ING's Eurozone Quarterly: A late-cycle economy?

Rising protectionist sentiment, the populist wave across Europe, a looming Brexit deadline and talks of a maturing cycle are all factors that seem to be playing a part in the slowdown of Eurozone's growth. One could say the expansion is now in late summer: the temperature still feels nice, but we know that the best is behind us

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Eurozone: That late summer feeling

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The Eurozone economy is still showing decent growth, but the pace of growth is likely to level off over the next two years, as the international environment has become less positive. At the same time a number of political hurdles can inject some uncertainty into the growth outlook but still we expect 2.0% GDP growth this year

Growing divisions

In his State of the Union, Jean-Claude Juncker, the president of the European Commission, made it clear the European Union has only 250 days left until the European elections in May 2019 to prove to citizens this Union is capable of delivering on expectations.

Indeed, the populist wave in Europe is weakening further European integration, and a victory of less European minded parties could further undermine the stability of the Union. That's why Juncker pleaded for a strengthening of the European borders and a reform of the Europ's asylum system, as the wave of immigration has been one of the important tailwinds for populist politicians over the last few years.

"As punishment beckons for Hungary, the process could lead to the country being stripped off its right to vote in the Council - which highlights the growing divisions in Europe"

Juncker also urged a further deepening of the Economic and Monetary Union (EMU), while simultaneously championing a more global role for the euro. Again these goals necessitate a lot of political cohesion which doesn't really seem to be happening at the moment.

Political tensions within Europe remain present, with the European Parliament voting to initiate the so-called Article 7 process against Hungary for violating some of the core European values. This process could lead to a country being stripped of its right to vote in the Council of the EU. While it is improbable, it'll go that far; it shows the growing divisions within Europe.

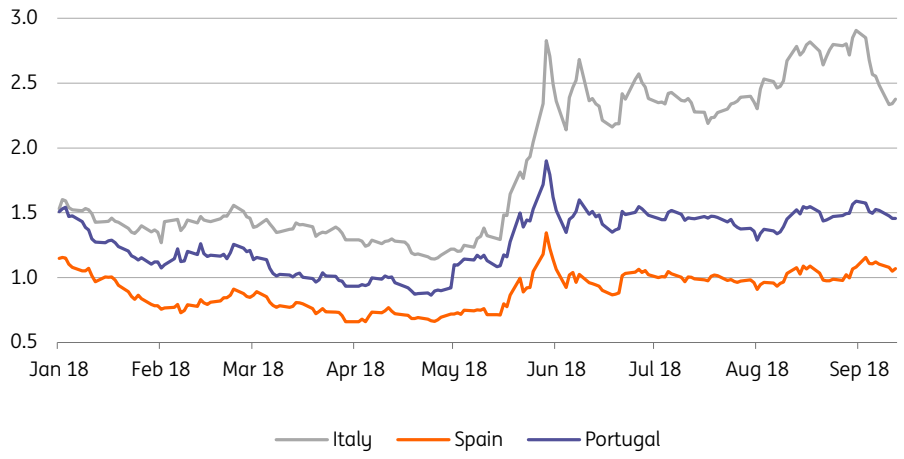
"Even if the Italian budget passes without too much fuss with the European Commission begrudgingly approving (our scenario), the Italian government might harden its stance later on Eurozone reforms"

The new Italian government has also been on a confrontational path with the EU since the beginning of its mandate: first on immigration, and the next battlefield could be the budget. Fortunately, the latest declarations indicate that all deficit rules will be more or less respected. But even if the budget passes without too much fuss with the European Commission grudgingly approving (our scenario), the Italian

government might harden its stance, e.g. on Eurozone reform, later, especially if the European elections strengthen its position.

The Italian 10-year bond yield shot up from 1.6% in May to around 3.30% at the start of September, partially reflecting redenomination risk. Fitch's recent change of the rating outlook to negative didn't help either. Fortunately, the less combative sounds emanating from the Italian government recently led to a relief rally, though it seems too soon to sound the all clear signal.

10-year spread with Germany



Source: Thomson Reuters Datastream

Brexit: What's the deal?

Meanwhile, the critical deadlines for a Brexit deal are also rapidly approaching.

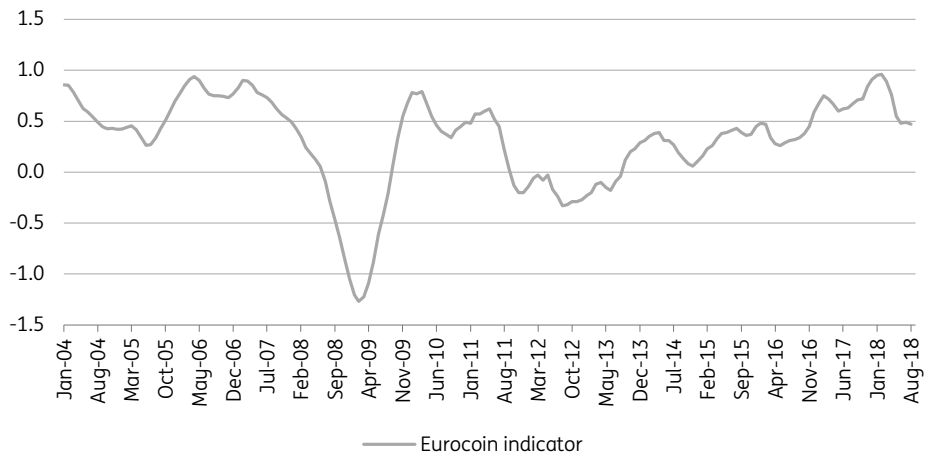
While the impact of a no deal is likely to be more harmful to the UK economy than to the EU, it would still inject an element of uncertainty and is likely to be felt more in countries with the strongest trade ties to the UK. While the withdrawal agreement shouldn't be the hardest nut to crack (as future trade relations between the UK and the EU are to be negotiated and ratified at a later stage), there are still some obstacles.

"Though the impact of a no deal is likely to be more harmful to the UK than the EU, it would still inject an element of uncertainty and is likely to be felt more in countries with the strongest trade ties to the UK"

For the EU, guarantees that the border between Northern Ireland and the Irish Republic remains open is a crucial point, while the divergence of views on the post-Brexit era within the UK majority could still set the scene for some cliff-hanger moments before the bill gets approved.

That said, our base case remains that a no-deal situation is likely to be avoided, though October has already been abandoned as a deadline to reach an agreement and a special summit in November seems in the making.

Eurocoin indicator shows growth is over the top



Source: Thomson Reuters Datastream

Growth is over the top

Meanwhile, economic data draws a rather unexciting picture of the Eurozone economy.

The second quarter saw 0.4% quarter on quarter GDP growth, the same as in the first quarter which was held down by exceptional factors such as adverse weather and flu epidemics. So no acceleration, but at the same time, the Eurozone economy hasn't suffered too much from the trade skirmishes, initiated by the Trump Administration.

Where do we go from here? On a positive note, we should mention Jean-Claude Junker's visit to Washington, which resulted in a cease-fire in trade hostilities, taking away some uncertainty for European companies. Nevertheless, the European Central Bank mentioned rising protectionism as one of the main risks to the economy in its introductory statement to the September press conference.

If protectionist measures by the US hurt major trading partners, it would ultimately affect Eurozone exports too. At the same time, the international economic environment has become less upbeat, with several emerging economies experiencing financial tensions, though this might be compensated to some extent by the still buoyant US economy.

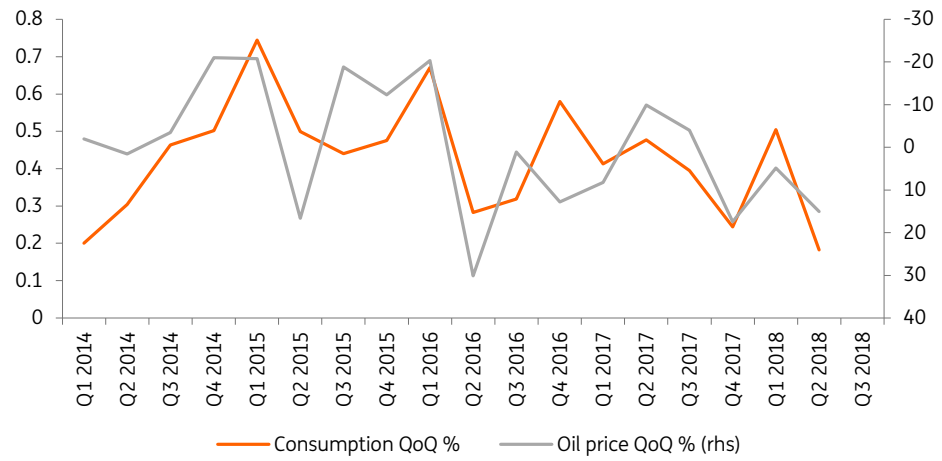
While in these circumstances it looks rather unlikely to see growth accelerating in the second half of the year, the underlying growth momentum remains strong enough to sustain the 0.4% QoQ pace for a little bit longer. Real disposable income is now growing close to 2%, while unemployment fell to 8.2% in July.

"All in all, we expect 2.0% GDP growth this year"

Admittedly, consumption growth has been disappointing in the second quarter, but that was largely due to the significant increase in oil prices, sapping households' purchasing power. It's unlikely that oil prices will see a similar surge in the coming quarters.

On top of that, the German fiscal policy is becoming more expansionary, which should sustain consumption. Although sentiment indicators have fallen back from the extremely high levels seen earlier in the year, they remain at a level signalling sustained growth. The Eurocoin growth indicator, a real-time gauge of GDP growth stood at 0.47% in August, after 0.49% in July. All in all, we expect 2.0% GDP growth this year.

Consumption hurt by oil price increase



Source: Thomson Reuters Datastream

That said, 2019 and 2020 are likely to see some deceleration, which is not that unusual given the fact that the output gap has now all but closed. It has to be said that the industrial production figures for July were on the weak side, suggesting a weak start of the third quarter. The more forward-looking indicators like the credit impulse or the OECD leading indicator confirm that the growth pace is over the top. We anticipate a 1.7% expansion in 2019 and 1.5% in 2020. In seasonal terms, one could say that the expansion is now in late summer: the temperature still feels nice, but we know that the best is now behind us.

ECB has started a slow exit

Headline inflation at 2.0% in August is basically an oil story, as underlying inflation remains stuck at 1.0%.

"Oil prices are still likely to keep headline inflation around 2.0% in the coming months, but from the second quarter of 2019 onwards, this effect will gradually peter out"

That said, growth in compensation per employee increased from 1.8% in the fourth quarter of 2017 to 2.0% in the first quarter of 2018, while growth in negotiated wages increased from 1.5% to 1.8% in the first quarter of 2018. So the trough in wage growth now looks behind us and the Phillips curve relationship, which still holds according to recent research by the IMF, is pointing to further upward wage pressure, which should ultimately also push core inflation higher.

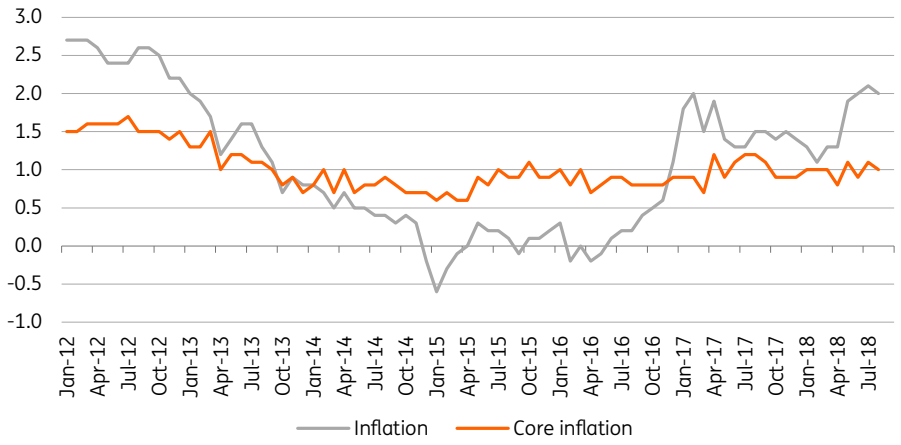
However, this is likely to be a very gradual process as inflation persistence in the Eurozone can be important, meaning that a period of low inflation has a tendency to keep a lid on future inflation. Oil prices are still likely to keep headline inflation around 2.0% in the coming months, but from the second quarter of 2019 onwards, this effect will gradually peter out.

"With markets starting to anticipate a slowdown in the US, pushing down the dollar, the scope for monetary tightening in the Eurozone will indeed be very limited"

We now expect 1.7% headline inflation in 2018 and 1.6% in 2019. The ECB remains at ease with its exit strategy, stopping net asset purchases by the end of 2018 and starting hiking rates in the second half of 2019. While we see the deposit rate at 0% and the refi rate at 0.25% by the end of next year, this is largely a normalisation process.

After that, the ECB will tread more cautiously in tightening monetary policy. Our end of year forecast for the refi rate in 2020 is only 0.50%. One has to bear in mind that with markets starting to anticipate a slowdown in the US, pushing down the dollar, the scope for monetary tightening in the Eurozone will indeed be very limited.

Inflation: an oil story



Source: Thomson Reuters Datastream

Eurozone economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	2.5	2.0	1.7	1.5
Private consumption	1.7	1.6	1.8	1.6
Investment	2.9	2.7	2.2	1.2
Government consumption	1.2	1.1	1.3	1.3
Net trade contribution	0.8	0.3	0.1	0.1
Headline CPI	1.4	1.7	1.6	1.8
Budget balance (% GDP)	-0.9	-0.6	-0.9	-0.9
Refi rate (eop)	0.00	0.00	0.25	0.50
10yr Bund (eop)	0.42	0.50	0.75	0.90

Source: Thomson Reuters, all forecasts ING estimates

Germany: Late is not too late

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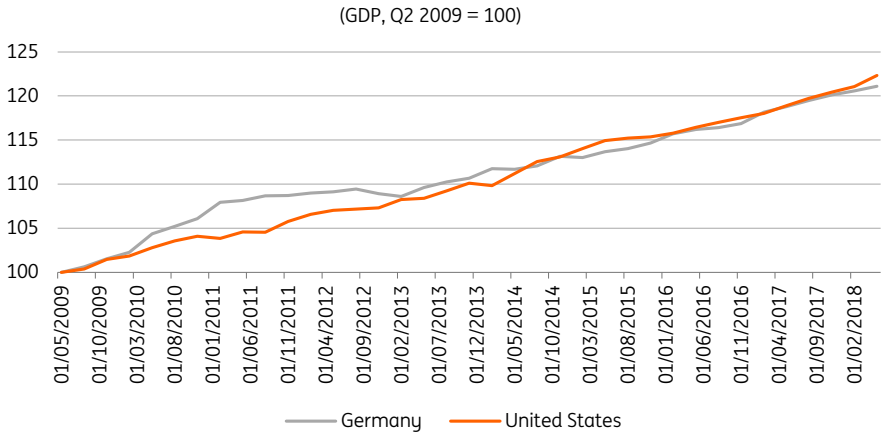
Between the late-cycle and the golden decade, the German economy is experiencing an unusual fluctuation in high-frequency data but the underlying trend remains robust. Could feel a bit like an Indian summer of sorts for a while

Contrary to the national football team, the German economy didn't have a rude awakening at the start of the summer. Instead, the economy returned as an outperformer of the Eurozone. The economy grew by 0.5% 2Q18 from 0.4% in the first quarter, on the back of strong domestic demand.

At face value, the current expansion remains impressive. The economy has been on a growth path for 34 out of the last 37 quarters, private consumption has been growing for 18 consecutive quarters, and even investments have started to increase significantly over the previous two years. Despite the international criticism, the German economy is already showing a very balanced growth model.

Like the US economy, Germany faces the same question whether an economy in its tenth year of expansion is about to slow down or whether the old saying that economic recoveries never die of old age still holds.

Cycling together



Source: Thomson Reuters Datastream

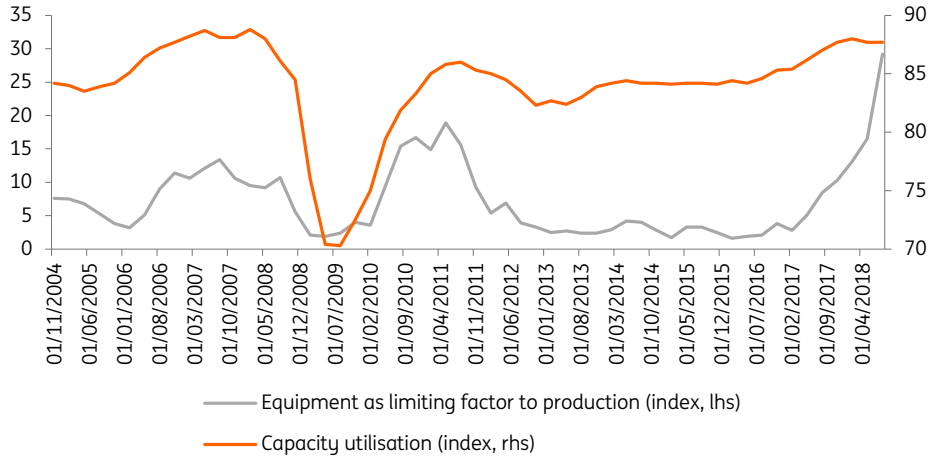
Several arguments in favour of the golden decade's protraction

The positive take on the economic outlook is based on a continuation of favourable external factors and solid domestic demand. Low-interest rates and a weak euro exchange rate should provide the economy with enough steroids to maintain its current growth pace. Also, the governments' decision to deliver on its election promises regarding a series of social policy measures should give domestic demand another push next year. Over the summer months, the government agreed to tax relief, pension increases and lower social security contributions to the tune of some 0.4% of GDP.

"The biggest trump card for German growth in the years ahead is probably investment"

The biggest trump card for German growth in the years ahead is probably investment. Recently, economic activity has increasingly been affected by supply-side constraints. While capacity utilisation is now at its highest level since 2008, the lack of skilled employees and adequate equipment has never been a more limiting factor to production than now. This simply means the economy urgently needs more investments, which it will eventually get but just not as quickly as one might have hoped.

Increasing supply-side constraints



Source: Thomson Reuters Datastream

Downside risks don't only stem from the external environment

The biggest risks to the positive outlook are clearly external. Even though up till now the trade war has hardly left any marks on the German economy, further escalation between the US and the EU and/or China would affect the export sector.

"Lack of structural reforms, drop in international competitiveness particularly in the areas of digitalisation and education, and problems in strategically important sectors all bear the potential to hamper"

For the time being, the EU seems to be off the US radar, but the list of German export partners getting hurt by sanctions, tariffs or economic crises is getting longer. Just think of China, Russia, Turkey, Iran or potentially the UK. If this trend continues, the recently witnessed restrengthening of Germany's Eurozone trade partners would not be sufficient to offset adverse effects from a fully-fledged trade war.

Admittedly, not all risks stem from the outside. The lack of structural reforms, drop in international competitiveness particularly in the areas of digitalisation and education, and problems in strategically important sectors all bear the potential to hamper German growth significantly. However, it is near impossible to predict when any of these structural shortcomings will start to show up in macro data.

Domestic politics has become more complex

Against the above background, ongoing tensions and developments in domestic politics matter.

The integration of refugees remains one of the most heated discussions in German politics. Over the summer, tensions within the government on border controls but also a further rise in polls for the Alternative for Germany (AfD) on the back of riots in Saxony shows how fragile the often-referred-to political stability in Germany actually is.

The next important milestone for German politics will be the regional state elections in Bavaria on 14 October. These elections and the political goal for the Bavarian CSU (the sister party of Angela Merkel's CDU) to defend the absolute majority of the last elections have been the basis for several tensions within the federal government. The CSU is afraid that it could lose the absolute majority as conservative voters move on to the AfD, illustrating the side effects of the CDU/CSU's shift towards the political centre under the long leadership of Angela Merkel.

Significant losses in the Bavarian elections could push the CSU to more extreme positions within the federal government, leading to new tensions and complicating the last years of what still looks like Angela Merkel's final term in office.

The trend of the last few months, i.e. a permanent seesaw of disappointing and impressive macro data, will continue. Maybe this is simply what characterises a late-cycle economy.
But all of this is assuming a very gradual end to QE and monetary policy normalisation as well as no further escalation of the trade conflict between the US and the EU.

The German economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	2.2	2.0	2.0	1.9
Private consumption	2.0	1.4	1.7	1.5
Investment	3.4	3.6	3.6	2.8
Government consumption	1.6	1.0	1.8	1.6
Net trade contribution	0.3	0	0.2	0.1
Headline CPI	1.7	1.7	1.6	1.8
Unemployment rate (%)	4.1	3.9	4.1	4.2
Budget balance as % of GDP	1.1	1.9	1.0	0.7
Government debt as % of GDP	64.9	60.5	57.2	56.6

Source: Thomson Reuters, all forecasts ING estimates

France: Emmanuel Macron 2.0

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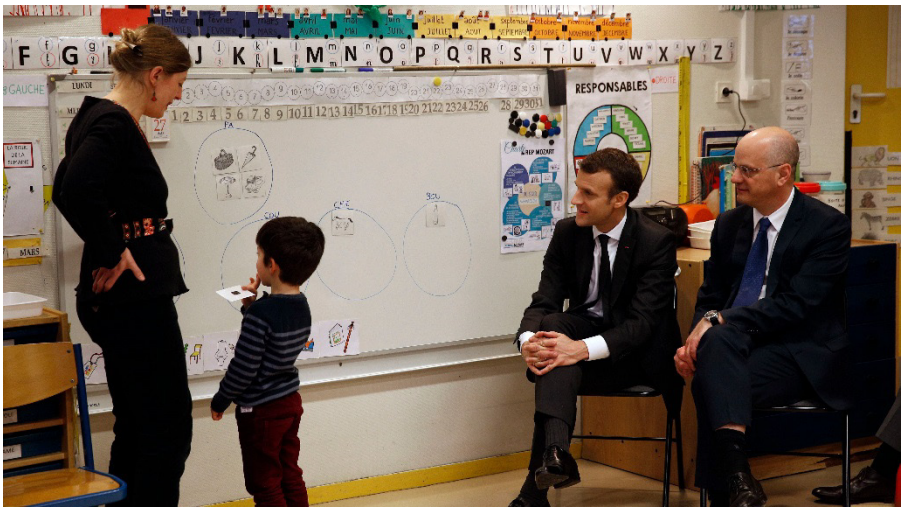
After a difficult summer which saw his approval ratings plummet, President Macron is starting his second year in a weaker position. If the number of ambitious reforms on the agenda are as high as the last, the French economy will be less supportive. We forecast GDP growth of 1.8% this year, a notch below 2017's 2.0%



Back to school

President Macron started his year by attending a class in a primary school which benefitted from one of his key first-year reforms, limiting the number of pupils per class for children aged five to six.

If past reforms have been slowly digested, President Macron now seems stuck in moving sands: isolated on the European scene while he made it a key reform area, affected in the polls by the judiciary troubles of one of his security guards, and losing two of his most popular ministers.

"It seems that Mr Macron has slightly changed his ways, favouring a less "Jupiterian" approach to domestic politics and consulting more widely both with his ministers and social partners"

His approval ratings have declined from 40% to 32% in the Ipsos political barometer between April and September. The departure of Nicolas Hulot, the French environment minister, could affect this approval rating further as the reason for his departure has to do with the very reason why Mr. Macron was elected, namely to prove that France can be reformed. If his most popular minister doesn't believe it anymore, it's hard to say that the second year of Macron's presidency has begun well.

Nevertheless, it'll be a busy year with several wide-ranging reforms scheduled, notably for unemployment benefits and pension regimes and the headcount cuts in the administration.

On the European side, he'll have to deal with the risk of a no-deal Brexit, with strong political opposition to his Eurozone reinforcement project and a potential political crisis with Italian populists in the European election campaign.

It seems that Mr Macron has slightly changed his ways, favouring a less "Jupiterian" approach to domestic politics and consulting more widely both with his ministers and social partners. This seems like an absolute minimum to regain approval and avoid a

political meltdown at the European elections which are going to be a strong political test in May 2019 and for which the President's party needs allies that have so far proven hard to find on the French political scene.

So far, the macroeconomic context of 2018 hasn't helped much. However, confidence and activity surveys show that there could be an uptick in the coming months and we think that the economic context should slowly be more supportive, before turning again at the end of 2019.

Domestic demand has disappointed in the first semester

In the first half of 2018, domestic demand was affected by higher oil prices (+35% year on year) and weeks of strikes in the transportation sector. In 2Q18, private consumption declined by 0.1% quarter on quarter for the first time since 3Q16.

Moreover, despite incredibly low-interest rates, consumers also refrained from buying more new houses as investment declined (by 0.1% QoQ) for the first time since mid-2015. This affected total investment growth, which wasn't supported much by businesses either. Indeed, corporate investment rebounded less than expected, by 1.1% QoQ after the dismal 0.1% registered in the first quarter, widening the gap with very high capacity utilisation rates (85.3% in the industry in 2Q18, the highest in ten years).

Even taking into account a rebound of activity in the second half of the year, the unexpectedly weak first semester will drive GDP growth below 2% this year.

But several indicators remain supportive

Looking at business investments, most surveys continue to point to several quarters of growth. PMI data shows confidence remained broadly stable in both the manufacturing and service sector throughout the summer. In the industry, business confidence has been stable since February at 110, slightly below its level of the end of 2017 and capacity utilisation is at record highs. This should drive corporate investments up in the second half of the year. That said, we are not overly optimistic either.

"We believe that after four good quarters, the outlook will be less supportive after mid-2019. We are not at the end of the cycle yet, but the countdown has begun"

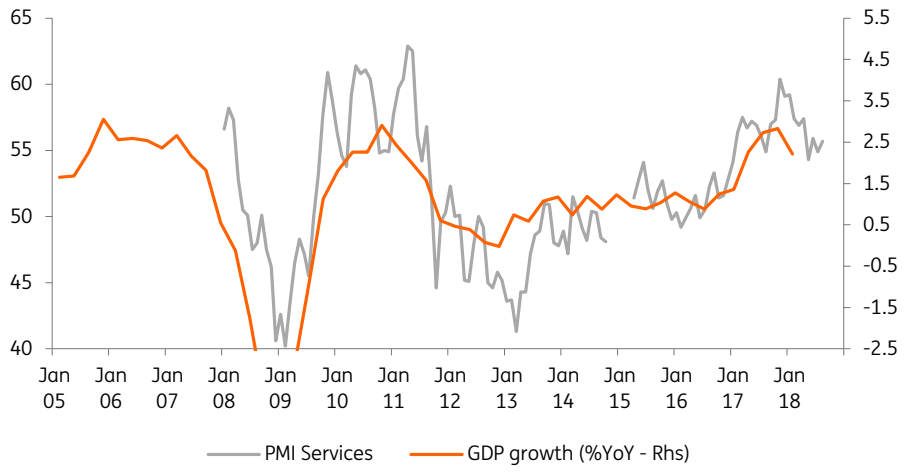
First, data from both July and August shows manufacturing companies are losing confidence in the general outlook (this component is at a 15- month low). This could be because order books, which had been filling up in the first half of the year, turned around in June while inventories, have been increasing since April and were in August at a two-year high. This is likely to continue leading to a stabilisation in industrial production in coming months, as already shown in industrial production figures since May: production growth has stabilised just below 2% YoY, far from its 4Q17 peak. Although the overall picture remains positive for investments, for the time being, it, therefore, seems that dark clouds are gathering overactivity in the manufacturing sector and that it is only a matter of time for confidence to decline again.

Second, in the service sector, confidence has been stable since April, and the August survey even brought some positive aspects: hiring intentions have rebounded, as well as the perceived pricing power. Recent investments have also been higher than expected. However, activity remains low in comparison with the end of 2017, so that investment intentions declined slightly in August. They remain high and consistent with an investment rebound in the second half of the year, but it could be short-lived.

Looking at housing investments, we noticed the drop in the second quarter. However, confidence surveys in the building sector show that the building sector remains the bright spot of confidence for the time being: capacity utilisation reached 90% for the first time this decade in June and hiring intentions remain elevated. Only the expected activity volume in new dwellings declined in August, despite very high order books. If

there is a drop in demand, it cannot be seen in activity indicators yet. As interest rates remain low, we continue to believe in a strong rebound of households' investments in 18Q3.

Activity in the service sector still points to above potential GDP growth



Source: Thomson Reuters, Bloomberg

Private consumption will remain subdued

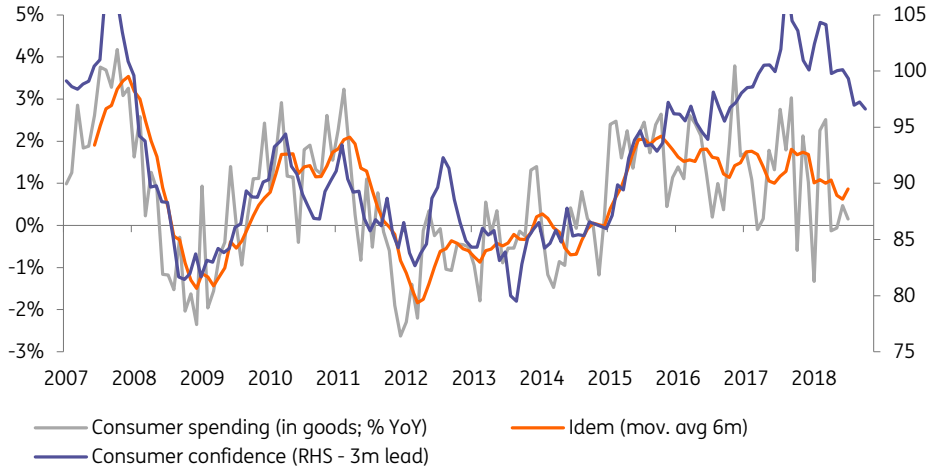
Investment growth should, therefore, reach 3.2% in 2018, lower than the 4.7% reached in 2017, but still on the recovery track. On the private consumption side, however, things are different. Household spending increased by a limited 0.2% MoM in July. Spending growth is still below 1% on the year. Looking at the long-term trend, it seems that spending growth has been declining slightly since mid-2015 despite improvements in consumer confidence. Indeed, consumer confidence was at 96.6 in August, which is consistent with a spending growth of almost 2% a year.

What the surveys are showing, however, is that the trend in consumer confidence is now down. If 96.6 remains at a higher level than in any month between 2015 and 2016, it is has been on a downward trend since December 2017 (104.3). Looking at the components, it appears that households are more positive about their savings now than in December, but this further improvement has been counterbalanced by a returning pessimism about the economic outlook and, since June, a return of unemployment fears.

The latter comes from the fact that the unemployed population has increased almost every month since March despite higher hiring intentions and a labour market reform (even the effect of ending subsidized contracts has abated since June). In the service sector, for example, the last PMI surveys showed that the improvements in the unemployment rate noticed in recent quarters could pause unless more demand is generated. Employment growth is weak by any measure. Even if this should allow the unemployment rate to fall below 9% in the second half of the year, we do not think that it will be sufficient to support strongly consumer confidence.

With the only improvements in confidence pointing to higher savings rather than spending, we think that the rebound expected in the third quarter in private consumption (+0.7% QoQ) will be short-lived, leaving private consumption growth a notch lower in 2018 than in 2017 (1.0% after 1.1% last year).

Confidence on a downward trend again, but still high compared to actual spending



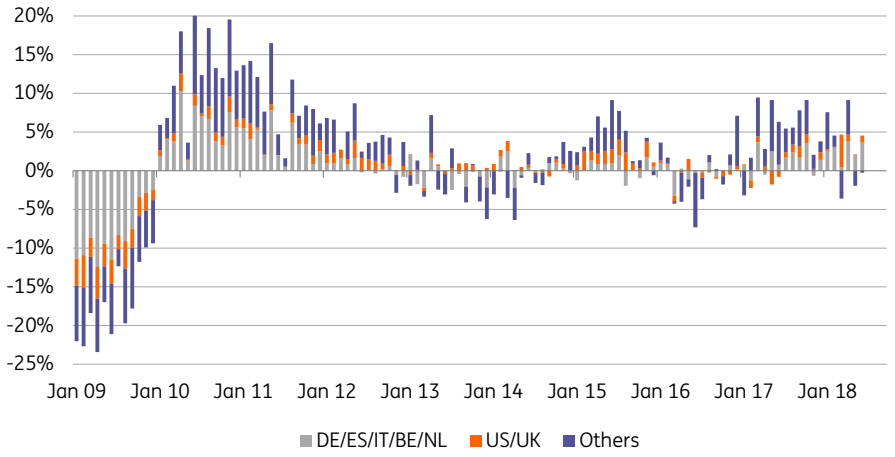
Source: Thomson Reuters

External demand has improved

Net exports are usually not the brightest spot in French growth reports. However, it could add 0.2pp to growth this year.

Despite the fear of trade wars and the slowdown of Eurozone demand, exports rebounded by 0.6% in the second quarter. In 2018, export growth should be above 4% (after 4.7% in 2017) while a weak private consumption should dampen imports. We expect the weak euro to continue supporting this dynamic in the second half of the year while next year will mostly depend on the Brexit situation. Finally, let's note that the French automotive sector is less exposed to the risk of trade tariffs from the Trump administration as only 1.6% of the automobile sector value added is linked to car exports to the US (versus 8.6% for Germany).

France: export growth contributions per geographic zone



Source: Thomson Reuters

We expect growth to reach 1.8% in 2018

The second half of the year should be more supportive of President Macron's reforms. But a number of external risks remain including a somewhat weaker Eurozone demand, Brexit turbulences which could impact exports to the UK (6.5% of total exports) and, finally, a stronger euro stemming from a tightening monetary policy in 2019.

This is why we believe that after four good quarters, the outlook will be less supportive after mid-2019. We are not at the end of the cycle yet, but the countdown has begun.

And this won't allow the French deficit to fully comply with Brussels

With 1.8% of GDP growth expected in both 2018 and 2019 and still a lot of uncertainties around how the President intends to lower public expenditures from 57% to 54% of GDP by 2020, doubts subsist in Brussels around France's capacity to get its public debt in order.

Especially, the railway reform implies that the French railway network debt has been included in gross public debt computations (the 35 billion euros amounted to a 1.3pp increase to 98.5%, recently made public by INSEE). With the government projection now down to 1.7% in 2018, the deficit to GDP forecast has been revised upwards, from 2.3% to 2.6%. The railway reform will not directly affect the budget deficit this year but will nevertheless add at least 0.1pp to budget deficits after 2019, until the railway network decreases its own financing needs. Moreover, the 2019 deficit will again be closer to the 3% limit in terms of GDP as some temporary corporate tax credits will become permanent expenditures.

If President Macron wants to gather more consensus around his ambitious Eurozone plans, he has to show more clarity on how France is doing its homework. The 2019 budget that will be presented in Brussels next month will show a budget deficit below the 3% of GDP threshold and a stabilising gross debt (just below 100%), but we expect the European Commission to point to the weak progress made in terms of the structural deficit. France is out of the excessive deficit procedure, but for how long?

French economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	2.3%	1.8%	1.8%	1.7%
Private consumption	1.1%	1.0%	1.7%	1.5%
Investment	4.7%	3.2%	4.2%	3.7%
Government consumption	1.4%	1.6%	1.7%	1.2%
Net trade contribution	0.1%	0.2%	-0.6%	-0.5%
Headline CPI	1.0%	1.5%	1.6%	1.9%
Unemployment rate	9.4	9.0	8.5	8.2
Budget balance as % of GDP	-2.6	-2.6	-2.9	-2.6
Government debt as % of GDP	97.0	98.5	99.0	99.0

Source: Thomson Reuters. all forecasts ING estimates. unemployment rates according to ILO definition

Italy: Budget test for the 5SM/League government

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The inconsistencies between a challenging 5SM/League attitude on budgetary issues and finance minister Tria's reassuring statements finally seem close to a solution. The compromise will unlikely be able to shift a gear in the current modest recovery, but we still expect the Italian economy to expand by 1.1% in 2018 and by 1% in 2019

Unconventional governance for an unprecedented government

The first three months of prime minister Giuseppe Conte's government, backed by the unprecedented alliance between the Five Star Movement and the Northern League, have been unconventional.

Matteo Salvini and Luigi Di Maio, the leaders of the two parties which signed the government "contract", have been continuously holding the scene, while prime minister Conte has played the role of the incidental notary, settling disputes when deemed necessary.

Salvini, the interior minister, set the scene on the migrant's issue, often challenging the European Union and European partners on burden sharing instances. While Di Maio, one of Italy's two deputy prime ministers and in charge of both economic development and the labour and welfare ministries, concentrated mostly on labour-related issues and has so far managed to gain parliament's approval to tighten labour laws and curb temporary job contracts.

Fiery rhetoric spooks markets

The duo's challenging rhetoric on budgetary issues is in apparent contradiction with the reassuring statements coming from the finance minister Giovanni Tria and has been a cause of concern for markets during the entire summer.

Market pressure and the outlook downgrade by the credit rating agency Fitch at the end of August apparently had an effect on Salvini's and Di Maio's stances, and, as a consequence, on PM Conte. More recently, they radically changed their tones, professing their commitment to approve a budget which will introduce pro-growth measures while respecting European fiscal rules.

Tria now talking about a piecewise approach to promises

Subsequent refinements by Tria and EU Commission representatives seemed to point to a possible agreement foreseeing some form of structural adjustment and a decline in the debt to GDP ratio in 2019.

Matching this with the reiterated commitment to start implementing economic electoral agenda strongholds, i.e. the flat tax, universal basic income and softening the strict pension rules introduced by the Monti government (the so-called Fornero reform) will prove challenging.

As all of this will add to the promise to sterilise the €12.4 billion worth value-added tax increase budgeted for 2019, it is no surprise that minister Tria and, importantly, PM Conte have recently referred to these three themes as an objective for the entire legislature, de facto anticipating a piece-wise approach.

Headline deficit target for 2019 due no later than 27 September

With negotiations between Salvini, Di Maio and Tria still ongoing, we still lack a precise indication on the target headline deficit numbers which will be put black-on-white in the updating note to the DEF, the economic and financial document which sets the macro framework to the following budget law.

The deadline for publication is 27 September, that of the submission of the draft budget law to the EU Commission is 15 October. If domestic political considerations push the fiscal slippage above what minister Tria would like, we still believe the deficit/GDP target would at most be set slightly above the 2% mark. Political opportunity considerations given the 2019 European Parliament elections might induce the Commission not to take a rigid stance on Italy.

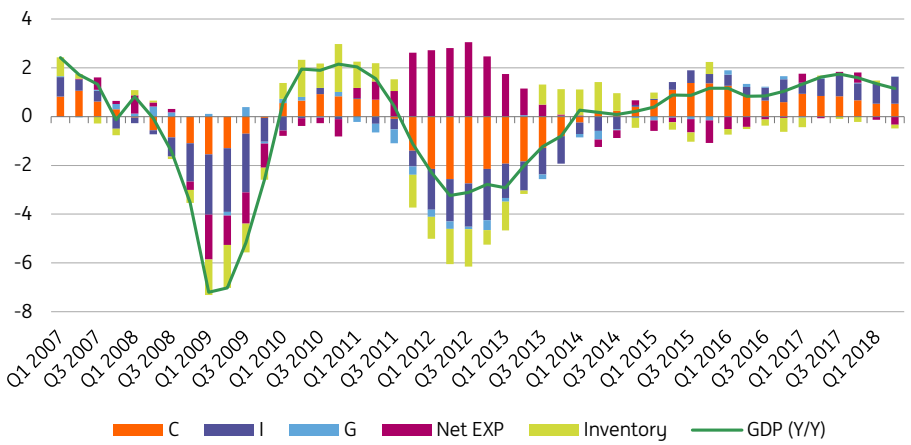
Meanwhile the economy remains in a soft growth spell

The discussion on the Italian budget comes at a time when the Italian economy is experiencing a prolonged soft spell, well anticipated by soft confidence data.

Having expanded by 0.3% quarter on quarter in 1Q18, GDP growth slowed to 0.2% QoQ in 2Q18, driven by domestic demand. Interestingly, the main driver turned out to be private investments, which contributed 0.5% to quarterly growth on the back of strong machinery and plant and transport equipment components. Inventories contributed another 0.2%, and national consumption added a meager 0.1%.

As expected, net exports were a drag, subtracting 0.5% from growth, on the back of softening exports and sharply increasing imports. Soft consumption was a bit of a surprise, given the underlying developments in the labour market.

Domestic demand driven recovery slowing down



Source: Datastream, ING

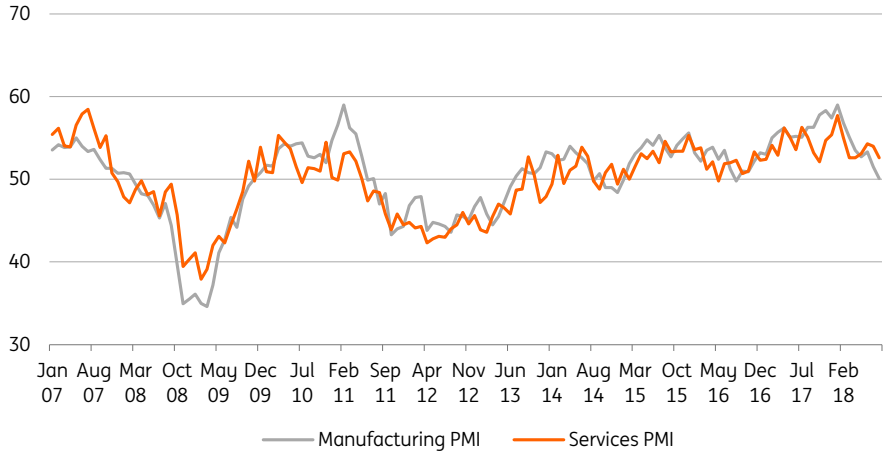
Confidence data point to no acceleration in 3Q18

Looking forward, we believe the soft growth spell might continue into 3Q18.

In August the composite index of business confidence set a new 18-month low, driven by a soft manufacturing component, which confirmed a weak spot. The marked decline in orders in the investment goods producers aggregate was particularly worrying, as it seems to dim hopes of an acceleration in investment activity in the last part of 2018.

To be sure, given the uncertainty surrounding the future fiscal stance of the League/5SM government, a prudent investment strategy with domestic businesses was far from surprising at the time the survey was run. The relevant PMI reading confirmed manufacturing softness at 50.1, which was consistent with near stagnation. Business confidence turned soft-ish also in the market service sectors aggregate, while it edged up with retailers and in the construction sector.

Manufacturing PMI close to contraction territory



Source: Datastream, ING

Private consumption more resilient on favourable disposable income

The small decline in consumer confidence isn't a reason for concern for the time being. It remains close to recent highs and looks backed by recent developments in the labour market.

The July labour market report, the first batch of hard data on 3Q18 confirmed positive, with an unexpected decline in the unemployment rate to 10.4%, admittedly resulting from a contraction in the labour force rather than from new job creation. When read in conjunction with accelerating June hourly wages data, labour market data point to a possible marginal improvement for private consumption over 2H18.

All in all, we expect the Italian economy to expand by 1.1% in 2018 and by 1% in 2019.

The Italian economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	1.5	1.1	1	0.9
Private consumption	1.4	0.9	0.9	1
Investment	3.9	4.6	2.5	1.6
Government consumption	0.1	0.2	0.6	0.7
Net trade contribution	0.2	-0.4	-0.1	0
Headline CPI	1.3	1.3	1.4	1.5
Unemployment rate (%)	11.3	10.8	10.5	10.2
Budget balance as a % of GDP	-2.3	-2	-2.1	-1.9
Government debt as a % of GDP	131.8	131.4	130.6	129.4

Source: Thomson Reuters, all forecasts ING estimates

The Netherlands: Domestic momentum stays

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The Dutch economy continues to grow above potential thanks to strong domestic demand, and as long as hard Brexit and trade war fears don't materialise, we forecast GDP growth of 2.8% this year and 2.5% for 2019, which is still above the Eurozone average

Soft indicators fell, but still point to strong growth ahead

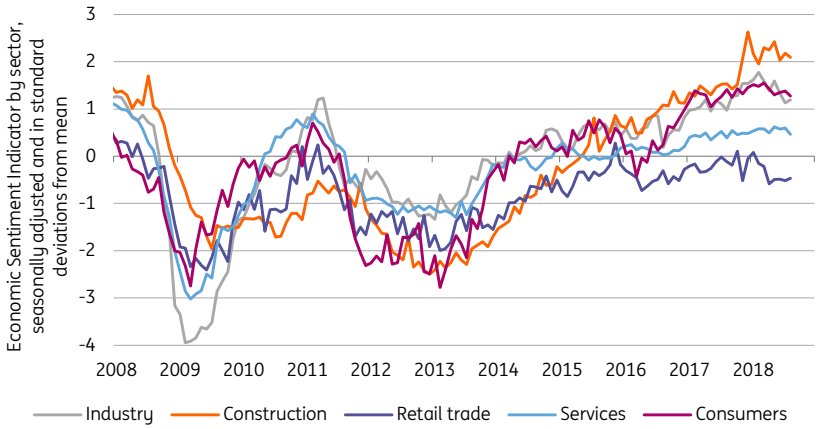
The outlook for the Dutch economy is still rosy, even though a number of survey indicators are currently lower than when they were at the peak, around the turn of the year.

We forecast GDP growth of 2.8% for this year and 2.5% for 2019, which in both years is above the potential growth rate and the Eurozone average.

"Strong domestic demand makes Dutch GDP growth less vulnerable to risks abroad than in recent years"

While geopolitical tensions seem to have affected the mood, the sentiment is still more positive than the historical average in services and industry and especially in construction. Purchasing managers' index shows the industry is more optimistic about domestic order positions than new export orders, however continuing export growth may be combined with downward risks for foreign demand. Fortunately, strong domestic demand makes Dutch GDP growth less vulnerable to risks abroad than in recent years.

Survey indicators lower but still above historical average



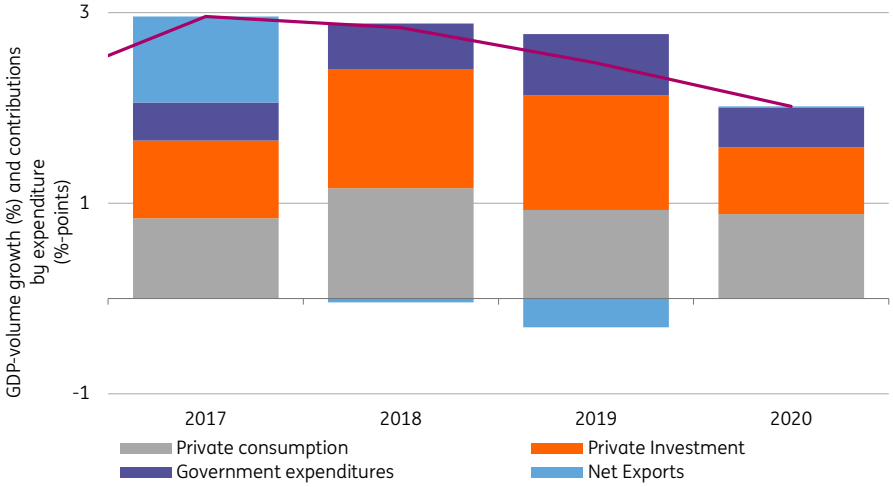
Source: DG ECFIN via Macrobond

Consumption acceleration keeps economy pacing forward

The mood in retail is still subdued and consumers haven't been going on spending sprees, despite 17 quarters of positive GDP growth in a row and domestic demand recently providing the most forceful push.

While a value-added tax hike in 2019 might somewhat limit the acceleration of household consumption, we expect consumers to start being less thrifty by the end of this year and in 2019. The continuous tightening in the labour market and wage growth that has finally begun to accelerate supports our view.

Domestic demand driving high growth



Source: Statistics Netherlands via Macrobond, ING estimates for 2018-2020

Import growth outpaces moderate exports growth

Due to an unusual and unexpectedly weak first quarter, Dutch exports are expected to grow at a subdued pace of 2.5% this year. Accordingly, we project weak import growth of 2.9%. Together, this drives the annual net contribution of foreign trade to nearly zero.

"Current account surplus is expected to remain around 10% of GDP"

During 2018 and 2019, export growth is projected to maintain its pace, although slightly below historical averages. On the back of further improvements of households' disposable income, businesses continuing to buy (foreign) equipment and the government restricting gas production (and hence net gas exports) in the earthquake-stricken province of Groningen, percentage-wise imports may grow faster than exports in the quarters ahead.

Nevertheless, the current account surplus is expected to remain around 10% of GDP.

Tighter labour market to limit further unemployment falls

The labour market continues to reflect strong growth, but employment growth might have reached its peak in the second quarter of 2018, recording 2.5% YoY.

"We forecast unemployment to fall a little further, reaching 3.5% in 2019, after 3.9% in 2018"

While unemployment fell to 3.8% mid-2018, the falls are slowing, also because more people are (re)entering the labour force. Growing businesses will continue to hire more people, but find it increasingly difficult to do so. More than one in four businesses is reporting shortages of workers as a factor limiting production.

We forecast unemployment to fall a little further, reaching 3.5% in 2019, after 3.9% in 2018. Persisting labour demand is starting to show up in wages. Wage growth remained very modest in recent years but agreed collective wage agreements showed an upward jump from 1.9% to 2.3% in half a year.

Policy boosts consumer price inflation in 2019

Increasing wage pressures are hardly visible in inflation figures yet.

Food, clothing and communication are currently keeping headline consumer price inflation at moderate levels, just above 1%. Fuel and energy price have caused headline inflation to rise from 1.4% in 2017 to a projected 1.8% in 2018.

We expect inflation to rise further to 2.6% in 2019, primarily due to an increase in the reduced VAT rate (from 6% to 9%). Food items and some services (e.g. theatre and hairdresser) will see the largest increases in prices. Also, wage pressure will start to feed into output prices during 2019.

All industries growing, except gas

All industries are growing in 2018 except gas production, which is likely to shave off 0.1 to 0.2%-points off GDP growth both in 2018 and 2019.

Once the political goal to entirely shut off the gas tap in the Northern Province of Groningen has been achieved, this may cost between 0.5% to 1% of GDP beyond our forecast horizon.

Commercial services, including IT and job agencies, construction and health care are the sectors that grow at the highest rates. The solid growth in commercial services, which is responsible for more than half of capital formation, contributes heavily to the steady investment outlook of around 6% in both 2018 and 2019.

Public finances in line with European norms despite fiscal expansion

Fiscal policy is largely in check, with a fiscal balance close to 1% of GDP in 2017 and years to come. For the long-term, only a minor consolidation challenge remains.

The Rutte-III government uses cyclical tax revenues to offset falling gas revenues as well as to spend more and cut taxes. There is procyclical additional spending on defence, education, R&D, civil service and infrastructure in 2018, which will increase in 2019. In 2019, labour taxes will be lowered, while energy taxes will rise. Government debt was 56.4% of GDP at the end of 2017, below the European norm of 60% GDP. We expect the drop to continue and fall below 50% of GDP in 2020.

Above potential growth in 2019 again?

Compared to previous business cycles, the positive output gap is small. From a domestic point of view, the economy has ample space to grow above the estimated potential rate of 1.7%. We expect GDP growth in 2019 to come in around 2.5%, conditional on foreign downwards risks such as a hard Brexit, or major escalation of the trade war not materialising.

For 2020 we expect a normalisation towards potential.

The Dutch economy in a nutshell (%YoY)

	2016	2017F	2018F	2019F
GDP	2.9	2.8	2.5	2.0
Private consumption	1.9	2.6	2.1	2.0
Investment	6.1	5.8	6.2	3.2
Government consumption	1.1	2.0	2.7	1.7
Net trade contribution (%-point)	0.9	0.0	-0.3	0.0
Headline CPI	1.4	1.8	2.6	2.0
Unemployment rate (%)	4.9	3.9	3.5	3.5
Budget balance (% of GDP)	1.1	0.9	1.1	1.2
Government debt (% of GDP)	56.4	53.1	51.0	48.0

Source: Statistics Netherlands via Macrobond, all forecasts ING estimates

Spain: Political challenges, while the economy decelerates

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The next couple of weeks are likely to be stressful for the Spanish prime minister as he confronts a number of thorny issues. Meanwhile, evidence of a slowing economy is mounting. For 2018 as a whole, we forecast a growth rate of 2.6% and 2.0% for 2019

2019 budget is the first political hoop

Parliament's rejection of the draft 2019 budget was the first serious blow to prime minister Pedro Sanchez's minority government. Only 88 parliamentarians (out of 350) voted in favour of the plan at the end of June, so the first political hurdle is the approval of the 2019 budget.

"A deal between Sanchez and Pablo Iglesias would mean the prime minister can be more confident about Podemos support in parliament"

Spain's leftwing party, Podemos, which holds 67 seats, didn't support the draft budget as it wanted softer deficit targets. However, Sánchez emphasised the importance of fiscal discipline and continued to pursue the deficit target of 2.2% of GDP. Finding a compromise will be difficult, and as the draft budget needs to be submitted to Brussels by 15 October, the pressure will increase.

Recently, however, Sánchez met with Pablo Iglesias, the leader of Podemos, to talk about common goals on education, housing and taxes. A deal between the two would mean Sánchez can be more confident about Podemos support in parliament and this increases the probability of budget approval and the chances that Sánchez governs until the next official elections in 2020.

The Catalonia problem

However, Sánchez's success depends a great deal on the second important political hurdle, namely Catalonia where he needs the support of Catalan pro-independent parties to approve the 2019 budget. Sánchez has already lifted financial controls on the region, moved prisoners closer to home and met with the new leader of Catalonia, Quim Torra. He has also offered the Catalan government a referendum on more autonomy.

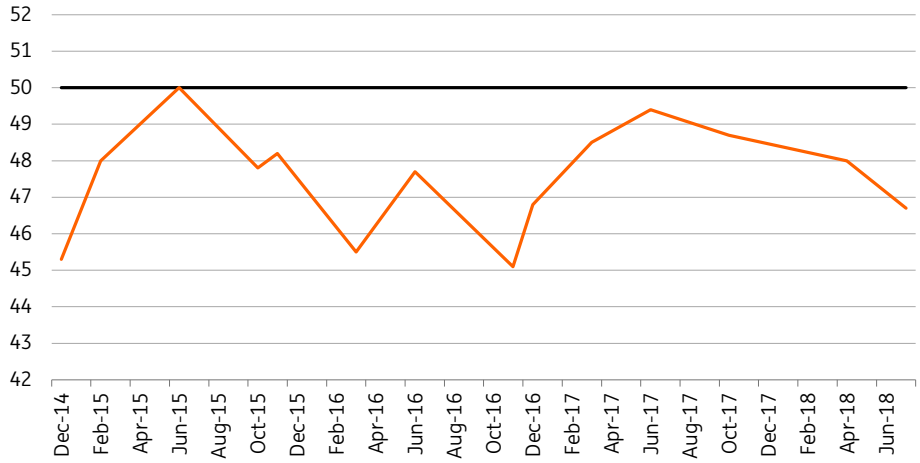
However, some sensitive events that are on the horizon could derail the prime minister's plans. On 1 October, there is the first anniversary of the Catalan unilateral independence referendum, so the tension on the streets is likely to rise, and the trial of the politicians that were jailed after the referendum could start in October. Quim Torra, the President of Catalonia, already said he would not accept "any sentence that is not total acquittal".

"If the budget isn't approved by parliament before the end of the year, then the 2018 budget will roll over, which implies no new measures can be taken"

An interesting and closely-watched poll by the Centro d'Estudis d'Opinio shows that support for an independent Catalonia remains high, but it doesn't reach a majority and is actually declining. Today, 46.7% of Catalans want Catalonia to be independent, whereas this was 48.7% in October 2017.

The poll, however, also shows that 62.3% of Catalans think that Catalonia has achieved an insufficient level of autonomy and this percentage already lies above 60% since 2007. The offer of Sánchez to have a referendum on more autonomy certainly is in line with the above, but it remains to be seen if it is enough to get the support of the pro-independent parties for the 2019 budget. If the budget isn't approved by parliament before the end of the year, then the 2018 budget rolls over, which implies no new measures can be taken.

Percentage of Catalans who want Catalonia to be an independent state



Source: Centro d'Estudis d'Opinio

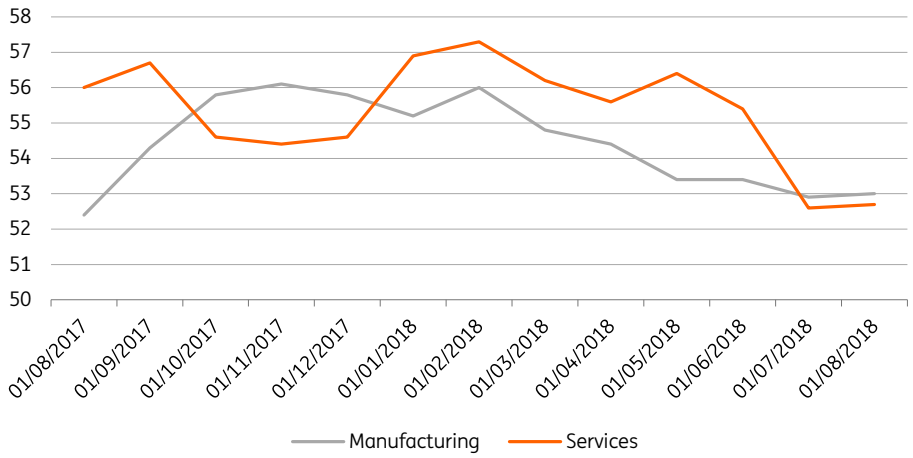
A slowing economy

According to the preliminary estimate of GDP, the Spanish economy slowed in the second quarter compared to the first. The economy grew by 0.6% quarter on quarter (QoQ), compared to 0.7% in the first quarter.

"This is the slowest growth rate in more than three years. Since 4Q14, the economy has expanded by at least 0.7% QoQ"

The first figures for the third quarter point to further slow down. Survey data, such as PMIs and the Economic Sentiment Indicator by the European Commission, continue to fall. The services PMI dropped sharply from 55.2 in June to 52.6 in July and remained at that level in August (52.7). The manufacturing PMI has already been in decline since the start of the year and came in at 53 in August.

PMIs stabilised in August, but are at a relatively low level



Source: Thomson Reuters

The first hard data for the third quarter doesn't show much movement compared to the second quarter. Retail sales fell in July by 0.4% year-on-year, compared to -0.1% in June. The uptick in headline inflation, from around 1.0% to above 2.0% in recent months, is a headwind for consumption. Industrial production growth is also on a downward trend since April 2018 and disappointed in July as it only grew by 0.5% year-on-year.

Due to the recent developments in some emerging markets, concern about the international presence of Spanish banks which could have negative spillovers increased. The Spanish banking sector has large exposure in terms of financial assets in Turkey, Brazil, Mexico and Chile.

"We think the Spanish economy is still in good shape but nonetheless, we forecast a slight slow down in the coming quarters"

However, these spillovers might be limited as Spanish banks follow the so-called subsidiary model, which implies large local claims (and mainly in the local currency) and large local operations. That said, a severe downturn in these countries, combined with falling exchange rates will, of course, impact the profitability of the Spanish banks.

That said, we think the Spanish economy is still in good shape. For example, the strong labour market will continue to support consumption. Nevertheless, we forecast the economy will slow down a bit further in the coming quarters.

Given the extraordinary performance in previous years (above 3% annual growth since 2015), this shouldn't be viewed as a sign of trouble. For 2018 as a whole, we forecast a growth rate of 2.6% and 2.0% for 2019.

Spanish economy in a nutshell (% YoY)

	2016	2017	2018F	2019F	2020
GDP	3.3	3.1	2.6	2.0	1.5
Private consumption	3.0	2.4	2.2	1.7	1.3
Investment	3.1	5.5	4.6	2.7	2.1
Government consumption	0.8	1.6	1.9	0.5	0
Net trade contribution	0.9	0.3	0	0.3	0.4
Headline CPI	-0.3	2.0	1.7	1.7	1.8
Unemployment rate (%)	19.6	17.2	15.5	14.5	14.0
Budget balance as a % of GDP	-4.5	-3.1	-2.6	-1.9	-2.0
Government debt as a % of GDP	99.0	98.3	96.9	95.3	94.3

Source: Thomson Reuters, all forecasts ING estimates

Greece: Thinking about life after the bailout programme

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The almost 'clean' exit from the third programme leaves Greece with many challenges ahead, the first of which will be devising a sustainably higher path of growth while sticking to the set path of reforms. But in the short run, the upcoming elections will be the first credibility test

The volatile economic recovery continues

The Greek economic recovery continues at a moderate pace, with a volatile pattern of growth. In 2Q18, GDP expanded modestly at 0.2% quarter on quarter (1.8% YoY), slowing down from an upbeat 0.9% in 1Q18.

"The wounds of the global financial crisis and three adjustment programmes are still visible as total employment is still 17% below pre-crisis highs"

Exports were the growth driver, while investments have so far failed to confirm the exceptionally positive reading of 4Q17. The flipside of this was a softer growth drag from the goods component of imports. The good news came from the private consumption front, which is finally benefiting from the ongoing turnaround in the labour market. Employment has been expanding at an average 1.5% year on year rate over 1H18, and the unemployment rate has recently fallen again below the 20% mark for the first time since 3Q11.

To be sure, the decline in the unemployment rate, while an undisputable positive, should be put into context, as it happened during a sharp contraction of the Greek labour force. The sustained pick-up in consumer confidence is getting sounder backing and is finally showing up in hard consumption data, which posted two 0.5% QoQ increases in a row in 1Q and 2Q18. The wounds of the global financial crisis and three adjustment programs are still visible as total employment is still 17% below pre-crisis highs.

Greece's clean exit

Having considerably overshot its general government budget primary surplus target in 2017, Greece seems to be in a position to meet the 3.5% of GDP primary balance target in 2018. Fiscal discipline monitoring will remain a recurring feature even after the third programme ended on 20 August 2018.

As the prime minister Alexis Tsipras wanted, Greece exited the program in a "clean" way, i.e. without resorting to any form of precautionary credit lines. This was made possible by the substantial €24bn liquidity buffer, funded partly with past Greek government bonds issuance, partly with domestic repo agreements and, crucially, with final disbursements from the ESM loan. The buffer aims to cover financial needs for at least 22 months after the end of the programme or more should the current stock of T-Bills be rolled over.

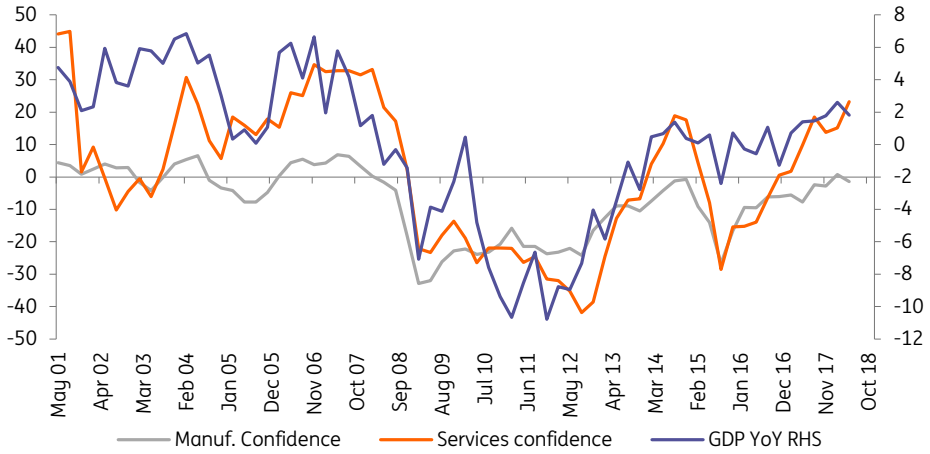
But don't confuse clean with control

However, the clean exit doesn't mean that Greece will soon regain full control of its state finances.

The program ended with a list of to-dos, with the medium-term debt relief measures agreed on the fulfilment of public finance targets. The latter remains very ambitious: the primary surplus is targeted at 3.5% of GDP until 2022 and 2.2% of GDP after that until 2060; if realised it would represent an unprecedented achievement.

Given the size of the outstanding Greek exposure to official lenders, it was decided that the country would be subject to "enhanced surveillance", which will entail quarterly reviews.

Confidence pick-up is helping recovery



Source: Datastream

The challenge: Restore sustainably higher growth

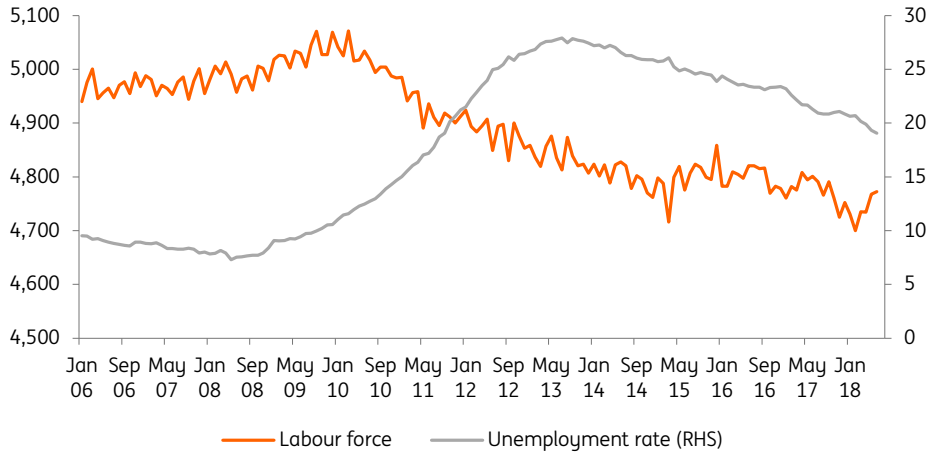
Looking forward, restoring sustainable growth conditions will likely be one of the top priorities for post-programme Greece.

"Having lost 25% of its GDP since the crisis began late in 2009, Greece desperately needs measures to redress sustainably higher economic growth"

A new pattern of growth will have to be found with a better balance between domestic and external demand components, trying to leverage on the big and fatiguing reforms made over the crisis years.

Having lost 25% of its GDP since the crisis began late in 2009, Greece desperately needs measures to redress sustainably higher economic growth. A renewed focus on investment in physical and human capital is likely to help stop the brain drain of discouraged young Greeks, who are still leaving the country in large numbers. This would likely help propel productivity, a key determinant of potential GDP.

Unemployment rate declining despite labour force pick-up



Source: Datastream, ING

The first credibility test - upcoming elections

In the short run, the upcoming legislative elections, due no later than October 2019, will be the first relevant credibility test for Greece.

Taking place a year after the country exits its three-year aid programme, the elections offer the government the temptation to run popular policies such as unwinding highly unpopular labour market reforms imposed by lenders.

While politically effective, this could turn out to be a risky exercise, as it could entail credibility costs and could affect the attractiveness of Greece to foreign and domestic investors at a time when it is much needed. Life under the programme had many reforms passing the parliamentary test but often meeting obstacles in implementation.

Life after the programme will be the right time for proper implementation, the prize being the ability to move Greece to a sustainable path of higher economic growth.

The Greek economy in a nutshell (%YoY)

	2017	2018F	2019F	2020F
GDP	1.3	1.9	1.9	1.6
Private consumption	0.2	1.2	1.4	1.3
Investment	9.5	-3.6	15.9	7.6
Government consumption	-1.2	-1.8	0.8	1.3
Headline CPI	1.1	0.7	1.1	1.3

Source: Datastream, all forecasts ING estimates

Belgium: An election year in sight

The Belgian economy continues to grow at a moderate pace. Having said that, the labour market is still doing well. In the short term, we don't expect many economic policy changes, as the long election period has just begun

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Weak consumption

Despite being positive, Belgian economic growth disappointed once again in the first half of this year at 0.3% and 0.4% in the first and second quarter respectively.

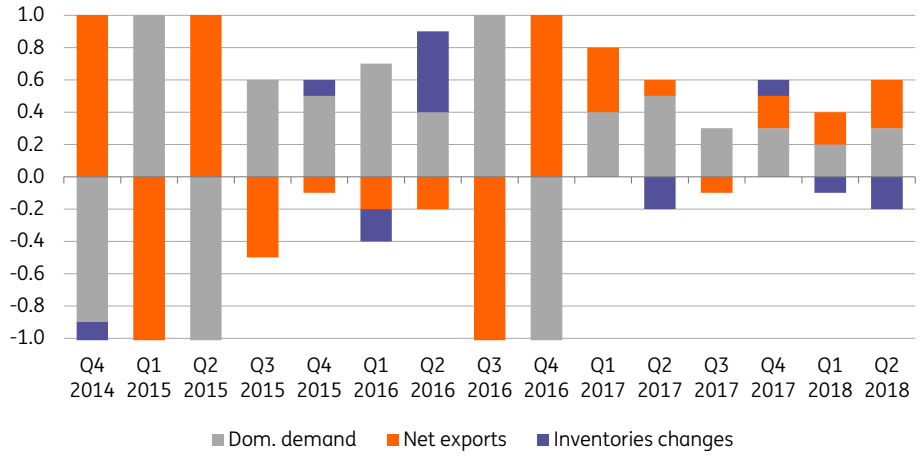
What is interesting is that while domestic demand was the biggest contributor to economic growth in 2017, things seem to be changing this year. Foreign trade contributed as much as domestic demand in the second quarter of this year, while the contribution of inventory changes was negative. Unfortunately, we can't say foreign trade contribution increased, but rather it was the domestic demand that decreased.

"Domestic demand was the biggest contributor to economic growth in 2017, things seem to be changing this year"

The evolution of household consumption remains the main handicap to more dynamic domestic demand. It increased only by 0.2% in the first half of the year, which is very low. For sure, households nominal disposable income rose in the second quarter by 2.9% year on year. This is due in particular to a decent increase in employment (+39,000 jobs during the first six months of the year).

However, considering the nearly 2% inflation, this leaves little room for consumption to increase in real terms. As a consequence, Belgian households have once again reduced their savings rate, (which is now below 11% and remains below the European average) to maintain the weak growth rate of consumption.

GDP growth contribution (percentage point)



Source: National Bank of Belgium, ING

Better conditions for growth, but...

The important question is therefore whether household consumption will accelerate over the coming quarters.

We can't exclude that the savings rate won't fall further, allowing consumption to improve, however, in the second half of the year, other factors should play favourably.

On the one hand, steady jobs creation will continue to fuel household disposable income. On the other hand, a wage indexation of civil servants and employees will take place in the very short run, while at the same time inflation should decrease somewhat.

This is why we believe growth should at least continue at the current pace. and if we're lucky, maybe even speed up a bit. In this case, GDP growth is expected to reach 1.6% this year and 1.7% next year provided that trade tensions don't escalate as that would undeniably be a negative shock for economic growth in Belgium, given its importance.

Election year

In the current climate, it'll be difficult to further reduce the public deficit by 2020, which as a reminder went down from 2.5% of GDP in 2016 to only 1.0% in 2017. All the measures taken up till now should make it possible to maintain this level next year, but much harder to improve it.

This is all the truer as new economic policy initiatives are not likely to be taken in the coming months. Indeed, an election year has just begun. On October 14, local elections will be held and on the 26th of May 2019 the federal, regional and European elections will take place.

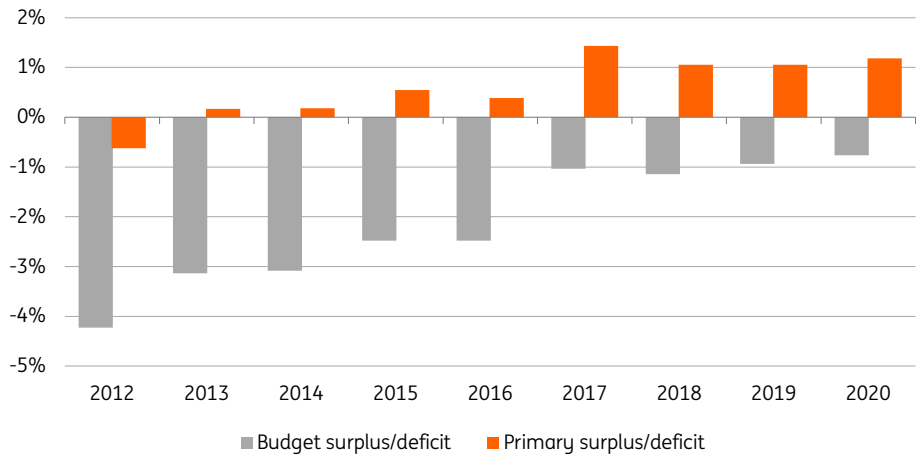
Local elections aren't the best time to assess the underlying strength of the different political parties. In many municipalities, citizen lists are proposed, or parties join together on a common list. It is only in the big cities that all the traditional parties are represented. This poll will nevertheless be an opportunity to assess the weight of some extremist or populist parties, but this will only give a partial picture. Afterwards, the preparation of the general elections of May 2019 will begin.

In this situation, it is likely that compromises to launch new economic policy initiatives will become increasingly difficult to reach. Indeed, let's remember that (i) the federal government brings together parties with very different objectives; (ii) only one French-speaking party is in the federal majority, which means that there is no majority in the French-speaking part of the Parliament and (iii) the federal and regional governments are formed of different coalitions. Therefore, it is not clear that the parties currently in

power will be able or even want to maintain the current coalitions after the elections, making it more unlikely that they want to allow their coalition partners any success on new policies in the run-up to the elections.

The recent announcement of the launch of a strategic investment pact could, therefore, be the last major project of the federal government. In concrete terms, this aims to strengthen investments in six key areas: digital, cybersecurity, education, health care, energy, and mobility. An amount of € 150 billion has been agreed by 2030. That said, the funding mechanisms will involve public-private partnerships. This is not, in itself, a net increase in public investment, but rather a political incentive to concentrate the resources available in certain sectors. So we don't expect much from this announcement, certainly not in the short run.

Public deficit has been considerably reduced...but is now likely to stabilise



Source: National Bank of Belgium, ING

Conclusion

So, the Belgian economy isn't doing that bad after all; though, as we've said, it could do better. Ultimately, it remains highly dependent on the international economic context, and the risks that weigh on it.

In terms of domestic policy, major reforms have been undertaken in recent years to structurally improve public finances and make the Belgian economy more attractive. But this reform package is coming to an end now, as a long series of elections begins.

The Belgium economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	1.7	1.6	1.7	1.6
Private consumption	1.3	1.0	1.6	1.6
Investment	0.7	2.2	1.0	1.3
Government consumption	1.3	1.0	1.2	1.2
Net trade contribution	0.5	0.7	0.5	0.4
Headline CPI	2.1	1.7	1.8	1.9
Budget balance as % of GDP	-1.0	-1.1	-0.9	-0.8

Source: Thomson Reuters, all forecasts ING estimates

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Austria: Still enjoying the isle of happiness

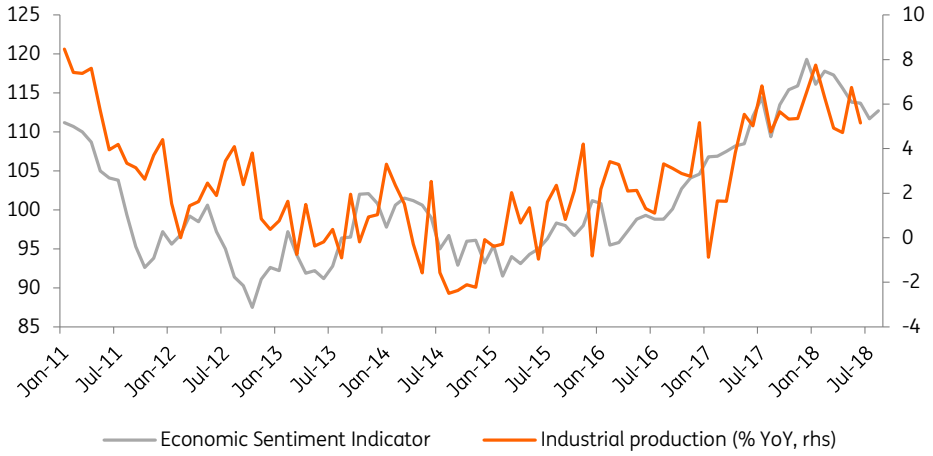
2018 marks another boom year for the Alpine republic, but for 2019 and 2020 we expect a gradual return to average growth levels cooling down to 2.2% and 1.8% respectively

Economic performance driven by domestic and foreign impulses

With first-quarter GDP growth coming in at 0.8% quarter on quarter and second-quarter growth at 0.7% QoQ, Austria's economy has seen a strong first half of the year. While we expect the current strong momentum to abate as the peak of the current economic cycle has been reached, a robust growth performance of 2.8% for 2018 is pencilled in.

Although risks to the growth outlook stem from foreign uncertainty factors such as a further escalation of the US trade conflict with major trading partners, the impact should be negligible for the Austrian economy this year. For 2019 and 2020 we expect a cooling down to 2.2% and 1.8% respectively.

Cooling down from high levels



Source: Thomson Reuters

The EU presidency isn't really a big deal

As far as the country's EU presidency is concerned, the focus is likely to shift from the migration issue to Brexit and the closing window of opportunity for a deal. However, in Austria, the chairing isn't really on people's radars.

According to a recent survey, 60% say they are ill-informed about the presidency, while only 19% attest the government is doing a good job and see new impulses on the EU stage. With less than a year to go until European parliamentary elections, the government has to step up its game, especially since 77% think the government's far-right junior coalition partner, the Freedom Party of Austria (FPÖ), would like to drop the EU presidency as it is an unnecessary cost and doesn't bring any benefits. Overall, 60% are in favour of scrapping the EU presidency.

Nevertheless, the government still has more than half of its presidential term to go, packed with foreign and EU-related uncertainty factors. With the economy currently on auto-pilot, it also has the opportunity to make an impression not only on the international stage but also domestically.

The Austrian economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	3.0	2.8	2.2	1.8
Private consumption	1.4	1.7	1.6	1.4
Investment	4.9	3.3	2.5	1.6
Government consumption	0.9	1.8	1.1	0.8
Net trade contribution	0.4	0.7	0.5	0.3
Headline CPI	2.2	2.1	2.0	2.1

Source: Thomson Reuters, all forecasts ING estimates

Portugal: On track for another good year

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The government continues to focus on reducing public debt and the deficit however strong house price growth is becoming a concern. We expect the economy to continue to perform well in 2018, although growth will be slower than last year and forecast annual growth of 2.1% in 2018 and 1.8% in 2019

The discussion about the 2019 budget is ongoing, but it seems the Portuguese government continues to focus on limiting the budget deficit and public debt.

The prime minister António Costa recently said the country should continue to do this to protect itself from external risks, such as a further escalation of the US-China trade war. In 2017, the Portuguese government debt in terms of GDP was the third highest in the Eurozone (125.7%), after Italy (131.8%) and Greece (178.6%). Costa recently said that the aim for 2019 is a deficit of 0.2% of GDP, which is even lower than last year's 0.9% excluding the one-offs such as the recapitalisation of the public bank Caixa Geral de Depósitos.

The draft budget is expected to be given to the parliament and the European Commission by 15th of October, after which it will be discussed in parliament, while the vote on the bill would take place at the end of November.

"In 2017, the Portuguese government debt in terms of GDP was the third highest in the Eurozone (125.7%), after Italy (131.8%) and Greece (178.6%)"

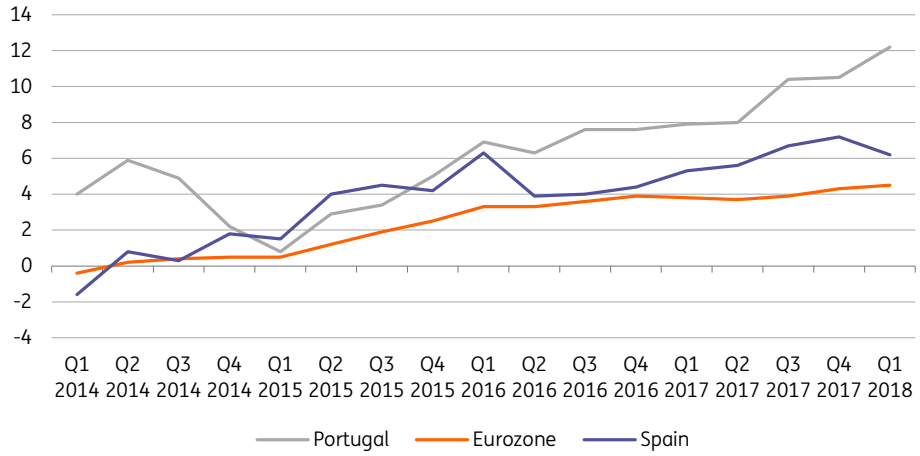
In the second quarter, the economy grew by 2.3% year on year, compared to 2.1% in the first quarter. Like the first quarter, net exports contributed negatively to growth, but domestic demand, and in particular consumption and investment, more than compensated. Consumption remains supported by a strong labour market. The unemployment rate continues to drop sharply and reached 6.8% in July. Employment growth has been declining since the beginning of the year but managed to stay above 2%. Soft data, such as consumer confidence and the Economic Sentiment Indicator (ESI) remain at high levels.

"The unemployment rate continues to drop sharply and reached 6.8% in July"

One issue that gets more and more attention is the sharp increase in house prices, which have been accelerating since early 2015 and reached 12.2% in the first quarter of 2018. This is almost twice as fast than Spain and three times as fast as the Eurozone. The strong growth rate is caused by surging domestic and foreign demand, while supply cannot keep up.

The government could take some measures in its 2019 budget to alleviate the pressure, for example curbing foreign demand by adjusted programs such as the golden visa and the non-habitual regime. However, the prime minister has recently announced that people who return to Portugal in 2019 and 2020 could get a reduction in income tax and discounts on their return trip and housing, which is likely to further exacerbate the problem.

House price growth accelerates



Source: Eurostat

We expect the Portuguese economy to continue performing well in 2018, although growth will be slower than last year. We forecast an annual growth rate of 2.1% in 2018 and 1.8% in 2019.

Ireland: Fingers crossed for a deal

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The Irish economy continues to show healthy signs of growth despite the Brexit uncertainty. While a no deal scenario could have significant ramifications, confidence is still at high levels, and modified domestic demand doesn't show any signs of slowing either.

Consumption catchup possible if cliff-edge situation avoided

The Irish economy continues to grow strongly despite the uncertainty around its future. GDP growth in the first quarter disappointed, but economic fundamentals continue to point to a stronger year for the Irish economy.

A decline in consumption despite continued strength in the labour market seems to reflect some of the uncertainty surrounding Brexit and trade disputes, but the drop in investment growth seems to reflect the swings in multinational corporation activity, impacting GDP negatively this quarter. This might be due to the changes in the American corporate tax system.

Modified domestic demand, which strips out multinational activity components, actually accelerated in the first quarter, which indicates domestic investment performed well at the beginning of 2018.

Even though consumption weakened in the first quarter, the outlook for consumers remains quite bright as expectations for the next 12 months don't seem to have adjusted for a worst-case scenario. After the referendum, general economic expectations in Ireland deteriorated somewhat, but have actually been recovering since early 2017. Expectations about consumer's financial situation and employment prospects have been stable at historically strong levels, which indicates that without a cliff-edge situation Irish consumption seems to be set for some catch-up in the second half of the year.

The Irish housing market continues to face supply worries, which means house prices are likely to continue to rise throughout the year. The 12.3% year on year growth in Q1 saw Dublin's price growth being outpaced by the rest of the country, indicating housing shortages are broad-based for the moment.

For Ireland, any deal is better than no deal

The Brexit negotiations are moving into a crucial phase, especially for Ireland. In the coming months, a withdrawal agreement deal needs to be reached, and a statement of intent on the aim of the trade talks will be drawn up. This needs to be ratified by all countries before the end of March 2019, when the UK will formally leave the EU. The Irish

border issue is part of the withdrawal agreement and remains the topic with the most uncertainty around it for the moment as both the EU and the UK are miles apart.

If a deal is not reached on the withdrawal bill, the impact on the Irish economy will be severe. A cliff edge scenario that would push the trade relationship to WTO rules which would result in a significant chance of a severe recession for the Irish economy. Given that 15% of total exports go to the UK at the moment, sectors like agriculture, pharmaceuticals, electrical machinery and wholesale and retail trade are strongly exposed to the British economy.

However, we believe that a deal will be reached as both sides are cautiously showing signs of flexibility. This would mean that a transition period under which existing rules remain active awaits, which would mean a soft landing for the British-Irish trade relationship is still the base case. While that is a positive outcome at this point, it does mean quite a long period of uncertainty ahead still as the trade relationship will take years to be defined in more detail.

The Irish economy in a nutshell (%YoY)

	2017	2018F	2019F	2020F
GDP	7.2	5.3	3.5	3
Private consumption	1.6	2.9	2.3	1.9
Investment	-31	7.2	6.8	4.9
Government consumption	3.7	3.5	1.6	0.7
Net trade contribution	14.5	0.9	-0.2	0.2
Headline CPI	0.2	0.8	1.7	1.7

Source: Macrobond, all forecasts ING estimates

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Finland: Peak growth?

The Finnish economy continues to outpace the Eurozone average in 2018, but a maturing cycle, weakening competitiveness and more uncertainty about the global environment will cause growth to deteriorate. Our outlook for 2019 and 2020 is more modest from 2.6% this year to 1.6% in 2020

Has Finland reached the top of the growth cycle?
After a surprisingly strong first quarter with GDP growth of 1.2% quarter on quarter, the Finnish economy has slowed to 0.3% in the second.
The significant drag in the second quarter was the volatility in government expenditures. Consumption and fixed investment both accelerated in Q2 though, indicating that domestic demand is gaining traction. Export growth continues to contribute positively to GDP as growth has resumed.
All in all, 2018 looks to be another strong year for the Finnish economy, but downside risks are beginning to impact the growth outlook. While the recovery only started in 2Q15, it looks like growth is set to slow down in the coming years as external and internal factors take effect.

With inflation still modest compared to the Eurozone average at 1.4% in August, the pace of real wage growth is encouraging and will underpin continued healthy consumption growth in the second half of the year.

However, the outlook for business investment is more unclear. Like the rest of the Eurozone, Finnish businesses are experiencing high capacity utilisation levels, which recovered quickly after the recession ended and has now surpassed its long-term average. This should boost the outlook for investment, but as uncertainty about the global economic outlook has affected confidence, investment decisions could be delayed. For the coming quarters, we expect investment growth to slow down somewhat compared to the strong Q2 data.

The outlook for 2019 and 2020 is more modest as we expect growth to slow from 2.6% this year to 1.6% in 2020. The recovery effects are fading as the economy has quickly caught up with potential. Without catch-up effects and with more headwinds facing the exporting sector, a cooling of the economy seems likely in the coming years.

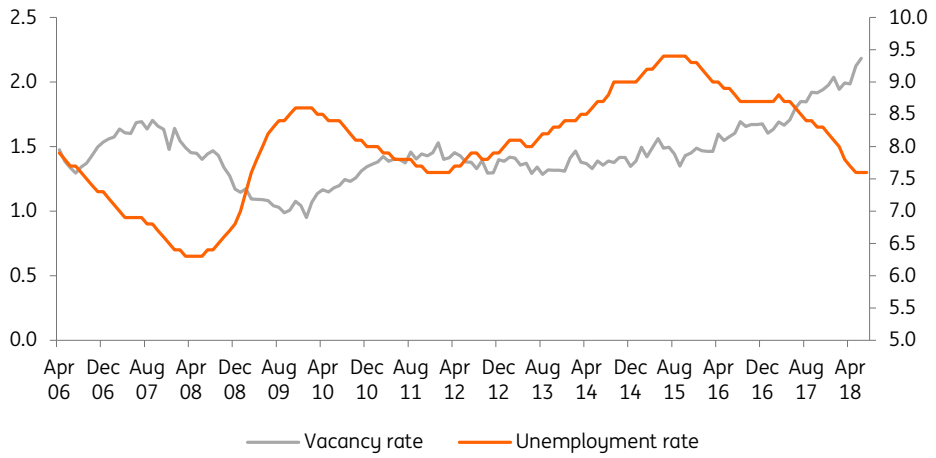
Labour mismatches are a barrier to competitiveness

While Finland has managed to achieve considerable improvements in its labour competitiveness over the past years, it seems that this will not last much longer. Signs of mismatches in the labour market are becoming a significant barrier to growth in the Finnish economy and businesses have started to raise wages again to counter the issue.

"With competitiveness weakening, the depreciation of the euro over recent months will be a welcome gift to Finnish exporters"

After significant negative growth, wage growth has started to pick up again and has accelerated to 2.9% YoY, the strongest wage growth since early 2014. This means that the competitiveness pact has had its success as it brought down unit labour costs, but is quickly losing impact as the economic upswing is causing labour shortages in many sectors.

Mismatches in the Finnish labour market are starting to show



Source: Macrobond

Broad-based labour shortages are occurring in a background of an elevated unemployment rate. It has come down to 7.6% in July according to the harmonised European definition, still well above the 6.3% trough seen in early 2008. Meanwhile, vacancy rates have increased significantly, indicating that mismatches in the labour market have become a key issue in the economy at the moment.

With competitiveness weakening, the depreciation of the euro over recent months will be a welcome gift to Finnish exporters. The outlook for exports is therefore relatively benign in the short run, but deteriorating unit labour costs and background of free trade concerns are likely to curb the potential in the medium term. Especially given the relatively sizable role in the global value chain of Finnish businesses, Finland remains rather vulnerable to global trade developments.

The Finnish economy in a nutshell (% YoY)

	2017	2018	2019	2020
GDP	2.8	2.6	2.0	1.6
Private consumption	1.3	1.6	2.5	2.1
Investment	4.0	3.6	2.8	2.0
Government consumption	-0.5	0.1	0.3	0.2
Net trade contribution	1.5	0.3	0.1	0.0
Headline CPI	0.9	1.1	1.6	1.7

Source: Macrobond, all forecasts ING estimates

Eurozone housing market cycle is maturing

The residential real estate market has been recovering in the Eurozone since 2012. However, ECB's quantitative easing program has boosted prices everywhere since mid-2015 through lower long-term interest rates that boosted mortgage credit growth. We think 2018 could see peak growth but expect the recovery to slow down after that

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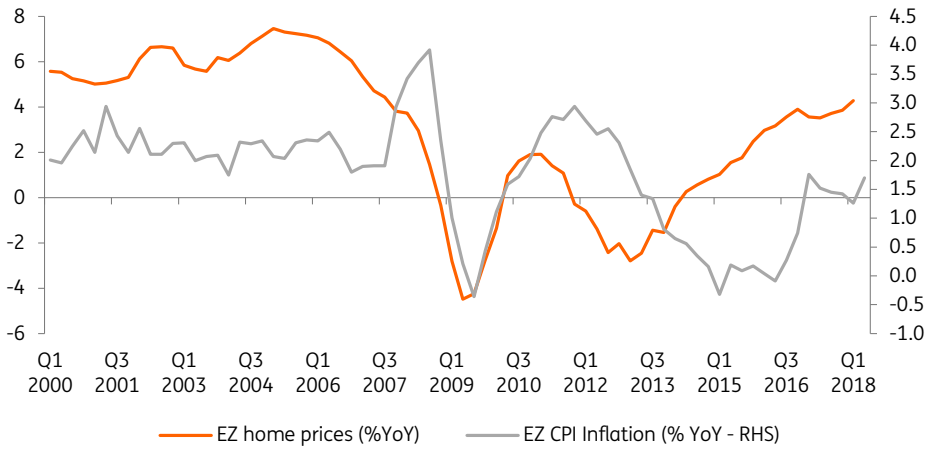
Eurozone: House price recovery continues

In 2014 and 2015, we saw house price growth rates below 2%, but in 2016, prices rebounded by 3.4% accelerating to 3.7% in 2017. We think 2018 could see peak growth as we forecast 3.8% but then a decelerating trend for the coming years.

Nevertheless, house price growth should remain above inflation, with growth forecasts of 2.8% and 2.6% respectively for 2019 and 2020.

Eurozone house prices and inflation



Source: ECB

Low-interest rates, supply shortages in some countries and accelerating economic activity that increased disposable income and hence demand has so far supported this growth. With consumer confidence still at a high and very generous financing conditions, the recovery should continue, which in turn is positive for activity levels and

employment growth. Business confidence in the construction sector reached levels in 2017, not seen in the last ten years, and hiring intentions followed.

This is likely to decrease supply shortages where they still exist, which - together with slowly rising rates – should limit house price growth somewhat in the whole of Eurozone in the coming years.

Core Eurozone

Germany: Boom in the real estate market continues

Since 2009, real estate prices have increased around 40 percent on the back of low interest rates, strong economic growth and record-high employment. The overall number, however, significantly masks diverging trends across regions. As in many other Eurozone countries, price increases have been much more accentuated in urban areas. The 40 percent increase across the entire country compared with an 80 percent increase since 2009 in the seven largest German cities.

Even though affordability, as measured by the price-rent ratio, has clearly deteriorated, there are still very little signs of a textbook-style real estate bubble. In fact, private household indebtedness has come down both measured in terms of percentage of GDP and in terms of percentage of disposable income. The share of mortgages in private household debt has remained stable. Also, the share of longer-term mortgages (i.e. loans with maturities of more than ten years) has increased in recent years.

Going into 2019, new orders in the real estate and construction sector signal some levelling off in activity. At the same time, however, the lack of real estate in urban areas combined with continued low interest rates and solid economic fundamentals points to ongoing strength in the real estate market, albeit at a slower pace.

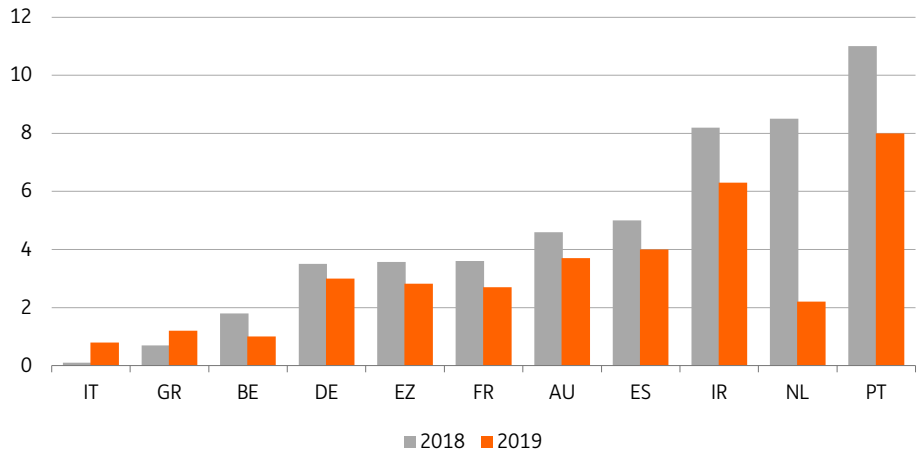
France: Market remains dynamic, without any sign of overheating

Some regional hubs are more dynamic than the average, with the champion, Bordeaux, which benefits from a new high-speed train link to Paris, posting a 25% growth over the last five years, against a national average of only 1.7%. Does not look like overheating with an increase of +25.4% over the last five years.

French housing prices are now 12% above their pre-crisis peak of mid-2009, and we expect them to continue to increase, by 2.7% in 2018 after 3.2% in 2018. A slowdown is therefore visible despite the fact that interest rates remain market supportive. It is worse in new housing activity though, as construction activity, which grew by 2.9% in 2017, stabilized in 2018 (-0.1% YoY so far this year). This had been confirmed by households' investment growth in 1H18 GDP figures (it increased by a mere 0.2% QoQ in 1Q18 and declined by 0.1% in 2Q18, their lowest rate since 2015).

While this sector has been recovering since 2015, we continue to see there the first signs of a peaking housing market cycle. As long as interest rates remain supportive, we do not believe in a hard landing, but construction activity figures since May are a sign that the housing market could be cooling down somewhat. In July, construction activity declined again, by 1.8% MoM, its 4th month of decline so far this year. This came despite very high confidence in the sector, record high capacity utilisation and order books: so, if there is no sign of demand dropping yet, some labour market shortages could well be part of the explanation. This is why we still think that house price growth should not plummet either.

Housing price growth forecasts across the Eurozone (in %)



Source: ECB, ING

Southern Eurozone countries

Italy: Ongoing soft recovery remains a positive for housing market

For the time being, this has been reflected in higher house transactions, but at a declining pace.

In 1Q18 the number of house transactions was up by 4.3% YoY (6.5% YoY in 4Q17), confirming close to the average 2017 growth rate. Improved affordability is making the purchase more attractive. The recovery in loans for house purchases continues at a stabilised 1.1% yearly clip. Overall, the mood of real estate agents remains decently upbeat on activity, but times seem not ripe yet for a quick turnaround of market valuations.

According to the July 2018 BoI-Tecnoborsa survey an increasing share of agents expects prices to stabilise over the next 12 months (76.6% in 2Q18 from 71% in 1Q18), and the share of those expecting prices to rise increased only marginally (to 3.9% from 3.6). The loan to value ratio, at 75%, is now higher than before the outbreak of the great financial crisis and is stabilising; the ratio of house purchases financed via mortgages, instead, increased further to 81.2%, highlighting an increasingly close link between credit availability and house purchases for financially battered households. Encouragingly for house price developments, the survey shows that the average discount from the original offer price declined further to 9.9% (from 10.9% in 1Q18).

Latest Istat house price data shows a divergence between existing homes (still on a decelerating decline) and new homes (picking up). We expect the ongoing moderate recovery of disposable income, in conjunction with still cheap mortgages, to support further house purchases. However, the ample slack in the market should prevent a big short-run showing on prices. We expect average house prices to edge up only marginally in 2018, and to post a modest acceleration in 2019.

Spain: House prices to moderate

In Spain, house prices grew by 6.2% YoY in the first quarter of 1Q, compared to the 7.2% QoQ in 4Q 2017. This is the first deceleration since the second quarter of 2016. For the rest of 2018, we expect house prices to moderate further and forecast an overall growth rate of 5.0%. Nevertheless, this is firmly above the Eurozone average.

Greece: Pace of expansion remains modest

In Greece, signals of an economic turnaround are getting more consistent, but the pace of expansion remains modest. Encouragingly, the recovery of employment (the main

engine of disposable income) seems to be continuing at a decent pace. To be sure, the delicate position of Greek banks on NPLs is still weighing on house-purchase related mortgage lending.

In July, lending for house purchases was still contracting at a 3.8% YoY clip. Improving confidence and income conditions were enough to stop the fall in house prices in 1Q18 and to induce a 0.8% YoY increase in 2Q18. The perspective of the end of the third ESM programme might have helped, as could over the next few quarters the actual exit effect.

To be sure, with the level of taxation on real estate assets still extremely elevated, barring unexpected accelerations in the pace of economic recovery, a sharp acceleration in house prices in the short run seems unlikely, notwithstanding very depressed current price levels. We see the YoY price recovery to continue over the next couple of years at a slightly accelerating pace.

Portugal: House price growth continues to surge

In Portugal, house price growth is accelerating since early 2015 and reached 12.2% in the first quarter of 2018. This is almost twice the rate of Spain and three times the rate of the Eurozone. The strong growth rate is caused by strong domestic and foreign demand, while supply cannot keep up. The government could take some measures in its 2019 budget to alleviate the pressure. Foreign demand, for example, could be reduced by adjusted programs such as the golden visa and the non-habitual regime.

Recently, however, Costa announced that people who return to Portugal in 2019 and 2020 could get a reduction of income tax and discounts on the return trip and in housing. The demand for houses will go up even more due to this policy, which has the potential of pushing house price growth even higher. We expect house prices to grow by 11% this year, compared to the 10.5% growth in 2017.

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