Investment Clock – Economic Update

Issue #24, January 2022

Multi asset views from RLAM

Royal London Asset Management manages £158.7 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 30 September 2021

This month's contributor

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US: Likely further fiscal stimulus alongside strong cash balances should support growth. Inflation risks are heightened versus the Euro area. Three rate rises now expected in 2022.

China: China's zero tolerance approach to Covid brings risks of repeat waves of social distancing measures. Macro policy is likely to become more accommodative.

Eurozone: Beyond near-term challenges, relatively robust growth is expected on average in 2022, but softer real consumer spending growth.

Japan: A strong vaccine programme and more fiscal spending have improved prospects post-omicron.

UK: Omicron is set to dent the economy near-term. Tighter macro policy, high inflation and weak real income growth leave the outlook weaker than expected.

Please visit investmentclock for our blog and information about our multi asset range.

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Challenges build

Slower and more 'normal' quarter-on-quarter rates of growth look likely over much of 2022. Omicron looks set to dent but not derail the recovery in early 2022. Fiscal policy is less supportive, monetary policy is on a tightening path and households are seeing a hit to real wage growth given still high rates of inflation. Healthy aggregate household and company balance sheets will help though, and significant vaccination coverage in developed economies should keep economies on a smoother (and less inflationary) track as the year goes on. Inflation is expected to fall in 2022, but to higher lows than expected before.

Summary

Omicron dents, rather than derails recovery: Omicron's high transmission rates have seen tighter rather than looser social distancing restrictions over the turn of the year, but high vaccine coverage should help mean an even milder dent to the economy than in early 2021. However, with less fiscal support in place and much of the offsetting adjustment having taken place last year (e.g. purchases of new IT equipment to enable working from home), the effect on GDP growth could still be significant.

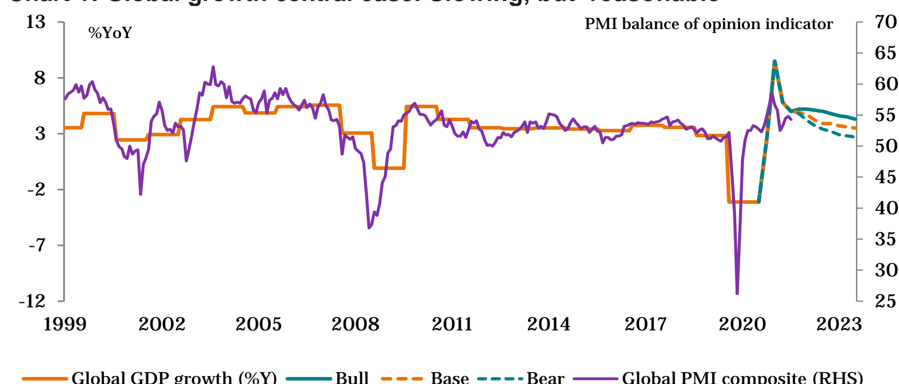
Shortage issues linger: Supply chain issues have been showing some signs of easing at the margin, though Omicron seems likely to extend them somewhat. Labour shortages remain a feature in many places and seem at least part-driven by factors likely to persist (e.g. early retirement). As Covid fades as a driver of consumer behaviour (given vaccine and booster rollouts) and policy adjusts, many labour shortage and supply chain issues seem likely to ease, however.

A touch more worried on inflation: Inflation is already stronger and lingering at high levels for longer than expected. *Underlying* inflationary pressures are likely to grow and inflation expectations have risen. Sustained high inflation would likely see central banks tighten much more aggressively than in the base case – potentially leading to a sharp economic slowdown. The forecasts still assume that inflation cools over 2022 into 2023, but the projections are higher than previously. Risks to the forecast are two-way though.

Growth challenges: Current high inflation poses challenges for the recovery. Pay growth isn't keeping up and household real income growth has slumped. Some economies have scope for lower savings rates to prop up consumer spending and some households may dip into stocks of excess savings but the case for consumption-driven outperformance has faded. Meanwhile, the policy backdrop is becoming even less accommodative and rate rises are likely in the US and UK, among others, in coming months.

Our multi asset team hold a modest overweight in stocks, which continue to face two-way risk but are more attractive than negative real yielding assets such as government bonds. Equities can grind higher but fears of policy tightening, or negative virus developments could see markets pull back. The team are slightly overweight commodities, given positive global growth prospects, and neutral on property.

Chart 1: Global growth central case: Slowing, but 'reasonable'



Source: IMF, IHS Markit, RLAM forecasts, January 2022.

Economic forecast summary

Chart 1: January 2022 base case

Region	2020 GDP growth	2020 CPI end Q4	2020 Policy Rate Q4	2021 GDP growth	2021 CPI end Q4	2021 Policy Rate Q4	2022 GDP growth	2022 CPI end Q4	2022 Policy Rate Q4	2023 GDP growth	2023 CPI end Q4	2023 Policy Rate Q4
US	-3.4	1.3	0.25	5.6	6.5	0.25	4.1	2.9	1.00	2.7	2.8	1.50
	(-3.4)	(1.3)	(0.25)	(6.0)	(5.1)	(0.25)	(4.0)	(2.2)	(0.25)	(2.6)	(2.4)	(0.75)
China	2.3	0.1	–	8.5	2.4	–	5.1	1.9	–	5.1	–	–
	(2.3)	(0.1)	–	(8.9)	(2.4)	–	(5.3)	(1.9)	–	(5.1)	–	–
UK	-9.4	0.5	0.10	7.2	4.8	0.25	3.9	3.4	0.75	1.6	2.1	1.00
	(-9.8)	(0.5)	(0.10)	(6.7)	(3.3)	(0.10)	(4.8)	(2.1)	(0.10)	(1.6)	(2.0)	(0.50)
Euro area	-6.5	-0.3	0.0	5.2	4.6	0.0	3.5	1.8	0.0	2.0	1.6	0.25
	(-6.5)	(-0.3)	(0.00)	(4.7)	(3.0)	(0.0)	(3.7)	(1.4)	(0.0)	(1.9)	(1.5)	(0.0)
Japan	-4.5	-0.9	-0.1	1.4	0.5	-0.1	2.1	0.6	-0.1	1.3	0.3	-0.1
	(-4.7)	(-0.9)	(-0.1)	(2.5)	(0.8)	(-0.1)	(2.6)	(0.5)	(-0.1)	(0.9)	(0.3)	(-0.1)
Global	-3.1	–	–	5.8	–	–	4.3	–	–	3.8	–	–
	(-3.3)	–	–	(6.0)	–	–	(4.5)	–	–	(3.7)	–	–

Source: National Statistics offices, RLAM forecasts; October 2021 estimates in brackets. US policy rate shows upper bound of US Federal Reserve (Fed) Funds target range. Euro area shows refi rate

Key economic policy forecasts

- With many economies regaining or close to regaining pre-crisis output levels, and with inflation well above target in many cases – monetary policy tightens in 2022.
- The forecasts assume that the US Federal Reserve (Fed) will raise rates in 2022, ahead of the ECB (2023). Although rate rises will be somewhat front loaded in the US and UK. No developed economy central banks are assumed to raise rates very rapidly.
- The forecasts assume that asset purchase programmes end within the first quarter of 2022 in the US, while continuing for longer at the ECB via the Asset Purchase Programme (APP) rather than the Pandemic Emergency Purchase Programme (PEPP).
- Fiscal support remains less supportive with Covid crisis-related programmes and funding having been, or being, wound up. However, sharp non-Covid related spending cuts are not in the central case, partly as spending to tackle longer-term challenges (e.g. climate change) steps up.

Global economic scenarios 2021-23 (Chart 1)

Upside scenario (20% probability): Consumption-fuelled boom; 'Goldilocks' outcome for inflation

- Compared to the base case, consumer spending accelerates as households rapidly reduce savings rates and spend savings built up over the crisis.
- Policymakers remain cautious, however, and do not start removing stimulus much earlier than in the base case.
- Inflation is only slightly higher than in the base case as growth runs above potential. A faster and more effective easing of supply chain problems and higher productivity growth help to contain inflationary pressure.

Base case (60%): Reasonable growth, slower inflation

- Omicron dents growth in early 2022. However, the second half of 2022 and into early 2023 is expected to see reasonable – albeit more 'normal'– rates of economic growth in major economies. That recovery is supported by a pick-up in fixed investment. Consumer spending disappoints in 2022 given high energy costs and slower real income growth.
- Inflation falls in 2022. However, by the end of the forecast horizon it is still somewhat higher than central banks are comfortable with in the US and UK. Underlying inflationary pressure rises as the output gap closes. Labour market shortage and supply chain issues linger in H1 2022.
- Fiscal policy remains less supportive, though the forecasts assume that a reduced multi-year US fiscal package is passed in Q1. Non-Covid public spending is not cut sharply over the coming twelve months.

Downside scenario (20%): High inflation leads to central bank panic

- Central banks tighten monetary policy much faster than in the base case as inflation remains stubbornly high and inflation expectations rise further. Consumer spending and business investment growth are weaker than in the base case on tighter monetary policy and slower real income growth.
- Government support remains similar to the base case, leaving overall policy settings tighter than in the base case.
- Inflation stays above central bank targets and supply chain problems recur.

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.

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Global economy: Supply chains bite

Covid is still holding back the recovery and Omicron has emerged as the latest threat to demand growth, but as vaccine protection has risen in developing economies, the economic threat from covid is as much about ongoing disruption to supply capacity as demand. Not all supply problems are related to Covid though and it seems reasonable to assume that they will be with us much longer than expected. There are benign and more disruptive ways for this situation to be resolved. The central case assumes a benign path where inflation falls significantly in 2022. An inflation driven 'bust' – where inflation expectations de-anchor and panicked central banks tighten too late and too sharply – is an increased risk. Central banks modestly tightening policy sooner rather than later could help lessen the risk of that scenario, but risks damaging a recovery that looks increasingly challenged by supply problems, high inflation and recurring covid outbreaks – all alongside less supportive fiscal policy.

Recovery challenged

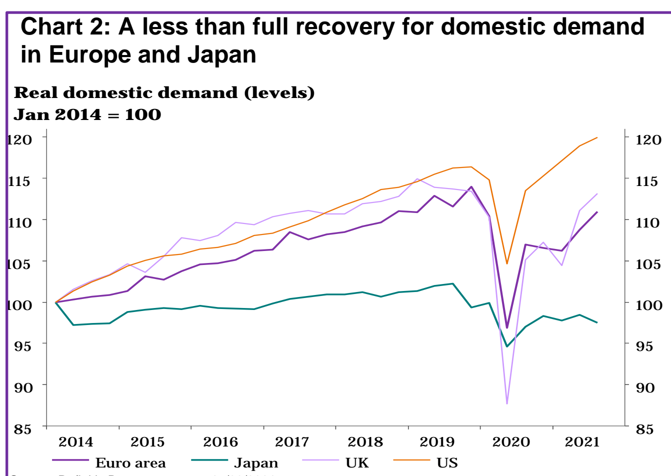
Global growth slowed over the summer, some of which was as expected. In the UK, for example, growth couldn't continue at the kind of rates we saw once lockdowns ended. Now growth looks likely to have slowed again, with Covid still holding back supply and with Omicron affecting demand growth in the near-term. The global PMI composite has dipped (Chart 1) and the narrative of output being held back by supply issues remains widespread.

Supply chain problems and labour market shortages are increasingly holding back the recovery before domestic demand has fully recovered (Chart 2) and adding inflationary pressure in a way more usually associated with being at the late stages of a business cycle recovery (before policy tightens and a downturn follows). Supply constraints are biting – whether staffing problems, hiring problems, transportation bottlenecks or shortages of some inputs. Survey measures capturing supply chain issues seem to have only eased marginally (Chart 3) and high inflation rates are common across economies.

As higher costs get passed on, household real incomes are coming under pressure. Households are increasingly experiencing something of a cost-of-living shock as inflation reaches high levels. In *aggregate*, post-pandemic savings can help shield consumers as will higher wages for some, but not all. There was evidence that it was wealthier households in the US and UK who'd built up the biggest savings stocks; wage gains are uneven by sector. Fiscal policy has also become less supportive for households and fiscal tightening looks set to pick up in 2022 in developed economies according to the latest analysis from the IMF (Chart 4). Higher interest rates may also weigh on household demand more as 2022 progresses.

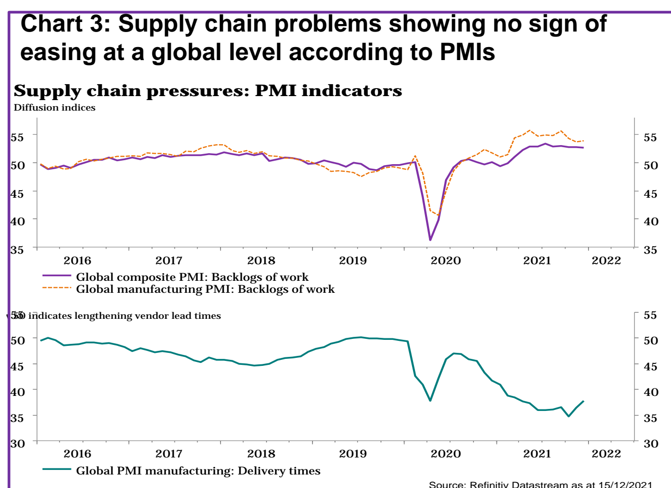
The latest batch of business surveys over the past two or three weeks still suggests that the recovery in the US and Europe is pretty robust, but that growth across most economies is slower than it was in the middle of the year. Looking across the PMIs suggests activity growth is relatively soft in China and Japan; is slowing in the Euro area (though national surveys paint a more upbeat picture) and UK; and is flattish in the US (Chart 5).

Chart 2: A less than full recovery for domestic demand in Europe and Japan



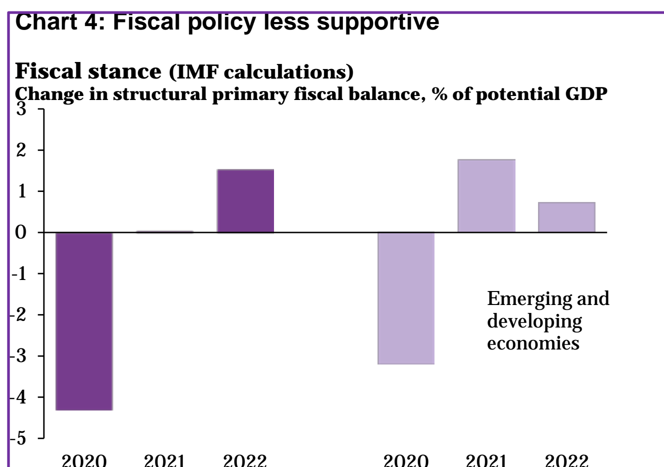
Source: Refinitiv Datastream, Eurostat, Cabinet Office (Japan), ONS, BEA. Data to Q3 2021.

Chart 3: Supply chain problems showing no sign of easing at a global level according to PMIs



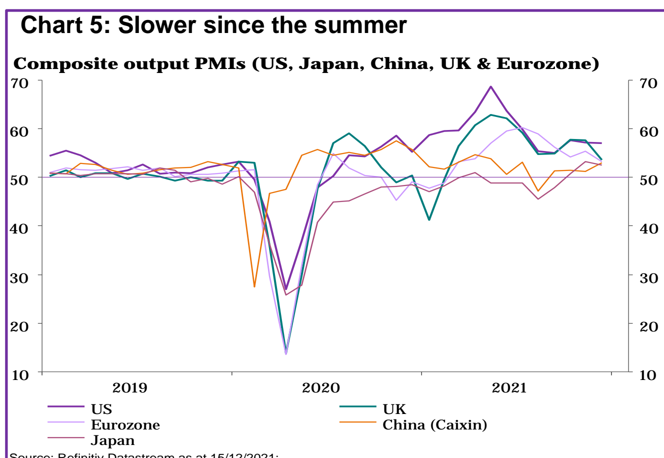
Source: Refinitiv Datastream, IHS Markit as at 15/12/2021.

Chart 4: Fiscal policy less supportive



Source: IMF October 2021 World Economic Outlook.

Chart 5: Slower since the summer



Source: Refinitiv Datastream, IHS Markit as at 15/12/2021.

Central case: Benign resolution

The forecasts on page 2 still envisage reasonable growth rates in 2022, normalising around pre-pandemic norms over 2022. Successful vaccine rollouts across developed economies (Chart 6) help limit lockdowns and gradually return more and more economies to normal patterns of economic activity, alleviating supply chain problems and labour shortages and easing inflationary pressure. High levels of household and corporate cash deposits help shield households and firms – in aggregate – from the pressure of rising costs while, in the case of firms, helping facilitate investment in greener, more energy and labour efficient technologies and processes. Indicators of business investment intentions remain strong for now (Charts 13, 29 and 35). However, the 2022 forecasts for growth are lower than in the September forecasts, reflecting the impact of higher energy prices and continued supply chain disruption in the second half of 2021. Against that backdrop, central banks raise rates gradually, but more than previously expected over 2022 given tighter than expected labour markets and higher inflation expectations.

Beyond Omicron, not so transitory supply shortages are one of the main threats to benign central case

Supply problems threaten to further reduce growth forecasts, raise inflation forecasts and bring forward central bank monetary policy tightening.

Drag on growth, boost to inflation: Supply chain issues (illustrated in Chart 3) are a drag on output and business optimism. Strongly affected areas of the global economy include transport/logistics and the autos sector, but the impact from input shortages, shipment delays and a related rise in costs is being felt broadly. In the short-term, things may get worse rather than better with the advance of Omicron. However, PMI indicators suggest that stocks of purchases have been rising faster than stocks of finished goods and orders (Chart 7), presumably reflecting firms trying to mitigate supply chain problems by holding larger inventories of inputs and likely making supply chain problems worse in the meantime. However, at some point those inventories will be large enough, at which point supply chain pressures should ease more markedly. Supply problems haven't just been about goods and raw materials though. Business survey measures of labour market tightness have been worsening across several economies (Chart 8).

Covid still has to take a large part of the blame: A large chunk of these problems can still be linked to Covid. Covid has brought huge movements in demand and supply that have not been in synch with each other or in synch across different economies. On the latter, not only have Covid outbreaks hit different countries at different times, but the tolerance of countries to Covid outbreaks still differs dramatically. China, lynchpin of global supply chains, maintains a zero-tolerance approach to covid; even small outbreaks in China have the chance of becoming relatively disruptive. Pre-pandemic supply of goods and staffing patterns were arguably designed to be agile and responsive to shifts in demand, whether via just-in-time manufacturing, fast fashion and zero hours contracts. However, changes in demand for certain products were huge over the pandemic and changes in supply have been forced rather than in response to demand (e.g. as staff have had to self-isolate or whole factories shut).

Likely to get worse before better? Omicron may extend supply chain problems for longer. Many companies will not have sufficient inventories and forward contracts to protect their businesses from continued large increases in input costs. If operating margins are crushed in some companies critical to supply chains (e.g. in the transport and logistics sectors) leading some to cease operating, that could worsen supply chain problems further. That could especially be the case as fiscal policy becomes less supportive (see below) and if monetary policy is tightened in response to supply-driven inflation pressure potentially leading to a much less favourable credit backdrop.

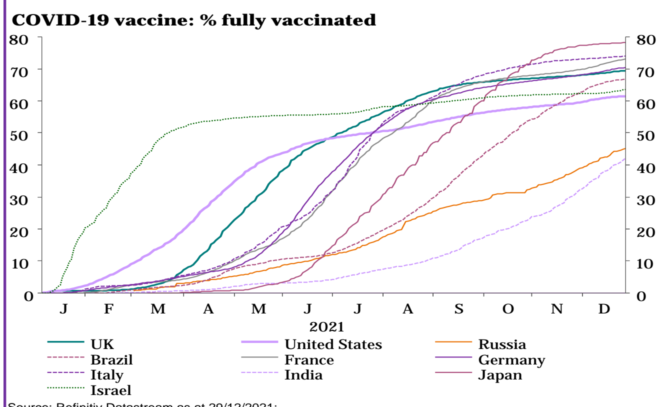
Less transitory, rather than permanent: The forecasts on page 2 don't assume that these problems are permanent. But do assume they linger well into 2022 while capacity adjusts and until Covid disruption fades further (on vaccine programmes, in combination with better medical treatments).

Fiscal policy: Less of a support

IMF data suggests that the fiscal stance is becoming much less supportive for the global economy. In 2022 that particularly applies to developed economies (Chart 4). The 2020/21 stimulus was too large to be sustainable and much of the support was *designed* to be temporary. The UK's furlough scheme has ended, while US stimulus cheques for households were a series of one-offs. On those IMF estimates, the change in structural primary fiscal balance (a proxy for the change in fiscal stance) is set to move from 0% to 1.5% GDP of tightening in advanced economies.

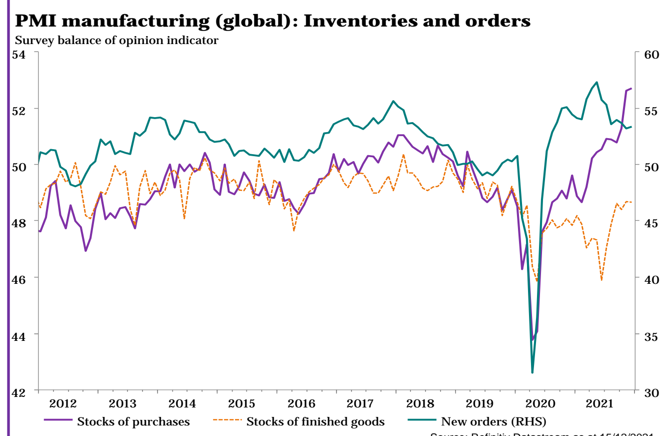
Fiscal policy set to drag more in some economies than others though. The US finally passed their long-awaited infrastructure bill and the forecasts still assume that a reduced form of the Build Back Better bill will pass too, though the impact of these packages will be felt over several years. The annual trajectory for fiscal policy is set to be much flatter than in the UK for example. The EU's 'Next Generation' fiscal programme is in the disbursals stage. However, the implications for different EU economies are diverse. The European Commission's forecasts imply that the overall Euro area fiscal stance will tighten over 2022 (Chart 39). The UK, meanwhile, is still planning a significant tightening in fiscal stance (Chart 51), despite the UK's October Budget being net stimulative. In general, a 'plunge into austerity' is not expected in developed economies, but some countries are preparing to rein in finances more than others.

Chart 6: UK, Euro area and Japanese populations have very high levels of vaccine coverage



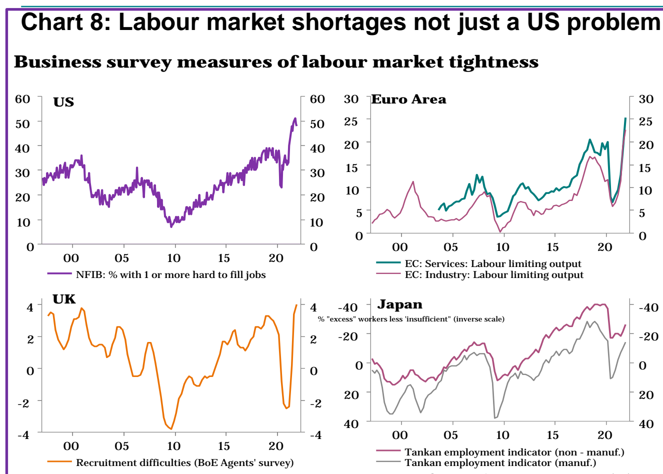
Source: Refinitiv Datastream, IHS Markit as of 29/12/2021

Chart 7: Supply chain problems increasingly driven by raw material stockpiling?



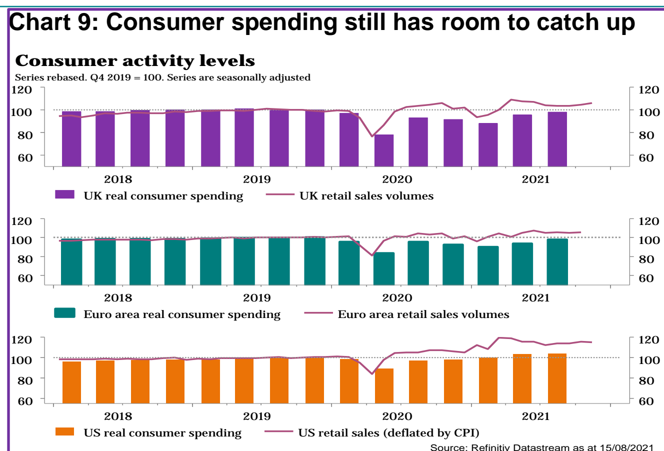
Source: Refinitiv Datastream, IHS/Markit as at 15/12/2021

Chart 8: Labour market shortages not just a US problem



Source: Refinitiv Datastream, NFIB, European Commission, BoE, BoJ as of 15/11/2021

Chart 9: Consumer spending still has room to catch up



Source: Refinitiv Datastream, ONS, US Census Bureau, BEA, BLS, Eurostat, ONS. Retail sales is to October in the US and UK, September in the Euro area, consumer spending to Q3.

Consumers and corporates: Less fuel in the tank?

We've already seen a strong consumer spending recovery as economies have opened up. However, as of Q3 at least, overall real levels of consumer spending were still a little below even pre-pandemic levels in the Euro area and UK, leaving more scope for 'catch-up' growth than in the US (Chart 9). Although retail sales grew strongly in the post-lockdown period, services have not fully caught up; overall consumer behaviour is still not quite back to pre-pandemic norms.

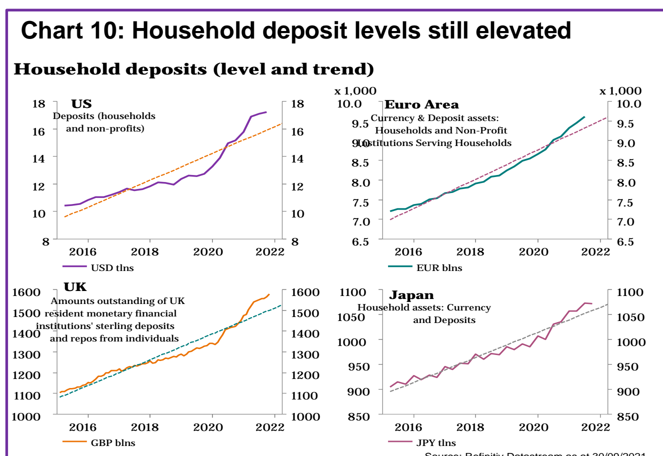
Plenty of theoretical fuel in the tank, but will consumers use it? Household bank deposits climbed substantially over the crisis and remain at elevated levels (Chart 10). Household saving rates are also still above pre-pandemic norms (Chart 11). Therefore, without even needing to dip into savings, households could fuel stronger real spending by spending a higher proportion of their incomes. However, if consumer price inflation runs ahead of wage inflation, we could see falling saving rates without any change in the volume of goods and services purchased. In the US, saving rates have already returned close to pre-pandemic levels, suggesting less remaining fuel for stronger consumer spending growth than in Europe. As explored in previous quarterly updates, consumers may also prove reluctant to dip into deposits or even save less month-to-month if their attitude to risk post-pandemic has changed.

In the meantime, challenges for consumers have grown: Higher energy prices, alongside generally higher levels of consumer price inflation pose challenges for real consumer spending prospects. Despite apparent labour shortages, *real* wage growth looks soft (Chart 12). Wage growth figures have been somewhat skewed over the past year or so by government involvement in the labour market and by mix effects where the balance of low and high paid workers in employment has changed. Wage figures should be cleaner by now though and they point to relatively strong *nominal* wage growth in response to labour shortages. However, not only is inflation high, but wage gains may be unevenly spread by sector and skewed more towards new employees (there is evidence of this in the UK, for example).

Business investment – room for improvement: The forecasts on page 2 still assume robust business investment growth in 2022, but non-residential/business investment is an area that seems to be lagging behind in the recovery outside the US (Chart 14). that points to scope for business investment to be a significant driver of growth in coming quarters. Investment indicators look strong (Chart 13). Aggregate cash levels are still high and borrowing costs low. There are also significant incentives to invest more, including low carbon transition and a likely desire to be less reliant on labour post-pandemic as well as a possibly growing desire to simplify supply chains and perhaps bring some stages of production in-house given supply chain problems in this recovery.

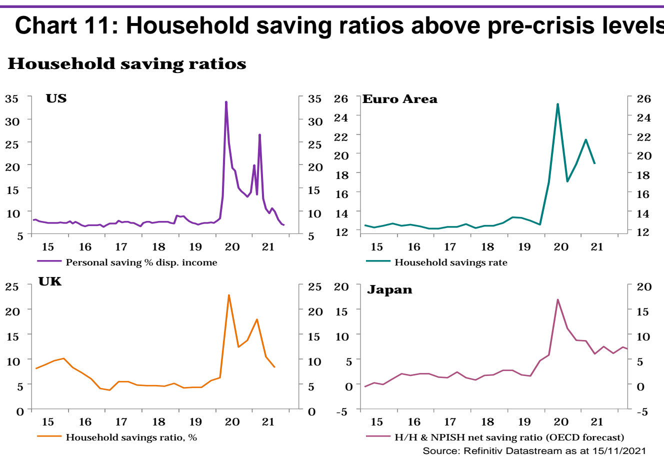
As with households, however, it is likely that the build in corporate cash is uneven. Challenges to the investment outlook are arguably rising too with margins squeezed by high input costs and where not all companies will be able to pass those costs on to end-customers; business confidence in the outlook has faded somewhat (Chart 15). Considering revealed supply chain strains, some companies may also decide to run with permanently higher inventory inventories, diverting resources.

Chart 10: Household deposit levels still elevated



Source: ECB, BoJ, Federal Reserve, BoE, Refinitive Datastream. Data as of Q3 2021

Chart 11: Household saving ratios above pre-crisis levels



Source: BEA, Eurostat, ONS, OECD, Refinitiv Datastream, as at Q2 2021 (Euro area), UK (Q3), November 2021 for US. Forecasts included for Japan

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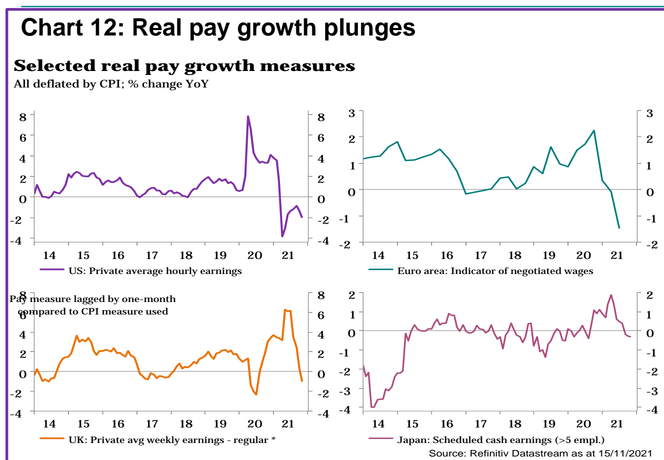
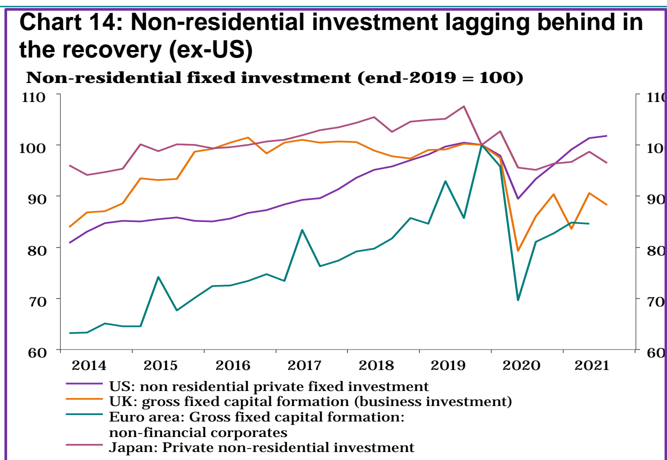
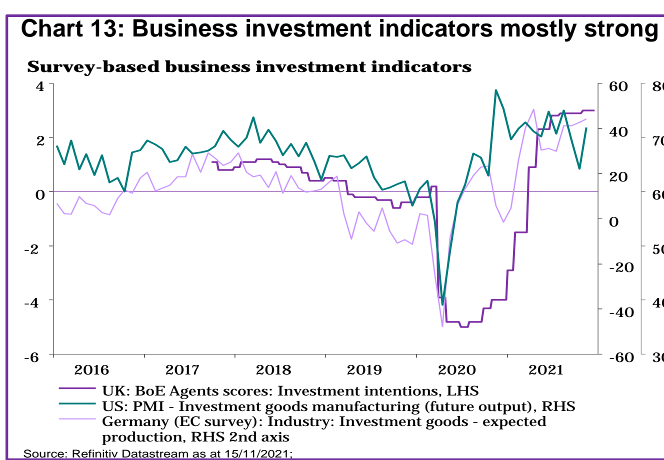


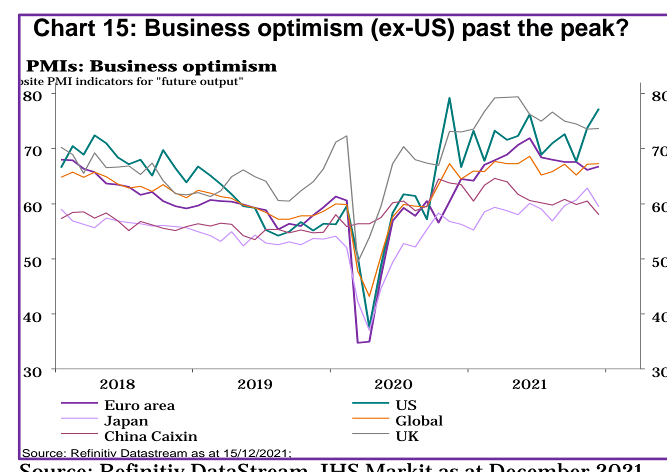
Source: Refinitiv DataStream, BLS, ECB, Eurostat, ONS, Japan's Ministry of Health, Labour and Welfare, Japan's Ministry of Internal Affairs & communication. Data to November 2021



Source: Refinitiv DataStream, BEA, ONS, Eurostat, Cabinet Office. Data for Q3.



Source: Refinitiv DataStream, Bank of England, IHS Markit, European Commission. Data as at November 2021.

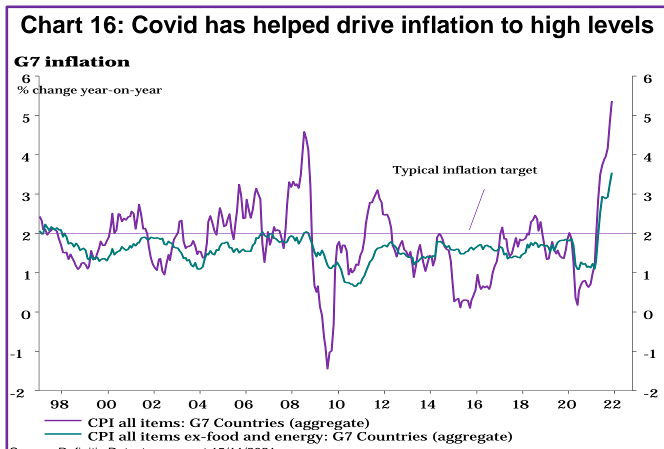


Source: Refinitiv DataStream, IHS Markit as at December 2021

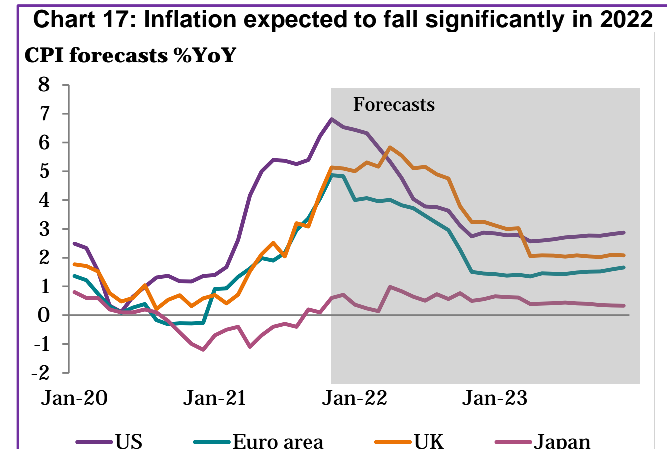
Inflation: Transitory, sure, but much higher inflation in the meantime…and just how transitory is transitory?

From transitory to lingering? Inflation has been driven to high levels (Chart 16), much of which can still be linked to Covid in one way or another, whether energy price base effects, re-opening effects (sectors suffering in the pandemic, later increasing prices), or supply chain problems. The CPI forecasts on page 2 have been raised since September, but still assume inflation fades (Chart 17). However, the longer inflation stays at high levels, the more likely inflation expectations will de-anchor and the more likely that higher costs are passed onto customers and that wages follow prices higher.

Supply chain stresses have become a significant driver of price pressure: Car prices emerged early as one area of pass-through of supply chain problems to final consumer prices, the shortage of semi-conductor chips affecting the availability of new cars and boosting prices for second-hand cars. Since then, more consumer facing companies have reported the need to pass higher input prices and the cost of supply chain problems onto end-consumers. Business survey measures of both input *and* output prices have duly hit record highs. Although the relationship between business survey input price measures in manufacturing and end-consumer goods prices doesn't appear too unusual in the UK and US, in the Euro area the data is consistent with businesses having a higher than usual willingness/ability to pass cost increases on (Chart 18). Risks to inflation are two-way from supply

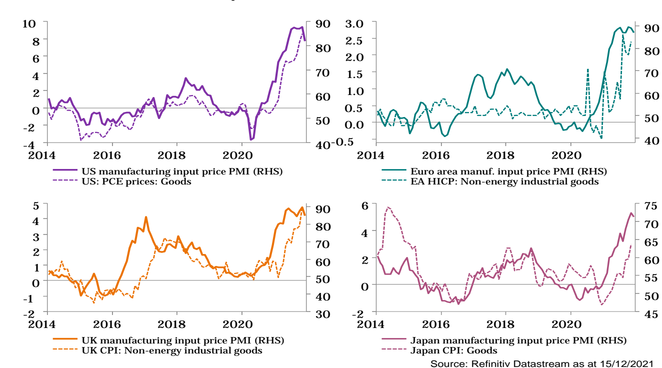


Source: Refinitiv Datastream, OECD as at 15/11/2021.



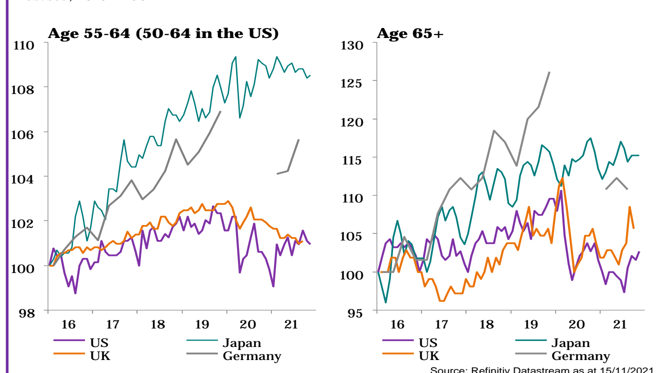
Source: Refinitiv Datastream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2.

Chart 18: Higher input prices being passed on quickly and, in some cases, more strongly than in the past



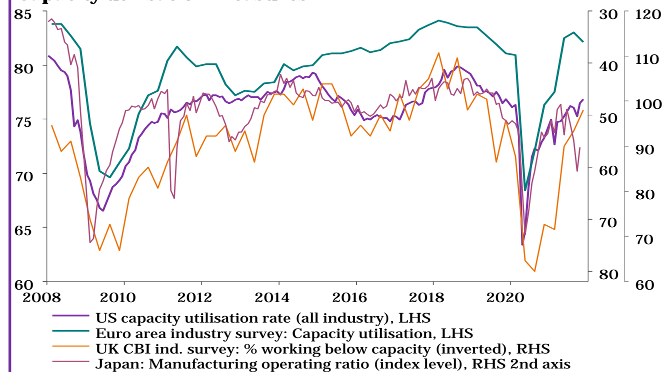
Source: Refinitiv Datastream, IHS Markit, BEA, Eurostat, ONS, as at 15/12/2021.

Chart 20: Drop in labour market participation of older age groups could be lasting



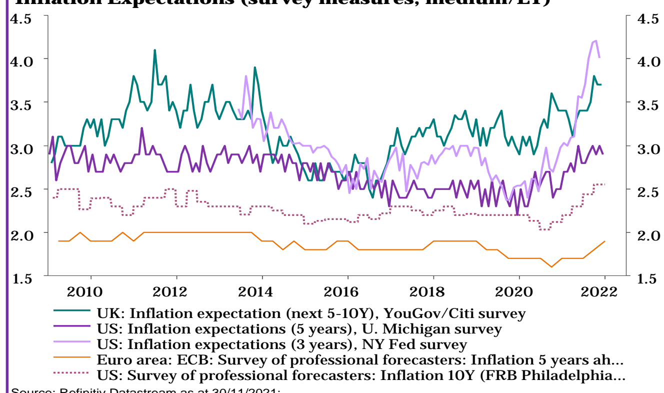
Source: Refinitiv Datastream, BLS, ONS, Ministry of Internal Affairs and Communications (Japan) and Eurostat as at 15/11/2021.

Chart 19: Despite current price pressures, capacity utilisation measures are not at extremes



Source: Refinitiv Datastream, Federal Reserve, European Commission, CBI, METI as at 15/11/2021.

Chart 21: Inflation expectations still trending up



Source: Refinitiv Datastream, YouGov/Citi, University of Michigan, FRB Philadelphia/New York, ECB as at November 2021.

chain issues at this point, however. There are already tentative signs in the data of supply chain issues easing. Falls in input costs could mean that inflation actually undershoots expectations over 2022.

Underlying inflationary pressures are likely to grow over the next year or so, even as Covid-driven inflation fades. Underlying inflation can be expected to build as slack in the economy recedes on a more sustainable basis. Overall GDP was still below pre-pandemic levels in the UK, Euro area and Japan in Q3 and, surprisingly, overall industrial capacity utilisation measures are not at extreme levels (Chart 19). Further economic growth, as Covid fades as a threat, should build the basis for *sustainably* tighter labour markets and higher pay growth. Data suggest that the link between unemployment and pay growth remained positive in the US and UK pre-pandemic, even if the relationship with consumer price inflation was less convincing.

Lingering labour market issues could accelerate that rise in underlying inflation: Labour market shortages may linger problematically in a number of economies. Some of the sources of labour market disruption may prove more lasting, even if initially prompted by Covid, e.g. where people have left the country or taken early retirement. Labour market participation among older age groups has fallen in a number of countries and only partly recovered (Chart 20). However, work in the US (see WSJ) suggests that those who have retired are those who can least afford to do so, suggesting that these decisions may not prove permanent once any Covid-related fears about returning to the workplace abate.

From lingering to lasting? If inflation expectations rise significantly, then what were temporary shocks to inflation can become more permanent. Inflation expectations have picked up in major economies, even at relatively long-time horizons (Chart 21). Very high recent inflation prints raise the risk that inflation expectations move higher in a more meaningful and lasting way. To some extent, this would likely be welcome in economies like Japan with a recent history of stubbornly low inflation. That is less likely to be the case for the US and UK and the forecasts on page 2, partly for this reason, assume rate hikes in the US and UK well before the Euro area and Japan. **If inflation expectations continue to rise, however, the risk grows that central bank confidence in 'transitory' inflation reduces more dramatically and that much sharper rate rises will be forthcoming**.

Central bank policy outlook

Central bank stances are shifting. During the pandemic there was an overwhelming need for very loose monetary policy and central banks obliged. As the focus has shifted from the demand impact of covid to the supply impact and as demand has recovered, central bank calculations have changed.

Interest rate rises are a very crude policy tool. Central bankers have been clear that they can do very little to sort out strained supply chains or labour market shortages. However, central banks can bring aggregate demand and constrained supply back into line by raising rates and softening demand. Clearly that is not the most appealing outcome when economies are not fully normalised and when more people are still unemployed than they were before the crisis. However, with inflation strong, inflation expectations have risen too (Chart 21). Central banks feel they can and should act to re-anchor inflation expectations should they rise too much. As output approaches pre-pandemic levels (Chart 22) and unemployment rates continue to fall (Chart

23), tightening monetary policy becomes an easier decision. For some central banks, financial stability concerns have increased too.

Over recent months, rate rises from the likes of the Norges Bank and RBNZ (Chart 24) have been accompanied by the US Federal Reserve tapering asset purchases, the Bank of England raising rates in December and others signalling earlier rate increases than previously, e.g. the Bank of Canada.

Interest rate rises look likely in 2022 in the US. An ECB rate rise still looks unlikely as early as next year given more difficulties pre-pandemic getting inflation high enough to hit the target sustainably (Chart 25).

Rate rises are likely to be gradual and limited… unless central banks panic (more) about inflation. Equilibrium interest rates have fallen in recent decades, reflecting multiple factors. Among them, aging populations as the post-war baby boomer generation moved towards retirement meant more saving and a need for safe assets. China joining the world trading system (and therefore 'global labour market') in earnest helped keep inflation and wage growth contained. These factors at least may be fading already as drags on equilibrium rates.

However, other factors seem likely to continue to weigh, including elevated debt levels in some sectors and economies that heighten sensitivity to higher interest rates (more can be done with smaller rate changes). Government financing could also become more of an issue in a high rate/yield environment, especially given the increased debt stocks that governments have built up during the pandemic. After the two big economic shocks of the last decade and a bit, the economy in a broad sense may also look riskier to people than before – that should also lower equilibrium interest rates (crudely, households will value a safe asset more highly when there is a higher chance of very bad outcomes).

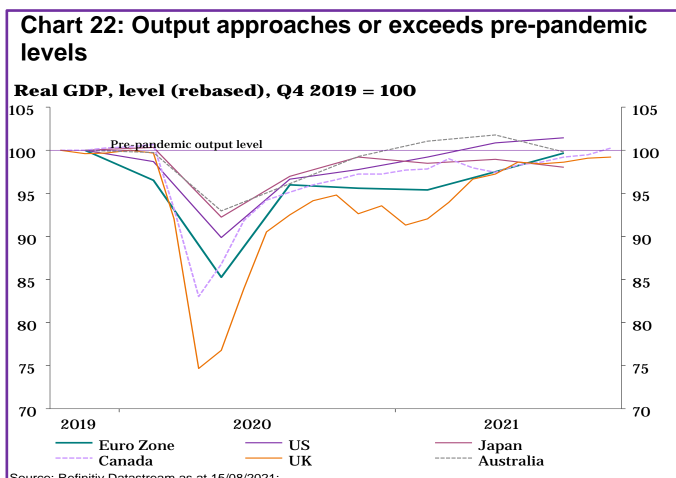
The forecasts on page 2 currently assume a 5-10 year ahead equilibrium interest rate of (only) around 2% in the US, 1.75% in the UK and 1.5% in the Euro area.

Climate change matters for the global economy next year, as well as beyond

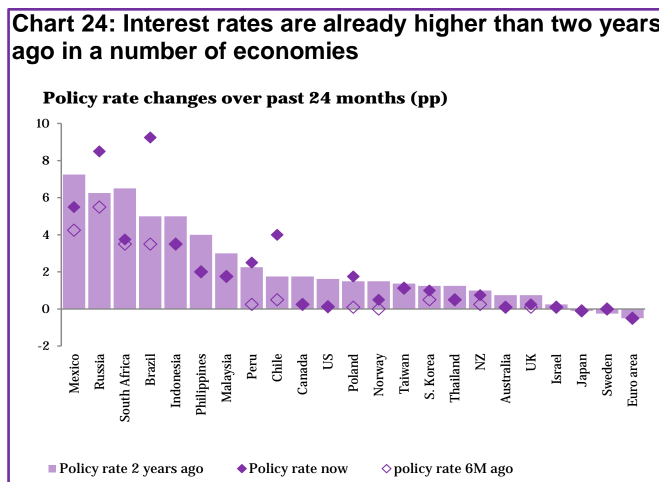
It has become harder and harder to consider climate change as only a concern for long-term, rather than short- or medium-term economic forecasts. While extreme weather events may grab news headlines, for developed economies, it is policymaker action that increasingly means that climate change is already impacting the economy and the near-term economic outlook. Policymakers and companies themselves are increasingly stepping up to address the challenges of climate change now. That brings transitional economic consequences forward, including more fiscal spending, cost pressures and labour market disruption (for more, see Economic outlook: Climate change for the near term).

That also means that some of the challenges currently facing the global economy could be worsened, or recur, as climate change transition incurs costs for companies. Labour market mismatches may increase and raise equilibrium unemployment (as jobs expand in some sectors and shrink in others), there may be increasing supply and demand mismatches for certain raw inputs and more need for fiscal spending for example.

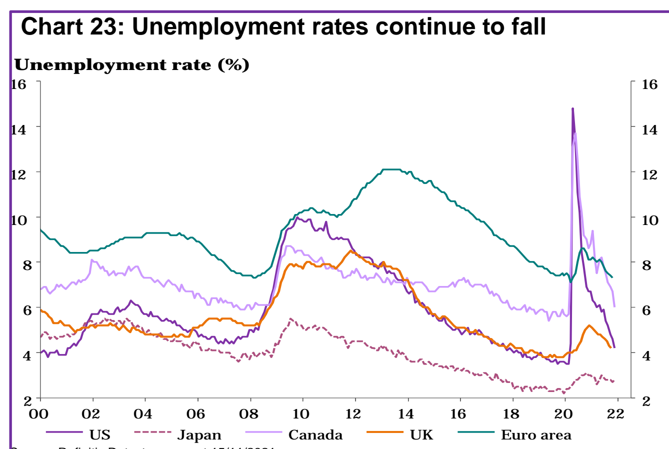
If some of these transition costs and challenges are not adequately addressed, they could also *hold back* the transition to lower carbon economies, worsening prospects for *longer-term* economic sustainability.



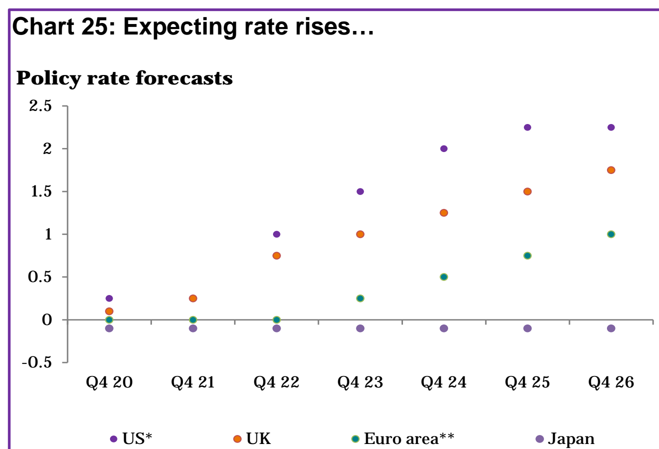
Source: Refinitiv Datastream, Eurostat, BLS, Cabinet Office (Japan), Cansim, ONS, ABS as of Q3 2021.



Source: Bloomberg as at 02/01/2022.



Source: BLS, Ministry of Internal Affairs & Communications (Japan), Cansim, ONS, Eurostat at 15/10/2021.



Source: RLAM economics forecast as at January 2022. **Euro area forecast is for the refi rate.

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United States: Resilient for now

The US economy has managed to grow through waves of Covid, avoiding lockdowns. Still accommodative monetary policy and the likely passing of further fiscal stimulus alongside strong cash balances should continue to support growth. Supply chain issues may linger, however, and some of the labour availability issues persist longer-term. There is less scope for 'catch-up' growth than in the UK for example. Inflation risks are heightened versus the Euro area. Rate rises look likely in 2022.

Near-term: Growth pick up in Q4

The business surveys still look consistent with robust growth rates (Chart 26) and a bit of a pick-up in activity growth rates in Q4. Q3 slowed after a fiscally boosted Q2 and with output dampened by hurricanes and supply chain issues and labour market shortages in Q3.

Less at risk from Omicron

Vaccination rates remain behind many Euro area economies, the UK and Japan. On the surface, that leaves the economy more vulnerable to further waves of Covid – including the Omicron variant. However, US authorities remain relatively resistant to restrictions resembling lockdowns compared to those economies.

Consumer: Inflation damages resilience

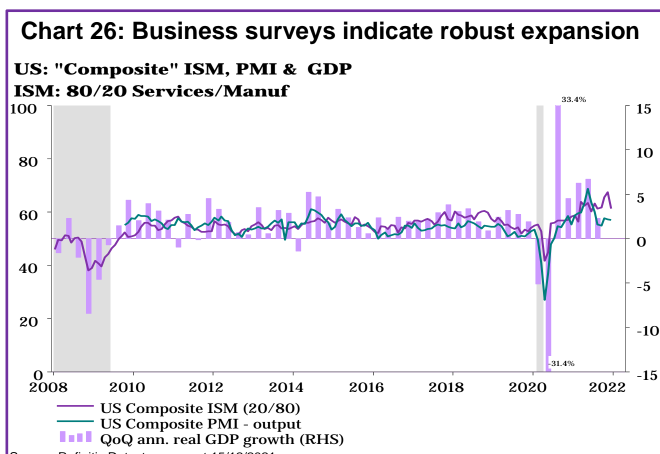
The forecasts on page 2 assume a somewhat weaker path for real consumer spending growth than previously, despite healthy jobs growth. Further fiscal spending and high aggregate saving levels can still provide support, but the savings *rate* is already close to 'normalised' (Chart 27) and real wage growth has deteriorated as inflation has risen (Chart 12).

Jobs market an insufficient shield: Evidence suggests high levels of US job openings and the Conference Board consumer survey measure of jobs plentiful versus hard to get is at very high levels (Chart 28). However, nominal pay growth is nevertheless not keeping pace with very high levels of inflation and swathes of Americans seem unwilling to re-join the labour market. The labour market participation rate of older age groups dropped by more than other major economies and have only partially recovered (Chart 20).

Investment: Less of a source of strength

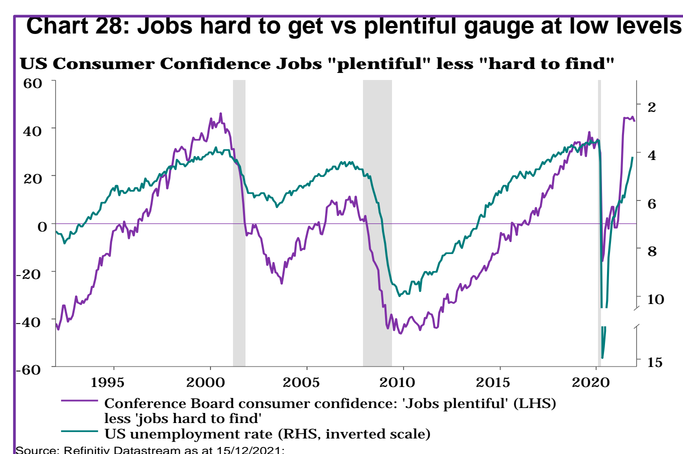
Surveys positive, but…: US investment intentions indicators are still consistent with robust growth in business investment spending. Lending conditions look supportive too, albeit less so than a quarter ago. However, these indicators have yet to fully reflect the additional uncertainty that the emergence of a new variant has brought. Businesses may also see the economic policy outlook as more uncertain with repeat debt ceiling standoffs, a very difficult passage for President Biden's recent fiscal bills and with mid-terms in 2022 that seem likely to increase rather than reduce political gridlock.

Chart 26: Business surveys indicate robust expansion



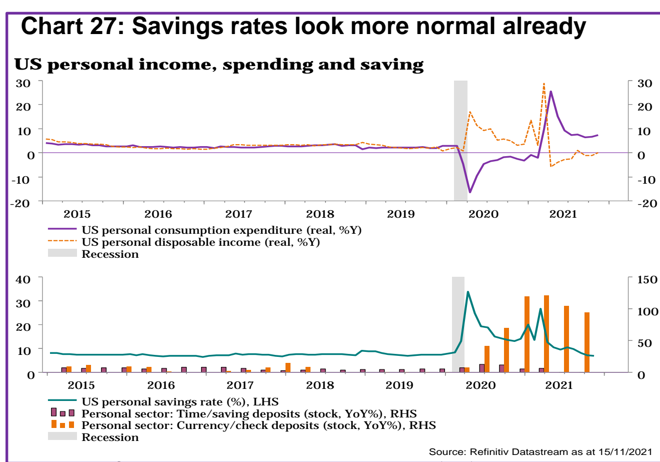
Source: Refinitiv Datastream, BEA as at Q3 2020, IHS Markit, ISM (December 2021)

Chart 28: Jobs hard to get vs plentiful gauge at low levels



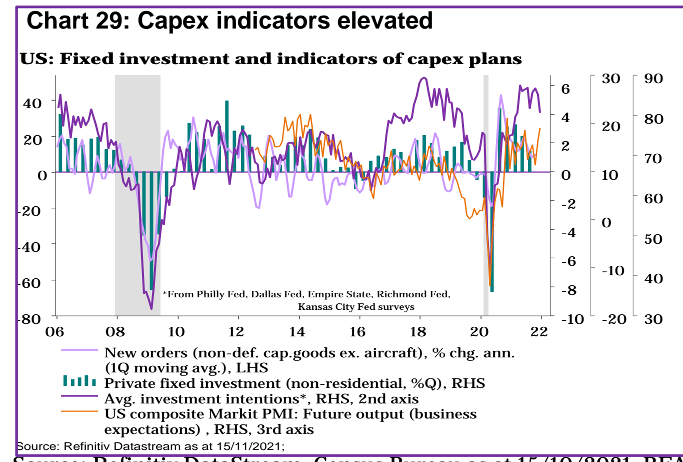
Source: Refinitiv DataStream, BLS, Conference Board as of December 2021

Chart 27: Savings rates look more normal already



Source: Refinitiv Datastream, BEA, as at 15/11/2021.

Chart 29: Capex indicators elevated



Source: Refinitiv DataStream, Census Bureau as at 15/10/2021, BEA (Q3), survey sources as listed (November 2021)

Medium-term outlook still supportive though: Incentives in the medium term for more investment spending remain strong. The low carbon transition and a likely desire post-pandemic to reduce reliance on labour are likely to support capex (Chart 29). With no significant improvement in China-US trade relations, incentives for re-shoring are still present too. The finally passed $550bn bi-partisan infrastructure bill is also set to deliver new investment in US infrastructure over five years. With that bill covering a wide range of spending from bridges to broadband, it may encourage broader private capex spending too.

Fiscal policy drag

The US fiscal stance turns less supportive. The US fiscal stance is already significantly less supportive (Chart 30) and looks set to remain so even incorporating the infrastructure bill and assuming that the Build Back Better/reconciliation bill is passed. The IMF calculations in Chart 30 incorporate both and builds in a bigger fiscal bill than looks likely to get through the Senate at present. That second bill is still widely assumed to pass, albeit in diminished size. However, it hasn't yet at the time of writing and already high inflation isn't helping the case for a fiscal spending boost. If the Build Back Better bill is not passed this year, arguably the probability of it passing in a recognisable form diminishes as policymaker stances may harden ahead of the mid-terms.

Mid-terms likely to bring (even more) deadlock

Mid-terms tend not to favour the party in power. The Senate is already a 50-50 Democrat Republican split and Democrats might lose their majority in the House of Representatives. President Biden's net approval rating has been negative since August. Time is also tighter for any of the provisions in the Build Back Better bill to be felt by voters by the time of the elections in October 2022. If the Democrats do lose either House or Senate, that presumably means a second half of the presidency dominated by executive action, not fiscal bills, with legislation becoming even more difficult to pass. It would also likely lessen the prospect of another generous dose of fiscal stimulus if the economy enters a downturn.

Monetary policy: Tightening in 2022

The forecasts on page 2 assume three 25bp rate rises in 2022, with risks skewed to less rather than more in that timeframe given a central scenario of a rapid decline in inflation over the year. The December median FOMC participant rates projection already shows three rate rises in 2022 – though they retained their guidance that maximum employment needs to be reached first.

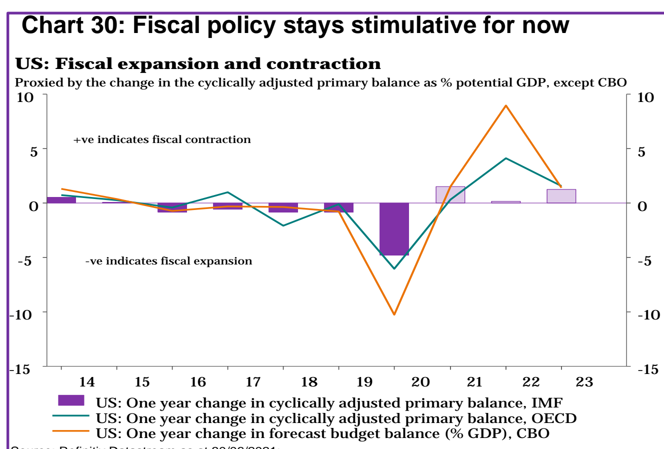
After starting to taper asset purchases at their November meeting, they have already moved towards speeding up these asset purchases, giving them 'optionality' to raise rates as early as March 2022 if inflation stays stubbornly high. Inflation is likely to fall significantly over 2022 (see below) which should take the pressure off the Federal Reserve for very rapid rate rises. However, the bar for rate rises has fallen with Chair Powell re-emphasising that reaching their 'full employment' threshold does not have to mean the labour market completely returning to pre-pandemic conditions. How many hikes we get this year will likely also depend on the approach they take on the balance sheet, where quantitative tightening may take the place of a rate rise later in the year.

Inflation risks heightened for the US

Base effects mean that US inflation is likely to fall sharply in 2022 with risks on both sides of the inflation projection, including on the downside if supply chain problems unravel, leading to falls in the prices of some inputs that are then passed on to customers (e.g. used car prices). However, the forecasts assume that the Build Back Better bill will be passed and US inflation expectations have risen significantly (Chart 21), leaving the balance of risks skewed to the upside. Rents are also a key source of upside risk to the forecast.

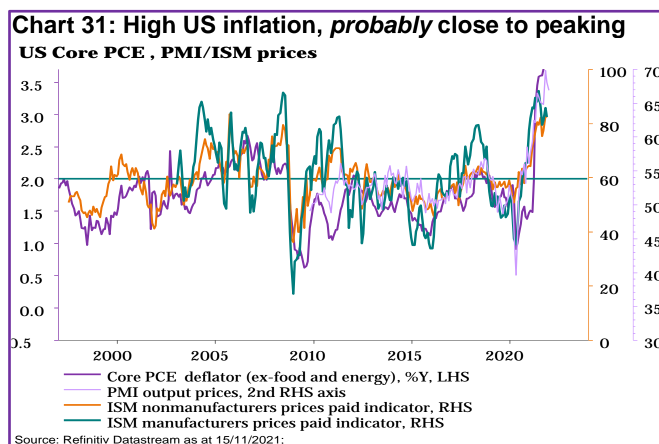
The labour market remains a source of upside underlying inflation risk too for now. Part of the reason for labour supply shortages appears to be an apparent reluctance to return to work. Surveys suggest a number of explanations, specifically childcare availability, retirement (see global section), and unwillingness to risk Covid exposure. Two out of three of these should ease as problems as Covid retreats as a threat over time. Any incentive to stay out of the labour force coming from higher unemployment benefits is over now; any from the build in savings post pandemic (Chart 10) should be starting to fade. So far, however, the participation rate has only ticked higher rather than risen significantly and it may prove particularly difficult to get retirees back into the labour force

Chart 30: Fiscal policy stays stimulative for now



Source: IMF (as at 13/10/2021), OECD (as at 01/12/2021) and CBO (as at 29/07/2021).

Chart 31: High US inflation, *probably* close to peaking



Source: Refinitiv Datastream, ISM, IHS/Markit, BEA, survey data as of August 2021, PCE deflator as of November 2021

China: Policy to steady the ship?

Covid dented China's economy over the summer; power supply and other supply issues have held back manufacturing. Meanwhile, China's zero tolerance approach to Covid brings risks of repeat waves of social distancing measures. Macro policy has become more accommodative, but policymakers are not signalling a strong wave of either fiscal or monetary stimulus, emphasising stabilisation.

Growth perks up, but mediocre for manufacturing

After localised lockdowns and travel restrictions earlier in the summer, surveys and hard data (Chart 32) have indicated some pick-up in growth since around August. Prospects for Q4 GDP growth therefore continue to look better than Q3. Surveys and hard data indicate relatively weak growth in the manufacturing sector, however. Power supply problems have dampened growth and overseas demand seems to be being held back by shipping delays and reduced demand. Even with the challenges of Omicron, as the overall threat from Covid diminishes over time, overseas demand is likely to swing further towards services and away from goods, benefitting China relatively less. Inventory build overseas (see global section) may also have been supportive for China in 2021, but seems likely to fade as a support in 2022 once companies reach a level of inventory holding that they are happier with post-pandemic.

Policy: More accommodative at the macro level

The broad direction of policy continues to become more accommodative. The PBoC cut the reserve requirement ratio (RRR) in December again (after cutting in July), Chart 33, releasing liquidity into the banking system. Further modest easing seems likely in coming months, though the PBoC has shown itself to be reluctant to cut interest rates.

The December Politburo meeting readout suggested more of a focus on stability of economic growth and the November State Council meeting guided towards accelerating local government special bond issuance.

None of this suggests that either the PBoC or wider government authorities are about to launch a full-scale easing policy, however. The PBoC for example reiterated that there would be no "flooding the market with liquidity".

Unimpressive growth assumed for 2022-23

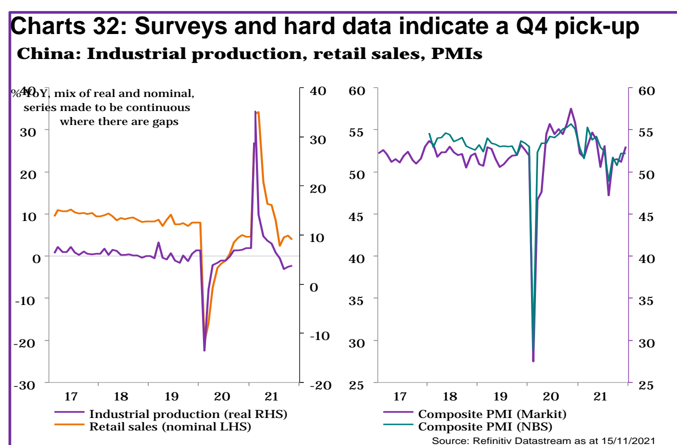
Despite some easing in the policy stance, and assuming some pick up in sequential growth, the forecasts on page 2 assume that China records ~ 5.0% real GDP growth in 2022 after a whopping 8.5% in 2021 and that after slightly faster growth in 2023 that growth recedes further in coming years rather than recovers back to pre-pandemic norms (~6-7%).

That reflects a number of different things, including an assumed further global swing towards services and away from goods demand as the Covid threat retreats, i.e. a challenging environment for China's manufacturers. China's currency has also appreciated markedly over the past couple of years. Consumer spending may face repeated setbacks if China retains its zero-Covid tolerance strategy too. With this approach abandoned in much of the world, Covid is likely to continue circulating and mutating and find its way back into China periodically. The forecast also reflects an assumption that China's authorities will focus on growth stabilisation, allowing a gentle decline in GDP growth with a focus on quality and social cohesion, rather than attempting to boost GDP at all costs.

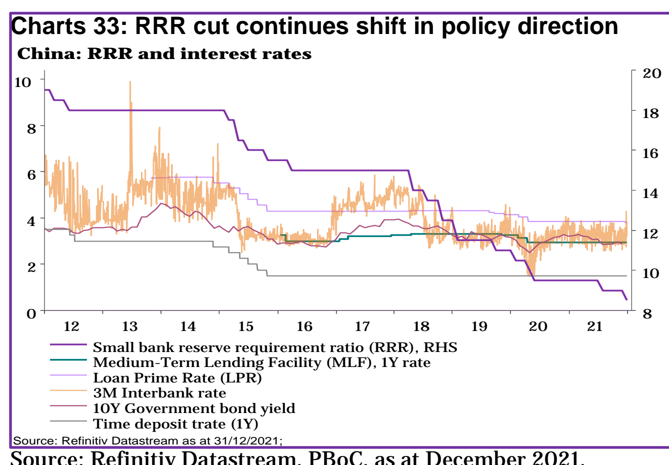
This forecast also reflects the long-term challenges facing China including an overhang of high corporate debt levels and deteriorating demographics as the population ages. Working age population growth has already been negative for several years. Plans to address the fall in fertility and increases in productivity could still work to increase the potential growth rate but the former will work over very long timescales.

External and domestic risks to the outlook

Alongside further waves of Covid and virus mutations, downside risks to China's outlook include several domestic risks from recurrent power supply problems to wider effects from a housing market slowdown. External factors continue to add risk to the growth outlook too. Taiwan remains a potential flashpoint in relations with the west and tariffs have yet to reduce on trade with the US. So far, manufacturers appear to have done a good job of passing cost increases onto overseas customers, with export prices rising much more strongly than CPI. At some point, however, with real incomes already crimped in major economies (see global section), that tolerance may face pushback in the form of tougher contract negotiations or reduced end demand for China-made products.



Source: Refinitiv Datastream, NBS, IHS Markit as at November 2021.



Source: Refinitiv Datastream, PBoC, as at December 2021.

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Euro area: Coming back to earth

Growth faces a near-term challenge from higher covid cases and tighter social distancing restrictions. Without the covid threat, the scope for strong growth would anyway be limited by the level of output already being very close to pre-pandemic levels and with Euro area output hampered by similar supply chain issues as elsewhere. The forecasts assume relatively robust growth on average in 2022 with a further recovery in business investment, but softer real consumer spending growth. The fiscal stance looks less set to be less supportive, despite disbursements of EU funds.

Growth outperformer faces challenging turn of the year

Q3 GDP growth was 2.2%Q (non-annualised), stronger than in the US, UK or Japan, again helped by easing social distancing restrictions, high levels of vaccine take-up and accommodative policy. There was strong growth in overall real consumer spending with consumer confidence at relatively high levels. The level of GDP has likely exceeded pre-pandemic levels in Q4. Supply chain problems remain disruptive, but surveys still look consistent with reasonable GDP growth for now (Chart 34).

Vaccine versus variants

Despite high vaccination rates, the winter covid wave coupled with the threat of the Omicron variant has meant some tightening of social distancing rules over the turn of the year, though falling short of full lockdowns so far (apart from the three-week full lockdown in Austria). The EU has also shown that once approvals are received, it can succeed in rolling out vaccinations quickly which bodes well even given the risk of needing new vaccines as Covid evolves. In the near-term, with the emergence of Omicron against already high covid case numbers, additional social distancing measures and voluntary caution from households are likely to worsen before they ease and near-term growth looks set to see a dent.

Still a strong case for a pick-up in investment

As elsewhere, corporate cash levels rose sharply over the crisis and could, in theory fund strong business investment spending growth whose recovery has lagged so far (Chart 14). Business loan growth remains positive, investment indicators still look consistent with relatively strong investment growth (Chart 35) and incentives to invest including reshoring, the green transition and lowering reliance on labour should have strengthened as supply chain problems have persisted (Chart 36), governments have committed to ambitious climate change objectives and labour shortages have worsened (Chart 8).

However, with the emergence of Omicron and the reminder that the Covid threat to business operations is far from over, the recovery in business investment seems likely to stall over the turn of the year until uncertainty clears. For some companies with less pricing power, high input costs will have led to a margin squeeze; as a crude indicator, the output price PMI at least has not been keeping up with the input price PMI (Chart 37). That would dampen firms' capability to fund investment internally.

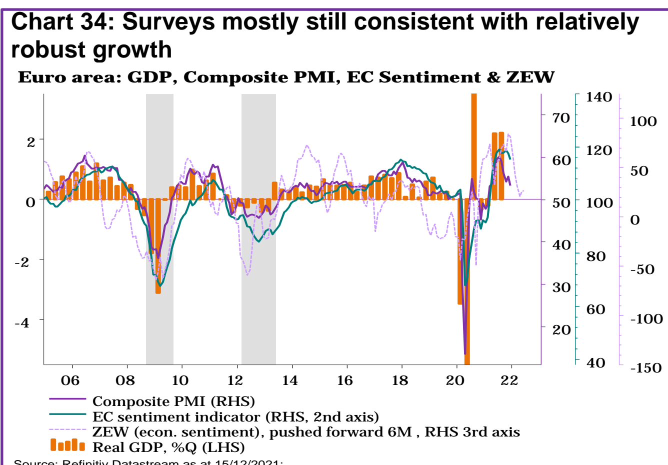


Chart 34: Surveys mostly still consistent with relatively robust growth

Source: Refinitiv Datastream, IHS Markit, ZEW, European Commission, Eurostat as at 15/12/2020 (GDP for Q3 2021).

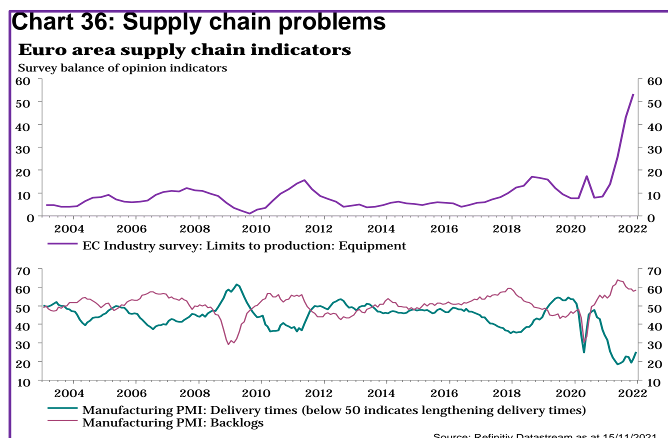


Chart 36: Supply chain problems

Source: Refinitiv Datastream, European Commission, IHS Markit, as of Q3 2021 (EC survey) and November 2021 (PMIs)

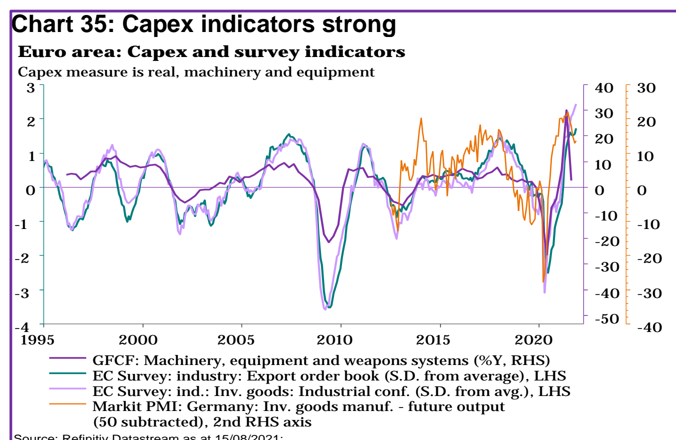


Chart 35: Capex indicators strong

Source: Refinitiv Datastream, Eurostat, European Commission, IHS Markit, as of Q3 2021 (GFCF) and December 2021 (surveys)

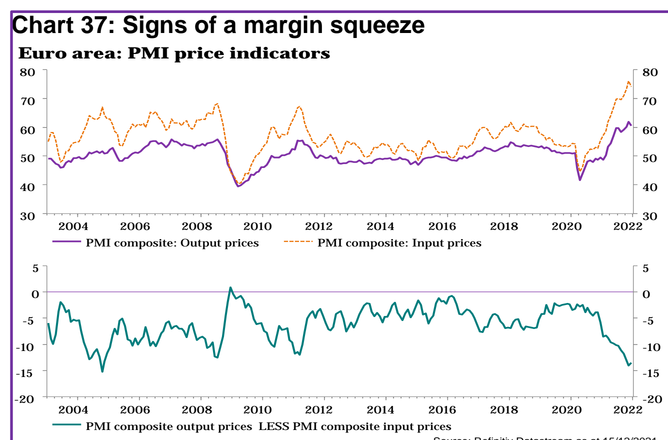


Chart 37: Signs of a margin squeeze

Source: Refinitiv Datastream, IHS Markit, as of December 2021

Consumer spending growth to slow

The level of real consumer spending was only some 2.5% below pre-pandemic levels (Chart 9) in Q3, indicating more scope for 'catch-up' growth than in the US, but much less than in the summer. Prospects for 2022 also look more challenging given very high inflation rates and the subsequent hit to real wage growth (Chart 12) and incomes (Chart 38), alongside tighter social distancing restrictions after the recent Covid wave and the emergence of Omicron. Consumer confidence remains sharply off the lows though (Chart 38), and on the latest available saving rate data at least, the data suggest plenty of scope for Euro area consumers to keep up spending levels by saving less (Chart 11). Hence, the forecasts on page 2 for now assume a moderation in average consumer spending growth, rather than a pull back.

Economic policy gets less supportive

Fiscal policy set to become less supportive, unevenly: The latest European Commission, OECD and IMF projections imply a significant shift in fiscal stance in 2022 after three years of fiscal expansion (Chart 39). Much of that should reflect the end of Covid support measures and should be somewhat softened by disbursements from the NextGenerationEU programme albeit with those disbursements set to be very uneven country-by-country. The new German government could yet prompt a significant change in fiscal plans there, with a strong focus on investment and less on balanced budgets, though the coalition treaty looks consistent with only limited change in overall fiscal approach.

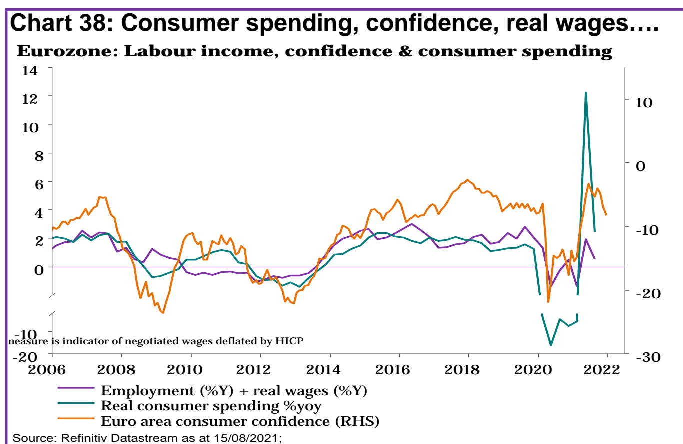
Covid support can be boosted if needed. The EU's temporary 'Support to mitigate Unemployment Risks' (SURE) programme, set up to provide support to national short-time working and similar schemes during the pandemic and financed by the issuance of EU social bonds, in theory could be expanded. The European Commission is still operating a temporary set of state aid rules to allow more support for economies during the pandemic and that framework runs until end-June 2022.

Expecting PEPP to end in March, no rate rises until 2023: The ECB have said that the PEPP asset purchase programme will end in March, but that it will remain part of the toolkit. Reinvestments can also be applied flexibly – including by jurisdiction, allowing for targeted support even when new overall asset purchases end as part of the PEPP. Purchases under the APP scheme will also be upped temporarily from March. A history of below target inflation makes rate rises less likely in 2022 in the Euro area than in the US and the UK. However, with inflation expectations higher and the output gap closing, a rate rise in 2023 is pencilled into the forecasts on page 2.

Inflation outlook: Likely to fall to higher lows

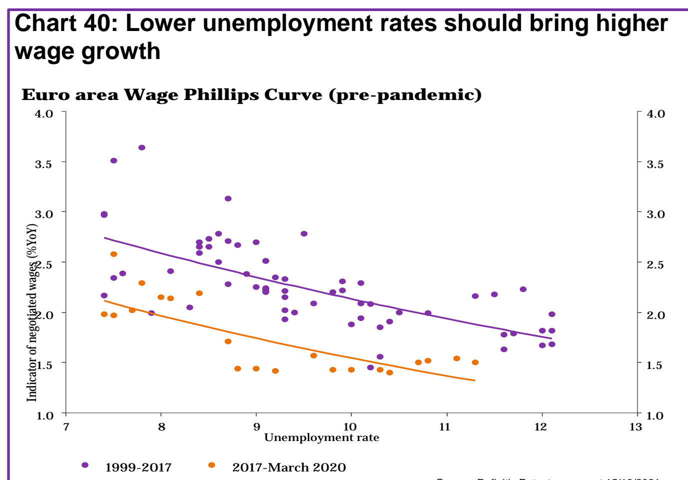
As elsewhere, there are clearly some significant upside risks to the inflation forecast in 2022 (which, for now, assume a gradual but significant fall in year-on-year inflation over 2022), should supply chain problems not ease. Wage growth should pick up too as unemployment rates continue to fall, providing more underlying support for inflation (Chart 40). In light of the rapid Euro area recovery from the pandemic as of Q3 2021 at least, with inflation expectations higher (Chart 41) and with no expected return to austerity across the EU, especially given Germany's left-leaning government, the inflation forecasts on page 2 are now higher in the medium term as well as the near term.

Chart 38: Consumer spending, confidence, real wages….



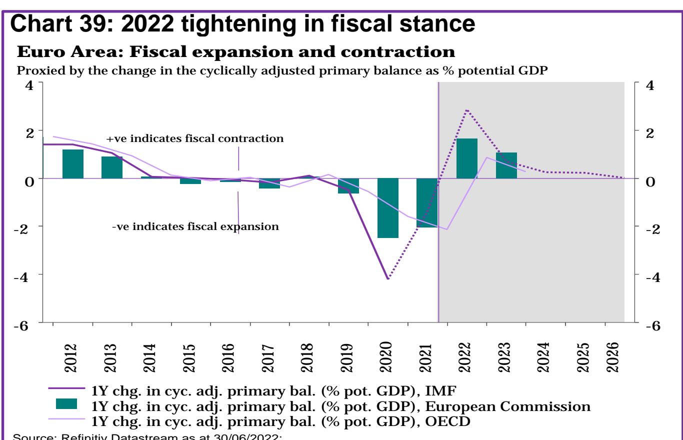
Source: Refinitiv Datastream, Eurostat as at Q3 2021, European Commission (consumer confidence) as at December 2021.

Chart 40: Lower unemployment rates should bring higher wage growth



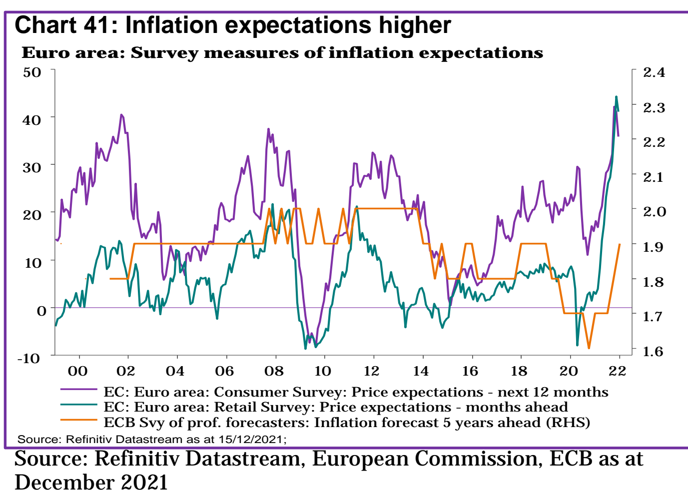
Source: Refinitiv Datastream, Eurostat, ECB, RLAM.

Chart 39: 2022 tightening in fiscal stance



Source: Refinitiv Datastream, IMF (updated 13/10/21), European Commission (11/11/21), OECD (01/12/2021)

Chart 41: Inflation expectations higher



Source: Refinitiv Datastream, European Commission, ECB as at December 2021

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Japan: Prospects healthier, but longer term challenges remain

Japan's recovery has been hampered by a low tolerance approach to Covid and repeat resurgences of Covid. However, a rapid vaccine programme improvement and yet another dose of additional fiscal spending leave prospects a bit healthier, Omicron permitting. High inflation looks less of a threat to the recovery than elsewhere too. The longer-term outlook remains challenging.

Unimpressive progress

Still bumpy hard data, but surveys look healthier: Month on month growth in key hard data like industrial production and retail sales remain bumpy (Chart 42), partly reflecting the ups and downs Japan has experienced with Covid and social distancing guidelines, despite Japan not seeing anywhere near the Covid case numbers of Europe and the US. Business survey data, however, was looking much healthier pre-omicron with PMIs recording some of their highest levels since the period before the pandemic (Chart 43).

Late vaccination outperformance has likely helped shore up confidence: Japan was late to launch its vaccine programme but progressed rapidly and now has a higher percentage of the population fully vaccinated (excluding booster shots) than Italy, France, the UK, Germany or the US. That has been accompanied by a pick-up in consumer confidence and in mobility data (recreation and retail), see Chart 44. Those high vaccination rates and proven ability to rapidly roll out a vaccine programme if required, should help underpin the economy through any new Covid waves. However, based on recent history, the Japanese government is also likely to tighten social distancing restrictions at a much lower level of Covid case numbers than in Europe or the US.

Yet more fiscal spending

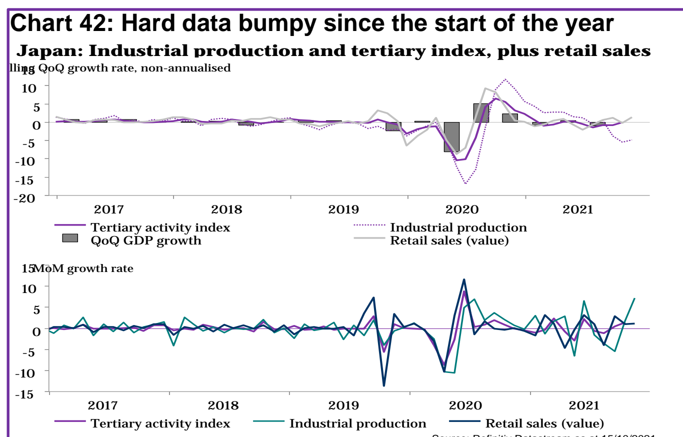
Under new PM Kishida, Japan has followed through with announcing yet another massive fiscal spending package. The headline size will exaggerate the likely final scale and impact on the economy; and previous packages haven't been fully spent. However, this should be a positive for activity growth and increases the probability of that the Japanese economy runs 'hot', pushing up inflation. The Cabinet Office estimate the impact of the package at 5.6% GDP, but independent analysis suggests that the impact seems likely to be less than half this, though still significant.

Challenges to growth

Near-term challenges on some dimensions look likely to be less than in other developed economies. In addition to the extra fiscal stimulus, inflation remains very low leaving no pressure on the central bank to tighten. However, with pay growth also low (measured by labour cash earnings), real labour cash earnings growth looks as unimpressive as elsewhere (Chart 12). A significant margin squeeze also looks a threat. Japanese companies also look somewhat less able or willing to pass on cost increases to end-consumers (Chart 18); the output price PMI measure trails well behind the input price PMI and PPI inflation has been running well ahead of CPI.

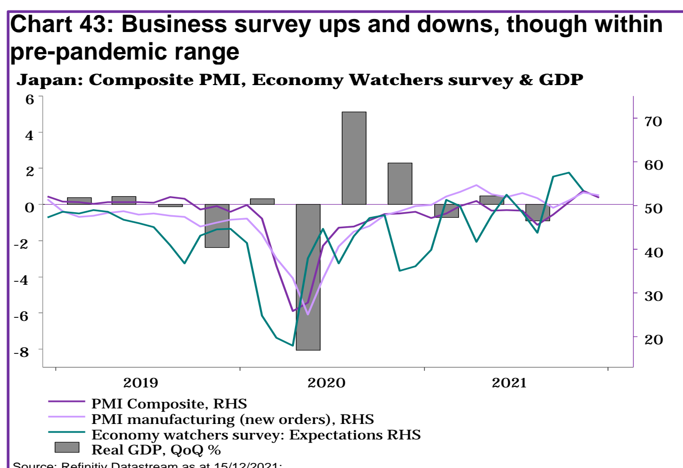
Longer-term prospects for Japan still look hampered by demographic challenges and unimpressive productivity growth (Chart 45).

Chart 42: Hard data bumpy since the start of the year



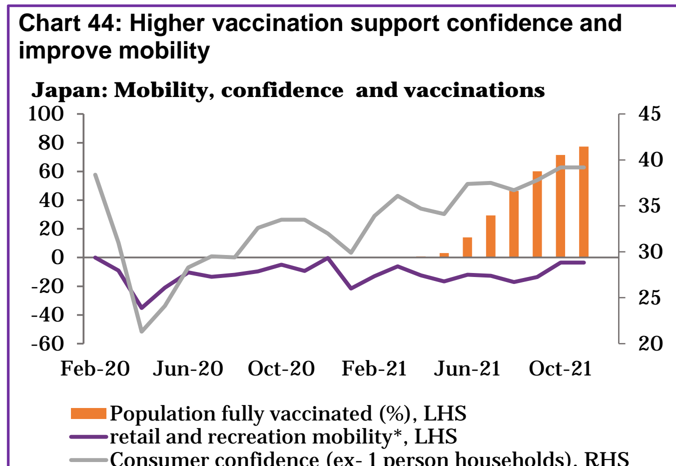
Source: Refinitiv Datastream, METI, Cabinet Office as at 15/10/2021.

Chart 43: Business survey ups and downs, though within pre-pandemic range



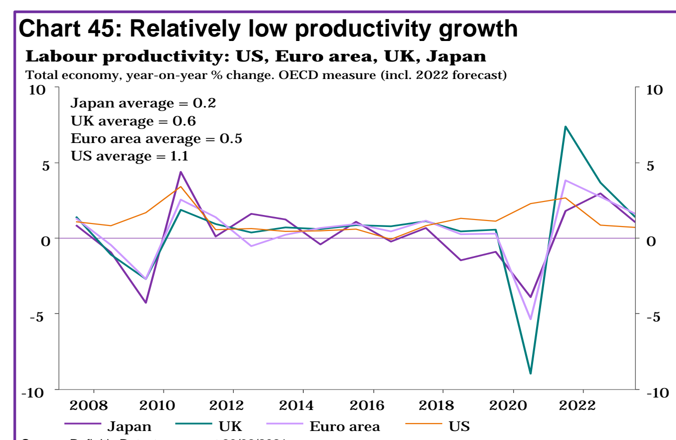
Source: Refinitiv Datastream, IHS Markit, Cabinet Office. GDP to Q2, Economy Watchers data as of December 2021.

Chart 44: Higher vaccination support confidence and improve mobility



Source: Google, Our World in Data, Cabinet Office (Japan), data as of November 2021.

Chart 45: Relatively low productivity growth



Source: Refinitiv Datastream, OECD as at 30/06/2021

United Kingdom: Challenged

Growth is set to slow again in the short-term as the UK goes through yet another Covid wave, but this time without the background support of the furlough scheme. The fiscal policy stance is tightening, monetary policy is tightening. Real pay growth is weak. An outperforming vaccination programme and household and corporate aggregate cash levels should help the economy return to reasonable growth rates though and prospects for business investment to drive further recovery still look good once uncertainty recedes. The labour market will remain an important driver of the monetary policy outlook and, ultimately inflationary pressure. Some of the factors constraining labour market availability are likely to prove sticky and keep the labour market relatively tight and potential growth constrained.

More ups and downs for activity growth ahead…

The UK economy bounced from lockdowns in Q2, the pace of growth slowing in Q3. Q4 and, and Q1 2022 are likely to see a hit following the resurgence in Covid cases around the turn of the year. Covid is again likely to mean additional ups and downs with December's business surveys already pointing to additional slowing (Chart 47). Those peaks and troughs are likely to be shallower than in 2021, but much will depend on how much tightening of social distancing restrictions takes place and how much government support is offered during any Covid led slowing.

Virus versus vaccine versus everything else

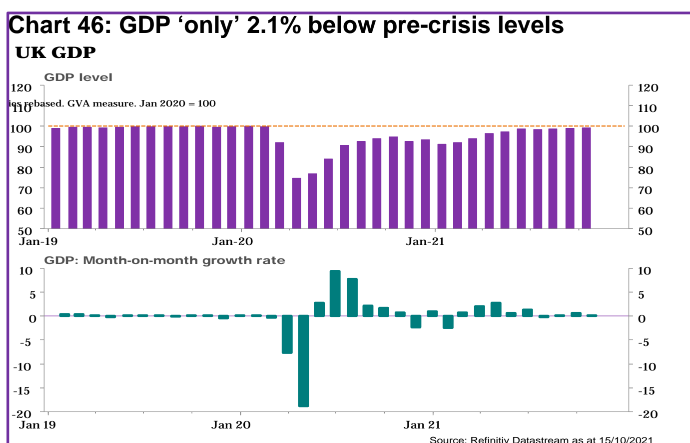
Omicron is a threat to the Q1 outlook, but the exceptional progress of the vaccine and now booster programmes clearly help prospects of a strong bounce-back by Q2 2022, while working against the likelihood that a full lockdown will be needed. As elsewhere, consumer spending and business investment may get support from heathy aggregate cash balances (Chart 10) and business investment is overdue some catch up to at least pre-pandemic levels when uncertainty lessens (Chart 48). Easing supply chain problems (see global section) should help manufacturing and construction.

The second half of 2022, however, is expected to see slower economic growth. A near-complete recovery to pre-covid levels of activity would anyway likely have been accompanied by slower growth, but a tighter fiscal stance, lingering labour availability problems (immigration rules, plus lower labour participation of older age groups), tighter monetary policy, ongoing Brexit transition amid still shaky UK-EU trade relations, and weak real household income growth are all likely to help slow the average pace of quarterly growth significantly this year.

Consumer spending –bifurcated and likely to slow

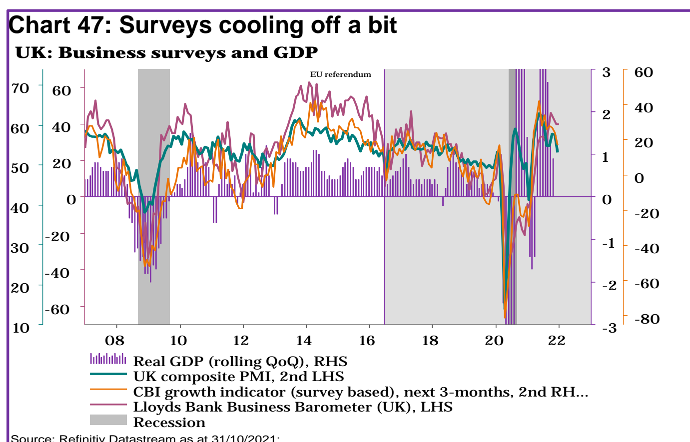
The overall level of consumer spending is near fully recovered, arguing for slower progress from here, but there is still room to go in terms of normalisation away from spending on retail goods and towards services. That normalisation is likely to be delayed by Omicron. Overall consumer spending growth also seems likely to be hindered by plunging real wage growth (Chart 12) as inflation continues to climb. Pay settlements have picked up a bit, but not enough to compensate.

Chart 46: GDP 'only' 2.1% below pre-crisis levels



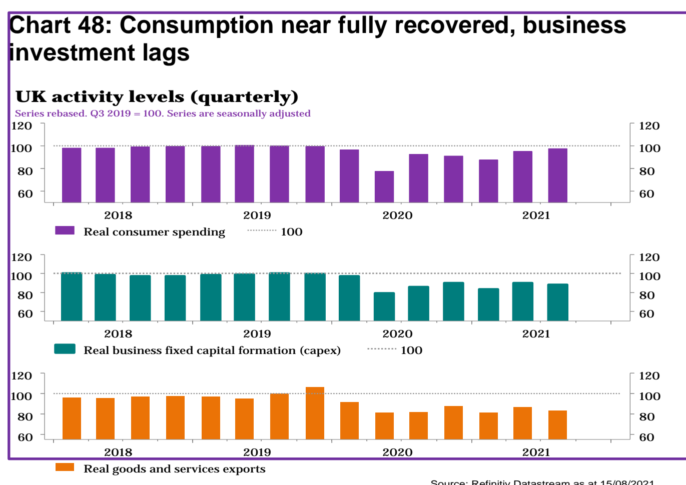
Source: ONS, Refinitiv Datastream (data to July 2021).

Chart 47: Surveys cooling off a bit



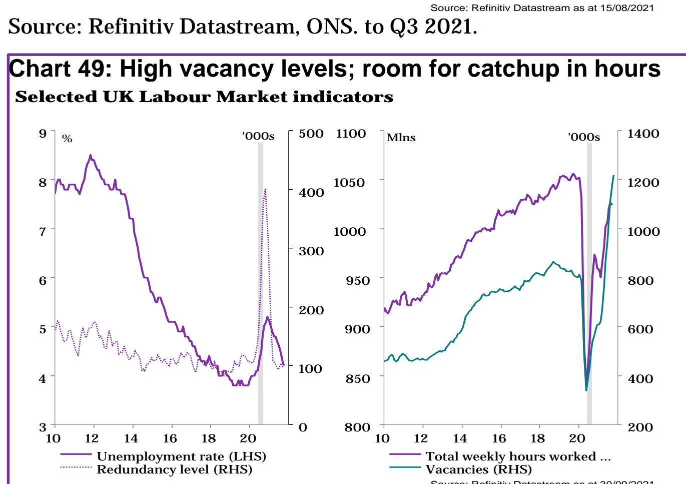
Source: Refinitiv Datastream as at 30/6/2021; IHS/Markit PMI data to August 2021

Chart 48: Consumption near fully recovered, business investment lags



Source: Refinitiv Datastream, ONS. to Q3 2021.

Chart 49: High vacancy levels; room for catchup in hours



Source: Refinitiv Datastream, ONS to Oct 2022

The forecasts do not assume a big pull back in consumer spending though. There is scope for hours worked to pick up in 2022 and high levels of vacancies (Chart 49) suggest opportunities for those with the right skills to make moves into higher paid roles. The household saving rate is still elevated; higher prices are likely to see households save less to help protect levels of real spending. The level of household deposits is still relatively high too, suggesting that some at least have plenty of liquid savings to spend if they choose.

Tighter social distancing rules and households pulling back on certain types of activity is already hitting hours worked and job security in certain sectors. If the furlough scheme is not reinstated, this situation is more likely to result in job losses than before. High levels of job vacancies make this somewhat less worrying than it might otherwise be. However, all else equal, the lack of such schemes seems likely to make households less willing to spend more and save less as they become less confident that the government is prepared to provide a backstop for household finances again.

Inflation: Higher before the fall

Consumer price inflation continues to climb (Chart 50) and is unlikely to peak until April 2022 when we are likely to see another substantial rise in energy prices (courtesy of the Ofgem energy price cap). The forecasts in Chart 17, assume a peak in CPI of 5.8%Y. They still have inflation well above target at end-2022, albeit much lower than the peak as base effects turn negative and on an assumption of easing supply chain issues.

The same uncertainty as elsewhere exists over how long supply chain problems will linger for (see global section), but this is a two-way risk for the forecast. Omicron likely extends their duration, but if supply chains improve and some price increases are reversed, CPI could be substantially lower than forecast. Medium term, tight labour markets may linger given the change in immigration regime and the potential that participation rates do not recover (see global section). That could mean repeat bouts of high pay growth. With higher levels of inflation expectations medium-term (Chart 21), these are also more likely to feed through into higher consumer price inflation. The forecasts on page 2 do not assume that CPI inflation is quite at target two years out.

Policy getting much less supportive

Fiscal policy has become less supportive in the UK (Chart 51). Despite additional spending announced at the October Budget, the end of several key elements of UK emergency fiscal support leaves the fiscal stance much less supportive. Current government fiscal plans infer a significant fiscal tightening in 2022-23 too, including via tax increases.

Omicron increases the chance that this fiscal tightening is delayed if the government decide to introduce lockdown-like measures and, alongside that, reinvigorate pandemic-period economic support programmes. Fiscal easing looks more likely than monetary policy easing in response to rising Covid risks and the Chancellor announced a (small) £1bn package of measures already in the build up to Christmas.

Monetary policy tightening – less gradual, but still limited: The Bank of England decided to hike rates 15bp to 0.25% in December and continue to signal that further policy tightening is likely to be needed. The question is how much and how fast? The forecast on page 2 now assumes two rate rises in 2022 (post-omicron in May and November) but one in 2023 when inflation is assumed substantially lower.

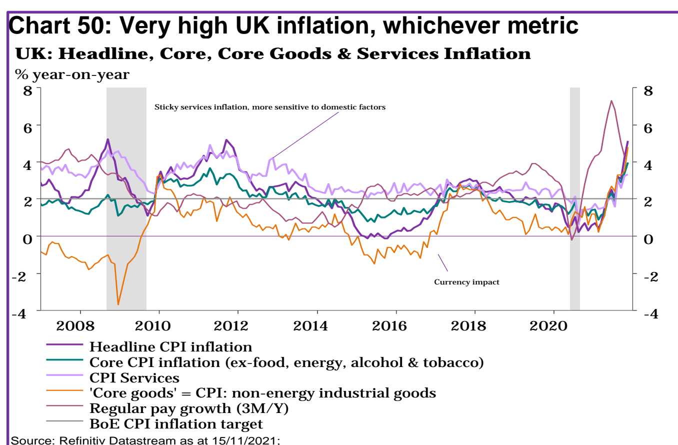
Bank of England forecasts in, and commentary around, the November Monetary Policy Report signaled that market expectations (at that point) of 1% Bank Rate by end-2022 were too much too fast. However, since November they seem to have become more worried about the medium-term inflation outlook and the potential for inflation expectations to rise given the high levels of current inflation. They have also satisfied themselves that the end of the furlough scheme has not led to a significant weakening of the UK labour market and the balance of their argument on the threat from Omicron in December seemed to be that Omicron was probably more of an upside than a downside risk to inflation.

Rate rises are likely to be relatively limited though, partly reflecting lower equilibrium interest rates (see global section), the likely sensitivity of the economy (including government finances to higher interest rates (see Returning to recovery for more), as well as the new tightening guidance which envisages the stock of asset purchases starting to be run down (by ending reinvestment of assets) when the policy rate reaches 0.5%. Hiking rates in December in the face of a sharply deteriorating economic growth backdrop with Omicron was also already a potentially serious down-payment to support lower inflation expectations.

Brexit: Still a source of risk to the outlook

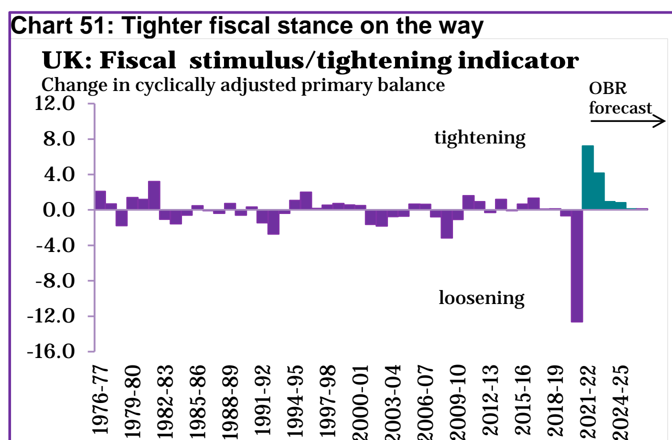
UK-EU trade relations have been tense all year. Though both sides continue to talk, they have yet to find a resolution to disagreements over implementation of the Northern Irish protocol. The forecasts do not assume that talks break down altogether, neither do they assume that either side moves very far down the path towards reintroducing tariff barriers to trade in light of continued disagreements. That scenario remains a significant downside risk to the forecasts, however.

Chart 50: Very high UK inflation, whichever metric



Source: ONS, to November 2021 except pay growth (average weekly earnings: regular pay) which is to November 2021.

Chart 51: Tighter fiscal stance on the way



Source: OBR, October 2021

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