

ECO PERSPECTIVES

Eco
PERSPECTIVES

by BNP PARIBAS

3rd quarter 2020

EDITORIAL

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What comes after the mechanical rebound?

The easing of lockdown measures has caused a significant improvement in business sentiment and a mechanical rebound in activity and demand. In the near term, the narrowing of the gap between observed and normal activity levels should gradually lead to less spectacular growth numbers. These are underpinned by pent-up demand, monetary and fiscal policy support and the possibility for households to use the extra-savings accumulated during the lockdown...



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WHAT COMES AFTER THE MECHANICAL REBOUND?

The easing of lockdown measures has caused a significant improvement in business sentiment and a mechanical rebound in activity and demand. In the near term, the narrowing of the gap between observed and normal activity levels should gradually lead to less spectacular growth numbers. These are underpinned by pent-up demand, monetary and fiscal policy support and the possibility for households to use the extra-savings accumulated during the lockdown. A lot will depend however on how uncertainty evolves. The health situation is not under control in certain countries and there are concerns about the risk of a flare-up. Households face income uncertainty due to bleak labour market prospects. Against this background, companies may tune down their investment plans.

EASING OF LOCKDOWN MEASURES CAUSES MECHANICAL REBOUND

Economic recoveries following a recession tend to be gradual. In the initial stage, concerns about the high level of unemployment will weigh on household spending whereas companies will probably wait for better visibility before significantly stepping up their investments. This recovery is different, at least in its early phase, because the recession was very atypical. The lockdown measures to bring the spreading of the virus under control introduced physical limitations on activity and demand, causing them to drop very significantly from their pre-pandemic levels. The easing of the measures has partly removed this constraint, generating spectacular month-over-month growth numbers. This is not so much about a sudden increase in the willingness to spend, rather it reflects the fact that households are again able to go out and spend. The rebound is mechanical. Consequently, business sentiment has improved significantly, witness the purchasing managers' surveys that in many countries are approaching the 50 mark –the borderline between contraction and expansion. In China, France and the US they have moved beyond this level. We should be mindful though that improved sentiment compared to the previous month does not tell us where we are in level terms. Indeed, on this metric, we are still well below normal.

MOVING TOWARDS A MORE GRADUAL RECOVERY

Inevitably, the acceleration of demand and activity growth seen in recent weeks cannot be sustained and in many countries, the mechanical rebound is now largely behind us. In France for instance, INSEE recently reported that household consumption is approaching the level seen before the pandemic. According to the Banque de France, the gap between current activity and its normal level has narrowed to 9%, coming from -27% in April. This should pave the way for less impressive although still sizeable monthly growth numbers. It is a recovery like a square root sign. Support factors in this respect are pent-up demand, policy measures –e.g. the temporary reduction of VAT in Germany, incentives to purchase a new, more environment-friendly car, income support measures- and the possibility for households to spend part of the savings accumulated during the lockdown.

EUROZONE REAL GDP (Q4 2019=1)

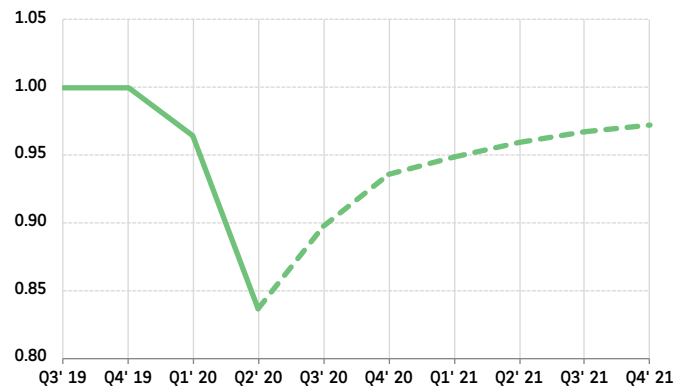


CHART 1

SOURCE: EUROSTAT, BNP PARIBAS FORECAST (JULY 2020)

UNCERTAINTY AS A KEY HEADWIND

However, important headwinds remain, as long as no vaccine or treatments have been found against the virus. In some countries and in several US states, the pandemic is not yet under control. In others, there is a flare-up of new cases, raising concern about the risk of a second wave. Households are confronted with income uncertainty due to the bleak labour market outlook that follows from cost-cutting initiatives by companies or their reluctance to hire new staff due to a lack of visibility. The central banks of Germany, France, Italy and Spain expect unemployment to be higher at the end of next year versus this year. A recent survey by the Atlanta Fed amongst 300 CFOs shows that, on average, hiring will be insufficient to reach by the end of 2021 the pre-pandemic employment level. This may cause a preference for precautionary saving over extra spending. Such behaviour, in combination with the significant increase in corporate indebtedness during the lockdown and a lack of visibility, should weigh on the willingness of companies to invest.

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UNITED STATES

THE ECONOMY REBOUNDS, BUT SO DOES THE PANDEMIC

In spring 2020, partially paralysed by the Covid-19 pandemic, the US economy entered the worst recession since 1946. Global activity contracted by more than 10% in Q2 before picking up slightly since the month of May. The question is how much of the lost ground can be recovered. With the approach of summer, business surveys are improving and the equity markets are rebounding, signalling rather optimistic expectations, possibly excessively so. Bolstered by the Federal Reserve's liquidity injections, the markets could be underestimating the risk of corporate defaults, especially given their increasingly heavy debt loads. The latest statistics on the propagation of the virus are not good.

The American people and their economy have paid a heavy tribute to the Covid-19 pandemic. Arriving in North America a little later than in Europe, and long played down by President Trump, the coronavirus has already caused the death of some 130,000 Americans, which unfortunately is only a provisional figure. As we are writing these lines, there has been an alarming surge in the virus, particularly in the southern states of Florida, Texas and California (see chart). With nearly 50,000 new cases reported daily in early July, the first wave of the epidemic is still going strong, and healthcare authorities are warning that it may be "out of control".

Due to lockdown measures and social distancing, the US economy has entered the worst recession since 1946. According to Federal Reserve Bank of Atlanta estimates, US GDP plummeted 12% in Q2 2020 (an annualised rate of 40%), a dramatic slump comparable to what was seen in Europe. In the absence of job retention schemes, the impact on the job market was huge, with the destruction of 20 million jobs. In May, the number of companies filing for chapter 11 bankruptcy protection surged 50% compared to the previous year.

Fortunately, the stalled economy did not get any worse, thanks to combined support by the US Treasury and the Federal Reserve, which has prevented interruption in global funding, a predominant component of all major crises.

THE FED REVIVES THE MARKETS

In the first weeks of March, risk reassessments combined with the prospects of an economic downturn triggered a widespread flight to cash. Orders to liquidate assets (equities, bonds and mutual fund shares) put pressure on players vital for the financing of the economy, including Primary Dealers and Money Market Funds. To prevent the economy from freezing up, the Fed mobilised considerable resources, most of which were unconventional. After lifting the limits on its quantitative easing policy, the Fed purchased virtually the equivalent of a full year of French GDP in just four months' time¹. A number of ad hoc refinancing programmes were launched and the Fed became less demanding about eligible collateral. By doing so, it positioned itself as the lender of last resort in absolutely all compartments of the debt market, including the primary and secondary markets as well as in the investment grade and high yield compartments.

Since the US dollar liquidity crisis was global, the Fed's interventions reached far beyond US borders. It concluded swap agreements with the main central banks around the globe. Altogether, the credit lines opened by the US Fed exceeded a trillion dollars, but since all of them have not been drawn on, the amount potentially available is actually much higher.

¹ USD 2,295 bn in net purchases between 26 February and 24 June 2020. Source: Federal Reserve.
² Financial Times, *Financial gravity will force credit default across Europe*, 24 June 2020

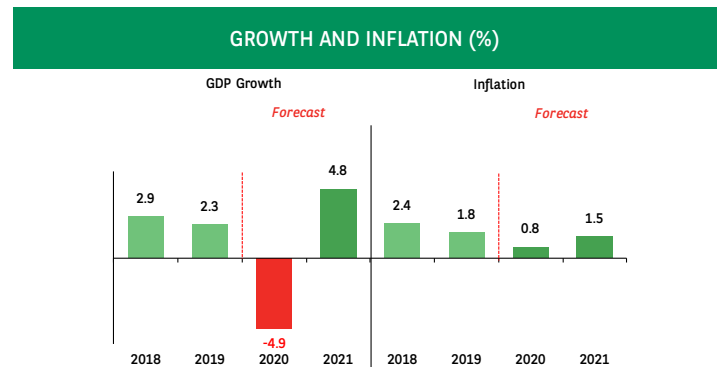


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

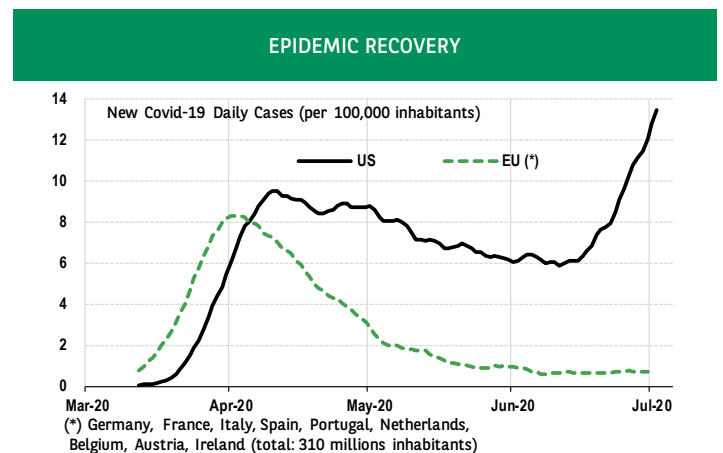


CHART 2

SOURCE: JOHNS-HOPKINS UNIVERSITY, BNP PARIBAS

Thanks to this virtually unlimited public reassurance, the markets were able to rebound rapidly and spectacularly. The most striking example is the cost of credit default swaps (CDS). After surging as high as a 1000bp in the high yield compartment, risk premiums began to ease as of 23 March, when the Fed activated its main support measures, including unlimited quantitative easing, and primary and secondary market corporate credit facilities (see box). Today CDS have returned to nearly normal levels, even though the number of credit events has surged in the United States and is showing signs of rising in Europe (FT, 24 June)². The equity markets, which are highly correlated, recovered part or all of the losses engendered by the Covid-19 crisis, and some



sector indexes, for technology and healthcare stocks, for example, rose above their pre-crisis levels.

LOOKING BEYOND A Q3 REBOUND

Since the economic recovery depends on keeping financing channels open, the Federal Reserve has done a lot to pull economic indicators out of depression territory. The fiscal deficit has also helped: roughly USD 1 trillion allocated to the Paycheck Protection Program (state-backed loans) and the extension of unemployment benefits helped maintain household income during the worst of the recession³. In May, as shelter in place and other protective measures were gradually lifted, private consumption resumed and employment picked up again⁴. The business climate perked up and the rally extended into June, with the Institute for Supply Management's purchasing managers index rising above the 50 threshold in manufacturing. After plummeting last spring, activity is bound to strengthen in Q3, partially making up some of the lost ground.

But what then? Looking beyond the fact that the epidemic has not disappeared, a number of imbalances that were already present before the crisis have worsened, making the recovery even harder. Corporate debt was already at a record high⁵ and has continued to swell, raising questions about debt sustainability in the sectors where declining sales will not be transitory (such as air transport, retailing, natural gas and shale oil). Equity and bond market investors have convinced themselves that the worst is over and that monetary policy will remain permanently accommodating, but the rallies of recent weeks are hardly grounded in economic fundamentals.

Would the markets continue to rebound strongly in H2 2020, the current PE multiples of the corporate listed on the S&P 500 would still be in the area of 30, e.g. close to historical peaks. According to the valuation model of the International Monetary Fund (IMF), risky assets, whether equities or corporate bonds, are historically overvalued⁶. From a strictly business perspective, the economic situation in the United States seems to have improved, but it also seems to be very vulnerable to any snags in the recovery or shifts in expectations.

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MONETARY SUPPORT MEASURES

• Conventional measures

Fed funds target rate	Cut by 100bp to 0%-0.25%
Discount rate	Cut by 150bp to 0.25%
Reserve ratio	Lowered to 0%

• Quantitative easing (USD bn)

	Limit	Outstanding*
Securities purchases (Treasuries, MBS, Agency MBS)	Unlimited	6,090.4

• Co-ordinated measures (USD bn)

	Limit	Outstanding*
Swaps ECB, BoE, BoJ, BNS, BoC	Unlimited	402.7
Swaps RBA, BCB, BoK, BdM, MAS, Riskbank	360	36.6
Swaps DanNB, Norges B., RBNZ	90	10.7

• Financing programmes (USD bn)

	Limit	Outstanding*
Repo operations		
Repurchase agreements (Treasuries, MBS, etc.)	5000	441.9
CPFF : Commercial Paper Funding Facility		
Purchases of commercial paper on the primary market	Ad hoc	4.3
PDCF : Primary Dealer Credit Facility		
State-backed loans to primary dealers	Unlimited	33.4
MMFLF : Money Market Fund Liquidity Facility		
Loans for eligible collateral: money market funds	Unlimited	53.2
PMCCF : Primary Market Corp. Credit Facility		
Corporate bond purchases in the primary market	500	0.0
SMCCF : Secondary Market Corp. Credit Facility		
Corporate bond purchases in the secondary market	250	6.6
TASLF : Term Asset-backed Sec. Loan Facility		
Loans for eligible collateral: asset-backed securities	100	0.0
PPPLF : Paycheck Protect. Progr. Lending Facility		
Loans for eligible collateral: state-backed loans to SME	Unlimited	57.6
MSLP : Main Street Lending Program		
Purchase and extension of new loans to SME	600	0.0
MLF : Municipal Liquidity Facility		
Municipal bond purchases (state, county, etc.)	500	1.2

* Maximum amount observed as of 18 June 2020

SOURCE: FED, BNP PARIBAS (C. CHOLET)

³ Committee for a Responsible Federal Budget, Covid Money Tracker, www.crfb.org

⁴ Of the 22 million job losses reported in March and April, 7.5 million jobs were created in May and June, leaving a net gap of 14.7 million jobs.

⁵ BNP Paribas Eco-Perspectives, United States: "2020: a year of living dangerously", January 2020

⁶ International Monetary Fund (FMI), Global Financial Stability Update, June 2020



CHINA

A GRADUAL BUT UNEVEN REBOUND

The economy has been recovering gradually since March, and the rebound in real GDP should be strong enough to enable it to recover rapidly the ground lost in the first quarter. Yet the shock triggered by the pandemic and the ensuing lockdown measures has severely weakened some sectors (such as export-oriented industries), some corporates (notably micro-enterprises and SMEs) and some households (especially low-income earners). The central bank has cautiously eased credit conditions and the government has introduced a stimulus plan estimated at about 5 points of GDP for 2020. Public investment in infrastructure projects remains the instrument of choice, but direct support to corporates and households are also expected to boost private demand.

After plummeting during the strictest period of the lockdown in February, economic activity has gradually turned around since March. The contraction in real GDP was unprecedented in Q1 2020, down 9.8% on a quarterly basis (and -6.8% year-on-year) but the Q2 rebound should be strong enough to completely regain the ground that was lost. On this point, China stands apart from most of the other big economies.

The turnaround observed over the past four months was mainly driven by a V-shaped rebound in industrial production and investment in public infrastructure and real estate. Even so, the economy has been hit by a severe shock that has left numerous scars. Certain sectors, notably those dependent on tourism and international demand, are still a long way from returning to normal. Although only temporary, the loss of corporate sales, jobs and household revenue will continue to strain domestic demand. Meanwhile, export prospects are darkened by the uncertain economic recovery in the developed countries and renewed tensions between China and the United States. Lastly, the risk of new outbreaks of the epidemic is hampering consumer behaviour¹.

Consequently, our short-term growth forecasts continue to have major downside risks. Inversely, they are firmly supported by the authorities' stimulus policies. Although the initial support package was relatively moderate, it has been gradually expanded and should keep pace with the economic recovery, even after the first rebound.

A DIFFERENTIATED REBOUND

All economic indicators point to a gradual recovery over the past four months, with industrial production and public investment rebounding more vigorously than private demand and services (chart 2).

On a year-on-year basis (y/y), industrial production swung back into positive growth as of April (+3.9% in volume, +4.4% in May). In the first five months of 2020, industrial production was just 2.8% lower than it was in the same period in 2019. The production decline in value terms has been accentuated by producer price deflation (-1.7% y/y on average since the beginning of the year), which has aggravated the deterioration in profits of industrial enterprises (19% lower in January-May 2020 compared to the same period in 2019).

On the demand side, the recovery since March has been bolstered by the rebound in investment, especially in public infrastructure, construction and the real estate sector, which were supported by the authorities' stimulus measures. Investment in the manufacturing sector picked up much more slowly, constrained by the difficult financial situation of enterprises, notably SMEs. Export companies remain being especially cautious. Even though foreign trade data show only a mild decline in merchandise exports over the period March-May (-2.2% y/y on average in USD), after the major disruption in February (-40%), export prospects remain bleak in the short term.

¹ In early June, the outbreak of new Covid-19 cases in Beijing led the authorities to reintroduce lockdown measures in certain districts. Fears have since eased, and official health reports show that the epidemic is currently under control, with a relatively flat curve for new infections over the past two months, and only 58 confirmed cases per 1 million inhabitants (some counties in China have been completely spared).

GROWTH AND INFLATION (%)

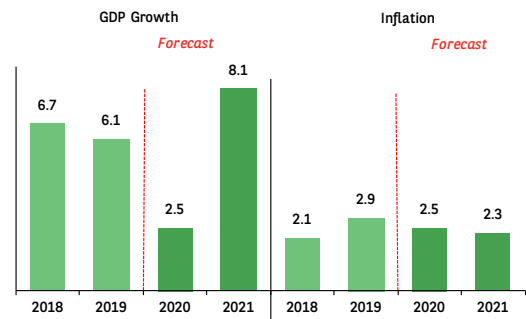


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

REBOUND DRIVEN BY SUPPLY, RETAIL SALES LAGGING BEHIND

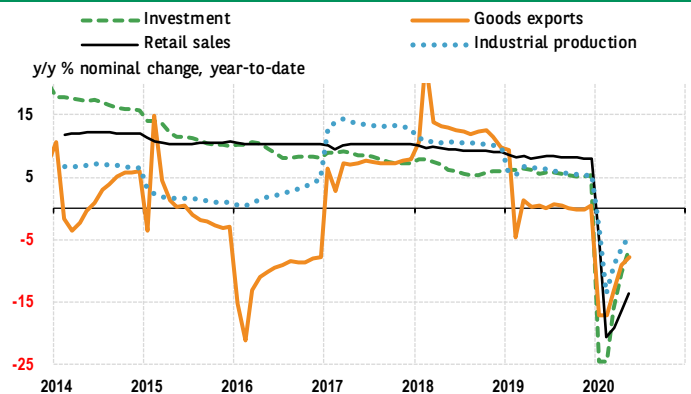


CHART 2

SOURCE: NBS, CUSTOMS

Private consumption has also struggled to recover, undermined by the downturn in the labour market and household revenues. The unemployment rate has held close to 6% since February (vs. 5.2% in 2019) and per capita disposable income declined by nearly 4% y/y in real terms in Q1 2020. In May, retail sales volumes continued to contract (down 3.7% y/y), despite a big rebound in automobile sales (+14.7%). Online sales of goods and services were naturally more dynamic (+13.2%). The factors that have been straining the recovery



in household consumption and exports are expected to persist in the short term, and the authorities are counting primarily on investment-related support measures to stimulate the economy.

FISCAL STIMULUS

The central bank has intervened right from the beginning of the Covid-19 crisis to address the liquidity needs of the financial sector. It has also eased monetary and lending conditions, and then encouraged banks to cover the cash flow needs of their clients and to refinance existing loans to prevent defaults and bankruptcies. Micro-enterprises and small businesses seem to be the main focus of the authorities' concerns. Total social financing growth accelerated from 10.7% y/y at the end of February to 12.5% at the end of May 2020 and should reach 13% to 14% by year-end 2020. The easing in credit conditions should remain relatively moderate in the end, as the central bank's leeway is much constrained by the excessive debt of the economy.

Stimulating economic growth will depend more on fiscal policy. Measures introduced and/or announced since February aim to help the sectors and companies hit hardest by the epidemic, to boost household revenue (notably by supporting employment), and to stimulate domestic demand. Public investment in infrastructure projects, which is still the government's instrument of choice, has rebounded strongly over the past two months. Direct measures to support corporates, employment and private consumption are expected to be implemented more gradually.

Following the annual session of the National People's Congress in late May, the government released its 2020 budget plan and announced a deficit target of 3.6% of GDP this year, up from 2.8% in 2019. Although this deficit target is historically high, it nonetheless suggests that the recovery plan will be moderate. However, the government's "official" budget largely underestimates the real amplitude of the stimulus, and Chinese fiscal policy in general. Fiscal policy is comprised of several segments, some of which are reported in the official budget, while others can be found in various off-budget accounts, such as the social security fund, funds financed by "special" central government bond issues, the special funds of local governments and the accounts of their financing vehicles. State-owned companies can also participate in stimulus measures. Lastly, transfers can be made between these various accounts over the course of the fiscal year.

In addition to the official deficit target, which is financed through so-called "general" bond issues (about 70% of which are issued by the central government and 30% by local governments), the authorities have announced the amount of "special" bond issues in 2020 to finance the supplemental budget allocated to post-Covid recovery measures. The central government will issue special bonds amounting to a total of CNY 1000 bn (1% of estimated 2020 GDP)², and the quota for special bond issues by local governments was increased by CNY 1600 bn to a total of CNY 3750 bn (3.6% of estimated 2020 GDP). Public debt is almost entirely denominated in RMB and issued in the local markets. Central government debt is still moderate and is projected at no more than 20% of GDP in 2020. In contrast, the debt of local government (including their financing vehicles) is high, estimated at about 50% of GDP.

Adding together the official deficit, the funds generated through special bond issues and the estimated amount of off-budget accounts, the "augmented" fiscal deficit comes to 10.9% of GDP in 2019 and is expected to reach 15.9% of GDP in 2020 (chart 3). This increase of about 5 points of GDP gives a more realistic picture of the size of the fiscal stimulus planned by the authorities. They have not specified

² The central government issued this type of bonds only twice in the past, in 1998 and in 2007.

OFFICIAL AND AUGMENTED FISCAL DEFICITS

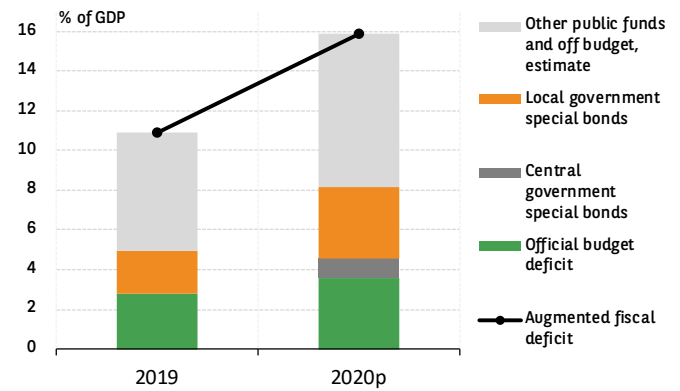


CHART 3

SOURCE: CHINESE GOVERNMENT, BNP PARIBAS

which amounts will be allocated to the various support measures.

We can nonetheless highlight two main kinds of measures: additional investment in infrastructure projects is estimated at about 2% of GDP, and direct support measures for corporates and households are estimated at about 3% of GDP. They notably include social security and tax exemptions and reductions, and an extension in the unemployment insurance system to accelerate benefit payments and cover more migrant workers.

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NEW RISK OF DEFLATION?

Like the vast majority of economies, Japan will go into recession in 2020. The expected rebound in 2021 is likely to be relatively mild. The latest economic indicators reveal an economic situation that is still highly deteriorated compared to normal times. Once again, massive fiscal stimulus has been set in motion. The Bank of Japan's monetary policy, notably through the Yield Curve Control, should largely reduce the risk of higher financing costs due to the expected rise in public debt.

The shock of the Covid-19 pandemic has hit Japan at a time when economic growth was already faltering. The combination of a VAT rate increase and a violent typhoon significantly weakened domestic demand in Q4 2019.

ANOTHER YEAR OF ECONOMIC HARDSHIP

After declining at a quarterly rate of 1.9% in Q4 2019, Japanese GDP contracted 0.6% q/q in Q1 2020. This decline can be attributed to another downturn in household consumption and a sharp drop-off in exports. Q2 2020 is bound to be much worse, with GDP plummeting by about 5% (q/q). The most recent information available to date suggests important difficulties. The Bank of Japan's Tankan indicator (see chart 1) dropped to all-time lows in both the manufacturing and non-manufacturing sectors. After bottoming out in April, the composite purchasing managers index (PMI) picked up again after the state of emergency for the country as a whole was lifted at the end of May. Even so, economic activity is still very weak. Composite PMI rose to only 38 in June 2020, after reaching 26 in April and 28 in May.

All in all, we estimate that the Japanese economy will contract by about 5% in 2020 before rebounding by a relatively mild 2.1% in 2021.

FISCAL STIMULUS AND MONETARY SUPPORT

To limit the negative economic impact of the current crisis, the government launched a massive fiscal stimulus. Estimated at about 20% of GDP, the overall package contains direct support for households and companies as well as transfers to local governments. According to the International Monetary Fund (IMF)¹, Japan's public debt, which was already the highest in the world prior to the pandemic, could reach an estimated 252% of GDP this year. Yet liquidity or solvency risks are still small because the vast majority of debt is held by local economic agents and benefits from an ample degree of monetary accommodation. One of the main policy tools will be to use the Yield Curve Control (YCC) to avoid an increase in financing costs for the Japanese government. The Bank of Japan corroborates this idea in its latest monetary policy statement². BoJ also doubled the ceiling on purchases of Exchange Traded Funds (ETF). The central bank's balance sheet continues to swell, after reaching the equivalent of 100% of Japan's GDP. These dynamics fit within an environment of deflationary risk, which has long plagued Japan's economic history.

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GROWTH AND INFLATION (%)

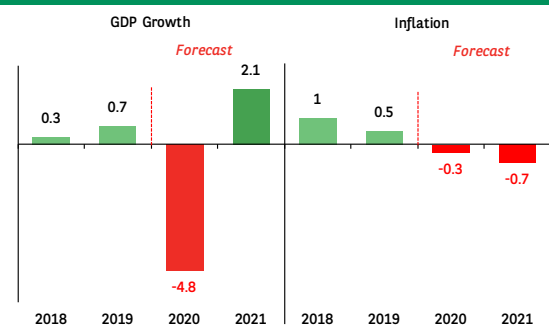


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

JAPAN: TANKAN INDICATOR

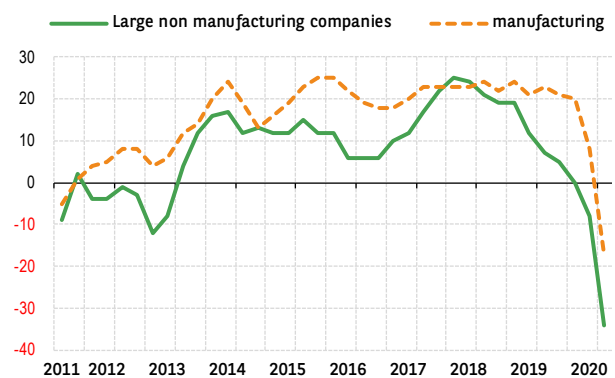


CHART 2

SOURCE: BANK OF JAPAN

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

² "The Bank will purchase a necessary amount of Japanese government bonds (JGBs) without setting an upper limit so that 10-year JGB yields will remain at around zero percent", Bank of Japan, June 2020



ERASING THE LOSS OF ACTIVITY WILL TAKE A LONG TIME

Although the Eurozone member countries seem to have the first wave of the Covid-19 pandemic well under control, they are now facing major economic hardships. The most recent leading economic indicators are showing signs of a turnaround but the road ahead will still be long. It will be hard to fully absorb the loss of activity reported at the height of the crisis. Public policies will play a crucial role. In the months ahead, the probability is very high that there will be a sharp increase in the jobless rate, especially for long-term unemployment, and a series of corporate bankruptcies. The European Central Bank (ECB) is providing member states with very favourable financing conditions. A response at the European level must come through, and the Recovery Fund needs to be set up rapidly.

It is still too early to know all the economic consequences of the current health crisis. Although there has been a massive loss of activity in the short term, the latest economic statistics available to date indicate that the worst could be over. In the months ahead, there is high risk of layoffs and corporate bankruptcies. If a second wave of the pandemic were to strike, the health crisis might well have a lasting impact on the Eurozone economy.

A LASTING LOSS OF ACTIVITY?

In Q1 2020, Eurozone GDP contracted sharply, down 3.6% quarter-on-quarter (q/q). This is bigger than the contraction observed in Q1 2009, in the midst of the great economic and financial crisis. In Q2 2020, GDP is expected to plunge even further since the European countries were in lockdown for a longer period during the quarter. Eurozone GDP is expected to contract by about 13.5% in Q2 2020. Domestic demand, especially household consumption, is expected to be extremely sluggish after contracting sharply in Q1. The automatic rebound expected in H2 2020 will not erase the loss of activity reported in the first half.

All in all, we expect Eurozone GDP to contract 9.2% in full-year 2020 before rebounding by 5.8% in 2021. Economic momentum remains highly uncertain in the months ahead. Looking beyond the hypothesis of a second wave of the pandemic, the economic rebound will be all the more robust and sustainable if economic agents regain confidence. Households fear more layoffs and hiring freezes, while companies are worrying about liquidity and/or solvency risks and sluggish demand. Health and economic risks could lead them to prolong their precautionary behaviour, and to postpone or even cancel investment projects. In any case, Eurozone GDP will not return to pre-crisis levels within our forecast horizon of year-end 2021. There is even the possibility that it could remain lower in the longer term, depending on the scenario (such as a second wave of the pandemic).

The impact of the Covid-19 crisis on the region's growth potential is also an open question. In the aftermath of crises, the developed countries tend to report slowing trends, notably after major and lasting shocks on demand. This could be the case today. The Eurozone's growth potential could be weakened by the loss of production capacity: we can imagine a sharp increase in corporate bankruptcies and long-term unemployment. Sluggish investment can also place a lasting strain on productivity gains. So far, the public policies implemented by Eurozone member states have limited these negative impacts of the crisis.

INDICATORS ARE PICKING UP, BUT ECONOMIC ACTIVITY IS STILL FLATERING

For the moment, the worst seems to be over. On the whole, the leading economic indicators available to date are showing a less negative

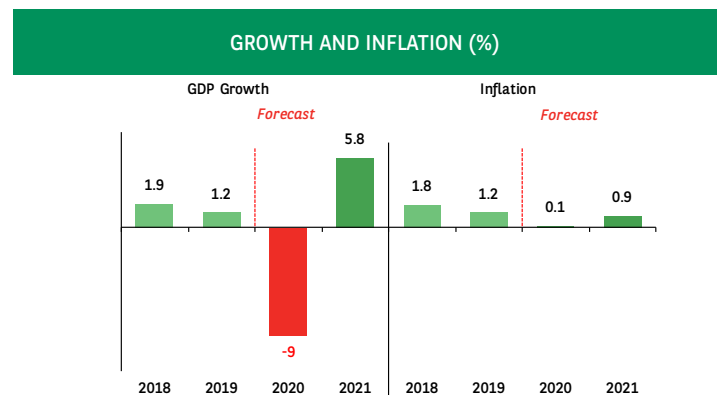


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

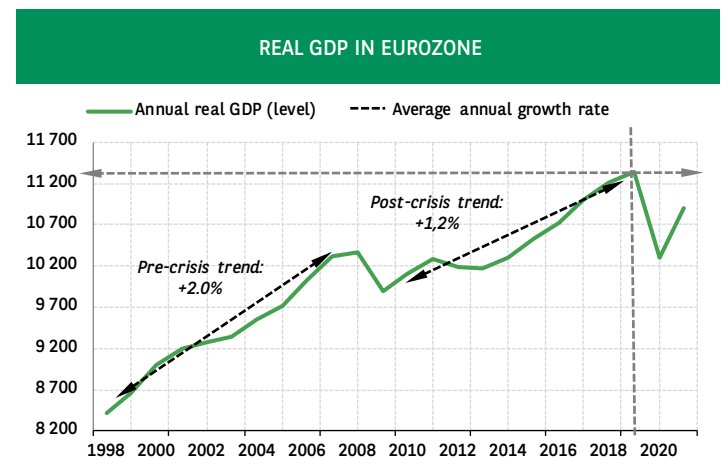


CHART 2

SOURCE: AMECO, BNP PARIBAS

signal. These indicators provide more up-to-date statistical information on economic trends. One of the most commonly used indicators is the Purchasing Managers Index (PMI). This survey of business leaders provides a reliable image of the economic health of various sectors of activity. The PMI for the services sector has picked up strongly, after dropping to 12 in April 2020, the lowest level since the creation of the Eurozone. In June it rebounded to 47.3, which is slightly below the 50 threshold that separates economic expansion from contraction. In other words, the level of activity is still very deteriorated. The rebound in PMI does not mean that the losses reported during the previous months of lockdown have been erased. Similar observations can be made



about business sentiment: the index has rebounded from April's low, but is still weak compared to past levels. Lastly, household confidence – which has also picked up from April's low – will play a key role. Although some households were hit by wage losses, measures were implemented to offset these losses (notably job retention schemes). A part of household consumption was restricted during the lockdown (for non-essential goods) and might remain that way in certain sectors (leisure services), households have involuntarily built up so-called “forced” savings, which might be spent during a recovery phase (which would be beneficial for both economic growth and public finances). A vigorous rebound in household consumption will depend on whether households regain confidence in the economic situation and in the government's fiscal policy response, which should strive to prevent any precautionary behaviour. With households lacking confidence and opportunities to spend, we should see a significant increase in the household savings rate. It is expected to hit 19% of gross disposable income in the Eurozone in 2020, which is much higher than the long-term average of about 13%.

ECB: MORE, FOR LONGER

“Our reaction function should nonetheless be clear: the ECB will respond to any significant tightening in financing conditions for as long as the negative effects of the COVID-shock persist”¹. Over the duration of this crisis, the European Central Bank (ECB) has adopted and will maintain a flexible approach. The Frankfurt-based central bank has increased the amount of securities purchases as part of its Pandemic Emergency Purchase Programme (PEPP), which now has a total envelope of EUR 1350 bn. The timeframe for purchases was also extended to the end of June 2021, and the maturing principal payments of securities purchased under PEPP be reinvested at least through the end of 2022. The ECB also further eased the conditions on targeted longer-term refinancing operations (TLTRO-III) for Eurozone banks. For banks exceeding the lending thresholds, new TLTRO-III rates will not be calculated on the average interest rate of the main refinancing operations but on the deposit facility rate. Based on the current deposit facility rate (-0.5%), for example, the interest rate on new TLTRO IIIs would be -1%.

M3 money supply growth has accelerated rapidly since the beginning of 2020. This is largely due to lending to public administrations, which was buoyed by the Eurosystem's intensification of sovereign bond purchases. Short-term liquidity needs might be the sole reason for the sharp acceleration in lending to non-financial companies². Despite monetary expansion, headline inflation has declined sharply (+0.1% in May, from 1.4% in January) under the impact of low energy prices, while core inflation is still mild. These inflation trends must be monitored closely.

A EUROPEAN RESPONSE: ANOTHER SMALL EFFORT

Europe now seems to be more proactive and countercyclical than in the past. The European Commission has proposed a Recovery Plan for Europe, with an envelope of EUR 750 bn. This marks a remarkable step forward that goes beyond the European budget, which does not take into account the health of the economy. To finance the Recovery Fund, the Commission will issue bonds on the financial markets on behalf of the European Union. The overall plan would comprise a large share of grants (EUR 500 bn), or about 3.5% of EU-27 GDP. These grants will be paid out in the first years of the next EU budget, between 2021 and

¹ The price of uncertainty and uncertainty about prices: monetary policy in the post-Covid-19 economy, Speech by Fabio Panetta, 1 July 2020
² Euro Area Bank Lending Survey, ECB, Q1 2020

EUROZONE: ECONOMIC INDICATORS

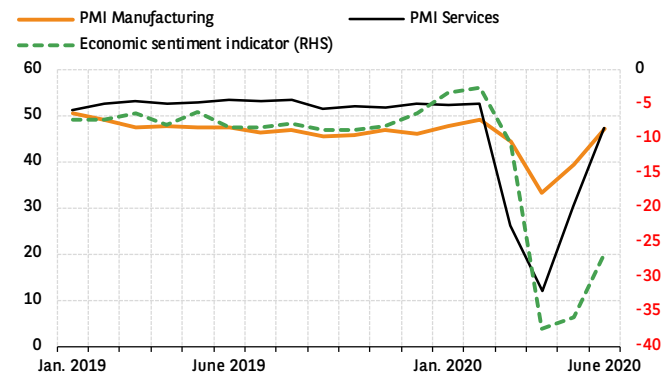


CHART 3

SOURCE: MARKIT, EUROPEAN COMMISSION

2024, and will not have to be paid back individually. The remaining EUR 250 bn will be distributed in the form of loans to member states. The proposed Recovery Fund, which must still be approved by all member states, will not transform Europe into a fiscal union. All the same, a rapid agreement between the 27 member states is not only expected but necessary.

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GERMANY

BUMPY RECOVERY DESPITE STRONG FISCAL STIMULUS

With the gradual easing of the lockdown restrictions, economic activity has shown signs of rebounding. The government stimulus plan might give further impetus to growth and also contribute to lower carbon emissions. The prospect of an EU stimulus is good news for Germany's export-oriented manufacturing sector. However, in the absence of a Covid vaccine or better treatments the recovery is likely to be bumpy. GDP is unlikely to return to its pre-Covid level before 2022.

EASING OF RESTRICTIONS LIFTS EXPECTATIONS

The economic climate has substantially deteriorated during the past three months because of the lockdown measures in order to stop the Covid-19 pandemic. However, there were some remarkable differences between sectors. In May, in the industry sector, manufacturing output was 23.7% lower from a year earlier. By contrast, construction was among the least affected activities, and production was even slightly above the level in May 2019. In the retail sector, clothing stores were particular hit, reporting a fall in turnover by 23.1% in May from last year after more than 70% in the preceding month. Nevertheless, the sector had also some clear winners. As bars and restaurants were closed, food stores reported an increase in sales of more than 10% in May, and online sales even rose by more than 30% from last year.

The trough is likely behind us. Following the decline in new Covid-19 cases, all German states have been gradually lifting lockdown restrictions since the end of April, although each at its own speed. The progressive opening of businesses has certainly contributed to the improvement in economic sentiment. Consumer confidence strengthened both in May and June and a further improvement is anticipated for July. Also the ifo climate index improved in June for the second consecutive month on the back of a rebound in expectations (chart 2). Nevertheless, in the manufacturing sector, the assessment of actual conditions continued to decline.

PREPARING FOR THE AFTER-COVID WORLD

As the country went into lockdown in March, the federal government launched a substantial emergency package worth EUR 750 bn largely aimed at protecting jobs and income. A key element was the short-time working scheme (*Kurzarbeit*), under which the Federal Employment Agency (FEA) pays 60-67% of the forgone wages of workers whose hours are being cut. The scheme was very successful in protecting jobs during the great recession in 2008-09. The emergency package also provided liquidity assistance and loan guarantees for businesses. *

On top of that, the government unveiled a stimulus programme, worth EUR130 bn, in early June. The Bundesbank estimate that the programme can boost growth by 1 percentage point in 2020 and 0.5 pp in 2021. In the first place, the programme intends to boost household spending. A key measure is a temporary VAT cut from 19% to 16% for the standard rate, and from 7% to 5% for the reduced rate between 1 July and 31 December. Other measures to bolster spending power are a EUR 300 one-off payment for every child and a reduction in electricity costs by a reduction in the renewable energy levy.

The package also includes substantial transfers to businesses through a EUR 25 bn loan support programme for small firms that have seen their sales drop by more than 60% for June to August. In particular firms in the hospitality sector are likely to benefit from this programme. Furthermore, the maximum amount for tax loss carry backs shall be increased temporarily for losses in 2020 and 2021 from EUR 1 mn to EUR 5 mn.

GROWTH AND INFLATION (%)

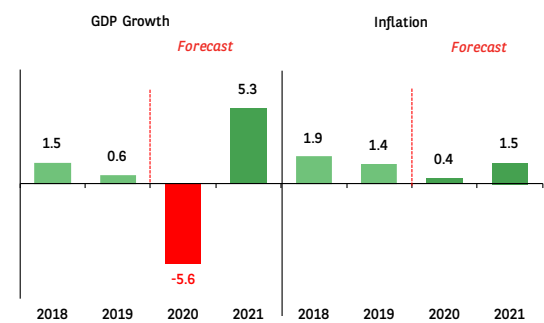


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

ENTREPRISES NOTE AN IMPROVEMENT IN CURRENT CONDITIONS

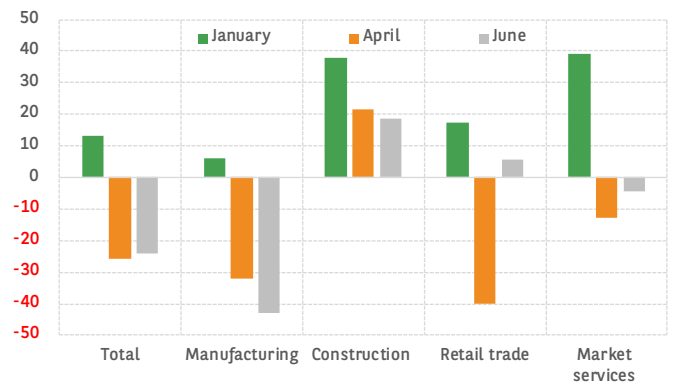


CHART 2

SOURCE: IFO SURVEY - ACTUAL CONDITIONS

At the same time, the government wants to use the package as an environmental policy instrument. EUR 50 bn is set aside to fund research into promising technologies such as hydrogen. Moreover, it wants to stimulate the use of electric vehicles (EV) by increasing the number of EV charging station. In addition, buyers of full-electric cars with a net list price of up to EUR 40,000 will be eligible for a grant of 9,000 euros, including 6,000 euros from the government and 3,000 euros from car manufacturers. However, the government refused to extend this bonus to petrol and diesel cars.



However, the government is well aware that Germany's export-oriented manufacturing industry cannot recover as long as the recovery in the neighbouring countries lags behind. Hence, the Chancellor's strong support for the European Commission's proposal to put in place a EUR 750 billion stimulus package. In that respect, it is a good thing that Germany has taken over the rolling presidency of the European Council for the second half of 2020.

RECOVERY TO REMAIN BUMPY

Even though the economy is showing clear signs of rebounding, the recovery is likely to remain slow and bumpy at times, at least until there is a Covid vaccine or better treatments. In their absence, substantial restrictions will remain in place, which will continue to weigh directly on productivity growth. As the fear for the virus is likely to stifle spending on capital and research & development, the potential growth is likely to be negatively impacted.

On the demand side of the economy, the current boom in retail spending is likely to fizzle out quickly when consumers remain wary about the virus. Moreover, the deterioration of the employment outlook is likely to lead to an increase in precautionary savings. Hence the saving ratio might remain at a relatively high level.

Labour market conditions have considerably deteriorated. In May, employment was 1% lower than a year earlier and the unemployment rate had risen to 4.4% compared with 3% in May 2019. Moreover, the number of hours worked has dramatically fallen due to the massive use of short-term work schemes. Applications for more than one-third of all employees had been submitted by the end of May (see chart 3). A part of these might eventually become fully unemployed. Unemployment is expected only to peak next year.

Compensation per employee is likely to decline in 2020 because of the large fall in hours worked. However, this is largely compensated for by an increase in short-time work benefits. It could rise again in 2021, as short-time work is diminishing. Nevertheless, wage growth is likely to remain subdued as the growing number of unemployed will limit the trade-unions negotiation power.

Profit margins are likely to be squeezed in 2020, as sluggish demand conditions make it hard for companies to recuperate the Covid-19 related costs in sales prices. Inflation is set to drop sharply in 2020, due to the decline in energy prices and the VAT cut. Inflation should rise again in 2021, as energy prices and the VAT rate return to their previous levels.

After a surplus amounting to 1.4% of GDP in 2019, the government will run a large deficit, around 6% of GDP, in 2020, due to the emergency spending and stimulus plan. In addition, tax receipts will disappoint and social security spending rise. However, as the economy slowly recovers, the deficit is projected to be limited to 3% of GDP in 2021. The debt GDP ratio, which had gradually declined in previous years to 60%, could reach 80% by end 2021.

The risks to our scenario are balanced. Upside risks include the possibility of a discovery of an effective treatment and/or a vaccine, which could give a boost to final demand. On the downside, a second wave of contagion might plunge the economy in recession again. However, a new generalised lockdown is unlikely. In addition, geopolitical tensions could intensify, in particular in the run-up to the US presidential election and the finalising of Brexit. This could be very damaging for Germany's large manufacturing sector.

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MORE THAN 7 MILLION IN SHORT-TIME WORK SCHEMES IN MAY

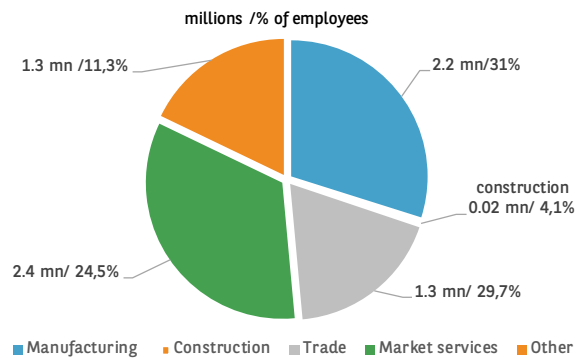


CHART 3

SOURCE: IFO



FRANCE

BETWEEN A V-SHAPE OR U-SHAPE, THE RECOVERY

After a massive recessionary shock, the French economy has been showing signs of recovering rather rapidly since May, raising hopes for a V-shaped recovery. Markit's composite PMI index and household spending on goods both rebounded spectacularly, which is encouraging. But these gains were largely automatic and will lessen as the catching-up effect wears off. To return to pre-crisis levels, it will probably take longer to close the remaining gap than it took to regain lost ground so far. There are several explanations: sector heterogeneity, ongoing health risks and the scars of the crisis. We foresee a U-shaped recovery (-11.1% in 2020, +5.9% in 2021). The risks seem to be well balanced, thanks notably to support measures that have already been taken or are in the pipeline.

THE SIZE OF THE SHOCK TO GDP

According to the INSEE's preliminary estimate, French GDP contracted 5.8% q/q in Q1 2020. This contraction provides a first glimpse of the size of the recessionary shock triggered by the Covid-19 pandemic and the lockdown measures taken to halt its spread. The second estimate was revised to -5.3% q/q, still the sharpest decline since 1949, matching the all-time record of -5.3% q/q in Q2 1968. Looking at the GDP breakdown, the only component that made a positive contribution was the change in inventory. Household consumption, public consumption, investment, exports and imports all plummeted.

Yet the Q1 contraction provides only a foretaste of what is expected to come in Q2. The first quarter was impacted by 15 days of the lockdown, whereas the second quarter will accumulate the negative carry-over, a full month of the lockdown in April plus another ten days in May. Moreover, the lockdown has been lifted very gradually. In its 27-May economic note, the INSEE warned of a 20% q/q decline, before revising its forecast to -17% q/q in its 17 June update. In early June, the Bank of France was forecasting a contraction of about 15% q/q (which is our central scenario), before revising it slightly to 14% in early July.

The size of the contraction, which was comparable to the ones that hit Spain and Italy, but was harder than the one in Germany, can be attributed to the stringency and duration of the lockdown, the sector structure of the French economy (heavy weight of market-related services), and the quasi-halting of key sectors at the beginning of the lockdown, whereas they continued to operate, albeit at a slower pace, in other countries (construction and public works, for example).

FIRST SIGNS OF A V-SHAPED RECOVERY

The sharp drop in Q2 GDP masks widely differing monthly trends. Most of the decline occurred during the trough month of April, while May marked the beginning of a turnaround. According to some indicators, the rebound was as spectacular as the preceding plunge, raising hopes for a V-shaped recovery, i.e. a rapid return to pre-crisis levels.

This was the case for the results of Markit's business climate survey. In June, the composite PMI index rebounded by 19 points (preliminary figure) after a 21-point gain in May. This brought the composite index to 51.3, slightly above the 50 threshold that marks the beginning of expansion territory. The rebound could be seen in both manufacturing (52.1) and services (50.3). As a result, the composite index has basically returned to pre-crisis levels (52 in late 2019-early 2020) after recovering virtually all of the 41 points lost in March-April. For once, France's performance was stronger than in Germany and in the Eurozone as a whole.

GROWTH AND INFLATION (%)

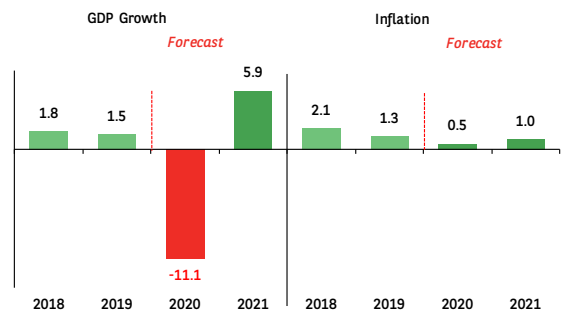


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

CONFIDENCE SURVEY

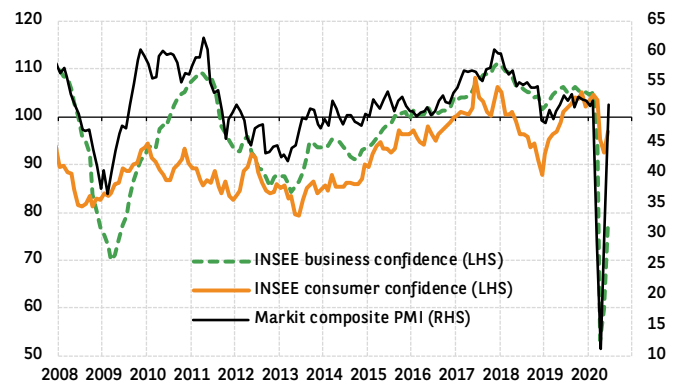


CHART 2

SOURCE: INSEE, MARKIT, BNP PARIBAS

Several other economic indicators also showed spectacular rebounds. In May, household consumption of goods rose 37% m/m, hiring reports for jobs lasting more than a month excluding temporary employment was up 76% m/m¹, and business start-ups increased 60% m/m. In June, new car registrations rose 79% m/m (after leaping 384% m/m in May), bringing them back to February levels. According to the first edition of the Boston Consulting Group's Recovery Barometer, France recovered relatively faster between mid-April and mid-June than Germany, Italy and the UK, judging by both business activity and consumer activity².

¹ The decline in the number of category A jobseekers is less impressive (-3.3% m/m) but we welcome the news that it began to decline as early as May.
² BCG, Economic Recovery Barometer, 1st edition, 26 June 2020



Yet between mid-February and mid-April, growth contracted even more sharply, which means the net result is still unfavourable: France was the country that regained the least lost ground. Along the same lines, household consumption of goods is still 9% below the year-end 2019 level, while hiring and new business start-ups are 50% and 25% below pre-crisis levels. Although these indicators seem to suggest that a V-shaped recovery is well underway, others tell a different story, such as the milder rebound in goods exports and industrial production (17% and 20% m/m in May, respectively). These figures serve as a reminder that there is still a long road ahead. May's rebound provides no guarantees of what will follow, and the V-shaped recovery is neither complete nor a given. The same question can be seen from a different angle: according to the most recent INSEE estimate, economic activity in June was 12% below the "normal" level. This is a significant improvement compared to April and May, when the economic loss was estimated at 30% and 22%, respectively. But will it continue at this pace in the months ahead? Will the remaining 12% gap close just as quickly? We cannot be sure, it is still a high step.

REASONS FOR A U-SHAPED RECOVERY

The less optimistic signals from the INSEE surveys also dampen hopes for a V-shaped recovery. In May, the composite business climate index gained only 7 points. Although the June figure rebounded strongly, up 18 points, the overall score of 78 was simply not as low as before. It was still far below the benchmark average of 100 (which is consistent with the trend growth rate of the French economy) and had barely made up half of the 52 points lost in March and April. Another mixed signal to keep in mind is the gap between the more optimistic view that companies have on their activity prospects and the lack of improvement in the balance of opinions relating to past trends. As to household confidence, the situation would seem to be better. In June, the composite index stood at 97, much closer to the 100 benchmark than the business climate. But this was not due to a stronger rebound (only 4 points) but to the fact that household confidence did not plunge as much during the lockdown (11 points). And while households are showing much more optimism about the opportunity to purchase big-ticket items, they are still a bit more pessimistic when it comes to unemployment future trends.

There is still great uncertainty over the shape of the recovery. Granted, growth rates are expected to be very high in Q3 (possibly even in the double digits), and to a lesser extent in Q4, but this rebound is largely automatic. It will taper off as the catching-up effects wind down, as the Bank of France points out in its July economic note. This is why growth is expected to decrescendo in a kind of tango-step recovery: quick, quick, slow...

Under our scenario, it will take time to return to pre-crisis levels, which is not expected to occur before 2022. This gradual pace is the reasoning behind a U-shaped recovery, although it might be more accurate to compare it to a square root sign or bird wing. The first explanation is sector heterogeneity: not all sectors are on the same page when it comes to the speed of the recovery and the return to normal. This is clearly outlined in the third edition of the Labour Activity and Employment Conditions Survey (Acemo-Covid) by Dares, which also states that business leaders are increasingly alarmed by the lack of demand prospects³.

JOB SUPPORT MEASURES

As part of the emergency relief plan, the job retention scheme was largely strengthened to encourage companies to keep their workforce. Several parameters illustrate the generosity of the short-time working scheme during the lockdown: 1/ the state and the Unedic fully covered the compensation paid by companies (up to 70% of gross wages, but without dropping below the minimum wage); 2/ wages were covered up to 4.5 times the minimum wage; 3/ coverage was expanded to include payroll workers, employees working at home and sales representatives. The generosity of the scheme is now being phased out gradually. Since 1 June, with the exception of companies shutdown for health-related reasons, companies are fully covered for 60% of gross wages. As of 1 October, this coverage drops to 60% of what the company pays out, and employees will receive 60% of their gross salary (72% of net), compared to 70% and 84%, respectively, currently (minimum wage earners are still covered 100%), for a three-month period that can be renewed once.

Since 1 July, this basic scheme has been coupled with a long-term job retention scheme (APLD). This scheme offers more incentives (coverage is the same as that in effect on 1 June), and is geared towards sectors hit by a lasting decline in activity. It must be submitted to company or sector approval for a six month period minimum or two years maximum, and validated by the *Dirrecte* (regional directorates for enterprise, competition, consumer affairs, labour and employment).

The recovery plan, which is underway, will give special attention to youth employment. In early June, an internship support package was announced. Its key measure is a big increase in hiring subsidies so that the first year of training does not cost the company anything, or at least not much. Other measures are being negotiated that aim to boost youth employment more broadly. Two options are on the table: a hiring bonus or a cut in employee contributions. Consultations are also on the agenda on vocational training and the unemployment insurance regime reform.

SOURCE: FRENCH GOVERNMENT, THE PRESS, BNP PARIBAS

Another explanation is that the Covid-19 pandemic is not over yet, neither its impact on growth, its surcharges nor the wait-and-see and precautionary behaviour it engenders. Lastly, the crisis risks leaving deep scars (defaults, unemployment, debt, precautionary savings, loss of productivity), despite the emergency measures deployed to buffer the recessionary shock: these scars will also strain the return to normal. The recovery needs support. While awaiting the global stimulus package, major sector support measures have already been announced and plans to support employment will all be revealed soon (see box).

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³ dares_acemo_covid_synthese_juin_2020.pdf



THE EPIDEMIC SPREADS TO THE ECONOMY

The outbreak of Covid-19 took hold in Italy earlier than in other EU countries, with strong negative effects on the economy. In Q1 2020, real GDP fell by 5.3%. The contraction affected all economic sectors: manufacturing, services and construction. Domestic demand had a negative contribution (-5.5%). Italian households become extremely cautious, reducing expenditures more than income: the propensity to save rose to 12.5%. The pandemic has dramatically hit the labor market: disadvantaged categories, such as low skills workers, those with precarious contracts and young people, are the most severely affected by the lockdown.

A WIDESPREAD CONTRACTION

The outbreak of Covid-19 took hold in Italy earlier than in other European countries. The Italian Government has rapidly acted, focusing on the necessary support to households and firms and approving a complex package, which increased the 2020 public deficit by EUR 75 bn. The measures taken to contain the spreading of the virus, together with the worsening of the global environment, had a huge impact on the economy, which at the beginning of 2020 had not yet recovered from the two previous recessions. In Q1, real GDP fell by 5.3% in real terms, falling 10% below the 2008 level.

The economic contraction was broadbased. Because of the quarantining of the entire population, services value added declined by almost 4.5%. The tourist sector, which accounts for more than 5% of total value added, also suffered from the significant decline of foreign travellers' expenditure, which fell by about 40% q/q in real terms, explaining 1% of the overall GDP contraction. Turnover of hotels and restaurants collapsed by almost 25% y/y.

The shutdown of productive sectors accounting for nearly 30% of national value added, together with the significant slowdown of global trade, had a severe effect on Italian industry, which had already declined by more than 1.5% in the previous one year and a half. In Q1 2020, manufacturing value added dropped by more than 9%. Production of means of transport and that of textiles products, clothes and shoes declined by almost 20%, while the pharmaceutical sector was the only to record a moderate increase of activity in comparison with the last three months of 2019.

In Q1 construction sector value added declined by almost 6%. From 2015 to 2019 this sector experienced only a moderate recovery, after the deep contraction recorded during the previous two recessions. As a consequence, at present, the value added is 40% below the 2008 level.

Available indicators point to an even bigger decline in Q2, although the decrease in the contagion made it possible to start easing the lockdown measures at the beginning of May. In April, manufacturing production declined by more than 20% m/m. As of mid-May, gas consumption for industrial use was down by almost 15% and electricity consumption by 6% compared with last year. In June, consumer and business confidence have only partly recovered the impressive decline recorded in May, remaining at a low level by historical standards. Additional measures are under discussion to support the recovery, which is expected to be moderate in the second half of the year.

FALLING CONSUMPTION AND INVESTMENT

In Q1, domestic demand excluding stocks subtracted 5.5% from GDP. Private consumption declined by 6.6%. Italian households have become extremely cautious. In Q1, gross disposable income fell by almost EUR 5 bn, less than expected given that the shutdown of economic

GROWTH AND INFLATION (%)

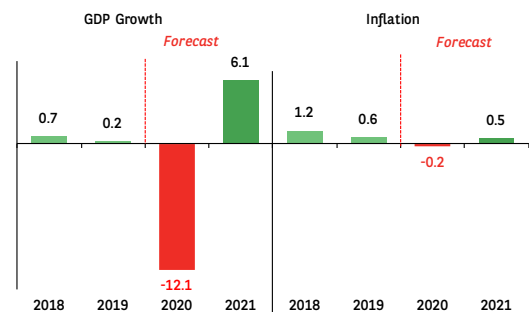


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

VALUE ADDED BY SECTOR

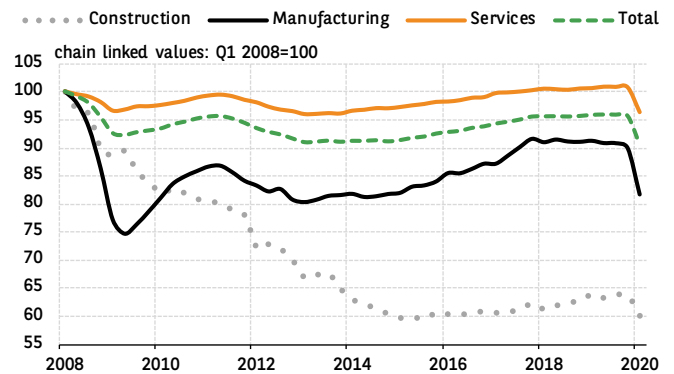


CHART 2

SOURCE: ISTAT DATA, BNP PARIBAS CALCULATIONSS

sectors involved around 35% of employment, while consumption was cut by more than EUR 17 bn. Italian households took some benefit from the measures approved by the Government to support incomes (extension of unemployment benefits, allowances to more impacted workers, deferral of the deadline of taxes and social contributions, among others). In Q1, the propensity to save of Italian households rose from 7.9% to 12.5%, the highest value in the last fifteen years.

The negative contribution of domestic demand was also the result of the decline of investment (-8.1%), with expenditure in machinery and equipment falling by 12.4% and that in means of transport by 21.5%.



From January to March, Italian firms reduced their investment by about EUR 4 bn, despite public guarantees having been made available up to EUR 500 bn to facilitate access to bank credit. Business value added declined by almost EUR 15 bn, also suffering the contraction of exports, which was more important than that of imports (-8% versus -6.2%), with a 0.8% negative contribution of net exports to the GDP decline.

THE EMPLOYMENT IMPACT OF COVID-19

The pandemic has hit particularly hard the labour market. According to ILO estimates, in Q2 2020, the number of hours of labour lost worldwide due to the lockdown or the reduction in the economic activities is equivalent to 365 millions of full time jobs. The peculiarity of the current crisis compared to the previous ones lies not so much in its absolute impact, as in the fact that it mostly affects many already disadvantaged categories, such as low skills workers, those with precarious contracts and young people. This will have important medium-long term effects worldwide, and is expected to severely decrease households' future incomes, with important consequences also on inequality and social cohesion.

A recent analysis conducted among EU countries studied the effects on employment of the anti-contagion measures which in the vast majority, implies the lockdown of the activities deemed non-essential and several strict limitations on the others. The activities that could be carried out by telework have been allowed to continue operating.

In Italy, in the most acute phase of the contagion, people employed in the sectors locked down and without the possibility of using telework were 11.5% of total (against 10% on average in the EU, 14.5% in Spain, 9.5% in France and 8.3% in Germany). Young workers have been particularly affected by the measure: in the EU on average over a quarter of people employed in the closed sectors (28%) are aged between 15 and 29 years; on the contrary, the presence of under 29 years old is lower both in the essential sectors (around 16%) and in those that activated teleworking (around 15%). In Italy, where the percentage of young people employed is lower than the EU average (12% versus 18.2%), in these latter activities only 6 out of 100 employees have less than 29 years, while in the essential ones the level reaches 10%. On the other hand, in the activities involved in the lockdown, the under-29s accounted for 23.4% of the total employment. These figures are of the utmost importance, since the sectors closed during the lockdown will not be able to return to the pre-crisis levels of activity until a significant easing of the measures of social distancing and a substantial recovery of tourism will be assured, which in the absence of a vaccine, may take a while. In the meantime, the condition of the young people in the labour market will be rather difficult, especially in countries where, on the eve of the epidemic, youth employment levels had not yet returned to those preceding the 2008-2009 recession (Italy, Greece and Spain).

The sectors closed during the lockdown mainly employ the weaker categories of workers, such as the self-employed and those with fixed-term contracts. In the EU, on average, the self-employed workers account for 22% of the total in the sectors involved in the lockdown, and just 11% in those that continued operating in teleworking. In Italy the percentage reaches 31.3%, one of the highest in the area. The same applies to fixed-term contracts, that in Italy concern 33% of the employed in the sectors deemed as not essential during the most acute phase of the epidemic. These sectors also employ 30% of low skill workers (who attained at the most a primary school diploma). On the other hand, for the sectors where it was possible to continue the activity remotely, the employees with at most primary education were below 8%, and 47% had a tertiary degree.

PERCENTAGE OF SELF-EMPLOYED DURING THE LOCKDOWN

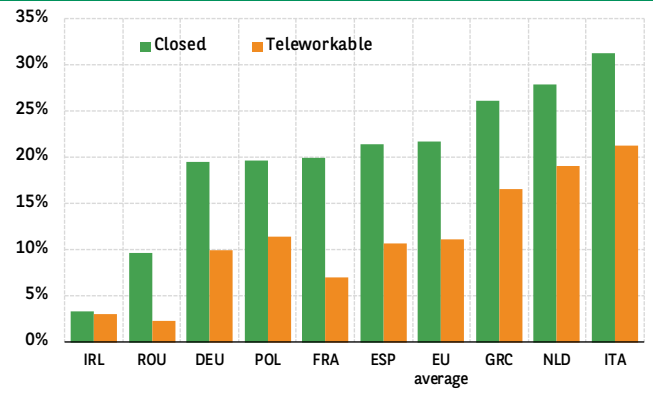


CHART 3 SOURCE: BNL CALCULATIONS BASED ON EU COMMISSION DATA

Although in a context of extreme difficulty, after the emergency phase, income support measures should be accompanied by policies aimed at supporting these workers and by investment in training and in education. The role of teleworking should also be revalued: it has given a competitive advantage to countries that, during the peak of the epidemic, have been able to convert "in-person activities" to telework faster and more efficiently than the others. Before the outbreak of the epidemic only 10% of workers in the EU could operate remotely on a regular or temporary base, with values below the average in Italy (4.3%) and higher in the Netherlands (around 25%), Finland (21%), France and Belgium (around 15%).

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RECOVERY MEASURES MEET FISCAL REALITY

The unprecedented economic contraction in H1 2020 raises serious doubts about the upcoming recovery. Although the reopening phase has proceeded smoothly so far, the recovery in employment was very small in June. Tourism remains under the threat of a resurgence of the Covid-19 epidemics in Europe. The swelling public deficit will force Prime Minister Pedro Sanchez to design a tight recovery package that balances between short-term emergency measures and long-term investments. This difficult equilibrium is likely to heighten the tensions in the governing coalition between Podemos and the socialist party. Subsidies allocated as part of the European Recovery Plan would give Spain some fiscal leeway, but the final terms and amount of the funds are yet to be finalised.

The Covid-19 crisis has erased the economic momentum that Spain has enjoyed in recent years. The 5.2% q/q contraction in Q1 GDP will be followed by an even sharper decline in Q2, probably above 10%. The successful reopening process and the mechanical rebound in activity observed since late May must be kept in perspective. Spain enters the summer season with a job market that has sharply deteriorated since February. The number of workers affiliated to the social security system increased slightly in June (+0.16%), but the contraction in Q2 was a record 4.9% (-947,514, see chart 2)¹. The number of jobseekers rose above 4 million in June².

On 17 March, the Spanish government implemented an emergency plan worth EUR 117 bn in public funds (EUR 200 bn including the private sector's contribution). The programme included EUR 100 bn in state-backed corporate loans and EUR 17 bn in direct aid, mainly for healthcare spending, job retention schemes and deferred tax and social security charges for companies and individuals.

Pedro Sanchez, Spanish Prime minister, subsequently announced a recovery plan for the tourism and automobile sectors, two sectors hardly hit by the crisis. The automobile sector will receive EUR 3.75 bn in support, including a relatively small portion of subsidies (EUR 1.1 bn). The tourism industry will receive EUR 4.26 bn in aid, including a large amount of state-backed loans (EUR 2.5 bn), EUR 850 million for companies to facilitate digitalisation, and EUR 300 million in subsidies³. A solidarity fund for autonomous community worth EUR 16 bn will also be deployed to help local communities meet their financial obligations.

The government must carefully calibrate corporate subsidies – especially the temporary unemployment scheme (ERTE) – to prevent a wave of layoffs while encouraging a maximum of companies to restart their activities as soon as feasible. The ERTE scheme was extended until 30 September, and will probably be prolonged again next fall (under different conditions that are less advantageous for employers). According to the Ministry of Labour, 1.83 million employees, or nearly 1 in 10 workers, were still under ERTE at the end of June.

DIFFICULTIES PALPABLE BEFORE THE COVID-19 CRISIS

The Covid-19 health crisis occurred in the midst of an already tense economic environment, with companies in many sectors facing deep structural mutations and a loss of competitiveness (automobiles, aeronautics, telecommunications). The Covid-19 pandemic has exacerbated these difficulties, but it is not the main cause, which is mainly structural. Nissan announced the closing of its Barcelona plant with more than 2500 job losses, and Airbus is now planning to reduce its personnel by 900 workers in the civil aviation division. A handful of major corporations have already announced a total of more than 5,000 layoffs in Spain⁴. The weight of the industrial sector has constantly

¹ Spanish employment agency (SEPE). Seasonally-adjusted data.

² 4,014,011 in June (SEPE, seasonally-adjusted data)

³ These subsidies will cover the creation of a tourism observatory as well as marketing and promotional activities

⁴ El Economista "La industria anuncia 5.140 despidos en España en el año del covid-19", 2 July 2020

⁵ The peak was 20.5% in Q1 2000 (Eurostat data)

GROWTH AND INFLATION (%)

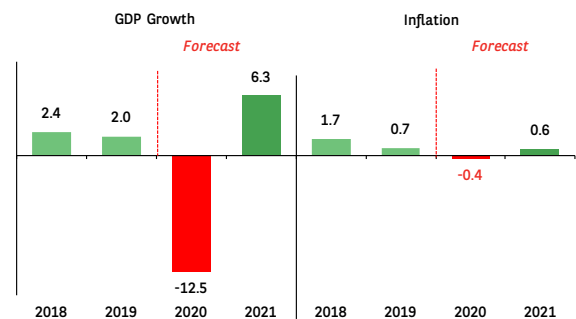


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

EMPLOYMENT

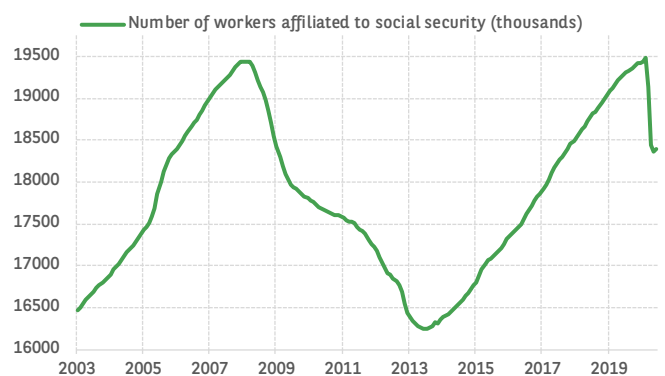


CHART 2

SOURCE: SPANISH EMPLOYMENT AGENCY (SEPE)

fallen over the past twenty years. Its share of total value added slipped to an all-time low of 15.5% in Q4 2019 (see chart 3). In the early 2000s, this share was above 20%⁵.

The rebound in tourism activity is also very uncertain. The reinstatement of lockdown measures in Leida (Catalonia) and A Mariña (Galicia) highlights the clouds looming over the economic recovery.



Arancha Gonzalez Laya, the Minister of Foreign Affairs, warned that new restrictive measures could be imposed locally again if the weekly contamination rate were to rise above the threshold of 50 cases per 100,000 inhabitants.

ECONOMIC STIMULUS AND FISCAL CONSTRAINTS

The months ahead will be crucial for Spain. The government must elaborate an ambitious recovery plan, while dealing with a tight budget. New growth opportunities are arising in Spain, notably in the renewable energy sector⁶. Brussels is likely to scrutinise Spain's recovery plan, the latter having to follow closely the targets defined in the European Green Deal. As it stands, Spain, along with Italy, is the biggest beneficiary of the European Recovery Fund announced by the European Commission at the end of May. Spain will receive EUR 77.3 bn, the equivalent of 6.2% of GDP. The terms and size of the European Recovery Fund will be discussed at the next European Summit on 17 July.

The government seems willing to align Spain with Brussel's targets. At the end of May, it unveiled the National Energy and Climate Plan which sets an objective of carbon neutrality by 2050. Parliament still needs to approve the plan, which will ban all new fossil fuel projects and will aim to achieve 100% electrical power generation from renewable energy sources by 2050. Building on this plan, seven of the remaining fifteen coal-fired power plants were shut down on 30 June. Coal accounted for nearly 15% of Spain's CO2 emissions in 2018, but had already fallen to 1.4% last May. Spain is one of the European countries that has made the most progress towards a cleaner energy mix.

The health crisis has heightened tensions within the governing coalition. The radical left wing led by Podemos is pressuring the Socialist Party of Pedro Sanchez to introduce strong social measures to support the most vulnerable populations. The so-called vital minimum wage – introduced in June – is an emergency measure pushed through by Pablo Iglesias, head of Podemos and the Minister of Social Rights. For the moment, the Socialist Party is ruling out the idea of a new tax on high-income earners, as proposed by Podemos. The Prime Minister admits, however, that a major fiscal reform will be necessary, given the fiscal situation⁷.

Meanwhile, the government has yet to reach a trans-party consensus on the outline of the recovery plan. It faces fierce opposition from the conservative party, the Partido Popular.

In the Stability Plan submitted to the European Commission, the government is now forecasting an increase in the public deficit from 2.8% of GDP in 2019 to 10.3% in 2020. Central government debt has risen sharply since the beginning of the crisis (see chart 4). According to the same government outlook, public debt to GDP ratio will hit 115.5% this year. Under these conditions, the European Recovery Fund would offer some policy leeway for the Spanish administration to reconcile social emergency needs with investments in the future.

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INDUSTRY (EXCLUDING CONSTRUCTION)

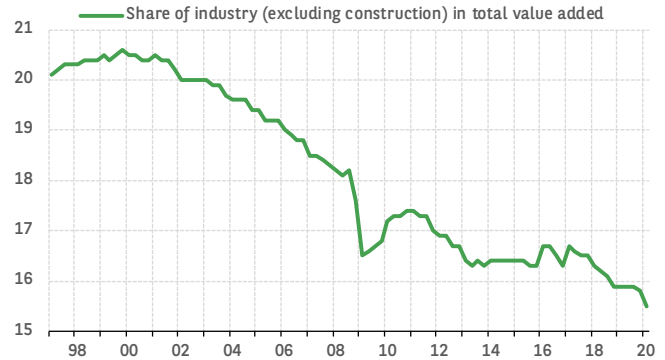


CHART 3

SOURCE: EUROSTAT, BNP PARIBAS

CENTRAL GOVERNMENT NET FUNDING REQUIREMENT

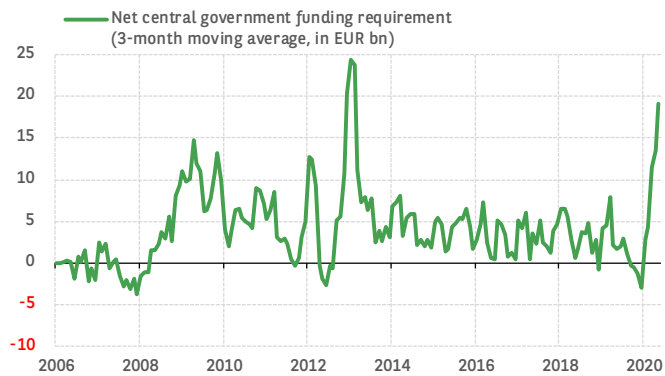


CHART 4

SOURCE: SPAIN MINISTRY OF FINANCE, BNP PARIBAS

⁶ See BNP Paribas Ecoflash "Spain: hopes of a green recovery", 9 June 2020

⁷ El Economista, "Sánchez anuncia que subirá impuestos, mantendrá las pensiones y el sueldo de los funcionarios", 2 July 2020



BELGIUM

18

DOWN WITH EVERYONE ELSE, BUT SLOWER TO PICK-UP AGAIN

We expect GDP to shrink 11.1% this year and grow by 5.9% next year. The unemployment rate could reach 9%, its highest level in 22 years. Different branches of the government have announced measures to counter the impact of the covid-virus but federal government formation talks are still ongoing, which complicates matters. As public debt is expected to come in at 123% of GDP by the end of the year, the room of maneuver is limited, but the need to support the economy will take priority, at least for now.

TOWARDS A DROP BY 11,1% IN 2020

Real GDP looks set to drop by 11.1% in 2020. Private consumption is expected to take a big hit in Q2 after it already declined 6.5% Q-o-Q in the first quarter. We expect it will only surpass the level of the last quarter of 2019 by early 2021. Gross fixed capital formation declined somewhat less in the first months of this year but we believe a bigger drop is forthcoming as short- and long-term uncertainties weigh on firms' appetite and ability to finance planned extensions. It will take several years before investments return to the level of the 4th quarter of last year.

We thus believe 2021 will only bring some restoration of activity with a year-on-year growth rate of 5.9% whilst staying below the level reached at the end of 2019. Some fiscal measures have been implemented at various government levels but already high public debt and the lack of a strong governing coalition may weigh on the policy flexibility and reactivity.

AGGREGATE TURNOVER ACROSS ALL MARKET-SECTORS

The final GDP numbers for the first three months of the years showed a Q-o-Q decline of 3.6%. As the Belgian government announced its semi-lockdown in subsequent steps on the 13th and the 17th of March, this number reflects the impact of roughly two weeks of the most stringent measures taken in the country.

Based on regular surveys by various sector federations and the NBB (National Bank of Belgium) it became clear that economic activity slowed down significantly in subsequent weeks. For the month of April, aggregate turnover across all market-sectors came in 33% below what would be expected in a world without covid.

Initially, especially construction and real estate activities struggled to continue operating under the stringent social distancing rules. Bars, restaurants and various types of event-organisers saw their turnover almost evaporate as their activities remained forbidden for most of the duration of the lockdown.

The stepwise loosening of lockdown-measures allowed most sectors to restart/resume their activities in the meantime, with aggregate turnover somewhat improving but still 20% lower than expected at the beginning of the year. Surveys identify a lack of demand as main reason for the lower revenues, although consumer confidence improved in both May and June.

What will happen in the longer term is highly uncertain, as bankruptcy risk is creeping up. The situation is most precarious in the aforementioned sectors of events, recreation, accommodation

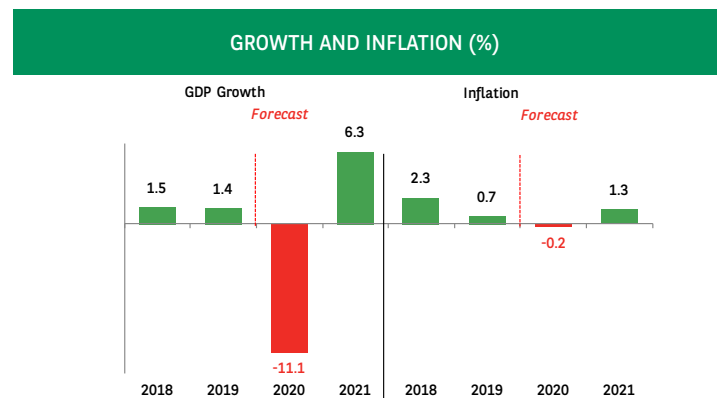


CHART 1

SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

and food services, but also road transport and transport equipment manufacturing look unstable. A rise of bankruptcies in autumn seems rather likely.

TEMPORARY UNEMPLOYMENT AND TELEWORK

In April, the national employment service (NES) registered 1.2 million requests for temporary unemployment: roughly 30% of all employees at least applied for this regimen. One of the key government measures had been to loosen the criteria for temporary unemployment and increase the proportion of the pay-out. Extending the duration of this arrangement to the end of 2020 for some sectors is under consideration.

The latest data out of the NES suggest 25% of all employees remained technically unemployed, a small improvement. More worrisome is that, according to a regular survey by the NBB, some 20% of those currently in temporary unemployment will lose their job as soon as they are no longer eligible for this scheme. We see the unemployment rate climbing to 9% at the end of this year, up from 5.3% in March.

Telework peaked early in April with, across sectors, almost 40% of all employees working full time from home and only a quarter of people full time present at their workplace. Early June, this situation had normalised to a large degree: the majority of employees were working full-time at their workplace, with only 15% still teleworking full-time. Over the same period, there has been a strong pick-up in configurations that mix telework & workplace presents, which is now the reality for about 15% of all employees.



PUBLIC FINANCE WILL DETERIORATE

The public finance outlook will deteriorate significantly. For 2020, central government revenues are expected to decline by about EUR 27 bn, as a consequence of the drop in GDP and hence the taxable base. Primary expenditures will most likely remain at last year's level in nominal terms. On top of that, additional spending to soften the blow of the coronavirus to the tune of EUR 10 bn has been announced.

The composition of the public debt, with an average maturity of 10 years, is somewhat favourable: the Belgian Debt Agency remains adamant it can further lower interest rates on the debt that will mature over the next couple of years. These benefits almost entirely offset the increase in total debt, resulting in stable interest charges during our forecast horizon.

All in all, we expect the deficit to reach 10.9% of GDP in 2020, up from 1.9% last year. The Federal Plan Bureau predicts that this deficit will remain close to 5% all the way up until 2025. The vast increase in borrowing needs pushes up the debt-to-GDP-ratio, from just below 100% last year to 123% for the end of this year. Despite this debt overhang, the FPB deems the risk of an interest-rate-snowball is highly unlikely.

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GREECE

20

A RISKY TOURISTIC SEASON

Despite successfully managing the Covid-19 pandemic, Greece will not avoid a severe recession in 2020. The tourism industry – which accounts for nearly 20% of the country's GDP – offers no guarantee for a solid recovery. The prospect of a resurgence in contamination in Europe will weigh on the tourism sector in the coming months. The Greek banking system will further weaken, and public debt will rise sharply. That said, the European Central Bank (ECB) has launched the Pandemic Emergency Purchase Programme (PEPP) in March, which allows the ECB to purchase Greek sovereign debt. This has kept a lid on sovereign rates. This difficult context may entice the government to draw a recovery plan that targets strategic sectors less linked to the tourism industry.

Greece is one of the European nations that has best managed the Covid-19 pandemic. In early July, the country reported fewer than 200 Covid-related deaths and the contamination rate per inhabitant was among the lowest in Europe. The 45-day reopening period initiated on 4 May is now over. Since 1 July, Greece has reopened its borders to foreign tourists from 14 countries outside of the EU, although a ban remains in place for travellers from the United States, India, Brazil and Russia.

Despite managing well the epidemics, Greece's economy will be hard hit. The contraction in Q1 GDP was limited to only 1.6% q/q because strict lockdown measures were implemented late in the quarter (23 March). Even so, the tourism industry came to a standstill in April-May and consumption plummeted in April, with retail sales reporting a record monthly decline of 27.6%. The purchasing managers index (PMI) for manufacturing climbed back to 49.4 in June, but this still signals sluggish growth. According to the European Commission, GDP will contract by 9.7% in 2020 before rebounding by 7.9% in 2021.

In response to the crisis, the government set up an emergency fiscal stimulus equivalent to 10% of GDP¹. This programme includes aid for the healthcare sector, the suspension of social security and VAT payments, EUR 800 in assistance² for employees unable to work because of the epidemics, an extension of unemployment benefits and state-backed loans via the Hellenic Development Bank.

Prime Minister Kyriakos Mitsotakis subsequently announced a EUR 24 bn recovery package focused on the tourism industry. The plans introduces a VAT rate cut from 24% to 13% on transport tickets (ferries, airlines, buses) as well as on non-alcoholic beverages. The government will continue to subsidize part of the wages of employees hit hard by the crisis, using the financial support from the European SURE programme³.

The evolution of the job market will be scrutinised. The unemployment rate had dropped below 16% in February, the lowest level in nine years. The government now forecasts the unemployment rate to rise to about 20% by the end of the year⁴.

Indeed, a rebound in tourism activity remains highly uncertain. The epidemic is not under control in the United States, China, Brazil and Russia, and the European Union has banned entry to all tourists arriving from these countries. If there is a resurgence of the epidemic in Europe (as seen in Portugal, Spain and Germany), the government would have to impose new restrictions.

GROWTH AND INFLATION (%)

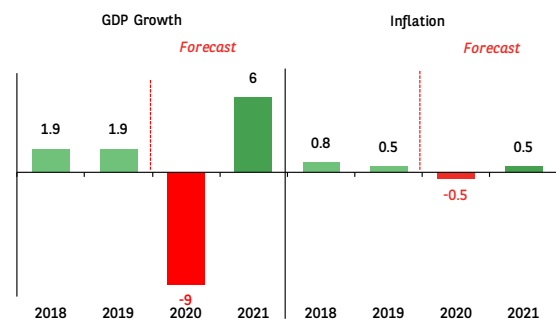


CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

The Covid-19 crisis will further weaken the banking sector. Although non-performing loans have diminished in recent years, they still accounted for 36.45% of Greek bank loans outstanding at the end of 2019 (IMF data). This will disrupt the Hercules bank securitisation programme, which was implemented last fall with the objective of lowering the share of non-performing bank loans outstanding below 20% by end-2021. Greek sovereign rates have nonetheless remained under control, partly thanks to the ECB's Pandemic Emergency Purchase Programme (PEPP) launched in March. Greek sovereign debt is one of the assets eligible for purchase in the PEPP.

The European Commission is now forecasting a fiscal deficit of 6.4% of GDP in 2020, which will narrow to 2.1% in 2021. The debt to GDP ratio will climb from 176.6% in 2019 to 196.4% in 2020, before falling back to 182.6% in 2021.

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¹ https://ec.europa.eu/info/sites/info/files/2020-european-semester-stability-programme-greece_en.pdf

² Based on 45 days

³ Support to mitigate Unemployment Risks in an Emergency (SURE) is a EUR 100 bn programme implemented by the European Commission in April to provide loans to member countries (partially backed by the EU) to protect jobs and especially to finance job retention schemes.

⁴ In the Stability Programme sent to the European Commission, the government expects unemployment to rise to 19.9% at end-2020



BNP PARIBAS

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UNITED KINGDOM

21

A BELATED AND UNCERTAIN ECONOMIC RECOVERY

Due to the late implementation of lockdown measures, the UK was hit hard by the Covid-19 pandemic. Consequently, the country is reopening after its European neighbours, and its economy has been particularly affected. The return to pre-crisis levels will therefore be long and difficult. What's more, the risk of a protracted crisis is all the greater due to two major threats looming on the horizon: a second wave of the pandemic requiring lockdown measures to be imposed again; and failure to negotiate a free-trade agreement with the European Union before the end of the year.

Because the government waited before implementing lockdown measures, the Covid-19 pandemic spread rapidly throughout the UK. With close to 45,000 deaths, it is the world's third hardest-hit country and Europe's most affected country. Consequently, the lockdown – which was finally imposed on 23 March – has been particularly long. While they reopened in early May in France and Germany, non-essential businesses only started welcoming customers again in mid-June in the UK, while bars and restaurants had to wait until early July. That said, although the authorities were slow to introduce lockdown measures, they were quicker when it came to economic support packages.

THE STATE TO THE RESCUE...

To counter the coronavirus health crisis, the UK government first allocated about GBP 15 bn for public services – with a particular focus on the healthcare sector.

Faced with a looming economic crisis, the government then took measures to support companies and households. Rishi Sunak, the Chancellor of the Exchequer, promised GBP 330 bn in guarantees for loans to companies, and added that the amount would be increased as needed. So far, these programmes have provided more than GBP 40 bn in financing (see table 1). What's more, the chancellor announced on 8 July a plan for jobs worth GBP 30 bn.

As far as households are concerned, the government launched the Coronavirus Job Retention Scheme (CIRS) and the Self-Employed Income Support Scheme (SEISS), which should mobilise funds of about GBP 80 bn. The job retention scheme has been extended until October, although the percentage of wages covered by the government, as well as the maximum amount of compensation, will gradually diminish.

...WITH SUPPORT FROM THE BANK OF ENGLAND

The Bank of England (BoE) has taken action on all fronts. It has cut its key rate by 65 basis points (bp) to an all-time low of 0.10%. It has also significantly expanded its quantitative easing programme. While before the crisis the central bank was targeting a stock of GBP 435 bn in bond purchases – primarily sovereign bonds – it has since raised this figure to GBP 745 bn. At the same time, it has created funding schemes for banks and building societies (Term Funding Scheme with additional incentives for SMEs – TFSME) as well as for companies (Covid Corporate Financing Facility – CCF) and launched a liquidity support facility for market participants (Contingent Term Repo Facility – CTRF) (see table 2). Lastly, the BoE negotiated swap agreements with the US Federal Reserve and extended the use of the Ways and Means Facility, which allows the government to directly seek short-term financing from it.

Although the bank and corporate financing schemes (TFSME and CCF) will last a few more months, the BoE has already begun to withdraw its support from other segments. The liquidity support programme (CTRF) was discontinued on 26 June, and the frequency of USD-liquidity providing operations was reduced from daily to only three times a week since July.

GROWTH AND INFLATION (%)

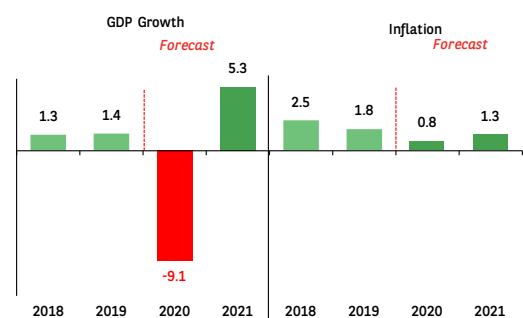


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

FISCAL SUPPORT PACKAGES (AT 28 JUNE, GBP BN)

Guarantees on corporate loans	
- Bounce Back Loan Scheme (BBLs)	29.5
- Coronavirus Business Interruption Loan Scheme (CBILS)	11.1
- Coronavirus Large Business Interruption Loan Scheme (CBILS)	2.3
- Future Fund	0.3
Job retention scheme and support for the self-employed	
- Coronavirus Job Retention Scheme (CIRS)	25.5
- Self-employed Income Support Scheme (SEISS)	7.7
Payment deferrals	
- VAT payments deferral scheme (outstanding at 7 June)	27.5

TABLE 1

SOURCE: GOVERNMENT

MONETARY SUPPORT PROGRAMMES (AT 24 JUNE, GBP BN)

Refinancing for banks and building societies	
- Term Funding Scheme with additional incentives for SMEs (TFSME)	14.2
Corporate financing facility	
- Covid Corporate Financing Facility (CCFF)	18.6
Liquidity support for market players	
- Contingent Term Repo Facility (CTRF)	11.4
Swap agreements with the US Federal Reserve	
- USD repo operations	7.7

TABLE 2

SOURCE: BANK OF ENGLAND



A SLOW RECONSTRUCTION PROCESS

The UK economy was hit hard by the protracted lockdown, as illustrated by figures released by the Office for National Statistics (ONS). After declining by nearly 6% in March, GDP plummeted by more than 20% in April, the first full month of lockdown. That is the biggest monthly decline since the series began in 1997 (see chart 2).

Of course, the figures for the next few months are bound to show signs of improvement, as the economy reopens and the various fiscal and monetary support programmes start to kick in.

Nonetheless, it will probably take a long time for the UK economy to return to pre-crisis levels, and its economic hardships will not end with renewed GDP growth. Thanks to the job retention scheme (CJRS) and support for the self-employed (SEISS), which have benefited nearly 12 million people, the unemployment rate held steady at 3.9% between February and April. That said, this figure also reflects a contraction of the workforce. In addition, more than 600,000 employees lost their jobs during the lockdown. Given the scope of the economic crisis and the imminent ending of government support programmes, unemployment will inevitably rise sharply in the months to come. The Office for Budget Responsibility (OBR) is forecasting a surge in the unemployment rate to 10% in Q2 2020¹.

UNITED KINGDOM GDP (INDEX VOLUME, BASED 100 = AUGUST 2016)

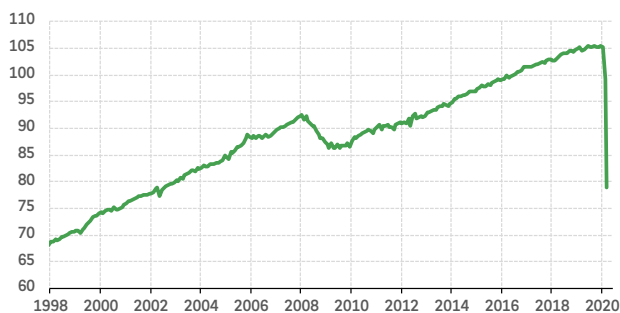


CHART 2

SOURCE: ONS

TWO MAJOR RISKS LOOM ON THE HORIZON

The size of the rebound is all the more uncertain due to two threats looming over the UK economy. The first is the risk of a second wave of the virus requiring lockdown measures to be restored – a scenario which possibility was recently reiterated by leading health professional groups². According to the OECD³, GDP growth would contract by about 14% in 2020 in that scenario, as opposed to 11.5% without a second wave of the virus.

The second risk is the failure of negotiations on a free-trade agreement between the UK and the EU. This risk is all the greater now that the UK has officially rejected the extension of the current transition period beyond the end of the year (see box).

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¹ See <https://obr.uk/coronavirus-analysis>
² See <https://www.bmj.com/content/369/bmj.m2514>
³ <http://www.oecd.org/economic-outlook/june-2020>

FOUR QUESTIONS ABOUT BREXIT

- **What is the UK's current position towards the EU?**

Although the UK officially left the European Union on 31 January 2020, it has entered a transition period through the end of the year to give the two parties time to reach an agreement on the nature of their future relationship. During the transition, the UK remains a member of the EU's single market and customs union, and the European Treaties continue to be binding. In brief, what we have seen is only a "political Brexit", while the "economic Brexit" is yet to come.

- **Where do things stand in terms of negotiations?**

After four rounds of negotiations, little progress has been made. Michel Barnier, the head of the European Commission's Task Force for Relations with the United Kingdom, has repeatedly pointed out the lack of commitment from his UK counterparts. According to him, that is particularly true in four areas: rules of economic and commercial fair play (the counterpart to the EU's proposal of a no-tariff, no-quota trade agreement), access to fishing waters and markets, police and judicial cooperation in criminal matters, and governance of the future relationship. Indeed, the British seem to be backtracking on certain commitments that were already made as part of the Political Declaration, such as the agreement to maintain the highest common standards applicable between the EU and the UK.

- **What next?**

Given the lack of progress on negotiations, a high-level meeting was held on 15 June between UK Prime Minister Boris Johnson, and Ursula von der Leyen, Charles Michel and David Sassoli, presidents of the European Commission, European Council and European Parliament, respectively. During the meeting, all parties took note of the UK's decision not to request an extension of the transition beyond 31 December 2020. As a result, they decided to intensify their talks in July and August. According to the EU, an agreement must be reached by 31 October in order for it to be ratified in time.

- **What are the possible scenarios?**

The negotiations can lead to two main outcomes, with a myriad of possibilities in between. The outcome that would create the least disruption would be a free-trade agreement with no customs duties. Yet that would still be a "hard" Brexit, as the UK would exit both the EU single market and customs union. At the other extreme, failure to reach a deal would result in the application of basic World Trade Organisation rules. This means that the hardest possible Brexit is still a very real possibility, which raises the risk of high financial market volatility and major economic difficulties towards the end of the year.



SWITZERLAND

23

EXPANSIONARY POLICIES TO AVERT DISASTER

After the deepest recession in recent history, economic activity is turning up again due to the gradual easing of the lockdown measures in Switzerland and the neighbouring countries. The exceptionally accommodative monetary and fiscal policy stances are also contributing to the recovery. SMEs have made use of the special loan programme and employees have benefitted from the short-time work scheme. Nevertheless, the recovery is likely to be slow, and economic activity is unlikely to return to pre-crisis levels before end 2022. The government is confident that the Covid-related debt can be repaid without raising taxes.

RECESSION BOTTOMED OUT IN APRIL

The coronavirus and the measures to contain the pandemic have resulted in the worst recession in recent history. Large sections of the economy were paralysed because of the lockdown measures. Even though these came into force only in March, GDP was 2.6% lower in Q1 2020 than in the previous quarter. The worst hit were the consumer-related industries directly affected by the mandatory closures such as the hospitality sector and part of the retail sector. The recession deepened in Q2. The KOF Economic Barometer reached an all-time low in April, as economic activity was about 20-30% below its usual level. As lockdown measures were gradually eased from the end of April onwards, the Barometer regained some ground in the following months, suggesting that the worst was behind. Nevertheless, the business situation in manufacturing continued to deteriorate because of contracting order books.

AN EXCEPTIONAL EXPANSIONARY MACROECONOMIC POLICY

As the country went into lockdown in March, the Federal Council acted quickly by adopting an emergency package worth CHF 72.2 bn (10.4% of 2019 GDP) of which CHF 41.4 bn in sureties and guarantees, mainly for SME loans. To obtain a guaranteed loan SMEs simply apply at their main bank. Small loans enjoy a complete state guarantee, while larger ones are guaranteed up to 85%. The latter are subjected to an examination by the banks, which guarantee the remaining 15%. In order to expand bank lending rapidly, the Swiss National Bank has set up the COVID-19 refinancing facility (CRF). The facility allows banks to obtain liquidity from the SNB, which is secured by the federally guaranteed loans.

The Federal Council also broadened access to the short-time working schemes by to include also fixed-term contract workers, temporary workers, apprentices, and self-employed. In addition, the waiting period before having access to the scheme have been abolished and administrative procedures simplified. In early July, the Federal Council extended short-time work benefits by another six months. The federal contribution to the unemployment insurance scheme was increased by 20.2 billion. Since April, 190k enterprises have applied for Kurzarbeit for 1.9 mn workers, which is around 36% of all employees.

Given the economic weakness and the fall in prices, monetary policy should remain very expansionary. The SNB is expected to keep the policy rate at -0.75%. The bank has also announced its willingness to intervene in the foreign exchange market to prevent an appreciation of the CHF.

GROWTH AND INFLATION (%)

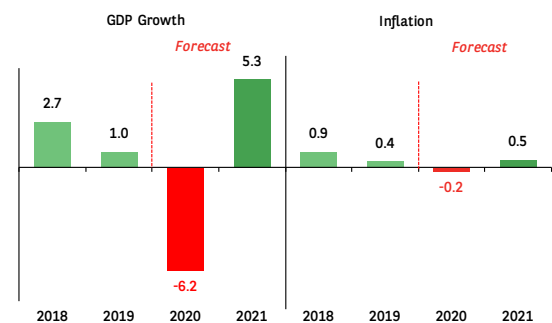


CHART 1

SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS

A LONG ROAD TO RECOVERY

Thanks to the very accommodative policies and the further loosening of lockdown measures in Switzerland and the neighbouring countries, economic activity is likely to rebound strongly in Q3. As a result, the fall in GDP might be limited to around 6%. Nevertheless, the recovery is likely to be slow and it may take until 2022 before the economy is back at its pre-crisis level.

The crisis has also led to a serious deterioration of government finances. The Federal Council is reckoning on a tax receipt shortfall of more than CHF 5 bn this year, partly due to tax deferrals. The overall government deficit is estimated at around 5% in 2020. The Federal Council projects the state budget to remain in deficit up to 2024. However, Finance Minister Ueli Maurer is confident that the pandemic-related debt can be repaid without tax increases.

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SWEDEN

A LESS SEVERE LOCKDOWN, BUT A VULNERABLE ECONOMY

At first sight, Sweden ranks among the countries best positioned to face the global economic crisis triggered by the Covid-19 pandemic. The government's restrictive measures were not as stringent as in most other developed countries (shops and restaurants remained open, for example), the Swedish economy does not have much exposure to the hardest hit sectors, and the authorities have comfortable policy leeway. Yet the country also presents some vulnerabilities that make us less optimistic about its capacity to rebound. Among those are its dependence on global trade and households' financial situation.

Faced with the Covid-19 health crisis, the Swedish government opted to impose restrictive measures that were much softer than those of its European neighbours. This strategy aims to eliminate the virus by rapidly reaching "herd immunity"¹. It is not surprising then that Sweden has one of the world's highest Covid-19 infection rates.

THERE ARE REASONS TO BE RELATIVELY OPTIMISTIC...

Although it is too early to say whether this strategy has been effective, the Swedish economy could show signs of relative resilience. First, it is not very exposed to the hardest hit sectors such as tourism. Second, its fiscal and monetary policy responses were generally appropriate. According to IMF estimates, all government measures will account for between SEK 544 bn and SEK 832 bn – which is equivalent to between 10.8% and 16.6% of last year's GDP. Moreover, public debt is low – at only 35% of GDP in 2019 according to Eurostat – which gives the government broad policy leeway. Similarly, the Riksbank, Sweden's central bank, has deployed a large monetary support package, which capacity is still far from being reached (see table). That is notably the case of its quantitative easing (QE) programme, which was increased to SEK 500 bn in early July and extended until June 2021.

... BUT THERE IS ALSO GROUND TO REMAIN CAUTIOUS

That said, Sweden also faces several major challenges. In the current environment, its high participation in global value chains² is concerning for two reasons. First, we have already witnessed a structural slowdown in trade since the beginning of the global financial crisis³. Second, the pandemic has dealt a further significant blow to global exchanges. In April, the World Trade Organisation was already estimating that global merchandise trade in volume terms would contract by between 13% and 32% in 2020⁴.

Moreover, the Swedish economy was not in the best of positions when it entered the crisis. This is especially true for households. Declining slowly but steadily since 2010, Sweden's unemployment rate began to rise again in the beginning of the year. The Covid-19 crisis has accelerated this trend, and the unemployment rate hit 9% in May. This is especially worrying given Swedish households' elevated debt burden. At nearly 190% in 2018 according to the OECD⁵, Sweden has one of the world's highest household debt ratios as a share of net disposable income – even though it is generally lower than those of neighbouring Scandinavian countries.

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1 See: <https://www.pasteur.fr/fr/espace-presse/documents-presse/qu-est-ce-que-immunite-collective>

2 Exports of Swedish goods and services account for about 45% of GDP according to the World Bank

3 See: <https://www.riksbank.se/globalassets/media/rapporter/staff-memo/engelska/2020/restrained-foreign-trade-after-2009-discussion-of-possible-consequences-for-sweden.pdf>

4 See: https://www.wto.org/english/news_e/pres20_e/pr855_e.htm

5 See: <https://data.oecd.org/hha/household-debt.htm>

GROWTH AND INFLATION (%)

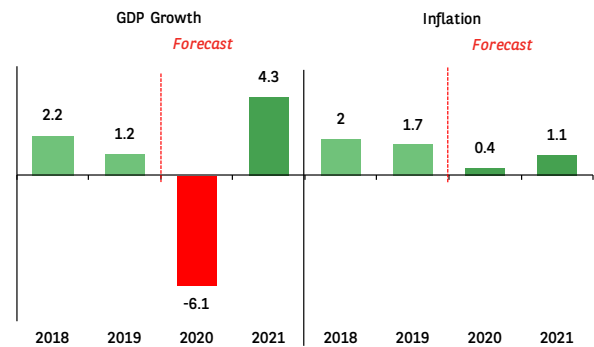


CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

RIKSBANK'S SUPPORT MEASURES (SEK BN, OUTSTANDING AT 30 JUNE)

	Budget	Outstanding
Collateral loans to banks for onwards lending to non-financial companies	500	162
Purchases of sovereign, municipal bonds and mortgage loans	500	136
Liquidity support programme	Unlimited	26
Loans in US dollars	60	2

TABLE

SOURCE: RIKSBANK



DENMARK

AN ECONOMY LIKELY TO BE RELATIVELY LESS AFFECTED

Faced with the Covid-19 pandemic, the authorities rapidly imposed strict protective measures that effectively maintained the health crisis under control. The economy was also in a relatively good position at the beginning of the crisis – notably thanks to low unemployment and public debt – and fiscal as well as monetary support measures were quickly introduced by the government and the central bank. With all that in mind, the OECD estimates that Denmark will be one of the most resilient economies in 2020, forecasting a fall in GDP “limited” to 5.8%.

Thanks to the early introduction of lockdown measures, Denmark was not hit as hard as the other European countries by the Covid-19 pandemic – especially compared to Sweden, which opted for much more flexible restrictive measures. The authorities were also swift to introduce measures to bolster the economy.

“MASSIVE” SUPPORT MEASURES

In its June outlook¹, the OECD described as “massive” the measures taken by the Danish government to support businesses and workers. In total, the measures could amount to the equivalent of nearly 18% of projected 2020 GDP, according to the international organisation. The measures have included job retention schemes, liquidity support measures for businesses, tax deferrals and loan guarantees.

When it comes to monetary policy, the central bank is restrained by the fixed exchange rate regime that pegs the Danish krone to the euro. In fact, it raised its key rate by 15 basis points in March to reduce downside pressure on the currency. Even so, it set up an “extraordinary credit facility”² to maintain favourable financing terms for banks. The central bank also set up swap lines with the European Central Bank (ECB) up to a maximum of EUR 24 bn, and with the US Federal Reserve up to a maximum of USD 30 bn.

THE ECONOMY COULD SHOW RESILIENCE

Admittedly, Denmark is an open economy highly dependent on foreign trade, with exports of goods and services accounting for about 55% of GDP. Consequently, it is very likely that the economy will be hit by the slowdown in world trade triggered by the pandemic. That said, the nature of its exports make the country less vulnerable than one might think. Its specialisation in pharmaceutical and agricultural products, which are basic necessities, will certainly buffer the shock (see chart 2).

Moreover, Denmark entered the crisis with low unemployment rate³ and public debt⁴, which will surely help to weather the crisis. That being said, the country also presents some vulnerabilities. For instance, at 282% of net disposable income, its household debt ratio is the highest among OECD countries⁵.

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GROWTH AND INFLATION (%)

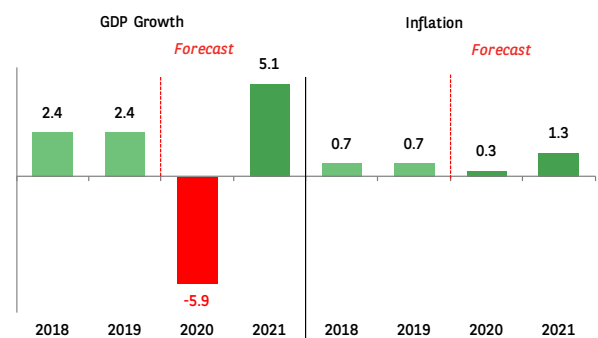


CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

EXPORTS (DKK BN)

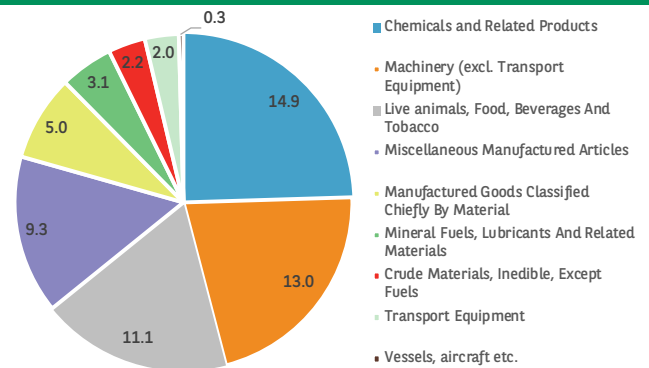


CHART 2

SOURCE: DENMARK STATISTICS

1 See <http://www.oecd.org/economic-outlook/june-2020>

2 See <https://www.nationalbanken.dk/en/pressroom/Pages/2020/03/DNN202005367.aspx>

3 From only 3.7% at the beginning of 2020, the unemployment rate rose to 5.4% in April. (See <https://www.dst.dk/en/Statistik/emner/arbejde-indkomst-og-formue/arbejdsloshed>)

4 According to Eurostat, the public debt to GDP ratio was 33% at year-end 2019.

5 See <https://data.oecd.org/hha/household-debt.htm>



FORECASTS

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ECONOMIC FORECASTS

%	GDP Growth			Inflation		
	2019	2020 e	2021 e	2019	2020 e	2021 e
United-States	2.3	-4.9	4.8	1.8	0.8	1.5
Japan	0.7	-4.8	2.1	0.5	-0.3	-0.7
United-Kingdom	1.4	-9.1	5.3	1.8	0.8	1.3
Euro Area	1.2	-9.0	5.8	1.2	0.1	0.9
Germany	0.6	-5.6	5.3	1.4	0.4	1.5
France	1.3	-11.1	5.9	1.3	0.5	1.0
Italy	0.3	-12.1	6.1	0.6	-0.2	0.5
Spain	2.0	-12.5	6.3	0.7	-0.4	0.6
China	6.1	2.5	8.1	2.9	2.5	2.3
India*	4.2	-4.7	9.5	4.8	2.5	3.5
Brazil	1.1	-7.0	4.0	3.7	2.5	3.0
Russia	1.3	-6.5	3.5	4.3	3.0	3.5

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

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS), LAST UPDATE: 07/07/2020

FINANCIAL FORECASTS

Interest rates, %		2019		2020				2019		
End of period		Q3	Q4	Q1	Q2	Q3e	Q4e	2019	2020e	2021e
US	Fed Funds (upper limit)	2.00	1.75	0.25	0.25	0.25	0.25	1.75	0.25	0.25
	T-Notes 10y	1.67	1.92	0.67	0.80	1.00	0.90	1.92	0.90	1.20
Ezone	Deposit rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
	Bund 10y	-0.57	-0.19	-0.46	-0.50	-0.40	-0.30	-0.19	-0.30	0.00
	OAT 10y	-0.28	0.08	-0.05	-0.15	-0.10	-0.05	0.08	-0.05	0.20
	BTP 10y	0.83	1.32	1.55	1.30	1.30	1.30	1.32	1.30	1.60
UK	BONO 10y	0.15	0.47	0.68	0.50	0.40	0.40	0.47	0.40	0.70
	Base rate	0.75	0.75	0.10	0.10	0.10	0.10	0.75	0.10	0.10
Japan	Gilts 10y	0.40	0.83	0.31	0.55	0.30	0.40	0.83	0.40	0.80
	BoJ Rate	-0.06	-0.05	-0.07	-0.10	-0.10	-0.10	-0.05	-0.10	-0.10
	JGB 10y	-0.22	-0.02	0.02	0.00	0.05	0.05	-0.02	0.05	0.15

Exchange Rates		2019		2020				2019		
End of period		Q3	Q4	Q1	Q2	Q3e	Q4e	2019	2020e	2021e
USD	EUR / USD	1.09	1.12	1.10	1.09	1.15	1.17	1.12	1.17	1.22
	USD / JPY	108	109	108	104	103	100	109	100	98
	GBP / USD	1.23	1.32	1.24	1.24	1.29	1.34	1.32	1.34	1.42
EUR	EUR / GBP	0.89	0.83	0.89	0.88	0.89	0.87	0.83	0.87	0.86
	EUR / JPY	118	122	118	113	118	117	122	117	120

Brent		2019		2020				2019		
Period-average		Q3	Q4	Q1	Q2	Q3e	Q4e	2019	2020e	2021e
Brent	USD/bbl	62	63	51	33	43	49	64	44	59

SOURCE: BNP PARIBAS GLOBAL MARKETS (E: ESTIMATES), LAST UPDATE: 07/07/2020



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