ECOPERSPECTIVES

1st Quarter 2024

> 2023 CLOSED ON A NOTE OF HOPE, WITH EXPECTATIONS OF RATE CUTS AND SIGNS OF STABILISING, PERHAPS EVEN IMPROVING CONFIDENCE SURVEYS. THIS HOPE HAS NOT DISSIPATED IN THE EARLY WEEKS OF 2024. IN THE ABSENCE OF A NEW SHOCK, INFLATION SEEMS TO BE ON COURSE FOR A RETURN TO THE 2% TARGET. THIS OPENS THE WAY TO THE FIRST STEPS IN MONETARY EASING, EXPECTED IN THE SECOND QUARTER.

ECONOMIC RESEARCH

BNP PARIBAS

The bank
for a changing
world

TABLE OF CONTENT

2024: A CRITICAL YEAR

2023 closed on a note of hope, with expectations of rate cuts and signs of stabilising, perhaps even improving confidence surveys. This hope has not dissipated in the early weeks of 2024. In the absence of a new shock, inflation seems to be on course for a return to the 2% target. This opens the way to the first steps in monetary easing, expected in the second quarter. These twin falls, in inflation and interest rates, and the encouraging pattern in the bulk of the economic data, fuel the expectations of a soft-landing scenario. But this is not to say that there are no risks or points worthy of continued attention. Geopolitical tensions remain high and capable of disrupting this scenario, most notably through their inflationary effects. The rise in company failures and the difficulties of the real estate sector also create downside risks for growth. In 2024, fiscal policy and consolidation efforts are likely to return to the forefront. Politics will also play an important role, given that there are several major elections on the horizon.

Often, if not always, a new year is portrayed as a crucial juncture. 2024 is no exception. In many aspects, indeed, it can be seen as a critical year. On the climate and ecological front this goes without saying, such is the urgency of stepping up efforts to decarbonise in the face of accelerating signs of warming[1]. The same is true of the geopolitical situation, with the continuation of the war in Ukraine – with no end in sight yet – and the ongoing conflict in the Middle East, where there are risks of a regional escalation, with the resulting impact on oil prices coming on top of disruption to shipping in the Red Sea and the associated increase in shipping costs. Politics will also feature large this year, with several important elections ahead, chief amongst them the European elections on 6 and 9 June and the US Presidential election on 5 November. Although these votes are unlikely to have a direct impact on the economy this year, their outcomes could shape prospects over the longer term.

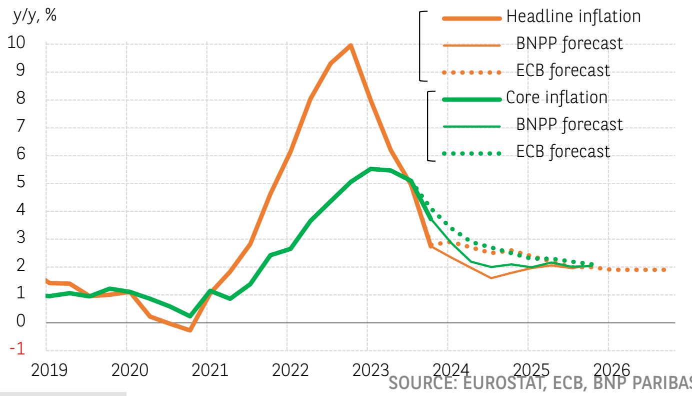
WILL THERE BE A SOFT LANDING?

2024 is also a key year for inflation and growth. Will inflation hit the 2% target this year? Will there be a soft landing for growth? A soft landing will depend in part on the speed at which disinflation continues and the scale, firstly, of the expected support of this lower inflation on confidence, household purchasing power and company margins and secondly, of the number of interest rate cuts allowed by falling inflation.

As far as inflation's return to its target is concerned, our forecasts suggest this will come fairly quickly and, notably, more quickly than the ECB currently expects (chart 1). Our inflation forecasts for the USA are also slightly more favourable (with the target met at the end of the year) than those of the Federal Reserve (expected inflation of 2.4% y/y in Q4 2024). Wages will be a key factor: whilst their enduring upward momentum means that wages have a positive effect on household disposable income and thus consumption, they also hamper inflation reduction, thus reducing expected gains in purchasing power and the support to consumption.

The significant improvement in consumer confidence on both sides of the Atlantic (since mid-2022 in the USA according to the University of Michigan survey, and since the autumn of 2022 for the European Commission survey), albeit from a very low base, is a good illustration of the positive role played by the easing of inflation and forms one of the encouraging signs of a soft landing. The same can be said for the stabilisation of the business climate in the Eurozone and the return of the US Composite PMI above the 50 threshold in January. The continued relatively robust health of the labour market is another source of optimism.

INFLATION IN THE EUROZONE AND FORECASTS



SOURCE: EUROSTAT, ECB, BNP PARIBAS

CHART 1

In the USA, the positive signal from improved household confidence has been backed up by their consumption, which remains strong. Still in the US, a major recessionary signal – the inversion of the yield curve – has eased somewhat (chart 2). These various developments seem to put meat on the bones of what one might consider the self-fulfilling prophecy of a soft landing: the expectation of such an event creates the conditions for it to occur, particularly as it fuels investors' risk appetite and reduces the financing cost for companies looking to issue debt.

Turning to the Eurozone, another characteristic of the expected soft landing and soft recovery is the passing of the baton between companies and consumers. In other words, we expect a slight increase in the strength of household consumption (as consumers take advantage of lower inflation to draw more heavily on their savings cushions) and a loss of dynamism in business investment. In the USA, household consumption is likely to run out of steam as a driving force, with consumers finding it harder to draw from excess savings built up during the Covid-19 crisis, but widely used in 2023. On both continents, the trend in the unemployment rate will have the final say. By definition there can only be a soft landing if the increase in unemployment remains limited. This could well be the case, notably due to persistent hiring difficulties (although these have become less intense and widespread), which encourage labour hoarding. Our assumption is also that the adjustment in the labour market, particularly in the USA, will come more from a reduction in the number of vacancies and less from redundancies, something we are already observing today.

1 See. 2024: two anniversaries - and hopes for an inversion of the emissions curve, 17 January 2024

Although this soft-landing scenario looks likely, it is nevertheless surrounded by numerous uncertainties and unknowns on the downside: thus we can not rule out the risk of a recession in 2024. Negative signals and areas of concern are hardly in short supply: increase in company failures, crisis in real estate markets, negative effects from past rate hikes that have yet to feed through (for companies needing to refinance debt, for households that borrowed at adjustable rates and now face increases in their interest payments), and lastly China, which continues to suffer from a number of weaknesses.

CHANGES IN THE POLICY MIX ARE RELATIVELY WELL ADAPTED

Changes in the policy mix will be another new feature of 2024: monetary policy is likely to become less restrictive, whilst fiscal policy will turn less accommodating. This will limit, but not prevent, any recovery. On the monetary side, cuts to policy rates are one of the few 'certainties' for the year ahead, as inflation falls – while this is not an absolute certainty, it has a very high probability of occurring. The timing of the first cuts and the number of cuts over the course of the year are nonetheless uncertain. Given our inflation forecasts, we expect that the ECB will act first, as soon as April, followed by the Fed in May. When it comes to the number of cuts, the Fed is likely to be slightly ahead of the ECB, with six versus five 25-basis point cuts respectively.

On the fiscal policy front, it should be expected that high public debt ratios will once again become a topic of attention, as will the fiscal consolidation efforts needed to ensure that public finances remain on a sustainable trajectory. In an environment where the gap between growth and interest rates is less favourable, a gradual but steady reduction in primary deficits would appear necessary. In Europe, this reduction will happen within the slightly more flexible – although not necessarily less complicated – framework of the new fiscal rules, after member states finally reached agreement at the end of 2023. According to European Commission data, fiscal policy in the Eurozone will indeed be less accommodating in 2024, if we judge not only by the expected reduction in structural primary deficits but also by their lower levels (with the notable exception of France) after already two years of reductions and thus negative fiscal impulse (chart 3). This rebalancing comes after the sharp deterioration in public finances in 2020, and to a lesser extent 2021, that resulted from the Covid crisis and the measures taken to help absorb the shock.

For the Eurozone in aggregate, although the negative fiscal impulse is currently lower than during Europe's sovereign debt crisis and the ensuing rapid fiscal consolidation, the figures are nevertheless relatively close (reduction in structural primary deficit of 0.7 of a point on average between 2022 and 2024, compared to 0.9 of a point from 2011 to 2014). The major difference is that the current fiscal consolidation is coming under more favourable economic conditions, making it contra-cyclical in nature in 2022 and close to neutrality in 2023 and 2024, rather than pro-cyclical as it was between 2011 and 2014. The situation in the US is harder to assess due to the lack of comparable statistics, but it will probably be fairly similar to that in the Eurozone in 2024. In the final analysis, changes in the policy mix in 2024 seem adapted to the current context of fighting inflation: monetary policymakers can allow themselves to be less restrictive as inflation is coming down and because of the complementary action of the fiscal brake.

Hélène Baudchon

helene.baudchon@bnpparibas.com

US: UNEMPLOYMENT RATE AND YIELD CURVE

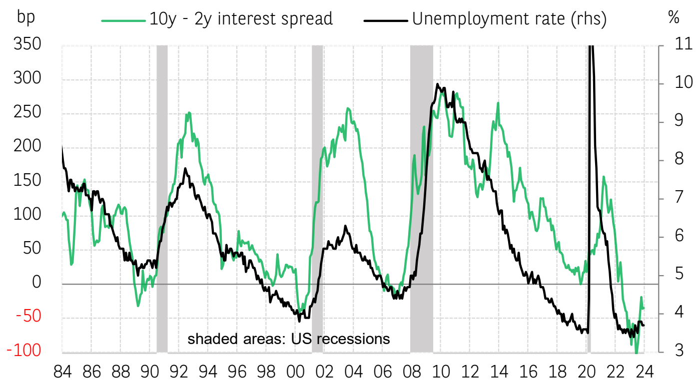


CHART 2 SOURCE: FEDERAL RESERVE, BLS, MACROBOND, BNP PARIBAS

EUROZONE: PRIMARY STRUCTURAL BALANCE (% POTENTIAL GDP)

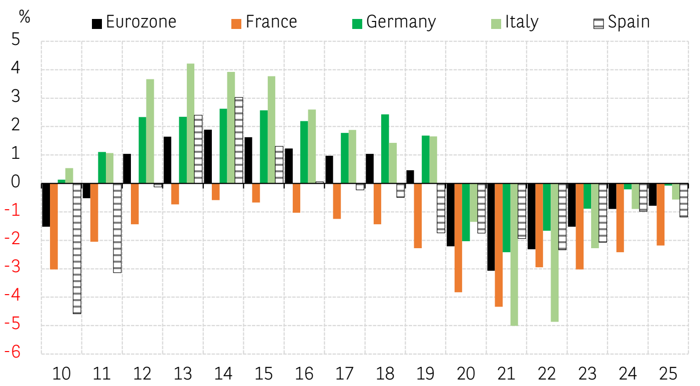


CHART 3 SOURCE: EUROPEAN COMMISSION, MACROBOND, BNP PARIBAS

UNITED STATES

EXCEEDING EXPECTATIONS

The possibility of a US recession triggered by monetary tightening is looking less and less likely given the resilience of an economy that continued to grow by 0.8% q/q in Q4 2023 and by 2.5% on average over the year. Our central scenario is now that of a marked slowdown albeit without an economic recession in H1 2024. The Federal Reserve can now look forward to a soft landing and consider rate cuts in 2024 – a year in which political events will take centre stage.

US economic growth showed surprising strength in H2 2023, initially accelerating to +1.2% q/q in Q3, compared to +0.7% in Q2, representing the largest quarterly increase for almost two years. Although the fourth quarter was less dynamic, growth nevertheless remained very positive at +0.8% q/q according to the first estimate, taking annual average growth to +2.5% in 2023. A deceleration to 2% is expected in 2024. However, while the delayed negative effects of monetary tightening should contribute to a significant decline in growth over the short term, they would not cause a recession or a decline in GDP. Our central scenario now expects a growth rate of +0.4% t/t in Q1 and +0.1% in Q2-2024.

Private investment recovered somewhat in 2023, recording four quarters of growth, after having contracted sharply in the course of 2022 under the impact of interest rate hikes. However, this aggregate result masks the significant difference between residential investment, which was naturally impacted despite two positive quarters at the end of the year, and non-residential investment, which continued to grow by an annual average of +4.4% in 2023 after +5.2% in 2022. Household consumption, on the other hand, proved resilient, emerging as the main driver of growth in Q4, rising by +0.7% q/q. However, household consumption is likely to end up being more visibly affected by the cumulative and delayed negative impact of monetary tightening, despite the expected continuation of the disinflationary trend. This would come about through a combination of pressure on household incomes resulting from a rise in the unemployment rate reaching 3.7% in December 2023 and higher interest charges.

FROM MONETARY ADJUSTMENT TO EASING?

The most recent monetary policy meeting in 2023 resulted in the Federal Reserve maintaining its interest rate target. This target has been stable at between 5.25% - 5.5% since July 2023, in line with our scenario. However, the median projections of the Committee members point to rate cuts in 2024, with the key rate at 4.625% at the end of this year compared to 5.375% in previous projections, whereas we see this rate at 4.0% and anticipate a first cut of 25 bps in May. For the Federal Open Market Committee (FOMC) members, the degree of monetary policy tightening therefore seems sufficient, and the disinflation process sufficiently advanced, to consider lowering the key rate in 2024. Inflation, as measured by the consumer price index, stood at +3.2% y/y in Q4 2023, compared with +7.1% a year earlier. We expect inflation to reach +2.6% y/y in the final quarter of 2024.

Nevertheless, the Fed refuses to declare "mission accomplished". Firstly, the extent of the fall in core inflation is more uncertain, particularly given the resilience of inflation in non-energy services excluding housing at +4.6% y/y in Q4 2023. As a result, the first rate cuts will consist of adjusting the policy rates to keep them stable in real terms in a context of falling inflation, rather than a desire to ease monetary policy. Indeed, the Federal Reserve knows that it needs to be cautious in managing what it hopes will be a soft landing for the economy, hence the continued reference to the possibility of future interest rate hikes, if necessary, in the statement following the last meeting. It should also be noted that this less restrictive approach to nominal rates should lead to an easing of financial conditions.

GROWTH & INFLATION

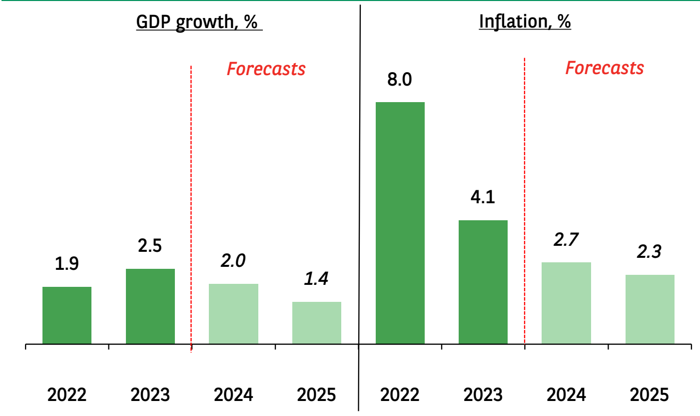


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

POLITICS TAKES PRECEDENCE OVER ECONOMICS IN 2024

Political issues will take centre stage over the course of the year, with the presidential election on 5 November firmly in the spotlight. At present, it is likely that the two candidates from the previous election in 2020, incumbent President Joe Biden (D) and his predecessor Donald Trump (R), will face each other again, a scenario not seen since 1968, even though it is being widely disapproved by most Americans according to opinion polls.

For the time being, the outcome of the election remains unpredictable. However, it should be stressed that the future President's room for manoeuvre, particularly in terms of economic policy, will depend on the composition of the Congress that emerges from the elections. In this respect, the main issues will be fiscal policy (if Donald Trump is elected with a Republican majority, the 2017 tax cuts are likely to be continued - or extended), the appointment of Jerome Powell's successor at the head of the Federal Reserve, and changes in US policies on customs tariffs (status quo with Biden, amplification with Trump). Continued efforts to combat global warming will also depend largely on the political affiliation of the future president.

Anis Bensaidani
anis.bensaidani@bnpparibas.com

CHINA

TAKING STOCK OF 2023

The post-Covid recovery in China's economic activity was not as strong as expected in 2023. The property sector crisis seemingly deepened further at the end of the year, the demand for housing did not pick up again despite support measures from the authorities, and weak household confidence weighs on private consumption. Conversely, the export-oriented manufacturing sector has performed better than expected over the past few months, in contrast with the performances of domestically oriented sectors.

Chinese economic growth stood at 5.2% in 2023, up from 3% in 2022. This recovery is largely due to the post-Covid normalisation of domestic demand and base effects. It has also been supported by cautious monetary and fiscal policy easing since last summer. However, the Chinese economy continues to deal with a large number of fragilities that are likely to persist in the short term.

These fragilities are concentrated in domestically oriented sectors and weigh on investment and private consumption. In particular, the property sector is still in the depths of a major crisis, which further intensified in late 2023. Property investment contracted by around 8% last year, just as it did in 2022. Property transaction volumes plummeted 23% y/y in December and 18% over 2023 as a whole, and the apparent recovery in housing starts seen in November (after falling for 31 consecutive months) was seemingly a false dawn. Only the number of completed projects has continued to improve (+16% in 2023, after a drop of 15% in 2022) thanks to the measures implemented by the authorities to finance the completion of unfinished projects. Conversely, the measures introduced to rekindle demand for housing have not made a difference. For the first time, total mortgages outstanding shrank in 2023 (-1.5% y/y at the end of September). Unsold housing stocks are still excessively high, while property developers continue to face enormous financial difficulties. However, access to loans for the healthiest developers has improved slightly over the last 18 months (total bank loans to developers were up +4% y/y in September 2023, compared to +1.5% in mid-2022).

Property prices have continued to fall. In December, the average drop in housing prices in China's 70 largest cities stood at 4.1% year-on-year and 0.8% month-on-month, which are the biggest falls since the correction in the property sector began in 2021. However, the overall fall in prices since the crisis began is relatively moderate: at the end of 2023, housing prices were estimated to be around 9% below their mid-2021 level on average.

The loss of confidence among households, private investors and lenders has significantly contributed to the property sector crisis not abating. Weak household confidence is also at the root of the weaker than expected recovery in private consumption in 2023, despite the effects resulting from the end of mobility restrictions. Retail sales volumes were up 7%, after contracting by around 2% in 2022.

At the same time, deflationary pressures emerged over the course of the year, as a result of not only weak domestic demand, but also falling food prices (-3% y/y on average in H2 2023, after rising 2.5% in H1), the correction in residential property prices and lower energy prices (fuel prices declined 5.1% in 2023). Consumer price inflation eased from +1.3% y/y in Q1 2023 to -0.3% in Q4. Core inflation stabilised at +0.6% y/y in the period from October to December, compared to +0.7% over the previous six months, which is low compared to the pre-Covid years (core inflation was 1.6% on average in 2019).

However, the increase in household purchasing power remained moderate in 2023 (disposable income per capita recovered +6.1% in real terms). Unemployment is still high among young people, and the employment prospects are uncertain, particularly in service sectors where the regulatory framework has become more stringent.

GROWTH & INFLATION

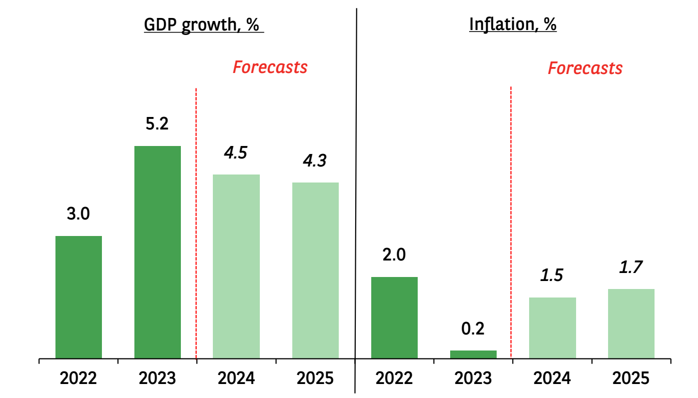


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

All of these factors adversely affect consumer confidence and spending. They are also compounded by the negative wealth effects of falling property and stock prices.

The recovery in service sector activity weakened in late 2023 given the weakness of household demand and lower base effects. Services growth stood at +8.5% y/y in December, bringing an end to four consecutive months where it accelerated gradually; it is estimated to be +8% over 2023 as a whole (vs. -0.1% in 2022).

By contrast, the performance of the manufacturing and export sectors has recently strengthened. Growth in industrial production further accelerated slightly in December (+6.8% y/y) and stood at +4.6% in 2023 (compared to +3.6% in 2022). Investment in the manufacturing sector recovered slightly in Q4 2023. Activity was largely driven by exports, which performed better than expected in 2023 despite a sluggish international environment. Goods exports stabilised in November and rose again in December (+2.3% y/y in current USD), following six months of decline. Most notably, export volumes have recovered in recent months, boosted by the reduced prices offered by Chinese companies in order to strengthen their market shares. As a matter of fact, China has managed to develop its product range (from low value-added consumer goods to green technology products), gain a foothold on the electric vehicle market, and diversify its markets in an attempt to offset the drop in sales in the United States and the European Union.

Christine Peltier
christine.peltier@bnpparibas.com

JAPAN

A MONETARY SHIFT IS DRAWING NEAR

Faced with a natural disaster and a political crisis, 2024 is off to a rocky start for Japan. However, the economic impacts of the earthquake that struck the country's west coast on 1st January 2024 are expected to be fairly limited due to the authorities' effective preparations and quick response in dealing with this type of event. After an expected growth of +0.4% q/q in the fourth quarter of 2023, activity should slow in the first quarter of 2024, although it will remain positive at 0.2% q/q. The fall in inflation and bond yields at the end of 2023 is providing some breathing room for the BoJ, which is expected to end its negative interest rate policy in March or April. The road to monetary normalisation will be challenging for the BoJ, which, through its large-scale purchases of government bonds, has exacerbated the liquidity problems and volatility in the JGB market.

On the political front, the start of 2024 is going to be difficult for Japanese Prime Minister Fumio Kishida. The Liberal Democratic Party (LDP) has been at the centre of a scandal since December 2023, with several of its members having failed to declare funds received in their political capacities, as required. Fresh information published at the start of the year have put the issue back in the spotlight, despite the members involved being sacked from the government during a reshuffle in December. Kishida's popularity is at rock bottom, plummeting to the lowest levels seen for a Prime Minister since 1947. Kishida's current mandate as LDP President ends in late September 2024, when the party elections are due to take place, but he could be forced to resign before this autumn.

The economic situation is also being affected, with activity remaining volatile in 2023. During the first half of the year, growth was driven by service exports after the final border restrictions linked to the Covid-19 crisis were belatedly lifted and thanks to tourism inflow (+1.2% q/q in Q1 and +0.9% q/q in Q2). This momentum then petered out and weak private demand (household consumption and corporate investment) pulled down Q3 growth (-0.7% q/q). We are anticipating an upturn in activity in Q4 2023 (+0.4% q/q), which would result in an average annual growth rate of 2.1% for 2023.

Despite rising production costs and ongoing acute labour shortages[1], the picture for Japanese companies in 2023 remained positive overall, particularly in relation to profits (before interest and taxes), which hit a record high in Q3 2023[2]. The depreciation of the yen has contributed to a significant rise in profits repatriated from abroad. However, it is mainly large companies with foreign subsidiaries and greater market power than small and medium-sized companies that have benefited from this effect.

The rise in consumer prices is showing signs of easing, with inflation excluding fresh food falling back to 2.1% y/y in December in the Tokyo region from a high of 4.3% y/y in January 2023. This has seemingly been positive for household confidence, which rose for the fourth consecutive month in December. This should support consumer spending, which is still far below pre-pandemic levels. However, with salaries stagnating, real wage growth remained in negative territory throughout the year, decreasing by 3.0% y/y in November 2023.

A RISKY CHANGE IN MONETARY POLICY

The BoJ continued to pursue an expansionary monetary policy in 2023. Additional flexibility was only added to the Yield Curve Control (YCC) policy, with two consecutive increases (in July, followed by October) to the intervention ceiling on 10-year government bonds. The negative interest rate policy (NIRP) remained in place. Japanese decision-makers, who have been influenced by years of low inflation, are looking to foster home-grown and sustainable price increases by strengthening a price-wages virtuous cycle.

GROWTH & INFLATION

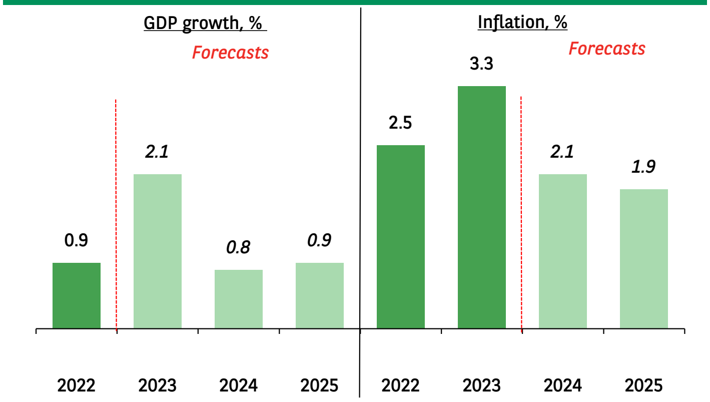


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

With this in mind, the annual wage negotiations (*shunto*), which will take place in the first quarter of 2024, should provide valuable information to BoJ members. The meeting on 18 and 19 March (the first post-*shunto* meeting) could therefore see an initial rate hike, which would bring the curtain down on almost eight years of negative key rates as a result. A second hike is expected before the end of 2024.

Therefore, 2024 is set to be the year of the monetary pivot in Japan. However, this pivot will be in the opposite direction to the anticipated pivots for other central banks, as it will not lead to a rate cut, but instead will involve the first rate hike in 17 years. Exiting the NIRP poses a major challenge for the BoJ, which continued to buy a large amount of government bonds in 2023 as part of its YCC policy. The share of JGBs held by the Japanese central bank, which had exceeded the symbolic threshold of 50% in Q1 2023, stood at 51.5% in Q3. In addition, some institutions, which hold a significant amount of government bonds on their balance sheets, would be potentially exposed to rising bond rates. This is particularly the case for insurance and pension funds, for which government securities account for more than a third of their assets, according to the Flow of Funds data from the BoJ. Ultimately, the BoJ's monetary normalisation, coupled with the start of an easing cycle by the US Federal Reserve and the ECB, is expected to reduce the 10-year yield differential between Japan and other developed economies. This could encourage Japanese investors, who have a strong presence on global bond markets, to repatriate some of their investments to Japan and result in the yen sharply appreciating.

Guillaume Derrien (with Nassim Khelifi, intern)
guillaume.a.derrien@bnpparibas.com

1 BNP Paribas Charts of the Week, Recruitment difficulties intensify in Japan, 10 January 2024
2 Source: Japanese Ministry of Finance. Year-to-date corporate profits, before interest and taxes, stand at JPY 73.2 trillion, a record figure. They account for 12.3% of GDP, which is not far off the all-time high of 12.5% recorded in Q3 2018.

INFLATION FALLS, THE ECB MANAGES EXPECTATIONS

Eurozone activity is expected to pick up moderately in 2024, buoyed by the fall in inflation and the start of a cutting cycle of policy rates, which, according to our forecasts, will take place in April. The labour market continues to surprise on the upside. However, industrial production is falling sharply and remains highly exposed to escalating tensions in the Red Sea and the repercussions on shipping and supply chains. 2024 will see a number of national parliamentary and presidential elections (Finland, Portugal, Belgium, Austria) and the European elections (6 to 9 June), which are likely to redraw the political landscape in the region and the balance of power within the European Parliament.

Growth and employment in the Eurozone held up well overall against the interest rate shock in 2023. In 2024, GDP growth is expected to remain broadly stable or might even slightly increase, according to our forecasts: the German economy is expected to recover, after contracting in 2023, while Southern Europe (Italy and Spain) should once again boost the Eurozone average. As often, French growth is expected to be in line with the average figure, increasing at the same rate as in the Eurozone in this case. At the same time, inflation in the region plunged in the second half of 2023. Its slight increase in December, to 2.9% y/y, was due to unfavourable base effects on the energy component. The decline in a number of alternative indicators (households inflation expectations and the ECB's PCCI index) is an encouraging sign of disinflation, which has been reflected in particular in the upturn in household confidence (European Commission). The latter climbed to its highest level in almost two years in December.

The labour market continues to defy concerns of a downturn, with the unemployment rate holding firm at an all-time low of 6.4% in November. However, while labour market conditions are likely to deteriorate in 2024, any downturn should be small. For the time being, this trend on the labour market remains in line with the movements in the PMI indices, as the employment index has only dipped slightly since August and remained at around the 50 threshold in December (49.7). Over the same period, industrial activity in the Eurozone has continued to lose ground, after being hit hard by a combination of adverse factors: a slowdown in China and heightened trade tensions with Beijing and increased foreign competition in new sectors (the automotive sector most notably). By November 2023, industrial production had tumbled 7.3% from its September 2022 peak. The latest ECB Economic Bulletin[1] once again put forward the assumption that the manufacturing sector is leading services activity in the cycle. Up until now, the manufacturing downturn is only having limited knock-on effects on other activities.

In response to market expectations around the start and scale of interest rate cuts in 2024, ECB members are looking to play for time. Robert Holzmann, governor of the Austrian Central Bank, who is seen as a "hawk", has even said that the start of the cycle of rate cuts may not happen before 2025 if the tensions in the Middle East were to escalate and their economic repercussions were to worsen[2]. Given the evolving situation in the region, and the initial tangible effects on maritime freight, this scenario unfortunately cannot be completely ruled out. However, the ECB does not believe that inflation will land on its 2% target quickly, which implies that there will be a rather protracted cycle of rate cuts (higher for longer scenario).

GROWTH & INFLATION

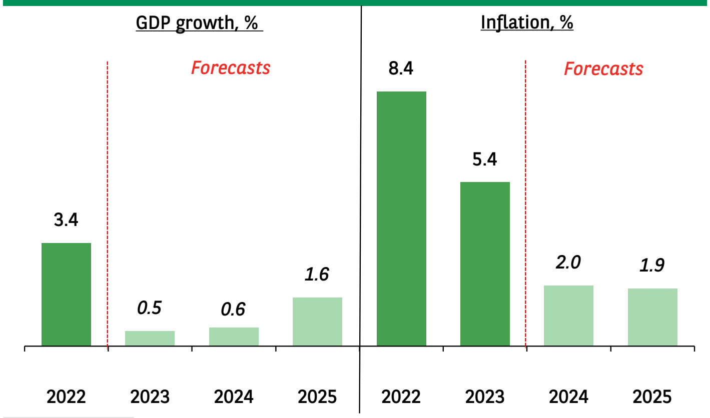


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Its latest macroeconomic projections, dating from December, suggest that inflation will not feasibly return to its target before the second half of 2025, which means that the disinflation phase will be much slower than what we are anticipating. Based on our forecasts, we foresee this to happen in the middle of 2024.

At its most recent monetary policy meeting in December, the ECB also decided to accelerate its quantitative tightening, by starting to reduce its PEPP portfolio by an average of EUR 7.5 billion per month from the second half of 2024, before discontinuing reinvestments under the programme from January 2025. This programme, which was established at the beginning of the COVID-19 pandemic in April 2020, has been substantial, as the total assets held under the PEPP (EUR 1.67 trillion) account for a quarter of the ECB's balance sheet in January 2024, which stands at around EUR 6.9 trillion. Assets held through the public sector purchase programme (PSPP), which is the largest component of the asset purchase programme APP (which was introduced in March 2015 and from which its repurchases discontinued in December 2018), amount to EUR 2.4 trillion, which is just over a third of the ECB's balance sheet.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 See Monetary policy and the recent slowdown in manufacturing and services, ECB Economic Bulletin, January 2024
2 See ECB's Holzmann Warns Rate Cuts Aren't Guaranteed This Year, Bloomberg, 15 January 2024

GERMANY

WHEN WILL GROWTH RETURN?

The cyclical slowdown in the German economy, which is similar to the one being experienced in the Eurozone, is part of a longer-term stagnation, with Q3 2022 standing out as the last quarter with significant growth. Even so, this figure is biased upwards, as the period benefitted from the post-Covid rebound. While the rise in energy prices was steep enough in 2022 to highlight the clear weaknesses of the German economy, which is specialized on energy-intensive sectors, some of these weaknesses had existed earlier. Against this backdrop, the prospect of a return to growth, which is our scenario for spring 2024, due to the drop in inflation in particular, is still shrouded in deep uncertainty and downside risk.

The German economy can be described as in a protracted period of stagnation, with growth missing since Q4 2022. Destatis' preliminary estimates even give a negative figure for the fourth quarter of 2023 (-0.3% q/q) and for 2023 overall (-0.1%).

Household consumption (which is lower than pre-COVID levels unlike a number of European countries, including France) and exports are just two of the poorly performing areas and have both followed the same downward trajectory as GDP since Q4 2022. Demand (both internal and external) is therefore declining, as confirmed by the European Commission's survey, which stated that, in Q4 2023, demand was a factor limiting production for 23% of industrial companies (+10 points in 6 months).

Of course, Germany, like its partners in the Eurozone, is suffering as a result of the consequences of the inflationary shock. It is therefore selling less both in the country itself and in its neighbours and, at the same time, it is beginning to see sales decline outside of the Eurozone, particularly in China (an 8.6% y/y decrease in exports in nominal terms over the first 11 months of 2023). China's willingness to opt for subsidised local production over imports is well known, and this will be further strengthened by the lead taken by Chinese manufacturers in developing electric vehicles.

GROWTH & INFLATION

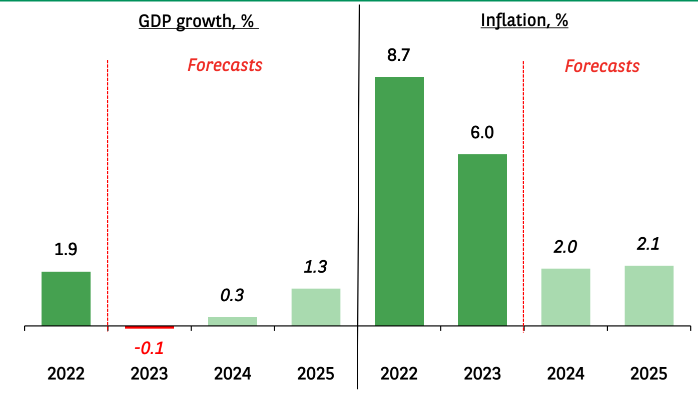


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

THE WORST HAS PASSED (OR HAS IT?)

Germany experienced some of the fastest disinflation out of all countries in 2023, notably because of a favourable base effect (energy prices were largely passed on to consumer and producer prices until November 2022 before dropping sharply), but also because inflationary momentum has largely faded away since the end of 2022. As a result, inflation (harmonised index) plunged from its peak of 11.6% y/y in October 2022 to 3.8% y/y in December 2023 (and 6.4% last August). More specifically, seasonally adjusted data show that prices only increased by 0.6% between June and December 2023 (compared to 3.1% between December 2022 and June 2023, and 3.6% between June and December 2022). Inflationary momentum has therefore disappeared.

Business climate surveys (IFO and ZEW) displayed a slight improvement, on the expectations component, giving credence to the idea of a future cyclical upturn. However, these expectations are still tentative and have been triggered by anticipated monetary easing. Although our central scenario includes a first policy rate cut by the ECB in April (by 25 basis points, with a total of 125 bp expected in 2024), when combined with falling inflation, will it be enough to kickstart German growth?

After all, there are still headwinds, not least because budgetary policy is expected to weigh on activity. Therefore, the ruling from the Karlsruhe Constitutional Court, which led to items which up until now were accounted for outside the budget being reintegrated into German public finances, did not alter the decision to reinstate the rule limiting the budget deficit to 0.35% of GDP from 2024. This resulted in some budgetary support being abruptly withdrawn, most notably some of the support for greening the economy, including an aid programme for purchasing electric vehicles being curtailed earlier than planned. This ruling and the decisions taken in response to it have dented consumer confidence, which has barely recovered despite the recent disinflation and runs counter to the trends seen in other countries: the balances of opinion among German households on the economic situation were still significantly below their historical average for both the last 12 months (-42) and the next 12 months (-29) in the European Commission's survey in December 2023.

However, disinflation could well boost optimism among households, with the balance of opinion in the GFK household survey on willingness to buy bouncing back to -8.8 in December from -15 in November (a level where the indicator had been hovering for 18 months).

MAKING UP FOR LOST TIME IS HUGELY DIFFICULT

Any rebound is expected to be cyclical. From a structural standpoint, the factors that have caused Germany to underperform compared to its European neighbours for nearly 6 years are still there. Greening the economy is a big challenge for the country to be delt with as soon as possible, in that it profoundly calls into question the established order and the German economy is still specialized on energy-intensive sectors that emit CO2, including the automotive, chemical and metal industries. One of the risks for the country is that the drop in emissions goes hand in hand with a more pronounced wave of de-industrialisation (and offshoring) than the one that has already taken place, as measured by the drop in industrial production capacities between the end of 2017 and the end of 2023, which we estimate at -6%.

According to Agora Energiewende, CO2 emissions from German industry fell by 12% in 2023, a phenomenon that the think tank states is primarily due to the concomitant reduced manufacturing output, particularly from energy-intensive sectors (with chemicals and pharmaceuticals down 8.2% y/y, and wood and paper down 13.4% y/y over the period from January to November 2023).

Stéphane Colliac
stephane.colliac@bnpparibas.com

FRANCE

STRENGTHS AND WEAKNESSES OF GROWTH

French growth weakened in 2023, as evidenced by the low figures for the business climate indicators in December. However, 2024 should kickstart the road to recovery. The major drop in energy prices from the levels seen at the start of 2023 will contribute to inflation continuing to fall, which is not expected to be jeopardised by most of the price-cap mechanism still in place for electricity being removed. The upturn in real wages, the healthy state of the aeronautics sector and the continued greening of the economy should enable a soft landing for growth in 2024, with an annual average figure of +0.6%. The expected slight rise in unemployment and the more pronounced increase in business insolvencies pose downside risks, however.

French GDP growth slowed down significantly in 2023, with an annual average of +0.8% according to our estimates, following on from 2.5% in 2022. It even fell to -0.1% q/q in Q3 (according to the data available at the time of writing). Although this negative GDP growth can partially be framed as a correction after the good Q2 performance (+0.6% q/q), particularly in terms of aeronautics and shipbuilding exports, growth was still considerably weaker in 2023 all the same. This was due to weak growth in household consumption (with inflation affecting food consumption in particular) and a drop in household investment. Conversely, corporate investment and foreign trade (with rebounds in aeronautics and electricity generation) boosted growth.

A TALE OF REBOUNDS AND A PROGRESSIVELY GREENER ECONOMY

We believe that a couple of rebound effects stimulated growth in particular in 2023. The first rebound effect (adding 0.35 pp) relates to electricity. The production fall had resulted in France becoming a net importer in 2022, taking 0.4 points off growth. In 2023, it managed to be again a net exporter. The second rebound effect (adding 0.3 pp) relates to aeronautics exports. While the rebound effect from electricity generation seems to be a one-off, this second rebound effect is expected to be longer-lasting and to add another 0.3 points to French growth in 2024 too (if Airbus achieves its target of higher deliveries).

The transitions that France must successfully navigate should provide another prolonged boost to growth. First of all, there is the digital transition, which can be harnessed through corporate investments in information and communications, which we estimated grew by nearly 8% in real terms in 2023, thereby adding 0.3 points to GDP growth. Secondly, there are the efforts to green the economy, which are already having an impact. Electric vehicles made up more than half of the 15% increase in car registrations in 2023. At the same time, the renewable energy sector accounted for a third of the growth in electricity generation in 2023 and also boosted manufacturing output, with a 66% y/y annual average increase in engine and turbine production (excluding aircraft and vehicle engines) at the end of November. However, works to improve the energy performance of buildings, experienced a slowdown in volume terms over the first 3 quarters of 2023 (+2% y/y, following on from +3.8% in 2022) according to the French Confederation of Craftspeople and Small Construction Companies (Confédération de l'Artisanat et des Petites Entreprises du Bâtiment - CAPEB).

As renovation work on a building often goes hand in hand with the sale of a property, the fall in the number of sales (928,000 cumulatively over 12 months at the end of September 2023 compared to 1,138,000 a year earlier) likely contributed to this slowdown.

The budgetary support for greening should be sustained. France's "green budget" is enjoying additional financing, with a EUR 7 billion increase in spending on environmental planning (by allocating some of the money paid in as a result of the planned rise in gas and electricity taxes). This allocation should result in a significantly less procyclical French budget than in 2012-13, when the government was looking to sharply reduce the deficit against the backdrop of declining growth.

LESS INFLATION, BUT MORE INSOLVENCIES

In Q3 2023, France was still one of the countries where prices were rising faster than wages (with basic monthly salaries rising at 4.2% y/y and inflation rising at 4.7% y/y, according to the French National Institute for Statistics and Economic Studies CPI). While France had curbed its inflation more than its Eurozone neighbours in 2022 (due to the energy price cap), it experienced slower disinflation in 2023, with higher increases in gas and electricity prices (due to the energy price cap being partially phased out). Even though wage growth is expected to slow between 2023 (+4.4% for the basic monthly salary) and 2024 (+2.8% according to our forecasts), it is expected to outstrip average inflation (+2%), which would provide a boost for household consumption in 2024.

At the same time, companies have seen their costs rise. While energy prices and wages have contributed to this, this increase is also evident in volume terms, as their intermediate consumptions (IC) in volume terms stood at an unprecedented 52% of production in 2023 (over the first three quarters). This increase in the ICs explains the rather unusual and significant discrepancy between the growth in gross production (+1.7% y/y over the first 3 quarters) and the growth in sectors' gross value added (+1.1% y/y).

As the shock caused by high inflation dissipates, the shock on interest rates will continue to have an impact in 2024, albeit an expected progressively weaker one as the year goes on. However, the downturn in building sector activity, is expected to deepen, following the sharp decrease in order backlogs in 2023. It has already had a knock-on effect on business insolvencies. According to data from Banque de France, in Q4 2023, business insolvencies exceeded their Q4 2019 level by almost 25% in the building sector (a figure which also applies overall), hitting a level that has only been exceeded on two other occasions: between Q4 2008 and Q1 2016, and between Q4 1992 and Q2 1994. In 2022, Altarès had estimated that insolvencies threatened 143,000 jobs, equating to 3.4 jobs per insolvency. In 2023, 240,000 jobs were at risk, equating to 4.2 jobs per insolvency. This is a Damoclean sword posing an upside risk to the slight rise in the unemployment rate that we are forecasting (with the unemployment rate reaching 8% at the end of 2024, compared to 7.4% in Q3 2023) and which would prompt households to increase their saving rate(after already saving 17.4% of their gross disposable income in Q3 2023).

Stéphane Colliac stephane.colliac@bnpparibas.com

GROWTH & INFLATION

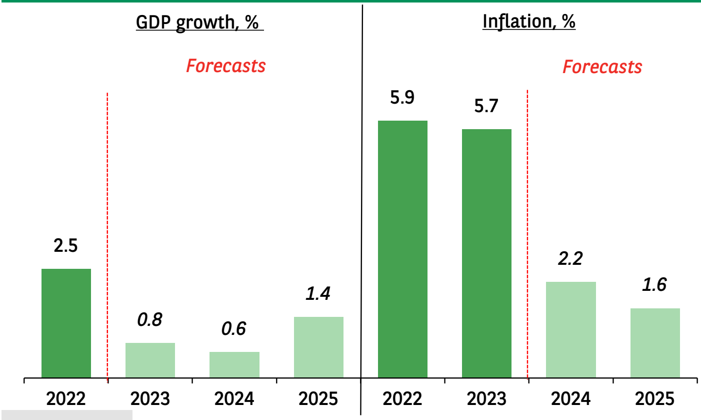


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

ITALY

A SLOWER AND MORE UNCERTAIN RECOVERY

In 2023, the recovery of the Italian economy slowed in a somewhat bumpy way. On the one hand, after supporting the first part of the recovery, fixed investment declined. But on the other hand, consumption surprised on the upside (+1.5% with respect to Q4 2022). Italian households benefited from both a significant improvement of labour market conditions and deceleration of inflation. Consumer confidence recovered, supporting private expenditures. In Q4 2023, inflation marked a decisive slowdown: the declining trend is mainly due to the deceleration of energy prices (up +1.2% on average in 2023 compared to +50.9% in 2022).

DECLINING INVESTMENT, REBOUNDING CONSUMPTION

In 2023, the recovery of the Italian economy slowed in a somewhat bumpy way. Real GDP rose by 0.6% q/q in Q1, declined by 0.4% q/q in Q2 and then slightly increased in Q3 (+0.1% q/q). Although the annual growth rate fell to 0.1%, GDP is still almost 3.5% higher than in Q4 2019, more than in other Eurozone countries.

In the first three quarters of 2023, net exports' contribution was negative, as exports declined more than imports. From January to October, the value of Italian sales abroad, which had increased by about 20% both in 2021 and in 2022, rose by only 1% annually, reflecting the slowdown of global trade and the disappointing evolution of the German economy.

After supporting the first part of the recovery, fixed investment declined. Spending on construction was affected by the phasing out of the building improvement incentives introduced during the Covid-19 crisis, while spending on machinery and equipment declined as a consequence of the deterioration of firms' profitability. Italian non-financial corporations suffered from rising interest rates, higher producer prices and labour costs, with the gross profit share falling to 42.5% in Q3 2023.

During the summer months, consumption surprised conversely on the upside, rising by about 1.5% with respect to Q4 2022. Italian households benefited from both a significant improvement of labour market conditions and deceleration of inflation (see below). In Q3, the employment rate rose to 61.5%, the highest level in the last twenty years. The number of employed people increased by 535,000 compared to Q4 2019, due to the growth in permanent employees, which more than offset the decline in both temporary employees and the self-employed. Households' gross disposable income rose to €331 billion, with purchasing power increasing by almost 4% in the last three quarters. Consumer confidence recovered, going well above long-term average, supporting private expenditures too.

INFLATION MARKS A DECISIVE SLOWDOWN

In the last quarter of 2023, inflation showed a decisive slowdown in Italy. After the +1.7% and +0.7% y/y recorded, respectively, in October and November, preliminary estimates in December showed inflation measured on the national basket (NIC) growing by only 0.6% y/y (it was +11.6% in December 2022). On average, consumer prices in Italy grew by 5.7% in 2023, from 8.1% in 2022. The declining trend is mainly due to the marked deceleration of energy prices (up +1.2% on average in 2023 compared to +50.9% in 2022). On the contrary, food prices accelerated further, rising +9.8% (from +8.8% in 2022), mostly due to the increase recorded in the first half of the year. In 2023, core inflation was 5.1% (from +3.8% in 2022).

In Q3 2023, house prices stagnated on a quarterly basis, although they grew on a yearly basis (+1.8% y/y from 0.7% in Q2 2023 according to Istat data).

GROWTH & INFLATION

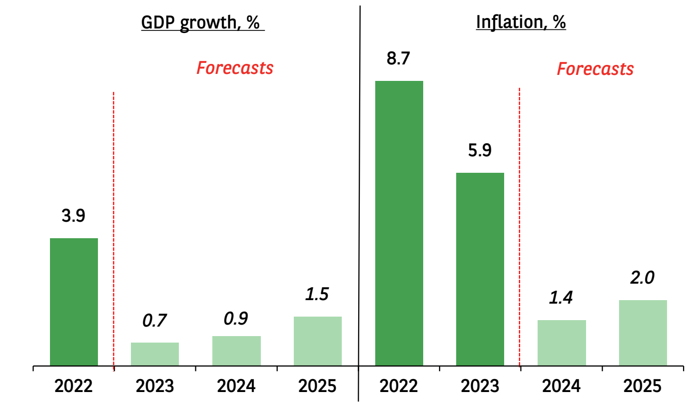


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

This trend is due to the strong increase of new house prices (+8% y/y from +0.6% in Q2 2023), which however barely account for 18% of the housing stock in Italy. The price of existing housing only grew by 0.5% y/y (+0.7% in Q2 2023). The carryover effect for 2023 is +1.3% (+4.7% for the new houses and +0.6% for existing). According to Bank of Italy's estimates, in Q3 2023, real housing prices have been negative for the seventh quarter in a row (-3.6% y/y). The slowdown in headline inflation recorded since September, however, has turned the quarterly change of real prices into the positive range (+1.5%) for the first time since mid-2022. On the transaction side, Italy's housing market remains depressed: in Q3 2023, volumes declined by 9.8% y/y on a national basis.

Paolo Ciocca
paolo.ciocca@bnlmail.com

Simona Costagli
simona.costagli@bnlmail.com

SPAIN

HOUSEHOLD CONSUMPTION REMAINS THE PRIMARY GROWTH DRIVER

In Q3 2023, Spanish growth eased slightly to 0.3% q/q. It was primarily driven by household consumption, which was itself supported by the resilience of the labour market and the increase in real wages. After an increase in H2 (from 1.6% y/y in June to 3.3% in December according to the harmonised price index), inflation is expected to fall again in 2024 and drop below the target of 2% in Q3. We expect growth to remain moderate at the end of 2023 and in early 2024 (0.2% q/q), before returning to positive territory. Spain will remain one of the drivers of the euro area for another year, with expected growth of 1.5% on an annual average versus 0.6% for the euro area.

The end of 2023 in Spain was marked by political news. Four months after the early general election and Alberto Núñez Feijóo's failure to win the investiture vote of the Spanish Congress of Deputies, Pedro Sánchez was, in the end, reappointed as head of government. This re-election was made possible by the support of the regional parties – including the Catalan independentists – and also by the coalition agreement negotiated between the Socialist Workers' Party (PSOE) and the left-wing alliance, Sumar. Nevertheless, risks of political instability remain, as the government's minority position in Parliament makes it vulnerable to the demands of the small parties in opposition.

Parliament's approval of extending into early 2024 the anti-crisis fiscal measures in place since November 2022also came with surprises. These measures include a gradual increase in energy taxes but a continuation of the reduction in VAT on staple foods, an extension for another year of the discount on urban transport fares, and an extension of the mechanism allowing households with variable-rate mortgages to restructure their loans at fixed rates without incurring additional fees. Although these measures are expected to disappear in the first half of the year, they will help to maintain moderate inflation and support households.

The annual growth rate of the Harmonised Index of Consumer Prices (HICP) has slowed significantly compared to 2022 (-4.9 pp over one year, to 3.4% as an annual average). As deflation of energy prices – the main factor in the price slowdown this year – subsided in H2, headline inflation rose again in Q4: in December, it stood at 3.3% y/y, higher than that of the euro area (2.9%).

THE LABOUR MARKET HAS PROVED RESILIENT THROUGHOUT THE YEAR

The 2021 labour market's reform continues to bear fruit. The rise in employment goes on (+700,000 over a year in Q3 2023) and is generating a drop in the number of unemployed (2.7 million in December, -130,000 over a year). Although still the highest in the euro area, the Spanish unemployment rate reached its lowest level in 15 years (11.9% in December). The growth rate of average pay negotiated in industry agreements (+3.5% y/y in November 2023) was once again above inflation. This return to real wage growth in positive territory is helping sustain economic activity, primarily in the services sector. The associated activity PMI index improved again in December and returned to levels seen five months ago (51.5). Employment prospects in the sector are positive too: according to the European Commission survey, companies are expecting rising employment over the next three months. The construction sector is also reporting production constraints due to labour shortages (highest level since 2015). As a result, although companies' hiring trends may be affected by rising labour costs (+5.7% y/y in Q3 2023), we are expecting good employment prospects for 2024.

GROWTH & INFLATION

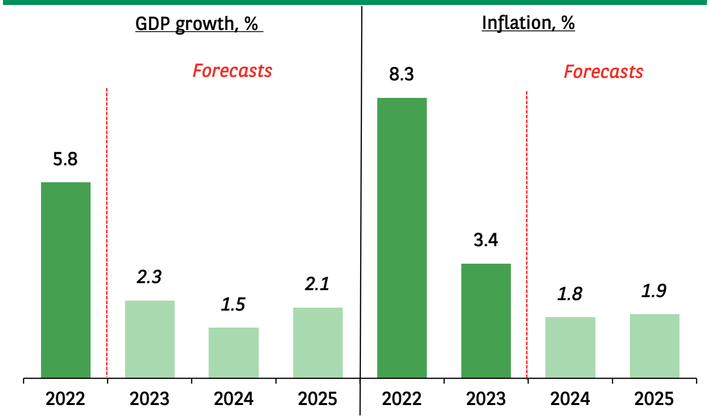


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

CONSUMPTION, THE PRIMARY GROWTH DRIVER

In 2023, household final consumption expenditure was the driver of Spanish growth. This is expected to continue in 2024, given the recovery in retail sales recorded in November (+0.9% m/m, 5.3% y/y) and the improvement in consumer confidence observed since September 2023 (+4.4 points over three months according to the European Commission survey). Foreign consumption is also expected to contribute positively to activity this winter. Since June 2023, the number of tourists has again exceeded its pre-Covid level. This will support exports of goods and services, as well as the GDP. According to our forecasts, Spanish growth will be +0.2% q/q in Q4 2023 and Q1 2024. For 2024 as a whole, it should remain higher (+1.5%) than euro area's growth (+0.6%).

THE HOUSING MARKET IS STARTING TO FEEL THE DELAYED EFFECTS OF MONETARY TIGHTENING

The housing market is once again becoming a weak point for the Spanish economy. The delayed effects of monetary tightening are starting to emerge. The rise in interest rates and the tightening of lending standards led to a 3.7% drop in one-year loans issued to residents in November. Combined with the continued rise in property prices (+4.2% y/y in November according to Tinsa), this resulted into a fall in the number of transactions (-28,550 in Q3 compared to Q2, i.e. a return to levels seen in Q1 2021). Nevertheless, the fall in interest rates expected during 2024 should gradually ease the tensions observed on the market.

Lucie Barette lucie.barrette@bnpparibas.com

NETHERLANDS

MIXED OUTLOOK IN 2024 BUT BETTER THAN 2023?

The country fell into recession during 2023, like in Germany across the border, but 2024 is expected to be better as the future government will have the financial resources to revitalise the economy. A little bit of patience will be needed though for things to settle down. The Dutch economy remains heavily exposed to the global environment, which is very tense at the start of this year.

A new government is currently being formed against the backdrop of an economic downturn. The country has already posted three quarters of negative growth, and there is every reason to believe that the future will remain bleak for some time to come. The Netherlands is in recession, just like Germany, and, with an economy heavily exposed to the global environment, the country's growth is likely to be lacklustre in 2024. Its principal export markets are expected to slow down this year, such as its neighbours in Europe, the United States and even China.

Dutch GDP started to decline in the first quarter of 2023, bringing the country into recession in the autumn. For the year as a whole, growth will therefore be very low but we are expecting a slight improvement in 2024, with growth standing at +0.7%, thanks to the measures to support purchasing power that the new government is expected to take once it has been formed. The labour market also remains buoyant, with the unemployment rate still very low (3.6%) and wages likely to remain high. Consumer confidence, which was severely shaken by the 2020 pandemic, is currently improving somewhat, aided by the noticeable slowdown in price rises and the prospects of rate cuts.

External demand is a determinant factor influencing growth in the Netherlands as the economy is extremely open to the rest of the world. The sum of exports and imports is about double the GDP. The deteriorating international environment severely impacted exports and imports, which fell by almost 4% in volume over 2023, after their remarkable growth in 2021 and 2022, with increases close to 15%. However, the country was able to continue to record a large trade surplus, close to EUR 11 bn in 2023 compared with EUR 6 bn in previous years. The current account surplus also improved from 5% of GDP in 2020 to 10% in 2023.

A SHARP DROP IN INFLATION

Inflation has been falling sharply since October 2022, in line with the drop in energy prices on global markets. It had peaked at 17% y/y in Autumn 2022 (according to the Eurostat harmonised inflation measure), but quickly began to ease, meaning that 2023 ended with prices rising at a rate of close to 1%. Core inflation continues to be higher, as is the case in several other European countries, not least because inflation in the services sector is proving to be more stubborn than expected. However, it had fallen from its peak of 8% to 3.3% in December 2023. Disinflation should continue in 2024 and we are expecting an average inflation rate of close to 3%, compared to 4.1% on average in 2023.

REAL ESTATE IS STRUGGLING, BUT THIS WILL ONLY BE TEMPORARY

Residential real estate has experienced severe disruptions throughout the year, in response to rising interest rates. Buyers have become cautious, with banks also becoming risk-averse, leading to a slight dip in prices, after having skyrocketed in 2020 and 2021. As 2023 has ended with bond interest rates easing nicely, real estate has already seemingly recovered slightly in several countries, including the Netherlands. Depending on how events play out on financial markets in 2024, this trend could continue, and the construction sector could see its prospects improve. The entire Dutch economy could enjoy a slight upturn, especially if, as the markets anticipate, the European Central Bank ends up easing its monetary policy, thanks to improved inflation figures.

GROWTH & INFLATION

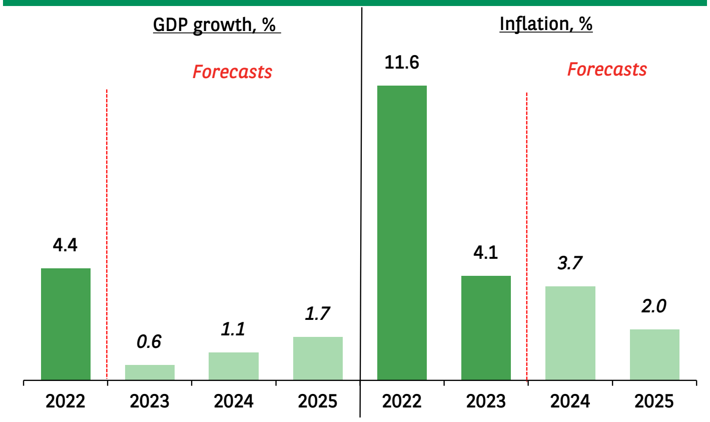


CHART 1

SOURCE: EUROPEAN COMMISSION (NOVEMBER 2023), BNP PARIBAS

On the other hand, corporate investment got off to a promising start in 2023, before things took a turn for the worse as a result of deteriorating confidence among business owners, who were daunted by the poor global economic climate and rising borrowing costs. Ultimately, investment is estimated to have increased still by around 3% over the entire year, which is significantly higher than in 2022 (1.8%). By contrast, 2024 is shaping up to be trickier, as it will take time for the effects of the interest rate hikes started in 2022 to subside and a great deal will depend on how global factors play out against a tense geopolitical backdrop.

SHIFTING TOWARDS A SLIGHT FISCAL DEFICIT

Finally, it should be noted that the country has large financial resources in order to support economic activity if needed, as public debt is close to 50% of GDP, while the budget deficit is virtually non-existent. The future coalition will undoubtedly allow a slight fiscal deficit: a figure close to -2% of GDP is often mentioned. This may seem high to Dutch citizens, but it should be put into perspective against the deficit levels seen more widely across Europe.

Sylviane Delcuve
sylviane.delcuve@bnpparibasfortis.com

BELGIUM

DOUBLE SHOCK INDUCES FUTURE-PROOFING INVESTMENTS

The Belgian economy looks set to grow at its current trend rate for the next few quarters. Despite a challenging international environment, characterised by restrictive monetary tightening combined with economic slowdowns in key trading partners, the economy has held up remarkably well. Consumer spending, supported by wage indexation, and robust investment are leading the charge. Capex expenditures are directed towards automation and climate transition in the wake of energy and labour costs hikes.

The Belgian economy has managed to experience a soft landing so far. After fears of a recession or at least a slowdown in growth for much of 2023, the Belgian economy now appears to be growing at or close to trend rates. In fact, it is one of the few EU countries to have avoided a single quarter of negative GDP growth since the start of 2022. The main drivers? Private consumption and business investment.

PRIVATE CONSUMPTION HAS BEEN WELL SUPPORTED

Belgian inflation, as measured by the Harmonised Index of Consumer Prices (HICP), peaked at 13.1% y/y in October 2022. Unique to this economy is its system of purchasing power protection: the health-index, an alternative measure of prices, reached a similar high level at around the same time, leading to automatic wage indexation. The rise in wage costs is weighing on international competitiveness in the short term (more on that below) but it provides a significant support to household disposable income. The National Bank (NBB) also reports that tax cuts had a further positive impact on purchasing power last year, thanks to the "bracket creep" (brackets rise slower than incomes, powered on by inflation). In 2022, more income (already indexed) ended up in higher tax brackets (not yet indexed). In 2023, the reverse happened; brackets rose faster than income so that a smaller share of income was taxed at the highest rates. As a result of all these developments, private consumption quicky picked up speed and has been humming along throughout 2023, growing at an average quarterly rate of 0.3%. In fact, the only component of GDP that has outpaced it in recent quarters is business investment.

BUSINESS INVESTMENT HAS BEEN EVEN STRONGER

When the ECB began its rate hiking cycle in mid-2022, dark clouds seemed to be gathering over Belgian companies. It looked like a perfect storm with rising financing costs, soaring energy prices, and increased labour costs as a result of the aforementioned wage indexation. Bankruptcy-rates, which at the time were still 20% below pre-covid levels, would surely rise rapidly.

Those fears turned out to be exaggerated. A recent in-house study, based on aggregated inflows and outflows on the bank accounts of corporate clients, underlined the remarkable resilience these firms displayed throughout the shocks, with activity levels across a wide range of sectors barely budging.

Indeed, higher energy costs did not seem to have much of a material impact on companies, as they were able to adapt quickly. Nor did the increase in labour costs. Of course, international competitiveness was on the decline. Compared with neighbouring countries, the cumulative wage gap since 2019 amounted to 4 percentage points in 2023. However, according to the NBB, wages in France, Germany, and the Netherlands will have fully caught up by 2026. Furthermore, an historical analysis of the labour cost shocks in our country suggests that companies usually take the hit in profits rather than reducing activities and employment.

GROWTH & INFLATION

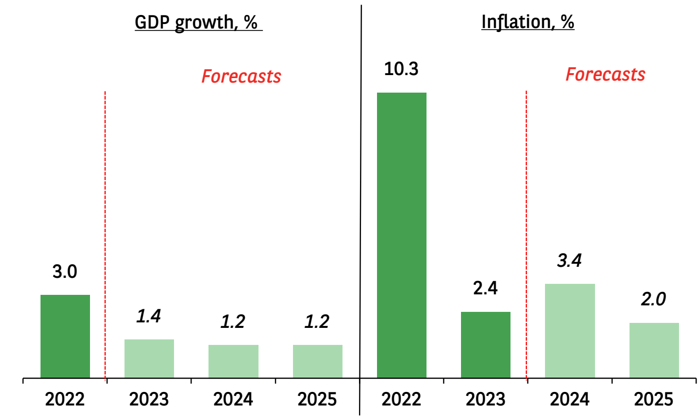


CHART 1

SOURCES: BNP PARIBAS FORTIS

The result? At the end of 2023, bankruptcy rates are still 5% below their pre-covid levels. Certain sectors, such as construction and transportation, overshot their trend rates. For the economy as a whole however, companies have weathered the labour/energy-price shock better than expected. This leaves only the financing shock.

Interestingly, a recent study by the NBB examined the extent to which Belgian companies benefited from three decades of declining interest rates. In addition to lower financing costs, Belgian firms improved their equity positions and cash buffers. Surprisingly, their investment rate did not increase significantly as a result, though remaining higher than the euro area average since around 2010. And this gap was once again evident from the summer of 2022 onwards.

Since then, gross fixed capital formation (GFCF) by Belgian firms grew at an astounding 2.5% per quarter, almost double its trend, seemingly unhindered by rising rates. However, over the same period, household investment (in dwellings) declined by more than 1% per quarter. The higher interest rate environment is proving to be less of a binding constraint on businesses as they source intercompany funding or draw down cash reserves.

So, what is the driving force behind this strong investment activity? Its roots seem to lie in the labour/energy-shock. Companies are investing mainly in digitalisation and automation in response to higher wage costs and labour shortages. They are also investing in the greening of production processes in order to reduce their exposure to energy price volatility and to comply with environmental regulations. With interest rates set to fall in 2024, we can expect this investment boom to continue for a while longer.

Arne Maes
arne.maes@bnpparibasfortis.com

GREECE

THE RECOVERY CONTINUES

Greece is expected to enjoy economic growth once again in 2024, but activity showed signs of slowing down in the second half of 2023. Real GDP stagnated in Q3 2023 and employment fell by 0.5% q/q. While strong tourism activity, against a backdrop of high inflation, is boosting tax revenue, its impact on real GDP is more muted. The sharp drop in the unemployment rate (which is now below 10%), the drastic improvement in public finances and the decline in public and private debt testify to Greece's solid recovery, which has been welcomed by the rise in equity and bond markets, and by the sharp tightening of spreads between Greek sovereign debt and the German Bund. However, the country is still grappling with long-term challenges and others are getting tougher to overcome: unfavourable demographic and investment dynamics are holding back potential growth, while the surge in property prices is fuelling new social risks.

The rebound in post-COVID activity has enabled the Greek government to combine economic growth and fiscal consolidation. Indeed, the country has weathered the successive shocks in Europe in recent years very well. In the third quarter of 2023, real GDP was more than 6% above the level recorded in the final quarter of 2019, which is double the figure for the Eurozone (3.0%). However, real GDP stalled last summer (0% q/q in Q3), held back by of a drop in household consumption (-0.4% q/q) and investment (-1.8% q/q). However, in 2024, economic activity is expected to benefit from the recent labour market recovery and the fall in inflation, which, after peaking at more than 12% y/y in summer 2022, fell back to 3.5% in December. The unemployment rate also dropped below 10% last autumn, dipping to 9.4% in November 2023, the lowest level since June 2009. Short- and medium-term trends thus remain encouraging and growth is expected to stay above 2% in 2024, according to the European Commission's November 2023 forecasts.

However, this recovery is fraught with risks: after a long correction phase, which lasted for almost eight years (2009-2017), property prices in the country have turned higher very sharply again, and rising interest rates did not reverse this trend in 2023. In fact, quite the opposite happened, as the increase in housing prices is now the fastest in the Eurozone, standing at 12% year-on-year in the third quarter of 2023[1]. Athens has become the European capital with the highest property inflation[2], and average prices sit just 3% below the 2008 all-time high. In response to this housing prices inflation, last year the government decided to tighten the eligibility requirements for residence permits for investment activity (also known as «golden visas»). Since the start of August 2023, the property investment threshold required to qualify for these permits has been doubled and now stands at EUR 500,000.

However, the longer-term outlook of the Greek economy continues to be clouded by unfavourable demographics, a stagnating working-age population and relatively low investment rates compared to other Eurozone countries. GDP per capita is still far lower than it was just before the 2008 financial crisis (nearly 17% below the 2007 level, according to Eurostat) and the gap with the euro area average, which had widened during the European sovereign debt crisis, only narrowed slightly in 2021 and 2022.

FISCAL CONSOLIDATION REMAINS A PRIORITY

The improvement in public accounts has undoubtedly been one of the most noteworthy underlying dynamics in Greece. After posting a primary deficit of 10% of GDP at the height of the Eurozone crisis, Greece recorded a primary budget surplus of 0.1% in 2022. This surplus is expected to have widened further in 2023: over the first eleven months of 2023, the General government primary surplus stood at EUR 6.3 billion, compared to EUR 3.7 billion during the same period in 2022.

GROWTH & INFLATION

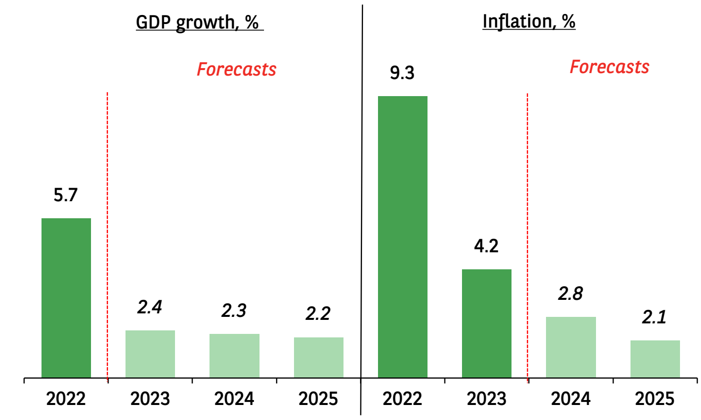


CHART 1

SOURCE: EUROPEAN COMMISSION (NOVEMBER 2023), BNP PARIBAS

Despite rising interest rates, the turnaround in the government accounts will reduce public debt significantly in 2023. The debt ratio stood at 167% of GDP in Q2 2023 and is expected to fall further in 2024, underpinned by the positive growth prospects. The Greek government also intends to use some of its cash reserves to repay in advance nearly EUR 16 billion of its debt to the European Stability Mechanism (ESM), which will help to accelerate the country's debt reduction.

After retaining his absolute majority in the Greek Parliament, Kyriákos Mitsotákis and his New Democracy party emerged strengthened from the Parliamentary elections on 25 June. He intends to continue the privatisation programme aiming to reduce government debt. Despite falling sharply over the past two years, the debt ratio is still currently the highest in Europe. In order to reach its objective, the Hellenic Financial Stability Fund (HFSF) is gradually withdrawing from the capital of the national banks that it had integrated during the sovereign debt crisis in order to keep the sector afloat. All of these measures, aiming at rebalancing the public accounts and liberalising the economy, have reassured the markets and have reduced the risk premium on Greek sovereign bonds. 10-year rates have fallen below the Italian rates since last spring and the spread between Greek and German rates has narrowed to just 100 basis points in January 2024.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 See BNP Paribas EcoConjuncture The residential property market in the euro zone put to the test of monetary normalisation, 17 January 2024.
2 See Athens Home Prices Are Surging Faster Than Other European Cities, Bloomberg, 17 November 2023.

UNITED KINGDOM

IN SEARCH OF A SECOND WIND

The UK economy is flirting with recession. The downturn in activity in the second half of 2023 is expected to continue until spring 2024 before an expected sluggish recovery, which nonetheless will be supported by the Bank of England (BoE) beginning its monetary easing cycle. Despite an uptick in December 2023, inflation remains on its downward trajectory, which is clearly reflected in production prices and CBI surveys. The turnaround in the labour market, which is still muted, is helping to reduce upward pressures on wages. While this is good news for inflationary momentum, it is also weakening private consumption. The BoE has little room for manoeuvre, with an initial policy rate cut expected to occur in June 2024. However, monetary easing is expected to be slow, with a drop of one percentage point (5.25% to 4.25%) anticipated in 2024.

Following a real GDP contraction of 0.1% q/q in Q3 2023, the ONS monthly figures indicate stagnating activity in October and November, and there is little sign of an upturn in December. Household consumption, impacted by the inflation crisis and the (moderate) deterioration of the labour market, fell in December. Retail sales (excluding fuel) were down 3.1% m/m in real terms in December, the sharpest monthly drop in three years. The end-of-year distortions of consumption patterns, caused by Black Friday, are not the sole cause for this decline, as retail sales fell 0.8% q/q over the entire last quarter.

Inflation rose slightly in December, to 4.0% year-on-year, but remains on a downward trajectory. The 3m/3m annualised rate for the CPI dipped below 1% in December, which clearly underlines the weakening price dynamics over the past few months, which will gradually materialise in the year-on-year rate. In addition, companies' production prices are not indicating that inflation is picking up again, as the fall of these prices, excluding energy, accelerated in December, taking it to -2.8% y/y. Consumer price disinflation is expected to continue during the first half of 2024, driven mainly by the slowdown in non-energy goods (food and household equipment). At the same time, although the deceleration in services prices will continue, it is expected to be more limited, once again due to sustained wage growth (see below).

Even though falling inflation should buoy consumption, a greater deterioration in the labour market would curb these effects. Its turnaround is seemingly muted so far, with the unemployment rate plateauing at 4.2% this autumn, after rising in Q2. However, the current recruitment trends are still difficult to analyse, as the Labour Force Survey (LFS) traditionally used by the ONS has been suspended since October 2023, due to statistical issues caused by falling response rates. The figures currently published are based on payrolls data and will be subject to substantial revisions. The ONS will start publishing the new LFS from spring 2024. Wages and job vacancies data continue to be updated as they come from different sources. A decline in this second indicator can be observed, and it is significant in a quarter of sectors, mainly in services (retail sales, transport and warehousing, information and communication), where the number of new vacancies has fallen below 2019 levels). The rise in regular wages has slowed as a result of the combination of falling inflation and rising unemployment. Even though the increase was still important year-on-year in December, at 6.0%, the 3m/3m annualised rate fell to 2.8%.

However, there are some positive developments to note. In particular, there is increasingly strong evidence that the property market is stabilising. Since last summer, the RICS survey has indicated a clear improvement in the outlook for housing transactions and prices. Since monetary tightening began in December 2021, property prices have fallen between 4% and 5% y/y according to various indicators (Halifax, Nationwide), but have seemingly started rising again since this autumn.

GROWTH & INFLATION

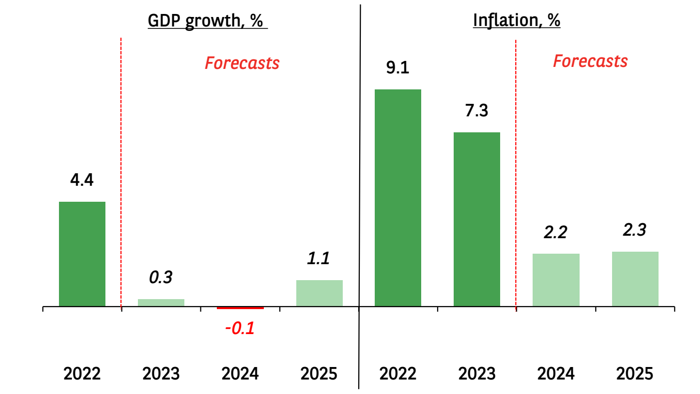


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

However, even though the negative effects of monetary tightening should gradually ease, they will linger during 2024. In its most recent Financial Stability Report, published in December 2023, the BoE estimates that just over half (5.5 million) of UK households with a mortgage have already refinance it since the rate hike cycle began at the end of 2021. Almost 5 million additional households are expected to do so by 2026. The tightening of credit conditions already left its mark in 2023. Arrears on mortgage repayments increased quite significantly, accounting for 1.1% of outstanding mortgages in Q3 2023, the highest proportion since Q2 2017[1]. These figures are still far below those seen during the 2008 crisis, when they peaked at 3.6% in Q1 2009. Nevertheless, household solvency is still under pressure, with mortgage interest payments continuing to rise sharply (+44.1% year-on-year in December, according to the retail price index).

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 Source: British Financial Conduct Authority (FCA).

SWEDEN

AFTER THE RECESSION, A SLIGHTLY BETTER OUTLOOK

The combination of rising inflation and the monetary tightening to combat it led the Swedish economy into recession. Declining household consumption and residential investment were the main drivers. Although the situation is not expected to deteriorate further in 2024, this does not mean that a dynamic recovery is to be expected. However, although Sweden is experiencing significant difficulties, it still has many assets to support activity in the medium term.

In line with our expectations, the Swedish economy entered recession in the third quarter of 2023. Real GDP contracted (-0.3% q/q) for the second consecutive quarter (-0.8% q/q in Q2). Real GDP stands therefore at its lowest level since the end of 2021. However, the preliminary monthly data we have for Q4 2023 suggests a slight improvement during this quarter (1% m/m increase in GDP in October and 0.2% m/m in November). On the other hand, the possible recovery over the next few quarters is expected to be modest and growth is likely to be close to 0% for the entire year in 2024 due to still constrained demand.

A SUSTAINED FALL IN INFLATION

Riksbank governor Erik Theeden recently said that he did not consider it necessary to raise the policy rate further, which currently stands at +4.0% (+400 bp between April 2022 and September 2023). This change in direction is due in particular to the significant reduction in inflation measured by the CPIF (Riksbank benchmark index, at a constant interest rate) in the second half of 2023. Inflation fell from a peak of +10.2% y/y in December 2022 to 2.3% a year later, with the process accelerating beyond central bank and consensus expectations in recent months. This acceleration has been made possible in particular by the easing of pressure on energy prices, combined with less rigidity in core inflation (+5.3% y/y in December 2023). The CPIF is expected to return to its target of +2% y/y by mid-2024, which, combined with sluggish activity, could lead to the central bank cutting rates for the first time as early as Q2 2024, despite the hawkish bias currently being maintained. In addition, while the weakening of the national currency, which reached its lowest-ever level against the euro in September 2023 (EUR 1 = SEK 11.95 on 15 September 2023), complicated the Riksbank's task of combating inflation by fuelling imported inflation, the krona's positive performance at the end of 2023 contributed to the positive disinflationary surprise.

Sweden stands out for the speed with which the combination of rising general price levels and interest rates have weighed on household consumption. This component of GDP has contracted for six consecutive quarters, reaching its lowest level in more than two years. In addition to the loss of purchasing power caused by inflation, this marked decline in household consumption can be explained by the country's structural characteristics. Swedish households have one of the highest levels of debt in the world (196% of disposable income in 2022 according to the OECD dataset) with a predominance of variable-rate mortgages - more than half of all mortgages have a rate that changes every three months. This exacerbates the sensitivity of demand to monetary policy decisions. The process of disinflation and possible rate cuts could therefore help to reduce the pressure on household consumption prospects in 2024. Developments in the labour market have also contributed to the weakening of consumption in 2023, with an increase in the unemployment rate (7.9% in November 2023, +0.6 pp y/y) likely to continue in 2024. However, this must be set against the increase in the participation rate, which is now above 75%, highlighting a structural improvement (71.8% on average over the previous decade).

GROWTH & INFLATION

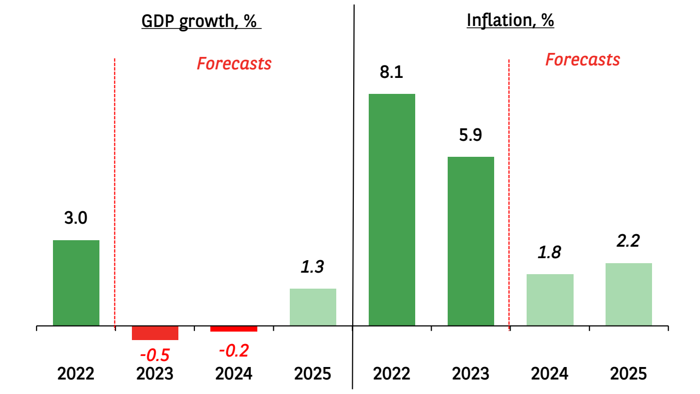


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

TWO-SPEED INVESTMENT

Like household consumption, Swedish residential investment has deteriorated significantly under the impact of monetary tightening. As measured by the national accounts, it has contracted for five quarters in a row, reaching its lowest level since Q1 2017. The parallel deterioration in housing starts is almost unprecedented, with the exception of the systemic crisis in the early 1990s and the 2008 financial crisis: their number has been divided by more than 4 between Q1 2021 and Q3 2023. As for housing prices, they started to fall at the end of 2022, culminating at -12% y/y in Q2 2023, but the shock has eased over the course of 2023. However, while it is now plausible that housing prices and housing starts have bottomed out, future developments - i.e. the likelihood and strength of a potential recovery - remain uncertain.

On the other hand, it should be noted that the non-residential component of investment has continued to show strength despite the slowdown in activity and monetary tightening. Productive investment has continued to grow, and in Q3 2023 was 24% above its pre-pandemic level (33% for intellectual property products). This is a definite asset for the national economy and is indicative of an underlying dynamism that should have a positive impact on the country's potential output.

Finally, although Sweden's budgetary situation is particularly favourable, as illustrated by a public debt and deficit estimated at 30.5 and -0.1 points of GDP respectively in 2023, there is no question of introducing a major countercyclical policy despite the sluggish production expected in 2024. Although the government is forecasting an increase in the public deficit to -0.7% of GDP in 2024, against a backdrop of lower tax revenues, the Minister of Finance, Elisabeth Svantesson (centre-right), recently publicly reiterated her commitment to a prudent fiscal policy that does not contradict the restrictive approach of its monetary counterpart.

Anis Bensaidini anis.bensaidini@bnpparibas.com

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2022	2023 e	2024 e	2025 e	Inflation 2022	2023e	2024 e	2025 e
United-States	1.9	2.5	2.0	1.4	8.0	4.1	2.7	2.3
Japan	0.9	2.1	0.8	0.9	2.5	3.3	2.1	1.9
United-Kingdom	4.4	0.3	-0.1	1.1	9.1	7.3	2.2	2.3
Euro Area	3.4	0.5	0.6	1.6	8.4	5.4	2.0	1.9
Germany	1.9	-0.1	0.3	1.3	8.7	6.0	2.0	2.1
France	2.5	0.8	0.6	1.4	5.9	5.7	2.2	1.6
Italy	3.9	0.7	0.9	1.5	8.7	5.9	1.4	2.0
Spain	5.8	2.3	1.5	2.1	8.3	3.4	1.8	1.9
China	3.0	5.2	4.5	4.3	2.0	0.4	1.5	1.7
India*	7.2	7.5	7.0	6.5	6.7	5.8	5.7	4.5
Brazil	2.9	3.1	1.8	1.8	9.3	4.6	3.6	3.9

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

SOURCE: BNP PARIBAS (E: ESTIMATES)

FINANCIAL FORECASTS

Interest rates, %		2024				
End of period		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
US	*"Fed Funds (upper limit)"*	5.50	5.00	4.50	4.00	2.75
	T-Note 10y	4.15	4.00	3.95	3.95	4.00
Eurozone	deposit rate	4.00	3.50	3.00	2.75	2.50
	Bund 10y	2.45	2.35	2.20	2.20	2.50
	OAT 10y	3.02	2.91	2.75	2.75	3.05
	BTP 10y	4.25	4.00	3.95	3.90	4.20
	BONO 10y	3.45	3.25	3.10	3.05	3.30
UK	Base rate	5.25	5.00	4.75	4.25	3.00
	Gilts 10y	3.90	3.75	3.65	3.55	3.65
Japan	BoJ Rate	0.10	0.10	0.25	0.25	0.75
	JGB 10y	0.95	1.20	1.35	1.35	1.35

Exchange rates		2024				
End of period		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
USD	EUR / USD	1.10	1.12	1.14	1.15	1.18
	USD / JPY	145	141	138	135	130
	GBP / USD	1.26	1.29	1.31	1.32	1.36
EUR	EUR / GBP	0.87	0.87	0.87	0.87	0.87
	EUR / JPY	160	158	157	155	153

SOURCE : BNP PARIBAS GLOBAL MARKETS (E ESTIMATES)

GROUP ECONOMIC RESEARCH

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com

OECD ECONOMIES AND STATISTICS

Hélène Baudchon Deputy chief economist, Head - United States	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Stéphane Colliac France, Germany	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Guillaume Derrien Eurozone, Southern Europe, Japan, United Kingdom - International trade	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Veary Bou, Tarik Rharrab Statistics		

ECONOMIC PROJECTIONS, RELATIONSHIP WITH THE FRENCH NETWORK

Jean-Luc Proutat Head	+33 1 58 16 73 32	jean-luc.proutat@bnpparibas.com

BANKING ECONOMICS

Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+33 1 40 14 30 77	thomas.humblot@bnpparibas.com
Marianne Mueller	+33 1 40 14 48 11	marianne.mueller@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François Faure Head – Argentina, Turkey – Methodology, Modelling	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam – Methodology	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot South Korea, Philippines, Thailand, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Cynthia Kalasopatan Antoine Ukraine, Central European countries	+33 1 53 31 59 32	cynthia.kalasopatan.antoine@bnpparibas.com
Johanna Melka India, South Asia, Russia, Kazakhstan	+33 1 58 16 05 84	johanna.melka@bnpparibas.com
Lucas Plé Africa (Portuguese & English-speaking countries)		lucas.ple@bnpparibas.com

CONTACT MEDIA

Mickaelle Fils Marie-Luce	+33 1 42 98 48 59	mickaelle.filsmarie-luce@bnpparibas.com

GROUP ECONOMIC RESEARCH

ECOCONJONCTURE

Structural or thematic topics.

ECOEMERGING

Analyses and forecasts for a selection of emerging economies.

ECOPERSPECTIVES

Analyses and forecasts with a focus on developed countries.

ECOFLASH

Data releases, major economic events.

ECOWEEK

Recent economic and policy developments, data comments, economic calendar, forecasts.

ECOCHARTS

Easy-to-read monthly overview of inflation dynamics in the main developed economies.

ECOPULSE

Monthly barometer of key economic indicators of the main OECD countries.

MACROWAVES

Our economic podcast.

HOW TO RECEIVE OUR PUBLICATIONS

SUBSCRIBE ON OUR WEBSITE
see the Economic Research website

&

FOLLOW US ON LINKEDIN
see the Economic Research linkedin page

OR TWITTER
see the Economic Research Twitter page

Published by BNP PARIBAS Economic Research

Head office: 16 boulevard des Italiens – 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
Internet: group.bnpparibas - www.economic-research.bnpparibas.com

Head of publication : Jean Lemierre / Chief editor: William De Vijlder

Copyright: Jo Panuwat D

BNP PARIBAS

The bank
for a changing
world