Prospects

Quarterly – No. 21/237 – July 2, 2021

WORLD – Macroeconomic Scenario for 2021-2022

Painfully divergent trajectories

Before we provide hasty diagnoses about the fallout from a crisis that will continue to impact us for some time, but that remains difficult to see (and analyse), there is cause for optimism in the short term. Growth is returning and strengthening. But let's save our enthusiasm for developed markets, given how fragmented emerging markets still are. US monetary tightening is expected to start earlier, and should remain gradual and measured: tapering first, then interest rates, and not before 2023. It is unlikely to set off any storms on the markets.

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Before we provide hasty diagnoses about the fallout from a crisis that will continue to impact us for some time, but that remains difficult to see (and analyse), there is cause for optimism in the short term. Thanks to vaccination progress; a gradual resumption of travel; and (ecovery & fiscal stimulus plans, growth is returning and strengthening. While our enthusiasm may be curbed by a possible resurgence of the pandemic (albeit a less devastating one) after summer, this again is limited to developed markets (DM). Emerging markets (EM) remain highly fragmented, based on criteria similar to those showing why the severity of the 2020 shock was so variable.

In the **US**, which is holding tight to its generous lead, massive stimulus measures plus vaccination progress mean the reopening is happening more quickly than anticipated, giving growth a real leg up toward recovery in Q1. Our upward revision to the forecasts is based on more growth-friendly consumption behaviour, with households prepared to draw more heavily on accumulated savings than they were previously, as well as solid investment, bolstered by a steady recovery and high confidence. **As such, growth is due to hit its peak in Q2, from which point a gradual deceleration is expected, down to 6.5% in 2021, then 4.0% in 2022[1].** Average growth should sit clearly above its long-

[1] The new fiscal support plan proposals are still in their initial stage and remain surrounded by high uncertainty. Right now, these plans are not priced into our forecasts, but they will be once there is enough visibility. Though it may be apparent in 2022, this growth booster is also meant to be diluted over time.

term trend on which it should converge late in 2022. To reflect higher prices in energy and even higher prices in real estate, along with higher core inflation (with second-round effects, and the stimulus plans' effect on consumer behaviour, sparking isolated price hikes, for example in used cars), projected inflation has been revised upwards; **however, this strong (and therefore impressive) acceleration in inflation is also likely to be fleeting**. Peaking at 4.5-5.0% until February 2022, inflation should then settle back to 'normal' at the end of the year (with core inflation at 2.3% and headline inflation at 2.1% at end-2022).

While its medium-term strength continues to be dragged down by mortgages (on which it is still too soon to comment), Eurozone growth promises to be stronger in 2021. Thanks to targeted, less-punitive restrictive measures; earlier recovery in other regions reactivating its manufacturing sector; the expected normalisation of spending behaviour; and the alleviation of localised constraints that are hampering supply, growth could reach 4.8% in 2021, then 4.5% in 2022. It could even go slightly higher due to risks that are moderately to the upside, though still bearish in the medium term. This kind of scenario rules out both a sustained recovery in inflation and a strongly deflationary trend. Since the same causes (very approximately) produce the same effects, inflation forecasts have been revised upwards. They include a **transient acceleration, putting headline inflation above its target during H221 and Q122** (with a peak around November, since headline inflation should peak slightly above 3% for core inflation close to 2%); and then a significant decline, back comfortably below the target at the end of 2022 (c.1.3%).

Within (fragmented) EMs, the recovery is easy to see. However, it promises to be very uneven, and threats are piling up – with the pandemic still the foremost threat. The post-Covid recovery is essentially split into two stages: triggered by an external push, then relayed by domestic factors. While progress on immunisation is itself quite uneven, growth will likely remain hampered by social-distancing measures, as well as restricted tourism, limited budgetary clout and strong monetary policy constraint. As inflation rises, central banks may opt for a more restrictive policy, even if inflation is only temporary. While the disinflation process is more recent, and inflation expectations more responsive, many emerging central banks (with credibility either recent or under construction) cannot afford to wait. Finally, in **China**, influenced by a decline in support measures, signalled by rapid fiscal consolidation and a general deceleration in funding, **the slowdown is expected to continue**. Growth is also proving to be increasingly unbalanced. Very robust supply is being matched by lesser domestic demand, because household consumption is still being penalised by the weak labour market, resulting in a higher savings rate. Our scenario assumes average growth of c.8.5% in 2021 (which is high, but not high enough to stabilise the labour market) and then a slowdown to 5.7% in 2022.

In the US, with the acceleration of growth and the supposedly transitory rise in inflation, adopting a much more restrictive monetary policy is not the top priority. **Although monetary policy is expected to be tightened earlier, it will remain gradual and measured: tapering first, then interest rates, and not before 2023.** The phase-down of asset purchases is not expected to begin until early 2022, and while June's hawkish turnaround suggests a faster rise in key rates, this would be limited to the first two rate hikes (by 25bp each) in 2023. Unlike 2013, the Fed's gradual tapering is not expected to trigger any market turbulence but rather to occur alongside a moderation of long rates, specifically driven by normalising inflation and abundant liquidity in the financial system. Our scenario adopts a ten-year sovereign rate of c.1.65% at end-2021, then 1.35% at end-2022: a moderate level caused, in addition to slow absorption of the output gap, by the weak so-called neutral interest rate that fits into a long and heavy downward trajectory that is unlikely to turn around quickly (if at all).

Despite the Eurozone's improved economic outlook and lower risks, the ECB is expected to maintain a highly accommodative monetary policy over the coming months, expanding the amount and the duration of the PEPP (which was supposed to end in March 2022) until the end of 2022. European sovereign bond yields are set to remain very low and could even drop further during the summer (lower volatility; carry trades; the ECB's June announcement of a "significantly higher pace" of securities purchases, to last into Q3; and the banking system's significant liquidity). Our scenario applies a German 10Y yield of -0.20% at end-2021 and -0.10% at end-2022, coupled with spreads that are still narrow in the 'non-super core' countries.

The withdrawal of accommodative monetary policy in the US, initially via measured tapering, is conducive to a moderate rise in the USD that will be more temporary than what we saw previously in 2013. Beyond that, supportive fundamentals will fade. These include the diversification of foreign exchange reserves (which is admittedly trending, and interrupted by periods of high risk aversion), which is bad for the USD and good for liquid alternatives such as the EUR.

Catherine LEBOUGRE

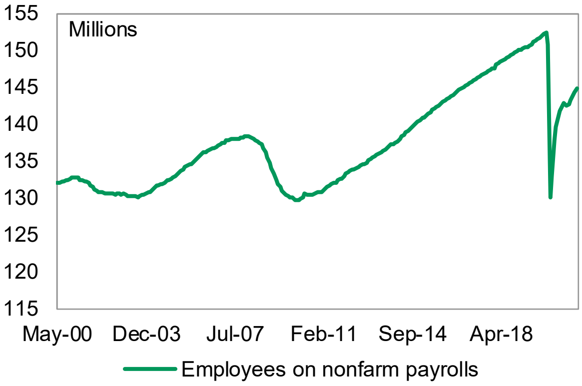
Developed countries – Daring to dream (at least a little)

Before we tackle the 'tricky questions' and provide hasty diagnoses on the fallout from a crisis that will continue to impact us for some time but that remains difficult to see (and analyse), there is cause for optimism in the short-term. Thanks to vaccination progress; a gradual resumption of travel; and recovery & fiscal stimulus plans, growth is returning and strengthening.

USA: GDP to top pre-crisis level by Q2 as re-opening marches forward

With the additional stimulus that was passed in March and solid, if slowing, progress on vaccinations that has led to a faster-than-expected pace of re-opening, we have upgraded our forecast since the last quarterly and expect very strong growth in the US in 2021, with GDP topping its pre-crisis level by Q2. Though growth slowed to 4.3% in Q420 following the initial surge, Q121 growth moved modestly higher and we expect to see further acceleration in Q221. Following Q2, we look for a gradual deceleration towards trend through the end of 2022 that leaves annual growth at 6.5% for 2021 and 4.0% for 2022.

US: payrolls remain around 7.5m jobs below pre-crisis peak

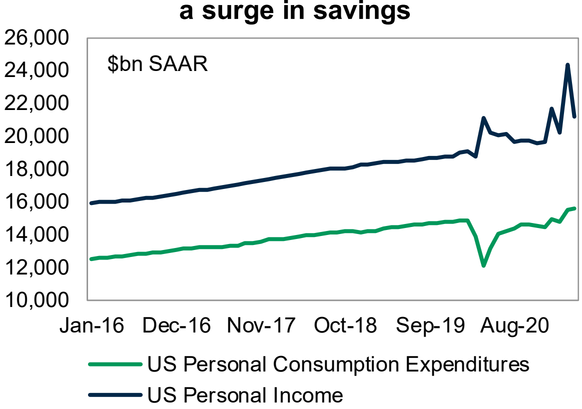


Sources: BLS, Bloomberg, CA CIB

While growth should be strong overall for the year, we expect the peak in Q2 given the timing of stimulus and re-opening. The latest round of stimulus checks was largely distributed in March, which led to strong momentum at the tail end of Q1 that should carry over to Q2. Additionally, while vaccination progress and re-opening timelines do vary by state, on balance states have moved towards re-opening at a faster pace than expected, with most essentially fully re-open already. Growth should remain strong after this peak, with only a gradual slowdown that leaves growth well above trend in both 2021 and 2022.

In addition to the changing quarterly pattern, our upgraded forecast reflects an expectation that consumers will be more willing to dip into accumulated savings compared to earlier in the pandemic. The multiple stimulus packages have led to a surge in personal income through both direct payments and enhanced unemployment benefits, resulting in a significant pile of accumulated savings, with some estimates putting the amount at roughly USD2trn.

US: stimulus has driven a surge in savings

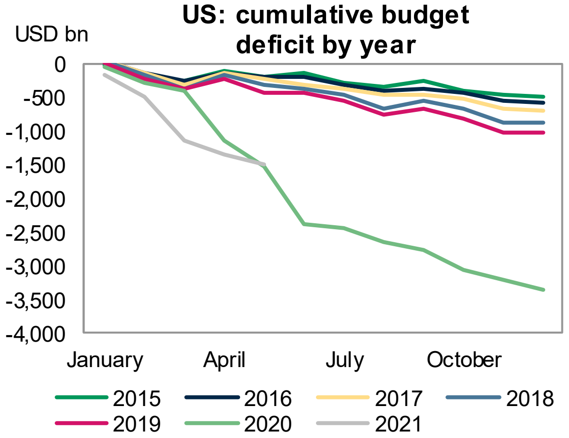


Sources: BEA, Bloomberg, CA CIB

While a number of earlier studies indicated consumers had been cautious with the first wave of stimulus checks, with significant amounts being saved or used to pay down debt, now that many can see a light at the end of the tunnel given strong progress on vaccinations, it looks as if they have been more willing to dip into accumulated savings, providing an impetus for faster growth. This should be reflected in stronger services spending in the coming quarters, as we look for a rotation into those categories that had been lagging earlier in the pandemic due to restrictions limiting personal contact.

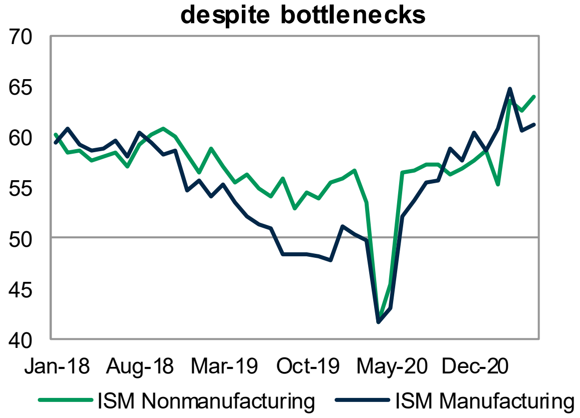
We would expect wage income to continue to recover as the impact of consumer-supporting stimulus wanes in the coming months. Though nonfarm payroll growth has been slower-than-expected the last couple of months, leaving payrolls around 7.5m below the pre-crisis peak, we believe this is due to labour supply constraints that are likely to ease in the coming months as enhanced unemployment benefits are phased out, schools re-open, and vaccinations continue. Given this view, we look for the unemployment

US: cumulative budget deficit by year



Sources: Treasury Dpt, Bloomberg, CACIB

US: businesses remain confident despite bottlenecks



Sources: ISM, Bloomberg, CA CIB

rate to drop below 5% by end-2021 and reach 4% by end-2022, which should continue to help support consumption.

After a strong early portion of the recovery, we look for investment growth to remain solid as well, as confidence remains high. While businesses have anecdotally been highlighting issues with labour shortages and supply chain bottlenecks, overall confidence in the outlook has not wavered, with the manufacturing ISM topping 60 for the past four months and the services ISM hitting levels in the 60s as well, including a record reading in May. While housing has shown some signs of levelling off after the initial surge, the sector remains strong and we look for residential investment to show continued strength as well, even if growth slows after the initial surge.

With the US economy expected to perform better than many peers in 2021 given stronger stimulus and faster progress on vaccinations, imports are likely to recover faster than exports, in our view. This will result in net exports providing a drag on growth this year, though the impact will be easily outweighed by other components and we expect some reversal in 2022.

The Fed may begin removing accommodation by the beginning of 2022, though it will be a gradual process with the Fed's overall stance remaining supportive for an extended period of time. That said, with rates still relatively low across the curve despite the increase earlier in the year, we believe Fed actions will have a limited impact in providing further impetus to the real economy on top of what it already has, and fiscal policy will play a larger role.

A wild card on this front will be progress on infrastructure or any other long-term economic plans proposed by the Biden administration, with the original proposals from Biden totalling around USD4trn. However, these proposals are still in the early stages and given the amount of uncertainty, are not incorporated in our current forecasts. While the size is significant, we would expect that the final amount will come in well below that level, spending would be spread out over a number of years, and it would likely be funded at least in part by tax increases which could offset some of the growth impetus.

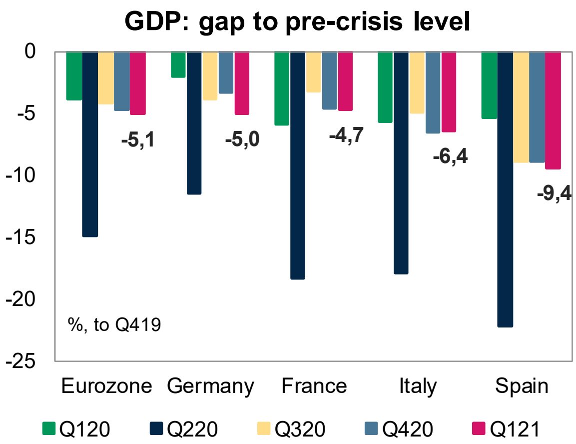
Additionally, with Republicans not willing to go much above USD1trn, the reconciliation process may be necessary, which would likely delay progress until the next fiscal year begins in October, meaning the impact may be more of a story for 2022 and beyond. Furthermore, some moderate Democrats have expressed hesitancy around some parts of the plans so even a reconciliation bill would likely result in a smaller package compared to the original proposals, though we will incorporate into our forecasts once more clarity is available.

Nicholas VAN NESS

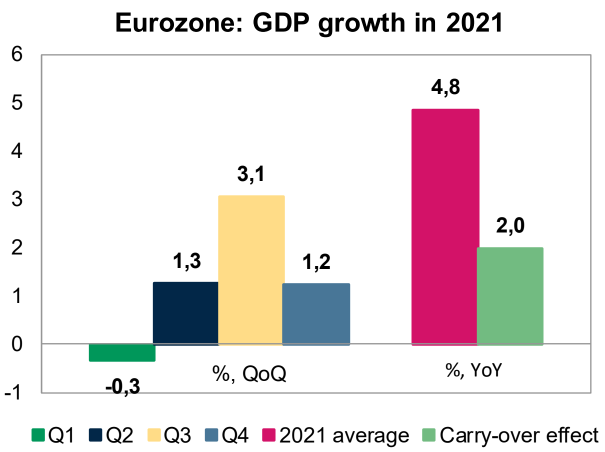
Eurozone: recovery is strong, but serious questions persist

The Eurozone economy has made it through the final phases of lockdown, limiting the negative effects on business activity to sectors that endured targeted restrictive measures, while benefiting from the earlier recovery of other areas that have helped jump-start its manufacturing sector.

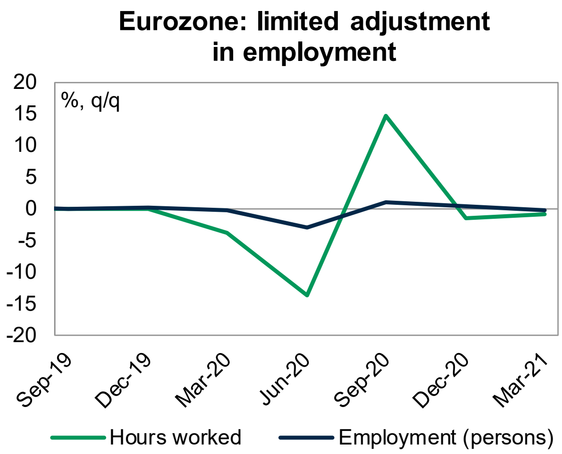
As behaviour returns to normal in the upcoming quarters, we expect a rebalancing among **sectors as the demand structure is**



Sources: Eurostat, Crédit Agricole S.A.



Sources: Crédit Agricole S.A.



Sources: Eurostat, Crédit Agricole S.A.

recomposed. Tensions in sectors that saw the highest increases in demand during the social distancing phase (IT, microprocessors) are expected to gradually fade, while many still-stressed sectors could see the start of a recovery and others a complete one. Therefore, **we see a very moderately reflationary scenario for the Eurozone in the short term, which rules out a lasting and sustained return to inflation or any significant deflation**. We project that GDP will grow by 4.8% in 2021 and 4.5% in 2022, accompanied by upside risks in the short term but continued downside risks in the medium term.

Localised and temporary constraints on supply

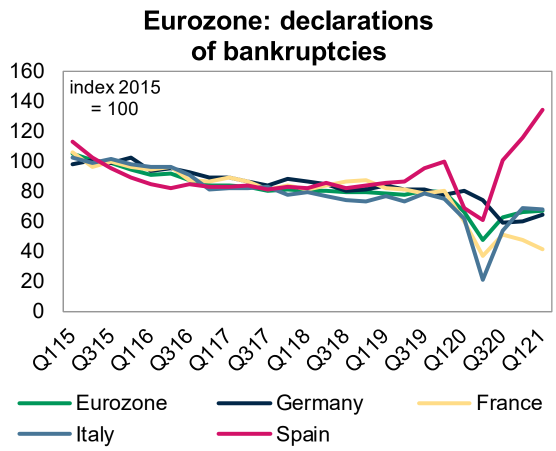
The decline in growth in Q121 was limited (-0.3% over the quarter) and less substantial than in Q420 (-0.6%). Once again, private consumption put the brakes on growth, but less so (-2.3%) than at the end of last year (-2.9%). Investment's contribution to growth lost some of its steam, with quarterly growth of 0.2% after 2.5%. This slowdown was mainly due to more sluggish housing investment (0.5% after 1.9%), but investment in other construction remained strong (1.4%). Business investment also kept up a good clip (1.2%), specifically in machinery and equipment, but was reduced by its transport asset component, which dropped sharply (-6.7%). This buoyant investment activity came as a surprise. While we did account for major public support for profitability, we expected businesses to proceed with more caution. The strength of demand for manufactured goods has certainly pushed business investment higher, but the European recovery plan may have also played an additional role: states have been anticipating European funds, though these have not yet been disbursed; and investment projects have been financed via national budgets, thanks to the EUR's fungibility.

Inventories continued to accumulate, further supporting growth. This was surely due to the drive to secure materials that were more expensive (commodities) or in short supply (semiconductors), and to further weakening of consumption.

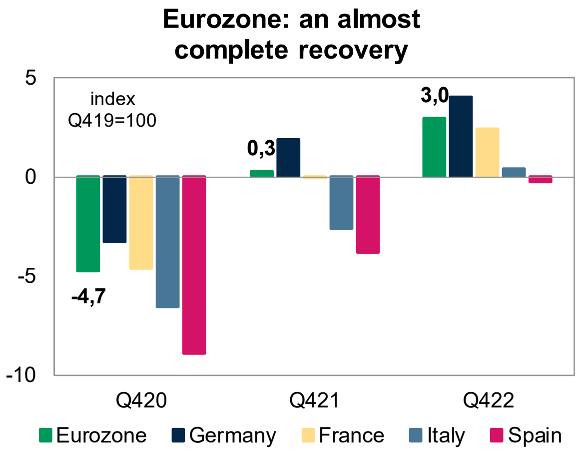
Trade lost some of its momentum, but its contribution to growth remained slightly positive. Foreign sales slowed due to exports outside the Eurozone, while intra-zone trade increased.

GDP is still 5.1% below pre-crisis levels, mainly due to the lag in private consumption (-9.5%). Investment was almost fully recovered in the major Eurozone economies, with the exception of Spain. The gap had almost closed in construction (-0.7%), while business investment lagged (-3.4%), mainly because of Germany.

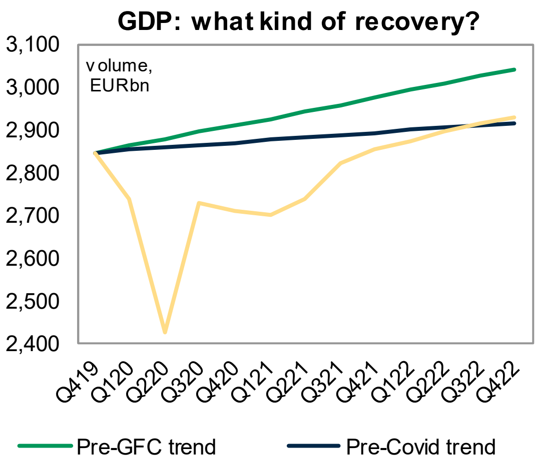
The strength of the recovery in the global manufacturing cycle created a virtuous circle of demand for capital goods, from which European producers benefited. Growing tensions over equipment, reported by producers in the Eurozone, mean that demand will stay brisk for the sector. Demand was no longer a constraint on production, according to industry surveys, and demand for consumer goods was still strong, driven by durable consumer goods, which was therefore a plus for electrical and electronic equipment production. This increase in business activity was good for the production of intermediate goods. The recovery in industrial output, compared to pre-crisis levels, was almost complete (-0.3%) in April, but very uneven. It was achieved more in Italy and Spain, where pent-up demand was greater and businesses reopened sooner. Chemicals, metals, and machinery and equipment have fully recovered; meanwhile, mining, textiles, and especially the automotive industry are still very much in decline. Computer and



Sources: Eurostat, Crédit Agricole S.A.



Sources: Eurostat, Crédit Agricole S.A.



Source: Crédit Agricole S.A.

electronic equipment output was already more than 40% above its 2019 mark.

Although foreign demand was strong, and domestic demand in the zone is expected to increase, industrial activity will remain disrupted in the coming months while massive inventories built up since the end of 2020 are absorbed and the supply of commodities and intermediate goods are still disturbed. Export routing may also be hampered due to disruptions in ocean freight. Such contrasts among industrial sectors are setting the stage for bottlenecks, and localised price pressures are consistent with GDP sitting far from pre-crisis levels and trends. Meanwhile, surveys in the service sector signal that business growth resumed as early as the first phases of lockdown easing, and the summer months will bolster renewed tourist flows inside the Eurozone. Consumption is expected to be much higher this summer than last, almost closing the gap with pre-crisis levels in France and Germany by the end of 2021.

We expect positive GDP growth in Q221 (1.3%), driven by a bigger contribution from consumption fuelling a stronger rebound in Q3 (3.1%), followed by continued brisk growth in Q4 (1.2%). With a growth overhang of 2% at the end of March, **average annual GDP is expected to increase by 4.8% in 2021** and by 4.5% in 2022. In our scenario, GDP is further along the road to a full recovery than it was in March, and should get there by Q421, just like investment. By contrast, the gap with pre-crisis consumption levels will not close until the end of 2022. All the major Eurozone economies will be back to pre-crisis GDP levels, performing better than in our March scenario, which predicted the gap would still be negative for Italy and Spain.

No real model for understanding this recovery

While the end of 2019 is a useful benchmark for measuring the recovery of supply and demand components, GDP levels must nonetheless exceed the mark before we can affirm that the recovery is achieved.

Arguably, **the recovery is truly successful once it no longer affects employment**. However, that impact is still unclear, since it came with a reduction in hours worked per employee (-7% in Q121, compared to pre-crisis levels). This imbalance was made possible by the roll-out of short-time work as well as a drop in participation in the labour market. The percentage of available workers not looking for work, measured against the extended labour force, rose by 2.3ppt at the peak of the crisis and was still 0.7ppt higher than pre-crisis levels at the end of 2020. Over the next few months, several simultaneous but opposite effects will emerge, making the employment/unemployment story hard to read. While a large portion of the hours not worked will be absorbed with the rebound in activity in sectors where restrictions are lifted, job losses will also be visible once the 'firing freeze' comes to an end and business failures are recorded. Such failures are still very low compared to pre-crisis levels (with the exception of Spain), because they have been greatly delayed by strong support for corporate liquidity. Also, with the return to activity of both short-time employed and the unemployed temporarily not seeking a job, we could see an uptick in the unemployment rate. That comeback to activity may also not be 'complete', which would mean a permanent reduction in potential labour supply. **We expect the unemployment rate to rise to 9.1% by Q122 before it starts to decline. Average annual unemployment is expected to reach 8.9% in 2021 and 2022.**

In addition, **this crisis is more transformative than a 'normal' recession**. By causing reallocations between sectors, it will only be over once the jobs it eliminated have been replaced by new jobs. And for this to happen, GDP must exceed the previous trajectory.

The pace of growth will depend on the answers to several key questions. What is the growth potential of industrial sectors that have already largely caught up to pre-crisis levels? What is the recovery potential of service sectors that still feature a wide gap? Will a normalisation of spending behaviours in services go hand-in-hand with a return to old patterns of consumption of goods? Is the activity gap compared to pre-crisis levels a good indicator of the output gap? Or has the crisis instead weakened potential growth by leaving indelible scars on employment and certain sectors? Will public policies not only heal those wounds, but also strengthen potential growth? How can we identify the respective shares of growth caused by massive public and monetary support and more autonomous growth? How should we assess the resilience of growth as public policies transition from generalised support to more targeted and limited support?

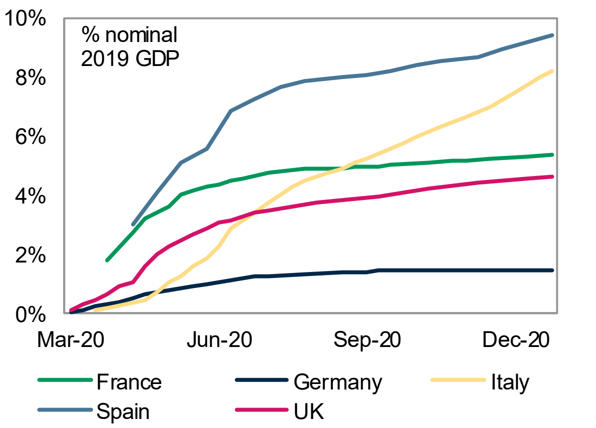
At this stage, our scenario cannot provide a definitive answer to all these questions. We do know that, because of public support measures, the Covid crisis has not yet had a visible impact on profitability and employment. But because of the signals these fiscal, monetary and regulatory institutions are sending, we are inclined to rule out any abrupt and premature withdrawal of support. And we anticipate that these institutions will provide medium-term support policies, not only to manage the exit from the crisis but also to support the significant sector reallocations that will follow.

Paola MONPERRUS-VERONI

Focus – European banks and financing the recovery

When the Covid-19 pandemic broke out, European banks had solid balance sheets, which meant they were able to participate in implementing bailout measures to maintain the economy, alongside fiscal, monetary policy and prudential authorities.

Stock of loans



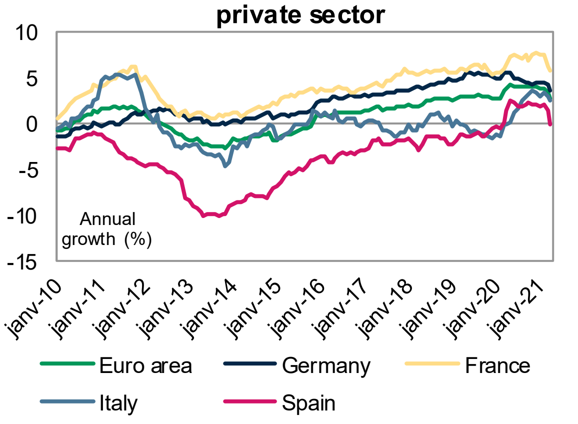
Sources: Bruegel, Crédit Agricole S.A.

Firstly, European banks granted moratoria, allowing households and businesses to defer their loan repayments in the wake of income losses related to lockdown measures. These repayment holidays involved 16% of loans to European businesses and 7% of mortgage loans to households in June 2020.

In addition, banks participated in the distribution of state-guaranteed loans, which allowed businesses to obtain the liquidity needed to meet their obligations and preserve their cash flow. While the practical arrangements for implementing these schemes vary between European jurisdictions, the principles are fairly similar, and interest rates on these loans were reduced across the board. In France, nearly EUR140bn in state-guaranteed loans were distributed (equal to over 5% of nominal 2019 GDP). The use of these instruments has been even more widespread in Italy (over 8% of 2019 GDP) and Spain (over 9%), where the decline in activity has been more significant due to longer and stricter lockdown measures. All in all, banks saw strong growth in the size of their balance sheets, with a substantial increase in outstanding customer loans in France, Italy and Spain in 2020.

This increase was financed by the sharp rise in deposits by both businesses and households, which built up a surplus of forced and precautionary savings that reached 14% of disposable income in Q220. Banks also benefited from favourable refinancing terms with the Eurosystem, thanks to the implementation of long-term refinancing measures (TLTRO III, PELTRO) and the ramp-up of asset purchase programmes. In this respect, banks have always had ample liquidity during this crisis. The interbank market's operating conditions did not deteriorate, contrary to what we observed during the Great Financial Crisis and the subsequent sovereign debt crisis. Finally, the cost of distributing loans dropped slightly due to the temporary reduction in prudential restrictions, with special treatment of moratoria, a decline in countercyclical macro-prudential buffers, adapted accounting standards when calculating provisions to limit the pro-cyclical impact and a reduction in capital requirements. These measures would free up EUR1.8trn in additional loans within the Eurozone.

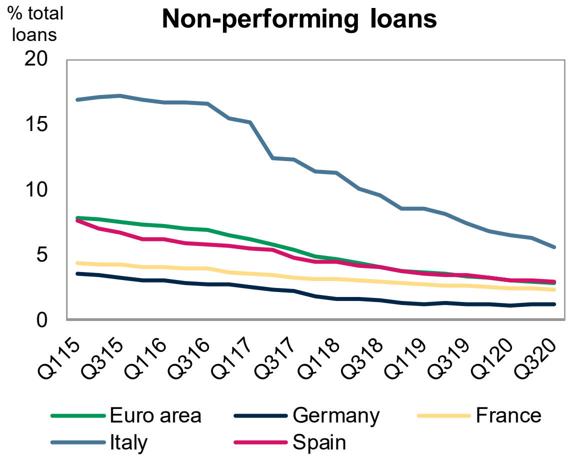
Loans to the non-financial private sector



Sources: ECB, Crédit Agricole S.A.

European banks were able to participate in the support effort because they had solid fundamentals at the outbreak of the crisis, but also because they were able to adopt prudent risk management policies. Firstly, they control the quality of the assets on their balance sheets. The share of non-performing loans in total outstandings has been declining for several years and reached its lowest level ever at the end of 2020. Risks on banking-sector balance sheets, measured by the ratio of risk-weighted assets to the total size of the balance sheet, have also decreased, as banks now benefit from a government guarantee on some of the loans they have granted.

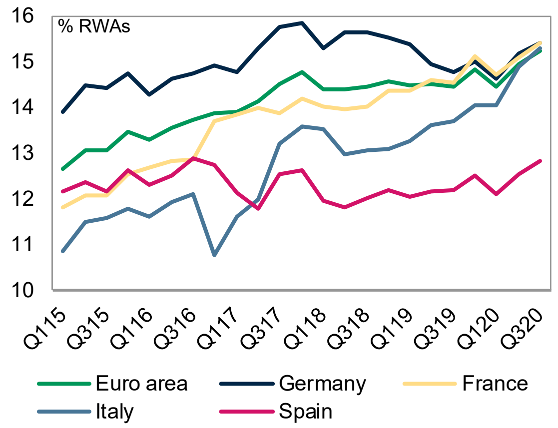
Non-performing loans



Sources: ECB, Crédit Agricole S.A.

However, the gradual withdrawal of support measures for businesses and households could lead to a rise in defaults and cause the quality of banks' loan books to deteriorate. As such, banks significantly stepped up their provisioning in 2020. Major institutions supervised by the ECB saw their cost of risk increase from 50bp at the end of 2019 to nearly 70bp in 2020. This prudent management also had a major impact on banks' 2020 financial results and profitability. Return on equity at these same institutions decreased from 5.2% in Q419 to 1.5% at the end of 2020.

CET1 ratio



Sources: ECB, Crédit Agricole S.A.

In most European countries, banks also continued to improve their solvency by increasing capital levels. Overall, the banks supervised by the ECB increased their capital by 4.0% in 2020, a figure that rises to 4.1% when considering core Tier 1 capital. The CET1 ratio, which measures banks' solvency using the ratio of core capital to risk-weighted assets, rose to its highest level in most major European countries. Spain exceeds all regulatory requirements in this area but is still at the back of the pack.

All in all, banks ended 2020 with inflated balance sheets but well-established financial health, which should now allow them to participate in financing economic recovery plans. However, some risks remain, which call for particular caution from the public authorities. Firstly, the banking sector's ability to absorb part of the economic shock depends on the orderly and gradual withdrawal of government support policies, whether they directly benefit non-financial agents (automatic stabilisers and fiscal policies) or provide an indirect benefit via the financial sector (accommodative monetary policy and prudential easing).

Secondly, the increase in public debt caused by the recovery plans is occurring alongside a rise in banking sector exposures to sovereign risk, which could trigger a potential vicious circle of governments and their banks both becoming weaker. This risk is mitigated by the decade-long process of deepening the European Banking Union, but this process is incomplete and it is now becoming urgent to finalise a shared resolution and deposit guarantee framework, as evidenced by recent statements from the European Council and the Eurogroup.

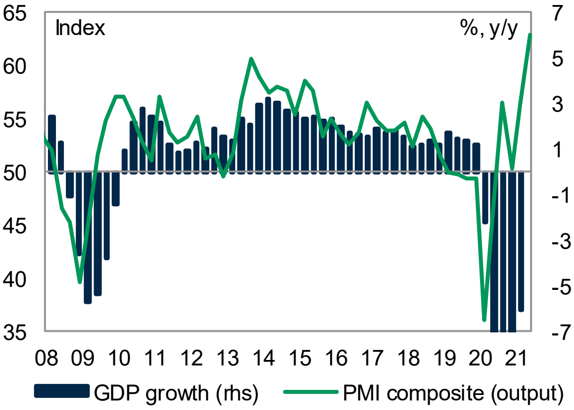
Finally, beyond their performance, which was severely impacted by the crisis, European banks face a structural profitability challenge, exacerbated by the low interest rate environment, which makes it necessary to overhaul and even consolidate the sector in some countries. This overhaul, which has already begun considering the major mergers seen in Spain and Italy, cannot be hampered by protectionist rhetoric between European countries and can be encouraged through favourable prudential treatment, according to the approaches already outlined by the European authorities.

Lionel POTIER

UK: the recovery gains strong momentum, but the reality check is approaching

Resilience during the third lockdown in Q121, followed by an earlier-than-expected activity rebound. There was a relatively limited contraction of GDP in Q1 (-1.6% QoQ) witnessing a higher level of resilience of household consumption to the government's restrictive measures on social activity and mobility than during the early period of the pandemic. The easing of social restrictions, which started in March in line with the government's reopening plan thanks to the success of the vaccination rollout, triggered a stronger-than-expected rebound of activity in March and April. The level of GDP has now recovered a substantial part of its pandemic-related loss and in April it stood 3.8% below its pre-crisis level.

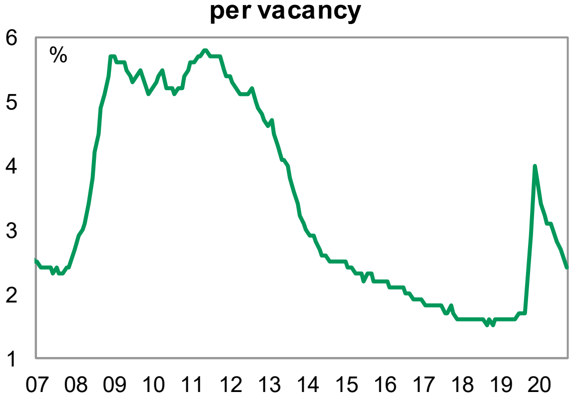
UK: composite PMI index and GDP



Sources: IH Markit, Crédit Agricole S.A.

Forward-looking indicators suggest that momentum of the recovery has strengthened further. PMI surveys have sky-rocketed and consumer confidence has recovered back to its pre-crisis level. We revise upwards our short-term forecasts significantly and expect more than 5% QoQ growth in Q221. The rebalancing of consumer spending from goods to services has already begun as suggested by the decline in retail sales volume in May (-1.4% MoM) though its level is still 9% higher than in February 2020. The labour market has been improving and shows pockets of tightness. The number of employees on the furlough scheme has fallen to 1.7m in May (6.5% of the workforce) from 3.4m at the end of April.

UK: number of unemployed per vacancy



Sources: ONS, Crédit Agricole S.A.

Fears from the Delta variant impose caution, but so far, the health situation looks under control. The number of new Covid-19 cases has risen sharply in recent weeks, leading the government to postpone the final stage of its reopening plan by four weeks, to 19 July. This may trigger a slight temporary correction in business surveys, although from very high levels without derailing the short-term economic prospects in our view. The country has reached herd immunity as the presence of coronavirus antibodies (through infection or vaccination) has risen to above 80% in England. Close to 43m people have received one dose of a vaccine and 31m (45% of the total population) have received two jabs.

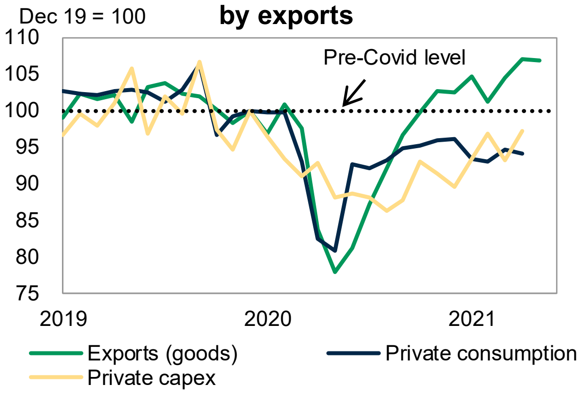
Growth is likely to slow sharply towards the end of the year as pandemic support unwinds. A key feature of the demand outlook beyond the initial post-pandemic rebound is the fact that a number of key government support measures are set to expire on 30 September, including the furlough scheme, the enhanced universal credit (GBP20 per week) and reduced VAT on food and accommodation services. This will likely result in a higher unemployment rate in Q421, which is likely to persist as some sectors will likely not recover to pre-crisis levels (eg, retail, hospitality, travel). Consumer confidence will likely take a hit, additionally amplified by strong inflation in the near term. We expect this to be followed by a sharp deceleration in household consumption at the turn of the year.

Strong near-term outlook leads us to increase our 2021 growth forecast significantly (from 5.6% to 7.4%), but to revise downwards our growth forecast for 2021 (to 5.6% from 6.6% previously). In our scenario, GDP reaches its pre-crisis level in Q421.

Slavena NAZAROVA

Japan: waiting for further vaccination while supported by exports and an expected economic package

Japan: recovery supported by exports



Notes: figures are in real terms
Sources: BoJ, METI, MIC, CACIB

We expect Japan's Q2 real GDP to have been flattish at -0.1% QoQ saar, as major prefectures have been under a state of emergency that ended on 20 June. Because Q1 was also under a state of emergency, any related downward impact on Q2 GDP will be limited in terms of QoQ changes. Meanwhile, exports, which are already above the pre-Covid level, will continue to underpin the economy.

PM Yoshihide Suga said in June that all those who want to be vaccinated will be vaccinated by either October or November. Assuming this, **we expect real GDP to visibly accelerate in Q3 and beyond with Q3 growing 6.1% and Q4 4.4%, both QoQ saar**, through the realisation of pent-up consumer spending and public investment as well as continued support from exports, especially to the US and the EU.

Starting in July, Japan heads into a highly political period with the Tokyo metropolitan assembly election on 4 July, the Tokyo Olympic/Paralympic Games held from end-July through early September, followed by an expected dissolution of the lower house by PM Suga, whose term as the LDP president ends on 30 September. **This dissolution of the lower house, which we expect to come in early September, is followed by a snap election within a forty-day period after the dissolution**.

These political events will constitute a good reason for the Suga cabinet and the ruling LDP to form an economic package as part of the party's manifesto for the coming snap election. We believe most of the financial sources of such a package will take the form of the carry-over of the third supplementary budget for the previous fiscal year (April 2020-March 2021), which has been pent up under Covid-19, and therefore will not need a large new supplementary budget. **Hence there will be a limited upward impact on long-term rates despite the ostensibly large scale of the package**.

Kyohei MORITA

Emerging countries – Uneven recovery

EM have embarked on an uneven recovery. Risks – such as growing inflation, market tensions and possible geopolitical surprises – are looming, but the biggest one remains pandemic uncertainty.

A two-step recovery

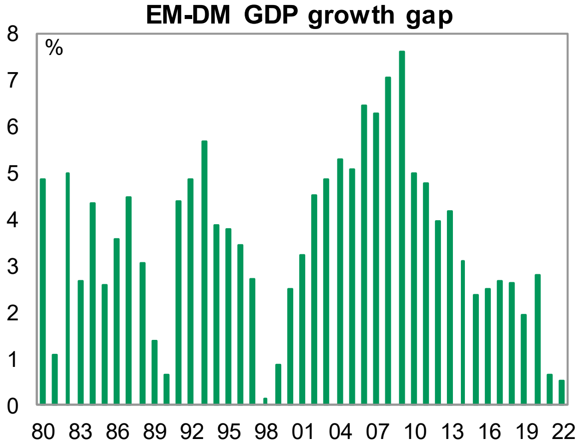
The post-Covid recovery in EMs is a two-step process, initiated first by an external pull, and then driven by a domestic push.

In the first step, **EMs have benefited from strengthening demand in developed countries and in China**. On the one hand, EM exports have regained momentum gradually since last year. EM exports (in value) have come back to above pre-Covid levels. The sharp rally in commodity prices across the board since mid-2020 has helped a lot. However, non-commodity exports have recovered as well. Over the past three available months (February-April), EM exports were up 22% in USD compared with two years prior.

EMs have also benefited from more accommodative global monetary conditions over the past five quarters, due to Fed and ECB dovishness in particular. This has allowed them to lower rates aggressively and to receive flows, which have gradually returned to EMs, particularly since Q420. Capital inflows were particularly strong between mid-May and mid-June 2021 (until the Fed meeting).

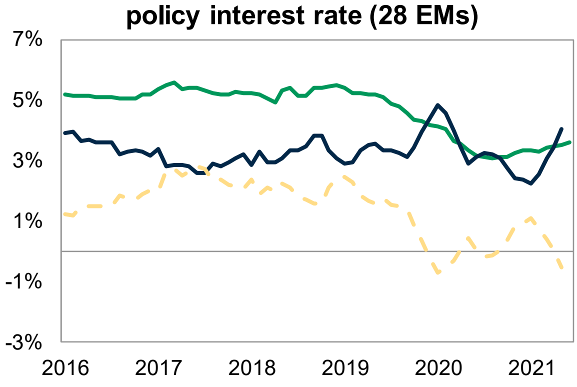
The second step has to do with **the normalisation in EM domestic demand as some countries have reopened**. To be sure, the normalisation is very far from being achieved for all EMs and remains very much challenged. EMs have been lagging DMs in terms of vaccination (with a robust lead from the US in particular) and in terms of reopening economies. Looking ahead, in H2, some countries may benefit from vaccination progress.

EM-DM GDP growth gap



Sources: Credit Agricole CIB, Bloomberg

EM GDP-weighted central bank policy interest rate (28 EMs)



Sources: CA CIB, Bloomberg

The pandemic likely to stay a key constraint in H2

However, this process will likely be strongly differentiated within EMs. Vaccination progress has been uneven. China has made very quick progress since mid-May and is close to developed countries on average when it comes to the proportion of vaccinated people. However, some uncertainties remain about different vaccines' efficacy against new variants. This may incite China to keep in place limitations on transport and communication. The rest of EMs are clearly lagging behind, with a few exceptions around the world: Central European countries and Singapore, and to a lesser extent some GCC countries, Turkey and Chile. Among the countries strongly lagging others, a distinction has to be made between the richest countries (with a higher GDP per capita) that have a strong track record in terms of containing the pandemic; and the poorest countries that do not have such a good track record. The first group will be less impacted by the remaining constraints. Economic growth in the second group will likely be more strongly impacted by Covid-related constraints. This second group includes many countries in Africa, South & South East Asia and part of Latin America. Current vaccination rates are particularly low in Egypt, South Africa, the Philippines, Thailand and Indonesia, among others.

Against this backdrop, **aggregated growth in EMs will remain constrained by social distancing measures, restrictions on tourism & transportation and lower fiscal flexibility when it comes**

to further supporting economies with government expenditure. This will somewhat cap the recovery in private consumption. This constraint should last longer in countries that rely on tourism.

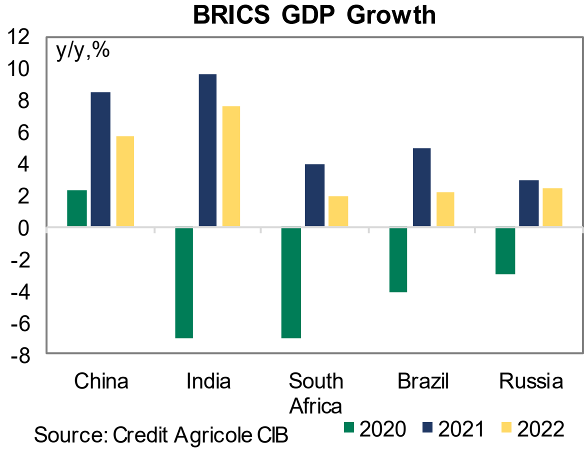
Investment still in a gradual recovery phase

After having contracted strongly last year, investment has rebounded, supported by a catch-up effect, but also by more accommodative monetary conditions. EM central banks have lowered policy rates across the board, and some of them have implemented QE-like programmes. Initially, the fall in inflation has limited the decrease in real interest rates. However, the more recent increase in inflation tends to minor real rates. The average EM real policy rate has become negative again. This could further support the improvement in investment, notwithstanding a possible deterioration in the Health situation due to the Delta variant.

The challenge of inflation

However, **as inflation continues to build up, it progressively becomes a challenge for EMs**. Weighted EM inflation (CPI YoY change) has increased from 2.2% in January 2021 to 4.0% in May. Most central banks, like the Fed, are saying that this inflation spike is temporary. However, the current inflation push is a multi-factor phenomenon, and as a consequence it is more difficult for central banks to deal with it.

BRICS GDP Growth



Source: Credit Agricole CIB

By multi-factor we mean that it is a combination of statistical base-effects (in principle temporary by nature), **pull factors** (reopening of economies), **push factors** (supply bottlenecks, partly Covid-related), **and commodity inflation**. From the central banks' point of view, it makes sense to hike rates to make sure that temporary factors remain temporary, and do not fuel inflation expectations in a way that would make it more difficult to control inflation later on. Until recently, monetary tightening was concentrated in specific countries, such as Turkey, Brazil and Russia. More recently, some Central European central banks (including in Hungary and the Czech Republic) have joined the club of hawks. In our view, others will join later. Out of the 20 core central banks we cover, we expect 9 of them to raise policy rates in H2 (so, likely two years ahead of the Fed).

This is not neutral. On the one hand, **higher rates could weigh on economic activity and cap the recovery**, adding to possible return of Covid-related constraints. On the other hand, **not hiking for the sake of protecting growth could open the door to the risk of being behind the curve at some point**, which could possibly hurt FX (and spreads). Conversely, higher rates could increase the carry attractiveness and support exchange rates for some currencies (provided the heath situation allows it).

Relative underperformance

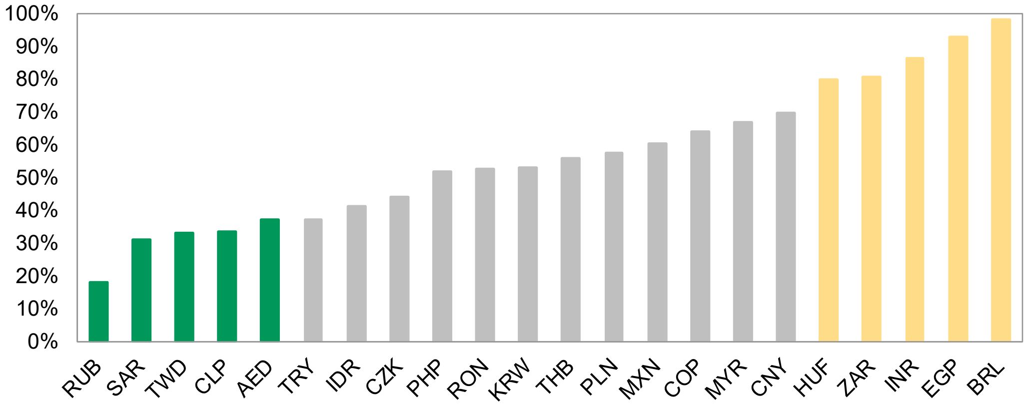
Let's talk numbers. **Our EM GDP growth forecasts do not look too bad on the paper. We expect EM GDP growth to reach 6.2% in 2021.** This is above the range observed these past few years. However, this is due in large part to the catch-up effect from a low base year. Another way to look at it is to measure the EM-DM growth differential. From that point of view, it looks much less flattering. The growth gap (EM growth above DM growth) is expected to reach only 1.3ppt this year, much below the average 3.1ppt print on average during the past ten years. Against such a backdrop, one can talk about EMs' relative underperformance, and this reflects the lag in vaccination progress as well as the narrower policy flexibility in EMs vs DMs.

Three risks, three divides

Such a base case scenario could be challenged by three main risks, in our view. And, given the amount of uncertainty that has unfolded over the past year and a half, it seems just fair to seriously consider these three risks.

First, **the epidemic risk**. It is already included in our base-case scenario to some extent. However, things could get worse. The main risk could come from a renewed spread of the pandemic (because of the Delta variant or another mutation), combined with relatively low vaccination rates in EMs (and also the differentiated efficiency of the various viruses). This could force lockdowns, weigh on activity, and have dramatic human and social consequences. Again, those countries that lack infrastructure (and display lower GDP per capita levels) would likely be the most impacted, and the lasting Covid crisis would then widen not only the gap between DMs and EMs, but also the gap among EMs – between more developed and less developed countries – and have social and political consequences.

Gross government debt-to-GDP ratio (IMF 2021 estimate)



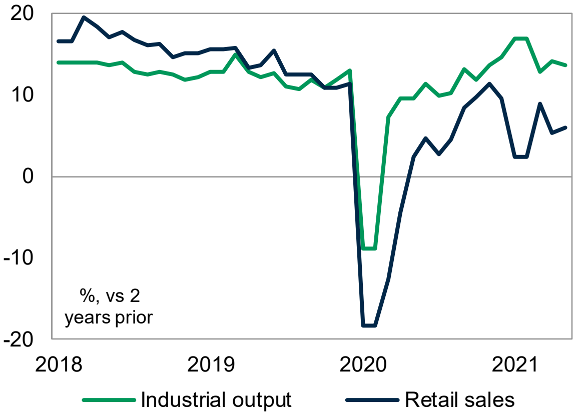
Sources: Credit Agricole CIB, IMF

Second, **a market risk**, or more precisely the risk of a widening divide between the economy and the markets, at least for some countries. From a market point of view, EM currencies have partly recovered, spreads have narrowed significantly, commodity prices have skyrocketed, supporting commodity exporters' terms of trade and currencies. This may continue if the Fed manages to keep the bond market in check. By contrast, from an economic point of view, the EM growth premium has narrowed (see above), many EMs have seen their financial flexibility eroded (including on the sovereign side, first of all in Brazil, India and South Africa). Some large EMs still have precarious external balances (for instance Turkey). And the economic situation could well be worsened by the health risk described above. This divide between the economy and the market is such that some EM currencies' valuations look stretched. What happens, when the gap narrows, is that these stretched currencies could adjust quickly. Possible triggers for such an unfortunate adjustment include a possible strong increase in US yields (Fed mismanagement, stronger-than-expected inflation?), a sharp adjustment in commodity prices, or an accident in a large EM. These are not currently in our base-case scenario for the next six months, but these are risks to take into account.

Third, **the geopolitical divide**. So far, the Biden administration's foreign policy vis-à-vis China follows the 3C framework: compete (on issues such as technology), collaborate (on issues such as climate change), confront (on issues such as human rights). These three dimensions suggest a less monolithic approach compared with that of the Trump administration. It also looks less confrontational. However, this does not mean it cannot become so. There are plenty of issues that could trigger a rise in US-China tensions. The more the market gets used to a less confrontational approach, the more it may be surprised when the tension rises, with possible negative effects on asset prices and feedback loops on economies.

Sébastien BARBÉ

China: key activity indicators



Sources: Bloomberg, CEIC, CA CIB

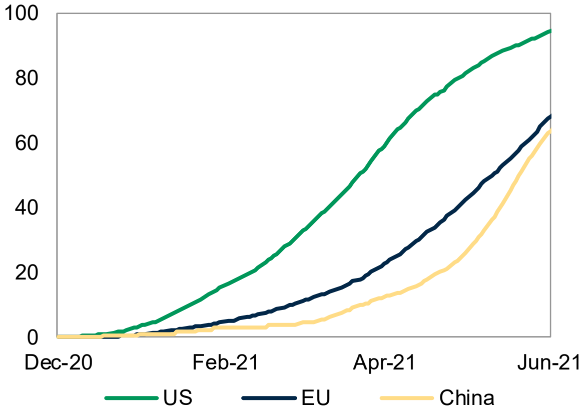
China: soft momentum to continue

H121 has seen a significant deceleration of China's sequential growth momentum compared to H220, both in terms of QoQ GDP growth and MoM growth of industrial production, retail sales and fixed asset investment. The slowdown primarily reflects a pullback in terms of policy stimulus, visible in rapid fiscal consolidation and an overall deceleration of funding growth in the economy.

It also seems that private domestic demand remains unable to bring back the country's growth momentum to pre-pandemic levels, largely due to relatively subdued household consumption, which in turn is capped by the fact that labour market weakness is boosting the savings rate.

As a consequence, China's growth is becoming increasingly unbalanced: output (both industrial and services) is up by about 14% over 2019 levels, while demand (retail sales and fixed asset investment) is rising only in the single digits. This gap is bound to bring production growth down at some point in the future.

Vaccine doses per 100 people



Sources: Bloomberg, CEIC, CA CIB

We believe that the relatively soft growth momentum of H1 is likely to last in the near-to-medium term, driving the YoY GDP growth rate down to about 8% in Q221, 6% in Q321 and 4% in Q421. As a consequence, annual economic expansion will probably average c.8.5% – a pace that seems fast on the surface but will not suffice to stabilise the labour market and revive consumption.

We also expect growth to slow to 5.7% in 2022 and gradually decelerate in the medium-to-long term. We note that the US will grow faster than China in YoY terms for about four quarters starting in Q221, and that both this and next year China will lose its position as the biggest contributor to global growth, which it has held for the past 15 years.

As a result, China's inflation is likely to remain well contained, averaging 1.3% in 2021 and 1.9% in 2022, and we now expect that monetary policy settings will remain unchanged until H222.

Risks around such outlook are finely balanced and manageable. On the downside, we note high economic leverage (306% of GDP as of last year), expensive real estate, income inequalities, the challenge of the middle income trap and negative demographic trends (population growth of just 1.7m or 0.12% in 2020). On the positive side, growth prospects are being boosted by rapid productivity gains, urbanisation, and acceleration of the vaccination campaign.

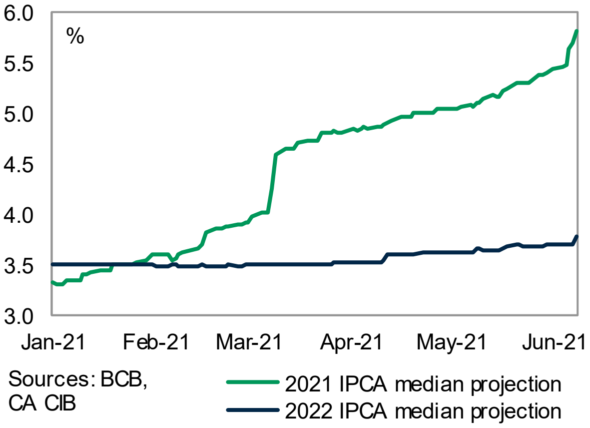
Dariusz KOWALCZYK

Brazil: fasten your seatbelts

A hawkish central bank along with the recent progress on key reforms have provided a positive boost to Brazil's assets with the currency, long-term government yields and CDS performing strongly since early April until now. Beyond the near-term reprieve however, we expect downside risks, including fiscal pressures and uncertainty ahead of the 2022 general elections, to start to dominate Brazil's narrative once again.

In response to sharply rising headline inflation, a rise in fiscal and political risks and a jump in inflation expectations, Banco Central do Brasil (BCB) initiated a monetary tightening cycle, ahead of most central banks in EM. The central bank started the lift-off from the historically low Selic level of 2% with steady increases of 75bp at each meeting, bringing the Selic to 4.25% so far. Given the BCB's latest guidance to bring the policy rate to neutral, we expect the Selic rate to end 2021 at 6.5%, comprised of 3% real rate, which is the BCB's estimate of neutral plus the inflation target of 3.5% for 2022. **The higher policy rate should provide an anchor for the currency going forward and help rein in inflationary pressures.**

Brazil: inflation expectations have increased sharply



Sources: BCB, CA CIB

Despite the ongoing struggle with the pandemic, Brazil's congress pulled off an impressive feat, by approving a series of progressive measures in 2020 and so far in 2021, including a sanitation reform that could pave the way for privatisation of the state-owned sanitation companies, an update to the bankruptcy laws, the central bank autonomy bill and a modest fiscal reform.

Adding to the positive momentum and in a major symbolic win for the administration, Brazil's congress approved the privatisation of the state-owned company Eletrobras in June. The government had estimated that anywhere between BRL15-60bn, or 0.2-0.8% of GDP, could be raised, with the lower end of the range likely closer to the actual number. While multiple congressional amendments were accepted by the administration to ensure passage, they also mean that the benefit to the sovereign debt profile will be marginal as whatever is received would be spent to lower retail electricity tariffs and increase public investment.

The next most important reforms from the markets' perspective are an overhaul of Brazil's cumbersome tax system and a reform of the public sector compensation and benefits structure, which represents the second largest mandatory expense in Brazil's budget.

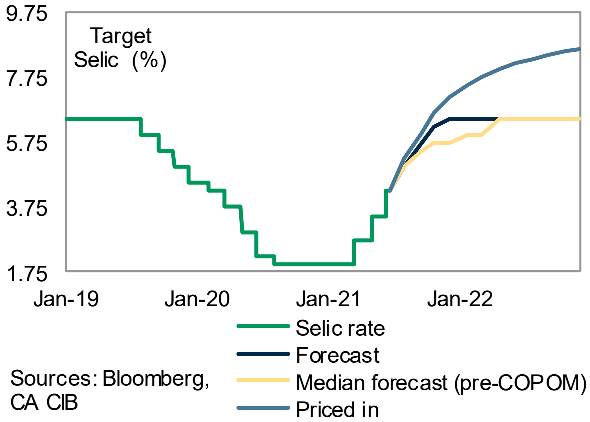
The administration and congress are working on several proposals as part of their efforts to reform Brazil's taxation regime, including merging two federal levies PIS and Cofins into a single federal VAT; an income tax overhaul, potentially including a tax relief for low-income earners, taxation on dividends, as well as a reduction in corporate taxes and changes to taxes on financial transactions; a programme for federal tax debt repayment relief; and a constitutional VAT reform merging a number of municipal, state and federal taxes. Given the higher hurdle required for a constitutional amendment, the approval of the constitutional VAT reform appears more distant.

Given the multiple proposals at play, the benefits will vary, but in any case will mainly accrue in the long term. As a reference, the IMF estimated last year that simplifying the system by reducing tax exemptions could raise government revenues by around 2% of GDP. Furthermore, cutting the costs associated with complying with the complicated tax regime could encourage investment and raise productivity. Research from the Brazilian Fiscal Citizenship Centre estimated that the introduction of a unified VAT could raise potential GDP growth by 0.5% over a decade.

The congressional approval process for the administrative reform, designed to overhaul compensation and other benefits of the new entrants into the public sector, kicked off in the lower house special committee in June. Similar to the tax reform, the focus on new entrants means that any fiscal benefits will be delayed. The senate fiscal watchdog IFI estimates a scenario where payroll containment measures could produce BRL128bn, or 1.7% of GDP in savings over ten years (BRL57bn at the federal level, or 0.8% of GDP, and BRL71bn, 0.9% of GDP in states). The economic team's forecasts point to savings of BRL300bn, or 4% of GDP, in the same period.

To sum up, while passage of reforms is important from the signalling perspective, there is limited impact on the sovereign debt profile, at least in the near term. The proceeds from the Eletrobras privatisation will be spent on reducing electricity tariffs and boosting public investment, while the benefits of the tax measures and a likely diluted administrative reform will accrue only in the long term.

BCB now intends to bring the policy rate to neutral



Sources: Bloomberg, CA CIB

Meanwhile, **Brazil's fiscal woes remain intact**. Brazil's debt-to-GDP increased from 76% in 2019 to 87% in 2020 based on the government's measure of gross debt and 98.9% based on the IMF's estimates that standardise the calculation across countries. While the IMF projects a slight decrease in the debt ratio in 2021, it will remain the highest among major EMs.

Furthermore, **while the administration has been adhering to the cap on primary expenditures on paper, it has been circumvented in practice** through various channels, be it through declaring a state of calamity, provisional measures or most recently through a constitutional fiscal reform. The above-the-cap expenditures amounted to around BRL525bn in 2020 and with the extension of the pandemic-related payments from April until July and, an additional extension for three more months until October, the above-the-cap spending for 2021 will amount to around BRL125bn.

With an eye on 2022 elections and to ease the transition from the expiring emergency stipend, the government is also looking to expand its flagship social assistance programme Bolsa Familia. **While the spending cap looks highly likely to remain intact in 2022, the fate of the fiscal framework will rest in the hands of the next administration.**

Olga YANGOL

Russia: monetary policy austerity and another wave

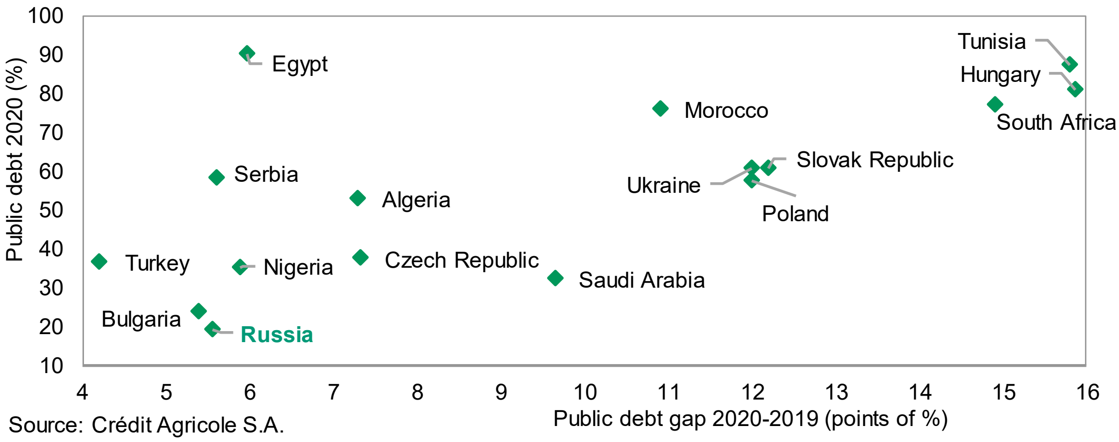
With its low vaccination rates, Russia is being hit by another wave of the pandemic. The government will likely aim to maintain financial balance and limit economic shutdown measures, as it did in 2020. Indeed, all public policy has been characterised by the same preference for stability and independence from international markets. Clearly, this preference is due to the weight of international sanctions on the RUB, sovereign spread and ratings. These sanctions are costing Russia 0.5% growth per year.

As such, **Russia is one of the EMs that has increased its stock of debt the least during the crisis, and its foreign currency reserves have remained high**, at USD465bn. This has underpinned the sovereign rating and limited risk on the RUB, along with the country's current account surpluses, in both 2020 and 2021, which have benefitted from rising oil prices and a smaller deficit from tourism. Fiscal austerity also appears to be returning quickly, with balanced Q1 public finances. However, this orthodox fiscal approach comes at the expense of public investments and potential growth, which remains weak at around 1.5%. Moreover, Russia is continuing to substitute domestic products for imports and diversify its commerce towards China (18% of trade compared to 8% in 2008).

In terms of monetary policy, Russia's central bank was one of the first to react to inflation (6.15% in June) and the cycle of rate hikes (5.5% currently) is not over. Production prices are soaring, driven by rising transport, commodity and food prices as well as a tense labour market (unemployment stands at 5.2%). On the demand side, inflation is being driven by the sharp rise in consumer lending (+19.6% YoY) and by expectations of higher prices, which are pushing households to spend now.

The combination of public health and inflation risks means that authorities have a treacherous path to navigate in H2, all the more so given that demonstrations are likely during September's parliamentary elections, as the middle class is rightly expecting income levels to stagnate for the foreseeable future, in our view.

Public debt: Russia's advantage



Source: Crédit Agricole S.A.

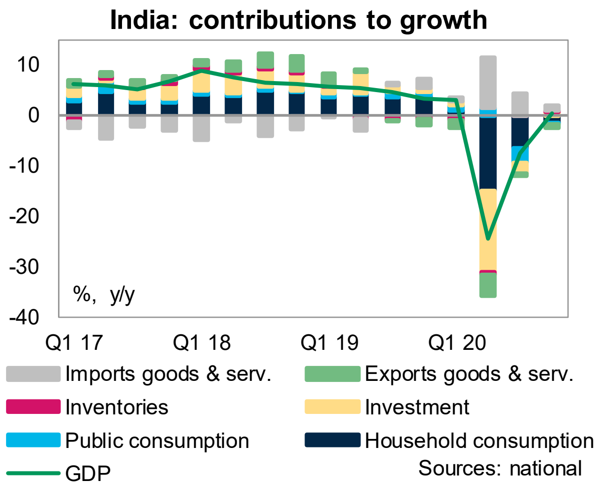
Tania SOLLOGOUB

India: uncertainty is the only certainty

The pandemic appears to have passed its peak at last, but the uncertainty it stirred up has yet to settle. Especially since progress on the vaccination campaign – an operational and logistical challenge for the country – is doing very little to rule out the spectre of another wave in the coming months.

At this point, the only certainty is that the public health situation is clouding our reading of the Indian scenario considerably, since it introduces so many angles:

- ✓ Extra-strong base effects in Q221 (GDP collapsed by 24% in Q220);
- ✓ Restriction measures taken (but no nationwide lockdown) in May;
- ✓ Bankruptcies masked by relaxed regulations;
- ✓ And improved external accounts due to weak domestic demand.



Paradoxically then, **our forecasts are more optimistic**: growth up to 9.6% for 2021 (compared to 7.4% in the previous scenario) and a smaller current account deficit (-1.2% instead of -2.2%). What the figures do not say is that an estimated 75m Indians have slid into poverty since March 2020, and the (90% informal) labour market is coming out of the crisis in even sorrier shape. India's structural problems, which are limiting the rebound in production (excessive dependence on agriculture, high unemployment and under-employment, chronic underinvestment) are also making the country dubious of any brisk recovery.

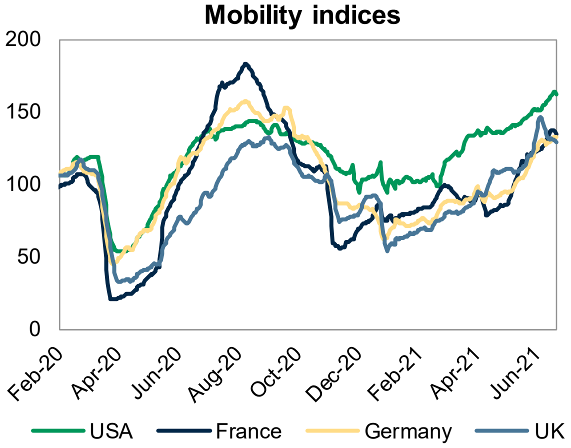
The government has long since exhausted any leeway it had, to the point of asking its ministers to make severe cuts in their operating expenses to come up with an additional USD2bn for the vaccination campaign. Negotiations over the vast privatisation plan, the cornerstone of the 2021-22 budget, are also slipping. On the monetary policy front, inflation's sharp acceleration to above 6% has plunged real rates back into negative territory, further paralysing the action of the Reserve Bank of India, which is still constrained by the fragile banking sector and the rate of non-performing loans.

Sophie WIEVIORKA

Oil – Iran's return

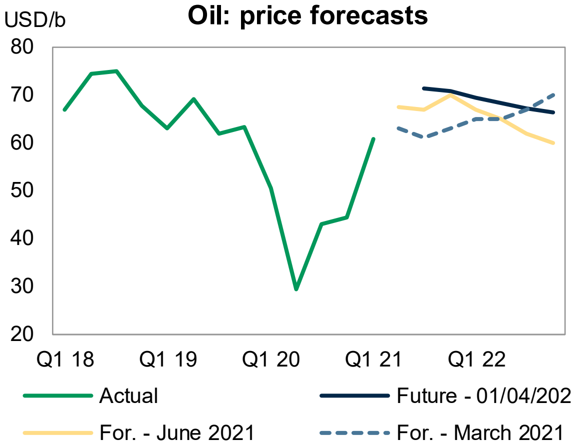
The second half of 2022 may very well look nothing like H221. In H221, oil prices are expected to remain high; in 2022, however, the oil market could wobble under a flood of Iranian oil.

Mobility indices



Sources: Apple, Crédit Agricole S.A.-Eco

Oil: price forecasts



Sources: Thomson Reuters, ICE, Crédit Agricole SA - ECO

Mobility indices in Europe and the US confirm that the recovery of oil consumption in OECD countries is accelerating as travel restrictions are lifted. The air traffic situation is also improving. The oil market is experiencing a phase shift between demand, which is steadily climbing, and supply, which is still OPEC+ controlled and evolving in stages. This supply/demand mismatch has been driving oil prices higher since April. Combined crude oil and petroleum product inventories in OECD countries are still holding steady in the upper historical range.

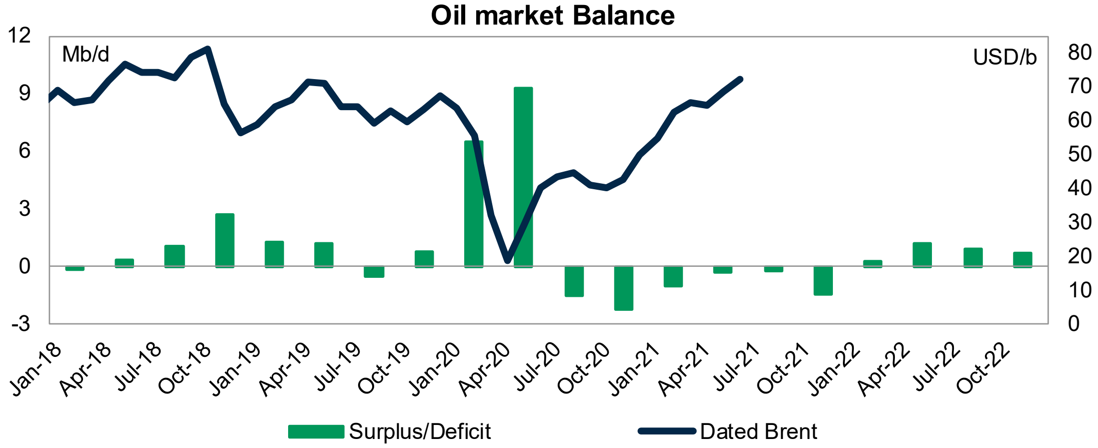
We expect this situation to continue for the rest of 2021, unless the spread of a new coronavirus variant forces new travel restrictions in the autumn.

For 2022, our scenario is based on the return of Iranian oil to the market, concomitant with the end of the OPEC+ agreement. We assume that negotiations between the US and Iran will end up with the US back in the Iran nuclear deal and a lifting of sanctions on Iranian oil starting in Q122. The return of Iranian oil would trigger a slight easing of oil prices in our view.

Therefore, our projected oil prices are USD69 per barrel for H221, and USD66 and USD61 per barrel, respectively, for the H122 and H222.

Stéphane FERDRIN

Oil market Balance



Sources: ©OECD/IEA, OMR, Thomson Reuters, Crédit Agricole SA - ECO

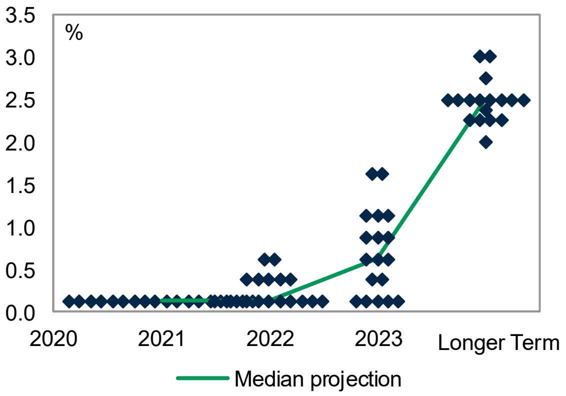
Monetary policy – No major urgency

Although monetary policy is expected to be tightened earlier in the US, it will remain gradual and measured: first taper, then a rate hike, but not before 2023. Despite the improved economic outlook and reduced risks, the ECB will maintain an accommodative monetary policy for the foreseeable future.

Fed: hawkish shift in June points to earlier lift-off

After remaining resolutely dovish since the beginning of the pandemic, the Fed began to signal at its June meeting that it is nearing the point when it will begin to consider removing accommodation. This hawkish shift was evident in the updated dot plot, which saw some upward migration in the dots resulting in the median now projecting two 25bp hikes in 2023 as opposed to unchanged rates, in line with our current expectations for lift-off in 2023.

FOMC June dot plot



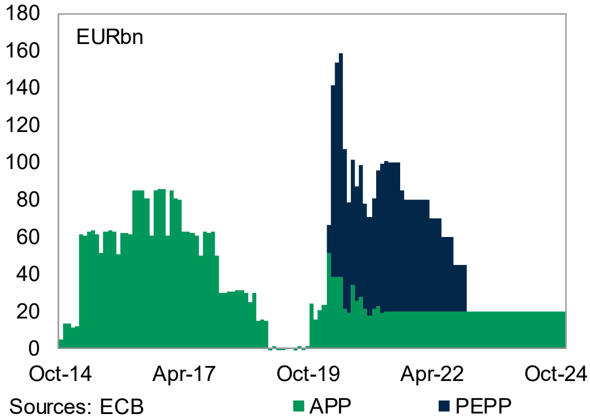
Sources: Federal Reserve, CA CIB

Before the Fed begins lifting rates, we expect the next step in policy normalisation to involve tapering asset purchases, with recent speakers noting that discussions are now underway. However, though discussions have begun, even the more hawkish speakers have conceded that it will take 'some time' to hash out all the details. Given this, combined with the fact that there are differing views on the timing, with some Committee members wanting to hold off until they see further progress in the labour market recovery, we believe the Fed will need a few meetings to figure out the details, with taper itself not starting until the beginning of 2022.

Of key importance in determining the final timing will be the evolution of the inflation outlook, in our view. While most speakers have continued to highlight that they expect the current overshoot to be transitory, with inflation moderating back towards target as re-opening related pressures ease, some have begun to stress the upside risks. If these risks play out and the overshoot begins to look like it could be more persistent, the Fed could be pushed into earlier tightening, especially if long-term inflation expectations were to become de-anchored.

Nicholas VAN NESS

ECB: purchase programmes, a little bit more



Sources: ECB

ECB: one final effort

Despite the improved economic outlook and reduced risks, the ECB is expected to maintain a highly accommodative monetary policy over the coming months.

In terms of its main tool, the PEPP, the ECB could decide to reduce the pace of purchases starting in September. This decision would not necessarily lay the groundwork for a definitive withdrawal of this extremely accommodative policy but would just be a slight adjustment to its easing strategy.

At the same time, the ECB will have to agree on the medium-term outlook for its monetary policy. Indeed, the PEPP is supposed to end in March 2022, which should compel the ECB to consider its next steps over the coming months. The best option would be to expand the PEPP budget to over EUR2trn and extend it until the end of 2022. There are other options (a temporary extension of the APP, or the implementation of new, highly favourable TLTROs), but these would be difficult to pull off in our opinion.

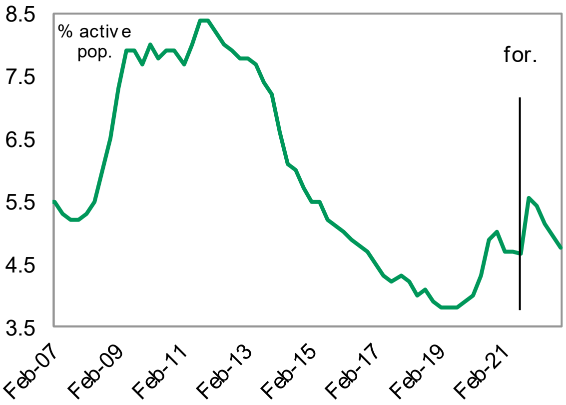
One way or another, **the ECB will have to extend its interventions once again, before it can finally consider a gradual withdrawal in the longer term**.

Louis HARREAU

BoE: looking beyond the initial economic rebound

The BoE will likely revise upwards its near-term inflation and growth outlook at its August MPC meeting, raising the probability of an earlier rate hike. The economic rebound has gained momentum recently and data has surprised to the upside relative to the BoE's expectations. CPI inflation reached 2.1% in May, above the BoE's 2% target for the first time since July 2019, and the BoE now expects a temporary rebound in inflation above 3%. The easing of the government's restrictions to activity has triggered a revival of prices in the sectors that were most hit by the pandemic. Similarly, in the labour market, the reopening of the economy seems to create pockets of tightness in some sectors struggling to hire the staff needed to respond to a sharp rebound in demand. This is likely to add upward pressure to wage growth in the near term. Pay growth has already accelerated sharply to 5.6% in the three months to April due to base effects as well as compositional effects in employment.

UK: unemployment rate



Sources: ONS, Crédit Agricole S.A.

The BoE will likely continue to look through the near-term period of strong growth and inflation and "focus on the medium-term prospects for inflation, including the balance between demand and supply, and medium-term inflation expectations, rather than factors that are likely to be transient." As always, a key factor will be the evolution of **the labour market. Its outlook remains uncertain.** The unemployment rate is likely to increase sharply in Q421 as the various support measures expire on 30 September, among which the Job Retention scheme, the Self Employment Income Support Scheme and the GBP20 a week increase to the Universal Credit. The end of the government's support will likely trigger a rise in redundancies among furloughed people, many of whom are in the food & accommodation, wholesale and retail sectors. Their integration in employment is likely to prove challenging due to skills mismatches with labour demand in expanding sectors and long-lasting changes in the economy (eg, increased digitalisation). The unemployment rate may prove persistently high during 2022. Hence, although the probability of an earlier rate hike has increased, we continue to expect the first rate hike in early 2023 only.

Slavena NAZAROVA

BoJ: YCC to be left intact with an additional 'greenish' prudence measure while 'tapering' is irrelevant for the bank

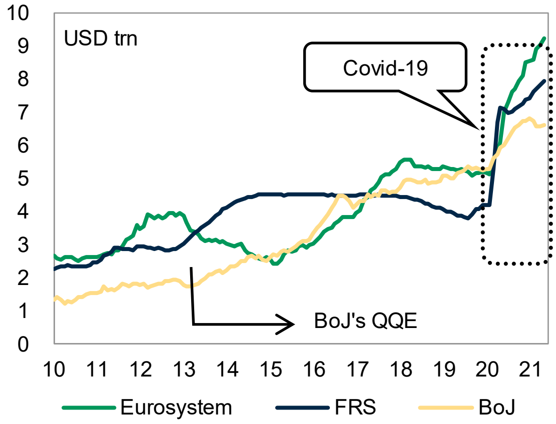
The BoJ's monetary policy currently has three pillars:

- ✓ YCC;
- ✓ Asset purchases of TOPIX-linked ETFs and J-REITs;
- ✓ And loan/credit measures under Covid-19.

We remain of the view that the BoJ will leave intact the first two for the foreseeable future, at least through 2023. The deadline of the third was extended from September 2021 to March 2022 at the latest June MPM for the third time, and this can be re-extended further depending on the future prevalence of vaccination.

BoJ Governor Haruhiko Kuroda has repeatedly said the BoJ is ready to take easing action whenever necessary and that such action mainly includes rate cuts. **We, however, do not think a rate cut will materialise**. Indeed, the BoJ newly introduced the Interest Scheme to Promote Lending in March, in which financial institutions receive higher interest on their current account deposits at the BoJ as the central bank cuts the negative IOER further and thereby the BoJ tries to mitigate the negative impact on financial institutions' profits at the time of rate cuts. **But the question is whether such a rate cut comes with a bigger and more lasting positive effect than a negative side effect, of which we are sceptical**.

Central banks' total assets



Sources: BoJ, ECB, Fed, CA CIB

Separately, **the BoJ announced at the June MPM that the bank would introduce a new funding measure for climate change**, through which it provides funds to financial institutions for investment or loans they make to address climate change issues. The framework is going to be presented at the July MPM and the bank likely plans to launch this new measure in 2021. However, **we are hesitant to take this as the beginning of the BoJ greening its monetary policy** because, in our view, it is more like longer-term quasi-prudence policy to tackle the risk that climate change will cause systemic risks. In this sense, it is a 'greenish' prudence measure rather than 'green' monetary policy.

Finally, we also need to note that whether to 'taper' is not a relevant issue for the BoJ. This is because the bank's primary policy target is YCC, ie, short- and long-term interest rates. Quantity is just a secondary parameter, for which there is no specific target existing, unlike until April 2020 when the BoJ officially dropped the "JPY80trn" language describing the targeted annual pace of an increase of JGB holdings. Besides, the central bank also dropped 'purchasing' targets and instead adopted 'maximum' targets of asset purchases of TOPIX-linked ETFs and J-REITs in March 2021 with actual purchases well below such maximum targets. These all led to a slower pace of an increase in the BoJ's balance sheet under Covid-19 than the Fed's and the Eurosystem's, suggesting that 'tapering' is not a relevant issue for the BoJ.

Kyohei MORITA

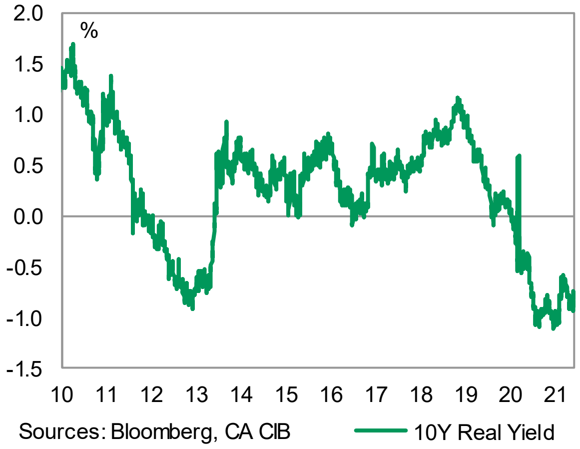
Interest rates – "This time, it's different"

Unlike in 2013, the Fed's gradual tapering is not expected to trigger any market turbulence but rather to occur alongside a moderate increase in long rates, specifically driven by normalising inflation and abundant liquidity in the financial system. European rates are expected to remain very low and may even fall further over the summer.

US: Fed taper unlikely to bring another tantrum this time

The Fed is on the path to taper asset purchases. But we caution investors not to use the 2013 taper tantrum playbook to price a massive selloff, because "this time is different." While we expect rates to rise modestly over the coming months, with the 10Y trading towards 1.65% by year-end, Treasury yields could decline once taper begins, which we expect to be early 2022.

Real yields to stay negative

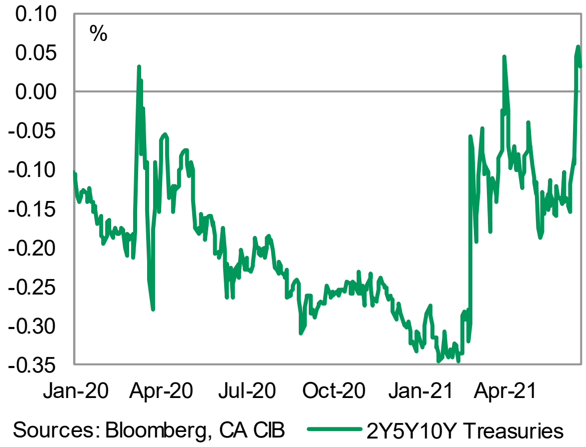


Sources: Bloomberg, CA CIB

We do not expect a significant selloff near-term, as inflation will likely normalise in H221 and the process continues throughout 2022. **The latest high inflation prints have been driven by a group of Covid-related components, which are unlikely to remain drivers of high inflation over an extended period of time.**

The peak of fiscal impulse is over, in our view. While Congress and the Biden administration are continuing negotiations on the Jobs and Families Plans, even if an agreement is reached, we expect the near-term boost to growth to be much more muted compared to the Covid stimulus packages, as the spending would be spread over a number of years and may be at least partially offset by tax increases.

Intermediate sector remains volatile



Sources: Bloomberg, CA CIB

There is ample liquidity in the financial system, evidenced in the record-setting Fed RRP facility. The Fed balance sheet keeps growing, albeit at a slower pace starting next year once taper commences, if our expectations are correct. It will likely take several months from the start to the end of taper, if the Fed follows the 2013 script. We believe lift-off will follow taper, and the Fed is not likely to taper and hike rates at the same time.

We expect **real rates to stay negative over the medium term**, as the output gap seems hard to close given the Covid-related job losses, about 7.5m currently vs pre-Covid. The low natural rate of interest rate, the so-called R-star, has been in a downward channel over the past three decades – a secular trend that is unlikely to reverse anytime soon. Low and negative real rates, combined with normalising inflation, would lead to a decline in nominal rates in 2022, in our view.

The intermediate sector is likely to stay volatile. We are biased towards a flatter yield curve in selloffs, eg, in 5s-30s, as initial taper fear-related selloff would lead the belly to cheapen. Conversely, as the economy transitions to more normal growth next year from the stimulus-driven surge this year, 5s-30s could steepen as rates move lower under taper.

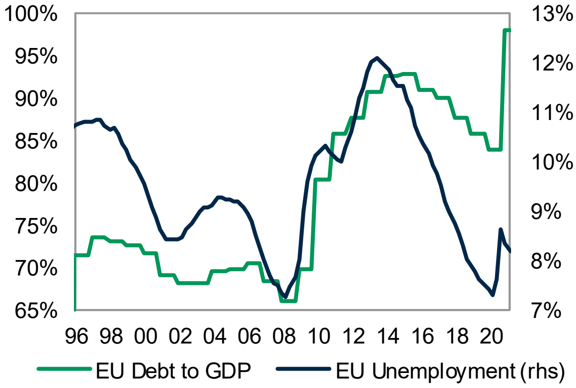
Alex LI

Eurozone: low for now, more uncertainty ahead

The next few weeks should reflect a summer lull in activity and policy direction, so we suggest that investors stay focused on exposure to lower yields. Indeed, as volatility tends to recede during the summer months, investors are usually enamoured with positive carry trades. This year should be no exception given that the ECB announced at its June meeting that the "significantly higher" pace of purchases will be extended through Q3, giving some respite to the EGB market. Added to this, a high up-take in TLTROs in June, and another operation due in September will also provide cheap, ample funding for carry trades, adding more liquidity to the banking system. Given their advantageous carry profile, BTPs are the most attractive and in our view should attract buyers, with a focus on the short end.

Vaccination programmes continue to progress throughout the Eurozone, which is a positive factor for activity levels, especially in the service sector, but new Covid variants and vaccine hesitancy imply that it is not clear sailing just yet. For the ECB, closing the output gap will require some time, though much less so than during the sovereign crisis. A new dynamic is that a much higher stock of debt needs to be considered over the long term as this should also act as a headwind with respect to inflation, not just the labour market. And though its growth and inflation forecasts have been boosted for 2021 and 2022, by 2023 core inflation should be back to 1.4%. With the amount of funding that has to take place for EGBs and the NGEU, and in addition to a declining inflation profile, **the ECB is sure to remain accommodative over that horizon with a significant ongoing level of balance sheet expansion**.

Stronger fiscal rather than labour market deterioration

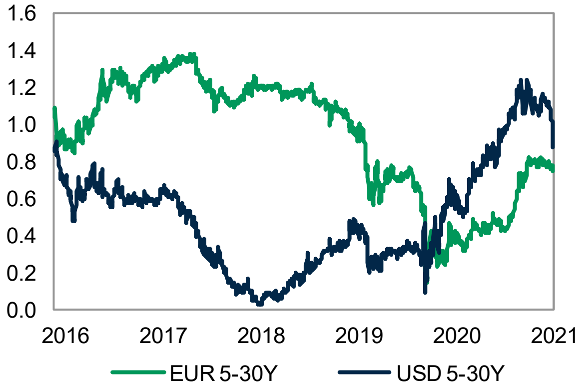


Sources: Bloomberg, CA CIB

Investors should have **two interesting events to look forward to in September**, though these are not assured to have a big market impact. First, **the ECB is expected to announce the outcome of its review where adjustments could be made to its inflation target in terms of composition and perhaps distribution rather than a big adjustment of the target level**. To us, the idea that raising its target materially to boost inflation expectations is simply not credible, though including house prices more fully could be on the agenda, for example.

Aside from the ECB, we also get **Germany's elections** in September. Until recently, the Green party was polling very strongly, suggesting that a 'left only' coalition could be mustered together – with clear implications: more government spending, pressure to drop the constitutional spending break and more EU solidarity. Together, these could be the required ingredients for a new pan-Eurozone sovereign issuer or a permanency to the NGEU and its green credentials. Recently however, the CDU has advanced in the polls and that outcome would clearly be for fiscal conservatism, even though there could be a strong green agenda in the case of a 'Jamaica' collation involving the Green party.

USD 5-30Y move should flatten the EUR curve too



Sources: Bloomberg, CA CIB

For rates investors, including EGBs, the change in the Fed outlook does have important ramifications. A hawkish Fed has put a strong flattening bias to the curve, with lower long-end yields. Due to correlation, this should imply core curve flattening as well in a grab for duration in the short term. True, a formalised tapering announcement should send USD front-end yields higher still, but the impact on long-end yield should be temporary. Given the timeframe involved in its balance sheet wind down, the front-end of the periphery curves should be protected by the ECB's own policy mix and carry arguments if we witness a risk-off environment due to the Fed.

In sum, we think that – credit and event risks aside – BTP short-end yields should converge towards SPGB yields and that investors should remain long duration in core markets over the next few weeks and months. To be clear, we are not looking for core EGB yields to return to their low levels, but rather to be pushed lower before evaluating the range of scenarios for Q421 in light of a number of less bond-friendly prospects.

Bert LOURENCO

Exchange rates – The dollar's temporary advantage

The withdrawal of accommodative monetary policy in the US, initially via measured tapering, is conducive to a moderate rise in the USD that will be more temporary than what we saw previously in 2013. However, beyond that, supportive fundamentals will fade.

G10 FX: Fed taper and the USD – how much of a positive?

We remain largely constructive on the USD in the next three to six months because we expect the Fed to move closer to tapering its QE and send nominal UST yields and US rates higher.

We remain largely constructive on the USD in the next three to six months because we expect the Fed to move closer to tapering its QE and send nominal UST yields and US rates higher. We therefore expect a (partial) replay of the QE taper episode from December 2013, which boosted the USD's nominal and real rate and yield advantage and helped the currency embark on an uptrend that lasted until 2019 (see also the left-hand side chart below).

We expect the Fed's QE taper to usher in dynamics that could result in some USD gains across the board in the coming months. Taking into account the current conditions, however, our expectations are ultimately for a more muted and transient USD appreciation than in the wake of the 2013 QE taper:

1 - Unlike in 2013, the Fed is not the only major central bank to tighten policy. Indeed, the Fed seems to be already lagging behind the likes of Norges Bank, the BoC, the RBNZ and even the BoE. In addition, while the ECB and the BoJ are expected to remain dovish, they are not expected to ease from here either.

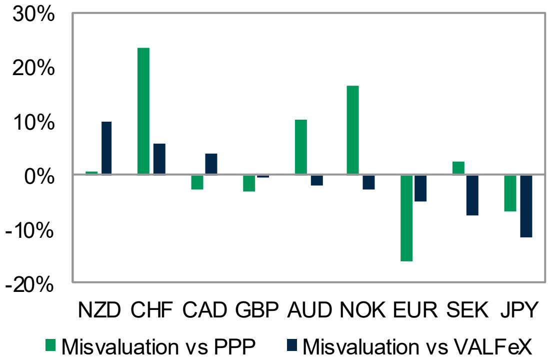
2 - The Fed's Average Inflation Targeting (AIT) framework could mean that US real rates and yields would remain negative despite the policy normalisation. This would be different from 2013 and thus may point to only fleeting USD gains mainly vs low-yielding G10 currencies.

3 - The tightening in the US and global financial conditions on the back of taper could erode risk sentiment. In Figure 10, we show a ranking of the G10 USD-crosses from most to least vulnerable to the combination of higher UST yields and weak risk sentiment. That being said, we think that the Fed would try its best to avoid a repeat of the 'taper tantrum' from Q213. In turn, this could suggest that any USD appreciation could be less pronounced than in the past.

Looking beyond the Fed and its QE taper, we further note that USD fundamentals have been steadily deteriorating. Indeed, the USD is looking expensive vs a number of G10 currencies including the EUR and the JPY (see the right-hand side chart below). In addition, we think that the positive impact from the US growth leadership on the USD will fade over time and thus allow USD-negative factors like the flows linked to global trade and portfolio diversification to play an even greater role in 2022. In particular, we expect that the fiscal shot in the arm of the US consumer should boost demand for imports and could lead to a lasting deterioration of US external imbalances from here. The US growth spill-overs could boost the economies of the US's trading partners and weigh on the USD vs their currencies.

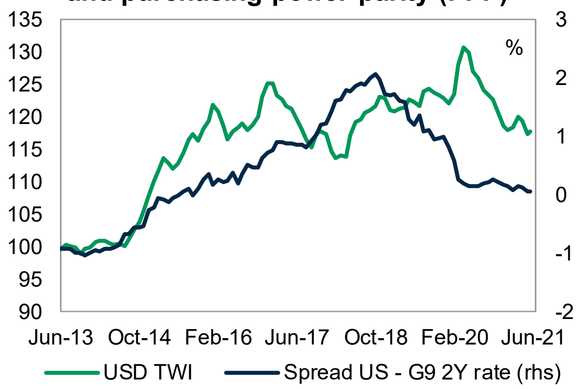
Assuming that President Joe Biden does not resort to fresh protectionist measures, chances are that the recent recovery in global trade would

The USD appreciated as its rate advantage grew after the Fed QE taper that was announced in December 2013



Sources: Bloomberg, CA CIB

Misvaluation of FX spot vs G10 VALFex and purchasing power parity (PPP)



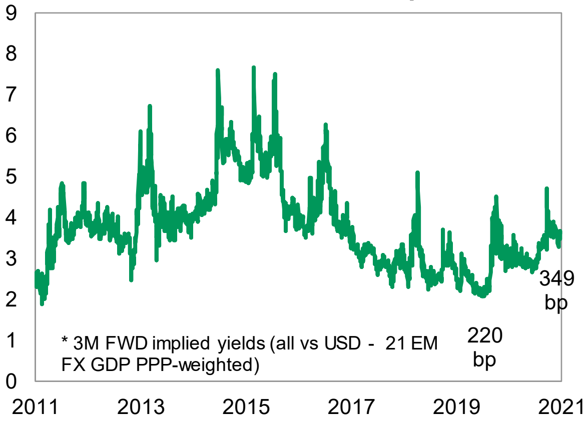
Sources: Bloomberg, CA CIB

continue and thus create an environment that supports the growth of US imports. A widening trade deficit could be damaging for the USD at a time when foreign investors worry about the recent sharp deterioration of the US twin deficits and their impact on the overvalued USD.

The developments will further underscore the broader point that the USD tended to weaken whenever the US economy has emerged as the growth leader of the world in recent years especially when global trade was recovering. Indeed, the USD TWI tended to sell off during periods of growing trade volumes. We expect global trade volumes to pick up further in H221 and 2022 as the post-Covid recovery broadens and deepens across the board. Subsequently, global exporters will be converting a growing share of their USD trade revenues into their home currencies while their respective central banks will be diversifying their growing FX reserves by selling USD and buying liquid proxies like the EUR for example.

Valentin MARINOV

EM-USD Interest rate spread



Sources: Credit Agricole CIB, Bloomberg

Emerging countries: a mild but conditional appreciation

The outlook for EM currencies in H2 is strongly linked with the fate of US yields. Our in-house view expects only a limited increase in 10Y yields (about 10bp in both Q3 and Q4). Should this materialise, EM currencies would hardly be pressured. In a risk scenario, where the US bond market would go through something closer to the 2013 taper tantrum, EM FX would likely weaken vs the USD, though.

Beyond the impact of US rates, **EM currencies may be mildly supported by a handful of factors**. First, **the market is buying a scenario of gradual reopening of economies as vaccination progresses**. In our view, there remain many uncertainties on that front, which have the potential to fuel FX volatility. However, should the scenario of a gradual reopening of economies remain valid, portfolio flows to EMs may be sustained.

Second, **higher interest rates** – as more EM central banks should gradually join the hawks' club – will fuel the EM-DM interest rate gap. That being said, the timing of the Fed's discussions on tapering may induce some more volatility close to Jackson Hole. Third, the fact that EMs are **lagging DMs** on average when it comes to vaccination suggests that EM demand may remain constrained compared with DM demand, which should slow the narrowing of the aggregated EM trade surplus.

The main risk to such a mildly constructive view reflects the uncertainty about the pandemic. Our concerns are explained in the EM macro section of this report. The bottom line is that **many EMs are exposed to possible new Covid waves, in a way that could challenge their economic recovery and worsen their financial profile**. Countries that already look vulnerable given their fiscal situation (including Brazil, South Africa and India) or their external position (including Turkey) still look vulnerable in this respect.

Sébastien BARBÉ

Economic and financial forecasts

Interest rate

		29-Jun	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
USA	Fed funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	10Y	1.49	1.55	1.65	1.50	1.45	1.40	1.35
Eurozone	Deposit	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
	10Y (Germany)	-0.17	-0.25	-0.20	-0.15	-0.15	-0.10	-0.10
10Y Spread vs. EUR	France	0.34	0.45	0.55	0.55	0.40	0.20	0.20
	Italy	1.05	1.10	1.20	1.30	0.90	0.80	0.85

Exchange rate

USD Exchange rate Industrialised countries		29-Jun	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Euro	EUR/USD	1.19	1.20	1.20	1.21	1.22	1.23	1.24
Japan	USD/JPY	110.45	112.00	115.00	112.00	112.00	110.00	110.00
United Kingdom	GBP/USD	1.38	1.40	1.40	1.42	1.43	1.44	1.45
Switzerland	USD/CHF	0.92	0.93	0.93	0.93	0.93	0.93	0.93
Asia								
China	USD/CNY	6.47	6.40	6.35	6.31	6.27	6.23	6.20
Hong Kong	USD/HKD	7.76	7.76	7.76	7.76	7.76	7.76	7.76
India	USD/INR	74.28	74.10	74.00	74.25	74.50	74.75	75.00
South Korea	USD/KRW	1133	1120	1110	1100	1090	1080	1080
Latin America								
Brazil	USD/BRL	4.96	5.10	5.20	5.25	5.30	5.40	5.50
Mexico	USD/MXN	19.79	21.00	20.75	20.50	20.50	20.00	20.00
Emerging Europe								
Poland	USD/PLN	3.80	3.71	3.71	3.64	3.58	3.54	3.47
Russia	USD/RUB	72.69	72.00	70.00	70.00	72.00	73.00	74.00
Turkey	USD/TRY	8.73	8.80	8.60	8.40	8.50	8.60	8.70

Commodities

		29-Jun	2021		2022			
Precious metals			Q3	Q4	Q1	Q2	Q3	Q4
Gold	USD/oz	75	1,980	2,020	2,040	2,080	2,120	2,140

Av. quarter price		29-Jun	2021		2022			
			Q3	Q4	Q1	Q2	Q3	Q4
Brent	USD/BBL	75	67	70	67	65	62	60

Economic Forecasts

	GDP (yoy, %)			Consumer prices (yoy, %)			Current account (% of GDP)		
	2020	2021	2022	2020	2021	2022	2020	2021	2022
United States	**-3.5**	**6.5**	**4.0**	**1.2**	**4.0**	**2.7**	**-2.6**	**-2.6**	**-2.7**
Japan	**-4.7**	**2.4**	**3.2**	**-0.2**	**0.1**	**0.6**	**3.2**	**3.9**	**5.1**
Eurozone	**-6.7**	**4.8**	**4.5**	**0.3**	**2.1**	**1.6**	**2.9**	**2.7**	**2.5**
Germany	-5.1	4.0	4.7	0.4	2.8	1.8	7.0	6.3	6.0
France	-8.0	5.8	4.3	0.5	1.9	1.5	-2.2	-1.0	-0.9
Italy	-8.9	4.5	4.1	-0.2	1.5	1.0	3.6	2.1	2.1
Spain	-10.8	5.4	5.5	-0.3	2.1	1.7	2.0	1.8	1.7
Netherlands	-3.7	2.6	3.3	1.1	2.0	1.9	7.8	8.0	8.4
Other advanced									
United Kingdom	-9.8	7.4	5.6	0.9	2.0	2.4	-3.5	-4.3	-5.6
Canada	-5.6	4.5	3.4	0.7	1.7	2.0	-2.1	-2.3	-2.0
Australia	-4.2	3.0	2.8	0.7	1.3	1.5	1.8	-0.1	-1.4
Switzerland	-5.3	3.6	2.1	-0.8	0.0	0.3	8.5	9.0	9.6
Asia	**-1.0**	**7.6**	**5.6**	**2.9**	**2.3**	**2.7**	**2.2**	**2.0**	**1.5**
China	2.3	8.5	5.7	2.5	1.3	1.9	1.9	2.8	2.3
India	-7.0	9.6	7.6	6.6	5.1	5.5	1.2	-1.0	-2.2
South Korea	-0.9	3.9	2.6	0.6	1.7	1.4	4.0	3.8	3.7
Latin America	**-6.6**	**5.1**	**2.6**	**8.5**	**9.9**	**8.2**	**0.2**	**-0.2**	**-0.6**
Brazil	-4.1	5.0	2.2	4.5	5.2	3.6	-0.9	-0.8	-1.0
Mexico	-8.2	5.1	3.2	3.2	4.6	3.6	2.5	1.3	0.8
Emerging Europe	**-2.5**	**3.7**	**3.4**	**5.1**	**7.1**	**5.3**	**0.6**	**0.9**	**0.8**
Russia	-3.0	3.0	2.5	3.4	5.2	4.0	2.2	3.0	3.0
Turkey	1.6	4.5	4.0	11.9	16.0	12.0	-5.1	-4.0	-4.0
Poland	-3.9	5.0	4.7	3.4	4.1	3.0	3.5	3.1	2.5
Africa, Middle East	**-3.9**	**3.2**	**3.5**	**8.0**	**6.2**	**6.1**	**-2.2**	**0.3**	**1.1**
Saudi Arabia	-4.1	2.7	3.5	3.5	2.9	3.0	-1.6	3.0	3.6
United Arab Emirates	-6.1	3.2	3.2	-2.1	1.0	2.1	5.8	8.5	9.8
Egypt	1.0	3.9	5.0	5.1	5.9	6.7	-4.5	-4.0	-3.5
Morocco	-6.3	3.9	3.2	0.6	1.1	1.5	-1.5	-3.2	-3.5
Total	**-3.5**	**5.8**	**4.4**	**2.9**	**3.7**	**3.3**			
Advanced economies	**-5.1**	**5.3**	**4.1**	**0.7**	**2.6**	**2.0**			
Emerging countries	**-2.3**	**6.2**	**4.7**	**4.6**	**4.5**	**4.2**			

Public accounts

	Government balance (% of GDP)			Public debt (% of GDP)		
	2020	2021	2022	2020	2021	2022
United States	**-16.0**	**-9.9**	**-6.1**	**98.2**	**104.5**	**105.6**
Japan	**-10.5**	**-6.7**	**-4.1**	**238.2**	**241.1**	**242.7**
Eurozone	**-7.3**	**-8.6**	**-4.0**	**100.3**	**102.6**	**97.5**
Germany	-4.2	-8.9	-2.9	69.8	74.5	74.0
France	-9.2	-9.1	-5.0	115.2	116.0	114.3
Italy	-9.5	-11.8	-5.9	155.6	158.2	156.0
Spain	-11.0	-8.4	-5.0	120.0	120.6	117.9
Netherlands	-4.4	-6.0	-1.8	54.4	58.6	56.9
Belgium	-9.4	-6.8	-4.5	114.1	114.4	114.5
Greece	-9.7	-10.0	-3.0	205.6	199.2	189.5
Ireland	-5.0	-6.0	-3.0	59.5	56.3	53.8
Portugal	-5.7	-4.5	-3.2	132.1	126.7	120.5
United Kingdom	**-12.3**	**-7.5**	**-3.3**	**102.1**	**100.0**	**95.2**

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Crédit Agricole S.A. – Economic Research Department
12 place des États-Unis – 92127 Montrouge Cedex

Publication Manager: Isabelle JOB-BAZILLE

Editor-in-Chief: Catherine LEBOUGRE – Armelle SARDA – Jean François PAREN

Editorial committee:

Developed Economies: Ticiano BRUNELLO – ticiano.brunello@credit-agricole-sa.fr
Pierre BENADJAOUD – pierre.benadjaoud@credit-agricole-sa.fr / Olivier ELUERE – olivier.eluere@credit-agricole-sa.fr
Louis HARREAU – louis.harreau@ca-cib.com / Catherine LEBOUGRE – catherine.lebougre@credit-agricole-sa.fr
Paola MONPERRUS-VERONI – paola.monperrus-veroni@credit-agricole-sa.fr / Kyohei MORITA – kyohei.morita@ca-cib.com
Slavena NAZAROVA slavena.nazarova@credit-agricole-sa.fr / Jean-François PERRIN – jean-françois.perrin@ca-cib.com
Lionel POTIER – lionel.potier@credit-agricole-sa.fr / Sofia TOZY – sofia.tozy@credit-agricole-sa.fr
Philippe VILAS-BOAS – philippe.vilasboas@credit-agricole-sa.fr / Nicholas VAN NESS – nicholas.vanness@ca-cib.com

Emerging markets: Sébastien BARBE – sebastien.barbe@ca-cib.com / Dariusz KOWALCZYK – dariusz.kowalczyk@ca-cib.com
Olivier LE CABELLEC – olivier.lecabellec@credit-agricole-sa.fr / Tania SOLLOGOUB – tania.sollogoub@credit-agricole-sa.fr
Sophie WIEVIORKA – sophie.wieviorka@credit-agricole-sa.fr / Ada ZAN – ada.zan@credit-agricole-sa.fr

Financial Markets: Xavier CHAPARD – xavier.chapard@ca-cib.com / Orlando GREEN – orlando.green@ca-cib.com
Alex LI – alex.li@ca-cib.com / Bert LOURENCO – bert.lourenco@ca-cib.com
Valentin MARINOV – valentin.marinov@ca-cib.com

Oil: Stéphane FERDRIN – stephane.ferdrin@credit-agricole-sa.fr

Information centre: Dominique PETIT – **Statistics:** Robin MOURIER, Alexis MAYER

Production and Editor: Fabienne PESTY

Contact: publication.eco@credit-agricole-sa.fr