

## COP outs ahead of climate conference

The Russian and Chinese presidents won't be at the COP26 climate conference so will anything agreed in Glasgow make a difference? We'll see. In the meantime, watch out for four key things we've identified as crucial for success. We've also got 4 takeaways on how Covid's influenced our shopping. And, for sure, the Bundesbank will have a new president in 2022

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# Four key things to watch out for at COP26

The long-awaited climate meeting, COP26, will start in Glasgow in the UK on 31 October. It will be crucial for those world leaders attending to align...



As the world recovers from Covid-19, the carbon clock has not stopped ticking. Climate models warn that current climate mitigation efforts set us on track to exceed +2° of global warming [in less than 25 years](#), and in 7 years if the threshold is lowered to 1.5°C. It all translates to very high physical risk according to [the latest IPCC report](#).

[New York Climate Week emphasises the need for action](#)

## 1 Will governments align their emission reduction policies with carbon neutrality?

Under the 2015 Paris agreement, countries committed to a trajectory consistent with carbon neutrality by around 2050, which implies holding global temperature rises to “well below” 2°C above pre-industrial levels while “pursuing efforts” to stay within a 1.5°C reach by 2100. But the original commitments made on cutting emissions at Paris, called the Nationally Determined Contribution (NDCs), were inadequate to hold the world within the Paris temperature targets.

Therefore, the agreement contains a ratchet mechanism by which countries would have to submit updated NDCs every five years. It is precisely the measurement of this commitment, country by country, that will be at the heart of the COP26 summit, which will meet in Scotland from October 31 to 12 November. The meeting is long-awaited as has been postponed by a year due to the

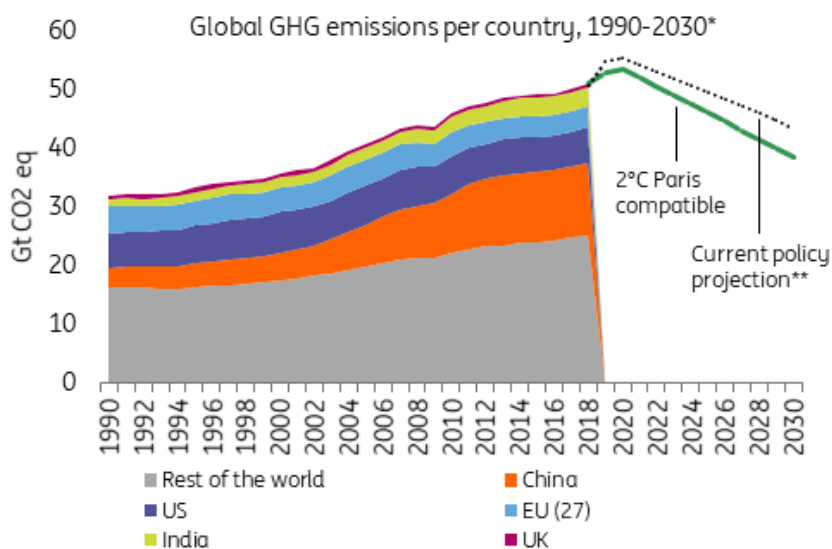
Covid-19 pandemic.

The current plans of the parties due to meet at the Glasgow conference put the planet on a 2.7°C of warming trajectory by the end of the century according to the [latest UNFCCC report](#), far from the Paris Agreement. According to the same report, if implemented, the updated NDCs (including those that have been newly submitted by the US, the EU, the UK and more than 100 others) are still inadequate. They would still result in a 16% increase in emissions by 2030 compared to 2010, whilst they would need to decline by about 45% during this period in order to keep a chance of not exceeding 1.5°C of warming.

[UK power price spike exposes the challenges of net zero electricity](#)

[The scenario-based approach for energy transition](#)

## Current carbon mitigation policies are not compatible with the 2°C Paris Agreement



*\*projections of emissions 2019-2030 from Climate Action Tracker, \*\*as of May 2021*

Source: Source: ING Research based on Climate Analytics and NewClimate Institute

So, the number one thing to watch for at COP26 is to what extent countries strengthen their carbon mitigation policies.

## 2 Will governments green their Covid-19 recovery plans at last?

Although global energy-related CO2 emissions fell [by a record of 5.8% in 2020](#) due to the various lockdowns in the US, the EU, China and India, they are expected to skyrocket again this year as the recovery is carbon-intensive, as was the recovery from the global financial crises in 2010. The IEA already expects emissions to rebound [by nearly 5% in 2021](#).

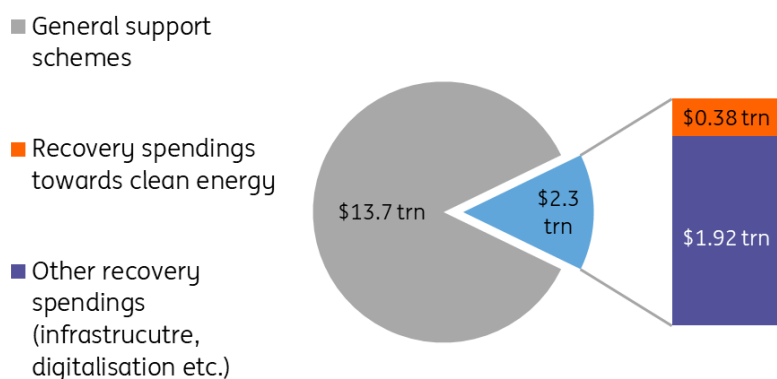
Covid-19 related discretionary fiscal spending for G20 members is of unprecedented scale. It currently amounts to around \$16 trillion (fiscal support schemes for households and companies and recovery plans altogether). But so far, the opening window to use recovery measures to accelerate a low carbon transition has [largely been missed for G20 countries](#), with spending predominantly neutral or negative on carbon emissions, despite the [EU Recovery and resilience plan](#) and Joe Biden’s plan to [“Build Back Better” and greener](#).

[Biden’s promise: Building back better and greener](#)

[The lacklustre take-up, so far, of Europe’s multi-billion rescue fund](#)

## Only a very small part of Covid-19 support is aimed at greening the economy

Global Covid-19 fiscal response, as of July 2021



Source: Source: ING Research based on IEA

A second point to watch for will be whether renewed carbon mitigation engagements are to be followed by a greening of global recovery plans.

### 3 Will China and India present credible commitments to phase out coal?

Despite efforts ahead of the COP26 to promote a global phasing out of coal power, an agreement still seems out of reach. Coal is still the world’s largest source of electricity generation ([35% of the global electricity mix](#)). It is the largest cause of greenhouse gases, responsible for [39% of CO2 emissions](#).

Therefore, seven countries (notably France, the UK, Germany and Chile) have already committed to phasing out coal and a few others (Denmark and Costa Rica) are even pushing for a diplomatic

initiative to get out of all fossil fuels (coal, oil and gas) altogether.

But the future of coal is in the hands of China and, to a lesser extent, India. China is not only the world's biggest emitter of GHG, greenhouse gasses, and it is the largest consumer of coal too. Almost 50% of China's CO2 emissions from fossil-fuel combustion are the result of power generation, of which virtually all are coal-fired power plants (i.e. 97%).

[Asia's race to net-zero: 12.4 trillion dollars and counting](#)

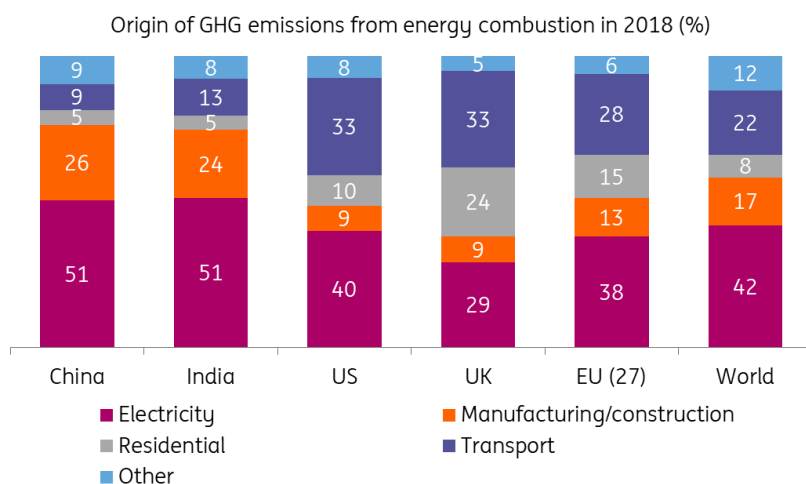
[Asia's race to net-zero: China](#)

[Now or never: Asia's sustainability challenge](#)

China has not yet submitted its updated NDC, but has announced a [target of carbon neutrality by 2060 and expects CO2 emissions to peak by 2030](#). President Xi Jinping's recently announced China would [stop funding new coal energy plants overseas](#) but the future of coal and carbon emissions is about domestic policies. On the domestic side, China's exploding energy demand is prompting Beijing to boost coal production in Inner Mongolia and imports from Australia, on the back of power shortages and surging energy prices.

[A recent study](#) from Global Energy Monitor pointed out that coal-fired power plants under development in China amounted to 247 GW, which is nearly six times Germany's entire coal-fired capacity (42.5 GW) that it wants to phase out by 2038. However, China is not the only question mark. Some of the major fossil fuel producers such as Saudi Arabia, Russia and Australia are also refusing to strengthen their NDCs ahead of COP26.

## Greening China and India's power sector makes a difference



Source: ING Research based on Climate Watch

So, a third decisive issue to watch for at COP26 is to what extent countries make credible claims to reduce the use of coal.

## 4 Will governments implement carbon markets and increase climate finance?

Raising these ambitions is largely dependent on climate finance. Developed countries promised to mobilise \$100bn a year by 2020 for the developing countries to help them cope with the effects of climate change. But that target has not yet been met, still falling short of \$20bn in 2019 [according to an OECD study](#).

Another key topic that will be under the spotlight at the COP26 is [article 6 of the Paris Agreement](#), which outlines ways that countries can achieve their mitigation goals in several ways, particularly through industry-wide emission trading schemes, such as the EU ETS carbon market and through voluntary carbon markets (VCM). If done right, both have the potential to [reduce the financial cost](#) to meet the Paris Agreement emission pledge whilst quickening the pace of the energy transition.

The carbon markets' mechanism is fairly simple. It relies on a “cap and trade” principle: each participant is attributed some “rights to emit” and participants with lower emissions can trade their excess credits to emitters that exceed their carbon budget. The overall cap guarantees that greenhouse gas emissions do not exceed the maximum level and the cap is lowered every year by a reduction factor.

Carbon markets sparked global attention in 2021 as carbon prices spiked within the EU carbon market. Furthermore, China officially launched its national carbon market, set to be the world biggest. Globally, carbon markets cover about 16% of global GHG emissions. But the path to implementing carbon markets is complex. In practice, carbon markets are yet to achieve their goal, as [less than 5% of global emissions](#) covered by carbon pricing initiatives are priced at a level consistent with achieving the goals of the Paris Agreement.

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### *The path to implementing carbon markets is complex*

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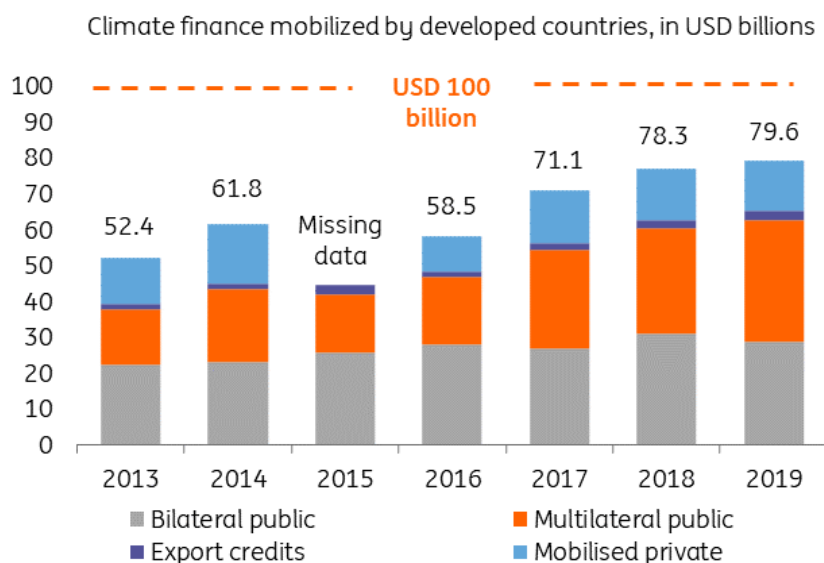
And the same goes on for Voluntary Carbon Markets (VCM): nice and shiny on the paper but thorny in practice. The idea with VCM is that they would allow countries to offset domestic emissions through emission reduction measures abroad. In this way, if it is cheaper for a country like France to cut a tonne of CO<sub>2</sub> in India rather than within its own territory the French government could finance a renewable energy project in India that would decrease emissions there, but that would count for the French emission reduction target. Such a mechanism would enable access to climate finance for poorer countries and cheaper cuts of emissions for richer countries.

All that requires transparency and the carbon accounting standards which come with it. Indeed, there could be a double-counting of emission reductions by both countries, which would give the impression that carbon emissions are falling faster than they actually are. Such offsetting projects need to comply with ESG (environment, social and corporate governance) guidelines too to enable additional benefits in terms of biodiversity protection, public-health improvements or job creation for local communities. Brazil, [for example](#), wants tree planting excluded, while the Democratic Republic of Congo would like to see it added. The issue with VCM is so complex that negotiations had already failed to achieve a full agreement at the COP24 in Katowice (Poland) and at the COP25



in Madrid (Spain).

## Climate finance for developing countries is still not enough



Source: Source: ING Research based on OECD

A fourth theme to watch out for at COP26 is to what extent negotiators make progress on implementing carbon markets and define practical guidelines for VCM.

So, there's clearly much to discuss and binding agreements are far from assured. Remember, too, that some of the leaders of the world's most polluting countries are unlikely to be there. Just this week, the Kremlin announced that President Vladimir Putin won't be attending in person, although he might show up via video link. Hopes are not high that China's President Xi will be there; Brazil's Jair Bolsonaro isn't flying out either.

COP26 has been described as the 'last best chance' of saving the planet. Weary campaigners and world leaders are well aware that we've heard that many times before. Let's hope we'll be surprised.

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# The 4 Covid-induced consumer shifts that changed our attitude to fresh produce

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Ireland rugby international James Ryan is an ambassador for the Aldi supermarket chain

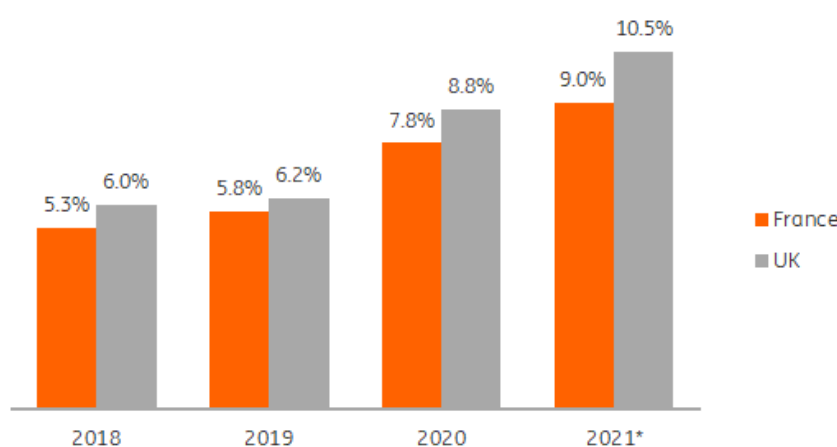
## 1 Shift from offline to online; fresh deliveries to your doorstep

Online grocery shopping has experienced an unprecedented inflow of new customers since March 2020, leading to growth at omnichannel retailers, grocery delivery services and meal-kit companies. According to NielsenIQ, one in three households in Western Europe shopped online for groceries in 2020. This compares to one in four in 2019. In terms of online market share, the UK and France stand out.

But online sales are growing rapidly elsewhere as well. In Italy for example, they grew by more than 40%, and in the Netherlands they grew by more than 50% during the first half of 2021. Fresh produce is generally one of the largest categories for online grocers, indicating that online shoppers don't seem to be that bothered that they can't pick their own produce.

## Online groceries have continued to gain market share

Share of online groceries as part of total grocery sales in France and the UK



Source: Source: NielsenIQ, IGD, \*France based on January to May, UK forecast for full year

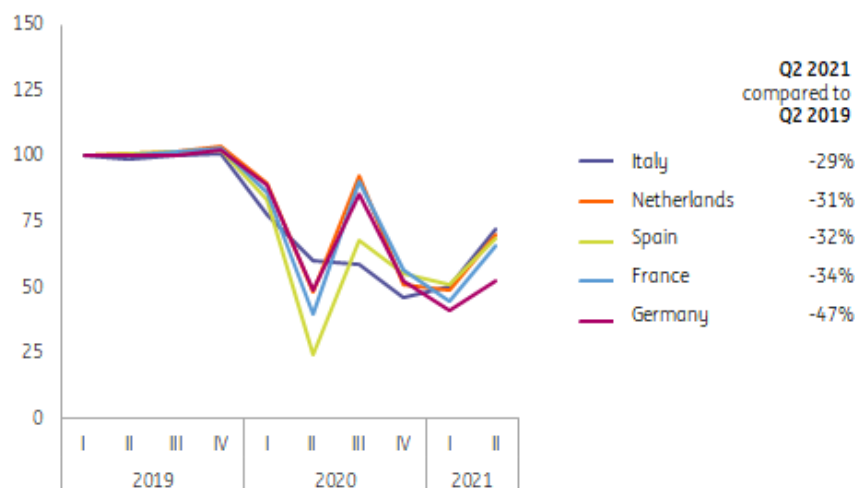
## 2 Shift between out-of-home and at-home; balance hasn't been restored

Given the lockdowns, 2020 was obviously a bumper year for at-home consumption. And even though most restaurants have reopened, it's interesting that the pre-Covid balance between out-of-home and at-home spending on food, hasn't fully recovered.

In the five largest eurozone economies, turnover in out-of-home consumption, was still down by 30% to 50% in the second quarter of 2021 compared with the same quarter two years earlier. At the same time, retail food sales in the eurozone are still higher in 2021 and deflated turnover, that's turnover adjusted for inflation, was almost 6% higher in the year to July compared with the same period in 2019. Retail sales of fruit and vegetables have been on the rise as well. In the UK, fruit sales increased by 2.1% and sales of vegetables by 6.5% in volume terms, according to Nielsen. Meanwhile, GfK data for the Netherlands, show that fruit volumes sold in the first half of 2021 grew by 2.8% and vegetables by 4.4%.

## Turnover in out-of-home eating and drinking was still much lower in the first half of 2021

Index of turnover in food and beverage service activities (1Q 2019 = 100), seasonally and calendar-adjusted data



Source: Source: Eurostat

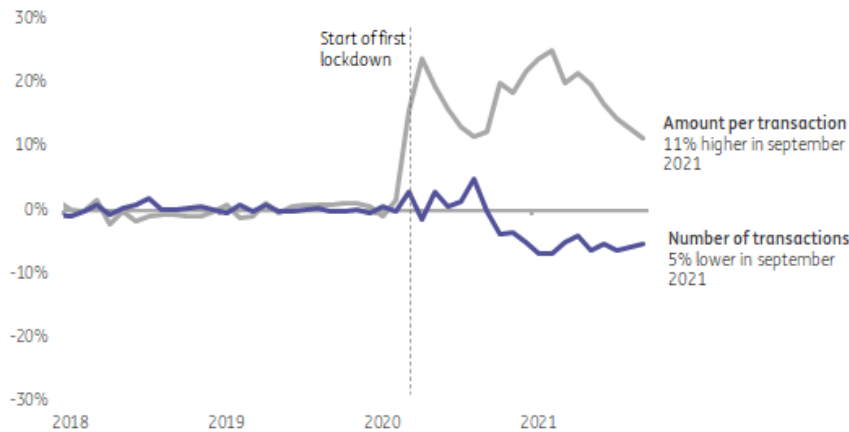
### 3 Shift to larger shopping trips leads to changes in the shopping basket

One-stop shopping is more popular since the start of the Covid-pandemic and people are still spending more per trip and making fewer trips to grocery stores. According to ING data, the total volume of debit card transactions in food retail in the Netherlands was down by 5% in September 2021, while value per transaction was up by 11% compared to pre-Covid levels. Although people visited stores less frequently, demand for typical 'impulse' fruit products (like berries) posted volume growth in many countries.

Outperforming the general upward sales trend were meal kits (due to more 'cooking from scratch') and products with a longer shelf life, such as carrots. Salad bowls and dry leaf salads underperformed. The initial stock up in March 2020 also led to a wave of interest in frozen vegetables and these are still experiencing higher demand compared with pre-Covid times.

## Debit card transactions in food retail show Dutch consumers go less frequently but spend more per trip

Difference between actual and pre-corona trend levels, based on monthly and seasonally-adjusted data



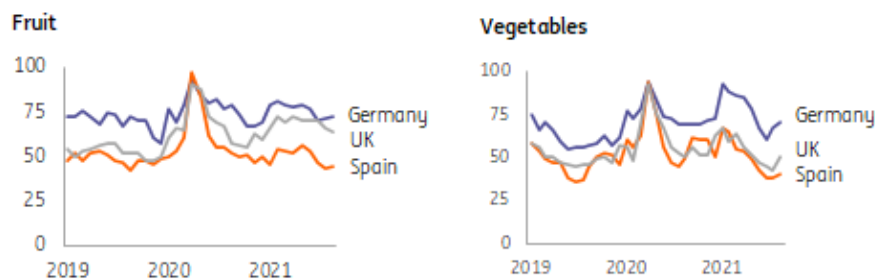
Source: Source: ING Research, based on ING data

### 4 Shift to healthier diets; so far, the balance looks positive

Covid sparked interest in both healthier diets and the immune system and Google searches for 'fruit' and 'vegetables' peaked during the first wave and vitamin C-rich products like citrus fruits were in high demand in that period. General search activity in many countries is currently well below the peak, but still somewhat higher compared to pre-Covid levels. Meanwhile, studies such as the influential ZOE Covid study in the UK, indicate that most households reported some change in their intake of fruit and veg. While some households reported positive and other households negative changes, on balance, there was an increase in the daily consumption of fruit and vegetable portions.

### Interest in fruit and vegetables peaked at the start of the Covid-pandemic

Search activity on Google on a scale of 0 (no interest) to 100 (maximum interest) in several countries, based on four-week periods



Source: Source: Google, ING Research

We expect that some shifts in consumer behaviour are here to stay, while others will gradually

reverse, as consumer behaviour evolves to a new normal.

## ✔ Offline to online shift is expected to be very sticky

The growth of online grocery sales is slowing down after a year-long rally. In June 2021, total online grocery sales in the UK even fell for the first time on a year-on-year basis. In our view, this fall can also be linked to food retail losing some revenue to out-of-home channels. Nevertheless, online grocery spending remains elevated compared to pre-Covid levels and a decline of the online market share within total grocery sales seems unlikely.

On the demand side, more consumers have become used to ordering online and there are more options that cater for their specific needs. The rise in online sales of non-food products also shows that once people have changed their habits, they tend to stick to them. The supply side continues to be very dynamic, thanks to investment by both multichannel retailers and pure players. Examples include recent funding rounds for rapid delivery companies and the 600 million EUR funding for the Dutch-based company, Picnic.

## ✔ At-home consumption will retain some market share

The balance between at-home and out-of-home spending on food is gradually returning. But out-of-home still has a lot of lost ground to make up over the coming years. For many people, working or studying from home is here to stay, at least to some extent. And business travel also isn't expected to recover completely. Both trends lead to fewer out-of-home consumption occasions. However, earlier [we pointed out that there will be regional differences](#) because the share of the population that can and will work from home is generally higher in Northern and Western Europe than it is in Southern and Eastern Europe.

## ✔ Necessity for larger shopping trips fades

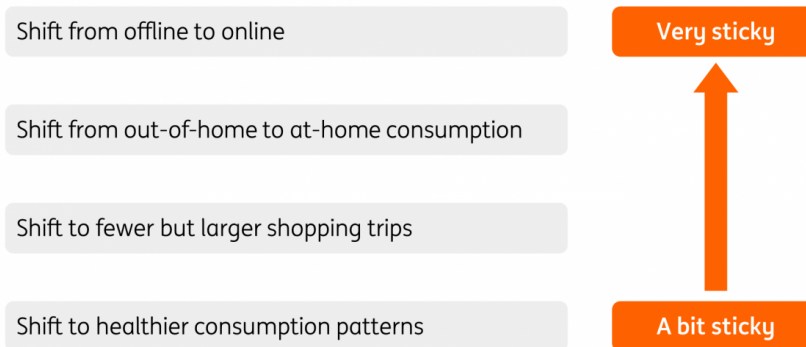
The impact of restrictions and curfews on the size of the average shopping basket has largely disappeared. What's left are requirements to wear a face mask in indoor places in some countries and the possibility of the re-introduction of some restrictions. Because the surge in larger shopping trips was primarily born out of necessity, it is less likely to stick post-Covid. At the same time smaller shopping trips to (convenience) food retailers may remain under pressure due to reduced work and tourism-related footfall.

## ✔ Healthier diets; will policymakers step up efforts to retain progress made?

The fact that Covid is still around at the start of the flu season could be beneficial for fruit and vegetables as a healthy diet can add an additional 'line of defense' to the immune system. But compared to 2020, many people can now also rely on vaccines to protect them. The big question is whether people will keep adhering to the recommended daily fruit and vegetable intake once Covid-fears fade. That remains to be seen, especially because our day-to-day food environment hasn't changed much. In the long run, much will depend on whether policymakers use the current momentum to implement measures aimed at nudging people towards a healthier lifestyle.

## Shifts in consumer behaviour have a different level of 'stickiness' in a post-Covid situation

Four shifts and their likeliness to persist



Source: Source: ING Research

Fresh produce companies are gearing up for the next phase. Consumer habits have changed as a result of the pandemic and people's behaviour will continue to evolve although the pace of change is likely to slow. Following the four shifts we've already mentioned, there are also four areas of strategic interest we've identified for fruit and vegetable companies.

### 1 E-commerce creates new opportunities

Fresh produce companies realise much of their online growth by growing together with the multichannel retailers they were already supplying. At the same time, online players such as Hello Fresh, Ocado, Picnic and Rohlik have become a 'new' sales segment, especially for fresh produce suppliers with a wide assortment. More e-commerce means the market for fruit and vegetables moves towards an even more just-in-time situation as online retailers often place their final orders when goods are already sold. While online sales are still relatively small, the segment provides opportunities for innovation including the possibility of selling more exclusive products because of the lower risk on waste.

### 2 Companies reconsider exposure to at-home and out-of-home

The uplift in volume sales in retail during the last year and a half has mostly been positive for the larger players in the fresh produce industry because they are generally focused on supplying the retail channel. Many suppliers have been seeking closer cooperation with retailers and that cooperation was much needed during the first wave to keep shelves stocked. The shift towards at-home was negative for many dedicated foodservice suppliers. It seems likely that fresh produce companies will increasingly direct their investment towards the retail channel while capacity geared towards supplying segments like catering will face pressure.

### 3 Fresh produce plays a central role in competition between retailers

Consumers who opted for larger shopping trips tended to favour certain supermarkets. During

2020, growth at full-service retailers outpaced that at discounters in Germany and the Netherlands. Elsewhere, like in Spain, (regional) retailers with stores in closer proximity to consumers did better than hypermarkets. Some retailers will focus on turning these tides and regaining lost market share. In doing so they are likely to pay more attention to their promotional activity in fresh produce to attract consumers.

## 4 Grab the opportunity to make healthier diets stick for longer

In terms of marketing, fresh produce companies have been able to ride an unprecedented wave of free publicity, but this will fade. However, the impact of the pandemic, in health and financial terms, provides the fruit and vegetables sector with a strong argument to emphasise the importance of a healthy diet to policymakers. We consider the backing of food policy a key element to making the shift to healthier diets stick for longer.

Apart from the highlighted developments on the demand side, prices and consumption of fruit and vegetables are also, of course, influenced by the seasonal availability of produce. Poor harvests due to adverse weather, and supply chain disruption, such as rising transport costs and labour shortages, also have a big impact on availability and final consumption. That was already the case before Covid but it became even more apparent during the first wave of the pandemic. Now we are on the road to recovery, those important factors are starting to play a larger role and they'll continue to impact the sustainability and durability of these noticeable consumer shifts.

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## Watch: The eurozone's economic headwinds are strengthening

Supply chain problems and surging energy prices are hitting growth and raising inflation in the eurozone, complicating the work of policymakers at the...



## headwinds for the eurozone



### **Watch: Eurozone facing headwinds**

The eurozone economy performed well in the second and third quarters, but growth has likely peaked and new challenges are emerging for the ECB. ING's Peter Vanden Houe, Chief Economist, Belgium and Luxembourg, takes a look.

[Watch video](#)

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## Bundesbank president Jens Weidmann to step down at year end

Bundesbank president Jens Weidmann has announced he'll be stepping down from the German Bundesbank by the end of the year. Getting the ECB to start...



Bundesbank president Jens Weidmann

The German Bundesbank announced on Wednesday that President Jens Weidmann will step down by the end of the year. Weidmann had asked German Federal President Frank-Walter Steinmeier to dismiss him from office on 31 December 2021. According to the Bundesbank's press statement, Weidmann will leave "for personal reasons". We assume and hope that there are no health or private issues at the basis of this decision but really "only" personal reasons.

Jens Weidmann continues what has almost become a tradition of German central bankers leaving office before the official end of their term. Just think of his two predecessors Axel Weber and Ernst Welteke, or ECB Executive Board members Jürgen Stark, Jörg Asmussen and Sabine Lautenschläger. Admittedly, the reasons for all of their early exits differed and only Weber and Stark left after public dissonance with the ECB's monetary policy stance.

The next hours and days might reveal whether there are any reasons related to the ECB's current monetary policy stance and inflation assessment involved in Weidmann's decision. At the same

time, ten years in office as Bundesbank president is not short. However, the press statement also says that “not to look one-sidedly at deflationary risks, but not to lose sight of prospective inflationary dangers either”. Monetary policy should respect “its narrow mandate and does not get caught in the wake of fiscal policy or the financial markets”. If anyone wants to see any symbolism in Weidmann’s decision against the current monetary policy, this would be a clear hint.

This comes at a crucial time for the ECB. The camp of the hawks is losing an important voice. At a time that increasing inflationary pressure seems to have fueled a more balanced inflation assessment than in the summer. Even if board member Philip Lane yesterday reiterated that the ECB’s forward guidance currently did not really justify financial markets’ speculation about future rate hikes, higher inflation (prospects), herd immunity and an economy returning to pre-crisis levels before the end of the year are creating a strong argument to withdraw the ECB’s emergency stimulus and start reducing asset purchases. Maybe the decision to do the latter will be Weidmann’s last success as Bundesbank president at the ECB’s December meeting.

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# Timing the Bank of England re-pricing

Markets are getting ahead of themselves on Bank of England tightening, and we expect some subtle warnings from the November policy meeting. That may not...



The Bank of England

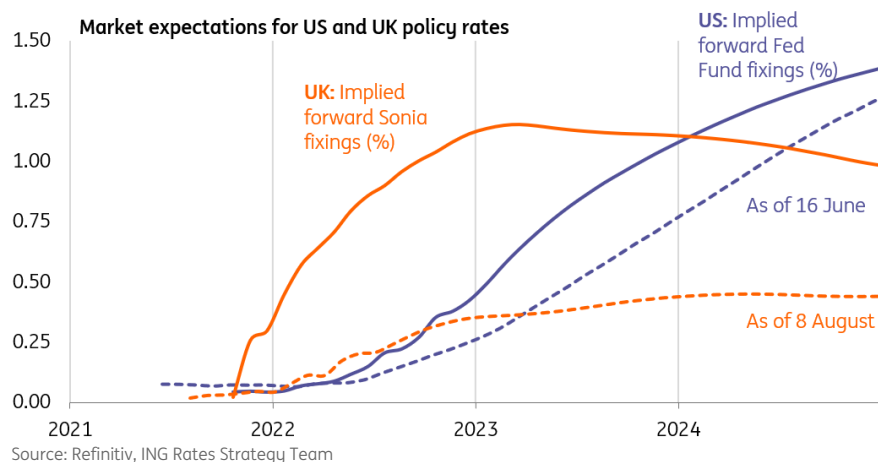
## Markets are banking on a rapid tightening cycle from the Bank of England

If financial markets are right, UK interest rates will have hit 1% by next summer. That would take the Bank rate to the highest level since before the global financial crisis. And that's on top of the Bank of England's planned move to shrink its balance sheet when rates hit 0.5%.

Economists are fairly united now that these market expectations are overdone. Unusually this pricing implies that the BoE will need to do more than the Fed to tackle rising inflation – something we think isn't justified. [Our own view](#) is that, beyond an initial rate hike in November, the subsequent tightening process is likely to be much more gradual than investors are currently pricing.

But picking out the catalyst for a rethink in financial markets is less straightforward. It may take some time for a correction to materialise.

## Investors are pricing in a lot more from the Bank of England than the Fed



Certainly, it seems that there's little appetite among Bank of England officials to lean against current market pricing. If anything they have doubled down on concerns about inflation risks. Governor Andrew Bailey said last weekend that policymakers will 'have to act'.

True, we have had some moderate pushback from some of the more dovish committee members. Silvana Tenreyro, who is perhaps the most dovish voter, said a rate hike would be 'self-defeating'. But policymakers have also hinted that the steeper yield curve is doing the Bank's job for it, in effect providing it with the inflation hedge it's looking for. That was essentially the argument put forward by newly-appointed MPC member Catherine Mann a few days ago.

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*If policymakers project less inflation, it's an implicit hint market pricing's gone too far*

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We'd also note that if the Governor votes for a hike, then much of the 'core' of the committee will likely follow. We wouldn't be surprised therefore to see six or seven MPC members (out of nine) vote for the rise this November.

Still, this should still be a warning sign for markets. The first rate hike is likely to be smaller than usual – a 15bp move compared to the more usual 25bp. And if that can't command a unanimous vote, then it's tricky to see further steps in a rapid tightening cycle gathering sufficient support.

There may be further hints of pushback contained within the new set of November forecasts. Remember the Bank of England plugs the latest market yield curve directly into its models. In the last set of projections from August, the Bank reckoned inflation would be on target in the medium-term, based on the 40bp worth of tightening by 2024 that was priced by markets at the time.

The latest, steeper yield curve would imply a downgrade to that inflation forecast, barring any offsetting, optimistic changes in assumptions elsewhere. We could see a bit of that – we may for instance witness upgrades to wage growth linked to the recent shortages in the labour market. But

we still wouldn't be surprised if policymakers project inflation to be a little below target in a couple of years' time – an implicit hint that market pricing has gone too far.

## GBP Rates: Cooler heads should prevail

Time will tell whether any of this will prompt a rethink in financial markets. Much has been said of the yield curve re-pricing of BoE rate hikes in October but comments often overstate the market's confidence in that tightening path.

Granted, there has been only limited retracement so far when it comes to hikes priced within the next 12 months, towards something we think is a more realistic trajectory for the Bank Rate, but one only needs to look at longer rates to show what the market thinks of this. For a start, the same curve implies rate cuts in the subsequent years, adding up to roughly 25bp between 2023 and 2025. If there was any degree of conviction that the 2021-22 hikes are sustainable, this isn't how the curve would look

**1%** Market expectations for Bank rate next summer

In longer maturities, the near-inversion of various segments, most prominently GBP 10s30s, is a sure sign that markets do not assign a high probability to 1% being reached in the Bank Rates. Policymakers have said that it could actively sell gilts to private investors after that point, and longer rates aren't consistent with that. In fact, we don't even think they reflect the possibility of balance sheet reduction after February 2020, when the Bank Rate should reach 0.5% according to market pricing.

The path for GBP rates most consistent with our macro view is a re-steepening of the curve due to lower rate hike discount at the front-end, but also reflecting more accurately the shortfall in gilt demand stemming from the BoE balance sheet reduction.

## GBP FX: Scope for a temporary set-back?

On a broad, trade-weighted basis GBP is now at the highest levels seen since the Brexit vote in June 2016. Driving this has undoubtedly been the story that the BoE falls into the camp of central banks prepared to react to the inflation shock.

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*We doubt this will turn the near term bullish trend for GBP*

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A re-pricing of the BoE cycle on the back of a very split vote to hike on 4th November or on some form of rate protest in the BoE's three year CPI profile (2024 forecast below 2%) could trigger a knee-jerk sell-off in the pound. The day risk volatility priced in the FX options market suggests that sell-off could drive EUR/GBP some 40 pips higher on the day.



Yet we doubt this will turn the near term bullish trend for GBP. The fact that the BoE has set its tightening stall out (like fellow G10 central bankers in Norway and New Zealand) suggests it is very hard to play the top in UK rates and the pound. Energy prices look set to stay supported this winter amidst low inventories and the lagged effect of the energy price rise look likely to keep inflation pushing higher over the next 5 -6 months.

Typically currencies perform well at the start of tightening cycles. Unless the BoE can convince markets of some kind of 'one and done' or 'two and done' when it comes to tightening, we think GBP finds support on any BoE-day disappointment.

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Opinion | 18 October 2021

## When and how to make the switch from USD Libor

ISDA has provided fixed spreads to be added to SOFR. So, use them? Probably, but alternative bank rates add a complexity, risking a perception of value...



### The simplest approach to conversion is to adapt the fixed spreads of the ISDA protocol

Holders of most USD Libor-linked product technically have until June 2023 to take action on transitioning to something other than USD Libor. This can be achieved by inserting language into documentation that takes the product from referencing USD Libor to referencing something else. In the vast majority of cases, that something else is the Secured Overnight Financing Rate (SOFR). For derivatives it is typically SOFR in arrears; that's where the liquidity is expected to be from 2022 onwards. For loans, the solution is often to transition legacy product to term SOFR.

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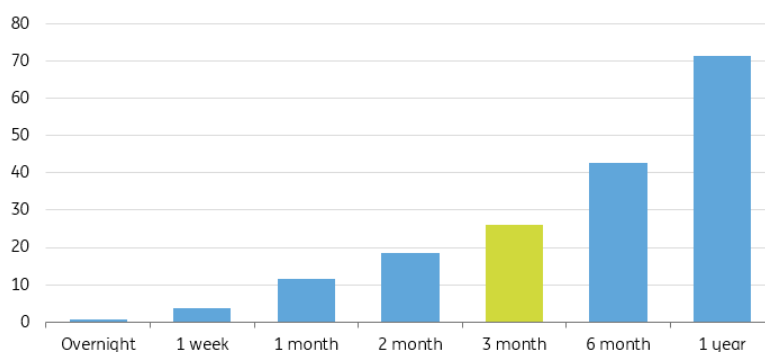
*For players that have signed up to the ISDA protocol, there is a good rationale to transition underlying loans under the same terms*

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For players that have signed up to the ISDA protocol, there is a good rationale to transition underlying loans under the same terms. As derivatives transition at end-2023 on fixed spreads that have already been determined (see below), using the same fixed spreads on the loans would maintain a perfect hedge. Such a solution can be inserted into loan documentation and is perhaps the most seamless solution for both derivatives and loans. This also applies to any derivatives written since 25 January 2021, which came under the ISDA protocol on initiation, and so the transition of loans underlying such swaps could be dealt with in the same way.

## ISDA 5yr Median Spreads for USD Libor vs SOFR (bp)

Set as at 5th March 2021



Source: ARRC

### ? What happens if the market spreads don't converge on the fixed ISDA ones?

A key question is whether there are advantages of doing an early transition. To better grasp the answer, we start by making the assertion that the spot basis that we see today between SOFR and Libor should converge on the ISDA fixed spreads as of end-June 2023. Theoretically, this should be the case, as the ISDA spreads are a fixed point in the future that should be hit. A large rump of the market for derivatives will transition at these fixed spreads at end-June 2023, so the theory is that the wider market should also converge on the same spreads, effectively as realised market forwards. Provided that happens, there should be no value transfer between borrower and lender, at the moment of transition.

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*There is the nagging risk market SOFR to Libor spreads in fact don't converge on the fixed ISDA spreads*

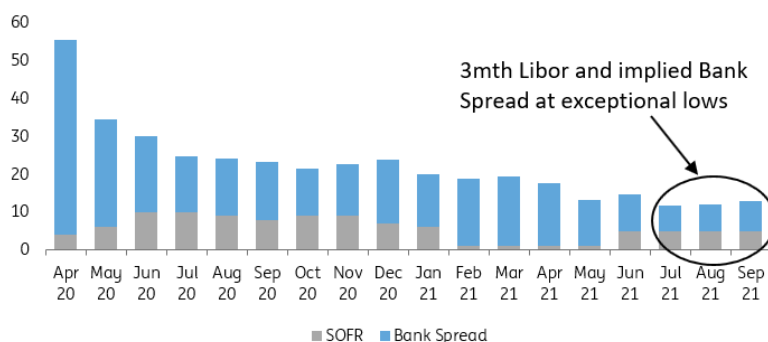
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But then again there is the nagging feeling that perhaps market SOFR to Libor spreads in fact don't converge on the fixed ISDA spreads. The deviation is quite large at the moment, where SOFR is 5bp and Libor is at 13bp, so the market spread is 8bp. This compares with 26bp on the transition from 3mth Libor to SOFR at mid-2023. Based on the current level of SOFR, this pitches implied synthetic Libor at 31.2bp (SOFR plus the spread). That is quite a difference versus today's 3mth Libor rate at 12.5bp, almost a 20bp deviation in absolute terms. The bulk of that 20bp differential should

dissipate between now and mid-2023, but this is where the existence of the likes of Bloomberg Short-Term Bank Yield Index (BSBY) or Ameribor, etc potentially muddies the waters.

## Libor split between SOFR and Bank Spread (bp)

Libor less SOFR gives the Bank Spread



Source: ING estimates, Macrobond

## The presence of other bank rates make a perfect convergence on the ISDA spreads more difficult

Simplistically, BSBY is calculated based on where banks fund themselves. It trades a few basis points through USD Libor, and that deviation has been reasonably stable over time. With BSBY a few bps below USD Libor and Ameribor a few bps above, they will always provide a reasonable guide as to where USD Libor would be, even when USD Libor is long gone. Now roll on to mid-2023. If at that time banks are funding themselves at levels that are commensurate with a 26bp bank spread, then we are all good. But, if banks are funding themselves either above or below this spread, then there is an implied value transfer risk, at the moment of transition from Libor to SOFR.

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*Implied value transfer risk at the moment of transition from Libor to SOFR remains*

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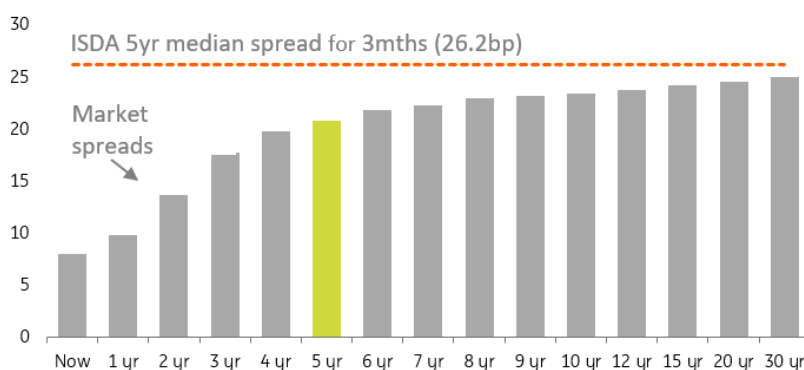
For example, if banks found themselves funding at levels close to today, then application of the fixed ISDA fallbacks would imply that borrowers transition at a credit spread adjustment that is too high. It could also work in the opposite direction, where a spike in bank credit funding costs could mean that borrowers optically transition at a spread that is too low. Now, this does not matter much if we are talking about a loan plus derivative combination, as they offset each other, and while the spread matters, there is no value transfer then (at the moment of transition). But for a stand-alone loan or swap, the spread employed at transition matters more.

## Market spreads are available as alternatives, effectively as breakevens

In the end, we may be just talking about just a few basis points and it may not matter much. Also, it is less of an issue for longer-dated product. The reason for that comes down to where the market discount pitches the spread between SOFR and Libor into the future. This varies by the maturity of the underlying (see below), with the tightest spreads for shorter maturities (bullied by tight spot spreads). Longer maturities see a convergence towards the fixed ISDA spreads, which makes a degree of sense as the fixed ISDA spreads are based off a 5-year median calculation, done this way to get at the essence of a fair long-term valuation.

### Spreads from SOFR to Libor (bp)

The basis market discount vs ISDA fixed spread



Source: ING estimates, Macrobond

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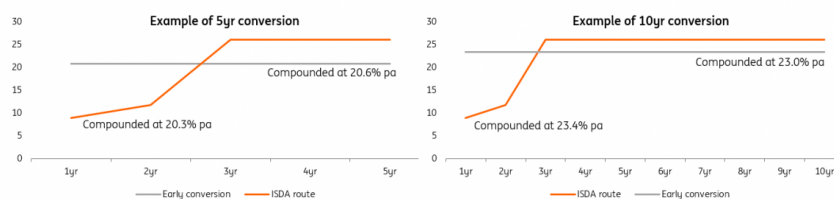
*We can confirm that SOFR to Libor spreads by tenor indeed act as break-evens to the fixed ISDA spreads*

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These market spreads assume that current tight SOFR to Libor spreads converge on the ISDA fixed spreads by mid-2023. The market spreads are effectively breakevens, so the SOFR to Libor spread for, say, a 5yr product is set at a spread that breaks even against an alternative route where the borrower continues to pay Libor at market levels and then pays SOFR plus the fixed ISDA spread from end-June 2023 onwards. We've done the calculations (see below), and can confirm that SOFR to Libor spreads by tenor indeed act as break-evens (or within a half of a basis point of it). If that is the case, there should be broad indifference between transitioning early at the lower market spread versus transitioning at end-June 2023 at the fixed ISDA spread.

## Early conversion versus mid-2023 ISDA conversion

Examples for 5yr and 10yr tenors



Source: ING estimates

### ? The big question is whether there is any arbitrage to go for here? Well, it depends.

So is there an arbitrage at all? An arbitrage can be found to the extent that the forwards are deviated from. It could be argued there has been a structural change where bank funding costs remain structurally tight versus the risk-free rate, helped by central clearing that reduces system risk, banks that are better capitalized than ever, and e.g. a persistent excess of demand over supply for bank commercial paper. If so, locking in at the fixed bank adjustment spreads available today results in higher borrowing costs, relative to latching on today's lower bank spreads.

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*There is a potential arbitrage for players that are willing to choose a variable bank spread*

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So, there is a potential arbitrage for players that are willing to choose a variable bank spread e.g. as provided by the likes of AXI, etc, and using that. The switch would be from Libor to SOFR plus a variable bank credit spread adjustment. And here, there could be value for borrowers to choose to transition early. In this way, the product is safely transitioned to SOFR plus this low but variable spread. And by the way, if it were term SOFR it would feel just like the Libor rate being paid today. One important caveat is that term SOFR and AXI or IHS spread product are in their infancy, and the latter, in particular, is not in a fully tradeable state. In consequence, this is something to be considered in the coming few months, rather than here and now.

**So, choose from these three:**

### 1 ISDA spreads

The baseline stance is to enjoy the low Libor rates being quoted now, and transition at the fixed ISDA spread to SOFR by end-June 2023. That is a defensible strategy, provided the caveats noted above are taken on board. It is certainly the more uncontroversial approach, and one that links nicely with the ISDA protocol, and is in any case the approach to be taken for derivatives written since 25 January. It is also a nice fit for portfolios of loans overlaid by derivatives, where derivatives can sign up to the ISDA protocol and loans can employ the same treatment (which is typical where loan language has been hardwired).

## 2 Market spreads

Alternatively, do the switch to SOFR sooner at fixed spreads in the market. The advantage of doing an earlier switch to a lower fixed spread (e.g. 20bp for a 5yr product) is not so much for full tenor savings in funding costs, as these spreads breakeven against a convergence on 26bp by end-June 2023. Advantage comes more from cleaning up the issue early, say at the same time as transition in other product, a lot of which gets done by end-December 2021. An additional argument is early transition avoids Libor spike risk between now and mid-2023; no reason to expect a Libor spike per se, but the early fixed transition avoids the risk completely.

## 3 Variable spreads (coming soon)

Or, latch on to low bank spread that will become increasingly available. This approach takes on more risk, but at the same time can result in structurally lower funding costs should banks continue to print at tight spreads over the risk free rate. In a similar vein, a link to BSBY or ICE, etc (rather than SOFR) could be considered as an all-in solution. Should banks be in a position to fund themselves at or around current funding levels, then by definition the likes of BSBY would trade well through a synthetic Libor constructed from term SOFR plus the fixed ISDA spread.

The counter-argument is that bank spreads could overshoot, and the borrower ends up with more expensive funding, and subject to funding spikes during times of stress. This is where the official sector has issues, and may well be where borrowers do too; choices to be made. We like latching on to super-low variable bank spreads, but fully understand the simplicity of hitching to the ISDA fixed spreads.

Finally, other relevant pieces on choices between SOFR and alternative bank rates can be found [here](#). And in addition, a piece on the choice between SOFR in arrears versus term SOFR can be found [here](#).

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# Global labour shortages: Just how bad can it get?

The lack of skilled workers is not only just another symptom of post-lockdown economics but also the result of more fundamental developments in the US,...



Shortages of all kinds have dominated economic headlines this year. After supply chain frictions, the end of lockdowns across the developed world has led to labour shortages in the US, the UK and the eurozone. We're going to look at the cyclical and more fundamental drivers of those shortages and examine the similarities and differences across the globe.

**194,000** US jobs added  
September  
*Worse than expected*

## US - A productivity boom that comes at a cost

The US economy has fully regained all of the lost economic output brought about by the pandemic yet employment remains 5 million below February 2020's level, which should, on the face of it,

come at a major social cost. Yet, this isn't due to a lack of worker demand. There are more than ten million job vacancies right now spread across all sectors with a record proportion of companies raising pay to try to attract staff. Instead, it is a problem with the supply of workers, which is both holding back output and increasing inflation pressures in the economy.

The conventional narrative is that we shouldn't be too concerned because workers are set to flood back now that schools have returned to in-person tuition thereby giving parents greater flexibility to find a job. At the same time Covid vaccinations are making the workplace safer and extended and uprated unemployment benefits, which may have diminished the financial attractiveness of work, have now ended.

### ***Where are the workers?***

The problem is that in the US September jobs report the labour force participation rate actually fell, while employment, as a proportion of people of working age, is on a par only with the levels we saw in the depths of the Global Financial Crisis.

Admittedly it is early days – the September jobs numbers are calculated the week of the 12th so the October report may be a better time to make an assessment – but remember that half of all states ended the Federal unemployment benefits in July. For no improvement in worker participation by September is a concern.

### ***Back for the holidays?***

One possible explanation for this is that households have built up savings buffers and don't have any urgency to return to work – cash, checking and time savings deposits have increased by \$3.5tn since the end of 2019. We are coming up to the holiday season which will add to household expenses and that could incentivise more people to seek work, but we won't know for sure for at least another couple of months.

### ***But it could be more structural***

We believe there is a more permanent loss of workers driven by a large number of older workers taking early retirement. The thought of returning to the office and the daily commute may seem unpalatable for many people and with surging equity markets having boosted 401k pension plans, early retirement may seem a very attractive option. On top of this, border closures will have hurt immigration and slower birth rates mean fewer young workers are now entering the workplace.

If correct, labour market shortages could persist for a good deal longer than the Federal Reserve expects, which will mean companies increasingly bidding up pay to attract staff. Not only that, but elevated quit rates suggest that companies may also have to raise pay to retain the staff they currently have given the high costs of worker turnover on moral, training and customer satisfaction. This points to more inflation pressures for the Fed to respond to with interest rates rising sooner and faster than currently priced by financial markets.

## Proportion of US workers quitting their job to move to a new employer each month (%)



Source: Macrobond, ING

# 7.5%

## Eurozone unemployment rate

Close to all-time lows

### Eurozone - a transitory problem with a permanent edge

The eurozone labour market has seen furlough schemes used in the pandemic at an unprecedented scale. This has made the labour market impact from the GDP shock seen in 2020 and 2021 as measured by the increase in unemployment unusually subdued. At 7.5%, the unemployment rate is now just 0.4 ppts away from its all-time low, reached in March last year. While concerns about labour shortages have started later than in the US and are less pressing than in the UK, they are increasingly mentioned as a concern for businesses. More than ever, businesses in industry report labour as a factor limiting production, in services this number is still below historical highs.

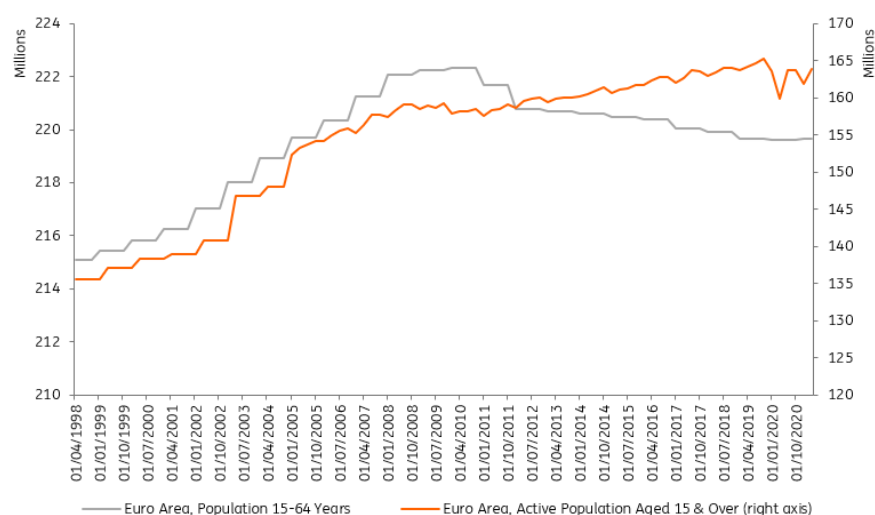
#### *Transitory or more fundamental?*

Some of the burden faced by businesses now is transitory, but the jury is still out on exactly how much of the problem will fade over the course of 2022. Arguments in favour of the transitional nature are continued slack in the labour market, ie untapped sources from the labour force, and still a sizeable number of employees in furlough schemes. On the other hand, many eurozone economies already experienced a lack of skilled workers pre-pandemic on the back of ageing and qualification mismatches. The current situation could simply be a return to the trends seen pre-pandemic once temporary mismatches fade.

An argument against a potential overheating of the eurozone labour market is the fact that the number of hours worked is still about 4% below pre-crisis levels, while employment is only 1.3%

below. This productivity loss will have to be made up in the aftermath of the crisis, dampening further employment prospects. However, even if there are clear reasons to believe that the labour market has still sufficient untapped resources to avoid current tensions to quickly become permanent, some sectors of the labour market do see mismatches due to occupation changes or changes in economic activity.

## Demographics are adding to structural labour shortage concerns in the eurozone



Source: Eurostat, ING Research

### *Ageing will put more pressure on the labour market*

In the longer run, however, demographics argue in favour of more structural pressure on the labour market. The working-age population has been shrinking since 2010 and the active population has only been able to grow due to measures taken for people to work longer (think of increased retirement ages and disincentivizing early retirement schemes). In the coming years, we do expect the labour force to start to decline more structurally.

### *Higher wages in 2022 but not necessarily in all sectors*

The rapid recovery of the labour market, the lack of skilled workers in certain sectors and the recent surge in inflation will in our view lead to higher wage growth in 2022. Mind you, the most recent data shows very low wage growth for 2020 and 2021, far below pre-crisis growth rates. However, this does not come as a surprise given the uncertainty, the economic slump and the increase in unemployment during the first lockdowns. Given the large sectoral differences, it could very well be that wage developments will also differ significantly across sectors and countries, making it harder to predict how overall eurozone wages will evolve. However, one way to fix the increasing mismatch between labour supply and labour demand could be wages, even if higher wages would not solve a qualifications mismatch.

**2%** Proportion of UK furloughed workers  
September

## □ UK - Jobs mismatch offset by structural challenges for wage growth

Like the Eurozone, the UK is facing a mismatch in the jobs market – albeit perhaps a more severe one. Stories of lorry drivers and food preparation workers are a daily feature in the British press. Partly this is a function of a rapid rebound in hiring appetite. Job adverts in hospitality have stayed comfortably above pre-virus levels since the reopenings, while payroll-based measures of hiring have shown a rapid improvement in employment in these hard-hit areas.

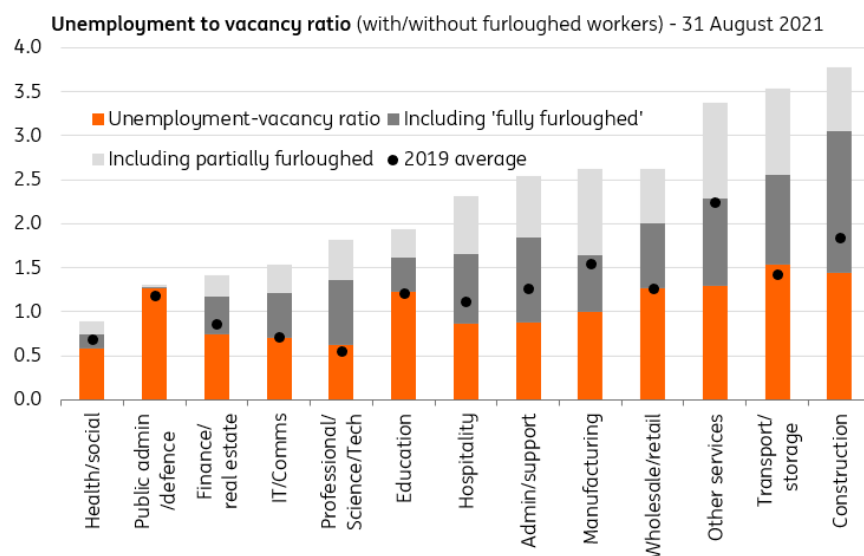
### *Outward migration during the pandemic has amplified shortages*

But shortages are also undoubtedly a function of the exodus of workers during the pandemic. ONS figures from the end of 2020 suggest there was a 7.4% fall in the number of EU nationals on UK payrolls, with declines particularly concentrated in the major cities. It's not clear how much of that has been reversed now travel restrictions have eased, but post-Brexit visa rules (which make it trickier to work in the UK in lower-paid roles) mean it will be permanently harder for UK companies to source staff from overseas. Recent temporary visa changes for specific roles, including lorry drivers, are unlikely to make a huge difference to that story.

### *The ending of the furlough scheme will have increased slack*

Still, while wage growth is pushing rapidly higher in these shortage areas, the situation is probably more balanced than headlines suggest. Around 2% of workers were still fully furloughed when the Job Retention scheme ended in September. And while we're not expecting a huge increase in unemployment now wage support has stopped, we expect numbers of those working fewer hours than they'd like to increase, as well as a possible increase in involuntary retirement. What's interesting is that furlough rates were still high over summer in a number of professions less obviously heavily affected by the pandemic.

## UK unemployed-to-vacancy ratio is higher when furloughed employees included in the figures



Source: ONS, HMRC, ING calculations

Unemployment is based on the sector in which the worker was last employed

### *The UK faces structural challenges too*

We expect this mismatch to fade over the next year or so, and that in turn should reduce concerns that wage growth is going to stay sustained for longer. And like Europe, there are structural challenges too. The UK's demographics challenge is perhaps less acute than some other parts of the EU, but the working-age population growth is nevertheless set to slow over the next decade. Like the US that may amplify some of the current shortages, but it's also a structural drag on UK potential growth. On that note, the UK's productivity challenge seems likely to stay, partly because business investment was stagnant in the years between the 2016 Brexit referendum and the Covid-19 pandemic.

In short, the wage growth outlook is undoubtedly uncertain. The Bank of England looks poised to hike rates imminently, partly as a result of short-term pressures on wage growth. But the near-term cyclical challenges – linked to the furlough scheme – and medium-term structural ones – demographics and Brexit – suggest wage pressures are unlikely to justify the series of rate hikes markets now pricing in the UK.

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