Economic perspectives

April 2020

Highlights

- The corona crisis is a major shock to the global economy. Economic growth will move into negative territory in the euro area and the US, but our base scenario envisages a strong recovery in 2021. This base scenario is, however, subject to major uncertainty. In general, risks are tilted to the downside.

- The epicentre for the covid-19 virus outbreak is on the move from China over Europe to the US. It is clear that all countries in the world will be affected, leading to a globally synchonized growth decline. In combination with lower oil prices, due to a negative supply and demand shock, this will result in major deflationary pressure on the global economy.

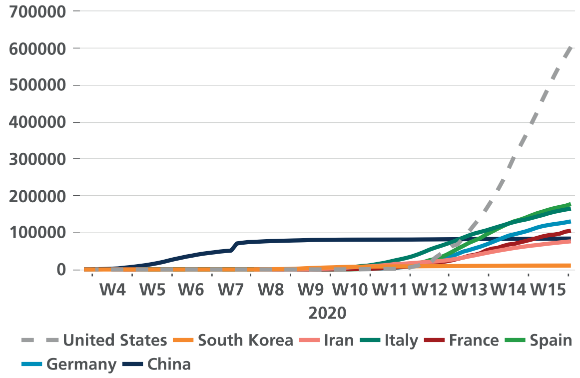
- Also emerging markets have been hit hard by the covid-19 crisis, but the health and economic impact could be even more severe and longer lasting than what's expected in advanced economies. Weaker public health systems, higher inequality and poverty, more limited fiscal space, and external vulnerabilities are factors that may exacerbate the coronavirus shock in emerging markets. There are, however, significant differences between the countries with some having better macroeconomic fundamentals and fewer external vulnerabilities (e.g. emerging Asia) than others.

- Fiscal and monetary policy initiatives aim to mitigate the economic impact of the corona crisis and to boost the recovery. However, policy reactions differ across countries, even within the EU. Monetary policy is expected to stay extremely accomodative in the future.

Global economy

The outbreak and international spread of the covid-19 virus is undoubtedly the main event now dominating the international economic outlook. Primarily, the corona crisis is a major health crisis and a human tragedy due to the loss of many lives despite all precautions and health care responses. Recent figures indicate that the pandemic's epicentre shifted from China over Europe to the US (figure 1). While the number of infected people seems to have stabilized in China, Europe is still struggling to cope with the situation. Nevertheless, among the largest economies, the US is facing the most gigantic challenge which at present the US healthcare system is struggling to deal with. The covid-19 virus continues its international spread, reaching all countries in the world, making it a true pandemic as designated by the World Health Organization (WHO).

Figure 1 - Novel coronavirus (covid-19) confirmed cases



Source: KBC Economics based on WHO

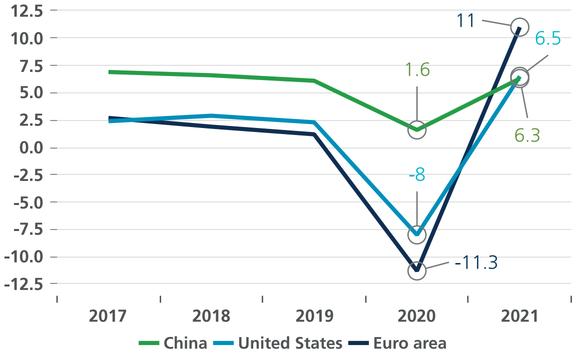
The virus itself as well as numerous policy responses to contain its spread are having a tremendous and most likely unprecedented impact on the global economy. As most countries introduced quarantine measures and in many cases far-reaching lockdown policies, economic activity slowed down substantially and was almost completely halted in certain sectors. There is no doubt that the covid-19 virus has changed the macro-economic outlook for the global economy. Most importantly, global growth will tumble as suggested by recent forward-looking indications in sentiment indicators. Both manufacturing and services are heavily impacted. Particular sectors like restaurants, tourism and retail trade are facing unprecedented drops in their economic activity as the corona crisis causes a negative demand shock. Simultaneously, the corona crisis is a negative supply shock too. In its early stage, while the covid-19 virus outbreak was still considered a major challenge to the Chinese economy alone, it became clear that global supply chains would be hit. This has only worsened as not only Chinese factories, but gradually factories in most countries are now facing production challenges and logistic difficulties to source inputs and service their international clients. Not surprisingly, the World Trade Organisation (WTO) recently indicated that it expects a major drop in global trade in 2020.

Despite the negative impact of the corona crisis on the global economy, it is important to emphasize that this is not a normal recession, but a temporary standstill due to the virus containment measures. One could compare it with the following: "The car doesn't drive because the traffic light has suddenly turned red, not because the engine has seized. Once the light turns green, the car will drive again, although some cars will restart faster than others."

Due to the corona crisis, the synchronized growth slowdown in 2019 won't be followed by a widespread international recovery, as many expected before the covid-19 pandemic, but rather by a major economic depression. The good news, however, is that this shock is due to a major health crisis and not due to notably poorer economic dynamics. The fundamental features for the global real economy before the virus outbreak weren't bad at all: many economies were at or near full employment, services activities were compensating for the decline in manufacturing activities that suffered in particular from the US-China trade war and the Brexit chaos, and private investment was growing in a low interest rate environment. The corona crisis will shake the structure of the global economy, but it's unlikely to fundamentally derail the global economy from its long-term growth path. While it is still too early to assess the long-term impact of this corona crisis, it is likely that certain things will change in the global economy in the aftermath of the corona crisis. A case in point is the international struggle to get sufficient medical supplies. One may expect that governments will aim to improve their access to such medical products. From a business cycle perspective, we believe that the economic shock caused by the covid-19 virus will be heavy, but short. Moreover, the recovery will be boosted by various policy initiatives to mitigate the economic damage (see further). Hence this will lead to a very dynamic episode in the global business cycle with a major growth decline in 2020 followed by a remarkable recovery in 2021.

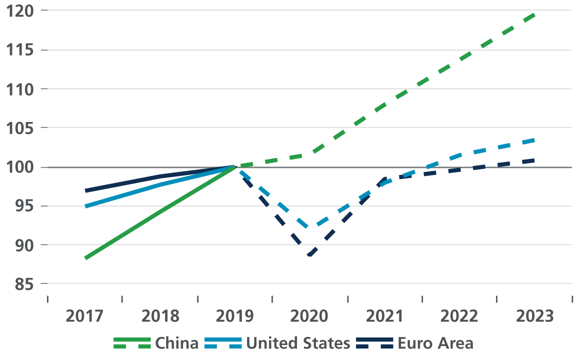
Despite this general expected growth pattern, the future virus evolution and policy reactions to it are subject to substantial uncertainty. This makes conventional forecasts of limited value given the potentially wide range of possible outcomes. Therefore we work with multiple scenarios to assess the future economic outlook. Apart from the base scenario, we distinguish

Figure 2 - Base scenario real GDP growth forecasts
annual average real GDP growth, in %



Source: KBC Economics

Figure 3 - Real GDP level
rebased 2019 = 100



Source: KBC Economics

between a more optimistic and a more pessimistic scenario. These three scenarios are distinct from each other in terms of the virus evolution, the lockdown measures and the economic implications. In our base scenario we assume that the current lockdown measures will be continued, by and large, in the euro area as well as in the US throughout the second quarter. The high human toll of the covid-19 virus makes it unlikely that governments will quickly relax precautionary measures. After all, the search for large-scale tests to identify infected people is still in its infancy. Moreover, the search for a vaccine will most likely take much longer. Only in the third quarter, does this scenario envisage that the precautionary measures will be gradually lifted. Consequently the first and second quarters will be hit substantially in the euro area, while the US follows – as the covid-19 virus reached the US later than Europe – with a substantial drop in the second quarter and a minor drop in the third quarter. Hence the quarter-on-quarter recovery starts only in the third quarter in the euro area and in the fourth quarter in the US. The recovery continues into 2021 leading to a strong year-on-year growth rebound in the calendar year 2021.

Compared to the base scenario, our 'optimistic' scenario assumes a shorter period of lockdown or disruption from far-reaching precautionary measures. Such a scenario could come about if extensive testing for covid-19 can be implemented or simply because society increases the pressure on governments to lift currrent lockdown policies. Such a scenario would automatically translate into a more limited downfall in economic growth. Finally, our 'pessimistic' scenario assumes that the covid-19 virus is not under control until a vaccine becomes available. As society may be opposed to long periods of lockdowns, governments might opt for on-off lockdown periods to migitate the impact on the health care system. Alternatively, it could be the case that there are periodic outbreaks of the virus forcing the repeated re-introduction of health related curbs on economic activity. Such a scenario implies that economic activity could be restarted soon, but would also be forced to shut down again later on. In general this will imply that the recovery from the corona crisis will take much longer. We assign probabilities to each of these scenario. At the moment, we're giving a 50% probability to the base scenario, 15% to the optimistic scenario and 35% to the pessimistic scenario. Hence risks are tilted to the downside.

Numerical scenarios

Our base scenario is shown in figure 2. In terms of annual numbers we expect a similar pronounced V-shaped pattern in all major economies. Note that one could call it rather a U-shaped pattern on the basis of a quarterly numbers, taking into account the gradual recovery in the second half of 2020. However, while the broad shape of the swings in activity are similar, the scale of impact differs substantially. In absolute terms, euro area growth is likely to be hit more than the US due to the drastic precautionary policy reactions in most European countries and the slower and more limited fiscal reaction. Europe's international openness to trade and investment as well as a weaker starting point in terms of lower growth in 2019 will also play against Europe. For the euro area, we expect growth to decline by 11.3 %, while US growth will drop by 8 % in 2020. We expect a similar recovery in 2021 in both regions, namely 11 % in the euro area and 6.5 % in the US. For China we presume a growth of 1.6 % in 2020, down from 6.1 % in 2019, and a recovery to 6.3 % in 2021. Under our base scenario this pattern implies a rather fast return to the long-term growth path, although it will take a while, in particular in the euro area, before the full effect of the corona crisis will be absorbed (figure 3).

Table 1 - Real GDP growth forecast in three scenarios
in %

Optimistic scenario					
	2017	2018	2019	2020	2021
Euro area	2.7	1.9	1.2	-6.0	6.5
US	2.4	2.9	2.3	-4.5	3.0
China	6.9	6.6	6.1	2.6	6.0
Base scenario					
	2017	2018	2019	2020	2021
Euro area	2.7	1.9	1.2	-11.3	11.0
US	2.4	2.9	2.3	-8.0	6.5
China	6.9	6.6	6.1	1.6	6.3
Pessimistic scenario					
	2017	2018	2019	2020	2021
Euro area	2.7	1.9	1.2	-14.0	-3.2
US	2.4	2.9	2.3	-10.0	-2.8
China	6.9	6.6	6.1	0.4	5.3

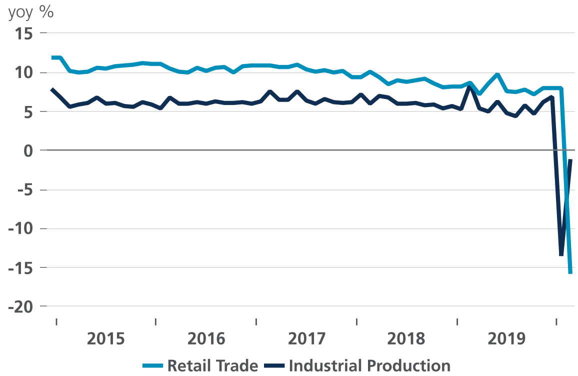
Compared to the base scenario, our optimistic scenario has a milder V-shaped pattern. In the pessimistic scenario the growth decline in 2020 is larger, ranging from -14% in the euro area, over -10% for the US to 0.4% for China. In 2021 one won't see a similar recovery in the euro area and the US yet. Euro area real gdp growth will equal -3.2% in 2021, against -2.8% for the US. One has to wait for 2022 to get a stronger recovery. All figures are available in table 1.

Hopeful news from China

In recent weeks, the number of new cases as well as covid-19 casualties dropped substantially throughout China. The Chinese city of Wuhan is considered the initial epicentre of the covid-19 pandemic. Symbolically, social and economic life is restarting in Wuhan. Meanwhile, Chinese economic indicators such as vehicle sales are the first to signal that economic activity is likely to recover soon after the virus gets under control. Additional March data suggest that the recovery is more dynamic in the manufacturing sector compared to the services sector, which in turn reflects the fact that businesses and factories have reopened, but consumers are still very cautious. Retail trade contracted sharply again in March (-15.8% yoy), while industrial production only contracted by 1.1% yoy in March, compared to a 13.5% contraction in February (Figure 4). In general, what more recent data out of China suggest is that the relative bounce-back after the lockdown can be strong, but that in terms of output levels, it will take more time to return to the pre-covid-19 scenario.

The fact that economic life in China is restarting relatively fast after the start of the virus outbreak is hopeful news for the global economy. Moreover, as a major economy, the Chinese recovery contributes to mitigating the economic shock in western economies. The Chinese demand for western goods as well as the Chinese supply of products will gradually recover. Despite these optimistic signals one has to be cautious. First, China remains vulnerable to the virus as a recent number of new cases indicate that people travelling from abroad may import the virus again into China. Second, the production and sales decline in the Chinese economy was sizeable, hence a full recovery may take a while and will be more difficult given the slowdown of the global economy.

Figure 4 - Chinese economic indicators



Source: KBC Economics based on NBS

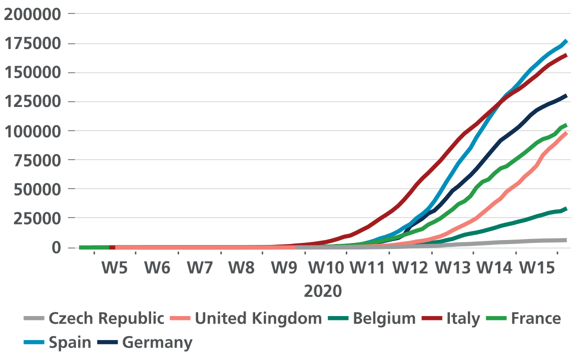
We expect Chinese real GDP growth to start to recover already in Q2, but growth in year-over-year terms will remain weak compared to China's previous growth path. This is because the threat of a new wave of covid-19 cases is still a risk in China, the very weak growth we expect globally in Q2 will weigh on China's growth, and confidence will likely be slow to fully recover. Overall, we expect China to grow only 1.6% in 2020, compared to 6.1% growth in 2019. In 2021, however, we expect annual growth to recover to 6.3%.

Struggle in Europe

After the initial outbreak in Northern Italy, the covid-19 virus succeeded in spreading widely across most of the European continent as well as the UK and Ireland (figure 5). Despite initially different approaches, most European countries turned to a broadly similar strategy of far-reaching quarantine and lockdown measures. The ultimate purpose is to reduce the near-term inflow of patients into hospitals as the number of hospital beds and other medical equipment would be insufficient to treat all patients simultaneously. Most European countries appear to be succeeding in this strategy. However, in certain regions of Italy and Spain, it is clear that hospitals have been overwhelmed by the number of covid-19 cases.

On the economic front, European governments are taking similar initiatives too, but there are also clear differences. Throughout Europe, governments aim to mitigate the impact of the corona crisis through temporary fiscal support to businesses and households. Fiscal support should help companies and individuals to survive the temporary economic shock. The financial sector is strongly involved to facilitate and support these temporary solutions. As such, the full force of the crisis can be avoided, in particular for fundamentally sound firms and households that face a temporary drop in their incomes. Special attention is paid to the situation in regard to the labour market. Most European countries introduced some kind of temporary unemployment schemes (see Box 1). Their purpose is to enable a faster restart after the lockdown measures are lifted and to avoid people losing jobs permanently. In the less flexible continental European labour markets, in particular, these kind of measures make sense. By contrast it might be expected that Anglosaxon countries like the UK and Ireland could face a more substantial increase in their unemployment rates. Apart from those transitory policies a debate is now underway in many countries to come up with more structual fiscal support to boost the recovery through public investment. However, European countries differ substantially in the available fiscal space to finance these kind of major policy actions. Both the temporary policies and an eventual increase in structural investment will undoubtely lead to large fiscal deficits and increasing public debt ratios in all European countries. Hence the corona crisis will cause a major deterioration in public finances. Given the exceptional nature of the corona crisis, most economists agree that these circumstances justify this kind of policy reaction.

Figure 5 - Novel coronavirus (covid-19) confirmed cases in Europe



Source: KBC Economics based on WHO

It is very regrettable that a major crisis like this corona crisis has led to European countries dealing with the issue separately. European coordination and cooperation remains limited. Health care is obviously a national competency and hence there isn't much the EU can do apart from some international coordination. In terms of economic policies the EU has more responsibilities, but unfortunately it lacks the automatic tools in scope as well as size to act fast and convincingly. There are no automatic fiscal stabilizers at the EU level. The common EU budget is much too small to deal with a major economic shock nor has it been designed for any role in such circumstances. Hence the EU can only provide support if new budgets and/or new instruments are created, similar to what happened after the global financial crisis and the European sovereign debt crisis.

So far, negotiations in the Eurogroup and the European Council have not gone smoothly. Individual European governments clearly disagree as to the kind of support mechanisms that should be launched and in particular on how and to what extent financial solidarity should underpin such support. The Dutch government has been the most visible opponent of massive financial support to countries hurt by the crisis, in particular to Southern European countries. However, the Dutch view is shared to varying degrees by a number of other (richer) EU member states. The latest compromise resulted in a measure of European support to small and medium sized enterprises as well as to temporarily unemployed people. The European

Investment Bank as well as the European Stability Mechanism will be used to provide some fiscal support to countries in need. However, it is clear that these European initiatives will be insufficient to cope with the corona crisis. It remains to be seen whether additional European initiatives will be launched in the future. If not, there is a risk that the European economy will face a more difficult recovery period as well as longer-term negative consequences of this unfortunate economic shock.

As European countries are hurt to various extents by the covid-19 virus and as policy reactions to the corona crisis differ across countries, we expect that European countries will face different growth dynamics. However, the general pattern remains the same: a major drop in economic growth in 2020 followed by the recovery in 2021. The magnitude of the shock as well as of the recovery differs, however, across countries (table 2).

New epicentre in the US

While European countries are getting the covid-19 virus spread under control, the US is now the main battleground against the covid-19 virus. Several US states have been hit hard by the virus outbreak. The state of New York, and New York City in particular, is currently hit the hardest, leading to an apocalyptic picture that one wouldn't expect in the richest country of the world. There is clearly no uniform, nationwide approach to deal with the corona crisis. Differences across US states, in terms of lockdown measures, precautions as well as other policy initiatives, are substantial.

Though the US healthcare system is clearly unable to cope with the covid-19 challenges, the US policy reaction to deal with the economic impact of the corona crisis has been much faster and far-reaching than in Europe. The US government, with the support of the Trump administration, the Senate and the House, launched a 2 trillion USD fiscal support package, which is roughly 10% of total US GDP. Apart from emergency budgets for the health care system, it includes financial support to companies as well as to US individuals and households. The latter includes an expansion of unemployment insurance as well as direct financial support, so-called helicopter money. All American citizens as well as US residents with a social security number will receive a cheque that will boost their consumption. Though the US policy reaction is far larger than in Europe, it was also more necessary as the US doesn't have similar automatic stabilizers as in most European countries due to their social security systems.

Emerging markets

As is the case nearly everywhere in the world, the covid-19 shock to emerging markets has been sharp, swift in its onset, and unprecedented. In many ways, however, the impact on emerging markets, from both a public health and economic perspective, may be even more severe and longer lasting than what's expected in advanced economies. Weaker public health systems, higher inequality and poverty, more limited fiscal space, and external vulnerabilities are factors that may exacerbate the coronavirus shock for many emerging markets. The sharp reversal in capital flows seen since the beginning of the year will only amplify these problems. Not all emerging markets fit the same picture, however. Some have better macroeconomic fundamentals and fewer external vulnerabilities, which will allow them to experience a more pronounced and dynamic rebound after the health crisis subsides. In particular, emerging Asia appears to be in a much better condition to face the current shock compared to other emerging markets. Furthermore, while times ahead may be very turbulent, with smaller, more vulnerable countries likely facing funding pressures, we expect that international players such as the IMF, World Bank and major central banks will step in as needed to prevent a systemic crisis that would threaten to derail the post-coronavirus global economic recovery. Indeed, we are already seeing first signs of such international coordination as the G20 discusses a

Table 2 - Real GDP growth forecast
annual average in %

	Optimistic scenario			Base scenario			Pessimistic scenario		
	2019	2020	2021	2019	2020	2021	2019	2020	2021
Germany	0.5	-5.5	6.0	0.5	-9.0	10.8	0.5	-11.5	-1.0
France	1.2	-6.0	6.5	1.2	-9.5	11.2	1.2	-12.0	-5.0
Italy	0.1	-8.0	9.0	0.1	-16.5	10.9	0.1	-19.1	-6.5
Spain	2.0	-7.0	8.0	2.0	-16.6	10.9	2.0	-19.6	-2.8
Netherlands	1.7	-5.5	6.0	1.7	-9.7	10.6	1.7	-12.2	-1.0
Belgium	1.4	-5.0	6.0	1.4	-9.5	12.3	1.4	-13.2	-3.2

Box 1 – Temporary unemployment a crucial pillar in avoiding a prolonged recession

Estimates for average real GDP growth in 2020 are written in blood red ink. The seldom seen negative numbers are the result of sudden stagnation in large parts of the economy due to covid-19. Nevertheless, there is also an optimistic element in the severely negative growth figures. After all, the base scenario assumes that the economy will largely recover as measures against the spread of the virus are lifted. In other words, the stagnation of the economy will not trigger a downward spiral of mass redundancies and bankruptcies. A crucial pillar for this scenario is the schemes of temporary unemployment and income support, which are now being activated, extended or created in many countries.

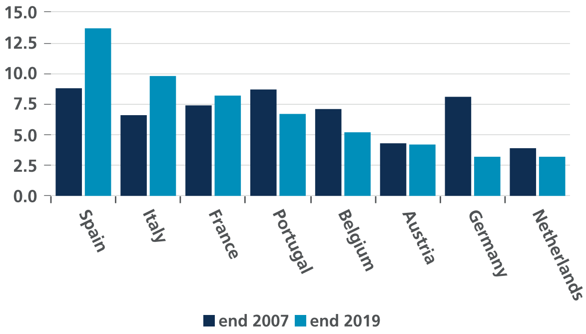
A sharp drop in turnover normally encourages companies to lay off employees. However, by this production capacity is definitively lost. When demand later picks up again, they have to look for new suitable employees. These employees have to learn the production processes again. This takes time (and costs) and slows down the restart of the economy. Companies with highly specialised employees will try to avoid dismissals as long as possible in the event of a drop in demand. In this way, they prevent the search and start-up costs when demand recovers. However, a sudden and very sharp drop in demand, such as today, reduces their financial breathing space for this. Moreover, the corona crisis primarily affects service sectors, where employees are sometimes a little less specialised and companies will still want to say goodbye to them sooner.

Temporary unemployment or income support systems help to prevent this. Belgium has long been familiar with the system of temporary or technical unemployment. Internationally, reference is often made to the German system of Kurzarbeit. It allows companies in certain circumstances to limit the working hours of employees. A government allowance then compensates, at least partially, for their loss of income. Thanks in part to Kurzarbeit, unemployment in Germany hardly rose during the deep recession after the financial crisis of 2008. Belgium, too, experienced only a limited rise in unemployment at that time.

Anglo-Saxon economies did not have such systems. They generally have more flexible labour markets. Economic shocks cause unemployment to rise faster and more sharply. In normal circumstances, a stronger recovery follows. Nevertheless, it reduces macroeconomic stability. Especially when, as at present, labour-intensive sectors with sometimes relatively low wages are hit. The loss of purchasing power as a result of mass redundancies can then sharply amplify the fall in demand in the economy and fuel a negative spiral. This will further increase the economic damage. The recovery from a deep crisis then threatens to drag on for longer, resulting in even more economic damage. As unemployment lasts longer, skills are lost. Ultimately, the long-term growth potential of the economy is eroded.

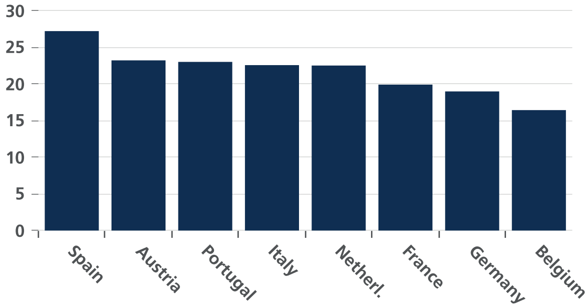
Many countries are now relying heavily on systems of temporary unemployment and income support. Existing systems are being extended and conditions made more flexible. The abruptness and scale of the economic shock make rapid and smooth

Figure B1.1 - Unemployment rate
as percentage of labour force



Source: KBC Economics based on Eurostat

Figure B1.2 - Employment in most vulnerable services sectors*
as percentage of total employment, latest figure
* horeca, retail & wholesale, arts, entertainment and recreation



Source: KBC Economics based on Eurostat

implementation essential. The UK is creating a system, and even in the US small businesses receive government support if they retain workers. Systems are also being set up in Central Europe, often in the form of wage subsidies to companies, similar to the French system of temporary unemployment

Temporary unemployment and income support systems are crucial in a crisis like this one. But they also cost the government a great deal of money. In principle, however, they are temporary expenditures. They do not structurally worsen public finances. They do not pose a problem if the objective of a rapid pick-up in economic output as soon as demand picks up is achieved. If that does not happen, or is insufficient, a problem for public finances will arise. Unemployment then becomes permanent and requires a different economic policy.

In this context, Spain deserves special attention. Despite strong economic growth in recent years, unemployment has still not returned to its pre-financial crisis level of end-2007 (figure B1.1). Today, the Spanish labour market once again appears to be one of the most vulnerable in Europe. More than a quarter of total employment is in services sectors which are very sensitive to corona crisis measures. This is significantly more than in the other (medium) large economies in the euro area (figure B1.2). The risk that part of the temporary unemployment will eventually become permanent is highest there.

moratorium on debt payments for low income countries.

Monetary policy as first defence line

As in normal in times of crisis, all central banks are playing a crucial role in mitigating the impact of the covid-19 pandemic. They clearly learnt from previous crisis periods and acted rather quickly and aggressively. Wherever possible, interest rates were lowered fast, and massive liquidity was provided to the financial markets where the demand for cash surged due to uncertainty. Moreover, additional unconventional policy tools have been used which basically seek to control over the full yield curve. By using these instruments, central banks seek to ensure that additional debt creation will be possible at reasonable interest rates. Moreover, by purchasing government and corporate bonds in unlimited quantities, the Fed and ECB have effectively signalled that the financial costs resulting from the corona crisis can be financed in the future.

Despite similar initiatives by all major central banks, it is clear that the ECB has not been as ambitious or as fast-moving in its reactions as the Fed. Initial mis-steps by the ECB led to a temporary upswing in long-term rates and intra-EMU spreads. It is clear that markets are nervous. A strong ECB commitment replicating Mario Draghi's famous promise to do 'whatever it takes' to keep the euro area together (again) and backed up by credible and far-reaching actions is needed to ease market tensions. However, scope for dramatic monetary actions is limited by the current low level of rates, by differences of opinion within the ECB and by the fact that the nature of the current crisis emphasises other forms of policy response beyond the competence of the ECB. Nevertheless, at this moment, by accident as much as design, the ECB is Europe's main line of defense against the financial impact of the corona crisis.

Oil price

An accident never comes alone. The corona crisis has coincided with a major drop in oil prices due to a political conflict between major oil-producing countries Saudi Arabia and Russia. This led to a strong increase in Saudi Arabia's oil production adding to a major drop in global oil prices, prompted by the lower demand for oil due to the corona crisis. The combined negative demand and supply shocks on the oil market resulted in a major drop in the oil price to around 20 USD per barrel. The oil price recovered from these extremely low levels after the US insisted on negotations between Saudi Arabia and Russia which resulted in an agreement to cut oil production again. Nevertheless, we expect oil prices to remain low in the near future as the major economic contraction caused by the corona crisis will continue to depress global demand for oil.

The combination of lower oil prices and a major global growth decline will lead to a substantial drop in global inflation. For the euro area and the US we even expect negative inflation in 2020.

Central and Eastern European Economies

Corona crisis hits Central and Eastern European economies too

Central and Eastern Europe is hit hard by the corona crisis too. Although the figures concerning the spread of the virus in the Central and Eastern European region are not as dramatic as in Western Europe, it is clear that the region will suffer from an unprecedented growth decline due to hits to the domestic economies in combination with negative international spillovers. For the Central and Eastern European countries, we also distinguish between three scenarios to assess the impact on real GDP growth. We expect the region to follow a similar growth decline and recovery path as the euro area, although the recovery is likely to be somewhat slower. We're confident that policy initiatives will boost the recovery. However, some specific features of the region's economy are likely to slow down the recovery. In particular, the strong dependence on multinationals, which may favour recoveries in their headquarter markets first, may lead to a slower recovery in the region. In addition, the relatively strong focus on the automotive industry, which is confronted with structural issues like declining global demand and technological transitions, is also expected to cause a slower recovery path. In our base scenario we still believe that the substantial growth decline in 2020 will be substantially compensated by the recovery in 2021 (table CEE1).

In many cases, the policy responses to the pandemic shock in Central and Eastern Europe were very similar to what we can see in more developed countries. We discuss both monetary policy initiatives and fiscal policy reactions.

Central banks deploying full arsenal

It was the regional central banks that put themselves at the frontline of the battle against the corona crisis, using virtually their full arsenal of monetary and regulatory measures related to banks' capital to mitigate as much as possible the crisis' impact. Hence, monetary policy acted faster and more swiftly than fiscal policy. Table CEE2 provides an overview of all monetary policy decisions taken.

In Central and Eastern European countries with their own floating currencies and independent monetary policy, the first logical step was reducing the official interest rates. Here, the best starting position was held by the Czech National Bank (CNB), which somewhat incomprehensibly increased its interest rates to 2.25% in February only. The CNB has since decreased its main interest rate by 125 bp so far, but it is obvious that further reductions will follow. The central banks of Poland and Romania were in a similarly advantageous position and decided to decrease their interest rates by 100 bp and 50 bp respectively. Both central banks supplemented their rate cuts by another conventional expansionary measure in the form of a decrease in minimum reserve requirements. In addition to that, the National Bank of Poland (NBP) launched aggressive purchases of Polish government bonds with a clear goal to ensure low financing costs of the huge public fiscal deficit. This expansionary monetary policy move by the NBP triggered a depreciation of the Polish zloty. Currencies elsewhere in the region also came under downward pressure (Figure CEE). The Hungarian forint in particular has weakened since the start of the pandemic. The forint weakening was actually so significant that it forced the Hungarian central bank to slightly tighten its monetary policy in the middle of the pandemic. The Hungarian central bank introduced a new one-week official rate that was set 95 bp above the main overnight interest rate. This surprising move was combined with further expansionary measures such as bond purchases and loan schemes for companies hit by the corona crisis. Hungarian forint money market rates are higher today than they were before the outbreak of the coronavirus crisis. Comparing across Central and Eastern European countries, the Hungarian and Polish central banks are the most

Table CEE1 - Real GDP growth forecast
in %

	Optimistic scenario			Base scenario			Pessimistic scenario		
	2019	2020	2021	2019	2020	2021	2019	2020	2021
Euro area	1.2	-6.0	6.5	1.2	-11.3	11.0	1.2	-14.0	-3.2
Czech Republic	2.4	-5.0	4.0	2.4	-10.0	7.0	2.4	-15.0	3.0
Slovakia	2.3	-5.0	4.5	2.3	-10.0	7.8	2.3	-14.0	1.5
Hungary	4.9	-3.0	4.0	4.9	-9.0	7.5	4.9	-12.0	4.0
Bulgaria	3.4	-4.0	3.0	3.4	-10.0	7.0	3.4	-12.0	4.0
Poland	4.1	-2.3	4.5	4.1	-5.7	6.0	4.1	-7.5	-0.5

Table CEE2 - Overview of recent central banks´ actions to fight the COVID-19 recession

	Main Policy Rate	Required Reserves Ratio	Counter-cyclical capital buffer	Bond purchases (QE)	Credits targeted to private sector	Tolerance for postponement of (loan) instalments
Bulgaria	lowered to 0%	no change	planned hike cancelled	No	No	Yes
Czech Rep.	from 2.25% to 1.0%	no change	from 1.75% to 1.0%	in the pipeline	No	Yes
Hungary	implicit hike	temporary to zero	no change	Yes	Yes	Yes
Poland	from 1.50% to 0.50%	from 3.50% to 0.50%	no change	Yes	No	No
Romania	from 2.50% to 2.0%	from 8.0% to 6.0%	no change	No	No	No
Slovakia	no change	no change	no change	Yes (see ECB)	No	Yes

aggressive and creative ones in their fight against the economic downturn. In particular, both central banks introduced schemes targeting, directly or indirectly, domestic private companies.

Moreover, central banks in Central and Eastern Europe are making efforts to help their economies by easing the regulatory-capital requirements for the banking sector. The latter include not only cuts to the counter-cyclical capital buffers, but also introducing some tolerance in assessing the capital adequacy requirements for commercial banks. In this context, it cannot be omitted that some central banks (for example in Bulgaria or the Czech Republic) will temporarily tolerate a postponement of instalments for several months (because of virus-related liquidity losses), while commercial banks will not need to increase provisions for such loans.

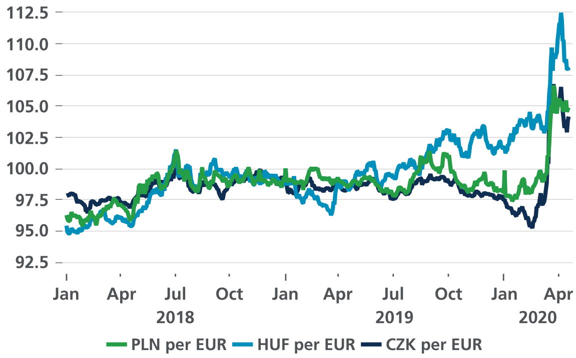
It is apparent from the above presented overview that the monetary authorities in Central and Eastern Europe used quite a wide arsenal of easing tools with the aim of keeping domestic economies alive during the pandemic. Whether these stimuli will be further expanded will depend on the development of the pandemic, which seems to be quite hopeful in particular in Central Europe. Nevertheless, as the region is yet to be fully hit by the corona crisis, central banks are ready to use their remaining ammunition for further monetary easing if necessary. In our opinion, this applies in particular to the CNB and NBP. Both central banks still have room to cut the official interest rates closer to zero, and in case of radical increases in fiscal deficits, massive purchases of domestic government bonds can be launched in a similar manner as the ECB, Fed or Bank of Japan. The only limiting factor for aggressive quantitative easing is further currency depreciations. Such depreciations could create undesirable side-effects like losses for the (FX) over-hedged exporters or domestic entities with loans in foreign currencies.

Gradual fiscal response to corona crisis

Central and Eastern European countries responded to the spread of coronavirus relatively quickly by introducing restrictive measures including (partial) restrictions on retail and mass events, school closures, the introduction of a two-week quarantine for foreigners returning, and subsequently closed borders for non-residents. After the introduction of the first restrictions, it was clear that the region's economies would not be spared by the corona crisis, so supportive and compensatory measures have gradually been introduced. These policy initiatives aim to compensate for the losses incurred by the business sector, and to mitigate the fall in the standard of living of households. At this stage, numerous fiscal policy initiatives have been announced by governments throughout the region. In particular, these include measures to make the labour market more flexible. The impact of the corona crisis on the Central and Eastern European labour markets is likely to be substantial and will break the positive trend of the previous years (see Box CEE). Various countries introduced some kind of 'Kurzarbeit' (except

Figure CEE - Exchange rates

XXX per EUR, rebased 01/01/2019 = 100



Source: KBC Economics based on Macrobond

Poland) which should compensate 60-80% of labour costs. Some governments also adopted measures such as interest-free or state-guaranteed loans and a tax reduction by reducing tax rates or by postponing tax payments. Moratoriums on loan repayments have been implemented promoting liquidity in the business sector.

If all promises are fulfilled, it will lead to a substantial fiscal stimulus in the region, equal to more than 10 percent of GDP. However, there is still much uncertainty and lack of implementation. This also explains why we remain cautious in our economic growth forecasts for the recovery phase. Obviously, these supporting measures will lead to a deterioration in public finances. The average fiscal deficit will widen to 4-7% of GDP and lead to increases in public debt in the range of 4-9%. Most countries in the region have rather sound public finances. Hungarian public finances are most vulnerable at this moment.

Box CEE - Labour markets in Central and Eastern Europe: calm before the storm

As a result of the evolving corona crisis, the economies of Central and Eastern Europe (CEE) have entered a recession that will undoubtedly change their recent labour market trends. Since 2013, the unemployment rate in the CEE countries has been falling steadily, even below the EU28 and euro area average. In some countries, labour shortages had become a limiting factor for economic growth, forcing companies to invest in new, less labour-intensive technologies. The most stretched situation was in the Czech Republic, where there was not only a rapid drop in unemployment to 2%, but also a record increase in the vacancy rate to more than 6%. In other countries, this indicator has also improved in recent years, but only in Hungary did it exceed the 2% level.

All countries are entering the current recession with record low unemployment and thus are in a better condition compared to the situation before the global financial crisis back in 2008-2009. Nevertheless, it is very likely that even in CEE countries, unemployment will rise significantly above the long-term average very soon. The intensity of dismissals will vary from country to country according to the degree of use of foreign employees with more flexible work contracts (especially in the Czech Republic, Hungary or Slovakia). March figures are not yet available for all CEE countries, but as in the Czech Republic the first change in trends on the labour market will soon be seen. Services, especially tourism, will be particularly affected in the first wave.

Unemployment rates will go up throughout the CEE region in the course of 2020 and 2021, particularly in Slovakia and Bulgaria where the rate is expected to reach 10% by the end of 2021. The Czech unemployment rate is expected to almost triple to 5.7% by the end of 2021. In Hungary, the impact will be felt most in 2020, with the unemployment rate doubling to 6.7% by the end of the year. The most critical factor will be the speed by which the CEE economies will return to normal, and the associated restart of the automotive industry as the most important branch of most Central and Eastern European economies. Another critical factor is the success of support measures taken by the governments to mitigate layoffs during the crisis. In most CEE countries, temporary wage subsidies are given to firms that need to either reduce working hours of the staff or temporarily put them on hold. The goal is to keep employees on the payroll so they can resume working when businesses re-open.

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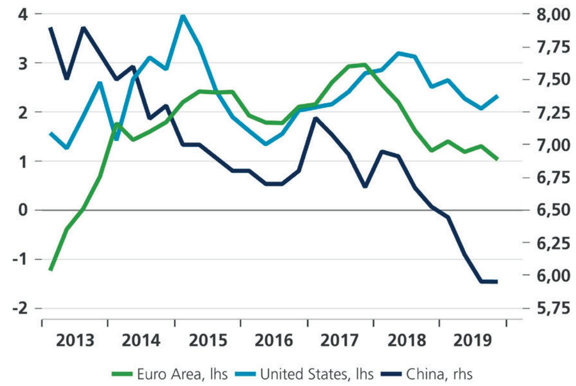
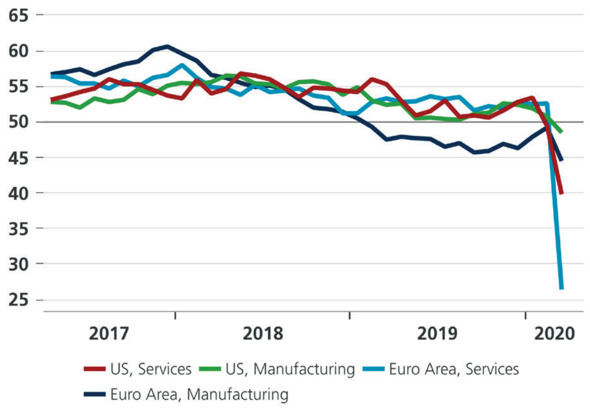
Figures

Real GDP
yearly change in %



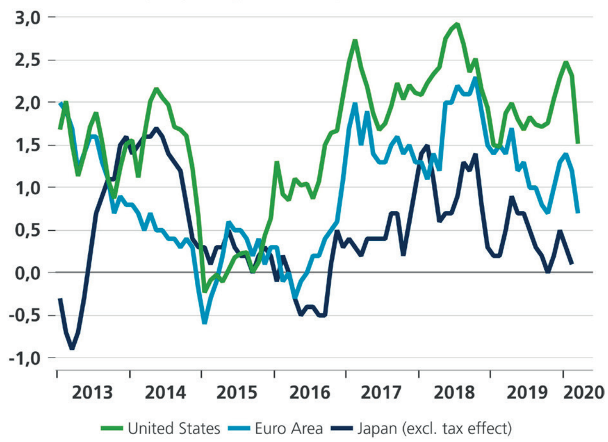
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



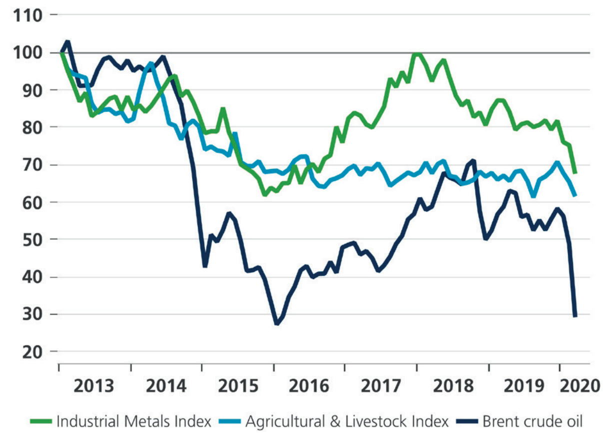
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



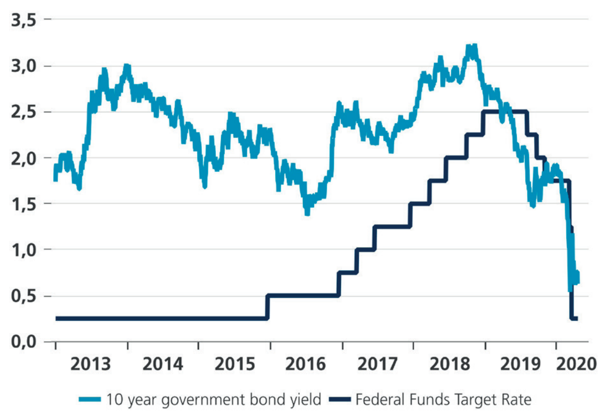
Source: KBC Economics based on Eurostat, Japanese Statistics Bureau, Ministry of Internal Af

Commodity prices
index, January 2013=100, in USD



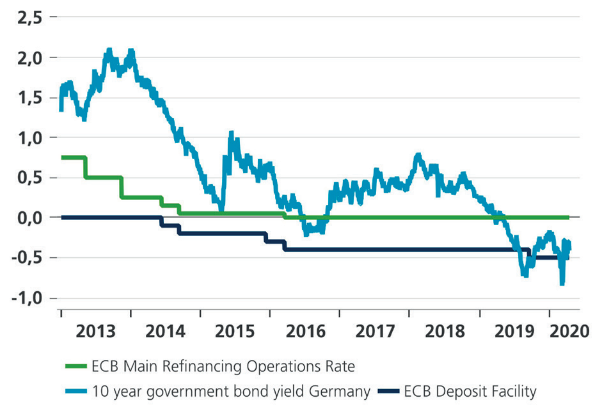
Source: KBC Economics based on World Bank, SPDJI

United States interest rates
in %



Source: KBC Economics based on Fed, Macrobond

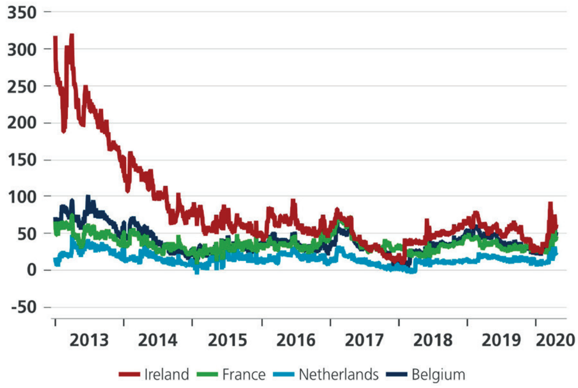
Euro area interest rates
in %



Source: KBC Economics based on Macrobond, ECB

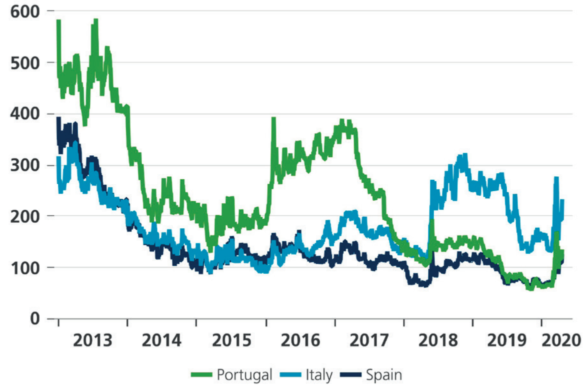
Figures

10 year government bond yield spreads to Germany
in basis points



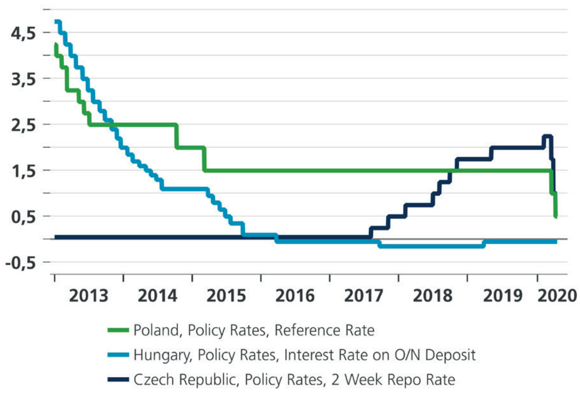
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



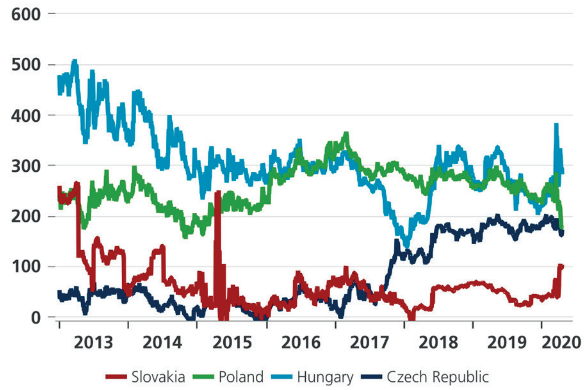
Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %



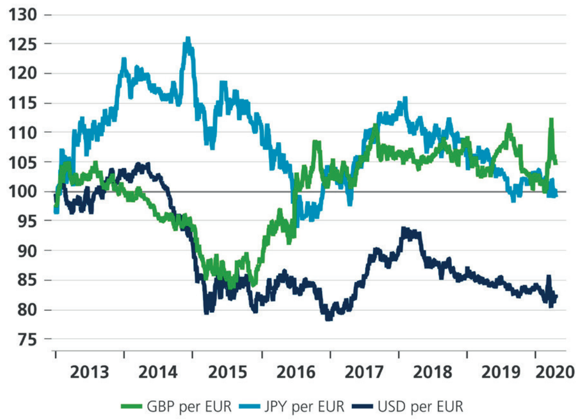
Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points



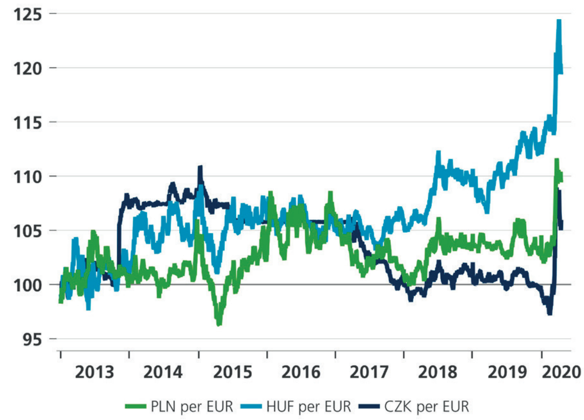
Source: KBC Economics based on Macrobond, AKK, Eurostat

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 and inflation (period average, in %)

		Real GDP growth			Inflation		
		2019	2020	2021	2019	2020	2021
Euro area	Euro Area	1.2	-11.3	11.0	1.3	-0.5	2.0
	Germany	0.5	-9.0	10.8	1.4	-0.2	2.5
	France	1.2	-9.5	11.2	1.3	-0.5	2.0
	Italy	0.1	-16.5	10.9	0.6	-1.0	1.0
	Spain	2.0	-16.6	10.9	0.8	-0.6	1.1
	Netherlands	1.7	-9.7	10.6	2.7	-0.2	2.5
	Belgium	1.4	-9.5	12.3	1.2	-0.7	2.2
	Ireland	5.5	-5.0	4.0	0.9	-1.0	1.5
	Slovakia	2.3	-10.0	7.8	2.8	0.5	1.8
Central and Eastern Europe	Czech Republic	2.4	-10.0	7.0	2.6	2.5	1.2
	Hungary	4.9	-9.0	7.5	3.4	2.9	3.1
	Bulgaria	3.4	-10.0	7.0	2.5	-0.5	2.5
	Poland	4.1	-5.7	6.0	2.1	2.7	2.4
	Romania	4.2	-10.0	6.0	3.9	-0.9	4.5
Rest of Europe	United Kingdom	1.4	-8.0	6.0	1.8	-0.5	2.5
	Sweden	1.2	-12.0	12.0	1.8	0.0	2.5
	Norway	2.3	-11.0	10.0	2.2	0.5	2.3
	Switzerland	0.9	-9.0	10.0	0.4	-0.5	1.5
Emerging markets	China	6.1	1.6	6.3	2.9	3.0	2.3
	India*	5.0	0.6	11.9	4.8	2.2	3.5
	South Africa	0.2	-14.6	2.4	4.1	2.8	5.0
	Russia	1.3	-4.9	2.9	4.5	2.8	3.5
	Turkey	0.9	-6.5	4.7	15.5	9.0	10.0
	Brazil	1.1	-11.0	3.6	3.7	2.9	3.8
Other advanced economies	United States	2.3	-8.0	6.5	1.8	-0.6	2.4
	Japan	0.7	-6.0	4.0	0.5	-0.5	0.0
	Australia	1.8	-6.5	7.0	1.6	0.5	2.0
	New Zealand	2.3	-7.0	10.0	1.6	-0.5	2.2
	Canada	1.6	-5.5	4.5	1.9	0.0	2.0

* Fiscal year from April-March

Policy rates (end of period, in %)

		14/04/2020	Q1 2020	Q2 2020	Q3 2020	Q4 2020
Euro area	Euro Area (refi rate)	0.00	0.00	0.00	0.00	0.00
	Euro Area (deposit rate)	-0.50	-0.50	-0.50	-0.50	-0.50
Central and Eastern Europe	Czech Republic	1.00	0.50	0.50	0.50	0.50
	Hungary	1.10	1.10	0.90	0.70	0.50
	Bulgaria	-	-	-	-	-
	Poland	0.50	0.50	0.50	0.50	0.50
	Romania	2.00	2.00	2.00	1.50	1.50
Rest of Europe	United Kingdom	0.10	0.10	0.10	0.10	0.10
	Sweden	0.00	0.00	0.00	0.00	0.00
	Norway	0.25	0.25	0.25	0.25	0.25
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	3.15	2.85	2.85	2.85	2.85
	India	4.40	3.65	3.65	3.65	3.65
	South Africa	4.25	3.75	3.75	3.75	3.75
	Russia	6.00	6.00	6.00	6.00	5.75
	Turkey	9.75	8.50	8.00	8.00	8.00
	Brazil	3.75	3.00	3.00	3.00	3.00
Other advanced economies	United States	0.25	0.25	0.25	0.25	0.25
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	0.25	0.25	0.25	0.25	0.25
	New Zealand	0.25	0.25	0.25	0.25	0.25
	Canada	0.25	0.25	0.25	0.25	0.25

Outlook main economies in the world

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10 year government bond yields (end of period, in %)

		14/04/2020	Q1 2020	Q2 2020	Q3 2020	Q4 2020
Euro area	Germany	-0.38	-0.30	-0.30	-0.30	-0.30
	France	0.09	0.00	0.00	0.00	0.00
	Italy	1.71	1.20	1.20	1.20	1.20
	Spain	0.82	0.45	0.45	0.45	0.45
	Netherlands	-0.11	-0.15	-0.15	-0.15	-0.15
	Belgium	0.17	0.10	0.10	0.10	0.10
	Ireland	0.21	0.10	0.10	0.10	0.10
	Slovakia	0.48	0.20	0.20	0.20	0.20
Central and Eastern Europe	Czech Republic	1.59	1.60	1.60	1.60	1.60
	Hungary	2.74	2.60	2.20	2.00	2.00
	Bulgaria	0.35	0.30	0.30	0.30	0.30
	Poland	1.42	1.80	1.80	2.00	2.20
	Romania	4.95	5.20	5.30	5.40	5.40
Rest of Europe	United Kingdom	0.32	0.40	0.40	0.40	0.40
	Sweden	-0.03	0.05	0.05	0.05	0.05
	Norway	0.72	1.10	1.10	1.10	1.10
	Switzerland	-0.32	-0.15	-0.15	-0.15	-0.15
Emerging markets	China	2.56	2.65	2.60	2.50	2.50
	India	6.50	6.70	6.50	6.30	6.25
	South Africa	10.49	11.90	11.60	11.55	11.55
	Russia	6.70	6.75	6.50	6.35	6.30
	Turkey	13.98	12.50	12.00	11.00	11.00
	Brazil	7.62	8.30	8.20	8.20	8.20
Other advanced economies	United States	0.74	0.80	0.80	0.80	0.80
	Japan	0.02	0.00	0.00	0.00	0.00
	Australia	0.93	0.90	0.90	0.90	0.90
	New Zealand	1.00	1.35	1.35	1.35	1.35
	Canada	0.72	0.90	0.90	0.90	0.90

Exchange rates (end of period)

	14/04/2020	Q1 2020	Q2 2020	Q3 2020	Q4 2020
USD per EUR	1.10	1.11	1.12	1.13	1.13
CZK per EUR	26.79	27.90	26.50	26.50	26.40
HUF per EUR	351.50	365.00	355.00	350.00	348.00
PLN per EUR	4.53	4.50	4.40	4.35	4.25
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.83	4.80	4.82	4.84	4.84
GBP per EUR	0.87	0.93	0.93	0.91	0.91
SEK per EUR	10.93	10.80	10.75	10.60	10.50
NOK per EUR	11.30	11.00	10.80	10.60	10.40
CHF per EUR	1.05	1.07	1.08	1.08	1.08
BRL per USD	5.16	5.45	5.20	5.20	5.20
INR per USD	76.11	77.00	76.00	75.00	74.00
ZAR per USD	18.29	20.00	19.00	18.50	18.50
RUB per USD	72.88	82.00	79.00	77.00	75.00
TRY per USD	6.79	6.70	6.80	6.90	6.95
RMB per USD	7.05	7.00	7.00	7.00	7.00
JPY per USD	107.23	108.00	107.50	107.00	107.00
USD per AUD	0.64	0.62	0.63	0.65	0.66
USD per NZD	0.61	0.61	0.62	0.63	0.63
CAD per USD	1.39	1.42	1.38	1.35	1.33

Outlook KBC home markets

	Belgium 2019	Belgium 2020	Belgium 2021	Ireland 2019	Ireland 2020	Ireland 2021
Real GDP (average yearly change, in %)	1.40	-9.50	12.30	5.50	-5.00	4.00
Inflation (average yearly change, harmonised CPI, in %)	1.20	-0.70	2.20	0.90	-1.00	1.50
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.30	6.20	5.80	4.80	11.00	7.00
Government budget balance (in % of GDP)	-2.00	-10.10	-4.20	0.70	-7.00	-6.00
Gross public debt (in % of GDP)	99.00	118.80	109.00	58.00	69.00	78.00
Current account balance (in % of GDP)	-1.40	-3.00	-2.00	-9.50	-4.00	5.00
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	4.00	-3.00	-2.00	2.30	-12.00	8.00

	Czech Republic 2019	Czech Republic 2020	Czech Republic 2021	Slovakia 2019	Slovakia 2020	Slovakia 2021
Real GDP (average yearly change, in %)	2.40	-10.00	7.00	2.30	-10.00	7.80
Inflation (average yearly change, harmonised CPI, in %)	2.60	2.50	1.20	2.80	0.50	1.80
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.10	5.20	5.70	5.70	9.00	10.50
Government budget balance (in % of GDP)	0.00	-4.80	-2.80	-1.40	-7.00	-3.00
Gross public debt (in % of GDP)	30.70	38.30	38.30	48.00	53.00	55.00
Current account balance (in % of GDP)	-0.10	-1.10	-0.40	-2.50	-6.50	-3.00
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	9.20	-2.00	-3.50	9.10	-5.00	-2.00

	Hungary 2019	Hungary 2020	Hungary 2021	Bulgaria 2019	Bulgaria 2020	Bulgaria 2021
Real GDP (average yearly change, in %)	4.90	-9.00	7.50	3.40	-10.00	7.00
Inflation (average yearly change, harmonised CPI, in %)	3.40	2.90	3.10	2.50	-0.50	2.50
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	3.30	6.70	5.50	4.10	8.00	10.00
Government budget balance (in % of GDP)	-1.60	-4.50	-2.80	-1.00	-4.00	-2.00
Gross public debt (in % of GDP)	66.40	75.10	70.60	19.90	24.00	26.00
Current account balance (in % of GDP)	-0.70	-2.00	-0.80	4.70	-3.00	3.00
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	14.80	-5.00	-3.00	6.00	-2.00	-1.00

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