EDITORIAL

2022: ASSESSING UPSIDE AND DOWNSIDE RISKS

Judging by the latest forecasts, the outlook for growth in 2022 is positive and, at some point during the year, inflation should start to decline. Uncertainty remains elevated however so there is a risk that key economic variables evolve differently than anticipated. The biggest 'known unknown' concerns the future development of the pandemic. Real GDP growth could surprise to the upside should inflation decline faster than expected. A tightening of financial conditions, more supply disruptions and inflation staying high for longer are the key sources of downside risk to growth.

Judging by the latest forecasts, the economic outlook for 2022 is positive. Real GDP growth should be strong and inflation, whilst staying elevated in the near term, should decline later on in the year[1]. However, this base scenario comes with a high degree of uncertainty. In the US, the members of the FOMC are nearly unanimous in their assessment that uncertainty about growth is higher than the average for the past twenty years (chart 1).[2] With a high level of uncertainty comes the risk that key economic variables evolve differently than anticipated. According to the FOMC, there is an elevated risk of inflation surprising to the upside and a more limited risk of a downside surprise to growth (chart 2).[3] However, a more granular approach is necessary, considering that uncertainty can have many causes, each with its possible implications in terms of growth and inflation surprises.

Exhibit 1 presents several sources of uncertainty, their likelihood of occurrence and the impact on activity.[4] The biggest 'known unknown' concerns the future development of the Covid-19 pandemic. The exponential spread of the Omicron variant and the challenges this raises in terms of vaccination campaigns and vaccine development, imply it is virtually impossible to assess the likelihood that the situation will be brought under control in 2022 or that it might take even more time. In the former case, uncertainty of households and business would drop, triggering an increase in demand – in particular in sectors such as contact-intensive services, which have suffered from restrictions and precautionary spending behaviour –, an acceleration of growth and a further increase of inflation concerns: bottlenecks might intensify due to the pickup in demand. In the opposite case, pandemic-related uncertainty becomes endemic, with further negative effects in the exposed sectors. It might also cause longer-lasting supply disruptions due to health-related absence of staff in production, transport or distribution. The latest ECB staff projections shed light on this by presenting two alternative scenarios, a mild one – with a faster resolution of the pandemic in the course of 2022 – and a severe one, with recurrent pandemic waves, a lower proportion of the population being effectively protected and a health crisis that continues until mid-2023. The model-based simulations show strong near-term growth under the mild scenario but a technical recession and disinflationary pressures under the severe scenario (chart 3 and 4).

Another potential surprise is that inflation declines faster than expected, due to the absence of second round effects and/or the rapid easing of supply pressures[5]. This would reduce the need for central

1. In its latest Economic Outlook, published early December 2021, the OECD forecasts real GDP in 2022 to grow 3.7% in the US and 4.3% in the euro area. Inflation is expected to reach 4.4% in the US (as measured by the personal consumption expenditures (PCE) deflator) and 2.7% in the euro area (HICP). These numbers are annual averages and mask the decline of inflation that is expected to occur in the course of 2022 The latest Survey of Economic Projections of the Federal Reserve –published on 15 December- put US real GDP growth –calculated by comparing the level of real GDP in the fourth quarter of 2022 with that in the fourth quarter of 2021- at 4.0% in 2022 and inflation (PCE deflator) –calculated in a similar way- at 2.6%. With inflation projected to decline in 2022, the FOMC members' projection, by focusing on inflation in the fourth quarter, is very different from the OECD forecast, which concerns the average for the year. The Eurosystem staff projections that were released on 16 December project euro area growth in 2022 at 4.2% and HICP inflation at 3.2%.
2. Source: Federal Reserve, Survey of Economic Projections. This also holds for the uncertainty about the unemployment rate and inflation. In the survey, participants provided responses to the question whether the uncertainty attached to their projection was higher or lower than the level over the past 20 years. The diffusion index shows the difference between the responses 'higher' versus 'lower' divided by the total number of participants, so a score of 100% means that all participants consider uncertainty to be above the long-term average.
3. Source: Federal Reserve, Survey of Economic Projections. The diffusion index represents the difference between the number of participants seeing risk tilted to the upside and those who see risk weighted to the downside, divided by the total number of participants.
4. The overview is non-exhaustive and the scores are purely judgmental.

FOMC MEMBERS' ASSESSMENT OF REAL GDP GROWTH UNCERTAINTY

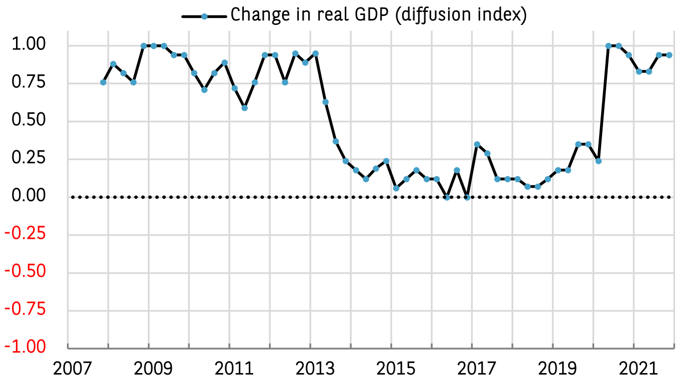

CHART 1 SOURCE: FEDERAL RESERVE, BNP PARIBAS

5. The second round effects refer to the influence of higher wages on prices charged by companies. The flash PMIs for December have shown a slight further shortening of delivery times –albeit from a historically high level- in the US, the euro area and the UK, signaling an easing of supply bottlenecks.

The growth outlook for 2022 is looking good but uncertainty remains elevated. The list of downside risks to growth is longer than that of potential positive surprises.

banks to tighten and fuel a 'risk-on' sentiment. Growth would benefit. However, given the intensity of the price pressures, such a scenario has a rather low likelihood. Inflation is more likely to surprise on the upside. Besides, the list of other downside risks is longer. In addition to endemic uncertainty about the pandemic, supply disruptions might continue, thereby weighing on growth and pushing inflation higher. This last point and the possibility that faster wage growth would cause an increase in sales prices imply that the likelihood of inflation staying elevated for longer is even higher than that of ongoing supply issues. Finally, (the prospect of) several rate hikes in the US might cause a tightening of financial conditions and trigger heightened equity market volatility and a widening of corporate bond spreads, thereby weighing on confidence and growth.

William De Vijlder

SOURCES OF UPSIDE/DOWNSIDE RISK: ASSESSING LIKELIHOOD AND IMPACT

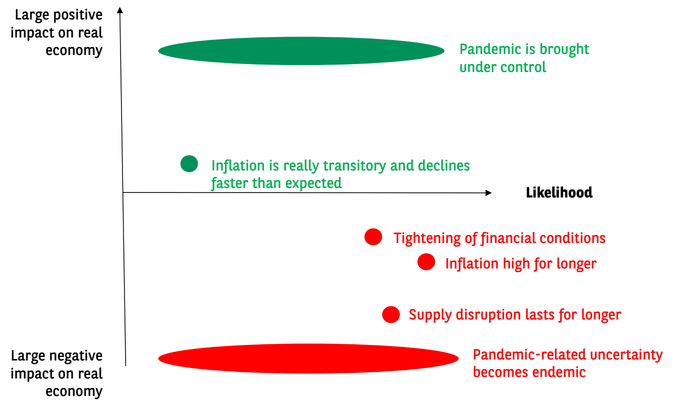

EXHIBIT 1

SOURCE: BNP PARIBAS

FOMC MEMBERS' ASSESSMENT OF GROWTH AND INFLATION RISKS

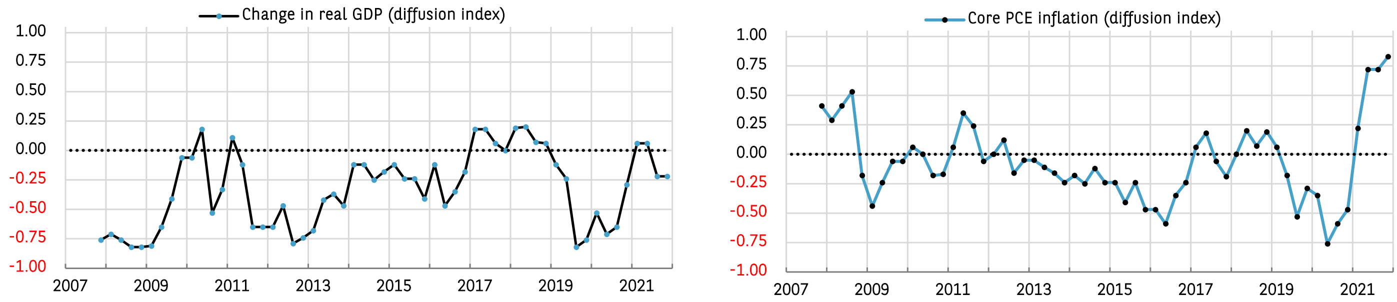

CHART 2

SOURCE: FEDERAL RESERVE, BNP PARIBAS

ALTERNATIVE SCENARIOS FOR EURO AREA REAL GDP

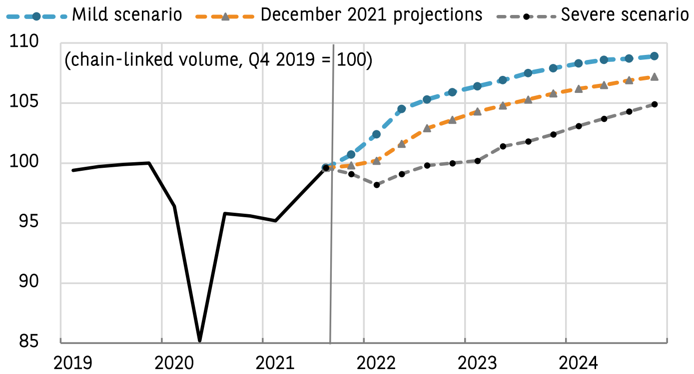

CHART 3

SOURCE: ECB (EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA, DECEMBER 2021), BNP PARIBAS

ALTERNATIVE SCENARIOS FOR EURO AREA HICP INFLATION

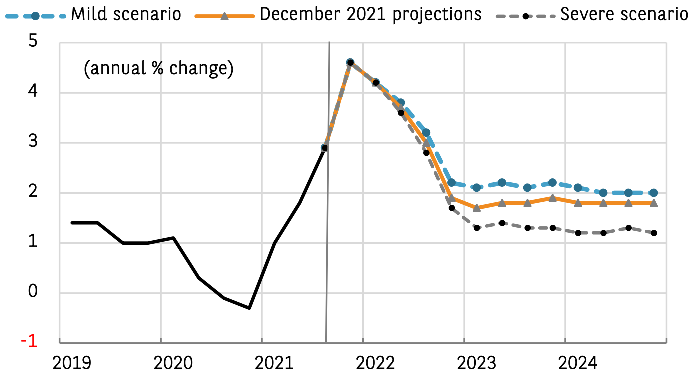

CHART 4

SOURCE: ECB (EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA, DECEMBER 2021), BNP PARIBAS