ECO PERSPECTIVES

4st Quarter 2021

EDITORIAL

2 **Underlying strength, but gathering clouds**

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ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

EDITORIAL

UNDERLYING STRENGTH, BUT GATHERING CLOUDS

Recent data show business and consumer sentiment has peaked and real GDP growth is expected to slow down whilst remaining well above potential. A key factor in this respect is the self-reinforcing interaction between spending, company profits and employment, against a background of easy monetary and financial conditions. In using the popular metaphor, until recently, the economic sky looked quite blue but clouds have been gathering. The message of central banks should become a bit more hawkish, in the US, political disagreement influences the economic agenda of the Biden administration and China is going through a major adjustment phase. Most importantly, supply bottlenecks continue to weigh on growth whereas the jump in gas and energy prices is raising concerns that inflation might stay high for somewhat longer.

The first half of the year has seen a broad-based improvement in business and consumer confidence in advanced economies but recent data show sentiment has peaked. Depending on the country, the second or third quarters should see the peak in quarter-over-quarter GDP growth this year. Subsequently, growth should slow down. The 'mechanical' recovery in sectors that initially had suffered from restrictions and later on benefitted from the lifting of these constraints, has run its course. Supply bottlenecks weigh on growth in a large number of sectors, in particular in the construction sector and the automobile industry. They act as a speed limit to growth but also exert an upward pressure on prices. This can in turn act as a headwind for consumer spending, through its impact on real disposable income, and corporate investments, through downward pressure on profit margins. In many countries, corporate capital formation has been very dynamic during the recovery and this accelerator effect may also start to lose some steam. Finally, a less expansionary fiscal policy implies that, as of next year, private demand will be called upon to sustain growth at a high level. Despite these various factors, real GDP growth should remain well above potential, underpinned by low interest rates, easy access to financing, increased resilience – thanks to high vaccination levels – to potential new waves of infections and the self-reinforcing interaction between spending, company profits and employment. In using the popular metaphor, until recently, the economic sky looked quite blue.

Clouds have been gathering however. We have moved from a monothematic world –centered around the sanitary situation- to a multi-thematic world, which is even more difficult to come to grips with in view of the number of moving parts. The message from major central banks is changing. Norway, South Korea and New Zealand have already seen rate hikes and the Bank of England is also sounding more hawkish. The Federal Reserve is expected to start tapering its asset purchases in November – an operation that should go smoothly – but, more importantly, an increasing number of FOMC members project a first rate hike next year. This prospect should put upward pressure on Treasury yields – with global spillover effects – and might also weigh on the risk appetite of investors globally, leading to a more volatile market environment. This in turn can have repercussions in the real economy. The importance of political factors is also on the rise. In the US, the prospect of next year's mid-term elections will complicate the task of the Biden administration to implement its economic policy agenda. In Germany, forming a new government will probably take considerable time. Its composition should influence the fiscal policy stance in Germany but also the debate on new fiscal rules at the European Union level. The Chinese economy is experiencing major adjustments following tighter regulations in various sectors and an effort to address the problem of elevated debt levels of certain state-owned and private enterprises. Slower Chinese growth will have global repercussions, via commodity markets and trade flows. Finally, a succession of supply-side shocks have increased uncertainty about the outlook and created upward pressure on prices. Business surveys in manufacturing and services continue to point to very high pressure in terms of input prices, despite a slight recent easing, and selling price expectations have also increased markedly. Delivery lags are still very long. In the euro area, the shortage of material and equipment are key factors weighing on production. Demand is not an issue considering that the vast majority of sectors have well-filled order books, compared to the long-term average but also compared to the pre-pandemic level. Supply-side bottlenecks reflect strong demand but also ongoing supply disruptions higher up in the global supply chain, causing significant increases in shipping freight rates and long delivery lags. Recently, another type of supply shock has emerged with the huge increase in gas prices, with knock-on effects on the price of electricity. Strong demand – on the back of the economic recovery, efforts to rebuild inventories that had dropped to very low levels and low production of wind energy – as well as supply issues play a role. Higher energy prices should weigh on household spending but they may also contribute to inflation staying high for longer. This has fueled a stagflation narrative, although this looks more like a description of a downside risk rather than a base scenario. Indeed, inflation should decline next year due to base effects and the easing of supply pressures, whereas growth should stay above potential.

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US AND EUROZONE BUSINESS SURVEYS

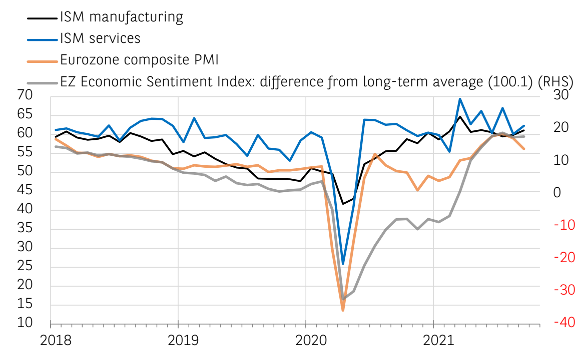

CHART 1 SOURCE : ISM, IHS MARKIT, EUROPEAN COMMISSION, BNP PARIBAS

STAGFLATION WORD COUNT IN BLOOMBERG ARTICLES (7-DAY MOVING AVERAGE)

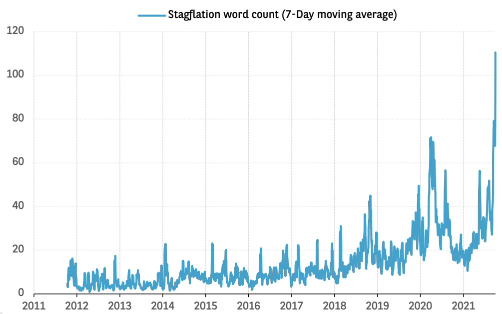

CHART 2 SOURCE: BLOOMBERG, BNP PARIBAS

BUDGET BATTLES AND MONETARY TIGHTENING

On the whole, the US economy has recovered very quickly, albeit unequally, from the loss of business caused by the Covid-19 pandemic. Exceptional Federal transfers have fuelled a spectacular rebound in private consumption, so much so that it is nearly overheating. Faced with a global parts shortage and hiring troubles, companies are having a hard time meeting demand. Prices have come under pressure. For the US Federal Reserve, the time has come to begin withdrawing monetary support. The debt ceiling has just been hit, and major budget bills remain in suspense until an agreement to raise the limit can be reached with the Republicans.

Known for its plasticity, and heated red hot by USD 5,000 bn in fiscal transfers, the US economy did not take long to erase the loss of business engendered by the Covid-19 crisis (chart 1). By spring 2021, numerous sectors had returned to or exceeded the pre-pandemic levels of 2019. The big exceptions were the leisure and transport sectors. With the partial or total lifting of travel restrictions, these sectors have also begun to recover, and are now struggling with capacity problems. Prices are currently rising at an annual rate of 5%, the fastest pace since 2008. Very early on, the US stock markets were betting on a recovery and holding to a vertical curve, but now they have shifted their focus to supply shortages and surging inflation, and its consequences for monetary policy. The business climate was euphoric through mid-summer, but has since eased somewhat, as illustrated by the decline in growth expectations, from an average of 7% to 6% in 2021. The latest subject of concern is the political battle over the debt ceiling: unless it is suspended or raised, the debt ceiling controversy could seriously compromise the recovery.

BUDGET BATTLES

With the Covid-19 crisis, the US Federal debt has ballooned dramatically, swelling by a record 25% in barely two years (chart 2). Estimated at USD 28,780 bn (USD 22,500 bn or 103% of GDP excluding intra-government holdings), the debt has already exceeded the authorised ceiling of USD 28,500 bn. As a result, Congress will have to raise or suspend the debt ceiling. Long considered to be a simple formality, the debt ceiling has been transformed into a political battleground between the Democrats and Republicans, ever since the Tea Party weaponised it in 2011 to counter President Barack Obama. An agreement was reached at the last minute in exchange for fiscal concessions, but the impasse nonetheless led Standard & Poor's to downgrade the US sovereign rating from AAA to AA+.

In her letter to Congress dated 19 September, US Treasury Secretary Janet Yellen expressed her alarm at the repeat of such a damaging saga, arguing that without a decision on the debt ceiling, the Federal government would find itself short of liquidity *"sometime during the month of October."* In addition to the probable shutdown of government services, the Treasury would no longer be able to issue debt, triggering a *de facto* payment default that would cause *"irreparable harm"* to the economy, to use Ms Yellen's words. For the moment, the standoff is coming from the Senate and the Republican Party, whose votes are normally needed to raise or suspend the debt ceiling. Such a decision requires a qualified majority of 60 votes, but the Democrats have only 50 seats. Borrowing authorisations are only supposed to cover spending that has already been approved, but the Republicans are trying to tie it to the Build Back Better plan, the budget package that encompasses the entire Biden agenda. The Republicans are hoping to influence a bill that has not yet come up for a vote.

What all does this bill cover? It pools together all of the measures that were not covered by the bi-partisan agreement, or that are unlikely to muster bi-partisan support. Spread over 10 years, the USD 3.5 trillion budget reconciliation bill only requires a simple Senate majority to pass. Its key objectives are outlined below:

- Strengthen the public healthcare system by making permanent the adjustments to the Affordable Care Act (Obamacare) contained in the American Rescue Plan (increase the federal government's share of health insurance premiums) and by expanding Medicare's healthcare coverage (which currently covers those age 65 and older);

- Promote the green transition via subsidies for renovations for more energy efficient buildings, the conversion to renewable energy sources, and the switch to electric cars, among others. It incorporates

GROWTH AND INFLATION (%)

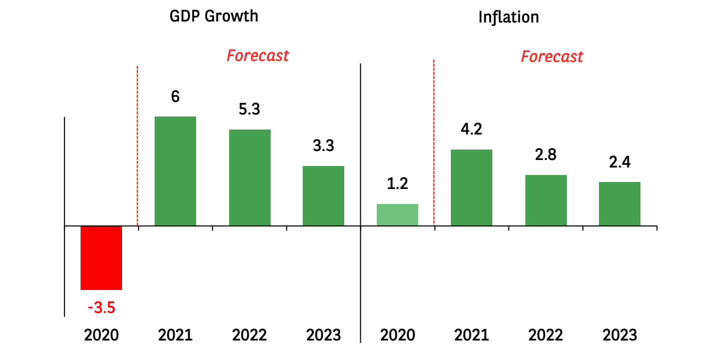

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

PRE-PANDEMIC GAP (FROM Q4 2019))

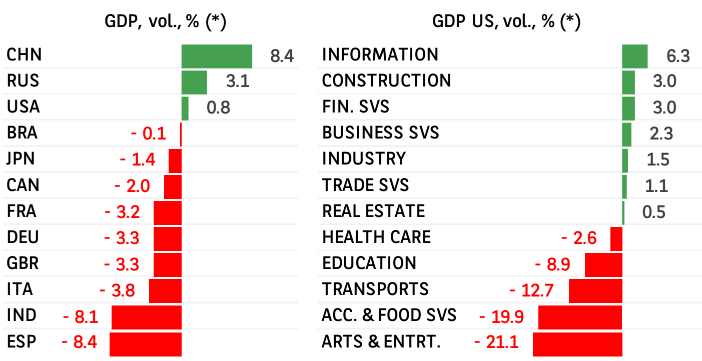

CHART 2

SOURCE : NATIONAL ACCOUNTS, OECD, BNP PARIBAS. COUNTRY ISO CODES practically all of the infrastructure measures initially incorporated in the American Jobs Plan, but that were rejected under the bipartisan agreement of 24 June;

- Support for families, especially low and middle income households, by making permanent the increase in child and worker tax credits included as part of the American Rescue Plan, by providing free access to kindergarten and 2-year community colleges, and by expanding access to the Electronic Benefit Transfer (EBT) programme that provides food stamps to students. Once again, virtually all of these measures can be found in the American Families Plan presented last April.

The Republicans oppose the reconciliation bill based on the argument that it would only add to the Federal debt, which is not exactly true. To offset the spending increases (which some call investment), the House of Representatives Ways and Means Commission (majority Democrat) intends to introduce an ambitious fiscal reform that would cover about two-thirds of the cost of the bill.

According to the estimates of the Committee for a Responsible Federal Budget, financing measures included in the last segment of the Build Back Better Plan would generate additional revenues of roughly USD 2.3 trillion over 10 years. For the most part, it would raise the corporate tax rate from 21% to 26.5%, raise the income tax rate for the upper tax bracket from 37% to 39.5%, eliminate the 20% Trump rebate on business income from pass-through entities, and raise the tax base and rate on foreign earnings (from 10.5% to 16.5%).

As we were going to press, the battle of nerves between the Republicans and the Democrats over budget issues was not affecting the economy or the markets as much as the shortage of parts and labour. The job market is recovering rapidly, with 4.7 million new jobs since the beginning of the year, and the Federal Reserve members esteem that it is far enough along to push ahead with the normalisation of monetary policy (see box).

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MONETARY TIGHTENING: THE AGENDA TAKES SHAPE

The Federal Reserve has successfully prepared financial markets for the gradual reduction in the pace of its asset purchases, thereby avoiding the market turbulence ('taper tantrum') that occurred in May 2013 following hints by Ben Bernanke that tapering was becoming increasingly likely. This time, things went smoothly because the Fed started communicating well in advance, and the pace of reduction should be gradual – so as to avoid market disruption in terms of demand versus supply – and, most importantly, it has been emphasized that tapering is not mechanically linked to the policy rate decision. We expect tapering to start in November, provided the labour market reports are reasonably good. Fed chairman Jerome Powell has stated that a *"gradual tapering process that concludes around the middle of next year is likely to be appropriate"*[1] . Our forecasts is in line with this message.

However, market attention will quickly shift to the timing of the first rate hike. Following last year's strategy review, the conditions for a lift-off in terms of the policy rate are more stringent than for tapering. It requires labour market conditions that are consistent with the FOMC's assessment of maximum employment – no numerical target has been set in this respect – and inflation that has risen to 2% and is on track to moderately exceed 2 percent for some time. The latest FOMC members' rate projections (the 'dots') show that an increasing number expects conditions will be met to justify a rate hike in 2022, but this really depends on the speed of decline of the unemployment rate and hence on growth in real GDP. We expect a first hike in the federal funds rate in the fourth quarter of 2022 followed by three more hikes in 2023. This prospect should push Treasury yields somewhat higher. This development is expected to have global spillovers, given that advanced economies' government bond yields are highly correlated due to capital flows. Research has shown that fluctuations in global risk appetite of investors crucially depend on the stance of US monetary policy. Emerging markets issuers and investors but also equity markets will scrutinise any change in guidance from the Fed on its policy rate. For the FOMC, it will be a balancing act.

1 Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 22 September 2021.

FEDERAL DEBT

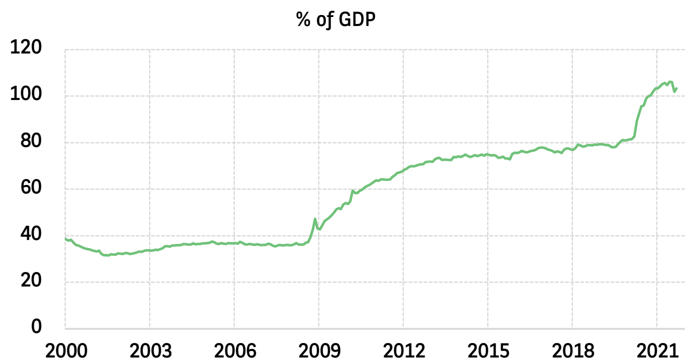

CHART 3
SOURCE: US DEPT. OF THE TREASURY

CHINA

PAINFUL ADJUSTMENTS

The Chinese economy is in the midst of a period of major adjustments. They arose after Beijing tightened regulations in a variety of sectors, from housing to certain new technologies and activities linked to the societal challenges facing the country. The adjustments can also be attributed to the debt excess problem of some state-owned and private enterprises, and reflect the authorities' determination to tighten their access to credit and to clean up practices in the financial sector. As a result, an increasing number of corporates is defaulting, and the troubles of the property developer Evergrande are symptomatic of the changes under way. For the authorities, the challenge is to maintain control over these events and to contain their negative impact on confidence in the financial system, on credit conditions for other economic agents and on economic growth.

NEW THREATS TO GROWTH

China's post-Covid economic rebound peaked earlier this year and growth rates have gradually returned to normal levels since March. However, the slowdown was particularly abrupt during the summer months and spread to all sectors. It can be attributed to both temporary factors as well as more lasting causes.

Lockdown measures and travel restrictions, which were reintroduced in August in response to the resurgence of the pandemic and the threat of the Delta variant, dealt another hard blow to private consumption. Growth in retail sales volumes slowed to 0.9% year-on-year in August, down from 6.4% in July and 11.9% in Q2 2021. Activity in the services sector was also hard hit by the lockdown measures (+4.8% y/y in August, down from 7.8% in July and 13.9% in Q2). The services sector has also been hit by regulatory changes in such industries as online services, tutoring and video gaming.

The tighter macro-prudential framework and credit conditions have also hit the property market while the tightening of fiscal policy in H1 2021 led to a major slowdown in investment in public infrastructure projects (see chart). As a matter of fact, after last year's post-Covid economic rebound, the authorities rapidly adjusted their economic policy to shift priority to debt reduction efforts by both local governments and corporates – notably property developers and state-owned enterprises.

Lastly, supply chain constraints have disrupted the industrial sector. Factories have been hit by an increasing number of power outages in recent weeks, as a result of strong demand, rising coal prices constraining energy production, rationing measures introduced in some provinces in order to comply with targets to reduce greenhouse gas emissions. Through August, however, industrial production growth slowed only moderately (+5.3% y/y, vs 6.4% in July and 9% in Q2) as it kept pace with persistently solid performance in exports (which still rose by 25% y/y in value in August). Moreover, investment growth in the manufacturing sector was also robust over the summer, bolstered by good corporate profit growth and historically high production capacity utilisation rates (78.4% in Q2 2021).

Although households are still extremely cautious, consumption and activity in the services sector should pick up as of September as most lockdown measures and travel restrictions are lifted. To a lesser extent, they should also get a boost from the advancement of the vaccination campaign (more than 70% of the population has received two doses). Consumer price inflation is still very low (+0.8% y/y in August), which may also encourage spending. In addition, the authorities are expected to support domestic demand again, mainly via carefully targeted measures to facilitate lending and a rebound in public investment.

GROWTH AND INFLATION (%)

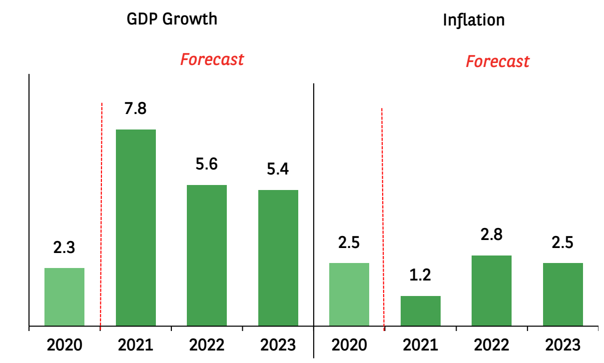

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

DOMESTIC INVESTMENT

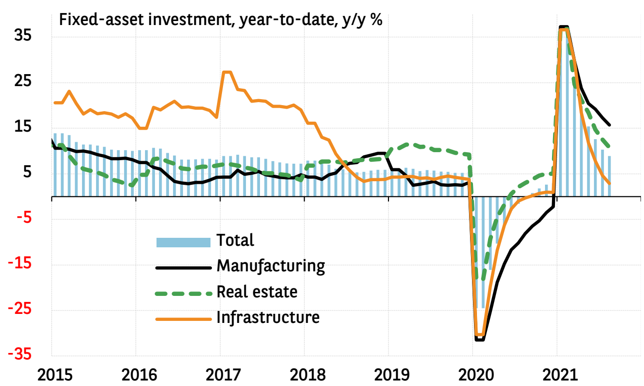

CHART 2 SOURCE: NBS

In the industrial sector, in contrast, supply-side constraints could persist for several more months. Above all, the adjustments being pushed by the authorities are placing new constraints on economic growth, at least in the short term.

First, the regulatory environment is becoming less predictable and less favourable for private investment in a number of sectors regarded as sensitive by Beijing. They include certain new technologies offering consumer services, data collection and activities pertaining to societal issues (such as education or wealth distribution).

Second, the number of payment difficulties and defaults, by both state-owned and private corporates, are on the rise due to: i) their heavy debt burden[1] and the deterioration in their financial performance after last year's crisis, combined with ii) government measures to reduce leverage levels in certain sectors by tightening their credit conditions, as well as to clean-up practices in the financial system (for example, by letting non-viable firms enter bankruptcy, and by weakening implicit state guarantees).

COMMON PROSPERITY, REAL ESTATE AND EVERGRANDE

Under this environment, the real estate sector is highly exposed. This is partly because the housing market plays a major role in the country's medium-term development strategy: moderate house price inflation and improvements in housing affordability are due to help stimulate household consumption and reduce inequalities, in compliance with Beijing's new priority to promote "common prosperity".

Second, the real estate sector is one of the most heavily indebted sectors, and it has largely benefited from the monetary easing measures introduced during the H1 2020 health crisis. Consequently, the authorities sharply tightened credit conditions and the prudential framework beginning in Q3 2020. They placed new limits on the banks' sector exposure[2] and imposed three "red lines" that property developers must comply with in terms of financial ratios[3]. Many provinces have also set up measures to discourage speculative transactions and moderate the rise in house prices.

In this increasingly restrictive environment, enterprises of the real estate sector have faced increasing financing and cash-flow problems in recent months. Growth in bank loans to property developers (which account for only part of the sector's financing sources) fell to 2.8% y/y in mid-2021, down from 8.4% in mid-2020. Growth in mortgage loans slowed to 8.6% from 14.8% during the same period. This downward correction should worsen in H2 2021. Meanwhile, housing construction and transactions have slowed, further reducing developers' liquidity levels (see chart).

The Evergrande case is symptomatic of the property sector's troubles. In the last days of September, Evergrande, which is the country's largest and most heavily-indebted developer, failed to pay part of the interests due to local banks and on its US dollar bonds. The Chinese government did not grant any direct support.

WHAT IS THE FALLOUT?

Corporate deleveraging efforts and the clean-up of financial-sector practices are positive trends that should lead to a better allocation of capital in the medium term. Yet the adjustments are painful in the short term. Evergrande's first defaults had a severe impact on confidence and the financial markets, if for no other reason than the company's size (which accounted for nearly 5% of the total value of China's real estate transactions in 2020), its heavy debt and debt profile (which is mainly short-term)[4]. Evergrande's troubles have also impacted its payments to suppliers and shadow banking credits, thus accelerating the spread of liquidity pressures to other institutions.

In recent weeks, local bond markets have been increasingly differentiating between property developers based on their credit rating. As a result, a certain number of small firms in the sector have found themselves cut off from access to financing and are in danger of defaulting. Bond issuers in other sectors, in contrast, do not seem to have been affected much so far. Moreover, the banking sector is stable. It is highly exposed to the real estate sector, which represented 28% of total bank loans outstanding in H1 2021 (of which 21% are mortgage loans and 7% are loans to developers), or 46% of GDP. Although some of the small banks may face severe difficulties due to property developers' troubles, China's largest banks have sufficient capital and provisions, and are robust enough to withstand the shock (and their direct exposure to Evergrande is manageable).

HOUSING MARKET CORRECTION

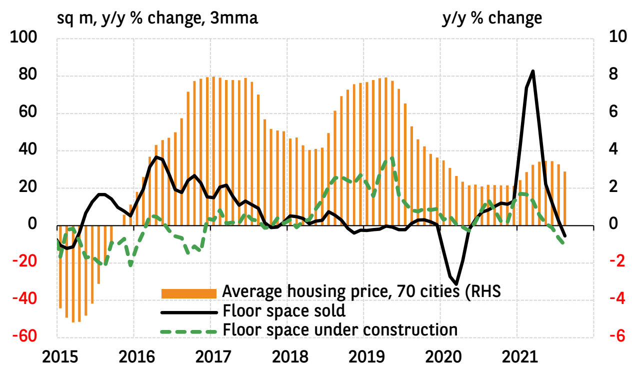

CHART 3

SOURCE: NBS

Above all, the authorities have the capacity to contain spill-over effects to financing conditions for the rest of the economy and to prevent instability risks in the financial system. The central bank has injected liquidity continuously in recent days, and the government is taking part in the negotiations between Evergrande and its creditors and in the debt restructuring process (asset sales, fund injections by other firms, etc.).

The Evergrande shock is unlikely to trigger a widespread liquidity crisis in the financial system. On the other hand, the forced deleveraging process for developers will have consequences on economic growth. Land sales, construction and housing transactions should continue to weaken in the short term. Yet the construction and real estate sectors are key growth engines for the Chinese economy. They account for 15% of GDP, and even 25% if we include indirectly linked activities. Real estate investment accounts for nearly a quarter of total investment. Moreover, land sales proceeds are a major source of revenue for local governments, and the majority of household wealth, especially in urban areas, is invested in real estate. Therefore, while allowing the weakest property developers to go bankrupt, the authorities are likely to take action to avoid a lasting contraction of the sector (by easing mortgage loan conditions, for example, or providing liquidity support for the most solid firms). Completing Evergrande's already existing construction projects is also likely to be one of the authorities' priorities, to address the discontent of families waiting for the delivery of their houses.

Completed on 29 September 2021

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1 China's corporate debt (most denominated in local currency) represented 159% of GDP in mid-2021, up from 152% at year-end 2019.
2 The ceiling on real estate loans (property developers + household mortgages) as a share of total loans varies depending on the size of the bank.
3 The property developers must comply with three ratios: debt/assets <70%, liquidity/short-term debt >1 and net debt/equity <100%. Developers have 2 years to improve their ratios. The more a developer exceeds these limits, the tighter the restrictions on its access to credit. In H1 2021, 7 of China's 50 biggest property developers exceeded the three "red lines".
4 Evergrande's debt and liabilities total nearly USD 300 bn, or 2% of Chinese GDP

JAPAN

RETURN TO "REVOLVING DOOR" PRIME MINISTERS?

The economy is likely to rebound in Q4 as health restrictions are being eased. Moreover, despite supply chain disruptions, the manufacturing sector should profit from the worldwide recovery. The consumption boom is likely to peter out soon, as wages growth is to remain sluggish. The main domestic support will come from the government spending, backed up by Bank of Japan (BoJ) 's yield curve control policy, and business investment thanks to improved profitability. Prime Minister Suga's resignation, although welcomed by financial markets, has rekindled fears that Japan may return to the "revolving door" era, in which the country changes prime minister every year.

A SHORT-LIVED REBOUND

The Japanese economy rebounded modestly by 0.3% in Q2 helped by solid business investment and strong consumption. However, the upswing was short-lived as the resurgence of the pandemic forced the authorities to declare the state of emergency in early July in the Tokyo area. This was later extended to almost half of the prefectures, covering 80% of the population. As a result, private consumption has remained stagnant, which in particular affected the hospitality sector. The Tokyo Olympic and Paralympic Games went ahead, although without spectators. At the same time, Japan's industry has been heavily impacted by supply chain disruptions and weak overseas demand. Semiconductors and other component shortages have forced plants to suspend operation, in particular in the automobile-related sector. These disruptions are likely to continue in Q4.

Economic surveys indicate that the economy could have contracted again in Q3. In August, the Economy Watchers reported a sharp deterioration in current and future conditions. The deterioration was confirmed by the PMI services activity index, which declined to 42.9. Although manufacturers reported a slight expansion in activity, the composite PMI Output Index fell from 48.8 in July to 45.5, a lowest since May 2020. By end September, the fifth wave of Covid-19 infection has largely subsided, while the vaccination has progressed largely as planned, with over 60% of population now having received at least one dose and more than 50% having received the second dose.

GROWTH AND INFLATION (%)

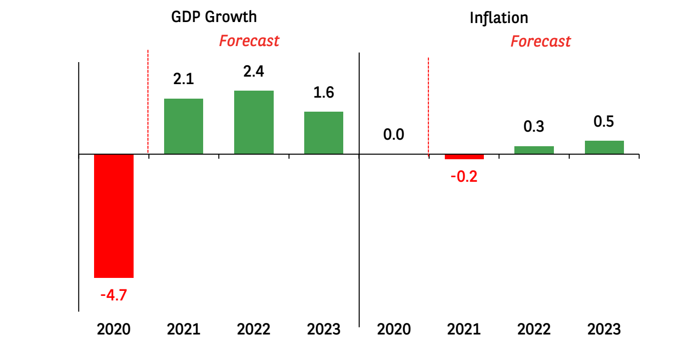

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

UNCERTAINTY AFTER SUGA'S DEPARTURE

As the government approval ratings slumped over the mishandling of the pandemic, Prime-minister Yoshihide Suga announced in early September that he would not seek re-election as leader of the Liberal Democratic Party and would step down as prime minister. The announcement was welcomed by the Tokyo Stock Exchange. The LDP has selected Mr Fumio Kishida, a former foreign affairs minister, as president to lead the party in the lower house election in October. Mr Kishida promised to shift away from the deregulation policies of his predecessors. However, restoring confidence in government will be a tough task, given the weakness of the Japanese health system and the institutional constraints. The risk is that Japan returns to a "revolving door" era, in which prime ministers only last for one year.

Independent of who becomes prime minister, the fiscal stance is likely to remain very accommodative despite the worsening of the government accounts: public sector debt amounts currently to around 240% of GDP. The policy is supported by the Bank of Japan, which is buying as much government bonds (JGBs) as necessary to keep the 10-year JGB yields at around zero percent. The BoJ's official inflation objective is 2%, but the central bank has few instruments left to achieve this target. In fact, Japan is among the few industrialised countries that have not experienced a substantial rise in the inflation rate in recent months.

A ROBUST RECOVERY IN 2022-23

In Q4, the economy should strongly rebound, as sanitary restrictions could be lifted due to the sharp decline in new infections. However, the consumption boost is likely to peter out quickly as wages growth is expected to remain very sluggish. In 2021, exports are likely to remain the main driving force behind the recovery, thanks to the ongoing upturn in the main trading partners, such as the US, China and other countries in East and South East Asia. Moreover, supply chain disruptions are likely to diminish next year. Domestically, growth will be supported by an expansionary fiscal policy, which is likely to focus on digitalisation and green growth. Furthermore, the improved financial position of the corporate sector in conjunction with the worldwide upswing in industrial activity is likely to boost business investment. However, inflation is likely to remain below 0.5%.

Completed on 5 October 2021

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GROWTH AND INFLATION SURGE

After rebounding vigorously in Q2 (+2.2% q/q), GDP growth is expected to maintain the same dynamic pace in Q3. Admittedly, supply-side constraints have just chipped away a few tenths of a percentage point of growth from our June forecast. September's business climate surveys are showing more traces of these tensions, especially in industry, and in Germany in particular. Even so, the survey results are still holding at high levels. Growth in the Eurozone will get a boost from the monetary and fiscal accommodation, the freeing of forced savings built-up by households, the recovering job market and the need for investment. We expect 2022 growth to be slightly higher than in 2021 (5.2% and 5%, respectively, in annual average terms). However, the optimism of the big picture is somewhat tarnished by the simultaneous surge in inflation, even though a rather large part is only temporary. The ECB is expected to continue giving priority to growth. It will only make minimal efforts to begin normalising monetary policy by letting the Pandemic Emergency Purchase Programme (PEPP) expire in March 2022. Moreover, it should be offset by a larger and more flexible Asset Purchase Programme (APP). But the ECB is also signalling that is being vigilant about inflationary risks.

GROWTH SURGES

After contracting slightly for two quarters (-0.4% q/q in Q4 2020 and -0.3% in Q1 2021) due to lockdown measures in various Eurozone countries, growth rebounded vigorously in Q2 2021 (+2.2% q/q, +14.3% year-on-year). This brings the growth carry-over to nearly 4%, while the shortfall from the pre-crisis level of Q4 2019 has narrowed to 2.5%. The rebound in household consumption (+3.7% q/q) explains 85% of this growth. Investment also made a positive but smaller contribution (0.3 points vs. 1.9 points for consumption). Net exports did not contribute to growth since strong export growth was accompanied by an identical rise in imports, reflecting the strength of domestic demand. Changes in inventory made a negative contribution of 0.2 points.

Comparing the performances of the four biggest member states, Italy reported the biggest rebound (+2.7% q/q), followed by Germany (+1.6%), France and Spain (+1.1%). For the Eurozone as a whole, Ireland was the leader of the pact (+6.3%) while Malta lagged behind (-0.5%). As to the gap between GDP and the pre-crisis level (see chart 2), Germany and France reported the smallest shortfalls (3.3% and 3.2%, respectively), followed closely by Italy (-3.8%), while Spain still has a long way to go before closing the gap (-8.4%). In comparison, GDP growth in the United States has already surpassed the pre-crisis level (+0.8%) while the UK is still relatively far behind (-4.5%).

The vigorous rebound in Q2 growth was already visible in the upturn in confidence surveys between April and June, for both Markit's PMI and the European Commission's Economic Sentiment Index (ESI). In July, the composite PMI and the ESI both rose another notch, with the PMI reaching the highest level since mid-2006 (60.2) and the ESI setting a new record high of 119.

In August, the two surveys dipped slightly lower. The PMI indices for September (Flash estimates) declined more sharply, which can be attributed to the impact of supply-side disruptions and upward pricing pressures at work since late 2020 and early 2021. At the aggregate level for the Eurozone, manufacturing PMI declined 3.3 points to 55.7 (output component), which is slightly sharper than the 2.7-point decline in the services PMI (to 56.3). Geographically, PMI declined more sharply in Germany than France.

Even so, these PMI levels are still consistent with strong Q3 growth, which we expect to be similar to the Q2 figure, before beginning to normalise in Q4 (+1.2% q/q). Various supply-side constraints have chipped off a few tenths of a percentage point of growth from our June forecast, but the sting has been fairly mild so far, and the lost ground should be gradually recovered in 2022. Assuming that demand will be less vigorous and that health restrictions hampering production will be loosened, our scenario makes the implicit assumption that supply disruptions and pricing pressures will not get a lot worse, and will not spread to other product categories. Yet this scenario is shrouded in uncertainty.

GROWTH AND INFLATION (%)

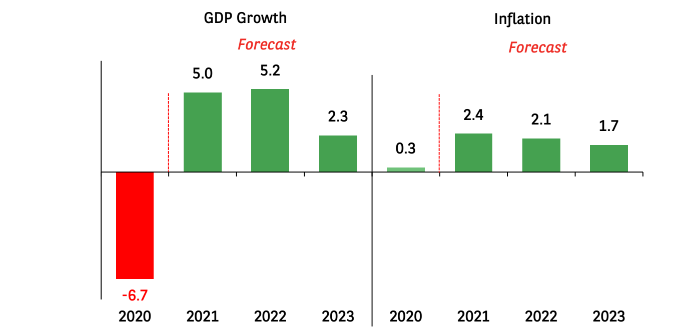

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP: DEVIATION FROM PRE-CRISIS LEVEL

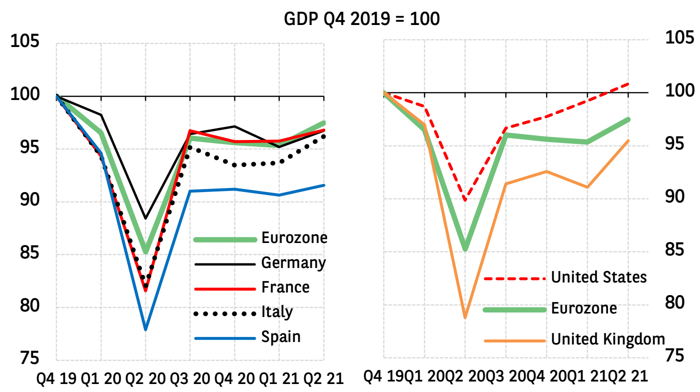

CHART 2 SOURCE: INSEE, EUROSTAT, BEA, ONS, BNP PARIBAS

The positive momentum in hiring, investment and pricing behaviour reflects the corporate sector's confidence in the robustness of growth prospects and its capacity to pass on higher input prices to output prices in order to preserve mark-ups. Yet this confidence must be monitored closely.

In 2022, the quarterly growth profile will slow down slightly. More importantly, however, it should remain significantly higher than the long-term trend, bolstered by the monetary and fiscal accommodative stance, the recovering job market, the unblocking of forced savings accumulated by households, and investment needs. Average annual growth is expected to be slightly higher in 2022 than in 2021 (5.2% and 5%, respectively), which sets the Eurozone apart from the United States and the UK. Germany and to a lesser extent Spain are expected to report stronger growth in 2022, while France and Italy are both expected to slow. Our 2021 forecast is identical to that of the ECB and the September consensus, while our outlook for 2022 is 0.6 and 0.8 points higher, respectively. The health situation remains an important downside risk, followed by the negative impact of supply-side constraints and the surge in inflation, to which we must add new fears about the scope of China's economic slowdown.

INFLATION GALLOPS

Since year-end 2020, Eurozone inflation has been on a distinctly upward slope. Twelve months ago, year-on-year inflation was still slightly negative, but in August 2021, it rose to +3%, the highest level since year-end 2011. The surge is strongest in Germany, followed by Spain, Italy and France (see chart 3). Yet it is still too early to speak of the return of inflation, since price increases have not spread to all components of the consumer price index, and they are not self-sustaining. Core inflation is much lower at 1.6% y/y. The increase in inflation is essentially due to a temporary relative prices distortion. A major base effect is at work, linked notably to energy prices. There is also the impact of supply-side constraints on the prices of certain commodities and industrial inputs, and the impact of surging demand for certain products following the end of lockdown measures. These upside pressures should dissipate in 2022.

Before ebbing, however, inflation is expected to continue rising through the end of the year. We expect inflation to peak in Q4 (as it verges on 4% y/y). This is bound to have an impact on corporate margins and household purchasing power. Yet signs of output prices increases and the generally well preserved financial situation of companies should help limit the negative impact on margins. And the impact on household confidence and consumption is likely to be mitigated by the large surplus savings available for them to dip into, as well as by the support of a healthier job market and by various fiscal support measures for households.

Another factor to watch for is the transmission of inflation to all components of the CPI and the triggering of a wage-price loop against a backdrop of strong hiring difficulties, which could lead to much higher inflation for longer. Yet the odds of such a scenario seem low given competitive pressures and the need to preserve market shares; as well as the high unemployment halo (which includes inactive people who are discouraged about finding work and those working part time but would like to work more). For the moment, there are no visible signs of second-round effects, nor really any need to fear them.

HARMONIZED INFLATION

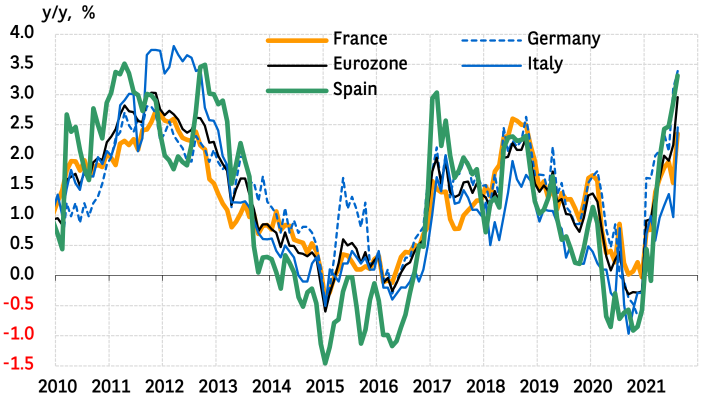

CHART 3 SOURCE: EUROSTAT, BNP PARIBAS

Naturally, the ECB is being vigilant, but we believe it might also welcome the return of some self-sustaining inflation. It would signal that growth is strong and that its "reflation" efforts have been effective. Inflation would finally approach the central bank's target. A little more inflation is also a way to oil the wheels of the economy and to facilitate certain adjustments[1]. In this case it would be "good" inflation. This is the basis of our scenario and inflation forecasts (2.4% in 2021, 2.1% in 2022, and 1.7% in 2023), which are slightly higher than the ECB ones (2.2%, 1.7% and 1.5%, respectively).

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EUROPEAN CENTRAL BANK

We expect the ECB governing council to decide at its December meeting to stop the net purchases under the PEPP in March next year and to increase the purchases in the context of the APP in order to avoid market disruption. This should also limit the spillover effect of higher US Treasury yields on Eurozone sovereign yields. We do not expect a rate hike over our forecast horizon, which runs until 2023.

The forward guidance on interest rates has set three key conditions that should be met before interest rates can be raised: the ECB should see inflation reaching two per cent well ahead of the end of its projection horizon, inflation should reach two per cent "durably for the rest of the projection horizon" and underlying inflation should be judged to have made satisfactory progress towards the target. With the exception of inflation in 2021 – which meets the first condition–, based on the ECB staff projections, none of the conditions are met over the projection horizon, not even in a more favourable alternative scenario.

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1 *Inflation is back with a vengeance — but is that a bad thing? Financial Times* (ft.com).

FOLLOWING IN MERKEL'S FOOTSTEP

After a strong recovery in Q2 and Q3, activity in the coming months could slow due to supply disruptions and sharp rising input prices. After his victory in the legislative elections, Olaf Scholz enters negotiations with the Greens and the liberals on forming a new coalition. The policies are likely to focus on protecting the environment and raising low wages. At the European level, the policies of the new coalition should not be very different from those of Angela Merkel.

COMING OUT OF THE CRISIS

The economy recovered strongly in Q2. GDP rose by 1.6%, but fell short of eliminating the drop in Q1 (-2%). The main reason for the upswing was the easing of the Covid-19 related restrictions. Business surveys indicate a continuation of the robust expansion in Q3. The PMI composite index rose to 59.2 compared with 57.4 in the three months to June. In addition, the ifo activity index rose to 100.7 from 96.7 in the previous quarter. However, businesses have become increasingly concerned about business conditions in the coming few months. That is in particular the case in the manufacturing sector, where the ifo business climate index has been on a deteriorating trend since July. Businesses are not only worried about shortages of intermediate inputs but also about the stark rising input costs, which are weighing on profit margins.

In the wake of strengthening activity, the labour market substantially improved. The unemployment rate has been on a descending trend since December 2020, reaching 3.6% in August, only 0.3 %-point higher than before the crisis. Moreover, the number of workers in the furlough scheme (*Kurzarbeit*) has been rapidly declining in all sectors. In August, only 2% of employees were in a furlough scheme compared with close to 20% in April 2020. As expected, the highest number was in the hospitality industry, 10% compared with 63% in April 2020.

At the same time, prices have been rising sharply. In September, consumer prices were 4.1% higher from a year earlier and we forecast inflation to rise to 4.6% in Q4. The *Bundesbank* attribute this mainly to temporary factors such as the return to the higher VAT rates on 1 January and the increase in crude oil prices. In September, energy prices were 14.3% higher from a year earlier. Moreover, businesses have charged higher prices to recoup some of the losses incurred during lockdown closures or owing to additional costs relating to safety measures. In addition, there is also a risk that supply bottlenecks might trigger additional price surges. If higher prices results in accelerated wage growth, the rate of inflation could rise perceptibly over the longer term as well.

For the moment, basic pay rises have been moderate. Nevertheless, tensions in wage negotiations are rising. Recently, a dispute between Deutsche Bahn and the railroad workers union culminated in nationwide strikes. Given the uncertain inflation outlook, the *Bundesbank* is against committing the very loose monetary policy stance for a protracted period. The central bank pleads for a gradual winding down of the pandemic emergency purchase programme (PEPP), as soon as the pandemic crisis has been overcome.

THE END OF THE MERKEL ERA

The German general election was narrowly won by the SPD (social-democrats) headed by finance minister Olaf Scholz. The party obtained 25.7% of the vote. The union parties CDU/CSU (Christian democrats) headed by Armin Laschet, the prime minister of Rhineland-Westphalia, ended second with 24.1% of the vote. It was the party's worst result in post-war history. By contrast, the Green party did quite well by almost doubling its score compared to the 2017 general election to 14.8%, and became the third largest political force. The next step is that the parties have to try to form a coalition that has the support of more than 50% of delegates in the Bundestag.

During the election campaign, Mr Scholz has put himself up as the candidate of the continuity. The wish to follow in the footsteps of Ms Merkel is not surprising. During her time at the Chancellery, Ms Merkel piloted the country through several crises. At the start of her mandate end 2005, Germany was considered as "the sick man of Europe". GDP per capita was around the same level as in France (chart 2). Fifteen years later, the income gap with the EU had widened to 46%, whe-

GROWTH AND INFLATION (%)

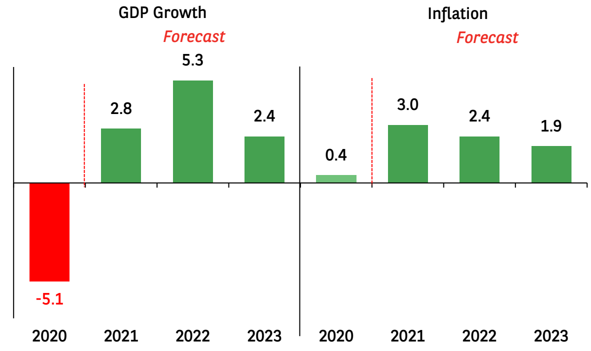

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

THE MERKEL ERA

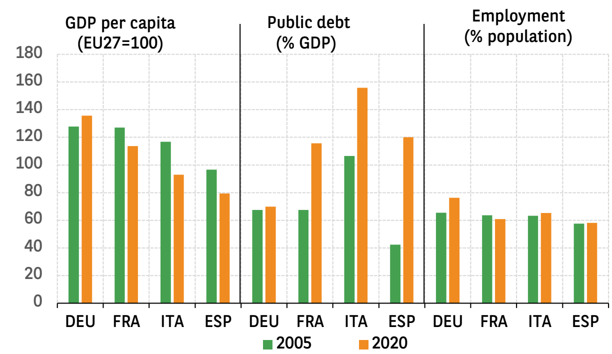

CHART 2

SOURCE: EUROSTAT

reas the French income gap had further narrowed to only 14%. This remarkable turnaround can be largely attributed to the labour market reforms (*Agenda 2010*) undertaken under her predecessor Gerhard Schröder (SPD). As a result, unemployment declined from 11.3% in 2005 to only 3.8% in 2020. Moreover, changes in the wage bargaining process resulted in more moderate wage deals, which allowed the country to regain price competitiveness. Production costs were further lowered by shifting taxes from direct taxation to indirect taxation. In 2007, the VAT was increased from 16% to 19% and wage and company taxes were lowered.

The irony is that the Agenda 2010 reforms have been a great disappointment among the SDP supporters. The party's score was halved between the federal elections of 1998 and those of 2017, from 40.9% to 20.5%. During the Merkel era, the SPD has always been in favour of softening some of the labour market reforms. In 2015, the party, as a junior partner in a grand coalition with CDU/CSU, was the main driving force behind the introduction of a national statutory minimum wage. The job losses that many observers had warned for did not materialise. One of the Mr Scholz's main election promises in the 2021 election campaign is to raise the minimum wage from EUR 9.60 to EUR 12 per hour.

In order to keep public finances in check, the government inscribed the so-called debt brake (*Schuldenbremse*) in the constitution in 2009. This mechanism, in line with the requirements of the Stability and Growth Pact, limits the Federal Government's structural net borrowing to 0.35% of GDP. It has been very effective in reducing Germany's debt-to- GDP ratio from 67.5% in 2005 to 59.7% in 2019. Starting from about a similar position as Germany in 2005, the French public debt actually deteriorated to 97.6% in 2019. Critics of the debt brake hold it responsible for the low level of government investment in particular for digitisation and education, and the bad state of the country's physical infrastructure.

Merkel's environmental record is more contested. After its sudden exit from nuclear energy following the disaster in Fukushima, Germany has invested heavily in renewable energies and yet achieved little on CO_2 reduction, as it delayed the exit from coal. The country achieved its climate targets for 2020, but that was due to the impact of the Covid-19 crisis on activity. Moreover, electricity consumers have paid a very high price for the transition.

During the Merkel era, female employment has substantially increased from less than 60% of the female working-age population in 2005 to 73.2% in 2020. However, many women work in low paid jobs or in so-called mini-jobs. An important disincentive for women to seek full-time employment is the joint taxation of married couples with full income splitting (*Ehegattensplitting*). As a result, the income gap between men and women is one of the highest in the EU (chart 2).

During the severe crises over the last 15 years, the German economy turned out to be much more resilient than that in the other European countries. At the European level, the Chancellor was often reluctant to give unconditional support to the other EU member states. However, at decisive moments, the Chancellor made the choice for Europe. She made sure that Greece could stay inside the Eurozone. In the case of the migration crisis in 2015, the Chancellor even took a serious political risk by opening the borders, in the first place for humanitarian reasons.

GENDER WAGE GAP (2020)

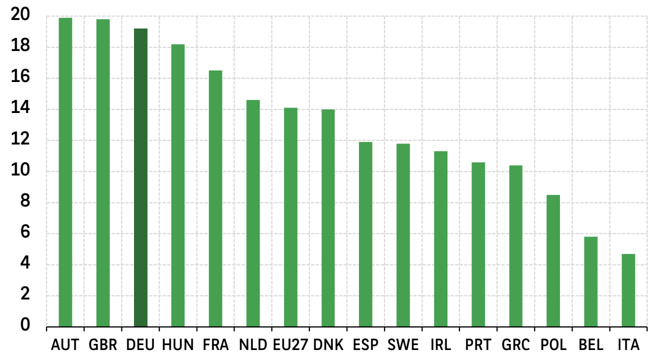

CHART 3

SOURCE: EUROSTAT

PROTECTION OF THE ENVIRONMENT AND LOW-WAGE EARNERS

If Mr Scholz succeeds in forming a coalition, the emphasis of policy is likely to be put on the energy transition. The severe flooding in the western part of the country this summer has once more underlined the importance of more investment in flood prevention and a worldwide reduction in CO_2 emissions.

The SDP is likely to soften the labour market reforms. It has already announced its willingness to increase the minimum wage to EUR 12 per hour (from EUR 9.60 currently). Moreover, the party may like to slow the raising of the retirement age, which should reach 67 by 2029.

The new *Bundestag* will decide the Budget for 2022. As the Covid-19 crisis wanes and the Covid-19–related support to the economy is gradually reduced, the discussion on restoring budget discipline is likely to come again to the fore. The outgoing government, in which Mr. Scholz was the finance minister, planned to comply with the debt brake again in 2023, as foreseen in the country's constitution. Mr Scholz has certainly remembered the lesson from the Covid-19 crisis that thanks to a healthy budget, the federal government was able to support generously the economy in the crisis, without a dramatic deterioration of the public accounts.

At the European level, the policies of the incoming coalition should not be very different from the outgoing one. Each German Chancellor will act in the first place in what he or she perceives to be in the interest of the country. Germany is expected to defend a return to the European budget rules to instil confidence in the euro. Support to other countries can only be given conditional on the implementation of structural reforms.

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STRONG GROWTH

Despite April's lockdown, French GDP rose strongly in Q2 2021, up 1.1% q/q. The lockdown's negative impact was very mild, and the economy rebounded strongly in June. Q3 growth is expected to reach 2.2% q/q, on the one hand buoyed by Q2 strong momentum, but on the other hand curbed by the supply-side constraints at work. In business climate surveys, optimism still prevails, although it has been fading since June. In Q4, GDP growth is expected to virtually close the gap, covering the last percentage point before economic activity returns to 100% of pre-crisis levels. This would bring average annual growth to 6.3% in 2021. In 2022, GDP growth is expected to return to more normal levels although it will remain strong, bolstered by the fiscal impulse. In addition to the downside risk of the health situation and the inflation surge, there are new fears about the scope of China's economic slowdown. Yet growth could also surprise on the upside thanks to the freeing of surplus household savings, the preservation of the financial health of companies, and fiscal stimulus measures.

Q2 MOMENTUM WILL BOOST Q3 GROWTH

According to the INSEE's second estimate, French GDP rose 1.1% q/q in Q2 2021 (0.2 points more than its preliminary estimate). This brings year-on-year GDP growth to 18.7%, thanks to a very favourable base effect (at the height of the Covid-19 crisis in Q2 2020, GDP plummeted 13.5% q/q). GDP is 3.2% below the pre-crisis level of Q4 2019. The GDP breakdown reveals some major and instructive differences between components (see chart 2). On the one hand, household consumption and exports remain depressed (5.9% and 9.5% below pre-crisis levels, respectively). On the other hand, corporate and household investment stand out for their dynamism (2.3% and 2.2% above pre-crisis levels, respectively). Seen in this light, the large forced savings accumulated by households currently seem to be benefiting housing investment more than consumer spending.

The Q2 growth figure was stronger than expected: we were looking for growth of 0.8% and the INSEE, 0.7%. Although French growth is not nearly as high as the Eurozone average (2.2% q/q) or in the United States (1.6% q/q), it is still a strong performance given the circumstances. Indeed, it is significantly positive despite the third lockdown in April. The negative impact of this lockdown was even smaller than the second one. According to the Bank of France, the loss of GDP relative to its pre-crisis level barely increased, from a little less than 4% in March to just over 4% in April 2021, while the gap widened from -3% in October 2020 to -6% in November. In May 2021, the shortfall narrowed again, to a little less than 4%. This was followed by stronger improvements in June and July, to about -2% and -1%, respectively. In August, the gap remained unchanged before narrowing slightly to -0.5% in September. This means the French economy is operating at 99.5% of its pre-crisis level.

For the Bank of France, these slight fluctuations in activity would lead to growth of nearly 2.5% in Q3, buoyed by the strong momentum of the Q2 rebound. Looking at this forecast and the INSEE's 2.7% forecast, there would seem to be some upside risk to our own estimate of 2.2%. Yet stronger growth in Q3 would mean less growth in Q4, because if the catching-up effect moves forward into Q3, then the residual automatic effect would be smaller in Q4. Our scenario is based on a mild catching-up effect in Q3 (due to supply-side constraints, see below), leaving GDP at 99% of its pre-crisis level, before virtually closing the gap with the last 1 percentage point in Q4. We are also counting on the gradual rollout of the France Relance recovery plan to support growth in Q4, lifting our forecast to 0.9% q/q, compared to the INSEE estimate of 0.5%. Although GDP is expected to return to pre-crisis levels in Q4 2021, this good news should not mask the persistence of major sector differences.

GROWTH AND INFLATION (%)

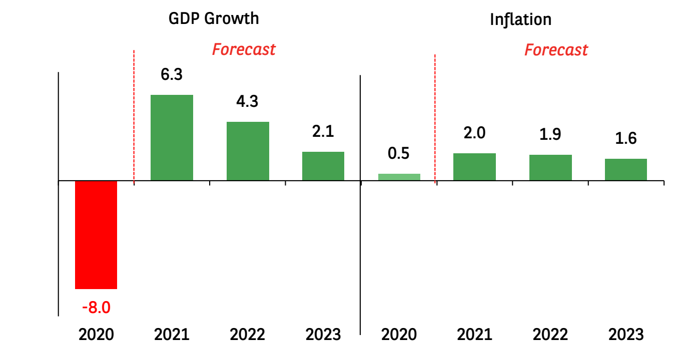

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP AND ITS COMPONENTS COMPARED TO THEIR PRE-CRISIS LEVEL

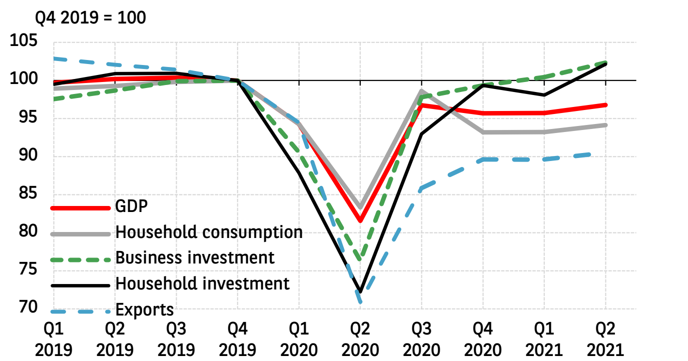

CHART 2 SOURCE: INSEE, BNP PARIBAS

The Covid-19 crisis has left deep scars on transport equipment manufacturing, transport and storage services, hotel and food services, and leisure activities (activity is down 23%, 8%, 14% and 11%, respectively in September 2021 compared to Q4 2019 according to INSEE). In contrast, the information and communications sector outperformed the other sectors, and business is 7% above the pre-crisis level.

SOURCES OF FRICTION (CONTINUED)

In Q2 2021, growth carry-over reached nearly 5%. This means there is a good chance that our full-year forecast of 6.3% will be met, even though Q3 and Q4 growth prospects do not look quite as strong as at the beginning of the summer. The sectors hit hardest by the crisis are returning to normal only slowly due to the health situation and ongoing restrictions. Above all, supply chain constraints, hiring difficulties and rising input prices have all accelerated since the beginning of the year and are having a more significant negative impact on the recovery than expected. The optimism shown in business confidence surveys has faded slightly, in addition to their expected normalisation after June's spike. At this stage, however, the decline is still mild and confidence remains high (see chart 3). Industry and construction are more exposed to supply-side tensions, while the service sectors are hit harder by health restrictions. In the months ahead, there could be a reversal in the performance of these sectors, with the services sectors pulling ahead, followed by construction and then industry.

Looking more specifically at hiring troubles, one positive point to keep in mind is that they are the corollary of some good news: the employment recovery. The size of the problem is surprising (given the available labour pool, based on the combination of unemployment, halo unemployment and underemployment) but also alarming since it restrains growth (although at this point it is hard to evaluate to what extent). There are several explanations for these hiring troubles: the specific nature of the Covid-19 crisis, stop-and-go growth trends, the preservation of jobs through job-retention schemes, the very heterogeneous nature of the sectoral shock and the ensuing difficulties of immediately reallocating and remobilising the workforce. This comes on top of existing structural problems, such as the attractiveness of certain professions and the mismatch between available labour and the skills that are needed. All of this further complicates the smooth matching of labour supply and demand. Yet as the economy and the job market begin functioning more normally, these hiring problems should gradually dissipate.

The other problem associated with hiring difficulties is their likely translation into wage inflation and the possible triggering of a wage-inflation loop and second round effects against a backdrop of surging inflation. For the moment, there is only anecdotal proof of wage pressures. Moreover, it is worth being cautious based on the experience of the years 2015-19, when the increase in hiring troubles was accompanied by only mild wage inflation (see chart 4). There is still slack in the labour market. Recent fiscal measures have also sparked a net rebound in corporate mark-ups, leaving more room for wage increases. Yet this leeway is limited, and it risks being absorbed by the concomitant rise in industrial input prices. There is also a small possibility, at least in most cases, that it will be passed on to output prices. In the end, it seems most likely that wage inflation will remain mild, although as the Bank of France warns, it could well prove to be stronger than expected. In our eyes, this would be rather good news if it signals a more normal functioning of the economy, and allows inflation to approach the ECB's target.

Another source of concern is the possible negative effect of the inflationary surge (1.9% year-on-year in August) on household confidence and consumption. As we have written in our analysis of the Eurozone, although the surge in inflation might be short-lived and contained (core inflation was still low at 1.5% year-on-year in August according to the INSEE national measure), it is still eroding purchasing power. However, the negative impact on consumption is likely to be mitigated by the strength of the labour market, the possibility of dipping into the accumulation of forced savings, the automatic minimum wage increase, which was moved forward to 1 October 2021, and a supplementary energy check of EUR 100, to be disbursed in December.

In 2022, supply chain disruptions and the health situation are unlikely to hamper growth as much as they did this year, but the automatic catching-up effect of the pre-crisis level is also likely to play a much smaller role. Even so, growth should remain strong (4.3%), buoyed by the fiscal impulse. The upside and downside risks to this scenario seem to balance each other out. The health situation remains a downside risk, to which we must add the inflation surge and fears about the size of China's economic slowdown. Inversely, growth could surprise on the upside thanks to the accumulation of surplus household savings, the preservation of the financial situation of companies and fiscal stimulus measures. Our 2021 and 2022 growth forecasts are respectively 0.2 points and 0.5 points above the September consensus.

Completed on 23 September 2021

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CONFIDENCE SURVEYS

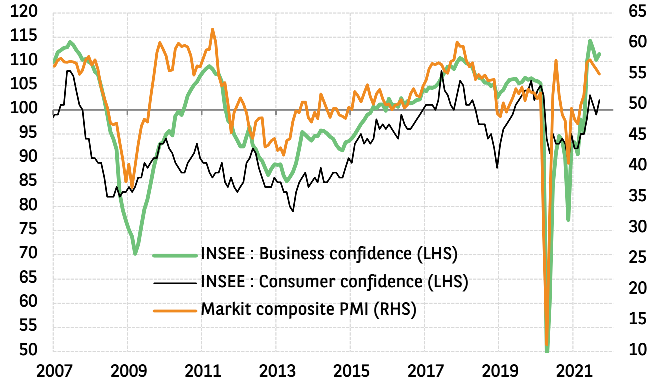


CHART 3 SOURCE: INSEE, MARKIT, BNP PARIBAS

HIRING DIFFICULTIES AND WAGES

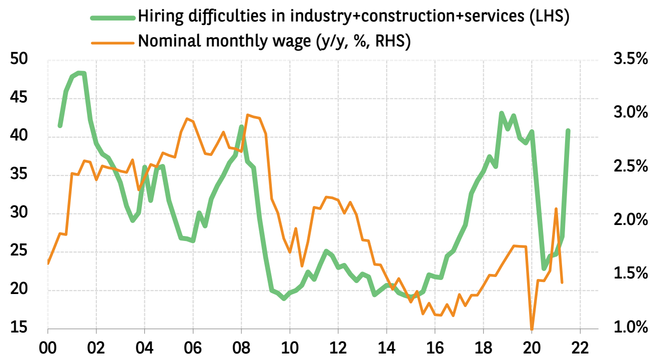


CHART 4 SOURCE: INSEE, BNP PARIBAS

WINDS OF OPTIMISM BLOWING THROUGH THE ECONOMY

The economic recovery has gradually gained momentum, becoming increasingly more widespread for various components and sectors. The improvement in the overall scenario has boosted optimism among companies, supporting business investment. While manufacturing activity had begun to increase in H2 2020, the services sector benefited from an upswing in consumption in Q2, despite the still disappointing international tourism trends. A wind of surprising optimism continues to blow through the Italian real-estate market, driven mainly by home purchases by many families keen to improve their housing conditions. In Q2 2021, residential sales recorded +70% growth compared to Q2 2020, and +26.1% compared to Q2 2019.

A MORE RESILIENT ECONOMY

The Italian economic recovery has gradually gained momentum, becoming increasingly more widespread for various components and sectors. Real GDP rose by 0.2% in Q1 2021 and then accelerated to almost 3% in Q2. The annual growth rate climbed above 17%, as a consequence of the deep plunge recorded in Q2 2020. The carry over for 2021, assuming no further increase in the second half of the year, is 4.7%.

In Q2, the contribution from domestic demand was positive (+3.1%), while stocks subtracted 0.8% percentage points from overall GDP growth. Thanks to the improvement in health conditions, most restrictions introduced to contain the spread of the virus were eased. Although households remained somewhat cautious, consumption rose by 5%, after -1.1% in Q1, also reflecting the strengthening of labour market conditions. The number of persons employed rose by 338 thousand, despite remaining well below pre-pandemic levels. Consumers mainly increased their spending on semi-durable goods and on services, which had suffered strongly in previous quarters. The recovery of domestic and global demand has boosted optimism among companies, supporting business investment. In Q2, capital spending rose by 2.4%, after +3.8% in Q1. Investment has already recovered the losses incurred during the pandemic crisis, recording a 5% increase compared to Q4 2019.

From April to June, the contribution of net exports became positive (+0.3%, after -1% in Q4 2020 and -0.4% in Q1 2021), as exports were stronger than imports (+3.2% and +2.3%, respectively), thanks to a dynamic external environment.

A WIDESPREAD RECOVERY

Manufacturing activity began to increase in the second half of 2020, reflecting the improvement in the global environment. Exports have recovered fully from the major decline registered during the first half of last year. From January to July 2021, Italian sales abroad rose by almost 23% on an annual basis, compared to around +16% in Germany and France. Manufacturing output increased by 0.5% in Q4 2020, 1.3% in Q1 2021 and 1.5% in Q2 2021, slightly exceeding the pre-crisis level. The recovery of global trade mainly supported intermediate goods production, with strong increases in the electrical equipment sector, as well as for metal products and rubber, plastic and non-mineral metal products.

With the gradual lifting of restrictions, the services sector benefited from an upswing in consumption. In Q2, value added rose by almost 3%, after declining in both Q4 2020 and Q1 2021 (-2.3% and -0.4%). The overall figure reflects the strong rebound in hotel and restaurant activity. Turnover rose by 35% Q/Q, despite remaining more than 40 percentage points below Q4 2019 value, as this sector is still severely affected by disappointing international tourism trends. In Q2, foreign travellers in Italy reached around 6 million, which is more than in Q2 020 (4.8 million), but far below the 25.9 million recorded in Q2 2019. According to national account data, non-residents' spending increased from EUR 1.9 billion in Q1 to EUR 2.4 billion in Q2 21, which is around one fifth of pre-crisis values.

GROWTH AND INFLATION (%)

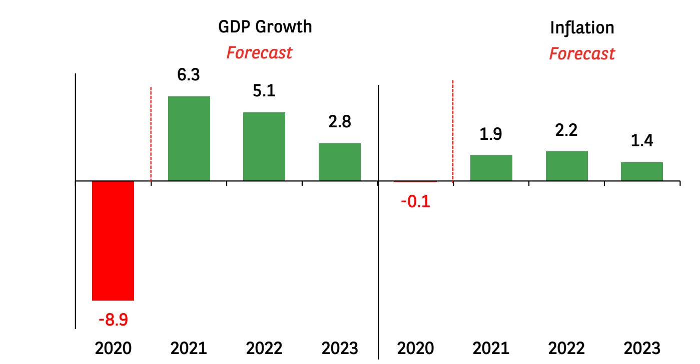


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

VALUE ADDED BY SECTOR

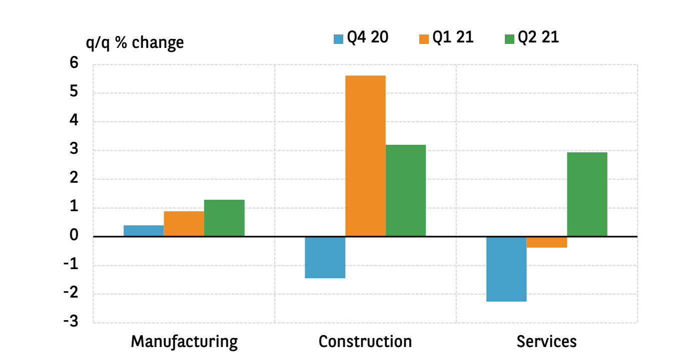


CHART 2 SOURCE: BNL CALCULATIONS ON ISTAT DATA

THE PANDEMIC IS OVER IN THE REAL-ESTATE MARKET

Despite the bleak forecasts at the beginning of the pandemic, a wind of surprising optimism continues to blow through the Italian real-estate market, mainly driven by the purchase choices of many families wishing to improve their housing conditions after the months spent in lockdown during the pandemic crisis. According to a recent survey conducted by Nomisma (an Italian institution specialising in the field), 3.3 million Italian families seem to be willing to buy a new home within the next 12 months. Among them, however, only about 800 thousand appear to have an adequate income that will enable them to actually proceed with a purchase, which is more than recorded in the surveys conducted before the pandemic.

The resilience that has characterised the Italian real-estate sector during the first months of the pandemic, and the reactiveness seen subsequently, will probably make it possible for the sector to close the long Covid parenthesis with unexpectedly brilliant performance. In fact, all of the main indicators have recorded positive growth rates since the end of 2020.

This year, the number of transactions will probably converge towards to projections made before the pandemic, with a cumulative decline not exceeding 4% in the two-year period from 2020 to 2021, compared to the pre-crisis scenario.

In Italy, the residential market continues to be dominated by private individuals, who account for around 95% of the demand and 87% of the supply. In the first half of 2021, 54.2% of the sales made by individuals were financed by taking out a mortgage, and in 75% of these cases, this involved the purchase of a residential home. The market's good dynamic is also apparent from the gradual decrease in the average discount applied to sales, which reached 9.3%, falling from 10.1% in the previous quarter.

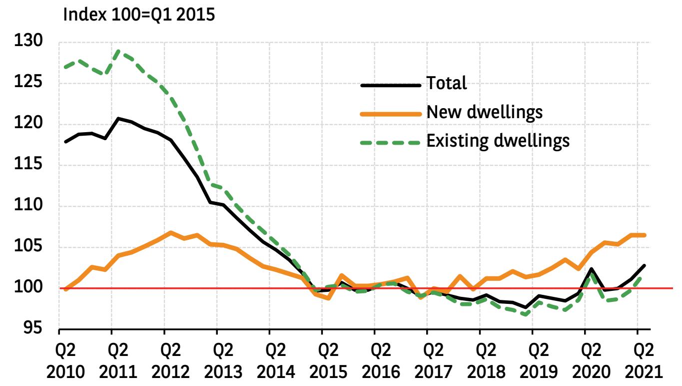
In Q2 2021, residential sales showed +73.4% growth, compared to the same quarter of 2020, and +26.1% growth compared to Q2 2019. In non-capital municipalities these values were higher (+81.6% with around 62 thousand houses sold and +31.3% with almost +33 thousand homes sold, respectively). In the capital municipalities, house transactions rose by 58% YoY (over 23 thousand more homes purchased than in Q2 2020 and almost 9 thousand more compared to Q2 2019, +16.1%). Compared to Q2 2019, house transactions in the main northern cities rose by 14.6%, and in the central regions by 34.2%.

The recovery in transactions evident from the comparison between 2021 and 2019 data involves all of the size classes, but mostly the largest ones (over 145 square metres). Between April and June 2021, home transactions in the top eight Italian cities increased by 14% compared to Q2 2019, with the greatest increases recorded in Genoa and Rome (+32.7% and +19.4%, respectively). Florence, Palermo and Turin recorded more moderate growth rates, but still in double digits. The increases in Milan, Naples and Bologna remained below 10% compared to 2019.

The indications on the price side are also positive, although the latest data shows a slowdown that is more evident in the southern regions and in some of the main northern cities, including Milan. According to Istat preliminary estimates, in Q2 2021 home prices in Italy rose by 1.7% QoQ, and by 0.4% YoY (this was +1.7% in Q1 2021). The increase on an annual basis was due mainly to the prices for new dwellings (+2.0%, down from +4.0% in the previous quarter), while prices for existing dwellings increased slightly (+0.1%, and was +1.2% in Q1 2021).

Assuming a zero change in prices in the second part of the year, the growth rate for home prices in 2021 would be +2%, a value that has never been reached with available data (2010). In the northwest and northeast regions, home prices rose by 0.1% and 0.3% YoY, respectively (from 1.8% and 2.3% in Q1 2021, respectively). In the central regions, home prices rose by 1.2% (compared to 1.4% in Q1 2021), while in the

HOUSE PRICES



GRAPHIQUE 3 SOURCE: BNL CALCULATIONS ON ISTAT DATA

southern regions and on the islands they fell by 0.2%. Among the main cities, in Milan home price growth slowed down to +1.4% YoY in Q2 2021, from +5.2% in Q1. The positive trend is entirely attributable to existing dwellings, for which prices increased by 3.6% YoY, while prices for new dwellings fell by 8.8% YoY. On a quarterly basis, the different dynamics are confirmed, with prices for new dwellings decreasing by 14.2% compared to the previous quarter, while prices for existing dwellings were up by 3.2%. In Rome, home prices in Q2 2021 recorded a negative growth rate (-0.5% in Q2 compared to +1.7% in the previous quarter).

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SPAIN

NEW RISKS ARE EMERGING

After the disappointing economic growth reported in H1 2021, Spain should record a robust rebound in activity in H2, assuming the health situation does not deteriorate. The inflow of tourists has picked up (but remains historically low) and employment has recovered. Yet inflationary risks are intensifying. With the surge in energy prices, the government was forced to take drastic measures to reduce the energy bill for households, which will weigh on public finances. Faced with a persistently uncertain environment, the government is bound to maintain an expansionist policy when it unveils its 2022 budget this fall, even though the health situation is more favourable for the moment thanks to the high level of vaccinations. The socialist government's top priority will be to consolidate the economic recovery, notably by protecting household purchasing power in the face of rising energy costs.

Growth figures were undoubtedly disappointing in Q2 2021. After contracting 0.2% q/q in Q1, real GDP rose only 1.1% q/q, which is a much smaller rebound than the INE's preliminary estimate of 2.7% q/q. Household consumption did not bounce back as strongly as expected. Moreover, the economy still has a long way to go before vast segments of activity return to normal. Several factors could hamper private consumption in the months ahead. In addition to rising inflation (see below), supply-chain disruptions are hurting industry, especially the automobile sector. New car sales in Spain fell by half between April and August 2021. Lastly, uncertainty looms over the evolution of savings accumulated by households during the pandemic – which the Bank of Spain estimates at nearly EUR 117 bn – since it could take a while to unblock them.

Yet the net turnaround in the job market since last spring creates encouraging prospects. More than 400,000 jobs have been filled since April[1], and employment is now only slightly below the pre-pandemic level. The jobless rate is still higher than in early 2020 (14.3% in July, compared to 13.7% in February 2020), but this partly reflects an increase in the active population. That said, given that a large portion of new hiring was seasonal, we must wait to see how employment is trending this fall to get a more precise idea of the vigour of the recovery. With numerous people returning to work, the number of individuals covered by the ERTE temporary unemployment scheme declined in August to the lowest level since the pandemic began (272,190).

The improvement in the job market also provides public finances with a little more leeway, especially for the central government accounts, which are still highly deteriorated. Spain is expected to report another substantial deficit in 2021, estimated at more than 7% of GDP according to the Bank of Spain, after reaching a record high deficit of 11% of GDP in 2020 (see box 1). The Spanish central bank is also forecasting another large deficit in 2022 (-4.3% of GDP) and 2023 (-3.5%). Assuming the health situation remains stable, growth should nonetheless accelerate in the second half of this year. Spain is one of the European countries with the highest vaccination rates, with nearly 80% of the population fully vaccinated at the end of September. The inflow of tourists continues to be hampered by the global health environment, although the level of activity in August is closing in on the pre-pandemic level observed in 2019. Indeed, the hotel occupancy rate rose to 65% in August, around 10 points below the 2019 level but significantly above that of 2020 (44%). Moreover, opinion surveys are still looking upbeat. The composite Purchasing Managers Index (PMI) is still historically high (60.6 in August). The survey highlights a particularly strong demand for consumer goods (see chart 2). According to the European Commission survey, household confidence has also returned to a level comparable with pre-pandemic levels.

GROWTH AND INFLATION (%)

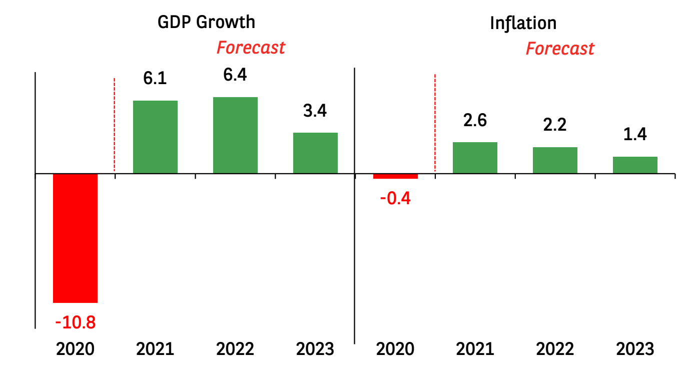

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

MANUFACTURING PMI, CONSUMER GOODS SECTORS

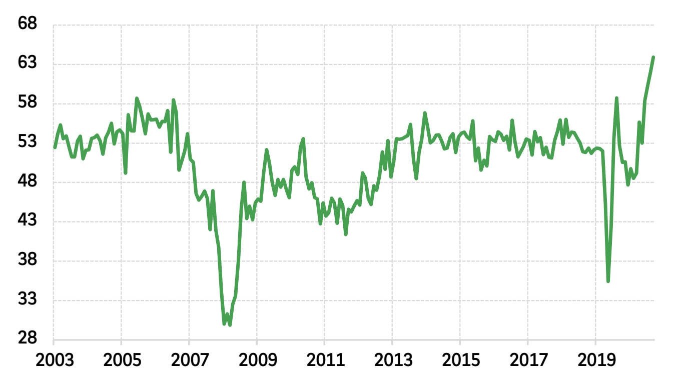

CHART 2 SOURCE: MARKIT

Another positive trend is the rebound in the real estate market, which is regaining colour after bottoming out in 2020. Several factors have come together, including historically-low interest rates[2], large household savings, and the democratisation of remote working. This has resulted in an increase in residential building permits and higher real estate prices in 2021 (prices rose 5.2% y/y in August, according to the TINSA index). Although the level of real estate activity is still far below that obser-

1 The number of payroll employees registered with Social Security rose by 412,447 over the past three months (source: SEPE).
2 The average borrowing rate fell below 1.6% for the first time in June (source: Bank of Spain).

ved during the speculative bubble of the 2000s, residential investment could provide a welcome boost to growth in the short to medium term. In August, construction sector employment, which was much more resilient to the health crisis than most other sectors, was already nearly 2% above the winter 2020 level.[3]

INFLATION SURGES: THE GOVERNMENT INTERVENES

Strong demand for natural gas coupled with supply-side disruptions triggered a surge in electricity and gas prices in Europe. Spain was one of the countries hit earliest and hardest by the price spike. Electricity prices in Spain soared 35% y/y in August, while natural gas prices rose 8.2% y/y. Higher energy costs had a significant impact on headline inflation and accounted for half of August's annual increase in the CPI. Moreover, it is unclear whether energy prices will level off or decline in the months ahead given the risk that natural gas supply problems could persist this winter.[4] The increase in energy prices could feed through to higher prices for other spending categories, notably food, which accounts for nearly a quarter of the consumer basket of Spanish households. Some components of the CPI, however, were still in deflationary territory in August, including communications (mainly telephone services), education, leisure and culture.

The surge in energy prices hits low income households hardest, as they devote a bigger share of their budget to these fixed costs. To preserve private consumption as best as possible and to avoid crimping the recovery, the government announced a series of measures. In early July the VAT rate on electricity was temporarily reduced (from 21% to 10%) through the end of 2021, and the tax on electricity production, which hurts companies, was suspended for three months. With electricity prices continuing to rise over the summer, the government announced new measures in early September that aim in particular at taking off electricity companies from part of their profits generated by the rise in gas prices on international markets market.[5] The reduced VAT rate on electricity might also be extended beyond December 2021.[6]

Completed on 23 September 2021

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PRELIMINARY RESULTS OF PUBLIC ACCOUNTS IN 2020

Public finances (EUR bn)	2020 (a)	2019 (b)	(a) - (b)	% of total (2020)
Total revenue	463.3	487.8	-24.5	-
Value added tax and import duties	129.6	147.5	-17.9	30.2
VAT	70.6	80.9	-10.3	16.6
Other	59.0	66.6	-7.6	13.7
Income and wealth taxes	125.3	129.2	-3.9	26.5
Income tax	121.0	124.8	-3.8	25.6
Other	4.3	4.4	-0.1	0.9
Capital gains tax	4.6	5.5	-0.9	1.1
Social welfare contributions	161.9	160.7	1.2	32.9
Employers	112.3	112.3	0.0	23.0
Households	42.4	41.2	1.2	8.5
Imputed contributions	7.1	7.2	0.0	1.5
Corporate taxes	6.7	8.8	-2.0	1.8
Dividends	4.7	6.2	-1.5	1.3
Interest	2.1	2.6	-0.6	0.5
Other revenue	26.7	26.9	-0.2	5.5
Total spending	586.4	523.4	62.9	-
Intermediate consumption	66.0	64.0	2.0	11.3
Employee compensations	140.5	134.5	6.0	24.0
Interest	25.2	28.3	-3.2	4.3
Subsidies	21.4	12.5	8.9	3.7
Social transfers (excluding cash)	228.1	196.8	31.3	38.9
Cash transfers	33.6	32.8	0.8	5.7
European Union-related expenditure	11.0	10.2	0.8	1.9
Fixed capital formation (public investment)	28.2	26.0	2.2	4.8
Other spending	32.3	18.2	14.1	5.5
Fiscal balance	-123.1	(% GDP: 11.0)		
Primary balance	-97.9	(% GDP: -8.7)		

The deterioration in Spain's public finances was sharp in 2020. The fiscal deficit widened by EUR 87.4 bn to reach EUR 123.1 bn, beating the dismal record of EUR 120.6 bn in 2009. Lower revenues and higher spending created a major scissors effect. Three quarters of the decline in revenue was due to the drop in tax collection on production and imports. This reflects the slowdown or halting of numerous activities during the various lockdowns. The remainder of the fall in fiscal revenues can be attributed to the drop in resources generated by corporate taxes as well as personal income and wealth taxes. Revenue from social welfare contributions increased since wages were maintained for most workers thanks to extended furlough (ERTE) schemes. These exceptional measures nonetheless led to a spectacular rebound in social transfers, which rose by more than EUR 30 bn in 2020. Note that the cost of debt narrowed again in 2020 as interest rates continued to fall.

BOX 1 SOURCE: SPANISH MINISTRY OF FINANCES, BNP PARIBAS

3 Source: Spanish employment office (SEPE).
4 Tagliapietra & Zachmann, *Is Europe's gas and electricity price surge a one-off?,* Bruegel
5 *El Gobierno recorta 2.600 millones a las eléctricas para contener el recibo de la luz, El Economista,* 13 septembre 2021.
6 *El Gobierno estudiará ampliar la rebaja del IVA a la luz más allá del 31 de diciembre, El Economista,* 21 septembre 2021

THE NETHERLANDS

BOGGED DOWN IN PETTY POLITICS

Following the gradual lifting of health restrictions, the economy rebounded strongly in Q2 and this dynamism continued in Q3. Despite the favourable economic climate and the satisfactory state of public finances, the political parties are still struggling to form a government even six months after the legislative elections. Nonetheless, the outlook remains bright, especially thanks to the rapid expansion of world trade.

GROWTH MOMENTUM IS SLOWING AFTER STRONG Q2

In Q2, economic activity rebounded strongly by 3.8% from the previous quarter, due to the gradual lifting of the lockdown in the Netherlands and the surrounding countries. Household consumption and exports grew strongly. Yet, persistent uncertainty concerning the pandemic weighed down on investment (-1.6%). In Q3, the CBS business cycle indicator continued to strengthen. However, business and consumer confidence are showing signs of levelling off, partly because of political uncertainties. Moreover, purchasing power is affected by the rapid increase in energy prices. In August, they were almost 16% higher from a year earlier. Nevertheless, core inflation has remained rather tame, only 1.7%, because of the freezing of social rents on 1 July. By contrast, the housing market has showed signs of overheating. In Q2, house prices were 20% higher from a year earlier and about 80% of dwellings were sold at a higher amount than the asking price. In combination with the housing shortage, it is one of the unintended consequences of the ECB ultra-loose monetary policy. It has limited access to the housing market for first-time buyers, who often opt for cheaper but more risky interest-only mortgages.

GROWTH AND INFLATION (%)

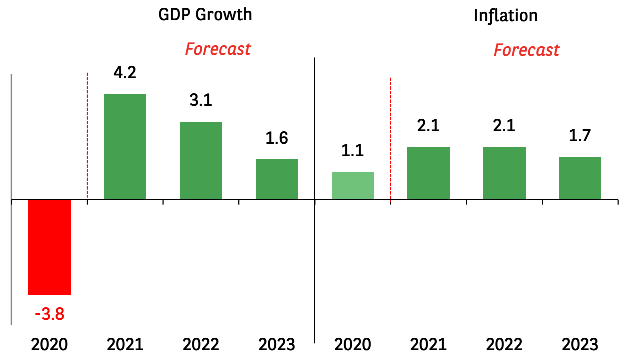

CHART 1

SOURCE: BNP PARIBAS

COALITION TALKS IN GRIDLOCK

Since January, the country is ruled by a centre-right caretaker government. The two liberal parties of the outgoing coalition, the VVD (conservative-liberals) and D66 (social-liberals), were the great winners of the general election in March. As these parties have less than 40% of the seats in parliament, they have been looking right and left for possible coalition partners in the past few months. Real negotiations about a coalition programme have not started even six months after the election. It is not excluded that the parties of the outgoing coalition decide to continue their cooperation in a new government despite frictions between them. New elections might be necessary if the gridlock in the government formation cannot be solved.

In September, finance minister Wopke Hoekstra presented the budget for 2022. The context is more favourable than in 2020, as the economy has been less affected by the corona crisis than initially feared. For 2022, Mr Hoekstra forecasts the budget deficit at 2.4% of GDP and the debt-to-GDP ratio at only 57.7%, both well within the limits Maastricht criteria, which are at the moment temporarily suspended. The major problem is the lack of ambition, which is inherent to the caretaker status of the cabinet. The government has reserved EUR 7 bn for environmental measures and EUR 1 bn for housing. During the debate on the budget, Parliament agreed on increasing spending by EUR 2 bn.

FIRING ON ALL CYLINDERS

Despite the political difficulties, the economic prospects look very good. As the pandemic is waning and the vaccination rate has reached close to two-thirds of the population, the government has decided to a further easing of restrictions by abandoning social distancing rules and the introduction of a vaccine pass. This is likely to boost activity in the coming months. At the same time, the government is also withdrawing support to companies, a rather delicate operation, which could increase the number of bankruptcies. As a consequence, unemployment, almost down to pre-crisis levels, might increase somewhat in the next few months.

Next year, growth will be broadly based. Private consumption is boosted by the opening of the services sector and the savings rate is projected to decline to pre-Covid levels. The accumulated savings during the crisis are unlikely to boost consumption significantly, as they have in particular benefited the high-income households with a relatively low propensity to consume. Moreover, these households might have used their additional savings to invest in the housing market. By contrast, low-income earners in the services sector that have been drawing down their savings during the crisis are likely to restore their buffers again.

Exports are projected to rebound thanks to the stronger expansion of world trade and external markets of relevance to the Netherlands. The current account could even reach 9% of GDP, which is only slightly lower than before the Covid crisis. Business investment is set to rebound strongly on the back of robust growth prospects. However, investments could be delayed because of supply disruption.

The main risk for the economy is the absence of a government that has sufficient support in parliament to handle the challenges that the country faces on climate change, housing, education and security.

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NEAR COMPLETE RECOVERY, GROWTH SLOWDOWN AHEAD

Belgian GDP increased by 1.7% in the second quarter. Consequently, quarterly GDP came within 2% of its pre-covid level. We expect full year growth to come in at 5.5% this year, slowing down to 3.0% in 2022. Increased government spending helped stave off worse outcomes for the labour market and Belgian firms, which resulted in a quick rebound in investment-related spending by all sectors. Private consumption is rebounding more gradually against a backdrop of GDP growth slowing down.

TOWARDS A SLOWDOWN

A Covid-hit Belgian economy had its GDP slashed by 6.3% last year. A successful vaccination campaign and subsequent loosening of most social distancing measures spurred on growth ever since. After growing at an above-potential pace since the beginning of 2021, we see growth slowing down in the second half of this year. In 2022, we anticipate a further normalization with quarterly growth slightly above potential.

ECONOMIC OUTLOOK

Our nowcast indicates that GDP was 1.2% higher in the third quarter, compared to the second. This implies growth slowing down from 1.7% in the period before summer, which was itself a high-mark for the period 1980-2019. A measure of total economic activity, based on aggregated bank-transaction data, shows how the recovery stalled somewhat since early August. Based on proprietary data, we consider that before the summer, retail spending was back at the level reached in 2019. This was followed by a particularly strong July and a subsequent loss of momentum. This might mean the much heralded "pent-up demand" effect has already run its course.

Consumer confidence is back at its July-peak, with fear of unemployment all but non-existent. Private consumption as a component of GDP was still 6% lower than pre-Covid levels before summer. We don't expect it to fully recover before the end of 2022.

PRICES RISING

HICP, a more volatile measure than CPI, showed prices rising at a whopping 4.7% year-over-year in August. This was mostly the result of a technical effect, with the traditional retail discount period taking place in August, rather than in July last year. Nevertheless, CPI-measured inflation has also been creeping up and most recently came in at 2.7%.

Housing prices are picking up, spurred on by a strong rebound in transactions. A reduction in the favorable tax-treatment of home-ownership at the start of 2020 caused a spike in transactions a couple of months prior, effectively pushing sales forward in time. The subsequent lull in housing purchases was exacerbated by the first bout of social distancing measures, which at some point banned prospective buyers from visiting for-sale properties. Since then, measures were relaxed and demand recovered swiftly to arrive back at the same level as in mid-2019.

The Bank of International Settlements' Residential price index rose by 6.7% over the last 12 months. This development is in line with what is happening in in neighbouring countries. The National Bank of Belgium (NBB) considers Belgian residential real estate 14% overvalued. According to the ECB's models the prices could be as much as 20% above a level supported by the fundamentals. The persistence of recent behavioural changes, such as the increase in remote working, could play an important role in the future development of this market.

GROWTH AND INFLATION (%)

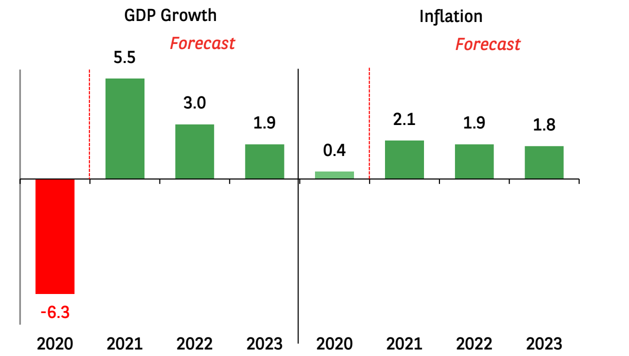

CHART 1

SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

COMPANIES REPORT ISSUES IN RECRUITMENT

Labour economist Stijn Baert (University of Ghent) recently pointed out that the Belgian labour market was the most stable one in the EU-27 since the onset of the Covid-pandemic. In his view, the rates of unemployment and inactivity (those without a job, not looking for it) barely changed between 2019 and 2020. The early expansion of the temporary unemployment scheme could have played an important role in this.

Attracting suitable staff however seems to have become more difficult as of late. The vacancy index, which indicates what proportion of jobs are vacant, is rebounding fast. It is now close to its 2018-peak of 4.5%. The latest survey data of the NBB revealed that close to 80% of all Belgian companies report issues in recruitment, with a lack of applicants the most notable problem.

The number of self-employed workers continued its upward trajectory, with an annual growth rate in line with the peak seen since 1996. This might explain, at least partly, the labour shortages on the hiring front. In contrast, the number of paid employees returned to pre-Covid levels only right before summer.

PUBLIC FINANCE

Supporting the economy throughout the pandemic took its toll on the government budget. The deficit reached 9.4% of GDP last year. The resulting increase in gross government debt will add more strain to a spending pattern which, before the Covid-19 crisis, was already difficult to sustain.

In its Article IV report, the IMF provides an estimate of the impact of the pandemic on the government budget. The economists of the Fund expect a yearly increase of the deficit to the tune of 2 percentage points over the period 2022-2025.

A similar conclusion was drawn by the Belgian Debt Agency. It sees yearly funding needs 10-20B€ higher on a yearly basis, compared to their pre-Covid estimates. On a more positive note, debt servicing costs continue their declining trajectory. Federal government interest expenditures, which stood at 1.75% of GDP last year, could drop to as low as 1.2% over the next couple of years.

For the broad coalition of the De Croo government, lower interest charges on outstanding debt should facilitate the task of bringing public finances under control. It remains to be seen what else will be done.

Completed on 23 September 2021

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THE VACCINATION CAMPAIGN IS PAYING OFF

Portugal's vaccination campaign seems to be paying off. It is the country that has vaccinated the most people in Europe – and one of the most advanced in the world – with nearly 85% of the population fully vaccinated at the end of September. The number of Covid-19 cases has fallen sharply after a surge in June-July due to the spread of the Delta variant. Portugal's economic recovery was slower than in most of the other European countries through Q2 2021, in part because it was hit by a more severe wave of the pandemic last winter. However, employment and housing activity have picked up strongly. As in several European countries, new risks have arisen as the pandemic wanes. Banking system risks must not be neglected: with a large share of loans currently under moratorium, the end of the Covid-19 crisis could be bumpy.

The contraction of Portugal's economy was sharper than previously thought last year. After revision from the National Statistical Institute (INE), real GDP fell 8.4% in 2020, compared to an initial figure of 7.6% (2019 growth was revised upwards by 0.2 percentage points to 2.7%). The downward revision in 2020 is mainly due to a bigger-than-expected contraction of activity in the hospitality and transport sectors, which were especially hard hit by lockdown measures. With the denominator effect coming into play, the public debt ratio rose to 135.2% of GDP in 2020.

At the end of Q2 2021, the Portuguese economy was still operating nearly 4% below the pre-pandemic level of Q4 2019. This major shortfall places Portugal among the laggards of the European economies. Even so, there are notable differences in the economic recoveries between sectors, with some that have returned to levels that are comparable with pre-Covid levels or very nearly so. This is the case for the construction, manufacturing, finance and insurance sectors. By contrast, other sectors have been slow to recover, notably the energy, retail and hotel & restaurant sectors harder hit by health restrictions.

Despite the mixed GDP data, employment rebounded by 2.8% in Q2 2021 and is now higher than the pre-pandemic level. The unemployment rate fell more moderately (6.6% in July) due to an increase in the active population, which is a positive trend. The labour market participation rate reached a new cyclical high of 59.3% in Q2 2021. Consumer confidence has also picked up, bolstered by the improvement in the labour market.

The housing market has also regained momentum with the easing of restrictive health measures. It did not slow much this winter, despite the wave of the pandemic that swept the country. House sales increased in Q2 2021 to the highest level in more than a decade, while real estate prices rose 8.3% y/y in July. Low interest rates fuelled demand. Indeed, borrowing rates continued to decline in 2021, dropping below 0.7% last April, according to the INE.

Though in decline, government subsidies aiming to limit the Covid-19 shock on the economy continue to weigh heavily on public finances. Portugal will report another large public deficit in 2021 (-5.0% according to the European Commission) and the stock of public debt could hold close to the level of 130% of GDP, despite the expected economic rebound in 2021. Yet the country entered the Covid crisis with healthy public finances: the General Government balance recorded a surplus of 0.1% of GDP in 2019 and it could report another primary surplus in 2022. Given its large debt stock, however, Portugal would be more vulnerable to an upturn in sovereign interest rates, which could occur if the European Central Bank decided to tighten monetary policy.

GROWTH AND INFLATION (%)

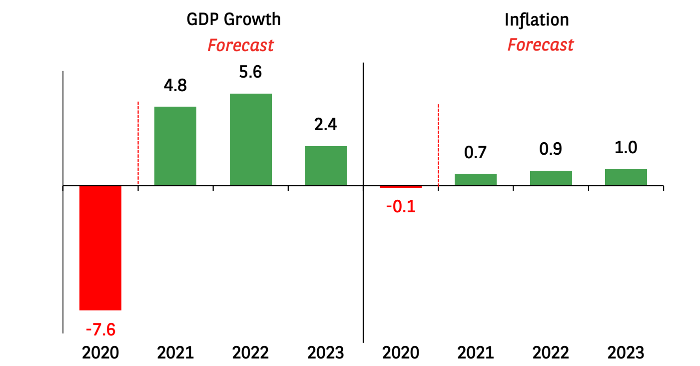

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Banking system risks also must be monitored closely. Temporary measures set up to buffer the Covid-19 shock helped lower the volume of non-performing loans (NPL). As a result, the NPL ratio fell to 2.9% for loans to non-financial companies (NFC) and to 1.6% for household loans in August 2021. Yet this trend could reverse itself following the expiration of the loan moratorium on credit to businesses and families, that became effective at the end of September. Portugal is one of the European countries with the highest share of loans currently under moratorium. In July 2021, they were estimated at 11.3% of total household loans and 28.8% of total NFC loans outstanding according to the Bank of Portugal.

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UNITED KINGDOM

BREXIT BREAKS

After paying a heavy toll to the Covid 19 pandemic, the UK is getting back on its feet. Now that more than 80% of the adult population has been vaccinated, the UK economy was able to reopen for business this summer and to operate almost normally despite the spread of the highly contagious Delta variant. Just as the recovery is running up against supply-side constraints, the government of Boris Johnson is removing fiscal support measures as it proclaims the end of "whatever the cost". Euphoric so far, the recovery should calm down somewhat by the end of the year.

The UK is finally getting back on its feet. Covid-19 was initially brushed aside by Prime Minister Boris Johnson before forcing the government to implement ever tighter restrictions. The pandemic triggered the worst recession in UK history (2020 GDP plummeted 9.8%) and caused 135,000 deaths, one of the heaviest tolls of the advanced economies. Now that more than 80% of the adult population has been vaccinated, the UK is finally exiting the crisis. Though still in the grips of the Delta variant, which is 40-60% more contagious than its predecessor, the "English" variant (renamed Alpha), the hospital system has reported only a mild upturn in severe cases (with at most 800 hospital admissions daily, down from nearly 4,000 at the height of the previous wave). With the reopening of business in phases since February, the economy has rebounded spectacularly, and has rapidly encountered supply-side constraints.

SUPPLY SIDE CONSTRAINTS, RISING INFLATION

Q2 2021 not only marked the end of a strict lockdown – it was even more severe than the one introduced during the first wave of the pandemic in spring 2020 – but was also a period of catharsis, during which British consumption surged at an annualised rate of more than 30%, and businesses bounced back, easily erasing the losses earlier in the year.

As in other countries where households benefited from massive support measures, curbing/restraintson spending led to the build-up of surplus savings, which are now flowing back into the economy (chart 2). Indeed, demand is so strong that supply is struggling to keep up: in transportation, construction and throughout supply chains, delivery periods are getting longer and bottlenecks are forming. Companies are experiencing hiring troubles, even in recovering sectors like tourism and leisure, where job vacancies have reached record highs.

Of course, this is not a specifically British problem. It can be found just about anywhere due to a global shortage of components (Asia, the main supplier, is still struggling with the virus), congested maritime traffic, and commodity market pressures by China and the US.

Yet in the UK, supply-side constraints have been exacerbated by Brexit, whose harmful effects are already palpable. With the return of immigration barriers to keep out European Union workers (visas, work permits, etc.), the obstacles to hiring and the recovery are not only cyclical. According to the Confederation of British Industry, the labour shortage could last two years.

These tensions are now carrying over to prices. At 3.2% in August, inflation has beaten the odds and soared to the highest level since 2012. Some base effects are to blame: the acceleration in inflation in August 2021 can be attributed in part (for 0.3 points) to the fact that prices are compared to the very low levels of August 2020, which is notably when the government launched its "Eat Out to Help Out" scheme that allowed bars and restaurants to propose discounted meals under certain conditions. However, the surge can also be attributed to the fact that many leisure and recreational activities -like hotels or restaurants- still operating at reduced capacity, were given no

GROWTH AND INFLATION (%)

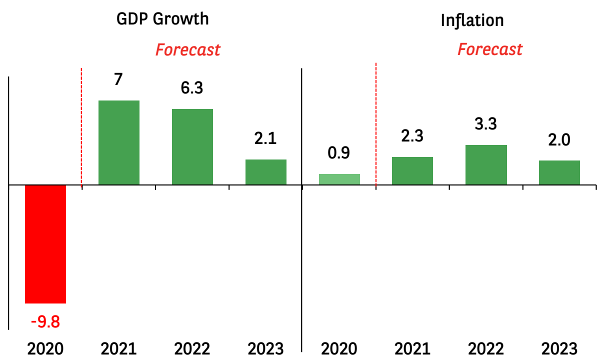

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

HOUSEHOLDS' SAVING RATIO

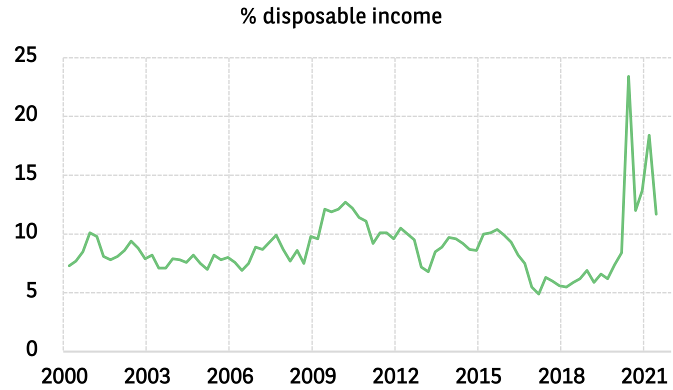

CHART 2 SOURCE: ONS, BNP PARIBAS

choice but to raise prices to meet the inflow of customers. The lifting of lockdown restrictions is also illustrated by strong pricing pressures on cars, notably used cars, much like the situation observed a few months ago in the United States.

With the upcoming VAT hikes (see below), the Bank of England (BoE) expects inflation to reach 4% by the end of the year, largely surpassing its 2% target. This inflationary surge is nonetheless expected to be short- lived, and the central bank does not intend to raise its base rate, currently set at 0.10%, until the economy has fully recovered. That condition has not been met yet. Although midway through 2021, economic activity is nearing pre-pandemic levels, there is still a shortfall of a little over 4 points of GDP. Yet closing the remaining gap is likely to be much harder, since the Johnson government plans to begin removing fiscal support measures this fall and to raise social welfare contributions in April 2022.

THE END OF "WHATEVER THE COSTS"

In the UK, like in most of the "liberal" advanced economies (such as the US, Canada and Australia), public support measures deployed during the health crisis have helped offset the relative weakness of social welfare shock absorbers. They have proved to play a vital role. According to estimates by the International Monetary Fund (IMF), the UK injected no less than GBP 340 billion (16 points of GDP) into the economy in 2020-21, a record for Europe. Although "whatever the cost" is no longer fully justified, its removal will nonetheless serve as a test case.

Fiscal support measures have already begun to be withdrawn. At the end of September, the government ended its main job retention schemes, namely the Coronavirus Job Retention Scheme (CJRS) and the Self-Employed Income Support Scheme (SEISS). Introduced in March and April 2020, these two programmes benefited roughly 14.5 million workers (payroll employees and the self-employed) and largely helped reduce the rise in unemployment, which barely rose above 5% at the height of the crisis. As the economy has recovered, these schemes have been allowed to expire. But for the 1.6 million employees still furloughed in their companies, this could prove to be a difficult awakening.

If the current labour shortage can facilitate the transition, things do not stop there. In addition to the job subsidies, the GBP20-a-week boost to universal credit was also eliminated for some 6 million British citizens. Moreover, all households will be hit by the increase in the reduced VAT rate for hotel and restaurant services (to rise from 5% to 12.5% in October 2021, then to 20% in April 2022). And the stamp duty holiday was reduced from GBP 500,000 to GBP 250,000 in July, and will be slashed to GBP 125,000 in October.

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NO "SINGAPORE-ON-THAMES"

Last March, Rishi Sunak, the Chancellor of the Exchequer, announced that the corporate tax rate would be raised from 19% to 25% as of 1 April 2023, raising some grumbles from Brexit supporters who had been dreaming of a "Singapore-on-Thames". The government's plans, which aim to raise roughly GBP 12 billion in additional revenues annually, is not anecdotal. Granted, it only applies to a minority of companies (the 30% that report earnings of more than GBP 50,000 a year) and will be offset during the previous two fiscal years (2021-22 and 2022-23) by a "super tax deduction" equivalent to 130% of fixed capital investment. Even so, it is the first corporate tax hike since 1974, when the Labour government of Harold Wilson raised to corporate tax rate from 40% to 52%, and an earth-shaking move within the Conservative party, which has always made corporate tax cuts the hallmark of its policies.

Lastly, to support the National Health System (NHS), whose spending soared by roughly GBP 100 billion (2.5 points of GDP) during the pandemic, Prime Minister Boris Johnson intends to raise the social welfare contribution by 1.25 points for employers (from 13.8% to 15.05%), employees (from 12% to 13.25%), and on dividends (from 7.5% to 8.75%). Effective as of April 2022, the permanent measure should generate additional revenues estimated at GBP 12 billion a year. It would also halt the erosion of NHS revenues, which as a share of GDP have declined constantly since 2010.

Already perceptible through the drop-off in real estate transactions and the downturn in purchasing manager indices (PMI), the slowdown in the economy is keeping pace with the shift in government policy. As it translates into growth figures, the economic slowdown could be especially visible by the end of the year, as the upturn in inflation erodes household purchasing power.

BOX 1 SOURCE: PRESS, OBR

TOWARDS A CALMING DOWN OF THE ECONOMY

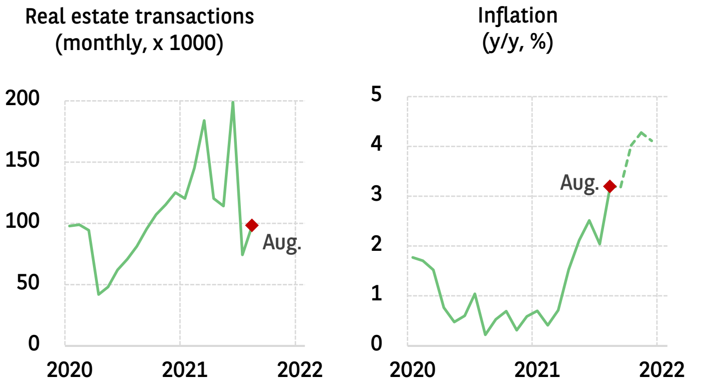

CHART 3 SOURCE: ONS, BNP PARIBAS

SWEDEN

RETURNING TO NORMAL

Initially tempted to experiment with herd immunity to combat Covid-19, the Scandinavian country with the highest number of Covid-related deaths has largely converted to vaccinations, and the economy is on its way to returning to normal. Sweden is taking advantage of its specialisation in machinery and transport equipment, for which there is currently strong global demand. Dynamic exports are boosting corporate investment. As the Riksbank prepares to end its securities purchasing policy, the Swedish government is trying to avoid withdrawing its fiscal support too abruptly.

As the Covid-19 vaccination campaign progresses (64% of the population was fully vaccinated when we went to press), the Swedish economy is picking up. GDP growth is expected to largely exceed 4% in 2021, which is strong enough to erase the loss of business accumulated during the pandemic by this summer. Moreover, it is expected to remain strong in 2022, with the European Commission forecasting 3.3% growth next year.

GROWTH RETURNS, INFLATION REBOUNDS

Thanks to its specialisation in machinery and transport equipment, a sector that is currently in high demand thanks to the global recovery, Sweden has reported a remarkable performance in foreign trade. Although exports have moved in fits and starts (attributable to the various waves of the pandemic), they have picked up much faster than in Finland or Denmark. By mid-2021, exports had surpassed the pre-pandemic level.

Dynamic export sales are driving corporate investment in equipment. The latest statistics for industrial orders (up 10.8% year-on-year in July) confirm this strong trend in investment, which should grow at an average annual rate of at least 5% in 2021.

After a long period of forced savings, Swedish consumers have begun spending again. Through summer 2021, consumer spending was holding to a slope of 4%, and this pace is likely to be maintained during the fall. Despite the spread of the Delta variant, the consumer confidence index held at a very high level in August. Prospects are still favourable: the European Commission expects private consumption to rise 5.5% in 2022.

After a brief drop into negative territory in spring 2020, prices have returned to an upward trajectory. In August 2021, inflation rose to 2.5%, largely due to energy (up 15% year-on-year) and food prices. Excluding these two components, core inflation was mild at 1.7%, which is compatible with the 2% target set by the Riksbank, Sweden's central bank.

AS QUANTITATIVE EASING ENDS, FISCAL POLICY IS CAUTIOUS

To support the economy during the pandemic, the Riksbank set up a very accommodating monetary policy, comprised notably of SEK 700 bn in securities purchases (essentially government bonds and state-backed loans), equivalent to 15 points of GDP. Its quantitative easing is rather similar to that of the European Central Bank (ECB), whose Pandemic Emergency Purchase Programme (PEPP) accounted for 16 points of GDP. Sweden's QE will end in Q4 2021 with the purchase of a final SEK 68.5 bn tranche of securities, after which the central bank's balance sheet should begin to level off. Its key rate will be maintained at 0%.

GROWTH AND INFLATION (%)

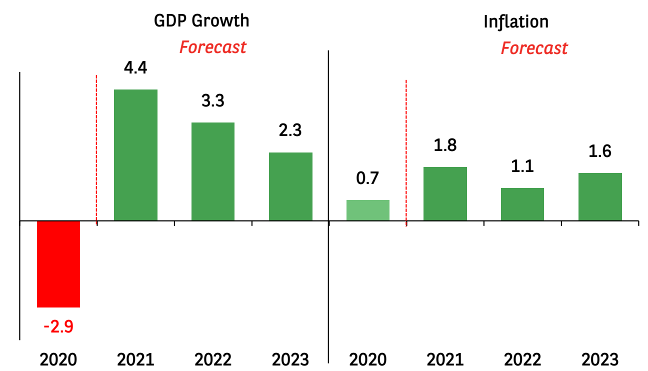

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Fiscal policy has played an essential role in countering the depressive effects of the pandemic (16 points of GDP were injected into the economy in 2020 via direct transfers and state-backed loans). To make sure it does not withdraw its fiscal support too quickly, the government has engaged in an ambitious energy transition programme in 2022 that will be covered in part by European funding as part of the Next Generation EU plan (SEK 34 bn). The government is also determined to reduce unemployment as well, which is still high at 9.4% of the active population (2021 average), notably among youth.

Despite the severity of the crisis and the massive efforts to counter it, Sweden's public finance situation remains solid. In 2021, debt levelled off at 41% of GDP (according to European Commission estimates), and the debt ratio should begin to decline as of 2022 as the economy swings back into growth.

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DENMARK

UNDER PRESSURE

With relatively few Covid-19-related deaths, and after what proved to be a mild recession in 2020, Denmark is one of the countries that has pulled through the pandemic the best. Economic activity has already returned to pre-crisis levels, the cyclical environment was still going strong over the summer months, and the spread of the Delta variant did not pose much of a threat to a largely vaccinated population. The rapid economic recovery is already revealing a few tensions in terms of production capacity and employment. The central bank is not very alarmed and is expected to maintain the status quo, with negative money market rates. The government has begun to better target its subsidies.

With a total of 2,650 deaths reported so far (455 deaths per million inhabitants), Denmark is one of the countries with the lowest number of Covid-19-related deaths (Sweden, for example, reported three times more victims as a share of its population). Thanks to a largely vaccinated population (76%, vs a European Union average of 66%), Denmark was one of the very first countries to lift all health restrictions (end of mask requirements and "vaccine passports"). As a result, after limiting its losses in 2020, the economy is recovering rapidly.

FIRST IN CLASS

GDP had already returned to pre-pandemic levels in Q2 2021, and full-year growth is expected to near 3% or more. As in many countries, the rebound was fuelled by the catching-up of private consumption, and in counterpart, the unblocking of forced savings built up in 2020. As fall approaches, this growth engine does not seem to have fully run its course yet, and the household confidence index is still holding at a high level.

Investment prospects are also positive, as illustrated by surveys of business leaders, which were still upbeat through August. Exports are driving production and equipment purchases, and export growth is easily expected to surpass 5% in 2021.

The rapid economic recovery has been accompanied by hiring troubles, as illustrated by the rebound in job vacancies over the past year. For Denmark's central bank, these pressures are only temporary because they are limited to competition between companies to find skilled employees as the health crisis comes to an end. They are unlikely to accelerate significantly to all employees[1].

Inflation rose to 1.8% year-on-year in August. This increase is largely due to energy prices, which accounted for 8% of the price index but 50% of the increase. Core inflation (excluding energy and food prices) is still very low at 0.7%. The Danish central bank hardly needs to change its policy after adjusting the key rate corridor last spring in response to upward pressures on the krone (DKK)[2]. It will maintain its key deposit rate unchanged at -0.6%.

Although the Danish government did not abandon the principle of "whatever the cost" during the crisis, the pre-existence of powerful social shock absorbers reduced the need for fiscal transfers. According to IMF estimates, since the beginning of the pandemic fiscal transfers have amounted to a total of DKK 79.5 bn, or 3.4% of 2020 GDP. Although this is high, it is nowhere near the amounts engaged by the so-called "liberal" economies, such as the United States and the UK. Government efforts went hand in hand with those of companies and employees, which helped limit the rise in unemployment. At 3.2% of the active population in July, the unemployment rate has returned to low levels.

GROWTH AND INFLATION (%)

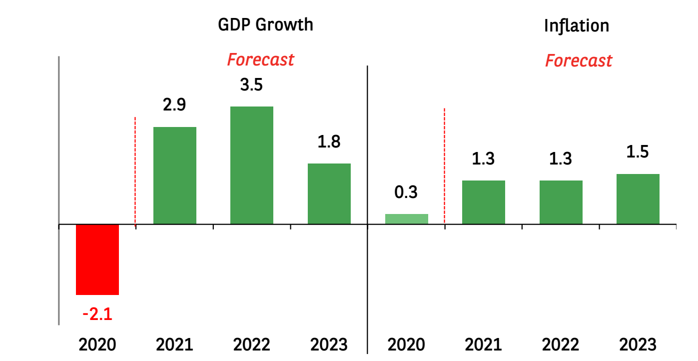

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

As economic activity returns to normal, the government has begun to better target its subsidies, reserving them for the most vulnerable sectors and companies. Its priorities are now shifting towards "green" investments. Denmark's fiscal policy is unfolding in a rather unrestrictive environment. It still has low deficits despite the pandemic (2.1% of GDP in 2021, according to the European Commission), and its public debt is contained at 40% of GDP.

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1 Denmarks Nationalbank, *Outlook for the Danish Economy*, September 2021.
2 BNP Paribas, *EcoPerspectives*, 2nd quarter 2021

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2021e	2022e	2023e	Inflation 2021e	2022e	2023e
United States	6.0	5.3	3.3	4.2	2.8	2.4
Japan	2.1	2.4	1.6	-0.2	0.3	0.5
United Kingdom	7.0	6.3	2.1	2.3	3.3	2.0
Eurozone	5.0	5.2	2.3	2.4	2.1	1.7
• Germany	2.8	5.3	2.4	3.0	2.4	1.9
• France	6.3	4.3	2.1	2.0	1.9	1.6
• Italy	6.3	5.1	2.8	1.9	2.2	1.4
• Spain	6.1	6.4	3.4	2.6	2.2	1.4
China	7.8	5.6	5.4	1.2	2.8	2.5
India*	7.0	11.2	6.2	5.4	4.5	4.3
Brazil	5.0	1.5	2.0	7.8	6.3	3.6
Russia	4.5	3.3	2.6	6.0	5.0	4.1

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

FINANCIAL FORECASTS

Interest rate, %

End of period		Q4 2021e	Q2 2022e	Q4 2022e	Q4 2023e
United States	"Fed Funds (upper limit)"	0.25	0.25	0.50	1.25
	T-Notes 10y	1.70	1.90	2.00	1.90
Eurozone	Deposit rate	-0.50	-0.50	-0.50	-0.50
	Bund 10y	-0.10	0.00	-0.10	0.10
	OAT 10y	0.40	0.40	0.20	0.40
	BTP 10y	1.10	1.10	1.00	1.20
	BONO 10y	0.70	0.70	0.70	0.90
United Kingdom	Base rate	0.10	0.30	0.50	0.80
	Gilts 10y	0.90	1.10	1.10	1.20
Japan	BoJ Rate	-0.10	-0.10	-0.10	-0.10
	JGB 10y	0.10	0.20	0.20	0.20

Exchange rate

End of period		Q4 2021e	Q2 2022e	Q4 2022e	Q4 2023e
USD	EUR / USD	1.15	1.13	1.12	1.10
	USD / JPY	111	112	114	116
	GBP / USD	1.37	1.36	1.37	1.38
EUR	EUR / GBP	0.84	0.83	0.82	0.80
	EUR / JPY	128	127	128	128

Brent

End of period		Q4 2021e	Q2 2022e	Q4 2022e	Q4 2023e
Brent	USD/bbl	74	72	73	80

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

CONJONCTURE

Structural or in news flow, two issues analysed in depth

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