ABN·AMRO

Group Economics | 24 June 2022

Global Monthly

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

Will the European economy survive a Russian gas cut-off?

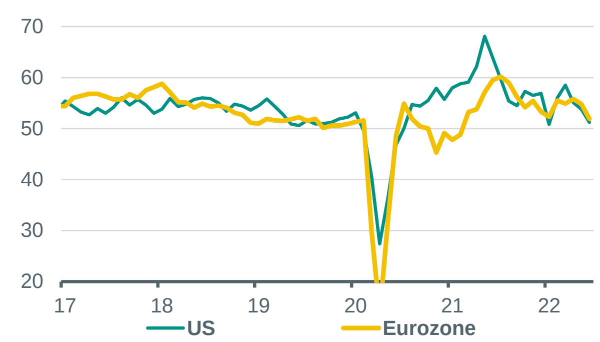
- **We expect a significantly steeper rise in interest rates, and stagnant growth over the coming year**
- **Against this backdrop, the threat of an abrupt cut in Russian gas supplies to Europe is beginning to crystalise, raising the prospect of a potentially deep recession**
- **We describe how a gas cut-off might cascade through the economy, and the policymaker response**
- **Regional updates: We explain our recent growth forecast downgrades for the *eurozone* and *the UK*, while in *the Netherlands*, we focus on the effects of a gas cut-off and risks to the housing market**
- ***The US* economy might escape a technical recession but underlying growth is expected to stagnate**
- **Economic activity has bounced back in *China*, but the demand recovery is lagging supply**

Global View: Another supply shock is hitting Europe, as the economy already shows signs of slowing

The risk of recession has grown further over the past month, as economies have shown increasing signs of slowing, and expectations for central bank policy tightening have increased sharply on the back of broadening inflation risks. On Thursday, the June flash PMIs indicated a sharp slowdown in growth on both sides of the Atlantic, driven by forward-looking indicators such as new orders and business expectations over future prospects. Against this backdrop, in the last few days it has become increasingly clear that yet another supply shock is likely to hit the European economy over the coming year. Russia appears to be cutting gas supplies to Europe abruptly ahead of the more gradual weaning off of Russian energy being pursued by European governments thus far. In this month's *Global View* we focus on the most likely future scenario for a gas stoppage that is already underway, and the economic implications. Before this risk began to crystalise over the past week, we had already made significant downgrades to our growth forecasts, with stagnation expected on both sides of the Atlantic making up our new base case for 2023. These downgrades come on the back of the massive hit to real incomes from high inflation – which is weighing heavily on consumption – and the sharp rises in interest rates we now expect over the coming year. However, an abrupt stop in Russian gas supplies would mean an even darker scenario – with potentially a deep recession in the eurozone and UK economies over the coming year.

Flash PMIs signalled a sharp slowdown in June…

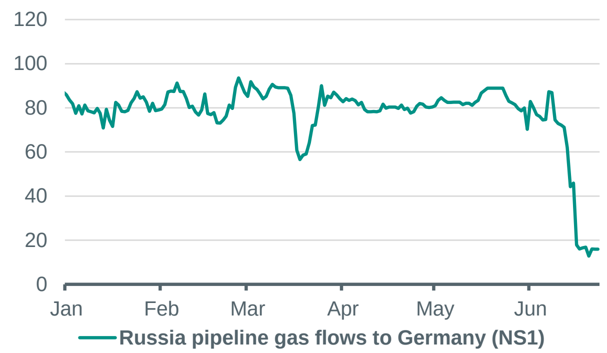
Composite flash PMIs, >50 = expansion, <50 = contraction



Source: Refinitiv

…as a European energy shortage looms

Million cubic metres per day



Source: Bloomberg

The renewed supply bottlenecks a Russian gas stoppage would lead to are taking place against a background of a global economy that is facing severe headwinds from stubbornly high and broadening inflation and a global monetary tightening in response. Therefore, we start with the macro and rates baseline scenario to which we have already made significant adjustments since last month (see table below). Subsequently we will sketch out a possible path of the gas stoppage and its implications for the European economy. While this analysis is focused on the eurozone, given the UK's integration into the European gas market the effects would be similar to that of the eurozone. As these developments are still very fresh and fluid, for now we give only a broad indication of the adjustments we are likely make to our forecasts. We will make more concrete adjustments to our base case as the way forward becomes clearer.

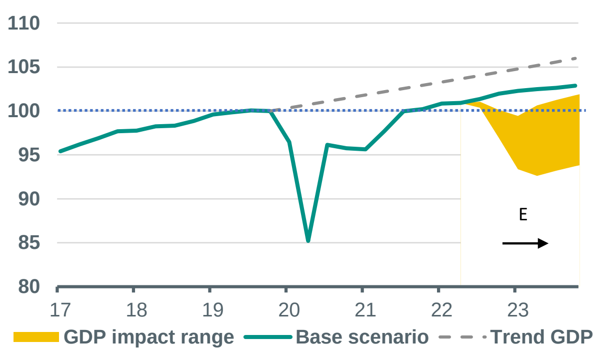
Forecasts

	2022	2023
Eurozone inflation	7.4	3.7
US inflation	9.0	4.6
Eurozone growth	2.9	1.3
US growth	2.5	1.3
ECB	0.75	1.00
Fed	3.75	3.00
Eurozone bond yields	1.65	1.35
US bond yields	3.70	2.80
EUR/USD	1.00	1.15

Red = upward adjustment likely, blue = downward adjustment likely
Source: ABN AMRO

Forecast Eurozone

Index, 19Q4 = 100



Source: Refinitiv, forecasts ABN AMRO Group Economics

Our new baseline on inflation and global tightening

We have raised our forecast for rate hikes for both the Fed and the ECB. In the US we are seeing persistently strong demand despite elevated inflation. In addition, we observe a more hawkish reaction function amongst FOMC members. As such, we now expect the upper bound of the Fed's target range to reach 4% by early 2023, with the risk to this forecast still tilted to the upside. Also for the ECB we have made a significant change to our view. After the likely 25bp hike in July, we expect a 50bp move in September, followed by 25bp steps until the deposit rate reaches 1% in February. We previously expected just two 25bp hikes in July and September. The main reasons for our ECB view change are threefold:

First, inflation has continued to accelerate beyond expectations. Even though the evidence suggests that the vast majority is driven by supply-side imported inflation and to some extent post-lockdown catch up, it still creates challenges for the ECB. Most importantly, there is a concern that continued high rates of inflation will dislodge inflation expectations, especially given the possibility that supply-side shocks will be more persistent.

Second, even though there is not too much that the ECB can do about supply-side driven inflation, there is a general sense that a very accommodative monetary stance is no longer appropriate. The ECB therefore wants to normalise policy or take it back to more neutral levels. While there is a lot of uncertainty about where neutral is, there is broad agreement in the Council that it is much higher than current levels and also above zero percent.

Third, the upward revision to our profile for the Fed's target range means that there would be additional downward pressure on the euro if the ECB does not continue to raise interest rates over the next few months. A weaker currency is undesirable in this environment, as it would add to imported inflation. Indeed, in contrast to the last few years, we now live in a world of 'reverse currency wars'. To be clear, the ECB will not be able to prevent the euro from falling, but it can reduce the extent of the decline.

Both the Fed's and the ECB's target range peaks are seen in February 2023. As a result of significantly tighter monetary policy, we have also downgraded our growth expectations for both the US and the eurozone for next year, and made adjustments to our bond yield and FX forecasts, given our projection for more rate hikes.

Against this background of already significant global turbulence, the impact of a gas stoppage from Russia to Europe is both hard to quantify and potentially highly impactful. In this Monthly we mainly focus on the channels of impact.

The likely path for Putin's gas stoppage

Five European countries are currently fully cut off from Russian gas imports. These are Poland, Finland, the Netherlands, Bulgaria and Denmark. Export cuts towards Germany and Italy are also happening: the supply through NordStream1 for Germany is down by 60% and Italy faces a supply decrease of 50%. The total drop in Russian gas exports towards Europe is around 60 bcm at the moment.

Reduced gas imports make the filling of European gas inventories to around 80% before October (the EU goal) challenging. At the moment, European gas **inventories** are around 55% filled (of which Germany: 59%, the Netherlands: 49%, Italy: 55%, France: 59% and Spain: 71%). Portugal and Poland already have completely full inventories. Even with inventories filled, however, a cold winter may mean that energy security is at stake.

Assessing the supply shock

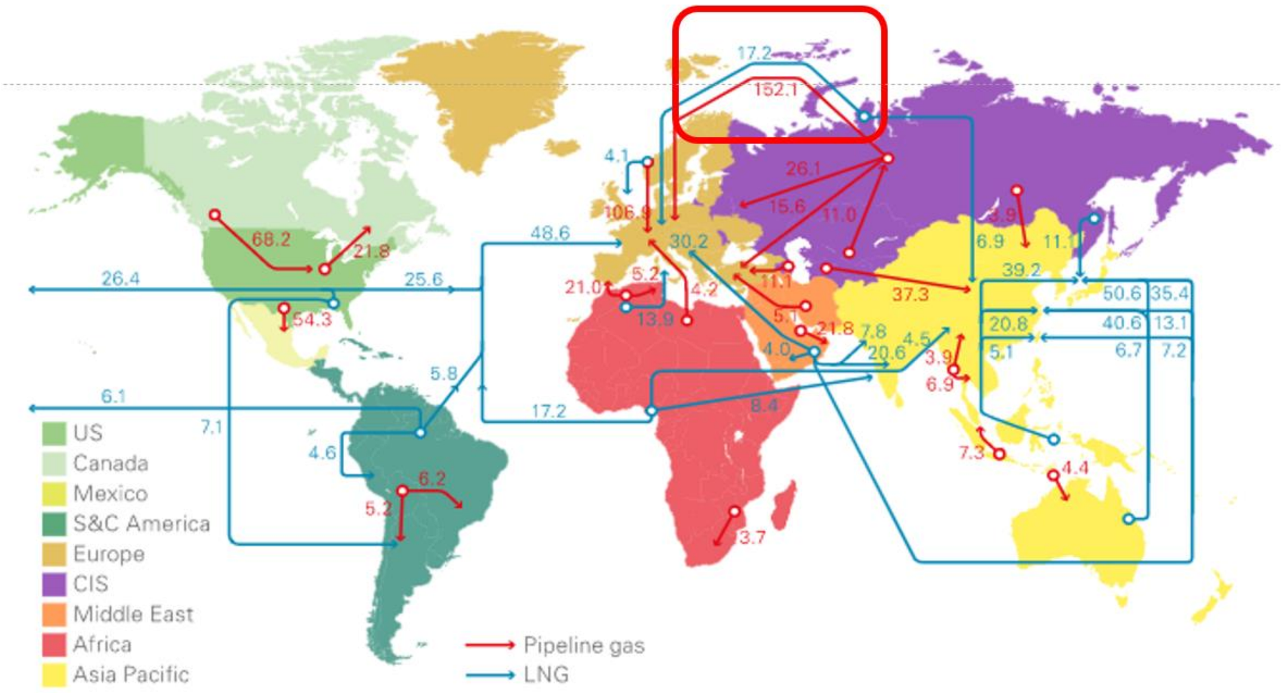
In terms of how far the gas cutoff might evolve, we see three possible scenarios:

1. The situation will remain as it is (a loss of -60 bcm),
2. Russian exports towards Europe will drop even further to 2/3rd of the 2021 imports (-100 bcm),
3. We see a full stop of further Russian gas exports towards Europe (-155 bcm),

The first scenario would basically imply that implementing the 10-steps of reducing gas dependency as published by the IEA would suffice in dealing with the reduced gas supply from Russia. This is a combination of LNG diversification, pipeline diversification, bioenergy, energy efficiency and an increased usage of heat pumps and wind/solar energy. A scenario that we deem very challenging but feasible without much additional economic damage.

Natural gas major trade movements 2020 – trade flows worldwide

X bcm



Source: BP

Scenario 2, a decline of 2/3rd of Russian gas exports, seems most likely. This would push Europe much further into a serious energy crisis. It means shortages, depending on (weather-related) demand, in combination with higher energy prices (gas, coal, oil, carbon, power) and fewer substitution options given the intrinsic rigidity of the gas infrastructure and the ongoing global quest for LNG now that pipeline gas becomes unavailable.

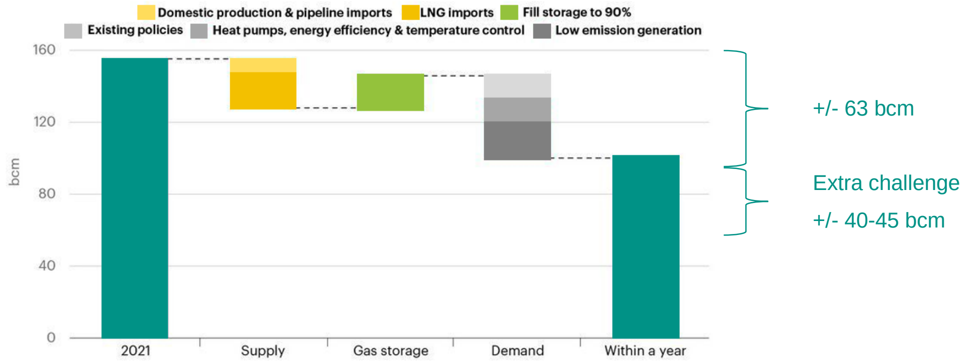
From a Russian perspective, leaving 1/3rd of exports in place would already create shortages and economic harm in the EU but also push up prices and as such still generate a high profit (even though export volumes are lower). While most of Russia's exports to Europe are under long-term contracts at cheaper prices, much of it is not, and some of the gas that is no longer exported to Europe can be diverted to Asia via LNG shipments.

The 20 bcm challenge

In this 2/3 reduction scenario, the first 60 bcm of gas reduction (which we are currently facing) can be seen as achievable according to the 10 step plan by the International Energy Agency .

IEA 10-step plan to reduce 1/3rd of EU gas imports from Russia

Bcm / EU gas imports from Russia



Source: IEA

A 2/3rd gas supply reduction would mean that of the 100 bcm gas that is currently still being imported, another 40-45 bcm drop in Russian gas exports towards Europe will follow in the coming months. The recent announcements of reopened coal fired power plants to enable a gas-to-coal switch could roughly tackle 22 bcm (of which 25% is in the Netherlands and Germany). Assuming that energy savings in the residential sector will be modest in the short term (possible 5 bcm on top of the already assumed energy savings in the IEA plan), the main burden will fall on industry. This implies a 15-20% drop in consumption by the industry sector (20 bcm).

No gas from Russia at all

In case of a full gas stoppage (scenario 3), Europe will have to deal with an additional 50 bcm shortfall (on top of the challenges of scenario 2) through a combination of demand reduction in industry, but also somewhat in the residential sector or even in power generation. This would create serious problems and shortages. See the Box below for a comparison of various studies done on the economic impact of such a scenario for the German economy.

All scenarios will trigger gas prices to remain high for longer. The shortages in the market would partly be countered by demand destruction, but tight market conditions will likely remain for the coming years. The gas-to-coal switch also adds upward price pressure to coal and carbon allowances, and would not trigger much relief for gas prices as the focus will remain on inventory building.

What a full gas stoppage to Germany could look like

A number of studies have been conducted discussing the economic implication of a full stoppage of gas imports on the German economy that provide an interesting framework for the discussion on economic impact in the Eurozone. The impact ranges widely from 0,3% to 8% (or even 12% of loss of GDP growth if large demand fallout is taken into account). The range of outcomes can be explained through different assumptions on the substitutability of gas from Russia with gas and gas related products from non-Russian sources. Differences in supplier network dependencies and as such cascading second round impact in non-energy intensive firms is another important variable that drives the differences in outcomes. Finally, the demand reduction from price increases is a factor that differentiates the economic impacts reported. The approach to economic impact assessment is similar in all studies and also to our own approach, which we outline below. It consists of 5 steps:

1 **Initial gas shortage and immediate replacement potential.**

(44bcm initial shortage – 14 bcm replacement potential = 30 bcm shortage).

The German economic imported around 44bcm of natural gas from Russia in 2021. Bare in mind that 2021 was a mild winter and thus understates the amount to compensate. The study from the Hans-Böckler-Stiftung (HBS) of May 2022 is the most recent one and it estimates that 14 twh of gas can be immediately replaced. Studies that find much milder impact take the assumption that most gas can be replaced immediately from the global market at adjusted prices. Given the inelastic supply of alternatives due to a) the European and in fact global search for alternatives, b) the infrastructure of pipelines that make alternative supplies less of an easy substitution, and c) the tight German labor market to refurbish the energy infrastructure, we believe that the initial supply shock will be quite large and most likely in line with the HBS study.

2 **Savings potential from industry and households**:

(Shortage of 30 bcm – industry and household savings of 16bcm = 13 bcm final shortage).

Estimates from the HBS study show that the industry may save 11 bcm without severe loss of output, while households could save 5,6 bcm by lowering their temperature, insulation, and renewable energy investments (on top of the 10 percent energy savings that are in the baseline from Repower EU plans). This assumption seems to be on the pessimistic side. According to a study by the IEA, households in Germany, France and the UK already managed to reduce their energy spending by 16 to 20 % with energy efficiency improvements in 2017, a year without fast increasing prices.

3 **Hit to energy intensive sectors** of 13bcm means 41% intensive industry output loss.

The initial impact would be confined to 6 energy intensive sectors in industry that are at the early stages of the German commodity chains (their estimated total value added is equal to around 4% of Germany's GDP) . As such the cascading second round effects on sectors that are not energy intensite but have strong supplier relations with these hard hit sectors will be large. The second round effects are best portrayed in the HBS study.

4 **Cascading output loss in connected sectors** could double to even quintuple GDP losses.

The studies start to diverge strongly at this stage, depending on whether the industry is assumed to be able to source its energy from the global markets (be it at much higher prices) or not. As we explained in step 1, we believe that the initial substitution options will be limited, at least in the short term.

5 **Demand fallout** from higher inflation could lead to a further loss of GDP.

Although much of the demand response to higher inflation is already included in our baseline scenario for the eurozone economy.

Our take: Given that a full gas stoppage is not our most likely scenario (rather a 2/3rd reduction) and the already decided reopening of coal fired power plants that is not taken into account in the above studies, we believe the economic impact is on the lower side of the distribution (we foresee a fall in eurozone GDP of 2-5pp relative to our baseline scenario). On the other hand, it is possible the studies discussed could be underestimating the impact. Most studies assume that the Repower EU plan as an achievable baseline which we do not deem that feasible. Finally, although governments are stepping in to some extent to cushion the blow to households from higher energy prices, their ability to reconfigure the energy infrastructure to fit alternative energy sources is severely hampered by staff shortages and other capacity constraints. The inflationary environment means the scope for monetary policy to help is also very limited.

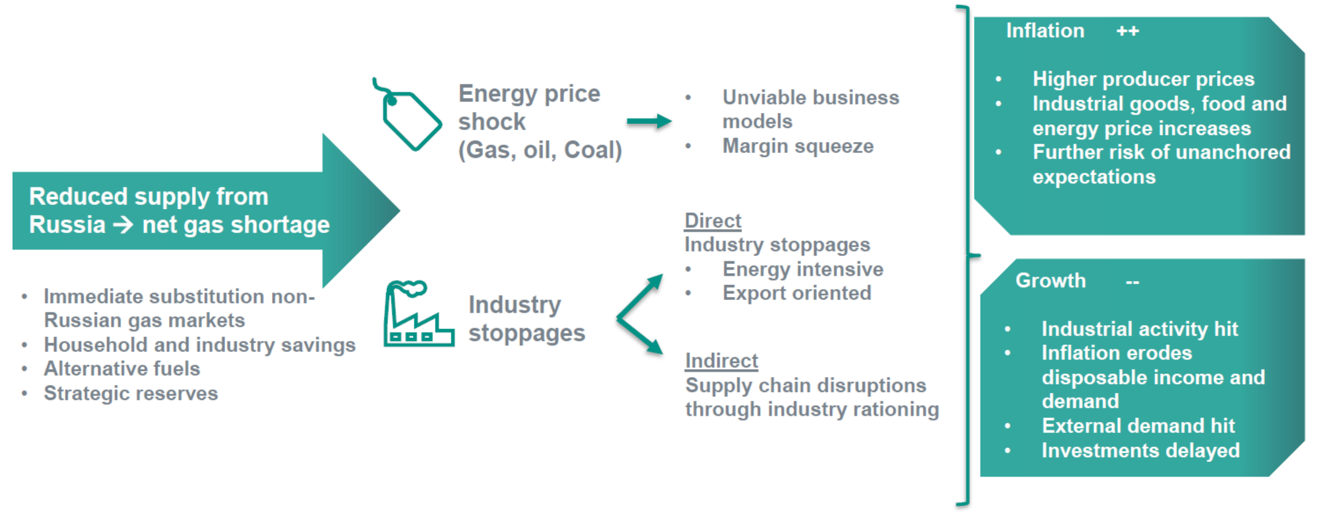
Economic Impact assessment

The flowchart below captures the main channels of economic impact that a severe additional supply reduction of Russian gas has on the economy.

The initial reduction of gas supplied will at first be mitigated as much as possible through sourcing from different geographies and fuel substitution. Energy efficiency improvements would also be maximized. Whatever shortfall remains after mitigation and substitution is the final supply shock that causes economic damage.

The supply shock triggers two initial effects: energy prices jump and industry energy use will be rationed by government regulation to protect households and essential sectors' energy consumption. Energy intensive sectors which are considered relatively less relevant to domestic consumption will be closed first.

Gas supply shock



Source: ABN AMRO Group Economics

The price shock in itself could also render some business models obsolete as the margin squeeze triggers losses and ultimately bankruptcies.

The direct effect from industry stoppages is output loss, but also indirectly these output losses cascade even to non-energy intensive sectors via supply chain linkages.

The effects put yet further upward push on prices, uncertainty and risk premia. Inflation erodes households disposable income and, depending on consumers' ability and willingness to dip into their savings, this will weigh consumption and economic growth. Uncertainty will weigh on investment which also affects medium term growth. Supply bottlenecks can withstand a lot of turmoil, but when confidence erodes, production networks can face serious distortions that take a long time to rebalance.

Eurozone

We have already lowered our growth estimates for the eurozone significantly since the start of the war in Ukraine. The jump in energy and food commodity prices and its impact on final domestic demand has been the major factor behind the downward revisions. The cut to GDP growth forecasts in 2022 and 2023 totals more than 2 percentage points so far.
The potential impact of an abrupt end of Russian gas exports to Europe is not yet in our baseline scenario. Such a scenario would hit Germany and Italy particularly hard, as they are the two big-6 eurozone countries that are most dependent on gas imports from Russia. Both Germany and Italy import almost all their gas needs, with Russia having a share of roughly 65% and 40%, respectively, in total gas imports before the start of the war in Ukraine (compared to, for instance around 17% for France).

The German and Italian governments have already presented plans to reduce their dependency on gas imports from Russia (amongst others by importing more from other destinations, such as several African countries, and by restarting coal-fired power stations), but each have said that this will take some time and that full energy independence from Russia would likely not be achievable before the second half of next year at the earliest.
The Italian and German Energy and Economics Ministers have announced that the implementation of legal measures to save energy are a real possibility in the next few months.

According to reports in the German press, the Federal Energy Agency has formulated a set of criteria by which decisions should be taken in the event of a gas emergency and potential shut downs in gas supply to the industrial sector. These include, the size of the plant and its energy use, the necessary lead time for gas procurement reduction or an orderly shutdown of the production facilities, the expected economic and business damage, the cost and duration of restarting after a gas supply reduction and the importance of the product to the general public.

Besides plans to limit gas usage (reports in the Italian press for instance mention plans to limit air conditioning in most public buildings to a minimum of 25 degrees Celsius this summer) Italy has also recommended that European Union member states put a limit on the price of gas imports from Russia to help curb inflation and the economic consequences in the bloc. Indeed the European Commission has also included the option of an administrative price cap on gas at the EU level in a set of short-term measures to tackle high energy prices and address possible supply disruptions from Russia (see **here**). Such a EU initiative could ease the burden for individual countries.

All in all, a disruption in gas supply in line with scenario 2, would imply a 20-25% drop in gas consumption by the eurozone industry sector (around 20 bcm). Such a drop would probably result in a deep recession in the eurozone economy (see chart on page 2 for a range of the potential impact). Unless there will be a common EU initiative for redistribution of gas and financial compensation, Germany and Italy would probably be hit relatively hard. Energy solidarity within the EU might cushion the economic impact, however in our current estimations we are not taking these into account.

The Dutch economy

The Dutch economy is less dependent on Russian gas than the eurozone average. That said, current inventory levels (48%) suggest shortages are likely this winter, and gas makes up a large share of total energy consumption (34%).

Therefore the impact off a Russian gas cut-off on the Dutch economy is as much linked to the price effect of the gas shortage as it is the effect that industry stoppages would have on activity.

The price effect would make many business models in energy-intensive sectors such as fisheries and horticulture to become obsolete. But further price rises would lead to even more problems. They would affect a broader share of the business economy compared to recent energy price shocks as the gas-to-coal shift and substitution of gas to other sources of energy will push up prices in electricity and oil markets as well. Industrial sectors that have the highest energy costs as a share of revenue would bear the brunt (chemicals, paper manufacturing, metals – see table below for gas usage as % of revenues).

Top 20 industries with high energy costs

Ranked by energy costs* in 2019

Sector	Energy costs (mln)	Energy costs (% of turnover)
Basic chemicals	1808	4.6
Greenhouse horticulture	1261	15.3
Petroleum industry	751	2.1
Refineries	749	2.1
Traditional catering	582	2.5
Basic metal industry	360	4.1
Building materials industry	235	3.3
Other chemical products industry	183	3.6
Rubber and plastic products industry	178	1.7
Provision of agricultural services	171	3
Fruit and vegetable processing industry	125	2.1
Flour industry	98	3.7
Mining and quarrying (excluding oil and gas)	50	3.3
Laundry industry	29	3.3
Surface treatment industry	52	2.7
Potato products industry	87	2.7
Bread and pastry industry	88	2.6
Demolition and groundwork companies	66	1.7

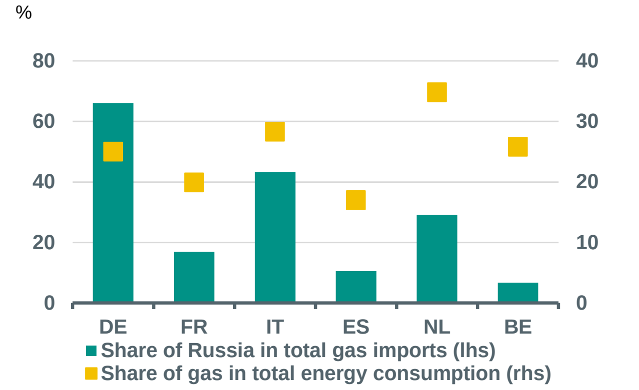
* Energy costs including electricity, gas and coal, but excluding e.g. petrol and diesel for transport
Source: CBS, figures greenhouse horticulture Agrimatie, calculations ABN AMRO Sector Advisory

Dutch industry has a share of 12% in total GDP, which is lower than the EU average. The most gas intensive sector is chemicals industry (25% of total gas consumption and 2% value added (VA)). The food industry has a 7% share in the total gas consumption (2% VA), but we deem it unlikely that this industry would be asked to shut down by the government.

The biggest economic impact on the Dutch economy could come from industry stoppages in other Eurozone countries (primarily Germany) which indirectly affects Dutch firms and demand for Dutch exports via supply chains. Emergency gas plans signal that larger industrial companies are expected to face energy rationing before SMEs, and as large companies are more integrated in global value chains, this may have a disproportionately bigger effect on Dutch trade as well. Interestingly, the sectors affected by this indirect effect are different than those hit by the direct effect. Trouble in supply chains will primarily affect the manufacturing of clothing (0.15% VA) and mining (1.03% of VA) sectors and to a lesser extent agriculture (1.8% of VA) and metals (1.4% of VA).

Whilst the impact in terms of lower growth and higher inflation will already become visible towards the end of 2022, we judge that the main impact will come in 2023. Growth is expected to be severely reduced – likely in a recession – and inflation will stay elevated more in 2023.

Russian gas-, and overall gas dependence



Source: European Commission, CBS, ABN AMRO Group Economics

Policy implications for the ECB and Fed

A gas stoppage would exacerbate inflation over the next year but also likely causes a deep recession. This creates even more uncertainty over the policy direction of the ECB.

In terms of the path for interest rates, a crucial factor will be when exactly the new scenario becomes clear and also the degree of fiscal support to households and firms. On balance, we think that the new scenario will likely lead to a lower path for interest rates than in our baseline. Although ECB policy rate rises to get policy closer to normal (and at least into modest positive territory) still look likely, the terminal rate will likely be lower than in the current base.

A recession and rising unemployment will likely lead to a lower outlook for inflation in the medium term compared to the ECB's current projections. As such, once the ECB factors this outlook into its projections, interest rate hikes are likely to be put on ice.

The new scenario will also likely trigger more turmoil in markets, possibly with disorderly moves, leading to a sharp tightening financial conditions as well as more severe fragmentation in terms of peripheral spreads. The ECB may therefore need to move to non-sterilised net purchases of peripheral bonds and eventually a broader QE programme with the aim of stabilising markets as well as spreads. The profile for bond yields will be lower than in the base case and could fall quite significantly in 2023.

For the Fed, we do not expect much impact from a Russian gas cut-off. The US is largely energy independent, and if anything a gas cut-off only puts more upward pressure on US inflation as it would raise demand even further for US LNG exports. While the US economy might be hurt from a demand angle given the recession we would expect in Europe, this would be less of a concern than in normal times given that there is still significant excess demand in the US economy. With Fed Chair Powell making clear in recent remarks that achieving price stability is 'unconditional', we think only a truly disastrous scenario for Europe involving a sustained disorderly tightening of financial conditions might derail Fed rate hikes.

China, a counterbalance for growth…

From a global growth perspective, China could function as a counterweight to the expected slowdown in the key developed economies in the coming quarters (even though we will cut our annual growth forecasts as we will explain in the regional part). That said, China's rebound from lockdowns in March/April will be unbalanced, bumpy and less spectacular than the recovery seen after the initial covid-19 shock in 2020. The recovery in industrial output and the fading of bottlenecks in production and transport is also beneficial for global supply chains.

Oil price impacted by (a.o.) China lockdown

Brent oil, USD/bbl

Source: ABN AMRO Group Economics, Refinitiv

…and an additional upward pressure on energy prices

While the rebound in China may form a counterweight in global growth terms in the coming quarters, a pick-up in China's demand and supply will add to the price pressures in global markets for energy, other commodities and industrial goods. Our base case of a gradual reopening in China is supposed to have an upward effect on energy prices while on the other hand it should help to reduce delivery times in global supply chains, and as such have a (ceteris paribus) downward effect on industrial goods prices. Depending on the severity of industry stoppages, global supply chains will again be disrupted and partly reallocated due to energy rationing in Europe, price increases and lower trade volumes. This would add to the structural realignment in global trade flows, as we already incorporated in our baseline scenario since the war in the Ukraine.

Eurozone: Growth outlook has deteriorated

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

- **We have lowered our growth forecasts and expect the economy to slow down sharply next year**
- **The ECB has opened the door for larger rate hikes. Following a first 25bp hike in July and a 50bp hike in September, it is expected to gradually raise rates until early next year**

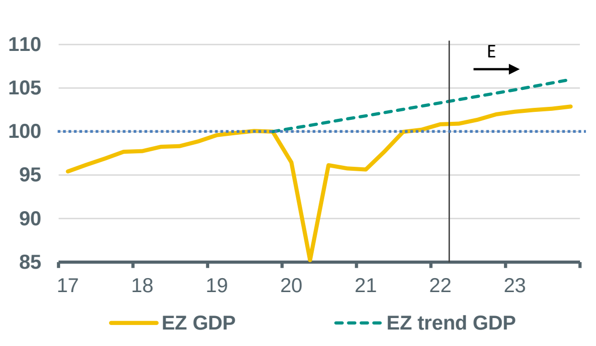
GDP growth in 2022 will probably turn out somewhat higher than we expected before. This change is mainly due to the upward revision for Q1 (to 0.6% from 0.3%). We have kept quarterly growth during 2022Q2-Q4 largely unchanged and still expect average growth of around 0.3-0.4% growth during these three quarters, when the easing of supply chain bottlenecks and the bounce in services consumption is expected to raise output and spending. However, moving into 2023 growth should slow noticeably, probably to levels well below trend. By then, consumers should have spent most of the savings that they accumulated during the pandemic. Consumption growth is expected to be supported by robust employment growth in 2022, but the outlook for the labour market should deteriorate towards the end of the year. Moreover, temporary catch-up effects in industrial production and fixed investment will fade. On top of that, eurozone domestic spending as well as global trade is likely to slow on the back of the more aggressive interest rate hikes by the Fed and ECB, which is tightening financial conditions. We have roughly halved our quarterly growth numbers for 2023 to around 0.1-0.2% qoq, which lowers annual growth to around 1.3%, down from our earlier estimate of 1.7%. Our forecast is well below the consensus forecast.

Inflation came in higher than expected in May, at 8.1%, up from 7.4% in April. Although the rise in inflation continued to be driven by energy and food prices, core inflation increased as well. Services price inflation is currently being lifted by a normalisation of holiday and leisure prices as well as the pass-through from high food and energy prices into, for instance, transportation services and restaurant and catering services. Meanwhile, supply chain disruptions and high energy prices are also contributing to higher non-energy industrial goods price inflation. Recent trends in commodity markets suggests that food and energy inflation will move even higher in the months ahead, but should start to decline in the Autumn. This will also reduce the energy-related rises in goods and services inflation. Wage growth is expected to increase this year and next, but the upward impact on underlying inflation will be moderate as labour productivity is expected to increase as well. Moreover, the deteriorating economic growth outlook should limited wage growth in 2023, as labour market conditions become less rosy. We expect the unemployment rate to rise somewhat next year.

Following its June meeting the ECB announced the end of QE and signalled a first 25bp rate hike in July. It seems that a 50bp hike is on the cards for September. Subsequently, we expect a 25bp hike during every Governing Council meeting until February 2023, when the deposit rate should reach 1.00% (up from -0.50% now). We have not pencilled in any rate hikes after that, which reflects our expectation for economic growth to slow down considerably in 2023.

Growth is expected to slow significantly

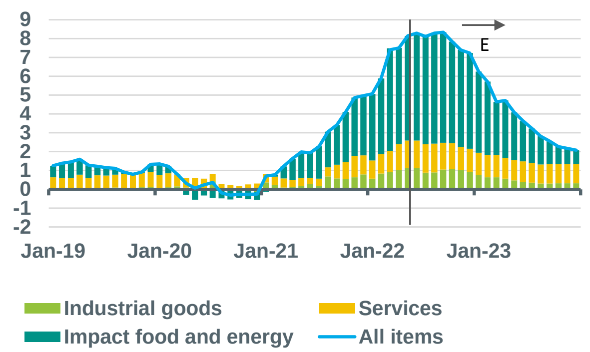
Index, 2029Q4 = 100



Source: Refinitiv, ABN AMRO Group Economics

Inflation to rise further in the coming months

pps yoy



Source: Refinitiv, ABN AMRO Group Economics

The Netherlands: Russian gas cut-off adds to the list of risks

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

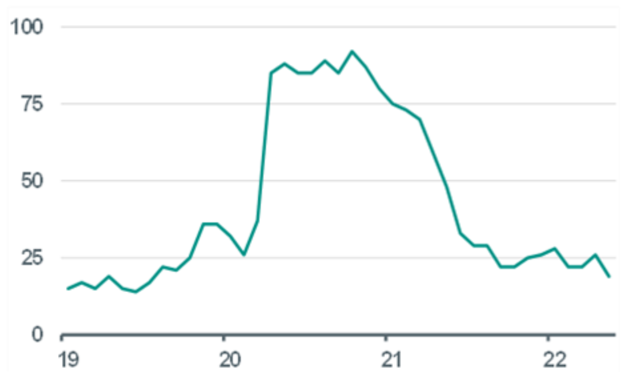
- **The risk of a Russian gas cut-off is beginning to crystalise. For the Netherlands, the indirect effects on supply chains and exports are likely hurt growth the most**
- **Monetary tightening and higher (mortgage) rates are dampening the outlook for the housing market**

As indicated in our **previous** monthly, we currently do not have a recession in our base case. However, in recent weeks a major risk to the outlook is crystalising: a European cut-off from Russian gas. While the Netherlands has already been fully cut-off from Russian gas imports, we lay out the possible channels of impact if this were to happen at the European level. While the Dutch economy is less dependent on Russian gas than the eurozone average, a broader cut-off would have significant *direct* and – given the importance of trade for the Dutch economy – *indirect* implications. Direct effects include a potential rationing of energy. Taking into account the government's emergency gas plans, the most gas intensive sectors such as chemicals (2% of VA; of which the fertilizer subsector contributes to 10% of total gas consumption) are expected to be first in scope of mandated stoppages. Indirect effects of foreign industry stoppages run via supply chains disruptions and reduced external demand. Germany – the largest export partner of the Netherlands – has already triggered stage 2 of its emergency gas plan, which could lead to higher gas prices for businesses and hence more insolvencies. In most emergency plans of EU countries, large industrial companies are subject to rationing before SMEs, and given that the former are more heavily integrated in global value chains, Dutch trade may be affected disproportionally.

While the risk of a Russian gas cut-off is beginning to crystalise, as explained in this month's *Global View*, we are yet to incorporate this into our growth projections. We maintain our growth forecasts of 3% for 2022 and 1.3% for 2023 for now, but risks especially to our 2023 forecast are now tilted to the downside. Central to our view for 2022 is the extent to which consumption is supported in the short term by the high stock of excess savings, fixed energy contracts which postpone the hit to disposable incomes, and strong labour market prospects. So far, consumption data for March and April – months with CPI inflation above 9% – confirm this view. Overall consumption is still expanding following lockdowns at the start of the year, also driven by a further rebalancing towards services from goods consumption. A crucial factor giving consumers the confidence to use their high stock of savings is a favourable view of the labour market. Surveys suggest that, despite the looming risks on the horizon, consumers' labour market expectations are still high, which supports consumer spending.

Consumers signal slowdown in consumption

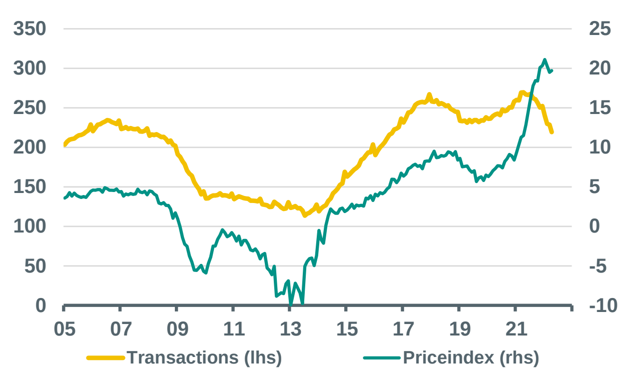
EC consumer survey, % of households that expect unemployment to rise



Source: ABN AMRO, CBS

Rise in interest rates is cooling the housing market

% change yoy



Source: ABN AMRO, CBS

Another drag on growth comes from monetary tightening. Mortgage rates have risen sharply lately, more than doubling compared to the beginning of the year. As a result, mortgage lending conditions are becoming less favourable and home buyers can borrow less. As living costs rise, people have less money to spend on their mortgage payments. As a result, banks have had to reduce the amount people can borrow to buy a home. We expect the housing market to soften. Early signals are the weakening market sentiment, the declining number of transactions and the increasing number of houses for sale. For now house price rises are still strong. However, early indications suggest this won't last. Next year the rise will turn out to be much lower, and in the case of a recession a price correction cannot be excluded.

US: Recession in all but name?

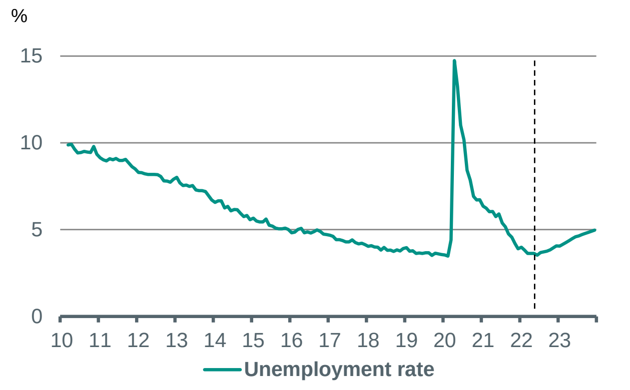
Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

- **A volatile supply side could mean the US *just about* escapes a technical recession…**
- **… but underlying growth is likely to weaken significantly on the back of a jump in interest rates**
- **This is likely to raise the unemployment rate by 1.5pp by the end of 2023, helping to cool inflation**

Notwithstanding the significant fall in the June flash PMIs this week, demand indicators so far in Q2 have been very strong in the US, with private consumption data showing continued above-trend demand for goods, and services recovering further back towards trend. Alongside an improvement in net exports, we expect this to drive a 3.8% annualised rise in GDP in Q2, following the 1.5% contraction in Q1. As we move into the second half of the year, however, we expect the growth environment to deteriorate. The deepening inflation hit to real incomes, combined with the tightening effect of higher interest rates – which is already hitting many households via higher mortgage payments and reduced net wealth via stock market declines – is likely to lead to broadly stagnant consumption (i.e. near zero growth) over the coming quarters. Fixed investment will be supported in the near-term by catch-up from the pandemic, as the supply-side continues to recover, but we expect investment to subsequently contract in the first half of next year. The headline growth picture is complicated by the supply-side disruptions and pandemic recovery distortions, and as such headline GDP growth is likely to continue to be volatile over the next few quarters on the back of swings in inventories and net exports. However, underlying demand is expected to weaken significantly this year and particularly as we move into 2023.

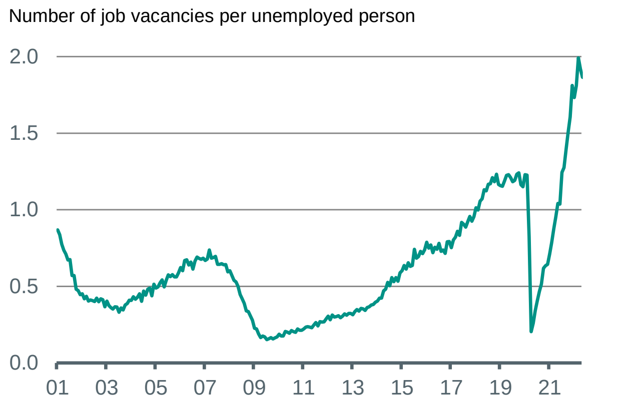
The projected weakening in demand is likely to lead to some rise in unemployment, probably beginning in late Q3 this year and picking up pace in Q4/Q1 next year. Our new base case is that unemployment peaks at c.5% in early 2024 from 3.6% as of May. This, combined with a significant fall in job vacancies, should bring the unemployed-job vacancy ratio down to below 1 by late next year from around 2 at present. This ratio has become a key metric for the Fed, as it reflects the significant supply-demand imbalance in the labour market that is risking a de-anchoring of inflation expectations. Indeed, on inflation itself, we have made a further upward revision to our 2022 annual average forecast to 9.0% y/y from 8.0% previously, and expect more of this strength to carry over into 2023, with inflation expected to average 4.6% (previously 4.1%). The Fed's key focus is on month-on-month readings, and here we expect readings to remain far above levels consistent with the Fed's 2% target for much of the remainder of 2022. Thereafter, the weaker labour market should drive a sufficient cooling in inflation by Q2 2023 to convince the FOMC that it has tightened policy enough.

We expect a 1.5pp rise in unemployment by end-2023



Source: Refinitiv, ABN AMRO Group Economics

This should drive a decline in the job vacancy ratio



Source: Refinitiv, ABN AMRO Group Economics

While we had already made a significant upgrade to our expectation for Fed rate hikes prior to the June FOMC meeting, with the upper bound of the Fed funds rate now expected to peak at 4% in February (up from our previous 2.75% expectation), the supersized 75% hike in June combined with Powell's hawkish signalling led us to frontload some of this tightening. We now expect one further 75bp hike in July, with this followed by 50bp moves in September and November, and 25bp hikes in December and February. The risks to rates continue to be to the upside, as are the risks to the inflation outlook itself.

UK: Steeper rate rises, despite recession risks

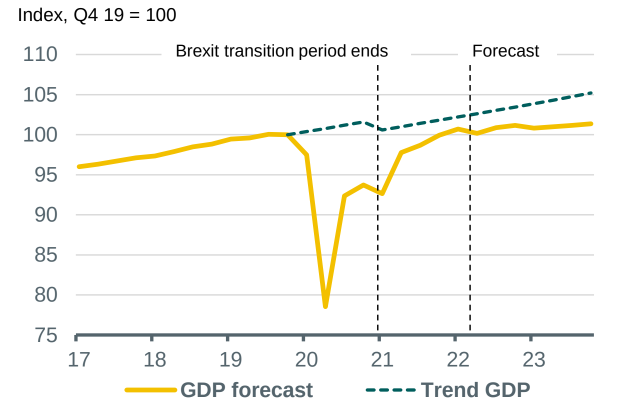
Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

- **The growing risk of a wage-price spiral has BoE policymakers worried. As a result, we have significantly raised our expectation for interest rate rises over the coming year**
- **Falling real incomes and sharply rising rates are likely to lead to a stagnation in economic activity**

The UK economy is expected to contract in Q2, as the unwind of pandemic-related health service activity (eg. NHS track & trace) offsets the broader recovery in the services sector. The economy should rebound subsequently, as the holiday season and the end of pandemic restrictions drives a strong recovery in travel over the summer months. However, beyond this we have significantly downgraded our growth forecast, principally for 2023. This is due to the rise in inflation risks, which are showing increasing signs of spreading to the labour market. This week, rail union TSSA negotiated a 7.1% pay rise for Merseyrail staff, amid a wave of strikes hitting the railways across the UK at present, while the minutes from the Bank of England's June policy meeting noted that a 'significant minority' of companies were reporting 'mid-year top-ups to pay', likely in response to high inflation. Such developments are naturally causing greater worry among members of the Bank of England's Monetary Policy Committee that inflation might evolve into a more entrenched and self-sustaining wage-price spiral. To pre-empt this risk, we now expect June's 25bp rate hike to be followed by a bigger 50bp move by the BoE in August, and we significantly raised our forecast for where we expect Bank Rate to peak, to 2.5% from 1.5% previously.

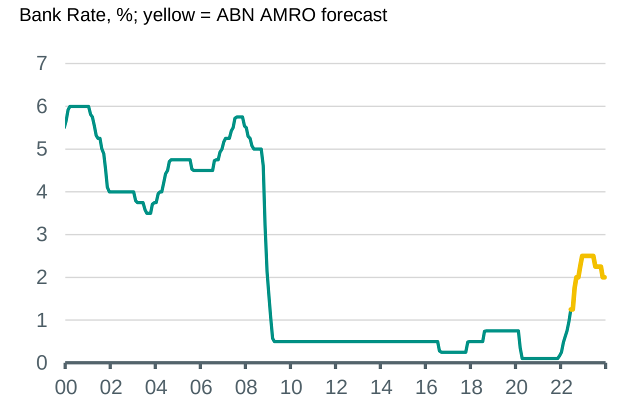
Steeper rate rises will add to existing downside growth risks coming principally from inflation itself, which is driving the biggest fall in real incomes on record. Among other things, this is keeping retail sales below trend, despite the significant savings buffer that households built up during the pandemic. Alongside the US and the eurozone, we expect this buffer to gradually erode over the coming year, as inflation continues to eat into real incomes. In the meantime, rate rises will naturally have a dampening effect on demand, with the red-hot housing market expected to cool, and fixed investment growth to fall back. All told, we expect the economy to slow to a crawl next year, with growth of just 0.3% projected, down from our previous expectation of 1.6%, and from a downwardly-revised 3.6% expectation (previously 3.8%) for 2022. The economy will likely be on the cusp of a technical recession next year, with unemployment expected to rise to nearly 5% by the end of 2023 from the current historically low 3.8%.

GDP is expected to stagnate over the coming year



Source: Refinitiv, ABN AMRO Group Economics

BoE to hike rates by more than we previously expected



Source: Refinitiv, ABN AMRO Group Economics

Will the BoE need to cut rates once the inflation hump has passed?

The peak we now expect in interest rates is still well short of current market pricing, which foresees the BoE raising Bank Rate to over 3% by next May. We think that by later this year, the economy should have sufficiently weakened to drive a rise in unemployment and a cooling in wage growth. Combined with a broader fall in inflation in the first half of next year, this could raise the prospect of the MPC reversing course and cutting rates to support growth, perhaps in H2 2023. Indeed, the MPC's projections from May – which were predicated on market pricing for Bank Rate to peak at 2.5% – pointed to a significant rise in unemployment and an undershoot of the 2% inflation target in the medium term (see **here**). Unless the Bank's internal neutral rate estimate has changed, this suggests rates are unlikely to stay this high for very long.

China: Turning the corner, in an unbalanced way

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

- **Economic activity has started to bounce back from the lockdown slump in March/April**
- **The rebound is led by the supply side, as strict Covid-19 policy leaves its mark on consumption**
- **We still expect momentum to improve in 2H-22, but cut our 2022 growth forecast to 4.2% (from 4.7%)**

May data confirmed our view that April would be the nadir of the contraction in activity following the broadening of lockdowns in March/April. Still, these data illustrated that this rebound is led by the supply side, with consumption and real estate lagging. We still expect momentum to pick up in 2H-22, the gradual reopening to continue and ongoing targeted fiscal support, cautious monetary easing and a relaxation of macroprudential regulation (including for real estate). Still, this recovery will be unbalanced, bumpy and less spectacular than the rebound from the Covid-19 shock in 2020. Given recent data and our changed US/Fed and eurozone/ECB views, we cut our 2022 growth forecast further, to 4.2% (from 4.7%).

China's recovery is led by the supply side, with ongoing strict Covid-19 policy leaving its mark on consumption
The PMIs and activity data for May confirm a macroeconomic turnaround led by the supply side, reflecting an easing of the nationwide lockdown intensity and measures taken to solve bottlenecks in production and transport. Annual growth of industrial production turned positive again in May, at +0.7% yoy (April: -2.9%), with for instance the car sector showing a clear rebound. Foreign trade has also profited from normalisation on the production side, with export and import growth accelerating. However, the ongoing contraction in retail sales in May (-6.7% yoy vs -11.% in April) shows that consumption is again lagging in the recovery process. Also, investment and sales data show that the property sector needs more time to recover from the lockdown-related slump. All of this underlines that ongoing strict covid-19 policy is leaving its mark on consumption, with consumer confidence also dropping to a record low in April. Although the official unemployment rate fell back a bit to 5.9% in May (April: 6.1%), youth unemployment reached a record high of 18.4%.

Recovery from lockdowns March/April led by supply side

Production of passenger cars, volumes, millions

Source: Refinitiv

… while the rebound in retail sales is lagging

Retail sales, values, % yoy

Source: Refinitiv

Combination of ongoing strict covid-19 policy and measures to safeguard growth is keeping recovery unbalanced
The gradual reopening from the March/April lockdowns will not be without hiccups, with downside risks imminent (see our May Monthly for more background on Covid-19 policy and alternative scenarios). This was illustrated by a recent re-tightening of measures in megacities such as Shanghai, Beijing and Shenzhen. While the evolving practice of "mass testing and mini lockdowns under dynamic clearing" is less disruptive to the supply side compared to what we have seen in March/April, so far it is not helping the demand side much. Beijing's policy to safeguard growth is currently more focused on production and investment, although a small reduction in the 5-year Loan Prime Rate in May may help revive consumer demand for housing. Infrastructure investment is being ramped up by eg. giving local governments greater financing freedom, encouraging banks to increase lending, and easing financing conditions for distressed real estate companies. All in all, the hardening trade-off of maintaining strict Covid-19 policy and safeguarding growth in the run-up to the CCP summit in November is keeping China's recovery from the lockdown slump quite unbalanced.

Key views on a page

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

Macro	Central Banks & Markets
Eurozone – GDP is expected to grow by 0.3-0.4% qoq on average throughout 2022Q2-Q4, but a sharp slowdown is expected moving into 2023. By then, consumers will have spent most of the savings they accumulated during the pandemic, while labour market conditions should worsen. Also, temporary catch-up effects in industrial production and fixed investment will fade and domestic spending will slow down due to the interest rate hikes by the Fed and ECB, which tighten financial conditions. Inflation rose to 8.1% in May and could rise further in coming months.	**ECB** – Following its June meeting the ECB announced the end of QE and signalled a first 25bp rate hike in July. It seems that a 50bp hike is on the cards for September. Subsequently, we expect a 25bp hike during every Governing Council meeting until February 2023, when the discount rate should reach 1.00% (up from -0.50% now). We have not pencilled in any rate hikes after that, which mainly reflects the fact that economic growth is expected to slow down considerably in 2023.
Netherlands – First quarter growth in 2022 was flat, primarily due to the lockdown and the end of pandemic support measures. For Q2 we expect positive growth driven by private consumption. The war in Ukraine and possible gas cut-off however is weighing strongly on the growth outlook. We expect Q2-Q3 growth to be modest, afterwards growth will slow down significantly. The labour market remains a bright spot with unemployment falling due to very strong labour demand with a record 133 vacancies per 100 persons unemployed.	**Fed** – Given persistently elevated inflation in the US, and upside risks to the outlook, we expect the Fed to hike rates a further 75bp in July. Thereafter, we expect two more 50bp hikes and two 25bp hikes taking the upper bound of the fed funds rate to 4% by February. Subsequently, we expect the Fed to pause, assuming inflation is moving back towards its 2% target. Risks are to the upside, both in the rate hike pace and in the terminal rate. The Fed begun unwinding its balance sheet in June, initially at a $47.5bn monthly pace, doubling to $95bn from September.
UK – Inflation held at over 9% in May following the rise in the household energy cap by Ofgem. At the same time, growth indicators remain broadly weak, as the inflation hit to real incomes weighs heavily on consumer confidence. We expect this to drive a contraction in the economy in Q2, before growth recovers (albeit modestly) in the second half of the year. In 2023 we expect the economy to stagnate, with a technical recession possible. The labour market remains strong for the time being, and inflation appears to be triggering higher wage growth.	**Bank of England** – The growing risk of a wage-price spiral in the UK triggered a hawkish pivot by the MPC at the June policy meeting. We expect now expect a 50bp hike in August, and Bank Rate to peak at 2.5% by year end. We think that by later this year, the economy should have sufficiently weakened to drive a rise in unemployment and a cooling in wage growth. Combined with a broader fall in inflation in the first half of next year, this could raise the prospect of the MPC reversing course and cutting rates to support growth, perhaps in H2 2023.
US – Growth appears to have slowed significantly in June according to the PMIs, but demand indicators overall have been very strong in Q2. Following a rebound in growth, we expect underlying demand to slow significantly in H2 and into 2023, as the decline in real incomes and interest rate rises begin to bite. Soft demand is likely to push the unemployment rate higher, although supply-side volatility means the economy might escape a technical recession. Risks to inflation continue to be to the upside, potentially requiring even bigger interest rate rises to bring back down.	**Bond yields** – Based on our updated Fed and ECB call, we expect another sell-off in both Treasury and German bonds in the coming months. We expect the 10y US Treasury yield to peak in Q3 this year at 3.9%. Similar path for the 10y Bund yield due to the US spill-over effects pushing Bund yields higher. However, we expect a significant drop in yields starting in Q4 where we expect markets to price out multiple rate hikes as economic growth is expected to slow down. Safe-haven demand expected to put further downward pressures on Bund yields next year.
China – May data show a recovery from the March/April lockdowns related slump.This rebound is led by the supply side, with ongoing strict Covid-19 policy leaving its mark on consumer confidence and consumption. We still expect momentum to pick up in 2H-22, assuming the gradual reopening to continue and targeted fiscal support, cautious monetary easing and a relaxation of macroprudential rules (including for real estate) to filter through. Still, given the recent data and our changed US/Fed and EZ/ECB views, we cut our 2022 growth forecast to 4.2% (from 4.7%).	**FX** – The deterioration in investor sentiment initially resulted in investors taking some profit on US dollar longs. However, they later bought dollars again when sentiment deteriorated even further. We think that the upside for the US dollar versus the euro is limited, barring sharp risk off periods or even more aggressive rate hikes by the Fed. Going forward, more Fed rate hikes will only be a US dollar positive so long as investors don't fear a sharp slowdown or a recession in the US. We expect more weakness on sterling due to the deterioration in the economic outlook.

Main economic/financial forecasts

GDP growth (% yoy)	2020	2021	2022e	2023e	Inflation (%)	2020	2021	2022e	2023e
United States	-3.4 ↓	5.7 ↓	2.5 ↓	1.3	United States	1.2	4.7 ↑	9.0 ↑	4.6
Eurozone	-6.5 ↓	5.3 ↑	2.9 ↓	1.3	Eurozone	0.2	2.6 ↑	7.4 ↑	3.7
Japan	-4.6 ↑	1.7 ↓	1.5 ↓	1.6	Japan	0.0	-0.2 ↑	2.0 ↑	1.0
United Kingdom	-9.3 ↑	7.4 ↓	3.6 ↓	0.3	United Kingdom	0.9	2.6 ↑	8.8 ↓	6.1
China	2.2	8.1 ↓	4.2 ↓	5.2	China	2.5	0.9	2.5	2.0
Netherlands	-3.9 ↓	4.9	3.0 ↓	1.3	Netherlands	1.1	2.8	8.5	4.3
Policy rate	**23/06/2022**	**+3M**	**2022e**	**2023e**	**10Y interest rate**	**23/06/2022**	**+3M**	**2022e**	**2023e**
Federal Reserve	1.75 ↑	3.00 ↑	3.75 ↑	3.00	US Treasury	3.07 ↑	3.90 ↑	3.70 ↑	2.80
European Central Bank	-0.50 ↑	0.25 ↑	0.75 ↑	1.00	German Bund	1.44 ↑	2.20 ↑	1.65 ↑	1.35
Bank of Japan	-0.10	-0.10	-0.10	-0.10	Japanese gov. bonds	0.23 ↑	0.25 ↑	0.25	0.30
Bank of England	1.25 ↑	2.00 ↑	2.50 ↑	2.00	UK gilts	2.32 ↑	3.60 ↑	3.05	2.00
People's Bank of China	3.70 ↑	3.65	3.60	3.60					
Natural resources	**23/06/2022**	**+3M**	**2022e**	**2023e**	**Currencies**	**23/06/2022**	**+3M**	**2022e**	**2023e**
Brent - Oil USD/barrel	111.7 ↓	110 ↓	120 ↑	120	EUR/USD	1.05	1.07 ↓	1.00 ↑	1.15
WTI - Oil USD/barrel	106.2 ↓	105 ↓	115 ↑	115	USD/JPY	134.9	127 ↑	130	120
Henry Hub - Gas USD/mn	6.86	7.0 ↑	5.5 ↑	5.5	GBP/USD	1.23	1.26 ↓	1.18	1.26
TTF - Gas EUR/MWh*	95.0 ↑	90 ↑	90 ↑	90	EUR/GBP	0.86 ↓	0.85 ↓	0.85 ↑	0.91
Gold - USD/oz	1,838	2,000	2,000	2,000	USD/CNY	6.70 ↓	6.50 ↑	6.80 ↓	6.50

Source: Refinitiv, Bloomberg, ABN AMRO Group Economics

* Brent, WTI, Henry Hub: active 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

Nora Neuteboom, Senior Economist | nora.neuteboom@nl.abnamro.com

FX & Rates Research

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

Jolien van den Ende, Senior Rates Strategist | jolien.van.den.ende@nl.abnamro.com

Sonia Renoult, Rates Strategist | Sonia.renoult@nl.abnamro.com