ECO PERSPECTIVES

3RD quarter 2021

EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

The bank
for a changing
world

EDITORIAL

LOOKING BEYOND PEAK GROWTH

The first half of the year has seen a broad-based improvement in business and consumer sentiment in advanced economies but elevated levels of business surveys reduce the likelihood of further significant increases. The third quarter is expected to see the peak in quarter-over-quarter GDP growth this year. Nevertheless, over the remainder of the forecast horizon – which runs until the end of next year – quarterly growth is expected to stay above potential. This favourable outlook for the real economy brings challenges for financial markets. Surprising to the upside in terms of earnings will become more difficult. Moreover, there is the question of the inflation outlook. For the time being, both the Federal Reserve and markets are relaxed about it but we should expect that over the coming months, the market sensitivity to growth and inflation data will be higher than normal in view of what they would imply for the Fed's policy stance.

The first half of the year has seen a broad-based improvement in business and consumer sentiment in advanced economies on the back of vaccination campaigns that were gathering speed, a declining number of new infections, the easing of Covid-19-related restrictions as well as ongoing policy support, both monetary and fiscal. International spillovers also played a role as reflected in the upbeat assessment of export order books.

In the US, first quarter real GDP growth has been strong but the second quarter should see an even better performance. The Eurozone has been lagging thus far, although after a contraction of GDP early on in the year, growth should be positive in the second quarter, but still lower than in the US. This should change in the third quarter, with a particularly strong performance in the Eurozone expected to outpace the US. How good can it get? Elevated levels of business surveys reduce the likelihood of further significant increases. Sectors that have seen an unleashing of pent-up demand – leisure, hospitality, retail, etc. – when restrictions were lifted, should gradually see a return to a more normal activity. In other sectors – the car industry, the construction sector – supply constraints may act as a headwind to growth.

Looking at advanced economies in general, the third quarter is expected to see the peak in quarter-over-quarter growth this year, with the increase in GDP slowing down thereafter. Nevertheless, over the remainder of the forecast horizon – which runs until the end of next year – quarterly growth is expected to stay above potential. Several factors should underpin this performance. Better company profitability and rising capacity utilization should boost corporate investments and lead to the creation of new jobs. Hiring plans of companies have already picked up, which bodes well for the employment outlook. As a consequence, households will feel less uncertain about the future, which should support spending, all the more so considering the savings accumulated during the lockdowns. Fiscal policy should still provide support, in particular in the Eurozone, with the gradual deployment of the Next Generation EU funds. Finally, ongoing easy monetary policy will facilitate the financing of private and public spending.

However, this favourable outlook for the real economy – activity, demand, employment – comes with challenges for financial markets. Slower GDP growth makes it more difficult for listed companies to surprise to the upside in terms of earnings. Another issue is what happens to inflation, in particular in the US. Inflation has spiked to 5% on the back of base effects – last year prices were subdued in many sectors due to the drop in GDP and lockdowns – and imbalances between supply and demand. The percentage of manufacturing companies reporting higher input prices is getting close to reaching record levels. The Federal Reserve argues this should be a temporary phenomenon considering that demand growth should slow and supply should pick up, although the number of FOMC members advocating a rate hike next year has increased. Rather than causing turmoil in the bond market, this has actually reinforced the credibility of the central bank, witness the recent decline in breakeven inflation. Nevertheless, we should expect that over the coming months, the market sensitivity to growth and inflation data will be higher than normal in view of what they would imply for the Fed's policy stance.

REAL GDP GROWTH

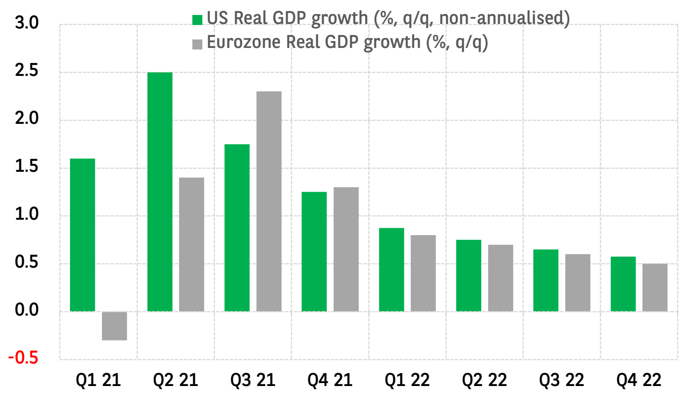


CHART 1 SOURCE: BLOOMBERG CONSENSUS (JUNE 2021), BNP PARIBAS

PRICE PRESSURES

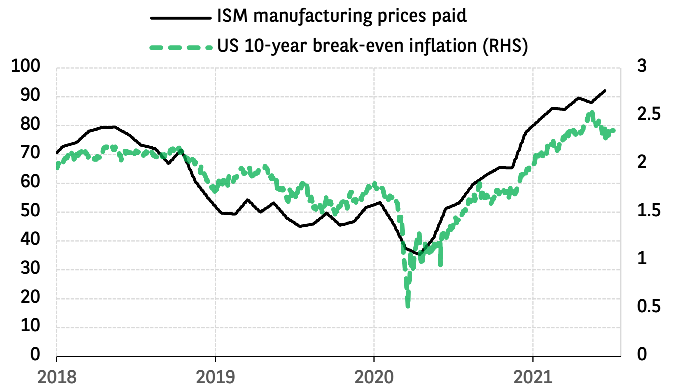


CHART 2 SOURCE: ISM, REFINITIV, BNP PARIBAS

William De Vijlder
william.devijlder@bnpparibas.com

UNITED STATES

IS INFLATION BACK?

With GDP growth of nearly 7% this year, the US economy is in the midst of a spectacular but uneven recovery, erasing the losses generated by the pandemic, but also leaving numerous workers behind. Fuelled by rising commodity prices and surging consumption, inflation has reached a peak of 5%, the highest since 2008. Esteeming that this flare up will be short lived, the Federal Reserve (Fed) is being tolerant and will forego a preventative tightening of monetary policy. Its top priority is to see the recovery spread to all sectors of the economy and to restore full employment in the labour market.

Inflation at 5% is something the United States has not seen in a long time. You have to look back to the summer of 2008 to find comparable pricing dynamics, when soaring oil prices sent Americans' energy bills skyrocketing (Brent crude oil peaked at over USD 140 a barrel). The arrival of the financial crisis quickly cut short this upsurge in prices. Thirteen years later, the emergence of inflation is again the centre of debate, especially whether or not it is likely to become entrenched.

A TEMPORARY FLARE UP

Yet the current bout of pricing pressures is not only about oil. At 3.8% in May, core inflation, excluding energy and food prices, is also accelerating under pressure from strong demand. In 2020, households saved nearly USD 3,000 billion, double the amount in a normal year, and these partially forced savings are fuelling the appetite for consumption in 2021, especially for travel. Although transport equipment and services (automobiles, plane tickets, etc.) account for barely 15% of the core price index, they explain half of the increase in core inflation, which seems to be highly concentrated. Excluding these two items, inflation would have held within the Fed's 2% target.

At this stage, it is hard to conclude anything but that it was a circumstantial flare up, especially since there are no obvious second round effects in which all wages would respond to the shock and maintain prices rising. In certain sectors under pressure, like online retailing, hiring needs are of course accompanied by pay increases, which are also justified by surging productivity gains (see chart 2). Inversely, however, a good number of more traditional businesses that were disrupted by the digital revolution are feeling pressure to reduce staff size and costs (see below and chart 3). In the end, the aggregated indexes are not showing signs of overshooting. Although average hourly wage increases seemed to be accelerating for a moment, they were primarily due to a composition effect, since the Covid-19 pandemic mainly eliminated the lowest paid jobs. According to the employment cost index, which is available on a quarterly basis and does not show the same bias, wage growth remained stable and even slowed slightly (wages and salaries rose 2.7% year-on-year in Q1 2021, vs. 3.1% in Q1 2020).

THE LABOUR MARKET HAS NOT FULLY RECOVERED YET

Considering that the upsurge in prices will be temporary, the Fed will forego a preventative tightening of monetary policy, a strategy that Fed chairman Jerome Powell reaffirmed during recent testimony before Congress[1]. Full employment is still the Fed's main objective, especially now that the Federal Open Market Committee (FOMC) is giving secondary importance to its inflation target (FOMC, 2020).

Although the labour market is regaining strength (2.4 million jobs have been created since the beginning of 2021), it is still convalescing.

GROWTH AND INFLATION (%)

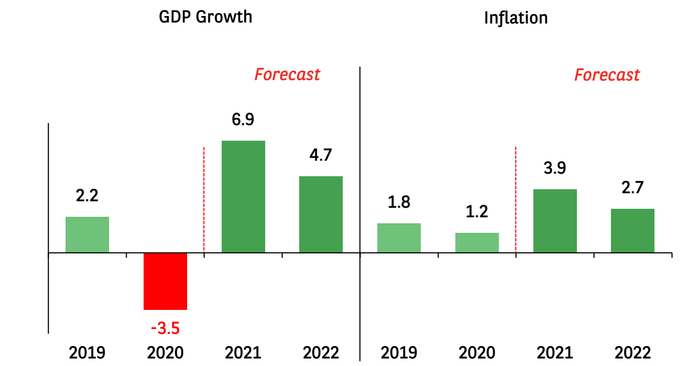


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PRODUCTIVITY IN ONLINE RETAILING* (2019 = 100)

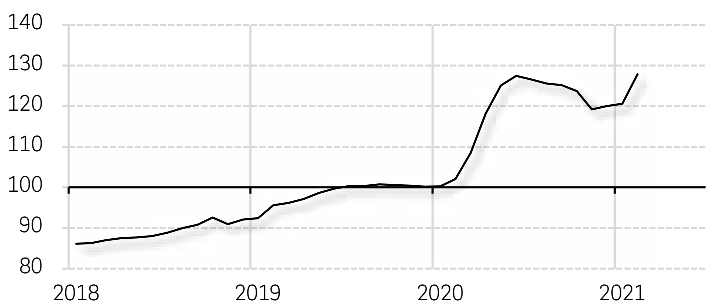


CHART 2 SOURCE: SAINT LOUIS FED, BLS

At 5.8% in May, the unemployment rate is high by American standards, and nearly 8 million jobs are still missing compared to the pre-pandemic situation. Moreover, job losses were also very unequally distributed (see chart 3). During the crisis, employment increased in certain sectors pertaining to the internet (online retailing, home delivery, storage, computer hardware production, technical expertise, etc.) and to residential construction, while other sectors continue to pay a heavy toll. Hotel and restaurant services, the leisure and entertainment industry, in-home care and services, and transport services and travel agencies continue to be very hard hit.

1 Powell J. H. (2021), *The Federal Reserve's Response to the Coronavirus Pandemic*, Testimony before the Congress select subcommittee on the Coronavirus crisis, June 22.

Another sign that the job market has not fully recovered yet is the labour force participation rate (workers and those actively seeking work as a share of the total population), which is still much lower than pre-crisis levels, even within the working age population (20 to 64 age group). About 3 million individuals have left the labour market, which can be attributed to several factors. Certain categories of workers (extras earning tips, the self-employed, seasonal workers, etc.) who were unable to work during the crisis have had more trouble than others justifying revenues that make them eligible for unemployment benefits (eligibility requirements differ from one state to the next). With the closing of schools and day care centres, many single mothers with children had no choice but to halt or postpone their job searches. Exclusion from the labour market may also have been accentuated by the digital divide and trouble accessing the internet.

It is not really surprising that low-skilled, low paid social categories were hit hardest. According to the Bureau of Labor Statistics (BLS), people with few or no diplomas (high school education or less) only account for 30% of the active population, but explain 80% of the post-Covid collapse. Even as the health crisis is widening inequalities, the Biden administration is having a hard time passing its reform measures. Without an agreement on its financing, the American Jobs Plan is proving to be much less ambitious than the initial version (see box). The American Families Plan calls for investing USD 1.8 trillion in improving education and health conditions for low-income families, but its only chance of passing depends on using the so-called fiscal reconciliation procedure for the second time this fiscal year (ending 30 September), in which case the government would only need to obtain a simple majority of 50 votes in the Senate.

Completed on 28 June 2021

Jean-Luc Proutat
Jean-luc.proutat@bnpparibas.com

A LESS AMBITIOUS INFRASTRUCTURE PLAN

The initial version of the American Jobs Plan (AJP) dated March 2021 called for investing USD 2.3 trillion in infrastructure over an 8-year period, but this figure has been constantly revised downwards ever since. President Biden managed to reach a bipartisan agreement in the Senate that would slash the AJP to a more moderate sum of USD 1.2 trillion (again over 8 years).

The biggest source of contention was the financing segment, which initially called for raising the corporate tax rate from 21% to 28%, and is now set to be covered by unused resources from the American Rescue Plan approved last March. The Committee for a Responsible Federal Budget (CRFB) currently estimates these funds at USD 876 billion (out of a total budget of USD 1.9 trillion), although there will obviously be less in the future when the AJP is rolled out.

Specifically, the bipartisan agreement calls for devoting USD 579 billion to new spending, and the remaining USD 325 bn to existing programmes. As in the initial version, a substantial share of the budget (USD 312 billion) goes to transport equipment, especially land-based equipment. The other major programme consists of renovating the telecommunications, water and power networks. In a major concession by the Biden administration to reach a bipartisan agreement, the new plan no longer covers efforts to improve housing, renovate public facilities, schools, housing, energy tax credits, etc. or to improve access to healthcare, which amounted to nearly USD 1 trillion in the initial version of the AJP.

SOURCE: CRFB, PRESS

EMPLOYMENT TRENDS BY SECTOR
%, FROM JANUARY 2020 TO MAY 2021

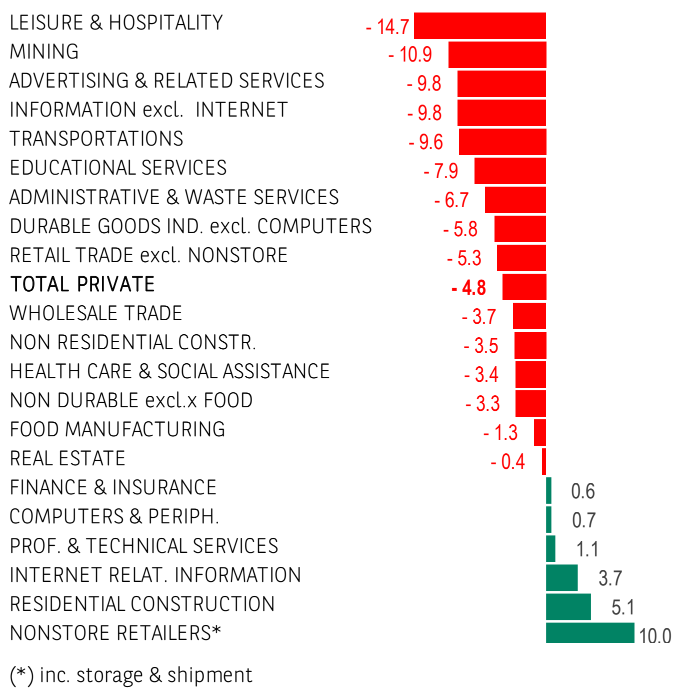


CHART 3

SOURCE: BLS

THE ECONOMIC RECOVERY IS STILL MIXED

Economic growth rebounded very rapidly following the Covid-19 shock, but this rebound has also been characterised by mixed performances between sectors and between demand components. Growth of industrial production and exports accelerated vigorously until early 2021 and is now gradually returning to normal. Meanwhile, the services sector and private consumption were slower to rebound, and their recovery still proved to be fragile in Q2 2021. Consequently, the authorities are likely to be increasingly cautious about tightening economic policy. Even so, they should still give priority to slowing down domestic credit growth and adjusting the fiscal deficits.

Economic activity rebounded rapidly following the Covid-19 shock of early 2020, with real GDP returning to its pre-crisis level by the end of Q2 2020. The recovery reached a peak early this year, and real GDP growth rates should return to more normal levels in the quarters ahead. China's economic rebound has also been characterised by very mixed performances between sectors and between demand components. These imbalances were still visible in Q2 2021. Consequently, many corporates are still fragile, especially small enterprises in the services sector, and the labour market has not fully recovered yet, which in turn is hampering the recovery in household demand.

MIXED PERFORMANCES

Industrial activity rebounded rapidly in spring 2020, which enabled China to respond to the surge in world demand for manufactured goods and to win market share. Industrial production and export growth accelerated vigorously through early 2021. Since March, base effects have dissipated, growth rates have been normalizing, and supply shortages in some inputs have started to constrain activity. Industrial production growth averaged (a still robust) 9.3% year-on-year (y/y) in April-May, compared to 24.5% in Q1 2021. Industrial growth did not slow as much in value terms due to the acceleration in producer price inflation, which rose from 1.7% y/y in February to a record high of 9% in May. Meanwhile, merchandise exports increased by 30% y/y in April-May (in value terms), compared to 70% in Q1. Growth in the industrial sector and exports should continue to ease gradually in the months ahead.

In the services sector, activity contracted just as much as it did in industry during the lockdown of January-February 2020, but the rebound started later and has been less vigorous. Even so, since March 2021, the growth rate in services production has surpassed that of industrial production (+15.4% y/y in April-May).

Meanwhile, private consumption growth continues to recover, but it has slacked off in recent months. The performance of retail sales fell short of expectations in April-May, increasing by 13% y/y in volume terms (compared to 33.5% in Q1).

RISING INEQUALITIES WITHIN URBAN AREAS

Changes in household savings illustrate how cautious individuals are. According to our estimates, the household savings rate increased from 34.6% of disposable income in 2019 to 37.7% in 2020, and these extra savings have been only partially absorbed so far.

Firstly, private consumption remains hampered by persisting health risks. Although the pandemic is largely under control in China, temporary and localised restrictions on mobility are still regularly introduced in case of the emergence of new Covid-19 cases. This risk should diminish with the ongoing acceleration of the vaccination campaign. On June 10th, 43% of the population had received at least one dose of the vaccine, and 16% were fully vaccinated (source: *ourworldindata.org*).

GROWTH AND INFLATION (%)

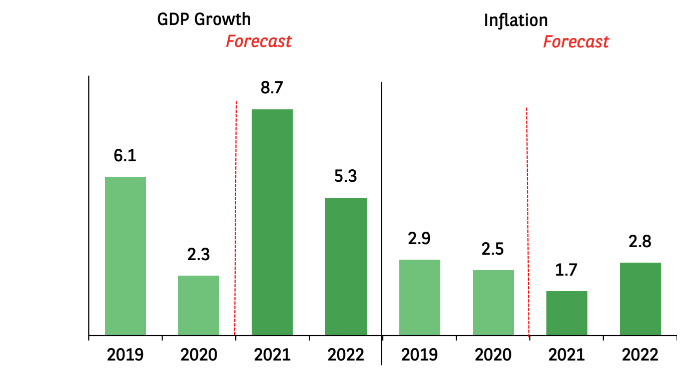


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

DIFFERENTIATED REBOUNDS

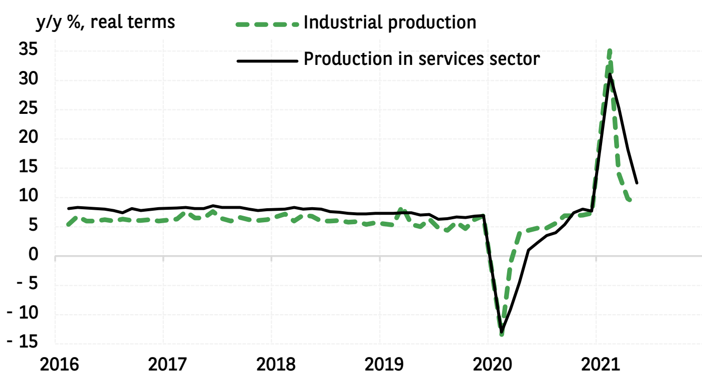


CHART 2 SOURCE: NBS

Although official unemployment rates continue to decline (the urban unemployment rate based on surveys fell to 5% in May, the same level as in May 2019), the labour market has yet to return to its pre-crisis situation. Job insecurity and underemployment have increased; youth unemployment rates remain particularly high (13.8% in May 2021 vs. 10.5% in May 2019); and job creation has been less dynamic (in Q1 2021, job creations were 8% below the Q1 2019 level). All of this has constrained the rebound in household income.

This is especially true for low-income households, the category that ran up the biggest losses during the lockdown and accumulated fewer savings in 2020.

In urban areas, disposable income per capita declined by 2.2% in real terms for low-income households (after increasing 5.2% in 2019), whereas it rose by 2.3% for high-income households (compared to +5.1% in 2019). Average real income of migrant workers stagnated in 2020. Rising inequalities and the difficulties of low-income households are contributing to delaying the turnaround in private consumption. Meanwhile, income inequalities between urban and rural areas have narrowed during the health crisis. In 2020, average disposable income per capita increased by 1.2% in real terms in the cities and by 3.8% in rural areas. The ratio between the two has declined slowly for several years, reaching 2.6 in 2020, and fell further in Q1 2021.

Consumer price inflation is still very mild and is unlikely to strain household spending, even though it has been accelerating over the past three months (to +1.3% in May from -0.2% y/y in February) after slowing throughout 2020 and early 2021. Food price inflation (+0.3% in May) is expected to remain low at least until fall, after flaring up in H2 2019 and H1 2020, and the increase in producer prices is having a limited impact on consumer prices. Core inflation has accelerated slightly (+0.9% in May), but remains lower than pre-crisis levels (it averaged 1.6% in 2019).

DOMESTIC INVESTMENT IS DICTATED BY ECONOMIC POLICY

After collapsing in Q1 2020 (-16% y/y in value), investment rebounded rapidly and rose by 3% in full-year 2020. Investment growth hit record highs in January-February 2021 (+35% y/y) due to large base effects, but it has since fallen back rapidly (to +5% y/y in May). Last year, the rebound in investment was mainly driven by real estate and public infrastructure projects, which were encouraged by policy stimulus measures. Therefore, the recent growth slowdown in investment in both sectors was largely expected given the gradual tightening in domestic credit conditions since Q3 2020 and the moderation in public spending.

In contrast, manufacturing investment picked up later in 2020 and is expected to continue to recover in 2021. It should be stimulated by the strong momentum in exports and industrial activity, very high industrial capacity utilisation rates, and the improvement in corporate profits. Despite a rather disappointing performance recently, we still expect manufacturing investment to strengthen in the short term.

INCREASINGLY CAUTIOUS WITHDRAWAL OF SUPPORT MEASURES

The authorities have shifted their priorities in recent months. Given the economy's strong performance after the Covid-19 shock, support measures have been withdrawn gradually. However, the authorities also admit that the economic recovery's foundations have remained "unstable", so they will probably be increasingly cautious when tightening economic policy.

Regarding monetary and credit conditions, the top priority is to slow debt growth and to combat financial-instability risks, primarily through prudential measures. Growth in total credit (social financing) slowed from 13.7% y/y in October 2020 to 11% in May 2021, driven by a slight decline in bank loan growth (60% of the total), a sharp slowdown in bond financing growth and the continued contraction in shadow banking credit. Total credit growth should continue to slow in the short term. In particular, property policy could be tightened further (with

DECELERATION IN DOMESTIC CREDIT GROWTH

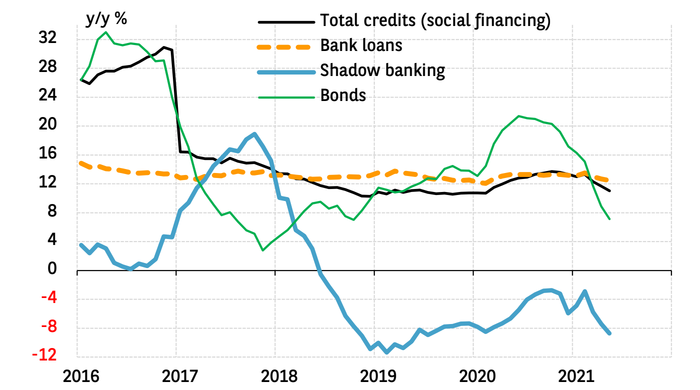


CHART 3 SOURCE: PBOC

stricter rules for transactions, financing of developers or mortgage loans). At the same time, key policy rates are expected to stay stable, and domestic liquidity will be maintained at sufficient levels to support manufacturing investment, boost the recovery of SMEs and the services sector, and avoid aggravating credit risks. The absence of strong inflationary tensions and appreciation pressure on the yuan should also provide incentives for the authorities to keep key interest rates unchanged.

On the fiscal policy front, priority will be given to adjusting the public accounts while continuing to provide support to the most vulnerable enterprises. Fiscal deficits swelled considerably in 2020: while the "official" deficit only increased to 3.7% of GDP from 2.8% in 2019, the consolidated deficit of the entire general government doubled last year. According to our estimates, it rose from RMB 4,600 bn in 2019, or 4.6% of GDP, to RMB 9,200 bn in 2020, or 9% of GDP.

Moreover, total government debt is moderate (it rose from 17% of GDP at year-end 2019 to 21% at year-end 2020 for the central government, and from 21.6% to 25.3% for local governments), but the debt load is unequally distributed. Above all, local governments are exposed to high contingent risks associated with the debt of their financing vehicles and other enterprises they own (according to the IMF estimates, the debt of financing vehicles was 38% of GDP at year-end 2020).

Signalling a cautious policy tightening move, the official deficit target for 2021 was lowered to 3.2% of GDP and the consolidated deficit of the entire general government should decline slightly to 7.5%. Deferrals/exemptions from taxes and social security contributions are unwound gradually, except for small enterprises. Public spending is moderated, in particular with a sharp slowdown in infrastructure investment growth – which contributes to both fiscal adjustment and domestic debt reduction efforts. As a matter of fact, new bond issues by local governments to finance infrastructure projects were cut back sharply in the first months of 2021.

Completed on 29 June 2021

Christine Peltier
christine.peltier@bnpparibas.com

JAPAN

A LAGGING ECONOMIC RECOVERY

The Covid-19 pandemic did not hit the Japanese economy as hard as the other advanced countries. In 2020, GDP growth did not contract as much as in other places. Yet a slow vaccination rollout and the lack of confidence of economic agents are straining the momentum of Japan's recovery. After a strong performance in late 2020, the Japanese economy is lagging somewhat compared to the United States and Europe. Consumer confidence – a key ingredient for a robust economic recovery – is still low compared to pre-crisis levels. This atmosphere is dragging down private consumption and the dynamics of the tradeable services sector as well. The services industry is having a hard time swinging back into growth. In this persistently tough environment, inflation will continue to hold near 0%, far from the central bank's 2% target. Monetary policy will remain accommodating and unchanged in 2021 and 2022, even though the Bank of Japan might allow long-term sovereign rates to rise to the upper range of 0.25%.

A TIMID REBOUND

After reporting a relatively strong performance in Q4 2020 compared to the other advanced economies, Japan experienced a difficult H1 2021. Japanese GDP contracted by 1% in Q1 2021, and could decline slightly again in Q2. A real but timid rebound is expected as of Q3. Starting in 2022, the Japanese economy is expected to slow sharply as growth converges towards its potential, which is structurally low. All in all, full-year Japanese GDP is estimated at 2.2% in 2021, after contracting 4.7% in 2020, and then will accelerate to 3.3% in 2022. Japan, like the Eurozone, is expected to return to its pre-crisis levels in Q4 2021. In 2022, Japan will lag behind the other advanced countries (see chart 2). The main reason for Japan's current troubles is the slow pace of its vaccination campaign. Even though it has accelerated in recent weeks, the vaccination coverage rate is still low: about 20% of the population has received a first dose, compared to nearly 50% in the European Union. This lag is draining consumer confidence. After bottoming out in spring 2020, consumer confidence rebounded but still falls short of pre-pandemic levels. Moreover, it declined again in May. The Japanese are starting to worry about the opening of the Olympic Games in July as well. These factors do not augur well for a strong rebound in private consumption, which already declined in Q1 2021. The corporate situation is also tough. Although corporate investment is beginning to pick up, it is still relatively low compared to pre-crisis levels, and the most recent economic statistics are sending very mixed signals. Since the outbreak of the Covid-19 crisis, the purchasing managers index (PMI) for tradeable services has failed to rise above the 50 threshold, which separates economic expansion from contraction. In the manufacturing sector, there has been a net improvement in the economic situation, although manufacturing PMI declined in June to 51.5, from 53 in May. The Tankan index for Q2 2021 could improve but will remain deteriorated.

With inflation holding close to 0% despite the recovery, the Bank of Japan will continue to support the economy in 2021 and 2022. Recently, however, it did begin to cutback ETF-type securities purchases. The BOJ could reactivate these operations if market conditions were to deteriorate sharply.

Completed on 28 June 2021

Louis Boisset
louis.boisset@bnpparibas.com

GROWTH AND INFLATION (%)

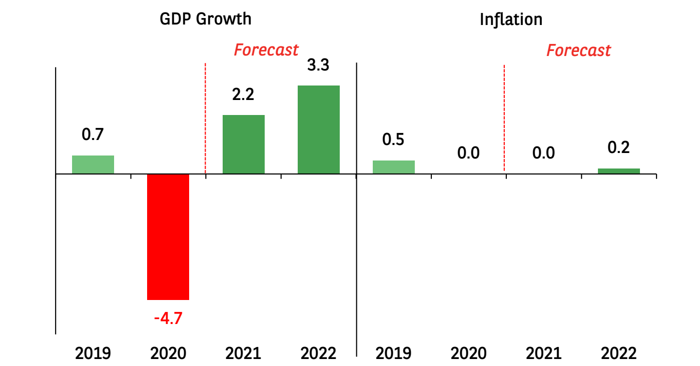


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP IN JAPAN, THE UNITED STATES AND THE EUROZONE (100= Q4 2019)

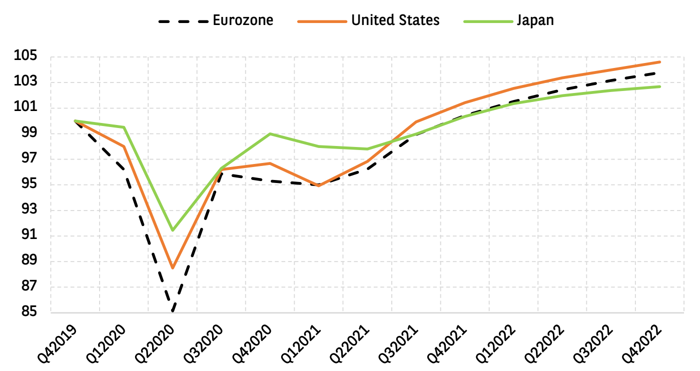


CHART 2 SOURCE: EUROSTAT, BNP PARIBAS GLOBAL MARKETS

A STRONGER RECOVERY, HIGHER INFLATION AND AN ACCOMMODATING ECB

The Eurozone economy is bouncing back. From a macroeconomic perspective, the region is closing the gap on the losses accumulated since spring 2020 more quickly than expected just a few months ago. Unless a new wave of the pandemic breaks out due to the spread of Covid-19 variants, Eurozone GDP should return to pre-crisis levels by the end of the year. Accelerated vaccination campaigns and the gradual lifting of health restrictions are reducing uncertainty and boosting the confidence of economic agents. Consumers, who have adapted to restrictive health measures, are playing a key role. Despite these favourable dynamics, public policies are remaining cautious. From a monetary perspective, the European Central Bank recently expressed some optimism concerning the Eurozone's capacity to rebound, although for the moment it is refusing to begin tightening monetary policy. As to fiscal policy, investors welcomed the European Commission's first bond issue to finance the Next Generation EU recovery plan.

A STRONGER-THAN-EXPECTED ECONOMIC RECOVERY

At a time marked by the gradual lifting of health restrictions, accelerating vaccination campaigns in the member states, and the continuation of accommodating economic policies, the Eurozone's economic situation is improving more rapidly than expected just a few months ago. After the losses accumulated throughout the long months of the pandemic, the economic recovery is now well underway and has spread to all segments of the economy. From a cyclical perspective, the situation in the manufacturing sector has improved significantly since April 2020, and manufacturing PMI reached an all-time high of 63.1 in June 2021. Although it has declined slightly, the "new export orders" component is still holding at a high level compared to the long-term average. Hard data confirm these survey results: industrial production increased massively in April for the second consecutive month, although a large part is admittedly due to a favourable base effect (+39.3% in April 2021, after +11.5% in March and -30% in April 2020).

In the tradeable services sector, where it is reasonable to expect activity to rebound more belatedly, the services PMI picked up again. After 50.5 in April and 55.2 in May, it rose to 58 in June, the highest level since early 2018. The lifting of health restrictions in most of the Eurozone member states, combined with the acceleration of vaccination campaigns, is providing economic agents with brighter prospects. The European Commission's business sentiment index continued to rise to 114.5 in May, the highest level since January 2018, and it is holding comfortably above its long-term average. Eurozone households are smiling again, and the consumer confidence index is now well above pre-pandemic levels. This favourable momentum is reflected in retail sales, which accelerated strongly in April. All of this augurs well for an ongoing catching-up movement in the Eurozone, especially since consumers have accumulated a considerable volume of savings over the past year.

All in all, the Eurozone's quarterly GDP growth will follow a relatively jagged profile in 2021, and GDP should return to pre-pandemic levels by the end of the year (Chart 2). GDP accelerated sharply in Q2 and again in Q3, driven by the rebound in household consumption. In Q4, the Eurozone economy is automatically expected to slow. Thanks to a strong carry-over growth effect, annual GDP growth will rise in 2022 compared to 2021, even though quarterly momentum is slowing. GDP growth is estimated at 4.8% in 2021 and 5.2% in 2022.

GROWTH AND INFLATION (%)

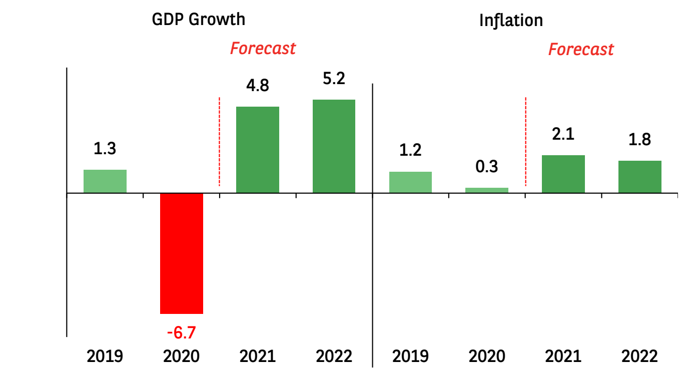


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP OF EUROZONE MEMBER STATES (100= Q4 2019)

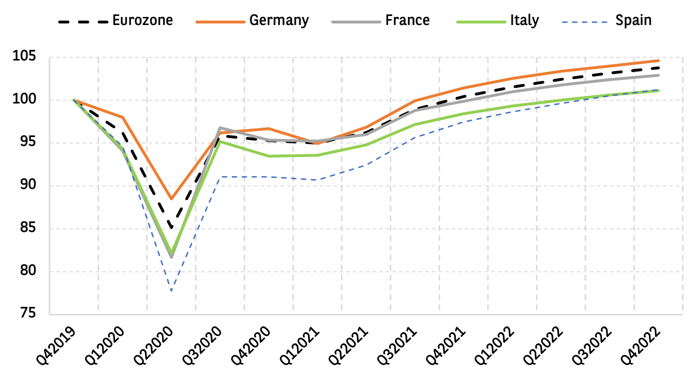


CHART 2 SOURCE: EUROSTAT, BNP PARIBAS GLOBAL MARKETS

RISING INFLATION: THE ECB BIDES ITS TIME

With the rebound in global demand, consumer prices have accelerated rather sharply in recent months, and these pricing dynamics are expected to extend into H2 2021. Yet rising inflation is mainly due to temporary factors (VAT movements in Germany, higher commodity prices, change in the weighting of the various components of HICP)[1].

According to our latest scenario, this inflationary surge is unlikely to last. This is also the ECB's point of view[2]. The European Central Bank expects inflation to peak this year. According to its latest macroeconomic projections, headline inflation will rise to 1.9% in 2021 before declining to 1.5% in 2022 and then to 1.4% in 2023, which is low with regard to the central bank's medium-term target of 2%. The ECB is counting on a slight upturn in the core inflation (which does not take into account products with the most volatile prices), which should continue to trend upwards to 1.4% in 2023. This is much faster than the average pace in recent years, which was close to 1%. The ECB does not expect a surge in inflationary dynamics, which will be curbed in part by the persistent imbalances in the labour market and by wage growth, which remains subdued (Chart 4).

Although the central bank is expressing some caution with regard to pricing trends, it is more optimistic when it comes to the Eurozone economy's capacity to recover. At its monetary policy meeting on Thursday, 10 June, the ECB nonetheless chose to maintain a wait-and-see approach and is not rushing to tighten its monetary policy. It will continue to make net securities purchases as part of the Pandemic Emergency Purchase Programme (PEPP), but at a significantly faster pace than at the beginning of the year. We expect PEPP to end in March 2022, since the economic emergency should be over by then. To avoid a sharp drop in liquidity, and considering the inflation gap, we expect securities purchases to increase under the existing Assets Purchases Programme (APP). Monthly net purchases could rise from EUR 20 bn today to EUR 40 bn or more. In any case, the ECB will probably maintain a flexible approach to its securities purchasing policy, in order to avoid as much as possible a tightening of financing conditions in the Eurozone, even after the crisis is over.

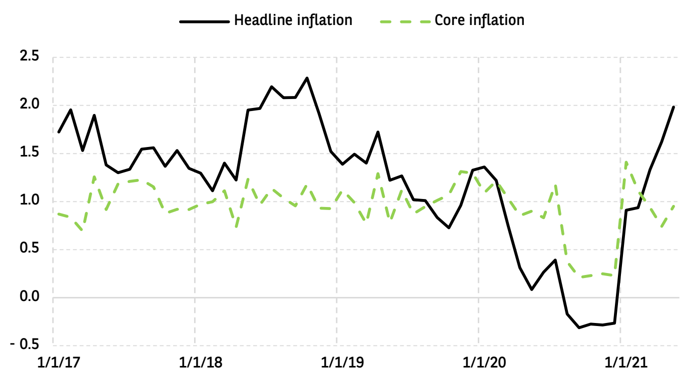
The Governing Council of the ECB seems to have postponed the more difficult discussions until the next meeting in September. By then, it could decide on whether to continue the PEPP, which as always will depend on the state of the Eurozone economy. Decisions will also be made under the framework of its strategy review. The first conclusions could emerge by the end of the year, which is no small matter. From a monetary perspective, the ECB could follow the Fed's lead and introduce a structurally accommodating bias to its monetary policy. It might also decide to pursue an average inflation target, which means that inflation would be allowed to exceed 2% for a certain time.

National fiscal policies need to accompany the ECB's monetary policy to avoid withdrawing support too abruptly and without differentiating between sectors. At the European level, the Next Generation EU recovery plan could have a favourable impact on the effectiveness of public spending, especially in the peripheral countries of the Eurozone. The European Commission's first issue of EUR 20 bn in bonds to finance this recovery plan was a success.

Completed on 28 June 2021

Louis Boisset
louis.boisset@bnpparibas.com

HEADLINE AND CORE INFLATION IN THE EUROZONE (%)



GRAPHIQUE 3 SOURCE: EUROSTAT

NOMINAL WAGE GROWTH IN THE EUROZONE (%)

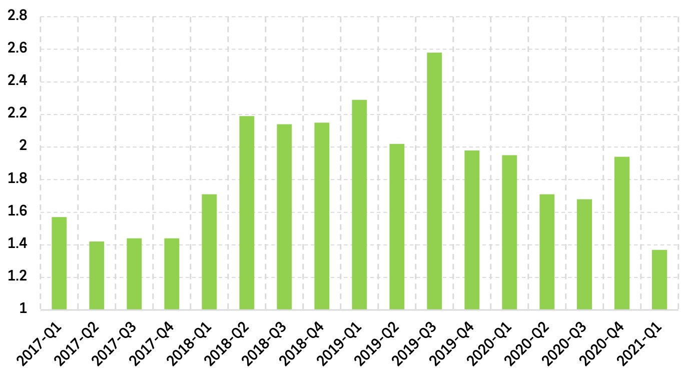


CHART 4 SOURCE: EUROSTAT

1 L. Boisset and G. Derrien, *Eurozone: the upturn in inflation could be short-lived*, BNP Paribas, April 2021
2 Macroeconomic projections for the Eurozone, ECB, June 2021

GERMANY

CHANGE IN CLIMATE

After a sharp contraction in Q1 2020, the economic climate improved significantly in Q2, as the domestic economy gradually opens up. In 2020, the government was very successful in limiting the impact of the coronavirus crisis for households and businesses. In 2021, the fiscal policy stance will remain very accommodative, and covid-19 support measures could amount to 3% of GDP. As the federal election takes place on 26 September, the budget for 2022 will be determined by the incoming government. Opinion polls point to a coalition between the CDU/CSU and the Greens, which should propel climate change to the top of the agenda. The economy is projected to grow robustly in 2021 and 2022. On the domestic side, the main engine of support is private consumption. The manufacturing sector should benefit from the EU's Next Generation programme. The rapid recovery could rekindle inflationary pressures and the ECB's monetary stance might become too loose for Germany.

CHANGE IN THE ECONOMIC CLIMATE

The German economy started the year in a bad way. Economic activity contracted by 1.8%, partly due to the tightening of Covid-19 related restrictions, such as shop closures from mid-December onwards. Moreover, construction activity had been brought forward to Q4, ahead of the expiration of the temporary VAT reduction on 1 January 2021. In addition, construction was also negatively affected by the exceptionally cold weather in early 2021.

In Q2, the economic climate improved drastically, as the fall in the infection rate allowed the gradual re-opening of the domestic economy. The ifo climate indicator for June even reached a highest since April 2018. Activity in the manufacturing sector had already started to strengthen in Q1, partly driven by strong demand from China (Chart 2). In the latest months, sentiment improved strongly in services and retail. Even though activity remains well below levels seen before the outbreak of the pandemic, production bottlenecks have become apparent due to lack of essential intermediate goods in manufacturing and construction. In addition, in the hospitality sector, enterprises have recruiting difficulties.

As the economy is opening up, the unemployment rate is inching down. In May, it stood at 4.4%, which is still 1.2 percentage points higher than in Q4 2019. Also, the number of employees on furlough (*Kurzarbeit*) is declining. In May, still 2.3 million, or 7% of the labour force were on furlough, of which more than half in services.

Inflation has been on a rising trend since the beginning of the year. In May, the harmonised index was 2.4% higher from last year. This is only due to the sharp increase in energy prices (9.5% y/y). By contrast, core inflation remained modest at only 1.6%.

FORCEFUL RESPONSE TO THE PANDEMIC

The government's rapid and forceful response to the pandemic has limited the economic consequences of the pandemic. In 2020, corona support measures amounted to about 2.8% of GDP, of which almost half in the form of subsidies and liquidity assistance for enterprises. The envelope for guaranteed loans and capital injections - the latter are only recorded in the debt level - amounted to even close to 30% of GDP. The fiscal balance (as a percentage of GDP) deteriorated sharply from +1.5% in 2019 to -4.2% in 2020 and the debt-to-GDP ratio rose by 10 percentage points to 70%.

The Covid-19 support measures were quite successful. Around 44% of German enterprises have called on at least one of the schemes. Even though GDP contracted by 4.8% in 2020, the unemployment rate has only increased by 0.7 percentage point to 3.8%. Household disposable income even increased by 0.7% and bankruptcies fell to a historically low level. As a percentage of GDP, the deterioration in the government budget balance was mirrored by a substantial improvement of the financial balances for household and businesses, as the current account surplus hardly changed (Chart 3).

GROWTH AND INFLATION (%)

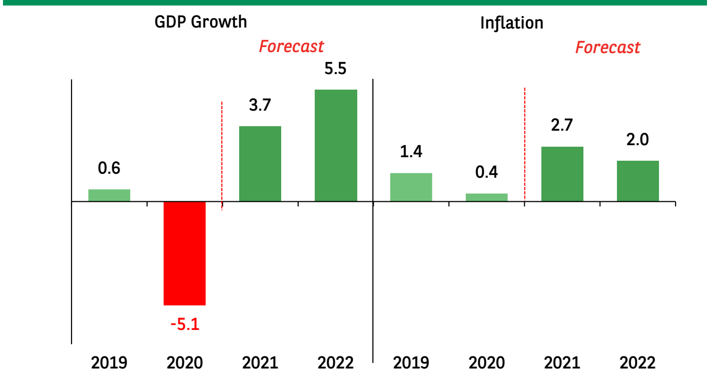


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

QUICK REBOUND OF MANUFACTORING PRODUCTION

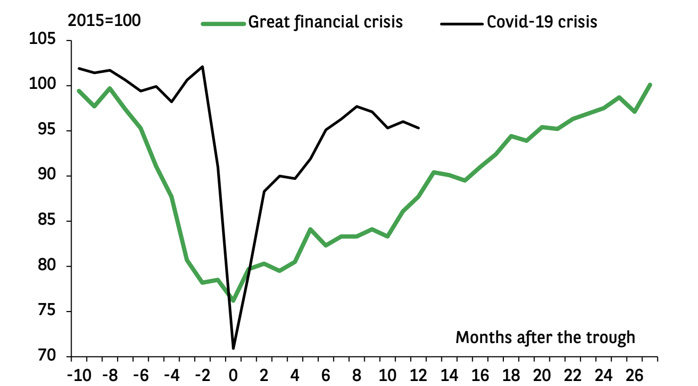


CHART 2 SOURCE: DEUTSHE BUNDESBANK, BNP PARIBAS

In 2021, the fiscal policy stance will remain very accommodative, and the Covid-19 support measures could amount to 3% of GDP. The short-time work scheme will remain in place until the end of the year. Health care spending will be stepped up to finance the vaccination campaign. Other fiscal measures include the abolition for most taxpayers of the solidarity surcharge, introduced in 1991 mainly to finance the German re-unification, and the adjustment of the income tax scales to eliminate the so-called "bracket creep".

Additional revenues will be raised from the new carbon pricing system for transport and buildings, which generally are not subjected to the European emission trading system. Up to 2025, the price of CO_2 certificates is fixed at EUR 25 per tonne of CO2. After 2025, the price is set by the market. The budget deficit is likely to increase to around 4.5% of GDP.

In the coming years, the federal government will step up investment spending to achieve its ambition of slashing emissions 65% from 1990 levels by the end of the decade and hit climate neutrality by 2045. This will be partly financed by EU's New Generation Plan (NGEU). The government has set aside around EUR 52 bn between 2022 and 2025. Before the crisis, the federal investment programme amounted to only EUR 38 bn.

The budget for 2022 will be ultimately determined by the new government that will be formed after the federal election on 26 September. The opinion polls show that the parties of the outgoing coalition of CDU/CSU (Christian Democrats) and SPD (social democrats) could each lose around 5% of the votes compared to the previous election in 2017. By contrast, the Greens could become the country's second largest party with around 20% of the vote, making a coalition between the CDU/CSU and the Greens the most likely outcome. In that case, climate change will become a major theme for the government agenda. On fiscal policy, the new coalition is likely to remain committed to returning to the European fiscal rules and the debt brake.

ROBUST RECOVERY AND RISK OF OVERHEATING

The economy is projected to grow robustly in 2021 and 2022. On the domestic side, private consumption will become the main engine of growth. Despite the coronavirus crisis, household disposable income has improved, shored up by extensive government aid. Nevertheless, households restricted spending as consumption possibilities were limited and on worries about contracting the virus[1]. Consequently, the savings ratio increased from 10.9% in 2019 to 16.2% in 2020. As the domestic economy is opening up, consumer spending is likely to normalise. The savings ratio could even temporarily drop below levels seen before the crisis, as households reduce the wealth accumulated during the crisis.

German manufacturers are likely to profit from the sharp rise in global demand. The sector is likely to profit from the implementation of the NGEU not only in Germany, but also in the other European countries. Moreover, the supply disruptions such as for semiconductors may abate in the coming quarters.

FINANCIAL SURPLUS (% OF GDP)

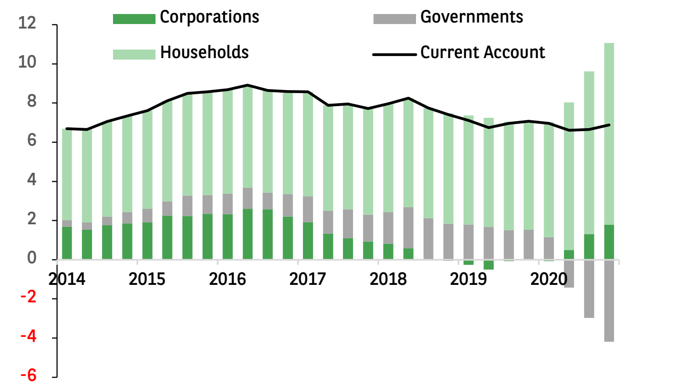


CHART 3 SOURCE: EUROSTAT

The renewed dynamism of the economy will boost the demand for labour, and skill shortages that existed before the pandemic are likely to return soon. This could result in higher wage settlements and a turn up in inflation. As the ECB policy stance is set with regard to inflationary pressures in the whole eurozone, it is not excluded that Germany will be soon confronted with too loose monetary conditions.

Completed on 24 June 2021

Raymond Van der Putten
raymond.vanderputten@bnpparibas.com

1 According to the Bundesbank Online Panel Household Survey, only 7% of households stated to have reduced spending because of fear of income losses.

FRANCE

ROBUST REBOUND

Based on May and June business confidence surveys, the French economy has been rebounding more vigorously than expected from the third lockdown. We have raised our Q2 growth forecast, from near zero to near 1% QoQ. In Q3, the mechanistic rebound would bring growth to about 3% QoQ. Growth is expected to ebb thereafter as the catching-up effects dissipate, although it should remain high, bolstered by the fiscal impulse. The downside of the vigorous upsurge in demand is that it is squeezing the supply side, which is less responsive. The ensuing supply chain constraints, higher input prices and hiring difficulties are all sources of friction that must be monitored since they could hamper the recovery. GDP growth could average 6% in 2021 (an optimistic forecast that is a half point higher than the June 2021 consensus), and will remain strong at an estimated 4.6% in 2022. In our eyes, the economic risks are balanced: the unlocking of forced savings that have accumulated over the past year is an upside risk, while supply-side tensions and pricing pressures are downside risks. Although the Covid-19 pandemic has diminished significantly, the health risk has not completely disappeared given the rapid spread of variants.

SIGNS OF A VIGOROUS RECOVERY

Judging by the business climate surveys for May and June, the French economy has been rebounding more vigorously than expected following the end of the third lockdown. Despite the lockdown, April survey results were already a positive surprise (by rising, in the case of the composite PMI from Markit, and barely dipping for the INSEE composite index, thanks in particular to a strong showing from industry). Buoyed by expectations of brighter prospects, the improvement in the May surveys was impressive, notably in services, even though lockdown measures had been lifted only partially. The INSEE survey results for June maintained this positive momentum, in keeping with the ongoing easing of health restrictions. Buoyed by all economic sectors, the composite index gained another 5 points (after 12 in May) to reach 113, the highest level since summer 2007. This is well above the pre-crisis level of 105, which was already higher than the benchmark of 100. It is also worth noting that since the beginning of the year, the business climate has picked up more rapidly than employment: the gap, which is unusually big, signals strengthening productivity gains (see chart 2).

The upturn in household confidence was less impressive (up 3 points in May and 4 points in June). Granted, the INSEE indicator rose 2 points above the benchmark level of 100 in June, but the index was still 2-3 points below the pre-crisis level of early 2020. However, a few very positive points are worth highlighting. In June, there was a big improvement in household assessments of their future standard of living in France and in the balance of opinions on the opportunity to make big-ticket purchases. Fears about unemployment trends have also dropped off sharply since the beginning of the year.

There are also some encouraging news from hard labour market data. Employment continues to surprise positively. Private sector payroll job gains were revised upwards in Q1 2021 (from +0.3 to +0.5 % QoQ). The unemployment rate remained virtually flat at 8.1% in Q1 2021. Hiring reports for jobs lasting more than 1 month (excluding temporary work) rebounded very strongly in May (+37% m/m), reaching the highest level since 2006 (the year the series began). The number of category A jobseekers registered with Pôle Emploi, the French employment agency, declined sharply in May (-3.7% m/m). Yet the indicator is still 8% higher than the pre-crisis level of February 2020. Based on the gauge of hiring reports (a 4-month moving average of more than 2.7 million contracts), the French labour market could return to good health rather quickly[1], but it will be much harder to reach the second gauge based on the number of jobseekers (the number of category A jobseekers must decline by 130,000 in 6 months).

1 See EcoFlash n°21-09, *The French labour market: outlook for 2021*, 6 May 2021

GROWTH AND INFLATION (%)

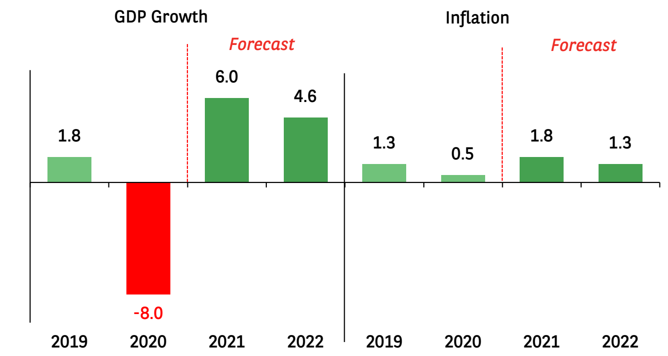


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

THE FRENCH BUSINESS AND EMPLOYMENT CLIMATE

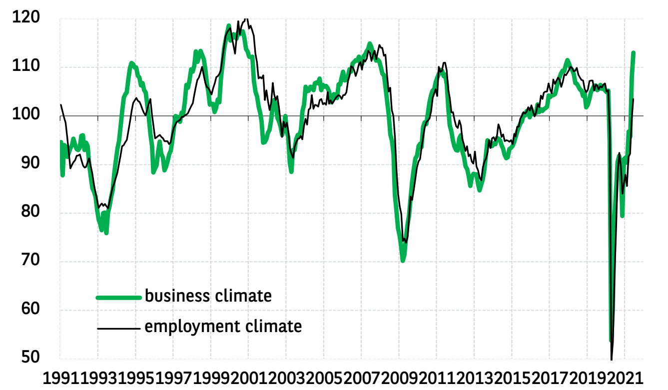


CHART 2 SOURCE: INSEE, BNP PARIBAS

Thanks to these various signs of improvement, there has been a reduction in the shortfall of GDP relative to the pre-crisis level. In its economic update of early June, the Bank of France estimated this shortfall at 6% in April, 4% in May and 3% in June, which points to a Q2 growth forecast of about 0.5% QoQ. Our own hypothesis is a bit more optimistic (shortfall of 3.5% in May and 2% in June), resulting in a Q2 growth forecast of nearly 1% QoQ. In Q3, the mechanistic rebound would then bring growth to about 3% QoQ. Growth should ease thereafter as the catching-up effects dissipate, although it should still remain high, bolstered by the fiscal impulse. By the horizon of year-end 2021, the economy could return to pre-crisis levels. But the recovery will probably continue to mask sector disparities: certain sectors will have surpassed their pre-crisis levels (real estate, financial services, information and communications, non-market services) while others will continue to fall short (transport equipment, hotel and restaurant services, leisure activities).

In 2021, average annual growth is expected at 6%, and it should remain strong in 2022 at 4.6%. Note that these forecasts incorporate an extra fiscal stimulus of EUR 10 bn in 2021 and 2022, which adds about 0.4 percentage points to growth each year. The stimulus aims to steer GDP back towards its pre-crisis trajectory.

THE DOWNSIDE TO VIGOROUS DEMAND AND OTHER POINTS TO MONITOR

The downside to the vigorous upturn in demand is that it is creating tensions in the supply side, which is less responsive. The ensuing supply chain constraints, higher input prices and hiring difficulties are all sources of friction that must be monitored closely as they could hamper the recovery[2]. Our scenario's underlying assumption is that these tensions will gradually diminish as economic activity returns to normal and supply and demand reach a new equilibrium. The recovery is unlikely to be hampered significantly. Yet these sources of friction represent a definite downside risk, an unwelcome negative shock that could lead to production shutdowns and smaller corporate margins.

The evolution of business failures is another point of fragility to watch. Business failures plunged in 2020 and in early 2021, but this counter-intuitive movement can be attributed to the effectiveness of emergency support measures. Corporate bankruptcies are now poised to rebound. The big question is by how much. We should expect to see bankruptcies return at least to pre-crisis levels (an increase of about 25,000). They have probably already begun to pick up, because April 2021 has marked the first increase since early 2019. What would be truly alarming is if the number of bankruptcies were to rise above this normalisation trend. Yet several factors should help contain the increase, including the ongoing economic recovery, the gradual withdrawal of emergency measures, the roll out of participation loans and other support measures under the France Relance plan, and new anti-bankruptcy measures.

Despite the big improvement in the health situation, it is still a downside risk: we cannot rule out the possibility of a new post-lockdown wave of Covid-19 with the rapid spread of variants in the background. Thanks to the increase in vaccination coverage, hopefully it will be possible to avoid another lockdown.

On the other hand, growth could also surprise on the upside if the unlocking of forced savings accumulated over the past year is bigger than expected and/or the labour market situation is better than anticipated. In our eyes, these upside risks balance out the downside risks.

PRICE COMPONENTS OF MANUFACTURING PMI AND INFLATION

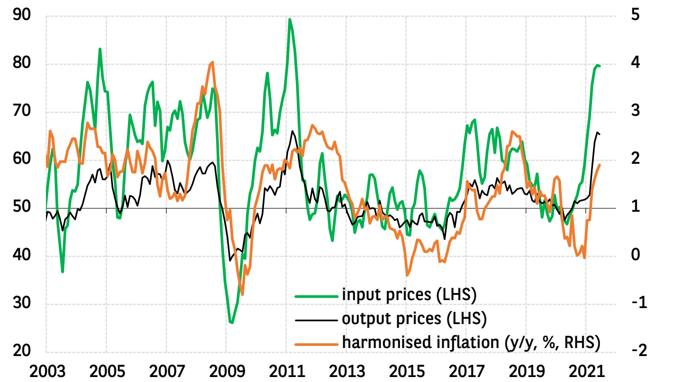


CHART 3

SOURCE: INSEE, MARKIT, BNP PARIBAS

ONE LAST FISCAL BOOST BEFORE SUPPORT IS GRADUALLY WITHDRAWN

As part of the supplementary finance bill for 2021 (PLFR 2021) presented in early June, the government raised its forecast for the fiscal deficit to 9.4% of GDP, which is 0.4 points higher than anticipated in April's Stability Programme, and 0.2 points higher than in 2020. This deterioration might seem paradoxical, because an upturn in growth as strong as the one expected in 2021 is supposed to reduce the deficit, and because the contours of the crisis exit strategy, i.e. the withdrawal of the safety net of emergency measures, have begun to be sketched out[3].

The reason behind this paradox lies in spending, whose expected increase is larger than the revenues' rise (EUR 64 bn and EUR 47 bn, respectively, compared to 2020). About 60% of the increase in spending can be attributed to "ordinary" expenditures, and to a lesser extent, support and stimulus measures (about EUR 25 bn). Another interesting figure is the sharp increase in credits under the Emergency Plan, which rose from EUR 6 bn in the initial finance bill to nearly EUR 45 bn in the PLFR 2021. Nearly EUR 30 bn corresponds to 2020 credits carried over to 2021, and about EUR 10 bn is for additional resources allocated to the Solidarity Fund and the short-term working scheme. This last increase in the budget of the emergency measures aims to prepare the ground for their future withdrawal. It should help ensure that their gradual withdrawal will be as painless as possible for the companies concerned.

During two extraordinary years marked by the crisis (2020) and the exit from the crisis (2021), the prevailing logic was "whatever it takes". The year 2022, in contrast, should mark the beginning of the return to a more ordinary constrained fiscal policy. Although the time is not yet ripe for greater austerity, the fiscal trade-offs promise to be difficult in the 2022 budget.

Completed on 30 June 2021

Hélène Baudchon
helene.baudchon@bnpparibas.com

2 See Chart of the Week, *Recovery in France: slowed before it started?*, 12 May 2021
3 See EcoTV Week, *France: start of the recovery and crisis exit strategy*, 21 May 2021

ITALY

THE RECOVERY IS GAINING STRENGTH

At the beginning of 2021, the economic growth surprised on the upside. In Q1, real GDP rose by 0.1%. Private consumption declined, reflecting the disappointing evolution of income and a still high propensity to save, investment rose by almost 4%. The recovery turned out to be uneven, with industry and construction seeing a quicker rebound, while services continued to suffer. The economic growth is expected to strengthen in the coming months. The acceleration of the vaccination programme and a significant improvement in the health outlook have boosted optimism among consumers and businesses. In order to make the recovery long lasting, Italy has to improve the quality of human capital to balance the decline in productivity also due to an elderly work force.

A BETTER THAN EXPECTED RECOVERY

At the beginning of 2021, the economic growth surprised on the upside. In Q1, real GDP rose by 0.1%, after -1.8% in Q4 2020. Domestic demand subtracted 0.1%, while stocks added 0.6%. Net exports had a negative contribution, as imports rose more than exports. The annual GDP growth was -0.8%, from -6.5% in Q4 2019.

In Q1, the recovery turned out to be uneven, with industry and construction seeing a quicker rebound, while services continued to suffer. Construction has already recovered pre-pandemic levels, with an 8% increase in comparison to Q4 2019, thanks to fiscal measures designed to support the energy improvement and the seismic strengthening of buildings. In Q1, manufacturing value added recorded the third consecutive increase (+0.7%), although remaining about 2 percentage points below Q4 2019. Italian industry benefitted from the recovery of global demand, with exports bouncing back to pre-pandemic level. Production of intermediate goods strongly increased, with that of rubber, plastic and non-mineral metal products rising by more than 4% and that of chemical products by about 2%. In Q1, a still disappointing domestic demand brought services' valued added almost 8% below Q4 2019. Trade, transport and accommodation contracted by about 2%, further offsetting the moderate recovery of financial activities and information and communication services.

GROWTH AND INFLATION (%)

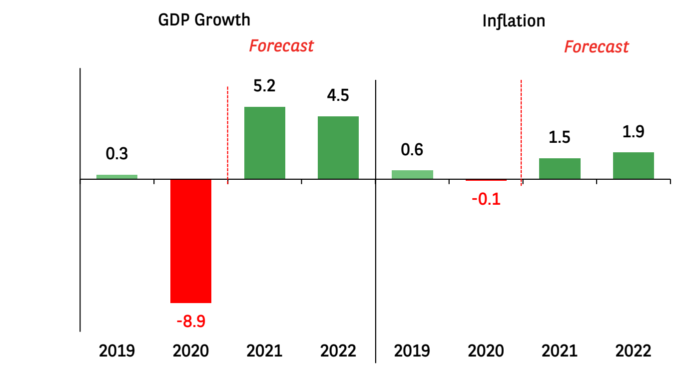


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

FEEBLE CONSUMPTION, STRONG INVESTMENT

In Q1, consumption fell by 1.2%, subtracting 0.7% from the GDP increase, reflecting the disappointing evolution of income. Labour market conditions remain uncertain. In Q1, the number of people in employment declined more than the number of hours worked, with labour units about 1.7 million below Q4 2019. Hourly contractual wages rose by 0.6% on annual basis, below inflation evolution. Private expenditure continued to be constrained by a still high propensity to save, as a consequence of the combination of fears about the evolution of the pandemic and the restrictions imposed to limit the spread of the virus. From January to March, households' bank deposits rose by almost €20 billion.

In Q1, the Italian recovery mainly reflected the strong rebound of investment, which rose by almost 4% q/q, with a 0.7% positive contribution to GDP growth, reaching the highest level in the last ten years. Expenditure on machinery and equipment increased by 3.5% and construction expenditures by about 5%. Italian firms benefitted from measures enacted to prevent a generalised tightening of credit, such as public guarantee on bank loans. Although the leverage index rose by about 2 percentage points in 2020, financial conditions of non-financial corporations strengthened. Firms' deposits rose to €480 billion or 38% of total financial debt, about twice as much as the 2008 level.

REAL GROWTH OF COMPONENTS
GDP, Q1-2021/Q4-2020

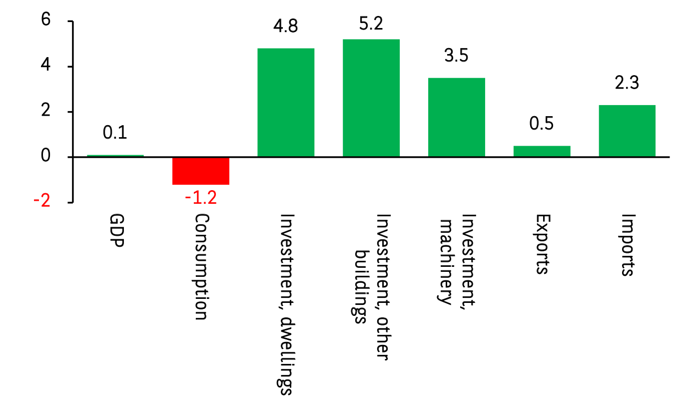


CHART 2 SOURCE: ISTAT

A RECOVERY THAT IS STRENGTHENING

The economic growth is expected to strengthen in the coming months. The acceleration of the vaccination programme and a significant improvement in the health outlook has driven up optimism among consumers and businesses. The easing of restrictive measures on mobility supports private expenditure, which also benefits from an improvement of income evolution and an increasing propensity to consume. In April, the number of both employed and unemployed persons increased, while that of inactive people declined. Consumption is also supported by a higher use of bank loans. The annual growth rate of bank consumer credit rose from -3% at the beginning of 2021 to +0.3% in April. From January to April, retail trade increased by 8.4% y/y, with a stronger demand for non-food items. In May, services PMI swung back into positive territory. Manufacturing continues to benefit from the favourable evolution of global trade. In April, exports rose by almost 3.5% m/m. Italian sales abroad have totally recovered the loss accumulated during the first part of the crisis, supporting industrial production, which increased by almost 2% m/m in April.

IN ITALY THE POPULATION SHRINKS AND GETS OLDER

The Covid-19 pandemic has shown the importance of an in-depth knowledge of the age structure of a population in order to make healthcare systems more resilient and education programmes more effective in endowing the different age groups with adequate skills in order to enter or remain in the labour market in a productive way.

Italy is one of the countries suffering the most from the growth in the number of elderly people in proportion to the other age cohorts, and to the contraction of the population. The number of residents has been declining for seven years in a row, decreasing to 59.258 million in 2021, 384 000 less than in 2019, mainly due to the birth rate decline. In 2020, only 404 000 children were registered, about one third less than the peak of 577 000 observed 12 years earlier. The drop in births is due both to structural factors - i.e. a reduction in the female population in childbearing age (conventionally set between 15 and 49 years old) - and to the reduction in the average propensity to have children. Estimates indicate that had the fertility rate remained at 2019 levels, when there were 420 000 births, there would have been around 413 000 births in 2020. The structural effect linked to the ageing of the female population alone has led to a reduction, all things equal, of at least 700 000 births. The remaining 9 000 missing births over 2019 would result from a lower propensity to have children.

Indeed, after reaching a peak of 1.46 children per woman in 2010, the total fertility rate undertook a declining trend leading to 1.24 children per woman in 2020 (the second lowest value in the last 20 years, after that of 2003). The reduction in birth rates affected all areas in the country. The Covid-19 pandemic has stopped the gradual lengthening of life expectancy at birth. After an extraordinary progress recorded since 1950 (when the average life expectancy was 66.5 years), life expectancy at birth stood at 82 years in 2020, 1.2 years below the 2019 level. It declined to 79.7 years for men (1.4 years less than the previous year) and to 84.4 for women (one year less than in 2019).

The increase in life expectancy at birth over the years has led to a significant increase in the share of the elderly population in total: the over 65-year old, in particular, reached 23.5% in 2020 (they represented 8.1% of the total Italian population in 1950). This figure is expected to increase up to 2049 (when this age group might end up accounting for 33.9% of the total population) and then gradually decrease.

WORKFORCE EDUCATION IN THE PRODUCTIVE SYSTEM

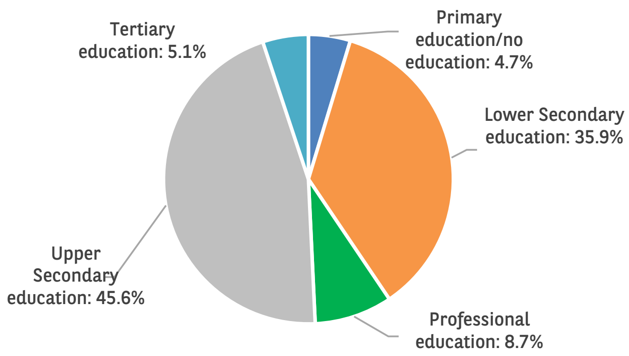


CHART 3 SOURCE: BNL CALCULATIONS ON ISTAT DATA

By contrast, between 1950 and 2020, the weight of the 0-14-year old age group more than halved, from 26.7 to 11.8% of Italian population. Among the elderly in Italy, 17,935 people were over 100 years old in January 2021.

In Italy, the analysis of the relationship between the age structure of the population and the quality of human capital is of great interest, owing to the growing presence of elderly workers in the production system, and because the average education of the employed is still low, even though the younger cohorts are on average more educated than the older ones. Italian workers' average age obviously reflects that of the general population. According to the latest Istat data, over 33% of the employed in Italian firms are over 50 years old, 52.6% are between 30 and 49 years old and only 13.6% are 15 to 29 years old. The large presence of the over 50 in the business system is not a problem per se; however, it may have negative consequences on productivity and propensity for innovation when accompanied by a low level of education, which is the case in Italy. According to Istat data, only 5.1% of staff in Italian firms have at least a tertiary education background or an academic diploma. This is an extremely low percentage, while employees who do not have education at all or have at most a primary school diploma make up 4.7% of the staff, and those having obtained a lower secondary school diploma, 35.9%. As expected, the percentage of less skilled employees (primary school or no qualification) is concentrated among older workers: (69.4% are over 50 years old); however, it is also not negligible in the 30-49 years old age group (over 27%) while it is quite small among younger staff (about 3%).

Completed on 24 June 2021

Paolo Ciocca
paolo.ciocca@bnlmail.com

Simona Costagli
simona.costagli@bnlmail.com

SPAIN

ECONOMIC ACCELERATION IN SIGHT

Just when the lights seemed to be turning green on the health front, the spread of the Delta variant in Spain, as elsewhere in Europe, is a cause of concern. The risks remain currently under control and economic activity should record a significant upturn this summer. The easing of travel restrictions and the introduction of the European health pass since 25 June should allow the Spanish tourist industry to lift itself back up, which would have positive knock-on effects on consumption and employment. Even so, and despite the fact that growth is expected to bounce back strongly, to 6.0% in 2021, the Covid-19 will continue to leave its mark on Spain's public finances. After a record year in 2020, the government deficit could remain at over 8% of GDP this year and stay elevated until 2022 at least. The European Commission's approval of Spain's recovery plan will, however, allow Madrid to receive the first round of European subsidies. Thus EUR 9 billion in grants could be allocated in July, with a further EUR 10 billion unlocked by the end of 2021.

THE PANDEMIC EMERGES AGAIN

Although our central scenario remains one of a solid economic recovery in Q3, the risks of a new wave of the pandemic caused by the Delta variant cannot be totally excluded. This is particularly true because the vaccination campaign seems to be levelling off in Spain[1], with just half of the country's population having received at least one vaccine dose by the end of June. The government's goal of vaccinating 70% of the population by the end of the summer nevertheless remains within reach according to the health ministry.

The tourist season would suffer from any worsening of the health situation in Spain and elsewhere in Europe if this leads to a renewed tightening of travel conditions between countries. Control measures (PCR tests, vaccination certificates) have already been reintroduced for British travellers coming to Spain. Before the pandemic, the tourism sector generated nearly 2.6 million jobs (direct and indirect) or just under 15% of total employment in Spain[2]. The figures related to the tourism activity that we have so far still bear the marks of lockdown measures and reflect the long road still ahead for a recovery. The number of overnight stays in May was still only around a quarter of the level seen in the same month in 2019. Even though these figures will improve significantly, a return to 2019 levels is unrealistic this year, and will still be a challenging target in 2022.

At this stage, we are still expecting economic activity to accelerate in the second half of this year – with growth of around 5.5% – after a timid recovery in the first semester. This represents a slight upward revision of our March forecast estimate for the full year 2021, up from 5.9% to 6.0%. Economic activity in Spain was hit this winter not only by another wave of infections – which caused the authorities to tighten again health protection measures – but also by winter storm Filomena in January. This paralysed large parts of the country for several days, further impacting economic activity in Q1, particularly in construction. This sector recorded the biggest contraction in activity in Q1 2021, at -4.3%, whilst real GDP fell 0.4% q/q. It is worth noting, however, that some components of demand held up really well. On the investment side, spending on machinery and equipment and on intangibles continued to grow over the winter, with the latter reaching record levels. But the most pronounced growth came from exports of goods. Exports by value grew by more than 8% in the first four months of the year, climbing well above the levels seen at the end of 2019 (see Chart 2). The recovery in capital goods exports was particularly strong (13.8% over the first four months of the year), but there was also significant increases in consumer goods (8.5%) and intermediate goods (7.0%). By country of destination, and over the same period, the biggest growth came from the eurozone (28.2%), most notably Portugal (30.7%), Italy (28.7%) and France (27.6%).

GROWTH AND INFLATION (%)

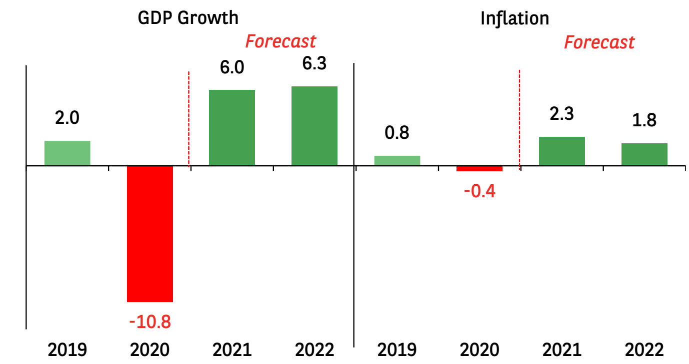


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GOODS EXPORTS HAVE UNDERPINNED GROWTH THIS SPRING

CHART 2 SOURCE: SPAIN FINANCE MINISTRY

1 *Spain misses June vaccination target with nearly three million doses still in storage, El Pais*, 22 June 2021.
2 Source: Eurostat.

CONSUMPTION AND EMPLOYMENT STILL CONVALESCING

The recent evolutions in surveys (PMI, European Commission) clearly point to an acceleration in activity over the summer. For example, the composite PMI hit its highest level for 20 years in May, at 59.2. Although the upturn in optimism was already visible in the manufacturing sector over the winter, the improvement in confidence in services occurred more lately, on the back of the gradual loosening of lockdown measures that still weighed on this sector last spring. However, so far there has been a significant lag between these (optimistic) survey data and more tangible data, for which a noticeable improvement is yet to materialise. This is particularly the case for the consumption (retail and car sales) and employment data. Nearly 4 of every 10 jobs lost during the first lockdown had still not been replaced by May.[3] This said, the construction sector is performing well, with employment in the sector already back above 2019 levels. National employment data nevertheless need to be viewed with some caution; workers on the ERTE short-time working scheme are considered as employed, although not all of them will return to employment. Despite a significant fall, nearly 500,000 workers were still covered by the ERTE scheme at the end of May.

Given these circumstances, and even though the process of scaling back the government's exceptional support measures is now under way, a large chunk of the support measures is likely to remain in place for several months yet, and will only be withdrawn very gradually. This is particularly true of the "widened" form of the short-time working scheme (ERTE) introduced at the onset of the pandemic, which has been extended to the end of September. The Spanish public finances will thus remain deeply in the red in 2021. The Bank of Spain (BdE) is now predicting a General government deficit of around 8% of GDP (8.2%)[4] for the year; the bank expects the deficit to remain high in 2022 (4.9%) and 2023 (4.3%). This is not solely due to the exceptional support measures the government has adopted to limit the shock of the pandemic, but it is also the consequence of a large underlying 'structural' deficit that predated the coronavirus crisis[5]. The ratio of government debt to GDP will therefore benefit only very slightly from the growth expected in 2021 and 2022, and will remain close to the threshold of 120% (118.0% in 2022 according to the BdE; from 119.9% in 2020).

Spain should nevertheless benefit in July from the first payments (EUR 9 billion) under the European recovery fund, following the European Commission's approval of its recovery programme. EUR 10 billion in additional grants should be released by the end of this year. However, this total of EUR 19 billion for 2021 falls short of the EUR 27 billion that the Spanish government initially expected to receive.

INFLATIONARY PRESSURES NOT AS STRONG AS IT SEEMS

As in other parts of Europe, inflation in Spain has climbed steeply over recent months, reaching 2.7% in May. However, underlying pressures remain contained. The overall increase in the CPI was almost entirely due to increases in energy prices, with two main contributors: first, the rise in petrol and diesel prices – CPI for petrol jumped 24.2% in May – and secondly the spectacular leap in electricity prices (36.3%). Removing the energy component from CPI gives a level of inflation much more benign, at just 0.3% in May (Chart 3). Indeed, some CPI components were even in deflation. This was the case, for example, in communications (-4.5% y/y), hotels and restaurants (-0.6% y/y) and alcohol & tobacco (-0.3% y/y). The gap between headline and underlying inflation (excluding energy and fresh food) has been the widest since the current data series began (January 2002).

RECORD GAP BETWEEN OVERALL AND CORE INFLATION

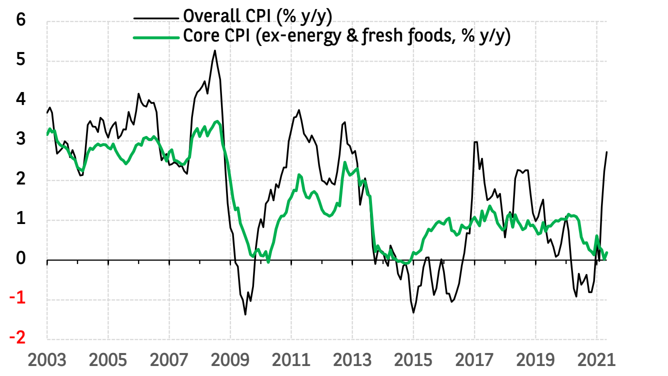


CHART 3 SOURCE: INE

In order to reduce the weight of electricity in household living costs, the government decided to cut on June 26 the rate of VAT on electricity from 21% to 10% until the end of the year. It also suspended the 7.0% tax on electricity paid by companies. The shortfall in tax revenue will be important, at nearly EUR 1.2 billion according to the government. This will further increase the budget deficit in 2021.

Completed on 28 June 2021

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

3 Data from the Spanish employment agency (SEPE).
4 Banco de España macroeconomic forecasts, June 2021.
5 See BNP Paribas EcoFlash *Spain: Towards a protracted increase in the public deficit?,* 21 January 2021.

BELGIUM

STRONG RECOVERY, BUT AT THE COST OF HIGHER PUBLIC DEBT

The Belgian economy grew at an above-potential rate in the first quarter of this year, and looks to be on course to maintain this pace throughout the year. Full year growth is expected to come in at 5.1%. Private sector sentiment is strong and the labour market is emerging from the health crisis virtually unharmed, with the unemployment rate still hovering at around 5%. Public finances, largely responsible for the current strong situation through extensive support measures, need to be improved over the medium-term, as the government aims to capitalise on the recovery to fix other, more structural issues.

GDP GROWTH AND VACCINATION COVERAGE

At the end of the first quarter, Belgian GDP stood 4% lower than its pre-Covid level. This is in line with the Netherlands but well above the European average. First quarter GDP growth exceeded the market consensus and early readings for the second quarter points to a further acceleration.

Household consumption still came in 9% below its pre-Covid level in the first quarter of 2021. High-frequency retail transaction data suggest spending was well short of a full recovery early in June, even if online shopping continued its upward trajectory.

The situation is somewhat different for investment spending, where a full recovery to the level of the fourth quarter of 2019 was in fact completed early in 2021. All categories of investment are growing, with government spending up 5% compared to pre-Covid levels.

The vaccination rollout is progressing quite smoothly. At the time of writing, at least 80% of all those aged 45 year and more have received at least one shot. This invalidates initial concerns about vaccine-scepticism among people belonging to this age group category, whereas reports last year suggested only 60% would be willing to get vaccinated. Regional heterogeneity could become worrisome, as the uptake is significantly lower in the region around the capital city of Brussels.

GROWTH AND INFLATION (%)

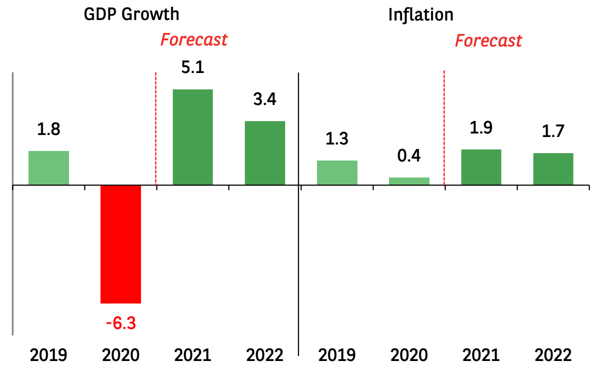


CHART 1

SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

ECONOMIC OUTLOOK

We expect the above-potential growth to persist for the next couple of quarters, with a normalisation only pencilled in for 2023. With QoQ-rates of at least 1% expected to persist throughout 2021, full year growth would come in at 5.1%. As a consequence, GDP levels are now expected to return to their 2019 Q4-levels at the beginning of 2022 in our updated outlook.

A recovery in private consumption is only foreseen for 2023, but government spending and investment are driving the positive medium term prospects.

At present, we see risks mostly on the downside. A slowdown of the vaccination campaign or an increased prevalence of the various variants of the virus could adversely impact our outlook. In addition, there is still some concern about the financial health of companies in the worst-hit sectors. A much feared “wave of bankruptcies” has so far failed to materialise and the likelihood of such an event further decays as the economic recovery steams ahead.

PRIVATE SECTOR BUSINESS CONFIDENCE ON AN UPWARD TREND

In May, business confidence went up for the sixth consecutive month. The improvement is most notable in the construction and service sectors, which are both reporting a stronger outlook for demand and their own activities. Supply disruptions are seemingly emerging in some sectors.

Trade, construction and manufacturing are amongst the hardest-hit sectors, with a shortage of supplies identified as the main issue. There are reports of input cost increases of 10-50% and companies expect to, at least partly, pass them through to their end-users.

Consumer sentiment also continued its upward trajectory with a strong increase in May. It is currently matching its high-mark of two decades, with especially the better outlook for unemployment in the next 12 months being a significant contributor.

Total employment has increased in the last quarter. Self-employment growth remained robust throughout the health crisis and the number of employees is increasing once again. Some 400 000 employees remain in temporary employment, as one in ten self-employed receives financial support.

Firms are reporting hiring difficulties, combined with a higher than usual staff turnover.

In the latest Covid-dashboard (NBB) 81% of households reported that their income was not impacted by Covid-19. Spending on residential real estate continues unabated. Just as in the neighbouring countries, housing prices are rising. The Bank of International Settlement's residential price index showed a 5.7% increase at the end of last year.

PUBLIC FINANCE : FINANCING NEEDS WILL REMAIN HIGH

The government deficit came in at just below 10% for 2020. Measures to support both workers and companies boosted the expenditure side, while the revenue share as a percentage of GDP remained stable.

Financing requirements are, however, expected to remain elevated for the foreseeable future, with the National Bank of Belgium forecasting a deficit of 4.5% for 2023. This would reflect a structural issue, as at that point, Covid-related spending will have all but abated. Accordingly, the debt-level will not decrease before the end of the projection period. It came in at 114% for 2020 and will likely be at around the same point by 2023.

The Belgian Debt Agency reported that as early as mid-June, the majority of the expected borrowing requirements for 2021 had been met. The average maturity of Belgian government debt continued its upward trajectory and stood at 10.2 years last month. Moreover, yields continued to decline, allowing to lock in the low rates for a longer time. The average interest rate on the outstanding debt is now 1.6%, roughly half as much as was the case in 2014.

With the health crisis seemingly more and more under control, the governing parties are shifting their focus to other areas. Structural challenges for the Belgian economy (rigid labour market, impediments to entrepreneurship, a decline in the working-age population and regional disparities) will need to be addressed head-on. After having dealt with arguably the largest crisis since the 2nd World War, it is now up to the De Croo government to show that it can also excel in the more mundane task of supporting a recovery.

Completed on 25 June 2021

Arne Maes
arne.maes@bnpparibasfortis.com

FINLAND

RESILIENT

Although Finland was one of the European countries hit the least by the Covid-19 pandemic, its economic recovery was nonetheless pushed back by a third wave of contaminations in late winter 2020 and early spring 2021. The economy will rebound in the second half of this year, buoyed by consumption and the upturn in global trade. GDP growth should range between 2.5% and 3% in 2021 and 2022. Very concerned about the solidity of its public finances, the country saw its public debt swell by about 10 points of GDP last year while the deficit rose to 5.4% of GDP.

RECOVERY IN SIGHT

Like its Norwegian neighbour, Finland is one of the countries that was spared the most from the Covid-19 pandemic, with one of the lowest Covid infection rates in Europe (175 deaths per million inhabitants at mid-June). Even so, Finland was hit by a third wave of the pandemic that was slightly more severe than the previous ones, which led the authorities to tighten health restrictions last winter. This temporarily halted the economic recovery and led to a mild downturn in Q1 GDP.

The health situation is now under control again and social distancing restrictions are gradually being lifted. Moreover, Finland has managed to reach a high vaccination rate, with over 55% of the population having received at least one dose of the vaccine at 20 June. The economy apparently began to rebound in May, and everything suggests that the recovery will accelerate in H2 if the pandemic continues to ebb nationally and across Europe.

Last year, given the pandemic's low infection rate, industry was not affected much by the problems of factory shutdowns or supply chain disruptions, so industrial activity is now poised to benefit from the rebound in global demand. Household spending is expected to act as a second growth engine for the recovery, as consumption is stimulated as of this summer by the lifting of social restrictions and by the accumulation of forced and precautionary savings during the pandemic. In the end, business sentiment has surged in recent months and is now approaching the cyclical peak of year-end 2017. After a mild contraction in 2020 (-2.8%), GDP growth is expected to rise above 2.5% this year and in 2022.

MOBILISATION OF PUBLIC FINANCES

Throughout 2020, the Finnish government adjusted and reinforced healthcare spending as necessary to combat the pandemic while adopting measures to support companies through a total of seven supplemental finance bills. The fiscal deficit rose to 5.4% of GDP, the highest level since 1995 and 4.5 percentage points higher than in 2019. The public debt ratio rose even further, up 10 percentage points to 69% of GDP, swollen by measures with no impact on the fiscal balance, such as tax deferrals, loans and capital injections.

Only part of last year's emergency measures were extended into 2021. According to the European Commission, temporary fiscal expenditures pertaining to the pandemic could be reduced to about 1.5% of GDP, down from 3% in 2020, which would allow the fiscal deficit to begin to consolidate this year and the public debt ratio to begin to level off.

Completed on 28 June 2021

Frédérique Cerisier
frédérique.cerisier@bnpparibas.com

GROWTH AND INFLATION (%)

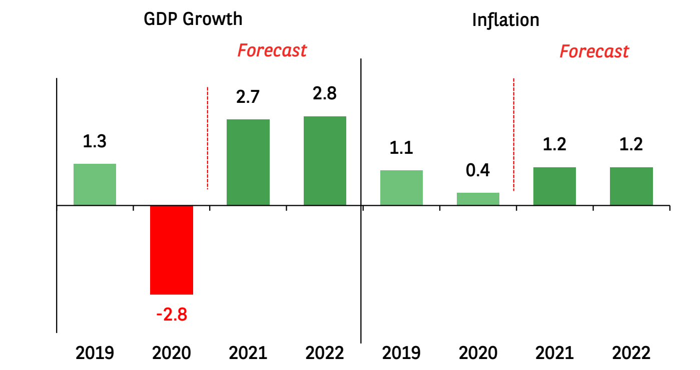


CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

GDP GROWTH AND ECONOMIC SENTIMENT

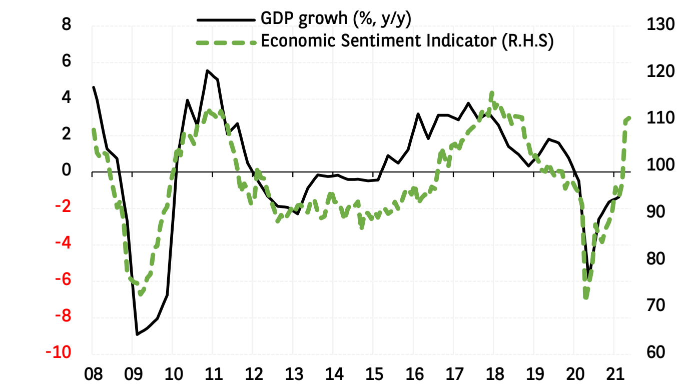


CHART 2 SOURCE: STATISTICS FINLAND, EU, BNP PARIBAS CALCULATIONS

GREECE

MIXED SIGNALS

The Greek economy is proving resilient, with the recovery through to Q1 2021 being faster than in most other Eurozone members. This has been driven primarily by the very significant increase in goods exports. The spread of the Delta variant in Europe represents a threat to the recovery in the tourism sector, which is essential to bolster growth and employment over the coming months. Pending this, the labour market shows continued fragility. The unemployment rate climbed to 16.3% in Q1, whilst the number of inactive workers jumped, partly due to the effect of rising numbers of workers on temporary unemployment. Creating employment and reducing the unemployment rate remains the country's major challenge, but Greece should continue to benefit in the short and medium term from favourable financing conditions, notably thanks to the support of the ECB.

With a real GDP loss of 2.3% in Q1 2021 compared to Q4 2019, the Greek economy has bounced back faster than most other countries in the Eurozone. The GDP gap for the single-currency area as a whole is twice as wide, at 4.7% (Eurostat). Although certain components of demand (private consumption and investment) are still fragile, exports of goods have bounced back strongly and have, in fine, been moderately impacted by the Covid-19 crisis. After a drop of 3.3% q/q in Q2 2020, which was fairly modest given the global economic context at the time, real exports of goods have since climbed by nearly 12%. They have now risen significantly above their pre-pandemic level. Real imports fell much more sharply during the pandemic, and are still a long way below pre-pandemic levels. As a result, net exports made a highly positive contribution to Greek GDP growth.

The scale of the recovery in tourism – which represents nearly 20% of national GDP – will now be the key factor in stimulating growth and employment over the next few months. The labour market weakened in Q1. The unemployment rate reached 16.3% and the number of inactive workers saw a spectacular jump. A substantial part of this increase resulted from the rise in the number of employees placed on short-term working scheme at the beginning of this year, in response to the latest wave of Covid-19. Even though many of these workers are likely to return to employment, the scale of such a recovery remains uncertain and will need to be closely monitored over the coming months.

GROWTH AND INFLATION (%)

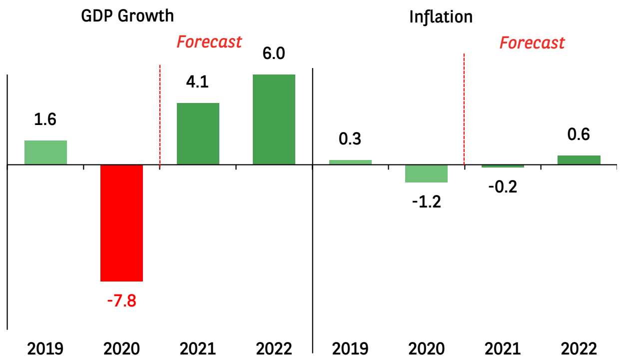


CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

LOW INFLATION HAS LIMITED INCREASES IN SOVEREIGN INTEREST RATES

Against the background of rising sovereign yields over recent months, Greece stands out as the exception. Interest rates on Greek sovereign bonds, and the spread against the German Bund, continued to fall in the first half of 2021. Unlike most other European countries, inflation in Greece has remained very subdued, at 0.13% in May 2021. This has helped limit upward pressure on sovereign yields, most notably the 10-year yield which hit a new low in June (0.97% on 11 June 2021).

Over the medium term, the support of the European Central Bank (ECB) should help keep sovereign interest rates and debt repayment costs low. A derogation clause in the Pandemic Emergency Purchase Program (PEPP) allows the ECB to buy Greek public sector debt securities, a transaction not authorised under the Public Sector Purchasing Program that has been in place since 2015. Non-performing loans, meanwhile, have continued to fall despite the pandemic, dropping to 27.0% of outstanding loans at Greek banks by the end of 2020 (source: IMF).

Greece, whose national recovery plan was approved in mid-June by the European Commission, has also seen a significant uplift in its grants from the EU's Recovery and Resilience Facility for 2021, from EUR 4 billion to EUR 7.5 billion. In total, the national recovery plan will have a budget of EUR 31.2 billion (18.1% of 2019 GDP) and will be split between grants (EUR 18.4 billion) and loans (EUR 12.7 billion).

Completed on 28 June 2021

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

UNITED KINGDOM

A POOR START

No sooner had the divorce agreement with the European Union been signed than the UK started disputing its terms. On 16 March, the British government was formally notified by the European Union for breaches of the Protocol on Ireland and Northern Ireland and violation of the duty of good faith. The final outcome, which can include sanctions, is yet to be decided. The fact remains that Brexit, described as a "historic mistake" by the remaining 27 members of the EU, appears as nothing more or less than what it is: a clear break. Admittedly, it will not stop the UK economy from recovering. Having managed to avoid tariffs, become a convert to "whatever it takes" and now being well on the way to winning out over Covid-19, the United Kingdom, like other countries, is enjoying euphoric economic conditions. Yet beyond the short term outlook, the benefits it could get from its decision to go its own way are still to be proved.

DEALS: NO SOONER SIGNED THAN BREACHED

Although it has reached a wide range of bilateral deals with trading partners (70 or so since Brexit, the most recent and by far the most important being that with Australia), the United Kingdom has presented its former European Union partners with something much less palatable. Looking strictly at data flows, the country is already visibly more distant. Having fallen to historically low levels in January 2021, the UK's trade with the EU has only partially recovered since its redeployment outside the single market has started (chart 2). On the political and diplomatic front, mistrust has become the order of the day. In early March, without prior discussion or consultation, Boris Johnson's government decided to postpone (to 1 October 2021) the implementation of checks on British exports to the EU passing through Northern Ireland, thus failing in its legal duties (see Box).

In response the EU issued the UK government with two formal notices for breaches of its agreement, one on breaches of the Protocol on Ireland and Northern Ireland and the other for a violation of the duty of good faith. The UK's response to these has been received and is being considered in Brussels. The next steps remain to be decided. If it remains unsatisfied, the Commission may issue a 'reasoned opinion', detailing the UK's failures to respect the withdrawal agreement. Ultimately, the European Court of Justice would be able to impose a fine or other penalty on the UK, or, in the event of a refusal to implement any ruling, could suspend the application of all or part of the Brexit treaties.

Although it has not triggered any official process, the issue of fishing rights has been another flashpoint that has pushed a wedge into the cracks in the trade and cooperation agreement between the UK and EU. Under this deal, the UK agreed to authorise European boats to fish in its waters in return for a 25% reduction in their catch quotas over the next five years. In the event, the few licences that have been issued suggest a much more restrictive policy, particularly for the waters around the island of Jersey, which is virtually off-limits to EU boats. French fishermen have been hit hard by this (70% of the catch in Brittany comes from British waters), and France is now putting pressure on the European Commission to enforce the terms of the agreement.

The list of on-going disputes is further swelled by the UK's policy for investment in offshore wind power, which favours UK companies and thus contravenes the 'level playing field' rules agreed with the EU (The Guardian, 2021)[1].

Vice President of the European Commission Maroš Šefčovič has stated that *"unilateral decisions and international law violations by the UK defeat [the Protocol's] very purpose and undermine trust between us."*

1 The Guardian (2021) 'Wind turbine clash adds to UK-EU post-Brexit tensions', June 17.

GROWTH AND INFLATION (%)

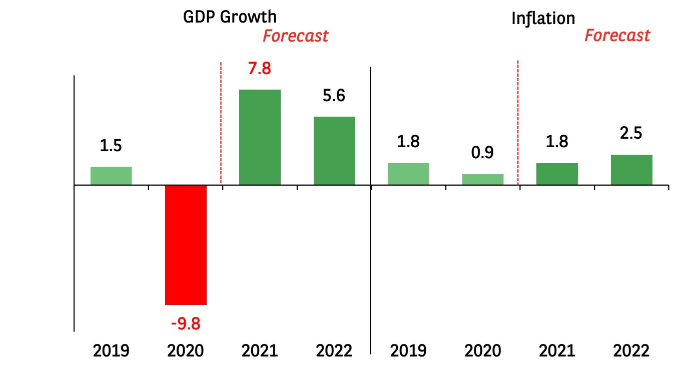


CHART 1 — SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

TRADE, THE START OF REDISTRIBUTION
AVERAGE OF MONTHLY EXPORTS AND IMPORTS, GBP BILLION, AT 2018 PRICES

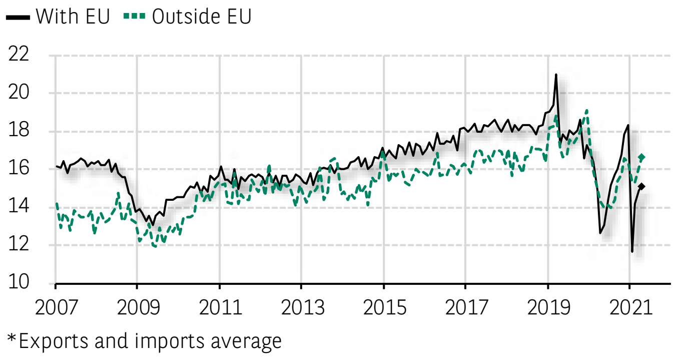


CHART 2 — SOURCE: ONS

Despite all efforts to manage it, the post-divorce relationship between the UK and the EU looks strained, and divergence inevitable.

LESS ATTRACTIVE?

After all, this was the goal of Brexit. As for its economic effects, these are hard to read in a situation still shaken by the health crisis. As with most countries that are on the road to vaccination (65% of the UK population has received at least one dose) and thus gaining some control over the pandemic, the UK is enjoying euphoric economic conditions. After a marked contraction in 2020 (9.8%, the largest since 1920) and a further fall in the first quarter of 2021, the economy is picking up again. The Organisation for Economic Cooperation and Development (OECD) predicts growth of 7.2% this year. The return to pre-pandemic levels of economic activity is expected to come in early 2022, at around the same time as in the eurozone. However, this seemingly favourable picture needs qualification on two points.

The first is that it has been accompanied by an exceptional increase in the "twin" fiscal and current account deficits. As an experienced practitioner of 'stop and go' policies, the UK government was one of the first to apply a 'whatever it takes' approach, and then to announce that this would be coming to an end in 2023. In 2021, the UK primary structural deficit (i.e. excluding interest payments) was more than 7% of GDP, making it the highest of all developed nations (Chart 3).

The second point is that investment is clearly lagging behind the recovery. According to the OECD, household spending, particularly the consumption of services, will be the first area to recover from the crisis, with business spending taking much longer[2]. In this area, therefore, both Covid-19 and Brexit could leave their scaring effects. Having left the European Union, the United Kingdom will not have access to the Next Generation EU programme to accelerate the green transition and promote infrastructure investment. To do this, the country will have to rely on its own resources and on its ability to attract capital, which for a long time has not been a problem. In 2019, however, the country lost its position as Europe's top destination for foreign direct investment to France (The Guardian, 2021[3]). Net capital inflows have been falling since 2016 (the year of the Brexit referendum), and the latest figures from the Office for National Statistics (ONS) show no reversal of this trend.

Completed on 28 June 2021

Jean-Luc Proutat
Jean-luc.proutat@bnpparibas.com

THE PROTOCOL ON IRELAND AND NORTHERN IRELAND

The Protocol on Ireland and Northern Ireland, which came into force on 1 February 2020, is an integral part of the withdrawal agreement and is therefore legally binding on its signatories, the UK and the EU. Designed to avoid a hard border on the island of Ireland, whilst also protecting the integrity of the EU single market, it creates a hybrid status for Northern Ireland, which remains in the UK customs union for goods not destined for the EU, but is aligned with European regulations (tariffs, VAT, state aid, etc.) for those goods liable to enter the EU. This requires the introduction of checks, including physical inspections (health and phytosanitary) on goods entering Northern Ireland from the rest of the United Kingdom, which it is the UK's responsibility to carry out. Monitoring of the protocol is the responsibility of an EU-UK Joint Committee, set up to supervise and facilitate the implementation of the withdrawal agreement. For the European side, Slovakian Maroš Šefčovič (also Vice President of the European Commission) acts as co-Chairman of the Joint Committee. Since the beginning of March 2021, his British counterpart is the former chief Brexit negotiator, David Frost.

The consent mechanism

The Protocol on Ireland and Northern Ireland is neither fixed nor irrevocable. The EU and UK agreed the so-called 'consent mechanism', which gives the Northern Ireland Assembly the deciding vote on the continuation of the Protocol's provisions. Four years after the end of the transition period (i.e. on 1 January 2025), the Assembly can decide, by simple majority, whether or not to terminate the Protocol. If it does, the UK will notify the EU that the Protocol will lapse two years later. Subsequently, the Assembly may vote every four years on the continued application of 'relevant EU legislation'.

SOURCE: EUROPEAN COMMISSION

TWIN DEFICITS (2021, % OF GDP)

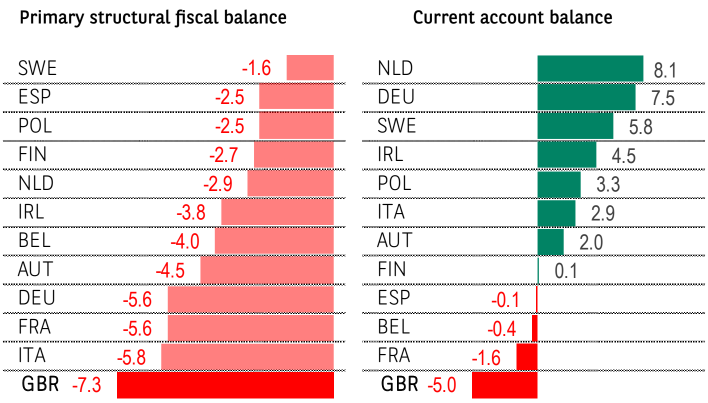


CHART 3

SOURCE: AMECO (ISO COUNTRY CODES)

2 At the end of 2022, private gross fixed capital formation is still expected to be 5 percentage points (in volume terms) below its pre-pandemic levels. See: OECD (2021) Economic Outlook, May.
3 The Guardian (2021) 'UK second to France again for attracting foreign investment in Europe', June 7.

SWITZERLAND

COMPETITIVENESS THREATENED

The very accommodative policies implemented by the Federal Council and the Swiss National Bank have been very successful in limiting the economic consequences of the pandemic. In 2020, economic activity contracted by 3%. The latest business cycle indicators point to a strong rebound in the second half of the year. The recovery is broad-based. Private consumption will be one of the main engines of growth, as households will spend part of the savings accumulated during the crisis. The breakdown of the negotiations between the Swiss Confederation and the EU, and the possible introduction of a global minimum corporation tax rate are likely to undermine the country's competitiveness in the medium term.

VERY ACCOMMODATIVE MACROECONOMIC POLICIES

To ease the impact of the pandemic on the economy, the Federal Council (FC) had spent CHF 15 bn (2% of GDP) in 2020, mainly on the short-time working scheme (CHF 10.8 bn) and loss of earnings compensation (CHF 2.8 bn). In addition, in collaboration with the Swiss National Bank (SNB), a loan guarantee programme was put in place. As tax receipts declined due to the contraction in output, the 2020 government budget showed a deficit of 2.6% of GDP, after having showed surpluses in excess of 1% of GDP since 2017. The debt-GDP ratio increased to 40% of GDP.

Fiscal policy is set to remain very accommodative in 2021. In its 2021 budget, the FC has reserved CHF 24.4 bn for expenses related to the pandemic. The budget envelope is very large on purpose to make it possible to react quickly if necessary. It is likely that the ultimate budget deficit in 2021 will only increase to 3.5% of GDP.

The monetary stance will remain very accommodative. The SNB is expected to keep its policy rate at −0.75%, and might intervene in the foreign exchange market to counteract strong upward pressure on the CHF. The easy monetary stance has led to strong price rises in real estate markets.

GROWTH AND INFLATION (%)

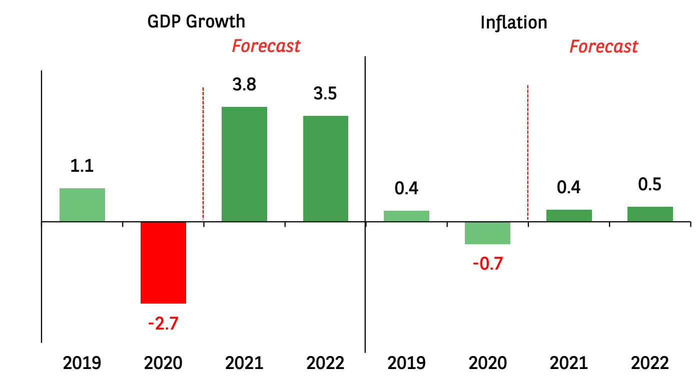


CHART 1 SOURCE: BNP PARIBAS

STRONG REBOUND BUT RISKS ON THE HORIZON

These policies were very effective, as GDP contracted by 2.7% in 2020, which compares favourably with the neighbouring countries. From September 2020 onwards the country was confronted with a second wave of Covid-19 infections, which forced the FC to re-impose lockdown restrictions. The economy contracted by 0.5% in Q1, after a meagre 0.1% growth in the preceding quarter. However, the decline was much less than in Q2 2020, as growing activity in the manufacturing sector partly offset the sharp decline in services.

From March onwards, business activity picked up again as the authorities gradually removed the restrictions. In May, the KOF economic barometer once again reached a historic high, signalling a strong recovery from the middle of 2021, provided that the containment of the virus continues to progress. The recovery is broad-based as the manufacturing sector is profiting from growing external demand, whereas services are benefitting from the removal of the lockdown restrictions. Private consumption will be one of the main drivers, as households are expected to reduce part of their accumulated savings during the lockdown period. In 2020, household savings amounted to 21% of net disposable income, compared with 16% before the crisis. Economic activity is likely to exceed the pre-pandemic level in the second half of 2021.

Two major risks are threatening the economy in the medium-term. Recently, the Swiss confederation broke off negotiations with the EU on a framework agreement that should regulate the relations between them. The immediate consequences are limited as the 100 and more bilateral treaties remain in force. However, the absence of a framework agreement creates uncertainty for investors on the future relationship. Moreover, it will also hamper the expansion of cooperation in new areas.

The second risk is the movement towards a worldwide minimum corporation tax. In most of the Swiss cantons, the corporation tax is lower than 16%. It is an important argument for attracting new business. If a worldwide minimum tax is agreed, the Swiss cantons will lose this important tool.

Completed on 24 June 2021

Raymond Van der Putten
raymond.vanderputten@bnpparibas.com

NORWAY

AN ECONOMY READY FOR TAKE-OFF

Largely spared by the Covid-19 pandemic, Norway reported one of the mildest recessions in Europe in 2020 (-2.5%). The economy is poised for a vigorous recovery in the second half, driven by the acceleration of global trade and the rebound in household consumption. In the light of these favourable prospects, and concerned about the acceleration in house prices, Norges Bank intends to begin raising its key rate gradually as of September, even though core inflation is low.

ROBUST GROWTH IN THE MONTHS AHEAD

With fewer than 150 deaths per million inhabitants in mid-June[1], Norway is one of the advanced economies that was spared the most by the Covid-19 pandemic. Over the winter and spring months, however, the country was hit by a wave of new cases. Although it was very small compared to the situation elsewhere in Europe, the Norwegian government nonetheless reintroduced health restrictions that strained economic growth. After rebounding strongly last summer and early fall, the economy faltered again during the winter months: GDP for mainland Norway[2] contracted 1% q/q in Q1 2021. Once this new wave of Covid-19 was brought under control, the government began to gradually ease these health restrictions, even though Norway's vaccination campaign was lagging somewhat behind its Nordic and European neighbours. At mid-June only 36% of the population had received at least one dose of the vaccine, whereas the government's target is to propose vaccines to all adults by the middle of August.

On the whole, economic data and survey results reveal an economy that has begun to benefit from the upturn in global demand and suggest that the recovery will accelerate during the summer months. Consumer spending is expected to rebound strongly since households are eager to spend the forced and precautionary savings they accumulated during the pandemic. Despite the decline in Q1 GDP, the OECD and the IMF raised their growth forecasts recently, and are now expecting mainland GDP to range between 3.5% and 4% in both 2021 and 2022.

NORGES BANK IS PREPARING TO RAISE ITS KEY RATE

After rising sharply at the beginning of the pandemic due to the depreciation of the krone and a temporary VAT cut, the core inflation rate followed by the central bank (CPI-ATE)[3] has fallen in recent months, notably under pressure from base effects and the appreciation of the exchange rate. According to the monetary policy committee's latest report, Norges Bank expects core inflation to hold below its 2% target for an extended period of time, after falling to 1.5% in May 2021. Yet the central bank also expressed concern about the acceleration in house prices, which rose by more than 11% y/y in May, driven up by the decline in housing starts and the increase in demand for housing during the pandemic. Aware of the role low interest rates play in these pricing dynamics, and in the light of favourable growth prospects, the Committee announced that it intended to begin raising its key rate gradually next September.

GROWTH AND INFLATION (%)

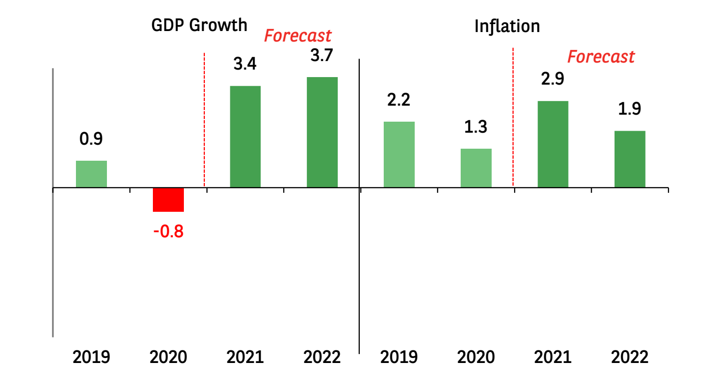


CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

KEY POLICY INTEREST RATE AND HOUSE PRICES

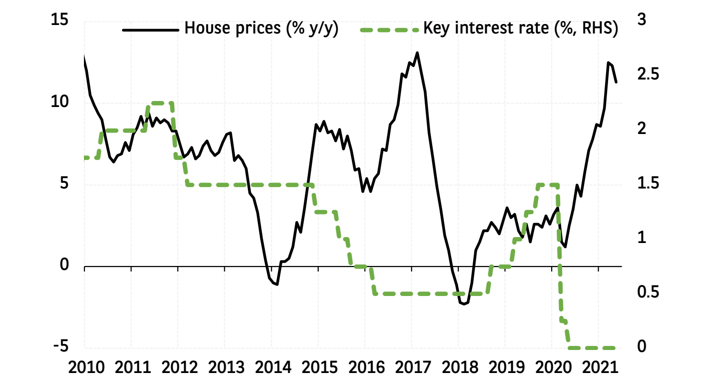


CHART 2 SOURCE: NORGES BANK, STATISTICS NORWAY

Completed on 28 June 2021

Frédérique Cerisier
frédérique.cerisier@bnpparibas.com

1 In comparison, at the same time, Germany had more than 1,000 deaths per million inhabitants and France had nearly 1,700 deaths per million.
2 GDP excluding oil-related activities.
3 CPI adjusted for tax changes and excluding energy products.

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2019	2020	2021 e	2022 e	Inflation 2019	2020	2021 e	2022 e
United States	2.2	-3.5	6.9	4.7	1.8	1.2	3.9	2.7
Japan	0.3	-4.7	2.2	3.3	0.5	0.0	0.0	0.2
United Kingdom	1.5	-9.8	7.8	5.6	1.8	0.9	1.8	2.5
Euro Area	1.3	-6.7	4.8	5.2	1.2	0.3	2.1	1.8
• Germany	0.6	-5.1	3.7	5.5	1.4	0.4	2.7	2.0
• France	1.5	-8.0	6.0	4.6	1.3	0.5	1.8	1.3
• Italy	0.3	-8.9	5.2	4.5	0.6	-0.1	1.5	1.9
• Spain	2.0	-10.8	6.0	6.3	0.8	-0.4	2.3	1.8
China	6.1	2.3	8.7	5.3	2.9	2.5	1.7	2.8
India*	4.2	-7.2	8.4	9.4	4.8	6.1	5.0	5.0
Brazil	1.1	-4.1	5.5	3.0	3.7	3.2	7.2	4.8
Russia	1.3	-4.5	4.5	3.0	4.3	3.4	5.8	4.3

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

FINANCIAL FORECASTS

Interest rate, %		2021					
End of period		Q1	Q2*	Q3e	Q4e	**2021e**	**2022e**
United States	"Fed Funds (upper limit)"	0.25	0.25	0.25	0.25	0.25	0.25
	T-Notes 10y	1.75	1.54	1.70	1.90	1.90	2.20
Euro Area	Deposit rate	-0.50	0.00	-0.50	-0.50	-0.50	-0.50
	Bund 10y	-0.33	-0.20	0.00	0.10	0.10	0.00
	OAT 10y	-0.11	0.14	0.35	0.55	0.55	0.30
	BTP 10y	0.63	0.84	1.10	1.40	1.40	1.10
	BONO 10y	0.34	0.49	0.70	0.90	0.90	0.80
United Kingdom	Base rate	0.10	0.10	0.10	0.10	0.10	0.25
	Gilts 10y	0.88	0.81	0.90	1.10	1.10	1.30
Japan	BoJ Rate	-0.04	-0.03	-0.10	-0.10	-0.10	-0.10
	JGB 10y	0.09	0.05	0.12	0.20	0.20	0.23

Exchange rate		2021					
End of period		Q1	Q2e	Q3e	Q4e	**2021e**	**2022e**
USD	EUR / USD	1.18	1.20	1.18	1.17	1.17	1.14
	USD / JPY	111	111	111	111	111	114
	GBP / USD	1.38	1.39	1.40	1.39	1.39	1.38
EUR	EUR / GBP	0.85	0.86	0.84	0.84	0.84	0.83
	EUR / JPY	130	132	131	130	130	130

*SPOT RATES AS AT 25 JUNE

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS)

GROUP ECONOMIC RESEARCH

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

Jean-Luc Proutat Head – United States	+33 1 58 16 73 32	jeanluc.proutat@bnpparibas.com
Hélène Baudchon France - Labour markets	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Louis Boisset European Central Bank watch, Euro area global view, Japan	+33 1 57 43 02 91	louis.boisset@bnpparibas.com
Frédérique Cerisier Euro area (European gouvernance and public finances)	+33 1 43 16 95 52	frederique.cerisier@bnpparibas.com
Hubert de Barochez United Kingdom, Nordic countries	+33 1 43 16 95 52	hubert.debarochez@bnpparibas.com
Guillaume Derrien Spain, Portugal	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Raymond Van Der Putten Germany, Netherlands, Austria, Switzerland – Energy, climate – Projections	+33 1 42 98 53 99	raymond.vanderputten@bnpparibas.com
Tarik Rharrab Statistics	+33 1 43 16 95 56	tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Laure Baquero	+33 1 43 16 95 50	laure.baquero@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+33 1 40 14 30 77	thomas.humblot@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François Faure Head – Argentina	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam, South Africa	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Stéphane Colliac Turkey, Ukraine, Central European countries	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Perrine Guerin, Sara Confalonieri Africa (Portuguese & English-speaking countries)	+33 1 42 98 43 86	perrine.guerin@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot Korea, Thailand, Philippines, Mexico, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Johanna Melka India, South Asia, Russia, CIS	+33 1 58 16 05 84	johanna.melka@bnpparibas.com

CONTACT MEDIA

Michel Bernardini	+33 1 42 98 05 71	michel.bernardini@bnpparibas.com

BNP PARIBAS

The bank
for a changing
world

GROUP ECONOMIC RESEARCH

CONJONCTURE

Structural or in news flow, two issues analysed in depth

EMERGING

Analyses and forecasts for a selection of emerging economies

PERSPECTIVES

Analyses and forecasts for the main countries, emerging or developed

ECOFLASH

Data releases, major economic events. Our detailed views...

ECOWEEK

Weekly economic news and much more...

ECOTV

In this monthly web TV, our economists make sense of economic news

ECOTV WEEK

What is the main event this week? The answer is in your two minutes of economy

MACROWAVES

The economic podcasts

POUR RECEVOIR NOS PUBLICATIONS

SUBSCRIBE ON OUR WEBSITE

see the economic research's website

ET

FOLLOW US ON LINKEDINN

wsee the economic research's linkedin page

OU TWITTER

voir la page twitter des études économiques

Bulletin édité par les Etudes Economiques – BNP PARIBAS
Siège social : 16 boulevard des Italiens – 75009 PARIS / Tél : +33 (0) 1.42.98.12.34
Internet : www.group.bnpparibas.com - www.economic-research.bnpparibas.com

Directeur de la publication : Jean Lemierre / Rédacteur en chef : William De Vijlder

BNP PARIBAS

The bank
for a changing
world