KPMG

Global Economic Outlook

April 2022

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Introduction

As last year drew to a close, KPMG's H2'2021 Global Economic Outlook was published. At the time, I described the previous twelve months as turbulent and uncertain with a constant wave of challenges and threats. Today, we find ourselves in an arguably even more unsettling period.

It goes without saying that economic forecasting is incredibly challenging in such a profound period of uncertainty, but it remains an effective tool for helping us to plot our course for the next months and years.

In this, the latest edition of KPMG's Global Economic Outlook, we've brought together the expertise of our global organization's economists, representing seventeen countries and three major regions. Our report focuses on the near-term forecast for 2022 and 2023, recognizing the need for businesses to understand what's likely to occur in the short to mid-term.

Before the outbreak of war in Ukraine, different territories and regions were at different stages of their post-COVID-19 economic recovery, and that is reflected in the analysis from our economists. But, while GDP forecasting varies, there are a number of clear, consistent themes and threats facing the entire planet today. Armed conflict may currently be restricted to Eastern Europe, but it's already having far-reaching consequences for all nations.

Supply chain issues have moved from a post-covid issue to a major immediate threat, with potential shortages in natural gas, metals and grains, among many others. While shortages will impact every territory, we anticipate a disproportionate impact on some of the world's poorest places and people, compounding long-term challenges for the planet's collective recovery. Meanwhile, inflation looks set to become a major theme for everyone, raising the threat of a worldwide cost-of-living crisis.

Economic forecasting is not a perfect science, but what KPMG's Global Economic Outlook does do is shine a light on the path ahead, providing a degree of guidance in an increasingly difficult journey.

Gary Reader
Global Head of Clients & Markets
KPMG International

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The global outlook: Without respite

Russia-Ukraine war to lower global growth prospects and increase inflationary pressures.

Central banks' change in policy stance could add to markets' volatility.

On-going geopolitical uncertainties could see further disruptions to production and trade.

As the global economy was gradually putting the COVID-19 pandemic behind, with many parts of the world lifting restrictions, and several economies returning to their pre-COVID size, another shock struck. The ongoing conflict between the Russian government and Ukraine since late February is a humanitarian crisis. It is also shaping up to be a prelude to a new geopolitical era, one where businesses may need to navigate an altered globalization map, and one where progress against global issues in areas such as health and climate change becomes harder to do.

Even if the conflict between Russia and Ukraine itself remains localized, it has broad implications for economies all across the world. While Russia and Ukraine together represent a relatively small part of the world economy, they account for a large share of global energy exports, as well as exports of a range of metals, food staples and agricultural inputs.

Russia is the world's largest exporter of natural gas, second largest exporter of oil and the third largest of coal. It is also a large exporter of titanium, uranium, aluminium, copper, nickel, and palladium. Ukraine is a significant source of global neon exports and produces components that are part of highly integrated automotive manufacturing supply chains, amongst others. Higher prices for energy and metals, coupled with delays in supply will hit industrial production the most, particularly in Europe. For example, the EU relies on Russia for about a quarter of its energy needs and sources a number of its manufacturing components from Ukraine. Global supply chains are likely to be put under further strain due to the rise in new cases of COVID-19 in China, which triggered new lockdowns across the country in March.

The conflict could also take a heavy toll on poorer countries and households in other parts of the globe through its impact on global food prices. Together, Russia and Ukraine account for 29% of global wheat exports. Ukraine alone is responsible for 13% of global corn exports as well as a large share of exports of other food staples such as sunflower seeds. Global agriculture production could be further hampered by a shortage of fertilizers, with Russia producing 20% of global potash, one of its components, causing overall food prices to rise and crop yields to fall.

Before this crisis, prices of many of these commodities were already high, and stocks low, as the COVID-19 pandemic had caused production to slow, and demand accelerated quickly when economies reopened. The escalation of the conflict between Russia and Ukraine, which resulted in a number of sanctions on Russia and paused most production in Ukraine has caused prices to rise further and exacerbated supply chain pressures for some industries.

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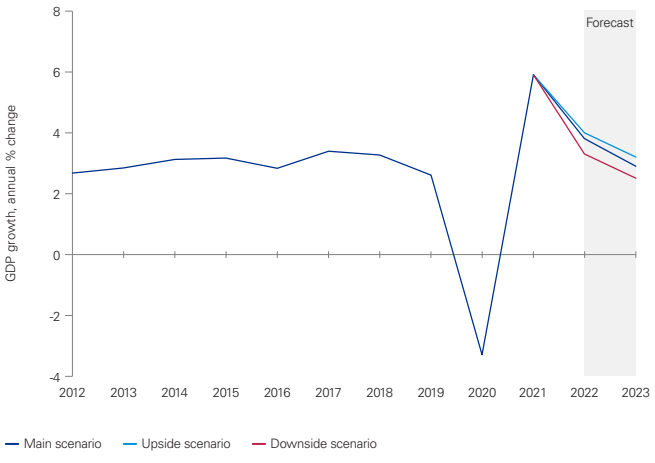
Global growth outlook

The outlook for the next two years will depend on how the conflict between Russia and Ukraine evolves. With so much uncertainty at present, we developed three scenarios to examine the prospects for the world economy. Our **main scenario** assumes that world oil prices will be US$30 higher than their path prior to the escalation of the crisis, while gas prices will be 50% higher across Europe. It also incorporates a 5% rise in global food prices. A more severe scenario, which is captured by our **downside scenario**, looks at the potential impact of world oil prices US$40 higher together with a 100% rise in gas prices for Europe and a 50% rise in gas prices for the rest of the world. The downside scenario also assumes a 10% rise in global food prices. Both scenarios incorporate a 23% rise in average metal prices and a 4% increase in the cost of agricultural inputs. They also include higher investment risk premia and additional government spending in Europe. Meanwhile, our **upside scenario** looks at the possible outcome in the event that the conflict is resolved sooner than anticipated, with prices returning to early February levels and production and trade flows restored.

Our analysis found that global GDP growth could range between 3.3%-4% this year and between 2.5%-3.2% in 2023, depending on the scenario (Chart 1). Individual country forecasts under our main scenario can be found in the country chapters, as well as in the Appendix. Our cut-off point for all forecasts and data in the report was 25 March 2022.

Chart 1: World GDP growth under three scenarios



Source: World Bank, KPMG projections using NiGEM.

Risks to our forecast are currently skewed to the downside. It is possible to envisage that the conflict between Russia and Ukraine escalates beyond our downside scenario, with cuts to energy supplies for example causing a significant disruption to production in parts of Europe. The COVID-19 pandemic is still causing shutdowns in major economies such as China, and a new wave could undo the progress in easing global supply chain blockages. The global economy emerged from the COVID-19 recession with higher public debt and as central banks raise interest rates, the servicing cost of sovereign debt increases, making it particularly challenging for emerging countries whose debt is denominated in an appreciating US dollar. With policymakers and many businesses still reeling from the consequences of the pandemic, they are less ready to counter another significant economic shock.

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Inflation on a high exacerbates central banks' dilemma

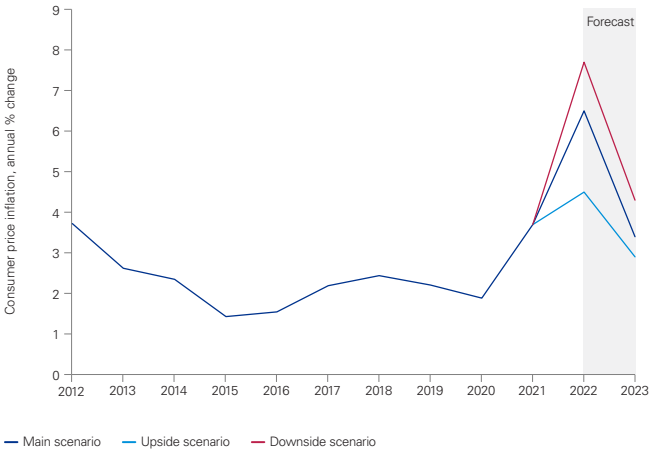
As we continue to emerge from the restrictions imposed by the pandemic, one of the major concerns has been the rise in inflation across many parts of the world. The conflict between Russia and Ukraine has further intensified these inflationary pressures. Our analysis found that global inflation could average between 4.5%-7.7% this year and between 2.9%-4.3% in 2023, depending on how the crisis evolves (Chart 2).

Higher inflationary pressures saw a change in the policy stance of central banks in several economies already last year, with rising inflationary pressures prompting many to start raising rates (Chart 3). So far, The Bank of England has raised its rates during three consecutive meetings and ended its quantitative easing (QE) program. The U.S. Fed began raising rates in March and indicated that rates could rise six more times this year. The change in central banks' stance, especially the Fed's, could add volatility to markets as they adjust to a new policy direction.

Going forward, the world economy will have to navigate a difficult period ahead under a cloud of geopolitical uncertainty. Businesses and households will be hoping for the best but should plan for potential ongoing disruptions and uncertainty.

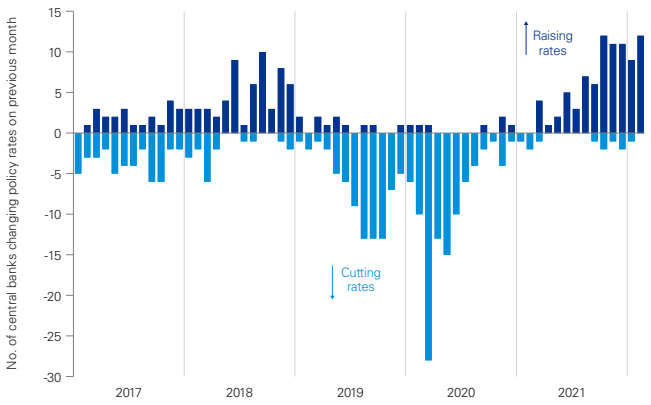
Yael Selfin
Chief Economist, KPMG in the UK

Chart 2: World inflation projections for 2022 and 2023



Source: World Bank, KPMG projections using NiGEM.

Chart 3: Central banks on the move



Source: Bank for International Settlements, KPMG analysis.
Note: Latest data are for February 2022.

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United States: Domestic tailwinds to outweigh geopolitical uncertainty

Even with some moderation from the robust growth seen last year, we still expect consumer spending to drive growth above the expected potential in 2022.

Inflation is expected to remain elevated for much of the year, driven in part by geopolitical events and continued supply chain disruptions.

The Fed has indicated that rates could rise six more times in 2022, bringing the policy rate close to its rate at the end of the last cycle.

The U.S. economy ended 2021 on a strong note, with economic growth achieving a seasonally adjusted annualized rate (SAAR) of 7% in Q4. Excluding the historic rebound in the third quarter of 2020, that is the fastest pace of growth since 2000. The surge in economic activity was driven in part by a restock in inventories, but consumption and investment also showed strength. While that economic momentum appears to have carried over into 2022, the war in Ukraine and continued supply chain disruptions have fostered additional inflationary pressures, increased downside risks to the economic outlook, and quickened the expected pace of monetary tightening.

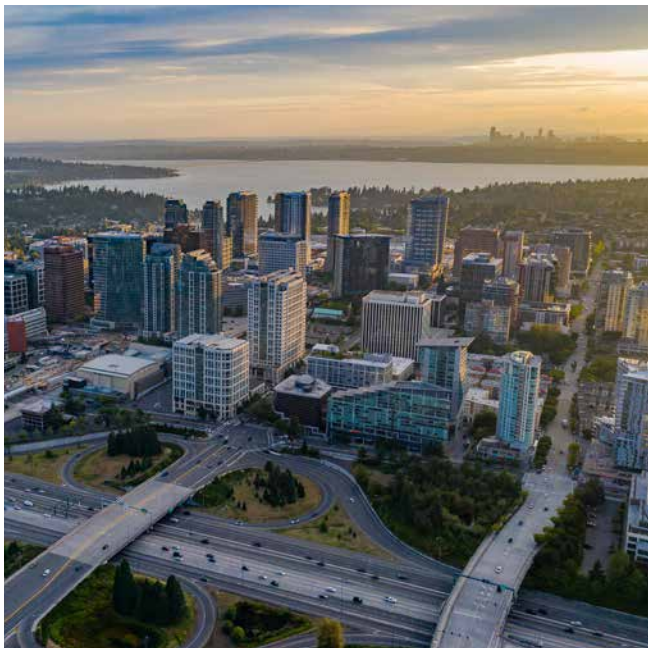
Conditions in the labor market remain tight, and despite elevated inflation, consumers continue to exhibit a willingness to spend. Both of these factors should remain tailwinds for the remainder of 2022. However, the global trade network was shocked again in late 2021 and early 2022 with commodity prices surging in response to Russia's invasion of Ukraine, and rising COVID-19 cases in some major trading partners closing factories and ports. The persistence of these factors will drive the inflation outlook for 2022. The ability of policymakers to tame these inflationary pressures without derailing economic momentum will dictate the path of growth this year.

The economy continues to add jobs at a pace that is higher than anything sustained in the previous cycle. The labor market added 1.2 million jobs in the first two months of the year alone. In contrast, the economy added 2 million jobs in all of 2019. Strong employment gains saw private sector wage gains that have doubled the average 12-month pace of wage growth during the previous expansion.

Table 1: KPMG forecasts for the U.S.

	2021	2022	2023
GDP	5.7	3.1	2.1
Inflation	4.7	8.2	3.7
Unemployment rate	5.4	3.6	4.1

Source: Source: BEA, BLS, KPMG analysis.
Note: GDP growth is shown for the full year. Inflation and unemployment rates are annual averages.



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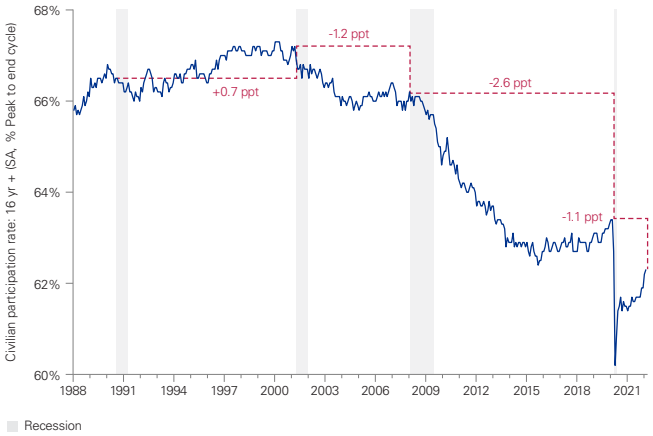
In the near-term we expect the labor market to remain tight, with elevated job gains and continued improvement in the labor supply as pandemic-related health and childcare concerns are alleviated, helping to bring workers off the sidelines. However, pre-existing dynamics, such as the aging of the population, were already weighing on labor force participation prior to the pandemic. We expect these factors to carry forward, limiting the supply of labor over the next couple of years. Elevated demand and persistent labor shortages will translate into continued strong wage gains in many sectors, which will boost incomes, but also intensify the pace of inflation.

Chart 4: Underlying factors are impacting labor force participation



Source: KPMG Economics, Bureau of Labor Statistics (February 2022), Haver Analytics.

Fiscal tailwinds have faded, and the savings rate has returned to levels experienced at the end of last cycle, suggesting that consumer spending is likely to slow from its robust 2021 pace. Still, the tight labor market and strong pace of wage gains will translate to solid consumer spending this year, even if persistently high inflation somewhat erodes real wages.

The war in Ukraine is unlikely to have a significant direct impact on the U.S. economic outlook as Russia is not a major trading partner and the U.S. financial sector is not materially exposed to Russian sovereign or corporate debt. Trade with Russia accounts for only 0.6% of total U.S. trade, and Russia ranks as the 28th largest trading partner. Additionally, U.S. banks hold a relatively small amount of Russian financial assets, with exposures accounting for half of all exposures to Sweden, one-fifth of all exposure to Italy and one-fiftieth of the total exposure to the UK financial system.

Even if the direct aggregate impacts from the Russian invasion of Ukraine are limited, the effects will be felt unevenly across sectors. The manufacturing sector is expected to experience the most significant direct impact through higher production costs and lower global demand for manufactured goods. The duration of the conflict will dictate the severity of economic disruptions, but the manufacturing sector was on solid footing before the war started, which should provide resiliency against the expected downturn in activity.

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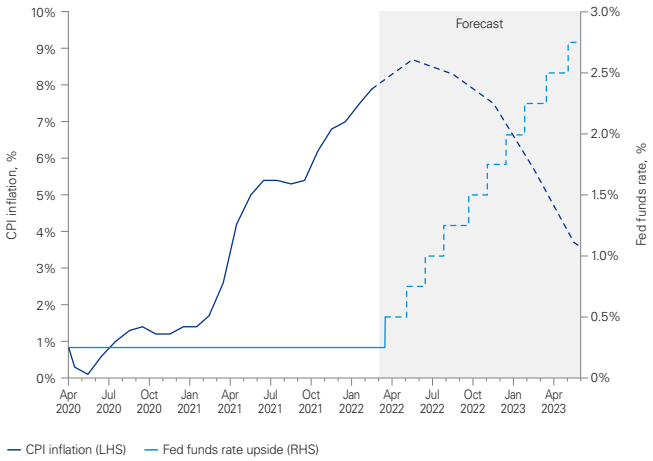
Moderating growth and strong inflationary pressures will remain a key storyline in 2022. The pace of 12-month headline CPI inflation reached a 39-year high at the end of last year and has only increased since. There were signs that inflation would start to ease this spring, but the war in Ukraine caused commodity prices to surge and further disrupted supply chains. The rise in commodity prices is increasing production costs in many industries, particularly manufacturing and energy, and this will likely further intensify inflationary pressures through at least the first half of the year. In addition to these external developments, the pace of inflation is likely to be driven by strong gains in the residential rental market. Even as the monthly pace of house price growth slowed over the second half of last year, the pace of rental price gains picked up. The relationship between rental prices and shelter components of CPI inflation is lagged, suggesting that strong price increases last year will continue to foster inflationary pressures in the first half of 2022. Taken together we expect the pace of year-over-year headline CPI inflation to remain above 8% for the spring and possibly into the summer.

Persistent inflationary pressures are affecting consumer inflation expectations, a potential worrying sign for policymakers. Five-year consumer inflation expectations hit 3.0% recently, the highest level experienced in the previous expansion, and are likely to turn even higher if current inflationary pressures remain elevated as expected. To stem the tide, the FOMC increased the federal funds rate by a quarter of a percentage point at their mid-March meeting. In the press conference following the decision, Fed Chair Jerome Powell noted that the impact to the U.S. economy from the war in Ukraine is uncertain, but policymakers are monitoring developments closely. He also stated that policymakers feel the economy is ready for both additional rate increases and a reduction in the central bank's balance sheet. In the Summary of Economic Projections that was released with the decision, the median forecast for the end-of-year federal funds rate was nearly 2.0%. We therefore expect a rate increase at each of the remaining six meetings this year, which would put the upper bound of the federal funds rate at 2.0% at the end of 2022.

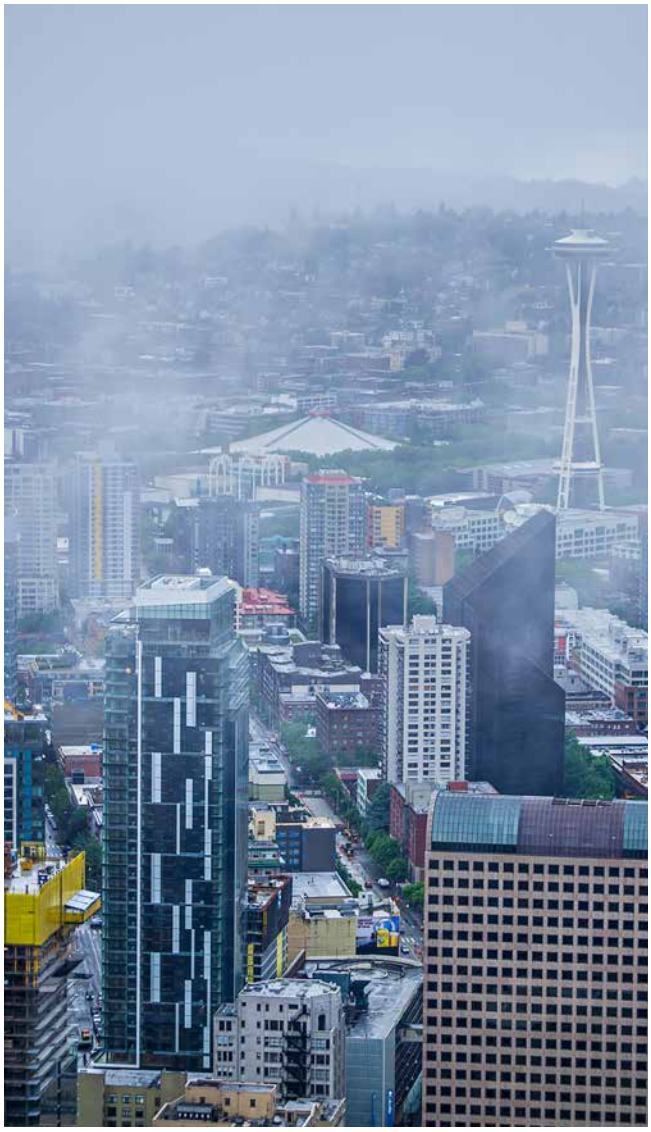
The U.S. economy entered 2022 in a strong position, but geopolitical developments and persistent inflationary pressures have increased the downside risks to the outlook. We don't anticipate that recent events will push the economy into recession, and we still expect the economy to grow above its potential in 2022. Whether that forecast materializes will depend on the ability of the Fed to engineer a soft landing in the face of intense inflationary pressures and increasing global uncertainty.

Timothy Mahedy
Senior Economist, KPMG US

Chart 5: Fed path will be determined by inflation trajectory



Source: KPMG Economics, Bureau of Labor Statistics, Haver Analytics.



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Canada: Labor recovery should withstand monetary tightening

Economic growth is expected to remain strong in 2022, driven by high prices for some key commodities and solid consumer spending.

Inflationary pressures will persist for most of the year, and tight labor market conditions signal that the risk to the inflation forecast is on the upside.

The central bank has already started raising rates, and we anticipate the policy rate to reach 2% by the end of 2022. The pace of hikes will likely be influenced by the pace of increases in the U.S.

Economic momentum slowed a little at the start of 2022, as the rise of the Omicron variant led to a tightening in economic restrictions. However, the surge dissipated rather quickly, and Canada has a relatively high rate of vaccination, with 83% of the population fully vaccinated. Growth will remain strong in 2022 as conditions in the labor market are very tight and wage growth continues to pick up – both tailwinds for consumer spending. There are some risks to the outlook from the war in Ukraine, but the U.S. is Canada's top trading partner, and the effects to the U.S. economy are expected to be moderate. That should translate into continued solid demand for Canadian export goods, particularly petroleum products. High inflation poses another risk to the outlook and the central bank has already started raising rates to tame pressures. We anticipate that strong growth and a surge in commodity prices will cause additional inflationary pressures in 2022, causing the Canadian central bank to raise rates to 2% by the end of the year.

Table 2: KPMG forecasts for Canada

	2021	2022	2023
GDP	4.6	3.8	3.1
Inflation	3.4	3.9	2.3
Unemployment rate	7.4	5.9	5.6

Source: Statistics Canada, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate.

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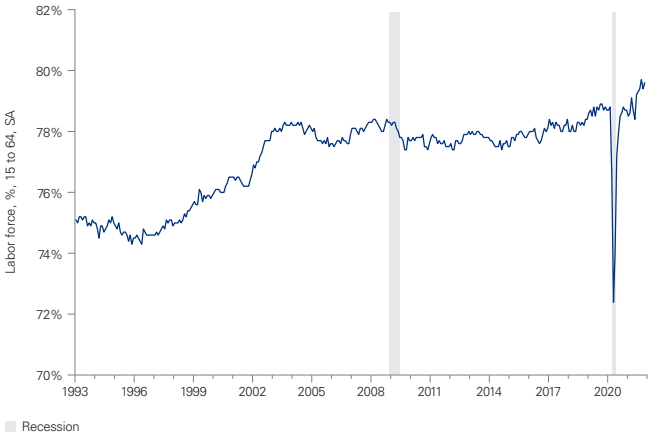
The Omicron surge had little impact on labor force participation, signaling that health and childcare concerns may be easing. This could help insulate the labor market from additional pandemic-related shortages should another wave of infections materialize. Still, one of the biggest challenges facing the Canadian economy over the next couple of years will be the lack of available labor. Labor force participation continues to climb, hitting an all-time high 79.7% in December of last year. Rising participation has been accompanied by continued declines in the unemployment rate. Above trend economic growth should keep demand for labor elevated, pulling down the unemployment rate further over the next couple of years. This will intensify overall private sector wage growth, potentially fostering additional inflationary pressures.

Canada's inflation rate reached a 30-year high in December, driven in part by sharply higher prices for food. House prices have also been rising rapidly as many workers transitioned to a work-from-home environment, increasing the demand for larger houses and apartments. The growth in transportation prices has trended down at the start of the year, but the pace of growth could pick up into the spring in response to additional supply chain disruptions from rising COVID cases in China and the war in Ukraine. We expect many of these price pressures to persist in 2022, which will lead to firmer inflationary pressures, with the possibility that the central bank will raise rates faster than expected.

At the March meeting, the Bank of Canada's Governing Council decided to raise the overnight interest rate by 25bps and acknowledged the increased uncertainty and likely firmer inflationary pressures stemming from the invasion of Ukraine. Policymakers expect the war to push inflation higher over the near-term and noted that the Council will use its tools to bring inflation back down towards its 2% target. The Council also noted that discussions have taken place on reducing the Bank's balance sheet. We anticipate that the Council will begin to reduce their asset holdings at the June 1st meeting.

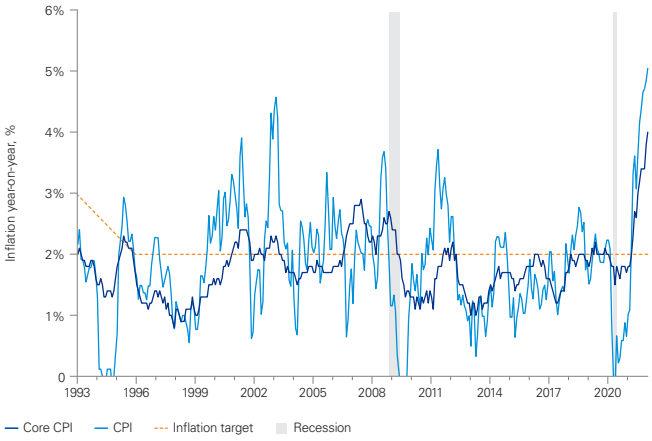
Even with the relatively rapid removal of monetary policy accommodation in 2022, we expect inflationary pressures to rise, largely due to very tight conditions in the labor market and continued elevated commodity price pressures trickling through to other sectors. The Bank may end up needing to move more quickly on rates than the market currently predicts, which may slow economic momentum, but it is unlikely to derail the expansion. What would be more troubling for the economic outlook would be a sharp slowdown in the U.S. or an even faster rate of inflation than currently expected. Neither is anticipated, but the probability of both occurring has increased since the start of the year.

Chart 6: Labor force participation rate recovered from pandemic



Source: KPMG Economics, Statistics Canada, Haver Analytics (January 2022).

Chart 7: Central Bank grapples with historically high inflation



Source: KPMG Economics, Statistics Canada (January 2022).

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Brazil: Can the central bank tame inflation?

High inflation is eroding real wages, which will weigh on consumption and growth in 2022.

Brazilian commodity exports will benefit from higher global prices, but more costly refined products could impact other sectors.

The central bank has already raised rates eight times, and more will likely be needed to curb intensifying inflationary pressures.

The Brazilian economy rebounded at the end of 2021, after contracting in the second and third quarters. The rebound was led by strength in the service sector and the agricultural industry. Looking forward, we expect growth to remain sluggish in 2022 as high inflation is expected to erode real wages further and the war in Ukraine combined with other supply chain issues are anticipated to weigh on the manufacturing and export sectors. The central bank is expected to raise rates further in 2022 to address inflationary pressures. Whether the bank can engineer a soft landing when inflation and inflation expectations are elevated will be a key question in 2022. The country's debt-to-GDP ratio is relatively high, and the central government may not be able to provide much fiscal support should the economy stumble again this year.

Brazil was particularly hard hit by the Omicron variant in December and January, which caused a contraction in consumer spending. Consumer confidence, a forward-looking measure related to spending, remains below pre-pandemic levels, likely due in part to double-digit increases in inflation. We expect inflation to remain high in 2022, which will further weigh on confidence and likely translate into slowed growth in consumer spending. The labor market should provide some offsetting effects. The unemployment rate is falling, and labor force participation is improving, trends we expect to continue. How much the labor force can offset negative consumption effects from COVID-19, inflation, and confidence will depend largely on growth.

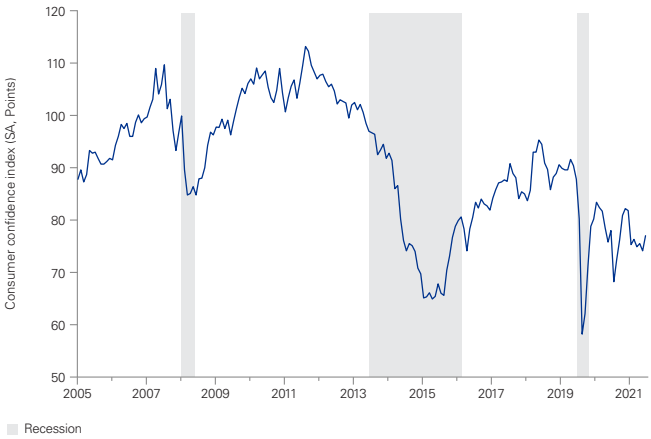
Table 3: KPMG forecasts for Brazil

	2021	2022	2023
GDP	4.6	0.6	1.9
Inflation	9.0	8.4	5.2
Unemployment rate	13.6	12.5	11.9

Source: Instituto Brasileiro de Geografia e Estatística, IMF, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate.

Chart 8: Consumer confidence makes little progress



Source: KPMG Economics, Fundação Getúlio Vargas, Haver Analytics (February 2022).

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Being heavily integrated in global trade, Brazil's exports have also suffered from supply chain logistics and infrastructure disruptions that are likely to continue throughout 2022. Exports slumped in Q4 at -2.4%. Brazil is heavily reliant on its exports of agricultural products, such as feed-grade soy, and oil/gas products. A lack of rain caused many farmers to harvest early, and fertilizer prices are expected to spike in the wake of the Russia-Ukraine crisis. Brazil imports more than 20% of its fertilizer imports from Russia, and stockpiles were already running low. The poor 2021-2022 harvest combined with fertilizer supply problems will have ripple effects into global prices for soy, corn, meat, cane sugar, and coffee, primarily. The drought hit hydroelectricity generation and caused a spike in energy prices, leading to a risk of electricity rationing. On the other hand, Brazil's exporters of oil and gas will receive higher prices for the near-term from the Russia-Ukraine crisis.

Year-over-year inflation hit an 18-year high of over 10.5% in February. High inflation came from fuel (33.3%), housing (14.6%), electricity (28.1%), and food (9.1%). The Russia-Ukraine conflict is likely to add additional pressures to all these commodities, especially refined fuels, electricity, and food products.

In response to the surge in inflation, the central bank has lifted the policy rate eight times to 10.75%, raising borrowing costs and further eroding fiscal capacity. The policy rate increases have reduced future inflation expectations but not significantly, signaling that the bank will likely need to continue raising rates, especially as the war in Ukraine drives many commodity prices higher.

Brazil's economy will face challenges throughout 2022 related to uncertainties surrounding weather in agriculture, inflation, the Russia-Ukraine crisis, and COVID-19. Inflation's effects on real wages will dampen household consumption, and supply chain logistics are placing challenges on Brazil's growing exports industries in agriculture and oil/gas. Given Brazil's high debt-to-GDP ratio and already high target interest rate, low growth in 2022 will only be worsened by fiscal and monetary policy positions. How the central bank navigates this period of stagflation will drive the economic outlook in 2022.

Timothy Mahedy
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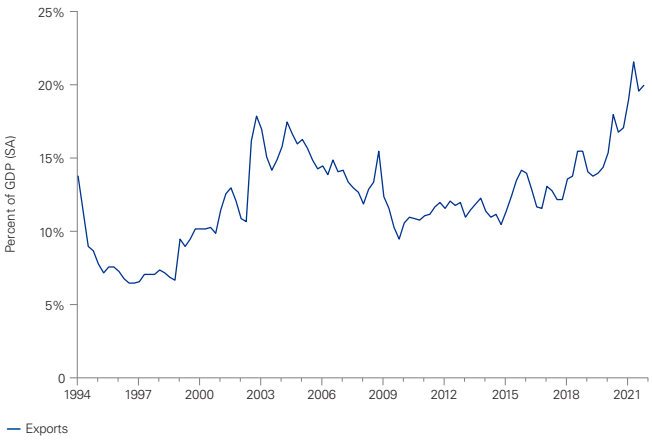
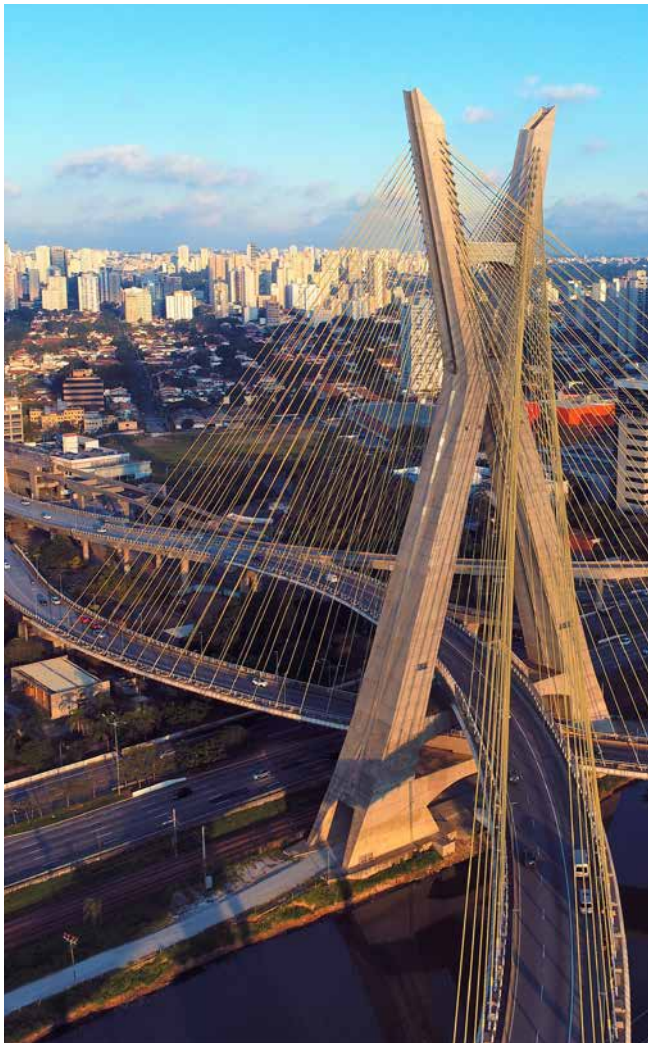
Chart 9: Exports climb as share of GDP



Source: KPMG Economics, Instituto Brasileiro de Geografia e Estatística/Haver. (December 2021).



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Mexico: Recovery dependent on external forces

The economy is rebounding due to a recovery in consumer spending and strong growth in the U.S., which is boosting Mexican exports. However, global headwinds will likely persist through much of 2022 and could threaten the recovery.

The auto sector has been particularly hard hit by global supply chain disruptions, which have been exacerbated by the war in Ukraine and rising COVID cases in China. Conditions are likely to worsen for production inputs such as aluminum, delaying a complete rebound in manufacturing.

The central bank is raising rates to combat inflation but faces headwinds from slow GDP growth and currency depreciation. Whether policymakers can thread the needle and curb inflationary pressures without causing an economic contraction is the key storyline of 2022.

The Mexican economy contracted for a second consecutive quarter at the end of 2021, with the growth in economic activity declining at a seasonally adjusted annual rate (SAAR) of 0.1%. The contractions were driven by a surge in infections from the Delta wave, and the erosion of real wages from persistently high inflation, both of which weighed on consumer spending. The war in Ukraine and a surge in infection rates in parts of China will likely exacerbate already stretched supply chains, fostering additional inflationary pressures. Policymakers will have to carefully thread the needle to ease these pressures without slowing economic momentum and tipping the economy back into a recession. Complicating the picture further, the peso could begin to depreciate if financial uncertainty in Eastern Europe causes a flight to quality in international financial markets. The impact of global events on the Mexican economy, and the central bank's ability to navigate the current high inflation, low growth environment will be key storylines in 2022.

The unemployment rate has dropped a full percentage point from January 2021 to January 2022 to 3.7%, near its pre-pandemic average of approximately 3.5%. The labor force participation rate also rose significantly to 58.3% from 56.2% at the same time last year, but still has some catching up to do to reach its 2019 level of 61.4%. After a steep increase in January, wages increased year-over-year from 427.45 MXN/day in February 2021 to 470.43 MXN/day in February 2022. The low unemployment rate and strong growth in wages suggest that consumption will rebound in 2022.

Table 4: KPMG forecasts for Mexico

	2021	2022	2023
GDP	4.8	2.3	2.5
Inflation	5.7	6.1	4.3
Unemployment rate	4.1	3.8	3.7

Source: Instituto Nacional de Estadística Geografía e Informatica, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate.

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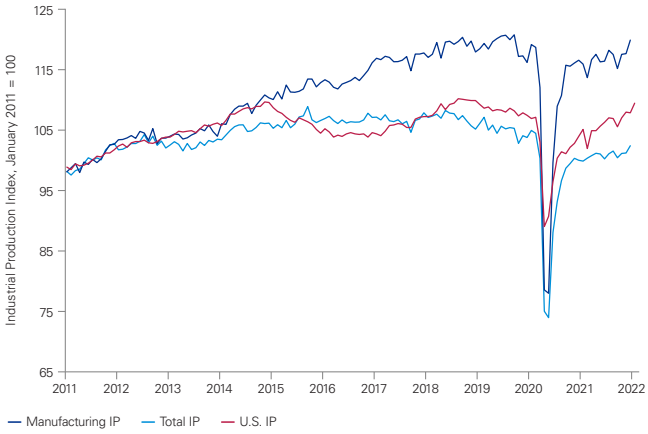
Global supply chain disruptions have weighed heavily on the Mexican economy. Goods and services exports make up around 40% of Mexico's GDP, and trade with the United States comprises about 80% of total exports. Specifically, a global shortage of semiconductors has caused Mexican automobile production to drop by 9.1% between January 2021 and January 2022, and vehicle exports have declined. While global supply chains in general will begin to recover in 2022, the semiconductor and metals shortages from ongoing supply chain problems, and the Russia-Ukraine conflict will likely lead to persistent challenges in the auto sector that will extend into 2023. The auto industry represents over 20% of manufacturing GDP in Mexico. Industrial production, especially in manufacturing, has largely returned to its pre-pandemic levels. Manufacturing industrial production in Mexico in general is on the recovery path and will hopefully offset some of the effects from the auto sector slump.

Mexico's export sector stands to benefit from the recent surge in global crude oil prices. The sector exports 1.3 million barrels a day, making it the 15th largest exporter in the world in 2020. Around 51% of that goes to the United States, which is likely to be less impacted than many other countries from the war in Ukraine, translating into continued solid demand for Mexican crude exports. However, the overall impact to the Mexican economy is more complicated. Mexico is a net importer of refined oil, and the government is subsidizing local gas prices, which will weigh on net exports and increase fiscal expenditure if global prices remain volatile. The public debt-to-GDP ratio increased from 53.3% in 2019 to 61% in 2020 and remained near 60% in 2021. Continuing to finance gasoline prices in this way will continue this upward trend and likely mean additional inflation, but the opportunity cost is much higher prices for consumers at the gas pump.

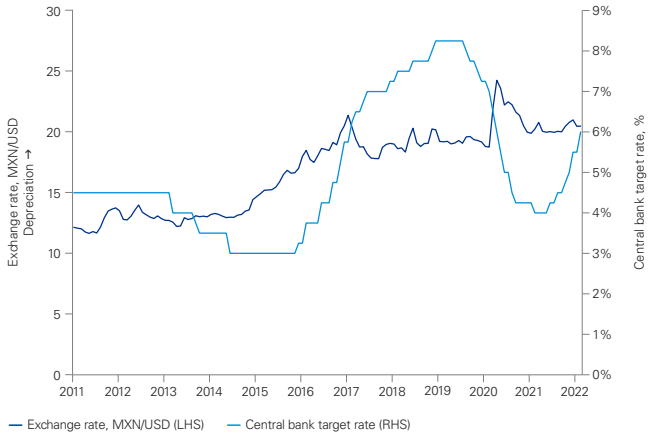
Inflation continues to gain pace, with year-on-year price growth reaching its fastest pace since January 2001. We expect the combination of continued global supply chain disruptions, a rebound in economic growth and some peso depreciation to keep inflationary pressures elevated in 2022. In response, the central bank will likely need to continue to raise rates, something it has already done six times in the last two years. The current rate of 6% is still below the 7.25% pre-pandemic rate, suggesting that the bank has some room to raise a bit further if conditions in the labor market continue to improve and demand from U.S. consumers remains elevated. Our forecast is that the Mexican economy will rebound modestly in first half of 2022, but the risks to the downside have increased recently and the economic outlook will largely be dependent on global events and the ability of the central bank to tame inflationary pressures.

Chart 10: Mexico manufacturing fully recovered



Source: KPMG Economics, Instituto Nacional de Estadística Geografía e Informática, Federal Reserve Board, Haver Analytics (January 2022).

Chart 11: Peso depreciation a risk despite expected interest rate increase



Source: KPMG Economics, Banco de Mexico, Haver Analytics (January 2022).

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ASEAN: Outlook buffeted by regional outbreaks and high commodity prices

ASEAN region rebounded at the end of 2021, but latest data suggests that China's Omicron wave and higher commodity prices are cooling momentum.

Inflation rates are rising but remain low by global standards. Export revenues for commodity producers have been boosted by higher commodity prices.

Currencies have been relatively stable this year, but rising interest rates globally could put some countries under pressure.

Daily case numbers from the Omicron wave have yet to peak in countries such as Malaysia, Singapore, Thailand and Vietnam. However, economies in the ASEAN region have started winding back restrictions and re-opening borders as part of their staged move towards COVID-19 as endemic phase.

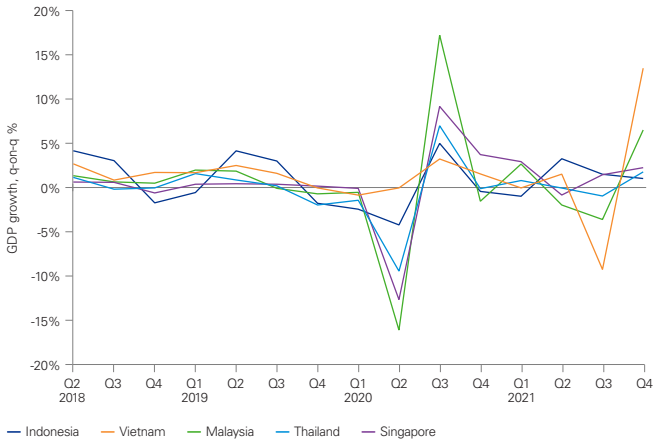
Economic activity among the ASEAN economies bounced back at the end of 2021, although the full impact of the Omicron wave will only be seen in Q1 2022. Quarterly GDP growth in Q4 2021 was positive for most of the economies in the region, after a contraction in the middle of the year. The result was particularly strong in Vietnam at 13.6% growth over the quarter, followed by growth of 6.6% in Malaysia.

Some headwinds to growth in the near term

However, the region is facing challenges in the near-term, particularly from higher commodity prices, the supply chain disruption created by the latest round of lockdowns in China, and rising global interest rates. Tighter monetary conditions globally will increase borrowing costs for many economies across the region. Furthermore, the shutdown of operations in China's major manufacturing regions (particularly Shenzhen) will put a drag on trade flows through the region, which will further dampen activity.

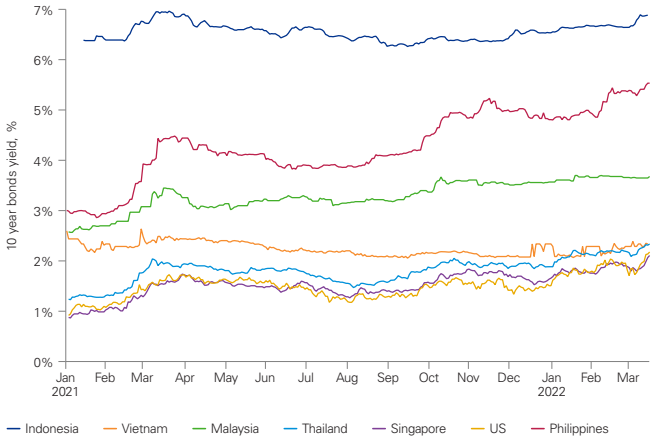
Indonesia is particularly vulnerable to negative shifts in market sentiment, with rising global interest rates making conditions more challenging for the central bank. The US Federal Reserve's rate hikes have in the past depreciated the local currency and devalued bonds; the central bank could be forced to raise rates to counter these market moves. Malaysia, Philippines and Thailand are also exposed to these spillovers, and they could be forced to raise domestic interest rates sooner than anticipated in response.

Chart 12: Quarterly GDP growth



Source: Macrobond, KPMG analysis.

Chart 13: 10 year bond yields, Asia



Source: Macrobond.

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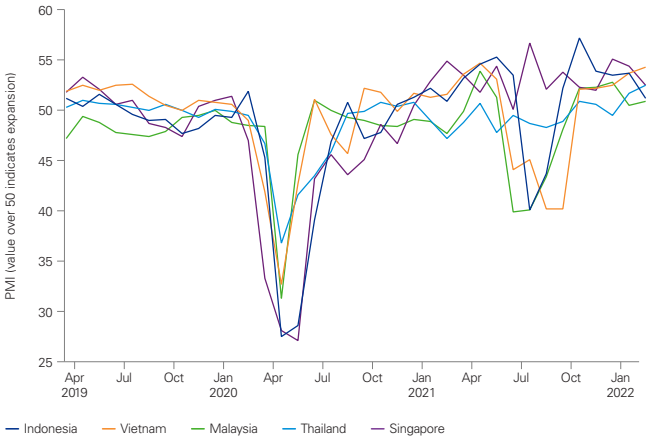
Inflationary pressures are rising

As elsewhere, inflation is picking up across the region. Energy and food prices have started to rise over the past few months and global supply chain issues persist. But unlike other parts of the world, momentum in prices is still relatively low – consumer price inflation in Indonesia, Malaysia, Thailand and Vietnam is currently sitting between 2% to 3%. Fiscal supports through the pandemic were generally smaller, resulting in a slower recovery in domestic demand and more muted local inflationary pressures. Singapore, where government support has been more significant, is an exception, with inflation currently at a high of 4%, not seen since 2013.

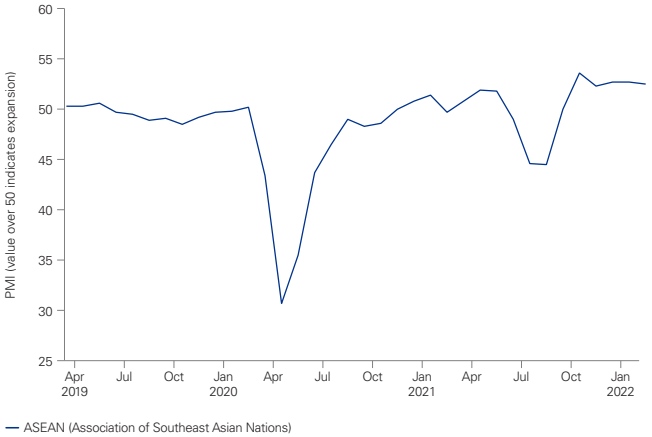
The recent rises in food and fuel prices will impact the region. A significant portion of wheat imports (to Indonesia and Philippines in particular) are sourced from Russia and Ukraine. Additionally, agriculture in the region is also heavily reliant on Russia and Belarus for potassic fertilizer. The adverse impacts of higher fuel prices are, however, partially offset in commodity-producing economies such as Indonesia and Malaysia through higher government revenues.

Chart 14: Purchasing Managers Index, Asia



Source: IHS Markit.

Chart 15: Purchasing Managers Index, ASEAN



Source: IHS Markit.

The Russian-Ukrainian conflict is also set to disrupt manufacturing supply chains, as a result of shortages in key inputs such as neon and semi-finished iron and steel, which are essential for the production of chips (neon) and cars, machinery and electronics (steel).

But manufacturing still holding up in most recent data

Notwithstanding the headwinds outlined above, the recovery from the disruption created by the Delta variant and the relatively limited impact of Omicron domestically is underpinning positive momentum across the region. The IHS Markit ASEAN PMI fell slightly in February but remains in positive territory, at 52.5. This decrease is underpinned by slight decreases in the PMI in Singapore, Malaysia and Indonesia in particular. Conversely, the IHS Markit Vietnam Manufacturing PMI charted an increase for the fifth straight month. Although manufacturers were upbeat about the outlook, sentiment was at a 6-month low due to cost pressures, supply issues and the Omicron variant – in the near-term, activity will be constrained by the disruption created by the current lockdowns in China.

Imports for consumption have risen by more than exports of commodities

Commodity-exporting countries such as Indonesia and Malaysia have benefitted from the recent rally in commodities prices, e.g. petroleum and crude palm oil, in the form of greater exports. Demand for exports have also increased as the ASEAN and advanced economies have re-opened. However, imports for consumption have grown much faster, causing the trade balance to deteriorate in several countries in the region.

Fiscal policy shifting focus to consolidation

Fiscal support packages introduced to ride out the impact of COVID-19 and imposed restrictions have not been extended. In fact, in some countries such as Indonesia and Singapore, attention has started to shift towards fiscal consolidation with the announcement of tax increases as initial signs of economic recovery emerge. This will slow growth momentum going through H2 2022 and 2023, as will the exhausting of the easy wins from re-opening, which will take the pace of growth in many countries back towards long-run trend rates.

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China: Stabilising growth amid strong headwinds

China has set its GDP growth target for 2022 at 'around 5.5%'. It is the lowest such target in many years but still an ambitious one considering the already large size of China's economy and strong headwinds the country faces, including the lingering COVID-19 pandemic, global supply shocks and an uncertain external environment.

Infrastructure and manufacturing investment, especially those contributing to China's innovation capabilities, digitalization, and green transformation, should see rapid growth in 2022.

Consumer price inflation is expected to remain under control, but rising commodity prices may put pressures on producer prices.

China's GDP totalled RMB114 trillion (USD17.7 trillion) in 2021, representing a significant increase of USD3 trillion from a year ago. The economy expanded by 8.1% in 2021 and averaged 5.1% for the past two years. China's GDP per capita reached USD12,551, which was higher than the global average and close to the threshold of high-income economies.

At the latest annual plenary session of the National People's Congress held in 5-11 March, the government set a GDP growth target at 'around 5.5%' for 2022. Although it was the lowest growth target set for China in several decades, it is still an ambitious goal considering the large size of the Chinese economy and strong growth headwinds, such as the lingering pandemic, global supply shocks and an uncertain external environment. Later this year, China will hold the 20th National Congress of the Communist Party of China, a major political event expected to bring changes to the country's senior leadership team. Recognizing the importance of maintaining a stable economic environment ahead of this major event, the government is expected to roll out more supportive measures to achieve the growth target.

Recent data showed a better-than-expected growth recovery in January-February 2022. Industrial production rose by 7.5% in the first two months, 3.2 percentage points higher than that in December. Supported by high-tech manufacturing and infrastructure investment, fixed asset investment grew by 12.2% in Jan-Feb 2022, compared to 2% in December 2021. We expect infrastructure and manufacturing investments, especially those contributing to China's innovation capabilities, digitalization, and green transformation, to see rapid growth in 2022.

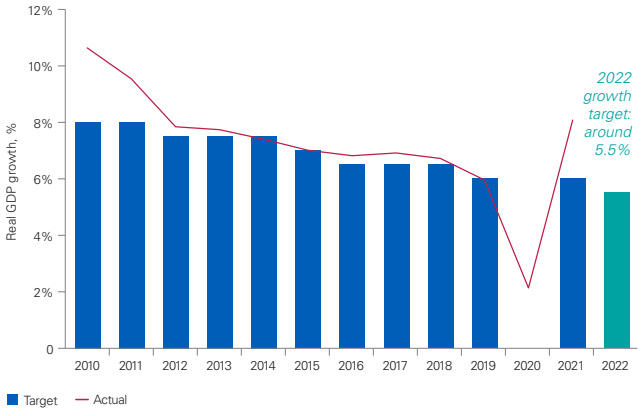
Table 5: KPMG forecasts for China

	2021	2022	2023
GDP	8.1	5.5	5.2
Inflation	0.9	2.3	2.3
Unemployment rate	5.1	5.1	5.1

Source: Wind, KPMG forecasts.

Average % change on previous calendar year except for the unemployment rate, which is the average annual rate. Inflation measure used is the CPI, and the unemployment measure is the surveyed unemployment rate.

Chart 16: The government has set 2022's GDP growth target at around 5.5%



Source: China's National Bureau of Statistics, Wind, KPMG analysis.

Note: No target was set for 2020 due to the COVID-19 pandemic.

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Meanwhile, the real estate market continues to face pressures. New property sales fell 9.6% and property starts dropped 12.2% from a year ago in Jan-Feb. The government has gradually eased regulations in some cities to stabilize the housing market, and China's Ministry of Finance also announced on 16 March that the much-watched pilot program on property tax will be postponed this year. However, the overall regulatory tone remains unchanged that 'housing is for living in, not for speculation'. The government also aims to expand long-term rentals and affordable housing to support a healthy real estate market.

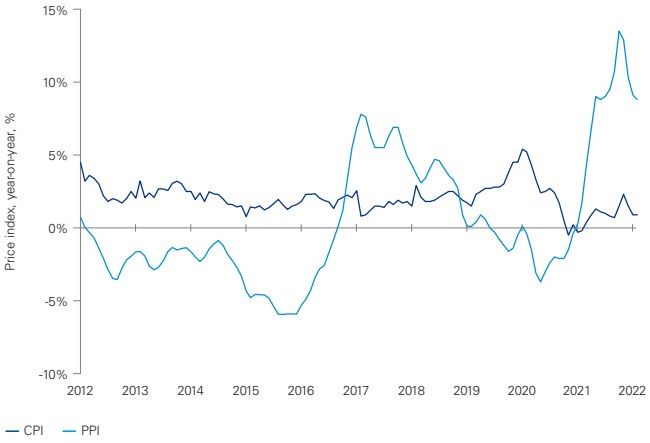
Consumption has been hit hard by the ongoing pandemic. The average growth rate of retail sales was only 4% for the past two years, which has lagged behind the recovery in industrial production and exports. Although the retail sector rebounded by 6.7% in Jan-Feb 2022, the recent surge of the highly transmissible Omicron variant may slow future recovery. Omicron has flared up in multiple regions across the country since March, leading many local governments to tighten mobility restrictions again. We expect China to maintain its 'dynamic zero-COVID policy' in the near future, which features a combination of targeted lockdowns, mass testing and rapid isolation.

Exports remained strong through 2021, growing by 30% for the full year of 2021. Robust external demand drove up industrial production and manufacturing investment, a main contributor to China's overall growth. Looking ahead, we expect China's exports to continue to do well but the growth rate will likely slow, as the comparison base is getting higher and demand recovery in advanced economies is shifting from goods towards services.

Against strong headwinds, the government is using both fiscal and monetary policy to stabilise growth:

- On the fiscal side, the government plans to increase its 2022 fiscal spending by RMB2 trillion to RMB26.7 trillion, representing an 8.4% year-over-year increase and much higher than the 0.3% increase seen last year. In addition, a quota of RMB 3.65 trillion for special local government bonds was approved, which should help support infrastructure investment. RMB2.5 trillion worth of tax cuts and refunds will also be rolled out.
- On the monetary side, the People's Bank of China (PBoC), China's central bank, has cut the required reserve ratio and reduced the loan prime rate (LPR). We expect more supportive measures to be released in the coming months.

Chart 17: Consumer inflation has remained muted



Source: China's National Bureau of Statistics, Wind, KPMG analysis.

Consumer price inflation (CPI) has remained muted, mainly due to the drop in food prices. Core CPI, which excludes energy and food prices, also slowed from 1.2% in January to 1.1% in February, reflecting the still weak consumption recovery. The Chinese government has set the CPI target at around 3% for 2022. We expect the CPI to rise by 2.3% in both 2022 and 2023. Meanwhile, producer price inflation (PPI) rose by 8.8% in February, down from 9.1% in January. Considering the recent surge in oil and gas prices caused by geopolitical unrest, we expect some upside pressure on PPI inflation in coming months.

Over 12 million new urban jobs were created last year and China aims to add another 11 million jobs this year. The surveyed unemployment rate came in at 5.5% in February, up from 5.3% in January and 5.1% in last December. With a record 10.76 million students expected to enter the workforce, the government is taking various measures to support the labor market. As such, we expect the unemployment rate to average 5.1% in both 2022 and 2023.

The Hong Kong (SAR) economy is expected to continue to recover in 2022, but the pandemic remains a key source of uncertainty. In response to the outbreak of the Omicron variant of COVID-19, the Hong Kong government reintroduced restrictions on travel and social activities. On 17 March, Hong Kong raised its interest rate by 25 basis points to 0.75%, after the U.S. Federal Reserve hiked its federal funds rate by an equivalent amount. Higher interest rates and the ongoing pandemic will likely put pressures on economic recovery in 2022. We expect the Hong Kong economy to grow by 3% in 2022, after expanding by 6.4% in 2021.

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Japan: Pandemic still disrupting activity, but recovery in sight

Easing COVID restrictions and falling case numbers are underpinning a pick-up in domestic demand.

Pace of inflation is rising but remains relatively low, majority of the lift is due to global commodity price rises.

Bank of Japan not expected to tighten policy, Yen has depreciated modestly following rate lift off in the US.

Japan's economy finished 2021 on a high note, with the economy expanding 1.1% on the quarter. Household spending led the way (+2.5% q/q), with low COVID cases enabling a rebound in spending. Exports also bounced back, by 0.9% q/q, underpinned by strong global demand for high tech manufactured products and an easing of supply chain disruptions due to Delta (particularly in Asia).

But momentum waned going into 2022, as cases of Omicron spread through the country and the authorities tightened restrictions. High frequency data suggests that household spending slipped back in January. The impact on activity levels is clear, with the services PMI dropping into contractionary territory in January and worsening in February, with respondents reporting that the spread of cases was the main cause.

Table 6: KPMG forecasts for Japan

	2021	2022	2023
GDP	1.7	2.8	1.8
Inflation	-0.2	1.0	0.4
Unemployment rate	2.8	2.6	2.5

Source: Cabinet Office of Japan, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate.

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Looking ahead, falling cases and easing restrictions (including some relaxation of the border closure rules) should underpin a rebound in spending in the near term. But as elsewhere, increasing fuel and food prices will dampen real incomes. Furthermore, Japan's norm for limited pay rises will reinforce the hit to living standards, with the annual Spring Negotiation of wages between unions and businesses projected to lead to broadly stagnant pay packets. Continued fiscal support will provide some offset for domestic demand, but overall momentum is expected to ease.

Industrial production and exports were also hampered at the start of the year by a combination of restrictions and supply chain disruptions across the region. February's manufacturing PMI recorded a further softening in momentum (although it remains in positive territory, at 52.7), and export volumes fell 1% y/y in January (partly due to the timing of Lunar new year celebrations in China and other export markets, but also a result of production cuts in the auto industry). Material shortages (a result of continued supply chain disruptions) and rising cases are the main drag, and the survey also highlighted that there are challenges on the horizon, with new orders stagnating; these trends will be exacerbated by the current lockdowns and factory closures in China. Overall, a combination of the end of easy wins from re-opening, pivoting spending (back towards services) in the global economy and higher commodity prices are all set to dampen growth momentum through 2022 and into 2023.

As in all other countries, the fallout from the conflict in Ukraine has complicated the outlook. Higher fuel prices are feeding through to the economy, which will underpin a sharp upturn in headline inflation. But limited increases in wages and local firms' reluctance to raise prices means we expect headline inflation to peak at a much lower rate, around 2% in mid-2022, than other economies.

Although inflation is likely to reach the Bank of Japan's target in the near term, we expect the monetary authorities to maintain their accommodative stance. Domestic inflationary pressures remain largely absent, a significant point of difference with other advanced economies. As a result, most of the current upward pressure on inflation will ease in the coming months, taking the pace of price rises back towards 0% in 2023.

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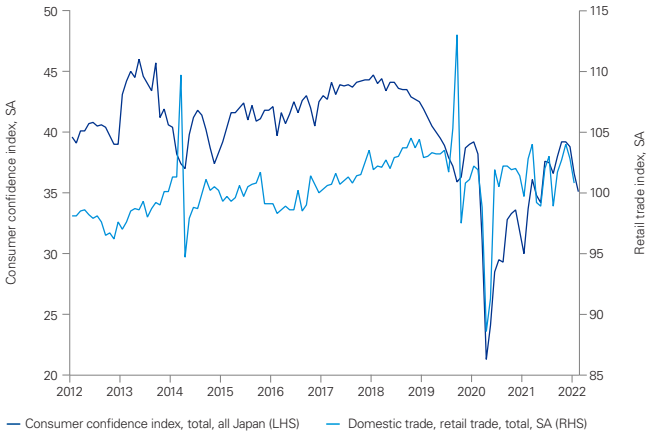
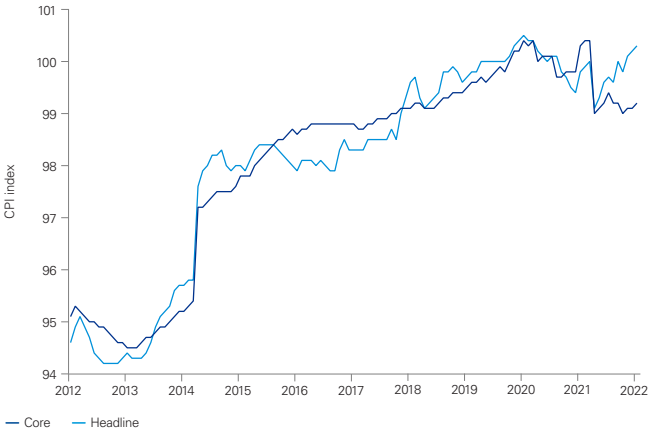
Chart 18: Retail trade and consumer confidence index



Source: Japan Ministry of Finance, Japan Cabinet Office.

Chart 19: Japan CPI index



Source: Statistics Bureau of Japan.

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India: Focus on infrastructure development to revive growth and create employment

India to remain among the fastest-growing economies in 2022.

Investments in infrastructure and manufacturing sectors to accelerate job creation.

Geopolitical tensions and shortage of raw materials major risks to growth.

On the back of rapid vaccination program roll-out and government support, India contained the impact of the COVID-19 third wave, while also pursuing the objective of economic recovery. Subsequent upticks across a range of indicators, including the mobility index, direct tax collections, and electricity demand, reflect positive levels of economic growth. India is expected to be among one of the fastest growing major economies, with the Reserve Bank of India (RBI) projecting GDP growth to be around 9.2% in FY22 and 7.8% in FY23[1].

Private consumption is still trailing behind pre-pandemic levels, factors such as the opening up of mobility, growing consumer confidence, and high-capacity industrial utilization, all point towards economic recovery. An increase in capital expenditure targets by the government and investments in the Infrastructure and manufacturing sector are expected to reduce the unemployment rate, which stood at a six-month high of 8.1% in February 2022[2].

However, retail inflation has been increasing steadily since September 2021 and stood at 6.07% in February 2022, owing to increasing oil prices, rising input costs and supply chain disruptions. Other issues such as semi-conductor chip shortage and high commodity prices also pose challenges to the growth of industrial sector. The Monetary Policy Committee (MPC) of the RBI has maintained an accommodative stance to pursue growth and keep inflation within the target. The central bank anticipates inflation rate to be around 4.5%[1] in 2023.

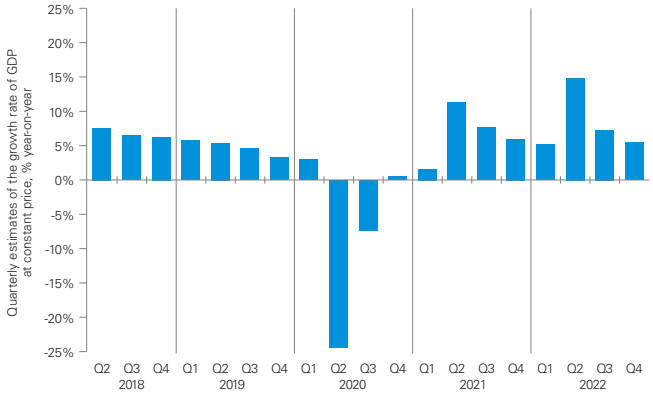
Table 7: KPMG forecasts for India

	2021	2022	2023
GDP	-7.3	9.2	7.7
Inflation	6.2	5.4	4.5
Unemployment rate	10.1	9.2	9.1

Source: Ministry of Statistics and Programme Implementation; CMIE, KPMG Analysis.

Note: Fiscal year is from April - March; for instance, 2021 spans from April 2020 to March 2021. Real GDP growth and Inflation rate for 2023 are advanced estimates by National Statistical Office (NSO)s and RBI staff estimates.

Chart 20: Quarterly estimates of GDP



Source: Survey of Professional Forecasters, RBI and National Statistical Office.

1 Governor's statement (February 2022), RBI, accessed on 21 March 2022
2 Unemployment in India, CMIE, accessed on 21 March 2022

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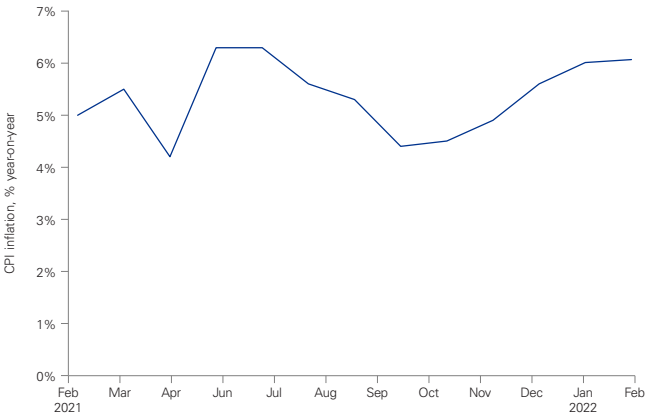
Chart 21: Consumer Price Index (past 12 months)



Source: Ministry of Statistics and Programme Implementation.
Note: Inflation rate for months Jan 2022 and Feb 2022 is provisional.

The predominant theme in the Union Budget of 2022-23 is its unprecedented focus on the creation and augmentation of physical and digital infrastructure. The budget also proposes the issuance of Sovereign Green Bonds to harness the untapped potential of the Indian green bond market along with other initiatives to help accelerate the adoption of green energy in the country. This unprecedented and intense focus on infrastructure serves objectives that are threefold:

- Modernizing and augmenting the country's stock of infrastructure assets in areas ranging from energy and transportation to urban and digital infrastructure
- Accelerating the pace of employment creation
- Reviving the economy to overcome pandemic-induced sluggishness

The GatiShakti National Masterplan for seamless multimodal connectivity continues to be the key focus area for augmenting transportation and logistics infrastructure. Government focus on driving Public Private Partnership (PPP) projects and extension of Production Linked Incentive (PLI) schemes to new sectors is expected to drive growth in domestic manufacturing and create more jobs. Initiatives such as reducing import duty and excise tax on fuel are some of the steps taken to reduce input costs and ease inflationary pressure on industry.

The Indian economy is expected to continue its positive growth trajectory, however, recent geopolitical developments are hurting domestic stock indices and creating volatility in crude oil prices and exchange rates. Given India's import dependence on crude oil, natural gas, and other commodities, a spike in inflation and in the current account deficit are aspects to be watched, particularly given the evolving geopolitical situation. Futhermore, uncertainty about the fourth wave and virus mutations pose a significant risk for future growth of the Indian economy.

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Australia: Economy moves decisively beyond the pandemic

Economy rebounding following easing of COVID restrictions, but recent floods in Queensland and NSW will temporarily reduce activity levels.

Domestic inflationary pressures are relatively low, projected to rise as wages growth picks up.

RBA expected to begin raising rates in August.

With vaccination rate targets achieved across states and lockdowns easing, GDP rebounded by 3.4% in Q4 2021. Household consumption led the way, but the impact of the Delta wave was seen in housing construction and machinery and equipment investment, which both underperformed. The Omicron wave put a further drag on momentum in early 2022, and the recent floods in Queensland and NSW have also disrupted activity. But we expect these factors to be temporary, with the impact of the floods set to be partly offset by reconstruction efforts. The current situation in Ukraine, rising inflation and the emergence of the Omicron BA.2 variant are significant downside risks to domestic demand. But commodity export income is being boosted by higher prices, overall underlying momentum remains positive. GDP is forecast to grow by 3.8% in 2022 and 2.2% in 2023.

The re-opening of the economy has revealed a number of tailwinds for growth:

- Eased restrictions, pent-up demand and a cushion of savings accumulated over the last two years are underpinning a rebound in household spending (and a pivot back towards services).
- Although COVID-related disruptions weighed on business investment in Q4 2021, the latest capex survey suggests firms remain optimistic. Spending in FY22 is set to grow by over 10% y/y.
- While the emergency pandemic supports are unwinding, government spending on infrastructure and maintenance projects is continuing, with activity rising by 0.9% in 2021, despite pandemic-induced disruptions.
- Residential construction activity is being underpinned by the HomeBuilder program. Supply chain disruptions and the floods in QLD and NSW are a near-term headwind, but activity will remain elevated as the pipeline of work is completed.

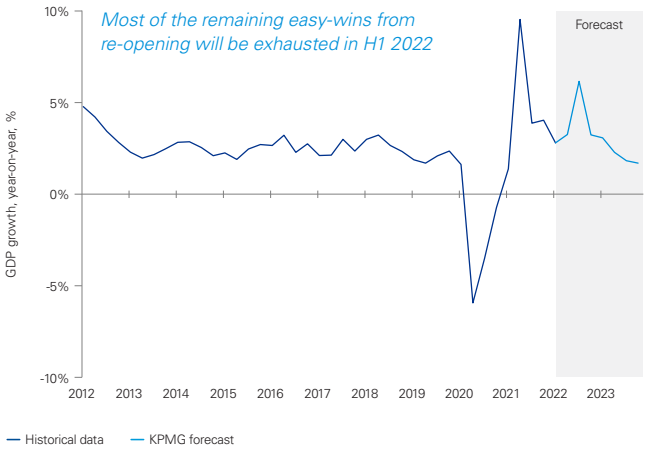
Table 8: KPMG forecasts for Australia

	2021	2022	2023
GDP	4.6	3.8	2.2
Inflation	2.9	3.7	1.9
Unemployment rate	5.1	4.1	3.9

Source: Australian Bureau of Statistics, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate.

Chart 22: Gross domestic product (GDP), 2019 prices; AU$ Bn



Source: Australian Bureau of Statistics, KPMG analysis.

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With all parts of the domestic economy currently firing on close to full throttle, demand for labor remains strong. Employment has now moved well beyond its pre-COVID level. With the participation rate at a record-high 66.2% and the number of job adverts still elevated, we expect the economy to approach full employment very soon. The anecdotal reports of shortages of skilled labor are confirmed in the data. The largest increase in job adverts in recent months has been seen in professional and financial services, construction and manufacturing.

These trends have also been reflected in wages growth with stronger growth in sectors with a concentration of highly skilled labor. Furthermore, businesses have often opted to reward their staff through discretionary bonuses, to avoid baking-in a permanently higher cost base.

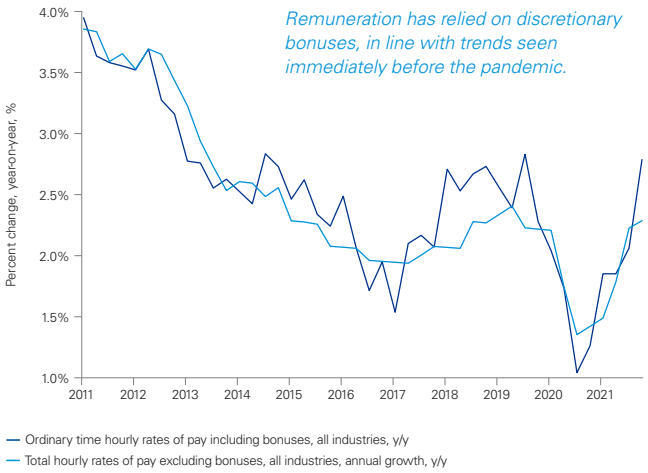
The conflict in Ukraine and Omicron outbreak in China are complicating the domestic outlook. Commodity prices have risen sharply, which is feeding through to inflation, with domestic petrol prices reaching record-highs in recent weeks. Price rises are also coming through in residential construction, imported products (which may rise further given the latest wave of production disruptions in China) and food; despite the strength in raw materials, the AUD has appreciated by a modest 1% since the start of the year.

Furthermore, moving through H2 2022 and into 2023, momentum will naturally cool as the easy wins from re-opening are exhausted, fiscal policy settings become less accommodating, the business capex cycle turns, and rising living costs weigh on consumer spending. The re-opening of the border will boost service exports and relieve some labor shortages, but it also enables overseas travel; overall the impact on GDP from re-opening is likely to be limited.

With the inflation and activity data continuing to beat the RBA's expectations, Governor Lowe has signalled that a first cash rate rise this year is now "plausible". Financial markets continue to expect the RBA to begin raising rates imminently. But the RBA are continuing to flag the uncertainty in the outlook and the response of businesses to higher costs, and their need to see a sustained step-up in momentum. We expect the Board to stand fast until August 2022, followed by steady rate rises to take the policy rate to 1% by mid-2023.

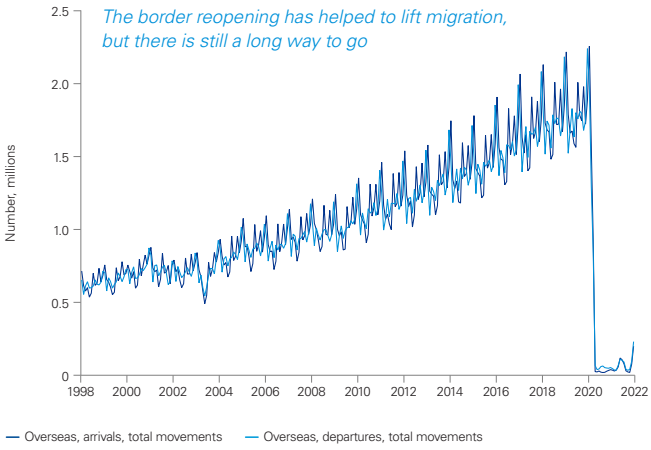
Dr Sarah Hunter
Senior Economist & Partner, KPMG in Australia

Chart 23: WPI growth, including and excluding bonuses



Source: KPMG Economics, Australian Bureau of Statistics, Macrobond.

Chart 24: Overseas departures and arrivals



Source: KPMG Economics, Australian Bureau of Statistics, Macrobond.

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Eurozone: Economic headwinds slow growth prospects

Economic recovery in the Eurozone continues to face supply side disruptions caused by COVID-19.

The Russia-Ukraine conflict will have a strong impact on trade, energy resources and prices, and cohesion within the Eurozone.

Inflation remains the main danger with changes to monetary policy less likely to come this year.

Even though the Omicron wave of COVID-19 had a more severe impact than many expected, most Eurozone member states did not implement as drastic measures as those implemented during the previous winter. Economic recovery continued in 2021 Q4, enabling the Eurozone to reach its pre-pandemic level. On the supply side, industrial production is still limited due to supply chain bottlenecks. These restrictions, however, are likely to diminish during the remainder of 2022, facilitating an expected further recovery among member states and their industries' supply chains. Additionally, congruent to the lifting of governmental restrictions in contact-intense sectors such as services, demand is also expected to shift in a positive direction. While pandemic-specific fiscal support will phase out over the course of 2022, supranational policies such as NextGenerationEU and its Recovery and Resilience Facility are promising to contribute to economic stimulus. Overall, the economy is expected to benefit from the gradual easing of pandemic driven restrictions and to pick up over the course of the year.

The economic outlook for the Eurozone in 2022 is mainly influenced by inflationary pressures. There are two developments that are responsible for the strong increase in prices across the monetary union: firstly, high energy prices, mainly driven by the conflict in Ukraine and a drop in imports of Russian resources. Secondly, an increase in food prices, given the global importance of both Ukraine and Russia as agricultural producers. In both cases, the overall price level in the Eurozone is affected both directly and indirectly through the intermediate goods channel.

Chart 25: Eurozone non-energy prices

Source: ECB.

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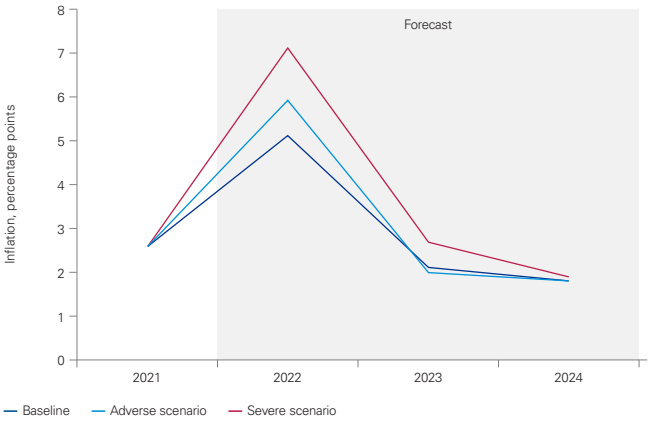
Apart from the positive developments regarding the pandemic, the conflict between Russia and Ukraine is casting a major shadow on any positive trend – in all respects. Russia is the EU's fifth largest trading partner, representing 4.8% of the EU's total trade in goods in 2020. The recent developments, both politically as well as economically, mark a drastic alteration in trade patterns for the Eurozone to its eastern neighbor. Apart from industrial goods, Europe's dependency on Russian fossil fuels, namely oil and gas, is even more problematic. In 2020, 26% of the EU's oil and 40% of the EU's gas originated in Russia. Even though the individual relationship between Eurozone members and Russia is highly heterogenous, the absence of Russian natural resources will have significant effects on energy prices across Europe. Set against this, the crisis has led to an increased cooperation between member states. By declaring a common response and emphasizing the values and morals of the EU, the European countries have shown strength and strong levels of cohesion.

Chart 26: ECB macroeconomic projections



Source: ECB Macroeconomic Projections March 2022.

Note: 'Adverse scenario' includes more severe restrictions on Russia and disruptions on supply chains; 'Severe scenario' implies an even stronger and long lasting effect on energy prices.

Taking into consideration the role of rising energy prices on inflation in Europe, the impact of the conflict between Ukraine and Russia on prices is likely to intensify the upward trend as observed since the summer of 2021. Significant increases in natural gas prices are likely to dampen economic activity through both the consumption channel and the intermediate goods channel. Furthermore, the ECB has communicated its willingness to tighten monetary policy conditions. In line with the actions that were taken by the U.S. Fed and the Bank of England since December 2021, the ECB has declared the end of several asset purchase programs such as the discontinuation of the pandemic emergency purchase programme (PEPP) in March 2022 as well as a gradual reduction of the asset purchase programme (APP). Taking into consideration the impact of the conflict on energy prices, the ECB expects key ECB interest rates to remain at their present levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon. Even though it emphasized its resolve to fulfill its mandate of price stability at an inflation rate of 2%, the central bank anticipates prices to increase by more than 5% in 2022. Quantifying the impact from high inflation on the economic recovery may be difficult at this stage.

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Germany: A new government with ambitious plans and several challenges

Fresh outlook from the new SPD-led coalition government.

Germany's dependency on Russian energy supply will be a dominating factor.

Optimistic market environment overshadowed by the rise of inflation and supply chain bottlenecks.

The economic outlook for Germany in 2022 is mainly influenced by its ongoing dependency on Russian fossil fuels. Even though the government is working on alternative sources, the new governing coalition in Berlin has rejected an overall import ban on Russian natural resources, since this would have a devastating impact on the German economy. Substituting Russian gas and oil will be a highly complex endeavor, which may take several years. In the absence of sufficient alternatives, both households and businesses will pay the price in the short and medium terms.

The new German government began its tenure in December 2021 and has faced a rough start from the beginning of its legislature. In line with the rest of the Eurozone, the German government implemented relatively soft measures in response to the COVID-19 Omicron wave during the winter and lifted most restrictions by the 20th of March 2022. Accordingly, economic activity is expected to improve over the coming months. Further, the new government's mix of green, liberal and social democratic policymaking highlights a new era in political leadership. Following 16 years of conservative decision making by Angela Merkel's CDU, the government of chancellor Olaf Scholz is promising to bring a new outlook to such topics as digitalization and sustainability which have according to a number of experts, been somewhat neglected in the past.

Together with other Western countries, the German government has implemented a broad spectrum of political, economic and financial sanctions against Russia. While trade between the two countries is relatively small (exports to Russia account for about 2.3% of German trade), the dependency on energy resources is highly significant: in 2020, 49% of natural gas in Germany was imported from Russia. While prestige projects such as Nord Stream 2 have been suspended, it is questionable how Germany can secure its energy needs without Russian imports. Compared to other Eurozone members, the German decision to retreat from the development or use of nuclear power that began in 2011 has led to an absence of viable alternatives.

Table 9: KPMG forecasts for Germany

	2021	2022	2023
GDP	2.9	2.2	2.9
Inflation	3.2	6.0	2.5
Unemployment rate	3.5	3.9	3.4

Source: Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP. Unemployment measure used is the ILO.

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While high energy prices have been the driving force of inflation in Germany over the second half of 2021, it is likely that this trend will be reinforced due to the Russian-Ukrainian conflict. As is the case of the Eurozone overall, the effect of steadily increasing prices on supply and consumption will dampen economic recovery in Germany over the remainder of 2022. Increasing gas prices do not only reduce the purchasing power of consumers but also lead to higher production costs across all industries.

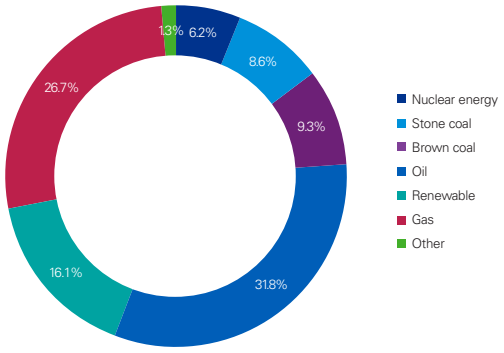
From a supply side, experts are expecting supply chain disruptions and other input bottlenecks to still be present over the course of 2022, with a recovery in 2023 – depending on the duration of the Russian-Ukrainian crisis. Accordingly, suppliers and producers are signaling less confidence regarding their ability to meet consumers' expectations in the near future. While private consumption fell in 2021 Q4, fewer restrictions and an increase in supply for services are likely to reinforce economic recovery from the demand side.

Similar signals were received from the German labor market: the unemployment rate in January 2022 was close to the historical low seen prior to the pandemic. Higher employment rates imply higher purchasing power, enabling a stronger economic recovery. Given these developments, Germany will hope to exceed its pre-pandemic level by Q2 or Q3 of 2022 – but again, caution is advised at this stage regarding the energy supply and prices.

In general, the overall economic outlook for Germany is characterized by a large number of uncertainties. Manufacturers and consumers are signaling confidence given their positive expectations regarding the end of the global pandemic however, the conflict between Russia and Ukraine is dimming the hope for economic recovery.

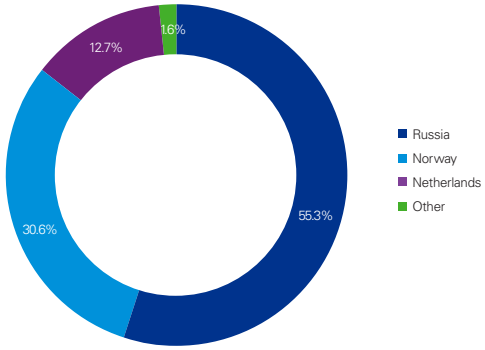
Dr Ventzislav Kartchev
Head of Business Intelligence/Markets, KPMG Germany

Chart 27: Primary energy consumption in Germany, 2020



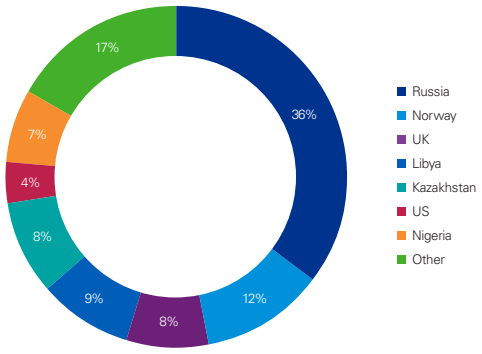
Source: AGEB.

Chart 28: German gas imports per pipeline, by origin, 2020



Source: BP/IHS Markit.

Chart 29: German oil imports by origin, 2020



Source: BAFA.

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France: Presidential election to shape the economic agenda in 2022

Presidential election in 2022 will shape the economic agenda.

Lower dependency on energy imports and relatively moderate inflation.

Strong, yet uneven, economic recovery.

While 2021 was characterized in France by a solid rebound of economic activity, the new government will face deteriorated public finances: public debt in 2021 was 114% of GDP. Rising inflation and the asymmetric effects of higher prices on social tensions could dominate political decision making and economic recovery in France as well.

Compared to countries such as Germany or Italy, France's main source of natural gas is not Russia but Norway, followed by the Netherlands. Even though France is less dependent on natural resources imported from Eastern Europe, the country is still affected by the overall increase in energy prices. In February, inflation in France came in at 4.2% compared to 5.9% for the Eurozone. French inflation is relatively moderate compared to other member states. Despite a relatively high-level autonomy in the energy sector, the French government announced last October a cap on gas and electricity prices until the end of 2022. A further package worth EUR2 billion to help consumers struggling with soaring fuel prices followed in March 2022. Given these preconditions as well as regulatory policies, the French economy is not expected to suffer under inflationary pressures as much as other Eurozone countries such as Germany.

Table 10: KPMG forecasts for France

	2021	2022	2023
GDP	7.0	3.0	1.5
Inflation	2.1	4.8	2.1
Unemployment rate	7.9	7.7	8.1

Source: Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

Despite the rebound of economic activity, with French GDP exceeding its pre-pandemic level quite significantly by the fourth quarter of 2021, the positive trend is not uniform across sectors. While the service industry was well above its 2019 level, manufacturing was suffering from supply chain bottlenecks.

The French labor market saw a strong recovery, with hiring difficulties reaching record levels. Strong domestic consumption and major improvements in terms of employment are the main drivers of economic recovery. The abolition of many restrictive measures due to the COVID-19 Omicron wave in the beginning of 2022 will certainly benefit consumption and demand.

A relatively moderate inflation rate is having comparably small effects on households' purchasing power and private consumption. On the supply side, producers are facing fewer burdens in terms of inputs, while supply chain bottlenecks are expected to ease further over the course of 2022.

The Russia-Ukraine conflict is posing a downward risk to growth over the next year. While energy dependency is not as crucial as it is in the case of other European countries, second round effects will feed into inflationary pressure to some degree.

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Italy: Slowing growth amid rising prices and uncertainty

Italian economy faces a slowdown in growth as it exits the recovery phase following the pandemic.

Rising energy prices could raise inflation and stifle consumer spending during 2022.

High dependence on gas for energy needs, coupled with political and fiscal risks leave longer term outlook uncertain.

Growth in the Italian economy slowed to 0.6% in the fourth quarter of 2021, leaving the level of GDP at 0.3% below the level in Q4 of 2019. As the economy continues to recover, GDP growth is expected to reach 3.7% in 2022, before slowing to 1.6% in 2023. Unemployment remains at relatively high levels and is expected to stay at 9.2% in both 2022 and 2023.

Latest surveys suggest a broad pattern of growth across both service and manufacturing sectors, with particular strength in the construction sector. The performance of the construction sector in Italy is partly being driven by the impact of the government's super-bonus scheme, which offers a significant rebate on the cost of domestic energy efficiency improvements. In addition, there are signs that the supply bottlenecks that stifled growth during 2021 are easing, although they remain at elevated levels.

The outlook for Italy's economy faces significant risks from the exposure to the economic impacts of the conflict in Ukraine. The Italian economy as a whole is particularly vulnerable to disruption in wholesale gas markets, with some 40% of total energy needs being met through natural gas, the highest share in the EU, and 24% of total energy supplied from Russia. Rising energy and commodity prices are expected to push inflation to 6.3% in 2022 and 2.7% in 2023. The Italian government has allocated EUR8bn to help the economy cope with higher costs of energy, aimed at shielding the most vulnerable households as well as financially exposed businesses and local authorities. Italy is also set to benefit from the largest share of the EU's Recovery Fund. Approximately EUR220bn will be used to support a modernization of the country's economy. Despite these measures, we expect households to face a significant squeeze during this year, with implications for lower consumer spending this year.

Table 11: KPMG forecasts for Italy

	2021	2022	2023
GDP	6.6	3.7	1.6
Inflation	2.0	6.3	2.7
Unemployment rate	9.5	9.2	9.2

Source: Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

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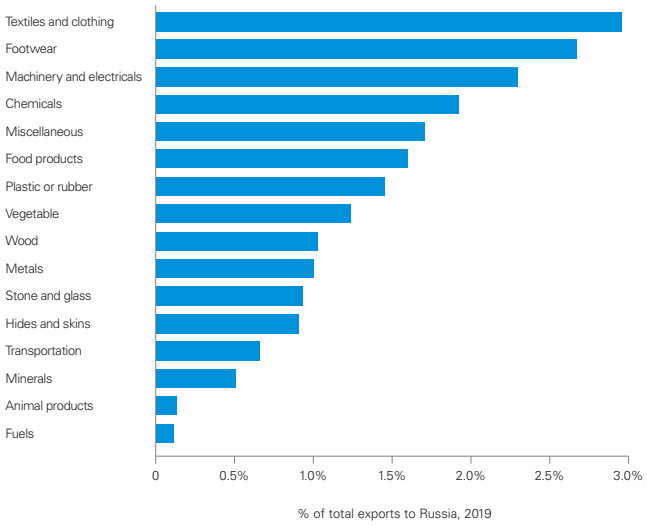
Among other sectors facing pressures, textiles and clothing, footwear, and machinery are likely to be the hardest hit by the fall in exports to Russia, which makes up 3%, 2.7% and 2.3% of exports in these goods categories respectively (Chart 30).

Political risks could re-emerge as a key driver of the outlook during 2023, as a general election is expected to be held before June 2023. Other risks arise from a still significant level of public sector debt, at around 150% of GDP, and potential tightening of monetary policy by the ECB, which could disproportionally raise the costs of borrowing in Italy.

Dennis Tatarkov
Senior Economist, KPMG in the UK

Chart 30: Share of Italy's exports to Russia



Source: World Bank WITS.

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The Netherlands: Recovery constrained by supply shortages

Recovery from COVID-19 continues, but shortages of labor and materials provide a headwind to production capacity.

Higher energy prices feed through to already elevated inflation, weighing on household disposable incomes and consumer confidence.

Expansionary fiscal policy set out by the new coalition government will provide a boost to growth over the forecast horizon.

The Dutch economy expanded by 5.0% in 2021, following a relatively mild contraction in 2020 by European standards. Growth was broad-based across all the major components (Chart 31). However, the recovery has been supported by only a limited bounce-back in consumption, which is yet to exceed its pre-pandemic level. That was largely caused by the introduction of strict lockdown measures in the first and the final quarters of 2021 to curb the spread of COVID-19. Despite the lifting of restrictions in February, consumer confidence has fallen to its lowest level since October 2020, with producer confidence also easing since the turn of the year, according to the CBS (Statistics Netherlands).

Table 12: KPMG forecasts for the Netherlands

	2021	2022	2023
GDP	5.0	3.2	1.3
Inflation	2.8	6.2	3.0
Unemployment rate	4.2	3.7	3.9

Source: Statistics Netherlands, Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

Chart 31: Outlook for the Dutch economy

Source: Statistics Netherlands, KPMG forecasts.

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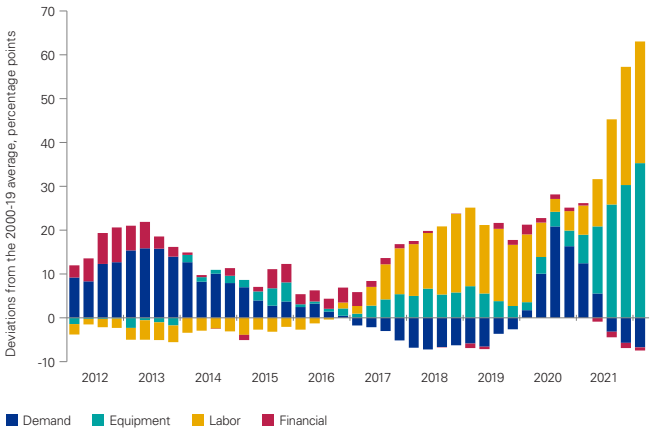
Supply constraints provide a key headwind to growth at present. Since the economy re-opened in 2021, businesses have been reporting increased capacity constraints. The pressure on global supply chains has led to supply bottlenecks for key materials, while a tight labor market has caused persistent staff shortages (Chart 32). The PMI data suggest some shortening of suppliers' delivery times in February, although the conflict in Ukraine will likely prolong the normalization of supply chains this year.

We have downgraded our growth forecast for 2022 to 3.2% and project growth of 1.3% in 2023. The key risks to the outlook stem from the situation in Ukraine, via higher energy prices, elevated uncertainty, and worsening pressures on the supply chains. Annual HICP inflation reached 7.3% even before the escalation of the conflict, driven by rising energy prices. Although Russia is not a major trading partner for the Netherlands, it is relatively important in terms of the supply of oil, and to a lesser extent of natural gas. According to Eurostat, imports from Russia constitute nearly half of gross available energy, compared to a quarter for the Eurozone. A disruption in energy supply could therefore have potentially serious implications for the country's production capacity.

Expansionary fiscal policy will provide a partial offset to slowing growth. The new coalition government was sworn in January after nearly 10 months of negotiations. In a move away from austerity, the government pledged a net increase in spending of EUR26.1 billion by 2025, with the bulk of measures dedicated to climate and environment, education and social security. Of the new Climate and Transition Fund and the Nitrogen Fund, together worth EUR60 billion, the majority of spending falls beyond the current government's term. As a result, the deficit is projected to remain above 3% of GDP after 2025, with debt exceeding 60% of GDP in 2030.

Chart 32: Factors limiting production in Dutch manufacturing



Source: European Commission business and consumer survey, KPMG analysis.

Michal Stelmach
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Spain: Eyes on the Eurozone core countries' evolution

Spain is not as dependent as other European countries on Russian gas but a reduction of activity in Germany and France will affect the Spanish economy.

The increase in energy prices and a deterioration of household income will also impact growth prospects.

Core inflation will still increase at a steady pace even if oil and gas shocks recede this year.

The COVID-19 pandemic has taken a high toll on the Spanish economy. While in 2019 GDP was still growing above EU and OECD average, in 2020 the economy contracted by 10.8%, much more than its peers. Despite this, the recovery in 2021 was slightly below the EU average, although in 2022, before the invasion of Ukraine, it was expected to gain momentum thanks to the full recovery of foreign tourism and to the growing impact of investments financed by the EU's Next Generation funds. The Spanish economy was expected to grow by 5.5%, but these expectations need to be modified considering the consequences of the war on the energy prices and disruption of trade and financial transactions with Russia.

Spain is not heavily dependent on Russian gas, as less than 10% of Spanish gas imports come from Russia, and it has enough infrastructure to handle all LNG imports by ship. But Spanish GDP and CPI are very sensitive to energy prices. Looking at the exchange of goods and services, trade between Spain and Russia is limited. Russia is the destination of 0.7% of Spanish exports and only 1.7% of the Spanish imports have Russian origin. Trade with Ukraine is even less significant. However, Spanish foreign trade is very dependent of the macroeconomic situation in the Eurozone. A sudden reduction of activity in Germany and France will be immediately reflected in the Spanish foreign accounts. This is especially true for the next two years, when the full recovery of the tourism industry is expected.

Table 13: KPMG forecasts for Spain

	2021	2022	2023
GDP	5.1	4.8	3.1
Inflation	3.0	6.8	3.2
Unemployment rate	14.8	13.8	13.2

Source: Eurostat, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the HICP.

In this context, and with all the uncertainties surrounding the current situation in Ukraine, we forecast GDP in 2022 to grow at 4.8%, mainly due to the expected increase in energy prices, the deterioration of real disposable income of households and the impact of the Ukrainian crisis in the core countries of the Eurozone. For 2023, GDP will grow at 3.1%, well above the Eurozone as Spain has still a gap to recover from the pandemic impact.

Energy prices could have a significant effect on inflation. CPI could rise by 6.8% in 2022 and 3.2% in 2023. Even if the oil and gas shocks recede throughout 2022, core inflation will still increase at a steady pace.

The unemployment rate, which in 2021 was at 14.8%, one of the highest in OECD countries, will continue to decrease but at a slower rate. We expect unemployment to be around 13.8% in 2022 and at 13.2% in 2023.

All these estimations are very sensitive to the duration and depth of the energy price shock, the ECB decisions on monetary policy, and the pace of restoration of the European Stability and Growth Pact.

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Head of Markets, KPMG in Spain

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United Kingdom: Feeling the squeeze

GDP growth is set to slow as consumers face a squeeze on disposable incomes.

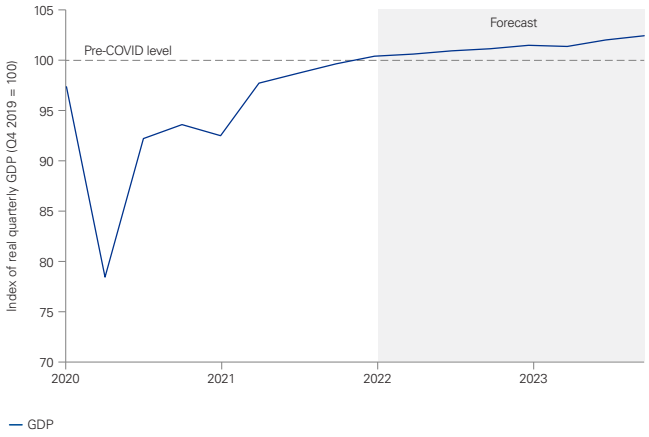
The conflict in Ukraine is expected to drive UK inflation both higher and more persistent.

A tight labor market underscores growing wage pressures and staff shortages.

After a brief contraction at the end of 2021, the UK economy has accelerated following the easing of restrictions from the Omicron wave early in 2022. However, we expect growth momentum to slow during the course of 2022, as the squeeze on consumer incomes, and the impact of higher energy and commodity prices caused by the conflict in Ukraine is felt in the UK. Overall growth for 2022 could reach 3.7%, before slowing to 1.0% in 2023.

Investment is expected to grow at a modest pace of 2.8% during 2022 and will be particularly impacted in 2023, which could see an overall contraction of 2.4%, as business investment falls following the winding down of the Government's super-deduction capital allowance. The net effect of the scheme, which incentivises firms to switch the timing of capital spending to take advantage of a 130% allowance on investments in certain plant and machinery, is expected boost investment in the run-up to the scheme's deadline, before a substantial drop from Q2 of 2023 onwards.

Chart 33: UK GDP growth expected to slow in 2022 and 2023



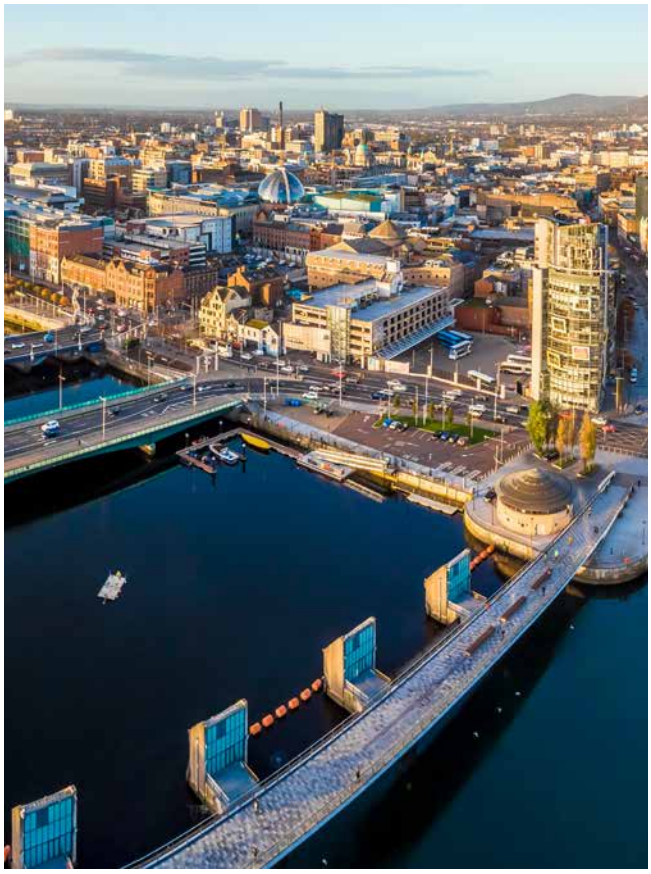
Source: ONS, KPMG analysis.

Table 14: KPMG forecasts for the UK

	2021	2022	2023
GDP	7.5	3.7	1.0
Inflation	2.6	7.9	4.1
Unemployment rate	4.5	3.9	4.3

Source: ONS, KPMG forecasts.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Inflation measure used is the CPI and the unemployment measure is LFS.



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Consumer spending is expected to be heavily affected by the squeeze on incomes, as household budgets come under unprecedented pressures from the rising costs of energy and an increasing tax burden. This will cause a marked slowdown in annual consumption growth, from 6.1% in 2021, to 5% in 2022 and 0.5% in 2023.

Lower-income households are particularly vulnerable to this year's rise in utility costs. Households at the bottom end of the income distribution potentially stand to lose more than 8% of their total disposable income during this year from the combined April and October 2022 energy price cap increases.

This also means that UK inflation is now expected to be both higher and more persistent due to the cost pressures arising from the conflict in Ukraine, as Chart 34 shows.

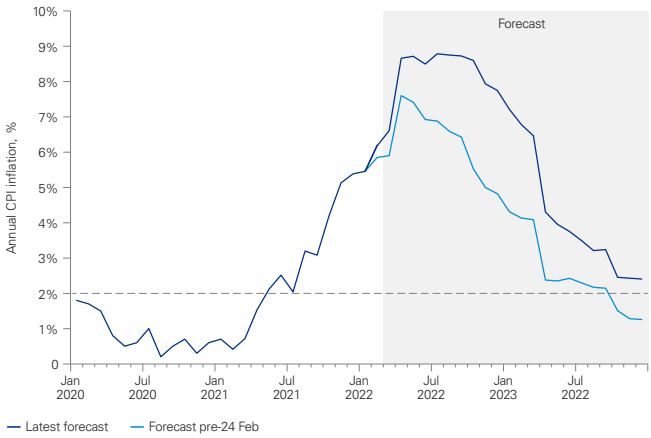
Energy prices remain the biggest single driver of rising inflationary pressures as the pre-announced increase of 54% in April to the energy price cap is now expected to be followed by another 30% increase in October 2022. Taken together, these increases could add more than 2 percentage points to inflation this year.

In addition, the conflict in Ukraine is expected to lead to rising food prices, both through higher fertilizer costs and higher wholesale food prices, as well as higher prices of some metals and other commodities. The combination of these pressures could push inflation to an average of 7.9% in 2022, before moderating to 4.1% on average in 2023.

With inflation remaining above the Bank of England's target of 2% throughout the next two years, we expect to see a gradual tightening of monetary policy over the course of 2022 and 2023.

This means that following three consecutive rate rises since the end of last year, we expect two more rate increases this year, although further increases are possible if inflation expectations increase significantly, followed by a modest tightening next year. The Bank of England can do little to combat high global energy and commodity prices, while their impact on inflation at the relevant policy horizon of 2-3 years' time is also likely to be limited. Instead, one of the key metrics for monetary policy is the pace of wage pressures, which are indicative of domestic demand imbalances that monetary policy can address. Our own view is that this pace of tightening is consistent with inflation returning towards the Bank of England's target level of 2% in the second half of 2024.

Chart 34: UK inflation is now expected to be higher and more persistent in 2022



Source: ONS, KPMG analysis.

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The UK labor market has continued to tighten. Despite the ending of the furlough scheme at the end of September 2021, the unemployment rate fell to 3.9% by early-2022, its lowest level since 2019. The demand for staff is currently very strong, with a record high vacancy rate reflecting the reopening of the economy, the fact that many foreign workers returned home during COVID-19, and potential skill shortages that have made it harder to match workers with jobs. Our forecast is for unemployment to remain very low in the coming months, as workers take advantage of the opportunities available, averaging 3.9% this year and 4.3% in 2023.

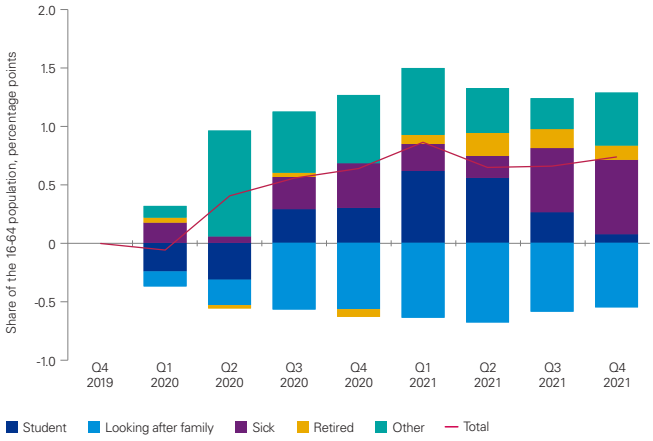
One of the consequences of a tight labor market is the ongoing pressure on wages. Pay growth tends to move in tandem with the intensity with which employees switch jobs, as job switchers tend to experience higher rates of pay growth than those that stay (Chart 35). Job-to-job flows rose to their highest level on record in Q4 2021, a phenomenon dubbed the "Great Resignation". In addition, the tight labor market will require employers to make greater efforts to retain staff. Given the current elevated level of inflation we expect pay pressures to intensify as employees make additional requests of their employers, knowing that available labor is scarce.

Chart 35: Labor market churn and pay growth

Source: ONS, Bank of England, KPMG analysis.

Note: Pay growth shows the Bank of England's estimate that excludes the volatile compositional and furlough effects over 2020-21, and ONS series otherwise. Latest data point is for three months to January 2022.

Chart 36: Changes in inactivity rate since 2019 Q4 by reason



Source: ONS, KPMG analysis.

We are also starting to see the limits to which vacancies can be filled by those re-entering the labor market. The inactivity rate – the share of the population not in work or actively looking for work – has risen since the end of 2019. While many workers stayed economically inactive to study during COVID-19, this trend has now reversed back to pre-pandemic levels, with higher inactivity largely explained by people staying out of the labor market due to sickness (Chart 36). In addition, the proportion of those who are not seeking employment but would still like to have a job is at its lowest level on record, having fallen particularly sharply for women. This suggests that the outlook for economic growth may need to rely more heavily on productivity gains rather than rises in employment.

The public finances have surprised to the upside this year, with borrowing in 2021-22 estimated at around £30 billion lower than at the time of the Autumn Budget and Spending Review in October 2021. This was largely driven by better than expected developments in economic growth and the labor market, which provided a boost to income tax, corporation tax, and VAT receipts. However, this was partly offset by higher debt servicing costs, which are estimated to have pushed interest spending by £13 billion relative to the previous forecast. Taking advantage of the windfall, the Government set out a package of support measures worth £11 billion to help households with rising energy bills, and raised the National Insurance contributions thresholds costing over £6 billion this year. However, a more persistent inflationary outlook and rising interest rates will continue to put pressure on the public finances over the forecast horizon.

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Middle East: High international energy prices will boost GCC economic growth

High international oil and gas prices will bolster Gulf Cooperation Council (GCC) economies, enabling the bloc to continue to lead the regional economic recovery.

Unemployment rates will continue to decline, with the heavy use of foreign workers providing labor market flexibility.

Upward price pressures in the GCC will remain restrained, but other countries in the region are likely to face difficulties preventing an upturn in domestic inflation.

GCC

The economies of the Gulf Cooperation Council (GCC), whose membership is comprised of Saudi Arabia, the United Arab Emirates (UAE), Kuwait, Bahrain, Oman and Qatar, have been experiencing an upturn since the second quarter of 2021, owing in part to a healthy recovery in international oil and gas prices during the same period. A further fillip has been provided by a spike in international energy prices since the escalation in the conflict between Russia and Ukraine.

Although international energy prices are unlikely to remain at current levels, given that the spike in part reflects uncertainty over oil and gas supplies owing to the war in Ukraine, they are likely to remain elevated in 2022. The positive impulse provided by the GCC's oil and gas sector – through both increased production and prices – will further support the ongoing economic recovery during the remainder of 2022 and into 2023.

Private sector confidence and activity, already supported by the easing of COVID-19-related restrictions, will further benefit from the high international energy prices as they strengthen GCC fiscal and balance of payments accounts – improvements in these indicators signal that GCC governments are better-equipped to offset any potential negative economic shocks. On balance, current trends in the domestic and international economies will support robust economic growth in both the GCC's oil and non-oil economies, with the pick-up in economic activity reducing unemployment rates.

Annual average inflation is expected to remain contained during 2022 and 2023. While COVID-19-related supply chain disruptions will remain a source of upward price pressures globally, both through production and transportation channels, inflation risks in the GCC will be cushioned by several factors. First, GCC governments have thus far been successful with their supply chain management strategies. Second, the substantial use of foreign labor in the bloc helps to limit the potential for inflationary pressures that could arise from their economic recoveries narrowing the output gap. Third, the exchange rate peg against the US dollar, used by most members of the bloc, will help to contain import inflation, given the expected stability of the US dollar. Finally, the boost to GCC fiscal positions stemming from high international energy prices, in turn, provides GCC governments with the fiscal resources and thus ability to offset the impact of high international commodity prices on domestic inflation, for example, through price caps.

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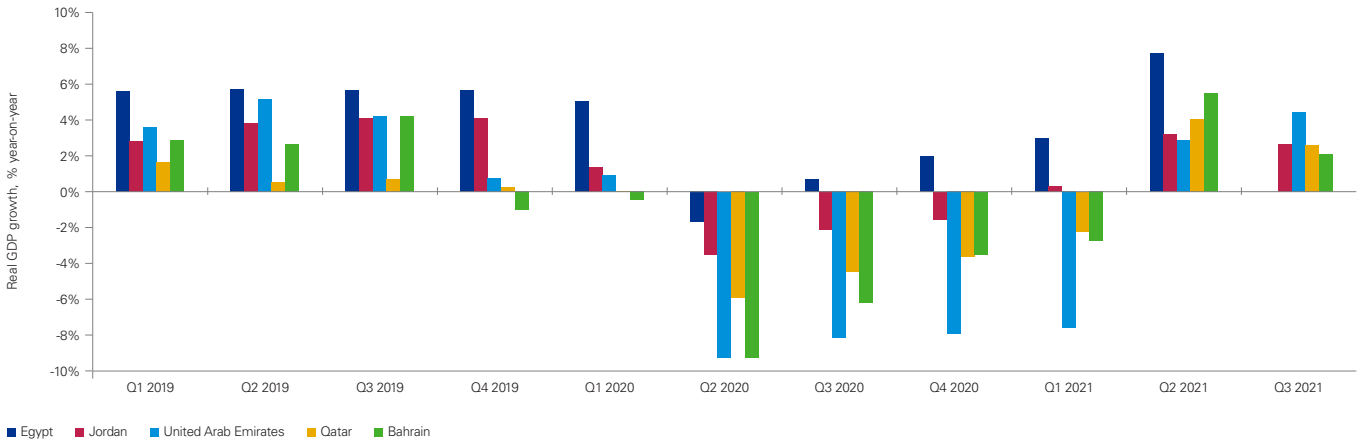
Chart 37: Both GCC and non-GCC economies saw a pick-up in activity during much of 2021 (selected countries)



Source: Haver, National statistical agencies.

Non-GCC

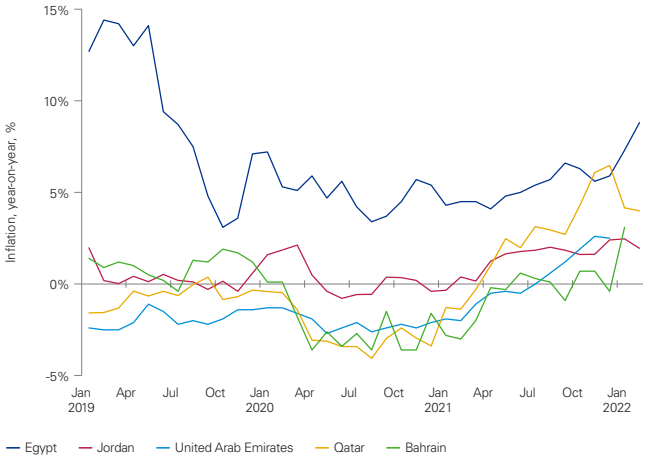
Non-GCC economies in the Middle East region are diverse in terms of their economic growth potential, but collectively many of these economies suffer from weak fiscal and balance of payments positions, volatile and weak economic growth rates, a low resilience to shocks and different degrees of political and/or social instability.

Base effects have flattered the economic performance of this group since around mid-2021 – many of these countries experienced significant economic contractions during the implementation of pandemic-related containment measures and, conversely, respectable headline growth rates have been recorded since their domestic economies and those of their main trading partners started to reopen, with the latter supporting external demand.

Our baseline assumption is that further lockdown measures in both this group and its trading partners will be limited. However, the positive impact of the aforementioned base effects will filter out in 2022. The economic disruption caused by COVID-19 containment measures resulted in a deterioration of already weak fiscal positions, further undermining the ability of non-GCC governments to boost their domestic economies and provide social support.

High international oil prices have placed further pressure on the fiscal and current accounts of non-GCC countries in the region. Elevated international commodity prices and exchange rate weakness are likely to continue to add to import inflation pressures. Import inflation is expected, in turn, to feed into domestic prices, undermining the purchasing power of households and confidence more generally. Governments will continue to lack the fiscal resources needed to offset the impact of negative shocks.

Chart 38: Upward price pressures in the region have largely remained muted in recent years, but are likely to build in non-GCC economies (selected countries)



Source: Haver, National statistical agencies.

Overall, real GDP growth rates are likely to be constrained in non-GCC countries during 2022 and 2023, limiting a strengthening of local labor markets. At the same time, high global commodity prices are expected to continue feeding through into domestic inflation, adding to economic volatility and uncertainty across the group.

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Saudi Arabia: Real GDP growth will accelerate sharply in 2022

A sharp rise in oil production and an ongoing recovery in the non-oil economy will support rapid real GDP growth in 2022-23.

The unemployment rate will continue to ease downwards even as the labor participation rate continues to rise.

Headline inflationary pressures will remain muted owing to a combination of base effects, policy measures and the stability of the local currency in international currency markets.

Real GDP growth and Unemployment

Real GDP in Saudi Arabia is estimated to have grown by 3.3% in 2021, following a contraction of 4.1% in 2020. According to GASTAT, there was a broad-based recovery in non-oil output, with most components of non-oil GDP showing a pick-up in activity. However, the headline growth figure was curtailed by weakness in the oil sector – this component grew by just 0.2%, largely owing to oil production being restricted under OPEC+ agreements.

In 2022, growth in the non-oil sector is expected to be driven both by the private sector and government initiatives and investments related to Vision 2030. The private sector will continue to experience a broad-based recovery, with key components that include manufacturing, wholesale and retail trade, hospitality and transport and storage being supported by an ongoing pick-up in both domestic and external demand. In particular, a continued easing of COVID-19 restrictions will bolster the retail- and tourism-related sectors during the year.

A continued easing of OPEC+ related oil supply limits and high international oil prices will be key to boosting Saudi Arabia's economic outlook in 2022. A reversal of OPEC+ oil cuts will support a double-digit expansion in Saudi Arabia's real oil economy. This expansion in oil production will drive volume growth even as high oil prices[1] will be felt through a variety of channels.

The dominant role that oil plays in export earnings and government revenues will support the balance of payments and public balance sheet positions respectively (the latter in turn providing the government with financing for its Vision 2030 initiatives that include infrastructure investment).

Table 15: KPMG forecasts for Saudi Arabia

	2021	2022	2023
GDP	3.3	6.7	3.9
Inflation	3.1	2.7	1.7
Unemployment rate	6.6	6.3	6.0

Source: GASTAT, KPMG forecasts.

Note: Average % change on previous year except for the unemployment rate, which is the annual rate taken from the Labor Force Survey and represents the rate for the total resident labor force. GDP represents real GDP growth at constant prices.

The importance of the oil economy and government spending will also bolster the private sector through both the consumer and business confidence routes. Trends in 2022 are expected to continue into 2023, although real GDP growth will slow to 3.9% as base effects limit the year-on-year expansion.

The current conflict between Russia and Ukraine is likely to provide upside risks for Saudi Arabia. Indeed, the Kingdom has been under pressure from major oil-using countries to increase oil production by more than is agreed under its current OPEC+ commitments, reflecting their concerns over the impact of the spike in international oil prices on inflation and domestic demand.

Current oil market trends provide Saudi Arabia, which maintains excess capacity (in contrast to many other countries in the oil bloc), with the potential to benefit significantly from current and future high oil prices (although we note that linkages between high energy prices, inflationary pressures and policy interest rates bring risks of recessionary conditions emerging in the country's main oil markets, which would ultimately reduce oil demand).

1 According to the Economist Intelligence Unit, the price of the OPEC reference basket is expected to average USD109.4 per barrel (pb) in 2022 and USD89.6 pb in 2023, compared with an annual average of USD66.3 pb in 2021

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The reversal of COVID-19-related restrictions and a subsequent pick-up in economic activity, that began in late 2020, has seen the total unemployment rate (defined as Saudi nationals plus foreign workers) fall from a recent high of 8.5% in the third quarter of 2020 to 6.6% in the third quarter of 2021 (latest available figure). The decline in the unemployment rate occurred even as the participation rate moved higher, indicating an underlying strength in the labor market.

The total unemployment rate is expected to continue to trend downwards, averaging 6.3% in 2022 and 6% in 2023, compared with an estimated average of 6.6% in 2021. Despite expectations for a robust economic performance over the next two years, the rapid rehiring process that has already occurred as the domestic economy reopened, will limit the headline improvement in the unemployment rate.

As COVID-19 restrictions remain in place for foreign entrants into Saudi Arabia, a potential skills mismatch in isolated pockets is possible over the next two years. Vaccination rates in countries where a significant part of foreign labor originates, such as India, could hamper the supply of needed labor Demand for construction workers who are largely sourced from South Asia, for example, is set to rise, even as such workers may continue to face COVID-19-related barriers to entry.

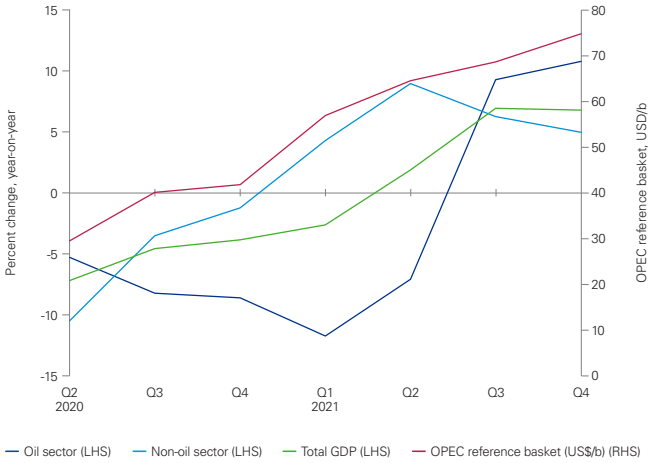
Inflation

Annual average inflation is expected to rise by 2.7% and 1.7% in 2022 and 2023 respectively. Saudi Arabia's inflationary path has diverged vis-à-vis its peers since 2020, largely in line with an increase in the value-added tax rate that the government implemented in mid-2020 – this policy created base effects that are still filtering through the economy.

Government measures such as price caps on fuel will also limit the impact of high international energy prices, a policy that is provided with fiscal sustainability as Saudi Arabia continues to benefit from these same energy price spikes. Moreover, although there are likely to be supply and demand imbalances in parts of the labor market (reflecting the aforementioned COVID-19 restrictions in relation to foreign labor entry), the domestic labor market is likely to respond effectively to the continued pick-up in the domestic economy.

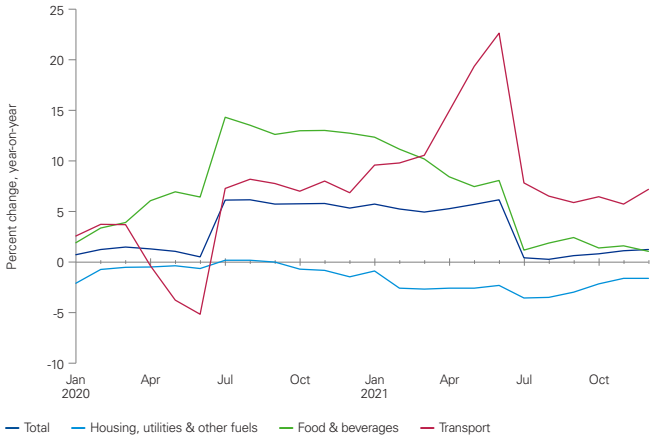
Owing to ongoing COVID-19-related supply chain disruptions, risks of upward price pressures remain. However we note that imported inflationary pressures have remained muted. This in part reflects the fact that domestic prices in Saudi Arabia's main supplying countries have not spiked significantly thus far. Import inflation will also be contained by expectations that the US dollar, to which the Saudi currency is pegged, will remain stable through 2022.

Chart 39: As an oil price-maker, oil output falls in KSA can reduce GDP despite rising hydrocarbon prices



Source: GASTAT.

Chart 40: Year-on-year inflation increases can be skewed by government measures and the dominance of oil in the domestic economy



Source: GASTAT.

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South Africa: Commodities help deal with global headwinds

Economic growth on a path back to pre-pandemic levels.

Inflation to increase to near upper bound of South Africa's inflation target range.

Commodity prices help counteract impact of rising inflation and slowing growth.

Real GDP growth and unemployment

South Africa continues its recovery from the economic contraction experienced due to the COVID-19 pandemic in 2020 and is set to reach pre-COVID-19 levels of real production over the course of 2022. However, as is true for the rest of the world, South Africa is facing increasing inflationary pressures due to global supply chain disruptions brought about by the COVID-19 pandemic and exacerbated by the Russian invasion of Ukraine.

The initial concern with respect to rising global inflation was that central banks would need to raise interest rates sooner and by larger increments than previously expected, thereby stifling economic growth. With the onset of the Russian conflict in Ukraine, expectations of commodity price inflation, and energy and food price inflation in particular, have increased along with the level of uncertainty surrounding the duration and economic reach of the conflict on the global and local economy. What is clear is that economic growth will be negatively impacted as a consequence.

South Africa is in a unique position where many of its natural resource exports, other than oil and gas, mirror those of Russia[1] and consequently, it has profited from the rise in commodity prices caused initially by COVID-19 supply disruptions and latterly as a consequence of the conflict in Ukraine. The result of the increase in commodity prices has been an improvement in South Africa's terms of trade (export prices over import prices) and has led to relatively large surpluses on its current account in 2020 and 2021. Besides the direct benefits thereof on its balance of payments account, this surplus has also underpinned a relatively resilient local currency and will also contribute to GDP growth in 2022.

GDP is set to grow by 2% in 2022 led by contributions from the finance, real estate and business services sector, and growth in personal services as well as mining, agriculture and trade, catering and accommodation.

Table 16: KPMG forecasts for South Africa

	2021	2022	2023
GDP	4.9	2.0	1.8
Inflation	4.5	5.6	4.4
Unemployment rate	34.3	34.7	35.5

Source: Statistics South Africa, KPMG analysis.

The projected growth in 2022 is noticeably lower than that achieved in 2021. It should however be understood that much of the growth in 2021 was due to technical base effects following the sharp COVID-19 induced contraction experienced in 2020.

The growth forecast for 2022 would have been marginally lower were it not for the reversing of the negative impacts of the civil unrest experienced in two provinces in July 2021, as well as the continued inclusion of a positive trade contribution from the mining sector on the back of elevated commodity prices.

Growth in 2023 is estimated to decline further to 1.8% and converge back to the average pre-COVID-19 level of 1.7% since 2010. The reason for the expected return to lower growth rates is that little tangible policy action has been taken to increase the lower investment and consumption spending caused by a reaction to a number of governance challenges including ongoing policy uncertainty, corruption, aging infrastructure and continued power shortages, the absence of growth stimulating policy interventions and inadequate levels of service delivery.

The expected rate of economic growth and the increased contribution to it made by the mining sector in 2022 would not be sufficient to reduce the high unemployment rate of 34.3% currently experienced in the country, as increasing costs and interest rates are expected to result in reduced levels of expenditure for both businesses and consumers.

1 These include palladium and other platinum group metals, gold, iron ore, coal as well as many other industrial metals.

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Inflation

Inflationary pressures for 2022 are set to increase and remain cost push in nature as aggregate demand still lags below its potential level. The main drivers of forecast consumer inflation are increasing energy prices, including both fuel and electricity prices, as well as food prices caused by ongoing supply chain disruptions following the COVID-19 pandemic and exacerbated by the Russian conflict in Ukraine.

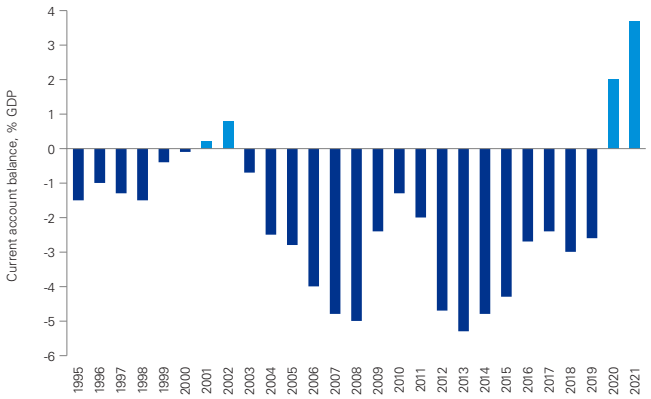
The global increase in commodity prices, including oil, has meant South Africa is facing rising imported fuel and food production costs. Energy supply, and in particular electricity, remain an ongoing concern for South Africa whose energy regulator awarded the state-owned utility an additional 9.61% increase in energy prices from 1 April 2022.

The positive balance on the current account resulting from the increased value of commodity exports, although being supportive of the rand, is not large enough to shield South Africa from these inflationary increases.

As a consequence, the headline consumer inflation rate is expected to increase towards the upper boundary of the central bank's inflation targeting range of 3% to 6% in 2022 before moving back towards the midpoint of the targeting range in 2023.

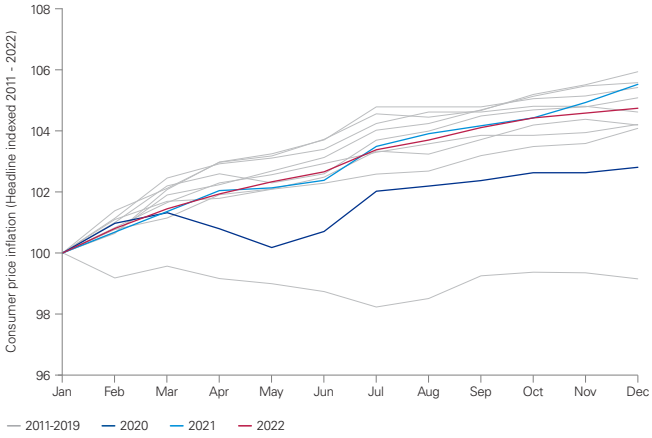
Frank Blackmore
Lead Economist, KPMG in South Africa

Chart 41: Current account balance



Source: Statistics South Africa, South African Reserve Bank, KPMG analysis.

Chart 42: Consumer price inflation



Source: Statistics South Africa, KPMG analysis.

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Nigeria: Modest economic growth trajectory amid heightened inflation

Nigeria's economic recovery is expected to remain moderate but increasingly broad-based.

High unemployment and underemployment rates are expected to persist into 2022.

Inflation will likely remain heightened on the back of higher energy and commodity prices, hikes in electricity tariffs and electoral spending.

Nigeria's economy achieved a stronger recovery than expected in 2021. Following a slower growth of 0.51% in the first quarter of 2021, the second and third quarters of 2021 saw much-improved growth in real GDP, growing by 5.01% and 4.03% respectively. Sustaining this positive trend, real GDP rose by 3.98% in the fourth quarter of 2021, resulting in an annual GDP growth rate of 3.4%.

The recovery was driven by stronger growth in the non-oil sector, supported by a rebound in the services sector and continued growth in agriculture while the oil sector contracted. In real terms, the non-oil sector contributed 92.7% to the nation's GDP growth in 2021, higher than the 91.7% share recorded in 2020.

Meanwhile, the real decline of the oil sector was -8.3% (year-on-year) in 2021 indicating an increase by 50 basis points relative to the decline rate recorded in 2020. Nigeria recorded an average daily oil production of 1.6 million barrels per day (mbpd) in 2021, lower than the daily average production of 1.8 mbpd recorded in 2020 by 0.2 mbpd. The oil sector contraction has been caused by low oil production due to OPEC+ restrictions as well as technical and operational issues that caused disruptions at key oil export terminals such as the Bonny, Forcados and Qua Iboe and increasing incidence of theft of crude.

Growth is expected to be increasingly broad-based in 2022. Agriculture, information, communications & technology (ICT) and manufacturing are expected to drive the expansion. An increase in demand through the adoption of digitization and use of data will continue to stimulate a very strong growth in the ICT sector. The Central Bank of Nigeria's (CBN) intervention funding and other production support initiatives should also strengthen the manufacturing sector's performance in 2022.

Other sectors, including trade, real estate and financial services will also support the economic expansion going forward, although we anticipate rates of growth in these sectors to be moderate.

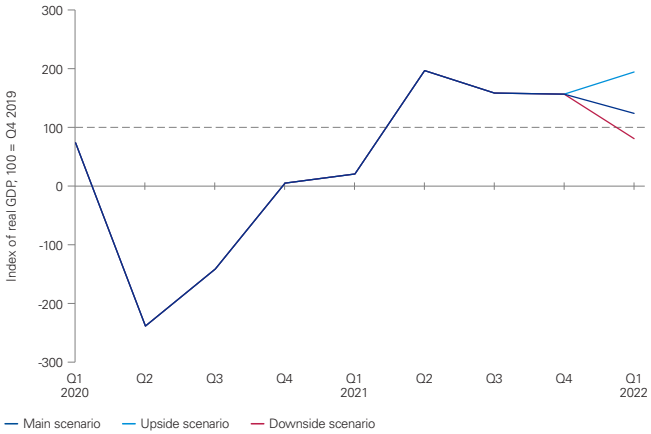
Table 17: KPMG forecasts for Nigeria

	2021	2022
GDP	3.4	3.3
Inflation	15.63	14.5

Source: NBS, IMF, World Bank, Rencap, BMI, NESG, SBG Securities, KPMG forecasts.

Note: Forecasts are based on main scenario of slow recovery. Inflation is based on % year-on-year change of CPI.

Chart 43: Growth in Nigerian economy is set to remain above pre-Covid levels in 2022



Source: NBS, IMF, World Bank, NESG, KPMG forecasts.

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The government has initiated broader expansionary policies, including spending on infrastructure and agriculture to accelerate the economic recovery. However, key government policy constraints will limit fiscal policy's contribution to growth in 2022. The fiscal space is constrained because of a growing portfolio of foreign and domestic debt and the decision not to remove the oil subsidy, which is likely to increase the fiscal spending on oil subsidy payments due to increasing crude oil prices in the global market.

The challenge posed by limits on increase of crude oil exports will impact the supply of foreign currency is likely to result in a further adjustment of the currency by the Central Bank so as to reduce the demand for imports.

On balance, we expect GDP growth to moderate slightly, with an annual average rate of 3.3% in 2022 versus 3.4% in 2021.

The employment market will remain structurally challenged in 2022. Relatively slower economic growth, limited investment by firms and a skills mismatch will constrain any progress in employment generation.

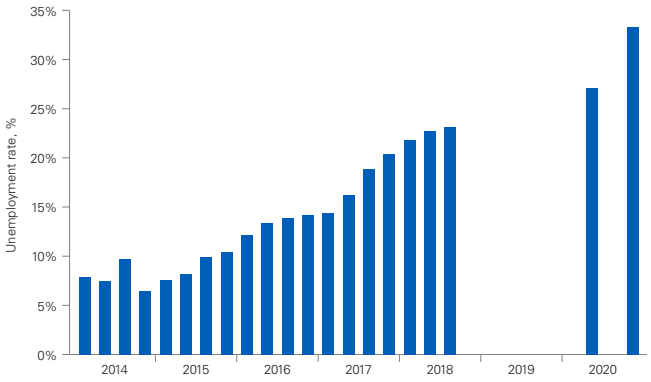
This is in spite of the government's plans to drive employment creation initiatives, and targets the creation of around 21 million jobs through the recently launched National Development Plan[1]. We expect that these initiatives if implemented effectively may boost industrialization and drive unemployment rate downwards over the period of the plan up to 2025.

Nigeria's inflation rate accelerated to 18.17% year on year in March 2022, from 15.75% year on year in December 2021, driven largely by higher food prices. The high level of inflation can be attributed to a combination of supply-side factors and related input shortages, including a disruption of agricultural activities caused by supply chain challenges, the lingering (and related) effects of COVID-19, an exchange rate depreciation, higher energy prices, and higher global food prices more generally.

As the base year effects gradually fade out, inflation is projected to remain in double digits in 2022 due to the following factors: Firstly, a continued surge in global energy prices, with brent oil price hitting an all-time high of USD110 per barrel in March 2022 due to rising geopolitical tensions, will drive up local energy prices which will impact manufacturers and households. Secondly, a persistent rise in global commodity prices such as wheat will translate to higher imported food inflation. Thirdly, an expected increase in electricity tariffs will also impact inflation.

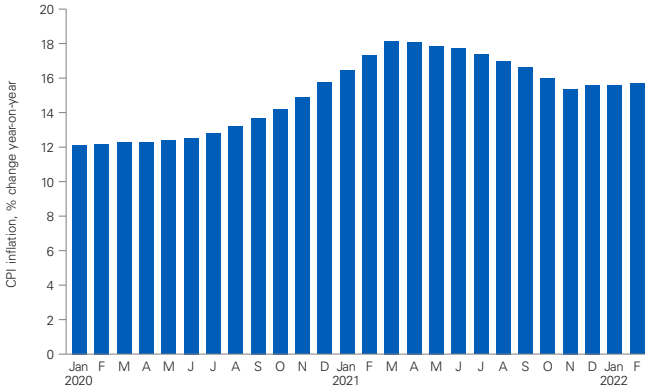
Olusegun Zaccheaus
Associate Director, Strategy and Economics,
KPMG in Nigeria

Chart 44: The pandemic has accelerated a long-running trend of rising unemployment



Source: National Bureau of Statistics.
Note: Break in series reflects insufficient data.

Chart 45: Headline inflation is decelerating but remains high



Source: National Bureau of Statistics.

1 National Development Plan 2021-2025.

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Appendix: Summary of KPMG forecasts

	GDP			Inflation			Unemployment		
	2021	2022	2023	2021	2022	2023	2021	2022	2023
World	5.9	3.8	2.9	3.7	6.5	3.4	6.0	5.3	5.3
US	5.7	3.1	2.1	4.7	8.2	3.7	5.4	3.6	4.1
Canada	4.6	3.8	3.1	3.4	3.9	2.3	7.4	5.9	5.6
Argentina	9.7	2.6	1.4	50.9	54.2	46.5	10.0	9.1	9.0
Brazil	4.6	0.6	1.9	9.0	8.4	5.2	13.6	12.5	11.9
Chile	11.8	2.9	1.0	7.2	5.9	4.1	8.9	7.4	6.7
Mexico	4.8	2.3	2.5	5.7	6.1	4.3	4.1	3.8	3.7
Colombia	10.6	4.7	3.2	5.6	7.2	6.1	13.8	11.9	11.0
Peru	13.0	3.3	3.1	6.4	6.0	5.2	8.7	6.4	6.7
Germany	2.9	2.2	2.9	3.2	6.0	2.5	3.5	3.9	3.4
France	7.0	3.0	1.5	2.1	4.8	2.1	7.9	7.7	8.1
Italy	6.6	3.7	1.6	2.0	6.3	2.7	9.5	9.2	9.2
Netherlands	5.0	3.2	1.3	2.8	6.2	3.0	4.2	3.7	3.9
Spain	5.1	4.8	3.1	3.0	6.8	3.2	14.8	13.8	13.2
Eurozone	5.3	3.2	1.9	2.6	6.0	2.4	7.7	7.3	7.2
Norway	3.9	4.3	2.5	3.5	2.3	1.2	4.9	3.6	3.7
Sweden	4.8	3.1	1.5	2.2	4.4	2.2	8.8	7.8	6.8
Switzerland	3.6	2.7	0.6	0.6	2.3	2.0	5.1	5.4	4.6
UK	7.5	3.7	1.0	2.6	7.9	4.1	4.5	3.9	4.3
Poland	5.7	4.6	3.2	5.1	8.4	6.5	2.6	3.7	3.7
Turkey	10.5	2.4	2.3	19.6	49.7	20.0	12.2	12.8	14.1
China	8.1	5.5	5.2	0.9	2.3	2.3	5.1	5.1	5.1
Japan	1.7	2.8	1.8	-0.2	1.0	0.4	2.8	2.6	2.5
Australia	4.6	3.8	2.2	2.9	3.7	1.9	5.1	4.1	3.9
India	-7.3	9.2	7.7	6.2	5.4	4.5	10.1	9.2	9.1
Indonesia	3.7	5.1	5.3	1.6	3.5	3.5	6.6	6.2	5.7
Malaysia	3.1	6.1	5.2	2.5	2.8	2.1	4.7	3.9	3.7
Philippines	5.6	6.3	6.5	4.0	3.5	3.2	7.8	6.8	5.9
Singapore	7.2	4.4	3.3	2.3	4.2	1.3	2.7	2.3	2.0
South Korea	4.0	3.0	3.0	2.5	3.3	1.3	3.7	3.5	3.5
Saudi Arabia	3.3	6.7	3.9	3.1	2.7	1.7	6.6	6.3	6.0
Nigeria	3.4	3.3	NA	15.6	14.5	NA	NA	NA	NA
South Africa	4.9	2.0	1.8	4.5	5.6	4.4	34.3	34.7	35.5

Source: National statistical agencies, KPMG analysis.

Note: Average % change on previous calendar year except for unemployment rate, which is average annual rate. Figures for India represent fiscal years 2020-21, 2021-22 and 2022-23. Consumer price inflation measured as % change Dec-on-Dec for Argentina, Chile, Colombia and Peru.

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