NatWest

Piecing together the post-pandemic economy.

The Year Ahead 2022

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Welcome to the Year Ahead

The Post-Pandemic Economy

John Briggs

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When we published our Year Ahead outlook one year ago, the world was in a very different place. Global governments were battling a seemingly untamable virus, and perennial lockdowns were not yet displaced by vaccinations – the real world effectiveness and societal impact of which were as yet unknown.

Yet we held a certain optimism for the coming year. Even as we published in the early days of vaccine approvals, we took solace in the fact that fiscal and monetary authorities the world over stood prepared to bridge the gap from pandemic to reopening.

As we look ahead to 2022, I feel optimistic once again, and this time with greater belief that the worst of the pandemic is behind us – with most economies in some stage of reopening or having reopened.

But the outlook is by no means more certain than it was a year ago, and big questions remain over what the global post-pandemic economy will look like: Do inflation dynamics in 2021 represent a permanent shift in global economics, or will the steady "normalization" of the economy bring a return to the dis-inflationary pressures that felt so insurmountable in the pre-pandemic world? Are labour market shortages set to wane in a less accommodative fiscal environment – or are more structural shifts to blame? Can global consumption hold up as governments start tightening pandemic-linked support? And how will central banks – and businesses, and investors – balance these risks?

That's precisely the focus of this year's outlook. In it, we take a closer look at the post-pandemic economy and focus on four major themes we believe will fundamentally drive the outlook across regions, sectors, and markets:

1. The "World of Shortages" and supply chain disruption
2. The handoff from Big Fiscal (fiscal retrenchment) to Big Consumer (savings-fueled consumption) – and how central banks will react
3. China and the global implications of Common Prosperity
4. And a look at just how inflationary the 'greenification' of the global economy is.

Underlying all of these is a risk of higher inflation for 2022, though with great dispersion amongst the major economies. Given that dispersion of both expected inflation and central bank reaction functions, 2022 will also be about which monetary authorities are moving when, and by how much, which we expect will be the primary driver behind asset prices – and potentially much more.

All of this may be unsettling for markets, businesses, and families. But there are reasons to be optimistic – not least, that as vaccinations become more widespread globally, we can now really begin to look beyond the pandemic. And that is a very hopeful thing indeed.

John Briggs

The Post-Pandemic Economy

Four key themes for 2022

We enter 2022 with major unknowns about the long-term shape of the post-pandemic economy, and whether the disruptions we have seen coming out of the global reopening are durable and, if so, how long they may last. To answer these questions, we have turned our focus on four major themes that we believe will fundamentally drive the outlook across regions, sectors, and markets.

John Briggs
Global Head of Desk Strategy

A World of Shortages

Shortages are everywhere. We look at several inter-related shortages to not only estimate how long they will last, but the potential impact on inflation: the US and UK labor markets, semiconductors, shipping and transport, and commodities and raw materials. The long and short of it - shortages will be with us for longer.

Listen to the podcast on Apple Podcasts or Spotify

Watch the webinar on YouTube

From Big Fiscal to Big Consumer – and how central banks will react

Fears of fiscal pullback are common. How much will consumer savings, much of it accumulated from fiscal transfers, buttress consumption as governments pull back? We think quite a bit. And given the potential for significant inflationary shifts in the post-pandemic economy, we see central banks reacting in different ways across regions – which is likely to be a primary determinant for asset prices in 2022.

Listen to the podcast on Apple Podcasts or Spotify

Watch the webinar on YouTube

China and the global implications of Common Prosperity

China's Common Prosperity policy is a game-changer in our view, with wide implications for both China's domestic economy and the global outlook.

Listen to the podcast on Apple Podcasts or Spotify

Watch the webinar on YouTube

How inflationary is the 'greenification' of the global economy?

The transition towards a greener economy poses macro uncertainties and short-term inflationary pressures. But the effects decrease significantly over the longer-term, driven by cheaper technologies. Policymakers must navigate carefully.

Listen to the podcast on Apple Podcasts or Spotify

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A World of Shortages

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The Post-Pandemic Economy: A World of Shortages

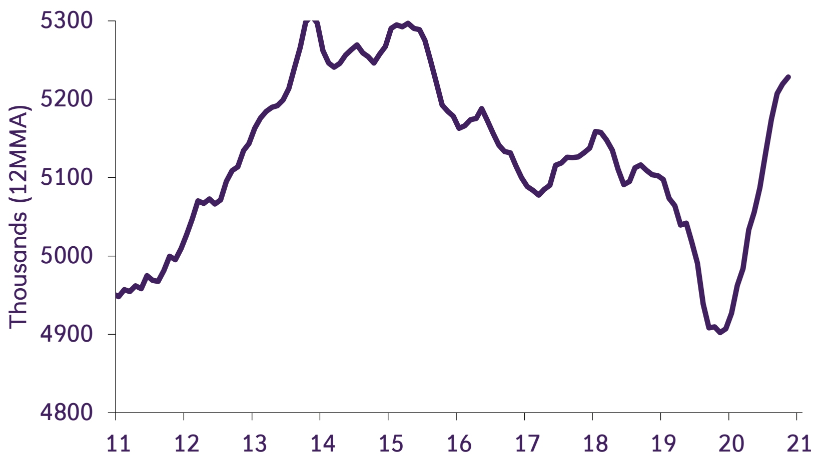
As the global economy has reopened, demand has clearly outpaced the supply of nearly everything from skills and employees to energy and commodities, and big questions remain over the scale and persistence of the disruption in the year ahead. We take a closer look at how long they're likely to last and the major implications for key sectors, markets, and regions.

Labour: problems are likely to persist in the UK and US

Many sectors globally have been hit by labour shortages over the past few months, problems that have been particularly acute in the US and the UK.

In the US, despite vaccination progress and economic reopening, many would-be workers remain on the side-lines for any number of reasons: ongoing health concerns linked to coronavirus infection; people awaiting retirement; workers focusing on other priorities; and mothers remaining at home to care for children (possibly reflecting a lack of childcare). In fact, one of the biggest factors holding back labour supply is the relatively low participation of women in the US job market. The pandemic has resulted in many women assuming the role of primary caregiver in their households. After the Great Recession, for example, it took a very tight labour market to attract this group of women to re-join the labour force, which leads us to believe their return to work following the pandemic will be slow.

Number of US women who do not want a salaried job and instead maintain families on a full-time basis
Source: US Bureau of Labor Statistics



The UK is subject to the same supply pressures as other advanced economies, but Brexit adds a layer of complexity. Although we still expect most of the effects of Brexit – weaker investment expenditure, trade frictions and reduced labour market flexibility – to be felt over the medium term, some of the consequences of leaving the European Union are already apparent, and reduced labour supply is among the most obvious. There's little doubt that net migration into the UK has fallen sharply in 2021 and, in all likelihood, many EU citizens who left the UK in the immediate aftermath of Brexit or during the pandemic are unlikely to return. There's a clear sense that the UK labour market will not be as fluid as prior to Brexit and the pandemic from now on.

Commodities and raw materials: (most) shortages likely to ease in early 2022

The rise in demand – partly the result of aggressive fiscal stimulus during the pandemic – since economies reopened has far outstripped supply. Resource-exporting countries in Latin America, the Middle East and Africa have experienced a slow recovery. This has led to shortages of raw materials such as precious and industrial metals, coal, and oil & gas, caused acute supply chain disruptions, and pushed prices higher.

As economies continue to reopen and vaccination rates pick up around the world, we expect exports of commodities and raw materials to pick up too. That said, increased production of key raw materials may continue to lag surging demand, which means upside pressure on prices could persist throughout 2022. For example, crude oil inventories are already quite low and they're likely to remain below pre-pandemic averages over the course of next year. Energy supplies are also subject to a range of geopolitical drivers, including the role of fossil fuels amid the need to cut carbon emissions, and supply management by the OPEC+ group.

Check out the results of our corporate survey on how businesses are addressing supply chain issues, rising inflation, and cost pressures.

Semiconductors: shortages likely until 2023 as new ways of working set in

A dearth of semiconductors has been among the most noticeable shortages we've seen recently, and it may have an outsized impact on the growth rates of many economies. That's because semiconductors are vital in a range of sectors, and shortages are having a profound impact on the ability of auto, smartphone, and computer manufacturers to meet demand (often to the detriment of sales).

The semiconductor industry is cyclical in nature, and the current upswing in the sales cycle has been amplified by the switch to the pandemic-induced work from home model, which has led to higher demand for electronic devices and increased adoption of smart home appliances. This increased demand looks to be here to stay as many working arrangements have shifted permanently.

Unfortunately, the explosion in demand for semiconductors has not been met by a timely increase in production capacity, resulting in supply bottlenecks for chips. Given that production capacity is slow to come online – it takes 1–2 years to redesign new production plants to meet rising demand), we expect the chip shortage to persist well into early 2023.

Shipping and transport: the worst may be behind us, but costs may be slow to come down in some regions

Developed markets saw an early pick-up in demand after the initial shock of the pandemic due to the huge fiscal support that was provided to their consumers. By contrast, many emerging markets experienced a faster recovery in production as their governments chose to prioritise the reopening of factories. But this has clearly resulted in increased demand for the shipping and logistics needed for goods to flow from emerging markets to more developed countries.

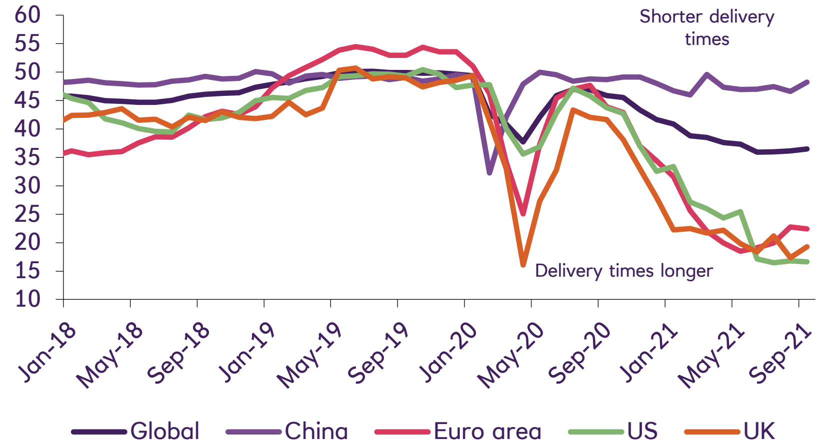
Congestion at ports, coupled with a mismatch between the supply and demand of containers, has led to soaring shipping costs. By the end of September, global sea freight rates for container shipping were almost ten times higher than in January 2020. Container prices represent a useful proxy for the price fluctuations of imported goods and reflect the impact of logistical shortages in the supply chain.

However, whether these cost increases will make their way into prices of final goods largely depends on the pricing power of companies. While the discrepancy between supply and demand for containers will eventually normalise, it looks likely to persist until well into 2022.

"In the US, the participation rate for prime working age men is 1.2 points below its 2019 level, while that for women is still 1.5 points below its 2019 level."

"There's a clear sense that the UK labour market will not be as fluid as prior to Brexit and the pandemic from now on."

For most regions, global shipping times remain elevated – and will for some time
Source: IHS Markit, NatWest Markets



In addition to higher prices, limited capacity is resulting in slower delivery times around the world, although the problem has been particularly pronounced in developed markets. The most recent set of manufacturing PMI data suggests that this situation is unlikely to ease as we approach the holiday season. In fact, it looks set to last at least through the first quarter of next year – if not longer.

Click here to learn more about how you can make your supply chain more resilient in a post-pandemic world.

Concluding thoughts: what about rising costs and inflation?

It goes without saying that the bottlenecks above are going to have inflationary effects, but their impact will vary by region and sector. Those that experienced faster recoveries in demand, such as the US, have generally witnessed higher consumer inflationary pressure, while those where the domestic demand recovery has lagged, such as China, are still registering relatively subdued price rises. Manufacturing hubs that mainly import raw materials have seen a more rapid surge in producer price index inflation.

But will these effects be temporary? We believe the risk is skewed towards more persistent inflationary pressures, for the developed world at least. Raw material shortages and logistics bottlenecks may ease in 2022, when demand normalises, and more countries reopen. Weather-related disruption to energy supplies should also ease sooner rather than later.

However, increasing semiconductor production and shipping capacity to accommodate structurally higher demand may take 1–2 years. The realignment of manufacturing supply chains and labour shortages may last even longer. These supply shortages may feed into higher prices for a wider range of goods and services, pushing up core inflation in the medium term.

Over the longer run, a shift in manufacturers' strategies to enhance supply chain resilience by building "just in case" rather than "just in time" supply chains may lead to structurally higher production costs and inflation, although this should be a gradual process. What's more, geopolitical changes that began prior to the pandemic, including Brexit and US-China trade tensions, might also be drivers of inflation over the long term.

"Risk is skewed towards more persistent inflationary pressures, for the developed world at least."

From Big Fiscal to Big Consumer – and how central banks will react

The Post-Pandemic Economy: fiscal retrenchment vs. consumer spending

We take a closer look at the handoff from generous fiscal policy to consumption-led growth in the year ahead, how central banks could react to new inflationary pressures, and what all of this means for markets.

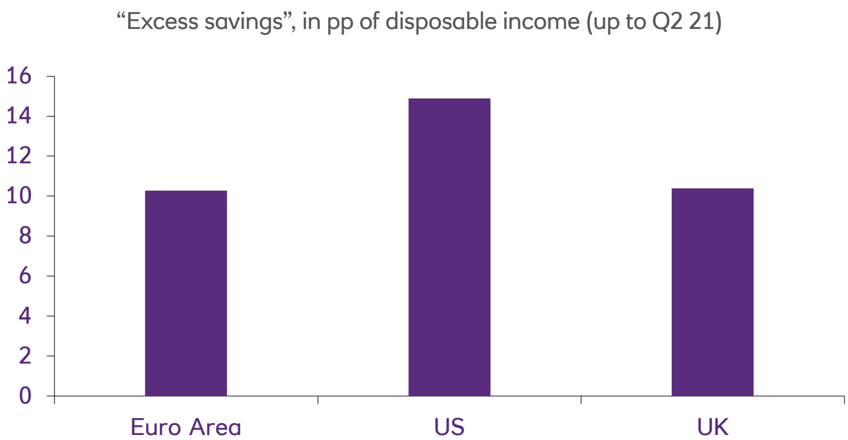
Private savings grew during the pandemic but how the money will be spent is less clear

Private savings skyrocketed in all major advanced economies during the pandemic, with government furlough schemes filling people's pockets at a time when lockdowns curbed opportunities to spend. Excess savings – in other words, the accumulated savings above pre-pandemic trends – amount to around 10% of gross domestic product (GDP) and 15% of disposable income in the US, and to around 6–7% of GDP and 10% of disposable income in the euro area and the UK. Some of these savings are bound to flow back into the economy as reopening leads to renewed growth in consumption and investment.

But where will the money be spent? A recent survey in the UK reported that 27% of respondents planned to spend their savings on consumer goods and services, with a further 10% planning to spend on home improvements. There have been similar findings in the US and Europe.

How much will be spent – and how fast – remain difficult questions to answer, although a 20% reduction of the excess savings over a period of 2–3 years seems to be a realistic scenario across the G3 regions (UK, US, and Euro Area). In addition to a normalisation of the propensity to spend, this should provide an extra boost to consumption of between 6–8 percentage points between now and the end of 2023, according to our estimates.

Excess savings (as a % of GDP) are largest in the US, thanks to aggressive policy support
Source: Datastream, NWM estimates



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A global economy saved by savings

All of this reduces the likelihood of the economy being faced with a 'fiscal cliff' – the withdrawal of fiscal support at a time when economies haven't fully recovered from the pandemic. There are fears that such a fiscal cliff could cause an abrupt slowdown in growth from 2022 onwards, but we believe these are exaggerated.

Instead, we think it's more appropriate to view fiscal policy tightening measures alongside the build-up of savings during the pandemic. These excess savings in part reflect previous fiscal stimulus measures, and the normalisation that we expect in the coming years should be seen as the delayed deployment of part of the pandemic fiscal stimulus. So, that fiscal boost will in reality continue to be felt for many years to come.

But the downside is that increased spending could also lead to more inflationary pressures building up, especially at a time of supply-side constraints. What might that mean for major central banks' reaction functions and, in turn, financial assets? Let's take a look.

UK: The Bank of England will tighten faster, which should support UK assets through 2022

The Bank of England's (BoE) approach has been clear throughout the pandemic. Shaped by the experience of the Global Financial Crisis, the Monetary Policy Committee opted to 'go big and go fast', in the words of Governor Andrew Bailey: slashing the Bank Rate to 0.10%, doubling quantitative easing (QE) purchases to £895 billion, and reviving lending support mechanisms (including substantial loan guarantees).

Yet as the UK economy emerges from lockdown, the Bank's proclivity for accommodative policy has waned. The proximate trigger for this hawkish shift is inflation overshooting. But while its near-term signalling is unambiguously hawkish, its underlying reaction function remains much more uncertain.

The problem is that the Bank's near-term policy shift has not been accompanied by more clarity about how far it is prepared to go. This increases uncertainty about its medium-term policy, and also raises the risk of either a policy error or a materially weaker domestic economy.

What does this mean for markets? There are tentative signs of 'policy error' risk, with three-month LIBOR futures on an upwards trajectory until autumn 2023, at which point rates then dip by around 10 basis points over the following year. For risk assets, much depends on how far the BoE is willing to go in tightening and how damaging that is to the economic outlook. Given the trends seen in the US and Europe (more on this below), a more aggressive BoE suggests there could be a period of relative outperformance for UK assets. And while the extent of that outperformance is unclear, it's reasonable to expect higher levels of market volatility in the UK in 2022 as well.

"A reduction of 20% of the excess savings over a period of 2-to-3 years should provide an extra boost to consumption of between 6% and 8% between now and end 2023."

US: Stronger inflation could mean higher yields, more volatility, but a stronger dollar

As long as inflation expectations stayed anchored, we expect the Fed to be "relatively" patient—by holding off on rate hikes until Q4 2022—versus the earlier start priced in by markets. However, given continued disrupted supply chains and labour market shortages, officials understandably seem a little more uncertain about the inflation outlook.

In 2022, we don't believe the Fed will be willing to tolerate too persistent of an inflation overshoot, and expect officials will need to fine-tune their communication (i.e., putting more emphasis on the importance of retaining price stability) and look for a gradual rise in rates.

What does this mean for markets? If inflation remains limited, volatility should remain low, risk assets supported, the US dollar relatively weak, and rates relatively contained, with a modest number of hikes priced in for 2023. However, markets will respond very differently if inflation – and in turn inflation expectations – rise to the point where the market thinks that the Fed is behind the curve. In fact, this is our baseline scenario for late 2022 and into 2023: with core inflation expected to bottom out around 2.6% in 2022, the Fed risks being forced to raise rates more aggressively to catch up.

All other things being equal, this should result in a stronger dollar. For rates, it could mean a steeper curve if accompanied by an inflation rate that fails to fall back toward the Fed's 2% target. Alternatively, though, it may imply a flatter curve if and when the Fed begins to hike aggressively. Overall, we are likely to see higher rates in either case – and more volatility for risk assets.

"If inflation and in turn inflation expectations continue to rise, the market may determine that the Fed is meaningfully behind the curve.

Euro Area: The European Central Bank will keep policy looser for longer, which is good for yields

The European Central Bank (ECB) culminated a decade-long dovish shift with its Strategy Review in July 2021. Although well known to ECB watchers by now, the main changes for the monetary policy approach are worth repeating:

- A new target inflation rate of 2% (year-on-year rate)
- The promise of a symmetrical response around that target
- Particular attention is being paid to the existence of a lower bound for policy rates, for the first time explicitly recognised as a major constraint to policy
- Assessment of financial conditions is now of fundamental importance.

Inflation is now rising quickly – which hasn't been lost on Europe's central bankers. But it's equally clear that the 'transitory' narrative (that these spikes will be short-lived) is still dominant. Most professional forecasts (the ECB's included) see inflation falling again and taking a long time to get back to target. Policy rates are likely to stay low for a long time to come – most likely until well into 2023 at least.

What does this mean for markets? If higher inflation does establish itself, a stronger euro looks likely as QE slows. Yields at the short end of the curve would probably rise more slowly than markets currently expect. Significantly higher rates will be slow to come, both as the ECB tries to re-anchor inflation expectations somewhat higher, and because the natural rate of interest is low. Until then, yield curves are likely to remain relatively steep.

Asset purchases and low rates will continue to support sovereign spreads and risk assets, even if the ECB does eventually exit its low-rate policy

China and Common Prosperity

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The Post-Pandemic Economy: China's Paradigm Shift to "Common Prosperity"

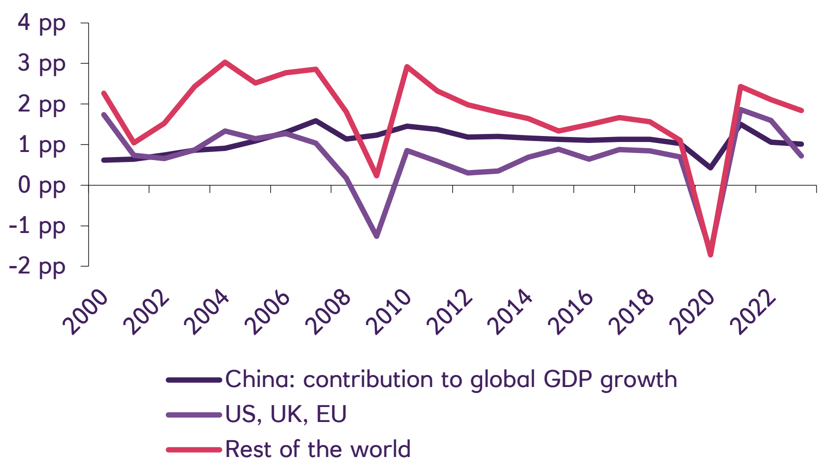
China's "Common Prosperity" policy looks set to be a game changer for the country as it refocuses its priorities away from economic expansion at breakneck speed at any cost towards a long-term goal of reducing domestic inequality in the years to come. We consider some of the key implications of the new policy and what they mean for the global economy.

Common Prosperity is a whole new ball game

The Common Prosperity policy represents a paradigm shift for China, with its focus on narrowing inequality and overturning the prior 40-year consensus of rapid market expansion at all costs and "letting some people get rich first". The government plans to use taxation and other means to redistribute income to expand the proportion of people in the middle class and increase the incomes of the poor, as well as reducing what it deems the "excessive" incomes of the super-rich.

The new policy means that local government officials will no longer be pressured to achieve lofty economic growth targets and will instead be incentivised to achieve what might be called "quality" growth. But this isn't to say that the Chinese growth story is in jeopardy: over the longer term, consumption by China's growing middle class and higher manufacturing value-add should ensure growth over a multi-year horizon is well supported. It's just that there will be a shift away from the debt-driven property and infrastructure investment of the past few decades.

China's contribution to global economic growth (GDP) is projected to fall below the combined contributions of the US, UK, and EU for the first time in more than a decade
Source: IMF forecasts, Haver, NatWest Markets



Meanwhile, further regulatory crackdowns look likely after the tutoring, internet, entertainment and gaming sectors were in the crosshairs earlier this year. For 2022 and beyond, President Xi has set out his aim to crack down on monopolies and the "disorderly expansion of capital". We would not rule out continued risks for domestic markets, although we'd expect them to be better signalled than they were in 2021.

What does 'Common Prosperity' mean for the global economy in 2022?

Even though China's drive for common prosperity is aimed at levelling up conditions within China, it has big implications for the rest of the world. Here are the six that are crucial for the global economy.

#1. A stronger domestic tech focus doesn't mean decoupling from the rest of the world

A key priority for China will be its continued focus on the development and competitiveness of high-tech, high-value-adding sectors like electric vehicles, artificial intelligence, high-end manufacturing, semiconductors. These sectors have been priorities for at least five years.

Yet the state's continued push towards indigenous technologies and innovation doesn't mean China will decouple from the rest of the world. Rather, it suggests to us a desire to protect itself from external trade and policy shocks like the Trump administration's trade wars and from increased competition with developed nations for dominance in tech. As ever, capital flows remain an important source of funding to fuel the investment needed to achieve these goals. Indeed, foreign direct investment (FDI) inflows into China have remained robust despite the pandemic and trade war with the US in recent years.

In the years to come, imports will be important in helping China meet its aim of increasing domestic consumption and shifting its growth model, with the current account surplus returning to its earlier trend of narrowing, before eventually moving to deficit.

"Further regulatory crackdowns look likely..."

#2. No change to the trajectory of China-US relations

Trade relations look set to "build back boring" in 2022 and become much less volatile. It's not just about trade – the focus is on competition for technological superiority and China's state-led development policies in the tech sector. If anything, we would expect the focus of tensions to shift more hawkishly towards tech, with the overall rules of engagement emphasising competition rather than tariffs.

"Trade relations look set to "build back boring" in 2022."

Recent US rhetoric suggests there will be continued enforcement of the Phase I trade deal, with no intention of removing existing tariffs and continued marshalling of US allies on a coordinated China trade policy. But coordinated action and a common agenda against China will be difficult given different countries' hugely varying bilateral exposures to Chinese trade, as well as the risk of persistent supply chain shortages.

Geopolitical tensions are likely to persist, but they should remain contained. But China's more assertive foreign policy (especially in its own backyard) will mean that regional tensions are likely to persist and will represent a source of headline risk. Issues such as Taiwanese independence, the South China Sea, and relations with the Australia, UK and US alliance could be particular focal points. Despite this, we don't think escalation into open conflict is on China's agenda, as we expect that it will stick to its current diplomatic playbook of hawkish rhetoric and posturing instead.

#3. Common Prosperity will not be a source of global inflation medium term

China's economic ambitions do not mean that the country will be able to rapidly end lower-value manufacturing. In fact, 2020 and 2021 have shown that China has been opportunistic in increasing its shares of trade and manufacturing.

Supply chain shifts were underway long before the onset of the pandemic. For example, the garment manufacturing chain has been partially relocating into south / southeast Asia since the mid-2010s due to Chinese wages rising – without any significant impact on global inflation.

If anything, decisions to near-shore (or onshore) manufacturing, reduce supplier concentration and fragilities (by introducing redundancies), or take on board more ESG considerations are more likely to be drivers of global inflationary pressures.

#4. China's influence over commodities rallies will probably decline

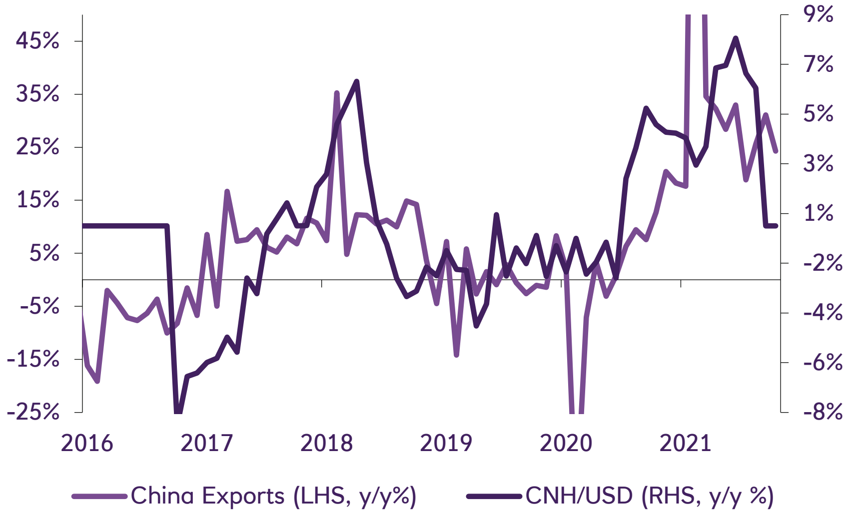
The sheer volume at which China produces things will be enough to backstop commodity demand, but we don't expect the country's credit impulse – the change in new credit as a proportion of gross domestic product (GDP) – to be big enough to lead to further major commodity rallies.

The impact of this on emerging markets as a whole should be muted, particularly in the FX space. While emerging-market currencies have generally moved broadly in line with commodity prices in the past, their performance has lagged during this upswing in the commodity cycle, despite exports performing reasonably well. We attribute their lacklustre performance more to lagging growth in emerging economies and subdued capital flows.

#5. Trade flows are likely to outperform FX

We expect export flows for China and its Asian manufacturing peers to continue to perform well as shortages persist into the first half of 2022. Financial flows into China will remain supported, particularly as passive inflows continue with the gradual inclusion of Chinese government bonds in the FTSE World Government Bond Index over the next three years.

Global exports remain resilient – and will continue to support the yuan
Source: Bloomberg, NatWest Markets



Importantly, we think that outflows will be constrained as well. Financial inflows slowed, but did not register outflows in 2021, even during the Q3 regulatory crackdown. A belated reopening of borders will also mean that tourism, the primary source of current account outflows, will remain muted and will resume later rather than sooner. The lack of outflows will bolster the current account balance in China, providing support for the yuan.

#6. Chinese tourism to return later rather than sooner

Finally, we think that stringent border controls and the zero-tolerance policy towards coronavirus are likely to persist well into the first half of next year as the government keeps a tight lid on infections in the lead-up to February's Beijing Winter Olympics and beyond. The return of Chinese outbound tourism will probably be belated, and the risks appear skewed towards a later and slower recovery of tourism-dependent economies in the region.

> **"The sheer volume at which China produces things will be enough to backstop commodity demand..."**

How inflationary is the 'greenification' of the global economy?

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The Post-Pandemic Economy: Is Going Green Inflationary?

As climate and social sustainability issues move to the top of the agenda, one of the biggest concerns is that greening the economy could result in higher inflation or 'greenflation'. In the Year Ahead 2022, we consider some of the key questions about the link between going green and inflation, and potential implications for central banks and for society.

One of the clearest trends in consumer preferences over the past few years has been the shift towards products and services that are more sustainable: environmentally friendly packaging for goods; clothing with reduced carbon footprints; and personal investment portfolios that incorporate sustainability criteria, to name a few.

Will producers be able to pass on higher prices for sustainable products?

Rising demand for sustainable goods has direct consequences for producers' pricing decisions as sustainable products tend to be more expensive. Exactly how much more expensive is difficult to measure, but there's clear anecdotal evidence in sectors like the fashion industry, where firms often report higher operating costs resulting from the implementation of sustainability measures. Similar patterns have been seen in the cosmetics, pharmaceutical, construction, housing, and food sectors.

Is the general public willing to pay more for sustainable products? It would seem so. The European Commission has reported that two-thirds of consumers would be willing to buy more sustainable products even if they were more expensive. Some studies have even suggested that up to 25% of those polled would be willing to pay over 10% more for greener products.

Consumers are willing to pay more for greener products, surveys suggest

Source: YouGov Survey, April 2021. Survey question: Do you agree or disagree with the statement: "I don't mind paying more of products that are good for the environment"

"The European Commission has reported that two thirds of consumers would be willing to buy more sustainable products even if they were expensive"

Broader cross-national surveys show that between 53–60% of consumers in most developed countries (Japan being the clear exception) are willing to bear higher costs for products that are seen as more environmentally friendly. Will consumers incur the higher cost when it comes to the actual purchase decision? If they do, it has clear implications for inflation.

Are carbon taxes inflationary?

Another factor to consider is whether long-term policy measures such as carbon taxes could push prices upwards. This is an important question as many countries have already implemented such schemes – there are currently 64 in place – and many others are looking to expand them or put them in place.

There have been few analyses of their implications for inflation. The most detailed study found that carbon taxes did not appear to have inflationary effects, and could even have a disinflationary impact as other prices tend to fall due to the decrease in income that they result in. For instance, a study found that real household incomes in Canadian provinces where a carbon tax had been introduced fell materially following the adoption of the tax, when compared with the rest of the country.

This doesn't rule out negative short-term effects on inflation. Most studies anticipate some near-term inflationary effects during the transition to a zero-carbon economy. For example, the implementation of climate-related measures in Germany earlier in 2021 resulted in energy price inflation.

"...most green-intensive minerals, such as silver and aluminium, have actually underperformed over the past 18 months."

Will the green transition result in commodity price inflation?

Commodity prices have surged recently, and some have argued that greening is partly responsible. There are both supply and demand levers at play: carbon energy production might be becoming more expensive as markets shy away from it, while metals that are required for the production and storage of green energy are subject to increasing demand.

Our own analysis casts some doubt on this. We found that the most green-intensive minerals, such as silver and aluminium, have actually underperformed over the past 18 months, while some of the sharpest price increases are seen for minerals in relatively low demand from greener technologies.

This doesn't necessarily mean that higher demand for cleaner energy won't become a driver of commodity prices over the long term. For some minerals, such as graphite, lithium and cobalt, additional demand from emerging technologies represents a challenge to current production levels. Shifting policy on oil might have contributed more directly to its recent price rises. Indeed, we believe private investor demand for investment in clean energy paired with public sector pressure on energy production is likely to be a theme that overhangs global energy markets over the coming years, affecting consumer demand and access to capital.

How much can technology help to reduce costs?

The declining cost of greener technology is at the core of the inflation argument and is likely to ultimately determine the net impact on prices over the long term.

The economics behind sustainable production and storage are encouraging.

According to Bloomberg, the global levelized cost of electricity (LCOE) for renewables has fallen sharply in recent years, even accounting for the recent spike in the prices of commodities used in alternative energy production.

Compared with an average LCOE of $70 / MWh for a gas-fired power plant and $62 / MWh for coal:

- Onshore wind has a global estimated LCOE of $41 / MWh, down from $112 / MWh in 2009.
- The equivalent LCOE for offshore wind is $82 / MWh, almost 60% lower than in 2009.
- The global LCOE for fixed-axis photovoltaic is $48 / MWh, down from around $370 / MWh in 2009.
- The global LCOE for battery storage is $138 / MWh, down from $500 / MWh in 2016.

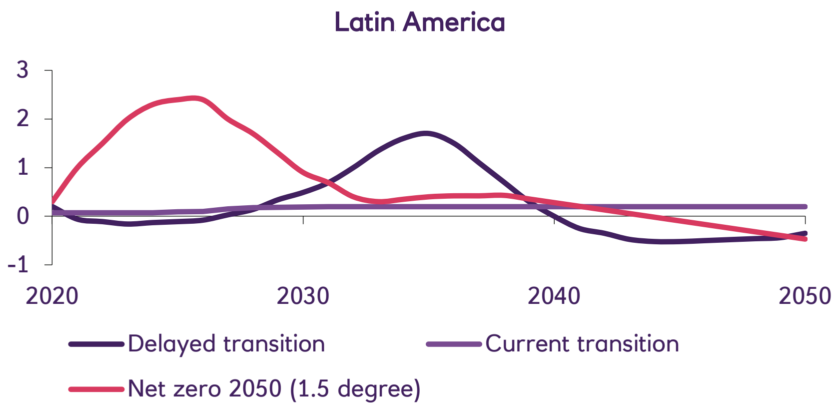
Two trends are at work here. The first is that renewable energy is becoming cheaper at a much faster rate than traditional power generation. The second is that alongside a huge rise in installed capacity, most renewables are now cheaper in absolute terms than their conventional peers. Both trends point towards disinflation.

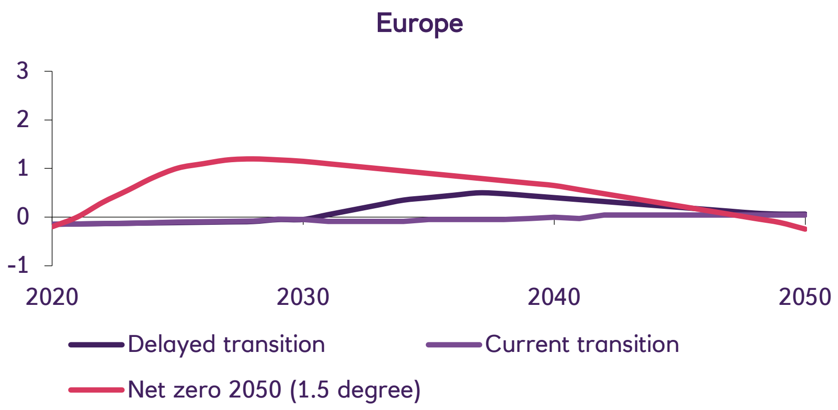
How much do central banks have to worry about 'greenflation'?

Initially at least, inflationary pressures and downward pressures on economic activity seem likely during the transition towards a greener economy. However, some of these consequences can be mitigated through public policy over time – especially if large investments in green technology end up boosting economic growth and eventually offer some price relief.

Public policy can help mitigate the inflationary impact of greening the economy

Some estimates suggest net zero could result in higher near-term inflation
Source: Network for Greening the Financial System





New energy policies in countries like Germany have added to pressures resulting from the rebound in demand and severe shortages in many sectors. ESG considerations have undoubtedly contributed to policy uncertainty for central banks, both in the G10 and emerging markets. However, the steady fall in energy prices from renewable technology reduces the likelihood of them becoming intractable issues for policymakers – even over the medium term.

Could we see a backlash from voters?

The transition to more sustainable economies brings other risks in our view. Those benefitting from green policies are widespread, while those opposing them tend to be concentrated yet much more motivated. In that sense, the potential for a backlash among electorates deserves careful consideration.

There are several arguments that are currently being used to oppose more sustainable policies, from job losses in carbon-intensive industries, to the potential for broadly higher costs for consumers. Most studies on carbon taxes have found an insignificant effect on output levels, but the argument that some measures are too expensive has been successful in shaping political opinions.

Ultimately, tackling climate change is a global long-term pursuit, but politicians are elected on a local short-term basis. Coordinated global action will help to provide the overall direction, but careful policy design that accounts for local political constraints will be required.

Six themes set to shape the corporate ESG landscape in 2022

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The Post-Pandemic Economy: Top Corporate Sustainability Themes in the Year Ahead

Sustainability continues to edge up the corporate agenda – so what does 2022 have in store? Our specialists discuss six key themes that will dominate the corporate sustainability outlook in the year ahead.

#1. ESG data to become more democratised

While many companies voluntarily disclose environmental, social, and governance (ESG) data, there is a lack of reporting regulations to define the metrics employed. This can make it difficult to evaluate them – and the targets that companies are meant to be hitting – against peers. Increasing the availability of comparable and meaningful ESG information, or 'democratising ESG data', – is essential to assess whether companies' sustainability strategies and initiatives are effective. It will also help investors make better-informed decisions about which companies to support.

The year ahead will see increased availability of freely accessible resources that will help us evaluate companies' sustainability performance. A good example is the Transition Pathway Initiative (TPI), which provides assessments of companies' transitions to net-zero. The TPI's new Global Climate Transition Centre, set to open in 2022, will expand the number of companies assessed from 400 to 10,000, a 25-fold increase.

Regulation also has a role to play as it can ensure the process of reporting ESG data is simplified, streamlined, and standardised. For example, the EU introduced the Non-Financial Reporting Directive in 2014, requiring around 6,000 large companies to publish standardised reports on the ESG policies they implement. In April 2021, the initiative was expanded to nearly 50,000 companies via the Corporate Sustainability Reporting Directive, with the first set of standards to be adopted by October 2022.

#2. Holistic decarbonization to become the priority

The past twelve months has seen a growing number of companies set carbon reduction targets and make commitments alongside improvements in sustainability governance, transparency, and reporting mechanisms. Building on this foundation, 2022 is likely to see **entire value chains play a more pivotal role** within transition strategies.

We'll see further pressure on companies to reduce greenhouse gas emissions in line with the science-based targets and report on their progress. Wherever firms are unable to target all of their Scope 3 emissions (indirect greenhouse gas emissions within a company's value chain), they'll increasingly be expected to implement targets for their most material activities.

As companies seek to address Scope 3 emissions, the ability to engage with supply chains in emerging markets to reduce emissions is likely to present challenges. We expect companies to rely on partnerships across sectors to deliver on broader decarbonisation targets.

#3. Green and social taxonomies will move to the fore

From 2022, the **EU Taxonomy Regulation** will oblige companies to report on their alignment with climate change mitigation and adaptation objectives. Alignment criteria for the remaining four categories (sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems) will be outlined in 2022 and enforced from January 2023.

In addition to the 'Green' Taxonomy, the EU has signalled its potential expansion to include social factors. Further details about the development of a Social Taxonomy are expected in 2022 and as a result, stakeholder pressure to account for social aspects will increase.

Taxonomies of sustainable activities aren't exclusive to the EU. As part of its 'Build Back Better' report in July, the UK government announced its intention to produce its own green taxonomy.

The development and application of sustainable taxonomies in 2022 will increase firms' reporting obligations and result in ESG criteria being further embedded in financing activities. Taxonomies will also provide an additional benchmark for investors and other stakeholders to assess corporate performance against, and lead to higher quality and more consistent reporting.

#4. Scrutiny of greenwashing will intensify

ESG markets have come under intensifying scrutiny in recent times, not least because of a series of high-profile whistle-blowers providing details about questionable practices in organisations that claim to adopt a sustainable approach.

With awareness of greenwashing on the rise, we expect investors to analyse corporate disclosures in greater depth and breadth in 2022. We also expect healthy scepticism from various stakeholders – not just investors – about companies' ESG claims and targets.

"Additionality" – the positive net-benefit associated with an activity or project – is therefore expected to remain high on investors' wish-lists, with corporates able to use labelled financing to bring the biggest impact, whether targeting benefits to society or the environment. This is likely to sharpen the focus on companies, activities, projects, and expenditures, to ensure they can evidence the real-world impact of their claims.

#5. Private ESG funding markets to take off

Sustainable finance first emerged within public funding market – the first labelled ESG instruments were bonds issued by multinational organisations. The concept is now gaining traction in private markets, with around €2 billion of ESG-labelled private debt transactions in 2021 according to Bloomberg.

A key driver of this trend is that improved ESG disclosures and data are enabling investors to evaluate the sustainability characteristics of private assets. Companies seeking to issue a sustainable private placement (PP) can now use a sustainability-linked structure, and US-domiciled investors – which are among the largest investors in PPs – are under increasing pressure to incorporate sustainability into their mandates.

Sustainability looks set to drive execution dynamics in the private markets in 2022, and issuers with strong ESG narratives or those introducing ESG structures are likely to prove attractive to a broader investor base and, in certain cases, secure a greenium (more attractive pricing).

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#6. Carbon markets transparency will improve

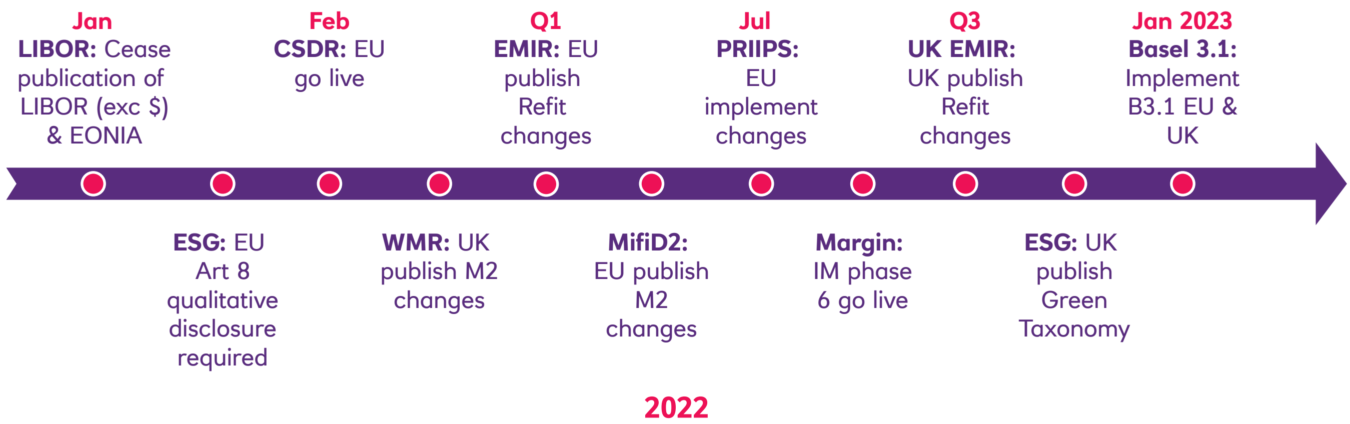
About one fifth of the world's largest companies have set out a net-zero or carbon-neutral pledge. With a wave of commitments in 2020 and 2021, attention has now turned to how firms are using voluntary carbon markets and buying carbon credits and offset emissions to achieve these goals. Companies will need to be more transparent in the use case of carbon credits, either to offset residual emissions, compensate for emissions in the value chain (Scope 3), or pursue "negative emissions. Nascent but fast-developing industry platforms like Project Carbon are helping to accelerate this trend.

With an agreement for implementing Article 6 cast at COP26, we expect the transparency of carbon offset projects to improve in the near to medium term, as companies will want to understand what the return on each credit looks like (particularly as they seek to avoid accusations of greenwashing. This will help carbon to be accurately priced on a company's or lender's balance sheet, and in turn, help develop the liquidity of carbon as an asset class.

The 2022 Regulatory Outlook

With LIBOR transition largely 'done' (except for the small matter of USD…), what regulatory topics do we expect to see dominate the landscape in 2022?

Looking down the road here is a quick list of what to look out for:



- **LIBOR** – January will see LIBOR end except for USD; no new transactions in USD LIBOR in any asset class are permitted from **1 January 2022** except for derivatives for risk management of existing positions, with USD LIBOR finally ceasing in June 2023; the FCA announcement permitting **tough legacy** transactions in GBP & CHF LIBOR to reference synthetic LIBOR rates will provide a welcome safety net for any positions that don't transition or fallback at year end, but it will leave a tail of trades still to deal with in 2022; EONIA also ceases publication in January (but EURIBOR continues).
- **ESG** – climate related and other ESG disclosures are going to become ever more prevalent in the industry; the EU has led the charge with SFDR and CSRD (see our **PIEs** note), but the UK has recently made **strong statements** in their Green Finance Roadmap about their commitment to reporting under Sustainability Disclosure Requirements (SDR) and the UK Green Taxonomy; first up in **January 2022** the EU is mandating qualitative disclosures under EU Taxonomy Regulation.
- **CSDR** – the Central Securities Depository Regulation (CSDDR) is scheduled to go live in EU on **1 Feb 2022**, although a delay to at least some of the requirements seems likely. The rules mean buy side firms that trade in-scope securities that settle on an EEA CSD will be subject to mandatory buy-ins and a penalties regime, as well as needing various contractual agreements and operational processes to be in place; the UK did not onshore CSDR but there may be extra-territorial impacts for UK firms operating in the EU.
- **WMR / MiFID2** – the Wholesale Markets Review (WMR) is the **UK review** of the MiFID2 regime it inherited from EU; a consultation took place earlier in 2021, the legislative results of which are expected in **Q1 2022**; though details and timing not yet clear, changes could have a significant impact in the area of transparency and the liquidity determination for fixed income / derivatives; meanwhile the EU is also revising MiFID2 with announcements expected in **Q2** following multiple CPs over last 2 years, though given EU trilogue process likely a further year before implementation.

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- **Margin** – Initial Margin Phase 6 goes live on **1 Sep 2022**. This pulls in a wide range of additional firms with AANA above $/€8bn; as with **Phase 5** (where repapering across the industry is still not complete with reliance on **Threshold Monitoring** to alert counterparties to when they are approaching levels where IM would be required), this will require a huge lift in legal docs and operational set up.
- **Clearing** – the temporary equivalence decision by the EU permitting EU firms to clear trades on UK based CCPs was due to expire in June 2022, however in November 2021 the **Commission agreed** to extend the exemption (though as yet we don't know for how long); at the same time the UK has announced plans to consider relying on 'comparable compliance' from their home country for non-UK CCPs; it will be interesting to see whether this new spirit of cooperation between the EU and UK at least in this particular area might extend more broadly in the future.
- **PRIIPS** – the change to the PRIIPS regulation is due to go live in EU on **1 July** (having been delayed from 1 January 2022); it revises the performance calculations for category 2 to 4 PRIIPS significantly, with only a minor modification to category 1 PRIIPS calculations; following agreement on a delay, the UK on-shored version of the revised regulation will be published in Q1 – it is not yet known what lead time there will be before implementation, but it is hoped it will not go live until Jan 2023.
- **EMIR Refit** – both EU and UK are reviewing their versions of EMIR under the general heading of 'EMIR Refit'; in the EU final results expected to be published in an RTS in **Q1 2022** which will give final detail for example on the Trade & Transaction Reporting changes that will be required, with go live probably 18 months later. In the UK a consultation expected by end 2021 with final rules published in **Q3 2022** for implementation the following year; in both cases quite substantial revisions expected to T&TR. There are also changes in pipeline from CFTC for Dodd Frank reporting, meaning the scale of impact to operations teams is likely to be substantial.
- **Basel 3.1** – will apply in both EU and UK from **January 2023**, implementing remaining Basel 3 provisions; the EBA has suggested that these rules will have an estimated increase of capital of 18.5% for EU banks; the PRA has been given significant discretion of how Basel 3.1 will be implemented for UK banks and plans to issue a consultation paper in Q3 2022.
- **Crypto Assets** - the draft 'Markets in Crypto-Assets Regulation (MiCA) is scheduled to come into force at the end of 2022; MiCA will establish a fully harmonised EU wide regulatory framework for crypto-assets which will include crypto-asset service providers (CASPs); the FCA published a consultation paper concerning crypto assets in January 2021, which ended in March.

For a more exhaustive list of the FCA's planned regulatory agenda see the **Regulatory Initiatives Grid** they published In November.

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