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Global Monthly

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

Are central banks doing enough to fight inflation?

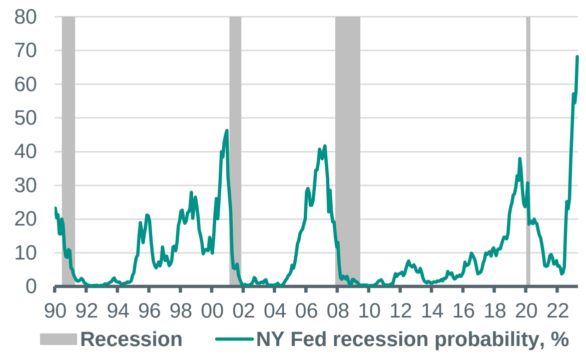
- **The global macro picture has been a confusing one recently, with clear signs of recession contrasting with other signs of surprising resilience**
- **We map out a range of macro indicators and make a judgement on which parts of the economy point to a recession, and which do not**
- **We think recessionary forces will ultimately prevail, because we judge that central banks need recessions to be sure inflation falls sustainably back to target**
- **Regional updates: We think core inflation has probably peaked in *the eurozone*, while in *the Netherlands*, we still see resilience in the economy despite the contraction in the first quarter**
- **Spending cuts loom in *the US*, even if Republicans agree to raise the debt ceiling**
- ***China's* economic rebound continues, but headwinds from property and US tech tensions are a drag**

Global View: Despite the mixed macro signals, central banks in any case likely need a recession

Central bankers have been at pains recently to remind financial markets that their job fighting inflation is not yet over – which was underscored by a shock UK inflation reading this week. While the Fed has sent the strong signal that it will likely keep rates steady at the 14 June FOMC meeting, and the ECB is likely approaching a peak in rates, the jury is still out on whether rates are being raised enough to generate sufficient economic weakness that brings inflation sustainably back to target. Complicating central bankers' jobs are the mixed signals economies are giving out of late. Aggressive rate hikes have put a clear dampener on credit conditions, global trade and manufacturing are sending strong recessionary signals, and the US debt ceiling impasse poses an imminent threat to the US and global economy. Meanwhile, labour markets are still exceptionally tight, and parts of the services sector are still in post-pandemic recovery mode. Indeed, though it was confirmed this week that the German economy had already been in recession in Q4-Q1, the eurozone aggregate and especially the US have proven more resilient. In this month's *Global View*, we try to make sense of the confusing picture by mapping out which parts of the economy point to recession, and which do not. Despite the pockets of resilience, we still think recessions are likely needed to bring inflation sustainably back to central bank targets.

Yield curve points strongly to a US recession…

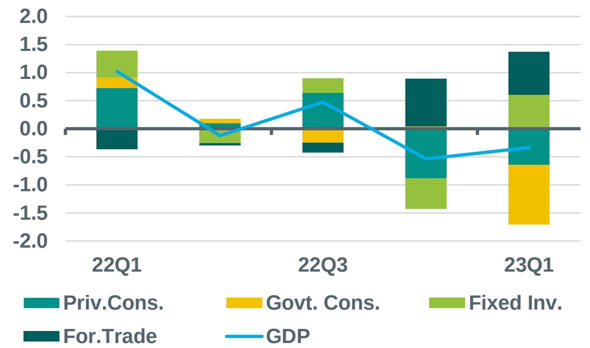
Recession probability in next 12 months (yield curve-based)



Source: Bloomberg, ABN AMRO Group Economics

…while the German economy is already in recession

% q/q sa, percentage point contributions



Source: Refinitiv, ABN AMRO Group Economics

Expansions do not die of old age – they are murdered by central banks

At a panel in early 2019, in response to former Fed Chair Yellen's assertion that 'expansions don't die of old age', her predecessor Ben Bernanke retorted: 'I like to say they get murdered'. While a gruesome depiction of a central banker's job, Bernanke was on the mark: unless triggered by a major exogenous shock (such as the most recent, pandemic-induced recession), recessions are normally caused by central banks raising interest rates 'until something breaks' – with the goal of ensuring inflation stays at (or falls back to) central bank targets. This is *Central Banking 101*.

If a central bank's job is to kill expansions that have got out of hand, how are they performing in their current tightening campaigns? In the below box, we map out various economic indicators across our main regions of coverage, and make a judgment over which are flashing red (pointing to recession), which are giving off mixed signals, and which suggest the expansion has further to run. Arrows denote recent trends in the data.

Our take is that while there are significant signs of imminent recession – particularly in the eurozone, where GDP was roughly stagnant in 2022Q4-23Q1 and Germany already entered recession – the overall picture is a mixed bag, suggesting the onset of recession could be further delayed. (Note: We include China in our heatmap due to its importance in the global economy, but it is subject to very different cyclical drivers and we do not expect a recession there.) As we will later argue, we continue to think that central banks will be determined to induce a downturn one way or another, for them to be confident that they have fought back sufficiently against the biggest inflation resurgence since the 1970s.

Recession Watch: Mixed signals, but also some clear early signs of recession

	Credit conditions	Business confidence	Yield curve / rate cuts expected	Housing	Manu-facturing	Corporate profits	Retail sales	Bankrup-tcies	Consumer sentiment	Investment	Labour market	Fiscal stance	Services
US	Red ↘	Red ↘	Red ↘	Red ↗	Yellow ↘	Red ↘	Green ↘	Yellow ↘	Yellow ↘	Yellow ↘	Green ↘	Green ↘	Green →
Eurozone	Red ↘	Red ↘	Red ↘	Red →	Red ↘	Green ↗	Red ↘	Yellow ↘	Yellow ↘	Yellow ↘	Green →	Yellow ↘	Green →
Netherlands	Red ↘	Yellow →	Yellow ↘	Yellow ↘	Red ↘	Yellow ↘	Green →	Yellow ↘	Yellow →	Green ↘	Green →	Green →	Green ↘
China	Green ↗	Green ↗	Green ↘	Red ↗	Yellow ↘	Yellow →	Green ↗	Yellow →	Yellow ↗	Yellow ↘	Yellow ↗	Green ↗	Green ↗

Green = Consistent with expansion Yellow = Mixed signals Red = Consistent with recession

↗ = Improving trend → = Stable trend ↘ = worsening trend

Credit conditions: Lending standards and loan demand both point to looming sharp declines in credit flows. Actual credit flows have already turned mildly negative in both the US and eurozone on the business side (consumer credit growth has slowed but still positive).

Business confidence: Conference board CEO survey, NFIB small business in the US, and ZEW and IFO confidence measures in the eurozone suggest a recession outlook.

Yield curve / rate cut expectations: Yield curves are inverted in the US and Germany. Significant rate cuts are expected by financial markets from the Fed in the US; to a lesser extent by the ECB. This typically points to a looming recession.

Housing: House prices have been falling in the past 6 months; moderately in the US, more sharply in the eurozone. Investment in house building contracted during 2022Q2-Q4 in the eurozone and has contracted in the US for eight consecutive quarters.

Manufacturing: World trade volumes have been on a downward trend since September 2022, and the global manufacturing PMI has persistently pointed to contracting output for the past 8 months. Manufacturing in the US is holding up somewhat better but is still weak.

Corporate profits: Following the post-pandemic surge, profits in the US are falling year-over-year. In the eurozone profits are still rising.

Retail sales: Goods consumption has trended lower in the eurozone for the past 12 months. In the US, sales have been robust on some measures, but high frequency indicators (such as Redbook's weekly data) point to falling sales y/y once adjusting for inflation.

Bankruptcies: Bankruptcies have risen in both the eurozone and the US, albeit from historically extremely low levels (they actually fell during the pandemic due to government support measures). While current bankruptcy rates are not yet consistent with recession, the trend is clearly for higher bankruptcies.

Consumer sentiment: Consumer sentiment has been historically low for some time in both the eurozone and the US, but largely on the back of high inflation. Confidence in job prospects remains relatively high, though it too has weakened in recent months.

Investment: Fixed business investment has continued to grow moderately in the US and in the eurozone, though it has clearly slowed from the post-pandemic rebound. The recent trend is for a further slowing.

Labour market: Labour markets remain exceptionally tight, and employment has continued to grow in both the eurozone and the US. However, there has been a clear slowing, particularly in the US, where job vacancies have fallen sharply in recent months.

Fiscal stance: Government spending has remained strong, particularly in the eurozone where governments stepped in to shield households from the energy crisis. These programmes are now being phased out (or are no longer applicable due to the fall in energy prices), but EU recovery fund flows will likely keep the fiscal stance from becoming too contractionary.

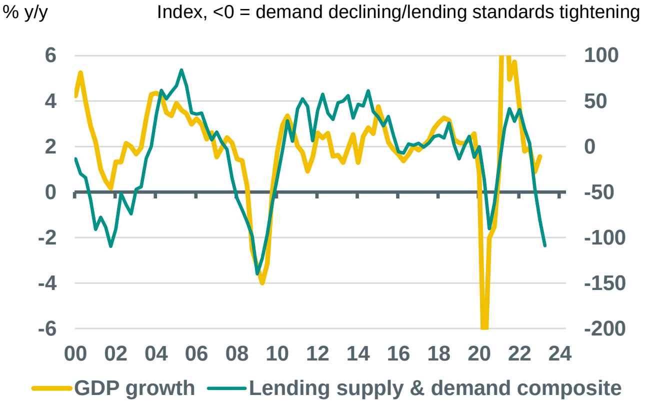
Services: With services consumption still below the pre-pandemic trend, activity has continued to expand in both the US and the eurozone. However, the pace of growth has not been anything to write home about, despite the strength suggested by services PMIs – in both regions growth has been at sub-trend rates.

Three clear signs of recession: 1. It's the credit conditions, stupid

How do central banks cause recessions? By tightening credit conditions. And if there is one historically very reliable leading indicator of recessions that is clearly flashing red right now, it's credit conditions (see also **Box 1 of our April Monthly**). Aside from higher rates making credit more expensive for businesses and households, concerns over the economic outlook have led to a tightening in both lending standards and declines in loan demand – in both the eurozone and the US – and this has been amplified by the banking sector turmoil following the failure of a number of regional banks in the US.

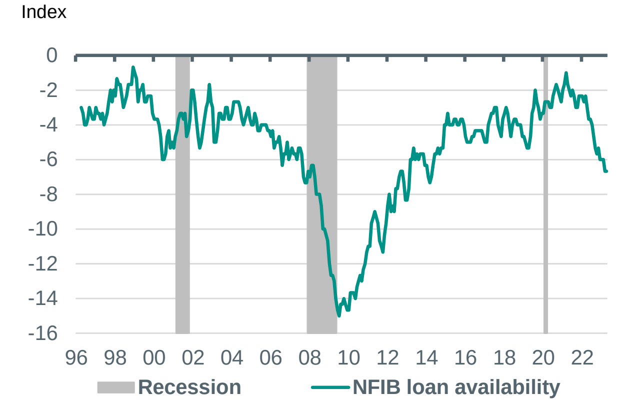
Less credit flowing into the economy means less money being invested by businesses or used for consumption by households, which inevitably weighs on activity. Based on historic patterns, the May update to the Fed's Senior Loan Officer Survey is consistent with US GDP growth falling to around -2% y/y over the coming quarters, which is lower than our expected trough of -0.4% (expected in Q4). Weekly bank lending data from the Fed already points to modest declines in loans to businesses. Consumer credit is holding up for the time being, but over time we expect tighter standards and higher household savings rates to lead to declines here too. In the eurozone, banks sharply tightened lending standards on loans to companies and mortgage loans since 2022 Q3, while demand for loans has dropped to historic lows and monthly flows in loans to companies and household have slowed the most since the eurozone debt crisis (excluding the pandemic).

Fed lending survey consistent with GDP falling -2% y/y



Source: Refinitiv, ABN AMRO Group Economics

Small businesses are finding it harder to get loans

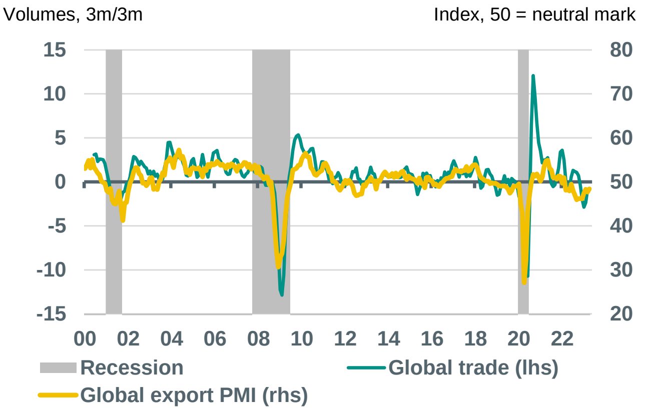


Source: Bloomberg, ABN AMRO Group Economics

2. Global trade and manufacturing are in a clear downturn

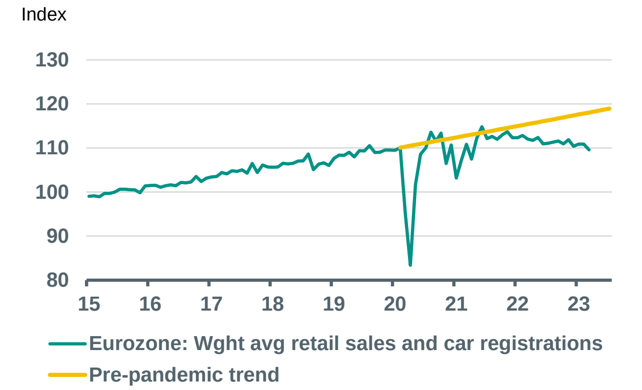
After peaking last September, global trade volumes have been on a declining trend. In the past, such persistent declines in trade volumes have not occurred outside recessions. The weakness in global trade has led to stagnating industrial production in the eurozone and in the US, while in China, production was much weaker than expected in April. Leading indicators such as PMI new orders and new export order indices point to more pronounced weakness to come. A key driver has been the significant weakening in goods demand – particularly in Europe, where high inflation has driven a sharper decline in real incomes, leading to persistent falls in goods consumption over the past year. In the US, goods consumption has been more resilient, but there are also signs of softening demand (evident for instance in Redbook weekly sales data).

World trade volumes on the decline



Source: Refinitiv, ABN AMRO Group Economics

Weak eurozone demand is likely a key driver



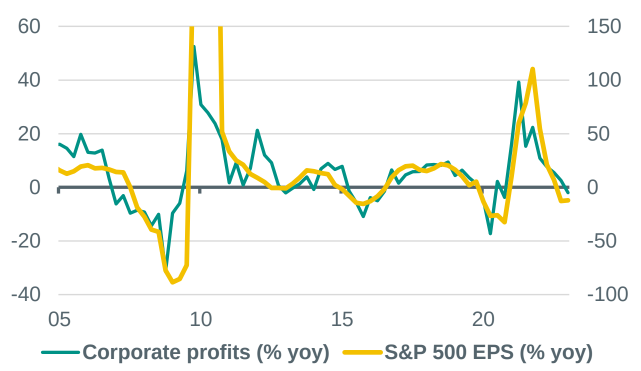
Source: Refinitiv, ABN AMRO Group Economics

Disturbances in China related to Zero-Covid (broad lockdowns in October/November followed by a messy exit in December) have also contributed to global trade weakness in late 2022, although according to CPB the reopening rebound has likely been a key factor in the uptick seen in world trade volumes in March. Still, with monetary policy expected to stay well in restrictive territory in advanced economies – keeping a firm lid on goods demand – the prospects for a sustained near-term recovery in global trade and manufacturing look slim.

3. Business confidence is weak and corporate profits are declining (in the US)

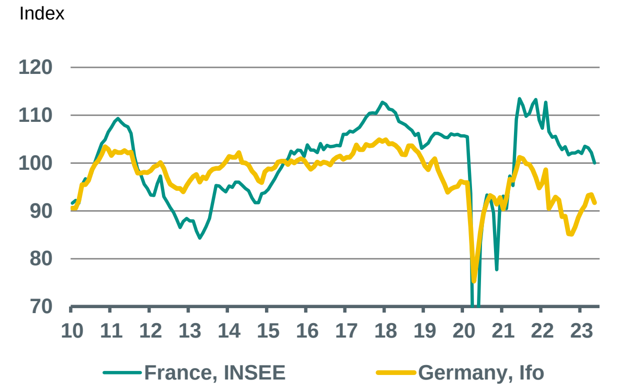
Various measures of business confidence signal recession on both sides of the Atlantic. The Conference Board's CEO survey in the US shows 87% of respondents expecting a shallow recession over the coming year. The NFIB small business survey index has fallen back below the pandemic lows. Corporate profits are now declining in the US following a post-pandemic boom in earnings. In most of the big eurozone countries business confidence is below the long-term average and declined further in April-May. In both regions, bankruptcies have been on a rising trend, albeit from historically very low levels. Bankruptcies are likely to continue rising in the coming quarters as tight financial conditions and weakening demand put increasing pressure on business solvency.

An earnings recession has started in the US



Source: Refinitiv, ABN AMRO Group Economics

Business climate in France and Germany has fallen

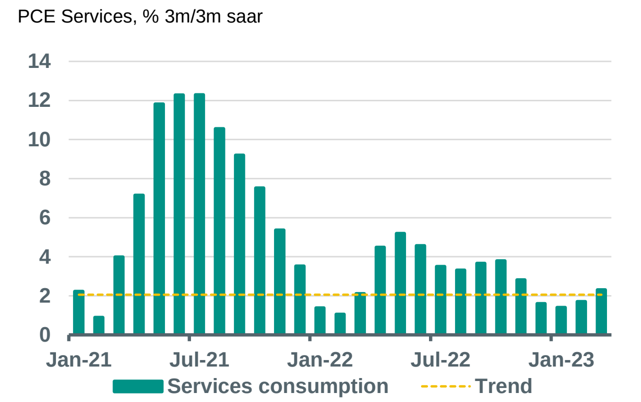


Source: Refinitiv, ABN AMRO Group Economics

Can the services recovery or the tight labour market prevent a recession from unfolding?

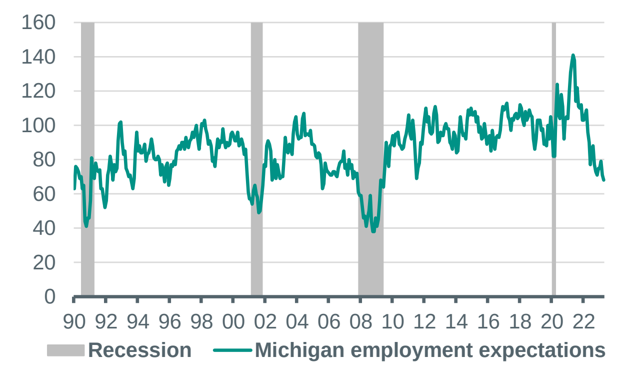
Among the areas of the economy clearly still flashing green are the services sector and the labour market – and these are reasonable factors to point to in making the case for no recession. Services consumption in both the eurozone and the US is still running around 2.5pp below the pre-pandemic trend, suggesting that there is still some room for catch-up growth. And a key factor supporting consumption broadly is that labour markets are exceptionally tight, meaning that any rise in unemployment is likely to be relatively modest compared with previous economic downturns.

US: Services activity is not exactly booming



Source: Refinitiv, ABN AMRO Group Economics

US: Labour market confidence is starting to crack



Source: Bloomberg, ABN AMRO Group Economics

While we think these are going to be crucial factors cushioning economies going forward, we see them as preventing downturns from turning more severe rather than preventing them altogether. Despite there still being room for services to recover from the pandemic, the sector will not be immune to the same headwinds that are weighing on goods consumption: namely tighter credit conditions and the hit to real incomes from high inflation. Indeed, though services consumption has continued to grow in recent quarters, the pace of growth has hardly been anything to write home about given the catch-up potential – we estimate services activity grew at a below-trend rate the eurozone and broadly at trend in the US in Q1. So, while the services economy is by no means weak, it is not exactly booming either.

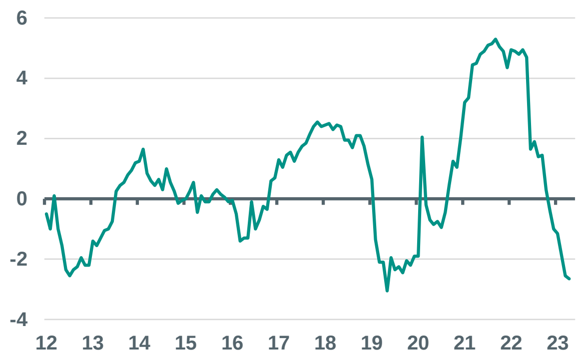
A crucial underpinning for consumption has been confidence in job prospects. Indeed, broadly weak consumer confidence has been largely the result of high inflation, with the employment subindices of consumer surveys showing much stronger confidence in job prospects. While jobs growth has remained robust for the time being in both the US and the eurozone, however, consumers are starting to worry more about the outlook. For instance, the Michigan employment expectations subindex fell to the lowest level since the 2008-9 recession in May. As labour markets continue to cool, and particularly as unemployment begins to rise, consumer caution – and spending cut-backs – are only likely to increase.

‘No landing’ isn’t impossible – but we would give it a low probability

Another case against recession is that inflation may continue to fall – all the way back to central bank targets – without a rise in unemployment, leaving central banks able to then cut interest rates to support continued growth in the economy. This is the so-called ‘no landing’ or ‘immaculate disinflation’ thesis. There are some good reasons to believe in such a scenario. First, much of the inflation we have seen was triggered by supply-side bottlenecks – disruptions to freight shipping, the war in Ukraine and Europe’s energy crisis – rather than being the result of major excess demand in the economy. This argument is much more applicable to Europe than it is to the US, where goods consumption surged to well above trend levels on the back of ultra-generous fiscal stimulus. Still, if we take as a given that *most* of the inflation surge is explained by the supply side, then the recent normalisation in supply bottlenecks – including the easing energy crisis in Europe – should now support a significant fall in inflation, even in the absence of a recession. The case for this was made by Bank of England Deputy Governor Ben Broadbent at the Bank’s May policy meeting.

Easing supply bottlenecks are disinflationary…

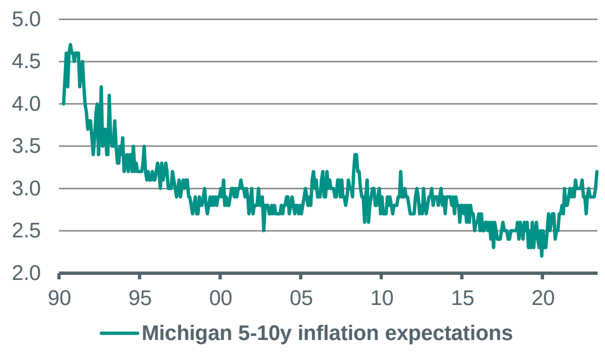
ABN AMRO Global Supply Bottlenecks Index, +6 = maximum bottlenecks



Source: ABN AMRO Group Economics, Refinitiv, Bloomberg

…but expectations are showing signs of de-anchoring

Expected inflation in 5-10 years, Michigan consumer survey % y/y



Source: Refinitiv, ABN AMRO Group Economics

A second major factor supporting this thesis is the sharp fall in job vacancies in the US – from a peak of around 12 million to 9.6 million as of March – which has occurred so far without a rise in the unemployment rate. That the Fed has seemingly been able to kill so much excess demand for labour without significant job losses so far is indeed remarkable.[1]

While we do not dismiss the ‘no landing’ scenario outright, we do see a relatively low probability of it materialising, for two reasons. The first concerns inflation expectations. Even if the initial driver of the inflation surge was supply-side driven, supply-side issues getting resolved does not necessarily take us all the way back to square one (the pre-pandemic era of below target inflation). That is because the post-pandemic inflation has clearly led to a rise in longer run inflation

[1] An alternative explanation is that the high level of vacancies was to a large extent due to reallocation of people between various sectors after the pandemic. So, lower vacancies could also mean the reallocation is making progress instead of demand for labour falling due to monetary policy tightening and the economic slowdown.

expectations, which – against the backdrop of a tight labour market – has led to higher wage demands and higher wage growth. Indeed, the latest Michigan survey of 5-10 year inflation expectations – closely watched by the Fed – rose to a new post-pandemic high of 3.2% in May. Meanwhile, unit labour cost growth has surged in the US, and has been running at 6% y/y for the past two quarters. A similar development is taking place in the eurozone, where wage growth has jumped in response to the energy crisis, without a corresponding rise in labour productivity. Unless businesses accept a fall in their profit margins, these costs will ultimately be passed on to consumers, potentially sparking a wage-price spiral. As such, although in big picture terms we expect inflation to continue falling in both the US and the eurozone, wage developments mean that inflation is unlikely to fall fully back to target without a meaningful rise in the unemployment rate.

Box 1: Differences in our view on the Netherlands versus the eurozone (Aggie van Huisseling)

During the pandemic recession, the Dutch economy already proved more resilient than the eurozone aggregate (see left graph). Most recent figures continue to show a slowing but resilient Dutch economy, despite the -0.7% qoq growth in Q1 of 2023. We expect the Dutch economy to continue to outperform the eurozone economy in 2023. There are several factors that contribute to this domestic resilience.

Labour market tightness

The labour market remains exceptionally tight. In April, the unemployment rate came in at 3.4%, while the participation rate rose to an all-time high of 75.7% (see right graph). The ratio of job vacancies to unemployed people also remains elevated at 1.2 vacancies per unemployed person. This signals that labour market tightness remains. We expect unemployment to edge up over the course of the year due to the normalization of bankruptcies and the slowing of the economy resulting in lower labour demand. However, the labour market will stay tight from a historic perspective due to the shortage of technical skilled personnel, labour demand from the public sector, and the ageing population. An overheated economy with a tight labour market is a source of resilience, but could also lead to elevated wage growth. In this regard, the Dutch Collective Labour Agreement (CLA) structure, where agreements are made for several years ahead, means that wage growth could prove more persistent.

Active contribution of the government

The Dutch government has an ambitious spending plan for the coming years, with investments in education, defence, housing and climate. In the first quarter of this year the government indeed contributed positively to growth despite the 0.7% contraction of total GDP. The impact of the expansive fiscal stance however is larger than the rise in government spending alone. Think for instance of the non-targeted energy compensation for households (to dampen the blow to purchasing power) and other energy support schemes for those receiving the minimum wage, and SMEs. We expect government spending to continue to support growth this year. The main constraint for spending is actually the tight labour market, meaning there is risk of spending falling short of targets, as we already saw in 2021.

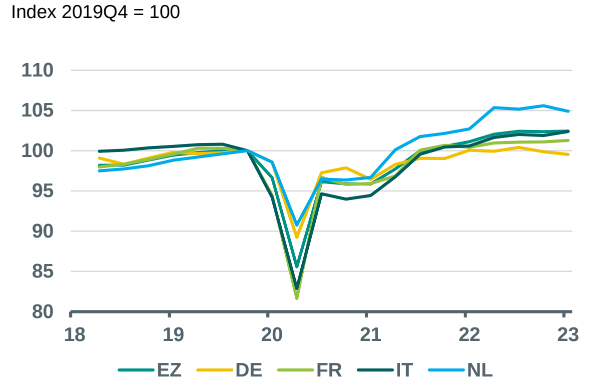
Resilience of household balance sheets

Dutch household balance sheets remain resilient. Due to a historically high savings rate during the pandemic, the stock of pent-up savings is substantial. Recently, the savings rate has returned to close to the pre-pandemic average, which indicates that a larger share of disposable income is used for consumption; but the wealth effect remains. The negative effects on spending from the expected correction in the housing market also seem limited from a historic perspective. Recent price declines come after a prolonged period of price rises, which means only a small share of recent buyers are hit significantly. In fact, on balance the majority of home owners still profits from a *positive* wealth effect stemming from earlier price rises. Additionally, the rules and regulations for mortgage loans, which have been in place since the financial crisis, mean that risks of negative home equity are much smaller: research by DNB (**link**) shows that if house prices decline by 20%, roughly 8% of outstanding mortgages would be in negative equity. This is significantly less than what we saw in the last major price correction (which ended in 2013), which left almost 30% of all mortgages in negative equity.

What does this mean for inflation?

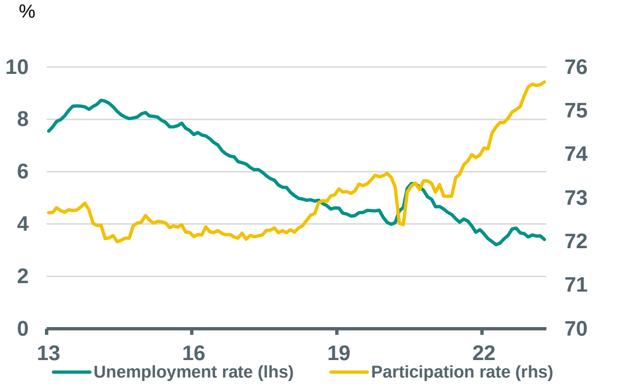
The consequence of all of this resilience is that the economy – which is overheated – stays overheated despite a cooling pace of growth. With high wage growth, and most recent CLAs pointing towards a further acceleration, we expect Dutch inflation to remain elevated above the 2% target. Inflation is expected to come down from 11.5% on average for 2022 to 4.3% in 2023 and 3.4% in 2024.

Dutch economy to slow down but resilience in place



Source: Refinitiv, ABN AMRO Group Economics

Main source of resilience is the tight labour market



Source: Refinitiv, ABN AMRO Group Economics

Secondly, while excess demand in the labour market has eased in the US without a rise in unemployment so far, there is no guarantee that this will continue – and historically, it is unprecedented for such a large drop in labour demand to occur without accompanying job losses. Fed Chair Powell acknowledged this himself in a recent post-FOMC press conference, while naturally expressing the *hope* that the Fed might achieve what had not been possible in the past.

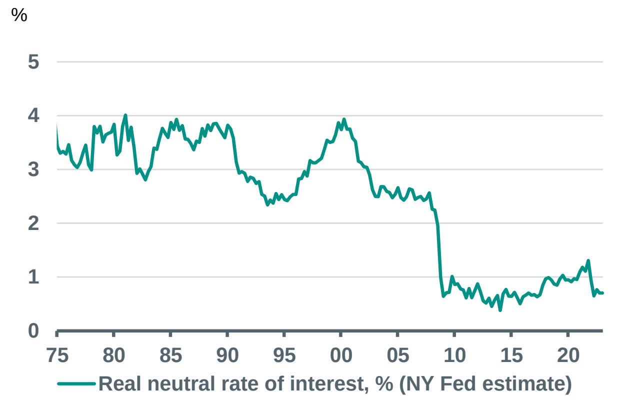
What does all of this mean? If recessions do fail to materialise over the coming months, we think it is unlikely inflation will fall fully back to central bank targets by itself.[2] Central banks may then need to tighten policy further in order to induce the necessary economic weakness (=recessions).

Box 2: Are interest rates really restrictive enough? NY Fed estimates suggest they are (Bill Diviney)

Key to answering the question 'are central banks doing enough' is knowing where the 'neutral' level of interest is, i.e. the level of interest that neither stimulates nor dampens the economy. Having an idea of this helps guide monetary policymakers in determining how far to raise interest rates. The neutral rate is impossible to estimate with precision, and ultimately, central banks must feel their way – being sensitive to incoming data to see if interest rate rises are indeed dampening demand as they intend. Still, there are some attempts using econometric methods to estimate the neutral rate that have produced helpful insights. The most famous of these was led by then NY Fed staffers **Laubach & Williams (2003)** (the latter is now NY Fed president). Estimates based on their (since updated) methodology suggests that neutral rates declined significantly in recent decades, and in the US, the real neutral rate had been estimated to be only a little above zero for much of the post-Great Recession era.

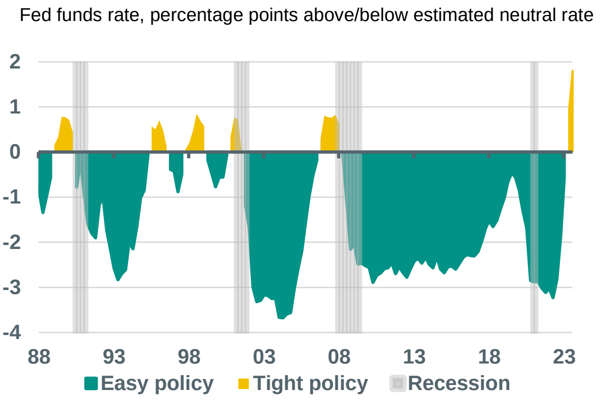
But with economies proving to be more resilient than expected in recent quarters – despite aggressive rate hikes by central banks – naturally came the question of whether neutral rates might have risen in the post-pandemic era? The NY Fed temporarily stopped publishing estimates of the neutral rate during the pandemic due to the economic disruption making estimates unreliable, but it resumed publishing of estimates last week. The take is that neutral rate estimates still remain very low, and in the US the real neutral rate is estimated to be just 0.7% at present (assuming long-run inflation at 2%, this implies a nominal neutral rate of 2.7%). In the eurozone, the ECB has communicated that it judges the nominal neutral rate to be around 2% - even lower than in the US.

US neutral rate remains historically low…



Source: Bloomberg , ABN AMRO Group Economics

…suggesting current policy is ultra-restrictive



Source: Bloomberg, ABN AMRO Group Economics

What does this mean for monetary policy and the economy? First, it means that policy rates likely are indeed already highly restrictive, it is just that the 'long and variable lags' mean that we do not immediately see the impact of them. This suggests patience on the part of central banks may be in order, at least for the time being. For the economy, it means that where recessions are yet to unfold, they are likely to – as it is historically unusual for monetary policy to be this restrictive and for there to be no recession.

Conclusion: Central banks are likely to favour price stability over preventing recession

If we take the view that inflation cannot fall fully back to target without a recession, and if we think central banks are genuinely committed to bringing inflation fully and sustainably back to 2%, then a recession looks unavoidable. A statement that Fed Chair Powell has repeated verbatim in each of his post-FOMC press conferences over the past year has been:

"Without price stability, the economy does not work for anyone. In particular, without price stability, we will not achieve a sustained period of strong labor market conditions that benefit all. The burdens of high inflation fall heaviest on those who are least able to bear them."

[2] We see a higher risk of this happening in the Netherlands, for instance, where our base case is for no recession. This is because ECB policy calibrated for the broader eurozone may prove to be insufficiently tight to bring inflation fully back to target in some specific countries. See also Box 1.

This statement makes crystal clear that – when push comes to shove – the Fed will favour achieving its 2% inflation target over stemming a rise in the unemployment rate, because ultimately, fulfilling the second pillar of the Fed's mandate (maximum employment) also depends on price stability. Indeed, the fact that the Fed is signalling that rates at the very least will stay in highly restrictive territory for at least the coming two years despite Fed staff forecasting a US recession, points to how determined the Fed is to get inflation back to target. For the ECB, where the inflation target is the *only* explicit goal of its mandate, this is likely to be even more so the case. Indeed, despite the German economy falling into a recession, there has been no let-up in hawkish comments from ECB Governing Council members. (Bill Diviney, Aline Schuiling, Arjen van Dijkhuizen, Aggie van Huisseling)

Eurozone: Core inflation has probably peaked

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

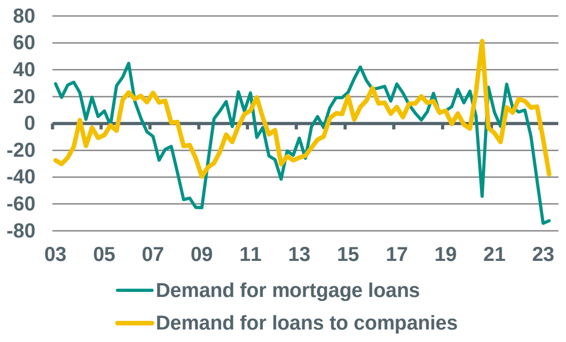
- **Eurozone GDP grew slightly in 2023Q1, but moderate contractions in GDP seem on the cards**
- **Core inflation probably has peaked, with the pass through of high energy prices easing**
- **We expect the ECB to hike rates further in the short-term, but the first rate cut could follow already by the end of the year**

Eurozone GDP expanded by 0.1% qoq in 2023Q1, whereas we had expected a small contraction similar to the -0.1% qoq that was recorded in 2022Q4. The detailed GDP report has not yet been published, but monthly activity data and details from individual countries indicate that growth was mainly driven by services consumption and a temporary jump in construction on the back of mild winter weather. Goods consumption and investment in machinery and equipment and inventories probably contracted in Q1, while net foreign trade probably lifted growth somewhat. Looking beyond Q1, we think modest contractions in GDP are on the cards. Past interest rate hikes by the ECB have already resulted in banks tightening credit standards on all types of loans, and demand for loans has also fallen. Moreover, actual loan growth has slowed down noticeably in recent months and house prices have declined. Also, the post-pandemic rebound in certain parts of services seems to have largely run its course, and construction will likely slow after the temporary boost in Q1. Finally, industrial production and exports are expected to remain weak as the global economy loses momentum. Despite the expected modest quarterly contractions in GDP, the annual average change in GDP will probably be slightly positive (+0.2%) this year, which is higher than our previous forecast of zero growth.

Inflation edged slightly higher in April (to 7.0%, up from 6.9% in March), but core inflation declined (to 5.6% from 5.7%). Base effects due to changes in energy prices last year temporarily lifted energy inflation in April, but it should fall sharply in the coming months. Food price inflation is also expected to decline based on recent trends in commodity and wholesale prices. Finally, core inflation is also expected to fall. Indeed, our calculations show that the pass-through of the rise in energy prices into the prices of goods and services that began with a lag of about six months after the start of the War in Ukraine, is easing. The inflation rate of energy-intensive industrial goods fell by 0.2 percentage points in April, after it declined by 0.1pp in March, while that of energy-intensive services fell by 0.1pp in April after being unchanged in March. We expect a further significant easing of the energy-intensive parts of inflation in the coming months, which should reduce core inflation. Our expectation of a recession should also bring wage growth down, helping inflation to fall back to the ECB's target over time.

Loan demand has plummeted

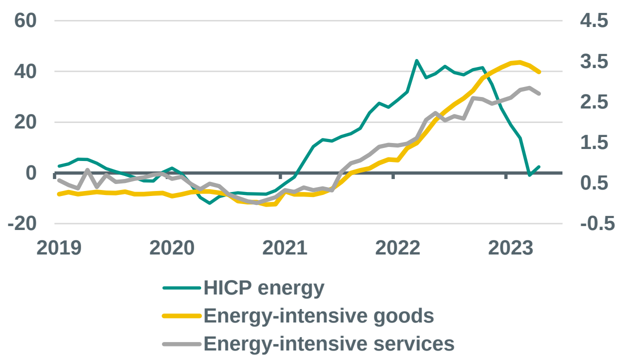
BLS, net change in demand for loans, positive is higher



Source: Revinitiv, ABN AMRO Group Economics

Inflation rate of energy-intensive good and services

% y/y



Source: Refinitiv, ABN AMRO Group Economics

As expected, the ECB raised the deposit rate by 25bp in May – a slowdown from earlier 50bp hikes. The ECB clearly signalled that its bias is towards further rate hikes. We expect two more 25bp hikes in both June and July, before a rate cut cycle begins in December and continues during 2024. Indeed, we think that as monetary policy tightening feeds through, the economy is likely to prove much weaker than the ECB currently expects in the second half of the year. As such, we expect an easing cycle to start from around the turn of the year.

The Netherlands: A slowing but resilient Dutch economy

Aggie van Huisseling – Economist | aggie.van.huisseling@nl.abnamro.com
Jan-Paul van de Kerke – Economist | jan-paul.van.de.kerke@nl.abnamro.com

- **GDP contracted by 0.7% qoq in 2023Q1, mostly driven by a negative trade balance and falling inventories**
- **We have lowered our growth forecasts to 0.7% for 2023 and 1.0% for 2024 (from 1.2% and 1.3%, respectively).**
- **Recent developments in the housing market show that the price decreases continued in Q1 2023**

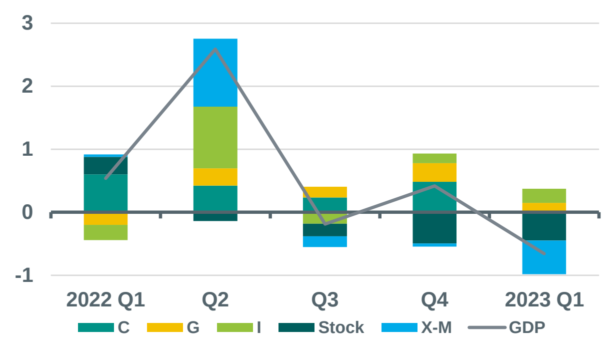
Last week, GDP data showed a quarter-on-quarter contraction of 0.7% in 2023Q1, following a 0.4% expansion in Q4 – which was revised downward from 0.6%. This means that Q1 growth for the Netherlands was lower than the eurozone average, which came in at 0.1% qoq. The figures indicate that the external environment of the Netherlands is weakening but that domestic demand is still resilient for now; albeit slowing. Indeed, the trade balance turned negative in Q1 as exports (-1.8% qoq) contracted more than imports (-1.3% qoq). This decline was driven by goods exports as services exports recovered further from the pandemic lows. The drop in private consumption in Germany (the Netherlands' main export market) by -1.2% qoq in Q1 probably played a role here. The change in inventories reduced overall GDP growth significantly, as companies are further depleting their stocks in the wake of slowing external demand. On the domestic side of the economy, demand has remained resilient for now. Government spending contributed positively to growth. Private consumption stagnated (0% qoq), despite elevated inflation and low consumer confidence. Dutch household spending is supported across all income groups by a still exceptionally tight labour market, accelerating wage growth, and government support to counterweigh the loss in purchasing power. As a result, we expect consumption to remain more resilient over the coming quarters compared to eurozone peers. Finally, fixed investment expanded by 1.1% qoq in Q1.

Based on the above we have lowered our growth forecasts to 0.7% for 2023 and 1.0% for 2024, down from 1.2% and 1.3% respectively. Although the slump in Q1 significantly raises the possibility of a technical recession (two consecutive qoq contractions), we do not expect a prolonged downturn or recession in the Netherlands – the economy will slow down primarily on the back of lower external demand but resilience, especially on the domestic front with a tight labour market, expansive fiscal policy and strong household balance sheets, is still in place (see also Box 1 in this month's Global View).

Indeed, thus far, households are resilient despite the loss of purchasing power. A significant slump in spending is also unlikely because consumption will remain supported by the energy price cap, while year-on-year wage growth has surpassed the inflation rate and will do so beyond 2023. Tightening of monetary policy will reach peak impact on the economy in H2 of this year. One channel of impact is declines in investment. However, in the near term there are signs that investment activity is still firm – for instance in the industrial sector. Finally, the housing market has turned a corner.

Negative trade balance had strong contribution in Q1

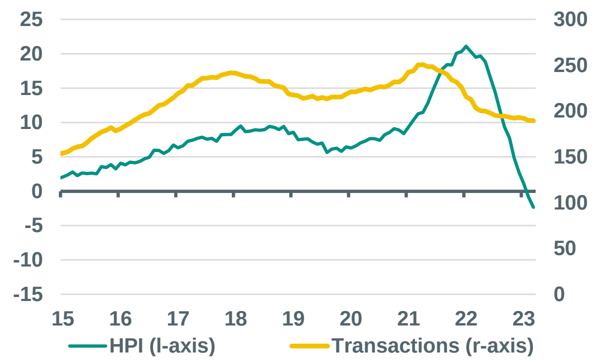
Contribution to percentage GDP qoq change in percentage points



Source: CBS, ABN AMRO Group Economics

Correction in both prices and transactions

%, yoy amount, 12-month average



Source: Refinitiv, ABN AMRO Group Economics

Recent developments in the housing market suggest price falls continued in Q1 2023. Higher mortgage rates have reduced affordability and have cooled housing demand. Buyers, of which many are reluctant to step into a market with falling prices, now prefer mortgages with a shorter fixed-interest period. Reticence amongst investors and nitrogen emission limits are constraining the construction of new housing. In the longer term, housing affordability should improve again due to wage increases. This will support price developments in 2024. We expect housing prices to fall by 6% on average this year, and by 4% in 2024. Due to base effects, this means that the majority of the price adjustments will happen this year.

US: Fiscal cuts will add to the headwinds

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

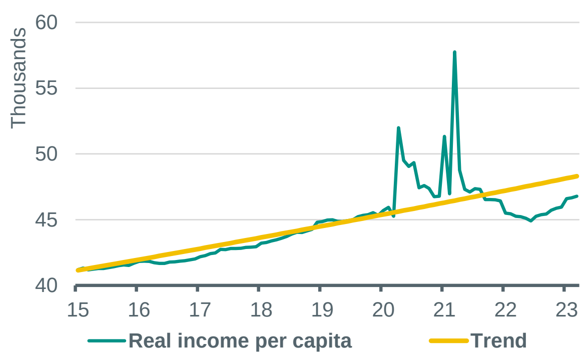
- **The economy was resilient in April, even if downward revisions took off some of the sheen. Still, the economy is clearly not in a recession, despite the headwinds from high interest rates and inflation**
- **Government spending cuts are expected to become an additional headwind going forward, as Republicans are unlikely to agree to a debt ceiling raise without them**
- **The Fed is now in wait-and-see mode. Our base case continues to be for no further hikes, but strength in underlying inflation and labour costs will keep hikes on the table for the time being**

The US economy exhibited resilience in April, with activity data coming in broadly stronger than expected. This was, however, offset by downward revisions to older data – a common theme in the post-pandemic era. To illustrate: the 250k jobs gain in April was offset by a -150k net revision for the previous two months; the 0.5% m/m rise in industrial production was offset by a 0.4pp downward revision to March; and the 0.6% m/m rise in core nominal retail sales was partly offset by a 0.2pp downward revision to March data. Still, the economy is clearly not in a recession either, with private consumption growing at a robust 3.8% q/q annualised pace in the first quarter – largely on the back of an exceptionally strong January. Indeed, while the warning signs from credit conditions are clearly there, and global trade and manufacturing weakness are a drag, the US consumer is keeping the economy humming along for the time being (see this month's Global View for more).

We continue to think this strength is unsustainable, given the headwinds from ultra-tight monetary policy and depressed real incomes due to high inflation, but timing the downturn is complicated, among other things, by policy lags and excess savings. Meanwhile, a further headwind still to come is from fiscal policy. While our base case is that a last minute bipartisan deal to raise the debt ceiling will be reached, this will not be costless to the Biden administration – nor to the US economy. Republicans will likely only acquiesce to something that involves substantial cuts to outlays. Relative to our baseline, this is likely to mean a reduced contribution from government spending to GDP growth and more job layoffs. In the meantime, there is a non-negligible risk that a deal isn't reached in time, with signs that Republicans believe such a scenario may hurt Democrats more than it hurts themselves. This is contrary to the 2011 experience, but it goes without saying that failure to reach a deal in good time would mean a more severe recession than we forecast (see our Q&A for more).

Real incomes still depressed by high inflation…

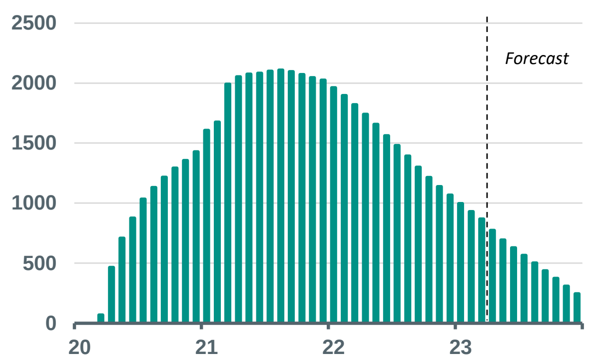
USD thousands



Source: Refinitiv, ABN AMRO Group Economics

…but excess savings continue to provide some buffer

Estimated excess savings from the pandemic, USD bn



Source: Refinitiv, ABN AMRO Group Economics

Against this backdrop, the Fed has strongly signalled that it would pause rate hikes following its most recent 25bp hike in May, which took the target range of the fed funds rate to 5.00-5.25% (this level has some symbolic importance, as it was the ultimate peak in rates on the eve of the global financial crisis). The stubbornness in underlying inflationary pressure – and particularly the strength in unit labour cost growth – means that a tightening bias will likely stay with the Fed for the time being. But while the economy has proven more resilient than expected at this stage, rates are already highly restrictive (see *Global View* Box 2), and given the lags of monetary policy it would appear prudent to monitor the impact of tighter credit conditions on the economy over the coming quarters. Should the economy prove more resilient than our forecast – which sees mildly contracting output in Q2-Q3 – the Fed could well be minded to raise rates somewhat further.

China: A reopening rebound is not the same as 'firing on all cylinders'

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

- **Following strong Q1 GDP and activity data, April data shows economy not firing on all cylinders**
- **… with headwinds from property, the global growth slowdown and US-China tensions still present**
- **Divergence between improving services/consumption and weakness industry/investment continues**

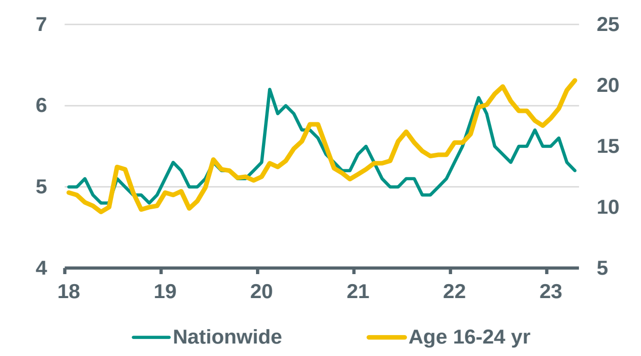
Last month, we upgraded our 2023 growth forecast from 5.2% to 6.0%, based on a strong Q1 GDP print, an upward revision of qoq growth in Q4-22, and solid activity data for March. Meanwhile, April data came in weaker than expected, showing that the economy is not firing on all cylinders, as the Zero-Covid exit does not mean all headwinds are gone.

Strong Q1 and weak April data point to ongoing divergence, as not all headwinds have gone with Zero-Covid exit
Whereas Q1 GDP growth and activity data generally confirmed the reopening rebound following Zero-Covid exit, April data on balance were disappointing. This seems to have contributed to a weakening in sentiment, with the yuan sliding against the US dollar and China's stock markets moving down again. In our view, the Zero-Covid exit is a crucial shift in the overall policy stance, but not a panacea for all the challenges China faces. The April data show the divergence between improving services and consumption – profiting the most from the reopening rebound – while weakness in industry and investment continues, with headwinds from the property sector, the global growth slowdown and US-China tensions remaining.

After promising signals in March, the recovery of the property sector lost some steam in April. Housing sales fell back, suggesting pent-up demand is fading. New building starts and property investment remain in contraction territory, although this also reflects a policy of prioritising the completion of existing projects. A more positive note came from the labour market, with the urban jobless rate falling to a 16-month low of 5.2% (although youth unemployment remains high), which should underpin the recovery in household income. Coupled with a gradual recovery in consumer confidence, this should help a further recovery in consumption. Comparisons with the stimulus-fueled consumption boom in the US are misplaced: for China it's more about a return to normal, as consumption clearly lagged in the pandemic years. Business confidence has improved following Zero-Covid exit, with the composite PMIs and the Cheung Kong index still at relatively high levels.

Unemployment rate drops again, youth unemployment high

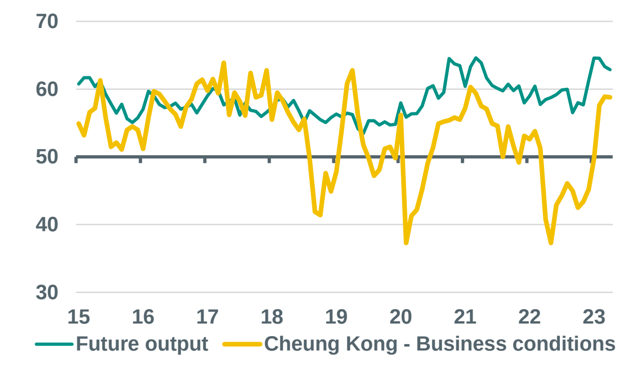
Surveyed jobless rate in urban areas, %



Source: Bloomberg

Business confidence/conditions improve after Zero-Covid exit

Caixin Composite PMI, future output / Cheung Kong Business Conditions



Source: Refinitiv

Policy support to remain targeted and piecemeal, with special attention for the property sector
We expect annual GDP growth to surge in Q2, but that reflects the weak base from a year ago, when China was in a broad Omicron-related lockdown. We expect qoq growth to fade in the course of 2023, following the 'reopening bonus' in Q1. On the policy front, we still think that the authorities will refrain from aggressive easing, as they want to limit the rise in leverage and prevent the overheating issues that arose after the rebound from the initial Covid-19 shock in 2020. However, we do not think that the new government team would tolerate another year of disappointing growth. On balance, we expect more piecemeal monetary easing in the form of a further cut in the reserve requirement ratio for banks and mini cuts in policy interest rates, including in the 5-year Loan Prime Rate used as a benchmark in mortgage lending. We also assume further fiscal support targeted at weak spots, including the property sector. Combined with the filtering through of previous easing measures, this should help the turn in the credit cycle to gain momentum, although we still do not expect a "credit bazooka".

Key views on a page

The global economy is sending mixed signals of late, with some clear signs of recession contrasting with other signs of resilience. The impact of monetary tightening is being increasingly felt, with credit conditions pointing to looming recessions, while the German economy already is in recession. Key near-term risks come from the tightening bank lending standards in advanced economies, and the US debt ceiling impasse. China's exit from Zero-Covid is offsetting the slowdown in advanced economies to some extent. While headline inflation has begun to trend lower, stubborn underlying inflationary pressures means the ECB and BoE are likely to continue raising rates in the near term, while the Fed is expected to maintain a tightening bias.

Macro	Central Banks & Markets
Eurozone – Eurozone GDP grew by 0.1% qoq in 2023Q1, whereas we had expected a moderate contraction. Still, incoming data and survey results for March-May indicate that moderate contractions in GDP during Q2 and the rest of the year are still on the cards, as domestic demand is hit by past and upcoming interest rate hikes by the ECB, and exports are limited by a slowdown in global growth. Core inflation seems to have peaked and should gradually decline during the rest of this year. It will be more sticky than headline inflation though, as parts of services inflation will probably continue to rise in the short term.	**ECB** – As expected, the ECB raised the deposit rate by 25bp in May – a slowdown from the earlier 50bp hikes. Also, the ECB plans to discontinue reinvestments under the APP as of July 2023. The ECB's bias is towards further rate hikes. We expect two more 25bp hikes in each June and July. We expect a rate cut cycle to begin in December as the economy is likely to prove much weaker than the ECB currently expects in the second half of the year. Moreover, headline inflation should drop sharply in the coming months and underlying inflationary pressures and core inflation should ease in the course of the year.
The Netherlands – Dutch GDP contracted by -0.7% qoq in 2023Q1. Most recent figures continue to show a slowing but resilient Dutch economy. Dutch GDP is expected to grow by 0.7% in 2023 (revised downward from 1.2%). Due to recessions in the eurozone and the US, external demand will be lower. Monetary headwinds will also be felt over the course of the year. The domestic economy remains resilient due to labour market tightness, government spending, and the resilience of household balance sheets. We have changed our inflation forecasts (HICP) to 4.3% in 2023 and 3.4% in 2024.	**Fed** – The FOMC raised the fed funds rate, probably for the final time this cycle, by 25bp in May. We expect the Fed will keep a tightening bias for now, but our base case is that by December, the Fed will be ready to start pulling back from the current highly restrictive policy stance. Following an initial 25bp cut, we expect the cut 25bp at each of the eight meetings in 2024, taking rates back to near neutral levels by end-2024. The risks to this forecast are skewed towards 1-2 more hikes if the economy proves to be more resilient, and/or potentially a later start to rate cuts.
UK – The easing energy crisis is softening the blow to household real incomes, helping the economy to dodge a recession, but the outlook remains weak due to tight monetary policy and a rising tax burden. Underlying inflationary pressure is exceptionally high, though there are some early signs that wage growth may be peaking. With rates expected to stay higher for longer, we now expect a prolonged period of stagnation. Even this may not be enough to bring inflation sustainably back to the BoE's 2% target.	**Bank of England** – The shock core inflation reading for April means the BoE is likely to hike once more in June, taking Bank Rate to 4.75%. MPC decisions over the next few months will be highly sensitive to incoming data, and we do not rule out further rate hikes. We have also pushed out the expected start to rate cuts to Q2 24, from Q4 23 previously, as we expect inflationary pressure to prove more sticky. This led us to significantly raise our end-2024 Bank Rate forecast, to 3.75% from 3.00% previously.
US – The economy is clearly slowing in response to higher interest rates, but at a snail's pace. We expect consumption to contract in Q2 as falling real incomes and reduced optimism over the outlook hit spending. Investment is also expected to remain weak, while spending cuts to raise the debt ceiling will become a further headwind. We still expect the NBER to declare a recession later this year. Inflation is expected to continue falling, but there is significant uncertainty over where inflation will settle given labour shortages and residual supply/demand imbalances in the economy.	**Bond yields** – Given our macro and central bank outlook, we judge that the rate hike cycle is approaching its end. We expect both central banks to start cutting rates by end 2023. As such, we forecast lower US and Euro rates going forward, with both the Treasury and Bund curve inversion peak now likely behind us. We think both curves are set to bull-steepen for the rest of the year with the 2s10s spread expected to steepen by as much as 100bp for the Bund and by 70bp for the UST as we enter 2024. Indeed, the steepening path has already started as the market has already started to price in rate cuts in 2023 and 2024.
China – Whereas Q1 GDP/activity data confirmed the reopening rebound led by services/consumption, April data did disappoint, affecting sentiment. Zero-Covid exit was a key policy shift, but not a panacea for all of China's challenges, as headwinds from property, a global slow-down and US-China tensions remain. We expect annual growth to surge in Q2 driven by a strong base effect, but qoq growth to fade following the reopening bonus in Q1. We assume ongoing piecemeal monetary easing and fiscal support targeted at weak spots, including property.	**FX** – We recently downgraded our EUR/USD forecast for 2024 from 1.16 to 1.10. First, we expect aggressive rate cuts for the Fed and the ECB. Even though we expect more cuts for the Fed, we are further away from market consensus for the ECB. Second, the options market is not convinced about a higher EUR/USD. Third, speculators already hold a substantial amount of long euro positions. Dynamics on the US debt ceiling could weigh on the dollar in the near term, but the pricing out of Fed rate cuts in the coming months should support the dollar. Market panic would be positive for the dollar.

Main economic & financial market forecasts

GDP growth (% yoy)	2021	2022	2023e	2024e	Inflation (%)	2021	2022	2023e	2024e
United States	5.9	2.1	0.7	1.6	United States	4.7	8.0	4.1	2.3
Eurozone	5.3	3.5 ↑	0.2 ↓	0.8	Eurozone	2.6	8.4	4.9	2.1
Japan	2.2	1.0	1.1	1.1	Japan	-0.2	2.5 ↑	2.8 ↑	1.5
United Kingdom	7.6	4.1 ↑	0.3 ↓	0.7	United Kingdom	2.6	9.1 ↑	7.4 ↑	2.9
China	8.4	3.0	6.0	5.0	China	0.9	2.0	2.0	2.5
Netherlands	4.9	4.5 ↓	0.7 ↓	1.0	Netherlands	2.8	11.6 ↓	4.3 ↓	3.4
Policy rate	**24/05/2023**	**+3M**	**2023e**	**2024e**	**10Y interest rate**	**24/05/2023**	**+3M**	**2023e**	**2024e**
Federal Reserve	5.25	5.25	5.00	3.00	US Treasury	3.74	3.35	3.25 ↓	2.75
European Central Bank	3.25	3.75	3.50	2.00	German Bund	2.45	2.30 ↑	2.20 ↑	2.00
Bank of Japan	-0.10	-0.10	-0.10	0.00	Japanese gov. bonds	0.41	0.55	0.65 ↓	0.65
Bank of England	4.50	4.75 ↑	4.75 ↑	3.75	UK gilts	4.21	2.80	2.60	2.20
People's Bank of China	3.65	3.60 ↓	3.60 ↓	3.60					
Natural resources	**25/05/2023**	**+3M**	**2023e**	**2024e**	**Currencies**	**24/05/2023**	**+3M**	**2023e**	**2024e**
Brent - Oil USD/barrel	76.3	85	90	100	EUR/USD	1.08	1.09	1.10 ↓	1.10
WTI - Oil USD/barrel	71.8	80	85	95	USD/JPY	139.5	135 ↑	135 ↑	125
TTF - Gas EUR/MWh*	46.6	30 ↓	35 ↓	40	GBP/USD	1.24	1.24 ↑	1.24 ↓	1.30
					EUR/GBP	0.87	0.89 ↓	0.89 ↓	0.85
Gold - USD/oz	1,941	2,000 ↑	2,000 ↑	2,200	USD/CNY	7.06	6.80	6.70	6.50

Source: Refinitiv, Bloomberg, ABN AMRO Group Economics

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

Macro Research Team

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

FX & Rates Research

Georgette Boele, Senior FX & Precious Metals Strategist | georgette.boele@nl.abnamro.com
Sonia Renoult, Rates Strategist | Sonia.renoult@nl.abnamro.com