The Big Picture

Investment Research
29 November 2021

Slower growth and rising inflation uncertainties

Highlights

- COVID-19 restrictions are set to weigh on economic activity this winter.
- Economic activity should pick up in the spring as COVID-related fears wane and supply chain problems ease
- Inflation is still set to moderate in 2022, but at a slower pace than previously expected
- A large inflation surprise forcing an abrupt central bank response and spreading of more dangerous and transmissible COVID-19 variants are key risks to our outlook

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Important disclosures and certifications are contained from page 38 of this report.

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The Big Picture is a semi-annual analysis focusing on the outlook for the global economy.
Read about the prospects for, and the most important risks to, the global economy.
The publication Nordic Outlook presents our expectations for the Nordic economies.

Important disclosures and certifications are contained from page 38 of this report.

Global overview

Slower growth and rising inflation uncertainties

- COVID-19 restrictions are set to weigh on economic activity this winter but growth will remain positive. Global goods consumption will remain elevated and production will have a hard time follow suit over the next 3-6 months.
- Economic activity should pick up in the spring from waning COVID-related restrictions, easing global supply chain problems and economic policy stimulus in China.
- Inflation is set to ease in 2022, but at a slower pace than previously expected, forcing especially the Fed to embark on tighter monetary policy.
- A large inflation surprise forcing an abrupt central bank response and/or spreading of more dangerous and transmissible COVID-19 variants are the key risk.

After the brisk recovery from the COVID-19 crisis last year, the momentum in the global economy is moving into a lower gear. Fading re-opening effect, waning fiscal stimulus and global supply chain challenges have weighed on manufacturing activity while service sector activity is challenged by the delta variant in the pre-summer in many emerging markets, followed by the US over the summer and lately in Europe, where several countries are starting to impose new restrictions.

At the same time, global inflation is rising to levels not seen since the run-up to the financial crisis in 2008. Rising energy and commodity prices, cost-push effects from supply chain bottlenecks, high goods demand and re-opening effects in services are some of the key factors globally. However, notably in the US, the combination of significant fiscal easing together with very lax monetary policies have added further to inflation pressures.

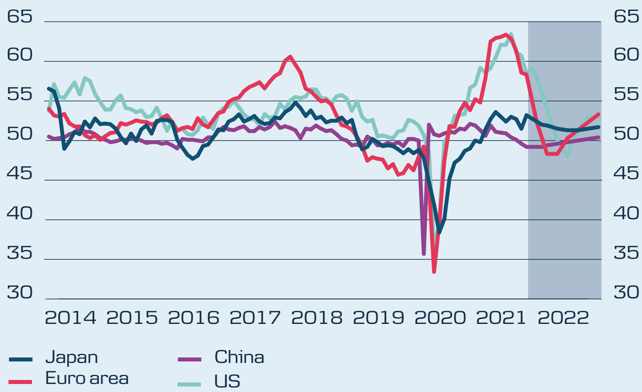
Covid restrictions to weigh on economic activity this winter

Despite relatively high degree of vaccination rates in the western world, covid cases are rising again in many countries in the Northern Hemisphere. While fewer are at risk of serious illness following the roll-out of vaccinations in many countries, hospitalisations are going up, especially in countries with low vaccine uptake, but also because protection from the vaccines is waning faster than expected and much looser restrictions compared to same time last year. Booster shots for especially elderly and people in high-risk groups are pulling in the other direction. Still, several European countries have already re-imposed restrictions and more are likely to follow, while emerging markets have seen a sharp fall in infection rates and a resumption in economic activity. However, the new variant discovered in South Africa called B.1.1.529, which may be more transmittable and dangerous than other variants, could spread to all regions and pose risk to economic activity.

While we generally think that restrictions will be lighter than last winter, we still expect the COVID-19 virus will cause headwinds for economic growth. Restrictions are being considered in more and more European countries. While the US and other emerging markets are also at risk given their relative low vaccine coverage. Apart from restrictions economic activity can also be hit by people becoming more fearful of catching the virus, which will weigh on especially service sector activity.

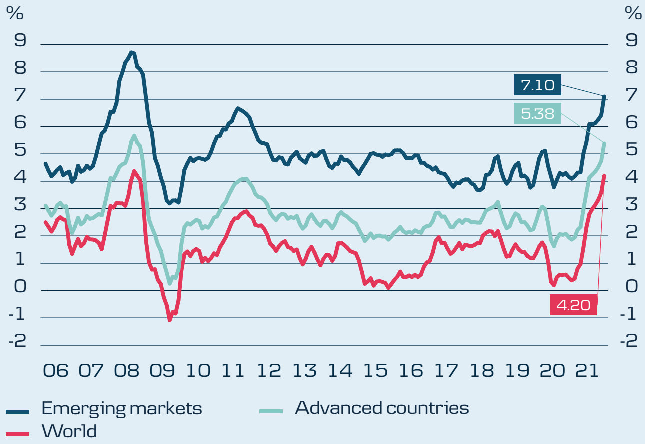
Without the hard lockdowns, the direct hit to economic growth is likely to remain much more moderate than a year ago. The biggest impact is, however, a shift away from service consumption towards goods consumption, which means that bottlenecks (high freight rates, long delivery times, empty shelves and higher underlying price pressure etc) remain unresolved for the next 3-6 months (see also next chapter on global supply problems). We have nevertheless lowered our near-term forecasts (Q4 21 and Q1 22) for both the US and Eurozone due to lower expected service consumption, more than outweighing possibly solid goods consumption.

Momentum in global manufacturing to fall before stabilising in mid-2022



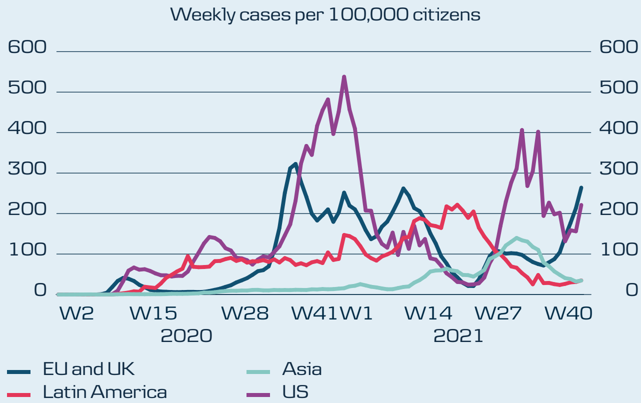
Notes: The US, Japan and euro area are from Markit PMI while the chinese is from National Bureau of Statistics (NBS).
Source: Marlit, China NBS, Marcobond Financials and Danske Bank

Inflation rising in both advanced and developed economies



Source: World Bank, Marcobond Financials and Danske Bank

Europe and US are seeing rising caces, while emerging markets have got it under control



Source: Mavrobond, WHO and Danske Bank

Economic activity should pick up in the spring

Economic activity should pick up in spring 2022, as soon as new cases come down, the fear factor declines and governments lift restrictions, supporting service sector activity. This should also ease supply chain obstacles, supporting a pick-up in production and supply of goods. Furthermore, global growth should also at that stage be supported by srtrengthening economic growth in China on the back of policy stimulus being rolled out in the next months. However, economic policies in the US and Europe will be less accommodating. The impact of the US infrastructure package on US growth is mostly about 2024-28 due to the fiscal policy lag for infrastructure projects (lag of shovel-ready projects) and the Build Back Better Act will be partly financed by higher taxes limiting the impact on economic growth. Furthermore, the negative real wage growth in Europe and US will be a headwind to private consumption.

Overall, we have become more cautious on economic growth since the last Big Picture in August. We have lowered our annual growth forecast for 2022 by almost a percentage point in both the US and China, seeing real GDP growth of 3.5% and 4.5% respectively. The euro area and Japan are both seeing growing at the same pace as before of about 4.2% and 2.0% respectively. We are generally more cautious on G4 growth than consensus in 22, especially for US and China. Given the different speed of recoveries, both the US and Chinese economies have reached their pre-crisis levels while the euro area are almost there while Japan are further away. However, apart from China, none of the three other countries have reached their pre-crisis growth trajectory. Given that we think that especially in the US there will be permanent effect on the labour supply, the economy is unlikely to fully recover the gap.

While there are certainly risks from new variants, we expect this winter to be the last one where governments may be forced to impose strict restrictions. The combination of a better vaccine booster strategy and better treatments means that we expect the advanced economies can finally start living with the virus. This supports the global economy in 2023.

Inflation to fall back in 2022, but at a slower pace than previously expected

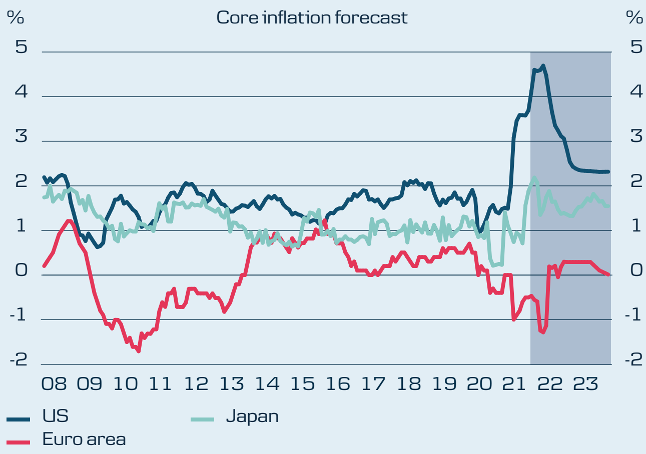
While inflation is still expected to fall back to more modest levels, price pressures are going to remain for longer than previously expected. Inflation pressures are clearly strongest in the US. In our base case, we expect US inflation to move higher in coming months going into 2022 due to higher energy and food prices and still rising goods prices before moving lower over the course of the year. Inflation is set to stay above 2% both in 2022 and 2023. In the euro area, we expect inflation to remain above the ECB's target until H2 22, but fall back to a 1.5-1.7% range thereafter. Especially, energy prices should remain a key inflation driver in the coming months, but this tailwind should start to fade in the course of 2022, in our view. As we expect wage growth to pick up in 2022, we see scope for an acceleration in services and core inflation in the coming years. In China, headline inflation is significantly weaker, although factory price pressures remain significant. The balance of risks are clearly skewed to the upside.

More cautious on G4 real GDP growth than consesus in 22, especially for US and china

	2021 DB	Consensus	2022 DB	Consensus
G4	6.0	6.1	3.9	4.4
United States	5.4	5.5	3.4	3.9
Euro Area	5.0	5.1	4.0	4.2
China	8.0	8.0	4.5	5.3
Japan	1.8	2.1	2.4	2.6

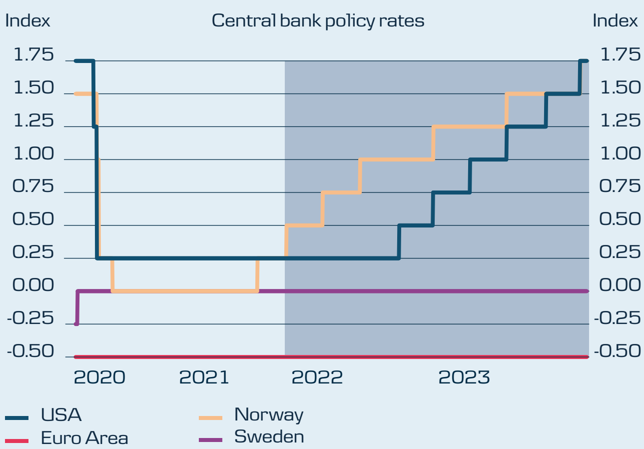
Source: IMF WEO, Bloomberg, Danske Bank

US inflation pressures clearly standing out



Notes: For the US, PCE core inflation is used.
Source: Macrobond Financials and Danske Bank

Central bank divergence



Source: Macrobond Financials and Danske Bank

Real GDP forecasts - Global overview

	2021				2022							
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022	2023
		% q/q				% q/q				% y/y		
G4	0.4	1.5	0.7	1.0	0.9	1.1	0.9	0.8	-2.0	6.0	3.9	3.1
United States	1.5	1.6	0.5	0.8	0.9	1.0	0.5	0.5	-3.4	5.4	3.4	2.2
Euro Area	-0.3	2.1	2.2	0.4	0.4	1.2	1.1	0.6	-6.5	5.0	4.0	2.0
China	0.2	1.2	0.2	1.3	1.2	1.3	1.2	1.3	2.2	8.0	4.5	5.0
Japan	-1.1	0.4	-0.8	1.3	1.1	0.4	0.4	0.4	-4.7	1.8	2.4	1.2

Source: Macrobond Financials and Danske Bank

With the rebound in the economies and significant inflation pressures, central banks have started signalling a roll-back of monetary stimuli. How fast differs from country to country, so monetary policy divergence is an important theme. Earlier this month, the Federal Reserve announced a gradual reduction in the monthly QE bond buying pace, which is set to end in June 2022 at the current pace. We expect that to be followed by two rate hikes (in September and December) followed by an additional four hikes in 2023. Risk is definitely skewed towards the Fed tightening sooner and faster than what we have pencilled in (and compared to what the Fed is signalling). While ECB will reduce its asset purchases in 2022 (and end its PEPP programme in March), we do not expect it to raise its policy rates until 2024. In China, both monetary and fiscal policy will be in easing mode to stabilise economic growth. We do not expect BOJ to claw back its monetary policy support anytime soon.

Higher inflation pressures and/or new more dangerous corona variants are a key risk to the global economy

A key downside risk to the global economy is significantly higher inflation forcing a more abrupt global central bank tightening. Overall we see upside risks for global inflation, especially over the next six months, as bottlenecks in manufacturing remain unresolved, lower labour supply that could trigger acceleration in wages amid excess demand and business passing on more of the high costs to the consumers, triggering a wage-inflation spiral. In this scenario, businesses will start pass on higher costs to customers and wage growth will accelerate to unsustainable high levels. To reign in the higher inflation and avoid a de-anchoring of inflation expectations, global central banks will have to impose a more forceful monetary policy tightening, which will be a major blow to global risk sentiment, increasing the risk of a significant economic backlash and sell-off of risky assets. Among other key risks is continuous COVID-19 mutations that are more contagious and possibly immune to vaccines.

Global Supply Challenges

Global Supply problems likely to last well into 2022

- Global growth is constrained by both material and labour shortages. Unusually strong US goods demand is a key driver of the former and the elevated level of Covid-infections indicates little easing over the winter period.

- Outlook for the current labour shortages remains more uncertain due to variance in development across different areas, but we see risks of permanently lower labour force weighing on potential GDP growth especially in the US.

Supply chain challenges weigh on industrial output

A key uncertainty for the global economic outlook stems from the fact that growth is not constrained by weak demand, but supply side challenges. The two main areas of shortages are related to raw materials and components, as well as labour. The materials shortages affect nearly all economies globally, although manufacturing focused ones are naturally the most exposed. While there are preliminary signs that freight rates and energy prices have peaked, we do not expect the supply chain issues to materially ease until well into 2022. Key driver of the current situation is the unusually high goods demand from the US, which has remained elevated even though restrictions on the service sector have been eased and delta-related worries appear to be fading.

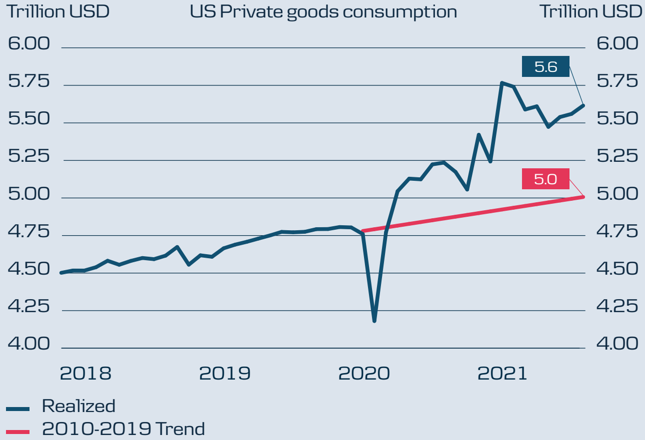
Private goods consumption in the US remained some 12.2% above the counterfactual pre-covid trend in October, while services was 3.2% below. The pandemic-induced change in consumption patterns has not reversed as anticipated and is likely maintained by both pent-up savings from the earlier stimulus as well as pandemic-related fear. Given that the vaccine coverage in certain US states remains low and people spend more time indoors as weather cools, we expect virus cases to remain elevated throughout the winter, which in turn could support goods demand for longer. Corporate goods demand has also risen, with durable goods orders excluding transportation around 19% above the levels seen in early 2020.

Raw material and component shortages are unlikely to ease materially before the US goods demand begins to normalize. The high demand continues to create bottlenecks, with an estimated 10-12% of global containers tied up in US ports. While the flow of goods happens mostly from China to the US, and thus largest issues emerge on the US side, China's strict zero--tolerance Covid-policy creates a risk of additional lockdowns also in Chinese ports. Temporary pause to shipments over the Chinese new-year was expected to ease some of the congestion in US ports, but given that the situation has weakened over the past months, this seems unlikely. Bottlenecks are likely to continue until next summer, when warmer weather should also once again ease the Covid-infections and support services demand.

Decline in labor force could weigh on potential GDP

The decline in labour force is another source of supply side uncertainty. The difficulty in gauging its impact and persistence lies in the uneven developments across geographical areas. While varying unemployment benefits and furloughing schemes most likely reduced incentives for working, for example early retirements have likely caused a permanent drop in the labour supply. We think this is evident especially in the US, where labour force and participation rates remain clearly below pre-pandemic levels despite the fact that most restrictions have already been eased, extraordinary unemployment benefits ended in the beginning of September and labour demand remains very high. Outside US, the situation remains mixed, but similar signs of lower labour force levels have emerged also for example in the UK and Germany.

US goods consumption has remained elevated

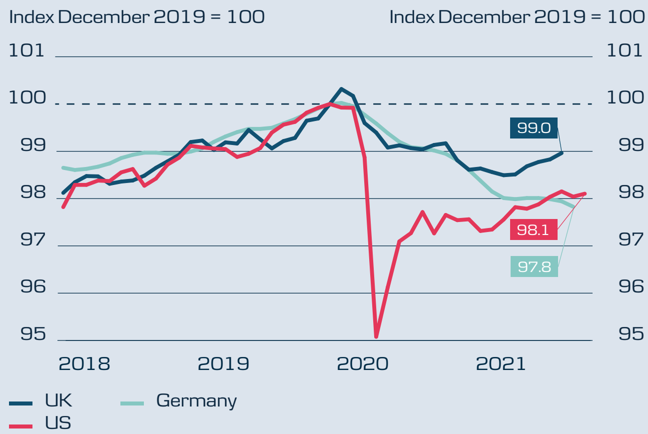


Source: Macrobond Financial

Material shortages weigh especially on manufacturing-focused economies

Source: Macrobond Financial

Decline in labour force is not purely a US-specific issue



Source: Macrobond Financial

US

The easy part is over

- We expect the economy will continue to grow in coming years but at more "normal" growth rates, as the easy part of the recovery is now over.
- We expect GDP growth of 3.5% in 2022 and 2.2% in 2023.
- Goods consumption is likely to remain elevated over the winter due to a new COVID-19 wave, adding to bottlenecks in manufacturing.
- Inflation is set to ease next year but remain global manufacturing above 2% both in 2022 and 2023.
- Labour demand is high and employment will continue to recover.
- The Federal Reserve is set to end QE bond buying June next year followed by the first rate hike in September. We expect the Fed to hike at every other meeting.
- Risk is skewed towards the Fed tightening sooner and faster than what we are pencilling in.

Back to normal growth rates

The US recession caused by COVID-19 was relatively short-lived and economic growth has been strong in 2021. GDP is now higher than in Q4 2019 but not all the way back to the old GDP trend path. To us, this suggests that there are some permanent damages to the economy caused by the pandemic. Looking at subcomponents, private consumption is basically back to the old trend path (suggesting no permanent damages to consumption) but private non-residential investments are still subdued compared to the period before COVID-19.

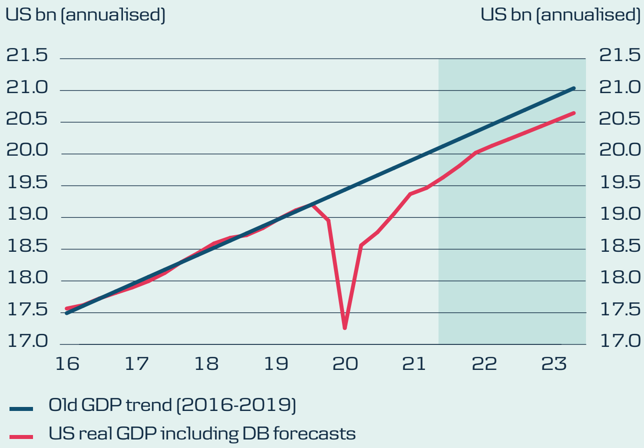
The "easy part" of the recovery is likely behind us and we expect more "normal" growth rates going forward. Admittedly, the "economic visibility" for the coming years is lower than usual, as we do not have historical experiences to draw on. We expect the US to be hit by another COVID-19 wave over the winter, which is a key uncertainty, but since we soon have a strong combination of vaccines and treatments, we expect the COVID-19 endgame is next year. We do not expect new tough restrictions (but some soft measures may get implemented in some Democratic states) but changed behaviour is a downside risk to the near-term outlook. This also means that the consumption pattern is set to remain skewed towards goods consumption over the next six months, adding to the bottlenecks in manufacturing. We expect a reversal to a more normal consumption pattern starting by late Q2 22. There are also upside risks to private consumption growth due to still high savings. Negative real wage growth pulls in the other direction, however.

Overall, however, we expect the economy will continue growing, but at more normal growth rates like it was the case before COVID-19. That also means that GDP is probably not going to return back to the old trend path. The big question is whether long-run potential GDP growth has slowed due to a combination of fewer investments and a lower labour force. We are not surprised the potential growth has declined slightly.
We expect GDP growth of 5.4% in 2021, 3.5% in 2022 and 2.2% in 2023.

Inflation is set to stay above 2%

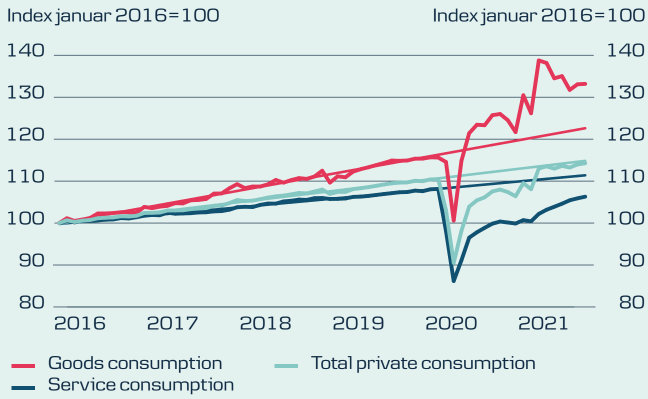
As we asked in our Big Picture last year: *"a lot of money has been injected to the system […] and when things start to normalise, we will likely see a sharp increase in demand. If this is not inflationary down the road, what is?"*. We were despite this observation still caught by surprise by how fast inflation came and how high it got. Inflation is not only driven by higher food and energy prices but has become more broad-based in recent months. We believe it is important to be humble when making inflation forecasts, as inflation is a very complicated process, but in our base case we expect inflation to move higher in coming months going into 2022 due to higher energy and food prices and still rising goods prices before moving lower over the course of the year. Inflation is set to stay above 2% both in 2022 and 2023. This also means that the Fed continues to overshoot average inflation of 2%, which is the new target after the regime shift in August 2020.

Real GDP growth back to normal



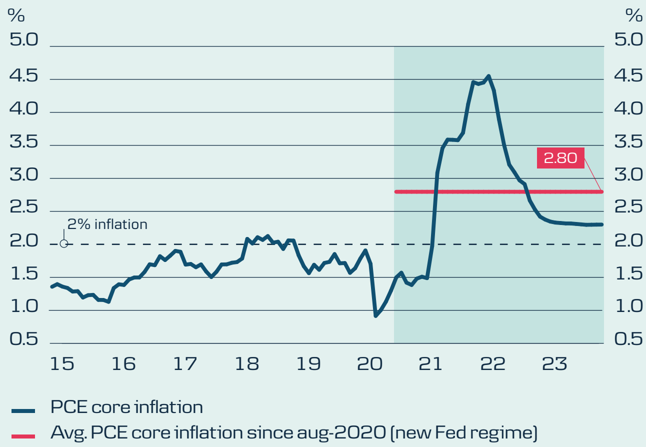
Sources: BEA, Macrobond Financial, Danske Bank

Total private consumption is back to normal but goods consumption remains elevated, explaining some of the bottlenecks globally



Sources: BEA, Macrobond Financial, Danske Bank

Inflation is set to ease in 2022 but stay above 2%



Sources: BEA, Macrobond Financial, Danske Bank

Overall we see upside risks, especially over the next six months, as bottlenecks in manufacturing remain unresolved as long as goods consumption remains elevated. Inflation expectations (especially short-term) have risen, increasing the risk of persistently high inflation. Additionally, a record-high share of businesses are reporting they expect to hike prices.

We forecast average PCE inflation of 3.8% in 2021, 3.6% in 2022 and 2.2% in 2023.

Hot labour market

The jobs report for October showed that employment is still more than 4 million lower than in February 2020. This is a bit surprising, as labour demand is very high (still 10.4 million job openings in September) and businesses are struggling to recruit new people. One explanation is that the labour force is still 3 million lower than in February 2020, caused by a combination of home schooling, COVID-19 fears and retirements (among other things). The big question is whether people will return to the labour force? We expect some (especially younger people) will return gradually over the next year, as COVID-19 fears fade. We do not expect, however, that all newly retired people will return, so there are permanent damages to the US labour market. Still, we expect the unemployment rate will drop below 4% in H2 2022.

Wage growth has accelerated in 2021 supported by the mismatch between labour demand and labour supply. We expect wage growth will remain high also in 2022, as a large share of businesses report they are raising compensation. An upside risk to the inflation outlook is that wage growth accelerates to unsustainable levels (e.g. a wage-inflation-spiral) or businesses pass more of rising compensation costs to consumers.

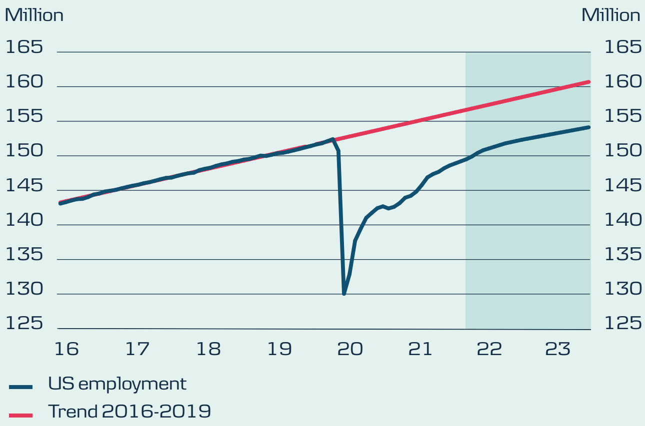
Time for the Fed to raise rates

The Federal Reserve is gradually moving in a more hawkish direction and the Fed announced the start of tapering at the meeting here in November 2021 with the ambition to conclude QE bond buying in June 2022. While Fed Chair Jerome Powell warned against relating the tapering announcement to the timing of rate hikes, we see the announcement as marking the beginning of tighter monetary policy. We expect two rate hikes in H2 2022 with the first one in September (and a total of four rate hikes in 2024), as the Fed will react to a combination of still high inflation and further labour market progress.

We believe risk is skewed towards the Fed tightening monetary policy sooner and faster than what we have penciled in in our base case. The Fed has begun discussing whether to increase the tapering pace, which opens the door for a third rate hike in 2022, in our view, with the first one in May or June.

Fiscal policy is a drag on growth in 2022, largely reflecting just how expansionary fiscal policy was in 2021. The bipartisan infrastructure package is supporting growth but mostly beyond our forecast horizon (2024-2028), as there is a policy lag from the decision to spend more money before the money is actually spent on new projects. We expect the Democratic Party to agree on an approximately USD1,750bn welfare package, which is positive for growth near-term, as spending is front-loaded and higher taxes are implemented more gradually.

Employment will continue to increase but not closing the gap to the old trend line



Sources: BLS, Macrobond Financial, Danske Bank

We expect the Fed to hike twice next year and four times in 2023 but risks are skewed towards even more tightening

Note: Past performance is not a reliable indicator of future performance.
Sources: Federal Reserve, Macrobond Financial, Danske Bank

Macro forecasts - US

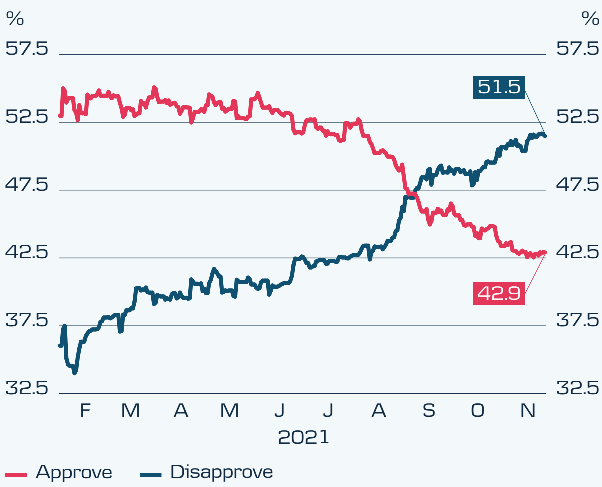
	2022				2023						
% change q/q AR	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2021	2022	2023
GDP	3.8	4.2	2.2	2.0	2.0	2.0	2.0	2.1	5.4	3.5	2.2
Private Consumption	2.4	3.0	2.0	2.0	2.0	2.0	2.0	2.0	7.8	2.9	2.1
Private Fixed Investments	4.6	4.8	4.3	3.1	3.2	3.2	3.3	3.3	7.8	3.6	3.4
Residential	6.0	6.1	5.3	3.6	3.6	3.6	3.6	3.6	7.6	5.4	4.0
Non-residential	0.0	0.6	1.0	1.4	2.0	2.0	2.0	2.0	8.7	-2.3	1.7
Change in inventories[1]	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	0.8	0.1
Public Consumption	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.7	0.8	1.0
Exports	2.4	2.0	1.6	1.6	1.6	1.6	1.6	1.6	3.7	1.9	1.6
Imports	3.0	2.6	1.8	1.8	1.8	1.8	1.8	1.8	13.2	3.3	1.9
Net exports[1]	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-1.8	-0.4	-0.2
Unemployment rate (%)	4.3	4.1	3.9	3.7	3.7	3.7	3.6	3.6	5.4	4.0	3.6
Inflation (CPI) (y/y)	6.1	4.5	3.5	2.3	2.2	2.2	2.2	2.1	4.6	4.1	2.2
Core inflation (CPI) (y/y)	5.3	3.9	3.2	2.7	2.5	2.4	2.4	2.4	3.5	3.8	2.4
Public Budget[2]									-14.9	-13.4	-4.7
Public Gross Debt[2]									130	126	124
Current Account[2]									-3.5	-3.5	-3.3
Fed funds rate[3]	0.25	0.25	0.50	0.75	1.00	1.25	1.50	1.75	0.25	0.75	1.75

1. Contribution to annualised GDP growth
2. Pct. of GDP (CBO and IMF)
3. Upper limit. end of period
Source: CBO. IMF. Danske Bank

Watch out for midterm elections in 2022

The midterm elections will be held on Tuesday 8 November. All 435 voting seats in the House of Representatives and at least 34 of the 100 seats in the Senate are up for election 8 November 2022. According to FiveThirtyEight, President Joe Biden's net approval rating has declined from +17pp in the beginning of his presidency to now -8.6pp. As of today, Democrats look posed to lose their majority, implying that President Biden becomes a lame duck on domestic policy. That is also why it is now or never for Democrats to get the welfare package over the finish line.

President Biden's approval rating has plummeted



Sources: FiveThirtyEight, Macrobond Financial

Euro area

Between light and shadow

- Following a moderation in the growth pace during the winter period, we look for an ongoing expansion of the euro area economy at 4.0% in 2022 and 2.0% in 2023, helped by private consumption and investments.

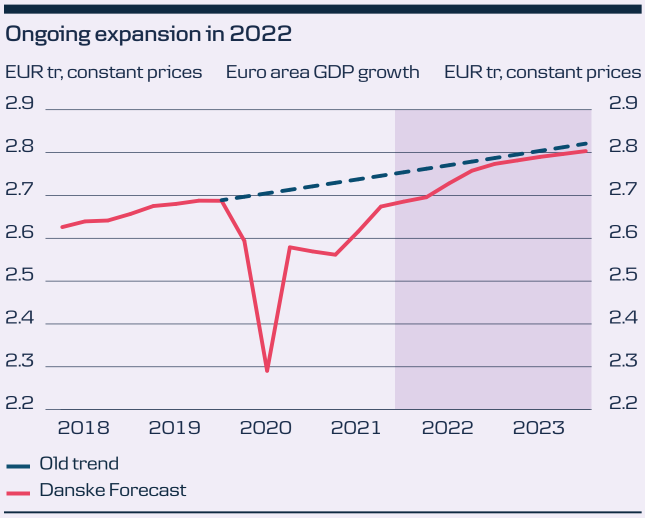
- As the economy is moving away from 'crisis mode,' we expect a tightening of the fiscal stance during 2022 and 2023. Potential EU budget rule reforms will be key to follow.

- Inflation pressures remain elevated during 2022, but headline inflation should fall back below the ECB's 2% target in 2023. While we expect ECB to slowly exit its crisis response tools, we do not expect it to raise policy rates until 2024.

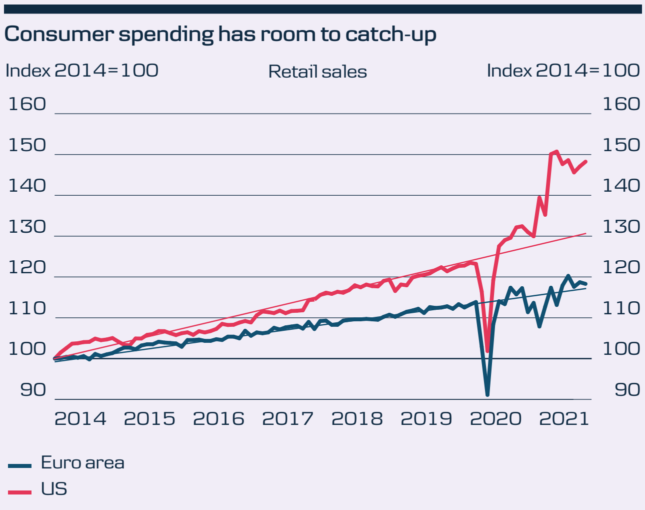
Exiting ‘crisis mode’

The euro area economy remains caught between light and shadow. In step with the improving epidemiological situation, a sense of economic ‘normality’ returned to Europe over the summer and with it a spending spree in services that left GDP only 0.5pp below pre-pandemic levels at the end of Q3. However, clouds have recently started to gather over the euro area growth prospects from a number of growing headwinds. Widespread global supply chain issues and slowing Chinese economy are constraining industrial production and exports. A resurgence of COVID-19 infections in many countries and patchy vaccination rates leave domestic demand exposed to setbacks during the winter period and rising inflation rates are adding yet another headwind to consumer spending. Consequently, we look for a noticeable moderation in the growth pace during the next six months. However, once the Covid-19 situation comes under control, prospects should start to brighten, as private consumption remains supported by improving labour markets, rising wages, high savings and fading inflation pressures. Investments and exports should also see a boost once supply bottlenecks start to ease up in light of full order books, high capacity levels, favourable financing conditions and not least increased EU fund absorption from the ‘Next Generation EU’ (NGEU) recovery fund. As the boost from domestic demand starts to wear off and a number of ‘pre-existing conditions’, such as low productivity and adverse demographic trends, come back to the fore, we project GDP growth to moderate from 4.0% in 2022 to 2.0% in 2023. Still, this implies that the euro area economy should convergence to its old trend path by 2023.

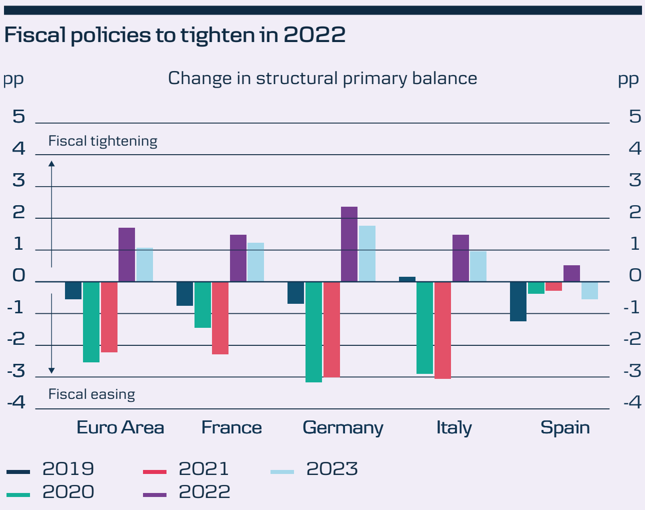
As the economy is moving away from ‘crisis mode’ we expect government emergency support measures increasingly to be rolled back, leading to a tightening of the fiscal stance during 2022 and 2023. That said, financing from NGEU continues to provide an important backstop for public spending and investments, and will continue to play a key role in alleviating the risk of diverging growth paths between euro area countries (see also Research Euro Area - Decoding Europe’s recovery plans, 17 May). The importance of structural reforms that are accompanying NGEU has been amply illustrated by this year’s growth performance, where the recovery pace of reform ‘laggards’ (such as Spain and Germany) has trailed behind those of reform ‘leaders’ (such as Italy and France). Shrinking budget deficits should allow the euro area debt to GDP ratio gradually to decline in the coming years, but governments will have to walk a fine line between managing their post-corona debt piles while allowing for productive investments, not least in light of Europe’s green transition ambitions. We expect EU budget rules to be re-instated from 2023, but with a flexible interpretation from the European Commission (see theme box). Greater political and market acceptance of higher debt burdens make the probability for a European debt crisis seem low, but in light of signs of a shift in the global interest rate environment towards tighter monetary conditions and potentially higher interest rates, it will be important for fiscally vulnerable countries such as Italy and France to find ways to make credible commitments to bringing public finances on a sustainable path.



Source: Eurostat, Macrobond Financial, Danske Bank



Source: US Census Bureau, Eurostat, Macrobond Financial, Danske Bank



Source: EU Commission, Macrobond Financial, Danske Bank

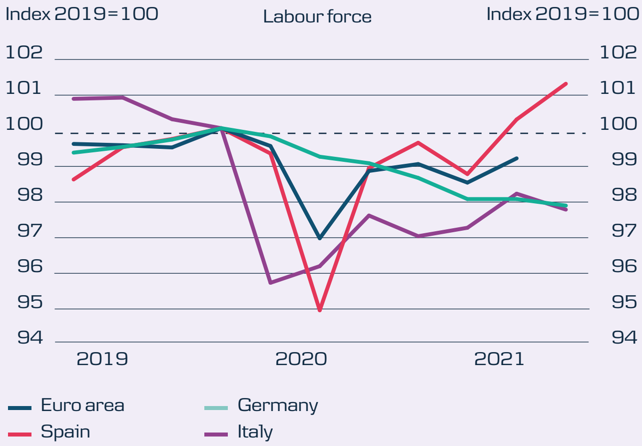
The big inflation question

The strength and speed of the euro area labour market recovery surprised on the upside during 2021, with the unemployment rate now back to pre-crisis levels. Still, the amount of total labour market slack has not yet fully returned to 'normal' in light of a growing number of inactive people who are available to work but not actively seeking. This leaves the question whether labour supply will return to pre-crisis levels as labour shortages are becoming more acute, especially in sectors were demand is strong. Diverging country trends are blurring the picture: while labour supply is already back above pre-crisis levels in Spain it has stagnated at ca. 2pp lower levels in Germany and Italy. With most short-time working schemes expiring with the turn of the year, we expect more workers to gradually return to the labour market during 2022, but the risk is skewed towards a slower return and that labour shortages and bottlenecks are with us for a more extended period of time. This could keep upward pressure on wages in place in 2022-23 even in a scenario where GDP growth is moderating.

Accompanying the recovery, the fortunes for euro area inflation have turned around markedly during 2021. HICP inflation has printed above the ECB's new symmetric 2% inflation target since July, fuelling market expectations of an ECB interest rate hike during 2022. Rising energy and commodity prices, cost-push effects from supply chain bottlenecks, tax changes and re-opening effects in services all contributed to the late inflation surge. Overall, we expect inflation to remain above the ECB's target until H2 22, but fall back to a 1.5-1.7% range thereafter. Especially, energy prices should remain a key inflation driver in the coming months, but this tailwind should start to fade in the course of 2022 in our view. That means, the fortunes for euro inflation remain dependent on developments in core inflation. As we expect wage growth to pick up in 2022, we see scope for an acceleration in services and core inflation in the coming years. That said, inflation sustainably converging towards the ECB's target would probably require continued sharp commodity price increases or a more persistent trend shift in wage growth above the long-run average (read more in Euro Area Research - Measuring the euro area inflation pulse, 15 November).

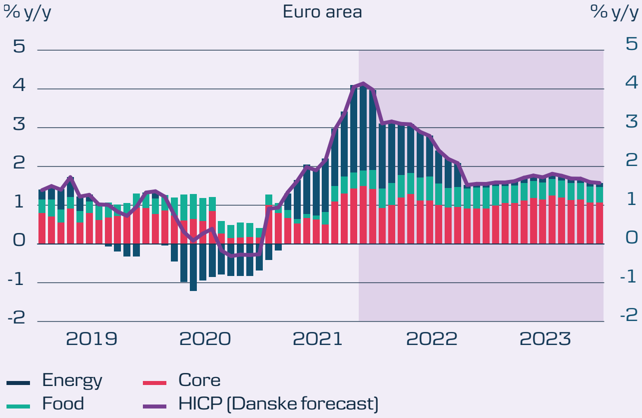
We expect ECB slowly to embark on the path of exiting its crisis response tools, starting with the phase out of net PEPP purchases in March 2022. At the same time, ECB will be keen to avoid any cliff effects and premature tightening of financing conditions, especially for fiscally vulnerable Southern European countries, and hence we also look for a scale up in the normal QE purchases to EUR 40bn per month. More liquidity operations (TLTROs) and an increase in the tiering multiplier that is exempting bank reserves from negative rates could complement the monetary policy re-calibration during 2022. That said, in contrast to current market pricing, we remain sceptic of ECB joining the growing camp for global central banks raising rates. With headline inflation still undershooting the target in 2023 and 2024 and underlying inflation pressures building only slowly, we see ECB in no hurry to create additional headwinds for the fragile euro area recovery from the pandemic and consequently do not foresee any policy rate increases until 2024.

Will people that left the labour force return? And how fast?



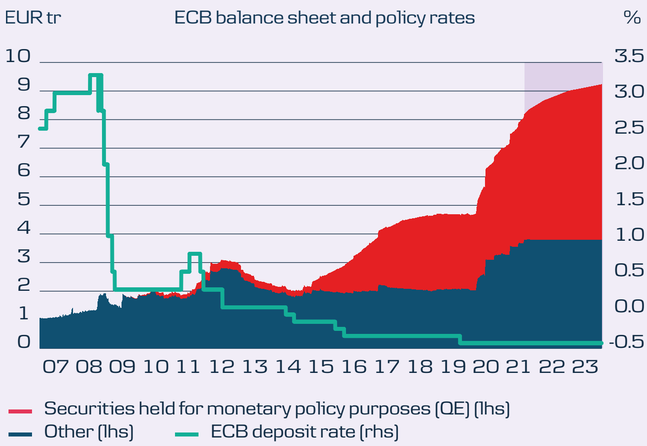
Source: Eurostat, Macrobond Financial, Danske Bank

Inflation to remain elevated in 2022, but fall back below target in 2023



Source: Eurostat, Macrobond Financial, Danske Bank

No ECB rate hikes before 2024



Source: ECB, Macrobond Financial, Danske Bank

Macro forecasts - Euro area

% Change q/q	2021				2022				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022	2023
GDP	-0.3	2.1	2.2	0.4	0.4	1.2	1.1	0.6	-6.5	5.0	4.0	2.0
Private Consumption	-2.3	3.4	3.4	0.5	0.6	2.0	1.5	0.4	-8.0	2.8	5.9	2.0
Fixed Investments	0.0	1.1	0.5	0.5	0.6	0.7	0.8	0.8	-7.3	3.9	2.7	2.2
Public Consumption	-0.5	1.2	0.4	0.1	0.1	0.1	0.4	0.4	1.3	3.2	1.1	1.3
Exports	1.1	2.7	2.5	1.0	1.5	2.0	2.0	1.5	-9.4	10.3	7.2	5.1
Imports	1.0	2.8	2.0	1.0	1.8	2.2	2.1	1.4	-9.3	7.7	7.5	5.2
Net exports[1]	0.3	0.1	1.3	0.2	-0.3	-0.1	0.1	0.4	-0.3	1.5	0.1	0.2
Unemployment rate (%)									7.9	7.8	7.3	7.1
HICP (y/y)	1.0	1.9	2.9	4.1	3.1	2.9	2.2	1.5	0.3	2.4	2.5	1.7
Core HICP (y/y)	1.2	0.9	1.4	2.1	1.5	1.7	1.4	1.3	0.7	1.4	1.5	1.6
Public Budget[2]									-7.2	-6.9	-3.6	-2.1
Public Gross Debt[2]									99.3	99.8	97.6	96.7
ECB deposit rate[3]	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5

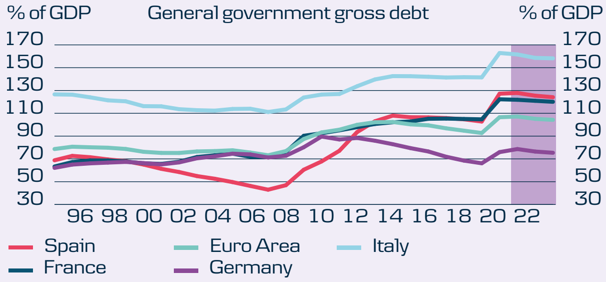
1. Contribution to GDP growth
2. Pct. of GDP
3. End of period
Source: Eurostat. Danske Bank estimates

Theme box: EU fiscal rules reform – opening Pandora's box

In the aftermath of the pandemic debt and deficit levels in euro area countries have seen a significant increase (see also Research Global - Public debt levels post COVID-19: much ado about nothing?, 30 September 2020). In response to the crisis, the EU suspended its budget rules in 2020 in order to give government more leeway to support their economies. In recent months the debate over reforming the controversial Stability and Growth Pact (SGP) rules has gathered pace. The key point of contention is the debt rule of the SGP that requires a 1/20th per annum reduction in debt ratios for countries whose public debt exceeds the 60% of GDP threshold. Many governments acknowledge that a strict application would imply a far too stringent fiscal retrenchment – especially for high debt countries such as Italy - that could endanger the ongoing euro area expansion. A second reform proposal centres on more favourable treatment of public investments. One idea is to exclude green investments from the debt and deficit calculations under a 'green golden rule', in order to ease hurdles for massive public spending programmes needed to achieve the transition to a carbon neutral economy by 2050. A Bruegel paper estimates that achieving EU climate goals would require an increase in total green investment of about 2% of GDP annually, of which public investment will have to amount to between 0.5-1% of GDP.

Given deep and longstanding divisions between fiscally conservative countries in the north and fiscal 'doves' in the south that are advocating a loosening of the rules, finding agreement on SGP reform will not be easy. Especially, 'frugal' countries are sceptical of the idea of excluding green investments in deficit calculations and fear a watering down of current limits. An agreement before H2 22 seems unlikely and we think the appetite for EU treaty changes is low. That said, one possible route could be a more flexible interpretation of existing rules by the European Commission, as already seen on countless occasions in the past with respect to i.e. Italian budget deficit violations.

Most euro area countries exceed the 60% public debt threshold



Source: EU Commission, Macrobond Financial, Danske Bank

Germany

Unchartered territory

- The economy is headed for a challenging winter period, as supply bottlenecks and a slowing Chinese economy are weighing on industry performance, while the private consumption growth engine is stuttering. From H2 22 the growth prospects should brighten and we look for GDP growth of 4.1% in 2022 and 1.9% in 2023, with the German economy catching-up with its old trend path by end-2022.

- Germany's long-term growth prospects remain mixed, with adverse demographics weighing on potential growth. Technological change and the transition to a climate-neutral economy present both a challenge and an opportunity.

- Inflation pressures should remain elevated in 2022, as ongoing labour market tightening and rising wage growth are supporting underlying inflation dynamics.

- With a centrist 'traffic-light' coalition government likely taking over, German politics is headed for unchartered territory. Financing ambitious public investment plans will be the key challenge.

In short supply

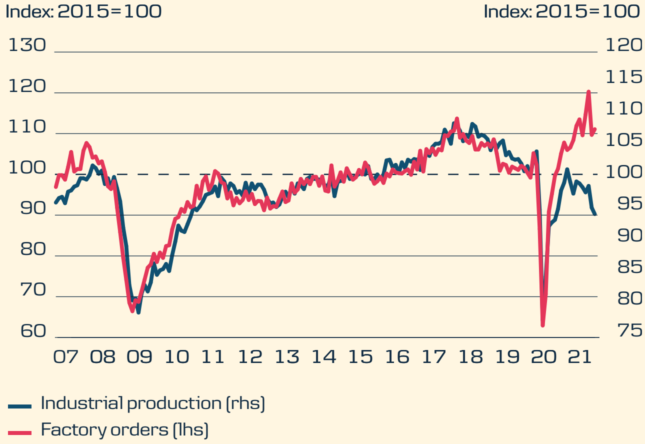
In many ways Germany is finding itself in unchartered territory. The 'era Angela Merkel' is drawing to an end and a new governing coalition is taking over that has never been tried before at the federal level. German industry, long the backbone of Germany's growth outperformance, is struggling with global supply chain bottlenecks and maintaining its competitiveness amid rising cost pressures and Europe's green transition efforts. Germany's economy has weathered the pandemic better than many euro area peers thanks to a smaller services sector, ample fiscal room and labour market support through the 'Kurzarbeit' scheme. However, its rebound during 2021 has been lacklustre. An important factor have been widespread global supply chain issues, that have hit German manufacturers – many of which are capital goods producers that rely heavily on intermediate inputs from abroad – particularly hard. Industrial production has shrunk since the start of 2021 and the near-term outlook remains clouded with supply issues in many industries expected to persist at least until H2 22 and China's economy – an important export market – also slowing rapidly.

A renewed surge in Covid-19 cases continues to cast a shadow on the near-term growth outlook. Germany's vaccination rate (69%) remains below the rates seen in other euro area countries such as Spain (82%), Italy (77%) and France (76%), and tighter restrictions and more cautious consumers leave contact-intensive services exposed to a setback during the winter period. A surge in energy prices is adding to the headwinds for consumers, eroding real disposable income, with German CPI inflation rising to 4.5% during October (highest since 1993). While some idiosyncratic factors (related to base effects from the VAT cut during H2 20) will dissipate in 2022, we expect inflation pressures to remain elevated in 2022, with German HICP averaging 2.5%. Developments in the labour market will play an important role how durable inflation pressures will prove to be. Labour shortages have already appeared in some sectors, as firms seek to hire and expand capacity amid continued high demand. With the expiration of Kurzarbeit in 2022, more people should re-join the labour force, alleviating labour shortages somewhat. However, with the unemployment rate expected to continue its downtrend in the coming years, falling to a new record low of 2.9% in 2023, we expect Germany's labour market to remain tight. This, combined with high observed inflation rates, leaves the potential for higher wage growth resulting from the collective bargaining rounds coming up in 2022 (see also Research Euro Area - German wages: what to watch in 2022).

Short-term pain, long-term gain?

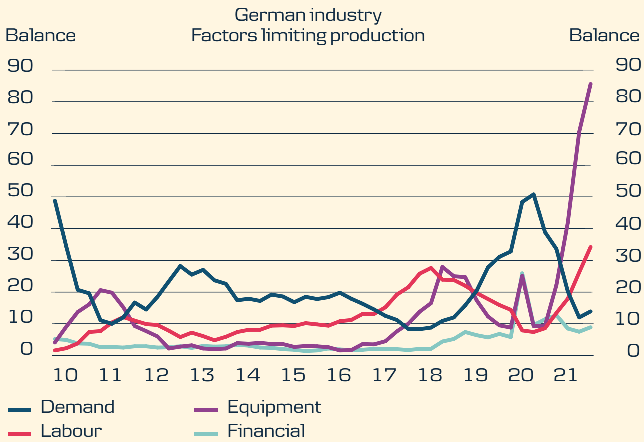
In sum, we see the German economy headed for a challenging winter period with a further downtrend in the growth momentum during Q4 21 and Q1 22, as supply bottlenecks and a slowing Chinese economy are weighing on industry performance and exports, while the private consumption growth engine is stuttering. That said, from H2 22 the growth prospects should start to brighten as supply constraints start to ease and pent-up demand support exports amid full order books. Ongoing employment growth, rising wages and accumulated savings buffers should also boost private consumption once Covid-19 headwinds abate during the summer. With many corona-related spending programmes expiring, fiscal policy will

Demand is outpacing supply



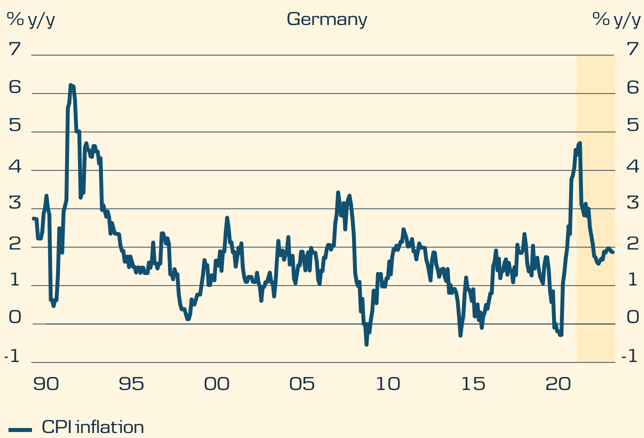
Source: Destatis, Macrobond Financial, Danske Bank

Material and labour shortages are weighing on manufacturing



Source: EU Commission, Macrobond Financial, Danske Bank

High inflation is eroding real disposable income



Source: Destatis, Macrobond Financial, Danske Bank tighten next year. However, in light of the increased focus on public and private investments in infrastructure, digitalisation and green technologies under the new government, investments will continue to hold a hand under Germany's growth performance in the coming years, not least in light of low borrowing costs, high capacity utilisation and strong construction activity. Overall, we look for GDP growth of 4.1% in 2022 and 1.9% in 2023, with the German economy catching-up with its old trend path by end-2022.

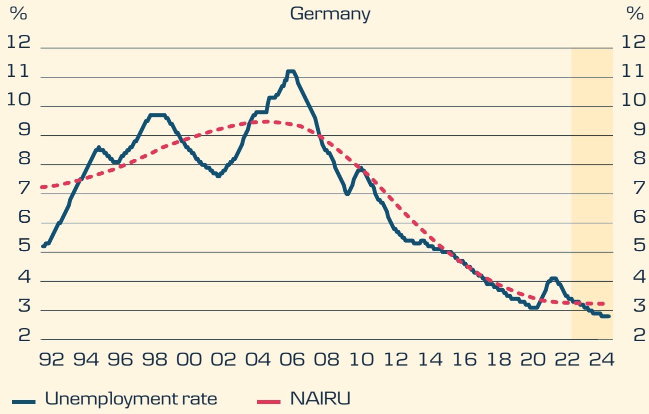
The long-term growth prospects of the German economy remain mixed. The working age population will start to shrink from 2023 onwards in the absence of increased net immigration, weighing on potential growth. Productivity growth has been declining for several decades, as innovation expenditures are increasingly concentrated on large companies. With technological change and the transition to a climate-neutral economy by 2050, parts of the capital stock will become obsolete and many German industries will have to adapt their business models and production processes, not least the important car sector.

German Politics enters unchartered territory

With the 'era Angela Merkel' drawing to an end, German politics has entered unchartered territory. Combining political forces on the left (SPD, the Greens) and right (FDP), we see the new 'traffic-light' coalition as a centrist government that will maintain a strongly pro-European stance. On foreign policy, we see scope for the new government under influence from the Greens to take a more critical stance towards China and autocratic leaders in the EU. Current Finance Minister Olaf Scholz will likely take over the chancellory and we see him as a steady hand with a measured and consensus-based leadership style in the tradition of Merkel. Whether he can fill the European leadership will only be seen over time and probably not before the next crisis hits.

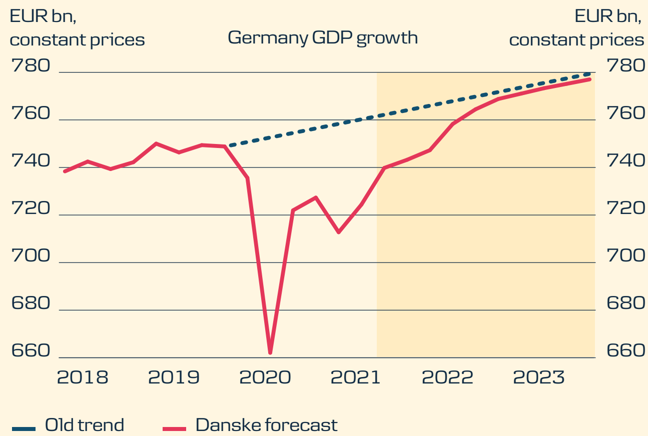
Preliminary results from the coalition negotiations point to an increased focus on public and private investments in infrastructure, digitalisation and green technologies. The exit from coal is planned for 2030, with 2% of the surface area earmarked for wind energy and solar panels to be installed on most roofs. The minimum wage is envisioned to be raised to EUR 12/h (from currently EUR 9.60/h) in the course of 2022, which should benefit especially low income households with a larger propensity to consume. The tricky part remains the financing, as the coalition plans to comply with the constitutional 'debt brake' by 2023 (limiting the structural deficit to 0.35% of GDP and government net borrowing to EUR 10-15bn per year), while also ruling out tax increases. This leaves a question mark how additional investments of at least EUR50bn per year will be financed. Favourable depreciation rules for digital and green investments will probably help, but the plan of finding additional budgetary leeway by eliminating 'unnecessary and climate-damaging' subsidies and expenditures rings hollow. Even if the money can be found in the end, bureaucratic hurdles, slow planning approvals and construction bottlenecks could still delay implementation on the ground. Debt relief for highly indebted municipalities would be an important measure to boost fiscal multiplier effects in our view, as most construction investment is realized at the local government level.

Ongoing employment growth means further labour market tightening



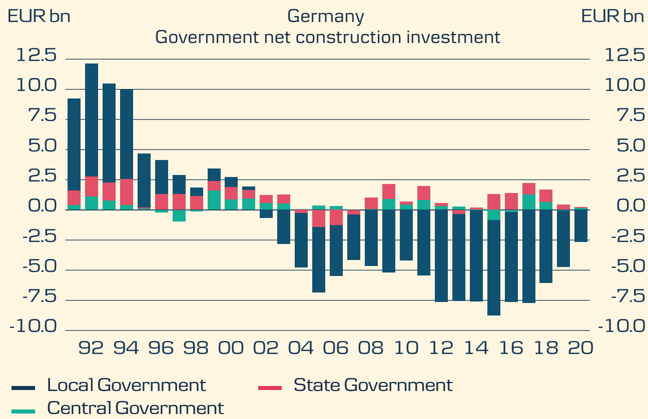
Source: Eurostat, EU Commission, Macrobond Financial, Danske Bank

Back to pre-pandemic growth path in 2023



Source: Eurostat, Macrobond Financial, Danske Bank

Local government bottlenecks impede infrastructure investments



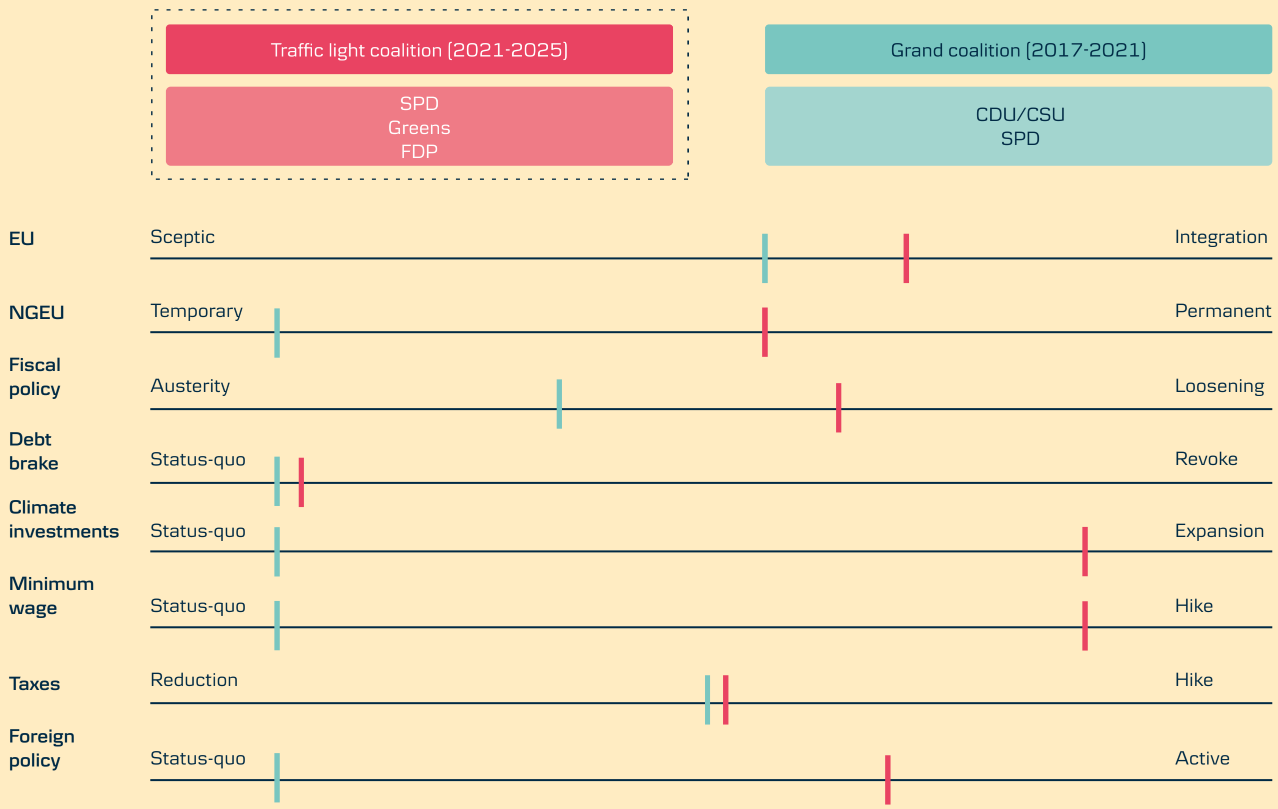
Source: Destatis, Macrobond Financial, Danske Bank

Macro forecasts - Germany

% Change q/q	2021				2022				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022	2023
GDP	-2.0	1.6	2.1	0.5	0.5	1.5	0.8	0.6	-4.9	2.6	4.1	1.9
Private Consumption	-5.2	3.2	4.1	0.8	0.9	2.5	1.0	0.4	-6.1	-0.5	6.9	1.9
Fixed Investments	-0.7	0.5	0.5	0.5	0.6	0.7	0.8	0.8	-3.0	2.2	2.5	2.2
Public Consumption	-0.7	1.8	0.3	0.1	0.1	0.1	0.4	0.4	3.5	2.5	1.2	1.3
Exports	1.4	0.5	-0.4	1.3	1.5	2.0	2.0	1.5	-10.1	7.7	5.4	5.1
Imports	4.2	2.1	-0.1	1.6	1.8	2.2	2.1	1.4	-9.2	7.9	6.7	5.2
Net exports [1]	-4.4	-2.8	-0.6	-0.3	-0.3	-0.1	0.1	0.4	-0.9	0.2	-0.4	0.1
Unemployment rate (%)									3.9	3.6	3.2	2.9
HICP (y/y)									0.4	3.0	2.5	1.8
Public Budget [2]									-4.3	-4.9	-2.1	-0.5
Public Gross Debt[2]									68.7	71.4	69.2	68.1

1: Contribution to GDP growth
2: Pct. of GDP
Source: Eurostat. Danske Bank

'Traffic light' coalition will focus on green investments



Source: Danske Bank

UK

Back to more normal growth rates

- The recovery is likely to continue but growth rates are coming down, as the easy part of the recovery is now behind us.
- We expect GDP growth of 5.1% in 2022 and 2.4% in 2023.
- Inflation is set to remain high in 2022 before moving lower in 2023. Increasing risk of persistent high inflation.
- Bank of England is set to hike multiple times in coming years due to a combination of further labour market progress and high inflation.
- We expect the renewed tensions between the EU and the UK will ease eventually.

Long-lasting damages created by Brexit and COVID-19

The UK economy was hit hard by COVID-19 but like other advanced economies, the UK has seen a swift recovery with GDP nearly back to pre-covid levels. GDP is still below the old trend path, partly because the labour force has shrunk. Businesses are still struggling with getting used to the new EU-UK trading relationship, which is also a negative factor for the economy.

New COVID-19 cases remain high in the UK but the relationship between new cases and hospitalisations is much weaker now (also due to a successful roll-out of boosters) and the government is not signalling that new restrictions are on their way. The bar for restrictions is higher in the UK than in other European countries. In our base case, we do not expect the government to implement tough measures (although some softer measures like working from home or facemasks could be) but the risk is skewed towards tougher measures if a new wave puts pressure on hospital capacity.

Just as it was the case for 2021, the economic visibility for the coming years is quite limited. We are, however, forecasting that the economic recovery will continue, mainly because our base is that the advanced economies are able to live with COVID-19 next year due to a combination of vaccines and better treatments. That said, we expect UK GDP will remain below the old trend path, revealing that Brexit and COVID-19 have created long-term damages to the UK economy. Overall, we are forecasting UK GDP growth of 5.1% in 2022 and 2.4% in 2023.

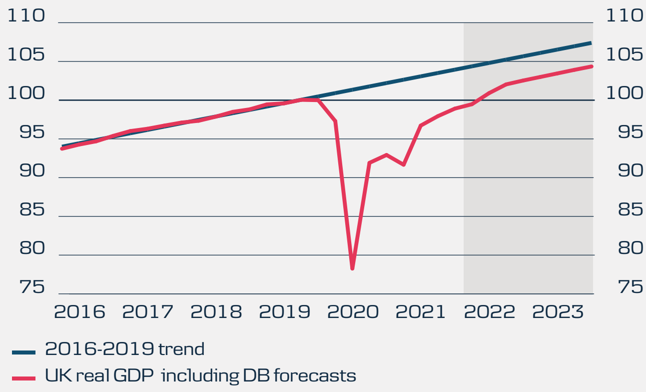
If we are wrong about the handling of COVID-19 and the UK government moves forward with tough restrictions, GDP is likely to fall (or at best move sideways) in Q1 22 but rebound quickly when restrictions are then lifted again.

High inflation is set to ease next year

Like in other advanced economies, inflation is high in the UK with CPI headline now above 4% y/y and CPI core above 3% y/y. All of the four major components (food, energy, services and non-energy industrial goods) are now contributing to inflation, so the rise in inflation is not only due to higher energy and food prices. The UK is hit by the same global forces as other countries but the situation is likely made worse by Brexit, as businesses are still struggling getting used to the new trading relationship, hurting imports from the EU. Inflation expectations have risen, especially short-term inflation expectations, increasing the risk of persistently high inflation.

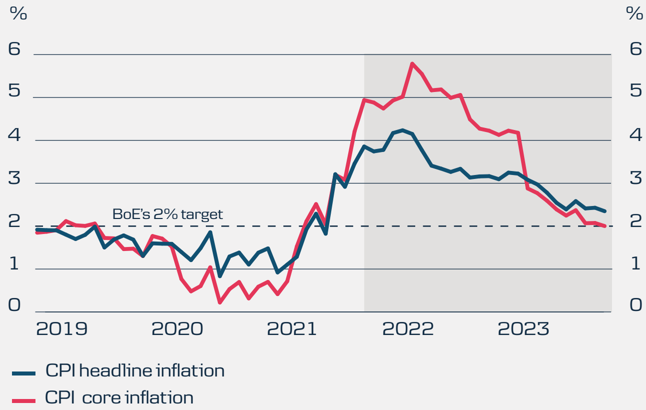
In our base case, we expect CPI inflation to rise further near-term, peaking in spring 2022 before starting to move lower. We are, however, expecting inflation will remain significantly above the Bank of England's 2% target over the course of next year. We expect CPI inflation to move closer to 2% in 2023. Especially near-term, we see upside risks to our inflation outlook, as we have been caught by surprise by the development in recent months.

UK economy is recovering but long-lasting damages from Brexit and COVID-19



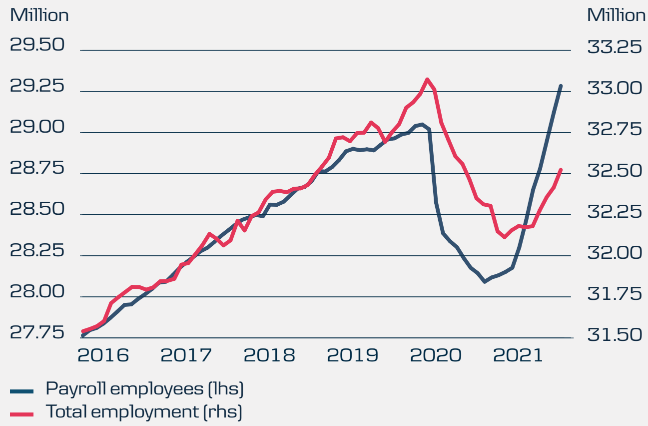
Source: ONS, Macrobond Financial, Danske Bank forecasts

Inflation is set to moderate next year but remain above 2% in both 2022 and 2023



Sources: ONS, Macrobond Financial, Danske Bank forecasts

Payroll employment is above pre-covid levels but total employment remains subdued



Note: Total employment is a broader employment measure than payrolls. The number of payrolled employees is, however, a faster indicator.
Sources: ONS, Macrobond Financial

The labour market dynamics are also important for whether inflation will remain high more persistently. The labour force remains more than 1% lower compared to pre-covid levels amid high labour demand, where job vacancies are now up 40% compared to February 2020. This means upside risks to wage growth and hence inflation. That said, wage growth has decelerated in recent months.

Tighter monetary policy in coming years

Bank of England created a lot of confusion among investors by keeping monetary policy unchanged in November despite market pricing. The Bank of England did, however, signal tighter monetary policy is moving closer, so when it happens is more about timing. One major difference between the Bank of England and the ECB is that the Bank of England did not struggle to the same extent with too low inflation before the covid crisis and hence the central bank is not as patient as the ECB.

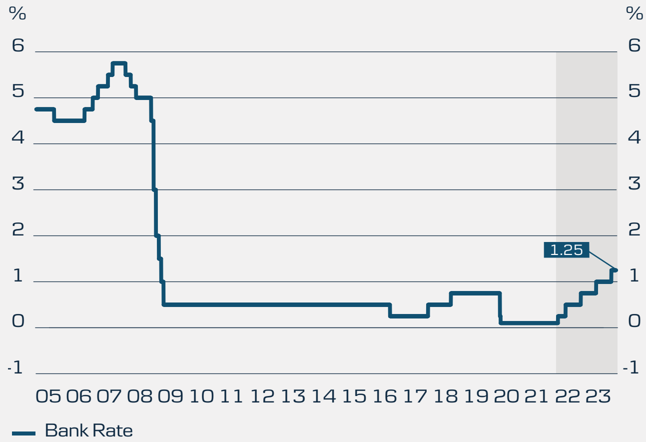
Our base case is that the first rate hike arrives in February 2022 but it could also be at the next meeting in December. The Bank of England tied the timing of the first rate hike to labour market outcomes, arguing that high inflation is mostly transitory. Regardless of the exact timing of the first rate hike, we expect a total of three hikes from now until year-end 2022 (a total of +65bp rate hikes). We believe it would be appropriate for the Bank of England to continue hiking in 2023, calling for a Bank Rate level of 1.25% by year-end 2023. Our base case implies that we believe the current market pricing for the number of rate hikes in 2022 is too aggressive (a total of +XXbp rate hikes are priced from now until year-end 2022).

Given the upside risks to inflation, we think risks are skewed towards the Bank of England tightening monetary policy sooner and faster.

EUR/GBP is set to move lower next year

EUR/GBP has become more volatile in recent months. Near-term, we see upside risks from rising Brexit uncertainties and the Bank of England, but we stick to our view that EUR/GBP is set to decline further over the coming year. The current USD-positive market environment is usually also positive for GBP and negative for EUR. We forecast EUR/GBP in 0.83 in 12M but the recent broad-based EUR weakness mean there is risk of EUR/GBP moving slightly lower than that means.

It's time for the Bank of England to tighten monetary policy



Note: Past performance is not a reliable indicator of current or future results.
Sources: Bank of England, Macrobond Financial, Danske Bank forecasts

Room for EUR/GBP to move slightly lower next year

Note: Past performance is not a reliable indicator of current or future results
Source: Bank of England, Macrobond Financial

Macro forecasts - UK

% change q/q	2022				2023						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2021	2022	2023
GDP	0.6	1.4	1.1	0.5	0.4	0.4	0.4	0.4	6.9	5.1	2.4
Private consumption	0.5	1.5	1.3	0.5	0.5	0.5	0.5	0.5	3.8	6.1	2.5
Government consumption	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	15.8	3.3	0.8
Fixed investments	1.5	3.0	2.0	1.0	0.9	0.9	0.9	0.9	4.5	6.5	4.8
Exports	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	-3.0	3.3	3.4
Imports	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0	4.8	3.7
Unemployment rate (%)	4.1	4.0	3.9	3.9	3.8	3.8	3.7	3.7	4.6	4.0	3.7
Wage growth (% y/y)[1]	3.1	2.6	3.2	3.5	3.7	3.8	3.9	4.0	4.9	3.2	3.9
CPI (% y/y)	4.9	5.5	5.1	4.3	4.2	2.7	2.3	2.0	2.5	4.9	2.8
Core CPI (% y/y)	4.1	3.8	3.3	3.2	3.2	2.9	2.5	2.4	2.3	3.6	2.8
Public budget[2]									-5.3	-0.6	0.5
Public debt[2]									96.9	96.7	96.7
Current account[3]									-3.4	-5.3	-4.7
BoE Bank Rate (%) (end of period)	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.25	0.10	0.75	1.25

1) Average weekly earnings excluding bonuses. % y/y
2) % of GDP. OBR forecasts
4) % of GDP. EU Autumn forecast
Source: OBR. EU Autumn forecast. Danske Bank

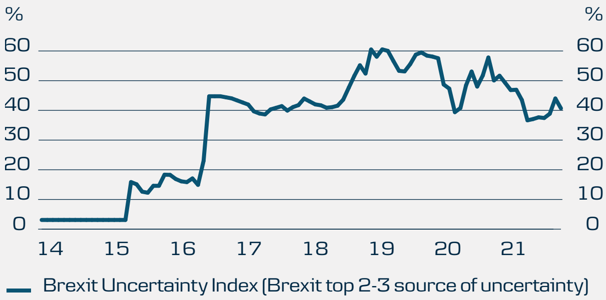
Brexit is no longer a market theme but tensions remain

Brexit has moved into the background as a market theme since the free trade agreement was finalised in late December 2020, but it is definitely still a hot political one. The UK and the EU are still discussing the Northern Ireland protocol and how to protect both the integrity of the EU and the UK single markets. EU has offered to ease some border control measures but the biggest hurdle is that the UK says oversight from the EU Court of Justice in Northern Ireland is unacceptable.

We do not expect neither the UK nor the EU to push the “nuclear button” despite the UK government’s threat to invoke Article 16, which allows both sides to unilaterally override parts of the protocol, is still hanging in the air. If so, some EU hardliners are arguing the EU should rip the free trade agreement apart, which is the worst case scenario both from a market and economic perspective, as it would create a lot of uncertainty. Ripping the free trade agreement basically restarts the Brexit clock due to the 12 months’ notice (Article 779 in the EU-UK Trade and Cooperation Agreement).

What we have learned over the past years is that the two sides can fight a lot but they find common ground eventually. This is also, why we do not think Brexit will become a major market theme although it remains a risk to monitor. If the situation “explodes” EUR/GBP is likely to move higher.

Brexit uncertainty remains high despite deal, according to businesses



Sources: The Bank of England, Macrobond Financial

Japan

Recovering from dire straits

- A long soft lockdown has left the economy as one of the big pandemic losers. The outlook is significantly brighter, though.
- Lack of supplies is hard on Japanese manufacturers. A weak JPY on the other hand provides tailwinds for exporters less affected by supplies.
- Another fiscal boost will provide short term tailwinds to the economic recovery but the government will have to unwind stimulus to reach fiscal balance by 2026.
- The BoJ is not facing a trade-off between growth and inflation. Thus, pull back of the pandemic programme and continued stealth tapering will be the only tightening from BoJ.

The pandemic has been hard on activity...

The Japanese economy has not fared well through the pandemic measured on economic activity. GDP remains 4.1 per cent below the last peak in 2019Q3 largely due to slumping private consumption amid the "state of emergency" where people have been asked to avoid non-urgent outings and restaurants have closed early. Service consumption was down 8 per cent in Q3 compared to the 2019 peak and goods consumption has also been weak as consumer confidence has touched record lows through the pandemic also affected by the 2019 VAT-hike.

The high level of employment protection has shielded regular employees from the crisis. Non-regular employees on the other hand have taken a big hit as many of these jobs are in the service sector. The large gap in salary and work conditions between employees with high and low affiliation to the labour market is one of the focus points for the new PM Kishida and his government. Since the initial shock from COVID19, the labour market has tightened steadily again with businesses reporting lack of labour at 2016-levels and the unemployment rate at 2.8% compared to the 2.2% low before the pandemic. The labour force is back at pre-pandemic levels, after having declined in 2020 particularly among women.

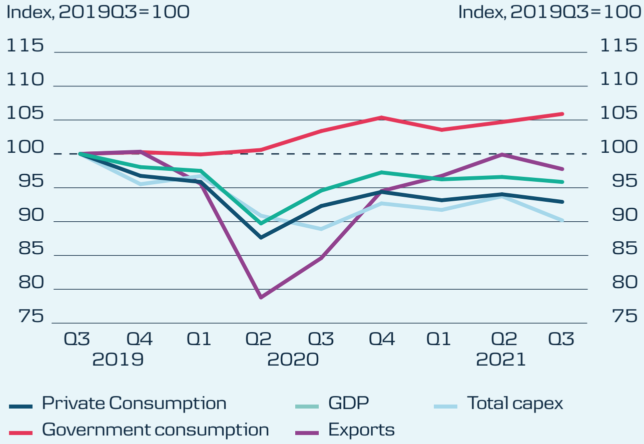
... but the economy is set for a strong rebound

Japan has emerged on the other side of the six month "state of emergency" with prospects of a strong recovery. An initially slow vaccine rollout has gained in pace and Japan stands as one of the countries with the highest vaccine uptake. For the first time since the start of the pandemic, PMIs indicate growth in the service sector in Q4 and consumer confidence has hit post pandemic highs, which bodes well for a pick-up in private consumption after a very slow two years. Consumers will face some headwinds from higher energy prices but they are counterweighed by lower mobile phone service charges. Yoy real cash earnings are slightly positive as companies are reluctant to increase expenses, as always.

The trade balance will take a hit from the higher energy prices given high dependence on foreign fossil fuels and the manufacturing sector is still faced with large challenges due to lack of supplies. Particularly the car sector is highly dependent on deliveries of parts like semiconductors and it has been forced to cut back on production. Thus, production of transport equipment was down 41% in September compared to pre-pandemic levels. Japan exported 168,000 passenger cars in September, down from 349,000 in the same month of 2020. The Japanese car sector makes up about 13% of the total manufacturing sector so this weighs quite heavy on the economy and it is a key reason that total exports remained 2.2% below pre-pandemic highs in Q3. Looking ahead, lack of supplies will continue to cripple a significant part of the manufacturing sector. On the other hand, JPY weakening amid a global economy in reflation mode has boosted competitiveness in the export sector, which will provide short term tailwinds for exporters less affected by broken supply chains.

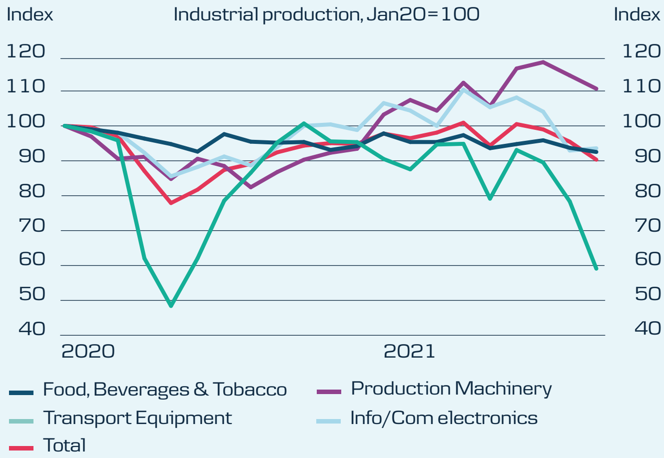
Despite slow production in the car sector, production capacity has declined significantly in the manufacturing sector through-

Pandemic woes



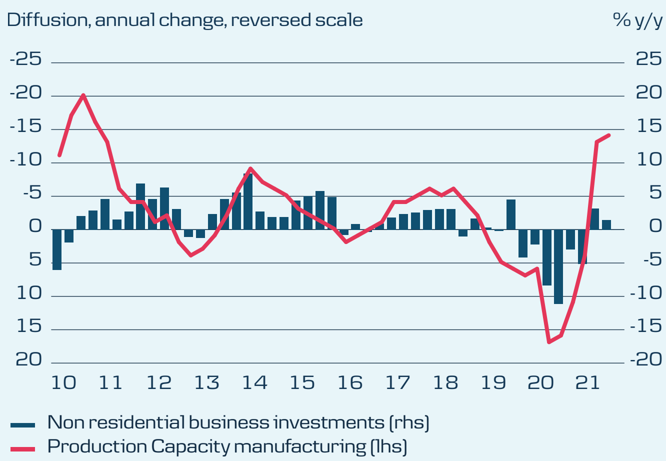
Source: Japanese Cabinet Office, Macrobond Financial

Car sector struggling with missing parts



Source: Japanese Cabinet Office , Macrobond Financial

Declining production capacity indicates increasing capex



Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial out the year. Private investments have been modest and remains about 10 per cent below pre-pandemic levels. Machinery orders have been strong recently and we expect business investments will be a solid growth driver going forward. Housing starts have also increased through 2021 indicating an increasing slope for residential investments after a few weak years. In general, capex will be supported by continued favourable financing conditions.

Stimulus boost before facing tightening needs

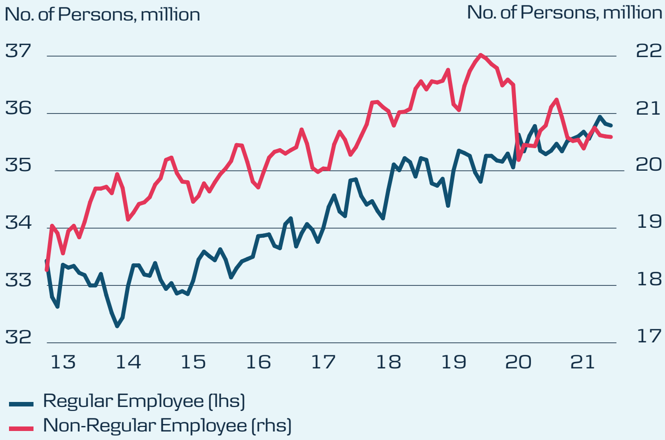
PM Kishida was elected on a promise to pass an extra budget to boost the economy in Q1. The government has introduced a JPY56tn package amounting to over 10% of 2020 GDP, partly funded by money from previous stimulus packages that have not been used in full. Thus, Japan is going against the global trend of unwinding stimulus measures as other economies experience overheating symptoms.

About half of the money from the package will go to increase the amount of hospital beds and boost vaccine development. Except for the most wealthy, families will receive JPY100,000 payouts for each child as was the case for every citizen in 2020, where much of the payout ended up as savings. Among other things, the government will subsidise oil refiners in an effort to cushion the energy price blow on households. The 2020 public deficit in 2020 and 2021 as a whole is turning out to be significantly smaller than feared last year. That said, the goal of fiscal balance in 2026 still seems ambitious.

With CPI inflation still close to zero, the Bank of Japan (BoJ) is facing a completely different reality compared to what we see in the other major developed economies. Energy prices have pushed inflation higher as everywhere but the underlying price pressure remains very modest. Despite the notoriously tight labour market, wage inflation has not moved higher for many years. With the labour market still recovering from the pandemic, it is hard to see why this dynamic would change now. Businesses' outlook for output prices have moved slightly higher amid the global lack of supplies and surge in energy prices but they remain at very modest levels. We expect CPI inflation to turn positive again next year but to remain modest over the forecast horizon.

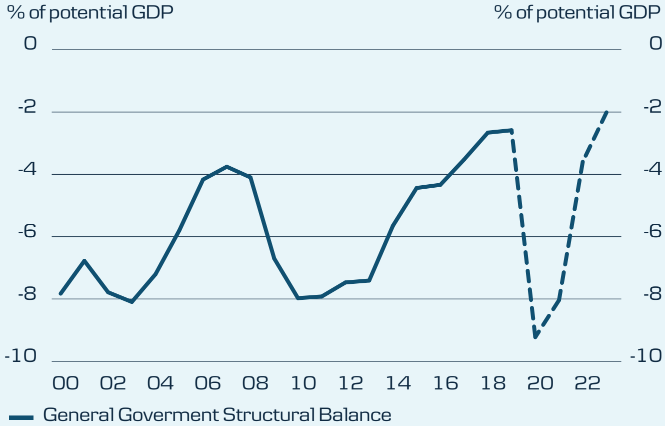
BoJ has de facto been tapering their purchases of government bonds through 2021 without causing any hick ups for the yield curve, which has been locked in at 0% for the 10-year yield since 2016. The pandemic programme in place to fund corporates with cheap loans is set to run out in March. BoJ is in no rush to withdraw stimulus from the market, however, recent yen weakening and pent-up demand as the service economy has been reopened will set the economy on the fast track to full recovery, which should also give the BoJ a window of opportunity to tighten up on its most recent measures.

Non-regular workers in the service industry were most affected by lockdown



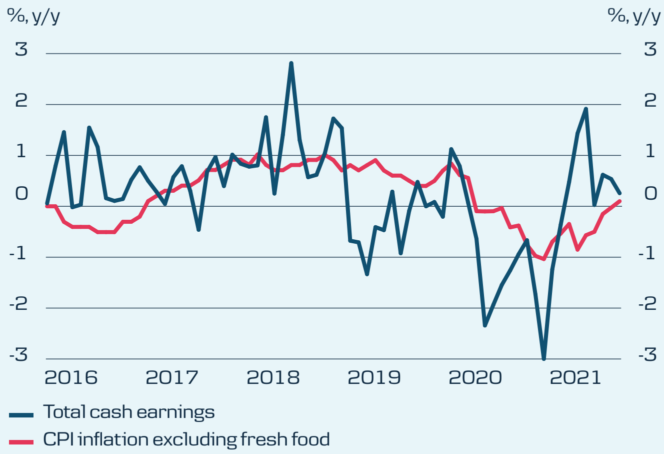
Source: Japanese Statistical Bureau, Macrobond Financial

Public deficit smaller than feared but still significant in 2020 and 2021



Source: IMF WEO, Macrobond Financial

2% inflation nowhere in sight



Source: Japanese Statistical Bureau, Japanese Ministry of health, labour and welfare, Macrobond Financial

Macro forecasts - Japan

% y/y	2019	2020	2021	2022	2023
GDP	0.0	-4.7	1.8	2.4	1.2
Private Consumption	-0.4	-6.4	1.4	3.3	1.4
Private Fixed Investments	0.8	-6.4	-0.8	1.0	0.0
- Residential investment	3.9	-7.0	-1.6	-0.3	0.8
- Non-residential	0.1	-6.2	-0.6	1.3	1.6
Public Investments	1.1	3.7	-2.2	-5.9	1.5
Public Consumption	1.9	2.8	2.7	2.2	0.7
Exports	-1.5	-11.8	10.9	3.0	3.2
Imports	1.1	-7.3	5.9	2.0	2.0
Unemployment rate (%)	2.4	2.8	2.8	2.6	2.5
CPI. excl. fresh food (y/y)	0.6	-0.2	-0.2	0.4	0.5
BoJ rate on deposit facility*	-0.1	-0.1	-0.1	-0.1	-0.1
10 year bond rate target*	0.0	0.0	0.0	0.0	0.0

*Note: *end-year*
Source: Danske Bank. Macrobond Financial

China

Moderate recovery in 2022

- The Chinese economy has faced significant headwinds during 2021 from a property crisis, more frequent covid outbreaks and power shortages.
- We look for growth to be weak in Q4 and Q1 but to recovery gradually during 2022 on the back of moderate policy easing. We look for growth in 2021 and 2022 to be 8.0% and 4.5%, respectively. In 2023, we expect growth to be back around trend growth of 5%.
- On the property crisis, we expect a muddling through scenario. We believe we have passed the point of'peak stress' but challenges will linger far into 2022 with the weakest names likely heading for default.
- Consumer price inflation is still well behaved in China and we expect it to stay that way. Producer price inflation is at very high levels but we look for a peak soon.
- China has taken several regulatory steps this year (crackdown on big tech etc.), but we don't see it as an assault on the private sector as such.

Headwinds piled up in 2021

After a strong post-covid recovery in 2020, headwinds started to pile up in 2021 and growth slowed down significantly. We see mainly three factors driving the slowdown:

1. Property crisis. China's tightening of regulation for developers in 2020 started to bite in 2021 when home sales turned lower and triggered a liquidity crisis for the most vulnerable developers. The crisis has led to a sharp drop in construction activity (see more below on the property crisis).
2. More covid outbreaks. The contagious delta-variant has led to more frequent outbreaks in China. As China continues its' 'zero-tolerance' policy, restrictions have become more frequent and put a dent on private consumption growth.
3. Power shortages. In September and October China was hit by power rationing giving a hit to production. The rationing was due to a combination of a) high demand, b) inadequate coal production leading to sky-high coal prices, c) reduced power generation by power companies using coal due to a cap on electricity prices and 4) seven key manufacturing provinces exceeding the 2021 target on CO2 emissions.

On top of these factors, a tighter fiscal policy also dampened growth. Chinese exports have been the pillar of strength as very strong US goods demand benefitted Chinese exporters.

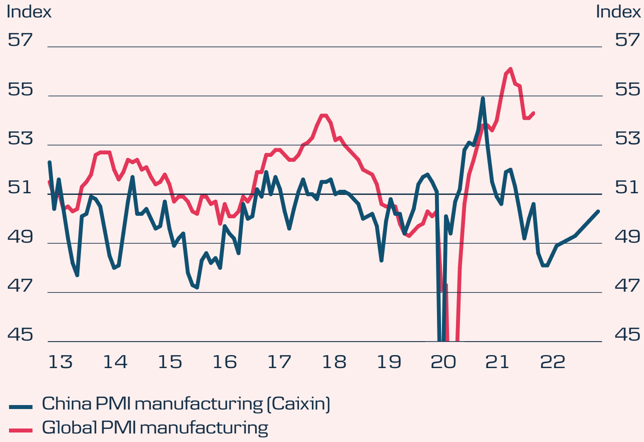
A moderate recovery in 2022

In the short term we look for growth to remain weak, not least due to a significant drag from the property sector but also because the shortage of power will remain a challenge throughout the winter as colder weather increases demand for heating. With the supply side of the economy hampered, it also means there is no quick fix to increase growth. Stimulating demand might just result in higher prices if supply is scarce. We do, however, look for moderate policy easing to compensate for the weakness in the construction sector. Easing measures will be directed towards easing cost pressures for small and medium sized companies hurt by the challenging environment. Local provinces have also been asked to use their lending quota for this year, which implies an increase in local government credit for financing of 'smart infrastructure' projects such as charging stations for new energy vehicles. We also look for the People's Bank of China to cut the Reserve Requirement Ratio in coming months to free up liquidity for banks to support the credit bond market and bank lending.

The more frequent Covid-19 outbreaks are likely to continue and will keep a dent on private consumption. We don't expect China to leave the 'zero-tolerance' policy on this side of the Communist Party National Congress in the autumn of 2022, unless new drugs for treatment can alleviate the human costs from the disease.

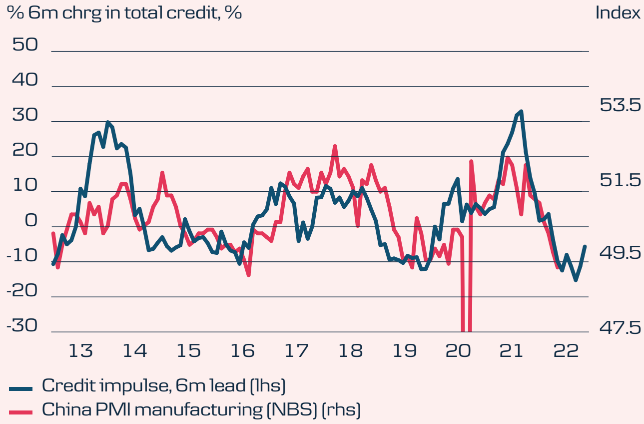
Exports are expected to remain strong over the winter, as we look for continued high goods consumption. The robust exports led to a record high trade surplus, which has supported a very strong CNY despite the cyclical downturn. The trade weighted CNY is at the strongest level in five years and we expect it to stay like that in the short term before weakening in 2022. A bottom in the credit impulse (see chart 2) suggests that growth should bottom in Q1 and we look for a moderate recovery during 2022. However, we don't expect growth to be

Chinese PMI at recession levels – but set to recover in 2022



Source: Macrobond Financial, Markit, Danske Bank

Credit impulse bottoming out. We expect a moderate move higher



Source: Macrobond Financial, PBoC, NBS, Danske Bank

China's property developers facing severe financing challenges

Source: Macrobond Financial, Markit, Danske Bank
Note: Past performance is no guarantee of future performance.

back at trend (around 5%) until the end of 2022. In 2023, we expect the economy to grow around 5%. We expect producer price inflation to peak out from the current highs as coal prices have come down from the recent highs and we look for global commodity prices to stabilize. The pass-through to CPI inflation has been limited and we expect it to stay below the 3% target this year and next.

Property crisis muddling through

While stress is far from over in the Chinese property market, we believe in a muddling through scenario in which we will see more developers default but at the same time Beijing securing financing options for healthy developers. With the property sector accounting for around 25% of the Chinese economy, China will not risk a deep financial crisis and we believe it has the tools to avoid one. The crisis is in our view not due to a housing bubble or a solvency crisis but rather a liquidity crisis triggered by Beijing when in August last year they tightened regulation towards developers to rein in too much leverage in the sector. The so-called 'three red lines' regulation put limits on how much leverage developers were allowed to have and added requirements on developer's liquidity, see also "No Lehman moment…. ". The new rules sent China's second largest developer, the highly leveraged Evergrande, into a liquidity crisis that has spilled over to the rest of the sector. All developers now see their financing channels severely squeezed putting them at risk of defaulting.

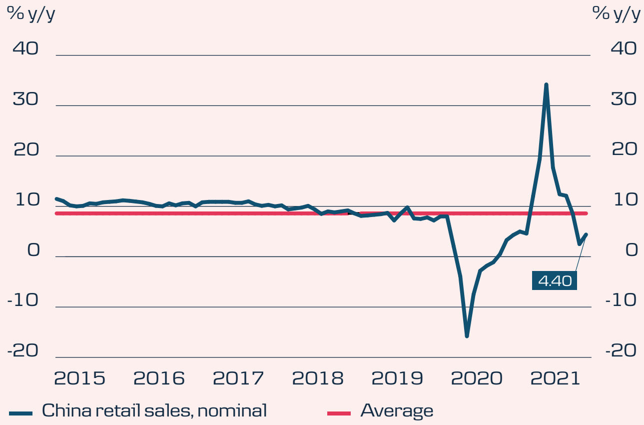
However, as we expected, when things got bad enough, Beijing would step in and make state banks and institutions become a 'lender of last resort'. According to state media, bond issuance rules for developers have been eased and state financial institutions been told to secure financing. We don't yet know how strong the safety net is and some developers may not get the needed finance. But Beijing will in our view make the healthy developers survive and the most leveraged ones may face defaults and a restructuring of their debt. While we don't expect a severe financial crisis, we do look for a big hit to construction activity and thus to overall growth.

A difficult transition of growth and energy – but medium term outlook still favourable

China is in a difficult transition period of growth. The engines of construction and infrastructure are slowing fast and new engines of growth from consumer demand, investment in high-tech manufacturing and green investments are set to take over. But is is a difficult transition and there are bound to be bumps on the road – as we now witness. The transition from fossile fuel energy to green energy is also challenging as seen in the current power shortage.

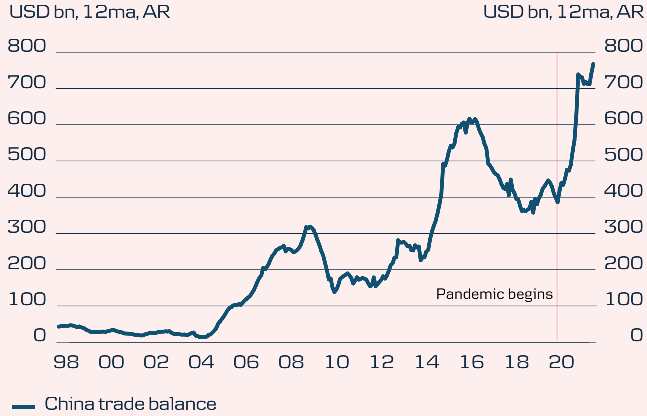
There is no doubt potential growth is slowing down in China. However, we still have see potential for China to grow robustly over the next decade. Investments in technology and education and more allocation of ressources into high-tech industries away from construction and infrastructure will be key. This is a key tenet in China's focus on quality over quantity of growth. Reforms that improve competition, by lowering entry barriers, cutting red tape for businesses and fighting vested interests and special privileges will also be important. We currently put China's potential growth at 5% and expect it to drop to around 4% by the end of the decades. If China can realize this, the Chinese economy will surpass the US economy by around 2030.

More frequent covid outbreaks and 'zero-tolerance' policy weigh on private consumption



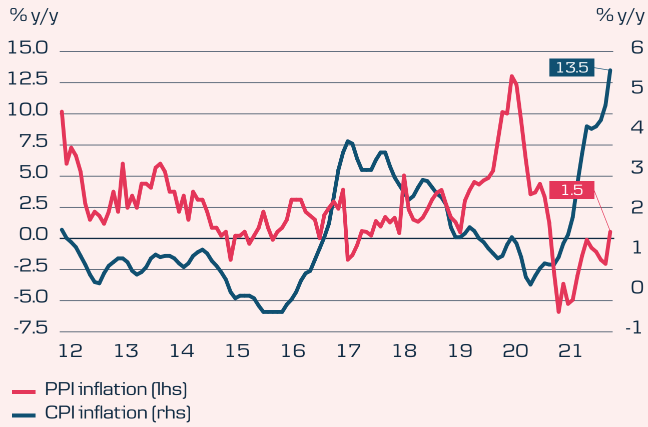
Source: Macrobond Financial, Markit, Danske Bank

Strong exports to US consumers fuelling record high Chinese trade surplus



Source: Macrobond Financial, Markit, Danske Bank

High PPI inflation not feeding through to CPI inflation, which is still far below 3% target



Source: Macrobond Financial, Markit, Danske Bank

Macro forecasts - China

% y/y	2018	2019	2020	2021	2022	2023
GDP[1]	8,0	5,6	5,3	8,0	4,5	5,0
Private consumption[1]	8,2	7,4	-0,8	10,2	6,0	6,0
Investment[1]	5,0	5	4,6	5,2	3,0	4,5
Net exports[2]	-0,2	-0,2	-0,7	0,5	-0,1	-0,2
Total investment share[3]	44,0	43,1	43,9	43,0	43,0	42,5
Total savings rate [3]	44,6	44,8	44,6	45,0	44,0	43,2
Current account balance[3]	0,6	1,7	0,7	2,0	1,0	0,7
CPI[1]	2,1	2,5	2,5	0,7	2,0	2,2
Household income (real)[1]	5,7	5,0	1,0	3,5	5,5	6,0
Household savings rate, % of disp income	34,8	34,4	37,1	33,7	31,8	31,0
Wage growth (nominal, urban)[1]	11,3	10,2	4	5,0	5,5	5,5
Government budget balance[3]	-7,5	-6,8	-6,2	-5,6	-7,0	-6,8
General government debt[3]	53,8	56,1	66,3	68,9	72,0	74,5

Notes: 2021-2023 is forecast. 1: % y/y, 2: contribution % to GDP, 3: % of GDP activity plus excludes land sale proceeds (source: IMF article IV report, January 2021),

Are China crackdowns an assault on the private sector?

During 2021 China has taken a series of measures that stirred up Chinese markets and hurt investor sentiment. They were by many seen as a sign that China was cracking down on the private sector as a whole looking for a stronger role for the state. However, we believe this is a misinterpretation of events. Below go through the policy moves one by one and give our view on the motivation:

1. Crackdown on Big Tech.
   Chinese authorities have tightened regulation of the tech giants Alibaba and Tencent and other big internet companies. The crackdown relates to abuse of market power, such as the so-called "Choose one of two" preventing companies on their platforms from working with other plat forms. We see it is as normal anti-monopoly regulation aimed at reducing entry barriers and improving the conditions for small and medium sized companies rather than an attack on private capital, per se.

2. Moves against the company Didi ("China's Uber").
   A few days after listing on the New York Stock Exchange in July, Didi, the world's biggest ride hailing company, was removed from most mobile stores in China. However, it followed a meeting a few days before with the cybersecurity regulator, which asked Didi for more guarantees the data of 500 million users, could not end on US hands, before listing. When Didi went on with the listing, the regulator responded. The move is about national security related to data and not targeting Didi because it is private per se. Reports suggest the apps is set to be relaunched soon.

3. Ban on private tutoring of school kids
   In September, China banned off-campus for-profit tutoring off school kids at age of around 6-15 years. This led to massive losses for a lot of private tutoring businesses. While again hitting private companies, the regulation was aimed at easing the study burden of kids, which has become substantial and been highlighted as a problem by the China's government for years. It also increases the cost of having children and the new ban may partly also be an attempt to lower the cost of having children to incentivise Chinese parents to have more than one child.

4. Restrictions on gaming.
   In August, China also tightened rules towards gaming with kids under 18 only allowed to game three hours per week and not on weekdays. The rules was according to Chinese authorities based on surveys by parents showing complaints about kids addiction to online games affecting their mental health. While again hurting private companies, it was not in our view because they were private as such.

Emerging Markets

Stagflationary forces and vaccine divide imply a fragile and uneven recovery

- Emerging economies have broadly witnessed a slower economic recovery from the pandemic compared to the developed markets.
- GDP volumes across Asian economies have largely returned to pre-pandemic levels while many economies in Africa and Latin America will take years to recover.
- Tightening of global financing conditions, a protracted pandemic, and rising prices imply downside risks to EM growth outlook in 2022-23.

EM recovery continues to lag behind DM

Emerging markets (EM) have broadly witnessed a slower economic recovery from the pandemic-induced shock compared to the developed markets (DM). Regional differences are substantial with GDP volumes across Asian economies having broadly returned to pre-pandemic levels in the course of this year, while many economies in Africa and Latin America will take years to recover. Differences in a country's capacity and approach in managing the COVID-19 pandemic, as well as the structure of the economy, trade relationships and terms of trade dynamics explain most of the divergence in the pace of economic recovery.

Economies suffering a more severe epidemic have in general witnessed a steeper contraction and a weaker and more fragile recovery. Economies heavily dependent on tourism will continue to struggle going forward as international travel could take years to recover. This year, the global industrial boom has benefited manufacturing-heavy exporters, particularly in South East Asia, while service-dominated economies (and particularly those where informal sector plays a significant role) have suffered. In this regard, booming energy and metal prices have benefited commodity exporters while some importers have even faced acute energy shortages, disruptive for economic activity. Yet, overall, more diversified economies have once again proven more resilient.

The IMF projects EM economies to grow by 5.1 % year-on-year in 2022, in line with analyst consensus (see Table 1). For 2023, the IMF sees a 4.6 % year-on-year GDP growth, slightly below consensus (4.8%). As a sign of increasing regional divergence, the IMF projects 5.6 % growth in 2022 and 5.3 % growth in 2023 for Asia, while growth in Latin America is expected to settle in the range of 2.5-3.0 % and around 4 % in Africa. Consensus projections for EM are weaker across the board apart from the exception of emerging Europe, where the IMF foresees 3.6 % growth in 2022 and 2.9 % in 2023, while analysts are a bit more optimistic. Looking at country-specific GDP trajectories for BRICS countries, Indian and South African economies will reach their pre-pandemic size by early 2022 while Brazil and Russia will take longer to recover (Chart 1). A comparison of selected large EM economies outside BRICS shows similar divergence with Taiwan outperforming, while the Turkish economy will not reach its pre-pandemic size over the forecast horizon (Chart 2).

Tighter financial conditions, protracted pandemic and rising inflation imply downside risks

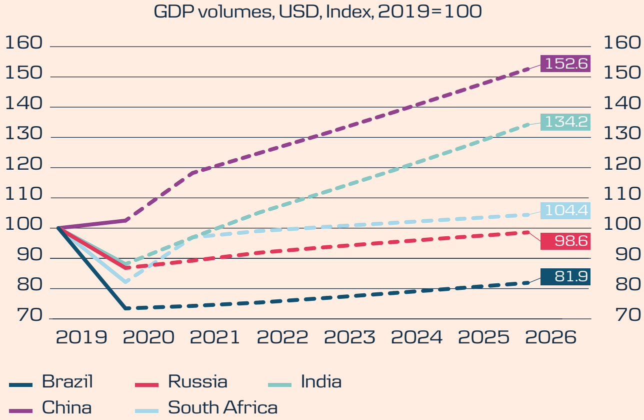
We outline three key downside risks to the EM growth outlook in 2022-23: 1) higher US rates and stronger USD on the back of looming rate hikes by the Fed, 2) low vaccination coverage and slow recovery in global tourism leaving some countries exposed to further negative effects from the pandemic, 3) and rising local inflation underscoring deficiencies in monetary policy credibility. The different risk factors could exacerbate existing external vulnerabilities while also weighing on overall economic activity and growth. A change in investor sentiment towards the EM could trigger either local or more widespread capital outflows, in the worst case, similar to what we saw during the 2013 taper tantrum.

Table 1: Consensus projections. EM (GDP yoy %)

Year	Emerging economies	Eastern Europe	Latin America	Asia ex-Japan	Africa
2021	6.4	5.5	6.7	7.0	3.9
2022	5.1	3.7	2.5	5.6	3.5
2023	4.8	3.3	2.6	5.3	3.4
Year	Emerging economies	Eastern Europe	Latin America	Asia ex-Japan	Africa
2021	6.4	6.0	6.3	7.2	3.7
2022	5.1	3.6	3.0	6.3	3.8
2023	4.6	2.9	2.5	5.7	4.1

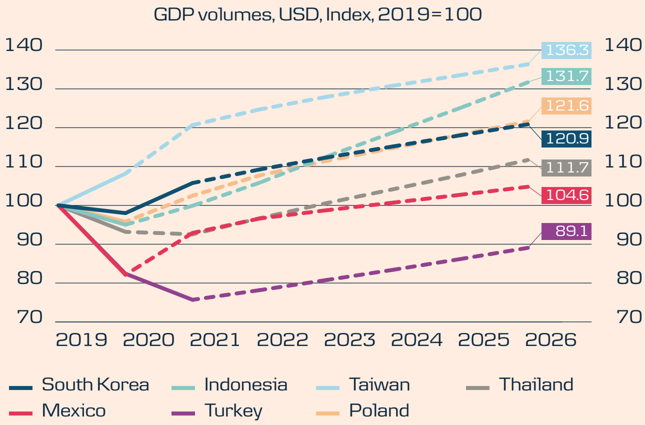
Source: IMF WEO, Bloomberg, Danske Bank

Chart 1: Projections for BRICS economies signal regional divergence



Source: IMF WEO, Macrobond, Danske Bank

Chart 2: Many EM economies will take years to return to pre-pandemic GDP levels



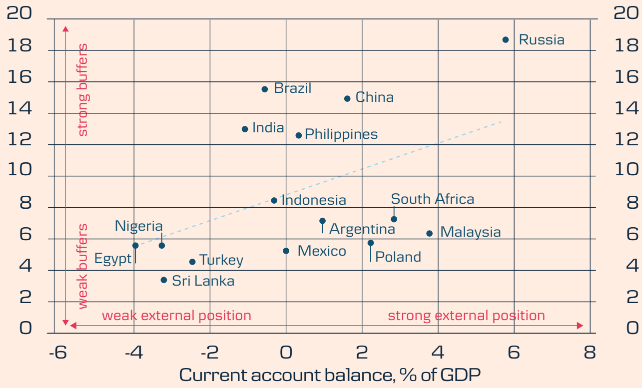
Source: IMF WEO, Macrobond, Danske Bank

Economies most vulnerable to the anticipated tightening of global financing conditions are the ones with the weakest external positions to begin with. High debt and high twin deficits are the key parameters that expose countries to external shocks. On the other hand, high foreign reserves add to a country's resilience. Mapping countries' buffers (reserves) against their exposure (CA balance) for a group of selected EM economies, shows that Sri Lanka, Kenya, Turkey, Egypt and Nigeria are in the most vulnerable position if and when global monetary conditions start to tighten, as shown in Chart 3.

The great global vaccine divide will remain another drag for many EM economies. While vaccination campaigns have shown promising progress across Latin America in H2-2021, coverage in most Asian and African economies is very low. In large parts of the world, vaccine uptake is likely to remain well below levels needed for herd immunity due to a number of barriers. Insufficient vaccine coverage in the global south is a risk factor for the global economy as it increases the likelihood of new, more deadly variants emerging. Yet, the local impacts are more pronounced and imminent. While the bar for imposing lockdowns could be high in many countries, local epidemics continue to undermine hospital capacity and increase government expenditure. Local economic activity can remain subdued, as businesses face labour shortages and refrain from investments in the context of protracted uncertainty. Going into 2022, we see potential for countries with higher vaccine uptake (particularly in Latin America and South East Asia) catching up DM in terms of growth, while countries with very low vaccine coverage (particularly in Africa) could be left even further behind (Chart 4).

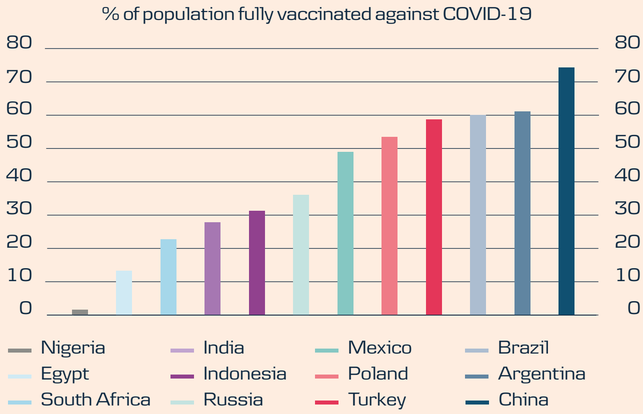
'Inflation, inflation and inflation' is what the major central banks have been debating most of the second half in 2021, and it is increasingly becoming a factor for EM economies as well. Food and energy prices have been rising particularly fast but also core inflation has been accelerating. As a response, many EM central banks have already started monetary tightening by hiking policy rates. Yet, real rates in many EM economies remain negative, which leaves many central banks in a difficult position. High inflation warrants a determined monetary policy response, but higher interest rates are a burden for governments – many of whom have issued more debt in the course of the pandemic. Higher rates could also derail the already fragile economic recovery by reducing appetite for investments. Same time, investors could interpret a failure by the central bank to respond to higher inflation as undermining their credibility, and hence, economies with lower real rates could be more prone to investor flight (Chart 5).

Chart 3: Countries with weak external position are more exposed to Fed tightening



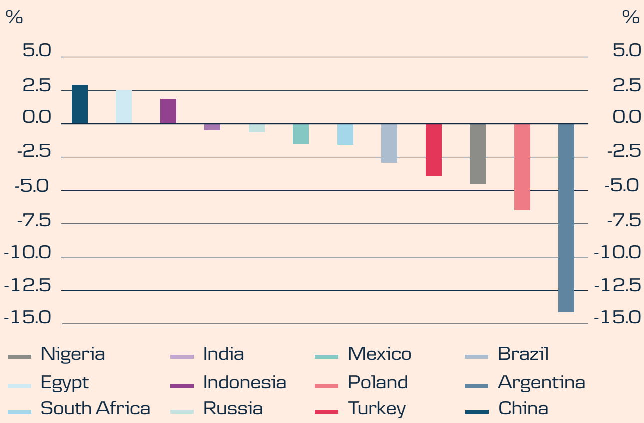
Source: IMF WEO, World Bank, Danske Bank

Chart 4: Many Asian and African economies are running behind in COVID-19 vaccinations



Source: Our world in data, Macrobond, Danske Bank

Chart 5: Low real rates help governments but expose economies to capital outflows



Source: National Central Banks, National Statistics Offices, Danske Bank

Table 2: SUMMARY TABLE on EM vulnerabilities*

Country	Total score	External vulnerability summary indicator	COVID-19 summary indicator	Real rate (%)	Net fuel exports (% of GDP)
Thailand	14	9	14	-1,9	-6,2
Turkey	14	12	13	-3,9	-2,0
Poland	14	8	10	-6,5	-2,7
India	13	15	11	-0,5	-4,4
Sri Lanka	13	18	12	-1,2	
Chile	13	11	5	-3,3	-3,9
Philippines	13	9	10	-2,6	-3,7
Egypt	12	16	18	2,5	-2,1
Argentina	12	12	7	-14,5	-0,7
Peru	12	7	12	-4,6	-1,1
South Africa	12	10	14	-1,6	-1,8
Nigeria	12	11	13	-4,5	10,5
Kenya	11	16	13	0,5	
Colombia	11	14	11	-2,6	6,2
Mexico	11	12	9	-1,5	-1,3
Brazil	10	12	5	-2,9	0,2
Vietnam	10	9	9	2,2	-3,6
Indonesia	9	10	15	1,8	1,0
Malaysia	7	9	8	-0,5	2,0
China	7	7	4	2,9	-2,2
Russia	6	1	12	-0,6	14,3

** External position is a summary indicator ranking countries according to their relative performance in five indicators (budget balance as % of GDP, debt-to-GDP, CA balance, NIIP and reserves as months of imports). COVID-19 exposure includes three indicators: share of population fully vaccinated against COVID-19, share of positive tests and international tourism receipts as a share of exports. Real rate serves as a proxy for monetary policy effectiveness and net fuel exports is also a single indicator. Total score takes the average of scores (ranks) across four risk categories.*

EM vulnerability heat map leaves Turkey, Thailand and Poland the most exposed

A comprehensive analysis of EM vulnerabilities is always challenging since the EM universe is so diverse, the different risk factors are often inter-linked and some of the risks are hard to quantify (e.g. political risk). Often, market pricing reflects the macroeconomic context, but at times, politics could become the sole market driver. Political events tends to dominate market pricing particularly in economies with unstable political regimes and authoritarian governments, and in lower-income economies.

Our total vulnerability indicator aims to capture the main risk factors for EM going forward. It measures the countries' relative performance using ten indicators across four risk categories: 1) external position, 2) the pandemic, 3) real rate and 4) net fuel exports. Table 2 summarizes our analysis and ranks countries based on their total score. It shows that Turkey, Thailand and Poland rank poorly on a number of indicators, while China and Russia bottom the rank being the least vulnerable. Although we see the global monetary policy tightening, protracted pandemic and rising inflation as key risks for EM going into 2022-23, we also highlight the negative impact from the rise in energy prices for importers. We expect energy prices to moderate in 2022-23 but the still elevated level will continue to burden many EM economies that depend on imported energy.

Disclosures

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