

In case you missed it: Rethinking rates

The global economic backdrop is looking murkier by the day. In the US, intensifying headwinds have prompted a rethink on the Fed's aggressive hiking plans while in Europe, weak data and seemingly endless political uncertainty have raised questions about the ECB's next move. And things are no less complicated in Asia...

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US: Signs of a slowdown?

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Source: Shutterstock

Headwinds are intensifying

The US economy has performed really well this year with a robust jobs market and massive tax cuts helping to generate the strongest year of GDP growth since 2005. But maintaining this momentum in 2019 will be hard, given the headwinds of the lagged effects of the strong dollar and higher interest rates along with the fading support from the fiscal stimulus and intensifying trade protectionism at a time of softer global growth. Housing and investment numbers suggest that this slowdown may already be underway.

Housing affordability weighing on activity

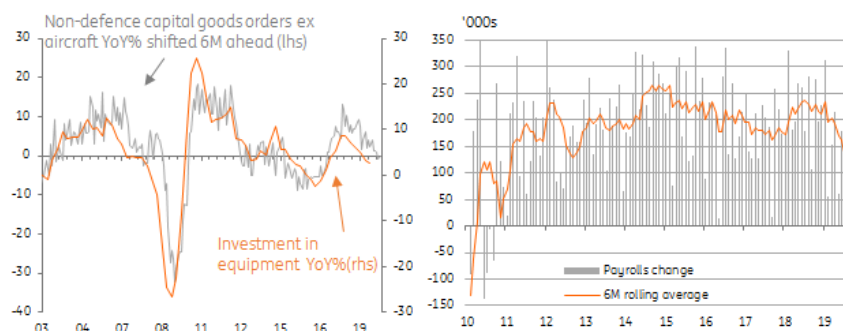
The housing market has been the area where this moderation in activity has been most noticeable. This should be understandable given 30-year mortgage rates are close to 5.2% right now – the highest for eight years – while house prices have been rising progressively. The S&P/Case-Shiller national average index is up 54% from the 2012 lows. Wage growth is picking up, but at 3.1% it remains well behind annual house price growth of 5.5% year on year as of August.

This combination of high prices and high borrowing costs have resulted in home purchases mortgage applications falling nearly 13% over the past four months while for refinancing the

downturn is over 40% since January.

We have seen home sales drift lower over the past 18 months on all of the main transaction measures and this is finally translating into weaker homebuilder sentiment. Indeed, the National Association of Home Builders index dropped eight points on Monday. This is the biggest drop since 2014 and takes the index back to the level seen in August 2016. With building permits down 8% since March, this suggests that home construction activity will be a drag on growth in 2019.

Housing figures point to slowdown



Capex concerns

The other area that is starting to cause a little concern is the corporate investment. President Trump had suggested that by lowering tax rates and encouraging companies to bring back overseas profits, this would stimulate investment and job creation in the US economy. The number of jobs in the US is certainly up, but the story on investment isn't as obvious.

The Federal Reserve has long been known to follow a key component within the durable goods report – non-defence capital goods orders excluding aircrafts. Aircraft orders tend to lead to big swings in the headline reading, as we saw today with a 21.4% decline in this component contributing strongly to a 4.4% drop in total orders. Defence orders can also be very volatile, so this “core” measure provides a better measure of what is going on in corporate America.

As the second chart below shows, it tends to lead investment spending and has historically had a very strong relationship. It isn't a good story right now with three consecutive monthly declines suggesting that the boost to corporate cashflows is not leading to stronger investment. Instead, a significant amount of those tax cuts appear to have been used to fund share buybacks and special dividends. Moreover, the uncertainty relating to protectionism may be making business more cautious.

Durable goods orders signal capex slowdown

	2019	2020	2021	2022	Longer run
Change in real GDP (Dec Fed forecast)					
Previous projection (September)	2.2	2.0	1.9	1.8	1.9
Unemployment rate (Dec Fed forecast)					
Previous projection (September)	3.7	3.7	3.8	3.9	4.2
Core PCE inflation (Dec Fed forecast)					
Previous projection (September)	1.8	1.9	2.0	2.0	-
Federal funds rate (Dec Fed forecast)					
Previous projection (September)	1.9	1.9	2.1	2.4	2.5

Source: Macrobond, Bloomberg, ING

Caution from the Fed?

We are certainly not suggesting the US is on the verge of a pronounced slowdown – we see GDP growth of 2.4% in 2019 and 1.8% in 2020, but some signs warrant caution on the US outlook. There are still positives for the US such as good momentum and robust wage growth, but looking at the situation all together it is understandable why Fed officials sound more mixed on the outlook.

For now, we are forecasting a December rate rise with three more rate rises next year, but the balance of risks does appear to be shifting towards a more modest rate hike path making it look as though two rate hikes are more likely than four.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Article | 21 November 2018

European politics in 2019: United in even more diversity

In European politics, 2017 was the year of hope for new momentum towards further integration. For a while, there was a real 'Europhoria'. In...



European leaders in Salzburg, Austria in September 2018

Leaving Italy's fiscal escapades aside, three main political themes should get financial markets' attention next year: elections for the European Parliament in May (held every five years), a changing of the guard in European top jobs, and German politics. Let's try to put these three potential risks into perspective.

1 European elections: Rise of the anti-EU parties?

It is hard to remember any single election which has not been labelled as important, crucial or trend-setting. Next year's European elections are no exception. While past European elections have been a low-key event with low participation rates, many financial market participants now pay a lot of attention to them, fearing a significant rise of EU-sceptical forces. However, as so often is the case, the reality is less exciting.

In fact, despite the rise of populist and EU-sceptical parties in national elections, there are several reasons to expect no significant change in the election result of the EU-sceptical parties compared with the last elections in 2014 (when they received some 20% of the seats in parliament):

- Brexit in itself will be a hit to the share of EU-sceptical parties in the European parliament. Currently, more than 50% of the 73 British MEPs sit in EU-sceptical political groups. As not all

- British seats will disappear (only 46 out of 73) and no other national election will see similar relative performances of eurosceptic parties, Brexit is a bumper for EU-sceptical parties.
- The 2014 European elections were a leading not lagging indicator for EU-sceptical parties' national election performances. Many parties saw significant gains in the 2014 elections already, followed by similar performances at subsequent national elections, particularly in the case of Front National and the Dutch PVV. It is questionable whether these parties could see further gains. Given recent polls, gains should only be expected from parties which had not done well in 2014 but in the more recent past, for example, the German AfD, the Italian Lega or the Austrian FPÖ.

An additional issue for the anti-EU-sceptical parties will be whether they can manage to get organised in one political group in the European Parliament. Currently, there are three political groups, the ECR (European Conservatives and Reformists, mainly dominated by the UK Conservatives and Polish PiS), the EFDD (Europe of Freedom and Direct Democracy, mainly dominated by UKIP and Five Star Movement) and the ENF (Europe of Nations and Freedom, mainly dominated by the French Front National and the Dutch PVV). Previous efforts to form a political group only succeeded in the case of the ENF. A lot of the EU-sceptical parties' impact after the elections will depend on whether or not they are able to work in and as one single group.

Gains of EU-sceptical parties in the percentage of total seats could be more limited than anticipated

In our view, next year's European Elections results could be less of a shock than many fear. Some erosion of the political centre, with social democrats and conservatives for the first time since 1979 losing their absolute majority, would continue recent national trends but could be mostly offset by gains of the liberals and Greens.

Due to the Brexit effect, gains of EU-sceptical parties in the percentage of total seats could be more limited than currently anticipated. Rather than an overall sharp increase, there could be a power shift within the group of EU-sceptical parties. As a result, the political centre could be more fragmented than in the past but the overall sentiment in the European Parliament should remain pro-EU. A former slogan of the European Union will probably have to be changed from "United in diversity" into "United in even more diversity".

2 European Musical chairs: An update

With the European Elections, the musical chairs game for European top jobs will enter its final round. All EU top jobs are up for grabs next year: President of European Parliament, President of the European Commission, President of the European Council, President of the ECB and two jobs at the ECB Executive Board. Filling these vacancies will be a masterpiece for game theory experts as a balance between nationalities, East and West, big and small, gender, experiences, political colours and previous jobholders as well as between institutions (the European Council and the European Parliament) will be required.

The likely fragmentation of the political centre will be an additional complication of the musical chairs game. In the past, social democrats (SD) and conservatives (EPP) held a majority in the

European Parliament and were able to do horse trading between each other. This will probably no longer be the case next year. However, despite an even more complicated nomination process, there is de facto no risk that any European institution will be headed by an EU-sceptical president.

The vacancies at the ECB are most interesting for financial markets

For financial markets, the upcoming vacancies at the ECB are most interesting. Chief Economist Peter Praet's term in office will end already in May next year. The terms of ECB president Mario Draghi will end in October and Executive board member Benoit Coeure in December. Normally, a successor for Praet will have to be found at the Spring Summit, but we would not be surprised to see government leaders leave the vacancy open to add it to the 'grand bargain' after the European Elections.

Currently, the Irish central bank governor Philip Lane is our favourite to succeed Praet. A highly skilled and another out-of-the-box thinker, Lane would likely continue Praet's very pragmatic approach. However, we would not even rule out Lane as a compromise candidate for the Draghi succession in case of a stand-off between France and Germany and obviously depending on the decision on the other European top jobs. When it comes to the potential Draghi successor, Bundesbank president Jens Weidmann could eventually return from the declared dead. There simply is no single candidate who ticks all the boxes and has emerged as the uncontested front-runner. Next to Weidmann and Lane, the list of potential next ECB presidents is still long and includes names like (strongest counter-arguments between brackets) Villeroy de Galhau (another Frenchman?), Liikanen (age and no longer active governor?) and outsiders like Hansson (who?), Rehn (too much a former politician) or Knot (anti QE and another Dutchman?). In our view, the nomination of De Guindos as vice-president has reduced the chances for former politicians to make it to the ECB top.

As regards the vacancies at the ECB, it is too early to come up with an estimated guess but we question is whether the ECB's monetary policy will actually change. Here, we would be cautious. No matter who will fill the vacancies, do not expect the ECB to return to a more dogmatic approach. The Draghi-Praet legacy of a very pragmatic and sometimes unconventional monetary policy will in our view survive the changing of the guard.

3 German politics: The new unknown

For many years the stability anchor of European politics, Germany is now in the final stages of the Merkel era and some fear this could become a source of instability. Listening to Angela Merkel at public appearances in recent days shows a relieved chancellor, freed from the restraints of her own party and coalition conflicts. Whether this will be enough for Merkel to push forward with further reform proposals at the European level remains to be seen. In the past, Merkel had been at her best when she could react not when she had to act.

While we do not believe the race for Merkel succession in the CDU will hardly undermine national or European politics, given the continuous fall of the SPD, another disastrous result at the European elections would increase the odds for a snap election towards the end of 2019.

Muddling through

No panic, this is Europe. This is probably the best label for our base-case scenario for European politics in 2019. Regarding potential political risks, 'Europhoria' might be gone but this does not mean that the Eurozone is about to disintegrate or be taken over by EU-sceptics. Progress towards deeper integration is still being made. The acid test for the Eurozone and greater Eurozone integration will be the next recession but not politics in 2019.

Author

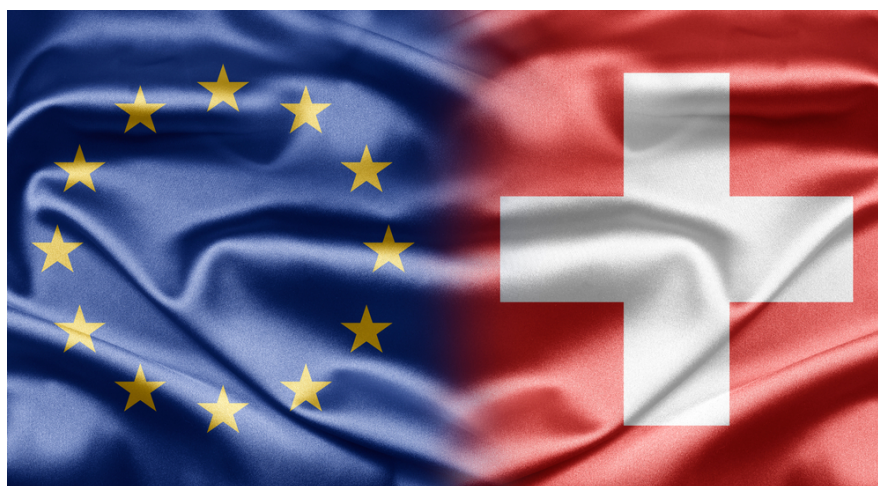
Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Switzerland: 'Self-determination' vote may have major impact on markets

A referendum in Switzerland on Sunday could complicate current negotiations with the EU and the economic and financial consequences could be significant



Source: ING
Switzerland and the EU

Referendum on 'self-determination'

Switzerland goes to the polls this Sunday to decide whether Swiss law should take precedence over international treaties. Supporters of the initiative, which was launched by the country's biggest party, the ultra-conservative and eurosceptic Swiss People's Party (SVP or UDC), say global agreements should be renegotiated or cancelled if they clash with the results of a domestic referendum.

The vote is a consequence of a previous referendum on immigration almost five years ago when a majority of Swiss citizens voted against mass immigration and asked for the introduction of immigration quotas. Such quotas would have been in direct opposition to the international treaties that existed between Switzerland and the European Union. And so after long discussions, and contrary to what was required by the Constitution, the initiative never became law. Instead, the government pushed through regulations giving priority to Swiss-based workers in certain sectors of the economy with the highest unemployment rates.

The SVP argues that the Swiss Constitution, which normally requires parliament to turn referendum results into law, has been overruled by international law, and it wants to stop this from happening

again.

Negotiations for the “framework agreement” could be affected

This vote really arrives at the worst possible moment because the Swiss and the EU are currently renegotiating their relations for the coming years. The EU wants a "framework agreement" to formalise relations and replace the 120 existing treaties. The purpose of this agreement is to force Swiss legislation to automatically align with European rules in certain areas. The framework agreement would also give the European Court of Justice an important role in conflict resolution. The initiative on Sunday has no direct link with these negotiations but it could certainly influence the process because a 'Yes' vote would make a framework agreement difficult to defend politically.

Negotiations between the EU and Switzerland have become bogged down lately and it is difficult to see how a framework agreement could be concluded quickly. The EU is putting pressure on Switzerland because it doesn't want to set an example for Brexiteers. It has decided to link the progress of the negotiations with the recognition of the Swiss stock market rules that allow cross-border trading.

Essentially, this means that in December 2018, without sufficient progress in the negotiations, Europe's access to the Swiss stock exchange and securities listed in Switzerland could be under threat. Without equivalence, Switzerland would probably apply the same measure to the EU and no longer recognise European stock exchanges. Needless to say, this threat is extremely significant for a global stock market such as Switzerland.

What are the possible consequences of Sunday's vote?

A 'yes' vote in Sunday's referendum could further complicate negotiations between Switzerland and the EU. We believe this outcome could completely block the negotiations, which are already suffering from strong domestic opposition. In turn, this could impact the granting of equivalence and endanger the entire Swiss stock market.

For now, polls indicate that a 'no' vote will prevail. But even so, the whole initiative could make Swiss politicians nervous, especially if there is some popular support for it. They might want to wait for Brexit to be resolved before starting discussions again.

Still, time is running out because the renewal of the European Parliament in May 2019 could further complicate the negotiations. And Switzerland will have elections in October 2019 which could frustrate negotiations even more as the Eurosceptic Swiss party (SVP) intends to make the fight against the framework agreement its electoral battle horse to gain even more seats in parliament.

Although we think that the EU will probably give Switzerland temporary stock exchange equivalence for 2019, this Sunday's vote could be the trigger for a total halt to the negotiations in 2019. If talks end and equivalence is not granted, the economic and financial consequences for Switzerland could be significant, putting pressure on the Swiss franc.

Author

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Brexit: Latest breakthrough no gamechanger for 'no deal' risk

The leaked draft of the UK-EU political declaration sent the pound soaring on Thursday morning, but what is still not clear is if this document will help...



Source: Shutterstock

It's fair to say that the draft Brexit withdrawal agreement that was announced last week hasn't gone down too well domestically. Pro-Brexit Conservative MPs have been deeply sceptical about the possibility of the all-UK customs arrangement that forms part of the Irish backstop. While it doesn't seem like this group of concerned MPs have the numbers so far to trigger a leadership challenge, they may well have enough backing to torpedo the deal when it is voted in Parliament.

Meanwhile, the Northern Irish Democratic Unionist Party (DUP) – whom the Conservative government relies on for its working majority in the House of Commons looks likely to reject the agreement too, citing concerns that the proposed backstop would create regulatory barriers between Northern Ireland and the British mainland.

In short, it now looks increasingly likely that the government will be defeated when the deal is presented to the House of Commons (most likely in mid-December).

Will the political declaration be a Parliamentary game-changer?

This is where the political declaration comes in. This 26-page document, which has now reportedly been agreed between the UK and EU, sets out in fairly vague terms some aspirations for the future trading relationship.

The hope is that this document will be enough to give unconvinced UK lawmakers the reassurances they need to approve the deal in parliament. The pound's initial reaction to the leaked details was surprisingly positive – against the euro, sterling rose by almost 1% in a few minutes.

But will the declaration really be a gamechanger for the parliamentary vote? Looking beyond the warm and cooperative tone of the document, there are a few reasons to be cautious.

1 This is just a draft

Before thinking about parliament, it's worth remembering this declaration is still in draft stage and will now be circulated around EU member states ahead of an ad-hoc European Council meeting on Sunday to sign it all off.

Interestingly, the 27 remaining EU states - which have stayed surprisingly united throughout the Brexit process so far are beginning to split. In particular, the Spanish government is reportedly seeking last-minute changes to the withdrawal agreement to allow discussions on Gibraltar to take place separately to the overall EU-UK trade negotiations that will commence after March 2019.

EU leaders indicate this is unlikely to derail Sunday's summit - and [many commentators](#) have flagged the elections in the Andalucia region of Spain (which neighbours Gibraltar) at the start of December. The Spanish government appears to be taking a tougher stance in Brexit talks to boost its share of the vote.

2 "Determination" to avoid backstop might not be enough to convince Brexiteers

Given all the concerns about the Irish backstop, the prime minister's challenge now is to convince lawmakers that it will never be needed - and at face value, the declaration contains some statements that might help her cause.

The document states that both sides reiterate a "determination to replace the backstop solution". The key line here is that "parties envisage making use of all available facilitative arrangements and technologies" - a nod to PM May's earlier proposals to use a mix of new technology and reciprocal tariff collection agreements to avoid a hard border. Certainly, the so-called "max-fac" solution - by which the UK would collect EU tariffs on its behalf and vice versa has been advocated by many of the Brexiteers in parliament over recent months.

However, as with everything in the declaration, nothing is legally binding. In reality, the EU has been very sceptical in the past about the practical and political ramifications such a system might have. And despite these reassurances, the fact that the Irish backstop will form a legally-binding part of the overall deal hasn't changed. We therefore still suspect many Brexiteers, along with the DUP, will feel inclined to reject the agreement when it is voted in parliament.

There are plenty of other interesting nuggets in the political declaration, but the upshot is that there is very little here to change minds in parliament — the challenge of getting the deal approved looks as tough as ever. This raises the question of what happens next if PM May lost the vote in December.

The most immediate question is whether there would be a Conservative leadership challenge. While the 48 letters required for this to happen didn't materialise this week, it still could happen in the aftermath of the parliamentary vote - although there is no guarantee Theresa May would lose.

As [we discussed in more detail last week](#), the next possibility is an election, although this would need two-thirds of MPs to vote in favour of it in a no-confidence vote. That would require a number of Conservative MPs to vote in favour of an election, and despite all the divisions among Tory lawmakers, this seems like a tall order. A second referendum could face similar opposition.

Even so, the political pressure for prime minister May to return to the negotiating table would likely be immense. If this were to happen, it seems unlikely that she would be able to win any fresh concessions on the withdrawal agreement (including on the Irish backstop), but the EU may be more open to changes in the political declaration - particularly given that none of this is legally binding.

In theory, this would then tee-up a second attempt to get the deal through parliament, potentially much closer to the UK's scheduled exit date in March. Many people have drawn parallels with the [Troubled Asset Relief Program \(TARP\)](#) vote in the US, which was rejected at first, but subsequently voted through the second time around after significant deterioration in financial markets.

Admittedly, it's not clear that the same circumstances would be true in the case of Brexit. Banks are widely perceived to be much sturdier than in 2008, while any market reaction to the mounting uncertainty will undoubtedly be adverse, but is unlikely to be as severe. That said, there appears to be a growing consensus amongst MPs that 'no deal' would be deeply damaging for the economy and on balance, we still feel the most likely outcome is that a fudge will be found to get the agreement approved.

But either way, we are unlikely to know for sure until much closer to the UK's scheduled exit date in March 2019. For the economy, this is likely to see growth slow over the winter months if businesses and consumers become more cautious, and we are unlikely to get another Bank of England rate hike before May next year at the very earliest.

[Read Brexit: What next for politics and the pound?](#)

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

China: Intervening in the yuan, for what?

The People's Bank of China spent CNY 91.58 billion on foreign-exchange sales in October. We believe this means the central bank wants USD/CNY to cross...



China's central bank spends second largest amount on forex sales in 2018

In October, the Chinese central bank spent CNY 91.58 billion on forex sales, which is the second largest amount in 2018. However, this was less than September, which was CNY 119.39 billion.

This data has always been eye-catching, especially during the yuan's depreciation, because it implies the central bank might have spent money in the market to stop or slow down the depreciation by selling dollars. And we don't completely rule out this possibility.

Given the speed of the monthly yuan depreciation in October, which was 1.56%, up from 0.55% in September, we believe the central bank might have sold dollars to intervene as the speed of the depreciation indicates more intervention.

Will the central bank intervene again in the coming months?

We don't think anyone can answer this question, not even the central bank.

- It seems the central bank is allowing the yuan to be more responsive to news, data and ad hoc information, which means the yuan is more flexible. This should imply the central bank

doesn't intervene frequently.

- But the central bank could be intervening with a target. This is more interesting because the market then wants to know what the 'target' is. Is USD/CNY at 7.0 a target or is there a line below that?

We think the central bank could be targeting small ranges that would lead USD/CNY to cross 7.0. For example, 6.91- 6.95 might be a target range for a certain period, then a weaker yuan range of 6.95 - 7.00 for later, so that eventually, USD/CNY crosses 7.0 without surprising the market.

Therefore, we don't agree that the People's Bank of China won't allow USD/CNY to cross the 7.0 handle.

We believe USD/CNY will depreciate when trade war tension escalates, and crossing 7.0 looks increasingly likely.

The central bank is more likely to be managing market sentiment by making sure the exchange rate doesn't surprise the market. The scale of interventions will become smaller as the exchange rate approaches 7.0 so that foreign exchange reserves only fall mildly.

For now, we maintain our forecast at 7.0 by the end of this year.

Correction: 22nd November 2018

An earlier version of this article misstated the value of the foreign-exchange sales as \$91.58 billion instead of CNY 91.58 billion. This version corrects the inadvertent error.

Snap | 22 November 2018

ECB minutes: Glimmers of doubt

The minutes of the October meeting of the ECB's Governing Council show some signs of doubt about the growth picture, though the ECB felt it was too...



Source: Shutterstock

Moderating global growth

From the minutes of the October meeting of the Governing Council, it's clear that the central bank acknowledges a moderation of global growth and some tensions in financial markets. While this was also reflected in the slightly weaker economic data for the eurozone, the overall feeling was that the news flow was still consistent with the baseline scenario of an ongoing broad-based expansion. At the same time, the Governing Council remained confident that underlying inflation would pick up on the back of higher wages and the build-up of pipeline price pressures.

Downside risks

While there was broad agreement that at present the risks to growth could still be considered to be balanced overall, a remark was made that a number of arguments pointed towards risks to the growth outlook tilting to the downside. Indeed, all members agreed that the risks related to the external environment were pointing downwards. It was recalled that the September 2018 ECB staff projections had incorporated a small acceleration in quarterly growth rates in 2019, compared with the profile for 2018, which could be revisited. The publication of the December 2018 Eurosystem staff projections would provide an occasion for a more in-depth assessment.

No change in policy guidance

While the Governing Council decided to leave the communication regarding monetary policy unchanged, there was also broad agreement that in light of still prevailing uncertainties and only gradually rising underlying inflation, it was essential to remain prudent, patient and persistent with regards to monetary policy.

What about Italy?

Italy was mentioned only in general terms (with some tightening of monetary conditions in the country), there was no discussion on how the ECB would have to cope with a potential escalation of the situation. However, the remark was made that the maturity of some of the targeted longer-term refinancing operations would fall below one year in the course of the next year, which could impact the evolution of excess liquidity and might affect banks' liquidity position. Given the fact that Italian banks have been amongst the main beneficiaries of the TLTROs, it is clear that a new TLTRO could mitigate some of the monetary tightening in Italy caused by the significant increase in sovereign bond yields.

Down but not out

Our take on the discussion in the Governing Council is that the assessment of the growth outlook could be somewhat more downbeat in December, without becoming outright pessimistic. Therefore, it is still unlikely that the ECB will refrain from ending its net asset purchases in December. However, we wouldn't be surprised if December's statement has a whiff of doubt in it, which would limit expectations of a rate hike to at most one in 2019. As for a new TLTRO, it is probably too soon to pencil it in now. A new TLTRO is only likely to be considered if the situation in Italy really deteriorates in the course of 2019.

Author

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Snap | 14 November 2018

Eurozone: a dismal third quarter confirmed

GDP growth in the Eurozone was confirmed at just 0.2% in Q3. Industrial production saw a decline in September. While a small recovery of GDP is expected...



The second estimate, GDP growth was confirmed at just 0.2% QoQ and 1.7% YoY. The main culprit was Germany, the Eurozone's stronghold throughout the 2010s, which saw its economy shrink by -0.2% in Q3. Disruptions in the car industry were an important driver of the first negative quarter since 2015 and the slow quarter in the Eurozone, but it seems that the worries about growth are broader than that.

Exports are weaker thanks to global problems related to trade wars and emerging markets, and consumption was dampened by the higher oil prices seen in Q3. The stagnation in Italy's economy adds to worries around the Italian budget. The confrontation with Brussels has not been resolved as the ball now returns to the European Commission's court that now has to decide whether to put Italy in an excessive deficit procedure.

Industrial production in the Eurozone posted a very small decline in Q3, adding to the slow growth performance. Production in September dropped by -0.3% MoM. On the year, growth is just 0.9% for industry and production is still well below the November peak. 2018, therefore, seems to have become the year of one-off excuses for a severe weakening of growth. The question is whether this

explains the whole picture or whether these are excuses along the lines of “the dog ate my GDP” and something more structural is happening. While a small recovery of growth in Q4 is in the making, it seems evident that the growth cycle for the Eurozone already peaked last year.

Author

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Poland: Bank supervision scandal and its impact on markets

A recent alleged supervision scandal in Poland will probably mean that the zloty underperforms regional currencies in the short term. The majority of...



Source: Shutterstock

The head of the Financial Supervision Authority (KNF), Marek Chrzanowski, [resigned last week](#) following allegations of corruption. [Media reports](#) claim Chrzanowski demanded money from Leszek Czarnecki, the main shareholder in two small banks facing liquidity, credit quality and mis-selling issues, to prevent them from defaulting or being forced into a takeover by other financial institutions. The Polish zloty (PLN) and local government bonds (POLGBs) underperformed Central and Eastern Europe (CEE) FX by about 1%, which we believe was a response to this unfolding story. Chrzanowski has denied the claims.

Not systemically important

The two banks in question- Getin Noble and Idea Bank- are not systemically important (4.1% of total assets of the banking sector), but they have a non-proportionally high share in total household deposits of the sector (7%). In the past, the banks struggled with credit-related losses

(due to excessively expansionary credit policy) and recently faced a risk of legal sanctions, due to the mis-selling of corporate bonds to household customers.

We see a few channels through which the fallout from this story may affect the currency and Polish local debt:

1 Liquidity constraints

According to the press, [both institutions now face the threat of deposit withdrawals](#) although the scale is unknown. The underperformance of Polish government bonds and the zloty, as well as asset swaps widening in the last week, signal that both institutions reduced liquid assets (effectively POLGBs holdings) to fight liquidity constraints.

According to publicly available balance sheets of both institutions, at the end of 2Q18, the banks had in their books about PLN9 billion of securities 'ready to sell' (presumably the majority was POLGBs). The institutions have probably already reduced their debt holdings, so further stress in POLGBs is likely to be limited. In the case of continued deposit withdrawals, they may rely on (costly) central bank aid (i.e. refinancing credit) - the National Bank of Poland and the macro-prudential committee have already pledged support if needed.

2 No second-round effects

We don't expect second-round effects. It is quite unlikely that other Polish banks would struggle with a confidence crisis - both institutions strongly differ from the banking sector in terms of reputation. Also, retail deposits up to €100,000 are secured by a deposit guarantee scheme, which means that 90% of all retail deposits in the Polish banking sector are guaranteed. Moreover, retail clients continue to flee the corporate debt market, moving towards 'safe' banks. In September, retail deposits in the banking sector increased by PLN4 billion.

3 Loose links

The links between the two banks and the rest of the sector are also limited. The lenders have had problems for a long time (as they had a large FX mortgages portfolio and got into problems when PLN started losing vs the Swiss Franc, and more seriously when the concept of FX mortgages conversion appeared). Thus, the banks lost much of their access to the interbank and the risk of a spillover via the interbank money market is limited.

4 Impact on local banks

The other channel via which this story may impact POLGBs and PLN is its impact on local banks and mutual funds capacity to cover the 2019 borrowing needs of the government. It is possible that if the two banks continue to suffer and ultimately fail under the resolution scheme, other financial institutions will be forced to take them over. At that point, the deposit guarantee scheme may need to inject capital. That would be costly for the banking sector but the number mentioned by some policymakers is about PLN2 billion, which doesn't differ from the average PLN1.7 billion deposit guarantee scheme spent in years 2014-2017 to rescue clients of savings unions (SKOK's) and cooperating banks.

The new contribution may constrain local banks' capacity to buy POLGBs, but on the other hand, we could expect retail clients to move to safe banks and out of the two banks that are in

trouble and mutual funds that suffered from Getback (securitisation company) in the last months. Also, the Ministry of Finance (MinFin) has already covered about 93% of 2018 borrowing needs (which gives it an extra buffer as we know the 2018 deficit will be lower than the adjusted plan) and pre-financed about 11% of 2019 borrowing needs. The MinFin announced last weekend that the 2018 general deficit would be close to 0.5-0.6% of GDP (below the adjusted MinFin forecast of 1.8% of GDP and the ING forecast of 1%). This is low enough to mitigate worries about a 2020 expansionary fiscal policy that the ruling PiS may run should the bank supervision scandal affect their support before the 2019 general elections.

5 Exposure to corporate debt

Another angle is the Polish financial sector's (mainly mutual funds) exposure to the troubled banks' corporate debt, which we estimate at PLN2.5 billion. Results from mutual funds (the main buyers of these corporate bonds) are already stressed due to problems at GetBack, which relied heavily on this form of funding. In the last three months, overall assets of mutual funds have shrunk by over PLN10 billion. We don't expect the two banks to default on these bonds, it is rather more likely that they will be taken over by other stronger institutions. Still, the mutual funds capacity to buy POLGBs should be limited, as it has in the last few months.

What now?

We think the noise associated with the bank supervision scandal may mean the Polish zloty continues to underperform CEE FX in the short term. The majority of first-round effects negatively affecting POLGBs are probably behind us. We think the impact on POLGBs will continue to be negative given the reliance of MinFin on local demand, but the sell-off should be limited given the superior budget position.

Authors

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

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