ECOPERSPECTIVES

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"REFLECTING JEROME POWELL'S STATEMENT THAT IT IS TIME TO ADJUST (I.E., LOOSEN) MONETARY POLICY AND SUBSEQUENT ACTION, IT IS ALSO TIME TO ADJUST FISCAL POLICY IN EUROPE AND THE UNITED STATES, IN THE DIRECTION OF TIGHTENING IN BOTH CASES. THIS IS A GOOD TIME, GIVEN THE CONTEXT OF MONETARY EASING, FALLING INFLATION AND POSITIVE ECONOMIC GROWTH. EVEN MORE THAN MONETARY EASING, THIS FISCAL CONSOLIDATION MUST BE GRADUAL SO AS NOT TO WEIGH TOO MUCH ON GROWTH."

ECONOMIC RESEARCH

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TABLE OF CONTENT

EDITORIAL

Reflecting Jerome Powell's statement that it is time to adjust (i.e., loosen) monetary policy and subsequent action, it is also time to adjust fiscal policy in Europe and the United States, in the direction of tightening in both cases. This is a good time, given the context of monetary easing, falling inflation and positive economic growth. Even more than monetary easing, this fiscal consolidation must be gradual so as not to weigh too much on growth. Like the central banks that have been determined in their response to the inflationary shock, governments will have to show the same determination and perseverance in the coming fiscal consolidation efforts, given their necessity and significance.

THE TIME HAS COME FOR FISCAL POLICY TO ADJUST

Reflecting Jerome Powell's statement that it is time to adjust (i.e., loosen) monetary policy and subsequent action, it is also time to adjust fiscal policy in Europe and the United States, in the direction of tightening in both cases. This is a good time, given the context of monetary easing, falling inflation and positive economic growth. Even more than monetary easing, this fiscal consolidation must be gradual so as not to weigh too much on growth. Like the central banks that have been determined in their response to the inflationary shock, governments will have to show the same determination and perseverance in the coming fiscal consolidation efforts, given their necessity and significance.

The question of the need for fiscal consolidation is not new. The magnitude of fiscal imbalances that have accumulated over the years in numerous developed countries has already justified taking action for some time, to regain room for manoeuvre and ensure that public debt ratios remain sustainable. Nor is the issue of the difficulty of undertaking such consolidation a new one, with regard to the choice of measures and considering the negative economic impact. The purpose of this editorial is to outline the terms of this debate and to point out that now is a good time to consolidate, because the tightening of fiscal policy can take place in parallel with the easing of monetary policy that has already begun, allowing the former's negative effects on growth to be cushioned by the latter's positive effects.

AN ADJUSTMENT IS NEEDED WITHOUT FURTHER DELAY

There is no doubt about the need for budgetary consolidation in the light of the deteriorated state of public finances. Of course, the scale of the budgetary imbalances to be addressed varies from country to country. The US budget deficit is extremely large (8.4% of GDP in 2023) and the public debt ratio stands at 124%, up 16 points of GDP compared to 2019[1]. In Europe, behind the aggregate figures (fiscal deficit of 3.5% in 2023, public debt ratio of 83%, up 4 points compared to 2019), the picture is mixed. Some of the low achievers of yesterday are no longer so: Greece, Portugal and Ireland have large primary surpluses and their public debt ratios are falling sharply, while Spain's budget deficit is about to fall below 3%. These good results can be attributed to (imposed) fiscal consolidation efforts and currently stronger growth. On the other hand, eight countries – Belgium, France, Italy, Malta, Slovakia, Romania, Hungary, and Poland – are subject to an excessive deficit procedure by Brussels and face significant budgetary adjustments. The new rules on European budgetary governance certainly give a little more time and flexibility to make these adjustments, but the intention is precisely to strengthen the credibility of the requested budgetary discipline. For these countries and the United States as well, the problem is not so much the level of government debt ratios as their upward trajectory, which must at least be interrupted and stabilised. It is also essential to regain room for budgetary manoeuvres.

Fiscal consolidation should also help in reducing the significant tensions between monetary and fiscal policy that formed since the 2008 financial crisis. Bolhuis et al. (2024)[2] measure these tensions by the difference between the neutral rate of monetary policy and the same concept applied to fiscal policy[3]. This fiscal r* can be considered as a ceiling of the real interest rate above which the debt trajectory can become explosive. Yet, since the early 2000s, this fiscal r* has fallen sharply, more than the monetary r*. The gap between the two (monetary r* minus fiscal r*) has thus become less and less negative, to almost zero by the end of 2022, its highest level since the 1950s, in their sample of 16 advanced countries. The lower the neutral fiscal rate, the smaller the room for manoeuvre to run a fiscal deficit. Since historically such tensions in the policy mix tend to be followed by negative economic consequences, an adjustment of the policy mix is necessary to reduce them. Budget consolidation would contribute to this by raising the neutral budgetary rate.

THIS IS A GOOD TIME TO ADJUST

An important facilitating factor: the evolution of the famous r-g gap appears to be favourable for such fiscal consolidation efforts. As already noted in a previous publication[4] – and underlined by the Bank of France with respect to France and true for other countries – "The upcoming period of gradual recovery and monetary easing is not unfavourable to the necessary fiscal consolidation needed to bring public debt under control."[5] In other words, this is the right time to implement a measured countercyclical fiscal adjustment. The negative effects of fiscal consolidation on activity will be mitigated by the positive effects of policy rate cuts. The recovery in the Eurozone would be limited, but not prevented, while in the United States, if there is fiscal consolidation – which does not seem to be in the air – it would participate opportunely in the slowdown of the economy, which remains dynamic in many respects[6]. It seems to us that it is not common for the evolution of the policy mix to appear so adapted to economic conditions. One might wish for an even more favourable outcome if there were explicit consultation and coordination of the joint action by monetary and fiscal authorities.

1 AMECO data.
2 Mind the gap: Gauging fiscal-monetary tensions through fiscal r-star | CEPR, 29 September 2024 ; Fiscal R-Star: Fiscal-Monetary Tensions and Implications for Policy (imf.org), 9 August 2024.
3 Fiscal r* is the real interest rate that stabilises a country's debt-to-GDP ratio given its primary deficit path when output is growing at its potential and inflation is at target. When fiscal and monetary r* are equal, policymakers can simultaneously stabilise debt and keep inflation at the target.
4 Eco Perspectives 3rd quarter 2024– Economic Research – BNP Paribas, Editorial | Economic outlook in the face of uncertain election outcomes (bnpparibas.com), 2 July 2024.
5 Macroeconomic projections – June 2024 | Banque de France (banque-france.fr), 11 June 2024.
6 For an overview of our baseline scenario, see Soft landing in sight, but don't unbuckle seat belts yet (bnpparibas.com), 30 September 2024. For a more detailed view of the economic situation and outlook in the large and some small OECD countries as well as in China, please refer to the various texts in this issue of *EcoPerspectives*.

GRADUALISM AND TARGETING ARE NEEDED

There are plenty of reasons to tackle current fiscal imbalances. There is also a consensus on the need to tackle them gradually. It is a question of demonstrating proportionate budgetary rigour and not of implementing an austerity policy so as not to repeat the mistakes of the early 2010s forced march during the European sovereign debt crisis. This is one of the messages put forward by the OECD, which in its latest economic outlook advocates for a return to fiscal discipline (the sooner the better) but not a return to austerity[7].

What is at stake is the means of carrying out budgetary consolidation, which levers will be activated in terms of tax increases and spending savings and cuts, knowing that it is not possible not use one of the two. The challenge is to identify and implement the most effective measures to reduce the deficit quickly and sustainably with the least economic, social, and environmental damage in the short and long term. In Europe, in particular, one way to minimise the negative impact on growth could be to implement measures that can unlock the still significant household savings surplus. Without going so far as to talk about growth-supportive consolidation, the idea is to have as credible a consolidation strategy as possible to ensure that households are as Ricardian as possible, i.e., draw on their savings at present by anticipating tomorrow's tax cuts. It is a difficult task and a balancing act for governments, but their fiscal adjustment programmes can be judged against these different criteria.

In conclusion, although this issue of budgetary consolidation concerns many countries, only Europe seems ready to commit itself resolutely to it, which is to be welcomed. The United States is facing huge fiscal imbalances that do not give the impression of being under control. Moreover, neither presidential candidate has a clear desire to engage on fiscal consolidation. US fiscal policy risks remaining accommodative rather than becoming restrictive, and this is an issue. US growth would be supported, more or less depending on the candidate, but does it really need such a support (apart from the one already provided by lower interest rates) at the cost of further weakening public finances and increasing the risk of financial stress. This concern is also true for China, which recently announced a major fiscal stimulus for its economy. This support is certainly necessary, but it must not obscure the fact that the country is also confronted, even if a priori to a lesser extent than the United States or Europe, with significant budgetary imbalances (Chinese statistics are lacking in readability and transparency).

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7 OECD presses governments on fiscal discipline, 'but not austerity' (ft.com), 25 September 2024 ; OECD Economic Outlook, Interim Report September 2024 | OECD, 25 septembre 2024.

UNITED STATES

POWELL'S LEGACY

On 18 September, the Federal Reserve (Fed) decided to lower its target range to +4.75% - +5.0% (-50 bps), initiating an easing of rates that looks set to continue during upcoming FOMC meetings. The direction of the movement is driven by the simultaneous slowdowns in the labour market and inflation. The scale of this movement aims to maintain a dynamic economy and falls within a broad and unprecedented interpretation of its dual mandate. Our baseline scenario suggests that disinflation will continue during the projection period with no recession in the meantime. At the same time, the United States is heading towards an even more significant presidential election than usual.

US growth accelerated in Q2 2024, with GDP growth of +0.7% q/q (+0.3pp compared to Q1), mainly driven by household consumption (0.5pp). At the same time, residential investment fell (-0.5% q/q), bringing three consecutive quarters of improving figures to an end. It is the only GDP component which is still (in volume terms) below its pre-COVID level. The Atlanta Fed's GDPnow indicates that growth has remained at +0.7% q/q in Q3. However, following Q3, we are expecting it to slow down to +0.4% - +0.5% in the coming quarters. In addition, we are forecasting an average annual growth rate of +2.6% in 2024 (+0.1 pp y/y), which is above the long-term estimates (+1.8%, according to the Fed).

Retail Sales Control Group data in July and August suggest that Q3 should confirm that growth in consumption has been continuing throughout the monetary tightening, in contrast to residential investment, i.e. the other interest-sensitive GDP component. However, the start of rates easing (see below) does not mean that all constraints on households are relaxing. In particular, the increase in rates has so far most notably resulted in a dramatic fall in mortgage applications, which is why the increase in the average rate on outstanding mortgages was small between Q4 2021 (3.9%) and Q1 2024 (4.1%). The delayed effects of the monetary tightening are expected to continue to be seen through the credit channel as mortgages are renewed, while the average 30-year rate is not expected to fall below 5.5% by 2026 (a significantly higher level than prior to the COVID-19 pandemic). Conversely, income continuing to catch up on inflation is expected to contribute a positive effect, while average real disposable income rose in 2023 (+4.0% y/y) for the first time since 2019 and the developments in average hourly wages and inflation in 2024, to date, point to further gains this year.

GROWTH AND INFLATION

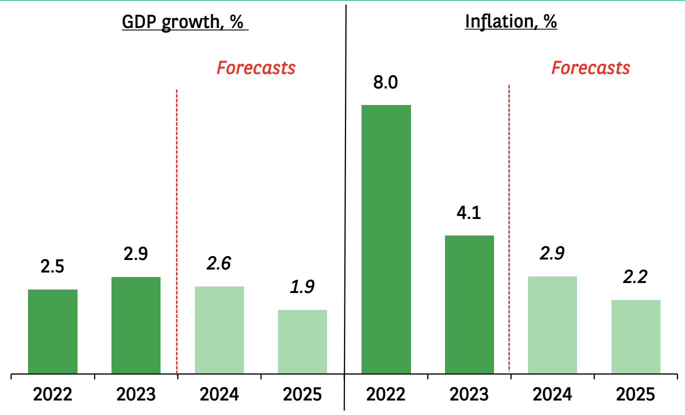

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PROTECTING THE SOFT LANDING

The September FOMC meeting resulted in the target range being lowered by 50 bps to +4.75% - +5.0%. The start of the easing cycle is due to the combined slowdown in inflation and the labour market, which is leading to more balanced risks around the dual mandate. Inflation (measured by the CPI) stood at +2.6% y/y (momentum of +0.9%) in August 2024, with an underlying index standing at +3.3% y/y (+1.9%). The Fed feels increasingly confident about inflation returning to its 2% target. The "unmistakable" labour market cooling, in the words of Jerome Powell, can be seen in particular in the nonfarm payroll growth slowdown (annual monthly average of +210k in September 2024, compared to +601k in Q1 2022, i.e. at the start of monetary tightening) and in the falling vacancy/unemployed persons ratio (1.1, compared to 1.9).

The decision to recalibrate monetary policy with the explicit objective of maintaining a dynamic economy (in other words, an economy where there are no substantial fears of an imminent sharp slowdown) is unprecedented. Indeed, the continued disinflation trajectory with no GDP contraction has remained the central scenario for forecasters, with no flying start to the monetary easing cycle, which traditionally only occurs during periods of severe contraction (September 2007 and March 2020). If the soft landing really was to materialise this year and next year, Jerome Powell, who congratulated the Fed for "restoring the balance between aggregate supply and demand, easing inflationary pressures and ensuring that inflation expectations remain well anchored", would become associated with a rare soft landing occurrence in American economic history. Its unorthodox new approach to upholding the dual mandate could also be a textbook case for conducting monetary policy in the post-pandemic era. However, the factors behind disinflation, including the effective role of monetary tightening, will continue to fuel academic debate.

THE 2024 PRESIDENTIAL ELECTION: WHAT ROLE WILL THE ECONOMY PLAY?

The 2024 presidential election will be contested between former President Donald Trump (Republican) and outgoing Vice-President Kamala Harris (Democrat). Despite social issues dominating debates, economic issues are still critical. Therefore, the main economic issues of the election include, in particular, the federal government's budgetary trajectory, while the elected president will have to appoint the successor to Jerome Powell as the Chair of the Fed in 2026. Finally, the perception of the incumbent administration's economic record will also play a role in the result, as the election is being held against the backdrop of a mismatch between public sentiment and the country's macroeconomic performance. In August 2024, 41% of Americans cited an economic issue when asked about "the major issue facing the nation", compared to 9% when Joe Biden took office. While polling puts Harris ahead of Trump nationally, winning in key battleground states (Arizona, Georgia, Michigan, Nevada, North Carolina, Pennsylvania and Wisconsin) will be decisive.

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NEW IMPETUS

In China, economic activity data of the last few weeks has been bad enough to shock the authorities into action. While support for domestic demand had remained stubbornly cautious for several months, the last week of September saw a succession of announcements of new monetary easing and then fiscal stimulus measures. This change in policy direction reduces, but does not eliminate, the downside risks to short-term economic growth. If the fiscal expansion plan, the precise content of which has yet to be specified, is implemented quickly, the growth target of "around 5%" set by Beijing for 2024 could be achieved.

LACK OF VIGOUR

China's economic growth remained sluggish over the summer. The slowdown seen in August, in both the industrial and services sectors, is likely to have continued into September, given the latest PMI indices. Industrial activity (+4.8% y/y in July-August, after +6% in H1 2024) was hampered by the slight fall in automobile production and by the more severe decline in heavy industries such as steel and cement. In contrast, electronic goods production remained buoyant, driven by the still rapid rise in exports. However, the outlook for exports is starting to look bleaker, due to the tariff barriers applied to Chinese goods by a growing number of developed and emerging countries.

In services, activity grew by +4.7% y/y in July-August, compared to 4.9% in H1 2024. Household consumption and private investment have remained depressed, and the crisis in the property sector has continued, despite the support measures implemented last spring. These measures have not revived demand for housing: mortgage lending has continued to fall slightly, and floor space sold has continued to fall (-18% y/y in the first eight months of 2024). Households are suffering negative wealth effects as a result of the fall in house prices (property assets accounted for 70% of the wealth of urban households at the start of the crisis in 2021). Added to this is the deterioration in conditions on the labour market. The urban unemployment rate rose to 5.3% in August, compared to 5% in June, and the unemployment rate for 16-24-year-olds rose sharply (from 13.2% in June to 18.8% in August) as a new crop of university graduates entered the labour market.

Against this backdrop, deflationary pressures have persisted, fuelled by the imbalance between weak domestic demand and industrial production overcapacity, falling property prices, slower wage growth and declining global commodity prices. In August, the consumer price index rose 0.6% y/y, but core inflation hit a low of 0.3%, and the production price index fell (-1.8% y/y) for the 23rd consecutive month.

GROWTH AND INFLATION

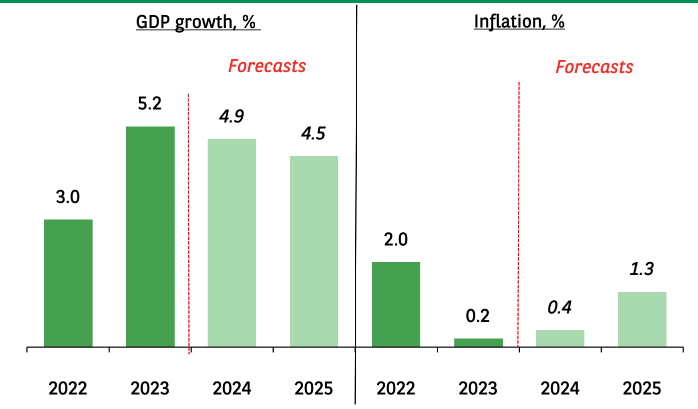

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

WILL THE NEW STIMULUS MEASURES BE ENOUGH?

The authorities' strategy of very gradual economic policy easing has become clearly insufficient due to the weak confidence in the private sector (including households, enterprises, and financial investors), continued deflationary pressures, the pressing problem of youth unemployment, and the prospects of a slowdown in goods exports. After deciding on 20 September to leave policy rates unchanged, four days later the authorities announced a package of monetary easing measures (including cuts in the reserve requirement ratios and benchmark interest rates), support for the property sector (reduction in the mortgage minimum downpayment ratio and cuts in new and existing mortgage rates, increased financing to state entities for the purchase of unsold homes), and support for the equity markets (financing facilities to financial institutions and companies for the purchase/buyback of shares).

These measures are in line with previous ones and are not, on their own, likely to reinvigorate private consumption or reverse the property market correction and the credit growth slowdown. Household pessimism, large stocks of unsold or unfinished homes, and the solvency or liquidity problems of many property developers remain powerful brakes. However, the monetary and financial measures were followed by the announcement of a (still to come) fiscal support plan, which could be a turning point if it is implemented quickly and effectively focuses on stimulating private consumption.

The central government may be considering issuing additional bonds totalling between RMB 2,000 billion and RMB 3,000 billion (1.5% to 2.3% of GDP) to finance various measures to help households, support local governments and recapitalise state-owned banks. The timetable and details of the measures are yet to be specified. If confirmed, the direct support given to household incomes and consumption (for example, through living subsidies and consumption vouchers) would represent a change of direction in fiscal policy, which has traditionally relied on property and investment projects to stimulate activity.

In addition, by announcing all the measures in the same week, the authorities also broke with their usual incremental approach and surprised the markets. The markets reached a low point in mid-September and then rebounded strongly. Between 20 and 30 September, the CSI 300 stock market index rose 26%, returning to its average level for H1 2023 (still 20% below its average level for 2021). The yuan also appreciated rapidly against the USD, approaching the threshold of RMB 7 per USD on 30 September, its strongest level for sixteen months. This rebound in the markets may bode an improvement in Chinese business and consumer sentiment. If it is implemented effectively and quickly, the authorities' new stimulus plan could have a positive impact on incomes and confidence, which is a prerequisite for stabilising, or even strengthening, economic activity in the short term.

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JAPAN

THE CALM AFTER THE STORM

The Bank of Japan is continuing with its incremental and cautious monetary tightening, with a single policy rate hike in Q3, which is expected to precede further movement in December, while the July decision has contributed to major financial market volatility. At the same time, the economy is recovering from a turbulent start to the year and inflation is still above the 2% target. In addition, the country has a new Prime Minister and early general elections are now scheduled for October 27th.

The Japanese economy rebounded significantly during Q2 2024, with GDP growth of +0.7% (in line with our forecasts), following the Q1 contraction (-0.6% q/q). Growth is expected to slow during the second half of the year, but will remain in positive territory (+0.2%-+0.3% q/q). Nevertheless, due to the negative carry-over effect for 2023 (-0.3 pp), in addition to Q1 data, 2024 is ultimately expected to see a negative average annual growth rate (-0.2%), i.e. a marked decline on 2023 (1.7%).

The growth in Q2 2024 is partly attributable to a technical rebound after the specific contingencies that disrupted activity at the start of the year, such as the earthquake on the Noto peninsula and disruptions to automotive production. However, the latter has still not caught up on its level at the end of 2023 (down -12.7% q/q in Q1 2024, before increasing +7.7% in Q2). Nevertheless, there are positive points to highlight, particularly in relation to private consumption, as its increase of +0.9% q/q has brought to an end four consecutive quarters of contraction. In addition, while foreign trade is once again making a negative contribution to growth, it is less important this time, with exports and imports increasing after their simultaneous declines during Q1. Therefore, although the relatively substantial variability of this GDP component (compared to domestic demand) should be noted, exports, which are Japan's principal growth driver, are recovering, while the increase in imports points to some kind of renewed demand.

Core inflation has been on the rise since the start of Q2, increasing from +2.2% to +2.8% y/y between April and August. Services prices slowed over the same period (from +1.7% to +1.4%), but have accelerated in month-on-month terms over the last two months. Nominal wages rose as the increases negotiated as part of the Shunto were implemented, helping real wages to post two consecutive months of year-on-year improvement in June and July 2024 for the first time since Q1 2022 (+1.1% and +0.4%), providing grounds for improved expectations around household consumption.

THE MONETARY EXCEPTION

The Bank of Japan (BoJ) is continuing with its incremental monetary tightening, in contrast to its G7 counterparts, after ending its negative interest rate policy at the start of the year. The detailed quantitative tightening plan, which involves almost halving the monthly Japanese Government Bond (JGB) purchase pace by Q1 2026, was presented during the July monetary policy meeting. The second hike in the key rate, the uncollateralised overnight call rate, to +0.25% (+0.15pp), also occurred during this meeting. This movement surprised observers and markets, contributing to renewed volatility on the markets at the start of August, illustrated by the VIX index soaring to its highest level since March 2020.

While the Governor of the BOJ, Kazuo Ueda, played down the relationship between the July decision and the financial market fluctuations in early August, officials (including Ueda) admitted that they should be taken into account in the tightening trajectory. Therefore, there were no changes

GROWTH AND INFLATION

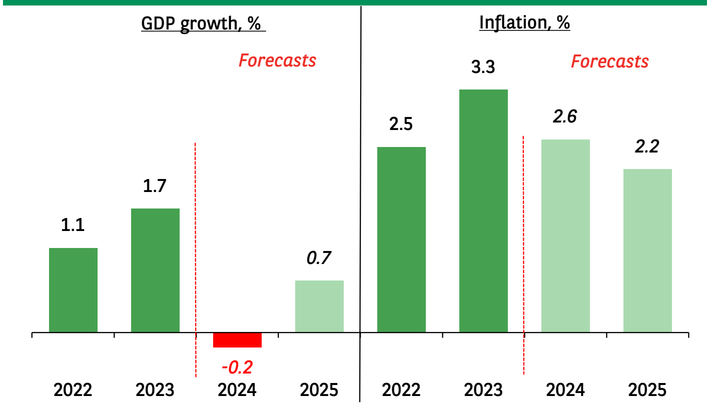

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

to the key rate during the September meeting. In addition, Kazuo Ueda reiterated the BoJ's intention to continue to hike its key rate and adjust the level of monetary policy easing. We anticipate a further rate hike during the December meeting (+0.25 pp), with the upward trajectory then gradually continuing towards neutral in 2025, i.e. three increases in the uncollateralised overnight call rate, taking it to +1.25% at the end of the year.

In addition, the yen has generally strengthened against the US dollar in recent weeks, with the USD/JPY falling from over 160 at the start of July to 143 on 23 September. As the interest rate spread with the Fed narrows, we expect the relative value of the JPY to improve further during the quarters ahead, with USD/JPY standing at 131 by Q4 2025.

POLITICAL CHANGES

The outgoing Prime Minister, Fumio Kishida (who was in office since October 2021), announced that he would not seek re-election as leader of the Liberal Democratic Party (LDP), meaning that he would be standing down from his government role after the election on 27 September. Kishida came to this decision against a backdrop of declining popularity and scandals surrounding his party. The campaign to elect his successor has resulted in the appointment of Shigeru Ishiba (former Secretary General of the LDP), who beat Shinjiro Koizum (former Minister of the Environment) and Sanae Takaichi (current Minister for Economic Security). Soon after, Shigeru Ishiba announced the holding of new early elections to the House of Representatives, scheduled for October 27th.

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HOLDING UP WELL, BUT TO WHAT EXTENT?

Growth in the Eurozone is expected to stabilise at 0.3% q/q in the second half of 2024, before picking up slightly in 2025, supported by the cycle of interest rate cuts. However, the difficulties in industry, highlighted by the deterioration in PMI indices in September, and the uncertainty about the Chinese economy, increase the downside risks to our forecasts. A more adverse scenario, in which the manufacturing sector drags the rest of the economy along with it, is not the preferred one at the time of writing. Although less pronounced, the differences in dynamism between countries and sectors are expected to continue into 2025.

Thus far, imported disinflation in manufactured goods has enabled headline inflation to fall back towards the ECB's 2% target, but this effect is set to fade. This increase would offset some of the disinflation that we foresee in services, which is expected to pick up next year, enabling headline inflation to stabilise at around 2% by the second half of 2025. With two further cuts expected in October and December, followed by two more in the first half of 2025, the ECB's terminal rate would be reached next spring. As a result, activity in the Eurozone is expected to strengthen in 2025, supported by a rebound in the German economy and a more favourable carry-over effect than in 2024.

THE CHINESE DILEMMA

Some sectors of European industry are currently caught between sluggish domestic consumption and Chinese overproduction, which is ultimately aiming to increase the country's market share by squeezing out local producers through lower price. With corporate margins falling in the second quarter and PMI employment indices for the manufacturing sector showing a clear deterioration in September (standing at 45.8, the lowest post-Covid level), a tipping point in the Eurozone labour market, which has so far held up remarkably well, is possible. The European Commission's quarterly survey of production constraints is also illuminating. While recruitment problems were, up until the end of 2022, the main constraint on activity, the lack of demand has since become the main factor again. It should be noted that this indicator has been fairly reliable in the past for indicating reversals in the economic cycle[1].

Responding to Chinese competition in a unified manner within the EU-27 remains a tricky task. The October 4th vote to ratify the increase in tariffs on Chinese electric vehicle imports highlighted the deep divisions between member countries, with only ten countries voting in favor of the measure, while five opposed it (including Germany), and twelve abstained (including Spain). Countries with strong links to the world's second largest economy (Germany, Slovakia, Hungary) are more reluctant to raise tariffs out of fear that Beijing will introduce tougher and more far-reaching retaliatory measures. As part of the transition to electric vehicles, some political leaders are also looking to attract Chinese car plants to their countries.

Furthermore, while a genuine decoupling in trade between the United States and China is seemingly well underway, a break between the EU and Beijing is yet to materialise, and, in some respects, trade dependencies have even deepened in recent years[2].

GROWTH AND INFLATION

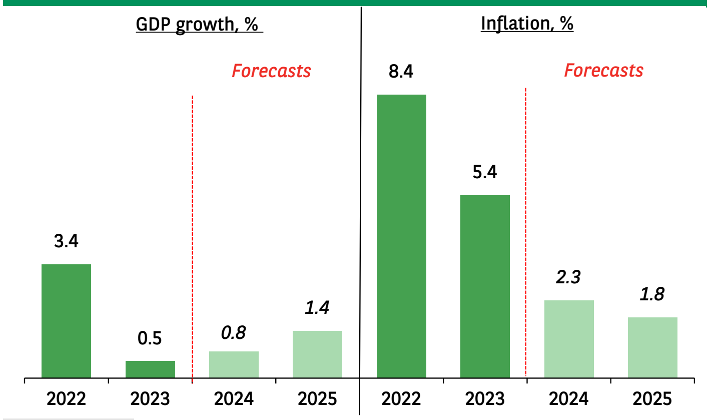

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Therefore, the current levelling-off of trade between the two blocs is primarily a reflection of the general decline in demand, rather than a shift in trade from the EU to other countries. The share of EU (extra-EU) imports from China has in fact remained stable over the last two years at over 20%[3].

A LARGE BUDGETARY GAP

As was the case in 2023, 2024 will see the fiscal position of the countries at the epicentre of the European debt crisis in the 2010s holding up very well. Greece, Portugal and Ireland are set to achieve primary surpluses close to or even above 2% of their GDP, while the deficit in Spain is expected to fall back below 3%. Against a backdrop of falling inflation across the Eurozone, the narrowing of spreads between the German Bund and Greek, Spanish and, above all, Portuguese yields reflects a significant fall in the risk premium assigned to these countries. Conversely, the budgetary adjustments to be made by the five countries[4] subject to the EU's excessive deficit procedure will act as a brake on activity, but are nonetheless essential for limiting tensions on the bond market.

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1 According to the survey for Q3 2024, 39.7% of companies surveyed cited demand as a production constraint, while 19.3% cited recruitment problems. It should be noted that, in this survey, companies are able to choose multiple answers.
2 See for example, *While the US and China decouple, the EU and China deepen trade dependencies*, PIIE Blog, 27th August 2024.
3 Source: Eurostat. 12-month moving average.
4 Belgium, France, Italy, Malta, Slovakia, plus Romania, Hungary and Poland outside the Eurozone.

GERMANY

IN A NEW INDUSTRIAL RECESSION

While there were signs of a rebound in German growth at the beginning of the year, the industrial recession was back from Q2 24, with a negative impact on the labour market that is now noticeable as the unemployment rate is rising. Against this backdrop, and following the withdrawal of support for the purchase of electric vehicles in December 2023, households have increased their level of savings. However, there are still modest signs of a rebound, with a slight increase in demand. At the same time, the government's awareness of the stalling of German industry could lead to the return of support measures.

The German economy is stuck in a stagnation that has lasted for almost two years. Q2 2024 GDP was even below the peak seen in Q3 2022 (by 0.5%). Between these two dates, household consumption fell by 0.9% and investment by 4.2%. External demand is not providing any relief. We can see actually that exports fell less than imports (-0.6% compared to -2.8%). At the same time, no other eurozone country has recorded such a stagnation. These figures therefore point to significant underperformance by Germany.

INDUSTRIAL RECESSION IS BACK

During this period, German industry experienced two recessions. The second one is underway. In Germany, industry and construction account for nearly one third of GDP (compared to one fifth in France). Their impact on growth is therefore significant. After a first recession between Q2 and Q4 2023, production in these sectors had rebounded slightly (+0.4% q/q) in Q1 2024. Contraction resumed in Q2 (-1.2% q/q) and a rebound in Q3 is unlikely. In July, industrial production reached its lowest level (excluding the Covid period) since April 2010. The IFO Business Climate Index fell in September to a level (-21.6) that was only lower during the recessions seen in 1993, 2009 and the Covid period.

At the same time, the capacity utilisation rate in industry was down from 86% in Q1 2022 (the start of the war in Ukraine and the resulting energy shock) to 77.4% in Q3 2024 (after 80.2% in Q2 2024). By comparison, in the eurozone, these rates were 82.8% in Q1 2022, 78.9% in Q2 2024 and 77.7% in Q3 2024.

These developments are meaningful, especially as they add to the Covid shock and to a significant loss of activity already before the pandemic: on average over the last 3 months, industrial production was 15% lower than the record seen in Q4 2017 (20% in metallurgy and 19% in automotive). This weakness is likely to lead to new site closures (already envisaged in the automotive sector), even though production capacities experienced an initial decrease of 6% following the Covid period (unprecedented apart from the reunification period), according to our calculations.

HOUSEHOLDS ARE TAKING THE HIT

The situation in industry is eroding one of Germany's greatest successes in recent years: the return to full employment. Admittedly, unemployment remains low and the main constraint facing the services sector remains the lack of labour (more so than the lack of demand). However, in industry, labour constraints have reduced and the unemployment rate has rebounded, rising from 3% - level seen pre-Covid and just a year ago - to 3.7% in July 2024. An increase that might continue if we believe the IFO survey's Employment Barometer, which fell to 94.8 points in August 2024. Excluding the Covid period and the 2008 crisis, this was a low not seen since 2005, i.e., just before the introduction of the Hartz reforms contributed to a sharp decline in unemployment in Germany.

According to the European Commission survey, German households do not believe in a recovery in activity: they have a negative perception of the economic situation in the past twelve months as well for the next twelve months. In August 2024, only 6.6% of households were willing to make major purchases in the immediate future, according to the European Commission, a proportion that has been consistently below 10% since March 2022, and which had rarely fallen below this level before.

GROWTH AND INFLATION

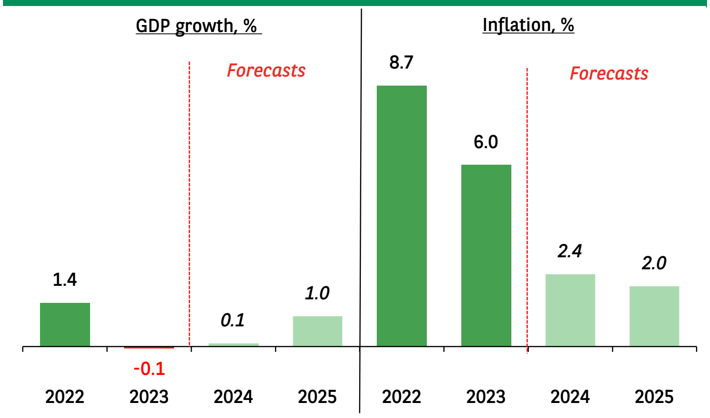

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The fall in inflation, which reached the symbolic 2% y/y mark in August 2024 (according to the harmonised index) compared to 6.4% a year earlier, is having only a limited impact on consumer confidence and consumption for the time being. According to Eurostat, the household savings rate even increased, to 21.2% in Q1 2024, compared to 19.9% a year earlier (and 18.2% at the end of 2019), of which almost half in financial savings (unprecedented percentage outside the Covid period).

ON THE VERGE OF A REBOUND?

Will 2025 see an end to stagnation? There are reasons for hope, albeit these are yet to be confirmed.

The first reason relates to demand. The new orders index in industry rebounded in June-July. This index is quite volatile; a 6-month average can help reduce this volatility. With this calculation, a rebound emerged in July 2024 (+1.2% m/m). Admittedly still limited, it interrupted the near-continuous fall seen since May 2022.

The second reason could come from the policy mix. The ECB cut its key rate again by 25 bps in September 2024. At the same time, we could see the return of help to buy electric vehicles. An urgent decision to end this support was taken in December 2023 in order to reduce the budget deficit (following the judgment of the Federal Constitutional Court in Karlsruhe). However, over the period December 2023 - August 2024, electric vehicle registrations fell by 36%. Volkswagen recently announced the potential closure of one of its plants in Germany, which would be a first. Following this announcement, the German government has therefore taken on the issue, and measures to support the sector might be forthcoming.

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SERVICES DRIVE GROWTH

Inflation and rising interest rates have resulted in the landing of domestic demand in the private sector overall (households and companies), without preventing French growth from maintaining a moderate pace (1.1% in 2023, 1.2% in 2024 according to our estimates), as a result of a drop in imports and therefore a positive contribution from net exports. Growth was also driven by service output (investment by companies in information and communications is even expected to overtake construction soon). This support is expected to drive stable overall growth in 2025, at 1.2%.

According to our estimates, French growth is expected to continue in 2024. This is paradoxical, given that household and corporate investment is falling, while growth in consumption should remain as modest in 2024 as in 2023, despite falling inflation and the one-off favourable effect of the Olympic Games. Nevertheless, growth has continued at a moderate pace (1.2% expected in 2024, after 1.1% in 2023). From a demand point of view, this can be explained by a strong positive contribution from foreign trade (estimated at 1.1 points), firstly, because France is importing less (positive impact of falling domestic demand, largely satisfied by imports) and, secondly, due to the rebound of two of its main trade surpluses (aviation and electricity). As for supply, service output alone can explain growth, while construction is declining sharply and industry more moderately.

GROWTH EXPECTED TO REMAIN CLOSE TO CURRENT PACE

H1 2024 was marked by stable household consumption volumes, even though their nominal gross disposable income (GDI) remained strong. It should even increase by 4.3% in 2024, according to our estimates. As a result, with disinflation now quite clear (2.2% y/y in August 2024, compared to 5.7% a year earlier, according to the harmonised index), household purchasing power (real GDI) should have increased by 1.5% in 2024 according to our estimates. An increase in real GDI which, combined with the sluggishness of consumption, has favoured a rise in the savings rate (17.9% of GDI in Q2).

A restraint in spending that has had an unexpected impact: French foreign trade saw a surplus in terms of volume, in the national quarterly accounts. Imports of goods and services have fallen below exports since Q4 2023, and the surplus has only increased since then to nearly EUR 3 billion in Q2 2024. This might be surprising, as there is a big difference with figures for the trade balance on goods as calculated by Customs (deficit of EUR 80 billion in 2024 according to our forecasts). But this figure is in terms of value and does not include services. The price effect is unfavourable, something we see whenever energy prices are high (which is currently the case, despite the recent drop in energy prices). The surplus on services, on the other hand, has changed little when measured in volume. Good news therefore came from goods, with mainly declines in imports of other industrial products (textiles, home and personal care) and capital goods. These decreases reflect both a phenomenon of deconsumption on goods (-4% compared to the end of 2021), linked to inflation and persisting despite ongoing disinflation, and the 4% y/y drop in tangible investment (goods and construction) by non-financial corporates (NFC). At the same time, the upturn in aviation and electricity exports has helped to restore balance for these two items.

Overall, this trade surplus in volume is expected to help growth remain close to 1%, as was the case, on average, between 2013 and 2015, the last period when the sluggishness of domestic demand had translated into a surplus of the same order. Hence a growth forecast of 1.2% once again in 2025.

GROWTH AND INFLATION

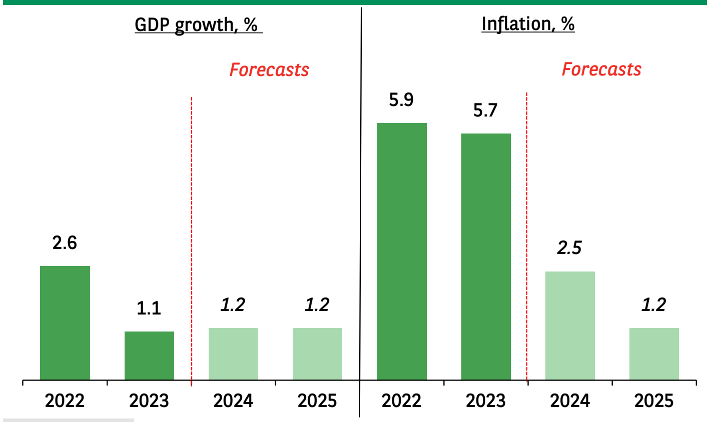

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

SOFTWARE TO TAKE THE LEAD OVER CONSTRUCTION

The financial situation of companies has been deteriorating for the past year, admittedly from a good starting point. While their value added has stabilised, the increase in labour costs (directly through wages and social contribution, indirectly through production taxes on the wage bill) explains the drop to 30.8% in Q2 2024 in their margin rate (versus 33.3% a year ago), compared to an average level since 2010 of 31.1%. The sharp slowdown in nominal value added and pressure on margins should prompt companies to be more conservative in terms of hiring (with a foreseeable stabilisation of employment, while high job creation still prevailed in Q1) and wages (gross monthly salary should increase from 2.8% in 2024 and 1.6% in 2025, according to our forecasts).

At the same time, the rise in net interest expenses for companies has reduced their gross savings, which, in Q2, only represented 80% of their investment (compared to a ratio close to 100% for most of the last 10 years). The result is a record potential financing need excluding changes in inventories in Q2 (nearly EUR 7 billion, i.e., 6% of their gross operating surplus, GOS), which companies were able to reduce (to 3 billion, i.e., 2.7% of their GOS), precisely by destocking. We estimate that this destocking should remove nearly 0.6 points from French growth this year, after already -0.4 points in 2023.

If a financing need has arisen, this is also because corporate investment has only partially decreased. While tangible investment has contracted by 4%, intangible investment is up 2.7% y/y (a well-established trend for nearly 10 years). Symbolically, NFC' investment in software (information & communication, EUR 19.7 billion in Q2 2024) is expected to quickly exceed their investment in construction (down to 19.8 billion in Q2), which had so far been their principal expenditure item. A transition to services, which is also noticeable in household consumption, and which should continue to drive growth in 2025.

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ITALY

STEADY BUT MODERATE GROWTH

The recovery of the Italian economy continues, although at a moderate pace. In Q2 2024, real GDP rose by 0.2% q/q, supported by domestic demand, while net exports' contribution was negative. The slowdown of investment reflected the decline of expenditure on dwellings, while machinery investment increased. Consumption moderately increased. Value added slightly accelerated in the services sector while continuing to contract in the manufacturing sector. The labour market has shown significant improvement since Q2 2021. In Q2 2024, the employment rate rose to 62.2%, a historical peak that, nevertheless, remains low in comparison with the main EU partners.

POSITIVE DOMESTIC DEMAND

The recovery of the Italian economy continues, although at a moderate pace. After increasing by 0.3% in Q1 2024, real GDP rose by 0.2% q/q in Q2 and by 4.7% compared to Q4 2019. Domestic demand added 0.1 percentage points to the overall growth, while net exports contribution was negative (-0.3% pp in Q2), as exports fell more than imports. From January to July, Italian sales to Germany fell by almost 5.5%. The contribution of stocks was strongly positive, at +0.4 pp.

In Q2 2024, consumption rose by 0.2%, after +0.3% in Q1, despite the gradual increase of the propensity to save. Although uncertainty about the global and local economic outlook persists, consumer confidence remains above its long-term average. The purchasing power of households increased above the pre-Covid level, as nominal income rose while inflation decelerated.

The moderate evolution of the economy mainly reflects the slowdown of investment, which rose by 0.3% in Q2, after +0.4% in Q1 and +2% in Q4 2023. The breakdown by items of expenditure was mixed, but better than expected. Investment in dwellings recorded the second decline in a row, given the cancellation of fiscal incentives to improve the efficiency of buildings, while those in other type of construction, including infrastructure and industrial buildings, increased by 1.8%, after +4.6% in Q1. Despite the uncertainty around new public incentives for ICT equipment, investment in machinery rose by 0.9% (+18.5% over Q4 2019). Business confidence has slightly improved, remaining above its long-term average.

The recovery of the Italian economy remained mixed by sector. Although decelerating, construction value added rose by 0.6% in Q2, from +2.9% in Q1. Services slightly accelerated, also benefiting from the further recovery of international tourism. From January to June, the number of foreigner travellers in Italy rose above 40 million, 2.2 more than in the same period of 2023. Manufacturing continued to be affected by the slowdown of both global demand and investment expenditures. In Q2, value added fell by 1% (-0.4% in Q1). Although declining on an annual basis, manufacturing producer prices remain more than 20% higher than at the beginning of 2021. Production has further declined, with a widespread contraction by sector.

EMPLOYMENT AT A HISTORICAL HIGH PEAK

In Italy, the labour market has shown significant improvement since Q2 2021. In Q2 2024, the number of people employed (seasonally adjusted value) reached 23.9 million, 409,000 units more than in Q2 2023, and 873,000 more than in Q4 2019, before the outbreak of the pandemic. The increase mainly involved the female component: in Q2 2024, there were 467,000 more women employed than in Q4 2019.

GROWTH AND INFLATION

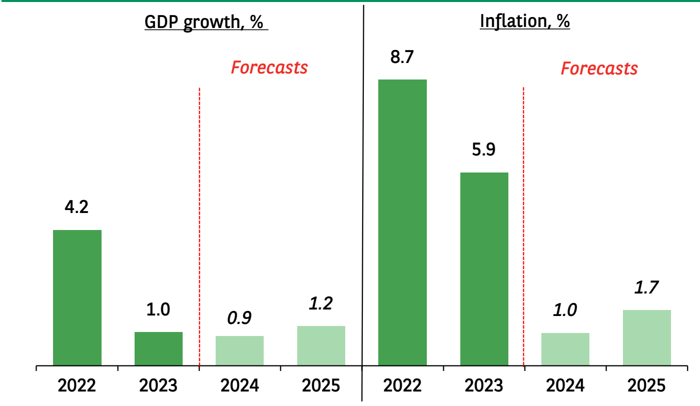

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Thanks to these latest improvements, the employment rate in Q2 2024 in Italy rose to 62%, a historical peak that, nevertheless, is still lower than those of the main EU partners (77.6% in Germany, 69% in France, 66% in Spain). This especially occurs in the female component (53.4%) and in the southern regions, where the employment rate (43.3%) remains significantly lower than in the rest of the country.

The employment rate is still strongly affected by the level of education. In Italy, 82.9% of the graduates between 14 to 65 years old are employed. This percentage drops to 62.9% among those with a high school diploma and to 44.9% among those with only a primary education or lower secondary school diploma.

Despite the improvement in the labour supply, in some sectors, Italian enterprises are experiencing some difficulties finding the necessary skills. In the first half of 2024, among the companies associated with Confindustria (the association of Italian enterprises) that were looking for personnel, 70% (mostly large industrial companies) reported difficulties in finding skills related to the digital transition, internationalization and the green transition.

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THE OUTLOOK REMAINS OPTIMISTIC

For the fourth year in a row, Spain will be the primary growth driver in the Eurozone. This country's outperformance is expected to continue over the remainder of 2024, albeit with very slightly less momentum than in H1 (expected growth of +0.6% and +0.7% q/q in Q3 and Q4 after +0.9% and 0.8% in Q1 and Q2). Foreign trade, mainly driven by the still significant growth in exports of tourism services, should continue to support activity. For its part, the marked fall in inflation (+2.4% y/y in August; -1.2 pp over two months), combined with the strength of the labour market, should allow private consumption to gradually recover.

FOREIGN TRADE WILL REMAIN THE PRIMARY SOURCE OF GROWTH

The post-pandemic upturn in tourism has continued to boost Spanish exports (+11.2% q/q in Q2). With 53.4 million foreign visitors arriving since the beginning of the year[1] (+11.2% compared to the same period in 2019), it is clear that 2024 will set a new record. However, the gradual deceleration in growth in tourism expenditure (+11.9% y/y in July, compared to +21.8% y/y on average since the beginning of the year) tends to show that exports of services (+1.0% q/q in Q2) could slow in the coming months.

In addition, the weakness in imports observed in Q2 (-0.2% q/q) - brought about by the decline in exports of manufactured products, which require foreign inputs, but also by greater energy efficiency and increased renewable energy production - should continue to have a positive impact on the contribution of foreign trade during the last two quarters of the year.

GROWTH AND INFLATION

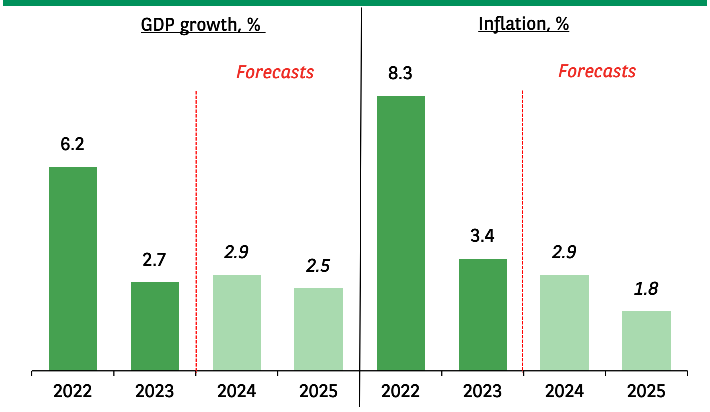

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

IMMIGRATION FUELS THE LABOUR MARKET

The remarkable strength of the Spanish labour market, observed since 2021, continues to be one of the sources of explanation for the significant growth in real GDP. The number of people registered with social security is steadily increasing, reaching 21.2 million in August[2] (+1.5% since the beginning of the year). This growth was mainly supported by the immigrant workforce, which itself increased by 7.6% over a year, and represented 14.9% of the total number of registered workers in Q2.

Nevertheless, as mentioned by the Bank of Spain in the latest quarterly publication of its forecasts[3], structural vulnerabilities remain. Although having fallen since 2021, the unemployment rate (11.5% in July) is still well above the Eurozone average (6.4%), and the number of long-term unemployed (for one year or more) has stagnated at 1.1 million since the beginning of 2023. Against the backdrop of an ageing working population, this stagnation suggests that this is an older workforce that is difficult to reintegrate into the labour market, making it difficult to continue reducing the unemployment rate in the years ahead. However, rising immigration is likely to address this problem of an ageing population in the next few years.

MOVING TOWARDS A GRADUAL FALL IN INFLATION, WHICH SHOULD ALLOW PRIVATE CONSUMPTION TO RECOVER

Spain seems to be gradually coming to an end to its inflationary crisis, with the annualised HICP slowing by 1.2 pp over two months and standing at 2.4% in August. Although services inflation persists (3.7%, +0.1 pp over a month), inflation on goods (1.1%, -1.1 pp), food (2.5%, -0.6 pp) and energy (-1.7%, -4.3 pp) surprised on the downside. The continued reduction in VAT on basic food products until the end of the year, and its extension to olive oil, have also helped disinflation. According to our forecasts, harmonised inflation should slow to 2.4% y/y in Q3 and Q4, and stand at 2.9% on average over 2024 as a whole.

Disinflation, combined with the robustness of the labour market and wage growth (+3.7% y/y in Q2), means that households are regaining purchasing power, which should ultimately stimulate private consumption in H2 and in 2025. Recent developments in the European Commission consumer confidence indicator show that intentions to make major purchases and buy a car in the coming year have returned to their highest levels since November 2019 (-20.6 and -80.3, respectively). Nevertheless, these trends are struggling to be reflected in hard business data: retail sales only increased by 0.3% (3m/3m) in July and new vehicle registrations fell by -13.6% 3m/3m in August[4].

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1 In July.
2 Seasonally adjusted data.
3 «Macroeconomic projections and quarterly report on the Spanish economy. September 2024", Bank of Spain.
4 Seasonally adjusted data.

NETHERLANDS

DUTCH ECONOMY REBOUNDS IN THE SECOND QUARTER

The Dutch economy avoided falling back into recession in the second quarter, thanks to a much smaller annual drop in exports and solid public spending, which was a promise from the new government. However, inflation is stronger than expected and will need to be monitored, as it could become a drag on private consumption. The outlook remains fine, nevertheless, but investments need to recover further in order to compensate for persisting labour shortages.

Dutch growth was revised sharply down in the first quarter, at -0.3% qoq and -0.7% yoy, as a result of a significant downward adjustment in export volumes of goods, reflecting notably the weakness of Germany. This Q1 GDP growth revision led to a lowering of expectations for the whole year 2024, from +0.8% to 0.6%, even though the overall economic view has not deteriorated. Growth is still expected to be close to 1.3% in 2025.

The second quarter turned out much better than the first thanks to stronger exports and dynamic government spending, as the new government had promised. On a qoq basis, GDP grew by 1%, which translates into a 0.6% growth on a yoy basis, back in line with growth in the euro area. While private consumption had been a supporting factor in the past quarters, essentially because wage growth was strong and the labour market very tight, things may worsen in the future if inflation does not calm down more in the near future.

BAD SURPRISE ON INFLATION

A stubbornly high inflation could indeed spoil the game, while the concern in several European countries is, on the contrary, the lack of impetus of falling inflation on consumption. Since May, inflation has indeed been picking up again, to reach 3.3% in August (up 0.7 pp). Core inflation performed even worse, reaching 3.5% in August (up 1 pp). Higher rents and high food prices explain this negative evolution. This unexpected increase in inflation led the Central Planning Bureau to revise its inflation forecasts upward, to 3.6% and 3.2% for this year and next.

GROWTH OUTLOOK STILL POSITIVE

Nobody seems to expect a severe deterioration in the economic outlook, as the labour market remains favourable, with an unemployment rate at 3.5% in July, and with plenty of vacancies (see chart). An in-depth study by Statistics Netherlands reveals that roughly half of all unemployed individuals are still in education, with many of them seeking part-time jobs. Not surprisingly, over one-third of employers cite labour shortages as the main impediment to growth.

This positive situation on the job market certainly explains the good standing of consumer confidence indicators, which, combined to the low unemployment rate, continue to paint the picture of a robust economy.

One point should catch our attention though: over past quarters, annual export growth has almost always been negative, reflecting the poor international context. Imports of goods and services declined by far less on a yoy basis in the second quarter, which led to a sharp drop in the still largely positive trade balance surplus (close to EUR11 bn in July). The persisting weak yoy evolution of exports is a cause for concern that will need close monitoring since a potential decrease in foreign demand for Dutch goods could ultimately weaken domestic economic activity.

GROWTH AND INFLATION

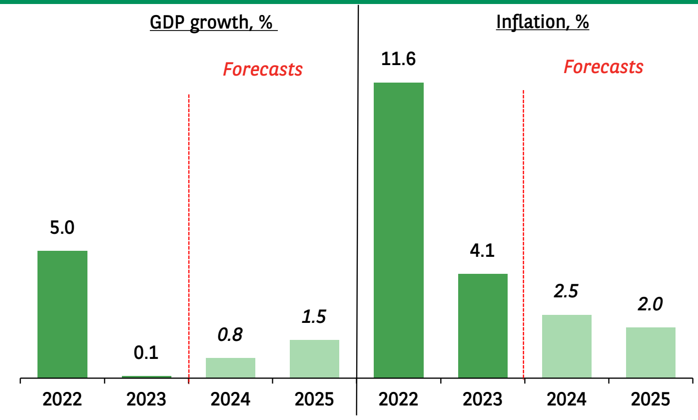

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

INVESTMENT MUST GET STRONGER

Industrial production declined again in July, making it a complete year with dropping volumes. This poor performance is most likely due to the lagged impact of higher energy prices, the poor international context, but also to still ongoing labour shortages, as many businesses report. In light of this, it will be extremely important that investment remains solid enough to make up for labour shortages if the country wants to maintain a strong economic base. Business investments were clearly hit by the high interest rates in 2023. A prolonged decline in business investment would make it harder to face these challenges and could be a drag on future growth.

STRONG RECOVERY IN THE RESIDENTIAL SECTOR

Finally, the housing market continued to recover at a speed that few had anticipated. Prices, which had dropped by more than 5% in 2023, when the ECB was tightening monetary conditions to fight inflation, have since turned positive again. In July, the yoy increase reached 10.7%, making it one of the strongest recoveries in the world. This sharp increase in prices illustrates once again the high-density issue that the Netherlands have always been confronted with in terms of housing market.

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BELGIUM

BELGIAN MANUFACTURING: AIN'T NO SUNSHINE

Our nowcast for the ongoing third quarter has Belgian growth at slightly below trend. Household consumption hasn't accelerated much, while typical-election year dynamics inflate government spending. Gross fixed capital formation, dominated by firm investment, remains positive but the underlying trend is worrying. Belgian manufacturers seem especially far from a return to normal, while the spectre of fiscal tightening looms.

Q2 real GDP growth reached 0.2% QoQ, slightly below consensus expectations of 0.3%, with the underlying trend in investment especially below potential. Private consumption growth remains a bit deflated, as government consumption picks up the slack, as it usually does in an election year.

We expect stable growth close to trend, throughout the second half of the year, as declining interest rates can help kickstart household real estate investment. A small bonus could be the positive contribution from international trade, with exports recovering faster than imports.

BELGIAN OUTPERFORMANCE

The Belgian economy has held up quite well since the start of 2022. In fact, it has outperformed the euro area as a whole by close to 1% cumulative quarterly GDP growth. The currency area's total growth was dragged down considerably by the significant economic underperformance of its largest member, Germany.

The German stagnation, with an average of zero quarterly growth since early 2022, of course also impacts the neighbouring countries, including key-trade partner Belgium. Germany accounts for 14% of Belgian imports (behind only the Netherlands) and close to 20% of exports. Recent in-house simulations suggest that a German slowdown of this magnitude shaves 0.3-0.4% pts of Belgian growth.

In absence of the German growth engine, overall business confidence remains well below its historical average. Zooming in on the manufacturing sector, the perceived rebound in sentiment at the start of the summer has given away to employment- and demand-related worries.

For the first half of the year, turnover across all manufacturers is down 5%. Sub-sectoral differences abound however, with machine, automotive, chemical, and metal plants hit especially hard. In contrast, pharmaceutical producers saw turnover increase by a sector-leading 8%. This sector was recently referenced as a key-contributor in "The future of European competitiveness" report. Pharma represents 5% of all EU-added value and more than 10% of all exports. Prominent headquarters located in Belgium are understood to be a key-driver of elevated R&D spending in the country, as it is one of only five Member States to exceed the EU's spending target of 3% of GDP.

MANUFACTURING PROBLEMS

Across the sector as a whole, Belgian manufacturers have barely contributed to overall GDP growth since early 2020, having in fact only supported quarterly economic expansion in 4 of the last 18 quarters. Meanwhile, total bankruptcies in the sector are up. Compared to pre-COVID, over the last 12 months, 10% more firms closed up shop, well in excess of the average for the entire economy.

GROWTH AND INFLATION

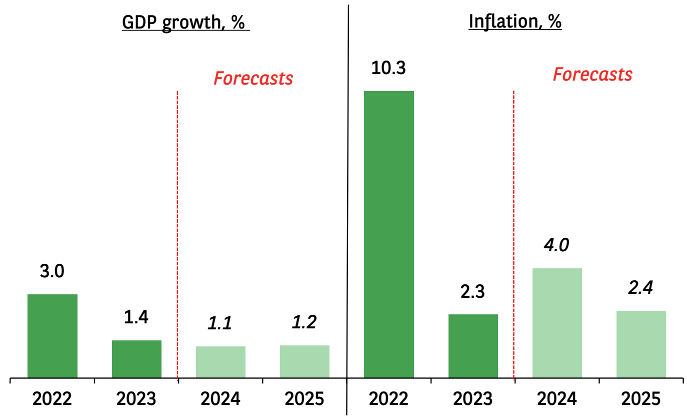

CHART 1

SOURCE: BNP PARIBAS FORTIS, BNP PARIBAS

What could help shift the tide for these less-than-optimistic businesses? Declining interest rates would be reasonably expected to provide some additional room for investment, but the number of firms citing financial factors as a constraint on production has barely budged, as "lack of demand" once again reigns supreme as a chief concern.

Actually, up until the end of last year, business investment had been accelerating. A couple of one-off transactions, including that of a large shipbuilder muddy the signal since the turn of the year. Anecdotal evidence collected by the National Bank of Belgium suggesting cost-cutting, induced by tighter profit margins, is now the talk of the town. With an average capacity utilisation rate reported at 74% - well below the long term average of 80% - expansionary investments are likely to remain on the backburner for a while longer. The manufacturing share of total investment has sunk to a 5-year low.

If the effects of monetary policy fail to lift-up business spirits, might fiscal policy perhaps do the trick? That seems highly unlikely in the current EU climate, as its fiscal watchdogs recently announced increased scrutiny for the Belgian budget. Fiscal consolidation is due but a first, limited attempt to form a government in the wake of the June elections has failed and all parties concerned are unlikely to strike an agreement before years end. In the preliminary notes that found their way into popular press, measures like an increase in energy taxes for producers will undoubtedly fail to inspire much optimism. For the time being, the outlook for manufacturers remains rather bleak as a result.

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UNITED KINGDOM

STRIKING THE RIGHT BALANCE BETWEEN GROWTH AND FISCAL CONSOLIDATION

The presentation of the budget on 30 October will be the first real test for Rachel Reeves. The deteriorating situation of the public accounts and the September 2022 *mini-budget* crisis, which is on everyone's minds, are leaving the Chancellor of the Exchequer with little room for manoeuvre. UK growth is expected to slow in the second half of 2024 (+0.3% quarter-on-quarter). The two policy rate cuts by the Bank of England (BoE) that we expect in 2024 (August and November) would enable growth to come close to its potential level during this year and in 2025.

The British economy is improving timidly. Domestic activity (consumption, investment) remains weak, despite the decline in inflation. The fall in inflation since the start of 2024 has come mainly from industrial goods, while deflation in energy, fuelled by decreases in the cap on regulated gas and electricity tariffs, has remained above 10% year-on-year. These two effects are expected to dissipate. While it remains limited at this stage, disinflation in services should continue over the course of 2025, allowing headline inflation to stabilise around the 2% target over time[1].

The upturn in housing activity is seemingly well underway, with sales prospects at their highest since the health crisis (RICS survey) and price indices (Halifax, Nationwide) rebounding by an average of 2.5% in the first half of 2024. However, the foundations of this recovery are fragile. The effects of the rise in interest rates have not yet been fully felt, with fixed-rate loans seeing their rates continue to rise this summer, in particular. The rise in mortgage arrears also continued in the second quarter (standing at 1.32%, the highest level since 2016). Furthermore, future rate cuts will not solve the fundamental problem of rising household debt in the United Kingdom. As a share of GDP, it reached 91.9% in Q1 2024, 10 percentage points higher than the peak before the 2008 financial crisis. Unlike the United States and many euro zone countries, where this aggregate ratio has plummeted over the past fifteen years, British households continue to rely quite heavily on credit, not least to cope with the high housing costs in the country.

In terms of fiscal policy, the road ahead is narrow for the Chancellor of the Exchequer, who will be looking to reassure the markets about Labour's ability to preserve the sustainability of public finances, while delivering the increased investment and spending promised during the election campaign. An in-between solution could involve making changes to the government's targeted measures for budget balance and public debt. This could involve removing specific investments from government spending, particularly investments linked to programmes created by the Labour Party (the National Wealth Fund and GB Energy). The public debt measure could also be amended to remove the BoE's losses on its asset portfolio, which are covered by the UK Treasury. In March, the OBR forecasted that the deficit would fall to 3.1% of GDP over the 2024-25 fiscal year (April 2024-March 2025), from 4.4% during the previous year[2]. This improvement would be partly due to a fall in debt interest payments, which had risen with the surge in interest rates and inflation in 2022-2023, as a result of the large proportion of UK government securities indexed to the price index (RPI)[3].

GROWTH AND INFLATION

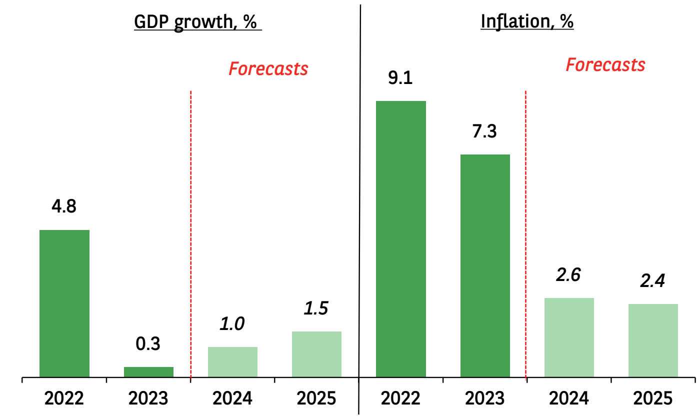

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

THE DRAGHI REPORT ALSO RESONATES ACROSS THE CHANNEL

The Draghi Report on the future of European competitiveness has prompted a number of reactions within the EU, but the findings of the former ECB President apply equally to the United Kingdom. With a productive investment rate (excluding investment in housing) that is almost 4 GDP points lower than in the United States, productivity gains standing at around 25 percentage points lower since the early 2000s[4], and a less buoyant demography, the drivers for growth seem more limited than on the other side of the Atlantic.

While the EU-UK Trade and Cooperation Agreement, which entered into force in January 2021, has not resulted in a decline in foreign investment in the United Kingdom[5], it has led to it levelling off. Brexit has also reportedly reduced opportunities in sectors with lower value added and high exposure to international competition (textiles and agriculture)[6]. UK exporters are also suffering as a result of a slowdown or even a decline in activity among some of their major trading partners (Germany, the Netherlands, France and China). In volume terms, UK exports of goods are down by nearly 20% from their pre-pandemic levels. However, the picture is not completely bleak: while some parts of the manufacturing sector do indeed seem to be struggling, the UK retains major strengths in certain industries (aerospace and pharmaceuticals) and, above all, in high value-added services, such as finance and information and communication services.

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1 The PMI index for sales prices in services fell in September to its lowest level since February 2021.
2 New forecasts will be released on 30th October.
3 In September 2024, 17% of the total Gilts stock was indexed to the RPI (UK Debt Management Office).
4 In purchasing power parity terms, between 2020 and 2023, hourly productivity increased by 19% in the UK, compared with 43% in the US (OECD).
5 See UK Attractiveness survey, EY, July 2024.
6 A report by Aston University (Birmingham) estimates that between January 2021 (the end of the transition period and the entry into force of the new trade treaty) and December 2023, Brexit resulted in a 27% fall in UK exports to the EU and a 32% fall in imports. See Unbound: UK Trade Post Brexit | Aston University.

SWITZERLAND

CLOSER AND CLOSER TO THE NEUTRAL RATE

In H2 2024, Swiss growth is expected to ease slightly (0.3% q/q in Q3 and 0.2% q/q in Q4 according to our forecasts). The persistent weakness of the country's main trading partners will continue to weigh on its growth, but the lagged impacts of the monetary easing initiated by the SNB in March 2024 should play out more favourably. We expect the SNB to make two further policy rate cuts by the end of the year, due in particular to the favourable developments seen in inflation in recent months.

IN Q2, REAL GDP GROWTH RETURNED TO ITS STRONGEST PACE IN TWO YEARS

After posting growth of 0.5% q/q in Q1, Swiss real GDP grew by 0.7% in Q2, boosted by sporting event rights (Paris Olympic Games and the UEFA European Championship)[1] and the sharp increase in chemical and pharmaceutical production (+8.4% q/q). This increase has significantly driven value added in the manufacturing sector (+2.6% q/q) which is, as a result, growing faster than at its historical average pace. However, the value added of other industrial sectors has fallen, mirroring the difficulties of the industrial sector seen among the country's European neighbours. Although capital investment fell (-1.4% q/q), the moderate increase in construction investment (+0.5% q/q) helped to limit the drop in total investment (-0.8% q/q). And lastly, private and public consumption components remained weak (+0.3% and +0.2% q/q) and below their historical average. Foreign trade, on the other hand, proved to be an important pillar of real GDP growth in Q2 (+2.3 pp contribution).

MOVING TOWARDS SLIGHT MODERATION IN ACTIVITY OVER H2

However, this recovery in Q2 is expected to have only a limited impact over the rest of the year. We expect Swiss real GDP growth to ease slightly in H2 (+0.25% q/q on average in Q3 and Q4), primarily due to the weakness of its main trading partners (the US and the Eurozone - mainly Germany).

In August, the KOF Swiss Economic Institute Economic Barometer (101.6; +1 point over a month) remained very slightly above its long-term average (100). And although having sharply risen since October 2023 (+14.3 points), the Economic Sentiment Indicator remains below 100 (90.9). Lastly, the manufacturing PMI reached 49.0 in August (+5.5 points over a month, the highest level seen since January 2023), suggesting that the downward trend in production in the sector could be coming to an end soon, but that the Swiss economy is still on a hesitant recovery trajectory.

In addition, the delayed impacts of monetary easing will provide some support for growth. The latter should have positive effects on the manufacturing sector, which tends to be sensitive to interest rate movements.

GROWTH AND INFLATION

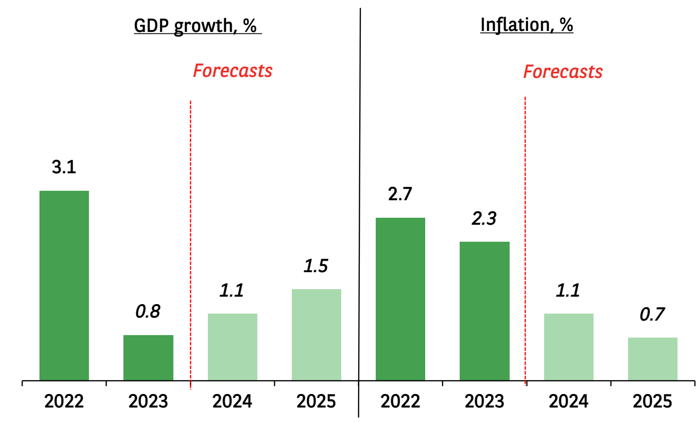

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

SNB EXPECTED TO MAKE TWO MORE RATE CUTS THIS YEAR

While the Swiss National Bank (SNB) was the first of its peers to begin its monetary easing policy with two rate cuts in H1 2024[2], we expect it to make two further cuts by the end of the year[3], due to favourable inflation developments and its intention to slow the appreciation of the Swiss franc.

The latter[4], observed since the key rate cut in June, could restrict growth by reducing Swiss export demand. If this momentum continues, the SNB could make the choice to adjust its key rate at future meetings.

For its part, disinflation continues: the HICP recorded an annual change of 1.0% y/y in August (-0.2 pp over a month), returning to its lowest level since September 2021. We expect inflation in Q3 (1.1%) to be significantly lower than the latest SNB 1.5% forecast[5]. However, pricing pressure is persisting, and these figures tend to mask the divergence between services inflation (2.1% y/y in August; +1 pp) and goods inflation (-0.5%; -0.5 pp). Nevertheless, overall inflation should remain within the target range of 0.0% to 2.0% throughout 2024 and 2025 (1.1% and 0,7% on annual average, respectively, according to our forecasts).

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1 Adjusted for the impact of sporting events, Swiss real GDP only grew by 0.5% quarterly in Q2 (after +0.3% q/q in Q1).
2 In March and June, from 25 basis points each to 1.5%, then 1.25%.
3 One of these rate cuts was made on 26 September 2024: the SNB lowered the policy rate by 25 bps to 1.0%.
4 Appreciation of the actual effective exchange rate of around 2% since June 2024.
5 Source: Quarterly Bulletin 2/2024 June, SNB.

AUSTRALIA

ACTIVITY IS STILL CONSTRAINED

Australian growth is facing an undeniable slowdown, which is linked to the prolonged constraints on households as a result of rising prices and interest rates, as well as slowing demand from its Asian trading partners. Stubborn inflation is currently an obstacle to easing interest rates. On the other hand, the migratory influx is boosting a labour market which remains buoyant.

Australia's economic growth has slowed significantly since the end of 2022. GDP grew by +0.2% q/q in Q2 2024 for the third quarter in a row, with public spending as the principal contributor (+0.4pp if public investment is included), and +1.0% year-on-year, which is the lowest since Q1 2020 (or even since 1991, if we are to exclude the COVID-19 period). Demand continued to be adversely affected by rising inflation and interest rates, as illustrated by decreasing household consumption in Q2 (-0.2% q/q), against a backdrop of falling disposable income per capita and a drop in consumer confidence. In addition, after buoying activity in 2023, non-residential investment fell over the first two quarters of 2024 (-0.7%, followed by -0.8% q/q). Furthermore, during the first half of 2024, increasing imports contributed to the decline in the growth rate; while, more broadly, Australian foreign trade was grappling with falling prices in its commodity exports (iron, coal and gas) and with declining Japanese demand.

The short-term growth prospects are subdued. Nevertheless, the introduction of income tax cuts (from 19% to 16% and 32.5% to 30%, respectively, on the first two brackets) should prevent consumption from reducing further during the second half of 2024. The consensus view is that the average annual growth rate will be +1.2% in 2024, a drop of 0.8 pp from 2023.

THE BENEFITS OF IMMIGRATION ON THE LABOUR MARKET

However, the labour market is still buoyant. Even though the unemployment rate has risen markedly over the last few quarters, from 3.5% in December 2022 to 4.2% in August 2024, at the same time, the number of people employed and the participation rate have been on an almost uninterrupted rise since the end of 2021. Most notably, the participation rate in August 2024 was 1.4pp above its 2019 average (67.1%, compared to 65.7%). Population growth, which stood at +2.4% y/y at the end of 2023 and was mainly driven by immigration, has helped to increase the size of the workforce in absolute terms (15.0 million in August 2024, compared to 13.5 million before the pandemic) and, ultimately, to boost the overall level of consumption and production. As a result, despite the decline in volume per capita, GDP has remained the same overall.

IT'S NOT YET TIME FOR MONETARY EASING

During its September 2024 meeting, the Reserve Bank of Australia (RBA) decided to keep the cash rate at +4.35% for a sixth meeting in a row. As a result, Australia's central bank is still part of a small group of OECD member countries which have not yet started monetary easing. The decision to maintain such a restrictive approach is mainly due to a lack of developments around disinflation.

GROWTH AND INFLATION

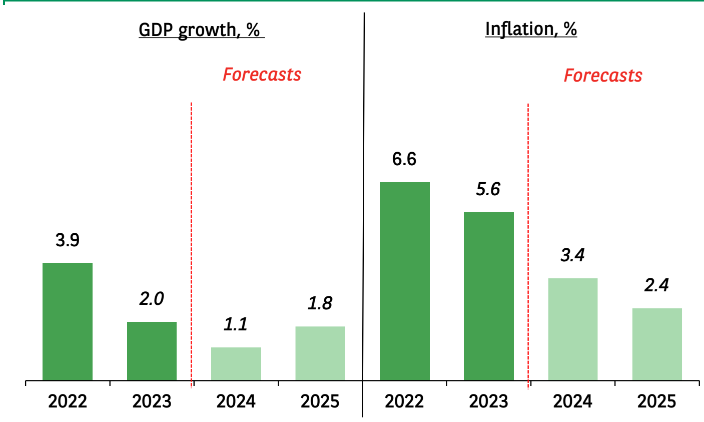

CHART 1

SOURCE: OECD, BNP PARIBAS

Although there has been a major slowdown in inflation since its peak of +7.8% y/y (the highest level since 1990) in Q4 2022, the consumer price index (CPI) has not really budged, with a year-on-year variation of +3.8% in Q2 2024, up on the previous quarter (+3.6% y/y), despite the target of 2%-3%. This has also been seen in the underlying price pressure measures, the CPI trimmed mean (which excludes the most volatile 30% of items) and the CPI weighted median (at the 50th percentile point of the distribution), despite their slowdown (+3.9% y/y and +4.1% y/y in Q2, respectively).

Although growth is slowing and the unemployment rate is heading higher, the RBA indicates that at this stage, the jobless rate remains "lower than estimates of rates that are consistent with full employment" and that "the output gap is positive but continues to narrow"[1]. The structurally-tight labour market is keeping wage pressure elevated, which in turn prevents inflation from falling more rapidly. Indeed, inflation is not expected to fall to midway between the 2%-3% target before 2026, according to both RBA and consensus expectations. Therefore, it is not yet a given that the monetary easing cycle will start in 2024. As at 24 September, market pricing is only 5bp down on the December meeting. As a result, the Australian currency is expected to strengthen against the US dollar in the short term.

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1 See Reserve Bank of Australia, Statement on monetary policy, August 2024.

FORECASTS

ECONOMIC FORECASTS

	GDP Growth				Inflation			
%	**2022**	**2023**	**2024 e**	**2025 e**	**2022**	**2023**	**2024 e**	**2025 e**
United States	2.5	2.9	2.6	1.9	8.0	4.1	2.9	2.2
Japan	1.1	1.7	-0.2	0.7	2.5	3.3	2.6	2.2
United Kingdom	4.8	0.3	1.0	1.5	9.1	7.3	2.6	2.4
Euro Area	3.4	0.5	0.8	1.4	8.4	5.4	2.3	1.8
Germany	1.4	-0.1	0.1	1.0	8.7	6.0	2.4	2.0
France	2.6	1.1	1.2	1.2	5.9	5.7	2.5	1.2
Italy	4.2	1.0	0.9	1.2	8.7	5.9	1.0	1.7
Spain	6.2	2.7	2.9	2.5	8.3	3.4	2.9	1.8
China	3.0	5.2	4.9	4.5	2.0	0.2	0.4	1.3
India*	7.0	8.2	6.9	6.7	6.7	5.4	4.7	4.3
Brazil	2.9	2.9	3.1	2.0	9.3	4.6	4.3	3.8

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

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

FINANCIAL FORECASTS

Interest rates. %		**2024**				
End of period		Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
US	*"Fed Funds (upper limit)"*	4.50	4.00	3.75	3.50	3.25
	T-Note 10y	3.80	3.70	3.70	3.65	3.65
Eurozone	deposit rate	3.00	2.75	2.50	2.25	2.25
	Bund 10y	2.15	2.10	2.10	2.15	2.25
	OAT 10y	2.88	2.80	2.85	2.85	2.95
	BTP 10y	3.60	3.40	3.45	3.55	3.65
	BONO 10y	2.93	2.85	2.85	2.88	2.98
UK	Base rate	4.75	4.50	4.25	4.00	3.75
	Gilts 10y	3.80	3.80	3.60	3.50	3.65
Japan	BoJ Rate	0.50	0.75	1.00	1.00	1.25
	JGB 10y	1.25	1.40	1.55	1.70	1.80

Exchange rates		**2024**				
End of period		Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
USD	EUR / USD	1.12	1.13	1.14	1.14	1.15
	USD / JPY	139	138	136	134	131
	GBP / USD	1.35	1.36	1.37	1.37	1.39
EUR	EUR / GBP	0.83	0.83	0.83	0.83	0.83
	EUR / JPY	156	156	155	153	151

SOURCE : BNP PARIBAS GLOBAL MARKETS

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