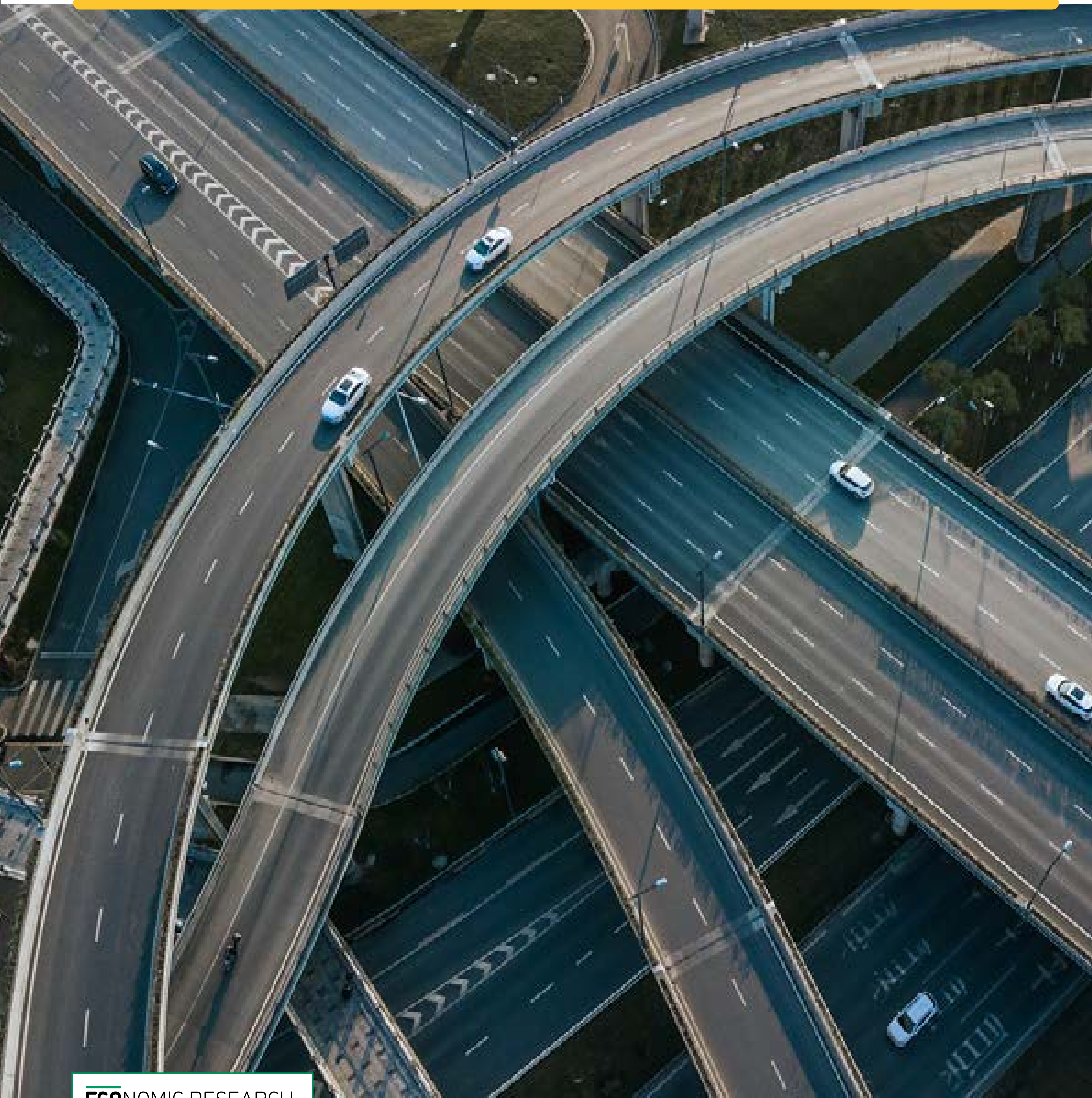
ECOPERSPECTIVES

2nd Quarter 2023



ECONOMIC RESEARCH

BNP PARIBAS

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A TOOL FOR EACH TARGET, OR HOW TO RECONCILE PRICE STABILITY AND FINANCIAL STABILITY

The recent difficulties faced by some US regional banks have reignited the debate about a potential conflict between pursuing price stability and financial stability at the same time. Should central banks, and the Fed in particular, stop tightening their monetary policy in order to maintain financial stability, even while inflation remains high? Or should they stay the course, continuing to increase their policy rates until they are sure that inflation is falling towards the 2% target, but risking destabilising the financial sector? The Fed and the ECB decided to stay the course during their March meeting, emphasizing that banking systems were generally sound, that visibility on the possible fallout from the recent turmoil is too limited and that they were still attentive to inflation risks. Thus, unless the economy cools abruptly, the Fed and the ECB have probably not completely finished with their rate hikes just yet.

The current monetary tightening cycle has been atypical in many respects. The pace of the rate increases hasn't been seen for a long time. The reaction of risky assets, such as equities or corporate bonds, which initially was negative (last year saw declining equity markets and widening corporate bond spreads) has been followed by a risk-on mindset, with markets speculating that the terminal value of the federal funds rate was not that far off.

Will the rate hike cycle also end in an atypical way? The recent events, which affected a number of US regional banks in March, raised the question as to whether the Fed will be forced, on financial stability grounds, to end its monetary tightening policy, or even reverse course and cut its rates, despite the still elevated inflation. In a matter of days, the markets have completely repriced the future path of the policy rate[1]. In addition, the two-year Treasury yield, which is very sensitive to changes in the outlook for monetary policy, showed extreme volatility. Its decline on 13 March was bigger than anything seen since the October 1987 stock market crash.

THE DEPENDENCE OF THE FINANCIAL SPHERE ON MONETARY POLICY

Whether there is a potential conflict between the pursuit of price stability (bringing inflation back to the 2% target in a timely way) and maintaining financial stability has been a hotly debated topic for years. The argument for a tradeoff states that a very accommodative monetary policy (with several years of the policy rate at the zero lower bound and quantitative easing) eventually causes financial imbalances (such as excessive borrowing to finance projects, particularly in real estate) and leads to a compression of risk premia and expensive valuation levels in the financial markets, leaving the financial sphere vulnerable to changes in course and tighter monetary policy.

Indeed, when monetary policy becomes restrictive, some projects become unprofitable, risk premia increase, equity valuations become less expensive and corporate bond spreads widen. This does not inevitably lead to a financial crisis (defined by strong instability and a disorderly correction in asset prices and the flow of credit), particularly as, up to a certain degree, the tightening of financial conditions is an integral part of monetary transmission. If anything, the surprise this year had been the resilience of the financial markets despite an ever higher federal funds rate, which sparked debate in early February around monetary policy becoming ineffective due to the easing of monetary and financial conditions[2].

The counter-argument, which claims that no such conflict exists, insists that a tradeoff would risk a central bank losing credibility in its fight against inflation, while inflation is still very high and disinflation is slow. At the same, losing credibility would also likely drive rates up, exacerbating the weaknesses of some banks, rather than easing them.

The difficulties faced by some US regional banks in March 2023 have rekindled fears about financial stability, prompting the government to take containment measures quickly[3]. In view of this turmoil, the question as to whether the Fed should pause its tightening in order to defuse the situation came to the forefront very quickly. Should it opt for financial stability over price stability?

A TOOL FOR EACH OBJECTIVE

The debate was settled in March, with price stability coming out on top. The Fed stayed its course, highlighting the general solidity of the banking system, the overly high levels of inflation and the lack of visibility on the possible fallout from the recent turmoil. The week before, the ECB had already hiked its rates once again, arguing that inflation is well above the target level and that there is a specific tool for achieving each target (separation principle), such as rate hikes for price stability, a range of liquidity mechanisms and the TPI (Transmission Protection Instrument) for financial stability and the smooth transmission of monetary policy. As a result, price stability and financial stability can be maintained at the same time. Finally, in their recent communication, the two central banks explicitly included the macroeconomic and financial conditions used for their assessment of the inflation path in their reaction function.

TOWARDS AN ACCELERATION OF THE TRANSMISSION OF MONETARY POLICY TO THE ECONOMY

However, recent developments are likely to accelerate the transmission of monetary policy as a result of their negative repercussions on financial conditions and lending standards exacerbating the tightening already underway, which, in turn, would be a drag on growth and inflation. The uncertainty stems from the extent of these negative repercussions. Considering that this further tightening will do part of the central banks' job, and that some caution is required in this more unstable and uncertain environment, both the Fed and the ECB would have to raise their policy rates less during this cycle. However, with inflation still very high and core disinflation slow, unless the economy cools abruptly, the central banks have probably not completely finished

1 The market-implied federal funds rate for next December has, at some stage, dropped 150 basis points to about 4.0%, before rebounding.
2 William De Vijlder, Ecoweek editorial of 6 February 2023: Central banks, markets and the economy wrong-footed on three occasions (bnpparibas.com)
3 The Fed decided to make additional liquidity available by setting up a new Bank Term Funding Program (BTFP), with securities pledged as collateral being valued at par. The Treasury Department approved measures to enable the FDIC to execute the Silicon Valley Bank and Signature Bank resolutions in a manner that will ensure full protection for depositors, both insured and uninsured. On 19 March, the

with their rate hikes just yet. Yet, the end of the tightening cycle has suddenly moved closer into view.

Our new forecasts from late March illustrate this and pinpoint the terminal level of policy rates earlier and 50bps lower than expected at the beginning of March: for the ECB, the deposit rate stands at 3.50% in June after two further expected hikes by 25 bps in May and June; for the Fed, the fed funds rate stands at 5.00-5.25% in June, following a final hike by 25 bps in May. We have also slightly revised our growth and inflation forecasts for the United States and the euro area downwards (*see table*). 2023 had started on a more positive note than expected, but since then, uncertainty and downside risks have risen.

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Fed, along with the ECB, the Bank of Canada, the Bank of Japan, the Bank of England and the Swiss Central Bank, announced that its dollar foreign exchange swaps would become more frequent (going from weekly to daily).

GDP GROWTH AND INFLATION

Average annual percentage change	GDP Growth	Inflation	GDP Growth				Inflation			
	2022		New forecast		Early March forecast		New forecast		Early March forecast	
			2023	2024	2023	2024	2023	2024	2023	2024
United States	2.1%	8.0%	1.4%	-0.1%	1.5%	0.0%	4.4%	2.6%	4.4%	2.6%
Eurozone	3.5%	8.4%	0.7%	0.5%	0.7%	0.8%	5.3%	2.5%	5.2%	2.6%

TABLE 1 SOURCE: BNP PARIBAS

ARE WE IN FOR A BUMPY LANDING?

According to the Atlanta Fed GDPNow Estimate, US growth will remain high in Q1 2023 (annualised quarterly growth rate of 3.2%). News on the labour market front also remains good. Everything would be fine if inflation were not also continuing at an elevated pace, arguing for a continuation of the Fed's rate hikes, the effects of which recently challenged certain banking models. Prior to this, we were expecting the tightening of lending standards to lead the economy in to recession. Further tightening would weigh more significantly on activity and ultimately, on inflation. Does this mean that the Fed will reach its terminal rate sooner and at a lower level? Our new forecasts (dated 30 March) duly note this possibility and we now expect the Fed Funds rate to reach 5.25% (upper range) in May (5.75% in July previously).

After the dip in H1 2022, growth rebounded and sustained an elevated rate (around 3% on a quarterly annualised basis in Q3 and Q4 2022), defying the signals of a recession sent by the Conference Board composite leading indicator (6-month change down 7% in annualised terms in February 2023) and, more specifically, the significant inversion of the yield curve (since July 2022 for the difference between the 10-year rate and the 2-year rate).

However, the solidity of growth in Q4 2022 needs to be put into perspective. Just over half can be explained by the positive contribution of changes in business inventories (after two quarters of very negative contributions). Household consumption has lost momentum and exports have fallen (imports have fallen even further, leading to a positive contribution of net exports).

The most negative point, and the weakest link best identified, is the real estate market. Residential investment has fallen for the seventh quarter in a row. This is one of the most visible effects of the ongoing monetary tightening, but not the only one, since the downturn dates back to mid-2021, while the Fed's first rate hike dates back to March 2022. During the subprime crisis, the drop in residential investment was even sharper (almost -60% between Q4 2005 and Q2 2009), but the extent of the decline over the last three quarters is no less spectacular (-5% q/q in Q2, -8% in Q3 and -7% in Q4). Taking a glass half-full view, the increase in non-residential investment remained sustained in Q4 (+0.8% q/q).

Without appearing as a weak link, households are more affected by the inflationary shock than companies. The former lost purchasing power while the latter generally maintained their margin rate in 2022. In terms of debt ratio, the notable point is that the household debt ratio has fallen to the same level as the same ratio for companies, at around 75% of GDP. In terms of confidence, the analysis is made difficult by the large discrepancy, on the household side, between the Conference Board indicator (above its benchmark level of 100) and the University of Michigan survey (very depressed, although it has recovered since its historic trough in mid-2022). On the corporate side, there is also a gap between the manufacturing sector where the signal is negative (ISM business climate index around 2 points below the threshold of 50 from December 2022 to February 2023) and services where the signal is very positive (ISM index at 55 in January and February).

The situation on the labour market remains reassuring, although job creation is gradually losing momentum and the unemployment rate has not fallen since March 2022 (bearing in mind that it only stands at around 3.5%, a record low).

Although debt in the non-financial private sphere is not, at first glance, a concern, the very high level of the public debt ratio is attracting more attention (115% of GDP). And the debate about raising the debt ceiling could generate some stress episodes, but a resolution will be found, even if it is at the last minute. Initial cracks, raising fears of a wider crisis, appeared in the regional banking sphere with the difficulties of the Silicon Valley Bank (SVB). At the time of writing, the risk appears to be contained, with measures having been taken rapidly. However, this should result in a sharper tightening of lending standards than the one already ongoing, which will impact growth. The downside risk also comes from the fact that inflation remains high and disinflation slow, arguing for a continuation of rate hikes. The situation is not out of control as inflation generalization seems interrupted (downward trend of the combined weight of items with above 2% month-over-month inflation in annualised terms). But it has gained in persistence, particularly through the shelter component.

GROWTH & INFLATION

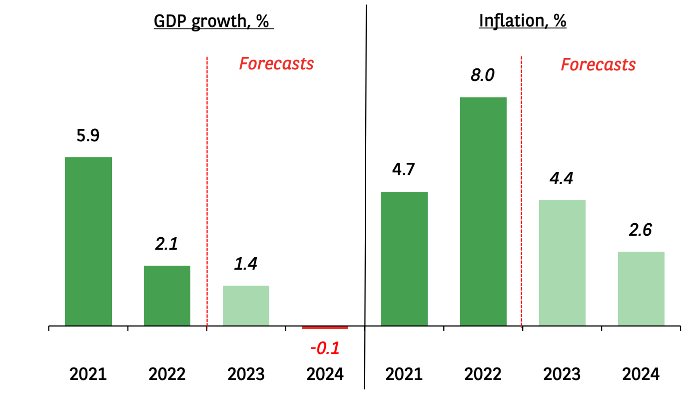

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Before the SVB shock, we thought that the US economy was heading towards a recession but its signs of resilience had led us to postpone this by one quarter. The expected further tightening in lending standards, following the SVB episode, would slightly accentuate the recession. It would nonetheless remain short (Q3 2023 to Q1 2024) and limited (cumulative drop in GDP of -0.9%). Our growth forecast is 1.4% in 2023 in annual average terms. More optimistic for this year than the March consensus (at about 0.5 points), we are much less optimistic however for 2024. Considering the negative growth carry-over and the negative effects of restrictive monetary policy that are still to come, we expect growth to tip slightly into negative territory this year compared with a consensus of +0.9%.

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CHINA

RECOVERY

China's economic activity started to rebound in late January, driven primarily by services and household consumption. Meanwhile, the crisis in the property and construction sectors has subsided. In the manufacturing sector, the growth recovery has remained moderate, hindered by the fall in automobile production and weakening exports. Economic momentum will remain strong in the short term. However, a number of significant downside risks to growth persist.

Following the abandonment of the zero-Covid policy in early December, the lifting of all restrictions on mobility and the end of the disruptions caused by the surge in the number of infections in December-January, Chinese economic growth has rebounded since the end of January. The recovery has been primarily driven by services, while the improvement in industry turned out to be more modest (Chart 2).

Activity in the services sector and household consumption have recovered more quickly than expected. After several months of contraction, retail sales volumes increased by around +2% YoY in January-February, despite the decline in car sales due to the end of tax incentives. Consumer price inflation remained low (+1.6% YoY in January-February vs. +1.8% in Q4 2022).

The crisis in the construction and real estate sectors has eased: new construction projects, housing sales and real estate investment all continued to contract in January-February YoY, but at much slower rates than in previous months. In addition, the average house price in the 70 main cities rose slightly in February (+0.1% MoM) after falling for 18 months (the total house price drop has been limited to 5.2% since July 2021).

In the manufacturing sector, the recovery in activity and investment has remained moderate: total automobile production fell sharply (but production of new energy vehicles continued to rise robustly), and export-oriented sectors were affected by global demand weakening.

Against this difficult but more reassuring backdrop, the National People's Congress held its annual meeting in Beijing at the beginning of March. The government notably announced its main macroeconomic objectives for 2023. The growth target was set at "around 5%", indicative of the cautious realism of the authorities. This target of 5% should in fact be easily reached, thanks to the momentum provided by post-Covid catch-up effects and the rebound in private demand and services activity. The dynamics seen in January-February will continue in the short term, and real GDP growth figures could improve thanks to greater base effects in Q2 2023. At the same time, by setting a low growth target for 2023, the authorities are first, counting on moderate support from fiscal and monetary policies, and second, recognising the existence of high downside risks.

These risks are firstly linked to the situation in the real estate sector: government support measures and the lifting of mobility restrictions should help stall the collapse of activity. Nevertheless, housing sales and new construction projects should remain hindered by the still poor confidence of potential buyers, the persistent financial difficulties of a large number of property developers and the slow pace of their debt restructuring. Secondly, the weak financial position of local governments, increasing risks in the financial sector, requiring fiscal consolidation efforts and constraining their capacity to resort to debt, should weigh on public investment. Moreover, downside risks are also emerging from the weak international environment, which is clouding the outlook for Chinese exports and, therefore, for production and investment in the manufacturing sector.

Uncertainties are also related to the labour market: its recovery could be limited, particularly if the rebound in industrial activity remains moderate, and this would continue to weigh on household sentiment and income. In fact, the urban unemployment rate rose slightly again in February 2023, reaching 5.6% on average across the country, and 18.1% for the 16-24 age group (compared to 5.2% and 11.9% respectively in 2019).

Structural factors of the growth slowdown add to these short-term downside factors (in particular, China's demographic dynamic and the slowdown in productivity growth). Lastly, private-sector confidence and demand could continue to be affected by internal regulatory risks (lack of visibility, increased control of the State and the Communist Party) and geopolitical tensions.

GROWTH & INFLATION

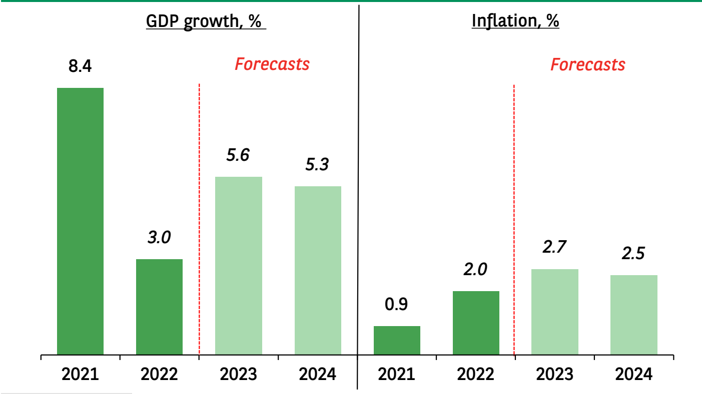

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

CHINA: POST-COVID RECOVERY

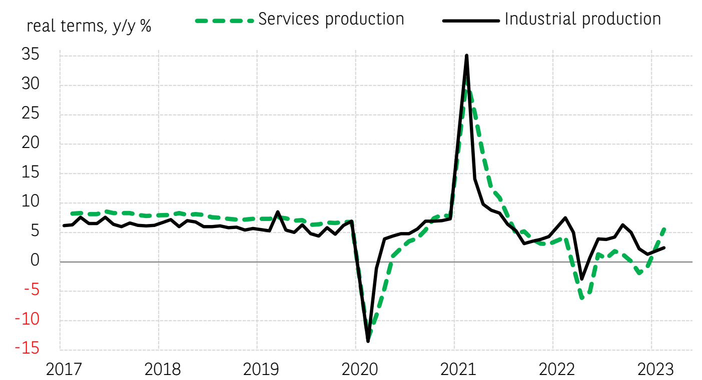

CHART 2 SOURCE: NBS, BNP PARIBAS

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JAPAN

BANK OF JAPAN: MOVEMENT BY JUNE?

With alarming inflation across the country, the new governor of the Bank of Japan (BoJ), Kazuo Ueda, will have a baptism of fire when he takes up his role. Even though price increases are expected to slow down during Q1 2023 thanks to government energy subsidies, core inflation has continued to rise this winter. Price dynamics are posing a major challenge and may force the BoJ into making changes to its interest rate control policy, despite bond yields falling off as a result of the recent US bank failures. The Japanese economy stagnated in Q4 2022, buoyed by foreign trade and private consumption during Q4 2022, but slowed by public and private investment. We expect growth to continue in 2023 (1.2%) at a similar pace to 2022 (1.1%), before a more sluggish growth takes hold in 2024 (0.8%).

Inflation fell in February (3.3% y/y), thanks to the energy subsidies introduced by the government. However, inflation could prove to be more persistent than expected in 2023 and put the BoJ's current monetary policy under increasing pressure. Firstly, core inflation (excluding fresh food and energy) continued to rise (3.6% y/y in February following an increase of 3.3% in January). Secondly, inflation become noticeably more widespread during Q4 2022: the BoJ's inflation spread index stood at 69.3 points in February, close to December record at 69.5. Finally, services inflation also grew more quickly (1.3% y/y in February compared to 0.8% in December). These factors, combined with major future wage increases, should keep inflation at close to 3% in 2023, with a return to the 2% target not expected before 2024.

Therefore, the new BoJ Governor, Kazuo Ueda, will be under pressure as soon as he takes up his position in April. While the BoJ should maintain an accommodating monetary policy, we expect Japan's yield curve control ceiling to be raised to 1% (10-year maturity) in the coming months (from its level of 0.5% today).

GROWTH & INFLATION

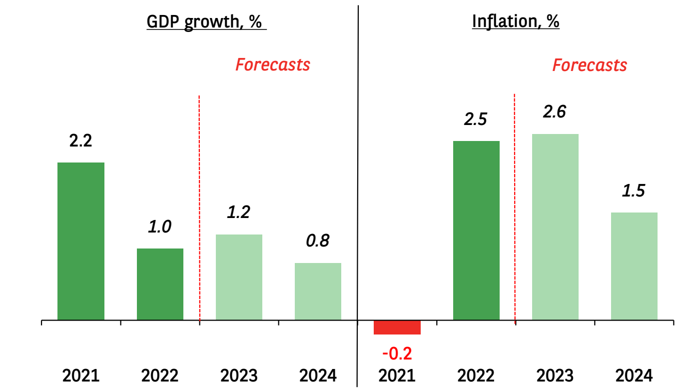

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A FALTERING RECOVERY

Japan has reopened to tourists, but the number of foreign visitors arriving in January was still at around half (44%) of its 2019 level. However, this did help the services sector to rebound and supported consumption growth by more than 0.25pt during Q4 2022. At the same time, there is still major catch-up potential, as spending among non-residents in Japan stood at one third of its pre-pandemic level at the end of 2022, and this should continue to help to boost the economy in 2023. Despite earnings falling in real terms for almost two years now, household consumption rose above its pre-pandemic level for the first time during Q4 2022.

The labour market tightened during Q4 2022 and is expected to remain under pressure throughout 2023. The unemployment rate is close to its historically low pre-pandemic level, standing at 2.6% in February. The number of new job openings has also matched its February 2020 level. Tight labour market conditions and persistent pressures on consumer prices may push wages up. According to the Japanese Ministry of Health, Labour and Welfare, nominal base wages rose 0.8% y/y in January 2023, down from the figures for the end of 2022 (+1.6% y/y in December). However, this rate should improve as a result of the annual Shunto wage negotiations, with final agreements expected in April. Prime Minister Fumio Kishida is in favour of a 3% wage increase, which is below the 5% rise being called for by the Rengo trade union (Japanese trade union). We believe that all sides will agree upon a 3.6% wage increase, which would just about offset the effects of inflation on purchasing power.

China easing its "zero-covid" policy is still only being felt moderately on the Japanese economy, but its effects should become more prominent by Q2 2023. Japanese industrial production, which is closely linked to exports to China and therefore to the Chinese economy, recovered by 4.5% y/y in February, after a 6.4% contraction in January, but is still 7.4% below its Q3 2019 levels. Car production, a major contributor to Japanese exports, was 11.2% below its pre-pandemic level in February. Exports to China, which had fallen in December and January, should continue their recovery which began in February (+20% m/m).

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THE ECB IS STAYING THE COURSE

Even though euro area inflation likely peaked last October, the disinflation process is expected to be slow, with inflation not expected to fall back to its 2% target level before 2025. The most recent macroeconomic projections from the European Central Bank (ECB) all point to this direction of travel. The second wave of inflation is significant, with the HICP excluding energy climbing by 7.9% y/y in March, while further food-price increases are expected for the months ahead. Despite this, economic activity within the Monetary Union is holding up better than expected against the double shock of inflation and interest rate hikes. While a recession is currently being ruled out for 2023, growth is still incredibly fragile. Unemployment remains at record lows, fuelling labour shortages and faster wage increases.

Negotiated wages (collective bargaining agreements) in the euro area have gone up over the past year, with a 2.9% year-on-year increase recorded during Q4 2022. Labour costs, which include expenses on top of gross salaries (employer social security contributions, training and recruitment costs, bonuses), increased more rapidly, with a 5.7% y/y rise recorded during Q4 2022.

Varying levels of tightness were felt on the labour markets from country to country, but recruitment shortages remained high across the euro area, at a time when the unemployment rate has been at its lowest levels since the Monetary Union was created, standing at 6.7% in February. The European Commission's quarterly survey has identified labour and equipment shortages as the main drags on business activity. However, as highlighted in the same survey, tighter financial conditions and slower demand are growing barriers that are expected to worsen over the course of the year.

At its meeting on 16 March, the ECB hiked the interest rate on its deposit facility by 50 basis points to 3.0% (the interest rate on the ECB's main refinancing operations was raised to 3.5%). However, we do expect further hikes, with the deposit facility rate peaking at 3.5% (and the refinancing rate peaking at 4.0%) in June. In its most recent macroeconomic projections (March 2023), the ECB revised its inflation forecast for the next three years (2023-2025) downwards, citing the larger than expected fall in energy prices as a determining factor. However, it revised its inflation forecast excluding energy for 2023 upwards from 5.3% to 5.8%. This significant adjustment implicitly reflects the lack of a clear picture around short-term trends in food prices. National governments across the board are still struggling to keep these prices in check, despite packages of measures being gradually rolled out (such as the «anti-inflation quarter» in France and the temporary abolition of VAT in Spain).

Business growth is still incredibly uncertain, and a contraction during Q1 2023 could yet occur. However, survey data improved over the quarter, suggesting that if there is a contraction, it will be small. The Composite PMI, which had been in contractionary territory since July 2022, rose back above this threshold at the beginning of the year (54.1 in March), driven by rises in the services sector (55.6), while activity in the manufacturing sector has continued on its downwards spiral (47.1). Despite the Chinese economy reopening and bottlenecks on global production chains easing, there still has not been a subsequent flurry of activity among European manufacturers. These manufacturers have been suffering as a result of stubbornly sluggish domestic consumption, which has been slowed by the drop in household purchasing power. In volume terms, euro area private consumption (national accounts) even fell during Q4 2022 (-0.9% q/q), remaining at around 1% below its pre-Covid level.

GROWTH & INFLATION

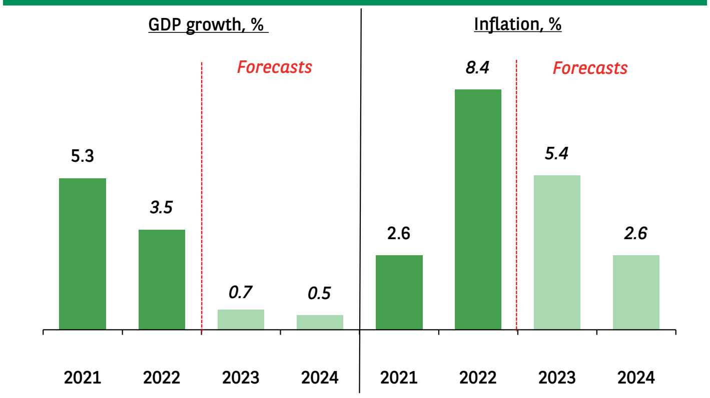

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

THE RELAUNCH OF THE EUROPEAN FISCAL COMPACT

Looking beyond the short-term concerns about the effects of monetary tightening, the European Commission plans to reactivate the Stability and Growth Pact rules in 2024, which had been frozen at the height of the Covid-19 pandemic and were once again suspended as a result of the war in Ukraine and the energy shock. The two main convergence criteria limit government deficits in euro area countries to 3% of GDP and debt in Member States to 60% of GDP. However, this framework will be relaxed so that it is better suited to the new economic environment, and in particular to government debt within the euro area, which is almost 25 GDP points higher than it was prior to the 2008 financial crisis. Member States will also need significant levels of investment to support their green and digital transitions, while seeking further financing in order to strengthen their energy and defence sectors. On 14 March, the Finance Ministers of the Eurogroup agreed on the broad outlines of this new European compact, which will still need to be refined and approved by the Heads of State. An agreement could be reached during the spring.

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GERMANY

GROWTH HAS WEAKENED, BUT EMPLOYMENT IS RESILIENT

Germany is the Western European country where GDP growth was the most negative in Q4 2022 (-0.4% q/q). Furthermore, economic indicators, although improving, remained relatively weak at the beginning of 2023. A further contraction in GDP in Q1 2023 therefore remains our central scenario. However, more favourable signals (slight disinflation, reopening of China, reduced supply shortages in the automotive sector) could lead to a return to growth from Q2. This has already been reflected in household confidence, although the weakness of growth in the euro area, since Q4 2022, could limit the intensity of this recovery.

Germany recorded a drop in its GDP in Q4 2022 (-0.4% q/q), in line with economic surveys. This was not the case in Q3, where GDP growth was positive despite deteriorated surveys (business climate, household confidence): a favourable figure which therefore led to a subsequent setback.

After three quarters of continuous growth (despite a deterioration in household confidence), private consumption fell in Q4 (-1% q/q), as a marked acceleration in inflation weighed on it (up to 11.6% y/y in October 2022). Investment in machinery and equipment also fell (-3.6% q/q), after a very good figure in Q3 (+5.4% q/q). Measured year-on-year (y/y), however, this investment continued to grow by 4.5% in Q4. A more structural reduction seems to apply to investment in construction (-2.9% q/q in Q4 and -6.8% compared to Q1 2022), which seems affected by the rise in interest rates.

SUPPLY CONSTRAINTS STILL PREDOMINANT

The proportion of companies reporting in the European Commission's Business Climate Survey that demand pressures are limiting their production has increased: 16% of manufacturing companies in Q1 2023 (compared to 11% a year ago), highlighting the weakening of the German economy. However, labour shortages are limiting production for an unchanged proportion of companies in industry (29%, the same as a year ago) and for an increased proportion in services (30% compared to 26% a year ago). These tensions are continuing to fuel significant job creation (457,000 in 2022, of which 112,000 in Q4), keeping the labour market under pressure and at the same time supporting household income. This good momentum continued in January (64,000 jobs created).

Supply difficulties are still limiting production for 47% of the companies surveyed, compared with 76% a year ago. The partial removal of these obstacles allowed German companies to replenish their inventories: the balance of opinion corresponding to their inventories of finished products reached 7.9 points in industry in February (European Commission survey) compared to -13.8 a year previously, and 7.5 as an historical average. The positive contribution of changes in inventories in Q4 2022 (0.4 points) therefore limited the negative impact of the contraction in demand on growth.

WHAT IF THE GERMAN RECOVERY CAME FROM... GERMANY?

In the past, for example in 2010, the growth recovery was largely driven by exports. Will the situation be different this time?

Admittedly, Germany has dual characteristics: in the S&P Business Outlook survey, it saw the sharpest improvement worldwide between October 2022 and February 2023 (by nearly 25 points), but it still has one of the most downgraded levels (only France has lower prospects). Two factors, to which Germany is highly exposed, explain the improvement: the automotive sector (fewer supply difficulties) and China (reopening

GROWTH & INFLATION

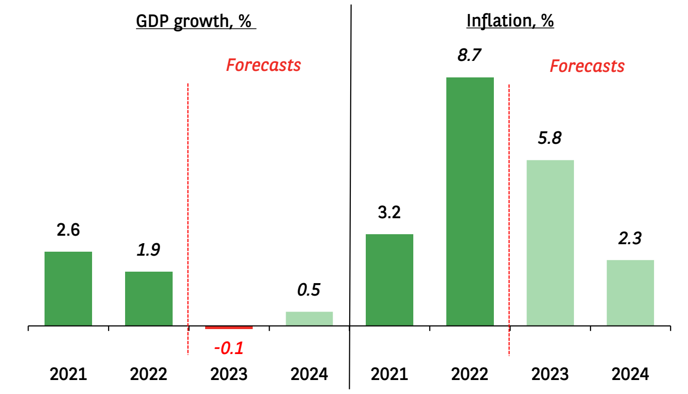

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

of the economy with the end of the zero-Covid strategy). These support factors for the German economy nevertheless remain moderate: new car registrations are up 14% y/y over the last three months to the end of February 2023 but remain 9% lower compared to pre-Covid.

However, more negative factors, such as the economic situation in the euro area, could hinder this recovery. As a result, the expected growth from Q2 to Q4 should not erase the negative growth carry-over effect at the end of Q1, for an annual growth forecast of -0.1%.

Above all, in our view, higher growth remains conceivable, driven by household consumption: it's a paradox because this demand item has, at no time, returned to its pre-Covid level, and its proportion in German GDP has structurally decreased compared to the beginning of the 2000s, by almost 5 points, more than any other demand item. However, disinflation which began after the peak in October 2022 (11.6% y/y) and the less deteriorated situation than expected (absence of energy supply shortages this winter) led to a rebound in household confidence, which is more pronounced for the time being in its expectations component. However, this is a characteristic of an economic recovery situation[1]. Such a recovery could be based on a more favourable purchasing power dynamic, with lower inflation, while income would be supported by a still tight labour market, as well as by the redistribution of high profits to employees.

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1See Stéphane Colliac, 'Germany vs. France: German consumers have confidence in the recovery; the French, not yet' Chart of the week, BNP Paribas, 15 March 2023.

FRANCE

LOW GROWTH IS EXPECTED TO CONTINUE

The energy crisis was less severe than initially feared during the autumn and winter. This prevented negative growth during Q4 2022 (+0.1% q/q) and provided grounds for relative optimism, as reflected in the rise in the INSEE business climate indicator from December to February. While the growth carry-over naturally led us to revise our growth forecast for 2023 upwards, growth is still low and reflects the sustained downturn in demand, particularly in household investment. In addition, while inflation is expected to decrease, it is still being buoyed by food prices, which, in turn, is adversely affecting household consumption.

Three factors should be considered when assessing the state of France's economy as a whole. Firstly, there was the pleasant surprise of an economic contraction being (narrowly) avoided during Q4 2022, as the risk of energy shortages affecting growth did not materialise. This could give a misleading view that the fundamentals of the French economy are stronger than they actually are. The second factor is other shocks, which are being felt more and more widely across the economy and are weakening its fundamentals. Despite expectations of no further inflation increases, price increases are coming one after another: our expected average inflation of 5.9% y/y for 2023 follows average infllation of 5.9% in 2022, which has hit household consumption hard (-1.2% q/q during Q4 2022). At the same time, rising interest rates are already affecting household investment, which decreased during the second half of 2022. This trend is expected to continue. Finally, the third factor is barriers to growth gradually lifting, which could help to prevent a recession. These include, in particular, semiconductor shortages easing and the Chinese economy reopening, which should ultimately provide a boost for the aeronautics, tourism and luxury sectors.

GROWTH & INFLATION

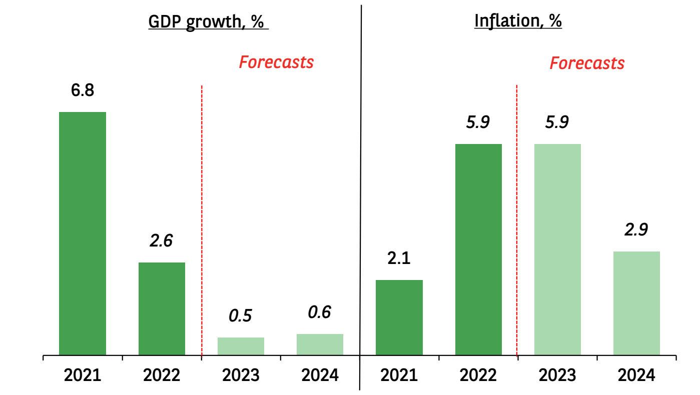

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

2022: MANY FACTORS CONTINUED TO SUPPORT GROWTH

2022 saw a number of post-Covid catch-up elements boosting growth, but these are expected to be less active in 2023. Services production bounced back and closed the gap with its pre-Covid trend, boosted by operations returning to normal in the tourism and accomodation and catering sectors. The labour market also erased the shock observed during the pandemic. As a result, employment also closed the gap with its pre-Covid trend, resulting in the unemployment rate dropping to nearly 7% for the first time since 2008. Companies were able to replenish their inventories, resulting in a 0.6 percentage point (pp) contribution of inventory changes to growth in 2022. Companies also increased their investment (contribution of 0.5 pp to growth), taking advantage of supply constraints starting to ease, particularly in the car industry, during the second half of the year.

Growth figures do not entirely reflect this dynamism within the economy, with the rising energy imports preventing shortages, despite electricity production falling by 20% y/y during the second half of the year. Higher gas inventories and additional electricity imports accounted for almost half of foreign trade's negative contribution of 0.8 pp to growth in 2022: growth would have hit 3.0% rather than 2.6% if it had not been for these unusual trends on the energy markets.

2023: CLEAR LOSS OF MOMENTUM, BUT A RECESSION SHOULD BE AVOIDED

One popular sentence is «when the construction industry is doing well, so does the economy», and the opposite is often true as well. However, the current economic climate in France has flipped the script on this adage. According to the French National Institute of Statistics and Economic Studies (the INSEE), while 12% of households had stated in January 2022 (a record) that they were considering buying a home within the next two years, this figure fell to 8% in February 2023. This is still higher than the record low (5%) last hit in November 2014. Nevertheless, this is a significant drop and is reflected in a 1.2% contraction in household investment between the first and second half of 2022, and an anticipated fall of 2.5% in 2023. Interest rate hikes, which are expected to continue, are helping to drive this trend. However, it should be noted that other building sectors are still enjoying more positive dynamics, such as new non-housing construction and, in particular, building improvement and maintenance.

However, the downturn in new housing alone does not sum up the state of the French economy. Supply constraints are still a major factor in the economic picture. Even though falling demand should eventually ease these pressures, it is still relative as things stand. Admittedly, order books for the manufacturing industry fell from 7.3 months in February 2022 to 6 months one year later, based on our estimates (which is close to their average level between 1990 and the present day). However, the easing of supply constraints and the reopening of markets (China) should benefit the transport equipment sector, which is still operating at far below its pre-Covid levels.

Wage increases, which are higher in 2023 than in 2022, should also boost growth. In addition, the energy price caps should protect purchasing power and help to keep household consumption at around the level recorded during Q4 2022, and therefore prevent a further drop. This stabilising factor is likely to ultimately prevent a recession.

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ITALY

THE RECOVERY REMAINS STRONG

In Q4 2022, GDP slightly declined on a quarterly basis. Domestic demand and the change in inventories subtracted 0.4 pp and 1.1 pp, respectively from the overall growth, while net exports added almost 1.5 pp. The Q4 GDP contraction mainly reflected the moderate weakening of the services sectors that had experienced a strong rebound in the previous six quarters. Despite its Q4 decline, services value added is 1.7% higher than in Q4 2019, explaining about half of the total recovery of the Italian economy. Overall, the 2023 outlook remains positive, with GDP expected to grow close to 1.0%.

In Q4 2022, the Italian economy recorded a mild contraction. Real GDP fell by 0.1% q/q, after +0.4% in Q3, with the annual growth rate falling below 1.5%. Domestic demand subtracted 0.4 percentage points (pp), as consumption declined by more than 1.5%; households suffered from the increasing inflation, which more than offset the recovery of nominal income, with the employment rate reaching the highest value in the last 20 years. In 2022, households' purchasing power stagnated, and the volume of retail sales declined, while the value of expenditure increased. The composition of private consumption has changed, with the share of services gradually increasing. The propensity to save fell to around 7.0%, with a negative effect on the new flows of financial investment. In Q4, net exports added almost 1.5 percentage points to GDP, as exports rose and imports declined, reflecting the weakening of domestic demand, while change in inventories subtracted 1.1 pp.

A STILL SOLID RECOVERY

Despite the Q4 contraction, the recovery of the Italian economy remains solid, both from a historical perspective and in comparison, with the other euro area countries. With respect to Q4 2019, real GDP rose by almost 2.0%, more than in France, Germany and Spain, while at the end of 2019 Italy was the only country that had not recovered the 2008 level yet.

The Italian recovery mainly reflects the huge rebound of investment (+20% compared to Q4 2019). Investment on construction strongly increased, with those on dwelling rising by more than 40%, benefiting from significant fiscal incentives to improve the energy efficiency. Besides, capital spending in machinery and ICT equipment rose by 20%. Despite the persisting uncertainty of the global scenario and the less accommodative monetary conditions, the propensity to invest of Italian non-financial corporations remained at historically high levels. Business confidence has improved above the long-term average.

A DIFFERENT SECTOR COMPOSITION

In Q4, the GDP decline mainly reflected the moderate weakening of activity in the services sectors, which had experienced a strong rebound in the previous six quarters. Despite the Q4 contraction, services value added is 1.7% higher than in Q4 2019, explaining about half of the total recovery of the economy. Value added strongly rose in construction and professional activities, while the financial and insurance sector is still almost 6.0% below Q4 2019. Trade, hotels and restaurants benefited from the recovery of tourism. In 2022, the value of expenditure of non-residents has almost totally recovered the 2019 level, also reflecting higher prices in the services sector, while the number of foreign travellers is still more than 20 million lower.

GROWTH & INFLATION

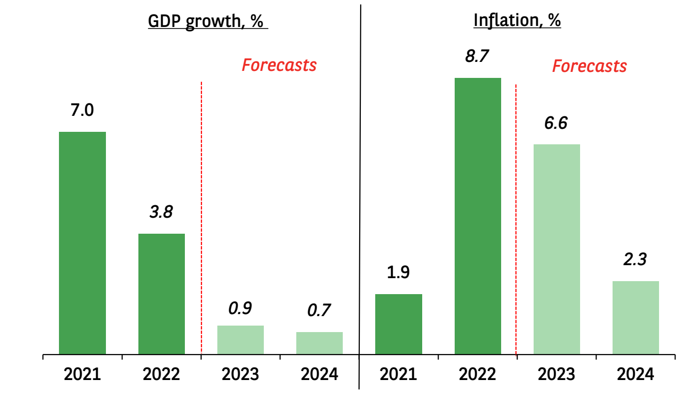

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

In the last two years and a half, the recovery of the Italian economy also reflected the improvement in the manufacturing sector. In Q4, despite the quarterly contraction, manufacturing production was almost 1.5% higher than in Q4 2019. The recovery of industrial activity masks mixed results by sector, with the energy intensive ones suffering from increasing costs. The evolution of production also reflected the increase of exports (+20% in 2022).

A BETTER OUTLOOK

Even after the Q4 contraction, the carry-over for 2023 is +0.4%. Households' consumption should resume, benefiting from both the further recovery of income and the gradual slowdown of inflation. Lower energy prices and costs of production are expected to ease pressures on firms' economic margins, with positive effects on the propensity to invest. Despite the persisting uncertainty surrounding the global scenario, exports should further increase. Overall, GDP is xpected to grow by almost 1.0% in 2023.

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SPAIN

FACING THE SECOND WAVE OF INFLATION

The Spanish economy held up better than expected in 2022 (+5.5%), but a slowdown in activity is expected this year. Industrial production is declining, hindered by the energy sector and intermediate goods and services. Investment and private consumption fell significantly in Q4 2022 and will remain under pressure in 2023 from rising interest rates and high inflation. Excluding energy, the rise in consumer prices accelerated further to 8.2% in February. The reduction in the public deficit – greater than expected in 2022 – is making it easier to continue budgetary support in 2023. However, while measures to counter the rise in energy costs have been effective, measures targeting other consumer items are more mixed: the removal of VAT on basic products, introduced in January, is still not curbing the rise in food prices.

In Spain, business surveys seem to rule out the risk of a recession in the short term. The Composite PMI rebounded sharply in February (+4.1 points to 55.7), driven by services (+4.0 points to 56.7), while the manufacturing index (+4.6 points to 52.1) rose above the contraction threshold for the first time since June 2022. Given its close correlation with inflation, which is falling, household confidence has risen in recent months. However, it remains well below the level reached before the outbreak of the war in Ukraine in February 2022. In addition, consumer purchase intention has been at its lowest since December 2020, evidence of the financial difficulties consumers are experiencing.

However, erosion of the purchasing power of the most vulnerable households will be limited by the government's decision to increase the minimum wage by 8% in January 2023, which will offset inflation, which stood at 5.9% for this month. This is the fifth increase in the minimum wage since the left-wing coalition came into power in 2018. At EUR 1,080 per month, the minimum wage now represents 60% of the national median income, which is in line with the target announced by the government at its inauguration.

Inflation has fallen from the peak of 10.8% y/y reached last July, thanks to measures to freeze energy prices, most of which are being continued in 2023. Nevertheless, the more widespread and persistent current price increases would keep inflation above 3% between now and the end of the year. In February, food prices saw a record increase of 16.6% y/y, followed by prices in the hotel and catering sector (+7.9%), while prices of household goods stabilised at a sustained rate of growth (+7.6%). As a result, core inflation (excluding energy and fresh products) rose to 7.0% y/y in February.

In addition, financing costs in Spain will continue to rise this year, fuelling the slowdown in money supply and credit. Year-on-year, housing credit flows had already fallen into negative territory last December and the contraction is expected to intensify, although effects on property prices do need to be put into perspective. Property prices also depend a great deal on the balance between supply and demand, and this balance remains a support factor for prices, supply being limited. Although the pace of increase in real estate prices has slowed in recent months, it remained dynamic in February, at +6.4% y/y.

Despite government actions to curb the energy shock, the public deficit fell significantly in 2022 and the primary deficit was halved, from EUR 60.8 bn 2021 (5.0% of GDP) to EUR 31 bn (2.3%), according to preliminary figures from the Spanish Ministry of Finance (CIGAE). Along with consumer price inflation and, to a lesser extent, wage inflation, job creation - still very dynamic this winter - is contributing to an increase in government tax revenue, which was up 9% in 2022. Public spending rose significantly, to 3% over the year, but less than income.

GROWTH & INFLATION

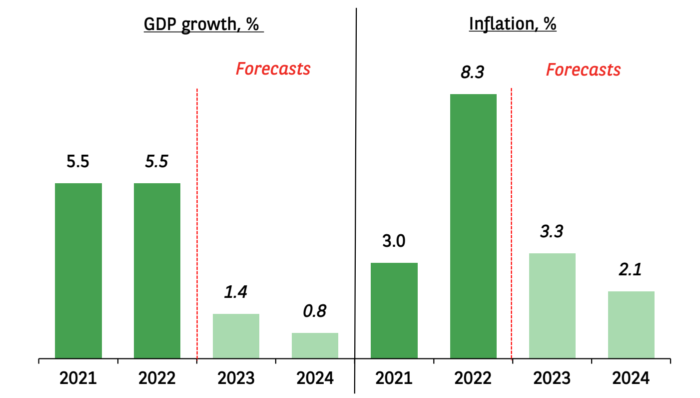

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

In fact, the good news for the Spanish economy is that net job creation is continuing. The number of employees affiliated to the social security system rose by 0.7% cumulatively over the January-February period, continuing the momentum of 2022 (+4.7%). Although the unemployment rate rose slightly in Q4 2022, to 12.9%, the labour market is resilient. Roll-out of the national recovery and resilience plan will also support new hires in the medium term. In this regard, the Bank of Spain believes that job creation will be concentrated within the digital sectors (information and communication, professional and technical services) as well as in construction, where new infrastructures linked to the green transition will require a surplus of labour[1]. Although the stimulus package should also help boost more investment momentum in the long term, its effects to date seem limited, judging by the current level of gross fixed capital formation[2].

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1 See The Recovery, Transformation and Resilience Plan and its macroeconomic impact from a sectoral standpoint, Bank of Spain Economic Bulletin, February 2023.
2 See BNP Paribas Eco Conjoncture, Productivity, an endemic weakness of the Spanish economic model, 8 February 2023

BELGIUM

PRIVATE CONSUMPTION: AN UMBRELLA FOR THE COMING STORM

Belgian GDP remains on a positive growth trajectory, even as monetary-induced clouds are forming. The historically large wage-indexation that benefitted a significant number of workers at the start of the year should spur on consumption in the short run. With disappointing corporate and household-real estate investments, and international trade decreasing, government spending is the only other positive contributor to growth, making for unsustainable public finances.

The Belgian economy surpassed expectations by growing 3.1% across 2022. However, after a strong first semester, the year's third and fourth quarter did entail a slowdown, as was the case in most large European economies. What sets the Belgian economy apart is its automatic wage-indexation, which results in regular wage hikes whenever inflation crosses a certain threshold. At the current juncture, large wage indexation is taking place, just as average inflation starts to decline. This bodes well for private consumption.

This should be enough to offset a slowdown in most other components of GDP. The balance of risks, chief amongst them the harder-than-expected monetary tightening, remains tilted firmly to the downside.

INFLATION DROPPED BELOW 6%

Inflation on a yearly basis, as measured by the HICP, came in at 5.5% for February. In doing so, it dropped below 6% for the first time in 16 months. In fact, the average price level has declined by almost 3% from its October peak.

This reflects a break in the underlying mechanics. Since January, energy-driven price pressures are no longer the largest contributor to headline inflation. Meanwhile, food prices have been surging, increasing on average by 1.2% every month since the start of 2022. It is also concerning that core inflation continues to accelerate.

HOUSEHOLDS ARE LESS WORRIED

Consumer confidence continues its recovery from October's low-point. Households are now less worried about employment loss, with the unemployment rate hovering just below 6% for the last three years.

Slower, but still strong employment growth and the above-mentioned wage-indexations spur on income growth. The Federal Plan Bureau expects real disposable income to increase by 4.2% in 2023.

If the current trends prevail, private consumption could accelerate over the next four quarters. The strong real income growth reminds us of early 2009. If household spending follows a similar trajectory as in the wake of the global financial crisis, it could mean a bonus of one percentage point for total GDP.

Such a bonus would help offset the turning tide Belgian firms are now facing. A tight labour market, still elevated input prices and more restrictive financing conditions conspire to lower profit margins.

Business confidence is recovering from last year's dip, but clearly at a slower pace than consumer sentiment. Retailers and manufacturers are increasingly worried about their outlook. Overall, gross fixed capital formation by firms has shown little signs of a revival over the last two quarters.

GROWTH & INFLATION

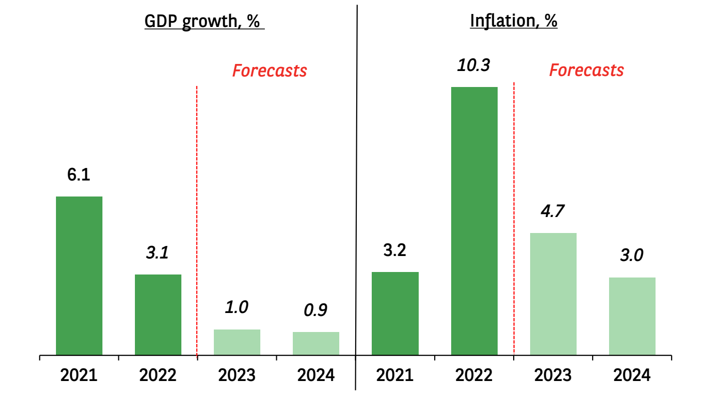

CHART 1 SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

PUBLIC FINANCES

Government consumption is now slowing down from its 2021 peak, when health-related expenditures picked up from their pandemic low. Investment spending should increase markedly throughout 2023, as defense spending shoots up and local governments gear up for the 2024 elections.

Against the backdrop of rising interest rates, government debt remains a big worry. In its most recent publication, the IMF strongly recommends imposing fiscal adjustment at the sub-national level as part of the general government's consolidation plans, and they further recommend strict spending limits and internalising the cost of overborrowing on the regional level.

It remains to be seen to what extent Alexander De Croo's broad coalition of governing parties will do as the doctors prescribe.

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UNITED KINGDOM

RECESSION DELAYED

The UK economy avoided recession in H2 2022 thanks to corporate investment and public and private consumption. Inflation figures in February surprised on the upside and remained at an exceptionally high level, which should continue to erode household purchasing power. As a result, the recession may only have been postponed. We now expect GDP to contract by -0.3% QoQ in Q1, then by -0.2% in Q2 2023. Faced with this situation, the Bank of England (BoE) is not expected to raise its key rate beyond a final hike of 25 basis points in March. This, plus accelerating disinflation, would allow a rebound in growth from H2 onwards.

The resilience of growth in Q4 2022 (+0.1%% QoQ) looks very much like the last stop before recession, which the country is not expected to avoid in H1 2023. Household consumption grew only +0.2% q/q in the last quarter and their situation is anticipated to deteriorate in Q1 2023. At 10.4% YoY in February (peak at 11.1% YoY in October), inflation continues to erode household purchasing power (real household disposable income in Q4 was 1.2% below its pre-pandemic level). This inflation is at historically high levels, particularly for food (+18.0% YoY) and for catering (+11.4% YoY). Real estate prices, impacted by the rise in credit rates (7% in February, the highest level since 2008, compared with 5.1% in September), also continued to fall in March (-3.0% YoY, the sharpest drop since July 2009).

As for companies, 2022 saw real investment growing by 10.8% compared to 2021. This increase is largely due to a catch-up effect after the sharp drop seen in 2020 (-12% on annual rythm), which was followed by only a modest upturn in 2021 (+0.9%). Nevertheless, the current level remains 3.1% below its pre-pandemic level. This investment support for growth is not expected to last in 2023, impacted by the combination of weak growth prospects and rising credit costs.

The labour market remained resilient at the beginning of the year, with the unemployment rate remaining at record lows (3.7% in January). The increase in nominal wages (+6.5% YoY excluding bonuses in January) is significant but not enough to offset inflation. Households should therefore see their purchasing power continue to diminish in H1 2023 before recovering in H2 under the effect of the expected disinflation which will not, however, be enough to offset the accumulated loss.

Our scenario forecasts recession in H1 (-0.3% then -0.2% QoQ in Q1 and Q2), before factors less negative than previously feared - notably a less restrictive budgetary policy than expected - facilitate a moderate upturn in H2 (+0.3% then +0.2% in Q3 and Q4). As an annual average, growth would nevertheless be negative (-0.4%), the only negative growth in this scenario of the main OECD economies that we track.

DISINFLATION: WILL THIS BE GRADUAL IN H1 AND FASTER IN H2?

Inflation has fallen since its October peak but remains above the 10% threshold. The full impact of the rise in interest rates will be felt this year, and inflation should fall more rapidly in H2, reaching around 3% in December. The first favourable base effects linked to the drop in energy prices should be visible in Q2. Inflation expectations have started to drop and will also contribute to disinflation in H2.

Faced with this situation, the BoE raised its key rate by 25 basis points to 4.25% at its meeting on 23 March. We expect this to be the last hike, and the BoE is expected to keep its key rate at this level until the end of the year. Quantitative tightening operations (reduction of the BoE balance sheet) are expected to continue in 2023, but the BoE should remain cautious in the face of the risks of recession affecting the UK economy by limiting its monetary tightening.

GROWTH & INFLATION

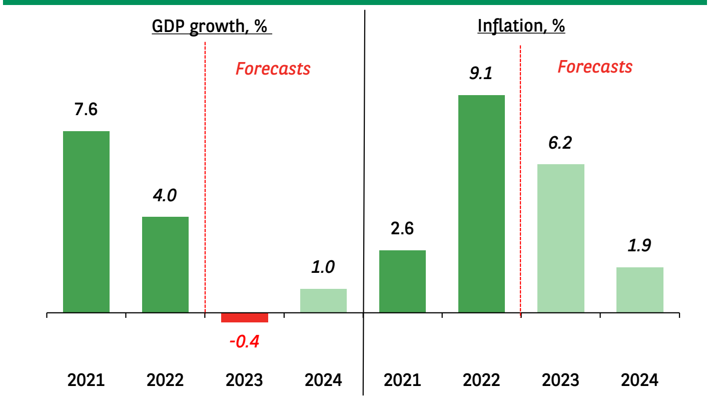

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A LESS RESTRICTIVE PUBLIC BUDGET THAN EXPECTED

According to the latest forecasts from the Office for Budget Responsibility, the public deficit (Public Sector Net Borrowing) will be reduced by 0.4 GDP points per year in average until 2028 compared to the November forecast. This improvement, due to more resilient activity than expected (upward revision of 0.8% of GDP by 2028 by the OBR), has enabled the government to announce a less restrictive budget than anticipated. The Energy Price Guarantee has already been extended until June, and the wage increases offered in the public sector could be higher than initially proposed. In our view, a revaluation of 5%, instead of the current 3.5%, would have an additional cost of GBP 3.7 billion per year for the government. Other measures aimed at increasing the labour force participation rate are also included (for an annual cost equivalent to 0.3% of GDP until 2028) and will help support households. At the same time, the government has also announced measures to support corporate investment equivalent to 0.4% of GDP per year until 2026 (GBP 9 billion) in order to offset the rise in the corporation tax rate, which will go up from 19% to 25% in April.

The agreement entered into with the EU on the Northern Ireland Protocol should avoid the cost to activity that would have occurred if this agreement had not been reached, but should ultimately have a limited impact on growth (making investments in Northern Ireland more attractive, but with a more marginal national economic impact).

After bond-related tensions in September 2022, a calmer political environment should therefore help restore budgetary leeway, providing support to the UK economy in the face of a difficult economic climate.

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FORECASTS

ECONOMIC FORECASTS

%	GDP Growth** 2021	2022	2023 e	2024 e	Inflation* 2021	2022	2023e	2024e
United States	5.9	2.1	1.4	-0.1	4.7	8.0	4.4	2.6
Japan	2.2	1.0	1.2	0.8	-0.2	2.5	2.6	1.4
United Kingdom	7.6	4.0	-0.4	1.0	2.6	9.1	6.2	1.9
Eurozone	5.3	3.5	0.7	0.5	2.6	8.4	5.4	2.6
Germany	2.6	1.9	-0.1	0.5	3.2	8.7	5.8	2.3
France	6.8	2.6	0.5	0.6	2.1	5.9	5.9	2.9
Italy	7.0	3.8	0.9	0.7	1.9	8.7	6.6	2.3
Spain	5.5	5.5	1.4	0.8	3.0	8.3	3.3	2.1
China	8.4	3.0	5.6	5.3	0.9	2.0	2.7	2.5
India***	8.7	7.0	5.7	6.0	5.5	6.7	5.4	4.5
Brazil	4.6	2.9	1.5	0.5	8.3	9.3	5.5	5.5

** Last update 31 March: Inflation of Eurozone, Germany, France, Italy, Spain; GDP and inflation of the United States*
*** Last update 28 March: GDP Eurozone, Germany, France, Italy, Spain*
**** Fiscal year from April 1st of year n to March 31st of year n+1*

SOURCE: BNP PARIBAS (E: ESTIMATES)

FINANCIAL FORECASTS

Interest rates %		2023			2024
End of period		Q2 2023	Q3 2023	Q4 2023	Q4 2024
United States	Fed Funds (upper limit)*	5.25	5.25	5.25	3.50
	T-Note 10y	4.30	4.10	3.90	3.65
Euro area	Deposit rate*	3.50	3.50	3.50	2.75
	Bund 10y	3.10	2.90	2.50	2.00
	OAT 10y	3.65	3.45	3.02	2.50
	BTP 10y	5.10	5.15	4.75	3.80
	BONO 10y	4.10	4.00	3.60	2.90
United Kingdom	Base rate	4.25	4.25	4.25	3.50
	Gilts 10y	3.70	3.50	3.25	2.85
Japan	BoJ Rate	-0.10	-0.10	-0.10	0.10
	JGB 10y**	0.45	0.60	0.65	0.80

Exchange rates		2023			2024
End of period		Q2 2023	Q3 2023	Q4 2023	Q4 2024
USD	EUR / USD	1.10	1.12	1.14	1.18
	USD / JPY	133	130	127	121
	GBP / USD	1.24	1.26	1.28	1.33
EUR	EUR / GBP	0.89	0.89	0.89	0.89
	EUR / JPY	146	146	145	143

** Last update 21 March: deposit rate ; 31 march 2023: Fed funds*
*** Last update 28 March*

SOURCE : BNP PARIBAS GLOBAL MARKETS (E ESTIMATES)

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