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Global business activity lost some momentum going into mid-year, probably due to the continued drag of tight monetary policy and increased political uncertainty. That will add to the impetus on major central banks to loosen monetary policy. However, for now they are still approaching the easing cycle cautiously because underlying fundamentals remain resilient. The disinflationary process remains bumpy, and while global headline CPI growth continued to decline modestly, it is still too high for comfort. More worryingly, core disinflation has made relatively less progress amid solid wage growth, underscoring the difficulty of balancing the goal of price stability against the risk of dragging the economy into recession.

Macro Picture

USA: gradual moderation in consumer spending aligned with a soft landing for the economy

EA: data point to slight Q2 GDP slowdown; fiscal rules back in focus in France, Italy and elsewhere

China: broad-based recovery out of sight as the third plenum approaches

Japan: industrial production rebounds; inflation bump in May due to cost-push factors

CESEE: solid Q1 GDP growth in Q1 followed by eased manufacturing PMIs in June

Markets

FX: EUR dropped post EU elections and is in a wait-and-see mode ahead of French elections

Rates: EU and US rates are expected to consolidate at their current levels

EM: sovereign spreads widened due to political uncertainty stemming from France

Credit: markets remain data-driven and continue to focus on central banks

Policy Outlook

USA: Fed dot plot points to a shallower near-term rate path, with fewer cuts this year

EA: ECB remains cautious on dialling back policy restriction amid sticky services inflation

Japan: weak yen boosts case for BoJ to hike interest rate at end of this month

CESEE: key countries about to encounter tighter fiscal constraints following the EC's EDP proposal

Key Downside Risks

DM: persistent high inflation requires monetary policy to remain restrictive for longer, renewed energy shock, growing trade restrictions, political developments lead to a long-lasting tightening in financial conditions

EM: growing geopolitical fragmentation leads to global supply chain disruptions, worries over the new world status quo after the elections in the US in November

Special Topic in this issue:
→ France: Mounting concerns about its fiscal consolidation path

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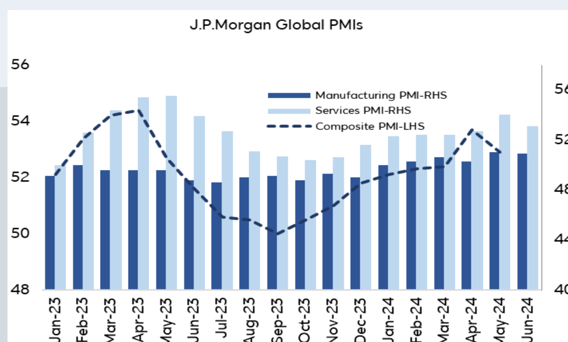
Macro Views

Global economic growth moderates into mid-year while the bumpy disinflationary process keeps major CBs cautious about the scale of easing cycles

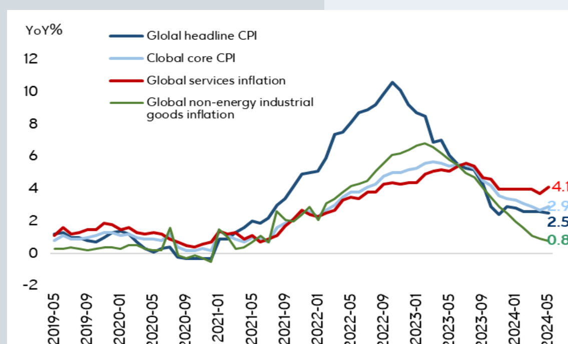
Figure 1: June PMIs point to some moderation into mid-year



Source: Bloomberg, Eurobank Research

Relatively weak flash PMIs for June pointed to some moderation in global business activity into mid-year, likely due to the continued drag from restrictive monetary policy and fading support from factors that had boosted global growth over the past year, such as US fiscal stimulus and easing supply supply-chain bottlenecks. Increased uncertainty about the election result in France and the highly significant US election just four months away may have also exerted a negative impact. Halting a seven-month rising streak, the global composite PMI dropped by 0.8pts to 52.9, unwinding much of May's 1.3pts gain, as the rates of expansion eased for both manufacturing and services (-0.1pts to 50.9 and -0.9pts to 53.1 respectively). Undoubtedly, the drop in a number of forward-looking indicators, including new orders and the future output PMI, adds a reason for caution. However, one monthly drop in the PMI does not necessarily mark a sustained reversal of the trend, particularly after seven straight months of gains. We are inclined to see the June PMI survey as signalling some loss of momentum from the robust prior seven-month upward trend rather than a signal for the start of a sustained downward movement. This holds considering the actual level of PMIs and the extent of the gains over the past seven months (3.7pts cumulatively). More importantly, fundamentals for continued global expansion remain vigorous, including healthy balance sheets, tight labour markets, and strong growth in real household income. Despite the drop in the June output PMI, the employment June PMI remained in an upward trend, rising by a further 0.4pts to a one-year high of 51.3.

Figure 2: Headline CPI on a slight downward trend, core CPI sees a more gradual decline



Source: OECD, Eurobank Research

Meanwhile, the disinflation process that took hold last year continued to look bumpy over the last few months. A renewed drop in consumer energy prices and rather contained food inflation helped global headline CPI growth decline modestly further in May, coming in at 2.5%YoY, close to its pre-pandemic average, but still too high for central banks' comfort. More worryingly, core disinflation has made relatively less progress since H2 2023, as the pronounced Q1 2024 increase in global core

services has yet to be fully reversed. Indeed, services inflation remained well-above pre-pandemic levels and not much lower than the levels recorded early this year. This is mainly due to ongoing upward pressures from tight labour markets and still elevated wage growth — in spite of recent signs of moderation, especially in the US and the UK — reflecting some payback after the 2021-2022 inflation surge that eroded households' real income. Adding to core inflation stickiness, the deflationary trend observed in goods prices in H2 2023, driven by easing supply-chain pressures and softening global goods demand, seems to have come to a halt lately.

Despite still elevated services inflation, some major central banks have already delivered initial rate cuts on the basis that there has been sufficient disinflation progress from recent highs. Others, though staying put on rates so far, have made clear their intention to move towards a lower degree of policy restrictiveness in the not-too-distant future, expecting wage growth to ease as inflation and labour market conditions normalise. In any case, none of them has signaled an intention towards a quick succession of rate cuts. Instead, they adopt a cautious stance towards easing, contemplating the speed and likely overall scale of rate cuts. All in all, major central banks will likely keep rates in restrictive territory for somewhat longer, by slowing or delaying easing cycles, while maintaining data dependence. They need more time to build sufficient confidence that inflation is moving sustainably toward target levels before making significant policy adjustments. This approach aims to balance the goal of maintaining price stability while also preventing the risk of dragging the economy into recession.

Developed Economies

US: The Fed kept the fed funds target range unchanged at 5.25-5.50% at its latest policy meeting, but the overall tone was somewhat hawkish, underscoring the "higher for longer" narrative. That said, the updated dot plot indicated a shallower rate path near-term, projecting just one 25bps rate cut by year-end instead of three signalled in March, reflecting expectations of a stronger inflation outlook and solid growth through the rest of the year. Indeed, consumer spending remains solid overall, despite gradually moderating, with households' net worth reaching a fresh all-time high of $161trn in Q1, and income gains still strong. Meanwhile, inflation data for May showed a slight easing for the second straight month, allaying concerns of a re-acceleration in price pressures following strong prints in Q1. Overall, a gradual moderation in consumer spending and softened inflation data could pave the way for lower rates by the end of the year.

Euro area: After more than a year of stagnation, the economy experienced a strong rebound in Q1 2024 (0.3%QoQ) mainly supported by a recovery in net exports. However, the unexpectedly weak PMI survey for June casts doubts over the economy's ability to maintain that growth momentum in Q2. Conditions remain restrictive, as suggested by the latest credit data for May which indicated continued weak bank lending dynamics, with private sector credit growth at just 0.8%YoY. Furthermore, global manufacturing activity remains sluggish and policy uncertainty has increased sharply following the surprising announcement of snap legislative elections in France. Provided that inflation remains on a broad downward trend, these developments make it more likely that the ECB will cut rates further this year, though it remains cautious about dialling back policy restrictiveness amid sticky services inflation.

Emerging Economies

EM: since our latest issue, assets have depicted mixed performance, lacking a clear direction. Equities firmed, with the respective MSCI EM index recording gains of approximately 2% intramonth. On the flipside, the respective currency index slid 0.5% month-on-month, approaching two-month lows, presumably due to fears over a potential change in the US presidency in November. These concerns were not offset by Fed Chair Jerome Powell's remarks that inflation in the US is on a downward path. Amid the lack of other major developments, the OECD-FAO Agricultural Outlook 2024-2033, published a few days ago by the OECD, caught our attention. It highlights that "developing economies will continue driving agricultural markets over the coming decade but with regional shifts projected." Specifically, a notable shift expected over the coming decade is the increasing role of India, Southeast Asia, and Sub-Saharan Africa, and the declining role of China. While China accounted for 28% of growth in global consumption of agriculture and fisheries in the previous decade, its share of additional demand over the coming decade is projected to fall to 11%. This decline is attributed not only to a declining population and slower income growth but also to a stabilization of nutrition patterns. In contrast, India and Southeast Asian countries are projected to account for 31% of global consumption growth by 2033, driven by their growing urban populations and increasing affluence.

CESEE: the highlight of the month was the EC's proposal to commence the excessive deficit procedure (EDP) for seven EU member states, including core countries in the CESEE region: Poland, Hungary, and Slovakia. Romania has been under a specific fiscal surveillance regime since 2020 due to insufficient fiscal alignment, with recent EU spring economic forecasts predicting continued loose fiscal policy until 2025. The EC's proposal is primarily symbolic at this stage, marking the end of the post-pandemic period that allowed for relaxed public spending. CEE economies, with Poland and Romania as key examples due to their size and prolonged loose fiscal policies, will face tighter fiscal constraints. According to the EC's compliance tracker, Poland and Romania have the lowest performance among developing European countries from 2011 to 2023 in terms of the current deficit rule. Projections indicate further breaches of the fiscal covenant for deficits as a percentage of GDP up to 3% up to 2025, impacting public debt during the same period.

Markets View

Foreign Exchange

EUR/USD: dropped to the 1.07-1.08 range post EU elections, and is range bound following the first round of the French elections, with the outcome being "softer" than what market was expecting. Focus still on the second round and on post-election political scene in France, overshadowing slightly for now inflation and rates path of central banks. This wait-and-see mode includes support levels at 1.0572, 1.0519 and 1.0465 and resistance levels at 1.0865,1.0918 and 1.0972. Implied volatility for 1M, 6M and 9M currently at 5.945%, 5.8575% and 6.365% respectively.

EUR/JPY: higher breaking above 172.5. Carry trade on JPY still paying off. Support levels include 168.90, 167.06 and 165.2182 and resistance ones the 175.6188,176.4882, and 177.3576. Implied volatility for 1M, 6M and 9M Implied Vols currently at 9.425%, 9.3% and 9.61% respectively.

Rates

EU: swap rates have remained at the same level after a volatile month. The 10yr swap is trading again in the 288bps area but having printed a low of 272bps earlier this month. The slope of the curve is steeper, with 5s-30s trading at -34bps, up from -38bps. Looking ahead, it is anticipated that yields will hover around the same levels, but much will depend on the result of the second round of the French parliamentary elections and news flow on post-elections party deals. The next ECB meeting is on July 18, where the Governing Council is expected to reiterate that the path of future rate cuts is data-driven.

US: swap rates closed the month flat. The 10yr swap rate had been mostly trading at around 400bps in late June, little changed from the previous month, after a short-lived drop to 380bps. The curve is steeper, with 5s-30s trading at -34bps, up from -40bps. Going forward, we expect rates to remain volatile as signals about the size of future Fed cuts remain mixed. Crude oil has risen by $10/bbl this month, challenging expectations for interest rate cuts. On the macro data front, the PCE data for May showed a slight easing for the second straight month, in line with expectations.

Emerging Markets Sovereign Credit

The increased political uncertainty in France, caused by President Macron's decision to call for snap legislative elections after his party suffered significant losses in the European Parliament elections, contributed to the widening of sovereign spreads both in developed and emerging markets. In CEE, Bulgarian external debt in EUR underperformed its peers, with the 10yr spread vs swaps widening by 24bps to 109bps. In Africa,

the South African USD sovereign bonds had a solid performance, as the new government of national unity raises the prospect for more reforms, stronger growth, and faster fiscal consolidation. The 8yr benchmark's spread is currently trading 13bps tighter compared with the end of May at 291bps. In Latam, the external Mexican debt recently reversed some of its recent losses due to the super majority obtained by the Morena party at the elections in early June. The 10yr USD-Mexican sovereign spread had been trading at around 186bps in late June, more than 20bps wider than the end of May, having reached a peak of 191bps in the month. Chilean dollar denominated sovereign bonds had a more solid performance, with the 10yr benchmark's spread trading 8bps wider at 117bps in late June. In the Middle East, high quality names like Qatar and Saudi Arabia were little changed, while in Israel the short-term EUR bonds underperformed the longer dated bonds of the curve, with the 3yr spread vs swaps ending almost 30bps wider at 143bps. We expect investors' appetite for directional risk-taking in EM to remain subdued with the search for alpha generation focusing on idiosyncratic opportunities and specific catalysts.

Corporate Credit

Rate cuts were increasingly in focus in June, with the ECB delivering their first rate cut in this cycle, lowering their deposit rate by 25bps to 3.75%. The bank of Canada also cut rates, becoming the fourth G10 central bank to cut rates this year. The Fed kept rates unchanged, as expected, but growing evidence of inflation cooling in Q2 helped cement expectations that rate cuts are still on the horizon. Political developments came to the fore after the European Parliamentary election results, which led to snap elections in France. Uncertainty over the French election led to a notable selloff among French assets, which spilled over to European risk assets in general. In equities, the CAC 40 saw its worst performance in more than a year, shedding 5% since the beginning of June, alongside losses for the DAX (-1.1%) and Stoxx 600 (-0.9%). Overseas, there was divergence between megacap stocks and the rest, with the Magnificent 7 up 9.6% and the S&P 500 +3.5% on the month to post a third consecutive quarterly gain. In commodities, oil prices increased 4.6% since the beginning of June, after OPEC+ assured that any plan to add barrels back to the market would be dependent on market conditions and that they could pause or reverse the planed rollback of production cuts if needed.

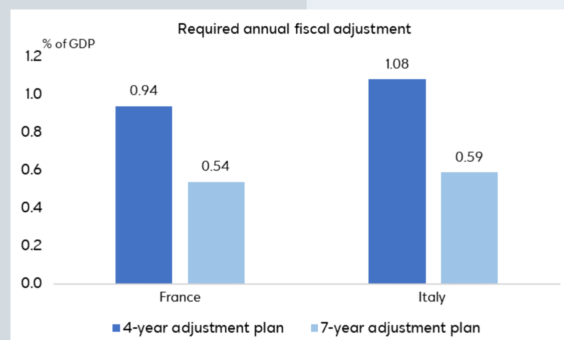
In credit, European synthetics underperformed relative to the US in the lead to the French elections. European credit spreads moved wider since the start of June, with Main +6bps and Xover +17bps vs +4bps and +11bps for CDX IG and CDX HY respectively. In EUR Corporate cash, IEAC widened +11bps on the month, with IHYG outperforming (+7bps since the end of May). There were no notable outperformers/underperformers among EUR IG cash sectors (all sectors +11-14bps on the month). In High Yield, Consumer Discretionary and Comms outperformed, ending flattish on the month, while Technology (+18bps) and Utilities (+14bps) underperformed. The European primary market saw muted activity, with total issuance in June reaching €109bn from €190bn in May and €145bn in April.

Special Topic: Mounting concerns about France's fiscal consolidation path

The European Commission (EC) published the 2024 European Semester Spring Package on June 19, recommending the opening of excessive deficit procedures (EDPs) for seven countries: France, Italy, Belgium, Hungary, Malta, Slovakia, and Poland. A deficit-based EDP implies that these countries have breached or are at risk of breaching the budget deficit threshold of 3% of GDP unless the deficit is judged to be due to exceptional factors and likely temporary, as was the case with Spain. Under EU fiscal rules, which re-entered into force in April 2024 after being temporarily suspended due to the Covid-19 pandemic in 2020, these countries need to make a minimum 0.5ppts structural deficit adjustment per year until the deficit drops below 3% of GDP. From 2025 onwards, the required adjustment will be defined using the structural primary deficit, excluding the impact of higher rates on interest payments and certain NGEU-related and military spending. The EC was planning to provide EU27 member states with guidance on fiscal adjustment trajectories in late June, focusing on the net expenditure path.

The European Council will meet on July 16 to endorse the EC's decision, marking the formal opening of the EDP process. The decision will be reached by a qualified majority. Private technical discussions will follow over the summer between the EC and member states to agree on the final adjustment path under the new fiscal rules, based on the default adjustment period of four years. However, some countries are expected to request an extension to a maximum of seven years if they commit to specific reforms and investments that improve resilience, growth potential, and support fiscal sustainability. The required fiscal adjustment plan under the EDP will likely be made public in November, along with the EC's assessment of the 2025 Draft Budgetary Plans (due for submission by October 15) and the approval of the new fiscal document, the Medium-Term Structural and Fiscal Plan (due for submission by September 20).

Figure 3: New EU fiscal rules might require a meaningful adjustment for some countries



Source: Bruegel (June 2024), Eurobank Research

Being subjected to an EDP, which puts public finances and the economy's performance under market scrutiny, comes at a critical juncture for France given recent political developments. The country is in the midst of early legislative elections after President Emmanuel Macron decided to dissolve the National Assembly following the poor performance of his party, Renaissance, in the June 9 European Parliament elections (14.6%), which was almost half the size of the support for the far-right Rassemblement National party (RN) led by Marine Le Pen. The latter surged, becoming the first French party to receive more than 30% of votes in European elections since 1984 (31.4%). The timing of early elections could challenge the finalization of the required adjustment plan, as the scheduled start of technical discussions between the

EC and France fell right in the middle of the election process. This process could drag on for longer, but more importantly, there are concerns that the election outcome could lead to a government less likely to comply with EU fiscal rules.

Potential post-election outcomes and risks of a cohabitation government

According to results from the first round of legislative election in France on June 30, the far-right RN party and its allies came first with 33.2% of the vote, its best electoral performance ever. The left-wing alliance New Popular Front party (NFP) (comprised of La France Insoumise led by Mélenchon, the French Communist Party, and the Socialist Party of France) emerged second with 28.1%, followed by the coalition of pro-Macron parties, Ensemble (comprised of Renaissance, the Democratic Movement, Horizons, En Commun and the Progressive Federation) with 21.6% and the centre-right Republicans with 7.2%. In terms of seats estimates in the 577-seat new National Assembly, RN could win 230-310, NFP 115-200 while Macron's centrist coalition would secure just 60-120 seats. Based on these results, a hung parliament is probably the most likely post-election outcome after the second round of voting, as the RN will struggle to form a majority government.[1] In the absence of a clear parliamentary majority, passing legislation would be challenging and the risk of fiscal slippage could increase sharply as there would be no scope for any corrective action. The government would likely attempt to secure parliamentary majority for each law on a case-by-case basis but would face the risk of a motion of no confidence. According to the constitution, the president cannot dissolve the parliament before a year has passed after elections, leaving him with no other option than to form a technocratic government until then.

Another scenario that remains within the realm of possibility sees RN forming a minority government with the implicit support of MPs from other parties, most likely the centre-right Les Républicains party (top candidates of Les Républicains publicly stated before the first round of elections that they would vote for a far-right candidate in the second round of snap legislative elections if their opponent was from the leftist alliance). Furthermore, a post-election scenario where the left-wing alliance forms a minority government with the implicit support of Macron's centrist coalition cannot also be ruled out completely. Under France's two-round electoral system, candidates who come second in the first round still have a realistic probability of winning in the second round if political parties not affiliated with RN and eliminated in the first round urge their supporters to vote for candidates running against RN. To that end, all party leaders of the NFP coalition publicly announced they would withdraw their candidates from the second round if they are in third position in the first round, to reduce the RN's chances of gaining a parliamentary majority. Similarly, Prime Minister Gabriel Attal declared that any candidate from Macron's centrist alliance parties who scored third should drop out of the race to prevent the election of an RN candidate, provided that the non-RN candidate shares Republican values.

In either scenario, whether a minority government is led by right-wing or left-wing parties, President Emmanuel Macron would be forced into a cohabitation period. This has occurred three times in the post-war period (1986-1988, 1993-1995, 1997-2002). During cohabitation, the President must appoint a prime

[1] France is divided into 577 single-seat constituencies, each hosting an electoral race based on a two-round majority system. In each constituency, a candidate wins in the first round if they receive more than 50% of the votes, provided this represents more than 25% of registered voters. If no candidate meets this threshold, a second round is held between the top two candidates, plus any candidate who received more than 12.5% of registered voters in the first round. In the runoff, the candidate who gains the most votes wins the seat.

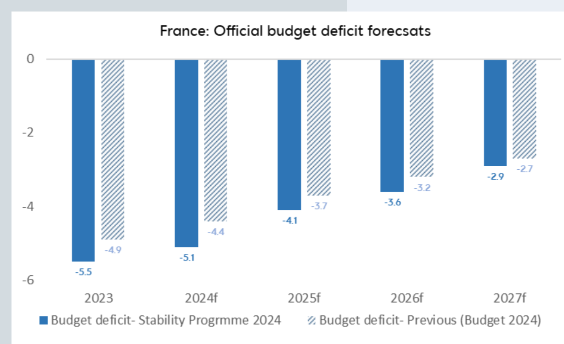
minister who has the backing of a majority in the National Assembly, aligned with the opposition rather than the President's party. Macron has strongly denied that he would resign before the end of his mandate in 2027.

During cohabitation, the prime minister — who selects cabinet members — and his government hold executive power over domestic affairs, including economic and fiscal policy. The President retains power over external affairs and defense as Chief of the Army. The President's power over domestic policy mainly involves delaying legislation by referring it to the Constitutional Council or sending it back to parliament for further examination. The President does not have a veto over the government's legislative agenda but can dissolve the National Assembly and submit laws to a referendum.

Mounting concerns about France's fiscal consolidation path

Even before the announcement of snap legislative elections, there were concerns about France's fiscal consolidation path. In 2023, France saw significant fiscal slippage, with the general government deficit increasing by 0.7ppts to 5.5% of GDP, deviating from the 4.9% forecast in the 2024 budget bill released in September 2023. Adding to these concerns, S&P downgraded France's sovereign credit rating in late May to AA- from AA, citing that the budget deficit is expected to remain above the 3% threshold by 2027. That development came just a few days after the IMF, in its "Staff Concluding Statement of the 2024 Article IV Mission", stated that "substantial additional efforts ... will be needed over the medium term" to get the country's public finance under control.

Figure 4: Fiscal targets revised upward after 2023 slippage



Source: French government, Eurobank Research

For 2024, 2025 and 2026 the outgoing government has revised its deficit targets upward to 5.1%, 4.1% of GDP and 3.6%, respectively, from 4.4%, 3.7% and 3.2% of GDP initially, while still aiming for a further gradual decline below 3% by 2027. The public deficit path was also revised higher. The outgoing government was expecting public debt to continue rising in 2024 (to 113.1% from 109.6% previously), reaching a peak of 113.1% in 2025 before it starts falling thereafter (to 112.9% and 112% in 2026 and 2027, respectively). The government's upwardly revised fiscal targets came after its decision not to pursue additional fiscal consolidation measures through an amended 2024 budget to address the higher-than-expected 2023 public deficit. Securing parliamentary approval for an amended budget would be challenging for the government, given its lack of a majority in the National Assembly.[2] Nonetheless, the government had pledged to find spending cuts amounting to at least €20bn for the 2025 budget to meet its fiscal targets.

[2] Securing parliament's approval for an amended budget posed a significant challenge for the Macron government given its lack of a majority in the National Assembly. As an alternative, the government would have to resort to the so-called 49.3 procedure to bypass parliament. Under the French constitution, the government can pass laws without a vote using the 49.3 procedure, unless a parliamentary majority votes in favor of a motion of no confidence.

However, the programs of both coalitions leading in the first round of elections (far-right RN and New Popular Front) are pledging significant fiscal expansionary measures. This raises the risk of fiscal slippage with France likely breaking EU fiscal rules already next year, given the high risk that the 2025 budget may undertake less fiscal consolidation under a new government than under the incumbent government.

RN's fiscal proposals

According to its electoral manifesto, the RN has proposed some fiscally expensive measures, though it has dialed down the scale of its planned fiscal loosening relative to its 2022 presidential platform. The proposed fiscal measures that are supposed to be financed by reduced foreigners' access to social benefits (e.g. social housing, emergency healthcare), and stronger policies against tax evasion include, among others:

- Lowering the VAT rate on energy from 20% to 5.5% (gas, gasoline, electricity).
- Exemption of workers aged under 30 from income tax
- Lowering production taxes on small and medium-sized enterprises (SMEs)
- Increasing funding for education and the justice system
- Exemption of companies from social security contributions provided they raise wages up to 10%
- Depending on the available fiscal headroom, reversing the 2023 pension reform (that was meant to lead to about €17bn in savings a year) and bring back the statutory retirement age to 62 from 64 currently. Those who entered the labor market below the age of 20 could be able to retire at 60 should they have contributed for 40 years

It is reportedly estimated that the implementation of the RN's proposed measures would widen the annual deficit relative to the current baseline by around €56bn, or 1.9% of GDP, taking the budget deficit above 6% of GDP by 2027. This is significantly less than the €102bn, or 3.5% of GDP that the independent liberal think tank Institut Montaigne had estimated Le Pen's 2022 programme would cost.

New Popular Front's Fiscal Proposals

The New Popular Front's fiscal platform includes similarly ambitious measures aimed at increasing public spending and social benefits. Key proposals include:

- Raising up to 10% public sector wages
- Indexation of pensions on wage growth
- Increasing housing benefits 10%
- Cancelling the July 2024 gas price hike
- Raising the net minimum wage to €1,600 per month
- Freezing prices of essential goods
- Reducing the VAT on public transport fares to 5.5%

- Reversing several of Macron's pro-business reforms, including the overhaul of pension reforms and scrapping the rise in the retirement age, with a medium-term plan to allow people to retire as early as 60 years old

According to NFP, these increases in spending would be mostly covered by stronger growth and tax increases focusing on the wealthiest, including, a higher top marginal income tax rate of 90% and a wealth tax on companies' super-profits, which Macron canceled in 2018. However, it is reportedly estimated that these tax increases would cover less than half of the cost for the spending increases, leaving an annual shortfall of around €88bn, or around 3% of GDP.

Risks of fiscal slippage

Overall, any alternative to the outgoing government would make it harder for France to reach the 3% of GDP threshold by 2027. The main opposition groups appear inclined towards expansionary budget policies, suggesting that France's fiscal trajectory will likely shift towards a looser stance, especially under a NFP-led government which seems less committed to the deficit target.

However, there are hopes that the risk of large fiscal slippage will likely prove less significant than first anticipated. This is because the incoming government may be wary of exerting further pressure on government debt markets, which have already come under intense pressure after the announcement of snap elections. The UK experienced a similar case in mid-2022 when Finance Minister Kwasi Kwarteng's announcement of tax cuts and the ensuing sharp spike in gilt yields forced the government to reverse these measures less than two weeks later. The lack of a parliamentary majority to pass legislation may also constrain the incoming government from pursuing some of its expansive spending measures. The incoming government may also consider some fiscal restraint as a political strategy to foster stability ahead of the 2027 parliamentary elections and the risk of a renewed sovereign credit downgrade.

Nevertheless, due to policy priorities, an incoming minority government led by far-right or left-wing parties would not achieve savings for the 2025 budget to the extent pledged by the incumbent government. Furthermore, even if the new government does not increase spending, this may also not suffice to stabilize France's fiscal trajectory. The 2024 Stability Program mandates adherence to EU fiscal rules and substantial additional fiscal consolidation aimed at gradually reducing public spending over 2025-2027, and ultimately bringing the budget deficit down to 2.7% of GDP by 2027. Reversing some of Macron's structural reforms or failing to commit to reforms could also hinder potential growth, exacerbating France's fiscal challenges. Under the EDP and not compliance with EC's recommendations, France faces the risk of a financial penalty.[3] Moreover, France could potentially lose eligibility for ECB programs, like the Transmission Protection Instrument (TPI), if corrective actions are not taken to address these fundamental issues.

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[3] The first assessment of whether a member state is complying with the EDP takes place between 3 and 6 months after the European Commission's recommendation. If the European Commission finds insufficient compliance with EDP recommendations, it will inform the European Council of its decision to charge the member state with a fine. Subject to the European Council's approval, the euro area member state will have to pay a fine equal to 0.05% of the previous year's GDP.

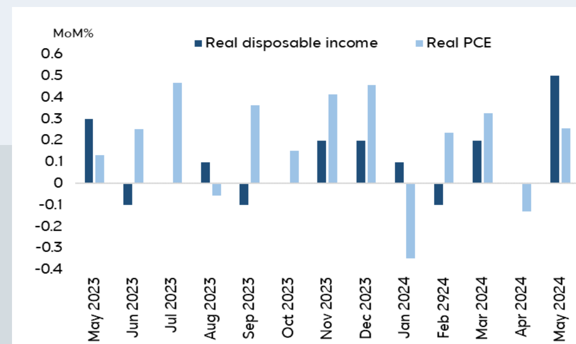
The outcome of the second round of snap elections on July 7 will undoubtedly lead to significant shifts in France's political landscape, with profound implications not only for the country itself but also for its relationship with the EU. An expansionary fiscal policy stance and prolonged non-compliance with EU fiscal rules could likely lead to confrontation with European partners. Enforcement and compliance remain critical priorities for the EC to enhance the credibility of the new fiscal rules, especially during the first year of their implementation.

US

June Fed dot plot points to a shallower near-term rate trajectory

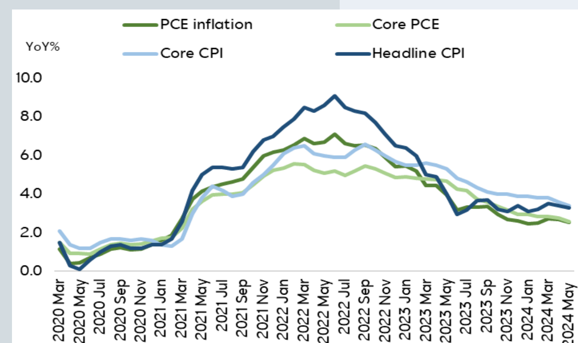
The Fed kept the fed funds target range unchanged at 5.25-5.50% at its latest policy meeting on June 12, as widely expected. However, the overall tone was somewhat hawkish, underscoring the "higher for longer" narrative as the Fed is waiting for more concrete evidence to gain greater confidence that inflation is on track to move sustainably back to the 2% target before it starts easing. That said, the updated dot plot indicated a shallower rate path near-term, projecting just one 25bps rate cut by year-end instead of three signalled in March, reflecting expectations of a stronger inflation outlook after upward surprises in the first three months of the year (2024 core PCE revised up by 2ppts to 2.8%) and solid growth through the rest of the year (2024 GDP unchanged at 2.1%), despite the downward revision in Q1 GDP. Indeed, though some evidence of strains in younger and lower-income borrowers is worth watching (credit card delinquencies have been rising steadily over the past few quarters), consumer spending remains solid overall, despite gradually moderating. Confounding earlier expectations for a rapid deceleration in household spending, fundamentals remain strong, with households' net worth up by 8.8%YoY in Q1 reaching a fresh all-time high of $161trn, and income gains still strong. Led by a 0.6%MoM advance in spending on goods, real PCE rose by a higher-than-expected 0.3%MoM in May after a 0.1%MoM drop in April, pointing to a healthy carryover effect of 1.2% into Q2, compared to 1.5% in Q1 and an average of 3.2% in H2 2023. Personal income also surprised to the upside, rising by 0.5%MoM, accelerating from April's 0.3%MoM increase, with wage and salary income rising by a hefty 0.7%MoM. This is consistent with strong hourly earnings growth in May's employment report (4.1%YoY) and aligned with a more than one-year high of 0.5%MoM in real disposable income. Meanwhile, inflation data for May showed a slight easing for the second straight month broadly driven by non-housing core services inflation, allaying concerns of a re-acceleration in price pressures following strong prints in Q1 (headline CPI -0.1ppt to 3.3%YoY, core CPI -0.2ppts to 3.4%YoY, both headline and core PCE at 2.6%YoY down 0.1ppts and 0.2ppts respectively). Overall, a gradual moderation in consumer spending and softened inflation data could pave the way for lower rates by the end of the year, with OIS forward rates pricing in fully a Fed 25bps cut in November.

Figure 5: Real PCE increased in May alongside real disposable income



Source: BLS Eurobank Research

Figure 6: Slight easing in inflation data in May for the second straight month after strong prints in Q1



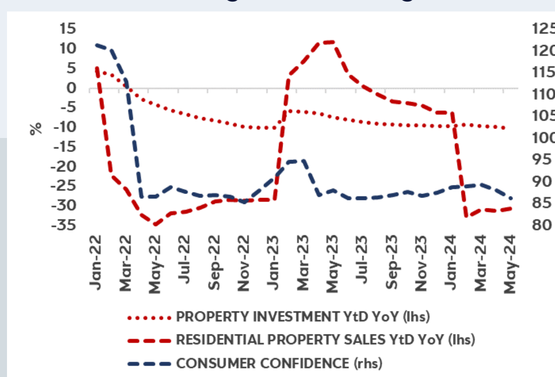
Source: BSL, Eurobank Research

China

Broad-based recovery out of sight as the third plenum approaches

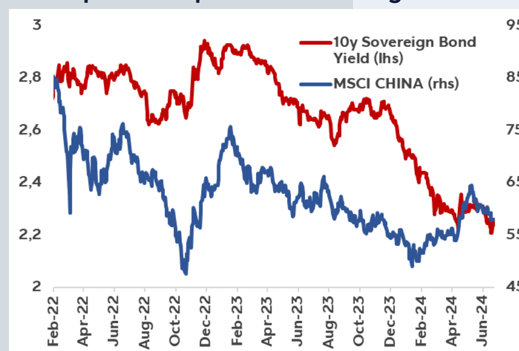
A spate of recent data continues to suggest that the long-awaited, even, and broad-based economic recovery has not arrived yet. Inflation remained stable at the ultra-low levels of 0.3% in May pointing to lukewarm demand whereas the factory-gate prices (PPI) kept deflating in May, as they have been since late 2022, boding well with the milder growth of industrial production for the same month (+5.6%YoY vs +6.7%yoY in April and undershooting expectations for 6.2%YoY). At the same time, despite the deliberations over policy stimuli and their gradual, maybe at a slower than required and anticipated pace, deployment, the consumer confidence index could not be revamped. It kept sliding for a third straight month in a row (86.4 In May from 89.1 in February with Jan 2021 – May 2024 average at 91.2), approaching the record low levels of November 2022 (85.5) when the sentiment was dampened by the series of lockdowns and the worsening of the property sector crisis. Regarding the policy roll out, based on Bloomberg calculations, the fiscal spending proceeds so far in 2024 are on a lower footing than in 2023 despite the wider fiscal deficit targeted for the current year (6.9% in 2024 from 5.9% in 2023). Concurrently, the state home-buying scheme announced in mid-May has not affected yet the residential nor the property market with new and used home monthly prices continuing to contract and with property investment and residential property sales from January to May keeping contracting by 10%YoY and 30%YoY. Against this gloomy backdrop, the third plenum, one of the biggest annual policy steering meetings, is scheduled for July. But to the dismay of investors and all economic agents, expectations for break-through resolutions that could act as a quick remedy are low. The bond frenzy at play reflects on the one hand the pessimism over the economic course and on the other hand investors' expectations that the PBoC will have to lower key policy interest rates in the form of additional required stimulus in the near term. Similar is the behavior of the MSCI China index, key gauge of the Chinese equity market, with the poor performance mirroring the dashed hopes over the decisiveness of the third plenum ahead.

Figure 7: Consumer confidence and real estate data are failing to break through …



Source: Bloomberg, Eurobank Research

Figure 8: ..dampening market sentiment with evident imprint on equities and sovereign bonds



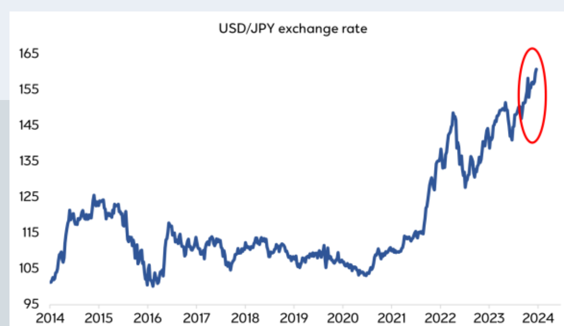
Source: Bloomberg, Eurobank Research

Japan

Weak yen and some macro data build case for rate hike this month

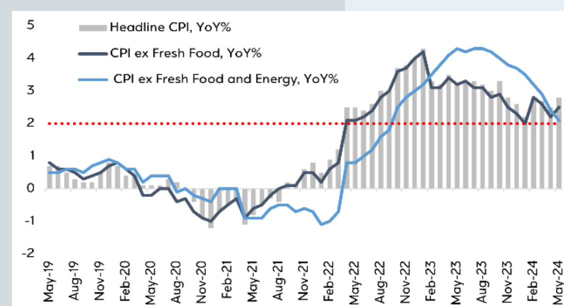
After a short period of relative respite following Japanese authorities' intervention in currency markets in April, the yen came under renewed pressure in the second half of June, with the USD/JPY hitting a fresh 38-year high and complicating policy makers' attempts at macroeconomic management. On the data front, industrial production grew 2.8%MoM in April, 0.8ppts above the consensus estimate, after it contracted 0.9%MoM in March, indicating that car manufacturing is rebouding after an auto scandal that disrupted output in Q1. The Bank of Japan's quarterly Tankan survey of businesses provided some mixed signals. Manufacturing performance and outlook both improved somewhat, beating consensus expectations, with non-manufacturing performance and outlook slightly deteriorating and unchanged respectively, broadly in line with market consensus. Crucially, the survey showed that businesses see inflation at 2.2% five years from now, up 0.1ppts from the Q1 survey, and lending some support to the proposition that inflation expectations are starting to anchor near the central bank's 2% target. That could be signal for the BoJ to hike at its July 31 policy meeting, with further support provided by an uptick in inflation in May as headline CPI increased 2.8%YoY compared with 2.5%YoY the month before. However, the inflation bump came largely from cost-push factors, which brings us back to the issue of the weak yen. BoJ officials have stated that the policy interest rate isn't a tool for controlling the country's exchange rate, and that to hike rates they are looking for evidence of sustained demand-led price growth. However, imported inflation poses a threat to that process by squeezing real incomes. That's leading many observers to expect a second 10bps rate hike this month, despite the fact that economy-wide real cash earnings have continued falling more than two years now and there are few signs yet of pay growth fuelling sustained services inflation – just an expectation that it will happen. As of early July, the market-implied odds of a rate hike this month stood at 51%, with the main argument for a possible delay to increasing the policy rate being that the BoJ will also start tightening monetary policy through reduced bond purchases. Meanwhile, with the USD/JPY crossing above the 160 level that proved to be the finance ministry's line in the sand in April, officials have been warning that they stand ready to intervene again in the FX market if the yen's depreciation should prove destabilising.

Figure 9: The USD/JPY surging to a 38-year high could lead to intervention by authorities



Source: Bloomberg, Eurobank Research

Figure 10: Weak yen led to bump in inflation in May due to cost-push factors



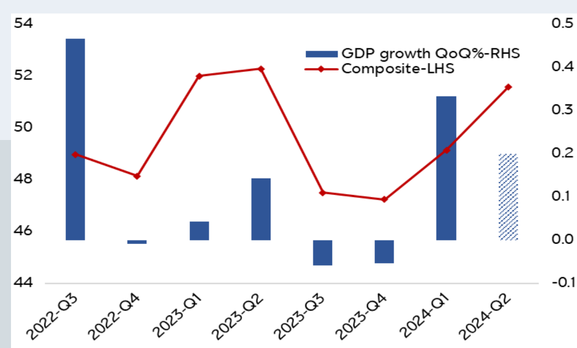
Source: Bloomberg, Eurobank Research

Euro area

GDP growth likely to slow in Q2 partially due to France's political uncertainty

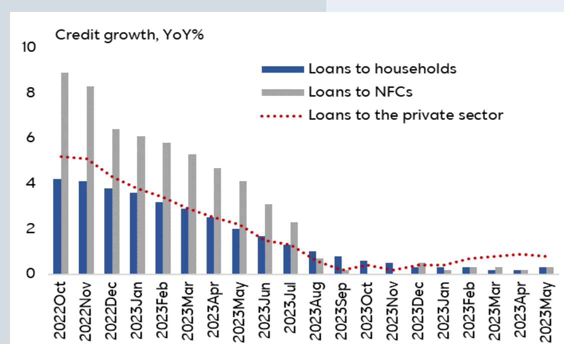
After more than a year of stagnation, the economy experienced a strong rebound in Q1 2024 (0.3%QoQ) mainly supported by a recovery in net exports (+1.7%QoQ, contributing 0.8ppts to GDP growth). However, the unexpectedly weak PMI survey for June casts doubts over the economy's ability to maintain that growth momentum in Q2. Conditions remain restrictive, as suggested by the latest credit data for May which indicated continued weak bank lending dynamics, with private sector credit growth at just 0.8%YoY. Furthermore, global manufacturing activity remains sluggish and policy uncertainty has increased sharply following the surprising announcement of snap legislative elections in France. Halting the upward trend seen between November and May which resulted in a cumulative increase of 5.6pts, the composite PMI dropped sharply in June to 50.9, marginally still in expansionary territory, down from 52.2 in May, indicating a modest GDP growth slowdown to 0.2%QoQ in Q2, according to the S&P Global. The June composite PMI decline was broad-based. The manufacturing PMI fell by 1.5pts to 45.8, the weakest reading so far this year, mainly due to new orders, which fell at a much faster rate than in May (-3.0pts to 44.3), and new export orders (-2.5pts to 45.0), reflecting a renewed deterioration in demand conditions. Services also lost momentum with the perspective index falling by 0.4pts to 52.8, though it remained in expansionary territory. Aligned with the latest weak PMI survey, the European Commission's economic sentiment indicator declined by 0.2pts to 95.9 in June, in contrast to consumer confidence which improved by 0.3pts to -14.0 — although still below its long-term average — supported by real household income gains. Meanwhile, industrial production unexpectedly dropped by 0.1%MoM in April after a 0.5%MoM increase in March, while risks to its outlook prevail. Alongside energy uncertainty, persistent monetary restrictiveness and subdued global manufacturing demand, the European Commission announced additional tariffs of up to 38.1% on Chinese electric cars starting in early July due to unfair trade practices, raising worries over possible retaliation from China that could potentially lead to an escalating trade war. Provided that inflation remains on a broad downward trend (June's headline CPI down 0.1ppts to 2.5%YoY), these developments make it more likely that the ECB will cut rates further this year, though it remains cautious about dialling back policy restrictiveness amid sticky services inflation (June's services inflation flat at 4.1%YoY).

Figure 11: PMIs point to GDP growth of 0.2%QoQ in Q2, according to the G&P Global



Source: Eurostat, Bloomberg, Eurobank Research

Figure 12: Continued weak bank lending dynamics



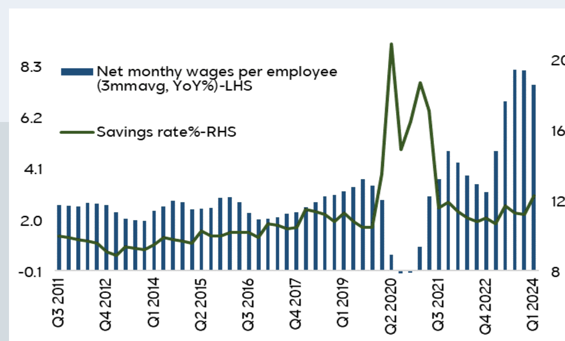
Source: ECB, Eurobank Research

Germany

The cyclical trough is likely behind us, but no strong upswing in sight

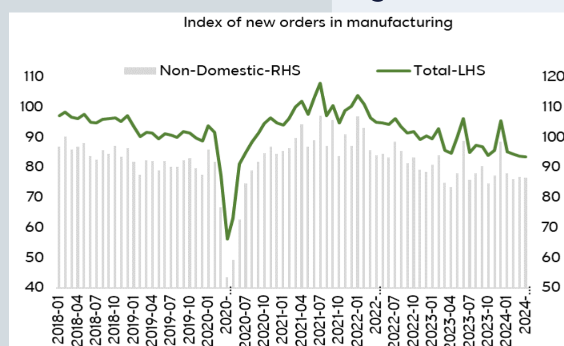
The economy rebounded in Q1 2024, expanding by 0.2%QoQ following a 0.5%QoQ contraction in Q4 2023 and an average growth rate of 0.1%QoQ in the first three quarters of last year, raising optimism that the cyclical trough is likely behind us. Construction investment recovered strongly (+2.7%QoQ) due to favourable weather effects, while net trade was also a growth driver (+0.5%QoQ) as exports grew more robustly than imports, outweighing contracting private and public consumption (both -0.4%QoQ). Looking ahead, data paints a cautious outlook for the near future, aligning with the view that the bottoming out will probably not be followed by a strong upswing. The manufacturing PMI dropped further into contractionary territory, falling by 2pts to 43.4, driven by a sharp decline in new orders. Meanwhile, the services PMI declined by 1.1pts to 53.1, bringing the composite PMI down from 52.4 to 50.4, marginally into expansionary territory. This confirmed the gloomy picture painted by Germany's prominent leading indicator, the IFO business climate index, which unexpectedly dropped after three consecutive increases at the start of the year, falling by 0.7pts to 88.6. The current conditions index remained stable, though at low levels (88.3), while business expectations plunged by 1.3pts to 90.3, marking the first decline in five months and casting a shadow over the strength of any consumer spending rebound, despite strong nominal wage growth (Q1 net wages per employee up by 7%YoY). Undermining any imminent consumption recovery, the GfK consumer climate indicator for July dropped by 0.8pts to -21.8, halting a four-month rising streak amid a worsening assessment of income expectations. Households remain cautious about spending income gains, preferring instead to increase savings (+1.1ppts to 12.4% in Q1). Concerns also persist about the sustainability of the construction sector's boost to economic activity in Q1. Building permits continued their downward trend in April, falling by 4.2%YoY, with the respective index standing close to 14-year lows. Similarly, weak manufacturing non-domestic orders, which declined by 1.6%YoY from January to April, raise doubts about the sustainability of net exports as a growth driver. Our 2024 GDP growth forecast remains unchanged at 0.1%. The economy is likely to stagnate in Q2 and embark on a moderate upward trend in H2 2024, supported by easing financial conditions and improved private consumption fuelled by strong wage growth.

Figure 13: Households remain cautious about spending income gains and prefer instead to raise savings



Source: Destatis, Eurobank Research

Figure 14: Net exports' Q1 bounce may prove unsustainable amid weak foreign manuf. orders



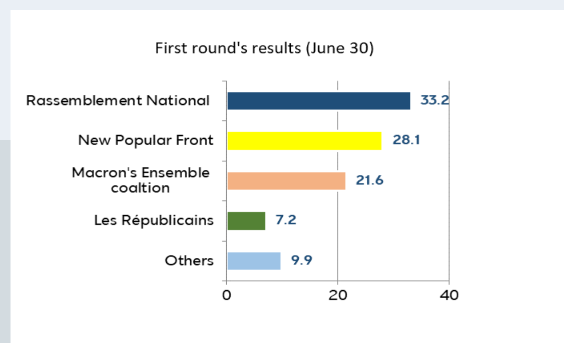
Source: Destatis, Eurobank Research

France

Heading into uncharted territory

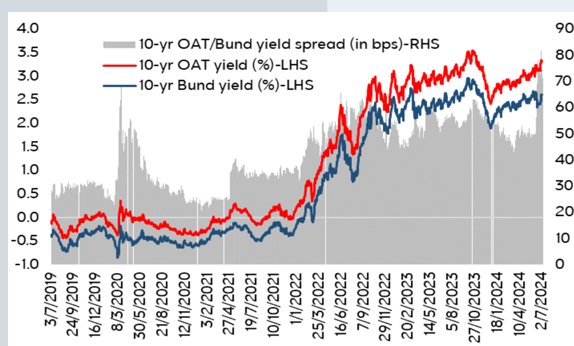
France is currently in the midst of snap legislative elections following President Emmanuel Macron's surprise move to dissolve the National Assembly after the heavy defeat of his centrist alliance, Ensemble, in the June 9 European Parliament election to the far-right Rassemblement National party (RN) party. Following the results of the first round of voting on June 30, the post-election outcome seems too close to call. The most likely scenario on July 7 in the run-off is a fragmented new parliament, with the RN securing the largest number of seats but falling short of an absolute majority. Before the announcement of snap elections, the economy was stuck in a sluggish growth trend over the past quarters, with GDP rising 0.2%QoQ in Q1, a small uptick from an average growth 0.1%QoQ in the prior two quarters primarily driven by a reacceleration in final domestic demand. Looking into Q2, survey results and hard data have been mixed, pointing overall to another quarter of sluggish growth. The INSEE consumer sentiment indicator dropped to 89.4 in June from May's 90.1, levels well below its long-term average (100). Similarly, the composite PMI fell further into contractionary territory, to 45.4 from 46.4 in May, mainly due to uncertainty about the election outcome. Industrial production recovered in April, rising by a five-month high of 0.6%MoM after a 0.2%MoM drop in March, but retail sales declined 0.4%MoM in April, the second consecutive monthly drop. Looking further ahead into H2, the outlook is highly uncertain as the post-election outcome which will set the direction of France's economy and public finances over the medium-term is still unknown. Under a scenario of policy continuity, we would expect a modest acceleration in economic activity in H2 on slightly improving household real incomes and monetary policy easing, with annual 2024 GDP growth at 0.8%. But risks on our base scenario are elevated. Heightened uncertainty about the potential implications of a shift in government could lead to slower growth amid weaker consumer and business sentiment. In addition, the positive impact of less restrictive monetary policy could be partially offset by tighter financial conditions amid a higher political risk premium, with negative repercussions for the fiscal outlook. On the latter, additional fiscal slippage after the sharp widening in the 2023 budget deficit that put France under the EDF in June is more likely under any alternative to the outgoing government due to policy priorities.

Figure 15: A fragmentated new parliament seems the most likely post-election outcome



Source: France's Ministry of Interior, Eurobank Research

Figure 16: The recent widening in the 10-yr OAT-Bund yield spread could worsen the fiscal outlook



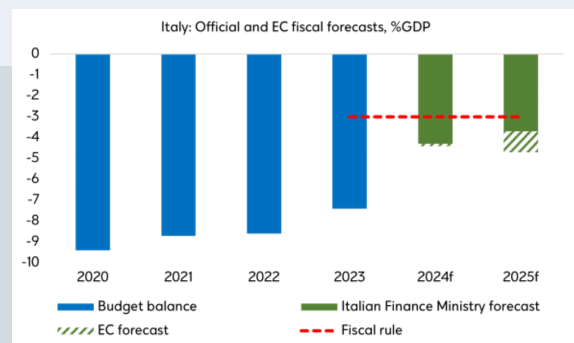
Source: Reuters, Eurobank Research

Italy

Commission's formal EDP recommendations eclipsed by turmoil elsewhere

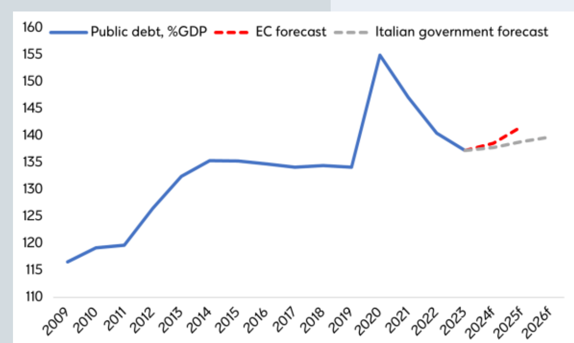
As expected, the European Commission on June 19 recommended an Excessive Deficit Proceure (EDP) against Italy for its fiscal slippage in 2023. Though this was highly anticipated before the elections to the European Parliament at the start of the month, in the event the news was largely overshadowed by the political turmoil, as well as fiscal risks, in France. To recap, Italy posted a 2023 deficit of 7.4% of GDP, down from 8.6% the year before and well below the government's forecast of 5.3% of GDP, with the budget largely derailed due to a poorly-calibrated pandemic-era building subsidy. With the EU's 3% deficit limit, which had been suspended due to the pandemic in the preceding years, now back in force, that made an EDP inevitable. The government projects – based on unchanged policies – that the deficit will narrow to 4.4% of GDP this year, but then widen to 4.7% in 2025. The Commission forecasts that the deficit will narrow to 4.4%-of-GDP this year, but then widen to 4.7% in 2025. On the debt front, the Commission forecasts that public debt will rise to 138.6%-of-GDP this year from 137.3% in 2023, and rise further to 141.7% next year – above its 2022 level of 140.5%. The Italian government, for its part, estimates that the debt ratio will rise to 139.8% of GDP by 2026 and fall after that. However, there are a couple of reasons why the impact of the EDP is likely to be slight and that the Italian government is probably on less of a collision course with Brussels than France's next government may potentially find itself on. Firstly, Prime Minister Giorgia Meloni was one of the few major European leaders who to emerge as one of the winners from the European Parliament elections, with her party peforming well, and she was being actively courted before the vote by EC President Ursula von der Leyen, who is now set to serve a second five-year term. Secondly, the Italian government is likely to comply with the requirement to reduce the structural deficit by 0.5% of GDP per year under the EU's new fiscal rules. Morever, they benefit from the requirement to cut the public debt by 1ppt of GDP per year while under the EDP. The government has until September 20 to submit its medium-term fiscal plan to the Commission, by which time it will have to work out how it will reduce the deficit. One possibility is that it will have to break its promise to extend tax cuts worth 0.5% of GDP beyond this year.

Figure 17: Italy now has to reduce its structural deficit by 0.5% of GDP a year under the EDP...



Source: Italian government, EC, Eurobank Research

Figure 18: ...but EDP also removes requirement to reduce debt by 1ppt of GDP a year



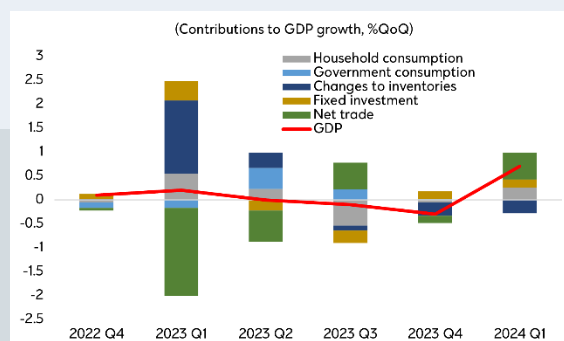
Source: Eurostat, Italian government, EC, Eurobank Research

UK

New government to take charge with economy in sweet spot of business cycle

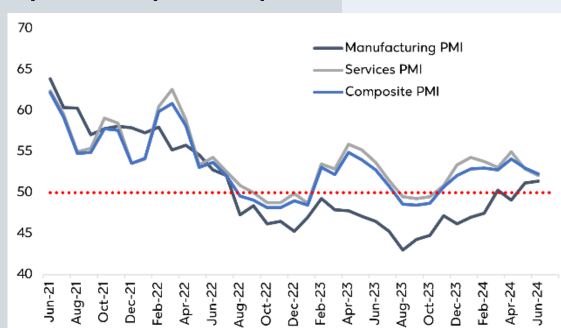
As this report is being published, UK citizens are still voting in a general election with the outcome not yet determined. However, barring what would be one of the greatest electoral upsets in history, the Labour party will win by a landslide, with the only question being how historic the margin will be in its scale. Ironically, Keir Starmer will succeed Rishi Sunak as prime minister at the helm of an economy that is looking far more robust than most observers last year envisioned, with growth momentum looking healthy and headline inflation coming down to the central bank's target. Final GDP figures for Q1 showed that the economy grew 0.7%QoQ, 0.1ppts more than the initial reading, after contracting 0.3%QoQ in Q4 2023. The main growth drivers were household consumption and net trade, which contributed about 0.3ppts and 0.6ppts respectively, as gross capital formation subtracted 0.1ppts from GDP growth. The net trade component boiled down to imports falling more quickly than exports, with the former decling 2.7%QoQ and the latter by 1%QoQ. In terms of growth momentum past Q1, the composite PMI in June dipped to 52.3 from 53.0 the month before, but remained above the 50 threshold that signified improving operating conditions for a ninth straight month. Services PMI dropped 0.8pts to 52.1, while manufacturing PMI increased 0.2pts to 51.4. On the inflation front, headline CPI growth slowed in May to 2.0%YoY from 2.3%YoY the month before, bringing it exactly into line with the Bank of England's target. Core inflation slowed to 3.5%YoY from 3.9%YoY in April. So Labour will assume power with an economy that's at a pretty good stage of its business cycle, but it will also inherit longer-term structural challenges such as weak labour productivity, chronically low investment, underfunded public services and, according to warnings from the Office of Budget Responsibility, virtually no fiscal headroom to reduce public sector debt in the medium term from its current level near 90% of GDP. The latter two issues are why the Conservative Party clung to the attack line during the campaign that a Starmer government would raise taxes, even though Labour pledged that there will be no increases to income tax, VAT or national insurance contributions. However, that doesn't rule out other taxes rising, and unless the new government changes the country's fiscal rules, it's likely that these will be frontloaded early in its five-year term so that it minimises any long-term damage to its popularlity.

Figure 19: Household consumption and net trade drove GDP growth in Q1 2024



Source: ONS, Eurobank Research

Figure 20: Composite PMI has remained in expansionary territory since November 2023



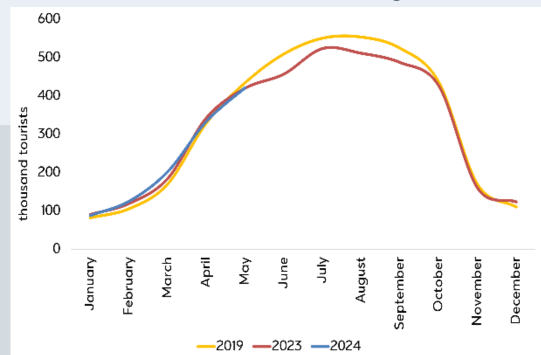
Source: S&P Global, Bloomberg, Eurobank Research

Cyprus

Tourism resilience amid changes in markets; disinflationary measures extended

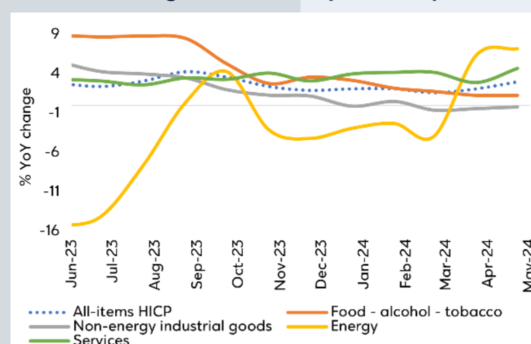
Mixed trends and developments concerning household consumption, the main growth driver in Q1 2024 and second most significant in 2023, came in June. HICP inflation accelerated further in May, to 3.0%YoY, a figure almost double that in March (1.6%YoY). The spike is mainly due to the energy component, where deflation of 3.9%YoY in March turned into inflation of 7.2%YoY two months later, a development closely linked to the abolition at the end of March of the reduced special levy on fuels. Recovering inflationary dynamics on one hand and fiscal overperformance up to April on the other hand (sur-plus of 2.1% of 2024 projected GDP vs. 1.3% of GDP last year), led the government to extend in mid-June the 0% VAT on meat, vegetables, and other products up to September, as well as subsidisation of utility consumption for households and businesses. The extension of these measures is expected to tame inflationary pressures on household demand, which, however, were not strong up to May, as despite the inflation spike that month, the volume of retail trade expanded 4.5%YoY after 5.5%YoY in April, and also in Q1 2024. A small boost to public consumption is expected from part of the additional public spending of €351.3mn (1.1% of the projected GDP) included in the supplementary budget approved in June. The mild credit expansion continuation in May for the sixth consecutive month (+1.2%YoY, as in April), from increased financing towards non-financial businesses (+0.6%YoY after +0.3%YoY a month ago), is expected to further escalate as monetary policy will be gradually loosened. An additional factor that will boost investment this year, offsetting the negative base effect on gross fixed capital formation in Q1, is the restart of RRF inflows. Resilience of tourist arrivals in May, an introductory month to the summer season, as they slightly exceeded their multi-year high level in 2023 (+0.3%YoY), contributing to the 1.2%YoY average increase in January-May, could be a credible indication of covering the losses in 2024 from countries that drastically contributed to the strong increase in arrivals and revenues last year (e.g., Israel) with tourists from other markets, such as Poland, Germany, France, based on broken down data on arrivals. Accordingly, the upward trend in tourism revenues in January–April (+5.5%YoY) could be extended during the peak of the summer season. These mostly favourable developments for domestic and external demand lead us to revise upwards our growth forecast for 2024, by 0.2ppts, to 3.1%.

Figure 21: Tourism heading for a level in between that of 2023 and the all-time high of 2019



Source: CYSTAT, Eurobank Research

Figure 22: Inflation spike mainly from energy prices, after abolishing the reduced special levy on fuels



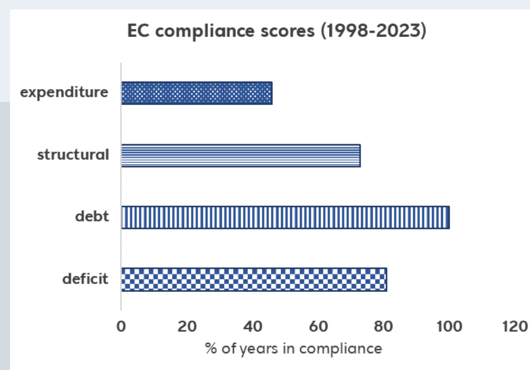
Source: Eurostat, Eurobank Research

Bulgaria

In search of a political agreement for government formation

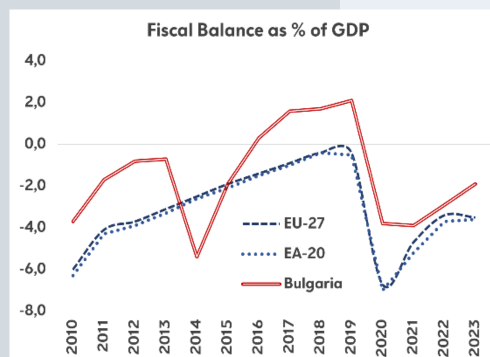
Almost one month after the parliamentary elections of June 9, held jointly with the elections for the European parliament, political stirrings continue in the effort of forming a coalition government. Reasoning on why the political impasse should be bypassed soon is self-explanatory, yet the economic aspects of the current deadlock should be outlined. Despite the lingering political uncertainty during the past three years, the economy shows resilience in terms of growth. Still, a series of reforms, either linked with the adoption of the euro, or with the unlocking of recovery and resilience funds (RRF), is delaying given the lack of political will and the embedded reluctance of caretaker and coalition governments within this three-year period. Indicatively, we quote the statement of the caretaker Finance Minister Lyudmila Petkova who stated at local press that the country is confronted with a six-month deadline to finalise the necessary legal changes in order to meet the requirements for receiving the second tranche from the RRF or otherwise any further delay beyond this point of time could result in loss of resources. It is worth noting that all recent outlooks from IFIs, among which the IMF in the Article IV Mission conclusions and the World Bank in the Global Economic Prospects in June and earlier in May the European Commission in its Spring Economic Forecasts, based their growth forecasts for both 2024 and 2025 on the timely rollouts of the RRF. As such, any loss of this pool of funds could result into possible trimmings of the said forecasts which range from 1.9% to 2.7% for 2024 (ours 2.2%) and from 2.5% to 2.9% for 2025 (ours 2.9%). June was also rich into reports by the EC. Thanks to the well cemented fiscal discipline, Bulgaria was not among the 3 CESEE economies (Poland, Hungary and Slovakia) about to enter an excessive deficit procedure as suggested in the EC Spring Package. Yet, the biannual convergence report of the ECB that assesses the progress towards the Euro adoption showed that Bulgaria, as broadly expected, does not fulfil the inflation criterion. The conclusion of the report paves the way for an official admission that Bulgaria's entry into the Eurozone will most probably extend beyond 2025, despite the substantial disinflation so far that results in May's print coming in at 2.3%YoY from 2.4% before.

Figure 23: Consistency in compliance with the Stability and Growth Pact rules...



Source: European Commission, Eurobank Research

Figure 24: ...results into fiscal discipline, stricter than the EU and EA average



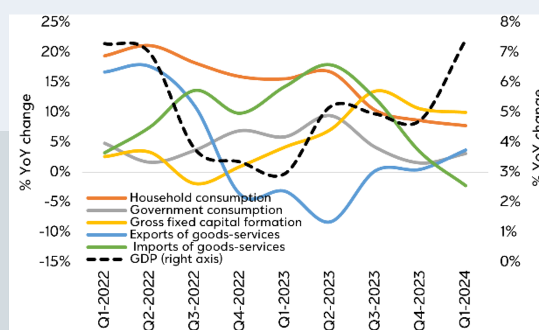
Source: Eurostat, Eurobank Research

Turkey

Tailwinds from abroad continue through exports and foreign direct investment

The improvement in the external trade balance that was the main growth driver in Q1 2024, did not slide back in Q2, according to the latest data. After deteriorating in April, for the first time in nine months, the goods trade balance resumed improving in May, with its deficit narrowing 48.0%YoY. Another auspicious development is that the improvement came mainly from higher exports (+11.3%YoY), a possible sign of stronger competitiveness, also reflected in the rise of the real effective exchange rate during January-May, a trend which could prolong the export growth. Tourist arrivals rose anew in May, gaining pace relative to April (14.0%YoY after 8.7%YoY) and matching their average increase in Q1 (+13.4%YoY). Additional favourable developments from abroad, are the continuous, large foreign direct investment (FDI) inflows supporting gross fixed capital formation amid severe monetary tightening by the central bank (TCMB). FDI rose by $11.1bn (+6.6%) in April relative to the Q1 2024 average, reaching $180.5bn, $38.7bn or 27.3% higher than in Q2 2023. In contrast, credit contraction in real terms continued in May, marginally smaller towards non-financial businesses (-5.3%YoY from -5.7%YoY in April), but significantly higher on the side of households (-13.3%YoY from -7.2%YoY). The TCMB left the key policy rate unchanged at 50% in June, restating that a switch to a monetary easing stance will not be made until a significant and sustained decline in the monthly inflation is observed, a position which, given the latest inflation prints, rules out such an event in the coming months. Specifically, headline inflation eased mildly in June, for the first time in 12 months, to 71.6%YoY from 75.4%YoY in May, with the monthly print slowing to 1.6% from 3.4%. Still, average annual inflation in Q2 stood at 72.3%YoY, the second highest in the last 26 years, and is expected to weigh on household consumption growth. Strong increases in utility prices since July, by 38% for households and services businesses, will weaken disinflationary dynamics in H2 2024. Statutory semi-annual raises for civil servants and retirees since July, compensating for purchasing power losses over the past six months, will boost short-term consumer spending, but will also fuel a wage-price spiral. In contrast to the previous two years, the minimum wage did not receive thus far a mid-year hike, which will put pressure on the real income of numerous households, also through linked allowances and remunerations. Under these opposite dynamics in GDP components, i.e., net exports and investment to the upside, our growth forecast for 2024 remains unchanged to 3.8%.

Figure 25: Inflation deceleration in June for the first time in a year from non-core components



Source: Central Bank of Turkey, Eurobank Research

Figure 26: Goods trade balance improves from higher exports, amid real effective exchange rate increase

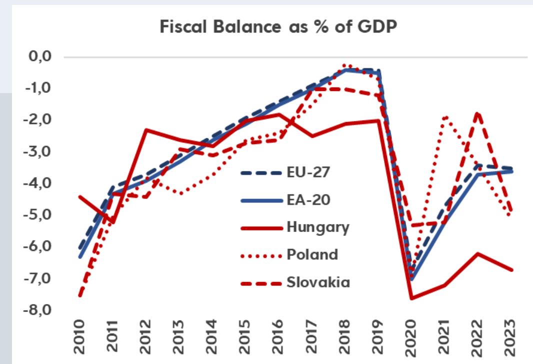
Source: Central Bank of Turlkey, Turkstat, Eurobank Research

CESEE

Excessive deficit procedure ante portas for key countries in the region

The highlight of the month was the EC's proposal to commence the excessive deficit procedure (EDP) for seven EU member states, including core countries in the CESEE region: Poland, Hungary, and Slovakia. Romania has been under a specific fiscal surveillance regime since 2020 due to insufficient fiscal alignment, with recent EU spring economic forecasts predicting continued loose fiscal policy until 2025. The EC's proposal is primarily symbolic at this stage, marking the end of the post-pandemic period that allowed for relaxed public spending. This proposal comes at a particularly complex time, with far-right parties gaining strength in the recent European elections (June 6-9). This has led to unexpected developments, such as the snap parliamentary elections in France on June 30 and July 7, and coincides with upcoming leadership changes in the main institutions of the European Union and NATO. Looking ahead, the period will be rich in political stirring at an international level, with the EU already highlighting the sustainability of public finances as a key issue to be monitored under the new fiscal rules.

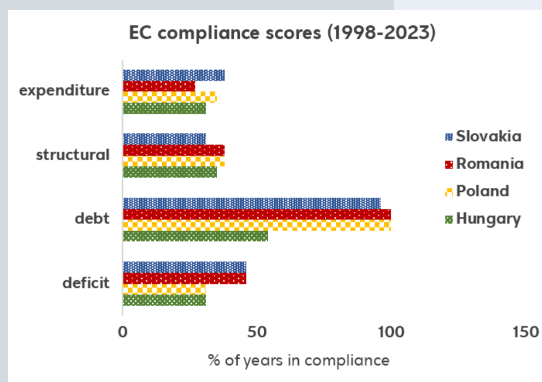
Figure 27: Fiscal slippages got more intense after the Covid-19 burst out ...



Source:Eurostat, Eurobank Research

CEE economies will face tighter fiscal constraints, with Poland and Romania as key examples due to their size and prolonged loose fiscal policies. According to the EC's compliance tracker, Poland and Romania have the lowest performance among developing European countries from 2011 to 2023 in terms of the current deficit rule. Projections indicate further breaches of the fiscal covenant for deficits as a percentage of GDP up to 3% up to 2025, impacting public debt during the same period. For Poland, fiscal adjustment could be more complicated due to the necessary increases in defense spending arising from its proximity to the Ukraine-Russia war front. The outcomes of the elections in France and the US in November could further increase geopolitical risk in the wider CESEE region. Therefore, initiating an early fiscal adjustment could help mitigate the overall risk profile of the region.

Figure 28: ..yet, triggers for EDP procedure appear to have been building up early on...



Source: European Commission, Eurobank Research

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2023	2024f	2025f	2023	2024f	2025f	2023	2024f	2025f	2023	2024f	2025f	2023	2024f	2025f
World	3.2	3.0	3.0	6.8	4.6	3.5									
Advanced Economies															
USA	2.5	2.3	1.8	4.1	3.1	2.4	3.6	4.0	4.1	-3.3	-3.1	-3.1	-6.5	-6.0	-6.0
Eurozone	0.5	0.7	1.4	5.5	2.4	2.1	6.6	6.5	6.5	1.7	2.3	2.3	-3.6	-3.1	-2.7
Germany	-0.2	0.1	1.2	6.1	2.5	2.1	5.7	6.0	5.8	6.1	6.5	6.5	-2.5	-1.7	-1.3
France	0.7	0.8	1.3	5.7	2.5	2.0	7.3	7.5	7.4	-1.4	-0.2	-0.2	-5.5	-5.1	-4.5
Periphery															
Cyprus	2.5	3.1	3.5	3.9	2.3	1.3	6.1	5.8	5.5	-12.1	-9.0	-7.0	3.1	3.5	3.7
Italy	0.9	0.9	1.1	6.0	1.2	1.8	7.7	7.4	7.4	0.5	0.9	1.3	-7.4	-4.7	-4.1
Portugal	2.3	1.7	1.9	5.3	2.4	1.9	6.5	6.5	6.4	1.4	1.6	1.4	1.2	0.3	0.1
Spain	2.5	2.3	1.9	3.4	3.1	2.2	12.2	11.7	11.3	2.6	2.5	2.2	-3.6	-3.1	-2.9
UK	0.1	0.7	1.5	7.4	2.6	2.2	4.0	4.4	4.7	-3.3	-2.6	-2.9	-5.0	-3.2	-3.1
Japan	1.8	0.3	1.1	3.3	2.4	1.9	2.6	2.5	2.4	3.6	3.9	3.7	-5.2	-4.2	-3.5
Emerging Economies															
BRICs															
Brazil	2.9	2.0	2.0	4.6	4.0	3.5	8.0	7.8	8.0	-1.4	-1.5	-1.7	-8.9	-7.2	-6.6
China	5.2	4.8	4.4	0.2	0.7	1.5	5.2	5.2	5.1	1.8	1.3	1.1	-4.6	-4.8	-4.8
India	7.8	7.0	6.5	5.7	4.8	4.5		NA		-0.8	-1.2	-1.3	-5.8	-5.1	-4.5
Russia	3.6	3.0	1.2	6.0	6.7	4.7	3.2	3.0	3.2	2.5	3.1	2.6	-1.9	-2.0	-1.5
CESEE															
Bulgaria	1.8	2.2	2.9	9.6	3.3	3.2	4.3	4.4	4.3	-0.3	0.2	0.2	-1.9	-2.9	-2.9
Turkey	4.5	3.8	3.5	53.4	57.9	24.2	9.4	8.5	8.0	-4.1	-2.5	-1.5	-5.3	-4.4	-2.0

Sources: European Commission, World Bank, IMF, OECD, Bureaus of National Statistics, Bloomberg, Eurobank Research

Eurobank Fixed Income Forecasts

	Current	September 2024	December 2024	March 2025	June 2025
USA					
Fed Funds Rate	5.25-5.50%	5.09-5.35%	4.79-5.05%	4.48-4.75%	4.17-4.40%
3m SOFR	5.32%	5.10%	4.83%	4.52%	4.19%
2yr Notes	4.76%	4.53%	4.24%	4.03%	3.85%
10yr Bonds	4.46%	4.25%	4.13%	4.06%	4.01%
Eurozone					
Refi Rate	4.25%	3.65%	3.35%	3.10%	2.85%
3m Euribor	3.71%	3.42%	3.19%	2.93%	2.67%
2yr Bunds	2.90%	2.52%	2.29%	2.19%	2.09%
10yr Bunds	2.60%	2.31%	2.24%	2.26%	2.24%
UK					
Repo Rate	5.25%	4.95%	4.65%	4.30%	4.00%
3m Sonia	5.12%	4.82%	4.42%	4.17%	3.80%
10-yr Gilt	4.26%	3.92%	3.78%	3.71%	3.62%
Switzerland					
3m Saron	1.19%	1.30%	1.28%	1.17%	1.25%
10-yr Bond	0.67%	0.77%	0.75%	0.73%	0.79%

Source: Bloomberg (market implied forecasts)

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