ECOPERSPECTIVES

1st Quarter 2025
December 2024

ADVANCED ECONOMIES

> “2025 COULD BE MARKED BY THE BEGINNING OF CONVERGENCE OF GROWTH RATES BETWEEN THE UNITED STATES AND THE EURO AREA, BUT BY DIVERGENT INFLATION TRAJECTORIES AND A DECOUPLING OF MONETARY POLICIES.”

ECONOMIC RESEARCH

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HOW DIFFERENT WILL 2025 BE FROM 2024?

The year 2024 is coming to an end, but political and economic uncertainties persist and are expected to continue into 2025, albeit in new forms. Donald Trump's economic agenda is known. On the other hand, the measures that will actually be implemented, their timing and their economic impact are among the great known unknowns of 2025. In any case, uncertainty itself is expected to be a major drag on growth next year. A convergence of growth rates between the US and the Eurozone is expected in the course of 2025, via a slowdown in US growth. The latter would suffer from the inflationary effects of Trumponomics and the resulting more restrictive monetary policy, with the Fed's expected status quo on rates throughout 2025. In the euro area, the expected strengthening of growth would remain limited and constrained, but the return of inflation to the 2% target would be secured, allowing the ECB to continue its rate cuts. 2025 would thus be marked by the beginning of convergence of growth rates between the United States and the euro area, but by divergent inflation trajectories and a decoupling of monetary policies. Next year should also be different from 2024 by a likely rise in unemployment rates. The possibility of a European revival and the potential introduction of bolder measures to address the region's structural challenges are among the upside risks.

2024 is not quite over yet and there is still a lot of uncertainty as the year draws to a close, but the focus is already on 2025. How different or similar will next year be to this year?

THE WEIGHT OF UNCERTAINTY

One point that 2024 and 2025 both have in common is the high degree of uncertainty adversely affecting the economic environment. This is certainly not specific to either year, as it has been a recurring feature for several years now. The nature and origins of this uncertainty differ over time, but it is actually persisting and even getting more intense. In 2024, the results of the numerous elections over the year were high among these known unknowns. Now that the results of these elections are known, they do create other uncertainties for 2025, however. First and foremost of these uncertainties, is President-elect Donald Trump's planned economic agenda, relating to which measures he will actually implement and when, and what the economic consequences will be both for the United States and the rest of the world (see box). And while some political uncertainties have disappeared, others have taken their place, particularly in France, Germany and Japan. Together, they stand as another impediment to growth[1].

GROWTH RATES WOULD START TO CONVERGE

Growth prospects on both sides of the Atlantic should somewhat continue their 2024 trajectories, with US growth remaining significantly higher than euro-area growth (with the 2025 annual averages standing at 2.1% and 1%, respectively). However, these figures are expected to mask a convergence starting in the course of 2025, with a fairly significant slowdown in US growth anticipated. Eurozone growth rebound is expected to remain limited, constrained by an ever-increasing number of headwinds[2] that will counteract those factors supporting growth[3]. Nonetheless, 2025 should still be slightly better than 2024 (0.8%). In 2026, we expect the US slowdown to continue (1.3%), which is partly why we do not expect a stronger growth rate in the euro area (1%). This slowdown will contribute to a significant narrowing of the growth gap between the United States and Europe. The United Kingdom and Japan are expected to see their economies accelerate quite sharply in 2025 (through a combination of monetary and fiscal support in the United Kingdom and a more supportive momentum of household disposable income in Japan) before slowing down again in 2026 (as the effects of US protectionist measures kick in).

FISCAL CONSOLIDATION AND RISING UNEMPLOYMENT

Unlike 2024, 2025 should see more fiscal consolidation and likely a more marked rise in unemployment rates. Against this backdrop, and despite help from lower interest rates and significantly higher purchasing power gains in 2024, it seems difficult to predict that 2025 will finally see a rebound in consumer spending in Europe and a sharp drop in savings rates. From this point of view, 2025 could look very much like 2024.

Corporate investment is also facing headwinds. On the one hand, there is the easing of financing conditions and the ever more critical need for digitalisation and the greening of production systems, while on the other, there are some signs of deterioration in companies' financial positions, fragile demand and prevailing uncertainty. Over the year as a whole, 2025 could see a deterioration in this growth component compared to 2024. Conversely, residential investment could benefit a bit more from the easing of credit conditions, with a knock-on effect of helping the construction sector to start coming out of the crisis that it has been facing. There are also hopes that the European automotive industry will also start to emerge from its current downturn. However, there is no certainty that the entire industrial sector will see an end to its recession. While the situation could be better in 2025, it should nonetheless be yet another challenging year for industry as a whole (with the aeronautics sector seemingly escaping this trend, with more positive prospects). The dichotomy between the difficulties in industry and the growth engine role of the services sector, one of the characteristics of 2024, is likely to continue into 2025.

INFLATION AND MONETARY POLICY ON DIVERGING TRAJECTORIES ON BOTH SIDES OF THE ATLANTIC

According to our forecasts, diverging inflation trajectories between the US and the euro area are what will primarily distinguish 2025 from 2024 and, as a result, lead to a decoupling between monetary policies.

1 See, for example, the recent work by the OFCE on quantifying the economic cost of uncertainty (https://www.ofce.sciences-po.fr/blog2024/fr/2024/20241203_RS/, 3 December 2024).
2 Increased uncertainty about trade policy, potentially weaker German growth, French fiscal consolidation and higher customs tariffs.
3 Increased real income, easing of credit conditions, buoyant economies in Southern Europe, continued disbursements of NGEU funds, and the likely increase in specific budgetary items (defence and decarbonisation).

We expect US inflation to rise again from Q2 2025 under the effect of Trumponomics 2.0 and this would prevent the Fed from continuing its cycle of rate cuts initiated in September 2024. The Fed will not be able to look through this new pickup in inflation given the still relatively favourable economic and financial backdrop. After an expected final cut of 25 basis points at the December FOMC meeting, we believe that it will opt for a prolonged monetary status quo on Fed Funds, whose target range would be kept unchanged at 4.25-4.50% until mid-2026. It is then expected to resume its rate cuts (we anticipate two of 25 bps each), once inflation reaches its peak according to our forecasts. Even if inflation remains high, US growth falling below its potential pace could enable the Fed to be more forward-looking.

In the euro area, disinflationary pressures should prevail, and the return to the 2% inflation target should be secured in 2025, enabling the ECB to continue the gradual easing of its monetary policy until it reaches the neutral level in the middle of next year.

Specifically, after four rate cuts of 25 bps in 2024, the ECB is expected to continue at this pace at each of the upcoming meetings and should therefore make four further rate cuts in 2025, taking the deposit rate down to 2% in June, which corresponds to the midpoint of our neutral rate range. However, it is likely that the ECB will cut rates below this neutral rate and begin to adopt an accommodative policy if the economy weakens more than we expect.

Overall, there are more downside risks than upside risks in this new baseline economic scenario. However, we will conclude by highlighting an upside one: Europe may bounce back with bolder measures being implemented to address the region's structural challenges[4].

Article completed on 13 December 2024

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4 For more information, read Isabelle Mateos y Lago's editorial, European Silver Linings, 12 November 2024.

TRUMP 2.0: DIFFERENCIATED DIRECT NEGATIVE EFFECTS, WIDESPREAD INDIRECT NEGATIVE EFFECTS

For the United States, our baseline scenario is based on an almost full implementation of Trump's economic platform, based on the following assumptions: A 25 percentage-point (pp) increase in tariffs on Chinese goods (up to an effective rate of around 40%): +10 pp in Q1 2025 and the remaining 30 pp being implemented from Q3 2025 and phased in over four quarters; an average increase of 3 pp in tariffs on other countries (with an overall effective rate of around 5%), starting in Q4 2025 and phased in over four quarters. In the short term, some countries, such as Canada and Mexico, should escape tariff increases. These would also not apply to goods with highly visible prices, such as oil or unprocessed food. TCJA tax cuts are extended and combined with government spending cuts, mainly in social welfare, including some in 2025-2026. The fiscal impulse should be slightly negative compared to 2024. On the immigration side, net new irregular arrivals are forecasted to fall to around 300,000 in 2025 (compared to 1 million in 2024 YTD and compared to a negative net rate of 129,000 in 2019). No large-scale involuntary departures are expected. Deregulation should take the form of a broad pause in new rulemaking, a streamlining of administrative processes, and targeted deregulation measures to support investment, especially in the energy sector.

The net impact (positive minus negative effects) on US growth of this programme is initially expected to be positive over approximately the first six months of 2025. The American economy should continue to show signs of resilience, supported by post-election optimism, before starting to suffer more noticeably because of the new Trump administration's economic policy, in particular its inflationary effects and an ensuing more restrictive monetary policy.

In a qualitative way, among Europe's major developed economies reviewed in our publication, we expect Germany and Italy to be the most vulnerable to increases in tariffs, given their close trade links with the United States, their high bilateral trade surpluses and their sectoral specialisation. The Netherlands is stuck in the middle: the United States is just the fifth largest destination for Dutch exports and the United States has a significant trade surplus with that country, but the Netherlands is also a hub for European trade.

France, on the other hand, appears to be relatively unexposed directly, with bilateral Franco-American trade being rather balanced. The mutual dependence of both countries on the aeronautics industry should also protect this sector. For Belgium and Spain, the direct consequences should also be limited, as both countries export relatively little to the United States. The weight of services in the Spanish economy is another protective factor, as this sector should not be affected by the higher tariffs. The United Kingdom also does not appear very vulnerable, as while there is a trade surplus with the United States, it is very small. Furthermore, the United Kingdom, like Spain and France, is a services-oriented country.

Outside Europe, Japan appears to be doubly exposed, as the United States is Japan's largest export market and China is the second largest. While the direct effects will be more limited for some countries than others, all will be negatively impacted by the all-pervasive uncertainty, but also by knock-on effects (through inputs and lower growth among European partners) and any trade war escalation or retaliatory measures. The net impact in terms of inflation is currently unclear, between the inflationary factors (due to higher tariffs and the depreciation of currencies against the US dollar), disinflationary ones (weaker demand, disinflationary pressures or even deflationary Chinese pressures) and the behaviour of corporates regarding their margins (to what extent they have pricing power and are able or not to protect their margins). The ECB and the BoE are expected to be able to continue their monetary easing by focusing on the downside risks to growth, while the BoJ is set to continue its very gradual tightening.

UNITED STATES

INFLATION SET TO PICK UP AGAIN

A turbulent 2025 is expected to follow a 2024 marked by dynamic growth and the start of a monetary easing cycle. While growth is expected to slow towards its long-term level, the political plans associated with the change of president and Senate majority suggest an increase in inflationary risk. As a result, the Federal Reserve is expected to put a premature end to rate cuts.

BETWEEN RESILIENCE AND « EXCEPTIONALISM »

The dynamism of the US economy continued unabated in the third quarter, as illustrated by the stability of the GDP growth rate at +0.7% q/q. More than ever in this cycle, household consumption is the driving force behind growth. It is underpinned by the catching-up of real incomes, as the year-on-year change in average hourly earnings has exceeded the annual change in the consumer price index since May 2023, and is being maintained by a limited deterioration in the labour market (see next section).

Overall, US economic activity has been particularly resilient to monetary tightening. However, the full effects of this have yet to be felt, particularly through mortgage lending. The size of the growth gap with its counterparts in developed countries links back to the concept of American «exceptionalism». In fact, we expect an average annual growth rate of +2.8% for the United States in 2024, compared to +0.8% for the eurozone and -0.2% for Japan. However, the gap is expected to narrow somewhat in 2025, as quarterly advances in US GDP slow towards their long-term level, to +0.5% q/q in Q1 and then +0.4% in subsequent quarters. As a result, the average annual growth rate would fall to +2.1%.

Our central scenario is changing from a soft landing to an uptick in inflation. The year-on-year price change should have continued to move towards its 2% target without this being accompanied by an economic recession. However, the outcome of the elections and the assessment of their implications for inflation (see related section) suggest that inflation will pick up again from Q2 2025 onwards. This will also have a downward effect on growth, mainly from 2026 onwards.

EMPLOYMENT: AVOIDING A SLIPPERY SLOPE

Labour market indicators continue to reflect a clear softening of the prevailing highly-tight situation at the start of monetary tightening (Q1 2022). Beyond the significant monthly variability (e.g. +78k in August and +223k in September), non-farm payroll job creation is displaying a clear slowdown on an annualised basis (12-month moving average). The annualised rate was +190k in November. The ratio of job vacancies to unemployed people (known as the «v/u ratio», one of the most closely watched gauges of labour market tensions), stood at 1.1 at the start of Q4 2024, compared with over 2.0 when the rate target was raised in March 2022. Finally, the unemployment rate gradually rose in 2024, until it stealthily triggered the recessionary signal of the so-called «Sahm rule». It currently stands at 4.1% (+0.4 pp YTD).

However, this downward trend is not synonymous with a worrying situation in absolute terms. In fact, the state of the indicators mentioned above suggests a less tense but still dynamic market. The current pace of net job creation is fairly robust, while the v/u ratio is only slightly below its pre-pandemic levels. The unemployment rate is still below the estimated neutral level (4.4%, according to the Congressional Budget Office), and the proportion of people unemployed as a result of redundancy out of the total number of people affected is still below the cumulative figure for voluntary redundancies and new entrants or returns to the market. In this respect, the start of the monetary easing cycle in September was intended as a preventive measure to avoid a further deterioration, which could prove more problematic for growth.

GROWTH AND INFLATION

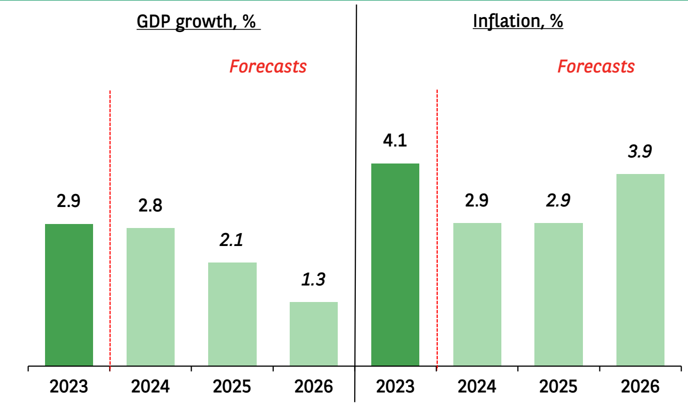

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

THE NEW INFLATIONARY RISK

US disinflation is continuing but has lost some of its momentum. The latest CPI data (November 2024) show a slight rise in the headline index to +2.7% y/y (+0.1 pp), while core inflation is stable at +3.3% y/y. Underlying trends, as measured by the 3m/3m annualised rate, are relatively unfavourable, rising in both dimensions. Inflation in non-energy housing and non-housing services is on a generally downward trend, but the potential for deceleration in the former could be constrained by higher real rates for longer.

Above all, the political plans of the future Trump administration are associated with a significant increase in inflationary risk. The main channels would be trade policy, with the final impact of tariff hikes borne by consumers, and migration policy, with downward pressure on labour supply linked to a significant reduction in the number of new arrivals, which would in turn increase tensions on the labour market. The re-acceleration in inflation is expected to take hold from Q2 2025 (+2.6% y/y, compared to +2.4% in Q1) before continuing, gradually, until mid-2026 (+4.0% y/y in Q2 2026). This would have negative consequences for growth, by squeezing real incomes and having a second-round effect on financial conditions (see section on monetary policy).

THE PERMANENT DEFICIT

The lack of fiscal consolidation following the support linked to the pandemic crisis has set the US budget deficit at new, historically high levels. The most recent projections (June 2024) from the Congressional Budget Office (CBO) put it at 7.0% of GDP in 2024, before averaging at

6.2% over the 2025-2034 period, fuelling the rise in the public debt ratio even more. In addition, Donald Trump's victory comes with upward risks to public finances, as the Committee for a Responsible Budget estimates that the new president's plans will cause the debt/GDP ratio to deviate by 18 pp from current CBO estimates by 2035.

2025 should see the extension of the Tax Cuts and Jobs Act, which came into force in 2018 and whose non-permanent clauses expire at the end of the year. A positive impact on growth, albeit moderate, can be expected via the investment channel. However, the US economy is currently close to full employment, reducing the potential effectiveness of Donald Trump's budget plans. On the other hand, the impact on public finances will almost certainly be negative, due to a loss of revenue that cannot realistically be offset by an increase in the tax base.

At the same time, the configuration of the 119th Congress (2025-2027, with the Senate and House of Representatives predominantly Republican) will in all likelihood provide a quick resolution to the issue of the debt ceiling, whose suspension expires in January 2025, by raising it.

MONETARY EASING THAT HAS FIZZLED OUT?

Comparative developments in inflation and the labour market have led to a rebalancing of the risks surrounding the Federal Reserve's dual mandate. As a result, the Fed was able to initiate a cycle of interest rate easing, with an initial major cut of 50 bps in September followed by a more usual cut of 25 bps in November, taking the target range to +4.5% - +4.75%. However, this phase of easing is likely to come to an end in the short term. The combination of robust growth, the upward momentum of inflation and the contained cooling of the labour market means that, for the time being, further rate cuts are «*not urgent*», as Jerome Powell has admitted. Above all, however, the re-acceleration in inflation from Q2 2025 should force the Federal Reserve to maintain a restrictive monetary policy.

THE NEW INFLATIONARY RISK

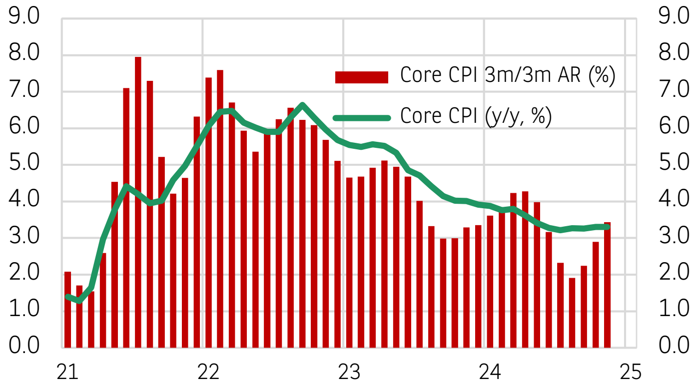

CHART 2 SOURCE: BLS, BNP PARIBAS

We expect a final rate cut (-25 bps) at the December FOMC meeting, before the rate target remains unchanged throughout 2025, at +4.25% - +4.5%. The last meeting of 2024 will also see the publication of the first Summary of Economic Projections (SEP) since the election. Therefore, while Jerome Powell asserts that the Fed does not «*speculate, guess, or assume*» and will not be influenced by political plans until they are implemented, the new projections could provide valuable insights into the vision of the members of the Monetary Policy Committee.

Article completed on 11 December 2024

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TRUMP 2.0

Donald Trump will return to the presidency of the United States for a four-year term beginning on 20 January 2025, following a landslide victory in the presidential election. The former and future president won the popular vote and all seven swing states. At the same time, the Republicans retained control of the House of Representatives and regained a majority in the Senate. This configuration, known as the "trifecta", will give the new president a great leeway to carry out his political plans.

While there is some uncertainty about the timing and scale of the programme's implementation, Trump's fundamentals are centred around four pillars: trade protectionism (tariffs), tax cuts (Tax Cuts and Jobs Act), a particularly aggressive stance on migration issues (mass deportations and a substantial reduction in net new arrivals) and deregulation (which will also apply to environmental issues).

Nevertheless, Trump's election in 2024 comes in a decidedly different macroeconomic environment from the one in 2016. This is illustrated by above-target inflation, fiscal metrics (public deficit and debt as a % of GDP) and substantially higher interest rates. This is part of our scenario on the inflationary risks associated with the president-elect's political plans.

CONSTRAINED ECONOMIC GROWTH

The upcoming protectionist shift in the United States, the structural difficulties in industry and the political instability in France and Germany will limit the eurozone's economic growth margins in 2025. However, the labour market is holding up well in many countries (the unemployment rate in the euro area is still at a record low level). In addition, some of the shock will be cushioned by inflation falling back down to its target level and by the continued cycle of interest rate cuts. Under these conditions, there is still anticipation of a slight increase in eurozone economic growth in 2025, to 1.0%, which will, again, be underpinned by significant differences in growth levels between Member States.

A MORE UNCERTAIN OUTLOOK AROUND STRONGER GROWTH

The scenario of tougher US protectionist measures remains a risk for the time being. However, while this policy will likely be implemented at least partially, it will not affect eurozone countries uniformly. Industry heavyweights, such as Germany, Italy and Ireland, which exported the equivalent of 3% or more of their GDP in goods to the United States in 2023 and which recorded major trade surpluses (principal focus of the Trump administration), are expected to be hit harder. However, trade agreements are possible in the long run, while the continued cycle of interest rate cuts and, to a lesser extent, the expected positive effects of the European Recovery Fund being ramped up on investment (*see box*) will support domestic demand. Differences in growth between Member States are expected to narrow in 2025, but the status quo from 2024 will not change. Spain should pull the eurozone average upwards again, with Italian and French growth standing at around the average level and Germany recording a more sluggish recovery.

LABOUR MARKET: PERIPHERAL COUNTRIES ARE HOLDING UP WELL

The labour market has been remarkably resilient in 2024, with nearly one million additional jobs created in the eurozone during the first three quarters of the year, and stable quarter-on-quarter growth of around 0.2%. There has been sustained employment growth in Spain and Italy, balancing out the declines seen in France and Germany. The eurozone labour market has been cooling but is still tight, with the vacancy rate moving slightly above its pre-COVID level during Q3 2024[1]. Under these conditions, the overall rise in the jobless rate in the eurozone should be fairly small in 2025, thanks, in particular, to economic activity in the peripheral countries holding up well. Nevertheless, if the downturns in Germany and France, which are already clear, were to intensify, this would affect the rest of the eurozone.

MONETARY POLICY: HALFWAY THERE

With four cuts in 2024 (the most recent occurring on 12 December), the process of normalising the eurozone monetary policy appears to be midway through, based on our forecasts. Interest rates are expected to settle at their neutral rate, which we estimate to be around 2%, in June 2025. However, should growth weaken further, the ECB could proceed with more rate cuts, which some members of the ECB's Executive Board have alluded to[2]. At the same time, the ECB will accelerate its quantitative tightening from January 2025, with the reinvestment of maturing securities within the PEPP portfolio being phased out completely.

GROWTH AND INFLATION

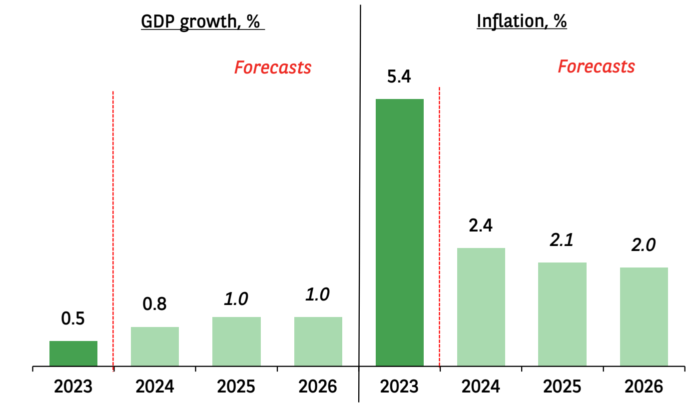

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

INFLATION: DOWN RATHER THAN UP

After a two-year period of uninterrupted disinflation (initially spearheaded by energy, and subsequently by industrial goods and food products), which helped inflation to fall below 2% y/y in September, inflation rose again due to adverse base effects on energy. Core inflation, driven by services, has remained broadly stable since spring 2024. However, some momentum in the services CPI has ebbed away, with an annualised 3m/3m rate dropping to 1.3% in November, its lowest level since August 2021[3]. Therefore, the scenario of core inflation gradually coming down to the 2% target is still intact. In addition, median household inflation expectations fell sharply (2.1% in October for three-year expectations), which is consistent with a continued slowdown in wage growth. Higher customs tariffs in the United States will have limited effects on inflation in the eurozone, as a decline in the euro caused by this policy, which will likely fuel inflation within the monetary union, will be offset by the negative effects on business activity.

FISCAL POLICY: ANOTHER GREAT DIVIDE

In 2025, fiscal policy is expected to be moderately restrictive in the eurozone, with greater control over current expenditure, particularly in Italy. The situation in France is still hanging on the adoption of a budget. Even with the deteriorating public finances of some countries, which have been subject to an excessive deficit procedure[4], we should not overlook the fact that fiscal consolidation has been continuing in the euro area overall. The public deficit is expected to come down close

1 According to Eurostat, the vacancy rate in the eurozone was 2.6% in Q3 2024, compared to 2.5% in Q4 2019.
2 See Financial Times article, *ECB must commit to faster rate cuts, says Bank of Italy Governor,* 19 November 2024.
3 Seasonally-adjusted data.
4 Belgium, France, Italy, Malta and Slovakia.

to 3% of GDP in 2024, compared to 3.6% in 2023. In Italy, the deficit will plummet in 2024, due to the Superbonus and energy subsidies being reduced. In Portugal and Greece, the country's fiscal consolidation and debt reduction are still a major policy focus, which should lead to a further increase in their primary surpluses in 2024.

STRUCTURAL CHALLENGES: A PRODUCTIVE BASE TO BE REBUILT

For the eurozone, generating growth underpinned more strongly by productive investment and productivity gains is still a key challenge. Between 2002 and 2023, hourly labour productivity gains in the eurozone increased by an average of 0.7% each year (compared to +1.6% in the United States[5]). This weaker performance is mainly due to the gap in intangible investments (software and R&D) that has been constantly widening for nearly twenty years. These investments currently account for more than 6% of GDP in the United States (Q2 2024), compared to 3 to 4% in the eurozone.

THE CURRENT ACCOUNT SURPLUS, SUPPORT FOR THE EURO

The eurozone's external accounts are still strong. Over a 12-month cumulative period, the current account recorded a surplus of EUR 425 billion in September, i.e. nearly 3% of eurozone GDP[6]. Although the trade surplus in machinery and equipment has shrunk from its record levels in 2014, due to Chinese competition in this segment in particular, the surplus in chemicals (made up largely of pharmaceutical products) has more than doubled over the decade. Meanwhile, the strength of tourism activity is driving the surplus on services to record levels. The current account surplus remains a support for the currency and the effective exchange rate, which, following a period of decline between 2008 and 2015, has generally been appreciating.

Article completed on 06 December 2024

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EVOLUTION OF REAL GDP IN THE EUROZONE (INDEX 2002=100)

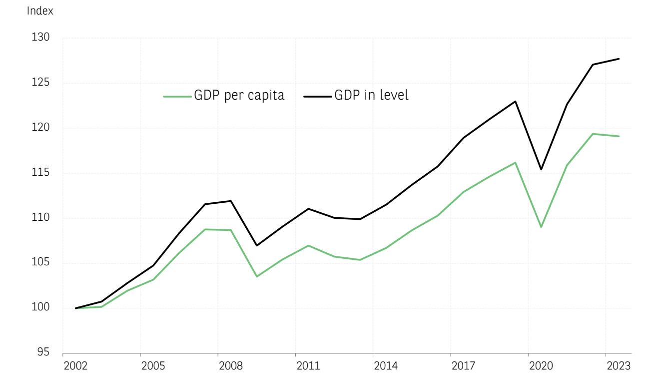

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS CALCULATIONS

DISBURSEMENT OF EU RECOVERY FUND (% GDP)

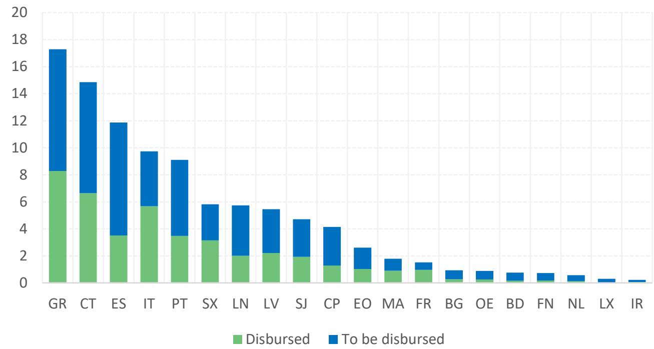

CHART 3 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS CALCULATIONS

5 OECD source. Constant purchasing-power-parity data (2015 basis).
6 Calculated against the 2023 nominal GDP.

EUROPEAN RECOVERY FUND: A RAMP-UP EXPECTED IN 2025

Almost four years after it was introduced (February 2021), the Recovery and Resilience Facility or RRF, commonly known as the "European Recovery Fund", has allocated less than half of its funds. At the beginning of December 2024, EUR 270 billion had been transferred to European Union Member States (EUR 95 billion in the form of loans and EUR 175 billion in the form of grants) out of a total budget of EUR 648 billion. With the official payment period spanning until the end of 2026, the next two years should see payments sped up, with more noticeable effects on investment as a result. This is the expectation of the European Commission, which, in its assessment of the medium-term fiscal-structural plans[1], stated that the absorption rate would increase to 0.4% of GDP in 2025. So far, the impacts on investment have been rather limited, and the mid-term report published by the European Commission in February 2024 highlighted a series of obstacles to distributing these funds on the ground, which are mainly administrative issues (such as higher procedural costs and a lack of human resources), but also the substitution effects between RRF funds and the EU Cohesion Policy programme.

1 See 2025 European Semester: Autumn package, European Commission, 26 November 2024.

GERMANY

REFORMS OR DECLINE

After outperforming between 2005 and 2018, German growth has since underperformed. Germany is the only major European economy to have seen its GDP stagnate for the third year in a row, due to the weakness of its industry (reflected this year in site closures and a moderate upturn in unemployment). The relative persistence of inflation and a fiscal policy limited by the debt brake rule are also weighing on the recovery potential. Finally, at a time when Germany is already being penalised by a lack of investment and high energy costs, it is vulnerable to a possible increase in US tariffs.

NO RETURN TO GROWTH IN THE SHORT TERM

According to our estimates, German GDP growth should be slightly negative in 2024 (-0.1% on annual average), as was the case in 2023, a pattern that the country already experienced in 2002 and 2003 (-0.2% and -0.5%), before a very moderate upturn in 2004-05. In our view, this is again what we can expect for 2025-26. Business surveys do not indicate any significant rebound in the short term. In November, the IFO business climate index fell back close to the level seen in September, which was already at its lowest since May 2020. Industry is the weak link. Indeed, the business climate in this sector (-21.9 in November) has only been getting worse during the recessions of 1993, 2008 and the COVID-19 crisis. Capacity utilisation even fell by almost 6 points in one year, to 76.3%, in Q4 2024, to such an extent that capacity destruction is expected in the automotive, chemicals and metalssectors, which is likely to have a negative impact on growth.

FAREWELL TO FULL EMPLOYMENT?

Germany is likely to see a return of unemployment in the coming months, after reaching a low of 2.9% in May 2019 and again in 2022. In industry, a third of companies saw their production limited by labour shortages at the end of 2022; they are three times less at the end of 2024. Fears of unemployment are at the heart of the sharp drop in household confidence in November 2024 (-5 points to -23.3), even as announcements of redundancy plans have multiplied. This dynamic should justify maintaining a high savings rate in 2025, and therefore moderate growth in household consumption.

However, the return of unemployment does not mean mass unemployment, and while industry plays an important role in Germany, the dynamics of the other sectors differ: in services, the proportion of companies where production is limited by labour shortages (27% in Q4) is not so different from two years ago (29%). Moreover, population trends suggest that major labour shortages will persist over the long term.

INFLATION: A GERMAN PECULIARITY

While household confidence has deteriorated, it is also due to the higher inflation the country is experiencing compared with its eurozone partners. Using our forecasts and comparing the general price level in 2025 with its pre-COVID level, the increase is almost 22% in Germany, compared with almost 4 to 5 points less in Spain, Italy and France. This difference can be explained, in particular, by a more marked rise in energy prices in Germany.

The sluggishness with which past inflation is passed on to negotiated wages (biennial bargaining), which rose by 8.8% y/y in Q3 2024, also explains the greater persistence of inflation. Even today, core inflation remains high (3.4% y/y in October) and is likely to remain above 2% throughout 2025.

GROWTH AND INFLATION

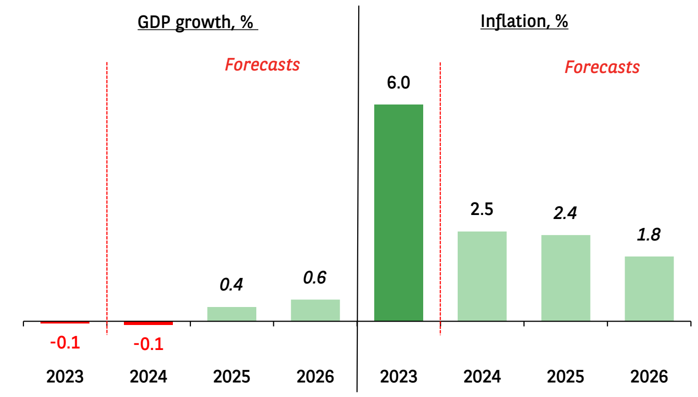

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PUBLIC FINANCES: RELEASING THE BRAKE PEDAL

Apart from exceptional periods (COVID crisis), when the room for manoeuvre was used, the debt brake rule limits the structural deficit to 0.35% of GDP. This rule has stabilised public debt at a level close to 60% of GDP (63% in 2024). It should be noted that a public investment effort, budgetary support for the green transition or an increase in the defence budget are not among the exceptions justifying an additional deficit.

The application of this principle prompted the withdrawal of subsidies for the purchase of electric vehicles in December 2023 (which resulted in a sharp fall in car sales and production). Moreover, it was a disagreement on this principle within the government that precipitated the break-up of the governing coalition in November. Reforming the debt brake will be one of the issues at stake in the early election on 23 February 2025. However, the time needed to build a new coalition means that a little patience is required to see German fiscal policy evolve.

FOREIGN TRADE: BROKEN-DOWN

In a country where exports account for almost 42% of GDP, their sluggishness is affecting GDP growth. In Q3 2024, exports of goods and services were 2.2% below their Q1 2023 peak. The damage is profound, since exports to the eurozone and China have stagnated compared with the pre-COVID period. This sluggishness is set to continue, in the absence of a sharp upturn in demand from these two regions, but also because of growing competition from China. Only exports to the United States have recently continued to grow, but the outlook is now uncertain (*see box*).

STRUCTURAL CHALLENGES: TWO AREAS OF TRANSFORMATION

The period of low growth mentioned above (negative in 2002-03 and weak in 2004-05) ended with fundamental reforms, including the Hartz Act, which made the labour market more flexible. However, Germany has reached the end of the model based on increasing the employment rate by achieving full employment at the end of 2018. This only makes accumulated delays more visible. Let's hope, however, that Germany will ultimately be able to make the necessary decisions, as it did in the early 2000s.

The first delay concerns investment, particularly public investment. In this area, no decision can be made until the political situation is clearer, and not before the second half of 2025. The second delay concerns the transition of the economy towards services. The reason why German growth is so low, apart from the fall in industrial production, is also because GDP from services is not taking over. Once again, this is a sign that investment is falling short of what it could be. On average, Germany has spent only 3.8% of its GDP on investments in intellectual property products over the past five years (compared with 5.1% in France). If more budgetary incentives are needed to get the ball rolling, there is room for manoeuvre in the budget, but their implementation depends on a relaxation of the debt brake rule.

Article completed on 05 December 2024

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GERMANY'S (DE) CONTRIBUTION TO EUROPEAN UNION (EU) TRADE SURPLUS WITH THE US (EUR BN)

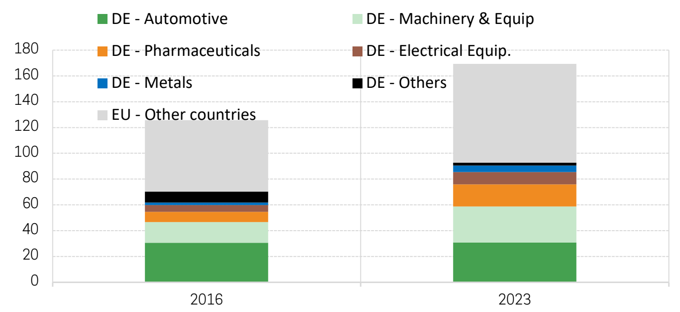

CHART 2 SOURCE: IMF, DESTATIS, BNP PARIBAS

GERMANY: CAPACITY UTILIZATION RATES (%)

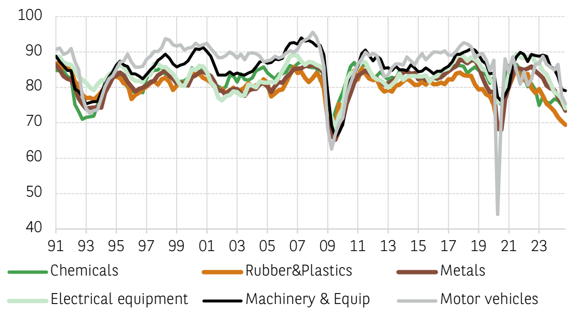

CHART 3 SOURCE: DG ECFIN, BNP PARIBAS

GERMANY VULNERABLE TO TRUMP 2.0

While energy production prices in Germany were 52% higher in September 2024 than in the summer of 2021, they were only 7% higher in the United States. For a country specialising in energy-intensive sectors, this is a more than significant problem of competitiveness, compounded by the lag in investments, including in the manufacturing sector. For example, while the market shares of the United States and Germany in world exports were comparable before the energy crisis, the United States' market share has not been challenged since, while Germany lost 1 percentage point of market share to 7.1% in 2023.

The paradox lies in the fact that the United States has been the only major growth market in recent years for German exporters, who have benefited from the resilience of US growth. However, German bilateral surpluses by product have only increased, leaving the country particularly exposed to an increase in US tariffs. Moreover, this exposure also extends to third markets from which German companies have been increasingly exporting to the United States, including Mexico. German exports to Mexico increased by 33% between 2019 and 2023 (thus contributing, along with other countries including China, to Mexico's surplus with the United States, which doubled between 2016 and 2023, reaching almost USD 220 bn).

The anticipated effects of a future increase in tariffs (which we are taking into account in our forecasts) are likely to have an immediate negative impact on German growth, which would then be affected by its implementation (with a particularly pronounced impact on growth in 2026).

The main sectors of German industry are in the front line, either because they could be directly targeted (the automotive industry), or because they are inputs into these sectors (metals, chemicals, plastics and rubber). These are sectors that would have little capacity to absorb such a shock, as they are already affected by a significant under-utilisation of production capacity.

FRANCE

GROWTH ERODED BY UNCERTAINTY

France's economic growth is set to slow over the next two years, and the unemployment rate is set to rise, at a time when the gains in purchasing power associated with disinflation are behind us and political uncertainty is likely to weigh heavily. A difficult period that could be cushioned by a rebound in aeronautical production, but which could also see the materialistion of downside risks weighing on trade opportunities in Germany and the United States. One of the challenges for France will be to achieve fiscal consolidation without affecting its attractiveness, and in particular the ability of its labour market to create jobs when the recovery takes hold.

GDP GROWTH WEAKENS

While growth in 2023 and 2024 (according to our estimates for the latter) was just over 1%, it is expected to fall below this threshold in 2025 and 2026. Business sentiment has been below its long-term average (100) since October 2023, but its decline accelerated from July 2024, reaching 96 in November. This deterioration was offset, until September 2024, by the rebound in household confidence from 81 in March 2023 (when inflation peaked) to 95, due to disinflation. This augured resilient growth and a change in determinants (less business investment vs. more household consumption). However, the sharp downturn in household confidence, from 95 to 90 between September and November, highlights the likelihood that household spending will not pick up the slack from business spending and that growth will suffer as a result.

UNEMPLOYMENT ON THE RISE

The deterioration in household sentiment is linked to the fear of a rise in unemployment (the balance of opinion on the outlook for unemployment rose from +28 to +42 between September and November 2024).

The noticeable deterioration in the manufacturing industry, linked to the absence of a rebound in demand in France and in the eurozone (including Germany), led to the first job losses in the sector in Q3 (1,700) since Q3 2017 (excluding the Covid-19 period). Market services, whose momentum has clearly run out of steam (an average of 4,500 net new jobs created over the last four quarters, compared with 36,000 over the previous four quarters), are set to follow suit. We expect private sector employment to fall by almost 100,000 jobs in 2025. This should accentuate the rebound in the unemployment rate, which remains moderate for the time being (from 7.1% in Q1 2023 to 7.4% in Q3 2024), to 8.5% in Q4 2025.

DISAPPOINTING DISINFLATION

Inflation slowed sharply in 2024 (1.7% y/y in November compared with 3.9% y/y a year earlier) and is now lagging behind wage growth (+2.3% for inflation compared with +3% for gross monthly wages on average in 2024), and even more so behind that of gross disposable income (GDI). The latter has also benefited from the rise in social benefits (+5.9% according to our estimate) due to their indexation to (high) inflation in 2023 – hence an increase in real GDI that we estimate at +2% in 2024.

However, this disinflation is not widespread. Inflation in services (half of the household consumption basket) remained at 3.1% y/y (harmonised index) in November 2024. This divergence is likely to remain significant in 2025. While average inflation should be closer to 1%, inflation in services is expected to remain above 2%, mainly due to the foreseeable rise in healthcare costs (consultations and supplementary health insurance) and insurance costs (home and car insurance). Wages should

GROWTH AND INFLATION

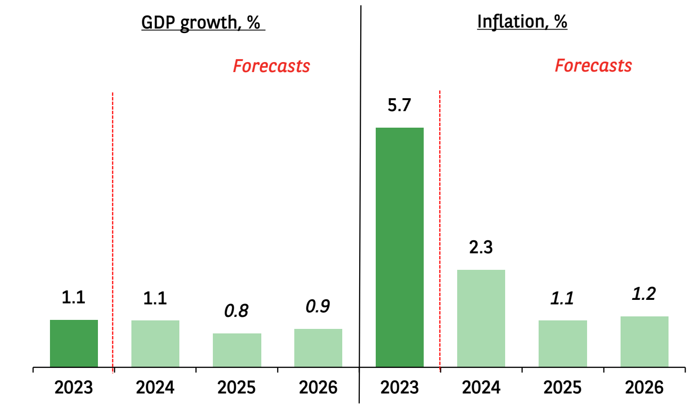

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

continue to rise slightly faster than inflation (+1.5% in 2025). However, real GDI is expected to stabilise, as it is not benefiting from the same dynamics as in 2024. As a result, growth in household consumption in 2025 is set to remain the same as in 2024 (+0.8%).

BUDGET: UNPLEASANT ARITHMETIC

In 2023 and 2024, the budget deficit was clearly out of sync between the initial Budget Acts and budget implementation (4.4% compared with 6.1% of GDP in 2024), a phenomenon linked to government choices (indexation of benefits to the high inflation of 2023) and unpleasant surprises on the revenue side (including the impact on VAT receipts of the weak growth in household consumption). In addition, from 2025 onwards, as nominal GDP growth falls due to the end of the inflationary period, the level of the public deficit stabilising the debt ratio should fall to 3% of GDP (from 7% in 2023). However, as the motion of no-confidence passed on 4 December should result in the 2024 budget being extended, at least for the first few months of 2025, the prospects for consolidation are at the very least postponed. However, at the level of the public deficit seen in 2024 (6.1% of GDP), the debt-to-GDP ratio would increase by three points per year and debt servicing would reach 3% of GDP in 2027 (compared with 1.8% in 2023), a dynamic that must be halted as soon as possible. If no new budget is adopted in 2025, we estimate that the extension of the 2024 budget could result in a deficit of 6.7% of GDP.

THE SWORD OF DAMOCLES HANGING OVER FRANCE'S ATTRACTIVENESS AS A BUSINESS LOCATION

Budgetary uncertainty must not be allowed to undermine the three-pronged strategy that has underpinned French growth over the past ten years: the labour market (reducing labour costs, reforms, increasing the employment rate), the business climate (reducing taxes on businesses and making it easier to set them up) and the development of services (also supported by the other two pillars). These three elements have fuelled the country's attractiveness to investors as well as an unprecedented wave of business creations.

However, while fiscal consolidation is necessary, it must not be to the detriment of these three elements. Budgetary support for employment (particularly apprenticeships) and tax stability for businesses were questioned during the preparation of the 2025 budget. While the rejection of this budget maintains a favourable budgetary framework in the short term, it does not remove doubts about the paths that further budgetary consolidation could take. This uncertainty is likely to penalise investment decisions in France over the coming quarters: investment by non-financial companies is likely to fall by 2% in 2025, after already falling by 1.7% in 2024.

EXPORTS: A GROWTH DRIVER IN 2025?

Foreign trade made a paradoxical contribution to French growth in 2024, with a positive net contribution that we estimate at 0.9 points, but which was largely due to the fall in imports (-1.3% y/y). The aeronautical industry was absent from the picture, owing to serious production difficulties that prevented it from ramping up to meet a full order book. As a result, this sector contributed just 0.2 points to export growth over the first three quarters of 2024 (+1.6% y/y), compared with 2.1 points in 2023. A rebound in aeronautical production in 2025 would therefore help to offset the more negative factors (*see box*).

Article completed on 05 December 2024

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FRANCE: MAIN EXPORTS TO THE US VS. IMPORTS (EUR BN)

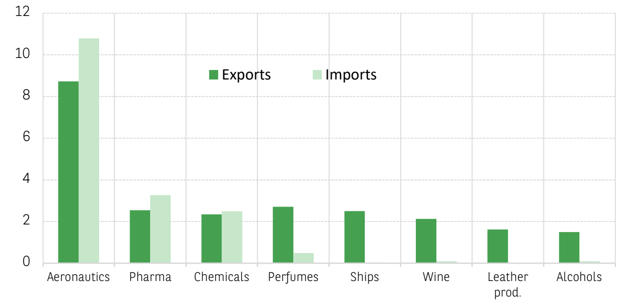

CHART 2

SOURCE: FRENCH CUSTOMS, BNP PARIBAS

FRANCE'S EXPORTS TO GERMANY (EUR BN)

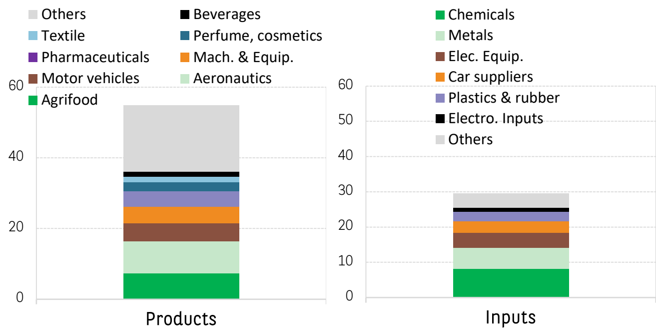

CHART 3

SOURCE: FRENCH CUSTOMS, BNP PARIBAS

PROTECTIONIST RISK: DIRECT OR INDIRECT EXPOSURE?

Bilateral trade between France and the United States is relatively balanced, with France even recording a slight deficit (EUR 5 billion over the last twelve months to the end of August).

This is also the case for aeronautics (France's leading export sector to the United States, but with a deficit of EUR 2 billion), where there is also a high degree of interconnections (joint venture in engines, use by Airbus and Boeing of numerous subcontractors on both sides of the Atlantic). Protectionist measures that would limit trade in this sector would therefore be detrimental to both partners, especially as it is already struggling with supply constraints linked to the difficulties encountered by its subcontractors in increasing their production, and the relative absence of competitors in a high-tech sector.

Otherwise, France's bilateral surpluses are in sectors where the US is less present (beverages, luxury goods). These sectors could be exposed to a risk of retaliation if, following initial US measures, a European response were to precipitate a new round of tariff increases by the United States.

On the other hand, France would probably be more immediately exposed to the impact of tariffs imposed on sectors on which the German economy depends (13.3% of French exports, compared with 7.8% for the United States). Germany accounts for half of Europe's trade surplus with the United States (*see the box in our text on Germany*). What's more, industrial inputs account for 40% of French exports to Germany. This is a key issue in explaining the decline in French exports to Germany since mid-2023 (-4.5 bn y/y cumulative over twelve months). This trend shows that, in the short term, France is more exposed to the risk, which is already present, of a partial de-industrialisation of Germany (which could be exacerbated by the rise in US tariffs).

ITALY

THE SUMMER BREAK FOR THE ITALIAN ECONOMY

In Q3 24, real GDP remained unchanged. Domestic demand added 0.5 percentage points to the overall growth, while the net exports contribution was negative. The economic slowdown reflects the disappointing performance of manufacturing (-1.3%), while the services value added rose 6.5% above pre-crisis level. Italian exports have been declining in the last year and a half. The potential implementation of new measures to protect US production by the new US administration might have a significant impact on the Italian production system. The Italian trade surplus with the US in the first eight months of 2024 stood at EUR 26.5 bn, about 70% of the overall trade surplus.

DOMESTIC DEMAND REMAINS THE MAIN DRIVER OF ECONOMIC GROWTH

Over the summer, the recovery of the Italian economy came to a halt. In Q3, real GDP remained unchanged, after +0.3% q/q in Q1 and +0.2% in Q2. Domestic demand added 0.5 percentage points to the overall growth. The net exports contribution was negative (-0.7 pp), as exports posted their third consecutive decline (-0.9%), while imports rose by 1.2%. The contribution of inventories was +0.2 pp. In Q3, real GDP rose by 0.4% y/y and by 5.6% compared to Q4 2019.

In 2024, the Italian economy is expected to grow by 0.5% according to our forecasts. In 2025, real GDP should gradually accelerate, benefiting from the further implementation of the NRRP and the acceleration of consumption, while the fiscal stance should become less supportive.

INCREASING PURCHASING POWER SUPPORTS HOUSEHOLD CONSUMPTION

Labour market conditions have further improved. The number of people employed has risen above 24 million, with the employment rate at 62.5%, 3 percentage points more than in 2019. Nominal wage growth has accelerated: from January to September, hourly contractual wages rose by more than 3%.

After falling to 0.7% y/y in September, inflation picked up to 1.6% in November, remaining well below Euro area average (2.3%). The acceleration reflected the monthly increase of prices of food products (+3.2% y/y, from +2.5% in October) and energy (-5.4% y/y, from -9%). In 2024 as a whole, inflation is expected to be slightly above 1%. In the years ahead, the evolution of prices should remain moderate, except in the services where wages are expected to exert further upward pressure.

As nominal income has increased more than inflation, the purchasing power of Italian households has recovered, sustaining private consumption, which rose strongly by 1.4% q/q in Q3 (+0.2% in Q1 and +0.6% in Q2), adding 0.8 percentage points to the overall growth. Consumer confidence remains above long-term average, despite the persisting uncertainty surrounding the overall scenario. In 2025, consumption is expected to accelerate, as nominal income should continue to increase more than inflation.

DISAPPOINTING INVESTMENT

Economic conditions for Italian companies have slightly deteriorated, as higher costs partly eroded economic margins. Although the annual growth rate has fallen into negative territory, producer prices in the manufacturing sector are still about 20 percentage points higher than at the beginning of 2021. Labour costs of non-financial corporations rose to almost EUR 150 bn, more than 55% of the value added. The profitability of companies, measured by the ratio between the gross operating surplus and the value added, declined to 42.6%, slightly above the lowest level in the last twenty years. Although still above the long-term average, business confidence has deteriorated. As a result, the propensity to invest has declined, also reflecting the uncertainty about the implementation of new fiscal incentives to support expenditure on machinery and equipment. In Q3, gross fixed capital formation recorded its third consecutive decline (-1.2%), subtracting 0.3 percentage points from GDP growth.

GROWTH AND INFLATION

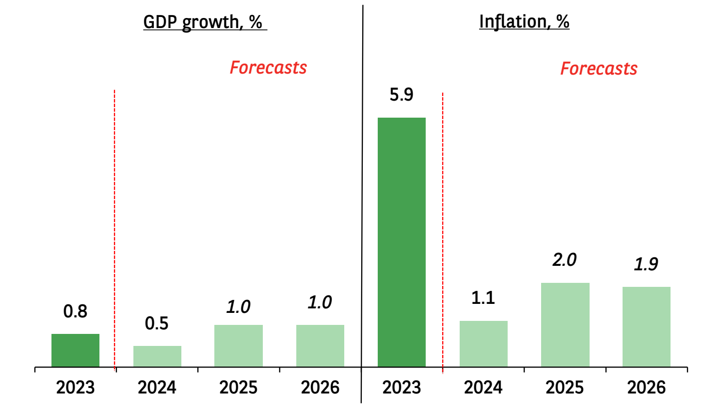

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A MIXED PERFORMANCE BY SECTOR

On the supply side, the slowdown of the Italian economy mainly reflects the disappointing performance of industry. In Q3 2024, manufacturing value added posted its eighth contraction in the last nine quarters (-1.3%). Production, which had increased by almost 3% in the first part of the recovery, has declined by 7% over the last two years, falling about 4.5 percentage points below pre-crisis level. The decline was stronger in more energy-intensive sectors, such as wood and paper, metals and chemical products. Production of textile products, clothes and leather items fell by more than a quarter compared to Q4 2019, also due to a long-term structural decline in activity.

The disappointing performance of the manufacturing sector reflects the slowdown of exports of goods, which have been declining in the last year and a half. In the twelve months ending in September, the value of Italian sales abroad fell to around EUR 620 bn, about EUR 20 bn below their value at the beginning of 2023. Italian companies are suffering as a result of the weakening of German economy, with total exports falling by 5.5% from January to September, with transport exports plummeting by more than 20% and metal products dropping by 12%.

The performance of the construction sector remains mixed. In Q3, the value added rose by 0.3% q/q, partly recovering from the previous decline (-0.7%). The residential sector is suffering as a result of both the phasing-out of fiscal incentives for housing renovation and the stubbornly high financing costs. Residential building permits have declined, signalling the risk of weakening activity in the coming quarters. Signs of resilience seem to come from non-residential buildings, which should be sustained by RRF-related spending.

Services are still the main driver of growth. In Q3 2024, value added increased by 0.2% q/q, after +0.6% in Q1 and +0.3% in Q2, rising to 6.5 percentage points above pre-crisis level. Services are benefiting from the recovery of tourism. From January to August, expenditure by foreigner travellers in Italy rose to EUR 38.5 billion, well above the same period in 2019, while the number of travellers increased to 62.8 million, 3.4 million more than in 2023.

A CAUTIOUS PUBLIC FINANCES STANCE

The EU Commission has approved the first Italian medium-term fiscal structural plan, based on a seven-year adjustment path, with a wide program of investments and structural reforms, ensuring continuity with those of the NRRP (judiciary, public administration, digitalization, competition and business environment). The Plan envisages a relatively rapid exit from the excessive deficit procedure launched by the EU Council in July 2024.

The public deficit is expected to drop below 4% of GDP in 2024, from 7.2% in 2023. The positive effect of the phasing-out of both measures to mitigate the impact of high energy prices and tax credits for housing renovations with the better-than-expected performance of tax revenues will be only partly offset by cuts to the labour tax wedge.

The draft budget for 2025-27, currently under discussion in the Italian Parliament, has a net expansionary effect of 0.4% of GDP in 2025, 0.6% in 2026 and 1.1% in 2027, when compared to the current legislation. The public deficit is expected to slightly decline in 2025 and then fall below 3% of GDP in 2026. Because of slower nominal growth, the debt-to-GDP ratio is expected to slightly increase, also reflecting the delayed impact of the tax credits for housing renovations, rising to 138% of GDP in 2026 and then falling in the years after.

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HIGH EXPOSURE OF ITALY TO HIKES IN US TARIFFS

The start of the new Trump presidency, and the potential implementation of new measures to protect US production, are expected to have a significant impact on the Italian production system, due to the strong commercial ties between the two countries.

The weighting of the United States in Italian foreign trade has been growing in recent years, and in 2022, the United States became the second destination for Italian exports, overtaking France. In the first eight months of 2024, 10.4% of Italian sales abroad went to the United States (for a value of EUR 43.3 bn). In the same period of time, the United States accounted for 4.5% of Italian imports (EUR 16.9 bn). The Italian trade surplus with the United States in the first eight months of 2024 therefore stood at EUR 26.5 bn, equivalent to approximately 71% of the overall Italian trade surplus.

On the US side, in 2023, Italy had the tenth largest trade deficit to the country. However, the deficit with Italy accounted for less than 1% of the US's overall trade deficit.

US multinationals also have a major presence in Italy. In 2022 (latest available data), they ranked second in number (2,603) but first in terms of employees (around 351,000), value added and turnover. In the manufacturing sector alone, US-controlled multinationals in Italy contributed 8.1% to the total value added. An analysis conducted by Istat shows that, in 2021, US multinationals in Italy in the pharmaceutical sector accounted for 46.1% of the sector's exports, while this same figure was 10.6% for the chemical sector. In terms of imports, in 2021, US multinationals generated over 54% of Italian imports of coke and refining products, and shares between 25 and 45% of imports of food, electrical equipment, machinery and furniture. With specific reference to Italy-US trade flows, in 2021, US-controlled multinationals in Italy were behind 11.7% of exports of transport (other than automobiles) to the US, as well as 8.9% of exports of machinery and 8.4% of exports of rubber and plastic.

CAN THE DRIVING FORCE BEHIND EUROPEAN GROWTH SUSTAIN ITS MOMENTUM?

Spain's outperformance is set to continue throughout our forecast horizon. Private consumption is expected to remain the driving force behind GDP growth, buoyed by slowing inflation and a strong labour market. The contribution of foreign trade is expected to fall due to an anticipated increase in imports and the potential second-round effects of higher US customs tariffs on Spanish exports. Investment is expected to recover, buoyed by NGEU funds and monetary easing. Finally, even though there is no draft budget for 2025, fiscal consolidation is expected to continue over the next two years.

NO CLOUDS ON THE ECONOMIC HORIZON

Spanish economic activity remained buoyant throughout the first half of 2024, mainly driven by foreign trade and the gradual recovery in private consumption. Based on the preliminary growth figures for Q3 and the initial data available for Q4, we expect growth to remain dynamic throughout the second half of the year. According to our forecasts, real GDP should grow 0.7% q/q in Q4, bringing average annual growth in 2024 to 3.1%, still significantly outperforming eurozone growth (0.8%).

Throughout our forecast horizon, we expect growth to be largely driven by private consumption, which itself is being boosted by the momentum of the labour market, growth in nominal wages and a slowdown in inflation, which are pushing up household purchasing power. In addition, investment should steadily recover, due to the gradual disbursement of funds from the European Union recovery plan, the monetary easing policy initiated by the ECB and the improving financial situation of non-financial corporations[1]. Public consumption will also be boosted by the release of European funds. The positive contribution of foreign trade to growth should gradually decrease. Service exports are likely to remain high in the coming years, due to continued high tourist flows, in particular. However, imports should also grow, buoyed by domestic demand. As a result, Spain would remain the eurozone's driving force over the next two years, even though its growth is expected to slow gradually (2.5% in 2025 and 1.8% in 2026).

Despite these good prospects, the balance of risks surrounding our central scenario is still negative. The implications of higher customs tariffs on exports to the United States (see box), global energy and geopolitical pressures and a potential economic downturn among Spain's main trade partners are uncertainty factors, which could adversely affect our scenario.

IMMIGRATION WILL CONTINUE TO BOOST THE LABOUR MARKET

The strength of the labour market, observable since 2021, remains one of the main sources of Spain's real and potential growth. The number of people registered with social security has been constantly increasing (21.3 million in October, i.e. +3.5% since the start of the year) and is expected to continue to do so in 2025 and 2026, mainly driven by the immigrant workforce (+5.8% year-on-year and 15.1% of the total number of registered employees in Q3). In addition, the unemployment rate has fallen sharply (11.2% in November, compared to 13.5% in November 2021). In the medium term, it should get close to its equilibrium level of 9.6% in 2026, according to the Spanish government's forecasts, which is still well above the eurozone average (6.3%[2]).

GROWTH AND INFLATION

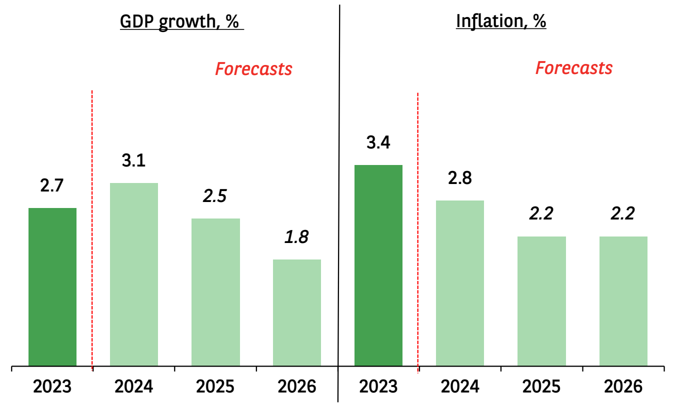

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A GRADUAL SLOWDOWN IN INFLATION

Since peaking at 10.5% y/y in August 2022, harmonised inflation has slowed sharply (2.4% in November 2024, according to a flash estimate from Eurostat). Due to the continued deceleration in energy and food prices, this trend is expected to persist in 2025 and 2026 (2.2% on annual average, respectively). However, core inflation is expected to remain higher over the period due to pressures on service prices, caused by strong tourism demand and wage tensions (negotiated wages were up 3.0% y/y in Q3 2024).

THE LACK OF BUDGET FOR 2025 IS NOT DAMPENING THE OUTLOOK FOR PUBLIC FINANCES

Given its minority position in Parliament, Pedro Sanchez's government is struggling to pass its legislative initiatives. After extending the 2023 budget in 2024, the Public Treasury will do the same thing in the early months of 2025, as no budget proposal for the coming year has been presented. Therefore, there has been no clear announcement about the outlook for public finances. Nevertheless, we expect the budget deficit to decrease over the next two years, due to lower public spending (in particular, due to the end of support to the private sector in response to rising energy prices) and higher revenue (higher social-security-contribution revenue due to the increase in the number of employees and the end of reduced VAT on basic foodstuffs).

1 Non-financial corporations debt levels are at their lowest in 22 years (81.3% of GDP in Q2 2024).
2 European Commission Forecast.

HIGHER US CUSTOMS TARIFFS: THE IMPACT ON SPAIN WILL BE LIMITED

Unsurprisingly, Spain will not be the eurozone country hardest hit by higher customs tariffs on exports to the United States. On the one hand, its strong dependence on the services sector (75% of gross value added) significantly protects it from increases in customs tariffs; on the other hand, Spain's direct exposure to the United States is quite low (the share of total Spanish goods exports to the United States only accounts for 5.4% of total Spanish exports, i.e. 2% of GDP), so the first-round impact, via the trade channel, will be small.

Nevertheless, it seems clear that second-round effects of the slowdown in growth of its main European trading partners (Germany, France and Italy) will affect Spanish exports to these countries and adversely affect domestic activity over the next two years.

This reduction in the public deficit[3], combined with the strong nominal GDP growth anticipated in the coming years, should help to reduce the public debt ratio further. However, it is expected to most likely remain above 100% over the forecast horizon.

SPAIN'S NET INTERNATIONAL DEBTOR POSITION CONTINUED TO IMPROVE IN 2023

Over the past decade, Spain's current account has remained in surplus (1.7% of GDP on average between 2012 and 2023). After declining due to the pandemic, this surplus increased in 2023 (2.7% of GDP) thanks to the sharp drop in energy prices and the significant surplus in the services balance (caused by the boom in the tourism industry). This recovery, combined with strong nominal GDP growth, has helped Spain's net international investment position to improve since 2021 (from -72.1% of GDP in Q3 2021 to -45.3% in Q3 2024).

STRUCTURAL VULNERABILITIES: CHALLENGES IN THE LABOUR MARKET

Although it has proved somewhat robust since the 2021 reform, the labour market is still one of the black spots in the Spanish economy. The youth unemployment rate (26.7% in October) is still high compared to the eurozone rate (15%), illustrating that the mismatch between education and the market's needs is more significant than elsewhere. In addition, the number of long-term unemployed people has settled at a high level of approximately 1 million since Q2 2023. Against the backdrop of an ageing working population, this suggests that Spain has an older workforce that cannot be easily reintegrated into the labour market. Therefore, further structural reforms are seemingly needed in order to improve productivity and reduce unemployment.

Article completed on 02 December 2024

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UNEMPLOYMENT RATE IN THE EURO AREA

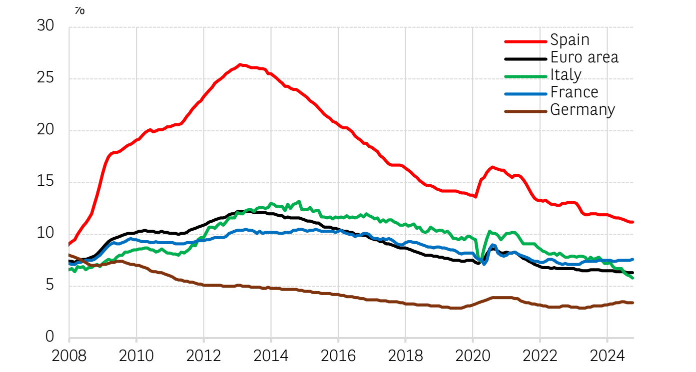

CHART 2

SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

SINCE 2023, SPANISH PERFORMANCE HAS MAINLY BEEN DRIVEN BY POPULATION GROWTH, WHILE GDP PER CAPITA HAS REMAINED RELATIVELY FLAT

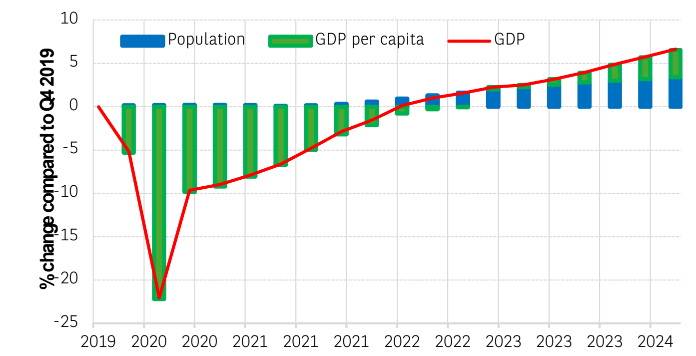

CHART 3

Note: productivity mesured by GDP per capita
SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

3 Estimated at -3.0% of GDP in 2024, -2.6% in 2025 and -2.7% in 2026 by the European Commission.

NETHERLANDS

GROWTH CATCH-UP

Following a period of economic stagnation in 2023, Dutch growth gathered momentum in 2024 on the back of solid consumer confidence and more favourable financial conditions thanks to the ECB interest rate cuts. At the same time, the Dutch labour market remains tight, with plenty of unfilled jobs; this should lead to stronger real-wage gains, thereby further supporting private consumption. While business investment has been declining since the start of 2023, there is hope that it will gradually recover in 2025 in line with additional monetary policy easing, which is expected in Europe. Public investment growth is also set to remain quite supportive implying a larger government deficit. However, this is not a cause for concern given the comfortable situation the Netherlands finds itself in compared to its major neighbours. The main downside risk to growth going into 2025 relates to the impact of weaker global growth due to higher US tariffs and less EU demand.

GROWTH SET TO IMPROVE WITH THE SUPPORT OF PRIVATE CONSUMPTION AND INVESTMENTS

The Dutch economy was one of the lowest performers in terms of growth in 2023 and early 2024. However, the situation has since changed and, as of the second quarter, GDP has been growing above the euro area average; this is despite the fact that some headway was lost in the third quarter as a result of persistent weak business investments and softer public spending.

Private consumption – already rather strong in 2023 – continued to support growth in the Netherlands. It is expected to benefit further from stronger real-wage growth linked to the still-tight labour market. The unemployment rate remains very low, yet there are still plenty of unfilled jobs on the market. While business confidence indicators show a modest recovery from the low levels recorded at the end of 2023, industrial production remains weak. Investment activity decreased for three consecutive quarters in 2023, with construction particularly affected by tighter financial conditions and labour shortages. Investment growth is set to experience a modest upswing in 2024 as financial conditions improve and public investment expands. Meanwhile, the technology, life sciences, sustainable energy and logistics sectors continue to play a major role in the Dutch economy. The Netherlands is also a key player in international trade, with ports like Rotterdam continuing to serve as global logistics hubs. Efforts to boost innovation in the tech sector and investments in the green economy (i.e. renewable energy, the energy transition, etc.) are expected to fuel a significant share of long-term growth. For the year as a whole, GDP is projected to grow by +0.8% (European Commission autumn forecasts).

In 2025, private consumption should remain well oriented, since the tight labour market will likely allow additional wage growth alongside falling inflation. Dutch households are also expected to benefit from tax cuts agreed on by the government. Contractual wages are set to increase by 6.4% in 2024, while current negotiations suggest slightly slower year-on-year growth estimated at 4.2% in 2025. Together with an increase in welfare benefits, real purchasing power is expected to increase by 2.5% in 2024 and by 0.7% in 2025, according to estimates published by the Netherlands Bureau for Economic Policy Analysis. A tax cut for very low-income households has been included in this estimate. The loss of purchasing power caused by the inflation shock of 2022-2023 should be reversed in 2025. This explains why consumer confidence has been holding up and continues to improve. House prices – hard hit in 2023 when interest rates went up – have been recovering at a very high speed in the interim due to an ongoing massive housing shortage (especially in large urban areas). In September 2024, the year-on-year increase in residential real estate prices exceeded 11%, which is most likely giving consumer confidence an extra boost.

GROWTH AND INFLATION

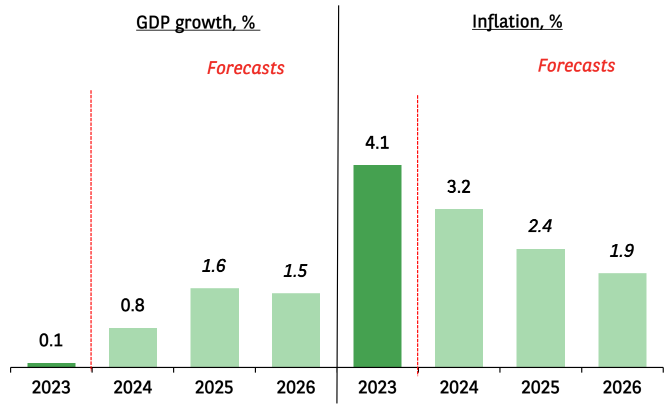

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

The combination of all these factors should lead to stronger GDP growth next year. According to the latest EC forecasts, GDP growth should be close to 1.6%, which amounts to twice the growth rate recorded for 2024. The main downside risk to this scenario involves weaker global (and EU) demand resulting from US tariffs.

INFLATION ON THE RISE BUT EXPECTED TO COOL DOWN

Inflation has been accelerating almost every month since the start of 2024, reaching 3.3% year on year in October. This upward trajectory can be explained by stubborn high inflation in services as well as high inflation for processed foods, both of which have been affected by an increase in excise duties on tobacco. Rental prices have also been adapted to match the higher inflation and are therefore also contributing to this higher rate of inflation. Going forward, services inflation, which is proving stickier than envisaged, is projected to reach its highest level in the last three months of 2024, before cooling down somewhat after this. According to the European Commission, harmonised inflation is expected to be 2.4% in 2025 and 1.9% in 2026 in annual average terms. This is significantly lower than the 2024 figure, which is expected to be close to 3.2%.

LARGER – BUT STILL SMALL – BUDGET DEFICIT AHEAD

The 2024 budget deficit is expected to end up at a much lower level than the one previously anticipated, essentially because government fiscal revenues (taxes on income and wealth) turned out to be higher than expected for the first half of the year. The European Commission expects the deficit to be very low overall: -0.2% of GDP by the end of 2024.

In 2025, Dutch public finances are expected to deteriorate somewhat for several reasons, among which higher social spending, higher public investment and the consequences of a court ruling that requires the government to return unduly paid taxes on asset returns to taxpayers. The government has also announced that it would be lowering the taxation rate on lower-income brackets, with the result that the deficit is expected to widen to 1.9% by the end of 2025 and 2.4% by the end of 2026. Decisions regarding a VAT increase on some products and services (motor fuel, cultural activities, etc.) are likely to soften the expected deterioration on the budget deficit, but it will not be enough to compensate for the increase in spending altogether.

Looking at Dutch public finances, it is important to keep in mind that the country's debt ratio is much lower than any other European country. The debt ratio is expected to increase modestly in 2025 and 2026, but it will not exceed 45% of GDP. This is of course a huge difference compared to other Euro-Area countries, where deteriorated public finances are indeed a cause for concern. The Netherlands is in a very different situation.

Article completed on 09 December 2024

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COMPARISON OF ANNUAL GROWTH IN THE NETHERLANDS AND THE EURO AREA

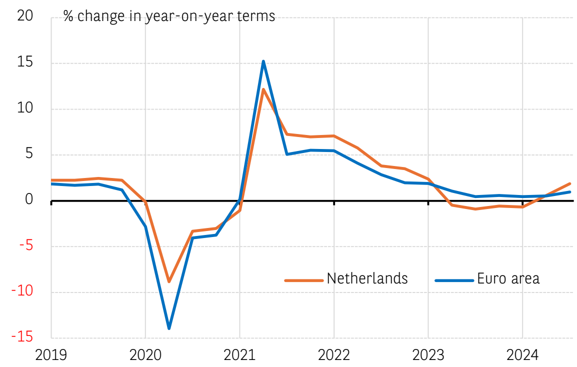

CHART 2

SOURCE: EUROSTAT, STATISTICS NETHERLANDS, MACROBOND, BNP PARIBAS

CHANGE IN THE RESIDENTIAL PRICE INDEX

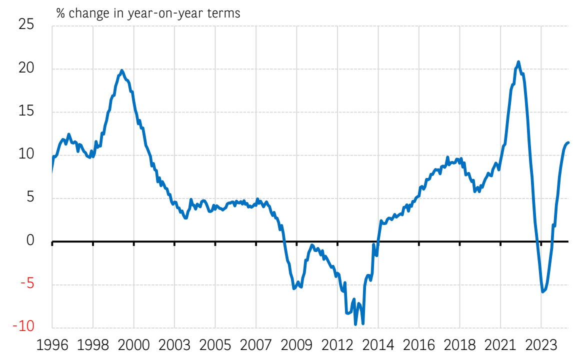

CHART 3

SOURCE: STATISTICS NETHERLANDS, MACROBOND, BNP PARIBAS

IMPACT FROM US TARIFFS ON THE DUTCH ECONOMY

Only 5% of all Dutch exports end up in the USA (putting it fifth on the list of export destinations). As a result, the US market is less important than the country's four major trading partners, namely Germany, Belgium, France and the UK. However, as the Netherlands operates as a primary trade hub for Europe as a whole, the effects of US tariffs on the Dutch economy could be markedly negative. The outcome would also depend on the price elasticity of demand in the US and on the capacity of the US economy to produce substitutes.

Top products exported from the Netherlands to the USA include office hardware, beverages, chemical products and transport materials. The Netherlands imports crude oil and gas, as well as medical instruments and vaccines from the USA. Since the start of the war in Ukraine, US exports of oil and gas to Europe have surged, a large volume of which passes through the Port of Rotterdam. As such, US exports to the Netherlands have increased sharply in recent times.

The Netherlands occupies a special position for the US economy because the US exports far more to the Netherlands than it imports. In other words, the Netherlands is the trading partner with which the USA has the highest trade surplus. For 2023, the trade balance between the US and the Netherlands reached a surplus of USD 44bn in favour of the US, while similar data with France and Germany showed bilateral deficits of USD14 bn and USD 83bn, respectively.

BELGIUM

TRADE-OFFS ABOUND

Belgian economic growth remains somewhat below but close to trend. Our nowcast for the 4th quarter indicated 0.3% QoQ growth. Domestic demand will have to continue to offset a negative contribution from net exports at a time when declining demand for specific products and a challenging external environment weigh down on the trade balance. Whereas, last year, firms' investment spending took on the role of growth engine, private consumption is now slowly returning to center stage. A pressing need for fiscal consolidation should hold back further increases in government outlay.

DOMESTIC DEMAND TO SAVE THE DAY

Belgian GDP growth remains stable, if somewhat below trend. After capex spending carried the brunt of economic growth last year, government spending took over, not surprisingly, in this election year. In stark contrast with the 2020-2022 Covid period, when vaccine production boosted exports, international trade has been a drag on GDP since 2023. This situation is likely to continue as external factors conspire to hinder exports recovery (*see box*). Domestic demand will have to offset this, with private consumption expected to return as this economy's workhorse. Subject to interest rates stabilizing at a lower level, we can expect private investment (both firms and households) to contribute as well, while fiscal tightening impedes further fiscal spending.

A recent study shows that Belgian households are quite well-off compared to those in most other EA-countries. Only in Luxembourg net wealth per household is significantly higher. About 50% of Belgian households' wealth is held in real estate. Real estate prices have been trending up gradually, despite higher interest rates, over the last couple of years. Currently, declining rents could help spur on transaction levels, still depressed, compared to 2022 levels.

Firms' confidence is picking up, with construction and services leading the charge. Manufacturers, having posted pessimistic takes throughout most of the year, seem to be turning a page. It remains to be seen however how resilient that newfound optimism turns out to be in the face of potential adversity in the external environment.

With the specter of trade war looming large and difficult government formation talks ongoing, risks are firmly on the downside.

LABOUR MARKET COOLING DOWN, SLOWLY

After demonstrating remarkable resilience throughout the Covid lockdowns, with especially strong job growth for self-employed works, the Belgian labour market has been cooling off somewhat. The Federgon-index for temporary labour had been falling since pre-Covid, a clear sign of cycle coming to an end. Survey data show that the fear of unemployment is now at its highest level in two years, while the vacancy rate remains stable. In 2023, more than half of all new jobs were created by the government, either directly or indirectly (non-market services). As from 2025, we expect the employment rate to further pick up, to the tune of 0.3-0.4 pp per year.

INFLATION: STILL BOOSTED BY 2023-LOWS, BUT WILL NORMALIZE SHORTLY

The Belgian economy has been sharing with Romania the questionable honour of "EU's highest inflation" since the beginning of this year. Rather than trending down a (late) double-digit peak, Belgian HICP has picked up again from turning negative in Q4 2023. The main culprit? Energy-price-inflation. The technical treatment of specific government support measures resulted in a double drag on Belgian inflation: these

GROWTH AND INFLATION

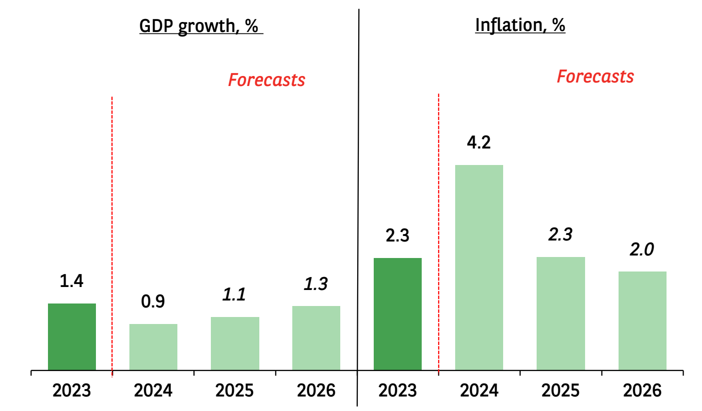

CHART 1 SOURCE: BNP PARIBAS FORTIS, BNP PARIBAS

measures drove down calculated energy price levels at the same time when prices indeed dropped significantly lower than their 2022 peaks. The result is that currently Belgian price levels – more or less progressing along at historical MoM rates – look high, compared to the lows of 12 months ago. This temporary effect should dissipate at the turn of the year, after which we expect FY inflation close to but slightly above 2%.

FORMATION TALKS DRAGGING ON WITH GOVERNMENT DEBT EVER RISING

At the moment of writing, 6 months after last June's election, no new federal government is in place. The negotiating parties – 2 center-rights parties from Flanders and Wallonia each plus the Flemish Socialist Party – continued their talks after November's local elections. It seems a final agreement is close, but it remains to be seen how much of aspiring-prime minister and long-time NVA-president Bart De Wever fiscal consolidation agenda will end up in that document. The NBB recently confirmed that the current fiscal deficit of -4.5% of GDP and debt to GDP ratio of 105.7% will likely reach -7.2% and a whopping 130% by 2038 under current policy settings. At the very least, a debt-ratio-increase of 1.5pp per year seems hard to avoid in any scenario.

Article completed on 09 December 2024

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TRADE WAR: SOME (INDIRECT) IMPACT

President-elect Trump persistent remarks about pending tariff hikes have Belgian firms worried. In the NBB's most recent Business Echo[1], more than half of all surveyed business share their pessimism for 2025. This year already, the significant slowdown of the German economy – a key trade partner for Belgian exporters – weighed economic activity down. According to in-house estimates, a 1%-slowdown in Germany could shave as much as 0.4pp of Belgian GDP growth.

The share of the US in total Belgian export is about 6%, which puts the US in the top 5, albeit at a considerable distance from neighbouring countries France, Germany and the Netherlands. Collectively, these last three account for half of all Belgian exports. Belgian firms export machinery, mechanical appliances & parts, metal & minerals (diamonds included), vehicles and plastics to the USA. These four categories account for about one third of all Belgium-to-US export. But pharmaceuticals reign supreme: this category represented 51% in 2022, up from 43% pre-Covid.

Post-Covid, Belgian trade has been slowing down substantially. This has been both a result of lower demand for vaccines and diamonds and decreased cost-competitiveness, at least partially a result of automatic wage-indexation. Since early 2023, growth rates for diamond exports have been negative or flat. As a result, diamond's share in total export dropped from 4% to 2%. A key driver of this decline has been the emergence of synthetic diamonds, especially in the US, which happens to be the largest market for demand. The labour cost handicap is slowly dissipating though, as wage developments in other (neighbouring) countries catch up. Prior to the US election, the contribution of net exports was expected to slowly revert from a net drag to a small positive for GDP growth over the next 5 years. Given the outcome and expected changes in the international environment, a likelier scenario is that net exports will continue to weigh on GDP growth.

1 https://www.nbb.be/doc/ts/publications/business_echo/2024_12_business_echo_publication.pdf

UNITED KINGDOM

RECOVERY EXPECTED, BUT THE ROAD TO MONETARY NORMALISATION WILL BE LONG

The UK's policy mix (a combination of fiscal and monetary policies) is expected to be more accommodative in 2025. Its positive effects will be limited, however, given the very gradual fall in interest rates and the introduction of more restrictive budgetary rules. After GDP growth in the third quarter of 2024 fell short of expectations (+0.1% q/q), activity is expected to strengthen in Q4 (+0.3% q/q) before stabilising around this level in 2025 (between 0.3% and 0.4% q/q). The United Kingdom, which has a trade balance almost in equilibrium with the United States and exports mainly services to the US, also seems to be in a better position than its European neighbours to avoid the rise in US tariffs.

ECONOMIC ACTIVITY: IN RECOVERY PHASE

Faced with the threat of US protectionism, the UK is in a unique position. Unlike the major industrial countries in the eurozone (Germany, Italy) and China, it has a very small trade surplus with the United States (less than GBP 2 billion in October 2024)[1], which could facilitate the terms of a future trade agreement between London and Washington. For the UK, which exports more services than goods to the US, the main shock would come from a more marked slowdown in activity within the European Union, its principal market. On the domestic front, consumer spending will continue to be held back by the scale of the past inflationary shock and by the process of refinancing households at higher rates, which is not yet complete. Indeed, the Bank of England (BoE) estimates that almost half of all mortgages will see an increase in interest payments by Q4 2027[2]. GDP growth is expected to rise next year to 1.4%, with an estimated carryover for 2024 of 0.4%. Activity will slow again in 2026, as a result of a more restrictive fiscal policy and domestic constraints (structurally high inflation, transmission of the rise in interest rates to households, and weak productivity gains) and external constraints (economic slowdown in the United States).

GROWTH AND INFLATION

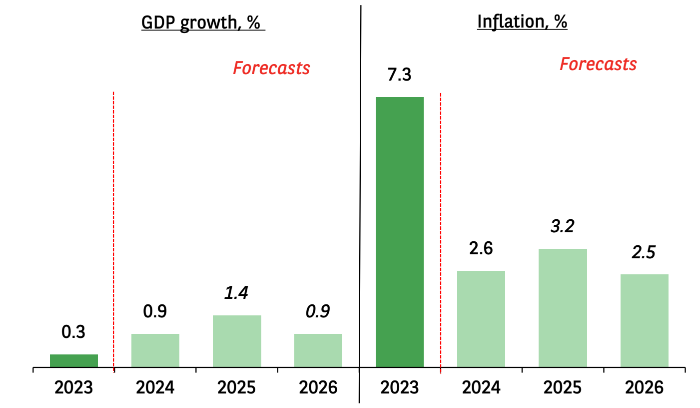

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LABOUR MARKET: SO FAR SO GOOD

Although there are more indications of a cooling in the labour market, there is no sign of a real downturn at this stage. The number of employees fell by 0.1% q/q in the third quarter, after rising by 0.1% over the first two quarters of 2024[3]. The composite PMI for employment was below the expansion territory in November (48.9), but it is not falling as much as in the eurozone. This autumn, the number of job vacancies has just returned to the levels seen in 2019, a level consistent with a labour market that is still under pressure. Nevertheless, this deceleration should be enough to bring about a gradual slowdown in wages, which were still rising at an annual rate of almost 5% in October.

INFLATION: RENTS DRIVE INFLATION IN SERVICES

Since April, inflation has stabilised around the 2% target, thanks to deflation in energy and manufactured goods. On the other hand, the fall in inflation in services remains very limited, and a number of measures included in the Autumn Budget, which will take effect next April (6.7% increase in the minimum wage, rise in private school fees, and an increase in the rate of employer national insurance contributions), will be inflationary in nature. The rise in rents is also fuelling inflation in services and, given the upturn in property activity (*see box*), there is no guarantee that prices will decelerate rapidly in 2025 - on the contrary. Since the health crisis, the pace of increase in rents has strengthened steadily, hitting 7.3% y/y in October, the biggest rise in 31 years. While this inflation item is unlikely to be a crucial decision-making variable for the BoE, it is nonetheless a further brake on monetary easing. Excluding rents, inflation stood at 3.8% y/y in October, a level which, while not satisfactory, can be seen as moderate.

MONETARY POLICY: NO INTEREST RATE LANDING BEFORE 2026?

The Bank of England therefore has relatively little room for manoeuvre, given the situation on the inflation front. The members of the Monetary Policy Committee (MPC) are likely to opt for the status quo at their meeting on 19 December, before embarking on a new cycle of rate cuts in 2025, albeit a very gradual one, more gradual than in the eurozone, at a rate of one cut per quarter. Interest rates would not stabilise at 3.5% until 2026. Monetary policy would therefore remain restrictive next year, albeit gradually less so. However, its effects would be counterbalanced by a more accommodative fiscal policy.

FISCAL POLICY: DEFICIT STABLE IN 2025, CONSOLIDATION TRAJECTORY INTACT

UK fiscal policy will be expansionary in 2025, with the OBR estimating additional budget spending of GBP 70 bn over the next five years (around 2% of UK GDP). Against this backdrop, the OBR forecasts that the public deficit will stabilise at around 4.5% of GDP in 2024 and 2025[4], before falling further to 3% by 2027. The government has also set new, more stringent budgetary rules[5] that make this consolidation more cre-

1 Cumulative over twelve months.
2 Bank of England Financial Stability Report, November 2024, page 46.
3 Administrative data published by the ONS.
4 Fiscal years.
5 In particular, the rule that previously required public debt to be reduced within five years has been reduced to three years.

dible. The debt target has been changed from a measure known as 'net debt' to 'net financial liabilities'. The latter measure incorporates a broader set of assets which, on a net basis, reduces the debt ratio by almost 14 points of GDP compared with the net debt measure (83.7% of GDP in October 2024).

STRUCTURAL CHALLENGES: MITIGATING THE EFFECTS OF DEINDUSTRIALISATION

The decline in activity and job losses in the industrial sector – extractive and manufacturing industries – have increased sharply since the health crisis. In particular, industry's share of value added hit a new low of 10.4% in Q3 2024. This is fuelling a number of drags on the UK economy, such as falling goods exports and a widening trade deficit, as well as social and territorial inequalities. Accelerating house building and improving public services will be two other areas where the government will be expected to deliver results in 2025.

EXTERNAL POSITION: A TRADE DEFICIT PARTLY OFFSET BY SERVICES

The UK's current account remained in deficit at 2.2% of GDP in Q2 2024, year-to-date, but has more or less stabilised at this level over the last two years. On the other hand, the UK has a very large trade deficit (equivalent to 7.0% of GDP), particularly with the EU, which has widened post-Brexit and affects all the major categories of goods. The largest deficits in relation to the rest of the world are in food products, energy, and machinery and equipment. However, a large part of this deficit is offset by the substantial surplus in services (6.1% of GDP), which reflects the country's continuing strengths in high value-added services (finance and information and communication services).

Article completed on 06 December 2024

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UK BILATERAL TRADE BALANCES (12-MONTH MOVING TOTAL)

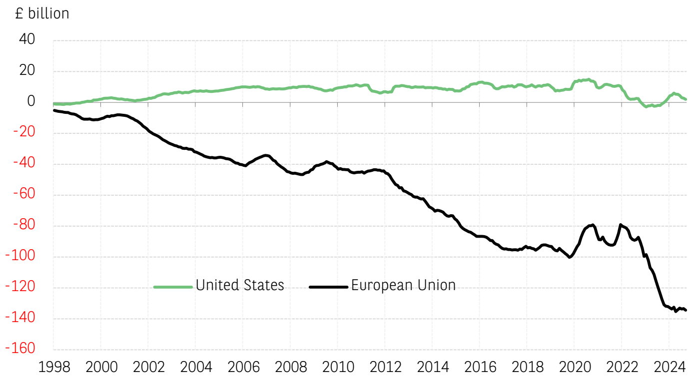

CHART 2 SOURCE: ONS, BNP PARIBAS CALCULATIONS

RICS SURVEY, SALES EXPECTATIONS IN THE UNITED KINGDOM

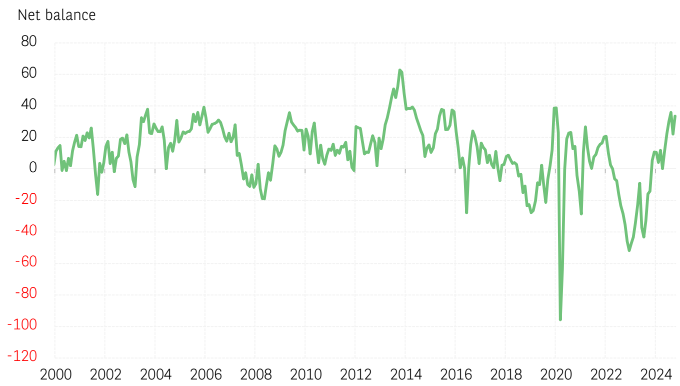

CHART 3 SOURCE: RICS, BNP PARIBAS

THE UPTURN IN THE PROPERTY MARKET, A SUPPORT AND A BRAKE ON ACTIVITY

The first interest rate cuts provided a further boost to the UK property market, which was already in a recovery phase even before monetary tightening was complete. The first signs of stabilisation came at the very end of 2022, with the beginning of a recovery according to the RICS survey[1], followed by a rebound in the volume of home loans. With 68,303 new loans (excluding renegotiations) granted in October 2024, the average for 2019 (65,784) has been exceeded. The rebound in house prices has also gathered pace, with the Nationwide and Halifax indices indicating a year-on-year rise in prices of around 4% in October-November.

The continued fall in interest rates and the increase in stamp duty announced in the Autumn Budget, which will take effect in April 2025, will strengthen this recovery in the coming months, against a backdrop of strong supply pressures. This will have the additional consequence of maintaining upward pressure on rents, and therefore on inflation. The upturn in property activity will increase pressure on the government, which has set itself the task of generating a construction shock, with the aim of building 300,000 new homes a year by the end of the government's term in 2029.[2]

1 The balance of opinion regarding sales forecasts hit a low of -51.8 in December 2022.
2 See BNP Paribas Chart of the Week, United Kingdom: the housing shortage, a major challenge for the Labour Party, 25 July 2024.

POLITICAL INSTABILITY AND VERY GRADUAL MONETARY NORMALISATION

The Japanese economy continues to be characterised by weak growth, which slowed in Q3. The positive momentum in inflation and wages is in line with the Bank of Japan's objectives. This picture should enable the Bank to continue its gradual monetary tightening. However, domestic political developments (general elections resulting in a loss of political strength for the government), as well as external ones (Donald Trump's victory) are not helping stability.

A REBOUND IN ANNUAL GROWTH AHEAD

Japanese growth slowed to 0.3% q/q (-0.2 pp) in the third quarter after catching up in Q2. We expect the same advance in Q4. As a result, the average annual growth rate in 2024 would be negative, standing at -0.2%, a significantly lower result than in 2023 (+1.7%), due to the negative carryover and the contraction in Q1.

Q3 growth was underpinned by private consumption (+0.7% q/q, +0.1 pp), which was the main driver of growth, far ahead of residential investment (+0.4% q/q, -0.8 pp). Conversely, productive investment was disappointing (-0.1% q/q, -1.0 pp), as was public demand. Finally, the largest negative contribution came from foreign trade, with growth in imports (+1.8% q/q) significantly exceeding growth in exports (+1.8% q/q).

In 2025, the sequential pace is set to be more moderate, with quarterly growth rates of around +0.1% q/q, more in line with the Cabinet Office's estimated potential growth. For the year, growth is expected to amount to 0.7%, significantly higher than in 2024, thanks to the improvement in household disposable income. However, the potential rebound in Japanese growth remains limited by supply constraints (*see below*).

GROWTH AND INFLATION

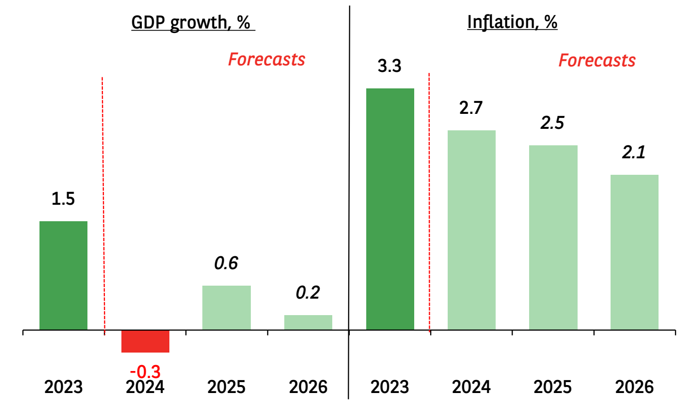

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LABOUR SUPPLY IMPASSE

The Japanese labour market - and, ultimately, the economic growth outlook - continues to suffer as a result of labour shortages. In Q4, the Tankan factor utilization index deteriorated further, linked to this lack of labour supply, to a record low (2003). Growth in the labour force, which is likely to address this problem, has stalled in recent months. The unemployment rate, which stood at 2.5% in October, has risen only marginally since the start of the year (+0.1 pp).

On the wage front, the latest figures, dating from September, show contractual wage growth set to hit a 30-year high, at +2.5% y/y. On the other hand, the real wage index is struggling to settle into positive territory on a long-term basis. In fact, two months of declining year-on-year change (with August and September at -0.8% and -0.4%, respectively) were followed two consecutive months of improvement.

UPWARD MOMENTUM FOR INFLATION

Inflation seems to have picked up again in Q4. After falling back in September due to the return of subsidised energy bills, both core inflation (excluding unprocessed food) and the new-core (excluding energy as well) index posted a monthly increase of +0.6% in October (after -0.3% and +0.1% in September, respectively). Divergent movements (-0.2 pp and +0.2 pp) brought the year-on-year change in the two indices closer together, at +2.3% y/y, while base effects from the previous year pointed to weaker figures. Inflation in services, at +1.5% y/y in October, which is particularly closely watched, has also gained momentum in recent months, with the exception of September. Finally, Tokyo inflation in November, a leading national inflation indicator, was also part of this acceleration trend (core at +2.2% y/y, +0.4 pp).

In 2025, the growing power of the wage-price loop and a persistently weak yen should keep core inflation above its 2% target, before returning to around this level from Q4 and into 2026.

POLITICAL INSTABILITY SET TO CONTINUE

Early general elections were held on 27 October. They were called by Shigeru Ishiba, following his appointment as leader of the Liberal Democratic Party (LDP) and head of government, replacing Fumio Kishida. The vote resulted in the LDP losing its absolute majority (233) in the House of Representatives, dropping from 259 to 191 elected members. In addition, the support of its traditional ally Komeito (24 seats) is insufficient to secure a majority position. This is a rare occurrence, not seen since 2009 in Japanese politics. However, Ishiba managed to hold on to the post of Prime Minister thanks to a minority vote on 11 November.

The new cabinet has announced a slight increase in the fiscal stimulus for FY2024 (which ends on 31 March 2025). This amounts to 13.9 trillion yen (2.3% of GDP), up from 13.2 trillion yen in 2023. The plan, which includes allowances for low-income households and continued subsidies on energy bills, has yet to be approved by Parliament. The Prime Minister is in favour of continuing to support households as long as wage growth does not exceed inflation. In addition, the new political configuration provides fertile ground for further budgetary support in 2025. The survival of the current government depends in particular on the support - or lack of it - of the Democratic Party for the People (DPP), which is in favour of tax cuts.

MONETARY POLICY

The Bank of Japan was cautious after its unexpected key rate hike last summer, keeping the uncollateralized overnight call rate stable at +0.25% at the two consecutive meetings in September and October. However, the BoJ is sticking to its scenario of «*continuing to raise the key rate and adjusting the degree of monetary easing*» on the basis of its forecasts for growth and core inflation (1.1% and 1.9%, respectively, in FY2025). Our own forecasts predict three rate hikes (+25 bps for each) in 2025, taking the key rate up to +1.0% by the end of next year, its highest level since 1995.

Furthermore, while the outcome of the US presidential election will have an impact on the Japanese economy (*see box*), Kazuo Ueda admitted that he was taking movements in the yen seriously in his «*economic and inflation projections*». He also said that if the JPY were to weaken further with inflation above 2%, this would call for countermeasures on the part of the BoJ.

Article completed on 11 December 2024

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JAPAN AGAINST SUPPLY CONSTRAINTS

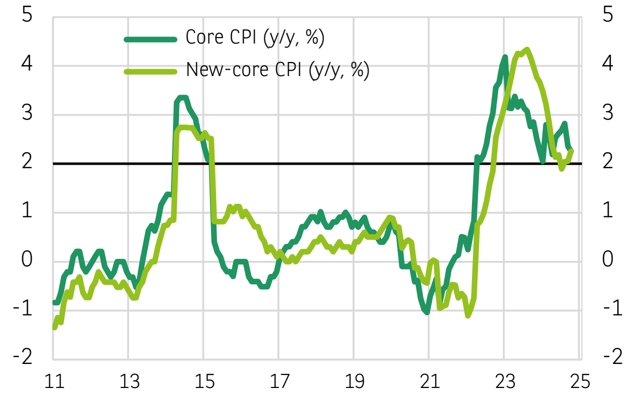

CHART 2 SOURCE: MACROBOND, BNP PARIBAS

INFLATION ABOVE ITS TARGET

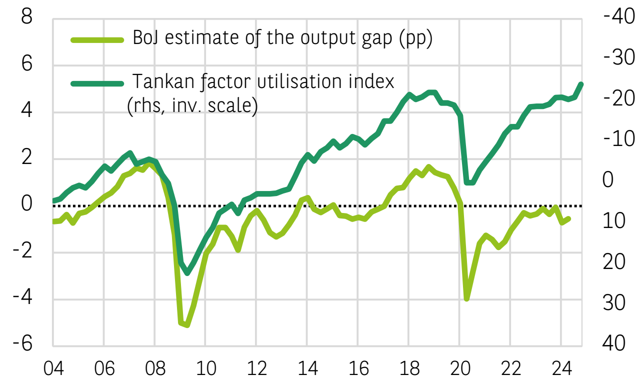

CHART 3 SOURCE: BANK OF JAPAN, BNP PARIBAS

JAPAN AND THE RETURN OF DONALD TRUMP

For Japan, Donald Trump's victory brings with it heightened geopolitical uncertainty, particularly on defence issues, but also on the economic front. On the economic front, the main risks relate to measures on customs tariffs and the potentially inflationary consequences of Trump's plans. The application of higher tariffs on Japanese products would damage the price competitiveness of its exporting companies (with little possibility of absorbing this in margins due to already sluggish domestic demand), with negative consequences for the growth of a country for which the United States is the leading export market (22% in 2023). In addition, China, Japan's second-largest market, is likely to be particularly targeted by Trump, with average effective tariffs rising to 40% (+25 pp) in Q1 2026 after an incremental increase, which could mean more negative effects through the indirect channel of a Chinese slowdown.

The yen could also deteriorate further against the US dollar if the US trade deficit were to narrow and, above all, if the Federal Reserve were to maintain its restrictive policy as a result of the expected rise in US inflation (since customs duties are borne by the end consumer). An appreciation in the USD/JPY exchange rate is generally favourable for Japanese equities and, in this case, could help to mitigate the impact of the tariff hikes. In fact, in Q2 2024, domestic companies' nominal profits broke the record set a year earlier, against a backdrop of a downward trend in the JPY. Conversely, higher imported inflation and greater monetary restraint to reduce the interest rate differential with the US would have a negative impact on demand, which is already structurally endemic.

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2023	2024 e	2025 e	2026 e	Inflation 2023	2024 e	2025 e	2026 e
United States	2.9	2.8	2.1	1.3	4.1	2.9	2.9	3.9
Japan	1.5	-0.3	0.6	0.2	3.3	2.7	2.5	2.1
United Kingdom	0.3	0.9	1.4	0.9	7.3	2.6	3.2	2.5
Euro Area	0.5	0.8	1.0	1.0	5.4	2.4	2.1	2.0
Germany	-0.1	-0.1	0.4	0.6	6.0	2.5	2.4	1.8
France	1.1	1.1	0.8	0.9	5.7	2.3	1.1	1.2
Italy	0.8	0.5	1.0	1.0	5.9	1.1	2.0	1.9
Spain	2.7	3.1	2.5	1.8	3.4	2.8	2.2	2.2
China	5.2	4.9	4.5	4.3	0.2	0.3	0.8	1.0
India*	7.0	8.2	6.0	6.7	6.7	5.4	4.9	4.2
Brazil	2.9	3.4	2.1	1.8	4.6	4.4	5.1	4.0

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

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

FINANCIAL FORECASTS

Interest rates. %

End of period		Q1 2025	Q2 2025	Q3 2025	Q4 2025
US	*"Fed Funds (upper limit)"*	4.50	4.50	4.50	4.50
	T-Note 10y	4.10	4.25	4.55	4.65
Eurozone	deposit rate	2.50	2.00	2.00	2.00
	Bund 10y	1.90	2.00	2.10	2.25
	OAT 10y	2.63	2.80	2.95	3.13
	BTP 10y	2.95	3.10	3.25	3.40
	BONO 10y	2.50	2.65	2.75	2.90
UK	Base rate	4.50	4.25	4.00	3.75
	Gilts 10y	4.15	3.90	4.00	4.00
Japan	BoJ Rate	0.50	0.75	0.75	1.00
	JGB 10y	1.20	1.40	1.40	1.60

Exchange rates

End of period		Q1 2025	Q2 2025	Q3 2025	Q4 2025
USD	EUR / USD	1.03	1.02	1.01	1.00
	USD / JPY	153	154	155	156
	GBP / USD	1.26	1.24	1.23	1.22
EUR	EUR / GBP	0.82	0.82	0.82	0.82
	EUR / JPY	158	157	157	156

SOURCE: BNP PARIBAS (MARKET ECONOMICS, INTEREST RATE STRATEGY, FX STRATEGY, COMMODITIES DESK STRATEGY)

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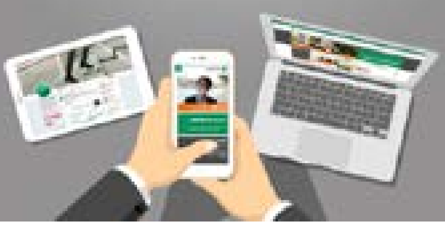

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