ECO PERSPECTIVES

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EDITORIAL

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Growing certainty that there will be less uncertainty

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ECONOMIC RESEARCH

BNP PARIBAS

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GROWING CERTAINTY THAT THERE WILL BE LESS UNCERTAINTY

In many countries the number of new Covid-19 cases has begun rising again, forcing governments to maintain or tighten health restrictions. This is the case for the Eurozone, among others, where a true rebound in growth and demand has been postponed yet again. The timing of the recovery will depend essentially on the effectiveness of restrictive measures and the acceleration of vaccination campaigns, but also on spillovers effects with some of its trading partners whose economies are picking up more rapidly. The United States is one such country thanks to its successful vaccination campaign and the enormous recovery plan that has just been launched. America's influence is not limited to providing greater opportunities for European exporters. The upturn in US bond yields has partially carried over to long-term rates in the Eurozone, pushing them higher. This trend largely reflects higher inflation expectations, although the Federal Reserve is convinced that the surge in inflation will be short-lived. Companies and households should welcome the bond markets' jitters, which clearly signal the sentiment that the economy really is improving.

In late 2020, there were high hopes that the health crisis would soon improve and that economic activity would rebound in its wake. In many countries and regions around the world, the actual situation was a big disappointment as the number of new Covid-19 cases began rising again, forcing governments to maintain or tighten health restrictions. The Eurozone is a case in point. Although Q1 GDP growth is expected to be positive on a quarterly basis, it is mainly due to the growth pick-up in the latter part of the fourth quarter of 2020. A real rebound in economic growth and demand has been postponed again, and its timing will depend mainly on the effectiveness of restrictive measures and the acceleration of vaccination campaigns.

DESYNCHRONIZATION IN THE REAL SPHERE

Another source of hope that will play a non-negligible role is the spillover effect of certain trading partners like the United States, but also China and the UK, which has already begun to ease health restrictions. In the US, high hopes for a successful rollout of vaccination campaigns earlier this year were largely surpassed. Economic growth was already beginning to recover, and will now receive another immense stimulus through the USD 1.9 trillion recovery plan. Although many disagreed with the size of the package, there was clearly a need for fiscal support, given the enormous gap between the number of Americans who managed to preserve their job or find a new one and pre-pandemic employment levels. The longer it takes to close the gap created by job destructions, the greater the risk that the pandemic will have hysteresis effects that leave a lasting negative impact. In the months ahead, Congress will begin debating a new plan that primarily targets the supply-side of the economy, including investment in infrastructure, the digital world, and innovation, with a bent towards preparing for climate change.

The Eurozone will benefit from the desynchronization of economic momentum with the United States. In economic surveys, companies are already expressing optimism about exports. This is especially true for Germany. The strong rise in the March surveys is also striking. The European Commission's economic sentiment survey is now very slightly higher than its long-term average, buoyed by brighter sentiment in several sectors (industry, services, retailing and construction) as well as among households. April's figures are unlikely to be as strong due to the introduction of new health restrictions, but the recent momentum in the surveys suggests that companies and households alike are increasingly seeing the glass as half full. There is growing certainty that uncertainty will decline. After all, the restrictive health measures and vaccination campaigns will eventually pay off.

US : TOTAL NON-FARM EMPLOYMENT

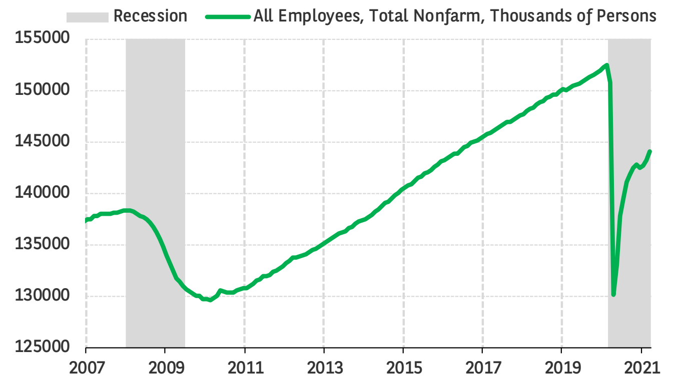

CHART 1 SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, BNP PARIBAS

SYNCHRONISATION IN THE FINANCIAL SPHERE

Naturally, the bond markets have not been indifferent to these developments. In the United States, 10-year Treasury yields have continued to rise, building on a trend that started last summer. Initially they reflected the higher inflation expectations of investors, although more recently, real rates have risen, buoyed by the US recovery plan. As usual, this momentum carried over to bond yields in other countries, including those of the Eurozone. As a result, the ECB had to accelerate the pace of its sovereign bond purchases to avoid a tightening of financing conditions, which would have been particularly unwelcome. The Federal Reserve remains stoic in the face of the bond markets' behaviour, although it admits that inflation will rise in the second half. There are several arguments: corporate surveys are already showing a net increase in input prices, and a strong acceleration in growth will inevitably lead to a supply and demand imbalance, since supply chains still bear the scars of last year's disruptions and, at least in the short run, will not be able to keep up the pace. Even so, the Fed considers that the surge in inflation will be short-lived. Supply will adapt and inflation expectations seem to be well anchored. This is a crucial factor for wage negotiations and price setting trends. The months ahead risk being caught in a tug of war between the bond markets and the Federal

Reserve. The Fed's communication policy will have to strike a very fine line to avoid throwing more oil on the fire. Companies and households should welcome the bond market's jitters, which clearly signal the sentiment that the economy really is improving.

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BREAK-EVEN INFLATION IN THE US AND IN GERMANY

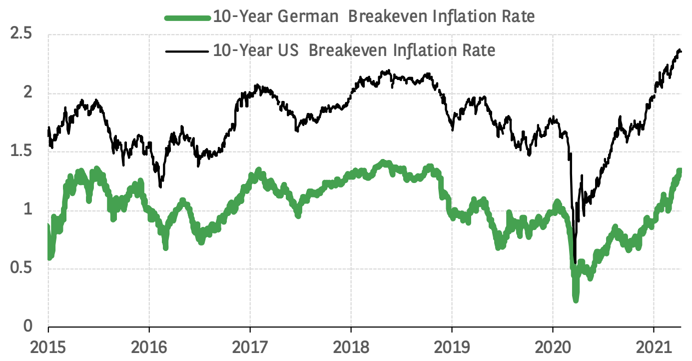

CHART 2 SOURCE: BLOOMBERG, BNP PARIBAS

AS THE EPIDEMIC WANES, THE ECONOMY SOARS

The US economy has taken off. Bolstered by the easing of the Covid-19 pandemic as much as by unprecedented fiscal support, GDP will soar by at least 6% in 2021, surpassing the pre-crisis level of 2019. Inflation will accelerate and temporarily overshoot the Federal Reserve's 2% target. Nonetheless, the central bank will not deviate from its accommodating stance. The Fed's top priority is employment, which continues to bear the scars of the crisis and has a long way to go before making up for all of the lost ground. As a result, monetary conditions will remain accommodating, both for the economy and the markets, even at the risk of encouraging some excessive behaviour.

Even as the United States passes the tragic threshold of 500,000 Covid-19 deaths, hopes are rising, day after day, that the crisis is nearing an end, bolstered by the acceleration of the vaccination campaign (170 million shots have already been given) and the concomitant decline in the rate of new cases, which has fallen practically to the lowest level since the pandemic began. In a televised speech, President Biden used the symbolic date of July 4th – Independence Day – for the possible return to normal. Google mobility indicators are already showing signs of improvement: following the rebound in employment (916,000 jobs were created in March), they confirm that consumer spending has picked up again as a growth engine, after stalling in the last months of 2020.

This growth engine will have no shortage of fuel. The American Rescue Plan, adopted on 11 March 2021, is a gigantic, USD 1.9 trillion stimulus package (9 points of GDP), which the Biden administration is widely targeting at households through stimulus checks, unemployment benefit boosts and tax credits (see box). It is still too early to say whether Americans will have a greater propensity to spend or to save this financial windfall. Either way, the impulse is so strong that the economic growth rate can only be revised upwards.

GROWTH AND INFLATION (%)

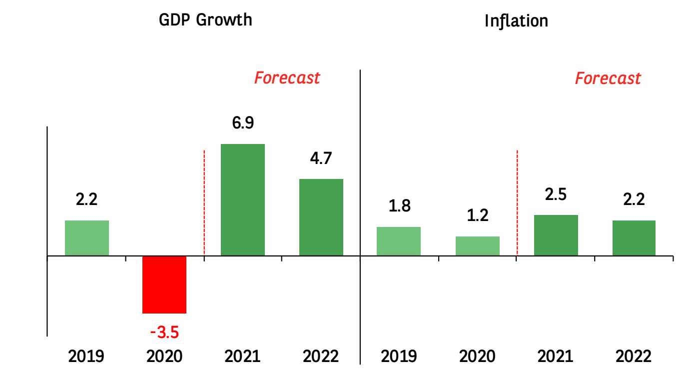

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GROWTH SURGES TO MORE THAN 6% AND INFLATION REBOUNDS

According to CBO estimates, the output gap – the production shortfall that must be closed before the US economy returns to its potential – is USD 960 bn. Twice as big, and coupled with the USD 900 bn stimulus extension voted in December 2020, the American Rescue Plan would quickly close the gap, even with a low multiplier. Assuming a multiplier of 0.5 and that most of the stimulus plan's USD 1.9 trillion will be rapidly deployed, the economy would grow by at least 6% in 2021. Under these circumstances, the US economy would be operating near full capacity approaching fall. At the current pace of vaccinations (2 million shots daily), it is reasonable to assume that by this same horizon, the sectors currently paralysed by the pandemic (hotel and restaurant services, entertainment industry) will have returned to normal operations and will have resumed hiring staffs. The return to full employment should be fairly rapid. For Treasury Secretary Janet Yellen, full employment could be reached as early as 2022.

Along with the upturn in commodity prices (oil prices have risen roughly 150% over the past year, and metals are up by 60%), growing tensions across the US economy are fuelling inflation expectations, notably in the markets, where 10-year indexed swap rates have risen to nearly 2.5%. Consumer prices are, de facto, picking up, if for no other reason than heavier energy and food bills. They also signal a catching-up effect. With fewer Covid-19 cases and the easing of lockdown restrictions, consumers are now able to make certain purchases that they had been putting off. Household demand for travels and durable goods (automobiles, household furnishings) is strong, contributing to

THE LATEST COVID-19 WAVE HAS BROKEN

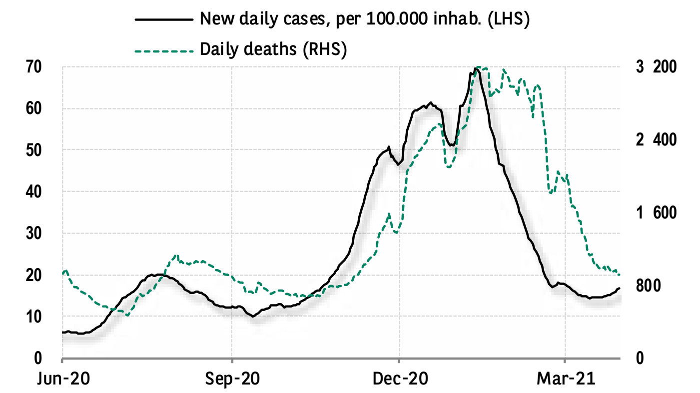

CHART 2 SOURCE: JOHNS HOPKINS UNIVERSITY

the rebound in prices. Starting in April and the months thereafter, when statistics are compared with the depressed figures of spring 2020, inflation will rise well above the Fed's 2% target, and could even reach 3%.

Yet the pick-up in inflation could be short-lived. In the United States, as elsewhere, wages and prices remain constrained by global forces, possibly even more so since the Covid crisis has accelerated the digital revolution in the services sector. They are no longer reacting as they

RETAIL INVESTORS MARGIN DEBT FOR EQUITY PURCHASES, % GDP

CHART 3 SOURCE: BIS

did before to labour market slacks, a phenomenon known as the "flattening" of the Phillips curve[1]. Inflation was already remarkably stable at around 2% during the historical decline of unemployment in 2010-2020, and there is little reason to believe it will accelerate over the long term.

RISK OF EXCESS

At the 17 March monetary policy committee meeting, the FOMC decided not to deviate from its accommodating stance: the Fed funds target rate would be maintained near zero and it would continue to make net securities purchases at a rate of USD 120 billion a month, including USD 80 billion in US Treasury securities and USD 40 billion in agency MBS. The Fed intends to continue expanding its balance sheet, which already exceeds the Federal deficit and has swollen to USD 3,500 billion (16.5% of GDP) since the beginning of the pandemic.

Useful for countering depressive shocks, monetary profligacy can also be a source of excess, and is not without drawbacks in the long term. The trillions of dollars created in counterparty to the Fed's asset purchases are being recycled widely, in the emerging markets, real estate, infrastructure, cryptocurrencies, or stock market. Cheap access to liquidity encourages risk taking and leveraging, including in market segments where liquidity cannot always be ensured. Facilitated by the increase in on-line trading platforms, debt financing of stock purchases has hit record highs, both in absolute terms and as a share of GDP (see chart 3).

Even before the Covid-19 crisis occurred, the International Monetary Fund (IMF) was repeatedly stressing the risk to macro-financial stability implied by rising leverage, especially in the corporate or non-bank financial sector (investment trusts and funds, etc.). Now, the stakes is high enough for the US Treasury Secretary to take action. On 31 March, Ms. Yellen decided she would reactivate the Financial Stability Oversight Committee's hedge fund working group.

Completed on 31 March 2021

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THE AMERICAN RESCUE PLAN

Although not as big as the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020, the American Rescue Plan is still double the size of the American Recovery and Reinvestment Act of 2009 and ranks among the largest stimulus packages ever approved by Congress. Totalling USD 1.9 trillion, half of the plan is geared towards households and as a result targets demand. Several measures merit our attention.

To help the unemployed, whose ranks have swelled by more than 4 million during the Covid crisis, jobless benefits will be extended through 6 September 2021 with a Federal contribution of USD 300 a week. In a small concession to its "whatever it takes" approach, the government scaled back the Federal bonus from an initial sum of USD 400 a week. Stimulus checks of a maximum of USD 1400 per person will be sent to American households for a total budget of about USD 400 billion. The child tax credit will be raised from USD 2000 to USD 3600 per dependent child under the age of 6, and to USD 3000 for each dependent child between the ages of 6 and 17. Although the Senate imposed some stricter income-based conditions and made the stimulus a little less generous, the measures cover a wide range of areas that largely exceed the economic victims of the pandemic.

According to estimates by the Institute on Taxation and Economic Policy, roughly 286 million men, women and children, or 86% of the US population, will receive a stimulus check from the Treasury in the weeks ahead. This is bound to fuel debate on the proper calibration of government subsidies. It is worth keeping in mind that total disposable household income did not diminish during the crisis, but to the contrary increased exceptionally thanks to transfers as part of the CARES Act. With spending curtailed over the past year, Americans have built up enormous savings: USD 2,850 bn in 2020 (16% of disposable income), more than twice the amount of 2019 savings.

THE AMERICAN RESCUE PLAN (USD BILLION)

HOUSEHOLDS	**910**
Direct stimulus checks	400
Tax credits (children, individuals)	160
Jobless benefits boost	270
Health insurance (extension of Obamacare...)	80
PUBLIC SERVICES AND INSTITUTIONS	**763**
Transfers to state and local governments	350
Transfers to schools and universities	170
Funding for testing and vaccination campaigns	123
Other (social welfare actions...)	120
COMPANIES	**226**
Transfers to ailing sectors	140
Transfers to pension systems	86
TOTAL	**1900**

SOURCE: ECOFLASH N°21-05, MARCH 2021 BNP PARIBAS

1 Proutat J.L. (2018), *The hypothetic return of inflation*, BNP Paribas EcoFlash, September.

CHINA

SHIFTING TOWARDS A MEDIUM-TERM PERSPECTIVE

At the end of the annual "Two Sessions", China's major political event, Beijing announced its economic targets for 2021 as well as the priorities of its new five-year plan. By setting this year's real GDP growth target at simply "more than 6%", which is lower than forecasts, the authorities are signalling that the economic recovery following the Covid-19 crisis is no longer the main focus of concern. In the short term, they will continue to cautiously tighten monetary policy and gradually scale back fiscal support measures. Above all, the authorities have affirmed their medium-term development strategy, which aims to boost innovation and drastically expand China's technological independence.

THE RECOVERY HAS PEAKED, ECONOMIC GROWTH REMAINS VIGOROUS

The Chinese economy ended the year 2020 on a solid note with real GDP growth of 6.5% year-on-year (y/y) in Q4. Industrial production and exports continued to report robust performances that went beyond a simple catching-up movement. Meanwhile, private consumption and the services sector continued to close the gap after they entered the rebound phase much later following the Q1 2020 lockdown.

Economic indicators for the first part of 2021 are hard to interpret due to major base effects generated by the abrupt shutdown of activity in Q1 2020. In fact, in the first two months of 2021, the growth rates for industrial production, activity in the services sector, investment and retail sales were all abnormally high on a year-on-year basis (above 30%).

On the supply side, industrial production was still robust in the first two months of the year, in spite of a few signs of a slowdown in the automotive sector (which accounts for about 15% of industrial activity) resulting from the global shortage of microchips. Industrial production was largely supported by strong external demand. Exports rose 60% y/y in January-February 2021, driven by sales of technological goods and medical devices, as well as consumer goods and automotive parts.

Meanwhile, the momentum of domestic demand growth has lost some of its vigour at the beginning of 2021, with the notable exception of real estate investment. Private consumption of goods and services was curbed by new lockdown restrictions that were introduced in late January and February in response to a surge in contaminations in the regions around Beijing and Northeast China. In addition, the situation of households is still fragile, undermined by last year's downturn in income and a weaker labour market. After falling continuously since spring 2020, the urban unemployment rate rose to 5.5% in January-February from 5.2% in December. Besides, the share of precarious jobs remains higher than pre-crisis levels. Finally, about 5 million migrant workers who lost their jobs in Q1 2020 (and are not counted among the official unemployed) have yet to find work again (286 million jobs were held by migrant workers at year-end 2020).

Private consumption is expected to strengthen in the short term, if for no other reason than the improvement in the health situation. The epidemic is under control, lockdown restrictions have been lifted and the vaccination campaign – which was very slow through mid-March – is projected to accelerate. The authorities also seem to be planning a few temporary measures to encourage household spending.

As to investment, enterprises in the manufacturing sector have been very cautious in January-February. Manufacturing investment is nonetheless expected to gain momentum in the short term because export prospects remain strong, industrial capacity utilization rates are high (78% in Q4 2020, the highest level in three years) and corporate profits are on the rise. This goes along with a rebound in producer prices (+1% y/y in January-February, after 18 months of deflation), driven up by higher industrial commodity prices. Additionally, the authorities' plans to increase investment in the technology sectors should rapidly become visible.

GROWTH AND INFLATION (%)

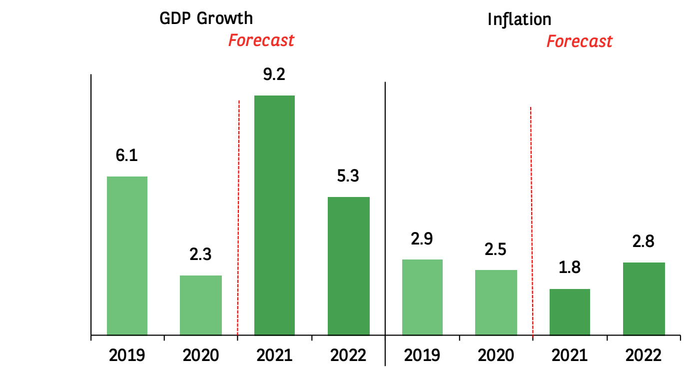

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A DYNAMIC PROPERTY SECTOR, FOR HOW LONG?

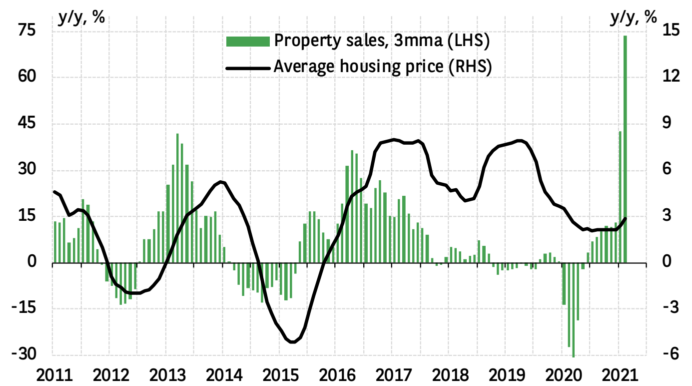

CHART 2 SOURCE: NBS, MACROBOND

CAUTIOUS NORMALISATION OF ECONOMIC POLICY

Following the annual plenary sessions of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) in March – two core institutions of China's political system – the authorities announced their key macroeconomic targets for 2021. They are calling for real GDP growth of "more than 6%" and inflation of 3%. By setting an economic growth target well below forecasts, the authorities are signalling that the economic recovery is no longer the main focus of their concerns. They are enlarging the manoeuvring room of economic policy, notably to better combat risks in the financial sector.

In the short term, the authorities are aiming to contain growth in corporate and local government debt, which rose sharply last year (total domestic debt of the non-financial sector was estimated at 280% of GDP at year-end 2020, up from 255% at year-end 2019). Yet this must be orchestrated carefully, without undermining the economic recovery or aggravating the difficulties of corporates that have been hit by last year's epidemic shock.

Credit policy will be tightened cautiously, mainly by adjusting the prudential framework. Moreover, the authorities will slow infrastructure projects, which are mainly financed through domestic bond issues by local governments. Beijing very moderately scaled back quotas of bond issues authorised in 2021 for both the local and central governments. Total quotas were reduced to RMB 7,200 bn in 2021 from RMB 8,500 bn in 2020. In addition, the authorities also lowered the government's "official" deficit target to 3.2% of GDP in 2021, from 3.6% of GDP in 2020. These cutbacks signal a very gradual and prudent withdrawal of fiscal and quasi-fiscal support measures in the year ahead.

Investment growth in public infrastructure has already slowed in recent months, a trend that is bound to continue. In contrast, there were still no signs of slowdown in property investment in early 2021, despite new prudential rules imposed on real estate developers since August 2020. Low domestic interest rates and ample household savings have continued to encourage real estate transactions. House price inflation even accelerated slightly in January-February (+2.7% y/y) after holding relatively stable since spring 2020.

THE 14TH FIVE-YEAR PLAN

Last month the authorities also unveiled the targets for the new Five-Year Plan for 2021-2025. At the heart of Beijing's strategy is the development of the technology sector. China aims to sharply reduce its dependence on foreign technological knowhow and goods, and to become a world leader in the scientific field. Spending on research & development will be increased by at least 7% a year (after a 10% increase in 2020), with a special focus on boosting fundamental research efforts and increasing the number of patents with a high technical content (from 6.3 patents per 10,000 residents in 2020 to 12 patents in 2025). This should accelerate China's catching-up movement with the more advanced countries. Moreover, the manufacturing sector will have to continue to rise the value chain, and the share of the digital economy is projected to be increased from 7.8% of GDP in 2020 to 10% in 2025. The authorities have announced several measures to help corporates, including tax deductions and subsidies.

The 14th Five-Year Plan also calls for other reforms, which were not spelled out in detail, but yet the country's challenges and medium to long-term goals are well identified. Beijing is striving to achieve "common prosperity". On the one hand, China's industrial, economic and social development will certainly rely on technology. On the other, priority will also be given to bolstering the health and social protection system, wealth redistribution and reducing inequalities, and reforming the hukou permanent resident system to improve access to public services for the entire population.

CHINA'S R&D SPENDING TO BE STRENGTHENED

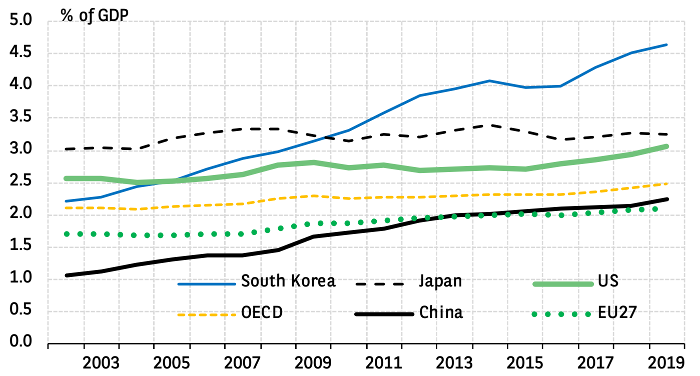

CHART 3 SOURCE: OECD DATA (2021), GROSS DOMESTIC EXPENDITURES OF R&D

China's ageing population was also identified as a major challenge. The median age of the Chinese population rose from 30.8 in 2010 to 38.4 in 2020 (similar to that of the US); the active population has been declining continuously since 2013; and the dependency ratio rose from 36.5% of the active population in 2010 to 41.4% in 2020. Measures are being explored to encourage natality, to postpone the retirement age (which is currently only age 50-55 for women and age 60 for men) and to extend the average duration of university education. Improvements in education, coupled with investments in innovation, are aimed at boosting productivity. Lastly, the "quality of economic growth" will also be improved by developing green industries and promoting measures to fight climate change; Beijing's goal is to be carbon neutral by 2060.

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CONFIDENCE NEEDS TO BE RESTORED TO ACCELERATE THE RECOVERY

As in other countries the world round, Japan reported a record-breaking recession in 2020 and the lack of consumer confidence, stifling domestic demand, could slow the dynamics of its economic recovery. Japan's vaccination campaign has been relatively slow, notably compared to the United States, but the country was not hit as hard by the pandemic as other countries. Faced with expectations of sluggish demand, Japanese companies will continue to be reticent about making investment decisions. This outlook could undermine Japan's already weakened growth potential. Tighter financing conditions would be especially harmful, and the Bank of Japan will remain vigilant in the current environment of rising interest rates.

STARTING TO RETURN TO NORMAL

Compared to other countries, Japan was not hit as hard by the Covid-19 pandemic, and the decline in economic growth was relatively more moderate in 2020, notably compared to the European countries. Japanese GDP contracted 4.8% last year, compared to 5.3% for Germany and 8.2% for France.

The signal from the most recent economic data is mixed. As in the Eurozone, there is a divergence in the catching-up movement between the manufacturing sector and market services. After bottoming out in April 2020, the purchasing managers index (PMI) for the manufacturing sector has risen almost continuously, and is now in expansion territory (51.4 in February 2021). This favourable momentum must still be confirmed by hard data, since industrial output declined again in January on a year-on-year basis. The services PMI, in contrast, has been stagnant on the whole since June 2020, and has not risen above the 50 threshold since the pandemic began. The lack of confidence of Japanese consumers has hurt the services sector, which is dependent on private consumption. Granted, Japan's vaccination campaign has been relatively slow compared to countries like the United States, but the country was not hit as hard by the pandemic. Even so, the consumer confidence index is still below pre-crisis levels. This situation is straining corporate investment in Japan, which declined again in Q1 2021. Japanese companies are expecting economic growth to remain feeble in the years ahead[1], which is hampering their investment decisions. These dynamics are harmful for the country's growth potential, which is already weak.

RISING INTEREST RATES: THE BANK OF JAPAN IS VIGILANT

Early 2021 has been marked by an upturn in long-term rates, a trend that fits within the dynamics of rising inflation expectations in the United States. Japan, like other economies, is facing upward pressure on the cost of financing, and this trend is likely to continue. The Bank of Japan has largely managed to contain these pressures by maintaining a yield curve control policy. The central bank is taking action to avoid any tightening of financing conditions. Japan's 10-year sovereign yields have not risen nearly as rapidly as their UK counterparts. Japanese monetary policy will continue to be especially accommodating in a persistently deteriorated economic environment at a time of unfavourable pricing trends. Core inflation fell again on a year-on-year basis in February 2021. Consequently, monetary policy will continue to support fiscal policy, since reducing the public debt is currently not a priority (the debt ratio may have reached 266% of GDP in 2020).

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GROWTH AND INFLATION (%)

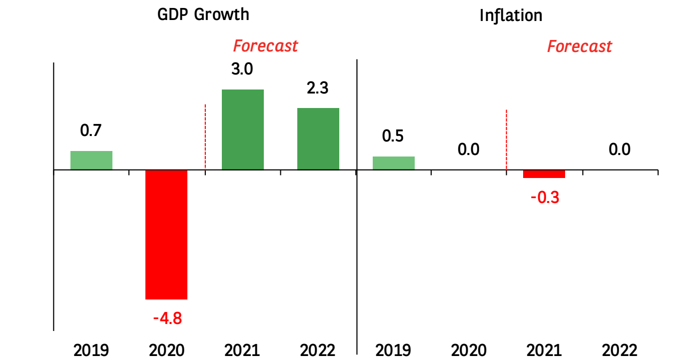

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

SOVEREIGN 10-YEAR INTEREST RATES (%)

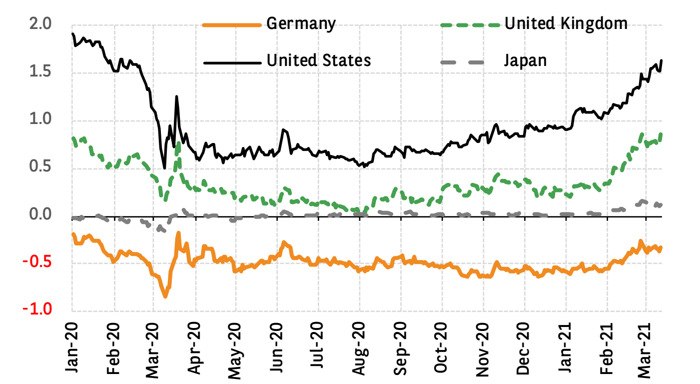

CHART 2 SOURCE: REFINITIV

1 According to an annual survey by the Ministry of Finance, the GDP growth rate expected by Japanese companies has trended downwards since the 1980s and is now at only about 1%.

A STRONGER THAN EXPECTED ECONOMIC RECOVERY?

The pandemic continues to spread rapidly within the Eurozone member states, and many uncertainties remain. Yet the most recent economic data are encouraging. Far from claiming victory, these signals nonetheless raise expectations of an accelerated economic recovery as of H2 2021. The greatest hope lies in the successful rollout of vaccination campaigns among national populations. The authorities will remain at the bedside of an ailing Eurozone economy, ready to help through public policies while trying to avoid any tightening moves that might hamper the recovery process. In terms of monetary policy, for example, Christine Lagarde announced that the ECB would step up the pace of securities purchases, which means that financing conditions are being closely monitored.

Although the virus is still spreading actively in most of the Eurozone member countries, the economic horizon has brightened with the rollout of vaccination campaigns. Yet the Covid-19 pandemic will have to come under full control and economic agents will have to regain confidence before the economy returns to more normal levels of sustainable growth.

SOME ENCOURAGING SIGNALS, DESPITE THE REST

Even as new health restrictions and lockdown measures are straining the momentum of the Eurozone recovery, some recent economic news is nonetheless providing grounds for optimism.

As a highlight the big increase in the March 2021 purchasing managers index (PMI), which is closely monitored by economic experts. After virtually stagnating since year-end 2020, the composite PMI rose above 50 to 52.5 in March (flash estimate), for the first time since October 2020. In other words, private sector activity in the Eurozone expanded for the first time in six months. This performance, which was much better than the consensus forecast, can be attributed to cyclical improvements in the manufacturing sector as well as in market services. Although the services PMI remained below 50, it nonetheless rose in March to 48.8, beating expectations. The manufacturing PMI reached a record high of 62.4 in March, up from 57.9 in February. Without jumping to conclusions, this strong performance reflects the turnaround in the “jobs” component, which rose to 54.7 in March, from 51.5 the previous month, as well as the upturn in the “new export orders” component (62.4).

Economic players seem to be adapting better to social distancing and other restrictive measures, but an ongoing improvement in Eurozone economic growth will depend on the success of the vaccination campaigns. This is the key to restoring the confidence of economic agents over the long term. Here too, the latest statistics are rather favourable: the European Commission’s economic sentiment and consumer confidence indices rose to the highest levels in the past year. Even so, the consumer confidence index is still fragile, and far below pre-pandemic levels.

On the whole, we expect to see a notable acceleration in the Eurozone’s economic recovery as of H2 2021. Three key factors will drive this movement: an increase in the pace of vaccinations, the release of pent-up demand once restrictive measures are lifted, and support from the policy mix within the Eurozone and from the American Rescue Plan. This rescue plan should have a positive impact on Eurozone growth in the quarters ahead. We expect to see a net rebound in Eurozone GDP growth over the full year (with average annual growth of 4.2%), followed by another acceleration to 5% in 2022. Under this scenario, Eurozone GDP could return to pre-crisis levels by H1 2022.

GROWTH AND INFLATION (%)

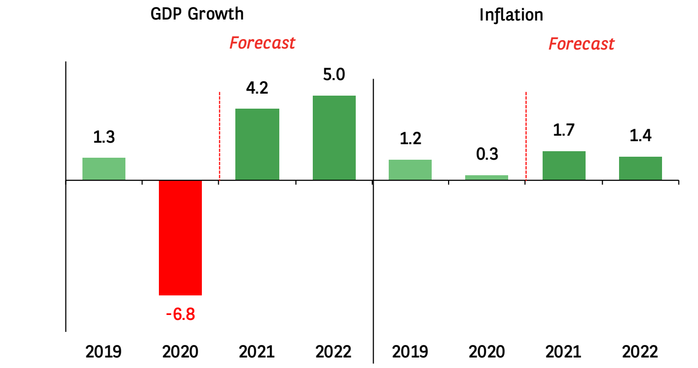

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PMI

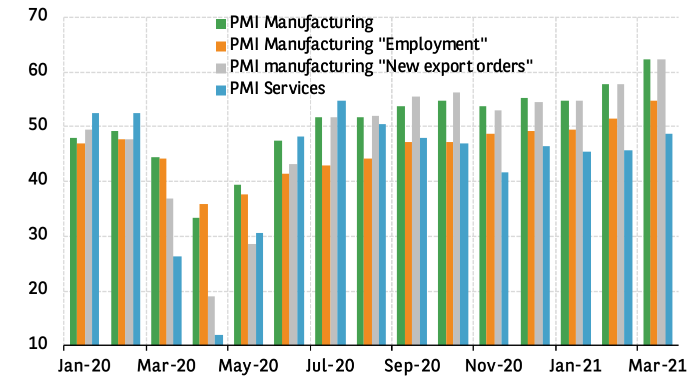

CHART 2 SOURCE: REFINITIV

ECB: FINANCING CONDITIONS AS AN INTERMEDIATE TARGET

A vigorous economic recovery coupled with rising input prices and longer turnaround times have raised fears that prices could accelerate sharply in the months ahead. These fears are particularly strong in the United States. In the Eurozone, where year-on-year inflation rose to 1.4% in January, before easing to 1.1% in February (see chart 3), the inflationary pressures observed since early 2021 are likely to be short-lived, making the risk of strong price increases less of an issue. From an economic perspective, the recovery phases in the United States and the Eurozone are following different dynamics. First, vaccination campaigns are rolling out much more rapidly in the US than in the member tates. Second, the American Rescue Plan, which is largely geared towards stimulating short-term demand, is much bigger in scope and thus more likely to create bottlenecks. Lastly, the contraction of US GDP in 2020 was only about half the size of that in the Eurozone (-3.5% vs. -6.8%) and the US output gap (i.e., the gap between effective and potential production) did not swell as much according to IMF estimates. Note that the current situation makes it very difficult to interpret pricing trends. From a statistical perspective, the pandemic and lockdown measures have made it impossible to report certain prices, and the average consumer basket has been modified significantly. Tax changes in 2020, like the temporary VAT cut in Germany, also create major base effects.

The rise in inflation expectations in the United States is putting upside pressure on US long-term rates, and through a knock-on effect, on Eurozone rates. For member states, the upturn in interest rates was nonetheless limited (see chart 3), which is reassuring given the Eurozone's more timid and differentiated recovery. The European Central Bank (ECB) insisted that the real danger lies in an upturn in interest rates without an improvement in the macroeconomic environment. According to the ECB, inflation is unlikely to rise in a lasting manner in the Eurozone. Despite an upward tendency, inflation is expected to rise to only 1.4% in 2023: which is still low compared to the central bank's medium-term target of 2%. Consequently, we should not expect any monetary tightening from the ECB.

At a meeting in March, ECB president Christine Lagarde took the financial markets by surprise when she announced that the central bank would significantly increase the pace of securities purchases as part of the Pandemic Emergency Purchase Programme (PEPP). Without changing the amount, Ms. Lagarde nonetheless indicated that volumes would be increased if necessary to maintain favourable financing conditions in the Eurozone. Even if the PEPP funds were used in full by March 2022 (when the programme is set to expire), the ECB would maintain its approach to avoid any tightening of monetary conditions. If the PEPP is not renewed, based on the assumption that the worst of the Covid-19 crisis is behind us, then the ECB might envision greater flexibility in securities purchases through the Assets Purchases Programme (APP). Fabio Panetta, an ECB Executive Board member, recently pointed out that monetary support would be necessary as long as inflation does not hold sustainably at the target level, which probably will not occur until well after the pandemic ends.

WHAT CAN WE EXPECT IN TERMS OF A FISCAL STIMULUS?

With so much uncertainty over the pandemic situation, it is difficult to discern how the Eurozone member states will orient their fiscal policy. The health crisis is getting worse in most countries, which suggests that fiscal support will be extended and increased at the national level. At the European level, even before the first subsidies from the Next Generation EU plan can be paid out -probably not until summer 2021- the programme is already being challenged. Germany's Constitutional Court has suspended the ratification process for the European Recovery

SOVEREIGN 10-YEAR INTEREST RATES (%)

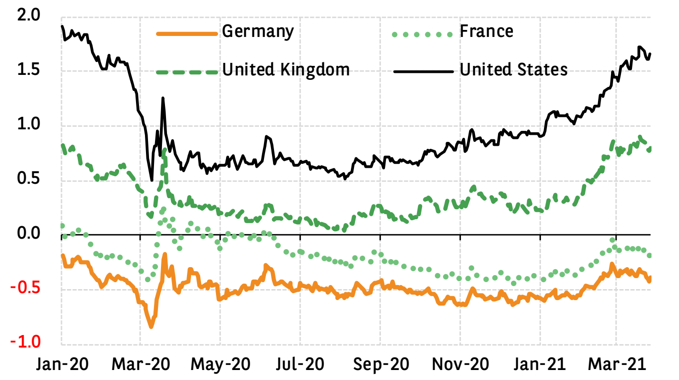

CHART 3 SOURCE: REFINITIV

INFLATION (%)

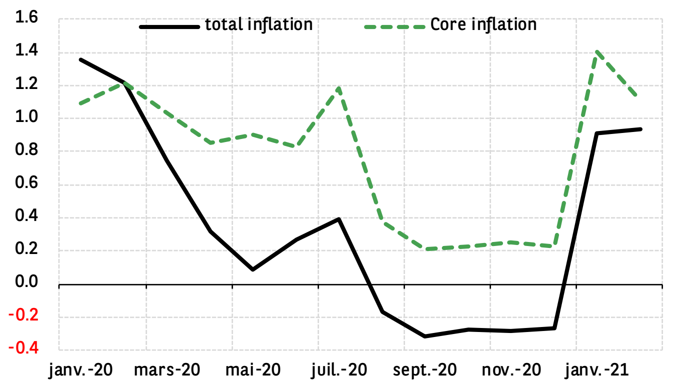

CHART 4 SOURCE: REFINITIV

Fund after an appeal was filed contesting the funding mechanism based on issuing European debt. Unfortunately, this major step towards European construction, initiated during the debt crisis, is still struggling to take shape.

Completed on 31 March 2021

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GERMANY

STRONG RECOVERY FROM MID-2021

After a difficult start of the year, business cycle indicators improved markedly in March on the hope that the worst of the Covid-19 crisis is behind us. GDP is projected to reach the pre-Covid-19 level by the end of 2022. Many of the government support measures will remain in place this year. Fiscal policy for 2022 will depend on the outcome of the general election in September. After a significant weakening of the Christian-Democrats in the polls, a coalition between Greens, social-democrats, and liberals cannot be excluded. The business sector has been severely weakened during the crisis, but this is unlikely to have long-term consequences.

THE FIRST GREEN SHOOTS IN MARCH

The increase in corona cases in Q4 2020 forced the authorities to impose a second lockdown from the beginning of November. In particular, services that involved intensive social contacts, such as bars, restaurants and theatres were closed. By mid-December, non-essential shops had also to lower their shutters. As a result, GDP grew by only 0.3% compared with 8.5% in Q3. This was the result of two opposing forces. On the one hand, activity in manufacturing and construction increased by more than 5%, while activity in market services (trade, communication and hospitality) contracted by around 4.4%.

This dichotomy between manufacturing and services was also observed in early 2021. Activity in the manufacturing sector continued to expand, despite the disruption in the car industry caused by shortages of semiconductors. By contrast, construction activity was severely affected by adverse weather conditions in January and February, while services remained subjected to lockdown restrictions. In March, the economic climate improved considerably. The IFO climate indicator rose to 92.7, a highest since September 2020. In particular, business optimism about the coming months rose sharply on the back of expectations of the easing of lockdown restrictions as infections were set to decline due to the ongoing vaccination campaign.

Despite the sharp fall in activity in 2020 (-4.9% and -5.3% adjusted for calendar effects), the unemployment rate rose only to 4.6% compared with 3.4% in early 2020. This is largely due to government measures to ease the impact of the crisis, and, in particular, the furlough scheme (Kurzarbeit). The Ifo Institute estimates that 2.8 million or 8.5% of employees made use of this scheme in February (chart 2). In accommodation and food services, more than 50% of employees were on furlough.

FISCAL POLICY REMAINS ACCOMMODATIVE

The Federal government was quick to respond to the corona crisis and ease its impact on activity. In March, a comprehensive support package for employees and enterprises worth EUR 750 bn (22% of GDP of 2019) was deployed. As a large part of the package consisted of guarantees, loans and tax deferrals, public spending rose by EUR 127 billion, of which €50bn was made available to support small businesses and self-employed persons. In June, the government presented a second support package worth EUR 130 bn. The measures focused on boosting demand through a temporary cut in the VAT - from 19% to 16% between July and December 2020, providing families with an additional EUR 300 per child and doubling a government-supported rebate on electric car. It also contained a €50 billion fund for addressing climate change, innovation and digitalisation. In November and December, further measures were introduced to support the most affected businesses during the renewed lockdown. As a result of these packages and the disappointing tax receipts, the financial deficit of the general government increased to 4.2% of GDP, a highest since 2009. Public sector debt amounted to 70% of GDP by the end of the year. For 2021, the deficit is likely to move sideways and the debt ratio could further increase to 75%. However, this is substantially lower than during the financial crisis, when the debt ratio reached 82.4% in 2010. In 2022, the government budget is expected to improve sensibly as stimulus

GROWTH AND INFLATION (%)

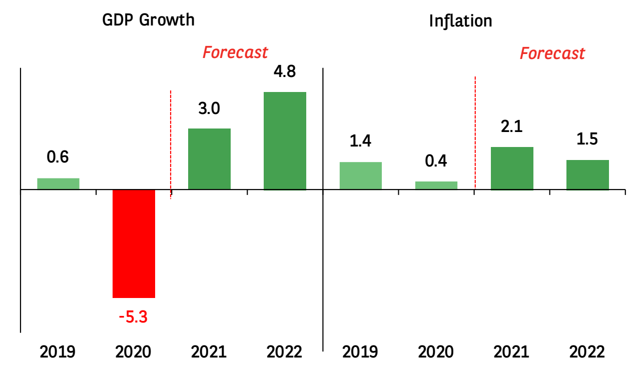

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

MANY EMPLOYEES STILL ON FURLOUGH

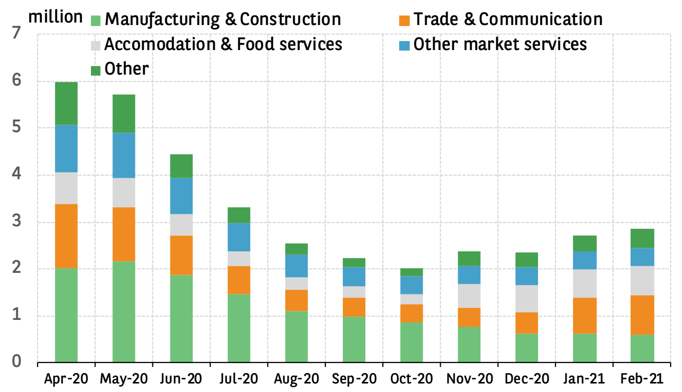

CHART 2 SOURCE: IFO, BNP PARIBAS

measures expire and tax receipts will rise because of the economic upswing. The deficit could fall below 2% of GDP.

The 2022 budget will depend on the next government. The current coalition between the Christian-Democratic parties (CDU/CSU) and the Social Democratic Party (SDP) is unlikely to be continued after the next general election, to be held on 26 September. The CDU/CSU, recently weakened by scandals, is likely to remain the largest block in the Bundestag. It might seek to form a coalition with the liberals (FDP) and the Greens, the so-called Jamaica coalition. On paper, it could reckon on a large majority in parliament. However, the programmatic differences might be hard to bridge. Since the weakening of CDU/CSU in the polls, a coalition of Greens, SDP and FDP, the so-called traffic light coalition, could become possible. At the moment, the combination stands to gain close to 50% of the seats. It might be very attractive for the Greens, as the leader of the party would become Chancellor for the first time.

HIGH ENTERPRISE DEBT, BUT NO LONG-TERM ECONOMIC DAMAGE

The outlook for 2021 depends largely on the course of the pandemic and the progress in the vaccination process. In our scenario, we assume that the decline in infection rates will allow a gradual easing of the lockdown measures eased from mid-April onwards. In that case, services could join manufacturing as a driving force behind the recovery. GDP is projected to grow by 3% in 2021 and 4.8% in 2022. By end 2022, GDP would have reached pre-Covid-19 level.

A major question is what will happen to enterprises if the government support measures are gradually withdrawn. In the past year, these measures have been very effective in keeping unemployment down and avoid bankruptcies. Despite economic activity contracting by around 5% in 2020, the number of bankruptcies actually declined by 15.5% compared to 2019. This is not only due to the suspension of the obligation for insolvent firms to file for bankruptcy, but also because of loans and grants that companies have received. Many fear that the state's generosity could increase the number of zombie firms, thus weakening the structure of the economy[1]. In a recent survey of the Ifo Institute and Frankfurter Allgemeine Zeitung among a panel of economists, 86% of them believed that the number of zombie firms had "increased" or "strongly increased" in Germany since March 2020.

It is likely that the lifting of the support measures will lead to an increase in bankruptcies. Even though for most firms, it will be business-as-usual, many of them may face high debts and some firms with a viable business model might even need to be restructured.

Indebtedness of the non-financial sector has reached a record level, which could weigh down on investment and productivity (Chart 2). The reassuring news is that research by a group of German and US economists shows that a boom in business loans is not likely to damage the economy in the long-term[2]. A possible explanation is that firms may switch to other internal sources of financing, i.e. equity instead of debt. Moreover, firm liabilities are ultimately limited by firm assets.

STEEP INCREASE IN BUSINESS INDEBTEDNESS

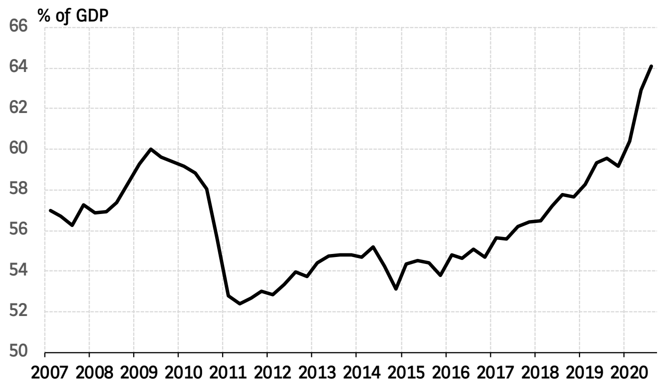

CHART 3 SOURCE: DEUTSCHE BUNDESBANK, BNP PARIBAS

If the going concern value drops below the market value, liquidation of the firm will ensue, the excess debt will be erased and the assets freed up for other productive ends. The smoothness of the liquidation depends on the efficiency of the insolvency process. In that respect, Germany is well placed. It has one of the most efficient insolvency regimes in the world[3]. On average, the length of the procedure is just over a year, with a recovery rate of almost 80% and the costs amount to only 8% of the estate.

Completed on 1 April 2021

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1 Baudchon, H., Boisset, L., Derrien, G., Van der Putten, R. (2021). *European Union: Europe: the shock of Covid-19 and the fear of accelerated zombification*, BNP Paribas Conjoncture, January.
2 Jordà, Ò., Kornejew, M., Schularick, M., & Taylor, A. M. (2020). *Zombies at large? Corporate debt overhang and the macroeconomy* (No. w28197). National Bureau of Economic Research.
3 The World Bank Group, Doing Business 2020

FRANCE

AN ACCORDION-LIKE EXIT FROM THE CRISIS

Contrary to what we were led to expect in late 2020, the discovery of vaccines did not end the stop-and-go nature of the recovery. In early 2021, due to the emergence of variants and the slow pace of the vaccination campaign, the exit from the crisis continues to follow a jagged trajectory. The light at the end of the tunnel seemed to be getting closer (Q4 2020 GDP did not decline as sharply as feared; a technical recession was apparently avoided in Q1 2021, with feeble but positive growth) but now it is fading again (the rebound has been pushed back until Q3, with Q2 growth verging on zero, and it could even slip into negative territory). The strong upturn in March confidence surveys is good but fleeting news, because it does not integrate the recent series of tightening of lockdown measures. We should expect a relapse in April before a turnaround in May, which we hope will be sustainable this time, thanks to the acceleration of vaccinations and support from the policy mix. The expected rebound in H2 would lift growth to an average annual rate of 6.1% in 2021, followed by 4.4% in 2022.

THE YEAR 2020 IN REVIEW

If we had to summarize the year 2020 in a few figures, we would use the following seven indicators. First, GDP plunged at an average annual rate of 8.2%, a record for France. It was also the third largest contraction in the Eurozone, behind Spain, the leader at -10.8%, and Italy, -8.9% (compared to a Eurozone average of -6.8%). Second, payroll employment declined only 1.3%. Third, household disposable income rose a slight 1.1%. These two trends, which are correlated, are remarkable given the massive recessionary shock that slammed the French economy. They attest to the effectiveness of emergency measures. Fourth, the household savings rate rose strongly, up 6.4 points to 21.4%, as households built up a combination of forced and precautionary savings, the corollary of the prevailing uncertainty and the preservation of gross disposable income at a time when consumption plummeted (-7%), largely restrained by a series of lockdown phases[1]. Fifth, the profit margins of non-financial companies declined sharply, down 4 points to 29.2%, the lowest level since 1985.

The sixth and seventh indicators are the fiscal deficit and the public debt ratio. According to preliminary INSEE estimates, both reached record levels at -9.2% and 115.7% of GDP, respectively. Yet these figures are not as bad as the government estimated in its fourth revised finance bill for 2020 (PLFR4 2020), which called for a deficit of 11.3% and a debt ratio of 119.8%. This means the enormous cost of the crisis was not as high as feared (+6.1 points for the deficit relative to 2019 and +18.1 points for the public debt). This can be explained in part by the smaller contraction in GDP than the government had forecast in its PLFR4 (-11%). All other factors being the same, this favourable forecasting error of GDP growth accounts for 83% of the erroneous deficit (1.7 points out of a total of 2.1). The wider deficit (in EUR billions) can be broken down as follows: 47% is due to the drop-off in revenues and 53% to higher spending. This created an open scissors effect that will probably be much harder to close than it was to open (see chart 2).

In our review of 2020, one of the key characteristics of this crisis was the jagged ups and downs of quarterly GDP growth, according to the series of lockdown and reopening phases. After a 5.9% q/q decline in Q1, GDP plummeted 13.5% q/q in Q2 before rebounding vigorously by 18.5% q/q in Q3. The economy then relapsed, declining 1.4% q/q in Q4, leaving it 5% below the pre-crisis level of Q4 2019. Household consumption was down nearly 7% from pre-crisis levels, while corporate investment and exports were down 5% and 10%, respectively. Another characteristic of this crisis is that consumption was hit harder than business investment, while the heavy toll paid by exports can be attributed to the weight of the aeronautics and tourism sectors in the French economy[2].

GROWTH AND INFLATION (%)

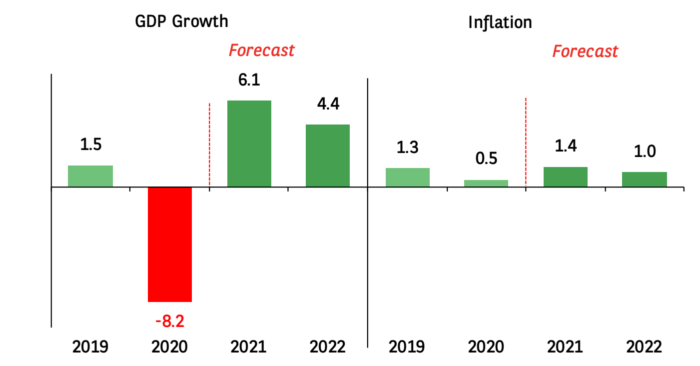

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

FISCAL REVENUE AND SPENDING: AN OPEN SCISSOR EFFECT

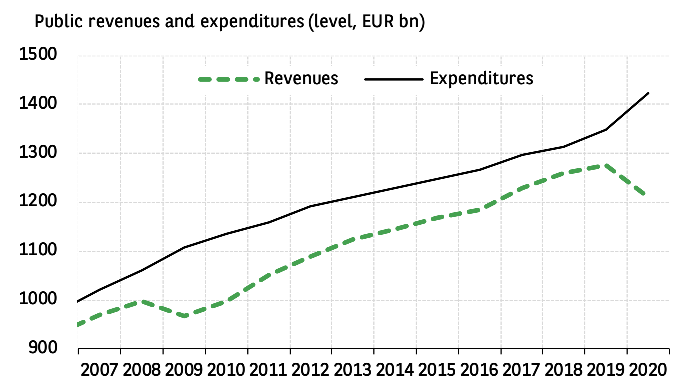

CHART 2 SOURCE: INSEE, BNP PARIBAS

1. Gebauer, J-F. Ouvrard, C. Thubin (2021), *Uncertainty over Covid-19 drives up French household savings*, Bank of France, Bloc-note Eco billet n°206, 3 March
2 INSEE, *Troubles in the aeronautics sector are preventing French exports from taking off again*, Note de Conjoncture, March 2021

THE RECOVERY IS DELAYED AGAIN

The economic situation is mixed in the first 3 months of 2021. GDP is expected to grow slightly in Q1, but thanks solely to a positive carry-over effect due to the rebound in activity in December 2020 after the end of November's lockdown restrictions. In January and February 2021, the French economy continued to operate at about 95-96% of its pre-crisis level according to INSEE and Bank of France estimates. In March and April, we expect France's operating capacity to deteriorate to about 93-94% of pre-crisis levels following the tightening of lockdown measures on 20 March for at least four weeks in 16 departments, which was then expanded to 19 departments. Fears of another decline in Q1 GDP seem nonetheless to have been put to rest. As a result, France is likely to have avoided a technical double-dip.

The strong upturn in March confidence surveys is good news, but it was a false start, illustrating the expression "one swallow does not spring make" (see chart 3). The improvement in business sentiment in the services sector and in household opinions on future living standards in France illustrate the country's rebound capacity, while the strength of business sentiment in industry illustrates the power of external support factors. It also brings to mind the dichotomy between industry, which is not hit as hard by restrictive health measures, and the services sector, which is more directly impacted. Yet March's improvement, notably in the services sector, was more of a technical rebound after February's decline, two movements that are uneasy to square with the relative stability of the Google mobility indices. Above all, for the different surveys, it was probably a very short-lived rebound because it does not include the impact of the most recently announced lockdown restrictions. These so-called leading indicators are lagging behind the times, a lag due to the rapid reversals in the health crisis. Consequently, we should expect the surveys to deteriorate again in April, before hopefully entering a more lasting upturn starting in May.

Seen in this light, Q2 prospects are not very encouraging. Assuming that activity rebounds as of May, based on the assumption that lockdown measures will be eased, GDP could rise slightly. Yet we cannot rule out the possibility of negative growth if the most recent health restrictions have a bigger than expected impact on activity in March and April, if new restrictions are announced, and/or if the expected rebound fails to materialise once lockdown restrictions are lifted. In a nutshell, there is still enormous uncertainty and any improvement in the economic situation hinges directly on the evolution of the health crisis.

Contrary to what we were led to believe in late 2020, the discovery of vaccines and the announced start-up of vaccination campaigns did not end the stop-and-go nature of the economic recovery. In early 2021, due to the emergence of variants and the slow pace of vaccinations, the exit from the crisis continues to follow a jagged trajectory. We still see the light at the end of the tunnel, but it keeps getting closer or farther away depending on the evolution of the health situation. As we write these lines, the light seems to be fading, whereas four months ago, in our previous analysis published in early December, we seemed to be nearing the tunnel's end. The economy's rebound capacity, and the potential for a vigorous recovery, are not called into question. Rather it is the timing of the rebound that has been pushed back by two quarters, from Q1 to Q3 2021. Given this background, although there has been some discussion on the various steps of the exit strategy, the time is not ripe to withdraw support measures, much to the contrary.

In 2021 as a whole, we expect GDP growth to average 6.1%. This is a rather optimistic forecast, a half point higher than the March consensus. Our optimism is based on the expected acceleration of the vaccination campaign and the effective support of the policy mix.

FRANCE'S REBOUND CAPACITY AS SEEN IN SOFT DATA

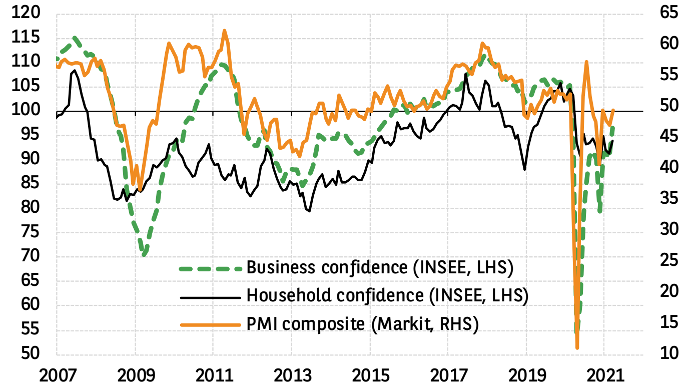

CHART 3

SOURCE: INSEE, MARKIT, BNP PARIBAS

FRANCE'S REBOUND CAPACITY AS SEEN IN HARD DATA

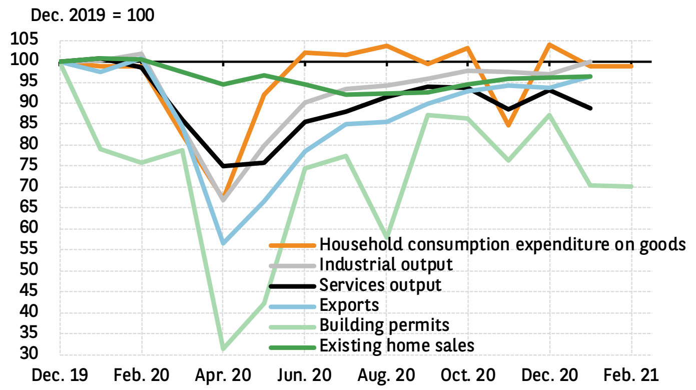

CHART 4

SOURCE: INSEE, BNP PARIBAS

In 2022, GDP growth should remain strong at an estimated 4.4%. According to our scenario, French GDP will surpass pre-crisis levels in Q1 2022. This would mark a first step. There can be no doubt that it will occur at one moment or another: the big question is one of timing, just how long will it take? Returning to pre-crisis levels in the span of about a year can be considered a relatively short period of time considering the severity of the shock. In contrast, there is a big difference between returning to pre-crisis levels and returning to the pre-crisis trajectory, i.e. the level of GDP that would have been reached in the absence of the crisis. The size of this gap is a measure of the scars left by the crisis. While the United States seems to be well on its way to returning to this pre-crisis trajectory as of 2021, which would be remarkable, the same cannot be said for France. Based on our outlook through 2022 and those of the IMF from 2023 to 2025, there could still be a gap of slightly less than 1% in 2025.

Completed on 31 March 2021

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ITALY

THE WAY TO RECOVERY GETS LONGER

In 2020, real GDP fell by 8.9%, with almost 2.5 million of full-time equivalent jobs lost. The decline in consumption was the main driver of the recession, accounting for three fourths of the economic downturn. Stagnating incomes and the lack of confidence increased households' propensity to save. The services sector was the most severely affected by the crisis, with value added declining by 8.1%, while manufacturing benefitted from the moderate recovery of exports. The problems raised by the pandemic combined with -and worsened- structural issues that had been slowing down the country's economic growth up to now. In the years to come it will be hard to implement a solid growth pattern without decisive interventions that would foster innovation and productivity.

HOUSEHOLDS WITH AN INCOME AND CONFIDENCE PROBLEM

Following the rebound in Q3 2020 (+15.9%), real GDP fell by 1.9% in Q4. The second wave of infections required new restrictive measures on mobility and economic activities. Both foreign and domestic demand made a negative contribution. Exports rose less than imports, while the contraction of consumption more than offset the increase in investments and the positive contribution of public expenditure.

In 2020 as a whole, real GDP declined by 8.9%. The decline in consumption was the main driver of the recession, accounting for three fourths of the GDP decline, much more than during the two previous recessions. Private spending fell by 10.7%, with a 6.5% negative contribution to the contraction of GDP. Italian households suffered both from the disappointing income evolution and the deterioration in confidence. In 2020, almost 2.5 million of full-time equivalent jobs were lost. From January to September, households' gross disposable income declined by more than EUR 20 billion and the propensity to save doubled, following the effects of restrictive measures and consumers adopting a more cautious behaviour.

In 2020, Italian households reduced spending on entertainment and culture, transports, restaurants and hotels, while increasing purchases on food and beverages, communication and house maintenance and services. Despite the pandemic, spending on health, which includes medical products, appliances, equipment and hospital services, declined by 6.2%. Online purchases, which accounted for 4% of total retail sales in 2019 (8% in France and 11% in Germany), rose by 35%.

2020: THE SEVERE CRISIS OF THE SERVICES SECTOR

The services sector, the only one that in 2019 had recovered the decline recorded during the previous two crises, suffered much more than the rest of the economy. In 2020, services value added declined by 8.1%, with a 6% negative contribution, with the number of full-time equivalent employees falling by 11%, almost 2 million less than in 2019.

The recession became widespread, but with differences among sectors. Information and communication value added rose by 1.9%, while that of financial and insurance activities fell by 2.6%. Entertainment & recreation and transportation & storage value added declined by about 15%. The hotel and catering sector was the most severely affected by the crisis: value added collapsed by 40%, with half a million of full-time equivalent jobs lost. Restrictions on cross- border travel impacted the tourism industry. Foreign travellers in Italy declined from 96.2 million in 2019 to 39 million in 2020, with expenditure contracting from EUR 44.3 billion to EUR 17.4 billion.

GROWTH AND INFLATION (%)

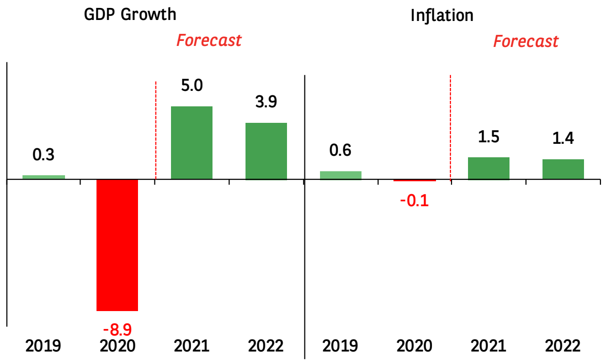

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

CONTIBUTIONS TO GDP GROWTH

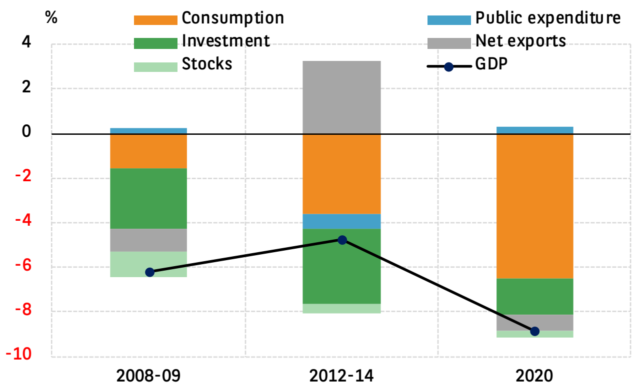

CHART 2 SOURCE: BNL CALCULATIONS ON ISTAT DATA

A MORE RESILIENT MANUFACTURING SECTOR

In 2020, manufacturing value added declined by 11.4%, mainly as a result of the strong contraction recorded in the first half of the year, while industry stagnated in Q4. The number of full-time equivalent employees in manufacturing declined by 376,000 (-11%), falling to about 3 million.

Textile, clothes and shoes sectors continued to be strongly hit by the crisis: value added declined by almost 25%, with a severe loss in employment. The contraction was milder in the food and beverages sector as well as in that of intermediate goods, such as chemical products and rubber and plastic products. Manufacturing benefitted from the moderate increase in exports. According to trade balance data, the value of Italian sales abroad has almost totally recovered the decline of the first part of the crisis.

NEW PANDEMIC, OLD PROBLEMS

In Italy, the problems raised by the Covid 19 pandemic combined with -and worsened- structural issues that had been slowing down the country's economic growth up to now (high public debt, a fragmented production system, low investment in education, R&D and innovation). In the years to come it will be hard to implement a solid growth pattern without decisive interventions that would foster innovation, productivity and sustainability.

At the outbreak of the Covid-19 pandemic, the latest data available showed a very fragmented productive system in Italy: micro-enterprises accounted for 95% of all Italian firms, employing 43.7% of the working population and contributing to 27.5% of the value added. In comparison with other European countries, Italian firms are smaller: they employ on average 4 persons compared to 4.5 in Spain, 5.6 in France and 11.9 in Germany. Firms' size affects both their productivity and propensity to invest. In Italy, labour productivity in a micro-enterprise amounts to EUR 30,000, vs EUR 72,680 in a large one. In the manufacturing sector, a large firm invests about EUR 14,500 per employee and per year on average, vs EUR 3,600 euros for a micro one. The prevalence of micro- and small-sized firms, and the subsequent low productivity and investment propensity, result in a scarce use of qualified personnel and digital infrastructures by Italian firms. According to the most recent Istat data, only 5.1% of the persons employed in the productive system have tertiary education or an academic diploma.

The use of digital infrastructures in Italy is strongly correlated to the firms' size: the so-called "digitally mature" companies (i.e. firms that make an integrated and advanced use of the available technologies) are mostly large firms: 23% of firms with over 500 employees, 15% of those which employ 250-499 persons and 10% of those with 100-249 employees may be defined as "digitally mature". Among small enterprises, the percentage of "digitally mature" ones does not exceed 2.3%.

The structural limits of a part of the Italian productive system also affected the capacity of adaptation and the effectiveness of the response to the challenges posed by the Covid-19 pandemic. According to a recent analysis conducted by Istat on the reaction of Italian business to the current crisis, it is possible to distinguish five clusters of firms: 1. "Static in crisis": companies that are heavily impacted by the health emergency and have not adopted specific reaction strategies; 2. "Static resilient": companies that have not implemented reaction strategies because they have not suffered from significant negative effects; 3. "Proactive in distress": companies hit by the crisis but which have put reaction strategies in place; 4. "Proactive in expansion": companies barely affected by the crisis that have not altered their previous development pattern; 5. "Proactive advanced": companies affected by the crisis, but which increased their investments compared to 2019.

At the end of 2020, about 75% of Italian companies with at least three employees had not defined any strategic framework to deal with the consequences of the crisis in the medium-long term, and about one third showed signs of crisis or distress. The five groups exhibit a strong internal homogeneity in terms of firm size: the «static in crisis» are on average much smaller than the «proactive advanced» ones (6.5 and 47.2 employees respectively).

ITALY: THE PRODUCTIVE SYSTEM BY FIRMS' SIZE (% OF TOTAL)

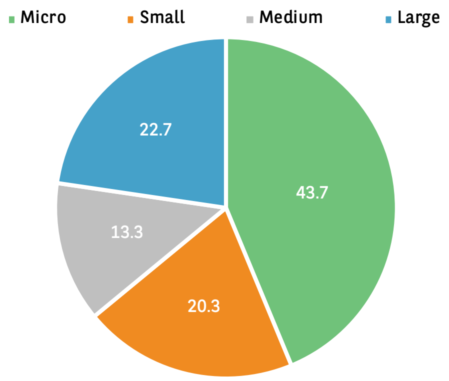

CHART 3 SOURCE: BNL CALCULATIONS ON ISTAT DATA

Even though firms' reaction to the crisis largely depends on the different impact that the lockdown measures had on the different sectors, it is obvious that the least productive units (with higher labour costs, a low-skilled workforce and a domestically-oriented business) suffered the most by far. Among the "proactive advanced" firms, the value added per person employed more than double that in "static in crisis" companies (about EUR 73,000 against EUR 33,000) and their workforce is on average more educated. As far as firms' activity is concerned, the most reactive companies are more numerous in the industrial sector, in particular chemicals, pharmaceuticals, electronics and beverages industries. In the services sector the firms that better reacted to the crisis are mainly those operating in the telecommunications, information technology, finance and insurance areas. Among the companies that suffered the most because of the crisis, regardless of the sector to which they belong, a high percentage did not make any structural investments (such as in R&D, human resources, technologies and digitization, human capital and training, internationalization, social responsibility and environmental fields) and therefore did not adopt any strategic changes to face the crisis.

Completed on 31 March 2021

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SPAIN

A RECOVERY SLOW IN THE MAKING

Economic growth remains extremely fragile in early 2021. In addition to the Covid-19 pandemic, Spain was hit by Storm Filomena in early January, which has had a direct negative impact, notably on consumption: both automobile and retail sales plummeted this winter. We now expect GDP growth to be flat in Q1. Even so, the economy could rebound strongly either this spring or more certainly by summer, although we cannot completely rule out the downside risks associated with the UK variant and a possible fourth wave of the coronavirus in Spain. We are forecasting real GDP growth of 5.9% in 2021 and 5.6% in 2022, following a record contraction of 10.8% in 2020.

To face up to the protracted health crisis, the government has extended most of the emergency measures launched in 2020, including a moratorium on corporate bankruptcies (which was extended through to 31 December 2021) and the ERTE short-time working scheme (which currently expires on 31 May). On 12 March, the government also approved a new fiscal stimulus package totalling EUR 11 bn. It comprises EUR 7 bn in direct aid for companies operating in the hardest hit sectors and regions[1], EUR 3 bn for corporate debt restructuring, and EUR 1 bn for any capital injections that might be needed. The ongoing pandemic – and its economic consequences – will certainly drive public spending above the government's initial targets. The government has formalised a record-high budget of EUR 239.8 bn for 2021. According to the Bank of Spain's central scenario, the public deficit is estimated at 7.7% of GDP this year, after peaking at an all-time high of 10.1% of GDP in 2020.

LIMITED HOPES

There are nonetheless good reasons to hope for a more significant rebound in economic growth this spring or more certainly by this summer. The number of new Covid-19 cases in Spain has dropped sharply, even though the pandemic's curve has begun to rise slightly again since the end of March. The vaccination campaign is progressing, albeit at a sluggish pace. On 29 March, nearly 16% of the population had received their first dose of the vaccine. As a result, Spain ranks among the European countries with the highest vaccine coverage, even though it remains far below the vaccination rates reported in the United States and the United Kingdom. Nonetheless, Prime Minister Pedro Sanchez announced that the number of doses would quadruple in Q2, which should in theory lead to a rapid acceleration of vaccinations. For the moment, the government is maintaining its target of vaccinating 70% of population by the end of summer, even though vaccine supply may remain a major obstacle in the months ahead.

The gradual easing of restrictive measures should trigger a significant rebound in economic activity. In any case, this is what some confidence indicators are suggesting, notably the PMIs for the services sector, which have improved sharply this winter (see chart 2). During the first reopening phase in May 2020, economic activity recovered rapidly, with real GDP growing 16.4% q/q in Q3. The global economic environment is also more promising than it was last summer, particularly in the United States and Asia. This should bolster Spanish merchandise exports to these regions, although Spain does not stand to benefit as much from this trade as its European neighbours (see box, next page).

As we explained in a previous EcoFlash[2], Spain's economic structure (with a focus on services and tourism) and an industrial fabric composed mainly of SMEs and precarious job contracts) suggests that the Covid-19 pandemic could have a bigger impact on growth in the medium term compared to the three other big European countries.

GROWTH AND INFLATION (%)

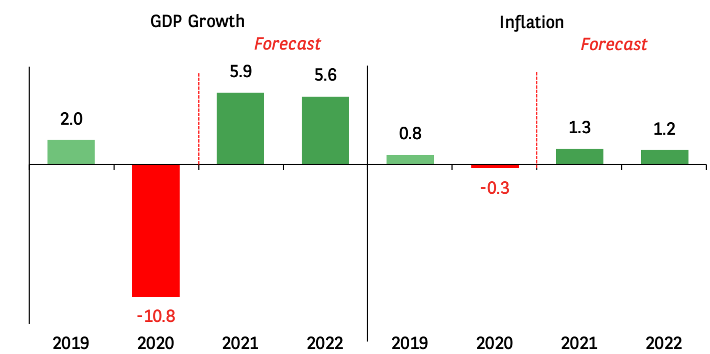

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

SERVICES PMI

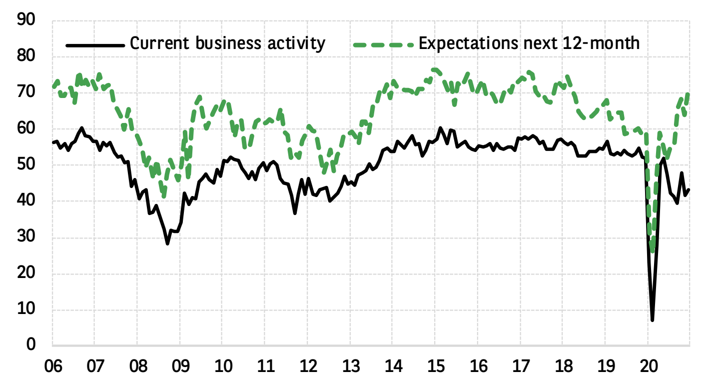

CHART 2 SOURCE: MARKIT, REFINITIV

Equity market trends seem to confirm this sentiment. At the end of March, Ibex, the Spanish equity market index, was still fluctuating about 15% below pre-crisis levels. In contrast, France's CAC 40 and Italy's FTSE MIB had made much more progress in closing the gap, while Germany's Dax had already reached new record highs as of mid March.

1 Aid will be available in 95 sectors. Moreover, EUR 2 bn will be allocated exclusively to the Balearic and Canary Islands, two regions hard hit economically by the Covid-19 crisis.
2 See BNP Paribas *EcoFlash, Eurozone: Four countries, four ways to recover*, 20 May 2020

WILL INFLATION REBOUND THIS SPRING?

Sluggish growth in the early part of 2021 has limited the rebound in consumer prices, unlike the situation in most of the other major European countries. In the Eurozone, the harmonised index of consumer prices (HICP) rebounded 0.7% between December and February, but in Spain it declined 0.8% over the same period (Eurostat). On a year-on-year basis, Spanish HICP even slipped back into negative territory in February. The only notable rebound was for energy prices, and by extension, transport prices, which followed the rise in commodity prices during the winter. Yet we cannot rule out the possibility of an upturn in inflation this spring. Bottlenecks in global supply chains (visible notably in PMI surveys) could eventually trigger an acceleration in Spanish inflation. Another upside risk factor for inflation is a strong rebound in economic activity from Q2 onwards.

RECOVERY PLAN: MADRID STEPS UP THE PACE

In the weeks ahead, the government will finalise and deliver its national recovery plan ('The Recovery, Transformation and Resilience Plan') to the European Commission. Spain's executive branch intends to submit its plan to Brussels by mid-April, two weeks ahead of the deadline imposed by the European Commission. Yet the first allocations via the Next Generation EU funds are unlikely to occur before the second half of 2021. To accelerate the process, the Spanish government plans to issue government bonds that will be reimbursed once the EU transfers have been completed. Spain's recovery plan, which must comply with the European Commission's guidelines, will have nearly two thirds of investments geared towards the ecological and digital transitions.

Yet one of the major challenges facing the Spanish authorities is to transform these "theoretical" allocations into concrete investments. Indeed, Spain has a poor track record when it comes to the utilisation of European structural funds. Under the previous European multi-year budget for the period 2014-2020 (ESIF), Spain used only 40% of the allocated funds, which was the second lowest absorption rate after Croatia.

Lastly, against the backdrop of the health crisis, this spring's main political event will be the early regional elections to be held in Madrid on 4 May. Pablo Iglesias, Deputy Prime Minister of Spain and leader of the Podemos party, has announced his candidature to be the region's president. To run for this election, he resigned as Deputy Prime Minister and was replaced by the Minister of Economic Affairs Nadia Calviño. The leader of Podemos will be facing Isabel Diaz Ayuso, the incumbent president and member of the People's Party. Madrid's election follows on the heels of February's regional election in Catalonia, which ended up strengthening the region's separatist parties. As has been the case for several years, Spain's political situation is an underlying risk that only compounds the country's currently severe economic difficulties, which are bound to worsen with the Covid-19 crisis.

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WILL SPAIN'S DEPENDENCE ON THE EUROPEAN COMMON MARKET HAMPER ITS RECOVERY?

Although tourism accounts for a major part of Spain's "external" revenue, merchandise exports are still a very important sector and its economic weight has continued to increase over the years. Goods exports as a share of GDP have gradually increased, to 24.1% in 2020, compared to only 18.5% in 2007, just before the global financial crisis (IMF data). Note that the pandemic did not have a notable impact on the share of exports compared to 2019.

This trend was accompanied by a greater concentration of Spanish exports on EU destinations, and France in particular. Inversely, for Germany, France and Italy, the share of exports to the EU has remained generally stable, and historically it has been much lower than in Spain (see table below). As a result, Spain should benefit relatively less from the rebound in activity and stronger demand from the United States and China. By extension, Spain risks being hit economically harder by the delayed rollout of vaccination campaigns, which means a belated lifting of business restrictions within the EU.

	Spain	Germany	France	Italy
Share of world exports in 2020 (%):	**1.8**	7.9	2.9	2.9
Share of national exports towards:				
United States	**4.6**	8.8	8.0	9.6
China	**2.7**	7.6	4.1	2.8
Japan	**0.9**	1.5	1.4	1.6
EU	**59.7**	52.5	52.4	50.8
Eurozone	**52.6**	36.8	45.6	41.0
United Kingdom	**6.7**	5.7	6.6	5.2
Asia (ex-China and "advanced" countries*)	**1.4**	2.5	3.0	2.3
Middle-East	**2.6**	2.0	3.5	3.7
Africa	**5.4**	1.4	4.7	2.7
Other destinations	**16.1**	17.9	16.2	21.1

* Advanced Asian countries (IMF classification): Australia, Hong Kong SAR, Japan, Korea, New Zealand, Singapore, and Taiwan

SOURCE: IMF DIRECTION OF TRADE STATISTICS

THE NETHERLANDS

WAITING FOR A NEW GOVERNMENT

Thanks to healthy government finances and a light lockdown strategy, the Netherlands weathered the crisis better than the surrounding countries. Nevertheless, the economy was in a mild recession in Q1 2021. Economic sentiment indicators point to rapid recovery in the second half of the year. Despite the clear victory of the outgoing government at the general election in March, the formation of a new coalition is in turmoil. Doubt has increased whether Mark Rutte can lead his fourth government in succession. The main task of the coalition is to put a recovery programme on the rails.

MILD RECESSION IN Q1 2021

The government's light lockdown strategy announced in March 2020 initially paid off. In 2020, the economy contracted 3.7%, –similar to the fall recorded during the financial crisis in 2009– but this compared favourably with the surrounding countries. As the number of infections rose rapidly after summer, a second partial lockdown was imposed from mid-October. The measures have been progressively tightened in the following months. The imposition of a curfew in January led to unprecedented violent protests and pillaging in many places in the country.

The economic impact of the second lockdown is likely to be much more limited than in March-May 2020. In Q4 2020, GDP contracted by 0.1%, largely due to a fall in household consumption (-1.4%). A further contraction (-0.5%) is expected in Q1 2021. By comparison, in Q2 2020, GDP contracted by 9%. The reason is partly due to the effectiveness of the policy responses to the crisis. Thanks to the furlough schemes, the unemployment rate declined to 3.6% in February after having peaked at 4.6% last August. In the same month, the number of bankruptcies was even at its lowest level for 30 years. Moreover, as household savings have increased to historically high levels due to limited consumption possibilities, house prices have been rising sharply. As elsewhere in Europe, the business climate improved in March, on the back of rising world trade. However, consumer confidence moved sideways.

GROWTH AND INFLATION (%)

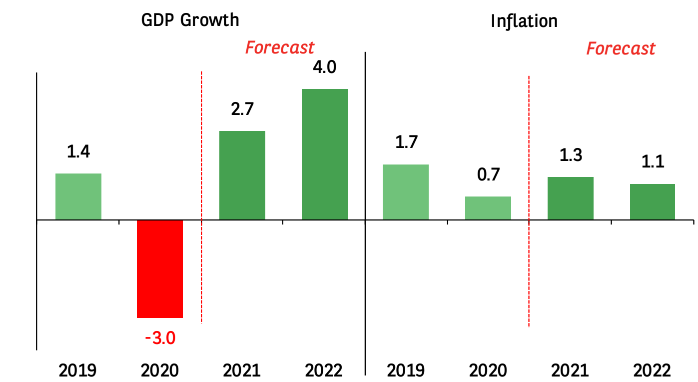

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

UNCERTAINTY CONCERNING GOVERNMENT FORMATION

In March, the conservative liberals VVD led by prime minister Mark Rutte remained the largest party at the general election. The social liberals (D66) came surprisingly second. Technically, it would be possible to continue the outgoing centre-right coalition with the Christian Democrats (CDA and CU), despite heavy losses of the CDA. However, the chaotic first phase of the formation process suggests that it can take some time before a new government is in place. After losing 5 seats and plagued by inner divisions, the CDA might be reluctant to join a new coalition. The social democrats (PvdA) and Green/Left are keen to join a new government, but this would imply a change in policy. Moreover, severely criticised by his former coalition parties during a parliamentary debate on the formation, Mr Rutte runs the risk of becoming an obstacle in the formation process. In general, the forming of a new government takes several months. The longest formation - that of the outgoing government - lasted 225 days. Speed is called for, as the country needs a new government to put a recovery programme on the rails.

Whatever the outcome of the formation process, the new government will continue its prudent budgetary policy. Thanks to the country's healthy financial position at the outset of the crisis, the government was able to support the economy better than the surrounding countries. Despite the important gains of the pro-EU party D66, the government will remain circumspect about deepening the European integration given the progress of the anti-EU parties in parliament.

LIFTING SUPPORT MEASURES MAY PROVOKE BANKRUPTCIES

In the coming months, as Covid-19 cases are expected to come down, lockdown restrictions could be lifted gradually. Household demand is likely to be one of the major engines for growth in the coming quarters as savings rates will return to pre-crisis levels. In the course of 2022, the economy could be back at pre-crisis level.

At the same time, the government is likely to withdraw gradually . This could cause problems for some enterprises that have been kept alive by transfers, loan guarantees and furlough schemes. Bankruptcies are expected to rise, in particular among companies that were already weak before the health crisis. For this reason, employment conditions could again deteriorate and unemployment may even rise to 5% of the labour force by the end of the year. As a result, collectively agreed wage increases could slow to 1.5%.

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BELGIUM

LIGHT AT THE END OF THE TUNNEL BUT BEWARE OF THE CHALLENGES AHEAD

The Belgian economy shrunk by 6.3% in 2020. This amounts to the biggest post-war decline on record. A better-than-expected fourth quarter pushed the final numbers up somewhat and will have a positive effect on the yearly growth rate for the whole of 2021, which we see at 3.7%. Consumption suffered during the second lockdown at year's end and is expected to dip again in April, as the government reinstated shopping on appointment only and instructed schools to extend the Easter holiday break. Unemployment increased significantly but less than was feared and the long-anticipated wave of bankruptcies hasn't quite materialised so far. Tough choices lie ahead for the multi-party government, which should also focus on reining in its budget deficit in the years to come.

OVERVIEW

Household consumption, which posted a 12% QoQ decline in the 2nd quarter rebounded only partially in the 2nd half of 2020. Total capital spending held up surprisingly well in 2020, after dropping by more than 20% in the 2nd quarter. A strong recovery in the 3rd and 4th quarters however resulted in a total spending a lot closer to pre-Covid levels at year's end (-2%). Government spending declined as non-urgent medical procedures were postponed when the second lockdown kicked in (it had also been the case during the first lockdown).

An increase in hospital admissions induced the federal government to announce a third lockdown at the end of last month. With schools closed for at least three weeks and non-essential stores working with appointments only, the impact on the virus' metrics remains to be seen. Just weeks before, the government had put forward the 1st of May as the date on which restaurants and bars could reopen. Whether or not it will be able to follow through on that is hard to say at the moment.

OUTLOOK

For 2021, we expect a partial GDP recovery, the Q4 2019 level being only reached in the second half of 2022. The underlying expenditure components will display some divergence over the short-term. At the start of this year, consumer spending is still about 5% below its pre-Covid level but we expect it to complete a full recovery by the end of 2021.

Business investment would still be 11% lower in 2022 compared to where it would have been without the pandemic, according to survey data. We expect household and government investment to pick up some of the slack by then, with a recovery to Q4 2019-levels for total investment expected by mid-2022.

The speed of the recovery will of course be highly dependent on any developments in the health crisis. The pace of vaccination is in line with that of the neighbouring countries, but well below rates reported in the United States and Israel. Despite the near-term uncertainty, most scenarios include at least partial relaxation of the most stringent social distancing measures towards the end of the year. Risks remain skewed towards the downside however.

LABOUR MARKET

The Belgian unemployment rate came in at 5.8% at the end of 2020, up from 5.1% at the start of the year. Early in the health crisis, the Belgian government installed various measures to support the labour market. For example, the temporary unemployment regime was made more generous and easier to access for employees. In April 2020, 1.2 million workers made use of this facility, up from a historical average of a mere 100,000. This number came down rapidly to around 250,000 over the summer. Despite fears of an upsurge, the second lockdown at the end of 2020 saw only a relatively small increase in temporary unemployment, with less than 300,000 workers listed as temporary unemployed in December 2020.

GROWTH AND INFLATION (%)

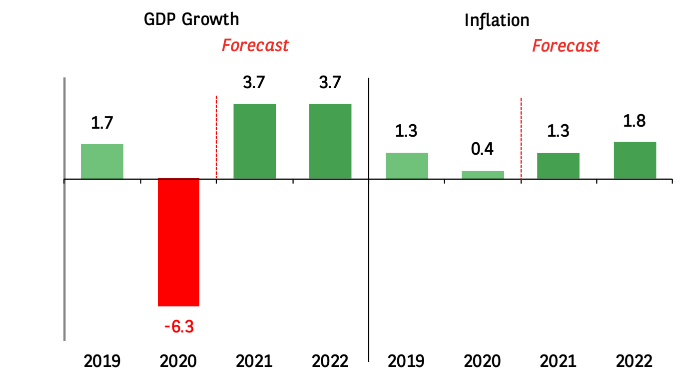

CHART 1 SOURCE: NATIONAL ACCOUNTS, BNP PARIBAS FORTIS

Once the current regime and the various measures supporting the self-employed expire, actual unemployment is expected to increase significantly. This increase would originate from three distinct channels: workers moving from temporary to full time unemployment, self-employed workers closing their business and firms with more than 10 employees going bankrupt. Each of these channels could contribute to adding another 100 000 unemployed workers at the end of 2021. Later on, we expect to see a gradual improvement in the situation, with unemployment declining from a peak of 7.7% back to below 7% by the end of 2022.

Work organisation has evolved markedly compared to the pre-Covid situation. In March, one out of three employees was reported to be working from home at least partially. Despite half of the participants to the ERMG-surveys reporting some negative productivity impact at minima, firms expect regular telework to become a permanent feature once the health-crisis is over. Across the whole economy, physical office space per employee is expected to decline by almost 10% over the next five years. This will undoubtedly have repercussions on the office market.

REAL ESTATE

Housing prices nonetheless continued their upward trajectory despite a background of price-limiting measures (the Flemish government scaled down its tax-advantageous treatment of mortgage payments ["*Woonbonus*"] in 2019) and a modest disposable income growth. Ultra-low interest rates however mostly buffered the impact. The National Bank of Belgium's valuation model points towards an overvaluation of 13.5% compared to underlying fundamentals at the end of 2020.

Real estate transactions were frozen during the most stringent phase of the first lockdown in April 2020, but activity levels recovered swiftly in the remainder of the year. The growth in outstanding mortgage loans persisted, despite more stringent loan-to-value requirements established by the National Bank of Belgium. Aggregated household debt came in at 66% of GDP in 2020, somewhat higher than the Eurozone average (62%).

PUBLIC FINANCE

Government revenues remained stable as a proportion of the economy but took a EUR 12 bn hit in nominal terms as the economy shrunk by 6.3%. Non-interest expenditures had been close to 50% of GDP for the last couple of years. Increased spending at various government levels brought this number closer to 60% for the whole of 2020. All in all, the NBB estimates that fiscal stimulus amounted to EUR 36 bn or 8% of GDP. About two thirds of this were discretionary spending, with the remainder consisting of automatic stabilisers, in operation during dire economic times.

Notable measures include the extension of the temporary unemployment regime (EUR 4 bn), bridging rights for self-employed persons (EUR 3 bn) and premiums in case of forced closure or sharp drop in sales (EUR 3 bn), next to additional support for the health sector (EUR 6 bn).

The exceptional low-rates environment allowed the Belgian government to further push down average interest rates on the outstanding debt. So even as the debt-to-gdp ratio shot up to 116%, yearly interest charges continued their downward trajectory from 2.0% of GDP in 2019 to 1.8% of GDP last year. The average rates on the outstanding debt are expected to decline further from about 1.7% currently to 1.3% by 2022.

Despite this positive evolution, debt-sustainability remains worrisome in the long run. With the government's focus slowly shifting from fire-fighting mode to kickstarting the economy again, a big challenge awaits federal Prime Minister De Croo. His broad coalition will need to get on the same page about future steps.

Completed on 31 March 2021

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PORTUGAL

THE WORST IS OVER

Portugal was one of the European countries hit hardest by the third wave of the coronavirus pandemic this winter. The government reinstated a "strict" lockdown that drastically reduced the spread of the virus. A very gradual reopening plan was launched on 15 March and will end on 3 May. Hopes for a solid economic recovery hinge on the vaccination campaign currently underway, but like elsewhere in the European Union, it is progressing at a slow pace. The success of the UK vaccination programme nonetheless raises promising prospects for the recovery of Portugal's tourism sector, which is highly dependent on British tourists. Real GDP could rebound by as much as 5-5.5% in 2021, after contracting by 7.6% in 2020.

Prime Minister António Costa unveiled a very gradual reopening plan – similar to the one in the UK – which began on 15 March and will end on 3 May with the opening of restaurants and cafés, among other businesses. From an economic perspective, the government announced a new EUR 7 bn fiscal package on 12 March. The big challenge in the weeks ahead will be to restart tourism activities. Important measures have already been taken: starting on 17 May, British tourists will be authorised to enter Portugal if they have a Covid-19 vaccination certificate or a document showing that they have recently had a negative PCR test. This announcement follows the UK government's decision to take Portugal off its red list, which means that travellers returning from Portugal will no longer have to observe a quarantine period. These encouraging prospects are reflected in the confidence indices, notably in the European Commission's economic sentiment index (ESI), which improved markedly in March (+7.6 points to 93.1). Even so, the ESI is far below its pre-crisis level, and consumer confidence is still extremely fragile.

In terms of employment, the government's job support measures have undoubtedly helped reduce the damages of the crisis on the labour market: employment fell by 1.9% in 2020, which is far less than the 7.6% decline in GDP in volume. Yet these gross employment figures mask important disparities. Young workers have been hit disproportionately harder by the crisis, a phenomenon that is illustrated by the sharp decline in the employment rate for the 15-24 age group in 2020 (see chart 2). The coronavirus crisis will leave deep scars on the insertion of young people in the labour market.

As to public finances, the 2020 fiscal deficit of 5.7% of GDP is relatively small compared to those of its European neighbours, as Portugal benefited from a fiscal surplus before the crisis. Even so, this is still a very significant deficit, and public debt swelled by nearly 16 points of GDP in 2020, bringing the debt ratio to 133.6%. Yet the short-term risks of Portuguese debt are very limited. After rising significantly in February, 10-year sovereign bond yields slipped back, close to the levels observed prior to the Covid-19 crisis (around 2%).

One last point: the decline in the number of real-estate transactions due to the health crisis does not seem to have reversed any upward momentum in Portuguese house prices, which continued to report very solid growth in 2020 (+8.4%)[1]. The sharp price increases can be attributed to the ongoing decline in mortgage rates coupled with a supply shortage of homes.

Completed on 31 March 2021

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GROWTH AND INFLATION (%)

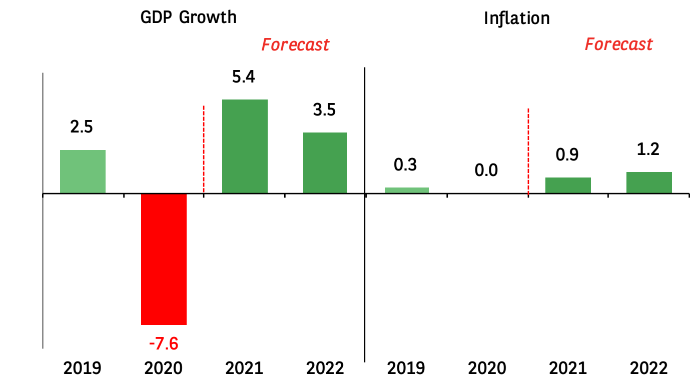

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

EMPLOYMENT RATE FOR THE 15-24 AGE GROUP (%)

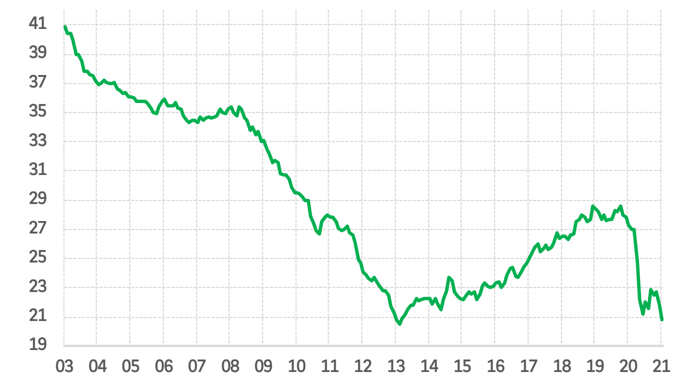

CHART 2 SOURCE: PORTUGAL STATISTICAL OFFICE (INE)

1 Portugal statistical office (INE)

UNITED KINGDOM

THE BRITISH LEAD THE WAY IN VACCINATION

Gambling has risks, but sometimes you win big. No stranger to risky gambles (Brexit, herd immunity to Covid-19...) the UK Prime Minister, Boris Johnson, can now claim that one of his wagers – betting early and big on vaccines – has allowed his country to be amongst the first to see the light at the end of the tunnel. Having been in strict lockdown since the beginning of the year, and whilst also suffering from a collapse in trade with the European Union, the economy now seems to have touched bottom; economic surveys and mobility reports promise better days ahead. Both fiscal and monetary policy will help support the recovery, before thoughts move to addressing the deficit, with the first turn of the screw expected in 2023.

Having been particularly hard-hit by Covid-19[1], the UK is now one of the countries vaccinating most rapidly. With 31 million vaccine doses given since the beginning of the year, coverage of the population has reached 45%, compared to just 17% in the European Union, where delays to the vaccination programme are piling up, as are frustrations with its British supplier. The result is that the pandemic is in retreat in the UK. With the death rate now down to 50 per day (from 1,500 at the peak of the epidemic in January) and the number of new cases at its lowest daily figure since the virus first struck, hope is finally starting to grow. Despite the double whammy of Brexit and the health crisis, the economy has even managed to find some stability.

In January, a strict lockdown and an unprecedented fall in exports to the EU – the result of the reintroduction of non-tariff barriers – caused a further fall in GDP of 3%, coming on top of the drop of nearly 10% in 2020. Since then, however, economic indicators have recovered. This is particularly true of surveys of purchasing managers, which look more optimistic, and the mobility reports from Google, which are showing some signs of movement. The recession in the first quarter is likely to prove less severe than expected, and then to give way to the beginning of a recovery during the spring.

GROWTH AND INFLATION (%)

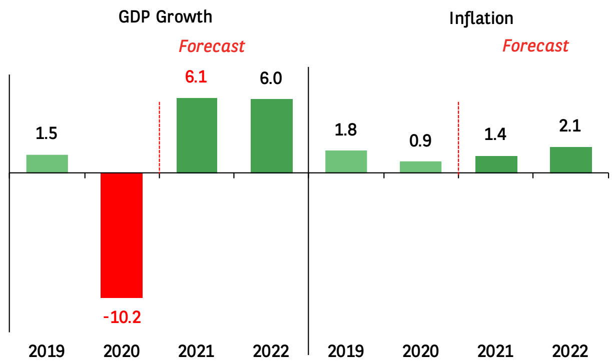

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

GOVERNMENT SUPPORT EXTENDED... FOR SOME TIME TO COME

The policy response will favour recovery over budget equilibrium for quite some time yet. As in most advanced economies where automatic stabilisers are weak, the health crisis has demanded a strong response from the authorities. The International Monetary Fund puts the UK government on the list of those that have done the most to tackle the depressive effects of the pandemic: 16 points of GDP have been engaged in the economy (excluding guarantees, loans and injections of capital), double the effort made in the European Union. As a result, the government deficit – at 16.9% of GDP in 2020, from less than 3% in 2019 – has seen unprecedented expansion.

In his budget, presented on 3 March, Chancellor of the Exchequer Rishi Sunak maintained a resolutely combative approach for the coming fiscal year (April 2021 to April 2022). He plans to devote a further GBP60 billion, or 3 points of GDP, to supporting economic activity, for instance by providing tax incentives for UK businesses to relocate[2]. This is a necessity. With Brexit, foreign direct investment has fallen to zero and has been replaced by net outflows for the first time in 35 years.

Monetary policy also promises to remain accommodating. In line with other major central banks, the Bank of England has supported government measures to tackle the pandemic by stepping up its asset purchase programme (raising target holdings from GBP475 billion to GBP895 billion by year end, or 42% of GDP). It has also brought its policy rate close to zero (0.1% since 20 March 2020). At its most recent meeting, on 17 March 2021, the Monetary Policy Committee noted the improvement in the economic outlook, but indicated that it would not change its policy. The end of "at whatever cost" (increases in business tax, the freezing of tax allowances and rates...) will come later... in 2023.

Completed on 2 April 2021

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1 127,000 Covid-related deaths had been recorded by 2 April 2021, or 190 for every 100,000 inhabitants, one of the highest death rates amongst the members of the Organisation for Economic Cooperation and Development (OECD).
2 Over a two-year period, capital expenditure within the national economic territory can be deducted from taxable profit at a rate of 130%. Estimated annual cost of the measure: GBP12 billion. Source: Office for Budget Responsibility, March 2021.

SWEDEN

THE HEALTH SITUATION IS STILL FRAGILE

After a second, particularly long and severe wave of Covid 19 in late 2020, Sweden has been dealing with a third wave of the pandemic since mid-February. Although the vaccination campaign is unfolding satisfactorily, the resurgence of the pandemic risks pushing back the expected profile of the recovery. Monetary and fiscal policy will remain accommodating as long as necessary.

Since the beginning of the pandemic, Sweden has endeavoured to respond to the health crisis using milder and less coercive social distancing measures and restrictions than most of its European neighbours. At the end of 2020, the country was hit by a second wave of contamination that was especially long and severe, and that only partially dissipated during the month of January. Since mid-February, a third wave has been taking shape with a high level of new contaminations. With more than 1,200 deaths per million inhabitants to date, Sweden has paid a relatively heavy toll, especially compared to its Nordic neighbours, who have been largely spared from the worst of the pandemic.

From an economic perspective, Sweden was hit by a relatively mild recession last year compared to the European average (-3%), similar to the ones reported by its northern European neighbours. The expected recovery in 2021 could nonetheless be delayed by several months if the current vaccination campaign does not rapidly cut short the third wave of the pandemic. After an especially robust Q3 rebound –which explains why Sweden's full-year 2020 performance was better than expected– GDP dipped again in Q4 (-0.2% q/q), pulled down by the second wave's impact on consumption. Sweden is the only Nordic country that reported a slight relapse, while its neighbours continued to benefit from a mild recovery in end-2020.

GROWTH AND INFLATION (%)

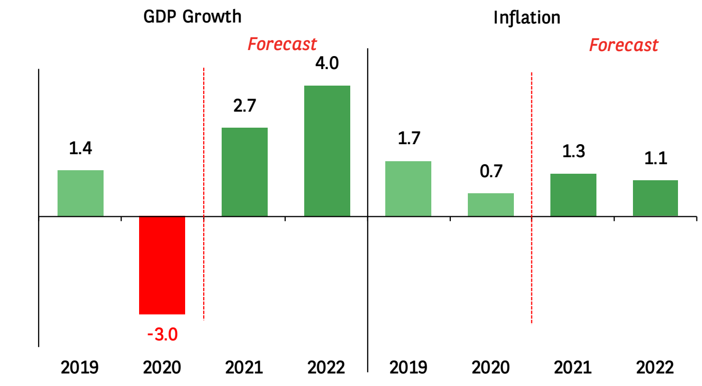

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

NEW CASES PER MILLION PEOPLE (7-DAY AVERAGE)

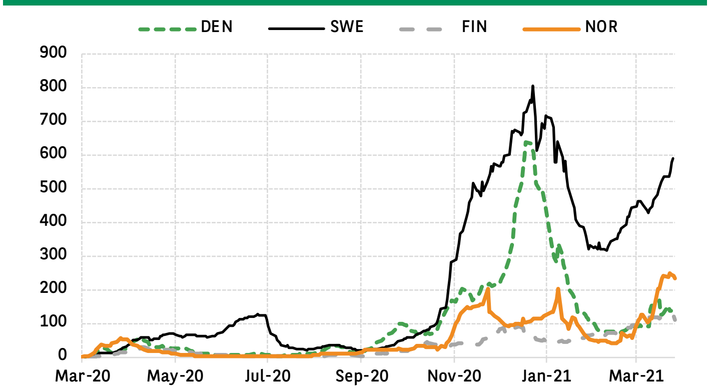

CHART 2 SOURCE: REFINITIV

ECONOMIC OUTLOOK FOR 2021

While the timing is less certain, it is relatively clear which factors will drive the recovery. Consumption will rebound first, fuelled by the end of social distancing measures and the release of "forced" savings accumulated during the health crisis. This will be followed by an upturn in exports (which account for nearly 47% of Swedish GDP), which are already picking up, especially in the manufacturing sector. In the first quarter, trade is likely to be hit by the impact of Brexit (the UK is Sweden's 6th largest trading partner), but it will then get a boost from the global recovery that will accompany the end of the pandemic. Given the high level of uncertainty, however, productive investment is unlikely to recover before 2022. For the moment, total investment expenditure is mainly being driven by a slight upturn in residential investment, in keeping with another acceleration in house prices since the beginning of 2020.

In the labour market, adjustments have hit unskilled and non-resident workers hardest, especially since they tend to be more numerous in sectors like hotel and restaurant services. On the whole, employment declined 1.4% year-on-year in Q4. The jobless rate was still holding at 8.9% in January 2021, compared to 7.2% in the year-earlier period. So far, the upturn in activity has helped reduce the number of workers participating in short-time working schemes. After peaking at 270,000 workers in May 2020, or about 5% of the active population, the number of furloughed workers dropped to 59,000 last December. It is only after the economic recovery gains a second wind that it should be strong enough to fuel a rebound in job creations and a lasting decline in unemployment.

ECONOMIC POLICIES CONTINUE TO PROVIDE SUPPORT

Inflation picked up sharply in Q1 2021, a trend largely linked to a base effect after the drop-off in energy prices in early 2020, but also to the current upturn in oil prices. According to Eurostat, the harmonised index of consumer prices (HICP) rose to 1.8% in February, from 0.6% in December 2020. The Riksbank's target rate (CPIF) followed the same trend and rose to 1.5% in February. Even so, the central bank considers that underlying pricing pressures are still low and are unlikely to rise sharply in the next few months given the underutilisation of production capacity and the strength of the Swedish krona (up about 4.5% from the Q1 2020 average).

Under this environment, the monetary policy status quo will probably be maintained. At its most recent meeting, the Riksbank let it be known that it intended to pursue its securities purchasing programme (with an envelope now set at SEK 700 bn) and will maintain its key rate at 0% at least through the end of 2021. Fiscal policy will be dancing to a similar tune: whereas the initial 2021 finance bill called for SEK 100 bn in support measures (equivalent to about 2% of GDP), four supplemental finance bills have already added another SEK 40 bn in spending.

Completed on 31 March 2021

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DENMARK

AN ALTOGETHER ENVIABLE SITUATION

With relatively few deaths and only a mild decline in GDP in 2020, Denmark has been fairly resilient in the face of the Covid-19 pandemic. To counter a second wave of the virus, more restrictive health measures had to be introduced in early 2021, which will push back the timing of the recovery, albeit without jeopardising it. With its vaccination campaign unfolding smoothly and the extension of fiscal support measures, the country is well positioned to exit the crisis. To better control the krone's peg to the euro, Denmark's central bank has made major adjustments to its monetary policy.

In 2020, Denmark's GDP contracted 3.3%. This decline is smaller than the European Commission's previous estimate and a far cry from the eurozone average (nearly -7% of GDP). The country's resilience is undoubtedly due to the weight of automatic stabilisers, Denmark's economic specialisation (in agricultural and pharmaceutical products, among others) and the successful management of the health crisis.

After a difficult period in late winter, when the pandemic surged and strict lockdown measures had to be introduced, the horizon is looking brighter. The second wave has waned and Denmark has had virtually no new cases of the virus. In early April, the country reported a total death toll of 2,420, which as a percentage of the population, is less severe than in most other countries[1]. Thanks to the rollout of a vaccination campaign (20% of the population has already been vaccinated) and the gradual reopening of businesses, the economy should be able to start up again. The European Commission is forecasting a GDP growth of 3.5% in 2021.

Like elsewhere, exports have been hard hit by the pandemic, notably in services (tourism), which plummeted 17.5% in 2020, while merchandise exports were more resilient (down only 2.6% in 2020). This 2-speed momentum is likely to persist throughout most or all of 2021. Although the tourism sector will remain sluggish until travel restrictions are lifted, merchandise exports should rebound as international trade recovers. In manufacturing, the business climate is already showing signs of improvement. In March, for the first time since summer 2018, the majority of business leaders have reported brighter prospects. Production volumes have picked up strongly (see chart).

MONETARY POLICY ADJUSTMENTS

Unlike most of the other central banks, Denmark's central bank did not resort to quantitative easing. Excess reserves did not soar, and the key reserve rate did not influence money market conditions as much as elsewhere. As a result, the positive Cibor-Euribor spread widened, putting upside pressure on the currency. To better control the krone's peg (DKK 746.038 for EUR 100), the central bank decided to narrow its interest rate corridor, by lowering its key refinancing rate (from 0.05% to -0.35%) and raising the deposit rate (from -0.60% to -0.50%), which is now identical to the ECB's rate. This effectively makes monetary policy more accommodating.

Completed on 2 April 2021

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GROWTH AND INFLATION (%)

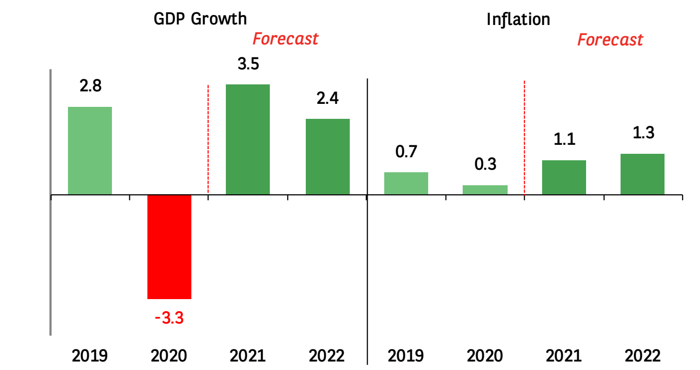

CHART 1 SOURCE : COMMISSION EUROPÉENNE, BNP PARIBAS

THE ECONOMY IMPROVES

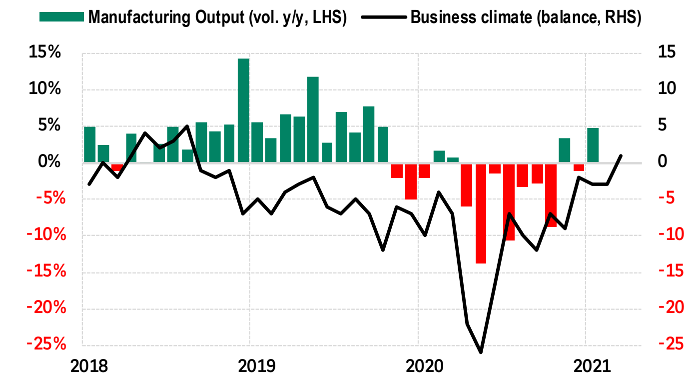

CHART 2 SOURCE: STATISTICS DENMARK

1 In early April 2021, the mortality rate was 41.7 per 100,000 inhabitants, which is nearly 5 times lower than in Belgium and the UK, and 3 times lower than for neighbouring Sweden, which unsuccessfully experimented with herd immunisation.

FORECASTS

ECONOMIC FORECASTS

	GDP Growth				Inflation			
%	2019	2020	2021 e	2022 e	2019	2020	2021 e	2022 e
United-States	2.2	-3.5	6.9	4.7	1.8	1.2	2.5	2.2
Japan	0.3	-4.8	3.0	2.3	0.5	0.0	-0.3	0.0
United-Kingdom	1.5	-10.2	6.1	6.0	1.8	0.9	1.4	2.1
Euro Area	1.3	-6.8	4.2	5.0	1.2	0.3	1.7	1.4
• Germany	0.6	-5.3	3.0	4.8	1.4	0.4	2.1	1.5
• France	1.5	-8.2	6.1	4.4	1.3	0.5	1.4	1.0
• Italy	0.3	-8.9	5.0	3.9	0.6	-0.1	1.5	1.4
• Spain	2.0	-10.8	5.9	5.6	0.8	-0.3	1.3	1.2
China	6.1	2.3	9.2	5.3	2.9	2.5	1.8	2.8
India*	4.2	-7.2	12.5	4.1	4.8	6.2	4.9	4.6
Brazil	1.1	-4.1	2.5	3.0	3.7	3.2	6.5	4.0
Russia	1.3	-4.5	4.0	3.0	4.3	3.4	5.1	4.0

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

FINANCIAL FORECASTS

Interest rate, %		2021					
End of period		Q1	Q2e	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	2.00	2.10	2.20	2.20	2.50
Eurozone	Deposit rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
	Bund 10y	-0.33	-0.20	-0.10	0.20	0.20	0.20
	OAT 10y	-0.11	0.00	0.15	0.50	0.50	0.20
	BTP 10y	0.63	0.70	0.90	1.35	1.35	0.20
	BONO 10y	0.34	0.45	0.60	0.95	0.95	0.20
UK	Base rate	0.10	0.10	0.10	0.10	0.10	0.10
	Gilts 10y	0.88	1.00	1.10	1.20	1.20	1.30
Japan	BoJ Rate	-0.04	-0.10	-0.10	-0.10	-0.10	-0.10

Exchange rate		2021					
End of period		Q1	Q2e	Q3e	Q4e	2021e	2022e
USD	EUR / USD	1.18	1.18	1.20	1.23	1.23	1.18
	USD / JPY	111	111	111	111	111	114
	GBP / USD	1.38	1.39	1.43	1.46	1.46	1.42
EUR	EUR / GBP	0.85	0.85	0.84	0.84	0.84	0.83
	EUR / JPY	130	131	133	137	137	135

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS)

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