



**WORLD
MACRO-ECONOMIC SCENARIO
2022-2023**

Quarterly – July 2022

Between a rock and a hard place

With the military situation in Ukraine still highly uncertain, the negotiation scenarios increasingly complex and geopolitical fragmentation emerging, the scenario is still based on the assumption that the conflict will last, and so it remains extremely uncertain. While the most developed economies came through the acute phases of the Covid pandemic in robust health, they now face adversity once again. The trend they were on is bending – or maybe it is broken.

This time, adversity equals supply and demand shocks, themselves the product of a powerful upstream inflation shock or even shortages of commodities or critical inputs. Aside from the war, you see, Covid rages still, and the collateral damage of China's strategy is obvious. **Accordingly, inflation has been adjusted substantially upward and is now the key factor in the worsening outlook:** inflation is averaging too high (8.3% in the US and 8.0% in the Eurozone in 2022), and it is more widespread and more persistent (4.5% and 5.4%, respectively, in 2023). Inflation is spurring earlier and more substantial monetary tightening and revising the growth scenario dramatically downward while also surrounding it with downside risks.

Far from the centre of the conflict, and still over-stimulated from anti-Covid strategies, the **US** should be quite resilient in 2022, during which even more volatile growth (2.6% on average) is expected to continue outpacing the trend. There are two key spring-backs keeping growth from folding and cushioning consumers from high inflation. Households' financial situation is sound, with abundant savings just starting to be dipped into. The big wage hikes – mostly on the lower end of the income spectrum – are being fuelled by tensions on the job market and are partially offsetting price jumps. But the supporting factors are falling away, and the risks are piling up. The effects of those risks are likely to be visible in 2023 and lead to a marked slowdown: not a 'full-blown recession', but a 'growth recession' in which the unemployment rate rises slightly and growth stays positive but, at 1.5%, lags behind its potential. This opens the door to a possible technical recession, although that is not our central scenario.

In the **Eurozone**, solid private-sector fundamentals and the post-omicron rebound are no match for the war's wreckage. The cut in natural gas deliveries and the embargo on Russian oil and coal are creating a major (though still limited and local) negative supply shock. Depending on what options there are for substitutions, and how critical natural gas is to production processes, sectors and countries are feeling it differently. Yet it is through inflation, dwindling purchasing power and demand that the Russian energy supply shortage is having its depressive effects. While the wage response is presumed to be moderate, government measures to aid households and the extra help from the surplus savings accumulated with the crisis are not entirely offsetting the loss in purchasing power reflected in the slowdown in consumer spending.

Boosted by a high carry-over effect, growth remains high (2.5%), but the average quarterly pace is barely above zero. As inflation moderates, growth will rebound slowly in Q223, reaching an annual average of 1.1% but suffering from the assumption, priced into our forecast, of production limits in some sectors. However, the risk scenario is highly likely: a scenario pinned on a cut-off of Russian natural gas supply, with the impact costing almost 2ppt.

In **emerging markets**, the risk of stagflation hangs heavy. Those countries are up against an acute growth/inflation dilemma (more violent inflation and growth shocks), though there are scant (or, for some, no) means of solving it, and tightening global financial conditions are a real challenge. So now emerging countries are moving into a dangerous phase – one that threatens the most fragile, fiscally and/or financially but also socially. And as usual, they are doing so disjointedly. The region most solidly stuck between the rock (growth) and the hard place (inflation) is, of course, Central Europe. On the other extreme, the Gulf countries are basking in their revenues. Latin America, prey to high inflation and strenuous monetary tightening, is still benefiting from better terms of trade, which are not solving fiscal constraints but, in the short term, are easing them. Asia is enjoying lower inflation and more resilient growth, but the energy-importing countries there are struggling with growing current account deficits. Asia stands to gain from the hoped-for Chinese recovery late this year (though it is easy to wonder how, without powerful – and traditional – public support, China will be able to achieve growth of "around 5.5%"). Meanwhile in Africa, high inflation and rising food insecurity are intensifying the continent's weaknesses and prolonging the damage from the pandemic.

Higher, more widespread and potentially more persistent inflation has toughened rhetoric and subsequently action from central banks. While the US is justifiably well ahead in the tightening cycle, the Bank of England is taking a more cautious (even ambiguous) approach and the ECB is only just starting to hike rates.

In the **US**, our scenario is based on a series of rapid increases bringing the target Fed Funds rate to 3.50-3.75% at the end of 2022, well above the median neutral estimate (2.50%). In spite of the priority given to controlling inflation (and to headline, not core, inflation), the anticipated slowdown may limit the extent of further hikes in 2023: our scenario assumes a stabilisation of

the Fed Funds rate next year. In addition, normalisation of the Fed's balance sheet will continue as announced in May, adding to tighter financial conditions.

After ten years of uninterrupted accommodative monetary policy in the **Eurozone**, the ECB will initiate rate lift-off starting in July. After the PEPP stopped in March, net purchasing under the APP is ending, and the central bank will make its first rate increase (25bp, bringing the deposit rate to -0.25% and the refinancing rate to 0.25%). The ECB's clear focus on controlling inflation is expected to bring these rates up to 0.75% and 1.25%, respectively, by end-2022 before greater pragmatism prevails, fuelled by clear signs of economic slowdown, pushing them down to 1.25% and 1.75% at the close of 2023. Meanwhile, TLTRO redemptions in 2023 should further restrict monetary policy through the quantitative tightening channel (reducing excess liquidity and returning ECB collateral to banks, then investors).

Under the influence of current and anticipated inflation spurring more proactive monetary tightening, interest rates have recovered significantly and proven more volatile. This upward trend is likely to continue. In the Eurozone, this is combined with higher sovereign risk premiums that are a concern for the ECB. In the US, the aggressive rise in key rates is expected to lead to a 10Y Treasury rate of nearly 3% at end-2022 and a sharper inversion of the rate curve. In the Eurozone, the rise in key rates without quantitative easing is upping financing costs, refocusing market attention on public debt trajectories and causing spreads to widen enough to bring back the risk of financial fragmentation. ECB members are saying that an 'anti-fragmentation' programme could be ready before summer ends. Given the legal constraints, this **ad hoc** tool should, at best, slow the widening of spreads: markets are expected to stay volatile and investors to stay prudent.

Catherine LEBOUGRE

FOCUS Geopolitics – The hunger war

At a time when our medium-term scenario is taking shape, the military situation is still just as uncertain, which suggests that the conflict could go on. On the other hand, the oil, natural gas and wheat wars are now giving the Russia-Ukraine conflict a lasting global geoeconomic dimension.

With no sign at all that the conflict will be settled, our economic scenario must still be prepared “in the shadow of war”, in the well-known words of Clausewitz. In concrete terms, this expression means that even the most senior experts cannot predict the military outcome of events, and that a strategic surprise is possible (on the ground or at the diplomatic level). So, we must be wary of even a hint of certainty, and work from a medium-term scenario not stating it is more likely to happen but simply that events are pointing to it as of the day the scenario is being written. For this quarter, our mid-range scenario has been revisited with the following ideas:

On the Russian side, as on NATO’s, several statements are announcing a long war. Of course, it is impossible to know what is propaganda and what is strategy, but the assumption of a prolonged war (at least until autumn) seems logical, as long as there is no clear progress on the ground. Faced with this scenario of a relative military stalemate, however, we can at least retort that the lack of ammunition may accelerate the end (or the stabilisation) of the high-intensity conflict, as may troop morale. As for Russia, the conscription issue will come up at some point during a drawn-out conflict, which will be a huge domestic policy risk.

Complex negotiation scenarios in the short term

It is also difficult to say what Moscow would consider enough of a military gain to initiate negotiations. And lest we forget, even though Russia seems to have won some territory in the Donbas, the Odessa question constitutes a major risk of further escalation, if Moscow’s intentions encompass a corridor to Transnistria. It is probably here that we will start to see the limits – or not – of the war.

Geopolitical fragmentation is happening in a climate of fear that international organisations cannot appease.

The more this war drags on, the more complex and longer the transactional scenarios become. Complex in that the negotiation scenario has become one of the dividing lines and lines of conflict even within the Western alliance. Complex in that no power seems

capable of mediating any longer, following the attempts by Italy, Israel and Turkey. Lastly and most importantly, complex in that it has become very sticky for the West to agree to any discussion with Russia while also accusing it of genocide. Meanwhile on the Russian side, the rhetoric of a war of civilisation against the West is making the road to the negotiation table just as congested.

Still, whatever happens militarily or diplomatically, nothing much will change the escalating economic war and its lasting consequences. The globalisation of the conflict is unfolding especially quickly around food issues, not just because of direct or indirect sanctions but also because of certain strategic roads and ports, or decisions to restrict exports that have been taken by thirty-odd countries, ranging from Indian wheat and sugar to Kuwaiti and Malay chickens to Egyptian lentils. These decisions go far beyond economic emergency. They are geoeconomic by nature, marking a real shift in the strategic universe for these governments, as their priority is to supply their domestic or even regional market (Kazakhstan is reserving its wheat for Central Asian governments that depend on Russian deliveries).

Let’s also remember that these decisions have often been accelerated by climate events like drought in India and floods in South Africa, showing us just where geopolitical and climate risks converge.

Dangers of geopolitical fragmentation in the long term

Against this backdrop, the long-term global geopolitical scenario is moving more and more in the direction of a general fragmentation of power relationships, even though blocs of allies are also emerging. So, we have a much more multi-polar scenario than we did in the Cold War, where many states are intent on cultivating their strategic autonomy.

This scenario could have even greater economic repercussions, since this geopolitical fragmentation is as yet disorderly, in a climate of urgency and fear that international organisations are proving unable to appease.

Tania SOLLOGOUB



DEVELOPED COUNTRIES

Inflation is biting

USA – Economy resilient for now, but mounting risks to lead to 2023 slowdown

Eurozone – The normalisation of the real economy will take longer

United Kingdom – Growth downgraded again

Inflation is biting

Despite coming out of the different Covid waves and peaks strongly, economies are facing adversity once again. The supply and demand shocks are themselves the result of a powerful inflation shock and shortages. Inflation is rising sharply and has also become more widespread and persistent, which has led us to downgrade our growth scenario but also attach several downside risks.

US ECONOMY RESILIENT FOR NOW, BUT MOUNTING RISKS TO LEAD TO 2023 SLOWDOWN

The US economy looks to remain relatively resilient in 2022 in the face of rising headwinds, but by next year we expect these headwinds to take a more severe toll, leading to a sharper slowdown in 2023. This pattern would leave growth at a solidly above-trend pace of 2.6% on an annual average basis in 2022 before slowing to 1.5% in 2023, though the quarterly pace may nearly stall by late 2023, dipping below 0.5% by year-end.

Despite our overall expectations for a resilient 2022, the pace may be somewhat choppy from quarter to quarter. Q1 GDP unexpectedly contracted at a 1.5% annual rate, though underlying momentum was stronger than suggested by the headline print, with final sales to domestic purchasers actually accelerating to 3.9% compared to 2.6% in Q421. As a result, we continue to expect a rebound above 3% in Q222 followed by a slowdown back towards 2% in the latter portion of the year, which results in annual growth of 2.6%.

Despite our overall expectations for a resilient 2022, the pace may be somewhat choppy from quarter to quarter.

Underpinning this near-term resilience are two main pillars of support that will allow consumers to cope with a period of elevated inflation, as we examined in more detail in a:

- ✓ Healthy household balance sheets combining (1) a significant pile of accumulated savings worth nearly USD2.5trn, which consumers have only just begun to dip into, with (2) a constructive wealth effect as

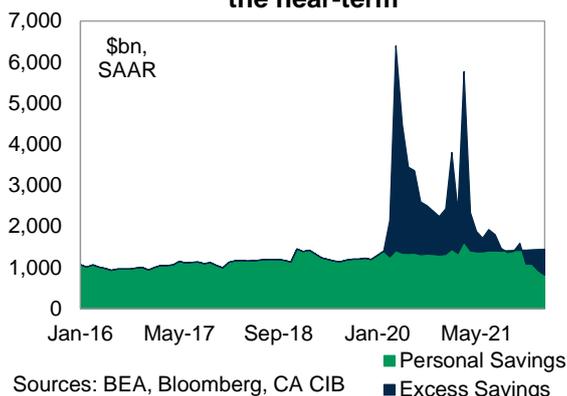
real estate and equity prices have risen sharply compared to pre-pandemic levels. While equity prices have retraced some of these gains, even taking into account market moves through Q122 shows a gain in cumulative household net worth of north of USD30trn, a comfortable increase compared to pre-Covid levels.

- ✓ A very tight labour market that has led to strong wage gains, which should at the very least mitigate price increases even if real wages have been declining for many. Additionally, those at the bottom end of the income spectrum, who generally have less support from the balance sheet factor, have seen even stronger wage gains that have outpaced inflation in some cases.

To be clear, none of this is to suggest a repeat of last year’s extremely strong 7.9% consumption growth, which would have been unlikely even if inflation had remained near target. However, the factors identified above should be enough to result in a consumption print with a 3-handle as opposed to a slowdown severe enough to approach a contraction, in our view, keeping growth at an above-trend pace this year.

However, this support will not last forever, and in 2023 we now expect a sharper slowdown as persistently high inflation leads to a more aggressive Fed and cuts into consumer purchasing power to a greater degree than we had previously anticipated. As a result, we now see a scenario that can be characterised as a ‘growth recession’ – a scenario in which growth remains

USA: accumulated savings to support consumption in the near-term



USA: wage growth remains elevated, but peak may be near



positive but slows to a below-potential rate while the unemployment rate ticks higher – with a 1.5% annual average pace. The quarterly pattern indicates an even sharper slowdown, with H223 growth in the 0.5% range, leaving a technical recession a real possibility, even if it is not our current base case.

As highlighted above, the key driver of the deteriorating outlook is inflation. Inflation not only remains far too high, but has become more broad-based and the May CPI report threw cold water onto the idea that we had moved past the peak. We now expect a stickier path, with headline CPI holding around the mid-to-high 8% range through Q322, only dipping below 7% in early 2023, and core CPI remaining below the March peak but moving very gradually on the way down to stay above 5% until December this year.

Consequently, we now anticipate that stickier and higher inflation will weigh more heavily on growth in 2023 through a few channels:

- ✓ The Fed has continually boosted its hawkishness through the first half of the year, and we now expect rates to move above neutral before year-end 2022. Combined with QT reaching a peak pace by 1 September, this should help tighten financial conditions further to weigh on growth.
- ✓ In this case, additional declines in equities may provide a hit to household balance sheets and thus a partial reversal of the strong wealth effect that consumers have experienced since Covid emerged, while interest sensitive sectors such as housing may decline further. A low share of adjustable-rate mortgages and low inventories providing support to home prices may limit spillovers to the rest of the economy, but a slowing housing sector should at the very least negatively impact residential investment and consumption of household durables.
- ✓ Higher inflation will likely keep real wage growth in negative territory for a longer period of time, which would cut further into consumer purchasing power.

Thus far, consumers have been able to dip into savings and/or borrow to maintain solid consumption, but eventually more households will work through savings/borrowing capacity, likely curtailing consumption growth.

- ✓ UofM consumer sentiment has plunged to an all-time low due to inflation concerns, worse than any point during Covid or the global financial crisis. While consumption data may remain at odds with this signal in the very near term, a widening gap between UofM consumer sentiment and the Conference Board's consumer confidence has reliably been followed by a downturn, indicating a high likelihood that rock-bottom sentiment will eventually manifest in actual consumption data.

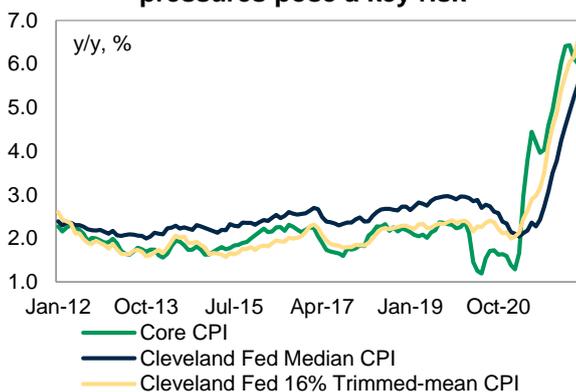
Investment may follow a similar lead to consumption, remaining relatively resilient in the near term before slowing more sharply next year.

Durable goods orders have been fairly solid and ISMs remain solidly in expansion, pointing to slowing but still positive investment in the near future. However, if financial conditions tighten further and consumer demand pulls back, then businesses may follow suit. Additionally, inventory rebuilding has been robust in recent quarters. While we expect rebuilding to continue, GDP is impacted by the change in inventories, so a still positive but slower pace of inventory replenishment would subtract from growth.

 Annual change	2022	2023
GDP	2.6%	1.5%
Inflation	8.3%	4.7%

As momentum slows, we believe that government spending is unlikely to ride to the rescue, in contrast to the unprecedented fiscal response to Covid. In the immediate future, opposition from Democratic senator Joe Manchin means that President

USA: broadening inflation pressures pose a key risk



USA: a rising gap between confidence & sentiment has typically preceded recession



Joe Biden’s Build Back Better plan looks to be dead in the water for now, and we expect no change after midterms. In these elections, Republicans look very likely to retake control of at least one chamber of

Congress, if not both, and they are all but certain to oppose any significant spending packages.

Nicholas VAN NESS

EUROZONE: THE NORMALISATION OF THE REAL ECONOMY WILL TAKE LONGER

The scenario of a drawn-out conflict means that we are forced to base our outlook for the Eurozone on several working hypotheses that carry a high level of uncertainty.

Solid fundamentals in the Eurozone’s private sector and the post-Omicron rebound will not be enough to fully offset the impact of the conflict. We are downgrading our Eurozone growth outlook for 2022 and 2023, and its pace will fall below potential as of mid-2022. The GDP gap to pre-pandemic levels, which has already been closed in France, Italy and the Eurozone average, will be filled a little later in Germany, but will not be closed in Spain within our forecast horizon.

Average annual growth will remain high in 2022 at 2.5%, driven by a solid carryover effect (2.5%) and Q1 growth of 0.6% (0.2% excluding the Ireland effect). However, average quarterly growth is barely above zero. Amid moderating inflation, growth will rebound modestly in the H223, reaching an annual average of 1.1%.

A contained, localised supply shock – for now

Reduced natural gas deliveries and the embargo on Russian oil and coal are a localised negative supply shock. There are substitutes, but these solutions are limited in the short term, especially when it comes to natural gas. According to the IEA, only 10-15% of Russian natural gas imports could be replaced by LNG imports in the short term.

One-quarter of the gas input used in electricity generation can be replaced by other energy sources, depending on the country and their energy mix.

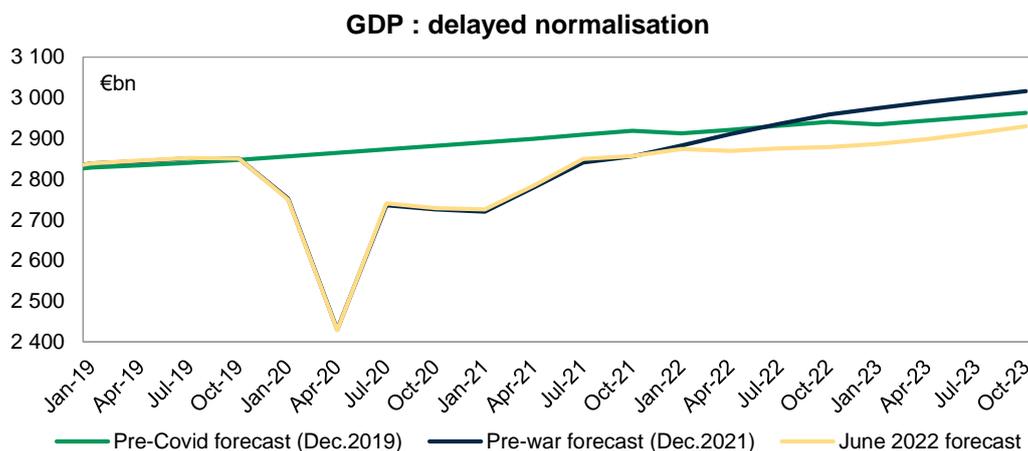
Although **households, industry and services can find substitutes for their energy consumption thanks to other inputs and final products that are less gas- and energy-intensive, natural gas cannot be replaced in many industrial processes** (eg, chemical processes). **Elasticity of substitution estimates for natural gas** in the Eurozone economies suggest that 10-20% can be substituted in the short term. However, this may increase in the longer term. Although **this elasticity is not high, the simple fact that it is not zero radically reduces the negative impact of the supply shock.**

The role of gas as a critical input in certain production processes may generate value chain amplification. The hardest hit sectors are expected to be chemicals, agrifood, transport equipment, textiles, non-metallic minerals and construction. Germany and Italy are the most vulnerable of the region’s major economies. At the time of writing, both countries have only moved to stage two of their emergency plans, which balance supply and domestic demand using market-based measures encouraging voluntary reductions in demand by industrial users. **At this stage, no rationing is to be imposed. However, this could prove necessary if our forecast for a further drop in supply in mid-2023 is confirmed. We also take into account constrained production in certain sectors in our forecast.**

Adversity is winning the battle with resilience.

A powerful but mitigated demand shock

Ultimately, the drop in Russian energy supply is primarily being transmitted in the form of a demand shock via increased prices and reduced



purchasing power. We are forecasting that inflation will peak in H222 and, although it will decline on the back of base effects that will positively impact the price index's energy component, it will remain high in 2023. Lost income is above 4% in 2022 and equal to 7% of households' fixed expenses. Government measures to support households have been able to reduce these losses by almost half (42%) in 2022. The excess savings accumulated during the pandemic – EUR890bn in the Eurozone as of the end of 2021 – are also providing additional support. This savings figure is 2.3 times the income loss caused by inflation. Although these savings are clearly skewed towards the wealthiest households, government support measures are primarily targeting the most vulnerable. **These mitigating factors do not entirely offset the loss of purchasing power, which is the reason behind the sharp slowdown in household consumption in our forecast.**

The terms-of-trade shock should remain stable

Our private consumption forecast assumes that **the wage response to higher inflation will be moderate, limiting the terms-of-trade shock by adding only a modest deterioration in unit wage costs and competitiveness.** The repercussions of higher, more widespread and more persistent inflation will be curbed by attempts to maintain employment in the face of a deteriorating economy. Until visibility on the inflation outlook is clearer, purchasing power losses are expected to be offset by bonuses rather than wage increases. This is exactly the stance that was taken during the most recent round of collective bargaining. **A substantial carryover effect (3% in Q122) related to higher numbers of hours worked, the impact of minimum wage increases in several countries and bonuses warrants solid growth in per capita wage in 2022 (4.4%). In 2023, the trend will be more directly linked to the terms of collective bargaining agreements and, as such, is forecast at 3.3%.** Given the normalisation of labour market participation, the unemployment rate will be mainly influenced by labour demand, which will be weakened by the slowdown in activity. **The renewed link between activity and the unemployment rate means that the latter is likely to rise slightly,** however, this will be mitigated by the resumption of short-time work schemes in certain manufacturing sectors hit by the supply shock.

The economic policy response

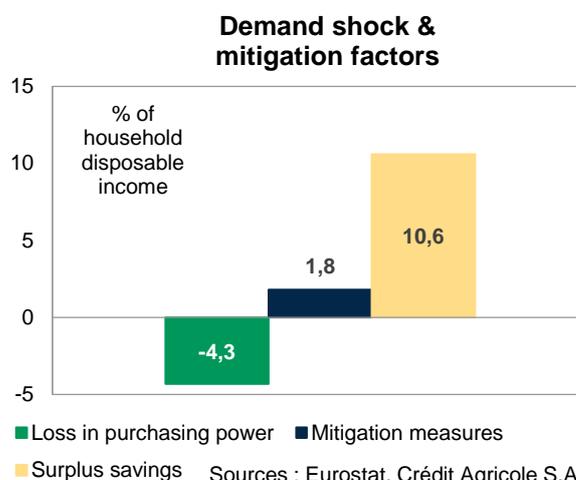
In this typical scenario of a supply shock triggered by a market failure (due to the power of a monopolistic supplier), state intervention in prices is justified and looks to be superior to any other solution. **In the absence of more direct, common EU action on natural gas prices, governments are adopting a targeted fiscal policy, reducing taxes and excise**

duties on energy and supporting the purchasing power of the hardest hit households and sectors. This policy will have an average budgetary cost of less than 1% of GDP and will be more than offset by the phasing out of Covid support policies and the improvement in the cyclical component of the public deficit. The fiscal stimulus excluding European funds will turn neutral once again, but the fiscal stance will maintain an accommodating bias thanks to the spending financed by the NGEU. The narrower deficit and negative interest rate-growth differential will further reduce the debt-to-GDP ratio in 2022. However, in 2023, the deficit reduction will not be enough to maintain the downward trend.

Annual change	2022	2023
GDP	2.5%	1.1%
Inflation	8.0%	5.4%

The increasingly likely risk scenario

The likelihood of a risk scenario where Russian gas supply is cut off completely is increasing. The later this occurs in our scenario, the more time substitutions and adjustments will have to take effect and mitigate the impact on growth. **In such a scenario, growth will be an estimated 2ppt lower than in our central scenario due to three increasingly acute shocks:** (1) a greater supply shock due to rationing; (2) a demand shock that will bite harder given higher inflation; and (3) a larger confidence shock accompanied by revised asset valuations. Economic policy action will therefore be crucial to temper the impact on activity but will be restricted by increasingly complex trade-offs.



Paola MONPERRUS-VERONI

UNITED KINGDOM: GROWTH DOWNGRADED AGAIN

The outlook is getting worse

We have downgraded our growth forecasts to 3.4% for 2022 and 0.9% for 2023, compared to 4% and 1.2%, respectively, in our April scenario, due to the combination of several headwinds. Firstly, inflation is expected to continue climbing, reaching 11% in October, primarily due to a further 40% increase in energy price caps. In addition, financial and monetary conditions have become much tougher in recent weeks, even though the BoE has not finished tightening its monetary policy. External demand is softening. We have reduced our growth forecasts for the Eurozone and the US, which are both key destinations for UK exports. The government’s support package released in May to help with the rising cost of living (totalling GBP15bn or 0.6% of GDP) is expected to add 0.3ppt to growth over the next 12 months. However, this will be mostly wiped out by the headwinds mentioned above.

The economy is slowing

Recent activity data has been disappointing. GDP has returned to its pre-crisis level and the recovery is naturally running out of steam. Activity declined in April (-0.3% MoM) after two almost stable months in February and March, leaving a growth carryover of -0.4% for Q22.

Short-term volatility due to the Queen’s jubilee

The Queen’s jubilee in June is likely to drag down Q2 growth figures, as there was one less working day during the month, but it should have the opposite effect in Q3. As an illustration, the ONS estimated that the

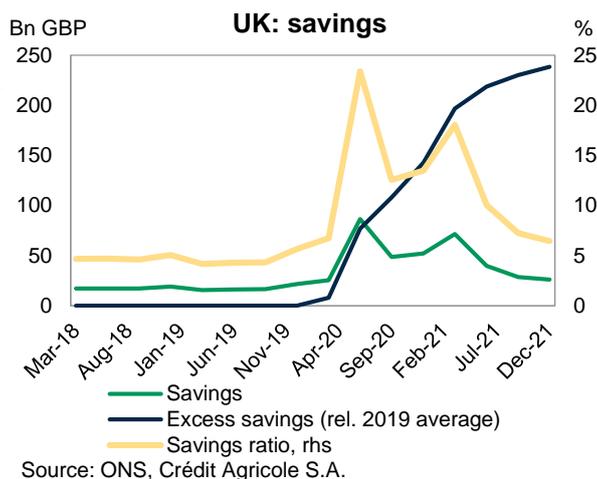
Diamond Jubilee would have a 0.3-0.4ppt impact on Q212 GDP, while highlighting the uncertainty around these estimates. The BoE estimates that the jubilee will clip growth by 0.25ppt. We expect GDP to decline by 0.5% in Q2 before experiencing a technical rebound of 0.4% in Q3.

 Annual change	2022	2023
GDP	3.4%	0.9%
Inflation	9.0%	6.4%

Factors underpinning private consumption are still apparent

With purchasing power expected to plummet this year (-2%, the biggest drop since the 1950s), households will have to dip further into the savings accumulated during the pandemic to cover their spending. Although the savings rate (6.5% in Q421) probably returned to its pre-crisis level in Q1, the savings surplus is still considerable at around GBP230bn, or 9.6% of GDP. Add to that the tight labour market where hiring challenges due to persistent shortages in the working population are conducive to wage renegotiations. The BoE’s Agents surveys show wage renegotiations up 5% this year, well above what was observed before the pandemic.

Slavena NAZAROVA





EMERGING COUNTRIES

Navigating through narrow channels

Overview – Navigating through narrow channels

China – Around or about?

Brazil – The tightening cycle is drawing to a close

Russia – Domestic weakness, external resilience

India – Playing catch up

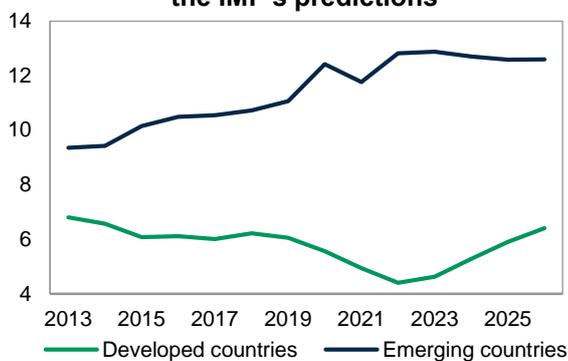
Navigating through narrow channels

The risk of stagflation is clear despite the wide gaps between regions and countries – stretched further by the rentier effect. Behind this inflation, a political risk cycle is looming, while general rate hikes could reveal underlying systemic liquidity risks in many emerging markets, exacerbated by Covid.

Developing countries are entering a tough quarter: they are facing down the growth/inflation jaws which are both stronger than in developed countries (more inflation and more growth shock) and harder to manage, because monetary and fiscal policies have less leeway, especially as the public health crisis has increased public debt in emerging markets, from an average of 52% between 2015 and 2019 to 67% of GDP in 2021. In these circumstances, the tightening of global financial conditions is a real challenge.

Almost every country, with the notable exception of China, is caught in this wave of inflation: 80% of developing countries have inflation that is higher than the five-year average. Nonetheless, the difference in the pace of price increases remains stark between Asia and the Middle East, which are less affected than Central Europe, Latin America and North Africa. This difference is echoed in the scale of interest-rate hikes since the end of 2021, which are averaging under 100bp in Asia, but are at 500bp in Colombia, 400bp in Brazil and 425bp in Poland.

**Interest payable on taxable income:
the IMF's predictions**



When all countries are hit by inflation, it is because supply shocks are universal (war and disrupted supply chains); but when they are hit in different ways, it is because those shocks are asymmetric in their direct impact: the war in Ukraine is hitting Eastern Europe first, and the Chinese slowdown is threatening Asia first. Rising wheat prices are impacting Africa first, before Asia, which is more dependent on rice. Nonetheless, these developing countries have something in common: they are on the front lines of a massive uncertainty shock, which is driving investors to look for safe havens in developed countries. According to UNCTAD, new direct investment in 2021 was concentrated in developed countries, driven by the

refocusing strategies of multinationals, which make up three-quarters of the total.

This confidence shock is attributable to three factors: (1) the uncertain ending to the war, of course; but also (2) doubts as to the viability of the Chinese growth model; and, last but not least, (3) the challenge to hyper-globalisation, which may be showing its limits due to Covid and then the war. Food inflation is the most acute symptom of such globalisation which has become dangerous for the 700m people experiencing food distress, or for countries worried about grain supply, ie, Egypt, Jordan, Lebanon, Morocco, Armenia and the smaller Central Asian countries. As for the many unilateral decisions to limit food exports, these are spreading the inflation shock, even to countries that are on solid economic footing. What about Singapore, for example, where the price index reflects the disruption of exported palm oil purchased in Indonesia or chickens from Malaysia?

From rate hike cycle to political cycle

The stagflation trap is very strong for EM central banks. They simultaneously have to manage the defence of the exchange rate, price increases – with indices more sensitive to energy and food as well as inflation expectations, which are falling fast – and the preservation of growth, where Covid left deep scars on labour markets. Maintaining the monetary authorities' credibility is tricky work, and for those countries that are just barely getting into monetary tightening, such as India, the pressure not to unhook from the global cycle is a constraint.

Central banks are also facing a high political risk. In Sri Lanka, Peru, Chile and Ecuador, protesters are decrying higher food prices and energy disruptions. As for the striking Chilean copper miners, they are sinking investment in the sector, reminding us that managing inequality must sometimes (always?) come before the financial rationale of the energy transition. In short, the social risk, so visible in a left-leaning Latin America, is now one of the most powerful avatars of the inflation wave. In South Africa, the good news on current account surpluses is not enough to counteract the jobless rate or stagnant growth stemming from public companies' inertia. And finally, let's remember that in 2008, when grain prices were soaring, there were uprisings in 60 countries. And the Arab Spring sprang from a Black Sea wheat crisis.

Watch out for systemic liquidity links: banks, governments, businesses

Monetary tightening cycles always train the spotlight on the usual suspects in terms of refinancing short-term foreign currency debt. In addition, EMs have a higher average level of interest to pay compared to their tax revenues than developed countries (12.8% vs 4.4% forecast by the IMF for 2022). For now, the EMBI Index does not point to a sovereign concern for the markets, which are no doubt reassured by the size of EMs' currency reserves.

EMs have a higher average level of interest to pay compared to their tax revenues than developed countries.

And yet, the increased sovereign exposure of developing countries' local banks –17.2% of total assets in 2021 – strengthens the sovereign/banking connection. This is a major risk, and the ratio is 42% in Egypt, 44% in Pakistan and 40% in Ghana. Liquidity links have also solidified between companies, banks and governments due to Covid. Rating agencies consider that 30% of EM businesses are at greater risk. Systemic risks in EMs have increased, and many shocks can reveal them.

Differences among regions persist

Ultimately, **in regional terms, Central Europe is feeling the biggest inflation/growth pinch.** But there are also countries that receive EU assistance and the prospect of deferred direct investments leaving Russia. So, the hard times are not expected by markets to last too long, especially as central banks are being responsive.

On the other extreme, **the Gulf nations are leveraging their rent,** with an accumulated current

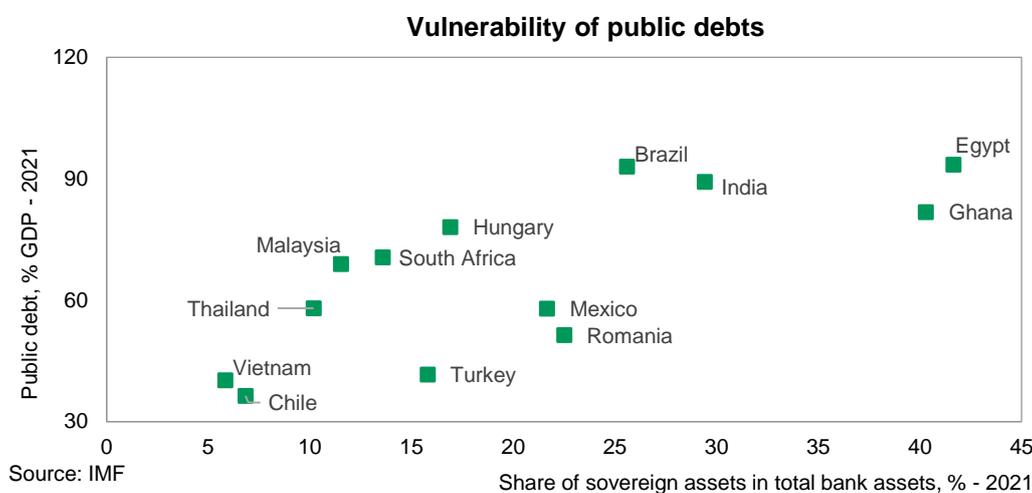
account surplus that is expected to rise from USD120bn in 2021 to USD400bn in 2022, and an increase in their public assets abroad. The United Arab Emirates are rising in the Kearney Foreign Direct Investment (FDI) Confidence Index, pulling ahead of Singapore. Meanwhile, others are profiting from this energy windfall, such as Egypt, where Saudi Arabian and UAE deposits to the central bank have helped to check the EGP's depreciation.

The UAE and Qatar had already come to Turkey's aid, as it is one of the energy-importing countries whose balance of payments is suffering from the energy war in Europe. Turkey, unfazed by its NATO membership, is trying to shore up its external accounts with tourism agreements with Russia (and drone sales to the whole world). But it has yet to adopt India's and China's solution of buying cut-rate Russian oil.

And in the middle ground, **Latin America is still benefiting from improved terms of trade** which is neither solving the structural (especially fiscal) problems nor providing any long-term answer to stagnant growth in major countries. Lastly, Asia is offering more resilient growth, despite current account deficits that are on the rise in the energy-importing countries. It stands to gain from China's end-of-year recovery.

Thus, EMs are moving into a dangerous phase that threatens the most fragile – socially, fiscally and financially. The solution is in the hands of central banks and governments, which have the delicate task of steering underlying stagflation. Still, the real issue behind inflation is growth, which is the only thing likely to reduce debt ratios, preserve investor confidence, reduce inequality and provide the resources to fight climate change.

Tania SOLLOGOUB



CHINA: AROUND OR ABOUT?

That is the question Chinese authorities must ask themselves. In March, they announced a growth target of “around 5.5%” for 2022. This would require a growth rate above 7% over the second half of the year. Right now, that seems out of reach, particularly as President Xi Jinping has said repeatedly that he does not intend to abandon the zero-Covid strategy which has been so costly both economically and socially.

China’s two heads

To no one’s surprise, **Q2 numbers are expected to show a clear slowdown in domestic activity** with declines in industrial output, retail sales and the real estate market, for growth that has not exceeded 1.5% YoY and has eroded by 2% or more on a quarterly basis. Add to this the new worry of youth unemployment figures, which came out to 18.4% in May, just as 11m new graduates are poised to enter the job market this summer. In the midst of this, it is hard to imagine that private consumption will see anything like a real recovery, particularly as households have increased their savings rates once again to manage the risks of another lockdown or an even worse labour market.

Against a backdrop of flat demand, the authorities also want to use the usual recipes more sparingly.

The paradox in this universe under duress?

Foreign trade. We expected foreign trade to decline due to the slowdown in western demand but, in reality, it has remained extremely robust. Of course, China is hurting as badly as the rest of the world from high commodity prices, but it has benefited from its “neutrality” in the Russia-Ukraine conflict by getting reduced prices on Russian oil (which is being sold at USD30-40/bl below market prices). On the other hand, exports have accelerated to around USD300bn per month. This puts China’s annualised trade surplus at an all-time high of nearly USD780bn. Just the thing to increase foreign trade’s contribution to growth and let in a little air.

What public support?

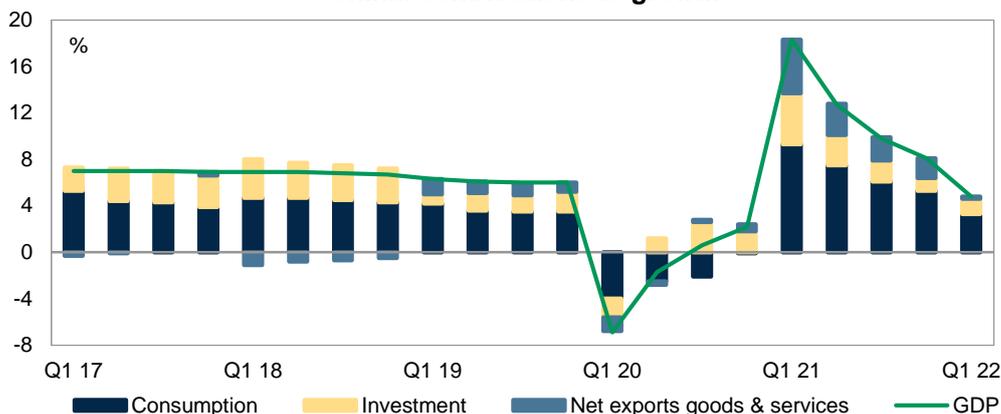
And Xi Jinping will need some of that air to show up strong to the 20th Congress of the CCP in the autumn, at which he is expected to be re-elected for a third term. It is hard to make the numbers fit. Against a backdrop of flat demand, the authorities also want to use the usual recipes more sparingly (accommodating monetary policy and acceleration of business loans) so as not to drive the economy deeper into debt, which had at last begun to diminish in 2021, but they have few alternatives. So public spending, specifically in the local communities, has been concentrated to fully activate the multiplier effect – and it could accelerate after the summer as the Congress draws nearer, before declining at the end of the year.

 Annual change	2022	2023
GDP	4.0%	5.5%
Inflation	2.4%	2.0%

The authorities also reviewed certain regulatory provisions, particularly in tech, to give a sector that is under pressure – but shows great job-creating potential – a little more breathing room. At last, they have made some concessions in the real estate sector, authorising new building permits even though it goes against some of their principles. Ultimately, then, it is still investment that will drive a great deal of growth in 2022. And the question comes up again: investment, but how much, and toward what growth target? China has shown that as far as public health goes, it intends to stick to the letter of the law. Now it remains to be seen whether the spirit can give life into the rest of it.

Sophie WIEVIORKA

China: contributions to growth



Sources : national

BRAZIL: THE TIGHTENING CYCLE IS DRAWING TO A CLOSE

Back to old tricks

With inflation persisting around 12% YoY, Brazil's congress is moving forward with a number of measures designed to lower fuel prices to consumers. A bill that forces the states to lower taxes on fuel, electricity, natural gas, telecommunications services and public transportation has been recently approved by congress. Separately, congress is reviewing a constitutional amendment that authorises the federal government to compensate the states that temporarily eliminate state taxes on diesel, through the end of this year, with combined compensation of up to BRL50bn. Although the timeline for approval of typically time consuming constitutional amendments before the summer recess in mid-July is tight, we believe the approval is likely given the importance of the issue to voters and the incentives for congress to score points ahead of the general elections in October.

former President Lula da Silva's Workers' Party indicate that the constitutional cap will also most likely be recalled under a potential Lula administration.

The constitutional spending cap adopted in 2016 has been arguably the strongest anchor for Brazil's fiscal dynamics.

The tightening cycle is drawing to a close

The decline in inflation from 12.13% YoY in April to 11.73% YoY was a welcome sign for the central bank (BCB) that inflation may be finally peaking. After lowering the size of the increase to the target Selic rate to 50bp at the last meeting in June, for a cumulative 11.75% of policy rate hikes since the start of the tightening cycle last year, the BCB has signalled that it is nearing the end with forward guidance for another hike "of the same or lower magnitude". We expect the tightening cycle to conclude with Selic rate at 13.75%, and as inflation converges to our 7.5% year-end forecast, expect the BCB to pivot towards a shallow easing cycle starting at the end of Q322.

With GDP rising by 1% QoQ in Q1, driven by continued post-pandemic reopening and expansion in the services sector, and thus solid momentum heading into the rest of the year, we have nudged up our growth forecast for 2022.

Lula remains favoured to win the election

Finally, ahead of the presidential election in early October, Lula remains favoured to win the election. We expect Lula's odds of winning to remain strong as long as the incumbent president Bolsonaro's approval rating remains under 40%, third-way party candidates struggle to gain momentum and the electoral focus remains squarely on the economy, an issue on which Lula traditionally scores highly among voters.

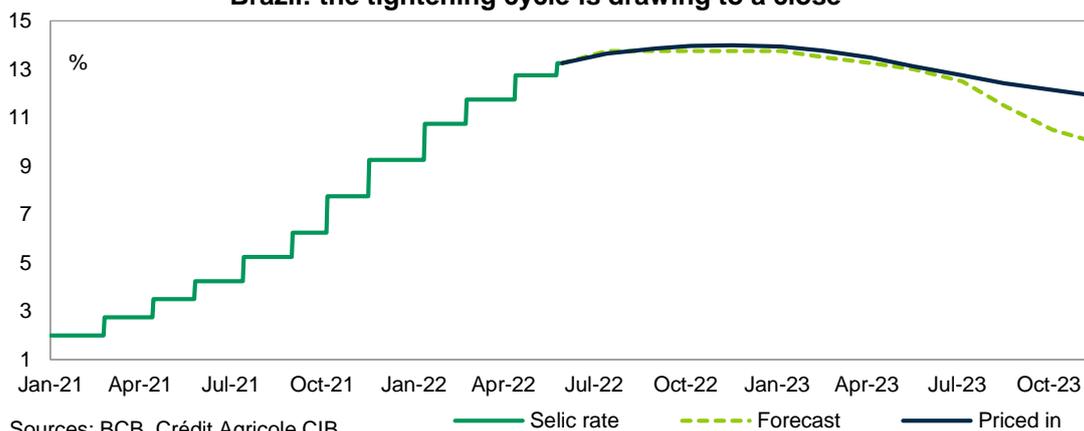
Olga YANGOL

Annual change	2022	2023
GDP	0.9%	1.2%
Inflation	7.5%	4.5%

The future of the constitutional spending cap is in question

It should be noted that the impact of the latest fiscal proposals, while significant for Brazil's fiscal situation in 2022, is even more important for the market's assessment of the fiscal framework under the next administration. The constitutional spending cap adopted in 2016 has been arguably the strongest anchor for Brazil's fiscal dynamics. The continued revisions to the rule under the current administration through various means signal that the cap is likely to be abandoned even if President Jair Bolsonaro is re-elected. Furthermore, the guidelines released by

Brazil: the tightening cycle is drawing to a close



RUSSIA: DOMESTIC WEAKNESS, EXTERNAL RESILIENCE

GDP growth is likely to contract strongly this year on the back of sanctions. Although it is difficult to come out with high conviction forecasts, we still expect a contraction close to the double-digits this year. The growth profile itself has been drastically modified by the very specific environment. In a nutshell, domestic demand is under strong constraint, whereas the contribution of net exports acts as a buffer.

Strong economic contraction

Both consumption and investment are suffering from disruptions and supply chain problems. Higher interest rates also put pressure on economic activity. In the first phase, the CBR abruptly increased its policy rate to 20%, shocking the financing of the economy. In the second phase, as the RUB was recovering, the central bank lowered the policy rate in April, and again in May and June. Currently at 9.5%, the 1W repo rate is back to where it was at the beginning of February. When it comes to interest rates, the picture is different depending on whether one looks at the YoY deflator or at a sequential deflator. Sequential inflation has decelerated strongly since April and reached close to zero in June. As a consequence, high real interest rates are constraining activity further. Investments represent a strong drag on growth in 2022.

Despite the sanctions from the US and EU, oil exports have remained strong. This is partly because other countries have imported more Russian oil YTD.

RUB recovery

Russia’s external situation strongly contrasts with its domestic situation. Despite the sanctions from the US and EU, oil exports have remained strong. This is partly because other countries have imported more Russian oil YTD. Higher energy prices have also helped (even after taking into account the price discounts Russia had granted). For instance, the value

of China’s imports of crude have increased by more than 100% in May compared to one year ago. India has also stepped up its imports of Russian oil. This shift in the regional structure of commodity exports reflects the geopolitical situation, and could actually last. It suggests Russia could be able to continue to benefit from export proceeds. The decrease of gas exports to Europe via Nord Stream 1 in June also suggests that Russia has enough leeway coming from its non-Western clients to consider using energy exports as a geopolitical tool.

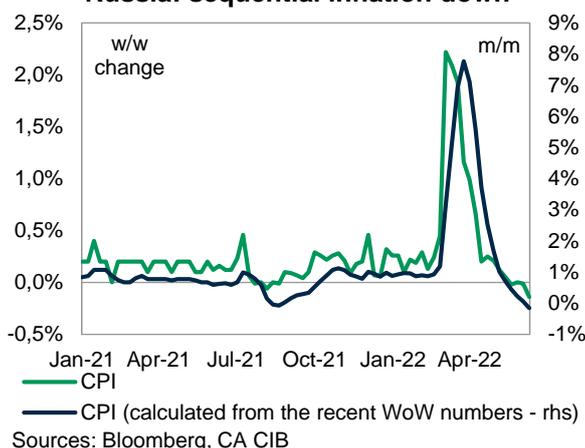
 Annual change	2022	2023
GDP	-9%	-2%
Inflation	17%	12%

How strong is too strong

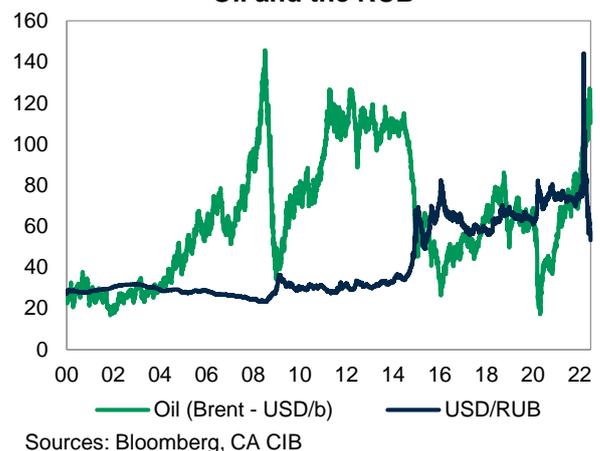
As a consequence of surging external surpluses (combined with capital controls), the RUB has rebounded after its initial collapse, and has appreciated far beyond its initial level. One could argue this is a sign that sanctions have had a limited financial impact, and a sign of Russia’s resilience. However, it also generates a difficult situation for Russia. A strong currency weighs on external competitiveness and caps the RUB value of commodity exports. It also fuels deflation risks. Against such a backdrop, a debate has emerged as to whether the monetary authorities should return to a policy aimed at controlling the exchange rate (which would contrast with the inflation targeting framework that has prevailed since 2014). The central bank would prefer to keep the current system, and it will likely continue to lower interest rates in order to fight deflation and cap the RUB’s exchange rate.

Sébastien BARBÉ

Russia: sequential inflation down



Oil and the RUB



INDIA: PLAYING CATCH UP

India's economy continues to emerge from the pandemic in reasonably good shape and we forecast real GDP growth of 7.4% in 2022; slower than the pandemic rebound in 2021, but nonetheless still respectable growth. Supporting growth will be the continued re-opening of the economy post Covid and rising consumption. The government's budget deficit is also expected to remain above 6% of GDP as it continues to spend big on infrastructure. A La Nina event and good monsoons should mean another solid growing season and firm agricultural production. India will also be a beneficiary of falling global refining capacity and a rising crack spread, which will boost its refining sector production.

India's economy will continue to rebound post Covid, but getting inflation back under control will be a major challenge.

Challenging growth, however, will be high inflation, which will lower households' spending power. We expect inflation to be 6.3% in 2022 and significantly above the upper end of the RBI's target range. Our Brent crude forecast for end-2022 is USD130 per barrel, so oil prices will not provide any relief from inflation. Imports of discount Russian Ural oil will not offset the higher cost of crude from the Middle East, which currently supplies about two-thirds of India's oil. Strong agricultural production will provide only modest relief from food prices inflation. We are sceptical of the inflation relief expected by the government from wheat export and sugar export restrictions. Government tax cuts on fuel, edible oils and materials for making steel as well as fertilizers only help offset some of the rise in these costs due to international pressures.

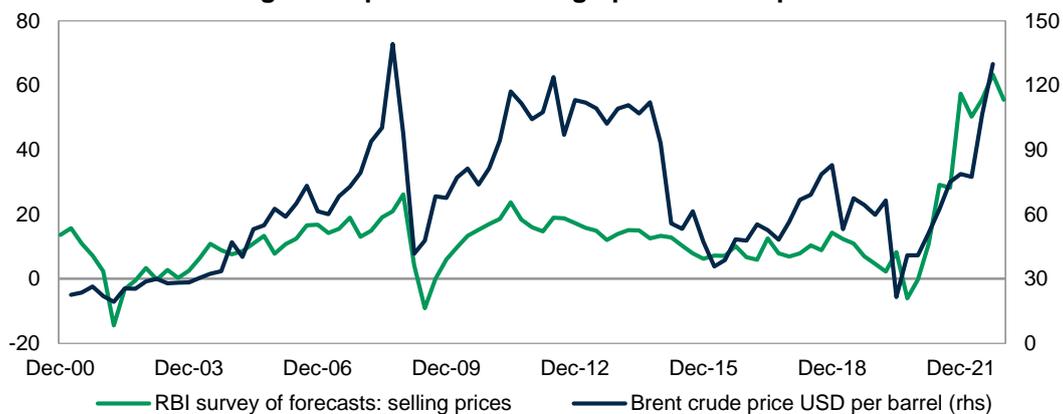
We expect RBI to hike its reverse repo rate to 6% by end-2022 from 4.90% currently. The central bank is yet to reach its pre-Covid level in rates (5.15%) and remains well below what it considers to be the neutral rate at 5.75%. RBI has started hiking when inflation was already above target and when inflation expectations were already tracking higher. So, the central bank will have to act swiftly to contain inflation.

 Annual change	2022	2023
GDP	7.4%	6.0%
Inflation	6.3%	4.5%

Despite aggressive rate hikes by RBI, the INR should continue to depreciate. We forecast USD/INR to peak at 78.50 in Q3 before declining to 77 by year-end on the back of a weakening USD. Persistently high oil prices and rising UST long-end yields will keep downward pressure on the INR in the near term. While RBI will be hiking rates aggressively, it has also pledged to limit the upside in long-end Indian government bonds in order to ensure orderly government bond auctions. Higher local rates will weigh on India's equity market and foreign capital inflows into India. India's current account deficit at 2.5% of GDP will also be a challenge to the INR, but RBI has over USD600bn in FX reserves to deploy to slow the currency's decline. Indeed, RBI wants to lean against INR depreciation in order to reduce imported inflation.

David FORRESTER

India: higher oil prices are driving up inflation expectations





SECTORS

Oil – All quiet on the Eastern front

Gas – You’ve really got a hold on us!

Aircraft manufacturing – The challenge of ramping up production!

Automotive – “May the force be with you”

Shipping – Traffic on the wane against a backdrop of persistent logistics crises

Oil – All quiet on the Eastern front

Without enough surplus oil capacity on the market, and no prospects for a political solution to the Russia-Ukraine conflict, the fallout that was immediately visible at the start of hostilities (high oil prices and oil crack spreads) is expected to last for the rest of 2022 and 2023.

The oil market is clearly still marked by the conflict between Ukraine and Russia. More substitutes for Russian oil are being phased in, keeping the spread wide between Russian and European oil prices – a spread that was formed as soon as the conflict began. Replacing Russian oil products is also sending crack spreads soaring¹ for gasoline, diesel and kerosene. The conflict’s impact on petroleum products is upping oil prices for consumers. The lockdown in Shanghai that ended in late May also added to the very recent oil price hike.

Our scenario is based on a stalemate in the Russia-Ukraine conflict and thus the extension of sanctions and reprisals between the West and Russia. Europe’s embargo on Russian oil and oil products, to be applied at the end of 2022, will remain in effect throughout 2023.

In this environment, the oil market will likely continue to suffer from supply shortages. Saudi Arabia and the other major producers from the Persian Gulf will increase their output but will not have enough of a margin to relieve the oil market in any substantial way. Faced with declining production, the other major OPEC producers like Nigeria and Angola will be ill-prepared to back Middle Eastern producers. Still under the yoke of US sanctions, Iran is expected leverage its Chinese and Russian support to ease production upward. Lifting US sanctions against Venezuela – key to any recovery for Venezuela’s production, the victim of several years of underinvestment – will not be enough to count on a rapid or widespread recovery in

oil production. The increase in US oil production, essentially due to the Permian Field and the liquids associated with natural gas production, will remain modest and will not be enough to offset the drop in Russian output.

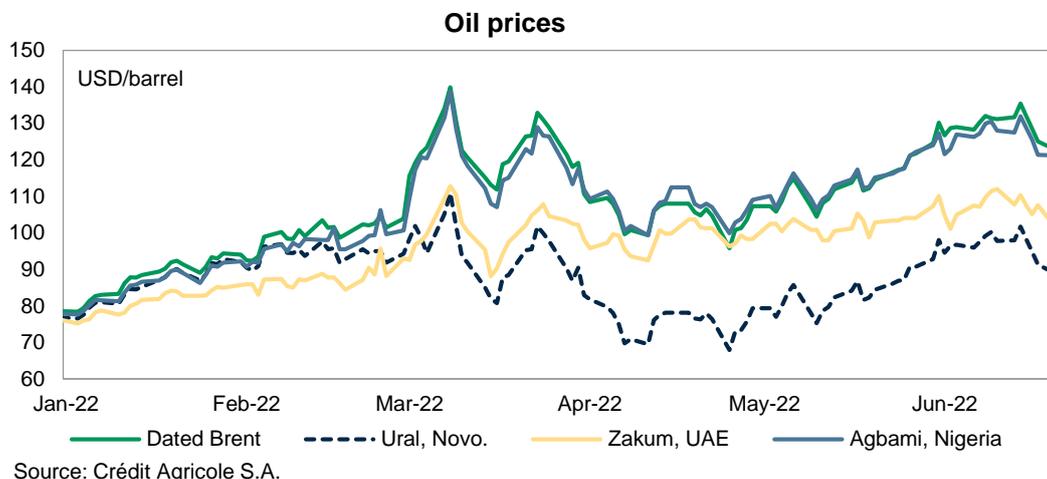
With refineries already operating at full volume and no new refining capabilities in Europe or the US, there is little hope of any easing in oil crack spreads in the short term. While the majority of new refining capacity is basically in the Middle East and China, China will likely limit its petroleum product exports to protect its domestic market.

Average oil price (barrel)	
H222	USD127
2023	USD131

Without the required inventory following several quarters of drawdowns, demand will have to adapt if the oil market is to be balanced. Under the impact of high oil prices and oil crack spreads, demand for oil in 2023 is expected to drop slightly.

Accordingly, our scenario assumes prices will stay high through the H222 and into 2023 at USD127 and USD131, respectively, per barrel.

Stéphane FERDRIN



¹ Crack spread refers to the pricing difference between a barrel of crude oil and its byproducts such as gasoline, diesel, heating oil, kerosene...

Gas – You’ve really got a hold on us!

The tug-of-war between Europe and Russia is bound to play havoc with Europe’s natural gas supply. With the natural gas disruptions coming from Russia, Europe’s only solution will be diverting LNG tankers from Asia.

The second quarter of 2022 showed a gradual decline in Russian natural gas imports. After flows through the Yamal pipeline crossing Belarus and Poland were stopped in April, and flows through the Druzhba pipeline through Ukraine were reduced, Gazprom now says that, since it cannot recover an essential part of the turbine that is under Western sanctions, it has no choice but to drastically cut natural gas flows through the Nord Stream 1 pipeline. Daily imports of Russian natural gas by pipeline are down by one-third, compared to this time last year.

Supposing that the flows via Nord Stream 1 and Brotherhood hold at the current level, Europe would import just 55bn/m³ of Russian natural gas, about one-third of its natural gas imports from Russia prior to 2020. When the conflict began, Europe announced it planned to reduce its Russian natural gas imports by the end of 2022. Today, its back is up against the wall, since it has to achieve its aim by offsetting this reduction by importing liquefied natural gas (LNG). **At current consumption levels, and with a natural gas inventory fill rate of 90% before winter (vs 77% the previous year), Europe will have to import nearly 156bn/m³ of LNG in 2022 compared to just 90bn/m³ in 2021.** This means 13bn/m³ of LNG must be discharged every month in Europe’s regasification terminals.

Now, over the first five months of 2022, monthly LNG imports average a little less than 12bn/m³. **So Europe must kick its LNG imports up a notch: this will not be easy, at least until September,** the projected startup date of the US terminal Freeport, which fell due to an incident and a technical shutdown in early June. With the temporary shutdown of Freeport and its annual capacity of 19bn/m³, the LNG market is threatened with the loss of 5bn/m³ over the next three or four months. Compared to 2021 LNG market data, then, Europe will have to increase its purchases on the spot/short-term market by 74bn/m³ (+150%). Considering that little of the new natural gas liquefaction capacity will be operational, with the exception of the US Calcasieu Pass terminal, Europe will have to draw more than 55% of the spot/short-term market to its regasification terminals in 2022; in 2021, Europe’s spot purchases amounted to just 17% of the

market. This means that Europe must divert nearly 74bn/m³ of LNG from its traditional customers, most of whom are in Asia.

This competition will inevitably result in higher natural gas prices, to the detriment of those LNG countries that are least equipped to adopt an “at any cost” policy. But even if those countries drop out, which seems likely, it will not be enough to quench Europe’s thirst. Europe will also have to retrieve its LNG tankers from its Chinese, Japanese and Korean customers. And Europe’s additional needs are enormous; those 74bn/m³ of LNG will make up more than 60% of Asian spot purchases in 2021. To avoid any shortage or rationing, Europe’s financial outlay will be massive, with natural gas prices that could routinely equal the prices Europe was paying in December and in March at the start of the Russia-Ukraine conflict. The situation will also have repercussions for the energy market in Asia. Asian customers who give up LNG will most likely turn to coal. The shift of 74bn/m³ from Asia to Europe could potentially mean a nearly 250m/tonne increase in coal consumption in Asia, which is 70% of China’s annual consumption.

The situation is not expected to improve in 2023 and could even worsen if the fighting in Ukraine reaches a stalemate and sanctions against Russia are extended. In that kind of scenario, Nord Stream 1 could be totally shut down in mid-2023. In fact, Gazprom usually conducts its maintenance operations on Nord Stream 1 in July. Still deprived of any equipment from the West, Gazprom could put an end to Nord Stream 1 operations. If flows were maintained through the Druzhba pipeline, Russian natural gas imports could fall by 24bn/m³, forcing Europe to import nearly 185bn/m³ of LNG – the entire spot/short-term market in 2021. Even with new floating regasification terminals in operation, but without any new natural gas liquefaction capacity in 2023, **it looks like Europe will have a hard time absorbing virtually all of the LNG spot/short-term market** – and so the risks of natural gas rationing and shortages for Europe will increase in 2023.

Stéphane FERDRIN

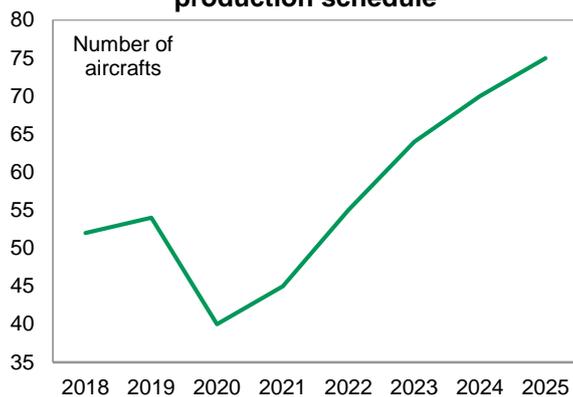
Aircraft manufacturing – The challenge of ramping up production!

Amid the recovery in air travel, the increased production expected from subcontractors is putting the entire supply chain under pressure. Ensuring the 2022-23 ramp-up can be achieved in an economy under strain (hiring, logistics, supplies of materials) is a key concern.

After two major crises – Boeing 737 Max and Covid – during which the sector showed great resilience and solidarity, it is now faced with the fallout from the Ukraine conflict.

While domestic air travel in China returned to its pre-crisis level in October 2020, the government’s zero-Covid policy severely impacted travel in the first half of 2022. Appetite for travel remains the same, even though the recovery of international travel remains highly dependent on borders reopening, which is reflected in bookings.

Airbus’ announced A320 monthly production schedule



Sources: Cour des Comptes, Crédit Agricole S.A.

The Russia-Ukraine conflict led 36 countries, including the 27 EU members plus Canada and the UK, to close their air space to Russia, which retaliated by doing the same. Elsewhere, international air travel to and from Russia appears to be continuing relatively normally, especially with China and India. The short- and long-term impacts of the conflict on air travel are likely to remain limited, especially since Russian air traffic does not account for a large proportion of global travel. Domestic air travel in Russia and Central Asia accounted for 5% of global air traffic in 2019, and the region’s international travel was negligible.

Amid solid demand, the Russia-Ukraine crisis is not causing European manufacturers to shift the timelines they are expecting from their subcontractors.

Successfully ramping up production remains the sector’s main concern, in terms of commercial, business and military aviation. Indeed, the different sub-sectors are not coming out of the crisis at the same pace as stakeholders are in varying positions in the industrial cycle and involved in different programmes. For subcontractors in narrow body programmes, the recovery is looking strong and will pick up further, stretching working capital requirements and cash flows. For subcontractors in the wide body programmes, the recovery is much further away.

Supply chains’ operating performance indicators are below the levels expected by customers, which shows how challenging it is for businesses to increase capacity.

The main headwind in terms of exiting the crisis is the weaker labour pool. While the sector has long been battling the fact that its production lines are not particularly appealing, debates on the impact of air travel on the climate have fuelled questions about how sustainable these jobs are. Increased competition from other sectors such as healthcare, energy and logistics is also having an impact.

 First trade surplus	
2019	EUR31.1bn
2021	EUR19.7bn

The aerospace sector expected it would have to ramp up production and began moving to secure supplies in 2021. It had already taken measures to secure supplies before the war broke out in Ukraine, in particular by building up buffer stocks and diversifying sources of materials. Although deliveries of metals essential to the aerospace sector – especially titanium – do not appear to be in jeopardy, persistently high prices in the long term will erode the sector’s competitiveness.

PASCALE ROMBAUT-MANOUGUIAN

Automotive – “May the force be with you”

The global auto industry continues to send mixed signals that are not matching up with past cycles or with any traditional macroeconomic analysis components.

Disrupted supply chains and rising commodity prices are resulting in higher volatility in auto production volumes, which is weighing even more disproportionately on profit margins. This series of external shocks is increasing uncertainty and the auto market outlook in 2022.

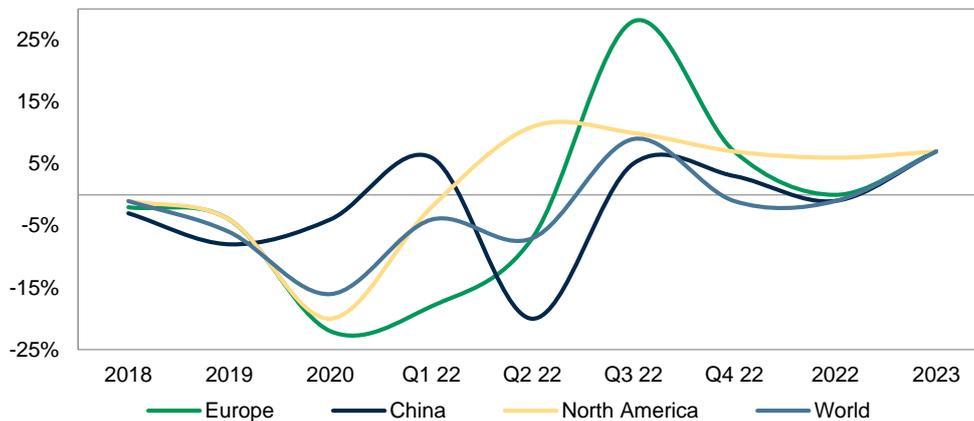
Widespread price increases: as a result of supply chain problems exacerbated by the conflict in Ukraine, prices on some commodities like aluminium have skyrocketed. At EUR3,000 per vehicle, the average cost of raw materials has risen almost 50% compared

to Q219 and now makes up 12% of the cost of a vehicle, compared to 8% in 2019.

More important are the rising costs of related materials used in making batteries: right now, more than commodities or semiconductors, it is the shortage of commodities used in making batteries – specifically lithium and nickel – that is worrying stakeholders. This is not only pushing up costs but also limiting growth in electric vehicles over the long term.

Véronique VIGNER

Evolution of automotive production



Source: Crédit Agricole S.A.

Shipping – Traffic on the wane against a backdrop of persistent logistics crises

Inflation, geopolitical uncertainty and logistics disruptions are dragging down demand and freight. Although there is no guarantee that high-season traffic will rebound, port tensions are expected to return to Europe and North America this summer.

Spot freight rates have ebbed sharply since the Chinese New Year. They are stabilising across Asia-Europe routes as the high season approaches, but continuing to decline on trans-Pacific routes, where there is now talk of overcapacity. Although spot rates are back down to where they were a year ago, they are still four to five times higher than pre-pandemic levels. At the same time, the **catch-up on contract freight rates** – which have doubled or tripled over one year – is more than making up for the spot's decline, driving growth in revenues and carrier profits, and adding to the inflationary push.

Demand is noticeably dampened now, with figures for 2022 now estimated at between -1% and +1%. Global container traffic fell back during Q1, with China's lockdowns partly to blame. With inflation bloating non-discretionary household spending and service expenses picking up again, imported goods purchases are suffering. On top of it all, geopolitical fears are putting a bigger dent in confidence. Retail sales volumes in the US, which drove growth for two years, are headed downward. Major retailers like Walmart are reporting excess inventory, casting doubt on the prospect of vigorous high-season traffic around the corner.

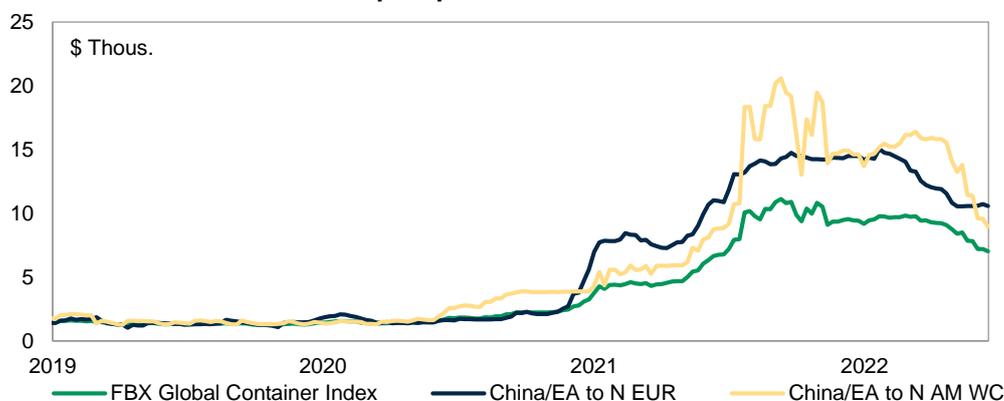
On the logistics crisis front, amid the wreckage in Ukraine and the lockdowns in China, **new obstacles**

are coming into view. With restrictions eased in China, a wave of shipment backlogs could overwhelm already bottlenecked Western ports. The news of another round of partial lockdowns comes as a reminder that the zero-Covid policy poses a latent threat to supply chains. **Tense wage negotiations in developed countries**, another of inflation's hazards, **are adding more pressure to congested ports.** While labour unions want to send a reassuring message on the ongoing dockworker contract squabbles in the US, it is in the Northern European hubs – particularly Germany, the new black spot of port congestion – that the summer promises to be high-risk, as overstretched ports face the threat of rotating strikes.

Once the high season is over, **the clouds gathering over demand are upping the likelihood that spot freight rates will come back down** and that average transport costs will start their descent, cushioned by the record-breaking contracts of 2022. The book-to-ship ratio is now at its highest level since 2010. Under the avalanche of deliveries expected in 2023 and 2024 plus, eventually, huge capacity that is currently neutralised by port congestion, **the sector could be back to overcapacity a year from now.**

Bertrand GAVAUDAN

Transport price of a 40-foot container



Sources : Datastream, Freightos, Crédit Agricole S.A.



MARKETS

Monetary policy – Curbing inflation is the priority

Interest rates – Much higher, much faster

Exchange rates – The dollar's advantage

Monetary policy – Curbing inflation is the priority

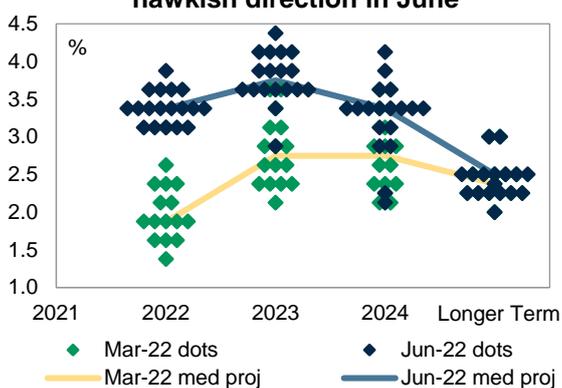
Higher, more widespread and potentially more persistent inflation has toughened rhetoric and subsequently action from central banks. While the US is justifiably well ahead in the tightening cycle, the Bank of England is taking a more cautious (even ambiguous) approach and the ECB is only just starting to hike rates.

FED: FOMC CONTINUES TO RAMP UP HAWKISHNESS

After executing an abrupt pivot in a hawkish direction at the end of 2021, the Fed has only continued to gear up its hawkishness, with inflation consistently surprising to the upside in the first half 2022. This was evident in the FOMC hiking by 75bp for the first time since 1994 at its June meeting, with another upward shift in the dot plot that now shows rates hitting 3.375% by year-end 2022 and 3.750% by year-end 2023.

With our own inflation forecasts having been consistently revised up since the beginning of the year, our expectations for the Fed have followed suit and we consequently expect a more aggressive tightening path. Our latest base case involves an additional 75bp hike in July followed by 50bp hikes in September and November and a 25bp hike in December to cap off the year. This front-loaded path would leave the year-end target range solidly above the Fed's median neutral estimate of 2.5% at 3.50-3.75%, roughly in line with current market pricing and just above the 2022 median dot.

Fed: Dot plot moves in a hawkish direction in June



Sources: Federal Reserve, CA CIB

However, in contrast to the dot plot that indicates further tightening in 2023, we expect the Fed to pause

after the December 2022 meeting, taking advantage of the optionality provided by front-loading the cycle. While inflation will still be high, it will at least be on the downswing based on our latest forecast. More importantly we expect macroeconomic data to start to show cracks in the second half of 2022 before more significant deterioration is evident as we move into 2023, complicating the Fed's decision-making process. At the moment, all factors are pushing in the same direction – towards more tightening. However, as growth slows and unemployment likely begins to tick higher, the Fed will then have to confront conflicting pressures on monetary policy given its dual mandate.

However, in contrast to the dot plot that indicates further tightening in 2023, we expect the Fed to pause after the December 2022 meeting, taking advantage of the optionality provided by front-loading the cycle.

Due to the strong focus on inflation, we do not anticipate the Fed cutting rates in 2023 even as growth slows sharply in our latest forecast. However, we believe the deteriorating outlook may limit the extent of further hikes in 2023 as the Fed attempts to balance these conflicting pressures. Risks likely continue to be tilted to the upside given upside risks for inflation, though exist in both directions as elevated recession probabilities could prompt a shallower path if a severe downturn were to develop.

Balance sheet run-off will continue as announced in May, reaching its peak pace by 1 September, and should also contribute to tightening financial conditions. QT officially kicked off on 1 June, with monthly redemption caps of USD30bn Treasuries and USD17.5bn MBS for a sum of USD47.5bn, which will be doubled in September to result in monthly reductions of the balance sheet totalling USD95bn.

Nicholas VAN NESS

EUROPEAN CENTRAL BANK: MONETARY POLICY TIGHTENING AHEAD

After ten years of uninterrupted accommodative monetary policy, the ECB will initiate rate lift-off starting in July.

The rebound in inflation over the first half of the year and the prospect of substantial increases in prices over the next six months have pushed the ECB to prepare to tighten its monetary policy, adopting a more aggressive approach at each Governing Council meeting.

The ECB will end its asset purchasing programmes starting on 1 July: the PEPP ended in late March and net APP purchases will stop in early July. It will then increase its key rates by 25bp on 21 July, bringing the deposit rate to -0.25% and the refinancing rate to 0.25%. This will be the first rate hike since July 2011.

We believe that the ECB will increase rates by another 50bp at September’s Governing Council meeting. The central bank indicated that it would hike by an additional 25bp if there is no improvement on the inflation front, which we are not anticipating before the end of the year at the earliest.

The ECB is likely to raise rates further in October and December. We are pricing in 25bp hikes, but the risk that the ECB takes a more aggressive approach is significant, since inflation is expected to remain very

high until the end of the year, and it is now clear that the ECB is going to make fighting inflation its number one priority.

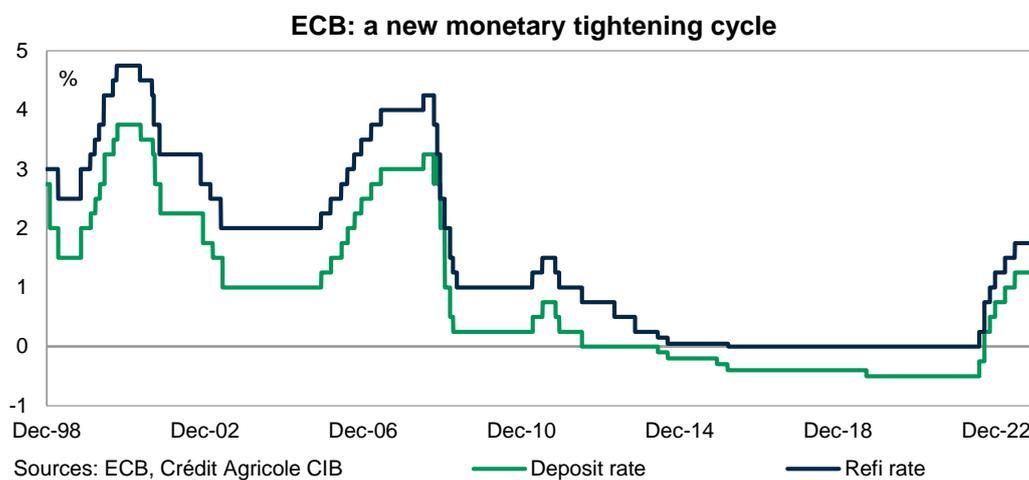
Although inflation will still be high, it should start to come down in early 2023.

Although inflation will still be high, it should start to come down in early 2023, while signs of a more fragile economy are likely to push the ECB to take a more pragmatic approach. As a result, we only expect two 25bp hikes in early 2023.

Meanwhile, TLTRO redemptions in 2023 are projected to track monetary policy tightening, through a quantitative tightening channel (reducing excess liquidity and returning collateral to banks and then investors).

Finally, the ECB is expected to unveil an “anti-fragmentation” programme over the coming weeks. Monetary policy tightening has triggered spread widening and could also increase financial fragmentation. A programme could be ready before the end of the summer according to ECB members.

Louis HARREAU



BANK OF ENGLAND: THE COMFORTABLE, CONDITIONAL CHOICE

While central banks in other developed economies are stepping up their pace of monetary tightening, the BoE is taking a more prudent approach and adopting more ambiguous language which, although not unusual, runs the risk of being inappropriate and even dangerous in the current inflationary environment.

A relatively modest tightening pace so far

In June, the BoE increased its rate by 25bp, bringing the Bank rate to 1.25%, the day after the Fed upped its own key rate by 75bp. Since the beginning of this tightening cycle, the BoE has raised rates by a total of 115bp, compared to 150bp for the Fed. The BoE also starting earlier – in December 2021 – compared to March 2022 for the Fed. However, the economic backdrop may warrant a more aggressive approach. UK inflation (9.1% in May) is higher than in the US (8.6%) and is expected to rise to over 11% by the autumn. The labour market is also extremely tight, with no sign of improvement in the immediate term. The number of vacant positions is at a record high (1.3m) and rising, recruitment difficulties are acute and persistent, and wages are being negotiated up by over 5% (according to the BoE). Furthermore, inflation expectations have increased over the last 12 months. Long-term inflation expectations rose to 3.5% in May according to the BoE/Ipsos survey, which is still only just above the historical average, but that figure may rise further given that realised inflation is expected to increase further in the coming months.

Given the labour market situation and the risk that inflation expectations will continue to rise, as well as the Fed's aggressive approach and its implications for the USD-GBP exchange rate, monetary tightening is

expected to continue. We have added three 25bp hikes to our central scenario, which would bring the Bank rate to 2% in November.

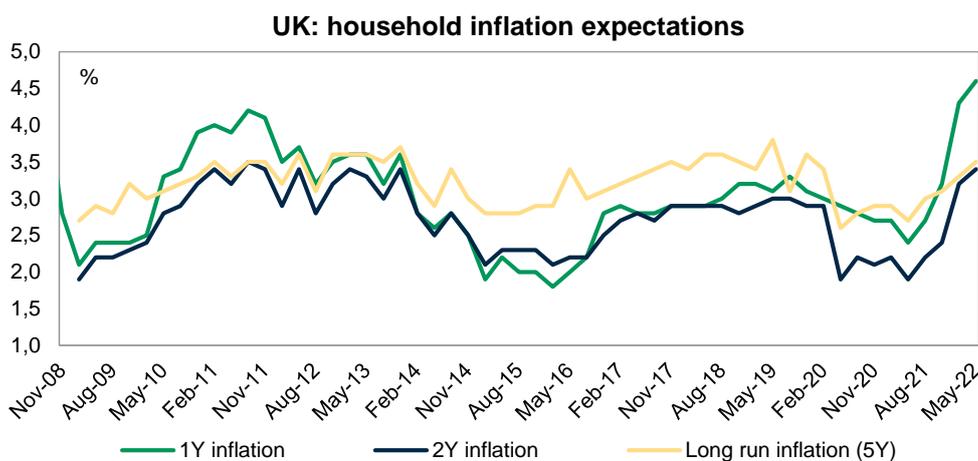
We have added three hikes to our central scenario, which would bring the Bank rate to 2% in November.

Ready to ramp up if necessary

In June, the BoE made two notable changes to its forward guidance. Firstly, it removed the sentence “some degree of further tightening in monetary policy may still be appropriate in the coming months” and introduced less explicit forward guidance indicating that the “scale, pace and timing of any further increases in Bank Rate will reflect the Committee’s assessment of the economic outlook and inflationary pressures”. Furthermore, the BoE stated that it will be “particularly alert” to indications of more persistent inflationary pressures, and will “if necessary act forcefully” in response. The word “forcefully” is clearly very important and tempers the dovish stance of the new forward guidance. This is one way that the BoE can recognise the high degree of uncertainty, without appearing hesitant over inflation, which would damage its credibility.

This new forward guidance suggests that the BoE is ready to act more aggressively if the medium-term inflation outlook rises significantly. As such, the door is open for a potential 50bp rise in August when the Monetary Policy Committee updates its inflation forecast.

Slavena NAZAROVA



Interest rates – Much higher, much faster

Influenced by more acute, more widespread and more persistent inflation, which in turn is driving more proactive monetary tightening, interest rates have risen sharply and are becoming more volatile. This upward trend is likely to continue. In the Eurozone, this is combined with higher sovereign risk premiums that are a concern for the ECB.

USA: FRONT LOADED HIKES TO FURTHER INVERT YIELD CURVE

As inflation remains far too high for comfort and more bad news is likely to come, we believe the Fed is set to front load rate hikes this year, taking the policy rate to restrictive territory by year-end. Such aggressive rate hikes will further invert the yield curve, in our view. We have revised up our Treasury yield forecast, and expect the 10Y yield at 2.95% and the 2-10Y yield curve to invert to -85bp at year-end.

The peak in the terminal rate in this cycle is close to 3.80% from about 2.90% in late May during the prior stock selloff (see chart 1). The market now expects a total of 200bp hikes by year-end. Fed Chair Jerome Powell has made clear that the Fed looks at month-on-month (MoM) inflation figures, which are not as impacted by base effects as year-on-year (YoY) figures are. Headline inflation rather than core has become the FOMC’s ultimate goal, because headline is what people experience and is important for expectations.

Although bond market volatility tends to be lower during summer, this year could be quite different with fluctuating Fed policy expectations. There will be one more **CPI report** (the June data due 13 July) before the 27 July FOMC meeting, which **will likely determine the size of the July hike**. Our house inflation forecast, which has a high MoM 1.0% increase in the June CPI,

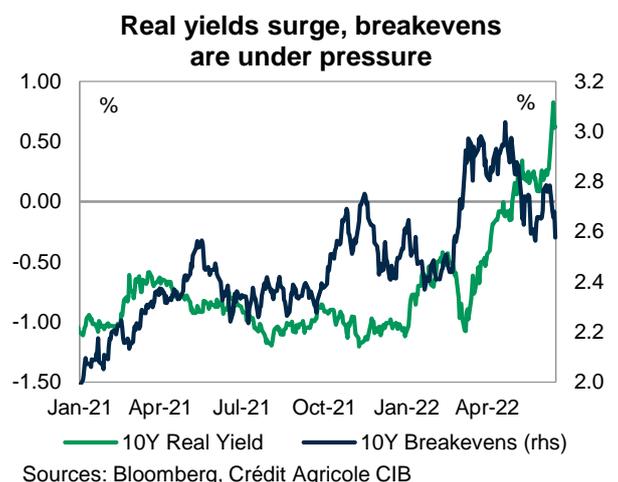
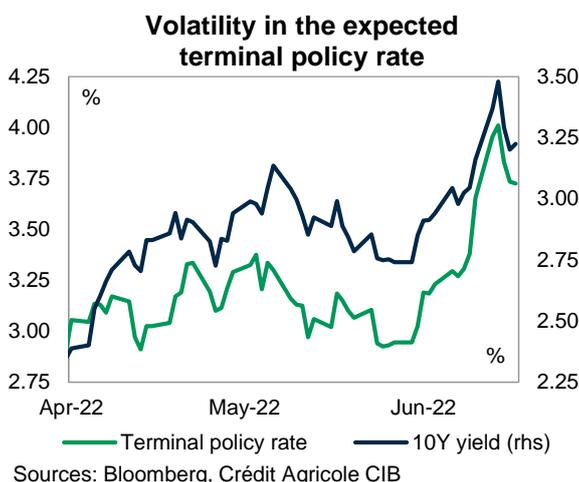
supports the market pricing of a high probability of a second 75bp hike in July.

Real yields have seen high volatility given the rapidly changing Fed expectations. The 10Y real yield had traded around +10bp in late May, and surged to +83bp on 14 June (see chart 2). TIPS breakevens have been under pressure, as aggressive hikes hurt risk assets while improving the long-term inflation outlook. With surging real yields, the TIPS index is down about 8% year-to-date on a total return basis.

Headline inflation rather than core has become the FOMC’s ultimate goal, because headline is what people experience and is important for expectations.

Despite hikes, liquidity has remained ample so far, with the Fed overnight reverse repo (RRP) volume continuing to stay above USD2trn recently. We expect such a high level of RRP to be maintained in the near term, as money market investors actively place cash in repo due to the shrinking Treasury bill supply. Bills have richened in the front end, outperforming other money market instruments. The outperformance is likely to continue until paydowns subside during the summer months, in our view.

Alex LI



EUROPE: TIGHTER POLICY NEEDED URGENTLY

The levels of EGB bond market volatility may seem enormous of late but they still pale in comparison to the activity of money market gyrations. Having been with low and negative rates for close to a decade, and the entirety of some investors' careers, the prospects of policy rates being above 2% never seemed viable. But this is what money markets have come to price because the inflation overshoot is so dangerously elevated and still rising for Europe. To be sure, the ECB or any central bank has no direct influence over commodity prices, given their blunt tools of a balance sheet and rates policy. However, there is no way this rise in prices can simply be looked at as a conventional supply shock.

Coming to this conclusion has taken the ECB and most other major central banks a long time and in doing so the problem of ingrained inflation has been elevated. Hence rates markets have quickly gone from the prospect of neutral policy being required, roughly around 1.25% for the ECB in our view, to modestly restrictive policy around 2%. As shown in the chart below, these steps require a new threshold that is creating market volatility to achieve. **Just as we had volatility suppression by central banks for around a decade, the unwinding of negative real rates policy and continuously growing balance sheets is spurring volatility levels only seen during the GFC.**

Having achieved our end-of-year yield targets on core and periphery EGB, and in light of restrictive policy now being priced into the EUR money market, one might think that the sell-off is over and we have reached a new equilibrium. The problem with this thinking resides in our belief that Eurozone inflation risks remain to the upside due to a variety of goods no longer being sourced from both Ukraine and Russia as well as a greater exposure to energy prices at large.

So if (core) inflation continues to rise we think this will put further pressure on nominal rates to rise further and for market participants to attempt to price in very restrictive policy because the ECB has and continues

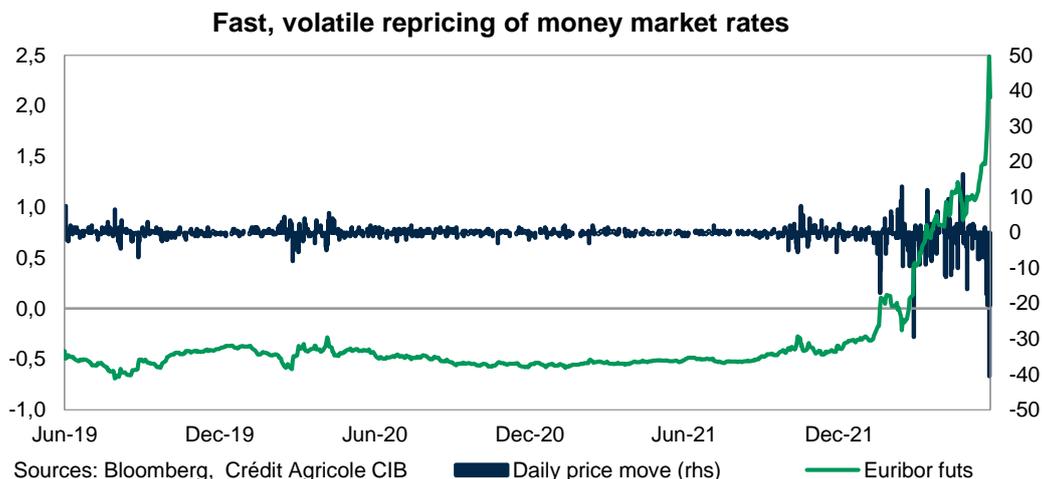
to be slow to respond to this inflation dynamic. Indeed, various studies on our part point to a more direct relationship between inflation and swap rates (as well as curve) developing over the past few months.

Belatedly, **the ECB will start hiking rates in July** but unlike the Fed, a reduction of its balance sheet is not an immediate priority but in time this will come too in the form of TLRO paybacks which should increase funding costs a bit. However, the bigger issue for periphery countries is not that their bonds are being used as TLRO collateral but rather, restrictive monetary policy is also a fiscal heading. Effectively, everyone's cost of funding will be driven higher, though some countries may have difficulties with that.

Though at face value, **negative policy rates and QE were only about preventing dis-inflation risks, this monetary policy has a strong fiscal component. Ceasing QE was never going to push EGB spreads wider independently because of the stock of purchases and excess liquidity this created.** But higher policy rates without QE most certainly was going to increase funding costs, uncover fundamentals and bring debt sustainability back into the spotlight.

The ECB has no direct influence over commodity prices, given their blunt tools of a balance sheet and rates policy.

Aside from the EU's trade surplus cratering this year, **higher policy rates have the objective to reduce growth while growth is needed to meet higher funding costs.** Remarkably, even without delivering its first rate hike and ending QE, the ECB is already in crisis mode about the cost of funding specifically for Italy which carries the biggest stock of Eurozone debt and whose interest rates have started to rise in a potentially worrying way. Investors, however, always ask for compensation for taking greater risks and in a tighter policy environment credit risks begin to appear from a variety of angles.

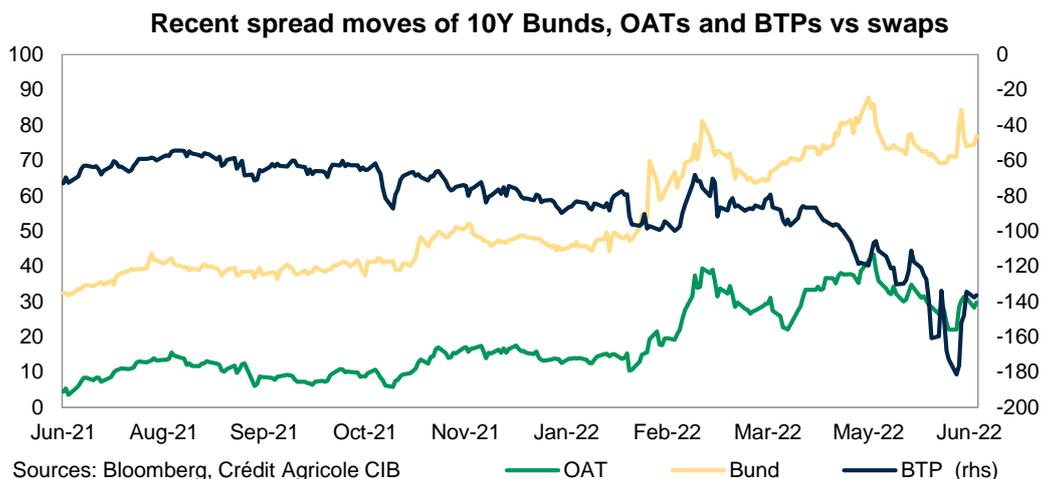


BETWEEN A ROCK AND A HARD PLACE | MARKETS

So it seems that in order to tighten policy to achieve its inflation target, and prevent the negative effects of persistently high inflation on society from taking hold, **the ECB will have to either take this growing credit risk onto its balance sheet or compensate investors for this somehow**. Achieving this, given the various legal challenges, policy objectives and political constraints will be no easy feat. In our view, whatever tool is finally devised will only act to slow down spread widening because the ECB cannot make a commitment to unconditionally buy bonds capping spreads unless the OMT framework is contemplated.

In summary, we think **the risks remain for higher EGB yields because inflation is massively above target and still moving higher**. Growth prospects are worsening from a number of angles which would also augur for flatter yield curves and tighter policy tends to be a headwind to risky assets. The outlook for EGB spreads is however very complicated and markets should remain volatile. In these circumstances, we think investors should remain cautious.

Bert LOURENCO



Exchange rates – The dollar’s advantage

The US is distanced from the war and proving resilient, it started monetary tightening early and in a determined fashion, and is risk averse: all the factors underpinning the USD’s appreciation are in place. Its recent appreciation and short-term appeal must not conceal the headwinds the currency faces.

DEVELOPED COUNTRIES: USD CASH IS KING, FOR NOW

The recent Fed hawkishness and the level of the USD safe-haven premium in FX markets have exceeded our expectations and we have adjusted our near-term FX forecasts to reflect this. While looking beyond the current bout of USD strength may seem difficult, we still think that the longer-term risks for the USD could be on the downside and maintain our less constructive USD view in the next 6-12 months.

The USD has been seen as the key beneficiary of the unfolding global economic slowdown:

- ✓ The US economy is seen as more resilient than its European and Asian counterparts that are plagued by geopolitical or pandemic headwinds;
- ✓ The Fed has emerged as one of the more hawkish G10 central banks in a boost to the USD’s rate appeal; while
- ✓ The recent risk-aversion spike has boosted demand for high-yielding USD cash.

The recent Fed hawkishness and the level of the USD safe-haven premium in FX markets in particular have exceeded our expectations and could mean that the high-yielding, safe-haven USD could maintain its dominant position in FX markets in the coming months. The USD-smile FX market paradigm can thus continue to drive the price action in G10 FX markets.

We have subsequently adjusted our near-term FX forecasts to reflect this. In particular, we have boosted our USD near-term forecasts vs the GBP,

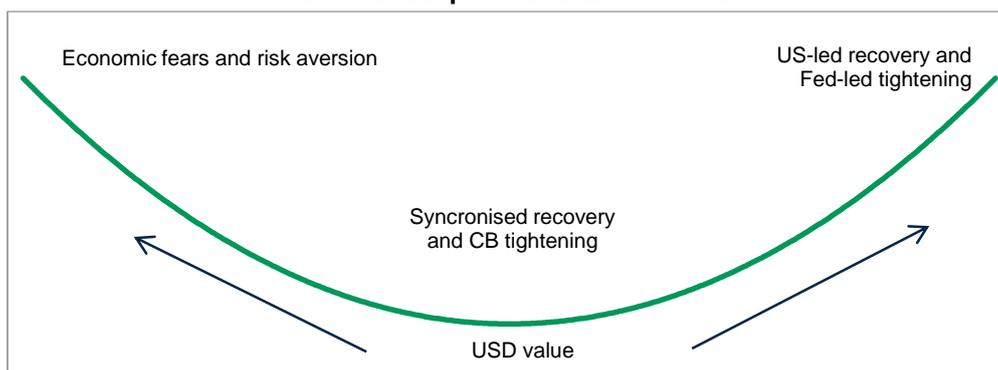
AUD, NZD, NOK and SEK. In contrast, we have revised higher our CHF forecast after the recent hawkish shift by the SNB. We also think that we have seen most of the USD gains vs the EUR and JPY. Looking beyond the current bout of USD strength, we further think that the longer-term risks for the USD could be on the downside.

First, we think that the current mix of soaring inflation and slowing growth differs from previous stagflation episodes given the historically low levels of unemployment and high levels of job vacancies, the healthy balance sheets of households and businesses as well as the abundant global market liquidity and the fiscal support measures in Europe. These should make in our view the global economy more resilient and allow central banks to normalise policies without triggering a ‘hard landing’ and thus stimulate policy divergence trades. China’s economy is also gradually opening back up and as it slowly builds momentum will erode the USD’s appeal.

The longer-term risks for the USD could be on the downside and maintain our less constructive USD view in the next 6M-12M.

Many Fed-related positives are already in the price of the USD in our view and with other G10 central banks catching up with the Fed, we could see the currency underperforming high-yielding proxies like the CAD, AUD and NOK especially if the current recession fears do not materialise in the coming months. This is further supported by the latest results from our FX score card analysis.

The ‘USD-smile’ market paradigm could continue to drive G10 FX price action as a result



Sources: Bloomberg, Crédit Agricole CIB

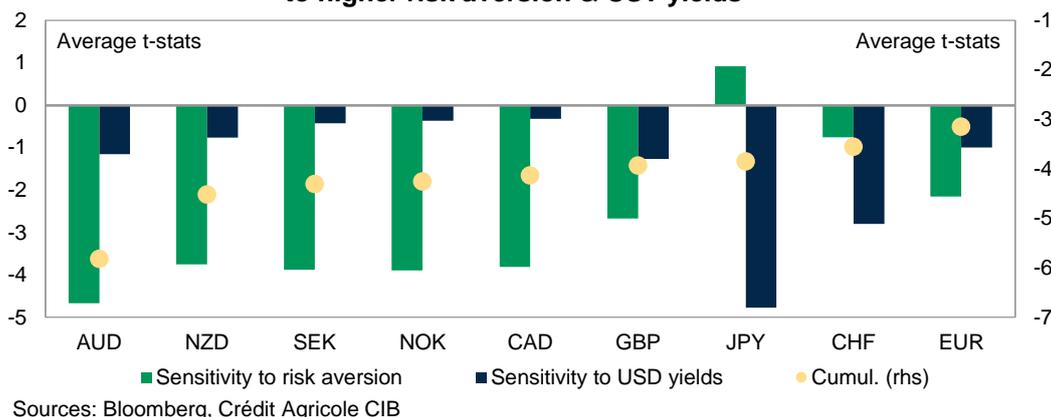
Second, our analysis of the G10 FX performance in the run up to and during the early stages of the last four US (and global) economic downturns and recessions since 1990 suggests that the USD performance has been mixed to negative overall. At the same time, the likes of the EUR, JPY and CHF have emerged as consistent outperformers. It is also worth highlighting that the GBP has emerged as one of the worst performing currencies overall.

Lastly, we also note that the US capital markets have attracted huge portfolio inflows from

investors in the Eurozone and Japan. The appeal of USD assets has been damaged by the Fed and the slowing US economy while the war in Ukraine can give the Eurozone domestic spending a boost as the ECB policy normalisation continues. All this can fuel repatriation flows and boost EUR/USD. The JPY could also benefit from repatriation flows especially if the recent risk-aversion moves on the back of global growth concerns weigh on USD-denominated risk assets.

Valentin MARINOV

G10 FX ranking based on historic vulnerability to higher risk aversion & UST yields



EMERGING COUNTRIES: HOT SUMMER AHEAD?

We see EM currencies remaining vulnerable, particularly to the global stagflation worries and to a possible further downward adjustment in global equity markets.

Beyond the relief

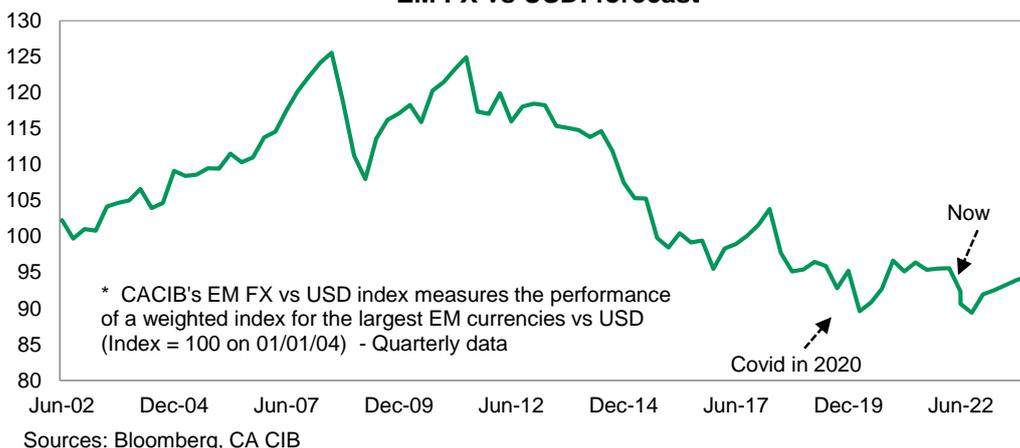
EM currencies have been relatively resilient to the flurry of hawkish actions taken and messages sent by globally relevant central banks earlier this month. This partly reflects a ‘buy the rumour, sell the fact’ logic. Also, these actions have likely reassured the market, as they cap the risks that central banks are or

remain behind the curve. After this recent series of actions, one could argue that the tactical rally could last in the short term.

Facing an unusual set of challenges

However, beyond the short term, we maintain a more cautious view. We would advise to stay defensive on EM into the summer. EMs should continue to face an unusual set of challenges. First, EM inflation has continued to accelerate. It is the case in EMEA and Latam in particular. In Asia, inflation has been much lower, but it has begun to increase, gradually.

EM FX vs USD: forecast



Rising inflation supports the interest rate outlook, with a negative effect on economic activity. It also erodes the population's purchasing power, and potentially fuels social tensions in the least developed countries.

Rising inflation supports the interest rate outlook, with a negative effect on economic activity.

Second, **higher US yields put pressure on external financing and cap the EM carry attractiveness.** In spite of higher EM rates, the US monetary tightening has led to a narrowing of the EM-US interest rate gap over the past four months

Equity markets: the swing factor

A specific risk comes from **the uncertainty regarding the equity market.** The correlation between EM FX and the US equity market has rebounded strongly since the beginning of the year, illustrating how the fate of EM currencies has become more strongly linked to the global scenario, and pointing to the risk that a correction on US equity markets would have for EMs

As a matter of fact, over the past ten years, episodes of US equity sell-off have led to massive underperformance of EM FX compared with their usual behaviour (and a much stronger underperformance compared with periods of bond sell-off). Against such a backdrop, the global stagflation risk, should it lead to a significant equity sell-off, for instance during the summer (a period when liquidity can be scarce), could expose EM currencies to a significant downward adjustment.

On top of it, **geopolitical uncertainty will likely remain strong in the coming months.** We assume sanctions against Russia will remain in place, with a persisting negative impact on energy supply (to Europe) and on food supply (to the world), with possibly

negative effects on inflation and economic activity. The relationship between the US and China is also likely to remain stressed, particularly as the US seems committed to face China's mounting ambitions in the Indo-Pacific region. Both the US and China have busy political agendas towards the end of the year. The US mid-term elections are due on 8 November. The 20th National Congress of the Chinese Communist Party, due in H2, may also be organised in November, according to the Hong Kong newspaper *Ming Pao*. Both events risk being preceded by political and geopolitical jockeying. Against such a backdrop, **spikes of geopolitical stress could add to the vulnerability of global equity markets and EM currencies.**

Such risks are the reasons behind our forecast profile for EM FX for the rest of the year. As charted below, **we expect EM FX to go down vs the USD in the coming months.** We believe there is a significant probability that the EM FX index revisit the low levels it saw at the beginning of the Covid crisis in 2020.

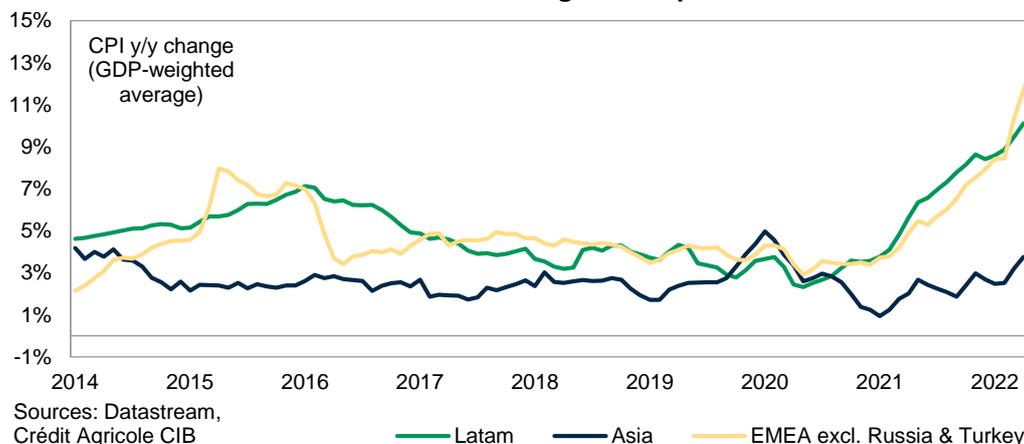
CNY: not so strong

The CNY may follow the same trajectory. In our view, there remains some downside (but limited) risk for the CNY. We see it heading towards 7.00 in Q3, as the economic recovery is incomplete and gradual. We then see it heading back to a mild appreciation closer to the end of the year.

In a second step, **EM FX should recover, at least partly, towards the end of the year,** assuming by that time (1) global inflation has peaked and begun to level off; (2) US yields follow the same trajectory; and (3) the re-acceleration in China becomes more obvious.

Sébastien BARBÉ

EM inflation: cross-region comparison





ECONOMIC AND FINANCIAL FORECASTS

Economic forecasts

Interest rates

Exchange rates

Commodities

Public accounts

ECONOMIC FORECASTS

	GDP (yoy, %)			Consumer price (yoy, %)			Current account (% of GDP)		
	2021	2022	2023	2021	2022	2023	2021	2022	2023
United States	5.7	2.6	1.5	4.7	8.3	4.7	-3.6	-3.7	-3.5
Japan	1.7	0.7	2.0	-0.2	1.3	1.2	2.8	0.8	1.5
Eurozone	5.3	2.5	1.1	2.6	7.8	4.9	3.5	2.4	2.6
Germany	2.9	1.7	1.0	3.2	8.3	5.6	7.4	6.8	6.7
France	6.8	2.4	1.3	2.1	6.0	4.5	-1.0	-0.7	-0.7
Italy	6.6	2.5	0.8	2.0	7.5	4.5	2.5	-0.6	-0.6
Spain	5.1	3.9	1.6	3.0	8.4	4.2	0.9	1.7	2.4
Netherlands	5.0	2.7	0.9	2.8	9.3	4.9	9.5	8.5	8.2
Belgium	6.2	2.2	0.9	3.2	9.6	5.3	-0.4	0.3	0.0
Other advanced									
United Kingdom	7.4	3.4	0.9	2.6	9.0	6.4	-2.6	-5.6	-5.9
Canada	5.1	3.8	2.0	3.4	6.3	2.9	0.6	0.2	-0.2
Australia	3.5	4.1	2.6	2.5	2.1	2.2	3.6	1.3	0.5
Switzerland	3.7	3.0	1.4	0.4	0.6	0.8	7.2	7.5	7.2
Sweden	4.9	1.4	0.8	2.2	6.8	4.8	5.6	4.7	4.1
Norway	4.0	1.7	1.4	3.5	4.7	3.2	15.4	13.7	13.5
Asia	7.3	4.8	5.3	2.2	3.6	2.7	1.6	0.9	0.7
China	8.1	4.0	5.5	0.9	2.4	2.0	1.8	1.2	0.6
India	9.6	7.4	6.0	5.1	6.3	4.5	-1.0	-2.5	-2.0
South Korea	4.0	2.8	2.5	2.4	4.6	2.5	4.9	3.9	3.7
Indonesia	3.5	5.0	4.5	2.0	3.0	3.0	-1.0	-1.3	-2.5
Taiwan	6.3	3.4	2.7	2.0	2.6	1.3	14.2	13.2	13.0
Thailand	1.6	3.4	4.0	1.2	4.1	1.2	-2.8	0.3	3.2
Malaysia	3.5	6.5	6.0	2.5	2.8	2.5	3.0	3.2	2.7
Singapore	7.6	3.8	3.0	2.3	4.8	1.7	18.6	16.8	15.2
Hongkong	6.4	1.0	3.6	1.6	2.1	2.0	8.3	5.0	5.5
Philippines	5.7	7.0	6.5	4.4	4.7	3.3	-1.8	-3.9	-2.6
Vietnam	3.9	6.5	6.7	2.5	3.5	4.0	1.5	2.7	2.5
Latin America	6.1	1.9	1.7	14.0	12.6	8.8	-1.4	-1.3	-1.4
Brazil	4.6	0.9	1.2	10.1	7.5	4.5	-1.4	-1.0	-1.5
Mexico	5.0	2.2	1.8	7.4	7.2	3.8	-0.4	-0.6	-1.0
Argentina	7.8	2.2	2.0	51.0	46.0	40.0	1.0	0.8	0.5
Colombia	10.7	4.5	2.8	5.6	8.4	4.2	-5.5	-6.5	-4.5
Emerging Europe	6.6	-2.1	1.2	9.2	17.7	12.4	1.8	2.9	0.7
Russia	4.7	-9.0		6.7	17.0		6.8		
Turkey	11.0	3.5	4.0	18.0	25.0	20.0	-2.0	-2.0	-4.0
Poland	5.9	4.1	3.3	5.1	12.4	7.4	-0.6	-4.2	-4.0
Czech Republic	3.3	1.6	3.5	3.8	13.5	4.2	-1.8	-0.3	0.0
Romania	5.6	3.9	4.5	5.0	12.8	5.8	-7.1	-6.1	-6.0
Hungary	7.1	2.0	3.5	5.1	7.0	3.9	-1.5	-1.0	-0.5
Africa, Middle East	4.4	4.2	3.6	9.7	11.0	7.8	3.0	6.6	4.7
Saudi Arabia	3.2	5.5	3.5	3.1	2.5	1.8	5.3	13.9	9.8
United Arab Emirates	2.8	5.4	4.9	0.2	4.5	2.9	9.4	14.1	11.1
South Africa	4.9	2.0	1.8	4.6	6.3	4.8	3.7	2.0	1.0
Egypt	7.1	4.5	5.0	5.2	13.9	9.8	-4.2	-5.0	-4.0
Algeria	3.9	3.5	2.3	6.6	10.7	7.3	-5.0	1.0	0.0
Qatar	2.9	4.7	3.1	2.3	4.2	2.6	14.6	21.0	16.0
Koweit	1.7	7.0	3.2	3.4	5.0	2.9	25.0	35.0	29.0
Morocco	7.7	1.5	3.7	1.4	5.0	2.5	-4.0	-6.3	-4.5
Tunisia	3.3	2.3	2.5	5.7	8.1	6.8	-6.7	-8.9	-5.3
Total	6.1	3.0	2.9	4.4	7.2	4.8	0.9	0.5	0.2
Advanced economies	5.1	2.5	1.4	3.2	7.0	4.3	0.2	-0.7	-0.6
Emerging countries	6.8	3.5	4.1	5.3	7.3	5.3	1.4	1.5	0.8

	2021				2022				2023			
Real GDP growth, QoQ %	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USA (annualised)	6.3	6.7	2.3	6.9	-1.5	3.5	2.2	1.9	1.5	1.0	0.5	0.3
Japan	-0.5	0.6	-0.7	1.1	-0.9	0.6	0.5	0.6	0.5	0.3	0.3	0.3
Eurozone	-0.1	2.2	2.3	0.2	0.6	-0.2	0.2	0.1	0.3	0.4	0.5	0.5
Germany	-1.7	2.2	1.7	-0.3	0.2	0.2	0.3	0.1	0.1	0.3	0.5	0.6
France	0.2	1.0	3.2	0.4	-0.2	0.3	0.2	0.3	0.3	0.3	0.4	0.4
Italy	0.2	2.7	2.6	0.7	0.1	-0.1	0.1	-0.2	0.2	0.4	0.5	0.6
Spain	-0.5	1.1	2.6	2.2	0.3	0.2	0.3	0.1	0.3	0.5	0.9	0.8
United Kingdom	-1.2	5.6	0.9	1.3	0.8	-0.5	0.4	0.1	0.2	0.3	0.4	0.4

	2021				2022				2023			
Consumer prices, YoY %	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USA	1.9	4.8	5.3	6.7	8.0	8.5	8.8	7.8	6.4	4.9	3.7	3.6
Japan	-0.5	-0.6	0.0	0.4	0.6	1.8	1.6	1.4	1.1	1.2	1.3	1.4
Eurozone	1.1	1.8	2.8	4.6	6.1	7.9	8.7	8.6	6.7	5.2	4.7	3.4
Germany	1.7	2.2	3.5	5.4	6.1	8.3	9.1	9.8	7.7	5.9	5.3	3.6
France	1.0	1.8	2.2	3.3	4.2	5.8	7.0	6.9	6.2	4.7	3.8	3.4
Italy	0.8	1.2	2.1	3.8	6.0	7.2	8.5	8.4	6.0	5.2	3.8	3.0
Spain	0.5	2.3	3.4	5.8	7.9	8.6	9.2	8.1	5.7	4.7	3.5	2.7
United Kingdom	0.6	2.1	2.8	4.9	6.2	9.1	9.8	10.8	10.1	6.9	5.6	3.0

	2021				2022				2023			
Unemployment rate, %	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USA	6.2	5.9	5.1	4.2	3.8	3.6	3.5	3.4	3.4	3.5	3.6	3.8
Japan	2.9	2.9	2.8	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.5	2.5
Eurozone	8.4	8.2	7.7	7.3	7.0	7.2	7.3	7.5	7.3	7.3	7.3	7.3
Germany	3.9	3.7	3.5	3.3	3.1	3.2	3.3	3.3	3.2	3.1	3.0	2.9
France	8.1	8.2	7.8	7.4	7.3	7.5	7.5	7.5	7.4	7.4	7.4	7.4
Italy	10.2	9.8	9.1	9.1	8.6	9.2	9.4	9.5	9.5	9.5	9.9	10.2
Spain	15.6	15.4	14.7	13.5	13.3	13.4	13.4	13.8	13.4	13.4	13.3	13.2
United Kingdom	4.8	4.6	4.2	3.9	3.7	3.8	3.9	4.0	4.1	4.2	4.2	4.2

BETWEEN A ROCK AND A HARD PLACE | ECONOMIC AND FINANCIAL FORECASTS

	GDP (b)	Private consumption (b)	Public consumption (b)	Investment (b)	Exports (b)	Imports (b)	Net exports (a)	Changes in inventories (a)
Eurozone								
2021	5.3	3.6	3.9	4.1	10.8	8.7	1.3	0.5
2022	2.5	2.4	0.9	3.6	5.4	7.0	-0.5	1.2
2023	1.1	1.1	0.7	2.3	2.8	3.3	-0.1	1.3
Q2 2022	-0.2	0.1	0.2	1.3	0.7	2.3	-0.7	1.3
Q3 2022	0.2	0.1	0.2	0.5	1.0	1.0	0.0	1.3
Q4 2022	0.1	0.0	0.2	0.2	0.7	0.8	0.0	1.3
Q1 2023	0.3	0.2	0.2	0.6	0.6	0.6	0.0	1.3
Germany								
2021	2.9	0.3	2.9	1.0	9.5	9.0	0.6	1.2
2022	1.7	3.5	0.2	1.6	3.5	7.6	-1.7	1.2
2023	1.0	1.5	1.2	0.9	2.2	2.8	-0.2	0.0
Q2 2022	0.2	0.6	0.3	0.1	2.7	3.0	-0.1	-0.1
Q3 2022	0.3	0.3	0.3	0.1	1.1	1.1	0.0	0.0
Q4 2022	0.1	0.2	0.3	0.0	0.6	0.8	-0.1	0.0
Q1 2023	0.1	0.2	0.3	0.2	0.2	0.4	-0.1	0.0
France								
2021	6.8	5.3	6.4	11.4	8.6	7.8	0.0	-0.3
2022	2.4	2.7	2.2	1.6	7.1	5.8	0.2	-0.2
2023	1.3	1.8	0.1	1.7	3.1	3.0	-0.1	0.0
Q2 2022	0.3	0.6	0.2	0.4	1.3	1.1	0.0	-0.2
Q3 2022	0.2	0.4	0.0	0.4	0.8	0.8	0.0	-0.1
Q4 2022	0.3	0.4	0.0	0.4	0.7	0.7	0.0	0.0
Q1 2023	0.3	0.4	0.0	0.4	0.7	0.7	0.0	0.0
Italy								
2021	6.6	5.2	0.6	17.0	13.4	14.3	0.0	0.3
2022	2.5	1.2	0.3	10.2	8.4	11.6	-0.8	0.5
2023	0.8	0.0	0.1	3.6	2.3	2.6	-0.1	0.0
Q2 2022	-0.1	-0.4	0.1	1.4	0.9	1.2	-0.1	-0.1
Q3 2022	0.1	-0.1	0.1	1.0	0.9	0.8	0.0	-0.1
Q4 2022	-0.2	-0.9	0.1	0.7	0.6	0.8	-0.1	0.2
Q1 2023	0.2	0.2	0.1	0.8	0.4	0.5	0.0	-0.1
Spain								
2021	5.1	4.6	3.1	4.3	14.7	13.9	0.6	0.5
2022	3.9	-1.0	1.3	8.0	13.4	6.6	2.4	0.0
2023	1.6	1.1	1.6	4.5	1.8	3.1	-0.3	0.0
Q2 2022	0.2	0.2	0.5	1.4	-0.1	0.8	-0.3	0.0
Q3 2022	0.3	0.2	0.5	1.8	0.5	1.5	-0.3	0.0
Q4 2022	0.1	-0.1	0.5	0.2	0.3	0.2	0.0	0.0
Q1 2023	0.3	0.1	0.4	1.0	0.3	0.6	-0.1	0.0
Portugal								
2021	4.9	4.5	4.1	6.5	13.1	13.1	-0.7	0.5
2022	5.8	4.2	2.4	8.6	14.6	11.4	0.7	0.1
2023	2.2	0.7	-0.5	7.2	6.9	5.6	0.4	0.0
Q2 2022	-1.0	-1.5	0.3	1.3	1.1	1.6	-0.3	0.0
Q3 2022	0.1	-0.4	0.3	2.4	1.5	1.8	-0.2	0.0
Q4 2022	0.4	0.1	0.2	2.0	1.4	1.4	-0.1	0.0
Q1 2023	0.7	0.4	-0.3	1.7	1.8	1.4	0.1	0.0
Netherlands								
2021	5.0	3.5	5.5	3.5	6.6	5.1	1.8	-0.5
2022	2.7	3.0	-0.9	1.8	2.1	0.9	1.2	0.1
2023	0.9	0.8	0.7	1.1	2.0	2.0	0.3	-0.1
Q2 2022	-0.2	-0.3	0.2	0.2	1.0	1.0	0.1	-0.3
Q3 2022	0.2	0.1	0.1	0.2	1.0	1.0	0.1	0.0
Q4 2022	0.2	0.1	0.1	0.2	1.0	1.0	0.1	0.0
Q1 2023	0.3	0.3	0.2	0.3	0.2	0.2	0.0	0.0
United Kingdom								
2021	7.4	6.2	14.3	5.9	-1.3	3.8	-1.5	0.4
2022	3.4	4.7	2.6	6.5	2.2	11.4	-2.7	0.6
2023	0.9	1.0	4.1	1.2	3.9	4.1	-0.2	-0.6
Q2 2022	-0.5	0.4	1.0	-2.0	3.0	-4.0	2.0	-2.7
Q3 2022	0.4	0.2	1.0	2.0	0.5	2.0	-0.5	0.2
Q4 2022	0.1	0.2	1.0	0.5	0.5	1.5	-0.3	0.0
Q1 2023	0.2	0.2	1.0	0.0	1.0	1.2	-0.1	0.0

(a) contribution to GDP growth (% , q/q)

(b) q/q, %

INTEREST RATES

Short-term interest rates		29-Jun	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Etats-Unis	Fed funds	1.75	3.00	3.75	3.75	3.75	3.75	3.75
	Sofr	1.52	2.75	3.50	3.50	3.50	3.50	3.50
Japon	Call rate	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01
	Tonar	-0.03	-0.01	0.00	0.01	0.02	0.03	0.03
Eurozone	Deposit	-0.50	0.25	0.75	1.00	1.25	1.25	1.25
	€str	-0.58	0.18	0.68	0.94	1.21	1.22	1.23
	Euribor 3m							
United-Kingdom	Base rate	1.25	1.75	2.00	2.00	2.00	2.00	2.00
	Sonia	0.95	1.20	1.20	1.20	1.20	1.20	1.20
Sweden	Repo	0.25	1.25	1.75	2.00	2.00	2.00	2.00
Norway	Deposit	1.25	1.75	2.25	2.50	3.00	3.25	3.50
Canada	Overnight	1.50	2.75	3.50	3.75	3.75	3.75	3.75

10Y rates		29-Jun	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
USA		3.11	3.35	2.95	3.00	2.95	2.85	2.80
Japan		0.23	0.25	0.25	0.25	0.30	0.37	0.45
Eurozone (Germany)		1.51	2.20	2.50	2.50	2.45	2.20	2.10
Spread 10 ans / Bund								
France		0.55	0.60	0.60	0.65	0.65	0.70	0.70
Italy		1.99	2.25	2.25	2.50	2.50	2.50	2.50
Spain		1.09	1.20	1.30	1.40	1.40	1.45	1.45

Asia		29-Jun	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
China	1Y deposit rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Hong Kong	Base rate	2.00	3.25	4.00	4.00	4.00	4.00	4.00
India	Repo rate	4.90	5.50	6.00	6.25	6.50	6.75	7.00
Indonesia	7D (reverse) repo rate	3.50	4.00	4.25	4.50	4.50	4.75	5.00
Korea	Base rate	1.75	2.00	2.25	2.50	2.50	2.50	2.50
Malaysia	OPR	2.00	2.50	2.75	3.00	3.25	3.25	3.50
Philippines	Repo rate	2.50	3.00	3.25	3.50	3.50	3.50	3.50
Singapore	6M SOR	2.46	3.01	3.32	3.30	3.39	NA	NA
Taiwan	Redisc	1.50	1.75	1.88	2.00	2.13	2.13	2.13
Thailand	Repo	0.50	0.50	0.75	1.00	1.25	1.25	1.25
Vietnam	Refinancing rate	4.00	4.50	5.00	5.00	5.00	5.00	5.00
Latin America								
Brazil	Overnight/Selic	13.25	13.75	13.75	13.50	13.00	11.50	10.00
Mexico	Overnight rate	7.75	9.00	9.50	9.50	9.50	9.50	9.50
Emerging Europe								
Czech Rep.	14D repo	7.00	7.00	7.00	7.00	7.00	6.75	6.50
Hungary	Base rate	7.75	9.25	9.25	9.25	9.25	9.25	7.50
Poland	7D repo	6.00	7.25	7.75	7.75	7.75	7.75	6.75
Romania	2W repo	3.75	4.25	4.25	4.25	4.25	4.25	4.00
Russia	1W auction rate	0.00	8.00	8.00	8.00	8.00	8.00	8.00
Turkey	1W repo rate	14.00	14.00	16.00	18.00	18.00	18.00	18.00
Africa & Middle East								
South Africa	Repo	4.75	5.00	5.00	4.50	4.00	4.00	4.00
UAE	Repo	2.15	2.90	3.65	3.65	3.65	3.65	3.65
Saudi Arabia	Repo	2.25	3.50	4.25	4.25	4.25	4.25	4.25

EXCHANGE RATES

USD Exchange rate

Industrialised countries		29-Jun	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Euro	EUR/USD	1.05	1.08	1.10	1.10	1.10	1.13	1.15
Japan	USD/JPY	136.3	132.0	130.0	125.0	122.0	120.0	118.0
United Kingdom	GBP/USD	1.22	1.26	1.29	1.29	1.30	1.34	1.36
Switzerland	USD/CHF	0.96	0.91	0.90	0.91	0.91	0.88	0.87
Canada	USD/CAD	1.29	1.25	1.23	1.22	1.21	1.20	1.20
Australia	AUD/USD	0.69	0.68	0.70	0.72	0.74	0.76	0.78
New Zealand	NZD/USD	0.63	0.62	0.64	0.65	0.66	0.68	0.70

Euro Cross rates

Industrialised countries		29-Jun	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Japan	EUR/JPY	143	143	143	138	134	136	136
United Kingdom	EUR/GBP	0.86	0.85	0.85	0.85	0.85	0.85	0.84
Switzerland	EUR/CHF	1.01	0.98	0.99	1.00	1.00	1.00	1.00
Sweden	EUR/SEK	10.66	10.40	10.20	10.00	9.90	9.80	9.70
Norway	EUR/NOK	10.34	10.20	10.00	9.80	9.70	9.60	9.50

Asia		29-Jun	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
China	USD/CNY	6.71	7.00	6.70	6.65	6.60	6.55	6.50
Hong Kong	USD/HKD	7.85	7.85	7.84	7.84	7.83	7.83	7.82
India	USD/INR	78.97	78.50	77.00	76.50	76.00	75.50	75.00
Indonesia	USD/IDR	14835	14800	14500	14400	14300	14200	14200
Malaysia	USD/MYR	4.40	4.50	4.35	4.30	4.25	4.20	4.20
Philippines	USD/PHP	54.7	53.4	52.4	52.0	51.8	51.0	50.5
Singapore	USD/SGD	1.39	1.41	1.37	1.35	1.33	1.32	1.31
South Korea	USD/KRW	1290	1320	1270	1250	1230	1220	1210
Taiwan	USD/TWD	29.7	30.4	29.6	29.4	29.2	29.0	29.0
Thailand	USD/THB	35.1	35.0	34.2	33.5	33.0	32.2	32.0
Vietnam	USD/VND	23255	23400	23000	22800	22700	22550	22500
Latin America								
Brazil	USD/BRL	5.24	5.50	5.30	5.35	5.40	5.45	5.50
Mexico	USD/MXN	19.98	21.50	21.00	20.70	20.50	20.25	20.00
Africa								
South Africa	USD/ZAR	16.01	16.00	15.50	15.00	14.50	14.50	15.00
Emerging Europe								
Poland	USD/PLN	4.45	4.29	4.20	4.19	4.16	4.04	3.96
Russia	USD/RUB	52.95	65.00	74.00	79.00	80.00	81.00	82.00
Turkey	USD/TRY	16.62	17.00	17.00	17.25	17.50	17.50	17.50
Central Europe								
Czech Rep.	EUR/CZK	24.73	24.90	24.80	24.70	24.70	24.70	24.70
Hungary	EUR/HUF	397	382	375	365	355	345	340
Poland	EUR/PLN	4.68	4.63	4.62	4.61	4.58	4.56	4.55
Romania	EUR/RON	4.94	4.94	4.94	4.94	4.93	4.92	4.91

COMMODITIES

Av. quarter price		29-Jun	2022		2023			
			Q3	Q4	Q1	Q2	Q3	Q4
Brent	USD/BBL	122	125	130	125	130	135	135

Av. quarter price		29-Jun	2022		2023			
			Q3	Q4	Q1	Q2	Q3	Q4
Gold	USD/oz	1,820	1,850	1,900	1,950	2,000	2,100	2,150

PUBLIC ACCOUNTS

	Government balance (% of GDP)			Public debt (% of GDP)		
	2021	2022	2023	2021	2022	2023
United States	-12.4	-6.5	-4.7	102.2	102.6	101.8
Japan	-6.4	-7.0	-3.5	242.3	244.4	244.2
Eurozone	-5.2	-4.3	-3.6	95.6	94.3	94.9
Germany	-3.7	-3.8	-2.3	69.3	69.7	71.0
France	-6.4	-5.7	-5.4	112.6	112.8	114.3
Italy	-7.2	-6.2	-5.3	150.8	147.8	147.2
Spain	-7.0	-4.8	-4.4	119.5	115.9	116.8
Netherlands	-2.5	-2.7	-2.6	53.8	53.1	52.7
Belgium	-5.5	-4.2	-4.0	108.2	108.9	107.4
Greece	-7.4	-4.2	-1.5	193.3	183.8	181.1
Ireland	-1.9	0.2	-1.0	56.0	50.8	49.7
Portugal	-2.8	-1.7	-1.0	127.4	121.4	119.9
United Kingdom	-8.3	-4.5	-2.6	102.8	100.9	101.2

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

Layout & Editor: Fabienne PESTY

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

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