ECO PERSPECTIVES

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Editorial

Uncertainty overshadows the cyclical environment
The slowdown is spreading widely. Although it is reasonable to expect growth to normalise, several sources of uncertainty (fears of a trade war, Brexit, the US government shutdown, etc.) are acting as headwinds. China has already announced new measures, and in the United States, the Federal Reserve is insisting on its patience (concerning inflation) and flexibility when it comes to adapting monetary policy.

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ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Editorial

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Human nature is inclined to risk aversion: people are more sensitive to losses than to opportunity costs. A slowdown almost inevitably creates discomfort, due more to fears of what might happen than to the actual squeeze on earnings or revenues. Households postpone big-ticket purchases, companies slash their investment budgets, and banks become more wary about granting loans. In brief, slowing growth endogenously generates uncertainty, which only reinforces the sense of losing momentum.

Against this backdrop, we must add the exogenous shocks arising from political decisions over the past several months: US-China trade tensions, American threats of protectionist measures aimed at the European automobile sector, the government shutdown in the United States, and in Europe, Brexit, where the situation remains totally opaque just two months before the date when the UK is set to leave the European Union.

This picture must also be rounded out with specific factors pertaining to certain countries: new anti-pollution standards that are hitting the European automotive sector, notably in Germany and France; social unrest in France; and uncertainty over the Italian budget, which has had a lasting impact on interest rates even though an agreement was reached with Brussels for 2019. China's efforts to get a grip on lending trends has also contributed to a structural slowdown. All of this has tended to drag down survey indicators in most countries since early 2018. More recently, growth figures are also trending downwards. Towards the end of the year, the slowdown even spread to the United States, which has long resisted economic headwinds thanks to an expansionist fiscal policy.

Confronted with the decline in these key indicators, the central banks have considerably softened their stance since the beginning of 2019. Federal Reserve chairman Jerome Powell insists on the Fed's patience – since inflation remains under control – and on its flexibility, thereby sending an implicit but clear message that the Fed will not remain passive in the face of deteriorating prospects. Speaking before the European Parliament, Mario Draghi insisted that figures were weaker than expected and for a longer period than anticipated. It can no longer be taken for granted that the first key deposit rate increase will occur next fall. In China, the central bank has cut the banks' reserve requirements, which means they will be able to step up the volume of lending.

These positive signals do not really change the situation. The slowdown in the world economy is not due to financing troubles or excessively high real interest rates. It reflects doubts about the sustainability of the expansion, which are largely fed by growing uncertainties. In China, for example, this is why fiscal measures (tax cuts to stimulate spending and bond issues to finance infrastructure investment projects) should have more of an impact than monetary measures. From a more fundamental perspective, it is urgent to eliminate the sources of uncertainty to prevent a simple slowdown from festering into something more severe. Several signals recently suggest a slight improvement in US-China trade negotiations, since it is in the interest of both sides to prevent growth from contracting. As to Brexit, in contrast, it makes perfect sense to exclude the possibility of a no-deal Brexit given its extremely negative consequences. Yet fears of a hard Brexit persist and continue to act as a headwind for both the UK and the European Union.

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Heatmap of manufacturing PMI

	WD	Developed Markets – NA		Europe												Asia-Oceania			
	World	CANADA	USA	EURO ZONE	AUSTRIA	DENMARK	FRANCE	GERMANY	GREECE	IRELAND	ITALY	NETHERLANDS	SPAIN	SWITZERLAND	UK	AUSTRALIA	NEW ZEALAND	JAPAN	SINGAPORE
Feb-18	**54.1**	55.6	55.3	58.6	59.2	70.8	55.9	60.6	56.1	56.2	56.8	63.4	56.0	65.5	54.9	57.5	53.5	54.1	52.7
Mar-18	**53.3**	55.7	55.6	56.6	58.0	61.0	53.7	58.2	55.0	54.1	55.1	61.5	54.8	60.3	54.8	63.1	53.2	53.1	53.0
Apr-18	**53.5**	55.5	56.5	56.2	58.0	54.4	53.8	58.1	52.9	55.3	53.5	60.7	54.4	63.6	53.9	58.3	59.3	53.8	52.9
May-18	**53.1**	56.2	56.4	55.5	57.3	48.2	54.4	56.9	54.2	55.4	52.7	60.3	53.4	62.4	54.2	57.5	54.4	52.8	52.7
Jun-18	**53.0**	57.1	55.4	54.9	56.6	50.2	52.5	55.9	53.5	56.6	53.3	60.1	53.4	61.6	54.2	57.4	52.8	53.0	52.5
Jul-18	**52.8**	56.9	55.3	55.1	56.8	55.9	53.3	56.9	53.5	56.3	51.5	58.0	52.9	61.9	53.9	52.0	51.3	52.3	52.3
Aug-18	**52.6**	56.8	54.7	54.6	56.4	59.3	53.5	55.9	53.9	57.5	50.1	59.1	53.0	64.8	53.0	56.7	52.3	52.5	52.6
Sep-18	**52.2**	54.8	55.6	53.2	55.0	53.6	52.5	53.7	53.6	56.3	50.0	59.8	51.4	59.7	53.8	59.0	52.1	52.5	52.4
Oct-18	**52.1**	53.9	55.7	52.0	53.8	66.5	51.2	52.2	53.1	54.9	49.2	57.1	51.8	57.4	51.1	58.3	53.8	52.9	51.9
Nov-18	**52.0**	54.9	55.3	51.8	54.9	57.9	50.8	51.8	54.0	55.4	48.6	56.1	52.6	57.7	53.6	51.3	53.7	52.2	51.5
Dec-18	**51.5**	53.6	53.8	51.4	53.9	58.1	49.7	51.5	53.8	54.5	49.2	57.2	51.1	57.8	54.2	49.5	55.1	52.6	51.1

	Emerging countries – LATAM		Eurasia				Middle East & Africa						Asia				
	BRAZIL	MEXICO	CZECH REPUBLIC	POLAND	RUSSIA	TURKEY	EGYPT	ISRAEL	LEBANON	SAUDI ARABIA	SOUTH AFRICA	UAE	CHINA	HONG KONG	INDIA	INDONESIA	VIETNAM
Feb-18	53.2	51.6	58.8	53.7	50.2	55.6	49.7	53.6	47.3	53.2	50.0	55.1	51.6	51.7	52.1	51.4	53.5
Mar-18	53.4	52.4	57.3	53.7	50.6	51.8	49.2	54.7	46.5	52.8	46.7	54.8	51.0	50.6	51.0	50.7	51.6
Apr-18	52.3	51.6	57.2	53.9	51.3	48.9	50.1	54.0	46.2	51.4	49.1	55.1	51.1	49.1	51.6	51.6	52.7
May-18	50.7	51.0	56.5	53.3	49.8	46.4	49.2	49.6	46.4	53.2	49.4	56.5	51.1	47.8	51.2	51.7	53.9
Jun-18	49.8	52.1	56.8	54.2	49.5	46.8	49.4	52.6	46.0	55.0	48.0	57.1	51.0	47.7	53.1	50.3	55.7
Jul-18	50.5	52.1	55.4	52.9	48.1	49.0	50.3	58.0	45.4	54.9	49.9	55.8	50.8	48.2	52.3	50.5	54.9
Aug-18	51.1	50.7	54.9	51.4	48.9	46.4	50.5	50.4	45.6	55.1	45.2	55.0	50.6	48.5	51.7	51.9	53.7
Sep-18	50.9	51.7	53.4	50.5	50.0	42.7	48.7	50.0	45.8	53.4	44.6	55.3	50.0	47.9	52.2	50.7	51.5
Oct-18	51.1	50.7	52.5	50.4	51.3	44.3	48.6	52.7	46.2	53.8	42.4	55.0	50.1	48.6	53.1	50.5	53.9
Nov-18	52.7	49.7	51.8	49.5	52.6	44.7	49.2	53.7	46.7	55.2	49.5	55.8	50.2	47.1	54.0	50.4	56.5
Dec-18	52.6	49.7	49.7	47.6	51.7	44.2	49.6		46.2	54.5	50.7	54.0	49.7	48.0	53.2	51.2	53.8

46 48 50 52 54

Source: Markit, BNP Paribas

United-States

Landing

The assumption that the US economy is heading for a landing is gaining ground, not just because of the shutdown. The disruption created by the trade war with China, the appreciation of risk on bond and equity markets, the peaking of the energy sector and the deterioration of real estate indices all suggest less buoyant growth. This view is shared by the US Federal Reserve, which has adopted a more cautious tone and suspended the increase in policy rates pending future macroeconomic data.

The wind has turned in the US and, as is often the case in the world's biggest market economy, it was the stock market that proved to be the weathervane. Over the final three months of 2018, equity prices fell by 15%; whilst not a crash, this is a serious correction, which anticipates a likely normalisation of company earnings[1].

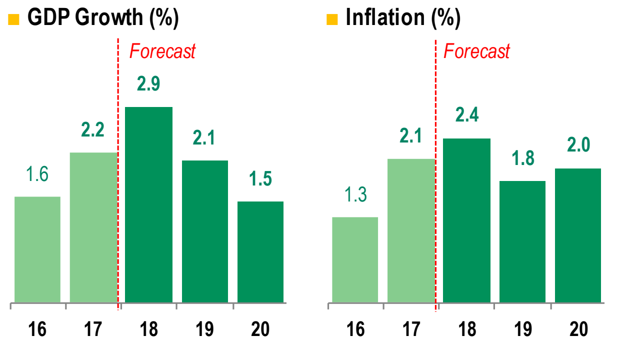
Blowback

There is little here that is surprising. With the effect of tax cuts waning, President Trump's trade war is claiming its first victims among US companies. In December 2018, the index of new industrial orders lost 11 points, registering its biggest fall since that triggered by the collapse of Lehman Brothers a little over ten years ago (Chart 2). In the industrial and exporting region of Philadelphia, the Fed's surveys suggest that expectations are less favourable.

With the price of oil dropping 25%[2], the energy sector is also feeling the pain. Highly leveraged, it is seeing tougher financing conditions (its risk premium is widening) and equity valuations falling. The immediate effects have been brakes on investment and production of oil and gas from fracking, which had set new records in 2018; these will be viewed differently depending on the importance one places on energy transition (see our article on page 24).

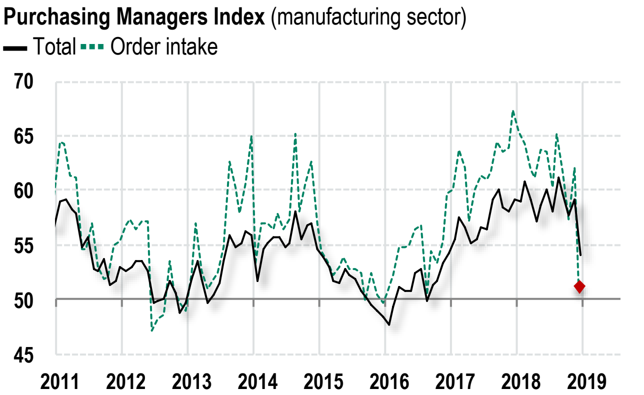
As mortgage rates rise, the real estate sector declines. The National Association of Home Builders (NAHB) index has lost ground, auguring over time a fall in housing starts and a correction in prices. Support will not come from the federal government, which, unhelpfully, is under a partial shutdown (see Box). This shutdown is already the longest ever, and will trim between USD5 billion and USD10 billion off economic activity each week[3]; its effects were not particularly visible at the end of 2018 but will be felt in the first quarter of 2019, when growth (at an annualised rate) will be trimmed by nearly one point.

1- Growth and inflation



Source: National accounts, BNP Paribas

2 - A sudden chill



Source: Institute for Supply Management

A change in tone from the Fed

Having made nine successive increases in the fed funds rate, taking it to 2.50% (upper limit), the Federal Reserve is now hinting at a pause. Even before the shutdown, members of the Open Markets Committee had tempered their economic diagnosis and their estimates of interest rate increases. Minutes from their last meeting (on 12 December 2018) suggest a cautious and watchful position, faced with feedback from business leaders in the field and

[1] Between 20 September 2018 (the last peak) and 31 December 2018, the Standard & Poor's 500 index fell 14.5%; over the same period, analysts downgraded their estimates of earnings per share.

[2] On 16 January 2019, a barrel of Brent crude oil cost USD61, 25% below its previous peak at the beginning of October 2018.

[3] Range of estimates based on the cost of the shutdown in the autumn of 2013. See: Committee for A Responsible Federal Budget (2013), *The Economic Cost of the Shutdown*, October.

imponderables such as Brexit, which the Fed has indicated it is following closely[4].

This change of tone has had its effects on the markets; for 2019 the forward yield curves suggest no monetary tightening but rather a status quo, or even a slight relaxation; in the sovereign bond segment, yields have fallen whilst the distribution across maturities has become nearly flat (Chart 3).

In the past, such a pattern has always presaged a slowdown in the US economy, and it is unlikely that this time will be any different. The flattening of the yield curve increases the carrying cost of debts and contributes to the inversion of the leverage effect, something that the US has made significant use of in recent years[5]. For a number of quarters now, the International Monetary Fund (IMF) has warned of increasing vulnerability of certain sectors of the economy such as energy, infrastructure, healthcare and telecommunications (IMF, 2018)[6]. The IMF indicates that the latest wave of corporate debt issuance not only set new records, but also carries the greatest risk. In 2018, 80% of issues subscribed by institutional investors (mutual or pension funds, insurance companies, etc.) were 'covenant lite', that is to say virtually without any guarantee. Half of leveraged lending was issued at multiples of at least five times annual operating income.

A widening trade deficit

Some USD45 billion in additional import tariffs have been applied since 2018; the US administration could go even further in 2019. On 17 February, the Department of Commerce will deliver its conclusions on the "threat to national security" represented by vehicles manufactured in the European Union, potentially opening the way to additional tariffs. On 1 March, tariffs on Chinese goods could be raised further. To what effect?

The tenuous link between tariffs and the trade balance has already been discussed on these pages[7]. And indeed, the increase in tariffs has, so far, done nothing to reduce the trade deficit. Quite the opposite; the trade deficit excluding oil widened over the final months of 2018. The 12 months cumulated deficit in October was USD800 billion, a record high. Ironically, the biggest increase came in the deficit with China, the country hit the hardest by far by new tariffs. Might this fact dissuade President Trump from going further in his trade war? One might hope so; but hope may not be enough.

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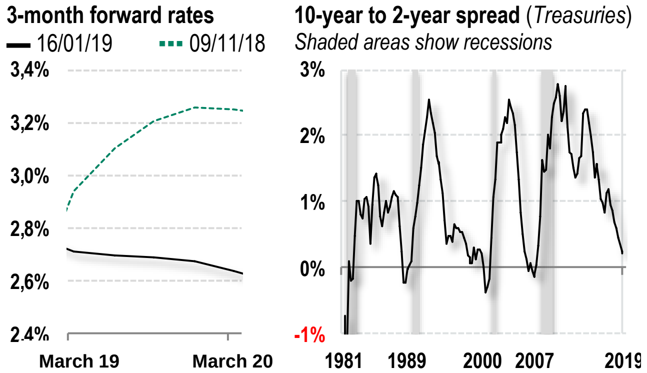
3 - Flattening out



Source: Thomson Reuters, US BEA

4 - The longest shutdown in history

Although it is far from the first of its kind, the current partial shutdown of the US federal government, which began on 22 December 2018, has set a new record for duration: at 27 days and counting on 17 January, it by far exceeds the 21-day shutdown under Bill Clinton at the end of 1995 and early 1996, let alone the average duration of 8 days. And at the time of writing, there is no end in sight, with the question of financing the wall that Mr Trump wants to build on the border with Mexico, the cause of the shutdown, still unresolved. The White House seems ready for the stalemate to continue at least until the State of the Union address, planned for 29 January. And we can not rule out the risk of a second shutdown later this year, at the time of the renegotiation of the debt ceiling, expected in September.

The negative effects on the economy come mainly from the knock-on effects of the immediate income shock for hundreds of thousands of civil servants required to work unpaid, on compulsory unpaid leave from services that are closed altogether, contract workers, subcontractors and those receiving social benefits, the payment of which could be under threat. The shutdown will cost between 0.1 to 0.2 of annualised quarterly growth per week. If it were to last throughout the first quarter, growth would be cut to zero. As a shutdown continues, its negative effects increase in a non-linear fashion. A significant part of the lost growth will, however, be made up in subsequent quarters thanks to employees receiving back pay. Employment data will also see a temporary impact.

The shutdown also interrupts the publication of data from the BEA and the Census Bureau (GDP, retail sales, consumer spending, durable goods orders, housing starts and building permits, new home sales), although not those from the BLS (employment and prices). As a result, the Fed will not have the usual range of statistical information available to it at its meeting at end-January nor, perhaps, that on 19-20 March.

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[4] Federal Open Market Committee (2018), Minutes, 18-19 December.

[5] Proutat J.L., (2017), *Is the US economy at a cyclical peak?*, BNP Paribas EcoFlash, June.

[6] Adrian T., Natalucci F., Piontek T. (2018), *Sounding the Alarm on Leveraged Lending,* IMFBlog, November 15.

[7] BNP Paribas EcoPerspectives, 3rd quarter 2018.

Eurozone

An anniversary against the background of a slowdown

After an eventful first twenty years, the eurozone is moving into a new phase of uncertainty. Growth has slowed markedly, and economic indicators have deteriorated. With temporary shocks and structural drags on growth, 2019 brings numerous risks. Against this background, and faced with underlying inflation that remains too low, the European Central Bank (ECB) is taking a cautious approach to this new year.

2017 already seems a long time ago. Since 2018 began eurozone growth has been slowing, and recent economic data suggest that the slowdown is becoming both more prolonged and more widespread.

Growing uncertainty

GDP grew by 0.2% q/q in Q3 2018, from 0.4% in the first half of the year and an average of 0.7% in 2017. International trade was responsible for a substantial share of this disappointing performance, having made a significant contribution to growth in 2017. The zone's four biggest economies (Germany, France, Italy and Spain) have all been affected by the slowdown, albeit to varying degrees. Germany and Italy saw negative growth in Q3 2018 (of 0.2% and 0.1% respectively), whilst Spain has retained some momentum.

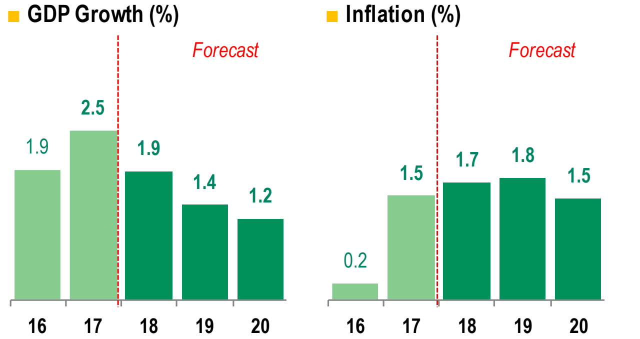
There are several factors to explain this slowdown. First, there is an expected and mechanical effect after a particularly buoyant 2017. Then there have been temporary localised effects, particularly in the German motor industry which has been held back by the introduction of new environmental standards. In addition, the climate of political uncertainty, particularly with reference to Brexit, is affecting both internal and external demand. Lastly, there are emerging supply side constraints, with the output gap virtually closing in 2017 and an unemployment rate close to its structural level. Many companies, especially in Germany, are facing growing difficulties in hiring staff.

The latest economic data suggest that the slowdown is set to continue. The purchasing managers' index for the eurozone (composite PMI) hit a 3-year low in December 2018, at 51.1. Although it remains in expansionary territory (i.e. above 50), its services component, which had held up well up until now, has been falling for a number of months.

All the major economies saw their PMIs slip during 2018 (Chart 2). In particular the French PMI fell very sharply in December in response to the 'gilets jaunes' protest movement. Meanwhile, industrial output fell in November in many eurozone countries, most notably in Germany (down 1.9% m/m).

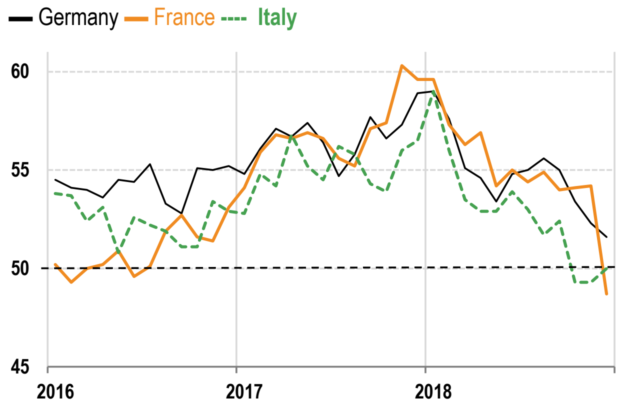
The economic gloom at the end of 2018 and rising levels of uncertainty threaten a sluggish 2019 and a forecasting picture ringed around with unknowns. On the trade front, an extension of increases in US tariffs, particularly on vehicles imported from the European Union, will hold back growth a little more[1]. A prolonged slowdown in growth in China, which remains an important export market for the German economy, would also be damaging. Germany has contributed nearly half of the eurozone's growth since 2010. The main source of support for economic growth is, in the end, likely to come from private consumption. Unemployment rates are at their lowest for ten years, employment rates are rising and wages are continuing to gain ground, albeit at a slower pace than in 2018.

1- Growth and inflation



Source: National accounts, BNP Paribas

2-Composite PMI



Source: Markit

[1] A. Berthou et al, *Costs and consequences of a trade war: a structural analysis,* Rue de la Banque, Banque de France, n°72, December 2018

These trends will support growth through consumer spending, which is itself a significant generator of employment[2].

The ECB remains cautious

Against this uncertain background the European Central Bank (ECB) remains cautious and flexible. Having ended net asset purchasing at the end of 2018 and undertaken to reinvest maturing securities for a prolonged period, the bank is not putting a stop to Quantitative Easing. By maintaining its balance sheet unchanged, at around 40% of eurozone GDP, through its reinvestment programme, the ECB will maintain a 'stock effect' that will continue to put downward pressure on long-term interest rates [3]. Monetary conditions will therefore remain accommodating.

The probability of a rate increase in 2019 is low and remains dependent on the sustainable convergence of inflation towards its target of 2%. In fact, inflation has fallen (to 1.6% y/y in December 2018, from 1.9% in November, Chart 3), in the wake of lower oil prices. The underlying inflation figure has struggled to get above 1% and for the time being seems unaffected by the marked upturn in eurozone wage growth of the past two years.

A brief look back at the expansionist monetary policy pursued since 2014 suggests that it has been positive overall. In particular, the risks of deflation, which were very real in late 2014 and early 2015, have been avoided. The ECB's use of non-conventional monetary policies and the strengthening of its forward guidance have helped consolidate the credibility of its actions and support economic activity in the eurozone, notably through the resulting reduction in financing costs and support for lending.

20 years on: a difficult convergence

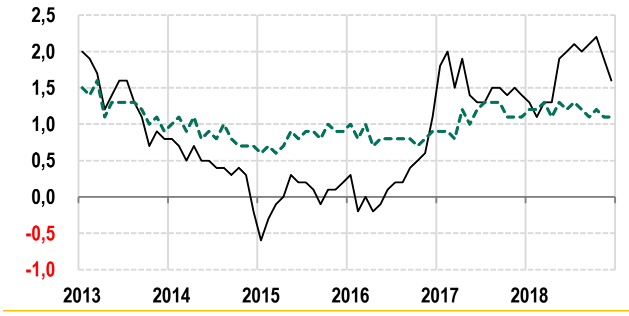
Although monetary policy has helped mitigate the impact of shocks since the creation of the single currency 20 years ago, challenges remain, notably in the area of real convergence.

Since its creation, the eurozone has seen average annual GDP growth of 1.4%, but this figure hides some disparities. Germany and France have seen similar levels of growth (around 1.4%), whilst Spain has grown faster (1.8%) and Italy has struggled (0.4%).

Despite two deep economic crises, the majority of eurozone member countries have significantly higher real per capita GDP than in 1999. However, convergence between member states has been more mixed. All other things being equal, and using Germany as our reference point, per capita wealth has tended to diverge since the introduction of the euro (Chart 4). The trend is somewhat different for the member states that joined more recently and are still catching up economically.

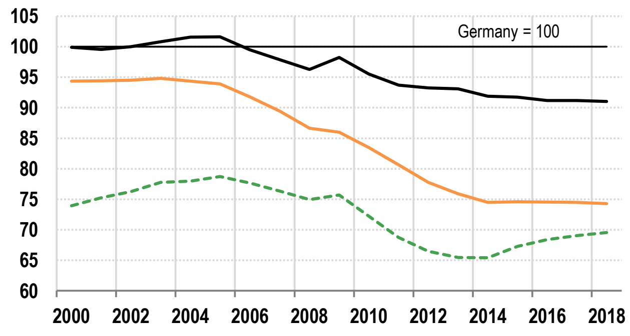
The divergence relative to Germany nevertheless needs to be seen in context. Over the past twenty years German population growth has been virtually nil, whilst the populations of France and Spain

3- Inflation



Source: Eurostat

4- Per capita GDP in real terms (as % of German per capita GDP)



Source: Eurostat, AMECO, BNP Paribas
Note: For the 2018 annual growth figure accrued growth to end Q3-2018 has been used.

have continued to grow strongly. In Italy, despite modest population growth over the period, per capita GDP has been pretty much stagnant on average.

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[2] R. Anderton et al., *Disaggregating Okun's law - Decomposing the impact of the expenditure components of GDP on euro area unemployment*, ECB, Working Paper Series n°1747, December 2014

[3] J. Dalbard, et al, *The end of net asset purchases does not put a stop to quantitative easing,* Banque de France, December 2018

Germany

Economic climate change

Economic growth has slowed markedly since the second quarter of 2018 and business surveys indicate that it is unlikely to change in the coming months. The exporting manufacturing sector is much affected by the slowdown in world trade. In the coming quarters, the domestic economy is likely to become the major engine behind growth thanks to an expansionary fiscal policy. More fiscal stimulus could be expected if the economy would slow further. This would also shore up the chances of the coalition parties at the next federal election set for 2021.

Slowing down

The business cycle has slowed substantially since the second quarter of 2018. Problems in the car industry following the introduction of new European emission standard resulted in substantial production losses. In addition, the banning of older diesel cars from city centres has also been affecting car sales in this segment. In November, automotive production was 12% lower from a year earlier. However, the problems are not only restricted to the car industry. Export demand in general has eased due to a slowdown in world trade. Furthermore, private consumption slowed, despite favourable developments in the labour market. As a result, the household savings rate is trending higher. The exception to the bleakness was housing construction, driven by shortages and rapidly increasing prices. Overall, Destatis estimates that GDP increased by 1.5% in 2018, i.e. a full percentage point less than in 2017.

Despite slowing demand, the unemployment rate has further declined to only 3.3% in November, the lowest in the euro area, while bottlenecks in the labour market have further increased. In the manufacturing sector, about one in four employers report recruiting difficulties. In the construction sector, 10% of builders report that it is even their main limiting factor. The German economy increasingly recruits foreign workers. In the twelve months to October 2018, the economy created as many as 700k jobs, of which 54% were occupied by foreigners. The German parliament recently adopted an immigration law to facilitate access to the labour market for workers from outside the EU.

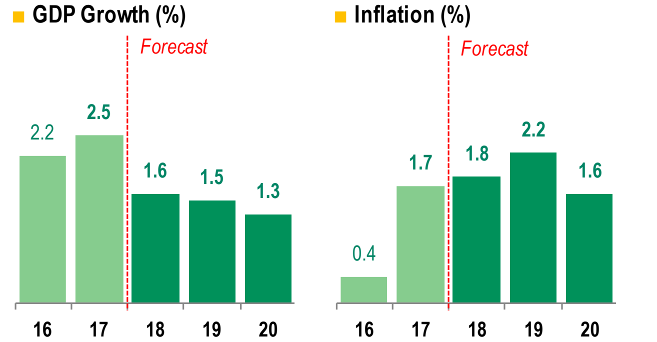
The favourable economic situation and growing labour shortages have resulted in a rise in negotiated pay rates. In the fourth quarter of 2018, basic pay was 3.2% higher from a year earlier. In the manufacturing sector, hourly earnings increased by 3.5%. These pay hikes have not yet resulted in a pick up in inflation.

Room for fiscal easing

Looking only at the economic results, the actual grand coalition between conservatives (CDU/CSU) and social democrats (SPD) should be doing quite well. The government finances are in rude health. For 2018, the government finances were again in surplus, estimated at 2% of GDP. Moreover, public debt declined to around 60% of GDP, for the first time since 2002.

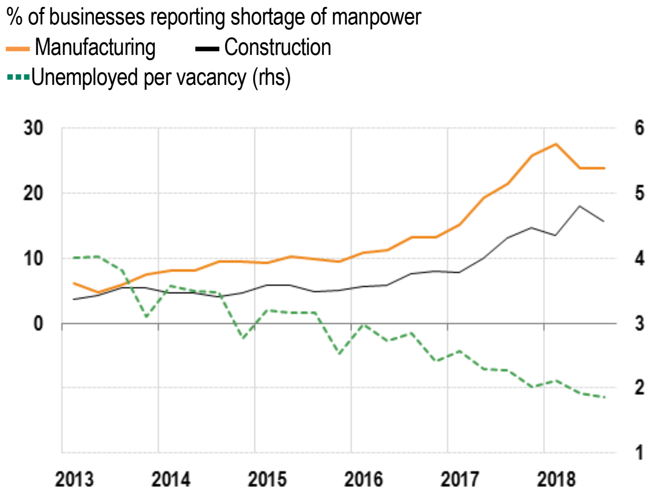
Nevertheless, many voters are unhappy with the ruling coalition, as can be seen in the polls and the outcomes of several state elections.

1- Growth and Inflation



Source: National accounts, BNP Paribas

2- Increasing bottlenecks in the labour market



Source: IFO, IAB, BNP Paribas

Following the disastrous results of the CDU/CSU in state elections in October, Chancellor Merkel announced to renounce the leadership of her party in December and to step down as chancellor at the next election to be in 2021. The CDU elected Annegret Kramp-Karrenbauer (AKK) as party chairman. This choice confirmed that the CDU wants to remain a broad people's party. The CDU/CSU is currently polling around 31%, slightly lower than at last year's federal election (32.9%).

The SPD is in a much more difficult position. In the polls, the party obtains the support of only 15%, compared with 21% at the federal election. Many party members would like the party to quit government at a suitable moment in order to rebuild the party from the opposition benches.

The Green Party profits most from the discontent. According to the latest polls, it would obtain 19% of the vote, a gain of 10 points compared to the 2017 federal elections. In eleven of the sixteen States, the Greens are already in the state government, mostly as junior partner. The populist right AfD is only doing slightly better than at the latest federal election. The next election is for the European Parliament in May. In autumn, several state elections will be held in the eastern part of the country.

According to the coalition agreement, fiscal policy should be mildly accommodative in the coming years. On the expenditure side, income transfers both at the federal level as the regional will be increased. This will be partly compensated by lower interest payments, as the government continues to borrow at extremely low interest rates. On the income side, tax reductions will be implemented even though the tax burden is estimated to decline only marginally. Pointing at the healthy budgetary situation, CDU leader Kramp-Karrenbauer has already called more tax cuts to head off an economic slowdown. By contrast, the SPD prefers stepping up spending on education, income transfers and digitalisation. Finance-Minister Scholz (SPD) remains cautious, warning that the era of windfalls in taxes is probably over.

Subdued growth in 2019-20

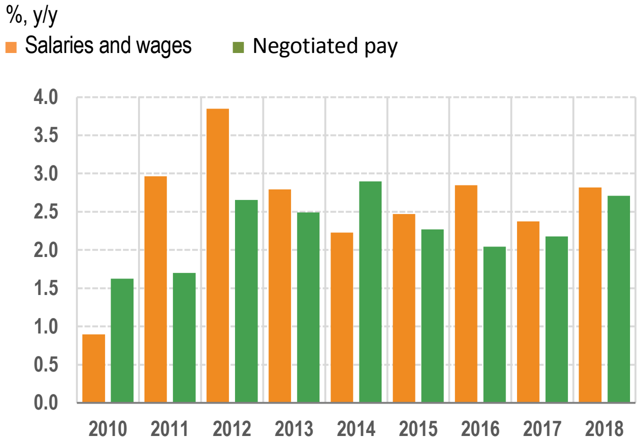
GDP growth is likely to be subdued in the coming quarters. The latest survey data is in line with this scenario of continuing weakness. The IFO climate index has been declining since September. It reached 101 in December, just above the average in 2015-16.

The activity slowdown is most obvious the manufacturing sector. The problems concern the new European exhaust norms are likely to be temporary and some catch-up should be expected in the coming months. The main problem for the sector is the slow growth of world markets. Both in 2019 and 2020, world GDP is projected to growth by around 3.3%, 0.5 percentage point lower than in 2017-2018.

By contrast, domestic demand is likely to remain rather strong thanks to the expansionary fiscal policy. This is likely to underpin household consumption in the coming quarters. Moreover, because of problems in the car sector, household have been delaying their car purchases. As a result, the household savings rate reached 10.7% in 2018, a highest since end 2005. This could give an additional boost to spending, in particular in the first half of this year.

Growth in government investment is likely to outpace GDP growth in 2019-2020, given the spending plans on transport infrastructure, childcare facilities and schools. However, administrative bottlenecks, the lack of building plots and capacity constraints might limit the execution of the programme.

3- Rising wage tensions



Source: Deutsche Bundesbank, Destatis, BNP Paribas

The lack of skilled workers is also likely to weigh on housing investment. Also other factors, such as the decline of the native-born German population and the increase in mortgage interest rates are likely to weigh on construction.

The downside risks to our projection are mainly related to the international environment, such as the undecipherable US trade policy and a possible disorderly Brexit. On the other hand, the domestic risks are on the upside; In particular, the healthy fiscal position gives the German authority some leeway in implementing a more expansive fiscal stance. This might also shore up the chances for the ruling coalition at the next federal elections in 2021.

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France

2019, another testing year

2019 is getting off to a less strong start, with economic activity having taken a hit from the 'gilets jaunes' protest movement. The collapse in consumer confidence has been abrupt and the global environment looks less certain. Against this background, fiscal policy is being loosened: the new plan to support the purchasing power of lower income households, announced in response to December's demonstrations, should help consumer spending to catch up, at least in part. It comes alongside measures already introduced in the 2018 budget to support consumers and companies. French growth is therefore likely to show signs of resistance.

A look in the rear-view mirror at what happened in 2018 helps set the particular context as we move into 2019. Many things changed in just one year. The optimism that reigned at the beginning of 2018 proved short-lived. The strong growth that was expected as a result at that time, building on that in 2017, did not materialise. And, having looked exceptionally clear at one point, the outlook grew significantly less rosy over successive quarters.

Yellow card

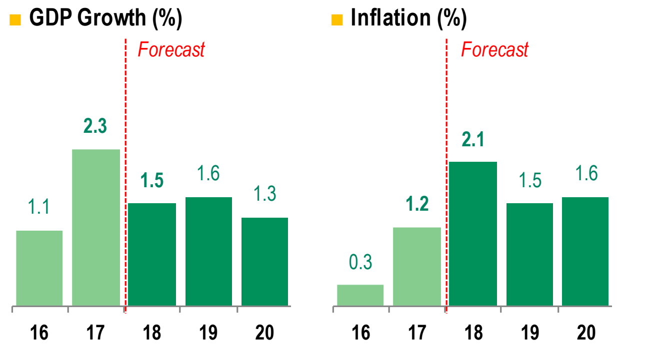
There were many reasons for this. External headwinds (a strong euro and high oil prices, trade tensions and the slowdown in global growth) coupled with domestic factors (supply-side constraints and recruitment difficulties) contributed to depress the underlying trend to a degree that exceeded expectations. French growth also faced a series of five shocks. Two were predictable, but proved highly disruptive (tax increases in Q1; the introduction of the Worldwide Harmonised Light Vehicle Test Procedures, or WLTP, in Q3); the other three were of the unforeseeable sort (warm winter weather; transport strikes in Q2 and the 'gilets jaunes' protests in Q4).

It follows that despite the dissipation of the factors that held back growth in Q2, there was scant recovery in Q3 (0.3% q/q according to the third estimate[1], after 0.2% q/q in Q2) and growth is expected to be again dragged down in Q4, with the 'gilets jaunes' protests wiping out the rebound that had been expected before the protests took place.

As far as the third quarter limited growth rebound is concerned, this was due to the limited upturns in consumer spending (0.4% q/q, from -0.1% q/q in Q2) and exports (up by just 0.3%, having been flat in Q2 and fallen by 0.4% q/q in Q1). These lacklustre figures came alongside similarly unimpressive numbers for public investment (stable after a 0.6% q/q rebound) and household investment (down just 0.1%, although this was the first quarterly decline since Q2 2015). Although the contribution from net exports was positive (0.3 of a percentage point), that was the only positive thing about it, as it was the result of a fall in imports (-0.6% q/q) and came alongside a negative contribution from inventories (-0.4 ppt). Business investment was alone in showing real vigour, and indeed growth accelerated from Q2 (1.3% q/q) to Q3 (1.5% q/q).

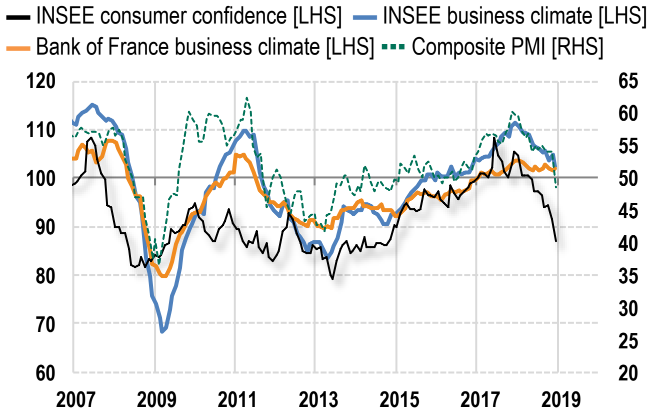
As far as the expected brake on growth in Q4 is concerned (we are now expecting 0.2% q/q instead of 0.6% in early October), it is largely the result of the 'gilets jaunes' movement[2], due mainly to its negative impact on consumer spending (which we now expect will struggle to grow, despite tax cuts which we previously expected to stimulate a rebound), but this is not the only effect. Business investment is also likely to be hit (accentuating the expected payback on investment in manufactured goods following the introduction of WLTP), as are exports (via a fall in tourist spending, which will eat into the strong expected increase as a result of late deliveries by Airbus and various other major contracts). A fall in Q4

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Confidence surveys



Source: INSEE, Bank of France, Markit

[1] The first estimate, confirmed by the second, was a little higher at 0.4% q/q.

[2] See also "France: A serious but temporary drag on growth", EcoFlash n° 15, 17 December 2018

GDP cannot be ruled out, but this is not the most likely scenario. For 2018 as a whole we now expect growth to reach 1.5%.

For the time being the only macroeconomic indicator of the negative effect of the 'gilets jaunes' protests has been the fall in some confidence surveys (see Chart 2). The fall in consumer confidence has been spectacular (down by 3 points in November and a further 4 points in December, taking it to 87, well below its long-term average of 100, and its lowest level since the end of 2014), with large declines also in the retail trade sector (down 7 points in December in the INSEE survey, taking it to 100, *i.e.* its long-term average) and services (down 6 points in December for the Markit PMI, thus falling to 49, representing the first time it has dipped below the threshold of 50 since 2016).

Other December surveys were less negative (-2 points for the INSEE survey and -1 point for the PMI in the manufacturing sector), positive (+2 points for the Bank of France industry survey) or flat (INSEE and Bank of France surveys in the services and construction sectors).

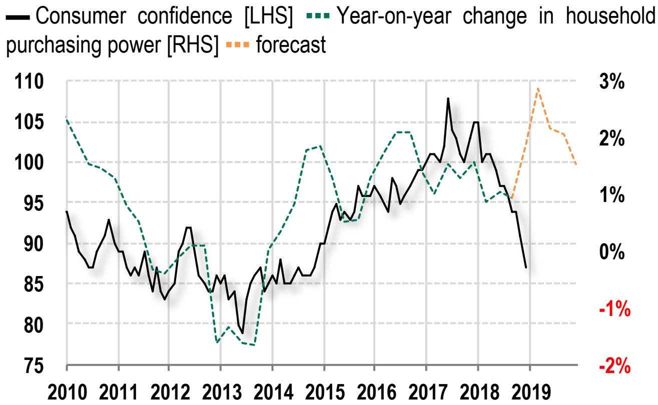
So the economic picture is not uniformly gloomy. The results of the Bank of France's surveys have allowed it to maintain its Q4 GDP growth estimate at 0.2% q/q. The good news, as we see it, lies more precisely in the absence of any further downgrading of this estimate after the 0.2 point cut in November. Between its Conjoncture in France report in October and its December report, INSEE also cut its Q4 growth estimate by 0.2 of a point from 0.4% to 0.2% q/q. Our own 'nowcast' model, based on survey data, suggests something a shade more positive, with estimated growth of between 0.3% and 0.4% q/q. The figure based on hard data is lower, however, at 0.2%, and carries a downside risk. Indeed, in the absence of figures for December, the assumption used of a continuation at November's level has the advantage of simplicity but almost certainly errs on the side of optimism.

2019: new year, same growth?

After a year of strong and steady growth in 2017, which exceeded expectations – followed by a year of weak and patchy growth, surprising on the downside, in 2018 – what will the 2019 vintage be like?

What is clear is that the year has begun with mixed prospects, worries are multiple and uncertainty considerable. There are many downside risks, whether international, financial or domestic. On the international front, the UK Parliament's rejection of the agreement with the EU on the details of Brexit (re)opens a period of uncertainty over the outcome of the process. Another significant risk is that the US economy is heading for a landing, and fears of this have been revived by tumbling equity markets at the end of last year. The scale of the slowdown in China is also causing significant concern, but this is not new. By contrast, the dramatic slowdown in the German economy[3] in the second half of 2018 is a new source of worry.

3 – Household purchasing power gains and consumer confidence



Source: INSEE, BNP Paribas forecasts

On the domestic front, our scenario of resilient growth is based on two central factors[4]. The first relates to the underlying trend, which we still believe to be solid, albeit somewhat slower, in particular thanks to a labour market that is expected to remain on the right track. We are forecasting an increase in private payrolls in line with that in 2018 (at an average of around 1% over the year), a fall in the unemployment rate that will be only barely smaller than last year (-0.2 of a point to 8.9%) and stronger momentum in wage growth (increases of nearly 2% for the basic monthly wage indicator and 2.5% for the average earnings per worker indicator).

The second source of resilience is the positive impetus of economic and fiscal policy. This impetus is for a part channelled through support to companies via the transformation of the employment and competitiveness tax credit (CICE) into a reduction in employers' social contributions. A larger share of the impulse will come from the expected positive effect on consumer spending of the tax cuts approved in the 2018 budget, backed up by the measures to support the purchasing power of lower income households announced by President Macron on 10 December, in response to the 'gilets jaunes' protests[5]. This assumes that the link between purchasing power and consumer confidence – which was clearly broken at the end of last year – is restored (see Chart 3). We believe that this stimulus package will support growth to the tune of 0.2 of a point. This additional growth will help offset the lower growth carry-over inherited from 2018, which not only leaves our 2019 growth forecast unchanged at 1.6% (in annual average terms) but also means that growth will be relatively (and remarkably) stable compared to 2018.

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[3] See page 3,7,15, 23

[4] We are not overlooking the introduction of the withholding personal tax in January as the source of a possible shock to growth in Q1. But we believe that if there is to be a shock, it could just as easily be positive as negative.

[5] *See* EcoFlash cited above for details of the support package

Italy

Risk of recession

At the end of 2018, Italy and the European Commission agreed on a new 2019 Budget Law, avoiding an Excessive Deficit Procedure. The 2019 public deficit has been lowered to 2% of GDP from 2.4% previously planned, and real GDP growth has been revised downward to 1% from +1.5%. This is still a challenging scenario as overall conditions in the Italian economy worsened in H2 2018. In Q3, GDP fell by 0.1% as investment, both private and public, significantly declined. After the downturn in September, exports in Italy recorded a +9.6% y/y increase in October, while they stagnated in November bringing the value of the sales abroad to 427 billion euros in the first eleven months of the year.

In the context of the Stability and Growth Pact, the European Commission identified in November 2018 the existence of a particularly serious non-compliance in Italy's 2019 draft budgetary plan with European Council recommendations and signalled the risk of backtracking on structural reforms.

A new agreement with the EU

At the end of last year, an agreement between the Italian government and the European Commission was reached, avoiding an Excessive Deficit Procedure. Despite the expected slower economic growth (+1% in 2019, down from +1.5% previously estimated), the public deficit is now planned to be 2%, 0.4% lower than in the previous budget draft, and then to decline to 1.5% in 2021. In 2019, the improvement of the public balance is the result of both higher revenues (EUR 1.7 bn) and lower expenditures (EUR 8.7 bn). The scenario for 2020-21 remains challenging as the reduction of the public deficit mainly reflects the activation of the safeguard clauses with annual VAT revenues increasing by almost EUR 30 bn.

A risk of recession

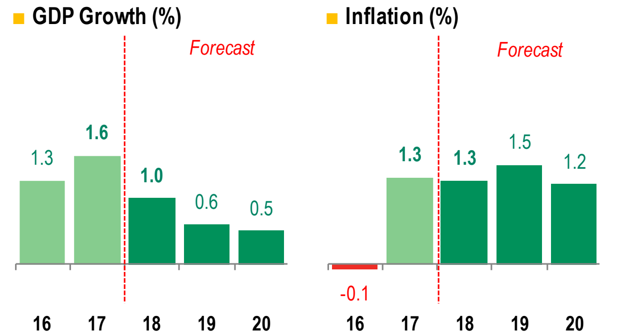
From the beginning of 2014 to the middle of 2018, the Italian economy recovered 4.5 out of the almost 10 percentage points lost during the crisis. In Q3 2018, real GDP fell (-0.1%), the first quarterly decline in almost four years. The annual growth rate was 0.7%, down from 1.7% reached in the middle of 2017. The latest data signal the risk of a further contraction in the last quarter of 2018. In November, industrial production fell by 2.6% y/y.

In Q3, manufacturing's value added decreased by 0.5% q/q, virtually stagnating from a year earlier. The worsening of economic conditions mainly affected those sectors that had strongly sustained the economic recovery. Production of pharmaceutical products declined more than 6% and that of automobiles almost 10%. For the first time since the beginning of 2014, the value added of services decreased while that of construction recovered further despite remaining more than 30 % below the 2008 level.

Declining consumption and investment

The Q3 GDP contraction reflected the negative contribution of domestic demand, which, excluding stocks, subtracted 0.3 point from the overall growth, suggesting a greater degree of caution amongst consumers and firms.

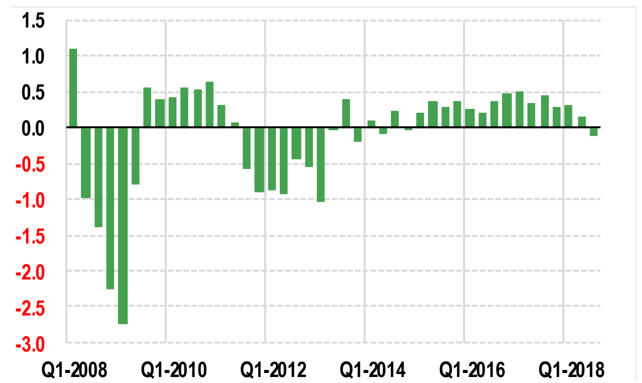
1- GDP growth and inflation



Source: National accounts, BNP Paribas

2- Italy: real GDP

q/q %



Source: BNL calculations on Istat data

Italian households suffered from the substantial stagnation of the labour market with the number of persons employed virtually unchanged in the past six months. In Q3, private consumption declined by 0.1%, due to losses in purchasing power and weaker consumer confidence, partly related to the fall in asset prices, and an increase in (precautionary) savings. Households particularly cut back on non-durable goods (-1% y/y), whereas spending on services rose moderately.

Business confidence has declined to the lowest level of the past three years amidst domestic political uncertainty and rising geopolitical tensions. The economic contraction has also curbed the recovery in firms' profitability. In Q3, gross operating income as a percentage of value added declined to 41.4%, more than 2 percentage points lower than two years earlier. Consequently, Italian non-financial corporations have further postponed investment expenditure - expenditure on machinery and equipment fell by almost 3% - while increasing their liquidity buffer with almost EUR 360 bn. Moreover, public investment was cut significantly, declining in nominal terms more than 10% y/y in Q3. From July to September, total gross fixed capital formation subtracted 0.2 point from overall GDP growth.

Exports: an uncertain recovery

After the downturn in September, Italian exports recorded a +9.6% y/y increase in October, while they stagnated in November, bringing the value of the sales abroad to EUR 427 bn in the first eleven months of the year (+3.5% more than the in same period of 2017). Meanwhile, the value of imported goods amounted EUR 391 bn euros (+5.7% y/y).

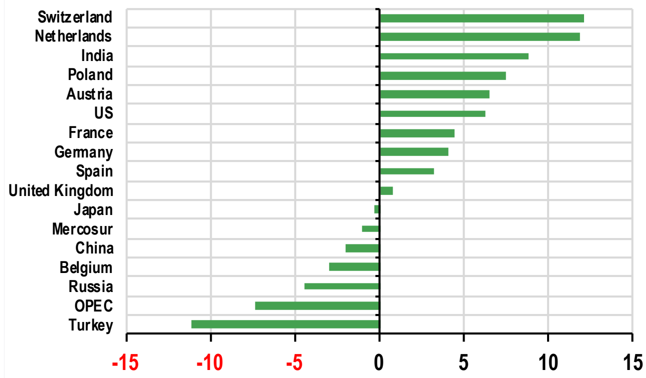
Amongst the main exported goods, metals and metal products recorded a 5.7% y/y increase, pharmaceutical products +8% y/y, machinery and equipment +1.9% y/y, food products +3% y/y and textile products +3.6% y/y between January and November. Exports of means of transport also increased slightly (+0.6%) despite the drop in exports of motor vehicles, which fell by 5.8% in the first eleven months of the year. In the same period, imports of motor vehicles remained basically unchanged (0.1%), thus generating a negative trade balance of about 9.8 billion euros for the sector.

As far as the destination of Italian goods is concerned, sales to EU countries between January and November rose 4.4% while those directed to non-EU countries increased 2.4%. As a consequence, intra-EU exports during the first eleven months of 2018 reached 56.7% of the total of Italian exports, a percentage slightly higher than that of the whole of 2017 (55.7%) and of 2016 (55.9%). More specifically, amongst the EU countries, Italian exports increased considerably to the Netherlands (+12.1%), Poland (+7.4%), Austria (+6.5%), France and Germany (+4.4 and + 4.1% respectively). These last two countries remain the main destinations of Italian sales abroad with a market share of 10.5% and 12.7% respectively, slightly larger than in 2017. Sales outside the EU grew, especially to India (+11.9%, which however is still a marginal destination for Italian exports), Switzerland (+8.8), and particularly to the United States (+6.2% thanks to the +15.8% peak recorded in November).

Over the years between 2012 and 2016, Italian exporting firms gradually increased the average value of exported goods from 1.93 to 2.02 million euros. This figure stems from an increase in the value of merchandise exports during the period (+7.5%) more than double that of the number of exporting firms (+3%, corresponding to 5.750 more units). The phenomenon affected firms of all sizes with the exception of those with less than 20 employees.

In the same period, the average number of countries served per exporting firm also rose to 6.2 on average, although the share of exporters with only one client remained unchanged after having fallen slightly in past years. The (small) increase of the number of markets served did not correspond to a greater diversification of the products sold, which is still limited: over half of the exporters sell just one product abroad, and the vast majority (94%) exports fewer than 10 products.

3- Italy: exports by destination
Jan.-Nov. y/y % change



Source: Istat

In spite of the increasing diversification of the markets served, today 50% of Italian exporting firms serve no more than two countries, and they all together account for about 4% of Italy's total exports. This is not significantly different from the situation in other countries; however, as the size of the firms grows, the diversification of the export markets of Italian firms remains rather limited while it grows remarkably in France and Germany.

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Spain

Growth slows but the economy continues to recover

The current slowdown is in keeping with the European economic cycle. Prospects are still looking relatively good, and Spain's expected growth rate is among the highest of the big eurozone countries. Unemployment is falling rapidly but it is still massive, especially long-term unemployment. Prime Minister Pedro Sanchez just presented his 2019 budget proposal to Parliament, but he is not sure it will pass. In any case, the deficit most likely slipped significantly below 3% of GDP in 2018, and Spain is preparing to exit the excessive deficit procedure that was launched 10 years ago.

A slowdown is underway

In line with the eurozone economic cycle as a whole, Spanish growth is slowing. At 0.6% q/q in Q3 2018, quarterly GDP growth was stable for the third consecutive quarter, but fell slightly below the growth rates reported in 2017. On a year-on-year basis, growth fell steadily to 2.4% y/y last summer, the lowest level in nearly four years. Data available for the fourth quarter suggest that growth was still relatively robust at the end of the year, driven by domestic demand, and household demand in particular. Retail sales were sluggish last summer but rebounded during the year-end period, thanks apparently to the drop-off in inflation, from 2.3% in October to 1.2% in December. Survey data, especial the purchasing manager indexes, support this image: after declining in Q3, the activity index for the services sector rebounded in October and has held at a high level (54) through the end of the year. In manufacturing, in contrast, the activity index has steadily weakened to 51.1 in December, reflecting the slowdown in foreign trade.

On the whole, after an annual growth rate of more than 3% over the past three years, GDP growth is estimated at about 2.5% in 2018. Though slowing, this is still one of the most robust growth rates of the big eurozone countries. It is also much higher than the country's long-term potential growth rate, as estimated by the various international institutions (which is currently closer to 1%). According to these estimates, the Spanish economy is on the verge of closing the output gap. Apparently, a few more quarters will be needed before we see the first signs of pressure on production capacity, prices and wages[1]. Buoyed by domestic factors, GDP growth is currently being hampered primarily by foreign demand. Ultimately, however, slowing international trade and uncertainty over changes in the European and global economic environment could end up straining investment spending. As in 2018, Spanish growth is likely to hold at about 2% in 2019.

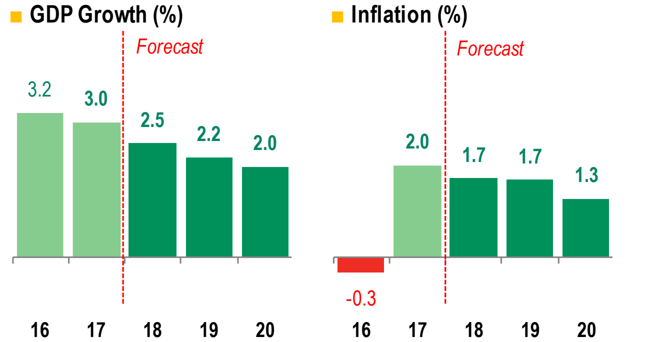
A labour market in transition

The labour market still faces major challenges. From an overall perspective, the labour market is in the process of recovering: employment dynamics are keeping pace with activity. Up 2.5% a year since 2015, employment increased nearly 2% in 2018, which is undeniably a solid pace. Since the cyclical trough in late 2013, nearly 2.1 million jobs have been created according to the national accounts. Thanks to these job creations, the jobless rate has declined by more than 11 points in 5 years, to 14.7% in November 2018. Nonetheless, this is still one of the highest jobless rates in Europe.

The scope of unemployment does not sit well with the idea of an economy nearing its long-term growth potential. A look at detailed data paints a highly contrasted picture of the labour market, which shows signs of both dynamic momentum and rising pressures, but also the impact of the crisis. In terms of unemployment, the number of short-term unemployed (unemployed for less than a year, see

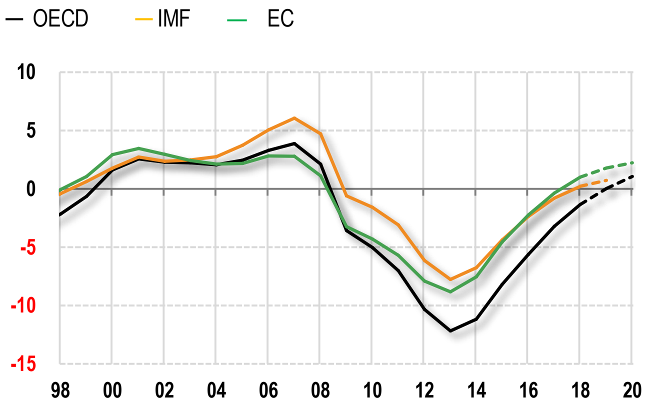
[1] The volatility of headline inflation should not be allowed to mask the great stability of core inflation, which has fluctuated around 1% since spring 2018, with no signs of accelerating.

1- Growth and inflation outlook



Source: National accounts, BNP Paribas

2- The turnaround is nearly complete
Estimations of the output gap (% of potential GDP)



Source: European Commission, IMF, OECD chart 3) is falling very slowly now and is about to return to the pre-crisis average. This suggests that a certain "cruising speed" may have been reached for the mobility of new entrants, and that tensions could emerge in certain sectors and skills levels. Long-term and very long-term unemployment (between 1 and 2 years, and more than 2 years), in contrast, is now falling rapidly, although it still accounts for more than half of the unemployed (54%), or 1.7 million individuals[2].

The Sanchez government nonetheless decided to raise the minimum wage by 22%, from EUR 858 to EUR 1050 a month, at the beginning of 2019. Although this leaves Spain in an intermediate position in terms of minimum wage levels in Europe (chart 4), it is nonetheless a big increase and follows on increases of 8% and 4%, respectively, in 2017 and 2018. Past increases seem to have had only a small gearing effect, and the turnaround in wages as a whole has been very mild so far[3]. The increase in nominal wage costs per capita was nil or negative in 2016 and 2017, and remained moderate before accelerating a little last summer, to 1.9% y/y, mainly in the services sector. Although it will probably accelerate again this year, at this point in any case, a minimum wage increase might seem surprising due more to the massive unemployment described above rather than to wage cost fluctuations (even relative to the other European countries).

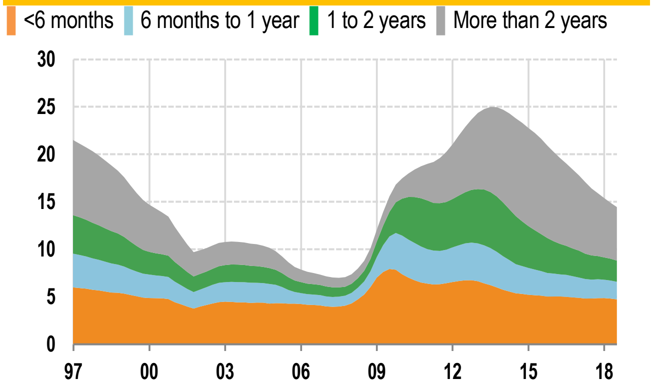
While awaiting the 2019 budget

The massive increase in the minimum wage is part of a broader economic policy that the Pedro Sanchez government has put forward in its 2019 budget proposal. It calls for an increase in social expenditures and pensions, along with higher taxes for high income households and major corporations.

Presented to Parliament in mid-January, the budget proposal might very well fail to pass due to the lack of a majority. The Sanchez government is in a minority position and must rely on the support of representatives from Podemos and the Basque and Catalonia pro-independence parties in order to pass legislation. The budget bill incorporates measures to boost investment spending in Catalonia, but this might not suffice to win their support as long as political negotiations over the Catalonia question are at an impasse. Until a new budget bill is passed, the previous year's budget is automatically renewed. Note that there is nothing new about this situation, which has already occurred twice since the latest legislative elections: the 2017 budget was not adopted until May 2017 and the 2018 budget until June 2018.

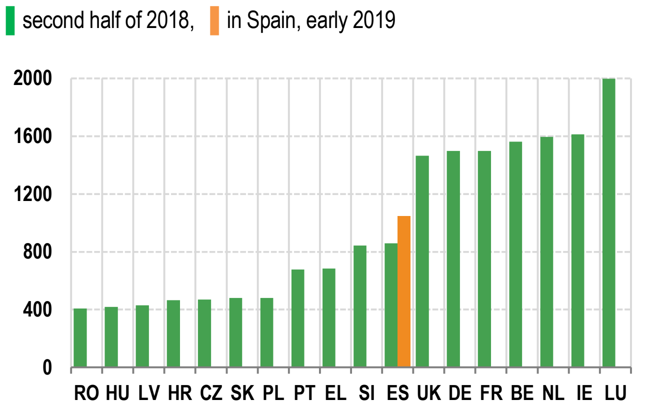
In any case, Spain's budget deficit fell below the 3% threshold last December (probably to 2.7% of GDP) for the first time since 2007, and it should officially exit the European excessive deficit procedure

3- Lasting unemployment
Breakdown of the unemployment rate by duration, % of the active population



Source: INE

4- Minimum wages in selected European countries
Gross monthly wages (12 months), in euros



Source: Eurostat, government

this spring. Spain is the last European country still subject to this special procedure. Low financing costs and vigorous growth should continue to reduce the deficit this year, masking yet again the probably expansionist nature of fiscal policy.

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[2] It is tempting to compare the scope of long-term unemployment with the number of jobs that were eliminated in the construction sector during the crisis: nearly 1.5 million workers (between early 2007 and today).
[3] According to OECD data, in 2007 the minimum wage in Spain amounted to only 40% of the median wage, which is one of the lowest levels in the OECD. Only the United States reports a lower level of 34% of the median wage. In France, the minimum wage amounted to 62% of the median wage in 2007.

China

Fiscal stimulus: the best option

Economic growth slowed to 6.6% in 2018 from 6.8% in 2017 and should continue to decelerate in the short term. The extent of the slowdown will depend on the still highly uncertain evolution of trade tensions between China and the United States as well as on Beijing's counter-cyclical policy measures. However, the central bank's manoeuvring room is severely constrained by the economy's excessive debt burden and the threat of capital outflows. Moreover, whereas Beijing has pursued efforts to improve financial regulation and the health of state-owned companies over the past two years, its new priorities increase the risk of interruption in this clean-up process. Faced with this situation, the central government will have to make greater use of fiscal stimulus measures.

In Q4 2018, real GDP growth slowed to 6.4% year-on-year (y/y), down from 6.8% in Q1 2018. The Chinese slowdown has been confirmed and is bound to continue in the short term. The size of the slowdown will depend on the evolution of China's trade relations with the United States, as well as on the authorities' actions to stimulate domestic demand. Although uncertainty persists over the signing of a trade agreement between Washington and Beijing anytime soon, the orientation of Chinese economic policy has become much clearer in recent weeks: counter-cyclical measures will be given priority in the short term.

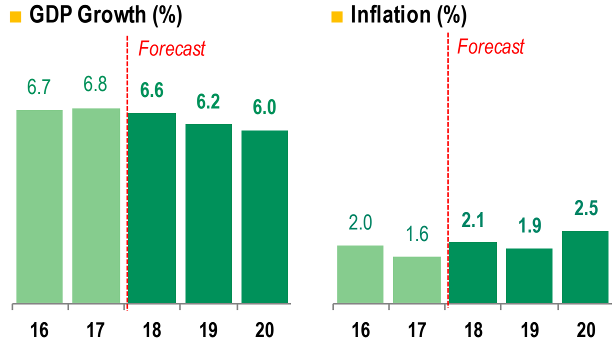
Industry facing difficulties due to declining demand

The slowdown in the industrial sector worsened towards the end of the year. Industrial production slowed from 6.9% y/y in January-May to 6% in June-August, and to 5.7% in September-December (chart 2). The poor performance of exports and retail sales, especially in the automobile sector, continue to darken prospects in the very short term. In December, manufacturing PMI dropped below 50, notably due to the sharp drop-off in the "new orders" and "export orders" components. The industry must also deal with the rapid decline in producer price inflation (+0.9% y/y in December, compared to +4.7% in June), in line with the decline in commodity prices and with the reduction in demand and production capacity utilisation rates. As a result, growth in profits of industrial enterprises has deteriorated sharply since Q3 2018.

Performance in the services sector is stronger. After losing momentum in Q1 2018, services growth has recovered slightly, bringing full-year 2018 growth to 7.6%. The PMI indexes also picked up towards the end of the year.

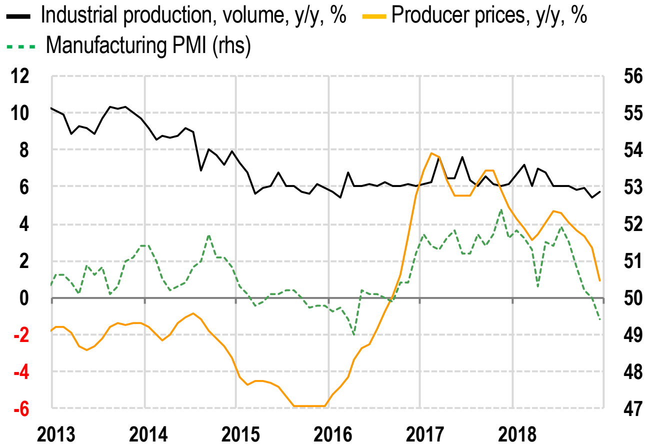
Exports levelled off recently, notably due to higher US trade tariffs[1]. After a Q3 rebound, fuelled in part by the acceleration of shipments to the United States in anticipation of higher tariffs and by the yuan's depreciation, sales of Chinese products slowed sharply in November (+5% y/y in value, after averaging +13% in the first 10 months of 2018) and contracted in December (-5%). Imports have

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Worsening slowdown in the industrial sector



Source: NBS

followed the same trends. Foreign trade should continue to contract at least through the first part of 2019. Thereafter, trends will largely depend on the result of current trade negotiations between Washington and Beijing.

Household consumption growth is slowing. Retail sales growth dropped to an all-time low in Q4 2018 (+8.3% y/y in value), hit by the downturn in durable goods purchases (reflecting the decline in housing sales) and the contraction in automobile sales (in line with the expiration of fiscal incentives and the structural slowdown in the

[1] About half of exports of Chinese goods to the US (USD 250 bn) is actually hit by tariff hikes of between 10% and 25%. The latest 10% increase was introduced in September on about USD 200 bn in merchandise sales. If Beijing and Washington fail to reach an agreement by March (the end of the truce), tariffs could be raised by 25% on these USD 200 bn in goods, or even extended to cover all Chinese exports. If an agreement is reached and Beijing makes concessions on the purchase of US goods (which is now our central scenario), the status quo could be maintained or recent tariff increases could be revised downwards.

sector). Online sales have also slowed but remain buoyant (+25% in 2018), and the same can be said for the consumption of services. Recent downward trends can also be blamed on the moderation of consumer credit (in a tighter regulatory environment), the erosion of household confidence, and another drop in income growth after the improvement of 2017. Weaker wage dynamics can be attributed to the troubles facing industry. In the short term, only stimulus measures can bolster household demand.

Economic policy easing is beginning to boost investment in infrastructure projects. Investment picked up in Q4 2018 after local governments were authorised to make more bond market issues for project financing. However, already heavy debt will continue to restrict severely their manoeuvring room. In the manufacturing sector, investment recovered in 2018 despite rising trade tensions, but should weaken again in early 2019 as a result of weakening exports and the deterioration in corporate profits. Real estate investment is unlikely to make a notable rebound, since volumes of transactions have declined since September 2018 and because the authorities should avoid overly easing the prudential regulations in the property sector. As a matter of fact, promoting a balanced and healthy development of the housing market and the combat against speculation remain top priorities of the government. All in all, the rebound in total investment (to 7.9% y/y in value terms in October-November 2018, from 5.4% in the first 9 months of the year) is likely to be mild in the short term.

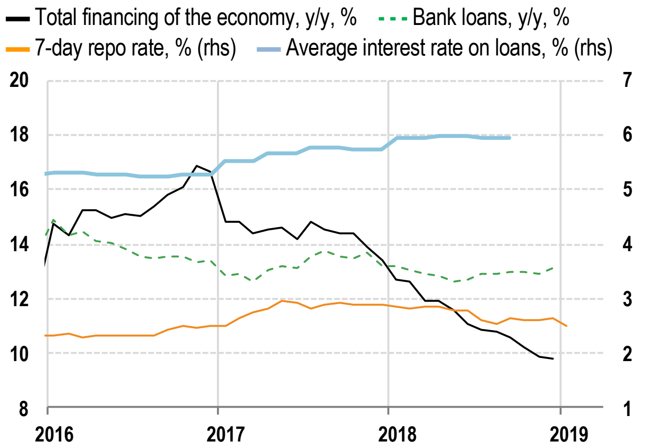
The authorities must give preference to fiscal stimulus

In recent months, the authorities have launched a series of contra-cyclical policies that should help contain the slowdown in economic growth. Monetary policy has been eased very cautiously. A new “targeted” financing facility has just been announced, essentially aimed at encouraging bank lending to small and mid-sized enterprises, and reserve requirement ratios continue to be lowered (to 13.5% in January 2019, down from 17% in March 2018). Net liquidity injections via open-market operations have also increased in recent days (but one of their main objectives is to prepare to respond to peak seasonal demand for liquidity).

The authorities are seeking to lower credit costs for corporates, stimulate lending and facilitate financing of local government investment projects. So far, money market rates have not decreased much (the 7-day repo rate has averaged 2.49% since early January, down from 2.63% in Q4 2018) and the average lending rate barely declined in 2018, after reaching 5.94% at the end of September (chart 3). The acceleration in inflation helped ease real interest rates through October, but this trend has since been reversed. Moreover, the increase in total credit to the economy continued to slow through the end of 2018 (reaching 9.8% y/y, down from 11.1% in mid-2018). This nonetheless masks a slight upturn in bank loan growth and bond financing in Q4 2018, which was more than offset by the contraction in shadow banking activities.

The timid easing of credit conditions reflects several problems. First, the debt excess of the economy and the low efficiency of new credit severely restrict the manoeuvring room of the monetary authorities

3- The easing in credit conditions remains timid



Source: Central bank

and the banks. Moreover, over the past two years, Beijing has pursued efforts to reinforce financial regulation, improve the health of state-owned companies and clean-up the real estate sector. It probably wants to avoid disrupting this process despite the redefinition of its priorities. Monetary policy is also constrained by the risk of capital flight and downward pressure on the yuan, at a time when 1) China’s external constraint is already being tightened due to the substantial narrowing in the current account surplus, and 2) currency depreciation would further feed trade tensions with the United States.

Faced with this situation, the central government will have to make more use of fiscal measures to stimulate demand without aggravating financial instability risks. It has the capacity to act, given the moderate level of its deficits and debt (estimated at 16% of GDP at the end of September 2018). Household and corporate income tax cuts have already come into effect since 1 January 2019, and other measures are likely to be announced soon, notably a lower VAT rate and new fiscal incentives for household purchases of cars and durable goods.

Yet if the economic slowdown were to continue in the very short term, the authorities probably wouldn’t hesitate to ease further monetary policy and to accelerate the implementation of infrastructure projects. More time will thus be needed to absorb the excessive debt burden of corporates and local governments.

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India

Mixed performance for the end of Narendra Modi's mandate

India's economic growth slowed between July and September 2018, hard hit by the increase in the oil bill. The sharp decline in oil prices since October will ease pressures, at least temporarily, on public finances and the balance of payments, and in turn on the Indian rupee (INR), which depreciated by 9% against the dollar in 2018. In a less favourable economic environment, Narendra Modi's BJP party lost its hold on three states during recent legislative elections.

Growth slows but prospects remain upbeat

In fiscal Q2 2018/19 (July-September 2018), India's GDP growth slowed to 7.2% year-on-year (y/y). The slowdown is mainly due to the negative contribution of net exports to growth, which was induced by a sharp rise in imports (oil and capital goods). Domestic demand was still dynamic even though it slowed slightly from the previous quarter. Household consumption was lifted by the easing of inflationary pressures (even though the decline in agricultural prices strained household revenues in rural areas). Investment growth remained buoyant for the third consecutive quarter (+12.5% y/y) due to the increase in government spending on infrastructure, an upturn in bank lending and the increase in production capacity utilisation rates in the manufacturing sector.

Against all expectations, the sharp rise in fuel prices was more than offset by the decline in food prices (-2.6% y/y in November), which still account for a very big share of the total consumption basket of Indian households (39%). Consequently, the increase in the general price index was limited to 2.3% y/y at the end of November, which is much lower than the target set by the monetary authorities (4% +/- 2 percentage points).

Despite the upturn in lending (+13% y/y), India's central bank decided to maintain its key rates at 6.5% at the December monetary policy committee meeting at a time of less volatility for the rupee (INR). Even so, interest rates on new loan production increased slightly in the third quarter (+20bp), reflecting the tightening of monetary policy in June and August.

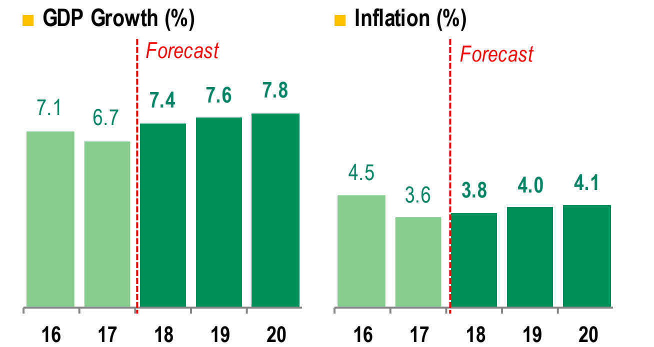
Growth prospects are still looking upbeat. For full-year 2018/19, growth is expected to near 7.4% before gradually accelerating over the next two years, despite the slowdown in foreign demand. Robust domestic demand will drive growth. The banking sector clean-up will favour a rebound in private investment in industry, even though interest rates are expected to continue rising slightly.

Central government budget overruns in the first 7 months of the fiscal year

After five years of fiscal consolidation, the central government should not meet its deficit reduction target for the second consecutive year (from 3.5% of GDP in 2017/2018 to 3.3% of GDP in 2018/2019). Fiscal revenues, and VAT revenues in particular, will fall far short of the government's targets.

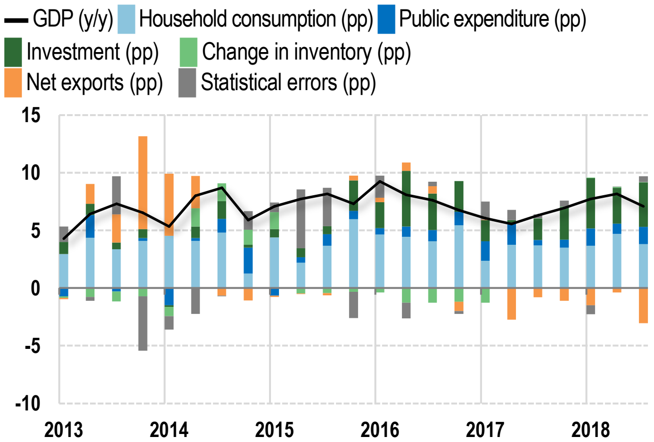
In the first 7 months of fiscal year 2018/2019, which will end on 31 March 2019, the fiscal deficit reached 104% of the annual target.

1- Growth and inflation



Source: National accounts, BNP Paribas.
Fiscal year from April 1st of year n to 31 March of year n+1

2- Economic slowdown in Q2-FY19



Source: CEIC

The government did not want to exceed 75% of its target during this period to avoid having to revise downwards the expenditures planned for the second half of the fiscal year. During the same period last year, the deficit amounted to 96% of its full-year target. The budget overrun is mainly due to revenues, which fell short of targets. Although fiscal revenues were up 8.2% compared to the previous year, they accounted for only 45.7% of the target in the first 7 months of this year, compared to 48.1% last year and an average of 50% over the past three years. Although VAT revenues increased significantly, they were still far below the finance ministry's forecast (35% of the full-year target).

In the first 7 months of the fiscal year, public spending was relatively in line with fiscal targets: it amounted to only 59.6% of full-year spending, slightly less than the previous year despite the increase in the cost of gasoline price subsidies (+7.2%). One positive point is that investment spending, which is vital for supporting medium-term growth, increased by nearly 9% compared to the same period last year and amounted to 58.9% of the full-year target.

Even so, it will be hard for the government to meet its 0.2 point deficit reduction target without significantly cutting back investment spending in the second part of the fiscal year. The decline in oil prices since mid-October should nonetheless help reduce gasoline subsidies and the shortfall in import taxes[1].

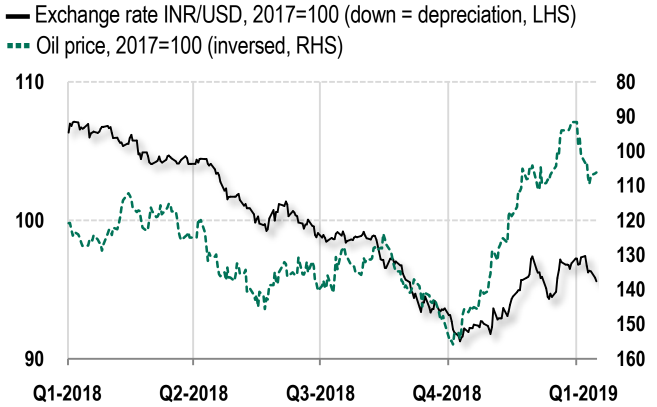
Contrary to the central government, the states managed to limit their fiscal deficit in the first half of the current fiscal year, which accounted for 35% of the full-year target of 2.6% of GDP (vs. 3.1% of GDP in 2017/18)[2]. This strong performance, like the one last year, mainly reflects the increase in revenues induced by central government transfers to offset the loss of revenues following the introduction of VAT. Unlike the central government, however, the states will concentrate most of their spending in the fiscal second half. Moreover, following changes of government after the 11 December elections, three states (Madhya Pradesh, Rajasthan and Chhattisgarh) announced additional spending measures. The new governors (members of the Congress Party) decided to cancel certain loans taken out by farmers (as was already the case in seven other states) and to increase the minimum selling prices of certain crops in addition to those announced by the Modi government last summer. For some states, such as Madhya Pradesh, the cost of loan cancellation can account for as much as 20% of their budget, and will thus have to be spread out over several years. Although there is only limited risk of budget overruns by the states, debt cancellations, like those benefiting public electrical utilities, are not favourable for implementing good governance and management of the country's credit risks.

Despite the risk of budget overruns, in October the IMF forecast a decline in the public debt to GDP ratio. Over the past five years, this ratio has risen by more than two percentage points according to the central bank, and remains much higher than the ratio for the other Asian countries (68.9% of GDP in March 2018 according to the central bank). A simple levelling off seems more probable.

State-owned banks: the situation stabilises

The situation of banks has stopped deteriorating but remains very fragile. In Q2 2018/2019, the doubtful loan ratio declined for the first time since mid-2014 to 10.8% (14.8% for state-owned banks). Although the provisioning rate is still far too low, it rose to 52.4% in September, up from 48.1% in March 2018. At the same time, solvency ratios deteriorated slightly. In order for the most fragile banks to meet the target ratio of 9% at 31 March 2019, the government announced that it would inject an additional INR 410 bn by the end of the fiscal year. Given their financial difficulties, the state-owned banks only managed to raise INR 240 bn of the needed INR 580 bn. Government support will amount to INR 1060 bn in fiscal year 2018/19. The central bank also announced that it would postpone by one year the 0.625% increase in the Capital Conservation Buffer to 2.5%.

3- Appreciation of the rupee (INR) and the decline in oil prices



Source: CEIC

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[1] To limit the impact of higher oil prices on purchasing power, in October the government lowered its import taxes on petroleum-based products and asked local governments to reduce the VAT rate on these products. Moody's estimates that the fiscal cost will be small (0.05% of GDP by the end of the current fiscal year).

[2] Monthly Bulletin of the Reserve Bank of India, December 2018

Brazil

A new era

The election of Jair Bolsonaro at the presidency of Brazil has marked a swing to the right, the weakening of traditional political parties and a return of the military to national politics. The new administration faces the challenges of rapidly engaging its fiscal reform, gaining the trust of foreign investors while reconciling ideological differences across its ranks. How society will adjust to a new era of liberal economic policy remains the greatest unknown. Meanwhile, the economy is still recovering at a slow pace. Supply-side indicators continue to show evidence of idle capacity while labour market conditions have yet to markedly improve. Sentiment indicators have shown large upswings in recent months which should help build some momentum in economic activity over Q1 2019.

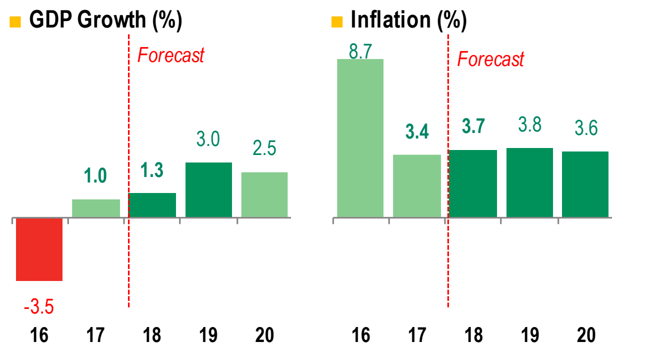
Tricephalic leadership?

Since the nomination of Jair Bolsonaro as Brazil's new president, the composition of the cabinet has seen the emergence of three distinctive groups within the administration: the economic technocrats, the military and the anti-globalist nationalists primarily embodied by the minister of Foreign Affairs, Ernesto Araujo, a stanch admirer of President Donald Trump's nationalistic rhetoric.

Leading the economic technocrats' contingent is Paulo Guedes who was confirmed at the head of a "super ministry" made up of the ministry of the Economy, the Ministry of Planning and the Ministry of Industry and Trade. Roberto Campos Neto, a previous executive at Banco Santander will be the next Central Bank governor while Joaquim Levy, another graduate from the University of Chicago - along with Guedes - and former Finance Minister under the 2nd Rousseff administration will head the third largest national development bank in the world, BNDES. Roberto Castello Branco, an economist by training and third "Chicago Boy" has been appointed as the new CEO of oil giant Petrobras following previous stints at mining company Vale and at the Central Bank. The leading agro-business lobbyist at the Chamber of Deputies, Tereza Cristina and one of only two women in cabinet will be heading the Minister of Agriculture while Ricardo Salles a lawyer and strong supporter of economic liberalism as well as a fervent critic of Presidents Lula and Rousseff was appointed as Minister of the Environment. Moving to deliver on his law and order platform President Bolsonaro appointed former anti-corruption judge Sergio Moro as Minister of Justice and saluted the nomination of Mauricio Valeixo as Brazil's Head of Federal Police. Both men were prominent figures in the "*Car Wash*" investigation and instigated the police operation that led to the detention of former President Lula in April 2018.

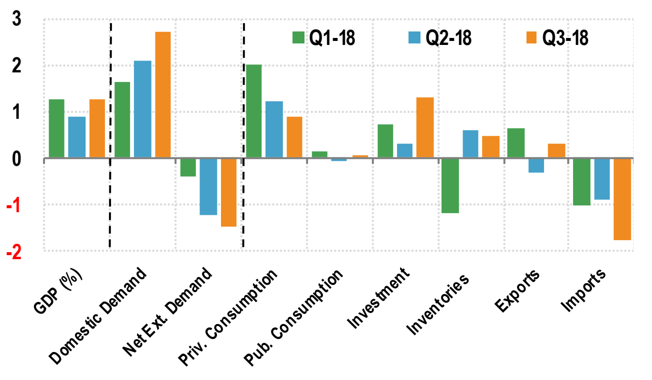
Military figures are also largely represented in the new administration making up more than one third of the new cabinet, a record for Brazil since its transition to a democratic regime.[1] Issues likely to steer up tensions between the three groups include: relations with China, the extent of privatizations and the rules for foreign investment, pulling out of the Paris climate change accords

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Percentage point contribution of components to GDP (y/y)



Source: IBGE, BNP Paribas

and its implication for a Mercosur-EU trade deal.[2] Many of these tensions are likely to be further exacerbated when the new Congress reconvenes in February. President Bolsonaro's unwillingness to build a stable coalition in exchange for political appointments may render policy-making more challenging down the line.

Rebounding confidence

The economy is still recovering at a slow pace. In Q3, the economy expanded by 0.8% q/q and 1.3% y/y in seasonal adjusted terms (s.a). Quarterly data benefitted from a low base effect following a

[1] Notable positions occupied by individuals with a military background include the Presidency (Captain), Vice Presidency (General) Ministry of Defense (General), Intelligence Office (General), Ministry in charge of political relations with Congress (General), Ministry of Science and Technology (Air Force senior officer), Ministry of Mining and Energy (Admiral), Ministry of Infrastructure (Military engineer), Ministry of Transparency, Supervision and Control (Captain), Secretary of Communication (General).

[2] Under a new policy, the European Union will refuse to sign trade agreements with countries that do not ratify the Paris climate change agreement.

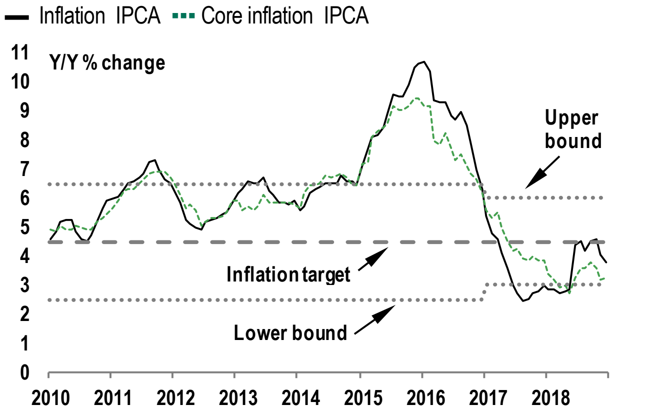
subdued Q2 owing to the truckers' strike. On the demand side, the increase was largely driven by investment and private consumption contributing respectively 1.3 pp and 0.9 pp to the y/y growth rate which was dragged down due to a larger negative contribution of net exports (-1.5 pp) (chart 2). Also as supply continued to outpace demand, the contribution of inventories to y/y GDP variation was again positive (+0.5 pp) for the second consecutive quarter. Revisions to GDP figures were made leading to GDP growing by 1.1% in 2017 vs 1% previously, bringing the statistical carry-over through Q3 2018 to 1.1%.

A number of tailwinds are currently supporting the economy suggesting that a risk of a business cycle reversal is limited. Households are generally better positioned to maintain consumption: real earnings have continuously risen on a y/y basis - albeit at a slow rate - after experiencing negative growth through much of 2016 and household debt relative to disposable income has fallen. Meanwhile, monetary policy is expected to remain accommodative as inflation risk remains subdued (chart 3). Credit to household, which has steadily expanded growing at an average monthly rate of 6.5% y/y through November, will continue to support private consumption while recent regulatory changes in the mortgage market should help boost residential investment.

The post-election phase has also witnessed a bounce back in sentiment indicators. The Consumer Confidence Index (CCI) advanced vigorously through Q4 reaching its highest levels in December since April 2014. Business sentiment also rebounded strongly reflecting the new administration's inclination to implement business friendly policies. The IBRE/FGV Business Confidence Index (BCI) increased by 1 point in December to 95.9 points its strongest rebound since March 2014. The increase was largely driven by optimism in the services, trade and construction sectors as confidence in industry remains subdued for the moment (chart 4). *Markit*'s composite PMI was also back in expansion zone in October (50.5) for the first time since May, ultimately reaching 52.4 in December. Bolsonaro's victory has also triggered a series of initial public offerings (IPO) after months of paralysis. The stock market reached historic highs gaining 12% since the second round of the election and is on course to break the 100.000 point mark. Meanwhile the USDBRL has had somewhat of a roller-coaster ride, strengthening ahead and during the elections, to then see much of its gains erased in the last two months of the year. While the currency has recovered somewhat since Bolsonaro's inauguration (+4%), the currency has yet to bounce back from hitting historical lows in 2018 that saw the BRL depreciate by 15% against the USD.

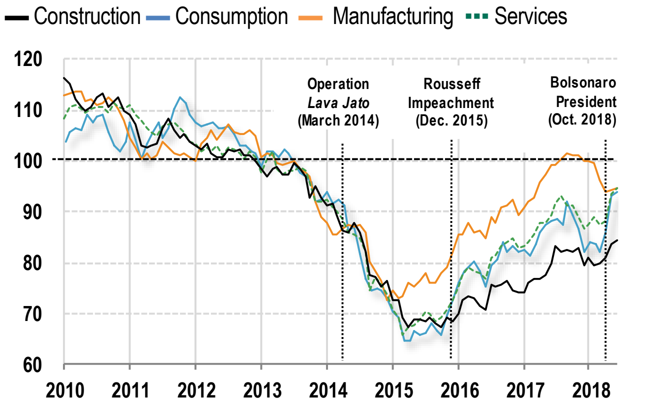
In the shorter term, a new trucker strike represents the greatest downside risk to the growth outlook. Moreover, with capacity utilization in manufacturing remaining far below pre-recession levels, industry still exhibits considerable slack. In line with auto output - which experienced a drop of 14% through H2-2018 - industrial production continues to be weak, essentially stagnating since July. Idle capacity is also evident in the labour market: unemployment remains high at 11.6 % decreasing only very slowly while underemployment has increased.

3- Inflation remains below target



Source: IBGE, BNP Paribas

4- Post-election rebound in confidence indicators



Source: IBRE/FGV, BNP Paribas

Corporate credit has also yet to recover, exhibiting a negative real growth rate since December 2014.

More fundamentally, reduced scope for fiscal policy flexibility limit the ability of the government to jump start the economy. In the medium term, structural impediments - namely low productivity, trade openness and investment combined with high levels of job informality, inequality and corruption – will continue to weight on the economy's medium term growth prospects.

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Russia

2019: greater uncertainty

In 2018, Russia swung back into growth and a fiscal surplus, increased its current account surplus and created a defeasance structure to clean up the banking sector. The "new" Putin government affirmed its determination to boost the potential growth rate by raising the retirement age and launching a vast public spending programme for the next six years. Yet the economy faces increasing short-term risks. Monetary tightening and the 1 January VAT increase could hamper growth. There is also the risk of tighter US sanctions, which could place more downward pressure on the rouble.

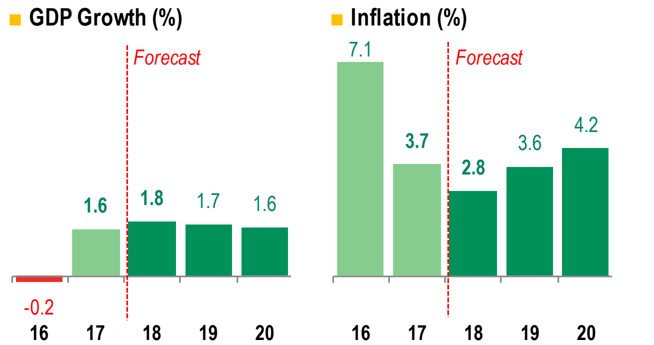
GDP growth slows in Q3

In Q3 2018, Russian GDP slowed to 1.5% year-on-year (y/y) from 1.9% the previous quarter. Growth averaged 1.6% in the first three quarters of 2018. Oil production rebounded by 5% thanks to a gradual increase in production quotas (+4% in the second half). In the agricultural sector, in contrast, activity contracted. Growth also slowed slightly in industry, but rose strongly in services. Leading indicators are still favourable for both the manufacturing and services sectors, but household consumption could be strained by the slowdown in employee purchasing power since August and the 1 January increase in the VAT rate, from 18% to 20%.

Since the beginning of H2-2018, inflation has accelerated to 3.8% y/y in November, compared to an average of 2.3% in the first six months of the year. For the moment, inflation is still lower than the monetary authorities' target of 4%. The upturn can be attributed to higher prices for food and non-food products as well as services. Three factors are driving inflation: unfavourable base effects (the 2017 harvest was particularly abundant, which helped lower food prices), higher gasoline prices, which carried over to transport costs, and the rouble's depreciation. From a 2-year horizon, growth prospects are still subdued and high risks loom over the economy. In December 2018, Russia agreed to reduce its oil output by 230,000 barrels a day (the equivalent of 2% of current production) starting in January 2019. The VAT hike and any second-round effects it might generate are likely to hamper domestic activity. So far, Russia's central bank is estimating that price inflation could range between 5% and 5.5% in full-year 2019, before falling back to 4% on average in 2020. Yet inflationary risk could be revised upwards if the US Congress decides to impose additional sanctions on Russia, which is likely to place more downward pressure on the rouble. To contain the risks of an inflationary spiral, the monetary authorities raised their key policy rate by 25 basis points to 7.75% last December and announced that further rate increases were now possible. Monetary policy tightening could strain investment, which has already begun to slow in the second quarter.

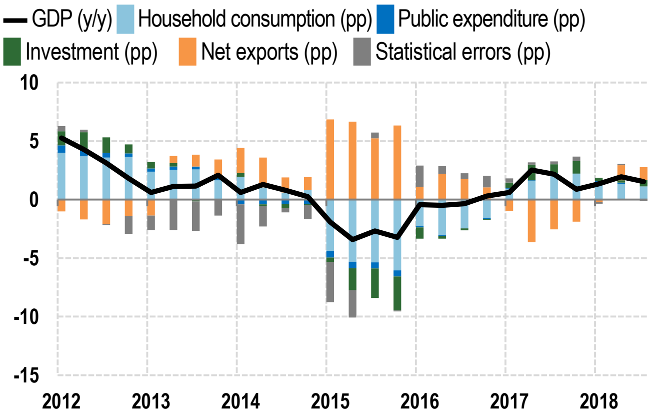
In the longer term, the World Bank estimates that Russia's potential growth rate will continue to erode from 1.5% in 2017 to 1.3% by 2022. Yet the institution esteems that this figure could be revised upwards to 3% if major reforms were implemented[1] to increase the active population (by raising the retirement age and adopting policies that favour immigration) and to encourage the spread of technical advances.

1- Croissance et inflation



Source: National accounts, BNP Paribas

2- Economic slowdown in Q3-2018



Source: CEIC

Fiscal policy aims to stimulate growth

Russia significantly consolidated its public finances in the first 11 months of 2018, thanks to strong revenue growth and tight control over public spending. Yet the government temporarily abandoned its target of maintaining a primary balance over the next six fiscal years, and is now forecasting a primary deficit of 0.5% of GDP.

[1] Russia, Economic Report, November 2018

The government has pledged to increase structural spending to stimulate growth. This "budget overrun" should nonetheless be limited.

In the first 11 months of 2018, the federal government reported a fiscal surplus of 3.7% of GDP, compared to a deficit of 0.7% of GDP in the year-earlier period. The deficit excluding oil and gas revenues was trimmed to 4.9% of GDP, 1 point less than in 2017, thanks to the decline in the public spending to GDP ratio. The government and administrations reported a primary surplus of more than 3% in the first 10 months of the year.

The consolidation of public finances in 2018 should result in a reduction in the public debt to GDP ratio. With the increase in public spending as of 2019, this ratio is expected to rise steadily over the next six years.

In May 2018, the government announced several measures to reverse the country's demographic dynamics, raise potential GDP, reduce poverty and extend life expectancy by 2024. To achieve this, the finance minister pledged to increase spending in numerous areas, including education, healthcare, infrastructure and support for SME. The cost of these measures was estimated at 1.1% of GDP per year over the next six years. The government plans to finance these measures in part by increasing the VAT rate (which will increase revenues by 0.5 to 0.6 points of GDP each year) and by streamlining oil sector taxation by 2024. The remainder will be financed by bonds issued in the domestic market. The increase in public debt is nonetheless expected to be limited to 5 points of GDP.

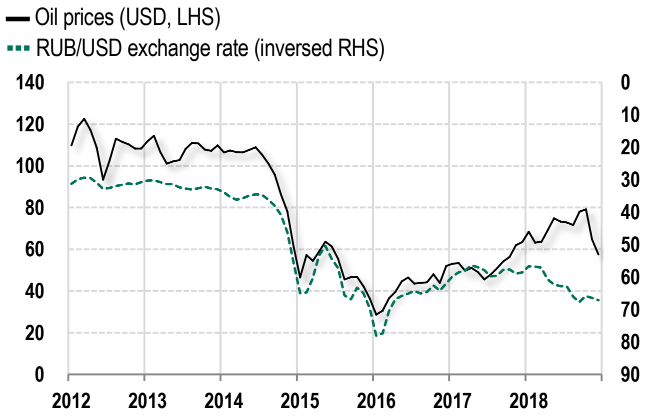
The banking sector is still fragile

The banking sector is still fragile due to its exposure to both credit risk and interest rate risk. Yet several factors should favour its consolidation, including government support, improved macroeconomic fundamentals and recent measures taken by the monetary authorities.

Over the past 12 months, the quality of bank assets has not improved even though companies are in a healthier financial situation since the rebound in economic activity (corporate loans account for 70% of all bank loans). According to the IMF, the share of doubtful loans in the banking sector as a whole has remained virtually flat at 10.7% in Q3 2018, compared to 10.2% at year-end 2017. In contrast, the share of lost or very doubtful loans[2] continued to rise according to the Central Bank of Russia, to 11.9% in October, from 10.5% at year-end 2017. The most fragile business sectors are construction and real estate, where the share of non-performing loans continued to rise over the past 12 months. Companies with foreign currency debt are likely to see their situation deteriorate even further with the rouble's depreciation.

The strong acceleration in household lending over the past 12 months could also become a source of concern. Household lending rose 22.5% y/y in October (up from 10.7% a year earlier). So far, the decline in interest rates on household loans maturing in more than a year (down 165 bp in a year) have helped partially contain the

3- The rouble has been disconnected from oil prices since 2017



Source: CEIC

increase in the household debt burden. The ratio of household debt to revenue is on the rise since lending has increased faster than household revenue growth, but it is still very moderate at about 25%. To date, there has not been an increase in late payments on consumer credit or mortgage loans. To contain the risk, however, and to encourage banks to reduce their exposure to households, the central bank took measures in May and September 2018 to boost the weighting of consumer credit and mortgage loans (for those with small instalments) in the calculation of risk-weighted assets. At the end of October 2018, the banks had satisfactory capital adequacy ratios, with CAR and Tier 1 CAR of 12.4% and 9.5%, respectively, in October 2018.

Greater interest rate risk is another source of concern. According to the central bank, the banks' exposure to interest rate risk has increased due to the growing mismatch in maturities between long-term assets and short-term liabilities. In October 2018, assets maturing in less than 1 year covered only 61% of liabilities of less than 1 year (vs 63% in January 2018).

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[2] Categories IV and V. These statistics integrate the bad loans that were held by the state-owned banks recapitalised in 2017: Promsvyazbank, Otkritie, B&N.

United Kingdom

Brexit update

On 15 January 2019, UK MPs rejected the proposed Brexit agreement reached by EU Heads of State two months earlier. With 432 of the 634 votes going against the deal, this result has significantly weakened Prime Minister Theresa May in future discussions with the EU and with Members of Parliament. Today almost anything looks possible, starting with a delay in the official date of the UK's departure, currently scheduled for 29 March.

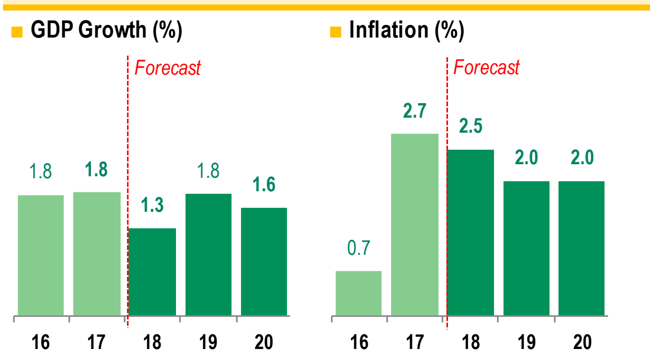
The extra month of talks – MPs were initially due to vote on the deal on 11 December 2018 – was not enough for Mrs May to win the support of her own party, nor any move by the EU to time-limit the 'backstop'[1] or remove it altogether. The backstop is the main sticking point for approval of the Withdrawal Agreement, but not the only one; support for a second referendum is becoming increasingly vocal, challenging the very principle of Brexit itself. Arguments for a second vote were strengthened by the European Court of Justice's ruling on 10 December 2018 that the UK is *"free unilaterally to revoke (...) the notification of its intention to withdraw from the European Union"*. However, in view of polling figures, the outcome of any second referendum would be highly uncertain.

If it is not cancelled, Brexit could be postponed at the UK government's request. The EU would consider such a request, while being restricted by the European parliamentary elections planned for 23 to 26 May 2019, as the Parliament will need to approve a withdrawal agreement (provided of course that there is an agreement to approve). Current Members of the European Parliament are due to hold their last plenary session from 16 to 18 April 2019, whilst the newly elected parliament – without any British members – will begin work at the beginning of July 2019. Under these circumstances, the EU may push back the 29 March Article 50 expiry date to give UK more time for its MPs to ratify an agreement, or call a general election, or a second referendum. It remains to be seen how much time would be allowed, and whether or not it would be enough to finally resolve the Brexit issue.

Continuation of financial activities

In case of Brexit, whether with a deal or without, the United Kingdom will become a third country and is likely to be subject to the equivalence regime with regard to its trade in financial services with the European Economic Area (EEA)[2] instead of by the passporting system currently in place. On this point, the adoption of the draft Withdrawal Agreement by MPs on 15 January would only have had the effect of delaying the loss of passporting rights to the end of the transition period, as the EU has refused to extend the benefits to British firms after withdrawal. The equivalence regime is significantly less advantageous and stable than passporting. Dependent on approval by the European authorities, equivalence can be granted for a limited time and covers a narrower range of geographical markets and business areas. Such restrictions threaten to impede access for European companies to the London market and for British companies to European markets. This change of regulatory regime will also require a change in the status of British and European companies seeking to continue to do business in the EEA, for the former, and the UK for the latter.

1- Growth and inflation



Source: National statistics, BNP Paribas

This said, the financial sector appears to be one of the best prepared, even in the event of a no-deal Brexit. In the latter event, the European Commission nevertheless believes that a sudden loss of access to London's clearing houses for European companies could affect the financial stability of the EU. For this reason, it is prepared to authorise such access for 12 months following a no-deal departure, to give European companies time to adapt and London's clearing houses a chance to obtain the equivalence needed for them to continue to do business in the EEA.

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[1] In order to avoid the reintroduction of a hard border between Northern Ireland and the Republic of Ireland, a safety net, or backstop, solution allows for the United Kingdom to remain in a customs union with the European Union beyond the end of the transitional period on 31 December 2020 if insufficient progress has been made on the future relationship between the two.

[2] Under a 1992 agreement, the EEA includes the EU and three members of EFTA: Iceland, Norway and Lichtenstein. Switzerland voted in a referendum not to join.

Global

Lack of progress in climate talks

The COP24 only succeed in agreeing on rules on measuring, reporting and verifying carbon emissions. In the meantime, the world is falling behind the objective to limit global warming to 1.5°C. CO_2 emissions are set to rise to 2030, whereas they should peak by 2020. Countries are underestimating the urgency for action or held back by commercial interests. Moreover, environmental legislation is met by growing public resistance. It demands a better framing of climate policies. Moreover, the climate change discussion should be broadened to the WTO.

Minimal results at the COP24

The Paris agreement, concluded at the 21st Conference of Parties (COP21) in 2015, was a milestone in the process of reducing CO_2 emissions worldwide. The almost 200 participating countries agreed on limiting global warming to 2°C above pre-industrial levels and continue efforts to keep it below 1.5°C. In addition, the developed countries reiterated their commitment to jointly mobilise USD 100 billion annually for climate action in the least developed countries.

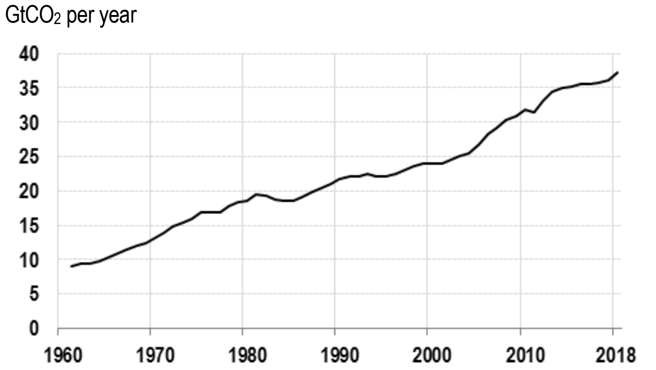
The agreement is not very demanding. Before the COP21, the countries had announced their own climate objectives, the so-called Nationally Determined Contributions (NDC), which were in many cases not very ambitious. The signatories decided that details of the deal, such as the measurement of the emissions and the procedures of upscaling the national pledges would be worked out at the subsequent COPs.

The process has not been a very smooth. Hardly any progress has been made in finding agreement on the USD 100 billion for climate finance by 2020, even though the promise was already made at the COP15 in 2009. Last year's COP24 held in Katowice (Poland) was a deception. It only succeeded at the last moment in accepting rules on measuring, reporting and verifying carbon emissions.

Ahead of the COP24 at Katowice (Poland), the Intergovernmental Panel on Climate Change (IPCC), the UN organisation for climate analysis, published a special report, "Global Warming of 1.5 °C". The main message is that the world is warming up quickly and more action is needed to bring the world economy back to a low carbon trajectory. It underlined the importance of keeping global warming below 1.5°C, which would require much more investment in particular in renewable energy sources. The conference failed to endorse the IPCC report "Global Warming of 1.5°C" because of opposition from four oil-producing nations, the United States, Saudi Arabia, Russia and Kuwait.

Time is running out for the negotiators to find solution how to upscale the national climate ambitions. The UN Secretary General Antonio Guterres has called for a special summit for head of states and government leaders in September 2019, ahead of the COP25. At the COP25, to be held in Chili, the process will be determined for upscaling the new climate objectives.

1- CO_2 emissions continue to grow



Source: Global Carbon Project

An unfavourable political environment

Although early signs of climate change have already appeared, many participants at the COP still deny the urgency for immediate action, as for most of them the catastrophic impacts will be felt well beyond the traditional planning horizons. Bank of England's governor Mark Carney has called it "the tragedy of the horizons". Normally, governments should have a responsibility in overcoming such market failure through developing policies and an appropriate regulatory environment.

Some countries are held back by commercial interests. Fossil fuel supply and thermal power investment are increasingly dominated by state-owned enterprises. During the COP24, both the US and Australia openly supported the coal industry. The Australian delegation argued that emissions could be effectively reduced by the development of carbon capture and storage. This is at odds with the recommendations of climate scientists who argue that countries should transition as soon as possible to renewable energy sources in order to avoid catastrophic levels of climate warming.

In June 2017, President Trump announced to pull the US out of the Paris Climate Agreement. For the moment, the US remains involved in the climate talks, as the rules stipulate that the country cannot leave before November 2020. The main argument of the US is that the treaty is not in its commercial interest. Thanks to deft diplomacy, in particular from the EU countries, the strongest backer of the accord, no other country followed the US initiative. Also inside the US, the decision has been heavily contested. Some US states, municipalities and businesses have stepped up their action to compensate for the lack of action by the federal government.

It is possible that Brazil may follow the US example. During his campaign, the newly elected President Jair Bolsonaro had pledged to pull his country out of the Paris Agreement. The country already withdrew its offer to host the COP25, officially for budgetary reasons. That conference will now be held in Chili. A departure of Brazil could be fatal for the treaty, as other developing countries could revise their position.

However, commercial interests may withhold the country from going down this road. During his address at the UN general assembly, French President Emmanuel Macron announced that his country, and by extension all the EU, will not sign any trade agreement with a country that do not respect the Paris agreement. Moreover, the EU trade commitments should include its environmental and social obligations. His position has been publicly backed by EU Trade Commissioner Cecilia Malmström. A possible withdrawal of Brazil from the Paris Agreement may halt the negotiations on a free trade deal between the EU and Mercosur countries. This would be very harmful for Brazil's very large agricultural sector. Moreover, Brazil is also one of the main beneficiaries of the Paris Agreement. The large rainforest acts effectively as a carbon sink. For this, the country receives subsidies in order to halt deforestation.

■ A different approach is needed

In order to limit global warming to 1.5°C, greenhouse gas emissions should peak by 2020. However, during the COP24, it was announced that the CO_2 emission had risen once more in 2018. According to the UN Emissions Gap Report, GHG emissions of the G20 countries, as a group, will not have peaked by 2030 unless there is a rapid increase in ambition and action within the next few years.

Unfortunately, many countries fall even behind on national environmental agendas. One problem is that environmental legislation is met by growing public resistance. As long as climate change does not seem a very pressing problem, it is very tempting to become free-riders and let the coming generations make most of the effort in cutting back greenhouse gases.

In particular, carbon taxes are often resisted, as users cannot change quickly to cheaper alternatives without incurring heavy costs. Moreover, for the tax payer, the link between carbon taxes and climate objectives is not always clear. These taxes could be perceived as just another way to finance the budget. In 2018, a modest increase in French carbon taxes triggered off heavy street protests which forced the government in reversing the measure. Voters in Washington State also recently rejected a carbon tax.

A solution could be the better framing of climate policy. Recently, George Shultz and Ted Halstead have proposed the so-called Carbon Dividends Plan. A carbon fee will be levied and the proceeds, the so-called dividend, will be directly put back into the people's hands. As the wealthier households tend to pollute more in absolute terms, they would face the highest costs. According to the authors, the bottom income deciles would experience the greatest net gains.

A second problem is that the Paris climate agreement is rather non-committal. Countries are free to formulate their own objectives, there are no sanctions if these objectives are not met and they can leave when they want. However, some changes in attitude can be observed. The EU is already arguing that trade agreements should include environmental and social obligations. William D. Nordhaus, the 2018 Nobel laureate in Economic Sciences suggests that countries could form coalitions, the so-called climate clubs that accept a carbon price. Import duties will be levied on goods from countries that do not belong to the club. These duties can be dependent on the carbon contents of the goods. It is an interesting idea that may require broadening the climate change discussion to the WTO.

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Economic forecasts*

%	GDP Growth 2018 e	2019 e	2020 e	Inflation 2018 e	2019 e	2020 e
Advanced	**2.2**	**1.7**	**1.3**	**2.0**	**1.7**	**1.8**
United-States	2.9	2.1	1.5	2.4	1.8	2.0
Japan	0.9	0.7	0.3	1.0	0.6	1.4
United-Kingdom	1.3	1.8	1.6	2.5	2.0	2.0
Euro Area	**1.9**	**1.4**	**1.2**	**1.7**	**1.8**	**1.5**
Germany	1.6	1.5	1.3	1.8	2.2	1.6
France	1.5	1.6	1.3	2.1	1.5	1.6
Italy	1.0	0.6	0.5	1.3	1.5	1.2
Spain	2.5	2.2	2.0	1.7	1.7	1.3
Emerging	**5.9**	**5.9**	**5.7**	**2.7**	**2.7**	**3.1**
China	6.6	6.2	6.0	2.1	1.9	2.5
India	7.4	7.6	7.8	3.8	4.0	4.1
Brazil	1.3	3.0	2.5	3.7	3.8	3.6
Russia	1.8	1.7	1.6	2.8	3.6	4.2

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

Financial forecasts*

Interest rates, %		2018			2018	2019						
End of period		Q1	Q2	Q3	Q4	Q1e	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
US	Fed Funds	1.75	2.00	2.25	2.50	2.75	3.00	3.00	3.00	2.50	3.00	3.00
	Libor 3m $	2.31	2.34	2.40	2.81	2.90	3.05	3.05	3.05	2.81	3.05	2.80
	T-Notes 10y	2.75	2.86	3.06	2.69	3.30	3.40	3.45	3.50	2.69	3.50	3.25
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.20
	Euribor 3m	-0.33	-0.32	-0.32	-0.31	-0.30	-0.25	-0.20	-0.15	-0.31	-0.15	0.00
	Bund 10y	0.50	0.31	0.47	0.25	0.55	0.60	0.80	1.00	0.25	1.00	0.90
	OAT 10y	0.60	0.62	0.75	0.71	0.95	1.00	1.10	1.25	0.71	1.25	1.15
UK	Base rate	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.25	0.75	1.25	1.50
	Gilts 10y	1.39	1.33	1.48	1.27	1.70	1.85	2.00	2.10	1.27	2.10	2.10
Japan	BoJ Rate	-0.07	-0.07	-0.06	-0.07	-0.10	-0.10	-0.10	-0.10	-0.07	-0.10	-0.10
	JGB 10y	0.04	0.03	0.13	0.00	0.15	0.15	0.15	0.14	0.00	0.14	0.08

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2018				2019						
End of period		Q1	Q2	Q3	Q4	Q1e	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
USD	EUR / USD	1.23	1.17	1.16	1.14	1.15	1.17	1.21	1.25	1.14	1.25	1.34
	USD / JPY	106	111	114	110	110	108	105	100	110	100	90
	GBP / USD	1.40	1.32	1.30	1.27	1.32	1.36	1.41	1.47	1.27	1.47	1.58
	USD / CHF	0.96	0.99	0.98	0.99	1.01	1.00	0.98	0.96	0.99	0.96	0.93
EUR	EUR / GBP	0.88	0.88	0.89	0.90	0.87	0.86	0.86	0.85	0.90	0.85	0.85
	EUR / CHF	1.18	1.16	1.13	1.13	1.16	1.17	1.18	1.20	1.13	1.20	1.25
	EUR / JPY	131	129	132	125	127	126	127	125	125	125	121

Source : BNP Paribas GlobalMarkets (e: Forecasts)

*At end of November 2018

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