Economic perspectives

UBB
Part of KBC Group

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Highlights

- Economic indicators in the euro area are showing tentative signs of stabilisation. Euro area real GDP growth stabilised at 0.2% in Q3 but underlying geographical differences persist. Growth figures for some major economies, such as France and Spain, were better than expected. On the contrary, Italian growth remains muted. Most importantly, the German economy reported marginally positive growth in Q3, meaning the largest European economy has narrowly avoided a technical recession. Our scenario for the euro area economy remains unchanged: we expect growth to recover gradually, but stay muted in the short-term.

- The deceleration of the US economy is becoming more pronounced, although a broad-based recession with negative spillovers from manufacturing weaknesses to the services sector is not likely. The US labour market is showing some signs of cooling but the overall performance remains resilient.

- Recent weeks have been characterised by a revived optimism driving movements in equity and bond markets. Positive signals from the US-China trade negotiations as well as a reduced likelihood of a hard Brexit were the main drivers. However, despite these favourable developments, we are not out of the woods yet. Uncertainty will remain key surrounding the US-China trade dispute and the Brexit saga. After all, the US-China partial trade deal and the approval of the UK withdrawal agreement will not be a final end point. These sentiment swings may continue to fuel financial market volatility at the end of 2019.

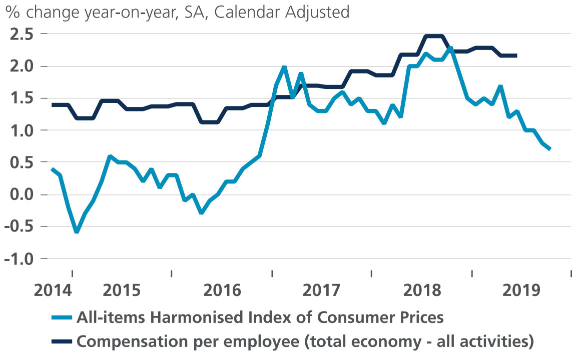
Global economy

Euro area: no further deterioration ahead?

The economic outlook for the euro area is gradually becoming less pessimistic. Several indicators signal that the recent economic slowdown in the euro area is coming to a halt. Real GDP growth figures for Q3 2019 indicate that euro area growth stabilized at 0.2% (qoq) with strong growth performance in some economies including France (+0.3% qoq), Spain (+0.4% qoq) and the Netherlands (+0.4% qoq). Also German growth figures for the third quarter positively surprised. Against expectations, Germany reported slightly positive real GDP growth in Q3 (+0.1% qoq), thereby avoiding a technical recession after negative growth in the previous quarter (-0.2% qoq). Besides, also the Central and Eastern European economies reported relatively strong growth figures, albeit with a moderation in growth rates across the region.

Looking forward, business sentiment indicators in most euro area countries have broadly stabilised, though still at very low levels. The overall picture remains broadly similar to previous months, with pronounced weaknesses in the manufacturing sector and some contagion towards services activities, with the latter mainly concentrated in Germany. Importantly, however, recent corporate sentiment indicators don't signal a further deterioration. Signs of a major turnaround remain absent for now but the stabilisation in sentiment suggests that there will be no further economic worsening either. Hence these indicators seem to suggest that the current dip is of temporary nature.

Figure 1 - Increase in euro area spending power thanks to drop in inflation combined with solid wage growth
% change year-on-year, SA, Calendar Adjusted



Source: KBC Economics based on ECB, Eurostat

Moreover, high frequency indicators confirm the persistent resilience of consumption demand in the euro area. Consumer sentiment has weakened somewhat in most countries, but nevertheless remains at remarkably solid levels. Furthermore, household expenditures are underpinned by the drop in headline inflation, which decreased further to 0.7% year-on-year in October. The downward trend in euro area inflation in recent months has been caused mainly by negative contributions of the energy price component (-3.2% yoy in October). Meanwhile, core inflation – excluding volatile components such as energy, food, alcohol and tobacco – continues to hover around 1% yoy. Given that nominal wages keep growing at a sound pace, the inflation decrease means a rise in spending power for consumers (figure 1). Furthermore, employment growth, although showing signs of weakening in some countries, remains supportive for private consumption. The slight increase in the households savings rate suggests that in case economic conditions deteriorate, there is still some buffer to consumption.

From the fiscal policy side, support - albeit moderate - for economic growth seems to be on the way in the coming years. Based on the draft budget proposals the euro area countries submitted to the European Commission and looking at the main euro area economies, Germany, the Netherlands and Italy plan for a mildly expansionary fiscal policy. Expressed as a percentage of their potential GDP, the reported change in the cyclically adjusted primary budget balance in 2020 compared to 2019 amounts to respectively -0.75%, -1.10% and -0.30% (negative sign meaning budgetary expansion). However, on current plans, fiscal policy is unlikely to dramatically boost euro area activity in the near term. Recent ECB calls for a more supportive fiscal policy stance may signal an increasing focus on the role of government spending in the European economy. However, it remains to be seen whether this emerging discussion will prompt considered interventions that will enhance productive and broader socio-economic capacity or simply lead to poorer trends in the public finances.

All in all, recent data confirm our scenario. Economic activity in the short term will remain rather subdued without a sharp or immediate rebound, but the downward trend in sentiment seems to have paused. The latter suggests that the euro area is not heading towards a deep, broad-based recession. Hence, our growth forecasts for the euro are unchanged. We project annual average real GDP growth to reach 1.1% in 2019 and 1.0% in 2020. We expect underlying quarterly dynamics to show a gradual recovery from 2020 on. Note that some international institutions, notably the IMF, are more optimistic and expect a more substantial economic recovery in 2020 for the euro area economy (1.4%). However, neither sentiment indicators nor structural dynamics convincingly support this optimism in our view.

German signals less negative

After months of disappointing activity reports and growing pessimism among corporates, most recent data cautiously signal that the end of the German economic downswing is likely near. This is evident in the soft but positive and clearly stronger than expected marginal gain in GDP for the third quarter. It is also consistent with other recent developments. In line with the stabilisation of global trade volumes, German export and industrial production data are no longer showing a further deterioration. Business sentiment indicators have been showing a more mixed picture, with messages from the national IFO indicator less pessimistic than from the PMI. Nevertheless, the manufacturing sector is the weakest link according to both indices. The main stronghold in the German economy remains private consumption. Consumer confidence has weakened, but remains at relatively high levels. Retail sales growth has strengthened again in recent months and, as a result, consumer spending supported the better than expected outturn for Q3 2019 GDP. Labour market trends, despite some early signs of unemployment picking up again in Germany, remain supportive for consumption going forward.

Overall, we expect German quarterly GDP growth to gradually recover in the quarters to come. Nevertheless, given the weak growth performance thus far in 2019, annual growth rates for this and next year are projected to be subdued and substantially below Germany's growth potential.

US deceleration, not a recession

The US economy continues to perform strongly, though at a slower growth pace. The advance real GDP growth estimate for Q3 2019 was broadly in line with the KBC estimate (1.9% qoq annualised versus 1.8% expected). The slight deceleration in real GDP growth compared to the previous quarter reflected decelerations in personal consumption expenditures and government spending and a larger decrease in non-residential fixed investment. Net exports contributed slightly negatively to growth. Based on early indicators for Q4, the business situation looks somewhat more gloomy. Confidence measures are downbeat with the ISM manufacturing remaining in contraction territory at 48.3 (albeit up from September's reading of 47.8) and CEO confidence index is at its lowest level since Q1 2009 (figure 2). This has been mirrored in the downward trend in industrial production, which decreased in September (-0.2% yoy) for the first time since 2016.

Nevertheless and more importantly, the services sector – which represents the vast majority of economic activity – is holding up relatively well (figure 2). The ISM non-manufacturing index jumped to 54.7 in October, thereby easing concerns about negative spill-overs from the export-oriented manufacturing industry towards the domestic services sector. Important sub-indices, such as business activity, employment and new orders also increased, suggesting that there will be no immediate relapse in November.

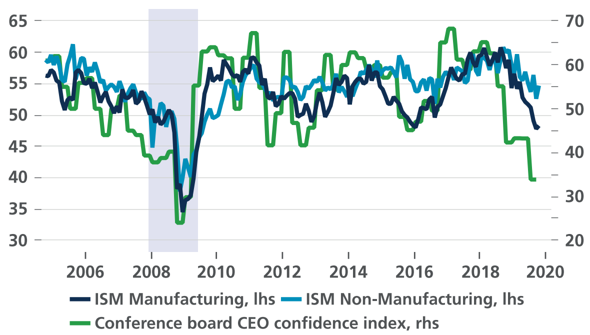
Meanwhile, the US labour market is showing some signs of cooling. Though national job growth remained solid in October (+148k), state-level data indicate a more mixed picture. Though still a small minority, there has been some uptick in the number of states reporting job losses. (see Box 1).

Overall, this is in line with our scenario of gradually decreasing US growth dynamics without a severe recession. Our US growth forecasts hence remain the same as last month. The 2019 annual average real GDP growth is expected to reach 2.3% and 1.7% in 2020. Private consumption will remain the main growth contributor going forward.

The return of market optimism

Equity and bond market movements are indicative of increased optimism in recent weeks reflecting positive signals coming from several sides. Recent developments in relation to the main risks to the global economy i.e. Brexit and the US-China trade

Figure 2 - US business confidence measures signalling upcoming downturn



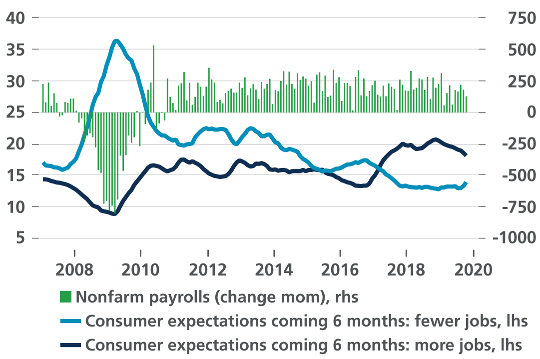
Source: KBC Economics based on ISM, TCB

Box 1 - US labour market showing signs of cooling down

The health of the US labour market is closely monitored by many economists. The fact that the American consumer is the backbone of the economy at least partly explains why. The positive news is that the monthly labour market report is still solid. In October 2019, 128,000 new jobs were created. That was considerably more than expected (85,000). Markets feared that the strike at the car giant General Motors would have a greater impact on the figure for October as striking people are not taking into account in the employment figures. In addition, job creation for the months of August and September was adjusted upwards by a strong 95,000. In October, the participation rate rose to 63.3% as more people either found work or began searching for a job. The unemployment rate increased marginally from 3.5% to 3.6% in October. From a long-term perspective, however, it remains very low. Wage growth was 3% year-on-year in October, which was more than sufficient to support real purchasing power.

However, the sky above the American labour market is not entirely free of (dark) clouds. One statistic that we will follow up further comes from the Conference Board Consumer Confidence survey. This is a monthly survey of American consumer confidence. In doing so, it emphasises the employment situation and is therefore closely linked to the 'payrolls'. The survey shows that the average consumer is becoming more gloomy about the future. A steadily decreasing number of respondents think that more jobs will be available over a period of six months (figure B1). On the other hand, the proportion that thinks that there will be fewer jobs over the same period of time is cautiously increasing. However, we don't think the US labour market is on the brink of a crash. Moreover, it is too early to talk about a change in sustainable trends. However, we will keep an eye on the further evolution of this data in the coming months.

Figure B1 - US labour market indicators



Source: KBC Economics based on BLS, TCB

war have supported this optimism.

Worries about the possibility of the United Kingdom exiting the European Union without any sort of deal have decreased now that the UK government and the European Commission agreed on a revised withdrawal agreement as well as on an extended deadline for the approval of this agreement by the British and European parliaments. It is now envisaged that the UK will leave the EU by the end of January 2020, or earlier if the withdrawal agreement gets approved by the British parliament sooner. However, that withdrawal agreement also envisages a transition period out to the end of 2020 during which the UK's current relationship with the EU would be effectively unchanged. On 12 December general elections will be held in the UK. Based on recent polls, Prime Minister Boris Johnson's Conservative Party is likely to strengthen its position – although opinion polls have given several seriously misleading signals in recent years. Hence, an approval of the withdrawal agreement in British Parliament before 31 January 2020 seems feasible and likely. Attention will then shift to what is likely to be a difficult task of negotiating a full trade agreement between the UK and EU before the end of next year but, for now, markets are understandably focussed on the much reduced threat of a disorderly Brexit.

Positive news also came from the US-China negotiation table in recent weeks. Negotiations appear to be going in the right direction and it now looks likely that a partial trade deal will be reached within a relatively short period of time. This 'light' trade deal could provide some temporary relief and is likely to cause a pickup in business sentiment in the short term once the deal is signed.

Financial markets reacted positively to these favourable developments in risk factors and the slightly better economic data. Both German and US long-term government bond yields increased significantly and are now almost fully recovered from their sharp drop during the summer months. Equity markets also flared up and the recent strengthening of some currencies (e.g. EUR versus USD, HUF and CZK versus EUR) illustrated the risk-on mode in markets. The recent upticks in long-term bond yield led us to revise our year-end forecasts for both the US and German bond yield towards 1.80% (from 1.60%) and -0.40% (from -0.70%) respectively. Hence, although we acknowledge that the recovery of long-term bond yields from that deepest levels is structural, we remain cautious about the future evolutions in long-term yields. Markets not only overreacted on the downside, but they are likely to overreact at this moment on the upside too, neglecting many risks that still surround the US-China trade war, Brexit and other international developments.

Uncertainty remains key

Although recent signals have been more positive than news flows over the past year, we want to stress that there are still difficult times ahead with likely lots of remaining uncertainties. In the case of Brexit, the withdrawal agreement is far from complete (see also: KBC Economic Opinion of 31/10/2019). The withdrawal agreement is only a temporary arrangement to avoid the UK crashing out of the EU and causing major economic damage. The future long-term relationship between the UK and the EU is vaguely outlined in an accompanying political declaration. It remains to be seen how that document's good intentions will translate into a detailed trade agreement between the UK and the EU27, as well as broader agreements on investments, regulatory cooperation, migration and labour mobility rights. The current deadline to reach a comprehensive UK-EU trade deal is set at the end of 2020. Given the complexity of matters, this is highly unlikely to be met. The turbulence leading up to the deadline is expected to cause a temporary drop in the German bond yield again towards end 2020. Hence, the Brexit 'cloud' will continue to darken the UK and European growth outlook going forward. Therefore, we keep our forecasts for end 2020 for the German 10-year bond yield unchanged at -0.30%, reflecting the expected uncertainty and possibly turbulence at the time the UK and the EU27 have to reach a final agreement on their future economic relationship.

In the case of the US-China conflict, we're not out of the woods yet. Aside from providing some short-term relief, the partial trade deal will most likely lack significant concessions and have no marked positive impact on growth. The structural issues – such as the lack of a credible Chinese enforcement system to police intellectual property rights and the US demand to reduce Chinese state involvement in industrial policies – are likely to remain unresolved. Also the battle for global technological and therefore economic leadership is unlikely to be ended (see also: KBC Economic Opinion of 24/05/2019). The further de-escalation in US-China trade war will hence have a limited effective economic impact as the structural political-economic conflict will continue to weigh on sentiment and growth.

Besides these risk factors, other elements remain on our risk radar as well. The protests in Hong Kong have been ongoing for quite some time now and are clearly impacting economic activity in China. Troubles remain relatively contained until now, but some wider spillovers cannot be fully excluded. For more detailed info, read Box 2.

Box 2 - It's not only Hong Kong's economy at risk

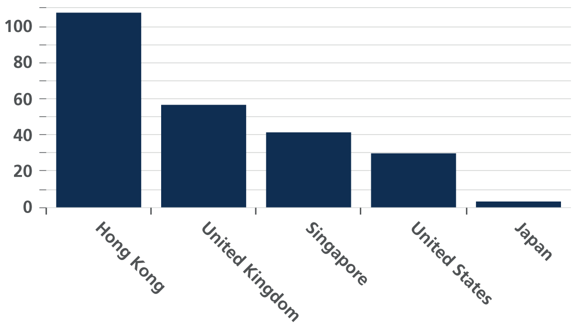
The protests in Hong Kong continue with no end in sight. Though the extradition bill that sparked the protests was formally withdrawn in September, the protestors have four other demands, including universal suffrage for electing Hong Kong's legislative Council and the Chief Executive.

While the protests may be political in nature, they have economic consequences. Already facing slowing growth in 2019 as a result of the US-China trade war and the slowdown in China, activity indicators in Hong Kong suggest that the protests are sharply weighing on the economy. The City University of Hong Kong Consumer Confidence Index, for example, has dropped sharply from 78 in April to 53 in September. The composite PMI also fell from 48.4 in April to 39.3 in October. Retail sales have sharply deteriorated too, contracting 18% yoy in September. Another area where the protests are clearly having a negative impact on the economy is in tourism flows. Tourist expenditure amounted to almost 10% of Hong Kong's GDP in 2018, 78% of which came from mainland China. In August and September this year, total tourist arrivals were down relative to a year earlier by 39% and 34%, respectively.

But Hong Kong's economy isn't the only economy at risk. Hong Kong is an important global financial hub, particularly for mainland China. Precisely because of Hong Kong's independent legal system, many international investors prefer to invest in China via Hong Kong. Over 65% of foreign direct investment (FDI) into China, for example, is channelled through Hong Kong. Furthermore, a large share of Chinese companies' Initial Public Offerings (IPOs) and bond issuances happen in Hong Kong. China has also used Hong Kong's status as a top financial hub to reap some of the benefits of a more open financial sector while also keeping its financial system isolated with strict capital controls. Bond Connect and Stock Connect, for example, allow for equity and bond trading between mainland China and the rest of the world through Hong Kong's financial infrastructure and institutions. China also channels the majority of its outward FDI, such as for its Belt and Road Initiative, through Hong Kong.

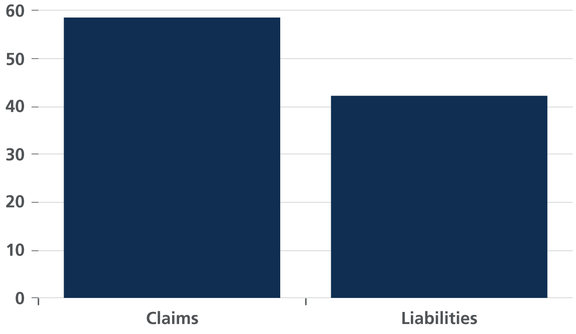
Furthermore, Hong Kong has also helped with China's goal of internationalising the Chinese currency. According to the BIS, average daily CNY turnover in Hong Kong is almost twice as high as in any of the other top global financial centres (figure B2.1). Given this close financial connection, the banking sectors of mainland China and Hong Kong are also significantly intertwined. According to data from the Hong Kong Monetary Authority, Hong Kong banking claims vis-à-vis mainland China are roughly 60% of GDP, while liabilities vis-à-vis the mainland are roughly 40% of GDP (figure B2.2). As a result, any long-lasting damage to Hong Kong's reputation as a preeminent global financial centre can have important ramifications for China.

Figure B2.1 - CNY turnover in top FX hubs
USD billion, daily average turnover



Source: KBC Economics based on BIS

Figure Box 2.2 - Hong Kong bank exposures vis-a-vis mainland China
% of GDP, 01/08/2019



Source: KBC Economics based on HKMA, HKC&SD

Central and Eastern European Economies

While the euro area economy has seen decelerating economic growth throughout 2019, the expansion in Central and Eastern Europe has remained solid, with real GDP growth mostly above potential. Such resilience seems striking, particularly in the context of a pronounced slowdown of the German economy, which is highly integrated with the region through trade and financial channels. In this respect, the fresh set of regional GDP figures for the third quarter suggests that the Central and Eastern European economies maintained steady economic momentum, albeit with a moderation in growth rates across the region.

The sole exception to the latter trend is Hungary, which keeps its position as regional growth champion, with real GDP growth accelerating from 4.9% yoy in the second quarter to 5.0% yoy in the third quarter. Meanwhile, the Polish economy experienced an economic slowdown to 3.9% yoy in Q3 from 4.6% yoy a quarter earlier. This, however, seems less dramatic if we consider that economic activity picked up from 0.8% qoq in Q2 to 1.3% qoq in Q3. The Czech Republic recorded year-on-year growth of 2.5%, slightly down from 2.8% yoy in the second quarter, keeping the economy on a relatively stable growth trajectory since mid-2018. On the contrary, Slovakia again disappoints with a further weakening of real GDP growth; while the economy expanded by 3.7% yoy in the first quarter of the year, it gradually lost momentum to 2.2% yoy in Q2 and 1.3% yoy in Q3.

Despite a slight deceleration of growth in the third quarter, Bulgaria's GDP reading surprised on the upside at 3.7% yoy, only marginally below the 3.9% yoy from the previous quarter. In contrast to the favourable Bulgarian result, Romania's expansion is clearly losing momentum. The pace of economic growth ticked down from 4.4% yoy in Q2 to 3.0% yoy in Q3, marking the slowest year-on-year real GDP reading since mid-2014.

Domestic demand in the spotlight

Although the detailed breakdowns of regional GDP readings are not yet available, we assume that once again robust domestic demand was the main driver of economic activity. Indeed, it is this shift from export to domestic demand-driven growth that we believe is largely behind the region's resilience to the weakening economic growth in Germany. Therefore, even though the manufacturing recession in Germany has resulted in a marked slowdown in industrial production across the region in recent months, its adverse impact on economic activity has been partly mitigated by strong private consumption. The general regional trend is thus set to remain unchanged – buoyant household spending, underpinned by strong consumer confidence, tight labour markets (with the unemployment rate reaching historical lows), and rapid wage growth.

Furthermore, the strong expansion has been supported by solid investment growth in the region, which remains well above that of the euro area. In this regard, the disbursement of EU structural funds plays a crucial role, not least in the cases of Poland and Hungary, which are capable of absorbing more than 2% of GDP annually. Last but not least, both Poland and Hungary also rely on a favourable mix of loose monetary and fiscal policy, which further underpins their impressive growth performance.

Further healthy expansion ahead

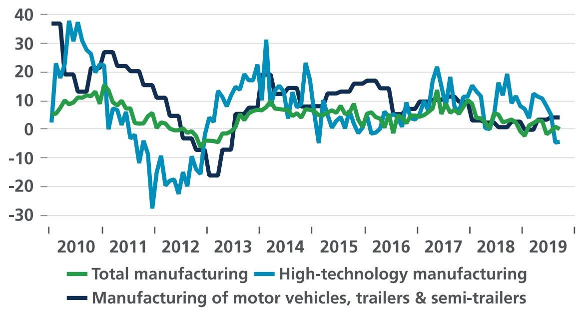
Looking further ahead, the growth prospects for the region remain positive. Nonetheless, much will be determined by economic momentum in the euro area, in particular, Germany. Despite the spectacular resilience seen so far, it would be naive to think that the region, which is so highly integrated into the German value chains (with the automotive industry as a prime example), would remain completely immune to long-lasting weakness in its key trade partner. In other words, the longer Germany remains "the sick man of Europe", the more challenging it will be for the Central and Eastern European economies to stay resilient.

For now, however, our base scenario assumes that economic activity in Germany will pick up again following the slowdown in 2019. In the absence of additional significant external shocks, such as a hard Brexit, economic growth across the region should remain healthy and only moderately slower in 2020. While intensifying supply constraints stemming from the labour markets are expected to increasingly constrain economic activity, the Central and Eastern European economies will continue to rely on domestic demand, especially on the strong consumer appetite fuelling private consumption. In addition, with the exception of Romania (which is currently on the verge of being placed under the EU's excessive deficit procedure), we see enough room for fiscal manoeuvring across the region. That is set to be partly used for non-discretionary spending (pensions and public wages) in 2020, but it should also stand ready to mitigate any unexpected weaknesses down the road. Overall, the region is well-positioned to continue outperforming the euro area in the remainder of 2019 and throughout 2020 and thus to remain on a fast convergence path.

Czech Republic

Figure CZ - Latest manufacturing production results show deterioration

Calendar Adjusted, SA, index 2015 = 100, % change year-on-year



Source: KBC Economics based on Eurostat

The first signs of a slowing economy

Although soft data, e.g. the PMI or confidence in industry, have, for more than a year, been indicating a decline in industry, which is the largest sector in the Czech Republic, only the latest production results clearly confirm this new unfavourable trend. In the last two months, production has declined in a large part of the manufacturing industry (figure CZ). However, in its largest component - the automotive industry - the results remain positive. This is mainly due to the current offensive of the largest domestic car manufacturer, which has launched several new and successful SUV models. And, as new orders indicate, this part of the industrial sector can continue to thrive. This double-track industry fits into the concept of a two-speed economy, which some central bank officials also refer to. The construction sector is also showing weaker performance. Although, as surveys between companies confirm, this is not the result of subdued demand, but rather a lack of capacity and, above all, a lack of staff.

Unemployment at the bottom

Despite a halt or even decline in growth in some sectors of industry and services, there have been no visible shifts in the labour market. Unemployment remained close to 2% in Q3, with vacancies remaining close to recent highs. Tensions in the labour market thus remain and are reflected in faster wage growth. Nevertheless, their upside inflationary impact is not so significant yet. Although inflation is in the upper half of the CNB's tolerance interval, its main cause is expensive housing. Rising prices of flats and rents are due to underdeveloped construction, while record energy prices based on electricity prices on the German market also contribute. Housing, together with volatile food prices, represents two-thirds of inflation in recent months.

The CNB is still waiting

At its November meeting, the Czech National Bank (CNB) Board voted on raising interest rates and, as in September, only two votes were found for this option. It can be seen that most of the Czech central bankers perceive foreign risks and uncertainties as a major obstacle to the continuation of so-called interest rate normalisation and prefer to wait. The CNB's new forecast envisages a two-fold increase in the repo rate in a very short time, but also a three-fold decrease in the second half of 2020. This somehow contrasts with the expected slowdown in GDP growth and inflation. Accordingly, the intention to raise rates is consistent only with the CNB's koruna forecast, which has the currency appreciating much slower than expected in all its previous forecasts. However, unless the Czech economy shows significant immunity to negative developments abroad in the coming months, the rate hike will not be very likely.

Thus, while short rates remain at their current levels, long ones have risen sharply in recent weeks. And there are at least two reasons behind the move. The first is developments in core markets, where the trend also reversed, and rates began to rise as concerns about further economic developments in the US and the euro area eased. The second is the hawkish rhetoric of the CNB, which still contrasts with the tune in the koruna market, which anticipates rather a decline in rates. The effect of these factors is significant volatility in the long end of the yield curve, and thus greater uncertainty in any future outlook. Therefore, it is all the more important to monitor changing trends in the domestic economy, and the domestic economy's reaction to developments in the Czech Republic's main trading partners.

Hungary

The NBH to stay dovish despite a weak forint and high core inflation. The Hungarian forint remains weak, and underlying price pressures in the overheated Hungarian economy remain very strong. Recall that Hungarian core inflation went up from 3.9% yoy to 4% yoy in October (figure HU), which is the highest reading since the end of 2012 (with the exception of May, when the figure was at the same level).

Hence, the key macro question in Hungary is still whether the low imported inflation may be able to counterbalance the weakening forint and the domestic driven price pressure, or whether the consumer price index will remain above the central bank's inflation target (3% yoy) for an extended period. We see that the labour market is still quite tight, so the wage dynamic might remain quite elevated in 2020. Additionally, households' willingness to borrow looks to be quite high, which also may boost domestic consumption. So, we think that the National Bank of Hungary (NBH) may miss its inflation target in 2020 as average headline inflation may be around 3.5% yoy.

Nevertheless, despite the accelerating inflation, the NBH may still maintain its dovish message, as it sees downside risks to inflation developments because of the external environment. In other words, the quite loose monetary conditions in Hungary may be maintained. At least the NBH hasn't increased the outstanding stock of HUF via foreign currency swaps. But we don't expect any substantial monetary tightening in the coming quarters.

Figure HU - Inflationary pressures at high levels
Consumer price index, % change year-on-year, national definition

Source: KBC Economics based on HCSO

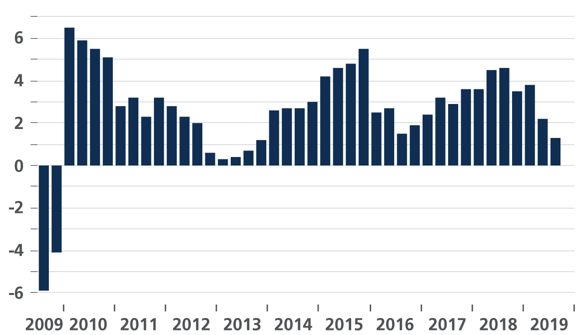
Slovakia

The economy is cooling

Economic growth slowed again in the third quarter of 2019. GDP growth reached 1.3% yoy according to the flash estimate, following the 2.2% yoy growth registered in Q2 (figure SK). Growth was affected by weaker external demand. Monthly statistics showed negative developments related to foreign trade due to a decline in exports. On the other hand, import dynamics remained untouched. Rising imports could signal higher consumer demand and investment growth. From the supply side, cooling GDP growth was affected by the worsening manufacturing, mainly in July and August. The visible impact of slower growth in main trading partners (e.g. Germany) was also evident in the automotive industry and production of metals.

Industrial production decreased in September compared to the previous year. This time, though, the fall was less pronounced. Industrial production fell year-on-year by 2.5%, after a slump by more than 8% in August, marked by summer holidays. Production fell particularly in the automotive, rubber, plastics and metal industries. Export results are signalling weaker demand for small and luxury cars produced in Slovakia. Conversely, the production of mid-class cars is growing. Overall, automobile production lost its standing as an export accelerator in the third quarter of 2019. The export of goods grew in September by 0.7% yoy. Imports, though, grew faster, at 5.7%. The accumulated surplus over the first nine months is 715 million euros, while a year ago this figure was some 2.2 billion euros. Another indicator signalling a slowdown at the end of the year is economic sentiment, which in October fell to 95.3 points in October, and is below its long-term average. Industry, retail and consumer confidence also decreased. This concerned in particular the expected falls in vehicle production and in the electrical industry. Conversely, confidence in services and in construction improved. The development of economic sentiment suggests slower economic growth at the end of 2019.

Figure SK - Economic growth slowed further in Q3
Real gross domestic product, index, % change year-on-year, national source



Source: KBC Economics based on SUSR

Inflation stagnates at 3%

Inflation in September remained at 3% yoy, the same value as a month earlier. Inflation was higher than predicted by the National Bank of Slovakia. This was due to growth in food prices and regulated prices. Food prices are rising faster than 5% yoy, driven in part by rising meat prices on world markets. Regarding domestic factors, inflation is being pushed by wage costs due to a rise in the minimum wage and in night work increments. Demand-side inflation was higher due to growth in prices of housing, catering and air tickets. Inflation should not continue to grow significantly and could fall slightly next year.

General government deficit and debt grew

The general government deficit increased after a second notification. In 2018, it reached -1.1% of GDP instead of the originally estimated -0.7% of GDP. Debt increased by 0.5 percentage points to 49.4% of GDP. For the purposes of comparison, the fiscal deficit in the EMU was -0.5% of GDP and public debt was 85.9% of GDP. Public debt is thus, again in the sanction zone according to the constitutional law on budgetary responsibility. This means that the Ministry of Finance will have to justify to Parliament the size of the debt and propose measures to further reduce it. Given the ECB’s current loose policy, though, this will clearly not affect the yield curve, or risk premiums. The Fitch rating agency confirmed Slovakia’s A+ rating with a stable outlook. Risk premiums for 10-year government bonds are around 40 points and yields copy the development of German Bunds.

Bulgaria

Upward revisions boost growth in H1 2019

While the original GDP readings suggested that the Bulgarian economy was gradually losing momentum in the first half of this year, the latest revisions showed that economic expansion remained on a solid footing. In Q1 2019 growth was revised upward by 0.4 percentage points to 3.9% yoy. In the second quarter the economy then expanded by 3.8% yoy following an upward revision of 0.3 percentage points. Such large revisions reflect the improved dynamics of domestic demand, pre-dominantly household consumption. This indicates that household spending remained more robust than we had expected, having been underpinned by high consumer confidence amid rapid wage growth and high employment. Meanwhile, stronger household consumption more than offset the downwards revisions to export growth, which reflect a more challenging external environment with key trading partners.

The revised data thus shows a striking contrast that is further confirmed by third quarter high frequency indicators. On the one hand, the external sector is clearly falling behind. The spill-overs from the increased uncertainty and less favourable external backdrop are most pronounced in the subdued dynamics of the industrial sector, driven by a sluggish performance across most of the manufacturing and utilities industries. On the other hand, consumer confidence continues to increase, and retail sales remain buoyant. This suggests that private consumption is set to remain the key driver of growth.

Overall, we believe that the fast pace of economic activity from H1 2019 will be difficult to maintain in the remainder of the year. First, a further deterioration of external performance might gradually kick in on the back of lagged contagion effects from an adverse external environment. Second, domestic demand, or more specifically household consumption, is also likely to cool down somewhat given limited room for further improvement in the labour market.

Inflation falls sharply lower

Price dynamics have been volatile in Bulgaria so far in 2019. While the beginning of the year saw the annual HICP inflation rate accelerating above 3.0% yoy, in September it slowed down sharply to 1.6% from 2.5% yoy a month earlier, marking the lowest reading since the start of 2018. Such a development is typical for this part of the year due to the end of the summer season and the decrease in some services prices. Hence, it comes as no surprise that September's drop reflects largely lower prices of in the segment of restaurants and hotels (-8.6% mom), recreations and culture (-3.5% mom) and transport (-2.1% mom). Meanwhile, the underlying inflation forces continue to be driven by food prices, lately influenced by the spread of African swine fever.

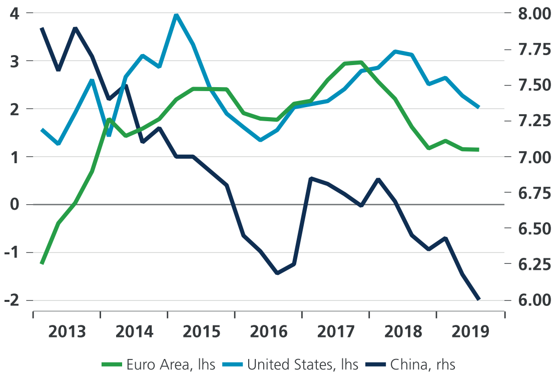
Government budget set to return to a balance in 2020

In October, Bulgaria's government approved the 2020 budget bill which targets a balanced budget. This year, the budget is expected to post a one-off deterioration, i.e. a fiscal shortfall of 2.1% of GDP, due to spending on fighter jets, thus ending three consecutive years of surpluses. Nonetheless, this one-off deterioration is unlikely to affect the medium-term sound fiscal performance. Overall, Bulgaria's public debt-to-GDP ratio is projected to gradually improve from 20.5% in 2019 to 16.5% in 2021, remaining among the lowest in the European Union.

In keeping with the trend set in recent years, the 2020 budget envisions increased spending on social policies, education and healthcare. More specifically, this will involve an increase in public wages by 10% at the beginning of 2020 or a rise in the minimum salary by BGN 610 starting January 2020 (which will be followed by an additional increase of BGN 650 in 2021).

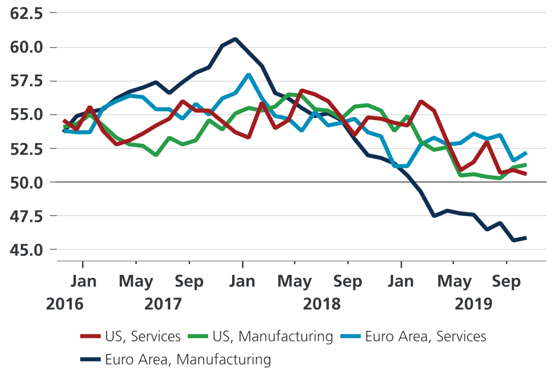
Figures

Real GDP
yearly change in %



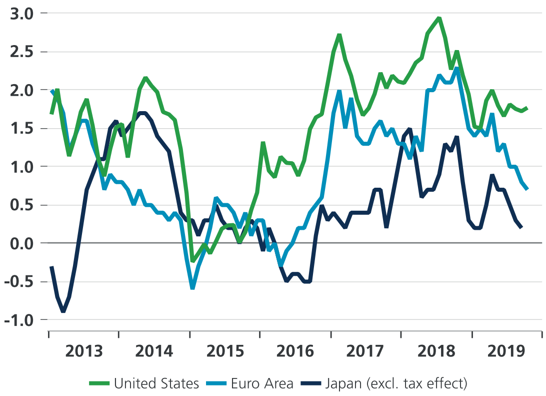
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



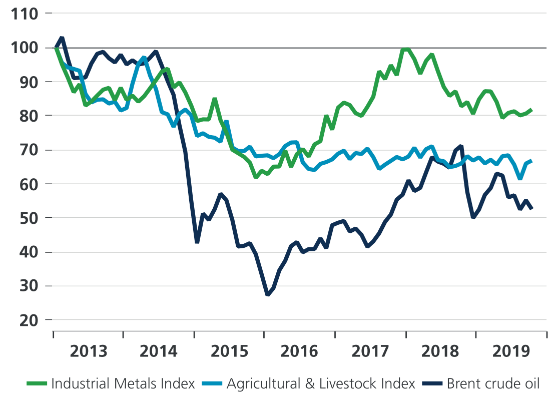
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



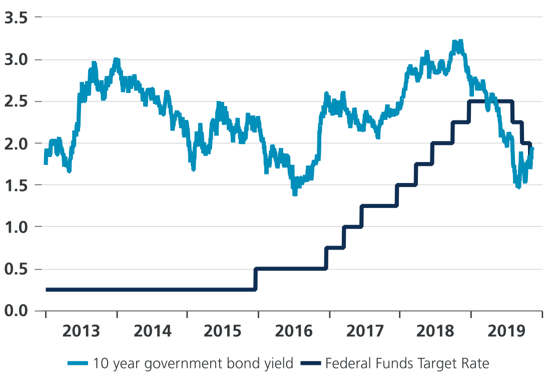
Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, BLS

Commodity prices
index, January 2013=100, in USD



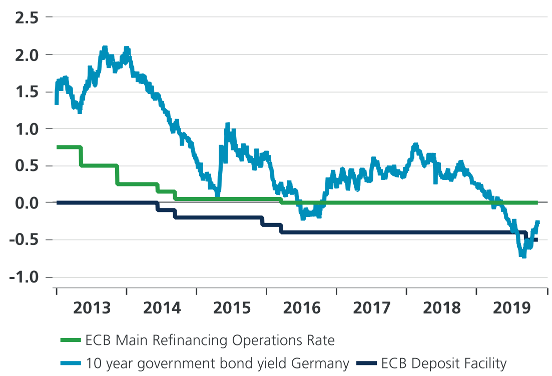
Source: KBC Economics based on World Bank, SPDJI

United States interest rates
in %



Source: KBC Economics based on Fed, Macrobond

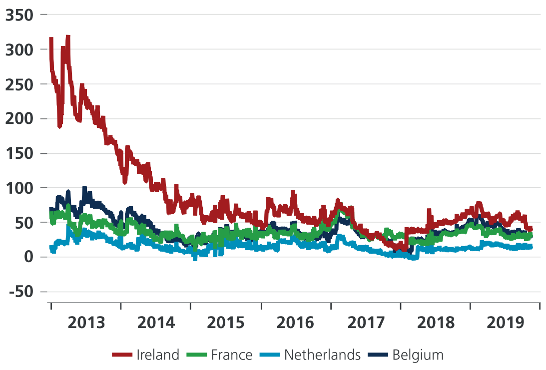
Euro area interest rates
in %



Source: KBC Economics based on Macrobond, ECB

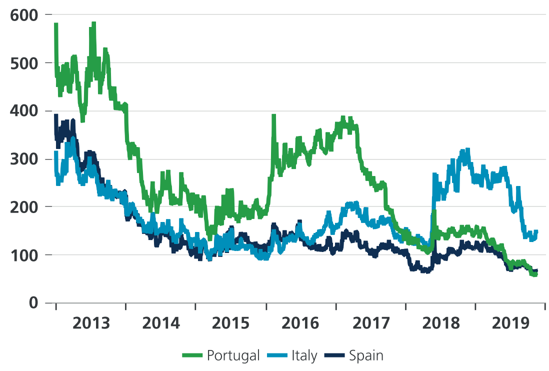
Figures

10 year government bond yield spreads to Germany
in basis points



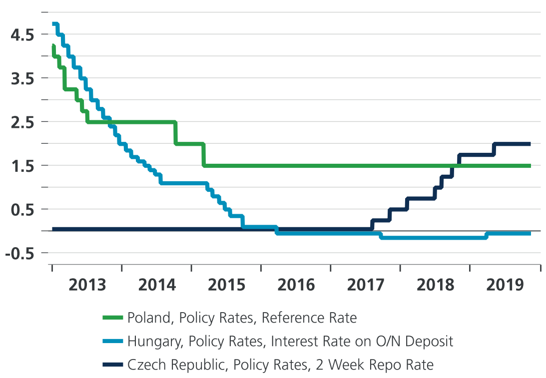
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



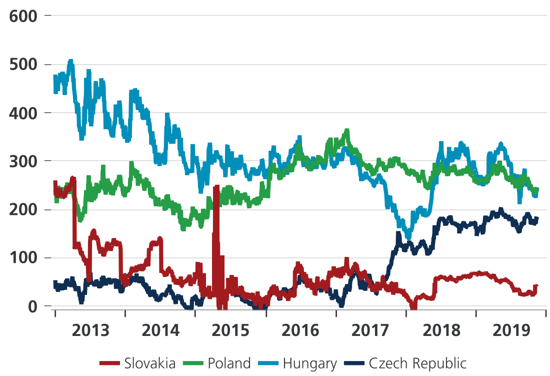
Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %



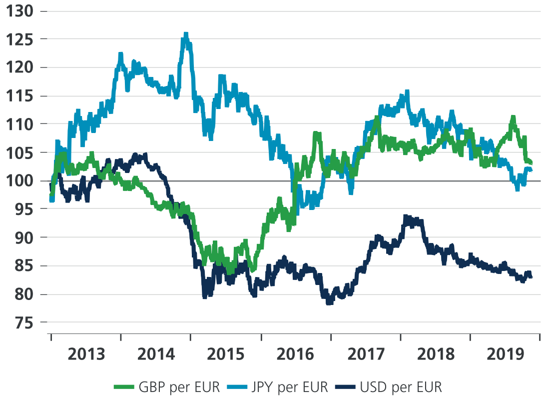
Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points



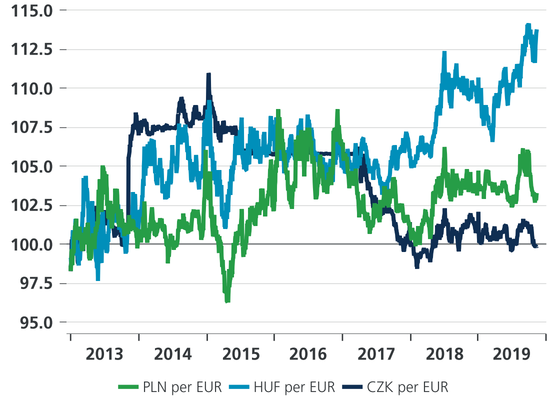
Source: KBC Economics based on Macrobond, AKK, Eurostat

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



Source: KBC Economics based on Macrobond

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



Source: KBC Economics based on Macrobond

Outlook main economies in the world

		Real GDP growth (period average, in %)			Inflation (period average, in %)		
		2018	2019	2020	2018	2019	2020
Euro area	Euro area	1.9	1.1	1.0	1.8	1.2	1.2
	Germany	1.5	0.5	0.7	1.9	1.4	1.5
	France	1.7	1.3	1.2	2.1	1.3	1.3
	Italy	0.7	0.1	0.4	1.2	0.8	0.9
	Spain	2.6	1.9	1.5	1.7	0.8	1.1
	Netherlands	2.6	1.7	1.5	1.6	2.6	1.3
	Belgium	1.5	1.3	0.9	2.3	1.4	1.4
	Ireland	8.2	5.0	3.0	0.7	1.0	1.5
	Slovakia	4.1	2.6	2.2	2.5	2.7	2.2
Central and Eastern Europe	Czech Republic	2.9	2.4	2.2	1.9	2.6	2.4
	Hungary	4.9	4.3	3.5	2.9	3.4	3.5
	Bulgaria	3.1	3.2	3.1	2.6	2.5	2.3
	Poland	5.1	4.3	4.0	1.2	2.1	2.7
	Romania	4.1	4.4	3.7	3.9	3.9	3.5
Rest of Europe	United Kingdom	1.4	1.2	1.1	2.5	1.8	1.9
	Sweden	2.4	2.0	1.9	2.0	1.9	2.0
	Norway	2.2	2.4	1.9	2.7	2.2	1.9
	Switzerland	2.8	0.8	1.2	0.9	0.5	0.6
Emerging markets	China	6.6	6.1	5.7	2.1	2.6	2.7
	India*	6.8	6.0	6.9	3.9	3.4	4.1
	South Africa	0.8	0.6	1.1	4.6	4.4	4.9
	Russia	2.3	1.2	1.7	2.9	4.5	3.7
	Turkey	2.6	-0.5	2.5	16.3	15.5	11.0
	Brazil	1.1	0.9	1.9	3.7	3.7	3.6
Other advanced economies	United States	2.9	2.3	1.7	2.4	1.8	2.1
	Japan	0.8	1.0	0.2	1.0	0.6	0.7
	Australia	2.7	1.7	2.3	2.0	1.6	1.8
	New Zealand	2.8	2.5	2.7	1.6	1.4	1.9
	Canada	1.9	1.5	1.6	2.3	2.0	1.9

* fiscal year from April-March

13/11/2019

Policy rates (end of period, in %)						
		13/11/2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
Euro area	Euro area (refi rate)	0.00	0.00	0.00	0.00	0.00
	Euro area (depo rate)	-0.50	-0.50	-0.50	-0.50	-0.50
Central and Eastern Europe	Czech Republic	2.00	2.00	2.00	2.00	2.00
	Hungary	-0.05	-0.05	-0.05	-0.05	-0.05
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.50
	Romania	2.50	2.85	3.00	3.00	3.00
Rest of Europe	United Kingdom	0.75	0.75	0.50	0.50	0.50
	Sweden	-0.25	0.00	0.00	0.00	0.00
	Norway	1.50	1.50	1.50	1.50	1.50
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	3.25	3.25	3.10	3.10	3.10
	India	5.15	4.90	4.75	4.75	4.75
	South Africa	6.50	6.50	6.25	6.25	6.25
	Russia	6.50	6.25	6.00	6.00	5.75
	Turkey	14.00	13.00	13.00	13.00	13.50
	Brazil	5.00	4.50	4.50	4.50	4.75
Other advanced economies	United States (upper limit)	1.75	1.75	1.75	1.75	1.75
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	0.75	0.75	0.75	0.75	0.75
	New Zealand	1.00	0.75	0.75	0.75	0.75
	Canada	1.75	1.75	1.75	1.75	1.75

Outlook main economies in the world

10 year government bond yields (end of period, in %)		13/11/2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
Euro area	Germany	-0.28	-0.40	-0.30	-0.20	-0.10
	France	0.02	-0.10	0.00	0.10	0.20
	Italy	1.31	1.00	1.30	1.60	1.90
	Spain	0.43	0.20	0.35	0.45	0.55
	Netherlands	-0.15	-0.25	-0.15	-0.05	0.05
	Belgium	0.01	-0.10	0.00	0.10	0.25
	Ireland	0.12	0.05	0.20	0.30	0.40
	Slovakia	0.03	-0.10	0.00	0.10	0.25
Central and Eastern Europe	Czech Republic	1.58	1.40	1.43	1.45	1.48
	Hungary	2.18	1.80	1.90	2.00	2.35
	Bulgaria	0.40	0.30	0.40	0.45	0.50
	Poland	2.11	2.00	2.10	2.20	2.30
	Romania	4.44	4.28	4.30	4.31	4.35
Rest of Europe	United Kingdom	0.78	0.70	0.75	0.75	0.75
	Sweden	0.05	-0.10	0.00	0.10	0.20
	Norway	1.58	1.45	1.55	1.65	1.75
	Switzerland	-0.41	-0.55	-0.45	-0.35	-0.25
Emerging markets	China	3.26	3.20	3.20	3.30	3.35
	India	6.53	6.55	6.65	6.75	6.80
	South Africa	8.50	8.40	8.40	8.50	8.55
	Russia	6.52	6.50	6.50	6.50	6.25
	Turkey	12.25	13.00	13.00	13.00	12.75
	Brazil	6.70	6.60	6.60	6.70	6.75
Other advanced economies	United States	1.90	1.80	1.80	1.90	1.95
	Japan	-0.05	-0.10	0.00	0.00	0.00
	Australia	1.26	1.20	1.20	1.30	1.35
	New Zealand	1.51	1.30	1.30	1.40	1.45
	Canada	1.61	1.45	1.45	1.55	1.60

Exchange rates (end of period)	13/11/2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
USD per EUR	1.10	1.11	1.12	1.14	1.16
CZK per EUR	25.57	25.60	25.40	25.30	25.20
HUF per EUR	334.88	332.00	328.00	323.00	326.00
PLN per EUR	4.28	4.28	4.26	4.25	4.30
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.76	4.75	4.75	4.70	4.65
GBP per EUR	0.86	0.86	0.88	0.89	0.91
SEK per EUR	10.71	10.65	10.60	10.55	10.50
NOK per EUR	10.12	9.90	9.80	9.70	9.65
CHF per EUR	1.09	1.10	1.10	1.11	1.12
BRL per USD	4.17	4.05	4.00	3.95	3.95
INR per USD	71.80	70.30	70.25	70.15	70.15
ZAR per USD	14.96	14.80	14.70	14.70	14.70
RUB per USD	64.37	64.00	65.00	64.00	64.00
TRY per USD	5.74	5.85	5.95	6.00	6.10
RMB per USD	7.02	7.05	7.10	7.15	7.15
JPY per USD	109.01	109.00	109.00	109.00	109.00
USD per AUD	0.68	0.69	0.69	0.70	0.70
USD per NZD	0.64	0.64	0.64	0.64	0.65
CAD per USD	1.33	1.32	1.31	1.30	1.30

Outlook KBC home markets

	Belgium			Ireland		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	1.5	1.3	0.9	8.2	5.0	3.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.4	1.4	0.7	1.0	1.5
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.8	5.7	5.9	5.7	4.9	4.9
Government budget balance (in % of GDP)	-0.7	-1.6	-2.4	0.1	0.3	0.4
Gross public debt (in % of GDP)	100.0	99.4	99.5	63.5	59.0	55.0
Current account balance (in % of GDP)	-1.0	-1.4	-1.8	9.1	-3.0	-3.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	2.9	2.7	2.1	10.2	2.5	2.5

13/11/2019

	Czech Republic			Slovakia		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	2.9	2.4	2.2	4.1	2.6	2.2
Inflation (average yearly change, harmonised CPI, in %)	1.9	2.6	2.4	2.5	2.7	2.2
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.0	2.0	2.1	6.1	6.2	6.3
Government budget balance (in % of GDP)	0.9	0.0	-0.5	-1.1	-1.2	-1.5
Gross public debt (in % of GDP)	32.7	31.0	30.3	49.4	48.0	47.5
Current account balance (in % of GDP)	0.3	0.2	0.1	-2.5	-3.0	-3.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	8.6	7.0	2.0	7.4	5.0	4.0

13/11/2019

	Hungary			Bulgaria		
	2018	2019	2020	2018	2019	2020
Real GDP (average yearly change, in %)	4.9	4.3	3.5	3.1	3.2	3.1
Inflation (average yearly change, harmonised CPI, in %)	2.9	3.4	3.5	2.6	2.5	2.3
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	3.6	3.5	3.5	4.8	4.7	4.6
Government budget balance (in % of GDP)	-2.2	-1.8	-1.0	0.1	-0.5	0.4
Gross public debt (in % of GDP)	70.8	68.7	65.9	22.1	19.0	17.7
Current account balance (in % of GDP)	0.5	-0.2	-1.0	2.4	1.2	1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	9.7	9.0	9.0	6.6	5.0	4.0

13/11/2019

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	Mathias Janssens	Jan Cermák	Dávid Németh	Petar Ignatiev
Senior Economist	Analyst	Senior Analyst	Chief Economist	Chief Analyst
johan.vangompel@kbc.be	mathias.janssens@kbc.be	jcermak@csob.cz	david2.nemeth@kh.hu	Petar.Ignatiev@ubb.bg
Lieven Noppe	Dieter Lapeire	Jan Bureš		
Senior Economist	Analyst	Senior Analyst		
lieven.noppe@kbc.be	dieter.lapeire@kbc.be	jabures@csob.cz		
			KBC Bank Ireland	
Cora Vandamme		Petr Báca	Austin Hughes	
Economist		Analyst	Chief Economist	
cora.vandamme@kbc.be		pbaca@csob.cz	austin.hughes@kbc.ie	
	CBC			
Jill Van Goubergen	Bernard Keppenne	Irena Procházková	Shawn Britton	
Economist	Chief Economist	Analyst	Economist	
jill.vangoubergen@kbc.be	bernard.keppenne@cbc.be	iprochazkova@csob.cz	shawn.britton@kbc.ie	
Allison Mandra		Dominik Rusinko		
Economist		Analyst		
allison.mandra@kbc.be		drusinko@csob.cz		
		Wouter Beeckman		
		Analyst		
		wbeeckman@csob.cz		

For general information:

KBC.Economic.Research@kbc.be

Visit our website www.kbceconomics.com 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