UBB
Part of KBC Group

February 2019

Highlights

- Temporary factors that slowed euro area economic growth in Q3 2018 have proven longer lasting than expected and persisted into the final quarter of 2018. Moreover, they, look to have remained in place into early 2019 as well. The outlook is, however, not all negative. There are still several elements that suggest a modest rebound in the second half of 2019. Based on recent developments and the technical consequences of a materially weaker starting point to the year, we have downgraded our annual GDP growth forecasts for the euro area to 1.1% for 2019 (from 1.5%). For 2020, our growth forecast stays at 1.4%.

- Activity data in the US economy remain strong, but there are early signs that suggest that the growth peak is behind us. In addition to the impact of the trade war, the general global economic slowdown and the late-cycle state of the US economy are beginning to take some toll. For these reasons, we slightly lowered our US growth forecasts for 2019 to 2.3% (from 2.5%) and to 1.8% for 2020 (from 2.0%).

- Central banks of major economies have sounded a more cautious note given declining growth and lower inflation expectations. Both the Fed and the ECB have recently signalled that they are currently assessing the state of the economy before implementing or changing any policy plans. For the Fed, we only expect one more rate hike in 2019. For the ECB we stick to our scenario of gradually increasing interest rates starting at the end of 2019. Long-term government bond yields have been dampened by lower expectations for short-term rates and continued safe haven effects.

Global economy

International slowdown

Various international institutions and professional forecasters have lowered their growth forecasts for the global economy for 2019 and beyond. This is no surprise given the uncertainty surrounding the global economy and continuing signs of economic weakening, which started in the second half of 2018 and have carried over into 2019. Though some factors are likely to be temporary, they will still weigh on the growth outlook for 2019 quite strongly, Some recovery in growth is still expected though, in particular in the European economies.

Sluggish euro area growth

The temporary factors that have been holding back euro area economic growth since Q3 2018 have lasted longer than initially expected. As a consequence, the disappointing economic results for the second half of 2018 are set to feed through into 2019 as well. A combination of external and internal factors has led to this. The loss of support from the external environment was in part due to international trade conflicts, in particular between the US and China. Although the EU is not directly targeted by any of the increased tariff rates, the bilateral US-China trade dispute, together with US threats to impose higher tariffs on car (parts) exports from the EU to the US, has significantly increased uncertainty. Related to this, but also due to other factors, there was a deterioration in the global manufacturing or tradeable goods sector.

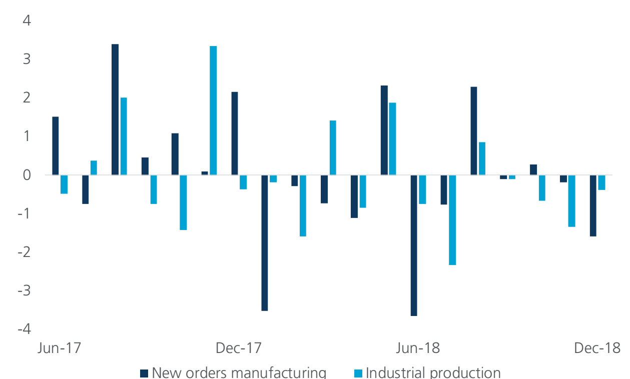
This has all been reflected in a continued downtrend of business sentiment, in particular in the manufacturing sector. Although we saw some cautious recovery of manufacturing corporate sentiment indicators in Spain and France in January, it is too early to expect a reversal in the rest of the euro area. In particular, sentiment in German manufacturing continues to decline. Moreover, the European Commission's Economic Sentiment Indicator, though still above its long-term average, has dropped significantly since the start of 2018. Overall, these leading indicators suggest a continuation of rather sluggish momentum at the start of 2019.

These developments in 'soft' indicators have also translated into weaker activity data. Euro area export growth slowed down in the second half of 2018. Import growth decelerated as well, but to a lesser extent, resulting in a negative contribution of net exports in Q3 and likely also in Q4 of 2018 (GDP growth composition for Q4 have not been published yet).

Besides external factors, euro area growth has also been dragged down by domestic or country-specific elements. Due to production challenges in the automobile sector to get certification under a new emission testing procedure, car production in Q3 was negatively impacted. While this was a disruption shared across the EU, the problems were particularly pronounced in Germany. Car manufacturers had to decrease production in Q3 and figures have only partially recovered since. Companies producing car parts were heavily affected too. The car sector difficulties were in turn also reflected in weaker private consumption figures in Q3. The struggles in German manufacturing seem to be more broad-based than the car sector though. German activity data for the industrial sector have been disappointing for several months in a row now (figure 1), with many industries facing difficulties. This suggests that especially the export-oriented German economy is suffering from global headwinds.

The social tensions in France also seemed to put a brake on euro area growth. French corporate and consumer sentiment took a deep dive in Q4 2018, which was mirrored in a stagnation of the private consumption contribution to real GDP growth in the fourth quarter according to preliminary figures. This was despite fiscal measures implemented before the social protests that were aimed to increase purchasing power. Fiscal policy uncertainty in some Member States, in particular in Italy, weighted on GDP growth figures for the euro area as well. The Italian growth slowdown was initially mostly due to lower trade activity. More recently, domestic demand has been disappointing as the uncertainty surrounding the government's

Figure 1 - Disappointing German manufacturing results
(% change month-on-month)



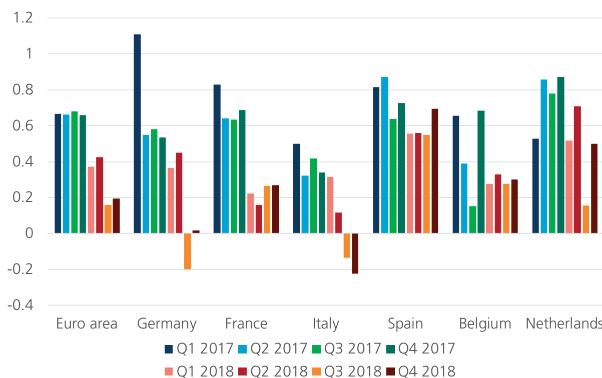
Source: KBC Economics based on Destatis Statistisches Bundesambt (2019)

policy and budgetary stance weighted on investments. As such, Italy entered a technical recession (two consecutive quarters of negative real GDP growth) in the final quarter of 2018.

Although the growth details are not known yet, Q4 real GDP growth for the euro area only slightly rebounded from its Q3 weakness (figure 2). Some of the above-mentioned factors are of temporary nature, but their effects are lingering on longer than initially projected. Preliminary figures point to euro area real GDP growth of +0.2% qoq in Q4 2018. The largest euro area economy, Germany, reported 0.0% qoq real GDP growth in Q4. This was slightly better than in Q3 (-0.2% qoq) and driven by solid contributions of business investment and government expenditures. The main disappointment came from Italy, with a negative growth result of -0.2% qoq, marking a second quarterly growth contraction in a row. Positive surprises came from Spain, where growth even accelerated in Q4 coming from already solid levels in earlier quarters. Despite the social unrest and the related negative impact on private consumption, French GDP growth unexpectedly held up at +0.3% qoq. These results again illustrate the large divergencies within the euro area as well as the resilience of several European economies to the international context of risks and uncertainties.

Looking forward, all signs point to moderate growth in the short-term. Leading sentiment indicators haven't shown a convincing turnaround yet and some temporary factors still linger. Nevertheless, the outlook isn't all negative. There are still several elements that suggest a small rebound in the second half of 2019. Although euro area employment growth is likely to slow down somewhat, wage developments are expected to remain supportive for real disposable income and private consumption. Also the relatively low inflationary environment

Figure 2 – Euro area growth rebound in Q4 very limited (real GDP, % change quarter-on-quarter)



Source: KBC Economics based on Eurostat (2019)

will be an underpinning factor. As the business cycle matures, capacity constraints are likely to build. In combination with support from other elements of domestic demand, this is expected to continue to support healthy growth in business investment, despite increased uncertainty.

We also assume that some of the risks and temporary factors that are currently weighing on growth will gradually fade out. The negative effects of the automotive industry problems will still linger on somewhat in H1 2019, but will eventually drop away. Regarding the trade war, we expect a muddling through scenario with no significant escalations, but also no large reversals of the protectionist measures implemented in 2018. We also don't expect the dispute to escalate into a direct confrontation with new tariffs between the EU and the US. However, if the US government decides to implement higher tariffs on European cars and car components, this would have tremendous effects on the European automotive industry with major negative spillovers to the entire European economy. The Chinese growth slowdown is currently weighing on the demand for European cars too. It is, however, likely that the Chinese government will implement additional fiscal and monetary stimulus to avoid a hard lending in the economy (see Box 1 - Chinese stimulus moderately supportive for global growth). This factor may provide some moderate support for euro area growth later this year.

Meanwhile, despite the deadline coming closer, we still stick to our scenario of a softish but not smooth Brexit. The final result will be a deal that is acceptable (or sufficiently ambiguous) for both the UK and the EU, without fully derailing economic momentum.

Despite the fact that we project a rebound in the quarterly dynamics of GDP growth in the second half of 2019, the past and ongoing sluggishness is not without repercussions for our average annual growth forecasts. Taking into account previously mentioned developments and assumptions, this resulted in a downgrade of our annual GDP growth forecasts for the euro area to 1.1% for 2019 (from 1.5%). For 2020, our growth forecast stays at 1.4%.

US economy strong but looming headwinds

Activity data in the US economy remain strong for now. Although there are no official first estimates for GDP growth in Q4 2018 available yet (due to the government shutdown, the responsible institute was closed), all indicators again suggest

Box 1 - Chinese stimulus moderately supportive for global growth

The gradual deceleration of Chinese real GDP growth over the past years has in part been the consequence of policymakers' strategy to transform the Chinese economy from high-speed to high-quality growth. This entails supply-side reforms tackling overcapacity and high leverage, containing financial risks and fostering new growth engines. The recent deleveraging efforts have slowed credit and infrastructure investment growth but also negatively impacted the economic growth rate. On top of this, the ongoing trade war with the US increased uncertainty affecting corporate sentiment. The deterioration in global economic momentum pushed down Chinese growth as well. In response to this, policymakers again shifted their focus to supporting economic activity in 2018. Rather than prioritising their longer-run commitments of deleveraging and structural reforms, authorities have made economic (and social) stability in the short-term their first concern.

Recent stimulus measures are intended to offset the slowdown via both the monetary and fiscal side. Cuts in the Reserve Requirement Ratio (RRR) for banks - a main monetary policy tool - and targeted medium-lending facilities are primarily aimed at boosting liquidity, especially in terms of lending to small- and medium-sized enterprises. Fiscal stimulus measures include tax cuts for individuals and corporates as well as measures to encourage increased investment spending by local governments. Nevertheless, in doing this, policymakers are still trying to find a balance between supporting growth while not derailing debt. After all, boosting investment via state-owned enterprises and local government debt accumulation will exacerbate inefficiencies and increase contingent liabilities of the state.

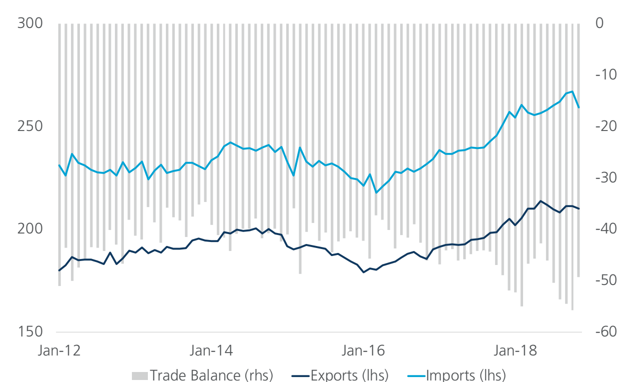
Overall, the Chinese stimulus measures will likely avoid a 'hard landing' or severe and abrupt fall in Chinese growth figures in the short term. However, since the Chinese authorities are constrained by longer-term risks and goals, the size of the measures will likely be more limited than seen during previous stimulus rounds such as in 2015-16. A rebound in Chinese growth in 2019 is therefore unlikely. This is reflected in our growth forecasts with 6.0% GDP growth for 2019 and 5.6% for 2020. In any case, Chinese policy support could also provide some moderate support for global growth, especially in the second half of 2019.

a quarter of healthy growth. The labour market continues to do well, with recent job creation figures still at high levels. We expect the negative economic impact of the government shutdown to be limited in size and time. The political turmoil did spark a peak in policy uncertainty (see Box 2: Economic policy uncertainty at historic highs), but this should ease as things get solved. Consumer and corporate sentiment indicators have come down in recent months. Nonetheless they remain at levels that are consistent with solid growth levels in the near future.

There are some early signs that suggest the growth peak is behind us. One such element are the most recent US trade figures, showing that the trade deficit narrowed to USD 49.3 billion in November (figure 3). Although this might sound good to President Trump, the underlying details are less reassuring. The decline in the deficit was mainly driven by lower imports into the US and a smaller decline in exports. The US trade deficit also decreased across most major trading partners. While it is too early to speak of a trend decline in imports as trade data tend to be volatile, this could be a first sign that also in the US the effects of the US-China trade war are starting to kick in.

Apart from the impact of the trade war, the US economy is facing several other (looming) headwinds as well. The general slowdown of global growth will continue to weigh on US export performance. Moreover, the late-cycle state of the economy is beginning to have some impact too. Consumer

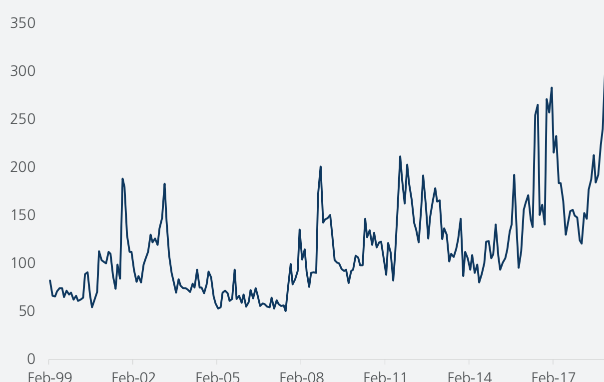
Figure 3 – US international trade (goods and services trade, in billions of USD)



Source: KBC Economics based on Bureau of Economic Analysis (2019)

Box 2 - Economic policy uncertainty at historic highs

Figure B2 – Global Policy Uncertainty Index at historical heights



Source: KBC Economics based on Economic Policy Uncertainty

Global economic policy uncertainty, a GDP weighted index based on quantified newspaper coverage of economic uncertainty, fiscal stability and dispersion between individual forecasts, has risen to an all-time high by the end of 2018 (figure B2). Escalating trade tensions against the backdrop of a dramatic increase in financial volatility are likely to have propelled the index. Indeed, at a country specific level we notice a considerable increase of economic policy uncertainty both in the US and China. Uncertainty in the US probably increased also due to the government shutdown. A (temporary) reopening of the US government, constructive headlines related to trade talks and strong improvement in financial market sentiment should ease the index during the first months of the year. Turning to the EU, we identify fears about the bloc's economic performance as a major cause for the rise in uncertainty. These growth worries are at least to some extent rooted in the trade conflict. Brexit might have created negative spillovers too. However, the latter is not the case for the UK, where we observe a relatively muted increase in the policy uncertainty indicator.

surveys recently show less consumer interest in buying cars and houses and, importantly, the positive effects from the fiscal reforms implemented at the end of 2017 will gradually fade. Based on these observations, we slightly downgraded our growth forecasts for 2019 to 2.3% (from 2.5%) and to 1.8% for 2020 (from 2.0%).

Fed in assessment mode…

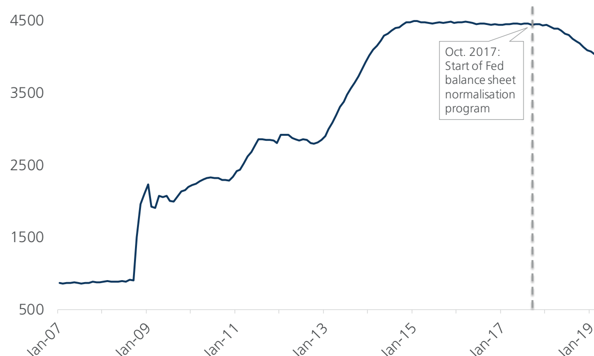
Central banks of major economies have adopted a more cautious stance of late. The US Federal Reserve signalled a softer intended policy path going forward even as its assessment of the US economy hasn't profoundly changed. The Fed didn't explicitly say that the monetary tightening cycle has come to an end, but recent data might still suggest otherwise. However, the monetary statement after the most recent Fed meeting at least signalled that there is also a chance that the monetary cycle is up for a long pause, allowing the Fed to monitor economic and other developments. According to the Fed, the risk of a rapid acceleration of inflation has disappeared. This means that the central bank no longer sees this as a reason to continue the tightening cycle at the pre-set pace.

Moreover, Fed Governor Powell clearly hinted that the 'tapering' of the balance sheet roll-off might come sooner than was expected (figure 4). This would imply that the size of the balance sheet will remain substantially higher than expected at the start of the run-off. By doing this, the Fed's balance sheet will become a more active monetary policy tool rather than a passive one. Implicitly, the Fed aims to keep more liquidity in the global financial system than initially planned. Based on this we adjusted out projected policy path for the Fed. The more cautious approach translates into only one rate hike by end 2019 with a policy rate peak at 2.625% - one rate hike less than in our January scenario. A slower balance sheet rundown with an earlier ending and hence a larger permanent balance sheet than initially planned is likely.

… while ECB is watching and waiting

Meanwhile, the ECB is trying to evaluate the evolving economic situation in the euro area. Rather than contemplating or preparing any near term alterations to the current policy stance, the ECB is now firmly in 'watching and waiting' mode. A formal acknowledgement that risks to the outlook for the euro area economy now lie to the downside implies that any material tightening of ECB policy entailing an initial rate rise is still a distant prospect. Since the first short-term priority of the ECB is

Figure 4 – Fed balance sheet normalisation probably slower in the future (Federal Reserve balance sheet, in billions of USD)



Source: KBC Economics based on Federal Reserve (2019)

to assess the persistence of the general uncertainty, incoming information will be crucial in determining the ECB's policy path going forward. For now, we therefore hold on to our ECB scenario. The first step towards a policy rate normalisation will likely only be taken at the earliest towards the end of 2019.

Another part of the ECB's non-standard monetary policy measures that are coming on the radar again are the targeted longer-term refinancing operations (TLTROs). These are Eurosystem operations that provide financing to credit institutions for periods of up to four years. They offer long-term funding at attractive conditions to banks in order to further ease private sector credit conditions and stimulate bank lending to the real economy. TLTROs are targeted operations, as the amount that banks can borrow is linked to their loans to non-financial corporations and households. The series of TLTROs that was introduced in 2016, will expire in 2020 and we expect it to be rolled over by a new series. An ECB announcement about this may come as early as March 2019.

Launching new TLTROs would be a means for the ECB to maintain its accommodative policy stance after the end of the APP. Moreover, it would keep the option open to raise policy rates in 2019 in order to reduce the side-effects of negative short-term interest rates. It would also prevent the ECB's balance sheet from shrinking, especially now that the Fed will likely adjust the pace of its balance sheet rundown. New TLTROs would furthermore help to maintain required liquidity ratios (LCRs etc) of European banks. However, there appears to be a significant risk asymmetry in terms of the markets likely response to the ECB's decision in this regard. If a new series of TLTROs is effectively announced, financial markets may react only moderately positively. On the other hand, if no new TLTROs are announced, severe adverse market reactions can be expected given their importance for the banking sector. The pressure on the link between the national sovereign and the banking sector would continue to be eased in case of a new TLTRO series, since banks could ensure their LT liquidity provision on the same scale as is currently the case.

Low long-term bond yields

The growth slowdown, a lower inflation outlook and the associated more cautious stance of major central banks, will have implications for long-term interest rates as well. Flight to quality and safe haven effects will cause the German 10y government bond yield to remain lower than previously expected. We now see it rising gradually towards 0.70% by the end of this year (down from 0.80%). We lowered our scenario for the US 10y bond yield from 3.25% by year-end to 3.0%. For the time being, intra-EMU spreads will likely remain low. However, towards end 2020 we project them to rise as global risk aversion will increase and as the ECB normalises its monetary policy.

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Central and Eastern European Economies

Resilient, but heavily dependent on the automotive industry

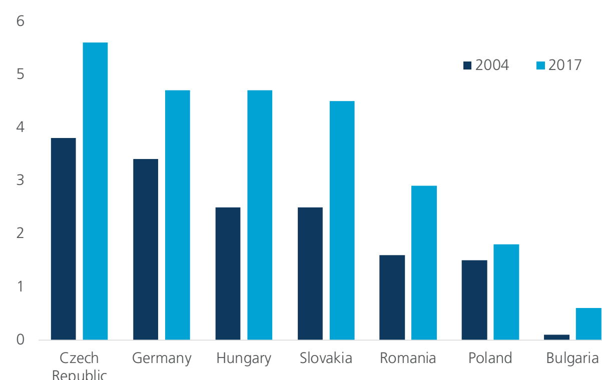
The EU is currently confronted with many international and domestic challenges and uncertainties. The final outcome of the Brexit negotiations remains unclear, Chinese economic growth is slowing, and a trade war escalation is still a risk. Moreover, the outlook for important European economies, such as Germany and Italy, has become significantly more pessimistic due to internal problems related to the manufacturing industry and policy uncertainties.

The European Commission's recently released Winter Forecasts mirror our view that growth will slow down considerably in Germany and in the euro area as a whole. However, the Commission's assessment of economic developments in Central and Eastern European economies remains almost unchanged. Although GDP growth estimates have been marginally revised downwards for the Czech Republic, Bulgaria and Poland, no corrections were made for other countries in the region. Clearly, the Commission believes that the region will overcome any potential impact of a European slowdown thanks to strong domestic demand.

We support that view, although one cannot neglect that most Central and Eastern European countries are predominantly export-oriented industrial economies with a strong role played by the automotive industry. Heavy clouds have been gathering over that sector, not only because of the new emission testing regulations that temporarily caused severe disruptions in car production across Europe. The difficulties in the automotive industry are also related to overall lower demand for new cars. The latter is due to several factors, including the winding down of successful sales cycle since 2013, the saturation of national markets in EU Member States, a drop in demand from the British market due to Brexit, and the Chinese growth slowdown. Despite some temporary effects that will gradually fade out, the automotive industry may hence be under pressure for longer. The US-China trade war and a potential implementation of US import tariffs on European cars and car components pose additional risks to the sector.

The automotive market losing momentum is primarily problematic for the Czech Republic, Slovakia, Hungary and Romania, where car manufacturing contributes about 3-6% to total value added (figure CEE). The region is very sensitive to international demand trends in the automotive sector. However, in past periods of car demand sluggishness, these countries proved to be quite resilient. Local car sales were boosted by strong domestic demand. Also, car manufacturers in the region turned out to be innovative and able to produce cars at good price-quality ratios. This kept car types produced in the region relatively attractive for foreign buyers.

Figure CEE – Share of the automotive industry in GDP
(in %)



Source: KBC Economics based on Eurostat

Looking forward, new car manufacturing plants such as the new Jaguar plant in Slovakia will be supportive for industrial output. Nevertheless, the automotive industry deserves close monitoring. A further decline in international demand might hurt the automotive industry and the entire regional economy directly as well as indirectly through supply chain links. Our expected moderate downturns in the euro area and US this year will trigger a decline in the automotive industry's growth rate and, therefore, lower its contribution to GDP growth. However, we do not expect this to be a major shock, such as seen in 2010-2012, since consumer surveys in the EU do not indicate a major contraction in car demand. The deferment of business investments in corporate fleet renovation remains an important risk. At the same time, the above-average profitability of the industry will likely decline due to growing wage costs.

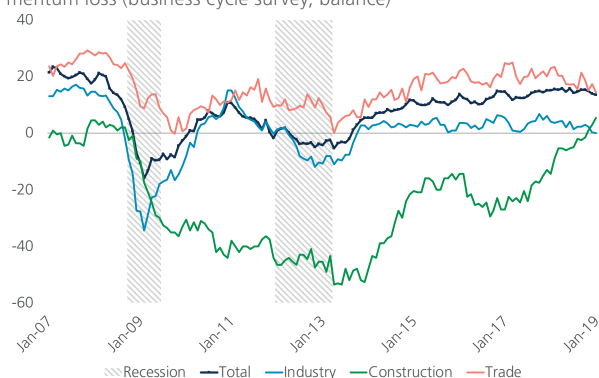
Czech Republic

More signs of a cyclical slowdown

The Czech economy likely maintained the relatively strong growth seen in the third quarter of 2018 (+0.6% qoq) through the final quarter of the year. However, there are several signs pointing towards an upcoming slowdown. For one, industrial production growth has been weak (-1.4% yoy in December 2018), mainly due to production declines in the automotive industry (-7% yoy). Although the working day-adjusted figure for industrial production (+1.8% yoy) was stronger, the industrial sector is clearly losing momentum. This is also confirmed by the latest manufacturing PMI which fell further below the 50 threshold in January due to significantly weaker orders. The same evolution is illustrated by the national business cycle survey (figure CZ1).

On the other hand, the construction industry is holding up well. Nevertheless, given the sector's relatively small size, this can only partly compensate for the manufacturing downturn. Moreover, growth in the construction sector is hampered by shortages of labour and materials. In addition, new orders indicate that we can expect a slower growth rate going forward compared to last year. The services sector cannot be relied on to provide any significant contribution to growth either, given a rather unconvincing performance of late. The only exception is retail, which faces increased consumer demand as reflected in a relatively high consumer confidence level. This stems from record employment levels, rapid wage growth, and relatively mild concerns about the future.

Figure CZ1 - Business confidence in industrial sector reflecting momentum loss (business cycle survey, balance)



Source: KBC Economics based on Czech Statistical Office (2019)

Labour market tightness, but no inflation pressures so far

The Czech labour market remains tight. While national statistics report a modest increase in unemployment at the turn of the year, it is only a seasonal fluctuation that will soon be offset by seasonal work increases. The unemployment rate will likely remain around 2% (according to Eurostat's harmonised methodology), the lowest in the country's history and the lowest in the EU. Though employment levels of both Czech and foreign employees are at record-highs, job vacancy levels are peaking. The number of vacancies has passed 330,000, which means there are currently three vacancies per unemployed person.

Such strong discrepancy between labour market supply and demand is also reflected in increased pressure on wage growth. Following the estimated wage increase of more than 8% last year, wage growth should slow down this year due to slower wage increases in the public sector. Even though wage growth remains above its long-term average and private consumption growth is supporting the economy, inflationary pressures remain moderate. Harmonised headline inflation only reached 1.6% yoy in December 2018 while core inflation was barely higher (1.7% yoy). The national inflation indicator, however, was somewhat higher (2.0% yoy in December, 2.5% yoy in January).

The inflation outlook does not suggest any sharp acceleration in price growth for the time being. Increased housing costs in the form of rising house prices, rents and higher energy prices are the main determinants of the current inflation level. Housing costs will remain important for overall inflation this year while pass through from high wage growth into prices will become more and more visible, particularly in services. Nevertheless, inflation should not move too far away from the central bank's target thanks to, inter alia, cheaper fuel. This also means lower pressure on monetary policy tightening (see Box 4).

End of fiscal expansion?

Considerably higher income tax revenues led to a small government budget surplus in 2018, compared to a projected deficit of CZK 50 billion at the time the budget was approved. Thanks to the significantly positive development on the income side, reflecting a strong economic performance, public expenditures increased by 9.5%. The 2018 public budget

surplus was probably close to 1% of GDP. As a result, public debt likely dropped to about 32% of GDP.

The Czech government has had the tendency to adopt pro-cyclical fiscal policies, meaning expansionary measures during economic booms and restrictive policies during downturns. One example of this was the period after 2008, when the government froze all public sector investment activity related to infrastructure building for years. In contrast, public investment has been an important growth contributor over the past couple years of strong economic growth. However, now that the Ministry of Finance and other institutions are projecting an economic slowdown, the fiscal policy stance is likely to change and become more restrictive again over the next two years. That said, increases in social and wage spending have been the main expenditure items. This leaves less potential for more flexible management of the cost side of the budget.

Demand for Czech government bonds remains high and yields are relatively low compared to the short end of the curve. Foreign investors, who held 42% of all government bonds in CZK at the end of 2018, still show a great interest. They hold a relatively stable part of the market and tend to rollover their portfolios when their bonds have paid off, regardless of increased risks in emerging markets or rising credit premiums in the euro area.

End of the real estate boom?

The latest Eurostat house price data (+8.7% yoy) does not yet indicate any cooling off in the Czech residential real estate market. The data refer to Q3 2018, just before the introduction of tighter regulation by the Czech National Bank (CNB) for mortgage lending. Demand for mortgages and real estate, therefore, was peaking at the time. The continued strong price increase in Q3 can be explained by housing supply clearly lagging the increased demand for real estate. Supply is still below the level reached before the latest recession. Bureaucratic obstacles are responsible for the slow supply reaction to the demand. Obtaining planning permission and building permits in the Czech Republic is an exceedingly long and complicated process. According to World Bank data, it takes an average of 246 days to obtain a building permit, ranking the Czech Republic 156thin the world.

The rise in house prices is expected to ease significantly in 2019 to +3.5%, down from an estimated +8.0% in 2018. We see several reasons for this. First, demand is becoming saturated. Excessive prices are driving some potential buyers out of the market. Based on several valuation measures, Czech residential property has become overvalued, albeit not yet excessively so. Second, tighter mortgage regulations on loan-to-values, debt-to-income and debt-service-to-income ratios will weigh on price developments. In recent months, evidence of softer price increases has already become clear from the price setting for some new projects. The Czech real estate market hence requires further close monitoring.

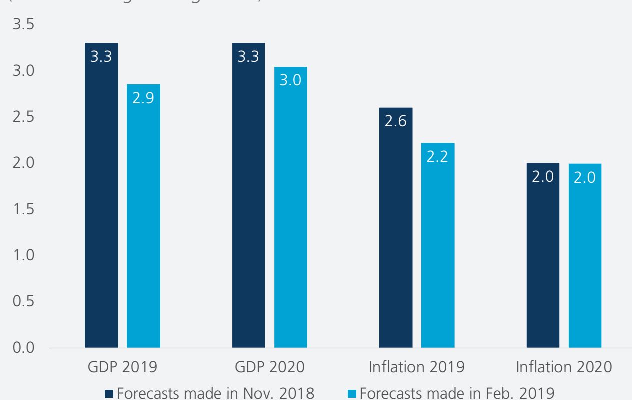
Box 4 - Central banks in Central and Eastern Europe also on the dovish side

With high global uncertainties and risks, and the central banks of major economies having moved into assessment mode, Central and Eastern European central banks are also opting for a cautious approach.

Czech National Bank prefers stability

Czech central bankers needed just an extra half-hour to confirm no change to interest rates at the February meeting. As expected, there were some votes in favour of higher rates. Nonetheless, they were clearly outnumbered by the votes in favour of stable rates for now. With respect to risks and uncertainties, the Czech National Bank (CNB) expressed a strong preference for stability although, naturally, the possibility of a rate hike this year was not ruled out. The Bank Board's decision was also supported by its new forecasts which, apart from predicting almost invariable rates over an 18-month time frame, also foresees a significant strengthening of the Czech Koruna.

Figure B4 – CNB forecasts: November 2018 vs. February 2019
(annual average change in %)



Source: KBC Economics based on NBB.Stat and Eurostat

The CNB is no longer as optimistic with respect to economic growth, which it cut by 0.4 percentage points to 2.9% for this year (figure B4). This brings the CNB's outlook closer to the more cautious figures we have been forecasting for some time. Still, compared to our 2019 GDP growth forecast of 2.6%, the CNB remains relatively optimistic, especially when taking into account the CNB's forecast of a slight growth acceleration in 2020 towards 3.0%. Therefore, the CNB forecast is likely to undergo further downward adjustment.

At the same time, the Czech Koruna still refuses to strengthen as quickly as anticipated by the CNB. Moreover, the February session has proved that the (previously reliable) decision-making scheme based on "the weaker the Czech Koruna, the higher the rates" is not automatically applicable. Uncertainties and risks, mostly of an external nature, have pushed the weaker koruna aside. This is demonstrated by the Governor's words that the CNB was under no pressure to raise the rates. Moreover, it was far from sure whether another 25 basis point increase in interest rates could help the Czech Koruna under such circumstances.

In the next months, we expect weaker economic figures to arrive from the European and, subsequently, Czech economies, which will not encourage any faster tightening of Czech monetary policy. The CNB will not be in a rush to tighten policy until there is more clarity about Brexit, the automotive industry slowdown and the ECB's policy path. We expect the Czech National Bank to restart interest rate raises, but no sooner than in the second half of the year when the fog above the current risks and uncertainties has cleared. Even so, the ambition to raise the rates will undoubtedly be significantly smaller than last year, so the return to "normal rates" is deferred further into the future.

National Bank of Hungary in data-dependent mode

All recent macroeconomic developments suggest that the fundamentals of the Hungarian economy may deteriorate in 2019, translating into an economic growth rate around 3.5% yoy, a financing capability of around 3% of GDP, and inflation close to the

inflation target of the National Bank of Hungary (NBH) (3% yoy). Given these factors, the appreciation pressures on the forint from a fundamental point of view have been gradually disappearing. Hence, the main question remains: When will the NBH start its normalisation cycle and what will be the speed of it?

The NBH left its base rate (0.9%) and interest rate corridor (O/N depo at -15bp and O/N lending at 90 bps) unchanged at its most recent monetary policy meeting in January. In addition, the Council left the average amount of liquidity to be crowded-out for the first quarter of 2019 unchanged, at least at HUF 400-600 billion. The Monetary Council is also sticking to its strategy of a very gradual and cautious normalisation of monetary policy. The start of this normalisation will depend on inflationary developments. This means there is still no clear forward guidance about the start or about the speed of the tightening cycle in Hungary. It also suggests the NBH may wait for several new inflation releases. Only when the data confirm that inflationary pressures are increasing with inflation hovering sustainably around the NBH's target of 3% yoy, can some normalisation of monetary policy be expected.

We expect no tightening until April-May. Thereafter, a decline in HUF liquidity, orchestrated by the NBH, will likely result in a modest interest rate rise on the short end of the curve. We expect more aggressive tightening only from H2 2019. Financial markets are probably pricing in an earlier and more aggressive pace of rate hikes into the EUR/HUF exchange rate. Hence, when the NBH turns out to be more cautious, the HUF will likely depreciate against the EUR and move back into the range of 320-325 HUF per EUR in the coming months.

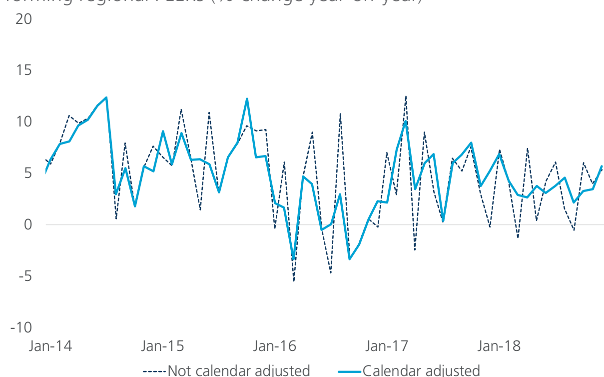
Hungary

Industrial growth strong for now

Hungarian industrial production has been decoupling from that of its regional peers, growing by 5.4% yoy in December (figure HU1). As a result, its contribution to GDP growth might remain roughly the same in 4Q18 as it was in 3Q18 (0.6%pt). Electronic and optical devices represented the highest growth, but vehicle production was also up. The December figure also implies that industrial output increased by 3.6% yoy in 2018 on average, a deceleration compared to 2017 (+4.6% yoy). The deteriorating global outlook might be compensated by some new production capacity in 2019. Hence, we expect industrial production growth in 2019 to be roughly on par with 2018.

The relatively weaker industrial developments globally are, however, reflected in the trade balance. The trade surplus moderated from EUR 8.1 billion in 2017 to EUR 6 billion in 2018. Exports increased 4.3% yoy while imports were up by 6.9% yoy last year. Imports were boosted by investments and household consumption. As EU funds spending and wage increases will remain present in 2019 as well, import growth may remain strong this year. Hence, we expect the trade balance to deteriorate further and move below EUR 5 billion in 2019, which may push down the current account surplus as well (below 1% of GDP towards end 2019).

Figure HU1 – Hungarian industrial production remains strong, outperforming regional PEERs (% change year-on-year)



Source: KBC Economics based on Hungarian Central Statistical Office (2019)

Bulgaria

Strong domestic consumption

In line with the general European trend, Bulgarian economic activity slowed in the second half of 2018. Industrial production dropped by 2.3% mom in December in seasonally adjusted terms, the sharpest monthly decline since May 2016. The most severe downturn was registered in the automotive industry (-25.4% yoy) and metal products (-25.0% yoy). In addition, domestic construction also struggled in December, declining by 2.4% compared to the previous month (seasonally adjusted). As such, a more pessimistic picture of the supply side of the Bulgarian economy appeared.

However, looking on the demand side, the growth story of the Bulgarian economy gets a different perspective. Despite a slight increase in the unemployment rate in Q4 2018, the labour market remains tight. As a result, robust wage growth together with moderating inflation pressures are expected to boost private consumption growth. After all, despite a mild slowdown, the December retail sales growth of 3.8% yoy supports the narrative of buoyant household consumption through the end of 2018.

In 2019 we expect a slight slowdown in GDP growth to 3.4% from 3.5% last year. The Bulgarian economy is again set to benefit from robust domestic demand. Private consumption will remain in the driver's seat with an expected rise of 7.7% yoy, and will be underpinned by an increase in the minimum wage and a rise in public sector wages. In addition, the projected increase in public infrastructure spending and a recovery in the use of EU structural funds will support fixed investment.

On the other hand, the external environment is becoming more challenging. The fallout from the Turkish crisis proved to be a significant drag on growth in 2018 and is expected to ease only moderately this year. The slowdown in the euro area will not be supportive either. Nor will the deceleration of exceptional economic growth in Romania – Bulgaria's fourth most important trade partner. As a result, given weaker demand dynamics in major export markets, the risks to Bulgarian growth are tilted to the downside.

Labour market still under pressure

Labour market dynamics remain tight which, together with additional public sector wage increases, is set to provide support for private consumption in 2019. According to Eurostat, the unemployment rate was at 5.2% in December, unchanged compared to the previous month, but 0.5 percentage points lower compared to December 2017. As the economy is now operating close to full employment, we expect to see job creation losing some momentum (figure BG1).

On the contrary, inflation pressures eased significantly by the end of 2018 (figure BG2). Although average annual inflation, measured by HICP, increased to 2.6% in 2018, the downward trend since the August peak translated into the rapid fall of consumer price inflation to 2.3% in December from 3.0% in November. The significant decline in inflation pressures was

Figure BG1 - Bulgarian economy close to full employment (unemployment as a % of active population, seasonally adjusted)

Source: KBC Economics based on Eurostat (2019)

Figure BG2 - Inflationary pressures eased significantly by the end of 2018 (Harmonised Index of Consumer Prices, % change year-on-year)

Source: KBC Economics based on Eurostat (2019)

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predominantly on the back of lower liquid fuel prices. Given the positive base effect (i.e. a hike in regulated energy and tobacco prices last year), as well as lower international metals and fuel prices, we have reduced our expectation of inflation for 2019 from 3.0% to 2.5%.

Conservative fiscal policy reflected in another budget surplus

Government policy continues to focus on fiscal prudence. The consolidated budget posted a small surplus for the full year 2018 at BGN 137 million, or 0.1% of GDP. This marks the third consecutive year of budget surpluses, albeit the least impressive relative to 1.6% in 2016 and 0.8% in 2017. The lower budget surplus mainly reflects increased spending, i.e. higher pension and health insurance payments, higher salaries in the education sector, and increased capital expenditures on infrastructure. Still, Bulgaria managed to reduce the government debt-to-GDP ratio to 22.1% in December 2018, ranking among the lowest in the European Union.

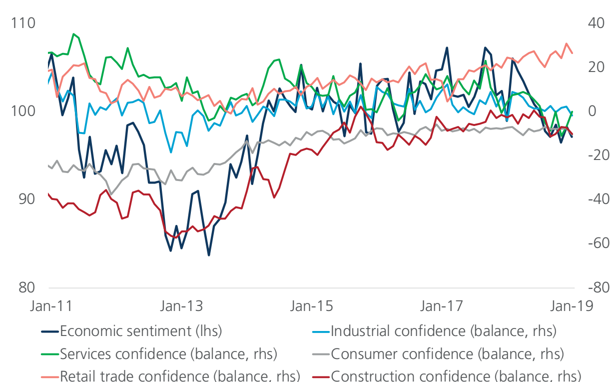
The stable fiscal position is expected to be maintained this year. We see the government budget balance in a surplus of 0.3% of GDP (compared to 0.5% projected by the government) on the back of the acceleration in EU spending and expenditure in critical areas (education, health and infrastructure). Overall, robust fiscal buffers offer enough space for automatic stabilizers to act without limitations in response to an unexpected shock, e.g. from external demand.

Slovakia

Following lower growth forecasts for the entire European economy, the Slovak Central Bank and the Slovak Ministry of Finance (MoF) also revised their growth forecasts downward. The National Bank of Slovakia (NBS) adjusted its GDP growth forecast to 4.2% yoy in 2019 (previously 4.3%), 4.0% yoy in 2020 (unchanged) and 3.0% yoy in 2021 (previously 3.1%). The MoF reacted in early February during the release of its regular economic forecasts. GDP growth was reduced to 4.0% yoy in 2019 (previously 4.5%), 3.7% yoy in 2020 (previously 3.9%), 3.2% yoy in 2021 (previously 3.3%) and 2.5% yoy in 2022. These revisions are a step in the right direction and are now closer to our own GDP growth forecasts (3.7% for 2019, 3.5% for 2020). The forecasts, however, consider only a limited amount of current risks (impact of Brexit, etc.). The MoF decreased the dynamics of exports to Germany and expects weaker private investments. However, both institutions confirm that the risks are on the downside, mentioning a possible hard landing of EU economy, the impact of Brexit, and protectionism. We expect more downside forecast revisions closer to our prognosis in the future.

The downward economic revisions from several Slovak institutions are in line with various recently released leading indicators. The index of economic sentiment decreased in almost all its sub-indices in January (with the exception of services). Economic sentiment decreased to 97.1, which is the lowest level in almost 5 years (figure SK1). Confidence in manufacturing was affected by the expected future decline of production by entrepreneurs. Orders in manufacturing decelerated from around 20% yoy to less than 11% yoy in November 2018. Almost all relevant industries registered a decline. The only exception was car production with a rise in new orders of almost 28% yoy. However, even with car production there are signs of the start of a gradual deceleration.

Figure SK1 - Economic sentiment starting to signal a gradual growth deceleration



Source: KBC Economics based on DG ECFIN

The foreign trade balance ended in a small surplus of EUR 68 million in November 2018 (vs. EUR 490 million last year). The foreign trade surplus should be around EUR 2.6 billion for the whole year of 2018 (vs. EUR 3.09 billion in 2017). However, it should rise once again with increased exports thanks to the new Jaguar plant. The local economy should be supported by the start of new export capacities in the car industry with a positive contribution from net exports to GDP in the future.

Slovak inflation slowed to 1.9% from 2.0% yoy in December 2018. This was mainly affected by the decline of fuel and air travel prices. Annual average inflation stood at 2.5% yoy in 2018. Inflation should accelerate in January 2019 due to higher regulated prices and an acceleration of food prices. We then expect a deceleration in the second half of the year, resulting in an annual average inflation rate around 2.6% in 2019. Despite labour market overheating, demand side pressures are still limited. The unemployment rate stayed unchanged at 6.1% in December 2018 which is an all-time low (7.4% in December 2017). However, factoring in the signs of a growth deceleration, the space for a further decline in unemployment will be limited. The number of job vacancies is close to all time-highs as well as the number of foreigners working in Slovakia (mainly Serbians and Ukrainians).

The state budget ended 2018 in a deficit of EUR 1.2 billion compared to the approved budget deficit of EUR 2.0 billion. The most significant contributing factor to the smaller deficit was the increase of tax revenues thanks to strong economic growth. The increase of revenues from the EU budget was also significant. This result probably means a further reduction of the public fiscal deficit from an all-time low of -0.8% of GDP in 2017 to -0.7% of GDP in 2018. Government bond spreads are around 70 bps above Bunds and they should gradually widen in a context of more international risk aversion and gradual ECB policy normalisation.

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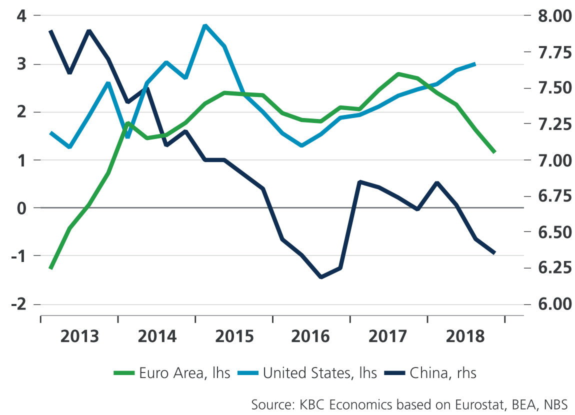
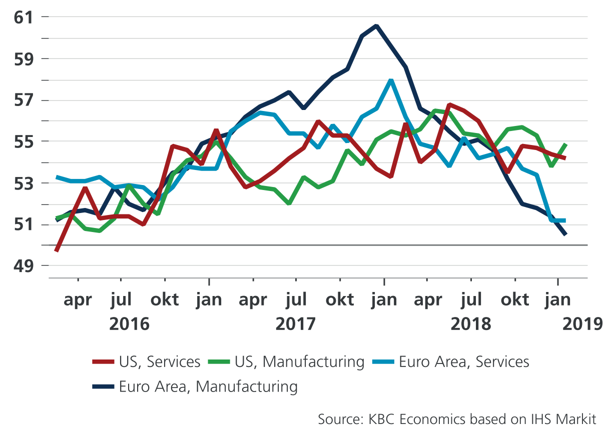
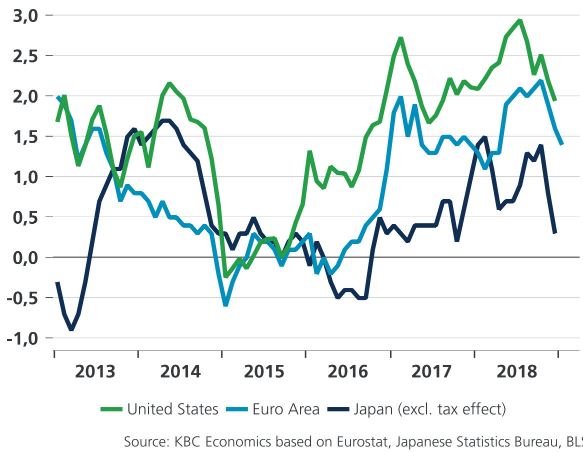
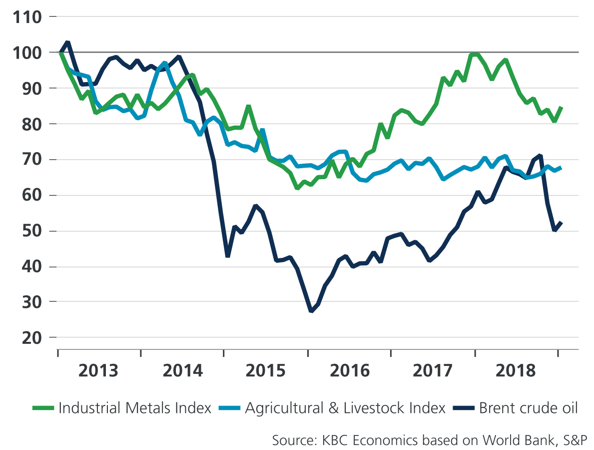
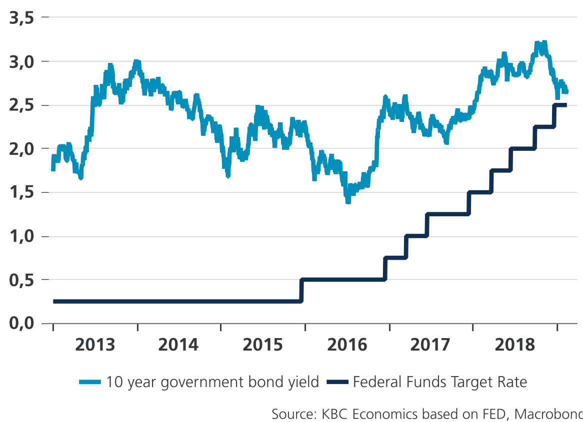
Figures

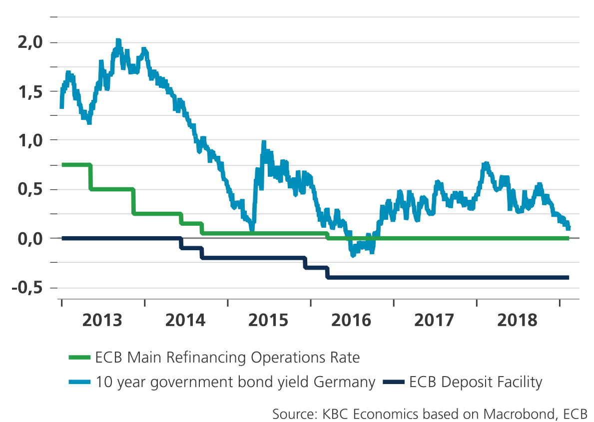






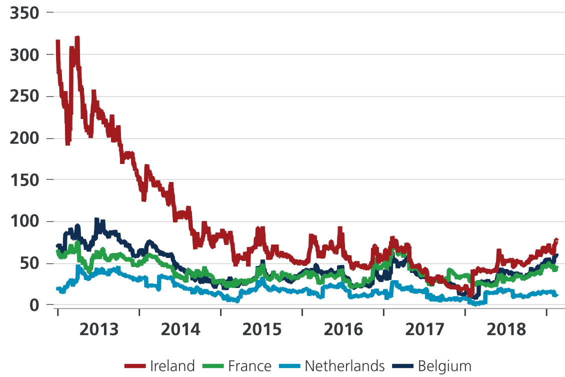






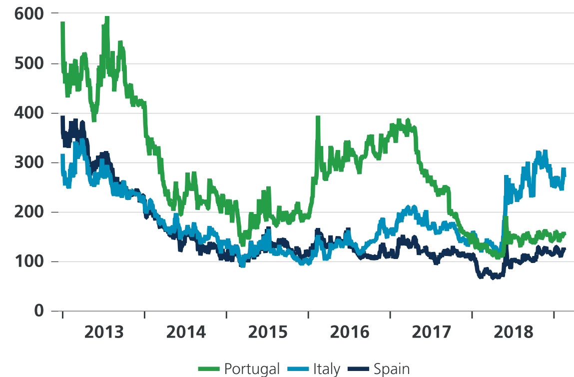
Figures

10 year government bond yield spreads to Germany
in basis points



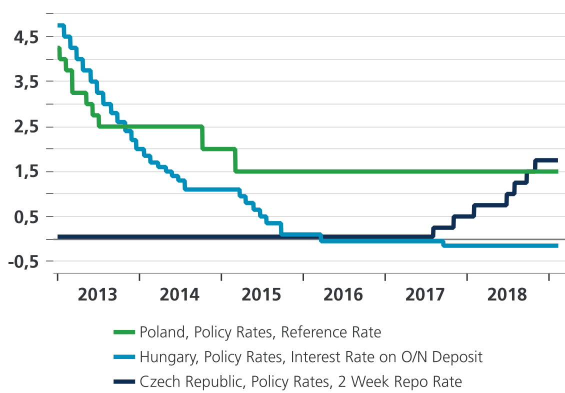
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



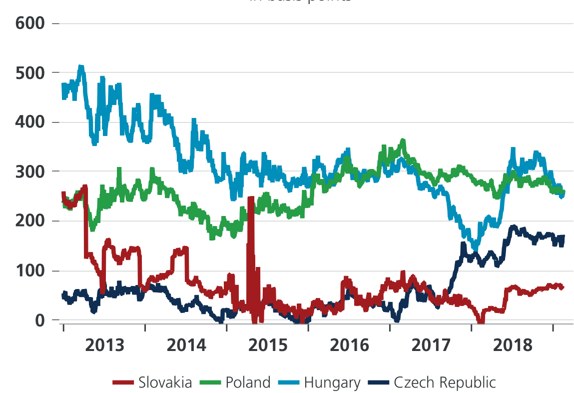
Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %



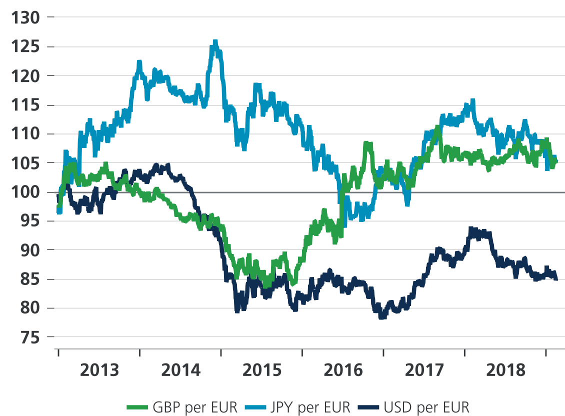
Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points



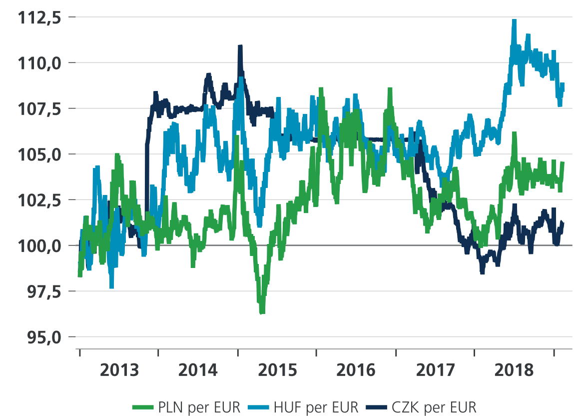
Source: KBC Economics based on Macrobond, AKK, Eurostat

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

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		Real GDP growth (period average, in %)			Inflation (period average, in %)		
		2018	2019	2020	2018	2019	2020
Euro area	Euro area	1.8	1.1	1.4	1.7	1.5	1.6
	Germany	1.5	0.9	1.5	1.9	1.6	1.5
	France	1.5	1.1	1.3	2.1	1.5	1.7
	Italy	0.8	0.0	0.6	1.2	1.2	1.3
	Spain	2.5	1.9	1.7	1.7	1.5	1.5
	Netherlands	2.5	1.5	1.5	1.6	2.1	1.7
	Belgium	1.4	1.2	1.1	2.3	1.8	1.7
	Ireland	7.0	3.5	3.0	0.7	1.6	2.0
	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	2.1	2.0
	Hungary	4.5	3.5	2.6	2.9	3.1	3.5
	Bulgaria	3.5	3.4	3.3	2.6	2.5	2.4
	Poland	4.9	3.3	3.2	1.2	2.6	2.5
	Romania	4.1	3.8	3.5	4.1	3.5	3.3
Rest of Europe	United Kingdom	1.3	1.4	1.3	2.5	2.2	2.1
	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	5.6	2.1	2.2	2.4
	India*	7.2	7.2	7.5	4.0	4.2	4.6
	South Africa	0.7	1.3	1.3	4.6	4.9	5.4
	Russia	1.8	1.4	1.7	2.9	4.8	3.9
	Turkey	3.0	-0.5	3.0	16.2	18.5	13.0
	Brazil	1.3	2.3	2.4	3.7	4.0	4.2
Other advanced economies	United States	2.9	2.3	1.8	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

Policy rates (end of period, in %)						
		08/02/2019	Q1 2019	Q2 2019	Q3 2019	Q4 2019
Euro area	Euro area (refi rate)	0.00	0.00	0.00	0.00	0.05
	Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40	-0.20
Central and Eastern Europe	Czech Republic	1.75	1.75	1.75	2.00	2.00
	Hungary	-0.15	-0.15	-0.15	0.00	0.50
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.50
	Romania	2.50	2.50	2.50	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	0.75	1.00	1.00	1.00	1.25
	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	6.25	6.25	6.25	6.25	6.25
	South Africa	6.75	6.75	6.75	7.00	7.00
	Russia	7.75	8.00	8.00	8.00	8.00
	Turkey	24.00	24.00	24.00	21.50	19.50
	Brazil	6.50	6.50	6.50	6.50	6.75
Other advanced economies	United States (upper limit)	2.50	2.50	2.50	2.75	2.75
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	1.50	1.50	1.50	1.50	1.50
	New Zealand	1.75	1.75	1.75	1.75	1.75
	Canada	1.75	1.75	2.00	2.00	2.25

Outlook main economies in the world

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10 year government bond yields (end of period, in %)						
		08/02/2019	Q1 2019	Q2 2019	Q3 2019	Q4 2019
Euro area	Germany	0.11	0.30	0.50	0.60	0.70
	France	0.55	0.70	1.00	1.15	1.30
	Italy	2.92	3.00	3.20	3.60	3.70
	Spain	1.23	1.40	1.75	1.88	2.00
	Netherlands	0.22	0.45	0.65	0.80	0.95
	Belgium	0.70	0.85	1.05	1.20	1.35
	Ireland	0.87	1.00	1.20	1.30	1.45
	Slovakia	0.83	1.00	1.20	1.30	1.50
Central and Eastern Europe	Czech Republic	1.65	1.95	1.90	2.00	2.10
	Hungary	2.70	2.90	2.95	3.00	2.90
	Bulgaria	0.88	1.00	1.20	1.30	1.40
	Poland	2.74	2.80	3.00	3.05	3.10
	Romania	4.80	5.00	5.20	5.30	5.80
Rest of Europe	United Kingdom	1.17	1.30	1.40	1.40	1.50
	Sweden	0.36	0.55	0.75	0.85	0.95
	Norway	1.68	1.90	2.10	2.20	2.30
	Switzerland	-0.29	-0.10	0.10	0.20	0.30
Emerging markets	China	3.15	3.20	3.30	3.40	3.40
	India	7.46	7.60	7.75	7.85	7.90
	South Africa	8.65	8.85	9.00	9.10	9.10
	Russia	8.19	8.30	8.25	8.20	8.20
	Turkey	14.08	14.50	14.50	14.00	14.00
	Brazil	8.98	9.10	9.40	9.60	9.80
Other advanced economies	United States	2.64	2.80	2.90	3.00	3.00
	Japan	-0.03	0.00	0.00	0.00	0.00
	Australia	2.10	2.25	2.35	2.45	2.45
	New Zealand	2.13	2.35	2.45	2.55	2.55
	Canada	1.88	2.05	2.15	2.25	2.25

Exchange rates (end of period)					
	08/02/2019	Q1 2019	Q2 2019	Q3 2019	Q4 2019
USD per EUR	1.13	1.14	1.15	1.17	1.20
CZK per EUR	25.79	25.70	25.50	25.20	25.20
HUF per EUR	318.82	323.00	325.00	325.00	321.00
PLN per EUR	4.30	4.30	4.33	4.35	4.40
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.74	4.75	4.76	4.77	4.78
GBP per EUR	0.88	0.89	0.90	0.90	0.90
SEK per EUR	10.50	10.25	10.00	9.85	9.75
NOK per EUR	9.74	9.55	9.30	9.27	9.25
CHF per EUR	1.14	1.14	1.16	1.17	1.17
BRL per USD	3.72	3.75	3.80	3.85	3.90
INR per USD	71.13	71.00	71.50	72.00	72.00
ZAR per USD	13.64	13.75	13.80	14.00	14.20
RUB per USD	66.00	66.00	66.00	65.00	65.00
TRY per USD	5.25	5.30	5.30	5.55	5.80
RMB per USD	6.74	6.80	6.95	7.00	7.00
JPY per USD	109.78	110.00	110.00	110.00	111.00
USD per AUD	0.71	0.72	0.73	0.74	0.74
USD per NZD	0.68	0.69	0.69	0.69	0.70
CAD per USD	1.33	1.29	1.26	1.26	1.25

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Outlook KBC home markets

	Belgium			Ireland		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	1.4	1.2	1.1	7.0	3.5	3.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.8	1.7	0.7	1.6	2.0
Unemployment rate (in % of the labour force, end of year, Eurostat definition)	5.5	5.5	5.7	5.3	5.0	5.2
Government budget balance (in % of GDP)	-0.8	-1.7	-1.8	-0.4	0.1	0.3
Gross public debt (in % of GDP)	102.3	101.5	101.0	64.0	61.0	59.0
Current account balance (in % of GDP)	-0.1	-0.4	-0.6	11.0	8.0	5.0
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	3.0	2.3	2.2	10.2	4.5	3.0

	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 %)	2.0	2.1	2.0	2.5	2.6	2.4
Unemployment rate (in % of the labour force, end of year, Eurostat definition)	2.0	2.0	2.0	6.1	6.2	6.3
Government budget balance (in % of GDP)	0.7	0.0	-0.5	-0.7	-0.6	-0.6
Gross public debt (in % of GDP)	32.2	30.8	30.0	49.0	48.0	47.0
Current account balance (in % of GDP)	0.5	0.6	0.4	-2.0	-1.0	-0.8
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	8.0	3.5	3.0	5.0	4.0	3.5

	Hungary			Bulgaria		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	4.5	3.5	2.6	3.5	3.4	3.3
Inflation (average yearly change, harmonised CPI, in %)	2.9	3.1	3.5	2.6	2.5	2.4
Unemployment rate (in % of the labour force, end of year, Eurostat definition)	3.6	3.5	3.5	4.8	4.7	4.6
Government budget balance (in % of GDP)	-2.4	-1.8	-2.0	0.2	0.3	0.3
Gross public debt (in % of GDP)	72.2	69.7	67.5	22.0	20.6	18.6
Current account balance (in % of GDP)	1.9	1.1	0.5	2.4	1.2	0.6
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	6.0	4.0	3.0	6.0	5.0	4.0

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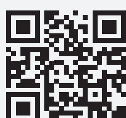

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