

ECO PERSPECTIVES

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ECONOMIC RESEARCH DEPARTMENT

Eco
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BNP PARIBAS

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Editorial

Global growth slowdown intensifies

The slowdown of global growth has gathered pace, forcing the Federal Reserve to cut the federal funds rate on two occasions, whereas the ECB has announced a comprehensive easing package. Nevertheless, the slowdown is expected to continue. Uncertainty is pervasive. Companies question the true state of demand faced with slower growth, trade disputes, Brexit worries, geopolitical risk. Corporate investment suffers and may impact households via slower employment growth. The room to boost growth via monetary policy and, in many countries, fiscal policy has become limited, and this is another factor which could weigh on confidence. Surveys of US corporate executives point towards a high concern about recession risk and the US yield curve inversion adds to the unease. However, the picture provided by a broad range of leading indicators is, at least for the time being, less bleak.

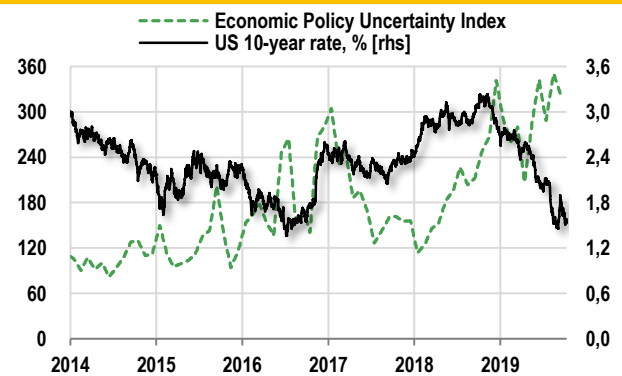
■ Slowdown gathers pace

The declining pace of economic growth has become a truly global phenomenon. Chinese growth continues to outpace the performance in the Western world to a very significant degree, but at 6.2% in the second quarter, it is getting close to the psychologically important 6.0% barrier. The trend towards slower growth should continue in the short run on the back of a cautious policy stance in boosting growth and a difficult international environment. The pace of growth is also slowing in the US, where corporate investment is weakening, although household consumption is resilient. As a welcome exception, Japanese growth has been stronger than expected early on this year, supported by domestic demand. Exposure to China, a subdued outlook for international trade and the fall-out from the VAT increase on consumption paint a challenging picture for the near term. In the eurozone, the good performance in the first quarter (+0.4% growth) has been followed by a meagre 0.2% growth in the second quarter. Private consumption has been resilient, underpinned by declining unemployment and dynamic wage growth. Investment has slowed, in part due to the high level of uncertainty. Within the eurozone, the divergence has increased. Germany, where the manufacturing sector is under intense pressure, is in a technical recession, whereas the French economy is very resilient. Another divergence is between industry and services, with the former suffering more given its higher exposure to international trade and to trade uncertainty.

■ Central banks have reacted but doubts about the effectiveness

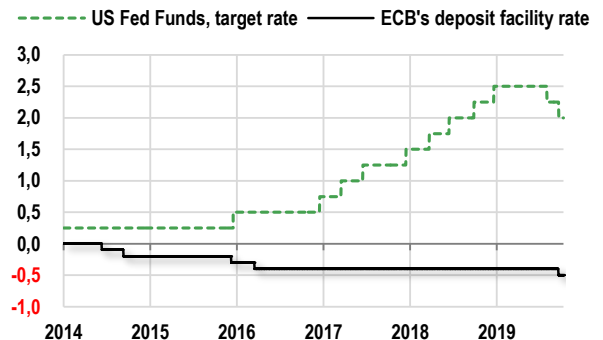
As a consequence, the Federal Reserve and the ECB have reacted by easing policy. This represents probably the biggest sea change compared to expectations about the world economy at the start of the year. Their reaction is very much proactive. In the US, the policy rate is being cut whilst the unemployment rate is at a 50 year low. In the eurozone, the labour market is still robust but concerns about the phase of soft growth lasting longer than expected, which in turn weighs on outlook for inflation and its convergence towards the target, have led the ECB Governing Council to a comprehensive easing package. Critics of this stance have become more vocal considering that the asset purchase program has been resumed. This has led to expressions of disagreement by Governing Council members. The introduction of state-dependent forward guidance, which implies that current policy is maintained (or eased further) as

1- Economic uncertainty is pervasive



Source: Economic Policy Uncertainty, Datastream, BNP Paribas

2- Central bank policy rate, %



Source: Federal Reserve, ECB, BNP Paribas

long as inflation hasn't converged sufficiently, and in a lasting way, to the target has also met criticism in some circles because it implies interest rates will remain very low and, for some, even negative for quite some time. A priori, this should support growth. Whether this will show up in the numbers depends in particular on confidence, i.e. on a much needed decline in uncertainty.

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United States

The slowdown continues

The contraction in world trade, exacerbated by President Trump's tariff offensive against China, has begun to spread to the United States. The economic slowdown, which can also be attributed to domestic factors, has prolonged throughout the summer of 2019, and business surveys do not suggest any improvements in the months ahead. Corporate investment will remain downbeat, while household consumption, which has been resilient so far, should begin to falter. In the face of this environment, the Federal Reserve -- which no longer provides forward guidance on upcoming policy moves -- is bound to lower its key rates again.

During the summer months, the US economy continued to slow although it seemed to be fairly resistant to the headwinds affecting world trade. The annual GDP growth rate dropped to 2%, one point below the 2018 level, which is still an enviable performance when seen from Europe, where recession is looming in countries like Germany, Italy and the UK. Yet, taking a closer look, the US economic slowdown is more severe than it might seem. The only factors limiting the fall in year-on-year GDP growth were public spending and inventory building in anticipation of new tariffs imposed by President Trump. Foreign trade provided a negative contribution, but the bulk of the slowdown was essentially due to domestic factors. It can be attributed to the decline in private investment, which was first seen in residential construction, and then spread to all sectors with the exception of software. Although consumption and employment are both resilient, they seem to be losing momentum. Lastly, business surveys are depressed and do not signal any improvements in the near future.

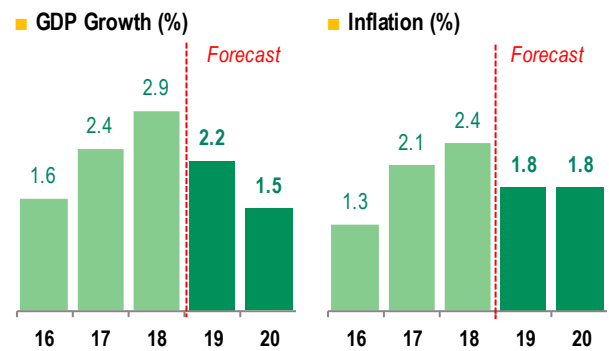
Downgraded prospects

The drop in the Institute for Supply Management (ISM) index for the manufacturing industry, as well as the reversal of the capacity utilization rate, suggest a further decline in capital goods spending. The drop could be particularly severe in the very capital-intensive oil and shale gas sectors, where the first signs of over-investment have emerged (chart 2). With production volumes at an all-time high of 8 million barrels per day (b/d), the profitability of new wells can no longer be taken for granted. Producing less than expected after being drilled too close to one another and operated by heavily-indebted industry players, the number of new wells is trending downwards¹.

US household consumption – which at USD 14,000 billion a year is five times higher than French GDP – is by far the most powerful driving force of domestic demand. In 2018, the combination of tax cuts, job creations and consumer credit created a rather high-octane fuel, but the mixture has weakened in 2019. Companies are not only re-assessing market outlets and scaling back investment, they are also slowing the pace of hiring. Net job creations have fallen to a monthly average of 161,000 between January and September, the lowest number in nine years. Given the population inflow into the labour market (1.8 million on average in 2018), job creations hardly suffice to bring down the unemployment rate, already standing at

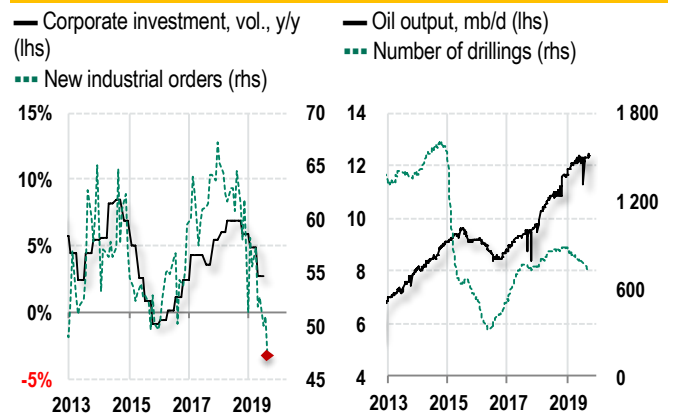
¹ The Wall Street Journal (2019), *Shale Boom Is Slowing Just When the World Needs Oil Most*, Sept. 29

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Downturn in the investment cycle



Source: Institute for Supply Management, US BEA, IEA.

all-time low (3.5% in September). Farmers and purchasing managers are no longer the only segments of the population suffering from President Trump's trade war. Even though consumer goods are not affected much, higher import tariffs are having a non-negligible impact on inflation (see box 3). Faced with higher prices for capital goods and inputs manufactured in China, there has yet to be a significant shift in demand towards other countries². US companies are bearing the costs, modulating the efforts granted by suppliers and their reactions to exchange rates. In the end, the

² French Treasury (2019), *Impact of first US-China trade tensions*, Lettre Trésor-éco n°244, September



impact on prices paid by end consumers is estimated at a few tenths of a point³. After holding to a slowing trend recently, core inflation rebounded to 2.4% in August. This has lowered the growth of real disposable income for US households.

Consumer credit is also less buoyant, which is not unusual at this stage of the business cycle: household non-mortgage debt has increased 55% from the 2009 low, coming back to relatively high levels as regard of disposable incomes. Car sales have matched all-time highs, so that the fleet has been largely renewed. Lastly, banks are tightening lending conditions at a time when transformation conditions have deteriorated due to the inversion of the yield curve (Wheelock, 2018)⁴.

■ More key rate cuts

In the months ahead, the Federal Reserve (Fed) will need to steepen the yield curve, which means further monetary policy easing. The Fed funds target rate has already dropped from 2.5% to 2%, and we think it could be lowered further, to 1.75% at end-2019 and 1.25% at end-2020.

Of course, the official position remains cautious and does not signal such a move. Having foregone "forward guidance", Federal Reserve Chairman Jerome Powell has linked any policy changes to upcoming economic publications. He also pointed out that monetary easing phases can sometimes be very short⁵. Yet he did not cite the most pertinent example: the Fed cut its key rates in the fall of 1998 to counter the potentially systemic effects of the quasi-bankruptcy of an entire hedge fund⁶, not to accompany a cyclical downturn, as now seems to be the case.

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3- Escalation of the US-China trade war

The facts. On 6 July 2018, the United States opted to apply a 25% tariff on a first list of products imported from China for a total of USD 36 bn, a decision immediately followed by retaliatory measures (see the tit-for-tat chronicle of events below). A little over a year after the hostilities were launched, some USD 250 bn in annual imports to the US from China (or about half of all purchases) are now taxed at an average tariff of 25%. This essentially comprises intermediate products and industrial capital goods (80%) while the remaining 20% is for end consumer goods. In retaliation, China has applied variable tariffs on all of its imports from the United States (USD 110 bn a year) and suspended soybean purchases.

Additional risks. In the heat of August, President Donald Trump said he wanted to increase the tariffs already applied to Chinese imports from 25% to 30%, and to impose tariffs on all Chinese imports that were not already taxed, representing an additional amount of USD 272 bn a year. This threat was supposed to take effect on 1 September 2019, but the date was pushed back to give the United States and China time to restart negotiations and try to reach a compromise, undoubtedly during the second week of October.

Date	 United States	 China
July-Aug. 2018	<ul style="list-style-type: none"> • 25% on \$50 bn (\$36 bn +\$16 bn) of imports from China (lists 1 & 2) 	<ul style="list-style-type: none"> • 5% to 25% on \$50 bn of imports from the US (list 1)
Sept.-Nov. 2018	<ul style="list-style-type: none"> • 10% on \$200 bn of imports from China (list 3) 	<ul style="list-style-type: none"> • 5% to 25% on \$60 bn of imports from the US (list 2)
May 2019	<ul style="list-style-type: none"> • 10% ↗ 25% on \$200 bn of imports from China (list 3) 	<ul style="list-style-type: none"> • Suspension of soybean imports
Sept. 2019	<ul style="list-style-type: none"> • 10% on \$120 bn of imports from China (list 4A) 	<ul style="list-style-type: none"> • Higher tariffs on \$60 bn of imports from the US (list 2)
Oct.-Dec. 2019? Threats	<ul style="list-style-type: none"> • 25% ↗ 30% on \$250 bn of imports from China (lists 1 to 3) • 15% on \$272 bn of imports previously without tariffs (list 4) 	<ul style="list-style-type: none"> • China attempts to ease tensions by postponing certain planned tariff increases and resuming soybean imports.

Consequences. Based solely on the measures already taken (and using the 2018 value of trade), the weighted average US tariff rate would rise from 1.7% in 2017 (one of the lowest rates in the OECD) to 7.7% in 2020 (one of the highest rates). China would be hit hardest. Its sales to the US have already declined (by 20% for the year for targeted products, a figure amplified, however, by early shipments in 2018) and US tariffs would cost its economy as much as 1 point of GDP in 2020. Yet there are no winners, and the IMF estimates that the shock has cost the US 0.7 points of GDP.

Source: French Treasury (op. cit.), IMF, BNP Paribas

³ Jean S. & Santoni G. (2018), *How Far Will Trump Protectionism Push Up Inflation?*, CEPII Policy Brief n°23, December. The two authors estimate that the sanctions already imposed on China (25% tariffs on USD 250 billion in annual imports) triggered a 0.25%-0.38% increase in inflation.

⁴ Wheelock D. (2018), *Can an Inverted Yield Curve Cause a Recession?*, Federal Reserve Bank of Saint Louis Blog, Dec. 27

⁵ Powell J., Press conference following the Monetary Policy Committee meeting of 18 September 2019

⁶ In this case, Long Term Capital Management (LTCM)



China

Difficult policy choices

Since Q2 2018, Beijing has let the yuan depreciate against the dollar each time the US has raised its tariffs on imported goods from China. Yet, exchange rate policy as an instrument to support economic activity is expected to be used moderately in the short term. There is also little room to stimulate credit given the excessively high debt levels of the economy and the authorities' priority on pursuing efforts to clean up the financial system, the public sector and the housing market. Torn between stimulating economic growth and deleveraging, the authorities' dilemma could get worse if recent fiscal stimulus measures do not have the intended impact on domestic demand, or if the external environment were to deteriorate further.

Real GDP growth slowed to 6.2% year-on-year (y/y) in Q2 2019, down from 6.4% in the previous quarter and 6.6% in full-year 2018. Growth should continue to slow in the short term since the support provided by policy stimulus measures will only partially offset the impact of the slump in external demand. The authorities' room for manoeuvre to stimulate growth has narrowed sharply in recent years due to the erosion of external surpluses and rising internal imbalances (excessive debt, need to clean up the public and financial sectors).

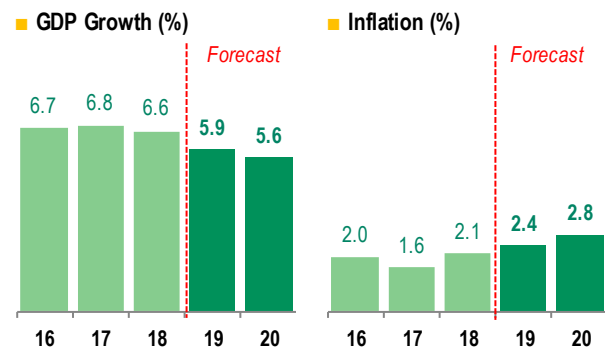
■ Yuan depreciation should continue to be moderate

In the first eight months of 2019, export revenues stagnated compared to the same period in 2018 (-0.05%) because of higher US tariffs and the decline in world trade growth. Thanks to a 4.5% fall in imports, the trade surplus increased by 30% y/y to USD 262 billion over the same period. The export sector's troubles are expected to get worse in the months ahead, and the outlook for 2020 is still very uncertain since it hinges on the outcome of trade talks between Washington and Beijing.

Since Q2 2018, the weighted average tariff imposed by the United States on imported Chinese goods has increased from 6.5% to about 20% at the end of September 2019 (tariffs have so far been raised on more than two thirds of these imports). The weighted average tariff could exceed 25% by the end of the year if the recently renewed trade talks were to collapse and the new tariffs announced by the Trump administration last summer were effectively introduced. It threatened to apply tariffs to all US imports of Chinese goods (totalling USD 550bn). Between the end of March 2018 and the end of August 2019, the yuan lost nearly 13% against the dollar (including 3% in July-August). This decline more than offset the increase in the yuan reported in the previous fifteen months. With each new increase in US tariffs (announced or effective), the Chinese authorities have responded by letting the yuan depreciate to partially offset the impact on exporting companies (chart 2). In September, despite the introduction of new tariffs, the yuan levelled off against the dollar because Beijing and Washington had agreed to restart trade talks.

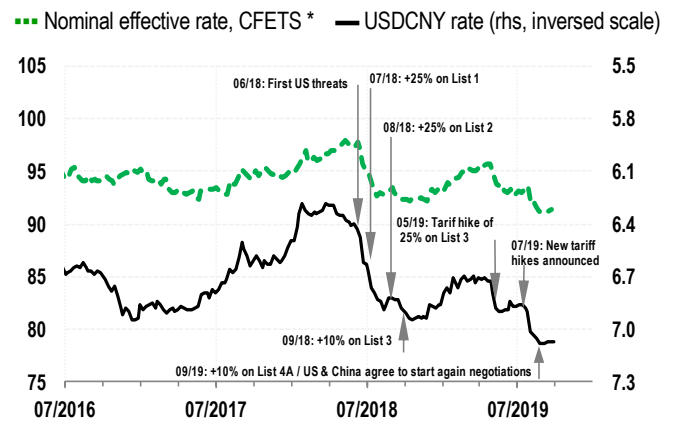
The authorities are expected to resort to the exchange rate policy moderately to stimulate economic activity in the short term. They fear the anticipation of currency depreciation could trigger a vicious circle of new capital outflows and yuan weakening. Yet this risk is limited given the existing controls on resident capital outflows (which have been reinforced since 2016, and then adjusted depending on

1- Growth and inflation



Source: National accounts, BNP Paribas

2- US tariffs and China's exchange rate policy



Source: China Foreign Exchange Trading Center, BNP Paribas.

* The CFETS index shows the yuan's weighted average exchange rate against the currencies of China's main trading partners.

** The lists of Chinese goods imported by the US and affected by tariff hikes are called "List 1" totalling USD 34 bn, "List 2" totalling USD 16 bn, "List 3" totalling USD 200 bn and "List 4A" of USD 125 bn (first slice of list 4).

balance-of-payment pressures). Moreover, the slight improvement in the current account surplus (it stood at 1.3% of GDP in H1 2019 and is projected 1.7% in full-year 2019, compared to 0.4% in 2018) and the expected increase in foreign portfolio investment inflows into China's financial markets (following recent market opening measures) might also help stabilise the exchange rate in the short term.



■ Credit is not responding much to monetary easing

Investment and private consumption growth continued to falter in Q3 2019. In value terms, investment rose by only 5.5% y/y in the first eight months of 2019, compared to 5.8% in H1 2019. Growth in retail sales slowed to 7.5% y/y in July-August, compared to 8.4% in H1 2019. There are several downside factors: the troubles in the manufacturing sector are squeezing corporate profits and affecting the job market; food price inflation has surged (+10% y/y in August), and growth in bank loans to households has slowed (+16% y/y in August compared to +21% at year-end 2017). In this morose environment, it is interesting to note that the housing market has picked up a bit, with transaction volumes increasing slightly again in July-August, while average house price inflation continued to ease (+5.3% y/y in August). In the commercial and office real estate markets, in contrast, sales volumes continued to slump.

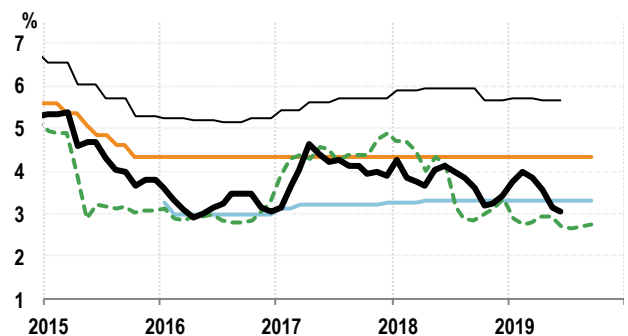
Monetary and fiscal policies have become increasingly expansionist since spring 2018 to counter the slowdown in domestic demand growth. Monetary and credit policy has been eased continuously and cautiously. Banks have been encouraged to increase lending to certain corporates, such as SMEs, the healthiest companies and the most buoyant sectors; liquidity conditions have been improved, thanks to successive reductions in reserve requirement ratios (the latest 50bp cut was in mid-September) and bank lending rates have been lowered slightly. To increase the effectiveness of its actions, the central bank announced a new interest rate reform in August 2019: the one-year loan prime rate will no longer be guided by the “benchmark lending rate”, but by the “medium-term lending facility (MLF) rate”. This change should improve the transmission of monetary policy and encourage the decline in interest rates on loans to the non-financial sector in the short term.

As a matter of fact, the weighted average lending rate on bank loans has not declined much since the beginning of monetary easing. From Q2 2018 to Q2 2019, it narrowed by 28 basis points (bp) in nominal terms and by 120bp in real terms (chart 3). Domestic credit growth has barely picked up. The rebound in bank lending (which accounts for two thirds of “total social financing”) proved to be short lived: after accelerating between H2 2018 and Q1 2019, nominal loan growth slowed again from 13.8% y/y in March 2019 to 12.6% in August. Banks have remained very cautious in view of the economic slowdown, the excessively heavy debt burden of borrowers, and high risk of defaults. Credit from non-bank financial institutions (shadow banking) has continued to contract, illustrating the authorities’ determination to continue cleaning up the financial sector. Bond issues were the only type of financing that has accelerated gradually over the past year (+11.3% y/y in August).

As a matter of fact, the authorities have little room for manoeuvre to boost credit. Beijing wants to stimulate domestic demand while also continuing to strengthen the financial sector’s regulatory framework, encourage deleveraging of both financial institutions and the weakest state-owned companies, and cool the property market in order to improve housing affordability. Excessive debt in the corporate sector (which was estimated at about 135% of GDP at mid-2019, excluding local government financing vehicles) and the already high level of household debt (55% of GDP) are major

3- Interest rates on bank loans do not decline much

Weighted average lending rate : — nominal — real
— 1Y Benchmark lending rate — 1Y MLF rate — 3M SHIBOR



Source: PBOC

factors constraining the growth and efficiency of new loans. Interest rates are expected to decline slightly further in the short term, and the authorities could try to ease monetary policy further if economic growth were to deteriorate further. Even so, this risks having only a very mild impact on activity.

■ The impact of fiscal measures should start to be felt

Growth in public infrastructure investment is beginning to pick up. It should strengthen further in the short term given the recent rebound in bond issuance by local governments for project financing. Yet the authorities have limited room for manoeuvre to boost public investment as local governments and their financing vehicles are also strapped with high debt (estimated at about 50% of GDP).

A series of fiscal stimulus measures have been introduced since 2018. Household tax cuts aim to stimulate consumer spending by providing direct support for disposable income. These measures are geared especially towards low-income households. For example, changes introduced over the past year include raising the income tax brackets for the lowest income earners. The authorities initially estimated that tax cuts would boost total disposable income by as much as RMB 660 bn, which could increase private consumption by a total of 1.2 percentage points. The positive impact on household spending was not visible yet in August’s economic indicators. However, the slight improvement in the “new orders” components of the PMIs for both the manufacturing and services sectors in September seems to suggest that a recovery in private consumption growth is possible in the very short term.

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Japan

The export sector is a source of concern

Japanese GDP growth was stronger than expected in early 2019. Despite the current troubles in the export sector, for the moment domestic demand - both public and private - is picking up the slack. In the short term, two sources of concern loom over Japan's macroeconomic scenario. First, Japan is highly exposed to the slowdown in both the Chinese economy and international trade. Second, the VAT increase in October will curb consumption during the year-end period and possibly in 2020 as well. Faced with these internal and external uncertainties, Japan will maintain accommodative monetary and fiscal policies, the effectiveness of which remains to be seen.

The most recent figures for Japanese economic growth were surprisingly strong as activity continued to expand at a relatively decent pace since year-end 2018. Yet two sources of concern still darken the horizon: the economy's exposure to Asia and the behaviour of Japanese consumers faced with October's VAT increase.

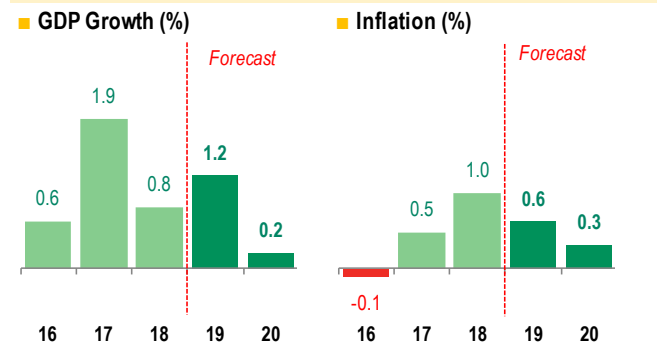
■ Sluggish exports

Since Q4 2018, Japanese GDP has grown at a relatively vigorous pace. Although quarterly growth declined, it remains relatively robust at 0.3% in Q2 2019, after 0.5% in Q1 2019 and 0.4% in Q4 2018. Like the other advanced countries, Japanese domestic demand picked up in H1 2019, but exports were hit by a sluggish environment. The economic slowdown in Europe and in the emerging markets, notably China, combined with the slowdown in world trade and the trade tensions are straining Japan's export and manufacturing sectors.

The latest cyclical indicators reveal a sharp and protracted deterioration in the manufacturing sector. For several months now, manufacturing PMI has held below 50, the threshold separating expansion from contraction (48.9 in September 2019). Meanwhile the services PMI is still resilient and holding at comfortable levels (52.8). This robust momentum could reflect the strength of private consumption in Q3 2019, buoyed by early purchasing ahead of October's VAT increase. The Bank of Japan's latest Tankan survey, an indicator of business confidence, delivered the same message. Manufacturing activity continued to deteriorate in 2019, while non-manufacturing companies showed resilience. Given the manufacturing sector's heavy weighting in the Japanese economy, however, its troubles could have a greater impact on the country's growth over the coming months. In Japan, manufacturing value added is equivalent to 20% of GDP, compared to an OECD average of 14%.

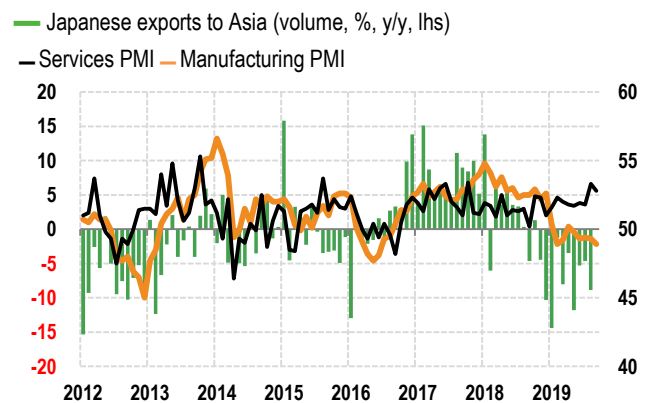
The difficulties in Japan's export sector began well before recent trade tensions. Highly concentrated in Asia, and in China in particular (nearly 20% of total exports), Japanese exporters have had to deal with a generally sluggish environment since 2011, when China's economy began to slow. Japanese exports to China were hard hit by a major backlash after the buoyant decade of the 2000s. In recent months, the difficulties in China, and in the Asian economies in general, have continued to erode the exports of Japanese companies. Japanese exports have declined continuously for several months.

1- Growth and inflation



Source: National accounts, BNP Paribas

2-Japanese exports and PMI



Source: Markit, Ministry of Finance

In 2020, Japanese GDP growth is expected to decrease further, to only 0.2%, compared to 1.2% in 2019. In addition to uncertainty over international trade, there is also concern about the 2-point VAT increase in October 2019 and the negative impact it is bound to have on household consumption. Public policy will remain accommodative, both in terms of monetary (which has only limited manoeuvring room) and fiscal policy (notably to offset the VAT increase).

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Eurozone

The ECB opts for more monetary support: how effective will it be?

At its September monetary policy meeting, the European Central Bank delivered a strong message. Through the broad mobilisation of its unconventional monetary policy tools, it aims to fulfil its mandate and reach its inflation target. At the press conference following the meeting, Mario Draghi seized the occasion to reiterate his call on certain eurozone governments to increase their fiscal support. The ECB is entering a long period in which it will have to remain mute, passing on the baton to the member states with comfortable fiscal leeway. This new round of monetary support is welcome considering the economic troubles facing the eurozone, although there are some doubts about its effectiveness.

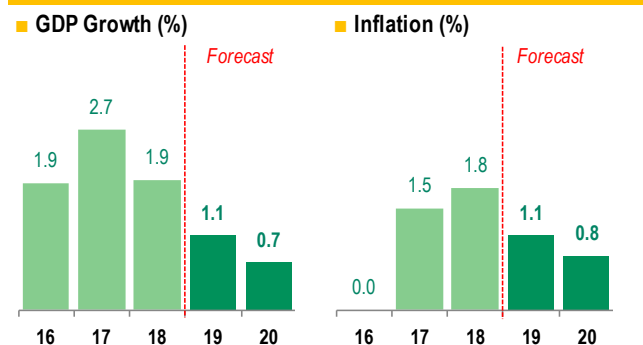
Once again, the European Central Bank (ECB) has shown that it can be extremely proactive. Looking beyond discussions on the redefinition of monetary policy and its targets, Mario Draghi has acted in keeping with his mandate. The big debate is now focused on the effectiveness of the measures announced at the 12 September monetary policy meeting and the adverse effects they might engender. Mr. Draghi again insisted on the need for greater fiscal support.

■ The ECB is preparing the groundwork for greater fiscal support

“In view of the weakening economic outlook and the continued prominence of downside risks, governments with fiscal space should act in an effective and timely manner”. The ECB’s Governing Council is now unanimously calling for more expansionist fiscal policies in the countries with sufficient fiscal manoeuvring room. Henceforth, fiscal tools will have to be the main instrument for stimulating demand so that the normalisation of interest rates can get underway. In this respect, this new round of monetary easing continues to ensure particularly favourable financing conditions for fiscal policy. The ECB made some major announcements at its 12 September meeting. Despite the reticence expressed by certain Governing Council members, the ECB and its President Mario Draghi decided to act quickly. A package of measures was announced that aims to fulfil its mandate and meet its inflation target:

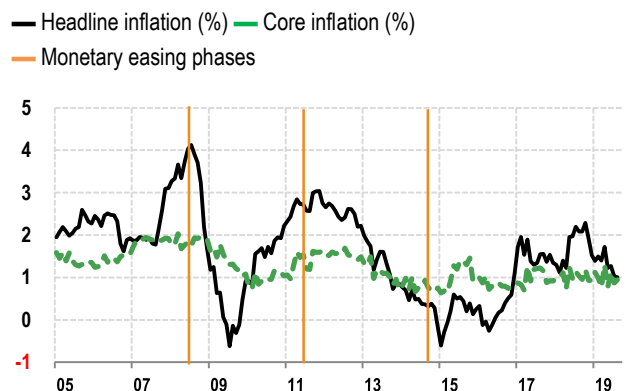
- Forward guidance will be strengthened by ruling out any rate increases until inflation had “robustly” converged with its 2% target. The press release explicitly refers to the core inflation component;
- The conditions for targeted longer-term refinancing operations (TLTRO) granted to eurozone banks will be improved by lowering rates and extending the maturity;
- The deposit rate applied to excess bank reserves will be reduced to -0.5% (from -0.4%) and a tiering system will be introduced. This system exempts part of bank reserves from negative interest rates in order to limit the negative impact on interest margins;
- Net securities purchases will be reactivated as part of Quantitative Easing (QE), with monthly purchases of EUR 20 bn starting in November 2019, for a duration as yet to be determined. These purchases will swell the ECB’s balance sheet again, which now accounts for about 40% of the eurozone’s GDP, thereby maintaining downward pressure on long-term rates in the eurozone.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Inflation and monetary policy



Source: ECB

Reading the chart: the orange bars refer to certain monetary easing phases conducted by the ECB. They comprise both key rate cuts and increases in the ECB’s balance sheet.

Unconventional monetary measures undertaken by the ECB since 2014 have had a positive macroeconomic effect. Without these measures, GDP growth and inflation would have been lower¹. The uncertainty currently straining the eurozone economy largely stems from external sources (see part 2). Under this environment, the effectiveness of the newly announced measures might be more limited than during previous phases of monetary easing.

¹ Speech by Philip R. Lane, *Monetary policy and below-target inflation*, Bank of Finland, July 2019

The ECB's next President, Christine Lagarde, is generally expected to be in line with Mr. Draghi. During a recent speech to the European Parliament, the former head of the IMF underlined the importance of fiscal policy to counter the current slowdown. Ms. Lagarde also reiterated the need to deepen institutional cooperation within the eurozone, notably through the creation of a common fiscal tool.

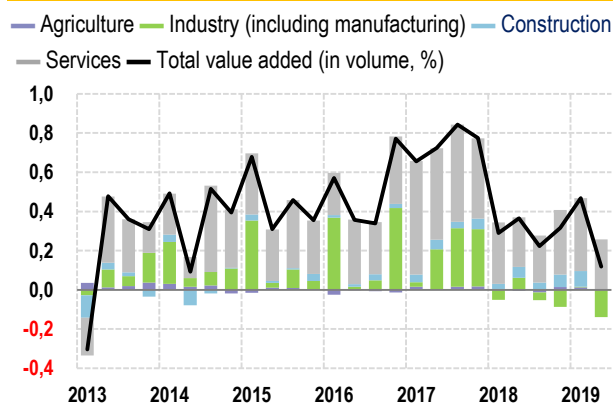
■ **The divergence of industry and services: an unprecedented situation?**

The current economic slowdown in the eurozone fits within a more global slowdown that can be seen in both the advanced economies and in the emerging markets. After a robust year in 2017, GDP growth in the eurozone seems to have faltered, slipping to an average of only 0.3% in the first half of 2019 (+0.2% in Q2 2019 and +0.4% in Q1). On the whole, private consumption -- the main growth engine in early 2019 -- has been resilient at a time of declining unemployment and dynamic wage growth. Investment has slowed, in part due to the high level of uncertainty. Despite a rather lacklustre international environment, foreign trade made a positive contribution to eurozone growth in the first half of 2019 after sharply curtailing activity in 2018.

For several months, the eurozone's economic situation has been marked by a sharp divergence between the dynamics of the manufacturing and services sectors. Since early 2018, manufacturing industry has made a generally negative contribution to eurozone growth (see chart 3). Inversely, the services sector is still resilient, thanks to strong domestic demand bolstered by an improving job market situation. This divergence is confirmed in the most recent economic publications for the eurozone. The purchasing managers index (PMI), which is closely monitored by economic observers for its sector-by-sector report on the health of the economy, has declined sharply in the manufacturing sector since the end of 2017 (see chart 4), while the services sector has been resilient.

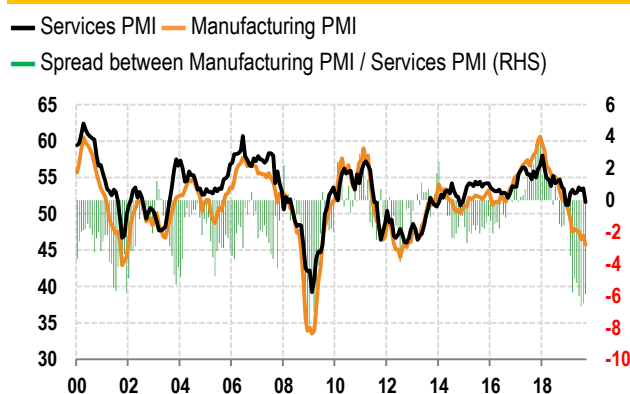
Structurally, activity in the manufacturing sector is more sensitive to shocks, especially external ones. However, the current situation seems to be rather unusual with regard to the eurozone's short history. Manufacturing PMI is particularly weak compared to the high score reported in the services sector. With the exception of 2008-2009, this is the widest gap ever reported since the euro's creation (see chart 4). This observation is especially true for the German economy, which has a bigger manufacturing sector and higher openness rate than its neighbouring countries. The absence of a rebound in world trade, confirmation of China's economic slowdown and uncertainty generated by trade tensions and Brexit negotiations are straining external demand and the manufacturing sector in particular. Though its share is growing, the services sector still accounts for only about 20% of global exports².

3- Contribution to the growth of total value added (pp)



Source: Eurostat

4- Spread between manufacturing PMI and services PMI



Source: Markit

How long can this situation last? How much longer will activity in the services sector withstand the troubles in the manufacturing sector? The key lies in the dynamics of domestic demand, and private consumption in particular. Consequently, we should keep a close eye on the job market situation in the short term.

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² Speech by Benoît Cœuré, *The rise of services and the transmission of monetary policy*, 21st Geneva Conference on the World Economy, May 2019

Germany

Unchanged policy despite stagnation

Weak data and business cycle indicators suggest that economy would be in a mild technical recession. The weakness is mainly in the manufacturing sector and has hardly affected the rest of the economy. Despite calls from different quarters, the government is unlikely to launch a fiscal stimulus, beyond what is in the coalition agreement and the climate package. Simulations show that spill-over effects of a fiscal boost to other countries will be limited. Moreover, the implementation might be hampered because of long planning periods and bottlenecks in the labour market. Political tensions could increase after the SPD congress in December.

■ A mild recession

Weak manufacturing data and business cycle indicators suggest that the economy contracted in Q3 for the second consecutive quarter, implying that the economy would be in technical recession. As the economy is currently operating close to full capacity, the current turbulence could for the moment be considered as a normalisation of the economic situation.

The weakness is in particular located in the manufacturing sector, against the backdrop of Brexit and elevated trade tensions. Germany's large manufacturing sector seems more affected than that in other countries. It is partly due to Germany's specialisation in transport and investment goods and its rather important exposure to the Chinese market. Moreover, several large firms listed on the DAX have been experiencing serious problems. The difference in price/book value between the S&P500 and the DAX is even at its largest for 18 years. By contrast, in the non-manufacturing sector, activity indicators, although weaker from a year earlier, remain at relatively high levels.

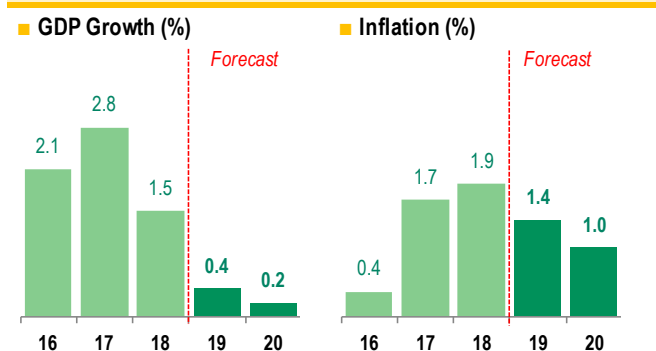
Despite the mild recession, labour market conditions remain extremely tight and vacancies remain at record high levels. In August, the unemployment rate stood at only 3.1%, the lowest in the eurozone. Given recent recruiting difficulties and the Germany's strict employment protection legislation, employers might prefer to hold on to their workforce by using short-time working schemes. The number of employees in these schemes has been increasing.

■ Government sticking to their fiscal guns

In September, Finance Minister Scholz announced the 2020 Budget. It will be mildly fiscal expansionary in accordance with the coalition agreement but the budget will remain in surplus (*Schwarze Null*). Policy will remain directed at increasing disposable income in particular for low and average income earners and families. This policy will continue in 2021 by increasing child benefits and the scrapping of the solidarity tax – a surcharge to help rebuild eastern Germany - for 90% of tax-payers. The authorities want to reduce the general government debt to close to 50% by 2023.

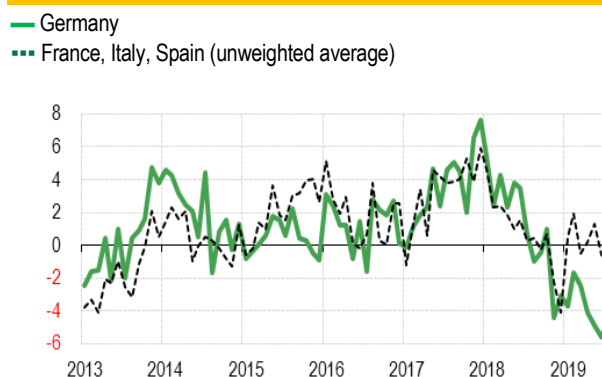
In addition, in the same month the government announced a comprehensive climate package in order to reduce CO₂ emissions by 55% from the 1990 level by 2030. From 2050, the economy should become carbon neutral. For the period 2020-2023, EUR 54 bn will be spent on incentives for climate-friendly behaviour and investment. This will be largely financed by the extension of the

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Manufacturing production (% y/y)



Source: Eurostat

emission trading system to cover the transport sector and the heating of buildings. The climate plan completes the earlier announced phasing out of coal by 2038. The government has made EUR 40 bn available for the restructuring of the coal regions over the coming 20 years.

Given the favourable budgetary situation and negative borrowing costs, the German government has come under pressure from international organisations such as the IMF and the ECB to use the fiscal room to support the economy. Recently also the German employers' organisation DBI joined the chorus. For the moment, these appeals have fallen on deaf ears. The German government argues that the economy is still operating close to potential. Moreover, because of the long lags and uncertain impact, fiscal



stimulus, beyond the operation of the automatic stabilisers, is maybe not the most appropriate instrument for the fine tuning of the business cycle. In addition, the spill-over effects on the rest of the eurozone is rather limited (see Box). However, Finance Minister Scholz has declared that he stands ready to loosen the purse strings in the case of an economic crisis.

■ Prolonged stagnation and political tensions

GDP growth is forecast to slow to 0.4% in 2019 and 0.2% in 2020. The main driver is domestic demand, in particular supported by generous wages increases. In Q2 2019, contract wages were 3.8% higher from a year earlier. Inflation is expected to decline from 1.4% in 2019 to 1% in 2020. However, core inflation is likely to increase gradually in the coming years, as a result of domestic wage pressures. The Bundesbank estimates that an increase in wage costs would lead to an increase in consumer prices by 0.3% in the medium term.

Heavy losses in the European and state elections for the governing parties CDU/CSU and SPD have led to tensions within the coalition. An increasing number of SPD members would like the party to leave the government. The SPD congress in December should elect a new leader – Finance Minister Scholz is amidst the contenders – and may choose a new direction, which could increase tensions in the coalition.

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3- The effectiveness of fiscal policy

We have used the NiGEM model to simulate the effect of an increase in government investment by 1% in GDP maintained over two years. Assuming no change in interest rates, real GDP in Germany would be 0.5% higher compared to the base run after two years.

This is substantially smaller than the initial shock, as the increase in demand pulls in more imports. Moreover, the labour market is set to tighten further which will drive up wages and consumer prices. In the second year, consumer prices will be 0.3% higher than in the base run. The resulting loss in competitiveness will also be supportive for imports, whereas exports may decline. As a result, the current account surplus will decline by 0.7% of GDP.

The initial deterioration of the government balance will be softened by the increase in tax receipts and reduced social spending. All in all, the government balance is set to deteriorate by 0.9% of GDP.

The spill-over effects to other countries are limited. The main beneficiaries of a fiscal boost are the small neighbouring countries. In particular, production in Hungary & Slovakia (both 0.4% higher than base run after two years) and the Netherlands & the Czech Republic (both 0.3%) will benefit from a German budget stimulus. The effect on France, Italy and Spain is close to 0.1% after two years.

These results should be interpreted with care. As a consequence of the shock, government investment would increase by almost 50%. It is doubtful if sufficient projects can be found on this scale and within a short time span. Moreover, labour shortages in the construction sector may form a major obstacle in implementing the programme.

Effects of fiscal expansion in Germany of 1 % of GDP*

	Year 1	Year 2
% from baseline		
GDP	0.45	0.46
Private Consumption	0.14	0.22
HCPI	0.10	0.30
% point difference from baseline		
Current Account**	-0.73	-0.66
Gov. financial balance**	-0.88	-0.89

*exchange rate, interest rates exogenous

** in % of GDP

Source: calculations BNP Paribas with NiGEM



France

Proven resilience

The French economy continues to show proof of resilience judging from the stability of its GDP growth – at an annualised rate of just over 1% – and the relatively strong showings of confidence surveys and of the labour market. Although prospects are still favourable, the horizon has darkened in recent months with Germany showing signs of recession, the escalation of trade tensions and lingering uncertainty over Brexit. We expect business investment and exports to decelerate sharply under the weight of a more uncertain, less buoyant external environment. Yet the slowdown is likely to be offset by the expected rebound in household consumption, supported by major fiscal measures to boost household purchasing power.

■ Cyclical indicators are still flashing green

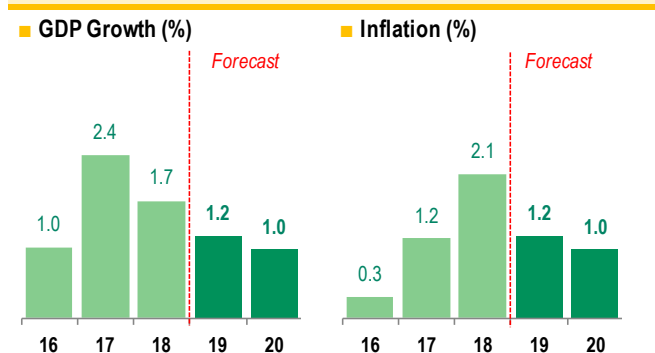
After a preliminary estimate of 0.2% q/q, the second estimate of Q2 2019 growth was revised upwards to 0.3% q/q, in line with expectations. Since Q3 2018, growth has not been very strong but remarkably stable and more solid than it appears at first glance: indeed, it relies on an average 0.4 percentage points contribution of final domestic demand. Hopes of a rebound in household consumption were dashed again in Q2 2019, as it rose by only 0.2% q/q after 0.3% in Q1. This bad news was nonetheless offset by good news on the investment front, with business investment accelerating to 0.9% q/q from 0.6%, and surprisingly strong household investment, up 0.8% q/q from 0.1% q/q. Changes in inventory and net exports moved in opposite directions again, with the former making a negative contribution of 0.2 points (after +0.3) and the latter a positive contribution of 0.1 points (after -0.3). The change in the contribution of net exports can be attributed to imports (-0.2% q/q following +1.1%) while exports remained sluggish (0.0% q/q following 0.1%), strapped by an unusually sharp decline in service exports.

Q3 growth prospects are still looking positive based on business confidence surveys available through September. Survey results suggest that growth will hold at the same pace as in the two previous quarters. On average, the INSEE composite index for Q3 held at the same high level as in Q2 (106), while the Markit composite PMI was slightly higher at 52 (from 51.3). The upward trend of these surveys since the beginning of the year, as timid as it may be, is another encouraging sign, as is the fact that weaker signals from the manufacturing sector have failed to spread to services for the time being. Lastly, consumer confidence is sending the most positive signal of the confidence surveys. In September, consumer confidence increased for the ninth consecutive month to 104. This score is sufficiently higher than the average reference point of 100 to consider that French households are no longer “less pessimistic” but “more optimistic”. Particular satisfaction can be expressed regarding the significant decline in fears about the evolution of unemployment.

Our nowcast model puts a damper on this positive interpretation of the survey results. Based on these soft data, Q3 growth is estimated at 0.2% q/q¹. This is in line with our growth forecast, while the INSEE and the Bank of France are estimating Q3 growth at 0.3% q/q. The reason we are somewhat less positive about this quarter

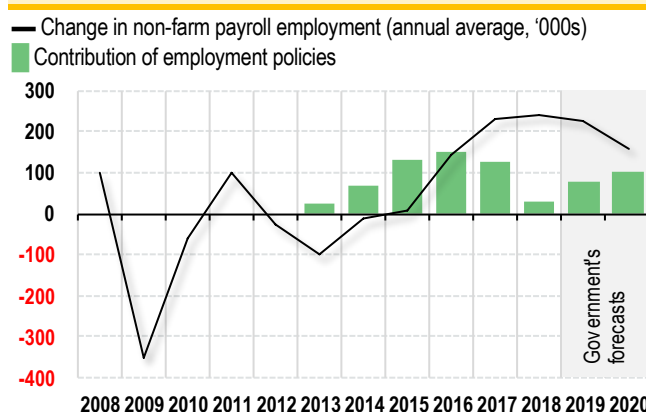
¹ The estimate based on hard data is only 0.1% q/q, but it is not very reliable since all Q3 data are not available yet.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Robustness of non-farm payroll employment



Source: INSEE, French government, BNP Paribas

and the next ones as well (we have lowered our 2019 and 2020 growth forecasts by 0.1 and 0.2 points, respectively, to 1.2% and 1%²) is our fairly negative analysis of Germany’s economic situation (see article in this publication), which spills over to French growth via the export channel.

We also expect business investment to drop sharply in the face of uncertainty, whose negative influence will be larger than the favourable impact of the currently loose financial and monetary conditions. Although the business confidence survey in the wholesale sector is not showing any early warning signs of such a

² These forecasts are lower than the Consensus mean. Our scenario is relatively pessimistic, explaining why we see risks as evenly balanced.



deceleration in business investment, the balance of opinions about investment are more mixed in the services sector. Moreover, in July, industrial business leaders revised sharply downwards their investment expectations for 2019. Moreover, after peaking in early 2018, capacity utilisation rates have also fallen by a little more than two points to 83.4%.

Since household consumption has still not picked up, we have also revised downwards our expectations. The latest monthly figures for household consumption of goods in August hardly showed any signs of a rebound. Consumption of core manufactured goods is not a lot more vigorous (transport equipment, residential goods, clothing and other goods). Even so, a rebound still seems like the most probable hypothesis, especially given the recent upturn in household confidence and new government measures to boost household purchasing power in the 2020 budget.

■ Support from the labour market

The buoyant labour market is both a cause and a consequence of the observed and expected resilience of French economic growth. The labour market's strength can be seen above all in the number of job gains, which continues to be surprisingly strong. The growth of private sector payroll employment is only slightly lower than the pace of GDP growth (1.3% in Q2 vs. 1.4% in year-over-year terms). This relatively robust momentum is accompanied by tensions (hiring difficulties, labour shortage) which, though no longer rising, are still strong. The upward pressure this tends to put on wages, however, has been limited so far, for a part because of the feeble labour productivity gains arising from the job-rich nature of growth. According to the DARES, this might also reflect the nature of labour market tensions: *"higher pressures seem to be largely due to high job turnover rates in certain very labour-intensive sectors for low-skilled workers, such as construction, personal services and food & hotel services"*³.

Unemployment statistics also reveal the robust nature of the labour market. The unemployment rate, which has fallen continuously since mid-2015, dropped to 8.5% in Q2 2019, the lowest level in ten years. Apparently, this is not only a cyclical decline. According to the DARES, the structural component has also fallen thanks to the reforms undertaken in recent years, notably to reduce the cost of labour.

Labour market prospects are still favourable too, both in the short term, based on the survey results available to date, and from the horizon of 2020, given the measures taken to enrich the job content of growth⁴ (see chart 2).

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³ DARES, *Le marché du travail en France : bilan des deux dernières années et perspectives*, Rendez-vous de Grenelle, 12 September 2019

⁴ CICE tax credit switch into an employers' contributions cut, Pacte law, hiring bonus, investment in skills plan (PIC), reform of the apprenticeship and vocational training system, unemployment insurance reform, increase in in-work bonus.

3- Green budgeting

Following the One Planet Summit in 2017, the OECD launched the Paris Collaborative on Green Budgeting to encourage the sharing of best practices in green budgeting (methodology and tools). In this respect, national budgets stand out as key levers for governments in fulfilling their environmental commitments.

A green budget details the environmental impact of government spending and revenue. A color-coded classification system, ranging from brown to green, highlights the environmental effects of fiscal and budgetary measures. Such a layout provides greater transparency for evaluating the budget's compatibility with the country's environmental goals. Moreover, this method can spur a virtuous circle from one year to the next, as the classification of measures as "brown" may create greater incentives for taking corrective measures.

In France's case, the Inspection Générale des Finances* (IGF) and the Conseil Général pour l'environnement et le développement durable** (CGEDD) submitted a preliminary report on this topic to the government in September 2019. They focused solely on classifying spending measures, as a consensus on the definition of environmental taxes has already been established. The report defines six environmental criteria:

- Fighting climate change;
- Adapting to climate change;
- Sustainable management of water resources;
- Transition to a circular economy and risk prevention;
- Prevention of pollution;
- Preservation of biodiversity and the sustainable management of natural spaces, farmland and forests.

Each spending item is given a score for each of these criteria using a scale of -1 (unfavourable) to 3 (very favourable).

As part of their study, the IGF and the CGEDD applied this method to four missions of the 2019 draft finance bill, in which EUR 55 bn of spending measures appeared as non-neutral. Between EUR 33 bn and 36 bn of spending measures were marked as favourable to the environment for at least one of the six criteria, and EUR 25 bn were marked as unfavourable for at least one of the criteria. Nearly half of the spending measures deemed unfavourable to the environment for at least one criterion (representing EUR 12 bn) are tax expenditures, and more precisely exemptions from domestic energy consumption taxes on petrol.

As a new practice, green budgeting is still at an early stage. The government has announced that it will introduce its first real green budget in 2021. The 2020 budget already fits within this framework given the publication of a new appendix to the budget proposal, entitled "Financing the Ecological Transition: economic, fiscal and budget tools at the service of the environment and the climate". As provided for in the 28 of December 2018 finance bill for 2019, it replaces the three existing appendices on the topics of environmental protection and climate change. This represents a first step in simplifying the analysis of the compatibility of the French budget with the country's environmental commitments.

* The General Inspectorate of Finance

** The General Council on the Environment and Sustainable Development

Source: French government, IGF, press.

Text box compiled by Zoé Klein, intern, BNP Paribas Group Economic Research



Italy

A long lasting stagnation

The new Government has approved the update of the economic and financial document, planning to raise the deficit to 2.2% of GDP in 2020. The 2020 Budget Law is estimated to amount to EUR 30 bn. Some measures contained in the budget, such as the cut of the fiscal wedge, are expected to sustain the economy with a positive effect on growth, despite an increasing uncertainty. In Q2, GDP increased by 0.1 y/y, as stocks negatively contributed to the overall growth, while exports continued to rise. Domestic demand suffered from the mixed evolution of labour market and the further delay of the full recovery of the housing market.

■ A new Government coping with old problems

After the August political crisis, a new coalition between the Five Star Movement and the Democratic Party has been formed. The new Government, still chaired by Giuseppe Conte, has approved the update of the economic and financial document. In 2020, the Government plans to raise the deficit to 2.2%, from 1.4% expected under the current legislation. The 2020 Budget Law, which will be approved by the end of the year, is estimated to amount to EUR 30 bn. The deactivation of the safeguard clauses on indirect taxation will cost EUR 23 bn. Other measures contained in the budget, such as the cut of the fiscal wedge and the confirmation of business incentives for high-tech investment, are expected to sustain the economy. In 2020, GDP is now forecasted to increase by 0.6%, despite an increasing uncertainty.

■ A persisting stagnation

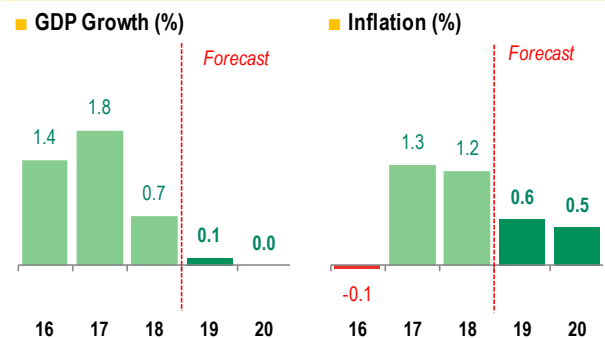
In the last one year and a half, the Italian economy has lost momentum. In Q2 2019, real GDP slightly increased (+0.1% both q/q and y/y). The breakdown of GDP data was mixed. For the fourth quarter in a row, stocks negatively contributed to the overall GDP increase (-0.2%), offsetting the positive support of domestic demand. Consumption continued to increase moderately (+0.1% q/q), also as a consequence of the still mixed evolution of labour market. In Q2, employment rose above 25.5 million, while the number of hours worked declined, (more than 500 million below Q1 2008). Capital expenditure rose by almost 0.4% q/q, as a result of a strong increase of investment in machinery and equipment, while construction investments declined.

In Q2, the contribution of net exports was positive, as exports rose more than imports. Although increasing, Italian sales abroad suffer from the uncertainty of the global outlook. According to trade balance data, in the first seven months of 2019, the value of exports rose by 3.2% thanks to a strong increase in the sector of pharmaceutical products (+28%), in that of food products and in that of textile products and clothes, while exports of means of transports declined by almost 5%. Italian firms benefited from a solid demand from the US (+9.2%) and from the UK (+8.9%), while sales to Germany significantly slowed (+1.1%).

■ The slowdown of manufacturing

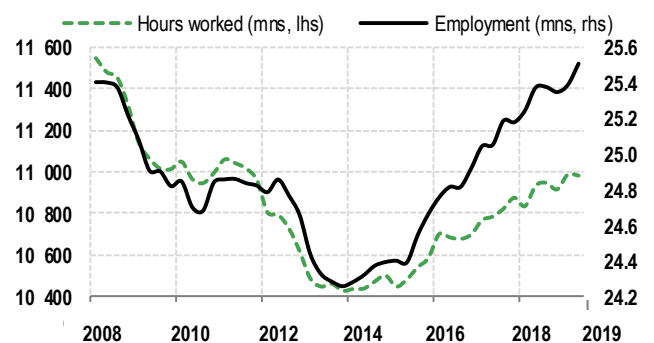
In Italy, the slowdown of economic activity mainly reflects the worsening of conditions in the manufacturing sector. In the last one year and a half, value added fell by 1.2%, to more than

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Labour market



Source: Istat

9 percentage points below the 2008 level. In the first seven months of 2019, industrial activity contracted by almost 1%. Given the strong relationship with exports, the decline of production had broader repercussions in the sector of means of transport, in that of textile products and clothes, in that of metal products and in that of machinery and equipment.

In Q2, value added of services has continued to experience only a moderate evolution, with the annual growth rate slightly positive (+0.2%). Value added declined by 0.7% y/y in the sector of financial and insurance activities and by 1.1% in that of professional activities, while real estate activities rose by almost 1%. From April to June, the slow recovery of value added of construction came to a halt, declining by 1.1%.



■ Housing market: recovery further delayed

In Q1 2019, according to Istat estimates, the prices of residential properties decreased by 0.8% y/y. A distinctive feature of the long period of decline in the Italian real estate sector is the divergence in trends between the new homes and the existing ones. During the first quarter of 2019, the prices of existing homes fell by 1.3% y/y, the ninth consecutive decline in a row, while new housing prices rose for the sixth consecutive quarter.

On the whole, the decline of house prices from 2010 (first year for which official data are available) amounts to 17.2%, totally due to existing homes, whose prices at the beginning of 2019 were 23.7% lower than they were in 2010. Prices of newly built houses were just 0.8% higher than eight years before.

In the same period (2010-Q1 2019), house prices increased by 48% in Germany, in France by 8.6%, while in Spain they decreased by about 9%.

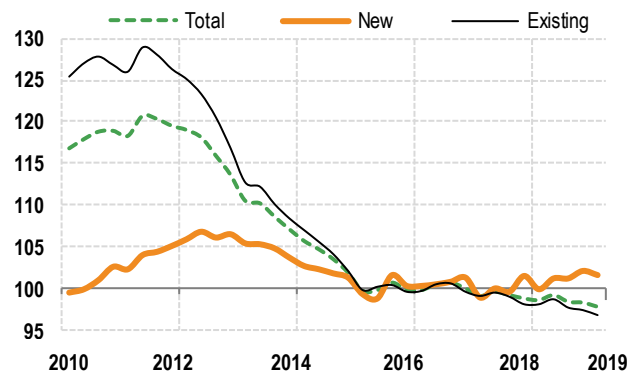
Should prices in Italy remain unchanged until the end of the year, 2019 would record a -0.8% with respect to 2018.

On the contrary, real estate transactions in Italy have been positive for sixteen quarters now. Between January and March 2019 residential property sales (non-seasonally adjusted) rose by 8.8% y/y (from 9.3% in the previous quarter) to almost 139,000 deals. Growth was positive in all areas of the country, in particular in the North East regions (+11.8% y/y) and in the Central ones (+10.7% y/y). Growth was particularly strong (+8.2% y/y) in the eight main Italian cities (in terms of resident population). In particular, double-digit increases were observed in Rome, (+11.9%), Milan (+11.3%), Genoa and Bologna (+15.2 and +12.9% respectively). In Palermo transactions slowed to +2% after having recorded a +18.5% at the end of 2018.

According to estimates by the Italian *Agenzia delle Entrate*, in 2018 (last data available) the combination of a declining price trend and an increase in sales led to a +5.2% in house market turnover, amounting to EUR 94.3 bn, 53 of which were concentrated in the Northern regions. Among the various areas, the largest increase was recorded in the North East (+9.4%), while in both the Central and Southern regions the increase in turnover barely reached +4%. In terms of turnover-per-housing unit, the drop amounted to 2,100 euros, mainly due to the reduction observed in the Center (-5,200 euros per unit) and in particular in Lazio (-6,250 euros per housing unit).

For the months to come, some qualitative analyses forecast an extension of the current sluggish phase: the monthly survey conducted last August by the Bank of Italy on the state of the sector shows that the share of experts reporting downward pressure on property prices remains stable compared to the previous months, and so does the margin of discount on offer prices. According to the same survey, the share of purchases financed by mortgages is growing, exceeding 80%, while the loan to property ratio is stable at 74.2%. The survey conducted by Nomisma (an Italian think tank) on household purchase intentions does not reveal substantial changes in the near future: in 2019 the number of households

3- House prices trend



Source: BNL calculations on Istat data

expected to buy a house is slightly decreasing compared to the previous year, while the percentage of those who claim to be looking for their first home is growing (to 74.8% from the previous 65.9%).

Italy remains one of the countries with the highest percentages of home ownership in Europe: in 2017 (last data available) 72.4% of households owned their own place (a percentage just slightly less than that of 2010) compared to 77.1% in Spain (down from 79.8% in 2010) 64% in France and 51.4% in Germany. The Italian home ownership reaches 83% when referred to the richest households (those with an income over 60% of the median value) while in the case of those with the lowest incomes (less than 60% of the median) the rate drops to 52%.

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Spain

Back to the ballot box

Spanish voters will be called back to the ballot box on 10 November, but there is no certainty that the election results will pull the country out of its current impasse. The political landscape is still too fragmented to produce a lasting coalition. The line to follow in the face of Catalan independence only exacerbates the divisions and helps justify the lack of co-operation. Meanwhile, growth has slowed somewhat more sharply than originally expected, although it is still holding around 2%, a performance that would be welcomed by many of the other big European economies. The elaboration and adoption of the 2020 budget bill will have to wait until a new government is formed.

■ A political impasse

Chalk up another collective failure for Spanish politics: although Pedro Sanchez clearly won the early legislative elections held on 28 April, he failed to form a government capable of winning the support of a parliamentary majority. The Socialist leader tried to form a minority government based solely on his party's support, but his plans ran up against Podemos' determination to integrate the new government as part of a veritable coalition. In late September he abandoned hopes of receiving a new mandate, and the King of Spain called new elections.

For the fourth time in four years, Spanish citizens will be called back to the ballot box on 10 November to elect their representatives. Although the tides could change in the weeks ahead, the first polls suggest that voters have no intentions of deviating much from the choices they made less than six months ago. If these trends are confirmed, the results will leave the balance of power in the parliamentary hemicycle virtually unchanged from the current situation¹. This might force party leaders to adjust their positions to exit the current impasse.

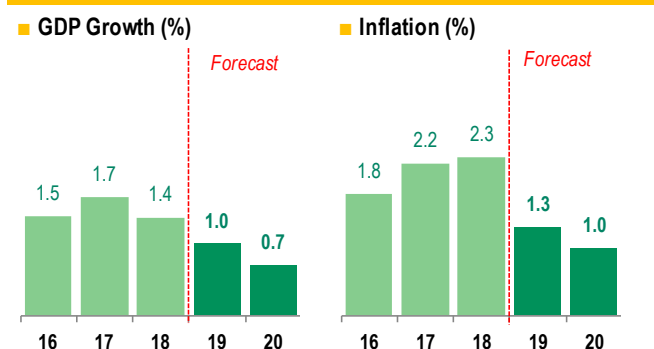
■ Heading towards a slowdown

Spain's image as a part of the European economic panorama has not changed: compared to the other major eurozone economies, the Spanish economy seems to be doing rather well. It boasts stronger growth with a relatively broader and more solid base.

Although economic activity has been resilient so far, there have been clear signs in recent weeks that the economic slowdown – which has already been perceptible at the European level for several quarters – is beginning to take hold and gain momentum on the Iberian Peninsula. In particular, the purchasing managers' index (PMI) for the manufacturing sector has clearly moved into contraction territory since last summer. Growth statistics for 2018 and early 2019 have also been revised rather sharply. Growth certainly seems to be better balanced: private consumption is not nearly as robust as initially announced and foreign trade, though still sluggish, did not slow as sharply as feared. All in all, the 2018 GDP growth figure was revised downwards to 2.4% (-0.2pp). At mid-2019, GDP growth was barely holding above 2% (2.1% y/y), while

¹ According to Politico's Poll of Polls dated 29 September 2019, the People's Party would build on its lead (21% of estimated votes, vs 17% in April), to the detriment of Ciudadanos (12% vs. 16%). The results are expected to remain virtually the same for PSOE (29%), Podemos (13% vs 14%), Vox (9% vs 10%), and the two Catalan nationalist parties ERC (4% vs 3%) and Junts (2%).

1- Growth and inflation



Source: National accounts, BNP Paribas

household consumption was up a little more than 0.8% y/y. In this environment, we revised our 2020 growth estimate down to about 1.5%. The slowdown is beginning to have an impact on the labour market, and employment rose only 0.3% q/q in Q2, the smallest increase since 2014. The unemployment rate has just fallen below 14% for the first time in ten years (13.9% in July) and continues to trend downwards for the moment, albeit at a lesser pace.

■ Public finances in autopilot

Under these circumstances, public finances will remain in autopilot. Like in 2019, the current political situation will make it difficult to prepare and adopt the 2020 fiscal plan, at least through the end of the year. Two key factors are likely to influence the process of reaching a fiscal equilibrium: 1) a slightly sharper-than-expected economic slowdown, which squeezes fiscal revenues in particular, and 2) the drop in sovereign bond yields in the eurozone, which obliges governments to regularly lower the average cost of debt on bond issues (0.37% in Spain for debt issued in H1 2019) and the annual debt servicing charge on public finances (2.4 points of GDP expected last April). Whether the next government is able to reach the 2019 deficit target of 2% of GDP, it will need parliamentary support to maintain the goal of reaching a public finance equilibrium by 2022.

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Belgium

Domestic demand under pressure to keep delivering

Belgian GDP growth is expected to come down from last year's 1.4% to a mere 1% in 2019 and 0.7% in 2020. This reflects a further slowdown in international trade, which is only partially offset by resilient domestic demand. Despite a slowdown in job creation, a pickup in disposable income spurs on private consumption well into 2020. Public finance remains a key risk-factor with government debt in excess of 100% of GDP. Further fiscal slippage seems almost inevitable with government formation talks not yet near a conclusion.

Business confidence in September stabilised below its long-term average level, confirming the downward trend since the start of the second quarter of this year. The Belgian industrial production index however posted a very strong increase right before the summer months, while the eurozone on average showed a decline for this measure over the same period. Clearly some caution should be exerted in interpreting the seemingly encouraging results of these surveys. Especially given the decline in industrial added value, which is estimated based on actual turnover-data.

Despite a strong showing in the 2nd quarter, investment growth is lagging behind what would be expected given its relationship with capacity utilisation rates. With the latter still above their long-term average, we suspect uncertainty with regards to geopolitical events (Brexit, US-China trade war) is weighing on investment appetite.

■ Labour market and prices

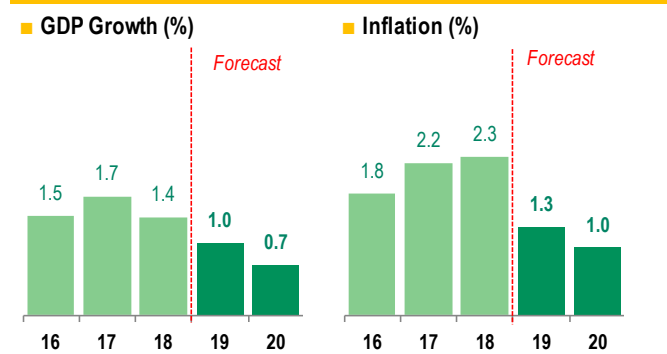
Since 2014, employment rose by 6% or almost 300,000 additional jobs. The unemployment rate is now well below 6%, with youth unemployment close to an all-time low of 13%. The employment rate of the population aged 20-64 remains perilously low. At 69.7% at the end of 2018 it is expected to fall short of its Euro2020 objective of 73.2% by 2020. Getting this number up remains a key-challenge to ensure the future sustainability of the country's social security system.

The vacancy rate, expressed as the number of vacancies compared to the total number of jobs in the service sector, has been above 4% since early 2017. This is well in excess of the eurozone average of 2.4%. Businesses struggling to fill job openings are symptomatic of the skill-mismatch between labour-supply and -demand. In addition, regional differences abound with higher unemployment rates in the Walloon (southern) part of the country.

During the last months, job-creation seems to be slowing down. The Federgon-index for temporary employment declined for 4th consecutive quarter. Previously, it had been on a five year non-stop upward trajectory from the 3rd quarter of 2013 onwards. Regardless of these early indications, private consumption is still expected to grow over the next quarters, with negotiated wages and wage indexation pushing up disposable income.

These factors will also contribute a further increase in hourly labour costs. The National Bank of Belgium (NBB) expects this increase to be only partially offset by productivity gains. The remainder would

1- Growth and inflation



Source: National Accounts, BNP Paribas

eat into producers' profits, rather than leading to higher prices. Headline inflation would fall back from 2.3% in 2018 to 1.3% in 2019.

■ Government policy

The public deficit improved markedly since 2014, moving from -3.1% to -0.7% in 2018. This was caused to an equal degree by two elements: declining interest charges and primary expenses falling faster than revenues. With regards to the first element, the Belgian Debt Agency has been instrumental in actively locking in the current low interest rates for longer on the outstanding public debt. The average maturity for the public debt went up by 4 years between 2007 and 2018, which is well in excess of the OECD-average of 2 years. As a result, the interest charges will likely remain at or below the current level of 2% of GDP for the foreseeable future.

The primary budget however is expected to deteriorate already this year, with the current minority government unable to push through unpopular measures to avoid further fiscal slippage. With government formation talks only just kicking off again, after the last regional formation talks were concluded last week, it's highly unlikely that this situation will be further mitigated still this year. We expect the headline deficit to reach 2% again for this year.

Such negative budgets will once again slow down the pace of debt-reduction. At 102% of GDP (2018) the public debt was well in excess of the Euro Area-average of 86%. This remains an important weakness of the Belgian economy.

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Austria

Vote of confidence in conservative policies

After its electoral success in late September, the conservative party (ÖVP) is expected to form a new government. To obtain a majority, the party could turn again to the FPÖ (far right). In that case, policies should remain largely unchanged and focus on fiscal consolidation and the reduction of the tax burden. The next government will face a less favourable economic environment. GDP growth could decelerate to around 1.2% in 2020. Nevertheless, public finances have improved considerably, giving the government sufficient leeway to fight a recession, if necessary.

■ The conservatives have won the election

The conservative party ÖVP of former Chancellor Sebastian Kurz clearly won the general election on 29 September. The party obtained 37.5% of the vote. To obtain a majority, Mr. Kurz has to look for a partner. A coalition with the Greens, which obtained their best score on record (13.8%) would look like an ill-assorted couple. The compromises it requires might be hard to swallow. Mr Kurz will not be tempted to revive the so-called grand coalition with the SPÖ (social-democrats). For its part, the SPÖ might not be so keen to join as it lost a significant part of its support: around 21.2% against 26.9% in the 2017 election. This leaves a coalition with the FPÖ (extreme right), weakened by scandals to 16.2% of the vote compared to 26% in the 2017 general election. The advantage of a continuation of a coalition with a much smaller FPÖ is that Mr Kurz could continue the old coalition programme centred on budget consolidation and the reduction of the tax burden, and obtain more ministers of his own party in the new government.

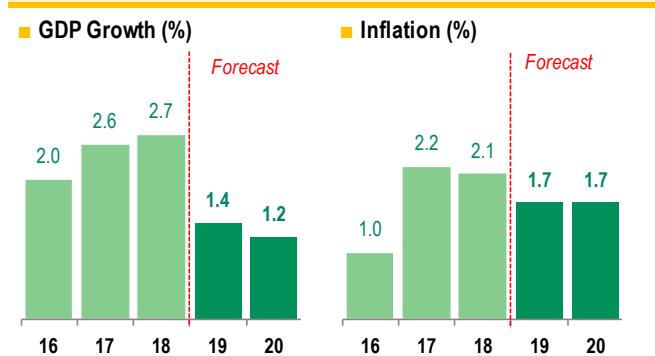
■ Healthy financial positions to confront the challenges

Any new government will be confronted with less favourable conditions than the first Kurz coalition. Whereas annual growth peaked at 2.7% in 2018, it is expected to slow to 1.4% in 2019 and 1.2% in 2020. This still looks quite favourable compared to other eurozone countries. The main reason for the growth deceleration is the slowdown in global trade. It has resulted in weaker demand from the eurozone, in particular from Germany and Italy, which account for almost 40% of Austrian exports. Manufacturers do not expect a quick improvement in the outlook. In our scenario, we expect production to only gradually recover in 2020.

In addition investment is slowing after having substantially increased in the past three years. In 2018, the investment ratio amounted to 23.9% of GDP, one of highest in the euro area. Because of the weakening of cyclical conditions and growing uncertainty, business investment has been slowing. In the building sector, housing permits have been losing momentum. These lead construction activity by about two years.

By contrast, private consumption should remain very dynamic underpinned by strong growth in household disposable income supported by a substantial increase in collective wages (2.9% against 2.6% in 2018) and some tax measures such as the introduction of the family bonus.

1- Growth and inflation



Source: National Accounts, BNP Paribas

Consumption growth should remain at around the same level as in 2018. In the coming years, even though disposable income is set to slow, consumption could remain rather dynamic, as households may be dipping into their savings.

Against this backdrop, labour market conditions are expected to remain very tight, and tensions may even rise further due to the retirement of the baby-boom generation. Immigration is likely to remain an important factor to overcome labour shortages. Wage settlements should remain generous, which will partly spill over in domestic prices, in particular for services. Inflation is expected to remain around 1.7% and core inflation could inch up to 2% in 2020 compared with 1.8% in 2018.

Public finances have improved considerably. Public debt has declined to 71% of GDP from 83% in 2010 and the budget shows a slight surplus. This would provide the government with substantial leeway to fight recession if necessary.

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Portugal

Renewed confidence

The economic slowdown has been very gradual so far, but it is expected to progressively spread during the second half of 2019 and in 2020. With unemployment at the lowest rate since 2002, households remain confident and have just renewed their confidence in Prime Minister Costa's administration. After winning the legislative elections of 6 October with more than 36% of the vote, the Socialist party is preparing to form a new government with the support of the other left-wing parties.

■ Slowdown underway

The economic slowdown in the eurozone continues to progress. The Portuguese economy has no chance of escaping this widespread movement and is caught up in the same uncertainties (spread of global trade tensions, Brexit, oil pricing trends...) that are currently creating downside risks for economic growth in the quarters ahead. Faced with this tough environment, Portuguese growth has proven to be very resilient so far, and we have barely had to revise our estimates. After two buoyant years, annual GDP growth did not slip back below 2% until year-end 2018. At 1.8% y/y, it has been resilient throughout H1 2019, with strong domestic demand, and investment spending in particular, offsetting a good bit of the negative effects of the slowdown in foreign trade. The slowdown is nonetheless expected to spread very gradually in H2 2019 and in 2020, driven notably by the easing of job creations and private consumption growth. At this point, we expect GDP growth to end up around 1.8% this year before slowing to 1.3% in 2020. That would bring next year's growth more or less in line with current estimates of Portugal's long-term growth potential, and for the fourth consecutive year, Portuguese growth would surpass the eurozone average (estimated at 0.7% in 2020).

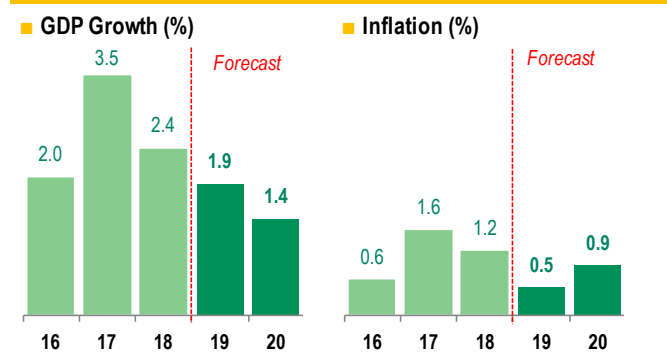
Particularly job-rich growth in 2017 and 2018 helped lower the unemployment rate to 6.5% in early 2019, the lowest level since 2002. In the first half of the year, the unemployment rate has more or less levelled off due to a slowdown in job creations (+0.7% y/y in Q2 2019, compared to +2.7% y/y in the year-earlier period), before resuming a downward trend in July and August. For the moment, this easing of employment growth has not really strained household confidence, and household spending continues to outpace GDP growth. At 4.5% of gross disposable income in Q2, the household savings rate is among the lowest in the eurozone.

■ Political continuity

Under this positive economic environment, the outcome of the 6 October legislative elections was no big surprise. Credited with successfully pursuing a social policy in recent years without disrupting the country's economic recovery, the incumbent party came out on top. The Socialist party won above 36% of the vote, and its leader, Antonio Costa, will be reappointed to head the government for a second mandate.

As in the previous legislation, he hopes to renew the past agreement with the other, more radical parties of the left: without

1- Growth and inflation



Source: National Accounts, BNP Paribas

participating in the minority government, they will nonetheless support its policies in the Assembly.

If this scenario is confirmed, we can assume that Portugal will maintain a prudent fiscal policy in the years ahead, even though the spreading economic slowdown is bound to put more pressure on the government. For the moment, in any case, fiscal consolidation continues. The fiscal deficit was trimmed to 0.5% of GDP in 2018 and should narrow further in 2019 (0.2% of GDP). Public finances will benefit not only from the support of economic growth, but also from the current fiscal discipline and from the ongoing effects of the very sharp drop in sovereign spreads in 2017. Under the current environment (further decreases in rates and spreads in H1, resumption of the ECB's net securities purchases as of November 2019), the expected reduction in debt servicing charges, estimated at ½ point of GDP over the next two years, could be surpassed. Moreover, the banking system's gradual recovery¹ reduces the risks looming over public finances. Based on current trends, the IMF recently estimated that the country could reach a fiscal equilibrium in 2020, and the public debt ratio could drop below the threshold of 100% of GDP by 2024.

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¹ The banking sector's non-performing loan ratio dropped back below 9% in Q1 2019, which is still poor, but much closer than in the past to the levels of the eurozone's other poor performers (with the exception of Greece and Cyprus).



Finland

Growth slows

Finnish growth had only just regained some momentum in 2015 before slowing again in 2018. GDP growth is expected to weaken further in the quarters ahead. The country's openness to trade exposes it to the deterioration of the global economic environment. Slower export growth and uncertainty linked to protectionist policies will undermine investment. Households, in contrast, should benefit from stronger wage growth. The unemployment rate has fallen to the lowest level since year-end 2008, and should continue to decline despite the slower pace of job creations.

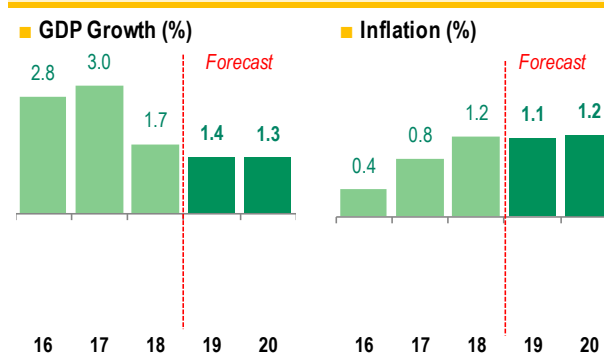
Finnish growth slowed sharply to 1.7% in 2018 (from 3% in 2017) and is expected to slow again this year. After rising 0.5% q/q in the first and second quarters, GDP is expected to increase by nearly 1.4% this year and by 1.3% in 2020.

■ A less favourable international environment

Finland will continue to reap the benefits of reforms to boost competitiveness¹ implemented in recent years. Its openness to world trade, however, exposes it to protectionist trade policies and the slowdown in the economic growth of its main trading partners, especially Germany². The deterioration of the international cyclical environment and the resulting sluggishness of non-resident investment will strain goods export momentum in the months ahead, especially since nearly a third of exports are comprised of capital goods. Moreover, there is still uncertainty over Brexit, the terms of which are still unknown.

Non-resident investment will slow in the months ahead due to the slowdown in exports. Residential investment provided major support for growth between 2016 and early 2018, but will now grow more moderately due to the slowdown in real estate price increases. Private household consumption should slow down slightly. Job creations grew at a hefty pace of 2.7% y/y in 2018, but should slow this year due to the slowdown in economic growth. Consumer spending, in contrast, will still be one of the main growth engines. Even a small decline in the unemployment rate should ensure a slight upturn in wages, which have long been contained by the "Competitiveness Pact". Job market pressures have increased, and the unemployment rate, at 6.6% in July, has returned close to NAWRU³, which the European Commission estimates at 6.5% in 2019. The growth of household disposable income will apparently offset the very slight acceleration in the inflation rate. Higher taxes on cigarettes and beverages should boost price inflation this year and in 2020. Yet these upside pressures will remain limited. Consequently, consumer price inflation, which was 1% y/y in August, should hold below the threshold of 2% y/y in 2019 and 2020.

1- Growth and inflation



Source: National Accounts, BNP Paribas

In recent years, Finland managed to clean up its public finances thanks to fiscal consolidation measures and a rebound in economic growth. The fiscal deficit is expected to contract slightly again this year (from -0.7% of GDP in 2018). Ongoing growth and the increase in indirect taxes should help offset the decline in income taxes and social security contributions. The arrival of a coalition government led by the Social Democrats in June 2019 could change matters as of next year. Wanting to end austerity, they plan to increase spending significantly. Yet new tax increases and privatisation schemes will probably not suffice to totally offset the increase in spending at a time of slowing growth. Public debt fell back below the 60% threshold in 2018 (to 58.9% of GDP), and should diminish again in 2019 thanks to a primary surplus, low interest rates and nominal GDP growth. Thereafter, it could decline more slowly than expected.

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¹ The "Competitiveness Pact", signed between the government and its social partners in 2016, extended the annual number of working hours by 24 hours without a wage increase, froze wages in 2017, and reduced employer social welfare contributions.

² In 2018, 15.1% of merchandise exports were shipped to Germany.

³ NAWRU, the Non-Accelerating Wage Rate of Unemployment, is the unemployment rate that does not trigger an acceleration in wages.



United Kingdom

Brexit update

As we approach 31 October 2019, the latest deadline for the British exit from the European Union (Brexit), who can say where the UK is heading? Probably not the Prime Minister himself, Boris Johnson, who lost his majority in the House of Commons in an attempt to suspend discussions and fuelled scepticism among his European partners by presenting a take it or leave it ‘compromise’ on the Irish backstop that is hardly applicable nor acceptable. This would leave the Brexit end-point with no deal, although this has been prohibited by a law, or the more likely, but by no means guaranteed, outcome of a new extension accompanied by an early general election.

It is now more than three years since the UK voted in a referendum to leave the European Union (EU). And yet, no one knows the direction in which the country is heading. A withdrawal agreement is on the table, but this has been rejected on three occasions by the House of Commons, so it would be quite some feat to get it ratified by 31 October 2019 (the next deadline). In a last attempt to find support at Westminster, Prime Minister Boris Johnson proposed to remove the “backstop” for Northern Ireland that was intended to prevent the return of hard border with the Republic of Ireland, while maintaining the integrity of the single market.

But his offer to the twenty-seven other EU member states (the 27) is unlikely to find favour either for its form (it has been presented as a ‘take it or leave it’ offer) or for its contents. Thin on detail, legally and operationally questionable, Boris Johnson’s alternative to the backstop suggests that the two Irelands could remain in a common regulatory zone, whilst belonging to two different customs unions (British and European) and that all this could be achieved without re-introducing border checks. At the time of writing, the European Parliament and the President of the Council, Donald Tusk, have given these proposals a pretty frosty reception.

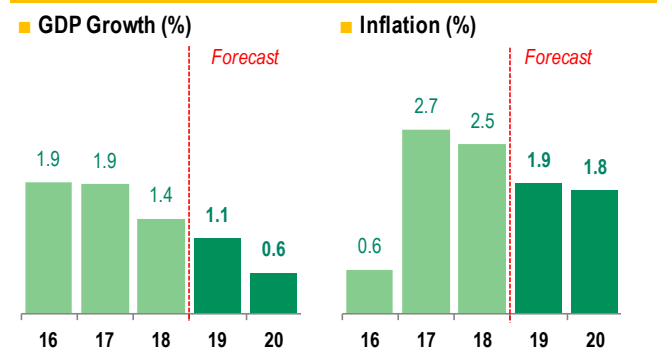
In the unlikely case Boris Johnson reaches a new deal with the 27, he would have the greatest difficulty in ratifying it, having lost his majority in a House of Commons he tried to suspend¹. This would leave the end-point either as a ‘no deal’, although this has been prohibited by a recent change in the law, or the more likely, but not by no means guaranteed, outcome of a new delay accompanied by an early general election.

Deal or no deal...

Whilst negotiating a withdrawal agreement (WA), the 27 have been actively preparing for the possibility of a no-deal exit. To do so, the Council and Parliament have adopted a series of contingency measures covering areas as varied as fisheries, data transfers, citizens’ rights, transports, chemicals or medicines. Most of the proposed solutions are temporary and subject to reciprocity from the UK (see Box 3); the European Commission has also indicated that they will in no way replace the EU’s rules and preferences, which will cease to apply to the UK on its departure date. The aim is to soften, as far as possible, the impacts of no deal, which nearly all economic actors – with UK businesses topping the list – believe to be both negative and inevitable.

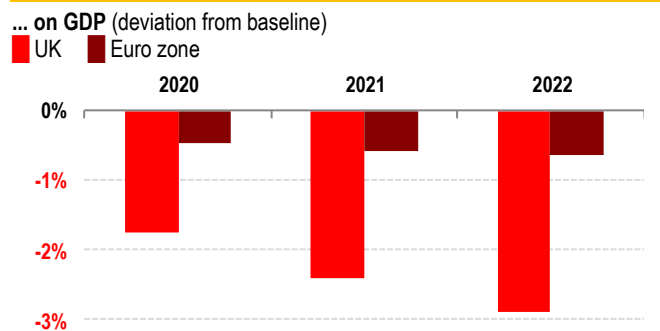
¹ The suspension was overturned by the Supreme Court on 24 September 2019.

1- Growth and inflation

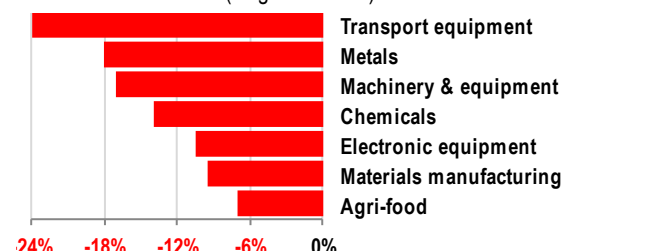


Source: National statistics, BNP Paribas

2- The economic cost of a no-deal Brexit...



... on production in certain sectors of UK economy
Deviation from baseline (long-term effect)



Source: OECD

In a study published recently², the Organisation for Economic Cooperation and Development put the loss in UK’s production following a no-deal at nearly 3 points of GDP by 2022. The National

² See OECD (2019), Interim Economic Outlook, September.



Institute of Economic and Social Research (NIESR) puts the figure at 5 points. This is only an average. Given the UK's role in European value chains, the losses would be particularly severe in several highly integrated sectors, like automotive and aerospace (Chart 2).

Whilst not negligible, the shock would be more bearable for the euro zone (a 0.6 pp loss in GDP after three year, five-times less than in the UK). Clearly, the picture would be very mixed from one country to the next, with Ireland, for instance, seeing an impact on growth eight times greater than that in Spain³. As a result, the support measures already include provisions to redirect EU resources (such as from the European Maritime and Fisheries Fund for example) towards the worst-affected sectors and regions.

A no-deal Brexit represents a leap into the unknown and no one can claim to be able to predict its exact consequences. Econometric analysis therefore plays only an indicative role. One of its merits, though, is that it shows that the process will end poorly for pretty much everyone; there will be no winners, only different types of loser. In the run-up to 31 October reason rather than desire is likely to push UK and EU leaders to agree a fresh extension (the third) prior to finally separating... or not. The UK could well hold an early general election, and at the moment the polls are showing a lead for Boris Johnson's Conservative Party.

■ ... the damage is done

Whatever the final outcome, the Brexit saga has already caused significant damage to the UK economy, which will be hard to repair. The transfers to continental Europe of the European Banking Authority, the European Medicines Agency, the security centre for the Galileo GPS system, or simply the subsidiaries and headquarters of groups seeking to secure access to the single market are all probably one-way moves. For the first time since the financial crisis of 2008, the UK's balance of payments has shown a chronic net outflow of foreign direct investment.

Economic conditions in the UK are deteriorating. Business surveys remained weak throughout the summer and GDP contracted in the second quarter. At 49.3 in September, the Purchasing Managers Index is at its lowest for ten years, apart from its brief collapse in July 2016 after the Leave victory in the referendum.

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3- Some examples of contingency measures adopted by the EU in the event of a no-deal Brexit

Citizens

On the withdrawal date, UK citizens will be considered as citizens of a non-member third country, without preferential treatment, implying enhanced border controls, passport and visa requirements and residence permits to travel and work in the EU, the withdrawal of mutual recognition of professional qualifications and of the automatic portability of social security rights, etc.

On condition of reciprocity, the contingency measures aim to guarantee UK citizens and their families resident in the EU prior to the withdrawal date the right to remain legally for a transitional period (12 months in France) during which time they can apply for permanent residence; they also seek to guarantee social rights acquired in the UK prior to the date of withdrawal, as well as equality of treatment in access to health care and the assimilation and aggregation of pension rights, etc.

Customs

On the withdrawal date, customs formalities and duties would apply immediately (declarations, VAT payments, possible guarantee requirements, etc.). Prohibitions or restrictions might apply. Import and export licences would be required, whilst Authorised Economic Operator (AEO) certifications granted by the UK would no longer be valid in the EU.

The contingency measures seek, as much as possible, to prevent blockages at borders and/or disruption to supplies: increased border post resources (both human and infrastructure), the temporary, conditional extension of the validity of checks and approvals for marketability carried out by the UK for certain products (medicines, veterinary products, etc.). In addition, nearly one hundred 'preparatory notices' have been issued to businesses to help guide them through the administrative and regulatory processes, adapt contracts, relocate facilities, restructure sites and so forth.

Air travel

On the withdrawal date, EU rules governing air travel services within the EU will no longer apply to the UK, resulting in the UK's loss of access rights for flights to EU destinations and for all flights (internal or international) operated within the EU or between the EU and a third country.

On condition of reciprocity the contingency measures aim to ensure basic air connectivity (maintaining services between the UK and the 27) for a short period of time, until 30 March 2020. After that date, carriers based in the UK will have to conform to EU requirements, notably in terms of ownership and control, in order to operate within the EU.

Source: European Commission

³ See Insee (2019), *Assessing the impact of Brexit on the economic activity of the UK's closest partners: the trade channel*, Conjoncture in France, March 2019.



Norway

Resilient growth

The Norwegian economy is expected to report robust GDP growth through the end of 2019, thanks to dynamic oil sector investments in Norway and abroad. Growth is expected to slow thereafter in a less favourable international environment. Moreover, investment in the Norwegian oil sector is expected to ease up in 2020. However household consumption should continue to grow at a relatively sustained pace, buoyed by wage acceleration. The central bank of Norway will not opt for any further rate increases in the quarters ahead. Inflation should hold near the central bank's target of 2%, while external risks are on the rise.

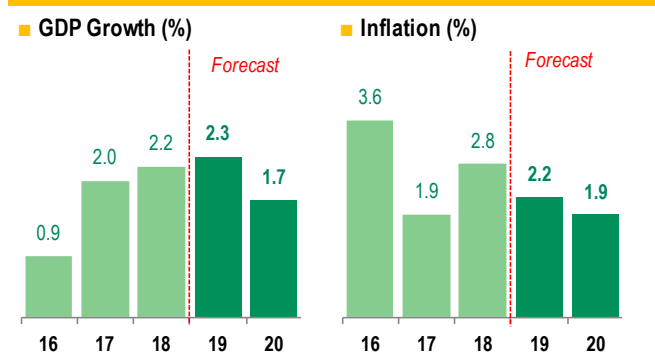
After a buoyant first half, the Norwegian economy is expected to report robust GDP growth excluding oil and maritime transport activities¹ through the end of 2019. The economy will grow somewhat more moderately thereafter, held back by a less favourable international environment and the slowdown in investment. Mainland GDP growth is expected to reach 2.3% this year and 1.7% in 2020 (compared to 2.2% in 2018). Total GDP growth is estimated at 1.4% and 1.8%, respectively, in 2019 and 2020 (vs 1.4% in 2018).

■ Dynamic household consumption

Norway's small, open economy should benefit from the recent depreciation of the Norwegian krone, as well as from strong global demand for oil services through the end of winter. Thereafter, demand is expected to drop off sharply. Exports are also expected to slump in 2020 due to trade tensions arising from protectionist policies as well as the deterioration in the cyclical environment of its main trading partners. Investment in the Norwegian oil sector has increased strongly since early 2018, lifted by the upturn in oil prices, and will continue to foster growth in the second half of 2019. Yet investment should ease up as of 2020. New development projects are likely to be smaller in scale than recently completed projects, mainly due to the lack of major oil discoveries. Residential investment and house prices are both expected to rise moderately in the quarters ahead. Corporate investment in the non-oil sector rose strongly between 2015 and 2018, but is expected to grow more moderately in the quarters ahead due to the completion of large-scale projects in the energy sector. Uncertainty over global growth prospects is also expected to erode investment incentives, especially in 2020. Consumer spending should continue to grow at a relatively sustained pace in the quarters ahead, despite higher interest rates and the slowdown in job creations. Unemployment is holding at a very low level (3.8% in July), which should boost household confidence. Moreover, it will be accompanied by stronger wage growth in 2019 and 2020. The real wages growth is also expected to accelerate. Consumer price inflation, which fell sharply in H1 2019 (to 1.6% y/y in August), is not expected to change much through year-end 2019, before accelerating slightly in 2020. The increase in unit labour costs and the recent depreciation of the Norwegian krone, undermined by all the uncertainty at the global level, should carry over to prices across the board. In September,

¹ Mainland GDP or GDP excluding oil and maritime transport activities accounted for nearly 84% of total GDP in 2018.

1- Growth and inflation



Source: National Accounts, BNP Paribas

the central bank of Norway announced its fourth key rate increase in a year, to 1.5%. Apparently, it will not opt for any further rate increases in the quarters ahead. The inflation rate is expected to hold close to the central bank's target of 2%, and external risks are on the rise. Moreover, foreign interest rates are particularly low. Faced with this environment, the central bank would apparently like to avoid an excessive appreciation of the krone, driven by an overly big distortion of key rates with those of the other central banks.

Norway is expected to benefit from a fiscal impulse of close to 0.5% of GDP excluding oil and maritime transport activities in 2019. The government is then expected to adopt a generally neutral fiscal policy in 2020. The non-oil structural deficit will hold just below the government's new threshold of 3% of the assets of the Norwegian Pension Fund Global². The weight of the deficit is expected to decline in 2020 thanks to a higher fund valuation (282.9% of mainland GDP in late 2018).

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² According to the fiscal rule, the amount deducted from the Norwegian Pension Fund Global to finance the deficit must not exceed the amount of revenues generated by the fund.



Economic forecasts*

%	GDP Growth			Inflation		
	2018	2019 e	2020 e	2018	2019 e	2020 e
Advanced	2.2	1.6	1.0	2.1	1.4	1.3
United-States	2.9	2.2	1.5	2.4	1.8	1.8
Japan	0.8	1.2	0.2	1.0	0.6	0.3
United-Kingdom	1.4	1.1	0.6	2.5	1.9	1.8
Euro Area	1.9	1.1	0.7	1.8	1.1	0.8
Germany	1.5	0.4	0.2	1.9	1.4	1.0
France	1.7	1.2	1.0	2.1	1.2	1.0
Italy	0.7	0.1	0.0	1.2	0.6	0.5
Spain	2.4	2.2	1.6	1.7	0.8	0.7
Emerging	4.4	3.8	4.2	4.7	4.8	4.5
China	6.6	5.9	5.6	2.1	2.4	2.8
India*	6.8	6.5	6.3	2.9	3.0	3.3
Brazil	1.1	0.5	2.0	3.7	3.7	3.5
Russia	2.3	1.2	2.0	2.9	4.8	3.8

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

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

Financial forecasts*

Interest rates, %		2019				2018	2019e	2020e
End of period		Q1	Q2	Q3	Q4e			
US	Fed Funds	2.50	2.50	2.00	1.75	2.50	1.75	1.25
	Libor 3m \$	2.60	2.32	2.09	1.70	2.81	1.70	1.25
	T-Notes 10y	2.42	2.00	1.67	1.00	2.69	1.00	1.50
Ezone	deposit rate	-0.40	-0.40	-0.50	-0.60	-0.40	-0.60	-0.60
	Euribor 3m	-0.31	-0.35	-0.42	-0.60	-0.31	-0.60	-0.60
	Bund 10y	-0.07	-0.32	-0.57	-0.80	0.25	-0.80	-0.50
	OAT 10y	0.26	-0.01	-0.28	-0.55	0.71	-0.55	-0.30
UK	Base rate	0.75	0.75	0.75	0.75	0.75	0.75	0.75
	Gilts 10y	1.00	0.84	0.40	0.55	1.27	0.55	0.75
Japan	BoJ Rate	-0.06	-0.08	-0.06	-0.10	-0.07	-0.10	-0.10
	JGB 10y	-0.09	-0.16	-0.22	-0.40	0.00	-0.40	-0.25

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019				2018	2019e	2020e
End of period		Q1	Q2	Q3	Q4e			
USD	EUR / USD	1.12	1.14	1.09	1.11	1.14	1.11	1.14
	USD / JPY	111	108	108	102	110	102	96
	GBP / USD	1.30	1.27	1.23	1.23	1.27	1.23	1.36
	USD / CHF	1.00	0.98	1.00	0.99	0.99	0.99	1.00
EUR	EUR / GBP	0.85	0.89	0.89	0.90	0.90	0.90	0.84
	EUR / CHF	1.12	1.11	1.09	1.10	1.13	1.10	1.14
	EUR / JPY	124	123	118	113	125	113	109

Source : BNP Paribas GlobalMarkets (e: Forecasts)



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