ECO PERSPECTIVES

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Eco PERSPECTIVES

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Editorial

Towards a slight growth pick-up

In recent months, the global manufacturing cycle has been bottoming out whereas in services a slight uptick has been noted. In addition, two major sources of uncertainty have seen a positive development: the US and China signed a trade deal and the UK and the European Union can at last start negotiations about their future relationship. Very accommodative central bank policy has contributed to buoyant market sentiment. The combination of these three factors - stabilisation of business sentiment, decline in uncertainty, supportive financial environment - implies conditions are met to see some uptick in growth. Nevertheless, caution prevails in this assessment, if only because later on this year, uncertainty may very well increase again.

Stabilisation of survey data

As illustrated in the chart, with the exception of Japan, the pace of decline of the OECD composite leading indicator is slowing which would suggest that in due course, some growth pick-up should follow. Recent business survey data have also brought some hope. Manufacturing purchasing manager indices have stabilised globally. Some economies have seen a slight increase from the lows seen in the summer and autumn of 2019 (eurozone, Germany, China) although the level remains low. Services PMIs are doing a bit better and the much dreaded spillover coming from last year's manufacturing slowdown has been avoided to a large degree. Importantly, export order assessments have also improved although the levels remain very low.

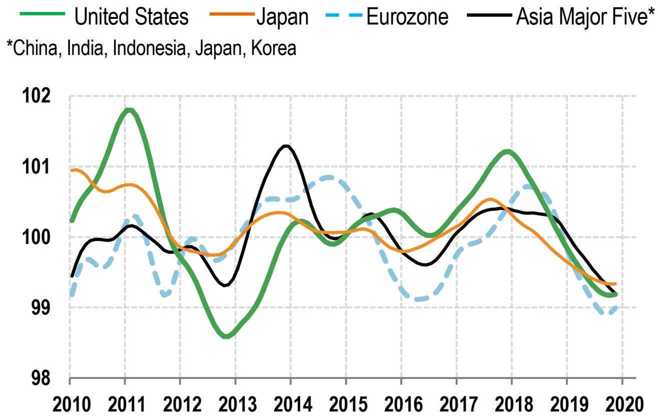
Easy financial and monetary conditions

The Federal Reserve and the ECB have accompanied last year's policy easing decisions with an (implicit) message that official rates will stay very low level for quite some time. Although the Fed's policy is data-dependent, the bar for considering a rate hike seems to be high and the necessary acceleration of inflation to tip the balance is very unlikely any time soon. Christine Lagarde's statement that an inflation rate of 1.6% as projected by the ECB for 2022 would not correspond to the aim that the central bank pursues, suggests that no rate hike is to be expected before the end of 2022, unless the ECB staff would have underestimated the inflation dynamics. This in turn would require a significantly faster growth of activity and wages, which doesn't look to be on the cards. This very accommodative monetary policy environment continues to stimulate the risk appetite of investors, all the more so given the decline in uncertainty, as explained below. The ensuing rally in equities has found its mirror image in an increase in government bond yields, reflecting the view that investors consider the economic outlook to have become somewhat less risky. All in all, financial and monetary conditions have eased, which, all else being the same, should end up supporting growth.

Uncertainty has declined, for now

Two issues which have been major sources of protracted uncertainty have seen a positive development as of late. In the UK, the huge victory of Boris Johnson in the December general election paves the way for a negotiation with the EU about the future relationship, easing fears of a no-deal hard Brexit. The signing of a trade deal between the US and China has avoided a new intensification of the trade war.

OECD composite leading indicator



Source: OECD, BNP Paribas

In addition, markets have reacted very calmly to the rising tensions between Iran and the US at the start of the year. They consider the risk of a major escalation as being very small. However, it can't be excluded that later on this year, uncertainty makes a comeback. Concerning the UK-EU negotiations, not enough time is left to strike a comprehensive deal by year-end. This, in combination with recent statements by the UK Chancellor of the Exchequer about his country's intentions to set its own rules and regulations suggest that negotiations will be tough. With respect to the US-China trade deal, it offers, upon closer inspection, little reason for cheer. It is an example of managed bilateral trade and thus creates trade diversion to the detriment of third countries, it maintains the bulk of the significant increase in tariffs introduced on both sides since the start of 2018 and, most importantly, it is only a phase 1 deal. Phase 2 negotiations – expected to start after the US presidential election in November 2020 - may very well be even tougher whereby the reciprocal threats of trade sanctions would end up dominating headlines again.

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United States

2020: a year of living dangerously

The dichotomy between economic and market trends has widened, in a context of accommodating monetary policy and rising corporate debt. Risks taken by institutional investors (pension and investment funds, life assurance companies) have increased, as has the vulnerability to any adverse shocks or changes in expectations. 2020 – an election year – is unlikely to bring calm. Welcome as it is, the truce in the trade war with China takes in the bulk of existing tariff increases, without producing any fundamental changes in the position of the US administration and its limited appetite for multilateralism.

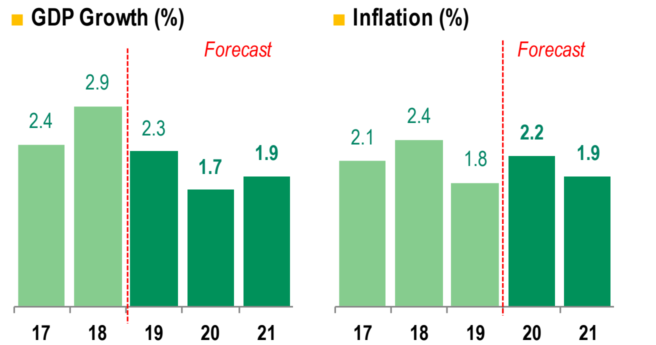
One is taking off, the other coming in to land. Whilst the US economy has been on a slowing trajectory for more than a year now, with the industrial sector dropping into recession, the equity market is still setting new records. In 2019, the Standard & Poor's index of the 500 biggest listed companies gained nearly 30%; at 3,230 on 31 December it was 106% above the record high of October 2007. The Nasdaq tech stocks index surged by 35% in 2019, taking its gains over the past seven years to 200%.

Higher, faster, riskier

Is this irrational exuberance? The fact is that in the United States, rising equity prices display a fairly distant relationship with the slower growth in earnings, resulting in stretched valuations (Figure 2 and IMF, 2019)[1]. With interest rates remaining low, equities' gains are based on an amplification of the leverage effect. In its latest Global Financial Stability Report, the IMF highlights the importance of borrowing in M&A activity and in share buybacks. The increase in the weighting of goodwill in total assets, and the high multiples used in LBO (leveraged buy-out) deals reflect increasingly ambitious bets on the future[2]. Increased risk taking can also be illustrated by the narrowing of spreads on high-yield debt (Figure 2), a market sector that the IMF also considers to be overvalued.

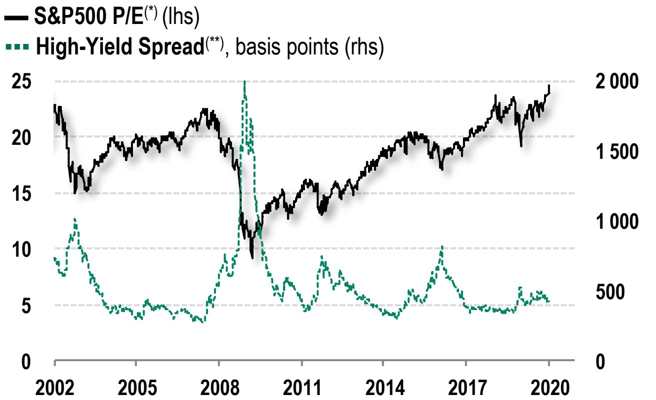
In the current phase of rising asset prices, institutional investors (investment and pension funds, life assurance companies) have played an increasingly important role. Whilst banks have, overall, slowed the expansion of their balance sheets and improved their resilience since the 2008 financial crisis, institutional investors have expanded their activity, taking a growing share of financing. They have also widened the scope of their quest for returns, in a context of falling interest rates on sovereign debt, the traditional core of their investment portfolios. A reallocation has taken place, away from cash and investment-grade bonds, to less liquid and more risky assets such as unlisted private debt, real estate and infrastructure. This has produced greater vulnerability to negative shocks or changes in expectations.[3]

1- Growth and inflation



Source: National statistics, BNP Paribas

2- Increased risk taking



(*) P/E: Price / cyclically-adjusted earnings per share

(**) Yield on speculative-grade corporate bonds – yield on 10-year Federal Government bonds.

Source: Refinitiv, BNP Paribas

In these early weeks of 2020, the increase in tensions between the United States and Iran does not appear to have provided a tipping point. Markets have been bolstered by the prospect of continued monetary accommodation[4], and hopes for the settlement of the trade war between China and the USA.

[1] International Monetary Fund (2019), *Global Financial Stability Report,* Chapter 1, October, pp 1-4. In September 2019, the IMF's valuation model suggested that US equity valuations were more than 2.5 standard deviations above fair value.
[2] Ibid, pp 25-37. 60% of LBO debt is for deals valuing the target company at more than six times annual operating income.
[3] Ibid, pp 41-49.

[4] In 2019, the US Federal Reserve cut its Fed Funds target rate by three-quarters of a point, taking the upper bound from 2.50% to 1.75%. Since October

Pressure on margins and investment

A scenario of calmer waters ahead is far from guaranteed. Granted, a deal between Washington and Beijing was signed on 15 January. 'Phase 1' of this agreement will bring a pause in the escalation of tariffs and, on the Chinese side, an increase in imports, notably of farmed products, guarantees on respect for intellectual property rights and greater market openness in the financial sector. The fact remains that the roots of the conflict – the battle for technological leadership – go deep[5] and that any real de-escalation in a possible 'Phase 2' has been pushed down the road, most probably beyond the presidential election on 3 November. Most of the tariffs enforced by the Trump administration will therefore continue to apply in 2020. This will take the average tariff on imports from China from 3% (in 2017) to 19%, increasing the cost of Chinese imports by some USD70 billion[6].

For US companies, the additional costs come at a moment when the effects of the 2018 tax cuts are diminishing and no longer serve to offset narrower operating margins. Pressure on earnings is rising, whilst the leverage is increasing; such a configuration often precedes or comes alongside an inversion in the US economic cycle (Figure 3 and Box 4). The tide has already clearly turned in the shale oil and gas sector, which has seen marginal returns fall and is cutting capacity in response.

Although employment and consumer spending are showing little sign of slowing, company investment has been falling since the autumn of last year. It is now the main vector by which the US economy is coming in to land. Surveys of purchasing managers suggest that this trend had not improved as we moved into 2020[7]. GDP growth has slowed, with the respective New York and Atlanta Fed's nowcasts suggesting a rate between 1% and 1.8% per year.

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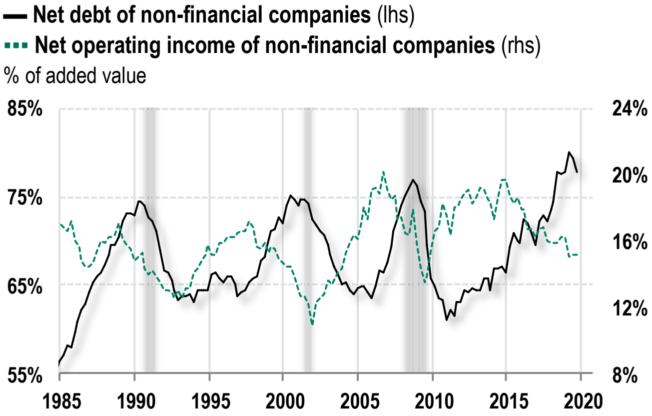
3- Debt grows, margins shrink



Shaded areas: periods of recession

Source: BEA, NBER, Federal Reserve (Flows of Funds)

4- The leverage effect

To understand the link between financial leverage and the return on equity, the balance sheet and profit account of companies can be written as follows:

(1) ***A= E +D***

(2) ***NP = EP - I***

*Where **A** is the total economic asset, **D** the total net debt, **E** the shareholder equity, **NP** the net profit, **EP** the economic or operating profit, **I** the interest rates burden (for simplicity, income taxes are ignored).*

By definition, the financial leverage is equal to the net debt to equity ratio, e.g. :

(3) ***L = D / E,***

*The economic return of asset (**er**) is the ratio of operating profit to total economic asset:*

***er = EP / A** ;*

*The return on equity (**roe**) is the ratio of net profit to equity :*

(4) ***roe** = NP / E*

$= (EP - I) / E$ *following (2)*

$= (re.A - i.D) / E$ *where i is the market interest rate*

$= [re.(D + E) - i.D] / E$ *following (1)*

➲ $\mathbf{roe = er + (er - i).L}$ *following (3)*

*Le financial leverage **L** raises the return on equity above the economic return if it exceeds the market interest rate. The leverage effect declines with the rise in market interest rates and/or the fall in economic return. In a case of reversal (**er** < **i**) the return on equity comes under pressure, which could speed-up the deleveraging process.*

Source: Vernimmen (2010), BNP Paribas

2019, it has also increased the size of its balance sheet in response to tensions in the repo market.

[5] Even while it was negotiating with the USA, the Chinese government announced its plan to replace, within three years, foreign IT equipment (computers, software, etc.) in use across government with Chinese equipment. See Financial Times (2019), *Beijing orders state offices to replace foreign PCs and software,* Dec. 8.

[6] Estimated impact in 2020. Under the terms of the Phase 1 agreement, the US administration cancelled proposed tariffs on a final list of products (list '4B'), consisting mainly of consumer goods, and also cut the tariff rate applied in September 2019 on USD 100 bn in imports from 15% to 7.5%. The earlier tariff increases (25% on USD 250 bn in imports) have been confirmed. In the final analysis, nearly two-thirds (65%) of US imports from China will be subject to tariffs.

See: Brown C.P. (2019), *Phase One China Deal: Steep Tariffs Are the New Normal*, Peterson Institute for International Economics, December 19.

[7] At 46.8 in December 2019, the industrial orders index calculated by the Institute for Supply Management (ISM), which has traditionally been strongly correlated with company investment, is at its lowest since April 2009.

China

The year starts with a reprieve

In 2019, economic growth slowed to 6.1%. Total exports contracted and domestic demand continued to weaken. The year 2020 is getting off to a better start as activity shows a few signs of recovering and a preliminary trade agreement was just signed with the United States. Yet economic growth prospects are still looking downbeat in 2020. The rebalancing of China's growth sources is proving to be a long and hard process, and economic policy is increasingly complex to manage. Faced with this situation, Beijing might decide to give new impetus to the structural reform process, the only solution that will maintain the newfound optimism and boost economic prospects in the medium term.

Real GDP growth slowed to 6.1% in 2019 from 6.6% in 2018. This slowdown can be attributed to both declining exports and sluggish domestic demand (charts 1 and 2). Although the most recent activity indicators and the first trade agreement signed between the US and China provide some ground for optimism as the year gets underway, economic growth should continue to slow in 2020.

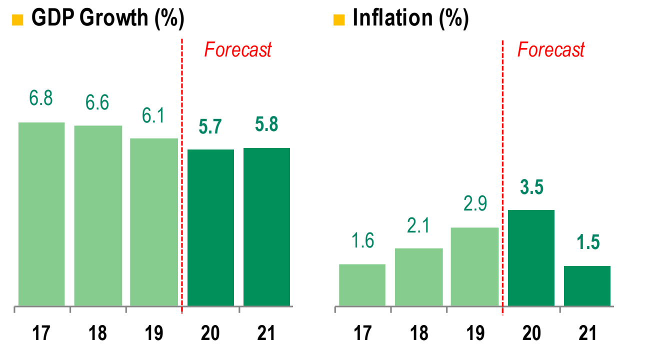
While economic policy has become increasingly accommodative over the past two years, the authorities have remained very prudent. They have very little manoeuvring room given the economy's debt excess and the need for ongoing efforts to clean up the financial system, state-owned enterprises and the housing market. In response to deteriorating economic growth prospects and the increasing difficulties of basing a stimulus policy on credit, the authorities have resorted to fiscal measures to support corporates and households. Might trade tensions with the US and the difficult process of rebalancing the sources of growth also encourage the authorities to give priority to structural reforms?

2019: external shock and the difficult transformation of China's growth model

Chinese exports were hard hit by higher US tariffs and the decline in global demand in 2019. Merchandise exports to the United States plunged by 12.9% (in USD value terms) compared to 2018, while total exports remained virtually flat (-0.1%). Although foreign trade made a positive contribution to GDP growth in full-year 2019, the export sector's troubles have had a big impact on the rest of the economy. Investment in the manufacturing sector rose only 3.1% in value terms in 2019: the investment growth slowdown sharpened due to worsening prospects for sales and weakening earnings. Meanwhile, private consumption has been hit by the industrial slowdown's impact on the job market and confidence. Average real household income slowed to 5.8% in 2019 from 6.5% in 2018, especially since consumer price inflation accelerated (reaching 4.3% y/y in Q4 2019). Inflationary pressures mainly reflected the surge in pork prices, which doubled between Q4 2018 and Q4 2019, driving up food price inflation (+17.3% over the same period). In contrast, core inflation eased from 1.8% y/y in Q4 2018 to only 1.4% in Q4 2019, a sign of sluggish domestic demand.

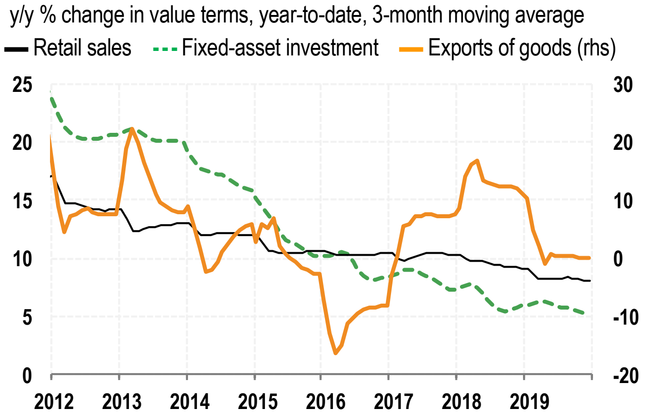
Households were also hit by tighter credit conditions, at a time when debt servicing charges are placing an increasingly heavy burden on their budgets (this reflects the steady increase in household debt, which rose from 28% of GDP at year-end 2011 to 55% at year-end 2019).

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Economic growth slowdown is broad-based



Source: NBS, General Administration of Customs

The accumulation of these negative factors explain why household spending growth has not picked up much in recent months despite fiscal stimulus measures. As a result, growth in retail sales volumes and online sales of goods and services barely levelled off in November-December 2019 (at 4.9% y/y and 12%, respectively). Automobile sales, which account for about 10% of total retail sales, have continued to decline albeit at a slower pace than at the beginning of the year (-2.5% y/y in Q4 2019, vs. -12.5% in H1).

Truce in the trade war

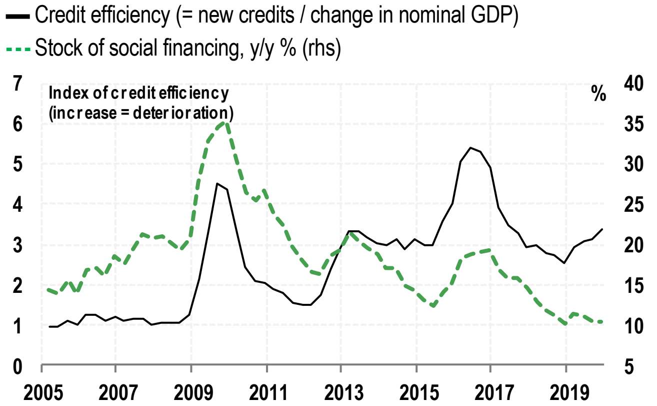
Yet China's economic performance seems to have improved slightly in recent weeks. Industrial production growth accelerated to 6.2% y/y in November 2019 and 6.9% in December, vs 4.9% in July-October. This timid recovery is in keeping with the rebound in exports, which rose by 7.4% y/y in December after several months of decline. The economy should remain somewhat more dynamic in the short term. China's National Bureau of Statistics (NBS) reported an uptick in manufacturing PMI (from 49.3 in October to 50.2 in November and December), which was largely driven by the rebound in the "export orders" component (which rose from 47 in October to 50.3 in December).

The United States and China have called a truce in their trade war since December and signing a preliminary trade agreement on January 15th. This contributed to the better industrial growth performance and renewed confidence of corporates and the markets. The fundamental problems behind US-China trade tensions are still in place and the next rounds of negotiations promise to be very complicated. Nevertheless, the "phase 1" agreement signed mid-January considerably reduces the risk of another increase in US tariffs in 2020. Under the phase 1 agreement, China has to increase its imports of US goods and services by USD 200 bn over the next two years (compared to 2017 purchases of USD 186 bn), including USD 78 bn in manufacturing, USD 52 bn in energy, USD 32 bn in agriculture and USD 38 bn in services. China also seems to be ready to make some concessions in terms of intellectual property rights and the access of foreign enterprises to its domestic market (looser regulations on technology transfers, and opening of the financial sector, for example). In exchange, the United States simply renounced the introduction of new tariffs, and reduced by half the amount of the last tariff increase, in effect since September 2019 (from 15% to 7.5% on about USD 120 bn in imports). The other tariffs introduced over the past two years will be maintained. As a result, the weighted average tariff imposed by the US on imports of Chinese goods will decline only slightly, from 21% at year-end 2019 to about 19% (vs 3% before the outbreak of the trade war). Tariffs will continue to be levied on two thirds of these imports.

Greater impetus for reforms?

Since 2018, the authorities have loosened their monetary and fiscal policies in order to stimulate activity. At the same time, they have remained cautious, and still pursued efforts to strengthen financial-sector regulations, contain the increase in household debt and try to reduce the debt of the most fragile corporates. Last year, in a particularly unfavourable international environment coupled with disappointingly sluggish domestic demand and growing corporate financial difficulties, the authorities were faced with the ever-growing dilemma of stimulating growth or reducing debt and pursuing reforms[1]. The authorities opted to make greater use of fiscal stimulus measures and to continue prudent monetary easing actions. The most recent measure, effective on January 6th, 2020, aims to

3- Credit efficiency deteriorated again in 2019



Source : NBS, BNP Paribas

stimulate bank loans to corporates via another cut in reserve requirement ratios (by 50 basis points to 10% for small and mid-sized banks and to 12.5% for the big banks).

Further stimulus measures might help boost economic growth in the short term, but they would also delay the process of cleaning up the economy while undermining medium-term growth prospects, notably due to the risk of financial instability and the declining efficiency of credit and investment. This danger was highlighted by the erosion of credit efficiency in 2019, after two years of improvement (chart 3). Stepping up structural reforms, in contrast, should limit these risks.

The most recently announced structural reforms aim to accelerate the opening of the financial sector. For example, foreign investors would benefit from greater access to asset markets and the limit on foreign ownership of certain asset managers and securities firms is to be lifted by the end of 2020. Faced with the need to make progress in negotiations with the US, but above all given the growing difficulties of rebalancing China's growth sources, Beijing might seek to give new impetus to structural reforms in 2020. In particular, the continued restructuring of state-owned enterprises (deleveraging, end of implicit state guarantees) and the strengthening of the financial system should help pave the way for better capital allocation and stronger medium-term economic growth prospects.

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[1] See EcoPerspectives: *China: what lies behind the rise in corporate defaults?"*, Q2 2019 and *"China: difficult policy choices,* Q4 2019.

Japan

The impact of fiscal stimulus is uncertain

In December 2019, the Japanese authorities decided to launch a major fiscal stimulus for the years ahead. A large part of the programme will target disaster prevention after the country was hit by a series of natural disasters recently. The stimulus will also limit the negative impact of last October's VAT hike, which probably strained private consumption in the year-end period. Buoyed in part by early purchases ahead of the VAT hike, household spending continued at a dynamic pace in Q2 and Q3 2019. The export sector, in contrast, was hard hit by the sluggish global environment. In 2020, public investment is expected to partially offset weak private consumption.

Given the lack of monetary policy leeway – a situation that is unlikely to change by 2021 – Japan has resorted to fiscal policy again. It has launched an ambitious fiscal stimulus plan equivalent to about 2% of GDP[1], including infrastructure investments to rebuild and protect against natural disasters. Yet the economic impact of this stimulus is still uncertain.

Sluggish growth in 2020

Although domestic demand – and private demand in particular – was robust in the first 3 quarters of 2019, it is expected to slow sharply in Q4, which would erode momentum in 2020. Household spending are likely to be curtailed by October's VAT hike. Typhoon Hagibis in October would curb corporate investment. Manufacturing output and exports were both severely weakened last year and are unlikely to rebound strongly in 2020. The most recent economic data is still looking downbeat: since May, the Purchasing Managers Index (PMI) in the manufacturing sector has held below 50, the threshold that separates expansion from contraction (48.4 in December). Moreover, the Bank of Japan's Tankan index for the manufacturing sector still hasn't picked up (-4 points in Q4 2019). The non-manufacturing sector also dipped slightly. Two factors to follow closely are China's economic growth, given its heavy weighting in Japanese trade, and the outcome of negotiations to halt the US-China trade tensions.

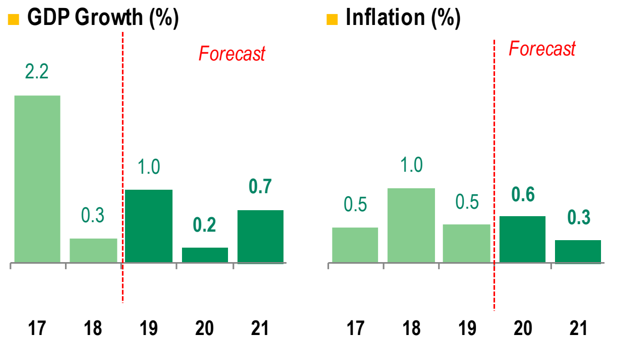
All in all, Japanese economic activity should slow to 0.2% in 2020 (down from 1% in 2019) before converging towards its potential in 2021. Without a significant acceleration in activity, inflationary pressures are likely to remain weak.

Major fiscal stimulus, but its impact is hard to evaluate

The fiscal stimulus package adopted by the Japanese authorities should limit the negative impact of the VAT increase. Yet, despite its size and apparently favourable structure (public investment will have a big impact on growth in the first year), it risks having only a mild impact on activity.

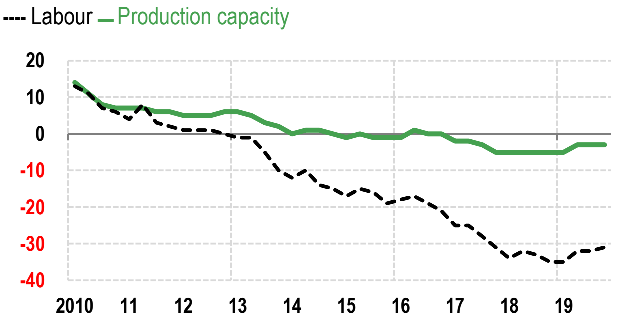
Indeed, it is hard to estimate the impact of a fiscal stimulus (in Japan, it is difficult to distinguish between trends and cyclical patterns), and the related fiscal multipliers are relatively less stable in Japan (the transmission channels for cyclical policies do not seem to be very efficient)[2]. Moreover, certain investment projects may have to be postponed due to labour shortages (see chart 2).

1- Growth and inflation



Source: National accounts, BNP Paribas

2-Diffusion index (% points)



Source: Bank of Japan

Note: The diffusion index shows the number of companies signalling surplus capacity (or labour) minus those reporting a shortage of capacity (or labour).

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[1] Part of the budget programme that was presented did not directly concern public demand.

[2] A. Auerbach and Y. Gorodnichenko, *Fiscal multipliers in Japan*, NBER, February 2014

Eurozone

2020: the year the economy begins to pick up?

Will the year 2020 be marked by a rebound in eurozone economic growth? More favourable signs seem to be emerging, although they have yet to show up clearly in hard data. In any case, eurozone growth is bound to remain low. In this environment, inflationary pressures will probably fall short of the central bank's target. Beyond that, the ECB Governing Council will be tackling new issues in 2020. Christine Lagarde announced a strategic review for the Frankfurt-based monetary institution. On the agenda: cryptocurrencies, climate change, technological progress, and inequalities.

Without signalling a strong rebound, several factors seem to suggest that growth is beginning to stabilise: survey indicators are no longer deteriorating in the manufacturing sector; some progress is being made concerning US-China trade talks and *Brexit*; financing conditions will remain very accommodative; and the labour market remains relatively resilient, despite signs of weakness.

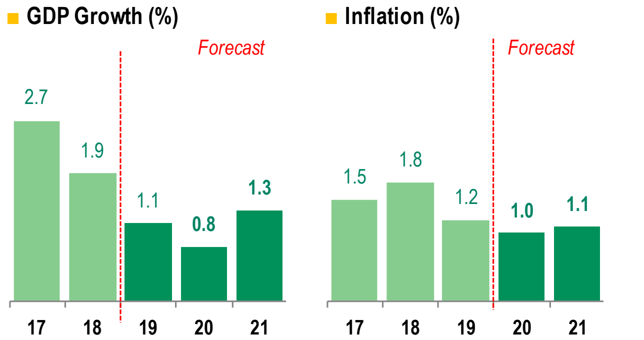
■ Growth fails to rebound

In 2019, the eurozone was hit by a sharp economic slowdown. Difficulties in the manufacturing sector that first appeared in the second half of 2018 persisted in 2019. Growth displayed a robust 0.4% in Q1 2019 but then decreased to 0.2% for the next two quarters. For the full year, our forecast calls for eurozone growth to average 1.1%, compared to 1.9% in 2018.

Cyclical and leading indicators nonetheless point to a certain stabilisation. The Purchasing Managers Index (PMI) in the manufacturing sector is clearly holding below 50, the threshold that separates expansion from recession, but at 46.3 in December 2019, it no longer seems to be deteriorating. The PMI in services rose to 52.8 in December, and is robustly holding in expansion territory. So far, fears that the manufacturing sector's troubles will spread to the services sector have failed to materialise. In the months ahead, the horizon could clear up somewhat. Real M1 money supply growth, the "narrow" money supply aggregate that provides relevant information on the potential for an economic recovery[1], is looking upbeat (see chart 2).

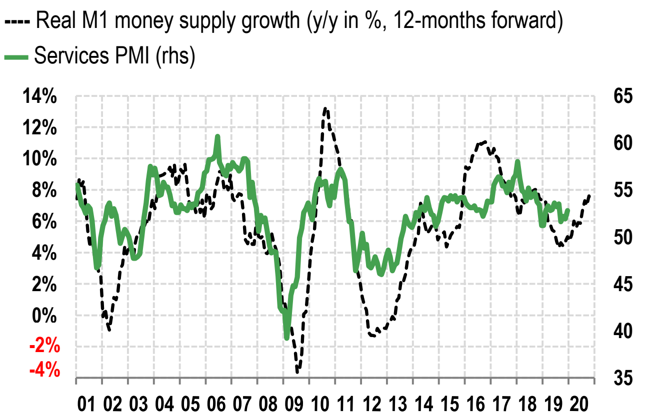
All in all, eurozone growth is expected to decrease to 0.8% in 2020 before rebounding in 2021 and converging towards its potential (see chart 3). Although household consumption is slowing, it should remain relatively robust at a time of ongoing wage growth. On the corporate side, investment is still going strong, buoyed notably by very favourable financing conditions. Note that the recent upturn in long-term rates reflects the renewed confidence of economic agents, especially concerning the reduced risk of recession. Yet the upturn in interest rates should remain mild in the face of low inflationary pressures (around 1% in both 2020 and 2021). As in 2019, eurozone fiscal policy is expected to be slightly expansionist at the aggregate level in 2020, providing only a timid boost to growth[2].

1- Growth and inflation



Source: National accounts, BNP Paribas

2-Inflation and monetary policy



Source: ECB, Markit
Note: M1, the narrow money supply aggregate, is comprised of bills, coins and demand deposits.

This scenario presents several risks, and certain indicators will have to be monitored closely in 2020. First, as we have pointed out for several months now, it is crucial for the labour market to remain resilient at a time of slowing activity. Although the sector has been hit by a major negative shock for several quarters, industrial employment seems to be less dynamic, but continues to progress at an annualised rate.

Eurozone exports must also operate in a persistently weak global environment. International trade failed to regain momentum, and in

[1] R. Fendel et al., *Predicting recessions using term spread at the zero lower bound: The case of the euro area*, VOX CEPR, January 2019

[2] European Commission, *European Economic Forecast - Autumn 2019*, November 2019

October, the volume of global trade contracted for the 5th consecutive month. In China, a major trading partner for the eurozone, economic activity is unlikely to begin accelerating again until the second half of 2020.

Lastly, we cannot rule out an external shock. Rising tensions in the Middle East could drive up energy prices, for example, while new tariffs could erode domestic demand.

ECB: a new era

Shortly after taking the helm as the new president of the European Central Bank (ECB), Christine Lagarde has already made her mark. The 12 December speech confirmed our previous expectations: ECB monetary policy will probably remain unchanged throughout our forecast horizon.

According to the ECB's latest projections, eurozone growth will remain weak in the short term, despite recent signs of stabilisation. In the medium term, although there are still high risks surrounding growth momentum, ECB staff points out that some of these risks could dissipate at least in part (notably concerning US-China trade talks). A slight upturn in activity and persistently strong wage growth could partially filter through in a pick-up in inflation, and core inflation could reach 1.6% in 2022 according to the ECB[3] (see chart 4). Yet Ms. Lagarde insisted that this inflation rate would not be considered as a "reached target", which reinforces our hypothesis that monetary conditions will not be tightened for a relatively long period of time.

In 2020, a key issue to follow will be the opening of the ECB's strategic review, as announced by president Lagarde. Like the US Federal Reserve, the ECB is launching a strategic review of its monetary policy targets and instruments (at a time when it has very little manoeuvring room), but the scope of the review is much broader. The Governing Council's agenda will also look into issues relating to cryptocurrencies, climate change, technological progress and inequalities. Scheduled to last a year, this strategic review will largely dominate discussions between observers.

It could also come up against the divisions that have appeared within the ECB in recent months, which Ms. Lagarde will have to address. The next monetary policy meetings will surely reveal more details on these issues.

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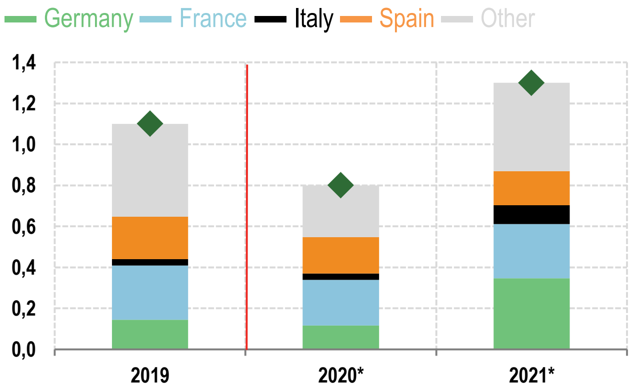
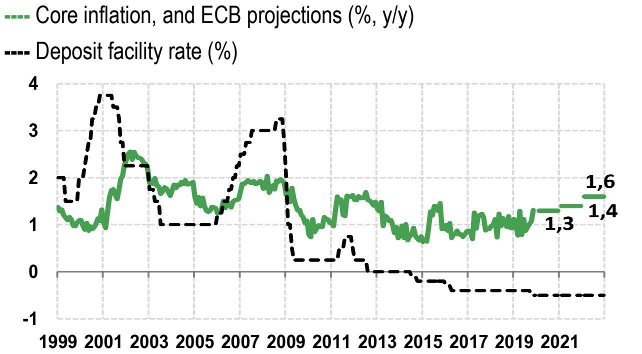
3-Contribution to eurozone growth by country (% point)



Source: Eurostat

** = forecast*

4-Core inflation and interest rates



Source: European Central Bank (ECB)
Note = The horizontal green lines represent the ECB's average annual core inflation projections for the years 2020, 2021 and 2022.

[3] European Central Bank, *Eurosystem staff macroeconomic projections for the euro area,* December 2019

Germany

Nearing a turning point

Economic activity increased by only 0.6% in 2019, as the decline in manufacturing production was offset by increased activity in more domestically oriented sectors. In the coming two years, the economy will be supported by more accommodative fiscal policies. From Q2 2020, the pick-up in exports related to the partial lifting of uncertainties may more than compensate for easing consumption growth. Nevertheless, GDP growth is expected to remain below potential. The possible departure of the SPD from the ruling coalition forms a major political risk.

A prolonged period of virtual stagnation

According to the latest statistics and business cycle indicators, economic activity hardly increased in Q4 2019. Industrial production might even have further contracted as the manufacturing PMI, despite its hesitant improvement, remained firmly below the 50 mark. In particular Germany's large car industry was affected. In October-November, production in this sector was about 20% lower from two years earlier.

By contrast, activity in construction and services held up quite well according to the ifo surveys. In the service sector, the indicator even rose in December to its highest level of the past six months. In construction, companies remained upbeat of their current business situation, but became more pessimistic about activity in the coming few months.

Despite the economic slowdown, labour market conditions have hardly deteriorated. In November, the unemployment rate amounted to 3.1%, only 0.1% higher than in the previous month. Moreover, job vacancies have remained at a relatively high level. Even in the manufacturing sector, many employers still report labour shortages as being a limiting factor for their production.

Nevertheless, employers' organisations and trade unions have been adapting to the weaker business climate, as recent wage settlements have been less generous than those concluded one year earlier. The negotiated wage rate in the period August-October 2019 was 2.4% higher compared to a year earlier. In early 2019, the annual rate of change stood at around 3%.

For the moment, the increase in labour costs has hardly affected consumption prices. In 2019, HICP inflation declined to 1.4% compared with 1.9% in the previous year, as the rise in energy prices slowed to 1.3%. By contrast, prices for services increased by 1.6%.

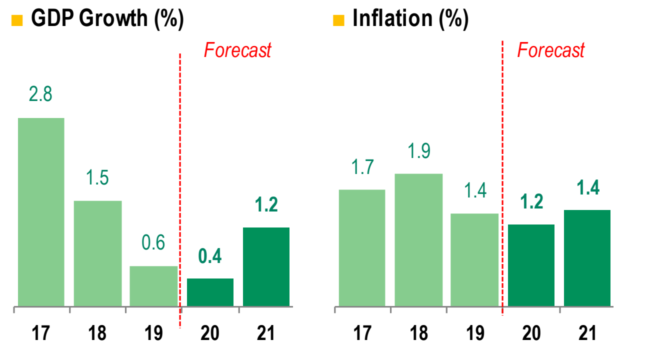
Fiscal easing

During the economic boom in the years 2014-2018, the government followed Keynes' advice to follow tight fiscal policies in order to restore government finances. The government indeed succeeded in reducing the debt-GDP ratio to 61.2% of GDP in 2019.

For 2020 and 2021, fiscal policy is set to be eased in line with the coalition agreement. Government investment will be stepped up in particular for transport and digital infrastructure and education. The government also intends to increase spending in order to reduce the emission of greenhouse gases (see below). As share of GDP, government spending - excluding interest payments - is expected to reach a highest in 2021 since the reunification peak.

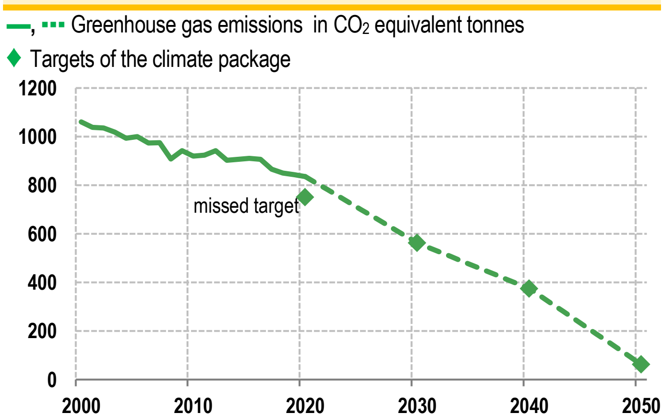
On the revenue side, income taxes will be lowered, in particular because of the partial scrapping of the solidary tax. On the other hand, additional tax receipts can be expected related to the rapid increase in wages and the progressiveness of the tax system. Moreover, energy taxes are set to increase. Overall, the tax burden will be virtually unchanged. Government finances are expected to

1- Growth and Inflation



Source: National Accounts, BNP Paribas

2- Growth and Inflation



Source: Umweltbundesamt, BNP Paribas

remain in surplus during the projection period and the debt-GDP ratio could decline below 60%.

The political uncertainty has increased as the SPD members elected as chair persons of their party Saskia Esken and Norbert Walter-Borjans, two critics of the grand coalition. They are calling for renegotiating the coalition agreement. However, CDU and CSU are unlikely to give in. This places the SPD for a difficult choice. Pressing too hard for policy change could lead to a government crisis and new elections. Given the SPD's position in the polls, a severe defeat is likely, which could pave the way for a coalition between the CDU/CSU and the Greens.

Greener policies add to inflation

Last December, the German Parliament adopted a climate package, targeting zero CO_2 emissions by 2050 (Chart 2). The intermediate objective is to reduce greenhouse gas emissions by 55% in 2030 compared with 1990. However, the government has admitted that the country will miss the 2020 target, a reduction of 40% of carbon emissions from the 1990 level.

The main measure is the creation of a CO_2 tax for sectors that are outside the scope of the EU Emission Trading Scheme (ETS). In 2021, the tax should amount to EUR 10 per tonne CO2. It will steadily increase to EUR 35 per tonne by 2025. Tax receipts will be used to finance climate protection measures such as lowering electricity prices, increases in commuter allowances, and subsidies for green projects.

At a macroeconomic level, the consequences of the package are likely to be limited. The CO_2 levy will result in a rise in energy prices by 2%, thus raising inflation by around 0.2% in 2021. Core inflation will be hardly affected. The effect on activity will also be quite limited. The tax will reduce disposable income, but as the receipts are completely used for climate protection spending, the impact on activity will be neutral. Moreover, as the measure does not affect large energy users that are subjected to the ETS, the possible effect on price competitiveness is likely to be limited.

However, the measure will have an impact on the income distribution. It is well-known that carbon taxes particularly hurt low-income families and seniors. On the positive side, it will shift demand away from polluting activities.

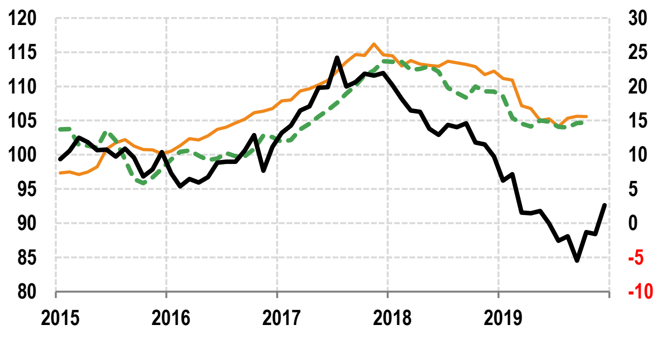
Exports prospects have improved

All business cycle indicators point to continuing subdued growth in Q1. Industrial production might even further contract, but this is compensated by a slight increase in activity in more domestically oriented sectors such as services and housing construction. Demand in these sectors is still underpinned by strong disposable income growth and robust labour market conditions.

However, the cycle may be about the turn. The ifo export expectations index rose significantly in December, underpinned by signs of an easing in the trade conflict and more clarity about Brexit after the UK general election (Chart 3). In particular, manufacturers of electrical products and pharmaceuticals are expecting a

3- Improving outlook for exports

Orders (2015=100, three-month moving average) :
Eurozone, Outside the eurozone
Export expectations (balance of opinions, RHS)



Source: Deutsche Bundesbank, IFO, BNP Paribas

significantly higher number of orders from abroad. Even in the automotive industry, managers have become significantly less pessimistic. This will compensate for slowing domestic demand growth. Despite very accommodative monetary and fiscal policies, household disposable income growth is projected to increase at a slower rate than in previous years. This will weigh on consumer demand and housing construction. Moreover, investment demand could weaken, as capacity utilisation ratios have fallen below their long-term level. All in all, GDP growth is expected to increase by 0.8% and 1.2% (adjusted for calendar effects by 0.4% and 1.2%) in 2020 and 2021, respectively.

Although growth will remain well below potential in 2020 and 2021, the labour market is likely to remain very tight. On the one hand, manufacturers have resorted to reducing work hours and short-time working schemes to avoid dismissing their core workers. In addition, employment growth remains strong in particular in non-market services. Moreover, immigration is likely to slow as job opportunities diminish. The unemployment rate is projected to remain at very low levels. Negotiated pay rates may further ease in 2020 due to the downturn in the industrial sector, but may pick up next year. Inflation excluding food and energy is expected to rise slightly as past wage increases, in particular in services, are gradually passed onto consumers. Total inflation could edge down in 2020 to 1.2% and slightly accelerate in 2021 to 1.4% .

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France

2020: new year, same trends

The year 2020 is expected to follow along similar lines as in 2019, a mixed performance marked by slow but resilient growth bolstered by the strength of final domestic demand. The economy is expected to keep running at about the same rate (1.1% after 1.3%). The rebound in household consumption should gather steam, fuelled by major purchasing power gains. The dynamic pace of investment, which looks hard to sustain, is expected to slow, while sluggish global demand will continue to curb exports. The intensity of several external downside risks declined in Q1 2020, including trade tensions, Brexit, and fears of a recession in the US and Germany. On the domestic front, upside risks continue to stem from supportive economic policies while the tense social climate constitutes a risk on the downside.

2019: false modesty

In Q3 2019, GDP rose 0.3% q/q, in line with expectations. This was the fourth out of the past five quarters in which growth hit 0.3% (the exception was Q4 2018, with growth of 0.4%). Nonetheless, it was a "small" 0.3% (0.27%), and marks a slight dip from the 0.4% average reported between Q3 2018 and Q2 2019.

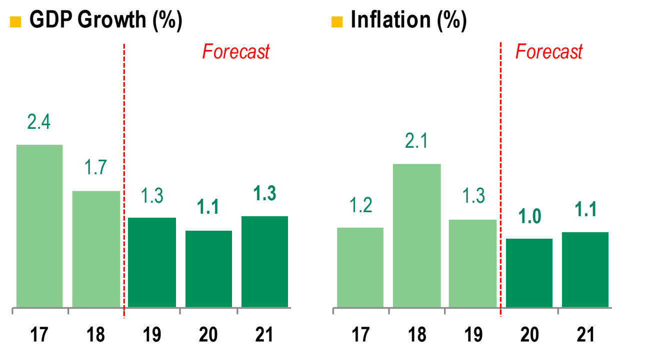
Yet even more so than in previous quarters, this performance was not as mild as it might seem. It masks the 0.6-point contribution of final domestic demand, compared to an average contribution of 0.5 points in the four previous quarters. Household consumption and business investment both rose slightly faster than in Q2, as the long-awaited rebound in the first gradually took shape, and the robust pace of the second was confirmed. Changes in inventory made a somewhat less negative contribution (-0.1 points, vs. -0.2 points). These favourable trends were offset by a marked slowdown in household investment (after an exceptional surge in Q2) and the negative contribution of net exports (-0.3 points), reflecting a rebound in imports and another small decline in exports.

Q4 growth prospects are favourable based on the business climate surveys available till December. They suggest that growth will hold at the current rate of 0.3%. The INSEE composite indicator is holding at a Q4 average of 106, the same high level as in Q3 and Q2, while the Markit composite PMI rose slightly again to 52.2, from 51.9 and 51.3, respectively.

The relatively favourable trends shown in French survey data in 2019 are noteworthy, especially compared to Germany (see chart 2). The most striking difference is in the manufacturing sector, where Germany has slid deep into recession territory while France is still in expansion territory, if only by a little bit. Trends are also different in the services sector, for partly the same reason: since the French manufacturing sector did not experience the same troubles as its German counterpart, the services sector has remained in favourable territory in France, while following a "humped" profile in Germany.

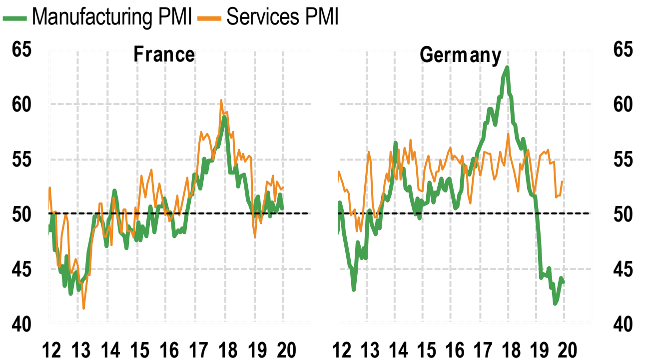
In France, the two indexes were at roughly the same level at the end of the year (50.4 for manufacturing PMI and 52.4 for services PMI), whereas in Germany there was a 9.2-point spread (43.7 and 52.9, respectively). This is only the second time the spread has been so wide since the great recession of late 2008-early 2009. The way in which this spread is absorbed will be one of the trends to watch in 2020. It is a key factor in our German scenario, with a ricochet effect on France. Our scenario calls for this differential to be absorbed on the upside, through an upturn in the business climate in the manufacturing sector. Based on the latest data, this process

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Business sentiment in France and Germany



Source: Markit, BNP Paribas

might be underway already. This brings us to the next question: the size of the ensuing rebound in growth, which we expect to be fairly mild.

Returning to the outlook for Q4, our nowcast soft data-based model projects growth of 0.2% q/q, which dampens somewhat our positive interpretation of the survey results. Yet our model made a similar projection for Q3. Since Q3 growth proved to be slightly stronger, it is possible that our model is underestimating Q4 growth again. This underestimation is also suggested by our forecast using hard data, which is higher (0.5%). Yet this projection is fragile because it is based only on October and November data.

Like the INSEE, we are forecasting Q4 growth at 0.3%, while the Bank of France is a little less optimistic with an estimate of 0.2%. As to the breakdown of growth, we forecast net exports to make a very positive contribution (0.3 points), buoyed by the strong rebound in exports that has been observed in every fourth quarter since 2016[1]. It would be offset by an equally negative contribution of the change in inventory, as signalled in survey data. Final domestic demand would make a slightly less positive contribution than in Q3 (0.4 points) due to a somewhat smaller increase in household consumption, a much lower increase in business investment, household investment and public consumption, and a comparable rise in public investment.

The strikes and demonstrations against pension reform, which have been ongoing since 5 December, risk eroding growth in late 2019 and early 2020. Although the business climate in December was not affected, it is likely only a matter of time. Household confidence proved more sensitive and declined sharply for the first time in a year (-3 points). The negative impact of such strikes on the economy is channelled through an immediate fall in the consumption of transport services, which carried over to activity in retailing, hotel and food services, leisure activities and tourism. At refineries and ports, blockades have also caused disruption. Yet although the impact might be substantial at the sector, microeconomic or regional level, it is small at the macroeconomic level. Certain expenditures definitively fall by the wayside, but others are stimulated, substituted or postponed. To give an idea of the order of magnitude, the INSEE estimates that previous major strikes had a negative impact on growth of between 0.1 and 0.2 points. And whenever there is a negative impact, it is followed by a catching-up phase and extra growth.

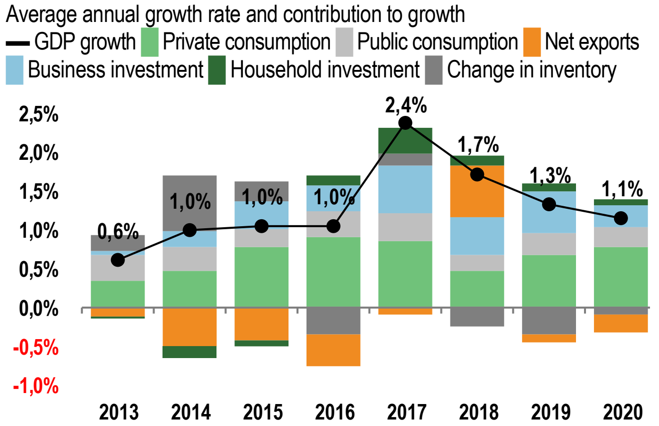
In 2019, the average annual growth rate adjusted for the number of working days is estimated at 1.3%, compared to 1.7% in 2018. While definitely a sharp slowdown, it is nonetheless misleading because, on the one hand, it masks the major contribution of final domestic demand, which rose to 1.8 points, from 1.3 points the previous year. The lower growth in 2019 can be attributed to the more negative contribution of the change in inventory (-0.4 points vs -0.3) and net exports' more normal contribution (-0.1 points instead of +0.7). On the other hand, French economy is not slowing down as sharply as the Eurozone average (1.1% vs. 1.9%) or Germany (0.6% vs. 1.5%).

2020: basically the same refrain

Broadly speaking, 2020 is likely to repeat the same refrain as in 2019: feeble but resilient growth. The growth engines will not be the same, however. Under our base case scenario, the contribution of household consumption (0.7 point vs 0.6 in 2019) will surpass that of total investment (0.5 points vs 0.8), which is a more customary configuration for the French economy.

All of the conditions seem to have come together for a bigger increase in household consumption: rising confidence, major purchasing power gains (lifted by job and wage growth, tax cuts and mild inflation) and dynamic lending at attractive terms. Yet the real question is just how much bigger. In 2019, all of these conditions had already come together, yet the rebound was still mild, partly because there is a certain lag before households react to bigger

3- Breakdown of growth



Source: INSEE, BNP Paribas

purchasing power gains. In 2020, this lag will no longer come into play, or less so in any case. Even so, we still expect French households to remain cautious. Consumer spending is only expected to pick up a little (1.4% vs 1.2%). Yet the rebound could be much stronger given the size of purchasing power gains (about 2% in 2019 and 2020, according to our estimates).

As to investment, in contrast, the conditions seem to have come together for a slowdown. The expected decrease in business investment will be partly automatic, after reaching a robust pace that looks hard to sustain. The mixed outlook for demand would also play a key role, and to a lesser extent, fewer pressures on production capacities. Favourable financing conditions should help buffer the slowdown. Public investment would suffer a payback as the municipal election cycle comes to an end[2]. Household investment would get a small boost from the strong momentum of the existing home sales market, although it would continue to be limited by sluggish activity in the new home sales market.

Export growth would remain mild in keeping with sluggish global demand. France is expected to maintain its (feeble) market share, as it has since 2013. It can count on its strengths (aeronautics, pharmaceutical products, luxury goods, cosmetics, agro-food and automobile equipment) and a favourable exchange rate.

All in all, we forecast growth at 1.1% in 2020 (1.3% using data unadjusted for the number of working days). This small slowdown compared to 2019 is not significant in our eyes. It masks a slight acceleration in the quarterly growth profile. Growth will continue to outpace the forecast for the eurozone (0.8%) and Germany (0.4%). We see 2020 as a year of consolidation: consolidation of the positive impact of purchasing power gains on household consumption, and in general, consolidation of the positive expected effects of recent reforms.

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[1] INSEE, *French quarterly exports depend heavily on the aeronautics and naval sector*, box pp 58-60, Note de Conjoncture, December 2019

[2] INSEE, *Municipal election cycle: what impact on public investment, employment and production?*, article pp 33-45, Note de Conjoncture, December 2019

Italy

Addressing present and future challenges

Italy continues to record a cycle of subdued activity, with the annual growth rate of real GDP slightly above zero, as a result of the feeble growth in services, the modest recovery in construction and the persisting contraction in the industrial sector. From Q1 2018 to Q3 2019, manufacturing production has fallen by more than 3%, with the strongest declines in the sector of means of transport, in that of metal products and in that of textile, clothes and leather items. Together with the short term slow down, Italy is going to face long term challenges due to the ageing population and its impact on the labour force and the pension spending.

Slowing exports, moderate growth

Since the beginning of 2018, Italy has been experiencing a cycle of subdued activity. In Q3 2019, real GDP rose by a mere 0.1% q/q for the fourth quarter running, despite a 0.3% positive contribution of stocks, with the annual growth rate slightly above zero.

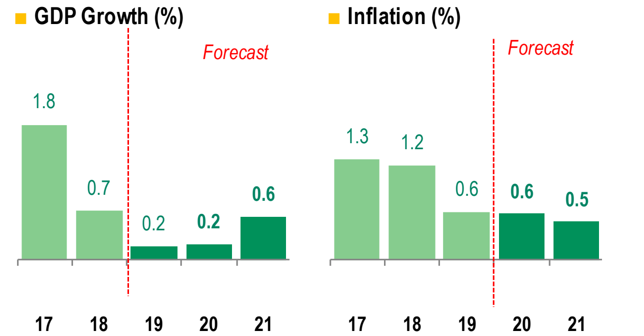
In Q3, net exports subtracted 0.4% from the overall GDP increase, as imports rose by 1.3% q/q, while exports declined by 0.1%. According to trade balance data, Italian exports have significantly slowed, reflecting the still weak international environment. In the first ten months of 2019, Italian sales abroad rose by 2.7% on annual basis, from +3.6% in 2018 and +7.6% in 2017, held back by Euro area slowdown. Exports to Germany, which account for about 13% of total, remained unchanged, suffering from the strong weakening of the manufacturing sector in this country, with sales of Italian metal products declining by more than 3%. On the contrary, the increasing risk of a no-deal Brexit supported exports to the United Kingdom, while those to the United States benefited from the strengthening of industrial activity, with sales of Italian machinery rising by 9%.

Strong consumption, feeble investment

In Q3, domestic demand added 0.2% to the quarterly GDP increase, as the robust dynamic of private spending more than offset the new contraction of investment. From July to September, consumption rose by 0.4% q/q, with the propensity to stay stable at around 9%. Household nominal disposable income continued to increase, benefiting both from the introduction of the “citizenship income” at the beginning of the year and from the further moderate improvement of labour market. In Q3, the number of persons employed rose above 25.5 million, the highest in the last twenty years, and that of hours worked partly recovered, despite remaining well below the pre-crisis level. Besides, the feeble dynamics of prices, with the annual inflation below 0.5%, has further sustained the evolution of the purchasing power of Italian households.

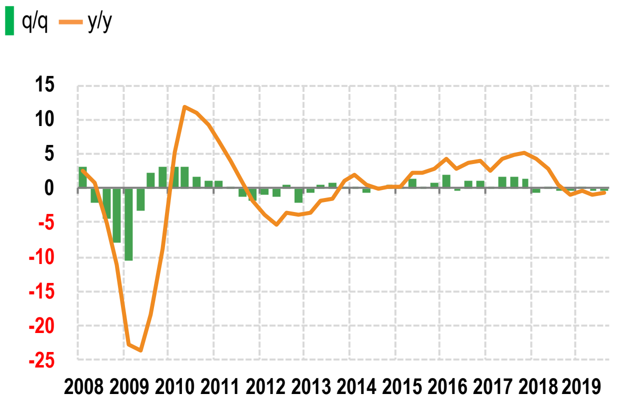
After having increased in the first half of 2019, also benefiting from the renewal of tax incentives, in Q3, investment declined by 0.2%, as those on means of transport strongly contracted and those on construction were virtually unchanged. Capital spending continued to suffer from the challenging evolution of profitability of Italian firms, which remained extremely cautious on their spending decisions. The propensity to invest, measured as the ratio between investment and value added, is still about 2.5 percentage points below the pre-crisis level, with USD 20 billion of lower annual capital expenditure.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Italy: manufacturing value added
(% change)



Source: BNL calculations on Istat data

Given the persisting uncertainty surrounding the economic and political scenario, Italian firms have further increased their buffer of liquidity, with the value of their bank deposits above USD 370 billion.

Manufacturing holds down economic growth

The still disappointing evolution of the Italian economy reflects the slightly positive growth of value added in services, the modest recovery in construction and the persisting contraction in the industrial sector. In Q3, value added of manufacturing declined by 0.2%, after -0.3% in the previous quarter, with the annual growth rate falling in negative territory (-0.6%), from +5% reached at the end of 2017. From Q1 2018 to Q3 2019, manufacturing production has declined by more than 3%, also as a consequence of the Germany industry slowdown. A strong contraction has been recorded in the automobive sector (-23%), in that of metal products (-7%) and in that of textile, clothes and leather items (-6.9%).

Ageing population poses new challenges

In the recent months the debate over the sustainability of public debt in Italy has gone hand in hand with the concern about the ageing of population and the challenge of maintaining adequate old age benefits while limiting fiscal pressure on current workers. The concern is all the more justified in Italy in the light of the burden of public pension spending, which in % of GDP is twice the OECD average: 16.2% compared to 8%.

According to the most recent OECD data, in Italy the old-age to working-age ratio amounts to 40 (i.e. there are 40 individuals aged 65+ per 100 persons aged 20-64), a value second only to the Japan's one (52). By 2050, that ratio in Italy is expected to reach 75.5, compared to 56 in France, 60 in Germany and 77.7 in Spain.

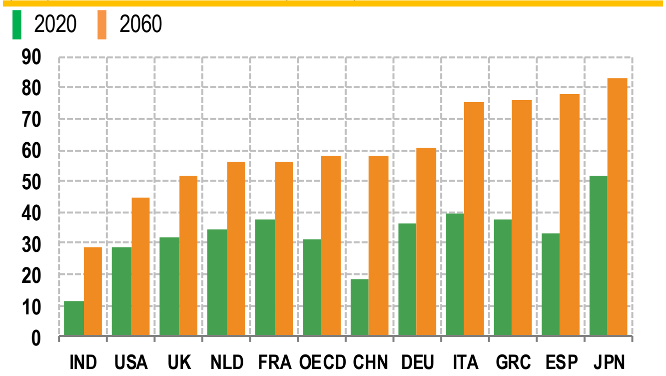
The evolution of such ratio depends, among other things, on the dynamics of the fertility rate, which in Italy has been decreasing for some years now. According to Istat, in 2018, 439,747 babies were born, about 18k less than in 2017 (-4%) and 140k less than in 2008 (-24%). The decrease in the number of new births is 67% due to the decline in the number of fertile women (those aged 15 to 49) that are today one million less that in 2008, and 33% to a decline in the fertility rate, from 1.45 children per woman in her fertile age in 2008 to 1.29 in 2018. Also declining is the contribution of migrant women to total fertility.

The decline in fertility has been accompanied by a decline in mortality, which has led to a significant increase in the life expectancy at birth in the country, from 66.5 years in 1950-55 to 83.3 years in 2015-20, one of the highest values in the world; above the OECD average is also life expectancy at age 65: 20.9 years against 19.7.

The increase in life expectancy has originated a significant increase in the proportion of the elderly people: the over-65 years old that in 1950 accounted for 8.1% of the total Italian population, in 2019 represented up to 22.8%. In the same period, the weight of the 0-14 years old class basically halved from 26.7 to 13.2%. Among the elderly people, 14,456 persons are at least 100 years old: a record value in Europe that Italy shares with France. In the decade between 2009 and 2019 the over 100 years old grew by more than 30%.

Italy has one of the highest future normal retirement age (71) among the OECD countries, along with Denmark (74), Estonia and the Netherlands (71). Like many other countries (e.g. the Netherlands and Spain) Italy has recently introduced measures (such as the so-called "Quota 100" Decree in 2019) which backtrack on previous policies that had been put in force to increase retirement age. "Quota 100" is a temporary measure applying until the end of 2021, which lets workers retire at age 62 provided that they have 38 years

3- Italy: average old-age to working-age ratio
(65+ years old per 100 people 20-64 years old)



Source: BNL calculations on OECD data

of contributions (instead of 67 years statutory required in 2018, with a contribution record of 42.8 years for men and 41.9 for women). The measure has a labour income ceiling aimed at limiting work incentive. According to INPS (the Italian National Welfare Institute) by November 2019 205,208 employed applied to access "Quota 100", mostly in the Southern regions. Among the applicants about 74% are men, 40% are less than 63 years old and 18% are over 65 years old. According to some preliminary analyses most applicants are residents in provinces characterized by high levels of unemployment and lower-than-average per capita value added.

Besides the burden it represents for public spending, the Italian pension system has some important shortfalls that deserve to be corrected: first and foremost, the impact that career breaks have on final pensions benefits. The close relationship between individual contributions and benefits in Italy's notional defined contribution scheme makes any career break particularly painful: according to OECD estimates, a 5 years break in the career of an average worker in Italy leads to a 10% decrease in his/her pension, against about 6% in OECD average. The problem is amplified by the spread that temporary jobs have had in the recent years. According to Istat, the share of temporary employed on total employment steadily increased from 13.5% in Q2 2008 to 16.9% in Q2 2019. Also increasing is involuntarily part time employment, while the number of self-employed workers, although slightly declining from 2008, is still significantly higher than OECD average (20% compared to about 15%). This difference is relevant, as self-employed pay lower contribution rates and receive, on average, lower pension than retired employed. This gap reaches the maximum of 30% in Italy, along with Germany and France.

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Spain

The new coalition takes its first steps

Although Spanish growth remains solid, it is by no means sheltered from the European slowdown. In 2020, growth is expected to continue slowing to about 1.7%, after reaching 2% in 2019. The slowdown is also beginning to have an impact on the labour market. From a political perspective, Pedro Sanchez was the winner of November's legislative election, although he failed to strengthen the Socialist party's position. He was invested as a prime minister in early January by Parliament and he will lead a minority coalition government alongside the extreme left Podemos. The coalition will depend on the implicit support of some regional and nationalist parties, notably the pro-independence Catalan ERC party.

Spain is expected to continue to rank among the fastest growing major European countries this year. After reporting an average annual growth rate of nearly 3% for the past five years, the Spanish economy apparently grew nearly 2% in 2019, well above the eurozone average.

Soft landing

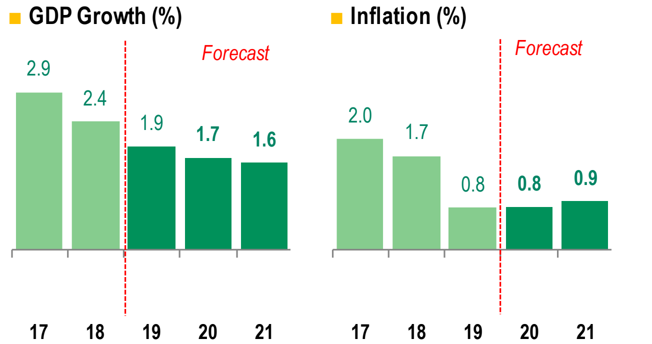
It goes without saying that the slowdown that has swept Europe has also hit the Iberian Peninsula, especially since its economy is much more open than in the past: exports of goods and services now account for nearly 34% of GDP in volume, up from 26% in 2007. Even so, the slowdown has been rather gradual so far, thanks notably to the resilience of domestic demand. Household consumption and corporate investment rose 1.4% year-on-year and 2.4%, respectively, in the third quarter. As to the year-end period, the Bank of Spain estimates that growth probably maintained a quarterly rate similar to that of the two previous quarters (0.4% q/q). Based on the information available so far, we expect retail sales to hold up strongly in the year-end period, while automobile exports rebound.

Purchasing manager surveys seem to concur with the idea of a growing decoupling of trends between the industrial and service sectors: industrial output has been contracting for the past few months while the service sector is much more resilient (see chart), buoyed notably by household demand, the turnaround in the housing sector and tourism. In the future, household income and behaviour will certainly play a key role in determining the resilience of Spanish growth. From this perspective, the news is mixed. Bolstered by job creations and wage increases, nominal disposable household income has increased by more than 3% year-on-year for the past two years, and continued to accelerate in mid-2019. As a result, Spanish households have been able to rebuild their savings. Spain's household savings rate is low compared to the European average, but it has picked up strongly since the beginning of 2018. This newfound manoeuvring room could prove to be handy just as the slowdown is beginning to have an impact on the labour market. With nearly 2.5 million job creations since the job market bottomed out in year-end 2013, job growth fell to just 1.8% year-on-year in Q3, the lowest level in the past five years, while the unemployment rate has levelled off in recent months at a very high level of 14%.

A fragile coalition

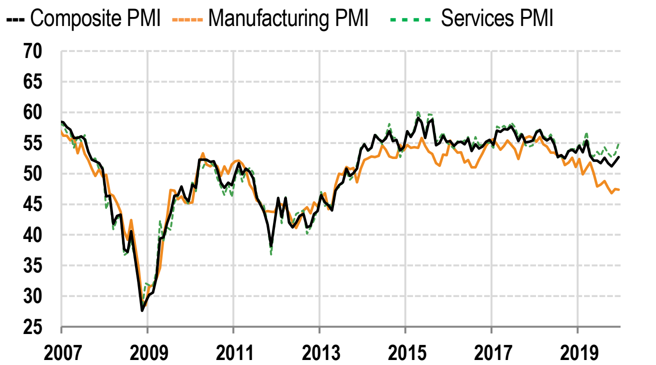
As polling data suggested, Pedro Sanchez came in first in the 10 November legislative elections, albeit without bringing together

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Activity in services is resilient
PMI (points)



Source: Markit

Spain's fragmented political landscape. This fragmentation has increased constantly since Podemos and Ciudadanos burst onto the political scene (around 2015), bringing to an end the bi-party system.

Divisions have only increased with the four general elections the country has held over the past four years. On the left, the balance of power was basically unchanged by November's election compared to the April 2019 results, with the Spanish Socialist Party (PSOE) winning 120 seats, or barely a third of the total in the new assembly, and Podemos winning 35 seats. On the right, the election was mainly marked by the collapse of the centrist party Ciudadanos, which lost four fifths of its seats to the Popular Party (89 seats), and by a new surge in the extreme right Vox party, which more than doubled its number of seats. Vox is now the country's third largest political power.

After several weeks of negotiations, Pedro Sanchez finally won approval in early January to head a PSOE-Podemos minority coalition government, thanks to the support of the Basque Nationalist Party PNV and the fortuitous abstention of the regional parties, notably the pro-independence Catalan Republican Left party (ERC).

Economic and institutional policies: walking a tight rope

What sort of policies, direction and scope of action will this minority coalition take? The investiture vote shows that Pedro Sanchez can only count on a very small majority of just 2 votes in the house of deputies[1]. Consequently, we can expect to see frequent power struggles throughout his mandate, as his various partners test the strength of the coalition. On the Catalan question, to win the ERC's support, Mr. Sanchez had to agree to open talks with the regional government and to submit its conclusions to voters in the region. Although renewing a dialogue is good news, a long and winding road lies ahead, because the two parties do not seem to have the same vision of the content and objectives of the talks (the Socialist want to reform its autonomous status while the ERC wants the right to self-determination).

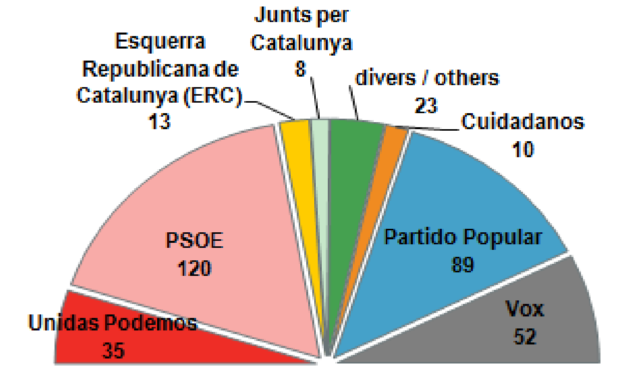
As to economic policy, it is worth recalling that after the April 2019 elections, Pedro Sanchez refused to form a coalition government with Podemos. He finally agreed to do so because this was the only feasible option after November's election. The coalition agreement between the two parties calls for higher taxes for big wage earners and major companies, and a minimum wage increase. To be more specific, the income tax rate on individual households would be increased by 2 percentage points for those making more than €130,000 a year, and by 4 points for those earning more than €300,000. Above €140,000, the capital gains tax would also increase by 4 points to 27%, from 23% currently. Lastly, the corporate tax reform would ensure a minimum tax rate of 15%, which would be raised to 18% for banks and oil companies.

In terms of spending, the coalition agreement calls for increased spending on public services, including healthcare, education and housing. Certain family benefits would be raised and pensions would be indexed to inflation again. Lastly, even though unemployment has levelled off at a very high rate in recent quarters, the government also plans to continue raising the minimum wage (after +8% in 2017, +4% in 2018, and +22.3% in 2019), gradually increasing it to 60% of the average wage within the next four years, (equivalent to another increase of roughly 30%).

At this stage, the 2020 budget has not been officially announced yet, much less approved. Pedro Sanchez still wants to guarantee a certain degree of fiscal responsibility, although a resolutely

3- Minority coalition

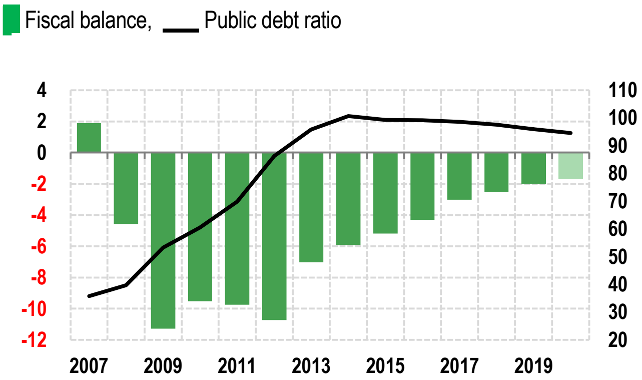
Political groups in parliament following the November 2019 elections, by number of seats



Source: Wikipedia

4- Budget forecast

% of GDP



Source: European Commission, 2020 fiscal plan dated October 2019

restrictive economic policy is highly unlikely[2]. He will be walking on a tight rope, especially in the midst of an economic slowdown. In 2019, the country already fell short of its targets, and the fiscal deficit apparently levelled off at 2.5% of GDP according to the Bank of Spain, compared to last October's forecast of 2%.

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[1] Pedro Sanchez did not win investiture until the second round of voting, during which he needed only a simple majority of deputies to win. Thanks to the abstention of a certain number of deputies, the Socialist was able to win the investiture and form a minority government, with 167 votes in his favour and 165 against.

[2] Despite European Commission recommendations to the contrary. As part of the preventative framework of the Stability Pact, the EC recommended that Spain continue to pursue fiscal consolidation efforts as long as the structural public finance deficit was not near an equilibrium.

Netherlands

Pension and climate challenges

Economic activity may have substantially weakened in Q4, due to the slowdown in world trade and the nitrogen and PFAS problems. Fiscal policy should become very accommodative, although it remains doubtful if the government will succeed in implementing all the spending plans. Growth is likely to slow this year, before picking up in 2021 on the back of a stronger global economy. However, climate challenges and labour shortages continue to weigh on activity in particular in construction. Moreover, pensioners may face severe cuts because of the deteriorated financial situation of the pension funds.

Sharp decline in activity in Q4

Since July 2018, the Statistics Netherlands business cycle indicator has been weakening. Until recently, this was not evident in the hard data. Economic growth held up reasonably well. In Q3, GDP growth amounted to 0.4%, virtually unchanged since the mid-2018.

However, early data indicate that activity came to a sharp halt in Q4. In November, industrial production declined by 1.1% from the previous month. This is partly attributable to the slowdown in world trade. Moreover, activity in the construction industry was severely impacted by the nitrogen crisis, following the High Court decision that the government's rules for granting permits for construction and farming activities that emit large amounts of nitrogen breached EU law. In addition, the construction sector was affected by the sharpening of the PFAS norms. The main effects of these problems on activity are expected in 2020 and 2021.

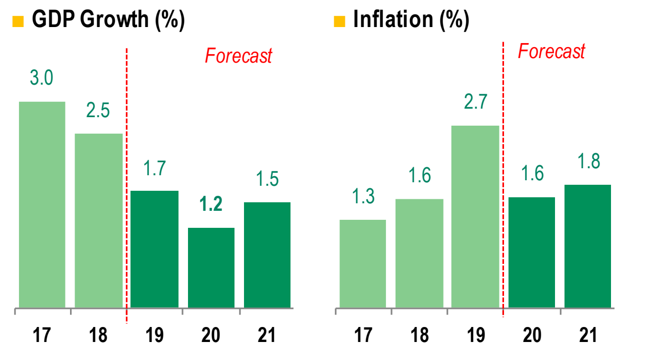
Also the labour market data indicate that activity is slowing. In August, the decline in the unemployment rate came to a halt at 3.5%. Nevertheless, labour market remains exceptionally tight. As a result, negotiated wages rose by 2.9% in 2019, a highest for a decade. The effect on consumer prices was limited. In 2019, inflation increased to 2.7% from 1.6 % a year earlier, but this was due to an increase in the reduced VAT rate by 3 points.

Important delays in investment projects

Fiscal policy is set to become more accommodative in 2020. According to the budget, government expenditure will rise by 0.6% of GDP, mainly due to the implementation of agreements on climate and pensions. In addition, the taxes will be lowered, in particular for households. Government finances will remain in surplus, but the structural balance is set to deteriorate by 0.7% of GDP. However, it remains questionable if the government succeeds in stepping up infrastructure spending. Investment projects have suffered delays because of the tightness of the labour market and long preparation procedures, which have been further complicated by the recent High Court decision.

At the presentation of the budget, the government also announced the setting up of an investment fund in order to benefit from the negative interest rates. It is generally assumed that the Fund could generate EUR 50 billion in investment projects, most of it financed by institutional investors.

1- Growth and Inflation



Source: National Accounts, BNP Paribas

Uncertain times ahead

GDP growth is set to slow to 1.2% this year, due to slowing world trade growth and important delays in construction projects because of the nitrogen and PFAS problems. Assuming a smooth Brexit process and a calming of international trade tensions, economic growth could accelerate to 1.5% next year. Inflation is set to fall to 1.6% in 2020 and could rise moderately in 2021, as higher labour costs spill over in consumer prices. A major domestic risk is the extremely low interest rate environment, which has weakened the financial position of pension funds. Some of them may be forced to cut their payments. Moreover, it will also affect pension claims of future generations.

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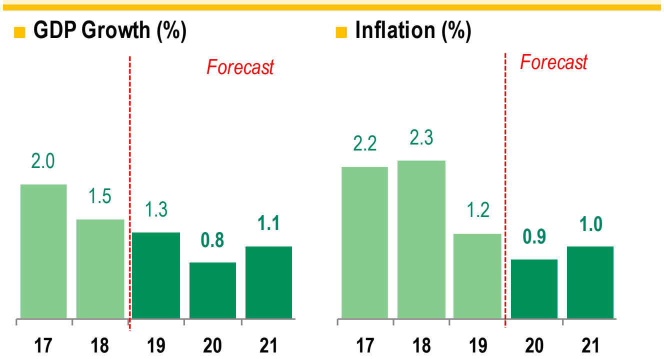
Belgium

Domestic demand under pressure to keep delivering

Belgian GDP growth is expected to drop to 0.8% in 2020, down from 1.3% in 2019. Domestic demand remains the key engine of growth, partially offset by a negative contribution from net trade. Private consumption growth is reduced as employment increases now at a slower pace, after 4 strong years. Investment growth is up, spurred on by public expenditures. The lack of a majority-backed government contributed to renewed fiscal slippage, which remains a key risk for the Belgian economy.

Belgian economic growth proved to be remarkably resilient, especially in the 2nd part of last year. Third quarter growth came in strong, spurred on by private consumption and consumer confidence rebounded somewhat at the end of last year. Business confidence continued its 4-month rise all through December and corporate investment growth has kept pace with 2018. Recently announced changes in the Flemish fiscal regime supporting first-time-homeownership caused some volatility in the number of transactions in the 2nd half of 2019. Based on the current numbers it seems that a large portion of the transactions were pushed forward in time to still benefit from the old regime.

1- Growth and inflation



Source: National Accounts, BNP Paribas

Labour market

The unemployment rate came in at 5.6% in October of last year. After strong employment growth in the period 2014-2018, job creation slowed down in recent quarters. The National Bank of Belgium (NBB) expects that 169 000 new jobs will be created in the period 2019-2022, which is almost a third less than in the previous four years.

The recent employment growth drove the employment rate to 70% in 2018. There is some further improvement expected in this area but the Belgian EU2020 objective of 73.2% will unfortunately remain elusive. The employment intensity of activity growth is expected to come down again, after rising in recent years. This is a consequence of the slowdown in labour-supply growth, with vacancy rates still well in excess of the EU-average.

The Federal Planning Bureau expects that the wage-indexation mechanism will kick in in March 2020. As a consequence, welfare transfers and wages for civil servants would increase by 2% in the subsequent 2 months. Purchasing power per capita should increase around 5% by 2022 according to estimates by the NBB.

Price and trade

Meanwhile, labour costs are picking up again, with yearly growth once again in excess of the EU19-average. Domestically, this effect will likely only partially spur on core inflation, as lower firm profit margins are expected to make up for the difference.

High labour costs have l been a key worry for a long time with regards to the international competitiveness of the small open economy that is Belgium. This has come all the more to the fore given the sustained loss of global market sharesince the beginning of the century.

In a recent study by the NBB, the positive impact of past Belgian wage moderation efforts are shown to have had only marginally benefitted international cost competitiveness. This is consequence of the specific characteristics of Belgian export flows, which are focussed on intermediate goods, have above average high-tech content and often occur between entities of the same multinational groups. As a consequence, these flows are much less sensitive to movements in labour costs. The study does however point out an important role for the Belgian authorities, through export promotion and removal of constraining barriers.

Government policy

Public spending increased markedly in 2019, driven by local government investment as per usual in an election year. For 2020 and 2021 additional public spending is expected, amongst others on a large infrastructure project near the city of Antwerp.

Public debt came in at just below 100% of GDP in 2019, after GDP was revised upwards as part of a major update of the methodology used to calculate the national accounts. The fiscal deficit reached a post-crisis low of 0.7% in both 2017 and 2018 but is expected to deteriorate significantly going forward. The improved figures in these years were a consequence of one-off-events and the absence of a majority backed government for the whole of last year likely pushed the deficit back up to 2%.Government expenditures are climbing, but revenues remain stagnant. The High Council of Finance, which advises the government on its multi-year budget, foresees deficits in excess of that for the near future. As such fiscal slippage is a key-risk for the Belgian economy.

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Greece

The recovery continues

Supported by catching-up effects, the Greek economy managed to accelerate slightly despite a slowing European environment. Confidence indices have improved strongly and the Greek state has successfully returned to the capital markets. The new centre-right government is seeking to cut taxes on labour and capital without sacrificing fiscal discipline. The recovery will be a long process, but it is on track.

Growth accelerates slightly

In 2020, the Greek economy entered its fourth consecutive year of recovery. The turnaround now seems to be well underway, although the acceleration phase is proving to be more laborious. Activity was a bit subdued in early 2019, but strengthened over the summer and seems to have struck a more solid pace throughout the second half. We estimate last year's economic growth at about 2.3%, up from 1.9% in 2018. The economy was mainly driven by a rebound in exports of goods and services (+9.5% y/y in volume in Q3 2019) and investment (+2% y/y in Q3), while household consumption seems to have slumped.

The most recent economic data and survey results justify a certain optimism. Although the manufacturing sector is still lagging, in keeping with the European economic cycle, tourism revenues are solid, house prices are picking up and the construction sector has begun to recover. The rebound in retail sales and new car registrations suggests that household consumption strengthened in late 2019.

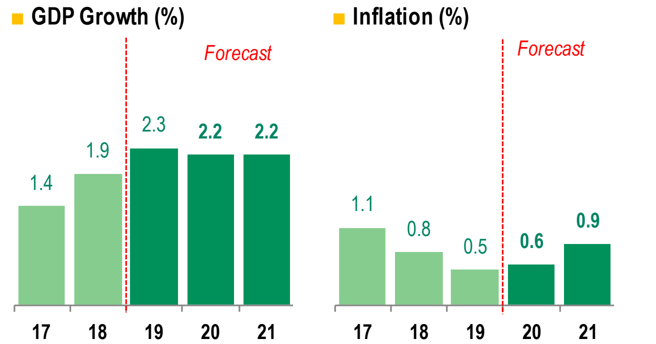
Most importantly, the European Commission surveys reveal a strong improvement in household confidence and in the business sentiment index at the end of last year, suggesting that domestic demand will make a bigger contribution in 2020. The recovery can also be seen in job market trends: ongoing job creations are obviously a key factor behind the improvement in the household situation, as the unemployment rate dropped back to 16.8% of the active population in September 2019. All in all, we expect 2020 growth to hold at roughly the same pace as in 2019, in line with the broad scenarios established after Greece exited the third adjustment plan.

Political alternation

As survey results suggested, the centre-right New Democracy party won the snap legislative elections in July 2019, with an absolute majority in parliament. Prime Minister Kyriakos Mitsotakis did not unravel the fiscal package adopted by the previous government in spring 2019, right before the elections (0.6pp of GDP in favour of households).

The 2020 budget calls for a series of measures, essentially tax cuts, designed to stimulate growth. The plan specifically calls for a cut in the corporate tax rate (to 24% from 28%), household income tax cuts, measures in favour of families, a decrease in social contributions and a cut in the dividend tax. The government claims

1- Growth and inflation



Source: National accounts, BNP Paribas

that all of these measures, estimated at 0.6 pp of GDP, will be entirely financed by stronger measures to develop electronic payments systems and combat VAT fraud, higher municipal and property taxes.

The European Commission welcomed this budget proposal and is forecasting a fiscal surplus of 1% of GDP in 2020, in line with the Greek government, after an expected 1.3% in 2019. Last fall the Commission also gave the green light to the launch of a securitisation scheme that would enable banks to unload nearly half of the non-performing loans that are still encumbering their balance sheets[1]. Special purpose vehicles (SPVs) set up under the Hercules Asset Protection Scheme will buy up the banks' non-performing loans and resell the securitised products to investors. The Greek government will guarantee the senior tranches of the securitised NPL.

Bolstered by these conditions and a favourable monetary environment, the return of Greek central state on the debt capital markets was successful in 2019 with four issues of 5, 7 and 10-year bonds totalling EUR 9 bn. Benefiting from a sharp reduction in spreads, Greek 10-year rates declined to nearly 1.5% at the end of December.

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[1] Although non-performing loans have declined sharply in recent years, they still account for 42% of Greek bank loans outstanding and amounted to EUR 71 billion in September 2019.

United Kingdom

Brexit update

On 31 January 2020, the United Kingdom will officially leave the European Union and all of its constituent institutions. Brexit will therefore happen in law if not in fact, as, during a so-called 'transition' period set to end on 31 December 2020, the British economy will remain a full part of the single market and the European customs union. Goods, services and capital will continue to move freely into and out of the EU, which will continue to have legal and regulatory authority. True separation will only come at the end of this period, once the framework of the future relationship has been settled. As has been the case for some time now, this final step does not look easy to achieve.

Winning 43.6% of the vote and 365 of the 650 seats in the House of Commons, the Conservative Party led by Prime Minister Boris Johnson was the big winner in the 12 December 2019 general election. There are therefore no more parliamentary obstacles to a separation of the United Kingdom and the European Union (EU).

On 19 December 2019, MPs voted by 358 to 234 in favour of the Brexit Bill, that enshrines the Withdrawal Agreement between the United Kingdom and the EU in law (see Box). Ratification is likely to follow, after debate in the House of Lords and assent by the Queen, which is a formality. Votes in the European Parliament (by simple majority) and then the Council of Europe (by qualified majority) will follow, for the legal withdrawal to take place at midnight (Paris time) on 31 January 2020. The United Kingdom will then officially leave all of the EU's institutions (Parliament, Court of Justice, Commission and so on) but will not immediately leave the single market, the rules of which it will continue to follow throughout the transition period which is expected to run until 31 December 2020.

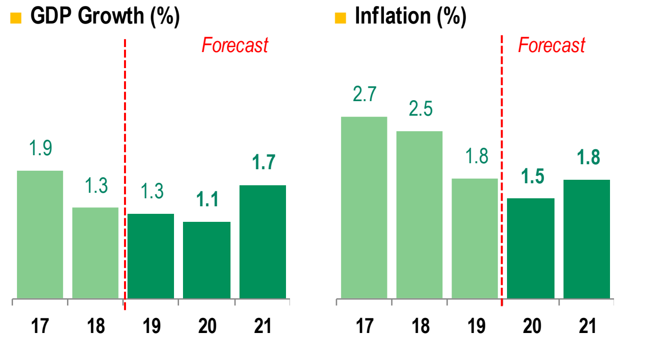
A red line that runs straight into a wall

By this deadline, the UK and EU are supposed to have set the framework for their future relationship and to have completd their effective separation. However, many European observers believe that the eleven month-period available to achieve this is too short. The Withdrawal Agreement includes the possibility of extending the transition period, but this has been formally rejected by Mr Johnson, who has included the 31 December 2020 date in UK law. The radical line adopted by the Prime Minister, with a full withdrawal (leaving both the single market and the customs union) to be completed rapidly, will be hard to hold.

First, because it will encounter significant political resistance. The UK's first past the post electoral system means that supporters of a 'hard' Brexit have taken control of Parliament, despite receiving a minority of the votes cast in the election. Alongside the Conservative victory in the House of Commons, the other standout feature of the 12 December election was the surge in support for nationalist parties in Norther Ireland, Wales and Scotland; these parties are generally opposed to Brexit and in favour of their countries remaining in the EU.

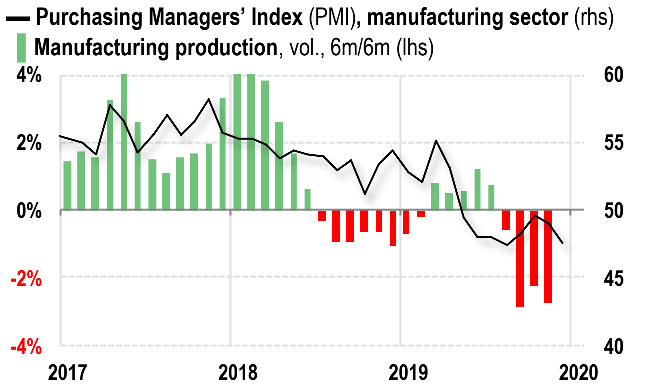
Secondly, because sooner or later a return to reality will be inevitable. Across all areas, from industry and agriculture, via energy and transport to data exchange and beyond, the links between the UK and EU are governed by a vast corpus of legislation and regulations consisting of around 600 structures.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Industry in recession



Source: Markit, ONS

These require the mutual respect of standards (technical, employment, health, environmental) and laws (geographical indications, intellectual property and so on). The task of undoing all of this only to replace it on a case by case basis with tariff or cooperation agreements will be onerous and complex. It promises tough negotiations with the EU, whose chief negotiator, Michel Barnier, has repeatedly stressed that he will not accept any agreement that risks the creation of unfair competition from the UK. But this is not the only task that lies ahead. By going it alone, the UK will also have to renegotiate, with 168 different parties, all of the trade treaties (there are 236 in total) that the EU has agreed with third countries.

The most difficult part of the whole process – defining Brexit in concrete terms – is, therefore, still to come, to the extent that the relief that may come from ratification of the WA could be short-lived. As we approach 31 December, the risk will clearly be that, for lack of time or ambition, the UK and the EU end up separating without an agreement. In this case, World Trade Organisation (WTO) rules would apply, which is in no-one's interest.

The economy is slowing down

The final months of 2019 saw a continued slide in business climate indicators, as the industrial recession strengthened its grip (Figure 1). The economy as a whole probably stagnated over the fourth quarter, with growth for the year of 1.2% on average. This was in line with the European average, as the euro zone economy also slowed and Germany flirted with recession. However, it looks a more modest performance when seen in the light of the trend in sterling[1], whose fall in value would normally be expected to boost activity.

However, the exchange rate elasticity of the UK's international trade is considered to be low[2]. Net exports did not increase in 2019, making a negative contribution to growth. Clearly, imports in anticipation of Brexit could have played a role in this, but the UK has also seen a deterioration in its cost competitiveness. Actions to increase the minimum wage are not the main cause of this. Even though it was described as historic, the increase announced by Mr Johnson (6.2% in April) does little more than continue the process of making up for lost ground that began under David Cameron. This has sought – but not yet achieved – the restoration of purchasing power losses suffered by workers after the 2008 crisis[3]. Its diffusion effect is highly dependent on the state of the economy; it ceases to be significant above the first quintile of the income distribution (NIESR, 2018)[4].

The weakening of the competitive position is in reality due above all to the slowdown in productivity growth, which has been particularly marked in the UK over the past decade[5]. It seems unlikely that Brexit will provide the solution to this problem.

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[1]Between December 2015 and December 2018 the pound fell 20% against the euro and 16% in nominal trade-weighted terms. Source: *Bank of England*

[2]See for example Bussière M., Gaulier G. and Steingress W. (2016) *Global Trade Flows: Revisiting the Exchange Rate Elasticities*, Banque de France, Working paper n°608, November

[3]Between the first quarter of 2008 and the first quarter of 2015, the index of real weekly wages (fixed and variable) across the economy fell by 11%. It has since recovered, but at the end of 2019 was still around 3% below its pre-crisis level.

[4] National Institute of Economic and Social Research (2018), *National Minimum Wage and National Living Wage impact assessment: counterfactual research*, February.

[5]Since 2009, average annual growth in hourly labour productivity has been 0.5% in the UK, compared to 1% in the euro zone. Source: Eurostat.

3- The main provisions of the Withdrawal Agreement

On 17 October 2019, the UK Prime Minister, Boris Johnson, and the 27 EU Heads of State or Heads of Government, agreed a Withdrawal Agreement. This incorporated the bulk of the previous version agreed by Theresa May in November 2018 (but never ratified), with the major differences relating to Northern Ireland, where the previous text was heavily revised. In summary, under the WA:

*1/ **A transition period will run from the date of withdrawal** until 31 December 2020, to allow the UK and EU to negotiate their future relationship. During the transition period, the UK will no longer be a member of EU institutions but will have continued access to the single market; it will follow the rules of the market (which, most notably, means that it will be unable to conclude trade agreements with third countries) and will remain subject to rulings from the European Court of Justice.*

*2/ **The status of foreign residents is secured.** The 4 million EU citizens resident in the UK, and the 1 million UK citizens resident in the EU on the withdrawal date, will be free to remain and continue their activities, and will have their rights guaranteed (in terms of access to healthcare, education, employment, receipt of pension benefits, family reunification and so forth).*

*3/ **The UK undertakes to settle its financial liabilities to the EU**, under multi-year commitments made (the 2014-2020 budget, for European projects, etc.). Although the WA does not specify an amount (the final amount will depend on the terms of the agreement on the future relationship), UK sources estimate the financial settlement at around EUR40 billion.*

*4/ **Northern Ireland will have special status,** in order to satisfy the requirements of the 1998 Good Friday Agreement and avoid the reintroduction of a hard border with the Irish Republic. In contrast to the provisions of the original WA, Northern Ireland will be able to form its own customs union with the rest of the UK after the transition period (that is to say it will apply UK tariffs). The 'backstop' that would have kept the EU and the UK in a single customs territory on a temporary basis has thus been removed, but not without significant concessions and restrictions. Northern Ireland will therefore continue to apply European customs rules for those products coming into its territory that could then be exported to the single market. With an open border between the North and the Republic, this will inevitably result in the introduction of controls on imports from Great Britain or third countries. Northern Ireland will also continue to follow EU rules in a number of areas such as agriculture, energy (it will remain in the single market for electricity), state aid and the application of VAT. This protocol will apply for renewable 4-year periods. It will be subject to the control of a joint UK and EU commission, with the Northern Irish Assembly having a say on renewal.*

Source: European Commission

Sweden

Growth continues to slow

GDP growth slowed sharply in 2019, and this trend is expected to be confirmed in 2020. Uncertainty surrounding the business climate and international trade are straining exports and investment. Consumption is barely rising and is unlikely to revitalize growth. Despite this environment, and with inflation near the central bank's 2% target rate, the Riksbank opted to raise its key policy rate from -0.25% to 0%. Even so, monetary policy is still accommodating.

After rising to 2.4% in 2018, Swedish GDP growth fell back to 1.4% in 2019, the lowest level since 2013. With sluggish demand and uncertainty straining exports and the business climate, growth is unlikely to accelerate in 2020. Consequently, we are forecasting a growth of 1.2%.

A deteriorated business climate

With its very open economy (45.6% of GDP is exported), Sweden is sensitive to fluctuations in international trade. In 2020, the economy will be hit by sluggish trade, notably with the European Union (58.3% of exports). Given Sweden's high exposure to the UK, the risk of Brexit[1] strained its market prospects in 2019. At the end of the year, PMI (which averaged 46.3 in Q4 2019) and corporate investment both declined. Although business leaders' fears should ease with the signing of the withdrawal agreement between the EU and the UK (see EcoFlash of 20 December 2019), the risk of a hard Brexit without a trade agreement in January 2021 could maintain a high degree of uncertainty. Under this environment, investment in machinery and capital goods should continue to contract in 2020.

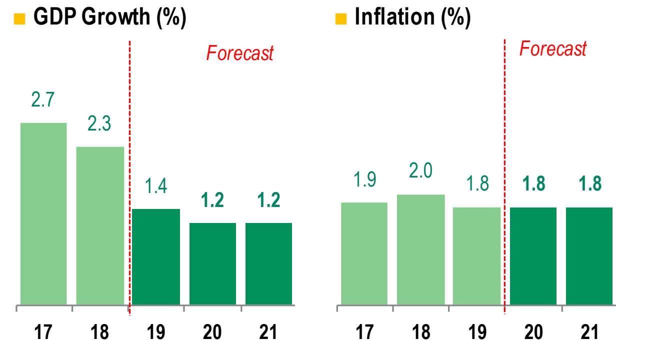
After plunging by 8% in 2019, housing investment could stabilise at a low level[2] due to the absorption of the stock of surplus housing on the market.

Private consumption continues to rise very slightly. It rose only 1% in 2019, after 1.6% in 2018. Despite the government's tax cuts, consumer confidence has eroded with the upturn in the unemployment rate, which rose from 5.8% in November 2018 to 6.8% in November 2019. Wage growth will also remain very moderate in Q1 2020.

At 1.8% in November, the inflation rate is approaching the Riksbank's 2% target. Looking beyond fluctuations arising from oil pricing trends, core inflation (excluding food and energy prices) has tended to accelerate, notably due to rent increases.

On 19 December 2019, the Riksbank opted to raise its key policy rate from -0.25% to 0%. The central bank considers that the application of negative interest rates over a long period of time could have negative induced consequences. With a repo rate of 0%, however, Sweden's monetary policy is still expansionist.

1- Croissance et inflation



Source: National accounts, BNP Paribas

In recent years, the public debt ratio has declined sharply (to 34.6% of GDP in 2019, from 45% in 2014) and Sweden has reported recurrent fiscal surpluses. The government is now using part of its leeway to stimulate activity by 0.5% of GDP in 2020. Incentives will be set up to encourage investment (notably for the energy transition), and households will benefit from additional tax cuts. A substantial part of the budget will also be devoted to healthcare, education and improving employability.

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[1] According to the Insee (*Evaluating the impact of Brexit on the activity of the UK's trading partners: the foreign trade channel*), Sweden is the seventh ranking country in terms of the loss of value added due to Brexit. Swedish GDP would decline by 0.6% in case of a hard Brexit, and by 0.3% for a soft Brexit.

[2] It is likely to hit a record low in 2020, falling below SEK 200 billion for the first time since 2015 (SEK 198 bn). It could recover thereafter.

Denmark

Resilient growth

In a less buoyant international environment, Denmark's small open economy managed to maintain a rather dynamic pace. Thanks to its sector specialisation (pharmaceuticals, digital, etc.), the economy has been fairly resilient despite the downturn in the global manufacturing cycle. A labour market verging on full employment and accelerating wage growth have bolstered consumption, which is still one of the main growth engines. With the Danish krone (DKK) pegged to the euro, the central bank's monetary policy will follow in line with ECB trends, and is bound to remain very accommodating. Fiscal policy will be geared towards the ecological targets of reducing greenhouse gas emissions.

Estimated at 1.8% in 2019, Denmark's GDP growth remains relatively robust so far, both with regard to its long-term potential (estimated at 1.6% according to the OECD) and to the European average (1.5%). In 2020, growth is expected to slow somewhat, and our forecast of 1.5% places it among the leading EU countries.

Buoyant consumption

Denmark's specialisation in the pharmaceutical and digital industries helped shelter it from the slowdown in international trade in 2019. Exports increased by 3.8%, compared to 2.4% in 2018. Yet export growth is likely to be less buoyant in 2020, given the feeble growth forecasts for key trading partners such as Germany (15% of exports). Although uncertainty over Brexit was partially lifted with the signing of the withdrawal agreement (see article on the UK), it is not about to disappear[1]. In 2019, this uncertainty helped erode the confidence of business leaders (the business climate component of the PMI declined), and investment contracted. By 2021, however, investment should benefit from the renovation of the biggest North Sea oil platform.

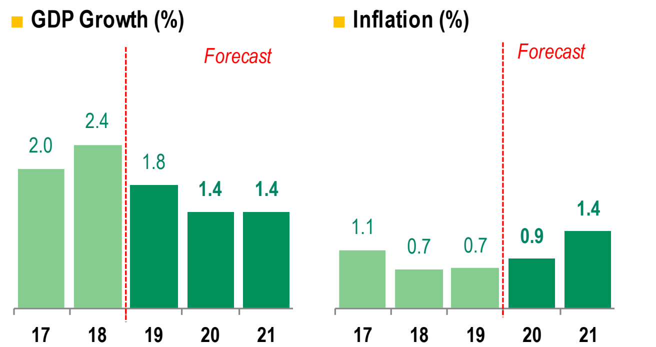
Although private consumption was hampered in 2019, it continues to drive demand and should be a support factor in 2020. In a country with a high labour market participation rate (79.4% for the 16-64 age group), the dynamic momentum of employment and wages (+2.5% on average in 2019) has a major gearing effect on household confidence and spending. Household spending is also bolstered by low inflation (barely equal to 1%) and interest rates, which have dropped into negative territory for certain home loans.

Monetary and fiscal support

The Danish krone is pegged to the euro, so the Danish central bank has followed the ECB's lead and adopted a very accommodating monetary policy. In September 2019, it reduced the repo rate to -0.75% to defend the kroner's exchange rate against the euro.

In 2019, a sharp increase in the pension yield tax helped swell the fiscal surplus, which amounted to 2.2% of GDP. The public debt ratio, which is one of the lowest in the European Union, was trimmed to 33% of GDP. The government recently tightened its targets for reducing greenhouse gas emissions[2], on the grounds that it wanted to use its manoeuvring room on behalf of a more ambitious social and environmental policy. In 2020, the government plans to invest DKK 1 bn in research on more eco-friendly, carbon-neutral alternative technologies. The budget also calls for increasing spending on public services, including healthcare and education.

1- Growth and inflation



Source: National accounts, BNP Paribas

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[1] The UK is Denmark's fourth biggest trading partner.
[2] Down 70% by 2030 (from the 1990 level)

Economic forecasts*

%	GDP Growth 2019 e	2020 e	2021 e	Inflation 2019 e	2020 e	2021 e
Advanced	**1.7**	**1.2**	**1.6**	**1.4**	**1.6**	**1.4**
United-States	2.3	1.7	1.9	1.8	2.2	1.9
Japan	1.0	0.2	0.7	0.5	0.6	0.3
United-Kingdom	1.3	1.1	1.7	1.8	1.5	1.8
Euro Area	**1.1**	**0.8**	**1.3**	**1.2**	**1.0**	**1.1**
Germany	0.6	0.4	1.2	1.4	1.2	1.4
France	1.3	1.1	1.3	1.3	1.0	1.1
Italy	0.2	0.2	0.6	0.6	0.6	0.5
Spain	1.9	1.7	1.6	0.8	0.8	0.9
Emerging	**0.0**					
China	6.1	5.7	5.8	2.9	3.5	1.5
India*	4.8	5.5	6.0	4.3	4.5	4.5
Brazil	1.0	2.0	3.0	3.7	3.4	3.7
Russia	1.1	1.6	1.8	4.5	3.7	4.0

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)
* Fiscal year from April 1st of year n to March 31st of year n+1

Financial forecasts*

Interest rates, % End of period		2019 Q3	Q4	2020 Q1e	Q2e	Q3e	Q4e	2018	2019	2020e
US	Fed Funds	2.00	1.75	1.75	1.75	1.75	1.75	2.50	1.75	1.75
	T-Notes 10y	1.67	1.92	1.85	2.00	2.10	2.25	2.69	1.92	2.25
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	-0.50	-0.40	-0.30	-0.30	0.25	-0.19	-0.30
	OAT 10y	-0.28	0.08	-0.20	-0.15	-0.10	-0.10	0.71	0.08	-0.10
UK	Base rate	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
	Gilts 10y	0.40	0.83	1.00	1.10	1.20	1.20	1.27	0.83	1.20
Japan	BoJ Rate	-0.06	-0.05	-0.10	-0.10	-0.10	-0.10	-0.07	-0.05	-0.10
	JGB 10y	-0.22	-0.02	-0.10	0.00	0.05	0.10	0.00	-0.02	0.10

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates End of period		2019 Q3	Q4	2020 Q1e	Q2e	Q3e	Q4e	2018	2019	2020e
USD	EUR / USD	1.09	1.12	1.12	1.13	1.13	1.14	1.14	1.12	1.14
	USD / JPY	108	109	100	98	96	96	110	109	96
	GBP / USD	1.23	1.32	1.35	1.36	1.36	1.39	1.27	1.32	1.39
	USD / CHF	1.00	0.97	0.99	0.99	0.99	1.00	0.99	0.97	1.00
EUR	EUR / GBP	0.89	0.83	0.83	0.83	0.83	0.82	0.90	0.83	0.82
	EUR / CHF	1.09	1.09	1.11	1.12	1.12	1.14	1.13	1.09	1.14
	EUR / JPY	118	122	112	111	108	109	125	122	109

Source : BNP Paribas GlobalMarkets (e: Forecasts)

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