Economic perspectives

January 2020

Highlights

- After the global economic slowdown in 2019, 2020 starts with a slightly more positive economic outlook. Economic sentiment as well as activity data suggest some recovery in the global economy, although not all regions will evolve equally well.
- We confirm our scenario of a gradual recovery in the euro area economy in 2020. The manufacturing sector seems to have reached its trough in the fourth quarter of last year and a gradual recovery throughout 2020 is to be expected. Meanwhile, domestic demand and services remain resilient with limited spillovers from the manufacturing weakness. Unemployment rates remain very low in most European economies, while wage growth remains substantial despite the recent growth slowdown.
- Also in the US economy, economic developments are in line with expectations. In the context of global manufacturing weakness and an unfavourable, though somewhat improved, trade environment, US industry keeps on struggling. However, several positive signs in the US economy justify optimism. Private consumption is holding up well and we expect it to continue to be an important growth driver, supported by ongoing improvements in the US labour market.
- The economic outlook offers some support for current financial market optimism, although various risks may still affect the outlook. The signing of the US-China phase I trade deal makes further escalation of the US-China trade conflict unlikely in the short-term. However, several structural issues remain unresolved, which will likely cause more sparks of trade hostility going forward. Moreover, the risk of a direct confrontation between the EU and the US has become larger now after several recent political confrontations. The UK will leave the EU at the end of this month, but the trade negotiations that follow are likely to be bumpy as it is entirely unrealistic to envisage a comprehensive agreement can be reached by the end of this year. Also geopolitical tensions persist. We don't expect the recent US-Iran conflict to escalate into a full-blown military confrontation. However, the intrinsic instability of the Middle East may cause volatility in financial markets in the future.
- This environment makes it likely that major central banks will remain on hold. There were some patchy signs that inflation in the euro area and the US might be picking up somewhat in recent months, but it is too early to speak of any sustained increase in underlying inflationary pressures.

Global economy

Euro area scenario confirmed

Recent weeks brought few surprises in the latest data on the euro area economy. Revised GDP growth data were not materially different from earlier releases. Corporate sentiment indicators are meanwhile confirming our scenario of stabilisation with early signs of improvements in the manufacturing sector. In particular PMIs are illustrating this, while improvements are less visible in the Economic Sentiment Indicator from the European Commission. Though corporate pessimism still dominates in the manufacturing sector, the earlier downward trend in confidence seems to have halted in most of the euro area economies. The main exception to this is the Italian economy, where business sentiment continues to decline and activity remains weak.

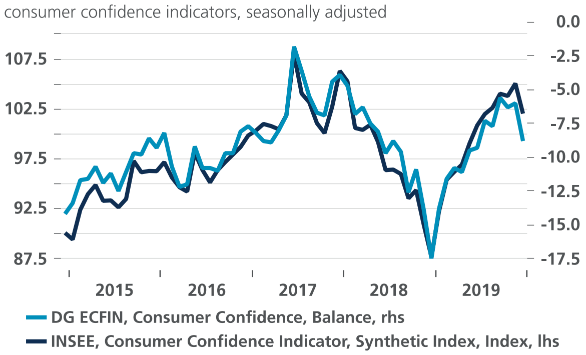
Meanwhile, private consumption continues to be resilient. Consumer confidence, though slightly down in recent months, is still at favourable levels. One country worth highlighting is France. In the context of social unrest and persistent strikes as a reaction to the pension reforms (also see KBC Economic Perspectives of December 2019), consumer confidence has only gone down marginally (figure 1). Compared to the slump at the end of 2018 due to the yellow vest protest, this recent downturn is very limited. Nevertheless, the longer social unrest persists, the higher the likelihood of a more severe effect on general economic sentiment in France. For now, we don't think there will be a material impact on the French growth outlook but we will keep monitoring the situation closely.

Drawing together these elements leaves us with unchanged growth forecasts for the euro area as a whole. Real GDP growth in 2020 is expected to recover from the 2019 weakness on a quarterly basis, but annual average growth will remain muted and slightly below potential growth at 1.0%. The recovery in euro area quarterly growth will be largely driven by the expected recovery in the German economy. Since we're at the start of a new year, our forecast horizon has also shifted forward. Looking to 2021, we expect annual average real GDP growth in the euro area to be somewhat stronger than this year (1.3%). These figures are corrected for any leap year effects (also see Box 1). Private consumption will remain an important growth driver.

In terms of risk factors, the picture for the euro area is dominated by threats to the downside. A further escalation of the US-China trade war is now less likely given the partial deal that was recently reached. Although the majority of tariffs between the two countries remain in place, the agreement reduces the trade uncertainties that companies face. However, a better US-China relationship does not guarantee a more favourable international environment for the European economy as the EU is increasingly becoming the target of more assertive trade policies by both superpowers (also see KBC Economic Opinion of 18 December 2019). The risk of a direct trade confrontation between the EU and the US is high on our watchlist because of its high probability and potentially severe economic impact in the euro area and in particular Germany.

The UK will formally leave the EU by the end of January but, with a transition period agreed to end 2020, the immediate threat of a no-deal Brexit has gone. Nevertheless, given the fact that the ensuing trade negotiations will likely be turbulent and structural damage that has been done to the UK economy, Brexit troubles are likely to cast a lasting shadow on the euro area economy going forward.

Figure 1 - French consumer confidence only limitedly hit by social unrest until now
consumer confidence indicators, seasonally adjusted



Source: KBC Economics based on INSEE, DG ECFIN

UK: uncertainty far from gone

Although recent Brexit developments have prompted short term relief, the latest economic data releases suggest UK growth is still weak and unbalanced. With expectations for some temporary pick-up in sentiment and spending as Brexit moves out of the headlines, a significant fiscal stimulus promised and the direction of negotiations between the UK and EU unclear, the Bank of England may opt to remain on the sidelines rather than implement a pre-emptive rate cut. However, elevated uncertainty will likely remain a feature of the UK economy and related policy decisions in the months ahead.

Box 1 - Leap year, a boost for growth?

2020 is a leap year: it numbers 366 days instead of 365. Of course, this will have economic consequences as there will be one additional day for consumption and production. In a leap year these are therefore automatically higher than in the previous year, at least if all other circumstances are the same. The latter is never the case in practice. But the leap day does have the consequence that the growth rate of the economy in a leap year is mechanically boosted relative to the previous year. Similarly, this mechanical effect is reversed for the growth rate of the year following a leap year.

At first sight, such an impact does not seem very important. But one extra day on 365 means an increase of rounded 0.3%. In reality, the theoretical impact is larger, because it is not the number of calendar days that is relevant, but the number of working days. This is not only determined by leap year effects, but also, and more importantly, by the statutory regulation of normal working days and public holidays. This differs from country to country and may even differ from region to region within countries. The latter is, for example, the case in Germany. The impact on the number of working days also varies from year to year, depending on the coincidence between public holidays and weekly rest days. In the euro area countries, there are on average about 250 working days a year. The “growth effect” of one extra day is then already 0.4%. However, the exact number of working days varies from year to year, sometimes by two to three or even more days. In Germany, for example, there will be 251.5 working days in 2020, compared to 247.8 working days in 2019 (source: ECB). This represents a “growth” of 0.9%. If the economy were growing at a rate of 4 to 5%, that wouldn’t make a huge difference. But with the current growth rates in most euro area countries of 1% or less, such differences are more than a drop in the well.

Of course, this mechanical growth effect is not one that most economic analysis is interested in. It looks for the real pulse of the economy. In order to measure it, it is important that the analysis is based on figures corrected for the number of working days. This is the case for most quarterly gross domestic product (GDP) figures, which serve as the basis for calculating economic growth.

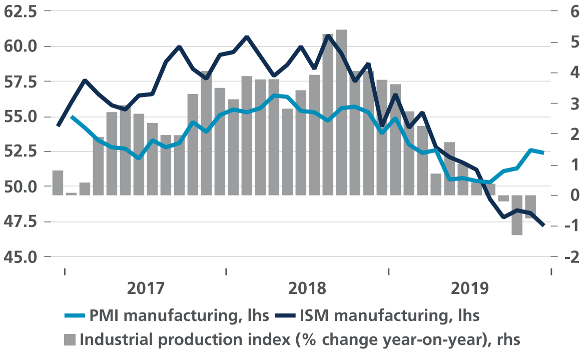
Where possible, KBC Economics only uses workday corrected figures in its analyses, publications and forecasts. This is a common practice in economic analysis which allows for the most accurate description of the strength or weakness of economic dynamics. However, growth figures also circulate on the basis of time series not corrected for the number of calendar days. For example, the quarterly GDP series published by Eurostat are adjusted for the number of calendar days, but the Eurostat annual series are not. The annual series use an accounting rather than an economic approach. Therefore, when comparing growth rates from different sources, it is important to bear in mind what adjustments the figures have or have not undergone.

The substantial majority won by Boris Johnson in the recent British election emphasises the extent to which the population at large now simply wants to ‘get Brexit done’. It also removes the key obstacle a previously fractured parliament presented to UK government decision-making. Finally, it also means the new Government is fully committed to Brexit. These developments will likely materially change the complexion of UK/EU negotiations. They make it very likely that the UK will adhere to the commitment not to extend the transition period beyond the end of 2020 (although a short technical extension may be possible). In turn, this makes it likely that any agreement between the UK and EU is ‘narrow and shallow’ rather than wide reaching. This implies a ‘bare-bones’ deal on trade in goods with very little coverage of services.

US industry struggling

A divergence between the services and manufacturing sectors remains a feature of the US economic picture. Corporate sentiment in the domestically-oriented services sectors is again trending upward while manufacturing shows little sign of improvement (figure 2). Industrial production has also been weak over the past few months. An element that could be an additional drag on the sector’s activity in Q1 2020 is the Boeing 737 Max production halt. Though the importance of the company in the total US economy is rather small, via indirect effects on suppliers there will likely be a - albeit muted - impact on Q1 GDP growth. This will only partially be offset by the end of the strikes at General Motors. Hence, we adjusted slightly downwardly our growth forecasts for Q1, but this didn’t have

Figure 2 - Not much signs of improvement in US manufacturing yet



Source: KBC Economics based on ISM, IHS Markit, Fed

Figure 3 - Geopolitical tensions caused only temporary spike in oil prices

Brent crude oil, daily price per barrel in USD

Source: KBC Economics based on ICE

an impact on our annual average growth figure. Therefore, we stick to our scenario with 1.7% real GDP growth in 2020. For 2021 we expect the growth pace to be roughly similar.

The unchanged scenario also remains underpinned by recent positive elements in the US economy. Retail sales and consumer confidence are holding up well, supported by still favourable developments in the labour market. Job creation has slowed throughout 2019, with rather disappointing payroll gains in December, but nevertheless remains reasonably solid. The unemployment rate held steady in the December reading to stand at 3.5%, maintaining the lowest level since 1969. These data suggest we may be approaching, or are at full employment. However, disappointing wage growth figures, with average hourly earnings growth falling below 3% yoy, are signalling otherwise and suggest that the unemployment rate isn't showing the full picture of the US labour market.

Looking at other indicators, there might be some room left for further jobs growth. The prime age (25-64y) employment to population ratio has recently reached the pre-crisis peak, but is below what was seen in the 1990s. Moreover, the prime age participation rate has moved up since its trough in 2015 but remains below both the pre-crisis average and what was seen in the 1990s. If we consider labour force flows, the net figure of people moving from unemployed to employed less unemployed to not in the labour force turned positive in 2016 as has remained positive since. Additionally, the net figure of people moving from not in the labour force to employed less not in the labour force to unemployed reached its pre-crisis peak in late 2016 and has continued to surpass this level since. A longer view of these data suggests that there is scope for both to remain in positive, and possibly increasing, territory for some time. As the prime age labour force participation rate remains somewhat weak, there is likely room for further solid payrolls growth. This will support consumer spending power going forward.

Geopolitical turmoil, no lasting impact

Global financial markets were spooked by the spike in hostility between the US and Iran at the start of the year (also see KBC Economic Opinion of 10 January 2020). Worries were, however, short-lived as US President Trump rather quickly cooled down tensions. Hence, the probability of an escalation of the military conflict has reduced. Following the attacks, the oil price jumped up to more than USD 70 per barrel of crude Brent oil, reflecting a spike in the geopolitical risk premium. As tensions abated relatively fast and there was no permanent disruption to oil supplies, the oil price shock was only temporary (figure 3).

Therefore, there will be no major impact on inflation figures, nor on (potential) GDP (see also Box 2). Nevertheless, the upward move in oil prices is not something new and has been seen since several months now. This has been due to the oil production cuts agreed by the Organization of the Petroleum Exporting Countries (OPEC) in December 2019 that keep oil supply relatively contained.

At the end of Q1 2020, the oil price is likely to remain somewhat elevated at USD 65 per barrel Brent due to more aggressive than expected production cuts by OPEC in Dec. 2019, some easing of the Sino-US trade tensions and an elevated geopolitical risk premium (which is probably overshooting). The oil price will moderate to USD 60 again from Q2 2020 on as high price sensitivity of shale oil production, which, from Q2 2020 on, will likely also offset the OPEC production cuts currently in place, as

Box 2 - Not all shocks are the same…

The recent surge of geopolitical tensions in the Middle East coincided with a spike of oil prices above 70 USD per Barrel Brent. What impact do economic shocks in general have on our scenario of economic growth and inflation? To make a correct analysis, we need to assess three characteristics: identification, magnitude and persistence.

Identification

In general, increasing oil prices are unambiguously associated with higher headline inflation. The link with economic growth is less clear-cut: it may be higher or lower. It really depends on the fundamental reason why oil prices are increasing.

To get the analysis right, it is important to assess whether higher oil prices are really the origin of the occurring economic shock, or whether they are themselves rather the consequence of another shock that occurred in the 'background'. Are they the result of an independent (exogenous) shock to the economy, e.g. due disruptions through political events such as war? In this scenario, higher oil process are probably associated with decelerating economic growth. Or is the increasing oil price simply an automatic (endogenous) response to another economic shock? For example, improving sentiment may accelerate economic growth, which in turn may also lead to higher demand for energy and hence also to higher oil prices. The economic characteristics of both scenarios is very different.

Magnitude

In order to have an analytical framework, economists often think of the economy as a system that operates on an 'equilibrium' path unless it is pushed away from this path by an external 'shock'. As this shock ends, the economy will gradually return to its equilibrium path. These shocks can differ both in terms of their magnitude and their persistence. Obviously, a stronger shock causes a stronger deviation of the economy from its 'normal' equilibrium path than a weaker one. The transition period to return to the equilibrium path after the shock has ended will also last longer, other things being equal. Whatever the magnitude of such a shock, the economy will normally return to its original equilibrium path, in some cases after a catch-up phase of the economic cycle.

Temporary versus permanent

Next to their magnitude, the persistence of economic shocks plays at least an equally important role. First, by their very nature, permanent shocks have a longer-lasting impact than temporary ones and hence a larger impact on the economy, other things being equal. Second, permanent shocks are also more likely to structurally change the equilibrium path of the economy in the long-run. For example, a permanent upward oil price shock may affect the long run potential real GDP growth rate of an economy (i.e. a negative supply shock), while a temporary shock will probably not. Third, a permanent shock may also affect expectations by economic agents, thereby creating an additional transmission channel to the economy. In the example of a permanent upward oil price shock, inflation expectations are likely to adjust upward as well, becoming self-fulfilling by feeding through into nominal wage negotiations (the so-called second round effects). If left unchecked, this effect would exacerbate the impact of the original shock on economic growth (downward) and inflation (upward). In order to prevent inflation expectations from spiralling up, central banks are therefore likely to respond to this permanent shock by tightening monetary policy, dampening economic growth even further. In case of a temporary shock, with no or little impact on inflation expectations, central banks are more likely to adopt a wait-and-see stance.

Application to our economic scenario

Applying this framework to the latest spike of oil prices, our assessment is that its magnitude is quite moderate and, more importantly, of a temporary nature. As a result, its impact on our economic scenario has been quite limited. However, we continuously monitor every parameter mentioned above, since they might change their nature quickly over time.

OPEC members are unlikely to fully comply with their agreed quota and as OPEC production cuts are unlikely to compensate for non-OPEC production growth in 2020. The risks to the oil price scenario are broadly balanced. A structural break in oil supply – e.g. caused by attack(s) on major oil installations – would cause the oil price to increase more permanently. While a renewed oil supply glut in case of no extension of the OPEC production quota would weigh on oil prices.

Euro area inflation seemingly rising

Euro area headline and core inflation rose to 1.3% yoy in December 2019. The increase was mainly driven by a larger contribution from food and services prices in recent months. This price evolution may owe something to the evolution of wages in the euro area. Due to increasing labour market tightness in many European countries, annual wage growth rose to 2.61% in the third quarter of 2019 (ECB figures). Higher wages generally seep through more strongly and faster into service prices, which seems to be the case in recent data. This is a structural form of inflation, for which we - and the ECB in particular - have been waiting for a long time. Also underlying the rise in services inflation were increased prices of holiday packages, which is a quite volatile component and may reflect technical changes in the measurement process rather than any marked build-up in price pressures in this area. Besides services and food prices, energy prices also again contributed positively to headline inflation as global oil prices climbed. It remains to be seen whether the recent modest upward move in euro area inflation is sustained.

In any case, the ECB's inflation target of around but just below 2% is still a long way away from current inflation readings. Therefore, we don't expect the ECB to change its monetary policy stance any time soon. In this context together with the envisaged economic developments, we expect German 10y bond yields to increase gradually throughout 2020-21, similar to the expected yield evolution in the US. This gradual normalisation of long term interest rates is still subject to risks. Negative news on the trade war or Brexit might lead to a temporary fall back in interest rates. On the other hand, more positive economic news or a structural change in monetary policy targets, as a result of the ongoing monetary policy evaluations at the Fed and ECB, might result in a faster than expected yield normalization. Hence uncertainty in terms of the evolution of interest rates persists.

Central and Eastern European Economies

From a short-term perspective, industrial output in Central Europe moderated in November. Production declined by approximately 1% mom (seasonally adjusted) in both Poland, Hungary and the Czech Republic. The first impression is that ultimately Central Europe is starting to feel more intense pressure from the German industrial recession. However, particularly for some countries, the link to developments in Germany appears weaker than expected. Moreover, across the region we distinguish various country-specific trends.

The current industrial output decline in the region comes at a moment during which we observe the first signs of industrial bottoming-out in Germany, as German sentiment indicators and output have cautiously stabilized. Hence, if connected, the recent output decline in the Central European region would suggest a substantially lagged effect which seems hard to explain. Moreover, the overall impact of the German industrial recession, which has lasted for more than one and a half years, on Central Europe has been somewhat limited and certainly country specific. While German manufacturing output has fallen by more than 8% between January 2018 and the end of October 2019 (recovering slightly in November), the situation in Central Europe is different. Especially in Hungary and Poland, manufacturing output is well above the levels recorded at the beginning of the German industrial recession. In contrast, the Czech Republic has seen a somewhat larger impact, though production levels have been basically flat since the start of the German industrial recession in spring 2018. Slovakia too seemed to have been more sensitive to developments in Germany, but industrial production data in Slovakia tend to be more volatile compared to the rest of the region (figure CEE1).

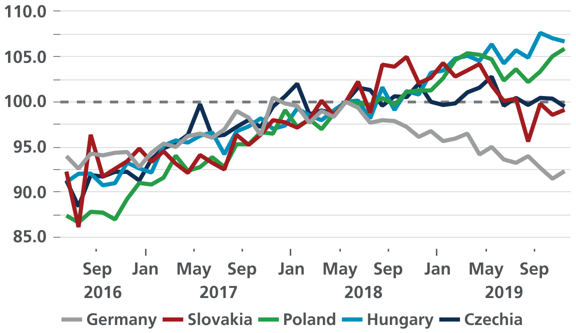
What explains the resilience of certain Central European industrial sectors? To some extent it is the lower sensitivity of the region's manufacturing sector towards Asian markets (specifically China and Korea) compared to Germany. This also helps explain why the region as a whole has been more immune to the spike in global trade uncertainty in 2019. Note that the global trade uncertainty index reached new highs at the end of Q3 2019. In addition, more resilient domestic demand supported by more relaxed fiscal conditions can explain the higher resilience of Poland and Hungary compared to the Czech Republic. Polish and Hungarian governments have been running budgets with structural deficits around 3% of GDP, while the Czech structural deficit was expected to be only -0.3% of GDP according to the European Commission.

Looking ahead, we remain cautiously optimistic with regards to regional industrial growth. Although the hard industrial data may deteriorate a bit further over the next few months, the bottoming-out of German sentiment and production data, the easing of both the US-China trade tensions and Brexit uncertainty, and the more encouraging regional leading indicators are the main arguments for our moderate optimism for the Central European economies in 2020.

Inflation pressures building, but monetary policy outlook stable

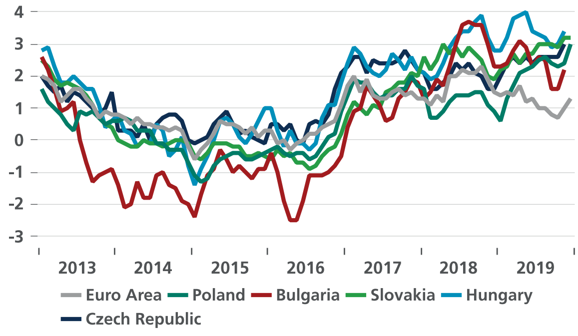
Our cautious optimism on the economic outlook for the Central European region is also important for our inflation and monetary policy outlook, especially given the recent higher inflation surprises in the region. Czech and Hungarian inflation

Figure CEE1 - Manufacturing output index
s.a., index 05/2018 = 100



Source: KBC Economics based on CZSO, DESTATIS, GUS, HCSO, Eurostat, SUSR

Figure CEE2 - CEE inflation markedly higher than in the euro area
HICP, % change year-on-year



Source: KBC Economics based on Eurostat

reached respectively 3.0% and 3.4% yoy in November, while Polish inflation jumped up to 3.0% yoy in December. Slovakia is among the countries with the highest inflation in the euro area with 3.2% yoy inflation in November 2019 and December 2019 (flash estimate), up from 2.9% yoy in October (figure CEE2). In the entire region, fuel and food contributed to the acceleration of inflation. The price of food is growing due to both domestic and external factors. Given the impact of both avian influenza and swine fever, further pressure on food prices can be expected in the Central European region. For Slovakia in particular, at the end of 2019 cost factors associated with the growth of the minimum wage also boosted inflation.

Czech Economy

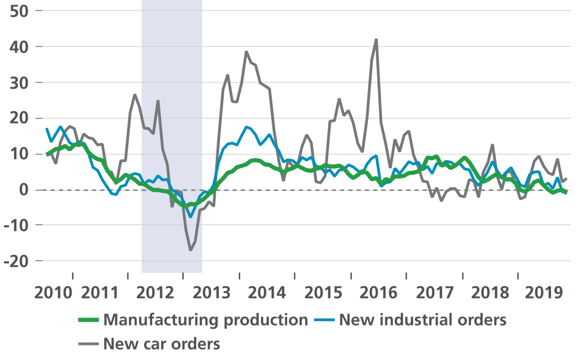
Industrial recovery, stable outlook

The outlook for the Czech economy remains subdued but ultimately stable. Czech industrial production lost further momentum in November and declined by 1.1% mom. The year-over-year fall is faster, reaching -3.2% for both the industry as a whole and the manufacturing sector. The main sectors weighing on industry are those that were hit most by the spike in global trade tensions in 2019. This is primarily the manufacture of basic metals (-12.3% yoy) and machinery (-7.2% yoy).

We remain cautiously optimistic for 2020 and expect the Czech manufacturing sector to recover slightly thanks to German bottoming from late 2019 and early 2020 lows. Our view has recently been supported by the stabilization of soft indicators. Both the industrial confidence indicator of the Czech Statistical Office and the Czech PMI recorded a minor improvement in December. Meanwhile, new foreign industrial orders have stabilized and the orders of the Czech automotive sector (a crucial part of the manufacturing industry) grew by more than 6% in November (figure CZ).

Figure CZ - Czech manufacturing and new orders

year-on-year change of 3-month moving average



Source: KBC Economics based on CZSO, Eurostat

Still, one must keep in mind that conditions in the most heavily hit sectors, such as machinery and basic metals, may remain challenging for a prolonged period. That is at least what we can see in the new orders statistics. In the case of machinery, new orders continued to fall by more than 8% yoy and in the case of base metals, new orders fell by 15% yoy according to the most recent data.

Meanwhile, the November trade data also point to slower growth in Q4 2019. Both exports and imports were declining. Although during the most recent month the fall in exports was faster than imports, over the whole year it was rather the opposite. Since January 2019 cumulative exports are still higher than a year earlier, with a growth rate faster than that of imports. As a result, the cumulative trade balance has moderately improved in 2019 and reversed the negative trend from the previous year. As such, net exports are expected to have contributed positively to Czech growth throughout 2019.

The moderate improvement of the trade balance could have contributed to positive sentiment on the Czech FX market. However, one should not overestimate this positive impact. The main driver of the recent Czech koruna gains was rather favorable global sentiment. Furthermore, the improvement in the trade balance has been somewhat offset by growing dividend outflows.

Slovak Economy

Outlook remains weak, but manufacturing tries to find ground

The Slovak economy slowed down substantially due to the global manufacturing slowdown. The manufacturing output decline in Slovakia throughout 2019 was strongly affected by car production. However, the November 2019 decline was mainly driven by negative developments in metal production and electrical engineering. By contrast, the production of cars decreased to a lesser extent. On a month-on-month basis, the automotive industry even experienced slight growth, which is a first good signal that may point to a bottoming-out, similar to the trends seen in Germany. However, car sales in Europe have not experienced a positive year. Logically, this was also felt by the Slovak economy, for which Western Europe is the largest trading partner. This was evidenced by slow growth in the sector, exports and GDP over the entire previous year.

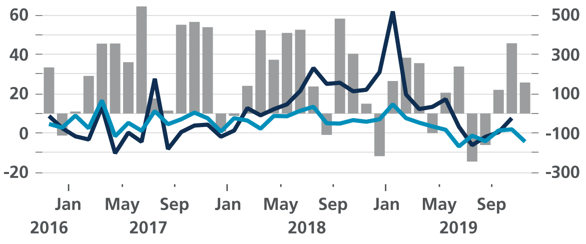
Apart from trends in manufacturing, the weaker outlook for the Slovak economy is visible from other sectors too. In October, construction decreased by 2.4% yoy, mainly due to a decline in new construction on the domestic market. The construction of buildings (especially apartments and offices) was kept at a solid level, supported by affordable and cheap financing. However, the construction of infrastructure projects such as roads and motorways was reportedly weak in the second half of 2019. In October alone, this indicator fell by almost 11%. This is also evident in the relatively low uptake of European funds which are the main source of public infrastructure funding.

The trade surplus reached a high in October (EUR 160 million euros versus EUR 110 million one year ago). Nevertheless, the surplus for the entire calendar year 2019 will be significantly lower than in 2018 (EUR 1.2 billion vs EUR 2.3 billion). This is due to weaker exports over the spring and summer (figure SK). There has been particularly weaker demand for cars in the main markets in Europe. Slovakia remains the largest car manufacturer per capita in the world. Developments in the automotive industry will therefore be very important.

Despite the Slovak growth slowdown, the unemployment rate remained at the same level in November as in October, at 5.7%. In the winter months it may increase slightly due to seasonal factors, particularly in the agriculture and construction sectors. However, in the early days of 2020 some employers announced their interest in foreign labor (Serbs, Bulgarians). This indicates a persistent shortage of domestic workers.

Figure SK - Weaker mid-year exports causing lower 2019 trade surplus

% change year-on-year



Source: KBC Economics based on SUSR

Finally, parliamentary elections are upcoming in Slovakia, which are announced for the end of February 2020. Opposition center-right parties with a focus on economic reforms are expected to form a new government. The political situation does not seem to affect the economic outlook at this moment. For instance, risk premiums remain relatively stable around 40 bps above the 10-year German government bond.

Hungarian Economy

Public finances improve and leave room for fiscal stimulus

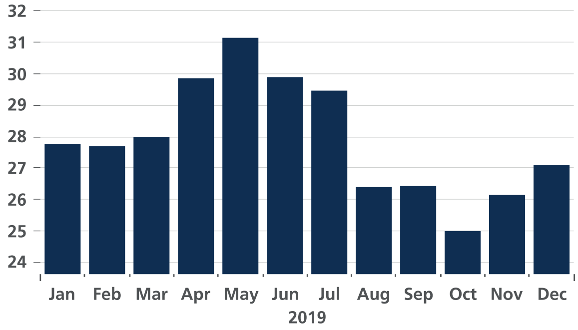
The latest figures for the Hungarian central public budget point to sound public finances. Cash flow figures point to a surplus of 2.7% of GDP in 2019, which is about 0.5% of GDP lower than in 2018. This cash flow surplus still has to be corrected for many items like local municipalities and EU funded projects. The cash flow figures indicate that revenues were substantially higher than expected thanks to higher VAT revenues as well as larger contributions from social fees, personal income taxes and excise duties. Hence, Hungarian public finances clearly benefited from the strong economic growth performance. Moreover, EU funding started to flow into the Hungarian budget in the second half of the year, as compensation for projects pre-financed by the Hungarian government. The final public deficit figure according to the EU standard methodology is expected by the end of March. Based on the current cash flow information, we project the Hungarian public deficit to reach 1.8% in 2019. Public debt to GDP is expected to moderate from 70.2% in 2018 to 67.5% in 2019.

For 2020 we believe the current Hungarian budget is conservative. A deficit around 1% of GDP could be reached which would further lower public debt to GDP to 64%. However, the key question is whether the Hungarian government will implement additional fiscal stimulus to boost the economy in the coming months. Such additional fiscal stimulus seems likely given the expected economic slowdown this year as well as the uncertainties surrounding the Hungarian economic outlook. Hence any policy change is likely to lead to a higher public deficit and a slower public debt ratio decline.

Bulgarian Economy

Economic recovery, but outlook remains fragile

Figure BG - Moderate increase in corporate optimism at the end of 2019



Source: KBC Economics based on NSI

The Bulgarian economy kept a robust pace in the first nine months of 2019 and fresh high frequency data suggests that the growth dynamics remained on a solid footing in the last quarter of the year. Industrial sector performance, which was rather sluggish for the most part of 2019, saw a surprising rebound in October; on year-on-year basis industrial production increased by 1.7%, following an upward revision to 0.7% in September. This largely reflects a return to growth in both the manufacturing sector and the mining industry, while the decline in the utilities sector continued and even accelerated. Together with gradually improving business confidence (figure BG) - especially in the manufacturing sector - the latest developments suggest that a cautious recovery of industrial production might be underway.

Meanwhile, retail sales in October picked up by 1.2% yoy, slowing from 2.6% yoy in the previous month. On a monthly basis, retail sales declined by 0.1%, marking a third month in a row of a relatively sluggish reading. The current softness is mainly concentrated in pharmaceuticals and cosmetics, while trade with textiles or computers continues to grow at a healthy pace. Still, looking at ongoing positive sentiment among retailers (well above the long-term average), the modest slowdown should not, in our view, fundamentally shift otherwise sound private consumption dynamics.

Overall, we expect that economic activity remained solid at the end of last year, albeit slightly weaker than in previous quarters. This should bring annual real GDP growth to 3.7% in 2019. This year, our expectation is for a gradual slowdown in growth dynamics to 3.1% on the back of a softer external backdrop that is set to weigh on the export performance. Hence, growth is expected to be underpinned by domestic demand, namely household consumption driven by favourable developments in the labour market, and a mildly expansionary fiscal policy. While investment growth is likely to be adversely affected by continued uncertainty and a challenging external environment, it may benefit from the disbursement of EU funds as the end of the 2014-2020 funding period is approaching.

Despite a mildly expansionary fiscal policy, the budget deficit is set to end up lower than expected. For the first 11 months of 2019 the consolidated budget surplus stood at BGN 1.3 billion, equivalent to 1.1% of projected gross domestic product. This was mainly driven by better tax collection and to a lesser extent by some spending cuts. As a result, the Bulgarian ministry of finance now expects that the budget shortfall will reach 1% of GDP in 2019, significantly outperforming its target for a 2.1% deficit. Although this will break a period of three years of budget surpluses, the public finances remain in overall good shape, particularly since the deterioration in the budget balance is largely the result of the lump-sum payment for F-16 fighters. This is confirmed by the low public debt-to-GDP ratio, which is projected to have fallen to 19.9% in 2019.

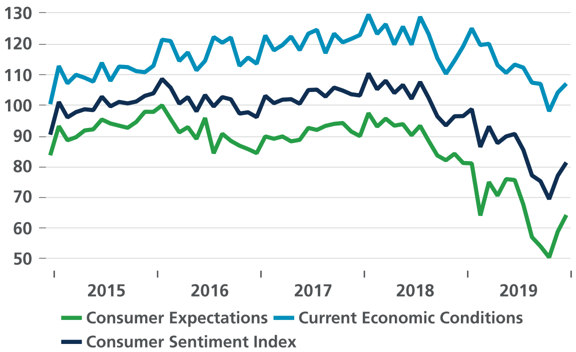
Irish Economy

The most recent Irish economic data were somewhat mixed but on the whole, reflect continuing solid economic growth despite some dampening influence from Brexit related uncertainty. The volume of retail sales excluding car sales (which have marked seasonality) fell by 1.2% mom in November, but this still translated to an annual increase of 1.9% yoy. The Irish unemployment rate stayed steady in December at 4.8%, down from 5.5% a year ago. Meanwhile, consumer sentiment results for December show a further easing in Irish consumers' concerns (figure IE). All five areas of the survey saw increases and December also saw the first back-to-back monthly gains in consumer sentiment in four years. The easing of Brexit concerns seem to be the main driver, but consumers were also more positive on income and spending plans as well.

Irish consumer price inflation ticked up to 1.1% in December due to higher oil and airfare prices as well as some pick-up in rents and electricity prices. This brought average inflation to 0.9% for 2019 as a whole, up from 0.7% in 2018 and the fastest annual rate of inflation since 2012.

Meanwhile, Irish property price inflation edged higher to 1.4% in November from 1.0% in October, which was the lowest rate in six and a half years. Increased supply is a small part of explanation of trend slowdown through past year and a half, but more importantly, affordability and uncertainty have constrained demand. Property price inflation is now running below earnings or employment growth and the longer term link between among these indicators may suggest to the prospect of a more positive trend for 2020.

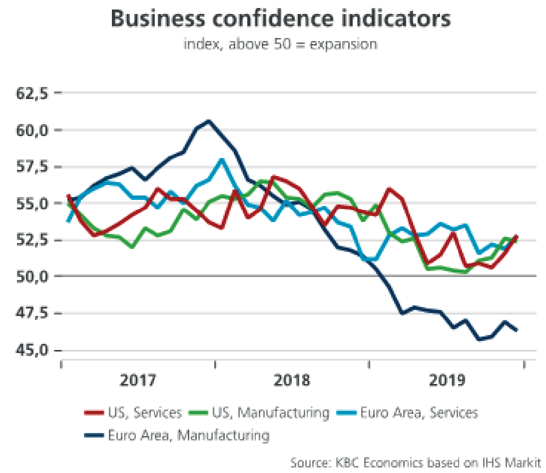
Figure IE - Further easing in Irish consumers' concerns



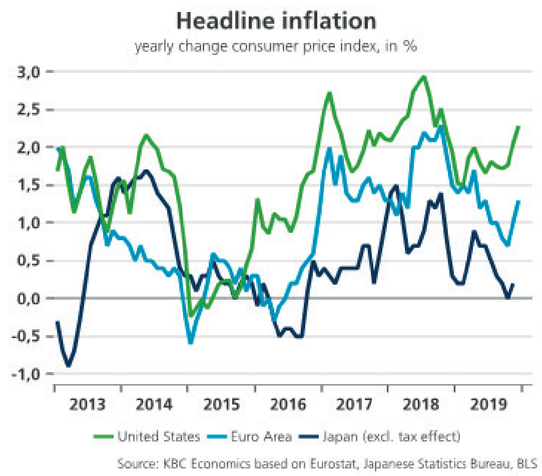
Source: KBC Economics based on KBC Ireland

Figures

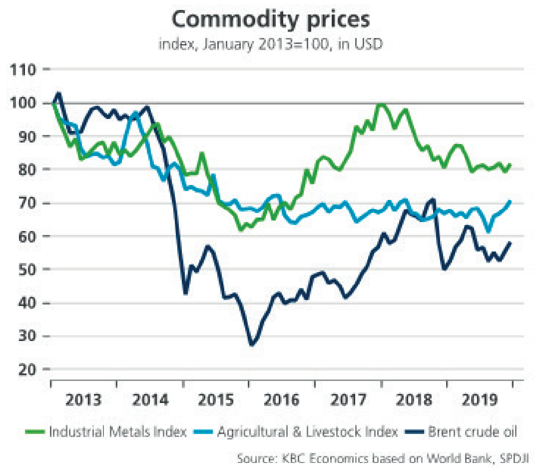
Real GDP
yearly change in %
4
3
2
1
0
-1
-2
8,00
7,75
7,50
7,25
7,00
6,75
6,50
6,25
6,00
5,75
2013 2014 2015 2016 2017 2018 2019
Euro Area, lhs
United States, lhs
China, rhs
Source: KBC Economics based on Eurostat, BEA, NBS



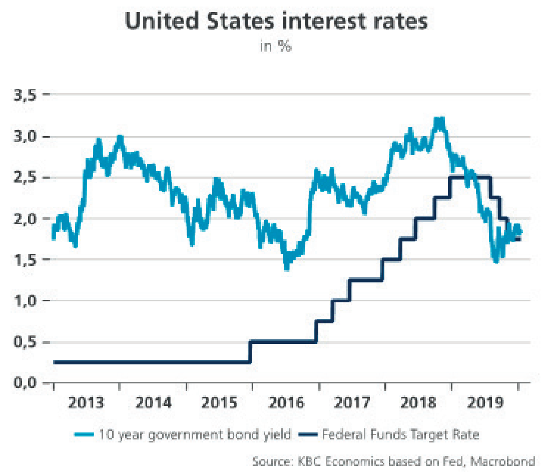
Business confidence indicators
index, above 50 = expansion
62,5
60,0
57,5
55,0
52,5
50,0
47,5
45,0
2017 2018 2019
US, Services
US, Manufacturing
Euro Area, Services
Euro Area, Manufacturing
Source: KBC Economics based on IHS Markit



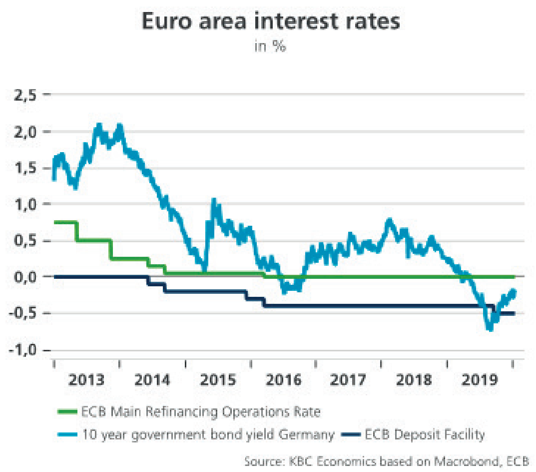
Headline inflation
yearly change consumer price index, in %
3,0
2,5
2,0
1,5
1,0
0,5
0,0
-0,5
-1,0
2013 2014 2015 2016 2017 2018 2019
United States
Euro Area
Japan (excl. tax effect)
Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, BLS



Commodity prices
index, January 2013=100, in USD
110
100
90
80
70
60
50
40
30
20
2013 2014 2015 2016 2017 2018 2019
Industrial Metals Index
Agricultural & Livestock Index
Brent crude oil
Source: KBC Economics based on World Bank, SPDJI



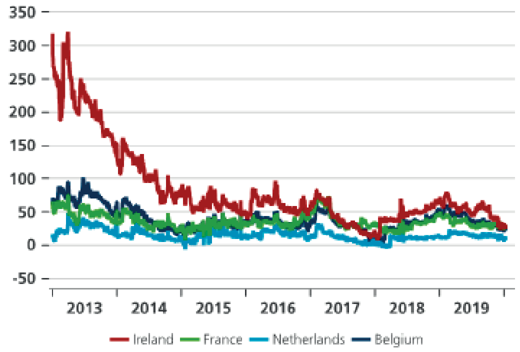
United States interest rates
in %
3,5
3,0
2,5
2,0
1,5
1,0
0,5
0,0
2013 2014 2015 2016 2017 2018 2019
10 year government bond yield
Federal Funds Target Rate
Source: KBC Economics based on Fed, Macrobond



Euro area interest rates
in %
2,5
2,0
1,5
1,0
0,5
0,0
-0,5
-1,0
2013 2014 2015 2016 2017 2018 2019
ECB Main Refinancing Operations Rate
10 year government bond yield Germany
ECB Deposit Facility
Source: KBC Economics based on Macrobond, ECB

Figures

10 year government bond yield spreads to Germany
in basis points

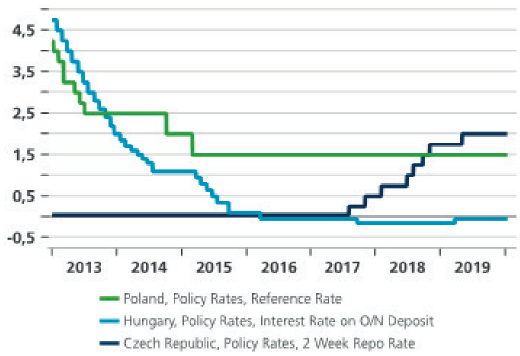


Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points

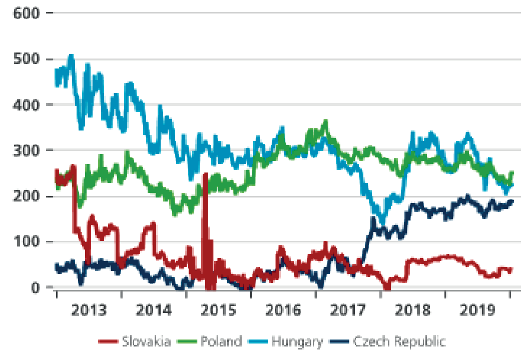
Source: KBC Economics based on Macrobond

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

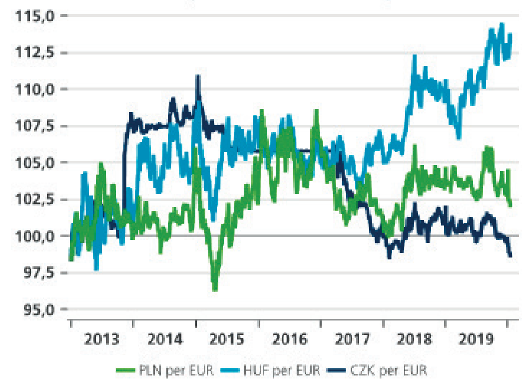


Source: KBC Economics based on Macrobond, AKK, Eurostat

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 %)		
		2019	2020	2021	2019	2020	2021
Euro area	Euro area	1.2	1.0	1.3	1.3	1.2	1.4
	Germany	0.5	0.6	1.3	1.4	1.5	1.7
	France	1.3	1.2	1.2	1.3	1.3	1.4
	Italy	0.2	0.5	0.5	0.8	0.9	1.1
	Spain	2.0	1.5	1.5	0.9	1.1	1.3
	Netherlands	1.7	1.5	1.6	2.6	1.5	1.8
	Belgium	1.3	0.9	1.2	1.3	1.4	1.5
	Ireland	6.0	4.0	2.2	0.9	1.5	1.9
	Slovakia	2.2	2.2	2.5	2.7	2.5	2.1
Central and Eastern Europe	Czech Republic	2.4	2.2	2.0	2.6	2.6	2.2
	Hungary	4.9	3.7	3.0	3.4	3.5	3.2
	Bulgaria	3.7	3.1	3.0	2.5	2.3	2.1
	Poland	4.3	3.8	3.5	2.1	3.2	2.5
	Romania	3.9	3.7	3.6	3.9	3.8	3.8
Rest of Europe	United Kingdom	1.3	1.1	1.1	1.8	1.7	2.0
	Sweden	1.4	1.3	1.6	1.7	1.7	1.8
	Norway	2.3	1.8	1.8	2.2	2.0	2.0
	Switzerland	0.8	1.2	1.3	0.4	0.3	0.6
Emerging markets	China	6.1	5.7	5.4	2.9	3.2	2.5
	India*	5.1	6.4	7.0	3.6	4.1	4.0
	South Africa	0.3	0.8	1.3	4.1	4.8	5.0
	Russia	1.2	1.7	1.6	4.5	3.7	4.0
	Turkey	-0.5	2.5	3.0	15.5	11.0	10.0
	Brazil	1.1	2.1	2.3	3.7	3.8	4.0
Other advanced economies	United States	2.3	1.7	1.7	1.8	2.1	2.1
	Japan	1.0	0.3	0.7	0.6	0.6	0.6
	Australia	1.9	2.5	2.5	1.6	2.0	2.0
	New Zealand	2.4	2.4	2.4	1.5	1.9	1.9
	Canada	1.5	1.6	1.7	2.0	1.9	1.9
* fiscal year from April-March							*16/01/2020*

Policy rates (end of period, in %)						
		16/01/2020	Q1 2020	Q2 2020	Q3 2020	Q4 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	1.75	2.00
	Romania	2.50	2.75	2.75	2.75	2.75
Rest of Europe	United Kingdom	0.75	0.75	0.75	0.75	0.75
	Sweden	0.00	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	3.10	3.10	3.10	3.10
	India	5.15	5.15	4.90	4.90	4.90
	South Africa	6.50	6.25	6.25	6.25	6.25
	Russia	6.25	6.00	5.75	5.75	5.50
	Turkey	11.25	12.00	11.00	10.00	10.00
	Brazil	4.50	4.50	4.50	4.75	5.00
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

10 year government bond yields (end of period, in %)		16/01/2020	Q1 2020	Q2 2020	Q3 2020	Q4 2020
Euro area	Germany	-0.21	-0.20	-0.15	-0.10	-0.05
	France	0.05	0.10	0.15	0.20	0.25
	Italy	1.40	1.55	1.65	1.90	2.20
	Spain	0.45	0.55	0.60	0.65	0.70
	Netherlands	-0.13	-0.05	0.00	0.05	0.10
	Belgium	0.02	0.10	0.15	0.25	0.35
	Ireland	0.05	0.30	0.35	0.40	0.50
	Slovakia	0.13	0.10	0.15	0.25	0.35
Central and Eastern Europe	Czech Republic	1.71	1.64	1.65	1.65	1.65
	Hungary	2.11	1.90	2.00	2.10	2.20
	Bulgaria	0.40	0.30	0.40	0.50	0.40
	Poland	2.26	2.30	2.40	2.50	2.60
	Romania	4.34	4.51	4.53	4.55	4.57
Rest of Europe	United Kingdom	0.64	0.90	1.00	1.10	1.20
	Sweden	0.14	0.20	0.25	0.30	0.35
	Norway	1.44	1.50	1.55	1.60	1.65
	Switzerland	-0.59	-0.50	-0.45	-0.40	-0.35
Emerging markets	China	3.14	3.20	3.35	3.45	3.55
	India	6.61	6.70	6.80	6.90	7.00
	South Africa	8.23	8.40	8.50	8.60	8.80
	Russia	6.34	6.50	6.50	6.25	6.00
	Turkey	10.64	13.00	13.00	12.75	12.50
	Brazil	6.77	6.80	7.00	7.10	7.20
Other advanced economies	United States	1.79	1.90	2.00	2.10	2.20
	Japan	0.01	0.00	0.00	0.00	0.00
	Australia	1.18	1.30	1.40	1.50	1.60
	New Zealand	1.54	1.60	1.70	1.80	1.90
	Canada	1.54	1.65	1.75	1.85	1.95

Exchange rates (end of period)	16/01/2020	Q1 2020	Q2 2020	Q3 2020	Q4 2020
USD per EUR	1.12	1.12	1.14	1.16	1.17
CZK per EUR	25.11	25.30	25.30	25.20	25.10
HUF per EUR	333.57	326.00	332.00	338.00	336.00
PLN per EUR	4.23	4.30	4.25	4.28	4.22
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.78	4.26	4.27	4.28	4.29
GBP per EUR	0.85	0.84	0.87	0.88	0.90
SEK per EUR	10.56	10.50	10.50	10.50	10.45
NOK per EUR	9.89	9.85	9.75	9.65	9.60
CHF per EUR	1.07	1.10	1.11	1.12	1.12
BRL per USD	4.17	4.10	4.10	4.00	3.95
INR per USD	70.93	71.00	71.00	71.00	71.00
ZAR per USD	14.39	14.30	14.50	14.50	14.70
RUB per USD	61.66	65.00	64.00	64.00	64.00
TRY per USD	5.85	6.00	6.10	6.20	6.30
RMB per USD	6.88	7.00	7.00	7.00	7.00
JPY per USD	109.97	109.00	109.00	109.00	109.00
USD per AUD	0.69	0.69	0.70	0.70	0.71
USD per NZD	0.66	0.66	0.66	0.67	0.67
CAD per USD	1.30	1.31	1.30	1.30	1.30

Outlook KBC home markets

	Belgium			Ireland		
	2019	2020	2021	2019	2020	2021
Real GDP (average yearly change, in %)	1.3	0.9	1.2	6.0	4.0	2.2
Inflation (average yearly change, harmonised CPI, in %)	1.3	1.4	1.5	0.9	1.5	1.9
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.7	5.9	5.8	4.8	4.8	5.1
Government budget balance (in % of GDP)	-1.6	-2.3	-2.8	0.7	1.0	1.0
Gross public debt (in % of GDP)	99.1	99.5	100.0	58.0	54.0	51.0
Current account balance (in % of GDP)	-1.4	-1.8	-2.0	-2.5	-2.0	4.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	3.4	2.1	2.0	2.5	2.5	2.0

16/01/2020

	Czech Republic			Slovakia		
	2019	2020	2021	2019	2020	2021
Real GDP (average yearly change, in %)	2.4	2.2	2.0	2.2	2.2	2.5
Inflation (average yearly change, harmonised CPI, in %)	2.6	2.6	2.2	2.7	2.5	2.1
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.1	2.2	2.2	6.2	6.3	6.4
Government budget balance (in % of GDP)	0.0	-0.5	-0.8	-1.1	-1.5	-1.5
Gross public debt (in % of GDP)	31.0	30.3	30.0	48.0	47.5	47.5
Current account balance (in % of GDP)	0.3	0.2	0.2	-3.5	-4.0	-4.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	7.0	2.0	2.0	5.0	4.0	3.0

16/01/2020

	Hungary			Bulgaria		
	2019	2020	2021	2019	2020	2021
Real GDP (average yearly change, in %)	4.9	3.7	3.0	3.7	3.1	3.0
Inflation (average yearly change, harmonised CPI, in %)	3.4	3.5	3.2	2.5	2.3	2.1
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	3.5	3.5	3.6	3.8	4.0	4.1
Government budget balance (in % of GDP)	-1.6	-1.0	-1.8	-1.0	0.4	0.2
Gross public debt (in % of GDP)	67.2	64.0	62.2	19.9	17.7	16.5
Current account balance (in % of GDP)	-0.7	-1.0	-1.2	8.0	4.0	2.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	15.0	10.0	5.0	5.0	4.0	3.0

16/01/2020

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