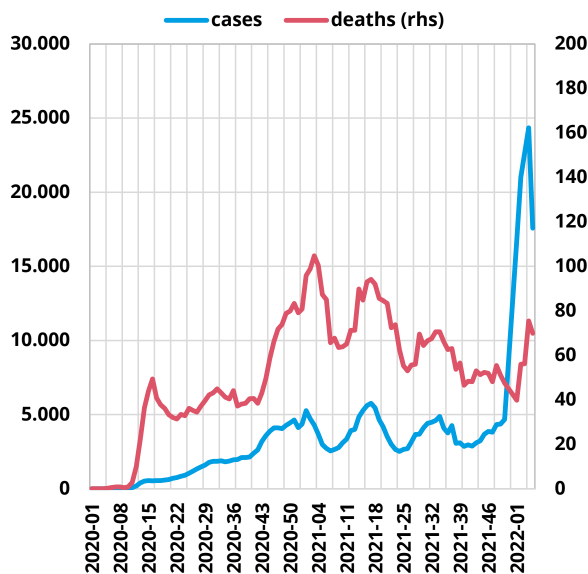
Creditreform Economic Briefs: Engineering a Monetary Policy Normalization Amid Geopolitical Threats

Following a bumpy start to the year for many economies amid the spread of the coronavirus' Omicron variant and related containment measures, Covid-19 is slowly losing some of its threatening character (see Figure **1**). Crucially, there is continued progress in immunization and effective treatment, and economic agents learn to adapt. Moreover, pundits point to improved prospects for the pandemic eventually turning into a less critical endemic.

Figure 1: On the way to an endemic?

Global coronavirus infection cases and deaths in thousands, weekly count



Sources: ECDC, Creditreform Rating

Against this backdrop, the topic of a tightening monetary policy stance in the face of more persistent and broader-based upward pressure on consumer prices has become more and more dominant over recent weeks. In this vein, the world's major central banks, including the Federal Reserve, the Bank of England, and the European Central Bank (ECB), have either hinted at more urgent required action to address inflationary pressures or have even started to act accordingly (see below).

That said, uncertainty over further virus mutations and their impact still remains pronounced. In addition, there are new risks on the horizon for financial markets and macroeconomic developments, coming among others on the back of an intensifying threat of Russian (military) aggression against the Ukraine.

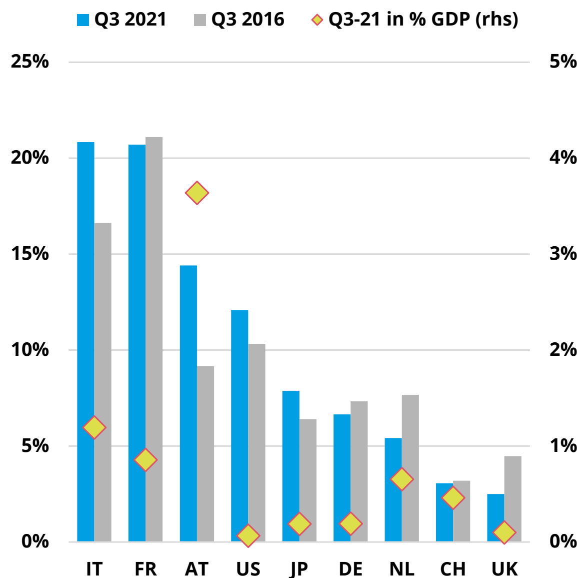
Russian aggression against Ukraine could cause the next shock to the global economy

A full-blown Russian invasion in Ukraine would presumably send shockwaves through markets, and it would be answered with a raft of severe sanctions by NATO and other Western allies. Possible counter-sanctions in such a case might have energy prices and costs for a number of other commodities and products increase drastically – ultimately heavily affecting the global economy in a still uncertain epidemiological environment. At the time of writing, Russia has recognized two breakaway regions in eastern Ukraine as independent and reportedly may have sent troops into these regions, allegedly to 'perform peacekeeping functions'. As one reaction, Germany has taken steps to freeze the process of certifying the Nord Stream 2 gas pipeline, and along with other Western countries, the EU is coordinating a strong response.

Further sanctions in case of a Russian invasion may also include cutting Russian banks off from the SWIFT global payment system, presumably causing local companies and banks heavily reliant on foreign funding to experience capital flight. However, such measures might also include risks for international banks with large exposure to Russia (see Figure **2**). Drawing on BIS data, international banks had claims on residents of Russia in the amount of roughly USD 121.5bn (on an immediate counterparty basis) as of Sep-21. Among these, euro area banks were owed USD 83.8bn, an increase of almost 11% in five years (Sep-16). The largest exposures by Italy, France and Austria account for more than 80% thereof.

Figure 2: We see significant financial interlinkages of Italian and Austrian banks

Claims on an immediate counterparty basis, consolidated positions on residents of Russia in % of total exposure of BIS-reporting banks (lhs) and in % of GDP



Sources: BIS, Creditreform Rating

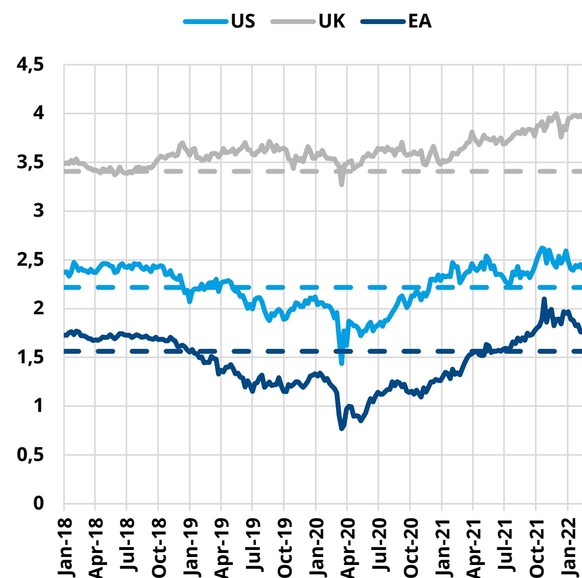
Apart from considerable financial ties with other major economies, Russia is above all a key supplier of oil, gas, and wheat, to name a few examples. Even without an invasion becoming reality, upward pressure on commodity prices will likely stay elevated for now. Russia's decision to deploy troops to eastern Ukraine has already caused energy prices to leap. If the crisis escalated further, energy security in Europe would be a major risk for the real economy and financial markets. The current shortages of certain commodities and intermediate products would likely be intensified sharply, thus not only maintaining price pressure, but also likely further delay pushed-back production supposed to take place this year.

Investments might be postponed in this case, and inflation rates would be set to climb further in such a scenario, possibly hampering private consumption. Governments might be forced to re-open the fiscal tap, at least in order to bring more relief to households and/or companies struggling to afford their energy bills. While we would consider this a risk scenario rather than a base case, given concerted efforts to de-escalate, uncertainty seems high at this point in time and the situation remains in flux. A more positive scenario would include Eastern European tensions to be contained.

Gradually fading supply bottlenecks and subsequent more limited inflationary pressure (see Figure 3), as well as increasing signs that the corona pandemic may be about to morph into an endemic could act as fuel to a rather robust economic cycle over the next few years, if central banks and governments manage a controlled withdrawal of support.

Figure 3: Longer-term inflation expectations put pressure on central banks to act

Average inflation rate over a five-year period starting in five years' time, implied by inflation-linked swaps, in % p.a.; dashed line: average 2015-2019



Sources: Refinitiv, Creditreform Rating

IMF lowers its 2022 growth forecast across the board

Risks that may not be quite as high on the agenda at this stage, but which still call for attention, include economic developments in China. The latter was part of the explanation why the IMF in its updated global economic outlook, published in January 2022, lowered its global GDP growth projection by 0.5 p.p. to 4.4% for the current year. With a view to 2023, the

IMF expects global GDP growth to moderate to 3.8%. The Chinese economy is likely to be dampened somewhat by very strict containment measures to stop Covid-19 from spreading, as well as from ongoing financial woes in the Chinese real estate sector. Any risks stemming from the Chinese real estate sector would have to be followed closely, as these could have major ramifications for financial markets and the global economy.

The IMF cut its Chinese growth forecast by 0.8 p.p. to 4.8% for 2022 and by 0.1 p.p. to 5.2% for 2023, following a likely GDP growth result of 8.1% in 2021. For emerging market and developing economies overall, the projections for GDP expansion were lowered by 0.3 p.p. to 4.8% in 2022. In 2023, this group of countries could reach a similar growth rate (4.7%).

With regard to advanced economies, for which growth expectations were cut by 0.6 p.p. to 3.9% regarding 2022 (2023: +0.4 p.p. to 2.6%), the largest downward revision was made to the expansion of economic output in the United States (-1.2 p.p. to 4.0% in 2022). After an expansion by 5.7% in 2021 (preliminary figure, US BEA), the US' economic growth looks set to moderate, given that the fiscal boost from the Build Back Better fiscal package might fall short of previous assumptions amidst question marks over legislation of parts of the package. Moreover, in view of multi-decade-high inflation rates, US monetary policy may well see a faster pace of tightening.

US GDP growth to moderate amid lower fiscal impulses and dawning monetary policy tightening

Nevertheless, the US economy is still likely to perform reasonably strongly, with the Federal Open Market Committee's (FOMC) latest economic projections from December 2021 being around 4.0% for 2022 (FOMC median) and approx. 2.2% for 2023. Forecasts have thus been revised upwards for the current year compared to the September 2021 forecast, and slightly downwards for 2023.

We expect private consumption to remain the key driver of US output growth this year, backed by robust employment and wage growth. Public and private investment should also contribute positively, although, as suggested above, fiscal support should be waning in 2022. The US headline inflation rate (All Urban Consumers, CPI-U) hit 7.5% in January 2022, with the core rate - less food and energy - coming in at 6.0%, its highest level since August 1982.

Given robust GDP expansion, labor market strength and increasing price pressure, the FOMC in its monetary policy meeting in January 2022 gave strong hints that it would soon raise the target range for the federal funds rate. The Fed also decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early March. We expect a 25bp interest rate increase in March, followed by further hikes this year, lifting the target range for the federal funds rate to at least 1.25% at the end of 2022.

Euro area economy back to pre-crisis level, but motor still stuttering in the short term

Euro area real GDP growth came in at 5.2% last year, according to preliminary data, showing a considerable rebound following the Covid-19-induced recession in 2020, when the total economic output plunged by 6.4%. Although the breakdown of the annual national account data is not yet available, domestic demand, still cushioned by substantial fiscal and monetary policy support, was likely the main driver of the recovery, with private and public consumption, as well as gross fixed capital formation all contributing positively. Net exports should have added to growth to some extent as well, on the back of recovering exports and imports.

Last year's final quarter saw real GDP expand by 0.3% q-o-q, likely held back to some extent by the Omicron variant of coronavirus which spread fast but did not lead to as many hospitalizations and intensive care cases as initially feared. Hence, economic output in the euro area had caught up with its pre-crisis level (Q4-19).

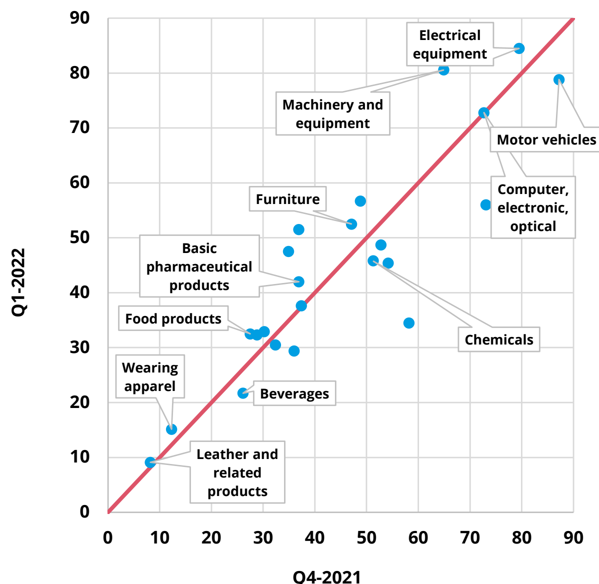
Efforts to suppress the virus spread will likely curb economic activity in Q1-22 as well, especially regarding contact-intensive services, judging by business survey indicators such as the Purchasing Manager Indices (PMI). However, having dropped to 51.1 points in January 2022, the services PMI recovered to

a three-month high of 55.8 points in February, continuing to point to growing business activities with a reading above 50 points.

In the manufacturing sector, the respective indicator edged down a little, to 58.4 points in February 2022, having improved to 58.7 points in the preceding month, thus hinting at comparatively robust growth despite ongoing supply chain issues. While shortage of staff appears to be even more challenging for the service sector, euro area manufacturing continues to battle with bottlenecks regarding materials and/or equipment (see Figure **4**), although reports hint at some reduced pressure by now. Despite the automotive sector remaining severely affected by this obstacle, there has been some perceived easing in January, according to the European Commission's business survey.

Figure 4: Shortages of material and equipment in the euro area persist

Factors limiting the production in the manufacturing sector, net balance of percentage shares of answers; dots above/below the red line indicate a deterioration/improvement compared to the preceding quarter



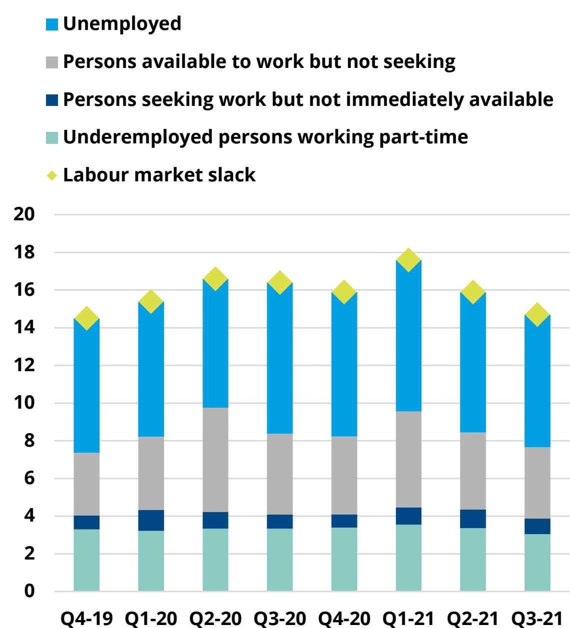
Sources: European Commission, Creditreform Rating

To some extent, the EC survey hints at difficulties to find (skilled) staff e.g. in computer programming, serving as a reminder that there is fierce competition for this type of talent worldwide. Such findings could also point to mismatches regarding labor supply and demand, potentially flagging risks of slower progress in the digital transformation. In addition, indicated difficulties to hire staff for the transport sector might raise concerns over getting to grips with the current supply chain problems any time soon.

Various measures capturing underemployment point to improvements following a peak in the first quarter of 2021 (see Figure **5**). Increasingly tight labor markets in several euro area economies appear not to be fully reflected in wage developments so far. Drawing on negotiated wages in the euro area as a whole, the annual rate decreased to 1.4% in Q3-21, having averaged 2.2% in 2019. However, total actual hours worked in the main job have also not yet returned to pre-crisis levels, showing a gap of 3.3% when comparing Q3-21 with Q4-19, suggesting that for wage pressure to occur on a broader basis, it takes further normalization in many areas.

Figure 5: Lower number of inactive people reflect improving labor market conditions, but may also be a harbinger of mounting inflationary risks

In % of extended labor force in the euro area



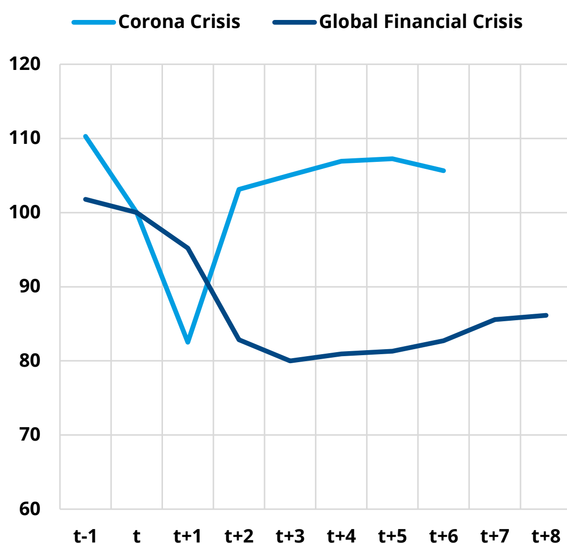
Sources: Eurostat, Creditreform Rating

Prospects remain constructive, and ECB is slowly changing its tune in view of persistent price pressures

Euro area economies, or more generally, EU economies, are increasingly busy implementing their Recovery and Resilience Plans. Disbursement of associated financing via the Research and Resilience Facility (RRF) is linked to reaching certain milestones and targets. This largest chunk of the NextGenerationEU (NGEU) program remains a pivotal instrument for financing parts of the twin transition towards more digital and more environmentally sustainable business models among the EU countries. As a corollary, domestic demand should remain a vital pillar to GDP growth this year, with mainly private consumption and RRF-boosted investment contributing, while government consumption should also add positively.

Figure 6: Investment in machinery and equipment recovering faster than after the Global Financial Crisis

Quarterly data on euro area investment in machinery and equipment, indexation to point in time t; for corona crisis: t = Q1-2020; for Global Financial Crisis t = Q3-2008



Sources: Eurostat, Creditreform Rating

As far as investment is concerned, the European Commission autumn 2021 investment survey found that, on a broad basis, industry managers expect investment activity to gain further traction in 2022, after having risen significantly in 2021 compared to 2020. This said, most of the answers suggested that replacement and streamlining processes was a major motive for investment so far, rather than extension. By the end of 2022, we would expect all euro area members to have regained lost ground since the outbreak of the pandemic (see Figure **6**).

Overall, we currently expect euro area real GDP growth to come in at about 3.9% this year, followed by a normalization to about 2.8% in 2023. The quarterly profile in 2022 will likely be comparable to last year's, with a relatively weak first quarter on account of high numbers of infections and constraints, and a period of catching up in the second and third quarter when restrictions are significantly eased and supply bottlenecks may present less of a burden.

HICP inflation may peak in Q1, possibly reaching 4.8%, before moderating in the course of the year. In its current winter forecast, the European Commission expected the euro area's inflation rate to average 3.5% this year, before declining to an average of about 1.7% in 2023. Risks seem tilted to the upside for the time being, given persistent supply bottlenecks and geopolitical tensions as elaborated above.

At its monetary policy meeting this February, the ECB confirmed its intention to discontinue the PEPP in March, as well as the previously communicated smoothing mechanism entailing a temporarily higher rate of net asset purchases under the Asset Purchase Program following the expiry of the PEPP. Following February's Governing Council meeting, we view an interest rate hike by the ECB already in 2022 as more likely as compared to our last Economic Briefs – though ultimately depending on the Governing Council's assessments as to duration, depth, and breadth of price pressures.

We think that the ECB will signal a less accommodative stance at its March monetary policy meeting as inflation projections are set to see a significant upward revision. However, geopolitical tensions may result in a more cautious approach after all. In December 2021, the ECB staff projected the inflation rate to rise to 3.2% in 2022 and to decrease to 1.8% in 2023, stabilizing at this level in 2024, whilst core inflation was forecast to be at 1.9% in 2022, before

moderating somewhat to 1.7% in 2023 and 1.8% in 2024.

With regard to measurement of inflation more generally, the ECB acknowledged in its recent monetary policy strategy review that the inclusion of costs related to owner-occupied housing may prospectively have to be considered in the HICP, thus better reflecting inflation relevant for households. Significant parts of these costs, such as purchases of dwellings and expenditures related to owning a house or a flat have not been considered in the HICP so far, even though home ownership rates in the euro area are at least at 70% for 16 out of the 19 euro area members. In light of more buoyant house price developments over recent years, this issue has gained prominence.

A broader set of risks including monetary policy mistakes and geopolitics is looming

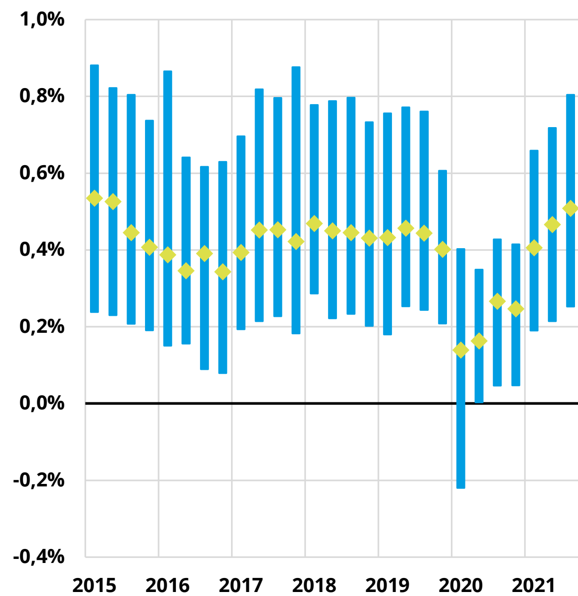
In the face of a likely changing monetary policy stance, risks related to associated higher financial market volatility are becoming more prominent. Apart from that, and amid the assumed fading threat of Covid-19 as more vaccines enter the market and improved medication is available. As regards the by and large sound banking sector, profitability has recovered from the pandemic (see Figure 7).

Risks seem to be shifting towards geopolitics in light of increasing signs of Russian aggression against Ukraine. Given Russia's significance as the EU's fifth-largest trading partner, accounting for 4.8% of the EU's total trade with the rest of the world in 2020, as well as a high degree of financial interconnection, any potential conflict should prove very costly.

Russia remains the largest supplier of natural gas and petroleum oils to the EU (see Figure 8). Among other things, natural gas is the most important source of energy in the euro area's manufacturing sector. Furthermore, EU direct investment in Russia came to EUR 311.4bn in 2019, making it the largest investor in Russia, while Russian direct investment in the EU was estimated at about EUR 136bn.

Figure 7: EU banking sector recovering from pandemic-related dent

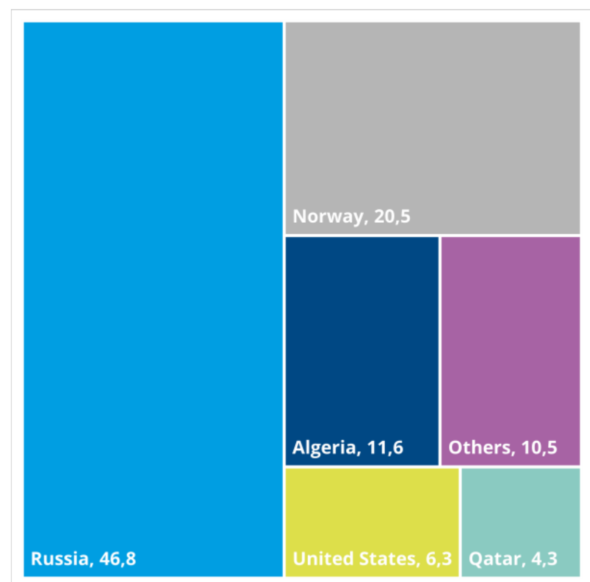
Return on assets in %; interquartile range and median



Sources: EBA, Creditreform Rating

Figure 8: EU is highly dependent on Russian gas

Extra EU imports of natural gas, share in % (value), first semester 2021



Sources: Eurostat (Comext), Creditreform Rating

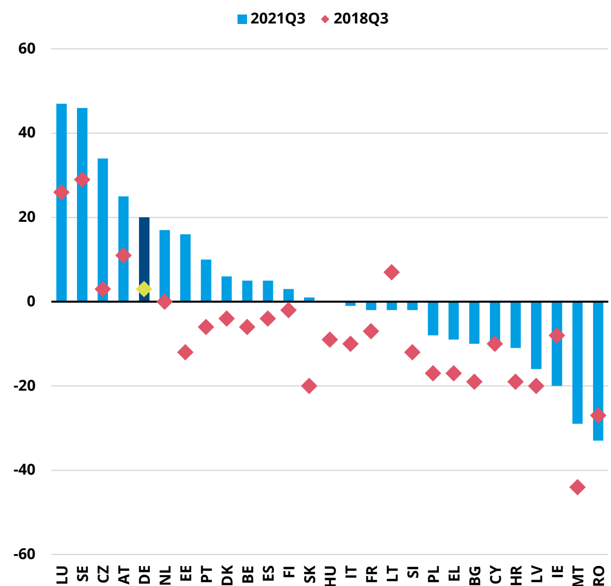
Higher energy prices and efforts to compensate poorer households for the effects thereof in several EU member states may slow the transition towards more sustainable energy forms. In addition, a larger divide between Germany and other euro area countries over energy security seems to become apparent, while neighbors such as France and the Netherlands not only stick with nuclear energy, but intend to expand on its use in order to achieve carbon neutrality by 2050. More generally, it seems unclear at this stage whether European countries will end up in fierce competition over how to achieve declared climate goals rather than pursuing a collaborative approach.

What is more, the EU obviously strives for more influence and less dependence, urging for insourcing certain value chains. While e.g. production of battery cells is to be built in Europe, several raw materials considered vital for the transition to renewable technologies, including lithium or graphite, but also copper and others, often stem from only a few countries, increasing other dependencies. In light of the shortages of semiconductors, the European is preparing the EU Chips Act, a set of measures to ensure the EU's security of supply, resilience and technological leadership in semiconductor technologies and applications, aiming to roughly double the EU's current global market share to 20% in 2030. The above-mentioned constraints may pose challenges on the way to desired 'digital sovereignty'.

Further risks we vigilantly monitor relate to the real estate sector, as also the latest assessment by the European Systemic Risk Board (ESRB) suggests. The ESRB concluded that in five countries, which had received recommendations or warnings in 2019 (Denmark, Luxembourg, Netherlands, Norway, Sweden), the vulnerabilities relating to residential property markets remained high, chiefly linked to a high level of debt of the household sector. At the same time, real estate risks are assessed as medium in six countries (Belgium, Czech Republic, Germany, Finland, France and Iceland), mainly due to highly leveraged household balance sheets and/or signs of overvaluation of housing prices and partly with lowered lending standards (see Figure **9**).

Figure 9: Germany among the EU countries with stronger hints towards overvaluation of residential property

Over-/undervaluation of residential property prices in %, estimates based on Bayesian estimated inverted demand model as valuation method



Sources: ECB, Creditreform Rating

Germany trailing euro area in terms of catching-up with pre-pandemic levels of total output

Following GDP growth to the tune of 2.8% in 2021 (preliminary result) on the heels of a decline by 4.6% in 2020, German economic output remained 1.5% below its pre-pandemic level (Q4-19) in the final quarter of 2021. GDP growth in 2021 was mainly carried by domestic demand, while exports expanded as well. Retail sales excluding motor vehicles in Germany increased overall in 2021 and reached a new record level, albeit masking very different developments in individual retail sectors. Meanwhile, exports increased by 14.0% in 2021, reaching a new record value of about EUR 1.38trn. Import growth came in stronger than that, rising by 17.1% and causing the (nominal) export surplus to shrink for a fifth successive year.

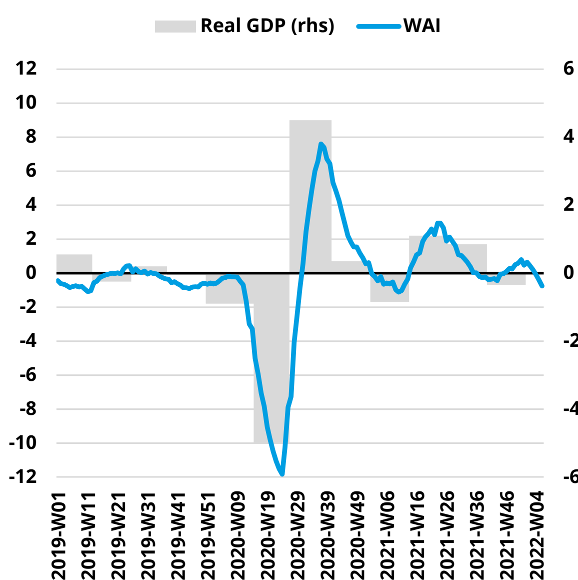
Economic activity in Q4-21 fell by 0.7% q-o-q, in particular weighed down by shrinking private consump-

tion in the face of containment measures to suppress the spread of the virus. While government consumption acted as a supportive pillar, investment in construction fell compared to Q3-21. Against the backdrop of comparatively slow vaccination progress of late, the economy seems to remain prone to setbacks through further virus mutations. As of 22 February, 74.8% of the total population had taken up the primary course, while 55.5% had received booster vaccinations, exceeding vaccination progress in the EU as whole (71.4% and 50.3%, respectively), but trailing France and Italy in this regard.

We expect economic output to remain affected by the Omicron wave in the first quarter of 2022, also due to temporary staff shortages linked to infections and precautionary quarantine, adding to constraints in place to suppress the spread of the virus and persistent cautious behavior by many consumers as far as contact-intensive services are concerned. Bundesbank's weekly activity index implies a GDP growth rate of -0.5% for the thirteen weeks to 13 February compared to the preceding thirteen-week period (see Figure **10**).

Figure 10: Restrictions amid the Omicron virus strain leaving their mark on economic activity

German quarterly real GDP growth in % (rhs), weekly (economic) activity index



Sources: Bundesbank, Creditreform Rating

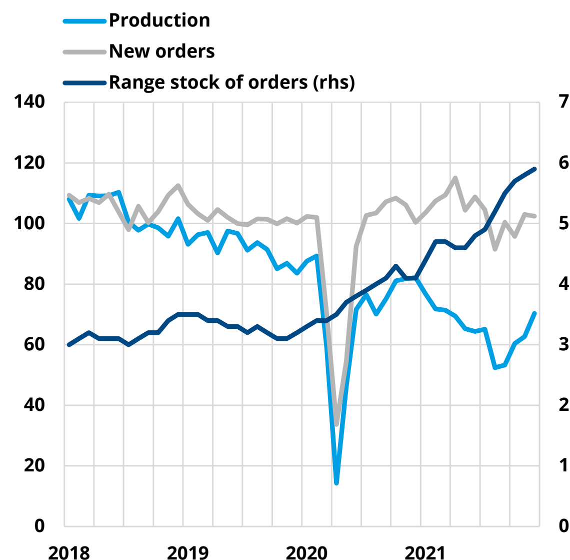
Industrial production still hampered by supply bottlenecks, with some green shoots in sight

Despite vivid new orders, industrial production remained curtailed by supply bottlenecks for various intermediate products and commodities. In December, production in the industry sector dropped by 0.3% against November and has not yet caught up with pre-crisis levels. The range of stock of orders has continuously increased since June 2020, and in November 2021 it reached its highest level (7.6 months) since this statistical series was introduced in January 2015.

New orders in manufacturing, which in December 2021 posted a second consecutive monthly increase. Considering the whole of 2021, new orders exceeded their level of the prior year by 17.8% and their level in 2019 by 9.3%, providing a strong basis for rising industrial production going forward. If supply bottlenecks are finally starting to ease, an industrial rebound thus appears well bolstered. Even in the battered automotive industry, perceptions are that supply issues may start to ebb (Figure **11**).

Figure 11: German car production picking up amid tentative signs of some easing of supply shortages

New orders and industrial production in manufacturing of cars, indices (2015=100), range of stocks of orders in manufacturing of cars in months



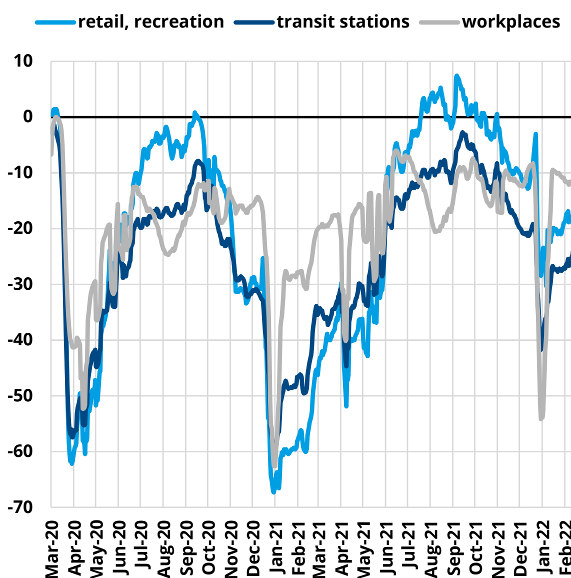
Sources: Destatis, Creditreform Rating

With a view to business climate indicators, following continuous deterioration over the second half of last year, the ifo business climate has posted its second consecutive increase in February 2022, to 98.9 points (Jan-22: 96.0), driven both by improved expectations for the coming six months and a more positive assessment of the current situation. The mood in the manufacturing sector has improved for a third consecutive month, hinting that the hindering supply shortages may be easing somewhat.

At the same time, the sentiment among German exporters has improved meaningfully at the beginning of 2022, with the respective index capturing export expectations rising to 17.4 points in January 2022, showing brightening prospects among most industries. Major German export industries such as manufacturers of machinery and equipment as well as the electrical and electronics industry are expecting significant growth in exports. After three weaker months, export expectations of the chemical industry improved markedly in January, too.

Figure 12: High-frequency data point to light at the end of the tunnel of the Omicron wave

Google mobility, 7-day moving average of percent deviation from baseline



Sources: Google LLC, Creditreform Rating

Other leading indicators such as mobility data, and the PMIs back a more constructive outlook (see Figure **12**). The services PMI shows further recovery in February 2022, reaching a six-month high (56.6 points, preliminary figure). The respective indicator for the manufacturing sector fell back to 58.5 points in February, still pointing to some remaining growth momentum amid tentative signs of easing of supply-side constraints. In January, the incidence of delays had dropped to the lowest level since December 2020, according to IHS Markit, underscoring the impression of some easing of supply bottlenecks. Apart from that, latest mobility data support the perception of rebounding activity more generally.

More inflation pressure down the line as companies are about to raise prices

The various lingering shortages amid recovering economic activity have not remained without consequences to price developments in Germany. A recent ifo survey points to companies' increased intention of raising prices. Surveyed over price expectations for the next three months, the indicator hit a new high in January, apparent in all sectors considered and particularly pronounced in the trade (wholesale and retail) sector.

In 2021, German HICP inflation increased to 3.2%. Apart from base effects caused by the low prices in 2020, including for energy prices, the expiry of the temporary VAT rate cut and supply bottlenecks contributed to rising consumer prices. Prices of energy products rose by 10.4% in 2021, following a 4.8% decrease in 2020, partly added to by the introduction of the CO_2 charge at the beginning of 2021. Food prices rose 3.2% last year.

Private consumption likely supported by favorable labor market development and higher minimum wage

Looking forward, household spending could thus be dampened by higher inflation rates, in particular as consumption-sensitive price categories are heavily affected. As mentioned above, given the geopolitical situation and the politically desired transitioning towards environmentally-friendly energy sources, price pressure is likely to stay elevated, although

some of the mentioned base effects will expire. However, labor market developments have remained favorable and, together with the envisaged further increase of the minimum wage to 12 euros per hour from October this year, supports expectations of growing consumer spending this year.

We note that willingness to hire remains at an elevated level, notwithstanding a second consecutive dip of the ifo employment barometer in January. In the manufacturing sector, hiring intentions rose for a third consecutive time. The unemployment rate declined from 3.6% to 3.3% in 2020-21, according to preliminary data. As of December 2021, the rate stood at 3.2%, close to historical lows prior to the outbreak of the corona crisis. Short-time work has not only helped to bridge the difficult initial phase of this pandemic, but has also supported jobs affected by limits to production owing to supply bottlenecks, as for instance experienced in the automotive industry and its suppliers.

Moreover, in February 2022, the government has extended the easier conditions for access to short-time work allowance until end of June 2022 and has extended the maximum period of entitlement from 24 to 28 months. In November 2021, roughly 574,000 employees were estimated to be subject to the short-time scheme, compared to roughly 2.4mn persons in November 2020 and close to 6mn persons at the height of the crisis in April 2020.

Gross fixed capital formation should remain supported by still favorable financing conditions, even though these are set to be become somewhat less advantageous in light of central banks, including the ECB, starting to sound somewhat more hawkish (see above). Investment will likely expand more significantly once the supply-side constraints start to wane more noticeably. Similarly, we would expect German exports to accelerate, and at this stage pencil in a positive growth contribution from net exports in 2022, which could become smaller in 2023 when domestic demand should moderate somewhat.

Overall, we currently expect German GDP growth of about 3.8% in 2022, which represents a downward revision compared to our previous Economic Briefs, followed by a moderation to about 2.7% next year. Germany remains particularly vulnerable to potential disruptions from Russian aggression against the Ukraine and possible multilateral sanctions, since Russia is Germany's biggest energy supplier. More than half of Germany's gas imports were supplied by Russia in 2020 (65.2%, volume terms). Moreover, Russian coal accounted for close to half of Germany's coal imports (2020: 45.9%), and almost 30% of oil and petroleum product imports stemmed from there.

Insolvencies remain tamed following expiry of pandemic-related regulation

Supported by various support schemes including the so-called 'Überbrückungshilfen', as well as by special regulation with a view to insolvencies between March 2020 and May 2021, the number of business insolvencies has remained relatively low throughout the corona crisis. Following the expiry of most of this special regulation at the end of May 2021, the number of actual business bankruptcies has tended to decline since then, suggesting limited catch-up effects. In 2021, the number of corporate insolvencies is likely to have been lower again than in the previous year, reaching a new record low. From January to November, there were just 12,832 corporate insolvency applications,12.2% fewer than in the corresponding prior-year period.

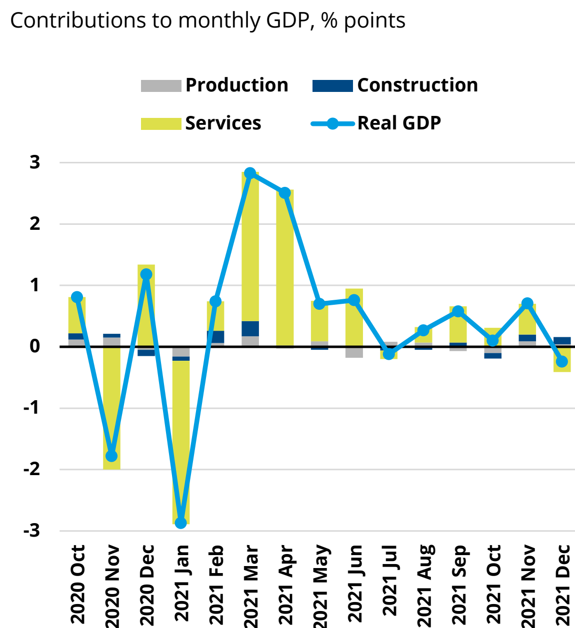
There are no signs of a major increase at the end of 2021 either. In November 2021, insolvencies rose by 4.6% y-o-y, marking the first increase since September 2019. However, compared with November 2019, hence prior to the corona crisis, the number of corporate insolvencies was 22.6% lower. Based on provisional Destatis data, the number of requests for normal business insolvency - an early indicator for actual insolvency filings - fell by 17.2% in January 2022 against the preceding month, following an increase by 18.0% in December 2021, thus continuing to suggest limited catch-up effects. Extended support such as 'Überbrückungshilfe IV', for which applications are accepted until end of April 2022, continue to back a benign scenario in terms of business insolvencies.

United Kingdom: Ongoing recovery, but higher inflation is taking its toll

Following a relatively steep GDP decline by European comparison in 2020 (-9.4%), the UK economy remained on an expansionary course over the last year, growing by 7.5% according to preliminary figures. In Q4-21, real GDP increased by 1.0% q-o-q (Q3-21: 1.0%), with household spending contributing the most to the expansion, while gross fixed capital formation also contributed positively. In the face of this development, real GDP was 0.4% below its pre-crisis level in the final quarter of 2021.

Figure 13: Services are the main driver behind monthly real GDP

Contributions to monthly GDP, % points



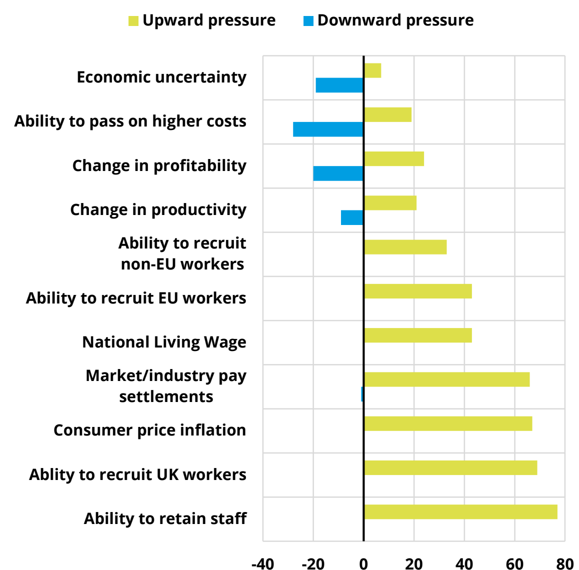
Sources: ONS, Creditreform Rating

Despite soaring infection rates due to the Omicron variant around the turn of the year, the government imposed relatively moderate restrictions compared to many other European countries. Nevertheless, these measures and somewhat adjusted consumer behavior led to a fall by 0.2% of the overall economic performance in December 2021 (see Figure **13**). Consumer-facing services fell by 3.0% month-on-month in December, leaving them 8.4% below their Q4-19 level, whereas other services were 2.8% above their pre-pandemic level. Meanwhile, consumer confidence fell for a second consecutive time in January 2022. However, the Omicron wave may ultimately prove to be only a short-term disruption to the economy, as coronavirus infections appear to be on the decline more recently.

Moreover, notwithstanding the closure of the UK's furlough scheme at the end of September, unemployment fell further to 4.1% in the three months to November 2021. Thus, redundancies post only little higher than rates seen prior to the pandemic and point to an increasingly tight labor market, which is also reflected in continued increases in employment and comparatively strong underlying earnings growth (see Figure **14**).

Figure 14: A tight labor market continues to exert upward pressure on wages

Factors affecting pay decisions in 2022, % share of answers



Sources: Bank of England, Creditreform Rating

As most other European economies, UK companies have reported supply-chain issues over the course of 2021. As of November 2021, some car manufacturers perceived improvements around previously reported shortages of semi-conductors. The government's latest pandemic support package for businesses, announced in December 2021, alongside fiscal plans elaborated in the Autumn Budget and

Spending Review in October 2021, should act as a stabilizing element to GDP growth going forward.

Business sentiment as measured by the PMIs remained at levels consistent with economic expansion, partly giving signals of increasing momentum of late. In the service sector, the PMI flash estimate soared to 60.8 points in February 2022, marking an eight-month high. The corresponding indicator for the manufacturing sector stabilized at 57.3 points..

At present, we expect UK real GDP to expand by 4.2% in 2022. We have nudged down our forecast for this year, mainly due to higher inflation likely curtailing private consumption and prospects of a somewhat tighter monetary policy course than previously expected – if geopolitical tensions ebb. Business investment should remain supported by the 'super deduction' tax incentive, which is to remain in place until Q1-23. With regard to 2023 as a whole, we pencil in GDP growth of about 2.0%.

Downside risks from ongoing need to cope with post-Brexit issues

We continue to see some downside risks for our UK scenario stemming from having to adjust to the post-Brexit world. A report published by the Committee of Public Accounts this February raises concerns over new border arrangements having raised costs to UK businesses. The committee also highlights that the UK government has delayed introduction of full import controls after the end of the transition period several times. Trade might thus experience frictions, in particular if passenger volumes across the Channel return to normal, as traders and hauliers in the EU would have to prepare on time.

Since from 1 July 2022 extra checks on agricultural and food imports from the EU are to take place at UK ports, and companies will need to be in a position to deal with the required logistics, i.e. which ports will be dealing with which products, ferry schedules etc. In this regard, some of the required infrastructure may not be completed in time, and the UK might face challenges pertaining to insufficient staffing. By the same token, the resignation of Northern Ireland's First Minister in February 2022 seems to underscore simmering difficulties around the handling of the de-facto-border between the UK and Northern Ireland.

We note there are continuous efforts on trade agreements with non-EU countries. In December 2021, the UK reached agreement in principle over a trade agreement with Australia, as well as over a digital trade deal with Singapore. In January 2022, negotiations on a Free Trade Agreement with India were launched.

While we do not consider a snap election ahead of the UK's scheduled parliamentary election in May 2024 a likely scenario, opinion polls show that the labor party has been gaining ground over recent months, partly associated with increasing public criticism over PM Johnson in relation to the Covid-19 lockdown. Labor is thus leading current opinion polls by a margin of about 8 p.p.

Monetary Policy Committee becoming more hawkish – we expect the Base Rate to be increased to at least 1.0% this year

Along with higher energy prices, supply bottlenecks have contributed to higher inflation rates. UK inflation hit 5.5% in January 2022, further up from 5.4% in December 2021. On average, the rate climbed to 2.6% in 2021 (2020: 0.9%). Reflecting the various price pressures, inflation is likely to remain well above its target over the medium term, currently expected to peak around 7¼% in April 2022. Against this background, the Bank of England's Monetary Policy Committee (MPC) saw sufficient reason to raise its policy rate already in December 2021, by 0.15 p.p. to 0.25%, followed by another rise by 0.25 p.p. to 0.50% in February, albeit with a narrower majority of 5-4 among the currently nine-member committee. The minority had preferred to raise the rate by 50 basis points.

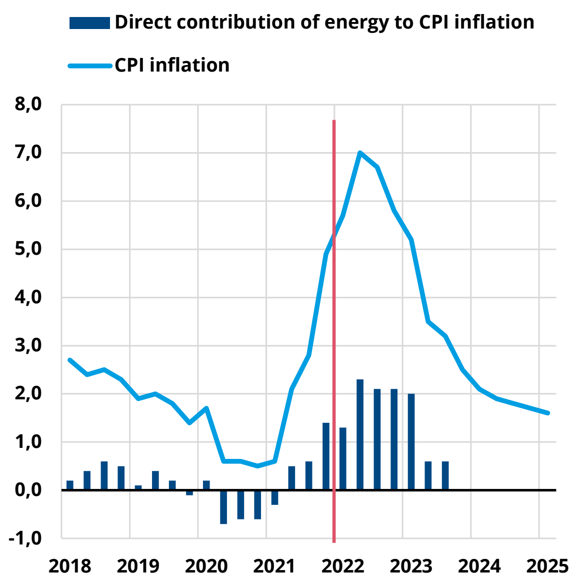
On this occasion, the MPC also voted unanimously to begin reducing the stock of gilt purchases by ceasing to reinvest maturing assets. In the same vein, the stock of sterling non-financial investment-grade corporate bond purchases is to be run down by ending reinvestment of maturing assets and by a program of corporate bond sales which is to be completed no earlier than towards the end of 2023 in order to fully

unwind the stock of corporate bond purchases. The MPC also stressed that it would not consider actively shrinking the stock of UK government bonds until the Bank Rate has risen to at least 1.0%, also depending on the economic conditions at that point in time.

The MPC projects price pressures to abate over the next few years. At this stage, CPI inflation is expected to decrease to slightly above the 2% target in two years' time, and below the target in the year after (see Figure **15**). Underlying wage growth is assumed to ease from next year

Figure 15: Burden from high energy costs expected to fade over the forecast horizon

CPI inflation in %, contribution of energy in p.p.



Sources: Bank of England, Creditreform Rating

We currently expect the MPC to increase its policy rate to at least 1.00% this year. To be sure, there are risks for a stronger increase in the Bank Rate, if the geopolitical tensions can be effectively contained. House price growth seems set to recede in this scenario, following an average annual increase of 9.9% in 2021, drawing on the HM Land Registry's UK house price index for all types of property.

Figure 16: Weaker start into the year and inflationary pressures prompted us to revise down our real GDP forecasts for 2022

In %, IMF forecasts for World, China, US

	2010-19	2019	2020	2021e	2022e	2023e
World	3,7	2,8	-3,1	5,9	4,4	3,8
Euro area	1,4	1,6	-6,4	5,2	3,9	2,8
Germany	2,0	1,1	-4,6	2,8	3,8	2,7
France	1,4	1,8	-7,9	7,0	3,6	2,0
Italy	0,3	0,4	-8,9	6,5	4,0	2,0
Spain	1,1	2,1	-10,8	5,0	5,7	4,1
UK	2,0	1,7	-9,4	7,5	4,2	2,0
US	2,3	2,3	-3,4	5,5	4,0	2,2
China	7,7	6,0	2,3	8,1	4,8	5,2

Sources: Creditreform Rating, FOMC, IMF

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