Economic Perspectives

May 2018

Highlights

- The global economy retains positive momentum, but sentiment - although still at healthy levels - has continued to soften in some economies while only showing a partial recovery in others. Some mean reversion after reaching multi-year highs at the beginning of 2018 is partially responsible for the drop. However, the persistent uncertainty around future developments on the trade front has also weighed on business optimism, particularly for firms in the tradeable goods or manufacturing sector. Overall, the economic environment remains healthy, albeit less excellent than seen at the start of 2018.

- Economic data for the euro area economy disappointed in recent weeks with a continued decline in corporate sentiment measured by PMIs and slower real GDP growth figures for Q1 than in previous quarters for most countries. A weaker growth contribution of net exports, largely driven by a stronger EUR in Q1, was the main cause behind the latter. Nevertheless, high consumer confidence and positive labour market developments will continue to underpin private consumption and remain supportive. All in all, in our view, the euro area economy remains in an expansionary phase with above-potential growth envisaged for the next two years. However, given recent developments, we have lowered our EMU growth forecasts slightly for this and next year.

- New developments in Italian politics are clearly a test for the sustainability of current low intra-EMU spreads and may trigger a renewed debate on the euro area's future.

- While US inflation has picked up somewhat in recent months, euro area headline and core inflation disappointed significantly in April. Seasonal effects regarding Easter holidays played an important role and indicate that this inflation dip will likely be only temporary. Nevertheless, recent softer economic data for the euro area economy prompted a somewhat more cautious message from ECB president Mario Draghi after the policy meeting in April. Hence, the first move towards tighter ECB policy still seems some distance away. We keep our base scenario unchanged and expect the ECB to continue its Asset Purchase Programme (APP) at least until September 2018 with a period of tapering thereafter.

- Focus article - The euro zone economic business cycle : quo vadis?

Global Economy

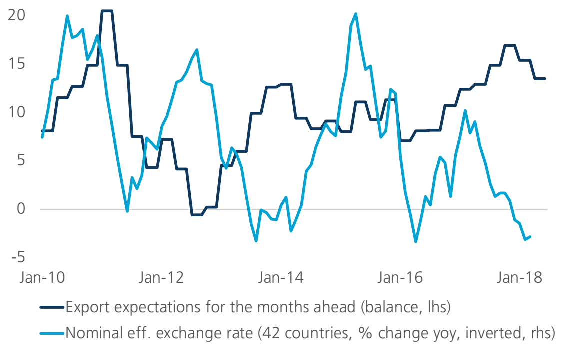
Slight deterioration of momentum

The global economy retains positive momentum, but sentiment - although still at healthy levels - has continued to soften in some economies while only showing a partial recovery in others. Some mean reversion after reaching multi-year highs at the beginning of the year is partially responsible for the drop. However, the persistent uncertainty around future developments on the trade front has also weighed on business optimism, particularly for firms in the tradeable goods or manufacturing sector. If the US and China are not able to reach an agreement on trade matters and the dispute escalates, an even sharper decline in sentiment would be very likely. Regarding the US tariffs on steel and aluminium that have already been implemented, evidence from surveys suggests some American manufacturers are finding that it has become more difficult and pricy to source certain materials. Moreover, some indicate that business planning is currently at a standstill until uncertainties about the announced - but not yet implemented - tariffs are resolved. This illustrates that introducing more import tariffs would not be beneficial to the US economy as President Trump claims.

Corporate sentiment in the euro area, measured by PMI indicators, showed no major recovery after its sharp drop recorded in previous months. Nevertheless, it is still at levels consistent with a solid economic expansion. Looking at survey details on a sectoral level, the European Commission's sentiment indicator shows sentiment in retail trade and industry was hit hardest, while the drop in services was smaller. Also important, in the construction sector - traditionally an important business cycle driver - sentiment stabilised at an historical high. The deterioration of business sentiment in industry is triggered by the perception of a loss of competitiveness, mainly on markets outside the EU. This may owe something to the impact of increased trade tensions, but might also be due to the recent appreciation of the trade weighted EUR exchange rate by almost 10% (figure 1). As the strong economic growth in 2017 was supported by net exports, the loss of competitiveness could become a drag on growth this year. Furthermore, capacity constraints are becoming a more important pressing issue for some European firms. Preliminary 'hard' figures for Q1 real GDP growth confirm the slowdown of the growth pace compared to the second half of 2017 for most EMU countries. Heterogeneity remains within the euro area though. Q1 growth disappointed in countries like France and Germany compared to Q4 2017, but growth remained at equal levels in Italy and Spain. Hence the growth slowdown in Q1 is not symmetric across Europe.

Figure 1 - Deterioration of business sentiment in euro area industry also linked to recent Euro appreciation

(export expectations in industry and the EUR FX)



Source: KBC Economic Research based on DG ECFIN (2018)

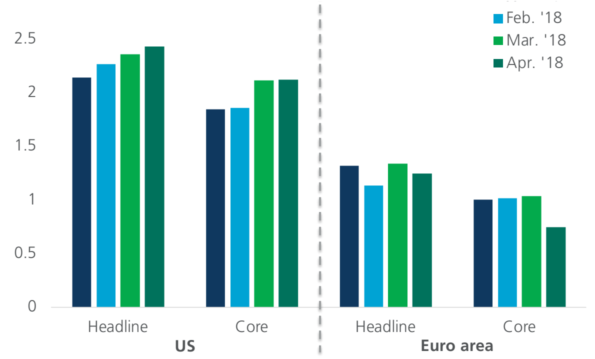
Nevertheless, there are still several supportive elements for the euro area economy as well. High consumer confidence and positive labour market developments will continue to underpin private consumption. All in all, in our view, the euro area economy remains in an expansionary phase with above-potential growth for the next two years. Nonetheless, given recent developments, we think our previous forecasts were a bit too optimistic. Therefore, we slightly lowered our EMU growth forecasts to 2.3% for 2018 (down from 2.5%) and to 2.0% for 2019 (down from 2.2%). In accordance with this, we also lowered our growth forecasts for Belgium as well as the Central and Eastern European home markets due to their sensitivity to negative international events.

Further diverging inflation paths

US inflation has edged higher of late (figure 2). Both headline and core CPI inflation are now above 2%, while the measures relevant for US monetary policy - headline and core PCE inflation - are also heading towards the Fed's 2% target. The Fed Committee stated that they expect core inflation to rise further in coming months but this doesn't imply a more aggressive policy rate hiking path than currently signalled by the Fed. The US central bank is therefore not inclined to tighten policy faster, even if inflation temporary overshoots the target level, in the context that it substantially undershot the Federal Reserve's target for many years. For this reason, we stick to our view on the Fed's normalisation path. Nevertheless, we have slightly adjusted the timing of the rate hikes in the coming year. We now see three more rate hikes in 2018 as inflation will increase and economic growth will peak. Meanwhile, the balance sheet rundown will continue at the predetermined

Figure 2 - US inflation edging higher while euro area inflation disappointed of late

(headline and core inflation, % change yoy)



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

pace. One more rate hike in 2019 will follow but this may mark the end of the Fed's rate hike cycle as the US economy should begin to show signs of a slowdown.

Euro area inflation disappointed significantly in April (figure 2). Headline inflation declined to 1.2% from 1.3% in March, while core inflation eased to 0.7% from 1.0% as services inflation fell. Base effects from last year related to the timing of Easter caused transport services and holiday packages inflation to decrease markedly. However, these effects will most likely be only temporary. Therefore, we do not change our scenario for euro area inflation. We still see it rising gradually but staying below the ECB's inflation target of below but close to 2%.

Recent softer economic data for the euro area economy, and subdued inflation data led ECB president Mario Draghi to give a rather cautious press conference after the policy meeting in April. He stated that the ECB wants to fully understand current developments before discussing future policy. The ECB is still moving on a path towards policy normalisation and remains confident that inflation will converge towards its below but close to 2% inflation target in the medium term. However, recent developments may mean that clear signals about the ECB's intentions will likely come later than previously envisaged. It is not unreasonable for the Governing Council to want to clarify whether the recent softening in a range of indicators could be warning of a renewed weakening of the euro area economy ahead of a change in the monetary policy stance. Moreover, given the significant shortfall in inflation relative to the target level, the ECB clearly wants to avoid any premature tightening of financial conditions. Therefore, the first move towards tighter ECB policy still seems some distance away. We keep our base scenario unchanged and expect the ECB to continue its Asset Purchase Programme (APP) at least until September 2018 with a period of tapering thereafter. The first policy rate increase will only be taken well after the end of the APP, meaning at the earliest during the second half of 2019.

These still divergent inflation and monetary policy paths between the two major economies together with renewed concerns of late about Italian political developments, significantly impacted financial markets. While the US 10y government bond yield rose by about 25bps to stabilise just around 3%, the German 10y government bond yield only rose about 10bps. Hence, the spread between the US and German long-term government bond yield is again above the peak seen at the end of 2016. The FX market also reacted to the contrasting tones of the central banks, differences in inflation data and Italian political concerns through a USD strengthening against the EUR.

Given the elevated interest rate differential, momentum remains supportive for the USD in the short term. We therefore expect the USD to appreciate somewhat more against the EUR on a 3-month horizon. On the medium to longer term our view remains unchanged though. Expectations of a first ECB rate hike and the consequences of late-cyclical fiscal stimulus measures (twin deficits) in the US will lead to EUR appreciation against the USD. Also for long-term government bond yields we haven't adjusted our scenario although the risks around it are more tilted on the downside. The German 10y government bond yield is expected to rise towards 1.30% by the end of 2018 as the end of the ECB's APP comes nearer. A further rise towards 1.75% by end 2019 is envisaged. Intra-EMU spreads are likely to rise towards the end of 2019 as the ECB tapers its bond purchases and a first rate hike draws closer. For the US we see bond yields rising further gradually towards the end of 2018 as the Fed continues its tightening cycle. Long-term yields will roughly stabilise in 2019 while the yield curve flattens further.

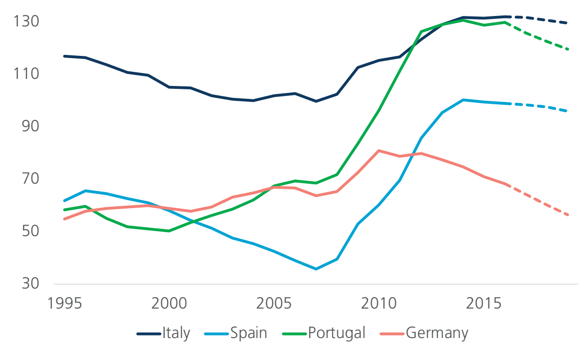
Old risks fading, new ones popping up

The mid-May threat by North Korea to suspend the much anticipated summit between the two leaders of the Korean Peninsula raised the possibility of yet another twist in the rollercoaster relationship between North and South Korea. Initially, the two countries expressed their willingness for talks in order to improve relations further. However, in mid-May, North Korea threatened to suspend the meeting following joint military drills conducted by South Korea and the US. Furthermore, North Korea has called into question its meeting with the US, currently slated for June 12 in Singapore, stating that the US must stop insisting it to 'unilaterally' abandon its nuclear programme. While the risk of an escalation of the nuclear conflict - with a potentially severe humane and economic impact - has diminished somewhat in the last few weeks, these recent events highlight how volatile these negotiations will continue to be in the coming future.

President Trump also made the decision to abandon the nuclear deal with Iran, which raises the risk of conflict in the Middle East and creates significant uncertainty about global oil supply. Moreover, he puts his relations with Europe at stake as he ignored the multiple European demands to stick to the agreement. The deal, that was signed by the US, Iran and five other major economies in 2015, contained limits on the Iranian nuclear program in exchange for less economic sanctions on the country. A renewal of those sanctions - which the US Treasury Department threatens to do within a six-month 'wind-down' period - would make it harder for Iran to sell its oil internationally. Iranian authorities, however, still considered that the deal was intact among the remaining parties. As a consequence of these heightened tensions and following the related oil price rise in recent weeks, we upgraded our oil price scenario. We now see oil prices develop towards USD 65 per barrel Brent oil by the end of 2018 (up from USD 60 per barrel).

On the European front, risk-related new was mixed in recent weeks. Positive messages came from the Greek banking sector. The four largest Greek banks reported solid results on the ECB stress test that was done in the light of the end of the European Stability Mechanism's (ESM) Stability Support Programme for Greece in August. The test determined whether banks will suffer a capital shortfall under an adverse shock scenario, using the same approach as the EU-wide EBA stress test. The outcome for the Greek banks was positive as the average

Figure 3 - Expansionary fiscal policies of new Italian government would raise the already high government debt even further
(gross government debt as a % of GDP)



Source: KBC Economic Research based on EC AMECO (2018)

capital depletion under an adverse scenario would remain contained enough. The recent stress test was not a pass or fail exercise as there were no predetermined capital thresholds that would trigger the need for precautionary recapitalisation (e.g. like the Italian bank Monte dei Paschi di Siena was forced to do). The test for the Greek banks was meant to determine the vulnerabilities and understand the impact of hypothetical adverse economic developments on banks. The test for Greek banks was frontloaded - the results of the 2018 EU-wide EBA stress test are only expected to be published in November - to guarantee that any necessary follow-up actions could be taken before the ESM Programme ends. The test results warranted no further need for recapitalisations though.

However, the most significant development in the first half of May was heightened concern about prospective political shifts in Italy. The country has seen a political deadlock since the elections in March resulted in the most votes for the populist Five Star Movement party and the most seats for an alliance of right-wing parties, but with no absolute majority for either. After the third round of government consultations failed, President Mattarella suggested forming a temporary 'neutral' government that would be in charge of approving the 2019 budget law. This government would remain in office until December of this year at the latest, after which new elections will be held. In the meantime, negotiations would continue and should the parties complete the formation of a new political majority, the temporary government would step down. The proposal hit fierce opposition from the far-right League party and the anti-establishment Five Star Movement, who initially proposed to have snap elections in July. Polls are suggesting that this would be favourable for the centre-right bloc that includes the League and former Prime Minister Berlusconi's Forza Italia. Nevertheless, changes are high that a snap election would lead to a similar inconclusive election outcome as seen in March. In this context, the Northern League party and the Five Star Movement started talks to form a coalition together.

Such a government would imply that fiscal policy is likely to be more expansionary, which would raise the already high government debt even further (figure 3). Moreover, this would be at odds with EU fiscal rules. In addition, many reforms will likely be rolled back. The recent political jitters led to a 30 bps rise in 10y Italian government yields from the start to the middle of May (and likely also acted to restrain their German counterparts as well as weighing on the exchange rate of the Euro against the US Dollar). For now, we haven't altered our forecasts for the Italian bond yield spread against Germany, although political events could spark short-term volatility spikes on financial markets in coming weeks.

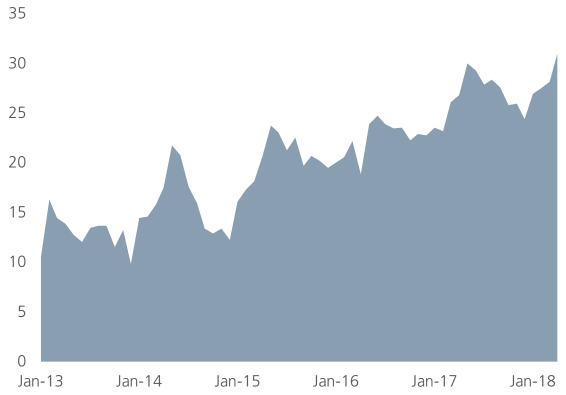
Bulgarian Economy

Business managers' optimism remains underpinned by high expectations about the Bulgarian economy going forward (figure 4). The composite business climate indicator increased by 2.8 points in April compared to the previous month, with growth in all monitored sectors - industry, construction, retail and services. The subindicator for the industrial sector increased by 0.7 percentage point due to the optimistic expectations of industrial entrepreneurs for the business situation of enterprises over the next six months, while also their export and production forecasts over the next three months were more favourable. The uncertain international economic environment and labour shortages remain the main problems for the business development, with the latest poll revealing an increase in the negative impact of the latter. Meanwhile, the unemployment rate in Bulgaria fell to 5.2% in March, the lowest level since December 2008 and below the EU average.

Regarding the Bulgarian long-term sovereign bond yield spread versus the German bond yield, we expect it to gradually increase towards 90 bps at the end of 2019. This gradual rise is consistent with our forecasts for the intra-EMU spreads given the currency board of the BGN against the EUR.

Figure 4 - Bulgarian corporate sentiment at peak levels thanks to favourable expectations

(business survey: business climate indicator)



Source: KBC Economic Research based on National Statistical Institute of Bulgaria (2018)

Detailed forecasts for the Bulgarian economy	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:
The euro zone economic business cycle : quo vadis?

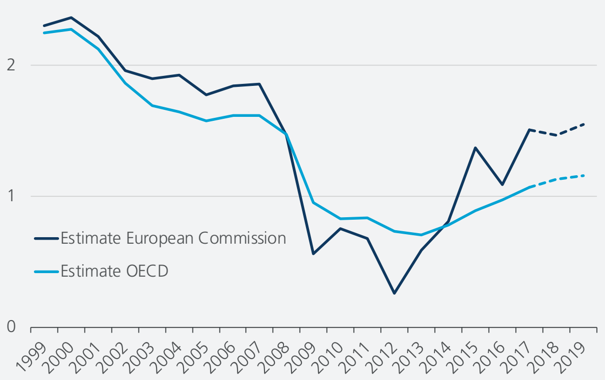
Last year was one of repeated upward revisions to growth projections for the euro area economy. In January 2017, real GDP growth was expected to be only 1.4% for the full year. Ultimately, growth turned out to be more than one percentage point higher. In doing so, the euro area clearly put the difficult recovery years after the financial crisis behind it. At the beginning of 2018, the outlook remained bright. In February, we raised our forecast for economic growth in the euro area in 2018 from 2.3% to 2.5%. This month, however, we are paring it back to 2.3%. Eurostat's preliminary estimate suggests eurozone GDP increased only 0.4% in the first quarter of 2018 compared to the last quarter of 2017. This is well below the 0.7% quarterly increase recorded in each of the three preceding quarters. This, together with the fall in many confidence indicators in the first months of 2018, suggests that the pace of economic growth in the euro area may have passed its peak. ECB President Mario Draghi recently also acknowledged that while growth is expected to remain solid the future pace might not match that seen through the past year. However, it is premature now to assume that we will see a spiral of downward growth revisions during 2018. Indeed, in addition to concerns about the strength of economic growth, there remain strong arguments for remaining confident that the business cycle will continue its expansionary phase for some time to come. However, it is worthwhile taking a closer look at the question of where the economy is heading. This also allows us to examine some important features of a typical economic cycle.

More difficult than it seems

The term 'economic cycle' is often used very loosely without specifying precisely what it means. In economic theory, the business cycle refers to a pronounced tendency for different sectors of an economy to experience broadly similar conditions to each other as the general economic environment moves from conditions of progressive strengthening followed by a progressive softening or downturn and eventually back towards another period of strength. If this shared experience is one of activity growing faster than the economy can sustain in the long term (the economy's potential growth rate), economists speak of an expansionary phase, an upswing or a boom. Such phases alternate periodically or cyclically with periods of economic weakness. In that case, there is an economic downturn or even a recession. In a growing economy, it is often quite difficult to establish with any great certainty the precise stage of the economic cycle an economy is at until well after that point (when the economy's current position may again be uncertain).

A key determinant of an economy's capacity to grow and, consequently, of its business cycle is its potential growth rate which, unfortunately, is not perceptible. It is a theoretical concept, which has to be estimated on the basis of assumptions and information which is often only available with a delay. In general, the stakes of all factors of production and productivity determine our potential growth. Moreover, potential growth itself is not a constant, but can change significantly as a result of demographic, social and technological developments. It can also be influenced by economic policies. The economic situation itself may also influence potential growth. For example, during a protracted recession, people may lose skills because they remain unemployed for longer. Machinery could also become obsolete as investment is delayed for longer and new technologies are being introduced more slowly. Such losses reduce the growth potential of an economy. Recessions that follow a financial crisis often take longer than usual and, accordingly, impose larger losses. These are precisely the conditions in which the Western economies - and the euro area in particular - have found themselves over the last decade. During the crisis years, estimates of potential growth, which was already on a downward trend before the crisis, were revised significantly further downward (Figure A). However, the recovery of the past year or so has meant these estimates are currently being revised upwards. The European Commission (EC) estimates the potential growth of the euro area economy at around 1.5%. The OECD is slightly more cautious (1.2%), the IMF uses a slightly higher figure than the EC.

Figure A - Potential economic growth in the euro area
(annual, in %)



Source: KBC Economic Research based on EC and OECD

The actual growth of the economy is, in principle, more measurable, although this also causes many difficulties in practice and, in any case, the information only becomes available in bits and pieces and a full (and unrevised) picture takes some considerable time to build. In short, estimating the current economic situation and, hence, where we might be in the business cycle is more difficult than it seems.

What is the current state of the economy?

Today, we have to base our assessment of the current state of the euro area economy on partial information. For example, for the first quarter of 2018, only a preliminary GDP estimate is available, without compositional data. The figure indicates a slowdown in growth from 0.7% (quarter-on-quarter) in the second, third and fourth quarters of 2017 to 0.4% in the first quarter of 2018. Figures for individual euro area Member States show a differentiated picture. A relatively sharp decline in the first quarter, compared to the last quarter of 2017, is noticeable in the two largest economies of France and Germany. But small open economies such as Belgium and the Netherlands are also clearly taking a step backwards.

This sharp slowdown is primarily due to the weakening of exports. This is reflected, for example, in the detailed GDP figures for France, the only large euro area country for which detailed growth components are available. It can also be deduced from the deterioration in industrial confidence in the first quarter. Traditionally, industry is highly oriented toward exporting its output. A deterioration in export prospects can therefore quickly causes a drop in business confidence. This is currently very evident in German industry, which is much more dependent on exports than industry in the other major euro area countries. Spanish and Italian industry has been less active on world markets, where business confidence has deteriorated less. We can therefore see that Italy and Spain can maintain their growth levels at the same level as at the end of 2017.

The worsening of export conditions may also be linked to increased international political tensions. In particular, the increased trade tensions between the US and China and the threat of an escalation into a real trade war involving the EU could play a role. However, the more difficult export conditions undoubtedly also reflect the strengthening of the euro against the currencies of the trading partners (see figure 1 in the main text). Compared to the average exchange rate vis-à-vis those currencies, in February-March 2018, the euro was more than 8% more expensive than a year earlier, a material change in pricing conditions in a world of low inflation and limited pricing power. The European Commission's business confidence indicators show that German and French entrepreneurs in particular have become more pessimistic about their competitiveness in markets outside the EU.

The weakening of exports is worrisome, as exports had become a more important driver of growth in the course of 2017. If this starts to sputter, the impact on the overall growth rate is likely to be significant. In the period 2014-2016, economic expansion relied heavily on private consumption. In particular, purchases of consumer durables were a major driver of the economic cycle at that time. As usual, these had frequently been postponed during the recession. After all, such purchases are often not absolutely necessary. "This car will drive for another year or so longer", or "that new kitchen can wait a little longer" would be sentiments expressed by many people when the threat of unemployment or weaker income appears. As a result, during a recession, demand for consumer durables in particular is particularly affected. When it subsequently re-appears, it supports the expansion phase. In 2014-2015, purchases of consumer durables grew strongly, particularly in the countries that were relatively hard hit by the euro crisis. It gradually weakened in 2016, but remained relatively robust overall. This also applied to total family consumption. This was supported at the time by a sensitive injection of purchasing power as a result of the sharp drop in oil prices in 2014 and 2015. However, especially in the second half of 2017, the contribution of private consumption to growth weakened and net exports became a more important driver of growth. Although we need to be careful on this point. The euro area growth figures are distorted by Irish data, related to activities of multinationals, that artificially boost the role of exports and diminish that of domestic demand.

In addition to deferring and catching up cycles of demand for consumer durables, investment is an important driver of the business cycle. A breakdown in confidence or a sharp rise in costs, for example due to high interest rates, wage slippages or significantly higher import prices, may encourage managers to reduce their investment plans. Traditionally, investment has made only a limited contribution to growth in the euro area. However, this component can fluctuate widely, with a major impact on GDP growth. The same applies to housing. It occupies a special place in the current economic cycle, because a real estate crisis in countries such as Spain, the Netherlands and Ireland was partly at the root of the long, double-dip recession in the eurozone. Between 2007 and 2013, for example, the Spanish housing sector more than halved.

The construction downturn in several euro area countries is one of the reasons why total investment in the euro area only started to make a positive contribution to growth (on an annual basis) in 2014. However, the recovery of corporate investment also got off to a difficult start, partly because of high indebtedness of companies in several euro area countries and the uncertainty of demand prospects that persisted for a long time. It was not until 2015-2016 that the investment dynamics strengthened. It is striking that investments were mainly made in transport equipment and ICT equipment, while the recovery of other investments remained much slower. Moreover, the growth rate of total investment in 2017 has already slowed down somewhat. However, this was only the result of lower investment in intellectual property products. Again, this figure could be distorted by the activities of a small number of multinationals operating in Ireland. Growth in construction investment accelerated, in particular in non-residential construction. This may indicate that investment in expansion is gradually gaining in importance. It would be an encouraging sign. In any case, on balance, investment continued to make a significant contribution to economic expansion in 2017.

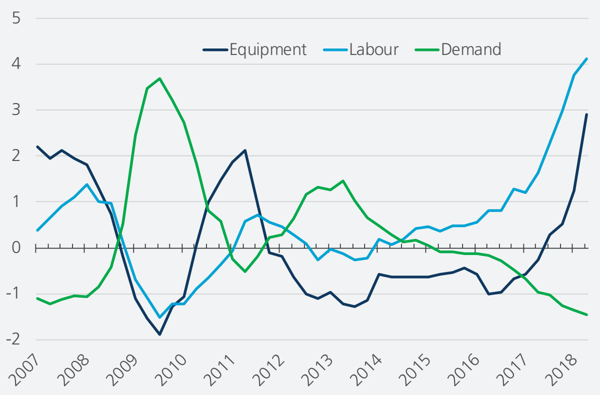
Quo vadis?

The extension of the investment cycle is crucial for further economic growth. Investment spending modernises and maximises the production apparatus. This enables productivity gains. Higher investment also tends to create new jobs. This will bring new purchasing power to the economy, which will continue to support demand growth. In this way, an investment cycle can create an upward, self-reinforcing, growth dynamic. To a certain extent, such dynamism appeared to be taking hold in the euro area during 2017.

However, in order to invest, trust is needed. The recent and in some instances sharp fall in most confidence indicators may therefore call into question the further strengthening of the investment cycle. For the time being, concerns in this regard should probably not be exaggerated. Firstly, it should be noted that the recent softening often followed very sharp and probably unsustainable rates of increase in the previous period. Despite the decline, many confidence indicators are still at (very) high levels, reflecting continued economic expansion. As mentioned above, confidence has fallen mainly in industry. The EC sectoral sentiment indicators show that confidence also eroded in the retail sector. This is probably due to the fact that the consumer impulse has been eroded because of the weakening of the catch-up demand for consumer durables. However, for services sectors in general, the EC indicator shows at most a very slight decrease, while in the construction sector it shows a stabilisation at a very high level. Consumer confidence is also peaking at a high level. A second important observation, therefore, is that there is currently no synchronous downward movement across all sectors of the economy. Furthermore, the overall assessment of orders and order books remains very positive. At the same time, the surveys suggest rather low stocks, despite an increase in recent months. In both industry and construction, production guaranteed on the basis of current orders is at historically high levels. Finally, economic growth can continue to be supported by the national fiscal policies and the ECB monetary policy. Fiscal policy in most euro area countries remains neutral to mildly expansionary in 2018 and 2019. The ECB's monetary policy will continue to be supportive for some time to come. The normalization of this policy, which we expect to see after September 2018, only means a gradual reduction in the level of stimulation. A tightening of the ECB's policy, which would slow down economic growth, is far from being forthcoming.

On the basis of the above elements, a further decline in the pace of economic growth seems unlikely in the short term. This does not prevent large (confidence) shocks, for example as a result of (geopolitical) events, from possibly turning around a favourable environment relatively quickly. The international economic environment remains favourable today, but also shows signs that a peak in the pace of growth has been reached (see main text). A more drastic cooling of the international economic

Figure B - Factors limiting industrial production
(standard deviation from long-term average)



Source: KBC Economic Research based on EC

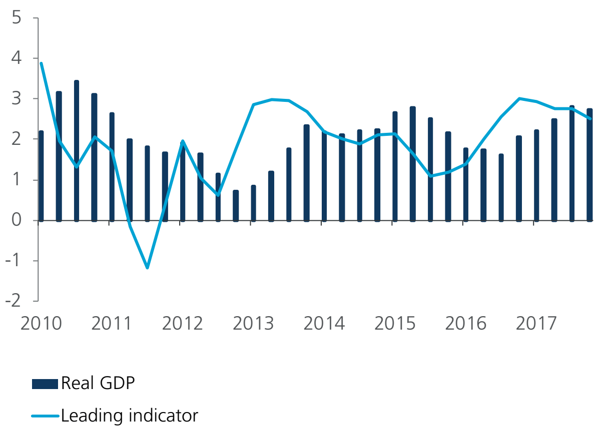
climate would, of course, also put the economy of the euro area in a more difficult position. In particular, a slowdown in the US economy, which is currently experiencing one of the longest economic upturns ever, could have a strong negative impact on the relatively open European economy.

A return to the exceptional growth momentum of 2017 may also be unlikely. Another slightly higher growth rate in the second quarter is possible to the extent that the figure of the first quarter has been negatively affected by exceptionally negative factors, such as severe weather conditions and an exceptionally large flu epidemic. However, the 2017 growth figures were probably unsustainably far above the potential growth rate the euro area can sustain. This can be deduced, among other things, from the fact that more and more entrepreneurs are starting to worry about rapidly increasing capacity shortages (figure B). In the EC sentiment indicators, these were the strongest signals, in addition to the loss of competitiveness in world export markets. A return to a growth rate closer to potential growth is therefore likely.

Yet, signals about capacity shortages are ambiguous. They may be the prelude to an imminent halt to growth and higher inflation. But they may also encourage more investment to increase capacity. This would not only maintain the actual pace of growth, but also serves to boost potential growth. Scarcity in the labour market is mainly due to shortages of employees with the right skills and qualifications. This is where the challenges for active labour market policies lie. In addition to confidence, government policy can also determine the direction of the economic cycle. Anyway, the very moderate inflation and only limited wage pressure in the eurozone (see focus article in the "KBC Economic Perspectives" of April 2018) suggest that the threat posed by the first track of an abrupt stop to growth and a surge in inflation is less likely for the time being.

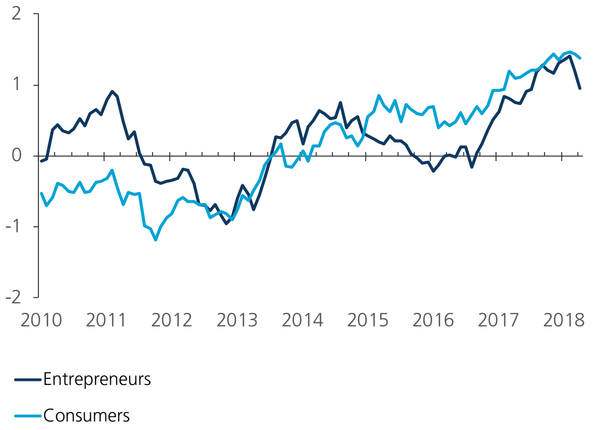
Overall, we have only modestly lowered our growth forecast for the euro area, to 2.3% in 2018 and 2.0% in 2019. Both figures are still well above potential growth. This means that the economy of the euro area will remain in a strong expansion phase.

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



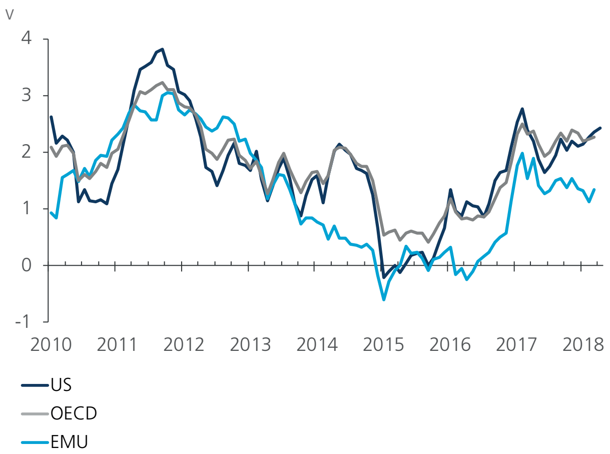
Source: OECD

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



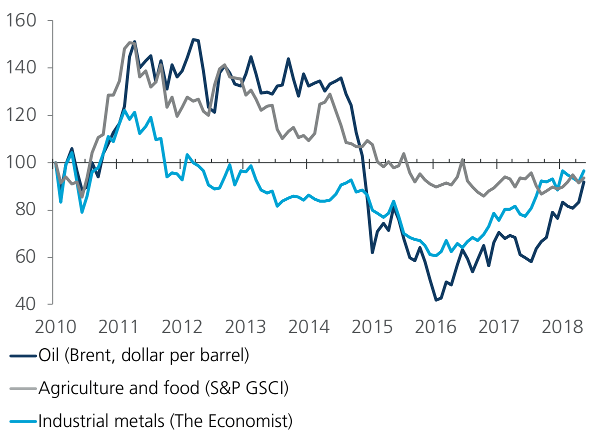
Source: National sources

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

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Outlook world economies

	Real GDP growth		Inflation	
	2018	2019	2018	2019
US	2.6	2.3	2.4	2.4
Euro area	2.3	2.0	1.5	1.6
Belgium	1.6	1.5	1.6	1.4
Germany	2.3	1.9	1.6	1.8
Ireland	6.0	4.0	0.9	1.6
UK	1.5	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	2.3	2.2
Poland	4.5	3.9	1.8	2.4
Czech Republic	3.2	2.7	1.6	2.0
Hungary	3.9	3.4	2.4	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	10.3	9.1
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	15/05/18	+3m	+6m	+12m
US	3.02	3.00	3.00	3.20
Germany	0.63	0.80	0.90	1.30
Belgium	0.88	1.05	1.15	1.65
Ireland	1.01	1.20	1.35	1.80
UK	1.48	1.75	1.90	2.45
Sweden	0.77	0.95	1.05	1.45
Norway	1.91	2.10	2.20	2.60
Switzerland	0.10	0.30	0.40	0.80
Slovakia	0.82	1.10	1.20	1.65
Poland	3.29	3.30	3.40	3.60
Czech Republic	1.89	2.00	2.00	2.15
Hungary	2.94	2.80	2.80	3.30
Bulgaria	1.25	1.64	1.73	2.20
Russia	7.32	7.50	7.50	7.50
Turkey	13.94	12.50	12.50	12.50
Japan	0.06	0.00	0.00	0.00
China	3.72	3.75	3.70	3.50
Australia	2.83	2.80	2.80	3.00
New Zealand	2.76	2.75	2.75	2.95
Canada	2.43	2.40	2.40	2.60

Policy rates	15/05/18	+3m	+6m	+12m
US	1.75	2.00	2.25	2.50
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	0.75	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	0.75	1.25
Hungary	0.90	0.90	0.90	0.90
Romania	2.50	2.75	2.75	3.00
Russia	7.25	7.00	6.70	6.55
Turkey	8.00	8.00	8.00	8.00
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	1.25	1.50	1.75

*Mid target range

Exchange rates	15/05/18	+3m	+6m	+12m
USD per EUR	1.19	1.18	1.22	1.28
GBP per EUR	0.88	0.88	0.89	0.90
SEK per EUR	10.32	10.00	9.75	9.50
NOK per EUR	9.57	9.50	9.35	9.25
CHF per EUR	1.19	1.19	1.20	1.22
PLN per EUR	4.28	4.30	4.28	4.20
CZK per EUR	25.53	25.80	25.30	24.80
HUF per EUR	316.71	312.00	312.00	313.00
BGN per EUR	1.96	1.96	1.96	1.96
RUB per EUR	73.81	71.63	73.20	75.52
TRY per EUR	5.24	5.19	5.37	5.63
JPY per EUR	131.03	129.80	134.20	140.80
RMB per USD	6.36	6.38	6.39	6.42
USD per AUD	0.75	0.75	0.76	0.78
USD per NZD	0.69	0.69	0.71	0.72
CAD per USD	1.28	1.28	1.26	1.25

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Contacts

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

For general information:

Anna Van Kelst (Management Assistant Jan Van Hove) anna.vankelst@kbc.be

Visit our website www.kbceconomics.be to find more analyses and projections of the KBC economists.

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