ECOPERSPECTIVES

2nd Quarter 2024

"2024 SHOULD BE THE YEAR OF THE START OF THE EASING CYCLE BY THE FEDERAL RESERVE, THE ECB, AND THE BANK OF ENGLAND, PRIMARILY TO ACCOMPANY THE EASING OF INFLATION. HOWEVER, THE TIMING OF THE FIRST CUT REMAINS UNCERTAIN, AS DOES THE NUMBER OF EXPECTED CUTS"

ECONOMIC RESEARCH

BNP PARIBAS

The bank
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world

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EACH CENTRAL BANK HAS ITS OWN PACE

2024 should be the year of the start of the easing cycle by the Federal Reserve, the ECB, and the Bank of England, primarily to accompany the easing of inflation. However, the timing of the first cut remains uncertain, as does the number of expected cuts. Conditions for a first rate cut in June seem to be in place for the ECB, which, according to our forecasts, would thus act before the Fed, whose first rate cut is expected in July (instead of June previously). The possibility is rising that the Fed will not cut rates at all this year because of the resilience of growth and inflation. Such a prolonged Fed monetary status quo could have more negative than positive consequences.

Until early April, our expectations of policy rate cuts[1] converged on a first synchronous move by the Federal Reserve, the European Central Bank and the Bank of England in June (depending on the meeting dates, 6 for the ECB, 12 for the Fed, and 20 for the BoE). Such a synchronicity, though unsurprising, was, however, uncertain given the higher-than-expected January and February 2024 US inflation figures, some desynchronization of business cycles, and the uncertainty inherent in any forecast. Developments during the week of 8 April led us to revise our Fed and ECB call and the BoE scenario may have to be adjusted too in the near future. With US inflation (as measured by the CPI) surprising again on the upside in March[2], we now expect only two rate cuts by the Fed this year, the first one in July and the second one in December (instead of three previously). For the ECB, we keep our forecast of a first rate cut in June, but we have ruled out our back-to-back cuts forecast (i.e. June, July and September), favouring a more gradual easing of one cut per quarter (in June, September and December), more in line with the ECB's cautious stance so far.

WHY CUT POLICY RATES?

For the United States, the main argument for lower policy rates – to accompany lower inflation – is becoming more difficult to advocate, owing to limited disinflation progress, if at all. The argument that the Fed could cut rates despite the current resilience of growth – on the grounds that this strength would primarily benefit from a non-inflationary supply-side recovery (supported by investment efforts, productivity gains, and an immigration-induced boost to labour force) – also seems to be weakened. Monetary easing can however respond to more negative signs which are emerging in the labour market, that put into perspective the robustness of non-farm payrolls gains until March. But these warning signs remain limited for now. Looking ahead to 2025, the US economy's expected soft landing scenario (which combines a return to potential growth and a continued slow decline in inflation to the 2% target) does not require nor permit rapid rate cuts.

The situation in the euro area is different and the case for rate cuts from June onwards is more compelling. True, on an annual average basis, we see Eurozone growth significantly increase between 2024 (0.7%) and 2025 (1.7%), while US growth would decrease also significantly (1.8% after 2.8%[3]). But Eurozone starting position is much less favourable than the US one. The recovery remains to be confirmed on this side of the Atlantic while growth is stronger footed in the US. In other words, Eurozone growth needs support, while US growth needs to be restrained.

ECB interest rate cuts would thus be helpful in this recovery process, against a background of falling inflation. These cuts would facilitate the necessary fiscal consolidation efforts too. Italian Governor Piero Cipollone, who recently joined the ECB Board, also recently delivered a very dovish speech. Instead of highlighting the inflationary fears linked to the combination of strong wage increases and weak productivity gains, he warned of the risk of a too rapid slowdown in wages (due to monetary policy being too restrictive for too long[4]). He points out that wages still have room for catching up and that their dynamism is one of the key factors in strengthening the nascent recovery in the euro area. Without the economic recovery, there will also be no cyclical rebound in productivity, which is, yet, crucial in returning inflation to its 2% target.

All in all, and as Christine Lagarde heralded it during her press conference early March[5], the ECB knew a little more at its meeting on 11 April about the data conducive to starting its monetary easing cycle, but not enough to act and cut. It should have gathered enough information and therefore "*know a lot more*" by the next meeting on 6 June to make the first rate cut. However, according to our forecasts, the economic conditions would allow only a very gradual easing of monetary policy. It will be a matter of accompanying the recovery without triggering a rebound in inflation, while the stickiness of some of its components prevent it from falling more significantly, not to mention the possible inflationary effects of the recent tensions on oil and gas prices. If it claims to be independent of the Fed, the ECB cannot completely ignore another possible source of imported inflation, if acting before and possibly with more cuts than the Fed led to a marked depreciation of the euro-dollar.

WHAT IF THE FED DOES NOT CUT AT ALL?

While the conditions for the ECB to cut rates seem about to be achieved, the possibility is rising that the Fed will not cut them at all – or even that it will have to raise them again – given the resilience of growth and inflation[6].

What could be the consequences? On the one hand, this could shake financial markets and economic agents, whose current risk-on mood and upturn in confidence are partly driven by rate cuts expectations. If the latter were to be disappointed, this could precipitate a correction in the financial markets and a business cycle downturn. Existing vulnerabilities (residential and commercial real estate markets, business failures, large debt refinancing needs, delinquency rates on credit cards) could expand and spread, driving the economy into recession.

1 All expected cuts are 25 bp.
2 For more details, see INFLATION TRACKER - APRIL 2024 | INFLATION REMAINS ON A DOWNWARD TREND, EXCEPT FOR THE UNITED STATES (bnpparibas.com), 12 April 2024.
3 This elevated figure for 2024 GDP growth benefits from a very positive carryover effect.
4 The confidence to act: monetary policy and the role of wages during the disinflation process (europa.eu), 27 March 2024.
5 Christine Lagarde said that, if the ECB was on track to meet its inflation target, more statistics would be needed before it could be sure: "we will know a little more in April, but we will know a lot more in June" (source: ECB, Monetary policy statement and press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 7 March 2024).
6 It should be borne in mind, though, that from the point of view of the Fed's preferred measure of inflation, namely the consumption deflator (PCE), the picture is not as negative as that depicted by CPI figures. Until February 2024 (last available point), the fall in PCE inflation was more pronounced and its level significantly lower (by 0.7 percentage points for headline inflation, which stands at 2.5% y/y, and by 1 pp for core inflation, which reaches 2.8% y/y). According to this PCE measure, inflation is thus less far off the 2% target.

In a recent analysis, the IMF highlights the wide diversity of situations across countries, which could mitigate the risk of such a spill-over[7] . And for the US in particular, the good news is that the characteristics of its residential housing market and the evolution of these characteristics since the 2008 financial crisis and the Covid-19 shock suggest a weakening of this monetary policy transmission channel. On the other hand, a Fed's monetary status quo would not necessarily be bad news if it is, partly, the result of the solid performance of the US economy: if the real world is doing well, it is a good sign for the financial world too. On balance, between the negative and the positive scenario, it is difficult to assess which one would prevail, but, in our view, the risks seem to be tilted to the downside.

To conclude, if we go back to the ECB's point of view, in our scenario, it would end up cutting rates before the Fed, which would be noteworthy news and a well-founded move according to our forecasts. It should be noted that several emerging market central banks have already started cutting rates and that the Swiss National Bank (SNB) paved the way for developed country central banks in March. The BoJ continues however to stand out from its peers, starting only to embark on a process of monetary tightening. As can be seen from the «heatmap» below showing policy rate changes since 2020, after the "big tightening" in 2022, when rate hikes were the rule, the time for a synchronous "big easing" has not yet come. Starting in 2023, the rate cuts would remain scattered in 2024.

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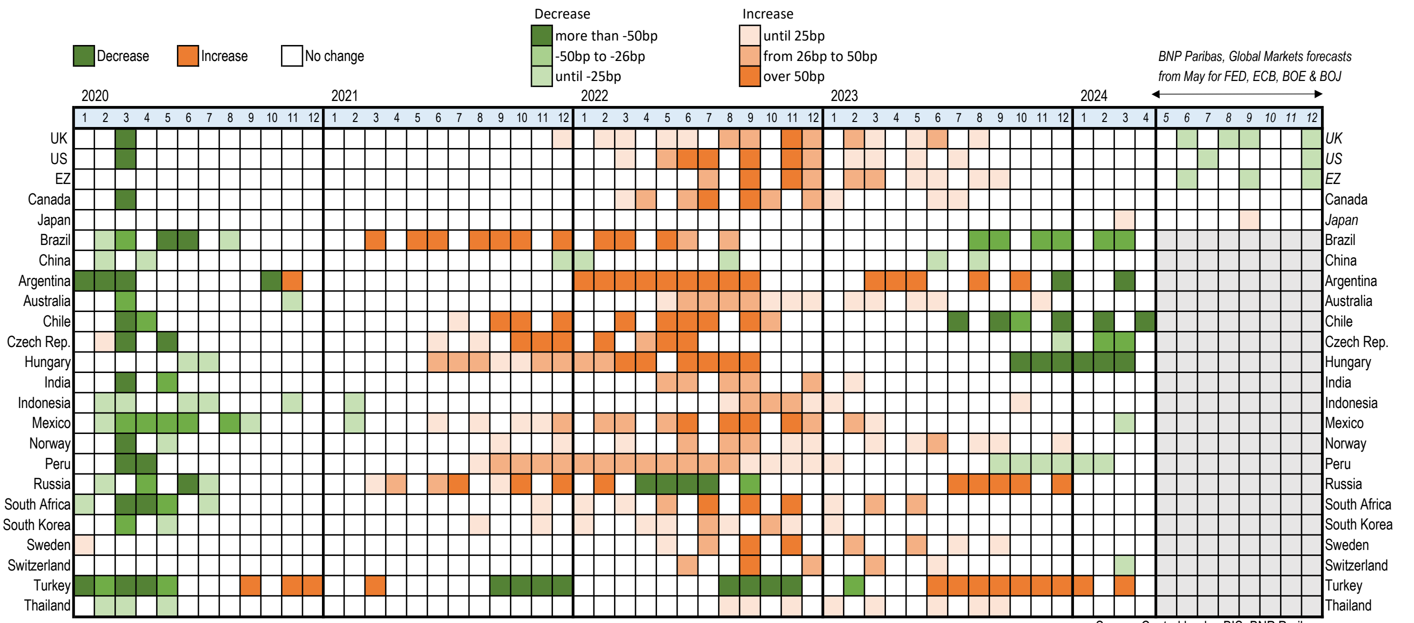
7 Housing is One Reason Not All Countries Feel Same Pinch of Higher Interest Rates (imf.org), 8 April 2024.

POLICY RATE CHANGES



Source: Central banks, BIS, BNP Paribas

THE FED IS IN WAITING MODE

In the first quarter, the median economic projections of the FOMC members maintain the scenario of three rate cuts for 2024. "Wait" is now the Federal Reserve's watchword: wait for the data, wait for more data, wait for the full effects of tightening, and wait for evidence that inflation is definitely on the way to 2% to become more substantial. In this respect, the first quarter of 2024 was disappointing. On the other side of the balance of risks, economic activity is still buoyant and does not need the timetable to be accelerated. Thus, the event of a delayed and smaller decrease in the policy rate has gained credibility, and we are now forecasting two rate cuts in 2024, bringing the Fed Funds rate to 4.75-5.00% at the end of the year.

Economic growth in the United States is expected to slow down marginally during the first quarter of 2024, standing at +0.7% q/q, according to our estimate. The ISM manufacturing index returned to expansionary territory in March 2024, standing at 50.3 (+2.5 pp), a significant print marking an end to a long period of 16 months in negative territory, historically a signal of a recession. However, this potential recessionary trend does not seem to have spread to the rest of the economy for the time being. Whether the upturn in this ISM manufacturing index is here to stay will be examined carefully in future publications. The latest revision to Q4 2023 GDP confirmed the quarterly growth rate of +0.8% q/q, but showed more dynamic household consumption and non-residential investment than initially estimated , contrasting with downward revisions on inventories and external trade. The robustness of its economy at the end of 2023 allows the country to benefit from a carry-over effect (+1.5 pp). This should contribute to an acceleration in annual average GDP growth in 2024, which we expect to stand at +2.8%, up from +2.5% in 2023.

Consumer sentiment recovered quite significantly in December 2023 and January 2024, helped by positive surprises provided by economic growth and, in particular, inflation (+3.2% y/y in Q4). This recovery was clear in both the Conference Board survey (110.9 in January 2024, compared to 99.1 in October 2023) and the University of Michigan survey (79.0 in January 2024, compared to 61.3 in November 2023). However, this improvement has since given way to a stagnation in the Michigan index (79.4 in March) and a deterioration in the Conference Board index (104.7) during Q1 2024, with the results mirroring the disappointing inflation figures (see below). Conversely, the sentiment among business leaders, as measured by the Conference Board survey, is on the upswing after hitting its lowest level in Q4 2022 since the major financial crisis (with the index standing at 29, compared to 24 in Q4 2008). The index stood at 53 in the first quarter of 2024, with balanced results for its sub-components (assessment of current conditions and expectations, sectoral and overall level). This paves the way for increased non-residential investment (which is already holding up well against monetary tightening) in 2024, as financial conditions are expected to be eased gradually.

MONITORING THE DISINFLATION TRAJECTORY

The second FOMC meeting of 2024 ended with the target rate being kept at +5.25 - +5.5% for the fourth consecutive meeting since the most recent hike in July 2023 (+25 bp). Most importantly, the dot plots were stable for 2024, with three rate cuts still planned, totalling -75 bp. This has happened despite upward revisions to median GDP growth projections (+2.1%, compared to +1.4% in December's projections) and core PCE inflation (+2.6%, compared to +2.4% previously) for 2024. However, inflation, as measured by the CPI, still stood at +3.2% y/y in February 2024, having accelerated again month-on-month in January (+0.3% m/m, +0.1 pp) and February (+0.4% m/m), while core inflation remained at +3.9% y/y, which was above consensus expectations (+3.7%). Nevertheless, these elements seem to have been implicitly factored into the median projections, based on the change in expectations for 2025 (three rate cuts compared to four previously) and the distribution of 2024 projections.

GROWTH & INFLATION

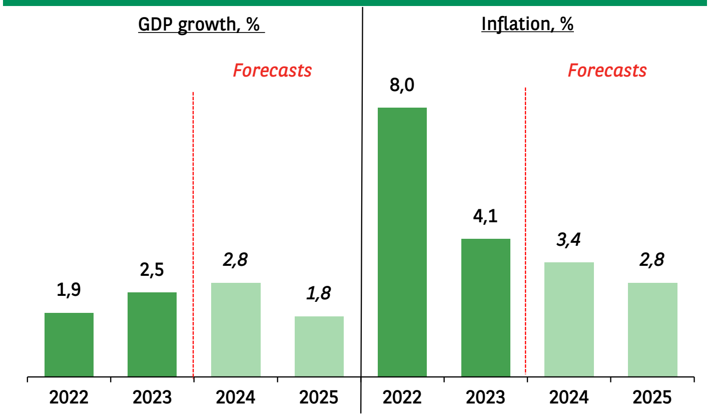


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Therefore, although the median projection is stable, it would simply take one more member to expect two cuts for the 2024 dot plot to translate upwards, which could be interpreted as a sign of an onset of latent pessimism.

Meanwhile, Chair Powell called for a balanced assessment, and even for people to take a step back from the latest figures, indicating that, in his view, they did not "materially change the overall picture", namely of "inflation moving down toward 2% on a sometimes bumpy path". March data was also disappointing, with a +0.4% monthly increase in both the CPI and the Core CPI, bringing the yearly growth to respectively +3.5% and +3.8% amid a strong non-shelter services inflation. As a consequence, the implied rates, as of 10th April 2024, suggest that the markets are now pricing only 1 to 2 rate cut(s) this year, contrasting with the 6 to 7 cuts they were anticipating at the beginning of 2024. We are now forecasting that the Federal Reserve will undertake two rate cuts, in July and December.

Given how close the first rate cut, in July, according to our central scenario, is to the presidential election, and, given the cumulative and delayed effects of monetary policy decisions, this will no doubt spark debate, despite Jerome Powell's strictly refusing to bring a political dimension into the operations of his institution, which he intends to keep independent and non-partisan. Finally, in the world of politics, it is now clear that the presidential election will be between the incumbent president, Joseph Biden (Democrats), and his predecessor, Donald J. Trump (Republicans), unless something unexpected occurs preventing this.

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A NEW RISE IN EXPORT POWER

Against a backdrop of sluggish domestic demand and strategic rivalries, particularly with the US, the Chinese government is further developing its industrial policy to support economic growth and strengthen "national security". Priority is being given to the high-tech and energy transition sectors. With considerable support from the government, these sectors are moving up the value chain, increasing their production capacity, lowering selling prices and winning export market share. The flood of green tech products is expected to lead to further trade conflicts in the coming months.

At the annual session of the National People's Congress held at the beginning of March, the Chinese authorities set out the main objectives of their economic strategy for 2024. In particular, to achieve the relatively ambitious growth target of "around 5%" for this year and stimulate supply, priority is being given to the "new productive forces" that are the new technology industries – ranging from artificial intelligence to the energy transition sectors (renewable energies, electric vehicles, lithium batteries).

China's industrial policy therefore continues to focus on production and innovation across the entire value chain of the targeted manufacturing sectors. It aims to support a continuous rise in the value chain in order to boost productivity gains and make China a major global tech leader. These priorities are not new (they were set out in the "Made in China 2025" programme published in 2015), but the authorities have increased their level of ambition over the past four years in response to a difficult domestic economic environment and an external context marked by strong commercial and strategic rivalries, particularly with the US. In particular, industrial policy must contribute to China's "national security" objectives and reduce its dependence on imported materials and foreign technologies.

Regarding demand policy, the authorities confirmed in early March the accommodative yet cautious stance they had been following for several months. New public investment in infrastructure is planned in 2024 but, at the same time, efforts are expected to be made to rationalise local government spending and restructure the debt contracted by their financing vehicles. In addition, new fiscal and monetary policy measures are being envisaged to stimulate domestic demand and stabilise the property sector, but the emphasis on boosting household consumption remains limited in reality.

In the short term, this economic policy risks amplifying the divergence in performance between sectors and the imbalance between domestic demand and supply, which have been apparent for several months now. On the one hand, domestic demand is lacklustre, still held back by the crisis in the property sector, regulatory uncertainties, and low confidence of consumers and private investors. This sluggishness persisted in January-February 2024, with property investment and house sales continuing to contract sharply, and the recovery in retail sales failing to gather momentum. Activity in the services sector slowed, contributing to a slight rise in the unemployment rate (to 5.3%). Also reflecting the weakness of domestic demand and the imbalance between supply and demand, consumer price inflation has, on average, been slightly negative since mid-2023 (at -0.2% y/y) and core inflation has remained low (+0.7% on average over the period July 2023-February 2024).

On the other hand, industrial production and production capacity continue to grow, especially – but not only – in the high-tech and green-tech sectors. These are largely supported by the government through a wide range of subsidies, tax incentives, low-rate credits and other financing measures. Manufacturing investment has gradually picked up since summer 2023, and the post-Covid rebound in industrial production has accelerated, with improvements seen in a large number of sectors. Government support and the increase in industrial production capacity

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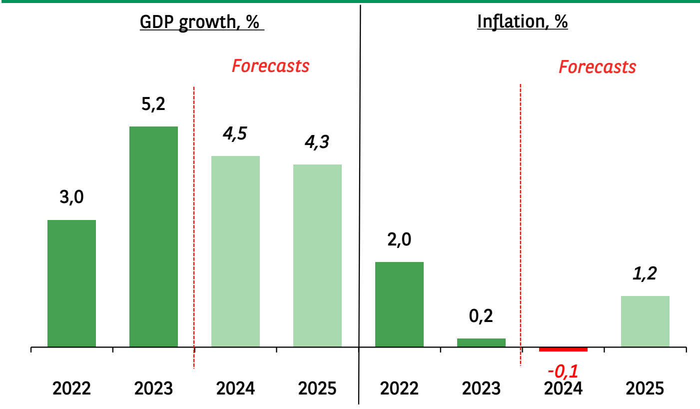

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

have enabled Chinese companies to aggressively lower their selling prices in order to increase their export volumes and strengthen their market share.

China's goods exports have picked up since November. They totalled USD 3,380 billion in 2023, fuelling a trade surplus that has almost doubled since 2019 (from USD 421 billion to USD 823 billion). China's share of total world goods exports has recently increased again. After only partially losing the ground gained during the Covid crisis, it recovered in H2 2023. It stood at 14.4% for 2023 as a whole (as in 2022), compared with 13.3% in 2019. A diversification of China's trading partners had initially offset the effects of "decoupling" from the US between 2018 and 2023, but the latter has come to a halt in recent months. China's share of US goods imports has also recovered, rising from 13.3% in H1 2023 to 14.3% in H2 2023 (compared with 22% in H2 2018).

In addition, China's global market share gains have been recorded across a wide range of products such as: low value-added consumer goods such as furniture and toys, organic chemicals and plastics, vehicles, electrical and electronic machinery and equipment and parts thereof. They have been particularly impressive for electric vehicles (with export volumes multiplied by 7 between 2019 and 2023 and by 1.7 in 2023), solar panels (exports multiplied by 5 between 2018 and 2023) and lithium batteries. The flood of Chinese products has given rise to growing concerns among industrial entrepreneurs and governments in the US, the European Union and now emerging countries, and is likely to lead to new trade confrontations in the coming months.

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JAPAN

THE LONG ROAD TO NORMALISATION

The Bank of Japan has made an admittedly expected, yet nonetheless historic, decision to end its so-called Negative Interest Rate Policy (NIRP), against the backdrop of an almost unprecedented long-term rise in the general price level. However, monetary normalisation will be an incremental process, with the current weak business activity, illustrated by an expected negative growth rate in the first quarter of 2024 and low expectations for the entire year, leaving no scope for any significant tightening.

The average annual growth rate for Japanese GDP stood at +1.9% in 2023, following on from +0.9% in 2022. This figure, which can be viewed as healthy, was nevertheless mainly due to growth carried over from the previous year (+0.5 pp) and a dynamic first quarter, with the year-on-year GDP growth rate standing at +2.3% y/y in Q2 2023. However, the second half of 2023 saw a sharp downturn in economic activity, with Japan only barely escaping a technical recession, with quarterly growth of +0.1% in Q4 following a contraction of -0.8% in Q3. This downturn is due to weak domestic demand, which is itself linked to rising prices (see below) and interest rates. As a matter of fact, private consumption and residential investment contracted over the last two quarters, which, together with the fall in public investment, adversely affected growth. Conversely, the resurgence in foreign trade, which was made possible thanks to a +2.6% q/q rise in exports in Q4 2023, added +0.15 pp to the quarterly growth rate, preventing the country from falling into a technical recession as a result.[1]

According to our forecast, Japanese GDP should contract slightly during the first quarter of 2024 (-0.2% q/q), as a result of the earthquake on 1 January and disruptions to car production. After this the economic recovery will probably be modest, with supply problems, particularly on the labour market, adding to the issue of sluggish domestic demand. In March 2024, the unemployment rate remained low at 2.6%, while the employment rate was 62.8%, a figure that was improving overall. However, despite this improvement, there has still been a notable drop in the number of labour market participants in absolute terms. Therefore, we are expecting an average annual growth rate of +0.4% in 2024, which is well below the rate for the previous year.

A HISTORIC MOMENT FOR JAPANESE MONETARY POLICY

In line with our expectations, the Bank of Japan (BoJ) decided to raise its key rate, the uncollateralized overnight call rate, during its monetary policy meeting in March. Therefore, by raising the target short-term interest rate to +0.0 - +0.1%, the institution altered interest rates for the first time since 2016. This increase is historic, as it brings the curtain down on the NIRP policy that had been in place for 17 years, with Japan being the only country which still had a negative key rate at the start of 2024. At the same time, the policy of yield curve control was discontinued. The BoJ believes that, as it is close to hitting its 2% target inflation rate in a smooth and sustainable manner, these two tools have fulfilled their role.

These changes are occurring against a backdrop of a massive change in the inflation regime in Japan. As a matter of fact, the key measurement for core inflation (excluding processed food) hit an annual average of +2.3% in 2022 and +3.1% in 2023, thereby exceeding the inflation target (raised from 1% to 2% in 2013) for the first time since 2014, a year that was already diverging from national inflation standards. In addition, the figure of +4.2% y/y in January 2023 was the highest since 1981. Finally, we revised our core inflation forecasts for the entirety of 2024 upwards to +2.9%, from +2.4% previously. On the one hand, this is the result of government decisions that are likely to raise energy inflation, i.e. the upward revision of the leverage on renewable energy (a contribution to the energy transition charged on electricity bills) and the non-extension of subsidies for electricity and gas from the summer onwards. On the other hand,

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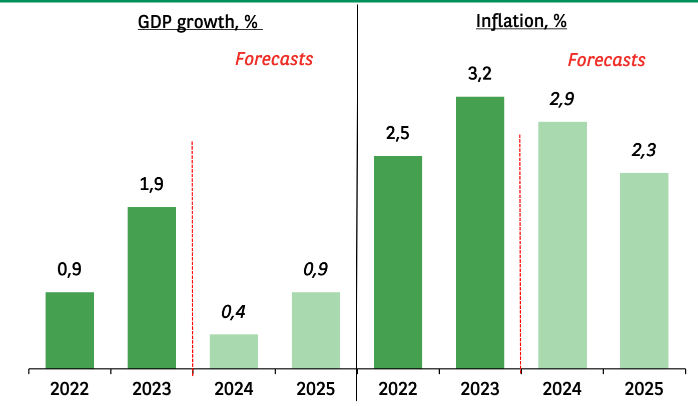

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

RENGO, the Japanese Trade Union Confederation, announced an average wage increase of +5.3% y/y, which exceeded expectations and was the largest rise for more than 30 years. However, at the same time, such a rise may trigger and fuel inflation and inflation expectations. This is in line with the BoJ's objective, for which a virtuous wage-price spiral must contribute towards achieving target inflation, but may raise fears about inflation sticking above 2%.

Japanese monetary policy is expected to normalise very gradually once this first stage has passed. The summary of the BoJ's opinions following its March meeting includes the assertion that the economy is not currently in a situation that requires rapid interest rate hikes. The end of negative interest rates is also not being presented as a transition to monetary tightening. This echoes the statements made by Governor Kazuo Ueda, following the BoJ meeting, that financial conditions should remain accommodating for the time being. Therefore, we are expecting half-yearly hikes, bringing the key rate up to +0.25% at the end of 2024 and up to +0.75% at the end of 2025. However, the risks around this scenario are on the upside, in view of the inflation forecasts and the current weakness of the yen. As of 3 April 2024, USD/JPY parity stood at 151.9, compared to around 115 at the start of 2022 and 130 at the start of 2023. While this weakness in the yen is fuelling fears about imported inflation, it has recently buoyed corporate profits. In particular, the currency has depreciated somewhat following the most recent monetary policy meeting, which can be attributed to the BoJ's stance on the need to maintain flexible financial conditions. Should the trend continue, this could result in calls for more substantial or faster movements by the central bank and/or interventions on the foreign exchange market.

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1 The first GDP estimate for Q4 2023 indicated a contraction of -0.1% q/q, meaning that Japan was in a technical recession.

A TWO-SPEED ECONOMY

Economic activity in the Eurozone is expected to gradually pick up over the course of 2024, buoyed by improving household purchasing power and falling interest rates. However, the industrial sector in the Eurozone is facing major structural problems, which will not (or will only slightly) be addressed by lowering the ECB's policy rates. The ramp-up of the EU's recovery fund should, in theory, enable southern Eurozone countries, which are the main recipients, to outperform again in 2024. However, so far, its effects have been relatively limited and the implementation problems, as highlighted in a recent European Commission report, will not go away completely this year.

Downside risks to growth in the Eurozone are mainly in the industrial sector, where the downturn in activity has showed no signs of stabilising this winter. Industrial production shrank significantly in January, falling to its lowest level in three and a half years, while the PMI indices for the sector continued to contract sharply (45.7 in March). In March, the PMI employment sub-index fell to its lowest level since August 2020, raising fears of a larger downturn in recruitment trends in this sector. The fall in industrial employment in the Eurozone needs to be halted before any turnaround can occur. This has not happened yet, as manufacturing employment levelled off in the second and third quarters of 2023, before falling 0.1% q/q in the last quarter. As a result, the share of industrial employment in the Eurozone hit its lowest ever level, at 12.8%, during the final quarter of 2023 (see chart).

However, job creation remained dynamic in a number of service sectors (information and communication, retail and wholesale trade, accommodation and public services), as well as in construction. The pressure on the labour market is expected to remain high in 2024, as evidenced by the Eurozone job vacancy rate, which, despite falling to 2.8% in Q4 2023, still remained far higher than its pre-COVID level.

After stabilising, Eurozone inflation fell again in March, to 2.4% y/y, according to Eurostat's preliminary estimate. Inflation is expected to get close to the 2% target in the second quarter of 2024, which would give the ECB more leeway to start cutting rates in June. This is expected to be followed by two further cuts by the end of 2024, which would be a moderate pace, and would continue into the first half of 2025.

Nevertheless, ECB members are trying to maintain a fairly firm line around their objective of price stability by focussing more on the trajectory in unit labour cost (ULC) as a key decision-making factor[1]. ULCs are calculated based on wage trends, but also based on other employee-remuneration components (including employer social security contributions) as well as productivity gains. Therefore, it is a more accurate measure than wages for assessing the pressure on companies' margins and their ability to absorb a rise in their costs. However, hourly labour productivity in the Eurozone fell by an annual average of 1.0% in 2023, according to Eurostat data, which led to an acceleration in ULCs (+5.8% y/y in Q4 2023, compared to 4.6% in Q4 2022) when, by contrast, harmonised inflation slowed down significantly (2.6% y/y in Q4 2023, compared to 8.0% in Q4 2022). Companies' margins, which, as a whole, had risen sharply in 2021-2022, gradually fell during 2023. If this trend continues, it would force more companies to adjust their prices, fuelling higher inflation as a result, assuming that the demand environment allows it.

Furthermore, the positive effects of the deployment in the European Union's Recovery and Resilience Facility (RRF) have not yet been clearly seen on the ground. Although investment excluding housing in the Eurozone was up by 3% in 2023, it is still 5% below its pre-pandemic level. In a mid-term evaluation[2], the European Commission highlights a number of obstacles in distributing these funds on the ground (administrative complexities, operating costs, centralised decision-making and a lack of consultation with all stakeholders). The report also points to the risk of substitution between the RRF and other European Union programmes, notably the Cohesion Policy. The RRF is expected to be ramped up this year, but there is still a risk that it may not in fine deliver as strongly as intended due to a lack of synergy between EU and national budgets.

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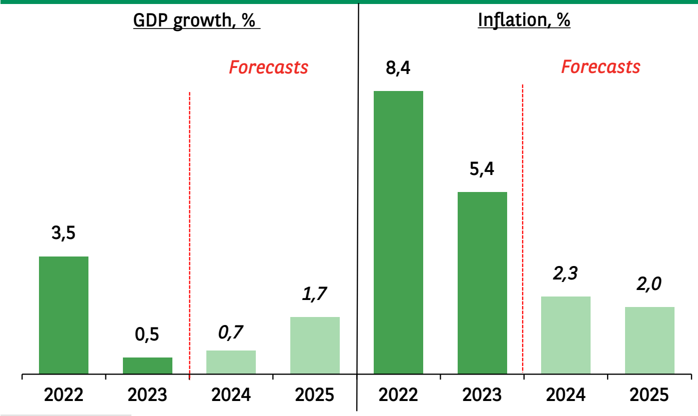

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EUROZONE: MANUFACTURING EMPLOYMENT

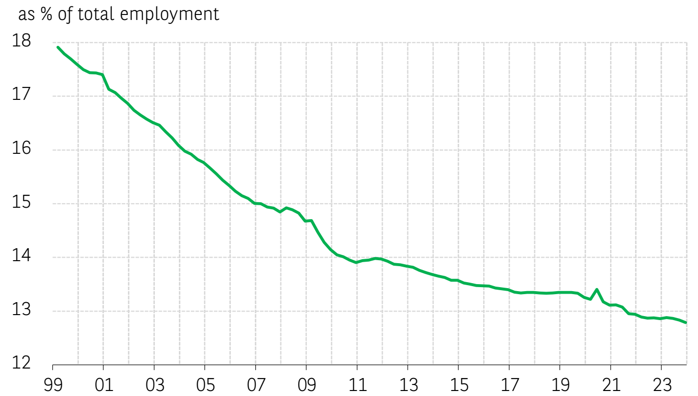

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

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1 See, for example, the interview with Luis De Guindos on 19 March 2024: Interview with Naftemporiki (europa.eu).
2 Mid-term evaluation of the Recovery and Resilience Facility (RRF) - European Commission (europa.eu)).

GERMANY

HAS GROWTH BOTTOMED OUT?

The German economy has been significantly underperforming the eurozone average and past standards for just over 6 years. The country might even be in recession again in Q4 2023 and Q1 2024. So has Germany bottomed out? From an economic point of view, this is likely because the moment of weakness, posted this winter, is partly due to exceptional effects. From a structural point of view, the German economy is expected to continue to post moderate growth, which would not allow it to regain its status as a driver of European growth.

Recent data give little cause for optimism. German GDP contracted by 0.3% q/q in Q4 2023 and by 0.1% on average over 2023 as a whole. The beginning of 2024 has shown no signs of recovery. Although manufacturing production grew by 1% m/m in January, it remained 1.5% below the level seen last November. The automotive industry is a factor, with production in January almost 10% below its November level. The removal of government support for the purchase of electric vehicles had an impact from December onwards, and supply difficulties due to the Red Sea crisis affected the sector from January onwards (including plant closures).

As a result, the IFO Business Climate Index (IFO-BCI) and the Consumer Confidence Index (CCI) experienced a moment of weakness in January and February 2024, reaching levels below those seen at the end of 2023: 86.9 on average for the IFO-BCI compared to 88.5 in December; -29.2 on average for the CCI compared to -25.4 in December. All of these elements suggest negative growth again in Q1 2024 (-0.1% q/q according to our forecasts), and therefore a recession in Germany.

AN ECONOMIC UPTURN IS LIKELY AS FROM Q2

Nevertheless, the German economy may well have bottomed out in Q1 2024. The interlude in January-February seems to have come to an end in March. The IFO-BCI (88.1) and consumer confidence index (-27.4) are close to levels seen in December 2023. This improvement should also be evident in production, in particular the automotive industry, which is expected to recover after the supply difficulties in Q1.

The rebound in growth expected in Q2 (+0.1% q/q) can be explained therefore, for the time being, by the end of a moment of economic weakness rather than by a long-term improvement in fundamentals. The combination of supply and demand constraints continues to characterise the German economy. New orders to industry, which have shown no signs of recovery in recent months, attest to low demand.

However, Germany should benefit from tail winds in 2024: a first interest rate cut by the ECB expected for June and an uptick in growth in the rest of the eurozone. However, German growth should remain lower than growth in the eurozone in 2024 (0% compared to 0.7%) and in 2025 (1.4% compared to 1.7%).

A TRANSITION PERIOD THAT SHOULD LAST

The underperformance of German growth is nothing new. Between Q4 2017 and Q4 2023, German GDP grew by 1.2% compared to 5.5% for the eurozone. This contrasts with the previous period (Q4 2009-Q4 2017), when the situation was the opposite: +19.6% for Germany compared to +11.8% for the eurozone. Previously, the country had already experienced a period of low growth, following reunification, until 2005 (a time when Germany was described as the sick man of Europe), before its growth caught up with eurozone growth (between 2005 and 2009).

The 1990s had started with a costly transition period, as the cost of reunification had to be absorbed. Concerns about Germany's status as a production site also arose (standort deutschland debate). In addition, from a public finances perspective, German public debt and the public deficit were close to those of France.

GROWTH & INFLATION

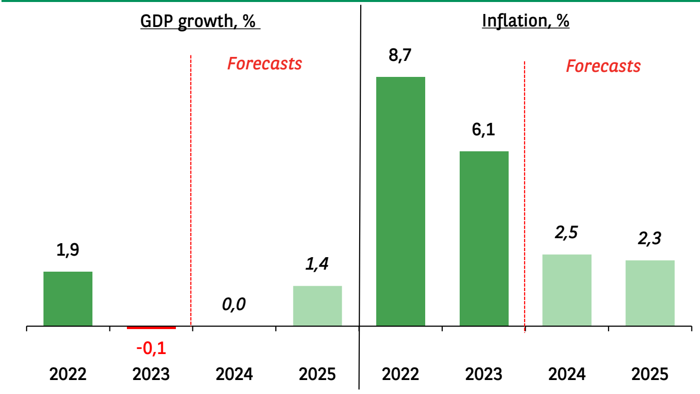

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Structural reforms ultimately closed this period on the up: the Hartz reforms (2003-05) transformed the German labour market, while public finances were governed by the debt brake rule, voted on in 2009, which limits the structural budget deficit to 0.35% of GDP. Germany also benefited from the integration of Central and Eastern European countries into the European Union in 2003 to outsource part of its production, while its exports benefited from the development of China (a member of the WTO since 2001).

Germany is now once again embarking on a transition that has two facets: adapting to climate change and taking into account the step-up in industrial policy in China and the USA. It is no coincidence that 2018 was the first year in which German growth fell below growth in the eurozone: automotive production peaked in 2017, just before the adoption of the first European standards more stringent for manufacturers (WLTP testing standards entered into force in September 2018). China's rapid industrialisation is another challenge: the country's density of industrial robots rose in 2017 from a ratio of 1 to 3 with regard to Germany to almost parity in 2022, according to the International Federation of Robotics. This step-up in the strength of China has already started to affect Germany's market share in global trade (6.6% in 2022 compared to 7.8% in 2019 according to the WTO), a decline that could become more significant.

Both transitions mean that Germany's competitive advantage is being challenged. The relative output loss is expected to continue as these transitions continue to take effect.

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FRANCE

MOVING TOWARDS RECOVERY

Just as in 2022 and 2023, the French economy got off to a weak start this year and is expected to see its growth accelerate in Q2. Although not in the same way as in previous years, headwinds affected the French economy in Q1 2024. Beyond this purely cyclical upturn, in order to return to more durable growth, we will need to wait for the return of French consumers, which we also expect to see in Q2. And lastly, corporate investment should once again bolster French growth, with the implementation of the France Green Industry plan in particular.

During the second half of last year, the French economy had just experienced six months of stagnation, following another period of stagnation at the turn of 2022-2023. The latter had been followed by a significant rebound (growth of 0.6% q/q in Q2 2023), but this was short-lived. Will it be different this time round? The answer is not that simple because, for the first time, there was no growth support from domestic demand items in Q4 2023: household consumption stagnated and corporate and household investment declined. Our scenario for 2024 envisages a gradual improvement, in Q2 rather than in Q1. Will we have to get used to seeing the French economy start slowly in Q1 and then pick up from Q2 onwards?

Q1: ANOTHER MISSED START

2024 may well have got off to a modest start too. Q1 2022 had suffered from the sudden acceleration of the inflationary crisis and from health restrictions linked to the Omicron variant, while the start of 2023 was affected by the risk of energy shortages. What will happen in 2024?

Several negative factors are at work: attacks on vessels in the Red Sea that disrupted supplies, further closures of automotive plants and a drop in production. At the same time, the further decline in imports of intermediate goods in January (French customs figures) does not bode well for an immediate return to GDP growth. Public finances were probably a factor too. At the same time, household consumption once again underperformed in Q1. In fact, even though inflation fell sharply (2.4% y/y in March according to the harmonised index, compared to 5.7% y/y in September 2023), the rise in the cost of services (insurance, transport), along with the partial withdrawal of the energy cap, affected household confidence in Q1, whose consumption of goods was eroded over January-February.

Alongside the energy cap, other support measures were removed (i.e., green bonus for company car fleets) or came into force belatedly (revamping of green bonus for private individuals' car purchase). Added to all this is maintenance of oil refineries, which required longer than usual shutdowns in Q1 2024. And lastly, activity in the building sector was affected by the cold weather in January. The balance of opinion on activity in new housing reached -37 in January, -39 in February, before recovering to -31 in March (INSEE business climate survey in the building industry).

Q2 2024: THE RETURN OF GROWTH?

It is likely that French companies did not achieve the levels of production they wanted in Q1 and that they might manage this in Q2 2024.

Moreover, demand is expected to return, with the dissipation of the last residual inflationary pockets still noticeable in Q1. At the same time, despite significant cumulative inflation (12% since autumn 2021, of which 21% on food or 6.5% on manufactured goods), prices stabilised for a significant share of household consumption. Prices of manufactured goods only increased by 0.1% y/y in March, and could quickly move into negative territory (production prices fell by 5.5% y/y in February 2024).

An uptick in households' willingness to spend could therefore result from price drops, particularly on typical everyday products (food) or more exceptional purchases, such as a car. What might trigger this kind of price cut? For cars, the price increase in the past (11% since autumn 2021) ultimately impacted demand, which should encourage manufacturers to lower their prices against the backdrop of cheaper new models (e-C3, R5 EV) and/or an additional green bonus (on top of what the government is proposing). Also, the adoption of more stringent criteria in terms of electrification of company fleets (financial penalties, which are being discussed in the National Assembly, would apply from 2024) could also bolster demand.

GROWTH & INFLATION

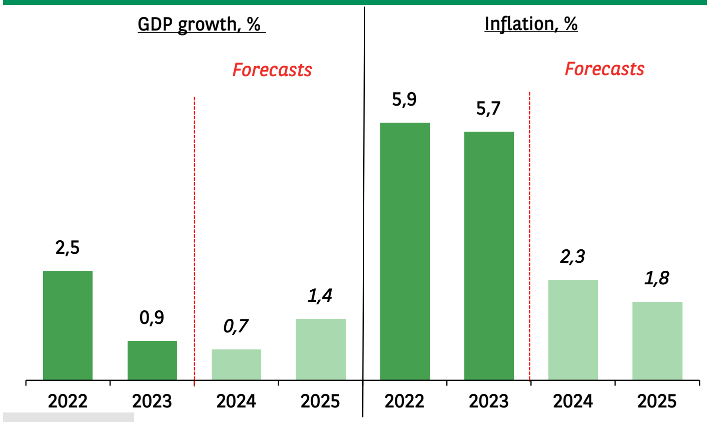

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

FOLLOWED BY: IMPLEMENTATIONS OF PLANS

France has been developing an industrial policy for several years now: corporate investment has benefited from tax incentives (extra depreciation measure in 2016), followed by aid from the Covid-19 period onwards (France Relance recovery plan). Alongside the France 2030 investment plan, the new France Green Industry Investment plan is expected to provide a new boost, with the entry into force in March 2024 of the new tax credit for investments in green industries (C3IV). In addition, the impact of the monetary tightening implemented by the ECB in 2022-23 is expected to ease. As a result, after a more negative period for corporate investment (which started in Q4 2023, -0.9% q/q), this investment is expected to rebound in 2024.

Overall, 2024 should therefore see the return of two important pillars of French growth (household consumption and corporate investment), and herald an even better 2025 (with a growth forecast of 1.4%).

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ITALY

A BETTER-THAN-EXPECTED SCENARIO

In 2023, Italian real GDP rose by almost 1%. The recovery of the economy was broad-based. Private consumption rose by 1.2% in 2023, benefitting from the further improvement in labour market conditions. In 2023, investment continued to be the main driver of the Italian recovery. Expenditures on machinery and ICT equipment were 20% higher than in 2019, with some first positive effects on Italian potential growth. The growth in investment since the post-pandemic period has increased the number of firms using technologies relying more effectively on digital transformation to boost productivity.

AN INVESTMENT DRIVEN RICOVERY

After declining by 0.2% in Q2, the Italian economy slightly recovered in H2 2023, growing by 0.2% both in Q3 and in Q4. In Q4 2023, real GDP was 4.2% higher than in Q4 2019, outperforming other main Eurozone economies.

In 2023, GDP rose by almost 1%. Change in inventories subtracted 1.3% from the overall growth, while net exports contribution was positive (0.3%), as imports declined while exports slightly increased. According to trade balance data, the value of Italian goods exports remained unchanged at EUR 626 billion. Exports in EU countries declined, suffering from the disappointing development of sales in Germany, while those in the United States rose by almost 3.5%.

The recovery of the Italian economy was widespread across all sectors. In 2023, services value added rose by 1.6%, adding 1.2 ppt to the overall growth, and that of construction increased by almost 4%. Although decelerating, manufacturing value added continued to grow (+0.2% in 2023), while production strongly declined (-2.5%).

Although sharply falling in Q4 (-1.4% q/q), private consumption rose by 1.2% in 2023. Labour market conditions further improved. The employment rate rose to 61.5%, the highest in the last twenty years. Purchasing power of households benefitted from both the recovery of nominal income and the decline of inflation. Despite the persisting uncertainty surrounding the overall scenario, consumer confidence improved, rising above long-term average.

In 2023, investment continued to be the main driver of Italian growth. Gross fixed capital formation rose by almost 5%, adding 1 ppt to real GDP growth. With respect to 2019, investment is up by more than 25%, while that in construction increased by almost 40%, benefitting from public incentives to improve energy efficiency of buildings. Expenditures on machinery and ICT equipment were 20% higher than in 2019, with some first positive effects on Italian potential growth, which rose from slightly above 0.5% (pre-pandemic IMF forecasts) to almost 1%.

THE SIZE OF ITALIAN FIRMS INCREASES

In Italy, the post-pandemic recovery went hand in hand with changes in the structure and strategic orientations of the business ecosystem. According to the second wave of the Istat "Permanent business census", a process of re-composition of resources emerged in favour of larger (and more productive) units between 2019 and 2022: medium and large enterprises recorded an increase in number and staff, compared to a limited increase (mostly contractions, actually) for the micro and small ones. In the industrial sector, the number of micro-firms decreased by about 7,000 units (-4.5%), in the market services sector by 9,000 (-1.1%), while in construction and personal services their number rose by about 390,000 (+10.3% and +31.7%, respectively).

GROWTH & INFLATION

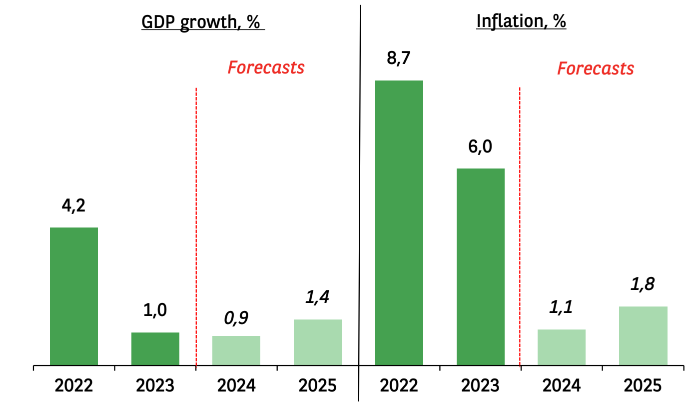

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The increase in employment observed in the three-year period is largely explained by the medium and large units, which account for 66.4% of the approximately 660,000 total additional employees. All firm size classes, except for the medium-sized ones operating in personal services activities, recorded an increase in value added (which was however also affected by the trend of inflation).

The result of these movements was an increase in the average firms' size, widespread across most sectors. Moreover, the growth in investment in digitalization seen in Italian companies since the post-pandemic period, has led to an increase in the number of firms keen and able to invest in technologies relying more effectively on digital transformation to increase productivity. Their number went up from 2.6% to 7% of total firms with more than 10 employees, while their weight in terms of employees increased from 16.2% to 22.2%.

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THE POWERHOUSE OF THE EUROZONE

In 2023, Spanish real GDP (up 2.5% on an annual average basis) grew much more than Eurozone real GDP (0.5% y/y). Household consumption, the main driver of growth, was buoyed by the strong labour market and slowing inflation. We are forecasting growth of 0.4% q/q in Q1 2024, before it accelerates in the subsequent quarters. Therefore, for the fourth year, Spanish growth is expected to be one of the Eurozone's driving forces (2% y/y versus 0.7% y/y).

HOUSEHOLD CONSUMPTION RESISTS DESPITE INFLATION

At the start of 2024, the evolution of Spanish inflation is experiencing a few jolts. After falling in February due to a lower increase in food prices (5.3% y/y in February; -2.1 percentage points over one month) and a further drop in energy prices (-4.6% y/y; -2.2 pp), harmonised inflation is expected to have risen again in March, according to the preliminary estimate from the Spanish National Statistics Institute (3.2% y/y, +0.3 pp). This increase would be fuelled by VAT on energy prices returning to 21% (compared to 10% over the previous three months), as well as by the rise in fuel prices.[1] With the package of fiscal measures to combat rising prices set to expire by the middle of the year, inflation could rise again in the second quarter. Like other Eurozone countries, service prices are continuing to exert upward pressure on Spanish core inflation, which, however, is expected to have eased slightly in March, according to the Spanish National Statistics Institute (3.2%, -0.3 pp). As wage growth is higher in Spain than in other Eurozone countries (4.2% y/y for Spain in Q4 2023, compared to 3.1% y/y for the Eurozone), there are still significant fears of a wage-price spiral being triggered.

Nevertheless, the overall inflation-slowdown trend, combined with this strong wage growth, is resulting in improved household purchasing power and is boosting household consumption as a result. Initial soft data also indicate that Spanish household consumption is likely to remain high at the start of the year. The PMI survey results point to improving private sector activity (with the composite PMI standing at 53.9 in February; +2.4 points over one month), mainly thanks to stronger demand. There was also a clear improvement in the European Commission's consumer confidence index in March (standing at -16, +1.3 points over one month). This is mainly driven by improving expectations around the overall economic situation (-18.6; +2.9 points) and the financial situation for the year ahead (-3.3; +2.2 points), which, in turn, are boosting consumers' intentions to make major purchases in the coming months (-23.3, which is the best level seen since the start of the war in Ukraine; +0.3 points over one month). This growth in consumption is also already clear in the hard data for February, with a significant increase in retail sales (+0.5% m/m in February) and new vehicle registrations (+3.1% q/q in Q1). In addition, tourism, which had hit record levels in 2023, did not slow down at the start of the year, as the number of arrivals continued to increase in February (+10.2% y/y), bringing the number of visitors to 5 million.

THE LABOUR MARKET IS NOT WEAKENING

Two years after the labour market reform, there are still structural vulnerabilities around the unemployment rate for the working age population and young people, as well as around the long-term unemployment rate. Nevertheless, recent developments in the labour market have continued to pleasantly surprise. In Q4 2023, the employment rate (15-64 year olds) was well above (65.8%) the average for 2010-2019 (58.8%), and the results published at the start of the year remain encouraging: companies[2] are continuing to report recruitment difficulties in the construction sector (12.3; +1.9 points over one month and 7 points above the 30-year average) and in the services sector (16.8; - 6.2 points over one month, but still 11.7 points above the 30-year average), and the number of workers affiliated with social security continued to rise in January (+103,000[3]), bringing it to 21 million.

GROWTH & INFLATION

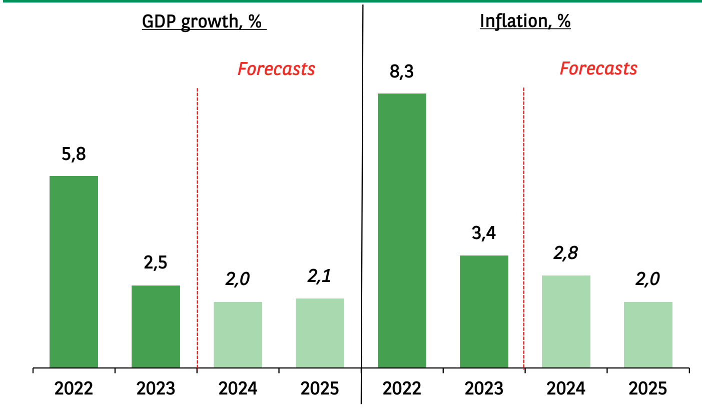

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

SPAIN'S MINORITY GOVERNMENT IS A SOURCE OF INSTABILITY

Prime Minister Pedro Sánchez and his government are currently struggling as a result of their parliamentary minority. After clashing for months with opposition parties in the hope of getting its 2024 budget adopted, the government ultimately admitted defeat and decided to extend the 2023 budget framework for another year, and then focus on the 2025 draft budget. However, this decision should not significantly affect Spanish public finances, as the budgetary situation at the start of the year was stronger than expected – with a public deficit of 3.7% of GDP in 2023 (compared to 3.9% initially anticipated) –, and the growth forecast for 2024 is very high (2% y/y).

Nevertheless, hostilities in the separatist camp of the Parliament of Catalonia made it impossible to vote on the regional budget, which led the President of the Generalitat de Catalunya to call a snap regional election for 12 May. The results of these elections are a cause for concern for Sánchez's government. Not only is Catalonia one of the Socialist Party's heartlands, but the already fragile government also relies heavily on the support of the two separatist rivals (the ERC and Junts). Therefore, if the ERC loses Catalonia's presidency, it could mean that its support for the socialist government in Madrid is being punished hard by voters, and the party would no longer have any interest in supporting Pedro Sánchez, who would then find himself in a tight spot.

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1 Which have now been constantly increasing for nine consecutive weeks.
2 According to the European Commission's March economic sentiment survey.
3 Not seasonally adjusted data.

NETHERLANDS

RECESSION SEEMS OVER

The short Dutch recession seems to be over, thanks to dynamic private and public consumption. Inflation continues to cool down, even though it remains stickier than thought in some sectors. A new government has still not been formed yet, but there is a consensus about the fact that once it is the case, public spending is set to increase further, giving the economy an extra boost. The Dutch economy is therefore likely to navigate a different, more positive, path from its neighbors'.

The Dutch economy expanded in the fourth quarter of 2023, ending the mild recession that hit the country in 2023 and led to a GDP fall of 1.1% from Q1 to Q3 2023. GDP grew by 0.4% on a quarter-on-quarter basis in the last three months of the year, bringing therefore growth for the whole year at a tiny +0.1%, one of the worst performances in the Euro Area.

Growth was made possible thanks to private consumption, as well as public consumption. Investments, on the other hand, suffered from the persisting negative business climate as the additional deterioration in business confidence index shows. All in all, a 2.1% quarter on quarter contraction of investment was observed in Q4. The main factors explaining this poor figure are most likely the elevated level of interest rates, as well as the gloomy geopolitical context, in which firms have a hard time making projections.

Inventories continue to be qualified as "too high" by many, so reduction was once again the key word in the last 3 months of the year. This also included a reduction in the storage of gas.

Looking forward, we expect investment to contract further during 2024, as higher financing costs will have a delayed negative effect on the cost of capacity expansion. On the other hand, we are quite confident that private consumption will continue to support growth, essentially because purchasing power is expected to improve further on the back of higher wages and lower inflation. The labour market is expected to remain tight, though a slight increase in the unemployment rate is expected. Dutch households, known to live on credit, seem to have moderated this bad habit over time. Expressed in percentage of GDP, the households' debt ratio fell from 120% in 2010 to less than 90% at the end of last year. Compared to neighboring countries, this ratio remains quite high (less than 60% in Belgium), but its decline over time is good news for economic stability. For 2024, the European Commission expect real GDP to grow by a modest 0.4%, before gaining some momentum in 2025, when growth is expected to reach 1.6% (winter forecasts).

INFLATION IS DOWN

The Dutch inflation rate came down sharply from its peak level, at more than 17% y/y in September 2022, to 2.6% y/y in February 2024 (HCPI measure). Core inflation remains slightly above that level, at 3%. As is the case in many countries, inflation proves stickier than anticipated in services, as well as for food. This is why expected ECB rate cuts have been somewhat delayed as weeks go by in 2024. Some patience will probably be necessary, even though there is no doubt interest rates will be cut this year. For 2024 as a whole, the European Commission expects Dutch inflation to be around 2.6%, and 2% a year later.

REAL ESTATE PRICES RECOVER

The Dutch housing sector has been particularly hit by the tighter monetary policy in Europe. Prices fell by as much as 5.8% y/y in May 2023, but they are already recovering, on hopes that interest rates have peaked and because mortgage rates already eased a bit. In February 2024, residential real estate prices were up by more than

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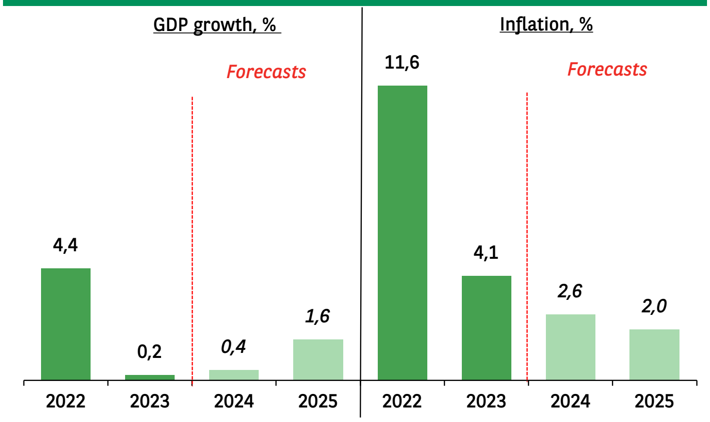

CHART 1

SOURCE: EUROPEAN COMMISSION (FEBRUARY 2024), BNP PARIBAS

4% on a year-on-year basis. The main causes of the recent rise in prices are the large wage increases and the limited supply. This fast recovery in the housing market is definitely another argument to explain the nice improvement seen on consumer confidence.

NO GOVERNMENT YET BUT THINGS ARE MOVING

When Geert Wilders secured the most votes in Dutch elections last year, his victory was seen as a clear illustration of how the far right could seize power in Europe. But four months on, he remains shut out, with mainstream parties in the Netherlands closing ranks to force his Freedom party to give up on the premiership as the price for joining a coalition government. A few months away from the June 9th European elections, the Dutch experiment underlines one of the enduring features of Europe's fragmented democratic system: winning votes is not winning power.

In the longer run, once a government is formed, there is a large consensus around the fact that public spending will increase, granting more purchasing power to Dutch households and further supporting the economy through stronger government investment. This is also the reason why the budget is expected to turn in the red, at -2% of GDP this year and the year after, versus a small 0.6% deficit in 2023. The low level of the public debt (below 50% of GDP in 2023) is however an important feature, allowing more spending without any problems. This is not the case in most other European countries, though.

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PRIVATE CONSUMPTION 2.0: MAIN ENGINE OF GROWTH NONETHELESS

Our first quarter nowcast confirms the outlook for the Belgian economy: it keeps cruising at close to trend-growth rates (0.3% q/q), despite the challenging external environment. One-off factors temporarily sped up normalisation in both firm investment and international trade, but private consumption once again carries the brunt of economic growth. Consumption patterns are changing however, with more e-commerce and share of total outlays spent on services. Belgian firms continue to demonstrate resilience, while the labour market cools down.

Fourth quarter GDP growth came in at 0.3% q/q resulting in full year growth of 1.5%. The main contributors were private consumption and firm investment. More precisely, in the first 3 quarters, firm capex contributed close to all economic growth, with net trade firmly negative. That changed in Q4 as one-off transactions (ships sold to foreign counterparts) pushed down corporate investment and increased export. Even after cutting through these specific developments, we expect investment growth to have slowed down nonetheless, while the downward trend in international trade seems to have at least bottomed out in recent months.

SHIFTS IN PRIVATE CONSUMPTION

After a short bout of deflation at the end of 2023, related to the technical treatment of energy bill support measures at the time when energy prices were well past their peak, harmonized inflation came in at 3.6% y/y in February. In doing so, the HICP-index surpassed its Oct'22 peak for the first time in 16 months. Further boosted by strong wage indexation at the beginning of 2023, this significantly limited real-wage losses for the Belgian economy, in stark contrast to the neighboring countries and the Eurozone as a whole.

Private consumption held up well, contributing about half of the 1.5% GDP growth that took place across 2023. We expect it to continue in this vein, carrying more than half of GDP growth in 2024, as consumer confidence looks to have stabilized around its long-term average.

Underneath this apparent return to "business as usual", important behavioral changes are lurking. One is the increased share of e-commerce. Using inhouse data, we noticed that online shopping, as a share of total expenditure by our retail clients, increased from 10% right before the onset of the pandemic to 22% and more early this year. Next to that, retail spending is up a healthy 17% since the start of the pandemic, in nominal terms at least. Adjusted for inflation however, volumes are down 4%, reaching a 10-year low point. This could be related to a shift of consumer spending away from goods, towards services. Eurostat-data seems to indicate that both the current share and the increase over the last couple of years is well in excess of the neighboring countries and the rest of the Eurozone.

FIRMS' FORTUNE

Much has been made of the significant government support doled out to Belgian firms over the last couple of years. Bankruptcy rates for the economy as a whole are only now just rising towards their pre-covid levels, and still then only gradually. Despite a high-profile impending bankruptcy case in the transport sectors, long-held fears of impeding bankruptcy-waves are now receding.

The onus has shifted to the opposite side of the medal: were otherwise unhealthy firms artificially kept alive by government support? In its latest publication, the National Bank offers a resounding "no" in answer to that question. The share of firms labeled "zombies" – those whose financing charges exceed their profit for at least three subsequent years and active since at least 10 years – has continued

GROWTH & INFLATION

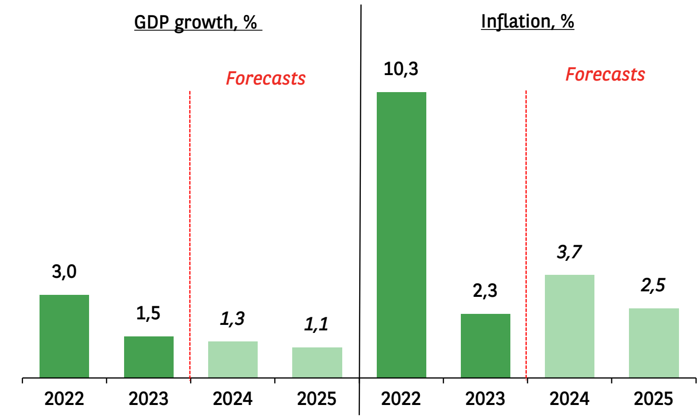

CHART 1

SOURCES: BNP PARIBAS GLOBAL MARKETS

its downward trend during the subsequent covid- and energy-crises. It declined from about 15% in 2010 to 11% in 2021. Next to that, non-performing-loans for domestic exposure across all categories is now lower than pre-covid.

Anecdotal evidence also suggests that Belgian firms are becoming more dynamic. Recently, and for the first time, the country registered a top 10 finish, as part of the FT1000-ranking of Europe's fastest growing companies. Eurostat data however suggest there is still room for improvement, with the share of fast-growing firms in Belgium (7%) below the EU average (9%).

More generally, confidence is picking up across the economy, even if fortunes diverge. Construction and especially manufacturing firms are regaining their optimism. Those active in trade are more negative, especially as vehicle-trade was hit by lower demand in March.

The labor market is slowly cooling of, as the share of industrial firms reporting it as a limiting factor further declined. The Federgon index of temporary labor, a leading indicator, has been trending down for a couple of quarters and job creation is slowing down, following suit.

International trade looks to have bottomed out at the beginning of the year. After increased activity (related to chemical and pharmaceuticals), it posted negative growth since the end of 2022. In year-on-year terms, that dynamic reversed around the turn of this year. Our outlook is one of gradual improvement, subject to significant uncertainty in the external environment.

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PORTUGAL

A STUNNING IMPROVEMENT IN PUBLIC FINANCES

After eight years of socialist government, the centre-right Democratic Alliance coalition won the snap general election held on 10 March. This shift in the political landscape, where no party now has an absolute majority in Portugal's Parliament, could be a source of instability in the country. Nevertheless, the sweeping consolidation of public finances during António Costa's term, as well as sound macroeconomic fundamentals, give the future government considerable economic and fiscal leeway. Portuguese growth is expected to remain well above Eurozone growth in 2024 (standing at 1.2%, according to the European Commission, compared to 0.7% for the Eurozone).

A SHIFT IN THE POLITICAL LANDSCAPE IS CREATING INSTABILITY

The surprise resignation last November of Portuguese Prime Minister António Costa, due to a corruption and influence-peddling scandal within his inner circle, forced the President of the Republic to dissolve Portugal's Parliament and call a snap general election, which took place on 10 March 2024. After eight years of socialist government, the centre-right Democratic Alliance (DA) party won the highest number of seats in the Portuguese Parliament (80 out of a total of 230), and its leader, Luís Montenegro, became Prime Minister. The Socialist Party (SP) came second, with 78 seats. Finally, the far-right Chega party became the country's third-largest political force. Having made an astonishing breakthrough by increasing its number of parliamentary seats from 12 to 50 in two years, it is seen as the big winner of this election.

However, with these results, Luís Montenegro cannot form an absolute-majority government in Parliament. As there is seemingly no alliance between the DA and Chega, or the DA and the SP, in the pipeline, the DA will most likely rule as a minority government, with opposition parties rejecting its future bills and voting down its proposed budgets, as is currently happening in Spain. However, this is not the first time in the history of Portuguese democracy that there has been a minority government[1]; therefore, the SP and DA are used to cooperating if a government does not have an absolute majority. Even though the SP leader insisted that his party would vote down the proposed budget in the autumn, in the current circumstances, both parties seemingly have an additional interest in cooperating, as they both would want to avoid another snap general election, which could give Chega another opportunity to increase its number of seats.

SOUND MACROECONOMIC FUNDAMENTALS

However, this shift in the political landscape is occurring at a time when Portugal's macroeconomic fundamentals are sound, which should reduce the potential risks resulting from a new party taking power and the minority government set-up. Portugal's annual average growth rate for 2023 was 2.3%, which is similar to Spain's (2.5%) and well above the Eurozone's (0.5%). It is expected to remain high in 2024 (standing at 1.2%, according to the European Commission), driven mainly by the strong performances in terms of household consumption and exports.

Over 2023 as a whole, inflation (harmonised measurement) slowed by 2.8 percentage points (from an annual average of 8.1% in 2022 to 5.3% in 2023) and looks to have stood at 2.6% y/y in March, according to the preliminary estimate from the Portuguese National Institute for Statistics. This drop in inflation, which will continue in 2024, combined with strong wage growth (+5.5% y/y in Q4 2023, according to Eurostat), should continue to boost household purchasing power. The strong labour market performance is also good news for household consumption. Although the unemployment rate has been relatively stable over the past five years (6.5% in January 2024), the employment rate (15-74-year-olds) reached an all-time high in Q3 2023, standing at 63.9%, almost three percentage points above the Eurozone average.

1 Particularly between 2019 and 2022.

GROWTH & INFLATION

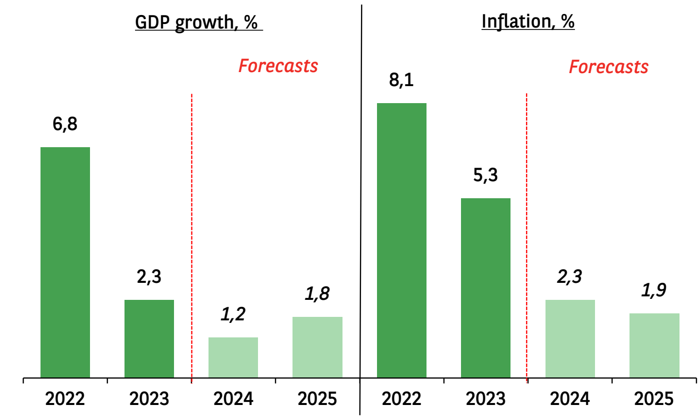

CHART 1 SOURCE: EUROPEAN COMMISSION (FEBRUARY 2024), BNP PARIBAS

Tourism should also continue to bolster exports. After the record tourism figures seen in 2023, with more than 18 million foreign tourists (+19% compared to 2022 and +11% compared to 2019), activity continued apace at the start of the year, with the number of foreign visitors hitting 964,700 in February (+10.4% y/y).

The broader roll-out of the EU's Recovery and Resilience Facility, from which Portugal is expected to receive EUR 16.3 billion in subsidies and EUR 5.9 billion in loans between 2021 and 2026, will sustain investment in 2024 and beyond. However, Portugal's political instability could affect future disbursements by Brussels, delaying the timeframes for investments and reforms associated with the country's recovery plan.

LARGELY HEALTHY PUBLIC FINANCES IN 2023

Throughout his term, the government of António Costa committed to restoring fiscal discipline. Recently, strong nominal growth in economic activity and rising tax revenues (+9% y/y in 2023) have helped public finances to improve. With a budget surplus of 1.2% of GDP this year, Portugal is enjoying its highest positive balance in its fifty years of democracy. Better still, the primary balance (excluding interest on debt) rose from a deficit of 8.5% of GDP in 2010 to a surplus of more than 3% in 2023, and the debt-to-GDP ratio fell below 100% in Q4 2023 (98.7%).

As a result, although the change of government may create uncertainty as to whether the pursuit of budgetary discipline started by the SP will continue, the country has some room for manoeuvre, with the 2024 budget still projecting a surplus of 0.2% of GDP for 2024.

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UNITED KINGDOM

THE INTEREST RATE SHOCK CONTINUES TO SPREAD

The economic outlook in the UK is still challenging. After a year 2023 marked by a gradual deterioration in activity (a slowdown in the first half of the year, followed by a contraction in the second half), GDP growth is expected to remain slightly positive in 2024. With the general election, scheduled to be held at the end of the year, Prime Minister Rishi Sunak, who is facing difficulties within the Conservative party, is struggling to reassure households who are bearing the full brunt of rising costs of living and interest rates. Despite a recovery in purchasing power and the resilience of the labour market, private consumption remains depressed. Nevertheless, the drop in inflation should lead to the start of monetary easing in June, which is expected to be modest, with a one-percent reduction (5.25% to 4.25%) expected in 2024.

Between declining inflation and falling business activity, the stance of the hawkish members of the Monetary Policy Committee has softened. Catherine Mann and Jonathan Haskel, who, up until now, were in favour of a further hike in the Bank rates, came back around to the status quo position in March. Inflation in the UK fell below 4% y/y in February and we expect it to drop under the 2% target during the second quarter of 2024, fuelled in particular by the removal of the price cap for electricity and gas. Nevertheless, services inflation, which is more driven by wage trends, is slowing less significantly, remaining above 6% y/y in February. In addition, this rise is identical to the increase in regular pay in the sector (+6.0% y/y in January).

Improving household purchasing power, buoyed by falling inflation and strong wage increases, has helped to buoy UK consumer confidence[1] and is expected to result in slightly increased economic activity over the course of 2024. However, this upturn is not translating into a genuine pick-up in consumption, as households choose, at this stage, to build up additional savings instead. As a result, the savings ratio rose above 10% of gross disposable income in the final quarter of 2023, which was twice as high as the pre-COVID level. This trend may seem counter-intuitive in a context of high inflation, but it is often seen during periods of economic slowdown or recessions. This was the case during the 2008 crisis and during the recession in the early 1990s[2]. This trend, which reflects an increase in precautionary savings, if it continues, will act as a drag on the economic recovery. It could limit the effects of government measures introduced in recent months, which carry a significant cost for the country's public finances. In March, Jeremy Hunt, the Chancellor of the Exchequer, announced a further two percent cut on National Insurance contributions for employees (and the self-employed), following an initial cut of a similar size during the autumn.[3]

Household finances continue to be strained by the increased cost of living and rising interest rates. The share of payment arrears within outstanding home loans hit 1.2% in Q4 2023, the highest level in six years[4]. These figures are still far below the one seen during the 2008 crisis, when the proportion of arrears peaked at 3.6% in Q1 2009. Nevertheless, the increase is underway and there are fears of further deterioration in 2024, as another part British households will have to refinance their loans at higher rates. Mortgage interest payments have continued to rise significantly this winter (+36% y/y in February, according to the Retail Price Index (RPI)) and the Bank of England expects household debt services costs to continue to increase until 2026, as the refinancing phase plays out.

GROWTH & INFLATION

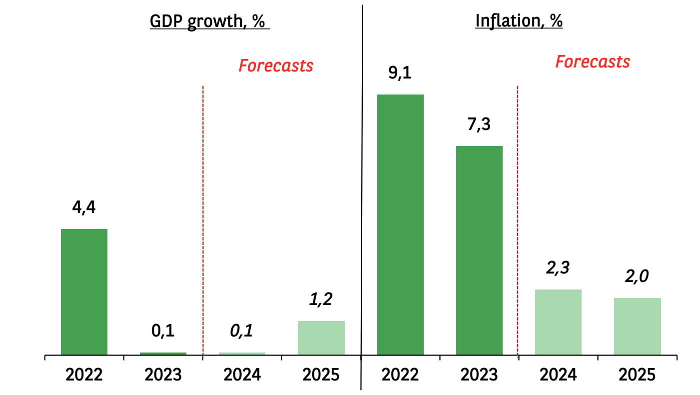

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Soaring credit costs are also spreading to the buy-to-let rental market, where rents have jumped since the end of the lockdown period. The increase is not abating; it is quite the opposite. According to the CPI, rent inflation hit 6.9% y/y in February 2024, which is its highest rate for exactly 30 years. Despite this, housing activity has recovered as interest rates have stabilised. The volume of mortgages has been increasing for more than a year and property prices are rising again, by more than 1.5% y/y according to the Nationwide index.

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1 The GfK 12-month household financial outlook index hit its highest level since November 2021 in March.
2 According to the ONS, the household savings rate jumped from 5.2% in Q1 2008 to 12.5% in Q1 2010. It rose from 6% in Q4 1988 to 13.9% in Q1 1992.
3 The initial cut to the National Insurance Contribution rate for the self-employed, announced in the autumn, was only one percentage point.
4 Data from the Financial Conduct Authority.

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2022	2023 e	2024 f	2025 f	Inflation 2022	2023	2024 f	2025 f
United States	1.9	2.5	2.8	1.8	8.0	4.1	3.4	2.8
Japan	0.9	1.9	0.4	0.9	2.5	3.2	2.9	2.3
United Kingdom	4.4	0.1	0.1	1.2	9.1	7.4	2.3	2.0
Euro Area	3.5	0.5	0.7	1.7	8.4	5.4	2.3	2.0
Germany	1.9	-0.1	0.0	1.4	8.7	6.1	2.5	2.3
France	2.5	0.9	0.7	1.4	5.9	5.7	2.3	1.8
Italy	4.2	1.0	0.9	1.4	8.7	6.0	1.1	1.8
Spain	5.8	2.5	2.0	2.1	8.3	3.4	2.8	2.0
China	3.0	5.2	4.5	4.3	2.0	0.2	-0.1	1.2
India*	7.2	7.5	8.1	7.1	6.7	6.7	5.5	4.8
Brazil	2.9	2.9	1.8	1.8	9.3	4.6	3.9	3.8

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

SOURCE: BNP PARIBAS (E: ESTIMATES; F: FORECASTS)

FINANCIAL FORECASTS

Interest rates. %		2024				
End of period		Q2 2024	Q3 2024	Q4 2024	Q2 2025	Q4 2025
US	*"Fed Funds (upper limit)"*	5.50	5.25	5.00	4.50	4.25
	T-Note 10y	4.25	4.20	4.20	4.20	4.20
Eurozone	deposit rate	3.75	3.50	3.25	2.75	2.50
	Bund 10y	2.35	1.95	2.00	2.25	2.50
	OAT 10y	2.87	2.50	2.52	2.80	3.05
	BTP 10y	3.70	3.35	3.45	3.80	4.00
	BONO 10y	3.19	2.82	2.85	3.15	3.38
UK	Base rate	5.00	4.50	4.25	3.75	3.25
	Gilts 10y	4.00	3.80	3.70	3.55	3.65
Japan	BoJ Rate	0.10	0.25	0.25	0.50	0.75
	JGB 10y	0.90	1.00	1.20	1.40	1.35

Exchange rates		2024				
End of period		Q2 2024	Q3 2024	Q4 2024	Q2 2025	Q4 2025
USD	EUR / USD	1.10	1.10	1.10	1.12	1.14
	USD / JPY	146	144	142	137	133
	GBP / USD	1.31	1.33	1.33	1.35	1.37
EUR	EUR / GBP	0.84	0.83	0.83	0.83	0.83
	EUR / JPY	161	158	156	153	152

SOURCE : BNP PARIBAS GLOBAL MARKETS

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