Economic perspectives

December 2019

Highlights

- The euro area economy is showing signals of bottoming out. Corporate sentiment indicators in the manufacturing industries are stabilising, although at low levels. The services sector remains resilient and consumers don't seem to be heavily affected by the global downturn. Hence, economic developments are in line with our scenario of a gradual recovery in quarterly GDP growth dynamics for the euro area. Therefore, our growth forecasts remain unchanged. Despite this optimism our scenario remains very cautious for the short run.

- The main risks to this outlook continue to be the uncertainty surrounding Brexit and further escalations of international trade conflicts even though near term concerns in both of these areas seem to have diminished markedly as a result of a decisive election result in the UK and growing expectations of some progress in US-china trade talks.

- More generally, however, the trade war is now taking place at various front lines. Particularly worrisome is the US threat to impose higher tariffs on typically French products in response to the French Digital Services Tax. This could trigger countermeasures from the EU, leading to a bilateral US-EU trade conflict. Such an escalation would hamper the economic recovery in the euro area.

- Some political risks are popping up again in the euro area as well. French protests against pension reforms, the inability to form a stable Spanish government coalition and some uncertainties surrounding the policy stance of the German Grand Coalition after a new leadership of the SPD was chosen, could all impact sentiment and economic growth.

- The US economy keeps performing relatively well, though the start of Q4 brought mixed activity results. Industrial production remains weak, in line with global developments. US consumers, meanwhile, continue to be optimistic, supported by buoyant labour market developments. Meanwhile Chinese growth keeps slowing down, with on top higher inflationary pressures, mainly caused by higher food prices.

Global economy

Euro area economy bottoming out

New releases for Q3 real GDP growth in several euro area countries were somewhat better than we expected (e.g. Germany, Netherlands, France). However, some historical GDP figures for the second quarter were revised downward. On balance, the impact on euro area average growth forecasts was only marginal and the general storyline hasn't been altered. As a consequence, our annual average GDP growth for the euro area as a whole remained unaltered at 1.1% for 2019 and 1.0% for 2020.

More importantly, it seems that the absolute worst has passed for the euro area economy. Corporate sentiment indicators continue to signal a stabilisation or even some slight improvement in the economic environment. Business confidence in the manufacturing industry remains at low levels, but doesn't show a further deterioration in most euro area countries (figure 1). The services sector remains quite resilient. Though weakened in past months, consumer confidence is holding up relatively well.

Although recent data on German activity – such as industrial production and new orders in manufacturing – pointed to a rather weak start of the fourth quarter, forward-looking indicators are signalling some cautious improvements. The IFO Business Climate Index slightly rose in November based on improvements in companies' assessment of the current economic situation and expectations. In particular in the services and trade sector the business climate improved. The increase in the manufacturing PMI in November suggests the tide might be turning. The industrial recession hence seems to be gradually bottoming out. Meanwhile German labour market conditions remain relatively favourable. However, the acceleration in the vacancies fall signals that industrial weakness has taken its toll on the labour market as well.

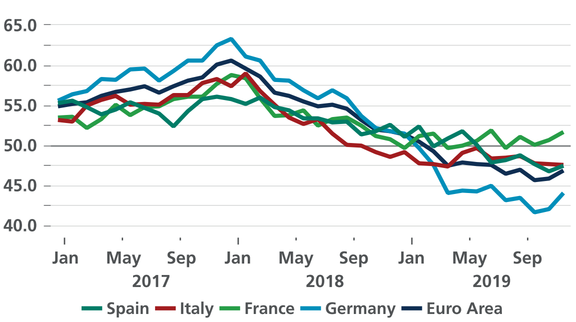
Based on the aforementioned facts, together with a better-than-expected real GDP growth result in Q3 (+0.1% qoq versus -0.1% qoq expected), fourth quarter growth will likely be lower again (-0.2% qoq) in our view. GDP growth in the third was quarter was underpinned by some one-off factors and hence the latest growth figure is unlikely to be sustainable.

Rocky start of Q4 in US

Though Q3 real GDP growth was revised slightly upwards (from 1.9% qoq to 2.1% qoq annualised), the start of the fourth quarter was rather rocky. Industrial production continued to decline in October even after excluding the effect of the strike at General Motors. However, three of the four main business sentiment indicators have remained in expansion territory. In the light of many domestic and external uncertainties, corporate investments remain rather weak though

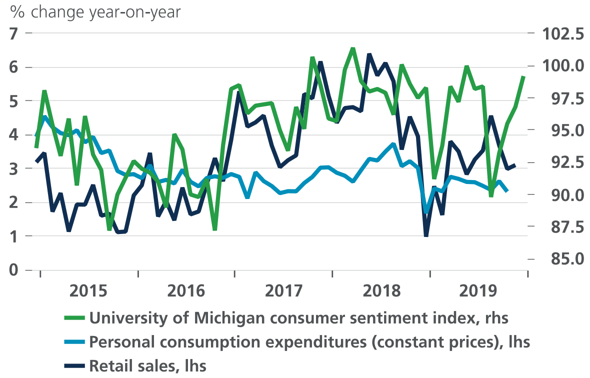
On the positive side, US consumers continue to remain mostly unaffected. Consumer confidence is still at high levels, with the University of Michigan's consumer sentiment index even increasing for the fourth month in a row in December (figure 2). Moreover, personal consumption and retail sales are showing solid year-on-year growth. Private consumption remains underpinned by solid labour market results. The November labour market report surprised on the upside, with stronger than expected jobs growth and upward revisions of job creation in previous months. Since growth support from the consumer

Figure 1 - Corporate sentiment in manufacturing showing no further deterioration
Markit PMI manufacturing, seeasonally adjusted



Source: KBC Economics based on IHS Markit

Figure 2 - US consumer remains resilient
% change year-on-year



Source: KBC Economics based on U.S. Census Bureau, BEA, University of Michigan

Box 1 – Preliminary views on the Fed's ongoing monetary policy strategy review

Washington-based Fed governor Lael Brainard offered her preliminary views on the Federal Reserve's ongoing review of its monetary policy strategy. The review is to be finalized next year. She started by admitting that she was struck that the effective lower bound (ELB) of policy rates proved to be a severe impediment to the provision of additional policy accommodation initially because of long delays needed to develop consensus and take action on unconventional policy which sapped confidence, tightened financial conditions and weakened the recovery.

In light of the likelihood of more frequent episodes at the ELB, the Fed's review should advance two goals. First, monetary policy should achieve average inflation outcomes of 2% over time to re-anchor inflation expectations at the central bank's target. Second, the Fed needs to expand policy space to buffer the economy from adverse developments at the ELB. With regard to inflation expectations, Brainard favours the symmetric approach. This implies supporting inflation a bit above for some time to compensate periods of underperformance. More specifically, she puts forward the idea of "flexible inflation averaging". By committing to achieving inflation outcomes that average 2% over time, the Fed would make clear in advance that it would accommodate rather than offset modest upward pressures to inflation in what could be described as a process of opportunistic reflation.

On the second topic, expanding policy space, Brainard advocates a more mechanical approach for policy action when policy rates hit the ELB in future downturns. In particular, she sees advantages to an approach that caps interest rates on Treasury securities at the short-to-medium range of the maturity spectrum - yield curve caps (YCC) - in tandem with forward guidance that conditions lift off from the ELB on employment and inflation outcomes. Both would reinforce each other. In addition, once the targeted outcome is achieved, and the caps expire, any securities that were acquired under the program would roll off organically, unwinding the policy smoothly and predictably. Brainard expects that effective security purchases would eventually be smaller under such a YCC system than compared with an outright buying programme.

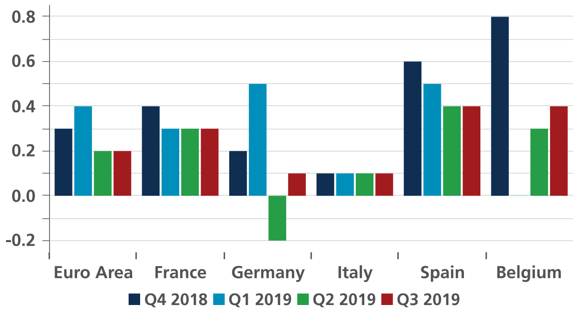
side remains solid, we stick to our growth forecasts of 2.3% and 1.7% for 2019 and 2020 respectively.

Politics posing risks

European political events in several countries are posing more risks to the outlook for the European economy. The French government's plans to reform the pension system and replace different existing pension schemes with a single, universal system triggered a storm of social protest and a general strike. Though the protests are of political nature, there is a risk that the public outcry against the government's reform agenda may dent confidence and possibly economic growth. As was seen at the height of the yellow vest protests in 2018, consumer confidence and spending could significantly suffer from social unrest (see Box 2). Nevertheless, the recent performance of the French economy was strong compared to other euro area countries (figure 3). Clearly, recent economic and labour market reforms are having a positive effect on the economy. We remain confident that the French economic outlook is bright, conditional on no excessive social unrest.

The Spanish political impasse continues. The November election results kept the Spanish parliament highly fragmented. The formation of a government remains challenging, but the provisional deal closed between the socialist PSOE and Podemos looks promising. Nevertheless, even if a government is formed, political and policy uncertainty will remain elevated and the risk of repeated elections persists as this new government is unlikely

Figure 3 - French economic performance has been relatively strong
Real GDP, Calendar Adjusted, SA, % change quarter-on-quarter



Source: KBC Economics based on Eurostat

Box 2 - France on strike against necessary pension reform

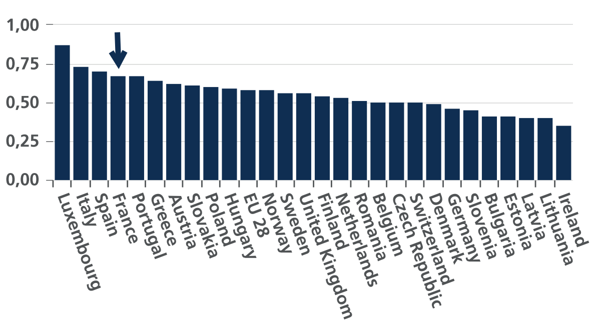
France is once more confronted with severe social unrest. Unlike the yellow vest protests that have continued for over a year, this time strikes are organised by the French unions. They are protesting against the pension reform that is currently being negotiated by the government of President Macron. This pension reform aims to replace the 42 existing pension schemes with a single, universal, points-based system, where one euro of contribution gives access to the same rights regardless of when it is paid or the status of the contributor.

The official goal of the reform is to improve the fairness and transparency of the pension system. Under current pension regimes, some workers such as train drivers can take their pension from the age of 52, which was originally seen as compensation for tough working conditions such as difficult hours and shift work. Another issue is that public sector pensions are calculated based on payments in the last six months before retirement while private sector pensions use the employee's 25 highest-paid years of work.

The proposed pension reforms make sense from an economic perspective. Apart from the perceived fairness, the affordability of the pension system is an important argument. The current replacement rate, the ratio of median gross pensions in the 65-74 age group compared to the median gross earnings of the 50-59 age group, is relatively high in France (figure B2.1). Combined with the relatively low effective retirement age of 60 years (figure B2.2), this results in a very expensive pension system, which will be strained even more as France moves towards an older population structure.

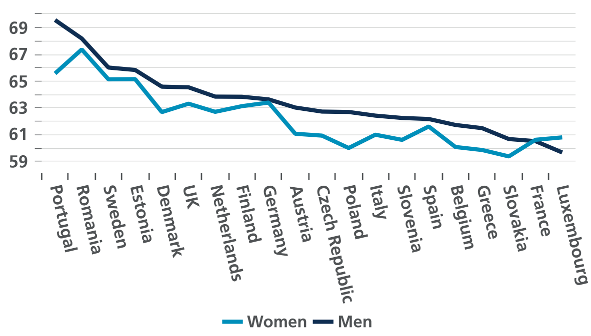
Pension reforms in France is a notoriously difficult thing to do. In 1995, the government of President Chirac was forced to back down from proposed changes to pensions of public sector workers after three weeks of strikes that immobilised much of the country's infrastructure. The current strike is open-ended and could drag on for some time. Depending on the length and intensity of the strikes, the impact on French GDP growth in Q4 and on confidence levels could be significant. From a long term perspective, the next weeks will be crucial. If the government fails to implement the reform because of the protests, French public finances will be under heavy strain in the years to come. However, so far, the French government managed to achieve a substantial part of its intended policy reforms. So if France survives another period of social unrest, this pension reform may contribute to a better economic performance in a structural way.

Figure B2.1 - Aggregate replacement ratio for pensions
median gross pension of 65-74 age group relative to median gross earnings of 50-59 age group



Source: KBC Economics based on Eurostat

Figure B2.2 - Average Effective Age of Retirement
in years



Source: KBC Economics based on OECD

to be very stable. Moreover, the impasse is likely to have fiscal implications as well. The budget for 2020 is still not passed and a roll-over of the 2019 budget is likely. In that case, there will be no (additional) fiscal stimulus measures. From a longer-term perspective, an unstable government is unlikely to find enough support for structural reforms. Hence, structural economic problems are unlikely to be tackled.

Another political source of uncertainty are recent events in Germany. The election of the new SPD leadership – one of the parties of the governing Grand Coalition – could cause some shift in the German policy stance. The outcome of the SPD election initially raised doubts about the continued existence of the Grand Coalition. However, a few days later the SPD stepped back from their earlier threat to pull out of the government alliance with the Christian Democrat Party. A collapse of the Grand Coalition before the federal elections of 2021 hence seems unlikely. The new SPD leadership continues to call for increased government investments and a reinforcement of the climate package. There is hence also a positive risk to economic growth attached to the new SPD leadership as they say the 'Schwarze Null' policy (also see KBC Economic Opinion of 07/05/2019) should not undermine continuing investment. Nevertheless, the most likely outcome is some limited additional stimulus in coming years, consistent with our scenario. The short-term impact on the business cycle will likely be muted given the traditional implementation lag of fiscal policy.

The outcome of the December 12th general election in the UK removes virtually all uncertainty about near term developments in relation to Brexit. The large majority won by the Conservative party of Boris Johnson ensures that he will be able to get parliamentary approval for the withdrawal agreement he negotiated with the EU in October. Hence, the UK will nominally leave the EU at the end of January 2020. However, to all intents and purposes the UK will continue to 'enjoy' the ties of membership during a transition period until the end of 2020. During this time Boris Johnson has promised a free trade agreement between the EU and UK will be concluded allowing a full and final departure at the end of 2020.

The unexpectedly large size of the majority won by Boris Johnson on December 12th means that he is no longer entirely reliant on small but previously important factions within the Conservative party or on the support of Northern Ireland's Democratic Unionist Party. This should give him more flexibility in negotiations on a future trade deal with the EU and could translate into a 'softer' Brexit than would have otherwise been the case. It should also provide the UK with scope to extend the transition period beyond 2020 if required (one extension of that period can be allowed if it is agreed by mid-2020).

While near term uncertainty has all but disappeared, more fundamental issues around the precise form of any eventual deal and, more importantly, whether it is feasible to reach a comprehensive agreement by the end of next year will likely translate into bouts of uncertainty through much of 2020. Significantly, this suggests renewed concerns about the risk of the UK 'crashing out' of the EU could return at one or more points during the year ahead with immediate and likely material impacts on economic sentiment in the UK and its main trading partners.

Notwithstanding the decisive outcome to the UK election, the achievement of a full free trade agreement between the UK and EU by the end of next year looks exceptionally ambitious, especially since the UK government envisages a notably limited agreement focussed on goods trade to enable the UK greater scope to conclude trade deals with other countries. However, to the extent that the UK uses that scope, regulatory and other checks on trade with the EU will be increased (to prevent the integrity of the EU single market being compromised via the UK).

Apart from many European political risks, the US is moving into the impeachment procedure against President Trump. Though the Democratic Party has convincing arguments that the president abused his political power, it remains unlikely that actual impeachment will happen as the Republican Party holds the majority in the US Senate, which has the ultimate say on a conviction.

Elsewhere, there remain various political risks too. The street protests in Hong Kong continue after the major election victory of the Pro-Democracy camp. Though protests are still massively attended, no new violence occurred. Moreover throughout Latin America there is social unrest that will pose major challenges to local policy makers. However, we don't expect any of these events to have implications on the global economic outlook.

Trade war at new fronts

The tone of the news flows about the US-China trade negotiations differs from day to day, but as of publication, expectations have grown that a phase-I trade deal will be signed by the deadline of 15 December. If there is an agreement, the US administration will not impose additional tariffs on imports coming from China. One of the main Chinese demands for a phase-I deal is that the US lowers some of the import tariffs that were already imposed. However, the US refuses to lower tariffs for a deal that doesn't tackle core issues such as intellectual property protection. Another outstanding issue is how to ensure China purchases more US agricultural goods – which would likely be part of the deal as well. In any case, a phase-I trade deal would not mean the end of the trade issues between the economies as fundamental problems remain and the technology war is set to continue in the coming years.

Meanwhile President Trump is broadening the trade war to new fronts. Under the accusation that many countries have devalued their currencies over the past few years, President Trump announced import tariffs on steel and aluminium coming from Brazil and Argentina. President Trump also fanned the flames in the US-EU trade conflict. As a reaction to the French Digital Services Tax (DST), the US Trade representative announced additional duties of up to 100% on French products with an approximate trade value of $2.4 billion - roughly 5% of the value of total US goods imports from France in 2018. The DST was implemented in France earlier this year and is a 3% tax on gross revenues from large digital companies active in France. A US investigation into the tax determined that it discriminates against US digital companies (such as Google). This prompted the creation of a list of targeted products, including amongst other things cheese, sparkling wine, handbags and some beauty products, with the effects of the duties beginning in January after a public hearing. The European Commission already announced its intention to take the conflict to the World Trade Organisation.

The trade conflict casts a new threat to the outlook for the euro area. If it indeed comes to a direct confrontation between the US and the EU, the assumed recovery of the euro area economy might become endangered.

Central and Eastern European Economies

Growth divergence in Central Europe and why EU funds matters

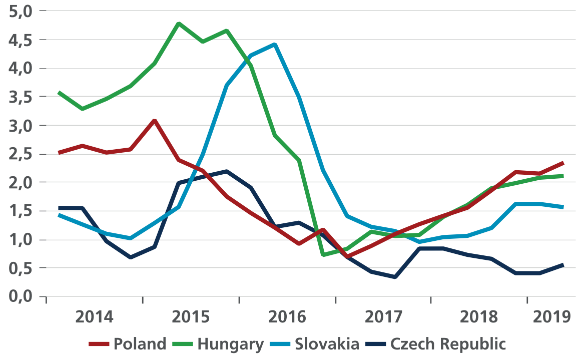
It was generally expected that the recent growth slowdown in the euro area, and in particular in Germany, would have a negative effect on Central and Eastern European economies. Overall, the region is still surprisingly resilient to the stagnation in the German economy. Nevertheless, we still notice some significant growth divergences in the Central European region since the beginning of 2018. On the one hand, there are the fast-growing Hungarian and Polish economies, characterized by annual GDP growth rates of 4-5%. On the other hand, there are the Czech and Slovak economies, growing at roughly half that rate. The individual regional economies, naturally, do not have an identical characteristics. Their growth rates, therefore, cannot be expected to be identical either. However, the differences in growth have been rather significant in the past quarters and this cannot fully be attributed to country-specific factors, such as varying dependencies on the German economy, the current fiscal policy stance or the progress in real convergence. Indeed, part of the growth differences also relate to the ability of the regional economies to make use in a timely manner of available transfers from the EU structural funds (European Regional Development Fund, European Social Fund, Cohesion Fund). This is an important insight, especially given the ongoing negotiations on the new EU multi-annual budget framework.

Poland on top, Czech Republic at the bottom

A comparison of the drawing of transfers from the EU structural funds, both across the countries of the region and over time, clearly documents which economies might (and which might not) have significantly benefited from the EU subsidies over the past years. The balance of payments data of the individual countries indicate that the Polish and Hungarian governments managed to accelerate the influx of money from the EU structural funds in recent quarters compared to the lows in 2017-16, with inflows currently amounting to about 2.5% of GDP (figure CEE1). However, the Czech Republic is at the opposite end of the scale, having managed to receive European subsidies worth only 0.5-1.0% of GDP. This is much less, not only in comparison with the countries of the region, but also compared to earlier periods. Transfers flowing from the EU structural funds to the Czech Republic reached a nearly historical low in the first half of 2019. Slower pay-outs of EU subsidies, however, also affected Slovakia, which received significantly less in recent years than the subsidy ceiling or the longer-term average.

Figure CEE1 - Transfers from EU structural funds

in % of annual GDP



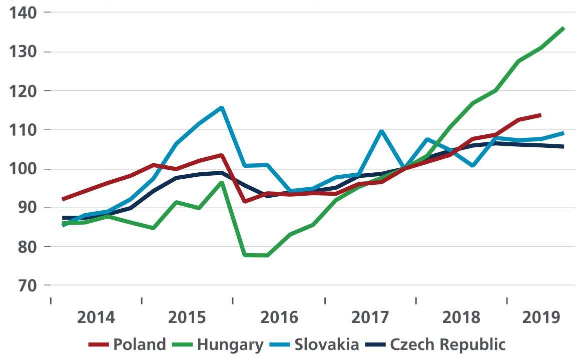
Source: KBC Economics based on Eurostat

Higher EU transfers, higher domestic investments

The above-mentioned differences in the relative level of transfers coming from the EU structural funds are not negligible at all. In our view, these EU funds affect the performance of the Central European economies in two dimensions. First, the investments financed by the EU structural funds should increase the growth potential of the respective economies via the supply side of the economy, i.e. improving productivity. We do see evidence of this and will present an analysis of this long-term phenomenon

Figure CEE2 - Investments in Central Europe

gross fixed capital formation, in constant prices, Q4 2017=100



Source: KBC Economics based on OECD

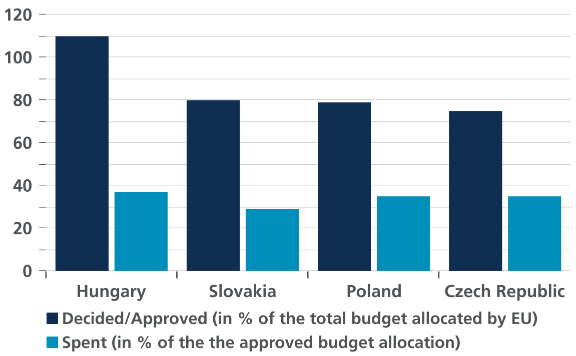
in a (forthcoming) Economic Research Report. Second, transfers from the EU structural funds also impact short-to medium term domestic demand in the Eastern European economies, mainly through investment. This is important for the business cycle and current growth rates. In this respect, we cannot ignore the differences between investment trends among the Central European economies over the past years (figure CEE2). While gross fixed capital formation has increased by more than 30% since the end of 2017 in Hungary, the increase in the same GDP component in the Czech Republic or Slovakia was only in the single digits.

Mind the seasonality of seven-year EU budget

An important question is whether the different trends in receiving money from the EU structural funds may change significantly in the short term. The truth is that pay-outs of structural funds has a certain aspect of seasonality over the course of the seven-year budget time horizon, as it speeds up at the end of the budget cycle. It is evident here that a clear leader in obtaining money from the structural funds is Hungary, which has been able to prepare and approve projects representing 110% of the 2014-2020 budget allocated to Hungary (figure CEE3). On the other hand, in the case of the Czech Republic the rate of approved projects is only 75% of what was allocated to the Czech republic by the seven-year budget, and moreover even only 35% of the approved allocation was spent.

The current seven-year EU budget is about to end, but the funds from structural funds can be paid-out until 2023. This indicates that countries like the Czech Republic or Slovakia still have a chance to promptly accelerate their administrative procedures to make progress in the approval of projects and in real pay-outs of EU structural funds. Such a positive development then may result in higher growth for several quarters to come in these countries. On the other hand, given the low level of approved projects and insufficient time to handle the whole process, the Czech Republic and to some extent Slovakia are at risk of not being able to absorb 100% of the allocated budget to them for the current 2014-2020 period. No wonder then that the growth gap between them and the other Central European countries is and will be bigger (all else equal).

Figure CEE3 - Implementation of EU long-term budget 2014-2020



Source: KBC Economics based on European Commission

Czech Republic

Economic slowdown confirmed

As already implied by the flash GDP estimate, Czech economic growth slowed in the third quarter. The economy grew by 2.5% yoy compared to 2.7% yoy in the first half of the year. In addition to net exports, growth was mainly fuelled by household and public consumption. This time, it was investments that worked as a negative factor, falling as a result of cuts in machinery and ICT expenditure (figure CZ). Investments followed a downward trend as non-financial enterprises completed their major investment projects and have not yet gathered the courage to venture into new ones in this period of uncertainty. By contrast, investment in housing and public sector-funded construction projects remains on the rise. However, especially in the latter case, whether the trend will continue largely depends on the willingness and ability of the government to finance such projects next year.

Once again, services (especially trade and transport) were the dominant factor on the supply side, whereas the contribution of industry, as traditionally the most important sector, came close to zero this time around. Domestic companies are increasingly affected by weak demand abroad, and so far only the automotive industry and manufacturing of electrical equipment have managed to remain in the black. However, whether they will be able to sustain this positive trend in the coming months is questionable. Soft data suggests that confidence in the industrial sector is falling again. This is clearly demonstrated by the PMI and especially the expectations sub index, which currently reports its worst figure since the indicator was introduced (2001). New order statistics in the industrial sector are also rather negative at the moment.

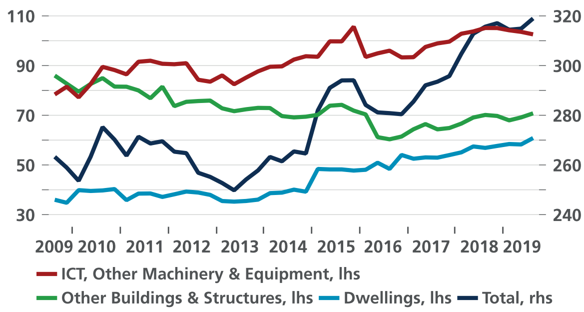
On the other hand, the construction sector is nowhere close to experiencing a shortfall in orders, which translates into a faster price growth for construction work and material. Regardless, considering its size, the sector can hardly be expected to compensate the downturn in industry, which accounts for almost a third of the entire economy.

Inflation remains in the upper half of the tolerance range

The economic slowdown is beginning to take its toll on the labour market. The fall in unemployment has already come to

Figure CZ - Investments in machinery and ICT equipment weighing on growth

gross ficed capital formation, constant prices, in billions CZK



Source: KBC Economics based on CZSO

an end, with the number of new vacancies ceasing to grow. Similarly, there was another slump in the growth of average and median wages in the third quarter. However, those effects were not significant enough to affect inflation, which remains in the upper half of the CNB's tolerance interval. At the same time, with ever more expensive housing and energy, inflation is very likely to stay high. By contrast, as it pertains to retail goods, inflation remains relatively low due to the intensifying competitive struggle between traditional "brick-and-mortar" shops and e-shops, whose market share already surpassed the 10% mark last year.

So far, the CNB has responded to the higher inflation with only one interest rate increase in 2019. At the last two sessions, the majority of the Bank Board opted to leave rates unchanged, justifying their decision by noting persistent external risks and uncertainties. We expect a similar outcome from the CNB session to be held in December, especially as the Czech economy is already beginning to experience some negative tendencies spilling over from abroad. Although the Central Bank's current forecast envisages two rate hikes already by the turn of next year (to be followed by a threefold decrease later on), we believe the CNB will wait longer. Also, the strength of the Czech koruna does little to make the Bank re-evaluate its position.

State budget deficit on the rise

The state budget deficit for the first eleven months of the year is approaching the full-year plan limit of CZK 40 billion. Negative tendencies are evident and will affect public finances next year. Above all, this includes the lower-than-estimated tax collection (especially for VAT) caused by slower economic growth and the previous, unjustified optimism on the part of the Czech Ministry of Finance. The other factor, which is likely to grow in severity next year, is a rise in social benefits, including pensions. Given the limited margin for manoeuvre, the options being considered for 2020 include a deficit higher than the approved CZK 40bn, or worse, investment cuts, which would only strengthen the pro-cyclical effect of the Czech fiscal policy.

Considering the high liquidity of the financial markets and the country's low indebtedness, bond markets currently assign low importance to these signs of a worsening fiscal balance. Consequently, bond yields remain low, even well below the CNB's main interest rate. Instead, they reflect the trends in yields seen on the European market, yet, in comparison to German Bunds, at least offer positive investment valuation. Interest rate curves on the swap market remain inverted, confirming that markets have not yet given up on their expected scenario in which interest rates drop further.

Hungary

Good start to the fourth quarter

The Hungarian economy has started the last quarter of 2019 with strength in both the industrial sector and retail business. The construction sector is also still booming, but we expect a massive slowdown for 2020 (from around 20% yoy currently to about half that rate). The preliminary industrial production figure showed 6.1% yoy growth in October. However, trends across sectors differ. The productions of vehicles, electronics and optical equipment and devices slowed down, while food and tobacco production rose above the average. Developments in the automotive sector are obviously very important for the overall economy. Vehicle production was quite volatile during the year, so it is still hard to predict whether the current weaker performance is driven by the global deteriorating environment or just a temporary drop. As globally lay-offs in the sector have been announced, it is quite likely that we might see weaker figures in vehicle production in the coming quarters.

But regarding retail sales, the quite elevated growth rate of around 5% yoy may continue next year as well. The October figure showed 5.7% yoy growth (figure HU). The sector has been boosted by massive real wage growth of around 7-8% yoy and also by booming consumer borrowing. As we expect the National Bank of Hungary to maintain the current low interest rate environment in 2020 and the debt-to-GDP ratio of households is still low compared to the region, consumer loans may boost consumption further. This is also true of real wage growth, even though it may slow slightly next year to around 5% yoy. Growth in the retail sector is still driven mainly by the sales of non-food products, but fuel consumption is also high.

Figure HU - Retail sales driven by high wage growth and consumer borrowing

retail sales, calender and seasonally adjusted, constant prices, % change year-on-year

Source: KBC Economics based on HCSO

Upgrade of 2019 annual GDP estimate

The remarkable economic growth seen thus far this year (5.1% yoy) and the strong start to the fourth quarter suggests that the Hungarian economy has been surprisingly immune to the deteriorating European performance. Although negative spillovers may still occur, Hungarian GDP will likely grow around 4.2% yoy in the fourth quarter. Consequently, we revised our growth forecast for the calendar year 2019 to 4.8%. The strong growth has in part been driven by the use of the EU funds money (see introduction), which could remain, at a maximum, at the same level in 2020. Most likely, however, it will be slightly lower. Additionally, fiscal support might also be lower as the budget plans for a 1% of GDP deficit next year compared to 1.8% of GDP this year. So, we maintain our view that the economy may slow to around 3.5% yoy in 2020. The main drivers of growth will remain domestic consumption and investment from the demand side, and market services and construction from the supply side. Industrial production will also remain a positive contributor to economic growth, although with a smaller pace than in this year.

Bulgaria

Economic growth remains robust

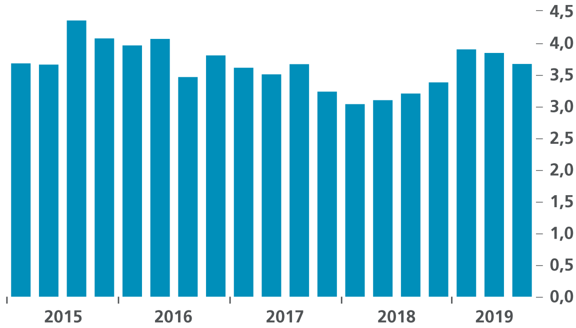
While economic growth across some Central and Eastern European economies saw a pronounced slowdown in the third quarter, Bulgaria's expansion remains surprisingly robust and among the highest in the European Union. Following real GDP growth of 3.8% yoy in the second quarter, the revised GDP reading for Q3 shows that economic activity ticked down only marginally to 3.7% yoy; on a quarter-on-quarter basis growth moderated from 0.9% in Q2 to 0.8% in Q3 (figure BG1).

A detailed breakdown of national account data confirms that growth was again driven by buoyant domestic demand. Private consumption continues to be the main driver of year-on-year growth, benefiting from a record-low unemployment rate and rapid wage growth. However, on a quarterly basis, household consumption has seen a material slowdown throughout the year (from 3.3% qoq in Q1 to 0.5% qoq in Q3), suggesting that consumer spending is somewhat losing momentum. Meanwhile, government consumption accelerated sharply from -0.4% qoq in Q2 to 2.3% qoq in the third quarter, driven by a more expansionary fiscal policy. Investment growth picked up mildly, however, overall dynamics continue to remain sluggish, likely dragged down by increased uncertainty amid a more challenging external backdrop. Last but not least, exports surprised on the upside having rebounded from -3.4% in Q2 to 4.3% in Q3, turning the overall contribution of net exports to real GDP growth marginally positive. Such a solid performance of the external sector is further underpinned by a historically high current account surplus of 8% of GDP in the third quarter, which we attribute to high competitiveness of the Bulgarian economy.

Given the better-than-expected GDP reading for the third quarter, indicating a continued resilience of the Bulgarian economy to a slowdown in its major trading partners, we have upgraded our forecast for annual growth in 2019 to 3.6%. Still, this implicitly assumes an easing of economic activity in the last quarter of this year to 3.0% yoy. Although no high frequency hard data have been released for the fourth quarter, we see a persistent weakness in industrial sector taking its toll on overall growth.

For 2020, we maintain our forecast of 3.1% growth driven by domestic demand, but it is subject to a number of external risks. Notwithstanding the fact that the Bulgarian economy has been so far able to shoulder increased uncertainty from trade disputes and slowdowns in the euro area and Turkey, it is highly unlikely that the economy would be able to continue performing so strongly if the external backdrop remains challenging. In other words, the longer the external weaknesses persist, the more difficult it will be for the Bulgarian economy to remain resilient.

Figure BG1 - Bulgarian GDP growth strong in 2019
real GDP growth in %, year-on-year, seasonally adjusted

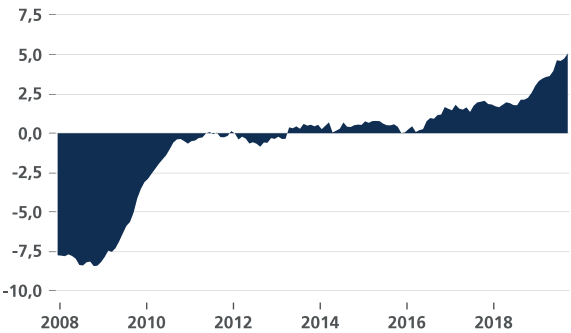


Source: KBC Economics based on NSI

Upgrade in sovereign ratings confirms solid fundamentals

Last month, the credit ratings agency Standard & Poor's (S&P) upgraded Bulgaria's sovereign credit rating from BBB- to BBB with a positive economic outlook, thus confirming the economy's solid fundamentals. Such fundamentals include a historically low unemployment rate, a strengthening fiscal position with low government debt, and a strong external position (figure BG2). Aside from these buffers, which would help in case of an adverse external shock, the agency also assessed positively Bulgaria's institutional convergence (such as the implementation of EU legislation on the central bank and macro-prudential supervision). Overall, the outlook for Bulgaria's sovereign credit ratings is assessed as positive by the other major credit rating agencies Fitch (BBB) and Moody's (Baa2).

Figure BG2 - Bulgarian competitiveness increasing
current account, in billions EUR, 12-month rolling sum



Source: KBC Economics based on BNB

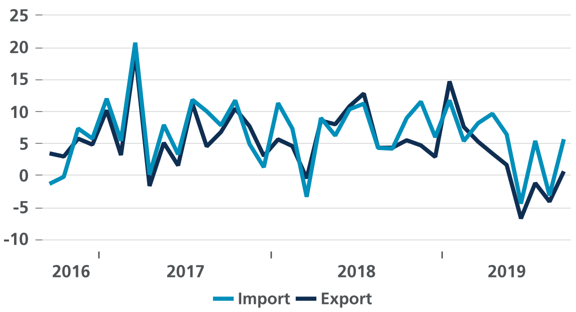
Slovakia

GDP growth has slowed significantly. Investments were a positive surprise.

The Slovak economy continues its cooling trend. The statistical office confirmed its preliminary estimate of 1.3% yoy growth in the third quarter. This follows growth of 2.2% yoy in the second quarter and even stronger growth at the start of the year. At the same time, growth in 2018 was revised downwards slightly, from 4.1% to 4.0%. Slovakia's performance is tracking the trend in Western Europe. The growth slowdown is mainly due to weaker external demand (figure SK). The slowdown in Germany has had a notable effect on Slovakia's foreign trade and manufacturing industry (especially in the automotive sector). Exports of goods and services reached -0.2% yoy, slowing from a rate of +9% yoy in the first quarter. The decline in imports can be linked to lower car sales in the main European markets in the third quarter.

By contrast, Slovak import growth accelerated from 1.5% to 3.3% yoy. These imports were probably destined for investments, because investment accelerated at the same time from 2.4% to 7.8% yoy. Machinery was the strongest area of investment despite the weak economic performance of Germany, Slovakia´s largest trading partner. The sectors with the most investment included refineries, wood processing and the automotive industry amongst others. The growth in imports and investments may be linked to the expected growth in the automotive industry when new production comes online. A decline in investment activity was observed in the public sector. This can also be seen in the underuse of EU funds, which are traditionally the main source of public sector investment. Government consumption growth slowed from 5% to 3.7% yoy.

Figure SK - Weaker external demand main reason behind Slovak growth slowdown
monthly data, % change year-on-year



Source: KBC Economics based on SUSR

Household consumption showed a similar slowdown, from 2.7% to 1.8% yoy. One reason for this is a deceleration in average wage growth from 9.7% to 7.7% yoy. Another factor is the continued growth of the household savings rate, which reached record levels (almost 11%) in Q3 2019. The creation of new jobs in the labour market is also slowing. Employment increased by 1% (1.4% in Q2) and jobs were created mainly in construction and the public sector. Manufacturing, on the other hand, saw a decline in employment fully reflecting the cooling of demand.

Given the surprisingly weak GDP growth in the third quarter, our estimate for 2019 growth is reduced to 2.2%. On the other hand, some evidence of slightly more favourable prospects is provided by the economic sentiment index, which jumped above its long-term average in November. It was driven upwards mainly by increasing confidence in manufacturing and retail. Entrepreneurs are expecting growth in demand and production in the near future.

Slight fall in inflation

Inflation fell slightly to 2.9% yoy in October (3% in September). The main driver was a weakening of demand factors in response to cooling economic growth. A faster fall in inflation was prevented by rising food prices and labour costs which are reflected in the cost component of inflation. Food prices have grown by more than 5% yoy. However, inflation should no longer rise significantly and could fall slightly next year. An important factor for its development will be the regulator's decision on increases in household gas and electricity prices for 2020 (the decision process is ongoing).

Budget approved

Parliament approved the 2020 budget. A general government deficit of less than 0.5% of GDP is forecasted. The more likely scenario, however, is a deficit of around 1.5% to 2.0% of GDP. The reason is the economic slowdown, as well as several overvalued dividend income items. It is therefore likely that the new government will have to introduce budget correction measures after the elections (29 February 2020). The bond market is remaining calm though. Ten-year bond yields have copied the trend for German Bunds. Spreads of around 40 points have been maintained on Bunds.

Ireland

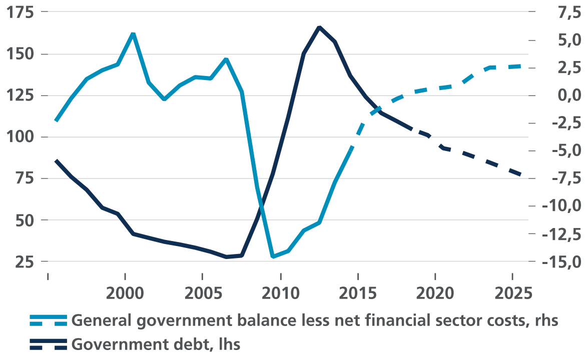
Irish GDP data for the third quarter confirm the continuing strong momentum in activity suggested by most higher frequency data. GDP increased by 1.7% on the preceding quarter to stand 5.0% higher than a year earlier. The robust increase reflects healthy increases in consumer spending and construction and further strong gains in exports. With near term Brexit risks sharply reduced, this broadly based improvement implies GDP growth will be stronger than we previously expected. We now see Irish GDP increasing by 6% in 2019 and 4% in 2020.

Recent higher frequency activity data show that manufacturing production continues to post annual increase in both the domestic oriented traditional sector and the modern export focused sector dominated by multinationals in sectors such as pharmaceuticals and IT. This has translated into strong end-November corporation tax receipts, which has resulted in notably larger than expected revenues overall and implies a larger than envisaged fiscal surplus of about 0.7% of GDP in 2019 (figure IE).

The Irish labour market continues to improve despite some sectoral and regional divergences. The latest data are showing that numbers employed increased by 17.3k in Q3 compared to Q2, which translated to annual employment growth of 2.4% yoy (+53.7k jobs). The unemployment rate for November at 4.8% is down from 5.6% a year ago.

Consumer price inflation ticked up marginally in November to 0.8% yoy from 0.6% yoy, but house price inflation dropped to 0.9% yoy. While this is the slowest increase in six years, it is effectively unchanged from September's figure of 1.0%. Given the latest macroeconomic developments, we think that the trend slowdown may be near to bottoming out. New supply has played some role but by and large we think that constraints on affordability, particularly in Dublin, are the main factor.

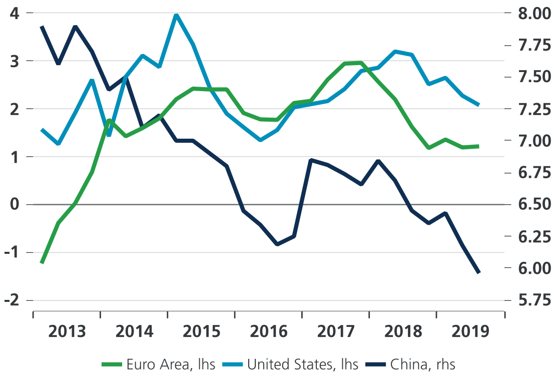
Figure IE - New fiscal targets not a major restraint
in % of GDP



Source: KBC Economics based on NTMA, CSO, Banque de France, Eurostat, ECB

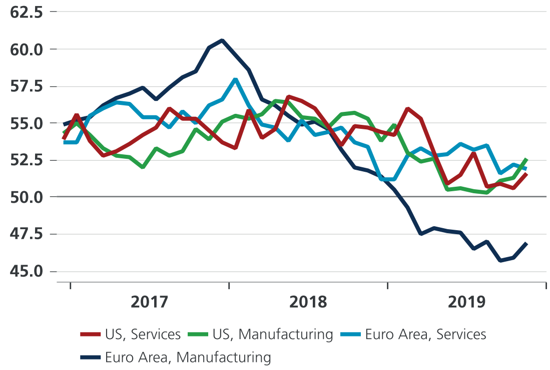
Figures

Real GDP
yearly change in %



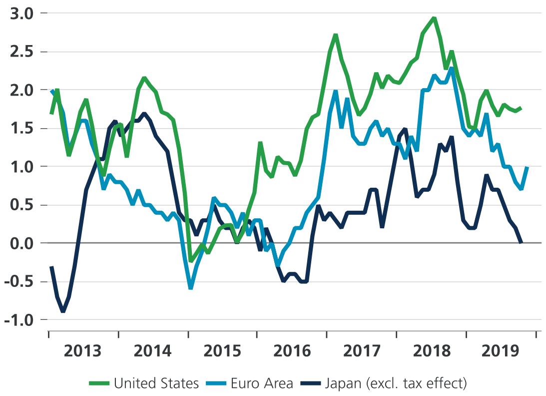
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



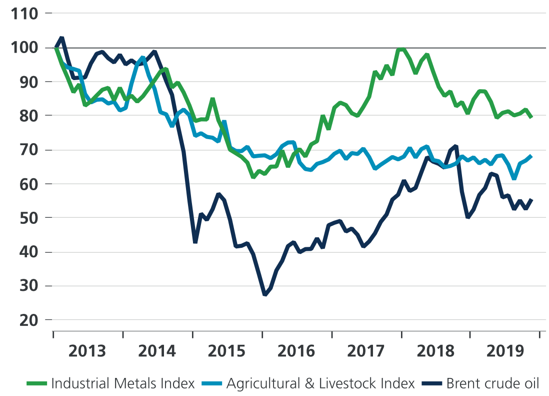
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



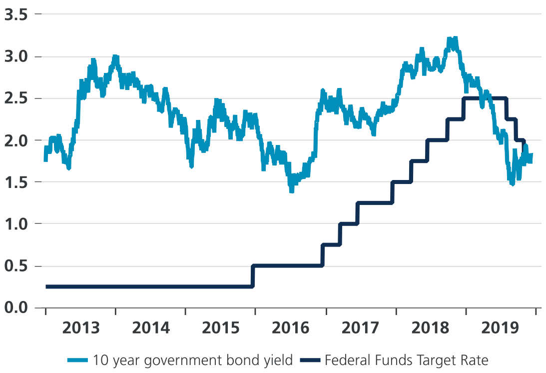
Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, BLS

Commodity prices
index, January 2013=100, in USD



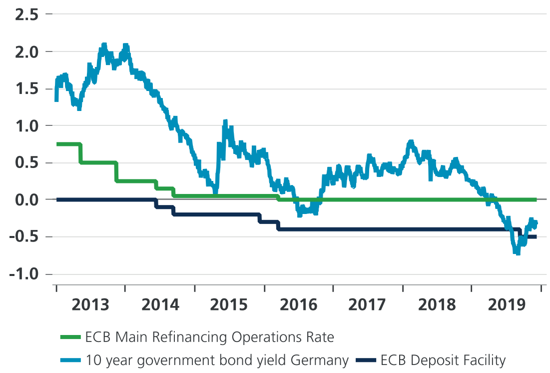
Source: KBC Economics based on World Bank, SPDJI

United States interest rates
in %



Source: KBC Economics based on Fed, Macrobond

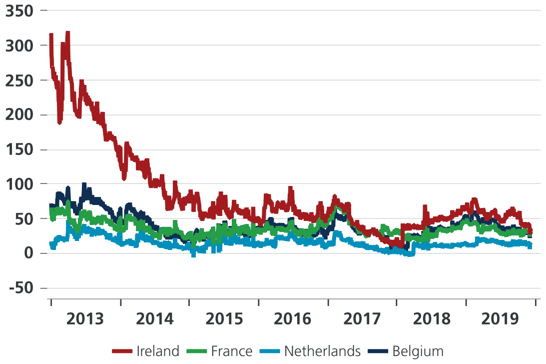
Euro area interest rates
in %



Source: KBC Economics based on Macrobond, ECB

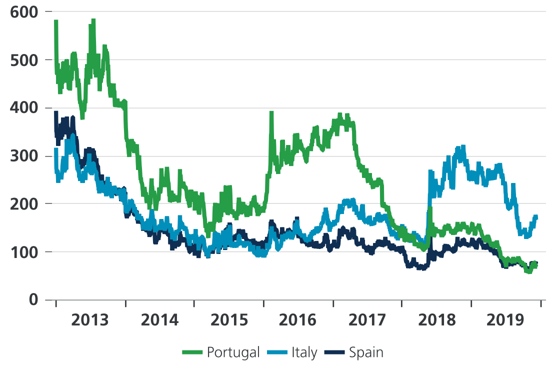
Figures

10 year government bond yield spreads to Germany
in basis points



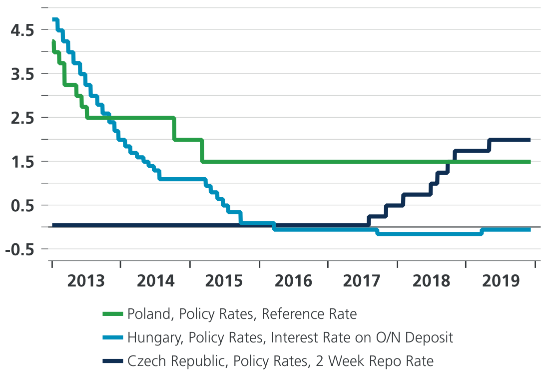
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



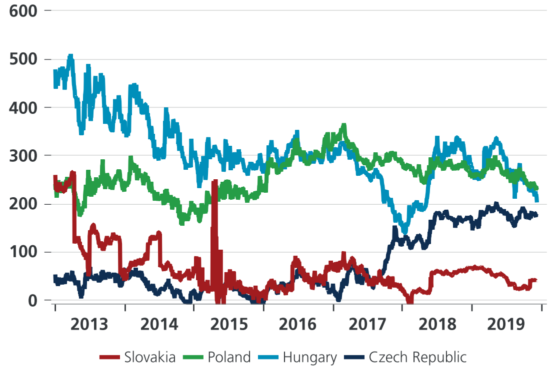
Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %



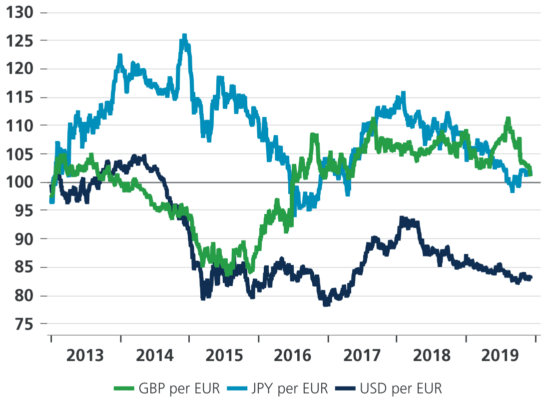
Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points



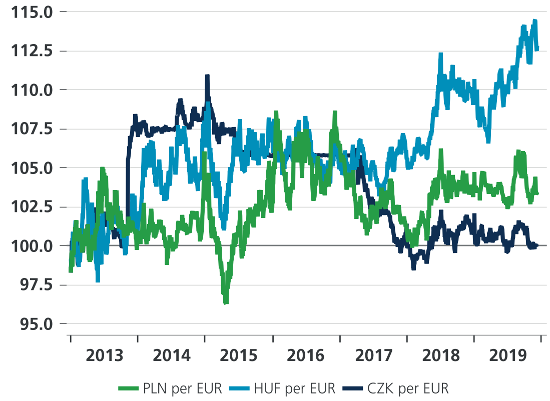
Source: KBC Economics based on Macrobond, AKK, Eurostat

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



Source: KBC Economics based on Macrobond

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



Source: KBC Economics based on Macrobond

Outlook main economies in the world

		Real GDP growth (period average, in %)			Inflation (period average, in %)		
		2018	2019	2020	2018	2019	2020
Euro area	Euro area	1.9	1.1	1.0	1.8	1.2	1.2
	Germany	1.5	0.5	0.6	1.9	1.4	1.5
	France	1.7	1.3	1.2	2.1	1.3	1.3
	Italy	0.7	0.2	0.5	1.2	0.8	0.9
	Spain	2.4	2.0	1.5	1.7	0.8	1.1
	Netherlands	2.6	1.7	1.5	1.6	2.6	1.3
	Belgium	1.5	1.3	0.9	2.3	1.3	1.4
	Ireland	8.2	6.0	4.0	0.7	0.9	1.5
	Slovakia	4.0	2.2	2.2	2.5	2.7	2.2
Central and Eastern Europe	Czech Republic	3.0	2.4	2.2	2.0	2.6	2.4
	Hungary	5.1	4.8	3.5	2.9	3.4	3.5
	Bulgaria	3.1	3.6	3.1	2.6	2.5	2.3
	Poland	5.1	4.3	3.8	1.2	2.1	2.5
	Romania	4.0	4.4	3.7	4.1	3.9	3.9
Rest of Europe	United Kingdom	1.4	1.2	1.1	2.5	1.8	1.7
	Sweden	2.4	2.0	1.9	2.0	1.9	2.0
	Norway	2.2	2.4	1.9	2.7	2.2	1.9
	Switzerland	2.8	0.8	1.2	0.9	0.5	0.6
Emerging markets	China	6.6	6.1	5.7	2.1	2.8	3.2
	India*	6.8	5.1	6.4	3.9	3.4	4.1
	South Africa	0.8	0.3	0.8	4.6	4.1	4.9
	Russia	2.3	1.2	1.7	2.9	4.5	3.7
	Turkey	2.6	-0.1	2.5	16.3	15.5	11.0
	Brazil	1.1	1.1	2.0	3.7	3.6	3.5
Other advanced economies	United States	2.9	2.3	1.7	2.4	1.8	2.1
	Japan	0.8	1.0	0.5	1.0	0.6	0.7
	Australia	2.7	1.7	2.3	2.0	1.6	1.8
	New Zealand	2.8	2.5	2.7	1.6	1.4	1.9
	Canada	1.9	1.5	1.6	2.3	2.0	1.9
* fiscal year from April-March							*12/12/2019*

Policy rates (end of period, in %)						
		12/12/2019	Q4 2019	Q1 2020	Q2 2020	Q3 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	2.00	2.00
	Hungary	-0.05	-0.05	-0.05	-0.05	-0.05
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.50
	Romania	2.50	2.85	3.00	3.00	3.00
Rest of Europe	United Kingdom	0.75	0.75	0.50	0.50	0.50
	Sweden	-0.25	0.00	0.00	0.00	0.00
	Norway	1.50	1.50	1.50	1.50	1.50
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	3.25	3.25	3.10	3.10	3.10
	India	5.15	5.15	4.90	4.90	4.90
	South Africa	6.50	6.50	6.25	6.25	6.25
	Russia	6.50	6.25	6.00	6.00	5.75
	Turkey	14.00	13.00	13.00	13.00	12.50
	Brazil	4.50	4.50	4.50	4.50	4.75
Other advanced economies	United States (upper limit)	1.75	1.75	1.75	1.75	1.75
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	0.75	0.75	0.75	0.75	0.75
	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

UBB
Part of KBC Group

10 year government bond yields (end of period, in %)						
		12/12/2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
Euro area	Germany	-0.32	-0.30	-0.30	-0.20	-0.10
	France	-0.01	0.00	0.00	0.10	0.20
	Italy	1.30	1.45	1.45	1.60	1.90
	Spain	0.41	0.45	0.45	0.55	0.65
	Netherlands	-0.19	-0.15	-0.15	-0.05	0.05
	Belgium	-0.03	0.00	0.00	0.10	0.25
	Ireland	-0.01	0.10	0.20	0.30	0.40
	Slovakia	0.08	0.00	0.00	0.10	0.25
Central and Eastern Europe	Czech Republic	1.51	1.40	1.46	1.48	1.49
	Hungary	1.87	1.80	1.90	2.00	2.35
	Bulgaria	0.40	0.30	0.30	0.40	0.50
	Poland	1.99	2.00	2.10	2.20	2.30
	Romania	4.73	4.28	4.30	4.31	4.35
Rest of Europe	United Kingdom	0.77	0.70	0.75	0.75	0.75
	Sweden	0.02	0.05	0.05	0.15	0.25
	Norway	1.47	1.45	1.45	1.55	1.65
	Switzerland	-0.60	-0.60	-0.60	-0.50	-0.40
Emerging markets	China	3.21	3.20	3.20	3.30	3.40
	India	6.77	6.65	6.65	6.75	6.85
	South Africa	8.37	8.40	8.40	8.50	8.60
	Russia	6.40	6.50	6.50	6.50	6.25
	Turkey	12.15	12.50	13.00	13.00	12.75
	Brazil	6.78	6.80	6.80	6.90	7.00
Other advanced economies	United States	1.81	1.80	1.80	1.90	2.00
	Japan	-0.01	0.00	0.00	0.00	0.00
	Australia	1.14	1.20	1.20	1.30	1.40
	New Zealand	1.54	1.50	1.50	1.60	1.70
	Canada	1.58	1.55	1.55	1.65	1.75

Exchange rates (end of period)					
	12/12/2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
USD per EUR	1.11	1.11	1.12	1.14	1.16
CZK per EUR	25.51	25.60	25.40	25.30	25.20
HUF per EUR	329.94	330.00	326.00	332.00	338.00
PLN per EUR	4.29	4.28	4.26	4.25	4.30
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.78	4.75	4.70	4.65	4.60
GBP per EUR	0.84	0.84	0.87	0.89	0.91
SEK per EUR	10.44	10.50	10.50	10.50	10.50
NOK per EUR	10.13	10.10	9.85	9.75	9.65
CHF per EUR	1.09	1.10	1.10	1.11	1.12
BRL per USD	4.12	4.18	4.15	4.15	4.10
INR per USD	70.65	71.30	71.00	71.00	71.00
ZAR per USD	14.66	14.70	14.70	14.70	14.70
RUB per USD	63.23	64.00	65.00	64.00	64.00
TRY per USD	5.80	5.80	5.95	6.00	6.10
RMB per USD	7.03	7.05	7.10	7.15	7.15
JPY per USD	108.61	109.00	109.00	109.00	109.00
USD per AUD	0.69	0.69	0.69	0.70	0.70
USD per NZD	0.66	0.66	0.66	0.66	0.67
CAD per USD	1.32	1.32	1.31	1.30	1.30

Outlook KBC home markets

	Belgium			Ireland		
	2018	**2019**	**2020**	**2018**	**2019**	**2020**
Real GDP (average yearly change, in %)	1.5	1.3	0.9	8.2	6.0	4.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.3	1.4	0.7	0.9	1.5
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.8	5.7	5.9	5.7	4.9	4.9
Government budget balance (in % of GDP)	-0.7	-1.3	-2.2	0.1	0.7	1.0
Gross public debt (in % of GDP)	100.0	99.5	99.4	63.6	58.0	54.0
Current account balance (in % of GDP)	-1.0	-1.4	-1.8	9.1	-3.0	-3.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	2.9	3.0	2.1	10.2	2.5	2.5

12/12/2019

	Czech Republic			Slovakia		
	2018	**2019**	**2020**	**2018**	**2019**	**2020**
Real GDP (average yearly change, in %)	3.0	2.4	2.2	4.0	2.2	2.2
Inflation (average yearly change, harmonised CPI, in %)	2.0	2.6	2.4	2.5	2.7	2.2
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.1	2.0	2.1	5.9	6.2	6.3
Government budget balance (in % of GDP)	1.1	0.0	-0.5	-1.1	-1.2	-1.5
Gross public debt (in % of GDP)	32.6	31.0	30.3	49.4	48.0	47.5
Current account balance (in % of GDP)	0.3	0.3	0.2	-2.6	-3.0	-3.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	8.6	7.0	2.0	7.4	5.0	4.0

12/12/2019

	Hungary			Bulgaria		
	2018	**2019**	**2020**	**2018**	**2019**	**2020**
Real GDP (average yearly change, in %)	5.1	4.8	3.5	3.1	3.6	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)	3.7	3.5	3.5	4.7	3.8	4.0
Government budget balance (in % of GDP)	-2.3	-1.8	-1.0	1.8	-0.5	0.4
Gross public debt (in % of GDP)	70.2	68.0	65.9	22.3	19.0	17.7
Current account balance (in % of GDP)	-0.5	-0.7	-1.0	5.4	8.0	4.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	14.3	15.0	10.0	6.6	5.0	4.0

12/12/2019

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