UBB
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Economic Perspectives

September 2019

Highlights

- A number of uncertainties hanging over the global economy escalated during the summer months, with new tariffs in the US-China trade war, the election of Boris Johnson as UK Prime Minister allied to his initially uncompromising line on Brexit, the collapse of the previous coalition government in Italy, and growing pro-democracy protests in Hong Kong. While to some extent risks related to these developments have eased compared to recent weeks, they have certainly not vanished.

- Despite the slowdown in Germany, the deteriorating external environment, and uncertainties stemming from Brexit and the US-China trade war, growth in the euro area continues with some resilience. Upward revisions to the Q2 growth figure for France and remarkably strong growth in the Netherlands tend to confirm our outlook for 2019 GDP growth at 1.1%.

- Relative to France, Spain and the Netherlands, Germany's economic momentum remains particularly weak. Problems in the German industrial sector stem from a general deterioration in the external environment, which further add to the structural difficulties already facing the automotive industry. German consumer sentiment continues to trend down, suggesting externally driven weakness may spill over to the domestic sector.

- Overall, however, consumers and the services sector remain the linchpins of the euro area economy at present. Given strong labour markets and low inflation, consumer spending is expected to remain strong. Negative spillovers from the manufacturing sector appear limited so far but could present a risk going forward. In general, we expect the German and euro area economies to recover modestly after the current temporary weakness, unless Brexit and the trade war cause further and harsher disruptions.

- The US economy is still motoring along, but a few warning signs, such as a drop in manufacturing sentiment and a slowdown in industrial production, signal some slowdown ahead. Furthermore, though the US labour market remains solid, recent revisions to jobs growth data show that jobs growth in 2018 and early 2019 was about 0.3% lower than initially thought while the August employment report showed the slowest jobs growth in two years.

- The ECB adopted a number of easing policies at its September meeting, including a cut to the deposit rate with a tiered deposit system, more generous terms for TLTROs, and restarting, for an indefinite period, the Asset Purchase Programme. Following a rate cut at its previous meeting, the Fed further lowered the Fed funds rate by 25 basis points to 1.75-2.00% in September.

Global economy

Euro area stumbling not tumbling

The global economy continues to trudge through the muck of Trump trade wars, Brexit politicking, and German slowdown fears. While these uncertainties remain a clear drag on both actual economic developments and the economic outlook, growth dynamics are still far from disastrous.

In the euro area, both geographical and sectoral differences persist, with particular weakness in Germany relative to, e.g., France, Spain and the Netherlands, and with particular weakness in industrial sectors relative to services and retail. Problems in the German industrial sector stem from a general deterioration in the external environment, which further adds to the structural difficulties already facing the automotive industry. The latest trade data show a decline in German exports in Q2, dragged down by a notable contraction in exports to the UK (figure 1). This likely owes something to the after effects of stockpiling by the UK in Q1 and demonstrates how the uncertainty related to Brexit is already disrupting economic developments. German export growth to China also decelerated significantly, reflecting the impact of slowing Chinese demand.

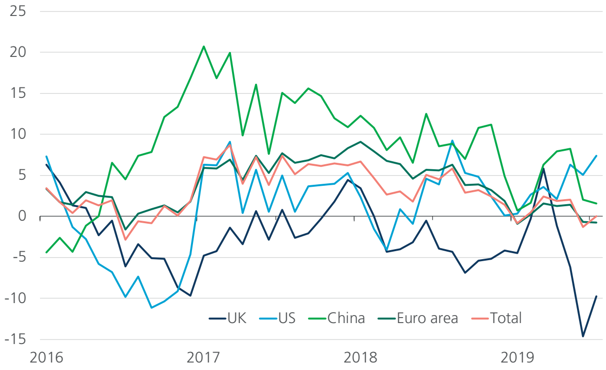
Given that headwinds such as Brexit uncertainty and slowing growth in China are expected to persist, and that German manufacturing sentiment remains notably weak despite signs of stabilisation, we anticipate only a tepid recovery in Germany in the near term. Furthermore, consumer sentiment in Germany continues to trend down, increasing the risk of spill-overs from the industrial sector to the consumer sector. However, historical revisions to German GDP growth have resulted in a more positive overhang effect from 2018, which in turn leads to a slight upward revision of our expectations for annual German GDP growth in 2019 from 0.4% to 0.5%.

In Europe more generally, consumers and the services sector remain the linchpins of the economy. Service sector PMIs are well above 50 (the boundary between expansion and contraction) in Spain, France and Germany, and the service PMI is still hovering above 50 in Italy (figure 2). Retail trade volumes also appear resilient, particularly in Spain, where retail trade growth is even accelerating. Also notable is a rebound in consumer confidence in France, that appears to be shaking off the negative impact of the yellow vest protests that started last year.

Furthermore, core inflation in the euro area remains weak with the headline figure even declining in most countries. Though this presents a problem for the ECB (see below), weak growth in consumer prices at a time of low (and in some cases still declining) unemployment rates in most countries, and still decent wage growth, means household purchasing power is being supported. As a result, consumer spending is expected to continue to support overall EU and euro area growth, though more cautious consumer sentiment means some easing in spending growth is possible.

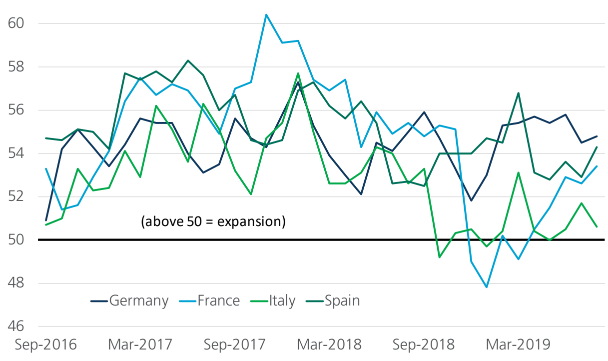
Last month, we raised our 2019 real GDP growth forecast for the euro area to 1.1% based on preliminary Q2 GDP releases. Upward revisions to the Q2 figure for France (from 0.2% to 0.3% qoq) and remarkably strong growth in the Netherlands of 0.5% qoq (not previously released) further support our outlook. Thus, despite the slowdown in Germany, the headwinds presented

Figure 1 - German export weakness
(3-month moving average, yoy %)



Source: KBC Economics based on DESTATIS

Figure 2 - Euro area service PMIs remain resilient
(index)



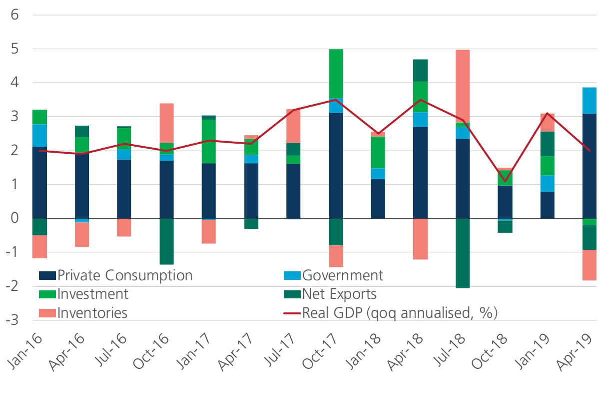
Source: KBC Economics based on IHS Markit by a deteriorating external environment, and the uncertainties stemming from Brexit and the US-China trade war, growth in the euro area remains resilient if relatively modest.

Is the US economy flashing warning signs?

The US is still motoring along, but a few flashing lights in the distance are signalling some slowdown ahead. Following a decline in manufacturing output in July (-0.5% yoy), manufacturing sentiment continues to deteriorate, with the ISM survey dropping into contraction territory at 49.1 in August. Industrial production overall is also decelerating, but not yet contracting. Furthermore, investment is weakening, and revisions to the GDP data show that investment growth in previous quarters was weaker than originally thought (figure 3). This reflects not only the slowing of the business cycle in the US, but also the impact of the trade war, which has increased uncertainty, particularly for the manufacturing industry.

While these developments corroborate our view that GDP growth in the US will continue to gradually slow over the coming quarters, some closely-watched indicators appear to be suggesting an increasing probability that the US is heading towards a recession. Specifically, the inversion of the yield curve has in the past been a reliable predictor of a coming recession, and by the beginning of September, the spread between the 10-year benchmark yield and the 3-month Treasury yield had declined to negative 50 basis points (it has since narrowed somewhat, but remains negative). Based on this spread, the Federal Reserve Bank of New York's recession indicator suggests the probability of a recession twelve months from now is just under 40%.

Figure 3 – US investment growth weak compared to consumption
(growth contribution in percentage points)



Source: KBC Economics based on US Bureau of Economic Analysis

There are some mitigating factors that should limit the extent of the slowdown in the US, however. First, consumer spending is the mainstay of the US economy, contributing to more than two-thirds of GDP growth and, similar to in the euro area, it remains relatively resilient. After a sharp drop in the University of Michigan Consumer Sentiment Index in August, the early September reading recovered somewhat while a similar measure, the Conference Board Consumer Confidence Index, has remained strong. Retail trade has also been notably robust through the summer months, and the most recent revisions to the GDP data revised up private consumption growth in Q2.

Similar once again to the situation in the euro area, the labour market in the US is also still very strong. Though there appears to be some easing in the pace of job creation in recent months, with August posting the slowest year-on-year gain in two years, there was still solid jobs growth of 1.4% last month. Similarly, the annual revision to the Bureau of Labour Statistic's job growth data show that job growth since March 2018 was about 0.3% lower than initially thought. However, the unemployment rate is still at its lowest level since the 1970s, and wage growth is still about 3.0% yoy.

Drawing these elements together, we expect consumers will continue to support the US economy and therefore keep our outlook steady, with annual GDP growth of 2.3% in 2019 and 1.7% in 2020.

Inflation remains below target

As mentioned above, both core and headline inflation remain weak in the euro area and well below the ECB's target. We expect annual inflation to reach only 1.3% in 2019. In the US inflation pressures are sluggish as well, with PCE inflation (the Fed's preferred measure) reaching only 1.6% yoy in July.

Though the trade war with China could have some upward impact on prices in the US, we continue to see inflation remaining below the Fed's 2% target this year and the next. On the assumption that the mid-September attack on Saudi oil production facilities has only a temporary effect on supply, we expect oil prices to stay roughly flat through 2020, and therefore don't expect any sustained upward pressure on inflation from this channel.

Central banks loosen policy

At its policy meeting on 12 September, the ECB undertook a range of easing initiatives. First, the deposit rate was cut from -0.40% to -0.50%. Second, the terms of the Targeted

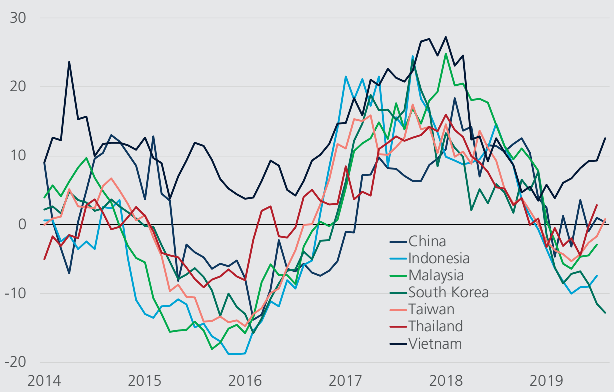
Box 1 – Emerging Asia slowdown

The trend deterioration in manufacturing sentiment and weakening of industrial production is not confined to the euro area and the US. Several economies in emerging Asia are also experiencing growth slowdowns thanks to a worsening external environment and cyclical factors. The trade war, the overall slowdown in China, and a downturn in the semiconductor industry are all interrelated developments weighing on the region. Export growth, particularly in emerging Asia, has deteriorated notably since last summer while import growth has also tumbled, falling even into contractionary territory in several instances (figures B1 and B2). Many economies in the region, notably Taiwan, South Korea, Malaysia and Singapore are highly connected to China via trade linkages. These trade linkages are based on both integrated value chains (i.e. trade in intermediate goods) and on final demand from China's large market of consumers. Taiwan and South Korea, for example, both send more than 25% of their exports to China. However, final demand from China accounts for 14% of Taiwan's total value added and only 8% of South Korea's value added. Thus, while both economies are highly dependent on exports to China, South Korea is relatively more reliant on the smooth functioning of established value chains with China.

The outlook isn't all doom and gloom for the region, however. Some economies in the region stand to gain in the long run from the trade war disruptions as businesses look to move production away from China. Vietnam, for example, has seen relatively strong export growth in 2019 and imports have remained far more stable relative to peers. Furthermore, several central banks in the region have room to ease policy and have been taking advantage of that room to support growth in 2019. Consistent with the trend in developed markets, both headline and core inflation pressures remain absent in most emerging markets. Weak inflation, expected easier policy from major central banks, and slowing growth concerns have led almost all central banks in the region to cut rates at least once in 2019, with the exception of the central banks of Vietnam and Taiwan.

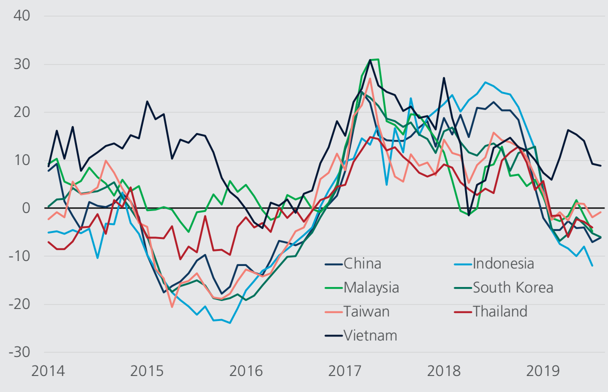
While looser policy should support growth, given that we expect gradual slowdowns in other major economies to continue, and given that we don't expect a comprehensive trade agreement between the US and China in the short term, emerging Asia economies will likely continue to face headwinds to growth going forward.

Figure B1 - Emerging Asia exports
(3-month moving average, yoy %)



Source: KBC Economics based on national authorities

Figure B2 - Emerging Asia imports
(3-month moving average, yoy %)



Source: KBC Economics based on national authorities

Long-Term Refinancing Operations (TLTROs) were made more generous by removing the 10 basis point spread over ECB policy rates that previously applied while also extending the maturity of these loans from two years to three years. Third, the Asset Purchase Programme (APP) was re-started. In addition, to limit the adverse impact of negative rates on the transmission of monetary policy through the banking sector, the ECB introduced a tiered deposit system that reduces the volume of reserves held by banks to which the now -0.50% rate applies.

Significantly, the ECB also dropped the 'date dependency' of its forward guidance. Previously, the ECB had signalled it would not raise its policy interest rates until the second half of 2020 at the earliest. It has now dropped all references to calendar dates. Now, instead, the ECB says rates will not rise until inflation is clearly seen to be approaching its target of below, but close to, 2% in a clearly sustainable manner. Similarly, the ECB indicated the restarted APP will be open-ended rather than (as in the past) having a signalled calendar date of completion. So, ECB forward guidance on policy is now explicitly formulated in terms of what has to happen to bring about a change in policy rather than when policy might change.

After some short-lived volatility, the market reaction to the ECB's package of measures was to push interest rates higher and the exchange rate of the Euro stronger. A range of factors likely contributed to this response. First of all, Mr Draghi called for fiscal policy to play a stronger role in supporting euro area growth. Implicitly, this suggested monetary policy may be at or close to the limits of its capabilities to support growth. In the same vein, unusually public reports of large-scale opposition encompassing several high-profile members of the Governing Council to the package of measures announced by Mr Draghi suggest the willingness to act again might be substantially impaired. Market doubts on the implementation feasibility of the APP (sufficient availability of government bonds) and the impact of the tiered deposit rate on money market rates also contributed to the firming in interest rates and the Euro in the wake of the ECB meeting.

The intention of Mr Draghi was clearly to introduce a package of measures at the September meeting that would keep the ECB on the side-lines for a long time and cement the 'lower for longer' position of the ECB when a new regime under Christine Lagarde takes charge at the beginning of November. Some in the markets now take the view that the current ECB easing cycle has come to an end. Our view is that barring major economic or financial surprises, the ECB will attempt to keep current settings in place until they see a clear recovery in the path of inflation towards their target.

Following a rate cut at its previous meeting the Fed further lowered the Fed funds rate with 25 basis points to 1.75-2.00%. We continue to anticipate a further 25 basis points reduction by the end of 2019, bringing total rate cuts this year to 75 basis points.

Risk escalation on pause but not gone

From a risk perspective, the summer months were anything but carefree and relaxing. The escalation of the US-China trade war, Italian political problems, the protests in Hong Kong, and new developments related to Brexit sent global uncertainty soaring. In some respects, risks have eased back in mid-September from the heights reached a few weeks ago. However, the uncertainties that plagued financial markets and global sentiment over the summer are far from resolved and could potentially flare up again at any time.

Trade war moving into a higher gear

At the beginning of August, the trade war moved into a higher gear after US President Trump announced additional tariffs on Chinese goods. China responded both with retaliatory tariffs of its own and by allowing its currency to depreciate past 7.00 CNY/USD – a boundary previously seen as one the Chinese authorities weren't willing to pass. This further escalation of the trade war between the world's two largest individual economies almost a year after it began sharpened concerns about the global outlook and shook financial markets.

Now, the two involved parties have once again announced that talks will take place in September, with a delegation from Beijing visiting Washington D.C. However, as we've mentioned previously, the conflict between the US and China goes far beyond trade concerns (e.g. technology, intellectual property rules). We therefore expect a continuation of the conflict with occasional flare-ups interspersed with periods of calm that leave a cloud of uncertainty lingering over businesses and from time to time cause major disruptions in financial markets.

New Italian government

Another risk factor that temporarily resurfaced over the summer months was political turbulence in Italy. In late-August, Italian Prime Minister Conte stepped down after a motion of no confidence was tabled against him by the leader of the far-right Lega Nord party, Matteo Salvini. The possibility of early elections rose dramatically, and with it the risk of problems surrounding Italy's 2020 budget – a draft of which needs to be submitted to the European Commission by the end of this month.

However, at the end of August, the centre-left Democratic Party and the populist Five Star Movement agreed to form a coalition government, with Conte remaining as Prime Minister. The relatively surprising agreement between the two parties avoids early elections and eased market concerns about Italy, at least temporarily. The spread between the Italian 10-year bond yield and the German 10-year bond yield declined sharply, and we now expect it to stay lower for the next few quarters. However, further political disruptions in Italy down the road are certainly still possible.

Ongoing twists and turns in the Brexit saga

The Brexit saga continues to take unexpected twists and turns, and while the 31 October scheduled date for the departure of the UK from the EU is rapidly approaching, when and precisely how the UK might leave remain unclear. Risks stemming from the Brexit saga escalated over the summer with the election of Boris Johnson as the UK's prime minister. Johnson's repeated determination to take the UK out of the EU on 31 October with or without a deal, and his willingness to bypass parliament to do so, sharply increased market fears of a hard Brexit.

At the beginning of September however, Johnson lost his majority in Parliament. In defiance of Government, Members of parliament subsequently passed a bill that requires the UK to request a Brexit delay until January 31 if no deal is reached. Parliament has also denied Johnson's request for new elections to be held before the 31 October deadline. These new developments are being interpreted by markets as materially easing the risk that the UK would crash-out from the EU. However, between now and the end of October, there may be many more twists and turns and perceived risks can still tilt again.

On balance, we continue to expect a short delay of Brexit until early next year, reflecting both an expected election before end-year and logistical difficulties in having legislation and technical preparations in place. In such circumstances, a transition deal will be agreed upon, opening up the prospect of possibly even more complicated discussions around the UK's future relationship with the EU. Therefore, even if the risks of a no-deal Brexit appear to have declined, we expect a strong degree of uncertainty stemming from Brexit to remain present in the coming months.

Honk Kong protests surfacing as a risk factor

The protests in Hong Kong have also surfaced as an important risk factor for the global economy given the importance of Hong Kong to China's economy and its role as an international financial hub. Hong Kong is China's third largest trading partner in terms of export destinations, receiving about 12% of China's exports. It also is seen as a gateway for investments flowing both in and out of China. Over 70% of foreign direct investment into China comes via Hong Kong and about 57% of China's overseas direct investment leaves China through Hong Kong. This is because international investors generally prefer the legal framework and investor protections present in Hong Kong. Furthermore, Hong Kong has positioned itself as an international financial hub, with average foreign exchange turnover of around USD 632 billion each day (larger than that of Tokyo and just under half the amount transacted in New York). Severe business disruptions in Hong Kong, therefore, could certainly spill over to China, and even lead to possible financial market disruptions globally. Finally, the protests, which call for democratic reforms for the special administrative region of China, could complicate trade negotiations between the US and China. Protesters are already calling for help from the US government and marched on the US Consulate in Hong Kong last week. Though the Hong Kong government finally withdrew the extradition bill that sparked the protests, risks related to the protests have not declined, as the protesters are demanding more fundamental changes.

In general, however, tensions dragging on the global economy and spurring risk aversion have eased somewhat compared to the summer months. Reflecting this, benchmark bond yields have bounced slightly off their recent lows. While 10-year yields in a number of countries, including Germany, France, Belgium and the Netherlands remain in negative territory, they are no longer dropping sharply as they were throughout the summer. Given that all of the risks discussed above persist, we still expect some volatility in long-term yields going forward. However, despite that volatility, we mostly see yields remaining around current levels through the end of the year, before starting a gradual normalisation. Furthermore, intra-EMU spreads relative to Germany are also expected to remain low and around current levels given expectations for easy monetary policy for an extended period.

We also continue to see the possibility of more volatility and weakness for the EUR versus the USD in the short term given the remaining risks present in the global economy and the possibility that these risks escalate once again. However, in the longer run we still expect a mild appreciation path for the EUR given current valuations.

Central and Eastern European Economies

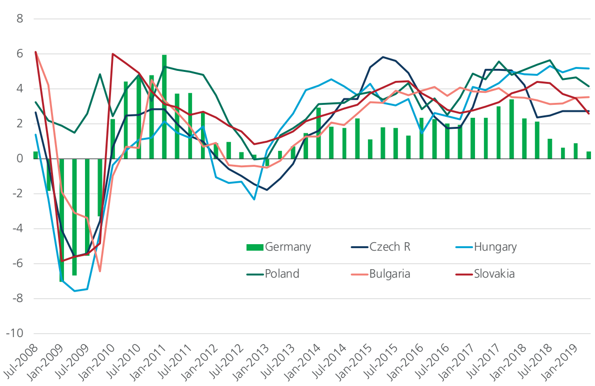
Resilience in focus

The latest GDP data continue to support the story of solid resilience in Central European economies towards the German slowdown. The majority of regional economies continued to expand at levels close to their average long-term growth rates, ranging from 0.7% qoq in the Czech Republic to 1.1% qoq in Hungary (figure CE1). Though growth did decelerate sharply in Slovakia, the big picture still remains intact; the German contraction has so far not had a significant impact on regional trade, and only a limited impact on investment activity.

The Czech economy managed to maintain a roughly stable growth rate in Q2 2019. Industry – formerly the largest and strongest engine of the economy – was replaced by services and construction, while on the demand side, household consumption has retained its leading role. A significant slowdown in investment activity in the corporate sector, meanwhile, can be attributed to the completion of large investments rather than a growing unwillingness to continue investing due to increasing risks and uncertainties. The Czech economy started the third quarter briskly too, as the figures from industry, trade and construction suggest.

The Hungarian economy also looks to be quite resilient so far. The latest figures from the retail and industrial sectors were quite strong. On the retail side, the main driver was the sale of non-food products, but fuel consumption also rose substantially. The main difference compared to previous years is a rapid increase in consumer loans, which suggests that the extra household spending comes from not only net real wage growth, but also from credit, which is less sustainable in the medium and long term. The industrial sector benefited from strength in the auto industry (see box CE1) and the fruition of previous investments.

Figure CE1 - Real GDP growth
(year-on-year change, %)



Source: KBC Economics based on Eurostat

Bulgaria also continues to record a strong economic growth performance. According to the preliminary GDP estimate, the economy expanded by 3.5% yoy in Q2 2019, maintaining its pace relative to the first three months of the year. On a quarterly basis, however, economic activity decelerated to 0.8% from 1.2% in the first quarter, pointing to a less rosy picture for the remainder of 2019.

The only exception was Slovakia, where in addition to more significant external weakness, seasonal adjustment difficulties could have played a role in leading to lower growth (from 3.7% to 2.0% yoy not seasonally adjusted).

Nevertheless, the region has proven mostly resilient to the German contraction so far. The question is, how long can this last?

How long can the resilience last?

Some factors currently offsetting the German weakness in Central Europe are temporary. For example, most Central European economies are less exposed to weaker Chinese demand than Germany. This could have played an offsetting role during the escalation of the trade war in Q2. Nevertheless, later on this year we may see a cool-down in German domestic demand, which would imply weaker exports and investment activity in Central Europe as well. Furthermore, during Q3, a hard Brexit once again became a more visible risk along with trade wars. And with regard to demand from the UK, several Central European economies are even more vulnerable than Germany (figure CE2).

As such, the longer the German recession and Brexit uncertainty will last, the more challenging it will be for the region to maintain its resilience. For example, in the Czech Republic, while hard data still appear favourable, soft indicators – especially the PMI – indicate that Czech companies have very negative expectations for the coming months (influenced as well by the

Box CE1 – Fleeting boost to industry from Czech and Hungarian auto sectors

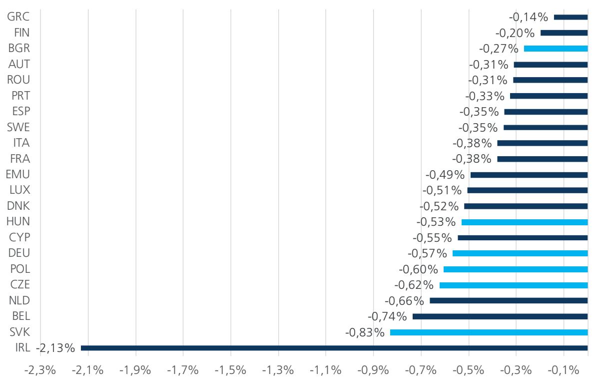
Strong performances in the automotive industries in both the Czech Republic and Hungry helped boost their respective industrial sectors in July. In the Czech Republic, new orders (including foreign ones) increased significantly, thanks in part to solid demand for production in the auto sector. The largest domestic car manufacturer in particular managed to succeed in the ailing European market with its new SUV models. In Hungary as well, industrial production delivered a big surprise in July, with its highest read of the year. The working-day adjusted figure showed an 8.7% yoy increase, mainly driven by the automotive industry.

However, the signal from the July figures should not be overestimated. In the Czech Republic they were influenced by the later start of the holiday in all three carmakers. As such, while the July figures were excellent, the August ones will be much worse. Similarly, the impressive industrial production growth figure in Hungary is not sustainable, especially since vehicle demand is not too promising. It wouldn't be surprising, therefore, if this outstandingly good figure is followed by a weak one in August, when lots of the factories were closed because of the holiday period.

'green wave' in the automotive industry). Nevertheless, for now we expect no hard Brexit and only a mild German recession in 2H 2019. Hence, we believe in only a moderate natural slowdown of Central European economies through 2020. And even in the case of more significant German troubles, there are more permanent factors that can offset external weakness.

In countries such as Poland and Hungary, loose monetary and fiscal policy, as well as ongoing heavy inflow of EU funds, can play a significant positive role. This is less the case for the Czech Republic, Slovakia and Bulgaria, where we see already certain weakness in investment activity. Even so, all the regional countries can still rely on a strong consumer fuelling domestic consumption. That is why a major regional cooldown would require a more significant and longer-lasting external shock (such as a hard Brexit).

Figure CE2 - Impact of decrease in UK imports from EU by 50%
(2014, % change in value added)



Source: KBC Economics based on WIOT

Box CE2 – Currency weakness is not just about Brexit

Central European currencies are having a difficult time even though the world's key central banks are back in the mode of monetary policy loosening, which usually helps regional assets. The principal external negative factors working against regional currencies are, naturally, Brexit and the related slowdown of Germany, which is the main trading partner for Central European economies. However, Central European currencies also face some negative domestic factors that put them under pressure.

Let's start with the Polish zloty, which will face two specific domestic factors within a month. One is a threat that may come from the European Court of Justice (CJEU). The CJEU should arrive at a decision regarding Polish mortgages previously provided in Swiss francs, with Polish banks facing possible fines totalling up to 3.0% of GDP. The Polish zloty does not like that. The court's decision should be made in late September or early October. Another short-term domestic risk factor for the zloty is the upcoming Parliamentary election planned for 13 October. While a change of government is not expected, it cannot be excluded that no party will have a majority and, in that case, it will be more difficult to form a coalition.

A negative domestic factor which is currently working against both the Hungarian forint and the zloty is the relatively relaxed monetary policy stance in Hungary and Poland, respectively. Due to accelerating inflation and very low interest rates applied by the National Bank of Hungary and the National Bank of Poland, real interest rates are now significantly negative in Hungary and Poland, which makes both the HUF and PLN less attractive in comparison to other currencies (and not only in emerging markets).

Finally, we should also mention a purely technical factor, which is, however, indirectly related to the situation in the export-oriented regional industry. Exporters' market behaviour, as well as central banks' surveys, indicate that the level of Czech and Hungarian exporters' FX hedging is relatively high, which means that they no longer have enough ammunition to support the koruna or the forint, respectively, in the event of currency weakness.

Box CE3 – Some fiscal deterioration for the fiscally responsible

In Bulgaria, the government has managed to keep the fiscal position in a surplus since 2016. However, the positive trend is likely to reverse this year. Though the government initially planned only a slight budget deficit of 0.5% of GDP for 2019, markedly higher defence spending (a purchase of new F-16 fighter aircrafts) in combination with increased spending on infrastructure and healthcare will likely result in a substantially higher deficit of 2.0% of GDP. Still, we expect fiscal discipline to be preserved. First, these measures are one-offs that will not deteriorate the outlook for 2020. Second, given a solid budget performance history and the overall low level of general government debt (19% of GDP), we believe that the government has the capacity to finance these measures without threatening fiscal sustainability.

It is also likely that Slovakia will not achieve a balanced budget this year according to the forecast of the independent fiscal council. The 2019 government deficit is likely to at least equal that of 2018 (0.7% of GDP). The economic slowdown makes it harder to achieve income targets. Furthermore, expenditures are growing, and politicians are unwilling to take measures on the expenditure side of the budget ahead of the upcoming parliamentary election in February 2020. However, public debt currently amounts to 48.9% of GDP and is below the penalty limit established by the constitutional act on budgetary responsibility. It is also much lower than the norm in the EMU. The risk premium on Slovakian sovereign debt remains low (around 40 bps over Bunds) and the expectation, and now announcement, of a further round of ECB quantitative easing has likely contributed to the narrow spread.

In the Czech Republic as well, medium- and longer-term bond market yields are not responding to the fiscal expansion that the domestic government wants to continue in 2020. The planned deficit – amounting again to CZK 40 billion – will entail a further increase in sovereign debt. In relation to GDP, however, debt should decrease slightly again thanks to GDP growth, and the Czech Republic will thus retain its position as one of the least indebted EU countries.

Czech Republic

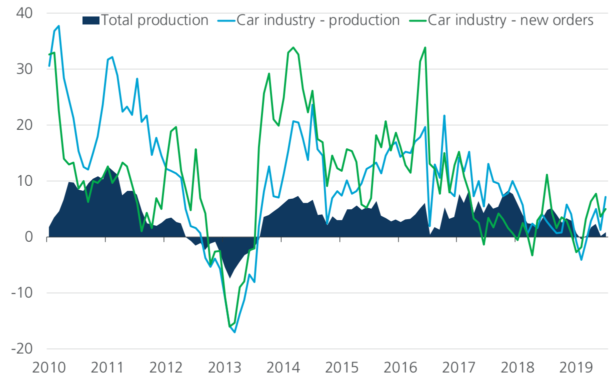
Despite inflation, risks keep interest rates roughly stable

In spite of the negative outlook of Czech companies, vacancies are still growing, and unemployment remains close to historical lows. Even a record-breaking employment rate of domestic and foreign workers has not yet alleviated tensions on the labour market. The result of these tensions is pressure on wages, which rose by 7.2% yoy in the second quarter, supported by a generous increase in salaries in the public sector.

Yet, even such wage pressure has not been significantly reflected in inflation. Although inflation remains in the upper half of the CNB's tolerance band and is currently even above the central bank's forecast (2.9% vs 2.6% yoy), its main cause is the rising cost of housing. This includes, primarily, record-breaking real estate prices and, consequently, rents reflecting a long-term insufficient supply of new flats, as well as energy prices in response to developments on foreign commodity exchanges. Inflation based on rising labour costs is reflected only in personal services and in hotel and restaurant prices, which have sustained a tendency to grow since the introduction of electronic registration of sales. We expect higher inflation in the coming months as well, when it will start to be influenced to a larger extent by rising food prices.

Despite increased inflation and a weaker Czech koruna, the CNB has kept its interest rates unchanged. Given that headline inflation, as well as core and monetary-policy relevant inflation, will return to the target value only sometime at the end of next year, the central bank can continue to wait on any adjustment of its policy stance. Although its current forecast assumes an increase and subsequent decline in the CNB's main interest rate, the accumulation of external risks and uncertainties will rather encourage cautious action. We assume that a significantly weaker expected economic result will cause the CNB to make one symbolic rate cut next year. However, financial markets still implicitly anticipate that interest rates will be significantly lower in the Czech Republic within a one-year horizon. In our opinion, these implicit rates reflect the extreme current surplus of liquidity and respond promptly to the euro curve development rather than domestic expectations.

Figure CZ1 – Czech Republic industrial production
(3-month moving average, year-on-year change in %)



Source: KBC Economics based on CSU

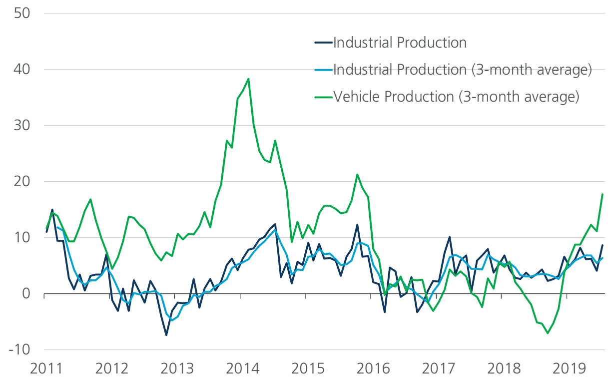
Hungary

Even with growth on strong footing, a dovish policy stance prevails

The Hungarian economy appears to have started the third quarter on strong footing with strength in both the retail and industrial sectors. Working-day adjusted retail sales were up by 6.4% yoy in July, exceeding the average performance of 5.8% yoy in the first 7 months of the year. In addition to the temporary boost from the automotive sector (see box CE1), resilience in the industrial sector, despite the worsening external environment, may be thanks to investments in previous years starting to work in full capacity this year. Strength in the industrial sector pushed up exports in July as well (7.6% yoy - the highest read in the last 12 months), leading to a larger surplus on the trade balance than a year earlier. We don't expect any sudden collapse in growth, but we do think that the August figures – especially in case of the industrial production and exports – may be substantially weaker. As such, we still forecast some slowdown for Q3 2019 to around 4.2% yoy, which would still lead to annual growth of 4.3% in 2019.

The National Bank of Hungary (NBH) left all its monetary policy tools unchanged in August, with a slightly dovish stance. The council highlighted that the deterioration of the external environment may slow Hungarian economic growth next year. They emphasized that inflation has started to moderate in recent months as they forecasted in their latest inflationary report, and they expect that core inflation will meet their 3% inflation target from next year. Based on the NBH statement we maintain our view of no monetary policy change in September. Although we see inflation remaining well above 3% yoy at least until the middle of next year, we expect that the NBH may remain in wait and see mode in the coming quarters. As we expect the economy to start to slow next year, the pressure on NBH to move towards monetary tightening may fade away. Furthermore, with no monetary tightening coming from the major central banks, the NBH will maintain its loose approach. A main risk to this outlook would be some substantial shock in markets that includes a significant weakening of the HUF, which is not our base case scenario at the moment. We therefore expect no major monetary policy adjustment this year or the next. The NBH may, however, fine-tune its monetary policy stance with foreign currency swaps as it did it in recent weeks.

Figure HU1 – Hungary industrial production
(year-on-year change in %)



Source: KBC Economics based on HCSO, Eurostat

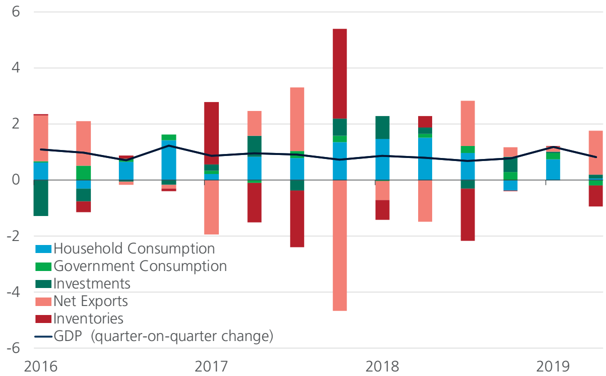
Bulgaria

Growth composition paints a less rosy picture

Though the Bulgarian economy maintained a strong pace of growth in Q2 2019 (3.5% yoy), the composition of growth was less buoyant than in the previous quarter. First, household consumption, the major growth driver in recent quarters, is losing momentum, slowing from 4.3% yoy to 2.1% yoy (or 0.1% qoq). This weakness, which is also visible in sluggish retail sales, comes despite a sustained downward trend in unemployment (the unemployment rate declined to a historic low of 4.4% in Q2 2019 compared to 5.7% a year earlier) and dynamic wage growth (4.3% qoq in Q2). The deceleration in consumption growth instead resulted from more pessimistic consumer sentiment and higher inflationary pressures in Q2. Although household consumption is to remain the main engine of growth, supported by the favourable labour market conditions, the recent slowdown is likely to be extended into H2 2019.

A second underlying weakness is apparent in the external sector. Though the contribution of net exports to real GDP growth turned positive, it was largely due to a surprising drop in imports, while export performance lost traction with a decline of 2.9% qoq. This is, in our view, a response to the more challenging external environment, i.e. a slowdown in Germany and Turkey, and continued trade tensions in the global economy. Weaker growth in key trading partners is set to be a drag on Bulgaria's growth going forward. Last but not least, investment growth is holding on relatively well, but continues to be hindered by a slow implementation of the EU-funded projects. There could, however, be some upside surprise to investments if an increased absorption of EU funds materialises.

Figure BG1 – Bulgaria real GDP growth
(quarter-on-quarter change in %, growth contributions in percentage points)



Source: KBC Economics based on Eurostat

In addition to the less supportive growth composition, employers are finding it increasingly difficult to find suitably-skilled workers on the local market. A possible solution to the growing labour shortage is to attract foreign workers. However, this is taking place only gradually due to administrative bottlenecks. Accordingly, we consider a further tightening of the labour market and rising labour costs to be a risk to Bulgaria's competitiveness should productivity growth remain sluggish. Overall, we expect to see a further easing of economic activity for the remainder of this year, with annual growth reaching 3.2% in 2019 and 3.1% in 2020. The deteriorating external environment represents the main downside risk to our outlook.

Slovakia

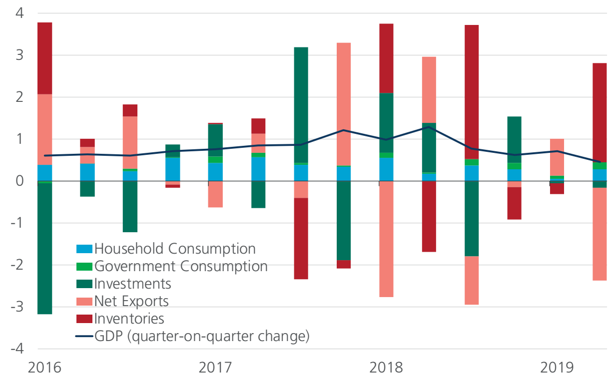
Economic growth slows drastically

Economic growth decelerated sharply in the second quarter, from 3.7% to 2.0% yoy not seasonally adjusted (or from 3.4% to 2.6% yoy seasonally adjusted according to Eurostat). GDP growth was the slowest in five and half years. The slowdown is mainly the result of negative developments for Slovakia's largest trading partners (especially Germany), which in turn affected net exports and investments. Exports of goods and services decreased nearly 2% yoy. This follows growth of nearly 7.2% yoy in the first quarter. Import growth slowed as well as a result of the declining exports and the end of imported capital goods for the construction of the new automotive plant. Investment decreased 3.8% yoy, which is the worst result in the last year. The investment decline affected the public and private sectors equally, with notable impacts including lower investment in machinery and slower building construction. Government consumption, meanwhile, increased by 4.2% yoy, its fastest growth in the last three years. Wage increases in the public sector of up to 10% (e.g. for new teachers) played a major part in this.

In the overall economy, average wages increased by 9.7% yoy, the most since 2007. Pay increases in the private sector were driven by labour shortages. Unemployment is at a record low level. It has been flat for the last three months though, which may point to an eventual slow reversal. While wage growth supported household spending, which grew 1.9% yoy, the overall impact is disappointing. The enormous growth in wages had a much stronger effect on savings (up more than 10% yoy), which exceeded its peak in 2000. Current trends point to a cooling in growth that will probably continue in 2020.

In July inflation grew to 2.9% yoy, its highest level since April 2018. The main contributing factors were increased food and fuel prices. As an indicator of demand pressure, net inflation (excluding regulated prices, food and changes in indirect taxes) increased only slightly, from 1.8% to 1.9% yoy. A contributing factor was more expensive foreign holidays. A slowdown in economic activity in the second half of the year could contribute to a decrease in inflation. Any increase in tariff barriers in international trade would have the opposite effect, however.

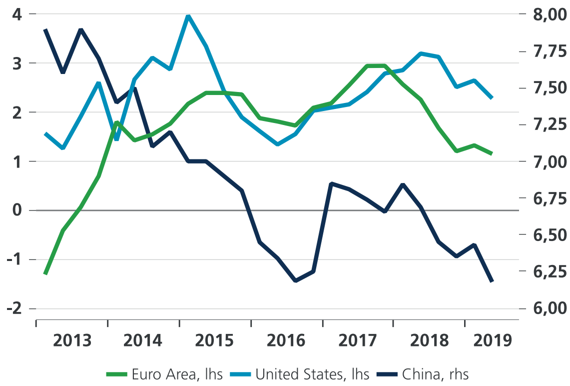
Figure SK1 – Slovakia real GDP growth
(quarter-on-quarter change in %, growth contributions in percentage points)



Source: KBC Economics based on Eurostat

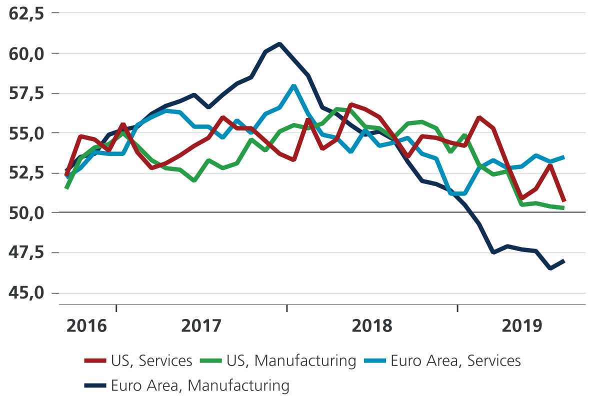
Figures

Real GDP
yearly change in %



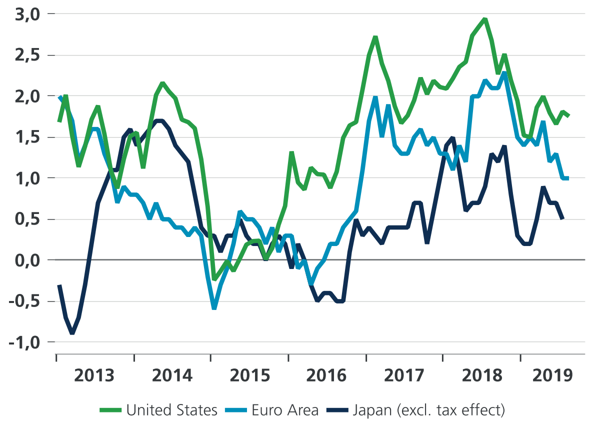
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



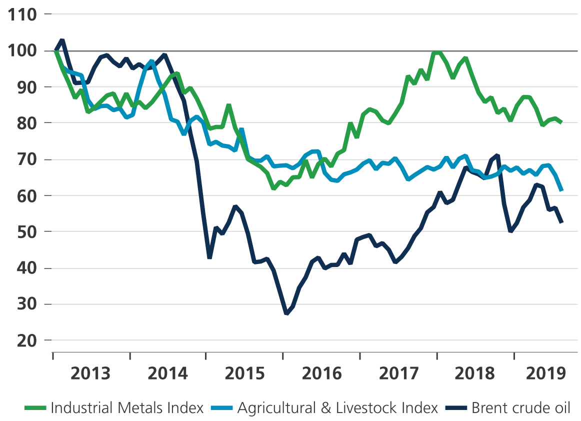
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



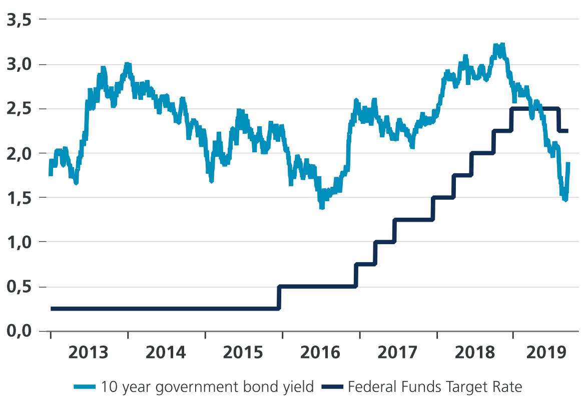
Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, BLS

Commodity prices
index, January 2013=100, in USD



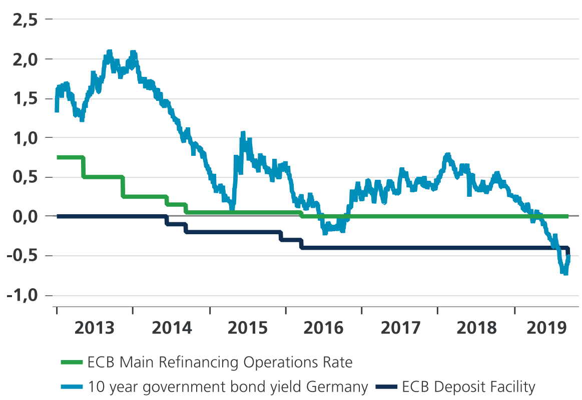
Source: KBC Economics based on World Bank, S&P

United States interest rates
in %



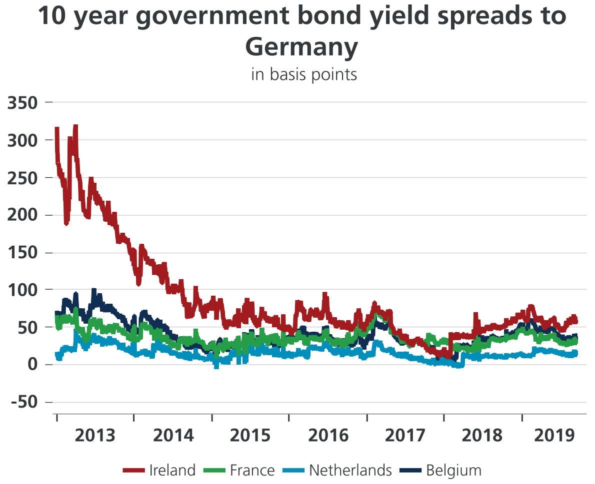
Source: KBC Economics based on Fed, Macrobond

Euro area interest rates
in %

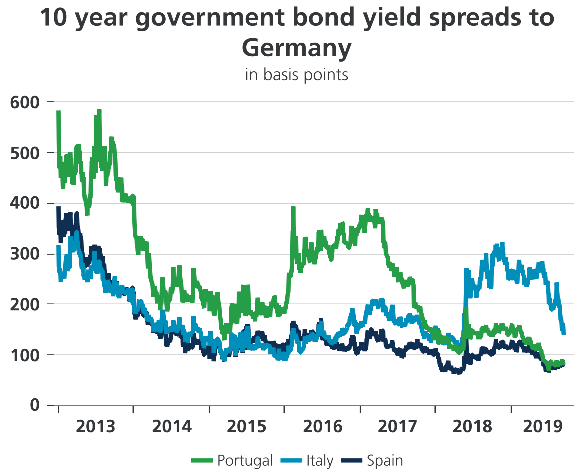


Source: KBC Economics based on Macrobond, ECB

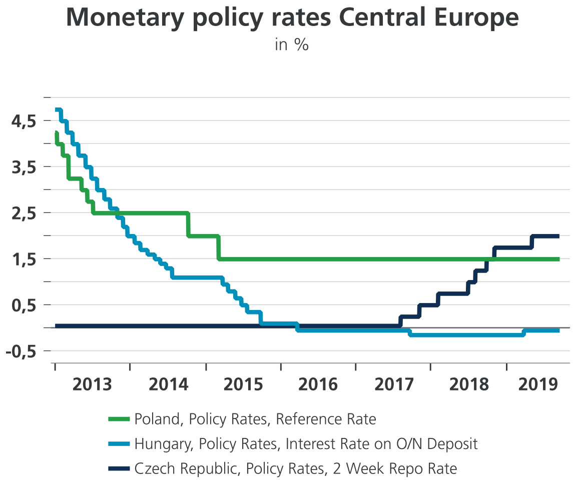
Figures



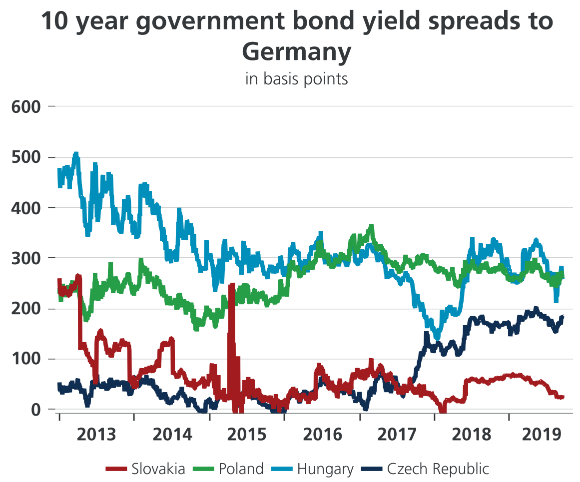
Source: KBC Economics based on Macrobond



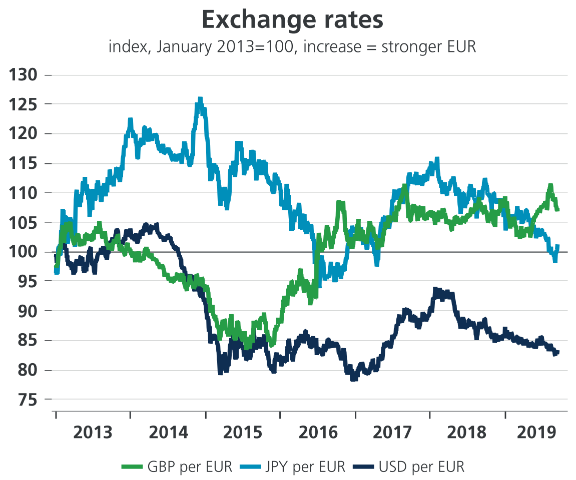
Source: KBC Economics based on Macrobond



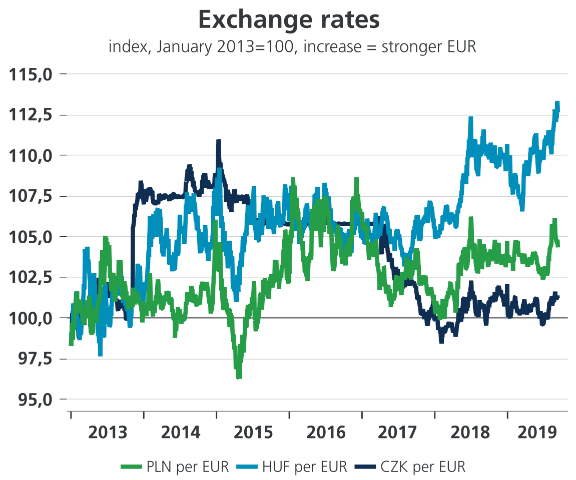
Source: KBC Economics based on CNB, MNB, NBP



Source: KBC Economics based on Macrobond, AKK, Eurostat



Source: KBC Economics based on Macrobond



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	1.9	1.1	1.1	1.8	1.3	1.5
	Germany	1.5	0.5	0.8	1.9	1.4	1.5
	France	1.7	1.2	1.1	2.1	1.3	1.6
	Italy	0.7	0.1	0.4	1.2	0.8	1.2
	Spain	2.6	2.1	1.7	1.7	1.2	1.6
	Netherlands	2.6	1.9	1.7	1.6	2.3	1.6
	Belgium	1.4	1.1	0.8	2.3	1.7	1.6
	Ireland	8.2	5.0	3.0	0.7	1.3	1.8
	Slovakia	4.1	2.8	2.2	2.5	2.5	2.2
Central and Eastern Europe	Czech Republic	2.9	2.4	2.2	1.9	2.4	2.4
	Hungary	4.9	4.3	3.5	2.9	3.4	3.5
	Bulgaria	3.1	3.2	3.1	2.6	2.5	2.3
	Poland	5.1	4.4	4.2	1.2	2.1	2.7
	Romania	4.4	3.6	3.5	4.2	3.4	3.3
Rest of Europe	United Kingdom	1.4	1.2	1.1	2.5	1.8	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	6.1	5.7	2.1	2.4	2.5
	India*	6.8	6.2	7.0	3.9	3.6	4.3
	South Africa	0.8	0.6	1.3	4.6	4.5	5.0
	Russia	2.3	1.2	1.7	2.9	4.5	3.7
	Turkey	2.6	-0.5	2.5	16.3	17.0	12.0
	Brazil	1.1	0.9	2.1	3.7	3.9	3.8
Other advanced economies	United States	2.9	2.3	1.7	2.4	1.9	2.1
	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

16/09/2019

Policy rates (end of period, in %)		16/09/2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
Euro area	Euro area (refi rate)	0.00	0.00	0.00	0.00	0.00
	Euro area (depo rate)	-0.50	-0.50	-0.50	-0.50	-0.50
Central and Eastern Europe	Czech Republic	2.00	2.00	2.00	1.75	1.75
	Hungary	-0.05	-0.05	-0.05	-0.05	-0.05
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.75
	Romania	2.50	2.75	2.75	2.75	2.75
Rest of Europe	United Kingdom	0.75	0.75	0.75	0.75	0.75
	Sweden	-0.25	-0.25	-0.25	-0.25	-0.25
	Norway	1.25	1.25	1.50	1.50	1.50
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	3.30	3.20	3.10	3.10	3.10
	India	5.40	5.40	5.00	5.00	5.00
	South Africa	6.50	6.50	6.25	6.25	6.25
	Russia	7.00	7.00	6.75	6.50	6.50
	Turkey	16.50	17.00	15.00	15.00	14.00
	Brazil	6.00	5.50	5.50	5.50	5.50
Other advanced economies	United States (upper limit)	2.25	2.00	1.75	1.75	1.75
	Japan	0.00	-0.10	-0.10	-0.10	-0.10
	Australia	1.00	1.00	1.00	1.00	1.00
	New Zealand	1.00	1.00	1.00	1.00	1.00
	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 %)		16/09/2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
Euro area	Germany	-0.48	-0.70	-0.70	-0.60	-0.50
	France	-0.20	-0.40	-0.40	-0.30	-0.20
	Italy	0.88	0.80	0.90	1.00	1.10
	Spain	0.26	0.05	0.05	0.15	0.25
	Netherlands	-0.35	-0.55	-0.55	-0.45	-0.35
	Belgium	-0.15	-0.30	-0.30	-0.20	-0.10
	Ireland	0.05	-0.15	-0.15	-0.05	0.05
	Slovakia	-0.18	-0.35	-0.30	-0.20	-0.10
Central and Eastern Europe	Czech Republic	1.42	1.05	1.05	1.15	1.25
	Hungary	2.13	1.80	1.80	1.90	2.00
	Bulgaria	0.43	-0.10	-0.10	0.00	0.10
	Poland	2.13	1.90	2.00	2.10	2.20
	Romania	4.25	5.30	5.80	5.80	5.80
Rest of Europe	United Kingdom	0.71	0.45	0.40	0.50	0.60
	Sweden	-0.13	-0.40	-0.40	-0.30	-0.20
	Norway	1.38	1.05	1.05	1.15	1.25
	Switzerland	-0.69	-1.05	-1.05	-0.95	-0.85
Emerging markets	China	3.11	3.00	3.00	3.10	3.20
	India	6.71	6.50	6.45	6.55	6.45
	South Africa	8.23	8.20	8.20	8.30	8.40
	Russia	7.00	7.10	7.10	7.05	7.00
	Turkey	14.77	15.00	15.00	14.50	14.50
	Brazil	7.38	7.35	7.20	7.30	7.40
Other advanced economies	United States	1.84	1.60	1.60	1.70	1.80
	Japan	-0.16	-0.20	-0.10	0.00	0.00
	Australia	1.17	0.90	0.90	1.00	1.10
	New Zealand	1.36	1.00	1.00	1.10	1.20
	Canada	1.47	1.15	1.15	1.25	1.35

Exchange rates (end of period)	16/09/2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
USD per EUR	1.10	1.11	1.14	1.15	1.16
CZK per EUR	25.88	25.90	25.70	25.50	25.50
HUF per EUR	331.88	330.00	323.00	323.00	323.00
PLN per EUR	4.32	4.39	4.28	4.28	4.25
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.73	4.77	4.78	4.78	4.78
GBP per EUR	0.89	0.90	0.88	0.90	0.91
SEK per EUR	10.67	10.55	10.45	10.40	10.35
NOK per EUR	9.90	9.70	9.50	9.45	9.40
CHF per EUR	1.09	1.11	1.12	1.13	1.14
BRL per USD	4.09	4.05	4.00	4.00	3.95
INR per USD	71.57	71.50	70.30	70.25	70.15
ZAR per USD	14.64	14.90	14.80	14.70	14.70
RUB per USD	64.03	66.00	66.00	65.00	64.00
TRY per USD	5.71	5.75	6.00	6.00	6.10
RMB per USD	7.07	7.12	7.15	7.15	7.15
JPY per USD	107.83	106.00	106.00	106.00	106.00
USD per AUD	0.69	0.70	0.70	0.71	0.71
USD per NZD	0.64	0.66	0.66	0.67	0.67
CAD per USD	1.33	1.30	1.30	1.30	1.30

Outlook KBC home markets

	Belgium			Ireland		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	1.4	1.1	0.8	8.2	5.0	3.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.7	1.6	0.7	1.3	1.8
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.8	5.7	5.9	5.6	4.8	4.9
Government budget balance (in % of GDP)	-0.7	-1.6	-2.3	0.0	0.3	0.4
Gross public debt (in % of GDP)	102	101.5	101.4	64.0	61.0	57.0
Current account balance (in % of GDP)	-1.3	-1.4	-1.8	9.1	7.5	6.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	2.9	2.6	2.1	10.2	2.5	2.5

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	Czech Republic			Slovakia		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	2.9	2.4	2.2	4.1	2.8	2.2
Inflation (average yearly change, harmonised CPI, in %)	1.9	2.4	2.4	2.5	2.5	2.2
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.0	2.0	2.1	6.1	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	31.0	30.2	49.0	48.0	47.0
Current account balance (in % of GDP)	0.3	0.2	0.1	-2.0	-1.5	-1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	8.6	5.0	2.0	7.4	5.0	4.0

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	Hungary			Bulgaria		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	4.9	4.3	3.5	3.1	3.2	3.1
Inflation (average yearly change, harmonised CPI, in %)	2.9	3.4	3.5	2.6	2.5	2.3
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	3.6	3.5	3.5	4.8	4.7	4.6
Government budget balance (in % of GDP)	-2.2	-1.8	-1.0	0.1	-0.5	0.4
Gross public debt (in % of GDP)	70.8	68.7	65.9	22.1	19.0	17.7
Current account balance (in % of GDP)	0.5	-0.2	-1.0	2.4	1.2	1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	9.7	9.0	9.0	6.6	5.0	4.0

16/09/2019

Contacts

KBC Group Economics and Markets (GEM)

Economic Research (KBC)	**Market Research (KBC)**	**CSOB - GEM Prague**	**CSOB Slovakia**	**UBB Bulgaria**
Jan Van Hove	Mathias Van der Jeugt	Martin Kupka	Marek Gábriš	Petya Tsekova
Group Chief Economist	Head of Market Research	Chief Economist	Analyst	Chief Economist
chiefeconomist@kbc.be	mathias.vanderjeugt@kbc.be	mkupka@csob.cz	mgabris@csob.sk	cekova_p@ubb.bg
Dieter Guffens	Peter Wuyts	Petr Dufek		Petar Ignatiev
Senior Economist	FX Analyst	Senior Analyst		Chief Analyst
dieter.guffens@kbc.be	peter.wuyts@kbc.be	pdufek@csob.cz		Petar.Ignatiev@ubb.bg
			K&H Bank Hungary	
Johan Van Gompel	Mathias Janssens	Jan Cermák	Dávid Németh	
Senior Economist	Analyst	Senior Analyst	Chief Economist	
johan.vangompel@kbc.be	mathias.janssens@kbc.be	jcermak@csob.cz	david2.nemeth@kh.hu	
Lieven Noppe		Jan Bureš		
Senior Economist		Senior Analyst		
lieven.noppe@kbc.be		jabures@csob.cz		
			KBC Bank Ireland	
Cora Vandamme		Petr Báca	Austin Hughes	
Economist		Analyst	Chief Economist	
cora.vandamme@kbc.be		pbaca@csob.cz	austin.hughes@kbc.ie	
	CBC			
Jill Van Goubergen	Bernard Keppenne	Irena Procházková	Shawn Britton	
Economist	Chief Economist	Analyst	Economist	
jill.vangoubergen@kbc.be	bernard.keppenne@cbc.be	iprochazkova@csob.cz	shawn.britton@kbc.ie	
Allison Mandra		Dominik Rusinko		
Economist		Analyst		
allison.mandra@kbc.be		drusinko@csob.cz		
		Wouter Beeckman		
		Analyst		
		wbeeckman@csob.cz		

For general information:

Sandy Schutyser (Management Assistant Jan Van Hove)	sandy.schutyser@kbc.be

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Contact: Jan Van Hove, Chief Economist KBC Group NV, Havenlaan 2, B-1080 Brussels, Belgium
Responsible editor: KBC Groep NV, Havenlaan 2 – 1080 Brussel – België – BTW BE 0403.227.515 – RPR Brussel
E-mail: economic.research@kbc.be