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Economic Perspectives

September 2017

Highlights

- The world economy continues to grow at a healthy pace that is now being seen across most regions with no signs as yet that increased geopolitical tensions are having any significant downside impact. However, inflation figures in major economies continue to fall disappointingly below expectations. Temporary factors are playing an important role, but more persistent restraining effects from low wage growth and global overcapacity should not be underestimated.

- The weak inflationary environment combined with solid growth numbers are not making the central banks' job of policy normalisation any easier. The ECB remains in a wait-and-see mode and hasn't unveiled any details on what policy steps might be expected after December of this year. Our view remains unchanged as we still expect the ECB to start tapering its Asset Purchasing Programme from the beginning of 2018.

- KBC Home Markets in Central and Eastern Europe have reported notably strong economic growth of late. The favourable economic environment in key trade partners is underpinning exports from the region. Moreover, private consumption is being supported by continuously improving labour market developments. However, some sectors are already reporting severe labour shortages, which will continue to put upward pressures on wages and eventually inflation.

- The Euro continued its strengthening against the USD, mainly driven by positive economic news about the euro area economy and expectations about monetary policy normalisation by the ECB. However, in the near term, the Euro appreciation may be overextended. Hence a temporary fall back in the Euro against the USD may be expected.

- In Focus: Government debt dynamics in the main euro area countries against the background of unconventional monetary policy and policy normalization.

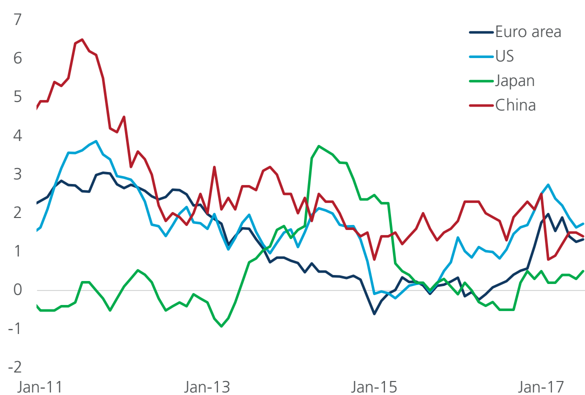
Global Economy

Solid growth

The world economy continues to grow at a healthy pace that is now importantly being widely seen across regions. Increased geopolitical tensions between the US and North Korea have not materially altered global economic prospects as a major outbreak of hostilities is thought very unlikely. In the euro area, both sentiment and activity indicators remain firm, confirming our projections of above-potential growth in the region for the upcoming period. Sentiment among services providers has retreated slightly from recent highs but remains at levels consistent with solid growth. Meanwhile, manufacturing PMIs surprised on the upside in the US, China and the UK, confirming the recovery of the manufacturing sector after the weakness in recent years. Hence, the global economic picture remains favourable. As reported data were in line with our expectations, we haven't adjusted our main growth forecasts for the euro area or the US.

Recent data on the US economy were comforting. Real GDP growth for Q2 was revised upwards, supported by strong private consumption and a substantial rise in business investment. Figures for Q3 suggest a moderate growth deceleration compared to the strong second quarter. Nevertheless, labour market developments remain positive and households' balance sheets are healthy. Therefore, private consumption expenditures will continue to be an important growth driver in the US for now. In our view, Hurricanes Harvey and Irma are posing only temporary risks to our US outlook. The main negative growth effects will most likely come via a reduction in exports of petroleum/coal products, oil/gas extracts and chemical products as the region affected by Harvey is an important production hub for total US output in these sectors. Moreover, some transitory weakness in industrial production, retail sales, job creation, building permits and consumer confidence together with rise in initial jobless claims is to be expected. Some negative effects will hence be seen in Q3 GDP growth figures, but the recovery with the rebuilding of destroyed capital stock will be visible in Q4. As a consequence, the overall fundamental US growth environment remains unchanged. Short-term political risks have also receded a bit as a deal was reached to extend the US debt ceiling and provide government funding beyond September until December 15. However, the issue will pop up again later on this year.

Figure 1 - Global inflation remains stubbornly low
(headline inflation, % change yoy)



Source: KBC Economic Research based on national sources

KBC Home Markets in Central and Eastern Europe have reported notably strong economic growth of late. The favourable economic environment in key trade partners is underpinning exports from the region. Moreover, private consumption is being supported by continuously improving labour market developments. However, some sectors are already reporting severe labour shortages, which will continue to put upward pressures on wages and eventually inflation.

Disappointing inflation

In the context of a very healthy growth climate, inflation remains stubbornly subdued (figure 1). US core and headline personal consumption expenditures (PCE) inflation, the indicator that is being watched most closely by the Fed, reached only 1.4% yoy in July. Moreover, it has been trending downward in recent months, away from the Fed's 2% inflation target. Temporary factors played the dominant role in this decline. However, several Fed FOMC members are increasingly cautious about the possibility of persistently low inflation. As a result, current inflation developments are being watched closely as a factor in determining the Fed's next policy steps.

In the euro area, headline inflation increased from 1.3% yoy in July till 1.5% yoy in August, just slightly above the core inflation of 1.2% yoy. However, during the press conference following this month's ECB meeting, President Draghi noted that while core inflation has risen in recent months, it has yet to show convincing signs of a clear upward trend. Indeed, the recent uptick in core inflation can mainly be accounted for by three sectors that are all related to tourism: package holidays, accommodation services and air transport. These inflation components tend to be very volatile and highly dependent on holiday timing effects. A study by the IIF shows that the

‘underlying’ core inflation - without the volatile and seasonal tourism sectors - has shown almost no sign of a pickup in recent months, and has been hovering around 0.8% for the last couple of years. The low inflation environment is mainly the result of subdued wage growth and global overcapacity. Moreover, the recent appreciation of the EUR is further constraining euro area inflation. The stronger Euro decreases import prices, depressing inflation figures. As a consequence, the ECB has revised down its forecast for headline and core inflation for coming years. This doesn’t make central banks’ path towards monetary policy normalisation any easier.

Our annual inflation forecasts remain unchanged at subdued levels. For the euro area, we see headline inflation reaching 1.5% this year and 1.3% next year, thereby staying significantly below the ECB’s ‘below but close to 2%’ target. Our inflation projections for the US are a bit more optimistic (2.1% for 2017, 2.3% for 2018) as rising labour market tightness should put upward pressures on wage growth and eventually lead to higher inflation.

As central banks’ communications didn’t bring much news, we stick to our view on central bank policies. The ECB will most likely announce some policy details in October. We expect that the ECB will continue its QE at a monthly pace of 60 billion EUR until December 2017. Thereafter, the real tapering will start and will be ended by mid-2018. As again stressed in the press release after the September meeting, the ECB will keep the deposit rate unchanged “for an extended period of time, and well past the horizon of the net asset purchases”. Therefore, we see the first deposit rate hike only at the beginning of 2019. Regarding the Fed, we still expect one more rate hike this year and three more in 2018. As inflation dynamics remain rather disappointing, the risks to this are skewed to the downside. The announcement of vice-governor Stanley Fisher’s resignation as Fed board member also leads to more dovish expectations on near term Fed policy. As previously announced, the Fed will most likely start running down its balance sheet this autumn.

USD weakness

Despite the context of a benign growth environment and a reduction of short-term political risks now that the deadline for the debt ceiling has been postponed, the USD has continued on its weakening path. This was not only the case against the EUR, but also against other currencies like the Japanese Yen and the Chinese Renminbi, leading to a broadly based weakening of the USD effective exchange rate. Several factors were behind this depreciation trend. First, President Trump has repeatedly disappointed the great expectations in relation to major US policy initiatives that he raised before his election. Instead, the political failures of the Trump administration have been piling up. The recent deal Trump was able to make with the Democrats to extend the debt ceiling and budget deadline to December was no game changer. After all, the problem was only postponed and not solved. Hence, market uncertainty about this matter will quickly return. Furthermore, in the context of rising geopolitical tensions between the US and North Korea, the USD no longer seems to be perceived as a safe haven currency as was typically the case in the past when market nervousness intensified.

Besides, ECB President Draghi's comments last week have done nothing to dispel the Euro's momentum against the USD. Although the exchange rate is not a policy target, it is clear that it is posing the ECB particularly tricky questions at present as it remains important for growth and inflation. The ECB’s wait-and-see stance is also postponing any prospect of clarity on when and how quickly the ECB will begin to exit from its QE programme. Draghi’s denial that any discussion had taken place on this issue at the early September policy meeting may have been intended to emphasise that the point of departure remains some time away. However, these sorts of uncertainty may be adding to pressure on the Euro as markets may have already priced the currency on the expectation of a looming first step away from QE. Nevertheless, in our view, there is at least some element of overshooting in the recent EUR appreciation. Therefore, we see the USD strengthening again somewhat against the EUR in the coming months and reaching 1.15 USD per EUR. The main short-term USD support may be the Fed that sticks to its communicated rate hiking course which has not yet been properly factored in by markets so far. Thereafter, the USD will likely weaken again as markets will begin to anticipate a first ECB rate hike.

French reforms taking shape

After several years of rather disappointing growth, weak productivity and a stubbornly high unemployment rate, the new French government seems to be committed to turning the tide with much needed reforms. Labour market reforms, that were put forward as a top priority during President Macron’s election campaign, are starting to take shape. The French government unveiled measures to liberalise the labour market aimed at increasing France’s attractiveness to foreign investors, stimulate businesses to hire more workers and tackle the still high unemployment rate. The proposed reforms would simplify and reduce the barriers to dismiss workers, provide flexibility to

adjust components of labour costs and facilitate more firm-level decisions - especially for SMEs. The measures form a good first step towards increasing France's growth potential.

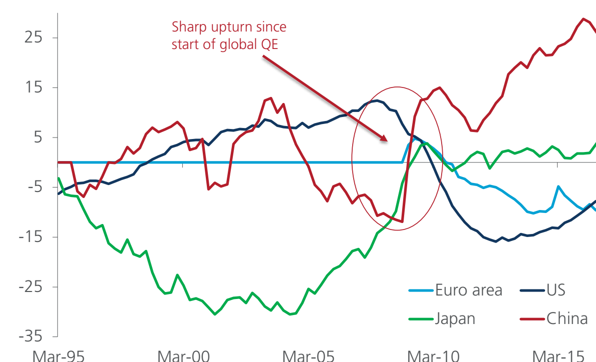
Before these measures are translated into law, the official texts will have to be presented in Parliament by the end of September and turned into decrees. Parliament will then have to validate the texts this autumn. The greatest risk to the enactment of these reforms are social unrest and union protests. However, two of the largest unions, although they expressed their criticism and disappointment, didn't join street protests. In any case, current developments and reactions indicate a quite constructive climate for further negotiations regarding upcoming unemployment, training and pension reforms planned next year. In the longer run it remains to be seen whether President Macron will be able to extend his reform programme.

German elections coming up

In the other key European economy, Germany, the outcome and aftermath of this month's elections should bring more clarity about potential upcoming reforms. As election polls suggest, our base scenario envisages the CDU/CSU gaining the most votes. Hence, it is highly likely that Angela Merkel remains in the seat of Chancellor. She will most likely have to form a coalition, probably with some smaller party like the Greens or the FDP. A grand coalition with the second largest party, the SPD, is less likely, but cannot be excluded.

Based on the main parties' campaign manifestos, we see some potential positive impacts on the German economy from proposed policy measures, albeit rather moderate. The major focus is rather on tax reductions and spending increases and less on structural reforms. Regarding European matters, the four largest parties are in favour of a common border policy and a strengthening of the EU's external borders, a hard position in the Brexit negotiations and a fair distribution of incoming refugees between the EU countries. Opinions about further European integration are more divided. The SPD and the Green party are in favour while the FDP is against. The stance of the CDU/CSU is more mixed, but the party has moved noticeably to a more EU-critical stance over time. The final coalition that will be formed, will determine whether there will be a French-German entente that can take the lead in strengthening the European project.

Figure 2 - Chinese credit gap still on upward trend from high levels
(deviation from trend of debt-to-GDP ratio, in % of GDP)



Source: KBC Economic Research based on Bank for International Settlements (2017)

Chinese debt mountain

Our base scenario for the Chinese economy is one of gradually slowing growth without a sudden hard landing. In these circumstances, the transition pace from an investment- and export-driven economy towards a more consumption-led economy will be moderate. After all, the Chinese authorities still want to underpin employment so that social stability will not be endangered. As already mentioned in our previous publications, the downside of this approach is that it entails a continuous debt build-up, both in the public and private sector, which is not sustainable in the long run. This has caused the credit-to-GDP gap - defined as the difference between the credit-to-GDP ratio and its long-run trend - to increase to 25%, the highest level worldwide (figure 2).

Despite its recent decline, the Chinese credit gap is still on an unsustainable upward trend. The upward movement started at the end of 2008/beginning of 2009 and coincided with the start of the Fed's quantitative easing. Via the peg of the Chinese currency to the USD, the Chinese economy simply imported a large amount of liquidity flows from the US. As a result, massive credit expansion could stimulate growth, leading to the immense debt mountain of today. If this credit bubble bursts, the Chinese authorities will likely have enough means to recapitalise affected banks. Furthermore, Chinese financial integration with the rest of the world is still relatively limited. Therefore, we don't think a local Chinese financial crisis would spark a global financial system crisis. Nevertheless, global economic growth would be negatively impacted via major Chinese trade partners.

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Bulgarian Economy

Real GDP estimates showed continuing growth in the Bulgarian economy in Q2 2017, similar to that in the other Central & South Eastern European countries. On an annual basis, GDP increased by 3.6% (0.9% qoq), with the key drivers being private consumption (4.2% yoy growth) and net exports. Investment, however, disappointed as it declined by 0.9% yoy (+2.4% qoq). The poorer performance of gross fixed capital formation, especially in Q1 of 2017 (-4.6% yoy), was due to the slow beginning of the new EU programme period for funds absorption. The latter are expected to accelerate and materialize in Q3 of 2017. Besides the EU funds absorption momentum for GDP growth, positive developments in the labour market are the main driver for the economy's robust performance. In particular, wage growth supports consumption growth. We estimate GDP growth for 2017 as a whole will reach 3.4% and 3.1% in 2018.

Bulgarian inflation is increasing again after a period of deflationary pressures that started in 2013. We expect annual inflation for 2017 to be 1.3%, supported by strong domestic demand and increasing shortages in the labour market. The unemployment rate has been declining for 2.5 years now and reached its lowest level since 2009 in June 2017 (5.9%).

Business sentiment has been in line with the favourable economic developments. In August 2017 the aggregate business climate indicator recorded a monthly increase of 0.5 p.p. due to improved sentiment in retail trade and the services sector. The Bulgarian economy keeps struggling with structural issues like low productivity, high corruption levels and unfavourable demographic changes. Nevertheless, Bulgarian authorities continue implementing vital structural reforms in order to improve the macroeconomic environment and ensure further economic convergence with the Western European countries. The recent visit of the French President Macron to Varna, held on 25th August, gave hope and support regarding the Bulgarian path towards its entry to the Schengen area and the euro area's waiting room.

Detailed forecasts for the Bulgarian economy	2016	2017	2018
Real GDP growth (in %)	3.4	3.4	3.1
Inflation (in %, harmonised CPI)	-1.3	1.3	1.5
Unemployment rate (in %, end of year, Eurostat definition)	7.6	6.8	6.6
Government budget balance (in % of GDP)	0.0	-0.5	-0.3
Gross Public debt (in % of GDP)	29.5	29.0	28.0
Current account balance (in % of GDP)	2.9	1.6	1.6
House prices (avg annual %-change, total dwellings, Eurostat definition)	7.5	6.0	5.0

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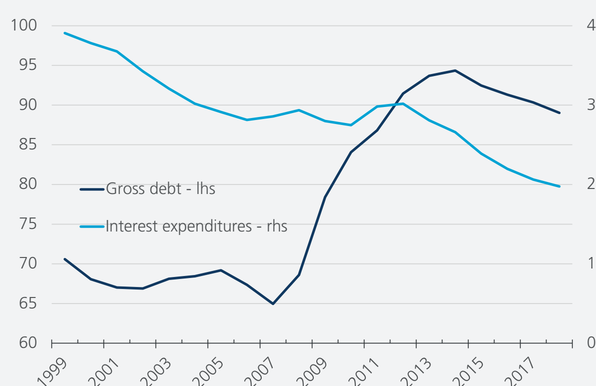
Focus article:

Government debt dynamics in the main euro area countries against the background of unconventional monetary policy and policy normalization

Unconventional monetary policy has contributed to a declining government debt ratio

The aggregate government gross debt ratio, i.e. gross government debt as a percentage of GDP, is now on a downward path in the euro area (figure 5). The unconventional monetary policy of the ECB – in particular the asset purchase programme or quantitative easing – has contributed to this decline in the government debt ratio in several ways. Clearly, by assisting recovery in the euro area recovery, it has helped improve the situation of the public finances in euro area economies. More directly, by bringing down market interest rates, it allowed governments to finance deficits and refinance maturing debt at historically low costs. As a result interest expenditures on government debt (as a percentage of GDP) have declined even more than the debt ratio itself (figure 5). Declining interest expenditures reduce the budget deficit and that, in turn, tempers the debt increase. Savings of this nature provided governments with the leeway to undertake fiscal policy actions which also contributed to the decline of the government debt ratio, as the aggregated primary budget balance, i.e. the budget deficit excluding interest payments, turned into a surplus form 2015 onwards.

Figure 5 - Government debt and interest expenditures in the eurozone (% of GDP)



Source: KBC Economic Research based on EC (Ameco); 2017-18: EC Spring forecasts

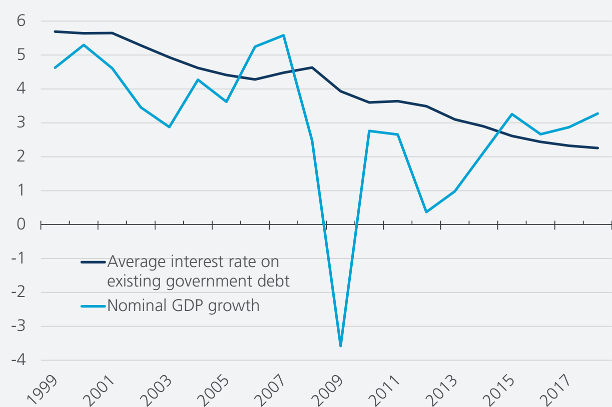
It is important to emphasise how important the recovery in economic growth has been to a healthier trend in the public finances of euro area countries. Stronger economic growth not only helps debt reduction by reducing the budget deficit through increased revenues (e.g. taxes, social security contribution, etc.) and decreasing expenditures (e.g. for unemployment). It also helps reduce the debt ratio by increasing the denominator of the ratio. The strengthening of real GDP growth lifted nominal economic growth (that also includes inflation) above the average interest rate on the government debt (the so-called implicit interest rate). From a mathematical point of view, this is a very important element for debt sustainability. When nominal GDP growth is above the implicit interest rate to be paid on the debt it is sufficient to maintain the primary budget balance constant in order to prevent a further increase of the debt ratio. These circumstances mean that the threatening so-called snowball effect of an ever increasing debt ratio is stopped.

One could argue that unconventional monetary policy has been the major contributor to the process of moving the euro area's public finances onto a more sustainable path. In recent history, there has only been a short period (2006-2007) without a negative snowball effect. As of today, nominal GDP growth is still rather low from an historical point of view. However, the implicit interest rate on government debt is in even more unusual territory at historical lows (figure 6). This reflects historical low nominal bond yields on government debt, the result of unconventional monetary policy, in particular government bond purchases by the ECB. This argument raises the question whether debt sustainability will be endangered by the ending of this asset purchase programme. More specifically, rising interest rates could reactivate the negative snowball effect.

Significant differences across countries

Before answering that question it is worth highlighting that there are significant differences in government debt dynamics across countries in the euro area. The decline of the aggregate

Figure 6 - Drivers of the snowball effect
(in %)

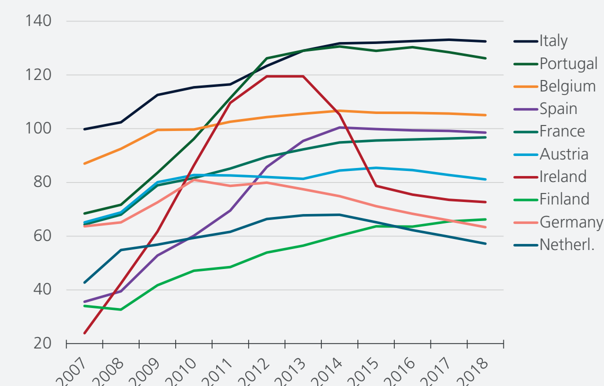


Source: KBC Economic Research based on EC (Ameco); 2017-18: EC Spring forecasts

euro area government debt ratio mainly reflects the decline in Germany, the Netherlands and Ireland (figure 7). Most other main euro area countries have a relatively stable debt ratio, although, according to the spring Economic Forecast of the European Commission (EC, 2017), a moderate decline of the debt ratio is forecast in Austria, Portugal, Spain and, to a lesser degree, in Belgium. Two main euro area countries still have an upward trending government debt ratio: Finland and to a lesser degree France. In Italy, the debt ratio will still rise in 2017, but is forecast to decline in 2018.

Differences in debt dynamics across countries reflect different underlying drivers. In most countries government interest expenditures (as a percentage of GDP) are at historical lows. Only Portugal, Spain and Ireland still bear interest costs above pre-crisis levels, reflecting much higher debt levels. The rising

Figure 7 - Gross government debt in the main euro area countries
(% of GDP)



Source: KBC Economic Research based on EC (Ameco); 2017-18: EC Spring forecasts

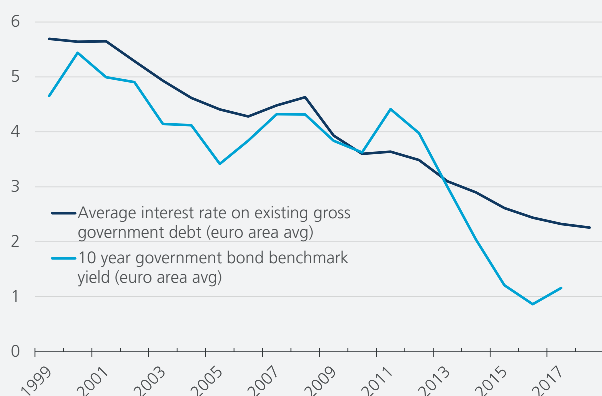
debt ratio in France and Finland stems from loose fiscal policy, reflected in primary budget deficits. On the other hand, the decline of the Spanish debt ratio is supported by a decreasing primary deficit. Importantly, at this moment most countries benefit from the positive snowball effect, with two notable exceptions: Italy and Portugal. As is the case in all other countries, the government of both countries is benefitting from declining interest rates, but the decline in Italy and Portugal has been smaller than in other countries, due to persistent high risk premiums on the government debt. On top of that, Italy, in particular has suffered from weak economic growth, implying that the snowball effect was still negative. The growth performance of the Portuguese economy has recently improved, mitigating the negative snowball effect in that country. Nevertheless, due to the still negative snowball effect, both countries are extremely vulnerable to a deteriorating primary budget balance. They need to maintain or even increase large primary budget balances to stop further increases of the debt ratio.

Normalisation and interest expenditures

Monetary policy normalisation can obviously affect the government budgets by increasing interest rates which would in turn increase governments' interest expenditures. The impact on the snowball effect depends on the current level of the average interest rate on the existing government debt, on the one hand, and the level of market interest rates at which new debt has to be financed, on the other. The speed of the impact depends on debt maturity and the budget deficits.

When new debt has to be issued at interest rates above the average interest rate of the existing debt, the average interest rate will rise. This possibly threatens debt sustainability, when it lifts the interest rate on government debt above nominal GDP and, by doing so, activates the negative snowball effect. In this respect, it is noteworthy that, today, the implicit interest rate on government debt is still (on average) more than 100 basis point above current long-term bond yields (figure 8). Consequently, though rising interest rates will make new debt issuances more expensive, they won't immediately result in a higher average interest cost. As long as the increase in market rates remains contained, new debt will still be issued at a lower cost than the average financing cost of the existing debt, resulting in a further decline of the average cost. In that sense, public finances are sheltered against monetary policy normalisation by a buffer against higher market interest rates.

Figure 8 - Interest rate evolution
(in %)



Source: KBC Economic Research based on EC (Ameco) and Eurostat; 2017-18: EC Spring forecasts

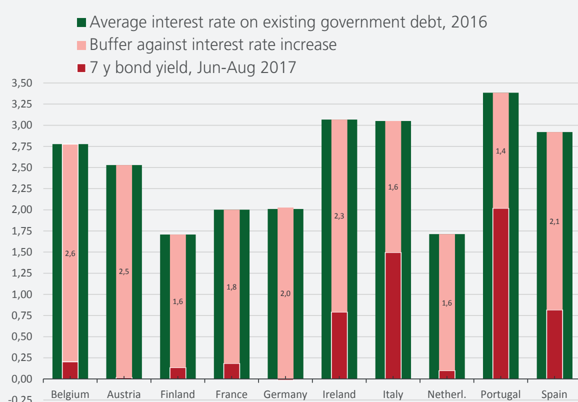
Yet, this buffer is uneven across countries, ranging from around 250 basis points for Belgium and Austria, to less than 140 basis points for Portugal (figure 9). The buffer reflects unequal funding conditions for sovereigns as expressed by yield differentials vis-à-vis Germany. Consequently, the size of the buffer not only depends on changes of the German bond yield but also on a country's spread. This is a double-edged sword: spread fluctuations could either strengthen the buffer or destroy it swiftly. In one scenario, monetary policy normalisation and a rise of German Bund and other government bond yields could undermine trust in high debt countries' debt sustainability. That would result in spread increases and add to those countries' debt sustainability concerns. In this scenario, increasing risk premiums would increase sustainability risks and trigger a further widening of the spread, which in turn would prompt a deterioration in debt sustainability. Spread widening would occur as a self-fulfilling prophecy. In a worst case scenario it could necessitate the activation of the OMT or a similar program by the ECB, i.e. necessitating the ECB to buy government debt as a buyer of last resort.

On the other hand, a more optimistic scenario might also be envisaged. Monetary policy normalisation and upward pressure on bond yields are likely to occur in an environment of stronger economic growth and a return of inflation to its target. On balance, this is a more favourable environment for debt sustainability. That perception could support a decline of a country's risk spread, at least for those countries that maintain a fiscal policy focus on debt stabilisation and further fiscal consolidation. Admittedly, the pursuit of prudent fiscal policy cannot be taken for granted in a more benign economic environment. In other words: the possible impact of monetary policy normalisation on government debt dynamics won't be independent of the way countries implement fiscal policy.

Fiscal policy matters

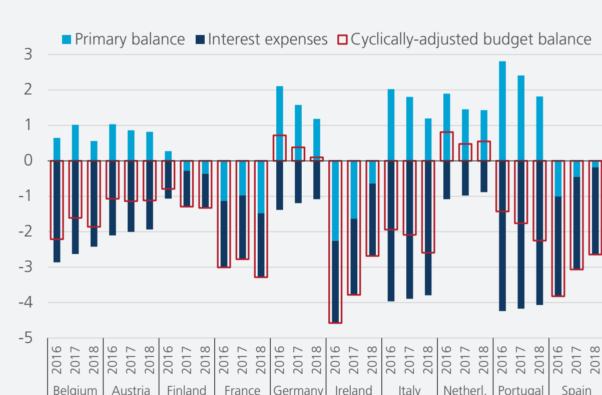
Fiscal policy consolidation efforts are often assessed on the basis of the evolution of the primary structural or cyclically-adjusted balance, i.e. the budget balance, excluding interest expenditures and corrected for the impact of the business cycle on the government budget. Primary cyclically-adjusted balances are deteriorating in all main euro area countries, except Spain and Ireland (figure 10). From this perspective, the challenge of fiscal policy is particularly heavy in France, that still has to create a primary surplus, and in Italy and Portugal, that struggle with maintaining high primary surpluses.

Figure 9 - Interest rate on existing debt and current market yields
(%)



Source: KBC Economic Research based on Eurostat and Thomson Reuters Datastream

Figure 10 - Cyclically-adjusted budget balances
(% of GDP)



Source: KBC Economic Research based on EC (Ameco); 2017-18: EC Spring forecasts

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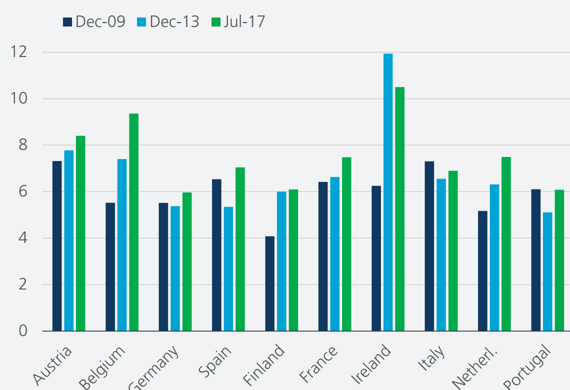
Yet, comparing the actual balances with the Medium Term Objectives, that are around -0.5% of GDP for most countries, reveals that the fiscal challenge is significant for all countries except Germany and the Netherlands. Again France stands out as the country facing perhaps the toughest challenge. Italy and Belgium are deviating from the objective, according to the latest EC forecasts. They are forced to tighten fiscal policy. Also Ireland still has a way to go. It is the country with the largest difference between the structural and the nominal balance.

All this implies that fiscal policy in most euro area countries will have to be rather restrictive in the period ahead, which at the aggregate euro area level could be compensated by a somewhat looser fiscal policy stance in Germany.

A matter of time

Higher market interest rates feed into the implicit interest rate through governments' gross financing needs. These depend on net financing requirement stemming from the annual budgets. So, the fiscal policy followed in coming years really matters for sustainability. Gross financing needs also depend on refinancing requirements of maturing existing debt. In that respect, it is noteworthy that treasuries have lengthened the average maturity of the outstanding debt. Again there are significant differences across countries and for some countries there has been no lengthening, when looked at in a longer term perspective (figure 11). Nevertheless, the overall picture is that recent low interest rates have been locked in for several years by all countries. This will also mitigate the immediate impact of higher market rates on the average financing cost of the debt.

Figure 11 - Residual maturity of outstanding debt securities
(in years)



Source: KBC Economic Research based on ECB

Impact on revenues

Unconventional monetary policy, more specifically the Asset Purchase Programme, helped fiscal policy not only by lowering interest rates, but also by increasing government revenues through increased taxes and profit transfers from the central bank to the government. From a pure conceptual, economic point of view the central bank is part of the government sector. In that perspective, one could argue that a government bond bought and held by the central bank disappears, as the government owns her own debt and pays interest to herself. Yet, in the macroeconomic national accounts the central bank is not considered as part of the government sector, but as a financial institution. Moreover, the European fiscal governance rules don't consider a consolidation of the central bank with the government sector, either. In fact, central banks need to be independent institutions, that in some countries, among which Belgium, are partly privately owned. Consequently, levels of discretion over central bank's profit distribution depend on governance and tax rules, that differ across countries. Moreover, the central bank profit itself depends on rules on risk provision, that also differ across countries. In this respect it is noteworthy that higher central bank revenues in countries with higher government debt yields reflect, in principle, higher risks. Taking this insufficiently into account in profit calculation, makes the issue of central bank profit distribution potentially politically controversial. According to a recent Bundesbank article, central bank's taxes and transfers to the government ranged in 2016 from 0% of GDP in low interest countries (Austria, Finland, Germany and the Netherlands) to 0.3% of GDP in Portugal. The article illustrated the huge heterogeneity across euro area countries in this respect.

Looking forward, it is noteworthy that stopping the Asset Purchase Programme won't act as a negative shock to money flows between the central bank and the governments' treasuries. In a first phase of policy normalisation, the positive spill-overs to the government budget are likely to continue. Indeed, the debt portfolio and the resulting interest income of central banks will continue to increase as long as the purchase programme runs. Tapering will temper the increase, but not stop it. Only ending the programme will stop the growth of the central bank's portfolio. As long as the bank maintains its portfolio the revenue stream remains intact. Re-investing maturing bonds at higher yields would even increase the revenue stream stemming from it. Yet, given the very long average maturity of the central banks' portfolios, this is unlikely to have major impacts in the near future. On the contrary, it is

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more likely that profits from the government bond portfolio will start declining sooner. The normalisation of the interest rate policy will indeed raise the funding cost of the central bank and thus reduce the net revenue stemming from the bond portfolio. Yet, as this normalisation of the interest rate policy is not likely to start very soon and is forecast to occur very gradually, it is unlikely to act as a negative shock either.

Conclusion

Unconventional monetary policy of the ECB helped fiscal policy by lowering the financing cost of government debt. Particularly in high interest countries it also increased government revenues from the central bank. The normalisation of monetary policy will increase the funding cost of new government debt, but only gradually, without immediately activating the negative snowball effect. The positive impact of unconventional monetary policy on governments' revenue will fade, but also only gradually.

The main conclusion with respect to the impact of monetary policy normalisation on public finances is that it doesn't have to result in an immediate, abrupt deterioration in debt sustainability. There are some buffers that shelter public finances from rising interest rates, but these buffers are thinner for the most vulnerable countries, reflecting market perceptions of risks. This is a double-edged sword, making both benign and very adverse scenarios possible. Obviously, future fiscal policy of individual countries will again become more important. In our base scenario intra-EMU spreads will moderately increase, on top of the gradually rising German Bund yield. Step by step, this will bring government debt sustainability and credit risk to the fore, even if such concerns seem unlikely to intensify to the point where they might threaten any early return to a crisis in the euro area.

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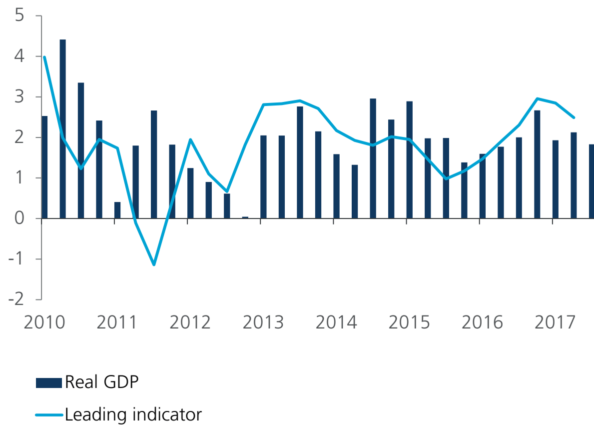
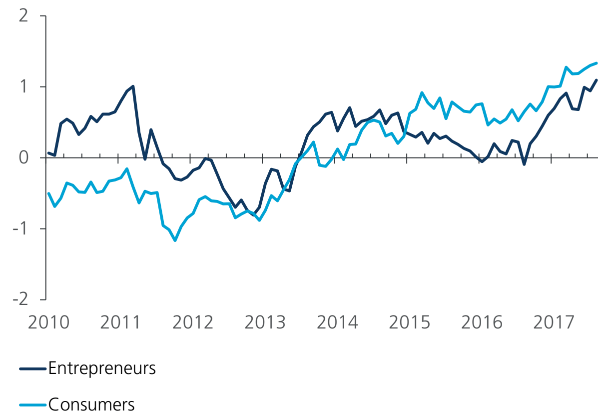
Figure 1 - Economic activity in the OECD
(annualised quarterly change in %)



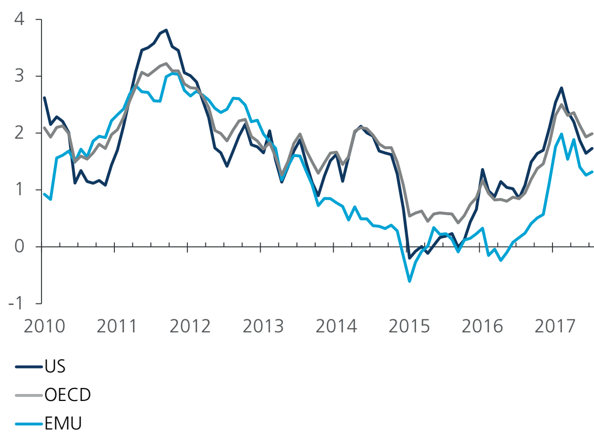
Source: OECD

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



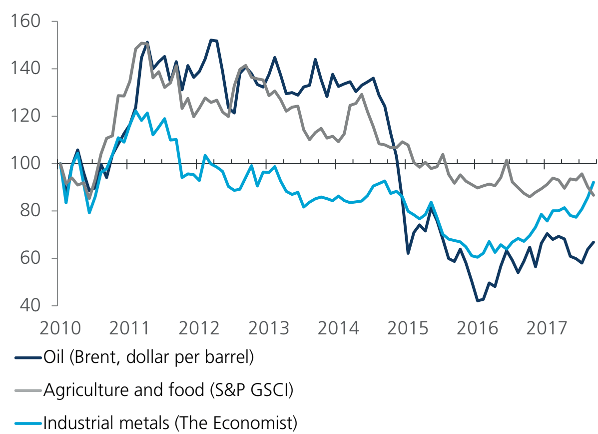
Source: National sources

Figure 3 - Inflation
(consumer price index, y-o-y change, in %)



Source: Eurostat, BLS and OECD

Figure 4 - Commodity prices
(January 2010 = 100)

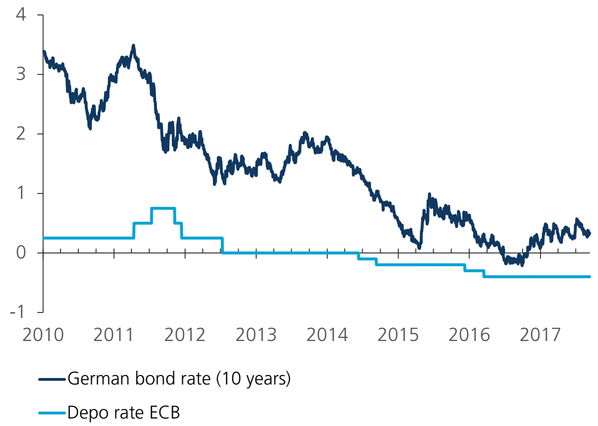


Source: ICIS pricing and S&P

Figure 5 - Interest rate movements US
(in %)

Source: Fed and Datastream

Figure 6 - Interest rate movements euro area
(in %)



Source: ECB and Datastream

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Outlook world economies

	Real GDP growth		Inflation	
	2017	2018	2017	2018
US	2.0	2.0	2.1	2.3
Euro area	2.0	2.1	1.5	1.3
Belgium	1.6	1.7	2.1	1.4
Germany	2.1	2.1	1.6	1.6
Ireland	4.0	3.5	0.3	1.0
UK	1.7	1.5	2.7	2.7
Sweden	2.6	2.4	1.7	1.8
Norway	1.7	1.9	2.0	2.0
Switzerland	1.4	1.7	0.5	0.6
Slovakia	3.2	3.5	1.2	1.6
Poland	3.8	3.4	2.0	2.1
Czech Republic	4.3	3.0	2.2	2.0
Hungary	3.7	3.5	2.4	3.2
Bulgaria	3.4	3.1	1.3	1.5
Russia	1.4	1.5	4.3	4.1
Turkey	3.9	3.2	10.6	8.1
Japan	1.3	1.0	0.5	1.0
China	6.7	6.3	1.7	2.2
Australia	2.3	2.7	2.1	2.2
New Zealand	2.6	2.9	1.8	1.9
Canada	2.7	2.0	1.7	2.0
World	3.2	3.3	-	-

10-year rates	12/09/17	+3m	+6m	+12m
US	2.15	2.50	2.60	2.70
Germany	0.36	0.70	0.70	1.00
Belgium	0.67	1.15	1.15	1.50
Ireland	0.69	1.15	1.20	1.53
UK	1.07	1.60	1.70	2.20
Sweden	0.77	1.15	1.15	1.45
Norway	1.49	1.85	1.85	2.15
Switzerland	-0.15	0.20	0.20	0.50
Slovakia	0.76	1.10	1.10	1.40
Poland	3.19	3.40	3.40	3.70
Czech Republic	0.95	1.20	1.20	1.50
Hungary	2.95	3.50	3.60	3.95
Bulgaria	1.69	2.05	2.05	2.35
Russia	7.53	7.90	8.00	8.10
Turkey	10.42	10.30	10.15	10.00
Japan	0.03	0.00	0.00	0.00
China	3.63	3.60	3.60	3.70
Australia	2.65	3.00	3.10	3.20
New Zealand	2.82	3.15	3.25	3.35
Canada	2.04	2.40	2.50	2.60

Policy rates	12/09/17	+3m	+6m	+12m
US	1.25	1.50	1.50	1.75
Euro area (refi rate)	0.00	0.00	0.00	0.00
Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40
UK	0.25	0.25	0.25	0.25
Sweden	-0.50	-0.50	-0.50	-0.25
Norway	0.50	0.50	0.50	0.50
Switzerland*	-0.75	-0.75	-0.75	-0.75
Poland	1.50	1.50	1.50	1.75
Czech Republic	0.25	0.50	0.50	1.00
Hungary	0.90	0.90	0.90	0.90
Romania	1.75	1.75	1.75	1.75
Russia	9.00	8.50	8.25	7.50
Turkey	8.00	8.00	8.00	8.00
Japan	-0.10	-0.10	-0.10	-0.10
China	4.35	4.35	4.35	4.35
Australia	1.50	1.50	1.50	1.75
New Zealand	1.75	1.75	1.75	2.00
Canada	1.00	1.00	1.25	1.25

*Mid target range

Exchange rates	12/09/17	+3m	+6m	+12m
USD per EUR	1.20	1.17	1.15	1.20
GBP per EUR	0.90	0.94	0.95	0.96
SEK per EUR	9.53	9.50	9.30	9.00
NOK per EUR	9.39	9.25	9.00	8.75
CHF per EUR	1.14	1.15	1.15	1.15
PLN per EUR	4.25	4.25	4.20	4.15
CZK per EUR	26.10	26.50	25.90	25.50
HUF per EUR	306.45	315.00	316.00	312.00
BGN per EUR	1.96	1.96	1.96	1.96
RUB per EUR	68.72	66.98	65.55	68.10
TRY per EUR	4.11	4.10	4.14	4.44
JPY per EUR	131.16	131.04	133.40	136.80
RMB per USD	6.53	6.68	6.68	6.68
USD per AUD	0.80	0.81	0.81	0.82
USD per NZD	0.73	0.74	0.75	0.76
CAD per USD	1.21	1.20	1.19	1.18

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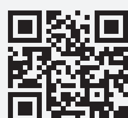

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