Business Cycle Monitor

June 2022

Belgian economic activity is expected to flatline in the second quarter of 2022[1]

- Belgian real GDP increased by 0.5 % in the first quarter of 2022. Hence, growth was more or less in line with the previous Business Cycle Monitor estimate (+0.6 %) and was revised up considerably compared to the NAI's first flash estimate.
- The sharp increase in uncertainty as well as the temporary hit to purchasing power due to high inflation and lagging indexation mechanisms should lead to a decrease in private consumption in the second quarter of 2022. In the somewhat longer run, fundamentals for private consumption remain solid.
- Business investment expanded in the first quarter, after a marked decline in the second half of the year. Business sentiment is on a gradual downward trend and demand expectations are worsening quickly. Hence, we expect business investment growth to moderate in the second quarter. Similarly, housing investment is also expected to decelerate in the second quarter.
- Government consumption growth should rise in the second 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 second 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 second quarter at about 0.3 %, while the "R2D2" model is more optimistic with a growth rate of 0.8 %. However, 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.
- All in all, we currently see a stagnation of economic activity (0 % growth) as the most plausible estimate. The drop in activity growth in March seems to have been less dramatic than initially feared, but the starting point and the carry-over for the second quarter is bound to be much worse than for the first quarter. Business confidence keeps trending down and demand expectations are falling. At the same time, the sharp decrease in consumer confidence in March and the mounting inflationary pressures are clearly and increasingly affecting consumer purchasing power and behaviour. Both will work to reduce the growth rate in the second quarter.

[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 June 2022. As all estimates and forecasts, it comes with a degree of uncertainty.

Euro area GDP increased by 0.6 % in the first quarter of 2022 but should decelerate in the second quarter of 2022

Following the economic rebound in the second and the third quarter of last year, surging energy prices, continued supply chain issues and the resurgence of COVID-19 caused activity in the euro area to decelerate markedly in the final quarter of 2021. However, **in the first quarter of 2022 GDP in the euro area accelerated again, reaching 0.6 % in volume terms compared to the fourth quarter[2].** The year-on-year growth rate rose to 5.4 %, also due to strong growth in 2021.

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]
	2021Q2	2021Q3	2021Q4	2022Q1	2022Q1	2022Q1
Euro area	2.2	2.2	0.3	0.6	5.4	0.8
Germany	2.2	1.7	-0.3	0.2	3.8	-0.9
France	1.0	3.2	0.4	-0.2	4.5	0.3
Italy	2.7	2.5	0.7	0.1	6.2	0.0
Spain	1.1	2.6	2.2	0.3	6.4	-3.4
Netherlands	3.8	2.0	1.0	0.0	7.0	3.1
Belgium	**1.7**	**2.1**	**0.4**	**0.5**	**4.9**	**1.6**
EU	2.1	2.2	0.5	0.4	5.2	1.1
UK	5.6	0.9	1.3	0.8	8.7	0.7
US	1.6	0.6	1.7	-0.4	3.5	2.8
JP	0.5	-0.7	0.9	-0.2	0.5	-0.7

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

Growth rates in all major euro area economies were clearly more muted than in previous quarters. Economic activity expanded slightly in Spain and in Germany. However, it was broadly unchanged in Italy and the Netherlands and decreased slightly in France. Certain smaller economies supported euro area growth more. Disregarding Ireland, the strongest growth rates in the euro area were recorded in countries where growth could benefit from the recent lifting of COVID-19 containment measures, such as Austria (1.5 %), Portugal (2.6 %) and Latvia (3.6 %). All in all, the euro area economy as a whole has now exceeded the pre-pandemic output level by 0.8 % but there is a lot of country heterogeneity. Output in The Netherlands and Belgium already strongly exceed the pre-pandemic level (by 3.1 % and 1.6 % respectively), while the French and Italian economies are at or just above that level. Economic activity in Germany and, in particular, Spain, is still clearly lower than before the pandemic.

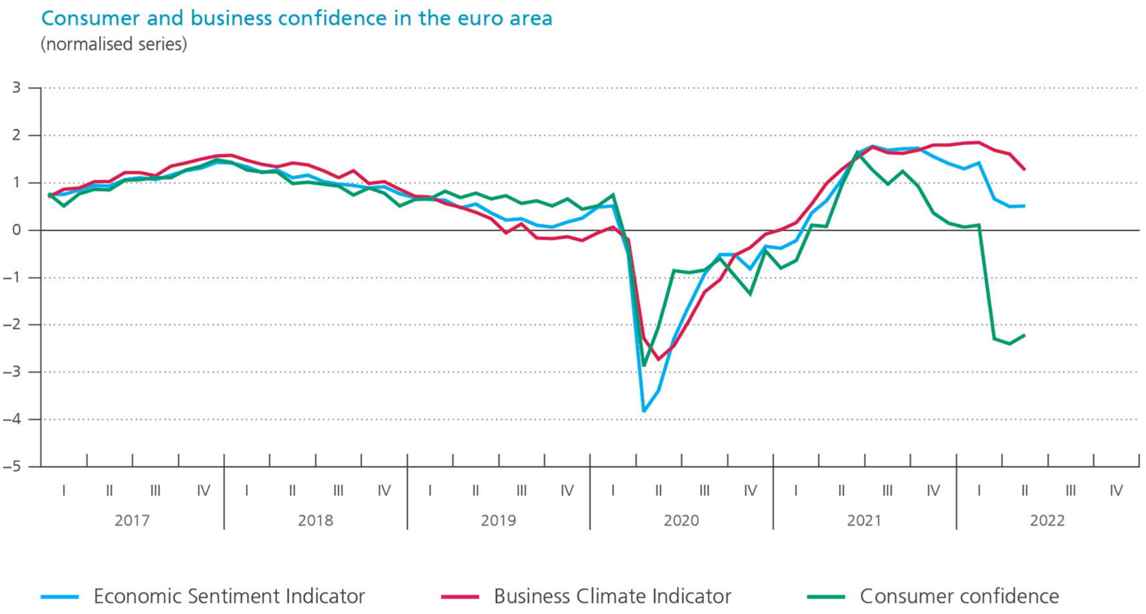
Among the major economies outside the euro area, the US economy surprisingly posted a 0.4 % decline in quarter-on-quarter terms in the first quarter of 2022. Despite this setback, economic output in the USA is still about 3 % above the pre-crisis level. Quarterly growth also came in negative in Japan, which has not yet recovered to the pre-COVID-19 output level. The UK economy, on the other hand, posted a solid 0.8 % quarterly growth and now exceeds its pre-crisis size by 0.7 %.

[2] Also due to very strong Q1 GDP growth in Ireland (10.8 %). However, GDP growth is notoriously volatile in Ireland due to the statistical accounting of certain transactions by multinational corporations.

Turning to the soft indicators, the EC's overall economic sentiment indicator (ESI), reflecting both the business climate and consumer sentiment in the euro area, stabilized in May after falling in March and April. Consumer confidence bottomed out after the sharp decline, while sentiment in the services and, to a lesser extent, the construction industries improved. However, confidence declined in retail trade and, in particular, in the manufacturing industry. Viewed over the longer term, the 'headline' ESI has come down from the very high levels of the summer of last year, when it reached a historic maximum (see Chart 1). Consumer confidence weakened much more than business sentiment. The latter held up longer and actually peaked in February but has also softened somewhat since.

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.

The PMI composite indicator for the euro area (see Chart 2, left-hand graph) declined slightly in May, but remains strongly in expansionary territory (i.e. at a level above 50). The minor decline stemmed from both services and the manufacturing industry. Whereas sentiment in the services industries had rebounded following the post-COVID-19 normalisation of consumer spending, confidence in the manufacturing industry was less affected by pandemic setbacks after the initial shock. The recent decline in manufacturing sentiment reinforces a gradual downward trend that started already back in mid-2021. The new export orders index for the manufacturing industry (see Chart 2, right-hand graph) fell slightly below the 50-point mark (i.e. declining) in April and remained there in May. Supply chain problems remain a significant cause for concern, as evidenced by the PMI supplier delivery times index remaining far below the 50-point mark. All in all, the current level of the PMI composite indicator remains consistent with further positive, but moderating growth of the euro area economy in the second quarter of 2022. In this connection, the minor improvement in the PMI delivery time indicator raises hopes that the impact of supply bottlenecks could be decreasing.

Chart 2

PMI indices

PMI indices for the euro area
(diffusion indices)

PMI manufacturing export orders and delivery times in the euro area
(diffusion indices)

Source: Markit.

The Belgian economy expanded by 0.5 % in the first quarter

According to the latest statistics released by the NAI, Belgian GDP expanded by 0.5 % QoQ in the first quarter of 2022. This is a significant upward revision compared to the NAI's earlier flash estimate and in the end first-quarter growth has turned out very close to our estimate in the March Business Cycle Monitor (0.6%). The 0.5 % increase is higher than potential and a tad above the growth rate in the last quarter of 2021. This relatively strong performance reflects the fact that the lifting of the containment measures in the last quarter still had an important carry-over effect on quarterly growth at the start of 2022. As expected, this has outweighed the headwinds coming from the spike in energy prices and the resurgence of supply chain problems. However, the post-pandemic normalisation is not likely to boost second-quarter GDP to the same extent, while the headwinds remain.

The breakdown of first-quarter GDP growth shows that private consumption expanded due to the recovery in the consumption of non-durables. Purchases of durable goods declined and may still have been affected by supply chain problems. However, both firm and housing investment rebounded. This suggests that the impact of uncertainty and the other headwinds still remained contained in the first quarter, even if the relatively large positive growth contributions of inventories could be consistent with a slowdown in consumer demand in the course of the quarter (or, alternatively, result from voluntary increases in inventories in the face of supply chain pressures). Public consumption and investment declined, in the latter case due to the fact that growth in the previous quarter had been boosted by certain military purchases. As expected, net exports contributed much less to growth than in the previous quarter: exports actually fell but imports declined slightly more.

The production approach to GDP shows first-quarter growth to have been mainly driven by services. In particular by consumer-oriented market services, which posted a 1.1 % growth. Activity in non-market services stagnated. Activity increased by 0.7 % in the construction industry while it declined by 0.7 % in the industrial branches. However, the latter is only due to a marked decrease in electricity production: output in the manufacturing-subset within the broader industrial branches remained stable on average compared to the fourth quarter.

Household consumption is set to decline slightly in a context of high inflationary pressures and elevated uncertainty

Private consumption recovered in the first quarter of 2022 and is again at its pre-pandemic level. However, it seems likely that consumption growth has at least lost traction in the second half of the quarter, which should reduce growth in the second quarter. Supply chain problems have worsened again and the war, as well as the spike in energy prices is weighing on consumer confidence, while real incomes fall at least temporarily.

Starting with the latter issue, consumer inflation shot up in May: the annual increase in the national consumer price index ballooned to about 9 %, the highest level since 1982, while the harmonised index of consumer prices reached the highest level since the start of this more internationally comparable indicator (9.9 %). The existence of the automatic indexation mechanisms for wages and other incomes does not prevent a temporary impact of this surge in inflation on purchasing power. First, inflation is still mostly driven by energy prices and motor fuels are not included in the health index to which the indexation mechanisms are anchored. Second, indexation is not instantaneous, but incomes are indexed with a certain delay. Hence, real incomes decline at least temporarily. The exact impact of inflation on real incomes depends on specific circumstances (e.g. whether the household has a fixed-rate energy contract) and consumption patterns but is likely to be larger for households in the lower middle class that are not entitled to the (extended) social for natural gas and electricity[3]. It should be stressed that purchasing power will be boosted once income indexation fully kicks in, in particular to the extent inflation is projected to decline gradually. **All in all, aggregate purchasing power is taking a hit in the short run but should rise again thereafter.**

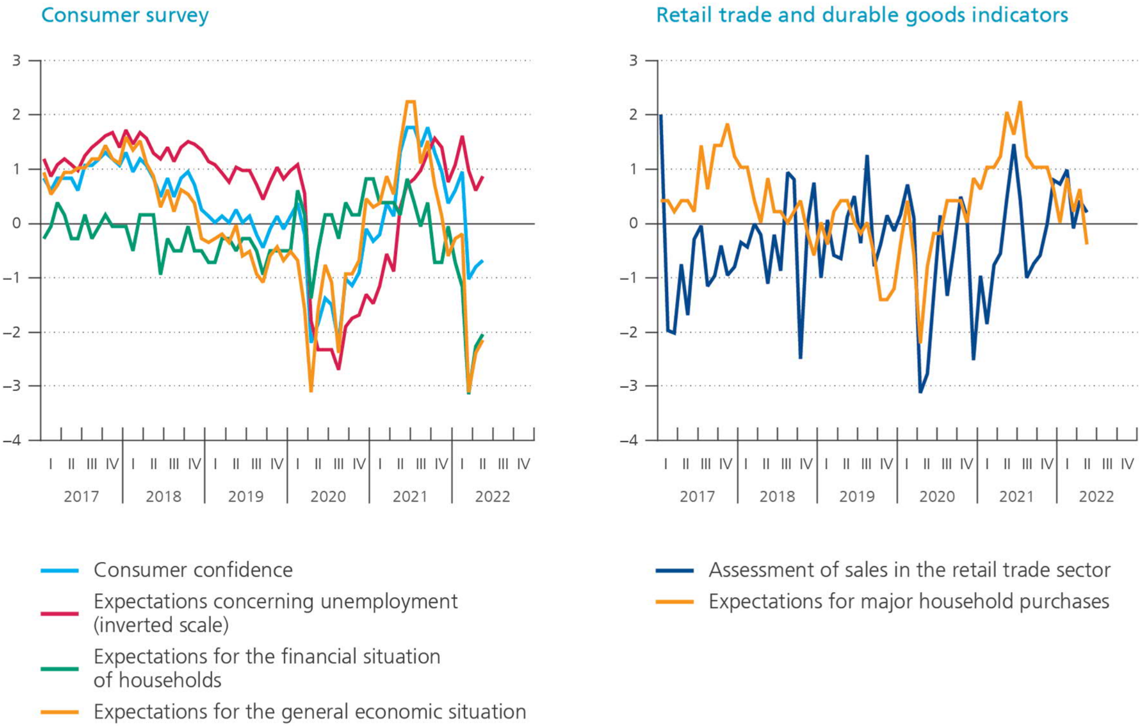
Turning to consumer confidence, headline consumer confidence has plummeted in March due to the large uncertainty after the start of the war (see Chart 3, left-hand graph). This partly reflects the worsened outlook for the Belgian economy, even though unemployment expectations, that are more relevant for consumption growth in the near term, remained somewhat more resilient. Still, the outlook for households' own financial situation also worsened dramatically and the overall confidence level remains very low, despite the limited recovery in April and May.

Other indicators (see Chart 3, right-hand graph) also point to deteriorated conditions and an uncertain outlook for consumption in the second quarter. The company managers' assessment of sales in the retail trade sector recovered only very partially from the fall in March. According to the indicator, growth in non-durable consumption in the first quarter could indeed have been mostly limited to the period prior to the Russian invasion of Ukraine, suggesting that the second quarter may have had a very weak start. This is corroborated by reports by retail federations which state that consumers are cutting back on purchases of goods such as clothing. In addition, the continued decline in expectations regarding major household purchases in the next twelve months does not bode well for durable goods consumption in the second quarter either, even if recent indications suggest that supply chain problems are no longer worsening.

[3] 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.

Chart 3

Indicators for private consumption growth
(normalised series)



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

More generally, the fundamentals for private consumption remain solid. The current pressure on real incomes should disappear as the indexation will gain traction and inflation is projected to gradually come down. In addition, overall purchasing power continues to be supported by increases in employment and hours worked (in particular as workers are still exiting temporary unemployment). Job creation may decelerate somewhat but is projected to continue. As indicated, this assessment is reflected in consumers' unemployment expectations, that remain quite resilient.

All in all, we expect private consumption to decline slightly in the second quarter of 2022. Consumption growth may remain sluggish over the summer, but it should pick up beyond the near term, if inflation and the geopolitical uncertainty decline somewhat.

Investment should expand more moderately in the second quarter

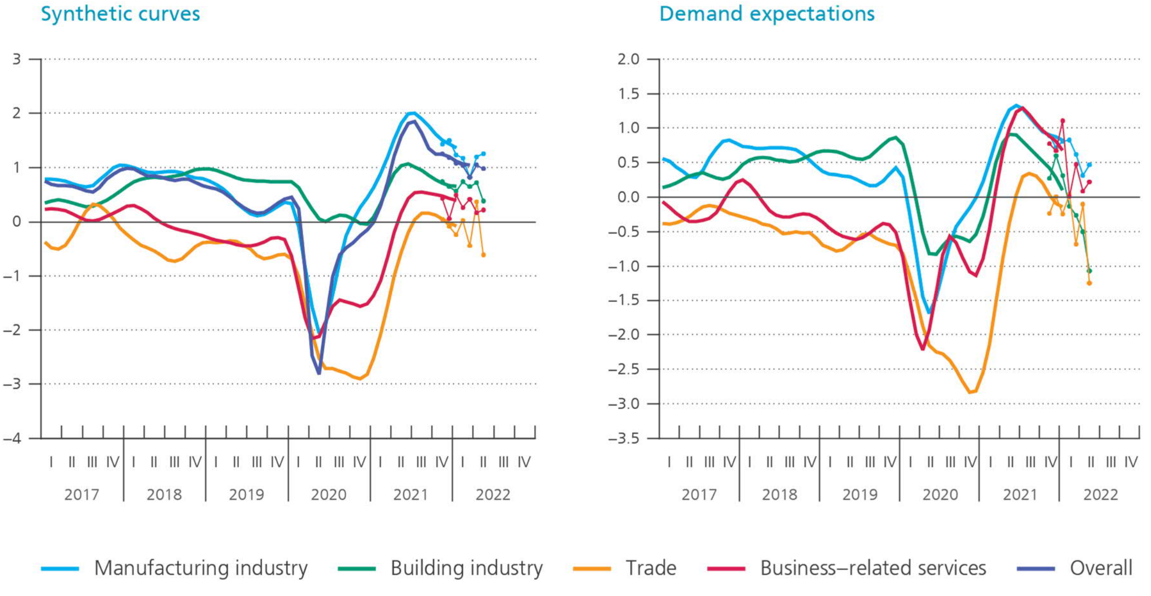
After a significant contraction in the second half of 2021 that was most likely due to mounting supply-chain problems and surging energy prices, business investment rebounded by close to 3 %, in the first quarter of 2022. While overall business confidence has gradually come down from the peak in the summer of 2021 (see Chart 4, left-hand graph), it held up much better than consumer confidence since the start of the war. In the most recent months sentiment seems to have stabilised in manufacturing while it continued to trend down very gradually in business-related services and somewhat faster in both the construction industry and in trade. **Overall, business confidence remains high even if its gradual downward trend continues for now.**

However, **demand prospects are worsening at a much faster rate** (see Chart 4, right-hand graph). Short-run volatility aside, the outlook for demand has deteriorated in all industries. For business-related services and the manufacturing industry, the decline remains broadly in line with the gradual downward trend observed before, but demand expectations have soured much more in the trade and the building industry. As regards trade, this seems to confirm the aforementioned negative outlook for private consumption. The demand outlook for the construction industry on the other hand, is suffering from the rising costs of building materials and the gradual increase in mortgage rates.

On the positive side for investments, the latest quarterly survey on production capacity in the manufacturing industry indicates that capacity utilisation in that industry actually increased markedly in April, to 81.8 %, 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 some companies or industries to speed up investments in order to boost labour productivity.

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.

Against this background, we expect a relatively limited impact of the worsening demand outlook on business investment growth; it should weaken but remain positive in the second quarter.

Residential investment also increased by close to 3 % in the first quarter and now exceeds its pre-crisis level by nearly 6 % already. 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, combined with the collapse of consumer confidence and the fall in the aforementioned indicator related to the demand outlook in the building industry all point to a cooling down of the housing market in the near term. However, fundamentals for the real estate market remain sound: mortgage rates are still low despite the uptick and, as indicated, households' income prospects remain robust in the somewhat longer run. **Overall, residential investment should clearly decelerate in the second quarter of 2022.**

In the first quarter government investment fell back but this was due to the disappearance of specific military purchases in the periods before. While the timing remains difficult to nail down, also because of the supply restrictions in the construction industry, **the roll-out of the recovery plans should boost government investment in the coming quarters**. Finally, the large positive growth contribution of inventories in the previous quarter is likely not to be repeated.

All in all, we expect that total investment growth should clearly moderate but remain positive in the next quarter.

Government consumption should recover somewhat

Government consumption decreased by 2.5 % in the first quarter according to the current NAI statistics. While it should be stressed that these first statistics on government spending are often revised significantly, the decline seems to be due to an unwinding of additional healthcare spending related to the vaccination campaign in the second half of 2021. The impact of this normalisation may be spread out over several quarters but should in principle fade. In addition, the increase in other spending programmes, such as for refugees, should push up government consumption to some extent. Against this backdrop, we currently expect **government consumption growth to increase somewhat in the second quarter in 2022.**

The growth contribution of net exports should remain close to zero

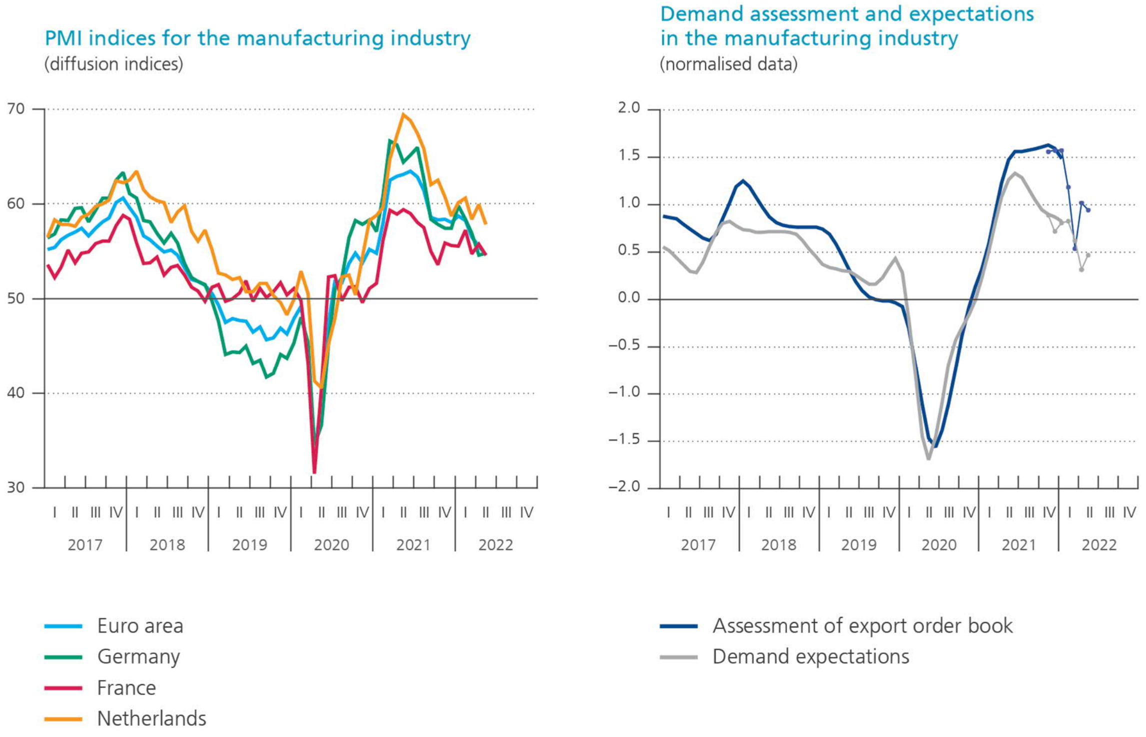
In the first quarter, exports decreased by 0.9 %, while import growth fell by about 1.1 %, resulting in minor positive contribution of net exports to GDP growth.

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 second quarter of 2021, before weakening rapidly in the third quarter due to surging energy prices and expanding supply chain problems affecting international trade. The first quarter of 2022 brought a new deterioration as economic headwinds intensified again. The euro area average index fell to 54.6 in May, indicating continued positive but weakening growth. 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 their colleagues in France and Germany is now nearly in line with the euro area average.

The most recent business survey data for the Belgian manufacturing industry show a similar picture. As indicated above, demand expectations have been trending down after their peak mid-2021. The very high inflation has strongly increased labour costs for firms, which comes on top of rising energy and input costs. Exporting firms are likely to pass this on to some extent to their selling prices, which should worsen their competitiveness at least temporarily. The assessment of the export order book has remained remarkably stable at a high level for a long time but fell sharply in February and March and has recovered only very partially since (see Chart 5, right-hand graph). All in all, we expect exports to contract further in the second 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.

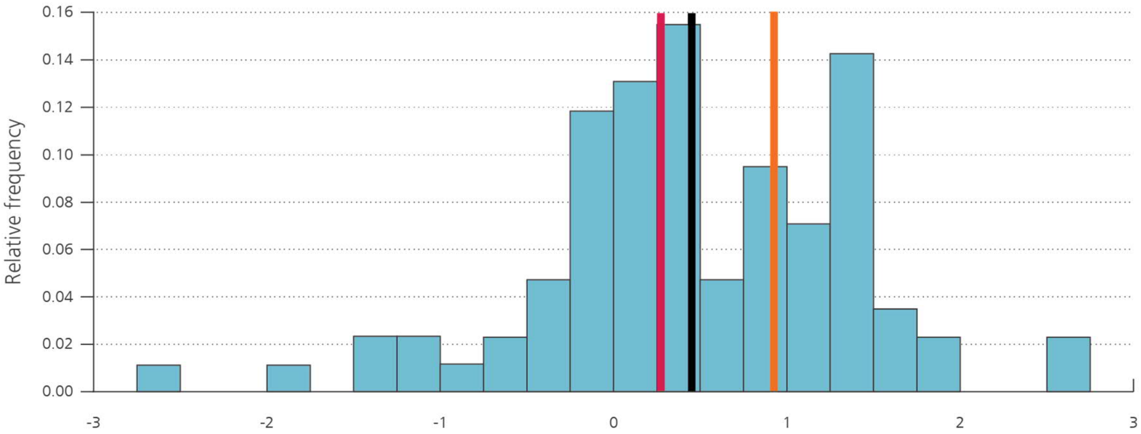
However, the slowdown in domestic consumption and investment should also reduce imports going forward. Overall, **we expect the contribution of net exports to GDP growth to remain broadly constant at around zero in the second quarter**.

The median value of the mechanical nowcasts points to broadly unchanged GDP growth in the second 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 prediction points to a moderately positive growth in the second quarter of 2022** (see Chart 6). The range is still very large at [-2.75; 2.75] % and skewed towards more positive outcomes; there are roughly two ‘peaks’ in likelihood, around 0 and 1, resulting in a median estimate of about 0.5 %. This would imply a constant growth rate compared to the previous quarter. 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.

Zero growth seems the most plausible estimate for the second quarter even is model nowcasts are more optimistic

Of the more elaborate standard NBB nowcasting models, “BREL” predicts 0.3 % quarterly growth in the second quarter, while “R2D2” estimates growth at around 0.9 %. 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 war in Ukraine and the reaction of economic activity to the resulting inflationary pressures may not yet 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.

In that regard, the drop in activity growth in March seems to have been less dramatic than initially feared. On the other hand, the starting point and the carry-over for the second quarter is bound to be much worse than for the first quarter. Business confidence keeps trending down and demand expectations are falling while the sharp decrease in consumer confidence in March together with the spike in energy prices and recently broadening inflationary pressures are clearly and increasingly affecting consumer purchasing power and behaviour. Both will work to reduce the growth rate in the second quarter.

All in all, we currently see a stagnation of economic activity (0 % growth) as the most plausible estimate. This nowcast is included in the Bank’s update macroeconomic projections that will be published on 13 June. It is in line with the left probability peak of the one-indicator models but below the range provided by the two model nowcasts. Hence, it should be seen as a conservative estimate and, on balance, risks seem tilted to the upside. It should again be stressed that the uncertainty of this nowcast is much higher than usual. The biggest risks to the outlook are related to the ongoing geopolitical tensions and escalating commodity prices.