

In case you missed it: The new reality

The list of things to worry about keeps getting longer: world trade is in reverse, Europe's biggest economy is stuttering, the US government shutdown is starting to hit growth and the UK government remains fiercely divided over Brexit. What happens now? We've got some thoughts...

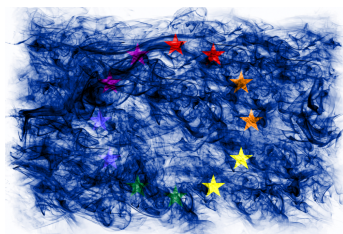
In this bundle



ECB meeting: Increased alertness

The European Central Bank has woken up to the new reality of increased uncertainty, and become more dovish in the process. At the same time, the bank has...

By Carsten Brzeski



FX

EUR & ECB: No help provided and none to be expected

The cautious and dovish ECB bias today underlines the lack of domestic reasons for a meaningful EUR upside. We expect EUR/USD to rise persistently but...



Germany

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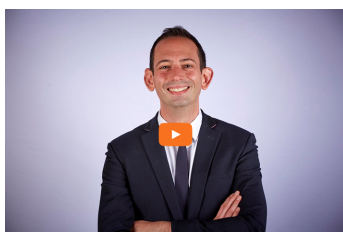
The German Ifo takes another nosedive, boding ill for any quick rebound of the German economy

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United States | Video

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Watch: The economic cost of the US government shutdown

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United Kingdom

Three thoughts on Brexit as lawmakers prepare to vote on 'Plan B'

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By James Smith



South Korea

Korea: Steady, but not exciting

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Snap | 24 January 2019

ECB meeting: Increased alertness

The European Central Bank has woken up to the new reality of increased uncertainty, and become more dovish in the process. At the same time, the bank has indirectly suggested that it's as much in the dark about the growth outlook as anyone else



Source: Shutterstock

European Central Bank HQ, Frankfurt

Today's ECB meeting did not bring any new action but marked a clear change in the ECB's growth assessment. While back in December, the bank's growth outlook for 2019 was still very upbeat- forecasting 1.9% GDP growth- it's now less optimistic. In fact, the ECB has finally caught up with reality. Reality is not yet a protracted slowdown but rather an unprecedented list of possibly severe uncertainties. This list is well-known: global trade tensions, a Chinese slowdown, the German automotive sector and Brexit. These risks are not new but ECB President Mario Draghi stressed that the ECB's biggest concern now is that these risks could materialise and he is concerned about the persistence of general uncertainty. The latter clearly runs the risk of becoming a self-fulfilling prophecy, eventually undermining still solid domestic demand through a negative sentiment loop.

At the same time, Draghi also said that a part of the ECB's Governing Council still does not exclude a more benign outcome and also stated that the probability of a recession was still low. In sum, the increased uncertainty, as well as the persistence of the uncertainty, motivated the ECB to shift its balance of risks to the growth outlook to the downside. To be precise, the ECB used a small linguistic trick, stating that "the risks have moved to the downside". This is slightly stronger than

the December “risks are moving to the downside” but not necessarily as strong as the usual “the balance of risks is tilted to the downside”. A small but significant detail. Welcome to the world of ECB watchers.

This is the first time since April 2017 that the ECB is using “downside risks” in its growth assessment. Actually, except for the period between April 2017 and December 2018, risks to the ECB’s growth assessment have always been to the downside since Mario Draghi took office.

Still reluctant to decide on new liquidity operations

Ahead of today’s meeting, there had been a discussion about the possibility of new targeted and longer-term liquidity operations. Here, the ECB still seems to be very reluctant to take any imminent decision. Several times during the press conference, Draghi stressed that banks were now stronger than ten years ago. More interesting, Draghi literally said that “several members mentioned the issue”. Remember that back in December it was “some” and in October it was “a couple”. No significant change here.

ECB is on higher alert

With today’s meeting, the ECB has joined the crowd of concern. The return of a downside risks to the growth assessment does not, yet, signal any policy changes but only a slight easing bias. Or to put it differently: the ECB also does not know where the eurozone economy is heading. Therefore, in terms of actual steps, not a lot has changed. The ECB will try to buy as much time as possible in the coming months to see how the March folly (Brexit, US-China trade talks, German automotives) will evolve. We will probably have to wait until the June meeting before the dust has settled. Until then, the ECB will be on higher alert than before. However, it will require a very benign outcome on all these risk factors to see Draghi hiking rates before he leaves office.

Author

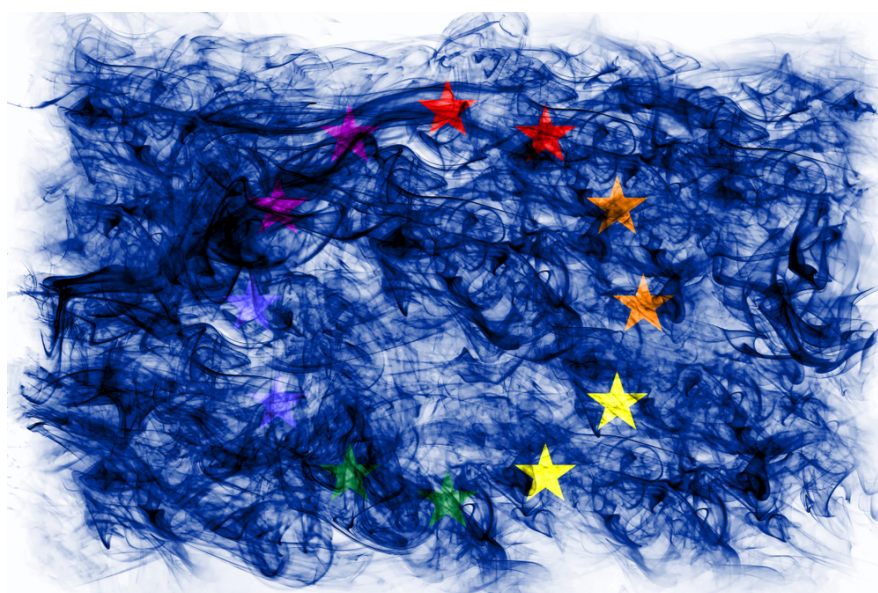
Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

EUR & ECB: No help provided and none to be expected

The cautious and dovish ECB bias today underlines the lack of domestic reasons for a meaningful EUR upside. We expect EUR/USD to rise persistently but only in response to structural USD weakness and for this to happen, we still need to wait a few more months



Source: Shutterstock

As expected, President Draghi's dovish comments during the ECB press conference today were largely in response to the recent slowdown in the Eurozone data. While not committing to a new set of liquidity operations (such as TLTROs), we expect a more direct hint at these measures in the upcoming March meeting (when the "relevant committees" might be tasked).

In our view, the lack of commitment to TLTROs was the main reason why EUR/USD rebounded from the strong horizontal support level of 1.1310 (though it is still lower on the day).

[For more details, read ECB meeting: Increased alertness](#)

Lack of domestic drivers for a stronger euro

With the rising likelihood of new TLTROs being delivered by the end of 2Q19 and the falling probability of an ECB deposit rate hike in 4Q19 (given slower than expected growth and CPI

remaining below target), this suggests the euro is unlikely to strengthen for good domestic reasons. This is in stark contrast to 2017 when expectations of policy normalisation by ECB led to a meaningful EUR rally. This is currently not the case as the second step of the ECB policy normalisation (meaningful rate hikes) is simply not on the table as growth and inflation dynamics have been fading.

EUR/USD to rise only once the dollar embarks on a structural downward trend

As we've written before in our [2019 FX Outlook: Peak Dollar](#), we see EUR/USD embarking on a more pronounced and persistent upwards trend only when the dollar peaks. Given our view, the Fed is not done yet with the tightening cycle (our economists look for two more Fed funds rate hikes this year, after the initial pause in coming months) this suggests a modest downside to EUR/USD in the coming months. We target EUR/USD 1.12 in three-months before a recovery to EUR/USD 1.20 by year-end as, by then, we expect the dollar to peak and embark on a structural downtrend.

Implications for EM FX: The drivers behind EUR/USD matter

Our take on the drivers behind the expected EUR/USD upside later this year (weak USD, rather than strong EUR) also means that even with higher EUR/USD in 2H19, central and eastern Europe FX is unlikely to be a meaningful outperformer in the wider emerging markets FX space as was the case in 2017 (remember when the Czech koruna and Polish zloty were the two best performing EM currencies).

This is because if higher EUR/USD is caused by a weaker USD (and not a strong EUR), this also benefits other EM FX regions and not exclusively CEE FX (which back in 2017 was the chief beneficiary of the ECB induced EUR rally vs its EM peers). The CEE FX segment should do well in USD terms later this year, but unlikely to be a significant outperformer in the more extensive EM FX space.

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Alissa Lefebre

Economist
alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte

Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klokk

Senior Economist, Netherlands

marcel.klokk@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

Germany: Another shocker in the Ifo

The German Ifo takes another nosedive, boding ill for any quick rebound of the German economy



Source: Shutterstock

99.1 Germany Ifo Index

From 101 in December

That's a shocker. Germany's most prominent leading indicator, the Ifo index, plunged in January, adding to latest growth concerns. With its fifth consecutive drop, the Ifo index now stands at 99.1, from 101.0 in December. The expectations component took a particularly severe hit.

Looking at the sector level, manufacturing lost much more momentum than the services sector. Needless to say that cars play an important role in this development. Still, both confidence in the manufacturing and the services sector are still above historical averages.

The manufacturing sector has been on a downward trend since last August, dragging the entire economy down. In fact, the German economy is currently suffering from a strange and also unique combination of homemade one-off factors such as the delayed introduction of new emission standards in the automotive sector or low water levels which prevented dropping global oil prices from reaching consumers but also a series of external uncertainties. Just think of the trade

tensions, a slowdown of the Chinese economy or Brexit. When the ECB yesterday talked about the risk of “persistence of uncertainties”, it clearly had the German economy in mind; It's the best example of how a fundamentally solid economy can be brought to its knees by risks and uncertainties.

Looking ahead, today's Ifo index suggests that it could take until the second quarter before the German economy regains momentum, mainly on the back of investments, consumption and some relief from the global risk factors. In this regard, Brexit is probably the single most threatening risk as a “no deal” Brexit would come at the most inconvenient time for the economy, namely exactly when it should be about to rebound.

All in all, we still think that the German economy could get away with one black eye. However, the shield that stronger domestic demand can offer against external risks will be put to a severe test in the coming months.

Author

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Snap | 25 January 2019

World trade: Trade war is starting to kick in

World trade is in reverse. In November 2018, 1.6% fewer goods crossed borders than in the previous month when the volume of world trade still grew 1.2% on a month-on-month basis. The less volatile three-month average growth figure took a nosedive as well with a decrease from 1.1% in October last year to 0.0% in November



Both advanced economies and emerging markets show a decline as of import demand, today's data release from the Netherlands Bureau of Economic Policy Analysis (CPB) shows. Emerging markets are leading the pack with a significant decline of 3.1%. Among the advanced economies, the US is no longer the locomotive for trade that it was in 3Q of last year. For the second month in a row, the US shows no growth of import demand. It looks as if the negative effects of higher tariffs

on American demand for foreign goods are finally starting to bite. The already released data on the value for American imports in December show stagnation what does not bode well for next's month data release on the volume of imports. Chinese data point in the same direction. The value of Chinese exports to the US was 3.8% lower in December than a year earlier.

We expect the damage of the trade war to increase over the next twelve months. By far the largest part of tariff elevations by the US and the subsequent retaliation by the US' trade partners, has only been implemented in the second half of 2018. This means that its detrimental effect on trade growth will continue well into 2019.

On top of that, we foresee more tariff elevations to come. We don't expect an all-encompassing deal between the US and China before the deadline of 1 March. The US' demands are simply too numerous and too complicated to be resolved on such short notice. On top of that, we think that China is not willing to give in enough to the rather demanding wish list of the US. The list does not only encompass lowering the bilateral trade deficit substantially but various changes in China's industrial policies as well. In an attempt to 'strong-arm' China into giving in more, we forecast President Trump to step up his trade war and impose further tariff increases on Chinese imports further during the course of the year.

For the short run, we don't expect a deal between the EU and the US either. Even before formal negotiations have started, things have become more complicated with indications that the US wants to add opening up of the EU agricultural markets to the agenda, traditionally a 'no go' for EU member states like France.

All together this will lift the share of world trade affected by the trade war from 6% last year to 13% at the end of this year. This will take of 1.1%-points of trade growth for this year and make 2019 a candidate to beat the 1.4% growth figure of 2016 as the weakest year for global trade growth since the trade collapse in 2009.

Author

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

A recovery in the US housing market can only be good news



Watch: Signs of hope in the US housing market

[Watch video](#)

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Watch: The economic cost of the US government shutdown

ING's James Knightley says the economic consequences of the US government shutdown are becoming more serious



Police patrol the US Capitol Building as the partial US government shutdown continues



Watch: The economic cost of the US government shutdown

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Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Three thoughts on Brexit as lawmakers prepare to vote on 'Plan B'

As we edge closer to a credible path to avoiding 'no deal', businesses are likely to remain wary when it comes to investment until any Article 50 extension is physically agreed and there's greater clarity on the Brexit endgame



Source: Shutterstock

The next instalment in the Brexit saga will come next Tuesday 29 January, as Members of Parliament (MPs) have their say on the government's 'Plan B'.

In reality, 'Plan B' looks pretty similar to 'Plan A', and Theresa May remains focussed on reducing concern surrounding the Irish backstop. But the focus is now centred squarely on a series of amendments Tuesday's motion. These amendments give MPs the opportunity to say how they'd do things differently when it comes to Brexit – and one, in particular, is attracting most of the headlines so far.

Labour MP Yvette Cooper has tabled an amendment that would effectively give the government until 26 February to get a deal approved, or Parliament will get an immediate vote on whether to apply for an Article 50 extension – for potentially until the end of 2019.

Now that key members of the Labour Party have thrown their support behind it, the amendment looks likely to succeed.

1 No deal gradually getting less likely – but it's too early for investment to turn a corner

Strictly speaking, none of this takes 'no deal' off the table completely just yet. But it is nevertheless significant as for the first time, there would be a clear and credible mechanism for lawmakers to avert a chaotic EU exit on 29 March. And assuming the amendment passes on Tuesday, there's little reason to think lawmakers would reject the opportunity to extend Article 50 in a vote at the end of February - assuming no deal has been approved by that stage.

That said, there are two reasons why businesses are likely to remain wary.

Firstly, the EU must unanimously approve any decision to extend the Article 50 negotiating period. In the past, European leaders have made it clear that a legitimate reason would be required to justify extra time – for instance, a second referendum or a meaningful shift in the UK negotiating stance. Admittedly, the view among EU members states appears to be softening on this issue and in the end, we think Brussels would grant an extension, although we're unlikely to know for sure until March. But remember, it would only take one country to put a spanner in the works.

Secondly, we don't know for sure how long any extension might last. The Cooper amendment specifies a nine-month delay, but this could be edited if and when lawmakers get their chance to vote on an extension. If the numbers are looking a bit tight, the timescale could get shortened to win over some undecided MPs. Equally, some EU leaders appear resistant to a longer extension. Austria's Chancellor Kurz said on Thursday that any extension shouldn't go beyond the European Parliamentary Elections (due to take place in May).

For the economy, the bottom line is that it's probably too early for businesses to change course on their contingency planning, which will keep the pressure on hiring and investment, and therefore overall economic growth, during the first quarter.

2 Cooper's amendment does PM May a favour – but the bar remains high for her deal to pass

With the chances of a long Brexit delay rising, the pressure is mounting on pro-Brexit MPs within Parliament to reconsider May's deal. The rhetoric of Brexit-supporting lawmakers has softened marginally towards the Prime Minister's." over recent days. In a radio interview earlier this week, prominent pro-Brexit Conservative Jacob Rees-Mogg said: "even Mrs. May's deal would be better than not leaving at all".

That said, the chances of the Prime Minister's deal passing the second time around seem low. The scale of her defeat a week-or-so ago means she'd need to convince around 115-120 lawmakers (out of a total 650) to change their minds. The Northern Irish, Democratic Unionist Party, who is propping up the government for its working majority, have made it clear the Irish backstop needs to disappear entirely to regain their support.

Importantly, the EU has made it pretty clear it is not prepared to renegotiate on the Irish backstop. Even if it were prepared to consider changes, Brussels would want to be 99% sure they would turn things around in the UK Parliament. Given that the Irish backstop isn't the only concern amongst lawmakers, there are no guarantees a revised version of May's deal would gain the necessary backing from MPs.

3 The road to a 'different' deal remains treacherous

Assuming May's deal struggles to gain support, and that Article 50 ends up being extended, this still doesn't answer the question of what eventual Brexit scenario will prevail.

In the aftermath of last week's vote, markets found a silver lining when Theresa May signalled she was prepared to go across party lines to seek a compromise. But while a softer Brexit stance stands a better chance of gaining majority support in Parliament, the road still remains challenging.

[As we've discussed in more detail](#) earlier, if May inches towards a softer stance, the pro-Brexit contingent of the Conservative Party will rapidly begin to lose patience. Labour Leader Jeremy Corbyn may well try and leverage this discontent in a repeat no-confidence vote, and this seems to be at least part of the reason why he is reluctant to endorse a second referendum at this stage.

Admittedly, the bar for the Conservatives, or indeed the DUP, to vote the government down seems pretty high. But even so, if an alternative Brexit strategy were to gain support in Parliament, then the Brexiteers could still express their dissatisfaction as the subsequent legislation passes through the House of Commons.

According to the [Institute of Government](#), there are still seven bills needing to be approved by Parliament to translate the UK's EU exit into law. There are risks Conservative pro-Brexit MPs could try to hold up this process if they view any revised deal as unacceptable.

In other words, at this stage, Theresa May has little incentive to reach across party-lines in search of a solution - although pressure from MPs will inevitably build. At some point, it is possible that lawmakers try to force indicative votes on different Brexit outcomes - although this seems less likely to happen next week given that no individual Brexit option is perceived to have majority support as things stand.

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Korea: Steady, but not exciting

Korea grew 2.7% in 2018, helped by a stronger-than-expected final quarter, which in turn was helped by some robust, but questionably sustainable growth in government spending. In 2019, the economy will struggle to grow faster than 2-2.5%



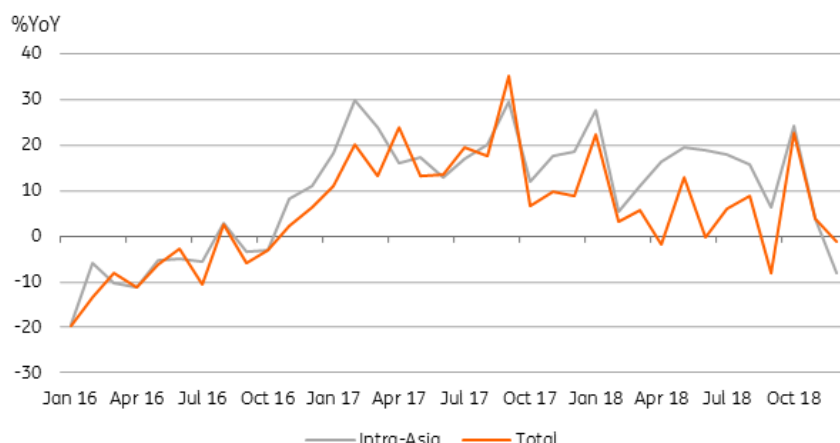
Source: Shutterstock

Economic activity – Growth under duress

Korea is a world class manufacturer of hi-tech and an exporting powerhouse. It is the fifth largest exporting nation on the planet, though ranks 11th in terms of GDP. In normal times, this enables the economy to punch well above its weight in terms of growth and corporate pricing power. These are not normal times.

The US-China trade war will claim many victims, but the closeness of supply chains in the Asia region means that important manufacturing players like Korea cannot hope to escape its effects. We can already see some signs of this in plunging export figures, but the damage runs deeper than just exports.

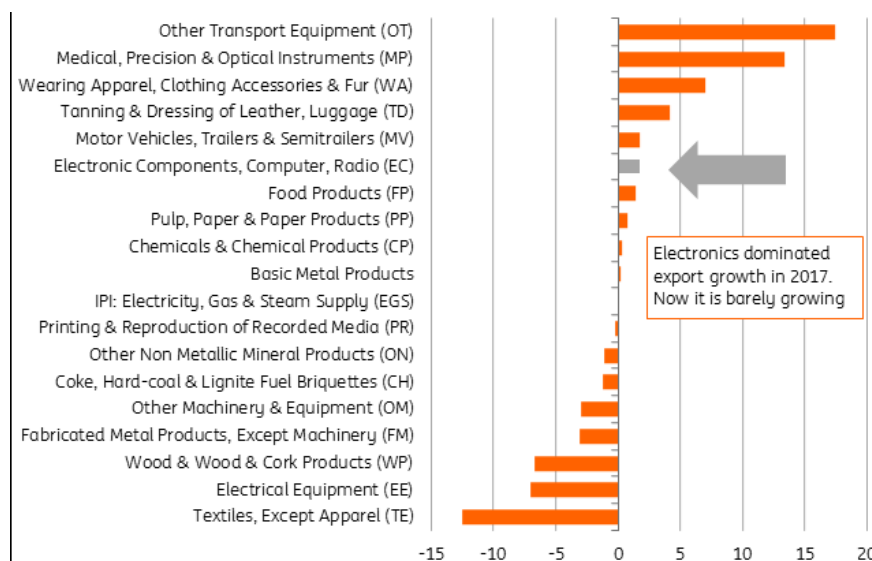
Export Growth - Intra Asia and total



Source: CEIC

In 2017, strong export growth was almost entirely driven by a resurgence in demand for electronics. Exports and output of other goods have barely improved since the financial crisis. Now the demand for these goods is softening. Overestimations of demand have led to overcapacity in many areas. Unit pricing is falling, and together with flat demand, this is squeezing profit margins.

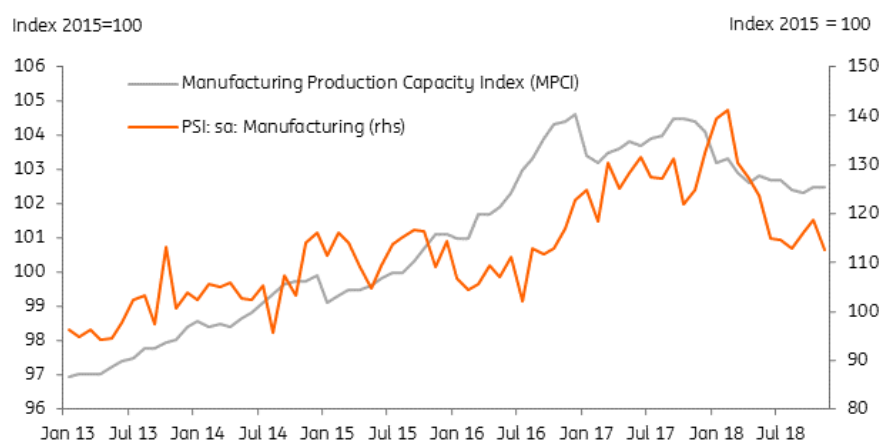
Export growth by type of product



Source: CEIC

The final flourish to 2018 GDP lifted our estimates for 2019 growth. Nevertheless, 2019 GDP will likely grow only in a 2-2.5% range (ING f 2.2%), rather than 2018's 2.5-3%. Korea is not alone. All of Asia is experiencing a growth slowdown. The US-China trade war is a significant part of the problem. Even a complete unwinding of all tariffs now would not lead to a return to prior growth rates. Some permanent damage has already been done. We don't expect such a reversal of the trade war anyway.

Production capacity index and output



Source: CEIC

With domestic demand likely to be weak and external demand not much better in 2019, we don't anticipate much change in Korea's trade or current account balances, with the forecast for 2019 of a 4.8% current account surplus close to the likely 2018 outcome.

Although the outlook for 2019 is heavily challenged, we see this as a temporary setback. Few doubt that the future of global prosperity lies in harnessing technological advancements, and that Korea is one of the best-placed economies globally to take advantage of that. It's just that at the moment, the distribution of much of that technology (5G) has not yet caught up with the hardware. That will change, if not in 2020, then surely by 2021. So this should just be a temporary, if rather lengthy, soft spot in an otherwise structurally sound and well-placed economy.

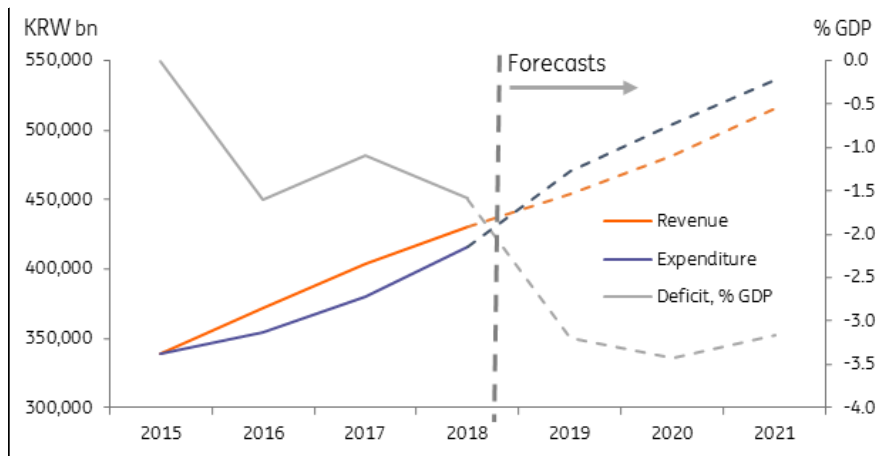
Likewise, the capacity excesses that are weighing on prices right now are in some ways not the worst sort of problem to have. This is an old-fashioned inventory excess and delivering an old-fashioned growth slowdown. It also means that old-fashioned policy responses, accommodative monetary policy and easy fiscal policy, should provide some helpful offset until the excesses clear when private demand eventually returns.

Fiscal policy – deficit widening, intentionally and unintentionally

The Ministry of Finance and Economy's published budget for 2019 shows a sizeable expansion (+9.7%) in government spending in 2019 aimed at job creation, R&D, social security, welfare spending, wellbeing and national defence.

The net impact on the economy will be less than this, with government revenues also being increased 7.6% from 2018 (an 11.6% increase in tax revenues). Officially, this should lead to a rise in the deficit of only 0.2% GDP. We suspect the deficit will rise rather more than this (ING's deficit forecast is -2.6% of GDP on a consolidated basis ex social security), as revenue assumptions from corporate earnings are likely to be overestimated, along with nominal GDP estimates. The net fiscal stimulus will probably be about 0.2% of GDP, but the additional difference between the 2018 and 2019 deficits is cyclical and doesn't count towards economic stimulus.

Fiscal deficit (consolidated ex social security)



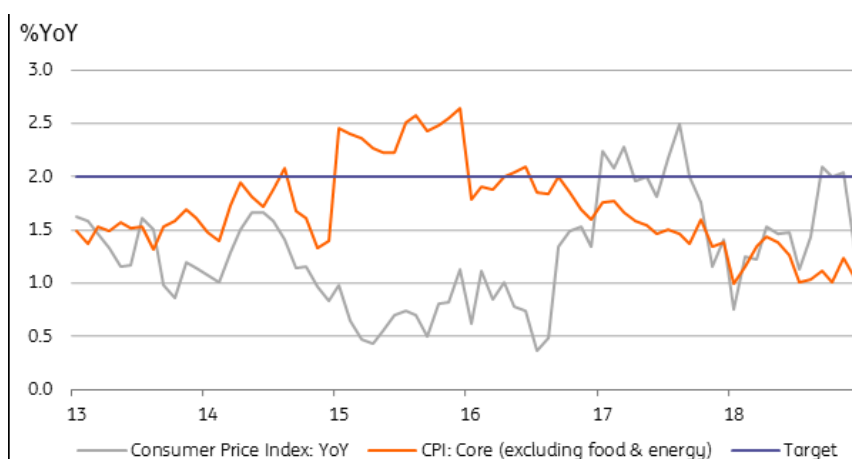
Source: ING, Ministry of Finance and Economy

Inflation – low, likely staying low

With a headline rate of inflation of 1.3%, and the same rate for core inflation, it really does not look like there is any notable price pressure in the economy, though saying that, as recently as a month ago, inflation had been trending at 2.0% or slightly above.

Some rewinding of earlier, higher food prices seems to have accounted for most of the headline decline, and such pipeline effects were fairly obvious before they happened. We can't forecast future weather-affected food prices, but absent any near-term shocks, inflation looks set to run well below the BoK's 2.0% target for the foreseeable future. Wages growth, meanwhile, is running at a fairly decent rate in excess of 2017 rates, though minimum wage increases will be underpinning some of this increase, and this should begin to drop out of wage figures in 2019 resulting in a slower pace of growth.

Korean inflation and BoK target



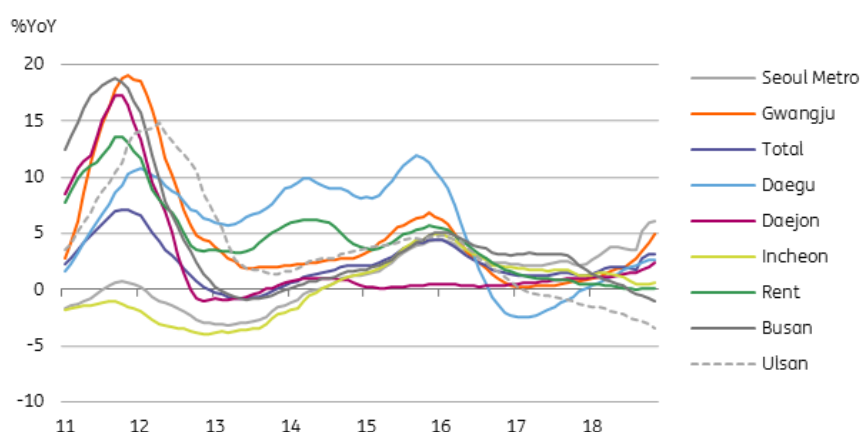
Source: CEIC

In fact, short of natural disasters or currency collapse, neither of which we are predicting, the outlook for Korean inflation remains extremely benign.

Monetary policy – nothing for ages, and then perhaps cuts not hikes

In an ideal world, the BoK’s November rate hike of 25 basis points to 1.75% would be reversed this year. And sooner rather than later. We don’t see this happening. The argument for the increase was not a strong one, resting on high ratios of household debt to disposable incomes, and a somewhat (but not very) elevated rate of house price growth and falling housing affordability in the Seoul metropolitan area.

Korean residential real estate prices %YoY



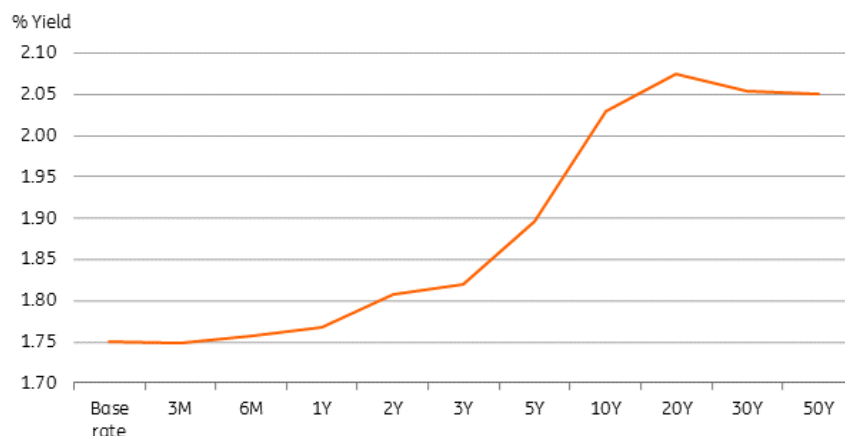
Source: CEIC

Responding to a perceived regional sectoral issue with a national policy response is always in danger of overkill, and on this occasion the timing seems to have been particularly unfortunate, coinciding almost to the day with a decline in national inflation.

We don’t think 2018’s hike will be reversed in 2019. Central Banks are as human as anyone else, and things would have to look spectacularly weak for them to affirm recent criticism of their hike by reversing it this year. Moreover, while we don’t find the household debt argument for the hike a compelling one, household debt in Korea is high, and to that extent, now that rates have risen, we wouldn’t encourage debt accumulation to go higher by cutting rates back again.

Moreover, saying that rates probably did not need to have been raised in 2018 is a different proposition to saying that they are too high now. Real rates are only slightly positive by about 40-45 basis points. That seems reasonable, though, one could make an argument for them being closer to zero as they are in many other Asian economies.

Korean sovereign bond yield curve slope



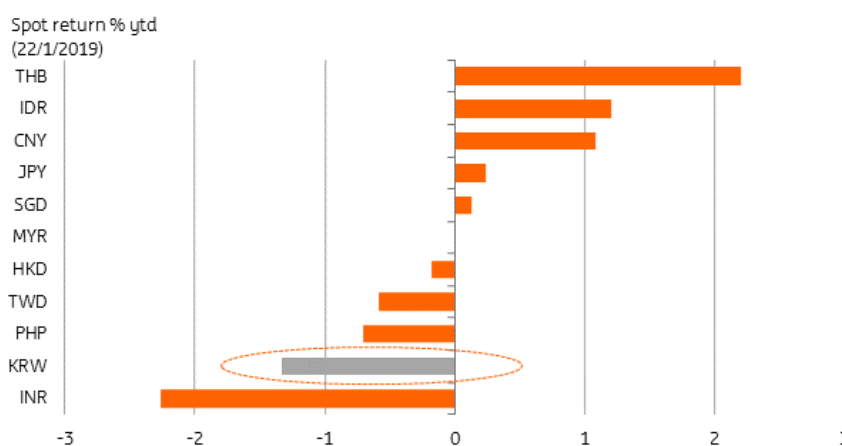
Source: Bloomberg

10Y KTBs are yielding only slightly more than 2.0% and the yield curve is exceptionally flat. Consensus forecasts for BoK base rates are also very flat, though there is a clear bias of forecasters towards tightening, recommencing next year. We are not sure that this is right. While that is probably the direction of travel, we can also see a case for rates to go down first, and the balance is probably only slightly tipped in the direction of hikes. That could change substantially.

Currency outlook – weaker first, then stronger

We can get some hint of the outlook for the Korean won from just looking at the first 22 days of the year so far, which shows the currency to have been the second weakest in Asia year-to-date, and second only to the Indian rupee. That is not a great place to be, though the outlook is not all bad.

Year to date Asian currency ranking



Source: Bloomberg

A lightening of the US-China trade war could play to renewed KRW strength. Though that remains a contentious call in our opinion - even despite recent optimistic noises from the US negotiating

side.

More likely, the KRW will simply passively benefit from USD weakness later in the year, as opinions about the resilience of the US economy and Fed tightening expectations are reassessed.

We still think there is some chance of a final bout of US dollar strength this quarter that could see Asian FX and the KRW, in particular, under weakening pressure before a later recovery. This would be based on markets reassessing the positive frame of mind in which they started the year. Though given recent hints from both the Fed and US government, we may have to revise this starting assumption, which would likely result in some downward revision to the USD/KRW 1130 forecasts in 2H19 - essentially the same as today's rate. We are biding our time making this decision, and recent China growth disappointments mean that our current FX call has still not passed its sell-by date.

Forecast summary

	1Q19	2Q19	3Q19	4Q19	2019	2020	2021
GDP (%YoY)	2.1	1.7	1.9	2	1.9	2.8	2.4
CPI (%YoY)	1.7	1.7	1.4	1.8	1.7	1.6	2
Unemployment rate (eop)	4	4.1	4.2	4.1	4.1	4	3.8
Residential real estate (%YoY)	3.1	3.1	2.8	1.8	2.7	1.8	3.4
Fiscal Balance (consolidated ex soc sec)					-3.6	-4	-4
Debt/GDP (%)					41.3	43.1	45
Current a/c balance (US\$bn and % GDP)	11.6	17.5	27.5	26.5	4.8	4.6	4.6
7-day repo rate (eop)	1.75	1.75	1.75	1.75	1.75	2	2.5
10Y yields (eop)	1.9	1.8	1.7	1.7	1.7	2.3	2.7
USD/KRW (eop)	1,150	1,140	1,130	1,130	1,130	1,100	1,080

Source: ING, Bloomberg, CEIC

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

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