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Western Europe Economic Outlook

April 2021

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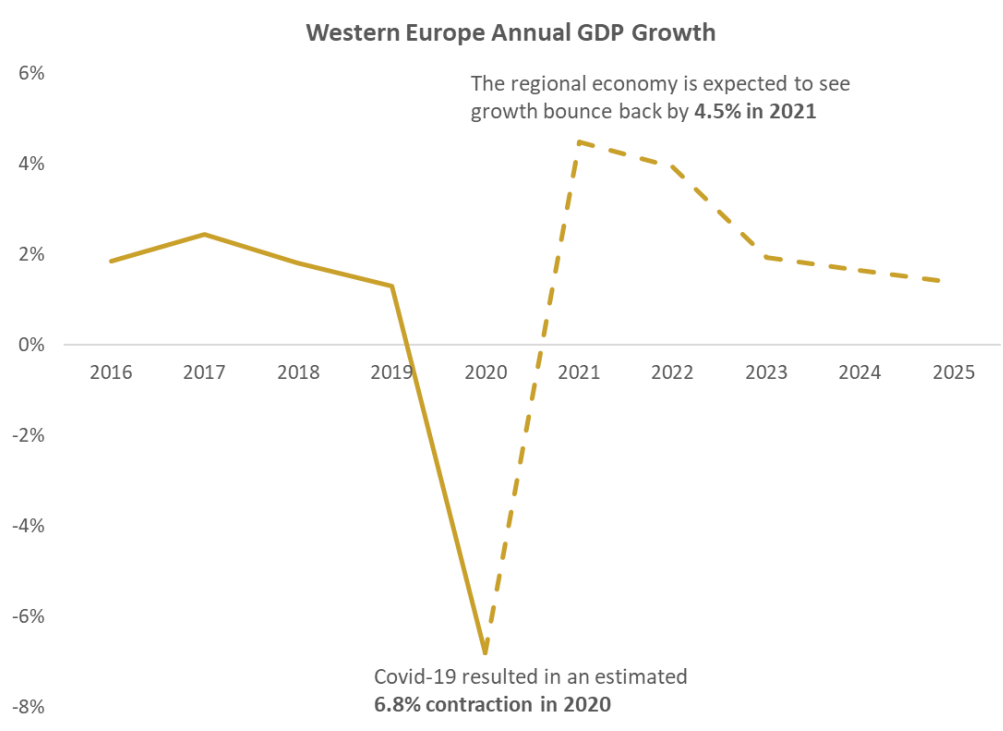
Regional Overview: Western Europe

Macroeconomic Developments & Outlook

Economic Growth

The Western European economy entered 2021 on a feeble footing, with the second wave of the Covid-19 pandemic having triggered the reimposition or tightening of lockdown measures across many countries in Q4 2020. Despite the launch of vaccine rollouts, the region's economic recovery is now being threatened by a third wave of the pandemic. Nevertheless, with vaccine programmes progressing and government policy measures continuing to support households and firms, the regional economy is expected to grow by 4.5% in 2021, following an estimated contraction of 6.8% in 2020.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).
Annual GDP growth has been calculated as a weighted average for the Western Europe region, which includes the following 20 countries: Austria; Belgium; Cyprus; Denmark; Finland; France; Germany; Greece; Iceland; Ireland; Italy; Luxembourg; Malta; Netherlands; Norway; Portugal; Spain; Sweden; Switzerland; UK.

Looking at a comparative picture across key regional countries, year-on-year GDP growth rates this year will be somewhat misleading, as the economies that were worst hit in 2020, such as Spain, will grow the fastest given the very weak baseline, even though economic activity will remain subdued. Overall, the region should see a more meaningful pick-up in growth from the second half of 2021, with regional GDP returning to its 2019 level in 2022.

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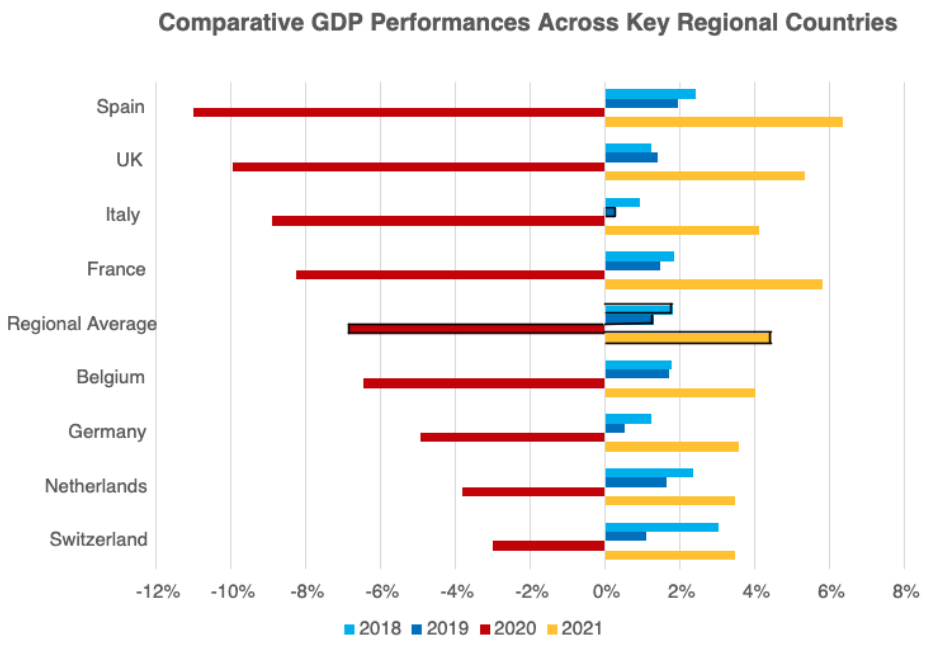

Source: IMF; Baker Ing
Data for 2021 is based on IMF estimates and forecasts.

Risks to GDP Outlook

The main downside risks to the projected recovery this year stem from the potential emergence and spread of more contagious variants of the coronavirus and stunted vaccine rollouts. Such developments would postpone the lifting of containment measures and weigh on confidence, thus keeping household savings rates high and further delaying investment decisions.

The recent blockage of the Suez Canal by a grounded container vessel for nearly a week in late March also poses a threat to the extent of the recovery this year. Indeed, the blockage put global supply chains – already battered by the Covid-19 pandemic – under much further pressure. The Suez Canal is one of the world's busiest trade routes, accounting for around 13% of total world trade[1]. While the blockage has been cleared, the resulting disruptions and backlogs in global shipping could take many weeks to fully clear. A report by Dun & Bradstreet and E2open[2] found that Europe is the region that will feel the strongest impact due to the blockage of the canal, with the most affected countries including Germany, France, Italy, Spain, Belgium, the Netherlands, Switzerland, Austria, and the UK.

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[1] https://www.allianz.com/en/economic_research/publications/specials_fmo/2021_03_26_SupplyChainDisruption.html
[2] https://www.dnb.co.uk/content/dam/english/dnb-solutions/the-suez-canal-looking-beyond-the-surface-to-access-the-full-economic-impact.pdf

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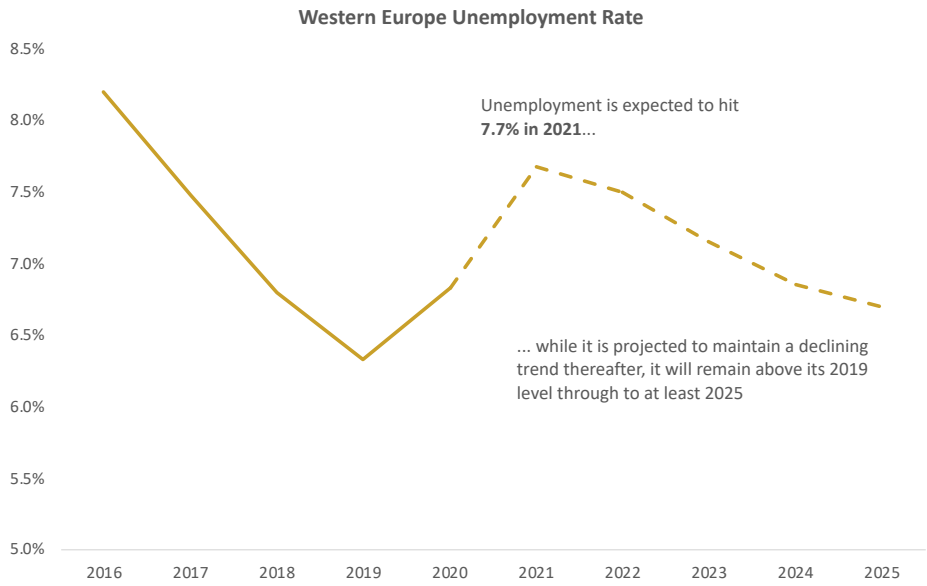
Unemployment

After falling by 0.5 percentage points to 6.3% in 2019, unemployment in Western Europe is estimated to have risen back up to 6.8% in 2020. The increase would have been substantially greater were it not for the various job support schemes implemented across the region. With countries preparing to scale back their unprecedented support measures for workers affected by the pandemic, the unemployment rate is set to rise further this year, and is estimated to hit around 7.7% - its highest since 2016. While the recovering economic backdrop should help joblessness to ease in 2022, it is nonetheless expected to remain at an elevated 7.5% - and is not expected to fall back below 7% until 2024.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).
Unemployment has been calculated as a weighted average for the Western Europe region.

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Inflation

Inflation in the region slowed sharply to just 0.4% in 2020 (from 1.3% in 2019) amid plunging economic activity as a result of widespread coronavirus lockdown measures. This was the slowest rate of consumer price growth since 2016. While inflation is expected to rebound in 2021 as economic recoveries take hold, it will likely stay substantially below most central bank targets. Indeed, consumers and businesses remain cautious with their spending plans, particularly as wage growth is still muted, uncertainty is still elevated, and government support is set to be gradually withdrawn.

Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).
Annual inflation growth has been calculated as a weighted average for the Western Europe region.

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Sovereign Credit Ratings

The table below shows the sovereign credit ratings for all countries in the region, from the big three credit rating agencies globally. Companies that have large public sector ownership, as well as those that borrow heavily from banks, are subject to sovereign risk via both the fiscal and financial channels. When investors believe a country is more likely to default on its debt, the interest rates paid on the debt of that country increase, in order to compensate investors for the higher perceived risk. In such situations, it is often the case that banks see their funding costs increase as well. As such, when sovereign credit risks are elevated, companies in that country can also see their credit risk increase, for example via less favourable bank lending conditions.

	Moody's		S&P		Fitch	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
Germany	Aaa	Stable	AAA	Stable	AAA	Stable
Denmark	Aaa	Stable	AAA	Stable	AAA	Stable
Netherlands	Aaa	Stable	AAA	Stable	AAA	Stable
Norway	Aaa	Stable	AAA	Stable	AAA	Stable
Sweden	Aaa	Stable	AAA	Stable	AAA	Stable
Switzerland	Aaa	Stable	AAA	Stable	AAA	Stable
Luxembourg	Aaa	Stable	AAA	Stable	AAA	Stable
Austria	Aa1	Stable	AA+	Stable	AA+	Stable
Finland	Aa1	Stable	AA+	Stable	AA+	Stable
France	Aa2	Stable	AA	Stable	AA	Negative
UK	Aa3	Stable	AA	Stable	AA-	Negative
Belgium	Aa3	Stable	AA	Stable	AA-	Negative
Ireland	A2	Stable	AA-	Stable	A+	Stable
Malta	A2	Stable	A-	Stable	A+	Stable
Iceland	A2	Stable	A	Stable	A	Negative
Spain	Baa1	Stable	A	Negative	A-	Stable
Portugal	Baa3	Positive	BBB	Stable	BBB	Stable
Italy	Baa3	Stable	BBB	Stable	BBB-	Stable
Cyprus	Ba2	Positive	BBB-	Stable	BBB-	Stable
Greece	Ba3	Stable	BB-	Stable	BB	Stable

Key

Investment Grade
Speculative Grade

Source: Moody's; S&P; Fitch; Baker Ing
- Ratings retrieved on 7th April 2021

As can be seen from the table above, the majority of countries in the region (18 out of 20) currently have 'investment grade' sovereign credit ratings with all three of the main credit rating agencies. This suggests that the credit risks associated with doing business with entities in the region are generally minimal. While Moody's rates Cyprus as 'speculative grade,' S&P and Fitch currently rate the country at their lowest 'investment grade' level. Greece, meanwhile, is rated at 'speculative grade' by all three agencies, indicating a more elevated degree of credit risk.

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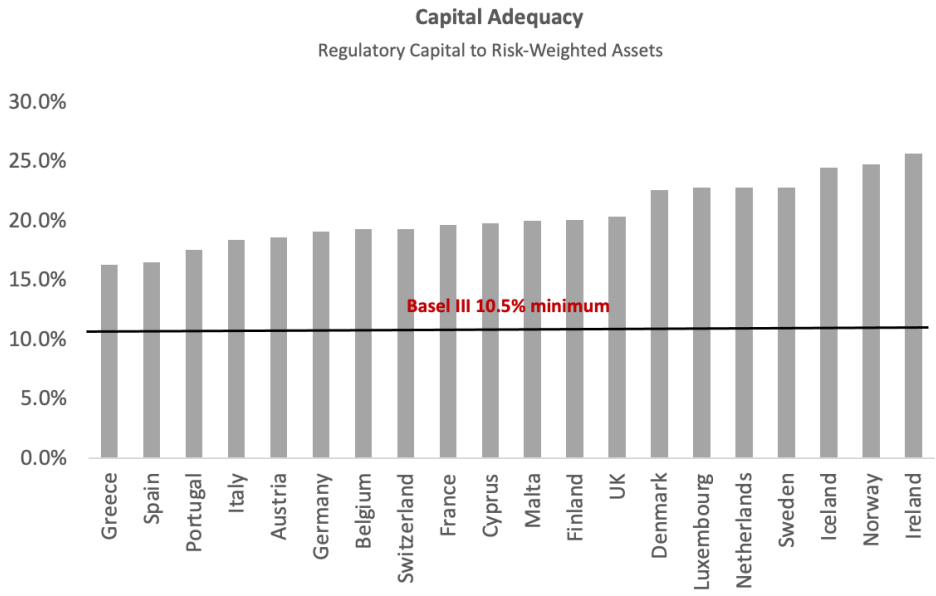
Banking Sector Update

The Covid-19 pandemic continues to have a negative impact on the banking sector. The banking system plays a crucial role in financing the real economy in Western Europe and particularly in financing small and medium-sized enterprises (SMEs). As such, in an effort to support banks and enable them to keep supplying vital credit to households and the corporate sector, governments and central banks have put in place a number of measures. These measures have included direct liquidity support and a relaxation of prudential requirements. Nevertheless, banking systems have come under significant stress, with their loan portfolios suffering as many borrowers continue to face difficulties in repaying their obligations as they come due. And this situation is likely to get worse before it gets better. Indeed, support for the banking sector, as well as measures to help firms (such as loan repayment moratoriums and loan guarantees), have so far suppressed the rise in payment defaults. The eventual withdrawal of such measures thus risks triggering a sharp increase in payment defaults and bankruptcies, in turn posing a threat to banking sector stability.

An assessment of two key metrics from the IMF's Financial Soundness Indicators provides some insight into the health of the region's banking sector. The chart below shows the 'regulatory capital to risk-weighted assets' ratio (a measure of capital adequacy) for every country in the region. This ratio gauges a bank's capital strength to withstand shocks and absorb unexpected losses. As per the Basel III global regulatory standard, banks are expected to have a capital adequacy ratio of at least 10.5%. As can be seen from the chart, all banks in the region currently exceed this minimum. Nevertheless, a deterioration in these positions going forward is highly likely given the ongoing impacts of the pandemic – with Greece, Spain and Portugal particularly vulnerable to falling below the regulatory standard.



Source: IMF Financial Soundness Indicators; Baker Ing
Data is latest available (ranging from Q1 2020 – Q4 2020)

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A key metric that is used to assess asset quality is the ratio of banks 'non-performing loans to total gross loans.' High levels of non-performing loans (NPLs) are problematic because they impair bank balance sheets, depress credit growth, and delay economic recovery. As can be seen from the chart below, the NPL ratios of all other countries in the region are dwarfed by those of Greece (29.8%) and Cyprus (17.7%). Greek and Cypriot banks have been saddled with high levels of problematic loans ever since the European Sovereign Debt crisis, which peaked during 2010-12, and was triggered by the 2008 Global Financial Crisis. While these levels have come down in recent years (Greece's NPL ratio was 40% in 2015), this downward trend will be interrupted by the Covid-19 crisis, which will likely see non-performing loans tick higher over the coming quarters, as firms and households start defaulting on their debt obligations as support measures are unwound.

Source: IMF Financial Soundness Indicators; Baker Ing
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Covid-19 impact on Eastern Europe & Central Asia

Economic Impact

More than a year after the start of the Covid-19 pandemic, many countries in Western Europe are enduring a renewed surge in infections. This 'third wave' has been triggered by the emergence of more infectious variants of the virus, a shortage of vaccines, and public lockdown fatigue – which arguably led to the premature easing of the social restrictions associated with the second wave.

The table below shows the number of deaths per 100,000 population in all countries across the region as of mid-April 2021. On this metric, Belgium and the UK are the two nations that have been hit hardest so far. However, John Hopkins University's classification of the twenty countries currently most affected by Covid-19 worldwide actually includes four countries from the region (highlighted in red in the table) – Germany, France, Spain and Italy. As well as taking account of deaths per 100,000 population, this classification also accounts for other information, such as the observed case-fatality ratio.

	Deaths/100K population
Belgium	205.5
United Kingdom	191.5
Italy	189.1
Portugal	164.5
Spain	163.4
France	147.7
Sweden	133.8
Luxembourg	125.6
Switzerland	122.7
Austria	109.5
Ireland	98.6
Netherlands	98.4
Germany	94.7
Malta	83.1
Greece	82.8
Denmark	42.1
Cyprus	22.9
Finland	15.7
Norway	12.9
Iceland	8.2

Source: John Hopkins University; Baker Ing
- The highlighted countries are those classified within the group of twenty countries currently most affected by Covid-19 worldwide.

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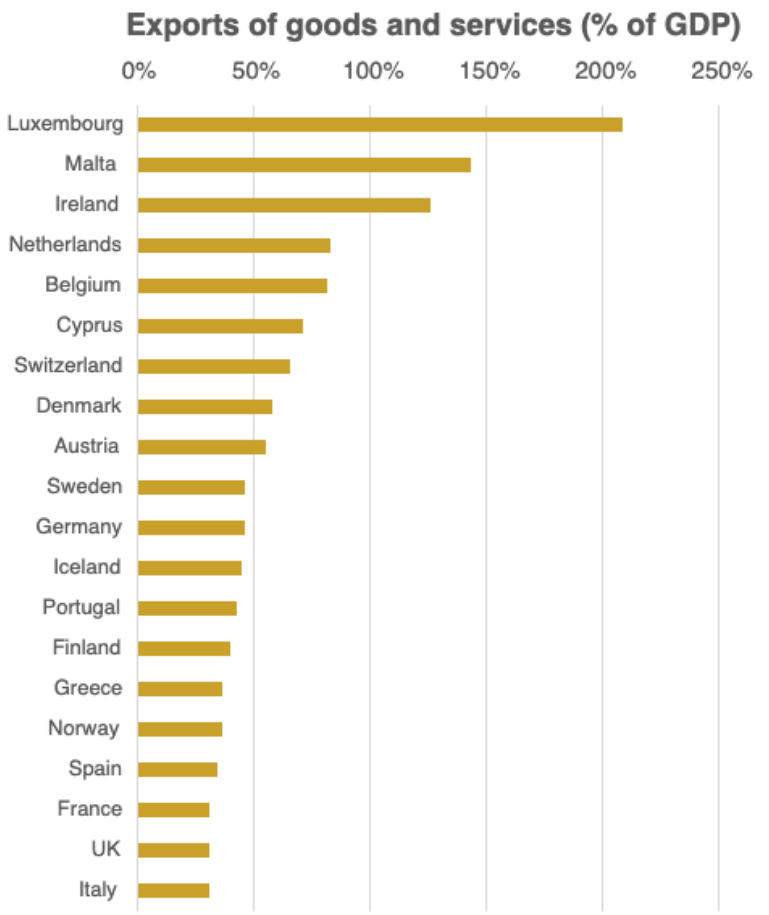
The third wave of the pandemic has led to the imposition of renewed lockdowns and other restrictions across many countries in the region, which will hamper and delay economic recoveries this year. Wide-ranging restrictions will likely remain in place in most countries until at least the end of Q2 2021, dramatically restricting domestic consumption and services activity. More positively, however, most factories in the region are currently able to stay open under the new restrictions, boding well for the region's manufacturing sector and ability to export goods. Exports are crucial for many Western European economies – accounting for over 50% of GDP in 9 of the 20 countries in the region, with these shares especially high in Luxembourg (209%), Malta (144%) and Ireland (127%). While external demand remains below pre-crisis levels amid the ongoing pandemic, it is recovering, with orders rising robustly from key markets such as China and the US.



Source: World Bank; Baker Ing
Data is latest available (2019)

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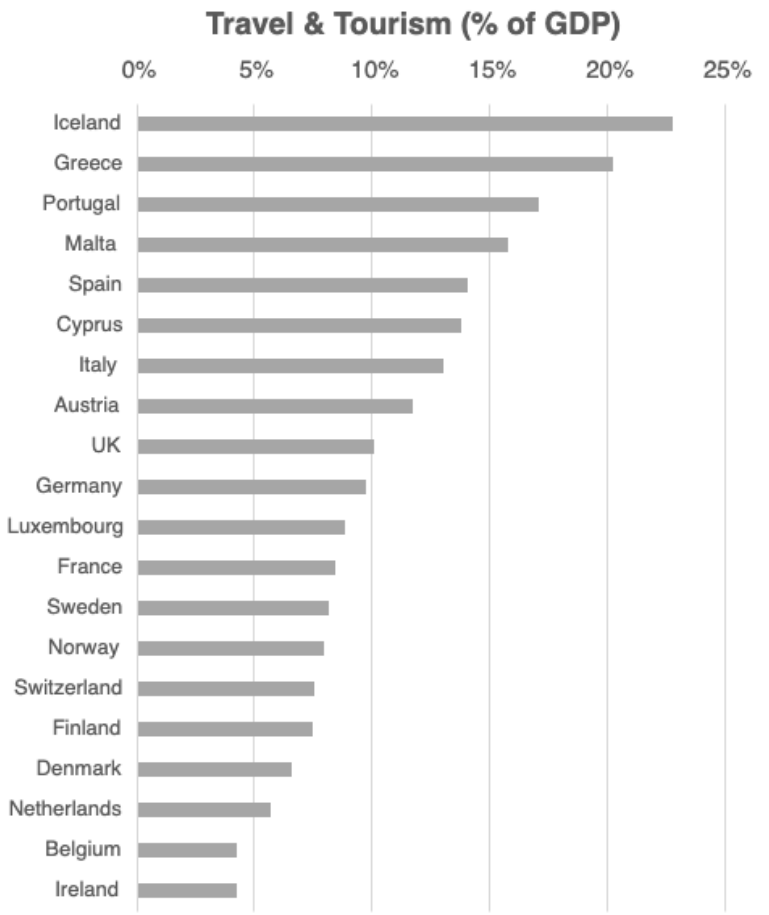
The global pandemic continues to weigh severely on Western Europe's travel & tourism sector. Many countries in the region are heavily dependent on tourism. Indeed, according to data from the World Travel & Tourism Council, the contribution of travel and tourism to GDP in 2019 was as high as 23% in Iceland, 20% in Greece and 17% in Portugal. It is also a vital sector in many other regional countries – accounting for over 10% of GDP in Malta, Spain, Cyprus, Italy, Austria, the UK and Germany. While 2020 data is only available for a small number of countries, it highlights the drastic impact that the Covid-19 pandemic has had on the travel & tourism sector so far – in Greece, for example, travel & tourism GDP fell by a massive 61.1% in 2020 – with the sector accounting for just 8.7% of the total economy (compared to 20% in 2019).



Source: World Travel & Tourism Council
Data is for 2019

With many of the businesses affected hardest by the pandemic having been given – and continuing to receive – significant government support, the Covid-19 crisis will result in credit risks remaining elevated for some time after economic recoveries take hold. As support is reined in – including financial aid, loan repayment moratoria, and measures such as waivers allowing over-indebted companies to delay filing for insolvency – the region could be hit by a wave of bankruptcies.

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Vaccine rollout outlook

Ultimately, the prospect of a stable lifting of lockdowns, economic recovery and improving business prospects is highly dependent on the success of vaccination programmes both domestically and globally. Domestically, while rollouts have been progressing well in some countries (including the UK, where 55% of the population were estimated to have received a vaccine as of mid-April), the EU vaccination programme has had a slow start, owing to delays in production and distribution, as well as concerns over the safety of the Oxford-AstraZeneca vaccine. Supply bottlenecks are likely to ease in the coming months, but widespread rollout of the vaccine across the EU is unlikely to be achieved until the end of 2021.

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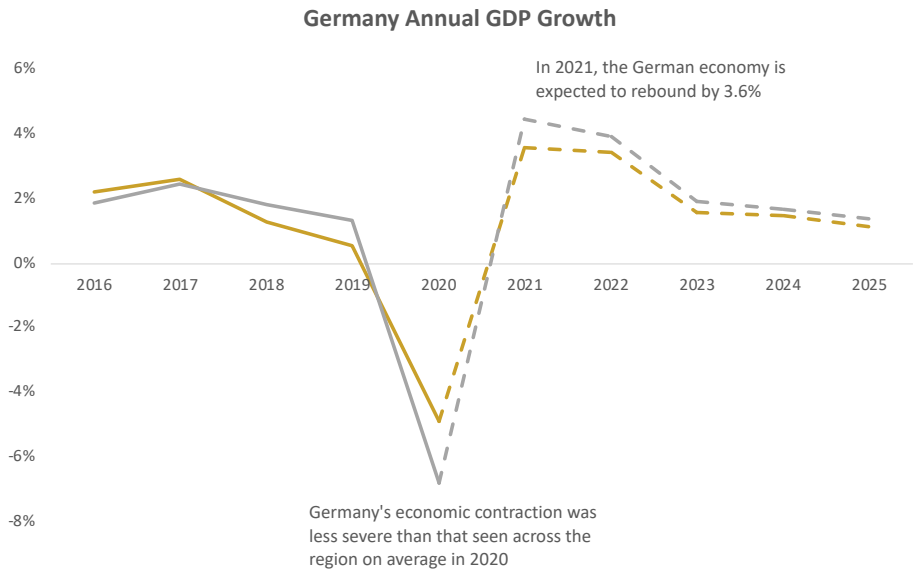
Germany

Economic Growth

Following ten consecutive years of expansion, the German economy contracted in 2020 due to the Covid-19 pandemic and the measures taken to contain it. GDP shrank by 4.9% as domestic consumption, private investment and external demand all slumped. However, the downturn was less severe than in the other major economies of Western Europe, including France, Spain and the UK. Germany's relatively better weathering of the crisis reflects less stringent lockdowns and a high level of government support. While supply chain disruptions hampered the country's large manufacturing sector – which accounts for almost 20% of GDP – the strongly recovering Chinese market has helped to support German factory activity.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

The economy is expected to rebound by 3.6% in 2021, with the bulk of the recovery likely to take place in the second half of the year. The recovery will be helped by the rollout of vaccines, which will allow the easing of lockdown restrictions, as well as ongoing generous government stimulus measures. In addition, the large export-oriented industrial sector, which is less affected by lockdown measures than the services sector, will continue to benefit from growing demand in China and other Asian markets.

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Household spending will also support the recovery – although consumers will likely maintain a high level of precautionary savings this year, much of the forced savings that accumulated during lockdowns will be drawn on to satisfy pent-up demand once restrictions are lifted. In addition, the 'Kurzarbeit' (short-time work) scheme has been extended to end-2021, which will support disposable incomes. 'Kurzarbeit' is a social insurance programme whereby employers reduce their employees' working hours instead of laying them off. Under the scheme, a worker receives 60% pay for the hours not worked, while receiving full pay for the hours worked.

In contrast, the services sector could continue to weigh on growth this year, and will take much longer to recover than manufacturing. Indeed, service sector businesses, particularly those which are contact-intensive, are unlikely to see a significant and lasting recovery take hold until 2022.

Bankruptcies, meanwhile, which decreased in 2020 owing to deferred reporting obligations and government financial support, could start to rise towards the end of this year.

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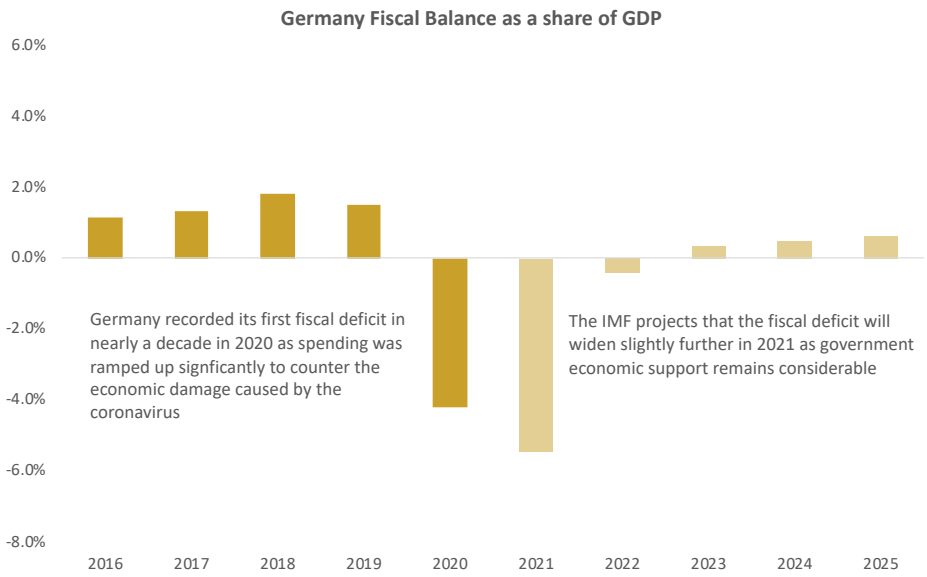
Fiscal Developments

After six years of fiscal surpluses, Germany's budget shifted into deficit in 2020 amid a massive increase in spending to cushion the economy from the fallout of the Covid-19 pandemic. The multi-faceted fiscal measures amount to more than 10% of GDP over 2020-2021, and comprise one of the largest fiscal packages in Europe. The measures include: the Kurzarbeit (short-time work) programme to support workers and incomes; a EUR50bn fund to help small businesses and the self-employed; EUR500bn liquidity assistance for companies that need help paying loans; EUR3.5bn spend on the healthcare system; tax deferrals; and a cut in VAT from 19% to 16% that was implemented during July-December 2020.

The government intends to maintain considerable fiscal support in 2021, which will be crucial to the economic recovery. As a result, the fiscal balance will remain in deficit this year, and will widen to an estimated 5.5% of GDP (from 4.1% in 2020).



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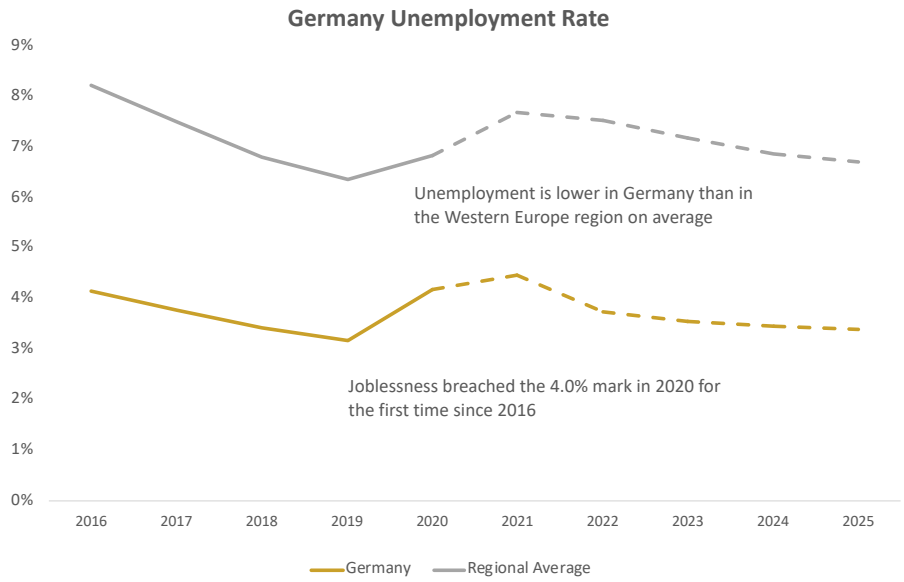
Unemployment

Unemployment in Germany rose in 2020 amid the Covid-19-related business closures and scalebacks. The jobless rate breached the 4.0% mark for the first time since 2016. IMF forecasts suggest that the unemployment rate will rise slightly further this year, to an estimated 4.4% (from 4.2% in 2020). Thereafter, it is expected to resume a declining trend through to 2025 and remain significantly below the Western Europe average. The government's short-time work scheme (Kurzarbeit), has played a crucial role in shielding the labour market since early 2020 and has been extended until end-2021. The scheme is helping to limit job losses and support workers' incomes. It has also helped companies to mitigate the costs associated with layoffs and future (re)hiring and training.



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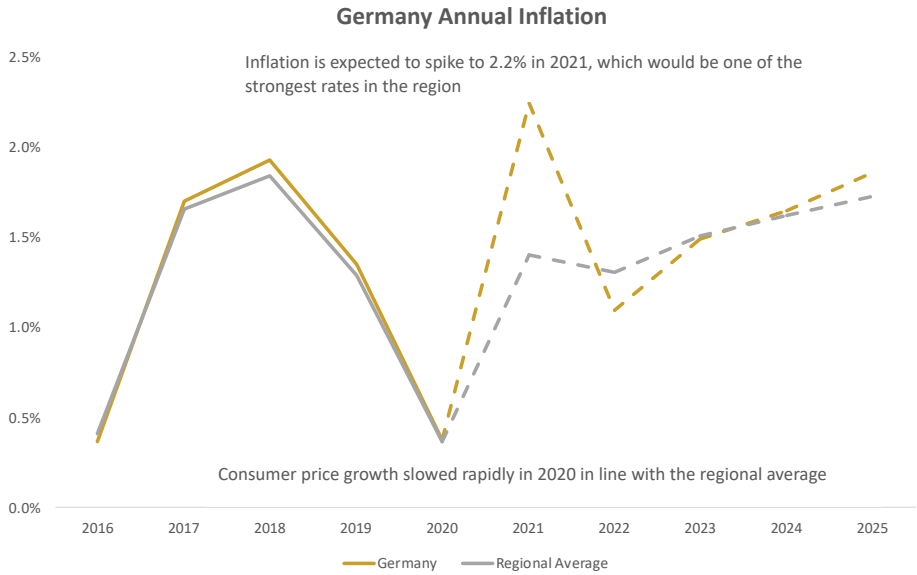
Inflation

In line with regional developments, German consumer price growth slumped in 2020 amid the hit to demand from the coronavirus, as well as low oil prices and a stronger euro (both of which reduced import costs). In addition, a VAT cut during July to December also contributed to the rapid cooling of prices last year, with inflation having fallen by a full percentage point from 2019 to just 0.4%.

Inflation is set to re-accelerate this year, and will average at a forecast annual rate of 2.2% – notably higher than the expected 1.4% regional average. This reflects the reversal of the VAT tax cut in January 2021, the introduction of new energy taxes, a rise in the minimum wage, and an uptick in demand-side pressures as the economy recovers. As base effects dissipate, inflation is then expected to ease to 1.1% in 2022.



Source: IMF; Baker Ing
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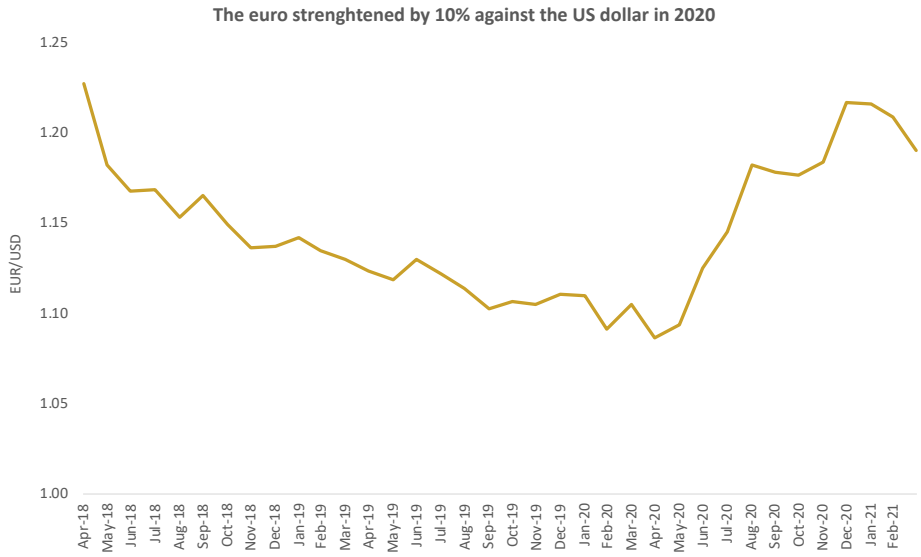
Currency Risk

The euro saw a turbulent 2020. It initially depreciated against the US dollar in the early part of the year, when the coronavirus pandemic forced European countries into lockdowns. After the EU announced the establishment of a recovery fund worth EUR750bn, and the Chinese economy (a key market for European exporters) began to recover, the currency began to rapidly appreciate. All in all, the euro gained 10% on the US dollar in 2020. Since the turn of the year, the euro has pared back some of its gains and could depreciate further against the US dollar in 2021, given expectations for a protracted economic recovery and the European Central Bank's maintenance of an ultra-loose monetary policy stance. Positively, a weaker currency would support the region's exporters by making goods and services sold abroad more price-competitive.



Source: OFX.com; Baker Ing

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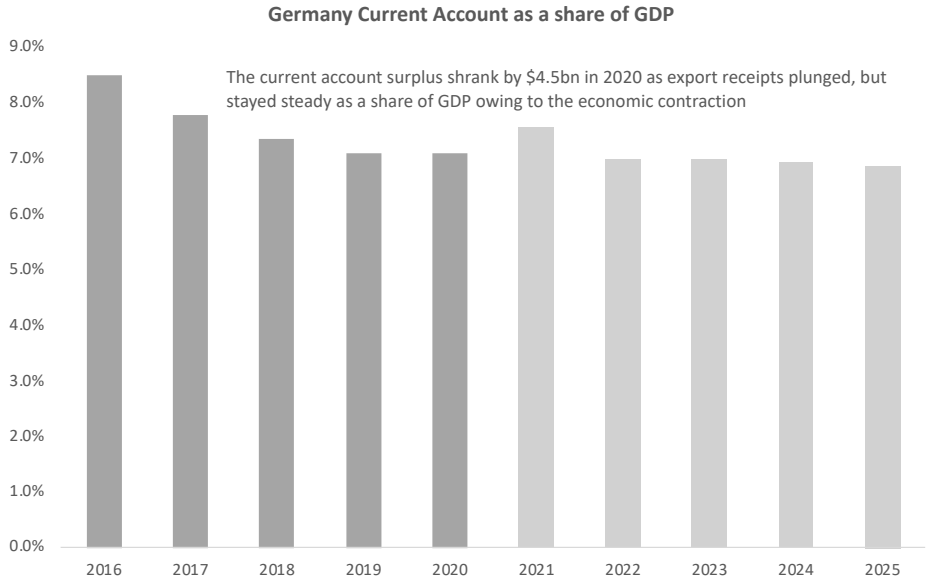
External Developments

Germany's large current account surplus narrowed by $4.5bn in 2020, reflecting a sharp fall in the goods trade balance as exports plunged amid the global pandemic. However, the current account surplus is expected to begin expanding again this year, and will account for an estimated 7.6% of GDP (up from 7.1% in 2020), as global demand recovers and a weaker euro promotes the price competitiveness of German goods on international markets. However, the extent of the export recovery will be hampered by still-weak demand among key European trading partners and ongoing supply chain disruptions.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the lighter shade).

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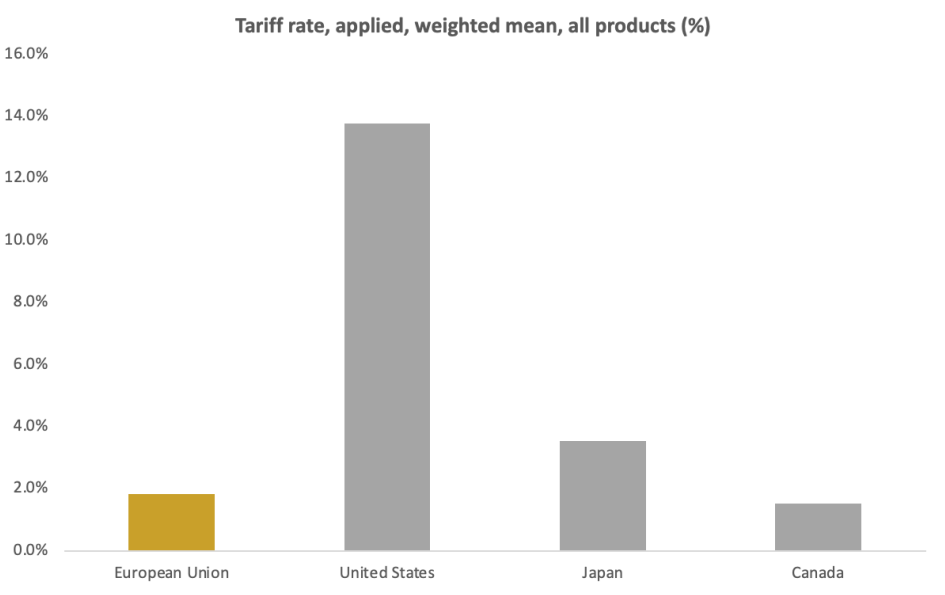
Trade Barriers

As a member of the European Union (EU), the EU Common Customs Tariff (CCT) applies to all imports coming into Germany from outside the EU (there are no tariffs levied on trade between members of the customs union). As such, the applied weighted mean tariff rate in Germany (and in all EU member states) is 1.8%. This is significantly lower than the equivalent tariff rate in the US, which was 13.8% in 2019, having risen sharply as a result of the tariffs imposed by ex-President Donald Trump on China. It is also lower than the applied weighted mean tariff rate in Japan (3.5%), but just above that in Canada (1.5%).



Source: World Bank; Baker Ing
The weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.
Data is latest available (2019)

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Non-tariff barriers to cross-border trade are generally moderate in Germany. In the World Bank's *Doing Business 2020* report, Germany is ranked 42nd out of 190 economies globally for the category 'trading across borders.' This compares relatively poorly with its big Eurozone peers, including France, Italy and Spain (which are jointly ranked 1st) and reflects the higher costs and time commitments associated with exporting from Germany.

		Germany	OECD high income
Time to export	Border compliance (hours)	36	12.7
	Documentary compliance (hours)	1	2.3
Cost to export	Border compliance (USD)	345	136.8
	Documentary compliance (USD)	45	33.4
Time to import	Border compliance (hours)	0	8.5
	Documentary compliance (hours)	1	3.4
Cost to import	Border compliance (USD)	0	98.1
	Documentary compliance (USD)	0	23.5

Source: World Bank; Baker Ing
The World Bank's OECD high income region includes 34 countries.

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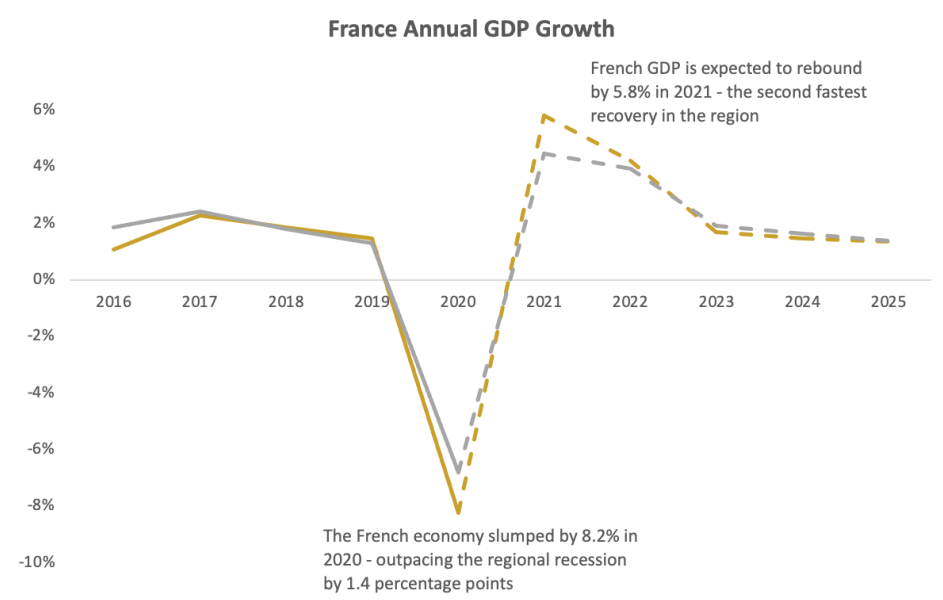
France

Economic Growth

The French economy contracted by a sharp 8.2% in 2020 as a result of the coronavirus, with the country being one of the worst affected globally by the pandemic. The tourism, manufacturing, retail and construction sectors were worst hit, reflecting the impact of strict lockdown and social restriction measures.

While the economy is expected to rebound by a robust 5.8% this year (one of the strongest projected growth rates in the region), activity in the first half of the year will remain weak. Indeed, growing concern over rising infection rates amid the third wave of the Covid-19 pandemic prompted the French authorities to announce a month-long lockdown on March 18th for the worst-affected regions of the country. Beyond this, some degree of restrictions are likely to remain in place for at least the first half of 2021, as the government gradually rolls out vaccinations.

The economic recovery should then gain pace in the second half of the year as restrictions are gradually relaxed and pent-up demand boosts household consumption and spurs business investment. Export-facing sectors, meanwhile, will continue to benefit from the recovery in Asia. Crucially, the projected recovery depends on the timely implementation of the vaccination programme and its success in conferring protection against any new variants that potentially emerge. Moreover, the extent of the recovery will be limited by impaired balance sheets and elevated unemployment.



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The recovery is expected to continue at a strong, albeit more moderate, pace of around 4.2% in 2022. While household consumption should continue to improve, the likelihood of a further deterioration in the labour market situation will be a limiting factor. Nevertheless, government support should continue to be substantial, particularly in the context of the 2022 presidential elections in which Emmanuel Macron will seek re-election.

In terms of protecting businesses, the French government has extended its exceptional insolvency measures related to the Covid-19 crisis to end-December 2021. These measures have so far prevented a rise in business failures from materialising. There is therefore likely to be a delayed rise in bankruptcies in 2022. If this rise is significant enough to put pressure on the banking system, which is already struggling with low profitability in the current environment, businesses could see their access to credit tighten.

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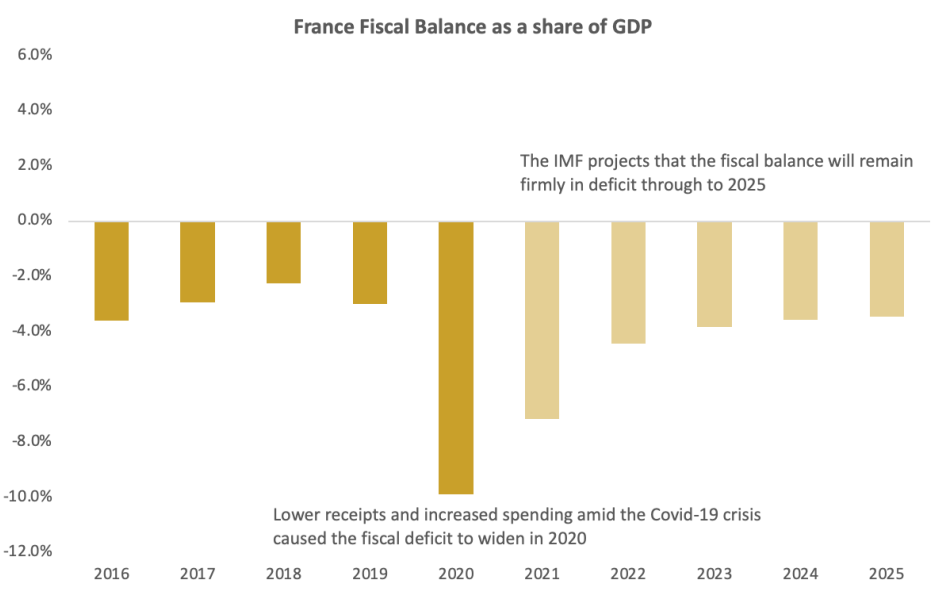
Fiscal Developments

A large emergency support package, including measures to support households and firms by preserving jobs and providing liquidity, was adopted by the French government in order to minimise the economic fallout of the pandemic. These measures include the expansion of France's short-time work scheme, grants for small firms and the self-employed, and public guarantees for bank loans to firms.

The cost of these support measures coupled with falling revenue caused France's budget deficit to increase in 2020, hitting 9.9% of GDP, up sharply from 3.0% of GDP in 2019. Looking forward, the budget deficit is forecast to remain at an elevated level in 2021 (7.2% of GDP) and 2022 (4.4% of GDP).



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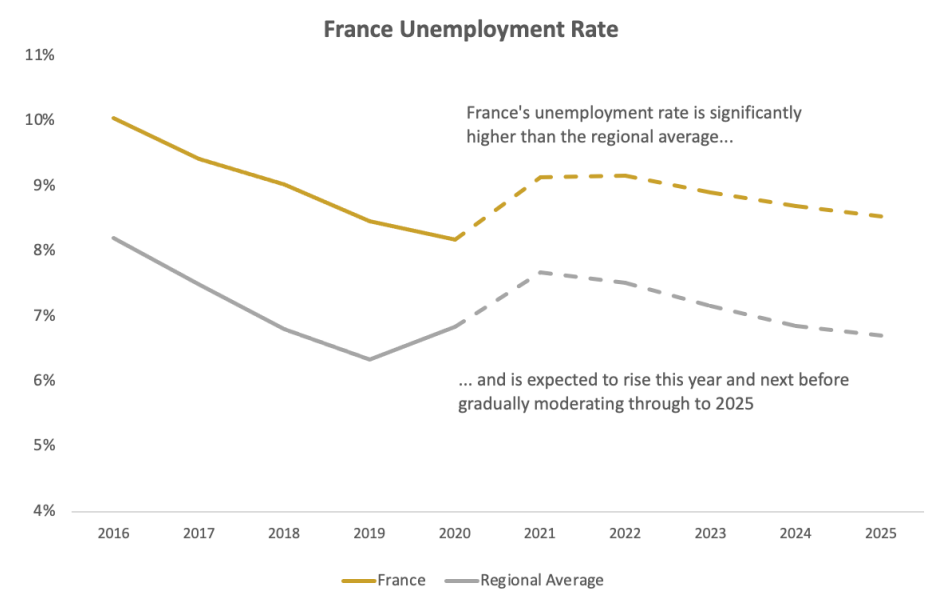
Unemployment

The Covid-19 crisis has had a sizeable negative impact on the labour market, despite government efforts to support employment and wages. Indeed, while the unemployment rate actually fell in 2020 (to 8.2% from 8.5% in 2019), this was reportedly due to a rise in inactivity – i.e., more and more people dropping out of the labour market and no longer seeking employment due to the current health crisis and lockdown measures. These people are therefore no longer counted in the unemployment statistics, thus giving a misleading impression of the health of the labour market.

Looking forward, the unemployment rate is set to rise to 9.1% in 2021 and 9.2% in 2022. Indeed, even once the worst of the crisis passes, the labour market will face a long recovery ahead, as the reining in of job support schemes no longer artificially depresses the unemployment figures.



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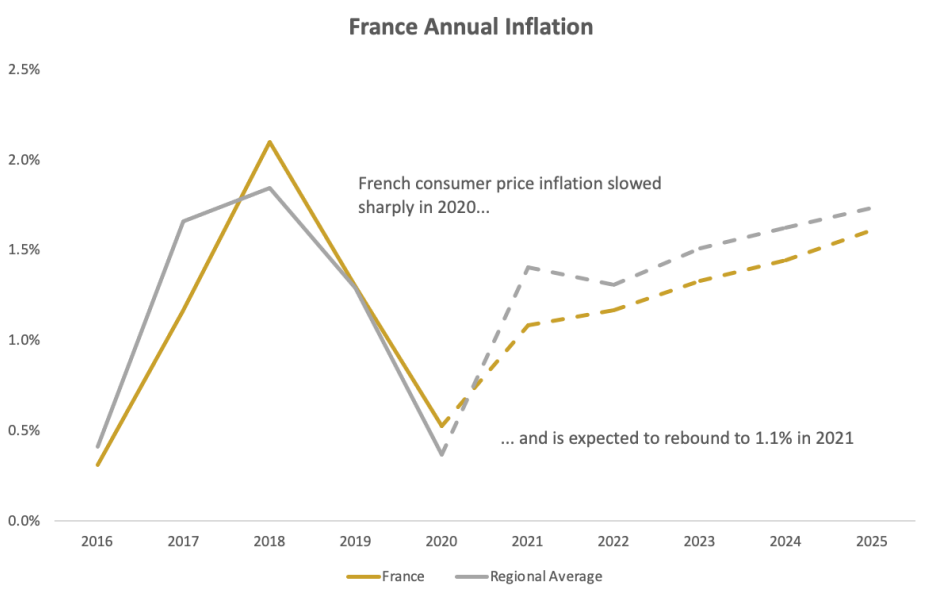
Inflation

French consumer price inflation slowed sharply in 2020 (to just 0.5% from 1.3% in 2019), reflecting the crash in global oil prices (which lowered France's import bill) and the sizeable negative demand shock. The recovering economic backdrop and rising global oil prices will see inflation pick up steam this year, to an estimated annual average rate of 1.1%, before rising slightly further to 1.2% in 2022.



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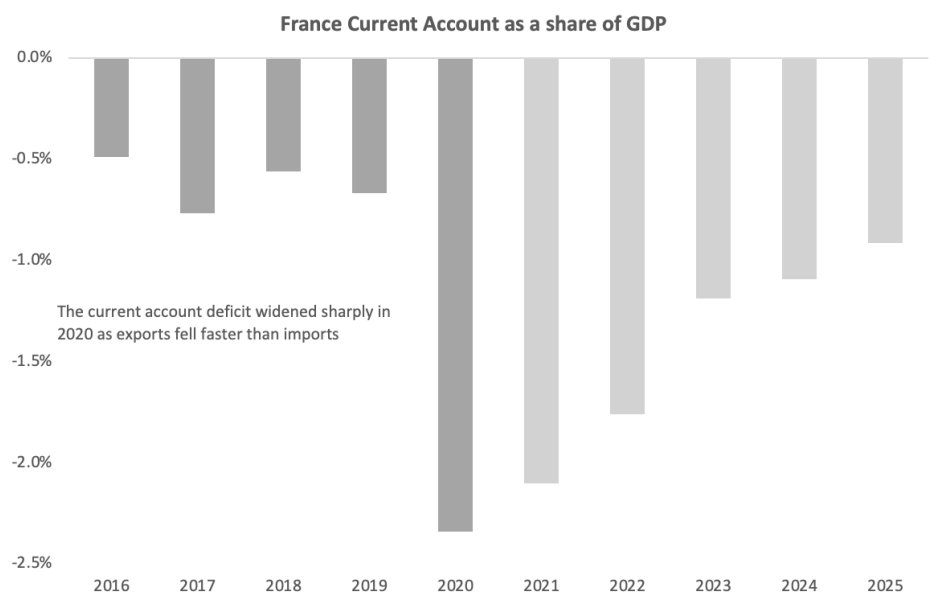
External Developments

France's current account deteriorated significantly in 2020 as exports fell much faster than imports. The plunge in French exports was caused by the global slump in demand owing to the Covid-19 health emergency, as well as France's large share of sectors most acutely affected by the crisis – such as tourism, automobiles, and aerospace.

While an improving external environment should help to bolster export demand going forward, it is nevertheless likely to remain constrained as key European markets continue to struggle economically, while tourism and global demand for transport goods remain weak amid ongoing social and travel restrictions. As such, France's current account is likely to register substantial, albeit declining, deficits over the coming years.



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Trade Barriers

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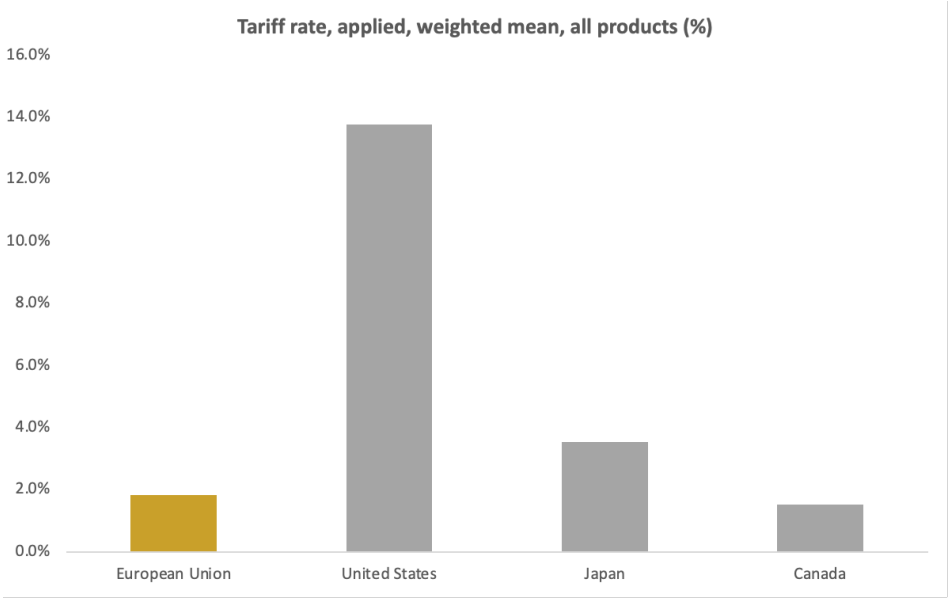

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Non-tariff barriers to cross-border trade are very low in France. In the World Bank's *Doing Business 2020* report, the country is ranked joint 1st out of 190 economies globally for the category 'trading across borders.' According to the report, the time and costs associated with both exporting and importing in France are negligible and considerably lower than in the OECD high income region on average.

		France	OECD high income
Time to export	Border compliance (hours)	0	12.7
	Documentary compliance (hours)	1	2.3
Cost to export	Border compliance (USD)	0	136.8
	Documentary compliance (USD)	0	33.4
Time to import	Border compliance (hours)	0	8.5
	Documentary compliance (hours)	1	3.4
Cost to import	Border compliance (USD)	0	98.1
	Documentary compliance (USD)	0	23.5

Source: World Bank; Baker Ing
The World Bank's OECD high income region includes 34 countries.

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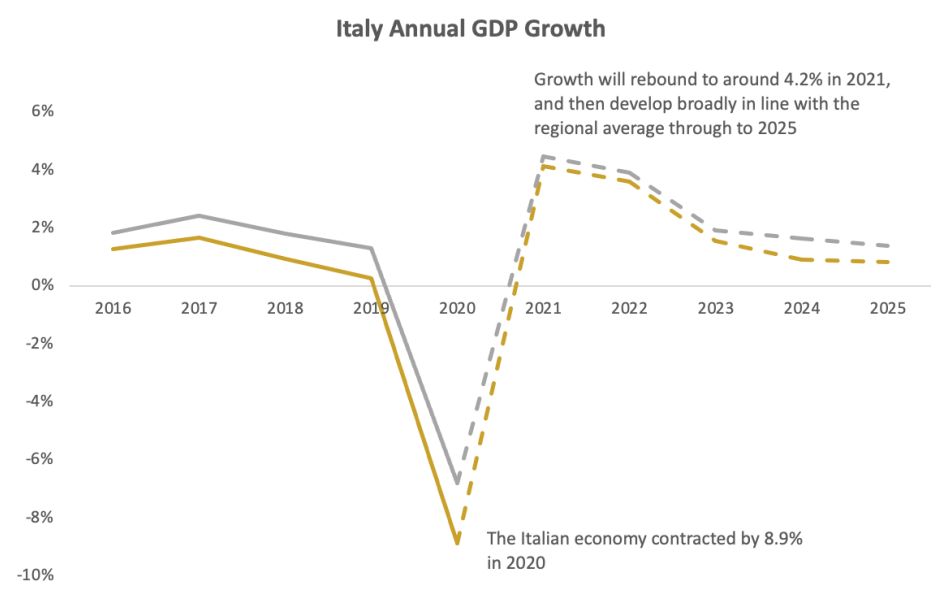
Italy

Economic Growth

The Italian economy contracted by 8.9% in 2020 as a result of the dual supply and demand shocks stemming from the coronavirus pandemic, with the hospitality, tourism, and transport sectors most severely affected by the restrictions on mobility and economic activity. Of the four largest Eurozone economies, Italy's downturn was not as steep as that of Spain (-11.0%), but was worse than that seen in Germany (-4.9%) and France (-8.2%).



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GDP is forecast to recover by around 4.2% in 2021, as the ongoing immunisation programme helps to provide an eventual exit from the pandemic. However, heightened uncertainty over emerging mutations could cause setbacks and delay the economic recovery. Nevertheless, Investment activity should be supported by increased EU funding this year and a continued accommodative fiscal policy stance, while the gradual reopening of the global economy will help to fuel foreign demand. Consumer spending, meanwhile, will be spurred by the eventual relaxation of restrictions, which should unleash pent-up demand in the second half of this year. However, ongoing caution and still-high uncertainty will limit the extent of the revival in both consumer spending and business investment. Meanwhile, the recovery of Italy's important tourism sector will lag behind, as travellers are expected to return only gradually.

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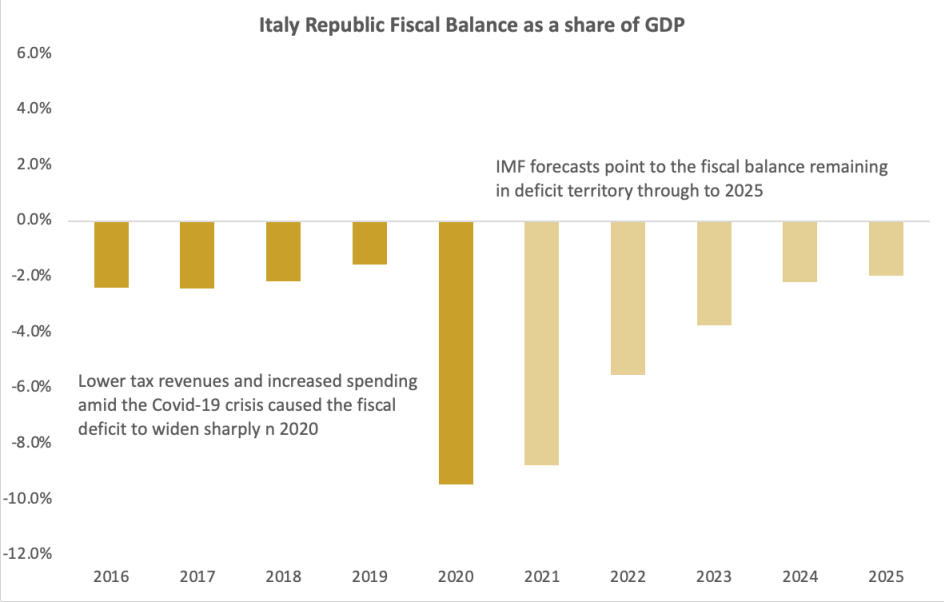
Fiscal Developments

The Italian government allocated significant fiscal resources to deal with the health crisis and cushion its social and economic effects in 2020, and large-scale support remains in place – including short-term work schemes and temporary moratoria on taxes and the servicing of bank loans. All in all, after registering a fiscal deficit equivalent to 9.5% of GDP in 2020, Italy is likely to register another substantial deficit this year (projected at 8.8% of GDP). The recovering economy and the phasing out of anti-crisis measures should help the government to rein in the deficit more significantly in 2022.



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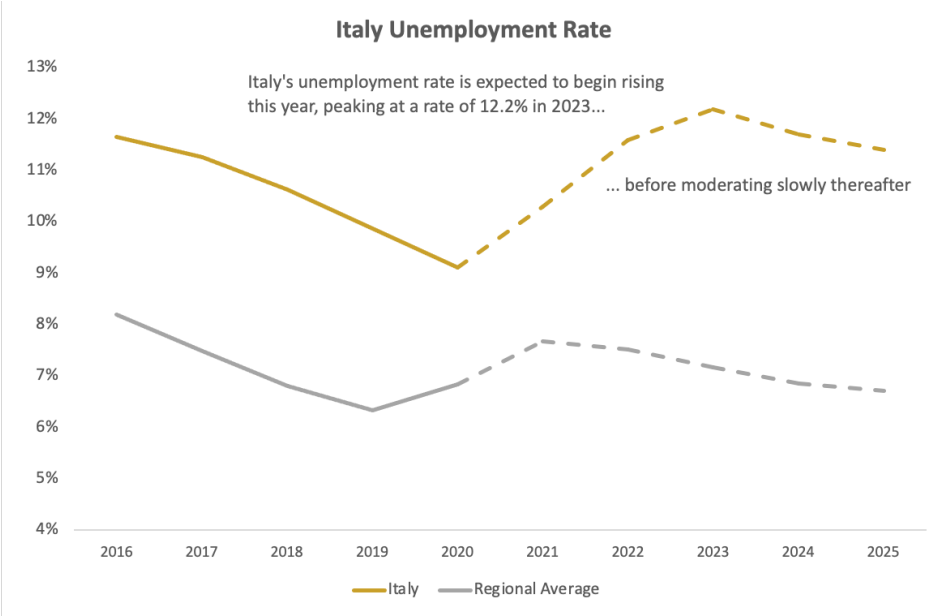
Unemployment

Italy's unemployment rate decreased in 2020 despite the hugely detrimental impact of the Covid-19 pandemic on the labour market. The jobless rate fell to an average of 9.1%, down 0.8 percentage points from 2019. As in France, this decline is misleading – rather than a sign of labour market resilience, it reflects the impact of many Italians having dropped out of the labour market altogether during strict lockdown periods (and thus falling out of the unemployment statistics), as well as furlough schemes and a government ban on laying off staff. The unemployment rate is expected to start rising this year, and continue increasing through to 2023 as labour market support measures expire and businesses continue to contend with high levels of uncertainty.



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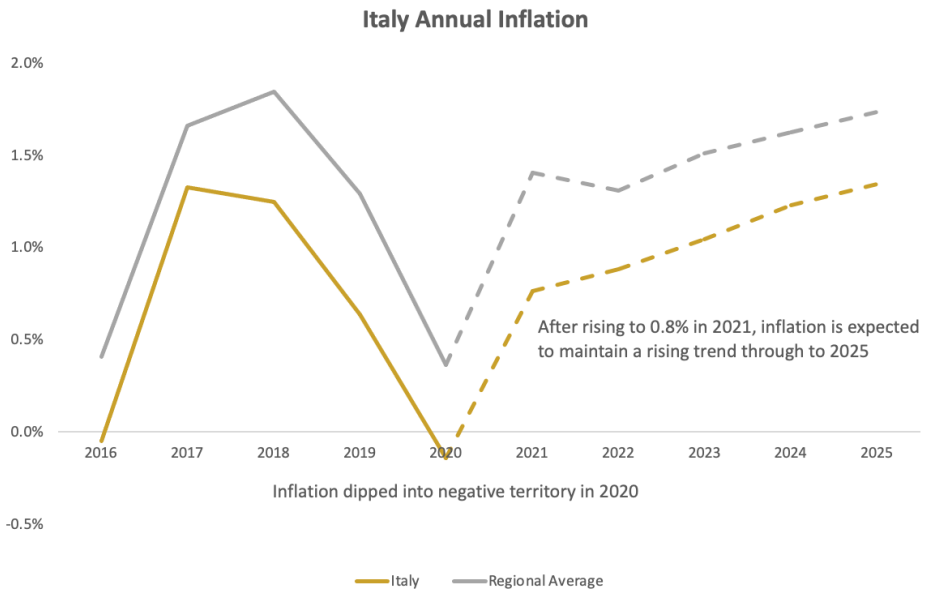
Inflation

Inflation dipped into negative territory in Italy during 2020, registering at an average annual rate of -0.1%, as domestic price pressures subsided sharply amid the slump in consumer and business demand, while the plunge in oil prices lowered import costs. Consumer price growth is expected to turn positive again this year and average at 0.8% y/y, before rising gradually further through to 2025. However, it will remain relatively muted in the coming years, and below the Western Europe average, as continued economic slack limits the scope for wage growth.



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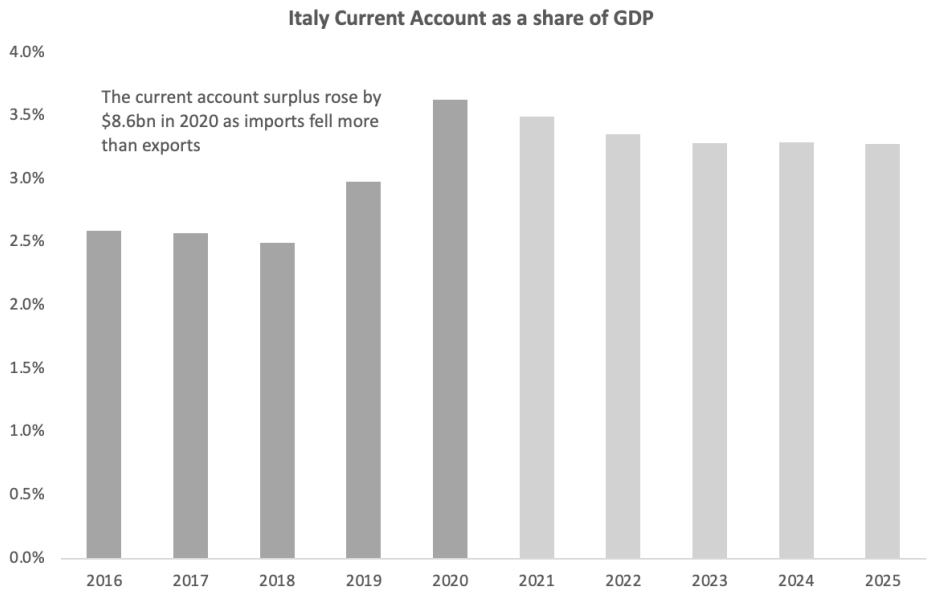
External Developments

In contrast to developments in Germany and France, Italy's current account surplus actually widened in 2020. This reflects an increase in the country's trade surplus, which occurred because the decline in the value of imports (-12.8% y/y) outpaced that of exports (-9.7% y/y). The sharp decline in Italy's import bill was a result of both the collapse in domestic demand amid pandemic-related lockdown restrictions, and the significant fall in Italy's import costs as international energy prices plunged.

As restrictions are eased, a gradual strengthening of domestic demand, coupled with firmer international energy prices, will increase the value of Italy's goods imports. However, this trend will be at least partially offset by a solid recovery for Italy's manufacturing exports, which will thus help to keep the overall external balance firmly in surplus this year.



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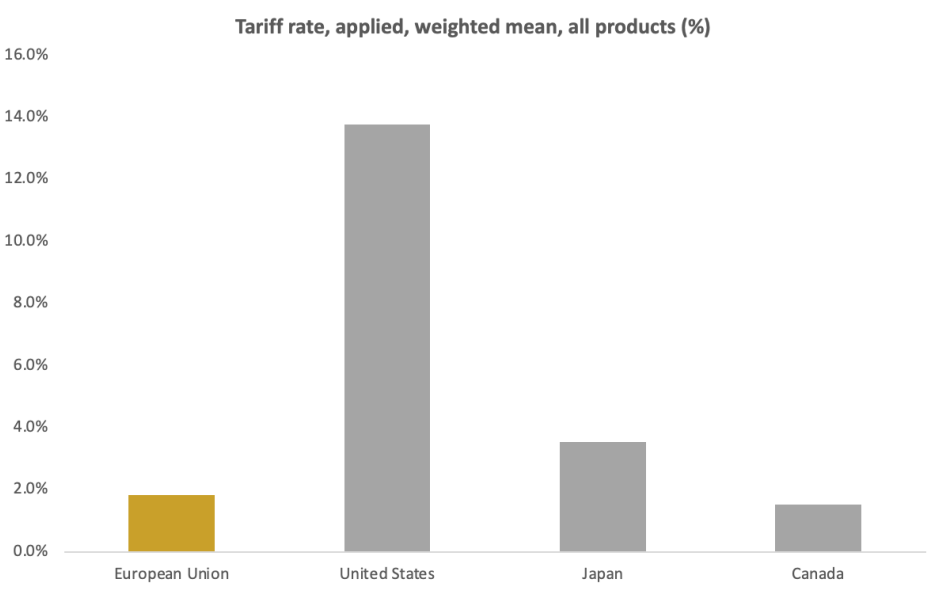

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Along with fifteen other countries, many of which are in Western Europe, Italy is ranked joint 1st out of 190 economies globally for the category 'trading across borders' in the World Bank's *Doing Business 2020* report. According to the report, non-tariff barriers to cross-border trade are very low in Italy, with both exporting and importing requiring very little time or financial outlay.

		Italy	OECD high income
Time to export	Border compliance (hours)	0	12.7
	Documentary compliance (hours)	1	2.3
Cost to export	Border compliance (USD)	0	136.8
	Documentary compliance (USD)	0	33.4
Time to import	Border compliance (hours)	0	8.5
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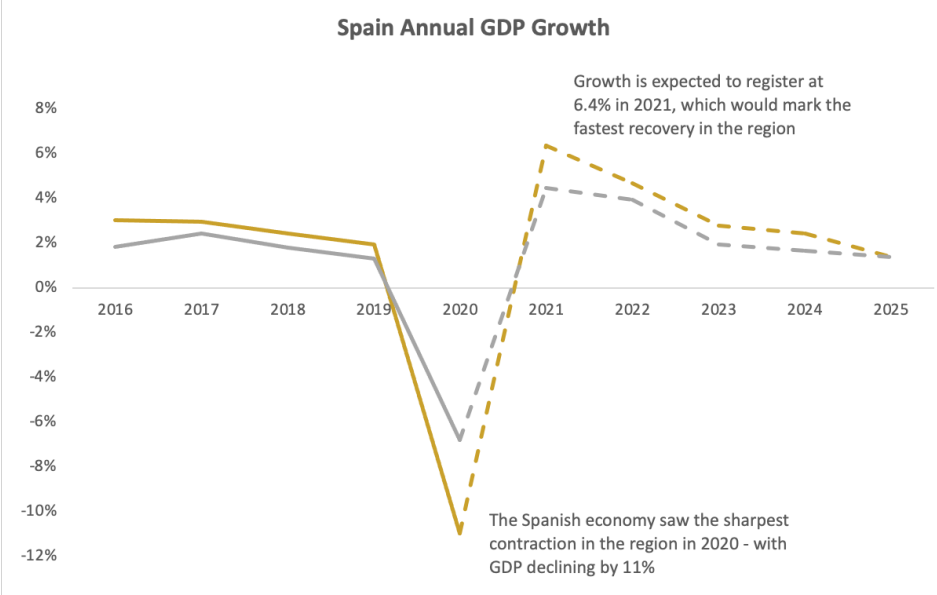
Spain

Economic Growth

The Spanish economy contracted by 11% in 2020, as the coronavirus pandemic and measures to contain it – both domestically and abroad – weighed heavily on activity and demand. Spain's recession was the most severe in the Western Europe region. This reflects a number of structural features that make the Spanish economy more vulnerable to Covid-19-related disruptions, including its high prevalence of small and medium size enterprises (SMEs), the importance of tourism, and the widespread use of temporary employment contracts.



Source: IMF; Baker Ing
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The economy is projected to partially recover in 2021, with growth of around 6.4%. Momentum will remain subdued in the first half of the year, as economic activity remains severely hampered by ongoing coronavirus restrictions. The anticipated pick-up in activity in the second half of the year depends crucially on the speed of Spain's vaccine rollout, which has been sluggish so far. The government's current plans to administer at least one dose of the vaccine to 70% of the population by the end of August are ambitious and at high risk of being delayed. Nevertheless, the progressive lifting of restrictions should boost economic activity from the third quarter onwards, driven by the materialisation of pent-up consumer demand and a rebound in investment helped by moderating uncertainty. Gradually recovering global demand will also help to lift exports.

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In 2022, the tourism recovery is expected to gain momentum, while domestic demand growth will likely ease once pent-up demand is exhausted. These developments should see growth moderate to around 4.7%. All in all, the recovery will be protracted and the outlook is highly uncertain, with risks heavily tilted to the downside amid uncertainty over the course of the pandemic. Moreover, the strong prevalence of SMEs in the economy, which tend to have minimal capital and small margins, indicates a high risk of a wave of business insolvencies materialising, particularly when the government withdraws its key support measures.

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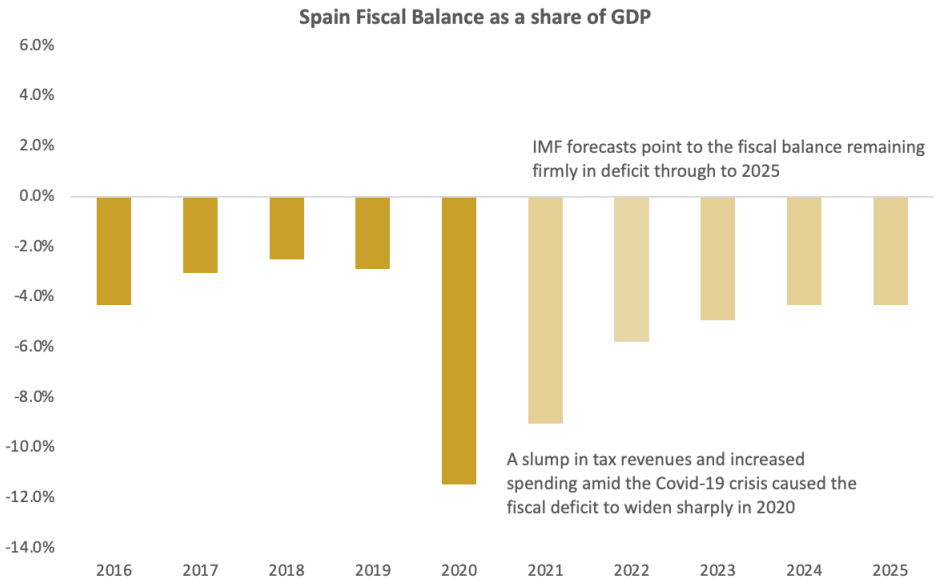
Fiscal Developments

A slump in tax revenues and increased spending amid the Covid-19 crisis caused Spain's fiscal deficit to widen sharply in 2020, to 11.5% of GDP. A multitude of policy measures to protect jobs and support firms – such as unemployment benefit for temporarily laid off workers and direct aid to support corporate solvency – are expected to remain in place until at least mid-2021, thus resulting in another large fiscal deficit this year (projected to amount to around 9.0% of GDP). Fiscal consolidation will see the deficit reined in over the coming years, but this will be a slow process, and it is expected to remain above pre-pandemic levels through to 2025.



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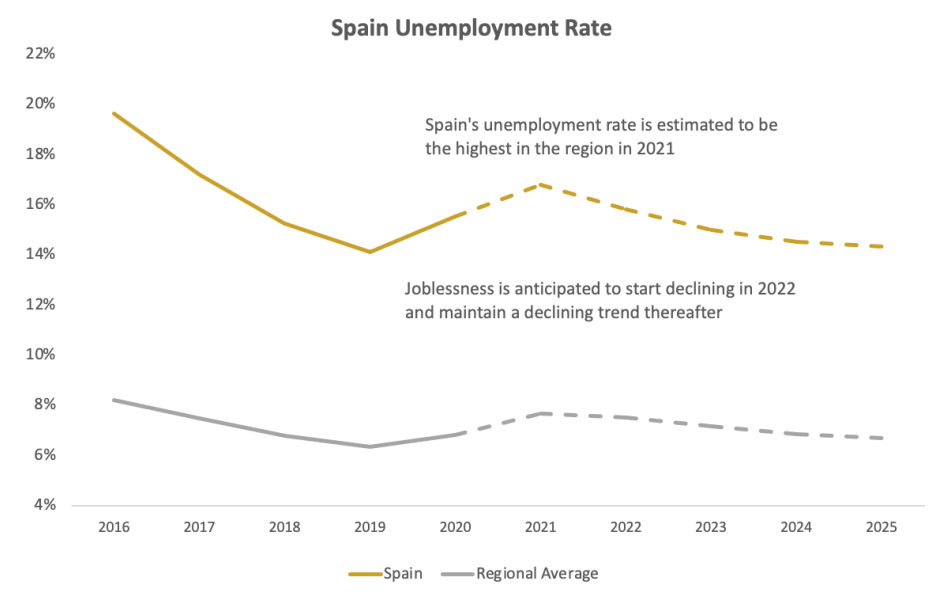
Unemployment

Despite Spain's ongoing furlough scheme, unemployment rose by 1.4 percentage points to 15.5% in 2020, and is expected to rise further – to a projected 16.8% – in 2021, as the country continues to reel from the economic impact of the pandemic. Thereafter, while the jobless rate should embark on a downward trend, it will remain elevated and substantially above the Western European average, reflecting a number of structural constraints – including the EUs highest rate of temporary contracts, among the highest proportions of low-skilled workers, and one of the lowest rates of internal mobility.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

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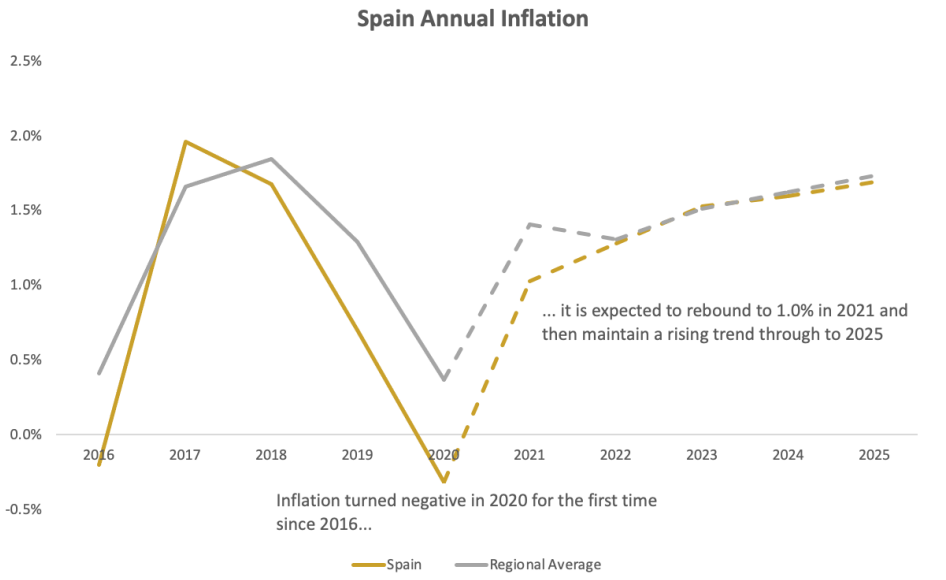
Inflation

Consumer price growth in Spain entered deflationary territory in 2020, registering at an annual average rate of -0.3%, owing to weak domestic demand, soft wage growth, and a fall in import costs due to a slump in global energy prices and a strengthening in the euro. Inflation should pick up to around 1.0% in 2021, owing to a rebound in private consumption and an increase in energy prices as global demand recovers. Inflationary pressures will then continue to build gradually, with inflation forecast to average 1.5% in 2022-25.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

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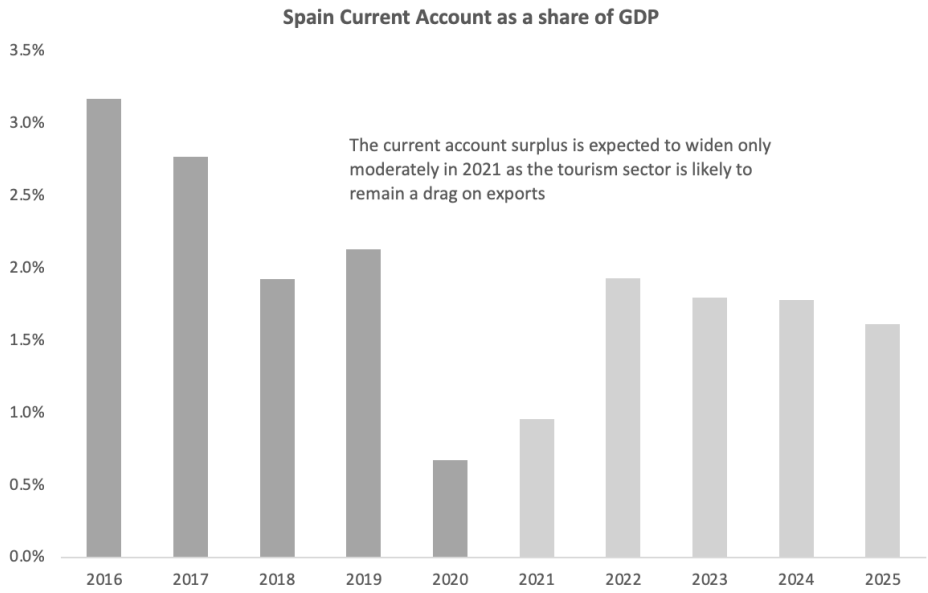
External Developments

Spain's current account surplus shrank to just 0.7% of GDP in 2020 (from 2.1% in 2019) as goods exports declined owing to the pandemic-induced slump in global demand, while receipts from tourism-related services plummeted, causing the services surplus to collapse. As the global economy strengthens, demand for Spanish export goods will pick up, helping to improve the country's trade balance, while a gradual recovery in tourism will also help the overall current account surplus to widen. All in all, the current account surplus should expand to 1.0% of GDP in 2021, and then average approximately 1.8% over 2022-2025.



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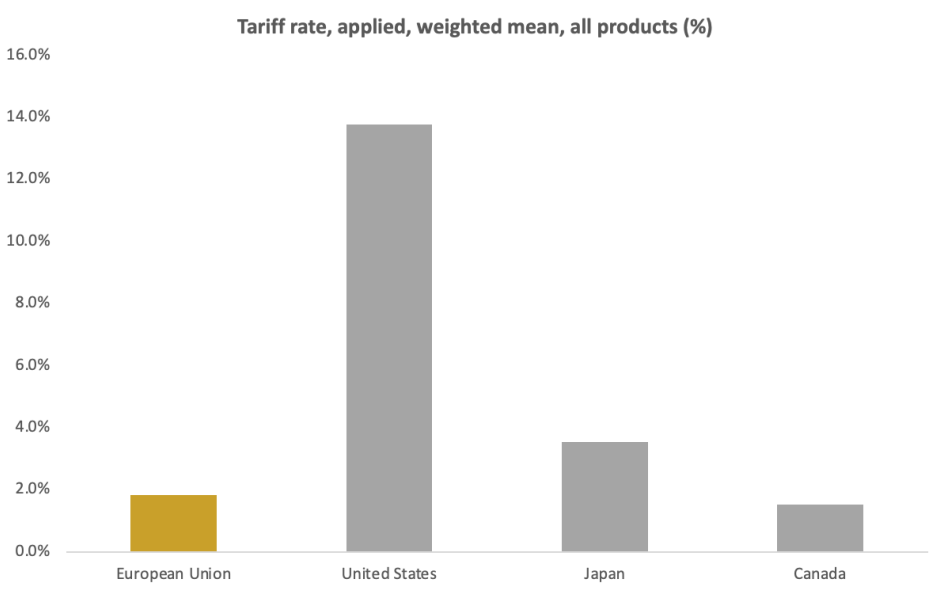
Trade Barriers

As a member of the European Union (EU), the EU Common Customs Tariff (CCT) applies to all imports coming into Spain from outside the EU (there are no tariffs levied on trade between members of the customs union). As such, the applied weighted mean tariff rate in Spain is 1.8%.



Source: World Bank; Baker Ing
The weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.
Data is latest available (2019)

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Along with eight other countries in Western Europe, Spain is ranked joint 1st out of 190 economies globally for the category 'trading across borders' in the World Bank's *Doing Business 2020* report. According to the report, non-tariff barriers to cross-border trade are very low. For example, the time required to meet documentary compliance requirements in Spain for importing and exporting is just one hour on average, compared to an average of 2.8 hours in the OECD high income region.

		Spain	OECD high income
Time to export	Border compliance (hours)	0	12.7
	Documentary compliance (hours)	1	2.3
Cost to export	Border compliance (USD)	0	136.8
	Documentary compliance (USD)	0	33.4
Time to import	Border compliance (hours)	0	8.5
	Documentary compliance (hours)	1	3.4
Cost to import	Border compliance (USD)	0	98.1
	Documentary compliance (USD)	0	23.5

Source: World Bank; Baker Ing
The World Bank's OECD high income region includes 34 countries.

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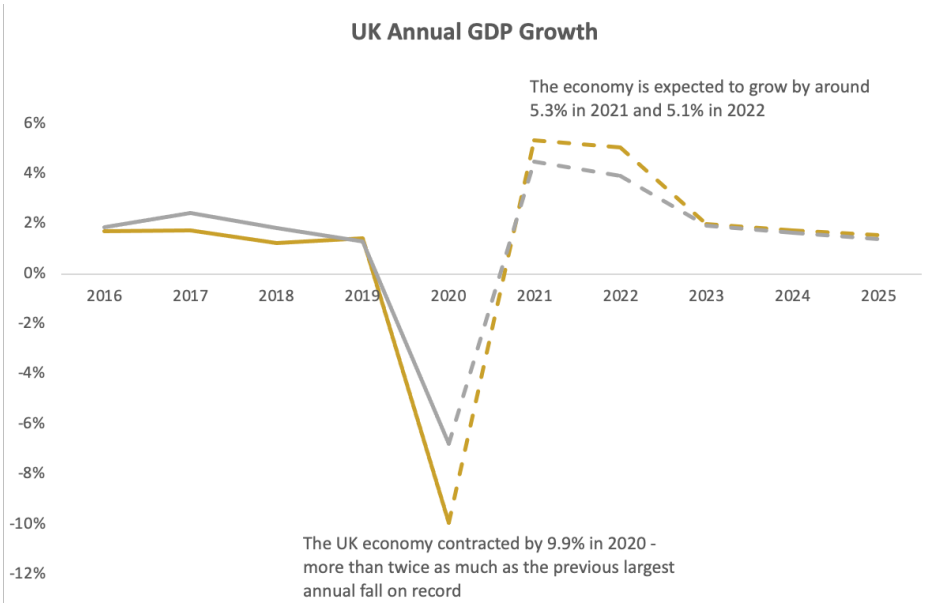
United Kingdom

Economic Growth

The coronavirus pandemic and resulting public health measures caused a severe economic contraction in the UK in 2020, with real GDP shrinking by 9.9% – more than twice as much as the previous largest annual fall on record. After contracting further in the first quarter of 2021 due to the long and strict lockdown implemented in January, the UK economy is now gradually reopening, and should see a significant bounce-back in activity commencing in Q2, as consumers start to spend pent-up savings and government incentives help to lift business investment. For 2021 as a whole, the economy is forecast to grow by 5.3%, notably above the regional average of 4.5%, reflecting the UK's relatively speedy vaccine rollout. However, Brexit-related disruptions as the UK adjusts to more limited access to the EU market could constrain momentum to some degree.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

Growth is likely to moderate only marginally in 2022, and is projected to register at a still-robust 5.1%. It will then moderate significantly, and is expected to average 1.8% during 2023-25, as catch-up growth abates and taxes rise.

Risks to the near-term economic outlook are to the downside, with uncertainty still elevated over the course of the pandemic globally, and the degree of balance sheet damage that has been sustained by households and small and medium enterprises. Indeed, as exceptional fiscal support abates, a sharp increase in debt defaults among both households and businesses cannot be excluded – particularly as many UK consumers and firms were already over-indebted before the pandemic.

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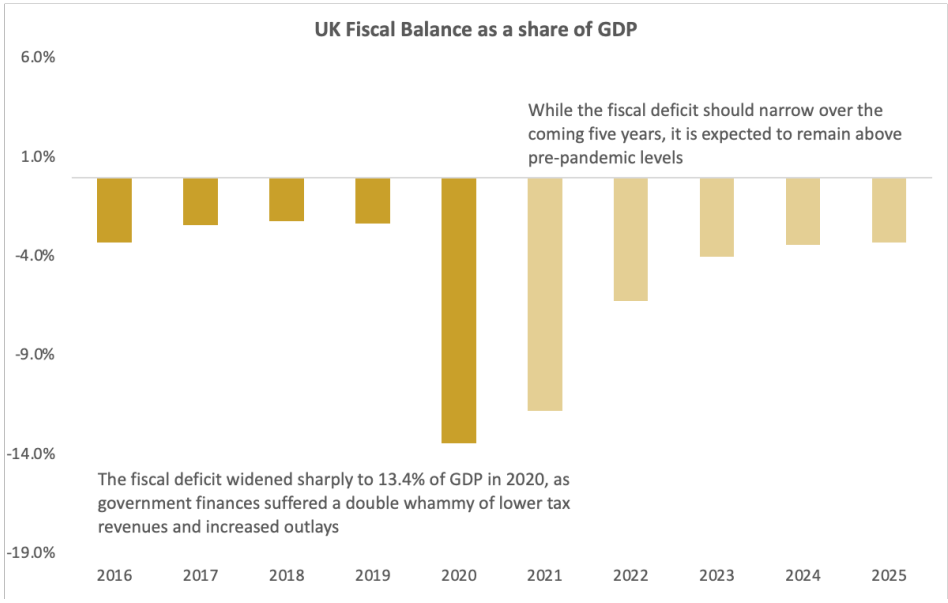
Fiscal Developments

Tax and spending measures to help households and businesses weather the Covid-19 crisis have included the Job Retention Scheme (in which the government covers 80% of workers' monthly wages up to £2500), property tax holidays, direct grants for small firms and firms in the most affected sectors, and three separate loans schemes to facilitate business' access to credit. Such measures have caused the UK fiscal deficit to widen sharply – to 13.4% of GDP in 2020 – more than eleven percentage points up on 2019. With the government starting to slowly rollback some of these measures this year, the fiscal deficit should narrow slightly. But with significant spending still planned and tax revenues to remain weak, the fiscal deficit is still set to amount to a substantial 11.8% of GDP in 2021. While it should narrow more significantly from 2022 onwards, it will still remain above pre-pandemic levels through to 2025.



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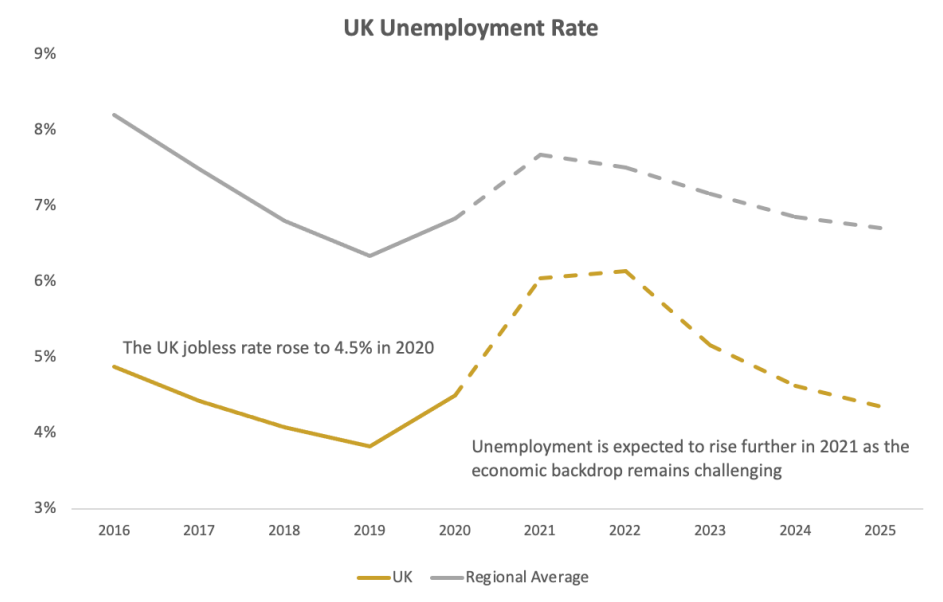
Unemployment

The UK unemployment rate rose to 4.5% in 2020, from 3.8% in 2019, as the closure of all non-essential shops and businesses during two national lockdowns, as well as massive supply chain disruptions and a slump in demand both domestically and across key foreign markets caused joblessness to spike. The extent of the rise was nonetheless limited by the government's Job Retention Scheme (furlough) for employed workers, as well as similar support for the self-employed, without which the unemployment rate would have risen more strongly. A third national lockdown at the beginning of 2021 will have led to further job cuts.

While the opening up of the economy from April should help to improve the labour market situation, many firms – particularly those in industries such as travel and hospitality – plan to shed workers, owing to expectations of a slow recovery in their sectors. As a result, many furloughed workers may eventually become fully unemployed. Therefore, the UK jobless rate is likely to rise further this year – to an estimated 6.1% – and is projected to remain at this level in 2022. Thereafter, the unemployment rate should resume moderating as economic fundamentals improve.



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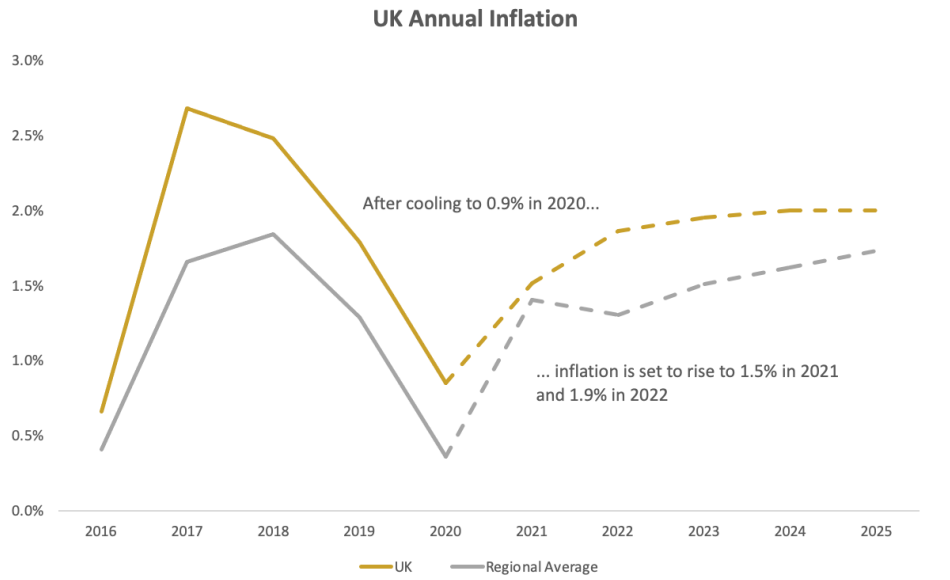
Inflation

UK inflation declined sharply in 2020 as a result of depressed demand owing to the coronavirus pandemic, which weighed heavily on price pressures and pricing power. All in all, the average annual inflation rate moderated to just 0.9% in 2020, halving from 1.8% in 2019. Inflation is set to rise to a projected 1.5% this year as price pressures pick up amid a rebound in demand. Brexit is also likely to stoke greater inflationary pressures as import costs increase. Inflation should rise slightly further in 2022, to around 1.9%, and then average approximately 2.0% over 2023-25.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

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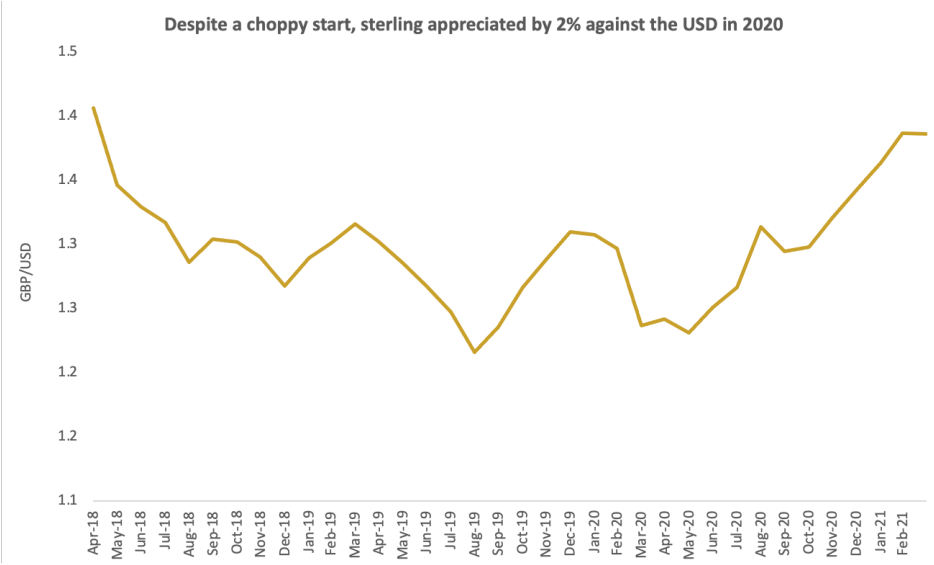
Currency Risk

Sterling depreciated sharply against the US dollar in March 2020, to a 35-year low of USD1.15:GBP, as the coronavirus crisis triggered a flight to safety and increased safe-haven dollar buying. However, the pound was quick to bounce back, rallying after an emergency rate cut from the Bank of England and an expansion of its quantitative easing programme. The announcement of additional fiscal stimulus for the economy was also supportive of the currency. All in all, sterling gained 2% on the US dollar in 2020 and ended the year trading at around USD1.34:GBP. It has continued to appreciate modestly in the first few months of 2021. The pound is likely to see some further appreciation this year, as the improving economic backdrop supports investment inflows and as Brexit uncertainty gradually dissipates.



Source: OFX.com; Baker Ing

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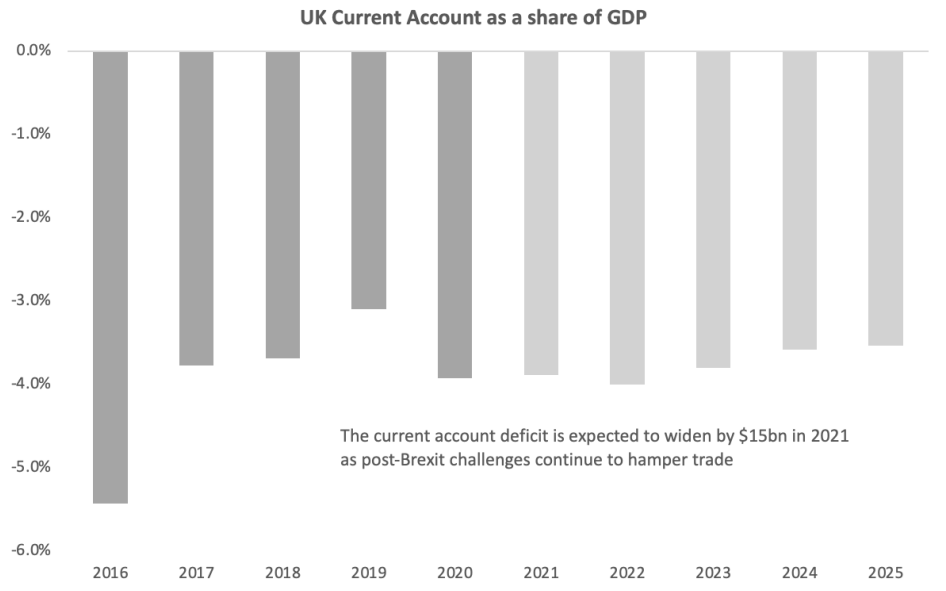
External Developments

The UK current account deficit widened to £73.9bn in 2020 from £68.6bn in 2019. The coronavirus outbreak caused global trade to plunge last year, as demand declined, travel was limited, and supply chains were disrupted by global lockdowns. In the UK, this led to a sharp fall in both imports and exports. As global trade rebounds, imports and exports should increase this year. However, post-Brexit disruptions are likely to weigh on exports, which could lead to a widening of the deficit in absolute terms in 2021. As a share of GDP, however, the deficit is expected to remain at 3.9% of GDP this year (the same rate as registered in 2020). Thereafter, the current account balance is expected to stay firmly in deficit territory, albeit moderating slightly to 3.5% of GDP by 2025.



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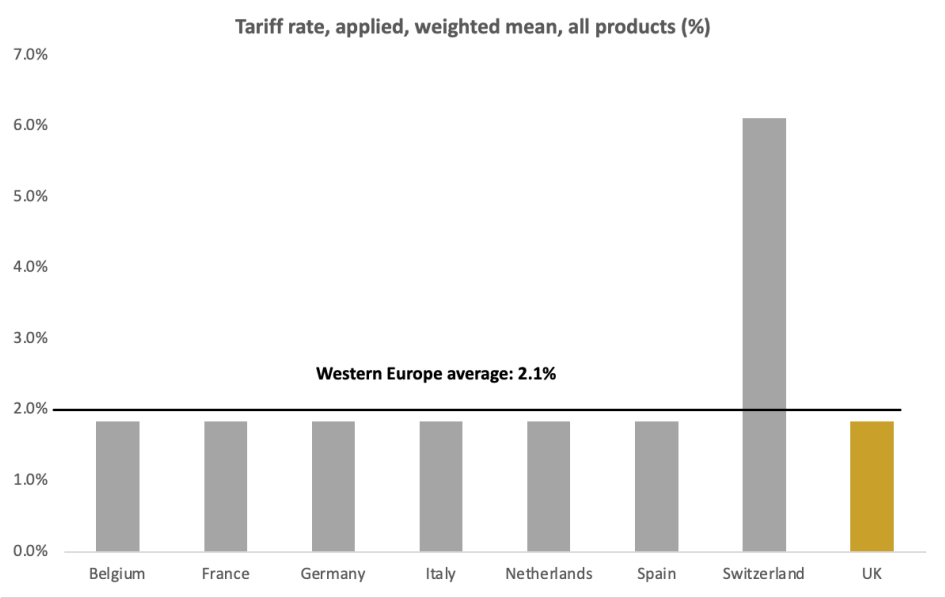
Trade Barriers

The UK's foreign trade relations are currently subject to a high level of uncertainty following its departure from the European Union in January 2020, and the provisional implementation of its new trade deal with the EU from the beginning of January 2021. Prior to this, the UK's applied weighted mean tariff rate was 1.8%, but this is likely to change going forward. Moreover, despite the implementation from the beginning of this year of the EU-UK Trade and Co-operation Agreement – which allows for tariff- and quota-free trade between the UK and EU – data and anecdotal evidence suggest that the UK's departure from the single market and customs union has raised the costs of UK-EU trade significantly.



Source: World Bank; Baker Ing
The weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.
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Non-tariff barriers to cross-border trade are generally moderate in the UK, but have risen since the beginning of this year owing to the elevated level of uncertainty surrounding post-Brexit regulations. Nevertheless, in the World Bank's *Doing Business 2020* report, the UK is ranked 33rd out of 190 economies globally for the category 'trading across borders.' This compares well with Germany, which is ranked 42nd, but is far below the rankings of other big Western European economies, including France (joint 1st), Sweden (18th), and Switzerland (26th). In general, the time and costs associated with importing into the UK are very low, while the time and costs required to export are greater – and generally more burdensome than the OECD high income average.

		UK	OECD high income
Time to export	Border compliance (hours)	24	12.7
	Documentary compliance (hours)	4	2.3
Cost to export	Border compliance (USD)	280	136.8
	Documentary compliance (USD)	25	33.4
Time to import	Border compliance (hours)	3	8.5
	Documentary compliance (hours)	2	3.4
Cost to import	Border compliance (USD)	0	98.1
	Documentary compliance (USD)	0	23.5

Source: World Bank; Baker Ing
The World Bank's OECD high income region includes 34 countries.

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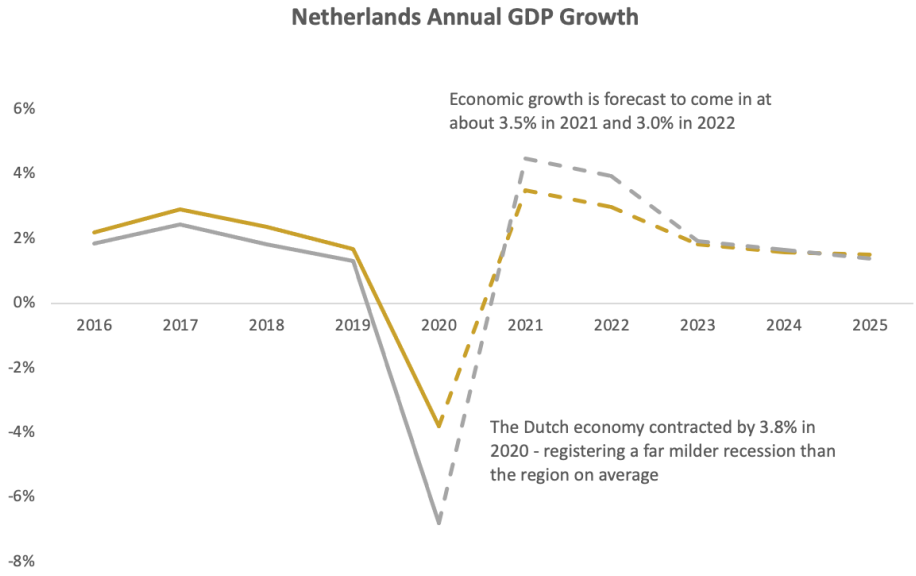
The Netherlands

Economic Growth

After contracting by about 3.8% in 2020 due to the pandemic, the economy is forecast to recover by 3.5% this year, as domestic and foreign demand pick up steam amid vaccine rollouts and a gradual relaxation of containment measures. However, the balance of risks remains tilted to the downside given lingering uncertainty surrounding the pandemic and its effects. Moreover, this year's GDP growth figures will be flattered by a supportive base effect.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

Business investment is expected to recover more slowly than domestic and foreign consumption, restrained by the hit to turnover and increased debt levels, especially in services-oriented sectors – which have been most severely affected by the pandemic.

In 2022, GDP growth is expected to register at a still-robust 3.0%, before then moderating to an average of around 1.6% in 2023-25 as catch-up growth is exhausted and policy becomes less supportive.

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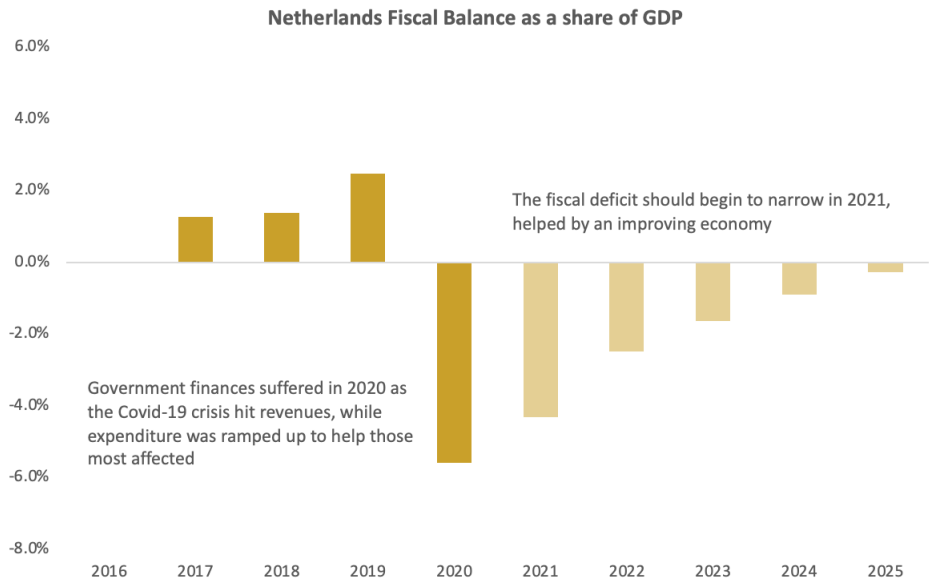
Fiscal Developments

Dutch government finances suffered in 2020 as the Covid-19 crisis hit revenues, while expenditure was ramped up to help those most affected. Indeed, the fiscal balance fell into negative territory, registering at -5.6% of GDP. Government support measures are set to continue operating until at least mid-2021, thus resulting in another sizeable budget deficit this year, of a projected 4.3% of GDP. Support measures implemented by the government to help households and businesses have included the subsidisation of labour costs for companies experiencing significant declines in income, small business allowances, and tax deferral schemes. These programmes have thus far been effective in containing bankruptcies, but their eventual withdrawal poses the risk of an insolvency spike.



Source: IMF; Baker Ing
Data is estimated, and data for 2021 onwards is based on forecasts (indicated by the lighter shade).

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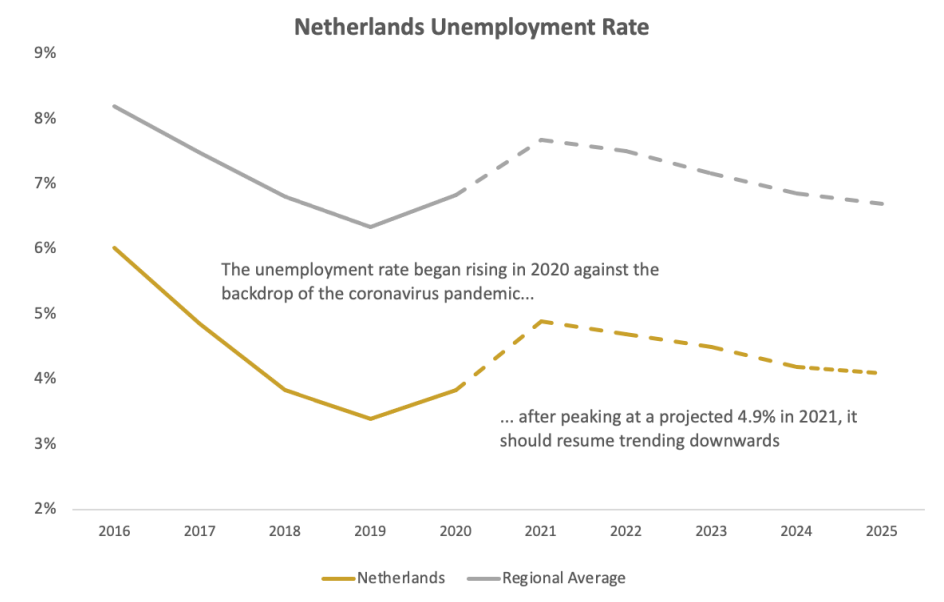
Unemployment

The Dutch unemployment rate began rising in 2020 against the backdrop of the coronavirus pandemic. Joblessness is expected to continue rising this year, peaking at an annual average rate of 4.9%, before then embarking on a moderating trend. Nevertheless, the unemployment rate is expected to remain above its pre-pandemic level through to at least 2025.

The sharp projected rise in unemployment this year is based on the assumption of a spike in business failures, particularly as government support measures are gradually withdrawn, and as uncertainty remains elevated amid the tentative economic recovery. Indeed, even once the worst of the crisis is over, the labour market is likely to take a significant time to recover, as laid-off workers could struggle to find new employment in the context of a slow economic pick-up.



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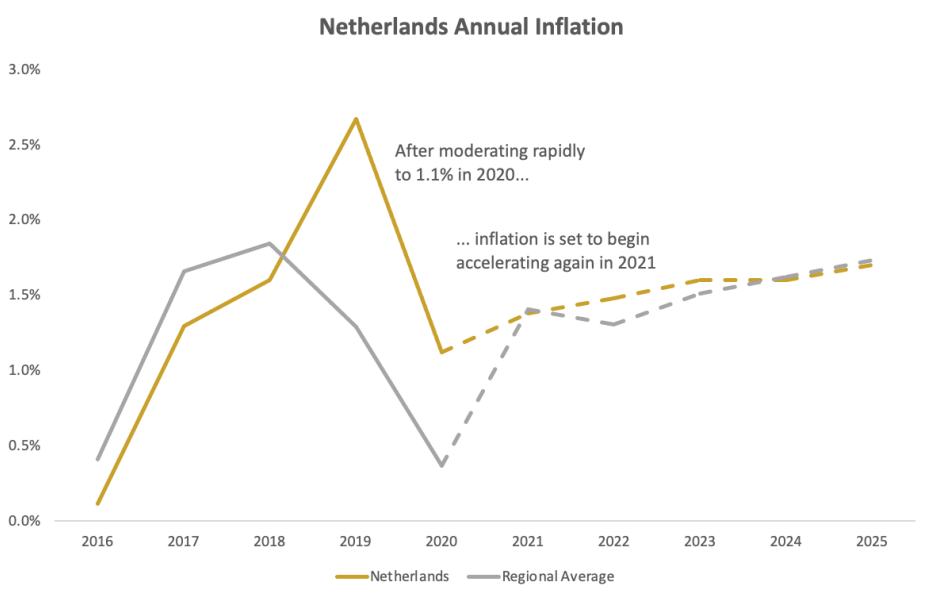
Inflation

Consumer price inflation in the Netherlands decelerated to 1.1% in 2020 from 2.7% in 2019, as subdued domestic demand, cooler cost pressures (particularly given the slide in global energy prices), and muted wage growth caused price pressures to moderate. Inflation is expected to pick up slightly in 2021, to a forecast rate of 1.4%, as economic conditions begin to normalise. Higher oil prices and recovering demand will likely see inflation rise mildly further in subsequent years, to an average rate of 1.6% over 2022-25.



Source: IMF; Baker Ing
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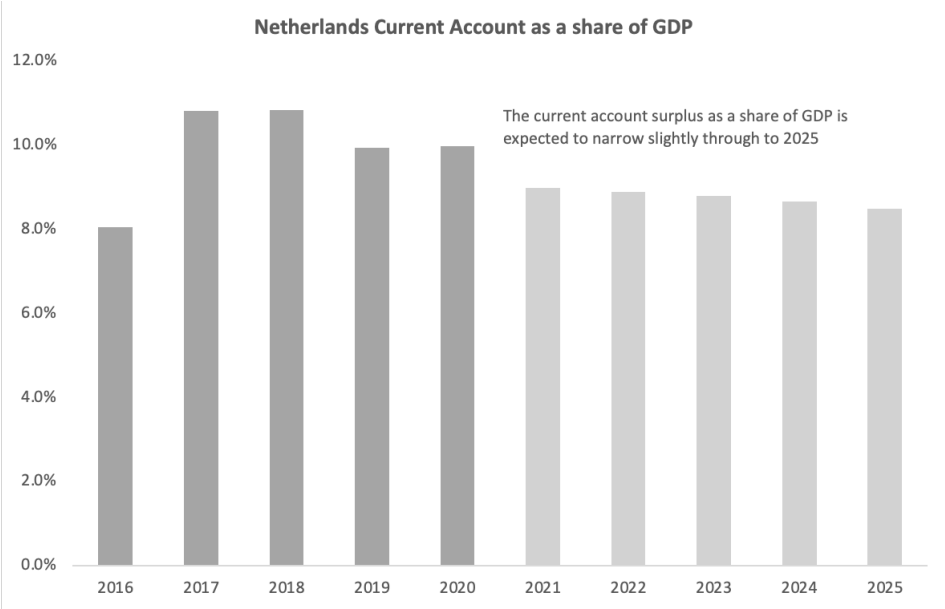
External Developments

The Dutch current account surplus remained broadly steady as a share of GDP in 2020, but is expected to narrow by one percentage point to 9% in 2021. Fluctuations in global trade affect the Netherlands more than other Western European economies owing to its role as an export hub for the wider European market, making it especially vulnerable to global crises such as the Covid-19 pandemic. While external demand and re-export activity should increase notably over the coming years on the back of global growth, strong import demand – particularly in the initial phase of the Netherlands' economic recovery – should result in the current account surplus narrowing as a share of GDP in the coming years.



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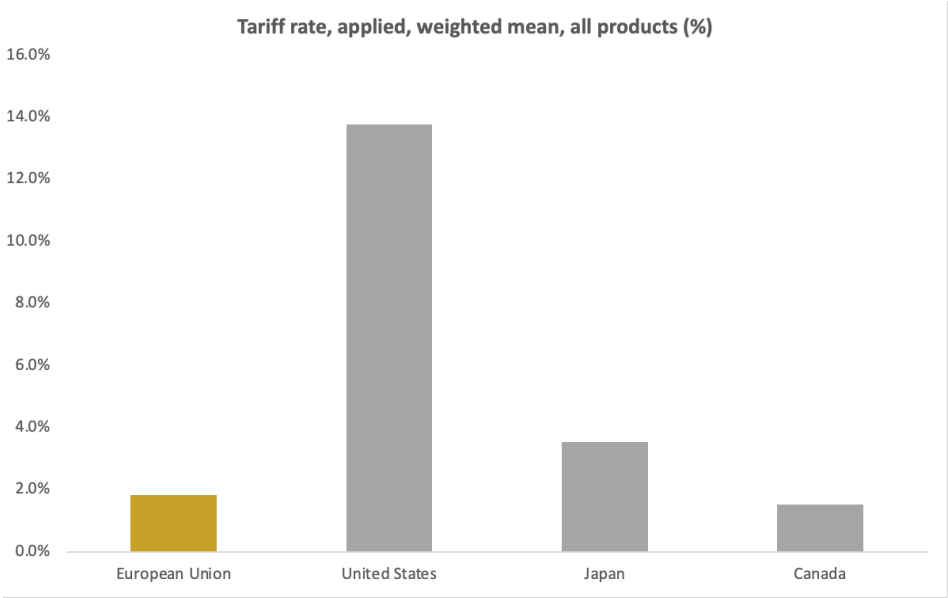
Trade Barriers

As a member of the European Union (EU), tariff barriers for trade in goods are imposed by the EU, and as such, the Netherlands' applied weighted mean tariff rate is 1.8%. While trade barriers remain considerable for many agricultural products, they are otherwise negligible.



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Along with eight other countries in Western Europe, the Netherlands is ranked joint 1st out of 190 economies globally for the category 'trading across borders' in the World Bank's *Doing Business 2020* report. According to the report, non-tariff barriers to cross-border trade are very low, and significantly below the average for OECD high income countries.

		Netherlands	OECD high income
Time to export	Border compliance (hours)	0	12.7
	Documentary compliance (hours)	1	2.3
Cost to export	Border compliance (USD)	0	136.8
	Documentary compliance (USD)	0	33.4
Time to import	Border compliance (hours)	0	8.5
	Documentary compliance (hours)	1	3.4
Cost to import	Border compliance (USD)	0	98.1
	Documentary compliance (USD)	0	23.5

Source: World Bank; Baker Ing
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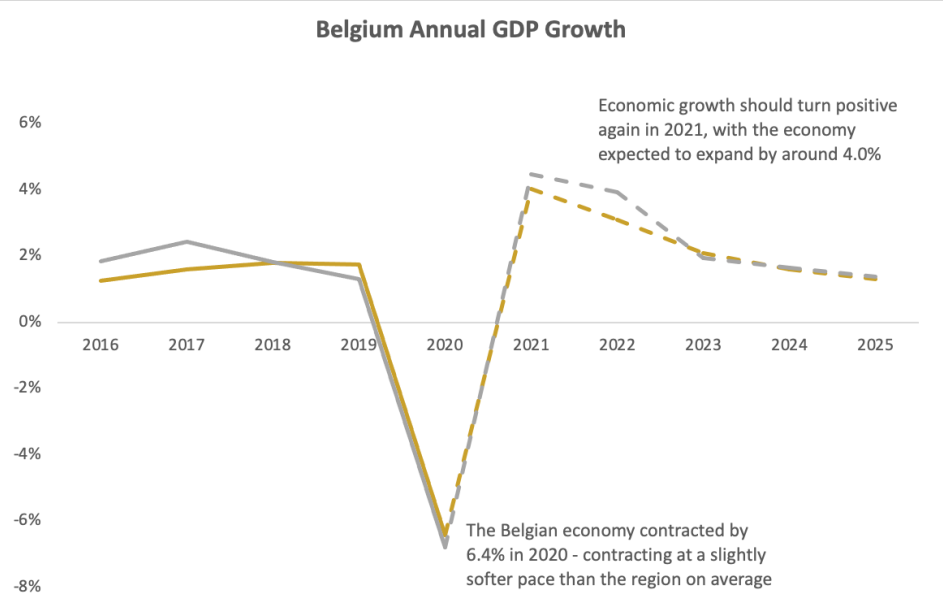
Belgium

Economic Growth

The Belgian economy was severely impacted by the Covid-19 outbreak in 2020, as domestic demand suffered from restrictive measures and a large slump in confidence. All in all, the economy contracted by 6.4%, a marginally softer pace of decline than the average seen in the Western Europe region.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

While the economy is expected to see GDP rebound by around 4.0% in 2021, most of this growth will be backloaded in the second half of the year. Indeed, the government reimposed strict lockdown measures in late March for a planned period of four weeks amid rising coronavirus infection rates and slow progress with vaccinations. These restrictions will weigh on second quarter growth significantly. Thereafter, the easing of restrictions will help to boost confidence, demand and investment in the second half of the year, while government policy will also remain supportive. In addition, strengthening global sales will benefit Belgian export manufacturers.

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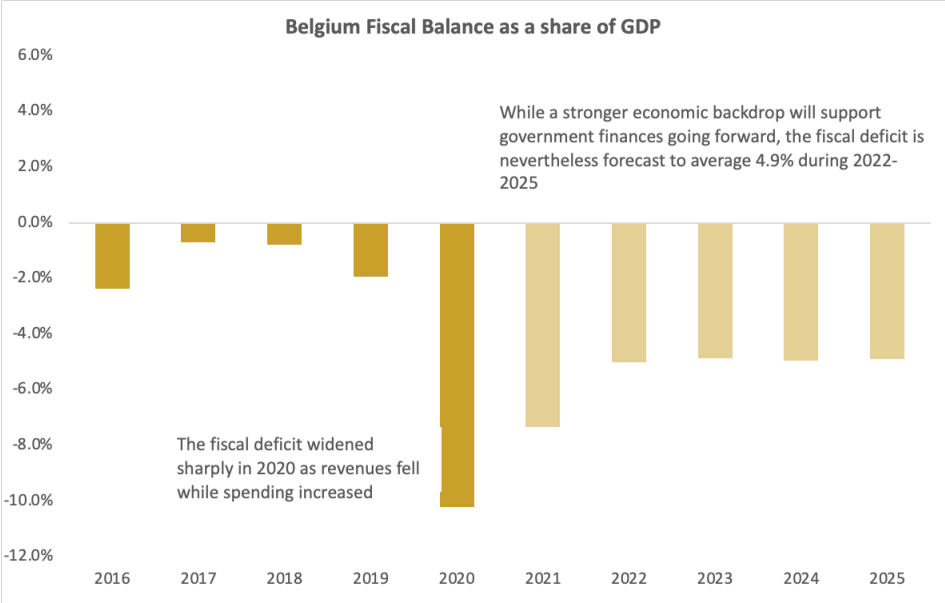
Fiscal Developments

The Belgian government has put in place a number of fiscal measures to address the crisis, including the postponements of social security and tax payments for companies and increased financial support for workers in temporary unemployment. These measures, coupled with a large fall in tax revenues on the back of depressed economic activity, resulted in the fiscal deficit widening sharply – to 10.2% of GDP in 2020, from 1.9% in 2019. While a stronger economic backdrop, as well as a reining in of support measures, will help government finances going forward, the fiscal deficit is nevertheless forecast to average 4.9% during 2022-2025.



Source: IMF; Baker Ing
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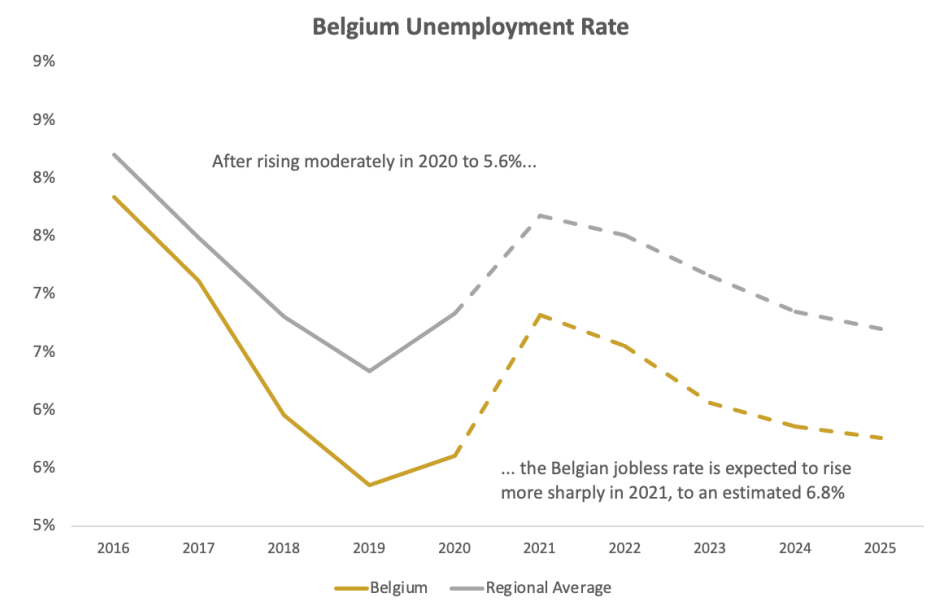
Unemployment

The Belgian unemployment rate rose only modestly in 2020 – to 5.6% from 5.4% in 2019. The government's furlough scheme ('chomage temporaire') has helped to cushion the impact of the Covid-19 crisis on the labour market. It has been in place since March 2020. Under the scheme, firms in sectors affected by the crisis are allowed to furlough workers, with the state paying 70% of employees' salaries. The scheme was recently extended until at least the end of June. However, its eventual expiry could trigger a wave of layoffs, and as such, the unemployment rate is forecast to rise more notably this year – to around 6.8%. Thereafter, labour market conditions should begin to improve again, in line with a stronger economic backdrop, thus helping the unemployment rate to resume a declining trend.



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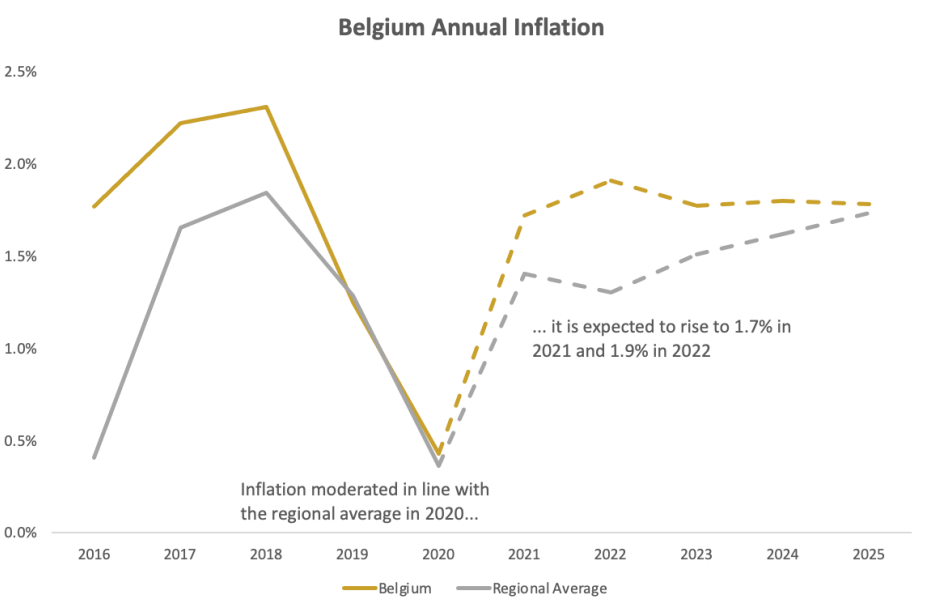
Inflation

Pandemic-driven deflationary pressures – stemming from lower global oil prices, a slump in consumer spending owing to lockdown restrictions, lower disposable incomes, and a sharp decline in investment – drove Belgian inflation down to just 0.4% in 2020, from 1.2% in 2019. In line with recovering global energy prices and strengthening domestic demand, inflation should rise up to approximately 1.7% in 2021 and then average around 1.8% over 2022-25.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

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External Developments

Belgium's current account fell into deficit in 2020 as foreign demand slumped and supply chain disruptions wreaked havoc on trade. Exports and imports are projected to start recovering this year as supply chains begin to normalise and domestic and global demand increase. All in all, the current account deficit is likely to widen further in 2021 and 2022, before then narrowing over 2023-2025 as external demand picks up more strongly.

Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the lighter shade).

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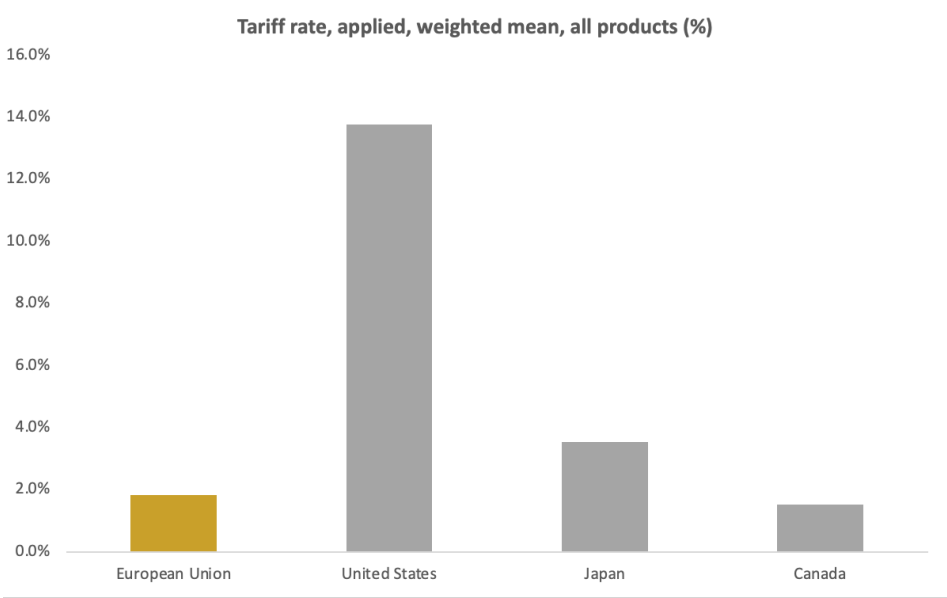
Trade Barriers

As a member of the European Union (EU), the EU Common Customs Tariff (CCT) applies to all imports coming into Belgium from outside the EU (there are no tariffs levied on trade between members of the customs union). As such, the applied weighted mean tariff rate in Belgium is 1.8%. While trade barriers remain considerable for many agricultural products, they are otherwise negligible.



Source: World Bank; Baker Ing
The weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.
Data is latest available (2019)

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Reflecting the relative ease of exporting to and importing from Belgium, the country is ranked joint 1st out of 190 economies globally for the category 'trading across borders' in the World Bank's *Doing Business 2020* report. According to the report, non-tariff barriers to cross-border trade are very low, and are significantly below the average for OECD high income countries.

		Belgium	OECD high income
Time to export	Border compliance (hours)	0	12.7
	Documentary compliance (hours)	1	2.3
Cost to export	Border compliance (USD)	0	136.8
	Documentary compliance (USD)	0	33.4
Time to import	Border compliance (hours)	0	8.5
	Documentary compliance (hours)	1	3.4
Cost to import	Border compliance (USD)	0	98.1
	Documentary compliance (USD)	0	23.5

Source: World Bank; Baker Ing
The World Bank's OECD high income region includes 34 countries.

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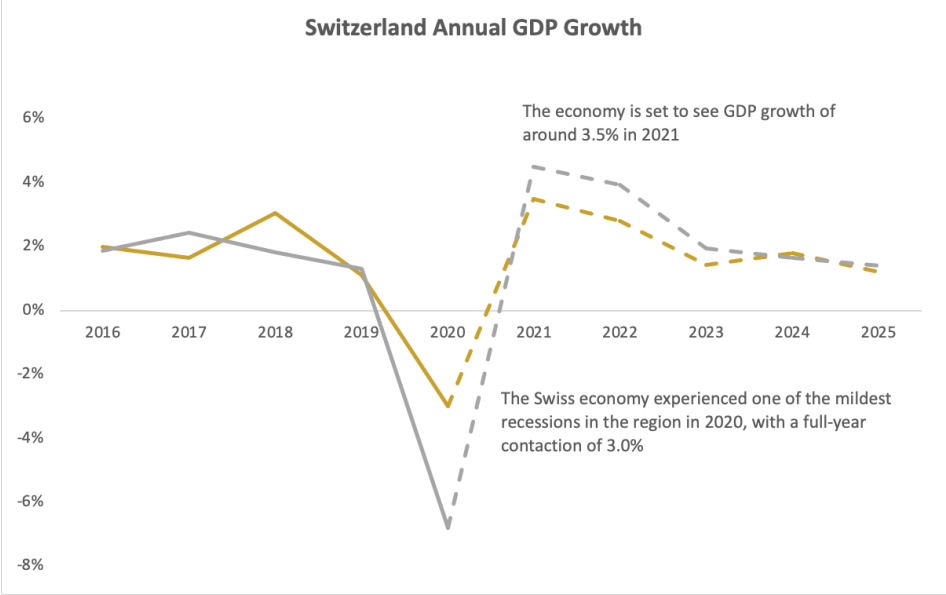
Switzerland

Economic Growth

The Swiss economy contracted by 3.0% in 2020 – one of the mildest recessions seen in the Western Europe region, where GDP declined on average by 6.8% last year. Switzerland's comparatively mild downturn was a result of its highly-competitive exports, for which demand has remained strong during the pandemic (e.g., pharmaceuticals and chemicals), its relatively low dependency on contact-intensive services sectors (e.g., tourism), a well-resourced health system, and carefully-targeted containment measures (e.g., no widespread closure of manufacturing). In addition, an early and strong government fiscal response helped to contain the economic damage of the pandemic.



Source: IMF; Baker Ing
Data for 2021 onwards is based on forecasts (indicated by the dashed lines).

In 2021, the economy is forecast to grow by 3.5%, as Covid-19 restrictions on economic activity are gradually withdrawn as vaccine coverage increases. An improved global environment, higher consumption and investment, and the continuation of accommodative fiscal and monetary policies will help to drive the recovery. Nevertheless, the outlook is subject to a high degree of uncertainty, as much depends on how the pandemic develops and the speed of vaccine delivery. Moreover, although unemployment, non-performing loans and bankruptcies have not yet risen sharply, this situation could change once government support is withdrawn.

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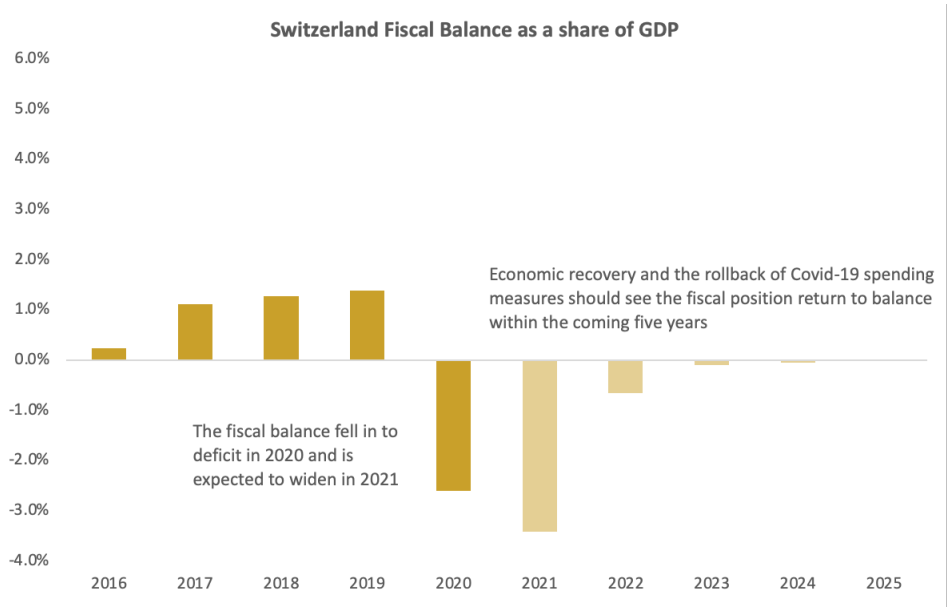
Fiscal Developments

Extensive fiscal measures taken by the Swiss government to mitigate the economic hit to businesses and individuals from the coronavirus pandemic, coupled with the fall in tax revenues owing to the economic downturn, resulted in the fiscal balance falling into deficit in 2020, with the budget deficit amounting to 2.6% of GDP. The continuation of support measures this year – including partial unemployment compensation, financial aid to particularly-affected firms, and loan guarantees for SMEs – will see the budget deficit widen to around 3.4% of GDP in 2021. Thereafter, the ongoing economic recovery and the reining in of government spending should see the fiscal position return to balance within the coming five years.



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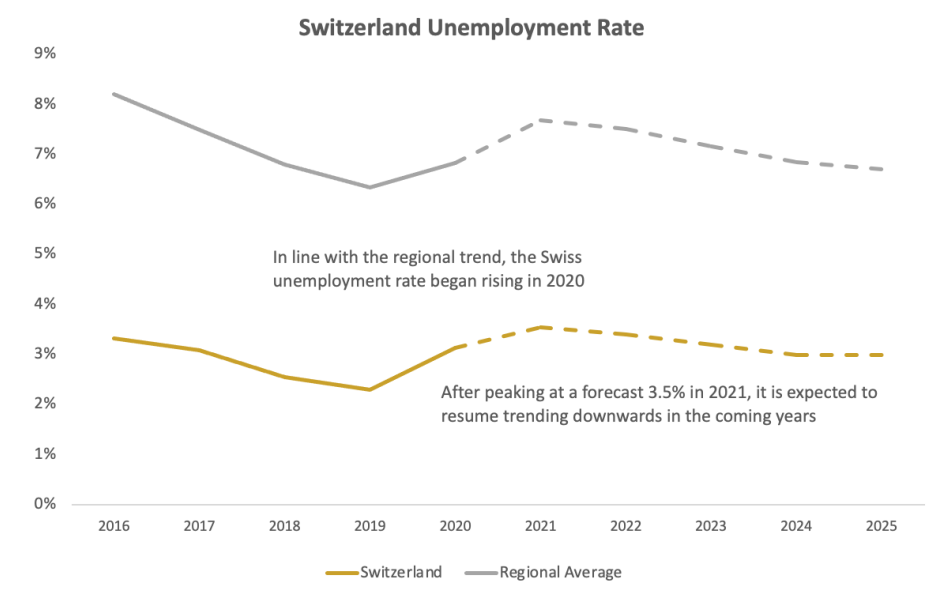
Unemployment

Swiss labour market conditions deteriorated in 2020 owing to restrictions imposed to contain Covid-19. All in all, the unemployment rate rose from an average of 2.3% in 2019 to 3.1% in 2020. Nevertheless, the extent of the damage to the labour market has been mitigated by ample government support, including a short-time work programme, income compensation for the self-employed, and extended unemployment insurance. After peaking at a forecast rate of 3.5% in 2021, the jobless rate should then resume trending downwards, and is likely to moderate to around 3.0% by 2025.



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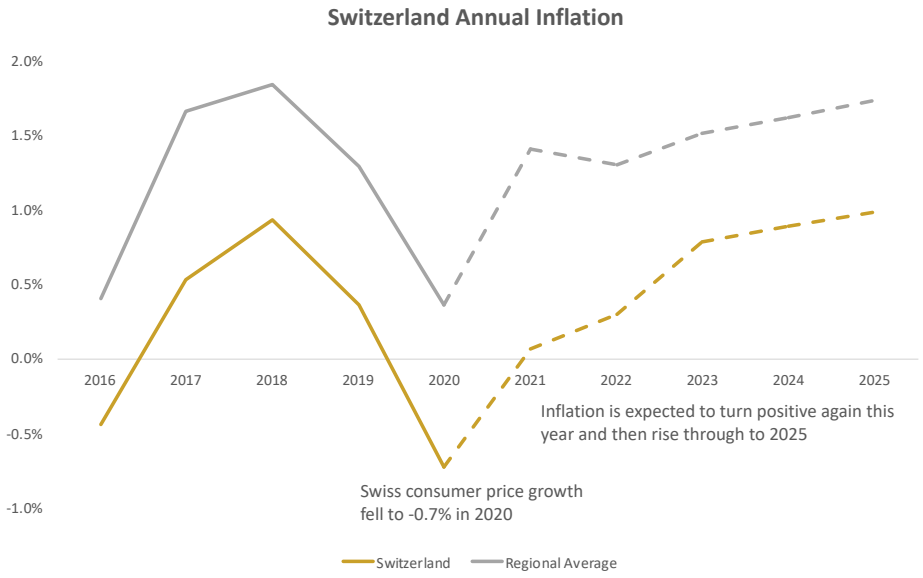
Inflation

Swiss consumer prices fell on average in 2020, with the economy registering a deflation rate of 0.7%. Domestic price pressures cooled due to the weak economic backdrop, while imported inflation declined on the back of a strengthening in the Swiss franc and a sharp slide in global oil prices. Inflation is projected to rise back into to positive territory this year, but will be extremely mild, with a forecast annual average rate of just 0.1%, before rising slightly further to 0.3% in 2022. Rising inflation will be supported by an uptick in household consumption, higher global oil prices and a potential depreciation of the Swiss franc amid waning safe-haven demand (which will lead to a rise in imported price pressures).



Source: IMF; Baker Ing
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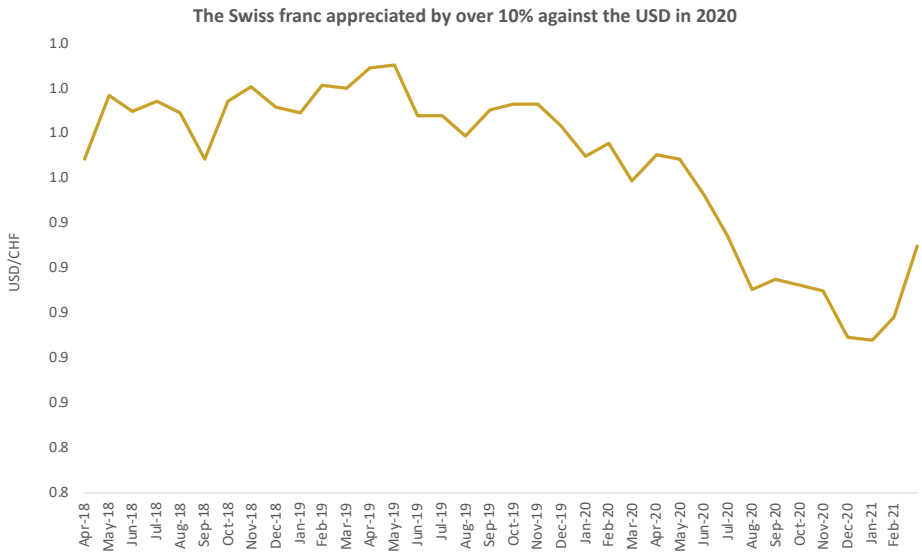
Currency Risk

The Swiss franc is viewed as a safe haven asset by the markets, and demand for the currency therefore increases during periods of global economic and/or political uncertainty. As such, demand for the Swiss franc soared in 2020 amid the outbreak of the Covid-19 pandemic. All in all, the franc appreciated by just over 10% against the US dollar last year. The franc has pared back some of its gains in the early part of 2021, as global confidence has started to improve, thus cooling the demand for safe haven assets. Looking forward, the currency is likely to see a depreciating trend this year as the global economy continues to gain strength and uncertainty abates. However, the franc could experience further bouts of appreciation over the coming quarters, particularly if the global economic backdrop remains weaker than expected.



Source: OFX.com; Baker Ing

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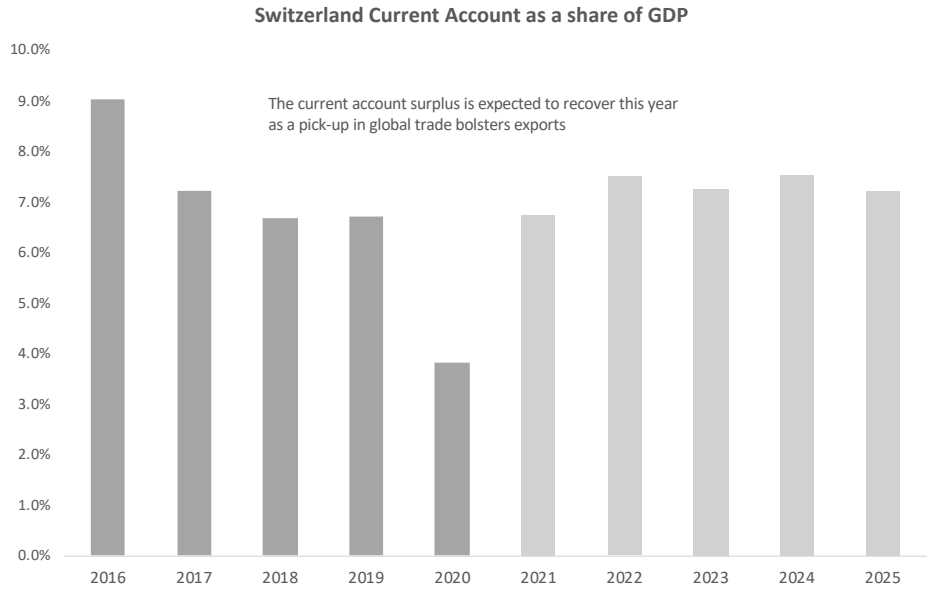
External Developments

Switzerland's current account surplus narrowed in 2020 as the global pandemic caused a slump in trade. While imports of goods and services declined by 3.4% y/y, exports fell by a heftier 6.8%. However, the decline in exports was not as sharp as that experienced by many other regional peers, owing to the high share of pharmaceutical products (for which demand has been high during the pandemic) in Switzerland's export mix. All in all, the current account surplus as a share of GDP fell to 3.8% in 2020, from 6.7% in 2019. It is expected to expand back up to 6.7% in 2021, supported by a recovery in external demand, a weaker Swiss franc, and improved investment inflows.



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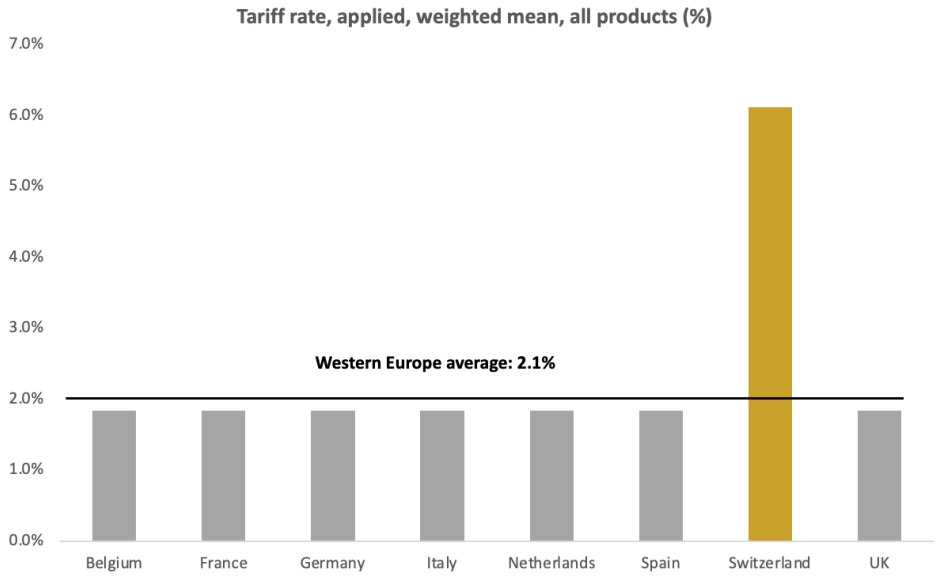
Trade Barriers

Switzerland's tariff barriers are by far the highest in the Western Europe region. Indeed, the applied weighted mean tariff rate was 6.1% in 2019 (latest data available) – four percentage points above the regional average of 2.1%. However, Switzerland has a free trade zone with the EU and its fellow EFTA (European Free Trade Association) members (Iceland, Lichtenstein and Norway), which means that there are no tariffs on trade with EU and EFTA countries. Switzerland also has a number of bilateral free trade agreements with other countries, including the UK, Japan, China, Mexico and Canada.



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Non-tariff barriers to cross-border trade are relatively low in Switzerland. As such, the country is ranked at a relatively high 26th out of 190 economies globally for the category 'trading across borders' in the World Bank's *Doing Business 2020* report. According to the report, the time and costs associated with both exporting and importing in Switzerland are reasonably low, and (with the exception of import costs) are below the average for OECD high income countries.

		Switzerland	OECD high income
Time to export	Border compliance (hours)	1	12.7
	Documentary compliance (hours)	2	2.3
Cost to export	Border compliance (USD)	115	136.8
	Documentary compliance (USD)	27	33.4
Time to import	Border compliance (hours)	1	8.5
	Documentary compliance (hours)	2	3.4
Cost to import	Border compliance (USD)	115	98.1
	Documentary compliance (USD)	27	23.5

Source: World Bank; Baker Ing
The World Bank's OECD high income region includes 34 countries.

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