Economic perspectives

June 2018

Highlights

- Macroeconomic developments in advanced economies have shown different paths in recent weeks. Data for the US indicate a recovery in Q2 after the soft patch in Q1. This is supported by a rise in corporate sentiment, a positive impact of fiscal policies and strong labour market performance. Therefore, we upgraded our US growth forecast for 2018 from 2.6% to 2.8%.

- Meanwhile, recent data for the euro area were somewhat disappointing. Amid heightened concerns about political instability in some euro area economies and darkening clouds on the international trade front, this signals that the pace of euro area GDP growth might moderate through 2018. This is in line with last month's downward revision of our EMU growth forecasts.

- Market fuss about the Italian mini-crisis has faded in recent weeks, but some 'damage' still remains. Italian rates are still elevated while German rates remain relatively subdued. Immediate crisis risks no longer loom, but longer-term risks remain substantial. It is likely that the current coalition will not address Italy's fundamental economic problems, and as such a slowdown in reforms combined with fiscal expansion is the most likely scenario. Moreover, when the ECB begins normalising its monetary policy, underlying concerns about public debt sustainability in the euro area as a whole will become a more important market theme again.

- Risks of a full-blown trade war have increased in recent weeks. The trade conflict is escalating as threats have turned to action now that president Trump has decided to lift the exemptions on steel and aluminium import tariffs for the main trading partners of the US. Going forward, the extent to which other countries will retaliate and whether this will lead to a protectionist spiral will be crucially important to the growth outlook. For Europe in particular, potential tariffs on US car imports are the main risk.

- Inflationary pressures in the euro area are slowly building. Headline inflation jumped up to 1.9% in May. This was mainly due to temporary volatile factors like upward pressures from energy and food prices. Nevertheless, it presented a window of opportunity for the ECB to change its forward guidance about the Asset Purchase Programmes (APP).

- After September 2018, the ECB will taper its purchases dropping the monthly purchase amount to EUR 15 billion from EUR 30 billion at present. The ECB also signalled its intention to end the APP in December 2018. However, to ensure that markets do not anticipate an early or aggressive move to higher interest rates, the ECB indicated that policy rates are not likely to rise at least through the summer of 2019. This is broadly in line with our scenario. The first step towards a policy rate normalisation will only be taken well after the end of the APP, i.e. at the earliest during H2 2019.

- Focus article - Currencies as economic weapons: why the euro is still no match for the US dollar

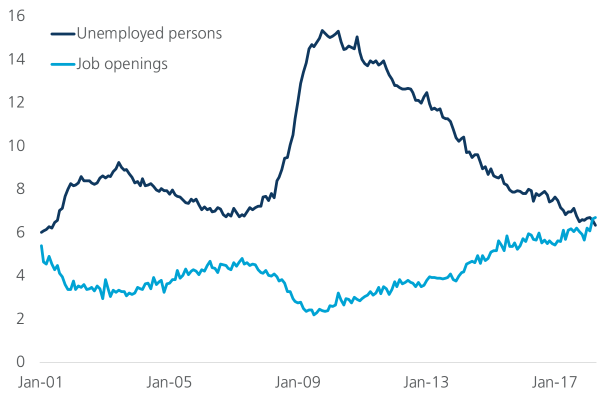
Global Economy

Desynchronization of US and EMU economy

Macroeconomic developments in advanced economies have shown somewhat different paths in recent weeks. Data for the US clearly indicate a recovery in Q2 after the soft patch in Q1. Corporate sentiment indicators in both the manufacturing and the services sector - measured by the ISMs - went up again in May. Also consumer optimism remains at high levels. The latter is supported by the persistently solid performance of the US labour market. Job creation was again above 200,000 while the Job Openings and Labor Turnover Survey pointed to increasing labour market tightness (figure 1). For the first time since the start of the series in 2000, the number of job openings rose above the number of unemployed. This will likely put upward pressure on wages and, consequently, on overall inflation. The strong labour market results together with a stimulus coming from the fiscal policy support our view that US growth will pick up in Q2 leading to a strong figure for 2018 as a whole. Therefore, we upgraded our growth forecast for 2018 from 2.6% to 2.8%.

Recent figures for the euro area were somewhat disappointing and didn't point to the much-hoped-for swift recovery after the weaker growth rate seen in Q1. As opposed to the US, the euro area composite PMI in May dropped to its lowest level in 18 months (54.1). While the indicator is still firmly above the neutral level of 50 that separates growth from contraction, the further drop indicates that corporate sentiment isn't recovering as in the US. Amid heightened concerns about political instability and darkening clouds on the international trade front, this signals that the pick-up in euro area GDP growth might take longer than initially thought. Activity data also support this view, as April German industrial production figures were again below expectations (-1.0% mom), likely negatively influenced by the four-month contraction in German factory orders. The consistency of the softer tone across nearly all recent-looking indicators of German economic activity, points to significant downside risks for German and euro area growth prospects. These developments are in line with last month's downward revision of our euro area growth forecasts.

Figure 1 - More signs of increasing labour market tightness in the US (in millions)



Source: KBC Economic Research based on US Bureau of Labor Statistics (2018)

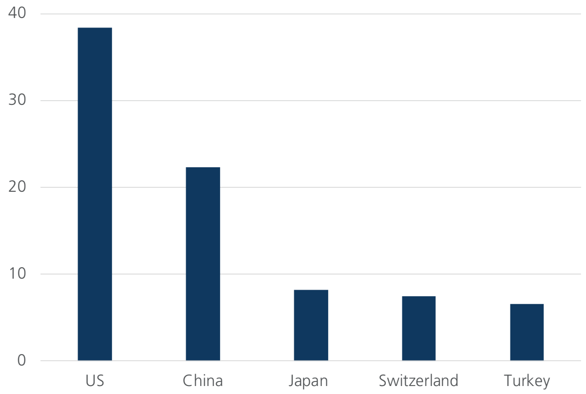
Full-blown trade war more likely

The trade conflict is escalating as threats have turned to actions now that US President Trump has decided to apply the steel and aluminium import tariffs on imports coming from its main allies. The earlier exemptions for, amongst others, Canada, Mexico and the EU were lifted since negotiations weren't producing the results desired by the Trump administration. The direct impact of the steel and aluminium import tariffs on European economies will be rather limited as the importance of the US market for European steel and aluminium exporters is relatively small. However, European producers will likely be confronted with higher import competition from outside the EU as emerging market producers in particular will look for alternative markets to the US to export to. Furthermore, a lot will depend on future policy response of others to the US measures. The EU has announced 25% duties on up to EUR 2.8 billion of US exports to the EU from July onwards. It remains to be seen whether these countermeasures by the EU and other US trading partners will cause a protectionist spiral.

An important risk going forward are tariffs on car imports into the US. The Trump administration has launched an investigation into the potential impairment of US national security by car imports. If such tariffs are imposed, the European economy would be heavily affected as it is highly active in global automobile value chains. Moreover, the US is the main destination market for European car exports (figure 2). As negotiations to reform the NAFTA agreement between the US, Canada and Mexico are still ongoing, the steel and aluminium import tariffs will not make it any easier to come to a consensus. Furthermore, the outcome of the G7 summit in Canada earlier this month, which concluded with President Trump refusing to sign the joint communique following a perceived slight from President Trudeau, did little to facilitate a constructive negotiation environment. It is hence very likely that a new NAFTA deal will not be reached before the year-end.

Figure 2 - US import tariffs on cars potentially harmful for EU economy

(EU exports of cars* by main destination country, in billions of EUR, 2017)



Source: KBC Economic Research based on Eurostat (2018)*

*Cars defined as Harmonised System product code 8703

Besides, the trade relationship between China and the US has turned even more sour. The US announced additional tariffs on imports coming from China worth USD 50 billion. The first set of targeted products covers USD 34 billion worth of imports from China and will be subject to an additional duty of 25% going into effect from July 6 on. The second set, worth roughly USD 16 billion, will be reviewed in a public notice and could still be adjusted depending on the outcome. These tariffs will then take effect later. China almost immediately reacted by announcing retaliatory tariffs worth a similar amount. Hence, prospects for the negotiations between the two superpowers have become more gloomy. Overall, the developments in recent weeks have notably increased the risk of a full-blown trade war. Everything depends on the next moves of the Trump administration and the tone of responses by its key trading partners.

Southern Europe: crisis avoided, fundamental risks remain

In Italy, coalition talks between the Lega and 5* Movement triggered a sharp and negative market reaction. Italian long-term government bond yields went up sharply and the Euro depreciated. Reflecting its safe haven status, the German long-term bond yield decreased initially but subsequently moved back up following seemingly hawkish ECB comments on the end date of its Asset Purchase Programme. The nature and extent of concerns around the direction of Italian politics and economic policies combined with some international spillovers led to increased fears of a new EMU crisis. Initial sharp market movements were an overreaction in our view. Now that the new government is in place and no dramatic early change in policy is envisaged, these event-risk effects are gradually unwinding. Nevertheless, some concerns will continue. Some political uncertainty will persist as it is unlikely that the current government will rule for a full term. After all, their election programs were very different. Moreover, given their policy plans, the current coalition will not tackle any of Italy's fundamental economic issues. A reform slowdown is therefore the most likely scenario.

There was some concern regarding spillover effects from the Italian mini-crisis to other countries. Portuguese and Spanish long-term bond yields rose as a consequence of the Italian events although to a notably lesser extent than their Italian counterparts. The Spanish economy has performed better than Italy in recent years, but some major economic challenges remain (e.g. further reforms of the labour market). The Spanish government debt-to-GDP ratio is lower than in Italy. However, compared to Italy, the Spanish economy is much more indebted to the rest of the world in terms of net asset position. As a result, Spain is potentially more vulnerable to a loss of confidence on the part of international investors. In general, the Italian events highlighted that the euro area still faces several fundamental issues. Once the ECB starts its monetary policy normalisation and stops being a buyer of first resort on the bond market, these fundamental concerns will likely come more to the foreground. In that case, in line with our base scenario, interest rates will rise and public debt sustainability will become a more important theme for financial markets again.

The euro area going forward

In the aftermath of the Euro crisis, several measures (e.g. the European Stability Mechanism, the Banking Union, etc.) have been taken to strengthen the EMU. However, with highly complex governance, no automatic crisis mechanisms and limited financial capacity, there are still structural shortcomings. Further steps are needed and hopes are high for the cooperation between German Chancellor Merkel and French President Macron. In September last year, Macron launched his ambitious reform agenda. At the time, he reached out to Germany to lead the implementation of the plans jointly. Merkel has recently responded to Macron's earlier proposals for the future integration of the euro area. The two plans share an underlying consensus as they both aim at unifying the continent. However, there are some important differences as Merkel puts more weight on the element of risk reduction while Macron's plans aim more towards risk sharing.

First, Merkel's proposals regarding a eurozone investment budget are less far-reaching than Macron's. Merkel suggests a gradual introduction of a budget worth "low double digits of billions". This would be significantly less than Macron's concept of a fiscal capacity reaching several percentage points of the euro area GDP. According to Merkel's plans, the investment budget would be used to address structural weaknesses in countries, in particularly focused on innovation. How the funds are spent would be under the control of national parliaments and not under parliamentary control at the European level as Macron suggested.

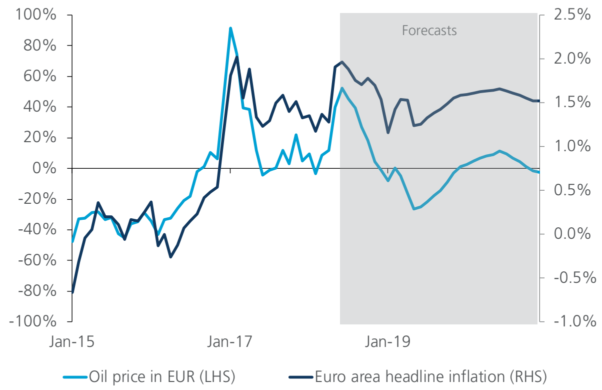
Merkel also expressed her vision on the future of a European Monetary Fund (EMF). Her view is that the EMF should play a role in controlling public finances of the Member States. The EMF should be able to give short-term credits according to Merkel's plans. These loans would provide aid to countries that get into difficulty due to external circumstances. Long-term loans provided by the fund would go hand in hand with necessary structural reforms. Moreover, according to Merkel, the EMF should have the authority and tools necessary to restore the debt sustainability of a country when needed. This last element suggests that a debt restructuring would be a condition of EMF loans. Conversely, Macron and other euro area leaders are opposed to such conditions.

Inflation climbing up

Euro area headline inflation jumped up to 1.9% in May, from 1.2% in April. The energy component was the highest contributor followed by food, alcohol and tobacco. Core inflation also jumped back up to 1.1% from 0.7% in April, supported by an uptick in services inflation. Temporary factors related to the timing of holidays compared to last year likely have played an important role in particular volatility in this area in recent months. Although energy inflation will remain a supportive element for headline inflation in the months to come, a partial fallback is highly likely in the second half of this year (figure 3).

Nevertheless, the ECB announced that it will start tapering their asset purchases from October onward, which is in line with our scenario. After September 2018, the ECB will taper its purchases dropping the monthly purchase amount to EUR 15 billion from EUR 30 billion at present. Importantly, the ECB also signalled its intention to end the APP in December 2018. However, to ensure that markets do not anticipate an early or aggressive move to higher interest rates, the ECB also indicated that policy rates are not likely to rise at least through the summer of 2019. Hence, the first step towards a policy rate normalisation will

Figure 3 - Higher oil prices will remain supportive factor for euro area inflation (% change yoy)



Source: KBC Economic Research based on Eurostat, Thomson Reuters (2018)

only be taken well into the second half of 2019 at the earliest. In accordance with this, we didn't change our scenario for the long-term German bond yields. We still see them rising towards 1.30% by end 2018 and 1.75% by end 2019, although the risks are mostly skewed to the downside.

In the US, a projected 2.8% real GDP growth in 2018, stimulated by fiscal policies, and rising inflationary risks are pointing towards more rate hikes by the Federal Reserve than previously envisaged. Therefore, our scenario now contains two more Fed policy rate increases by 25bps this year and two hikes in 2019 - instead of one in our May scenario. The latter will likely happen in the first half of next year as US growth will begin to slow down. Hence, this will also be the end of the Fed's tightening cycle in our view. As a consequence of this slightly more aggressive view on the Fed combined with the impact of worsening public finances, we revised our USD and long-term bond yield forecasts up somewhat. We now see the 10y bond yield reaching 3.20% by end 2018 and end 2019, up from respectively 3.10% and 3.00%. Accordingly, our view on the USD against the EUR has strengthened, reaching 1.22 USD per EUR by end 2018 (from 1.26 USD per EUR). In the short term, the USD exchange rate can be somewhat volatile but we expect no major appreciation of the USD anymore.

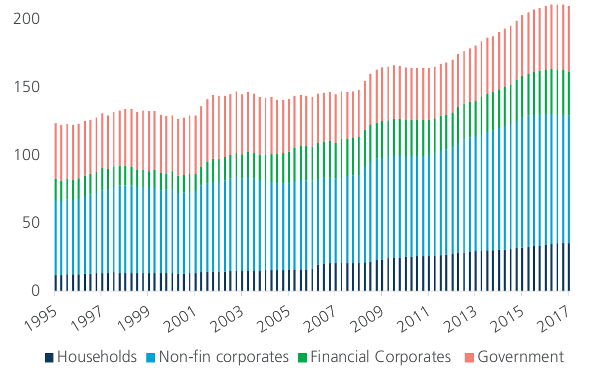
Emerging markets back on the radar

After a period of remarkable stability on financial markets, volatility spiked again in recent months. Increased political uncertainties in some important euro area economies and the heightened international trade tensions were important factors. However, rising concerns about some emerging markets (EMs) have also caused more maket volatility. In particular, concerns about Argentina and Turkey have garnered significant attention.

Argentina is no stranger to economic disaster and market turbulence. Optimism among investors flourished, however, when President Macri took power in late-2015. He inherited severe macroeconomic imbalances from his predecessors with multiple debt defaults in the past, double-digit inflation, and sizable fiscal and current account deficits. The recent bout of market volatility is a reminder that investor confidence, and Argentina's economic recovery, remain on shaky ground. Indeed, the Peso has been under pressure since the central bank (BCRA) raised its inflation target at the end of 2017, and eased its policy rate in January this year. A steeper slide began at the end of April, along with a broader decline in emerging market currencies, as rising interest rates in the US are expected to present a notable headwind to emerging market capital inflows. In response, the BCRA increased its policy rate by a cumulative 1275 bps to 40% between 27 April and 4 May, while the fiscal authorities announced a narrower primary fiscal deficit target. Moreover, the IMF and Argentine authorities reached an agreement on a high-access Stand-By Arrangement (SBA) worth USD 50 billion. High-access precautionary arrangements are established when the recipient does not intend to draw on the available credit, but can do so if necessary (i.e. thereby providing an additional buffer to bolster liquidity and investor confidence). In that sense, the SBA could bolster investors' confidence, which is crucial to keep the country on track with its reforms.

Meanwhile, Turkey came into the spotlight because of the strong depreciation of the Turkish Lira against the USD and the EUR. The main reason for this was the fear that a turn to more market unfriendly economic policies by President Erdogan is on the way. Fiscal stimulus will continue in 2018, despite the fact that the Turkish economy is already in overheating territory. Moreover, as Erdogan aims to increase his grip on the central bank, an appropriate policy mix cannot be achieved. As a result, inflation will likely continue to significantly overshoot the central bank's target, despite a material deceleration of economic growth. Inflation expectations are unanchored and international investor confidence has been undermined. The central bank cannot respond adequately to either of these problems. This triggered the sharp increase in the country's risk premium and depreciation of the exchange rate. Domestic economic risks come on top of risks related to the domestic political situation. Snap elections for both the president and parliament later in June are likely to be won by Erdogan, but could increase polarisation within society and undermine the legitimacy of the new government. They could result in a reinforcement of the authoritarian tendencies for which the presidential system gives room. Going forward, the Turkish situation hence remains precarious.

Figure 4 - Rapid build-up of emerging market debt since financial crisis
(EM-27* debt, in % of GDP, by GDP-weighted averages)



Source: KBC Economic Research based on IIF (2018)
*EM-27: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Ghana, Hong Kong, Hungary, India, Indonesia, Israel, Kenya, Korea, Malaysia, Mexico, Nigeria, Pakistan, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, Turkey, Ukraine.

The recent jitters about Turkey, Argentina and some other emerging market currencies have raised concerns about a potential upcoming Asian-style EM crisis like the one seen in 1997-1998. Since 2008, there has been a rapid build-up of EM debt, mainly led by corporates (figure 4). This was driven in part by the global low interest rate environment and the consequent search for yield. Corporate debt is highly concentrated in several Asian economies (Hong Kong, China, Singapore). However, for many EMs outside Asia, the currency profile of corporate debt is concerning. According to World Bank data, 33% of outstanding corporate debt (excluding China) is financed by cross-border sources, which is denominated in non-local currencies like the USD or EUR.

Moreover, in several EMs, foreigners own more than 30% of local currency government bonds. This makes these countries prone to speculative attacks like the ones recently seen in Turkey or Argentina. The most vulnerable countries are those with greater external financing needs and/or weaker fiscal positions (Argentina, Egypt, Turkey, South Africa). Nevertheless, so far bond issuance remains strong. Also corporate credit ratings are mostly stable with a few notable swings (e.g. Brazil). Furthermore, growth in general remains solid. Most EMs are also in a better position than at the end of the nineties as fewer EM currencies are pegged to the USD. Hence, some ingredients for a crisis are there, but it's not a foregone conclusion at this point. A lot of it will depend on external factors - for instance, a more aggressive Fed policy or a severe escalation of the trade conflict could be a trigger for more EM troubles.

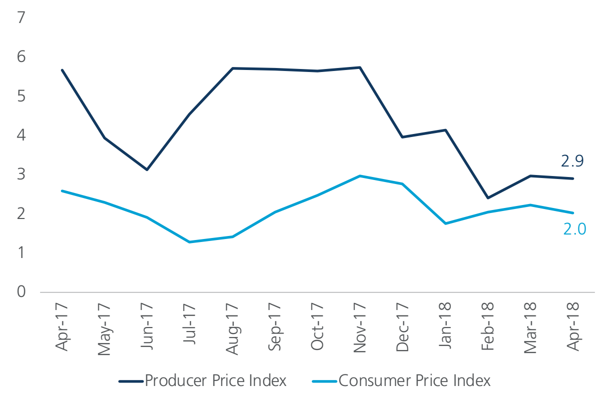
Bulgarian Economy

According to preliminary data from the National Statistical Institute, Bulgaria's real GDP grew by 3.6% yoy in Q1 of 2018 (0.9% qoq). The growth rate remained unchanged compared to the previous quarter. The main growth drivers were gross fixed capital formation (+7.0%) and final household consumption (+3.3%). Exports and imports of goods and services increased by 4.4% and 4.6%, respectively. We expect consumption growth to remain the main growth driver in the coming quarters. Export growth will likely slowdown as a consequence of global rising trade tensions.

Producer prices rose by 0.7% mom in April, with the largest price increases recorded in the manufacturing sector. On an annual basis producer prices grew by 2.9% yoy in April, compared to 3.0% yoy in March (figure 5). Hence, the downward trend in producer price inflation seen since the end of last year continues. Consumer price inflation also came down slightly in April (to 2.0% yoy from 2.2% yoy in March). Current output price developments look like a precondition for stabilising consumer inflation over the next few months.

Figure 5 - Continuing downward trend in Bulgarian producer prices

(PPI and headline inflation, % change yoy)



Source: KBC Economic Research based on Bulgarian National Statistical Office (2018)

Detailed country forecasts	2017	2018	2019
Real GDP growth (in %)	3.6	3.5	3.4
Inflation (in %, harmonised CPI)	1.3	1.5	1.7
Unemployment rate (in %, end of year, Eurostat definition)	5.7	5.6	5.5
Government budget balance (in % of GDP)	0.8	-0.5	-0.5
Gross Public debt (in % of GDP)	25.1	24.7	24.2
Current account balance (in % of GDP)	5.0	3.4	1.4
House prices (avg annual %-change, total dwellings, Eurostat definition)	9.0	6.0	5.0

Focus article - Currencies as economic weapons: why the euro is still no match for the US dollar

Since the creation of the euro in 1999, the Single European currency has evolved into the second most important currency in the international financial system. However, there is still a significant gap to the US dollar in virtually all relevant criteria of this system. According to some criteria, the relative importance of the euro has even somewhat declined in the aftermath of the European sovereign debt crisis. The euro is unlikely to replace the USD as the dominant international currency, even in the longer run. Two of the most obvious obstacles are the continuing absence of sufficiently deep and liquid financial markets in the euro area, despite some significant progress after less than 20 years, and the periodically reappearing concern about the long-term stability of the currency area. Moreover, the ECB neither hinders nor promotes the international use of the euro. A truly international role of the euro would have far-reaching consequences for the ECB's monetary policy.

The US dollar as a political weapon

International relations have been quite turbulent recently, especially since the election of US President Trump. One of the latest examples is the unilateral withdrawal of the US on May 8th from the nuclear agreement with Iran. This withdrawal effectively re-imposed US economic sanctions against Iran, that had been suspended when the agreement was reached.

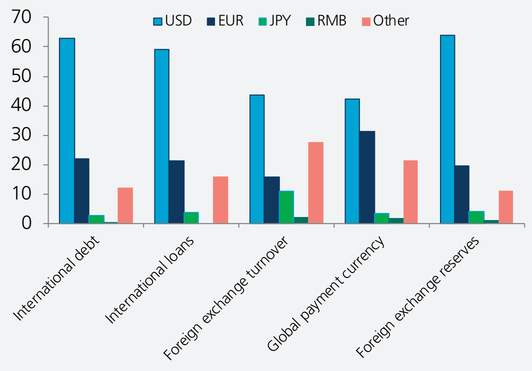
This decision by the US not only affects US-Iranian economic and financial relations, it also has an impact on non-US firms doing business with Iran. These firms, too, are facing US sanctions when they want to do business on the US market themselves. This is not only restricted to real economic activity, but also to financial transactions. This widens enormously the scope and repercussions of the US measures.

Where does the US derive the economic power to impose such sanctions with extraterritorial effects? The main part of the answer lies in the unique position of the US dollar as the world's dominant international currency. The evolution of the global economy and the development of the international political as well as financial architecture since the Second World War means the US dollar's standing worldwide remains notably elevated, some significant distance ahead of the second most important currency, today, the euro. This is the case for all relevant measures, such as the creation of international debt instruments and loans, turnover on the foreign exchange markets and the use as an international transaction and FX reserve currency.

Transactions in many markets, such as commodity markets, are executed in US dollars. Any firm engaging in an oil-related

Figure A - The euro on an unchallenged second place, but with a significant gap behind the US dollar

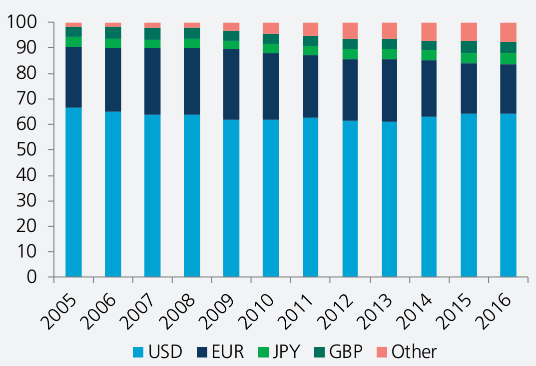
(percentages, end-2016 data or latest available)



Source: ECB, IMF, SWIFT, BIS as reported by ECB

Figure B - The euro's share in global foreign exchange reserves has declined again

(Currency shares in FX reserves with disclosed currency composition (at current exchange rates))



Source: ECB, IMF as reported by ECB

transaction with Iran, is likely to be involved in a financial transaction in US dollars. Since all of these financial transactions in US dollar sooner or later have to be settled via accounts in the US banking system, the firms involved also become subject to US jurisdiction. This mechanism is not limited to the oil market. Any economic agent that engages in financial transactions or is building up foreign exchange reserves in US dollar, directly or indirectly faces an exposure to US legislation.

The role the US dollar is playing in enforcing US sanctions against Iran gives us a cause to have a closer look at the current functioning of the international financial system. Even on the eve of the 20th birthday of the Single European Currency, its use as an international currency is still not comparable to the one of the US dollar. Moreover, as a result of the European sovereign debt crisis in the early 2010s, the euro's modest share in financial transactions and reserve build-up started to decline again somewhat. This was probably mainly the result of a decline of confidence of international economic agents in the reliability, or even the survival, of the European currency.

Current International financial system with flaws

The current international financial system (IFS) is an informal system with no formal rules of operations. In practice, it is organised with the US dollar at its core, and consists of a mostly uncoordinated system of fixed or floating exchange rates. In particular the absence of any formal correction mechanism for unsustainable external imbalances is a weakness.

Unlike the current system, the preceding Bretton Woods system did have formal rules, formalised in a Treaty, including the agreed fixed exchange rate against the US dollar and the dollar's convertibility into gold at a fixed parity. The Bretton Woods system effectively ended in 1971 when then US President Richard Nixon stopped the USD's convertibility to gold. Since 1971, almost all currencies have been so-called fiat currencies, in the sense that they derive their value solely from the authority and credibility of the issuing country, and more specifically of the issuing central bank. Within this informal system, all agreements between the countries concerned are made either on an ad hoc voluntary basis or, in some cases, completely unilaterally.

"The dollar is our currency, but your problem"

The significance of the power to act in a unilateral fashion is repeatedly illustrated by Presidents Trump's economic policies. They underline the fundamental problem that almost inevitably arises when an IFS is constructed around one dominant currency. As long ago as 1961, the Belgian economist Triffin described the dilemma arising from the conflict of interests between the various national policy objectives on the one hand and the monetary and financial stability of the common IFS on the other. In economic terms, there is a problem of coordination since negative consequences of national policies on the rest of the IFS are not taken into account by individual national policy-makers.

The implications of this potential divergence were spelt out in US Treasury Secretary John Connally's famous remarks in 1971, "[…] the dollar is our currency, but your problem." Unsurprisingly, one of the main reasons of the collapse of the Bretton Woods system was the inconsistency of US domestic economic policies (increasing budget and current account deficits, together with rising inflation) with the 'rules of the game'. In the end, the fixed conversion rates of all participating currencies to the US dollar, and hence ultimately to gold, proved unsustainable.

Similarly, some current US economic policies may not be consistent with global economic and financial stability. This is arguably the case for current US trade policy, the late-cyclical fiscal stimulus increasing the risk of a boom-bust economic growth path and, as mentioned earlier, the explicit use of the IFS to unilaterally enforce a national policy objective which is not even of an economic nature itself. This obvious lack of international policy coordination makes it clear that the current IFS is far from perfect, with lots of room for improvements.

What makes the US dollar so appealing ?

If the current IFS has such important shortcomings, then what are the reasons for the continued dominance of the US dollar in the IFS, even in the absence of any formal agreement on this? There are a number of characteristics that a currency must have in order to play a significant international role. At this moment the US dollar is the only currency fulfilling these conditions.

First of all, the currency must be supported by a (very) large economy, because fiat money is essentially a claim to goods and services of the issuing country. It is precisely this need for credibility that often leads small economies to link their currency to the currency of a larger economy (such as Denmark) or even to establish a currency board (such as Bulgaria and Hong Kong).

The size of the economy also promotes the international use of a currency because there are more (domestic) users from the outset, which reduces transaction costs for potential new users. In the economic literature, this phenomenon is described as economies of scale on the demand side. These help to explain the sustainability of the status of an international currency once it has acquired such a status. This was the case, for example, for the British Pound in the 19th and early 20th century, and it has been the case for the US dollar since the end of the Second World War.

A second critical condition for an international reference currency is the existence of liquid and easily accessible financial markets. International investors should have at their disposal an adequate amount of safe financial assets issued in the international currency of their choice. The other side of the coin is the willingness of the country of the international currency to supply sufficient financial assets. In other words, that country must be prepared to incur sufficient debt to meet international demand for that debt. Specifically, this country must accept to run systematic current account deficits. By paying for them in its domestic currency? the country provides sufficient financial liquidity for the smooth functioning of the IFS and takes up its role of the ‘global central banker’.

Thirdly, in addition to the size of the economy and the presence of well-developed financial markets, a sound and stable political, legal and macroeconomic framework plays an equally critical role. Particular attention is paid to the enforceability of the law by independent courts, which guarantees international investors the protection of their investment property.

Finally, in the long term, the combination of geopolitical status and political stability of a country plays a decisive role. A country that at some point in history exercises a hegemonic power, has an interest to stimulate the international use of its currency. Such a role of central banker of the world economy has major economic advantages. This includes in particular the ‘exorbitant privilege’ of being able to issue debt and settle import bills in one’s own currency, since this currency is readily accepted. All else being equal, this significantly reduces borrowing costs and helps to insulate the domestic economic from exchange rate volatility.

Can the euro catch up to the US dollar as an international currency ?

The creation of the euro in 1999 has not yet led to a diversified IFS. Although the euro has now taken second place according to most criteria, it is not a real alternative to the US dollar in the sense that we would have moved to a truly bipolar IFS. On the contrary, based on some criteria, the international importance of the euro has decreased somewhat again since the European sovereign debt crisis.

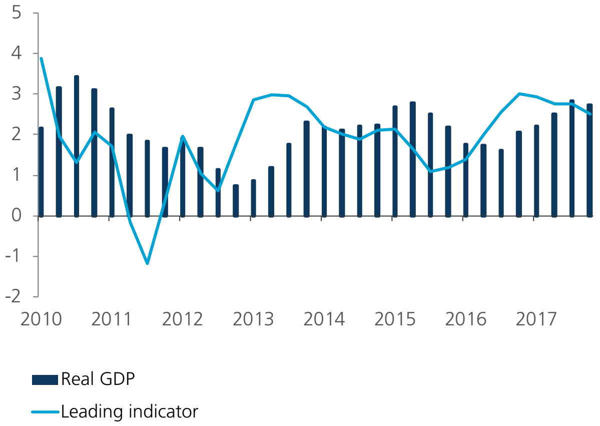
Three factors played key roles in limiting the increase in the international use of the EUR. First of all, there is still no pan-European bond market and a trend towards renationalisation in European bond markets has further reduced the necessary liquidity.

Arguably, the development of large and deep Euro–based financial markets could simply be a matter of time. However, for this to occur there must be full confidence that EMU is irreversible. Recent Italian political events highlighted that even 20 years after the creation of the euro, the survival of the euro area in its current form cannot be taken for granted. This is partly reflected by the sudden doubling of the Italian sovereign yield spread versus German government long-term bonds. This underlying persistent uncertainty on financial markets is obviously not helpful in promoting the international role of the euro.

Finally, it is questionable whether Europe actually wants a genuinely international currency similar to the US dollar. The international use of its currency would mean that the ECB would lose a large part of its control over the effective total money supply and hence also over domestic inflation. This was an important reason why the Bundesbank was reticent at the time about the international use of the then German mark. The European Central Bank is not very keen on this either. The ECB's official position remains that the international role of the euro should be primarily determined by market forces. The ECB therefore neither hinders nor promotes the international role for the euro.

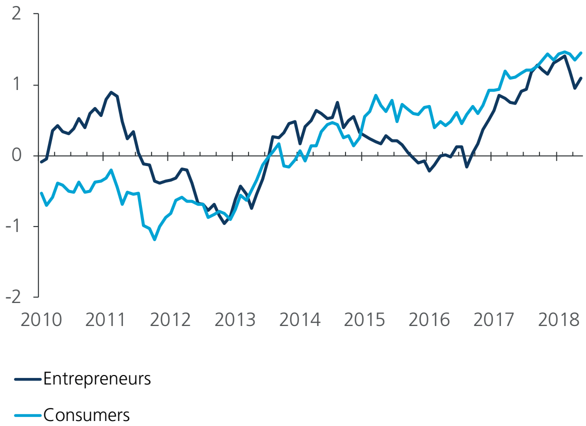
The most likely development for the next decade is therefore a continuation of the current system, with the dollar as the international anchor and a relatively modest role for the euro. However, in such a unipolar scenario, the importance of preserving and even enhancing international policy coordination becomes more important than ever.

Figure 1 - Economic activity in the OECD
(annualised quarterly change in %)



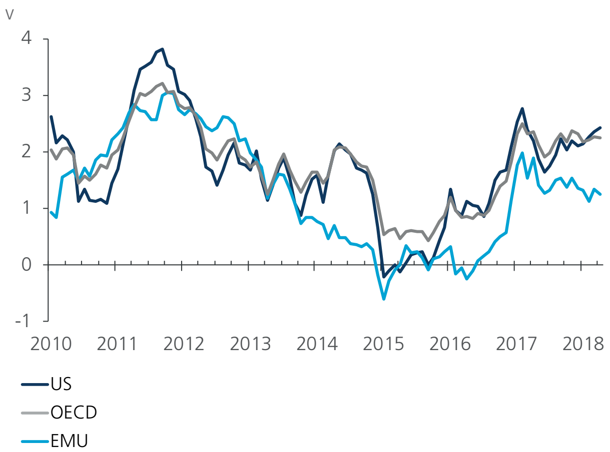
Source: OECD

Figure 2 - G4 confidence
(standard deviation from the long-term average)



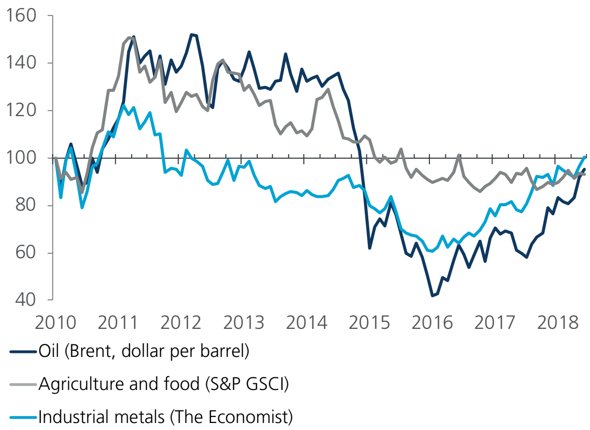
Source: National sources

Figure 3 - Inflation
(consumer price index, y-o-y change, in %)



Source: Eurostat, BLS and OECD

Figure 4 - Commodity prices
(January 2011 = 100)

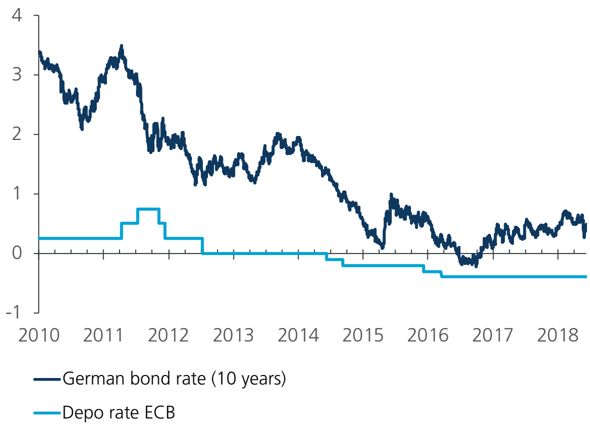


Source: ICIS pricing and S&P

Figure 5 - Interest rate movements US
(in %)

Source: Fed and Datastream

Figure 6 - Interest rate movements euro area
(in %)



Source: ECB and Datastream

Outlook world economies

	Real GDP growth		Inflation	
	2018	2019	2018	2019
US	2.8	2.3	2.4	2.4
Euro area	2.3	2.0	1.5	1.6
Belgium	1.6	1.5	1.7	1.4
Germany	2.3	1.9	1.6	1.8
Ireland	6.0	4.0	0.9	1.6
UK	1.4	1.3	2.5	2.1
Sweden	2.6	2.1	1.8	2.0
Norway	2.3	2.2	1.9	1.8
Switzerland	2.1	1.8	0.7	1.0
Slovakia	3.8	3.8	2.8	2.6
Poland	4.5	3.9	1.8	2.4
Czech Republic	3.2	2.7	1.6	2.0
Hungary	3.9	3.4	2.5	3.2
Bulgaria	3.5	3.4	1.5	1.7
Russia	1.8	1.6	3.7	3.8
Turkey	4.2	4.0	11.0	9.9
Japan	1.3	1.0	1.0	1.0
China	6.5	6.3	2.3	2.3
Australia	2.7	2.8	2.2	2.4
New Zealand	2.9	3.0	1.8	2.0
Canada	2.1	1.9	2.3	2.1
World	3.9	3.9	-	-

10-year rates	14/06/18	+3m	+6m	+12m
US	2.95	3.00	3.20	3.30
Germany	0.48	0.80	1.30	1.50
Belgium	0.86	1.10	1.60	1.85
Ireland	1.01	1.20	1.75	2.00
UK	1.36	1.75	2.30	2.65
Sweden	0.64	0.95	1.45	1.65
Norway	1.88	2.20	2.70	2.90
Switzerland	0.06	0.35	0.85	1.05
Slovakia	0.82	1.10	1.60	1.85
Poland	3.28	3.30	3.50	3.60
Czech Republic	2.16	2.00	2.15	2.35
Hungary	3.53	3.20	3.30	3.70
Bulgaria	1.20	1.65	2.18	2.40
Russia	7.55	7.50	7.50	7.50
Turkey	15.73	14.75	14.50	14.50
Japan	0.04	0.00	0.00	0.00
China	3.68	3.70	3.70	3.50
Australia	2.73	2.85	3.05	3.15
New Zealand	2.99	3.05	3.25	3.35
Canada	2.32	2.35	2.55	2.65

Policy rates	14/06/18	+3m	+6m	+12m
US	2.00	2.00	2.50	3.00
Euro area (refi rate)	0.00	0.00	0.00	0.00
Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40
UK	0.50	0.50	0.75	0.75
Sweden	-0.50	-0.50	-0.50	-0.25
Norway	0.50	0.50	0.75	0.75
Switzerland*	-0.75	-0.75	-0.75	-0.75
Poland	1.50	1.50	1.50	1.75
Czech Republic	0.75	0.75	1.00	1.25
Hungary	0.90	0.90	0.90	1.10
Romania	2.50	2.75	2.75	3.00
Russia	7.25	7.00	6.75	6.75
Turkey	17.75	17.75	17.75	17.75
Japan	-0.10	-0.10	-0.10	-0.10
China	4.35	4.35	4.35	4.35
Australia	1.50	1.50	1.50	1.75
New Zealand	1.75	1.75	1.75	2.00
Canada	1.25	1.50	1.50	1.75

*Mid target range

Exchange rates	14/06/18	+3m	+6m	+12m
USD per EUR	1.18	1.18	1.22	1.25
GBP per EUR	0.88	0.88	0.89	0.91
SEK per EUR	10.16	10.00	9.75	9.50
NOK per EUR	9.45	9.40	9.35	9.25
CHF per EUR	1.16	1.18	1.20	1.22
PLN per EUR	4.28	4.33	4.25	4.20
CZK per EUR	25.68	25.80	25.00	24.80
HUF per EUR	320.62	316.00	315.00	313.00
BGN per EUR	1.96	1.96	1.96	1.96
RUB per EUR	73.67	72.57	75.03	76.88
TRY per EUR	5.48	5.43	5.67	5.88
JPY per EUR	129.87	129.80	134.20	137.50
RMB per USD	6.39	6.40	6.41	6.42
USD per AUD	0.76	0.76	0.77	0.78
USD per NZD	0.70	0.70	0.71	0.72
CAD per USD	1.30	1.28	1.26	1.25

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