

# ING Monthly: The masks, and the gloves, are coming off

Governments and central banks have a new fight on their hands, this time with inflation. As we hopefully see off Covid, the masks, and the gloves, are coming off. ING's team of economists around the globe tell us what that means for world markets, economies and sectors in February's ING Monthly

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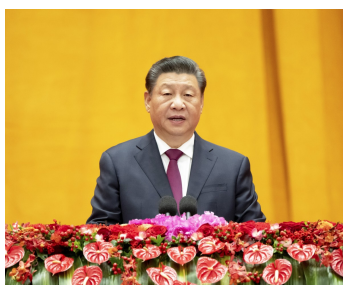
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# ING Monthly: The masks, and gloves, are coming off

Governments and central banks have a new fight on their hands, this time with inflation. As we hopefully see off Covid, the masks are coming off. And so are the gloves



## Governments and central banks are rushing to the exit

Carsten Brzeski on why bankers and politicians are desperate to normalise everything. But what's behind the exit door?

[Watch video](#)

## Telling inflation who's the boss

As the world discovers it can largely live with Omicron, it's not just the masks that are coming off. Central banks are starting to take off the gloves as the 'grand rotation' begins and it's the big ones setting the tone. Remember that just last year, markets were predicting the first US interest rate rise in 2024. Clearly, the Fed's determination to start normalising monetary policy right now has surprised many. And it's sending a clear message: The age of cheap money has come to an end. It's casting off the mantra of 'lower for longer' and is determined to bring in a series of rate hikes and shrink its balance sheet. Inflation, not Covid, is the new kid on the block who needs to be shown who's the boss.

While the Bank of England has followed through with another rate hike, the European Central Bank is still lagging behind when it comes to normalising monetary policy. The ECB, however, is not living on a different planet, it only lives in an economy which is lagging behind the US, explaining the currently still more muted reaction.

While the US economy already reached its pre-crisis level in the second quarter of last year, with a broad inflation spread and labour shortages putting pressure on wages, the eurozone is not there yet. Here, the economy reached its pre-crisis level only at the end of 2021 with differences across countries, inflation still mainly driven by higher energy prices and the labour market has run hot only in a few (core) countries. However, we still think that the ECB and the eurozone will soon be in the same spot as the US, forcing the ECB to speed up tapering and prepare the ground for a first rate hike in early 2023.

Inflation remains the hot topic of the moment. The pass-through from higher energy and commodity prices is not yet over. Companies will continue charging higher prices to consumers and inflation will first spread further into different sectors of the economies before slowing down. And who doesn't expect further price markups in the pandemic-hit sectors such as retail, culture, hospitality and leisure once restrictions are lifted again? At some point, we'll see an almost natural end to this pass-through as neither consumers nor companies can endlessly pay any price charged. This is why we expect inflation rates to eventually come down towards the end of the year.

## **3D inflation: Decarbonisation, deglobalisation and demographics**

The even more interesting question, however, is what will happen to inflation once all pandemic-driven disruption is over. Here, the discussion has only just started. In our view, inflation beyond the pandemic can be labelled as '3D inflation': inflation structurally driven by decarbonization, deglobalization and demographics.

Decarbonisation implies huge investment programmes by governments that need fossil fuels and commodities, but also the price or taxes as a corrective instrument to change human behaviour. Just think of what it needs to build offshore wind parks or railways for high-speed trains. Or how people can be disincentivised to use air traffic or eat too much meat, to mention only a few examples.

Under deglobalisation, China has moved from being a disinflationary force with cheap products and cheap labour to an inflationary driver with high demand for commodities and it's producing higher quality and higher-priced products. The trend for reshoring also opens the door to higher wages. And that's true of demographic changes too, unless all vacancies can be filled by algorithms or robots.

## **The 'delicate risk' to major central banks**

This 3D inflation poses a very delicate risk to major central banks as it is as much globally driven inflation as the disinflation of the last decade was driven by external factors such as globalisation and digitalisation. Most central banks tried fighting deflation with unconventional measures and the jury is still out whether they actually succeeded. It is simply impossible to oppose the 'counterfactual' argument that things would have been worse without central bank action.

But what happens if central banks start chasing inflation that, in reality, is as out of reach as the deflation of the last decade? The adverse effects from trying to bring down inflation could be even larger than the adverse effects from fighting deflation. Chasing the current energy and the future 3D inflation could come at the cost of slowing down economies at a time of significant structural change due to the green transition. It could be considered an interesting policy experiment.

Right now, rushing to the exit makes sense and will continue. We will also see governments rushing to roll back Omicron's restrictions, probably sooner in the US and Europe and later in Asia. But, for central banks, rushing to the exit always bears a risk of policy mistakes, be it by stumbling to the exit or by being too fast.

We all know what to do to reach the exit door. We should also start to think about the inflation and central bank reality we'll then find behind it.

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## At a glance: The world right now

As central banks become increasingly hawkish and geopolitical risks build, we look at the latest developments in the global economy and what they mean for our forecasts



### United States

The steep fall in mobility and consumer spending in December and January reflects Covid caution and threatens economic contraction in the first quarter. But as the Omicron wave passes, strong underlying fundamentals point to a rapid recovery that will set the Federal Reserve on the path of five rate hikes in 2022

### Eurozone

The eurozone recovery is hitting a soft patch on the back of Omicron and high energy prices, but it should gain speed again from the second quarter onwards. The more lasting inflation story is pushing the European Central Bank towards a gradual change of tone. Net asset purchases are likely to end in September, leaving the door open for a rate hike by year-end.

### United Kingdom

The UK is past the worst of Omicron and the economic impact has been fairly modest. Like Europe, the recovery faces a new test in the form of falling disposable incomes. But the Bank of England is focused squarely on inflation. The Bank has hiked rates twice and has begun the process of shrinking its balance sheet. We expect two further rate rises this year.



## □ China

China is reporting 50 confirmed Covid cases per day as its population prepares to celebrate the Chinese New Year. Localised social distancing measures are tight in Beijing, which will hurt catering businesses, but some consumption items will benefit. Luckily, infrastructure investment should take off after the holiday.

## □ Asia ex-China

Compared to other parts of the world, policy rates in Asia are barely moving. Most central banks in the region are hanging on to their growth-supportive monetary stances, and rates in China are actually being cut. Inflation has not shot up as fast or as far as it has in Europe or the US, requiring less pushback from policymakers.

## □ Central and Eastern Europe (CEE)

There is a higher risk of inflation staying elevated across the CEE region than in the developed EU economies, as the labour markets remain tight and the expansionary fiscal stance overlaps second-round effects from energy prices. This reinforces our view that the tightening cycle the CEE3 central banks have started will continue, albeit at different speeds.

## □ Commodities

As tensions between Russia and Ukraine grow, so does the risk that it spills over into global commodity markets. A conflict against the two nations and/or tough sanctions against Russia has the potential to significantly tighten commodity markets. The European natural gas market is most vulnerable.

## □ FX

The dollar is near its cyclical highs as the Fed prepares to embark on a tightening cycle. Has all the good news been priced into the dollar and how will central bank balance sheet adjustments hit FX markets? We continue to think that the Fed terminal rate is prone to being re-priced higher over the coming months and that the dollar rally has a little further to run.

## □ Rates

We expect the US 10yr to break above 2%, though we're not calling for it to go much above 2.25%, as we acknowledge the demand effect which is robust and is likely to remain a factor. The euro 10yr swap rate should get to the 50-75bp area, or at the very least remain comfortably above 50bp (it's not there just yet). And the 10yr German yield should not be dipping materially negative again.

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# US growth to rebound as Omicron caution fades

The steep fall in mobility and consumer spending in December and January reflects Covid caution and threatens economic contraction in the first quarter. But as the Omicron wave passes, strong underlying fundamentals point to a rapid recovery that will set the Federal Reserve on the path of five rate hikes in 2022



People movement dropped sharply through December and January as the Omicron wave peaked

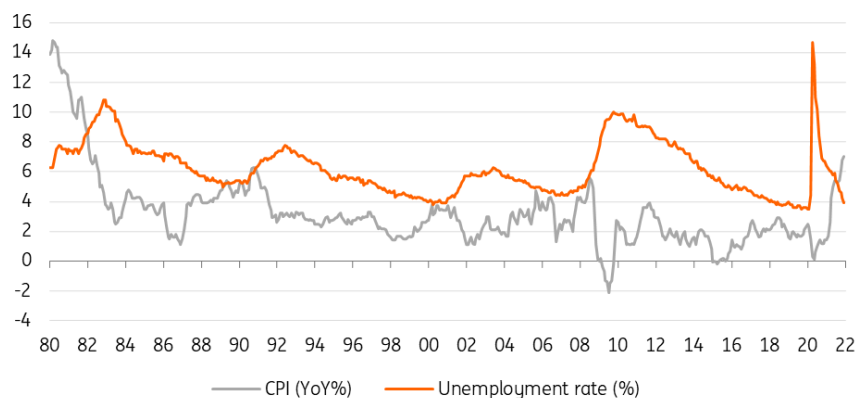
## Fed sounds the call for action

The US economy is now more than 3% larger than before the pandemic struck, inflation is running at 7% year-on-year and the unemployment rate is back below 4%. Given this backdrop, the Federal Reserve has given markets the nod to say it is ready to raise interest rates in March and follow this up with a series of rate hikes throughout 2022.

After a hawkish post-Federal Open Market Committee (FOMC) assessment from Fed Chair Jerome Powell, where he refused to rule out raising rates at every meeting this year, the market is now settling on four or five hikes for 2022. We are at the more aggressive end and expect the Fed to kick off with consecutive 25bp moves in March, May and June with additional increases in September and December.

They could of course do more, but with the Fed set to allow some maturing assets to run off its \$9tr balance sheet from July onwards, this quantitative tightening can do some of the heavy-lifting with the added benefit of helping to keep the yield curve positively sloped.

## US unemployment rate versus consumer price inflation 1990-2021



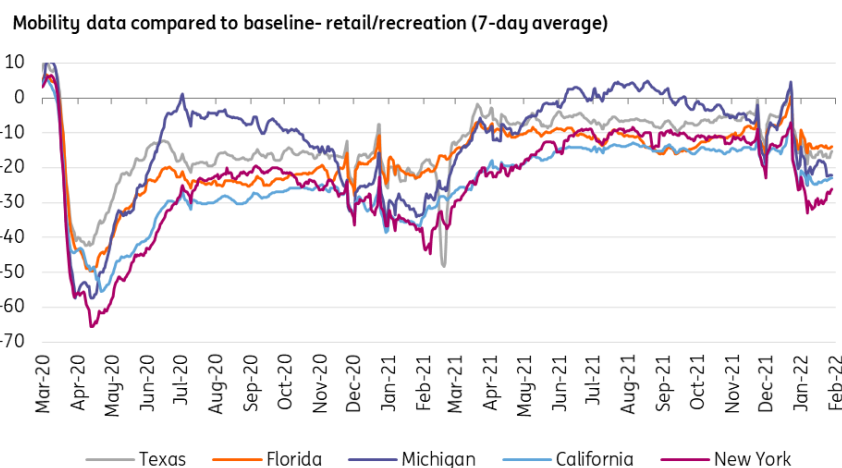
Source: Macrobond, ING

## Covid caution means near-term economic weakness

There have been some calls for an initial 50bp as a signal of intent to get inflation under control, but given the Omicron wave dampened activity and hiring in the early part of 2022, we think this is a low probability event.

In fact, our 1Q gross domestic product (GDP) growth forecast is now 0% with consumer weakness in November and December showing little sign of abating through January. The massive inventory rebuilding experienced in 4Q21 is also likely to partially unwind and we doubt that exports will grow anywhere near the 24% annualised rate seen in the final three months of last year. As such we can't rule out the possibility of a negative 1Q GDP print.

## People movement dropped sharply through December and early January



Source: Macrobond, ING

## Worker demand to keep boosting household incomes

Nonetheless, we are hopeful that better data in February and March will set us up for that first rate hike as well as a strong economic expansion in 2Q. Covid cases are falling in many parts of the US and this should result in consumers and businesses engaging more fully with the economy again.

Household fundamentals are in good shape with household wealth having risen \$30tr since the end of 2019. Workers are also feeling more of the benefits from growth through higher incomes. Demand for workers is at record levels – the chart below shows there are 1.7 job vacancies for every unemployed person in the US – and the quit rate is also near record highs, suggesting companies are not only having to pay workers more to recruit staff, but also consider paying more to retain current employees.

## Ratio of job vacancies to unemployed people has never been higher



Source: Macrobond, ING

## Economic strength set to broaden

While wage growth isn't keeping pace with the cost of living at the moment, we expect better news for the second half of the year as inflation starts to slow. Fed rate hikes will take some steam out of the economy, but inflation is being primarily driven by supply-side pressures and we are cautiously optimistic that production bottlenecks and Covid-driven worker shortages will gradually improve and allow inflation rates to slow towards 3-4% by year-end and back to 2-3% in 2023.

At the same time, corporate investment intentions remain firm and inventories will continue to be rebuilt over the next couple of years. Then there is the already-approved Federal government investment programme, while President Joe Biden is seemingly acknowledging that by dropping some of the more contentious policies within his Build Back Better plan he stands a better chance of getting at least part of the package approved. After all, he needs all the good news he can get going into November's mid-term election where the Democrats risk losing control of Congress, which would bring their legislative agenda to a grinding halt.

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## The eurozone's recovery is hitting a soft patch

The eurozone recovery is hitting a soft patch on the back of Omicron and high energy prices, but it should gain speed again from the second quarter onwards. The more lasting inflation story is pushing the European Central Bank towards a gradual change of tone. Net asset purchases are likely to end in September, leaving the door open for a rate hike by year-end



There is still hope that the eurozone economy will put in a more than decent growth performance this year

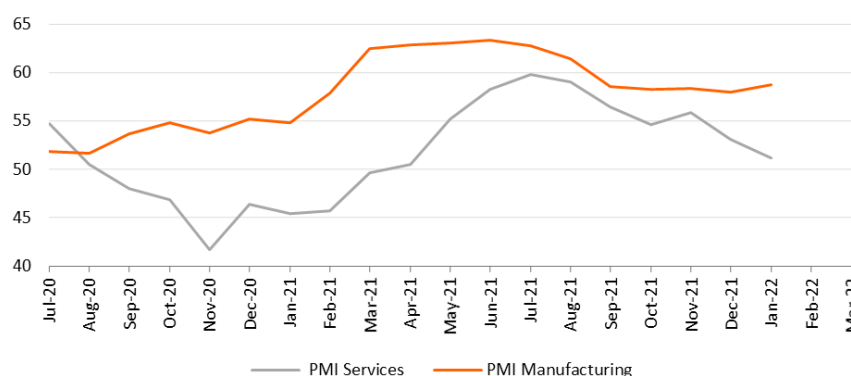
### Another weak quarter likely

After a weak fourth quarter, with only 0.3% quarter-on-quarter growth, the eurozone is likely to also see subdued growth in the first quarter of 2022. January was hit by a record number of Omicron infections, leading to higher absenteeism due to illness, which in turn hurt production. At the same time, containment restrictions were a brake on consumption, especially in the services sector. The good news is that with the peak in infections probably reached, restrictions in many countries are now being relaxed.

Supply chain problems, which were probably the biggest cause of the gross domestic product (GDP) contraction in Germany in the fourth quarter of last year, have also subsided a little, causing

the Ifo-indicator to improve in January. It is probably too early to say that the frictions in the supply chain are completely behind us, as Omicron lockdowns in China might spell trouble again. High energy prices remain another headwind that is likely to weigh for some time on consumption expenditures.

## Weakening in services sector on the back of Omicron



Source: Refinitiv Datastream

## Tight labour market

While the current circumstances are mixed, there is still genuine hope that the eurozone economy will put in a more than decent growth performance this year. The consumer has certainly been hurt by high energy prices, but government support is softening the blow in many countries. The savings ratio is still several percentage points above its pre-pandemic average, which could provide some extra spending power, especially since brighter labour market prospects could reduce precautionary saving. The unemployment rate fell to 7.0% in December, vacancies are at a very high level, and a growing number of companies are signalling labour scarcity.

So consumption will probably remain a driving force of the recovery. On top of that, the impact of the European recovery fund will start to kick in this year, adding to growth, especially in the southern member states. Over the coming years fiscal policy is going to become a bit less expansionary as the Stability and Growth Pact is likely to return in some form, perhaps not yet fully in 2023, but certainly in 2024. All in all, we expect 3.7% growth this year and 2023 might still see 2.7% before slowing down to a more long-term potential growth rate of 1.5% in 2024.

## Improving labour market perspectives will push down savings ratio



Source: Refinitiv Datastream

## Another inconvenient inflation surprise

Another month, another inflation forecast increase. Indeed, the preliminary estimate showed the harmonised index of consumer prices (HICP) inflation at 5.1% in January, even higher than December's 5%. However, with the January 2021 German value-added tax (VAT) hike disappearing from the equation already shaving off 0.5 percentage points from the inflation rate, the current figure was really bad. Of course, energy prices remain the biggest culprit, with little visibility for the next few quarters, although it seems unlikely that they will increase as much as they did in 2021.

For the European Central Bank (ECB), the underlying inflation story is more important. At 2.3%, core inflation remains above the ECB's medium-term target and second-round effects could prevent a decline. We now see headline inflation of 3.3% this year, with risks skewed to the upside. 2023 might see inflation below 2% temporarily, but at the end of the year, this threshold should be surpassed again.

## ECB has become less dovish

The least one can say is that higher-than-expected inflation has increased the pressure on the ECB. In a recent interview the ECB's chief economist, Philip Lane, stated that wage increases of 3% were compatible with the 2% medium-term inflation target. As we expect wages to pick up by 3-3.5% this year, the ECB's target seems within reach. Lane also mentioned that the policies needed to fight very low inflation would no longer be needed if inflation remained stable at around 2%.

The February ECB press conference already sounded more hawkish, with the risk to the inflation outlook now tilted to the upside. We now believe that net asset purchases will end in September. This creates room for a deposit rate hike before the year is out, though this isn't a done deal yet. But it seems very likely that by the summer of 2023 the deposit rate will have left negative territory for good.



## Author

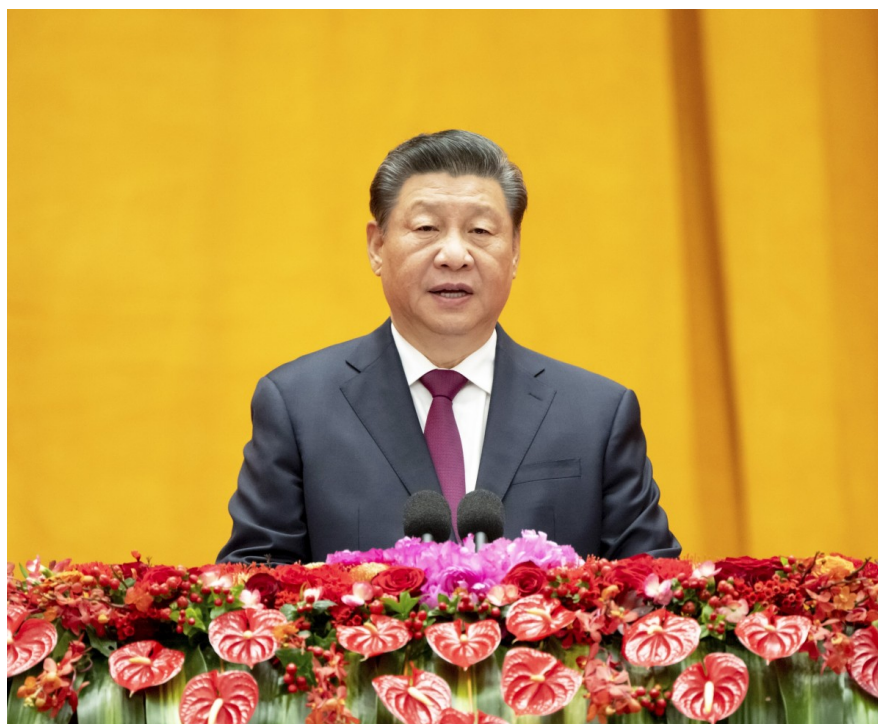
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# China's economy to endure another Covid New Year

China is reporting more confirmed Covid cases per day as its population prepares to celebrate the Chinese New Year. Localised social distancing measures are tight in Beijing, which will hurt catering businesses, but some consumption items will benefit. Infrastructure investment should pick up after the holiday



Chinese President, Xi Jinping, addressing a Chinese Lunar New Year reception at the Great Hall of the People in Beijing

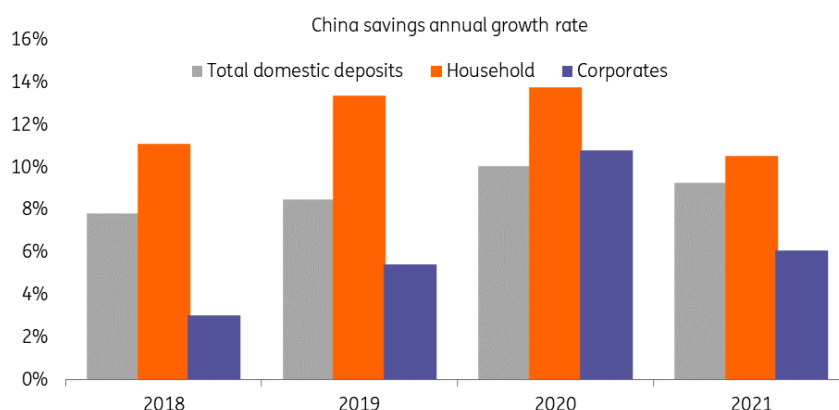
## Another Chinese New Year with social distancing measures

Covid is still present in China, although the number of reported cases remains small, and China is still maintaining its zero-Covid policy. As a result, even with small numbers of reported Covid cases, localised areas in Beijing City have tightened social distancing measures and people flows. Some of those who intended to leave Beijing to travel to their hometowns are now stuck in the city. As well as Beijing, another Covid hotspot is Hangzhou, and travel agencies have cancelled cross-provincial travel in and out of the area.

All these as well as future people flow restrictions will hurt catering and travel businesses. But for overall consumption, we still believe there will be some growth compared with the previous Chinese New Year as job stability has improved over the past few months. Household savings rose at a slower pace in 2021 compared to 2020 as the more recent social distancing measures have been more localised, and overall people flows have improved. This has helped the economy return to some sort of normality.

For this Chinese New Year, we expect that sales of clothes and beverages will benefit the most as we believe the government will continue to limit the degree of social distancing measures. But Beijing will experience a more stringent set of policy measures because the authorities want the Winter Olympics, which open on 4 February, to run smoothly.

## Overall savings have been falling



Source: PBoC, ING

## Infrastructure investments vs real estate developments

We understand that the government is eager to minimise the economic and market impact of defaulting real estate developers. This will be done by organising mergers and acquisitions at a deep discount. Buyers will likely be developers and asset management companies with state backgrounds. We also expect that the other real estate developers will build more slowly than they have in the past to avoid piling up extra debt.

With these factors in mind, some building materials could be affected as demand from real estate developers will slow. But infrastructure investment should pick up some of the slack after the Chinese New Year as the central government is urging local governments to front-load projects in the first half of the year. This policy should be addressed in the "Two Sessions" to be held on 4 and 5 March 2022.

## Forecasts

We aren't yet revising our GDP forecasts. These currently stand at 4% Year-on-Year growth in the first quarter of this year, and 5.4% for the whole of 2022. This is partly because the People's Bank of China (PBoC) has confirmed that it will deliver a more accommodative monetary policy in 2022. We expect to see more rate cuts in the 7D reverse repo, 1Y Medium Lending Facility, 1Y and 5Y Loan Prime Rates. As an indicator, we forecast the 7D reverse repo rate to fall from 2.2% at the beginning of the year to 1.7% by the end of the year. This forecast, however, relies on Covid cases remaining limited and confined to small area outbreaks, so the risks are skewed to the downside.

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## Bank of England set for further hikes amid inflation concern

The Bank of England has hiked rates for a second consecutive meeting and we now expect further moves in March and May. But that might be more or less it



Governor of the Bank of England, Andrew Bailey

There's a growing sense that the UK is past the worst of Omicron. With the exception of young children, Covid-19 cases have decreased markedly from the peak and hospitalisations have fallen too. The UK has benefitted from comparatively high booster vaccine coverage in those age groups most vulnerable to severe disease.

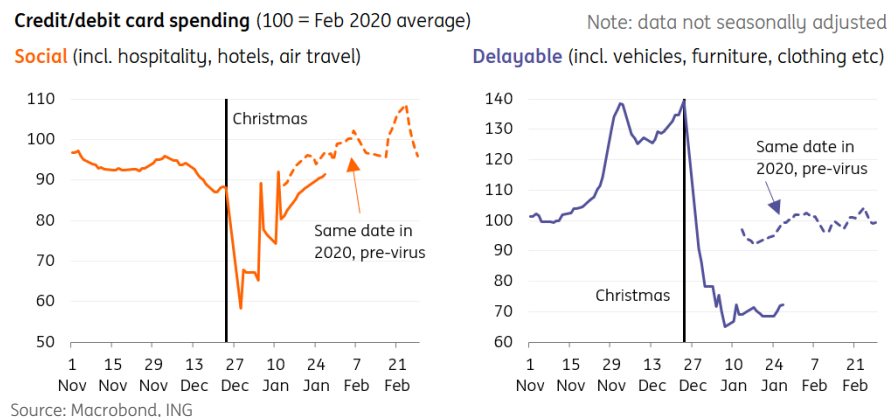
All of this means that the economic damage from Omicron has been relatively contained, at least relative to past waves.

While consumers became decidedly more cautious in the run-up to Christmas – nervous about being in isolation during the festivities – they appear to have become more relaxed as January has progressed. Daily card data shows 'social' spending is tracking only slightly below levels seen in January 2020, before the pandemic.

The recent decline in Covid cases among adults and a recent shortening in self-isolation periods should also go some way to ease staff shortages. Absence rates in consumer services had topped 5% in early January.

In short, the total GDP impact of the latest wave, spread across December and January, is unlikely to top 1%, and most of this lost output will likely be regained within weeks.

## Social spending is tracking only slightly below January 2020 levels



Nevertheless, the pace of recovery is likely to slow as we move through the year. The combination of higher inflation and forthcoming tax rises means that real disposable incomes are set to continue falling, even when accounting for further gains in employment over the coming months.

That doesn't necessarily mean consumption will also decline and, to some extent, the excess savings built up through the pandemic, now amounting to roughly 8% of GDP, will help offset the income strain. In December, household deposits rose by their smallest amount since the start of the pandemic, a sign perhaps that consumers are now dipping into savings to sustain spending.

Slower consumption will also be partially offset by a decent year for business investment, having underperformed developed market peers consistently since the 2016 Brexit referendum.

## Inflation the central concern for the Bank of England

At the Bank of England, the attention remains squarely on inflation.

Household energy costs are set to rise by roughly 50% in April, and a government-financed £200 discount in October will simply net out a further increase in the price cap forecast for the same month. This means inflation will peak close to 7% in the spring and end the year close to 3.5%. Concerns about headline inflation remaining higher-for-longer have prompted a second consecutive rate hike from the Bank – and in fact four out of nine policymakers voted for an even faster, 50bp move.

The Bank is clearly keen to act pre-emptively, and we now expect a further rate rise in both March and May. But that might more-or-less be it.

Elsewhere, the political drama in Downing Street is unlikely to change the economic policy outlook materially, even were there to be a change in leader. Nevertheless, these latest developments have meant Brexit has taken a back seat and fears of an imminent escalation in UK-EU tensions have subsided. Foreign Secretary Liz Truss has taken over negotiations and while the core

disagreements don't appear to have changed, the atmosphere has improved.

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# Asia: Central banks still focused on growth

There have been some notable tweaks to policy accommodation in recent weeks, but central banks in Asia-Pacific are still favouring growth over inflation concerns



Lee Ju-yeol, the Governor of South Korea's central bank, has raised rates far more than his peers in the Asia-Pacific region

## Growth vs Inflation

The last few weeks have seen inflation figures in Asia ticking higher on average, and a couple of central banks have even tightened policy rates. Most notably, the region's most hawkish central bank, the Bank of Korea (BoK) raised policy rates for a third time to 1.25%. And the Monetary Authority of Singapore (MAS) has also surprised markets with an unscheduled adjustment to its exchange rate policy.

But compared to other parts of the world, in particular, Central and Eastern Europe, policy rates in Asia are barely moving. Most central banks in the region are hanging on to their growth-supportive monetary stances, and rates in China are actually being cut.

The main reason for this difference in central bank behaviour is inflation. It's not that there is no inflation in Asia. Inflation rates on average have edged higher. But inflation has not shot up as fast or as far as it has in Europe or the US, requiring less pushback from the region's central banks. The

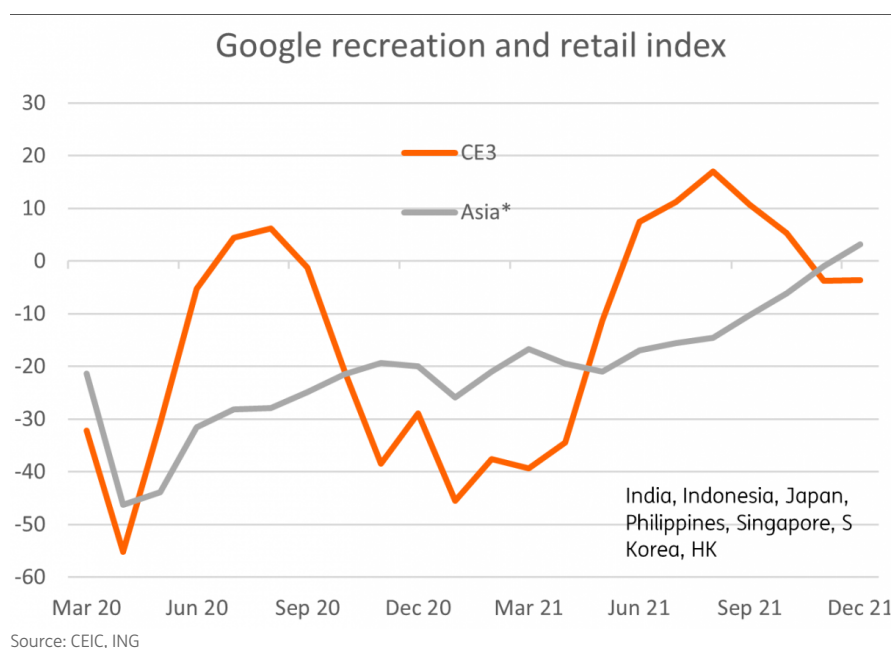


most recent upticks in inflation came from Australia, where the headline number has now reached 3.5%YoY. But that's only half what it is in America And inflation in Singapore and Korea, where policy has been tightened, is no higher than 4%. And of course, China bucks the trend again with inflation actually falling recently.

So why is inflation so much better behaved in the Asia-Pacific region? There is no one reason, and we've written about it extensively [here](#), but below we list some of the key contenders:

## Asian gradualism vs all-or-nothing approach to lockdowns of CE3

Google retail and recreation index



## 4 reasons why Asian inflation is behaving better than elsewhere

1. **Gradual re-opening.** When you compare the Google retail and recreation indices for the CE3 (see chart above) with the average for Asia, you can see that from the initial movement restrictions imposed in response to the initial Covid wave, the re-opening in Asia has been quite steady and gradual. The shift in demand to goods that distinguished the lockdown, and then the swing back to demand for services as economies have re-opened has been far more gradual in Asia, arguably resulting in less intense bottlenecks in supply.
2. **Supply constraints:** These have been a feature of price rises in Western Economies, in particular, though not exclusively for semiconductors. Production of semiconductors is concentrated in Asia. And it seems that at the moment, much of this production goes to satisfy markets in the region, rather than far-flung export destinations.
3. **Logistics:** A secondary factor magnifying this supply constrain effect is logistics. It is still up to nine times more expensive to ship goods from Asia to Europe or the US than it is to import them from the US or Europe to Asia. These pass-on costs are therefore much smaller in Asia.
4. **EM vs DM:** Where we do see inflation in Asia, it seems to be more of a developed-market

phenomenon: Interestingly, and although there is some elevated inflation in some Emerging Asia, the greatest pick-up in inflation (from admittedly very low pre-pandemic rates) in Asia seems to have been in the more developed economies. A lot of this is energy (wrapped up in transport components) but these economies will also have a higher weight from services in their basket, which might also be a reopening factor.

Inflation may have a little further to go in Asia, and we also haven't yet seen the full impact of Omicron, which may exacerbate supply constraints further. But even though policy rates will likely rise further this year to offset this inflation, we aren't expecting aggressive hikes from Asian central banks this year.

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Article | 4 February 2022

## The fight against inflation continues throughout Central and Eastern Europe

Growth seems to have remained robust in central and eastern Europe (CEE) as 2021 ended. Flash GDP data showed a 5.7% expansion in Poland for the full year, not far from our 5.9% estimate, boosted by a resilient consumer sector and solid investment activity



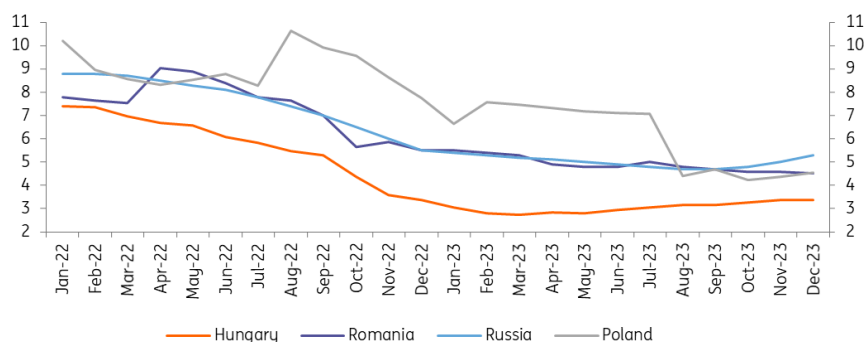
Source: Shutterstock

Prime Minister Mateusz Morawiecki visit in Kiev, Poland Feb 2022

Later this month we expect even better growth numbers for Romania (+6.5%) and Hungary (+6.7%) as the Omicron wave seems to have had a marginal impact on consumers' behaviour while the fiscal stance remained loose.

However, as the economic growth stayed robust, inflation continued to surprise to the upside. It is true that estimates have been wrong by a narrower and narrower margin, but still they predominantly underestimate inflation. Despite a mix of measures aimed at protecting households from higher energy prices, year-end headline inflation climbed to 8.6% in Poland, 8.2% in Romania and 7.4% in Hungary.

## Inflation (YoY%) trending lower but not low enough



Source: National sources, ING estimates

We renew our view that there is a higher risk of inflation staying elevated across the CEE region than in the developed EU economies, as the labour markets remain tight and the expansionary fiscal stance overlaps second-round effects from energy prices. While in Hungary the inflation rate could average 5.7% in 2022 and enter National Bank of Hungary's (NBH) target band of 2%-4% in 2022 in 4Q22 already, Poland and Romania see their inflation rates set to stabilise about 1 percentage point above the upper level of their 1.5%-3.5% target range. We estimate average 2022 and 2023 inflation to be around 9.0% and 6.0% in Poland and 7.5% and 5.0%, respectively, in Romania. This reinforces our view that the tightening cycle the CEE3 central banks have started will continue but at a different pace.

In Hungary we expect a terminal key rate of 5.50% to be reached in mid-2022, followed by a relatively long pause until 3Q23 and a policy relaxation towards 4.5% in late 2023. National Bank of Poland (NBP) and National Bank of Romania (NBR) on the other hand are more likely to continue their policy tightening into 2023 as well, reaching a terminal key rate of 4.50% in Poland and 4.00% in Romania. For the latter, increased attention should be paid to the Lombard rate (credit facility), which could become the relevant policy rate for most of 2022 at least. For both NBP and NBR we see risks of frontloaded rate hikes, meaning that the terminal rates could be exceeded in 2022 already. On top of everything, the labour market is set to remain tight across the region leading to mounting risks of a price-wage spiral.

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# Commodities and the Russia-Ukraine crisis

As tensions between Russia and Ukraine grow, so does the risk that it spills over into global commodity markets. A conflict against the two nations and/or tough sanctions against Russia has the potential to significantly tighten commodity markets



US Secretary of State Antony Blinken (L) and Russian Foreign Minister Sergei Lavrov (R) attend bilateral talks on soaring tensions over Ukraine in Geneva

## Tough sanctions would rattle commodity markets

Several commodity markets are starting to price in some geopolitical risk around the growing tension between Russia and Ukraine. There is still plenty of uncertainty over how the situation will evolve, but it is still worthwhile to look at what the potential impact could be should tension boil over into a conflict.

A scenario where the West fails to react with tough sanctions against Russia if it were to invade Ukraine means that the potential impact for commodity markets would be more limited, although the uncertainty would still likely be bullish in the short term. There would still be a risk to Russian gas flows via Ukraine to Europe. While, depending on the scale of any invasion, it could also potentially have an impact on the production and export of Ukrainian agricultural commodities, including corn and wheat.

However, in a scenario where the West reacts strongly with sanctions that target key Russian industries, this could have a far-reaching impact on the commodities complex. It could potentially lead to a significant tightening in energy, metal, and agri markets, which would provide only a further boost to an asset class which already has an abundance of positive sentiment in it.

Even if sanctions are not imposed on certain industries, financial sanctions could still make trade difficult, as it would be an obstacle for making payments.

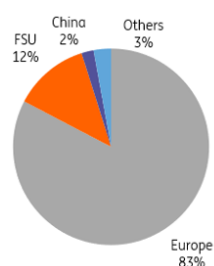
## □ Energy related sanctions would hit Europe the most

The European natural gas market is most vulnerable. The region is already dealing with an extremely tight market. Therefore, any further reduction in Russian gas flows to the region would leave the European market exposed. Russia is the dominant supplier of natural gas to Europe, with it usually making up anywhere between 40-50% of European gas imports. Nord Stream 2, which is now complete, is awaiting regulatory approval before Russian gas can flow through it. However, the US has already made it clear that in the event of sanctions, Nord Stream 2 would be targeted.

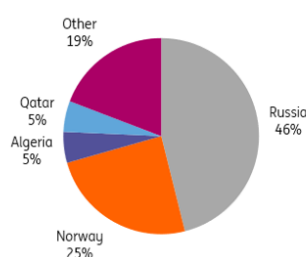
It would be difficult for Europe to stomach sanctions which effectively cut off Russian gas supply, or at least a large portion of these flows, given the region's dependency on Russian gas and the ongoing energy crisis. Therefore, the EU would likely be less willing to go for an aggressive approach that cuts off Russian gas completely.

## Gas exports and imports

Russian gas exports by destination (%)



EU gas imports by origin (%)



Source: Gazprom, Eurostat, ING Research

Note: 2020 data. Gas flows to the EU from Ukraine and Belarus assumed to be Russian gas

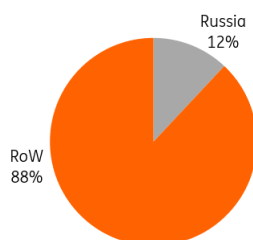
## □ Crude oil impact

Sanctions would also be a risk for the oil market. Russia is the second-largest crude oil exporter after Saudi Arabia, with crude and condensate volumes averaging in the region of 5MMbbls/d. Any potential action taken, which impacts a large share of these exports, would likely push the global market into deficit and would be extremely bullish for oil.

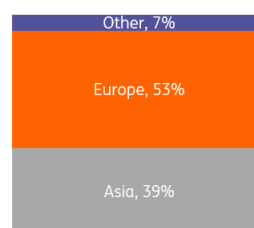
Europe would once again likely feel the impact the most, with around a quarter of its imports coming from Russia. While Asia, and in particular China, is a large importer of Russian oil. However, Western sanctions would unlikely have a significant impact on flows to China. In fact, sanctions could lead to increased Russian oil flows to China at discounted values.

## The importance of Russia and crude oil

Russian share in global crude oil exports (%)



Russian crude oil exports by destination (%)



Source: BP Statistical Review 2021

Note: 2020 data

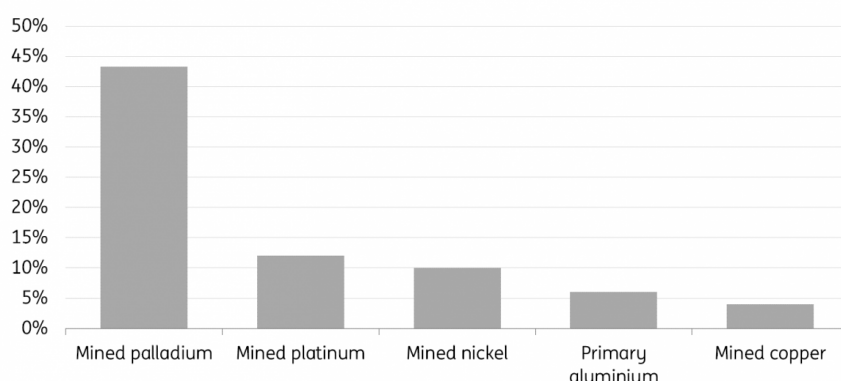
### The aluminium market: Memories of 2018

We don't have to go back too far to see the impact that sanctions on Russian aluminium producer, Rusal had on the global aluminium market. US sanctions against Rusal rattled the aluminium market in 2018, with Russia the largest aluminium producer, after China. Russian primary aluminium production makes up around 6% of global output, and 15% of ex-China output. The global aluminium market is in deficit now and so any disruption to these flows would only push the market further into deficit.

Sanctions could also possibly have an impact on output from European aluminium smelters. As we are currently seeing, smelting capacity in Europe is having to shut down due to high power prices. In a scenario, where sanctions impact Russian gas flows, this would only drive European energy prices higher, risking even further capacity restrictions in the region.

Russia is a sizeable producer of nickel, copper, palladium and platinum. Therefore, some of these markets could also tighten up significantly.

### Russian share in global production for selected metals (%)



Source: USGS

Note: 2020 data

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## FX: As the Fed tightens, the dollar rally has some way to run

The dollar is near its cyclical highs as the Fed prepares to embark on a tightening cycle. Has all the good news been priced into the dollar and how will central bank balance sheet adjustments hit FX markets? We continue to think that the Fed terminal rate is prone to being re-priced higher over the coming months and that the dollar rally has some further to run



Some tricky decisions lay ahead for the Fed Chairman, Jerome Powell

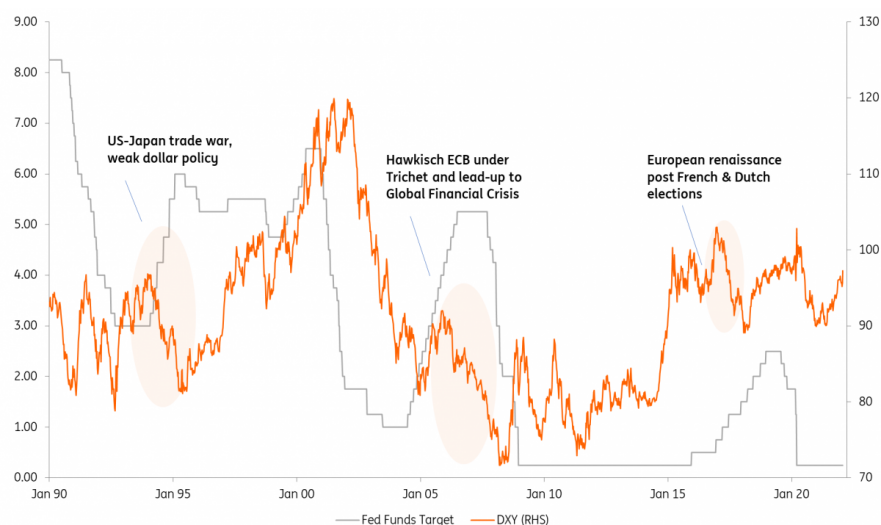
### Dollar's rally hits the hard yards

We have seen some commentators recently suggesting that the start of the Fed tightening cycle is normally associated with a top in the dollar. The rationale seems to be along the lines of 'buy the rumour, sell the fact'. Or in other words that FX markets – largely driven by the expectations channel – have all the good news of tighter policy already priced into the dollar by the time the Fed's hiking cycle begins.

We've outlined a stylised chart of Fed tightening cycles since 1990 marked against the DXY – a trade-weighted measure of the dollar heavily weighted towards European currencies, and you can see that below. One can probably make out around four tightening cycles during that period. Using a broad brush, most cycles have been associated with some periods of dollar strength – as one

would expect with a central bank welcoming tighter monetary conditions.

## Fed tightening cycles and the dollar



Source: ING, Refinitiv

But periods of exceptions – as you can see in 1994, but also in 2006 and 2017 – were very much driven both by US policy choice and developments overseas. In 1994 the dollar was under broad-based pressure as the new Clinton administration fought a trade war with Japan. Dollar under-performance of the Fed tightening cycle in 2006 was a function of the take-off in the ECB policy rate under hawkish President Trichet. In 2017, DXY weakness was again driven by a re-assessment of the euro's prospects following the Dutch and French elections.

What of the Fed tightening cycle in 2022? We doubt the Fed cycle's positive effects on the dollar will be undermined by domestic US policy. Here the White House, like many administrations around the world, will increasingly favour a strong currency to keep inflation in check and to protect real incomes. A re-assessment of European growth prospects and a hawkish ECB would be a threat to a strong dollar story. After this month's hawkish ECB press conference, this threat seems a little more real. Yet we would argue that a very aggressive Fed tightening cycle - including five hikes in 2022 - can see the dollar largely hold onto gains. In particular, the Fed terminal rate is currently priced near 1.60/70% and could well be priced closer to 2.50% as 2022 progresses.

## Clash of the balance sheets

A further challenge to FX markets in 2022 is how to understand the role of central bank balance sheets. For example, does a quicker reduction in the Fed's over the ECB's balance sheet have any implications for EUR/USD?

We take our lead on this from [this research piece](#) produced by then ECB Council Member, Benoit Coeure, in 2017. The article looked at the FX impact from QE. Our take from this was that QE did indeed drive international portfolio choices, especially fixed-income choices. But linking those international fixed-income allocations with currency moves was near impossible.

The ECB's QE programmes have played a major role in driving the eurozone's basic balance (its net current account, net foreign direct investment and net portfolio flows summed) into deeply

negative territory. The biggest driver of the negative basic balance is fixed income flows, where ECB QE has driven both eurozone residents and foreigners out of eurozone fixed income. This large negative basic balance leaves the euro vulnerable.

But as the 2017 report concluded, short-term interest rate differentials, capturing expectations of policy rates, have a much bigger say as to where FX rates are headed. Based on our team's forecast yield spreads between German and US sovereign bonds, we expect EUR/USD to stay under pressure in the first half of the year. However, a sustained move below 1.10 looks too much of a stretch now because of the hawkish ECB. And we are revising our FX forecasts this month in favour of EUR/USD trading within a 1.10-1.15 range through to year-end.

## Two year yield divergence suggests EUR/USD stays under some pressure



Source: ING, Refinitiv

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Article | 4 February 2022

## Rates: Are we there yet? Nope

When kids ask that question, they already know the answer. It's a journey for market rates, and we're still on it. Even if macro oomph is met by demand for bonds, there are looming liquidity reductions ahead. These can tip the balance, as can actual rate hikes, not to mention the threat of central bank bond selling



When kids ask 'are we there yet?' they already know the answer. It's a journey for market rates too, and we're still on it

### We've already hit some milestones with market rates, yet the Fed has not even started to tighten

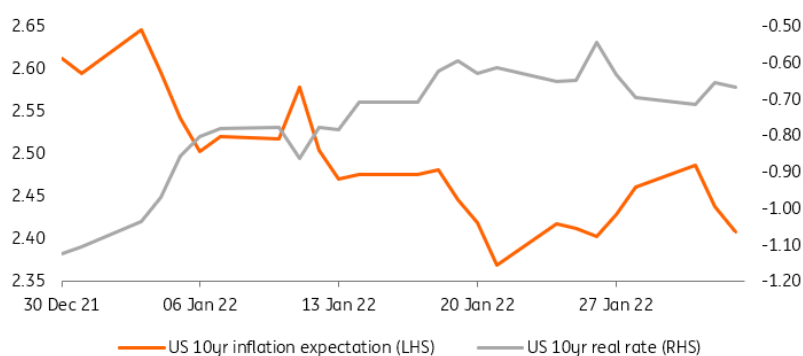
It's been quite a start to the year for rates, with some key levels hit. For example, the US 10yr touched 1.9%, its highest since the pandemic began. The Euro 10yr swap rate is almost at 60bp now, compared with negative territory for most of 2021. And the 10yr German yield has broken above zero for the first time since mid-2019 and approaching 15bp. There are stories behind all of these moves, but the common theme is one of a pronounced macro reflation, and a nod from central banks that this has their undivided attention.

The US Federal Reserve in particular has increasingly acknowledged that supply-induced price hikes have indeed morphed into an inflationary process. And it is telegraphing an intention to calm that process through monetary tightening. Yet, so far the Fed has done nothing apart from talk. It has tapered its bond purchases, but it is actually still buying bonds, still expanding its balance

sheet. And its first rate hike is not till March. It's all talk. The walk lies ahead.

Meanwhile, both the ECB and Bank of England have ramped up the interest rate risk too, and markets are keen to price in steeper money curves. Central banks are on a mission to catch up with the inflation genie that was unleashed in 2021, and left untamed till now for good reason – recovery from the pandemic took precedent.

## Real yields have risen as inflation expectations have fallen



Source: Macrobond, ING estimates

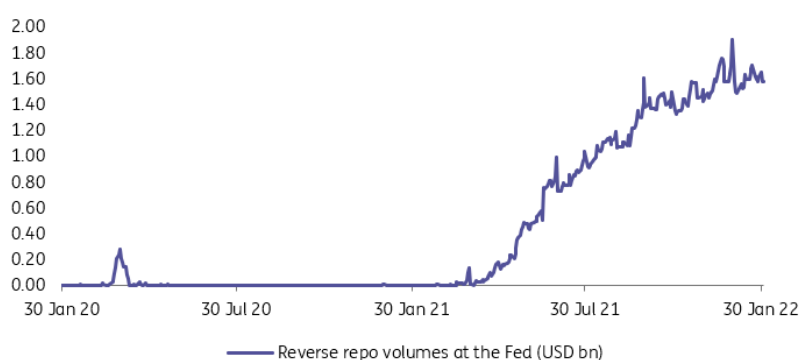
The market reaction has not just been seen in higher 10yr nominal rates. Under the hood, we see that rises in real rates have been the dominant driver. Inflation expectations have in fact been easing, and thus acting to curb rises in nominal rates. But as real rates have risen by more than inflation expectations have fallen, the net effect is higher nominal rates. Lower inflation expectations will please central banks, as it shows that their actions (even if only verbal, e.g. the Fed) are having the required effect.

## A tightening in liquidity conditions through 2022 will prove the tipping point for another lurch higher in market rates

The big question is what happens now. macro factors beyond the Omicron-impacted turn of the year are robust and should pull rates higher. This will be muted by buyers of bonds that continue to show up as a supportive factor on the flows front. Weak data in the current quarter will provide a short-term excuse to buy bonds, although the market should look through this.

So, other factors? There are many, in particular on the liquidity reduction front. By mid-year, the Fed will have started to take liquidity out of the system by allowing maturing bonds to roll off the curve. This has the rounded effect of reducing bank reserves and tightening liquidity. Basically, the imbalance in the US between liquidity and collateral needs to shape-shift, and that will require significant volume reductions in liquidity before having an effect. It is still a tightening though, even if it's not having a material effect until later in 2022.

## One measure of the ample room the Fed has for liquidity reduction



Source: Federal Reserve, ING estimates

In addition, early eurozone targeted longer-term refinancing operations (TLTROs) repayments in June (€800bn) will effectuate a tightening of euro financing conditions, against a backdrop where the European Central Bank (ECB) will also taper in 2H22, and is shaping up to hike rates in 2022 (yes we used the word hike, a foreign term in ECB circles for more than a decade). This is a big deal. The discount is building already, but there is much more to go.

There are two other factors that will evolve over the course of 2022. First, both the Fed and the ECB have the potential to sell bonds back to the market. Now they are unlikely to do this, but it remains a possibility, especially for the Fed, that the market should at least acknowledge as it discounts where market rates should sit. Second, as the Fed hikes rates, foreign players will find it easier to synthetically create alpha through buying dollars cheaply in foreign exchange forwards, which can reduce demand for vanilla US treasuries.

There is enough here to force market rates higher than they are today. The US 10yr should break above 2%. We're not calling for it to go much above 2.25%, as we acknowledge the demand effect which is robust and is likely to remain a factor. The euro 10yr swap rate should get to the 75bp area, or at the very least remain comfortably above 50bp. And the 10yr German yield should not be dipping materially negative again. In fact it is on a journey to 25bp.

And let's first put the Russia / Ukraine issue out there. Suffice to say that a deepening in the crisis puts a typical flight-to-safety bid into US treasuries, pulling market rates lower. How much? Depends on how bad. For now we're assuming a status quo. But it's digital – an unpredictable on/off switch that can flick back in to dominate. Let's leave it at that.

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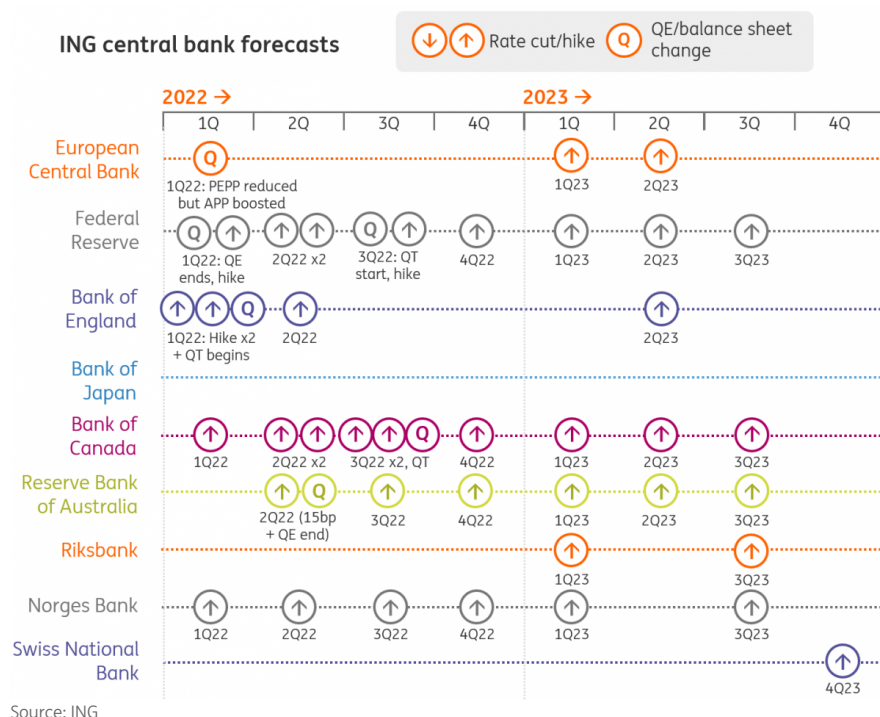
# Our guide to central banks and the race to hike rates

Several central banks have taken a decidedly more hawkish stance over the past couple of months. Our economists look at what's likely to come next



The ECB's Christine Lagarde and the Fed's Jerome Powell pictured in 2019

## Our central bank forecasts



## US Federal Reserve

Hawkish commentary from Fed Chair Jerome Powell following the January FOMC meeting suggests the central bank means business. With inflation at 7% and the labour market tightening far more quickly than officials expected, he didn't rule out raising rates at every FOMC meeting this year, arguing they have plenty of room to do so without hurting the jobs market.

The market is even pricing a chance of a 50bp move, although we don't think this is likely given the Omicron wave has heavily dampened activity and job creation at the start of 2022. Instead, they are set to raise rates 25bp at consecutive meetings in March, May and June, with a further two hikes in the second half of the year. They will also start running down their balance sheet (Quantitative Tightening) from 3Q and this is likely to do a lot of the heavy lifting for policy tightening. This means the eventual peak in the Fed funds target rate is likely to be closer to 2% than 3%.

## European Central Bank

Even if headline inflation stays at elevated levels for longer than expected, we see the ECB in no position to consider hiking interest rates any time soon. The drivers behind high inflation and higher inflation projections are still mainly driven by supply-side constraints and not by demand. In other words, tightening monetary policy would do little to ship containers faster from Asia to Europe or reduce energy prices. Consequently, the ECB needs to make a fine distinction between a dropping necessity to continue stimulating the economy and actually bringing higher inflation down.

With high inflation and inflation projections surrounded by high uncertainty, the eurozone economy back at its pre-crisis level, and labour shortages soon leading to higher wages, we expect



the ECB to accelerate tapering and eventually stop net asset purchases in September, keeping the door open for a rate hike, possibly even before the end of this year.

## Bank of England

The Bank of England has increased interest rates for the second consecutive meeting, amid ongoing concern about high headline inflation rates. In fact four-out-of-nine policymakers voted for an even faster, 50bp hike.

Clearly the Bank is keen to act pre-emptively, with inflation set to remain well above target this year. We expect another rate rise in March and May. The fact that the Bank has now begun quantitative tightening is unlikely to alter that timeline all that much.

However, if our rate hike forecast is roughly accurate, the BoE will also 'consider' actively selling gilts back to the market – and this could come before the summer. This is a process fraught with challenges, and we suspect if the Bank does ultimately do this, it will be in fairly low volumes. Nevertheless, this is uncharted territory, and we suspect at this point the Bank may pause on rate hikes to gauge the impact. We also suspect that by later this year, some of the current inflation concerns will have eased. That suggests the five hikes markets are pricing this year may well prove to be an overestimate.

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# Clogged supply chains won't hold back trade

Demand for consumer goods rose strongly last year despite the profound disruption to supply chains due to the pandemic. We expect goods world trade volumes to have increased by 10.6% in 2021. For 2022, global trade should not only normalise in 2022 but continue growing despite still challenging circumstances



California Governor, Gavin Newsom, inspects an overloaded port in California in November last year

## World trade normalises and continues to grow despite challenges

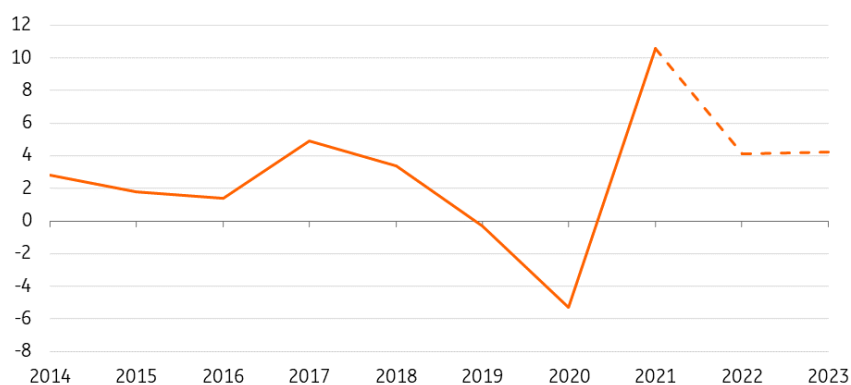
Going into 2022, we expect trade growth rates to return to their pre-pandemic levels in line with a continued but weakened global economic recovery. 2021 was an exceptional year driven by pandemic-related catch-up effects. For this year, we pencil in a growth rate in merchandise world trade of 4.1%, while we expect world GDP growth to come in at 4.4%.

Despite ongoing supply chain frictions and average containerised transport costs expected to remain high, a shift by consumers back into services will only be moderate in 2022 because of Covid caution. They might reduce some of their increased spending on the likes of electronics and furniture while resuming spending on services, while seeing higher energy and food prices. Overall,

however, the preference for goods remains elevated as recent data on consumer spending in the US or the eurozone shows.

## World trade in 2022: Return to pre-crisis growth rates

Global goods trade volume, %YoY



Source: CPB, ING estimates

## Asia to remain a driving force in 2022

Trade growth remains uneven, however, when you look at different regions. Intra-Asia trade still has strong growth perspectives, following an improvement in Asian industrial production over 2021 as well as significantly higher container throughput. A slowdown of economic activity in China, however, remains a concern for northeastern Asian industrial economies. Here, less real estate construction activity could be offset by more infrastructure investment though.

On a global level, we expect larger flows of oil and oil products alongside the global recovery of road and airline traffic and we think that [China should remain a major driver of growth for metals](#) stimulated by the energy transition. We expect global automotive production to [increase by up to 10%](#) and that will create extra trade volumes although the semiconductor shortage will remain a limiting factor. Lastly, the implementation of regional trade agreements in Asia and Africa will likely affect regional trade flows positively.

## Supply chain slump and elevated tariffs will drag through 2022

Yet, a combination of shipping capacity and container shortages, unforeseen incidents and ongoing labour shortfalls which contributed to spiking container rates last year, might dampen our growth outlook. And 2022 started off with new records here. Based on UNCTAD data, those costs pushed China to Europe port-to-port container costs up to some 15% of the average value of goods transported (up from 2-3%).

The effect of massive port congestion occupying 10-15% of the global fleet capacity feeds back to that disruption. After Chinese New Year we do expect things to improve. But when spot rates come down, term contract rates of large shippers are still being negotiated higher. We concluded earlier that container rates will [remain under upward pressure](#) and won't return to pre-pandemic levels anytime soon.

## Risks ahead but trade fundamentals are still solid

The pandemic remains an uncertain factor affecting the outlook for 2022. Supply chain troubles and higher shipping costs also continue to pose risks to growth. At the same time, last year also showed this doesn't necessarily hamper the world from continuing to trade. We're optimistic given the economic outlook, a hopefully receding pandemic, and clear evidence of richly filled order books. We expect trade volume growth to hold up well this year, resulting in a more moderate but still sound growth rate for world trade.

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## The Mattarella-Draghi ticket provides short-term government stability

The re-election of President Sergio Mattarella, a solution of last resort, should help to secure government stability until the end of the legislature period. Prime minister Mario Draghi will likely try to maximise efforts to deliver on the recovery plan, and play an active role in the reform of the stability pact



Italian President Sergio Mattarella has agreed to serve a second term

### Mattarella re-elected to preserve institutional stability

Last year, when looking at possible risky events for 2022, we singled out the Italian presidential election, due to the fact that this would happen when the implementation of the recovery plan would still be at a very early stage and that any relevant discontinuity would risk slowing the process.

Uncertainty was accentuated by President Sergio Mattarella's clear hints about his unwillingness to run for a second term, which he deemed an institutional overstretch. Still, with a national unity government in office, it seemed quite possible for political leaders to reach an agreement on a non-divisive candidate. The reality turned out to be more complicated than that. Political leaders approached the contest positioning themselves according to a centre-right vs centre-left division, and some of them did not manage to set the election in the right context. After a false start and

cross vetoing, the electoral process resumed only after centre-right parties failed to impose as the winning candidate the speaker of the Senate, who fell victim to internal filibustering. The futile and confused attempts which followed ultimately highlighted that the only solution to preserve institutional stability was to re-elect outgoing President Mattarella, who accepted the position out of a sense of duty and responsibility.

## **The Mattarella/Draghi ticket should help secure government stability**

In our view, the re-election of Mattarella, with Mario Draghi as prime minister, remains the outcome best suited to secure continuity in the government action for the rest of the legislature (due to end in Spring 2023). To be sure, political troubles within the League and the 5 Star Movement (5SM), damaged by the poor management of the presidential election week, might occasionally reverberate on the government. However, we believe that the risk of severe incidents or protracted tactical filibustering is lower now than a month ago.

## **Expect an acceleration on the recovery plan front and a gradual normalisation of fiscal policy**

PM Draghi, fully backed by Mattarella, will likely push to speed up the implementation of the recovery plan, pressed by the long list of targets and milestones (102 between them) to be met this year to get the 2022 European funding. Showing that Italy can deliver would also have a positive side effect: it would give Draghi extra credibility capital at the negotiation table for the upcoming review of the Stability and Growth Pact. With that in mind, any evidence that Italy is fully aware that the time for limitless fiscal expansion is coming to an end would clearly help.

Still, rising cross-party calls on the parliament to authorise ample pre-emptive extra deficits to compensate businesses and households for the impact of higher energy prices, suggest that such a normalisation in fiscal policy might not be frictionless. So far finance minister Daniele Franco has managed to resist pressures, preferring a gradual approach, which will be difficult to defend should the energy inflation rally continue unabated.

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Article | 4 February 2022

## The stars are aligning for a eurozone wage growth rebound

Labour shortages, high inflation, increased minimum wages: 2022 is set for a decent recovery in nominal wage growth. For the European Central Bank, this will add to medium-term inflation pressures, likely serving as a key argument for a first rate hike in early 2023



The placard reads 'Increase salaries 400 euros per month' at a demonstration in Paris last month

Everyone in Frankfurt and well beyond is looking at the labour market to see whether second-round effects of the current inflation shock are already visible in the data. We don't yet see evidence of that as the ECB's index for negotiated wages actually reached its lowest wage growth figure in decades in the third quarter of last year (1.3% YoY). However, if the labour market is a lagging indicator, wage developments are the *mother* of all lagging indicators. Looking ahead, we expect wage growth to significantly accelerate in 2022 and 2023 to around 3 ½% as most important wage growth drivers point to a sharp increase.

### Labour shortages continue to rise

The past few months have seen rapid declines in unemployment, much more so than expected. The economy recovered more quickly than expected, which resulted in a stronger-than-expected labour market rebound. Furlough schemes – key for keeping unemployment relatively low in 2020

– saw a sharp decline in take-up in 2021, even though global supply chain frictions led to renewed demands for furlough schemes in the manufacturing sector. Risk scenarios of a significant increase in structural unemployment have luckily not materialised and we now expect unemployment to continue its downward trend in the coming year as employers' hiring expectations remain very strong for the beginning of 2022.

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### *Labour shortages are set to remain a dominant economic theme of 2022*

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At the end of last year, we wrote in-depth on labour shortages emerging and since then, new data shows that the labour market has tightened further. Vacancy rates are now higher than before the pandemic, while businesses have already indicated for a longer period that worker availability has never been so problematic for their production as we see now. In the eurozone, there are still fewer people active than before the crisis, which means that there is still some slack on the labour market fringes that could help cushion the problems to a degree unless people dropped out of the labour force for good. In any case, it looks as if labour shortages are set to remain a dominant economic theme of 2022.

The relationship between wage growth and unemployment has weakened over the past decade, resulting in a flare-up of the debate about whether the relationship between unemployment and inflation – the Phillips curve – is dead. It looks as if at least the relationship between unemployment and wage growth is still alive, but with a year lag and flatter than seen before. In layman's terms, it's taking longer for wage growth to emerge from low unemployment and it leads to less wage growth as well.

It's important to note that the past decade has seen lacklustre employment developments and mild shortages. Now that labour market tightness has become more pressing, it seems logical that this will have more impact on wage growth once again. Look back at 2019 for example, when shortages also resulted in a modest run-up in wage growth, which was halted by the pandemic. It is possible that with labour shortages back to pre-pandemic levels, wage growth will pick up where it started in 2019.

## **Inflation empowers union demands**

It's not just labour shortages that would point to higher wage growth though. Another key driver in the eurozone is inflation, especially since wage setting in the eurozone is predominantly done through collective bargaining agreements and inflation is an important input used in these negotiations. Purchasing power is currently being squeezed by inflation at its highest level since the 1980s and eurozone negotiated wages closely follow inflation developments historically.

In some countries, like Belgium and France for example, inflation has a direct impact on wage growth through indexation. Other countries see inflation passed through via higher union demands that result, in turn, in better negotiation outcomes for workers. In the past, unions have either used actual inflation rates or the ECB's medium-term inflation target in the bargaining process. Both used to be very close to each other. In the current bargaining rounds, expectations are that current inflation rates and the loss of purchasing power will play a more important role than in the past.



Labour market shortages are likely to add to unions' bargaining powers and make positions preferring job security over higher wages less likely.

Overall, the relevance of wage settlements depends on how much of a country's employment is covered by collective bargaining agreement, and in the eurozone, that's a lot. Also, collective bargaining agreements, centralised or decentralised, have a strong signalling effect on private-sector wage agreements. This results in a strong relationship between overall wage growth and 'negotiated' wage growth.

For the eurozone, we find the correlation between negotiated wages and inflation to be the strongest with a two quarters' lead for inflation. This means that wage growth historically trails inflation by about half a year.

## Corporate profits have been strong, allowing for wage growth

Besides factors like labour shortages and purchasing power maintenance, another important driver of wage growth in the eurozone is whether businesses can *afford* any salary increases. If corporate profits have weakened, stronger wage growth can be expected. However, healthy corporate profits should increase the likelihood of wage increases, sharing corporate profits with employees. The relationship historically shows a lag of some five quarters. Right now, corporate profits have shown a particularly strong rebound since the reopening of economies in mid-2020, suggesting ample room for higher labour compensation over the course of 2022.

## Minimum wage increases have been generous this year

Another important factor contributing to higher wage growth in 2022 is the sizeable increase in minimum wages in several countries. Germany is the most notable, with an expected increase to 12 euros per hour promised by the new coalition (an almost 30% increase). Other countries also see minimum wages increase, think of Portugal with a rise of 6%, and France and Belgium corrected for inflation, which will result in a sizeable jump. The Netherlands has also agreed to increase the minimum wage by 7.5% but will do so in steps throughout the government's term. The impact of higher minimum wages works through to the average of course, also because it generally impacts wage categories above the minimum as well.

## Wage growth to accelerate to 3% and more

A simple empirical model that has performed well historically would suggest nominal wage growth to recover to about 3-3.5% over the course of 2022, but relationships in economics are rarely mechanical. We have to keep in mind that Germany has a relatively small amount of wage negotiations coming up, which dampens the growth in negotiated wages. Also, a key question is whether unions – whose positions have weakened over recent decades – can convert the better negotiation positions into higher wage growth. On the other hand, overall wage growth in sectors without collective bargaining seems to already be outpacing negotiated wages significantly in some eurozone markets but data on this is severely distorted at the moment due to compositional effects in the labour cost index data. Overall, we think that wage growth of around 3% seems like a fair number to rebound to, possibly over the next two years.

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*The relationship between unemployment and inflation is*

## *becoming more significant*

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So, is the Phillips curve alive and kicking then? It seems so, although it looks like it needed supply shock therapy to be revived. The current high inflation is of course hardly a result of low unemployment, but will in turn feed through to the wage growth channel which in turn boosts medium-term inflation estimates. It's very early days, but it looks like the relationship between unemployment and inflation is becoming more significant again.

For the ECB, this will be an important argument for a rate hike in early 2023. For the current inflation spike, policy is not so relevant. The ECB can hardly fill gas reserves or add to the container shortage. What it can do is act on cyclical developments that look favourable, with an economy recovering quicker than expected and wage growth which is set to rebound this year. With inflation expectations of around 2%, Lagarde will have the luxury that Draghi never had: hiking interest rates.

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