Business Cycle Monitor

September 2022

Belgian economic activity is expected to contract by 0.2 % in the third quarter of 2022[1]

- Belgian real GDP increased by 0.2 % in the second quarter of 2022; while this constitutes a clear slowdown compared to the first quarter, this is slightly better than our estimate of zero growth in the previous Business Cycle Monitor.
- GDP growth benefitted from a further expansion of private consumption and services in particular. However, the sharp increase in energy prices and lagging indexation mechanisms are at least temporarily reducing household purchasing power while consumer confidence remains low. This should lead to a decline of private consumption in the third quarter of 2022. Fundamentals remain sound, however, and household consumption is likely to pick up beyond the near term as price pressures soften and the indexation mechanisms push up nominal incomes.
- Escalating production costs and the uncertain economic outlook have led to a contraction of business investment in the second quarter. Business sentiment remains on a gradual downward trend and demand expectations are worsening further. Hence, we expect business investment to decline again in the third quarter. Housing investment is expected to edge further down as well.
- Government consumption should continue to grow moderately in the third quarter, while the roll-out of investment plans should boost government investment.
- The growth contribution of net exports should remain close to zero in the third quarter as exports and imports are likely to decline to roughly the same extent.
- The NBB nowcasting model "BREL" currently estimates quarterly growth in the third quarter at about -0.4 %, while the "R2D2" model is clearly much more optimistic with a growth rate of 1.5 %. The uncertainty of these nowcasting models remains exceptionally large as the massive shocks since the start of the COVID-19 crisis constitute a challenge for the estimation of standard time-series models. Additional elements should be taken into account, such as the potentially increasing production cuts in certain industries due to the very high energy prices.
- All in all, we currently expect economic activity to contract by 0.2 % in the third quarter. This is in line with median of the one-indicator models and towards the more pessimistic end of the range provided by the two model nowcasts. It should again be stressed that the uncertainty of this nowcast is high. Given the recent positive surprises coming from household consumption and the strong labour market, a more positive outcome is definitely possible. At the same time, the economic situation is likely to worsen further if the current energy price pressures persist or intensify.

[1] This is a short-term NBB estimate and should not be confused with the official statistics published by the National Accounts Institute (such as the flash GDP estimate, which is released one month after the quarter has ended). This NBB estimate is based on nowcasting models, as well as expert judgment and incorporates information up to 7 September 2022. As all estimates and forecasts, it comes with a degree of uncertainty.

Euro area GDP increased by 0.8 % in the second quarter of 2022 but should decelerate significantly in the third quarter of 2022

After a brief episode of very strong growth associated with the (partial) reopening of many euro area economies in the second and the third quarter of last year, the autumn wave of COVID-19, surging energy prices and escalating supply chain issues caused activity to decelerate from the final quarter of 2021 on. Despite intensifying headwinds, the euro area economy kept the pace and second-quarter growth beat expectations: **in volume terms, euro area GDP growth came in at 0.8 % compared to the first quarter.** The year-on-year growth rate reached 4.1 %.

Table 1

Real GDP growth rate
(percentages, adjusted for seasonal and calendar effects)

	Quarter-on-quarter change				Year-on-year change	Gap vs pre-COVID-19 level[1]
	2021Q3	2021Q4	2022Q1	2022Q2	2022Q2	2022Q2
Euro area	2.3	0.4	0.5	0.8	4.1	1.8
Germany	0.8	0.0	0.8	0.1	1.7	0.0
France	3.3	0.6	-0.2	0.5	4.2	1.0
Italy	2.7	0.7	0.1	1.1	4.7	1.1
Spain	2.6	2.2	0.2	1.1	6.3	-2.5
Netherlands	1.5	0.7	0.5	2.6	5.4	5.6
Belgium	**2.1**	**0.4**	**0.5**	**0.2**	**3.3**	**1.8**
EU	2.2	0.6	0.6	0.7	4.2	2.3
UK	0.9	1.3	0.8	-0.1	2.9	0.6
US	0.6	1.7	-0.4	-0.1	1.7	2.6
JP	-0.5	1.0	0.0	0.5	1.0	0.2

Sources: EC, U.S. Department of Commerce, Cabinet Office Japan.
1. The pre-COVID-19 reference is 2019Q4

Growth rates in major euro area economies diverged to a greater extent that in the previous quarter. On the back of strong net exports and business investment, second-quarter economic activity expanded by a surprisingly strong 2.6 % in The Netherlands. The Italian and Spanish economies grew by about 1 % in the second quarter of 2022, benefiting from the removal of most remaining COVID-19 restrictions and recovering tourism flows. Following a slight contraction in the first quarter, the French economy expanded by 0.5 %, aided by net exports. The manufacturing-heavy German economy is proving particularly vulnerable to the surge in energy prices. Although first-quarter GDP growth was revised up significantly, second-quarter growth turned out weaker, coming in at just 0.1 %, mostly supported by household and government consumption.

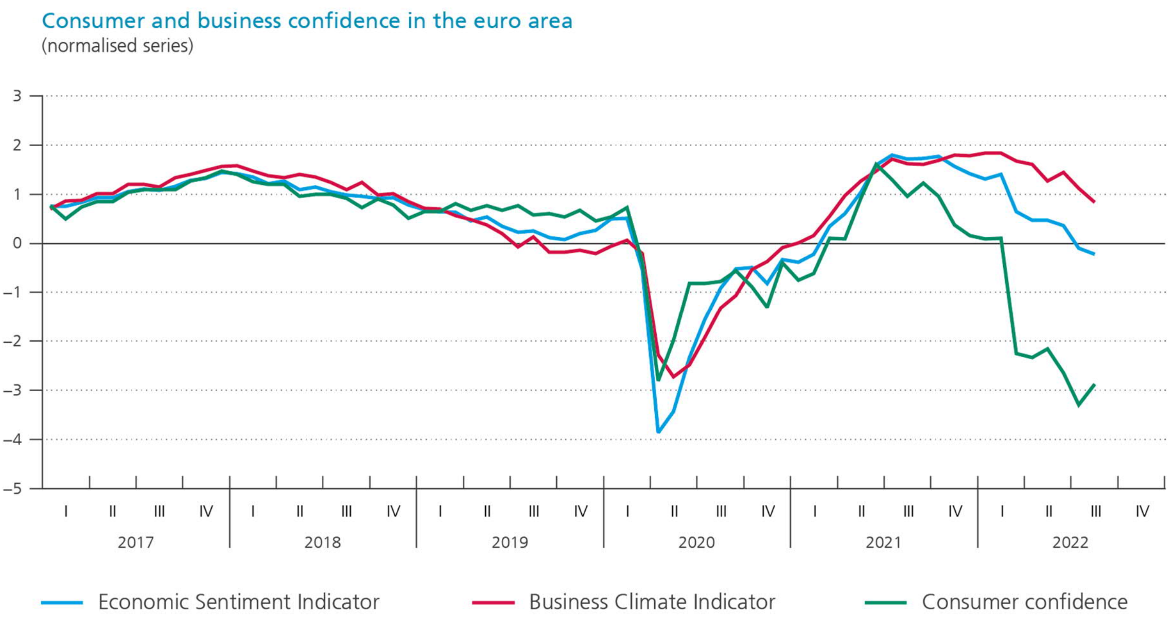
The moderate but continued growth has allowed many euro area economies to regain their pre-pandemic output levels. The euro area economy as a whole now exceeds the pre-pandemic output level by 1.8 %. Leading the pack, the Dutch economy is currently 5.6 % larger than before the pandemic. The Belgian economy exceeds the 2019-Q4 benchmark by 1.8 %, which is slightly more than the French and Italian economies. In contrast, the German economy has only just regained the pre-pandemic output level in the second quarter of 2022 and GDP in Spain is still clearly lower than before the pandemic.

Among the major economies outside the euro area, the US and the UK economies contracted slightly in the second quarter. For the US, this is the second consecutive quarter of negative growth, even though employment continues to expand strongly. Despite this setback, economic output in the USA is still about 2.6 % above the pre-crisis level. The Japanese economy posted a solid 0.5 % quarterly growth and now also exceeds the pre-pandemic output level.

Soft indicators for economic activity generally continue to weaken. The EC's overall economic sentiment indicator (ESI), reflecting sentiment from both the supply side and demand side in the euro area, declined further in August. The sub-indicator related to overall consumer confidence improved slightly (see Chart 1), which was mirrored by in a small uptick in sentiment in retail trade. Nevertheless, sentiment in the services industries fell further. Short-run volatility aside, consumer confidence has worsened dramatically since the turn of the year, even dropping below the lows seen during the COVID-19 pandemic. The effect on the ESI has long been dampened by robust confidence in the construction and manufacturing industries. However, sentiment in those industries has been falling as energy prices surged again over the summer months, despite some evidence of easing supply restrictions. Nevertheless, the Business Climate Indicator (BCI) remains firmly above both its long-run average and the pre-pandemic level. This does not seem to point to the economy being in a deep crisis.

Chart 1

Sentiment indicators for the euro area

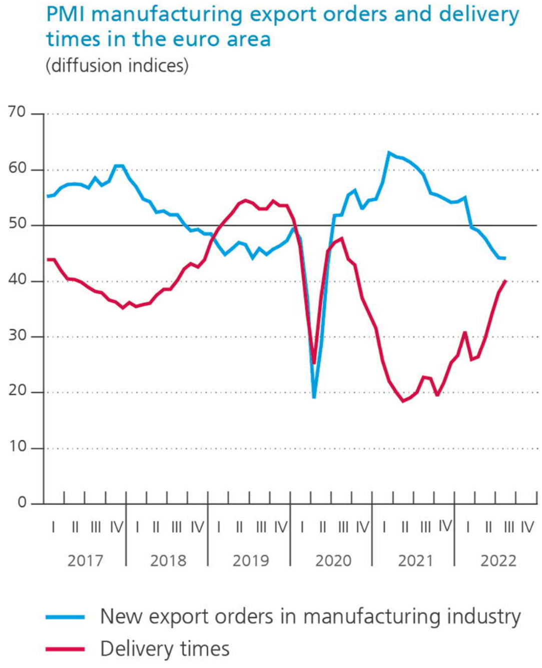


Source: EC.
Note: the original series are normalised around their historical averages and divided by their standard deviation.

Similarly, the PMI composite indicator for the euro area (see Chart 2, left-hand graph) declined further in August, having already fallen below 50 in July, which in principle signals a mild contraction in economic activity. The latest drop in the composite indicator stems from deteriorating sentiment in both services and, in particular, the manufacturing industry, although the services indicator is not in contractionary territory yet. Contrary to services, confidence in the manufacturing industry recovered more rapidly after the initial pandemic-related shock. It has long remained very robust due to the post-pandemic surge in demand for goods despite the headwinds related to rising input prices and supply bottlenecks. This 'boom' seems to be coming to an end. The recent decline in manufacturing sentiment follows a gradual downward trend that already started back in mid-2021. The new export orders index for the manufacturing industry (see Chart 2, right-hand graph) fell further below the 50-point mark (i.e. declining) over the summer, as mounting energy prices deteriorated the competitiveness of European manufacturing. The significant easing of supply chain tensions, as evidenced by the PMI supplier delivery times index, does not suffice to counter the prevailing sentiment and may in fact (at least partially) be a sign of falling demand. All in all, the current level of the PMI composite indicator is consistent with a limited slowdown of economic activity in the euro area in the third quarter of 2022.

Chart 2

PMI indices



Source: Markit.

The Belgian economy expanded by 0.2 % in the second quarter

Belgian GDP growth decelerated in the second quarter of 2022. According to the latest statistics released by the NAI, GDP expanded by 0.2 % QoQ. This confirms the NAI's earlier flash estimate and is slightly better than our estimate in the June 2022 Business Cycle Monitor (0.0 %). Given the deterioration of the external environment in the second quarter, the slightly positive growth suggests that the post-pandemic recovery dynamics continued to support growth and outweighed the headwinds coming from the outbreak of the war in Ukraine and the spike in energy prices. However, in our view this is unlikely be repeated in the third quarter, while headwinds have increased.

As regards the breakdown of second-quarter GDP growth, private consumption surprised on the upside and expanded strongly; this was once again driven by the consumption of non-durables, which now clearly exceeds pre-pandemic levels. Purchases of durable goods, on the other hand, declined further and are now 12 % below the pre-pandemic level. Durables may still have been affected by supply chain problems, but consumers are likely to also have held back on making important purchases given the increasingly uncertain environment. Both firm and housing investment were expected to moderate but fell back somewhat more than anticipated. The marked decline in business investment partly reflects the unwinding of certain one-off purchases of commercial vessels abroad in the first quarter (which does not affect GDP). Public consumption and investment increased in line with expectations, the latter being particularly volatile lately due to certain deliveries of military purchases. Net exports contributed slightly negatively to growth in the second quarter, close to our neutral estimate.

The production approach to GDP shows second-quarter growth to have been mainly driven by services. Market services, in particular, expanded by 0.6 %. In contrast, activity in non-market services declined by 0.4 %. Activity also declined in the manufacturing industry while it still rose slightly in the construction industry.

Household consumption is set to decline slightly in a context of continued inflationary pressures

Second-quarter private consumption held up much better than we expected in the previous BCM, when supply chain problems started worsening again and the war, as well as the spike in energy prices were weighing on consumer confidence and purchasing power.

In hindsight, the deterioration of supply chain issues proved only brief and minor, as evidenced by the aforementioned delivery times indicator (Chart 2, right-hand graph). Nevertheless, we suspect that some spill-over effects coming from the easing of the remaining pandemic-related restrictions in the first quarter may have provided a good start for private consumption growth in the second quarter. However, private consumption should at least decelerate in the third quarter: the impact of the inflation spike on consumer confidence is substantial and lagging indexation mechanisms do not prevent an (at least temporary) erosion of real incomes and purchasing power.

Starting with the latter issue, the year-on-year increase in the national consumer price index shot up to about 10 % in August, the highest level since 1976 and the more internationally comparable harmonised index of consumer prices displayed the largest increase on record (10.5 %). While real incomes are much better protected in Belgium than elsewhere due to the existence of the automatic indexation mechanisms for wages and government transfers, the size and pace of the price increases is bound to have at least a temporary impact on purchasing power. Indexation is not instantaneous but comes with a certain delay depending on the specific mechanism applied. For some employees, the compensation can take up to a year. In addition, while natural gas and electricity are fully taken into account, motor fuels are not included in the health index to which the indexation mechanisms are anchored. Furthermore, even for a good that is fully taken into account in the index, the compensation only reflects the impact on an ‘average household’. In the current circumstances, this means that lower-income households may not be fully compensated as long as gas prices remain this elevated (as the share of their income that is spent on energy is typically higher than average). Finally, certain types of income, most notably those of self-employed, are not automatically indexed. For the latter, adjusting prices and contracts to fully reflect the rise in costs may take more time and prove to be challenging, in particular in a deteriorating economic environment.

All in all, heterogeneity between households can be substantial. The exact impact of inflation on real incomes depends on specific circumstances and consumption patterns (type and level of income, type of fuel used for heating, energy efficiency of the home, etc). The impact is likely to be largest for households in the lower middle class that are not entitled to the (extended) social for natural gas and electricity.[2]

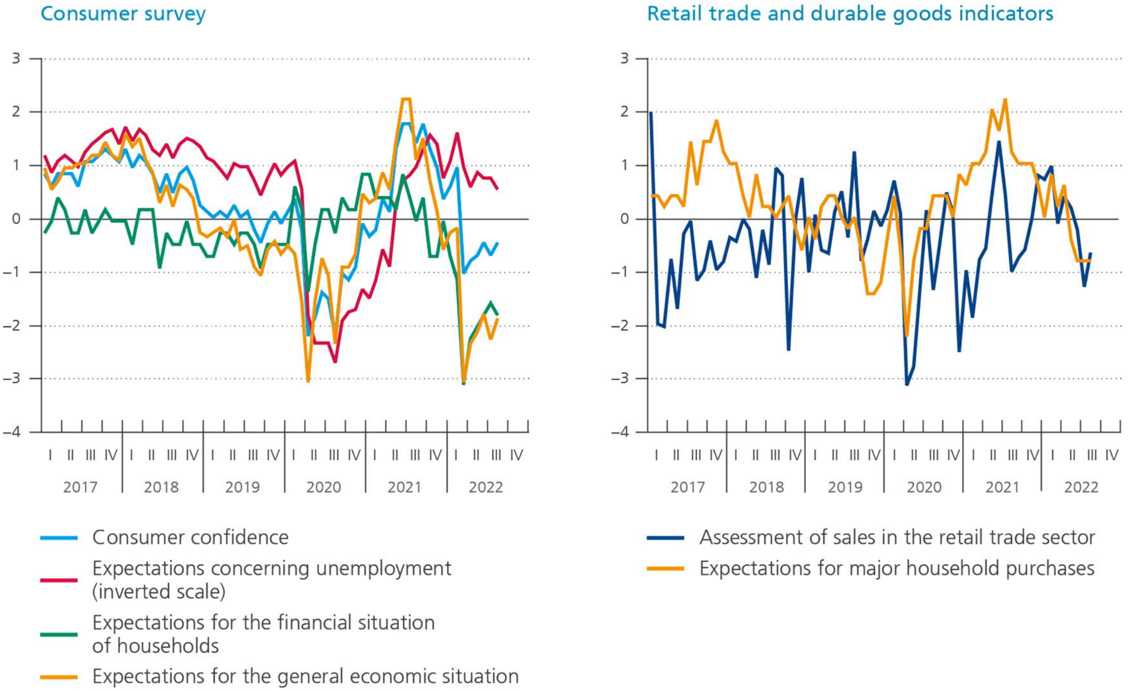
Against this backdrop, consumer confidence has worsened substantially. The headline indicator fell back in March and has recovered only very partially since (see Chart 3, left-hand graph). However, the sub-indicator related to unemployment expectations, which is most relevant for consumption growth in the near term, held up better. Fundamentally, overall purchasing power continues to be supported by positive growth in employment and hours worked, as the labour market remains very robust. Job creation may decelerate somewhat in the near term but is projected to continue. Nevertheless, households’ expectations for their financial situation and for the general economic situation took a very large hit and indicators related to household purchasing behaviour (see Chart 3, right-hand graph) point to a deteriorated outlook for private consumption in the third quarter. The company managers’ assessment of sales in the retail trade sector suggests that sales were robust in the first quarter. However, the indicator came down markedly after May and remains at a very low

[2] See also “A Distributional Picture Of The Purchasing Power Effects Of The 2021-22 Energy Price Shock And Compensating Measures”, ECARES working paper by Capeau, Decoster, Güner, Hassan, Van Houtven, Vanderkelen and Vanheukelom on the purchasing power effects of the recent energy price shock, March 2022.

level despite the small uptick in August. Hard data for retail sales up to June show sales volumes gradually edging down. This implies that consumption may have had a particularly weak start in the third quarter. In addition, the continued decline in expectations regarding major household purchases in the next twelve months does not bode well for durable goods consumption either, even if recent indications suggest that supply chain problems are improving.

Chart 3

Indicators for private consumption growth
(normalised series)



Source: NBB.
Note: the original series are normalised around their historical averages.

All in all, we expect private consumption to decline slightly in the third quarter of 2022. In the longer run, consumption growth should pick up when inflation and the geopolitical uncertainty decline and as the indexation mechanisms gradually catch up with the current decrease in aggregate purchasing power.

Investment should decrease in the third quarter

Current conditions are also likely to continue to depress business investment. The growth rate of investment spending by firms was already gradually softening following the large rebound after the pandemic-triggered crash in early 2020. However, the contraction in investment that materialised in the second half of 2021 was most likely triggered by mounting supply chain problems and surging energy prices and coincided with a downward turn in the overall business sentiment indicator (see Chart 4, left-hand graph).

While the first quarter of 2022 saw a partial recovery in investment as supply chains problems eased and energy prices stabilized, the outbreak of the war in Ukraine and the ensuing consequences for European energy prices amounted to a new shock for European businesses. Although business confidence held up much better than consumer confidence, the outbreak of the war in Ukraine accelerated the downward trend in sentiment. Faced with escalating production costs and an increasingly uncertain economic outlook, firms axed or postponed their investment plans, leading to a new contraction of business investment in the second quarter. This left business investment about 4 % below its pre-pandemic level.

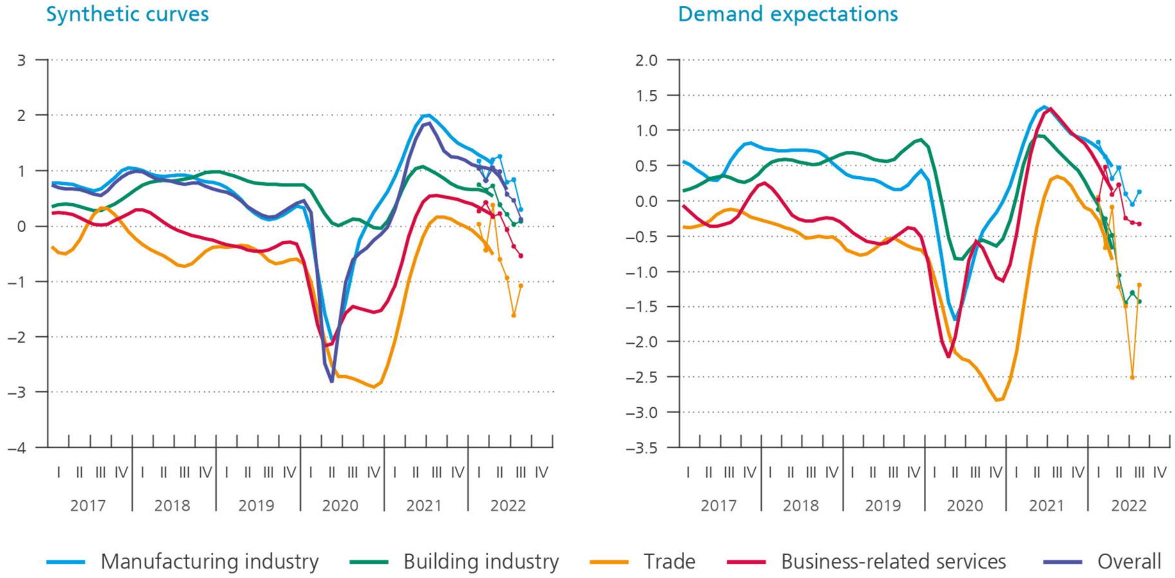
The downturn in business confidence is broad-based, with sentiment in manufacturing, trade and business-related services falling back to their pre-pandemic levels and the construction industry dropping to levels last seen in the early days of the pandemic. The downturn is particularly substantial in the manufacturing industry, where confidence had been historically high since mid-2020 as a large backlog of orders had to be fulfilled and supply chain problems led to increased stock build-up.

Overall, business confidence has returned to pre-pandemic levels and continues to trend down gradually.

Looking ahead, demand prospects have deteriorated considerably in all industries, although the most recent results may signal a tentative bottoming-out (see Chart 4, right-hand graph). Short-run volatility aside, for business-related services and the manufacturing industry the existing downward trend did not accelerate markedly, but demand expectations have soured to a larger degree in the trade and in particular in the building industry. As concerns trade, the decline is somewhat at odds with the surprisingly positive second quarter growth of private consumption in that quarter, but it corroborates our aforementioned negative outlook for private consumption. The steep downturn in the demand outlook for the construction industry reflects the rapidly worsening business climate in that industry, as firms have trouble passing on increased costs of building materials while the gradual increase in mortgage rates and the deteriorated economic outlook start weighing on demand.

Chart 4

Business sentiment and demand expectations
(normalised series)



Source: NBB.
Note: the original series are normalised around their historical averages and divided by their standard deviation.

On the positive side for investments, capacity utilisation in the manufacturing industry fell to 80.7 % in July but remains above both the pre-crisis level and the historical average. In addition, the important labour shortages that often prevent a further expansion of production could incite companies or industries to speed up investments in order to boost labour productivity.

Overall, against this background, we expect business investment to contract again in the third quarter.

Residential investment declined by 0.4 % in the second quarter, although it still exceeds its pre-crisis level by about 5 %. Prices for residential real-estate have risen spectacularly during and after the pandemic, in a context of persistently low mortgage rates. The recent rise in mortgage rates, low consumer confidence, the (temporary) hit to purchasing power and the fall in the aforementioned indicator related to the demand outlook in the building industry all point to more muted developments for the housing market in the near term. However, fundamentals for the real estate market remain sound: despite the uptick, mortgage rates remain low and the labour market remains robust. **Still, residential investment is expected to continue to decline slightly in the third quarter of 2022.**

In the second quarter, government investment rebounded after two negative quarters. This demand component remains volatile due to the temporary effects of large, specific military purchases. Overall, while the timing remains difficult to nail down, **the roll-out of the recovery plans should boost government investment in the coming quarters**. Finally, the growth contribution of inventories should remain close to zero.

All in all, we expect total investment growth to remain negative in the next quarter.

Government consumption should continue to grow moderately

Government consumption increased by 0.5 % in the second quarter according to the current NAI statistics. While it should be stressed that these first statistics on government spending are often revised significantly, the slightly above-average growth was likely boosted by spending for refugees. Although the refugee inflow has been lower than initially anticipated, we expect spending to still increase somewhat in the near term, causing **government consumption to grow at a moderate pace in the third quarter in 2022.**

The growth contribution of net exports is expected to remain close to neutral

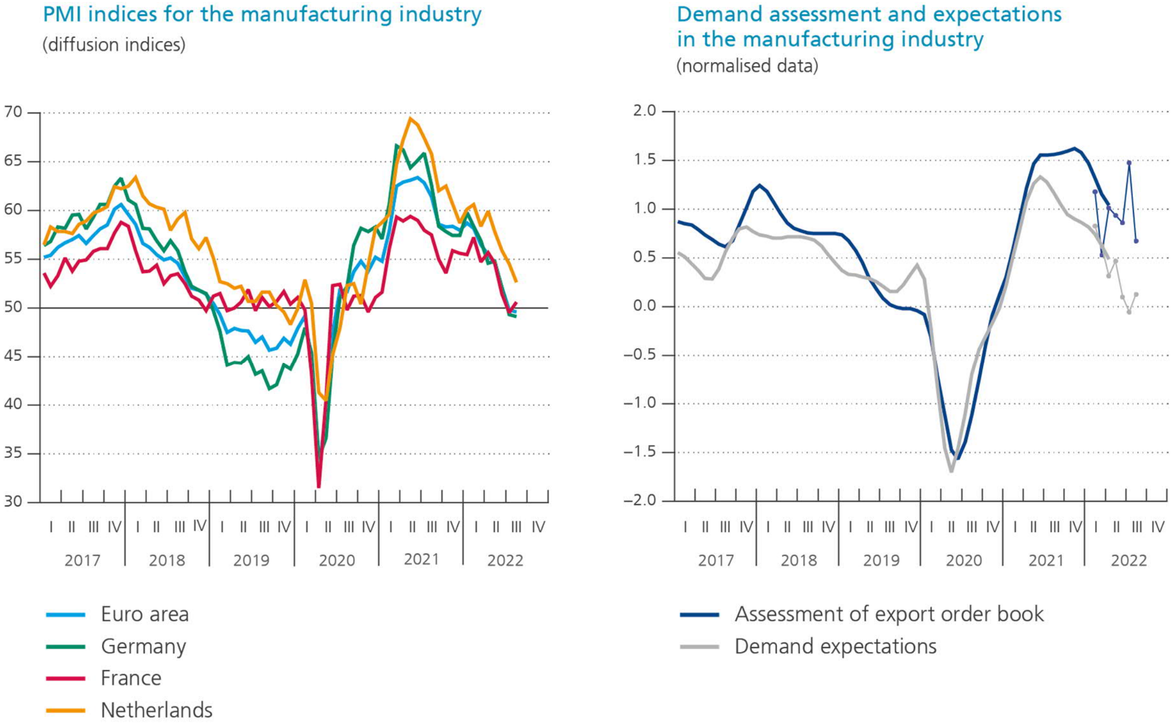
Second-quarter exports decreased by 0.6 %, while import growth fell by about 0.4 %, resulting in a moderate 0.2 pp negative contribution of net exports to GDP growth.

Using the PMI manufacturing index as a proxy for foreign demand (see Chart 5, left-hand graph), demand growth for Belgian exports peaked in the course of the second quarter of 2021, before weakening rapidly in the third quarter due to surging energy prices and expanding supply chain problems affecting international trade. After a brief stabilization, intensifying economic headwinds brought a new deterioration in the second quarter of 2022. The euro area average index fell just below 50 in July and remained there in August, indicating a very moderate contraction of activity. Looking at the most recent data for Belgium's neighbouring countries (and main trading partners) shows very similar results. Optimism among purchasing managers in the Dutch manufacturing industry seems to be holding up slightly better, but sentiment among businesses in France and Germany is nearly in line with the euro area average.

Business survey data for the Belgian manufacturing industry show a similar picture. As indicated above, demand expectations have been trending down after peaking mid-2021. The surge in inflation is rapidly increasing labour costs for Belgian firms through the indexation mechanism, which presents an additional challenge in addition to rising energy-related costs. Export-oriented firms are likely to take a hit, as their profit margins are being squeezed and a pass-through of higher costs to their selling prices worsens their competitiveness position. The assessment of the export order book has worsened considerably since the start of the year, although it remains above pre-pandemic levels (see Chart 5, right-hand graph). All in all, we expect exports to contract further in the third quarter of 2022.

Chart 5

PMI indicators in neighbouring countries and export orders in manufacturing



Sources: Markit, NBB.
Note: the series in the right graph are normalised around their historical averages and divided by their standard deviation.

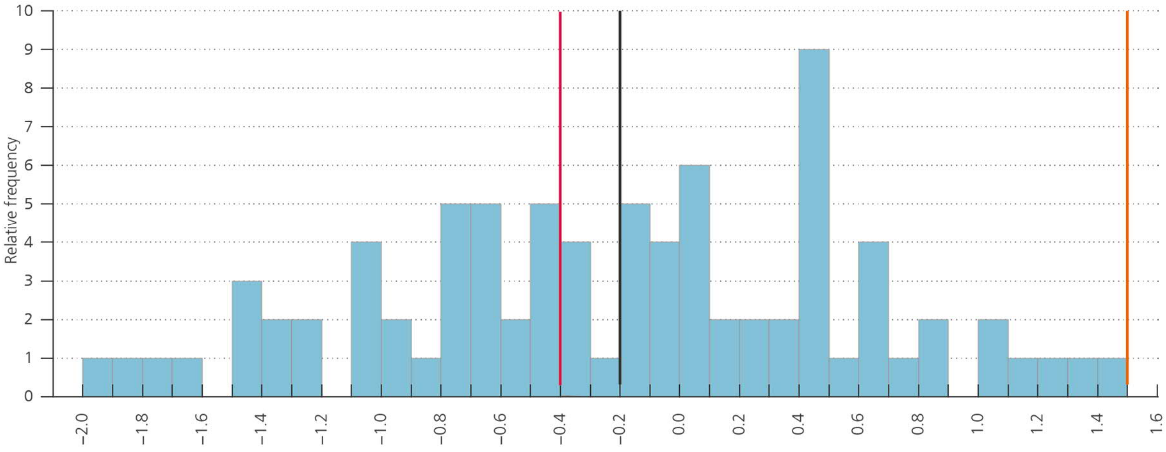
However, the slowdown in domestic consumption and investment should also reduce imports going forward. Overall, **we expect the contribution of net exports to GDP growth to remain close to zero in the third quarter**.

The median value of the mechanical nowcasts points to moderately negative GDP growth in the third quarter of 2022

The informational content in the most recent survey and financial data can be summarised by looking at the range of mechanical GDP predictions using one-indicator bridge models**. The median of the different predictions points to a moderately negative growth in the third quarter of 2022** (see Chart 6). The range is still large at [-2.0; 1.5] % and the distribution is quite wide, indicating considerable uncertainty. Note that the past forecast performance of these simple models suggests that these individual predictions should be interpreted with caution, even in normal times.

Chart 6

Histogram of one indicator bridge model predictions using a broad set of survey and financial data and NBB nowcasting model predictions for real GDP growth in second quarter of 2022



Source: NBB.
Note: The black line corresponds to the median of the one-indicator bridge model predictions for the current quarter GDP growth, while the red and the orange lines respectively correspond to the predictions from the bridge model “BREL” and the dynamic factor model “R2D2”, respectively.

A small contraction of economic activity seems the most plausible scenario for the third quarter

Of the more elaborate standard NBB nowcasting models, “BREL” predicts a negative quarterly growth of 0.4 % in the third quarter, while “R2D2” estimates growth at around 1.5 %. However, as indicated above, the uncertainty of these nowcasting models remains exceptionally large as the massive shocks since the start of the COVID-19 crisis constitute a challenge for the estimation of standard time-series models. Moreover, the economic fallout from the reaction of economic activity to the peak in inflation may not be fully captured by the indicators and coefficients used in these models. Therefore, these model-based estimates need to be complemented with information gathered from other sources, as well as expert judgment.

An important issue in that regard is the direct impact of the current price levels for electricity and natural gas on certain energy-intensive production processes (in the manufacturing and food industries in particular). While this remains anecdotal for now, companies may find it no longer profitable to continue their operations and voluntarily reduce output or temporarily stop production. It is very difficult to estimate the impact of this phenomenon (that should remain limited to certain industries) on overall GDP growth. However, as gas and electricity prices have rallied further in the second half of the quarter, this is likely to intensify in the weeks to come. Hence, the currently available indicators may not yet fully capture the worsening outlook.

All in all, we currently expect economic activity to contract by 0.2 % in the third quarter. This is in line with median of the one-indicator models and towards the more pessimistic end of the range provided by the two model nowcasts. It should again be stressed that the uncertainty of this nowcast is high. Given the recent positive surprises coming from household consumption and the strong labour market, a more positive outcome is definitely possible. At the same time, the economic situation is likely to worsen further if the current energy price pressures persist or intensify.