ECO PERSPECTIVES

4th quarter 2022

EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

The bank
for a changing
world

EDITORIAL

THE RECESSION NARRATIVE

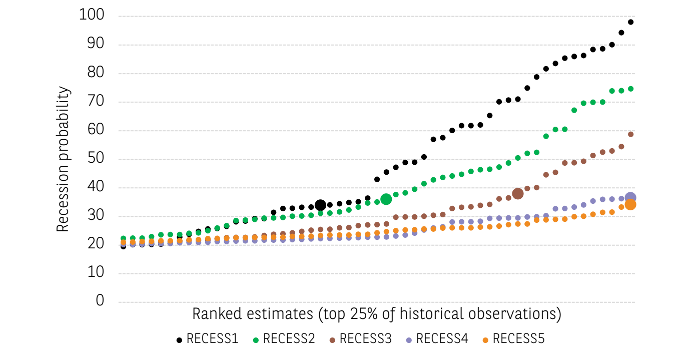
Inflation has been the dominant economic theme for months, but, under the influence of aggressive monetary tightening, one can expect this won't last. At the same time, recession concerns are mounting. Central bankers acknowledge that their action may cause a technical recession, a huge majority of US CEO's expect a recession and consensus forecasts show an increased recession risk in the US and even more so in the euro area. The recession narrative should lead to a wait-and-see attitude, of putting spending and hiring decisions on hold and creates a mutually reinforcing negative interaction between hard data and sentiment. A key condition for this to end is growing belief that central banks will have done their job and can afford to stop tightening. Whether reaching that point will really boost confidence will however depend on how the economy and the labour market have reacted to the rate increases.

In the public debate about the economic situation, inflation has been the dominant theme for months, but one can expect this won't last. Surveys show easing pressures in global supply chains and input prices, several commodity prices have declined recently and, although wage growth remains robust in the US and should accelerate further in the euro area, aggressive monetary tightening should be a key driver of gradual disinflation. In parallel, recession concerns have been increasing and, eventually, they will overtake inflation as the key topic of economic discussions. Federal Reserve Chair Jerome Powell has acknowledged that bringing inflation under control will cause some pain. According to a recent Conference Board survey, 81% of US CEOs are preparing for a recession over the next 12 to 18 months. They expect it to be brief, shallow and with limited global spillovers. 12% are gloomier and expect a deep recession with material global spillovers, whereas only 7% do not anticipate a recession. Growth forecasts have been revised downwards, although the Survey of Professional Forecasters conducted by the Federal Reserve of Philadelphia still expects positive quarterly growth in the US over the entire forecast horizon, which runs until Q3 2023. However, the assessment of the recession likelihood has increased significantly for the short run and is at a record high for the medium run (four or five quarters ahead, which corresponds to Q2 and Q3 2023) (*chart 1*). In the euro area, the Bloomberg consensus expects negative growth in the final quarter of this year and the first quarter of next year (*chart 2*). ECB chief economist Philip Lane, referring to the rate hikes, has recently stated that *"we're not going to pretend this is pain free"*, adding that a technical recession cannot be ruled out.[1]

The reasons behind the downward shift in the growth outlook are well-known. Inflation is eroding households' purchasing power and corporate profit margins. In Europe, more and more firms are temporarily stopping production in reaction to high gas and electricity prices. Central bank rate hikes, as well as the anticipation of further rate increases, have raised the cost of borrowing, which is weighing on demand, especially in the housing sector in the US. Although the order books in the manufacturing sector are still well-filled, the trend of incoming orders is down, even more so with respect to new export orders. Subdued growth in China is playing an important role in this respect. Finally, the war in Ukraine has been an important factor, to a large degree through its impact on commodity prices.

The recession narrative makes people doubt and worry. Not only will they scale back their base case scenario of income, sales, profits, but their conviction level about the forecasts will also decline. Firms will increasingly adopt a wait-and-see attitude until a clearer picture emerges. Investment plans will be put on hold. Hiring intentions will be scaled back -this is already visible in EU survey data-, which eventually should give rise to increasing unemployment expectations of households. This in turn should weigh on consumer spending. At some point, this mutually reinforcing negative interaction between hard data -activity, demand, etc.- and soft data -confidence-, should stop.

UNITED STATES: LIKELIHOOD OF BEING IN A RECESSION



The chart shows the probability of negative quarter-over-quarter growth of real GDP for the quarter in which the survey was conducted (RECESS1) and the four following quarters. Data are ranked in ascending order. Only the upper quartile of the data are shown.

CHART 1

SOURCE: SURVEY OF PROFESSIONAL FORECASTERS, PHILADELPHIA FED, BNP PARIBAS

EURO AREA: DISTRIBUTION OF REAL GDP GROWTH FORECASTS

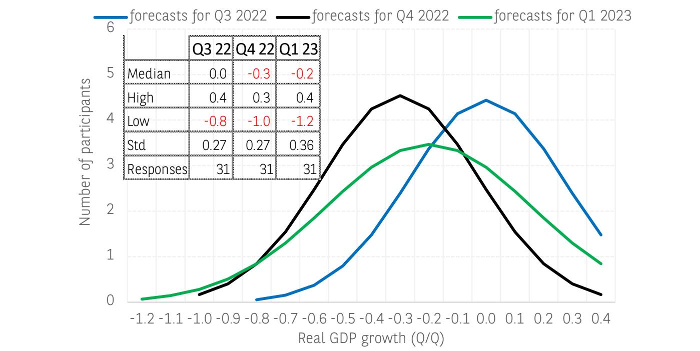


CHART 2

SOURCE: CONSENSUS BLOOMBERG, BNP PARIBAS

A key condition is growing belief that central banks will have done their job and can afford to stop tightening. It implies that rate hikes, despite their aggressiveness, have a silver lining: the cyclical peak in the policy rate will come sooner than under a gradualist approach. Whether reaching that point will really boost confidence will however depend on how the economy and the labour market have reacted to the rate increases.

William De Vijlder
william.devijlder@bnpparibas.com

1 Source : ECB to inflict pain as it hikes rates into next year, economist says, Reuters, 17 September 2022.

UNITED STATES

CLOSE TO INFLATION PEAK?

Following a second contraction in its GDP in Q2, the outlook for the US economy is at least uncertain. Inflationary pressures are showing signs of easing, but the pace of disinflation could be longer than expected. While consumer confidence recently paused its downward trend and in fact recovered slightly in August, business surveys show a sharp decline in sentiment, particularly in the manufacturing sector. The Federal Reserve has continued the rapid rise in its fed funds rates, which are now at restrictive levels.

GDP fell again in Q2 (-0.9% on an annualised quarterly basis after -1.4% in Q1), mainly due to the drop in private investment and a smaller inventory. Based on our forecasts, the mechanistic upturn in growth in Q3 may continue over several quarters, but at a relatively slow pace. On the inflation side, several indicators suggest a potential slowdown in inflation from mid-2022 (fall in the energy and input prices, slowdown in the price of goods, fewer tensions on the labour market) but there is still a significant amount of uncertainty. And even if this fall in inflation materialises in the coming months, which is the most likely scenario, it is likely to stay above the 2% target until 2024. Having propelled its key rates into restrictive territory (3.00% - 3.25%) with a rise of 75 basis points in September, the Fed is expected to continue its restrictive policy until the end of the year.

Inflation, as measured by the Consumer Price Index (CPI), stood at 8.3% y/y in August, a very high level but down compared to July (8.5% y/y). This reduction is mainly the result of the recent drop in the price of crude oil, partly offset by the sharp increase in food prices. And while total inflation fell, core inflation rose sharply from 0.4 percentage points to 6.3 per cent, raising fears that the inflation peak has not yet been reached.

In fact, inflationary pressures are continuing with the rebalancing of consumer choices from goods to services (cf. figure 2). Due to the health restrictions during the Covid crisis, many consumers had shifted a part of their consumption of services towards goods. This atypical increase in the demand for goods, particularly at the start of the post-Covid recovery, had contributed significantly to the rise in the price of durable goods. However, this rise has slowed significantly since the start of the year (from 11.5% y/y in January to 5.6% y/y in July), with consumption shifting back towards services. The demand for services has returned to its pre-Covid levels but not yet its trend, suggesting that demand could continue to increase.

The rise in property prices has also contributed significantly to the increase in consumer prices (2.1 points year-on-year in August), in particular via the rise in property prices in the cost of home-owner properties. And property prices are still expected to rise in the coming months, despite rising interest rates and signs of a market slowdown. Moreover, inflation in healthcare services, which made a significant contribution to the rebound in core inflation in August, could continue, mainly as a result of salary increases for healthcare workers.

Between the slowdown in the economy and the continued high inflation, a recent divergence has appeared between householder and business sentiment. Consumer confidence in fact improved during August, according to surveys by the Conference Board and the University of Michigan. The perception by households of their personal financial situation even recovered for the second consecutive month, thanks in particular to the positive performance of the labour market. Despite a slight increase in the unemployment rate (+0.2 points in August, to 3.7%), the labour market remains solid, which is supportive of the purchasing power of Americans and mitigates the impact of the rise in the cost of living. Total nonfarm payroll employment is slowing down but remains significant (+315k m/m in August), particularly in the business services, healthcare and retail sectors.

GROWTH & INFLATION

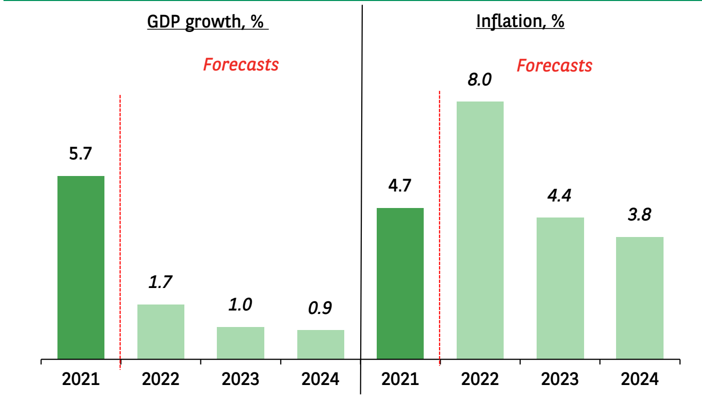


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

US: SERVICES & FOOD INFLATION RISES AS GOODS & ENERGY INFLATION EASES

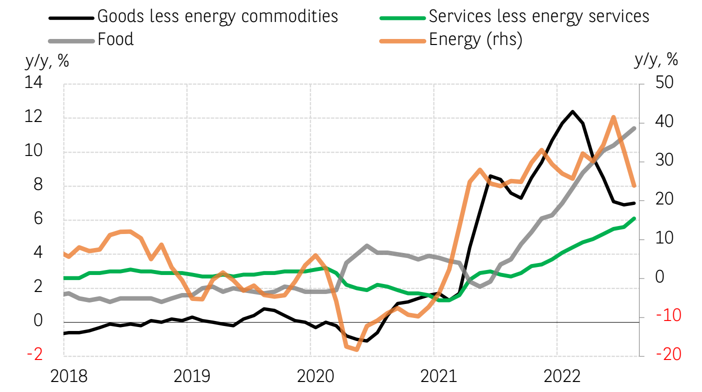


CHART 2 SOURCE: BLS, BNP PARIBAS

On the corporate side, the latest surveys of the business climate have not reflected this slightly improved outlook among households. The Philadelphia Federal Reserve's survey showed a marked slowdown in manufacturing activity (-16.1 points in September) as did the New York Federal Reserve's survey (-11.9 points in September). Nevertheless, the Empire State Manufacturing Survey also indicates that companies are anticipating an upturn in economic activity in the coming months. Specifically, businesses could benefit from the measures in the Inflation Reduction Act, which was passed in August and which is intended to accelerate energy transition in the US economy.

Félix Berte
felix.berte@bnpparibas.com

CHINA

MALAISE

The recovery in activity since the end of the lockdowns imposed in Shanghai in the spring has been very gradual. It picked up in August, notably supported by public investment and tax measures, but it is likely to lose steam again in September. As exports begin to suffer from weaker global demand, the continuation of the zero-Covid strategy and the serious crisis in the property sector continue to weigh heavily on confidence, private consumption and investment. An easing of the health policy and more wide-ranging actions to support the property market seem to be the only measures capable of lifting the Chinese economy out of its current gloom.

Activity has recovered slowly since the end of May, when the lockdowns imposed in major economic centres such as Shanghai started to be relaxed. The rebound has been gradual in the industrial sector, and more sluggish in the services sector. However, the growth figures in August surprised on the positive side. The recovery strengthened both in industry (+4.2% year-on-year after +3.8% in July and +0.6% in Q2 2022) and the services sector (+1.8% y/y after +0.6% in July and -3.3% in Q2) despite numerous headwinds (new restrictions on mobility, drop in hydro-electric production and rationing in several provinces, slowdown in exports). Support policy measures by the authorities contributed significantly to this improvement. In particular they led to a rebound in car sales (driven by tax measures) and new public investment in infrastructure projects.

However, the upturn in activity is likely to be interrupted again in September: internal obstacles to growth continue to persist and the external environment is deteriorating. The slowdown in export growth in August was substantial and widespread (+7% y/y after +17% on average over the previous three months). It is expected to continue in the short term given the expected weakening in global demand. While the export sector has been a key driver of Chinese growth over the past two years, activity driven by the domestic market will struggle to fill the gap.

Firstly, the zero-Covid policy continues to be very strict (although it was adjusted slightly at the beginning of July) and is likely to be maintained until at least the end of 2022. The number of Covid cases rose over the summer and the average level of restrictions on mobility in the country increased again. Admittedly it is still far from its April-May level and disruptions as severe as occurred in Shanghai last spring are now unlikely. However, the continuing threat of new restrictions is weighing heavily on people's confidence. The lockdowns imposed in Chengdu and Shenzhen in the first half of September were in fact relatively short-lived but strict, and they hampered activity, particularly in the services sector. Retail sales, which recovered in August, may slow down again in September (in real terms, sales increased by around 3% y/y in August, after they stagnated in July and fell by 7% in Q2).

Secondly, the crisis in the property and construction sectors continues. Property sales, construction projects and construction starts continued to fall rapidly in August, and the average house price has lost 3.4% over the past year. In recent weeks the authorities have increased their efforts to boost mortgage lending and housing demand (through interest rate cuts or an increase in loan-to-value ratios in some provinces) as well as to improve property developers' cash flow and complete housing construction projects (new financing has been granted by state policy banks, rescue funds have been created by local governments). For the time being the effects of these support measures have remained limited and many developers remain financially strangled. The effects of the property market crisis on the rest of the economy are exacerbated by the significant loss of investor and household confidence which accompanies the decline in property prices, delays in the delivery of prepaid housing, the rise in the number of payment defaults on the part of developers and, more generally, the deterioration in income prospects. A broader support plan could become essential to lift both the property market and the economy out of the current gloom.

GROWTH & INFLATION

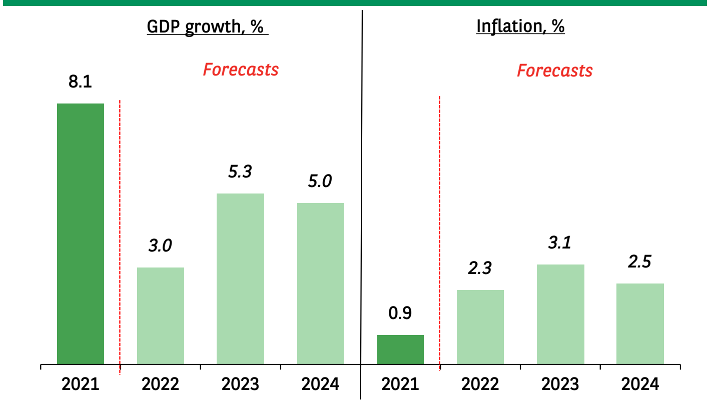


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

CHINA: PERSISTING CRISIS IN THE REAL ESTATE SECTOR

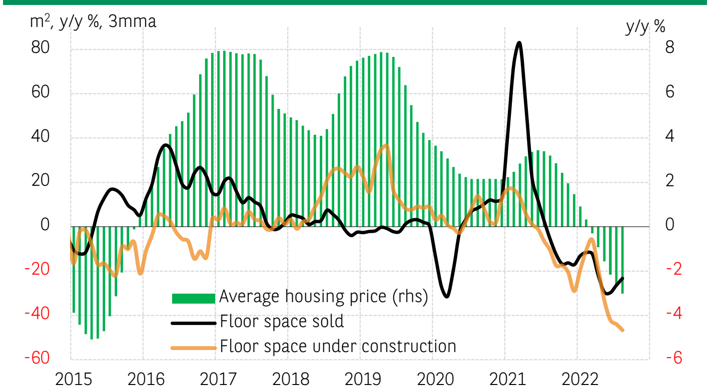


CHART 2 SOURCE: CEIC, BNP PARIBAS

Christine Peltier
christine.peltier@bnpparibas.com

JAPAN

BANK OF JAPAN KEEPS ON TRACK

The Yen continued to plunge this summer, reaching its lowest level against the dollar in 24 years. The Bank of Japan (BoJ) is keeping its yield curve control policy unchanged, exacerbating the gap with other major central banks and, consequently, downward pressures on the currency. This depreciation has also led to an unprecedented widening of the trade deficit. Although the pace of inflation is significant for the country (3.0% y/y in August), it remains under control and at a lower level than in 2014 and the start of the Abenomics programme. Even if it's tightening, there is still room for manoeuvre for the BoJ. However, with a GDP level almost 2.5% below its 2019 summer level, Japan remains the G7 country where the upturn in activity has been the least pronounced since two years.

The Japanese economy is suffering from multiple obstacles, in addition to the energy crisis. Country access restrictions have been maintained as part of the fight against Covid-19, even if they will be, for the most, lifted on October 11th. The industrial sector, which represents almost 20% of domestic activity, is still weakened by supply problems as well as by the economic situation in China, where the zero-Covid policy and difficulties in the real estate sector are causing a slowdown in demand. China remains the leading destination country for Japanese goods[1]. The lockdown introduced in Shanghai last May, for example, led to a plunge in industrial production in Japan (-7.5% m/m in May). This subsequently rebounded after the lockdown was lifted.

PRICE-SALARY LOOP: IS IT DIFFERENT THIS TIME?

The BoJ wishes to initiate a price-salary loop as a prerequisite for a readjustment of its monetary policy. However, this is not materialising. Wages were even down 2.1% y/y in July in nominal terms and 4.7% y/y in real terms[2]. The low wage dynamics partly reflect the strong structural rigidities in the country. But the rise in inflation and still very significant recruitment problems –observable for example in the Tankan surveys – are an unprecedented combination that is conducive to pushing wages upwards. The unemployment rate had reached a record 2.2% just before the global pandemic and could come close to this again, with some indicators of tensions on the labour market having returned close to pre-crisis records this summer[3].

In addition, Japanese companies have considerable room for manoeuvre to raise wages if necessary. According to figures from the Ministry of Finance, they recorded pre-tax profits in the second quarter of 2022 (in level terms [Y24.6 tr] and as a share of GDP [18%]). The increase in production costs, exacerbated by the drop in the Yen, therefore seems, for the time being, to have been well absorbed by companies, which have passed on a large share of this increase to consumers. Nevertheless, the increase in imports left its mark on the country's trade balance: it moved from a comfortable surplus of Y262 billion (USD 1.82 billion) in July 2021, to a record deficit of Y1,808.7 billion (USD 12.6 billion) twelve months later.

POLITICAL SHIFTS

The global energy crisis and the exacerbation of geopolitical tensions in the China Sea have led to major political upheavals in Japan in recent weeks. Fumio Kishida's government first announced the restart of 17 nuclear reactors by the summer of 2023, which have been shut down since the Fukushima disaster in 2011. New constructions of nuclear plants could also begin. Over the past decade, the share of nuclear energy in the country's energy mix has decreased considerably, from 13% (2009) to 3% (2019), a drop mainly offset by fossil fuels and solar.

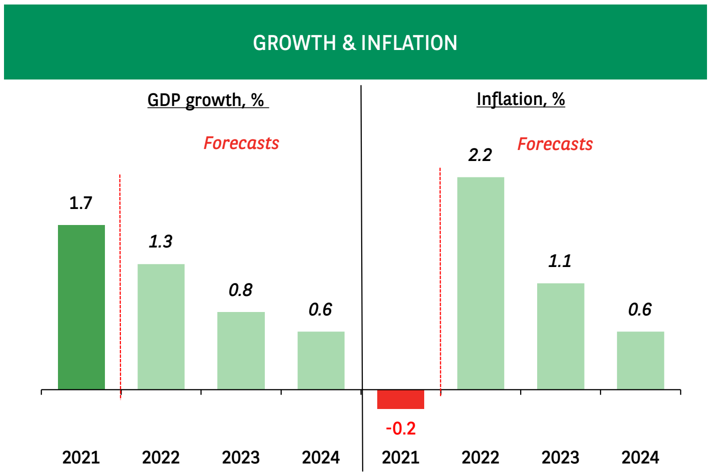


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The second major upheaval is that military investment should be drastically increased over the next five years, with a possible doubling of public spending in this sector by 2027. More precise figures will be revealed at the end of the year, with the approval of the budget for 2023 and the unveiling of the new national security strategy. Military expenditure has only fluctuated between 0.8% and 1.0% of GDP over the past sixty years. However, this expenditure will feed the deficit and public debt, forecast in the 2022 budget at 6.5% and 249.6% of GDP respectively. Against this difficult political and economic backdrop, curbing public spending will once again not be a priority for the current administration.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 Its share of total exports stood at 21.6% in 2021, compared with 18.0% for the United States, IMF Direction of Trade Statistics.
2 Family income and expenditure survey, Statistics Bureau of Japan
3 The ratio between new job openings and jobseekers rose to 2.4 in July, close to the all-time high of April 2019 (2.48).

HEADING FOR A RECESSION ?

The current unprecedented combination of shocks (inflation, health crisis, geopolitical issues, energy crisis, climate, monetary issues) is likely to overburden the Eurozone resilience and push the region into recession over the coming quarters. The deterioration in confidence surveys this summer provides an early indication of this likely outcome. However, we expect the recession to be limited in scope, in large part due to budgetary support. This recession should be followed by a moderate recovery as the various shocks start to ease. Faced with the continued surge in inflation, the ECB has moved up a gear. It will probably raise its rates by a further 125 bps by the end of the year (bringing the deposit rate to 2%) and then wait and see thereafter, allowing time to assess the extent of the decline in growth and in inflation.

At the time of writing it is still difficult to be certain, but a recession in the Eurozone over the coming quarters does seem inevitable. Or to be more precise, such a scenario now seems more likely than a scenario without a recession. After a better-than-expected first half of the year (bringing the growth carry-over to 3.2% in Q2 2022), the current unprecedented combination of shocks (inflation, health crisis, geopolitical issues, energy crisis, climate, monetary issues) is likely to overburden the resilience seen to date.

There are already early signs of this in confidence surveys. The deterioration in the business climate is not as pronounced as the decline in householder confidence, but it is starting to reach warning levels. The composite PMI in the manufacturing sector fell below the 50 threshold in July and has continued to fall in August (49.6). The figure for the services sector was only a hair's breadth away according to the flash estimate for August (50.2), following four consecutive months of quite marked decline, and the final estimate, revised downwards, pushed it through the threshold (49.8). The Eurozone's Economic Sentiment Index (ESI) also fell sharply in July (a generalised fall across all sectors), falling below the benchmark 100 threshold, and then fell further in August (a decline that concerned only industry and the services sector).

We also expect these surveys to continue their downward trend over the next few months, or even to fall more steeply. The energy savings needed to cope with the unfolding energy crisis will weigh on activity. And the deterioration in the business climate is probably not yet fully reflective of the extent of the negative impact, in view of the rise in the examples of struggling businesses / sectors, due to the accumulation of problems and their propagation across the economy.

For the time being, employment prospects based on surveys are only starting to be a little less positive. Factors such as the healthy pace of job creation in the first half of the year (which has helped employment to exceed by 2% its pre-pandemic level), the continued decline in the unemployment rate over a year and a half (6.6% of the labour force in July) and the ongoing hiring difficulties mean it is possible to temper concerns somewhat. The recession towards which the Eurozone seems to be heading could just be "technical", i.e. limited to two quarters of moderate decline in GDP (-0.2% q/q in Q3 and -0.3% q/q in Q4 2022 based on our forecasts). The healthy tourism season and the budgetary support measures are also significant short-term cushioning elements (which could also push back the recession to Q4 2022 and Q1 2023). This limited expected contraction also presupposes that the energy crisis will remain under control, which is by no means certain. The adaptability of companies, their generally favourable financial situation before the war in Ukraine, the savings buffer available to some households and the need for investment to decarbonise the economy are, however, more reliable supportive elements.

In 2023 the fading of the various shocks should allow a moderate upturn in growth. Our growth forecasts for 2022 and 2023 are very close to the September consensus mean (0.1 point below in 2022, 0.1 point above in 2023). But the wide dispersion of forecasts for 2023 (+1.3% / -0.8%) illustrates the uncertainty and the difficulty in fully understanding the current situation and how it will develop.

GROWTH & INFLATION

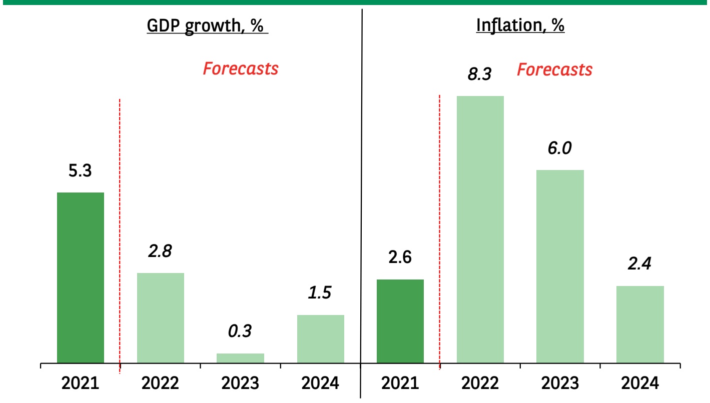


CHART 1 — SOURCE: BNP PARIBAS GLOBAL MARKETS

The inflationary situation remains difficult. Some of the upstream inflationary pressures are certainly easing (delivery times, input prices, oil) but it may take time before their downward impact on inflation becomes visible, particularly as they are offset by inflationary pressures which are continuing to increase (gas and electricity prices, food prices, lagged effects of past price rises, wages, euro). The elevated level and generalisation of inflation have made it persistent and therefore more difficult to reduce. According to our forecasts the peak should be near – inflation is likely to be around 10% year-on-year in September – but it should remain around this rate until the end of the year and there remains considerable uncertainty about the timing and the level of this peak. In our scenario, inflation should start to fall a little more sharply from spring 2023. However, it would still be around 3% at the end of 2023 and would only reach the ECB's target at the end of 2024.

Faced with the continued rise in inflation, the ECB has moved up a gear and raised its key rates by an exceptional 75 basis points at its meeting on 8 September. However, this move, which is not intended to become the norm, may be followed by another of the same magnitude on 27 October and by +50 bps on 15 December. The deposit rate would then reach 2%, i.e. the estimated level of the neutral rate. We then expect the ECB to stay at that level, allowing time to assess the extent of the delcine in growth and inflation (with the risk, however, of having to do more in view of the expected slow pace of disinflation).

Hélène Baudchon
helene.baudchon@bnpparibas.com

GERMANY

DARK CLOUDS GATHERING

The question is no longer whether or not Germany will slide into recession, but rather when and to what extent. The surprising resilience of German GDP in the 2nd quarter should not disguise the significantly worse outlook for the rest of the year. With continuing supply constraints, the new risk of energy shortages, rising production costs and high and widespread inflation that severely reduces household purchasing power, Germany is unlikely to avoid a fall in its GDP. However, the extent of the downturn should be limited.

German GDP in fact exceeded expectations in the 2nd quarter by stabilising (+0.1% q/q), contrary to the expected fall. This was largely due to support from public consumption, which once again rose sharply (+2.3% q/q). The other drivers of domestic demand, private consumption and investment, have seen declines (-1.6% and -2% respectively below their levels at the end of 2019).

The prospects for Germany over the second half of the year are seriously threatened by the risk of energy shortages, particularly from 2 September, the date from which Gazprom has decided to shut down its gas deliveries via the NordStream1 pipeline. Although gas stocks should be replenished by early November, which will offer some security over the short term, they will only provide enough cover for two months' consumption. If there is a risk of a "blackout" the German government could voluntarily ration the supply to the industrial sectors, which consume the most energy. Four major sectors appear to be particularly energy-intensive: the chemical industry, wood/paper production, the metalworking industry, and rubber/plastic production (*Chart 2*). Even a partial shutdown of these industries would have a major impact on the country's activity since, on the one hand, they represent almost a third of the industry sector's added value (31.9%, i.e. 6.2% of GDP) and, on the other, they are also suppliers to a large number of other sectors.

The first indicators available for the current quarter already show a fairly significant decline in economic activity. Manufacturing production (-1% m/m in July to -4.8% below its pre-crisis level) and new orders for industry (-1.1% m/m in July, a drop of -9.3% since the start of 2022) are down. In terms of external trade, the deterioration is just as noticeable with a sharp reduction in the trade surplus (-800 billion euros over one month in July to 5.4 billion euros compared to around 20 billion euros at the end of 2019). Surveys confirm the decline in activity at the end of the 3rd quarter. August PMIs are down in both industry and services, with both sectors now below their technical expansion levels. Analysts surveyed in early September by the ZEW have revised their assessment of the current situation downwards (-1.8 pts m/m to 54.3) as well as their expectations for the next six months (-1.5 pts m/m to 55.3). Over 2022 as a whole, growth in GDP should be around 1.4% thanks to a carry-over effect of +1.8% at the end of Q2, but GDP is then expected to contract over the second part of the year. On the other hand, activity is expected to be more or less stagnant in 2023, with an expected growth rate of just 0.4%.

Germany is also having to cope with very high inflation. The harmonised consumer price index rose by +8.3% over one year in August. The energy shock has spread very rapidly to manufactured goods, which rose 14.7% y/y. Inflationary pressures are likely to continue for the rest of the year and inflation is expected to reach +8.1% on average over 2022, before slowing significantly in 2023, to +4.7%.

Although prices are continuing to increase, income paid to employees (including wages and bonuses) slowed in nominal terms in the 2nd quarter (+2.9% y/y following +4% y/y in Q1) due to the reduction in the distribution of bonuses, which resulted in a very sharp fall in earnings in real terms (-4.4% y/y following -1.8% y/y in Q1). Faced with such a decline in purchasing power, the government of Olaf Scholz announced new measures worth 65 billion euros (or 1.8% of GDP) on 4 September. These included: an energy allowance for pensioners (300 euros) and for students (200 euros), a further reduction in VAT on gas (from 19% to 7%), and the extension of the rail transport subsidy. With total expenditure exceeding 3.5% of its GDP according to Bruegel estimates, Germany is now one of the most interventionist countries in Europe against the backdrop of the inflationary shock and the energy crisis.

GROWTH & INFLATION

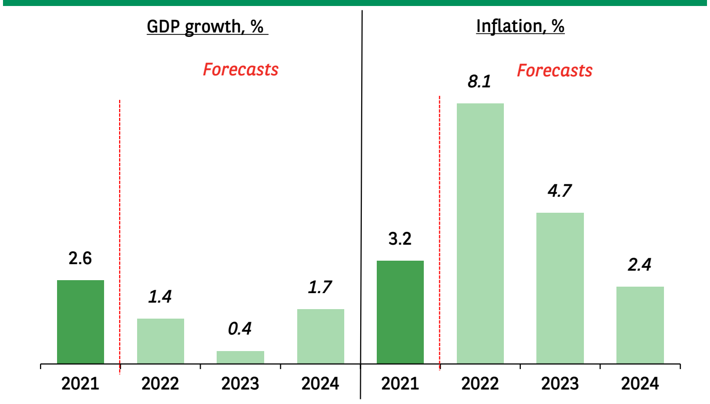


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GERMANY: INDUSTRIAL ENERGY INTENSITY INDEX

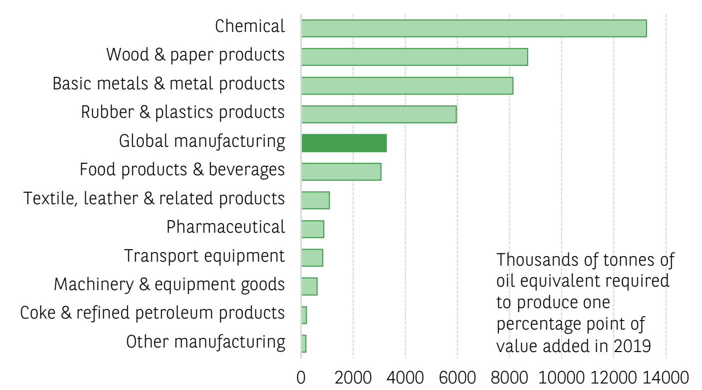


CHART 2 SOURCE: ANNUAL SURVEY OF INDUSTRIAL ENERGY CONSUMPTION (ASIEC, 2019), CALCULATION BNP PARIBAS

Anthony Morlet-Lavidalie
anthony.morletlavidalie@bnpparibas.com

FRANCE

IS A RECESSION COMING?

French growth was surprisingly up in the second quarter (+0.5% q/q), supported by the positive impact of the lifting of Covid-19-related restrictions on tourism and leisure. The rest of the economy was almost flat according to our estimates (+0.1% q/q) due to accelerating inflation. After a negative first quarter (-0.2% q/q, including "after adjustment"), this indicates a narrowly avoided recession. Looking ahead, however, the deterioration in business surveys, the impact of energy prices on businesses, the drought and the decline in electricity production increase the recessionary risk.

The lifting of Covid-19-related health restrictions from March onwards contributed significantly to the surprise rise in French growth in the second quarter (+0.5% q/q). The accommodation and catering sector and spending by non-residents in France (mainly tourism and business travel) alone explain the growth in household consumption and exports, showing the otherwise rather weak dynamics of the other growth drivers. The employment figures bear out this sense of both the positive and the negative, with 187,000 net new jobs created in the first half of the year, but, at the same time, 36,000 job cuts in temporary employment.

WHERE DO WE START?

This positive growth performance in the second quarter may come as a surprise given the ongoing inflationary shock. Indeed, one might expect it to have had a greater impact on activity, particularly as it severely affected household confidence from March onwards (-7 points over 1 month). Household confidence was the first to deteriorate as a result of the sharp rise in oil prices following the outbreak of war in Ukraine (+23% in March). The figures can be reconciled with this reality by adjusting the change in GDP for the impact of changes in Covid-19 restrictions[1]. In the first quarter, growth remains at -0.2% q/q, but in the second quarter, this adjustment implies a limited growth in GDP of 0.1% q/q. The succession of these two figures points to a narrowly avoided recession.

The impact of the inflationary shock can be seen in the dynamics of household purchasing power, which fell in both the second quarter (-1.1% q/q) and in the first quarter (-1.6% q/q). Other items of household expenditure are more affected by purchasing power constraints (with fairly sharp declines in agri-food, transport equipment and capital goods). On the other hand, construction activity statistics remain dynamic. They seem to be more related to an order book that was largely filled in the past and delays on construction sites (cost constraints and scarcity of labour), while new orders are down.

WHERE ARE WE HEADED?

Leading indicators have all deteriorated, including the business climate calculated by INSEE (-10 points for the index in the manufacturing sector between February and August) or households (-17 points on the composite index between December 2021 and August 2022, the balance of opinion at -37 on the desirability of making major purchases in August, the lowest since the crisis of 2008) or the PMI indexes (which are now flirting with the threshold of 50, synonymous with contraction). It therefore appears that growth momentum is waning. After an already sluggish first half of the year, and considering that the exceptional effects linked to tourism and leisure are unlikely to boost growth beyond the third quarter, the risk of a recession is significant.

GROWTH & INFLATION

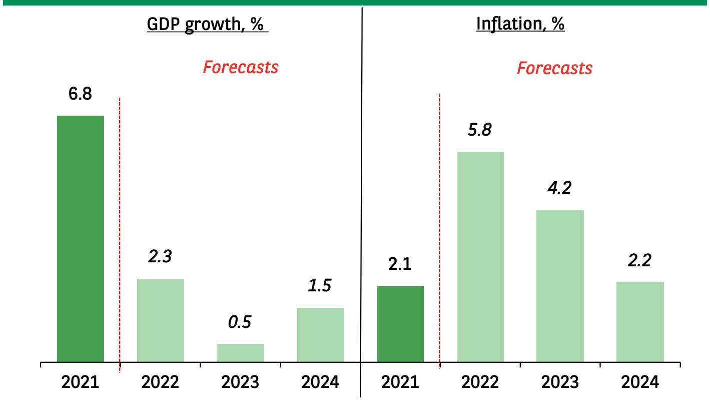


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

Furthermore, the manufacturing sector has characteristics that, combined, are typical of a pre-recession situation: a sharp drop in demand (order books fell from 7.3 to 5.9 months between February and August 2022 according to our estimates), and inventories now above normal.

That said, the rise in energy prices is taking place in a context of drought. This reinforced the decline in electricity production (accelerating since it began in March, -23% y/y in July) and weighed on agricultural production, causing the food component of the INSEE price index to rise in August by 1.7% m/m (the highest since January 2002). Overall, we expect inflation to stabilise around the August level (5.9% y/y) by the end of the year, with the fall in oil prices (reinforced by the fuel rebate) offsetting inflationary pressures elsewhere. In a move similar to the rest of the euro zone, business producer prices are expected to increase further, reflecting the rise in wholesale electricity prices (+7.9% m/m in Germany in August). This points to constraints on business, linked to a risk of shortages this autumn/winter, and increases the likelihood of a recession.

Stéphane Colliac
stephane.colliac@bnpparibas.com

1 Household consumption is adjusted by freezing the transport services, accommodation and catering items at their fourth quarter level and by cancelling half of the decline observed in Q2 on agri-food products (based on the assumption that the decline in the consumption of agri-food products corresponds in part to the increase in catering spending). Exports are restated by freezing tourism at its fourth quarter level.

FROM A ROBUST RECOVERY TO AN UNCERTAIN OUTLOOK

During the first half of 2022, the Italian economy has gradually gained strength. In Q2 2022, the real GDP was 1.1% higher than in Q4 of 2019. The carry-over for 2022 is 3.5%. The recovery that resulted was widespread in a variety of sectors. Construction continued to grow, recording a robust increase in comparison with the pre-COVID level, while both manufacturing and services increased as well, benefiting from the recovery of tourism. The overall outlook for the Italian economy has become more uncertain. Households and firms are extremely cautious. In the three months ending in July, industrial production fell by more than 1.5% q/q. The value of retail trade continued to rise, while the volume of sales declined, suffering from the acceleration of inflation.

A ROBUST AND WIDESPREAD RECOVERY

During the first half of 2022, the Italian economy gradually gained strength. The real GDP rose by 0.1% in Q1 and by 1.1% in Q2, with the annual growth rate slightly below 5.0%. The carry-over for 2022 as a whole, assuming that no further increase occurs in the coming quarters, is 3.5%. Italy has already totally recovered from the losses recorded during the last recession, with the real GDP 1.1% higher than in Q4 2019.

In Q2, the recovery was widespread in certain sectors. Construction activity continued to grow, although at a slower pace. The value added is almost 30% higher than in Q4 2019. This robust rebound reflects the positive effect of fiscal incentives, aimed at improving the energy efficiency of existing dwellings.

After a +0.1% gain in Q4 2021 and a downswing of -0.9% in Q1 2022, the manufacturing sector began to grow, benefiting from the favourable evolution of foreign demand. In Q2, value added rose by 1.5% q/q, reflecting the robust increase in the production of electronic, wood and paper products, electrical equipment and machinery.

Thanks to the improvement of the COVID pandemic and the easing of social restrictions, services value added rose by 1.0% in Q2, after falling -0.1% in Q1. Trade, transport and storage continued to experience solid and dynamic growth. Accommodation and food services activities benefited from the recovery of tourism. The value of the expenditures of non-residents in Italy almost reached 12 billion euros, about three times of that in Q2 2011 and slightly more than in Q2 2019.

THE ROLE OF DOMESTIC DEMAND

The recovery of the Italian economy continued to be driven by domestic demand, while the net exports contribution was still negative, as imports rose more than exports (respectively +3.3% and +2.5% in real terms). In Q2, private consumption rose by more than 2.5%, with a 1.5% positive contribution to the overall growth, also reflecting the improvement of labour market conditions. The number of persons employed has risen above 23 million, and the employment rate has already recovered from the pre-crisis level. In Q2, fixed investment rose for the eighth consecutive quarter in a row. In comparison with Q4 2019, gross fixed capital formation increased by more than 15%. The propensity to invest has risen, although it remains below that of France and Germany.

INCREASING UNCERTAINTY

The outlook for the Italian economy has become more uncertain, as a consequence of the worsening of the global scenario, the persisting of geopolitical tensions and the further increase of inflation and interest rates. Households and firms are extremely cautious.

GROWTH & INFLATION

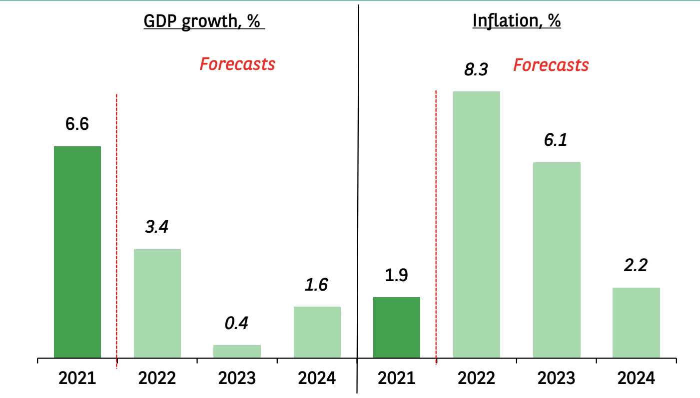


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

In July, Italian firms have augmented their buffer of liquidity. The value of bank deposits of non-financial corporations increased by more than 20 billion euros on a monthly basis, reaching 435 billion euros.

The evolution of activity in the manufacturing sector begins to reflect the effects of both higher costs and the weakening of foreign demand. In July, industrial production rose by only 0.4%, with several sectors, such as wood, chemical, electronic and metal products experiencing a decline of activity. In the three months ending in July, production declined by more than 1.5% q/q.

The impact of increasing prices on household expenditures is becoming increasingly evident. In August, the consumer price index for the whole nation (NIC) rose by almost 8.5% with the highest increases showing in the energy and food components. In July, while the value of retail trade continued to grow, volume sales contracted by 0.9% y/y, with those of food products falling by more than 3.5%.

Paolo Ciocca **Simona Costagli**

paolo.ciocca@bnlmail.com simona.costagli@bnlmail.com

SPAIN

THE INFLATIONARY SHOCK IS SEVERE

Spain is unlikely to avoid a difficult winter. Although its economy is structurally less vulnerable to energy shortages, the inflationary shock is severe and is not slowing down, with an inflation rate of over 10% in August. The rise in non-energy prices is amplifying relentlessly. Despite government action, the decline in purchasing power for Spanish households will be among the biggest in the Eurozone. Although tourism is likely to have helped business to cope with the third quarter, we are expecting a contraction in the fourth quarter of 2022, which is likely to continue through the winter. Job creation was strong again this summer, but opinion surveys are also pointing to a downturn on the way.

Spanish inflation shows no signs of easing. The rise in consumer prices remained above 10% in August, at 10.5% y/y. However, it fell slightly compared to July (10.8% y/y), due to the decline in private transport prices (-3.5% over one month), which itself was fuelled by the drop in prices at the pump. Conversely, underlying inflation (excluding energy and perishable foods) continued to rise, to 6.4% y/y in August. The government is struggling to contain the general rise in inflation. While most measures so far have been aimed at reducing the energy bill, a broader range of actions will gradually be implemented. For example, the government is aiming to reach an agreement with major distribution companies on a cap on the prices of essential products[1].

Economic activity in Spain has so far remained on track. Real GDP rose by 1.3% in the first half of the year, slightly above the Eurozone average (1.1%). However, these good figures need to be tempered by the catch-up effect enjoyed by the economy, whose recovery post-lockdown is less substantial than its European neighbours. At the end of the first half-year, Spanish GDP was still 2.5% below its Q4 2019 pre-pandemic level, while the Italian and French GDPs had already more than covered this deficit and German GDP had just caught up with it. Although it recovered sharply in Q2 (+3.2 q/q), private consumption is likely to suffer over time from the drop in household purchasing power, which is particularly significant due to the high level of inflation. According to our estimates (May 2022[2]), the fall in purchasing power may exceed 4% in 2022 as an annual average, one of the largest losses in the Eurozone. Despite a strengthening of support measures this summer (reduction in VAT on gas from 21% to 5% effective from 1 October to 31 December 2022, subsidies for rail transport) and the extension of those already in place (reduction of 20 cents on a litre of petrol extended until the end of 2022), we now expect a contraction in activity of 0.4% q/q in the last quarter of the year.

However, employment has continued to surprise positively, accentuating the lag with the evolution of GDP. According to the Spanish employment agency (SEPE), the number of workers registered with social security system rose again in August (+62,136), with gains generalised across all three major sectors: services, industry and construction. In the first eight months of the year compared to the same period a year ago, employment rose by 1.7% (+334,000), bringing the unemployment rate down to 12.6%, its lowest level since September 2008. However, this momentum could stall. Opinion surveys are becoming less positive, both the European Commission survey (the consumer survey unemployment index for the 12-month ahead was the worst in 18 months) and PMI surveys (the composite employment index was at its lowest since the first quarter of 2021, at 50.4 in August).

GROWTH & INFLATION

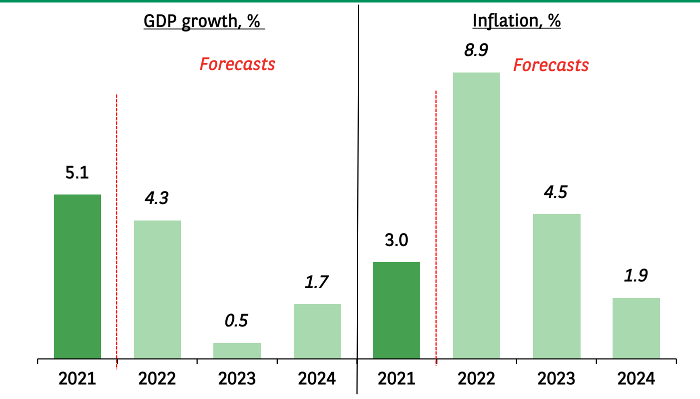


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Structurally, Spain is better placed to cope with a total breakdown in Russian gas supplies. Compared to other European countries gas imports from Russia make up a small part of Spain's total gas imports (around 13% in 2021). Diplomatic tensions with Algeria have undoubtedly led to a drop in gas deliveries from this country, but Spain seems capable of replacing these shortfalls by using other suppliers, including by liquefied natural gas from the United States[3]. Spain also has the most developed LNG infrastructure in Europe (a third of the infrastructure in Europe is located in the country)[4], even though a large part of it is currently not used. To this end, the government has announced its intention to reopen the El Musel re-gasification site (in the north-west of the country) from next January, ten years after its closure.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 See *"Díaz y Garzón contactan con la distribución para intentar poner tope al precio de 20 o 30 productos básicos"*, (Díaz and Garzón talk to the distribution sector in an attempt to cap the prices of 20 or 30 basic products) *El País*, 5 September 2022.
2 See BNP Paribas Ecoflash, *Energy price inflation in the Eurozone: government responses and impact on household purchasing power*, 20 May 2022.
3 See "Spain Not at Risk If Russia Cuts Gas Flow, Network Operator Says", Bloomberg, 12 July 2022
4 See Natural Gas in Europe, The Potential Impact of Disruptions to Supply, IMF Working Paper, July 2022, table page 9.

BELGIUM

THE TENSION IS RISING

Belgian GDP grew by 0.2% in the second quarter of this year. Private consumption continued its upward trajectory in the first half of 2022 but is expected to slow down as inflation remains at an all-time high. Higher labour and energy costs are weighing on firms, with investment expenditures once again below pre-pandemic levels. A recession as from the end of this year looks unavoidable. Active fiscal policy should ensure it remains a shallow one but the cost to public finances will be sizeable.

Belgian GDP came in at 2% above its pre-pandemic level right before summer. Private consumption accelerated throughout April, May and June. Gross fixed capital formation weakened from the first to the second quarter of this year. Net trade didn't contribute much to growth, as both import and export volumes posted similar (negative) growth rates.

Price pressures and geopolitical uncertainty will continue to weigh on the outlook, even though fiscal support will somewhat offset monetary tightening. We expect to enter a recession by the end of the year, as domestic demand looks poised to slow down further. A normalization of energy markets paves the way for growth normalization by the second half of 2023. Full year GDP growth is expected to come in at 2.4% this year, mostly as a result of the strong quarterly growth in 2021 and the resulting carry over effect. For 2023 we foresee a mere 0.4%.

INFLATION SHOULD REMAIN IN DOUBLE DIGIT TERRITORY

Inflation on a yearly basis, as measured by the ECB's preferred metric HICP, shot through the 10%-barrier in June, setting an all-time record. It is expected to remain in double digit territory through the remainder of the year.

The impact of energy prices seems to have peaked over summer, but now core and food-related inflation are gathering pace. In fact, average prices for food and non-alcoholic beverages have been increasing by more dan 1% per month since the start of this year.

A unique feature of the Belgian economy is its automatic wage-indexation. Wages and income transfers throughout the economy are tied to the health-index and rise automatically to align with this index, albeit with varying frequencies. As such, wages might take some time to catch up with the current runaway inflation but are all but guaranteed to eventually do so.

All in all, the purchasing power of the average Belgian household would remain almost flat this year and actually increase 0.7% in 2023 according to calculations by the Federal Plan Bureau. Beneath this headline average number however, widely diverging individual situations are materializing. For those in the lowest income-quintile that are excluded from social support, inflation could be as much as 2 percentage points higher than the population average.

The unemployment rate stood at 5.3% before summer, barely above the pre-pandemic low of 5.1%. Consumer confidence continued its bumpy recovery since the record-breaking dip at the start of the Russian invasion.

Consumption of non-durables was elevated before summer, more than offsetting the decline in durable goods purchases. Recent numbers however, point towards a deterioration of retail trade. The appetite for large purchases is also waning, with increasing mortgage rates weighing on households' repayment capacity. Over the first five months, the number of building permits for residential real estate declined by 3.4% versus last year.

GROWTH & INFLATION

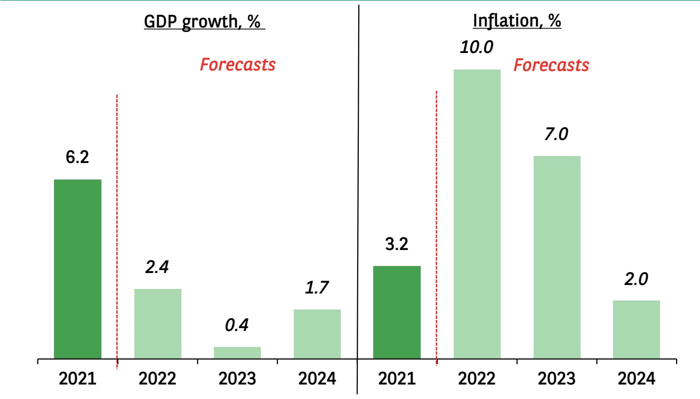


CHART 1 SOURCE : NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

Firms are suffering across almost all sectors. Especially manufacturers became more pessimistic last month. Fewer orders add to persistent difficulties in sourcing input materials and hiring qualified staff.

So far, there is no meaningful increase in the number of bankruptcies. In fact, on a weekly basis, fewer firms are closing down than before the start of the pandemic. During the summer months, there was a slight increase in construction firms going bankrupt, but the heavily anticipated wave of businesses closing down has not materialized.

Corporate investment continues to disappoint. Volumes in the first half of this year did not exceed their pre-covid levels. It remains to be seen to what degree firms will pause or even cancel planned investments in light of the deteriorating economic environment.

PUBLIC FINANCE

Covid-induced spending increased the budget deficit and the energy crisis made things worse, with the federal government having spent already close to 1% of GDP on supporting households and firms as gas- and electricity prices of rates climb higher.

A recent report by the Federal Plan Bureau paints a damning picture: the deficit is expected to hover around 5% at least for the foreseeable future. As a result, the public debt could be in excess of 110% of GDP by the end of 2025. With the cycle of ever lower borrowing rates now broken by a forceful ECB, the government has its challenges laid out in front of it.

Arne Maes
arne.maes@bnpparibasfortis.com

PORTUGAL

A LESS SEVERE ENERGY SHOCK THAN ELSEWHERE

With a relatively limited risk of energy shortages, Portugal should record some of the largest economic growth in the eurozone this year. A number of favourable factors are driving these growth levels. There has been substantial carry-over growth from 2021 and real GDP rose sharply in Q1 (+2.4% q/q), before stabilising in Q2. The recovery in tourism has also boosted business activity this summer. Despite the aid measures for households and businesses, which the government estimates are worth EUR 4 billion so far in 2022, there should be a slight surplus on the primary budgetary balance for this year. Since he came to power in 2015, and despite successive crises, Prime Minister António Costa has persistently keep a fiscal discipline, which has not greatly hindered the country's economic growth.

Portugal has not been able to escape the inflationary shock, which is unparalleled in recent times. With inflation standing at close to 10% in August (9.3% y/y), the measures taken by the government to control the spike in energy prices are not enough. The rise in energy prices has slowed slightly (with prices remaining very high at +24% y/y in August, however), thanks, in particular, to the impact of the electricity tariff shield, which was introduced last spring, and the drop in oil prices. However, the spread of inflation to all consumer items is increasing: the underlying measure (which excludes energy and food products) recorded its strongest growth in almost thirty years in August, standing at 6.5% y/y. The fall in purchasing power due to rising inflation, as well as the effects of rising interest rates on debt servicing, is causing a significant deterioration in Portuguese households' financial situations. As a matter of fact, their ability to save is at its lowest since 2008 (according to a European Commission survey).

However, this drop in household purchasing power should only be apparent in Q4 2022 growth figures. Business activity during Q3 should have benefitted from tourist numbers returning very close to their 2019 levels. However, the gap has not closed completely: the hotel occupancy rate hit 70% last July, compared with 71.1% in July 2019 (according to the INE, the Spanish National Statistics Institute). In addition, the labour market is holding up well against the shocks thus far: the unemployment rate was 5.9% in July, which is slightly lower than the rate in late 2019.

Developments on the real-estate market will be closely monitored due to the current tightening of credit conditions. For the time being, price dynamics have been remarkable. Apart from a slowdown during the health crisis, the rise in housing prices has been relentlessly accelerating since 2015, hitting a record 16% y/y last July. In order to curb demand, in early 2022, the government announced that foreign investors looking to benefit from Golden Visas can no longer buy residential properties in certain areas, restricting their access to the majority of coastal towns and cities, where the housing supply is stretched. However, the effects of this measure have not yet been felt on prices, with the housing shortage still having a major influence on prices.

A new budgetary package worth EUR 2.4 billion was made available in early September in order to support households trying to cope with the inflationary shock. It includes a VAT cut on electricity from 13% to 6% (which will be in effect from 1 October 2022 to 31 December 2023), upgrading pension rates and sending a EUR 125 cheque to almost 5.8 million citizens. The price of public transport passes will be frozen in 2023, while rent increases will be capped at 2%. In addition to this spending, more structural measures were announced, such as relaxing legal conditions for households and SMEs to move from the market rate to the regular rate for gas, which was announced this summer. With this final helping hand, the interventionalist package from

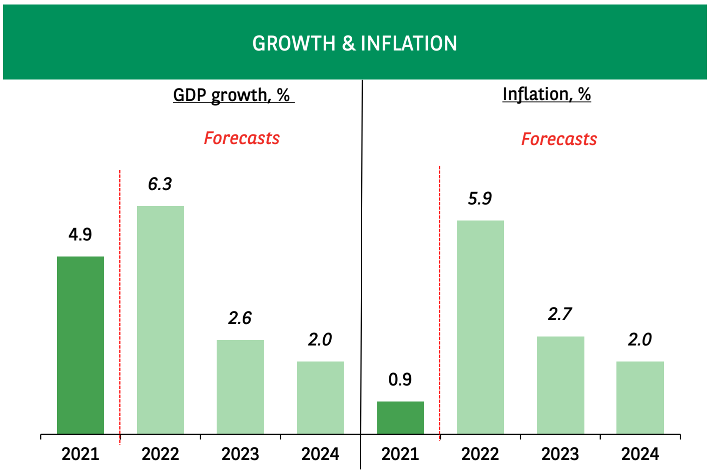


CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

António Costa's government is in line with the eurozone average, with EUR 4 billion budgeted for all the "anti-inflation" measures announced so far in 2022. That is the equivalent of 1.9% of national GDP (2019).

In its stability programme, the government was expecting public debt to reduce gradually, to 100% of GDP by 2025 compared to 121% today (Q2 2022). Even though these forecasts are usually optimistic, and although they were made before the most recent budgetary package, the primary surplus expected by the government (0.3% of GDP in 2022, 1.6% in 2023) seems achievable as things stand: cumulatively over the first seven months of the year, the general government's primary balance recorded a surplus of EUR 4.4 billion. This figure is very close to 2019 levels (EUR 4.87 billion) and is much better than the same period in 2021 (a deficit of EUR -2.93 billion). In 2019, the primary balance registered a surplus of 3.1% of GDP. Therefore, all in all, despite the succession of recent crises, Prime Minister António Costa has persistently exercised fiscal discipline since he came to power in November 2015, which has not been detrimental to the country's business activity. For the past five years, growth in Portugal has been higher than the eurozone average.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

FINLAND

HOUSING POLICY: A GREAT SUCCESS STORY

Finland, like other Nordic countries, has so far shown itself to be particularly resilient to the current financial shocks, but the clouds are gathering over the "Land of the Midnight Sun". After five consecutive quarters of growth, buoyed by robust domestic demand, activity is expected to slow significantly in the second half of 2022 due to the persistent geopolitical tensions, tightening of financial conditions and price rises that are impacting on corporate margins and on the purchasing power of households. In an increasingly less favourable economic environment Finland can, nonetheless, be pleased with its structural efforts and in particular with the success of its housing policy. With the eradication of homelessness, a growing supply of residential housing and property inflation that remains under control, the results are spectacular.

Economic activity in Finland recorded a 5th quarter of expansion in Q2 2022, with dynamic GDP growth of +0.9% (q/q). It is now +3.5% above its pre-Covid level and Finland's GDP has even closed the output gap. This progress is driven by robust domestic demand in which both private consumption and investment are significantly ahead of their pre-Covid levels (+3% and +3.7% respectively, compared to Q4 2019). On the other hand, foreign trade continues to be hampered by exports, which remain -3.7% below their pre-Covid level, unlike imports, which are experiencing strong growth (+9.7% compared to Q4 2019).

However, the second half of the year is likely to be much less positive. The Finnish economy is expected to slow significantly, on the one hand because of a decline in investment caused by the sharp rise in business production costs and, on the other, because of a decrease in private consumption due to the erosion of household purchasing power. Economic surveys point to these less favourable prospects with quite a marked decline in household confidence (-19 pts in August over a year) and sector-based business climates, all of which are now below their long-term average (apart from in the industrial sector).

The European Commission forecasts annual average GDP growth of 1.8% in 2022, but Brussels did not yet have the figures for the 2nd quarter available at the time of its forecast. However, as these were better than expected, growth should be stronger than anticipated. As for inflation, it is expected to reach an annual average of 6.4% in 2022 before falling significantly to 2.8% in 2023.

From a more structural point of view, Finland stands out with its exemplary housing policy. Faced with growing needs, the country has invested heavily in the construction sector so that the number of houses built will continue to increase. Over the first 6 months of the year, the number of building permits was +13.8% above the average figure between 2010 and 2019. For their part, the professionals in the construction industry are managing to overcome the current difficulties (supply problems, higher construction costs) and residential housing starts over the first 6 months of the year were 15.5% above their 2010–2019 average. This ambitious housing policy, combined with a so-called "zero homeless" strategy[1], has had the direct result of almost completely eradicating homelessness in the country. Indirectly, the massive flows of housing stock brought to the market and destined for sale have enabled property inflation to be controlled (*Chart 2*). As a result, prices for Finnish residential housing only rose by 10.3% between Q4 2019 and Q2 2022, while they rose by an average of 32.9% in the OECD countries over the same period. This gives the country greater financial stability with a lower risk of a downward correction in housing prices in the current context of generalised monetary tightening.

GROWTH & INFLATION

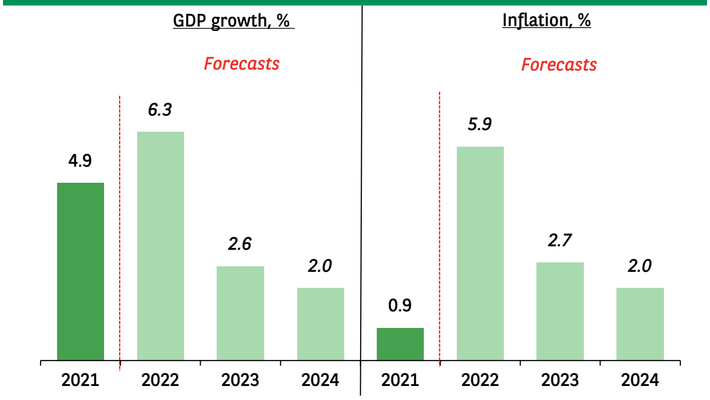


CHART 1 SOURCE: OECD, BNP PARIBAS

FINLAND: NOMINAL HOUSE PRICES

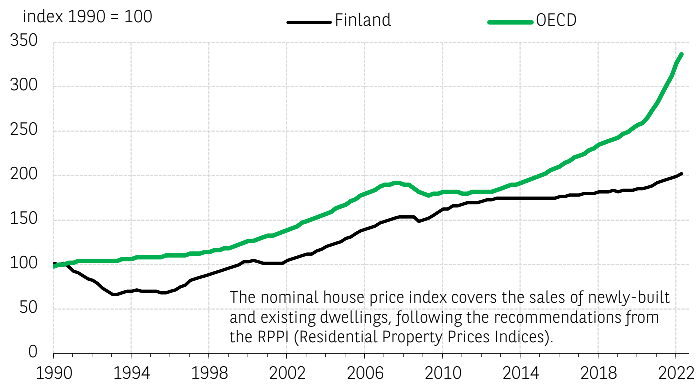


CHART 2 SOURCE: MACROBOND, OECD, BNP PARIBAS

Anthony Morlet-Lavidalie
anthony.morletlavidalie@bnpparibas.com

1 OECD (2021) "Finland's Zero Homeless Strategy: Lessons from a Success Story"

UNITED KINGDOM

ESSENTIAL BUDGETARY SUPPORT

UK growth contracted slightly in Q2, but the economy should not enter a recession before Q4. On the one hand, the labour market continues to operate at full employment, which will partially absorb the sharp impact of inflation on purchasing power. On the other hand, the new government plan to support households and businesses should mitigate future energy price increases. Faced with persistent inflation, the Bank of England (BoE) is further accelerating its monetary normalisation, at the risk of precipitating a contraction in the economy.

The United Kingdom suffered a slight contraction in its GDP in Q2 2022 (-0.1% q/q), mainly due to the drop in household consumption (-0.2% q/q) and the fall in public spending (-2.9% q/q). According to our forecasts, the UK economy should rebound very slightly in Q3 thanks to Boris Johnson's government's support plan, before experiencing a marked contraction in GDP in Q4 2022, against a backdrop of persistent inflation and rising interest rates. This contraction in GDP could be partially mitigated by the new support measures announced by Liz Truss. For the time being, business climate surveys indicate a contraction in industrial activity and a slowdown in activity on the services side.

PURSUING MONETARY NORMALISATION

Although inflation slowed slightly in August (9.9% y/y), mainly reflecting a drop in fuel prices (86.2% y/y compared to 114.1% in July), it continued to spread, as evidenced by the increase in underlying inflation (6.3% y/y). Inflation should continue to rise to a peak probably at around 13.8% in Q1 2023[1], before slowing down but still staying well above the 2% inflation target.

Furthermore, tensions on the labour market, which is still operating at full employment (3.6% unemployment rate from May to July) are supporting wage growth (+5.5% y/y in nominal terms from May to June, i.e. -2.6% in real terms), which is slightly dampening the impact of inflation for households. Although there is no wage-price spiral at the moment, wage increases in certain sectors (transport, postal services, etc.) should slow down the pace of disinflation in 2023.

Faced with persistent inflation and a robust labour market, the BoE accelerated the hike in its bank rate, with a further hike by 50 basis points at its meeting on 22 September, bringing it to 2.25%. The BoE also announced the start of the sale of UK Treasury debt securities (gilts) held under its Asset Purchase Facility (APF) programme. This reduction from GBP 80 billion over the next 12 months should strengthen monetary normalisation.

" LOW TAX, BIG STATE "

To cope with the energy and cost of living crisis, Liz Truss had no choice but to implement a massive support plan for the economy. With a duration of two years from 1 October, this programme is structured around three measures.

The plan first provides for capping the average electricity and gas bill for households at GBP 2,500 per year, well below the GBP 3,548 estimated by Ofgem (the UK energy regulatory authority). To this end, the government is preparing an "energy price guarantee" at supplier level as well as the temporary abolition of the green levy. This programme is in addition to the household support plan (GBP 37 billion) announced in June, which included targeted aid (GBP 400) for the most vulnerable households.

On the business side, the government proposes to put in place a similar "energy price guarantee" mechanism, for a period of six months, before moving towards a more targeted system, the measures of which have not yet been specified.

GROWTH & INFLATION

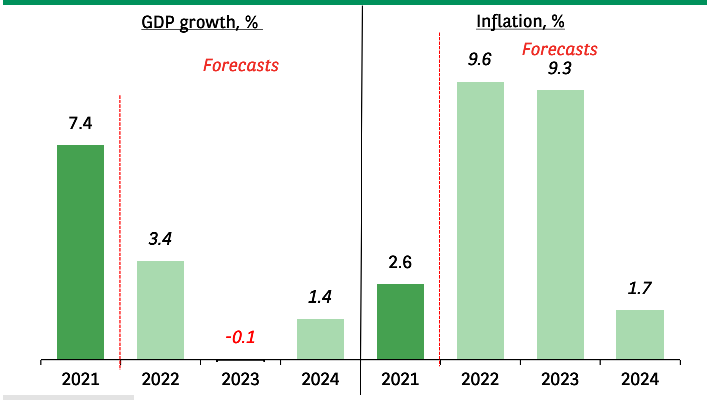


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The third flagship measure of the support plan aims to guarantee stability in the electricity market by ensuring sufficient liquidity. HM Treasury and the BoE will set up a GBP 40 billion liquidity fund (Energy Markets Financing Scheme) to facilitate the massive margin calls faced by market players.

Although the measures in this plan are necessary to mitigate the impact of inflation, its scale will weigh heavily on the public finances. According to government estimates, this plan would cost between GBP 100 and 200 billion (between 4.5 and 9% of GDP), well above the GBP 80 billion of the household support plan during the Covid-19 crisis. The Debt Management Office (DMO) should soon issue a more detailed estimate of the budgetary impact of this plan on the public finances. So far, no countervailing measures have been announced, so the plan would be financed by increased use of public borrowing.

The fiscal and budgetary policies announced will put pressure on the UK public finances. On the one hand, Liz Truss has announced a support plan without countervailing measures. On the other hand, her campaign promise to prioritise tax cuts for households and businesses (of around GBP 30 billion) could further widen the public deficit. As a direct consequence of this deterioration in the budget outlook, gilts (UK Treasury securities) saw their yield rise sharply across the maturity curve. For the first time since 2011, the yield on 10-year sovereign bonds (10Y gilts) exceeded 3.2%. The other notable development is on the currency market side: despite these higher interest rates, sterling continued to fall, particularly against the dollar. On September 19, GBP fell to 1.1410 USD, its lowest level since 1985.

Félix Berte
felix.berte@bnpparibas.com

1 This figure does not take into account the effects of the new support plan. Recent government measures should significantly reduce inflation.

SWEDEN

COULD ITS INSTITUTIONS GRIND TO A HALT?

After eight years in opposition, the conservatives have returned to power in Sweden in rather unfavourable circumstances. Although economic activity has proved resilient so far, it is showing clear signs of a slowdown. And faced with rising inflation, the population is demanding more support from the state authorities. Furthermore, the government will quickly need to adopt a position on the NATO accession process before assuming the presidency of the European Union from 1 January 2023. The difficulty will be managing to form a coalition government spanning the Liberals (on the centre-right) to the Sweden Democrats (far-right).

The Swedish economy recorded good growth in the second quarter (up 0.9% quarter on quarter), buoyed by household consumption up 7.5% on its pre-crisis level and even more dynamic investment (up 11.3% compared to Q4 2019). However, a clear slowdown in growth is likely to occur in the third quarter as suggested by the monthly GDP indicator, which stalled in July due to a marked drop in household consumption. The next unpleasant surprise could come from industrial production, since inventories of finished goods are at a record high while purchase intentions have fallen to very low levels (*Chart 2*). Against this backdrop, growth in GDP is expected to be almost zero in the second half of 2022 and at the beginning of 2023, before improving over the rest of the year to rise by an annual average of 0.8%, according to the European Commission.

The polls predicted an extremely tight general election[1] in Sweden, predictions which proved accurate since no winner could be declared on Sunday 11 September, the day of the election. This took until Wednesday 14 September, once every vote had been counted and recounted. The Social Democrats and other parties in the governing coalition were beaten by just two seats and so cannot seek a third consecutive term in office. The left-wing coalition won 173 seats in the Riksdag (Swedish Parliament) compared to 176 seats for the right-wing bloc composed of the Liberals, Moderates and Christian Democrats and the far-right (Sweden Democrats). The far-right Sweden Democrats also scored an historic 21% of the votes, more than any other party on the right. But this victory for the conservatives is not the whole story. The leader of the Moderates and right-wing political bloc Ulf Kristersson must now attempt to form a government. This promises to be a complex task, given the scale of the disagreements between the far-right and the Liberals, who have until now always refused to cooperate with the Sweden Democrats. In 2018, it took 134 days for the left-wing parties to establish a government. Just as much time is likely to be needed this year.

The direct consequence of this is a risk of parliamentary paralysis, even though the population has been hit by the problems of inflation and the cost of living, the NATO accession process has not been finalised, and the country must take up the presidency of the European Union on 1 January 2023. Nevertheless, the right-wing bloc has clearly set out its stall. In the short term, it wants to support households struggling with the cost of living by reducing fuel taxes and lowering income tax thresholds. These measures would be funded in the medium term by reductions in unemployment and sickness benefits, since the bloc intends to maintain fiscal discipline. This orthodoxy, implemented by successive governments for 30 years, has certainly reduced public debt (from 69% of GDP in 1995 to 36% in 2021), but it has simultaneously led to a surge in private debt, so much so that the country's total debt grew by about 65 percentage points between 1995 and 2021, from 118% to 215% of GDP.

GROWTH & INFLATION

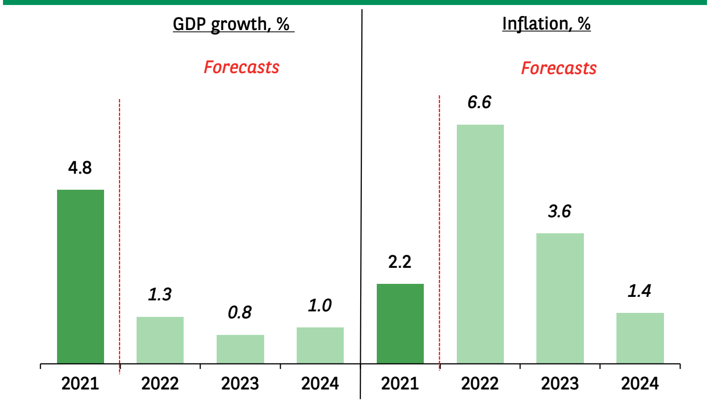


CHART 1 SOURCE: OECD, BNP PARIBAS

INVENTORIES AND CONSUMPTION: TOXIC SQUEEZE

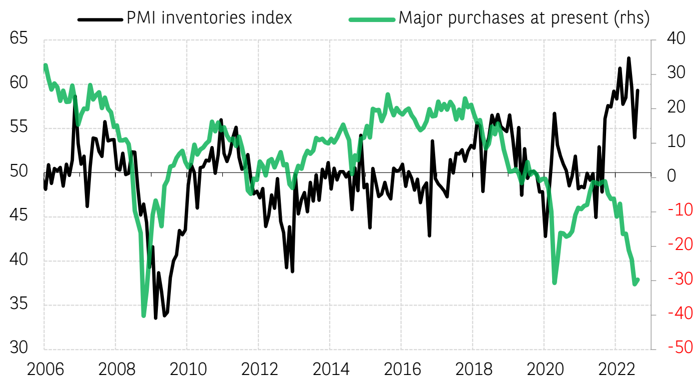


CHART 2 SOURCE: S&P GLOBAL, SWEDBANK, EUROPEAN COMMISSION, BNP PARIBAS

Anthony Morlet-Lavidalie
anthony.morletlavidalie@bnpparibas.com

1 As we illustrated in the EcoFlash "Can populist forces take power in Sweden?"

SWITZERLAND

THE SWISS FRANC: AN UNWAVERING SHIELD AGAINST INFLATION

Switzerland differs from other European countries in that it has significantly lower inflationary pressures, protected as it is by its strong currency and by resilient business activity which should continue to grow for the rest of 2022 and during 2023. Although the Swiss National Bank (SNB) is likely to argue that 3.5% inflation year-on-year in August is a reason to raise its key rate by 75 bps on 22 September, and so exit from its policy of negative interest rates, it is unlikely that this monetary tightening will last over the longer term, as inflation is already showing signs of slowing down.

Apart from a period of stagnation in the 1st quarter of 2021, Swiss GDP has continued to grow since the start of the post-Covid recovery. It has even returned to its pre-Covid growth path. In the 2nd quarter of 2022 GDP showed an increase of +0.3% q/q, buoyed by the momentum in private consumption (+1.4% q/q) which itself has been supported by the upturn in activity in the hotel/catering sector (+12.4% q/q). However, the catch-up is not yet complete in this sector since activity is still 10% below its pre-crisis level, as is the case in the leisure sector (-17%). Investment is the only dark cloud in terms of domestic demand, since it is still running at a lower level than at the end of 2019, exacerbated by investment in construction which is 6.4% below its pre-crisis level.

Switzerland is unlikely to be spared the global economic slowdown in the 2nd half of 2022, but the country should avoid recession. According to the OECD, growth should be around 2.5% this year, before slowing to 1.3% in 2023. Leading indicators are giving contrasting signals, but overall activity should continue to grow. The sector-based indicators of the latest KOF economic barometer show that growth in the services sector is likely to remain positive, but it may slow down in the industrial sector. The manufacturing PMI is more positive because, despite a slight slowdown in recent months, it is still clearly in expansion mode (56.4 in August). For the first time since 2007, the Swiss National Bank (SNB) tightened its monetary policy on 16 June by raising its main key rate by 50 bps (from -0.75% to -0.25%). And it is likely to turn the screw again with another 75 bps rise at its next meeting on 22 September. The later actions of the SNB, compared to those of the FED and the BoE, can be explained by the fact that the inflationary shock has been less severe in Switzerland. The SNB also wants to avoid stifling this dynamic too quickly, emerging from 20 years of a fight against deflation (since 2000, Switzerland has experienced 81 months of negative inflation, i.e. 42% of the time). Swiss inflation only exceeded the SNB's target[1] in the early part of 2022, while this phenomenon appeared in the rest of Europe around the end of 2021. Furthermore, price rises have been modest, since inflation was only 3.5% in August year-on-year compared with 9.1% in the Eurozone. As a yearly average inflation should be 2.8% in 2022, before tailing off to 1.9% in 2023, according to OECD forecasts.

The main reason for the lower inflation in Switzerland is the strength of the Swiss franc, which so far has been able to substantially contain the rise in import prices. A second determining element is the fact that the domestic market is a very low inflation environment (with companies controlling their costs, including their payrolls), as evidenced by production prices which barely exceed the rise in consumer prices (+4.1% in July over one year) and which are already showing signs of easing as they have fallen for the 3rd consecutive month. It therefore seems unlikely that the SNB will engage in a process of monetary tightening to the same extent as the FED or the ECB, because inflation is showing signs of slowing down and an increase in interest rates would lead to a further strengthening of the franc, which would harm exports and adversely impact the economic situation.

GROWTH & INFLATION

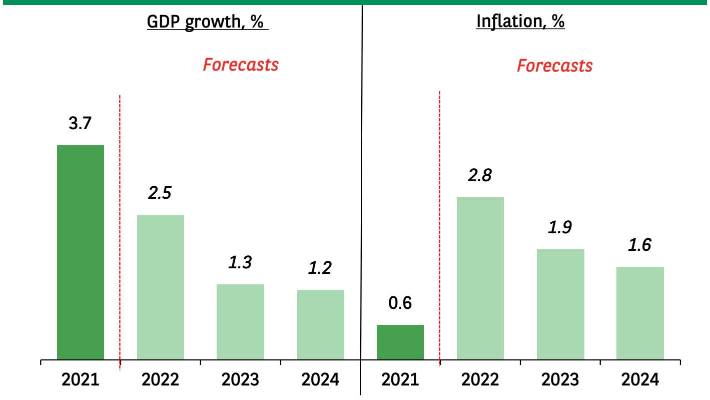


CHART 1

SOURCE: OECD, BNP PARIBAS

SWITZERLAND: INFLATION, PRODUCER PRICE AND POLICY RATE

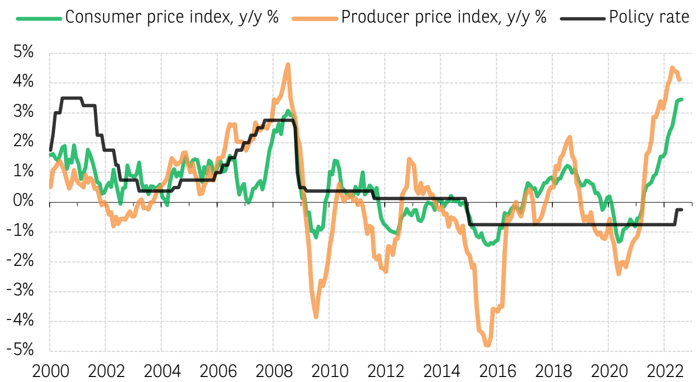


CHART 2

SOURCE: MACROBOND, SNB, BNP PARIBAS

Anthony Morlet-Lavidalie
anthony.morletlavidalie@bnpparibas.com

1 the Swiss National Bank (SNB) : The SNB "equates price stability with a rise in consumer prices of less than 2% per annum. Deflation - i.e. a sustained decrease in the price level - also breaches the objective of price stability. "

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2021	2022 e	2023 e	2024 e	Inflation 2021	2022 e	2023 e	2024 e
United-States	5.7	1.7	1.0	0.9	4.7	8.0	4.4	3.9
Japan	1.7	1.3	0.8	0.6	-0.2	2.2	1.1	0.6
United-Kingdom	7.4	3.4	-0.1	1.4	2.6	9.6	9.3	1.7
Euro Area	5.3	2.8	0.3	1.5	2.6	8.3	6.0	2.4
Germany	2.6	1.4	0.4	1.7	3.2	8.1	4.7	2.4
France	6.8	2.3	0.5	1.5	2.1	5.8	4.2	2.2
Italy	6.6	3.4	0.4	1.6	1.9	8.3	6.1	2.2
Spain	5.1	4.3	0.5	1.7	3.0	8.9	4.5	1.9
Emerging countries								
China	8.1	3.0	5.3	5.0	0.9	2.3	3.1	2.5
India*	9.3	8.3	6.2	6.5	5.4	7.9	5.9	5.5
Brazil	4.6	1.5	0.0	1.2	8.3	11.0	7.1	4.3
Russia	4.5	-7.0	0.8	0.3	7.1	14.0	10.5	7.6

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS) * FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1

FINANCIAL FORECASTS

Interest rate, %

End of period		Q2 2022	Q4 2022 e	Q1 2023 e	Q2 2023 e	Q4 2023 e
US	Fed Funds (upper limit)"	1.75	4.50	4.50	4.50	4.50
	T-Note 10y	2.97	3.55	3.50	3.45	3.30
Eurozone	Deposit rate	-0.50	2.00	2.00	2.00	2.00
	Bund 10y	1.37	1.90	2.20	2.20	2.10
	OAT 10y	1.80	2.55	2.90	2.85	2.75
	BTP 10y	3.29	4.40	4.60	4.50	4.40
	BONO 10y	2.46	3.20	3.70	3.60	3.50
UK	Base rate	1.25	3.00	3.00	3.00	3.00
	Gilts 10y	2.21	2.95	2.95	2.90	2.90
Japan	BoJ Rate	-0.04	-0.10	-0.10	-0.10	0.00
	JGB 10y	0.23	0.25	0.25	0.25	0.45

Exchange rate

End of period		Q2 2022	Q4 2022 e	Q1 2023 e	Q2 2023 e	Q4 2023 e
USD	EUR / USD	1.05	1.00	1.01	1.02	1.06
	USD / JPY	136	137	135	133	127
	GBP / USD	1.21	1.14	1.13	1.13	1.18
EUR	EUR / GBP	0.86	0.88	0.89	0.90	0.90
	EUR / JPY	142	137	136	136	135

End of period		Q2 2022	Q4 2022 e	Q1 2023 e	Q2 2023 e	Q4 2023 e
Brent	USD/bbl	115	100	102	107	115

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS) MARKET ECONOMICS, INTEREST RATE STRATEGY, FX STRATEGY * BASE CASE

GROUP ECONOMIC RESEARCH

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

OECD ECONOMIES AND STATISTICS

Hélène Baudchon Head - Eurozone - Climate	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Felix Berte United States, United Kingdom	+33 1 40 14 01 42	felix.berte@bnpparibas.com
Stéphane Colliac France	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Guillaume Derrien Southern Europe, Japan - International trade	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Anthony Morlet-Lavidalie Germany, Northern Europe	+33 1 53 31 59 14	anthony.morletlavidalie@bnpparibas.com
Veary Bou, Tarik Rharrab Statistics		

ECONOMIC PROJECTIONS, RELATIONSHIP WITH THE FRENCH NETWORK

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

BANKING ECONOMICS

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

EMERGING ECONOMIES AND COUNTRY RISK

François Faure Head – Argentina, Turkey – Methodology, Modelling	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam – Methodology	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot South Korea, Philippines, Thailand, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Perrine Guérin South Africa & English/Portuguese-speaking African countries	+33 1 42 98 43 86	perrine.guerin@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Cynthia Kalasopatan Antoine Ukraine, Central European countries	+33 1 53 31 59 32	cynthia.kalasopatan.antoine@bnpparibas.com
Johanna Melka India, South Asia, Russia, Kazakhstan	+33 1 58 16 05 84	johanna.melka@bnpparibas.com

CONTACT MEDIA

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

BNP PARIBAS

The bank
for a changing
world

GROUP ECONOMIC RESEARCH

CONJONCTURE
Structural or in news flow, two issues analysed in depth

EMERGING
Analyses and forecasts for a selection of emerging economies

PERSPECTIVES
Analyses and forecasts for the main countries, emerging or developed

ECOFLASH
Data releases, major economic events. Our detailed views...

ECOWEEK
Weekly economic news and much more...

ECOTV
In this monthly web TV, our economists make sense of economic news

ECOTV WEEK
What is the main event this week? The answer is in your two minutes of economy

MACROWAVES
The economic podcasts

SUBSCRIBE ON OUR WEBSITE
[see the economic research's website]

ET

FOLLOW US ON LINKEDINN
w[see the economic research's linkedin page]

OU TWITTER
voir la [page twitter] des études économiques

Published by the BNP Paribas Economic Research
Headquarter: 16 boulevard des Italiens – 75009 PARIS / Tel : +33 (0) 1.42.98.12.34
Internet: www.group.bnpparibas.com - www.economic-research.bnpparibas.com
Head of publication : Jean Lemierre / Chief editor: William De Vijlder

BNP PARIBAS

The bank
for a changing
world