Business Cycle Monitor

December 2022

Belgian economic activity is expected to contract marginally by 0.1 % in the fourth quarter of 2022[1]

- The latest NAI statistics put Belgian real GDP growth at 0.2 % in the third quarter of 2022. While this constitutes a clear slowdown compared to the second quarter, this is clearly better than the NAI's initial flash estimate of -0.1 % and our own estimate of -0.2 % in the previous Business Cycle Monitor.
- GDP growth benefited from an unexpected expansion of private consumption and services in particular even though consumer confidence remains near a record low. Nevertheless, indicators and hard data point to a stagnation of private consumption in the fourth quarter of 2022. However, household consumption is likely to pick up beyond the near term as price pressures soften and the indexation mechanisms push up nominal incomes.
- Even more than in previous quarters, escalating production costs and the uncertain economic outlook have led to a contraction of business investment in the third quarter. Business sentiment and demand expectations remain at low levels, although some improvement was seen in the very latest data. All in all, we expect business investment to decline again in the fourth quarter. Housing investment is expected to edge further down as well.
- Government consumption should grow very moderately in the fourth quarter, while the roll-out of investment plans should lead to positive government investment growth.
- The growth contribution of net exports should come in negative again in the fourth quarter, as export growth is likely to underperform import growth.
- The NBB nowcasting model "BREL" currently estimates quarterly growth in the fourth quarter at about -0.1 %, while the "R2D2" model is clearly much more optimistic with a growth rate of 1.0 %. 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 expect economic activity to contract by 0.1 % in the fourth quarter. This is below the median of the one-indicator models and in line with the most downbeat of 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. The balance of risks seems to be on the upside.

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

Euro area GDP growth remained positive in the third quarter but should contract slightly in the fourth quarter of 2022

Euro area economic activity has been remarkably resilient since the outbreak of the war in Ukraine and the ensuing fallout on commodity and energy markets. The 0.8 % quarter-on-quarter growth in the second quarter was likely still boosted to some degree by post-pandemic reopening dynamics, with household consumption in many euro area economies recovering after governments scaled down restrictive health measures. This effect may still have affected the third quarter to some extent as well: despite intensifying headwinds and a massive surge in energy prices, third-quarter euro area growth in volume terms **came in at 0.3 % compared to the second quarter.** The year-on-year growth rate reached 2.3 %. The services sector supported growth, while value added from manufacturing activity declined.

Table 1

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

	Quarter-on-quarter change				Year-on-year change
	2021Q4	**2022Q1**	**2022Q2**	**2022Q3**	**2022Q3**
Euro area	0.5	0.6	0.8	0.3	2.3
Germany	0.0	0.8	0.1	0.4	1.3
France	0.6	-0.2	0.5	0.2	1.0
Italy	0.9	0.1	1.1	0.5	2.6
Spain	2.3	-0.2	1.5	0.2	3.8
Netherlands	0.6	0.3	2.4	-0.2	3.1
Belgium	**0.6**	**0.6**	**0.5**	**0.2**	**1.9**
EU	0.7	0.7	0.7	0.2	2.4
UK	1.6	0.7	0.2	-0.2	2.4
US	1.7	-0.4	-0.1	0.7	1.9
JP	1.0	0.1	1.1	-0.3	1.9

Sources: EC, U.S. Department of Commerce, Cabinet Office Japan.

Growth rates in most major euro area economies moderated significantly in the previous quarter, with Germany being a remarkable exception. Despite being heavily exposed to the current energy price shock, German GDP accelerated to 0.4 % in the third quarter, up from 0.1 % in the second. Both services and manufacturing supported German GDP growth. Falling output in manufacturing branches such as the chemical industries were more than compensated by increases in the automotive and machinery industries. Production in the latter industries was likely supported by rapidly improving supply chains. Elsewhere in the euro area, the Italian economy expanded by 0.5 % and quarterly GDP growth came in at 0.2 %, in France and Spain. The Netherlands was the only larger euro area country where economic activity contracted slightly but this was preceded by a vigorous second quarter that benefited from strong reopening effects.

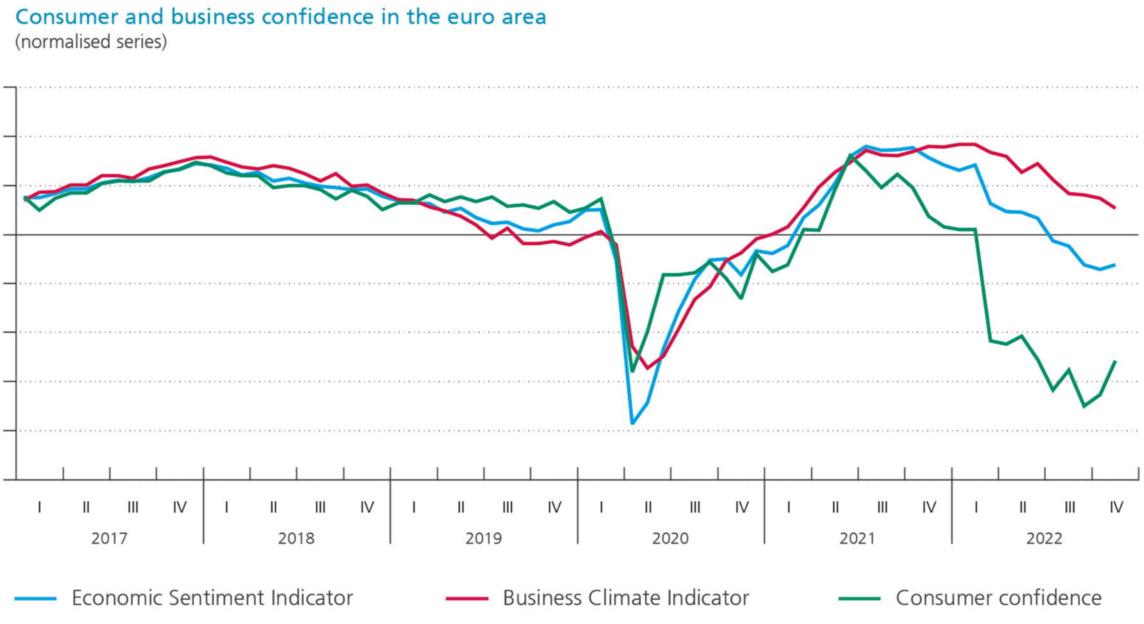
Among the major economies outside the euro area, the economies of the UK and Japan contracted slightly in the third quarter. After two consecutive negative quarters, economic output in the US rebounded and grew by 0.7 % in the third quarter.

Generally speaking, soft indicators for economic activity are weak, but do not point to an imminent, deep economic crisis. The EC's overall economic sentiment indicator (ESI), reflecting sentiment from both the supply side and demand side in the euro area, edged up in November. There are tentative signs that consumer sentiment, which had weakened dramatically since the turn of the year and which remains near the lows seen during the COVID-19 pandemic, is now bottoming out. The labour market remains resilient. The sub-indicator related to overall consumer confidence improved slightly in November (see Chart 1) on account of a more positive outlook by households of their current and expected financial situation. This was mirrored in retail trade confidence, which edged up as well for the second consecutive month after the low in September. In addition, after months of gradual weakening, sentiment in the services industries came in stable due to an improving demand outlook.

However, confidence in the construction and manufacturing industries continued to worsen in November. Sentiment in manufacturing in particular fell as energy prices surged over the summer months, despite growing evidence of easing supply restrictions. The latest assessment by managers in those industries shows a continued deterioration of the level of order books and an uncomfortable degree of stock building. This is reflected in the further drop of the Business Climate Indicator (BCI) in November, although it remains firmly above both its long-run average, as well as the pre-pandemic level.

Chart 1

Sentiment indicators for the euro area

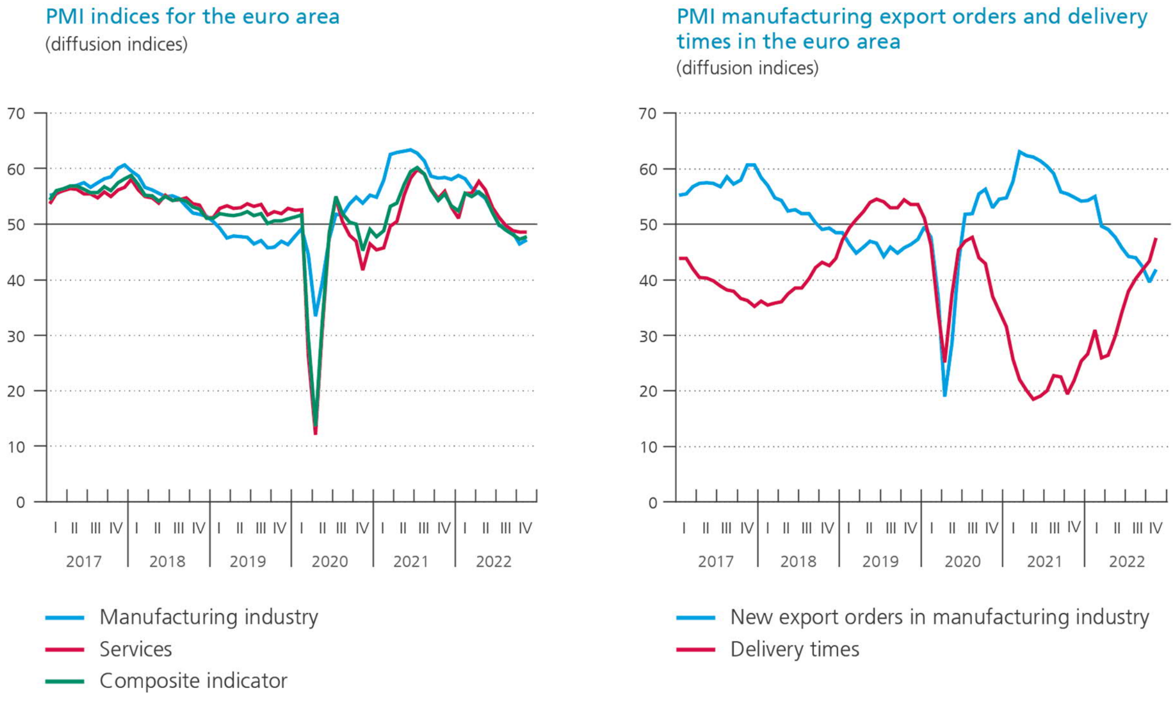


Source: EC.
Note: the original series are normalised around their historical averages and divided by their standard deviation.

Similarly, the PMI composite indicator for the euro area (see Chart 2, left-hand graph) has fallen below 50 since a couple of months, which in principle signals a mild contraction in economic activity. As indicated above, in reality, the euro area economy has still expanded slightly. At the same time, given the amplitude of the shocks in the energy and commodity markets in recent quarters and the sustained high inflationary environment, the deterioration of confidence among purchasing managers seems comparatively mild. This could be due to unexpected economic resilience, but other factors are likely also at play, such as the high levels of direct and indirect government support for firms and households being rolled out in many countries. The small uptick that was recorded in the composite indicator in November was driven by a slight improvement in confidence in the manufacturing industry, whereas confidence levels in the services industry have been more or less stable since September. The edging up of manufacturing confidence could just be down to short-run volatility, but anecdotal evidence suggests that the decline in input and energy prices in the autumn has reduced the pressure on manufacturing industries somewhat; some even reopened production lines that had been shut down in the third quarter. The uptick in November is also visible in the new export orders index for the manufacturing industry (see Chart 2, right-hand graph), but its level remains quite far below the 50-point mark (i.e. negative growth). European energy prices remain elevated and have eroded the competitiveness of European manufacturing. The significant easing of supply chain tensions, as evidenced by the PMI supplier delivery times index reaching pre-crisis levels, does not suffice to counter the prevailing sentiment and is likely at least in part caused by falling demand. All in all, the current level of the PMI composite indicator seems consistent with an additional, albeit limited slowdown of economic activity in the euro area in the fourth quarter of 2022.

Chart 2

PMI indices



Source: Markit.

The Belgian economy expanded by 0.2 % in the third quarter

Belgian GDP growth decelerated in the third quarter of 2022. According to the latest statistics released by the NAI, GDP expanded by 0.2 % QoQ. This is clearly up from the NAI's earlier flash estimate of -0.1 % and higher than our estimate in the September 2022 BCM (-0.2 %).

Much of the stronger-than-expected GDP growth was driven by the strong out-turn for consumption by households. Although consumer confidence plummeted in surveys and despite the headwinds coming from the very high inflation, private consumption still expanded by 0.7 % on a quarterly basis in the last quarter. The increase was driven by both durables and non-durables, although consumption of durables was still far below the pre-COVID-19-level.

The resilience of private consumption may be due to continuing reopening dynamics[2] but also to the fact that actual purchasing power has not been eroded as much as standard indicators suggest. Belgian households are on average particularly well protected against price shocks given the automatic indexation mechanisms for wages and social benefits. In fact, the measured increase in the health index, which is used for the indexation of nominal wages and replacement incomes, is

[2] The integration of the annual accounts for 2021 in the new releases of the NAI has brought about a downward revision of past household consumption. Whereas the previous estimate was that private consumption regained its pre-COVID-19-level in the first quarter of 2022, the current vintage of the data indicates that this only happened in the past quarter.

likely to overstate the actual increase in the cost of living.[3] This implies that nominal increases due to indexation could boost purchasing power. In addition, the government has taken a range of other measures. For example, the (extended) social tariff for natural gas and electricity now shields about 1 in 5 households to a large degree from current energy prices. Taken together, the share of the population that is losing purchasing power may be smaller than anticipated – although heterogeneity between households can be substantial. The exact impact on real incomes depends on specific circumstances and consumption patterns.

Turning to the other demand components, both firm and housing investment contracted in the third quarter, as was expected. The decline in public investment in the current quarterly statistics is more surprising, given the roll-out of recovery plans. Public consumption stagnated, whereas we expected moderate growth in the September 2022 BCM. Finally, net exports contributed negatively to growth in the third quarter, in line with our estimate.

The production approach to GDP shows that third-quarter growth has been mainly driven by services. Market services, in particular, expanded by 0.6 %. Activity also rose slightly in the construction industry. In contrast, activity declined by 0.9 % in the manufacturing industry and by 0.2 % in non-market services.

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

Third-quarter private consumption held up much better than we expected in the previous BCM, despite the plummeting of consumer confidence as energy prices continued to surge over the summer, as all countries sought to fill up gas reserves.

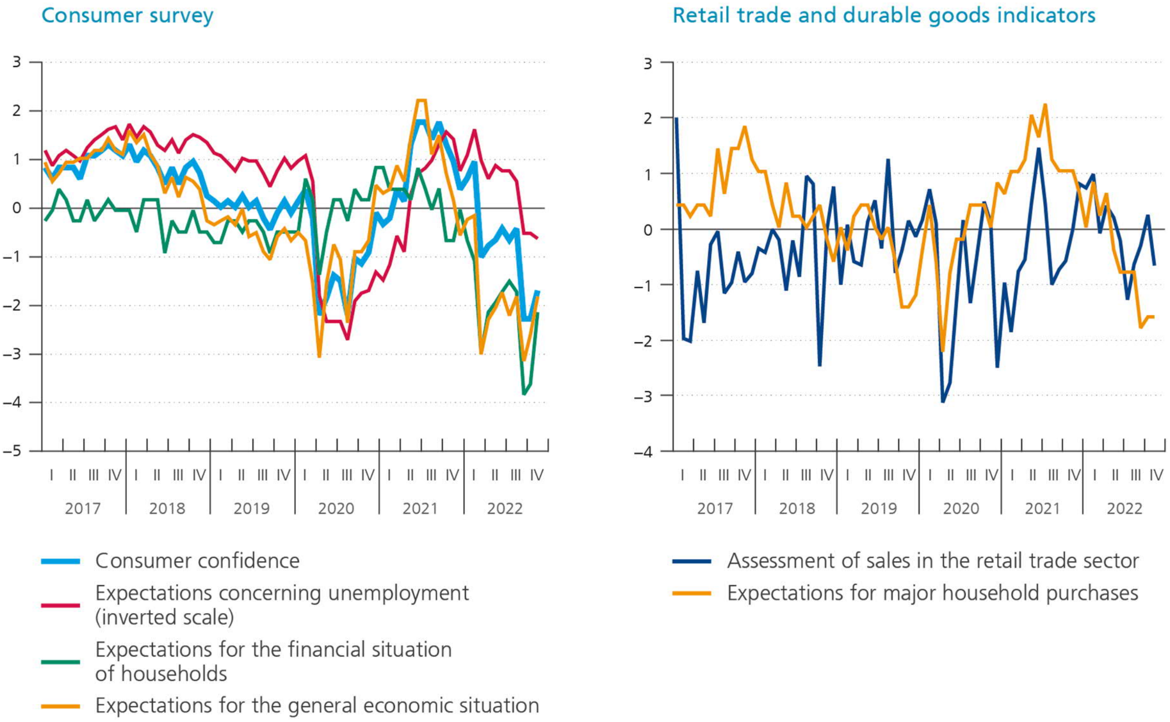
Consumer confidence recovered somewhat in November (see Chart 3, left-hand graph). The improvement in the headline indicator was driven by households' expectations regarding their financial situation and the general economic situation. However, consumer confidence remains near its all-time low and the sub-indicator related to unemployment expectations, which has been a more relevant predictor of near-term consumption growth, still worsened slightly.

Fundamentally, overall purchasing power continues to be supported by positive growth in employment and hours worked, as the labour market remains very robust, but job creation may decelerate somewhat in the near term. Indicators related to household purchasing behaviour (see Chart 3, right-hand graph) point to a mixed outlook for private consumption in the fourth quarter. Company managers' assessment of sales in the retail trade sector as recorded in the NBB Business Survey suggests that sales were robust in the latter half of the third quarter and in October. However, the indicator came down markedly in November. Hard data for retail sales up to October show sales volumes declining again, after rising in late summer. In addition, the continued weakness in expectations regarding major household purchases in the next twelve months does not bode well for durable goods consumption. All the indicators taken together point to private consumption growth most likely remaining subdued in the fourth quarter.

[3] Please refer to the NBB blog post by Jana Jonckheere: '[Energy prices and inflation: it's complicated]'.

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 stagnate in the fourth quarter of 2022. In the longer run, consumption growth should pick up again as inflation and the geopolitical uncertainty decline and as the indexation mechanisms boost aggregate purchasing power.

Investment should continue to decrease in the fourth quarter

Business investment in volume terms contracted in the third quarter and the business environment remains difficult for companies. After having already lost momentum soon after the rebound in the wake of the pandemic-triggered crash, business investment started contracting in the second half of 2021. This coincided with a first downward movement in the overall business sentiment indicator (see Chart 4, left-hand graph) after the latter had reached an unprecedented peak in mid-2021. While supply tensions eased later in the year, the Russian invasion in Ukraine in early 2022 constituted a new shock for European businesses. The war resulted in a wave of economic sanctions and a further acceleration of prices for natural gas and (gas-derived) electricity. Although business confidence held up much better than consumer confidence, the fall-out of the war strengthened the existing downward trend in sentiment.

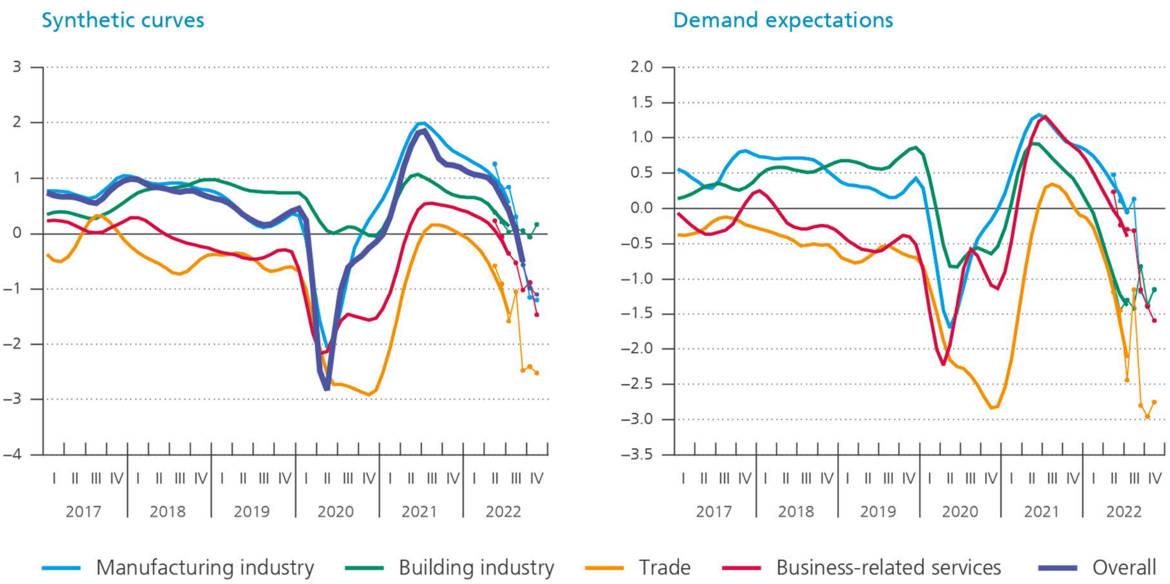
The downturn in business confidence has been broad-based in the last months: sentiment in all branches of activity has now fallen back below pre-pandemic levels. The latest data for November mostly confirm the existing trend, although the rate of decline appears to be easing. At the level of the individual branches, confidence in the trade industry is now virtually stable near its COVID-19-lows, while sentiment in the business-related services and in the manufacturing industry decreased further, although only marginally in the latter. Confidence in the building industry, on the other hand, edged up in November. **Overall, business confidence continues to trend down gradually, but there appear to be tentative signs of a bottoming-out in the latest results.**

Demand prospects deteriorated considerably in all industries (see Chart 4, right-hand graph) and plummeted in particular after the unprecedented spike in energy prices in the late summer. The increasingly negative outlook has caused companies to re-evaluate new expansionary investments. In particular energy-intensive industries are reported to be struggling with their relative cost-competitiveness and the profitability of new investments in the current environment. Capacity utilisation in the manufacturing industry as reported in the quarterly NBB survey on production capacity fell to 76.2 % in October, down from 80.7 % in July and now clearly below the historical average.

The trough may be behind us, though. Supply chains are rapidly normalising (also due to more subdued demand) and natural gas and other input prices have come down. A tentative bottoming-out of demand expectations may be detected in the most recent results for November. While the downward trend is still mostly there for business-related services, the outlook edged up in the manufacturing industry, but also in the trade and building industries. As regards the latter, expectations for demand seem to have stabilized at a level far below the COVID-19-lows, reflecting the fundamental deterioration of the business climate over the past year in that industry, as firms are faced with increased costs of building materials while the rise in mortgage rates is an additional element (on top of the deteriorated economic outlook) that is depressing demand in that industry.

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.

Overall, we expect business investment to contract again in the fourth quarter. The deteriorated context is likely to continue to weigh on business investment somewhat longer, in particular given the current increases in labour costs. However, the outlook is tentatively improving and anecdotal evidence suggests that most companies are also looking beyond the current crisis for their investment projects. Productivity-enhancing investments and digitalization efforts, for example, were reported to be maintained or even stepped up in order to counter the effects of rapidly rising wage costs and a structurally tight labour supply. The same goes for greening and energy-efficiency investments, as energy prices are not likely to return to their pre-pandemic levels anytime soon.

Residential investment declined by 0.9 % in the third quarter, remaining just above its pre-crisis level. All signs point to more muted developments for the housing market in the near term. The aforementioned indicator related to the demand outlook in the building industry is stagnating at a low level and consumer confidence remains low, despite the recent uptick. Mortgage rates – although still low from a longer-term perspective – are rising and gradually eroding household lending capacity.

On the positive side, the labour market remains structurally tight, but consumer expectations regarding the labour market appear slightly less robust. All in all, **we expect residential investment to continue to decline in the fourth quarter of 2022.**

In the third quarter, government investment decreased for the fourth consecutive quarter. 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 become more neutral.

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

Government consumption should expand very moderately

Government consumption stagnated in the third quarter according to the current NAI statistics. While it should be stressed that these first statistics on government spending are often revised significantly, the stagnation in the past quarters appears to have been mostly due to a normalisation of public consumption after the unwinding of COVID-19-related spending. This effect should gradually fade, and we expect spending to increase somewhat in the near term, causing **government consumption to grow at a very moderate pace in the fourth quarter in 2022.**

Net exports are expected to again contribute negatively to growth

Third-quarter exports increased by 1.9 %, while imports grew by about 2.2 %, resulting in a moderate 0.3 pp negative contribution of net exports to GDP growth.

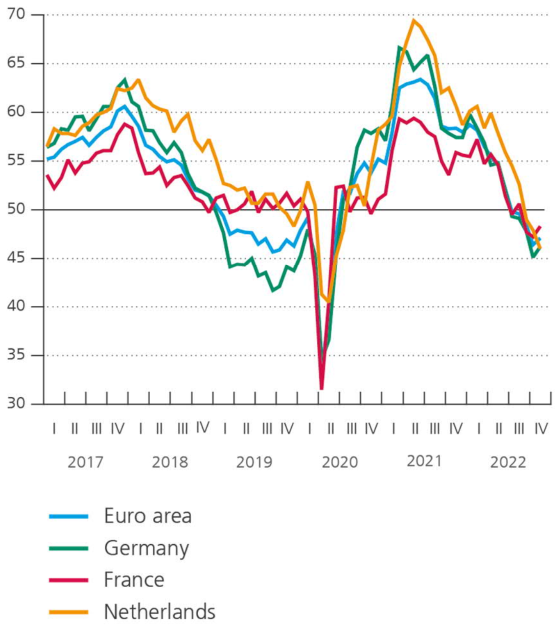
Using the PMI manufacturing index as a proxy for foreign demand (see Chart 5, left-hand graph), demand growth for Belgian exports peaked in the course of the second quarter of 2021, before weakening rapidly in the third quarter due to surging energy prices and expanding supply chain problems affecting international trade. After a brief stabilization, the war in Ukraine and rapid intensification of (energy) price pressures brought a new deterioration that has continued until very recently. The euro area average index, that already fell below 50 in July, decreased steadily until October, in principle indicating a continued contraction of activity. The latest observation for November shows a slight uptick to 47.1. Confidence among purchasing managers in the manufacturing industries in Belgium’s neighbouring countries (and main trading partners) shows a very similar pattern, although sentiment in the Netherlands continued to deteriorate in November.

The recent decline in confidence in the Belgian manufacturing industry as recorded in the NBB Business Survey data is more pronounced. As indicated above, the downward trend in demand expectations after the peak in mid-2021 is an international phenomenon, but Belgian firms are facing an additional challenge. The surge in inflation is increasing their labour costs more rapidly than elsewhere through the indexation mechanism. A pass-through of those higher costs to selling prices worsens the competitiveness position of Belgian companies. Profit margins, although on aggregate still above-average up to mid-2022, will be squeezed. Moreover, business intelligence indications suggest that some manufacturing companies are already losing sales to foreign competitors with access to cheaper, subsidized energy. The assessment of the export order book plummeted in the third quarter, although it remains above pandemic levels (see Chart 5, right-hand graph). All in all, we expect exports to contract in the fourth quarter of 2022.

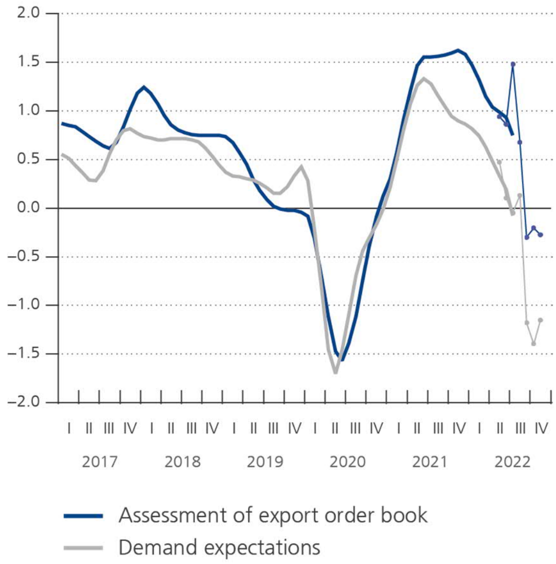
Chart 5

PMI indicators in neighbouring countries and export orders in manufacturing

PMI indices for the manufacturing industry
(diffusion indices)



Demand assessment and expectations in the manufacturing industry
(normalised data)



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

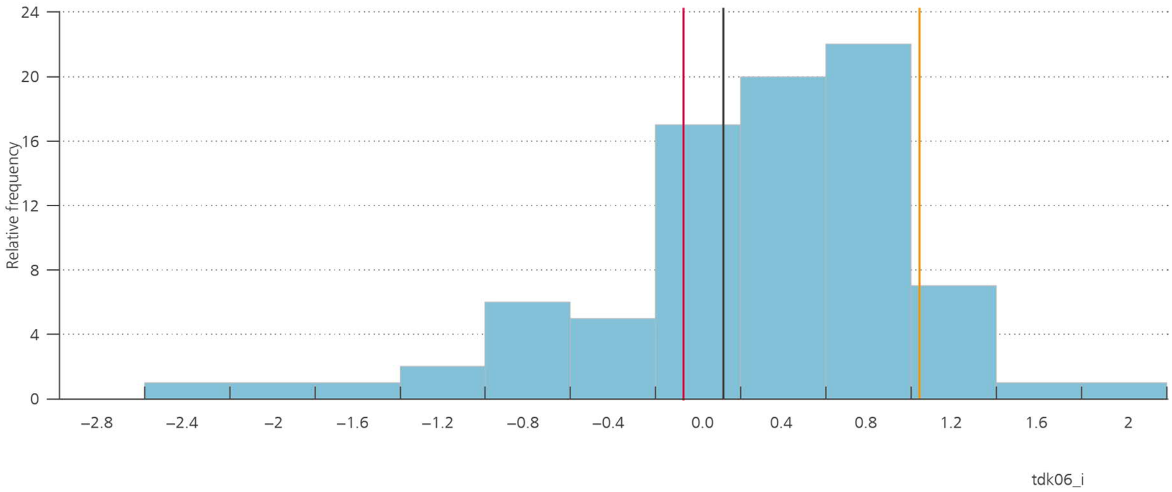
However, the slowdown in domestic consumption and investment should also reduce imports going forward. Overall, **we expect the contribution of net exports to GDP growth to remain moderately negative in the fourth quarter**.

The median value of the mechanical nowcasts points to slightly positive GDP growth in the fourth 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 slightly positive growth in the fourth quarter of 2022** (see Chart 6). The range is still large at [-2.0; 1.5] %, but the distribution is slightly narrower than in the recent past. Nevertheless, uncertainty remains considerable. 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 the fourth quarter of 2022. Relative frequency in percentages.



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 slight contraction of economic activity seems the most plausible scenario for the fourth quarter

Of the more elaborate standard NBB nowcasting models, "BREL" predicts a negative quarterly growth of -0.1 % in the fourth quarter, while "R2D2" estimates growth at around 1 %. 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 net impact of a potential overcompensation of households for current price levels for electricity and natural gas. Some analysis that the actual outlays on gas and electricity still remain relatively subdued and that the combination of the indexation of incomes and government measures may actually overcompensate a significant part of the population and, hence, boost their actual purchasing power. This could continue to support private consumption in the near term.

All in all, we currently expect economic activity to contract by 0.1 % in the fourth quarter. This is just below the 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, in particular due to the resilience of private consumption, is definitely possible. The balance of risks seems to be on the upside.