ECO PERSPECTIVES

1st Quarter 2023

EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

THREE 'CERTAINTIES', MANY UNCERTAINTIES

From an economic perspective, 2022 will go down in history as the year in which elevated inflation made a surprising comeback forcing major central banks to start an aggressive tightening cycle. It is highly likely that in twelve months' time we will look back at 2023 as a recession year, a year of disinflation, and a year in which official interest rates reached their terminal rate and stayed there. As usual, the list of 'known unknowns' is long. Energy prices might increase again after their recent decline, disinflation might be slower than expected, policy rates might peak at a higher level than currently priced by markets, and the recession might be deeper and longer than anticipated. However, we should also pay attention to factors of resilience: companies hoarding labour, thereby limiting the rise in unemployment, the support from fiscal policy in many European countries, the need to invest in the context of the energy transition.

Economists seldomly use the word certainty when commenting their forecasts. After all, economic activity is so dynamic and subject to unforeseen events that projections are often, if not always, surrounded by a high degree of uncertainty.

Looking at 2023, the list of 'known unknowns' is long but, focusing on the US and the Eurozone, there are also 'certainties', i.e. developments that are highly likely to occur. The first one is disinflation, which refers to a sustained decline in headline inflation. A key driver is a favourable base effect. Following the recent and expected evolution of energy prices, their contribution to headline inflation should decline quite a lot. In its latest projections, the ECB expects the contribution of energy to annual inflation to drop from 3.8 percentage points in 2022 to 1.6 percentage points in 2023. In addition, easing supply chain pressures -shorter delivery times, decline of input price inflation- and subdued demand, which should weigh on the pricing power of companies, should also contribute to a decline in inflation.

The second 'certainty' is the peak in central bank policy rates. Rate hikes in 2022 have been front-loaded, which means that the pace and extent of tightening has been swifter than in previous cycles. It also implies that the terminal rate should be reached more quickly. This stance has been motivated by the huge inflation overshoot -the gap between observed and target inflation- and the need to bring inflation expectations, which had been drifting higher, rapidly under control.

Finally, we forecast a recession in the Eurozone, which we see as inevitable, with three quarters of negative quarter-on-quarter growth starting in Q4 of 2022. Survey data have already reached a level that corresponds with negative quarterly growth (chart 1). In the US, we expect a recession of similar length but starting later, in Q2 2023. The decline of the index of leading indicators is also pointing in that direction (chart 2). The latest ECB projections also have a recession -short-lived and shallow- but in the US, Federal Reserve Chairman Powell preferred not to express a view on the matter in his recent press conference.

With these 'certainties' come many more uncertainties. Top of mind is of course how the war in Ukraine might evolve and what this could mean for the economy. Another question concerns inflation, where risks continue to be tilted to the upside, meaning a slower than expected pace of disinflation.

Even if energy prices were to remain stable, past increases could still fuel inflation. As old, fixed-price energy contracts come up for renewal, the ensuing cost increase for companies could be reflected to some degree in higher sales prices. However, this depends on the price elasticity of customer demand, at least if alternatives are available. If disinflation disappoints, investors might expect a higher terminal rate for central bank policy rates.

EUROZONE: GDP GROWTH AND ECONOMIC SENTIMENT INDICATOR

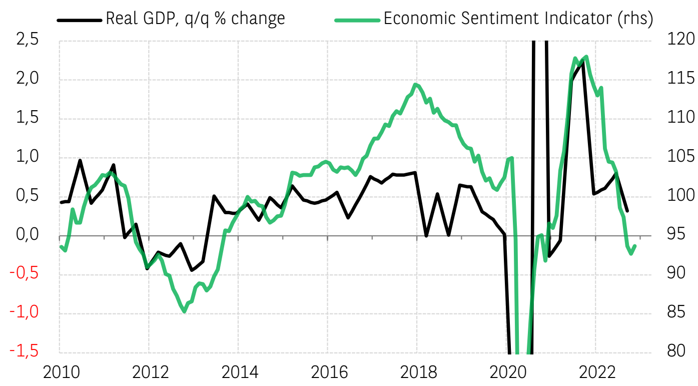

CHART 1 SOURCES : EUROSTAT, EUROPEAN COMMISSION, BNP PARIBAS

US CONFERENCE BOARD LEADING ECONOMIC INDEX

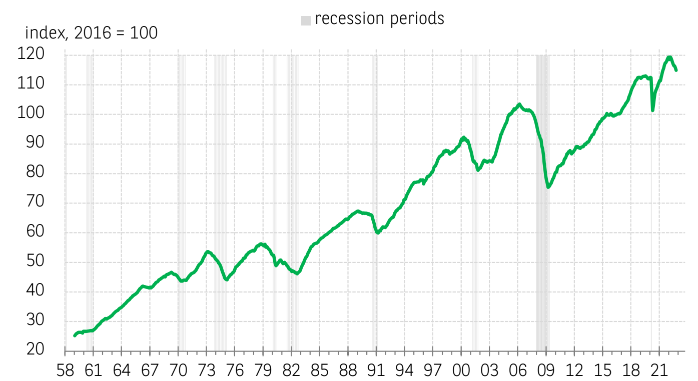

CHART 2 SOURCE: CONFERENCE BOARD, NBER, BNP PARIBAS

This could weigh on financial markets -higher bond yields, lower equity prices- but also on confidence of households and firms and hence on demand. Slower disinflation and higher rates would imply a longer period of subdued or even negative growth, so the length and depth of the recession is another source of uncertainty. In the Eurozone, the evolution of gas prices will be another important factor, given the concern that rebuilding inventories for the next winter could lead to significantly higher prices.

When gauging the list of uncertainties, it is also important to keep in mind the factors of resilience. In the US and the Eurozone, companies continue to struggle to fill vacancies. It is highly likely that, rather than laying off staff when demand weakens, they will hoard labour to have the necessary staffing when demand picks up. The accumulated 'excess savings' during the pandemic are another support factor, although they have been partly eroded already by high inflation. In Europe, the fiscal support in many countries to cushion the inflation shock and the implementation of the investment plans launched in response to the pandemic also bring resilience. Last and certainly not least, the energy transition implies a necessity to invest.

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UNITED STATES: A RECESSION LIES AHEAD

US growth recovered significantly during Q3, but is expected to slow down during Q4 according to our forecasts. The labour market is still tight, but early signs of a slowdown are emerging. Headline inflation appears to have peaked, but core disinflation remains to be confirmed, which would forced the Federal Reserve (Fed) to continue its monetary policy tightening, even if it means pushing the economy into a recession in 2023. Looking at the budget, compromise will be key when the next deadlines approache, given the divided Congress following the mid-term elections.

US GDP growth rebounded strongly during Q3 (+2.9% quarterly annualized rate of growth, after revision), following two quarters of negative growth (-1.6% during Q1 and -0.6% during Q2). The upturn in growth was driven by the very positive contribution of net exports, which was based on a big increase in exports of goods and services (+15.3%) and a large fall in imports (-7.3%). Despite the inflation shock, personal consumption expenditures held up well (+1.7%) and contributed positively to growth, as did non-residential fixed investment, which rebounded in Q3 (+5.1%), following a slump in Q2. By contrast, residential investment continued to fall, dropping for the sixth consecutive quarter (-26.8%). Despite showing signs of resilience, the US economy is expected to slow down, before going into a rather mild recession in 2023, due to the sizeable inflation shock and the Federal Reserve (Fed) monetary tightening. We expect inflation persistence to convince the US central bank to keep its policy rates at restrictive levels until at least 2024.

AN UPCOMING SLOWDOWN IN SPENDING

For the time being, consumer spending is still high, given the inflation shock and the rise in borrowing costs. Retail sales rebounded strongly in October (+1.3% m/m). This momentum can be seen in both vehicle sales (+1.3%), thanks to disruptions along supply chains abating, and gasoline sales (+4.1%), but also in Retail sales excluding gas and autos which rose +0.9%. However, the inflation shock could well end up impacting more negatively consumer spending. According to the Conference Board and University of Michigan indices, consumer confidence fell further in November (-2 points and -3.1 points respectively), mainly due to a deterioration in their financial situation. In addition, the gap between consumer confidence about the current situation and the situation in 6 months' time (Conference Board), and the situation in 12 months' time (University of Michigan) is narrowing, which indicates that customers are less confident about the future (see chart 1). In the past, such a deterioration was a leading signal of recession.

THE END OF "GREAT RESIGNATION"?

For the time being, the good performance of the labour market continues to bolster purchasing power. Even though the unemployment rate remained stable in November (3.7%) after rising in October (+0.2 points), nonfarm payrolls gains remained significant (+263k m/m), albeit at a slower rate than in October (284k, following revision). Labour shortages, i.e. an insufficient number of workers available to meet the demand, remain at high levels.

One way to measure labour shortages is to look into the relationship between the number of jobseekers (U) and the level of job vacancies (V). In October, there were almost two vacancies for every person looking for a job, suggesting that labour shortages are very severe (see chart 2).

GROWTH & INFLATION

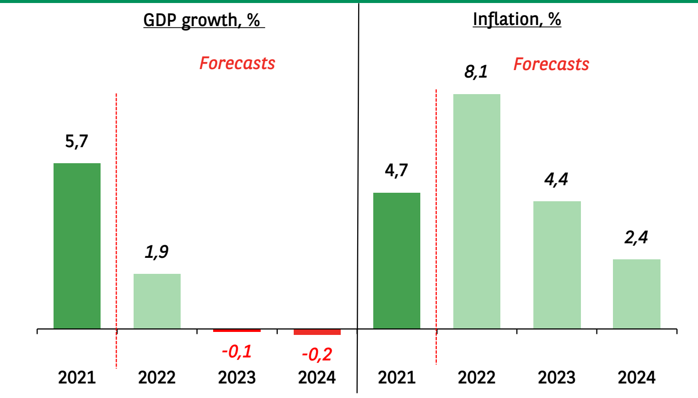

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

HOUSEHOLD CONFIDENCE

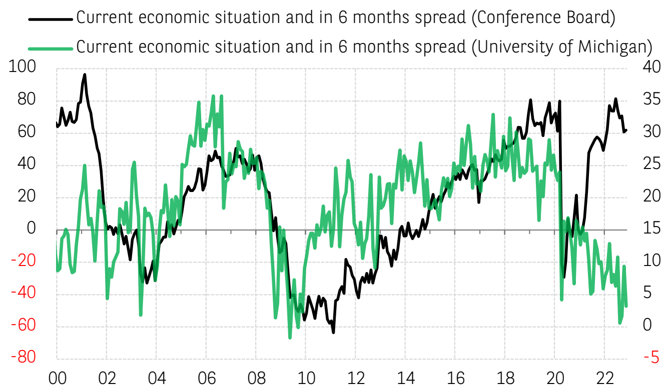

CHART 2 SOURCE: CONFERENCE BOARD, UNIVERSITY OF MICHIGAN, BNP PARIBAS

There are several potential factors behind this tight labour market. The labour shortage is partly due to less efficient matching, mainly due to the lack of qualifications and training within the labour force, but also due to a fall in the participation rate, driven in particular by large numbers of early retirements. Another potential explanation emerges by breaking down job postings into two categories: one type of posting targeted at unemployed workers and the other one applied to poach workers (from existing positions at other firms). A recent article by the Federal Reserve Bank of Dallas[1] illustrated that the number of job postings for poach workers is much higher than the number of jobs available for unemployed people, which, in particular, highlights how many people are moving from one job to another («The Great Resignation»). According to this analysis, the fall in the number of job postings, as a result of the upcoming slowdown in economic activity, could result in a minor rise in the unemployment rate, as it would hit job postings designed to poach workers harder.

These tight labour-market conditions contribute to the dynamism of wages, which is bolstering purchasing power to some extent against the rising cost of living. Annual growth in average hourly earnings (AHE) hit 4.9% (y/y) in October, but remained largely negative in real terms (-2.8% y/y), i.e. adjusted for inflation. Early signs of a deceleration in wages are appearing however. According to the Atlanta Federal Reserve's Wage Growth Tracker[2], the median percent change in the hourly wage of individuals peaked between July and August (+6.7% y/y), before somewhat slowing to +6.4% (y/y) in October and November. This slowdown in wage growth was particularly pronounced for job switchers between July (+8.5%) and October (7.6%), before rebounding in November (+8.1%) . The trend is still unclear for job stayers (+5.5% in November, compared with +6.1% in June). If this trend of a slowdown in wage growth is confirmed, which is highly likely, employees may be less inclined to change jobs for salary reasons, which could alleviate the tightness of the labour market.

The easing of tightness on the labour market is also expected to support the ongoing disinflation. Since peaking in June (9% y/y), the consumer price index (CPI) continued to slow down to 7.8% (y/y) in October. This downtrend is lessclear-cut for the core component (6.3% y/y), particularly in view of the continued rise in inflation in non-energy services since July 2021, which hit 6.8% (y/y) in October.

Faced with persistent inflation and a still tight labour market, the Fed is expected to continue tightening its policy rates and reducing its balance sheet. However, the pace of interest rate hikes could well slow down, from the December meeting, according to Fed Chairman Jerome Powell. On the one hand, the Federal Open Market Committee (FOMC) does not want to overtight, which would push the economy into a recession. On the other hand, he also does not want to slow down prematurely the tightening of its monetary policy, as this could lead to inflation spiralling out of control again. After all, disinflation is still limited to goods and real estate prices, while inflation continues to spread in services, driven by an overly tight labour market (see chart 3).

A DIVIDED CONGRESS

The mid-term elections brought contrasting fortunes for the two main political parties, as the Republicans won a majority in the House of Representatives, while the Democrats held on to the Senate.

This divided Congress will force the US government to look for compromises around the budget. In the short term, the government must deal with the expiry of the continuing resolution on 16 December, which, without an annual budget for the 2023 fiscal year, would lead to a government shutdown. In the medium term, as the debt ceiling will be hit during 2023, despite buoyant fiscal revenues, it will need to be lifted. If a deal, possibly last-minute, between Democrats and Republicans is the most likely scenario, the debate is likely to be a fierce one.

UNFILLED JOB VACANCY PER UNEMPLOYED PERSON

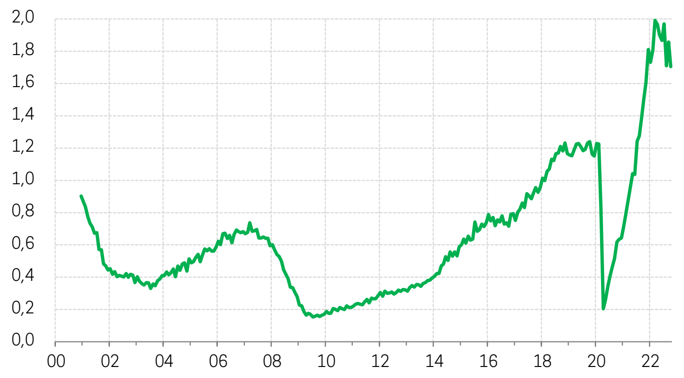

CHART 3 SOURCE: BLS, BNP PARIBAS

COMMODITIES AND SERVICES INFLATION

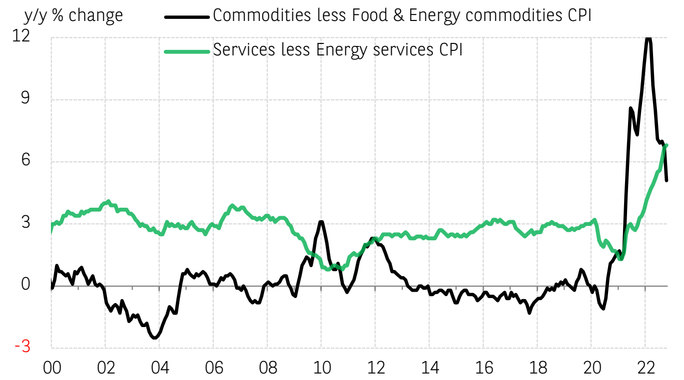

CHART 4 SOURCE: BLS, BNP PARIBAS

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1 Anton Cheremukhin, «Does Employers' Worker Poaching Explain the Beveridge Curve's Odd Behavior?», Dallas Fed Economics, November 2022.
2 Félix Berte, «The end of wage bargaining power», Charts of the week, BNP Paribas, November 2022.

CHINA

YUAN UNDER PRESSURE

The depreciation of the yuan since the beginning of the year and portfolio investment outflows have been largely due to diverging trends in Chinese and US interest rates. They also reflect a loss of investor confidence and the deterioration in China's economic growth outlook. Meanwhile, China's external financial position is still very strong.

The yuan has lost 11% of its value against the US dollar since the beginning of the year, which is almost the same extent as in 2015-2016. This weakening is firstly linked to the general strengthening of the dollar, which has accompanied US monetary tightening since March. In fact, the depreciation of the yuan in nominal effective terms has been much more moderate: the CFETS index (calculated by the China Foreign Exchange Trade System based on a basket of 24 currencies) fell by only 5% over the first eleven months of 2022. However, the weakening of the yuan has also resulted from internal factors and the dynamics of the Chinese balance of payments.

While US interest rates have increased rapidly in 2022, the Chinese authorities have relaxed (moderately) their monetary policy in order to stimulate domestic demand, in the absence of strong inflationary pressures. The spreads between US and Chinese interest rates have therefore reversed and widened, which has significantly changed international financing conditions and capital flow determinants. Against this backdrop, China has recorded large capital outflows, in particular due to interest rate arbitrage transactions. According to balance of payments data, net portfolio investment outflows reached a record USD 159 bn in H1 2022 (-1.8% of GDP). They resulted from an increase in net portfolio outflows from residents (whose net portfolio flows are structurally negative) and from significant sales of Chinese securities (mainly bonds) by non-residents (whose net portfolio flows were negative in H1 2022 for the first time since H2 2015, and represented -0.9% of GDP). It is estimated that total net portfolio investment outflows continued (but moderated) over the rest of 2022.

Chinese enterprises that are most reliant on foreign financing (especially property developers) are experiencing difficulties in these circumstances, but the impact on China's overall capacity to cover its external financing needs is very limited. Firstly, because the other components of the balance of payments have performed better. In the financial account, net direct investment (DI) flows decreased but remained positive over the first three quarters of 2022; and net outflows related to debt and other investments reduced (in part thanks to the decline in Chinese credit abroad). The risk of a massive capital flight is in fact contained by the existence of controls, which have been reinforced since 2015 and are notably aimed at limiting resident capital outflows. Meanwhile, the current account surplus has continued to increase, reaching USD 310 bn over the first three quarters of 2022 (+2.4% of GDP).

Secondly, China remains little dependent on external financing despite the gradual opening up to foreign investors. Its basic balance (current balance + net DI flow) is positive, its external debt is low (15% of GDP) and foreign investors' participation in its financial markets remains modest (they accounted for 3% of total outstanding local bonds at the end of 2021 – but 11% of government bonds – and less than 5% of equity market capitalisation). Finally, China has a very solid external liquidity position. Its foreign exchange reserves (USD 3,052 billion at the end of October) largely cover total external debt and protect against episodes of capital outflows. Foreign exchange reserves have declined only slightly since the beginning of the year, partly because the central bank's direct interventions in the foreign exchange market to contain the depreciation of the yuan have been small. The central bank has preferred to combat currency pressure via prudential measures (such as the cut in the reserve requirement ratio on foreign currency deposits). In addition, the authorities could also be satisfied with a weaker yuan in an attempt to support the export sector.

GROWTH & INFLATION

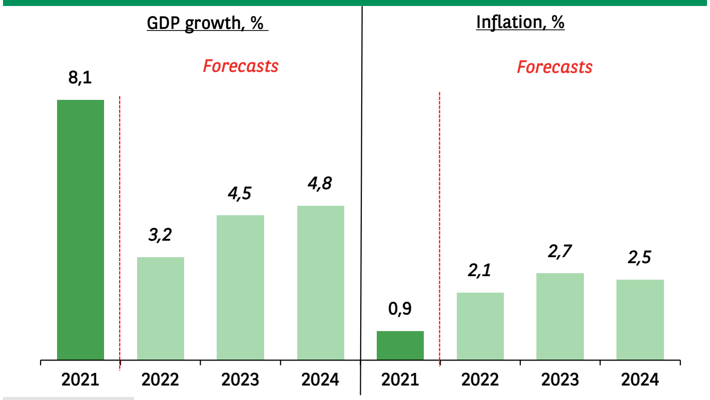

CHART 1 SOURCE: REFINITIV, BNP PARIBAS

CHINA: DIVERGING INTEREST RATES

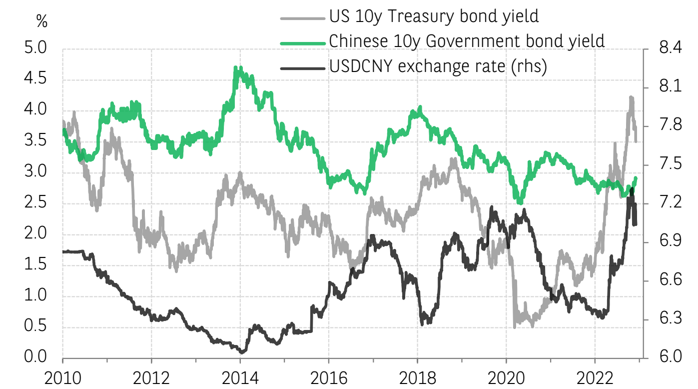

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

In the short term, however, the weakening in global demand will continue to slow China's export growth. The current account surplus is expected to fall, exerting new downward pressures on the yuan. Future dynamics in capital flows – and thus in the exchange rate – are more uncertain. The interest rate spreads between the United States and China should narrow when the US Federal Reserve interrupts its monetary tightening cycle (which is expected in Q1 2023) and assuming China's economic growth prospects improve. However, foreign investors are likely to remain cautious, as their confidence has been weakened in the past two years by China's zero-Covid policy, the crisis in the real estate sector, the rise in regulatory risk and geopolitical tensions.

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JAPAN

ON THE HUNT FOR GROWTH

Along with the United Kingdom, Japan has had the least vigorous recovery out of all of the G7 countries during the last two years. The country even recorded a 0.3% q/q contraction in real GDP in Q3 2022, pulled down by slowing residential investments and net exports. Even though consumption expenditures grew during Q3 (+0.2% q/q), it is still well below its 2019 levels. The end of Covid-19 restrictions, which were completely lifted in October, will provide additional growth during the last quarter of the year, but the overall increase for 2022 will be rather sluggish (+0.9%). We are expecting a further slowdown in business activity in 2023 (+0.3%), which implies a return to pre-pandemic levels during 2024 at the earliest.

The current economic scenario, which is already not very favourable, is still vulnerable to a range of external factors, and, in particular, to pandemic-related developments in China. Although the Chinese authorities have started to ease some restrictions, they remain binding. Covid-19 outbreaks have skyrocketed in some regions, disrupting the country's industrial production line operations once again. Japanese companies, particularly those in the motor-vehicle sector, are heavily reliant on these production lines in China. The war in Ukraine and its repercussions on the global energy market, which are still not yet fully clear, could once again hinder business activity, as Japan imports most of its energy resources.

However, the labour market continued to recover, with the size of the country's workforce and the employment rate now returning very close to 2019 levels. However, inflation accelerated this autumn (3.5% y/y in October at a national level and 3.6% y/y for Tokyo in November) and therefore further eroded consumer purchasing power, which fell by 2.2% q/q during Q3 2022 (Family Income & Expenditure Survey). As a result, this has forced some households to reduce their spending on non-essential goods. According to the Japanese Cabinet Office's survey, during November, purchasing intentions on durables among Japanese households hit their lowest levels since the survey began in 1982.

Wage growth in Japan is therefore still at historically low levels, but the rise in inflation and the ongoing major recruitment problems are an unprecedented combination that could drive salaries up. As a result, salary negotiations next spring will be a major event: Rengo, the country's largest Trade Union Confederation, is demanding wage increases of around 5%, which would be the highest rise for 28 years.

In order to absorb the energy shock, a second supplementary budget for the 2022 tax year (1st April-31st March) was introduced in early November, which committed to an additional Y29.1 trillion in public spending. This rise significantly reinforces the first supplementary budget introduced last May, which stood at Y2.7 trillion. This increased spending will be mainly financed (80%) by debt, which will mostly be absorbed by the Bank of Japan (BoJ). Since the start of Quantitative and Qualitative Monetary Easing in April 2013, which coincided with the launch of the Abenomics programme, the BoJ has bought more than Y400 trillion (USD 2940 billion) worth of Japanese sovereign bonds, and its share in total public debt has quadrupled, going from 10% in early 2013 to 43% in September 2022.

THE FALLING YEN INFLATES PROFITS

According to the Japanese Ministry of Finance report, Japanese corporate profits fell sharply during Q3 (-5.3% q/q), but this drop must be analysed with the benefit of hindsight. Corporate profits hit an al-time high during the previous quarter and remain elevated this autumn, at Y23.3 trillion or 17.0% of GDP.

GROWTH & INFLATION

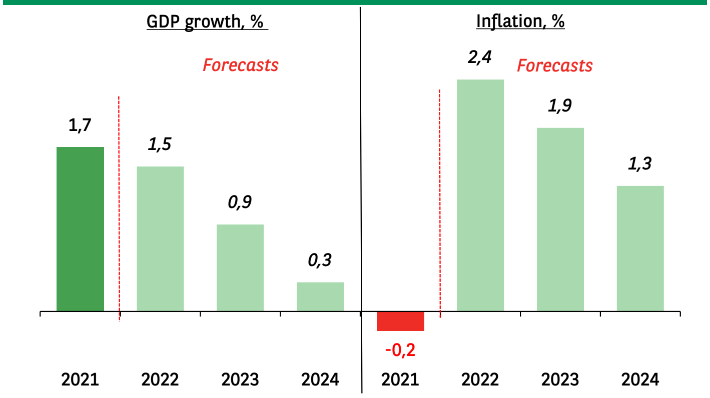

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

In addition, the downturn during the third quarter stemmed particularly from the services sector (-13.1% q/q), which was hit harder by the weak recovery in domestic consumption than export-oriented industrial companies. In fact, export-oriented industrial companies managed to post record Q3 profits, up 6.9% q/q, thanks to the drop in the yen, which has helped to inflate profits repatriated from subsidiaries based abroad. These subsidiaries are accounting for an increasingly large proportion of Japanese industrial companies[1].

However, the exchange rates effect is expected to significantly wear off during 2023. With inflation slowing in the United States, and expectations that the US Federal Reserve will raise its key rates less than expected, the yen has already regained ground vis-à-vis the dollar. Even though Japanese Government bond interest rates are still fixed at the limit set by the BoJ (0.25% on 10-year bonds), pressure on the Japanese central bank to change its yield curve control policy, which has been in place since September 2016, has somewhat eased. Nevertheless, the expected appointment of a new Governor of the BOJ in April 2023, replacing Haruhiko Kuroda, will be a pivotal moment. However, it is unlikely that this new Governor will radically shift the direction of monetary policy, which should remain very accommodating.

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1See the BNP Paribas Charts of the week: An increasingly large proportion of Japanese subsidiaries based abroad, 1 November 2022

WILL THERE BE A GROWTH OUTAGE THIS WINTER?

It seems highly likely that for the eurozone, 2023 will bring an easing in inflation, a contraction in GDP and a peak in the ECB's policy rates. The uncertainties lie in the scale of disinflation and of the recession, and in the level and timing of the peak in rates. According to our forecasts, the fall in inflation will be rapid on the surface (with headline inflation dropping from around 10% y/y in Q4 2022 to 3% in Q4 2023), but this will mask a slower fall in core inflation, which we expect to remain above 2% in a year's time, from 5% at present. In the face of this persistent inflation, we expect the ECB to hike its deposit rate by 100bp, to 3%, by the end of Q1 2023 and then maintain this restrictive level throughout the year, despite the recession. The recession, meanwhile, is expected to be shallow and short-lived, thanks in particular to fiscal support and the resilience of the labour market, which both allows and justifies the ECB's restrictive approach.

RECESSION LOOKS INEVITABLE...

Although eurozone growth provided another positive surprise in Q3 (up 0.3% q/q, taking the growth carry-over to 3.4%) and thus dodged the expected contraction, repeating this performance in the current quarter, and also the next two, is a tougher task. A recession is not a certainty, but we believe it is inevitable. Although consumer confidence saw some small signs of improvement in October and November, it remains depressed. The deterioration in business climate surveys remains relatively well contained, but in absolute terms are still pointing towards a contraction in activity (Figure 2). Above all, we are expecting that their decline will continue as we have not yet seen the full effects of the inflationary shock, the energy crisis and monetary tightening.

...BUT IT COULD BE SHALLOW AND SHORT

A severe and prolonged recession can not be ruled out given the unprecedented accumulation and scale of the shocks listed above. But for the time being we believe that the most likely scenario is a shallow and short-lived recession. Thus we expect GDP to contract by -0.4% q/q in Q4 2022, then -0.5% in Q1 2023 and -0.2% in Q2 2023 before a modest recovery in the second half. In annual average terms, we expect GDP growth of 3.2% in 2022, followed by a contraction of -0.5% in 2023 and then a recovery to 1.3% in 2024.

The first of the factors containing the expected recession is the substantial fiscal support introduced at the national and European levels (Figure 3). In the short term, economic activity should continue to be supported by the continued catching up from the pandemic in sectors where this is not yet complete, although this effect is not far from reaching its end. The easing of supply chain difficulties, allowing the order backlog to be addressed, is another factor in supporting the economy. More broadly, the extra savings built up by households during lockdown periods and the relatively good financial situation of businesses at the beginning of 2022 aresignificant shock absorbers: households and companies have had something of a buffer to absorb the current shocks and this will remain the case, albeit to a lesser extent as the shocks have started to eat into these reserves.

The scale and urgency of investment needs, particularly in the areas of digital technology and the energy transition, are another source of substantial support to growth, although these could be limited by hiring and skills constraints and less favourable financing conditions. This wave of green investment could help in a soft landing for the economy similar to that seen in the second half of the 1990s, when investment in new information and communications technologies contributed to a soft landing for the US economy.

The relatively good performance of the labour market thus far has been encouraging. We also see the persistent hiring difficulties (in part a reflection of the strength of employment) as a specific and significant source of resilience to the slowing of activity in this cycle; it will encourage companies to hoard staff. We are counting on these elements to limit the predictable increase in unemployment rates and the knock-on effects of the deterioration of the labour market on activity. In our scenario, the limited contraction in the economy and in employment will feed into each other.

GROWTH & INFLATION

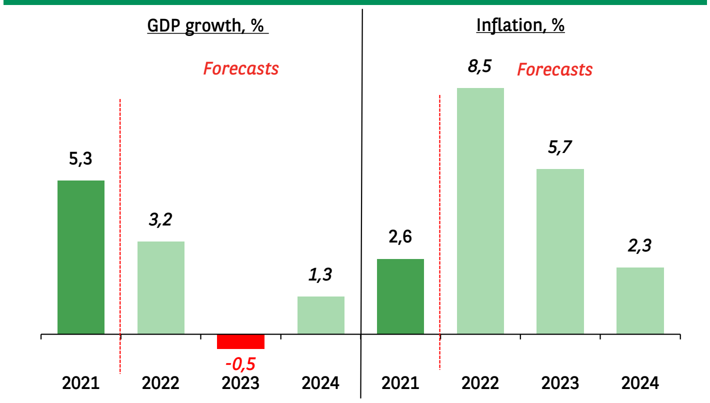

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EUROZONE: COMPOSITE PMI AND ECONOMIC SENTIMENT INDICATOR

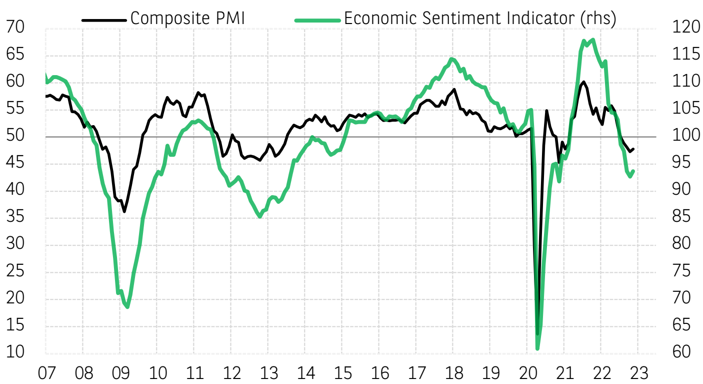

CHART 2 SOURCE: S&P GLOBAL, EUROPEAN COMMISSION, BNP PARIBAS

The disinflation expected in 2023 represents another source of support, by easing the downward pressure on confidence, consumer purchasing power and company margins. Disinflation will also signal the end of policy rates hikes, which should also have a positive effect on expectations and behaviour.

SOURCES OF SUPPORT BUT DOWNSIDE RISK AS WELL

Our forecast for 2022 is in line with the December consensus average, but it is more negative for 2023 (by 0.4 of a point, bearing in mind that the consensus range is broad, from a high of +1.3% to a low of -1.4%). Although our scenario is relatively negative, we think that the risks still lie on the downside. The reaction of company margins, the labour market, real estate markets and the financial sphere to the ongoing shocks could be more negative than expected, with a possible additional contagion effect coming from the USA, where the expected recession will come later than that in the euro zone (between Q2 and Q4 2023). The extent of disinflation remains uncertain. The Covid-19 pandemic remains a significant risk factor.

A financial shock, coming on top of the others, cannot be ruled out. Bank balance sheets are certainly more solid and consumers and companies are not more indebted than in 2007[1] , on the eve of the subprime crisis, but government debt is much higher. And there are sizeable vulnerabilities amongst unregulated financial actors, in the more risky market segments and in those where liquidity could suddenly dry up.

The supply of energy, particularly gas, continues to hang over Europe like a particularly hefty sword of Damocles. This risk, which is specific to the eurozone, comes on top of an energy price effect that is already much higher than in the USA, for example, and as high as it was during the oil shocks of the 1970s[2] . The deterioration in the terms of trade and the associated loss of real income are even higher according to estimates from the ESM (European Stability Mechanism): in Q1 2022 this loss was estimated at 1.7% of GDP, a figure that was already higher than the 1.3% loss calculated for 1974 and which can only have increased since, given further rises in energy prices.

Lastly, central banks face the hefty challenge of calibrating monetary tightening: neither too much, which would damage growth, nor too little which would prevent inflation from being swiftly brought under control. Although our scenario assumes that they will rise to this challenge, the risk of mistakes is not inconsiderable. In its October 2022 World Economic Outlook, the IMF estimated at 25% the probability that global growth in 2023 will be less than 2% (something that has happened only five times since 1970, in 1973, 1981, 1982, 2009 and 2020): the high level of this probability illustrates the scale of downside risks[3].

THE ECB IS DETERMINED

With its 50bp rate increase at its 15 December meeting (after successive 75bp increases in September and October), the ECB marked the first turning point in the monetary tightening cycle it began in July, made possible by the first encouraging signs in the expected disinflation coupled with more unfavourable signals on the growth front. Although it is nearing an end, the tightening cycle is not there yet: we are expecting the ECB to make two further rate increases in February and March 2023, of 50bp each, taking the deposit rate to 3% and the refinancing rate to 3.50%.

FISCAL RESPONSE TO THE INFLATIONARY SHOCK AND ENERGY CRISIS

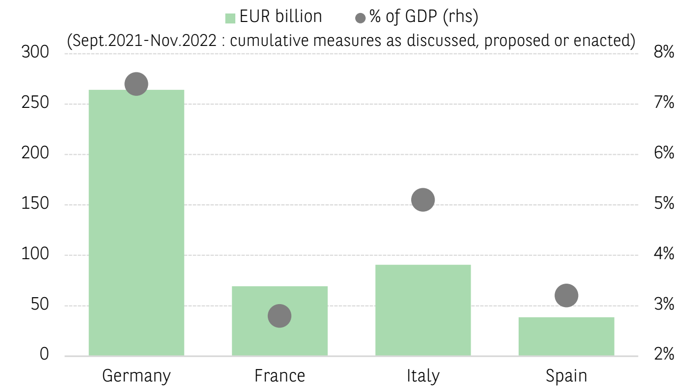

CHART 3 SOURCE: NATIONAL GOVERNMENTS, BRUEGEL DATASETS (LATEST UDPATE: 29/11/2022), BNP PARIBAS

We expect the ECB will then hold them at this restrictive level throughout 2023, despite the recession, in the absence of core inflation falling sufficiently close to the 2%-target by the end of next year. To strengthen its action, the ECB will make another important monetary shift in 2023, with quantitative tightening (QT) beginning to shrink its balance sheet. This normalisation, in contrast to the rapid and large hikes in interest rates, is likely to come in progressive steps. The ECB will have to balance flexibility and predictability.

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1 According to data compiled by the Banque de France (% of GDP).
2 According to data from BlackRock Investment Institute, drawn from BP's statistical review of world energy, which compares the weight of oil, gas and coal consumption to GDP (in USD). In 2022, this ratio was 11.7% for the EU and 5.3% for the USA, from 12% and 10% respectively in 1980.
3 This low scenario from the IMF would come about under the plausible combined effect of an unexpected fall in global oil supplies, an additional weakening in the Chinese real estate market, continued labour market tensions and tighter financing conditions (see box 1.3, pp 33-36, WEO October 2022).

HOW INTENSE WILL THE RECESSION BE?

Unexpected to say the least, +0.4% growth in German GDP in the third quarter should not distract from the bigger picture. While the power of the end of catch-up effects surprised the consensus which did not expect such dynamism in activity in the third quarter, there is no doubt that German growth drivers are fading one by one under the weight of an extremely unfavourable economic climate: record inflation, energy crisis, drop in global demand... After a last stand in Q3, it therefore seems unlikely that Germany could continue to post positive growth over the last three months of the year. While Germany's entry into recession is almost confirmed, the question of how intense it will be is much more up in the air.

In the third quarter, German GDP fully benefited from the end of catch-up effects, posting unexpected growth of +0.4% (q/q) after +0.1% in the second quarter. This increase in activity was made possible by the recovery of demand items, which were still operating well below their pre-Covid level. This is the case for private consumption, buoyed by spending on services, particularly in catering and accommodation, which grew by +1% in the third quarter (q/q). But this also concerns investments in machines and equipment, which started from a very low level and increased by 2.7% (q/q) without however returning to their level at the end of 2019 (-2.5%).

A DETERIORATED ECONOMIC SITUATION THAT IS WEIGHING ON GROWTH DRIVERS

These almost mechanical rebound effects must not make us forget the extremely unfavourable context Germany is in. Companies and households are the first to express their concerns in economic surveys. Business leaders' sentiment over the current situation has reached a record low in November since the beginning of the year, according to the IFO survey. In each sector of the economy, the climate is well below its long-term average: services (-23 pts), retail (-20 pts), wholesale (-20 pts), industry (-16 pts), construction (-6 pts). And consumer confidence fell sharply in December (-44 pts below its long-term average).

While the radical message sent by surveys is not fully reflected in the hard data, the fall in many indicators has already been visible since the beginning of the year. Industrial production is down 2.3% year-to-date and shows no sign of improvement, as demand for the industry is declining completely with new orders falling 12% year-to-date. The corollary of this weakening of industrial production is the loss of dynamism of German exports. With one exception in the first quarter of 2022, external trade has contributed negatively to growth since mid-2021. The deterioration of the trade balance is massive: at the beginning of 2022, Germany still had a surplus of more than EUR 10 billion per month, whereas in September this surplus was only EUR 4 billion.

On the domestic demand side, household consumption is held back by double-digit inflation that erodes purchasing power. This can be seen in particular in the consumption of goods with retail sales falling by 5% since the beginning of the year. As far as investment is concerned, companies are cautious in the realisation of their investment projects, since uncertainty about future activity is high. This caution has led to investments always falling below their pre-crisis level, and investments in machine tools and heavy equipment are particularly suffering from the poor business climate.

THE INFLATION PIVOT

German inflation is constantly breaking records with consumer prices rising by +10% year-on-year in November. Going back to just after the Second World War, inflation reached +11.4% in October 1951 as a result of virulent deflation over the whole of 1950. This inflation continues to be driven by energy prices, since electricity prices (+26% y/y in October), gas prices (+74% y/y in October) and coal prices (+102% y/y in October) are not slowing down. In the face of the energy impact, manufacturers passed on part of their increase in production costs in their sales price, as evidenced by the rise in prices of goods in November,

GROWTH & INFLATION

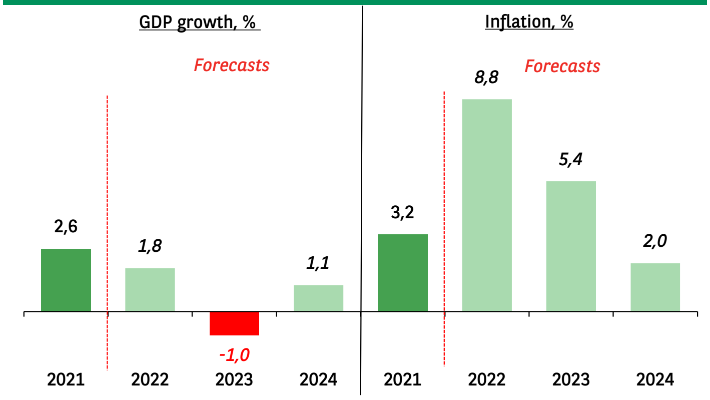

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EMPLOYMENT IN GERMANY

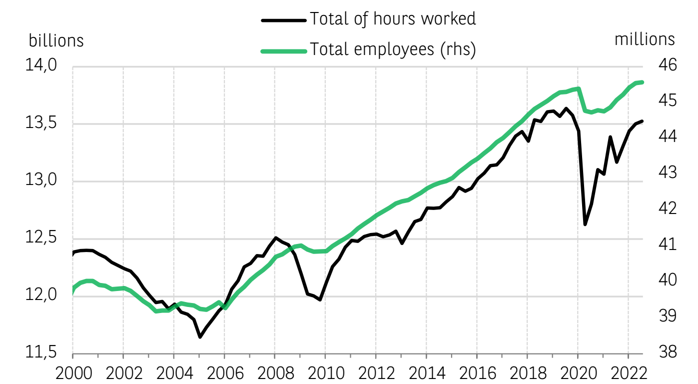

CHART 2 SOURCE: DESTATIS, BNP PARIBAS

which stood at +17% (y/y) compared with only +3.7% in services (y/y). However, this excessively high inflation is not expected to last over time and the first signs of a dip are appearing. Firstly, inflation fell slightly between October and November (from +10.4% y/y to +10% y/y), possibly indicating a pivot in the tenth month of 2022. Secondly, producer prices in industry, which are upstream of consumer prices, fell sharply, from +45.9% year-on-year growth in September to +34.6% in October. The same applies to wholesale prices (+17.4% in October year-on-year, after +19.9%).

As this inflation is not accompanied by such a significant revaluation of wages, households' purchasing power is suffering. In fact, the hourly wage per employee (including bonuses) slowed sharply in the third quarter to +2.2% year-on-year (after +5.4% in the second quarter). This has led the OECD in its latest economic outlook to highlight that real wages per capita fell by more than 4% (y/y) in the third quarter in Germany.

Furthermore, the last salary renegotiations obtained by the powerful IG Metall union will not allow salaries to catch up with prices. The agreements concluded for electrometallurgy workers provide for a 5.2% increase in salaries in June 2023, followed by a 3.3% increase on 1 May 2024, accompanied by a bonus of EUR 3,000, which will be divided into two tranches, one in March 2023 and the second in the following year. A first costing of these agreements shows that the overall increase in income for these four million employees should be in the region of 5.6% in 2023, then 4.6% in 2023. However, this calculation does not take into account companies that will be removed from collective agreements due to their excessively deteriorating financial situation. However, it is possible that a larger than normal share of companies may withdraw from sectoral agreements, since the spike in production costs is straining companies' margins and profitability.

A DECEPTIVE LABOUR MARKET

As in the rest of Europe, the labour market has weathered the multiple shocks affecting the economy. The ILO unemployment rate stands at its pre-Covid level at around 3% and the number of people employed in September was 0.4% above its end-2019 level. However, this momentum came to a halt last May, since net job creation has since been 0%. In addition, a specific feature of the German market is that the number of hours worked is still below its pre-Covid level (-0.4%). In other words, the number of people employed has increased, but a proportion of the contracts offered have been precarious with a rise in restricted part-time contracts.

The crisis also accelerated sector divergences. While some sectors have massively hired labour since the end of 2019 such as information & communications (+8.4%) or the public sector (+4.6%), others have destroyed jobs such as the manufacturing sector (-3.1%) or the retail and accommodation/catering sector (-1.7%).

At the same time, recruitment difficulties have increased considerably. In the fourth quarter, 41% of industrial companies (compared with 16% in Q4 2019) mentioned the lack of labour as a limiting factor in their production in the European Commission's survey. This rate reached 38% in the construction sector and 41% in the services sector (compared with 13% and 27% respectively in Q4 2019). This was in a context where the rate of vacancies was at a record level (4.8% in Q3 2022 compared with 3.4% in Q4 2019). This indicates a deterioration in the labour market's matching ability.

HISTORIC GOVERNMENT SUPPORT

Despite a delay in public intervention in comparison to other European countries, the German government decided to intervene massively to support its economy. This should allow the country to experience only a moderate and limited contraction in activity over time.

On 4 September, Olaf Scholz announced a new package of measures[1] for an amount of EUR 65 billion, followed on 29 September by a «defence shield» of EUR 200 billion[2]. This budget will finance the maintenance of a reduced VAT rate on energy at 7% until spring 2024 and the capping of gas and electricity prices for households and businesses. The government will subsidise 70% of companies' normal gas and electricity consumption (based on last year's consumption) and 80% of household consumption. With regard to pricing, the cap on gas prices for companies will be set at 7 cents per kilowatt hour (kWh) compared to 12 cents per kWh for households (except for heating: 9.5 cents per kWh). For electricity, the mechanism provides for a limit of 40 cents per kWh for households and 13 cents per kWh for large companies. All of these measures should enter into force on 1 January 2023, except for the gas price limit for households, which should enter into force on 1 March 2023 but which could ultimately be brought forward to 1 January, according to information from the government.

As a reminder, the average annual gas bill for a German household has increased by 250% in a year, according to data from the energy price comparison tool Check24. As an example and based on the October prices when the price per kWh came out at EUR 0.186, the introduction of the price cap will save slightly more than EUR 1,000 for an average household with a consumption of 20,000 kWh per year. The Ministry of the Economy estimates at this stage that the scheme should cost the Federal State EUR 54 billion by the end of April 2024, of which EUR 21 billion will be intended for companies. These estimates remain very uncertain as they are based on price assumptions for gas and electricity.

This massive public support, the total amounts of which announced exceed 8% of GDP, will make it possible to significantly relieve the production costs of industrial companies and thus preserve their profitability and export competitiveness. Because the great fear of the German government is the prospect of seeing its industrial fabric crumble or relocate to the other side of the Atlantic Ocean in the United States. In addition, transfers to private individuals will help support households' purchasing power in 2023 in order to best preserve household consumption.

Finally, public support for the activity should also be reflected in dynamic public consumption, as seen since the post-Covid recovery. In fact, consumer spending carried out by the public authorities has increased by 0.8% on average per quarter since the start of the Covid crisis, representing an increase in quarterly public consumption of EUR 14.4 billion between Q3 2022 and Q4 2019.

Germany is therefore unlikely to escape an economic recession, but a relatively short and shallow recession is the most plausible scenario.

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1 See EcoWeek of 19 September for details of measures
2 See EcoWeek of 17 October

YEAR ZERO

The figure zero should define French growth in 2023. The carryover should be zero, due to a second half-year 2022 in which the positive performance observed in the third quarter should be cancelled out by negative growth in the fourth quarter (with a key contribution of a further drop in household consumption). The quarterly growth momentum recorded in 2023 is not expected to provide any further support. A further contraction in GDP is expected in the first quarter, mainly due to a further acceleration in inflation and the probability of lower inventories in companies. The upturn expected to occur from the second quarter should be moderate, limited to offsetting the drop in the first quarter. There should be average growth of zero, which therefore includes a period of recession, at the turn of 2022–23, but an atypical recession. French corporates should continue to suffer from supply-side constraints, which in turn should support investment expenditure.

HIGH ACTIVITY IN Q3

In the third quarter, French growth benefited both from post-Covid catch-up effects and from the anticipation of production in the event of a difficult winter, which enabled it to continue to rise beyond what conditions at the time suggested (0.2% q/q in the second quarter, after already +0.5% q/q in the second quarter).

The first set of factors supported the production of services (from the second quarter), in particular those associated with households' tourism and leisure spending. This materialised in part as a substitute for other expenditure due to purchasing power constraints. Thanks to the reduction of supply difficulties, these catch-up phenomena also prompted an increase in automotive production, as well as of machinery and equipment, enabling a recovery in corporate investment (+3.1% q/q).

The second series of factors led to the anticipation of production (industry and building) and supplies (energy), increasing stocks. Thus, the contribution of stocks (0.3pp) was greater than GDP growth in the third quarter.

A FIRST ASSESSMENT OF GROWTH IN 2022

According to our forecasts, over the year as a whole, inventories constituted the main dynamic, with corporate investment coming second (chart 2[1]). The inventory rebuilding estimated in 2022 fully compensates for the cumulative negative contribution in 2020 and 2021. Other items, in particular household consumption and public consumption, above all contributed through their carryover to GDP growth.

In other words, although household consumption was higher in 2022 than in 2021, it was mainly due to health restrictions which penalised the latter in spring 2021, while its own dynamic was negative in 2022. This aspect can be explained mainly by the impact on purchasing power suffered in the first half of 2022 and was not offset by the upturn in the latter from the third quarter onwards (household consumption was stable in the third quarter). Another factor explaining the poor performance of consumption is the fact that some of it remained constrained by supply problems, particularly car purchase.

A TECHNICAL RECESSION

We expect a recession, i.e. two consecutive quarters of negative growth, in the fourthquarter of 2022 and in the firstquarter of 2023. This anticipation is firstly based on the gradual diffusion of a new inflationary impact (chart 3). The latter comes from two causes, one associated with the drought of the summer of 2022 and its consequences for food inflation, the other corresponding to a further rise in energy prices.

GROWTH & INFLATION

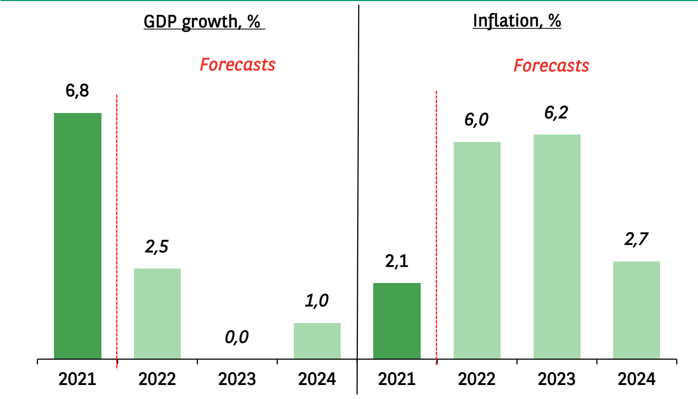

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

CONTRIBUTIONS TO 2022 GROWTH: CARRYOVER AND DYNAMICS RELATIVE CONTRIBUTIONS

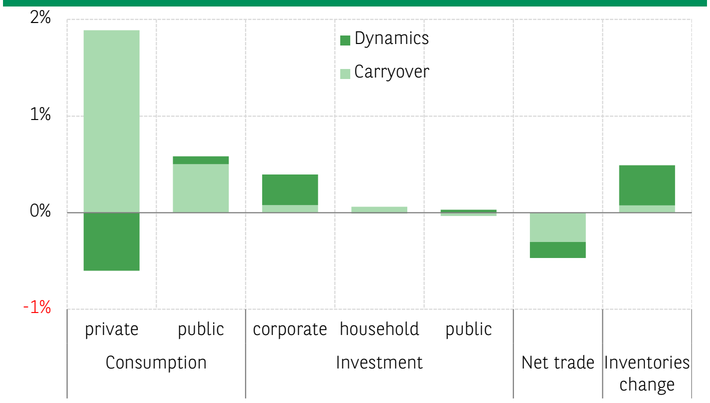

CHART 2 SOURCE: BNP PARIBAS

The rise in food prices is very substantial (+12.2% in November y/y) and is reflected in the development of household consumption in goods in October, which was very negative (-2.8% m/m). Thus, per capita food consumption is at its lowest since 1988. The drop in energy consumption also contributed to the sharp drop in consumption in October and

1 The carryover's calculation uses the figures observed in Q4 2021 for each demand item and keep it constant throughout the whole 2022 year.

appears to have continued thereafter, according to RTE data. These two elements should bring the French economy closer to a contraction in GDP in the fourth quarter.

The rise in regulated gas and oil prices by 15% at the beginning of 2023, as well as the withdrawal of the fuel discount, should lead to a further increase in energy inflation. At the same time, the rise in the wholesale price of electricity suffered by companies is leading prices of manufactured goods and services to rise, in particular those adjusted on a calendar basis on January 1st (especially transport services) or at the end of the annual negotiations on prices with large retailers.

All these elements should be combined to increase inflation above 7% at the beginning of 2023 (6.2% year-on-year in November 2022). The result will be declines in purchasing power (-0.6% q/q in the first quarter and -0.4% in the second quarter, after +1% q/q in the 3rd quarter according to our scenario) and household consumption (-0.4% q/q in the fourth quarter, then -0.2% q/q in the first quarter 2023), against a background of rising saving rate (17.2% on average in 2023, after 16.7% in 2022).The production that companies seemed to have anticipated in the third quarter could lead to a subsequent downward adjustment and therefore to continued negative growth in the first quarter. In fact, inventories appeared to be much higher than their average level in INSEE's latest economic surveys in industry. The indicator of the survey on past production deteriorated in November, but to a moderate extent. In fact, the precise timing of the setback largely depends on the speed with which stocks are being cleared, as well as the ability of companies to continue their production under good conditions for longer than expected (as autumn was milder than expected and so did not create any strain on energy supply): clement conditions that benefited to the construction sector. At the same time, the automotive sector saw its supply difficulties shrink, allowing production to fill some of its backlog on demand (which was reflected in high order intake and delivery times), particularly ahead of Black Friday. However, demand indicators (opportunity to make significant purchases in the household survey, order books in the business climate in industry) remained lower for several months than at the beginning of 2022. These elements reinforce the hypothesis of a downward adjustment of industrial production in the middle of winter.

A "PHONY RECESSION"

A recession is therefore our central scenario. Beyond this, 2023 should subsequently be penalised by significant growth restrictions, in particular due to the continued rise in interest rates, which is why we are anticipating zero growth over the year as a whole.

The recession we expect looks quite different to its precursors. The very clear predominance of supply difficulties in industry and the very low level of demand shows strong originality (figure 4), a trend already present in the French economy but which the recession recorded at the time of Covid increased. The upcoming recession is unlikely to fundamentally change the characteristics of the French economy: the various challenges, in particular the green transition or full employment, have in common that they highlight the need for supply side transformation. Thus, 2023 should remain, like its precursor, a year of particularly high corporate investment (with an investment ratio of 26%, close to the record level of 26.3% reached in the third quarter of 2022).

FRANCE: CONSUMER PRICES CUMULATIVE CHANGES

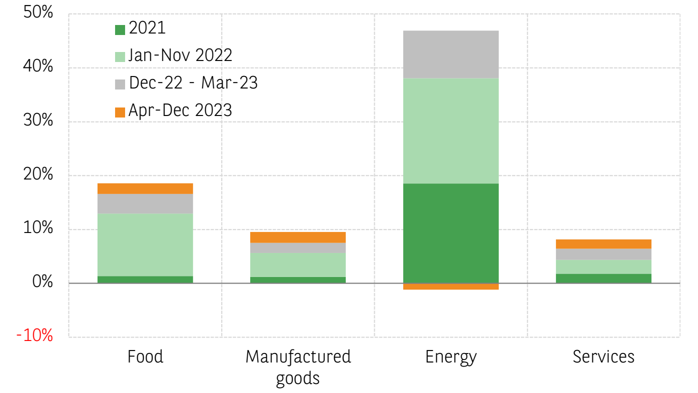

CHART 3 SOURCE: INSEE, BNP PARIBAS CALCULATIONS AND FORECASTS

FRANCE: MANUFACTURING SECTOR, DIFFICULTIES OF SUPPLY AND/OR DEMAND

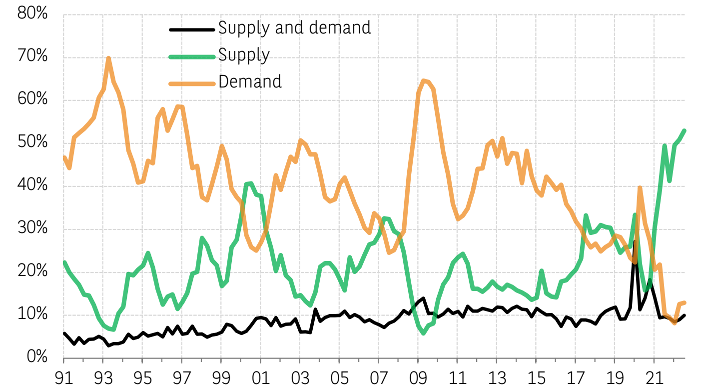

CHART 4 SOURCE: INSEE, BNP PARIBAS

Furthermore, the labour market will remain relatively tense. Employment should formally erode under the effect of the economic slowdown (predictable impact in construction and on temporary employment in particular) and the gradual weakening of the post-Covid job creation dynamic (in particular in catering and leisure). However, continued high recruitment pressures argue for job retention, even in the event of a recession. This aspect should be combined with the ongoing wage negotiations to favour faster wage growth in 2023 (5% compared to 3.4% in 2022). Faster wage growth may lengthen the disinflation process and should drive nominal GDP growth in 2023 (3.9%).

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ITALY: A MORE UNCERTAIN SCENARIO

During the summer, the Italian economy continued to show a strong resilience against increasing uncertainty. In Q3 2022, real GDP rose by 0.5% q/q, benefiting from the recovery of services, while both manufacturing and construction suffered. Domestic demand more than offset the negative contribution of net exports. A wind of growth continues to blow on the Italian real estate market. In Q2 2022, residential sales recorded a +8.6% y/y growth, while house prices in the same quarter grew by 5.2% y/y. Although the carry-over for 2022 is 3.9%, the outlook for the Italian economy has become more uncertain. Households suffer from high inflation, with purchasing power declining, while firms have to cope with increasing costs of production.

A STILL POSITIVE EVOLUTION

During the summer, the Italian economy continued to show a strong resilience against increasing uncertainty. In Q3 2022, real GDP rose by 0.5% q/q, with the annual growth rate around 2.5%. Domestic demand added 1.6 percentage points to the overall GDP increase. Private consumption rose by 2.5%, as households benefited from the further easing of social restrictions. Despite less favourable financing conditions, investment increased by 0.8%. The contribution of net exports was negative (-1.3 percentage point), as imports rose more than exports (respectively, +4.2% and +0.1%).

The sector composition of economic growth strongly changed. Construction, which was the main driver of the GDP increase in the previous two years, significantly decelerated, also reflecting a shortage of workers, with value added declining by 2.0%. Rising costs of production and the worsening of the global scenario negatively impacted the manufacturing sector, which has recorded a 0.2% decline.

In Q3, the recovery of the Italian economy reflected the favourable evolution of services. Value added increased by 0.9%, more than offsetting the decline in the other sectors, benefiting from both the rebound of tourism and the change in the composition of household consumption.

Despite the carry-over for 2022 at 3.9%, the outlook for the Italian economy is extremely uncertain. The annual growth rate of the consumer prices index went above 12% y/y, negatively affecting household purchasing power. The volume of retail sales declined, while the value of expenditure continued to increase, with the propensity to save falling slightly above 9.0%. Given the persistent uncertainty of the overall scenario, the risk of a postponement of investment decisions has further increased.

THE REAL ESTATE MARKET KEEPS GROWING

In the first half of 2022, the Italian real estate market continued to grow at a faster than expected rate. This positive trend can be seen both in terms of rising prices and transactions.

Between April and June 2022, house prices recorded an increase of +2.3% q/q and +5.2% y/y. It was the twelfth consecutive quarter of growth in a row. However, despite the rise recorded in the last three years, in June 2022 house prices in Italy were still 8.3% lower than in 2010 (the first year since these data were collected).

House price growth in the second quarter of 2022 was widespread in the country; however, none of Italy's geographical areas has rebounded to the 2010 levels yet, with the important exception of Milan, where prices in June 2022 were 17.4% higher than 12 years earlier. Rome, on the other hand, is still lagging behind. In the capital, town house prices were about 23% lower in June 2022 than in 2010.

GROWTH & INFLATION

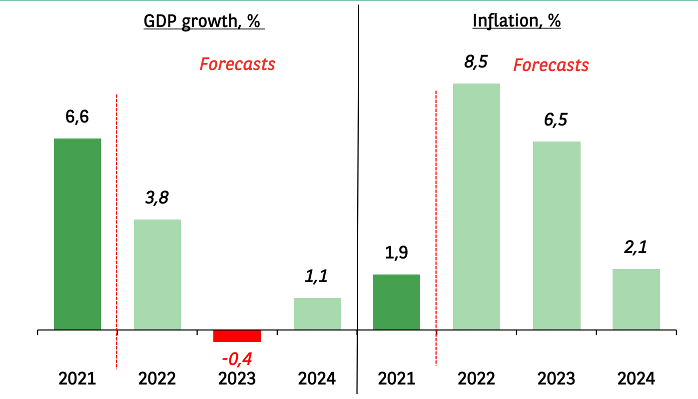

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The good performance of the Italian real estate market is mirrored by the trend of house transactions. In the first and second quarter of 2022, transactions grew by 12% and 8.6% y/y, respectively. The increase involved all of the geographical areas.

In Italy, the residential market is still dominated by private individuals, who cover approximately 96% of the demand. In the first half of 2022, 50.2% of the sales made by individuals were financed by a mortgage. This share is only slightly above that of the previous quarters.

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SPAIN: MANAGING NEW RISKS

Spain is now the eurozone country with the lowest inflation rate, standing at 6.7% in November. Government measures to curb the rise in energy prices are paying off, although the underlying CPI is still rising significantly. The slowdown in inflation is expected to continue in 2023, but the government will keep on providing significant support to the economy. The 2023 budget, discussed in parliament, extends most of the support measures until the end of next year. Faced with the rise in mortgage rates, Madrid eased repayment conditions for households via loan restructuring facilities while allowing for a temporary freeze on monthly payments. In addition to the energy crisis, the government will have to manage credit risk, in a country still marked by the banking and real estate crisis of the past decade, but with households generally less indebted than in the past.

After reaching 10.7% in July, consumer price inflation fell sharply to 6.7% in November. The Spanish economy, which suffered from the surge in energy prices and, as a result, a rise in inflation, earlier than its European neighbours – the 2% threshold had been crossed in April 2021, three months before the eurozone average – recorded the weakest rate within the monetary union in November. The Iberian exception, which has been in place since spring 2022 and which consists of limiting the price of gas so that it is not the most expensive energy that sets the price of electricity, has paid off. The cap on regulated gas prices and the decline in the global price of energy commodities also provided some breathing space.

In addition, the government extended the cap on regulated gas tariffs, until the end of 2023, to 5% for households and public authorities eligible for the so-called last resort gas tariff (TUR), for which the majority of consumers are eligible. Until the end of next year, the authorities also increased the social bonus, which reduces electricity bills by up to 80% for the more vulnerable households. Combined with significant base effects, energy prices could fall into deflation this winter. That said, core inflationary pressures remain high and did not fade until October (6.2% y/y). Business confidence surveys, particularly PMIs for services, do not yet indicate a turnaround in sales price dynamics, which remain at a historically high level (the PMI price charged index for services rose to 60 in November). We now expect activity to contract over the next two quarters. Real GDP grew slightly in the third quarter (+0.2% q/q) but remained 2% above its level at the end of 2019. Consumption, the country's main driver of growth, shows little sign of a tangible recovery.

Despite the lack of growth in activity, the labour market is more than resilient. According to the Spanish employment agency (SEPE), after a stabilisation since the beginning of the year, unemployment fell significantly in October-November (-166,500 over the two months as a whole) to reach its lowest level in fourteen years. The number of people employed increased in November (+79,000 jobs, seasonally adjusted figures), for the seventeenth consecutive month. If employment remains unchanged in December, recruitment will end 2022 up 2.4%, a very solid figure given the economic shock experienced by European economies this year.

At the same time, the number of permanent contracts (part-time and full-time contracts combined) increased by 103,000 and now accounts for more than 70% of total jobs. The equivalent percentage was only 62% at the end of 2021, a few weeks before the new labour law came into effect in February, the main purpose of which was to tighten the conditions to encourage employers to hire full-time employees.

The increased release of funds for the National Recovery and Resilience Plan (PRR) will further support activity in 2023. The volume of funding for this programme already expanded significantly in 2022, with EUR 19 billion unblocked during the first nine months of the year, i.e.

GROWTH & INFLATION

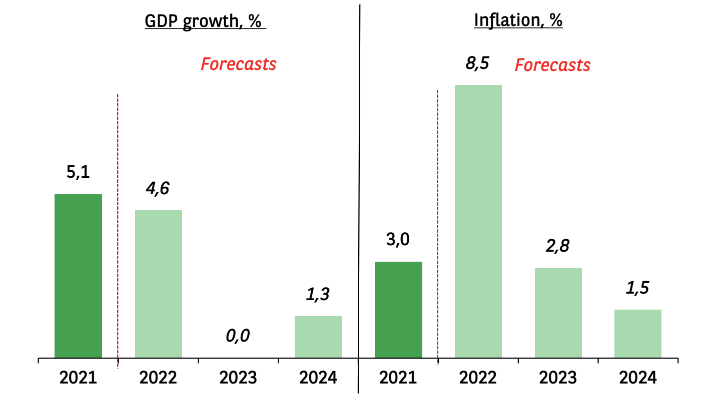

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EUR 7 billion more than at the same time last year. These funds are fully financed by European subsidies from the "Facility for Recovery and Resilience" plan, the payments of which (EUR 69 billion in total) are mainly concentrated in 2022 and 2023. Minister of Economy Nadia Calviño formalised Spain's request at the end of November to obtain a new tranche of subsidies, the third of which, EUR 6 billion, should be paid before the end of the year.

REAL ESTATE AS A NEW SOURCE OF FRAGILITY

With the rise in refinancing rates in the eurozone, the conditions and costs of mortgages in Spain increased, with rates going from an average rate of 1.5% at the end of 2021 to 2.4% in September 2022. This rise, which was still modest but will increase as the ECB continues to raise its policy rates, has already led to a drop in new bank loans (-0.4% between August and October, the sharpest drop in three months since June 2020). As a result of a tight market due to supply constraints, the rise in real estate prices in the country is not slowing: they jumped 1.7% m/m and 9.1% y/y in October, the highest annual rate for more than 15 years (see chart 2). While a decline in the volume of real estate activity is expected in 2023, price trends, which depend on the balance between supply and demand, remain more difficult to assess.

In addition to the energy issue, households will therefore be faced with the increase in the costs of loans. The mortgages market has certainly undergone a profound change of structure over the past few years, with a significant shift from variable-rate to fixed rates. These, which represented less than 5% of new mortgages in 2011, now account for two-thirds of the originations in September 2022 (This trend has however begun to reverse once again with the rise in credit costs making variable rate loans attractive). For these households having taken advantage of the period of low interest rates to obtain and sustain more favourable and stable borrowing conditions, the tightening of credit conditions will have a logically low impact. However, the share of variable rates in the total outstanding credit remains a minority. Payment difficulties should therefore increase in 2023, although the improvement in the labour market is somewhat limiting these risks. In addition, Spanish household debt remains well below its level at the threshold of the 2008 financial crisis. As a share of gross disposable income, household debt stood at 89.3% in Q2 2022, compared with 136% at the peak recorded in Q2 2008 (see chart 3).

Nevertheless, in view of the impact of this rise in interest rates on the financial situation of more vulnerable homeowners, the government integrated targeted protection measures into the 2023 budget: ease of restructuring mortgage loans, freezing monthly repayments for 12 months and extending the term of the loan up to 7 years. At the same time, the annual rent capping measure of 2%, first introduced in March 2022, was extended in 2023.

On the corporate side, the increase in refinancing costs should be more severe in Spain than in France or Germany in particular, due to the use of more variable rates and shorter maturities[1].

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SPAIN: HOUSE PRICE GROWTH

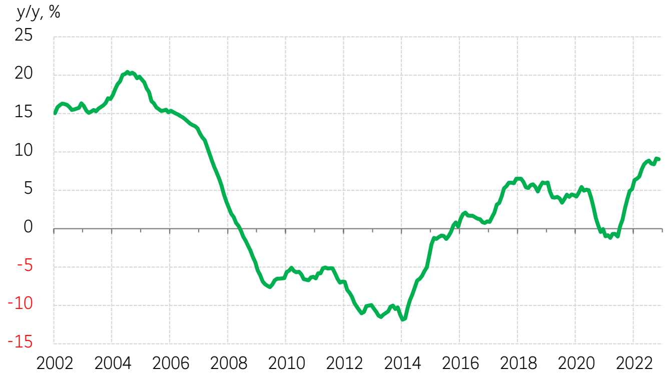

CHART 2 SOURCE: TINSA, BNP PARIBAS CALCULATIONS

SPAIN: HOUSEHOLD DEBT TO GROSS DISPOSABLE INCOME RATIO

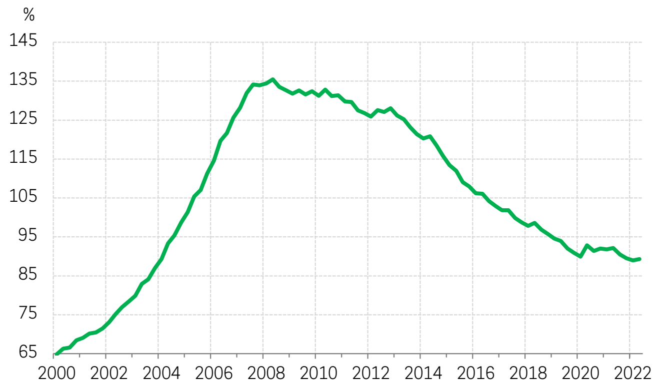

CHART 3 SOURCE: ECB, BNP PARIBAS

1 See M. Gueuder and S. Ray. Rising interest rates: European companies will not be affected at the same rate, Banque de France Bulletin, December 2022. In this study, the share of variable rate loans from Spanish companies is estimated at 38%, compared with 20% in Germany and 17% in France.

BELGIUM

CLOUDY SKY

Belgian GDP avoided a dip in Q3, but our present forecast suggests Q4 could be worse. A short and shallow recession looks likely as record-shattering inflation is expected to gradually abate throughout 2023. Consumer spending and corporate investment remain sluggish, but the negative impact of energy prices on household budgets looks more limited than many had feared. Active government intervention played a big part here, but fiscal consolidation remains necessary.

The Belgian economy, somewhat surprisingly, avoided the start of a recession right after the summer. The National Bank published final quarter-over-quarter growth of +0.2%, after having estimated mere weeks ago that a decline of economic activity was more likely. For now, our base case remains a short and shallow recession, with a return to positive growth in the second half of 2023. More worrisome is that, even after a large (positive) revision of the National Accounts, both private consumption and, to a larger extent, gross capital formation were still lagging behind their pre-covid levels in Q2. Government spending and especially foreign trade have been spurring growth, but for a complete post-covid recovery private domestic demand will need to shift gears. This will likely not happen before the second half of 2023.

DOUBLE-DIGIT INFLATION

Inflation on a yearly basis, as measured by the ECB's preferred metric HICP, came in at 13.1% y/y for October. It is expected to remain in the double-digit territory throughout the remainder of the year. Energy inflation, which seemed to slow down over the summer, was back up to 67% y/y. More disturbing, food inflation also keeps accelerating and still looks to cross the 10% y/y barrier this year. All-in all, our base case entails a steady decline throughout 2023, with inflation still above 3.0% at the end of the next year.

HOUSEHOLDS' CONCERNS

Consumer confidence, which came in at an all-time low in September and October, recovered somewhat in November. Despite persistent low unemployment, households worry about the labour market, next to their ability to save and the general health of the economy. Geopolitical uncertainty and most notably high energy prices seem to weigh on household sentiment.

The impact of higher gas and electricity bills so far, however, might be a lot less than previously feared. Reduced consumption, changes in payment plans and active government intervention, such as doubling the share of households eligible for a reduced energy price scheme (social tariff) from 10% to 20% of the population, could have reduced the blow to household budgets, at least partially, for now.

BUSINESS CREDIT

Confidence in almost all sectors remains on a downward trajectory, as it has been since the start of the Russian invasion of Ukraine. There is some positive news in the construction sector, where order books are improving, despite households reporting a reduced appetite for major investments. Firms also report trouble in accessing credit. This indicator is near an all-time high, reached around the Great Financial Crisis of 2008-2009. Small firms and those in the services sector especially are struggling.

GROWTH & INFLATION

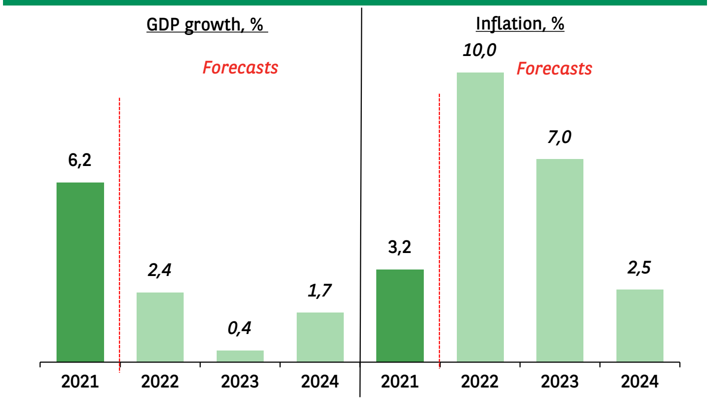

CHART 1 SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

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AUSTRIA

A SLUMP ON THE HORIZON ?

After dynamic business activity during the first six months of the year, Austrian growth slowed very dramatically during Q3 2022, due to the economic downturn both nationally and internationally. GDP is not expected to rebound over the final months of the year and is even poised to stagnate in 2023. However, the downturn in business activity has not stopped the government from announcing an ambitious reduction in the public deficit, which would fall below 3% from next year. This would result in a sharp decrease in the public-debt-to-GDP ratio. These commitments appear to be credible, as the incumbent Green President, Alexander Van der Bellen, was easily re-elected on 9 October, offering political stability to the country following the debacle of the 2016 election.

Over the first six months of the year, Austrian GDP grew very substantially (+1.2% during Q2, following growth of +1.9% during Q1). However, this strong momentum was halted during Q3, as GDP growth slowed dramatically to +0.2% (q/q). This slight decrease in business activity is expected to continue during the final months of the year, as the European Commission is anticipating growth of +4.6% in 2022, with the growth rate carried over at the end of Q3 standing at +4.8%. 2023 is expected to be marked by stagnating business activity in particular, as well as a slight resurgence in inflation. Business activity is only expected to recover gradually, with no green shoots until 2024. Austria's exposure to and dependence on Germany will negatively impact its trade in 2023 and 2024, even though the country is expected to have a small surplus in its trade balance in 2022, thanks to the recovery in service exports, led by tourism (a sector which accounts for almost 15% of GDP).

The government has high public-debt reduction targets. The high nominal GDP growth buoyed by double-digit inflation (+10.6% y/y in November, i.e. the highest level since 1952) has helped to sharply increase government revenue, while expenditure is still under control with limited support measures. As a result, the government's budget balance is expected to fall below the 3% deficit-to-GDP ratio from next year. The public-debt ratio is expected to dip by 7 points between 2021 and 2024 (82% to 75% of GDP) (see Chart 2).

Despite the adverse economic climate, the unemployment rate is expected to stabilise at its current level of around 5% in 2023. This level, which is close to the NAWRU (estimated at 5.25% by the European Commission), is consistent with a projected decline in inflation to +6.7% on average in 2023, followed by +3.3% in 2024. Wage dynamics are expected to contribute to this disinflation, as, after peaking during Q1 (+6% y/y), a slowdown is looming, with wages only rising +5% (y/y) during Q3.

In the world of politics, the Austrian people re-elected the 78-year-old incumbent Green President, Alexander Van der Bellen, as the country's leader on 9 October. Van der Bellen won 56.7% of the votes cast in the first round. This landslide victory was not a surprise, as the leader of the Green (Grüne) Party, supported by the traditional parties (the Social Democratic Party and the People's Party), had enjoyed a clear lead in the polls. This result was due to the declining support for the far right party, the Freedom Party of Austria (the FPÖ), the largest opposition party in Austria, over several years as a result of a number of corruption scandals that have ruined the nationalist party's credibility. The re-election of the incumbent President offered political stability in Austria following a tumultuous election in 2016, where suspected fraud when counting the ballot papers led to the results of the second round being cancelled and the second round being rerun.

GROWTH & INFLATION

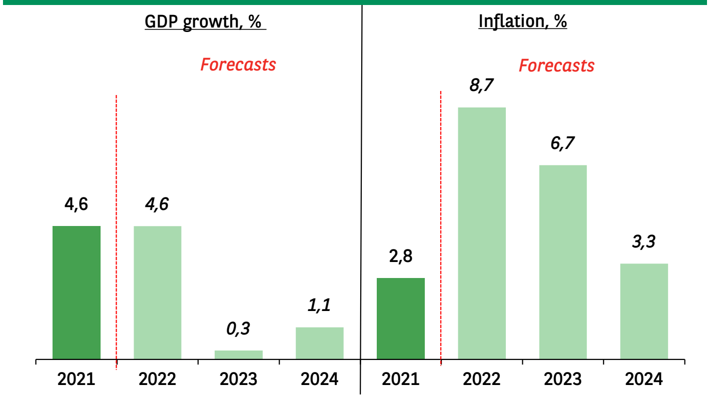

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

AUSTRIA: FISCAL BUDGET BALANCE AND PUBLIC DEBT

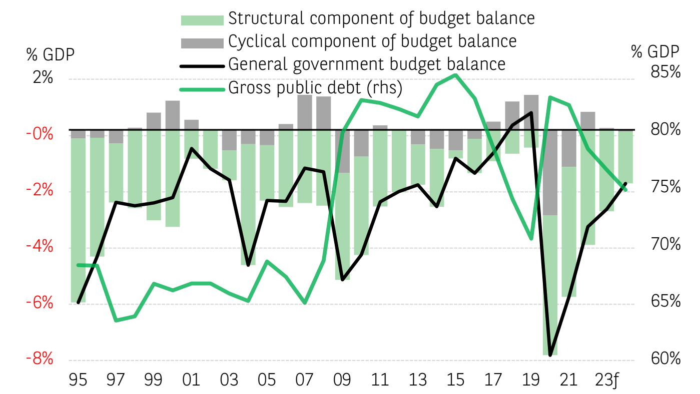

CHART 2 SOURCE: MACROBOND, EUROPEAN COMMISSION (AMECO), BNP PARIBAS

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GREECE

CONTINUING POSITIVE MOMENTUM

Despite the significant rise in inflationary pressures, the Greek economy continued to grow quickly during the first half of 2022, at a rate of 4.1% over the period. Nonetheless, real GDP fell back 0.5% q/q in Q3 despite tourism activity holding up well and the labour market being resilient. Indeed, the unemployment rate dropped during Q3 2022 (-29k), hitting its lowest level since December 2009. Almost 80% of the rise in unemployment recorded during the economic crises in 2008 and 2011, which ran from autumn 2008 to spring 2013, was wiped out. As a result, even though it is still very high, the unemployment rate fell below 12% in October (11.6%). However, the Greek economy, which mainly depends on the rest of Europe for its trade and energy supplies, is still highly vulnerable to the economic situation on the continent deteriorating.

With inflation rising, Kyriákos Mitsotákis' government significantly increased the minimum wage by 7.5% in May, which did not fully offset the rise in inflation, however. Inflation peaked at 12.1% in September, before falling back to 9.5% in October. The jobless rate fell back to 11.6% in November. However, Greece is still a long way off the structural unemployment rate, which, according to estimates by the European Commission (EC), stands at between 8% and 9%. This is expected to limit the second-round effects on wages and further constrain consumer purchasing power. As a matter of fact, the EC's quarterly survey, which assesses company production constraints, confirms that recruitment pressures are lower in Greece than in the eurozone as a whole , which should prevent inflationary pressures on wages from building up to excessively.

A NEW CHAPTER BEGINS

As expected, on 20 August, Greece left the European Commission's enhanced surveillance programme, which it had entered in 2018. However, the European Commission will keep a particularly close eye on the country, along with Spain, Ireland, Portugal and Cyprus, due to the European Union assistance that it received during the sovereign debt crisis (via the European Stability Mechanism and the European Financial Stability Facility EFSF mechanisms), with some loan repayments for this support being spread over many years (up to 2070 for Greece). Accordingly, the European Commission is continuing to closely assess developments in public finances and the sustainability of the country's debt.

Greece's exit from this surveillance programme, however, illustrates the notable improvements in the country over the past few years, particularly around its fiscal position. The central government's primary balance, which recorded sizeable deficits in 2020 and 2021 due to the Covid-19 pandemic (deficits amounted to 6.9% f GDP and 5.0% of GDP respectively), is expected to recover significantly in 2022, before likely moving into surplus territory in 2023. As a result, the public debt ratio is expected to fall sharply this year, and more than in 2021: the government is targeting a fall to around 170% of GDP, a major decrease from the record levels seen in 2020 (206.3% of GDP).

As a matter of fact, the government can take advantage of a better-than-expected scissor effect (a rise in taxes collected and a fall in social transfers) in order to finance some of its inflation support package targeted at households and businesses, without threatening the fiscal trajectory set in the 2022 budget. In its Stability Programme submitted to the European Commission on 15 October, the Greek government acknowledged, in particular, the permanent three percentage-point cut in the social security contributions rate (end of 2022), as well as the abolition of the solidarity tax, which were two support measures adopted during the pandemic and which were expected to expire at the end of 2022.

GROWTH & INFLATION

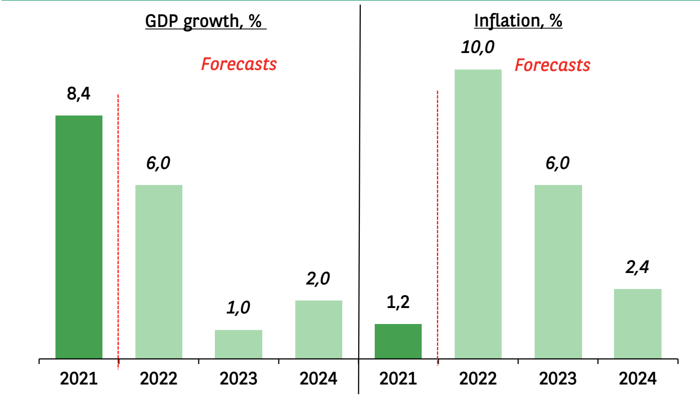

CHART 1 SOURCE: OECD (JUNE 2022), BNP PARIBAS

Thanks to the strong performance of the economy and the Hercules bad debt securitisation programme (which was put in place in October 2019 and ended in October 2022), the Greek banking sector recorded a further drop in the stock of non-performing loans (NPLs), as well as in the NPL ratio, which had fallen to 10% at the end of Q2 2022. However, 2023 is expected to be a difficult year, with the combination of risks (high inflation and rising interest rates) likely to lead to greater payment difficulties for households and businesses.

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UNITED KINGDOM: RECESSION

UK growth contracted sharply in Q3, confirming that the economy has gone into recession. Household and business surveys confirm this fall in consumption and investment, which is likely to continue in the coming months. Faced with persistent inflation which continues to spread, the Bank of England is continuing to tighten its monetary policy, despite the economy entering recession. The simultaneous announcement of a support plan for households and fiscal consolidation measures by the new government should help in the fight against inflation while supporting the lowest income households.

Unlike the major economies of the euro zone and the United States, whose growth is resilient and was positive in Q3, the United Kingdom quarterly GDP growth fell by 0.2% (q/q) in Q3, compared with +0.7% in Q1 and +0.2% in Q2 (after revision). This decline in growth can be explained by a greater than expected destocking dynamic as well as by a contraction in private demand (household consumption and corporate investment), while public demand again supported growth. The very strong contribution from foreign trade helped to limit the contraction in growth. According to our forecasts, UK GDP would continue to contract in Q4, marking the entry into recession of the economy: GDP should, in fact, continue to contract over the next three quarters, to the point that growth in 2023 on average would also be negative (-0,9%). This downturn in activity is likely to slow inflation, with the peak expected in Q4 2022.

SLOWDOWN IN PRIVATE DEMAND

Household consumption contracted in Q3 and this trend is likely to continue in the coming months. The financial situation of households remains under pressure due to the high inflation in food products (+16.5% y/y), at its highest for 45 years, and energy (+90% y/y), despite the support measures put in place by the government since October. The rise in interest rates increases the cost of mortgage loans and rents, which in turn contributes to the reduction in household purchasing power. Despite a slight improvement in November, the GfK consumer confidence index remains close to its record low (-44 points).

The slowdown in consumption is also likely to affect business investment. According to various surveys by the Confederation of British Industry (CBI), business optimism continues to fall sharply in the industrial and service sectors. When asked about barriers to investment, companies say that they are more concerned about the uncertainty in demand than about labour shortages or financing costs.

PERSISTENCE OF INFLATION

Inflation continues to spread throughout the economy, driven by high volatility in energy and food prices and a particularly tight labour market. The consumer price index (CPI) rose by one percentage point to +11.1% (y/y) in October (+2% m/m). However the government's cap on electricity and gas prices for households and businesses helped to reduce inflation by 2.7 points in October, which otherwise would have been 13.8% according to the ONS. Core inflation remained stable year-on-year (+6.5%), but continued to rise month-on-month (+0.7%), which is likely to justify a further rise in key rates, which is expected to be 50 basis points according to our forecasts, at the December meeting of the Monetary Policy Committee (MPC).

The persistence of inflationary pressures is forcing the Bank of England (BoE) to continue raising its key rates and to further reduce its balance sheet (quantitative tightening), despite the economy falling into recession. Furthermore, the measures announced by the government should on this occasion contribute to the fight against inflation, which should

GROWTH & INFLATION

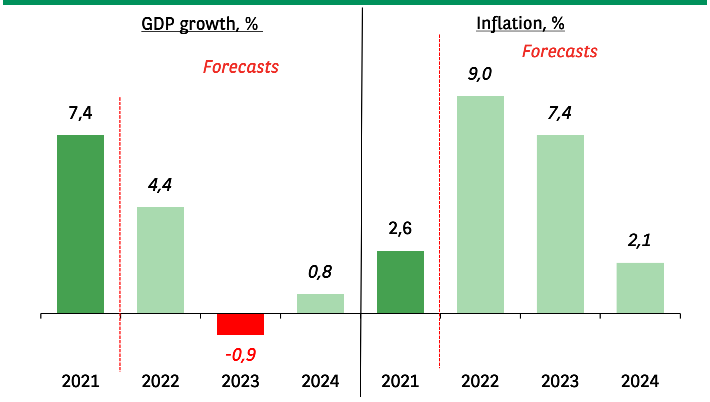

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

allow the Bank of England to reach its terminal rate more quickly than expected.

NEW FISCAL PARADIGM

While public demand supported growth in Q3, the situation could well reverse, in light of the recent measures announced by Jeremy Hunt, the Chancellor of the Exchequer, in his Autumn Statement. The plan for "stability, growth and public services" consists of two elements with different objectives. Firstly, the government foresees the continuation of targeted support for purchasing power (£26 billion) thanks to an extension of the Energy Price Guarantee from April 2023 onwards, as well as the increase in the National Living Wage (+9.7%) and social security and pension benefits (+10.1%). Companies will not see an extension in April of the support measures they have benefited from since October. Secondly, the plan envisages a policy of fiscal consolidation with a dual objective: to combat inflation and to guarantee the sustainability of public finances by generating revenues of £55 billion by 2027-2028. In this context, the government plans to increase tax revenues by around £25 billion over five years, in particular due to the increase in corporation tax (from 19% to 25% in April 2023) as well as by applying an exceptional (windfall) tax on oil and gas companies. In addition, the government is aiming for savings in public expenditure (£30 billion), despite announcements of further spending for the National Health Service (NHS), education and research and development.

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DENMARK

THE END OF AN IMPRESSIVE RUN?

Up until now the Danish economy has continued to impress, with a strong post-Covid rebound which has propelled its GDP well above its pre-crisis level, but the future now looks a lot less bright. If inflation had not yet been able to fully undermine household purchasing power due to significant job creation and a level of over-saving which helped to mitigate the impact, these one-off shock absorbers are coming to an end and real household income is expected to fall over the coming quarters. The government is remaining relatively impassive in the face of this brutal shock and the fiscal response remains very limited, with public accounts that are in surplus and likely to remain so. Public debt should converge towards only 32% of GDP by 2024..

The impressive post-Covid growth in Danish GDP continued (+0.5% q/q) in the 3rd quarter of 2022 after +0.9% q/q in the 2nd quarter. GDP is now 6.4% above its level at the end of 2019. As has been the case since the post-Covid rebound, growth was buoyed by investment (+0.8% q/q), which was around 17% above its level at the end of 2019. On the other hand, private consumption stalled in the 3rd quarter under the weight of an increase in consumer prices, which reached 10.1% in October over one year, although retail sales showed a degree of solidity in the consumption of goods at the beginning of the 4th quarter. This resistance could surprise as the increase in nominal salaries (+4.9% year-on-year in Q3 2022) is much lower than inflation. Rather, the explanation lies with the labour market, which is particularly vigorous. In the 3rd quarter employment rose by 4.4% year-on-year, and the Danish unemployment rate stood at only 2.3% according to the International Labour Office definition (see figure 2). This level of job creation has therefore enabled purchasing power to be maintained on an aggregate basis, without having positive growth in real wages. The over-savings accumulated over the past two years have probably also helped to support consumption. Furthermore, the significant rise in energy prices does not seem to be affecting manufacturing production, which continues to perform remarkably well. Over the course of one year to September, Danish manufacturing production recorded a staggering growth rate of 23%. The specialisation of Danish industry in strategic sectors[1] which are expanding strongly continues to be a winning strategy.

However, this strong momentum in the Danish economy is expected to stall in 2023. The labour market is expected to stabilise, and purchasing power will be eroded because of inflation. Exports are expected to weaken as global demand falls. And investment, particularly in construction, could fall with the rise in interest rates on home loans. For all these reasons, after a strong growth year in 2022 (+3%), the European Commission expects GDP in 2023 to be stagnant (+0%), followed by a gradual recovery in 2024 (+1.3%) (see chart 1).

Despite the decline in purchasing power, the Danish government is opting for less support for households and businesses, allowing it to keep the public finances in the black with an expected budget surplus of 1.8% of GDP in 2022. The government should continue to benefit from revenues that are higher than their expenditure in 2023 and 2024. This will result in rapid deleveraging, since public debt, which stood at 36.6% of GDP in 2021, should converge towards 32% of GDP by 2024.

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GROWTH & INFLATION

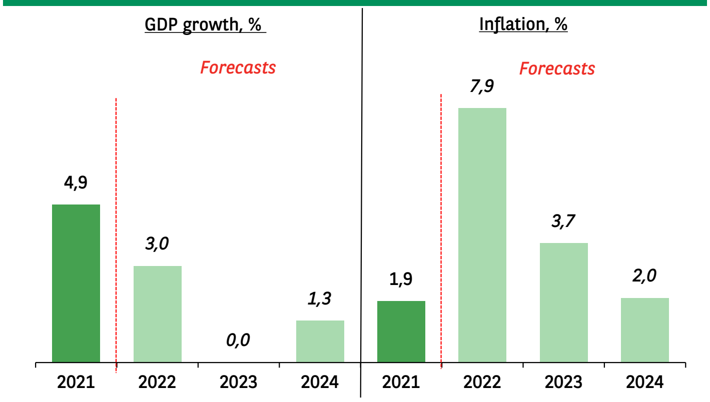

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

DENMARK: LABOUR MARKET

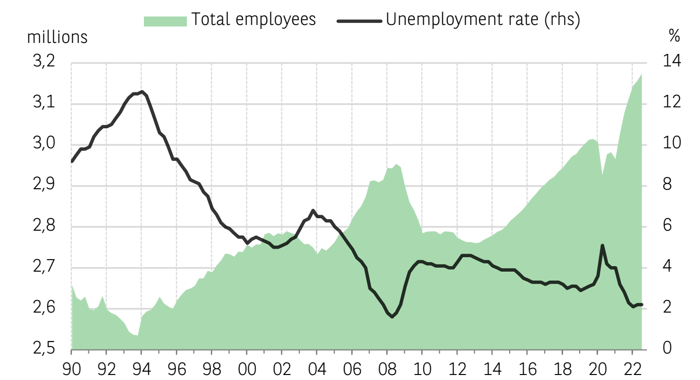

CHART 2 SOURCE: MACROBOND, STATISTICS DENMARK, BNP PARIBAS

1 We discussed this in the Q3 2022 EcoPerspective

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2021	2022e	2023e	2024e	Inflation 2021	2022e	2023e	2024e
United-States	5,7	1,9	-0,1	-0,2	4,7	8,1	4,4	2,4
Japan	1,7	1,5	0,9	0,3	-0,2	2,4	2,1	1,3
United-Kingdom	7,4	4,4	-0,9	0,8	2,6	9,1	6,9	2,1
Euro Area	5,3	3,2	-0,5	1,3	2,6	8,4	5,6	2,3
Germany	2,6	1,8	-1,0	1,1	3,2	8,8	5,7	2,0
France	6,8	2,5	0,0	1,0	2,1	6,0	6,4	2,7
Italy	6,6	3,8	-0,4	1,1	1,9	8,7	7,2	2,0
Spain	5,1	4,6	0,0	1,3	3,0	8,3	2,3	1,5
China	8,1	3,2	4,5	4,8	0,9	2,1	2,7	2,5
India*	9,3	8,3	6,2	6,5	5,4	7,9	5,9	5,5
Brazil	4,6	3,0	0,5	1,3	8,3	9,4	5,4	4,9
Russia	4,5	-7,0	0,8	0,3	7,1	14,0	10,5	7,6

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

SOURCE: BNP PARIBAS (E: ESTIMATES)

FINANCIAL FORECASTS

Interest rates, %		2023				2024
End of period		Q1 2023	Q2 2023	Q3 2023	Q4 2023	Q4 2024
United States	Fed Funds (upper limit)	5.25	5.25	5.25	5.25	3.25
	T-Note 10y	4.30	4.00	3.75	3.50	3.25
Eurozone	Deposit rate	3.00	3.00	3.00	3.00	2.00
	Bund 10y	2.75	2.65	2.50	2.30	2.00
	OAT 10y	3.45	3.30	3.10	2.90	2.50
	BTP 10y	5.25	5.05	4.80	4.60	3.80
	BONO 10y	4.05	3.90	3.75	3.55	2.90
UK	Base rate	4.25	4.25	4.25	4.25	3.50
	Gilts 10y	4.00	3.75	3.60	3.35	3.15
Japan	BoJ Rate	-0.10	-0.10	-0.10	-0.10	-0.10
	JGB 10y	0.25	0.25	0.25	0.25	0.25

Exchange Rates		2023				2024
End of period		Q1 2023	Q2 2023	Q3 2023	Q4 2023	Q4 2024
USD	EUR / USD	1.01	1.00	1.03	1.06	1.10
	USD / JPY	140	138	133	128	120
	GBP / USD	1.09	1.08	1.11	1.14	1.18
EUR	EUR / GBP	0.93	0.93	0.95	0.95	0.95
	EUR / JPY	141	138	137	136	132

SOURCE : BNP PARIBAS GLOBAL MARKETS (E ESTIMATES)

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