ABN·AMRO

Group Economics | 24 April 2023

Global Monthly

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Will cash buffers limit the coming downturn?

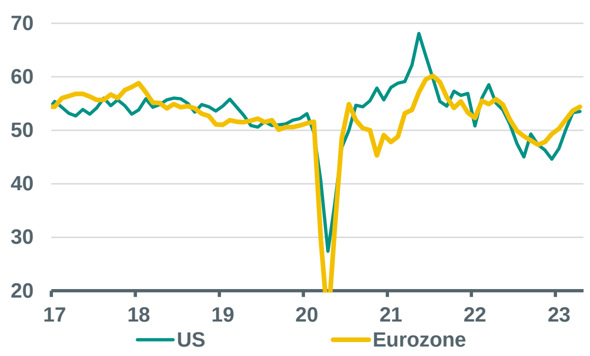
- **While the tightening of bank lending conditions clearly points towards an upcoming downturn, corporate and household balance sheets point towards resilience**
- **Looking into these buffers in detail, we find that households are better placed to weather the coming recession than corporates, and that the US is better placed than the eurozone**
- **However, buffers can only blunt or delay the onset of recessions, which we judge will be necessary to bring inflation sustainably back to target – both in the US and in the eurozone**
- **Regional updates: A contraction in GDP looks to be taking shape in *the eurozone*, while in *the Netherlands*, consumption has exhibited resilience despite the headwinds**
- **The economy is cooling in *the US*, but not yet quickly enough to bring inflation back to target**
- ***China's* Q1 GDP surprised to the upside, leading us to raise our 2023 growth forecast**

Global View: Buffers may delay the economic pain necessary to lower inflation, but not avoid it

Advanced economies seem to be caught in a tug-of-war recently between a resumption of the post-pandemic rebound on the one hand, and on the other, tighter financial conditions resulting from aggressive rate hikes and the recent banking turmoil. April flash PMIs for both the eurozone and the US suggest continued economic resilience – almost entirely concentrated in services – while other surveys, including the US NFIB and the Fed's Beige Book point to a building headwind from tighter bank lending standards. To add to the mix of conflicting drivers, China's reopening rebound is also turning out to be stronger than expected. We judge that the recent resilience in the US and eurozone will prove temporary, and that tighter financial conditions will ultimately prevail, pushing advanced economies into recession. In this month's *Global View*, we the explore the link between credit and GDP growth historically, and assess whether the strength in household and corporate balance sheets may partly explain why tighter financial conditions are taking longer to affect activity. The rebound in momentum suggested by the PMIs is not a positive for the medium-term outlook, in our view. Rather, it raises the risk that central banks may have to go further in hiking rates to ensure inflation falls fully back to target.

Flash PMIs staged a further recovery in April

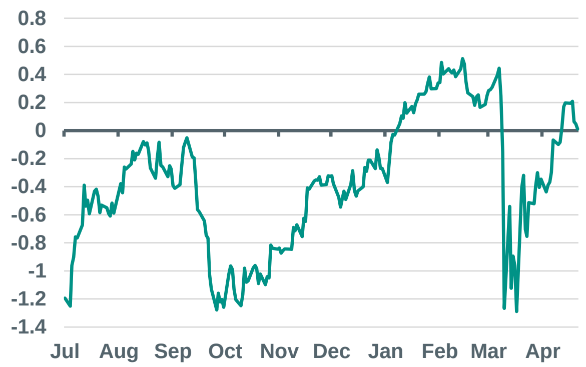
Flash composite PMIs, index; >50 = expansion, <50 = contraction



Source: Refinitiv, ABN AMRO Group Economics

US financial market conditions have normalised

Financial conditions; >0 = accommodative, <0 = tight



Source: Bloomberg, ABN AMRO Group Economics

Taking stock: Financial conditions – and the risk of a credit crunch – have eased

Since our March publication, worries over the banking sector have significantly receded. Flows to money market funds in the US have gone into reverse, the banking sector in aggregate has seen a recovery in deposits, and weekly lending data has stabilised. Financial market sentiment has been supported by a slew of Q1 bank earnings releases which showed that small and medium banks have managed to navigate the turbulence so far. Indeed, Bloomberg's US financial conditions index has fully retraced the tightening that took place in March and is now well into accommodative territory. Reflecting this, daily issuance of short-term corporate debt (commercial paper) – which briefly collapsed in March – is now back to normal.

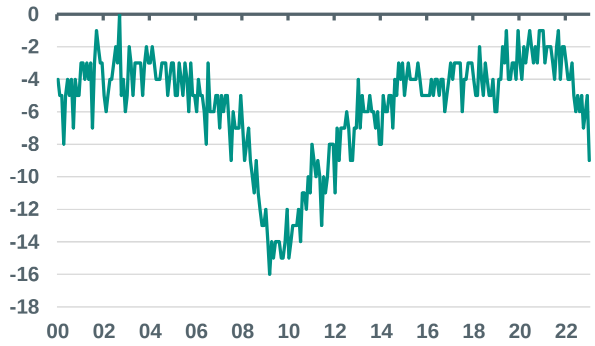
Bank deposits recover as MMF flows go into reverse…

US Money Market Fund assets, USD bn

Source: Bloomberg, ABN AMRO Group Economics

…but survey evidence points to tighter loan standards

NFIB small business availability of loans index



Source: Refinitiv, ABN AMRO Group Economics

Set against these positive developments, more qualitative or anecdotal evidence does point to some tightening in bank lending conditions. The small business NFIB survey suggested a significant decline in loan availability, with this sub-index falling to an 11 year low in March. The Fed's April Beige Book last week also pointed to increased difficulty in acquiring credit. A key focus for policymakers will be the quarterly updates to the Fed's Senior Loan Officer's Survey (SLOOS) and the ECB's Bank Lending Survey (BLS), due out in the coming weeks. These are likely to show some further tightening in lending standards, though it remains to be seen whether such a tightening will be sustained.

As we described in our March Monthly, a major tightening in lending standards poses significant downside risks to the growth outlook, as it would do part of the central bank's work in terms of bearing down on credit growth and in turn economic activity. Indeed, we find that lending standards surveys are a strong leading indicator for economic activity, and this is something we explore in Box 1.

We still expect recessions in the US and eurozone – buffers can only delay the timing

Given the tightening in financial conditions – primarily driven by the surge in interest rates – we have **long expected** that the US would experience a mild recession in 2023, and the consensus and more recently the Fed's board staff have also come around to this view. In the eurozone, too, although the near-term outlook has improved on the back of the receding energy crisis and the rebound in China (see Box 3), we still expect a moderate recession this year. However, a key argument against these mild/moderate expected downturns becoming more severe is the strength in household and corporate balance sheets, on both sides of the Atlantic. The cash buffers built up during the pandemic means we are unlikely to see the jumps in bankruptcies and in unemployment that we see in a more severe recession. How are these buffers looking currently?

Over the coming pages, we look closely at household and corporate balance sheets on both sides of the Atlantic to come to a judgment on whether financial buffers may blunt or delay the impact of credit tightening on economic activity. Overall, we judge that households are better placed to weather the coming recession than corporates, and that the US is better placed than the eurozone. However, buffers can only blunt or delay the onset of recessions, which we judge will be necessary to bring inflation sustainably back to target – both in the US and in the eurozone. As we stated in our March Monthly, should economies continue to prove more resilient than we expect, we think central banks will need to respond with further rate hikes in order to induce the necessary economic pain (falls in demand and rises in unemployment) to be sure that inflation falls fully back to 2%.

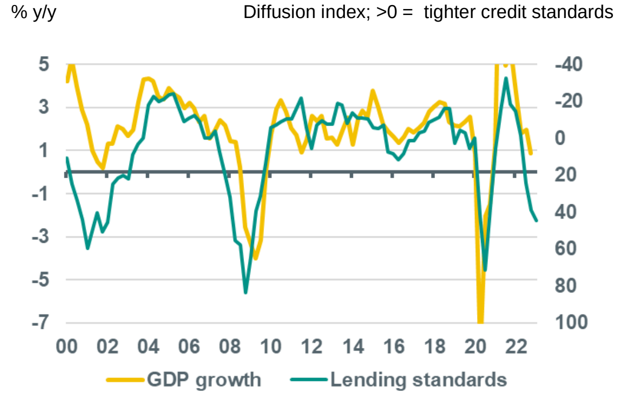
Box 1: Credit and the economy (Aggie van Huisseling)

The tightening of credit standards and the impact on economic activity and thereby GDP growth works through two channels. Firstly, the tightening of standards means less credit availability and thereby less spending by firms or households that depend on banks for credit. Secondly, lenders may become cautious because a tightening of standards could indicate disturbance ahead. All in all, lending standards are a strong leading indicator for economic activity, with tighter standards implying reduced economic activity (link). Surveys on bank lending, such as the US Senior Loan Officer Survey or the ECB Bank Lending Survey (BLS) contain data on loan officer expectations on credit standards. As one would expect, these lead credit growth (link). Additionally, credit standards appear to function as an amplifier to shocks to the macroeconomy, as posed by Bernanke, Gertler, and Gilchrist (link). This means endogenous credit standards can operate as *financial accelerator*.

What does the literature tell us?

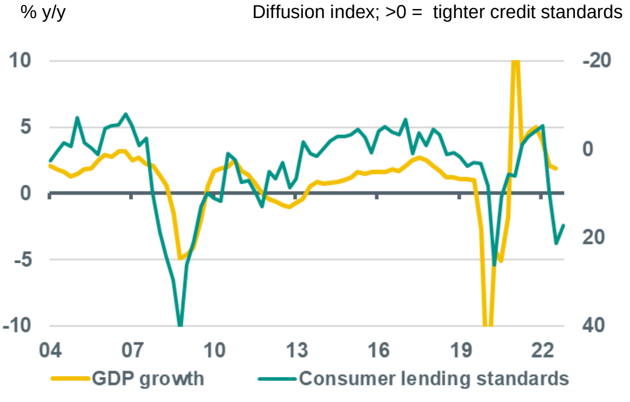
Various papers confirm the channels described above. Firstly, surveys on bank lending appear to be a strong leading indicator for credit growth. De Bondt et al. (2010) find that the ECB's BLS responses significantly lead loan growth by one quarter for household lending and four quarters for enterprises. These results are consistent with those from the US Senior Loan Officer Survey (link). It also finds that – on top of interest rate and demand effects – the net tightening of credit standards based on BLS responses causes quarterly bank loan growth to decline by 1.3 percentage points. This finding is confirmed by Köhler-Ulbricht et al. (2016) which also find that BLS indicators lead bank lending growth and are well-anchored with financial developments (link). Secondly, credit standards can be viewed as early indicators of GDP growth (link, link, link). De Bondt et al. (2010) finds that BLS responses to a tightening in credit standards to enterprises leads real GDP growth by three to four quarters, with an ultimate impact on euro area real growth of between 0.8 and 1.0 percentage points during the 2008 financial crisis (link).

Correlation for US GDP growth and lending standards



Source: Refinitiv, ABN AMRO Group Economics

Strong correlation EZ GDP and consumer credit



Source: Refinitiv, ABN AMRO Group Economics

What do we see in the data (i.e. the historic correlations)?

To confirm the above findings, we looked at the historic correlations for GDP, business fixed investment, the credit impulse (for corporations, households, consumer and house purchase), credit demand (for firms, housing and consumer), and BLS credit standards (for firms, housing and consumer). The correlations between GDP growth and the listed indicators are strongest with the consumer credit impulse (0.41), the previous quarter net changes in housing credit standards (-0.45) and consumer credit standards (-0.46). This implies that tighter credit standards as indicated in the BLS – as well as the actual decline in credit – correlates with a decline in GDP. Next quarter responses to housing and consumer credit standards also correlate with GDP growth, but the impact is less strong (-0.34 and -0.35 respectively). The correlations with business fixed investment growth are similar to those described before for GDP; but now corporate credit also correlates more strongly. That is, for the corporate credit impulse we see a 0.39 correlation with business fixed investment growth. The correlations with the BLS net change in credit to firms last and next quarter and investment are -0.45 and -0.33, respectively. This shows that credit to firms more strongly correlates with investment than with GDP, which fits the intuition. Naturally, we observe strong negative correlations between the BLS variables and the credit impulses, which shows that tighter credit standards and lower credit impulse go hand-in-hand. Finally, credit demand positively correlates with GDP growth; but most strongly for consumer credit and housing credit demand.

Surveys have become less reliable since the pandemic, and so greater caution is warranted

Although bank surveys have been a strong leading indicator for economic output historically, we would interpret current survey results with greater caution in the current environment. Over the past year we have observed a decoupling of surveys such as PMIs and consumer confidence from economic activity, and it remains to be seen if bank lending surveys retain their explanatory power.

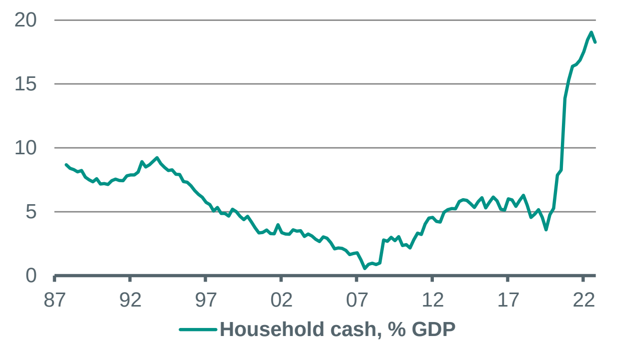
US: Household balance sheets have never been in better shape

Whichever way you look at it, household balance sheets in the US look very healthy. Household debt, the debt service ratio, and delinquencies are all historically low. The stock of consumer credit (including credit card debt) is still below the pre-pandemic trend. And the vast majority of mortgages are at fixed rates for the duration of the mortgage term (typically 30 years), insulating most households from rising mortgage rates.

Households also continue to hold significant excess savings from the pandemic period. According to the Fed's flow of funds, checkable deposits totalled $4.8tn as of Q4 (18.3% of GDP), down only a little from the peak in Q3, and nearly five times the pre-pandemic level. As is customary in any discussion on household savings, we must add the caveat that the bulk of this is skewed towards higher income households, with the Fed's distributional financial accounts suggesting that around 70% of the excess accrued since the pandemic sits with the top income quintile, with the bottom 40% holding just 10% of the excess. Meanwhile, the recent rise in the savings rate – albeit still holding at levels below the pre-pandemic norm – does suggest that households are approaching a limit in how willing they are to use excess savings (see chart on page 5). With lower income households having much smaller (in many cases zero) buffers, and given the continued pressure on real incomes from high inflation, we still therefore expect consumption to stagnate this year. But overall, it is clear that low household debt, combined with substantial cash buffers, will continue to cushion the expected downturn in consumption.

Household cash is still much higher than pre-pandemic

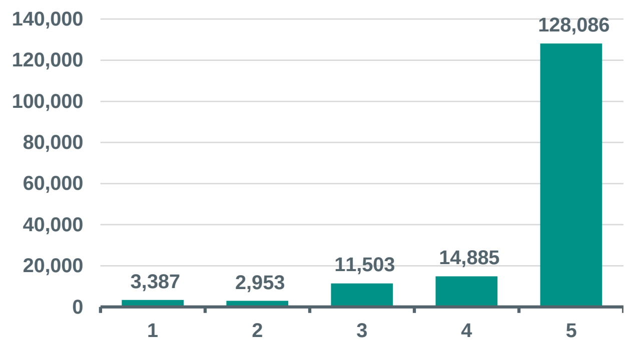
US checkable deposits and currency held by households, % GDP



Source: Datastream, ABN AMRO Group Economics

But most of it sits with higher income households

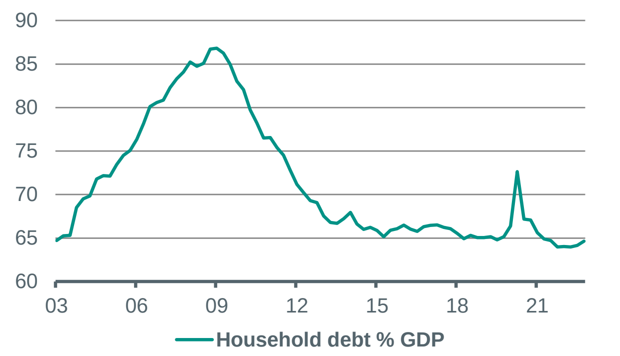
Average excess savings per household since 2019, by income quintile (USD)



NB: As of Q4 22. Source: Federal Reserve, ABN AMRO Group Economics

Household debt remains historically low

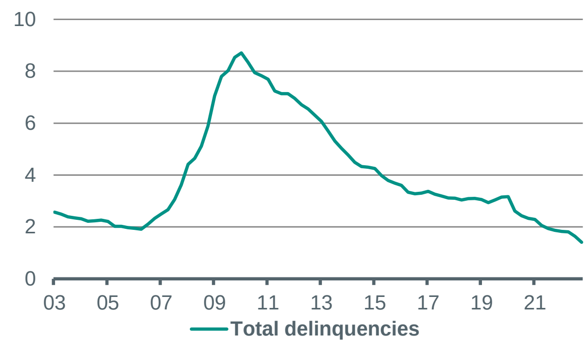
% GDP



Source: Datastream, ABN AMRO Group Economics

Debt delinquency rate has fallen even further

% household debt with repayments behind by more than 90 days

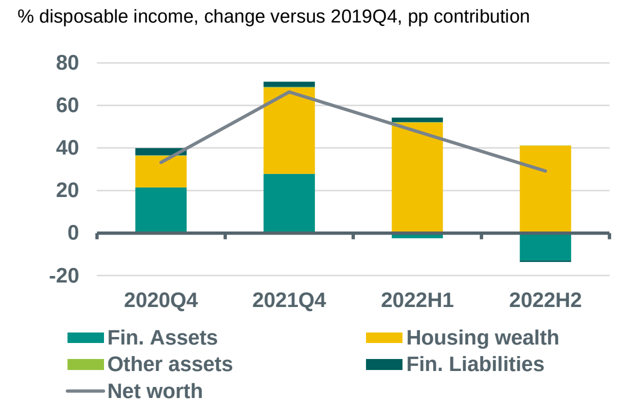


Source: Datastream, ABN AMRO Group Economics

Eurozone: Household buffers have melted away

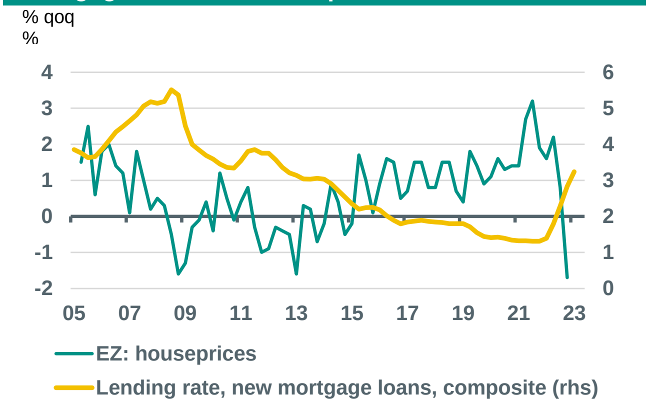
In the eurozone, total household net worth rose by over 7 trillion euros (66% of disposable income) over 2020-21. This enabled consumer spending to rise at a faster pace than disposable income over subsequent quarters, which is indeed what happened in 2022. Consequently, more than half of the extra net worth that had accumulated during the pandemic had melted away by the end of 2022. Importantly, the stock of liquid financial assets has almost returned to pre-pandemic levels, and only illiquid housing wealth remains significantly higher than before the pandemic. This has two consequences. First, eurozone households can no longer finance excess consumption by using extra accumulated liquid assets. Moreover, house prices have begun falling, and we see indications that households are now attempting to replenish total net worth by limiting consumption and saving more. Indeed, the household saving rate increased in Q4 22 for the first time since the first wave of the pandemic, and the savings rate is now above the pre-pandemic normal.

EZ Household net worth versus pre-pandemic



Source: ECB, ABN AMRO Group Economics

Mortgage rates and house prices



Source: Refinitiv, ABN AMRO Group Economics

Impact of higher interest rates on consumption moderated by fixed rate mortgages

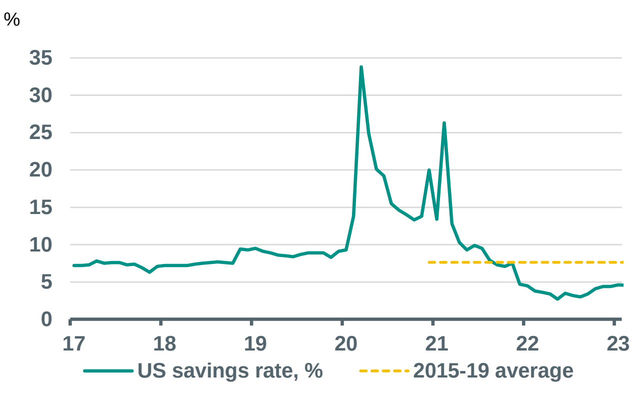
Recent research by the ECB (here and here) highlights that the impact of higher interest rates on household debt service ratios will be limited in the near term due to the high share of fixed-rate mortgages in many countries. Nevertheless, the share of flexible rate mortgages in new contracts has jumped recently, as households do not want to lock in current high rates for too long. The ECB reports suggest that consumers are already incorporating the impact of higher interest rates in their economic decisions, particularly in their plans for discretionary consumption. Indeed, this is has become visible in the incoming hard data for goods consumption, with retail sales volumes falling -1.0% 3m/3m in February, following a 0.6% qoq contraction in Q4 22 (see also the eurozone chapter).

With that said, as in the US, household debt is historically low in the eurozone (see chart on page 7). As such, although interest rate hikes are starting to bite, and consumers have clearly reached a limit in their use of excess savings, the strength of balance sheets will still help to prevent the coming downturn from becoming severe.

Households in the US appear more willing to use buffers than in the eurozone

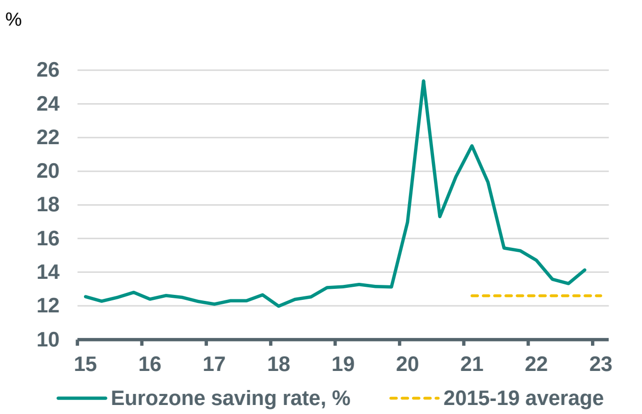
One final point we must emphasise on the willingness of households to deploy buffers is: *wealth preferences matter.* The clearest indication of this is the savings rate, which historically is relatively stable. A savings rate below 'normal', pre-pandemic levels suggests a willingness to run down savings, while a savings rate above normal suggests a preference to rebuild buffers. In this regard, it appears that 1) households in the US have been much more willing to run down excess savings than those in the eurozone, and therefore 2) there is more downside risk to consumption in the eurozone than in the US. This supports our view of a more pronounced recession in the eurozone than in the US.

US savings rate below the pre-pandemic average…



Source: Refinitiv, ABN AMRO Group Economics

…but in the eurozone it is above pre-pandemic average



Source: Refinitiv, ABN AMRO Group Economics

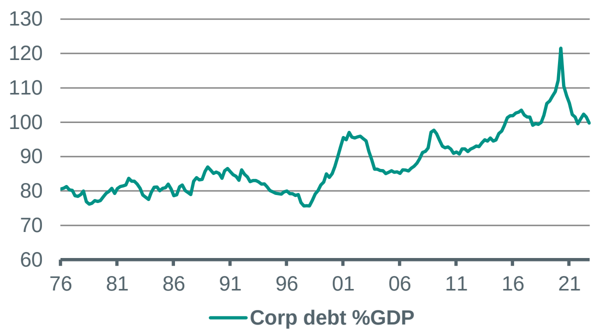
US corporate balance sheets not as strong as for households, but still healthy

On the corporate side, balance sheets are not nearly as strong in the US as for households, but fundamentals still look solid. Corporate debt is relatively high at around 100% of GDP, though given that much of this is fixed at relatively low rates from prior to the recent surge in rates, the debt service ratio is close to the long term average. Meanwhile, cash balances are off their pandemic highs, but still historically elevated, and the share of profits in national income is also historically high. As a cross-check for financial stress, bankruptcies fell during the pandemic period and remain exceptionally low.

All of this does not mean business activity has been immune to the tightening in financial conditions. On the contrary, business investment has contracted for the past three quarters, and we expect investment to remain weak for much of the year ahead (the Inflation Reduction Act will provide some support for investment, but more in the medium term). At the same time, while we do expect strength in balance sheets to prevent the kind of surge in bankruptcies we see in a typical recession, we still expect a rise in bankruptcies back to more normal levels. High interest rates are likely to put increasing pressure on balance sheets as debt comes due for refinancing – leading to a likely rise in debt service ratios – while cooling consumer demand will likely reduce pricing power and in turn put downward pressure on profit margins.

Corporate debt remains elevated

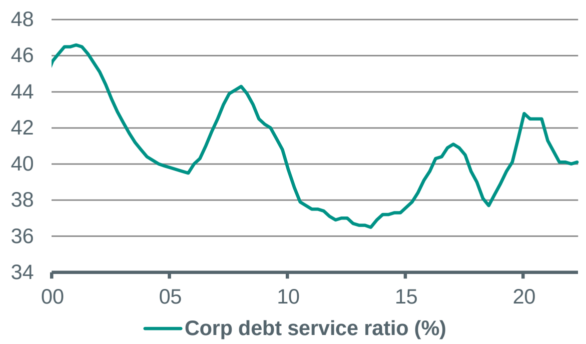
Total non-financial corporate debt, % GDP



Source: Datastream, ABN AMRO Group Economics

But debt service ratio is close to the long-term average

Ratio of interest payments to income (BIS calculation)



Source: Datastream, ABN AMRO Group Economics

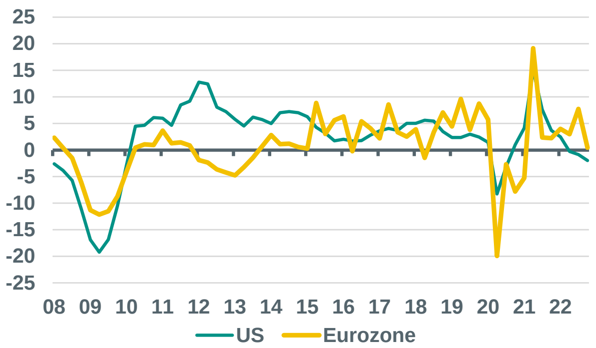
Bankruptcies remain exceptionally low

Chapter 11 bankruptcy filings

Source: Bloomberg, ABN AMRO Group Economics

Business investment is contracting

Business fixed investment, % y/y



Source: Datastream, ABN AMRO Group Economics

Eurozone corporate buffers could blunt credit tightening impact, but not avoid it

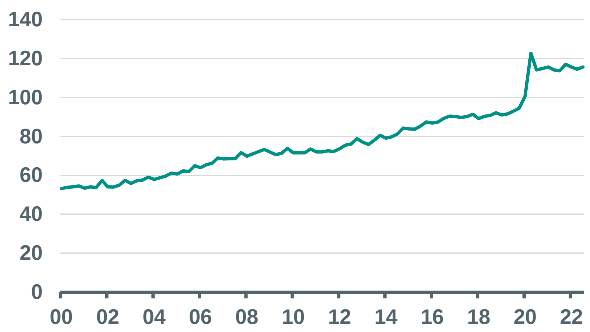
Non-financial corporations in the eurozone have accrued solid financial buffers since the pandemic. On the income side, profit margins have expanded on aggregate, which has helped lift cash balances to well above pre-pandemic levels. On the cost side, despite rising interest rates since H2 of last year, debt-service-ratios have so far remained stable and debt as share of GDP is in most countries on a declining trend since the pandemic induced rise.

The strength of balance sheets gives corporates a significant buffer against tighter credit conditions. Buffers can be used to deleverage in order to keep debt ratios low in a rising rates environment, kept as a rainy day fund to avoid bankruptcy as demand falls, or to help self-finance investment in an environment of reduced credit availability (although the latter is less likely given the weak growth outlook).

Buffers are more a source of short term relief rather than lasting strength. The blunting factors are temporary, which means tighter credit conditions will eventually have an impact. At the same time, as with household wealth, there are significant disparities beyond the aggregates. Size and sector differences matter, as was apparent with previous episodes where lending was constrained. During the sovereign debt crisis bank lending to SMEs was fell disproportionately compared to larger firms (see chart below). Even if SMEs have higher buffers now, they are probably less than the aggregates suggest, meaning tighter credit conditions will still have an impact. In a **recent speech** by ECB Chief Economist Philip Lane, a distinction was also made between 'old' and 'young' companies, with young companies (who generally lack buffers) facing much greater financing difficulties in an environment of tightening lending standards than more established companies.

Firm balance sheets contain ample liquidity…

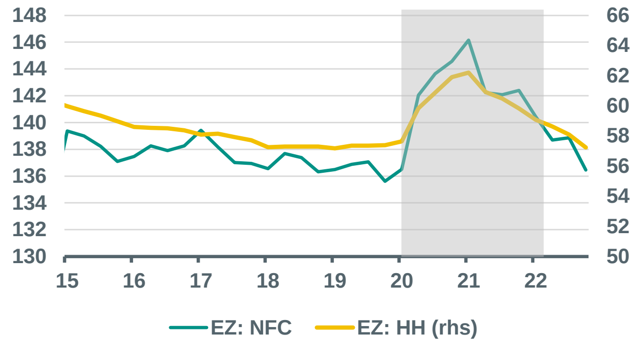
Currency & deposits as share of GDP, %, eurozone



Source: ECB, ABN AMRO Group Economics

… while debt is on a downward trend

%, debt as share of GDP



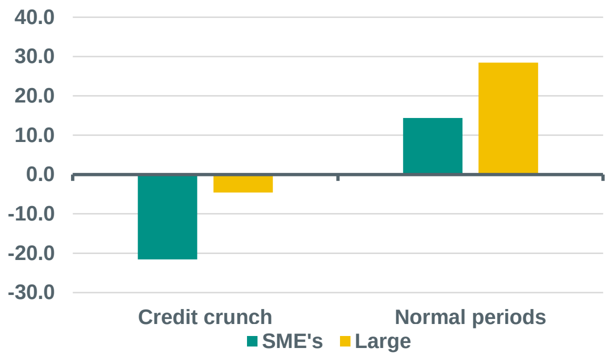
Source: Refinitiv, ABN AMRO Group Economics

All told, we judge that buffers help blunt or delay the impact of credit tightening, but that some significant impact on activity is inevitable. Indeed, as with the US, investment in the eurozone contracted in Q4 22 (see chart on page 5), and we expect tighter credit conditions to weigh on investment throughout the coming year. Bankruptcies have also surged, and are now well above the pre-pandemic level (see chart below). (Bill Diviney, Aline Schuiling, Aggie van Huisseling, Arjen van Dijkhuizen, Jan-Paul van de Kerke)

> Box 2: An ECB study (**link**) shows that the corporate debt composition also plays a crucial role in the impact of credit conditions. The use of bond financing relative to bank borrowing has expanded to 30% for euro area firms, up from around 15% in mid-2008. The study concludes that – when responding to an adverse aggregate supply shock – the option of bond finance blunts the impact of a tightening in the bank lending transmission channel. Working the other way, bond finance also amplifies monetary policy transmission channels that have broader financial market implications (such as QE). Countries with a low share of bond finance are more impacted by changes in short-term interest rates, while those with a high share of corporate bond financing are more affected by measures impacting the long-term rates.

SMEs more vulnerable to tighter loan standards

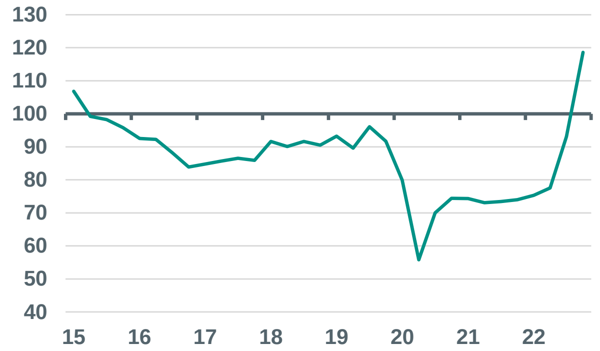
Perceived willingness of banks to lend, Credit crunch=average of 2009-2013



Source: ECB SAFE survey, ABN AMRO Group Economics

Eurozone bankruptcies surged in Q4 22

Index, 2015 = 100



Source: Eurostat, ABN AMRO Group Economics

Box 3: Chinese lending is turning the corner after Zero-Covid exit (Arjen van Dijkhuizen)

While in developed economies credit growth is slowing on the back of aggressive rate hikes, the Chinese credit cycle is currently going in the opposite direction. The rapid exit from Zero-Covid, a more growth-oriented policy stance, and increasing signs of a stabilising property sector are the most important drivers. We think the turn in the credit cycle has further to run, although we do not expect a credit boom similar to for instance the one seen after the global financial crisis.

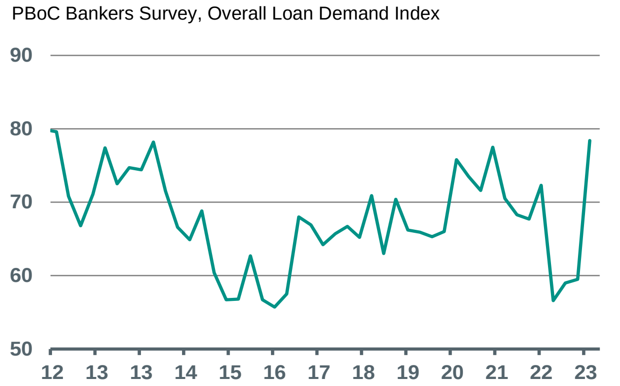
The property sector slump and Zero-Covid dampened credit growth in recent years…

In recent years, credit growth in China has been impacted by a number of factors. First, a structural impact comes from the financial deleveraging/derisking campaign initiated in late 2016. The goal of this campaign was to keep overall leverage in check by roughly matching lending growth with nominal GDP growth, while curtailing the most risky parts of the financial system such as shadow banking. Second was the introduction in August 2020 of the 'three red lines' policy for the highly leveraged property sector, which ultimately triggered payment distress among a wide range of property developers (including giant Evergrande), and culminated in a severe property sector downturn. Third, repeatedly (including in 2022), the pace of lending was impacted strongly by the combination of Covid-19 flare-ups and strict Zero-Covid policy resulting in recurrent broad lockdowns. On the household side, for instance, Zero-Covid and the problems in the property sector led to a sharp drop in consumer confidence and a collapse in demand for mortgage loans.

China's credit cycle is starting to turn

Source: ABN AMRO Group Economics, Bloomberg

Loan demand improves sharply after Zero-Covid exit



Source: Bloomberg

…but the credit cycle has turned after the end of Zero-Covid, with a more growth-oriented policy stance

Already in the course of last year, the Chinese authorities started with finetuning macroeconomic policy, and shifting the pendulum back to growth stabilisation, as the economy was hit hard by Zero-Covid and the property downturn. They resorted once more to piecemeal monetary easing, rather than introducing a GFC-style credit bazooka, by implementing mini cuts (of 15-35 bps) of several policy rates. The 5-year loan prime rate – used as a benchmark in mortgage lending – was cut the most (by 35bp, to 4.30%) to support real estate. Additional space for banks to lend was created by the further reduction in the reserve requirement ratio for banks, by 50bp in 2022, and a 25bp cut, to 10.5%, in March 2023. The authorities also used moral suasion to convince state banks to increase lending, and took specific steps to ease financing constraints for property developers. They also raised quota for local government bond financing to support infrastructure spending; the downside of this is that off-balance sheet borrowing through so-called local government financial vehicles (LGFVs) has risen to almost 50% of GDP, with LGFVs in poorer provinces experiencing payment difficulties.

Still, the most impactful policy shift was the abandonment of Zero-Covid initiated in December 2022. Though the messy character of this exit initially contributed to a further slowdown in lending, the disturbances from Zero-Covid exit proved rather short-lived. The Chinese economy has since clearly rebounded, led by the services sector, consumer confidence has started improving (although being still at relatively low levels), the housing market shows more and more signs of stabilisation, mortgage lending has started to pick up, and overall credit growth is accelerating again. This was illustrated for instance by the better than expected lending figures for March, and by the fact that the overall loan demand index in the PBoC's banking survey jumped to a 9-year high of 78.4 in Q1-2023.

Turn in credit cycle has further to run; China's rebound is cushioning global slowdown

Against this background, we assume the turn in China's credit cycle has further to run, although we expect the authorities to continue to aim at keeping the overall leverage ratio in check, take measures to contain LGFV debt, and prevent the type of overheating issues that arose after China's rapid rebound from the initial Covid-19 shock in 2020. On the global scale, we think that China's reopening rebound and the turn in the credit cycle will help to cushion the impact of the slowdown in developed economies to some extent, though we do not think this will be a major game changer given the fall-out we expect (and are already experiencing) from unprecedented sharp rate hikes in the developed world, and with monetary policy working with famously long and variable legs.

Eurozone: GDP contraction taking shape

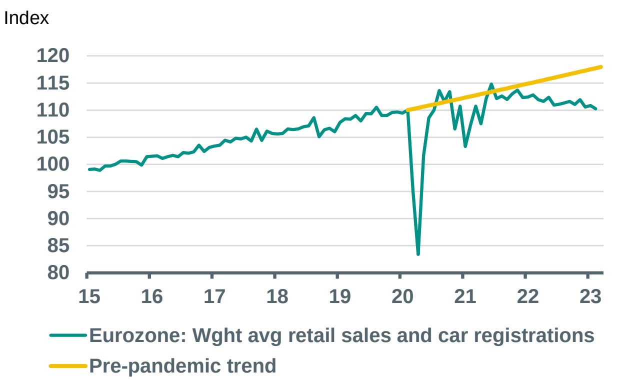
Aline Schuiling – Senior Economist | aline.schuiling@nl.abnamro.com

- **The eurozone economy seems to be heading towards a moderate recession. We expect a modest contraction in GDP during most of this year**
- **Underlying inflation is not easing yet, with wage growth higher than expected in Q4 and core inflation rising in March**
- **We expect the ECB therefore to hike rates further, with the deposit rate peaking at 3.75%**

Economic data for January-February indicate that eurozone GDP probably contracted slightly in 2023Q1, but also that the composition of growth has changed compared to 2022Q4, when GDP was stable. Data for retail sales and car registrations show that the contraction in private consumption that began in Q4 probably continued in Q1. Next, investment in machinery and equipment probably rebounded in Q1, after it contracted sharply in Q4. This was pre-signalled by a sharp rise in Germany's orders for capital goods from other eurozone countries. Meanwhile, investment in housing and buildings is expected to continue to contract in Q1. Mild weather probably temporarily stimulated construction activity in Q1, but underlying activity in the sector remains weak, as is also illustrated by the low level of the PMI for the sector. Finally, net exports probably contributed less positively to GDP growth in Q1 than in Q4. We think that exports picked up in Q1, but that imports also strengthened, meaning that, on balance, the impact on GDP growth was limited. The risks to our forecast for Q1 GDP seem tilted to the upside due to the one-off positive impact of China's post-pandemic rebound. Looking beyond Q1, we expect GDP to continue to contract modestly during most of the year, as the impact of past and upcoming interest rate hikes will continue to build in coming quarters, weighing on domestic demand, global growth and eurozone exports.

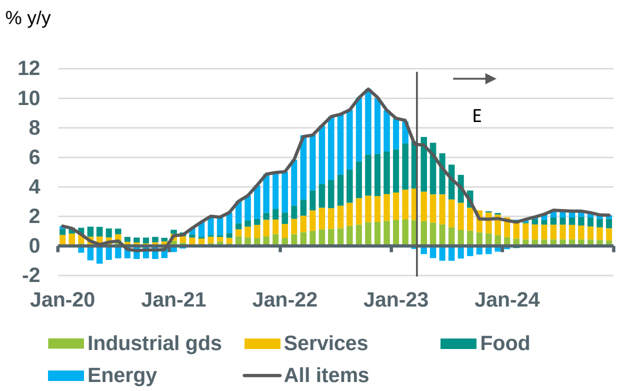
Headline inflation has dropped from a peak of 10.6% in October 2022, down to 6.9% in March 2023. The drop was thanks to falling energy price inflation, with food price inflation and core inflation still trending higher. Looking ahead, we expect both headline and core inflation to fall rapidly later in the year on the back of the decline in wholesale energy and food prices, as well as dissipating supply chain bottlenecks. Core inflation will probably be more sticky than the headline rate in the short-term, but should also ease going forward. The lagged impact of higher energy prices on the prices of goods and services should peter out in the coming months. The only part of inflation that could rise somewhat further is services sector inflation, which could be pushed higher by rising wages on the back of the labour shortages that emerged in the sector after the pandemic. However, the economic slowdown is expected to lift unemployment somewhat in the course of the year, which should reduce overall wage growth and also services sector inflation.

Goods consumption is falling



Source: European Commission, ABN AMRO Group Economics

Inflation drops lower, core rate resilient



Source: Refinitiv, ABN AMRO Group Economics

At its March meeting, the ECB hiked its key policy rates by 50bp, while dropping all guidance on future policy moves. It seems that the ECB's bias is still towards further rate hikes, at least if its baseline scenario plays out. Our baseline sees the deposit rate peaking at 3.75%, before a rate cut cycle begins in December and continues during 2024. Our base scenario is for a 50bp hike in May and a 25bp hike in June, but the risks are tilted towards a slowdown to 25bp in May and, subsequently, two more 25bp hikes in June and July.

The Netherlands: Consumption resilient, despite purchasing power loss

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- **We expect annual growth to slow to 1.2% in 2023 (from 4.5% in 2022)**
- **The near-term risks to our view are tilted to the upside, while medium-term risks are to the downside**
- **HICP inflation is expected to average 4.6% in 2023 and 4.1% in 2024**

Dutch GDP is expected to grow by 1.2% in 2023 and 1.3% in 2024, cooling down from 4.5% annual growth in 2022. We expect external demand to be lower due to recessions in the eurozone and the US (with both investment and consumption slowing). This weakens the outlook for Dutch exports, which we already observe in the PMI data. The most recent industry PMI showed the new export orders component dropping (read more here). Given the lagged impact of monetary policy – with the brunt of the impact coming around five quarters after the rate hikes – and more rate hikes in the pipeline (we expect the ECB deposit rate to peak at 3.75% in June), monetary headwinds will increasingly be felt over the course of the year. The housing market has already turned a corner on the back of tighter monetary policy and rising interest rates. This means that the support for consumption via the wealth channel effect for new home owners is falling away, which creates a drag on consumption in 2023. In the near term, we expect lower house prices to lead to declines in housing investment. Investment generally is expected to be set for a weak year due to tighter financial conditions and higher rates, but – more importantly – also due to worsening future growth prospects. Finally, the government has stepped in and wage growth is picking up: CLA-wages came out higher than the inflation figure in March. However, the cumulative blow to purchasing power from recent rises in inflation is not fully offset.

Despite the risks to the medium-term outlook mentioned above, recent activity data show that near-term risks are tilted to the upside. Thus far, consumption has proven to be resilient despite the loss of purchasing power. The February figures for consumption show that spending on services remained strong, although aggregate private consumption has slightly decreased (mom). Consumption is supported by an ever tight labour market and government support. We see government support, such as the energy allowance for low income households providing a strong short run impulse for spending. Households are decreasing their rate of additional savings as was shown by the decline in the savings rate in the fourth quarter. The stock of pent-up savings remains a buffer. Moreover, the indexation of pension funds by 7% on average and the 10% rise in the minimum wage (and linked to that, social security) provides support. However, for the remainder of 2023 we still expect consumption to slow, with big ticket items leading the charge. Looking at new passenger car registrations, the first signs of cooling are already apparent.

Meanwhile, headline inflationary pressure is easing, but core inflation is likely to stay somewhat elevated. The NEVI PMI for March showed that the majority of firms in the panel said input prices have decreased (to 46.4 which is below the neutral 50 mark) and suppliers‘ delivery times became shorter. This creates downward pressure on prices. Although headline inflation is pushed down by energy base effects, the broadening of (core) inflation is expected to continue well into 2023.

Deterioration in demand visible in new export orders

NEVI PMI, index (50 = neutral mark)

Source: NEVI, ABN AMRO Group Economics

Services consumption still keeping up

Index; 2021 = 100, 3m moving average

Source: CBS, ABN AMRO Group Economics

US: Cooling, but not quickly enough

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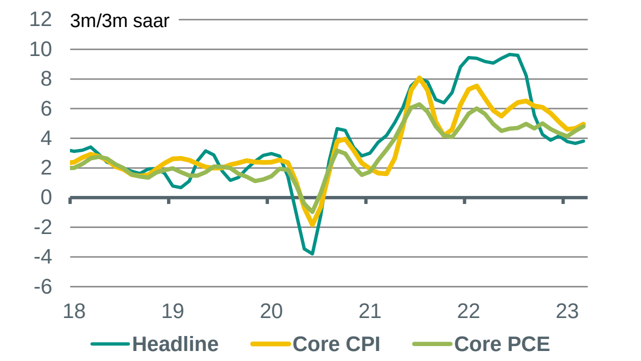
- **The US economy is cooling, but only very slowly. Financial buffers are likely a key factor**
- **Our base case continues to be for contracting output in Q2-Q3. Any further delay to the downturn raises the risk that inflation becomes entrenched at a higher level than the Fed's 2% target**
- **Fed officials are sounding more cautious given the tightening in lending standards. We see a risk of more rate hikes if tighter lending standards prove to be temporary**

The US economy continued to cool over the past month, but at a snail's pace. Nominal retail sales fell by 1% m/m in March, though the bulk of this was driven by falling gasoline prices (which fell 4.6% m/m, according to the CPI data). 'Core' retail sales, i.e. excluding gasoline & autos, fell by a much more modest 0.3% m/m. The March decline was a drop in the ocean following the 2.8% surge in core retail sales over January and February. Indeed, the details showed continued solid growth in online sales with only modest declines in some categories, such as apparel, which is normalising from the post-pandemic catch-up phase. Eating out (which is reported alongside retail sales) also remained strong, suggesting resilient demand in the face of significant price rises at restaurants recently. All told, we estimate that real retail sales (adjusting for inflation) are still around 2.5pp above the pre-pandemic trend, suggesting persistent excess demand for the time being. A key support for consumption has been continued solid jobs growth. Here, too, although the pace of growth has slowed, it has not been enough to push the unemployment rate any higher. We now expect the unemployment rate to begin rising in earnest in Q3, later than our previous Q2 expectation.

Risk has risen that inflation settles at a higher level

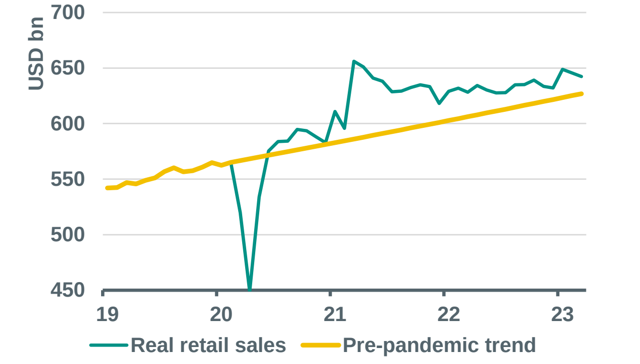
Various inflation measures, 3m/3m seasonally-adjusted annualised rate



Source: Refinitiv, ABN AMRO Group Economics

Real retail sales still above trend

USD bn (real number for March is our estimate)



Source: Refinitiv, ABN AMRO Group Economics

A key reason for the delayed slowdown in the US is likely the significant financial buffers of households and corporates (see *Global View*). While the household saving rate has picked up from the lows, suggesting somewhat less willingness to rely on buffers, that willingness is still there. We expect this effect to gradually diminish as the year progresses, as the headwinds from tighter monetary policy intensify. For now, Q1 GDP is likely show solid growth of 2-2.5% when the advance estimate is published in the coming week, but we continue to expect mild contractions in output in Q2-Q3. Any further delay to the downturn will likely keep inflation higher for longer, raising the risk that it settles at a higher rate than the Fed's 2% target. Indeed, while on a range of measures inflation momentum has definitely cooled, recent monthly readings suggest that inflation has settled at around 4% – double the Fed's target. We expect monthly core inflation to remain stubbornly high for at least the next 2-3 months on the back of rebounding used car prices, continued pass-through from higher housing rents, and elevated unit labour cost growth.

Given the persistent risks around inflation, we continue to expect the Fed to hike rates by another 25bp at the 2-3 May FOMC meeting, and money markets have now mostly priced out any probability of a pause. Fed officials have sounded more cautious on the chance of any further rate rises, given the uncertainty over tighter lending standards, which could do some of the Fed's tightening job for it in terms of bearing down on demand. Should the tightening in lending standards prove ephemeral, we see a risk the Fed could raise rates further over the summer to be sure that inflation falls sustainably back to target. For now, we expect the fed funds rate to peak at 5.00-5.25%, and for the Fed to start cutting rates in December.

China: The reopening rebound firms, led by consumption/services

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- **Based on Q1 GDP data (and Q4-22 revision), we raise our 2023 growth forecast to 6.0% (from 5.2%)**
- **March data confirm rebound is led by consumption/services; property sector recovery continues**
- **Inflationary pressures remain subdued so far, but Beijing will take cautious approach towards easing**

China's reopening rebound, led by consumption/services, has firmed. Real GDP growth accelerated in Q1, while activity data for March on balance point to strengthening momentum, with the housing market stabilising further. The main risks to the Chinese economy are the downturn in global demand, and ongoing tensions with the US on tech and Taiwan.

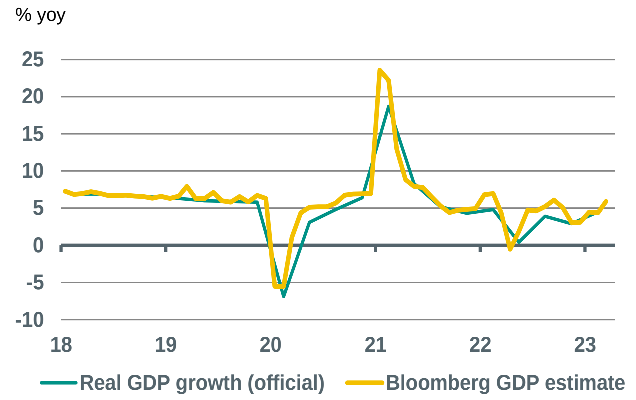
We raise our 2023 growth forecast to 6.0% (from 5.2%) and lower our 2024 growth forecast to 5.0% (from 5.2%)

As expected given the reopening rebound, real GDP growth accelerated sharply in Q1-23. Seasonally adjusted qoq growth rose to 2.2% qoq (Q4-22: 0,6% - revised from 0.0%), with annual growth rising to 4.5% yoy (Q4-22: 2.9%). After the Zero-Covid exit related payback, we expect qoq growth to moderate in the course of 2023. Still, annual growth will surge in Q2, reflecting the base effect from Q2-22 – when China was faced with broad lockdowns following Omicron-flare ups. Based on the Q1 GDP data (also taking into account the upward revision for Q4-22 and related spill-overs), we raise our 2023 growth forecast to 6.0% (from 5.2%). Partly reflecting the stronger 2023 base, our 2024 growth forecast is now 5.0% (was 5.2%).

March data confirm the rebound is being led by consumption and services; property sector recovery continues

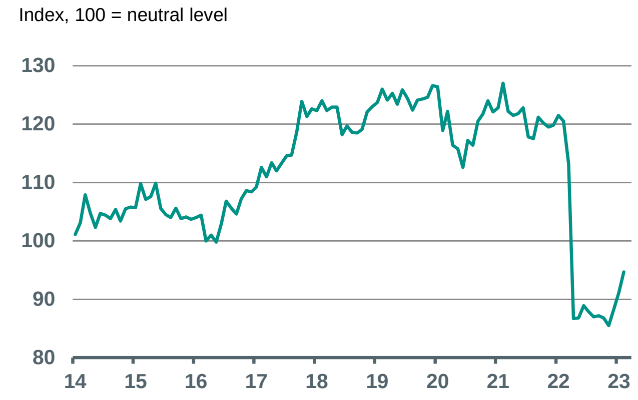
The March data were a bit of a mixed bag, but pointed to stronger growth momentum led by services/consumption. After surging services PMIs, retail sales jumped to 10.6% yoy, the highest pace since June 2021. Residential property sales accelerated to 7.1% yoy in Jan-March, showing that real estate is recovering, with consumer confidence gradually improving and mortgage loan demand rebounding (see also Box 3 in *Global View*). Still, property investment remains lacklustre, while broader investment growth came in weaker than expected. On the industry side, the manufacturing PMIs lost some ground, while industrial production accelerated to 3.9% yoy (from 2.4% in Jan/Feb), but less than expected. The jobless rate fell by 0.3 pp to to 5.3%, but youth unemployment rebounded to 19.6%. Foreign trade (exports in particular) and lending came in stronger than expected. Bloomberg's monthly GDP estimate for March rose to a 6-month high of 5.9% yoy (February: 4.4%).

GDP growth accelerates in Q1, following Zero-Covid exit



Source: Bloomberg

Consumer confidence gradually improving, but still quite weak



Source: Refinitiv

Still-low inflation provides room for policy support, but we think Beijing will take a cautious approach

Despite the reopening rebound, inflationary pressures remain subdued so far. Headline (CPI) inflation dropped to a two-year low of 0.7% yoy in March, driven down by food and fuel prices. Core inflation edged up marginally, to 0.7% yoy, but is still very low. Producer price inflation fell even deeper in negative territory, to -2.5% yoy. Going forward, we expect inflationary pressures to pick up, although we cut our 2023 CPI forecast to 2.0%, from 2.5%. Although from an inflation perspective there is still room for further stimulus, we think Beijing will take a cautious approach. We expect policy makers to refrain from aggressive easing, while keeping any support piecemeal and targeted, as they want to contain overall leverage and prevent the overheating issues that arose after the rebound from the initial Covid-19 shock in 2020. We think Beijing will assume that the natural rebound from Zero-Covid exit will 'do the job', while other previous easing measures are still filtering through.

Key views on a page

The easing energy crisis in Europe is leading to more shallow expected recessions in the eurozone and UK. Consumption will continue to be weighed by falling real incomes, and the impact of monetary tightening is being increasingly felt – with housing markets clearly correcting on the back of the surge in mortgage rates. Key near-term risks come from the tightening bank lending standards, but strong financial buffers could blunt the impact of this. 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 Fed, ECB and BoE are likely to continue raising rates in the near term.

Macro	Central Banks & Markets
Eurozone – Incoming data indicate that eurozone GDP contracted slightly in 2023Q1. The impact of past and upcoming interest rate hikes will increasingly be felt. We expect GDP to contract moderately during most of 2023. Underlying inflation has not eased yet and wage growth accelerated faster than expected in Q4. Headline inflation will fall rapidly this year due to drops in wholesale energy and food prices as well as dissipating supply chain bottlenecks. Core inflation will be more sticky in the short-term, but should also ease going forward.	**ECB** – The ECB raised the deposit rate by 50bp in March. It seems that its bias is still towards further rate hikes, at least if its baseline scenario plays out. Our baseline scenario sees the deposit rate peaking at 3.75% before a rate cut cycle begins in December and continues during 2024. Our base scenario is for a 50bp hike in May and a 25bp hike in June, but the risks are tilted towards 25bp in May and two more 25bp hikes in June and July. If financial market stress and worries about banks were to flare up again, the ECB would probably use other instruments, instead of amending its rate policy in first instance.
The Netherlands – Dutch GDP is expected to grow by 1.2% in 2023 (from 4.5% in 2022). We expect external demand to be lower due to recessions in the eurozone and US. Monetary headwinds will be felt over the course of the year. Despite risks to the medium-term outlook, recent activity data show that short-term risks are tilted to the upside. Consumption has proven to be resilient despite the loss of purchasing power. The labour market is expected to soften, but overall tightness is here to stay. We raised our inflation forecasts (HICP) to 4.6% in 2023 and 4.1% in 2024.	**Fed** – The FOMC raised the fed funds rate by 25bp in March. We expect another 25bp hike in May, with a risk of further hikes if tighter lending standards prove short-lived. 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 Fed to cut 25bp at each of the eight meetings in 2024, taking rates back to near neutral levels by end-2024. The risk is tilted towards rates staying higher for longer, given the persistence of underlying inflationary pressure.
UK – While the easing energy crisis is softening the blow to household real incomes, the tax burden is set to rise significantly over the coming year. The UK may dodge a recession but the economy is expected to remain weak. The medium term outlook will critically depend on the evolution of labour productivity which remains weak. CPI and wage inflation has rebounded, raising the risk that inflation settles at above target levels. The risk to inflation is skewed to the upside because of a structural shortage of workers and public sector unrest.	**Bank of England** – Recent upside surprises to wage and inflation data means the BoE is likely to hike once more in May, taking Bank Rate to 4.50%. MPC decisions over the next few months will be highly sensitive to financial market developments and incoming data. In our view, the economic weakness that is evident in the activity and employment data will start to exert downward pressure on wage growth as 2023 progresses. However, risks currently are tilted towards a higher peak in rates, and a later start to rate cuts (currently expected from Q4 onwards).
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 on tighter credit conditions. Inflationary pressures have rebounded, while labour hoarding persists. 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 hiking cycle is approaching its end. The Fed is expected to peak in May and the ECB in June before both start cutting rates end of 2023. As such, we judge that the Treasury and Bund curve inversion peak are now 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 already started in the US on the back of this banking turmoil in March.
China – The reopening rebound, led by consumption/ services, is firming. Real GDP growth accelerated in Q1, while activity data for March on balance point to a stronger growth momentum, with the property sector recovering. Also taking into account the upward revision for Q4-22 and related spill-overs, we raise our 2023 growth forecast to 6.0% (from 5.2%). Partly reflecting the stronger 2023 base, our 2024 growth forecast is now 5.0% (was 5.2%). Main risks to the economy are the downturn in global demand and ongoing tensions with the US on tech/Taiwan/Russia.	**FX** – EUR/USD tested the important level of 1.10 but moved below again. This was mainly because expectations about monetary policy of the Fed and the ECB moved more in our direction. We think that it is difficult for EUR/USD to break and stay above 1.10 in the current environment. We keep our our EUR/USD forecast for the end of 2023 and 2024 at 1.10 and 1.16 respectively. We foresee a higher EUR/USD in 2024 because of the larger amount of rate cuts we expect for the Fed compared to the ECB in 2024.

Main economic/financial 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	0.0	0.9	Eurozone	2.6	8.4	4.9	2.1
Japan	2.2	1.0	1.1	1.2	Japan	-0.2	2.5	2.3	1.3
United Kingdom	7.6	4.1	0.1	1.7	United Kingdom	2.6	9.1	6.4	2.1
China	8.4	3.0	↑ 6.0	↓ 5.0	China	0.9	2.0	↓ 2.0	2.5
Netherlands	4.9	4.5	1.2	1.3	Netherlands	2.8	11.6	4.6	4.1
Policy rate	**19/04/2023**	**+3M**	**2023e**	**2024e**	**10Y interest rate**	**19/04/2023**	**+3M**	**2023e**	**2024e**
Federal Reserve	5.00	5.25	5.00	3.00	US Treasury	3.60	3.75	3.25	3.00
European Central Bank	3.00	3.75	3.50	2.00	German Bund	2.50	2.55	2.10	1.90
Bank of Japan	-0.10	-0.10	-0.10	0.00	Japanese gov. bonds	0.43	0.55	0.65	0.75
Bank of England	4.25	4.25	3.75	3.00	UK gilts	3.86	3.00	2.60	2.20
People's Bank of China	3.65	3.65	3.65	3.65					
Natural resources	**19/04/2023**	**+3M**	**2023e**	**2024e**	**Currencies**	**19/04/2023**	**+3M**	**2023e**	**2024e**
Brent - Oil USD/barrel	83.1	80	90	100	EUR/USD	1.10	1.08	1.10	1.16
WTI - Oil USD/barrel	79.2	75	85	95	USD/JPY	134.7	131	128	124
TTF - Gas EUR/MWh*	55.2	45	55	50	GBP/USD	1.25	1.24	↓ 1.22	↑ 1.32
					EUR/GBP	0.88	0.87	↑ 0.90	↓ 0.88
Gold - USD/oz	1,995	1,900	1,900	1,900	USD/CNY	6.89	6.80	6.70	6.50

Source: Refinitiv, Bloomberg, ABN AMRO Group Economics

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

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