

ECO PERSPECTIVES

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ECONOMIC RESEARCH DEPARTMENT

Eco
PERSPECTIVES



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Editorial

Growth concerns on the rise

A sigh of relief followed the publication of first quarter GDP data. However since, growth concerns have picked up again on the back of a collection of new economic data but also — and perhaps more importantly — due to continued high uncertainty. The latter stems from concerns over the extent of the slowdown and its consequences in terms of economic risks. It also emanates from escalating tensions between the US and China over trade. The effects of this confrontation already show up in the Chinese data while in the US, mounting anecdotal evidence also point to its detrimental impact on business and the agricultural sector. The Federal Reserve has turned a corner and indicated that rate cuts are coming, much to the joy of the equity market. The ECB has also changed its message: with risks tilted to the downside and inflation going nowhere, it considers more easing is necessary.

■ New records

While the S&P500 reached new highs, US treasury yields dropped on the back of a revised outlook regarding the path of monetary policy and further declines in the term premium. Based on calculations by the Federal Reserve of New York, this risk premium, which investors are supposed to receive for taking on duration risk, has reached a record low of -90 basis points at the beginning of July. As shown in the charts, the decline of US bond yields has, quite understandably, mimicked the decline of the purchasing managers index (ISM) for the manufacturing sector. The coincidence of a record high stock market and a record low term premium raises a certain discomfort: declining bond yields reflect unease about the economic outlook, so one wonders how long the stock market can stay immune to these concerns. The drop in US yields has been accompanied by a considerable descent into negative territory of Bund yields as well as yields in other eurozone bond markets. Apart from the usual transatlantic correlation, the change in message coming from the ECB has played a key role in explaining such dynamics. Indeed, if we take at face value the ECB president's speech in Sintra towards the end of June, a new cycle of easing is coming.

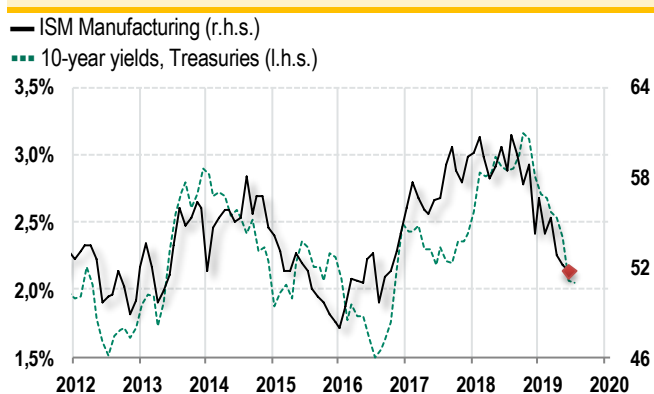
■ Growing concerns

While a sigh of relief followed the publication of first quarter GDP data, concerns over growth have since picked up again. China continues to slow down and in the eurozone the manufacturing sector, in particular in Germany, remains under pressure, although services are holding up well. While France witnessed some improvements, the picture in the US is mixed. The pace of job creation remains, on the whole, strong but investment activity is weakening. Market based signals (the inversion of certain parts of the yield curve) have raised recession fears, while increasing anecdotal evidence point to the detrimental impact of tariff increases on businesses and the agricultural sector. Although the US entered its 121st month of economic expansion, it appears that euphoria has largely given way to caution.

■ Tipping point

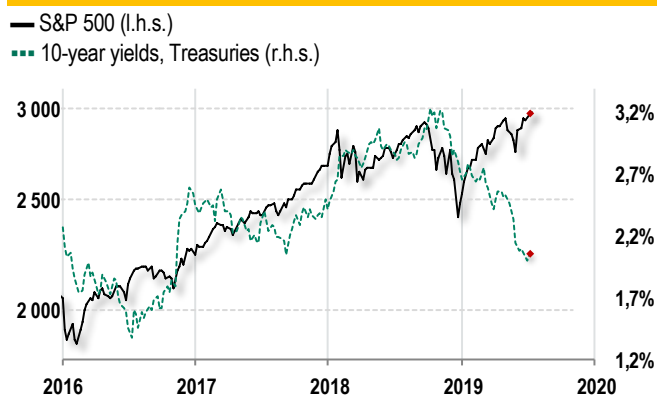
Against this background of increased growth concerns, the key question for the coming months remains whether a tipping point will be reached. Fundamentals (labour market, income growth, corporate profits growth, interest rates) are, on the whole, still satisfactory, but a protracted period of uncertainty could weaken the

1- US Treasury yields vs ISM Manufacturing



Source: Institute for Supply Management, Refinitiv

2- S&P 500 vs US Treasury yields



Source: Refinitiv

influence of these fundamentals on growth. This in turn could weigh on confidence and market behaviour and trigger a negative feedback loop. A reduction in uncertainty would obviously provide a boost of confidence and create an uptick in growth. Trade negotiators should keep this in mind when they meet.

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United States

Monetary policy at a turning point

Although household consumption remained rather buoyant at springtime, foreign trade as well as investment may have weakened. In June, the business survey results were lacklustre, while the Federal Reserve opened the door to cutting interest rates. Already back on the campaign trail, President Trump is unlikely to soften his hard line on tariffs, although he will surely remain as unpredictable as ever. The economy is likely going to need some support.

In all likelihood, the US Federal Reserve (Fed) will cut its key rates by the end of the year. Not because the economy is doing so badly. Until June, consumption and the job market have been solid, unemployment kept very low. Yet the snapshot provided by the Federal Open Market Committee (FOMC) at its latest monetary policy meeting was rather flattering. But headwinds are building up, especially those that are hampering trade, which is becoming increasingly alarming for American producers¹.

■ Monetary easing seems almost certain

The slowdown in world trade has already depressed several business climate indicators, although it has yet to carry over to GDP, which rose at an annualised rate of 3.1% in Q1. The benchmark index of the Institute for Supply Management (ISM) has plunged since last summer. In June, manufacturing ISM slipped to 51.7, which is not far from the discomfort zone at which business volumes begin to stagnate.

The dichotomy between surveys and the national accounts never lasts very long, so that the Fed expects hard data to become less rosy and is gearing its communications accordingly. Key rates are currently fluctuating within a range of 2.25% and 2.50%, and the announced rate cut seems all the more credible given that it is in line with market expectations. Since spring, there has been an inversion of the yield curve for all maturities up to 5 years: in the past, such yield curve inversions have always preceded or accompanied monetary easing (see chart 2).

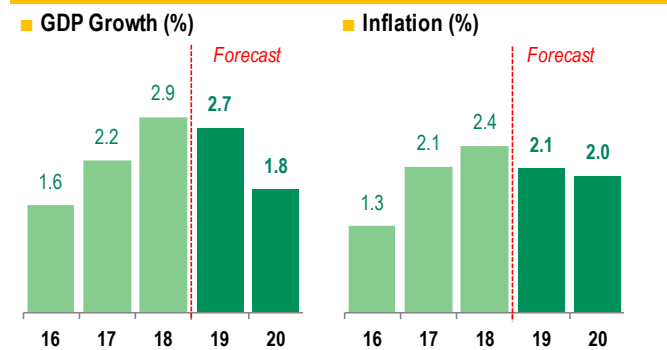
But that is not all. Although it revised its inflation outlook to 1.8% in 2019 and 1.9% in 2020², the FOMC indicated that it did not find wage and price dynamics to be excessive for this point in the cycle, notably with regard to the official target of 2%³. Unit labour costs (wages, bonuses and charges per unit of output) declined in the first quarter (-0.8% for the year in the non-farm sector), which is not very frequent and foreshadows milder inflation.

¹ “[...] our contacts in business and agriculture report heightened concerns over trade developments. These concerns may have contributed to the drop in business confidence in some recent surveys and may be starting to show through to incoming data.” Powell, J. (2019), Press conference following the 19 June FOMC meeting.

² Core personal consumption expenditure price index, excluding energy and food; year-on-year, for Q4 2019 and Q4 2020.

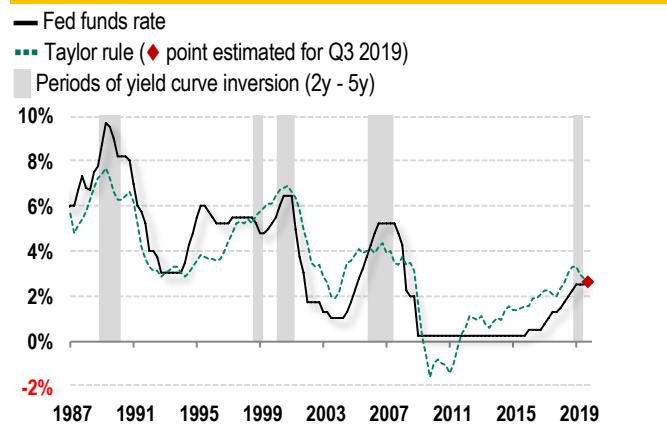
³ “[...] committee participants expressed concerns about the pace of inflation’s return to 2 percent. Wages are rising, [...] but not at a pace that would provide much upward impetus to inflation.” Powell, J., Ibid.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- End of a cycle



Source: Federal Reserve, CBO, Refinitiv.

According to the Taylor rule (see box 3 and chart 2), the inflation gap (the spread between observed and expected price inflation) should swing into negative territory, and the output gap (the spread between actual and potential GDP) should indicate fewer pressures on production capacity. Under these conditions, the Fed would at least mark a pause, and is more likely to opt for a key rate cut. President Trump would be wrong to rejoice even though his wishes are about to come true: by adopting a more accommodating stance, the central bank would not be following his orders as much as providing the necessary support for an increasingly likely US economic slowdown.



■ **No immediate appeasement with China**

Despite the truce announced at the Osaka G20 summit meeting on 29 June and just after the United States imposed new tariffs on China⁴, it seems vain to expect any easing of US trade tough line. First, appeasement does not fit with the political calendar. Already back on the campaign trail for the 2020 election, President Trump intends to reap as much political gain as possible from his hard-line policy, as economically risky as it might be. More importantly, the nature of US-China trade relations has changed profoundly in recent years and the two rivals are now in open competition to achieve technological supremacy.

Although the United States is still in the lead, notably in semiconductors, its supply chains are integrating a growing share of Chinese components: 85% of the taxed imports are part of the production process of major US corporations (Lovely & Liang⁵). The image of US-China trade in which Chinese textiles and household appliances are traded for American nuclear power and aeronautics equipment, which still prevailed when China joined the World Trade Organisation (WTO) in 2001, is an outdated stereotype that no longer corresponds to reality. In 2018, clothing, footwear, home furniture and travel goods only accounted for 14% of US imports from China, and their weighting has been slashed in half over the past twenty years. They have been replaced by telecommunications (the largest import category) and transport equipment, machinery and other industrial equipment, which now account for 30% of imports and are designed for all purposes, both civil and military.

The cards have been shuffled and re-dealt: the next time US trade negotiators face off with their Chinese counterparts, they are less likely to worry about the trade deficit and more about the challenges of cybersecurity and defence. Besides, when they do meet, “the security people are in the room”⁶.

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⁴ On 10 May 2019, the tariffs applied on some USD 200 billion in US imports from China were increased to 25%, from 10% in September 2018. All in all, USD 250 billion in annual imports from China are now hit by the 25% tariff.

⁵ Lovely M. E., Liang Y. (2018), *Trump taxation primarily hits multinational supply chains, harms US technology competitiveness*, Policy Brief, Peterson Institute for International Economics, Policy Brief, May.

⁶ Cited by *The Economist* (2019) “A new kind of cold war”, May 18th.

⁷ Taylor, J.B. (1993), *Discretion versus Policy Rules in Practice*, Carnegie-Rochester Conference Series on Public Policy, n° 39.

⁸ Adam Shapiro A., Wilson D.J. (2019), *The Evolution of the FOMC’s Explicit Inflation Target*, Federal Reserve Bank of San Francisco Economic Letter, April 15.

3- The Fed funds rate: what does the Taylor rule say?

Established in 1993 by the American economist John Taylor⁷, the Taylor rule links a central bank’s key rates to current and expected inflation trends, as well as to the output gap (the difference between observed and potential GDP). Using the following key:

i_{FF} : Fed funds rate, the US central bank’s key rate

y : Real GDP (log-level)

y^* : Potential real GDP (log-level)

π : Smoothed observed inflation rate

π_a : the central bank’s expected inflation rate

r^* : the real neutral or equilibrium short term rate

the Taylor rule can be written as follows:

$$i_{FF} = r^* + \pi + 0.5 \cdot (\pi - \pi_a) + 0.5 \cdot (y - y^*)$$

Results

Although it has the merit of simplicity, the Taylor rule depends on several exogenous variables that cannot be observed directly, and which are subject to diverse and fluctuating estimates. Another subject of debate is the empirical validity of its coefficients (initially set at 0.5).

Nonetheless, the Taylor rule describes rather accurately the fluctuations in the Fed funds rate over the past 30 years, notably during turning points (see chart 2).

Using the core PCE deflator (core personal consumption expenditure, excluding energy and food), a benchmark frequently used by the Fed (see Shapiro & Wilson, 2019)⁸, inflation came to 1.6% in Q1 2019, which is lower than the Fed’s 2% target and the long-term inflationary trend of 1.7% based on a Hodrick Prescott filter. Whether we use this figure or the 2% target to evaluate inflation expectations, the inflation gap seems to be slightly negative. Above all, the Taylor rule also depends on the hypotheses used for the real neutral rate (r^*) and the output gap.

In the initial Taylor rule, r^* is constant and set at 2%. Yet, it is largely admitted that the neutral rate has shrunk in the aftermath of the Great Recession. r^* would now range between 0.5% and 1.5%, using the FOMC long term projections for the Fed funds rates (we retain 1%). As regarding the output gap in 2019, it is also subject to various estimates: -0.1% (OECD), +1.1% (CBO) or +1.4% (IMF). Depending on various hypothesis, the Taylor rate would finally range from a 2.5% to 3.3% at the start of the year, e.g. no so far from the actual Fed funds rates.

Estimation of the Taylor rule, % (Q1 2019)

π (T1 2019)	1.6		
π_a	1.7		
r^*	1.0		
$y - y^*$ (2019)	CBO	IMF	OECD
	1.1	1.4	-0.1
	3.1	3.3	2.5
i_{FF}	2.5		



China

Hard blow

With the export sector hard hit by US tariff measures and private consumption growth weakening, investment growth has slowed. Although domestic demand could pick up in the short term, bolstered by monetary easing and fiscal stimulus measures, export prospects depend on the outcome of trade talks between Beijing and Washington, which remains highly uncertain. The authorities are bound to use foreign exchange policy sparingly to avoid creating a source of financial instability. Moreover, the current account surplus has improved again in recent months.

China's economic growth continues to slow. After decelerating for four quarters, real GDP growth remained stable at 6.4% year-on-year (y/y) in Q1 2019, but is expected to slow again in Q2. The troubled export sector is the main reason for the slowdown, but domestic demand growth is also very sluggish.

■ The export sector is in shock

The increase in US tariffs on imports of Chinese goods has been a hard blow for exporters, especially since tariffs were raised at a time when world trade growth was already slowing. Trade tensions between the two countries and growing protectionism have had a direct impact on shipments of Chinese merchandise to the United States, but they have also begun to have an indirect impact on world demand, by eroding business confidence and investment. Tariff hikes have rapidly had a cascading effect on Asian supply chains as well.

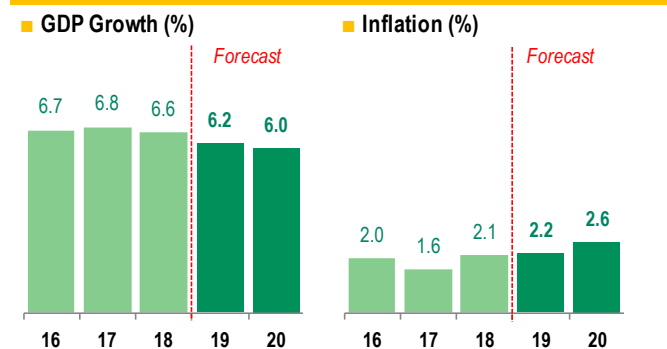
Chinese export growth slowed from 14% y/y in H1 2018 to 8% in H2, before slipping slightly into negative territory in the first 5 months of 2019. Exports to the US, which amounted to USD 480 bn in 2018 (19% of Chinese exports), declined by 9% y/y in the first 5 months of 2019 according to China's General Administration of Customs (see chart 2). US imports of Chinese goods that were hit by a 25% tariff hike as of July-August 2018 (about USD 50 bn) shrank rapidly following the US decision; their decline reached about 30% y/y in the first 4 months of 2019. Then the USD 200 bn of Chinese imports that were hit by a 10% tariff hike in September 2018, raised to 25% in May 2019, also contracted rapidly (following a rebound in Q3 2018 in anticipation of tariff increases): their decline reached more than 20% y/y in the first 4 months of the year, and the situation undoubtedly deteriorated in May-June.

Chinese exports to the rest of Asia (48% of exports) have also declined since December (-2% y/y), signalling the rapid transmission of US protectionist measures to other trading partners integrated in regional supply chains. Exports to Europe (19% of China's total exports) have continued to rise, but have nonetheless become less vigorous in the past six months, increasing by an average rate of only 7% y/y compared to 11% over the previous six-month period.

■ Private consumption growth slowing sharply

Private consumption growth has weakened. In April-May 2019, retail sales growth slowed to a new low of 7.9% y/y in value terms (vs an average of 9% in 2018) and 5.8% in volume (vs 7% in 2018). The

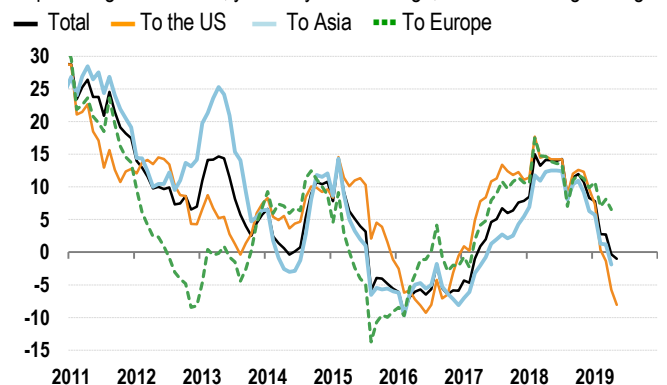
1- Growth and inflation



Source: National accounts, BNP Paribas

2- Exports falling

Exports of goods in USD, year-on-year % change, 6-month moving average



Source: China's General Administration of Customs

decline in automobile sales (-3% in 2018 and -13% y/y in January-May 2019) has had a heavy impact on the overall performance (automobiles account for about 10% of the total value of retail sales), but other sectors have also reported sluggish sales, notably durable goods (in line with the decline in real estate transactions) and leisure goods. Online sales growth has eased since H2 2018, but is still robust (+22% y/y in the first 5 months of 2019). Consumption of services is also still dynamic (it is estimated to account for nearly half of total consumer spending) but seems to be slowing more significantly in recent months.



The poor performance of private consumption is worrying because it delays the process of rebalancing the economy at a time when China is facing very unfavourable external conditions. The sluggishness of Chinese consumers is partially due to the troubles in the export sector and its consequences on confidence and the labour market. As a matter of fact, the “jobs” sub-component of the manufacturing PMI published by the National Bureau of Statistics has deteriorated rapidly since September 2018. In June 2019, it hit a low of 46.9 compared to an average of 48.9 in 2017-2018.

Consumer price inflation accelerated to 2.6% y/y in May-June 2019 from an average of 2.3% in 2018 and 1.6% in 2017. Inflation is mainly driven by a rapid increase in food prices over the past 3 months (+6.9% y/y in April-May, compared to an average of 1.8% in 2018). Meanwhile, core inflation declined slightly from 1.8% y/y at the end of 2018 to 1.6% in May 2019, a sign of sluggish domestic demand. Inflationary pressures are unlikely to hamper the accommodating bias of monetary policy in the short term, but they will constrain households' real income. The increase in per capita disposable income already slowed last year, dropping from 7.3% in real terms in 2017 to 6.5% in 2018, and standing at 6.8% y/y in Q1 2019.

The slowdown in private consumption growth can also be blamed on the weaker expansion in real estate loans and consumer credit. This has resulted from a still relatively tight property policy, from the strengthening in financial-sector regulation implemented since late 2016, and from repressive measures introduced more recently to reduce the number of P2P platforms for loans between individuals. At the same time, the household debt burden has increased in recent years and may well have begun to strain consumption. Household debt accounted for 53% of GDP at the end of 2018, up from 49% at year-end 2017 and 33% at year-end 2013.

In response to the slowdown in exports and private consumption, investment growth also decelerated in the first 5 months of the year, notably in the manufacturing sector (3.2% y/y in value, compared to 6.2% in 2018).

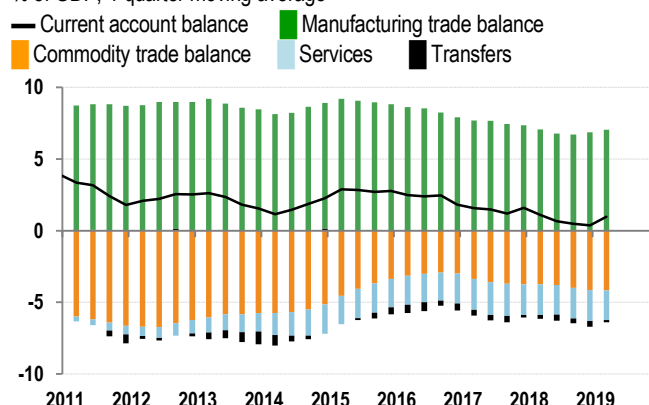
The economic growth slowdown is expected to continue in the very short term. Export prospects remain very uncertain given the major disagreements between Washington and Beijing, even though trade talks are due to resume. As to domestic demand, the main factors behind the slowdown in private consumption are still in place. Soon, however, spending of households and corporates should begin recovering, bolstered by fiscal stimulus measures launched since early 2019 and by the ongoing but prudent easing of the credit policy.

■ Moderate deterioration in external accounts

China is bound to maintain a prudent foreign exchange policy. Over the past year, the authorities have responded to the increase in US tariffs by letting the yuan weaken against the dollar (by 9.1% between end-March and end-December 2018, and then by 2.5% in May 2019). These bouts of depreciation have helped partially offset the impact of tariff hikes on exports. Although more could follow, they are bound to be moderate in scope, temporary and followed by slight re-appreciation movements. An overly rapid depreciation of

3- Current account surplus still persisting

% of GDP, 4-quarter moving average



Source: SAFE

the yuan risks triggering periods of financial instability and capital outflows, which Beijing would rather avoid.

Moreover, recent dynamics in China's external accounts have tended to reduce the downward pressure on the yuan. After shrinking rapidly in 2018, the trade surplus has begun to swell again since early 2019 (USD 131 bn in the first 5 months of the year, compared to USD 102 bn in the same period of 2018) despite the poor export performance. Imports contracted more sharply given the reduced need for industrial inputs, sluggish domestic demand and the decline in commodity prices.

The services balance continues to show a major deficit due to the solid momentum of Chinese tourism abroad, but it has levelled off at close to 2% of GDP since last year. All in all, the current account surplus picked up slightly in Q1 2019 after contracting from 1.6% in 2017 to 0.4% in 2018 (chart 3). As to the financial account, net capital flows have been relatively stable since early 2019. Foreign exchange reserves have increased slightly, reaching USD 3100 bn at the end of May 2019.

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Japan

Risks on the rise

Although Japan's economic openness is relatively limited, the high concentration of Japanese exports to China, and the other Asian countries in general, creates a major external risk for the dynamics of Japanese growth. This situation is squeezing the manufacturing sector, but for the moment, its difficulties do not seem to have carried over to the other sectors of the economy. The VAT increase planned for October should encourage households to make some early purchases, while the high level of uncertainty is hampering corporate investment. In this environment, the Bank of Japan is expected to maintain a very accommodating monetary policy, although this is unlikely to trigger a sustainable upturn in price inflation.

Hit by a typhoon in the third quarter, Japan's economic growth profile was highly volatile in 2018. The planned VAT increase in October 2019 should dampen private consumption in the year-end period as well as in 2020, while Japan's high exposure to Asia, and China in particular, makes the country highly vulnerable to an extended economic slowdown in the region.

All eyes riveted on Asia

In 2018, the Japanese economy slowed down sharply, with annual growth of only 0.8%, compared to 1.9% in 2017.

In Q1 2019, growth was relatively robust at 0.6% q/q. Foreign trade made a net positive contribution to growth, thanks essentially to a contraction in imports at a time of sluggish domestic demand. Exports also declined, especially to destinations on the Asian continent. For the rest of the year, plans to increase the VAT rate from 8% to 10%, which the authorities have scheduled for October after postponing it on two occasions already, should encourage households to make early purchases. Private consumption is likely to rise significantly in Q3 before slowing again in Q4. The negative effect will continue in 2020. Investment risks being undermined by the persistently high level of uncertainty, especially in the manufacturing sector, which is more exposed to the current slowdown in world trade and in the Chinese economy (China accounts for about 20% of Japanese exports). The Bank of Japan's most recent Tankan survey, a reliable indicator of business confidence, shows that the situation in Japan's manufacturing sector has eroded sharply again. The purchasing managers index (PMI) for the manufacturing sector paints a similar picture: at 49.3 in June, below the 50 threshold that separates expansion from contraction. The other sectors seem to have been spared for the moment.

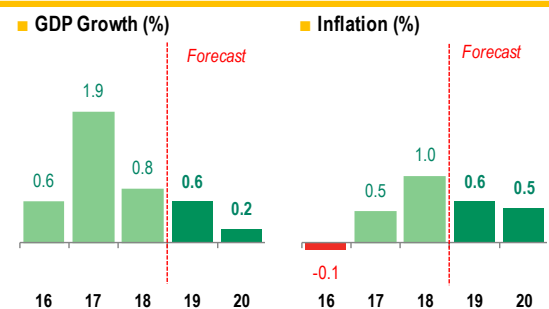
All in all, Japanese growth is expected to drop sharply to an average annual rate of 0.2% in 2020.

An ever more accommodating monetary policy

The Bank of Japan's monetary policy is already largely expansionist, but these sluggish macroeconomic projections could convince it to add another degree of accommodation at its monetary policy meeting in late July. It could begin by extending its forward guidance.

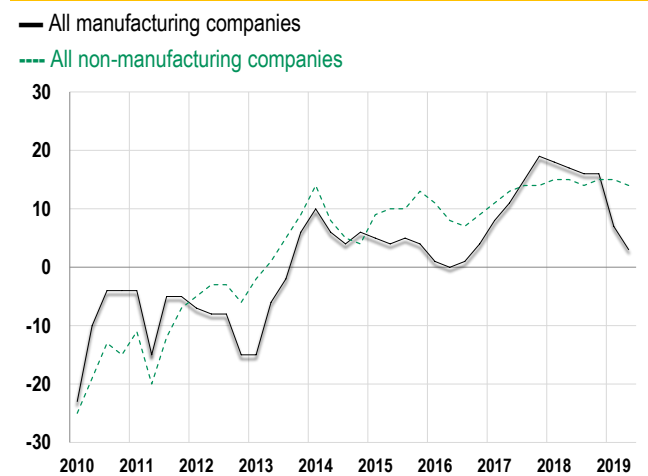
Even though its balance sheet accounts for 100% of the country's GDP, and interest rates are already negative for a broad range of maturities, the Bank of Japan's monetary policy has not had the intended impact on price momentum. Year-on-year inflation has

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Bank of Japan's Tankan indicator



Source: Bank of Japan

averaged only 0.5% since the beginning of the year and has held below 1% since early 2016.

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Eurozone

The ECB lends its support again

The months pass but nothing seems to change. Growth in the manufacturing sector is struggling to accelerate in a persistently uncertain international environment, while buoyant domestic demand is boosting activity in services. The stronger-than-expected first quarter performance sends a more optimistic message than economic surveys. Faced with a downturn in inflation expectations and the downside risks to the Eurozone's economic scenario, the European Central Bank (ECB) has been proactive again. It is prepared to ease monetary policy further and the new measures have been set up much earlier than expected. Yet faced with stubbornly mild inflation and only limited manoeuvring room, the ECB is bound to take a frugal approach.

Economic growth was stronger than expected in the first part of 2019. In the quarters ahead, activity will continue to be shaped by a precarious balancing act: faltering external demand will continue to strain the manufacturing sector, but without its full impact being carried over to the services sector. Labour market dynamics will play a key role. The ECB says it is prepared to ease monetary policy further.

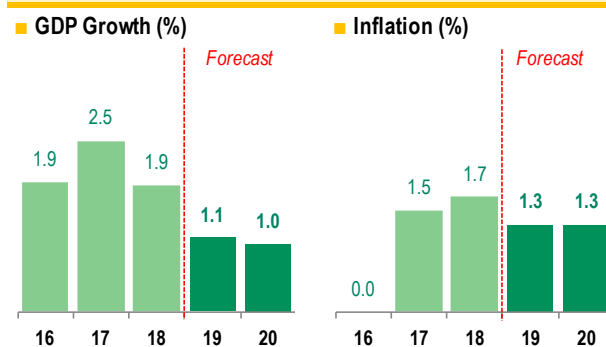
■ With a strong job market, what could go wrong?

In Q1 2019, eurozone growth was higher than expected at 0.4% q/q, after averaging 0.2% q/q in Q2 2018. Private consumption, the main growth engine in the first quarter, accelerated at a time of falling unemployment and strong wage momentum, while investment is still relatively robust despite the high level of uncertainty. After severely curbing eurozone activity in 2018, foreign trade supported growth in Q1 2019.

The most recent economic publications for the eurozone seem to confirm the dichotomy between growth profiles in the manufacturing and services sectors since the beginning of the year. Manufacturing PMI levelled off somewhat in June (47.8), but has followed a sharp downward trend since year-end 2017 (see chart 2). Services PMI, in contrast, has been resilient, and even rose in June to 53.4, the highest score since end-2018. As we have often pointed out in recent months, these developments illustrate both the rather sluggish external environment and the persistently favourable contribution of domestic support factors. In terms of trade, several factors are squeezing world demand for eurozone exports, including the less buoyant emerging economies, due notably to China's economic slowdown, the slowdown in world trade and high uncertainty due to trade tensions between the United States and some of its key trading partners. This deterioration can be seen in the "new export orders" component of the PMI, which has fallen sharply since the beginning of 2018, to 47 in June.

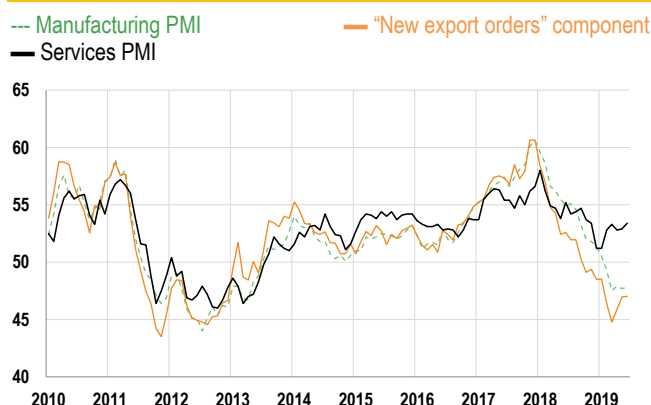
For the moment, the prevailing climate of uncertainty does not seem to have affected aggregate domestic demand, especially investment, which was very resilient in Q1 2019 (+1.1% in q/q) in an extended protracted period of very low interest rates. Household consumption is also very buoyant (+0.5% q/q in Q1 2019). This performance is largely due to the resilient job market, the ongoing decline in the jobless rate (to 7.7% of the active population in Q1 2019) and wage acceleration. Despite the sector's hardships, employment in the manufacturing sector has remained relatively robust. This could

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Eurozone PMI



Source: Markit

signal a labour hoarding effect, since sector players do not expect the slowdown to last very long.

Looking forward, thanks to a negative gearing effect in H2 2018, eurozone growth is expected to dip sharply in full-year 2019 before levelling off at around 1% in 2020 (see chart 1). Difficulties in the manufacturing sector could eventually carry over to the services sector, since the two sectors are highly interconnected. Maintaining healthy job market dynamics and unemployment trends in the months ahead will continue to play a key role. In the short term, Germany will be hit hardest by the global economic slowdown, given



its openness to trade, while Italy will continue to struggle with major structural headwinds. France will also slow but not as sharply, although a sharper-than-expected drop off in German growth could have major indirect consequences.

■ **A favourable policy mix for growth**

“In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required”¹. In his Sintra speech on 18 June, ECB president Mario Draghi opened the door to new monetary easing measures. These measures could be set up more rapidly than expected.

Several announcements were already made at the 6 June monetary policy meeting. The ECB decided to extend its forward guidance for another six months, pushing back any key rate increases until mid-2020. It also presented a few details on the next wave of TLTRO (TLTRO-III). Compared to previous operations, conditions seem to be slightly less accommodating, notably in terms of interest rates. The rates accompanying these operations will reach -0.3% at best, compared to -0.4% for TLTRO-II.

Why did the ECB soften its monetary message within just a 2 week interval, between 6 and 18 June? First, the ECB was responding to the first signs of an uncoupling of inflation expectations. Second, the US Federal Reserve was scheduled to meet the next day, and was expected to adopt a more accommodating stance. In this respect, the sharper tone of the ECB president’s speech was an attempt to prevent the euro from appreciating against the dollar. Following his speech, German 10-year yields dropped even more sharply into negative territory, while French 10-year rates hit 0%. The ECB is thus prepared to intervene again. Although it still has some manoeuvring room, it is smaller and not without risks, which means it must be used sparingly.

Fiscal policy is also expected to ease, which would stimulate demand and growth in the eurozone. This is notably the case for Germany, where taxes have been cut for low wage earners, for example, and in France, thanks to emergency measures adopted following the “yellow vest” movement. Although the overall easing of the policy mix could have a favourable impact on economic activity, it might not have the intended impact on inflation dynamics.

■ **Inflation: far below target**

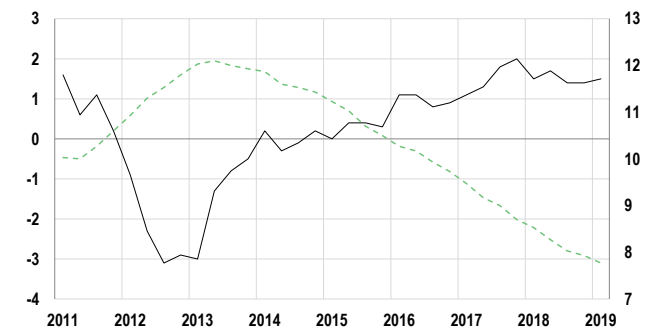
Eurozone inflation is still below its medium-term target of 2% and has not benefited so far from the upside pressure on unit labour costs. The structural weakness of inflation in the advanced countries is not limited exclusively to the eurozone. Some reasons for this structural weakness include globalisation, digitalisation, and income inequality. Benoit Cœuré² recently highlighted the tertiary expansion of the eurozone economy as a factor limiting inflation’s responsiveness to monetary policy. Prices in the services sector

¹ *Twenty years of the ECB’s monetary policy*, Speech by Mario Draghi, ECB Forum on Central Banking, Sintra, 18 June 2019

² *The rise of services and the transmission of monetary policy*, Speech by Benoit Cœuré, 21st Geneva Conference on the World Economy, 16 May 2019

3- Unemployment and manufacturing employment

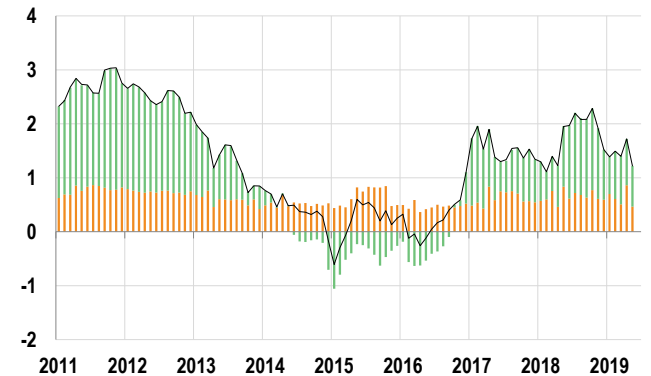
— Manufacturing employment trends (% , y/y)
- - - Jobless rate (% of the active population, rhs)



Source: Eurostat

4- Inflation of goods and services

— Total inflation (% , y/y) of which: — Contribution of goods (pp) and — Contribution of services (pp)



Source: Eurostat, BNP Paribas

change less frequently due to wage rigidity (services are labour intensive) and less exposure to international competition (although rising, the services sector still accounts for only 20% of total exports).

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Germany

Ebbing confidence

As international trade slows, the economy is mainly supported by expansionary fiscal and monetary policies and real disposable income growth. After a mild contraction in Q2, the economy is expected to grow modestly in the second half of the year. In 2020, exports may strengthen again and growth could return to close to potential. Due to its deep integration in global value chains, Germany is relatively hard hit by the global trade slowdown. This integration has undoubtedly brought benefits by improving productivity and skill-intensity. However, it has also accentuated income inequality.

■ A disappointing second quarter

Early indicators point to a slight growth contraction in Q2, following a surprising strong performance in the preceding quarter (0.4%). The latter could be attributed to temporary factors such as mild winter weather which stimulated construction activity, the end of supply difficulties in the car industry related to the introduction of the WLTP, and increased demand from UK clients in the run-up to the Brexit deadline.

Meanwhile underlying business conditions have continued to deteriorate. In June, the ifo climate index fell once again. At 97.4, it has reached its lowest level since November 2014. On balance, companies remain satisfied with the current situation, but express concern about the coming months, as order books are thinning. Only in the construction sector, the climate index remains at a relatively high level. Moreover, uncertainty among firms is relatively high. Since Q4 2018, the ifo dispersion index, which measures the dispersion of firm's expectations regarding the six-month business outlook, have been at around 59, a level earlier observed in the wake of the financial crisis.

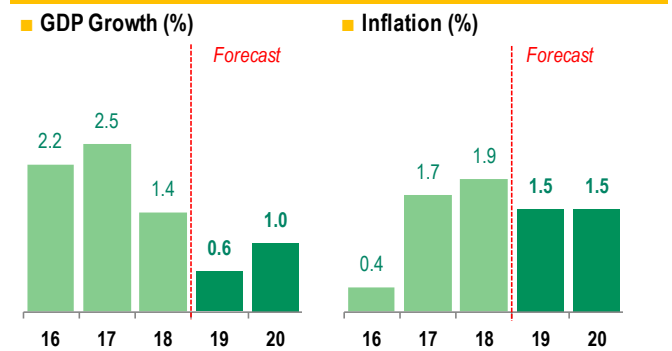
Nevertheless, the labour market remains well oriented. In April, employment was still about 1% higher from the previous year and the harmonised unemployment rate stood in May at 3.2%, the lowest in the eurozone.

Given the tensions in the labour market, negotiated wages have risen sharply in recent months. In Q1 they were almost 3% higher from a year earlier. Overall labour costs rose by 2.3% over the same period. However, this has hardly affected inflation. In May, consumer prices were only 1.4% higher from a year earlier.

■ An expansionary fiscal stance

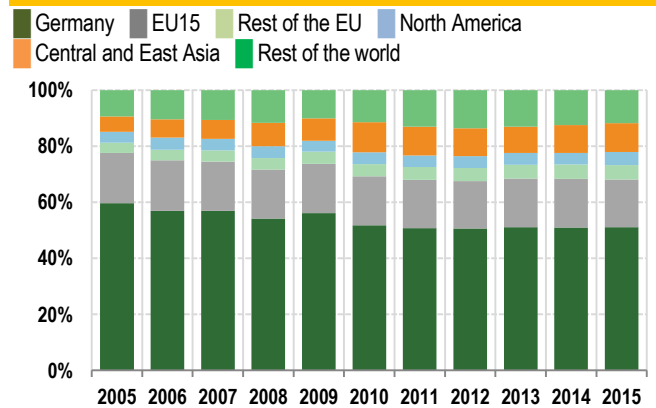
The coalition parties lost heavily in last May's European election. The CDU/CSU (conservative, Christian-Democrats) remained the largest party, but the SPD (social-democrats) ended third after the Greens. Many SPD supporters would like to quit the grand coalition. However, the prospect of crushing defeat and the upcoming election for a new chairperson do not make it a likely option for the moment. In the coming months, confrontations between the coalition parties are likely to increase, as the SDP would like to have more influence on government policies in areas such as the introduction of a basic pension or climate policy.

1- Growth and Inflation



Source: National Accounts, BNP Paribas

2- Value added by country of origin in final demand for the German manufacturing industry



Source: OECD TIVA statistics, BNP Paribas calculations

In accordance with the coalition agreement, fiscal policy will be loosened considerably, in particular on the expenditure side. Government spending on transport infrastructure, child care and education will be increased. Moreover, the pension entitlement for people who raised children will be improved (mothers' pension). Income taxes and social contributions will not change substantially. The income tax cuts are just enough to compensate for bracket creep. Moreover, lower unemployment contributions will be offset by increased contributions for the long-term care insurance.



Given the fiscal loosening, the general government surplus will probably shrink markedly from 1.7% of GDP in 2018 to 1% in 2019 and 0.75% in 2020. Moreover, tax receipts, in particular from the corporate sector, are likely to disappoint. On the positive side, interest payments continue to decline because of the exceptionally low interest rates. As a result, the debt ratio will continue to fall and will fall below the 60% of GDP mark, for the first time since 2002.

■ Growth may pick up in 2020

In the coming quarters, the economy will be mainly driven by expansionary fiscal and monetary policies. In addition, domestic demand will be supported by earlier concluded generous wage settlements and a well-oriented labour market.

Against this backdrop, only a slight increase in GDP is expected in the second half of 2019, mainly due to robust government and household demand. By contrast, manufacturing production growth will remain sluggish given the slowing of international trade. It is likely that this will also spill over to the rest of the economy. In particular, the uncertain business climate is not very conducive for investment. Assuming an orderly Brexit, some of the trade uncertainties may be lifted towards the end of the year, which will be favourable for German exporters. Moreover, construction activity will remain supported by low interest rates and the infrastructure projects. Growth is projected to be again close to potential, estimated at 1.4%.

■ Integration in global value chains

At the moment, the large Germany's large manufacturing sector is very much affected by the slowdown in international trade. During the past decades, German manufacturers have become very integrated in global value chains. In order to remain competitive in world markets, they have off-shored low value added and labour intensive processes. As a result, the domestic share of value added in total demand declined from 60% in 2005 to 51% in 2015. Most of the value added is still produced in the EU (73% in 2015) but the share of China has substantially increased, from 1.8% in 2005 to 6% in 2015. Moreover, a shift to the former communist countries in central and Eastern Europe is observed, their share in the value added increasing from 3.7% to 5.2%. The trade in value added statistics also show that 4.1% of the value added of the German manufacturing sector came from the US in 2015, compared with 3.3% in 2005. It underlines once more that US trade sanctions may also indirectly affect US industry.

The manufacturing sector receives also inputs from other sectors, such as services. Its share in terms of value added has remained rather constant at around 33%. Against this backdrop, it is not surprising that business services are also impacted by the slowdown in manufacturing production.

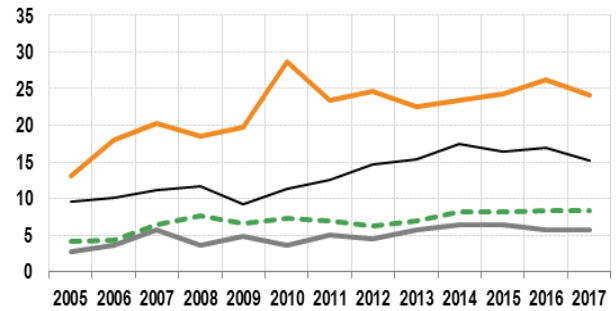
The offshoring of low value added and labour intensive processes have had a profound effect on the German labour market. It is not that the number of jobs has declined. On the contrary, jobs have increased and unemployment is at a record low. However, the nature of the jobs has changed, as the economy has become more knowledge intensive. Between 1995 and 2009 (latest data available)

3- The risk of in-work poverty has increased

% of employed people earning less than 60 % of the median equivalised disposable income after social transfers

Single person : — with children, — without children

Two or more adults: - - - with children — without children



Source: Eurostat

the share of hours of worked by high skilled persons increased from 21.8 to 27.7%. This has been a contributory factor to the growing inequality. Although partly compensated by the redistribution of income through the tax and social security system, the risk of poverty among people in the working-age population has increased over the past 15 years.

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France

Growth continues

The signs of stabilisation seen at the beginning of the year have been followed by improvements in confidence surveys. The upturn in consumer confidence has been the most marked and the most encouraging of these. The rather more mixed nature of the economic data available tempers these positive signals somewhat, and leads us to forecast stable growth in Q2, at 0.3% q/q, making this the sixth quarter in a row to see growth at around this pace. This stability, which is remarkable in and of itself, is likely to continue over the coming quarters according to our forecasts. It is a good sign of the resistance of French growth to downward pressures. Under our scenario, this resistance demonstrates a degree of effectiveness in the measures taken to support consumers and businesses.

■ So far so good

Since the beginning of 2018, although it has been slow, French growth has set itself apart by its stability, a sign of its resistance to downward pressures. In Q1 2019, real GDP rose by 0.3% q/q, in line with expectations, which we believe is good news given the rather mixed economic indicators at the time. The upward revision of the Q4 2018 growth figure (from 0.3% to 0.4% q/q) provided more good news¹, while the stability in the domestic demand contribution (0.4 percentage points in Q1 2019 as in Q4 2018) is another positive factor. This stability was driven by a small but encouraging acceleration in consumer spending (up 0.4% from 0.3% q/q) offset by a similarly small deceleration in total investment (up 0.5% from 0.6% q/q) and public consumption (up 0.2% from 0.4% q/q). From one quarter to the next there was a mirroring of the effects of the changes in inventory contribution (negative then positive to the tune of -0.2 of a point and then +0.3 of a point) and net exports contribution (positive then negative at +0.3 of a point and -0.3 of a point respectively). Payrolls gains also remained on a positive trend, rising 0.4% q/q in Q1 2019.

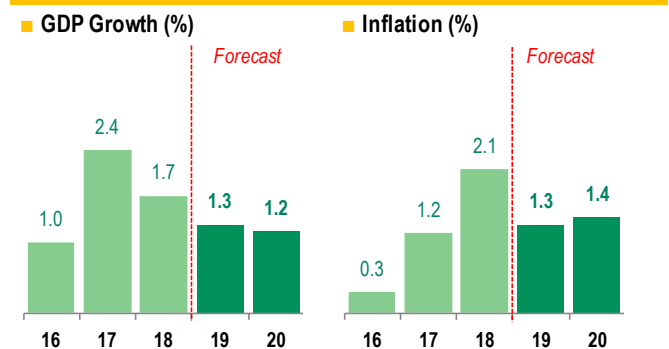
Growth prospects for Q2 are a little less mixed than in previous quarters thanks to the uptrend in confidence surveys. Their improvement remains limited and fragile. The return from slowdown to expansion territory of INSEE's new 'business confidence clock' is described as hesitant². These developments are nonetheless positive, particularly when contrasted with the less encouraging signals on the German economy. The difficulties of France's main trading partner will not be without their consequences for the French economy, but for the time being this latter is coming out quite well.

Since the trough at the start of this year, France's composite PMI has gained 5 points (having lost 11 points in 2018), taking it to 52.7 points in June. This increase has been based on improving conditions in services (up 5 points to 52.9 in June) and to a lesser extent in manufacturing (up 2 points to 51.7 in June). The fact that the German composite PMI figure is similar (at 52.6) hides a significant, unusual and unsettling divergence between the manufacturing number (45) and that in services (55.8). As far as national surveys of business confidence are concerned, the INSEE composite index is rising whilst the German Ifo is declining (the former is up 4 points since the start of the year; the latter down 2

¹ The growth figure for 2018 was also increased from 1.5% to 1.7% (swda).

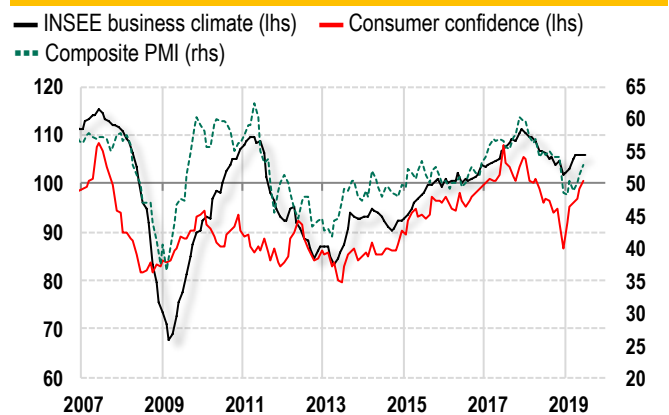
² See "France: new INSEE business confidence clock", Charts of the Week, 26 June 2019

1- Growth and inflation



Source: National statistics, BNP Paribas

2- Confidence surveys



Source: INSEE, Markit, BNP Paribas

points). At 106, the INSEE index is significantly higher than the reference average of 100. This level is consistent with a quarterly growth rate of 0.5% to 0.6%. The most encouraging improvement has come in consumer confidence: in June, after six consecutive monthly increases, total gains of 14 points took it to 101, finally moving it (just) above its reference average of 100 for the first time since April 2018.

The positive signal from surveys has been tempered by the more mixed picture from the activity data available for April and May. However, our nowcast model suggests that whether on the basis of soft data or hard data, Q2 growth is estimated at just 0.3% q/q. This fits with our forecast as well as the INSEE one while the Bank of



France has just revised down its estimate, from 0.3% to 0.2% q/q. In our scenario, growth is expected to remain stable at this rate of 0.3% q/q for the sixth quarter in a row, whilst, to continue the comparison, German growth is expected to be zero or slightly negative (from 0.4% q/q in Q1).

■ Seizing the moment

This pattern is matched by prospects for the next few quarters, with French growth expected to maintain this rate of 0.3% q/q. Average annual growth is expected at 1.3% in 2019 and 1.2% in 2020. The cornerstone of this resilience remains the expected rebound in consumer spending, dragged along by rising purchasing power. On this point, from 2019 on, the exception is likely to become the rule and consumer spending's contribution should be again greater than total investment's one, after two years where the situation has been the other way round.

However, uncertainties remain over the rebound in consumer spending, and more specifically over its scale. The upturn in consumer confidence is a good sign, but for the time being, the hard data are not showing the same vigour. We continue to believe that this is only a matter of time. The reaction of consumer spending to increased purchasing power is not immediate. And the relatively high proportion of constrained expenditure, which has little or no sensitivity to changes in purchasing power in the short term, could further slow the reaction time and limit the reaction itself³. This said, by relaxing the constraint on revenue, the additional purchasing power is likely to have a significant stimulus effect on compressible, discretionary spending.

Time is moving on, however: the rebound in consumer spending cannot take too much longer to feed through or the expected GDP growth will not materialise. The importance of the timing of this rebound refers more globally to the good timing of the measures to support households' purchasing power. We believe that these measures are well-timed and that, when combined with the ones to support businesses, their support to domestic demand should help offset, and perhaps more than compensate for, the slowdown in external demand. Even so, there is still a risk that this support will prove ill-timed, and that its benefits will pass unnoticed – all the more so if the external headwinds prove stronger than expected, making it harder to demonstrate the effectiveness of the economic policy adopted.

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³ See M. Beatriz, T. Laboureau and S. Billot, "How are purchasing power and household consumption linked in France in 2019? An analysis of the different categories of households and forms of consumption", INSEE Special Analysis, June 2019

3- Reform of the unemployment benefits system

At the end of 2018, the guidelines sent by the government to social partners to renegotiate unemployment benefit sought to rework the aggregation rules for benefits and earned income, set an approach to reduce the use of short-term contracts and aimed to produce between EUR 1 billion and EUR 1.3 billion in annual savings between 2019 and 2021. When no agreement was reached, the government took back over and presented its version of the reform on 18 June 2019. It includes 12 incentive and support measures, whose main goal is to fight job insecurity. Savings over the period are estimated at EUR 3.7 billion. Of this total, EUR 350 million are allocated to strengthening resources at the Pôle Emploi employment service. The Prime Minister has also set a target of reducing the number of jobseekers by between 150,000 and 200,000 by 2021 thanks to these reforms. We set out the measures below in the order in which they will be introduced:

1 November 2019

(1) opening unemployment benefits to people who have resigned (providing that they have at least more than 5 years' service and have a professional project) and to (2) self-employed people in bankruptcy proceedings (minimum revenue of EUR 10,000 per year in the two years prior to the bankruptcy).

(3) new rules on eligibility and rebuilding of rights (EUR 2.8 billion in savings). At present a claimant needs to have worked for at least 4 of the previous 28 months; this will rise to 6 of the previous 24. As far as rebuilding rights is concerned, it will now be necessary to work for 6 months rather than just 1 to create new benefit rights. The effect of these tougher terms on precariousness is debated (either an increase or a decrease appears possible). Its counter-cyclical nature should also be considered, as it (more or less) restores the rule that was in force prior to the relaxation of 2009 (6 months worked in the previous 22).

(4) tapering of benefits: -30% from the 7th month for people with previous gross monthly salaries over EUR 4,500 per month with a net minimum benefit of EUR 2,261, except employees aged 57 or over (EUR 210 million in savings). This measure aims to reduce the duration of unemployment of this specific category of workers. But as they are net contributors to the system, the measure is seen as unfair and unjustified.

1 January 2020

(5) discounts and penalties on unemployment insurance contributions for companies with more than 11 employees in the seven sectors that are the biggest users of short-term contracts: food, drink and tobacco product manufacturers; specialist scientific and technical activities; hotels and restaurants; water production and distribution; transport and warehousing; manufacturing of rubber and plastic products; woodworking, paper making and printing. If a company has a contract termination rate (giving rise to registration at Pôle Emploi) higher (or lower) than the sector average, it will pay a penalty (or get a bonus). The contribution will vary between 3% and 5% (the current level is 4.05%) and will apply to the whole payroll. The discounts and penalties will balance each other in each sector. Calculation of termination rates will be based on rolling 3-year data. Companies will start to pay penalties or receive bonuses from January 2021 on the basis of 2020 data. The restriction to seven sectors has been questioned, but after evaluation the system could be extended to the whole economy. A fixed rate tax of EUR 10 will also be applied to customary fixed-term contracts.

(6) to (11) a new range of support and services for new claimants, companies and workers in insecure positions.

1 April 2020

(12) new method for calculation of benefits (EUR 700 million in savings) on the basis of monthly income rather than daily pay for days worked. Benefits cannot be less than 65% of previous net monthly income, nor more than this income, as is possible in some cases at present. This should help discourage the splitting of contracts.

Source: French government, press, BNP Paribas



Italy

A moderate recovery, in a mixed scenario

In Q1 2019, Italy came out of recession. The overall scenario remained mixed. The GDP annual growth rate was negative. Imports strongly declined and exports slightly increased, with a positive contribution of net exports. Both households and firms remained cautious, postponing consumption and investment. Cyclical indicators suggest a disappointing evolution in coming months, making more challenging the fulfilment of public finance objectives. The Italian Government approved an update of the 2019 Budget, with the public deficit around 2% of GDP, reaching an agreement with the European Commission and avoiding the disciplinary procedure.

In Q1 2019, Italy partly recovered from a mild recession in the second half of 2018. Although real GDP rose by 0.1% q/q, the annual growth rate was negative (-0.1%), for the first time since 2013. The breakdown of GDP data was mixed. The 0.5% net exports contribution mainly reflected the contraction of imports (-1.5%). Italian sales abroad rose by 0.2% q/q. In Q1, domestic demand added 0.2% to the overall growth, while stocks subtracted 0.6%. Value added of construction rose by 2.4% q/q, despite activity remaining feeble, as signalled by the evolution of new building permits. Value added of services declined by 0.2% q/q, with a significant contraction in the financial sector and in that of professional activity, while manufacturing recorded a slight increase.

■ The immediate outlook is gloomy

Despite the moderate recovery in Q1, expectations remain uncertain. Business confidence worsened, hovering around the lowest level in the last four years. Italian firms remain extremely cautious. In Q1 2019, the 0.6% increase in investment was the result of higher expenditures on construction, while that on machinery and equipment and that on means of transport declined by 2.2% and 5% q/q. Production fell both in March and in April, with a bigger decline in machinery and equipment sector, in metal products and in the transport sector.

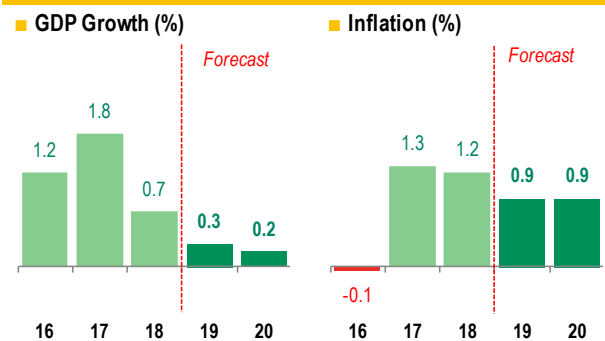
The worsening of confidence also affects Italian consumers, with a negative effect on private spending. This happened despite signs of improvement in the labour market, with the unemployment rate falling to 9.9% in May. In Q1, despite a 0.9% increase of purchasing power, consumption rose by only 0.1% q/q, as households increased their savings rate to 8.4%.

As cyclical indicators disappoint, it will be more challenging for the government to reach its public finance objectives. In June, the European Commission stated that Italy was experiencing excessive macroeconomic imbalances. The Italian Government approved an update of the 2019 Budget, reaching an agreement with the Commission and avoiding the disciplinary procedure. In 2019, the public deficit is expected to be around 2% of GDP, about EUR 7 bn lower than previous estimates, benefiting from higher revenues and lower expenditures.

■ Firms have improved their situation over the long run

Economic and financial conditions of Italian firms have improved. In 2018, the leverage ratio was around 40%, about 9 percentage points below the 2011 level. Benefiting from tax incentives, firms

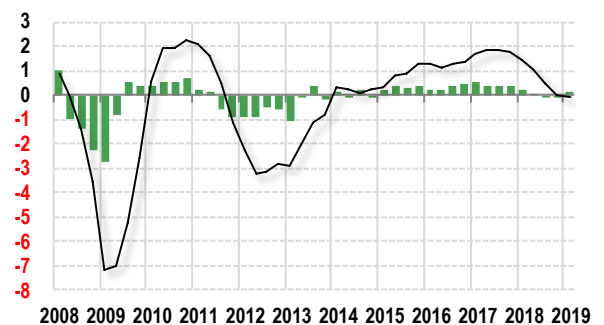
1- GDP growth and inflation



Source: National accounts, BNP Paribas

2- Italy: real GDP

— y/y, ■ q/q (% change)



Source: Istat

made significant new capital injections, while cutting debts. The improvement of the financial structure was also the result of the cleansing which occurred during the crisis leading to the disappearance of weaker companies. In 2018, value added of firms reached the highest level in the last twenty years. Besides, firms benefited from lower interest expenditure, as the rise of Government bond yields has not yet impacted the cost of credit. In 2018, the average cost of financial debt was 1%, from more than 6% in 2008. Italian non-financial corporations also took advantage from the decline of tax payments, with a saving of more than EUR 20 bn with respect to 2007. Despite these improvements, the recovery of

profitability is still disappointing, as labour costs increased more than value added. In Q1 2019, the gross operating surplus to value added ratio declined to 40.7%.

■ Tourism: a support for the economy

In 2018, international tourism turnover amounted to EUR 1,226 bn, +2.9% compared to 2017. United States continued to be the country with the highest receipts. The market share of Italy grew slightly, reaching 3.4%, the sixth highest value in the world after those of US, Spain, France, Thailand and the United Kingdom. In 2018 total expenditure by foreign travellers to Italy rose by 6.5%, amounting to about EUR 41.7 bn (a little slowdown after +7.7% in 2017) while the number of visitors increased by 3.7%. International tourism receipts account for 2.4% of GDP in Italy, 8% in Greece and Portugal, 5% in Slovenia and Spain. The Italian value is lower than the average of both the European Union and the Euro area. According to balance of payments data, in Italy international tourist receipts account for about 40% of total exports of services and about 7% of total exports of goods and services. The balance of travel, which is structurally positive, reached EUR 16.2 bn. The surplus of Italy's tourism balance in relation to GDP is higher than the European average and, among the main Euro area countries, it ranks second after the Spanish one.

The growth of the tourism sector in Italy has been taking place since the end of the international financial crisis: valued at current prices, in 2018 international tourism receipts were almost 50% higher than in 2009, while spending of domestic residents travelling abroad was 25% higher than in 2009. Overall, in 2015 (the last year for which these data are available), tourism-related industries in Italy represented 5.9% of the total value added of the country.

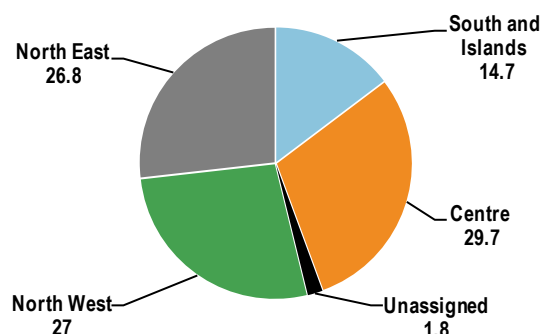
Visitors from the Euro area contributed the most to 2018 growth, both in terms of number and tourism receipts. Germany, along with the United States and France, is still the largest importer of Italian tourism services. Spending by German tourists in Italy rose by 8.2% y-o-y, those from France and United Kingdom by 9% and 17.2% respectively. These three countries generate over a third of total Italy's tourist revenues. Outside the EU, US is the largest importer of tourist services from Italy.

The regions of the center of Italy, with a higher tourist appeal due to the presence of a large number of art cities, are still the favourite destinations of foreign travellers, with almost 30% of total arrivals in 2018. The Southern regions and the islands reached a 15% share of total arrivals from abroad. This last area, despite the progress made in recent years, still presents a gap between international tourism revenues and the "tourism potential". In the south of Italy and the islands are indeed located about three quarters of the Italian sea coasts and national natural parks; these regions also host a large number of museums and archaeological sites.

In 2018 foreign travels of Italians amounted to 65.7 million, with an expenditure of EUR 25.5 bn (+1.8% and +3.8% respectively compared to 2017). The expenditure of Italian travellers who visited other countries in the Euro area grew more than the average in three countries: Greece, Spain and Germany. Among the destinations outside the European Union, the trend in spending was

3- Foreign travellers expenditure

(2018; % of total)



Source: BNL calculations on Bank of Italy data

particularly strong in North America, and especially in the United States.

The tourism sector in Italy is characterized by the presence of small and very small firms. According to Istat in 2016, around 97% of firms in this sector employed less than 10 persons (compared to 95% in the total industry and services). Firms with 20 or more employees only represent 0.9% of the total (compared to 1.8% in industry and service sectors). However, the presence of multinational hotel chains and other tourist services, including transport services, supplied by foreign companies operating in Italy is significant. Foreign invested enterprises in the tourism sector in Italy employ 6.1% of total employees in the sector and produce about 14% in terms of both the added value and the turnover. In the 2012-2016 period, firms in the tourism sector recorded a positive performance: their value added increased by 12.5% in nominal terms, against a change in the broader service sector of +11.2% and of 8.8% in the total industry and services. The increase in the value added in the tourism sector was due to a marked decline in the costs, rather than to an increase in firm's turnover.

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Spain

In search of a majority

Spanish growth is still robust, but that does not mean it is totally immune to the European slowdown. Although growth is expected to slow this year, it should have no trouble holding above an average annual rate of 2%. After winning April's legislative elections, Pedro Sanchez is still seeking a majority that would enable him to head the executive branch and form a new government. Spain officially exited the European excessive deficit procedure recently. Although a budget has not been formally adopted for 2019, the authorities are aiming for a primary surplus.

■ Solid growth is bound to slow

As survey data suggests, Spanish growth has proven to be quite resilient to the downturn in the international environment and the European slowdown in early 2019. Activity even accelerated slightly on a quarterly basis, with Q1 GDP up 0.7% q/q, the strongest growth since year-end 2017. Moreover, the breakdown of growth is favourable, and better balanced than we expected. First-quarter growth benefited from a net rebound in productive investment (+6.8% y/y in Q1 2019), and seems to be less dependent than we feared on household consumption (+1.4% y/y) and residential investment (+3.8% y/y), which is still looking upbeat.

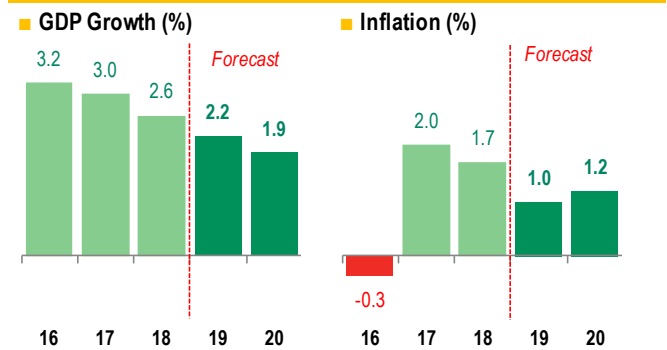
Foreign trade, in contrast, has continued to contract, a trend that began in H2 2018. Although the decline in exports of goods and services (-0.5% y/y) was limited by the strong performance of tourism, there has been an increasingly sharp drop in imports (-1.2% y/y), which limits the widening of the trade deficit observed last year. All in all, Spanish growth reached 2.4% y/y in Q1, compared to a eurozone average of 1.2%. According to the most recent survey data, a slowdown is very probable as of spring. This slowdown could extend somewhat into the quarters ahead, since the erosion of confidence is no longer limited to manufacturing and has now spread to the services sector. In general, however, GDP growth should have no trouble surpassing an average annual rate of 2% in 2019.

Under this environment, job creations have been very dynamic so far, up 2.5% y/y in Q1 2019, the biggest increase since year-end 2017. After employment bottomed out in late 2013, Spain has created 2.5 million jobs. The unemployment rate has just fallen below 14% of the active population for the first time in ten years, after rising above 26% in 2013, and it should continue to decline in the quarters ahead, albeit at a somewhat slower pace. Job creations, combined with mild inflation (which boosts household purchasing power), are the main source of resilience of domestic demand.

■ Seeking a majority to govern

Unsurprisingly, Pedro Sanchez came in first in the early legislative elections held on 28 April, with 28.7% of the votes cast. PSOE, the Spanish socialist party, won 123 of the 350 seats in the Chamber of Deputies, the lower house of parliament. This is nearly twice as many as its main opponent, the People's Party (66 seats), whose support evaporated with the milder wing shifting its support to the centre-right party Ciudadanos (57 seats) and the more radical wing to Vox, the extreme right party (24 seats).

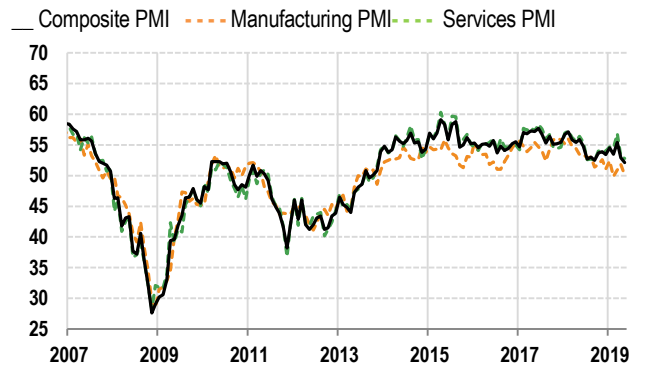
1- Growth and inflation



Source: National accounts, BNP Paribas

2- Slowdown ahead

Purchasing Manager Index (PMI, points)



Source: Markit

The PSOE victory will not necessarily reinforce Spanish political stability. In its new configuration, the Chamber of Deputies is no less fragmented than the previous one, and the party leader benefits from only 35% of the seats in parliament¹, compared to 39% for Mariano Rajoy and the People's Party following the 2016 elections.

In this situation, Pedro Sanchez has patiently awaited the outcome of the European elections as well as the municipal and local elections before starting the necessary deal making to form a new executive team. The elections revealed that the leader of

¹ The PSOE benefits from an absolute majority in the Senate, where most of the Senators are elected via a majority vote.



Ciudadanos, with whom a majority coalition is numerically possible, has rather decided to join the opposition alongside the People's Party, and was prepared, in some cases, to lend its support to local candidates of the Partido popular who were also supported by Vox.

On the left, no majority coalition is possible without the support of the Republican Left group, which includes the Catalan independence representatives of the ERC. Apparently, Pedro Sanchez would prefer to form a minority government based solely on the Socialist party, while seeking extra support from different sources depending on the issue. Yet this project runs against Podemos' plans to integrate the government as part of an official coalition with the Socialist Party. So far, nothing has been decided yet and the two parties are exploring the creation of a "co-operation" government. A first investiture vote is scheduled on July 23rd, but we cannot rule out the possibility that talks will extend beyond the summer break². Despite his electoral victory, Pedro Sanchez's future government may well have to rely on the support of a coalition as fragile as the one that backed the previous administration.

■ A smaller deficit despite the lack of a 2019 budget

Note that it was precisely after the previous parliament was unable to adopt a 2019 budget that Pedro Sanchez was forced to call April's early elections. Consequently, the 2018 budget has been automatically renewed for 2019, at least for now, and a series of additional measures were adopted by decree, notably in December 2018.

In terms of spending, these measures validated a general 1.6% increase in pensions, which is well above the legal minimum of 0.25%, and bolstered social welfare and local spending (including the extension of paternity leave, better benefits for unemployed seniors, and an extra boost for small pensions). According to the stability programme submitted to Brussels, increased spending will total about 0.4 percentage points (pp) of GDP, and will be financed by a slightly higher increase in revenues (0.5 pp) through higher social contributions and other taxes.

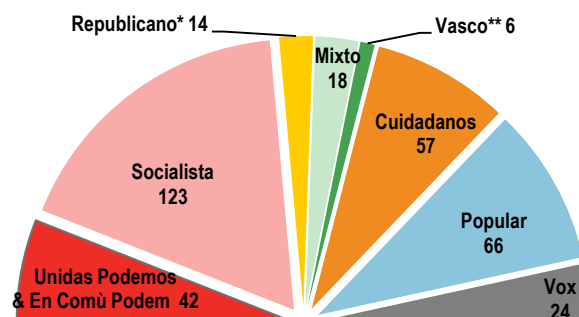
On the whole, fiscal policy will be slightly restrictive this year according to the authorities, and virtually neutral according to the European Commission. Once again, deficit reduction will be ensured through economic growth and the decline in interest charges. The decline, estimated at 0.1 pp compared to 2018 (interest charges declined from 2.5% of GDP to 2.4%), could be even bigger than expected given recent developments: Spanish 10-year sovereign rates have fallen sharply in recent weeks to 0.4% at the end of June.

All in all, the executive branch expects Spanish public finances to reach a primary balance in 2019, with the public deficit as a whole narrowing to about 2% of GDP, from 2.5% in 2018. In the stability programme submitted to Brussels last spring (prepared by the outgoing interim government), the authorities intended to strengthen

² In this first vote of confidence, an absolute majority is required to appoint the head of government. In the event of failure, a new vote is held two days later, where only a simple majority is required. If, within two months of this first election, no candidate has won the nomination of the Congress, new elections will be held.

3- Seeking a majority

Political groups in the lower house of parliament after the 28 April 2019 elections (number of seats)



* ERC Catalan nationalists

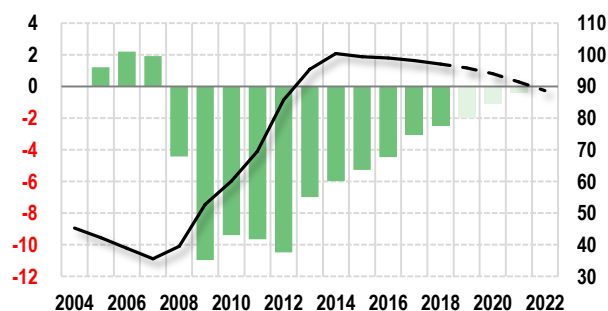
** PNV Basque nationalists

Source: Wikipedia

4- Fiscal outlook

% of GDP

Fiscal balance, — Public debt ratio



Source: European Commission, 2019-2022 Stability Programme

structural adjustment measures over the course of the 2019-2022 fiscal programme (for a cumulative total of 1.5 pp of GDP over 4 years), and to reach a public finance equilibrium by 2022 (chart 4). In 2020, fiscal savings measures have already been announced for a total of 0.5 pp of GDP³, but it is uncertain whether the upcoming minority or coalition government will be in a position to pass them.

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³ Including corporate tax reforms to limit the fiscal optimisation of major corporations and to lower the rate applied to SME (0.1 pp); a financial transaction tax (0.1pp); an income tax on digital activities (0.1pp) and measures to fight tax evasion (0.1).



Netherlands

Slowing towards potential

GDP growth is slowing due to the strong deceleration in global trade. Nevertheless, the economy continued to operate close to its potential until 1Q 2019 thanks to the strength of domestic demand, underpinned by strong disposable income growth and an expansionary fiscal policy. As the government has lost its majority in the Senate, it needs the cooperation of the opposition parties for passing new legislation. However, a government crisis is not imminent. Even if GDP growth is expected to slow below its potential in the coming quarters, public finance metrics will continue to improve up to 2020.

■ Clouds in the (blue) sky

Up to mid-2018, economic growth has been quite strong, largely above potential growth. It has however steadily declined from 3% in H1 2018 to 1.7% in 1Q 2019 and a new deceleration is expected in Q2, as reflected by the deterioration of CBS business cycle indicator. Until 1Q2019; the level of economic activity was still operating well above potential. Labour shortages have increased as the unemployment rate has declined to less than 3.5%. In Q1 2019, despite a stagnation in real wages caused by an increase in the reduced VAT rate (from 6% to 9%) and firmer oil prices, real household disposable income still rose by a decent 2.4% y/y, underpinned by strong employment growth (2.4%). This has stimulated private consumption and boosted housing prices. In April, household consumption (in volume terms) was 2% higher from last year. Moreover, in May house prices rose by 7.2% y/y, reaching a new historical high.

However, the Dutch economy is suffering from the gloomier external environment. In the manufacturing sector, production is declining (in April, industrial production was 1% lower than a year earlier) and orders books are thinning. Producer confidence is at its lowest level since 2016.

■ Government has lost majority in the Senate

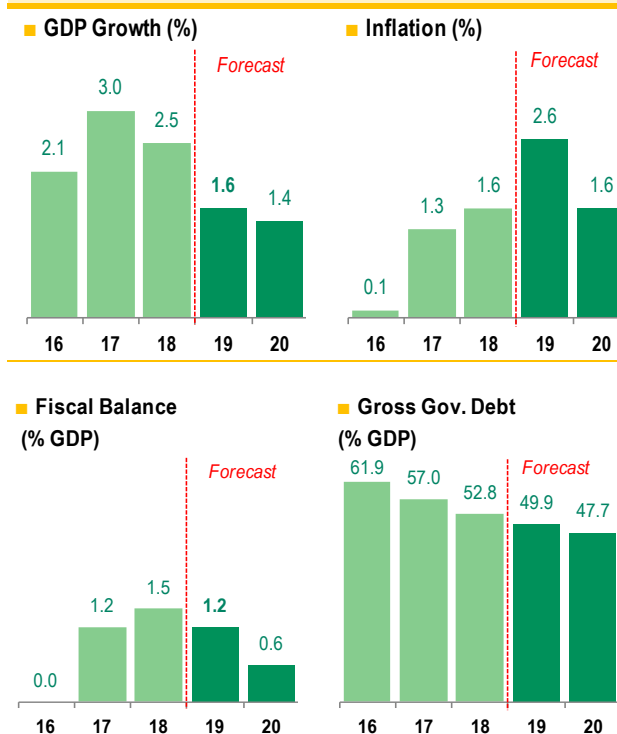
The centre-right coalition is not doing well in the polls and could lose almost one third of its seats if an election were to be held. Following severe losses in local elections, the government already lost the majority in the Senate. Even though the Senate cannot force the government to resign, it can block legislation. As a result, the government is forced to negotiate with the opposition parties to avoid gridlock. Even though the government has only a small majority in the second chamber of parliament, a political crisis is not imminent. The next general election should be held in March 2021.

Recently, the climate law passed both houses of parliament with an overwhelming majority. The law sets emission targets. The ultimate aim is to reduce greenhouse gases by 95% from the 1990 level by 2050. However, the law does not include measures to achieve this target, nor sanctions in the case of non-compliance.

■ Fiscal support

The economy will decelerate further in the coming quarters. Rising uncertainty has affected consumer and producer confidence and undermined investment spending. Nevertheless, growth should

1- Key indicators



Source: National Sources, EU Commission, BNP Paribas

remain close to its potential rate thanks to strong growth in consumer spending, underpinned by a still supportive real disposable income growth (thanks to a normalisation in inflation) and an expansionary budget policy.

Indeed, the government finances are in excellent shape. In 2018, the budget surplus amounted to 1.5% of GDP and the debt/GDP ratio has declined to less than 50%. This has allowed the government to pursue a fiscal expansionary policy, although less than initially planned. Indeed, major spending plans in infrastructure and defence have encountered considerable delays.

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Belgium

Household spending stabilises growth

Over the next quarters economic growth will remain stable. Rising labour market capacity constraints and a lower contribution by net international trade are weighing on the overall outlook. With also uncertainties in the international (trade war, Brexit) and national (government formation talks) context unlikely to dissolve anytime soon, our base case is one of below potential growth up until 2020.

GDP growth just reached 0.3% in the first quarter of the year, in line with our outlook of 1.0% for 2019. The continued low unemployment pushed up private consumption. The resulting growth in domestic demand could only partially offset the lower contribution of net trade.

■ All eyes on the labor market

The unemployment rate has been on a downward trend since many years now. The Michel-I government, currently still a minority coalition after its largest party jumped ship at the end of last year, proclaimed job creation to be its key priority at the start of the legislation. Since then the unemployment rate came down from 8.5% and has been hovering around 5.5% during the last half year.

Tensions are rising however as businesses struggle to fill out positions. The vacancy rates, measured as open positions as a percentage of the total number of positions, has been above 4% since early 2017. That is well in excess of the EU28-average of 2.5%. In a recent study, the National Bank of Belgium (NBB) identified as the main contributing factors a growing skill gap and weak geographical mobility, especially from the southern, French-speaking part of the country towards Flanders, in the north.

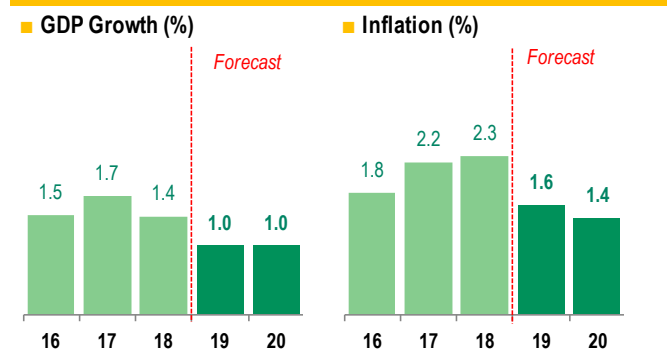
The NBB expects hourly wage costs in the private sector to increase on average with 2.3% per year in the next 3 years. This marks the end of a period during which the Michel-I-government reaped the benefits of an active cost management policy. The one-off indexation jump (a temporary freeze in the indexation mechanism, foregoing the automatic hike of some wages to match an increased cost of living) contributed greatly to closing the unit labour cost gap with the rest of the European Union.

According to the NBB, it is unlikely that the higher labour costs will feed through directly to prices and it expects profitability to decline somewhat. In any case, the current labour cost dynamics are expected to deteriorate Belgium's international competitiveness at a moment when international trade as a whole faces significant uncertainty.

Overall net trade will contribute less to growth than in 2018, as next to slower export growth we expect private consumption to drive an increase in import. As a result the current account should remain in negative territory, but no too far away from zero.

We see investment decelerate, as utilisation rates are coming down again, but we expect government expenditures to rise faster than last year. A big contributing factor here is the infrastructure project around the city of Antwerp.

1- Growth and inflation



Source: National Accounts, BNP Paribas

Private consumption growth will make the largest contribution. A record low unemployment rate and positive effects of the income tax shift are fuelling household purchases. The temporary dip in the third quarter of last year was mainly explained by lower expenditures on durables, related to stricter emission testing procedures for cars amongst other causes.

Next to that, the NBB expects that the threshold for wage indexation will be reached in January. This will lead to a wage rise for many government officials and other employees. Real household disposable income is expected to grow by 5% over the next 3 years. Taking into account the (limited) population growth, this would translate into purchase power growth per capita of 3.5% over the same period.

In the wake of the May federal elections, a key risk factor is lengthy government formation talks. On average the last 5 formation periods took about 6 months, which would suggest a new federal government could be ready to go no earlier than the end of this year.

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Greece

A new majority takes over

The economic recovery continues. Growth is accelerating and for the moment it has reached the lower range of expectations. After four and a half years in power, Alexis Tsipras passes on the helm to Kyriakos Mitsotakis, leader of the centre-right New Democracy party, which has led in the polls since 2016. The new Prime Minister is unlikely to call into question the prescribed public finance trajectory as the country exits the European financing programme.

■ Greece recovers despite the European slowdown

The economic recovery continues, and at this stage is still in line with the scenario of the international institutions and creditors. Growth accelerated from 1.4% in 2017 to 1.9% in 2018, which is in the lower range of expectations (full-year growth of between 2% and 2.5% in the years following the exit from the European adjustment programme). Last year, economic growth was mainly driven by the rebound in exports of goods and services, as well as by the strong growth of private consumption. I

In late 2018 and early 2019, both of these growth engines slowed, however, bringing GDP growth to 1.3% q/q in Q1 2019. Survey data suggests that the business climate and confidence are still looking upbeat, although neither improved during the spring. It is probable, however, that household consumption will continue to support growth and could even strengthen in the quarters ahead. Strong job growth (2.1% y/y in March) and mild inflation (0.6% in May) are boosting household purchasing power. Over the next few quarters, household income will also get a lift from the minimum wage increase (10.9%) implemented in early 2019, even though the unemployment rate is still very high (18.1% in March). The Tsipras government also launched a series of measures in favour of households in early May, a few days before the European legislative elections.

Hampered by the European cyclical slowdown, foreign trade should make a somewhat smaller contribution to growth despite the strong performance expected in the tourism sector. Buoyed by powerful catching up effects, growth should hold above 2% on average in the years ahead. Our 2019 GDP growth forecast of 2.4%, however, clearly has downside risks.

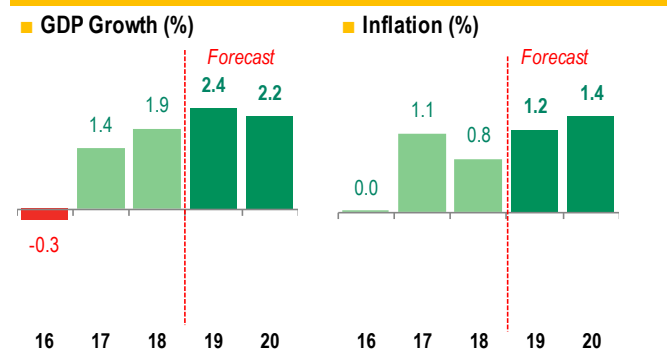
■ Political alternation

Following his party's poor performance in the European and local elections¹, Alexis Tsipras decided to call snap legislative elections on 7 July. As expected from the polls, the centre-right New Democracy (ND) party easily won the elections with just under 40% of the vote, versus almost 32% for Syriza². Given the electoral bonus of 50 seats for the winning party, Kyriakos Mitsotakis will

¹ His government also lost its parliamentary majority in early 2019 after its coalition partner, the Independent Greek party, withdrew its support to protest the name change concluded with the Republic of North Macedonia.

² Provisional results on July 8th 2019.

1- Growth and inflation



Source: National accounts, BNP Paribas

have an absolute majority in Parliament, and be able to form a government on its own.

In its Enhanced Surveillance Report, the European Commission expressed some concern about the size and composition of the fiscal package implemented by the previous government³, but the shortened pre-electoral period helped limit the pressure and risks of the campaign on public finances. The New Democracy's campaign platform focused on reducing red tape and tax cuts, but did not call into question the fiscal trajectory ironed out at the end of the financing programme, under pressure from creditors and the need for compliance.

Greece's fiscal surplus increased again in 2018 to 1.1% of GDP. At the same time, the public debt ratio peaked at 181.8% of GDP (EUR 334.6 bn) and should enter what promises to be a long narrowing trend starting in 2019. The Greek government is gradually returning to the capital market and has already made two 5 and 10-year issues for a total of EUR 5 bn. In a favourable environment of low European interest rates, yields on Greek 10-year government bonds were nearing 2.5% at the end of June, about 200 basis points lower than in early 2019.

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³ The Greek government estimated the cost of the campaign on public finances at 0.6% of GDP, but the European Commission thinks the cost will be closer to 1%.



United Kingdom

Brexit update

Brexit has been behind thirty-seven resignations from the government responsible for managing the process, the latest being that of Prime Minister Theresa May herself. Having failed three times to get the Withdrawal Agreement through Parliament, she had little choice but to ask for an extension of the Article 50 period and then in the end to resign. The two candidates to take her place are the current Foreign Secretary, Jeremy Hunt, and his predecessor, Boris Johnson. Whilst Mr Johnson claims he can negotiate a changed deal and trigger Brexit from 31 October 2019 (the latest deadline), Mr Hunt plans to seek more time in order to renegotiate to allow for an orderly exit.

The relative strength of the UK economy in the first quarter of 2019 (with GDP growing by an annualised 2%) should not be allowed to mask the true situation. First, the rebound was driven by an intense phase of inventory building in preparation for a Brexit that did not in the end take place, and ran counter to the picture painted by surveys of business leaders, which were more gloomy. The fundamental trends are not good. Foreign direct investment flows have reversed to a position of net outflows; the trade deficit has widened; and the pound has not recovered (Figure 1). Meanwhile, flows of immigrants from the European Union (EU) have dried up (with less than 60,000 net arrivals in 2018, equal to the low point of 2009), which is hitting the real estate sector. Whether it is the former Foreign Secretary, Boris Johnson, or his successor, Jeremy Hunt, who succeeds Theresa May, the future Prime Minister will inherit an economy under pressure; moreover, they will have very little time to act, given the current Brexit departure date of 31 October 2019.

■ Replace the Prime Minister, but to what end?

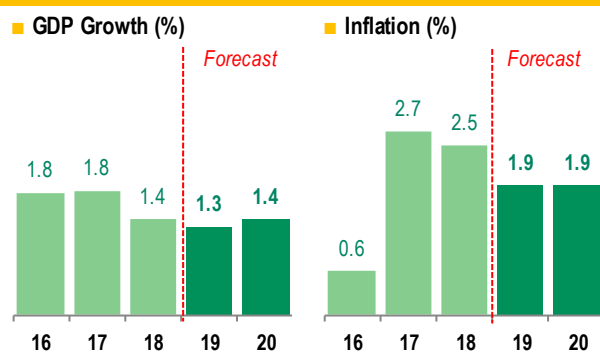
Having declared after the Brexit referendum that the UK could have its cake and eat it when it came to the Single Market, candidate Johnson will have his work cut out to persuade the twenty-seven EU heads of state or government (the 27) to offer his country better terms for its departure.

His chances of success are close to zero. When they accepted an extension of the Article 50 period to 31 October 2019, the 27 were clear that the Withdrawal Agreement they had reached with Mrs May in November 2018 would not be renegotiated. One key issue is the ‘Irish backstop’¹ which is a stumbling block for some in the UK but seen by Europe as a guarantee of the integrity of the Single Market. Although there is some (limited) room for rewriting the Political Declaration (which is not legally binding, but sets the direction of travel for post-Brexit negotiations), the incoming Prime Minister should not count on being able to put anything other than the current withdrawal agreement before the House of Commons.

However, with the Withdrawal Agreement having already been rejected three times, any ratification before 31 October looks highly unlikely, especially given that current parliamentary arithmetic casts

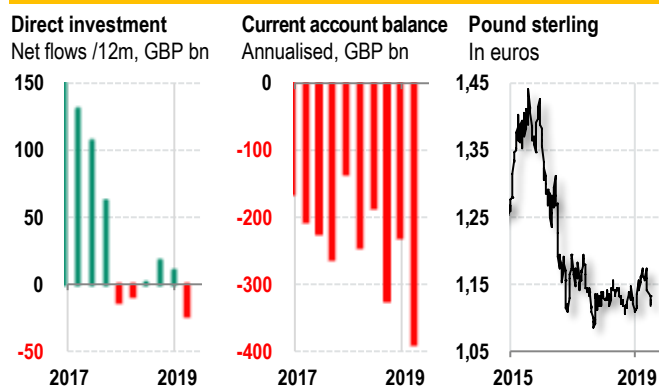
¹The Withdrawal Agreement states that once the UK has left the EU, and in order to avoid the reintroduction of a physical border between Northern Ireland and the Republic of Ireland, a safety net, or ‘backstop’ will apply to Northern Ireland. Under the Agreement and until the ‘future relationship’ is settled, Northern Ireland will remain in a temporary customs union with the EU and will have full alignment of standards (legal, technical, environmental, etc.).

1- Growth and inflation



Source: National statistics, BNP Paribas

2- Slippery slopes



Source: ONS, Refinitiv

Northern Ireland's Democratic Unionist Party as the referees, preventing any compromise.

The more clear-sighted Jeremy Hunt recognises that the UK is not currently in a position to enact the terms of the divorce agreement with the EU. He has argued for a further delay to Brexit, which, if his candidacy is successful, will not take place until 2020. In response, Boris Johnson has promised that the UK will leave the EU by midnight on 31 October, even if there is no deal in place.

A quick list of the regulatory and tariff complications of a ‘no deal Brexit’ is enough to show that such an option, even if some emergency measures were put in place (continuity of payment and settlement business, temporary extensions of licences, etc.) would



have the harshest economic impact for the UK (box 4). According to recent estimates from NIESR² it would result in a cumulative loss of 5 points of GDP by 2021. On the political front, it would also be difficult to get a no deal outcome through, for two reasons.

First, because it is far from certain that this approach is supported by a majority of the British people. Granted, at the European elections of 23 May, a good third of voters opted for the extremist Brexit Party or UK Independence Party (UKIP), both vehemently opposed to the EU and in favour of a clean break from it. However, the various pro-European parties (Liberal Democrats, Greens, Change UK, Scottish National Party) received more votes (6.7 million in all, or 40% of the total). Punished for their indecisiveness, the Labour and Conservative parties garnered less than a quarter of the votes and were the big losers in this election (figure 3). The European elections therefore revealed a fragmented political landscape, but also delivered an important message: in the UK supporters of a hard, or 'no deal' Brexit are many, but they are nevertheless a minority.

Secondly, the House of Commons signalled, in an indicative vote on 14 March, that it would oppose a no deal Brexit under all circumstances. Any Prime Minister seeking to push things to the wire would therefore run the risk of finding himself in a minority after a no-confidence vote. He would still have the ultimate option of proroguing parliament beyond midnight on 31 October, claiming that it would be necessary to do so to allow negotiations with EU partners up until the last minute³. This would lead to a 'hard Brexit' by default, but create such political turmoil that the question of its validity and the possibility of an early general election would immediately arise.

■ An early election?

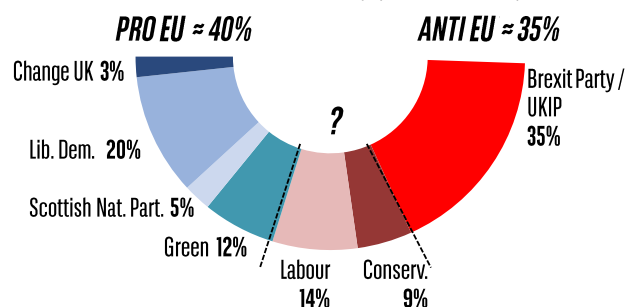
If in the end the House of Commons is unable or unwilling to ratify the Withdrawal Agreement but is also opposed to a no deal exit, its replacement would seem to be the only chance of moving out of the impasse. The question is thus not if but when and under what circumstances an early general election would take place. If the 31 October deadline seems too close, the 27 would in all likelihood agree to a further delay on the grounds that a general election in the UK could change the situation in a way that would allow an orderly withdrawal or even resubmit the question of Brexit to the British people.

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3- A fragmented landscape

Results of the European elections on 23 May (% of votes cast)



Source: Press

4- A (non-exhaustive) list of the regulatory and tariff consequences of 'no deal'

Without a transitional period [...] trade relations with the UK will be governed by general WTO rules, without application of preferences as of the date of withdrawal. This means in particular that:

-Customs formalities will apply, declarations will have to be lodged and customs authorities may require guarantees for potential or existing customs debts.

-Customs duties will apply to goods entering the EU from the United Kingdom, without preferences.

-Prohibitions or restrictions may also apply to some goods entering the EU from the United Kingdom, which means that import or export licences might be required.

-Import and export licences issued by the United Kingdom will no longer be valid in the EU.

-Authorised Economic Operator (AEO) authorisations issued by the United Kingdom will no longer be valid in the EU.

-Member States will charge VAT at importation of goods entering the EU from the United Kingdom.

-Rules for the declaration and payment of VAT [...] and for cross-border VAT refunds will change.

-Movements of goods to the United Kingdom will require an export declaration. Movement of excise goods to the UK may also require an electronic administrative document (eAD).

Etc.

Source: European Commission, How to prepare for Brexit, Customs guide for businesses (extracts)

² National Institute of Economic and Social Research (2019) "Modelling the Short- and Long-run impact of Brexit" NiGEM Observation n°14, 31 May.

³ See the opinion expressed by former Conservative MP Nick Boles on the Guardian website, May 29.



Sweden

Growth slows

The robust GDP growth reported in 2018 is bound to slow this year. Sweden's main trading partners have been hit by slowdowns, which is having a negative impact on export momentum. The slowdown in job creations will also strain household consumption. Yet it is the reduction in residential investment that is expected to curtail economic activity sharply in the months ahead. Although inflation should near the central bank's 2% target by the end of the year, monetary policy will probably remain accommodating in the months ahead due to the uncertainty surrounding economic trends.

Acquired GDP growth gave the Swedish economy a big boost in 2019 thanks to Q4 2018 and Q1 2019 growth rates of 1.2% q/q and 0.6% q/q, respectively. Yet the robust growth rates reported between 2014 and 2018 are bound to slow this year. From 2.3% in 2018, GDP growth could slow to 1.8% in 2019 and hold at a similar level in 2020, which is less than Sweden's long-term potential, estimated by the OECD at 2.1% y/y in 2019.

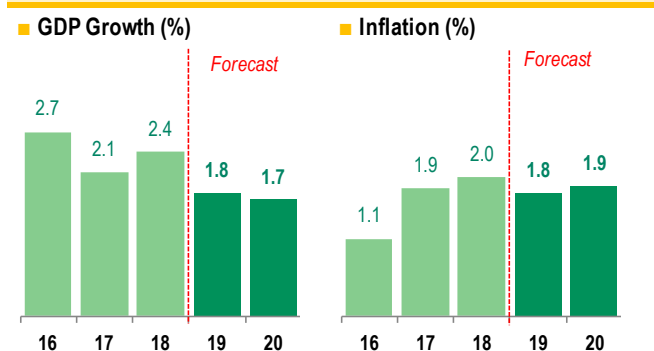
■ Decline in residential investment hampers growth

Sweden's main trading partners, the eurozone, Norway and the United States, have been hit by economic slowdowns that will have a negative impact on export momentum in the quarters ahead. Sweden's open economy also exposes it to the risks straining global trade due to trade tensions between the United States and its trading partners. There is also persistent uncertainty about the impact of Brexit -- the terms of which are still unknown -- on the UK and the rest of the European Union. The slowdown in exports and the growing concerns of business leaders, as expressed in confidence survey, will undermine investment in machinery and capital goods. Residential investment will continue to hamper growth as well in the months ahead. After making a strong contribution to growth between 2014 and 2017, residential investment has contracted since summer 2018 due to the sluggish housing market.

The pace of private consumption is also expected to slow in 2019. Disposable household income is barely expected to rise. Wages will probably increase at a slightly stronger pace. The employment rate has reached an all-time high, and labour market tensions have picked up in recent months. Moreover, the qualifications of unemployed workers do not match those required for job openings. The slowdown in economic activity, however, is expected to slow the pace of job creations.

The slight decline in consumer price inflation is bound to be short-lived. From 2.1% y/y in May, the inflation rate is expected to ease slightly into the fall months due to the more moderate increase in energy prices this year. Thereafter, it should gradually approach the official target rate of 2%. The base effects linked to energy prices are also expected to taper off. The upturn in food prices and rental rates as well as the past depreciation of the Swedish krona are also expected to place upward pressure on consumer prices. Lastly, wage growth, as moderate as it may be, is also likely to push up consumer prices. Riksbank, Sweden's central bank, which has lifted its key rate from -0.5% to -0.25% in December 2018, should

1- Growth and inflation



Source: National accounts, BNP Paribas

maintain an accommodative monetary policy. The Riksbank prefers to consolidate economic growth and consumer prices. It also wants to avoid weakening the position of heavily-indebted households.

The economic slowdown combined with new expansionary fiscal policies will strain the fiscal surplus in 2019, which declined in 2018 due to increased public spending. Sweden plans to reduce employer social charges and to increase spending on education, social services and the environment. Even so, it will continue to report a fiscal surplus of close to 0.5% of GDP this year (compared to 0.9% and 1.4% of GDP, respectively, in 2018 and 2017). Sweden is also expected to continue reducing the public debt ratio. From 38.8% of GDP in 2018, it should approach the 35% limit that Sweden imposed on itself as of 2019, thanks to a primary surplus, low interest rates and a nominal GDP growth.

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Denmark

Steady growth

Denmark's small open economy is bound to be hit by the economic slowdown affecting its main trading partners in the quarters ahead. Household consumption will remain the main growth engine thanks to job creations, wage growth and mild inflation. With consumer prices up only 0.7% y/y in May, inflation should remain mild. The Danish economy is also expected to benefit from an accommodating monetary policy in the quarters ahead, although this will depend on the policy stance adopted by the European Central Bank (ECB).

After GDP growth rates of 2.3% in 2017 and 1.5% in 2018, Denmark's growth profile should be much less jagged in 2019. A patent export in Q1 2017 distorted GDP growth in 2017¹ and 2018. Growth momentum should be relatively buoyant despite a less favourable international environment. After rising 0.1% q/q in Q1 2019, GDP growth is expected to near 1.7% this year and in 2020, which is close to the average growth rate for 2017 and 2018 (+1.9%) and the country's long-term potential rate, which the OECD estimates at 1.6% in 2019.

■ Growth driven by consumption

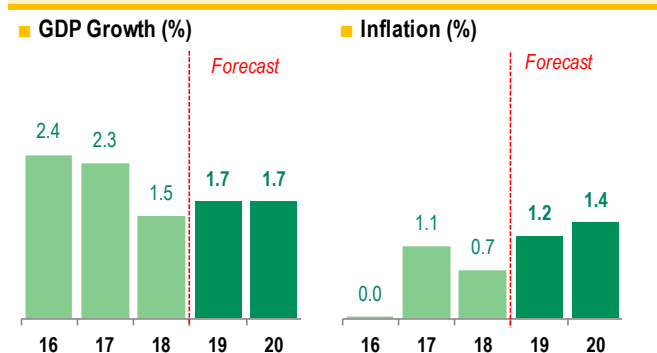
Denmark's small open economy is bound to be hit by the slowdown in growth in Germany, Sweden, and the United States, its main trading partners². Yet doubts persist over the size of the slowdown. Much depends on the pursuit of protectionist policies and world trade trends. Similarly, Brexit – the terms of which are still unknown – poses a risk for the Danish economy given its close trade ties with the UK (which accounted for 6.7% of exports of Danish goods in 2018). Investment in machinery and capital goods will also be undermined this year by less favourable growth prospects and negative acquired growth. Residential investment, which rose strongly between 2015 and 2018, is also expected to weaken due to the slowdown in house price inflation.

Apparently household consumption will continue to be the main growth engine in the quarters ahead. Job creations are expected to slow slightly, in line with activity, although they should continue to increase at a sufficient pace to maintain unemployment at a low rate (5.3% in April). A tighter labour market should generate greater wage pressures and drive up disposable household income and spending in the months ahead. Moreover consumer price inflation should be moderate.

Wage growth is likely to push up consumer prices in the months ahead, but inflation was only 0.7% y/y in May and will apparently hold below 2% y/y for several more quarters.

The Danish economy is also expected to benefit from an accommodating monetary policy in the quarters ahead (the deposit facility rate is currently -0.65%). Yet Danish monetary policy

1- Growth and inflation



Source: National accounts, BNP Paribas

depends on that of the European Central Bank (ECB), since the Danish krone is pegged to the euro³.

In 2018, Denmark reported a fiscal surplus of 0.5% of GDP, which is likely to diminish slightly again in 2019. Economic growth should bolster public finances, but property tax refunds and the decline in the pension yield tax could strain the fiscal balance. Denmark should nonetheless report a fiscal surplus, which leaves the authorities some manoeuvring room in case of a slowdown. Similarly, public debt is expected to decline again in 2019, from 34.1% of GDP in 2018, thanks to a primary surplus, low interest rates and nominal GDP growth.

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¹ A patent exported in Q1 2017 contributed 0.4 percentage points of GDP growth in 2017 and had a similar negative impact in 2018.

² In 2018, exports to Germany, Sweden and the United States accounted for 15.5%, 11.5% and 8.3% of the country's exports, respectively.

³ The Danish krone benefits from a fluctuation band of 2.25% on either side of the pivot exchange rate of DKK 7.46 to the euro.



Economic forecasts

%	GDP Growth			Inflation		
	2018	2019 e	2020 e	2018	2019 e	2020 e
Advanced	2.2	1.8	1.3	2.0	1.6	1.6
United-States	2.9	2.7	1.8	2.4	2.1	2.0
Japan	0.8	0.6	0.2	1.0	0.6	0.5
United-Kingdom	1.4	1.3	1.4	2.5	1.9	1.9
Euro Area	1.9	1.1	1.0	1.7	1.3	1.3
Germany	1.4	0.6	1.0	1.9	1.5	1.5
France	1.7	1.3	1.2	2.1	1.3	1.4
Italy	0.7	0.3	0.2	1.2	0.9	0.9
Spain	2.6	2.2	1.9	1.7	1.0	1.2
Emerging	4.5	4.2	4.7	4.7	4.8	4.3
China	6.6	6.2	6.0	2.1	2.2	2.6
India*	7.0	7.4	7.6	3.4	3.5	4.2
Brazil	1.1	0.8	2.5	3.7	3.9	3.9
Russia	2.3	1.5	1.7	2.9	5.1	4.1

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

* Fiscal year from April 1st of year n to March 31st of year n+1

Financial forecast

Interest rates, %		2019				2018	2019e	2020e
		Q1	Q2	Q3e	Q4e			
US	Fed Funds	2.50	2.50	2.00	2.00	2.50	2.00	1.75
	Libor 3m \$	2.60	2.32	2.00	2.00	2.81	2.00	1.80
	T-Notes 10y	2.42	2.00	1.95	1.90	2.69	1.90	2.25
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Euribor 3m	-0.31	-0.35	-0.30	-0.30	-0.31	-0.30	-0.30
	Bund 10y	-0.07	-0.32	-0.05	0.00	0.25	0.00	0.15
	OAT 10y	0.26	-0.01	0.30	0.30	0.71	0.30	0.45
UK	Base rate	0.75	0.75	1.00	1.25	0.75	1.25	1.25
	Gilts 10y	1.00	0.84	2.00	2.10	1.27	2.10	2.10
Japan	BoJ Rate	-0.06	-0.08	-0.10	-0.10	-0.07	-0.10	-0.10
	JGB 10y	-0.09	-0.16	-0.02	-0.02	0.00	-0.02	-0.05

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019				2018	2019e	2020e
		Q1	Q2	Q3e	Q4e			
USD	EUR / USD	1.12	1.14	1.16	1.20	1.14	1.20	1.25
	USD / JPY	111.0	108.0	105.0	102.0	110.0	102.0	95.0
	GBP / USD	1.30	1.27	1.32	1.38	1.27	1.38	1.49
	USD / CHF	1.00	0.98	0.99	0.97	0.99	0.97	0.94
EUR	EUR / GBP	0.85	0.89	0.88	0.87	0.90	0.87	0.84
	EUR / CHF	1.12	1.11	1.15	1.16	1.13	1.16	1.18
	EUR / JPY	124.0	123.0	122.0	122.0	125.0	122.0	119.0

Source : BNP Paribas GlobalMarkets (e: Forecasts)



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