UBB
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Economic perspectives

March 2019

Highlights

- The general downward trend in corporate sentiment that has been around for several months still remains. Businesses remain pessimistic, particularly in the manufacturing sector, which suggests that a significant rebound is not yet in sight. However, a closer look at the details suggests that some specific countries, such as France, are showing cautious signs of bottoming out in the first months of 2019. Corporate sentiment in the services sector has also shown a partial recovery of late.

- While the picture is constantly changing, it remains the case that, unless there is a decisive intervention in the coming week, the UK will exit the EU on March 29th 2019 as set out in the terms of its EU Treaty Article 50 declaration. As the current debate in the British Parliament is mainly concentrated on the Irish border rather than on a wide range of issues, we believe a deal is still possible with further 'clarifications' or re-structuring of commitments around the Irish border. For this reason, a 'softish but not smooth' Brexit remains KBC's base scenario.

- Given the ECB's downwardly adjusted forecasts for inflation and growth and the new forward guidance, we altered our projected monetary policy path. In our updated scenario, we expect the ECB to postpone its first rate hike until Q2 2020. Moreover, the ECB announced further long term funding arrangements (TLTRO-III) for euro area banks providing two year funding. These would be launched at a quarterly frequency running from September 2019 until March 2021.

- Fewer expected rate hikes from the Fed together with the dovish stance of the ECB will give emerging markets some respite and ease pressures on emerging market currencies in general. There are, however, some risks on the horizon. A sharper than expected global growth slowdown, a deterioration of the ongoing trade war negotiations and some country-specific vulnerabilities will still contribute to volatility. South Africa may be one such emerging market where mounting risks and vulnerabilities keep it on an especially rocky path going forward.

Global economy

End of sentiment deterioration in sight?

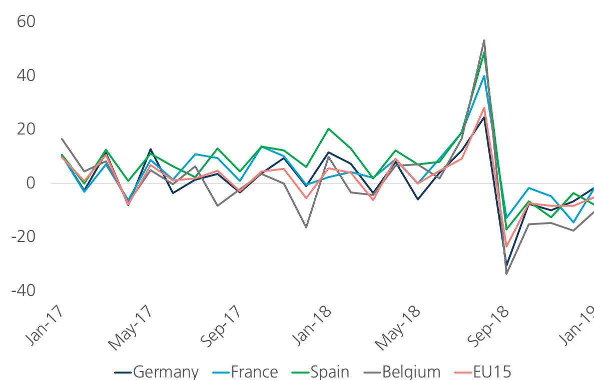
The general downward trend in corporate sentiment that has been around for several months now still remains. Businesses remain pessimistic, particularly in the manufacturing sector, which suggests that a significant rebound is not yet in sight. Factors such as the ongoing uncertainties around the Brexit negotiations, trade war jitters and a continued slowdown in Chinese growth are still weighing on manufacturing firms that are heavily dependent on the international trade environment. These negative effects are the most visible in economies with a high trade openness, such as the euro area and Japan. In February, the Markit manufacturing PMI of both countries dropped below the 50-level which theoretically separates expansion from contraction. This has also been reflected in disappointing data for exports and industrial production.

However, a closer look at the details suggests that some specific countries are showing cautious signs of bottoming out in the first months of 2019. In France, manufacturing sentiment measured by the PMI rose in February for the second month in a row. Social unrest had a clear negative impact on sentiment towards end 2018, but these effects were temporary. Also, the more domestically-oriented services sector reported an improvement in sentiment in most developed markets. This signals that underlying growth determinants such as supportive labour market conditions are still in good shape. Investment growth remains positive despite the worse sentiment. While it is not entirely clear that there is a trend reversal in global sentiment indicators, the recovery in the services sector and the uptick in some specific countries might indicate that the downward trend is coming to an end. This is in line with our expectation of a better second half of 2019, in particular in the euro area where the growth momentum slowed down markedly in the second half of 2018.

Less buoyant growth projections

The continuous sentiment deterioration since early 2018 that has been linked to global uncertainties, inevitably translated into weaker activity data and slower growth figures. Indeed, compared to our previous growth projections for 2018-2019, there have been several downgrades in the past months. The significant downward revision of real GDP growth in the euro area for 2019 we implemented in February was in line

Figure 1 – Passenger car registrations showing cautious recovery (new passenger car registrations, % change year-on-year)



Source: KBC Economics based on ACEA (2019)

with forecast adjustments by other large institutions such as the European Commission, the OECD and most recently the ECB. The main disappointments came from Italy and Germany. An important distinction though is that the growth issues in Germany are likely of a more temporary nature, while more structural weaknesses might cause Italian figures to remain sluggish. Troubles in the car manufacturing sector, which was one of the main factors causing weak German growth in H2 2018, seem to be fading out. Figures for new passenger car registrations have been showing a cautious recovery in recent months (figure 1). Indicators for German manufacturing were mixed in January, with still declining new orders, but turnover is increasing again.

To reach our 1.1% real GDP growth forecast for the euro area in 2019 - which matches that of the new ECB projection and is 0.1 percentage point higher than the OECD number - a rebound in the second half of the year is required. We think this is not unlikely. The euro area labour market is still doing well and wage developments are expected to remain supportive of gains in real disposable income and private consumption. Business investment should show healthy growth figures as capacity constraints are building in the later stages of the business cycle. We also assume that some of the risks and temporary factors that are currently weighing on growth will gradually fade out throughout the year, leading to a rebound of activity in Germany later this year. Hence, although our annual GDP growth forecasts for the euro area might seem rather pessimistic for 2019, the underlying quarterly dynamics are actually above potential growth in Q3 and Q4 of 2019. Moving into 2020, the quarterly growth dynamics will moderate again. However, given the growth pick-up we expect in the course of 2019, this will nevertheless numerically translate into a higher

annual growth rate in 2020 than in 2019. Consequently, we confirm our forecasts of 1.1% annual real GDP growth in 2019 and 1.4% in 2020. It should be noted that this is an aggregate figure for the euro area. Significant growth differences across EMU countries will likely persist.

We have become less optimistic about the outlook of the US economy as well, particularly for 2020. We expect growth to slow down despite the impressive growth performance in 2018. Recently published official figures confirm our forecast of 2.9% for the US economy last year. As an illustration of waning optimism, our 2020 forecast US GDP growth was 2.0% a year ago, compared to 1.6% currently. Policy decisions, such as the increases in trade tariffs implemented by the Trump Administration, combined with other global headwinds, such as the Chinese growth slowdown and the persistent uncertainties around the Brexit negotiations, have weighed on the prospects for US growth.

Moreover, some internal issues will drag on US growth as well. The positive effects of the fiscal stimulus measures will gradually fade out. Given the current political differences between Democrats and Republicans, broad-based political support for a new fiscal stimulus package ahead of the 2020 presidential elections is highly unlikely. Additionally, there is the possibility of a so-called 'fiscal cliff' if discretionary spending caps for fiscal year 2020 are not raised. The 2018 Bipartisan Budget Act significantly increased fiscal year 2018 and 2019 discretionary spending caps established in the 2011 Budget Control Act (BCA). This sets up a funding cliff with discretionary spending levels set to drop sharply in the remaining two years - 2020 and 2021 - of the BCA's discretionary caps. Hence, we think that the growth acceleration in Q1 and Q2 2020 is unlikely, and we remove it from our scenario. Assuming stable quarterly growth dynamics in the first half of 2020 puts our annual US real GDP growth forecast for 2020 at 1.6% compared to 1.8% in February.

Brexit uncertainty continues

While the picture is constantly changing, it remains the case that, unless there is a decisive intervention in the coming week, the UK will exit the EU on March 29th 2019 as set out in the terms of its EU Treaty Article 50 declaration. A week of political chaos in the UK in mid-March saw the government unable to obtain support in the British Parliament for the proposed withdrawal agreement and an accompanying clarification. That clarification was intended to ease concerns in the UK that the wording of the withdrawal agreement could mean that the UK could be permanently trapped in the EU. However, this proposal was rejected by the UK parliament on March 12 by an unusually large margin, 391 no-votes against 242 yes-votes. Subsequent parliamentary votes ruling out a 'no deal' Brexit and calling for an extension to the March 29th exit date emphasise concerns among British politicians but have no legal force to deliver their preferred outcomes.

With just under two weeks to go before the scheduled exit date, the margin of the Government defeat on its agreement proposals might suggest that a 'crash out' Brexit is likely. For this to be avoided, a level of political realism and compromise not evident in the UK to this point will need to emerge. That said, as the debate is mainly concentrated on the Irish border rather than on a wide range of issues, we believe a deal is still possible with further 'clarifications' or re-structuring of commitments around the Irish border. For this reason, a 'softish but not smooth' Brexit remains KBC's base scenario. It should also be noted that financial markets are strongly of the view and perhaps even overly complacent that some solution will be found to ensure the UK does not crash out of the EU on March 29th.

While a range of indicators suggest the UK economy is seeing some negative impact from Brexit related uncertainty in areas such as consumer sentiment, home prices and business investment (figure 2), growth overall has remained modestly positive if slower of late. The initial estimate of monthly GDP growth did fall unexpectedly in December but rebounded in January. The outlook for the coming year is very unclear because of continuing uncertainty about the timing and manner of the UK's proposed departure from the EU. However, if a withdrawal agreement is reached, GDP growth for 2019 should be close to 1.5%. If no deal is struck, GDP growth is likely to be negative. Market expectations could change quickly

Figure 2 – Some negative impact from Brexit on UK indicators

Source: KBC Economics based on Rightmove, GfK, ONS (2019)

and repeatedly because of notable difficulties in arriving at a workable compromise. This means that the next month could see Brexit concerns causing further volatility but this bumpy path is broadly consistent with our long held expectation of a 'softish but not smooth' Brexit process.

ECB on hold for now

As a notable confirmation of market expectations that ECB policy rates will remain 'lower for longer', the ECB signalled a significant change in its policy outlook at its March meeting. The ECB pushed back the earliest possible timing of it first rate hike beyond the end of 2019. The key aspect of this wording is that it only identifies the earliest possible date for a rate increase. So, there remains quite a bit of uncertainty about when the first rate hike by the ECB will exactly take place. Moreover, the ECB announced further long-term funding arrangements (TLTRO-III) for euro area banks to replace those maturing through the next year. The new series of Targeted Long-Term Refinancing Operations (TLTROs) providing two year funding would be launched at a quarterly frequency running from September 2019 until March 2021.

In our updated scenario, we expect the ECB to postpone its first rate hike until Q2 2020. Our reasons for this delay are the ECB forward guidance itself and the low core inflation rate which is well below the ECB's own policy target. Indeed, the latest ECB Staff projections suggest that the Governing Council have become a good deal less convinced of a clear upward path in the trajectory of inflation. With projected inflation reaching only 1.6% in 2021 (we expected 1.5%) - decidedly below the ECB's target of an inflation rate 'below, but close to, 2% over the medium term' - the new forecasts support the ECB's decision to postpone the timing of a first possible rate hike into 2020.

Nevertheless, we expect that the postponement of a possible rate hike will not lead to a permanent cancellation in this economic cycle. From a growth and inflation perspective, there may not be a compelling reason to raise policy rates any time soon. However, we expect the ECB will move its policy rates away from their current levels that are close to their effective lower bounds. We see a number of reasons for the ECB to do so. First, by introducing the new series of TLTROs, the ECB acknowledges that the euro area financial sector is still fragile and in need of stable longer term liquidity provision by the central bank. This is particularly the case in Southern European economies. Against this background, the ECB will likely want to get rid of the distorting impact of negative money market rates on European banks as soon as feasible. Second, the ECB is in practice will likely be unable to lower its policy rates further from current levels in case the euro area economy drifts into a new recession. Related to this are financial stability concerns that would argue against encouraging perceptions that current rate settings are semi-permanent which might lead to an unhealthy dependence on such an environment.

We therefore expect that the ECB will want to sustain expectations of a normalisation path even if this now appears to be more gradual than previously envisaged. It should also be emphasised that uncertainty in terms of the timing and magnitude of ECB policy normalisation will remain an important feature of the interest rate climate for some time to come in part because of uncertainty about the broader economic backdrop in terms of activity and inflation. Indeed such a partial policy normalisation would have been easier to sustain in the more favourable growth environment up to early 2018.

Specifically we now expect the ECB to raise its deposit rate the first time by mid-2020 and to finish 2020 just out of negative territory at 0%. For 2021, we expect three more rate hikes, bringing the deposit rate to 0.75%. The refinancing rate is expected to be 25 basis points higher, i.e. at 0.25% and 1.00% at the end of 2020 and 2021 respectively. As already mentioned, the risk to this timing and number of rate hikes is significant. Wanting to partially normalise its policy rate is one thing, being able to do so in the upcoming state of the business cycle is another.

The expected combination of 'lower for longer' short-term interest rates and the continued presence of abundant excess liquidity in the euro area implies that long-term bond yields will be lower than previously expected. After the ECB announcement, the German 10 year government bond yield even dropped to marginally above 0%.

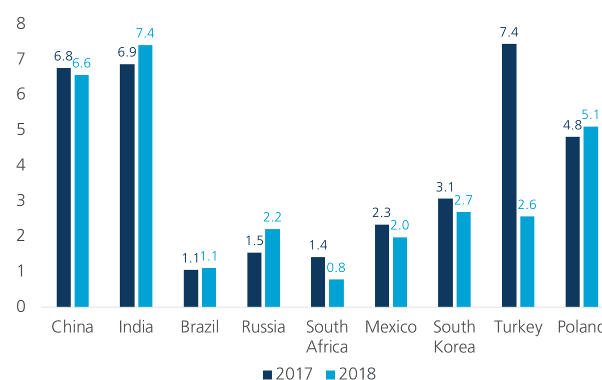
At the same time, these extreme low levels also indicate the reasons why we nevertheless expect bond yields, and intra-EMU sovereign spreads, to moderately rise again beyond the next few quarters. We expect the German 10 year bond yield to rise more moderately, reaching 0.60% (versus 0.70% in February) and 1% (versus 1.10% in February) at the end of 2019 and 2020 respectively.

At current levels, the German benchmark bond yield includes a highly negative term premium, which is not the case to the same extent for US or Japanese yields. This artificially depressed term premium is the direct effect of the ECB's monetary policy and not likely to be sustainable. This highlights a major difference between the euro area and Japan. Despite similar long term bond yields in Japan and Germany at this moment, European inflation expectations are higher than those of Japan.

We think that it will be the European nominal bond yields that shift sooner or later and bring the current strongly negative real yields closer to zero, where they broadly are already in the Japan at this stage.

In the short term, the expected upward move of bond yields may be triggered by a somewhat normalised risk aversion from its current magnitude that almost pushed German yields below 0%. Furthermore, in the second half of 2019, we expect further ECB forward guidance about its expected policy rate path. To the extent that our expectations of a first hike in mid-2020 turns out to be correct and reflected in the ECB's communication, bond markets will start to price that into moderately higher yields as well. This also applies to intra-EMU sovereign spreads. As was the case for ECB policy, substantial risks are attached to our bond yield scenario as well.

Figure 3 - Annual GDP growth rates in emerging markets (real GDP, annual % change)



Source: KBC Economics based on national authorities (2019)

Our adjusted outlook for short-term and long-term interest rates, in particular for the US-euro area differentials, also implies a weaker expected path for the EUR versus the USD. This is the case even against the background of the recent Fed thinking in terms of a lower number of remaining rate hikes in this cycle and its intention to end the balance sheet rundown by the end of this year. Compared to last month our expectations for Fed policy remain unchanged although we acknowledge that we are slightly more hawkish than current market expectations.

KBC Economics' unchanged expectations for Fed policy and a more dovish ECB suggest that the EUR may slightly depreciate further to 1.11 USD per EUR. Later and more moderately than we previously expected, the EUR will start to appreciate again versus the USD. This will happen from mid-2019 on. More specifically, we see it rising towards 1.15 USD per EUR by end 2019 and 1.25 USD per EUR by end 2020. The main reasons for a stronger EUR are the bottoming out of the interest rate disadvantage for the EUR versus the USD, and the expected growth rebound in the second half of this year in the euro area (which we do not expect for the US). Moreover, the expected appreciation of the EUR should also be viewed as a partial reversal of its current cheap valuation. The EUR's current level of 1.12 USD per EUR is much weaker than our estimate of a fundamental fair value of about 1.33 USD per EUR. Our scenario still leaves the EUR well below that level by the end of 2020.

Emerging markets: some respite amidst risks

Despite several internal and external headwinds, economic growth in emerging markets generally held up reasonably well through 2018 (figure 3). Nevertheless, the official lowering of growth expectations by the Chinese government is a clear signal of a general cooling down in the emerging markets. After an annual GDP growth rate of 6.6% in 2018, the Chinese government now expect growth to be between 6% and 6.5% in 2019, below its previous official target. This is a clear acknowledgement of a faster downward growth trend. However, to avoid a hard landing, Chinese authorities are still implementing more growth stimulus measures.

Too much pessimism is inappropriate. The global growth slowdown with in particular the Chinese growth deceleration, the still-unresolved trade war, and general emerging market financial turbulence midway through last year didn't derail emerging markets' growth. Furthermore, easier financial conditions due to a shift in expectations for monetary policy normalization in advanced economies is growth supportive. Less expected tightening from the Fed together with the dovish stance of the ECB will ease pressure on emerging market currencies in general.

There are, however, also some signs of weakness on the horizon. Risk aversion among investors remains high and there are indeed several risks that could still present significant headwinds to growth in emerging markets going forward. Such risks include a sharper than expected global growth slowdown or a deterioration of the ongoing trade negotiations. Outstanding country-specific vulnerabilities, such as high indebtness, and certain idiosyncratic developments will still contribute to volatility (also see Box 1 - South Africa's potentially rocky outlook). Despite these potential risks, we nevertheless hold on to our view of no general systemic emerging market crisis over the forecast horizon.

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Box 1 - South Africa's potentially rocky outlook

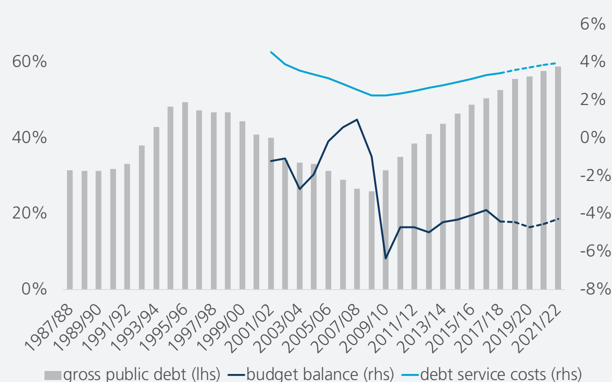
South Africa may be one emerging market where mounting risks and vulnerabilities keep it on an especially rocky path going forward. South Africa is no stranger to weathering macroeconomic ups and downs, and the economy has long been plagued by a 'twin deficit' problem - i.e. sizable deficits on both its current account (3.5% of GDP) and fiscal account (4.4% of GDP). These deficits make South Africa vulnerable to negative shocks, whether external or internal, that can dry-up financing. This is particularly true regarding South Africa's capital account given that a substantial portion of it is financed by portfolio flows, which tend to be more volatile.

Focus more recently has been on South Africa's fiscal outlook. In late February the government released its 2019 budget review. The budget received notable attention due to two factors. The first is a financing crisis unfolding at Eskom, a state-owned electricity company that generates 95% of South Africa's electricity. The government has stepped in to not only restructure Eskom, but also to provide monetary support over the next three years amounting to roughly 0.5% of South Africa's GDP per year (ZAR 23 billion annually for a total of ZAR 69 billion). The second important factor is that South Africa's government debt is teetering on the edge of being downgraded to 'junk status' by Moody's, the last major rating agency that gives South Africa's long-term foreign currency debt investment-grade status (currently Baa3). With a review coming up at the end of March, the 2019 budget was a crucial opportunity to signal to the ratings agency that South Africa's fiscal situation is under control, and that government debt will stabilise.

While the authorities have not agreed to absorb Eskom's debt, the fiscal support for the struggling company on top of weak tax revenue growth will weigh on South Africa's fiscal consolidation efforts going forward. Indeed, the main budget deficit relative to GDP in fiscal year (FY) 2018/2019 was 0.6 percentage points wider than anticipated in the 2018 budget (4.4% vs 3.8% budgeted), due mostly to tax revenue shortfalls (Figure Box 1). Furthermore, the main budget deficit target for FY 2019/2020 has been revised up to 4.7% of GDP (from 3.8% of GDP anticipated in the 2018 budget). The authorities in South Africa have pencilled in a narrowing deficit going forward, which they project will help stabilise public debt at 60.2% of GDP in 2023/2024. Moody's however, may not be so easily convinced. The rating agency responded to the 2019 budget by noting it reveals a "further erosion in fiscal strength," and that the government has "limited fiscal flexibility amid a challenging economic environment."

A downgrade to below investment grade status would likely be significantly disruptive to South Africa's economy, triggering capital outflows and downward pressure on the currency. Such a downgrade would also raise the interest rate on South Africa's debt, making it even more difficult for the government to bring down its fiscal deficit. The South African rand has depreciated more than 5% over the past month, reflecting investors' concerns over such an outcome. However, while the implied 1-month volatility of the South African rand has surpassed that of the Turkish lira—a currency that has been hammered by financial markets the past year—the implied volatility remains much lower than levels reached only 6 months ago. At the moment, it therefore remains a wait-and-see game for South Africa. In the short-term, the wait is on Moody's rating decision. In the long term, the wait is on assessing whether the government can in fact follow through with its promises to bring down the fiscal deficit.

Figure B1 - South Africa's fiscal accounts (in % of GDP)



Source: KBC Economic Research based on South African National Treasury, 2019 Budget

Central and Eastern European Economies

GDP growth figures for Q4 2018 are now available for most Central and Eastern European (CEE) countries. Generally speaking, these figures indicate a continued strong growth performance throughout the region. This performance is even more remarkable given the general economic slowdown in the euro area, and in particular in Germany. Hence, it is clear that there are mitigating factors at play keeping the growth level up in Central and Eastern Europe. Strong domestic economic performances, supported by EU funding and accommodating fiscal policies, play an important role. Despite the overall solid growth performance, there are differences across countries though (figure CEE1). For example, while growth accelerated in the Czech Republic between Q3 and Q4, there is a clear downward trend in Slovakia and there was a disappointing Q4 in Poland. The short-term developments are markedly different from the long-term trends, however, as Poland and Slovakia have experienced the most impressive growth paths in the past decade (figure CEE2). More generally, growth developments in the CEE region in recent years have been substantially stronger than the euro area trend.

Resilience despite German slowdown

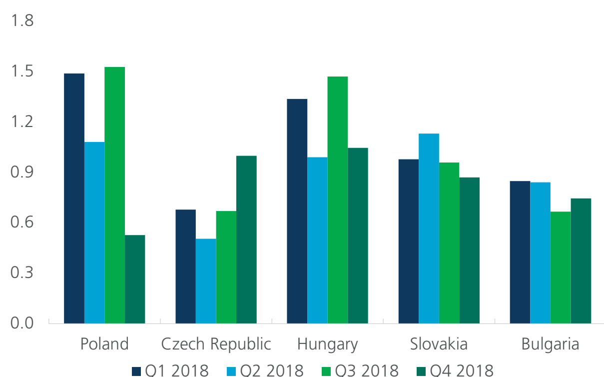
The latest GDP growth figures across Central Europe clearly point to resilience against the slowdown in the German economy - by far the most important export destination for all of the Central and Eastern European economies. The German economy slowed significantly in the second half of 2018, declining by 0.2% qoq in Q3 and stagnating in Q4. Hence, it only narrowly escaped a technical recession, which is defined as two consecutive quarters of negative growth. The significant slowdown was the result of both temporary factors (such as new emission regulations in the automotive industry) and more permanent factors (such as slower Chinese demand growth). At first glance, it might seem surprising that growth is holding up in Central and Eastern Europe. For now, the region appears to be resilient to the evolutions in the German business cycle.

What is behind this resilience towards the German slowdown? First, it may be the nature of the slowdown, which is widely believed to be driven by temporary factors. It therefore should not have a significant negative impact on investment activity in the region. Second, some of the more permanent negative factors, such as weaker growth in China, are less damaging to the Central and Eastern European economies since the regional exposure towards China is significantly lower compared to Germany. Finally, the fiscal stance of the Central and Eastern European economies is in many cases much more relaxed than in Germany, where the budget surplus has been growing (as a share of GDP) since 2014. The argument holds especially for Poland and Hungary that have significant cyclically adjusted deficits. Looking ahead, the disparity may become even larger now that Poland has announced a new fiscal stimulus package amounting to 2% of the country's GDP.

Looking forward

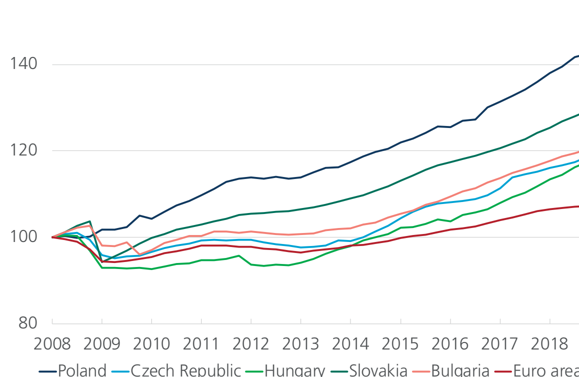
Despite the region's current resilience to the German economic slowdown, we expect slower German growth to have a moderately negative influence on the Central and Eastern

Figure CEE1 – Real GDP (% change quarter-on-quarter)



Source: KBC Economics based on Eurostat

Figure CEE2 – Real GDP (index, Q1 2008 = 100)



Source: KBC Economics based on Eurostat

European region in the first half of 2019. This is also signaled by the recent worsening of the Czech and Polish business confidence indicators (PMIs). Several other leading indicators, including new orders (based on European Commission´s surveys), appear to be resistant to the German slowdown so far. In addition, our own economic models, based on a variety of soft indicators, do not point to a major slowdown. However, if the German slowdown persists longer than expected, its impact on the CEE region could become more significant.

Consequently, our growth forecasts indicate a mild slowdown throughout the region. The expected growth slowdown in some countries is larger due to country-specific factors. Hungarian growth, for example, is expected to slow significantly. This is because the current growth rate is strongly supported by EU funding which will gradually fade out in the years ahead. Romanian and Bulgarian growth is expected to be under pressure too, given the weak economic outlook in some of their important trading partners, such as Turkey, Greece and Italy.

Tight labour markets

The encouraging growth environment in Central and Eastern Europe is supportive of regional labour markets. Throughout the region, unemployment rates continue their declining trend. Tight labour markets, in turn, cause wage acceleration. Nominal labour costs (compensation including taxes and excluding subsidies) increased on an annual basis by 9% in Hungary, 7.7% in the Czech Republic and by 6.9% in Slovakia (figures for Q3 2018). Throughout the region we notice attempts to increase participation rates, support the labour market by allowing migrant workers, and to implement further labour market reforms. In addition, the private sectors in various countries are aiming to reduce their dependence on labour through new investments. It is, however, unlikely that these initiatives will be sufficient to overcome capacity constraints. Tight labour markets may jeopardize further economic growth in the longer run. Some growth slowdown may, however, lead to some bottoming out in the unemployment rate, although no signs of this are visible yet.

Czech Republic

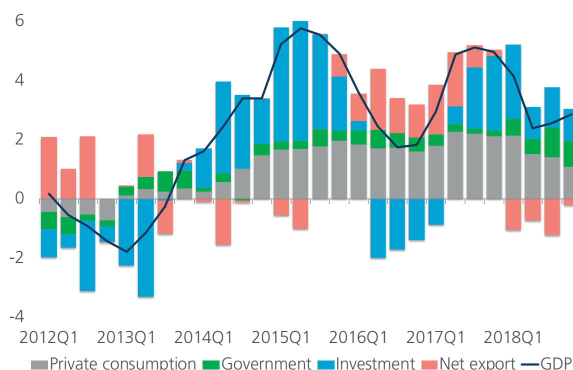
Weaker growth ahead

The most recent growth figures for 2018 confirm the Czech economy is in solid shape. However, there is a growing contrast between those figures and new (soft) data released since the beginning of this year. For instance, the purchasing managers index for industry dropped to a six-year low in February. Meanwhile, according to the first official estimate, GDP grew by 0.9% qoq in the last quarter, translating into a 2.8% yoy growth rate (or 3.0% annual growth over the full year). On the demand side, growth was supported by investment and government consumption, as well as by a smaller drag from net exports (figure CZ1).

The investment boom was by no means surprising given the shortage of labour that domestic companies have been confronted with for more than two years. Higher investment activity, particularly when it comes to machinery and ICT, is a natural response, aiming to deal with labour shortages by means of new technologies. Public sector activity was also higher in an attempt to make up for the deficit in investments the past few years. Household consumption was surprisingly poor over Q4, rising by only 2.2% yoy despite solid wage and employment growth. On the supply side, economic growth was driven mainly by the manufacturing industry, namely car manufacturing and the production of electrical equipment. Trade activities and the construction sector also performed well.

Despite the strong Q4 results, we expect the Czech economy to slow in 2019 and beyond. Due to the deteriorating outlook for the European, and particularly German, economy, we expect a further economic growth deceleration and a decline in the external trade surplus. The evolution in European demand, the automotive market cycle, and tensions in the domestic labour market remain the main risks.

Figure CZ1 – Contributions to variation in GDP by expenditure approach (change year-on-year, in % points)



Source: KBC Economics based on CSU (2019)

Inflation moving above target

Despite deteriorating business sentiment, the domestic labour market situation has not changed, in line with general regional developments. Employment rose in the last quarter of 2018, while unemployment remained at a historical (and European-wide) low. Consequently, wages grew at a brisk pace. This was lower than expected by the Czech National Bank (CNB), but it was a consequence of base effects from the previous year. While wage growth lagged behind the CNB forecast, inflation at the beginning of the year exceeded it easily. After a jump to 2.5% yoy in January, inflation reached 2.7% yoy in February. This is well above the CNB's target and its current forecast, but still within the central bank's tolerance band.

More than half of the current inflation is fuelled by higher housing costs, i.e. real estate, rents, energy, water and heat. More expensive services, food, and cigarettes also make a minor contribution to inflation growth. Core inflation has even reached 3% yoy, which is equal to the upper limit of the central bank's tolerance band of ± 1% around its 2% inflation target. However, this is very likely just a temporary peak as inflation will likely come down rapidly within roughly three months, due to last year's comparative base. In the second half of the year, the year-on-year core and headline inflation should remain close to the CNB's target. This is particularly true if the decline in consumer demand, which started in the second half of last year, continues in 2019.

Central bank chose to wait

The CNB continues to assume that the labour market tensions, reflected in the higher wage growth, will act as a significant pro-inflation factor and facilitate a further interest rate normalisation. The CNB's base scenario forecast does not expect any further rapid interest rate increases. However, both its alternative (sensitivity) scenarios, which are based on slower Koruna strengthening and a hard Brexit, anticipate a stringent tightening of monetary policy. Moreover, a considerable proportion of the Bank Board is in favour of rate increases.

However, due to international risks and uncertainty, the Board still voted to remain on hold at the February meeting.

This year's second monetary policy meeting takes place at the end of March, where we believe there will be another postponement in raising interest rates until international developments are clearer, and more figures are available for the domestic economy. The CNB does not need to rush given the postponement of the ECB's normalisation process. Therefore, we are cautiously counting on one more interest rate hike this year, although it will probably only occur in the second half of the year.

Financial markets also expect one more rate hike this year. However, the bond market may start paying more attention to developments in public finances, or the public sector borrowing requirement, which, in contrast to previous years, may start to grow again. This is due primarily to the fact that the generous increase in social spending coinciding with a decelerating economy will turn the budget into a deficit. Hence this policy may require an intervention in the form of budget cuts next year. Therefore, we cannot rule out that after the successful test of a new (small) bond in euros in February, the state might offer a much larger issue of Eurobonds to foreign investors later this year. Although the money will come from a different source, the domestic budget problem will not become any easier.

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Hungary

Solid outlook for 2019

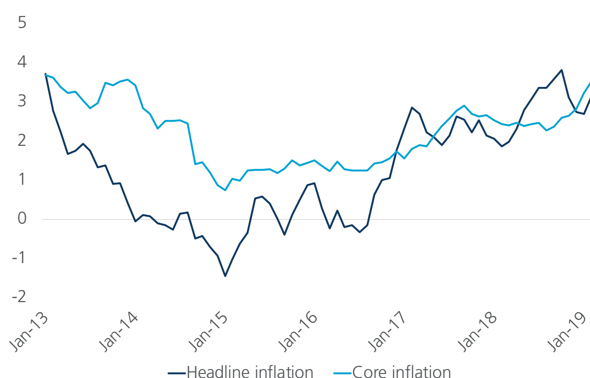
Contrary to the Czech economy, the Hungarian economy started 2019 off on a surprisingly positive note. This is the message conveyed by the hard data for retail sales and industrial production. Production (in working-day adjusted terms) rose by 5% yoy in January. Hence, in contrast to, for instance, the Czech or German economies, the Hungarian industry has not yet experienced a significant deceleration. The development of business sentiment in manufacturing (PMI) supports the same conclusion, as the Hungarian PMI has not followed the bearish trend visible in the rest of the region.

Inflation surprises on the upside

The Hungarian consumer price index delivered a surprise, with inflation accelerating from 2.7% yoy in January to 3.1% yoy in February, versus a market expectation of 2.9% yoy. Core inflation also jumped substantially, from 3.2% yoy in January to 3.5% yoy in February, which is the highest read since end-2013 (figure HU1).

Almost all subgroups showed an acceleration in price increases, but the most notable acceleration was in food products. Unprocessed food prices increased by 2.6% mom, mainly due to a jump in potatoes and other vegetable prices, while processed food prices also rose by 1.1% mom. With regard to tradeable goods, there was some price moderation in February (seasonal effect), but it was smaller than in previous years. Meanwhile the market services prices maintained their increasing trend. The latter two product groups confirmed our view that strong domestic consumption may push inflation up this year. On the cost side, fast wage increases also contribute to inflationary pressures.

Figure HU1 – Inflation surprising on the upside (consumer price index, % change year-on-year)



Source: KBC Economics based on HCSO (2019)

There is a notable difference between the January and February increases in core inflation: the former was driven more by the excise duty hike on tobacco, while the latter by pure market reasons. As such, it will be interesting to see how the Central Bank of Hungary (MNB) judges the current figure. Core inflation excluding indirect tax changes went up from 3% yoy in January to 3.2% yoy in February (a new peak since 2008).

Central Bank of Hungary will not speed up monetary normalisation

The MNB Monetary Council finds itself now in a difficult situation. On the one hand, strong Hungarian economic growth and above-target inflation calls for monetary tightening, while on the other, the deteriorating international environment - with slowing European and Chinese growth and lower inflation in the euro area - calls for loose monetary conditions. Additionally, the MNB also wants to boost lending, which requires low interest rates as well. We still think that Hungarian economic policy is too loose, as both fiscal and monetary policy supports the economy in an excessive way, which increases the risk of overheating. Despite this risk, we still don't expect a fast monetary policy adjustment. Headline inflation may peak in March around 3.3% yoy, followed by a gradual moderation to 2.5% yoy till mid-summer, again followed by another turn. As such, we might see headline inflation at 3.5% yoy in December of this year.

This inflation orbit suggests that the MNB may rather smoothly adjust its monetary policy till the summer, so we maintain our view that the average amount of liquidity to be crowded-out will be maintained around HUF 400 billion in Q2 2019 - it doesn't really matter whether it is HUF 300 billion or HUF 600 billion, as in both cases it pushes the internal banking rate close to the low end of the interest rate corridor. Furthermore, we expect the overnight deposit rate to be increased from -0.15% to 0% around the beginning of summer, and to end the year around 0.50%. The average liquidity to be crowded-out might be decreased to zero in the autumn, which might push up the very short end of the curve.

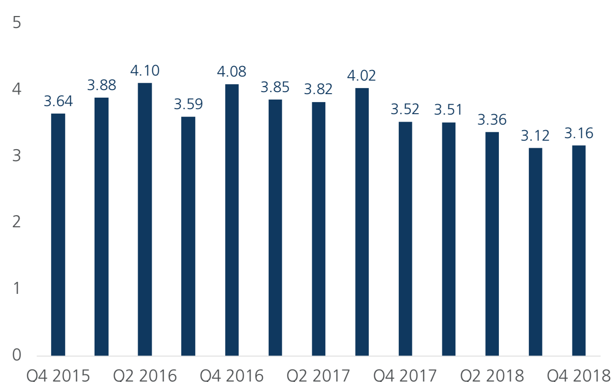
Bulgaria

Economic expansion moderated in 2018

The latest national accounts data confirmed that the Bulgarian economy ended 2018 on a rather soft note. According to the National Statistical Institute (NSI), the economy expanded by 3.2% yoy in the fourth quarter, marginally above the third quarter's reading of 3.1% yoy (figure BG1). On a quarter-on-quarter basis, the economy grew by 0.8% in Q4 2018 compared to 0.7% in the previous quarter. Overall, fourth-quarter figures showed surprising weakness in household consumption amid deteriorating consumer sentiment and moderating wage growth. As a result, domestic consumption recorded a decline of 0.1% qoq for the first time in four years. Moreover, investment somewhat lagged expectations with year-on-year growth slowing from 7.0% in Q3 to 6.6% in Q4. This was despite earlier indications of faster absorption of EU funds, as well as fiscal easing by the end of the year. Ultimately, the external sector was the key driver of growth. After contracting for two consecutive quarters, exports of goods and services saw a rebound of 1.4% yoy in Q4, suggesting resilience amid a more challenging global backdrop. These volatile evolutions indicate that the Bulgarian economy is very sensitive to developments in the surrounding and euro area economies, but also relatively resilient.

For the year as a whole, real GDP growth lost momentum markedly, dropping to 3.1% from 3.8% in 2017. The main driver of growth remained domestic demand. While private consumption accelerated on the back of raising real wages and favourable labour market developments, the increase in public consumption reflected mainly higher spending on wages. In addition, the recovery in the disbursement of the EU funds provided a boost to investment growth. Therefore, the slowdown in economic growth reflected mainly the negative contribution of net exports, i.e. the weakening of exports due to softer external demand from key trading partners on the one hand, and solid imports dynamics underpinned by strong domestic demand on the other.

Figure BG1 – Q4 2018 real GDP growth marginally above the third quarter's reading (real GDP, seasonally adjusted, % change year-on-year)



Source: KBC Economics based on NSI (2019)

We expect that the Bulgarian economy will keep a strong pace of expansion in 2019 and 2020 with real GDP growth of 3.2% and 3.1% respectively. The downward revisions to our forecast (-0.2 percentage points. in both 2019 and 2020) reflect slightly weaker, though still solid, private consumption growth. This is due to worsening consumer confidence in Q4 2018 that is carrying over into 2019. In addition, a more challenging external environment, i.e. the slowdown in major EU export markets together with a sharp downturn in the Turkish economy, will also weigh on exports that are expected to recover only moderately throughout the year. In total, we expect Bulgaria to follow the growth slowdown throughout the region, but at a slower pace.

Labour shortage at historical peak

Favourable labour market developments continue to prevail in 2019. According to the revised Eurostat data, the unemployment rate remained at 4.8% in January, down from 5.6% a year earlier. Moreover, as the overall number of unemployed persons edged only marginally higher to 159,000, it is still close to a record low. As a result, the level of labour shortage is at a historical peak with the greatest shortages in industry and construction, but lately also in services. Meanwhile, contrary to other Central and Eastern European economies, the number of workers arriving from outside the European Union is still limited and mostly concentrated in a few economic activities. This, coupled with adverse demographics, poses a serious challenge to future growth.

Despite the strong labour market and still solid wage growth (7.4% yoy Q4 2018 for the public sector and 6.8% yoy Q4 2018 for the private sector), inflation pressures continue to weaken. Annual inflation, as measured by HICP, dropped to 2.2% in January, mainly on the back of decline in transport prices. As fuel prices rose again in February, the downward trend in transport prices is likely to turn around. Nonetheless, we believe it is unlikely to lead to a sustained acceleration in the inflation rate this year given the expectations of stable oil prices, as well as the strong base effect. All in all, we expect annual inflation to reach 2.5% in 2019.

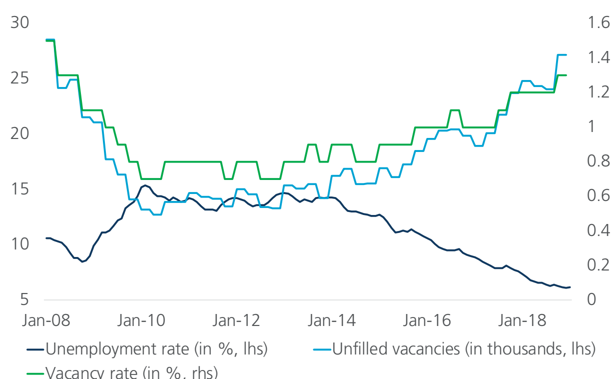
Slovakia

Slovak GDP growth decelerated from 4.6% yoy in Q3 2018 to 3.6% yoy in Q4 2018 according to preliminary data from the Statistical Office. This deceleration is in line with the recent deceleration in the euro area. We expect that the results in Q4 2018 were influenced by weaker household consumption, as is indicated by a gradual worsening of the monthly retail trade figures. Rising imports may have also negatively affected the previously positive contribution of net exports to GDP growth.

The central bank and ministry of finance revised their growth forecasts downwards to 4.2% yoy and 4.0% yoy respectively for the year 2019. We expect even somewhat weaker growth (3.7% yoy), as we expect a more negative effect on Slovakia from the economic slowdown in the euro area, and in Germany in particular. However, Slovakia should be, to some extent, protected by the start of production in the new Jaguar-Land Rover plant (in NR region) in 2019. The effect of this new export-oriented plant has been very limited so far (production started at the end of 2018). The automotive industry was the main engine of growth in 2018 thanks to the implementation of new car model production and increases in market share. This extraordinary positive development will probably not be repeated this year. Economic sentiment indicators stopped their gradual decline at the beginning of 2019, which is a positive sign though. Sentiment improved in the manufacturing sector. However, due to deceleration in the euro area, it is too early to say whether the Slovak GDP deceleration was only a temporary phenomenon.

Slovak HICP inflation increased to 2.2% yoy in January 2019 from 1.9% yoy in December 2018. This was driven mainly by cost factors and administrative factors (e.g. food and energy price increases). Average inflation stood at 2.5% yoy in 2018.

Figure SK1 – Limited room for further unemployment rate declines



Source: KBC Economics based on Eurostat, Slovakian Statistical Office (2019)

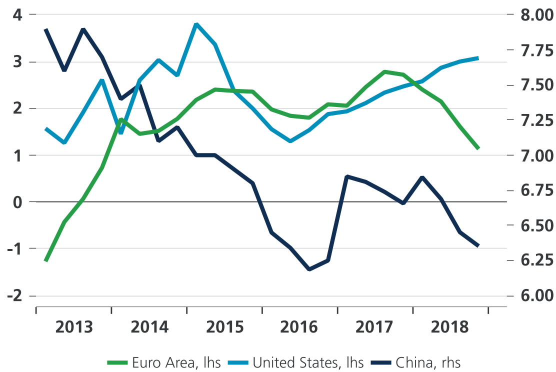
Upward price developments should accelerate in early 2019 - due to higher regulated prices and an acceleration of food prices - and persist through H1 2019. We expect HICP deceleration in the second half of 2019 with average inflation in 2019 around 2.6% yoy. The National Bank of Slovakia reduced its inflation forecast for 2019 to the same level.

The harmonised unemployment rate (Eurostat) stood at 6.2% in January 2019 and has been roughly unchanged the last three months (figure SK1). This remains an all-time low unemployment rate. The room for further unemployment rate declines will be limited. This is already visible in some confidence indicators. However, the number of job vacancies is still at all-time highs.

Government bond spreads hovered in a narrow range around 60 basispoints in February. Budget developments have been positive, but we can expect more populistic proposals for non-covered tax reductions or expenditure increases as there are regular Parliamentary elections in the spring 2020. Presidential elections scheduled for March 2019 should not have a significant impact on the market, but could reveal voters' preferences (generally, one expects a gradual decline in the current government's popularity). However, ECB policy will remain the most important factor influencing the development of the government bond spread.

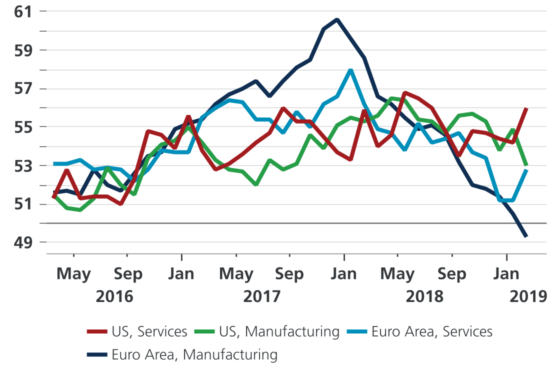
Figures

Real GDP
yearly change in %



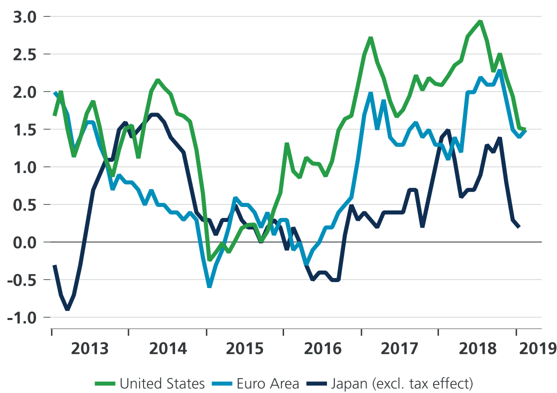
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



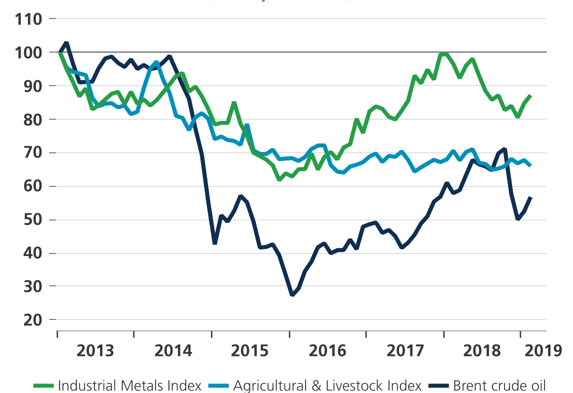
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



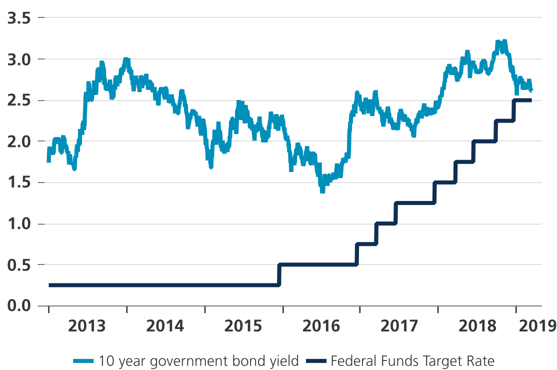
Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, BLS

Commodity prices
index, January 2013=100, in USD



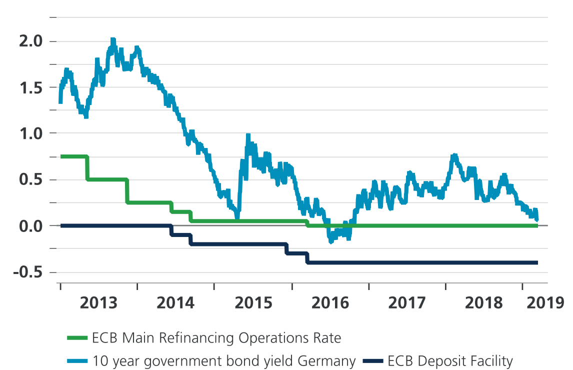
Source: KBC Economics based on World Bank, S&P

United States interest rates
in %



Source: KBC Economics based on FED, Macrobond

Euro area interest rates
in %



Source: KBC Economics based on Macrobond, ECB

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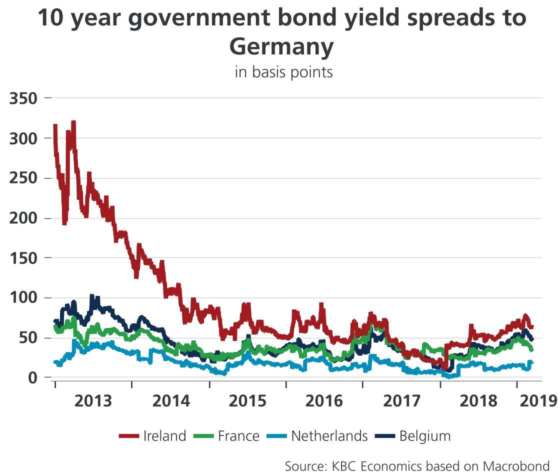
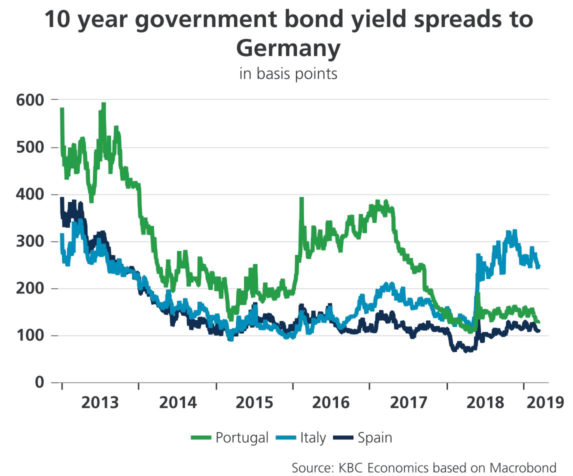
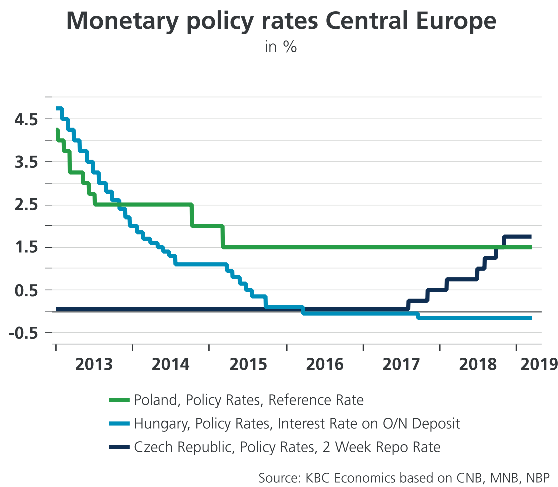
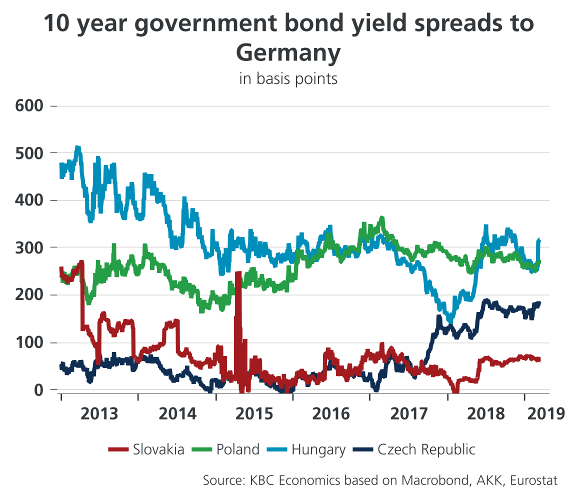
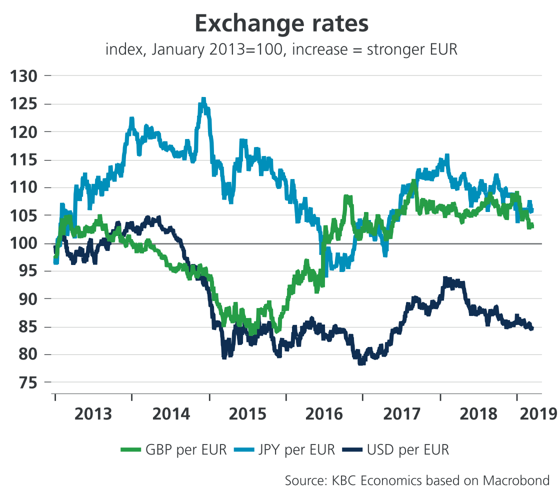
Figures

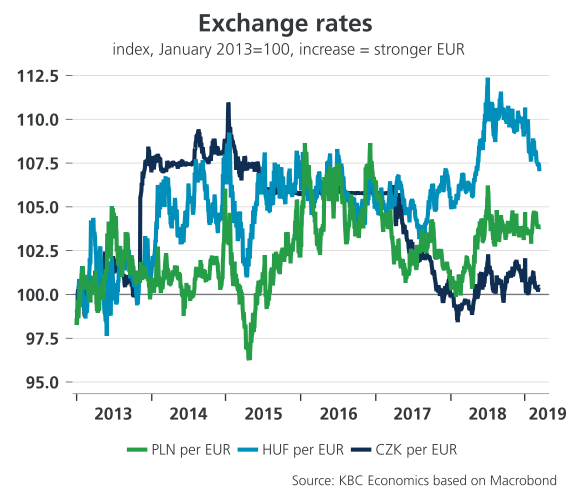












Outlook main economies in the world

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		Real GDP growth (period average, in %)			Inflation (period average, in %)		
		2018	2019	2020	2018	2019	2020
Euro area	Euro area	1.8	1.1	1.4	1.7	1.3	1.5
	Germany	1.5	0.9	1.5	1.9	1.4	1.4
	France	1.5	1.1	1.3	2.1	1.3	1.6
	Italy	0.8	0.0	0.6	1.2	1.0	1.2
	Spain	2.5	1.9	1.7	1.7	1.5	1.5
	Netherlands	2.5	1.5	1.5	1.6	2.1	1.7
	Belgium	1.4	1.2	1.1	2.3	1.7	1.6
	Ireland	6.7	3.5	3.0	0.7	1.6	2.0
	Slovakia	4.1	3.7	3.5	2.5	2.6	2.4
Central and Eastern Europe	Czech Republic	3.0	2.6	2.3	2.0	2.1	2.0
	Hungary	5.0	3.7	2.6	2.8	2.9	3.5
	Bulgaria	3.2	3.2	3.1	2.6	2.5	2.4
	Poland	5.1	3.5	3.3	1.2	1.0	2.5
	Romania	4.1	3.8	3.5	4.1	3.5	3.3
Rest of Europe	United Kingdom	1.4	1.4	1.3	2.5	2.0	2.1
	Sweden	2.4	2.0	1.9	2.0	1.9	2.0
	Norway	2.4	2.2	1.8	2.8	2.0	2.0
	Switzerland	2.6	1.6	1.6	0.9	0.8	1.0
Emerging markets	China	6.6	6.0	5.7	2.1	2.2	2.5
	India*	7.0	7.1	7.4	4.0	4.1	4.6
	South Africa	0.8	1.3	1.3	4.6	4.7	5.4
	Russia	2.3	1.4	1.7	2.9	4.8	3.9
	Turkey	3.0	-0.5	3.0	16.2	18.5	13.0
	Brazil	1.1	2.1	2.4	3.7	4.0	4.2
Other advanced economies	United States	2.9	2.3	1.6	2.4	2.1	2.2
	Japan	0.8	0.9	0.5	1.0	1.0	1.4
	Australia	3.0	2.7	2.7	1.9	2.1	2.4
	New Zealand	2.8	2.8	2.6	1.6	1.9	2.0
	Canada	2.1	1.9	1.7	2.3	1.8	2.1

* fiscal year from April-March

Policy rates (end of period, in %)						
		17/01/2019	Q1 2019	Q2 2019	Q3 2019	Q4 2019
Euro area	Euro area (refi rate)	0.00	0.00	0.00	0.00	0.00
	Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40	-0.40
Central and Eastern Europe	Czech Republic	1.75	1.75	1.75	2.00	2.00
	Hungary	-0.15	-0.15	-0.15	0.20	0.40
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.50
	Romania	2.50	2.50	2.50	2.75	2.75
Rest of Europe	United Kingdom	0.75	0.75	0.75	0.75	1.00
	Sweden	-0.25	-0.25	-0.25	-0.25	0.00
	Norway	0.75	1.00	1.00	1.00	1.25
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	4.35	4.35	4.35	4.35	4.35
	India	6.25	6.25	6.00	6.00	6.00
	South Africa	6.75	6.75	6.75	7.00	7.00
	Russia	7.75	7.75	7.75	7.75	7.75
	Turkey	24.00	24.00	24.00	21.50	19.50
	Brazil	6.50	6.50	6.50	6.50	6.75
Other advanced economies	United States (upper limit)	2.50	2.50	2.50	2.50	2.75
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	1.50	1.50	1.50	1.50	1.50
	New Zealand	1.75	1.75	1.75	1.75	1.75
	Canada	1.75	1.75	1.75	2.00	2.00

Outlook main economies in the world

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10 year government bond yields (end of period, in %)						
		11/03/2019	Q1 2019	Q2 2019	Q3 2019	Q4 2019
Euro area	Germany	0.07	0.05	0.25	0.50	0.60
	France	0.47	0.40	0.75	1.05	1.20
	Italy	2.57	2.55	2.95	3.50	3.60
	Spain	1.16	1.05	1.50	1.78	1.90
	Netherlands	0.26	0.25	0.45	0.70	0.85
	Belgium	0.57	0.55	0.80	1.10	1.25
	Ireland	0.70	0.70	0.95	1.20	1.35
	Slovakia	0.74	0.75	0.95	1.20	1.40
Central and Eastern Europe	Czech Republic	1.88	1.85	1.85	2.15	2.15
	Hungary	3.28	3.10	2.80	3.00	3.20
	Bulgaria	0.74	0.80	0.91	1.18	1.30
	Poland	2.88	2.90	3.00	3.05	3.20
	Romania	4.74	4.80	5.20	5.30	5.80
Rest of Europe	United Kingdom	1.18	1.20	1.40	1.40	1.50
	Sweden	0.29	0.30	0.50	0.75	0.85
	Norway	1.71	1.70	1.90	2.15	2.25
	Switzerland	-0.33	-0.35	-0.15	0.10	0.20
Emerging markets	China	3.17	3.35	3.50	3.60	3.65
	India	7.51	7.70	7.85	7.95	8.00
	South Africa	8.67	8.95	9.10	9.20	9.20
	Russia	8.46	8.40	8.25	8.20	8.20
	Turkey	14.95	15.00	14.50	14.00	14.00
	Brazil	8.90	9.25	9.40	9.60	9.80
Other advanced economies	United States	2.64	2.65	2.90	3.00	3.00
	Japan	-0.04	0.00	0.00	0.00	0.00
	Australia	2.02	2.05	2.30	2.40	2.40
	New Zealand	2.11	2.15	2.40	2.50	2.50
	Canada	1.76	1.80	2.05	2.15	2.15

Exchange rates (end of period)					
	11/03/2019	Q1 2019	Q2 2019	Q3 2019	Q4 2019
USD per EUR	1.12	1.12	1.11	1.13	1.15
CZK per EUR	25.65	25.60	25.10	25.50	25.20
HUF per EUR	315.54	318.00	324.00	320.00	318.00
PLN per EUR	4.30	4.30	4.33	4.35	4.40
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.75	4.75	4.76	4.77	4.78
GBP per EUR	0.85	0.85	0.87	0.88	0.88
SEK per EUR	10.56	10.50	10.40	10.25	10.00
NOK per EUR	9.74	9.70	9.50	9.40	9.35
CHF per EUR	1.14	1.13	1.15	1.16	1.17
BRL per USD	3.84	3.90	3.95	3.95	4.00
INR per USD	69.84	70.10	70.80	71.00	71.50
ZAR per USD	14.33	14.60	14.80	14.90	14.90
RUB per USD	65.96	66.00	66.00	65.00	65.00
TRY per USD	5.44	5.40	5.30	5.55	5.80
RMB per USD	6.72	6.70	6.75	6.80	6.85
JPY per USD	111.22	110.00	110.00	110.00	111.00
USD per AUD	0.71	0.70	0.71	0.71	0.72
USD per NZD	0.68	0.69	0.69	0.69	0.70
CAD per USD	1.34	1.35	1.33	1.31	1.29

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Outlook KBC home markets

	Belgium			Ireland		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	1.4	1.2	1.1	6.7	3.5	3.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.7	1.6	0.7	1.6	2.0
Unemployment rate (in % of the labour force, end of year, Eurostat definition)	5.5	5.5	5.7	5.7	5.1	5.2
Government budget balance (in % of GDP)	-0.8	-1.7	-1.8	0.1	0.2	0.3
Gross public debt (in % of GDP)	102.3	101.5	101.0	64.0	61.0	59.0
Current account balance (in % of GDP)	0.1	-0.3	-0.5	11.0	8.0	5.0
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	3.0	2.3	2.2	10.2	4.5	3.0

	Czech Republic			Slovakia		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	3.0	2.6	2.3	4.1	3.7	3.5
Inflation (average yearly change, harmonised CPI, in %)	2.0	2.1	2.0	2.5	2.6	2.4
Unemployment rate (in % of the labour force, end of year, Eurostat definition)	2.0	2.0	2.0	6.1	6.2	6.3
Government budget balance (in % of GDP)	0.7	0.0	-0.5	-0.7	-0.7	-0.7
Gross public debt (in % of GDP)	32.2	30.8	30.0	49.0	48.0	47.0
Current account balance (in % of GDP)	0.7	0.6	0.4	-2.0	-1.5	-1.0
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	8.0	3.5	3.0	5.0	4.0	3.5

	Hungary			Bulgaria		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	5.0	3.7	2.6	3.2	3.2	3.1
Inflation (average yearly change, harmonised CPI, in %)	2.8	2.9	3.5	2.6	2.5	2.4
Unemployment rate (in % of the labour force, end of year, Eurostat definition)	3.6	3.5	3.5	4.8	4.7	4.6
Government budget balance (in % of GDP)	-2.0	-1.8	-2.0	0.1	-0.5	0.0
Gross public debt (in % of GDP)	70.9	68.7	66.7	22.1	19.0	18.6
Current account balance (in % of GDP)	1.3	0.9	0.6	2.4	1.2	1.0
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	7.5	4.0	3.0	6.0	5.0	4.0

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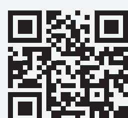

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