

ECO PERSPECTIVES

Eco
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3rd quarter 2022

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Increasing concerns about the growth outlook

The level of activity in the US and the euro area is very high but growth has already slowed down significantly and quarter over quarter growth should remain low for the remainder of the year. Doubts about the cyclical outlook are on the rise due to a combination of elevated inflation, geopolitical uncertainty and monetary policy tightening.



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EDITORIAL

INCREASING CONCERNS ABOUT THE GROWTH OUTLOOK

The level of activity in the US and the euro area is very high but growth has already slowed down significantly and quarter over quarter growth should remain low for the remainder of the year. Worries about the cyclical outlook are on the rise due to a combination of elevated inflation, geopolitical uncertainty and monetary policy tightening. Survey data on input prices and delivery times have eased but the levels are still very high. Wage growth remains strong in the US and is picking up in the euro area, creating concern that inflation would decline more slowly than expected. In addition, assessing the true state of demand has become very difficult.

The level of activity in the United States and the euro area is very high, as witnessed by huge labour market bottlenecks and order books that are full. However, growth has already slowed down significantly and quarter over quarter growth should remain low for the remainder of the year.

Concerns about the cyclical outlook are on the rise. Although supply bottlenecks have started to ease in the US and the euro area, they still are a headwind to growth, both directly - long delivery times constrain activity - and indirectly, with high inflation weighing on demand. Geopolitical uncertainty remains elevated. High inflation is significantly eroding households' confidence and purchasing power and it is putting pressure on corporate profit margins. Long-term interest rates have moved higher, making external financing for companies more expensive due to the rise in the risk-free rate of interest and the widening of corporate bond spreads. Assessing the true state of demand is difficult: the strong order books may partly reflect a reaction of customers to long delivery times. An easing of supply disruption and slower demand growth may trigger order cancellations.

As shown in chart 1, investment plans of US companies have been scaled back. Financing conditions for households have also deteriorated. In the US, the jump in mortgage rates has been accompanied by a significant increase in the number of unsold homes. Equities are down significantly from their recent peaks under the combined influence of a downward revision of earnings growth, higher risk-free rates and an increase in the required risk premium that reflects mounting risk aversion of investors.

Slowing growth and elevated and rising inflation represent a discomforting combination. The latter forces central banks to tighten policy aggressively to bring it back to target, to avoid an unanchoring of inflation expectations and thus maintain their credibility, but this will increase the worries of households, companies and financial markets about the growth outlook. For the avoidance of doubt, Jerome Powell has stated that the rate hikes of the Federal Reserve will be unconditional. Even if it triggers a recession, the federal funds rate will move higher until the FOMC is confident that it is meeting its inflation target. Unsurprisingly, US recession fears are mounting. On the European side, low quarterly growth means that little is needed to end up in a 'technical' recession. 'Technical' means two successive quarters of slightly negative growth rates. A full-fledged recession seems unlikely in the near term due to the carry-over effect of last year's growth, a catching up of demand in a post-Covid-19 world, the strong labour market to date, accumulated excess savings, a positive fiscal policy impulse and huge investment needs.

The guidance of the ECB has also become more hawkish in recent weeks. Against this background, the easing of price pressures as shown by survey data on input prices and delivery times, is welcome news (chart 2 for the US; a similar evolution is visible in the euro area), although the levels are still very high and the improvement needs to be confirmed in the coming months. In combination with ongoing strong

US REGIONAL FED MANUFACTURING SURVEYS: INDEX OF FUTURE CAPITAL EXPENDITURES

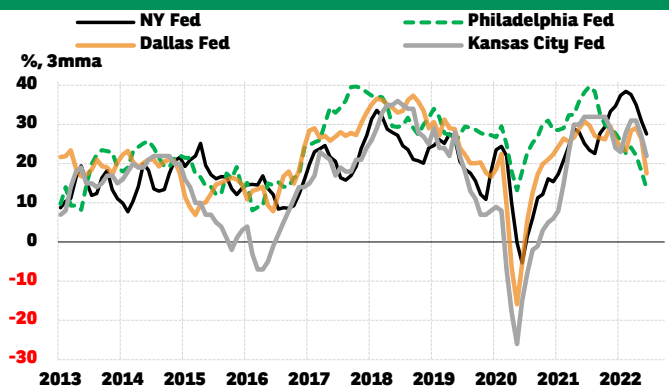


CHART 1

SOURCE: FEDERAL RESERVE BANKS OF NEW-YORK, PHILADELPHIA, DALLAS & KANSAS CITY

US: MANUFACTURING PMI AND INFLATION

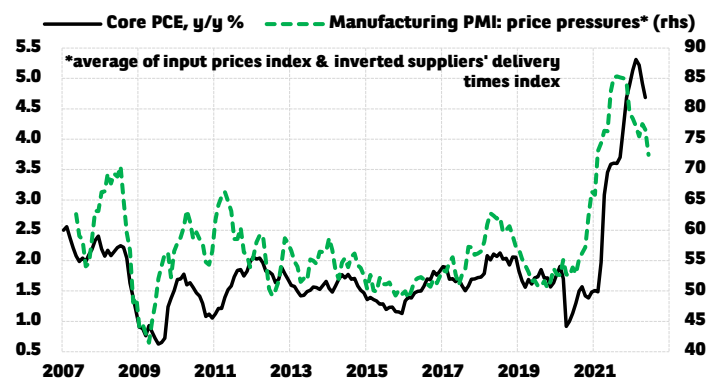


CHART 2

SOURCE: S&P GLOBAL, BEA, BNP PARIBAS

wage growth in the US and a pick-up in the euro area, as well as a risk of further increases in certain commodity prices (energy, food), there is a concern that inflation would decline more slowly than expected, thereby forcing central banks to keep on tightening.

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UNITED STATES

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ACCELERATED NORMALISATION OF MONETARY POLICY

Inflation's unexpected rebound in May forced the Federal Reserve (Fed) to accelerate the normalisation of its monetary policy. In mid-June, the Federal Open Market Committee (FOMC) decided to raise the fed funds rate by 75 basis points (bp). At the same time, the Fed began to shrink its balance sheet through Quantitative Tightening (QT). For the moment, the US economy is holding up well, supported by robust fundamentals such as employment. Yet activity is beginning to slow under the impact of tighter lending conditions and deteriorating global economic prospects. The US economy will come under fierce pressure as it navigates towards a hard or soft landing.

Inflation continues to surge with the consumer price index rising to an annualised rate of 8.6% in May, driven by the upturn in energy and food prices, which contributed 2.4 points and 1.3 points, respectively. Inversely, core inflation continued to ease on a year-on-year basis (to 6% from 6.2% in April and 6.5% in March). In contrast, core inflation was still high on a month-on-month basis (+0.6% m/m), buoyed by robust aggregate demand (illustrated by the increase in production capacity utilisation rates, to 78.9% in April, far above pre-crisis levels) as well as by pressures throughout the supply chain, which were much stronger and more persistent than expected. Looking at survey data, input prices have continued to rise since early 2022 (82 in May, up from 73 in January according to the ISM index) which could fuel more inflation in the months ahead.

Stimulated by a job market at full employment and an unemployment rate of 3.6% in May, wage increases, which tend to be inflationary, must be monitored closely. Labour shortages are also driving up average hourly earnings (AHE, up 5.2% y/y in May), notably in leisure and hotel services (+10.2%), business services (+6.5%) and health care (+5.7%). Higher labour costs combined with lower productivity (-0.6% in the year to Q1 2022) are beginning to squeeze corporate margins. Yet wage increases nonetheless encourage workers who had left the job market to return to work, notably newly retired workers, which should help ease somewhat job market pressures as well as the impact of the inflationary shock on purchasing power. The Biden administration also intends to review US immigration policy to increase the number of work visas to fight against labour shortages.

To achieve a soft landing of the economy, monetary policy would have to be conducted cautiously. However, inflation remains way too high and signs of a slowing economy are already feeding fears of recession, although its timing and extent are hard to estimate. Even so, key policy rates are being raised at a very fast pace. At its most recent mid-June meeting, the FOMC opted to raise the fed funds rate by 75 basis points (bp). Moreover, it could maintain this pace at the next FOMC meeting in July. All in all, we are looking for an additional 175bp increase in the Fed funds rate by the end of the year. This would bring the upper range to 3.5% at the end of this tightening cycle. As the Fed begins to reduce the size of its balance sheet, there is also some concern about its impact on the real economy and financial stability. Between June and August, the Fed will no longer reinvest USD 47.5 bn of assets that reach maturity each month. And starting in September, it plans to accelerate the reduction of its balance sheet by USD 95 bn a month. It remains to be seen how well the US economy can hold up in the face of such a rapid normalisation of monetary policy.

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GROWTH & INFLATION

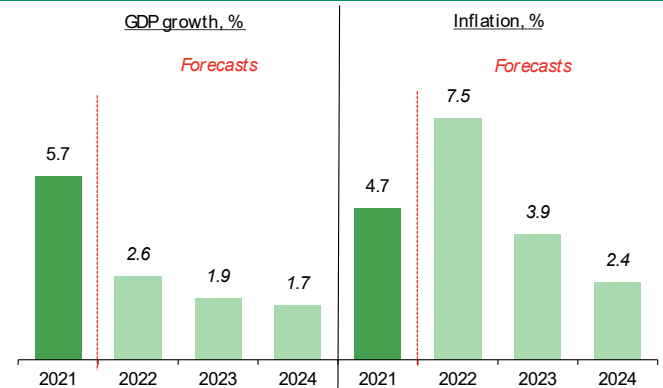


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

US: AVERAGE EARNINGS AND INFLATION

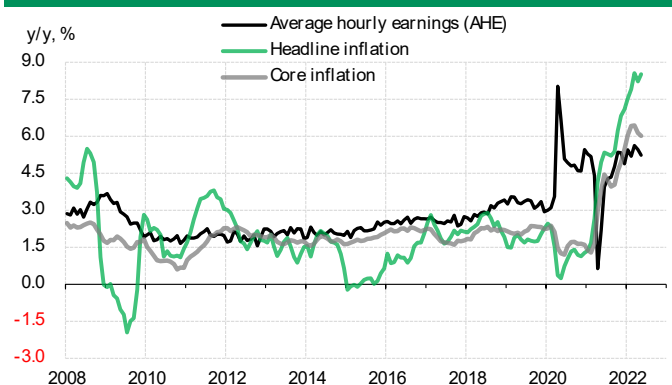


CHART 2

SOURCE: BLS, BNP PARIBAS



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CHINA

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WEAKENING ECONOMIC GROWTH OUTLOOK

China's economic activity contracted in April and May 2022 because of stringent mobility restrictions introduced in major industrial regions such as Shanghai. Since late May, restrictions have eased gradually and activity has started to rebound. As downside risks remain high, the authorities continue to ease their fiscal and monetary policies. While credit demand stays weak in spite of the decline in interest rates, the current global environment and the risk of capital outflows may constrain the central bank's room for maneuver.

Economic activity has recovered since late May as mobility restrictions have eased gradually in Shanghai and across the country. Industrial production started to rebound, notably encouraged by reviving exports, while activity in the services sector and retail sales still contracted in May. Investment growth reaccelerated, driven by infrastructure projects.

In the short term, economic growth is expected to pick up but downside risks are high. First, the health situation remains uncertain and the authorities should maintain a tough anti-Covid strategy until late 2022. Second, private consumption will also struggle to recover because of the slack in the labour market. The unemployment rate rose from 5.1% at end-2021 to 5.9% in May 2022. It increased faster in the 31 major cities (6.9% in May). More worryingly, the unemployment rate of young people between 16 and 24 years of age reached a record high of 18.4% in May.

Meanwhile, the impact of higher consumer price inflation on household purchasing power should be moderate. CPI inflation was only 2.1% y/y in April and May. Core inflation is low (0.9% y/y) given weak domestic demand while inflation in food and energy prices remains limited despite global pressures, due to the continued fall in meat prices and partial controls on grain and energy prices.

The crisis in the real estate and construction sectors continues (volumes of property transactions fell by 24% y/y in the first five months of 2022), which acts as a strong drag on employment, domestic investment and consumption of durable goods. Measures have been introduced to encourage transactions, and access to mortgage loans and short-term financing for property developers has been eased cautiously. However, the authorities keep their objective of moderating housing price inflation and deleveraging property developers.

Finally, export growth rebounded in May (+16.8% y/y vs. 3.7% in April) and may continue to recover in the short term due to fewer logistics disruptions. However, exports are unlikely to be as strong an engine of growth in 2022 as in 2021 given the slowdown in global trade.

As a consequence of large downside risks, policy easing continues. On the fiscal front, support measures focus on new infrastructure investment and on corporates, notably SMEs and manufacturing firms (through tax cuts, subsidies, or the deferred payment of social security contributions). A reduction in the passenger car purchase tax, which was part of the new package announced in late May, is one of the few measures targeting private consumption. While some provinces have also given out cash subsidies to consumers, the total amounts are small.

Domestic lending rates and money market rates have declined since late 2021. However, the central bank (PBOC)'s leeway for further rate cuts is narrowing in the current global environment and due to the risk of capital outflows. Meanwhile, the authorities have made a large

GROWTH & INFLATION

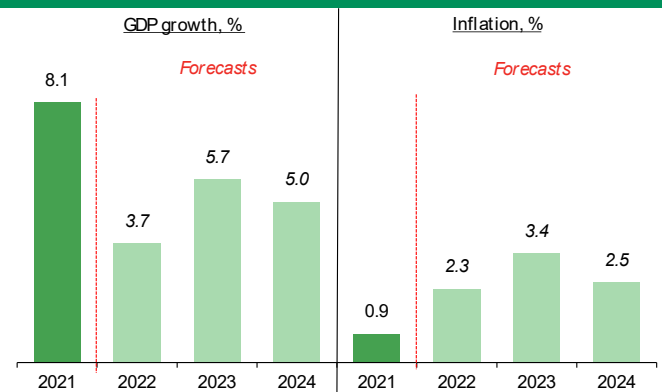


CHART 1

SOURCE : BNP PARIBAS GLOBAL MARKETS

CHINA: RESTARTING

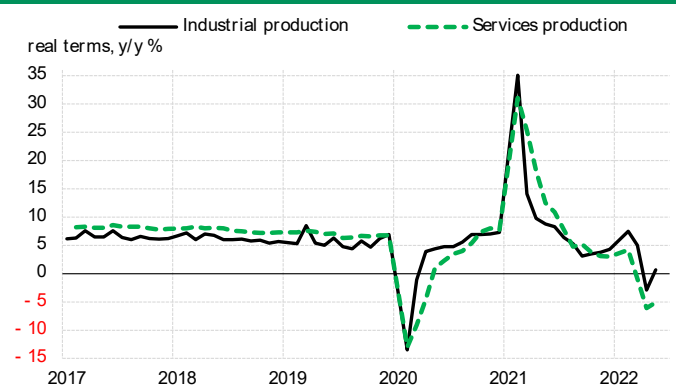


CHART 2

SOURCE: NBS, BNP PARIBAS

use of credit policy instruments such as bank loan quotas and targeted loan programs (to support SMEs, rural areas and crisis-hit sectors). However, policy effectiveness is much constrained by weak credit demand. Indeed, domestic credit growth acceleration has so far remained limited.

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CAN JAPAN ASSUME ITS SINGULARITY MUCH LONGER?

Since early 2022, inflation has been rising, albeit moderately, for the first time since 2014, while growth contracted in Q1. The yen has depreciated sharply due to the Bank of Japan's very accommodating monetary policy, which is out of step with the other major central banks, who have already begun to tighten their monetary policy. In June 2022, BoJ Governor Haruhiko Kuroda still thought it was "necessary" to maintain a yield curve control policy to boost core inflation to a "stable and sustainable" level. Yet currency depreciation aggravates imported inflation and further erodes household purchasing power. A few weeks before the legislative elections of 25 July, the government is likely to reinforce measures to support household purchasing power.

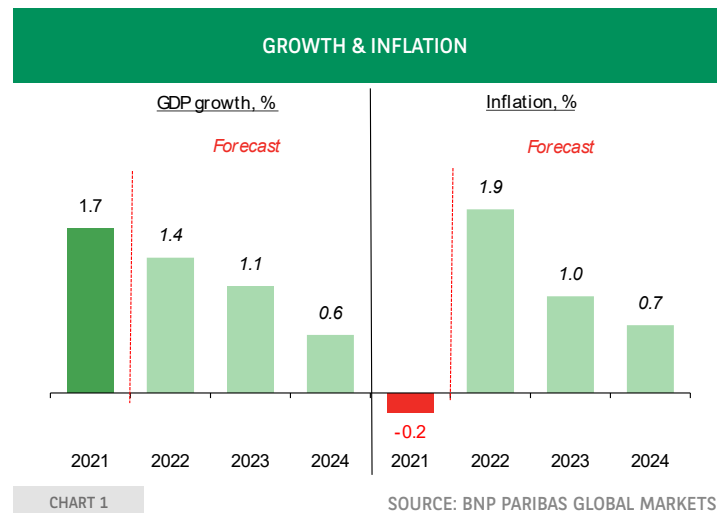
The Bank of Japan (BoJ) justified the continuation of its policy of yield curve controls, insisting on the "temporary" nature of current inflation. The entire annual increase in the consumer price index (CPI), which rose 2.5% y/y in April 2022, can be attributed to higher prices for energy and food products, that are essentially imported and thus highly exposed to the surge in international commodity prices, which has been amplified by the war in Ukraine. Excluding energy and perishable food items (the BoJ's core inflation target), the CPI rose only 0.8% y/y in April 2022. This low figure is another reason why BoJ Governor Haruhiko Kuroda argues for maintaining its policy of yield curve controls, which he claims is "necessary" to boost core inflation to a "stable and sustainable" level¹.

The absence of widespread price inflation reflects the sluggish nature of domestic demand, which is why Japan's cumulative performance has lagged behind that of the other advanced countries since the 2021 recovery. In Q1 2022, real GDP was still 2.5% below the 2019 level, whereas it has already exceeded pre-Covid levels by 3.7% in the United States and 0.5% in the Eurozone. Japanese GDP contracted in Q1 2022 (-0.1% q/q). Notably, there was a decline in the consumption of durable goods (-0.8% q/q) and semi-durable goods (-1.8% q/q), which was hampered by the supply chain problems of businesses, who were also hurt by shortages of components and global supply chain disruptions, especially in China. Consumption of services also contracted (-0.1% q/q) due to health restrictions introduced last winter to curb the expansion of the Omicron variant.

The divergence in monetary policies between the BoJ and the Fed resulted in a sharp depreciation of the yen, which has fallen 22% against the US dollar since the beginning of the year. The deterioration of Japan's current account surplus is also adding downward pressures on the currency. Higher energy prices have increased the cost of imports, while the shutdown of borders due to health restrictions has reduced external revenues. In Q1 2022, foreign trade made a negative contribution of 0.4 points to Japanese GDP as import growth (+3.3% q/q) largely exceeded the rise in exports (+1.1% q/q).

SUPPORT FOR HOUSEHOLDS

The yen's depreciation accentuates imported inflation, which is deeply felt by households. In Q1 2022, household purchasing power declined 2.5% q/q². To limit this decline, the government has implemented a series of support measures since the end of April 2022 totalling JPY 6.2 trillion (USD 48.2 bn), including a check of JPY 50,000 (USD 391) per child for low-income households. Since the majority of these measures are debt financed, they will further erode government finances.



The OECD is now forecasting a public deficit of 6.9% of GDP in 2022, up from 5.7% in 2021. The Japanese authorities have also renounced their target of generating a primary fiscal surplus by 2025. Yet fiscal revenues will get a boost from the expected rebound in private consumption, following the removal of health restrictions and the reopening of Japan's borders to tourists. In place since March 2020, the partial lifting of this restriction will allow 20,000 tourists to enter the country daily according to the government, although this is a far cry from the 2019 average of 88,000 tourists (METI).

Looking beyond economic measures, the government also intends to transform its growth model to foster the emergence of a "new capitalism", one that is more sustainable and equitable in the long term. It aims to better divide up value added between profits and wages. The three "arrows" established by the previous Prime Minister, Shinzo Abe, could give way to redistribution policies that favour households coupled with stricter corporate measures. A more precise road map is expected to be presented following the election of the House of Councillors, Japan's upper house of parliament, in July 2022, an election that the ruling Liberal Democratic party is once again favoured to win.

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¹ "The Bank's Thinking on Monetary Policy: Toward Achieving the Price Stability Target in a Sustainable and Stable Manner", BoJ speech (6 June 2022)

² Households Family Income Survey, Statistics Japan, April 2022.



EUROZONE

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MORE INFLATION THAN GROWTH

Until May, Eurozone growth has been relatively resilient to the series of shocks that have swept the region, but its pace should slow more significantly in the months ahead. We cannot rule out the possibility of a recession, even though that is not our base case given the numerous sources of growth: post Covid-19 catch-up potential, surplus savings, investment needs and fiscal support measures. Our scenario appears to signal stagflation (inflation will be much higher than growth in 2022 and 2023), but with the big difference that the unemployment rate is not expected to rise much. The ECB is preparing to begin raising its key policy rates to counter the inflationary shock. We are looking for a cumulative 250bp increase in the deposit rate, bringing it to 2% by fall 2023.

According to our scenario, the Eurozone economic environment is getting worse first before getting better. On the one hand inflation continues to soar and supply chain disruptions persist, aggravated by the war in Ukraine and China's zero-Covid strategy, and on the other hand, the stock markets collapsed in May-June and long-term rates rose rapidly against the backdrop of an accelerated, effective and widely expected normalisation of monetary policies. As necessary as it may be, this monetary normalisation is nonetheless stirring things up.

Let's look more closely at inflation, the core problem. It continues to rise and gain in strength. Inflation hit 8.1% year-on-year in May (0.7 points higher than in April) and still shows no signs of peaking yet. Inflation remains mainly driven by the energy component (for a small half), but core inflation is rising too (3.8% y/y, 0.3 points higher than in April). The relative contribution of manufactured goods prices has been rising for the past year, to 44%, while that of services prices has been falling, to 56%. Core inflation explains nearly a third of headline inflation (this share has been more or less stable for the past year) while the food component now accounts for 20%. Over the past year, the relative contribution of the food component has a little more than doubled, while the one of the energy component has declined by 10 points. Another indicator of diffusion is that in May, as in April, about 70% of the components of the HICP and core inflation index had increased by more than 2% y/y. Alternative measures of core inflation (super core, median and the trimmed mean) range from 4% to 7% y/y, which also shows the extent of the problem. Unsurprisingly, inflation expectations are also rising, albeit moderately for the moment.

Yet the economic news is not all bad. The business climate in industry, services and construction has not deteriorated much up through May, the most recent data point. Business climate indexes are holding at high levels, which is consistent with strong growth. The retail business climate and consumer confidence, which are more exposed to the inflationary shock, declined sharply in March and April, but this trend did not get any worse in May. The signals from the job market are still reassuring: the unemployment rate is low and stable, hiring difficulties remain very high as well as hiring intentions, and household fears of unemployment stay low. It is also worth reiterating that there are major sources of growth: post Covid-19 catch-up effect, surplus savings, investment needs and fiscal support measures.

Even so, growth is expected to slow down more sharply in the months ahead. After +0.6% q/q in Q1 2022 (a figure inflated by the 0.4-point contribution of the surge in Irish GDP, which rose nearly 11% q/q), we expect Eurozone GDP to contract by -0.2% q/q in Q2, followed by barely positive growth in Q3 (+0.1% q/q) before rebounding more strongly in Q4 (+0.5% q/q), buoyed by the above-mentioned support factors and the expected easing of the inflationary shock and supply chain disruptions. This rebound should extend into 2023. In 2022, we are forecasting average annual growth of 2.5%, which might seem high (thanks to the carry-over of 2.5% in Q1 2022) but is actually low (considering the 1% y/y growth forecast for Q4 2022).

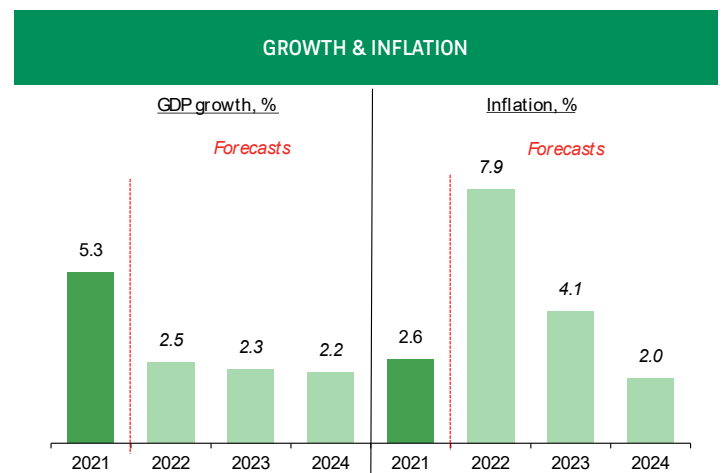


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

Current forecasts of average annual growth (not only ours, but those of other international institutions) also stand out for what seems like stagflation: inflation will be much higher than real growth in 2022 and 2023, before normalising somewhat as of 2024. The difference with a scenario of true stagflation, however, lies in the unemployment rate, which is not expected to rise very much.

Under this environment, the ECB confirmed that on 1 July it would end its net asset purchases via the Asset Purchase Programme (APP). The central bank is also preparing to begin raising its key rates, with Ms Lagarde announcing a 25bp increase in the deposit rate on 21 July. We cannot exclude a bigger move. We are then looking for two 50bp rate hikes in September and October, followed by three 25bp rate hikes in December, February and March. Two final 25bp rate increases in June and September 2023 would complete this cycle, bringing the deposit rate to 2%, within our estimated range for the neutral rate (1.5-2.5% for the nominal rate; -0.5% to +0.5% for the real rate). At this level, the ECB's monetary policy would not be restrictive. A new tool is also being prepared to combat the unwarranted widening of spreads within the Eurozone, in order not to interfere with the normalisation and smooth transmission of monetary policy.

Our scenario, like the ECB's, calls for a soft landing of the economy, with growth slowing down (under the impact of the inflationary shock and orchestrated via monetary normalisation) in a controlled manner (thanks to the support factors mentioned above), albeit sufficiently to ease inflation. Lower inflation, in turn, should help ease the downward pressure on growth. We see the current inflationary shock as intrinsically disinflationary and not a source of stagflation.

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GERMANY

AFTER IMPORTED INFLATION, DOMESTIC INFLATION?

Germany is one of the Eurozone countries hit hardest by the Russia-Ukraine war, which is leading towards feeble growth prospects and high inflation. German GDP is expected to barely increase by 1.3% in 2022, compared to a Eurozone average of 2.5%. Average annual GDP growth will remain 0.9% below the year-end 2019 level. At the same time, inflation is expected to reach 8.1% in 2022, driven up by high energy prices. Between the minimum wage hike promised by the government and expected wage increases in many sectors, wage growth should accelerate strongly in 2022, but may not be sufficient to offset the inflationary shock.

Germany has significantly reduced its energy imports from Russia (by about 35% since the outbreak of the war) by increasing natural gas shipments from Norway and the Netherlands, and by ramping up imports of liquefied natural gas (LNG). Yet supply troubles and the geopolitical context have placed a heavy strain on the economy. Although GDP -driven entirely by investment-grew a slight 0.2% q/q in Q1 2022, household consumption and the trade balance both contracted, squeezed by the war in Ukraine. Q2 prospects have deteriorated. Consumption contracted in April, with retail sales down 5.4% m/m, while foreign trade has slumped. The Kiel Institute's leading indicator on trade suggests that the trade balance will plunge in Q2 to its lowest level in two decades. Lastly, business leaders have very low expectations of future business: the executives and analysts surveyed by the IFO and ZEW are clearly pessimistic (balance of -17.8 in May and -27.6 in June, respectively). The same goes for household expectations (-9.3 in May) (see chart 2).

The geopolitical environment has sharply driven up energy and commodity prices. Inflation rose to 7.9% y/y in May, a record high since February 1952 for West Germany. It is mainly fuelled by energy prices (+38.3% y/y in May), but inflation is also spreading to goods (+13.6% y/y) since many companies have already carried over part of the increase in production costs to their end prices. Although inflation has not yet spread to the services sectors (+2.9 y/y), the programmed increase in the minimum wage (from EUR 9.82 currently to EUR 12 in October) could change the situation since it will touch numerous sectors (temporary employment, cleaning and security services). Even so, it seems fairly unlikely that Germany will be hit by a price-wage spiral. Despite a favourable environment for wage talks, with a very low unemployment rate (3% according to the ILO definition in May) and the job vacancy rate at an all-time high (4.1% in Q1 2022), inflation is too high to be fully offset by wage increases. Wage talks between labour unions and management since the beginning of the year seem to be heading towards an average wage increase of 4%, not including bonuses, but that will not be enough for average household purchasing power to hold in positive territory.

Faced with the inflationary shock, the government is providing only minimum support to households and companies (limited assistance with strict compliance criterion). The public deficit will barely reach 2.5% of GDP this year (compared to 3.7% in 2021). Christian Lindner, the Finance Minister, intends to comply with the constitutional stipulation limiting the Federal government's structural deficit to 0.35% of GDP. Moreover, beginning in 2022, the government has begun to sharply reduce the public debt ratio (by about 3 points of GDP). The only manoeuvring room could come from the creation of a special off-balance sheet fund, the cost of which would not appear on the Federal government's public deficit, as was the case for the recently-approved EUR 100 bn investment plan for defence.

GROWTH & INFLATION

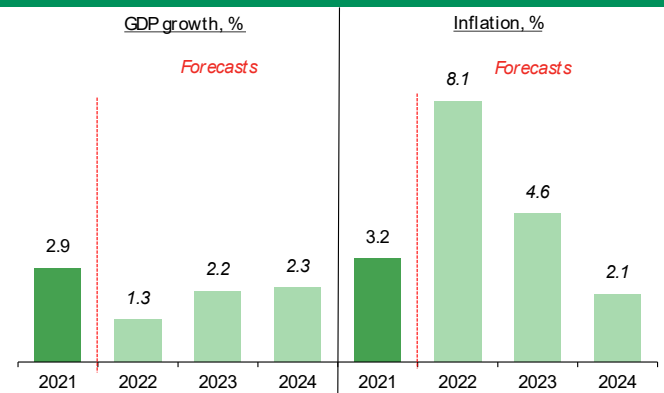


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

GERMANY: BUSINESS EXPECTATIONS

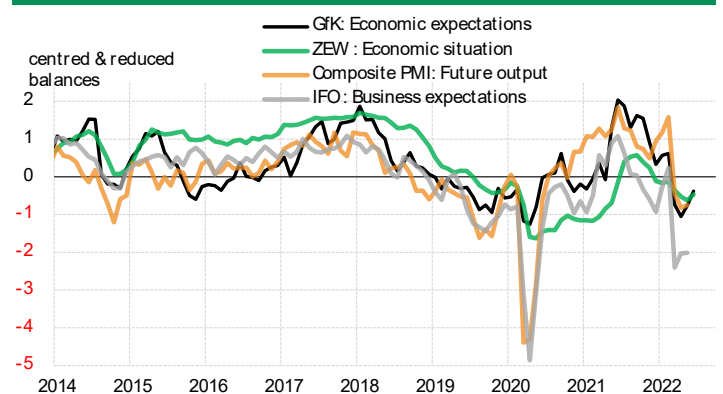


CHART 2

SOURCE: IFO, ZEW, GfK, S&P GLOBAL, BNP PARIBAS

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FRANCE

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THE SHOCK TO PURCHASING POWER IS SMOOTHED BUT NOT FULLY ELIMINATED

The French economy is stuck between three developments with different effects: an inflation shock that is denting consumer spending, a negative supply shock (supply constraints in industry) and the lifting of public health restrictions (benefiting growth as of the second quarter, having held it back in the first quarter). Government measures that have limited inflation were unable to prevent negative growth in the first quarter. However, the positive impact of the lifting of public health restrictions and a rebound in purchasing power should allow for a recovery towards positive growth in the third quarter (+0.3% q/q).

France suffered a fall in GDP in the first quarter (-0.2% q/q), largely as a result of the 1.5% q/q slide in household consumption. According to our calculations, around two thirds of this decline in consumer spending is due to acceleration in inflation (5.2% y/y in May according to the INSEE index, 5.8% y/y according to the harmonised index), with one third corresponding to "lost opportunities" (impact of public health restrictions relating to the Omicron wave at the start of the year on accommodation/catering and transportation, supply restrictions limiting car and textile sales).

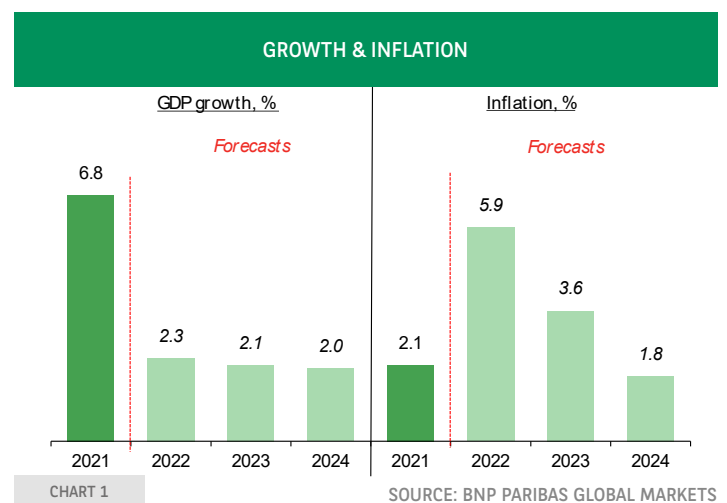
INFLATION SPREADING MORE AND MORE

The inflation shock that rattled France during the last year stems from energy prices (+28% y/y at the end of May). We expect energy prices to stabilise at their current high level between now and the end of this year. Meanwhile, all other prices should continue to rise. According to our calculations, future increases in food prices (+4.2%) and services (+2.2%) are similar to those already seen over the first five months of 2022 and higher in terms of manufactured goods (+2.9% vs. 1.9%). This means that inflation has not yet reached its peak and is expected to near 6.5% y/y in September.

This brisk inflation is denting household purchasing power (-1.8% q/q in the first quarter according to INSEE) and consumer spending (-1.5% q/q). The reduction in purchasing power has been limited by the measures adopted by the French government but not avoided. The freeze on regulated gas prices at the October 2021 level, the 4% cap on electricity price rises in February 2022 and the rebate of EURO.18 per litre on fuel (until July 2022, and likely to be extended) have avoided 2 points of inflation (according to our estimates and those of INSEE). However, a rebound in purchasing power is not likely until the third quarter (+0.9% according to our forecasts). A new package of measures is expected in the coming weeks, including an increase in civil servant wages and pensions (costing EUR4bn and EUR5bn respectively in 2022, assuming an increase of 4%) and a possible one-off "food cheque" planned in September (which we estimate at EUR1.2bn). Ultimately, loss of purchasing power should reach 0.8% in 2022 on our estimates, slightly lower than in 2013 (-1.1%), the worst level in history, but with a different cause, having previously been due to higher taxation. In 2022, according to our calculations, the government's policies will be favourable, as the loss of purchasing power could have reached 3.1% without anti-inflation measures. As a result of this more severe than previously anticipated inflation shock, we have cut our 2022 growth forecast by 0.9 percentage points to an average of 2.3% for the year.

THE EXISTENCE OF OTHER GROWTH DRIVERS

To achieve this level, growth in France will have to improve gradually. We expect zero growth in the second quarter and a slight rebound of 0.3% q/q in the third quarter. This is not by any means because of the inflation shock no longer having an impact, or even having less of



an impact, but because of other growth drivers becoming apparent. The economy is only partly back to normal post-Covid and the lifting of health restrictions as of February 2022 should have a favourable impact. It is therefore likely that the accommodation and catering sector and transportation services will return to their pre-Covid level between now and the third quarter.

At the same time, aeronautics made a significant contribution to growth in exports in the first quarter. As of the second quarter, tourism should add to this. For example, the Greater Paris region welcomed around 12.1 million tourists between January and May, 80% of whom were foreign (compared with 3.7 million and 15.1 million over the same period in 2021 and 2019). These two factors will mask momentum in other types of exports, for which the picture is more mixed (in keeping with the slowdown in growth in other countries, particularly in the eurozone), but they should allow for further growth in exports.

These growth drivers should enable the French economy to return to growth as of the third quarter and provide more moderate support thereafter. Household spending and investment – the decisive factors behind growth – will therefore have to firm up for this to continue.

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A BETTER RECOVERY IN A MORE COMPLEX WORLD

In contrast to the previous recessions, the Italian economy has already recovered what it lost in 2020. The carry over for 2022 is 2.6%. In Q1 2022, real GDP rose by 0.1%, with an annual growth rate above 6%. Value added for construction continued to increase, while manufacturing declined and services stagnated. The economic recovery mainly reflects the robust evolution of investment, while private consumption declined, as Italian households remained extremely cautious. Imports rose strongly, bringing the current account balance into negative territory. The economic recovery in 2021 was less intense in the Southern regions than in the Centre-North, thereby widening the gap between the two areas.

In Q1 2022, real GDP rose by 0.1% q/q, with an annual growth rate above 6%. In contrast to the previous recessions, the Italian economy has already recovered what it lost in 2020. The carry over for 2022 is 2.6%. At the beginning of 2022, the services sector was affected by the worsening of the pandemic. Value added stagnated, with turnover of accommodation and food service activities declining. Despite an increase, receipts relating to international travel remained well below the pre-crisis level. Supply-side bottlenecks and the sharp increase in commodity prices continued to penalise industrial activity. In Q1 2022, manufacturing value added declined by almost 1%, while that of construction rose further.

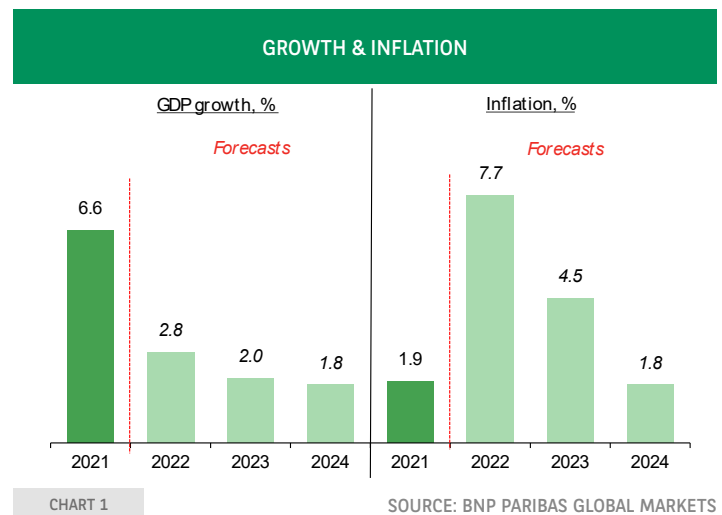
In Italy, the economic recovery mainly reflects the robust evolution of investment, which increased by more than 3% on average on a quarterly basis from the beginning of 2021, benefiting from fiscal incentives and still favourable financial conditions. In Q1 2022, gross fixed capital formation was around 15% higher than in Q4 2019. The propensity to invest for the overall economy rose above 21%, but remained below the levels for both Germany and France.

In Q1 2022, consumption declined by 0.8%, after stagnating in Q4 2019. At the beginning of 2022, consumer confidence weakened, reflecting the resurgence of the pandemic and the worsening of the global scenario. Households remained extremely cautious, further increasing the liquidity buffer, with the stock of bank deposits amounting to almost EUR 1,180 billion, and EUR 15 billion more than in December 2019. With still moderate wage growth, increasing inflation further dented purchasing power, with low-income households suffering higher food and energy prices.

In Q2 2022, the contribution of net exports was negative (-0.3%). The value of energy imports rose to EUR 27 billion, from EUR 10 billion in Q1 2021, and that of intermediate goods to EUR 56 billion. The current account recorded a deficit of EUR 8.6 billion, from a EUR 7.5 surplus in the same quarter of 2021. The balance of goods went from a EUR 13 billion surplus to a EUR 3.7 billion deficit, while the services deficit was unchanged.

THE NORTH-SOUTH GAP

In Italy, the current situation reflects highly divergent trends between the different geographical areas. In the decade preceding the outbreak of the pandemic, the gap between Centre-North and Southern regions widened. The greater dependence of the Southern economy on domestic demand and public spending contributed to the varying performance of the two areas. In 2019, the Southern regions' real GDP was still 10 p.p. below the 2007 level, while that of the Central and Northern regions was just 2 p.p. below. The pandemic affected the regions of the Centre-North and the South in a similar way. According to the latest available estimates, however, the 2021 recovery was less intense in the Southern regions. In fact, the divergence between the two areas is particularly evident when we consider the labour market: in 2020



(the last year for which comparison is possible) the male employment rate in the North was 74.1%, and in the Centre 70.4%, while in the South it was around 56%. Among women, the equivalent values were 59%, 55.2% and 32.5%. In the South, inactivity reached an astonishingly high level of 60% for women. Over the past decade, the business system in the Southern regions also weakened: firms' average size is far lower than in the Centre North (2.9 employees against 4.3 on average). Southern firms also show a delay in the adoption of digital technologies.

Efficient use of the resources provided under the PNRR (the Italian Plan to implement the Next Generation of EU funds) could help reduce the gap between the North and South of Italy. The resources of the Plan, together with those of the Complementary Fund, the Structural Funds and the Development and Cohesion Fund, constitute around €200 billion available to the Southern regions up to 2030.

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SIGNIFICANT RESILIENCE TO SHOCKS

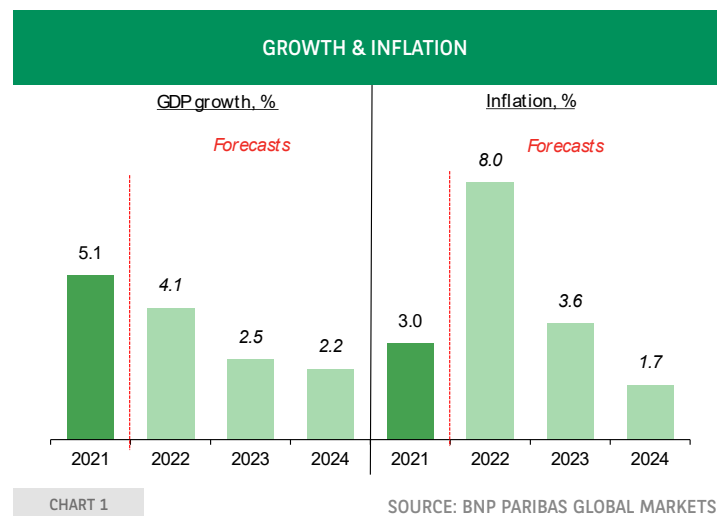
After a weaker economic rebound than its European neighbours in 2021, Spain is expected to report solid growth of more than 4% in 2022. Despite the Ukraine war's impact on inflation and purchasing power, the job market remains on an uptrend, with 186,000 jobs created in the first five months of the year. This dynamic should extend into the summer months with a stronger recovery in tourism, although current disruptions affecting the airlines in Europe could undermine this outlook. Moreover, inflation might not peak until later in the year, since price increases for food and household appliances are currently gaining traction.

Employment growth in Spain shows no signs of easing before the summer months. Nearly 186,000 net job creations were reported between January and May 2022, extending the sharp rebound of 2021 (473,000 job creations). The unemployment rate fell back to 13.3% in April. Compared to February 2020, when employment last peaked prior to the first Covid-19 lockdown, there has been significant hiring in the information and communication sectors (+87,511), as well as in various public sectors, notably education (+119,044) and healthcare (+137,864). Inversely, employment in finance and insurance (-13,177), hotel services (-23,295) and retail activities (-10,738) continues to fall short of pre-Covid levels.

Although the job market situation is still upbeat, the situation is more complicated in terms of inflation. In March, the harmonised index of consumer prices (HICP) nearly reached the threshold of 10% y/y, at 9.7% y/y, before easing to 8.5% y/y in May. Inflation is likely to ease more rapidly in Q4 2022, even though it should remain high (above 3%) through the end of H1 2023. On 15th June a price cap on natural gas was introduced and will help shield households from higher energy prices (+34.2% y/y in May). Even so, consumer price inflation continues to rise in other spending categories, notably food and non-alcoholic beverages (+11% y/y), household appliances (+5.9%) and food and restaurant services (+6.3%). Producer prices continued to soar last spring (+45.1% y/y in April). Although partially absorbed by corporate margins, this increase will also be carried over to sales and consumer prices.

MODERATE WAGE INCREASES

Although wages increased significantly in Q1 (+4.3% y/y according to INE), a price-wage spiral does not really seem to have materialised yet. Wage increases are mainly due to the knock-on effect of the increase in the minimum interprofessional wage (MIW) on the lower end the pay grid. The MIW was raised by 3.6% to EUR 1,000 in January. With the exception of three sectors (energy, information & communications, and finance & insurance), wage increases were reported in all sectors, and were especially large in hotel services. The average base wage in this sector (EUR 1,120.16 a month in Q1 2022) is close to the WIM, and wages rose by two thirds (68.4%) compared to Q1 2021. For the moment, higher wages are mainly due to government measures rather than corporate decisions, even though in certain sectors, like hotel services, labour shortages are also helping to drive up wages. Moreover, only a quarter of workers are covered by an inflation clause that would allow them to fully or partially adjust their wages to inflation¹.



Under this environment, the government could strengthen its support measures in favour of households and companies (EUR 17 bn so far, excluding price caps²). Reduced taxes on energy products, which currently expire in July, will probably be extended. The introduction of a windfall tax on energy providers is also being explored, similar to the measure implemented in Italy.

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¹ See: *Solo uno de cada cuatro trabajadores tiene cláusula de revisión salarial contra la inflación*, El País, 10 June 2022

² See: BNP Paribas EcoFlash, *Energy price inflation in the Eurozone: government responses and implications for household purchasing power*, 20 May 2022.

THE NETHERLANDS

11

INFLATION, BUT NOT JUST CONSUMER PRICE INFLATION

With an energy mix comprised of nearly 90% fossil fuels, the Netherlands have been hit by the full brunt of the sharp rise in oil and gas prices since the outbreak of the Russia-Ukraine war. As a result, the Netherlands has one of the highest inflation rates in Europe. Even so, household consumption is resilient, and the majority of companies esteem that business will remain vigorous in the months ahead. Thanks to this strong performance, the government has been able to focus on a limited series of support measures while continuing to reduce the debt of public administrations. Yet the Netherlands also faces another type of inflation that is just as alarming: house price inflation. With too few houses to cover all of the country's needs, residential housing prices have soared 29% since year-end 2019.

Despite limited dependence on Russia (which supplies only 23% of the energy used by the Netherlands), the country faces a veritable challenge since nearly 90% of its energy mix is comprised of fossil fuels. To diversify suppliers, the Dutch government is relying on its port infrastructure (Rotterdam is Europe's biggest port) by increasing the use of liquefied natural gas (LNG). This should help offset fewer imports from Russia as well as the October 2022 closing of the Groningen natural gas field, the biggest in Western Europe, which once covered 40% of the country's natural gas needs. The Netherlands' very high exposure to fossil fuels at a time when energy prices are soaring explains why the energy component of the price index was still up nearly 70% y/y in May (after peaking at 103% y/y in March), driving headline inflation to unusually high levels (+10.2% y/y in May). According to OECD forecasts, 2022 inflation is expected to average 9.2%. In the second half of the year, energy inflation will gradually give way to that of manufactured goods, as industrial companies pass on part of the increase in producer prices (+27.4% y/y in April) to their sales prices.

These bouts of inflation have gotten the better of household confidence, which almost fell to an all-time low in May (-47). Even so, consumption has not faltered: April retail sales were nearly 7% higher than at year-end 2019. This strong momentum is reflected in the confidence of business leaders, whose growth forecasts look upbeat, buoyed by sectors in full expansion, such as electronics components. All in all, the business cycle tracker calculated by the Netherlands' central statistics office (CBS) held at a high level in June. With acquired growth of 2.8% in Q1 2022, GDP growth will remain high in 2022, at an average annual rate of 2.9%. So far, economic activity remains resilient, which means public support measures can be limited to monetary aid for low-income households, such as energy checks, and energy price reductions (the VAT rate on petrol and diesel was reduced from 21% to 9%). As a result, the government has been able to contain the public deficit while continuing to reduce the public debt ratio, which it first began in 2021.

The Netherlands is also suffering from another type of inflation that is just as alarming if not more so: house price inflation, which has soared since 2014. This inflation can be blamed more on structural problems than on a cyclical shock. In the most densely populated country in Europe, where the need for new housing is estimated at about 1 million units by 2030, the prices of existing homes surged by 19.7% y/y in April. This trend can be attributed to the growing housing shortage as well as tax incentives that encourage real estate ownership. The recent upturn in home loans (+2.3% y/y at the end of Q1) also supports demand, at a time when household debt is already very high (close to 200% of disposable income in 2021).

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GROWTH & INFLATION

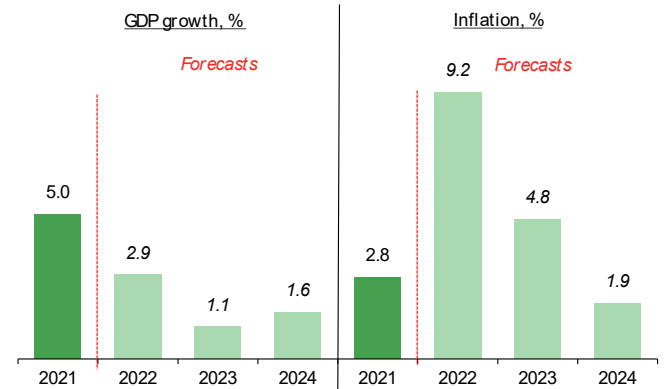


CHART 1

SOURCE: OECD, BNP PARIBAS

NETHERLANDS: REAL ESTATE PRICES

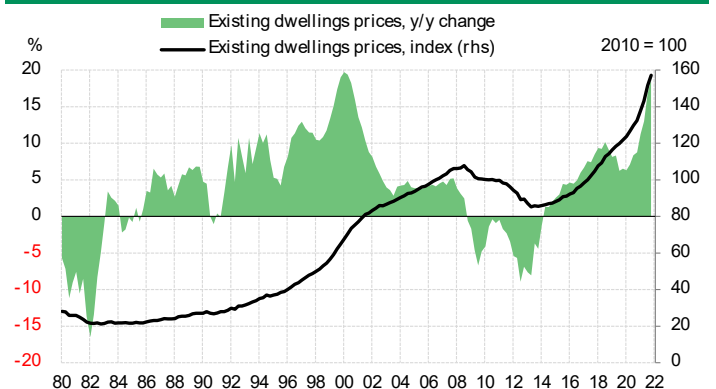


CHART 2

SOURCE: MACROBOND, BIS, BNP PARIBAS



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BELGIUM

12

WAIT FOR THE REBOUND

Belgian GDP grew by 0.5% in the first quarter of 2022, as inflation continues to reach new all-time highs. Consumer confidence took a hit at the start of the Russian invasion, with growth subsequently likely to have come to a standstill. Index-linking of wages as an income-protection mechanism should eventually soften the inflation-induced blow to private consumption, but the international competitiveness of Belgian firms will suffer as a result. Against a backdrop of rising interest rates, fiscal consolidation remains crucial.

Belgian GDP recorded 0.5% q/q growth for the first three months of 2022. Economic activity exceeded pre-Covid levels for the first time in Q3 2021. In Q4, growth remained above potential, albeit driven almost exclusively by net trade and stockbuilding. 2022 began with more broad-based growth, as gross fixed capital formation and private consumption picked up again.

Price pressures and geopolitical uncertainty will continue to weigh heavily on the outlook for the next quarters, however. We expect GDP to remain flat over the summer and only start to climb again at the end of this year, when headline inflation should be past its peak. Expected full-year growth of 2.3% seems to indicate a buoyant economy, but no less than 1.8% point of this growth is contributed by the strong basis effect, as a consequence of the strong recovery in 2021. We expect both GDP growth and inflation to normalise gradually towards the end of 2023.

HOUSEHOLDS SUFFER

CPI came in at 9.9% in May, an all-time high. HICP for the same month is expected to break through February's (record-)reading, with the flash estimate currently also at 9.9%.

Energy prices are still the main driver. Food prices also gained momentum, however, having risen by 1% per month on average since the start of this year. Core inflation should peak right after the summer.

Not all households suffer equally from these higher prices. A recent study by the NBB shows how families in the lowest income quintile experience inflation rates at 1% point or more above those in higher quintiles, even though for some of them the pain is reduced via such measures as social tariffs.

The NBB points out that real income growth would still be positive this year, due to increased employment growth. On a per capita basis, however, it will probably remain flat. Contrary to the Eurozone as a whole, Belgian real wages are expected to post significant gains (4.5%) across 2022-2024, the bulk of which will take place in 2023.

The accumulated (forced) savings are predominantly held by those in higher income groups. These households are not expected to contribute much to (supporting) consumption, due to their higher propensity to save.

Over the short term, consumption will suffer. Despite nominal spending reverting to pre-Covid levels last month (according to our in-house metrics), the situation is still a source of concern. Private consumption, as the largest component of total GDP, remains below its pre-pandemic level in volume terms. We expect it to decline further, due to the loss of purchasing power, before stabilising at year-end.

INVESTMENT GROWTH IS EXPECTED

Investment by non-financial corporates grew by almost 3% in the last quarter. Investment growth is expected to remain elevated in the foreseeable future, since in the latest round of survey data fewer firms reported either labour or equipment as factors limiting production.

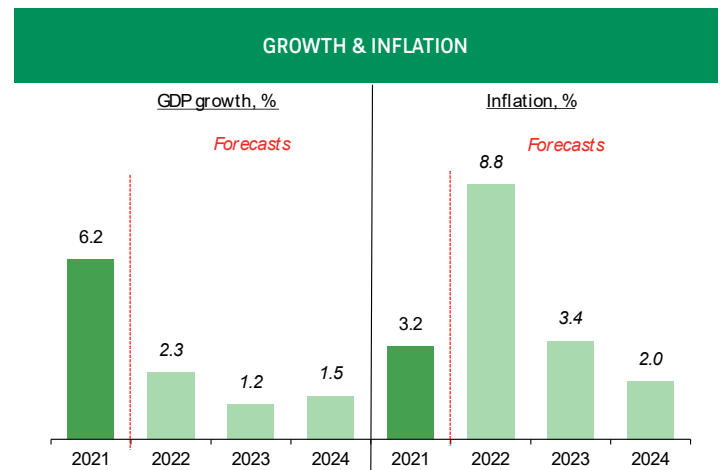


CHART 1

SOURCE: COMPTES NATIONAUX, BNP PARIBAS FORTIS

Especially manufacturers, which experience high utilisation rates, will probably be able to expand their productive capacity in the short term. Hourly wage costs could increase by 12% in the 2022-2023 period, almost solely due to the wage-index-linking mechanism. Over the same period, the wage gap with neighbouring countries, France, Germany and the Netherlands, could deteriorate by around 5%.

A recent study by the NBB of micro-data for Belgian enterprises provides an estimate of the ease with which firms can push price increases through to the end-user. The pass-through was estimated at 60% and is generally higher for larger, more energy-sensitive firms.

A majority of the Belgian firms that participate in the business confidence survey flag their intentions to raise selling prices over the next three months. All in all, profit margins are expected to decline somewhat, but remain above their long-term average throughout the forecasting period.

This might help explain why the number of bankruptcies is still well below the pre-pandemic average. In this respect, the current situation compares favourably with earlier crises (2001, 2008-2009), when bankruptcies drifted 10-15% above pre-crisis levels.

The public finance outlook remains negative. Income support measures to combat higher energy prices, the cost of the booster vaccination drive and expenditure on Ukrainian refugees have all contributed to an increase in government spending.

The deficit is not expected to fall back below the 3% threshold during the next year. Further fiscal consolidation is needed, however, as rising interest rates are no longer just a distant prospect.

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GREECE

13

PROSPECTS ARE STILL ENCOURAGING

After surging above 10% this spring, inflation will be the main headwind hampering Greek GDP growth in 2022. Yet the economy has proven to be resilient so far. Unemployment has been at the lowest rate since 2010, and GDP has rebounded robustly since the end of lockdown measures in 2020. A recession is unlikely this year, especially since tourism is primed for a solid summer season. On 20 August 2022, Greece will officially exit the European Commission's enhanced economic surveillance programme, which it entered in June 2018. In May, the country also repaid the last of the IMF loans (EUR 1.9 bn) contracted during the 2011 crisis. Eleven years later, Greece is taking another step towards the normalisation of its economic system.

Greece is one of the Eurozone economies that has recovered fastest after the lockdown restrictions of 2020. After rebounding 8% in 2021, real GDP rose strongly again in Q1 2022 (+2.3% q/q), bolstered by private consumption (+2.5% q/q) and investment (+3.7% q/q). At the end of Q1 2022, GDP growth was about 2.5% higher than pre-pandemic levels, a figure three times higher than the Eurozone average. The unemployment rate fell back to 12.5% in April, the lowest level in 12 years. This figure must be kept in perspective, however, since the active population has contracted sharply since the outbreak of the global financial crisis of 2008/2009, notably among youth¹. Even so, the Greek economy has proven to be resilient so far, and the risks of recession seem to be more limited than in the rest of Europe. The country will probably benefit from an excellent summer tourist season, even though these prospects could be tarnished somewhat by the social unrest and labour shortages currently plaguing the airline industry.

The main risk factors in H2 2022 are concentrated around the consequences of monetary tightening in the Eurozone (and the resulting upturn in bond yields) and inflation. The latter is spreading rapidly, and rose above 10% in May (harmonised CPI of 10.5% y/y). Although energy prices (+60.9% y/y) are still by far the main driving force behind the increase in inflation, prices are also rising faster and more for food (+12% y/y), hotel and restaurant services (+5.1% y/y) and household equipment (5.1% y/y). Since a big share of consumer products are imported, the country has been hit harder by global price increases arising from shortages and the disruption of international trade. We cannot rule out another acceleration in inflation, since consumer price increases sharply in H1 2022.

To strengthen support measures for households and companies, the government plans to extend the reduction in the VAT rate for restaurant and transport services, and to expand the elimination of the solidarity tax to the entire population in 2023 (for the moment, the tax cut only applies to private sector employees). Yet the government's fiscal manoeuvring room is very tight: the OECD is forecasting a primary deficit of 4.1% of GDP in 2022.

NO LONGER THE EPICENTRE OF EUROZONE FEARS?

Despite intensifying concerns about the possible fragmentation of the Eurozone and the sharp rise in Greek sovereign bond yields, the yield spread with the German Bund is still smaller than for Italy. This could reflect in part that some fundamentals are now more favourable for Greece. Even though its public debt is higher than Italy's, the Greek government has cut back its refinancing needs more sharply (22.4% of GDP in 2021, compared to 30.6% in Italy), and this differential should continue to widen according to the European Commission's projections².

¹ Down 372,000, or 7.3%, between Q3 2009 and Q1 2022.

² See: Fiscal Sustainability Report, European Commission, April 2022

GROWTH & INFLATION

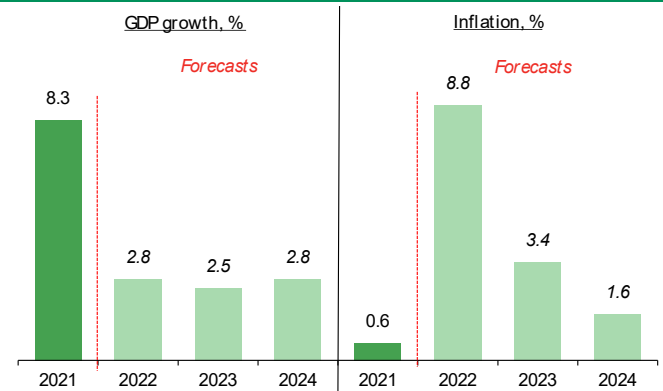


CHART 1

SOURCE: COMMISSION EUROPÉENNE, BNP PARIBAS

Greece's political situation also seems to be more stable than in Italy, where the coalition led by Mario Draghi remains fragile. The Greek Prime Minister, Kyriakos Mitsotakis, enjoys a comfortable parliamentary majority (The New Democracy party holds 158 seats out of a total of 300) and his popularity is high. Greece will hold its next general election in August 2023, which gives the government some time to make headway with certain key reforms such as the creation of a new land tax, an overhaul of the land registry system, and the privatisation of the Public Gas Corporation).

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UNITED KINGDOM

HEADING TOWARD RECESSION?

Inflation continues, driven by factors specific to the UK economy. On the one side, we have a labour market with full employment, favouring wage rises. On the other side, we find the UK economy's exposure to the consequences of the invasion of Ukraine putting considerable pressure on energy prices. Despite increasing its policy rate early, and then building on this with a succession of further hikes, the Bank of England is struggling to control rising prices. The government has little choice but to intervene to bolster household purchasing power. The economy is already slowing, and there is a risk it will worsen.

Inflation has continued since the beginning of the year (9.1% y/y in May), driven by a sharp increase in the price of goods (12% y/y in April) and a rise in the price of services (5% y/y in April). Despite the MPC's successive increases in the policy rate, core inflation has continued to rise rapidly (6.2% y/y). When it comes to energy prices, the trends have been spectacular. In April, the price of the energy components of the consumer price index increased sharply: 113% for fossil fuels, 95% for domestic gas and 54% for electricity.

These inflationary pressures have hit households hard and consumer confidence in future prospects has collapsed to record lows. The GfK index has fallen to -40 points, with very negative expectations for the next twelve months for both the economy (-56) and personal financial situation (-25).

Although it has still not returned to its pre-pandemic levels, the labour market remains resilient. Between February and April 2022, the employment rate continued to climb, taking it to 75.6%, but it remains 0.9 of a point below its pre-Covid level. Driven by an upward trend in wages, the activity rate has increased (79%), which has contributed to an increase in the quantity of labour available. The return of inactive workers to the labour market does not necessarily translate into a return to employment. Although the unemployment rate is low by historical standards, it started to rise again in April, when it was 0.1 of a point higher than in March; however, it remains close to the full employment level at 3.8%.

Tension in the labour market is generating a significant increase in nominal wages. Average wages (including bonuses) are growing at 6.8% y/y, benefiting much more the private sector (+8%), particularly the financial and business services sector (+10.6%), than the public sector (+1.5%). Nevertheless, real average weekly earnings (AWE) saw positive growth (of 0.4%) only by virtue of bonuses, most notably in the financial and business services sector. Faced with wage trends that are still too timid and unevenly spread across sectors to offset the loss of purchasing power, social unrest is becoming apparent, and the threats of strikes are multiplying, particularly in transport and healthcare.

Faced with the rising number of such disputes Rishi Sunak, the Chancellor of the Exchequer, has opted to boost household purchasing power through a GBP15 billion support package. Bigger and more targeted than expected, this package should support consumption, or at least limit its contraction, over the autumn. It will also offset the planned increase in fiscal pressure that households have been facing since February 2020 (increase in social security contributions in April 2022 and a new tax to finance health and social care from April 2023).

Against this background of economic and political pressure, the number of negative indicators is piling up. With the measures to support households not due to come into force until the autumn, inflation is continuing to rise and the slowdown in growth is already clearly visible. The contraction in the economy has worsened over several months (-0.3% m/m in April from -0.1% m/m in March). This slowdown was confirmed in May, with retail sales falling by 4.7% y/y. Nor are the survey data (Flash PMI) particularly encouraging, with the manufacturing PMI down to 53.4 and the services

GROWTH & INFLATION

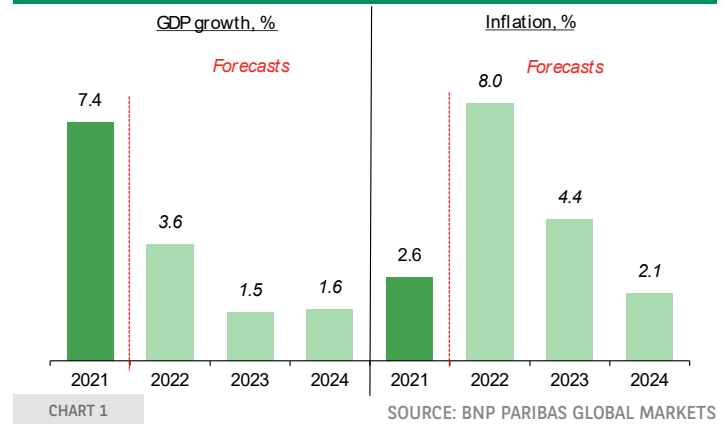


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

UNITED KINGDOM: SURGE IN ENERGY PRICES

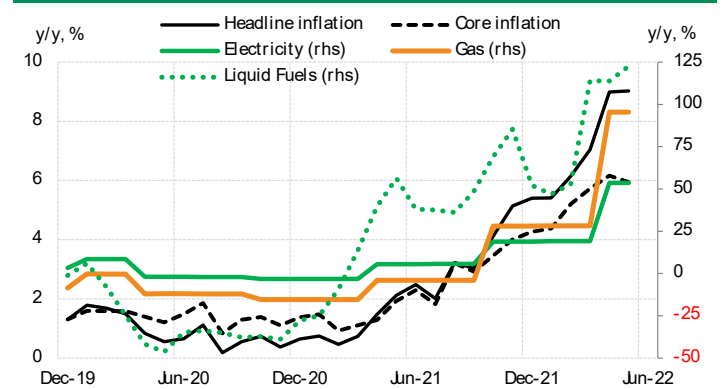


CHART 2

SOURCE: ONS, BNP PARIBAS

PMI stagnating at the low level of 53.4. The Bank of England has continued its monetary tightening at the steady and moderate pace of 25 basis points, but this has not yet managed to slow inflation. The necessary continuation of monetary tightening can only further damage growth, with the risk of dragging the UK into a recession before the end of the year.

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DENMARK

15

INDUSTRIAL SOVEREIGNTY: FROM DREAM TO REALITY

Denmark stands out for its vigorous economic recovery, which was much stronger than that in the other European countries. The Danish economy quickly returned to pre-crisis levels and even exceeded its pre-pandemic growth trend. Industry is in full expansion thanks to its positioning in high value-added market segments. Yet this dynamic momentum is threatened in the short term by surging inflation and job market pressures. The central bank has not yet begun the process of normalising monetary policy, although it plans to tighten monetary conditions gradually and progressively in the near future.

The Danish economy rebounded very strongly after the Covid-19 shock. At the end of Q1 2022, GDP growth was trending 6% above the pre-crisis level of Q4 2019 and even 2.3% higher than the GDP trend observed before the pandemic, the only European economy to do so. An industry in full expansion fuelled this momentum. At a time when reindustrialisation is a core part of the European project, Denmark is leading the way with an industry that is gaining new ground: in April, manufacturing output exceeded the pre-Covid level by 19.4% (see chart 2). This is because Danish industry is positioned in high value-added products such as pharmaceuticals, machinery, and renewable energy sources, such as manufacturing wind turbines. According to OECD forecasts, GDP growth should remain solid at 3% in 2022 despite the geopolitical environment. Although Denmark is self-sufficient in terms of its energy needs, business could slow due to sluggish global demand and rising inflation.

Looking beyond the cyclical environment, Denmark's economic momentum fits within a process of improving its long-term growth potential. Buoyed by very dynamic investment (+12.2% above the pre-crisis level in Q1 2022), notably in the renovation of real estate assets and digitalisation of the economy, the nature of this growth suggests that Denmark could end up strengthening its total factor productivity.

Like many other European countries, the Danish economy is nonetheless threatened in the short term by rising inflation. Driven up by soaring energy and food prices, inflation hit 7.4% y/y in May, the highest level since June 1984. This inflationary surge is squeezing household purchasing power, and confidence plunged in May to an all-time low of -22.4. Faced with high inflation, the Danish central bank has followed in the wake of the European Central Bank so far by maintaining its key policy rate unchanged (at -0.6%), while gradually adopting a more hawkish message about the possibility of tightening monetary policy over the course of 2022.

The job market situation continues to improve with an unemployment rate of 4.3% in April – close to an all-time low – and a labour market participation rate that continues to rise (80.1% in Q1 2022). The number of job vacancies continues to hold at record highs, a sign that labour shortages are intensifying.

From a fiscal perspective, the government began tightening the screws as of 2021, when it generated a fiscal surplus of 2.3% of GDP. The government is expected to maintain tight control over public finances over the next two years. This should help erase some of the scars of the crisis by bringing the public debt ratio back to the 2019 level of 33.6% of GDP, after rising by more than 8 points during the Covid-19 crisis in 2020.

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GROWTH & INFLATION

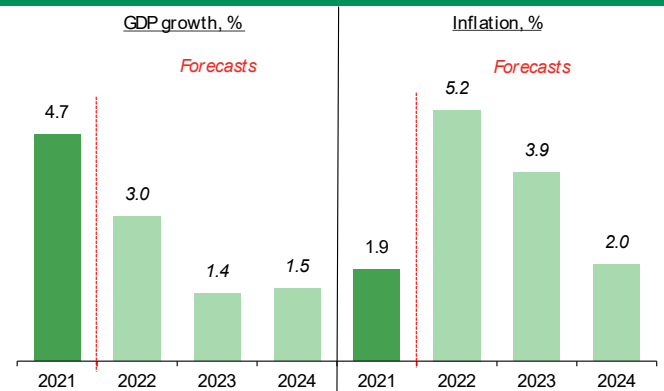


CHART 1

SOURCE: OECD, BNP PARIBAS

DENMARK: INDUSTRIAL PRODUCTION

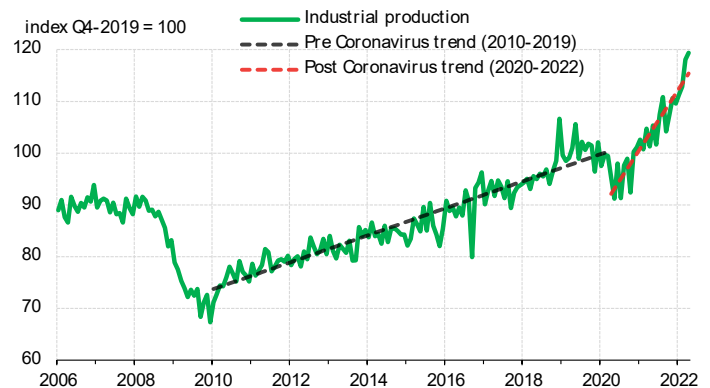


CHART 2

SOURCE: MACROBOND, BNP PARIBAS



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NORWAY

TO ADDRESS INFLATION, A COORDINATED TIGHTENING OF THE POLICY MIX

After being severely hit by the Omicron variant, economic activity picked up again as of February, and the recovery is expected to continue with growth reaching 4% in 2022. Through no fault of its own, Norway is one of the big winners of the Russia-Ukraine conflict thanks to a substantial increase in oil and gas revenues, which are expected to reach NOK 1,500 bn in 2022 (about EUR 143 bn). Although inflation is milder than in the other European countries, the Norwegian central bank has expressed its determination to tighten monetary conditions as much as necessary to break the inflationary momentum. To bring inflation within its target range, NorgesBank plans to gradually raise its key deposit rate to 2.5% by the end of 2023.

Norway was severely hit by the Omicron variant despite preventative health restrictions introduced in late 2021. Business slumped under these restrictions and mainland GDP (excluding oil and gas activities) declined by 1% m/m in January, before picking up again in February and March (+0.6% m/m and +1.2%, respectively). For the full quarter, Q1 2022 GDP contracted 0.6% q/q, but is still 2.7% higher than the pre-pandemic level. As a major energy producer (the world's 8th and 15th largest producer of natural gas and oil, respectively), Norway is not very dependent on Russia (less than 8% of energy consumption) and consequently, is not hurt much by the Russia-Ukraine war. Through no fault of its own, the country is even one of the big winners of the conflict because it benefits from both higher energy prices and new orders from countries seeking to diversify their supply sources. Nordea Bank estimates that oil and gas revenues will reach nearly NOK 1,500 bn in 2022 (about EUR 143 bn).

Compared to the other European countries, Norway has not been hit as hard by rising inflation (+6.2% in May 2022 y/y, compared to a Eurozone average of 8.1%). Despite more moderate inflation, the government has introduced several measures to boost purchasing power: direct subsidies, electrical power tax cuts, and higher housing allowances. The total cost of these measures should near NOK 9 bn (EUR 860 m). Moreover, Norway's unemployment rate has fallen to a very low level (2.9% in March 2022) and the number of job vacancies has risen significantly (+41.4% y/y in Q1), increasing the bargaining power of workers. Labour unions and corporate management are anticipating wage increases of 4% in 2022 according to the NorgesBank quarterly survey for Q2 2022. Thanks to the limited erosion of purchasing power, household consumption is holding up well (+0.6% m/m in April) and largely surpasses the pre-pandemic level (by 4.8% compared to year-end 2019).

In the face of inflationary pressures, NorgesBank was one of the first central banks to begin normalising its monetary policy. After holding at 0% through September 2021, the key rate was raised by 25 basis points (bp) on three occasions. Yet with prices accelerating more rapidly than expected, the national statistics institute (SSB) foresees an exceptionally big 50bp rate increase at the end of June, which would be the biggest rate increase in a decade. To bring policy in line with its price stability target, i.e. core inflation of close to 2% in the medium term, the central bank has already announced that the deposit rate could rise to 2.5% by year-end 2023. At the same time, the government declared that it would do its part to fight inflation by limiting increases in public expenditure. This will entail the suspension of several construction projects. Norway thus stands apart for the co-ordination of the monetary and fiscal policy mix at a time when most of the other European countries are still pursuing support measures.

GROWTH & INFLATION

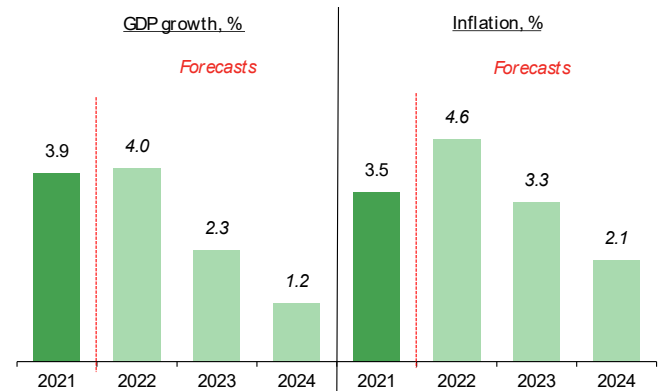


CHART 1

SOURCE: OECD, BNP PARIBAS

NORWAY: ACTIVITY INDICATORS

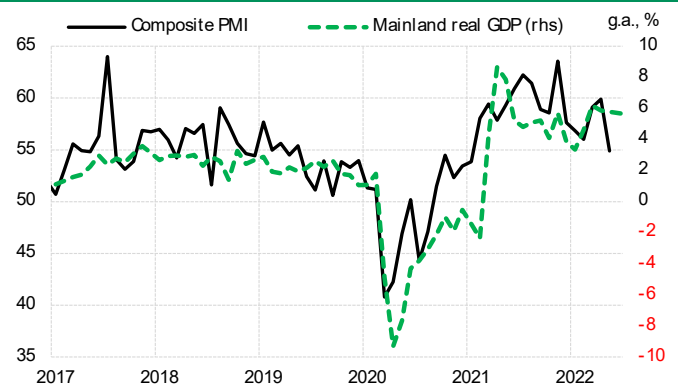


CHART 2

SOURCE: NIMA/DNB MARKETS, STATISTICS NORWAY, BNP PARIBAS

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FORECASTS

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ECONOMIC FORECASTS

%	GDP Growth				Inflation			
	2021	2022e	2023e	2024e	2021	2022e	2023e	2024e
United-States	5.7	2.6	1.9	1.7	4.7	7.5	3.9	2.4
Japan	1.7	1.4	1.1	0.6	-0.2	1.9	1.0	0.7
United-Kingdom	7.4	3.6	1.5	1.6	2.6	8.0	4.4	2.1
Euro Area	5.3	2.5	2.3	2.2	2.6	7.9	4.1	2.0
• Germany	2.9	1.3	2.2	2.3	3.2	8.1	4.6	2.1
• France	6.8	2.3	2.1	2.0	2.1	5.9	3.6	1.8
• Italy	6.6	2.8	2.0	1.8	1.9	7.7	4.5	1.8
• Spain	5.1	4.1	2.5	2.2	3.0	8.0	3.6	1.7
Emerging countries								
China	8.1	3.7	5.7	5.0	0.9	2.3	3.4	2.5
India*	9.3	8.3	6.2	6.5	5.4	7.9	5.9	5.5
Brazil	4.6	1.5	0.0	1.2	8.3	11.0	7.1	4.3
Russia	4.5	-7.0	0.8	0.3	7.1	14.0	10.5	7.6

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS) * FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1

FINANCIAL FORECASTS

Interest rate, %

End of period		06/17/2022	Q3 2022e	Q4 2022e	Q2 2023e	Q4 2023e
US	"Fed Funds (upper limit)"	1.75	3.00	3.50	3.50	3.50
	T-Note 10y	3.24	3.10	3.20	3.10	3.00
Ezone	Deposit rate	-0.50	0.25	1.00	1.75	2.00
	Bund 10y	1.66	1.60	1.80	2.25	2.25
	OAT 10y	2.08	2.15	2.38	2.85	2.85
	BTP 10y	3.57	3.85	4.40	4.65	4.75
	BONO 10y	2.75	2.95	3.40	3.75	3.75
UK	Base rate	1.25	2.00	2.50	2.50	2.50
	Gilts 10y	2.46	2.30	2.50	2.65	2.50
Japan	BoJ Rate	-0.10	-0.10	-0.10	-0.10	0.00
	JGB 10y	0.23	0.24	0.25	0.25	0.45

Exchange rate

End of period		06/17/2022	Q3 2022e	Q4 2022e	Q2 2023e	Q4 2023e
USD	EUR / USD	1.05	1.09	1.12	1.16	1.20
	USD / JPY	135	131	130	125	120
	GBP / USD	1.22	1.25	1.27	1.32	1.36
EUR	EUR / GBP	0.86	0.87	0.88	0.88	0.88
	EUR / JPY	141	143	146	145	144
End of period		06/17/2022	Q3 2022e	Q4 2022e	Q3 2023e	Q4 2023e
Brent	USD/bbl	113	120	122	125	125

SOURCE: BNP PARIBAS (E: ESTIMATES, FORECASTS) MARKET ECONOMICS, INTEREST RATE STRATEGY, FX STRATEGY * BASE CASE



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