Economic perspectives

April 2019

Highlights

- Recent activity and sentiment data signal a continued globally synchronised downward growth trend. The weakness remains concentrated in the manufacturing sector. Meanwhile, more domestically-oriented services sectors are holding up well.

- For the euro area we expect a growth rebound in the second half of 2019. A key element in this scenario is a gradual recovery in German economic activity after the disappointing results during recent months. Such a recovery is likely for several reasons. First, distorting events like the introduction of new CO_2 emission regulations in the automotive industry and the impact of exceptional drought will fade out. Second, some temporary growth support will come from a further reversal of the inventory cycle. Third, global financial conditions improved compared to the end of 2018 as central banks became more dovish and long-term interest rates decreased. Chinese policy stimulation will likely start having a positive impact on German growth as well.

- Uncertainties in the global economy remain high and numerous. The latest Brexit extension means a continuation of high uncertainty for British firms, British trading partners and for the global economy as a whole. We keep our view that some kind of agreement will be found in the end without a collapse of the UK or EU economy. However, the longer the uncertainty lasts, the more sentiment will be harmed and investment decisions may be postponed. The risk of an escalation of the trade dispute between the US and the EU also remains on the agenda, despite the expected (re)start of bilateral trade negotiations.

- Recent economic data did little to warrant a change in the cautious stance of major central banks. On the contrary, both the Fed and the ECB have adjusted their reaction functions towards greater dovishness based on the latest inflation and growth evolutions. For the ECB, this implies that interest rate normalization will start in 2020 at the earliest. For the Fed, we now pencil in a rate cut in 2020 as reaction to the deceleration in the US economy. In response, long-term bond yields will remain low throughout 2019.

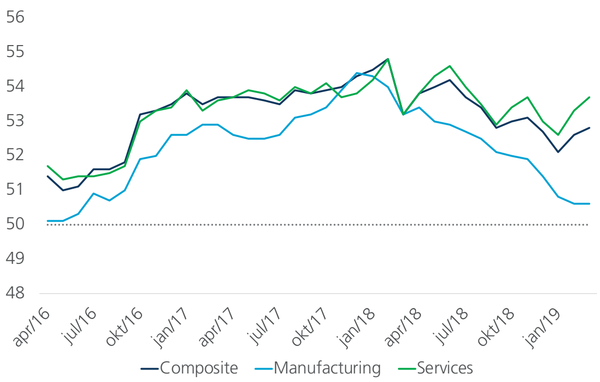
Global economy

Synchronised slowdown

The IMF recently joined a long line of international institutions by cutting its growth forecasts for the global economy. The IMF expects advanced, emerging and developing countries to face a substantial growth slowdown in 2019 and envisages global GDP growth will be at the slowest pace since 2009. Recent activity and sentiment data signal that the global synchronised downtrend of economic growth continues. The weakness remains concentrated in the manufacturing sector (figure 1) while the more domestically-oriented services sector remains stable. The global PMI for services even rose for the second month in a row in March. Although its current level of 53.7 is below the multi-year highs reached at the beginning of 2018, it still points towards healthy corporate confidence among services providers. This is despite economic activity slowing across regions and continued uncertainty globally. Strong domestic demand, in particular in developed economies, is likely the main factor behind the resilience in the services sector.

Contrary to the geographically synchronized trend in 2019, the latest IMF figures confirm our view that some regions are likely to benefit from a growth rebound in 2020. In particular for the euro area, our scenario contains a number of temporary factors that weigh on growth this year, but that make a recovery later on this year very likely. One factor that may support growth in the second half of this year and throughout 2020 is additional Chinese fiscal and monetary policy measures. Some positive effects are already becoming visible, such as the rebound in Chinese business confidence indicators in recent months and could also be consistent with better-than-expected retail sales and industrial production data for March. The government's and the central bank's measures to stabilise economic growth and avoid a hard landing likely played a role in this. Additionally, the positive messages coming from the trade negotiations between the US and China may have also contributed to the uptick in corporate sentiment. Finally, Chinese consumers appear to be reaping the benefits of the stimulus measures, leading to a pick-up in retail sales growth. Hence, our scenario of a gradual but orderly slowing of the Chinese economy remains in place. As the Chinese market is an important export destination for many countries and products, healthy Chinese economic activity should result in positive international spill-over effects. These will underpin the recovery of global growth in this year and next year.

Figure 1 - Global weakness concentrated in manufacturing sector (global PMIs, 50 = neutral level)



Source: KBC Economics based on IHS Markit

Overall, emerging markets are doing relatively well in the context of heightened international uncertainties and the deterioration in the international trade climate. Corporate confidence is at solid levels across regions (e.g. Brazil, Russia, India). And although emerging markets are suffering from the Chinese growth slowdown and the trade war between China and the US, particularly those in Asia, their economies remain quite resilient. Hence, we don't see signals pointing towards a general systemic emerging market crisis in the near future. That being said, idiosyncratic vulnerabilities remain. Recent events in Turkey highlighted that country-specific risks will continue to contribute to financial market volatility (see Box 1).

German rebound

A key part of our growth scenario for the euro area economy is the assumed rebound of German economic activity after the disappointing results of the past months. The current weakness of the German economy is the result of a combination of factors. While the weaker global economic environment is negatively affecting German export growth, German import growth remains strong due to domestic job creation and favourable wage evolutions boosting consumption (figure 2). Consequently, German GDP growth in recent quarters has been driven mainly by domestic demand components such as private consumption, investment and government expenditures. Although German exports have remained resilient despite the global uncertainties and economic slowdown, net exports are not contributing much to overall German growth as import growth exceeds export growth.

Furthermore, industrial weakness has broadened, starting from

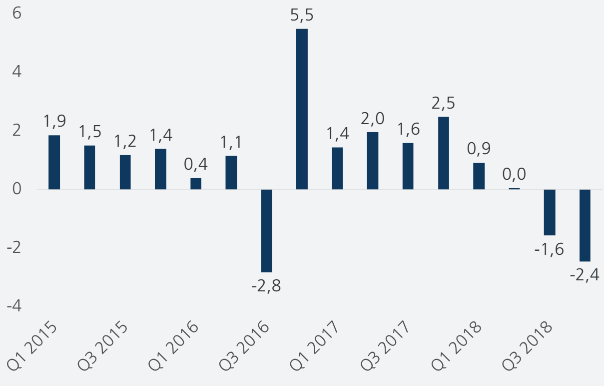
Box 1 - Painful Turkish economic downturn impacting local election results

At the end of March, Turkish voters went to the polling booth for the local elections - the first election round since the major constitutional changes and the shift towards a presidential system last year. Although the AKP - President Erdogan's party - received the most votes nationwide (44%), the party suffered a heavy blow as his party lost control of the capital, Ankara, and the major economic centres of Istanbul and Izmir, to the main opposition party (CHP). Hence, the opposition secured its grip over the only centre of power outside the otherwise centralised presidential system.

One of the key reasons behind the worse-than-expected election results for the ruling party is the weakening of the Turkish economy. The trigger was the currency crisis of late summer 2018 when the Turkish Lira depreciated by more than 30% against the USD. Underlying macroeconomic imbalances - a weak external position and increased reliance on volatile short-term capital inflows - were fully exposed. As a result, for the first time in a decade, the Turkish economy fell into recession with real GDP declining by 1.6% qoq in Q3 and by 2.4% qoq in Q4 2018 (figure B1).

This year, we expect the economy will shrink by 1.5% (with the risks tilted to the downside) given the ongoing events, including a rapid drop in domestic demand on the back of a sudden stop in capital flows and subsequent credit crunch. Moreover, there are no suggestions of a rapid recovery of economic activity in the near future. The economy's fundamentals remain weak and extremely vulnerable as corporate balance sheets are fragile, foreign reserves are limited and the Lira remains volatile. In addition, the external environment will be challenging due to the expected slowdown of the EU economy, Turkey's main trading partner. Given the lack of scheduled elections, the upcoming years seem to be a suitable period for reforms to strengthen Turkey's economic fundamentals. However, for these to be effective, some notable changes to economic policy will be needed (also see KBC Economic Opinion of 4 April 2019).

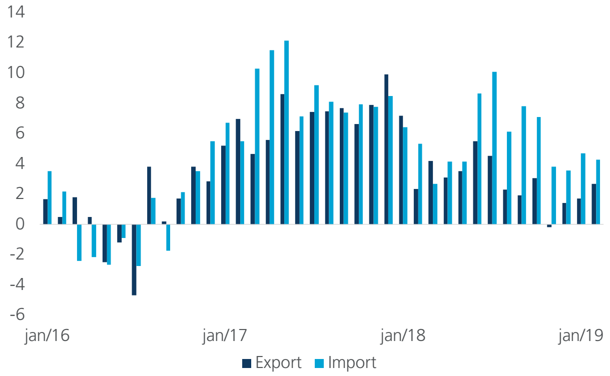
Figure B1 - Turkish economy in a recession (real GDP, % change quarter-on-quarter)



Source: KBC Economics based on TurkStat

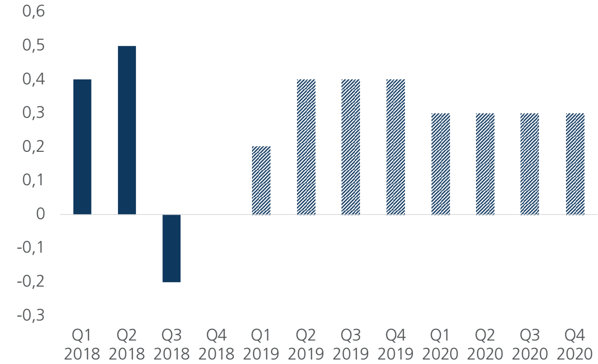
the automobile industry (due to new CO_2 emission regulations) and the chemical industry (suffering from transportation issues due to low water levels in the Rhine), and spreading towards other manufacturing subsectors. German automotive production dropped by 7.2% in H2 2018 compared to H1 2018. New orders in manufacturing dropped by 8.4% yoy in February. The unexpected temporary headwinds led to a strong inventory build-up in Q2 and Q3 2018 and the subsequent run-down thereafter. Supply side constraints stemming from the increasingly tight labour market are also holding back the manufacturing sector. Whether this is temporary or structural depends on the willingness to invest in additional capacity. The continued strong investment growth seems to suggest that the capacity constraints can be overcome. The temporary decline

Figure 2 - German import growth exceeds export growth (goods trade, seasonally and calendar adjusted, % change year-on-year)



Source: KBC Economics based on Destatis

Figure 3 - Weak annual averages mask still decent German quarterly growth dynamics (real GDP, % change quarter-on-quarter, forecasts from Q1 2019)



Source: KBC Economics based on Destatis and own forecasts

in manufacturing output also mitigated the actual capacity constraints.

In the short term a recovery is likely for several reasons. First, there will be some temporary growth support from a further reversal of the inventory cycle. Second, global financial conditions improved compared to the end of 2018 as central banks became more cautious and long-term interest rates decreased. Chinese policy stimulation will likely begin having a positive impact on German growth in H2 2019 as well. It is also important to note that our weak annual average growth forecast for 2019 masks relatively favourable quarterly growth dynamics that area broadly in line with estimated potential growth (figure 3). In terms of the longer-term economic outlook, growth is likely to gradually weaken further. To a large extent this will be the result of supply side factors such as the labour market tightening and increasing labour shortages, which will be aggravated by demographic factors and will weigh on potential growth. The main risks to this scenario are of a political nature (Brexit and global trade policies).

Uncertainty remains high

Uncertainties in the global economy remain high and numerous. One of them is the Brexit saga. Despite the extended period for ratification until 12 April 2019, Members of the British Parliament were not able to find a majority support for the Withdrawal Agreement (WA) Prime Minister May and the European Council endorsed in November 2018. In response to the UK's request for a further extension of the Article 50 period, the European Council granted a further extension to allow for the ratification of the Withdrawal Agreement with an end date of 31 October 2019. This period can be seen as a 'flextension' in the sense that the UK can also leave the EU earlier once the WA is ratified by the UK Parliament. The extension comes with a few conditions though. The UK is obliged to participate in the European Parliament elections if the WA has not been ratified by 22 May 2019. Moreover, the UK committed to "act in a constructive and responsible manner throughout the extension period" implying it will not hamper the decision-making processes of the EU.

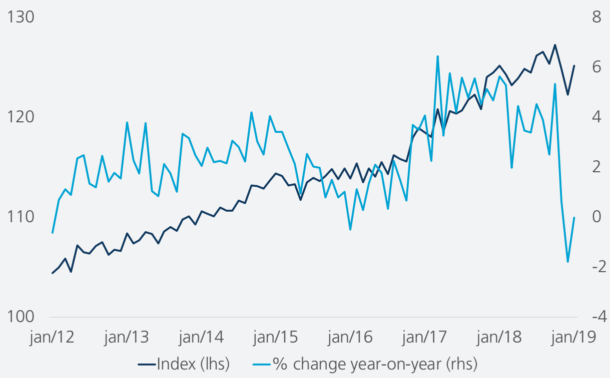
The new extension means a continuation of high uncertainty for British firms, British trading partners and for the global economy as a whole even if it seems to reflect an overwhelming desire to avoid a hard Brexit. We keep our view that some kind of agreement will be found in the end without a collapse of the UK or European economies. However, the longer the uncertainty lasts, the more sentiment will be harmed and investment decisions may be postponed. Hence, although the extension implies a larger probability of a softer Brexit outcome, it also means that uncertainty will continue to weigh on economic activity.

Another factor of uncertainty, in particular for the European economy, is a potential escalation of the trade dispute with the US. The risk of US import tariffs on cars and car parts would be harmful for the euro area economy. Moreover, the threatened measures in response to the conflict between Airbus and Boeing could be an additional cause of economic damage (see Box 2). Furthermore, geopolitical risks have risen of late. The conflict in Libya escalated in recent weeks, which was mirrored in a rise of the oil price. Other tenuous political situations in countries like Iran, Nigeria and Venezuela remain vulnerable and susceptible to oil supply disruptions.

Box 2 - Global trade in a dip

Whereas 2017 brought a lot of positive surprises on the economic front, with stronger-than-expected GDP and trade growth, 2018 was defined by a slowdown in trade and activity. This weakness has been seeping through into the start of 2019 as well. The World Trade Monitor of the Dutch Bureau for Economic Policy Analysis (CPB) illustrates this very well (figure box 2.1). The index measures international trade volumes of goods flows on a monthly basis. The figure clearly indicates the strong results in 2017, the struggles in 2018 and the collapse of trade growth at the end of the year. The first figures for January 2019 only show a partial recovery in goods trade.

Figure B2.1 – CPB World Trade Monitor (merchandise trade volumes)



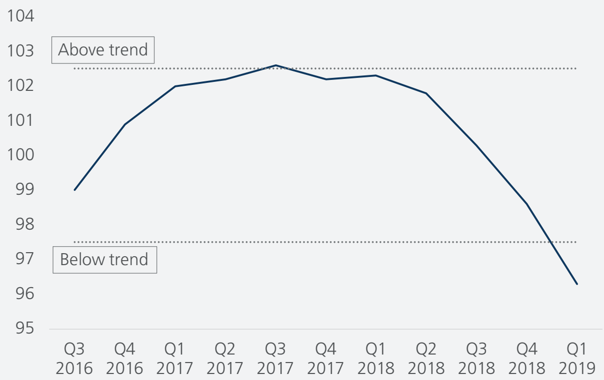
Source: KBC Economics based on Dutch Bureau for Economic Policy Analysis (CPB)

Based on preliminary estimates by the World Trade Organisation (WTO), the global annual average growth rate of international trade volumes was 3.0% in 2018, well below the WTO's initial estimates and significantly less than the 4.6% growth pace recorded in 2017. The very disappointing fourth quarter figures were the main cause of this notable underperformance in 2018. Weakness in trade growth was mostly concentrated in Europe and Asia, two regions with a very important share in total global trade flows. However, on the bright side, commercial services trade reported strong growth in 2018 (+7.7%), for the second year in a row, supported largely by robust services import growth in Asia.

Several factors were at the origin of the disappointing results for goods trade. The escalation of the trade war between the US and China was undoubtedly one of them. Multiple rounds of import tariff increases on both sides caused trade flows between the two countries to be distorted. Moreover, trade flows of other economies with close trade ties with the US or China were affected. The increased uncertainty led to a global negative impact. The persistent opacity surrounding the UK's exit out of the EU also weighed on global trade flows. Weaker global demand and a decline in global GDP growth contributed as well to the deceleration in trade growth. In addition, temporary factors played a role. The problems in the German car manufacturing industry due to new emission test regulations and the US government shutdown likely led to transitory postponements in consumers' and businesses' purchase decisions.

Forward-looking indicators don't suggest any marked improvement for international trade in the near term. Corporate sentiment, as measured by PMIs, is still on a downward trajectory in the manufacturing or tradeable goods sector. In particular the subcomponent of export orders remains weak overall. The World Trade Outlook Indicator of the WTO does not appear to be pointing towards a recovery of trade growth in the first half of 2019 (figure box 2.2). Based on these findings, the WTO revised its forecasts for merchandise trade volume growth down to 2.6% in 2019 and 3% in 2020. A rebound of trade growth in 2020 is not unlikely, and this is consistent with our scenario of a partial recovery in global activity.

Figure B2.2 - WTO World Trade Outlook Indicator



Source: KBC Economics based on World Trade Organisation

An important determinant for trade going forward will be the evolution of the trade tensions and surrounding uncertainty they cause. Trade negotiations between China and the US are still ongoing. A final deal has not been reached. Communications from people involved speak of progress, but a possible deal has been postponed until May at the earliest. One of the main stumbling blocks is whether or not the tariffs that were already implemented will be rolled back. Moreover, the US demand for enforcement mechanisms is a difficult topic for the Chinese authorities. Nonetheless, the US and China recently agreed on setting up enforcement offices that will monitor the compliance to the deal. Our base scenario doesn't contain a further escalation of the US-China conflict as we think reaching some kind of an accord in the near future seems more likely. However, underlying issues will not be fully resolved. It is likely that the dispute will move away from trade issues to focus more on technology matters as China is focusing more on the production and export of products with high added value (also see KBC Economic Opinion of 11 April 2018).

Apart from the conflict with China, the US is building trade tensions with the EU. In the context of the long-standing conflict between aircraft manufacturers Airbus and Boeing, the US announced additional tariffs on imports of European products. The tariffs are a reaction by the US against the presumed illegal subsidies of the European governments to Airbus. The preliminary list includes products worth some $11 billion. This threat comes on top of the risk of additional US import tariffs on cars and car parts. For the already weakening European economy, these are notable factors of uncertainty that could potentially harm economic activity. Nevertheless, the EU decided to give a green light to new trade negotiations with the US. Although this is a hopeful signal, as long as trade tensions hold steady and uncertainty remains high, trade flows and investment decisions will be distorted globally.

Monetary policy doves ruling

Recent economic data have not persuaded any of the major central banks to change their cautious stance. At its most recent policy meeting, the dovishness of the ECB was again emphasized. ECB President Draghi signalled that the ECB is able and willing to use its full 'toolbox' of policy instruments to ensure inflation converges towards its target. By doing this, the ECB is adding a more dovish tilt to its forward guidance and is undertaking additional 'verbal easing'. This more dovish position on the outlook for policy is clearly a reflection of a more negative economic outlook.

Our scenario for the deposit rate hence remains the same as last month, with the first rate hike only in the second half of 2020. The main motivation for it will be a move towards deposit rate normalisation out of negative territory. Financial stability considerations and the adverse impact on the European banking sector play an important role. However, in order to limit the policy tightening signal coming from this depo rate hike, the ECB is likely to decrease the upwards corridor between the refi and the depo rate to 10 basis points from 40 basis points at present.

In line with this and given the recent movements in the German long-term bond yields, we moderated the upward path of German 10 year yields expected for the forecasting horizon. In particular we now see them rising to 30 basis points by the end of 2019 and 60 basis points by the end of next year. Several arguments are underpinning this. The latest ECB forward guidance, including its reference to 'mitigating' policy measures if appropriate, could point to lower for longer short term rates in the case of a tiered rate system. Moreover, there is continued strong liquidity supply. Global risk aversion in the light of heightened economic and geopolitical uncertainty will also continue to weigh on German long-term yields. In circumstances where demand for German bonds is particularly strong, the prospect of shrinking supply because of an expected fall in Germany's debt to GDP ratio could also be an important factor. In particular in the short run, the upward potential for the German 10 year bond rate seems non-existent. The extended Brexit-deadline, the global trade tensions and the expected new discussions on the Italian budget later on this year are likely to weigh on German rates.

In the US, monetary policy dovishness is also dominating (see Box 3). We therefore don't expect any further rate hikes over the forecast horizon. In fact, given the expected moderation in the pace of growth, a rate cut around Q2 2020 has become likely. The run-down of the balance sheet will likely be completed by September 2019.

Box 3 - The Fed's U-turn

The Federal Reserve has gone a good deal further in the monetary policy U-turn it started at the start of the year. The US central bank shelved all rate hike bets for the remainder of the year and is now pursuing an end to its balance sheet run-off by September. Moreover, the new Fed projections pencil in only one more rate hike this cycle (2020). Patience appears to be the central bank's key word. Fed chair Powell seemed discouraged by the fact that the central bank didn't achieve its 2% mandate "in a more symmetrical way". One of the main drivers behind the Fed's rigid pace of rate hikes last year was an expected inflation overshoot which didn't materialize. Fed governors now want firm evidence of higher inflation before taking more action. Dark international clouds are piling up above the economy. Therefore, the Fed made clear that there's no rush to act in "one direction or the other", stating that "It may be some time before the outlook for jobs and inflation calls clearly for a change in policy".

The updated Fed dot plot mirrors the Fed's wide-shared willingness to stay side-lined, at least for now. The median policy rate forecast for this year declined from 2.875% in December (2 hikes) to 2.375% in March (no hikes). Importantly, 11 out of 17 governors backed this unchanged policy view, compared to only 2 out of 17 in December. The 2020 median federal funds rate estimate dropped from 3.125% to 2.625%. That should be the final rate hike this cycle, with the 2021 median at 2.625%. FOMC Minutes of the March policy meeting reflected Fed Chair Powell's doubt though that it shouldn't be taken for granted that the next move will be a rate hike rather than a rate cut. Short term interest rate markets currently discount a 40% probability of a rate cut at the Fed's final meeting this year (December 11).

Apart from the dovish shift in the new dot plot, the Fed altered its balance sheet normalization principles and plans. The Fed intends to slow the pace of the decline of its balance sheet over coming quarters. The Fed currently lets USD 30bn in Treasuries and USD 20bn in mortgage-backed securities (MBS) mature on a monthly basis without replacing them. The cap on monthly redemptions of US Treasuries will drop from the current level of USD 30bn to USD 15bn beginning in May 2019, before ending them altogether at the end of September. The Fed's balance sheet shrunk from over USD 4.5tn at the start of the run-off in Q4 2017 to below USD 4tn currently. By the end of September, we estimate it to be around USD 3.75tn. That's far higher than original estimates of a decline towards levels in the area of USD 2.5tn.

Central and Eastern European Economies

As Central and Eastern European countries are relatively open economies, they are sensitive to the European and global slowdown. Moreover, as many of these countries have a substantial automotive industry, they are also affected by the events in the German automotive industry. However, generally speaking, we continue to see strong resilience throughout the region. Domestic factors, like favourable labour market developments, investment growth supported by EU funds, and domestic monetary policies, compensate for the international headwinds. Nevertheless, we do observe signs of economic weakening in a number of countries, with economic sentiment indicators all pointing downwards (figure CEE). The underlying trends and economic dynamics are, however, not uniform across the entire region.

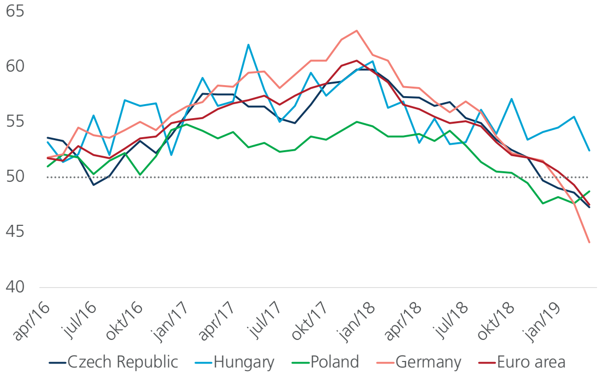
Not surprisingly, countries that are most integrated in the German industrial network suffer most from the ongoing weakness in the German economy. The Czech Republic and Slovakia are clearly affected more than other countries in the region. Cross-border linkages in the automotive industry could also potentially harm Central European economies, though there is not strong evidence for this at this moment. Rather, it appears that the Central European automotive industry is relatively unaffected by the supply side challenges in the German automotive industry. Obviously, the general economic slowdown in the euro area negatively affects the demand for any European cars. Hence, while there is some negative demand effect, the supply side seems relatively well sheltered. Moreover, new models and new production plants compensate, at the aggregate level, for any decline in other segments of the automotive market.

From a more structural and longer-term perspective, tight labour markets continue to cause capacity constraints for the industrial and construction sectors. Though positive for consumer confidence and household consumption, high wage growth may ultimately jeopardize the region's international cost competitiveness. In the short run this is not yet an issue given positive productivity developments and the continued potential for international labour cost convergence. Continued strong investment growth helps overcome capacity constraints.

The economic outlook for the region very much depends on developments at the European and global stage. The region clearly realizes that a hard Brexit could cause substantial economic damage. Hence, the extended Brexit deadline causes a longer period of uncertainty.

Another crucial factor will be the recovery in Germany, which we expect in our scenario. Recent developments signal how sensitive the Central and Eastern economies are to the European business cycle. The possibilities for domestic policies to compensate for international trends are limited. In general, we note that central banks in the non-euro area countries have become more cautious. Normalization of monetary policy is postponed due to international uncertainties and the ECB's more dovish and cautious stance. There is definitely scope for domestic fiscal stimulus if the economic outlook worsens. But at this moment such policies are likely to cause more harm than good, as it is not unlikely that many countries in the region are approaching a situation of overheating.

Figure CEE - Corporate sentiment indicators pointing downwards (manufacturing PMIs, 50 = neutral level)



Source: KBC Economics based on IHS Markit, HALPIM

Czech Republic

Contrasting hard and soft data

Revised official GDP data reveal a slight decrease compared to the previously published data for Q4 2018. With 2.6% growth in Q4 2018 and 2.9% for the entire calendar year, the Czech economy cooled down compared to 2017 (4.5% growth) but is still performing very strongly. Apart from the slight decrease in 4Q 2018 estimated growth, more underlying data has become available. As expected, non-financial corporations maintain their strong investment appetite, clearly reacting to the scarcity of labour. As a result, investments to GDP increased again. Faster wage growth caused, however, a drop in corporate profitability. The ratio of profitability to value added dropped to 47% in 2018, still significantly above the European average. The financial sector's profitability increased slightly to 61%.

Soft indicators like the PMIs or short-term surveys suggest that the Czech economy has been losing momentum since the beginning of this year. The drop in industrial output in January was partly compensated by a production increase in February, and orders have improved too. Yet, the latest industrial PMIs indicate a further slowdown in the largest domestic sector, representing one third of the Czech economy. The performance of the automotive industry is particularly unconvincing. On the one hand, the industry has to cope with reduced demand from most European markets while on the other, it is unable to guarantee sufficient production levels for some models to match the demand for SUVs. Overall, however, car production fell by 7.9% to 231,000 units in the first two months of 2019. Fortunately, statistics on expected new orders show no significant downturn that would indicate a recession in the sector. Recovery seems the most likely scenario in the short run. In the longer run, the main challenge for the Czech industry remains the tight labour market, as the order books continue to look promising.

The construction sector did very well in February, thanks to the positive developments in both building construction and civil engineering. Sentiment in the construction sector is distinctively positive too, while other sectors are starting to show signs of pessimism.

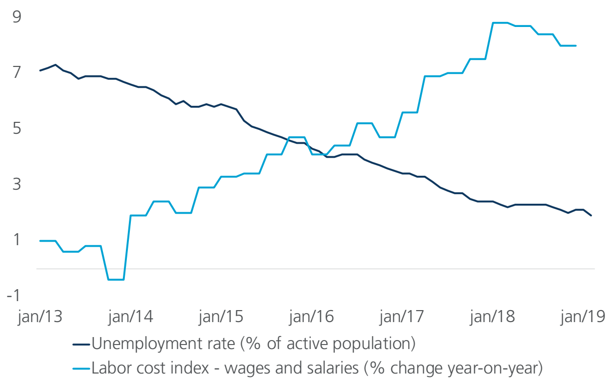
Czech consumers are becoming more concerned about their future financial situation and unemployment. Obviously, the reports on decelerating growth in Europe and potential threats to long-term economic developments in the Czech Republic are reaching consumers. We can therefore expect that the consumer sentiment deterioration – albeit not dramatic yet – will gradually translate into a lower willingness to spend as well as to lend.

Minimum unemployment and record vacancy rates

Unemployment remains close to the all-time low. According to harmonized data, the unemployment rate was 2% in February, while the number of vacancies continued along its upward trajectory. On average, there are currently three vacancies per unemployed person. This is, of course, an exceptional situation from both a domestic and a European perspective. Tensions in the labour market will lead to further wage increases in 2019, albeit probably slower than in 2018 due to the less generous public sector salary growth (figure CZ).

Wage growth is clearly affecting headline inflation, although it is far from being the dominant inflation factor. The rising cost of housing due to more expensive real estate, higher rents, and higher energy prices are still the most inflationary factors. The energy price evolution reflects the earlier rise in electricity prices in the German market affected by environment-friendly activities in the form of emission allowance trading and the boom of green, but often inefficient, power plants. This brought year-on-year inflation to the upper limit of the Czech National Bank's (CNB) tolerance interval (3%) in March. Nonetheless, more than half of this inflation was due to the housing costs just mentioned. They will remain the main inflation driver in the coming months, too. We expect that starting in summer,

Figure CZ - Tensions on the labour market will lead to further wage increases



Source: KBC Economics based on Eurostat

inflation will tend to fall rapidly towards the target, as the high comparative basis of the previous year kicks in. Therefore, the CNB should have no problem meeting its inflation target in the medium run.

Sit and wait policy

In light of uncertainties and risks, the CNB board decided to leave interest rates unchanged in March. Five members of the CNB board voted again for stability, while two voted to raise interest rates for the third time in a row. Therefore, the CNB's position remains unchanged and there will be no rush to raise interest rates until there have been some clear (sufficiently positive) signals from the economy. We continue to expect the CNB to implement another interest rate increase in the second half of this year. By that time, it will be clear whether the European, and in particular the German, economy is recovering. Moreover, the extended Brexit uncertainty forces the CNB into a wait and see mode too.

Although we do not expect a rate change at the upcoming meeting in May, the event remains interesting as new CNB forecasts will be published. The CNB's current forecast is based on the optimistic assumption of an accelerating economy and a rapid strengthening of the Czech Koruna. As the Koruna outlook plays a very important role in the rate determination, it will be interesting to see how the CNB views the exchange rate development in its new forecast. So far, the CNB has assumed that the koruna would strengthen by more than 2% to an average of 25.20 per euro in Q2 2019. For the time being, even the existing interest rate differential with the euro seems insufficient to drive such CZK appreciation considering the volume of speculative capital and the high levels of exporters' exchange rate hedging. Moreover, financial markets do not expect the CNB to continue raising rates. The interest rate curve remains inverted. However, the entire yield curve remains far above its euro area counterpart.

Hungary

No signs of slowdown yet

Contrary to the growth slowdown in the Czech and Slovak economy, the Hungarian economy appears to have had a strong start to the year based on retail sales and industrial production figures. The former was expected as real wage growth reached about 6% yoy and consumer confidence remains strong. These figures suggest that domestic consumption may continue to boost growth in 2019 too. Even so, the magnitude of the jump in retail sales (8.4% yoy) was a surprise, and continued growth around that level in the following months would suggest that the Hungarian economy is overheating. It is mainly non-food products sales that are booming, in particular sales of clothing, furniture, and electronic devices etc., which were up more than 10% yoy in February.

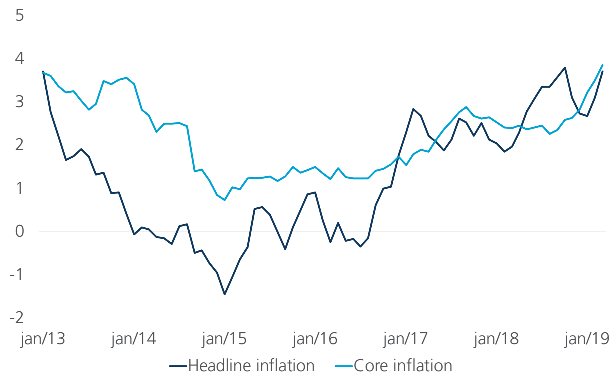
An even bigger surprise comes from industrial production. Despite the deteriorating European and global economic environment in the previous months, the Hungarian industry keeps on accelerating. While industrial production increased by only 2.2% yoy in September 2018, growth accelerated to 5.9% yoy in February. It seems the newly entering capacities were able not only a counterweight to the less favourable international economic environment so far, but even helped accelerate industrial production. In particular, the production of vehicles, computers and electronic device is growing.

Looking ahead, we are confident that consumption growth will continue. Driven by the tight labour market, we expect wages to grow by 10% yoy, supporting retail sales. We expect retail sales to grow by more than 6% yoy in 2019. By contrast, the outlook for industrial production is much harder to predict. For now, we expect industrial production to increase between 4-5% yoy in 2019. However, continued weakness in the external environment might ultimately harm Hungarian industry too, albeit clearly later than elsewhere in Central Europe. The strong domestic economic performance might deteriorate the external balance further, causing the current account surplus to disappear. All of this clearly points to an overheating Hungarian economy.

Price pressures building

While the Hungarian economy has been doing well, price pressures are building. Recall that the Hungarian consumer

Figure HU - Price pressures are building up (consumer price index, national definition, % change year-on-year)



Source: KBC Economics based on Hungarian Central Statistical Office (HCSO)

price index jumped in March to 3.7% yoy, up from 3.1% yoy in February and 2.7% yoy in January (figure HU). Moreover, core inflation and all inflation figures, which are monitored by the Hungarian National Bank (NBH), like core inflation filtered from indirect tax changes or demand sensitive inflation, have accelerated since last August from around 2.3% yoy to around or even above 3.5% yoy in March.

The latest figures confirm our view that the strong domestic consumption and the fast wage increases are creating inflationary pressures in the economy. Similar to other countries in the region, we expect headline inflation to moderate slightly in the coming months, driven by base effects in oil prices. We expect headline inflation to be around 3% yoy by July, while core inflation may even accelerate further and might go above 4% yoy temporarily. Additionally, we see headline inflation reaching the 3.7% yoy level again in December, so the drop of the inflation is likely to be temporary.

June NBH rate hike a done deal

The macroeconomic situation increases the risk that the NBH was not aggressive enough to stop the upward inflation trend. If we look at inflation expectations, they have been moving up since 2016. Households already see inflation moving above 4% yoy.

Despite the higher inflation, we don't expect any substantial change in monetary policy for the coming two months, as the NBH may want to see how the European slowdown and potential recovery will develop, and how long the ECB and other central banks may keep their loose monetary conditions. We expect that the stock of foreign currency swaps may moderate further in the coming weeks. The NBH would like to see the 3-month Bubor around 25 basis points versus the current level of 16 basis points, as it expected that the monetary policy changes delivered in March to have pushed up the short end of the curve by 10 basis points, which hasn't happened so far. We also expect that the NBH may increase the overnight deposit rate by 10 basis points in June again, and the 3-month Bubor might be around 40-50 basis points at the end of the year.

Hence in our view, it is quite unlikely that the NBH will start an aggressive tightening cycle in the near future, except in the case the Hungarian forint is suddenly pushed into much weaker levels (which is not our base case scenario). We have to highlight again that, from an economic perspective, we see more and more signs of an overheating domestic economy, which has to be monitored closely in the following months. An overheating economy increases the risk of an exchange rate weakening in the medium term if the NBH doesn't tighten its monetary policy, or if the international environment doesn't trigger a cool-down of the Hungarian economy.

Bulgaria

Slowing down, but still promising

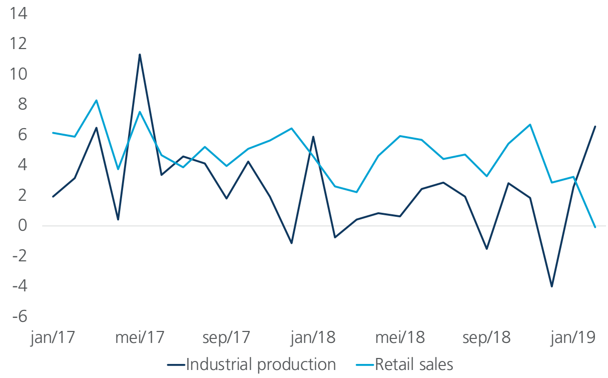
After two years of robust economic growth, the pace of economic expansion lost traction in Bulgaria last year. Nonetheless, the underlying quarterly dynamics of real GDP growth suggest that the economy gained some slight momentum in Q4 2018 with growth accelerating to 3.0% yoy from 2.7% yoy in Q3. Turning to 2019, this momentum seems to be maintained, although the short-term indicators give somewhat mixed signals.

To start with, industrial production rebounded strongly in the first two months of this year (figure BG). After rather disappointing figures in Q4 2018, likely reflecting the weakness in the German manufacturing industry, industrial output jumped 6.6% yoy in February, following the 2.6% yoy rise in January, and thus marking the strongest expansion since May 2017. February's acceleration was driven by a strong pick-up in manufacturing output, particularly of fabricated metal products, but also by a substantial expansion in the mining and quarrying industry. A similarly positive development can be observed in construction. Construction output grew by 9.2% yoy in February, largely owing to an improvement in the dynamics of civil engineering from negative growth of 4.1% yoy in January to a positive increase of 3.5% yoy in January. Moreover, further support came from building construction which accelerated to double digit growth.

A less optimistic picture is, however, emerging from the latest retail sales figures. On a monthly basis, retail sales decreased by 0.6% in February, following the declining trend that started in December 2018. The weakening momentum is also evident from the year-on-year dynamics as retail sales marked its first, albeit marginal, decline of 0.1% since 2013 (figure BG). Such a development is mainly due to the decrease in sales of food, beverages and tobacco, but a sharp drop in online sales also weighed on the overall result.

Still, prospects for the months ahead might not be all that gloomy given the improvement in business sentiment among retailers in March. This was mainly triggered by improvements in sales volume expectations over the next three months, which support our view that retail sales will return to moderate growth. After all, this is in line with our expectations of a general slowdown in consumption this year on the back of deteriorating consumer confidence and higher inflation weighing on real wage growth. Overall, however, favourable labour market conditions suggest

Figure BG - Short-term activity indicators giving mixed signals (% change year-on-year)



Source: KBC Economics based on Bulgarian National Statistics Institute

that the slowdown in consumption growth will not be drastic and household consumption should remain the key driver of the ongoing economic expansion.

Unemployment rate expected to tick down

The favourable developments in Bulgaria's labour market were a defining feature of 2018 and this year is not likely to be different in that regard. The latest unemployment figure signals that the labour market is tightening further; according to the Bulgarian Employment Agency, registered unemployment fell by 0.2 percentage points to 6.2% in February, following a seasonal increase in January. Similarly, according to Eurostat's harmonized unemployment figures, the Bulgarian unemployment rate remains low by historical standards at 4.7%, down from 5.4% a year earlier.

While such a development gradually translates into higher household disposable incomes and consequently boosts economic activity, from the supply side perspective, Bulgarian companies find it increasingly difficult to cope with the historically unprecedented labour shortage, especially in industry and construction. Moreover, given our expectations of a further decline in the unemployment rate through 2019-2021, the situation is not likely to improve materially; in fact, the opposite is expected due to the negative demographic trends that will be reflected in a further decreasing labour force. As a consequence, job creation is expected to lose its importance as a key growth-supporting factor.

While inflationary pressures eased significantly by the end of

2018, HICP inflation posted a 0.3% mom increase in February. The annual inflation also edged up to 2.4% in February, mainly driven by higher food prices. All in all, we confirm our forecast of an annual inflation rate of 2.5% for 2019.

Government bond yields to trend down further

Bulgaria's 10-year government bond yields have been declining constantly since the global financial crisis in 2008, backed by favourable developments on both domestic and external fronts. This year we expect the Bulgarian spread to the German 10-year government bond rate to remain limited to 65 basis points at the end of 2019. Apart from the impact of unaltered monetary policy by the ECB in 2019, we expect that the steady trend of Bulgaria's sovereign debt reduction will continue, supported by the Ministry of Finance's plan for a negative net financing of government debt.

Slovakia

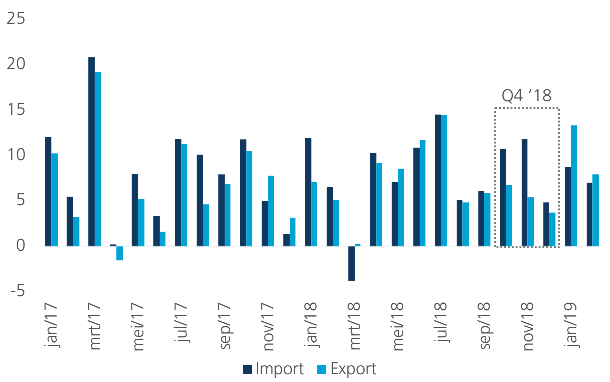
External environment causes a cool down

Similar to the Czech economy, Slovakia is feeling the global and European economic slowdown too. Growth is gradually decelerating, although detailed figures still suggest that the Slovak economy is in good shape. In Q4 2018, economic growth slowed to 3.6% from 4.6% yoy. The main cause for this growth deceleration was the negative contribution of net exports. Export growth continued to slow down, while import growth remained strong thanks to strong domestic demand supported by higher wages and job creation (figure SK). At the same time, higher imports were also associated with investment activities (e.g. the construction of a new car manufacturing factory). In particular, exports outside the euro area performed weakly.

On the supply side, economic growth was driven particularly by the manufacturing industry, notably car manufacturing. This was noticeable in the export performance too. Car exports continued to be strong, despite the general export growth slowdown, notably because of the launch of new models.

The economic slowdown at the end of 2018 as well as the detailed GDP structure necessitated another downward revision of the Slovak National Bank's (NBS) growth rate estimates. GDP growth was revised to 3.5% for 2019, which roughly corresponds to our economic scenario. The NBS justified its revision based on the recent developments in the European car industry as well as recent developments in the external environment. The extended Brexit uncertainty and the global economic deceleration triggered a more cautious assessment of the near future.

Figure SK - Strong import growth results in negative net exports contribution to Q4 2018 GDP growth (% change year-on-year)



Source: KBC Economics based on Slovakian Statistical Office

Favourable labour market

Favourable labour market developments continue to support the economy. Towards the end of 2018, the employment rate increased by 1.9 % yoy, accelerating from the 1.4% reported in Q3 2018. As a consequence of job creation, the unemployment rate dropped to a new historic low of 5.8% in February. At the same time, the vacancy rate as well as the number of employed foreigners are at historic highs. Real wage growth accelerated from 3.3% in Q3 2018 to 3.5% yoy in Q4 2018. This was supported by inflation falling below 2% at the end of the year. All of this supports household consumption, which accelerated to 3.4% yoy in the last quarter of 2018. Households mainly increased their spending on housing and food. However, other spending, such as holidays, culture, furniture and services increased as well.

Government consumption accelerated too, particularly due to higher self-administration expenses in relation to local elections at the end of 2018. After a sharp drop in the preceding quarter, investment provided a pleasant surprise. The strong investment growth of 9% yoy can be attributed particularly to the investment activities of the public sector. This means primarily investments in infrastructure, enhanced by an increased use of EU funds. In the private sector, mainly investments in car manufacturing increased in relation to the completion of the construction of a new Jaguar plant.

Gradual inflation growth

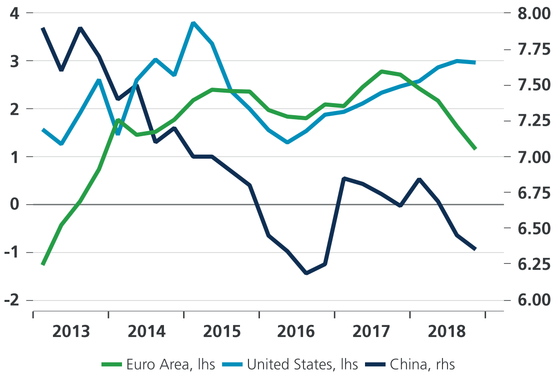
Through the beginning of the year, Slovak inflation has been gradually accelerating. In February, it reached 2.3% yoy from 1.9% yoy at the end of 2018. For the time being, inflation has been most influenced by cost factors. The jump is mainly caused by higher food and fuel prices, supported by oil price increases as well as food commodity price increases in the global market. We expect the inflationary pressures to continue in the first half of 2019, and then calm down in the second half of the year due to base effects.

ARDAL took advantage of the financial market situation

The Slovak Debt and Liquidity Management Agency (ARDAL) took advantage of the favourable situation in the financial markets and decided to extend its offer at the longer end of the yield curve with a new benchmark. At the beginning of April, bonds to the amount of EUR 1 billion were sold through syndicated sales. The new benchmark bonds mature in 11 years. In the sale, the spread was 21 points above interest swaps, or 1 basis point below the current interpolated curve. The total demand was five times higher than the supply. This signals a strong appetite among international investors for bonds from the Central and Eastern Europe region since mid-2018. The current yield to maturity of 0.78% represents a spread of roughly 72 basis points above the German bund level.

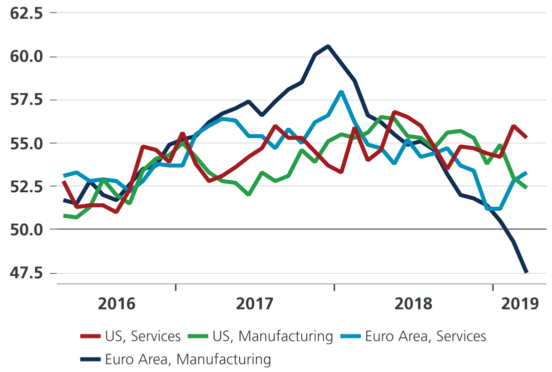
Figures

Real GDP
yearly change in %



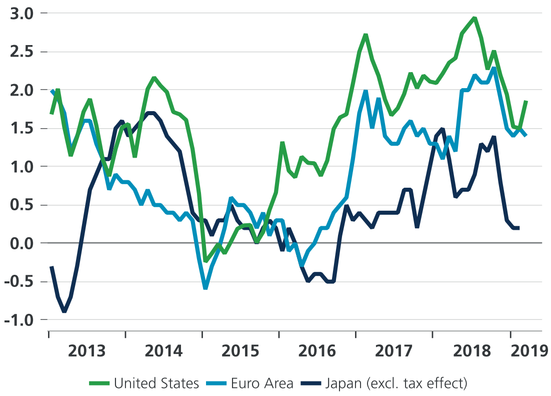
Source: KBC Economics based on Eurostat, BEA, NBS

Business confidence indicators
index, above 50 = expansion



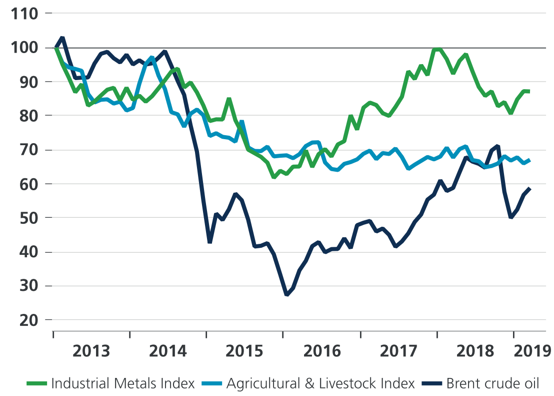
Source: KBC Economics based on IHS Markit

Headline inflation
yearly change consumer price index, in %



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

Commodity prices
index, January 2013=100, in USD

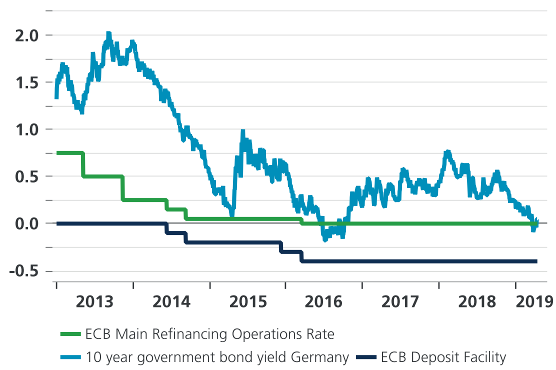


Source: KBC Economics based on World Bank, S&P

United States interest rates
in %

Source: KBC Economics based on FED, Macrobond

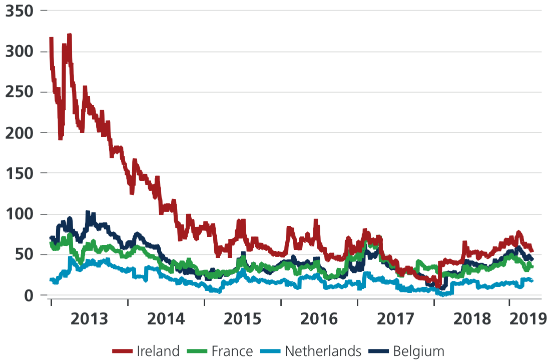
Euro area interest rates
in %



Source: KBC Economics based on Macrobond, ECB

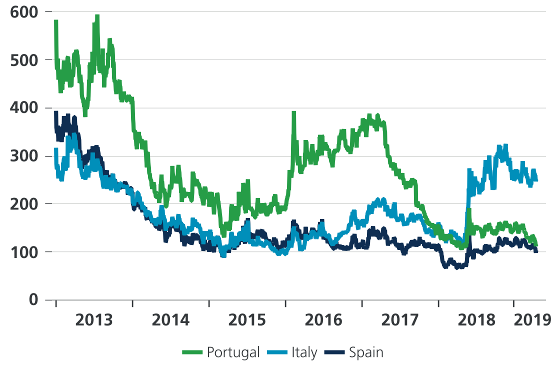
Figures

10 year government bond yield spreads to Germany
in basis points



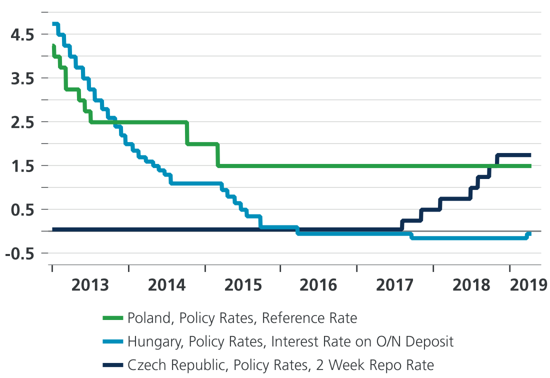
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



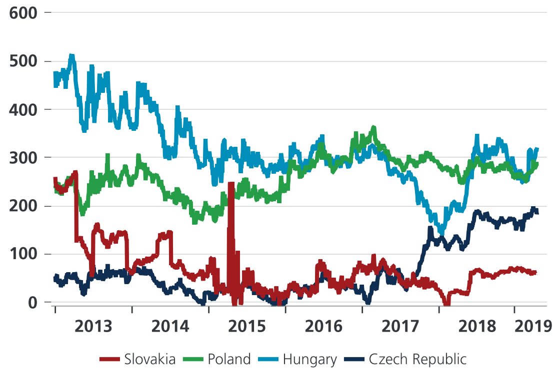
Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %



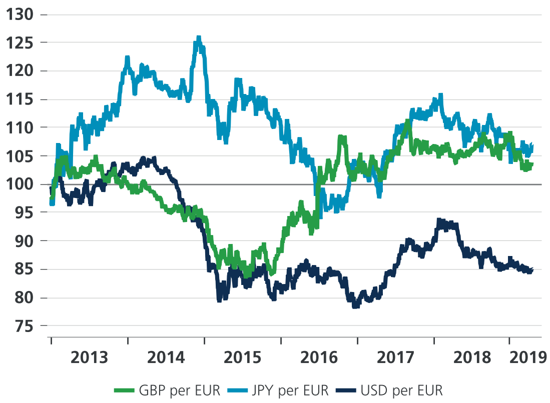
Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points



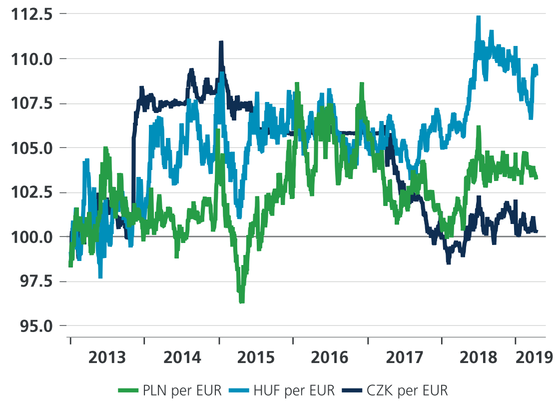
Source: KBC Economics based on Macrobond, AKK, Eurostat

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	1.8	1.1	1.4	1.7	1.3	1.5
	Germany	1.5	0.9	1.5	1.9	1.4	1.4
	France	1.5	1.1	1.3	2.1	1.3	1.6
	Italy	0.8	0.0	0.6	1.2	1.0	1.2
	Spain	2.5	1.9	1.7	1.7	1.5	1.5
	Netherlands	2.5	1.5	1.5	1.6	2.1	1.7
	Belgium	1.4	1.2	1.1	2.3	1.7	1.6
	Ireland	6.7	3.5	3.0	0.7	1.5	1.5
	Slovakia	4.1	3.7	3.5	2.5	2.6	2.4
Central and Eastern Europe	Czech Republic	2.9	2.6	2.3	2.0	2.2	1.9
	Hungary	4.9	3.9	2.6	2.8	3.0	3.5
	Bulgaria	3.2	3.2	3.1	2.6	2.5	2.4
	Poland	5.1	4.4	3.7	1.2	1.5	2.5
	Romania	4.1	3.8	3.5	4.1	3.5	3.3
Rest of Europe	United Kingdom	1.4	1.4	1.3	2.5	2.0	2.1
	Sweden	2.4	2.0	1.9	2.0	1.9	2.0
	Norway	2.4	2.2	1.8	2.8	2.0	2.0
	Switzerland	2.6	1.6	1.6	0.9	0.8	1.0
Emerging markets	China	6.6	6.0	5.7	2.1	2.2	2.5
	India*	7.0	7.1	7.4	4.0	4.2	4.7
	South Africa	0.8	1.3	1.3	4.6	4.9	5.5
	Russia	2.3	1.4	1.7	2.9	4.8	3.9
	Turkey	2.6	-1.5	2.5	16.3	17.0	12.0
	Brazil	1.1	2.0	2.4	3.7	4.0	4.2
Other advanced economies	United States	2.9	2.3	1.6	2.4	2.1	2.2
	Japan	0.8	0.9	0.5	1.0	1.0	1.4
	Australia	3.0	2.7	2.7	1.9	2.1	2.4
	New Zealand	2.8	2.8	2.6	1.6	1.9	2.0
	Canada	2.1	1.9	1.7	2.3	1.8	2.1
* fiscal year from April-March							*15/04/2019*

Policy rates (end of period, in %)						
		15/04/2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
Euro area	Euro area (refi rate)	0.00	0.00	0.00	0.00	0.00
	Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40	-0.40
Central and Eastern Europe	Czech Republic	1.75	1.75	2.00	2.00	2.00
	Hungary	-0.05	0.05	0.15	0.25	0.50
	Bulgaria	-	-	-	-	-
	Poland	1.50	1.50	1.50	1.50	1.50
	Romania	2.50	2.50	2.75	2.75	2.75
Rest of Europe	United Kingdom	0.75	0.75	0.75	1.00	1.00
	Sweden	-0.25	-0.25	-0.25	0.00	0.00
	Norway	1.00	1.00	1.00	1.25	1.25
	Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging markets	China	4.35	4.35	4.35	4.35	4.35
	India	6.00	6.00	6.00	6.00	6.00
	South Africa	6.75	6.75	6.75	7.00	7.00
	Russia	7.75	7.75	7.75	7.50	7.25
	Turkey	24.00	24.00	21.50	19.50	19.50
	Brazil	6.50	6.50	6.50	6.75	6.75
Other advanced economies	United States (upper limit)	2.50	2.50	2.50	2.50	2.50
	Japan	-0.10	-0.10	-0.10	-0.10	-0.10
	Australia	1.50	1.50	1.50	1.50	1.50
	New Zealand	1.75	1.75	1.75	1.75	1.75
	Canada	1.75	1.75	1.75	1.75	2.00

Outlook main economies in the world

10 year government bond yields (end of period, in %)		15/04/2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
Euro area	Germany	0.06	0.00	0.10	0.30	0.35
	France	0.42	0.40	0.60	0.90	0.95
	Italy	2.57	2.70	3.10	3.30	3.35
	Spain	1.08	1.20	1.35	1.60	1.65
	Netherlands	0.25	0.20	0.30	0.55	0.60
	Belgium	0.52	0.55	0.70	0.95	1.00
	Ireland	0.59	0.70	0.80	1.05	1.10
	Slovakia	0.64	0.65	0.75	1.00	1.05
Central and Eastern Europe	Czech Republic	1.87	1.90	1.95	2.00	2.05
	Hungary	3.33	3.00	3.00	3.10	3.05
	Bulgaria	0.61	0.60	0.72	0.95	1.02
	Poland	2.89	3.00	3.10	3.20	3.30
	Romania	5.04	5.20	5.30	5.80	5.80
Rest of Europe	United Kingdom	1.23	1.10	1.20	1.30	1.30
	Sweden	0.43	0.40	0.50	0.70	0.75
	Norway	1.81	1.75	1.85	2.05	2.10
	Switzerland	-0.26	-0.30	-0.20	0.00	0.05
Emerging markets	China	3.38	3.25	3.30	3.30	3.30
	India	7.39	7.35	7.35	7.40	7.40
	South Africa	8.47	8.50	8.55	8.60	8.60
	Russia	8.25	8.25	8.20	8.15	8.05
	Turkey	17.51	15.00	145.00	14.00	14.00
	Brazil	8.99	9.15	9.30	9.30	9.30
Other advanced economies	United States	2.56	2.50	2.50	2.50	2.50
	Japan	-0.03	0.00	0.00	0.00	0.00
	Australia	1.96	1.90	1.90	1.90	1.90
	New Zealand	2.08	2.05	2.05	2.05	2.05
	Canada	1.76	1.75	1.75	1.75	1.75

Exchange rates (end of period)	15/04/2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
USD per EUR	1.13	1.12	1.12	1.15	1.15
CZK per EUR	25.64	25.55	25.50	25.20	25.10
HUF per EUR	320.17	324.00	322.00	320.00	318.00
PLN per EUR	4.27	4.30	4.33	4.35	4.33
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.76	4.76	4.77	4.78	4.78
GBP per EUR	0.86	0.87	0.87	0.88	0.88
SEK per EUR	10.46	10.40	10.25	10.00	10.00
NOK per EUR	9.61	9.50	9.40	9.35	9.35
CHF per EUR	1.13	1.15	1.16	1.17	1.17
BRL per USD	3.88	3.95	3.95	4.00	4.00
INR per USD	69.35	70.00	70.50	71.00	71.00
ZAR per USD	14.00	14.50	14.60	14.80	14.80
RUB per USD	64.31	66.00	66.00	65.00	65.00
TRY per USD	5.81	2.60	5.75	5.90	5.80
RMB per USD	6.71	6.75	6.80	6.85	6.90
JPY per USD	112.00	111.00	111.00	111.00	111.00
USD per AUD	0.72	0.72	0.72	0.73	0.73
USD per NZD	0.68	0.67	0.68	0.69	0.69
CAD per USD	1.34	1.33	1.31	1.29	1.29

Outlook KBC home markets

	Belgium			Ireland		
	2018	**2019**	**2020**	**2018**	**2019**	**2020**
Real GDP (average yearly change, in %)	1.4	1.2	1.1	6.7	3.5	3.0
Inflation (average yearly change, harmonised CPI, in %)	2.3	1.7	1.6	0.7	1.5	1.5
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	5.8	5.7	5.8	5.7	5.1	5.2
Government budget balance (in % of GDP)	-0.7	-1.7	-1.8	0.1	0.2	0.3
Gross public debt (in % of GDP)	102.0	101.5	101.0	64.0	61.0	59.0
Current account balance (in % of GDP)	-0.1	-0.4	-0.6	11.0	8.0	5.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	3.0	2.3	2.1	10.2	4.5	3.0

15/04/2019

	Czech Republic			Slovakia		
	2018	**2019**	**2020**	**2018**	**2019**	**2020**
Real GDP (average yearly change, in %)	2.9	2.6	2.3	4.1	3.7	3.5
Inflation (average yearly change, harmonised CPI, in %)	2.0	2.2	1.9	2.5	2.6	2.4
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.0	2.0	2.0	6.1	6.2	6.3
Government budget balance (in % of GDP)	0.9	0.0	-0.5	-0.7	-0.7	-0.7
Gross public debt (in % of GDP)	32.7	31.3	30.5	49.0	48.0	47.0
Current account balance (in % of GDP)	0.3	0.4	0.3	-2.0	-1.5	-1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	8.0	3.5	3.0	5.0	4.0	3.5

15/04/2019

	Hungary			Bulgaria		
	2018	**2019**	**2020**	**2018**	**2019**	**2020**
Real GDP (average yearly change, in %)	4.9	3.9	2.6	3.1	3.2	3.1
Inflation (average yearly change, harmonised CPI, in %)	2.8	3.0	3.5	2.6	2.5	2.4
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	-2.0	0.1	-0.5	0.4
Gross public debt (in % of GDP)	70.8	68.7	66.7	22.1	19.0	18.6
Current account balance (in % of GDP)	0.5	0.0	-0.2	2.4	1.2	1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	7.5	4.0	3.0	6.0	5.0	4.0

15/04/2019

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