Economic perspectives

May 2019

Highlights

- Preliminary figures indicate that real GDP growth in the euro area recovered to 0.4% qoq in Q1 2019. Available details suggest that domestic demand remained the main driver of economic growth. The Q1 GDP growth figures confirm that weakness in H2 2018 was exaggerated by several temporary elements and signal that the euro area is not heading towards a recession in the near term. Nevertheless, the recent growth acceleration is likely to be only temporary and therefore unlikely to be the forerunner of any longer-term acceleration of the underlying growth dynamics. Our scenario of a general trend of growth deceleration remains in place.

- US GDP growth for Q1 2019 surprised on the upside. However, a look at the growth composition highlights some signs of underlying weakness in final domestic demand. In particular private consumption growth reported a marked deceleration, which is at odds with the strong performance of the US labour market. The acceleration in the headline growth figure was mainly supported by a stronger growth contribution from net exports and an inventory build-up. We still expect GDP growth to slow in the coming quarters.

- Since there are currently no major macroeconomic or price-related factors that warrant a change in monetary policy, we stick to our scenario for the ECB and Fed. Our scenario for the ECB deposit rate hence remains the same as last month, with the first rate hike only in the second half of 2020. Regarding the Fed, we don't expect any further rate hikes over the forecast horizon. In fact, given the expected moderation in the pace of growth going forward, a rate cut in the course of 2020 is likely.

Global economy

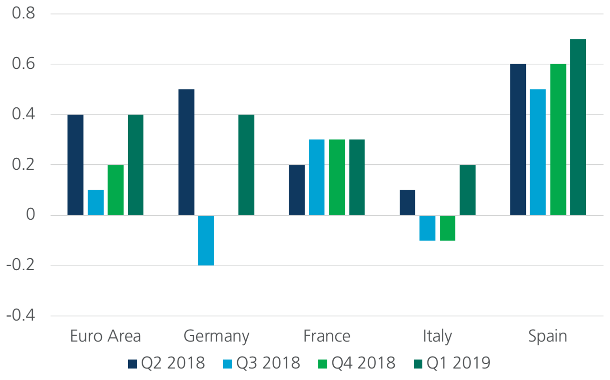
Positive EMU surprise in Q1

Preliminary figures indicate that real GDP growth in the euro area recovered to 0.4% qoq in Q1 2019 (figure 1). The latest growth figures confirm that weakness in the euro area in H2 2018 was amplified by several temporary elements and signal that the euro area is not heading towards a recession in the short run. Nevertheless, the growth figures don't suggest an acceleration of the underlying growth dynamics. Available details suggest that domestic demand remained the main driver of economic growth. Private investment also continues to support European growth. The trend of continuous strong domestic demand, combined with external headwinds, is consistent with recent survey results, in which persistently weakening sentiment in manufacturing industries is being compensated by some strengthening of sentiment in services and continuous strong sentiment in the construction sector.

Private consumption and, to an extent, investments will continue to support growth going forward. Strong international headwinds are, however, expected due to the slowdown in other major international economies, notably the US and China, even amplified by rising trade tensions and geopolitical conflicts (Iran, North Korea, Venezuela…).

Looking at individual euro area countries reveals clear growth differences among the member states. Spain (again) strongly outperformed, mainly thanks to a continuous positive growth contribution of net exports. Meanwhile France, Italy and Belgium published figures below the euro area average.

Figure 1 – quarterly real GDP dynamics (% change quarter-on-quarter)



Source: KBC Economics based on Eurostat

TheItalian economy remains the major laggard despite some recovery in Q1, while the French economy is still vulnerable with substantial social challenges and concerns about public finances.

Most importantly, the rebound in German GDP growth (figure 1) contributed substantially to the euro area recovery at the beginning of 2019. German real GDP growth bounced back to +0.4% qoq in Q1 2019, from -0.2% and 0.0% respectively in Q3 and Q4 of 2018. The Q1 figure was in line with average growth for the euro area as a whole. Though growth composition details haven't been published yet, the German national statistical institute reported strong growth in investments and household consumption expenditures. The German growth revival came earlier than we expected, since we previously projected the recovery only in the second half of this year.

Nonetheless, we still see continued weaknesses in the largest European economy. While some industrial sectors are recovering, total manufacturing output is still showing a slightly negative trend, with persistent negative growth figures for total manufacturing production in Q1 2019 (also see Box 1). This observation, combined with the continued downward trend in manufacturing sentiment, raises concerns about persistent weaknesses in the sector. By contrast, there has been a remarkably strong growth in the output of the construction sector in Q1 2019. Rather than reflecting an acceleration of the underlying growth dynamics, this could possibly be related to good weather conditions. Retail sales also recovered from weaknesses in the second half of 2018, which was reflected in the first quarter GDP growth figures. The recovery was likely a correction of weak Q4 2018 retail sales growth figures rather than the start of a new upward trend though.

Based on the actual Q1 growth figures, we upwardly adjusted our 2019 annual average growth forecast for the euro area from 1.1% to 1.2%. Hence this upward revision is merely the result of stronger-than-expected Q1 growth results. It does not reflect a fundamental growth upheaval. As such, our scenario with a general trend of growth deceleration remains in place. Since 2020 quarterly growth dynamics remained unchanged, our 2020 annual average growth forecast was downgraded from 1.4% to 1.2%. Due to this mechanical adjustment, we are now more pessimistic about the growth prospects for 2020 than most other forecasters and international institutions. We think the assumption of another rebound later on in 2019 has become unlikely given the latest escalation in the US-China trade war (see further) and the continued and even strengthened uncertainty created by increasing protectionism and Brexit.

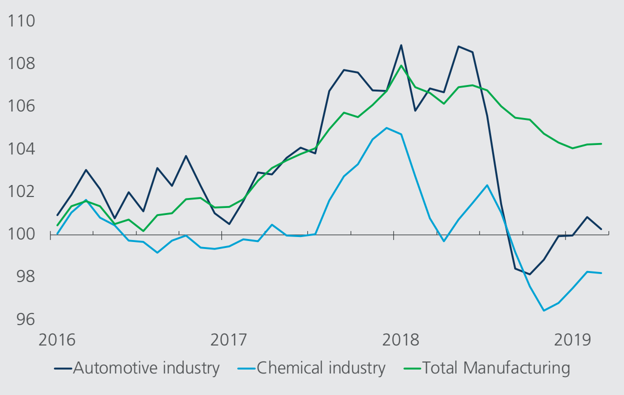
Box 1 - German industry faces new challenges

The sharp slowdown in the growth of the German economy in 2018 was partly due to exceptional factors. The failure of car manufacturers to be prepared in time for the application of the new global test procedures led to a major disruption in the production and sale of passenger cars. Between May and October 2018, production in the German automotive industry fell by almost 10% (in volume) (figure B1.1). At the same time, an exceptionally low water level on the Rhine caused transport problems. The Rhine is an important link between German industry and the North Sea, Belgium, the Netherlands and Switzerland. Approximately 80% of the German freight transport by ship sails through it. The chemical industry is particularly dependent on the supply and transport of goods by sea. This explains why the low water level contributed to a drop in chemical production of almost 8% between the end of 2017 and November 2018.

By definition, temporary factors fade. As expected, production is recovering in both sectors. In the first quarter of 2019, the automotive industry produced 1.3% more (on an annual basis) than in the fourth quarter of 2018. In the chemicals sector, this growth was approximately 6%. This normalisation contributed to the growth recovery of the German economy in the first months of 2019. Unfortunately, however, this can be said much less for the whole of German industry. Indeed, in the first quarter, production in the total manufacturing industry was still slightly below the average level of the previous quarter. At best, one can argue that the downward trend, which started in the course of 2018, has stabilised.

However, downside risks remain. Confidence indicators continue to deteriorate (see main text). While two major domestic logistic problems have been solved, German industry is still experiencing the headwind of the slowdown in international trade. The latter has slackened considerably since the turn of the year, and it has immediately been accompanied by a fall in orders in German manufacturing, particularly from outside the euro area (figure B1.2). At the same time, stocks are rising sharply. This suggests that the production of the German manufacturing industry will resume its downward trend of 2018 in the coming months.

Figure B1.1 - Industrial production in Germany (volume index, 2015=100, 3-month moving average)



Source: KBC Economics based on German Federal Statistical Office

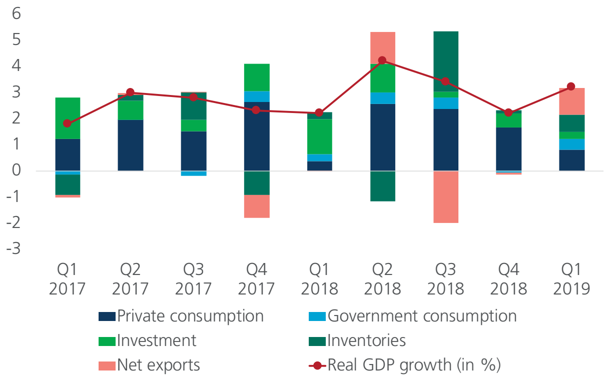
Figure B1.2 - German manufacturing industry and world trade (volume index, 3-month moving average, annual change in %)

Source: KBC Economics based on German Federal Statistical Office and Dutch Bureau for Economic Policy Analysis

Underlying weakness in US

US economic growth for Q1 surprised on the upside, as real GDP growth accelerated from 0.5% qoq in Q4 2018 to 0.8% qoq in Q1 2019 (from 2.2% to 3.2% in annualised rates) per the advance estimate (figure 2). Although this headline figure is exceptional, a closer look at the details highlights some areas of weakness. The growth contribution from domestic demand fell to 1.5 percentage point in Q1 (annualised) from 2.2 percentage points in Q4. In particular private consumption growth reported a marked deceleration, which is at odds with the strong performance of the US labour market. Investment growth also slowed compared to the previous quarter. The acceleration in the headline growth figure was mainly supported by a stronger growth contribution from net exports, with an improvement in exports while imports fell. The latter is another sign that

Figure 2 - Higher US Q1 growth, but underlying weaknesses (contributions to real GDP growth, in percentage points)



Source: KBC Economics based on Bureau of Economic Analysis

domestic demand weakened in Q1.

Another factor that contributed to the unexpected US GDP growth acceleration in Q1 compared to the previous quarter is the build-up in inventories. Survey data from the ISM manufacturing inventories component in recent months have been consistent with this upward trend of inventory build-up above its long-term average, towards the upper bound of the 'normal' range. The key question here is whether this inventory build-up was voluntary or involuntary. The latter would mean that firms are increasing their inventories as a result of lower-than-expected demand. Comparing the new orders - a proxy for incoming demand - and inventories components of the ISM manufacturing suggests that the inventory build-up has been mainly involuntary. This ratio tends to return to its long-term average, hence a decline in Q2 is likely. It implies that the growth contribution from inventories in Q2 will most likely be negative.

Going forward, we expect private consumption to recover somewhat towards from the weak Q1 growth contribution. Continued strong labour market results will remain supportive. Given the stronger-than-expected growth results in Q1, we upgraded our 2019 annual average GDP growth projection to 2.5% from 2.3% previously. The main risk that could derail the US economy is the impact of the US-China trade war, that escalated further with the unexpected implementation of higher tariffs on US imports from China and the announced retaliation measures by China earlier this month.

Trade war fears popping up again

Alongside the publication of surprisingly strong GDP growth figures for the first quarter of the year, risks to the global economy have again increased substantially. Somewhat unexpectedly, the US-China trade war escalated further. Because US President Trump and his negotiation team didn't think the trade talks with China were going as smoothly as hoped for, Trump decided to increase pressure on China and implement higher import tariffs on Chinese goods worth USD 200 billion. In response, China announced retaliatory measures by increasing import tariff rates as well, albeit on a much smaller amount of imports from the US. To add some more fuel to the fire, the US also started the process for implementing import tariffs on essentially all Chinese products that are not affected yet.

These actions might be a part of a negotiation tactic to reach a deal in the near future. New trade negotiations are planned at the G20 meetings in June, so reaching a deal has become more difficult but is still possible. After all, in the build-up to the US presidential elections in 2020, Trump would like to claim a trade deal with China as a personal victory. Nevertheless, the US-China conflict is not exclusively about free trade, but also about technology (also see KBC Economic Opinion of 11 April 2018). The recent executive order that effectively prohibits US companies from using any telecoms equipment manufactured by the Chinese firm Huawei illustrates this once again. Technological leadership will determine economic leadership in the future. As a consequence, the confrontation between China and the US, and by extension the economic power struggle between the West and the emerging economies, is not an overnight event but an endeavour that will stretch for years while a new and workable model for future globalisation is found.

In a sense, the new escalation in the US-China trade war is a relief for the European Union and Japan. Now that the US focus remains on the Chinese trade battle front, the decision on implementing higher US import tariffs on cars and car parts was postponed by six months until November 2019. Although delayed, the tariff threat remains on the table until the end of the year. Hence, it continues to be a substantial risk to the EU economy.

Brexit uncertainty supporting UK GDP… for now

Despite the continued Brexit uncertainty, UK real growth accelerated from 0.2% qoq in Q4 2018 to 0.5% qoq for Q1 2019. In fact, Brexit uncertainty may have even supported growth. Many companies increased their production and inventories during Q1 to create a buffer against supply and trade flow disruptions in case of a no-deal Brexit. This inventory build-up is a one-off and will, at least partly, be reduced in the second quarter now that the Brexit deadline is postponed until October 31. Apart from the large contribution of the inventory component, real GDP growth was also significantly supported by domestic demand as private consumption remains solid. Financial markets reactions to the GDP figures were limited though. Uncertainty about the future remains high and volatility will continue to be a key element going forward (also see Box 2).

No reasons for monetary policy changes

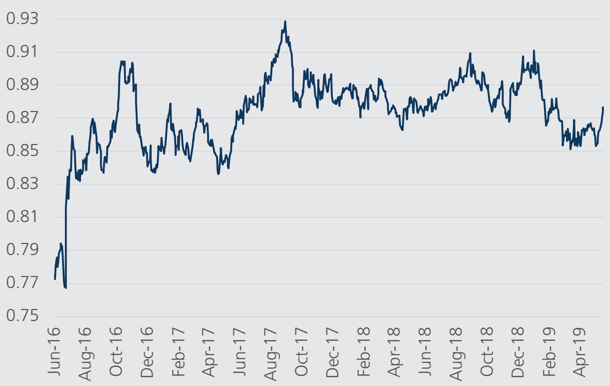
As inflation remains rather muted and mainly driven by volatile components and some seasonal effects in major economies, central banks are not in a hurry to change policy paths. Apart from some seasonal effects – related to the timing of Easter – oil price developments, which were by rising geopolitical tensions in the Middle East, positively contributed to recent headline inflation. The oil price effect will last throughout H1 2019. However, since slowing global economic growth will weigh on oil demand, we expect the oil price to move back towards USD 65 per barrel by the end of 2019. Hence, oil price effects will still be a drag on annual average headline inflation in 2019 as a whole.

Since there are currently no major macroeconomic or price-related factors that warrant a change in monetary policy, we stick to our scenario for the ECB and Fed. Our scenario for the ECB deposit rate hence remains the same as last month, with the first rate hike only in the second half of 2020. The main motivation for it will be a move towards deposit rate normalisation out of negative territory. Financial stability

Box 2 – Brexit uncertainty and sterling volatility

As May’s Brexit deal has been rejected by Parliament three times, she decided to engage with the Labour opposition in an attempt to win over their support. The pound showed remarkable strength at the beginning of May, despite the lack of progress in the talks between Prime Minister Theresa May and Labour party leader Jeremy Corbyn (figure B2). Markets were frontrunning a potential cross-party Brexit agreement. May hinted at a “kind of” customs union post-Brexit earlier this month, a key demand by Labour. Meanwhile, the local elections showed major losses for May’s Conservative Party, to a large extent the result of the Brexit stalemate. Markets were hoping this would create a sense of urgency at the minds of policy makers. News flows, however, suggested no such thing. Jeremy Corbyn even pulled the plug on the cross-party negotiations. Markets are reassessing the case for a short-term breakthrough, sending sterling back lower. The pair edges back up in and even above the 0.85-0.87 trading range. We expect this kind of Brexit related volatility in EUR/GBP as long as uncertainty around Brexit persists.

Figure B2 - GBP per EUR



Source: KBC Economics based on Macrobond considerations and the adverse impact on the European banking sector play an important role. However, in order to limit the policy tightening signal coming from this depo rate hike, the ECB is likely to decrease the upwards corridor between the refi and the depo rate to 10 basis points from 40 basis points at present.

Flight to quality and safe haven effects, sustained excess liquidity, scarcity factors due to regulation, the sustained German budget surplus, relatively subdued European (core) inflation and a dovish ECB will cause German 10y bond yields and intra-EMU sovereign spreads to remain low in 2019. The main exception to the latter could be Italy. National political jitters and a potential new confrontation with the European Commission in the context of the 2020 budget discussions after the summer months, might lead to increased financial market volatility and spikes in the spread to the German 10y bond yield.

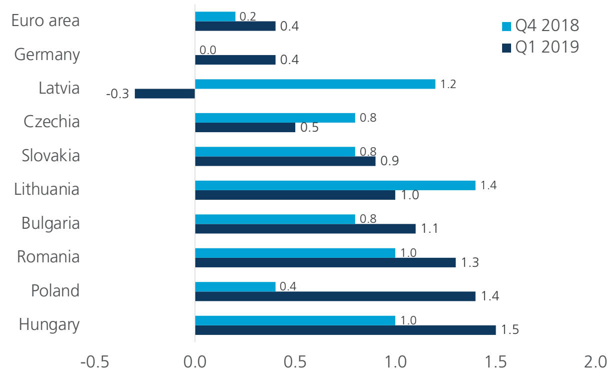
Regarding the Fed, we don’t expect any further rate hikes over the forecast horizon. In fact, given the expected moderation in the pace of growth going forward, a rate cut in the course of 2020 is likely. The run-down of the balance sheet will likely be completed by September 2019. By the end of September, we estimate it to be around USD 3.75tn, significantly higher than the original estimates of a decline towards levels in the area of USD 2.5tn. As a consequence, we expect long-term bond yields to remain roughly flat throughout the forecast horizon.

Central and Eastern European Economies

Growth surprises on the upside

GDP growth in Eastern Europe surprised to the upside in Q1 2019 according to recently published (preliminary) data, in line with positive growth surprises in the euro area. Still, the growth divergence between Central and Western Europe appears to remain. A general regional slowdown in Central and Eastern Europe, which was expected based on weak business sentiment indicators (PMIs, most prominently) at the beginning of this year, has not been confirmed by the new data.

Figure CEE – Real GDP in Central and Eastern European economies (% change quarter-on-quarter)



Source: KBC Economics based on national sources

Real growth accelerated in more than half of the Central and Eastern EU-members that have reported their GDP growth figures so far. Only the Czech Republic, Latvia and Lithuania reported a growth deceleration in quarter-on-quarter terms. Moreover, despite the quarterly slowdown, the Czech economy was still able to grow 2.5% yoy, which is significantly better than, for example, German year-on-year growth of 0.7% in Q1. Although in the past preliminary GDP figures have been subject to later revisions, the basic message looks robust enough to withstand future adjustments: growth remains relatively strong throughout the Central and Eastern European region.

The first quarter´s top economic performer in Eastern Europe was Hungary, which saw real GDP grow by an impressive 5.3% yoy and 1.5% qoq (figure CEE). But other economies in the region (including Bulgaria, Romania and Poland) have also been able to grow faster than 1.0% qoq or 4.0% in annualised terms.

Although detailed data on the composition of Q1 GDP in Central and Eastern Europe aren't available yet, we can safely assume that the solid regional economic performance was primarily driven by robust growth in domestic demand. Both the Czech and the Bulgarian statistical offices have suggested that net exports also made a positive contribution to GDP growth. In Hungary, the regional economic tiger, there are also clear indications that growth was boosted by strong household consumption and investments. In this respect, we note one figure in particular: the exceptinoal 48% yoy jump in real construction output in the first quarter, which sends a clear signal of very strong domestic investment activity.

Considering additional macroeconomic indicators like real wage growth or the unemployment rate, it now becomes very hard to deny that the Hungarian economy is showing signs of overheating. As a result, the already existing pressures on the National Bank of Hungary to tighten its monetary policy may intensify. In our opinion, though, policymakers will not immediately give in to the various external pressures at their May meeting. Rather, the central bank is more likely to deliver the next interest rate hike in June.

All in all, fresh GDP readings from Central and Eastern Europe surprised on the upside. From a longer-term perspective, the region clearly outperforms compared to the sluggish growth trend in the euro area. For the rest of this year, we expect sustained solid economic growth in the region with GDP being driven primarily by strong domestic demand. This demand will be fed by robust wage growth, policy stimulus (e.g., the Polish fiscal expansion) and strong investment activity (supported by the ongoing inflow of EU funds).

Czech Republic

Mixed economic figures

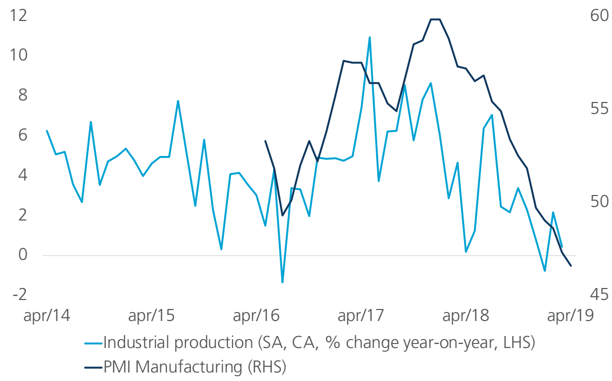
The Czech economy is going through a moderate deceleration phase, but there are several reasons to remain optimistic. The current slowdown is most visible in the manufacturing sector, which is the country's largest sector, accounting for almost one third of GDP. The manufacturing PMI has been declining for ten consecutive months and currently stands at 46.6, the poorest result in more than six years (figure CZ). Industrial companies have felt another drop in new purchase orders and have even begun laying off employees. Moreover, prospects for automotive production – the most important subsector of Czech manufacturing – are still far from optimistic due to more general European market developments.

On the other hand, the situation in the construction industry has taken a positive turn – both engineering and building construction are booming thanks to new projects in the public as well as private sectors. Moreover, the first quarter was characterised by a pickup in residential construction which, until now, remained short of its performance achieved during the last recession. While the increased supply of new apartments can alleviate tension in the real estate market, the question is whether this is a new trend or just a fluctuation in a single quarter. This year, the construction industry will positively contribute to Czech economic growth, but its share in GDP is very small.

Labour market tensions not diminishing

Although the Czech economy is facing a cyclical slowdown, there has been no change in the labour market situation. The harmonised unemployment rate is close to 2%, while the vacancy rate is increasing, albeit at a much slower pace than last year. Despite poorer economic results, the Czech Republic remains the country with both the lowest unemployment rate and the highest vacancy rate within the EU at the same time. Neither lower employment in the industrial sector, nor companies' responses to lower purchase orders, nor earlier investments in automation and robotics, have threatened this result. Even though the circumstances of the labour market have not changed significantly, wage growth could slow down a bit this year, mainly due to the expected slower public sector wage increases.

Figure CZ – Czech economy's moderate deceleration phase most visible in manufacturing sector



Source: KBC Economics based on HIS Markit, CZSO

The ongoing, fairly rapid rise in wages is also reflected in inflation evolutions. After the 3% yoy peak in March (i.e. the upper limit of the Czech National Bank's (CNB) tolerance interval), inflation fell to 2.8% in April. It is still true that more than half of the inflation rate is due to the rising cost of housing, specifically in rents and energy, which account for a quarter of the consumer basket. In the last month, inflation spurred by higher fuel prices reflecting the higher oil price on global markets. By contrast, the prices of consumer goods in stores have been only slowly rising, despite persistent strong consumer demand. This is the result of intensive competition between brick-and-mortar stores and e-shops whose revenues grow significantly every year.

The CNB has raised interest rates once again

The CNB reacted to higher inflationary pressures by raising its interest rates by another 25bps in early May. The higher inflation enabled the central bank to continue its declared path of "normalising" interest rates; after ten years, the principal interest rate (the two-week repo rate) thus returns to 2%. The CNB's latest decision relied on a new forecast, which assumes a subsequent interest rate stabilisation until the middle of next year at least. Nonetheless, the central bankers' comments suggest that they are unwilling to commit to any other step at the moment, and that more or less nothing has been ruled out. As inflationary pressures have started to ease, and inflation is expected to return to the 2% target level within a year's time frame, there is no need for the CNB to rush further interest rate hikes. This is particularly true since the bank finally revised its previously super-optimistic outlook for economic growth. However, the big unknown is the Czech Koruna which still refuses to strengthen as envisioned by the CNB in the long term. Therefore, it will probably be the Koruna that tips the scales when the CNB makes a decision on its next steps. However, given the weakening economy and lower inflationary pressures, we assume that there is no acute risk of any additional rate hike soon.

Financial markets are not pricing in any rate hike either. The swap curve remains inverted and envisages no rate hike over a two-year time frame. Bond yields are below the repo rate, thus responding to the persistent surplus of free liquidity in the Czech market. Markets appear to completely ignore the deteriorating public finances, which will require increased government bond issuance and accelerate the growth in public debt. In the first four months of 2019, the budget deficit reached CZK 30 billion, even though the state used CZK 20 billion from the privatisation account as an aid. With respect to the approved deficit (CZK 40 billion), there is no way the state's current performance could be perceived as positive. The budget will have to cater for a slower growth in tax revenues as well as for an expansion in social spending.

Hungary

Growth and inflation up

The strong Hungarian growth performance in Q1 (5.2% yoy) clearly led to accelerating inflationary pressures. Hungarian headline inflation surprised to the upside again. Recall that consumer price growth accelerated from 3.7% yoy in March to 3.9% yoy in April (figure HU). The seasonally adjusted core inflation remained at 3.8% yoy in April after 7 months of acceleration, starting from 2.3% yoy in August 2018.

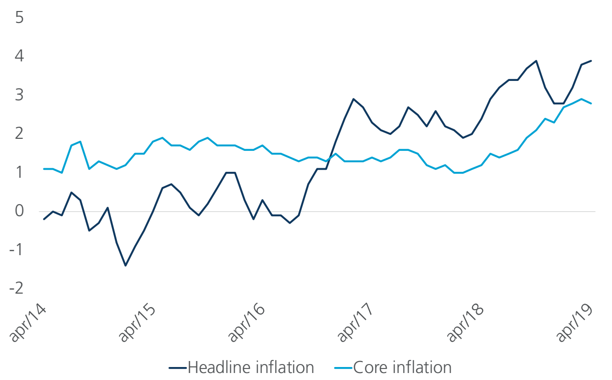
The fuel price jump (6% mom) was the main reason behind the further acceleration of inflation, but higher tobacco and market service prices also boosted food inflation. Market service inflation has accelerated in every month this year, compared to the same month the previous year. Moreover, there has been a continuous acceleration over the last one and half years. The tax adjusted market service inflation reached a more-than-10-year peak at the end of April. It definitively confirms our view that the domestic components (strong domestic consumption and substantial wage hikes) are causing inflationary pressures in Hungary.

Looking ahead, headline inflation may start to moderate in the following months and may bottom out around 3.2% yoy in August and September, assuming there won't be any further increases in the oil price. This drop will be driven by a negative base effect while underlying inflation may remain relatively elevated, meaning that core inflation will stay above the target but slightly below 4% yoy. In the last quarter of this year, headline inflation may, however jump again – possibly even above 4% yoy, also due to base effects. So, we expect to see 2019 annual average inflation around 3.4%.

The NBH's may stay on hold in May despite higher inflation

The National Bank of Hungary (NBH) Monetary Council believed in recent months that the slowing international environment and the low imported inflation could cool down Hungarian inflation too. As such, it will be interesting to see how the NBH reacts to the surprisingly good growth figures, in particular as inflation has now reached the upper band of the NBH's tolerance range.

Figure HU – Strong Hungarian growth performance led to accelerating inflationary pressures (HICP, % change year-on-year)



Source: KBC Economics based on Eurostat

Clearly, given the combination of inflation overshooting NBH's target, fast economic growth (driven by strong domestic consumption), the tight labour market, strong wage growth and the rapid increase in household borrowing (monthly new mortgage lending is at pre-crisis levels) implies a clear and loud call for monetary tightening. Nevertheless, despite all of these strong signals we don't expect a rate hike from the NBH during its May rate-setting meeting. We do, however, think that the NBH will increase its O/N deposit rate by 10bps again in June, and should follow up with two additional 10bp rate hikes in both the 2nd and 3rd quarter. We also expect that HUF liquidity will decline further and the 3-month Bubor may rise to 0.4-0.5% by the end of the year.

Last but not least, it is also important to mention that the government may issue a new retail bond, from the 1st of June, with a higher interest rate than on currently available retail papers. This is, in a way, a form of monetary tightening. If it succeeds in reallocating households' savings (for example by channelling some deposit from banks into this new paper), this initiative can extract some HUF liquidity from the economy, causing upward pressure on the short end of the curve.

Bulgaria

A batch of mixed signals

Available data continue to show a mixed picture for the Bulgarian economy in the first quarter of 2019. On the one hand, industrial production expanded strongly in the first three months of the year; after the sharpest expansion in nearly two years in February (6.6% yoy), industrial output increased by 2.8% yoy in March on the back of a strong pick-up in the manufacturing and mining industries. In addition, developments on the external front were also favourable with merchandise exports surging by almost 11% yoy. This suggests that the contribution to GDP growth from net exports is likely to improve this year after having been a significant drag on growth in 2018 due to fallout from the Turkish currency crisis. These positive developments are reflected in the economic growth acceleration in Q1, reaching 3.4% (annualised) from 3.2% in Q4 2018.

On the other hand, the figures from the demand side of the economy are far less optimistic. Consumer confidence deteriorated in April, albeit from a relatively elevated level. Compared with three months ago, the expectations of both the urban and rural population over the next 12 months turned particularly more negative. As such, Bulgaria goes against the international trend in which consumer demand is holding up economic performance. Lower consumer confidence has had a clear impact on retail sales, which have lost momentum since the beginning of the year. While in February retail sales marked the first drop in five years, growth remained sluggish at 0.6% yoy in March, indicating less rosy prospects for household consumption growth this year.

Labour shortage becoming more pronounced

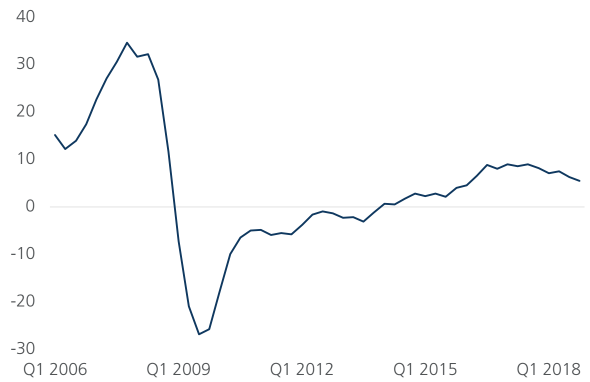
Labour market developments continue to be favourable with the unemployment rate falling to a 10-year low of 4.6% in March according to Eurostat's harmonized unemployment figures. While the tight labour market has been fuelling wage growth and consumer spending, it also led to a significant shortage of labour supply, especially among high-skilled workers. Moreover, given the adverse demographic outlook, the medium to long-term outlook is hardly optimistic, as the loss of skilled workers will likely depress productivity growth, reduce potential output and put significant pressure on public finances. To address the challenge of an acute labour shortage, the government has recently introduced new policies, including initiatives to bring back overseas Bulgarians and agreements with neighbouring countries regarding imported workers.

Inflationary pressures intensified in March with annual HICP inflation rising to 2.8% yoy on the back of higher food prices (5.0%) and prices of housing and utilities (4.6%). For the year as a whole, we expect inflation to average 2.5%.

Housing market is cooling down

After a robust, two-year long period of house price growth, supported by a combination of rising real wages, higher consumer confidence and low interest rates, the Bulgarian housing market cooled down in the last quarter of 2018 (figure BG). According to Eurostat, house prices increased by 5.5% in Q4 2018, which marks the slowest growth since the first quarter of 2016. Still, we interpret the recent figures as a healthy downward correction rather than a trend that would lead to a more drastic slowdown, or even possibly a decline in house prices in Bulgaria. The reason is that the number of real estate transactions continues to grow, albeit at a slower pace, which together with the rising number of building permits and favourable developments in terms of mortgage credit, suggests no fundamental weakness in the market. The recent slowdown can thus be attributed mainly to fading interest from foreign investors in the Bulgarian property market. While in 2017 net foreign direct investment in the Bulgarian real estate sector amounted to EUR345.7 million, last year recorded net outflow of EUR148.9 million.

Figure BG – Bulgarian housing market is cooling down (house price index, existing and new dwellings, % change year-on-year)



Source: KBC Economics based on Eurostat

Slovakia

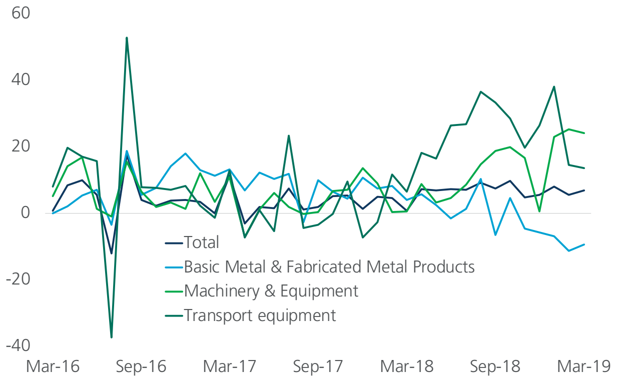
Economy holding up well, but slowdown expected

Similar to the Czech Republic, Slovak economic activity is gradually slowing too. Q1 annualised growth amounted to 3.8%, only marginally below the 3.9% figure for Q4 2018. However, there are clear signals that this strong economic performance is unlikely to be maintained in the near future. In February, industrial production growth fell to 5.6% yoy from the 7.2% achieved in January. Indeed, industrial performance has been volatile in recent months. Both positive and negative factors played a role. On the one hand, it was negatively affected by the weaker growth in Western Europe. On the other hand, a positive impact came from the launch of a significant new car factory.

In particular, the figures for February show a slowdown in Slovak transport vehicle production. However, there are also base effects at play considering we saw a strong year-on-year increase in February 2018. Metal production, one of the strong pillars of the domestic manufacturing industry, has fallen dramatically for the fifth month in a row (-9.4% yoy in March 2019), clearly affected by cyclical factors (figure SK). For the time being, machinery production has been doing well, recording a year-on-year jump of more than 25% Production in this subsector continues to accelerate, although the question remains how long this trend will last.

There is clear uncertainty about future developments in the Slovak industrial sector. The lead indicators in Slovakia and abroad have been falling, suggesting a cooling down in demand for Slovak industrial products. Business sentiment in the domestic industry dropped significantly in March 2019. This is a consequence of deteriorating expectations regarding both current and future product demand. The domestic market is also worried about the unfavourable development of purchase factory orders in the German market. Together with the poor development of confidence in the services and construction industry, the deterioration in industrial sentiment suggests a further deceleration of economic growth in the first half of 2019. This was reflected in the EC's spring forecast, which reduced GDP growth estimates from 4.1% to 3.8% in 2019. For next year, the EC expects 3.4% growth instead of 3.5%. These estimates are closer to our current prediction.

Figure SK – Slovak manufacturing production (CA, % change year-on-year)



Source: KBC Economics based on SUSR

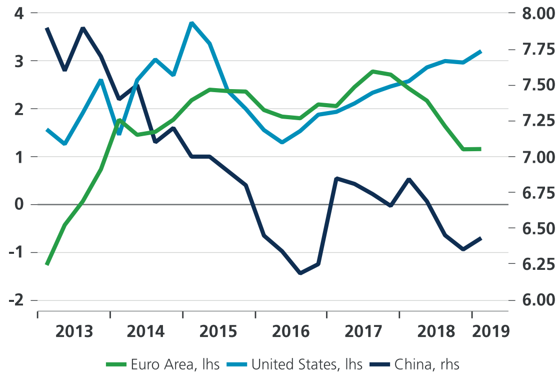
In March, inflation grew from 2.3% yoy to 2.7%. The drivers included rising prices of fuel and food, as well as higher prices for air tickets and used cars. Even core inflation, which is an indicator of demand pressures, has also risen to 2.4% yoy from 1.9% a month earlier. The developments in the first quarter are more or less in line with the overall expectations. Inflation is expected to slow down in the second half of the year, which is also linked to the current deceleration of economic activity.

The deficit has shrunk, but elections are looming

Eurostat confirmed that the general public deficit fell to -0.7% of GDP in 2018, decreasing by 1 percentage point compared to last year. The result was also 1 ppt better than the budget target thanks to better economic developments. The EC adjusted downwards its outlook for this year's target by 0.2 ppts to -0.5% of GDP. Given the upcoming parliamentary elections and the increase in proposed social spending, we are more pessimistic and assume that any further deficit reduction would be difficult to achieve. However, this is unlikely to affect government bond rates very much. The interest on government bonds is supported by the ECB's simulative monetary policy. Moreover, the Slovak public debt ratio is one of the lowest in the EU. In 2018, Slovakia's public debt was 48.1% of GDP while in the euro area, the average figure is 87.1%. The risk premium for ten-year bonds should therefore only slowly keep rising from its current 50 basis points above the German Bund towards 65 bps by the end of 2020, as the ECB is expected to announce the start of further monetary policy normalisation.

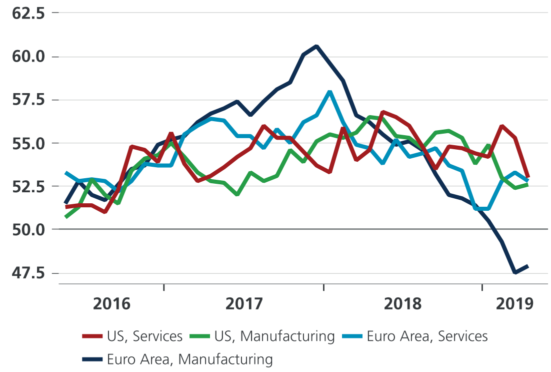
Figures

Real GDP
yearly change in %



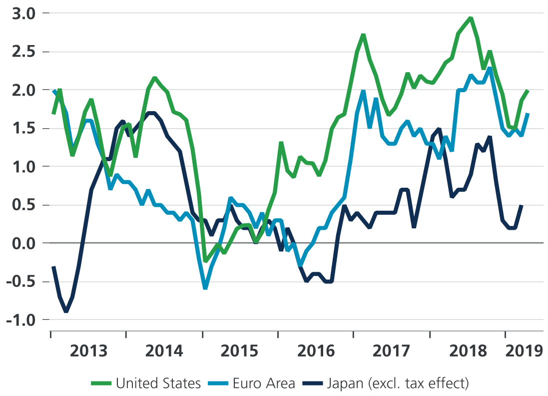
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



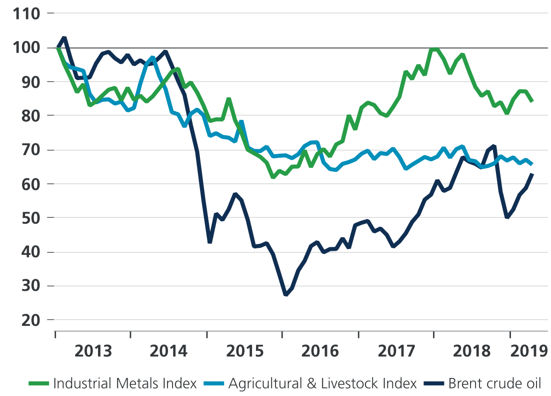
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, BLS

Commodity prices
index, January 2013=100, in USD

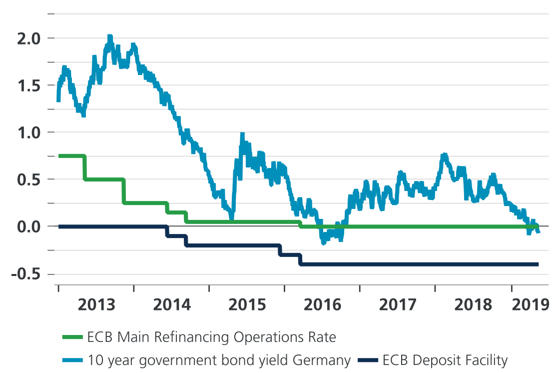


Source: KBC Economics based on World Bank, S&P

United States interest rates
in %

Source: KBC Economics based on Fed, Macrobond

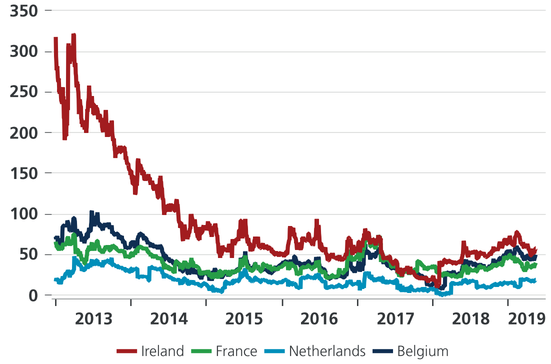
Euro area interest rates
in %



Source: KBC Economics based on Macrobond, ECB

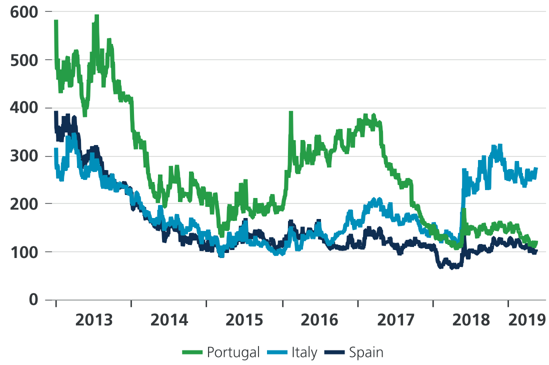
Figures

10 year government bond yield spreads to Germany
in basis points



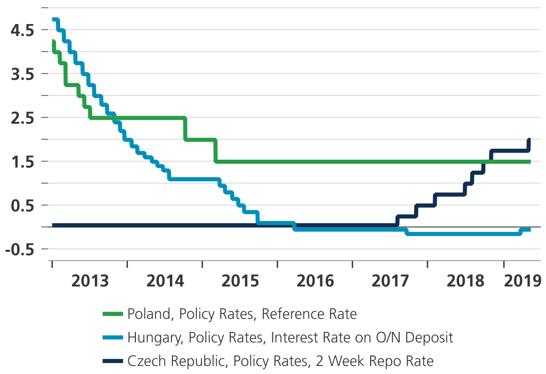
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



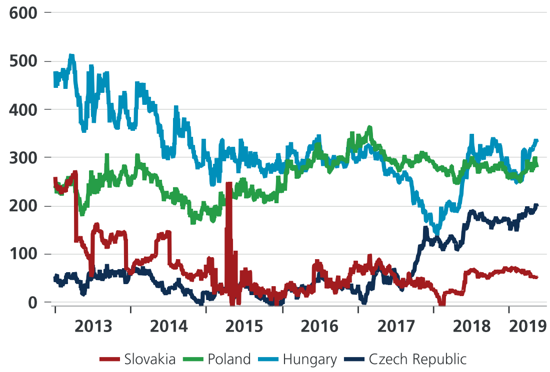
Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %



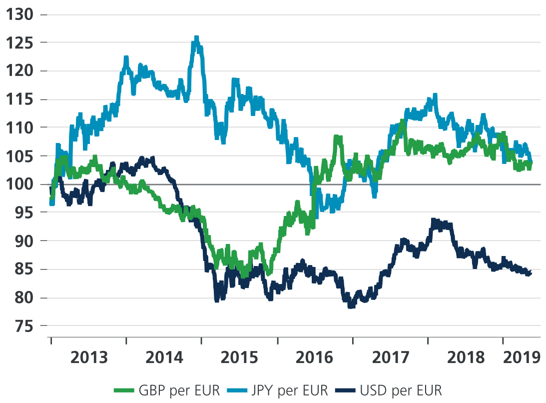
Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points



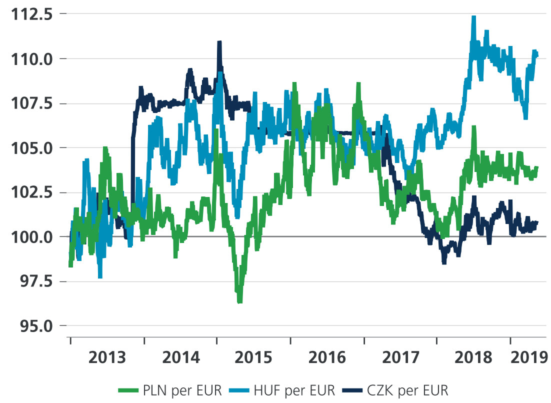
Source: KBC Economics based on Macrobond, AKK, Eurostat

Exchange rates
index, January 2013=100, increase = stronger EUR



Source: KBC Economics based on Macrobond

Exchange rates
index, January 2013=100, increase = stronger EUR



Source: KBC Economics based on Macrobond

Outlook main economies in the world

		Real GDP growth (period average, in %)			Inflation (period average, in %)		
		2018	2019	2020	2018	2019	2020
Euro area	Euro area	1.8	1.2	1.2	1.7	1.3	1.5
	Germany	1.5	1.0	1.3	1.9	1.4	1.4
	France	1.5	1.2	1.1	2.1	1.3	1.6
	Italy	0.8	0.1	0.4	1.2	1.0	1.2
	Spain	2.5	2.0	1.5	1.7	1.5	1.5
	Netherlands	2.5	1.6	1.3	1.6	2.1	1.7
	Belgium	1.4	1.2	1.1	2.3	1.7	1.6
	Ireland	6.7	3.5	3.0	0.7	1.5	1.5
	Slovakia	4.1	3.7	3.5	2.5	2.6	2.4
Central and Eastern Europe	Czech Republic	2.9	2.6	2.3	2.0	2.2	1.9
	Hungary	4.9	3.9	2.6	2.8	3.4	3.5
	Bulgaria	3.1	3.2	3.1	2.6	2.5	2.4
	Poland	5.1	4.5	4.2	1.2	1.9	2.7
	Romania	4.1	3.8	3.5	4.1	3.5	3.3
Rest of Europe	United Kingdom	1.4	1.4	1.4	2.5	1.9	1.9
	Sweden	2.4	2.0	1.9	2.0	1.9	2.0
	Norway	2.4	2.2	1.8	2.8	2.0	2.0
	Switzerland	2.6	1.6	1.6	0.9	0.8	1.0
Emerging markets	China	6.6	6.0	5.7	2.1	2.4	2.6
	India*	7.0	7.1	7.4	4.0	3.9	4.5
	South Africa	0.8	1.1	1.4	4.6	4.9	5.2
	Russia	2.3	1.4	1.7	2.9	4.8	3.9
	Turkey	2.6	-1.5	2.5	16.3	17.0	12.0
	Brazil	1.1	2.0	2.4	3.7	4.0	4.0
Other advanced economies	United States	2.9	2.5	1.6	2.4	2.1	2.2
	Japan	0.8	0.9	0.5	1.0	1.0	1.4
	Australia	3.0	2.7	2.7	1.9	2.1	2.4
	New Zealand	2.8	2.8	2.6	1.6	1.9	2.0
	Canada	2.1	1.9	1.7	2.3	1.8	2.1

* fiscal year from April-March

13/05/2019

Policy rates (end of period, in %)		13/05/2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
Euro area	Euro area (refi rate)	0.00	0.00	0.00	0.00	0.00
	Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40	-0.40
Central and Eastern Europe	Czech Republic	2.00	2.00	2.00	2.00	2.25
	Hungary	-0.05	0.05	0.15	0.25	0.50
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.50
	Romania	2.50	2.50	2.75	2.75	2.75
Rest of Europe	United Kingdom	0.75	0.75	0.75	0.75	1.00
	Sweden	-0.25	-0.25	-0.25	-0.25	0.00
	Norway	1.00	1.25	1.25	1.25	1.50
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	4.35	4.35	4.35	4.35	4.35
	India	6.00	6.00	6.00	6.00	6.00
	South Africa	6.75	6.75	6.75	7.00	7.00
	Russia	7.75	7.75	7.50	7.50	7.25
	Turkey	24.00	24.00	21.50	19.50	19.50
	Brazil	6.50	6.50	6.50	6.50	6.50
Other advanced economies	United States (upper limit)	2.50	2.50	2.50	2.50	2.50
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	1.50	1.50	1.25	1.25	1.25
	New Zealand	1.50	1.50	1.50	1.50	1.50
	Canada	1.75	1.75	1.75	1.75	1.75

Outlook main economies in the world

10 year government bond yields (end of period, in %)		13/05/2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
Euro area	Germany	-0.06	0.00	0.10	0.30	0.35
	France	0.34	0.40	0.60	0.90	0.95
	Italy	2.71	2.70	3.10	3.30	3.35
	Spain	0.98	1.00	1.25	1.60	1.65
	Netherlands	0.13	0.20	0.30	0.55	0.60
	Belgium	0.44	0.50	0.65	0.90	1.00
	Ireland	0.53	0.55	0.70	0.90	1.00
	Slovakia	0.53	0.55	0.70	0.90	1.00
Central and Eastern Europe	Czech Republic	1.89	1.85	1.95	2.05	2.10
	Hungary	3.33	3.00	3.00	3.10	3.05
	Bulgaria	0.62	0.60	0.70	0.90	1.02
	Poland	2.86	3.00	3.10	3.20	3.30
	Romania	5.03	5.20	5.30	5.80	5.80
Rest of Europe	United Kingdom	1.12	1.20	1.20	1.30	1.30
	Sweden	0.21	0.40	0.50	0.70	0.75
	Norway	1.71	1.75	1.85	2.05	2.10
	Switzerland	-0.35	-0.30	-0.20	0.00	0.05
Emerging markets	China	3.32	3.35	3.35	3.35	3.33
	India	7.39	7.40	7.40	7.45	7.45
	South Africa	8.52	8.50	8.55	8.60	8.60
	Russia	8.17	8.25	8.15	8.10	8.05
	Turkey	20.15	18.50	17.50	16.50	15.50
	Brazil	8.85	9.00	9.25	9.30	9.35
Other advanced economies	United States	2.41	2.50	2.50	2.50	2.50
	Japan	-0.04	0.00	0.00	0.00	0.00
	Australia	1.70	1.90	1.90	1.90	1.90
	New Zealand	1.83	2.05	2.05	2.05	2.05
	Canada	1.69	1.75	1.75	1.75	1.75

Exchange rates (end of period)	13/05/2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
USD per EUR	1.12	1.12	1.12	1.15	1.15
CZK per EUR	25.77	25.60	25.60	25.40	25.20
HUF per EUR	323.65	324.00	322.00	320.00	318.00
PLN per EUR	4.30	4.30	4.33	4.30	4.25
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.76	4.76	4.77	4.78	4.78
GBP per EUR	0.86	0.87	0.87	0.88	0.88
SEK per EUR	10.83	10.65	10.25	10.00	10.00
NOK per EUR	9.81	9.65	9.40	9.35	9.35
CHF per EUR	1.13	1.15	1.16	1.17	1.17
BRL per USD	4.00	3.95	3.95	4.00	4.00
INR per USD	70.57	70.00	70.50	71.00	71.20
ZAR per USD	14.32	14.50	14.60	14.80	14.85
RUB per USD	65.44	65.00	66.00	65.00	65.00
TRY per USD	6.11	6.20	6.30	6.40	6.45
RMB per USD	6.88	6.85	6.88	6.90	6.90
JPY per USD	109.54	111.00	111.00	109.00	109.00
USD per AUD	0.70	0.70	0.70	0.71	0.71
USD per NZD	0.66	0.66	0.66	0.67	0.67
CAD per USD	1.34	1.33	1.31	1.29	1.29

Outlook KBC home markets

	Belgium			Ireland		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	1.4	1.2	1.1	6.7	3.5	3.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.7	1.6	0.7	1.5	1.5
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.8	5.7	5.8	5.5	5.1	5.2
Government budget balance (in % of GDP)	-0.7	-1.7	-1.8	0.0	0.2	0.3
Gross public debt (in % of GDP)	102.0	101.5	101.0	64.8	61.0	55.0
Current account balance (in % of GDP)	-1.3	-1.2	-1.0	9.1	7.5	6.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	2.9	2.3	2.1	10.2	4.0	3.0

13/05/2019

	Czech Republic			Slovakia		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	2.9	2.6	2.3	4.1	3.7	3.5
Inflation (average yearly change, harmonised CPI, in %)	1.9	2.2	1.9	2.5	2.6	2.4
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.1	2.0	2.0	5.9	6.2	6.3
Government budget balance (in % of GDP)	0.9	0.0	-0.5	-0.7	-0.7	-0.7
Gross public debt (in % of GDP)	32.7	31.3	30.5	48.9	48.0	47.0
Current account balance (in % of GDP)	0.3	0.4	0.3	-2.0	-1.5	-1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	8.6	3.5	3.0	7.4	5.0	4.0

13/05/2019

	Hungary			Bulgaria		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	4.9	3.9	2.6	3.1	3.2	3.1
Inflation (average yearly change, harmonised CPI, in %)	2.9	3.4	3.5	2.6	2.5	2.4
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	3.7	3.5	3.5	4.8	4.7	4.6
Government budget balance (in % of GDP)	-2.2	-1.8	-2.0	2.0	-0.3	0.4
Gross public debt (in % of GDP)	70.8	68.7	66.7	22.6	19.0	17.7
Current account balance (in % of GDP)	0.5	0.0	-0.2	2.4	1.2	1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	9.7	4.0	3.0	6.6	5.0	4.0

13/05/2019

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