ECO PERSPECTIVES

4th quarter 2020

EDITORIAL

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ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

EDITORIAL

AFTER THE RECOVERY, THE QUESTIONS

For several weeks now, the improvement in economic data has been slowing down. On the one hand, this loss of momentum is unsurprising as it followed a substantial rebound which could not last. On the other hand, this development could reflect the economic reaction to the rise in the number of new Covid-19 cases in many countries. Furthermore, the level of uncertainty which remains very high, affecting households and businesses, should also play a role. As a result, monetary and especially fiscal policies remain crucial in ensuring that the recovery continues pending the release of a vaccine.

The pace of improvement in economic data is slowing down. This observation can be interpreted in one or two ways. The first is that this loss of momentum is unsurprising, perhaps even inevitable. It follows a substantial rebound which in turn followed a collapse in survey data, economic activity and demand during lockdown. This rebound was mechanical: businesses that had closed, or slowed to a crawl, have been able to start up again since lockdown ended. Consumption has also picked up. This again was a mechanical response. It had fallen because consumers could no longer go to shops and restaurants, rather than because of a lack of cash. Quite the contrary, savings rates rose sharply as a result of lockdown. After such a strong movement, it is only normal that the improvement in the business climate from one month to the next should slow down.

The second interpretation is less reassuring. It is based on the observation that certain survey data have weakened as of late. This is the case for the purchasing managers' index for the services sector. Services are more exposed to the health risk than manufacturing, so this fall could reflect the economic reaction to the rise in the number of new Covid-19 cases in many countries. But this is not the only factor. The outcome of negotiations on the future trading relationship between the UK and EU remains highly uncertain. A no-deal departure would represent a significant additional shock for the UK economy but also for those of its major European trading partners such as Ireland, Germany, the Netherlands and Belgium. In the US, there are growing concerns that the result of the presidential election will be challenged, which could create several weeks of considerable uncertainty for financial markets.

Over and above the effect of these factors that will play a role in the short term, the health situation will remain a key determinant of consumer and business behaviours. New measures to stop the spread of the virus will have not only a direct influence on demand and economic activity, but also an indirect effect as a result of increased caution. For households, forced saving during lockdown has created a substantial reserve of purchasing power. The possible use of this will nevertheless depend on confidence in future prospects, most notably when it comes to the labour market. Although expectations of unemployment in the euro zone have fallen recently, they remain at a high level. In the US meanwhile a number of major companies have recently announced substantial job cuts. Forced saving could thus be transformed into precautionary saving.

For businesses, surveys in Germany and the US show that, unsurprisingly, levels of uncertainty remain very high, albeit lower than they were a few months ago. Given lower profit margins and, for many, increased debt ratios due to the lockdown, company investment plans risk being held back. For these reasons, the Federal Reserve and the ECB have both sent out a very strong message: their policies will remain accommodating for a long period and, if needed, will be relaxed still further. However, as Jerome Powell, Chair of the Federal Reserve, observed, *"…these are lending powers and not spending powers […] a loan that could be difficult to repay might not be the answer."*[1] Fiscal policy will therefore remain crucial in ensuring that the recovery continues pending the release of a vaccine.

EUROZONE: CONSUMER SURVEY, UNEMPLOYMENT EXPECTATIONS

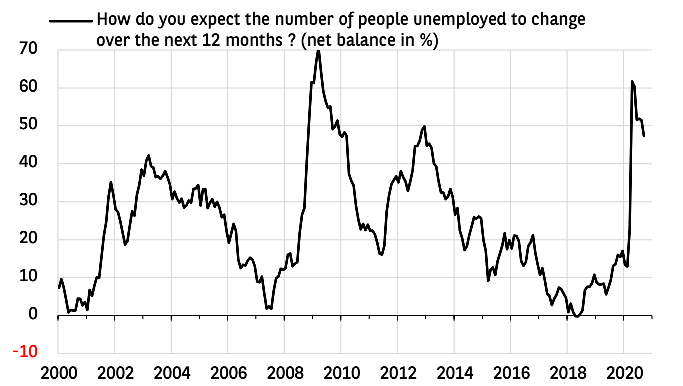

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

IFO DISPERSION - UNCERTAINTY OF GERMAN COMPANIES

CHART 2 SOURCE: IFO , BNP PARIBAS,

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1 Testimony of Jerome H. Powell, Chair of the Federal Reserve Board of Governors before the Committee on Financial Services of the US House of Representatives, 22 September 2020

UNITED STATES

MONETARY EASING, POLITICAL UNEASE

Social distancing and lockdown measures implemented to combat the Covid-19 pandemic severely damaged the US economy in Q2 2020, resulting in a record 9.1% decline in GDP. The ensuing recovery is still incomplete and inequitable, as many of Americans still unemployed because of the pandemic are from low-income categories. The health toll is getting worse, and the United States is the country with the highest number of deaths (nearly 200,000 victims to date). President Donald Trump long played down the disease but must now deal with consequences during the run up to the presidential election on 3 November. Although the incumbent president is lagging in the polls, the election's outcome is still highly uncertain.

The US economy, like nearly every other economy, was partially paralysed in spring 2020 due to lockdown measures introduced to contain the Covid-19 pandemic. US GDP plummeted by an unprecedented 9.1% in Q2 2020 (an annualised rate of 31.7%). Business nonetheless managed to recover thanks to the brief respite offered by the disease and massive support from the Federal government, with transfers of roughly USD 2,200 billion over the past six months, nearly the equivalent of France's GDP[1]. As fall approaches, household and corporate economic surveys have returned to quasi-normal levels. According to estimates by the Atlanta and New York Federal Reserve Banks, GDP rebounded between 6% and 7% in the third quarter.

AN INCOMPLETE AND INEQUITABLE RECOVERY

That leaves a shortfall of 4-5 percentage points of GDP relative to 2019 levels, which is less than in Europe but still a considerable gap to close. Whereas unemployment figures need to be approached with caution (see box), job statistics probably paint the most realistic picture of the severity of the shock. Available through August, it shows that only half of the 22 million jobs destroyed between March and April have been restored. Although it cannot be compared with the 2008 financial crisis, the Covid-19 pandemic has had similarly profound and inequitable repercussions on the labour market.

Two thirds of the job losses reported since February have hit unskilled and low-income populations. This is also where we find the highest concentration of people experiencing difficulties enrolling in the unemployment insurance system[2]. As a result, numerous low-income Americans have been excluded from the labour force. Data from the Bureau of Labor Statistics (BLS) shows an historic decline in the participation rate for adults without a diploma[3], and this decline cannot be seen in the rest of the population, at least not to the same extent. Since February, nearly 4 million people have already left the labour market (see chart), and this exodus from the radar screen can have unexpected effects on certain macroeconomic variables. This is the case for hourly wages, for example, where the buoyant rise recently (+6.6% year-on-year in Q2) is due less to the enrichment of American workers than to a reduction in working hours and to the underrepresentation of the poorest categories[4]. There are no inflationary pressures, to the contrary: increasingly fierce competition and the need to slash inventory have tended to pull down consumer prices in recent months[5].

The recovery is also unequal not only by population but also by sector. Unsurprisingly, the sectors that have preserved or returned to quasi-normal levels of business and employment are those with a large domestic footprint (residential construction, utilities, food retailing etc.), or specifically requested during the crisis (computer equipment, financial services, telecommunications, etc.). In contrast, the situation is still very difficult in sectors that depend on international trade and/or imply large crowds or physical contact. Hotel and food services,

GROWTH AND INFLATION (%)

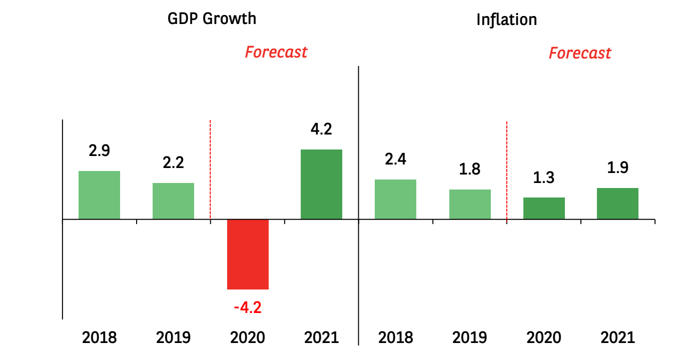

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

ACTIVE POPULATION WITHOUT A COLLEGE DIPLOMA

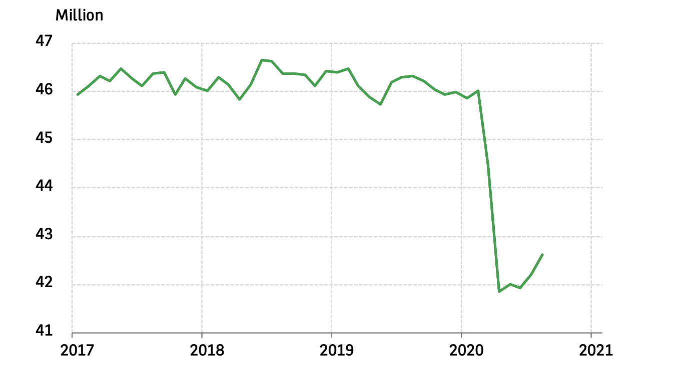

CHART 2

SOURCE: BUREAU OF LABOR STATISTICS

1 Committee for a Responsible Federal Budget (2020), USD2.2 of USD4 Trillion in Fiscal Relief is Out of the Door, September.
2 According to estimates by One Fair Wage, a large percentage (44%) of hotel and food service employees who lost their jobs during the pandemic did not have unemployment insurance in May 2020. See CNBC, 2020, "Study finds 44% of US unemployment applicants have been denied or are still waiting", May 15.
3 Adults in the 25 and over age group, without a college degree or only a high school diploma.
4 The Washington Post, 2020, "The awful reason wages appeared to soar in the middle of a pandemic", May 15.
5 Food, energy and used car prices are notoriously volatile in the United States. To better understand inflationary trends, the BLS proposes a "core" price index for goods that excludes these three components. Although core inflation rebounded a little in August, it is still on a downward trend: -1.3% at an annualised rate over the six months prior to the latest reckoning.

leisure and the performing arts, transport industries and services, and clothing together account for 15% of total US employment, but about half of the job losses since February.

MONETARY EASING, POLITICAL UNEASE

A full recovery should not be expected soon. Most countries are experiencing resurgence in Covid-19 cases and international trade is far from showing a return to normal. Aware of difficulties, the Fed has embarked on a policy shift. At the Jackson Hole Symposium in late August, Fed chairman Jerome Powell unveiled new longer-term monetary policy targets and strategy that seem to herald in a system of unlimited monetary easing. The inflation target is still set at 2%, but will now be assessed *"over time"*, a manner of indicating greater tolerance of overshoots. The job mandate will become asymmetric. It aims explicitly to eliminate any shortfalls, but will no longer attenuate any labour market tensions, a decision that de facto disqualifies the Taylor Rule.

Presented as the end of a long process of disinflation and the lowering of the neutral rate, this new strategy is also shaped by exceptional circumstances which require the Fed to monetise considerable quantities of public debt. In counterpart, the Fed is creating an unprecedented amount of central bank liquidity, which risks feeding asset bubbles (see chart). Another inconvenience is a loss of precision in forward guidance. In the end, assuming the situation will return to better fortunes, it is hard to see what might trigger a change of course. Monetary policy committee members have just updated their macroeconomic projections, and they do not foresee any rate increases before 2024.

That year will also mark the end of the 4-year term of the next US president. Who the winner will be is still an open question, and one that risks dominating the headlines well beyond Election Day on 3 November. The most likely winner, at least theoretically, is the Democrat Joe Biden, who has a significant and stable lead in the national polls (50% of voting intentions, compared to 43% for the incumbent Republican, Donald Trump). Yet the results will hinge on a few swing states (which could swing to one candidate or the other). Under the "winner takes all" principle, the candidate that receives the most votes in a state will receive all of that state's electoral college votes, which are the only votes that count when electing the president. A candidate who receives the most popular votes can still lose the election, as was the case with Hillary Clinton, who had nearly 3 million more popular votes than her rival Donald Trump.

If the results are tight, they are bound to be contested by one of the two parties, a scenario that Donald Trump has already espoused. Mail-in ballots lie at the heart of the upcoming battle: though welcomed in the midst of a health crisis, they risk slowing down the vote counting process. Donald Trump also sees them as a source of fraud, without which his victory is basically assured[6]. If he fails to win the presidential election on 3 November, the current occupant of the White House may well be reluctant to concede.

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THE DIFFICULTY OF MEASURING UNEMPLOYMENT

Like in almost all business sectors, the production of macroeconomic data was disrupted during the Covid-19 pandemic. Establishing price indices or unemployment figures, to cite but two, implies field surveys that could not be carried out normally. Concerning the collection of unemployment data, which is collected directly through individuals, the BLS said it had proceeded by using telephone interviews almost exclusively, resulting in a much lower response rate than normal (70% in August, compared to 83% normally). Not only is the margin of error higher, the results could underestimate the unemployment rate (8.5% in August, but in reality, more than 9%), since many respondents said they were employed even though that had not worked during the reference period. A priori, employment data collected directly from companies should be more reliable, if for no other reason than the response rate is higher (77%, close to the pre-crisis average).

SOURCE: BUREAU OF LABOR STATISTICS

MAGIC MONEY

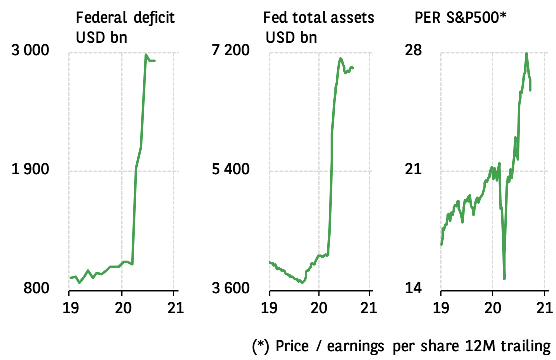

CHART 3
SOURCE: FED, STANDARD & POOR'S

6 "The only way we are going to lose this election is if it is rigged [...] That is the only way we can lose this election, so we have to be very vigilant." D. J. Trump, Wisconsin speech, 18 August 2020.

CHINA

HOUSEHOLDS ARE STILL WORRIED

The economy continues to recover. Initially driven by a rebound in industrial production and investment, the recovery broadened over the summer months. Exports have rebounded and activity has also picked up in the services sector. Yet it continues to be strained by the timid rebound in household consumption, which is far from returning to normal levels. The unemployment rate began to fall right again after the end of lockdown measures, but this decline has been accompanied by an increase in precarious jobs and large disparities, with the unskilled and young college graduates being particularly hard hit.

Whereas the economic recovery since March has been initially driven by the rebound in industrial production and investment in public infrastructure and real estate, there has been a more widespread strengthening in activity since the summer. Exports have posted a solid rebound and growth in the services sector has gained momentum. Although private consumption has shown some signs of recovering, households remain very cautious. In the months ahead, whether the economic recovery consolidates will depend largely on the authorities' stimulus policy as well as on export performance and labour market trends.

A BROADER RECOVERY

Industrial production has continued to strengthen, rising 5.6% year-on-year (y/y) in August in volume terms (+3.6% in value), up from 4.8% in June and July. In the first eight months of 2020, industrial production slightly exceeded the level reached in the same period in 2019 (+0.4%). Activity seems to have returned to normal in a large number of industrial sectors. Yet many corporates still remain severely weakened following the losses reported in Q1 2020. Although profits of industrial enterprises have rebounded over the past four months, they were still 8% lower in January-July 2020 than in the same period in 2019. In the services sector, activity has continued to pick up slowly (+4% y/y in August, vs 3.5% in July and 2.3% in June). After a more drastic downturn than in industry during the Q1 lockdown, the recovery since March has proved to be slower.

On the demand side, the rebound continues to be fuelled by domestic investment. In the first eight months of 2020, investment was only 0.3% below the level reached in the same period in 2019. It remains driven by new projects in public infrastructure and real estate. Manufacturing investment also rebounded in August; yet, in the first eight months of 2020, it was still 8.1% below the level reached in the same period in 2019. In the short term, investment in infrastructure should remain dynamic, bolstered by a still expansionist fiscal policy stance. In contrast, monetary policy is expected to be less supportive, which should contribute to slower growth in real estate investment. In the manufacturing sector, the rebound in investment should gain momentum if corporate profits continue to improve and export performance remains solid. Even so, corporates will probably maintain a cautious approach, due to possible financial difficulties and because uncertainty over the recovery in world demand and US-China tensions continue to strain export prospects.

After declining rather moderately over the period March-June, merchandise exports rebounded by 7.3% y/y (in USD) in July and 9.5% in August (Chart 2). This strong performance is mainly due to high demand for medical devices and equipment and technological goods, as well as to China's advantageous position in the Covid-19 crisis: as the first country to reopen after the lockdown and to start up production, it has been able to respond rapidly to demand from its trading partners as soon as it began to rebound. As a result, China has managed to increase its share of global exports (to about 14% in H1 2020 from 13.3% in 2019). As total import value has declined (volumes have increased but price effects have remained negative), the trade surplus has grown in recent months.

GROWTH AND INFLATION (%)

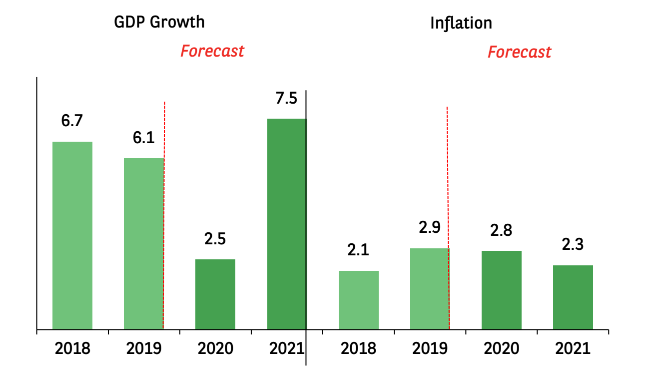

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A STEADY EXPORT REBOUND

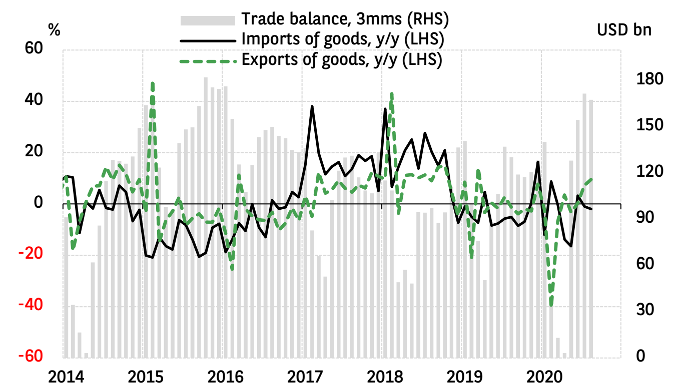

CHART 2 SOURCE: GENERAL ADMINISTRATION OF CUSTOMS

China is far from reaching the level of purchases of US goods stipulated in the Phase 1 trade agreement signed with Washington earlier this year (imports in the first seven months of 2020 would have accounted for a little less than half of the target for the period according to estimates by the Peterson Institute for International Economics), but neither party is presently calling the trade deal into question.

PRIVATE CONSUMPTION IS STILL RESERVED

Private consumption has shown signs of recovery but still seems far from returning to normal. In value terms, retail sales reported slightly positive growth in August (+0.5% y/y) for the first time this year, but they were still down 1.1% in volume terms. In the first eight months of 2020, retail sales were still well below their 2019 level (-8.6% y/y). E-commerce has continued to make inroads. The amount of online retail sales of goods increased 16% y/y in August, and accounted for 36% of retail sales in H1 2020, vs 25% in 2019. Evidently, households are still worried. Consumer confidence indexes began to recover in July, after plummeting throughout the first half, but they are still holding below 2018-19 levels. This mistrust can be attributed principally to health risks and labour market trends.

THE CRISIS LEAVES ITS MARK ON THE LABOUR MARKET

The main official unemployment rate (based on people registered at the local employment service agencies) has not increased much, rising from 3.62% in Q4 2019 to 3.84% in Q2 2020 (equivalent to 10.1 million individuals). The unemployment rate estimated by the National Bureau of Statistics (NBS) based on survey data is considered to be more exhaustive; it increased more sharply from 5.3% in December 2019 to 6.2% in February (Chart 3). It has fallen again since March (to 5.6% in August) but remains higher than the pre-crisis unemployment rates.

However, these official unemployment rates largely underestimate the shock that has hit the population. First, the scope of calculation is limited since: 1) it only takes into account the urban labour market, and 2) it excludes a large number of migrant workers who lost their jobs in urban areas during the lockdown, many of whom returned to their rural residence. According to the most common estimates, at least 80 million individuals throughout the country had lost their jobs at the end of February (out of 775 million jobs in 2019, of which 291 million were held by migrant workers).

The labour market began to improve as of March as the unemployment rate fell and migrant workers began to return to urban areas. However, the situation remains very difficult for certain categories of individuals. Average unemployment rates mask high disparities, with the unskilled and recent college graduates being hit hardest. In 2020, 8.7 million young college graduates must enter the labour market, mostly during the summer. As a result, the unemployment rate for the 20-24 age group continued to rise in August according to the NBS (it would be close to 20%). The government is particularly alarmed by this situation and has asked local governments and state-owned enterprises to strongly step up their hiring this year. Lastly, the downturn in the job market is also illustrated by the significant rise in precarious jobs (part-time work, self-employed, online retailers...) which is partially encouraged by the authorities.

As a result of these dynamics, the average disposable income per capita declined by 1.3% y/y in real terms in H1 2020 (the 3.9% contraction in Q1 was followed by a slight rebound in Q2). This trend has resulted from the decline in real wages and the collapse in net business income (for self-employed). The loss of earned income has strained private consumption even more since it has mainly affected low-income households, and has not been offset much by an increase in social welfare benefits. The authorities have introduced a few measures to directly support households, but yet their stimulus plan has focused primarily on programmes to support corporates and public investment.

OFFICIAL UNEMPLOYMENT RATES UNDERESTIMATE THE Q1 SHOCK

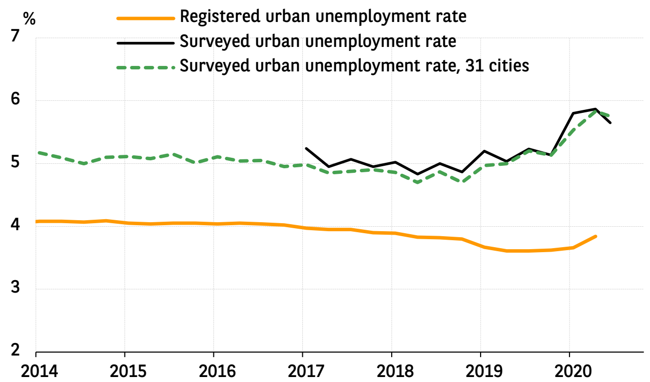

CHART 3

SOURCE: MINISTRY OF HUMAN RESOURCES AND SOCIAL SECURITY, NBS

The improvement in labour market conditions, observed as soon as lockdown restrictions were lifted, could continue in the short term thanks to public-sector construction projects and most importantly if export performance remains strong, thus supporting activity in the manufacturing sector. This is still uncertain, however, as it will depend on external conditions. At a time when the squeeze on household income could continue to be felt for some time to come, the strengthening in China's social welfare system increasingly appears to be necessary to stimulate private consumption in the short and the medium terms.

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ECONOMIC POLICY CONTINUITY

It will take a long time for Japan to erase the economic shock of the Covid-19 pandemic. Even though lockdown measures were less restrictive than in other countries, Japanese GDP is poised for a record contraction in 2020. The expected rebound could be mild. Household confidence and business activity indicators have stagnated, sending mixed signals about the strength of domestic demand. The Covid crisis is bound to accentuate the weaknesses of the Japanese economy: sluggish growth, low inflation and record-high public debt. Prime Minister Shinzo Abe's resignation is unlikely to lead to any major policy changes as Japan continues to pursue expansionist economic policies.

The Japanese economy experienced a historic contraction of GDP in Q2 2020 (-7.9% q/q), the third consecutive quarterly decline (-0.6% in Q1 2020 and -1.8% in Q4 2019). The lag created by the Covid-19 crisis will not have been closed by the end of our forecast horizon.

ANOTHER TOUGH YEAR ON THE ECONOMIC FRONT

Even though lockdown measures were less restrictive than in other regions of the world, especially compared to Europe, Japan was not spared the economic shock of the Covid-19 pandemic. Real GDP temporarily plummeted to mid-2011 levels, prior to the launch of Abenomics. Prime Minister Shinzo Abe's recent resignation is not expected to significantly change the economic policy trajectory (see below). Hard hit by private consumption and corporate investment, Q2 2020 GDP contracted by 7.9% q/q. Moreover, the expected catching-up effect in Q3 2020 and beyond risks being relatively mild.

Indeed, the latest cyclical indicators suggest that the economic recovery is losing momentum. According to the Bank of Japan's Tankan indicator, business activity deteriorated sharply in the manufacturing and non-manufacturing sectors in Q2 2020 (Q3 statistics were not available yet when this article was written). More recently, after rebounding strongly, the composite Purchasing Managers Index (PMI) levelled off in August at 45.2, far below the 50 threshold separating expansion from contraction. In the manufacturing sector, which accounts for more than 20% of GDP, activity continues to improve (47.2 in August after 45.2 in July). Business in the services sector has stalled, in contrast, and continues to be undermined by lacklustre household spending. Retail sales are still trending downwards (-1.9 % year-on-year in August, after -2.9% in July). The latest figures on household confidence did not alleviate concerns about private consumption: after picking up briefly, confidence seems to have stagnated below its level at the beginning of the year. Moreover, Japanese exports, which tend to be dominated by high value-added products, could be further strained by sluggish external demand, notably in the machinery and transport equipment segment. Lastly, the Haishen typhoon that swept the country in early September could place another squeeze on demand, notably in terms of corporate investment.

POLICIES CONTINUITY AFTER SHINZO ABE'S RESIGNATION

Yoshihide Suga was named Prime Minister to replace Shinzo Abe, but this is unlikely to lead to any major economic policy changes. According to preliminary information at our disposal, Mr. Suga is expected to provide continuity with "Abenomics" and the three "arrows" of Mr. Abe's programme: a very accommodating monetary policy, abundant public spending, and structural reforms.

GROWTH AND INFLATION (%)

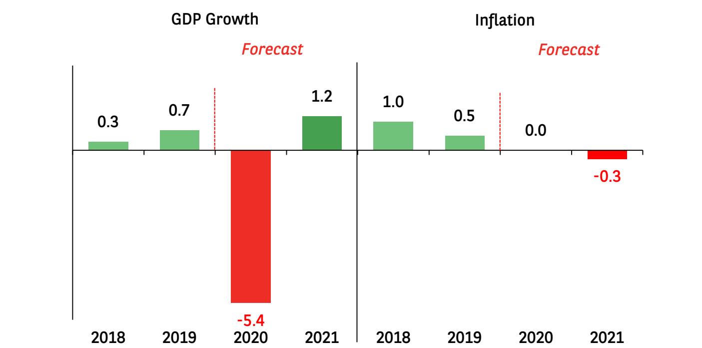

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

REAL GDP (BILLION YEN, ANNUALIZED)

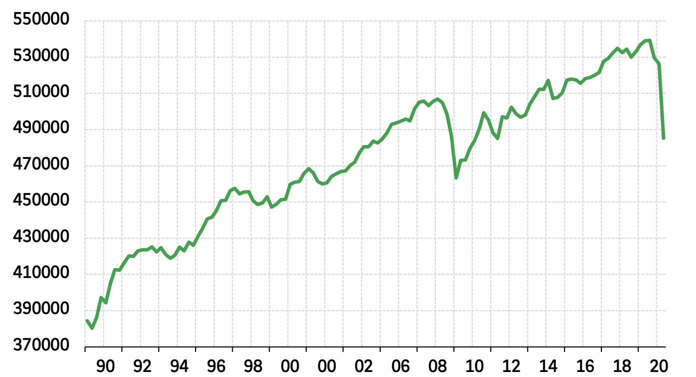

CHART 2 SOURCE: CABINET OFFICE

The new Prime Minister underscored how fiscal support was more important than ever to turnaround the Japanese economy during these times of crisis. Getting a grip on public debt -which will exceed 250% of GDP in 2020[1]- does not seem to be a priority.

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1 Fiscal Monitor: Chapter 1 – Policies to support people during the Covid-19 pandemic, IMF, April 2020

EUROZONE RECOVERY: RUNNING OUT OF BREATH

After a more vigorous than expected recovery following the end of lockdown, the trend now seems less energetic. There is still lost ground to make up and the end of the year, beset by uncertainty on the health and economic fronts, is likely to see a marked decline of growth. In our central scenario, there is no return to pre-crisis GDP level before the forecast horizon at the end of 2021. Coupled with this, deflationary pressures are building, and the strengthening of the euro intensifies this dynamic. So far the European Central Bank has been patient, but has indicated its willingness to take new measures. If the current situation persists, an extension of emergency monetary measures, in terms of both size and duration, looks likely.

The economic recovery in the eurozone appears to be running out of breath. After an historic contraction in Q2 2020, and a mechanical rebound in Q3, economic activity is likely to slow significantly over the next few quarters. Recent inflation movements are a source of concern for monetary policy makers.

THE GAP HAS NOT YET CLOSED

The recent stabilisation of economic indicators sends a mixed signal. Following the lifting of lockdown measures, economic activity bounced back strongly but has since stabilised. The composite Purchasing Managers Index (PMI)[1] for the eurozone slipped back from 54.9 in July to 51.9 in August. Activity keeps growing continues at a slower pace than in previous months. A similar picture emerges in services, where the PMI fell from 54 in July to 50.5 in August. In manufacturing, the PMI stabilised at 51.7 in August. The services sector continues to suffer from cautious consumer behaviour. Services, which account for a majority of household expenditure (more than 50% of the total in the eurozone)[2], have suffered in particular from a lack of consumer confidence in the region. The consumer confidence index has seen no further improvement since June and remains below its levels in the months leading up to lockdown (-14.7 in August, from -11.6 in March and -6.6 in February). This observation can be observed in retail sales dynamic. Although retail sales figures are an incomplete record of final household consumption, they suffered a sharp fall since when they have posted only a timid recovery. They grew by only 1.3% in June (year-on-year), and then slowed to +0.4% in July.

In all, we expect eurozone GDP growth to bounce back to 9.0% q/q in Q3 2020, having fallen by 12.1% in Q2 2020, before slowing markedly, to 1.5%, in Q4. Growth is likely to average -8.0% over the whole year 2020, before rebounding to 5.2% in 2021. These trends will not allow the economy to return to pre-crisis levels within our forecast horizon (Figure 2). Significant differences exist between individual eurozone countries. The differences in speed of recovery weigh on the performance of each country given the zone's integration, notably in terms of trade. High level of uncertainty surrounds the macroeconomic scenario, in particular caused by the resurgence of the epidemic in some eurozone countries. According to ECB estimates, under a pessimistic scenario (a big second wave of the epidemic and enhanced protective health measures), real eurozone GDP at the end of 2022 would still be nearly 6% below its pre-crisis level.

INFLATION HEADACHES

In this macroeconomic situation that remains depressed and uncertain, deflationary pressures are mounting. In August, total eurozone inflation fell into negative territory, at -0.2% y/y, for the first time since mid-2016. Underlying inflation[3] fell back considerably, hitting a record low of +0.4%. In more detail, the sharpest decline in prices since the beginning of 2020 has come in the transport sector, which is hardly affected by the abrupt fall-off in tourist numbers since the beginning of the pandemic. Inflation figures for recent months should be treated with some caution. Some of the slowing of prices comes in shifts in

GROWTH AND INFLATION (%)

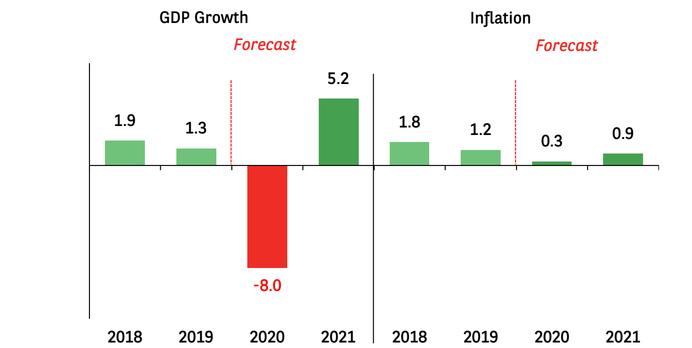

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

REAL GDP GROWTH

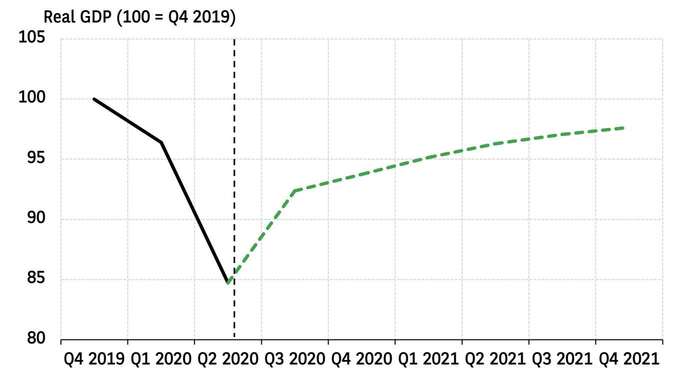

CHART 2

SOURCE: AMECO, BNP PARIBAS

1 The PMI is based on data from a survey of business leaders. The survey offers a reliable picture of the economic health of various sectors of the economy (manufacturing, services, construction). Phases of contraction and expansion lie either side of the 50 point threshold.
2 B. Cœuré, "The rise of services and the transmission of monetary policy", Speech at the Conference on the World Economy, May 2019
3 Underlying inflation is corrected for volatile components (energy and food) as well as alcohol and tobacco.

timing of the sales season in certain eurozone countries (France for nstance), as well as the VAT cut in Germany as part of its economic stimulus package. Although it is probably still too early to talk about deflation[4], these are nevertheless striking figures that put the ECB in a tricky position.

The negative demand shock triggered by the Covid-19 crisis has hit price trends. This movement has been amplified by the strengthening of the euro against the dollar and also against a trade-weighted basket of currencies for the eurozone (nominal effective exchange rate). This stronger currency reduces imported inflation which, ultimately, reduces domestic inflation. Although the effect of currency movements, particularly when on a small scale, is less pronounced than in the past, the situation is nevertheless being followed closely by the monetary authorities. In addition, recent moves by the US Federal Reserve (Fed) could result in changes at other central banks. The Fed has modified its inflation target, and is now aiming at an average figure of 2%. As a result, no increase in US rates is expected in the near future. The Fed has introduced a fairly accommodating bias into its policy, creating structural support for the euro against the dollar. The ECB, which has itself launched a strategic review, will need to take this into account.

At its quarterly meeting in September 2020, the ECB, through its President, Christine Lagarde, indicated that the currency issue is important, but did not make any immediate changes to its monetary policy. The current high level of uncertainty, the increasingly anaemic-looking recovery and a tightening of financial conditions as a result of the euro's continued appreciation could lead the ECB to extend its Pandemic Emergency Purchase Programme (PEPP) beyond June 2021 and to increase its total envelope, currently set at EUR 1.350 billion. It seems clear from the ECB's blog that the monetary institution is ready to do more. A recent post from its Chief Economist, Philip Lane, said: "It should be abundantly clear that there is no room for complacency. Inflation remains far below the aim and there has been only partial progress in combating the negative impact of the pandemic on projected inflation dynamics".

National stimulus programmes will form another key pillar in the recovery. The risk of defaults and rising unemployment over the coming months is particularly high. On a European scale, the agreement reached regarding the "Next Generation EU" stimulus plan is a key stage and the thorny question of its financing is as urgent as ever. In their votes on 16 September 2020, MEPs recognised the need to introduce new sources of revenue into the EU's budget (own resources). These new taxes, targeting digital businesses for example, could, however, be a new source of conflict between member states.

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PURCHASE MANAGERS INDEXES

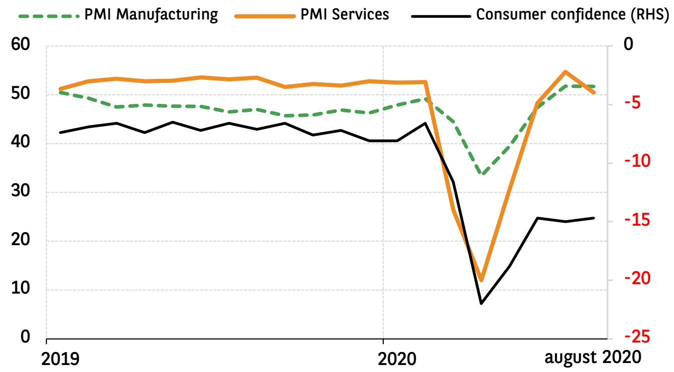

CHART 3 SOURCE: MARKIT, EUROPEAN COMMISSION

INFLATION

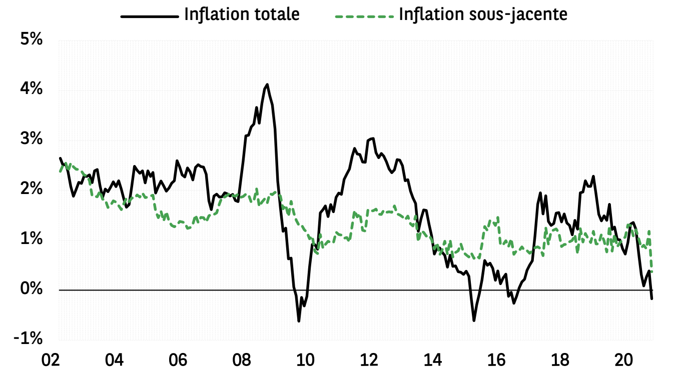

CHART 4 SOURCE: MARKIT, BNP PARIBAS

4 Deflation is defined as a permanent and widespread process of falling prices. A situation where only certain prices fall is not considered to be deflation.

GERMANY

AFTER THE VIRUS, THE THREAT OF ZOMBIES

A strong rebound is expected in Q3 (7.2%) following the progressive lifting of restrictions. Nevertheless, the recovery is likely to remain slow and bumpy at times, at least until there is a Covid-19 vaccine or a better treatment. Thanks to the widespread use of furlough, the labour market has held up reasonably well. However, the scheme may also have been delaying a necessary restructuring, which could weigh on the long-term performance of the economy. The huge increase in public spending to ease the economic consequences of the virus have forced the authorities to activate the debt brake exemption clause. The excess debt will be repaid over 20 years starting in 2023.

A REBOUND, BUT NOT IN ALL SECTORS

The lockdown measures to contain the coronavirus resulted in a sharp drop in activity in Q2 in Europe. In Germany, GDP contracted by 9.7%, which compared reasonably well with the rest of the Eurozone (-12.6%). An important reason for this was that the lockdown measures were less strict in Germany, as the authorities succeeded in limiting the spreading of the virus by widespread testing.

Starting at the end of April, lockdown measures have been progressively lifted resulting in a rebound in activity. After having reached a trough in April (74.4), the ifo business climate index gradually improved in the following months and reached 93.4 in September (2015=100). Nevertheless, activity has remained well below pre-crisis levels. In July, manufacturing production strengthened by 0.3% on the previous month, the third consecutive improvement, but was 12% lower from a year.

The sector most affected by the pandemic was services, as social distancing requirements made it difficult to resume activity. Retail sales rebounded strongly after April. In July, sales were 5.6% higher than a year ago. By contrast, the hospitality sector continued to suffer. Despite the strong rebound in turnover in accommodation and food in July (22% from a month earlier), it was still 27% lower compared to last year. Overall, the economy is likely to have rebounded strongly in Q3, by 7.2% (to be announced end October).

FURLOUGH MAY DELAY RESTRUCTURING

Despite the collapse in output in Q2, the labour market held up reasonably well. The unemployment rate (ILO definition) inched up to 4.4% in July compared with 3.8% in March. The main reason for this subdued reaction is the widespread use of furlough (*Kurzarbeit*). Ifo estimates that in August, the number of *Kurzarbeiter* fell by one million to 4.6 mn, i.e. 14% of socially insured employment. The decline was mainly due to the trade and the hospitality sectors. Nevertheless, in the hospitality sector still 34% of the employees are on furlough.

The advantage of *Kurzarbeit* is that firms would not lose skills during the crisis. Once demand picks up, staff is available again immediately. However, this argument sounds less convincing the longer the crisis lasts. Moreover, *Kurzarbeit* does not only benefit dynamic sectors that are only suffering a temporary decline in activity. It also benefits sectors such as the embattled car and metal industries, and postpones their necessary restructuring. Furthermore, *Kurzarbeit* is also widely used in the hospitality sector. In this case, the scheme is not aimed at protecting skilled labour and technologically advanced firms but serves a social objective.

Recently, the government decided to keep *Kurzarbeit* in place at least until the end of 2021. The decision was probably politically motivated, as the general election is to take place in autumn 2021. In the same vein, the coalition parties CDU/CSU and SPD have agreed to extend a freeze on insolvency rules put in place to avoid a wave of corporate bankruptcies due to the coronavirus crisis. The freeze would have been ended in September. A new date to end the scheme has not been set yet. The danger is that the very low interest rate environment in combination with these policies could create conditions, which are very conducive to the creation of zombie companies[1]. Zombies can weigh on the economic performance because they are less productive and their presence lowers investment and employment at more productive firms.

GROWTH AND INFLATION (%)

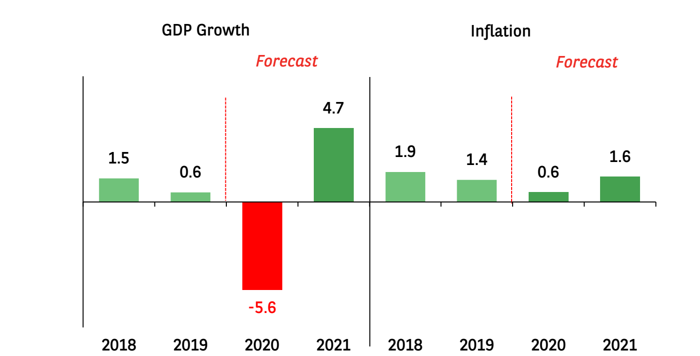

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

IFO CLIMATE INDEX SIGNALS UPTURN

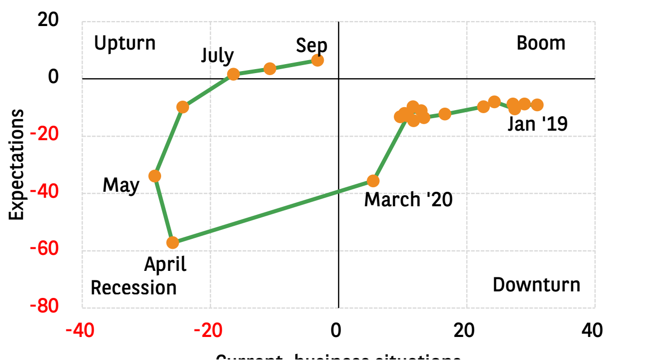

CHART 2

SOURCE: IFO, BNP PARIBAS

1 Zombie companies are firms that are unable to cover debt servicing from current profits over an extended period.

DEBT BRAKE TEMPORARY OUT OF ORDER

The pandemic has not only led to a historic output slump, but also to a record budget deficit, which could reach 7% of GDP in 2020. One third of the deficit is related to the automatic stabilisers, such as disappointing tax receipts and higher social expenditure due to the shrinking of the economy. The rest is due to two special packages introduced by the government in March and June.

The first package, worth EUR 750 billion, included fiscal measures to support the healthcare system and mitigate the economic impact of the lockdown measures on enterprises and households. This was followed in June by a comprehensive stimulus programme worth EUR 130 billion that did not only have demand measures, but also included measures to strengthen future growth and sustainability. These packages in total will increase the deficit by 5% of GDP.

The debt ratio is set to climb from 60% end 2019 to 75% end 2020. The exceptional circumstance forced the authorities to activate the debt brake exemption clause. The excess debt will be repaid over 20 years starting in 2023.

A BUMPY RECOVERY

Even though the economy is showing clear signs of rebounding, the recovery is likely to remain slow and bumpy at times, at least until there is a Covid-19 vaccine or better treatments. GDP is projected to rebound by 4.7% next year after the 5.6% contraction in 2020.

On the demand side of the economy, the current boom in retail spending is likely to fizzle out quickly if consumers remain wary about the virus. Moreover, the deterioration of the employment outlook is likely to lead to an increase in precautionary savings. Hence, the saving ratio might remain at a relatively high level. Finally, consumers might bring forward their purchases before the end of December ahead of the end of the temporary VAT cut. In addition, investment could remain sluggish due to squeezed profit margins, as companies may find it difficult to recuperate the Covid-19 related costs in sales prices.

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THE FALL IN THE OPERATING SURPLUS WILL WEIGH ON INVESTMENT

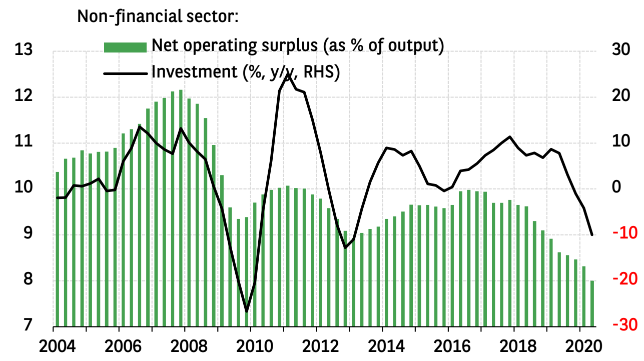


CHART 3

4-QUARTER MOVING AVERAGE
SOURCE: DESTATIS, BNP PARIBAS

FROM FAST, THE RETURN TO NORMAL IS BECOMING MORE ASYMPTOTIC

After a rapid restart in May and June, the economy was back to 95% of its normal level in August. However, the improvement is now slowing as the automatic catch-up effects fall away and as substantial disparities between sectors and persistent public health constraints and uncertainties remain in play. Even so, Q3 is expected to see a substantial rebound (of around 15% q/q). It will be in Q4 that growth is likely to fall back like a soufflé. This period will determine the next chapter in the recovery. Hence the significance of the stimulus package in its double role of softening the blow from the crisis and boosting the recovery now under way. We estimate that this package will add 0.6 of a point to growth in 2021, taking it to 6.9%, after a contraction of 9.8% in 2020.

AFTER THE GREAT CONTRACTION, A GREAT BUT TEMPORARY REBOUND

According to INSEE's second estimate, French GDP plunged by 13.8% q/q in Q2 2020, coming on top of the 5.9% q/q drop in Q1. The Q2 GDP contraction was slightly smaller than initial estimates from INSEE (-20% q/q) and the Banque de France (-15% q/q); these estimates were subsequently revised to -17% and -14% respectively. Matching, but amplifying, the pattern of the first quarter, all components of GDP saw substantial falls. In ascending order (by the size of the fall), public consumption was "least" affected (-10.3% q/q)[1], followed by private consumption (-11.8%), corporate investment (-13.4%), imports (-16.4%), household investment (-17.1%), public investment (-17.4%) and, hardest hit of all, exports (-25% q/q). The highly positive contribution from changes in inventories (+0.9 of a percentage point) went a little way to limiting the overall collapse.

We would also note, in the detailed figures for Q2, the very limited fall in gross disposable household income (-2.3% q/q, from -0.3% q/q in Q1), the ensuing increase in the household savings rate of nearly 8 points (to 27.4%, building on a gain of 5 points in Q1) and the marked deterioration of corporate mark-ups (-3 points, to 26%, in Q2, having already lost 4 points in Q1). The question now is at what speed these indicators will return to their pre-crisis levels (15% for the savings rate and 33% for margins) and the scale of the support (unblocking of forced savings) or drag (rebuilding margins) that GDP growth will experience as a result.

The slightly smaller than expected contraction of the economy in Q2 resulted from the strength of the economic rebound since lockdown ended on 11 May. This has been visible in the recovery of survey data on the business climate (the INSEE composite index gained 38 points between May and August, whilst the Markit PMI was up 46 points between May and July), consumer spending on goods, and industrial production (which gained 50% and 41% respectively between April and July).

However, the recovery is still incomplete. Both INSEE and the Banque de France estimate that in August the economy was around 95% of its normal level. In August, INSEE's composite business climate index was still 9 points below its reference level of 100. Consumption of goods has bounced back to above its pre-crisis levels, but consumption of services remains depressed, leaving total consumption at 2% below pre-crisis levels according to INSEE. Industrial production is still 7% below its February 2020 level. Moreover, the improvement is now slowing as the automatic catch-up effects fall away whilst persistent public health constraints and uncertainties remain in play. According to INSEE, the economy was running at 82% of its normal level in May, a 12-points gain on the low point in April (which marked the activity trough). In June the increase was 9 points, in July 3 points and in August 1 point. August's 6-point fall in the composite PMI, to 51.6, marked a return to a less optimistic reality too.

The economic recovery is also being held back by significant disparities between sectors, which are affecting in return employment prospects. The hardest hit sectors (those where activity in Q3 2020 is 5% or more below Q4 2019 levels) account for around 40% of total employment (see Chart 2).

GROWTH AND INFLATION (%)

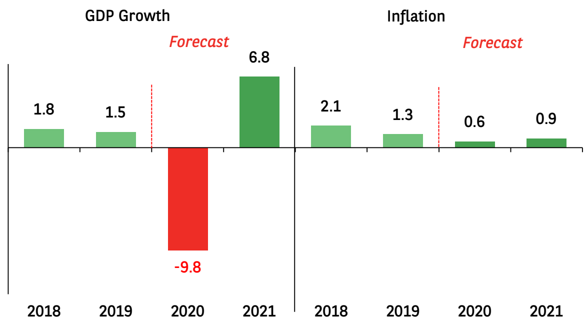


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

SECTOR DISPARITIES

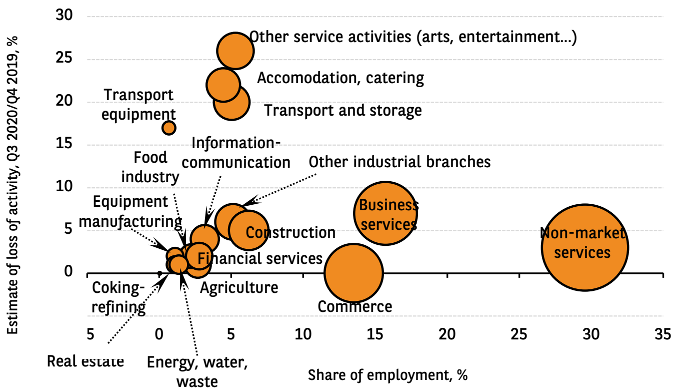
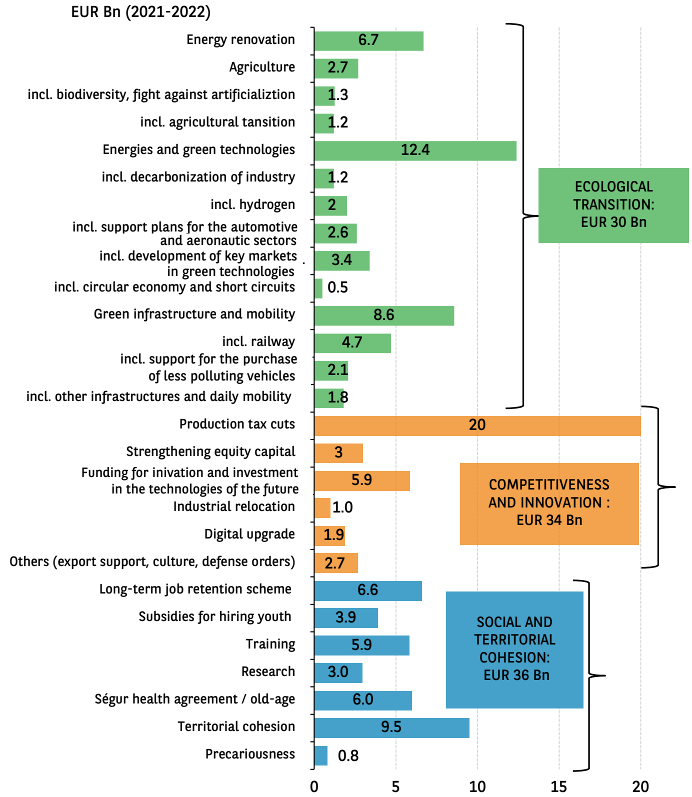


CHART 2 SOURCE: INSEE (8 SEPTEMBER ESTIMATES), BNP PARIBAS

1 See INSEE for the methodological reasons behind this fall.

There will nevertheless be a sizeable automatic rebound in Q3 activity (the INSEE expects a growth rate of 17% q/q, the Banque de France 16% and ourselves 13%). But what is clawed back in the third quarter will come at the cost of the fourth: growth will collapse back like a soufflé, to 2.5% q/q according to our estimates (1% q/q according to INSEE). For 2020 as a whole, GDP is expected to contract by 9.8%. All other things being equal, the slower growth at the end of 2020 will carry into 2021. But this does not factor in the effect of the recovery plan, which we estimate at 0.6 points of additional growth (conservatively assuming a multiplier of 0.5 and that 30% of the EUR 100 billion France Relance programme will be injected in 2021). This would put average growth over 2021 at 6.9% (in line with the consensus). This estimate is surrounded by balanced risks: the stimulus package creates upside risk, whilst the health situation and uncertainties relating to Brexit and the US elections represent downside risks. To borrow INSEE's analysis, the engine of growth is both turbo-charged and throttled down. By way of comparison, the OECD is more pessimistic (with a 2021 growth forecast of 5.8%), whilst the Banque de France and the government are more optimistic (7.4% and 8% respectively) – with the former specifying that it has only taken partial account of the stimulus package as it does not have all the details. It is also worth noting the Banque de France's belief that French GDP will return to its pre-crisis levels in early 2022, earlier than the euro zone as a whole.

KEY MEASURES AND VALUES OF THE FRANCE RELANCE PLAN



SOURCE: GOVERNMENT, BNP PARIBAS

FRANCE RELANCE: SUBSTANTIAL FISCAL STIMULUS BUT IT IS STILL TOO EARLY TO JUDGE HOW EFFECTIVE IT WILL BE

The challenges for the France Relance programme are substantial, as it will not only have to support growth in the short term (avoiding the ongoing recovery to fizzle out, with a target of getting GDP back to pre-crisis levels by 2022), but also strengthen prospects for the medium to long term, or *"build the France of 2030 today"*. Hence the emphasis on supply-side rather than demand-side measures. The substantial support to businesses is also a result of the cost of the crisis, which has been higher for companies than for households. Under the recovery plan, support for households comes via measures to support employment, which in turn goes partly through support for companies contained in the "competitiveness" section of the programme. Other, more direct measures to support employment are contained in the "social cohesion" section too. Positive effects are also to be expected from the support provided to environmental transition. Employment is the key linking variable between supply and demand. It is no accident, therefore, that it is at the heart of the recovery package.

There is no doubt that the sums being made available are substantial. These are, by design, split more or less equally between the three pillars of the plan (environment, competitiveness, cohesion), which choice is hard to disagree with. The debate now relates to the likely effectiveness of the plan over both the short and long term. For the time being this is hard to judge. More precisely, although we might expect positive effects, their scale is unclear.

The first question is at what speed the EUR 100 billion will really be injected, and how the total will be split between 2021 and 2022 and between front-loaded and back-loaded measures. We hope that the presentation of the 2021 budget at the end of September will shed some light on this. The effectiveness of the programme might be undermined by its ambitions and by the risk of dilution. It is perhaps reasonable to ask if the double role of shock-absorber (addressing the scars left by the crisis) and support (for the recovery and for future growth) is not too ambitious for a single plan. One might also worry that a single instrument (for example the cut in production taxes) is used to serve several purposes (competitiveness, employment, innovation, relocation). All of which raises the question of the adequacy of the resources committed, in terms of both value and duration. There is also an underlying issue of the targeting and proper allocation of resources: this will be watched closely by the government.

Nor is the decision to support the supply-side without risk. Since the summer, economic surveys have shown an emerging risk of a demand-side shock: according to INSEE, many companies express their fears of losing market prospects. Supporting them by reducing production costs and increasing their growth potential through innovation is necessary, but it is far from certain that this will be enough in current conditions: more direct, visible and immediate support for demand might need to be considered. To achieve this, attention is turning to the forced savings accumulated by households, how quick this could be unblocked and how to avoid it being converted into precautionary savings. There is no easy answer. Thus far, the government has opted against a temporary cut in VAT, as in Germany, which it considers inappropriate. Instead it is banking on the positive impacts of the recovery package on employment: the more households feel reassured in this area, the more they will consume.

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TOWARDS AN UNCERTAIN RECOVERY

In Q2 2020, real GDP fell by 12.8%, dropping down to values recorded in the 1990s. A weakened domestic demand was the main driver of the recession, with households reducing their expenditure and investment falling by 15%. The contraction became widespread. The real estate sector sent mixed messages: in Q1 2020 prices went up while transactions experienced a sharp decline. Latest data have signaled a rebound of the economy, even if the scenario remains uncertain. The strength of the recovery will depend on the behaviour of businesses and households, which will in turn be affected by the evolution of the pandemic. In the real estate sector, both prices and transactions should experience a sharp decline by the end of the year. Transactions should only partially recover in 2022.

BACK TO THE 1990S

Italy was the first Western economy where the epidemic took hold. Severe restriction measures to contain the propagation of the Covid-19 were implemented some weeks before other countries. The limitation of people movements and of social interactions and the closure of many productive activities had a negative impact on the economy. In Q2 2020, at the height of the national lockdown, real GDP collapsed by 12.8% q/q (-5.5% in Q1 2020). Net exports contributed negatively (-2.4%), as exports declined more than imports (respectively -26.4% and -20.5%), The contribution of inventories was also negative (-0.9%). On annual basis, the economy contracted by 17.7%, dropping down to values observed at the beginning of the 1990s.

The economic contraction was widespread. In the manufacturing sector, which had already been experiencing a slowdown of activity since the beginning of 2018, value added declined by 22.2% in Q2 (-9.1% in Q1). In the first half of 2020, production fell by more than 30% in the transportation sector as well as in that of textile, clothes and shoes, while the areas of food and pharmaceutical products slightly declined. In the services sector, which was the only one to have recovered the losses of the previous two recessions, value added fell by 11% in Q2 (-4.7% in Q1). As a consequence of stringent restrictions on travel, turnover in accommodation and food services activities declined by more than 60%. According to current account data, international tourism receipts in Italy collapsed from EUR 12 billion in Q2 2019 to EUR 1.8 billion in Q2 2020, with the number of foreign travellers falling from 25.9 to 4.9 million.

SLUGGISH DOMESTIC DEMAND

In Q2, domestic demand was the main driver of the impressive drop in GDP, with a 9.5% negative contribution.

Private consumption fell by 6.7% in Q1 and 11.3% in Q2, accounting for more than 10 percentage points of the economic contraction recorded in the first half of the year. Italian consumers reduced their expenditure by more than EUR 45 billion, mainly cutting down on services and durable goods spending. Households economic conditions worsened further. Despite the introduction of a temporary prohibition to lay off workers, from Q4 2019 to Q2 2020, the number of persons in work declined by more than 750 thousand, with the employment rate in June falling to about 1.5 percentage points below the peak reached in 2019, while that of hours worked collapsed by almost one fifth. Consumer confidence data suggest that the propensity to save has remained high in Q2, after having increased above 12%, the highest value in the last fifteen years. Although declining from the record reached in April, the amount of household's bank deposits is still EUR 23 billion higher than in December 2019.

GROWTH AND INFLATION (%)

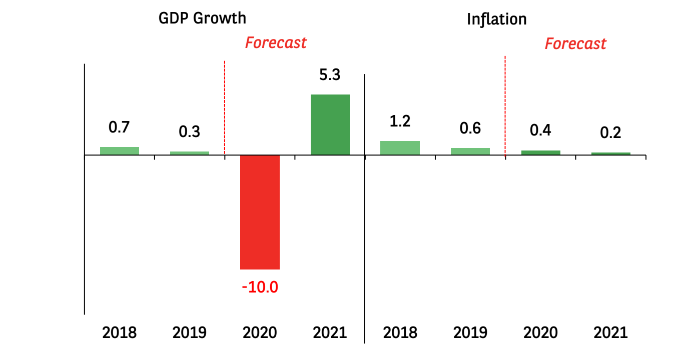

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LABOUR MARKET

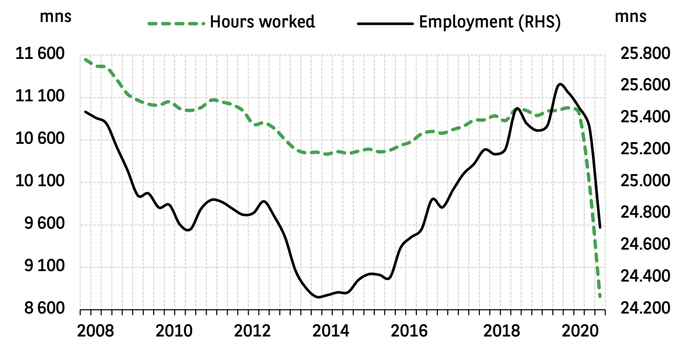

CHART 2 SOURCE: BNL CALCULATIONS ON ISTAT DATA

The recent dynamics of domestic demand also mirrored the huge decline in investment (-15% in Q2 and -7.5% in Q1), which subtracted about 4 percentage points from GDP. Since the beginning of the crisis, expenditure on gross fixed capital formation has declined by EUR 17 billion. From Q4 2019 to Q2 2020, investment in machinery and equipment fell by 25% and those in means of transport by 38%. Italian firms remained extremely cautious, owing to the persisting uncertainty about the economic outlook. According to trade balance data, in Q2, exports declined by 15% q/q, with means of transport, clothes, shoes and machinery contracting strongly, while sales abroad of food and pharmaceutical products ncreased slightly.

A STILL UNCERTAIN RECOVERY AHEAD

Latest available data have signalled a rebound of the Italian economy in Q3. The reopening of global trade supported exports, which increased strongly in May and June, after having collapsed in the previous two months. With the gradual reopening of activity, industrial production rose by more than 60% from the trough reached in April. The cancellation of the general quarantine and the easing of social restrictions supported domestic demand, with retail sales rebounding in May and June, though slightly declining in July. Besides, in June, the number of persons in work rose by 85 thousand.

The worst seems to be behind us, however the outlook remains extremely uncertain. After the Q3 rebound, a slowdown of activity is expected between the end of the year and the beginning of 2021. The strength of the recovery will depend on the behaviour of businesses and households, which will be determined by the evolution of the pandemic.

CONSTRUCTION SECTOR: VALUE ADDED

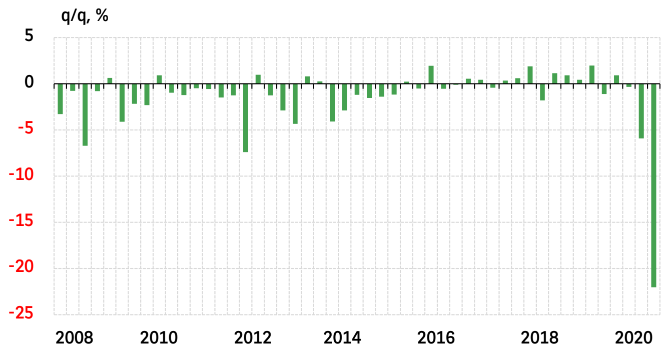

CHART 3

SOURCE: BNL CALCULATIONS ON ISTAT DATA

MIXED SIGNALS FROM THE REAL ESTATE SECTOR

In Italy, the real estate sector sends mixed messages. Between January and March 2020, according to Istat (*Istituto Nazionale di Statistic*a) estimates, the price of residential properties has increased by 1.7% yoy, the largest increase since Q2 2011. The performance is due both to newly built houses and (above all) existing ones whose prices have increased by 0.9% and 1.9% yoy respectively, showing a clear acceleration compared to Q4 2019. On a quarterly basis house prices have increased by 0.9%. The restrictive measures introduced in March to stop the spread of the Covid-19 pandemic did not have a significant impact on the prices of residential properties, whose sales were finalized before the outbreak of the sanitary crisis. In the quarters to come, however, house prices are expected to record a sharp decline.

On the whole the decline of house prices from 2010 (first year for which official data are available) to Q1 2020 amounts to 15.8%. This decline is due to a significant price decrease of existing homes, with prices 22.2 % lower at the beginning of 2020 than in 2010. Newly built houses prices were just 1.5% higher than eight years ago.

On the contrary, the measures introduced in March to stop the pandemic have drastically limited the possibility of signing new notarial deeds since March, leading to a sharp decline in real estate transactions. Between January and March 2020, residential property sales (non-seasonally adjusted) declined by 15.5% y/y (from -3.3% in the previous quarter) to about 117,000 deals (14,000 less than in the same quarter of the previous year). The decline was homogeneous in all areas of the country, with negative peaks in Milan (-19.3%), Naples (-19.5%) and Genoa (-19.2%). In Rome transactions declined by 14.8%. According to some preliminary estimates in Q2 2020, the decline in real estate transactions should have been much deeper than in Q1. By the end of the year, transactions should be less than 500,000 from 603,000 in 2019. The recovery in 2022 will probably be only partial.

The overall construction sector has suffered dramatically from the lockdown and the ensuing recession. According to Istat data, in Q2 2020 the value added in the sector declined by 22% compared to Q1 2020 and 26% with respect to the same quarter in the previous year.

As a consequence, the sector has suffered a decline in employment: in the first half of 2020, employment has decreased by 40,000 units compared to the same period in 2019, accounting for about 3% of the overall loss recorded by the entire economy in Italy over the same period.

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SPAIN

FISCAL COMPROMISES ARE INEVITABLE

The Spanish economy registered a record contraction of 22.7% in the first half of 2020. With the public deficit likely to rise above 10% of GDP this year, the government faces some difficult decisions, notably on the terms and conditions of its temporary layoff scheme (ERTE). The recovery in industrial production since the easing in lockdown restrictions in May is encouraging. However, this only partially compensate for the slow pick-up in activity in other sectors. The final quarter of 2020 will be a pivotal moment. A substantial programme of support for employment and investment (under the recovery package announced this autumn) is needed, while narrowing down support more specifically towards the sectors lastingly affected by the crisis.

Spain has been Eurozone's hardest hit economy by the Covid-19 crisis. Real GDP plunged by 18.5% in the second quarter of 2020. There were significant declines in all components of demand (consumption, investment and exports). We now expect GDP to shrink by 13.0% in 2020, before growing by 5.0% in 2021.

Local lockdowns have been introduced in several areas – and in particular in Madrid – in an attempt to halt a surge in new cases in the country. The worsening situation could hold back the economic recovery over the coming months, although the current situation is, for now, not as bad as in February-March. The Purchasing Managers index (PMI) slipped back into contractionary territory in August (composite index of 48.4).

INDUSTRY 'DRIVING' THE RECOVERY

Nevertheless, the industrial sector has turned higher over the summer, led by a rebound in consumer goods and more particularly durable goods. In July, car sales climbed back above their level at the start of the year, before dipping in August. The introduction of the government's Renove 2020 scheme – a programme offering subsidies for the purchase of cleaner vehicles – has stimulated demand. By July, industrial production was only 3.5% below its pre-crisis levels.

This recovery in consumer goods has occurred elsewhere in Europe (France and Italy for example). This resulted in a stronger demand for Spanish exporters. The trade balance improved significantly as a result, posting a surplus in June (EUR 746.9 million), for the first time since the current data series began[1]. However, this increase only partially compensate for the loss in revenue from tourism activity, which caused a sharp deterioration in the balance on services. The current account thus deteriorated this summer.

The Spanish economy remains more structurally exposed to the current crisis than its European neighbours, as it is more dependent on non-tradable services (retail, construction, hotels and restaurants) and SMEs[2]. These activities have been hit harder by public health restrictions and the fall in tourism. The latter struggled to recover over the summer. In July, the hotel occupancy rate was 35.6%, half of July's 2019 level (71.7%).

It is still too early to assess the full impact of the crisis on the labour market. The unemployment rate climbed to 15.8% in July and employment in August remained 3.5% below February's level[3]. However, we have seen a gradual, albeit modest, pick up in employment growth since the easing in lockdown restrictions in May. The PMI data suggest that the recovery in employment will continue in the coming months (see Chart 2). This trend is of course fragile and dependent on the evolution of the epidemic over the coming weeks and months.

GROWTH AND INFLATION (%)

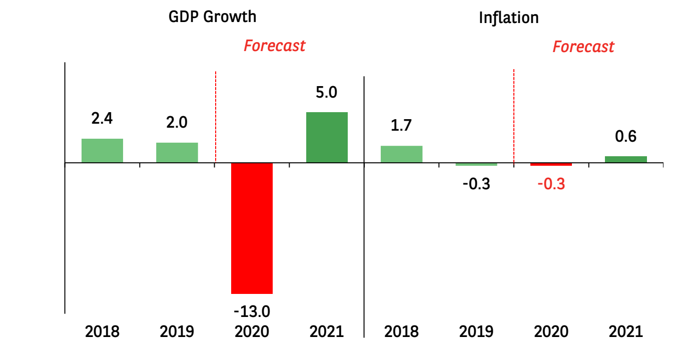

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PMI INDEX AND EMPLOYMENT

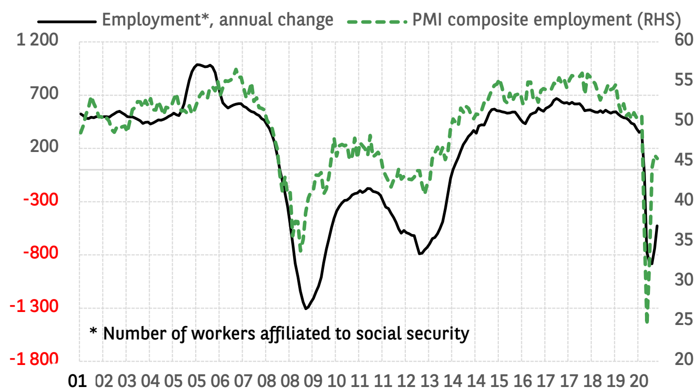

CHART 2 SOURCE: MARKIT, BNP PARIBAS

Young workers have been heavily impacted by the crisis, due to the more precarious nature of their employment status (short-term, seasonal, temporary work). The jobless rate for the 15-24 age group has increased by more than 10 points this year, reaching 41.7% in July. Youth unemployment remains nearly fifteen points below its 2013 peak[4]. Nevertheless, the reincorporation of this category into the labour market will remain a key challenge for the Spanish authorities going forward.

1 January 1985 Seasonally-adjusted data
2 For more details, please see BNP Paribas EcoFlash Euro zone: Four countries, four ways to recover, 20 May 2020.
3 Spanish employment agency (SEPE). More precisely, this figure represents the number of workers affiliated with the social security system.
4 55.9% in July 2013

A FISCAL PUZZLE

The Spanish government must find the right balance over the recalibration of its temporary layoff scheme (ERTE). The current scheme, which is due to expire on 30 September, will be extended, but it is likely to become more selective and further limited to the sectors the most heavily impacted by health restrictions or those facing a longer recovery period (aeronautics, automotive industries). In return, the Labour Ministry has extended the tightening of redundancy conditions to 2021, which operates mainly via an increase in redundancy payments. According to the Ministry, there were 813,000 employees under the ERTE scheme at the end of August, down from around 3.4 million during the peak in May.

These adjustments to employment support measures come against a difficult backdrop in public finances. In its September forecast, the Bank of Spain estimates that the budget deficit will widen between 10.8% and 12.1% of GDP in 2020 depending on the scenario considered[5]. Under both scenarios the debt-to-GDP ratio will climb by more than 20 points (to between 116.8% and 120.6%).

However, the funds allocated to Spain under the European Recovery Plan (Next Generation EU) should allow Pedro Sanchez's government to introduce a substantial recovery package. Under the 21 July agreement, Spain will receive EUR 72.7 billion, or 5.8% of its GDP, in subsidies spread over the period from 2021 to 2026.

The national recovery plan must be approved by the European Commission in order for these funds to be released. The government has already unveiled a major investment programme in the digital sector – España 2025. This programme, run jointly by the public and private sectors, will last through to 2025 and will be worth a total of EUR 140 billion, EUR 70 billion of which will be allocated between 2020 and 2023. After the emergency measures taken this summer –particularly to support the automotive and tourism sectors– the government will, in the coming months, set an agenda that focuses more on competitiveness and the transformation of the Spanish economy.

TOWARDS SERVICES DEFLATION?

The fall in economic activity during the first half of 2020 is causing downward pressures on consumer prices. The consumer price index (CPI) dipped 0.52% year-on-year (y/y) in August. The underlying CPI (excluding energy and perishable food) rose by only 0.43% y/y in August, its lowest annual increase since April 2015. This was partly due to lower services prices, a sector that is suffering more from the restrictions measures. The fall in the services CPI (excluding rents) over the past six months has been the biggest since the current data series began in January 2002. The last six months have seen major falls in the leisure, restaurant and hotel sectors, which follow price declines in transport, gas and electricity (Table 1).

This downward pressure on prices is also visible in the real estate market. Despite historically-low interest rates[6], property prices fell by 2.3% between May and August (TINSA index)[7]. That said, inflation could pick up in 2021, as the effect of falling energy prices at the beginning of this year recedes.

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CHANGE IN CPI

CPI (August 2020)	Weight in CPI	Annual growth rate	Contribution to annual growth rate	% change 6-months	Contribution to % change 6-months
Total CPI	100.0	-0.52	-0.52	-0.79	-0.79
Core CPI (excluding fresh foods & energy)	80.5	0.43	0.34	-0.13	-0.11
Food & non-alcoholic beverages	19.5	2.20	0.43	0.81	0.16
Alcoholic beverages & tobacco	2.9	0.50	0.01	0.23	0.01
Clothing & footwear	6.5	1.04	0.06	0.46	0.03
Housing, water, electricity, gas & fuel	13.4	-2.74	-0.37	-0.95	-0.12
Furniture & household equipment	5.8	0.44	0.02	0.39	0.02
Health	3.9	0.50	0.02	0.37	0.01
Transport	15.4	-4.40	-0.71	-4.45	-0.72
Communication	3.8	-1.22	-0.05	-0.57	-0.02
Recreation & culture	8.4	-2.06	-0.17	-1.92	-0.15
Education	1.6	0.82	0.01	0.39	0.01
Restaurants & hotels	12.1	0.47	0.06	-0.59	-0.07
Other goods & services	6.8	1.51	0.10	0.70	0.05

TABLE

SOURCE: INE, BNP PARIBAS

5 https://www.bde.es/bde/en/secciones/informes/boletines/relac/Boletin_Economic/Informes_de_proy/
6 According to the Bank of Spain, the average mortgage rate was 1.92% in July.
7 The average price per square meter of land fell by 15.2% y/y in Q2. See El precio del suelo urbano se hunde un 15% y cae por debajo de los minimos de 2013, El Economista, 16 September 2020.

THE NETHERLANDS

SUFFICIENTLY DEEP POCKETS FOR STIMULUS

Economic activity contracted less than in the neighbouring countries (-8.5%). Hard data confirm a rebound in Q3, although social distancing rules are weighing on activity, in particular in services. Thanks to the substantial financial buffers, the government can cope with the considerable costs caused by the Covid-19 pandemic. In 2021, the deficit is projected at around 5% of GDP and the debt ratio may end up just above 60%. The centre-right coalition is likely to lose the majority at the next general election in March 2021. If the social democrats and greens do well, a purple coalition would be possible.

REBOUND AFTER LOCKDOWN

Economic activity contracted sharply in Q2 by 8.5%. This compared favourably with the neighbours Germany (-9.7%) and Belgium (-12.1%), where lockdowns were stricter. Since May, the economic climate has gradually improved, in line with the easing of the lockdown restrictions. However, the economic sentiment indicator, on a rising trend since May, was still 5% below its long-term average.

Hard data confirm the gradual improvement of economic activity. In July, industrial production was almost 6% lower than a year ago, compared to around -12% in April-May. In some parts of the services sector, the rules on social distancing have prevented the reopening of businesses or slowed their activity. In the hospitality sector, sales were almost 60% lower in Q2 than a year ago. By contrast, retail sales have been booming since the reopening of shops. In July, the sales volume was 7% higher compared to a year earlier.

The government's emergency package launched in March has proven to be effective in preserving businesses and employment. The unemployment rate inched up to 4.5%, only 1 percentage point higher than before the crisis thanks to the extensive use of the furlough schemes NOW and Tozo (for self-employed). In the period June–August these schemes were used for 1.4 mn workers, i.e. 16% of the working population.

GROWTH AND INFLATION (%)

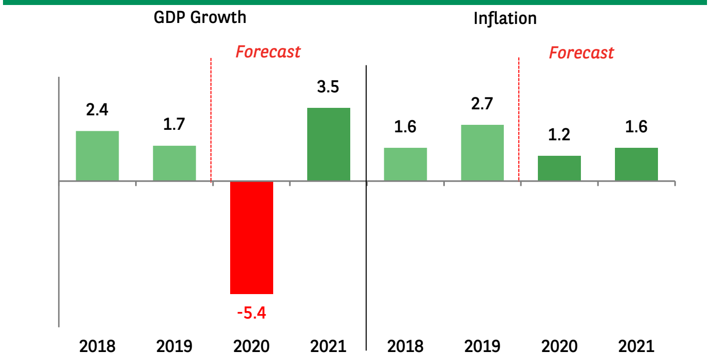

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

FISCAL POLICY TO REMAIN VERY ACCOMMODATIVE

Thanks to the substantial financial buffers, the government can cope with the substantial costs provoked by the Covid-19 pandemic. Discretionary measures and automatic stabilisers might have negatively affected the government budget by almost EUR 70 bn (or 8.7% of GDP). As a result, a budget deficit of 7.6% of GDP is expected for 2020. The debt ratio, which also includes direct loans and tax deferral, could increase to around 60% of GDP compared with 49% in 2019.

In September, the government presented the 2021 Budget. The economic situation requires a very accommodative fiscal policy. Nevertheless, the deficit is projected to be slightly lower than in 2020 (5% of GDP), as some discretionary measures end. The debt ratio is projected to increase further to 62% of GDP.

Households will benefit from tax reductions, which were already decided before the Covid-19 outbreak. However, the business sector will be confronted with tax increases as support measures end and due to the scrapping of the projected reduction in the corporate tax rate. In 2021, purchasing power will increase on average by 0.8% against 2.2% in 2020. In particular, middle-income households and those with children will benefit.

The government has announced the setting up of a National Growth Fund for knowledge development, infrastructure, research and innovation. An independent commission will approve the projects. The size of the fund will be a total of EUR 20 bn for the period 2021-2026, of which EUR 1 bn to be spent in 2021.

POLITICAL UNCERTAINTY AHEAD

It will be difficult to form a government after the next general election to be held in March 2021. According to the polls, Prime Minister Rutte's party VVD (conservative liberal) will remain the largest, but his centre-right coalition will lose the majority. Moreover, the extreme right parties PVV and FVD are projected to gain about 25% of the vote. If the social democrats and greens make a good score, a return of a purple coalition – a coalition without the Christian democrats – would be a possibility. A long formation period lies probably ahead.

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BELGIUM

MORE ROBUST THAN EXPECTED, BUT NEW COALITION HAS TOUGH CHOICES TO MAKE

We expect the Belgian economy to lose 7.5% of its size this year and grow by 4.6% next year. Consumption is on course for a strong recovery but corporates remain hesitant to invest, with government interventions expected to pick up some of the slack. Belgium has a new government after 16-month deadlock. The new coalition will have its work cut-out for it, as both supportive measures in the short term and a deficit-reduction program in the medium term are needed.

The impact of the Coronavirus was already felt in the GDP numbers for the first quarter of this year, which came in at 3.4% below Q4 2019. As the bulk of the lockdown measures only kicked in at the end of March, the hit to the 2nd quarter proved to be even more substantial, at 12.1%. The industry and construction sectors shrank by about 13%, services activity was 11.5% lower than in the first quarter.

A partial recovery in the remainder of the year will be led by consumer spending and supported by government measures. Investment will take longer to rebound, as we only see it reaching its 2019 levels well into 2022. For the whole economy, on a quarterly basis GDP should have recovered the level of the last quarter of 2019 by the end of 2022.

CONSUMER CONFIDENCE STARTED RECOVERING

A survey by the Belgian National Bank (NBB) indicated three distinct factors holding back private consumption at the beginning of the summer: shops being closed, shopping being less enjoyable than before and fear of catching the infection. The first factor was more or less eliminated through the subsequent easing of the lockdown directives, but the impact of social distancing measures is likely to stick around longer on the shopping experience, at least until a vaccine becomes widely available. This goes as well for the fear of the virus which feeds directly into the confidence channel.

Consumer confidence started recovering through June and July but the subsequent partial lockdown of certain provinces seems to have taken its toll as in August it dropped back to its May-level which was the lowest since 1993. Saving rates likely rose due to forced saving during the lockdown. The drop in consumer confidence risks to 'block' part of these savings in the coming quarters, which could weigh on consumer spending though overall purchasing power is expected to actually hold up for the next couple of years. An additional boon during the past months was the "staycation"-effect: the decimation of international tourism eliminated most spending by foreign visitors in Belgium but encouraged additional consumption by residents unable to go abroad. This had a positive outcome on Belgian economy as a whole.

THE IMPACT FOR CORPORATES DIFFERS

For corporates, the impact of Covid-19 differs by sector. According to an NBB-survey, at the end of August, 8% of all corporates considered bankruptcy likely in the next coming months across the economy. This number increases to one-third for sectors like accommodation and food service activities, events and recreation and road transport (persons). In the same survey, the total number of respondents who believe themselves unable to remain operational beyond the next 3 months has declined from about 40% in March to 20% in August.

Corporate investment, which represents about 70% of all Gross Fixed Capital Formation, could end up 20% lower than its 2019-level on a full year basis. Low capacity utilisation rates, uncertainty and pressure on profit margins are the main culprits here.

REGULAR UNEMPLOYMENT LEVELS WOULD PEAK

The number of employees registered in the "temporary unemployment"-scheme peaked in April with 1.2 million applicants. Since then,

GROWTH AND INFLATION (%)

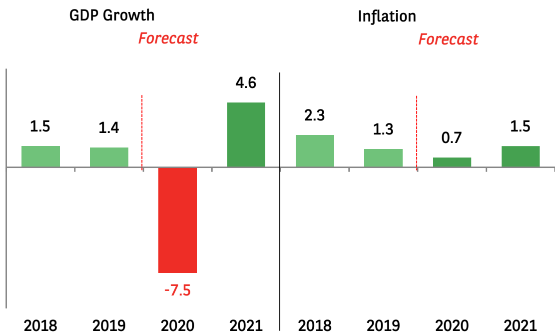

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

the total number of registrations has declined each month, reaching about 300 000 in July. Interestingly, a survey by the NBB revealed that, in April, corporations expected 20% of the employees on temporary unemployment to be made redundant.

With total unemployment up by 30,000 since the beginning of the year, this expectation has failed to materialise so far. In fact, the current increased unemployment rate is back at the level it stood at the beginning of 2019, which at the time was considered to be well below the non-accelerating inflation rate of unemployment (NAIRU).

Looking forward, we expect temporary unemployment levels to revert to their long-term average value of around 100,000 by the beginning of next year summer. From the 200 000 decrease in temporary unemployment, we think about 50% will lose their job. At that point, regular unemployment levels would peak, with about 130,000 more unemployed men and women than at the beginning of this year.

GOVERNMENT REVENUES ARE LIKELY TO DECLINE

The government measures, needed to prop up the economy, will increase the budget deficit significantly. Already more than EUR 16 billion additional spending was announced, as Belgium requested assistance from the European SURE-fund to help foot the cost of labour-supporting measures. Furthermore, government revenues are likely to decline by around EUR 15 billion. All things considered, we expect an increase in the primary deficit by at least EUR 40 billion, with the headline deficit coming in at -11.7% for 2020.

The governor of the NBB recently expressed his opinion that this deficit might decline to 6% by 2023, but that would require the installation of a clear budget-plan. For the new government just formed almost 500 days after the last election, the stakes are high. It's first priority will be to support the recovery in the near term but eventually less popular decisions will have to be made.

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ONE OF THE MOST RESILIENT ECONOMIES IN EUROPE

Finland's economy was showing signs of weakness even before the Covid-19 pandemic started – indeed, GDP contracted a bit in the fourth quarter of 2019. In spite of that, the economy has been one of the most resilient in Europe. That is notably because the pandemic has been relatively contained, allowing the authorities to impose softer restriction measures. Another reason is the substantial support provided by the government.

So far, Finland's economy has been one of the least affected in Europe by the economic crisis triggered by the Covid-19 pandemic. In the second quarter, GDP contracted by « only » 4.5%. In addition, the recession in Finland will probably remain milder than in most other European countries.

First, Finland has been relatively spared from the pandemic itself. The mortality rate of Covid-19 in Finland is, at about 50 deaths per million population, among the lowest in Europe. Combined with the strong healthcare system, this has allowed the government to impose softer restriction measures than most other European countries – with the notable exception of Sweden – according to the Oxford Covid-19 Government Response Tracker[1].

What's more, the Finnish government has provided substantial support to the economy, including measures such as direct funding for firms, the extension of unemployment security, the extension of social benefits, and the temporary lowering of private-sector pension contributions. The Ministry of Finance estimates that these will be equivalent to about 2.5% of 2019 GDP. The government has also pledged loan guarantees worth more than EUR 10 bn (4.2% of 2019 GDP), capitalisations, and the easing of payment terms for taxes due this year. Existing automatic stabilisers should also provide strong support to households and businesses by limiting income losses. In total, the IMF estimates that, combined with these stabilisers, the government package of fiscal, liquidity and regulatory measures will, if fully utilised, represent a boost of nearly 30% of GDP.

When it comes to monetary policy, the European Central Bank has substantially eased its stance, notably by massively increasing its asset purchases as well as expanding and lowering the cost of its longer-term refinancing operations for credit institutions.

RISKS ARE TILTED TO THE DOWNSIDE

While Finland's economy seems well positioned to weather the crisis, it presents some weaknesses that could delay, or indeed derail, any recovery.

First, the country is highly reliant on intermediate goods, which makes it vulnerable to supply-chain disruptions. That could be a big drag on the economy if global trade failed to recover rapidly. In any case, the structural slowdown in trade that started with the global financial crisis is unlikely to end soon, and could thus become a slow-burning issue for this small and open economy.

What's more, Finnish public finances will come out of the crisis substantially weaker. The Ministry of Finance forecasts that the government deficit will exceed 8% this year, pushing the debt-to-GDP ratio up by nearly 12 percentage points to more than 70%. And it expects the ratio to keep rising after that. Admittedly, Finland can count on a still limited public debt burden, particularly compared to Southern European countries.

GROWTH AND INFLATION (%)

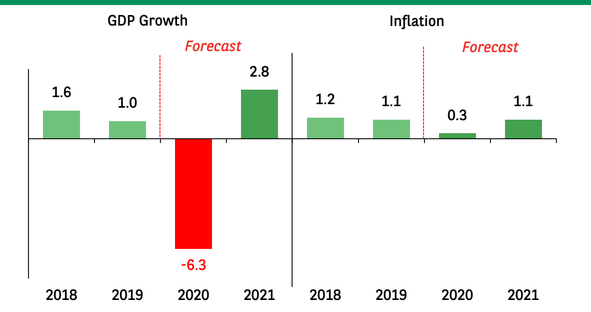

CHART 1
SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

However, weaker public finances could be an issue in the long term given the challenge that will arise from demographics. In 2014, the government enacted reforms raising the retirement age to 65 and linking it to life expectancy from 2027. Nevertheless, that might not be enough to balance the government's books, given the rapidly ageing population. The old-age dependency ratio –the ratio between the number of people aged 65 or over and the working age population– is, at 36.0% in 2020, already among the highest in Europe. According to Eurostat data, the ratio will rise to nearly 50% by 2050 and to more than 60% by 2100[2].

Another area of mild concern is the household sector, where both debt-to-GDP and debt-to income ratios have increased over the past decades – even though the ratios are still much lower than the equivalent ones for Sweden and Denmark for instance.

That being said, debt sustainability risks are likely to remain limited in both cases as long as interest rates remain low.

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1 https://www.bsg.ox.ac.uk/research/research-projects/coronavirus-government-response-tracker
2 https://ec.europa.eu/eurostat/web/products-datasets/-/tps00200

PORTUGAL

SOME FISCAL LEEWAY TO SUPPORT THE RECOVERY

Despite managing well the epidemic, Portugal has experienced a severe economic shock in Q2. Real GDP plunged by 13.9%, pulled down by sharp falls in goods and services exports (-36.1% q/q) and private sector consumption (-14.0% q/q). Investment dropped (8.9% q/q). The country has been heavily impacted by the collapse in tourism inflows and foreign activity, particularly in Spain. External factors could also hamper the recovery, particularly given the surge in new Covid-19 cases in Spain. Nevertheless, the improvement in public finances operated in recent years should translate into a government deficit for 2020 smaller than in other European countries – around 7.0% of GDP according to government estimates. This provides relatively more leeway to support the recovery.

Despite the easing of lockdown measures, many difficulties have persisted this summer. The UK's government decision to impose – between 10 July and 20 August– a quarantine period for travellers returning from Portugal has caused further downward pressures on the tourism sector. In July, arrivals were nearly two-thirds below their 2019 levels[1]. The same quarantine measure was reintroduced on 10 September. In addition, the resurgence of Covid-19 cases in Spain may indirectly impact Portugal's economic recovery – until the end of this year at least – due to the trade connectivity between the two countries[2].

Unsurprisingly, the impact of the lockdown measures on the labour market has been strong: employment fell 3.8% between January and July. The jobless rate climbed above 8% in July (8.1%) –its highest level since October 2017– while the youth unemployment rate (15-24 years old) rose to 26.3%. However, the labour market was already losing momentum well before the Covid-19 outbreak. The annual growth in employment had been slowing since 2018, reflecting the weakening in new job offers (see Chart 2).

The effects of the current crisis on the public finances should also be put into context. The country has improved its budgetary position over the past decade and posted a surplus of 0.2% of GDP in 2019. The public deficit will be substantial this year, but should remain close to the level recorded in 2010[3]. The government deficit in 2020 is thus likely to be smaller – relative to GDP – than in Spain or France. These two countries were still running large structural budget deficits prior to the pandemic.

That said, Portugal's government debt remains the third highest in Europe, behind Greece and Italy. As a share of GDP, public debt climbed to 127.2% in Q2. The European Commission now forecasts that the government debt-to-GDP ratio will hit 131.6% in 2020, before falling back to 124.4% in 2021, as growth rebounds.

Lastly, deflationary pressures are building, reflecting the protracted decline in demand. The core CPI (excluding processed foods and energy) fell by 0.4% over the last six months (August-February).

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GROWTH AND INFLATION (%)

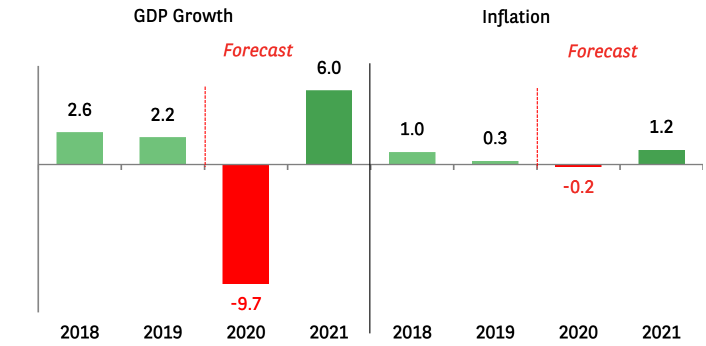

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

NEW JOB OFFERS

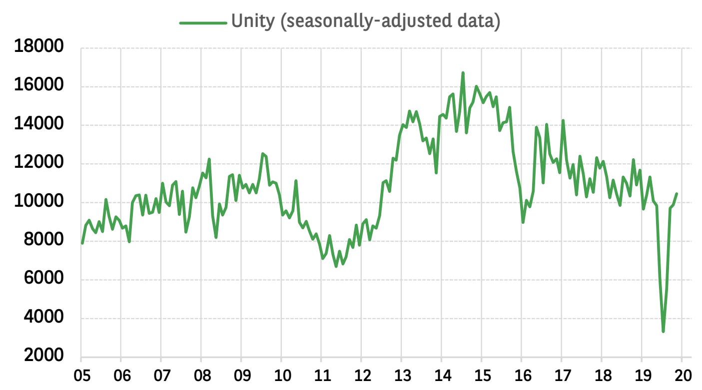

CHART 2 SOURCE: NATIONAL STATISTICS, BNP PARIBAS

1 According to Portugal's national statistical office (INE), the number of overnight hotel stays was 1.024 million in July 2020, down from 2.849 million in July 2019.
2 Spain accounts for approximately a quarter of Portuguese goods exports..
3 Between January and July 2020, the central government's deficit was EUR8.48 billion, compared with EUR8.90 billion in the same period in 2010.

UNITED KINGDOM

OUT OF THE FRYING PAN INTO THE FIRE?

While UK GDP has bounced back since May and has made up half of lost ground caused by the Covid-19 pandemic, the economic crisis is still far from being over. In particular, concerns are mounting over the labour market, as the government's furlough scheme will be terminated in the next few weeks. Meanwhile, the end of the transition period that maintains the UK in the EU's single market and customs union is coming up fast. Disagreements during the negotiations raise fears about the UK leaving without a trade agreement, which could have an even bigger impact on the economy in the long term than the current crisis.

According to data from the Office for National Statistics (ONS), UK GDP dropped by nearly 20% in the second quarter, which was the biggest fall in Europe. Over the first half as a whole, only Spain did worse than the UK (see chart 2). The ONS monthly GDP index rebounded in May and then has continued to rise in June and July (last available data).

Nevertheless, GDP is still close to 12% below its pre-pandemic level[1], which mainly owes to the services and construction sectors (chart 3). In particular, the index for the accommodation and food sector is still 60% below where it was in February – in April it was 90% below that level.

THE PROTRACTED EFFECTS OF THE ECONOMIC CRISIS

After slumping earlier this year, economic activity is now on the path to recovery. However, the economic crisis will be felt for some time, as the authorities' response delayed some of its adverse effects. One example is conditions in the labour market, where more than twelve million individuals have benefited from the government's furlough scheme (Coronavirus Job Retention Scheme, CJRS) and its support programme for the self-employed (Self-employed Income Support Scheme, SEISS). However, the government is planning to replace these programmes in October and withdraw some of its support to businesses. As a result, fears are rising about a surge in the unemployment rate, as some firms will not be able to pay the full wages of their employees.

Admittedly, thanks in part to these programmes, the unemployment rate has only marginally increased since the Covid-19 crisis started, reaching 4.1% in July. However, advanced indicators suggest that UK payrolls already dropped by about 700 000 between March and August. The Bank of England forecasts that the unemployment rate will reach 7.5% at the end of the year – with the young and low-skilled workers likely to be the most affected. Nevertheless, Chancellor Rishi Sunak, who thinks that *"indefinitely keeping people out of work is not the answer"*, has pledged to continue to be "creative" to find ways to support the labour market.

Another consequence of the crisis, inflation will probably remain weak in the coming months, which could push the Bank of England to loosen monetary policy further if economic conditions were to deteriorate again. CPI inflation dropped back to 0.5% in August[2], owing to the impact of the crisis on demand, the drop in oil prices earlier this year, the temporary cut to the VAT rate for the hospitality sector, and the Eat Out to Help Out scheme – which provides 50% discount up to GBP 10 for the clients of participating restaurants. The Bank of England forecasts that inflation will remain under 1% at least until the start of 2021, which is much below its medium-term target of 2%.

BREXIT, THE OTHER MAJOR THREAT

Meanwhile, the end of the transition period, established in the Withdrawal Agreement signed between the UK and the European Union

GROWTH AND INFLATION (%)

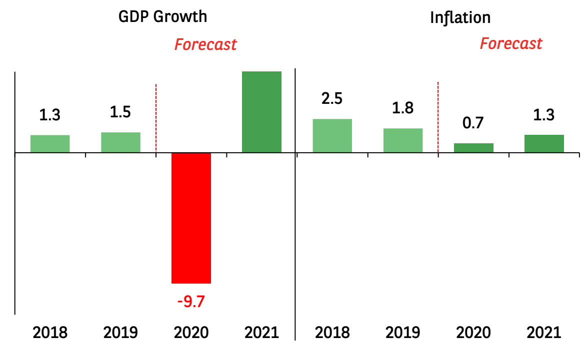

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP GROWTH (%)

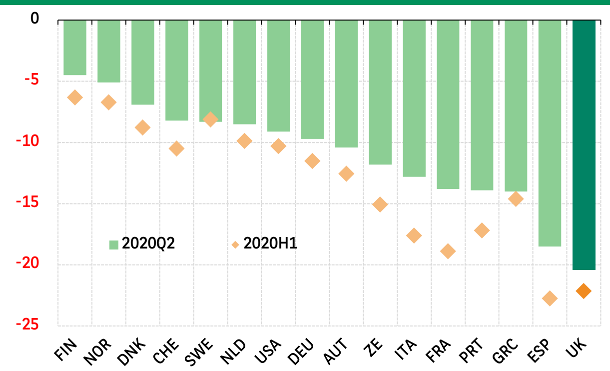

CHART 2 SOURCE: EUROSTAT

(EU), is coming up fast. If the period is not extended, which is very likely, the UK will leave the EU's single market and customs union on 31 December 2020. However, the negotiations for a free-trade agreement between the two parties are making little headway. After eight rounds, there are two key stumbling blocks to an agreement.

The first obstacle is about ensuring a level playing field, which means setting up a framework to keep competition between the two parties open and fair in the long term. While this had been agreed to in the Political Declaration that laid the foundations of the ongoing talks, British negotiators are now refusing both to commit to maintaining

1 https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/july2020
2 https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/august2020

high standards and to put in place appropriate mechanisms to prevent distortions of trade and unfair competitive advantages.

Fisheries is the second source of dispute. While the UK would like to take back control of its waters, the EU negotiators want to maintain access for EU fishermen on terms similar to those that applied while the UK was in the EU.

What's more, the UK seems to have hardened its negotiating stance in recent days. Prime Minister Boris Johnson has announced at the start of September that the UK would "move on" if no deal was found before 15 October. The government has also presented draft legislation – the Internal Market Bill – that would break with some aspects of the Withdrawal Agreement, even though the text is legally constraining.

While the aim could be to win concessions from the EU, the possibility of an exit without a trade deal is real. According to most economists, that could have a big bearing on economic growth in the UK in the long run (see chart 4). Given the share of their production they export to the EU, some sectors, such as electronics, would particularly suffer from this kind of divorce (see chart 5).

In the meantime, the UK seeks to replicate the free-trade agreements the EU has signed with the rest of the world. The aim is to prevent a return to basic WTO rules, as these would put many tariff and non-tariff barriers to trade.

So far, the UK has signed roughly twenty trade deals with a total of fifty countries[3]. The most important is the one signed with Japan in September. However, except on certain aspects – such as financial services, digital technologies or e-commerce – the deal does not go much further than the one that ties Japan with the EU. What's more, according to the British government's own estimations, the deal that was just signed will only boost UK GDP by GBP 1.5 bn in the long term, which is equivalent to 0.07% of 2018 GDP[4].

Overall, the countries with which the UK has signed trade deals so far represent only 10% of the country's total trade (imports and exports). By comparison, EU countries represent nearly 50% of the UK's total trade. This underlines how important a trade deal with the EU would be for the UK economy.

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BREAKDOWN OF GDP AND ITS COMPONENTS

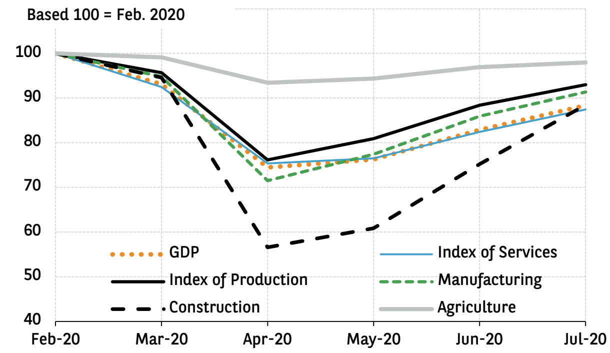

CHART 3 SOURCE: ONS

LONG-TERM IMPACT ON UK GDP OF RETURN TO WTO RULES

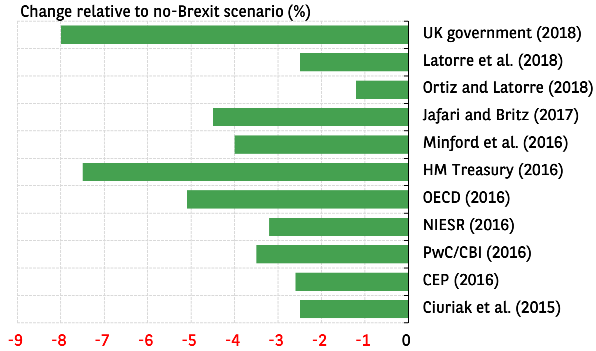

CHART 4 SOURCE: VARIOUS

SHARE OF UK PRODUCTION BY SECTOR EXPORTED TO EU (%)

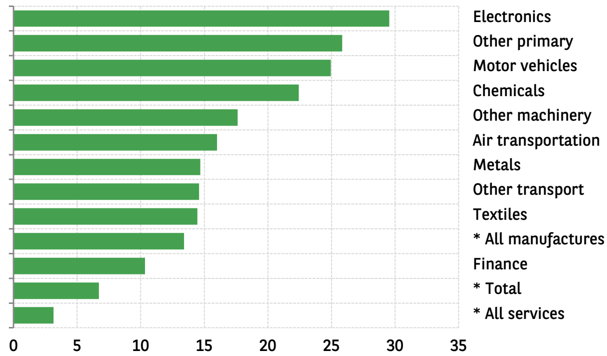

CHART 5 SOURCE: PIIE

3 https://www.gov.uk/guidance/uk-trade-agreements-with-non-eu-countries
4 https://www.gov.uk/government/publications/uks-approach-to-negotiating-a-free-trade-agreement-with-japan/uk-japan-free-trade-agreement-the-uks-strategic-approach

NORWAY

BACK TO GROWTH DESPITE TWO LARGE SHOCKS

Not only was Norway affected by the Covid-19 pandemic, but the country also had to face a big fall in the price of its main export: oil. Nevertheless, these two shocks have been cushioned by the structure of the Norwegian economy and the authorities' fiscal and monetary response. The country's economy is now one of the best positioned to return to its pre-pandemic levels. Indeed, it is already showing signs of improvement.

Since the start of this year, Norway has suffered from two major shocks to its economy. First, the country has been affected by the Covid-19 pandemic, even if the restriction measures put in place by the government have managed to contain the progression of the virus – in fact, Norway has infection and death rates among the lowest in Europe.

In addition, Norway had to deal with a big fall in oil prices. Between 31 December 2019 and 21 April 2020, the price of Brent dropped by more than 70%, dragging the Norwegian krone down. Oil prices have rebounded since and the price of Brent has doubled, but it remains 40% below where it was at the start of the year.

THE CONSEQUENCES FOR THE ECONOMY

Over the first half of 2020, Norway's GDP dropped by nearly 7%, and "mainland" GDP, which excludes the oil sector, declined by more than 8% – which is about the same as the fall in Sweden, where restriction measures have been softer.

Like elsewhere, fiscal and monetary authorities came rapidly to the rescue[1]. For the first time since the mid-1960s, the general government balance has recorded a deficit. In the second quarter, the deficit amounted to NOK 64 bn, which is equivalent to about 8% of GDP. Deficits are unusual in Norway because the government can count on revenues from the oil sector, which have been gathered in the Oil Fund (Government Pension Fund-Global, GPFG) since 1990. However, the use of the Fund is regulated[2]. Over time, transfers to the central government budget (the structural non-oil deficit) cannot exceed the expected real return on the Fund, which is currently estimated at 3%. Nevertheless, this leaves some flexibility, as excesses can be compensated over the years. What's more, *"significant emphasis"* is placed on *"evening out economic fluctuations to contribute to sound capacity utilisation and low unemployment"*. This means that, even if the structural deficit exceeds 3% this year, fiscal rules will not be breached.

As far as monetary policy is concerned, the Norwegian central bank (Norges Bank) could count on large room for manoeuvre compared to the Swedish Riksbank or the ECB for instance. The Norges Bank therefore has been able to ease monetary policy substantially by lowering its base rate from 1.5% to 0%, its lowest level ever.

SIGNS OF IMPROVEMENT

Thanks to the lifting of restriction measures and to both fiscal and monetary policy support, the Norwegian economy has bounced back over the past few months. GDP rebounded in May and has kept rising in June and July. Overall, the economy has made up half of lost ground. Furthermore, the country's statistics bureau (SSB) is quite optimistic, forecasting that activity will have returned to its pre-pandemic level before the end of 2021[3], which will probably be sooner than most other European countries.

GROWTH AND INFLATION (%)

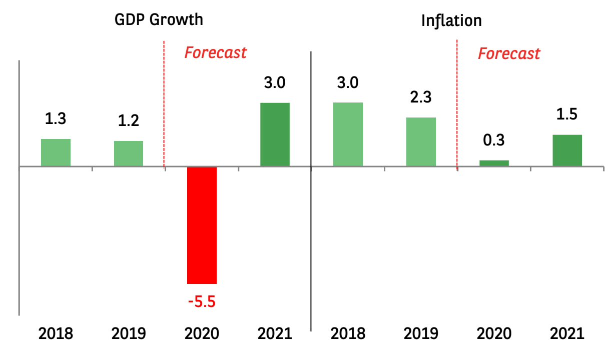

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Meanwhile, the Norges Bank has already adopted a more hawkish stance at its last meeting. The weakening of the krone that accompanied the drop in oil prices has raised fears about upward pressures on inflation. While SSB forecasts the CPI inflation rate to stand at 1.5% this year, it estimates that the underlying inflation rate (CPI-ATE) will reach 3.1%. It is certainly with that in mind that the Norges Bank is already anticipating rate hikes in the coming years[4], which no other major central bank is planning at the moment.

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1 https://www.regjeringen.no/en/topics/the-economy/economic-policy/economic-measures-in-norway-in-response-to-covid-19/id2703484/
2 https://www.regjeringen.no/en/topics/the-economy/economic-policy/economic-policy/id418083/
3 https://www.ssb.no/en/nasjonalregnskap-og-konjunkturer/artikler-og-publikasjoner/better-times-in-sight-but-situation-remains-serious
4 https://www.norges-bank.no/en/news-events/news-publications/Press-releases/2020/2020-06-18-press-release-rate/

FORECASTS

ECONOMIC FORECASTS

	GDP Growth			Inflation		
%	2019	2020e	2021e	2019e	2020e	2021e
United States	2.2	-4.2	4.2	1.8	1.3	1.9
Japan	0.7	-5.4	1.2	0.5	0.0	-0.3
United Kingdom	1.5	-9.7	6.9	1.8	0.7	1.3
Eurozone	1.3	-8.0	5.2	1.2	0.3	0.9
Germany	0.6	-5.6	4.7	1.4	0.6	1.6
France	1.5	-9.8	6.8	1.3	0.6	0.9
Italy	0.3	-10.0	5.3	0.6	-0.1	0.4
Spain	2.0	-13.0	5.0	0.8	-0.3	0.6
China	6.1	2.5	7.5	2.9	2.8	2.3
India*	4.2	-11.4	9.6	4.8	5.5	3.4
Brazil	1.1	-5.0	3.0	3.7	2.6	2.6
Russia	1.3	-5.0	3.1	4.3	3.3	3.5

FINANCIAL FORECASTS

Interest rate, %		2020				2020				
End of period		Q1	Q2	Q3	Q4e	Q1e	Q2e	Q4e	2020e	2021e
United States	Fed Funds (upper limit)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	Treas. 10y	0.67	0.80	0.64	0.75	0.90	1.00	1.20	0.75	1.20
Eurozone	Deposit rate	-0.50	-0.50	0.00	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
	Bund 10y	-0.46	-0.50	-0.54	-0.30	-0.20	-0.10	0.00	-0.30	0.00
	OAT 10y	-0.05	-0.15	-0.32	-0.05	0.05	0.15	0.25	-0.05	0.25
	BTP 10y	1.55	1.30	0.77	0.90	1.20	1.40	1.50	0.90	1.50
	BONO 10y	0.68	0.50	0.16	0.30	0.50	0.20	0.70	0.30	0.70
United Kingdom	Base rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
	Gilt 10y	0.31	0.55	0.14	0.30	0.30	0.40	0.70	0.30	0.70
Japan	Taux BoJ	-0.07	-0.10	-0.03	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
	JGB 10y	0.02	0.00	0.02	0.05	0.05	0.10	0.15	0.05	0.15

Exchange rate		2020				2021				
End of period		Q1	Q2	Q3	Q4e	Q1e	Q2e	Q4e	2020e	2021e
USD	EUR / USD	1.10	1.09	1.17	1.23	1.24	1.25	1.27	1.23	1.27
	USD / JPY	108	104	106	102	101	99	95	102	95
	GBP / USD	1.24	1.24	1.28	1.41	1.43	1.45	1.48	1.41	1.48
EUR	EUR / GBP	0.89	0.88	0.91	0.87	0.87	0.86	0.86	0.87	0.86
	EUR / JPY	118	113	124	125	125	124	121	125	121
Brent		2020				2021				
Period average		Q1	Q2	Q3	Q4e	Q1e	Q2e	Q4e	2020e	2021e
Brent	USD/bl	51	33	41.02	49	61	58	-	44	59

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS), LAST UPDATE: 09.10.2020

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Bulletin édité par les Etudes Economiques – BNP PARIBAS
Siège social : 16 boulevard des Italiens – 75009 PARIS / Tél : +33 (0) 1.42.98.12.34
Internet : -

Directeur de la publication : Jean Lemierre / Rédacteur en chef : William De Vijlder

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