ECOPERSPECTIVES

4th Quarter 2023

> “THE FURTHER WEAKENING OF ECONOMIC ACTIVITY AND LOWER INFLATION THAT WE EXPECT TO SEE BY THE END OF THIS YEAR SHOULD PROMPT THE FED, LIKE THE ECB AND THE BOE, TO STOP RAISING THEIR POLICY RATES. HOWEVER, A FURTHER TIGHTENING CANNOT BE RULED OUT.”

ECONOMIC RESEARCH

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EDITORIAL

THE LIKELY END OF INTEREST RATE HIKES BUT NOT OF MONETARY RESTRAINT

The rate hikes cycle is coming to an end. The further weakening of economic activity and lower inflation that we expect to see by the end of this year should prompt the Fed, like the ECB and the BoE, to stop raising their policy rates. However, a further tightening cannot be ruled out. Interest rate hikes would not be followed immediately by cuts: to continue the fight against inflation, monetary response is expected to hold policy rates at their current high level for an extended period, until mid-2024 according to our forecasts. The first rate cuts would then occur to accompany the sharper fall in inflation and offset its positive impact on real policy rates. From this point of view, monetary policy would remain restrictive until the end of 2024.

In September 2023, out of a sample of some 40 central banks, only around ten raised their policy rates, including the ECB. After the global tightening movement that began at the end of 2021, such a move is now more of an exception than a rule (see Chart 1). The ECB raised its policy rates instead of leaving them unchanged as we expected, standing out above all from the US Federal Reserve (Fed) and the Bank of England (BoE) which opted for the status quo in September (Fed funds range maintained at 5.25-5.50% and BoE bank rate unchanged at 5.25%). This decision was expected for the Fed, but not for the BoE. It was certainly not in line with our scenario, and the vote was very tight with four out of ten committee members in favour of a 25 bp increase to 5.5%.

RATE HIKES ARE NOW MORE OF AN EXCEPTION THAN A RULE

As regards the ECB, its decision was surrounded by considerable uncertainty, between the arguments in favour of a further rise (still very high inflation and unsatisfactory disinflation) and those calling for a status quo (deterioration in credit supply and demand, delayed effects of the monetary tightening, loss of momentum of GDP growth). We thought that concerns about GDP growth would outweigh those about the sluggish disinflation and that the ECB would opt for the status quo; on the contrary, by hiking once again for the tenth consecutive time in a row, the ECB showed that the inflation situation remained a major concern. This is not surprising given its inherent reaction function, which depends on its assessment of the inflation outlook in the light of the incoming economic and financial data, the dynamics of core inflation and the strength of monetary policy transmission[1].

While the ECB acknowledges the good transmission of monetary tightening to the economy through the credit channel, progress on disinflation still appears to be insufficient and there is still a long way to go before returning to the 2% target. While the ECB expects headline inflation to be close to 3% y/y by the end of this year, a figure that is significantly lower than the peak reached a year earlier (10% y/y in Q4 2022), core inflation is expected to fall much less, at 4.1% y/y in Q4 2023, only 1 percentage point lower than in Q4 2022. By 2024, further progress is expected to be limited. Headline inflation would lose only 0.4 points between Q4 2023 and Q4 2024 (at 2.9% y/y). The expected decline in core inflation is larger (-1.6 points), but it would remain significantly above 2% (2.5% in Q4 2024). Inflation would not return to the target before the end of 2025: slightly below for headline inflation (1.9%), and slightly above for core inflation (2.1%). Our 2024 inflation forecasts are close to those of the ECB[2] as well as our growth forecasts, as the ECB significantly revised its eurozone scenario downwards between June and September[3], a revision that we thought would lead it to favour the status quo.

CENTRAL BANKS POLICY RATES: NUMBER OF HIKES VERSUS NUMBER OF CUTS

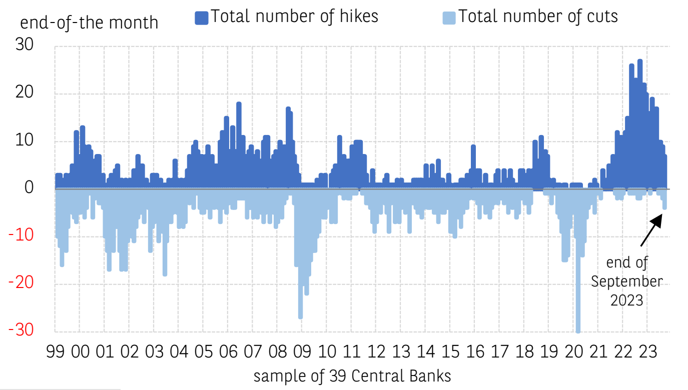

CHART 1 SOURCE: CENTRAL BANKS, BIS, DATASTREAM, BNP PARIBAS

The Fed and the BoE must deal, broadly speaking, with the same trade-off and balancing act as the ECB – fighting inflation without an unduly negative impact on the economy – but their decision in favour of the status quo in September may have been facilitated by somewhat more advanced disinflation in the US and bigger downside risks to growth in the UK. Moreover, since the ECB has, so far, increased its policy rates less (450 basis points between July 2022 and September 2023, compared with 525 basis points for the Fed between March 2022 and July 2023 and 515 basis points for the BoE between December 2021 and August 2023), this gives it additional latitude to complete its hiking cycle, if need be, all things being equal. If one also compares the degree of monetary restraint measured by real policy rates (nominal rate minus spotted inflation in year-on-year terms), the Fed has been in restrictive territory since Spring 2023. This is not the case for either the ECB or the BoE. From this perspective, these two central banks may not have completed the rate hikes, unlike the Fed.

END OF RATE INCREASES BUT NO EXPECTED CUTS UNTIL MID-2024

According to our forecasts, the Fed, the ECB and the BoE should no longer raise their policy rates or change them before mid-2024, which should mark the first rate cuts. The Bank of Japan (BoJ) stands out because it would begin its monetary tightening in April 2024 when the issue of monetary loosening would likely begin to emerge more clearly for the Fed, the ECB, and the BoE.

1 William de Vijlder, Ecoweek editorial, 18 September 2023 : ECB: at the peak (bnpparibas.com).
2 Except for headline inflation by the end of 2024, which we expect to be lower (2.3%).
3 In June 2023, the ECB expected a growth rate of 0.9% in 2023 in annual average terms and of 1.5% in 2024; in September, these figures had been revised down to 0.7% et 1%, respectively.

The end of the rate hikes cycle is not yet certain, however, given the still high inflation and the contained economic slowdown at the time of writing. The Fed's status quo in September was characterized as a "hawkish pause"[4], which also applies to the BoE. But rather than deciding on further rate hikes, monetary policy could now be achieved by maintaining policy rates at their current high levels for a prolonged period. This is an important line of communication s for central banks recently, as illustrated, for example, by the emphasis on perseverance by Bank of France Governor, François Villeroy de Galhau, in a recent speech[5].

We have been defending this "high for long" position for some time now. "Long" translates, concretely, in our forecasts, by rates kept at their current high level for 8 months for the Fed, the ECB and the BoE (policy rates unchanged from October 2023 to May 2024). However, this long duration is not as long as the previous "high-for-long" period which lasted 15 months, from June 2006 to August 2007 in the US (with Fed funds at 5.25%, i.e. the current low range). Unlike that time (which was followed by a severe financial crisis and a major recession), our current baseline scenario does not anticipate such a deterioration in the economic situation, far from it.

The rate cuts envisaged from mid-2024 do not respond to the economic downturn: they mainly accompany the fall in inflation, to offset its positive impact on real policy rates. We expect regular rate cuts from the Fed and the BoE (five, 25 bp at each meeting) and more gradual ones from the ECB (three, 25 bp each). This normalisation simply avoids further monetary policy tightening; there is no real easing by the Fed and the ECB, which is somewhat less the case for the BoE given our inflation forecasts (see Chart 2). From this point of view, monetary policy would remain restrictive until the end of 2024.

We would like to draw attention to the large gap existing between our rate scenario for the Fed and the Fed's own projections. According to its September dot plot, the median Fed funds estimate includes a further 25bp increase by the end of this year and only 50bp of cuts next year. Part of the explanation for this gap is the Fed's more optimistic growth forecasts, whose revised scenario approaches much of the expected soft landing. Compared to the June economic forecast, the growth forecast was significantly raised for 2023 (+1.1 percentage point, to 2.1% year-on-year in Q4 2023) and 2024 (+0.4% ppts, to 1.5%), the unemployment rate was lowered for both years (-0.3 ppts to 3.8% in Q4 2023, -0.4 ppts to 4.1% in Q4 2023) as well as core inflation in 2023 (-0.2 ppts, to 3.7% year-on-year in Q4 2023). Even the IMF, in its October 2023 World Economic Outlook, which has been just published, considers that the probability of a soft landing has increased (bringing inflation down without a major downturn in activity)

This more optimistic assessment of the economic situation, particularly in the United States, is also reflected in Google's search for the term 'soft landing', which has recently soared and replaced the term 'recession' (see Chart 3). We do not entirely share this optimism and continue to believe that the US will not escape a recession as a result of tighter monetary policy. The recent tightening of monetary and financial conditions, through higher long-term rates combined with the rise in oil prices and the USD appreciation, tends to strengthen this scenario and weaken that of a soft landing. But, given all the shocks, the shallow nature of the recession we anticipate could give the impression of a soft landing.

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REAL POLICY RATES*

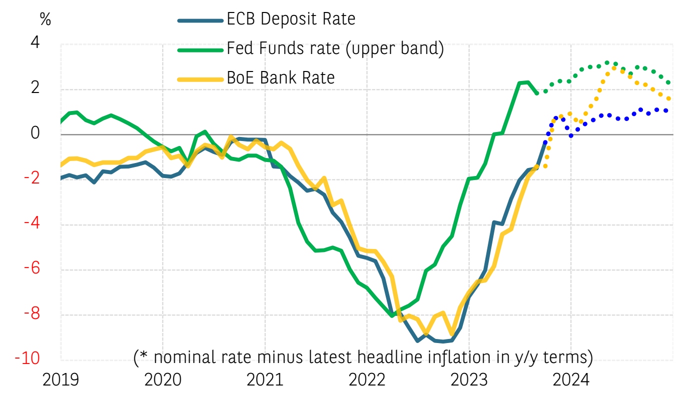
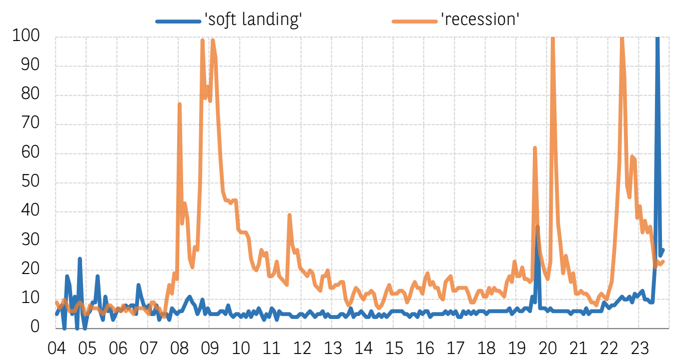


CHART 2 SOURCE: EUROSTAT, BLS, ONS, CENTRAL BANKS, MACROBOND, BNP PARIBAS

NUMBER OF OCCURRENCES OF 'SOFT LANDING' AND 'RECESSION'*



* indice showing the search intensity of the two terms in Google

CHART 3 SOURCE: GOOGLE, BNP PARIBAS

4 *William de Vijlder, Ecoweek editorial, 25 September 2023* (Federal Reserve: high(er) for longer (bnpparibas.com))
5 *onetary policy in the euro area: was it too late? Or could it now be too much? | Banque de France (banque-france.fr), ECB – CEPR – Banque de France Conference – Paris, 25 September 2023*

UNITED STATES

THE INVISIBLE TIGHTENING

The US economy keeps growing and postponing the occurrence of a recession that is still likely, but not in 2023 and in a circumscribed way. While households' consumption has so far proven resilient to the monetary tightening, the delayed and cumulative effects should eventually impulse a recessionary dynamic. The first fallout is already visible on the real estate market and the labour market has exhibited signs of easing. If rate hikes are probably over, the restrictive stance is not.

US GDP advanced by +0.5% (q/q) in Q2, an important increase enabled by the improvement in nonresidential investment (+1.8% q/q) linked to the implementation of the Inflation Reduction and CHIPS acts. Consumption brought a positive contribution again, despite a slowdown (+0.1pp v. +0.6pp in Q1). If the GDP growth rate should improve in Q3 (+0.9% q/q according to our forecast), we anticipate a sharp slowdown in Q4 (+0.1% q/q) before a slip into recession in H1 2024. The excess savings inherited from the pandemic era and the resilient labour market have contributed to postpone a widely expected recession so far, but the fade of these supporting factors and the cumulative and delayed effect of monetary tightening should eventually hit US growth and induce a contraction of GDP in Q1 (-0.3% q/q) and Q2 (-0.1% q/q) 2024.

The labour market reports some signs of easing of tensions, such as the rebound in the participation rate (62.8% in August) and the slowdown in the pace of non-farm payrolls (+189k between June and August 2023 v. +241k for the three months prior), although the latter was counterbalanced by a surprisingly positive figure in September (336k, the highest since January). We anticipate that the slow puncture will persist, and that the unemployment rate will rise to 4.7% (3.8% currently) before the end of 2024 in the wake of the recession predicted for H1 2024. This could be close to a soft landing: admittedly, the United States would observe a GDP contraction together with a higher unemployment, but on a somewhat contained scale, particularly in view of the magnitude of the monetary tightening that started in March 2022 (+525bps, the steeper since +1005bps in 1980 – 1981 under Paul Volcker's governance).

THE DIRECT EXPOSURE OF REAL ESTATE MARKET TO MONETARY TIGHTENING

Thirty-year fixed mortgage rates are currently trending around 7.3% according to Freddie Mac, the highest since 2001, against 3.5% before the beginning of rate hikes. In addition to the impact on real estate demand, this is constraining the supply of existing homes since potential sellers are unwilling to switch to a higher level of debt service. Therefore, the existing home sales have nearly steadily eroded since February 2022. Their monthly average amounts to 4.23 million since early 2023, against 5.46 million between January and August 2022. In the meantime, housing starts have fallen to a 3-year low in August (1.28 million), mitigated by a significant improvement in building permits (+6.9% m/m).

The 'New' component of the sector is therefore taking advantage from a carryover effect and was improving since November 2022 in 3-month moving average before receding in August (699k in August, -12k monthly). This should translate into the quarterly national accounts and the Atlanta Fed GDPnow is forecasting a growth of residential investment (+1.3% q/q) in Q2), following a 9-quarter streak of contraction. However, this will probably prove insufficient to support the whole real estate sector, notably because of the relative size of the new-homes market compared to existing homes (8.5 times less transactions in average since 2007). Furthermore, the NAR Affordability Index is still trending at standards unseen since the mid-1980s (87.7 in August).

GROWTH & INFLATION

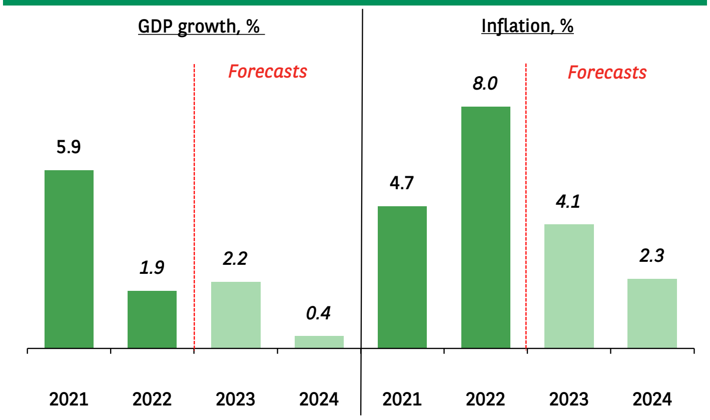


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

HIGHER FOR LONGER

The September FOMC meeting resulted in holding the target at 5.25%-5.50%, following a +25 bps hike in July, and despite the summer increase in inflation (+3.7% y/y for the CPI in August vs. +3.1% in June). The rate decision was disclosed together with the Summary of Economic Projections Q3 update, which views an additional +25 bps by the end of the year, followed by -50 bps in 2024 - implying an upward revision of the expected rate for the end of 2024. Our baseline scenario is unaffected, as we still consider the de jure monetary tightening over, although risks are tilted to the upside. The general stance of the Federal Reserve and Jerome Powell remains hawkish, although the risk management question is increasingly present. It must be highlighted that, with time moving on and inflation moving down, holding the nominal interest rates translates de facto into further tightening.

Finally, there are several points to be monitored over the coming weeks. On the one hand, consumption could suffer from the resumption of student loans repayments starting in October. On the other hand, it is also likely to be constrained by sustainably higher level in oil prices (the Brent price is currently higher than 85 USD), which would undoubtedly exert upward pressures on inflation and could threaten the anchoring of expectations. In addition, a government shutdown is still plausible and would disrupt government action and weigh on federal employees (4M people), while the potential consequences of the UAW strike are uncertain.

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CHINA

THE DIFFICULT TASK OF REVIVING GROWTH

After some hesitation, the Chinese authorities finally stepped up their stimulus measures over the summer. The recent slight upturn in economic growth is set to continue in Q4 2023. However, action by the central bank and the government remains constrained, cautious and measured, while internal and external obstacles to economic activity are still powerful. In the real estate sector, even if activity stabilises in the short term thanks to support measures, it is likely to remain hampered by the financial fragility of developers and weak buyer sentiment.

The downward trend in China's economic growth, which has been ongoing for around fifteen years, intensified in 2022 and 2023. Real GDP growth stood at 3% in 2022 and should barely exceed 5% in 2023, despite favourable base effects linked to the end of the health restrictions.

Economic activity has been weakened for two years by an accumulation of powerful internal and external obstacles: unprecedented crisis in the real estate sector, wave of regulatory tightening in services, strict zero-Covid policy applied until December 2022, significant drop in household and investor confidence, lack of room for manoeuvre for monetary and fiscal policy makers, weakening global demand and tensions with the United States. These obstacles have added to the long-term structural factors of the Chinese economic slowdown: decline in the working-age population, moderation of productivity gains and exhaustion of the growth model driven by investment and debt.

Thus, the post-Covid rebound in Chinese growth, observed in Q1 2023, ran out of steam in the spring, and the authorities only provided a very cautious and gradual policy response. However, they have stepped up their stimulus measures since July, and there have been some signs of improvement. Already in August, activity in the services sector strengthened slightly (+6.8% y/y compared with +5.7% in July), supported by retail sales (+4.5% y/y in volume compared with +2.8% in July). Growth in industry also recovered slightly (+4.5% in August compared with +3.7% in July). The latest leading activity indicators and PMIs point to a further slight improvement in September.

The central bank slightly lowered policy rates (between the end of May and the end of September, the 1-year MLF rate was cut from 2.75% to 2.5%) as were the reserve requirement ratios (the average ratio fell from 7.6% to 7.4% in September). This monetary policy easing goes with support measures aimed at containing the real estate crisis and with the acceleration in bond issuance by local governments in H2 2023 in order to finance new public spending. The central government has also extended a number of tax incentives for SMEs and households.

In the property sector, the continued contraction in activity (and its spillover effects on the rest of the economy and confidence), the increasing number of payment defaults by developers and the spread of risks in the financial sector have led the authorities to adjust their policy in recent months, while maintaining their objectives of making the market healthier (through the deleveraging of developers and the moderation of the cost of housing). Initially, the measures taken were mainly aimed at financing the completion of projects already underway. Since August, the authorities have stepped up their efforts to restore demand for housing. They have announced an easing of prudential rules relating to the purchase of housing and the granting of mortgage loans (including a reduction in down-payment ratios), as well as a reduction in interest rates on mortgage loans (for both new loans and existing loans). These changes are implemented differently by the government of each city depending on the local property market situation. Thanks to these measures, real estate activity could bottom out and stabilise, or even recover slightly, by the end of the year. This should help the economic improvement seen since mid-summer to continue in Q4 2023.

GROWTH & INFLATION

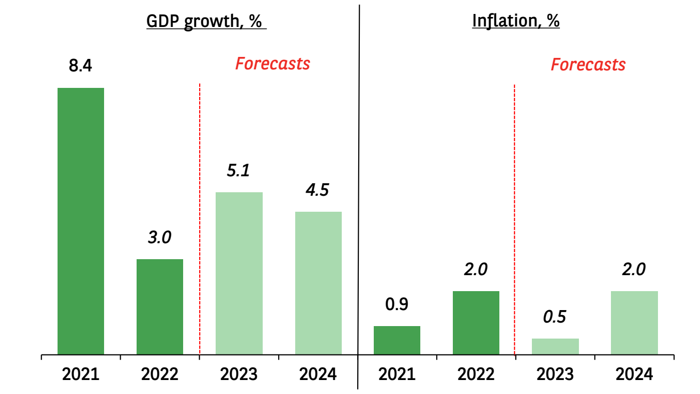

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

However, the recovery in activity remains fragile, households are still wary, property developers remain faced with severe financial difficulties, and the authorities' room for manoeuvre to increase support for economic growth is narrow. While consumer price inflation remains very low (+0.3% y/y in August), the central bank's room for manoeuvre is limited by downward pressure on the yuan. The yuan has depreciated by 13% against the US dollar since April 2022 (of which 5% between end-March and end-September) due to the growing differential between US and Chinese interest rates and the large portfolio investment outflows .

Furthermore, economic policy remains heavily constrained by the excessive debt of the private sector and local governments. Total domestic debt reached 284% of GDP in mid-2023 compared with 247% at the end of 2019. This debt limits the central bank's ability to encourage new loans and discourages both bank lending supply and demand from households and enterprises. The fall in confidence is also weighing on credit growth. On the fiscal front, policy is constrained by the fragility of local governments resulting from their own debt (30% of GDP in mid-2023) and that of their financing vehicles (estimated at around 50% of GDP).

Finally, the authorities' action is dictated by longer-term objectives. Beijing seeks to build a more balanced economic growth model, strengthen financial discipline, promote 'common prosperity' and stimulate innovation and the high-tech sectors. The priority is not to support growth in the short term, but to reduce the risks: internal (in particular financial instability) and external (the tensions with the US explain China's efforts to achieve self-sufficiency in advanced technologies).

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DOMESTIC DEMAND IS SLOWING GROWTH

After sustained growth in H1 2023, driven by external demand, the Japanese economy is beginning to slow down. Private demand (household consumption, corporate investment) is offering little support for growth. Although inflation has stabilised at around 3%, it is eroding household purchasing power, which is still not benefitting from significant wage increases. Nevertheless, according to the Ministry of Finance data, corporate profits hit a new record in Q2. Fostering a better redistribution of profits to wages remains a priority for Fumio Kishida's government, which is preparing a new wave of budgetary measures in October. The Bank of Japan, which also monitors wage developments, is not expected to make any major adjustments to its monetary policy before the results of the annual wage negotiations (Shunto) next spring. However, adjustments to the yield curve control policy cannot be ruled out until then.

In the first semester 2023, the Japanese economy was still able to benefit from favourable catch-up effects linked to the belated lifting (in May 2023) of the last border restrictions introduced during the health crisis. This has led to a significant rebound in service exports, which are also driven by the inflow of tourists to the country. As a result, Japanese GDP climbed in Q2 2023 above the pre-Covid peak. However, this positive trend conceals a persistent weakness in private demand. Household consumption and corporate investment are still recording a significant deficit compared to 2019, in the order of 3% for both; this gap even increased in Q2. In fact, real GDP growth for Q2 was revised downwards, from 1.5% q/q initially to 1.2% q/q, mainly due to a greater contraction of these two components, which partially offset the increase in net exports[1]. We are now expecting a sharp slowdown in growth in Japan in the coming quarters, starting with Q3 (+0.1% q/q) and Q4 (+0.3% q/q). On average, growth should reach 2.0% in 2023 thanks to the favourable carry-over effects in H1.

Labour shortages in the Japanese labour market and difficulties for companies to recruit (visible in the Tankan survey) are not enough to fuel sufficient wage growth to support consumption. Nominal wages increased by 1.1% y/y in July after increases of more than 2% in May and June (Ministry of Employment), which is below the rate of inflation; therefore, real wages have not seen positive year-on-year growth since the beginning of 2022. The repeated call from Bank of Japan Governor Kazuo Ueda for companies to grant larger wage increases is a priority for Fumio Kishida. The Japanese Prime Minister, who proceeded with a minor cabinet reshuffle in mid-September, will be unveiling a new budget package in October.

This debate on wages is not without justification. Japanese companies are doing well overall. According to the Ministry of Finance (MoF)[2] quarterly survey, profits rose sharply again in Q2 (+9.5% q/q), to an all-time high, both in terms of level (JPY 26.9 trillion) and as a share of GDP (18.2%). The business model of Japanese companies - based on the dynamics of subsidiaries located abroad - continues to demonstrate its strengths[3]. The significant depreciation of the yen in 2023 has increased profits repatriated from abroad, but companies are also taking advantage of their broad international deployment to optimise their production process and get closer to the various domestic markets. The business climate in the Tankan survey for Q3 corroborates this finding, with a Diffusion Index of 10 compared to 8 in Q2. This positive development is particularly marked for large companies (+4 points to 17), while the index is up more modestly for medium-sized companies (+1 point to 12) and has settled at 5 for small companies.

GROWTH & INFLATION

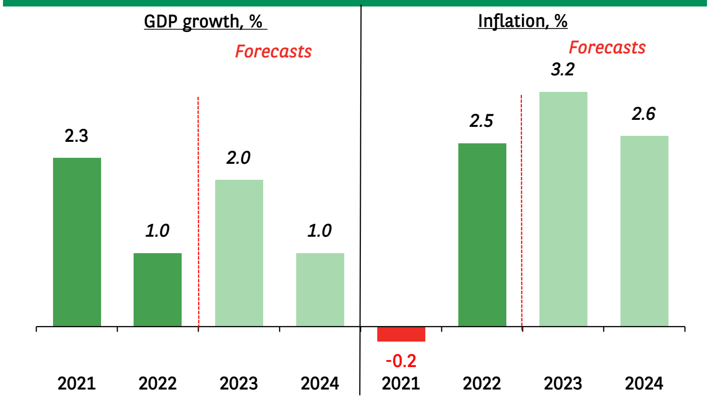

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The challenge for Japan therefore lies in promoting domestic inflation, through the wage-price spiral, while limiting the risk of imported inflation. For the time being, this dynamic remains stalled, although recruitment problems are intensifying, as demonstrated by the Tankan Employment index, which shows a balance of opinions at -33 in Q3, compared to -32 in the previous quarter. In addition, the forecast for the next quarter (-37), should it materalise, would be the worst since 1991.

The start of normalisation of monetary policy in Japan is therefore not expected, according to our predictions, before the next collective wage negotiations (Shunto) in spring 2024, a deadline which should coincide with the publication of the major monetary policy review, announced by Governor Ueda last July.

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1 Household consumption and non-residential investment fell by 0.7% q/q and 1.0% q/q respectively in Q2 2023.
2 https://www.mof.go.jp/english/pri/reference/ssc/r5.4-6e.pdf
3 See BNP Paribas Ecoflash, *Foreign subsidiaries, a key driver of Japanese industry,* 8 June 2022

THE HALT IN GROWTH BECOMES CLEARER

Eurozone company surveys (PMI, European Commission) continued to deteriorate throughout the summer, although a slight improvement was observed in September for the PMI. The rise in policy rates by 25 basis points in September – the last one according to our forecast – will amplify this phenomenon. We do not expect a recession in the euro zone as a whole in 2023, but moderate growth at 0.5%, mainly due to a favourable carry-over effect in 2022. After a slightly positive first semester, eurozone activity is likely to stall in the second semester. Significant growth differentials are expected between the Member States.

According to our forecasts, eurozone activity is likely to stall in the second half of 2023, under the effects of a contraction in GDP in Germany (Q3 and Q4) and France (Q3 only) which should be offset by growth in Italy and, above all, Spain. Furthermore, hourly labour productivity in the eurozone fell in the second quarter (-1.0% y/y): given the significant increase in hourly compensation (+5.4% y/y), the unit labour cost (ULC) rose sharply in Q2 by +6.5% y/y. The largest ULC increases occurred in the manufacturing and energy sectors (+7.6% y/y), as well as in the 'commerce, transport, accommodation and food services' component (+8.2% y/y). Faced with a deteriorating economic climate, and an above-inflation rise in ULC, the labour market should lose momentum. However, the extent of this decline and an increase in the unemployment rate should be relatively limited given persistent recruitment difficulties. The unemployment rate remained at a record low of 6.4% in September.

In the wake of the pandemic, corporate activity within the monetary union was initially limited, mainly by supply constraints (equipment, labour). These constraints, which are reducing slightly, remain significant, and are now supplemented by a weakening in demand. There are multiple signs of slowing activity: the European Commission's economic sentiment index reached its lowest level in three years in September; M3 money supply fell back into negative territory on an annual basis in July for the first time since spring 2011 and fell further in August (-1.1% y/y); mortgage and corporate loans slowed sharply to 0.5% y/y in August.

The tightening in credit should limit private investment growth, despite the expected support from the Next Generation EU programme, most of which is still to come. At the end of September, the European Commission published an update on the programme's progress[1]. On 1 September 2023, EUR 153.4 billion, i.e. only 20% of the fund, had been paid to Member States, two-thirds in the form of subsidies (EUR 106.3 bn) and one-third in the form of loans (EUR 47.1 bn)[2].

Inflation slowed sharply in September, moving from 5.2% y/y in the previous month to 4.3% according to Eurostat's preliminary estimate. Although another slowdown is expected in the autumn, its scope could be more limited than expected, mainly due to the upturn in oil prices since this summer, whose effects on the energy component are already clearly visible (+4.7% cumulatively over the August-September period[3]). Core inflation has also dropped since its peak in March this year, falling from 5.7% to 4.5% in September. The crossover of inflation and wage curves, expected in the second half of the year, is likely to limit a further fall in inflation. However, it will allow real wages to rise slightly after an uninterrupted fall of almost two and a half years. The indicator of negotiated wages, calculated by the ECB, rose 4.3% y/y in Q2, the same pace as in the previous quarter.

GROWTH & INFLATION

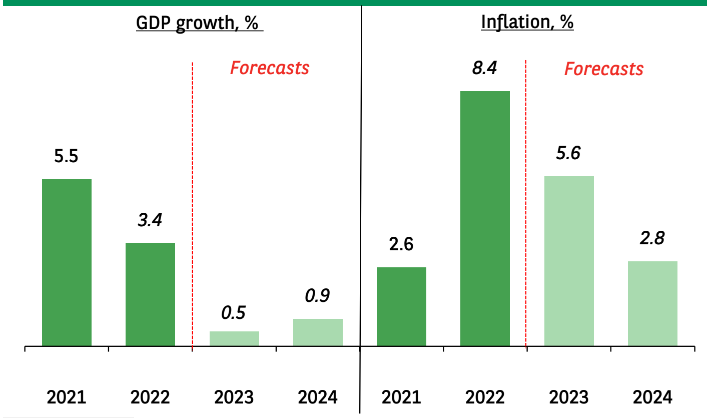

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

National authorities have taken notes of the economic slowdown and some have downgraded their growth forecasts for 2023 (particularly Italy and France). Nevertheless, fiscal support will remain significant, and the trajectory to reduce public deficits has been reduced in France and Italy. A return to below the 3% GDP target has been pushed back by one year: it would now be reached in 2026 for Italy and 2027 for France, respectively. All Member States will need to submit their budget plans to the European Commission by 15 October. The year 2024 will also mark the end of the suspension of the Stability and Growth Pact, and the introduction of new public finance management criteria. Last April, the European Commission presented the outlines of a new system, which all Member States will have to discuss and endorse by the end of the year. Although we do not anticipate any further interest rate hikes by the ECB, the gradual withdrawal of fiscal support will constitute an additional growth-limiting factor in the euro zone in 2024.

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1 OM_2023_545_1_EN_0.pdf (europa.eu)
2 Countries that have applied for loans so far are Italy (EUR 37.9 billion), Greece (EUR 5.3 billion), Romania (EUR 2.7 billion), Portugal (EUR 1.1 billion) and Cyprus (EUR 26 million).
3 HICP measurement for the euro zone.

GERMANY

STANDORT DEUTSCHLAND?

The German economy is affected by the transmission of the inflationary shock to household consumption. However, the underperformance of the German economy also reflects more structural difficulties, reminding the "Standort Deutschland"[1] debate. These difficulties began in 2018 shortly before the first European regulations aimed at adapting the automotive sector to climate change were implemented. Manufacturing output has never returned to the November 2017 peak and production capacity in the sector has declined. Against a backdrop that is still difficult, we expect another recession in the second half of 2023.

In Q2 2023, Germany narrowly avoided a third consecutive quarter of GDP contraction (0% q/q, after -0.4% in Q4 2022 and -0.1% in Q1 2023). Over the last three quarters, consumption trends (private and public) have been very close to those of GDP. While the high level of inflation has affected private consumption, public consumption has failed to drive growth as well. At the same time, exports (which account for almost half of German GDP) fell by 1.1% q/q in Q2, back to their Q4 2021 level.

As well as underperforming in the short term, German growth has also been disappointing for several years, and the reasons are likely to persist in the quarters ahead. According to our forecasts, the second half of 2023 will see another moderate recession (-0.1% q/q in both Q3 and Q4).

INDUSTRIAL CORE UNDERPERFORMANCE

The main economic surveys are deteriorating again after a slight improvement in spring. In industry, they fell below their October 2022 level (they were then penalised by a peak in inflation at 11.6% y/y according to the harmonised index). Contrary to 2022, according to the Ifo survey, companies are less worried about the future ("expectations" component at 77 in October 2022 compared with 83 in September 2023) but more about the current situation: -2 in September compared with 13 in October 2022 in industry and 9 compared with 21 in October 2022 in services. In both cases, the indicator is at its lowest since spring 2010.

Household spending intentions remain weak: they are being penalised by the rise in interest rates and are therefore not benefiting from the relative disinflation (6.4% y/y in August 2023). Demand became the number one limiting factor for production (according to the European Commission) in the first three quarters of 2023 in intermediate goods sectors (chemicals, plastics/rubber, metals, wood/paper), while supply constraints remain a major headwind for transport equipment and machinery and equipment. With labour shortages affecting fewer sectors, job creation decreased (42,000 jobs created in Q2, after an average of 94,000 over the previous four quarters).

The problems faced by German industry seem structural. Manufacturing production peaked in November 2017, shortly before the introduction of the first European environmental standards in the automotive sector (WLTP standards) in September 2018. In the first half of 2023, manufacturing production was 8.3% below its level at the end of 2017 (-11% in the automotive and metals sectors, -15% in chemicals). In Q2 2023, investment in machinery and equipment only exceeded the level at the end of 2017 by 1.3% (compared to +16% in France). As a result, in Q2 production capacity (which only decreased from Covid onwards) remained 6% lower than its previous level (an unprecedented phenomenon). With industry accounting for almost a quarter of the German economy, its underperformance affects GDP: In Q2 2023, GDP was only +1.3% above its level at the end of 2017, compared with +5.1% for the eurozone and +4.2% for France.

GROWTH & INFLATION

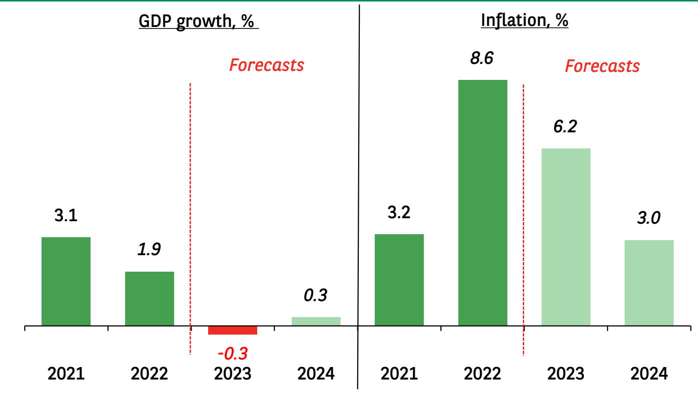

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

POOR PROSPECTS FOR THE EXPORT SECTOR?

Between the end of 2017 and Q2 2023, German exports of goods and services increased by 4%. This total increase masks a smaller increase for goods alone of 1.3%, i.e. the same change as GDP. However, between 2012 and 2017, cumulative GDP growth (nearly 11%) was largely supported by exports (+22%), particularly in goods (+19%). Exports therefore lost their role as a growth driver.

The loss of market share in China, particularly in the automotive sector, is one of the explanatory factors. Germany accounted for 4,2% of Chinese imports over the last twelve months (to the end of August 2023), 1 percentage point lower than two years earlier (at the same time, France's market share remained stable at 1.4%).

In terms of investment, the dynamics of the main competitors contrast with the sluggishness seen in Germany. However, since statistical series are not measured in the same way, the comparison remains imprecise. In China, growth in investment (fixed-asset investment, or FAI, which is not measured in real terms), in the manufacturing sector is clearly erasing the shock of the Covid-19 pandemic: in this sector, between January and August 2023, FAI was 37% higher than its level over the same period of 2017 (135% in electronics, 100% in electrical equipment and almost 60% in chemicals). In the United States, the manufacturing sector's investment in construction (nominal data here again) grew by 76% y/y in January-July 2023, and more than tripled in electrical, electronic and IT equipment (supported by the Chips Act). In Germany, on the contrary, industrial investment in buildings fell by 1% y/y (and by 6% compared with 2017) in Q2 2023. These developments, although difficult to compare, let expect a continued erosion in German market shares.

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1 'Standort Deutschland' is used to refer to Germany as a place of production. This expression was used for the first time in the early 90s, when this question was first asked. We are asking it again today.

FRANCE

THE GRASSHOPPER AND THE ANT

The French economy is characterised by a dichotomy. Household spending – consumption and investment – has decreased in volume (-1.4% and -6.6% in Q2 compared to Q4 2021), while corporate investment has increased (+6.7% between Q4 2021 and Q2 2023). This factor, combined with the reduction in constraints on the production of transport equipment, has enabled high growth in Q2 (0.5% q/q). While these factors should continue to support economic activity in the medium term, growth may be constrained in the coming quarters by the fall in demand against the background of high household savings.

French growth was surprisingly up in Q2 2023, reaching 0.5% q/q. This performance comes from exports in the transport equipment sector (automotive, aviation and naval) and corporate investment (+0.5% q/q in Q2). Conversely, household consumption and investment contracted, affected by still-high (albeit falling) inflation and persistently high interest rates. This divergence, observed since the beginning of 2022, between a part of demand that is holding up and another that is shrinking, has weakened growth without, however, making it disappear. This has also enabled job creation to continue, although at a slower pace (21,000 net new jobs in Q2, compared with an average of almost 94,000 over the previous four quarters). The erosion of existing resilience factors should weigh on both GDP and employment growth in the second half of the year.

INCOME GROWING FASTER THAN GDP

The dynamics of sectors' accounts, whether households or non-financial companies, were rather positive in the first half of 2023.

Households suffered a fall in purchasing power in the first half of 2022, as income increases came afterwards: the EUR 20 billion from the law on purchasing power passed in July 2022 and pay rises (other than the minimum wage) in the second half of 2022 (first bonuses, then pay rises in early 2023). However, in Q2 2023, nominal gross disposable income (GDI) growth (+9.1% y/y) far outstripped that of the consumption deflator (+7% y/y). While net compensations have not yet made up all the lost ground (+6.6% y/y), it is income from capital (+20.8% y/y) and income from redistribution (benefits are growing faster than taxes) that are boosting purchasing power (+2% y/y).

Q2 2023 also saw the margin rate of non-financial companies rise to 33.2% (above their long-term average: 32%). This reflects the ability of these companies to pass on rising costs to selling prices.

Overall, income momentum improved and could have generated higher growth. But while companies are investing, household spending is still missing out.

COMPANIES CONTINUE TO INVEST

Corporate investment has been one of the most consistent supports for French growth in recent quarters. The investment rate reached 26.1% of gross value added over the past 12 months; in the 90s, it was only 20%. More than half of the difference can be explained by the increase in investment in information and communication: from 16% of the total investment in 2000 to 26% over the past twelve months. An acceleration in construction and machinery & equipment investments is the second driver (from 2016-17). This enabled the French economy to stabilize its industrial production capacity after the decline observed as from 2000.

At the beginning of 2023, companies' sound financial capacity also enabled them to self-finance part of their investment, limiting the impact of rising interest rates. However, the latter is weighing on demand (particularly that of households). Lower new orders should therefore ultimately lead to fewer investments.

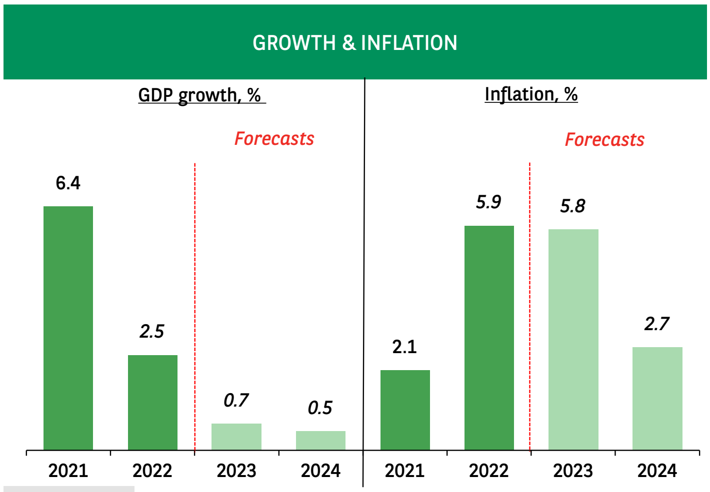

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PENT-UP DEMAND FROM HOUSEHOLDS? NOT RIGHT NOW

In Q2, household savings reached 18.8% of GDP, the highest level since 1979 (excluding the Covid-19 period). This high level of savings could be a sign of pent-up demand. However, since the end of the pandemic-related restrictions, the savings rate has never returned to its pre-Covid level.

For a household, savings have two purposes: investing in housing or building up financial savings. However, the former has been declining for several quarters: at 9.8% of GDI in Q2 2023 (4 points below its 1979 level). According to our estimates, financial savings will account for around 8% of GDI on average in 2023, a quite unprecedented level (excluding the Covid period): never before the proportion of the GDI spent by households was so low.

In the 70s, wage growth (and purchasing power) was high (indexation clauses), which encouraged households to take on debt (despite the very high interest rates at the time). In fact, the growth in their income quickly reduced the burden of monthly repayments on their GDI. However, we are not seeing anything like this at the moment. The dynamic of household purchasing power since the end of 2021 has been very different from that of the 1970s: the proportion of debt repayment in household budgets should not reduce as significantly as it did then.

In addition, the high level of interest rates is holding households back on their purchases of durable goods. This, along with the limited supply of electric vehicles and their price, means that saving is not a choice but the result of a lack of opportunities. Demand could free up later, but not in the short term: according to our forecasts, the downturn in household investment will not end before 2025, while household consumption should return to normal growth (of around 0.3% q/q per quarter) in 2024, but without any catch-up effect compared with 2022-23.

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ITALY

EASING GROWTH MOMENTUM

In Q2, real GDP declined by 0.4%, driven by weakening domestic demand. Investment in machinery and equipment fell, reflecting the worsening of firms' economic and financial conditions. Consumption slightly recovered in real terms. Italian households suffer, however, from both higher consumer prices and increasing interest rates. In Q2, there was a contraction across many sectors. Services value added unexpectedly declined, reflecting the slower recovery of tourism. Inflation is slowly falling: in September it grew +5.7% y/y. Contrary to most predictions, in Q2 2023 house prices increased by 2.0% q/q.

AN UNEXPECTED GDP CONTRACTION, DRIVEN BY DOMESTIC DEMAND

The recovery of the Italian economy stuttered in Q2 2023. After a 0.6% increase in Q1, real GDP fell by 0.4%, with the annual growth rate declining from 2.1% to 0.3% and the carryover for 2023 from 0.9% to 0.7%. Despite the Q2 contraction, Italian GDP is 3% higher than in Q4 2019.

In Q2, domestic demand excluding stocks subtracted 0.4% from the overall growth, driven by falling investment, which declined by almost 2%, with a 0.4% negative contribution to the GDP. Spending in construction decreased by more than 3%, mainly due to the phasing out of the extraordinary incentives for building improvement. Investment in machinery and ICT equipment fell by 0.7%, reflecting the worsening of economic and financial conditions of firms, which are still coping with producer prices 20% higher than at the beginning of 2021. Given increasing interest rates and the worsening of the global scenario, bank loans to non-financial corporations declined by more than 7% on an annual basis. Q2 private consumption moderately recovered in real terms, slightly going above pre-crisis levels, while the value of expenditure is almost 15% higher. Italian households benefited from the further improvement of labour market conditions, while suffering from both higher consumer prices and increasing interest rates. In Q2, net exports' contribution was negative (-0.2 percentage point), as exports declined while imports remained unchanged.

In Q2, there was a contraction of activity across many sectors. Manufacturing recorded the fifth decline in the last six quarters, with value added slightly above pre-crisis levels. Industrial activity suffered in sectors with higher production costs, such as chemical, wood, paper, rubber and plastic. Services value added unexpectedly declined, reflecting the slower recovery of tourism. In H1 2023, expenditure of foreign travellers was higher than in the same period of 2019, while the number of travellers was lower by about 4.5 million.

INFLATION ON A (SLOW) DECLINE, HOUSE PRICES ON A (SLOW) UPWARD TREND

In September, HCPI inflation grew 5.7% y/y (vs. +5.5% in August), the second lowest rate since January 2022. Among the main components of spending, food and beverage prices experienced the highest growth: 9% y/y (from 10.1% in August), while, on the opposite side, education and communication services recorded the lowest rate of growth among the HCPI items (+1.5% and -0.3% y/y, respectively). Contrary to most forecasts, in Q2 2023 house prices increased by 2.0% q/q and by +0.7% y/y (after +1.0% y/y in Q1 2023). This trend is attributable both to the prices of new homes, which grew by 0.5% y/y (+5.3% in Q1 2023), and to those of existing ones, which rose by 0.8 % y/y (+0.3% in Q1 2023). The carry-over effect for 2023 house prices is +1.4% (+3.8% for new homes and +0.9% for existing ones).

GROWTH & INFLATION

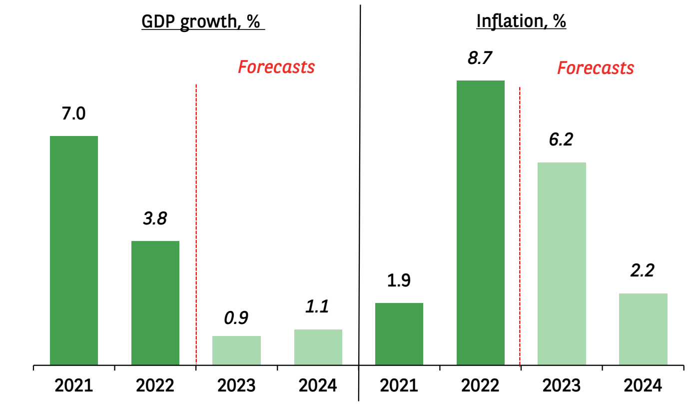

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

House prices growth was quite heterogeneous between the different areas of the country: in the North-West regions, house prices continued to grow (+2.5% y/y in Q2 2023 from +2% in Q1), while in the North-East they slowed down (+1.1% y/y from 1.9% in Q1). Regions in the Center and the South, on the contrary, recorded negative growth: -0.7% and -1.5% respectively on a yearly basis (from +0.1% and -0.7% in the previous quarter). House prices have continued to grow in all cities where the Index is monitored by Istat. In Milan in particular, prices accelerated (+7.1% y/y in Q2) from the previous quarter (+5.8%), while in Rome it slowed (+0.6% from +1.9% in the previous quarter). These trends occur in the context of marked decline in trading volumes that in Q2 decreased by 16.0% on a national basis (-8.3% y/y in Q1).

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SPAIN

THE ECONOMY IS HOLDING UP WELL, PEDRO SANCHEZ TOO

Until this summer, the Spanish economy had proved resilient to the interest rate shock. Private consumption and investment were up respectively, 2.7% y/y and 2.0% in Q2 2023. The positive trend in the labour market and the savings accumulated during the pandemic supported household spending, along with the decline in inflation, which allowed purchasing power to stabilise. However, these supports are falling off. Economic activity will slow in H2 2023 but will not come to a standstill. However, with growth now forecast at 2.2% in 2023 as a whole, Spain will remain one of the drivers of the euro zone this year.

The end of the year will continue to be driven by political developments, with the attempt to form a new coalition government. Leader of the People's Party (PP), Alberto Núñez Feijóo, whose party won the general election on 23 July (137 seats), failed to obtain the required majority of 176 seats during the voting on 26 and 27 September in Parliament. The ball is now in the court of the Socialist Party (PSOE) and the current Prime Minister, Pedro Sánchez, who has until 27 November to secure a majority, before a new vote in Parliament. While an agreement between the PSOE (121 seats) and Yolanda Díaz's new Sumar party (31 seats) has been secured, the mustering of the independent parties (ERC, Junts, Catalan European Democratic Party, DeCat), which had joined forces with the PSOE to form a coalition in 2019, is proving problematic: it would imply that Pedro Sánchez is making a move and deciding to grant amnesty to several senior Catalan independence politicians. The Spanish left is divided on this matter. If this fails, new parliamentary elections will be held on 14 January 2024.

Should a new vote take place, it would occur in a less buoyant economic context than in July. Job creations have started to stall, with a gain of just 0.1% between May and August[1], following a very strong increase in H1. The deterioration in the economic situation in Europe along with the rise in labour costs (estimated by the INE at 5.7% y/y in Q2), are beginning to impact companies' recruitment decisions. However, some industries are still hiring, thanks to structurally-rising demand. This is the case for information and communication (+5.8% y/y), healthcare (+3.2% y/y) and transport and logistics (+4.3% y/y).

After reaching a low of 1.9% in June, inflation is heading higher again, driven in particular by the increase in oil prices. The latter is being quickly passed on to fuel prices, which jumped by 5.7% m/m in August. Unfavourable base effects are also playing a role. The rate of disinflation in energy prices is expected to slow sharply in the second half of the year. Furthermore, inflation in services is not slowing down (4.7% y/y in August, excluding rents), and growth in base wages, although relatively contained, has now overtaken inflation. The increase in wages negotiated in sector agreement was 3.4% y/y in August.

The housing market is proving more resilient than expected to the rise in interest rates, and prices are still rising at a sustained pace (+5.3% y/y in August, according to Tinsa). Mortgage rates have continued to rise, reaching an average of 4% this summer. This remains much lower than the level reached during the last phase of interest rate hikes in 2006-2008, when rates topped 6% (INE). However, household borrowing has been steadily contracting for almost a year, though non-performing loans and even more so foreclosures, have remained at historically low levels. Although slow to materialise, a sharper deterioration in the housing market is a concern, because of the delay in the effect of monetary tightening on the economy.

GROWTH & INFLATION

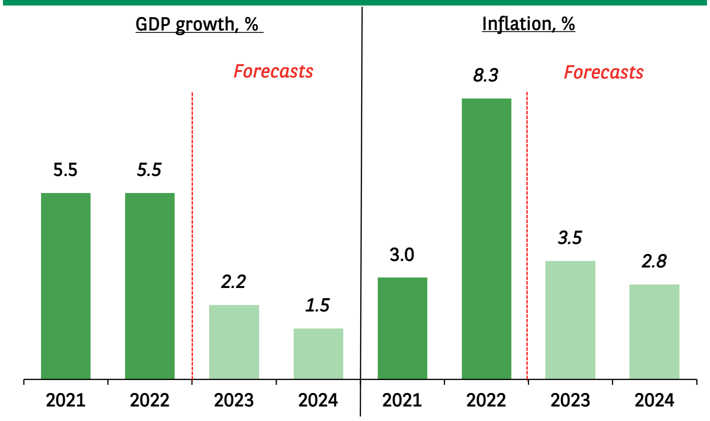

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Nevertheless, the economy is looking more resilient to the interest rate shock today than it was fifteen years ago. Household debt has fallen sharply since then, even after an upturn observed during the health crisis: at 83.4% of disposable income in Q1 2023, household debt was at its lowest level in ten years and more than 50 percentage points below the 2008 peak (135.5%).

As a result, the slowdown in Spanish growth should be moderate in H2 2023, with an expected increase in Q3 and Q4 of 0.3% q/q and 0.2% q/q respectively. Furthermore, in mid-September, the INE revised the GDP data for the period 2020-2022. Real GDP growth has been revised to 6.4% in 2021 and 5.8% in 2022, compared to an increase of 5.5% initially reported for both years. While not significant, these adjustments indicate that the post-Covid upturn in activity has been more pronounced, which is more in line with the positive trend in the employment data.

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1 Source: Spanish State Public Employment Service (SEPE).

BELGIUM

WINTER IS COMING

Negative revisions to GDP figures have darkened the mood of the Belgian economy. We expect GDP to remain flat throughout the second half of this year as monetary policy does its job. Short-term volatility in inflation numbers looks likely, resulting in a temporary bout of deflation near year's end. The labour market remains in good health, suggesting a soft landing is in the cards. Successful government bond emissions could tempt some last-minute pre-election spending by the De Croo-government, but the long-term outlook for public finances remains bleak.

The Belgian economy has been on a downward trajectory since the start of the year, with quarterly growth slowing down from 0.4% q/q in Q1 to 0.2% q/q in Q2. This was further emphasised by downward revisions to the NBB's outlook, as monetary policy starts to bite. While our latest nowcast suggests +0.1% q/q growth in Q3, we expect GDP to remain more or less flat in the second half of 2023. We do not think a recession is likely. A gradual normalization should occur in 2024.

CORE INFLATION REMAINS ELEVATED

Inflation on a yearly basis, as measured by the HICP, came in at 2.4% in August, ending the trend of declining inflation that started late last year. The HICP stood at its highest level this year, but is still almost 3% below the October 2022-peak. Core inflation actually declined over summer but remains elevated (6.1%). Food prices keep on rising, however, as has been the case for the better part of the last two years with average monthly food inflation of 1.0%. Energy prices, near their lowest level in 12 months, continue to drag headline inflation down. Due to the technical treatment of household-support measures related to energy bills, Belgium could experience deflation briefly at the end of this year, followed by a temporary uptick in total inflation. By the end of 2024, inflation should be close to, but above 3.0%.

GROWTH & INFLATION

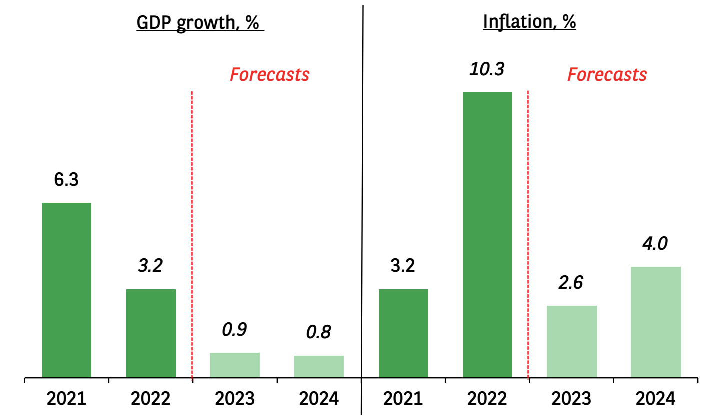

CHART 1

SOURCES: BNP PARIBAS GLOBAL MARKETS

A STABLE LABOUR MARKET

Despite the general economic slowdown, the unemployment rate has barely budged. It stood at 5.7% in the latest figures, on par with its pre-pandemic level of early 2019. Job-creation did seem to slow down early this year, as quarterly employment growth came down from 30,000 jobs at its peak to 15,000, returning to trend in the process. Vacancy rates remain elevated but did drop off somewhat, as is the case in neighbouring countries. Perhaps the current situation is best summarised by the Federgon Index, which captures demand for temporary labour. This index did experience a significant drop at the start of the pandemic but recovered equally fast. Zooming out, however, it becomes clear that temporary labour had been first cooling off and trending down since 2019 already. The current state of the labour market thus resembles a classic, cyclic slowdown.

More importantly, so far, it looks like a soft landing. Having recovered from the double hits of the COVID and energy crises, consumer confidence remains close to its long-term average. Households are moderately positive about their financial situation, likely spurred on by a significant wage indexation and the inflation cool-down.

Meanwhile, the real estate market is expected to further cool, with new mortgage applications falling by around a third compared to last year. Price levels haven't really sunk much though. In fact, they rose somewhat according to the latest BIS-numbers, with the NBB pointing out that this might be a temporary consequence of changes in composition.

Business sentiment stabilised after four consecutive months of decline, according to the NBB's latest confidence barometer. Underneath this headline number, different sectors are experiencing diverging fortunes. Firms active in the trade sectors are reporting improved outlooks for both the demand and the supply side. Constructors, however, are reportedly hit by diminished demand, no doubt a result of rising interest rates. Bankruptcies for the economy as a whole are still 10% below pre-COVID levels, on a 12-months-moving average basis. That is not the case for all types of business as especially those in manufacturing, construction, transporting and warehousing currently seem to be undergoing something of a purge.

After successful bond emissions, thisunexpectedly strong appetite from investors implies – for most observers – that the De Croo government now finds itself in an interesting position, as its financing needs for this year have been more than met. Overall public finance remains in dire straits however. The budget deficit, which came in at close to 4% last year, looks set to increase further, even as temporary COVID and energy-crisis related measures now take up a smaller share of the total budget. In the current high rate environment, the interest-rate snowball effect is re-emerging. Under conservative assumptions, the debt ratio looks set to increase by more than one percentage point per year, from an already high 105%.

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UNITED KINGDOM

CLOUDS ARE GATHERING

The UK economy shows increasing signs of deterioration. An upturn in unemployment is visible, and the PMI employment data fell sharpy in September. The consequences of monetary tightening are spreading and no sector has been spared; first and foremost, the housing market and even the public sector, recently shaken by the bankruptcy of several councils, including the city council of Birmingham, the country's second largest city. While inflation in the UK is falling, it remains high compared to its European neighbours, notably due to stronger wage increases. However, the Bank of England is not expected to raise the Bank rate again, even though the vote in September (when a hike was expected) was decided by a single vote. The scenario of a recession in H1 2024 remains our central forecast, followed by a slight recovery in activity linked to the start of the cycle of lower interest rates. We expect to see this from Q2 2024 onwards.

The upward revision by the ONS of GDP for 2020-2022 will have given the UK a bit of good news. The contraction of activity in 2020 was revised lower, from -11.0% to -10.4%, while the upturn in 2021 was more significant, up from +7.6% to +8.7%. A full recovery of the activity lost during the pandemic, which had not yet occurred by the summer of 2023 according to previously available data, was actually achieved as early as the last quarter of 2021. However, the economic situation in the UK remains challenging. The country is facing one of the hardest growth-inflation trade off among developed countries.

The reversal of the labour market seems to have begun. After reaching a low of 3.5% in August 2022, the unemployment rate (3m/3m) rose to 4.3% in July 2023. The increase is likely to continue in the second semester. In addition, PMI employment data deteriorated significantly in September: the composite employment index fell by 4 points to 46.4, the biggest monthly drop since the start of statistics in 2007. This indicator for the manufacturing sector had already been significantly below the expansion threshold for several months (46.3 in September). The services index is now falling (-4.8 points, to 46.4 in September), which is consistent with the strong increase in wages in the sector, which is forcing companies to make wage bill adjustments by reducing the volume of jobs.

At 6.3% in August, the one-year increase in the consumer price index (CPI) is now lower than the increase in regular wages in the country (7.9% y/y). Nevertheless, rising interest rates continue to exert pressure on household purchasing power. According to the Retail Price Index (RPI), which includes interest payments on mortgages, these payments were up by more than half within a year (+60.3% y/y in August), accounting for 1.8 percentage points of the increase in the RPI, i.e. nearly half of the gap between the CPI and the RPI, which had posted a rise of more than 9% y/y in August[1]. The CPI, which only takes into account changes in rents, considerably underestimates the drop in purchasing power of UK households who have taken out mortgages, of which the cost of repayment has soared.

These difficulties are not confined to the private sector. Some councils - and not the smaller ones - have had to activate Section 114 in recent weeks for towns and cities that are unable to meet their financial commitments. This is the case in Birmingham, the country's second largest city; but it's not the only one, because councils in Greater London (Croydon, Thurrock and Woking) have had to use this aid mechanism, which could lead to intervention by central government.

GROWTH & INFLATION

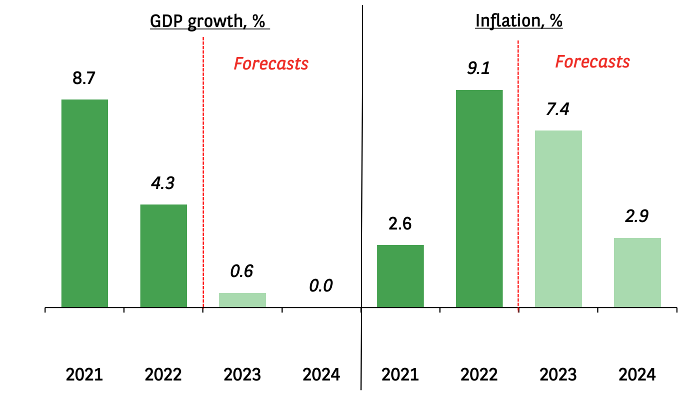

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The slowdown in inflation and activity played in favour of keeping the Bank rate at 5.25% in September. However, the vote was very close, with four out of ten committee members voting for an increase of 25 bps to 5.5%. While we do not predict any further rate hikes in the future, the pace of a drop in interest rates in H1 2024 should prove slower than previously expected. However, we maintain our forecast that interest rate will be at 4% by the end of 2024. The replacement in early November of John Cunliffe, who was in favour of an increase of 25 bps in September, by Sarah Breeden, could provide more weight to the MPC "doves", thereby confirming our scenario of a terminal rate reached in September.

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1 The remainder of the difference between the RPI and the CPI (0.95 pp) can be explained both by the inclusion in the RPI of other housing-related indicators (council tax, home insurance) and differences in data aggregation formulas. This explained, respectively, 0.5 pp and 0.8 of the difference between the RPI and the CPI.

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2021	2022	2023 e	2024 e	Inflation 2021	2022	2023 e	2024 e
United-States	5.9	1.9	2.2	0.4	4.7	8.0	4.1	2.3
Japan	2.3	1.0	2.0	1.0	-0.2	2.5	3.2	2.6
United-Kingdom	8.7	4.3	0.6	0.0	2.6	9.1	7.4	2.9
Euro Area	5.6	3.4	0.5	0.9	2.6	8.4	5.6	2.8
Germany	3.1	1.9	-0.3	0.3	3.2	8.6	6.2	3.0
France	6.4	2.5	0.7	0.5	2.1	5.9	5.8	2.7
Italy	7.0	3.8	0.9	1.1	1.9	8.7	6.2	2.2
Spain	5.5	5.5	2.2	1.5	3.0	8.3	3.5	2.8
China	8.4	3.0	5.1	4.5	0.9	2.0	0.5	2.0
India*	9.1	7.2	6.1	6.0	5.5	6.7	5.9	5.0
Brazil	5.0	2.9	3.1	1.8	8.3	9.3	4.7	4.2

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

SOURCE: BNP PARIBAS (E: ESTIMATES)

FINANCIAL FORECASTS

Interest rates, %		2024				
End of period		Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024
US	*"Fed Funds (upper limit)"*	5.50	5.50	5.25	4.75	4.25
	T-Note 10y	4.20	4.05	3.95	3.90	3.90
Eurozone	deposit rate	4.00	4.00	3.75	3.50	3.25
	Bund 10y	2.60	2.45	2.40	2.30	2.35
	OAT 10y	3.17	2.99	2.93	2.85	2.92
	BTP 10y	4.50	4.25	4.10	4.10	4.25
	BONO 10y	3.70	3.45	3.35	3.30	3.40
UK	Base rate	5.25	5.25	5.00	4.50	4.00
	Gilts 10y	4.00	3.80	3.60	3.65	3.70
Japan	BoJ Rate	-0.10	-0.10	0.10	0.10	0.25

Exchange rates		2024				
End of period		Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024
USD	EUR / USD	1.10	1.11	1.12	1.13	1.15
	USD / JPY	145	145	140	138	135
	GBP / USD	1.29	1.29	1.29	1.30	1.32
EUR	EUR / GBP	0.85	0.86	0.87	0.87	0.87
	EUR / JPY	160	161	157	156	155

SOURCE : BNP PARIBAS GLOBAL MARKETS (E ESTIMATES)

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