highs. This suggests that the unemployment rate consistent with low and stable inflation – or the NAIRU – is higher than it was before the pandemic, driven at least in part by a significant fall in labour force participation. Indeed, following research by the Fed suggesting that much of the current shortfall in participation has been driven by early retirees – i.e. people who are unlikely to return to the labour force – we have brought forward our expectation for when the Fed will reach its full employment goal of c.4% unemployment to Q2 2022, from Q4 previously. Labour force participation should still increase somewhat over the coming year, potentially aided by the proposed support for childcare under Build Back Better, but we do not expect this to be enough to fundamentally change the dynamics we are now seeing in the labour market in the near term.

Labour cost growth is accelerating sharply

Source: Refinitiv, ABN AMRO Group Economics

Economy might already be at full employment

Unemployment, % (Period after dotted line is our forecast)



Note: 'Non-inflationary unemployment' refers to the NAIRU estimate by CBO. Source: Refinitiv, ABN AMRO Group Economics

The combination of upside risks to inflation expectations and an unexpectedly tight labour market has led us to bring forward our expectation for interest rate rises. With the Fed now likely to end asset purchases by March next year – brought forward from the previous June expectation – we expect the Fed to begin raising the fed funds rate in June, half a year sooner than our previous, early 2023 expectation. In total, we expect three 25bp rate hikes in 2022, and three more such hikes in 2023, taking the target range of the fed funds rate back to the pre-pandemic level of 1.5-1.75% by end 2023. We think the goal of this accelerated pace of policy tightening will be to keep a lid on longer run inflation expectations, and to be in a better position to tighten policy further should inflation remain higher than expected in the medium term. However, we do not at this stage expect a policy tightening that bears down aggressively on demand. As such, and given the lags with which monetary policy typically affects the economy, we have not made adjustments to our growth forecast for 2022, which we expect to remain well above trend at 4.1%. For 2023, we expect a significant slowdown in growth, on a combination of fading post-pandemic catch-up effects and tighter monetary policy. While our headline growth forecast for 2023 is 2.3%, this will be flattered by carry-over strength from 2022, with quarterly annualised growth expected to average 1.4% – well below trend.

China: Growth risks to remain in Year of the Tiger

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- **Strong full-year annual growth masks exceptionally weak, pandemic-driven qoq growth this year**
- **We have lowered our annual growth forecasts for 2021 and 2022 to 8.0% and 5.3%, respectively**
- **Zero-tolerance covid-19 policy, Omicron and real estate add to risks…**
- **…but we expect further piecemeal policy easing and other measures to stabilise growth**

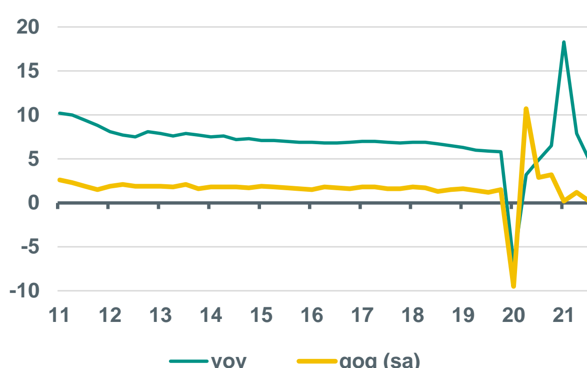
On 1 February 2022, China's Year of the Tiger will start. The tiger is seen as the animal king in the Chinese zodiac, being associated with 'strength, the exorcism of evils and braveness'. Whether these characteristics will prove symbolic for China's economy in 2022 remains to be seen. Over the past two years, the economy followed an unusually volatile, pandemic-driven growth pattern. Thanks to a strong base effect from the initial covid-19 shock in Q1-2020, annual growth will reach ±8% in 2021, which would be the highest pace since 2011. While this reflects China's strong initial rebound from the pandemic, the recovery has clearly stalled this year, reflecting zero-tolerance covid-policies and other self-inflicted headwinds. We have lowered our growth forecast for 2022 to 5.3%, and see risks still tilted to the downside (see our recent publication ***Will the Chinese Dragon keep flying*** for more background on China's longer-term growth challenges and scenarios).

Looking back at 2021: Strong average annual growth masks weak quarterly growth

In sequential growth terms, the rebound from the pandemic shock has clearly stalled this year. In Q1-Q3 2021, qoq growth averaged a meagre 0.5%, with hardly any growth in Q1 and Q3. This stalling momentum, combined with base effects, is also reflected in a plunge in yoy growth, from 18.3% yoy in Q1 to 4.9% yoy in Q3. China's slump is to a large extent 'self-inflicted'. First, a zero-tolerance covid-19 policy has been kept in place, although (Delta) flare ups in terms of case numbers remain very low from an international perspective. This has depressed (services) consumption and this explains why consumption continues to lag in the recovery. Second, with annual growth easily surpassing the rather conservative growth target of 'above 6%' adopted in March 2021, policy makers have seized the opportunity to address longer-term financial stability risks. For instance, tackling leverage in real estate, with the 'three red lines' policy constraining finance for property developers. Drags from real estate intensified further following Evergrande's woes. The government also intensified and expanded a regulatory crackdown on internet companies. Third, Beijing's aim to address environmental issues resulted in a power crunch, hitting industrial production in recent months and triggering a spike in energy prices. With pandemic drags fading compared to the summer, and energy policies having been eased in the meantime, we anticipate quarterly growth to pick-up in Q4-2021 (but yoy growth to fall further), although we have cut our full-year 2021 growth forecast to 8.0% (from 8.3%).

High average yoy growth in 2021 masks weak qoq growth

Real GDP growth



Source: Bloomberg, Refinitiv

Recovery of private consumption is lagging

Total retail sales, values, CNY bn

Source: Refinitiv

Outlook for 2022: Omicron makes loosening of zero-tolerance covid-19 policy less likely

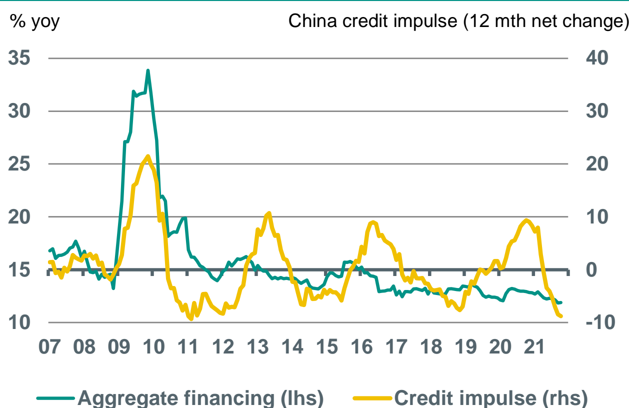
Looking forward to 2022, the recent emergence of the Omicron variant in South Africa (which looks even more contagious than Delta) brings another layer of uncertainty. Although it is still early days for an overall assessment, at this stage Omicron seems to have reduced the likelihood that China will ease its zero-tolerance covid-19 policy soon. China's leadership has profiled itself as the global champion of pandemic control and seems to tolerate the macroeconomic costs so far, while the

population also seems to approve of its approach. While China has ramped up its vaccination rate sharply, uncertainty regarding the effectiveness of China's vaccines – certainly in relation to new variants – does not make a regime change likely at this stage. For sure, cross-border traffic will remain highly restricted. Domestically, a careful easing of policy after the Beijing Winter Olympics in February may be on the cards (should the effects of Omicron prove manageable), but Beijing has already indicated it will not mirror the 'stop-go policies' of European governments, nor the *laissez-faire* approach of the US.

… but we expect further piecemeal policy easing and other measures to stabilise growth

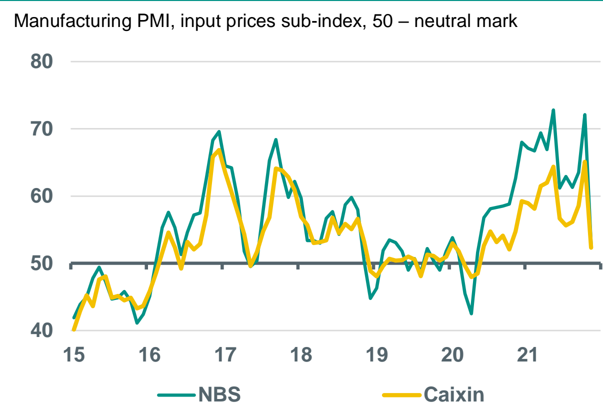
What does all of this mean for the outlook? Following the high, pandemic-driven, volatility of qoq growth rates in 2020-21, we expect some normalisation in 2022, but Omicron is the wild card. Risks from virus flare-ups remain, both on the demand and the supply side. The adherence to strict covid-19 policies will keep a lid on the further recovery in private consumption. We should add that China's zero-tolerance covid-19 policy has become more targeted over time (partly thanks to the use of IT), with lockdowns and other mobility restrictions now much more localised than in the initial phases of the pandemic. What is more, while – on balance – Omicron looks to be a risk-negative for China at this stage, it may have a positive effect as well. So far, China's ongoing export strength can be partly attributed to a global (pandemic-related) demand shift to goods, and Omicron may delay a rotation back to services. Meanwhile, we expect investment to pick up in 2022, as we foresee a further piecemeal easing of macro policies. Following a State Council meeting in early December, the PBoC announced another 50bp RRR cut per mid-December, in line with our expectations, and we have pencilled in another 50bp cut for next year. Moreover, we anticipate ongoing moderate fiscal support in the form of increased space for local governments to finance infrastructure, including climate-related, projects. We also expect Beijing to take measures to contain the drags from the real estate sector. Policy inaction would mean that annual growth in 2022 will likely fall below Beijing's preferred trajectory next year. China's 2022 growth target will be announced at the annual National People's Congress in early March 2022, but we may already get a glimpse of this at the Central Economic Working Conference later this month.

Credit cycle to bottom out on piecemeal easing steps



Source: Bloomberg

Cost price pressures ease



Source: Refinitiv

We expect producer price inflation to ease and consumer price inflation to rise

In the course of this year, China's producer price inflation has accelerated sharply, reaching a 26-year high of 13.5% yoy in October. This acceleration, which has contributed to global inflation fears, is largely driven by commodity-related sectors, resulting from the global rise in commodity prices, and aggravated by a domestic power crunch. We expect annual PPI inflation to come down next year (although potential supply shocks from Omicron could delay this process going forward). A relaxation of energy policy has already caused a downward correction of energy and other commodity prices. This was also reflected in a sharp drop in the sub-indices for input prices in China's latest manufacturing PMIs. Meanwhile, the most recent data confirm that the pass-through of higher cost prices into consumer price inflation (CPI) and core inflation is still limited, partly reflecting the still weak state of domestic demand. The gap between PPI inflation and CPI inflation reached a record-high of 12%-points in October. Still, with signs of this pass-through starting to rise and the food price cycle (dominated by pork prices) turning, we expect consumer price inflation to rise to an average of 2.5% in 2022, from 1.0% this year.

UK: The Brexit-pandemic supply crunch

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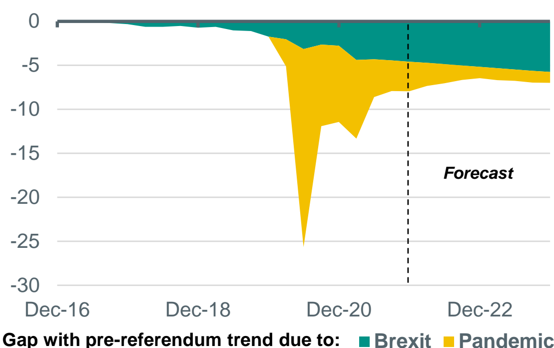
- **The economy is weaker than it appears, despite the sharp rebound in GDP this year and next**
- **Pandemic supply-side disturbances are conspiring with unique Brexit-related hits to the economy's productive capacity. This is limiting growth, and pushing inflation higher**
- **The mix of a shortfall in demand but an even bigger shortfall in supply poses a unique challenge for the Bank of England, which is likely to begin raising rates as soon as this month**

The UK economy was one of the hardest hit by the pandemic in 2020, with a peak to trough fall in GDP of 22% (compared with 15% in the eurozone, and 10% in the US). It is therefore no surprise that the rebound in 2021 has been among the strongest: we expect full year growth of 6.8%, compared with 5.1% in the eurozone, and 5.6% in the US. The strength of the rebound overstates the strength of the economy, however; GDP has just about recovered its pre-pandemic peak, but the economy is still expected to be 3.5pp smaller at the end of this year than it would have been absent the pandemic – and this is before we even talk about Brexit. Indeed, the effects of the pandemic are difficult to fully disentangle from Brexit given the timing of the UK's departure from the Single Market, a little under a year ago. The impact of new border checks and immigration restrictions has been significant, however, and aside from reducing the potential output of the UK economy, the reduced supply side capacity of the economy is also one of the main reasons the Bank of England will likely have to tighten monetary policy sooner than other major central banks. This earlier tightening of policy ought to bring inflation back to target, but it will also inevitably weigh on demand in the medium term.

Pandemic effect fading, but Brexit impact is

GDP gap with pre-referendum (2016) trend, percentage points



Source: Refinitiv, OBR, ABN AMRO Group Economics

Inflation would stay above target without rate hikes

CPI, % yoy; Forecast = BoE estimate under different policy rate scenarios

Source: Bank of England, ABN AMRO Group Economics

As with the eurozone and the US, inflation has picked up significantly in recent months, rising to a 10 year high of 4.2% yoy in October, and is expected to peak near 5% in the spring, when Ofgem (the national energy sector regulator) raises the household energy price cap to reflect the recent jump in wholesale gas prices. Indeed, although household energy bills already rose significantly in October, this incorporated only part of the rise in wholesale prices, with the result that some 28 energy suppliers have gone bankrupt this year so far, covering 5.8m households. However, energy is not the only driver of inflationary pressure in the UK. Core CPI inflation also rose to a 10 year high of 3.4% yoy in October. The UK has not experienced the same excess goods consumption that we have seen in the US – retail sales are broadly in line with the pre-pandemic trend. However, the UK is also facing some idiosyncratic supply-side bottlenecks via Brexit that are pushing up inflation, in addition to those faced by economies globally in recent months (such as shipping tariff rises and semiconductor shortages).

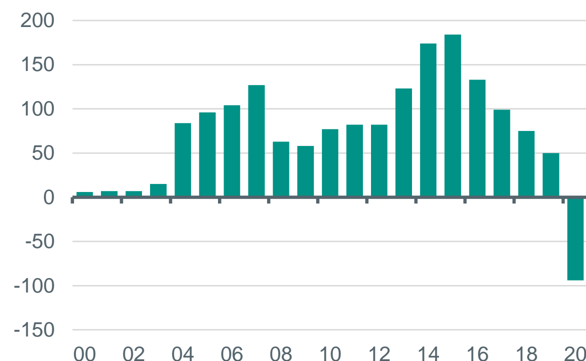
The BreX-Factor: UK is running up against capacity constraints sooner than elsewhere

First off are the permanent, albeit one-off cost-push pressures related to the UK's exit from the EU's customs union at the end of 2020, which has increased the bureaucratic burden on importers and exporters. While full checks have yet to start on UK imports from the EU – checks on UK exports on the EU side began from day one – businesses have already faced

higher costs from the need to prepare for the start of checks (this has been repeatedly delayed, with checks now due to start in phases from next January to July). Time and money spent on bureaucracy is time and money that cannot not spent on raising the economy's productive capacity. While we had expected an immediate impact from increased border frictions on the goods sector, however, a more surprising effect of Brexit has been a worker shortage, following the end of free movement of people linked to the UK's Single Market exit. While the movement of migrant workers has been hampered globally by the pandemic, in the US for instance, migrant worker levels have more or less normalised. The UK saw a net outflow of EU citizens for 2020 as a whole – the first such outflow in three decades – following many years of net inflows from the continent. Although we only have estimates for 2021, the latest data to June suggests that outflow has continued. This pairs well with data suggesting a very tight labour market, despite the continued shortfall in aggregate demand vs pre-pandemic trend, as well as the many anecdotal reports of difficulty finding staff for vacancies often filled by EU workers. The most visible of these shortages – and one that has had a near-systemic impact – has been that of lorry drivers, which has led at various stages to fuel shortages and supermarket shelves being empty of certain goods. As well as having a restraining impact on consumption, this has also put upward pressure on inflation.

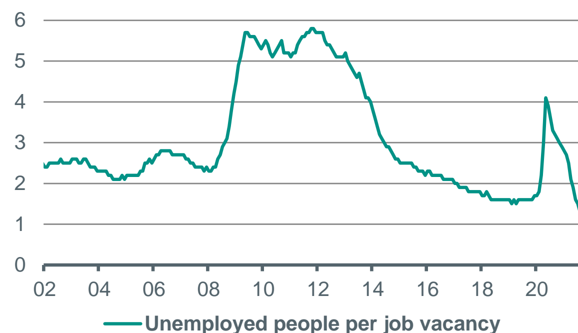
The net effect of all of this is that the economy is running up against capacity constraints much sooner than we are seeing in other advanced economies, with potential output perhaps even lower than the pessimistic assumptions we laid out in last year's UK Outlook publication. While we expect the economy to continue its strong recovery from the pandemic in 2022, with growth of 4.9% expected, the level of output is likely to significantly lag what would have been possible absent both the pandemic and Brexit, with a net shortfall in GDP of around 6.5pp at end-2022 on our estimates. In 2023 – once the bulk of the pandemic recovery is behind us – Brexit will continue to limit growth in the supply side of the economy, with the drag on output therefore increasing modestly (see chart on previous page).

First net outflow of EU migrants in three decades…



Source: Refinitiv, ONS, ABN AMRO Group Economics

…likely a key driver of the tight labour market



Source: Refinitiv, ABN AMRO Group Economics

Rate hikes look increasingly necessary to bring demand back into balance with weaker supply

This mix of a continued shortfall in demand but an even bigger shortfall in supply poses a unique challenge for the Bank of England, which has until now aimed to support demand, but is now having to be mindful of the inflationary consequences of the supply shortfall. This is particularly pertinent given that inflation has been historically higher in the UK compared with the US and especially the eurozone, with a bigger corresponding risk of a de-anchoring of inflation expectations. With inflation already far above the central bank's 2% target, and little sign of an increase in labour supply either from a loosening in the government's strict new immigration regime, or from the end of the pandemic wage subsidy scheme in October (which initially looked like it would generate some rise in unemployment), governor Andrew Bailey and a number of MPC members began signalling imminent rate rises over the coming months. Our base case is that, following an initial 15bp rate hike in December – which will take Bank Rate to 0.25% from the current 0.10% – we expect another two 25bp hikes next year (in February and August), followed by two 25bp hikes in 2023 (also February and August). This takes Bank Rate to 0.75% in 2022, and 1.25% in 2023. This is slightly less tightening than what we have pencilled in for the Fed, as the UK has less of an excess demand issue than we are seeing in the US. Rather, the case for tightening in the UK rests more on a) the unique supply-side constraints from Brexit, as well as b) historically higher inflation expectations.

Central banks and markets: Fed policy tightening to leave its mark

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- **Fed set to speed up its tapering of asset purchases and embark on a significant rate hike cycle**
- **Tightening is focused on getting ahead of an inflation problem, which makes this time different**
- **ECB faces different macro conditions and will keep policy accommodative, while ending the PEPP**
- **US Treasury yields will rise significantly, especially the short end, leading to curve flattening**
- **Euro yields will be pulled up modestly by the US move; Policy divergence will see EUR/USD decline**
- **Omicron unlikely to trigger new stimulus, unless financial conditions tighten severely**

Fed will go faster than markets currently expect

Against the background of a broadening rise in inflation, consumer goods spending that has sky-rocketed, subdued labour supply and rising wage growth, the Fed will likely remove accommodation at a faster rate. Although the Fed has set out a timetable for tapering asset purchases at a gradual pace through to June, it seems likely that it will shorten the taper period to March. This will set up an early start to a rate hike cycle. With the Fed having already met its average inflation goal, and the labour market likely at full employment, we judge that the Fed will start to hike the fed funds rate in June 2022. In total, we expect the Fed to raise the fed funds rate three times in both 2022 and 2023. Thereafter, we expect a more gradual pace of two hikes per year, until the fed funds rate reaches 2.50-2.75% by the end of 2025. This is around the FOMC's neutral rate estimate of 2.5%. The graph below shows the cumulative number of rate hikes we expect in our base case, and what market expectations are based on Eurodollar futures and the US swap curve. As can be seen, our base case is for faster and more significant Fed rate hikes, especially 3-4 years ahead.

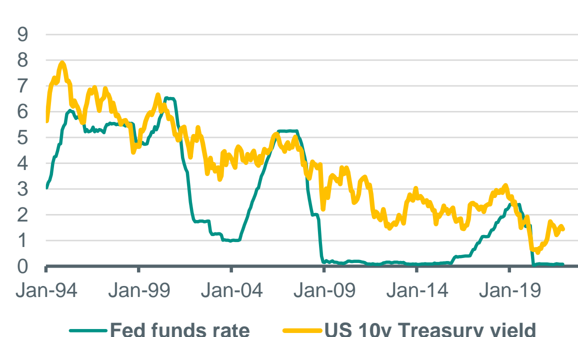
US Treasury yields will rise as markets price in a higher terminal rate

An important driver for the 10y US Treasury yield is expectations for where the Fed's policy rate will ultimately be 3y ahead. Indeed, the 10y US Treasury yield has a very high correlation with the 12th Eurodollar position, whereas the 2y US treasury yield has a very high correlation with the 4th Eurodollar position as shown in the graphs above. Given that we forecast the Fed funds rate to be at its eventual peak of around 2.50-2.75% by end 2025, we expect longer term yields will move higher in 2022, with the 10y US Treasury yield settling at around 2.6% at year-end. In previous cycles, the 10y US Treasury yield also settled around the eventual peak in the Fed funds rate, although well ahead of that time. Once we move closer to the first rate hike, which we have pencilled in for mid-2022, we expect the US Treasury curve to bear flatten. We expect this will be most pronounced in the 2s10s and 2s30s area of the US Treasury curve, as was also the case in previous rate hike cycles.

Expectations for Fed rate hikes

Source: Bloomberg, ABN AMRO Group Economics

US Treasury yield and Fed policy cycles



Source: Bloomberg, ABN AMRO Group Economics

ECB to keep policy more accommodative, with divergence weighing on the euro

The expected tapering and rate hikes by the Fed and the resulting rise in US Treasury yields should also put some upward pressure on their European counterparts. The divergence between US and eurozone rates is expected to put downward pressure on the euro, which would raise eurozone growth and inflation, all other things being equal. Nevertheless, we think

that the euro area is facing a different set of macroeconomic circumstances compared to the US. The rise in eurozone inflation is much more narrowly based, wage growth is subdued and consumer demand is much weaker than in the US. Indeed, we expect an output gap to remain in the eurozone at the end of 2022, despite growth at around 0.7% qoq in 2022, which is well above the trend rate. Therefore, underlying inflationary pressures will remain weak. In combination with the ECB's new inflation framework, this suggests that policy will remain easier for longer, with purchases under the APP continuing and policy rates remaining on hold during the coming years. Based on our growth and inflation forecasts and considering the fact that the ECB is likely to start hiking the deposit rate 12 to 18 months before it reaches its inflation goal, we judge that an ECB rate hike cycle is still some years away. This points to a significant policy divergence between the Fed and ECB over the coming years, which will see the euro decline significantly against the dollar.

Tug of war in Europe could lead to Bund volatility

Nevertheless, a sharp rise in Treasury yields will also leave its mark on Euro rates. Indeed, this is what we saw during the previous Fed rate hike cycle, despite the ECB remaining on hold. Technicals also become somewhat less favourable. Given the end of the PEPP, we expect higher net adjusted supply of government bonds in 2022 compared to 2021. Overall, we expect longer term yields to move higher, while short term yields are expected to move sideways. This would result in a bear steepening of yield curves in the euro area. Our baseline is for a 10y Bund yield of around 0% at the end of next year, though we could see more significant spikes in between, given a tug of war between the upward pull from the US and a dovish ECB. Despite lower asset purchases overall, the APP will have an important role in this story. We expect the ECB to remodel the APP into an envelope that can be used flexibly to fight against financial conditions tightening too quickly.

US and European bond yields and the last Fed hike cycle

Source: Bloomberg, ABN AMRO Group Economics

Financial conditions

Source: Bloomberg, ABN AMRO Group Economics

Omicron a downside risk to growth but could even be an upside risk to inflation

Investors are digesting what Omicron means for the monetary policy outlook. We have not factored Omicron into our economic, central bank or market forecasts at this stage. However, our current thinking is that central banks will not react to Omicron by easing policy aggressively or even at all. We still think that the Fed is heading for monetary tightening. The ECB will also keep to its previous course of ending the PEPP, while maintaining optionality as well as accommodation via its other instruments. Our unchanged outlook for central banks reflects that the starting point compared to Covid I is different in terms of the supply side and inflation, and Omicron could prove to be at least as much a supply shock as a demand shock (see previous chapter on how Omicron might impact the economic outlook). We do think that a very sharp tightening of financial conditions would be the game changer for central banks, though we are currently nowhere near close to that at this point. (Jolien van den Ende, Bill Diviney, Aline Schuiling & Nick Kounis)

Key views on a page

We expect the post-pandemic recovery to continue in 2022, with above trend growth in the eurozone, the US and China. However, uncertainty over the economic outlook is now arguably the highest it has been since the start of the pandemic in early 2020. While economic growth has been strong, as economies have largely opened up, the supply-side has struggled to keep up with resurgent demand, with the consequence being inflation. This has brought forward the likely timing of interest rate rises in the US, and while we do not expect the ECB to follow, given the very different macroeconomic circumstances in the eurozone, this will have global spill-over effects over the coming year. The spread of the new Omicron variant poses downside risks to growth, but upside risks to inflation.

Macro	Central Banks & Markets
Eurozone – Following a sharp rebound in growth in 2021 Q2-Q3, the economy has entered a soft patch. Supply side bottlenecks and record-high (energy price) inflation are restraining growth in industrial production and also reduce consumers' real disposable income. In addition, a new coronavirus wave is hitting the region. Following this soft patch, growth is expected to return to above trend, supported by monetary and fiscal policy as well as a further labour market recovery. Inflation is likely to drop lower in the course of 2022 and should end up below the ECB target in 2023. There still is some slack in the labour market and wage growth has slowed down.	**ECB** – We don't expect the PEPP to be extended despite the eurozone's struggle to contain the Delta strain and the new threat of the Omicron strain. Even if Omicron leads to new global restrictions/lockdowns for a longer period, it is unclear at this stage what that would mean for the medium term outlook for inflation. The ECB can maintain policy accommodation via its forward guidance on policy rates and by extending net purchases under the APP. Although the profile of inflation over the next year has risen, inflation is still likely to undershoot the 2% target over the medium term. As such policy rates are unlikely to go up during our forecasting horizon.
Netherlands – In 2021 the Dutch economy experienced high growth following the easing of restrictions, annual growth is expected to come out at 4.4%. Going forward growth is set to remain above trend. Constraints to growth stemming from the notoriously tight labour market and supply bottlenecks will weigh heavier as the economy closes the gap to trend growth. Moreover, Covid developments raise downside risks to our growth forecast of 3.8% for 2022. Inflation, temporarily pushed up by energy prices and the pass through of price pressures from supply bottlenecks, will come down over the course of 2022.	**Fed** – Given persistently elevated inflation in the US, and upside risks to the outlook, we expect the Fed to announce an acceleration in the tapering of its asset purchases in December, with purchases now expected to end in March (our previous expectation was June). Following this, we expect the Fed to begin raising the fed funds rate in June, half a year sooner than our previous, early 2023 expectation. In total, we expect three 25bp rate hikes in 2022, and three more hikes in 2023, taking the target range of the fed funds rate back to the pre-pandemic level of 1.5-1.75% by end 2023.
US – The economy grew strongly in 2021, and above trend growth should continue in 2022. However, the continued tilt in goods vs services consumption is keeping inflation risks firmly to the upside. Unexpected tightness in the labour market is also putting upward pressure on inflation, with the expected recovery in labour supply now less than we previously thought. The spread of Omicron could – if anything – intensify those risks. While we expect above-trend growth to continue in 2022, we expect growth to slow to below-trend rates in 2023, on a combination of fading post-pandemic catch-up effects and tighter monetary policy.	**Bond yields** – Given that we forecast the Fed funds rate to be at its eventual peak of around 2.50-2.75% by end 2025, we expect longer term yields will move higher in 2022, with the 10y US Treasury yield settling at around 2.6% at year-end. In previous cycles, the 10y US Treasury yield also settled around the eventual peak in the Fed funds rate, although well ahead of that time. Once we move closer to the first rate hike, which we have pencilled in for mid-2022, we expect the US Treasury curve to bear flatten. The rise in US Treasury yields should also put some upward pressure on their European counterparts, despite the ECB keeping its policy rates on hold.
China – Strong full-year growth this year reflects the base effect from the initial covid-19 shock, but masks weak sequential growth. China's slowdown is to a large extent self-inflicted (zero-tolerance covid-policy, real estate, power crunch). We expect a pick-up in qoq growth in Q4-2021, but have cut our growth forecasts for 2021 and 2022 to 8.0% and 5.3%, respectively. Zero-tolerance policy, Omicron and real estate add to growth risks in the Year of the Tiger, but we expect further piecemeal easing and other measures to stabilise growth. We expect (currently high) PPI inflation to ease in 2022 and (currently low) CPI inflation to rise, but to remain below the PBoC's target.	**FX/EURUSD** – We expect more weakness in EUR/USD. The key driver will be a significant policy divergence between the Fed and the ECB over the coming years. We now expect that the Fed will begin hiking interest rates in mid-2022, with the goal of returning the Fed funds rate to the pre-pandemic target range of 1.50-1.75 by the end of 2023. We believe that the ECB is facing a different set of macroeconomic circumstances than faced by the US central bank. The ECB has also explicitly ruled out a rate hike in 2022 and has hinted that it could well be "on hold" for much longer. Our forecast for EUR/USD at year-end 2021 is 1.10 and 1.05 for year-end 2022.

Country and region forecast tables

Key forecasts for the Eurozone	2020	2021e	2022e	2023e
Economic outlook (% yoy)				
GDP	-6.5	5.1	3.9	2.3
- Private consumption	-8.0	3.5	5.4	2.2
- Fixed Investment	-7.3	4.4	4.3	4.1
- Net exports (contribution pps)	-0.4	1.2	0.2	0.0
Inflation	0.3	2.5	1.7	1.1
- Core inflation	0.7	1.4	1.2	1.3
Unemployment rate	7.9	7.8	7.7	7.5
Interest and exchange rates (eop)				
ECB deposit rate	-0.5	-0.5	-0.5	-0.5
3M Euribor rate	-0.5	-0.6	-0.6	-0.6
10yr yield (Bund)	-0.6	-0.2	0.0	0.1
EUR/USD	1.22	1.10	1.05	1.00

Key forecasts for the Netherlands	2020	2021e	2022e	2023e
Economic outlook (% yoy)				
GDP	-3.8	4.4	3.8	2.4
- Private consumption	-2.9	1.3	2.4	1.3
- Fixed Investment	-0.9	0.5	-0.2	0.4
- Net exports (contribution pps)	0.1	2.1	0.9	0.2
Inflation	1.3	2.3	2.4	1.4
Unemployment rate	3.8	3.3	3.1	2.8

Key forecasts for the United States	2020	2021e	2022e	2023e
Economic outlook (% yoy)				
GDP	-3.4	5.6	4.1	2.3
- Private consumption	-3.8	8.0	3.1	2.0
- Fixed Investment	-2.7	7.9	6.0	5.2
- Net exports (pp contribution)	-2.3	-1.0	-0.5	-0.4
Inflation (PCE)	1.2	3.8	3.2	1.9
- Core inflation (PCE)	1.4	3.2	2.9	2.0
Unemployment rate	8.1	5.4	4.0	3.3
Fed funds rate (eop, upper bound)	0.25	0.25	1.00	1.75

Key forecasts for China

	2020	2021e	2022e	2023e
Economic outlook (% yoy)				
GDP	2.3	8.0	5.3	5.2
CPI inflation	2.5	1.0	2.5	2.0
Unemployment rate (urban areas)	5.2	5.0	4.9	4.8
Interest and exchange rates (eop)				
1-Year Best Lending Rate	4.35	4.35	4.35	4.35
1-Year Loan Prime Rate	3.85	3.85	3.85	3.85
USD/CNY	6.54	6.40	6.20	6.15
EUR/CNY	8.00	7.04	6.51	6.15

Key forecasts for the UK

	2020	2021e	2022e	2023e
Economic outlook (% yoy)				
GDP	-9.7	6.8	4.9	2.3
- Private consumption	-10.8	4.0	6.9	2.7
- Government consumption	-6.3	15.8	5.1	1.3
- Fixed Investment	-9.1	4.4	5.1	2.8
- Net exports (pp contribution)	-5.7	0.9	0.1	0.1
Inflation	0.9	2.5	3.8	1.9
- Core inflation	1.4	2.3	3.6	2.4
Interest and exchange rates (eop)				
Bank of England Bank Rate	0.10	0.25	0.75	1.25
GBP/USD	1.37	1.36	1.33	1.30
EUR/GBP	0.89	0.81	0.79	0.77

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