BELGIAN PRIME NEWS
Quarterly publication

BELGIAN DEBT AGENCY

NationalBank OF BELGIUM
Eurosystem

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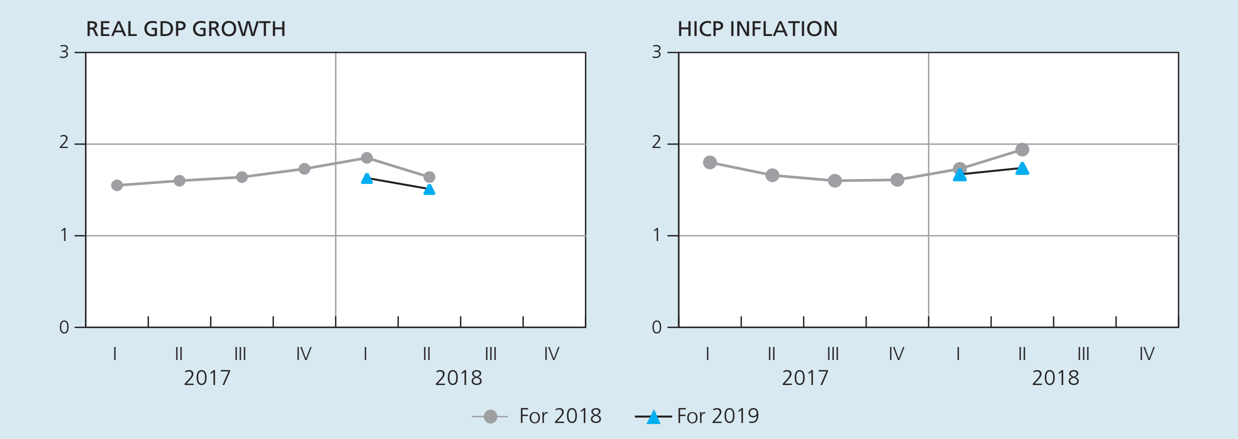
- SPECIAL TOPIC: Are inflation and economic activity out of sync in the euro area? What about Belgium?
- FINANCIAL MARKETS AND INTEREST RATES: Lower financial market volatility, but higher sovereign risk premia in the euro area amid political tension.
- TREASURY HIGHLIGHTS: Two-thirds of the 2018 funding plan already achieved.

CONSENSUS **Average of participants' forecasts**

	Belgium			Euro area		
	2017	2018p	2019p	2017	2018p	2019p
Real GDP(1)	1.7	1.6	1.5	2.4	2.2	1.8
Inflation (HICP)(1)	2.2	1.9	1.7	1.5	1.6	1.5
General government balance(2)	-1.0	-1.2	-1.4	-0.9	-0.9	-0.9
Public debt(2)	103.4	101.8	100.5	86.7	85.9	84.3

(1) Percentage changes.
(2) EDP definition; percentages of GDP.

SUCCESSIVE FORECASTS FOR BELGIUM



Source: Belgian Prime News.

MACROECONOMIC DEVELOPMENTS **Global risks appear to be on the downside**

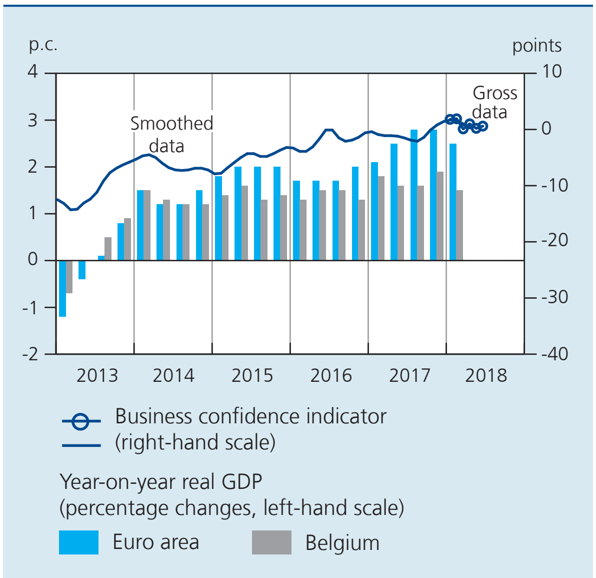
Following strong performance in the course of 2017, growth in most advanced economies slowed down somewhat in the first quarter of this year, notably in the United States, Japan and the euro area. While temporary factors (bad weather circumstances or strikes) are said to explain part of this slowdown, it is likely that growth in some advanced countries has shifted to a lower gear in a more persistent manner. After all, there are many risks involved, ranging from political uncertainties that generate market volatility to the (earlier-than-expected or) stronger incidence of possible supply-side constraints. Finally, the recent spike in oil prices is likely to trigger higher inflation in 2018 at least and may weigh on consumption.

In Belgium, GDP growth came in at 0.3 % in the first quarter of 2018, slightly below the euro area growth rate. While business investment was below expectations, net exports and private consumption turned out to be very dynamic. However, the latter was primarily driven by durable goods purchases, which does not necessarily point towards an ongoing expansion of consumption in the coming months. Business and consumer confidence indicators are still at high levels, but have clearly deteriorated compared to end-2017. Against this background, the average GDP forecast for Belgium and the euro area has been revised downwards from the March estimate. **BPN participants currently expect growth in Belgium to reach 1.6 % in 2018 and 1.5 % in 2019. In the euro area, GDP is expected to grow by 2.2 % in 2018 and 1.8% in 2019.**

The labour market has continued to perform relatively well, although domestic job creation has clearly weakened since the second half of 2017, partly favouring an increase in average working time. Meanwhile, on the nominal side, headline inflation is being pushed up by higher oil prices. In May 2018, HICP inflation in Belgium reached 2.3 %. **According to the consensus forecast, inflation should average 1.9 % in 2018 and 1.7 % in 2019 in Belgium, while it is likely to work out at respectively 1.6 and 1.5 % in the euro area.**

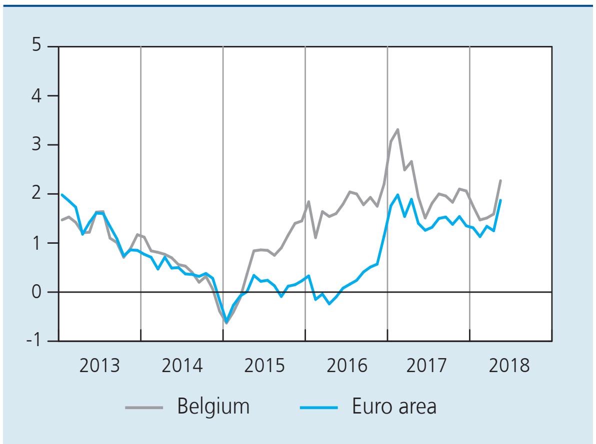
The first official public accounts for the year 2017 released by the National Accounts Institute put the general government deficit at 1 % of GDP – an improvement of 1.5 percentage points on 2016. The reduction in the budget deficit was due in part to a structural improvement in public finances, reinforced by the continuing upturn in the economy, the low interest rate environment, and unexpectedly favourable advance payments of corporation tax. **Belgian Prime News participants expect the public sector deficit to worsen slightly to 1.2 in 2018 and 1.4 % of GDP in 2019.** This implies that additional fiscal consolidation efforts would be required to achieve the medium-term objective, which is a balanced structural budget. In March 2018, the federal government confirmed its intention to improve the structural budget balance by 0.3 % of GDP in 2018, as proposed in the draft budgetary plan in October 2017. On the basis of their own macro and budgetary forecasts, **the BPN participants anticipate a slow reduction in the Belgian public sector debt, from close to 102 % of GDP in 2018 to 100.5 % of GDP in 2019.**

GDP GROWTH AND BUSINESS CYCLE INDICATOR



Sources: EC, NAI, NBB.

INFLATION (HICP)
(annual percentage changes)



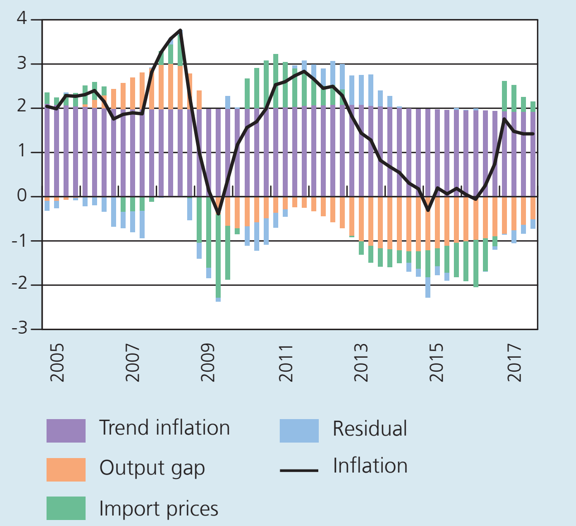
Source: EC.

SPECIAL TOPIC **Are inflation and economic activity out of sync in the euro area?**[1] **What about Belgium?**

In recent years, the advanced economies have generally recorded sustained economic growth, combined with surprisingly low inflation. Many economists have therefore talked about the "missing inflation" puzzle, because accelerating economic activity usually goes hand in hand with inflation.

Countries however showed contrasting situations. In the euro area, despite an acceleration of economic growth and a gradual decline in the unemployment rate following the end of the sovereign debt crisis in 2013, the nominal variables have lagged behind. Also in the United States, wage and price rises have largely remained out of step with the economic conditions for some time after the crisis. As the dual mandate of price stability and full employment of the central bank looked likely to be achieved, it was nevertheless possible to start normalising monetary policy from 2015. Moreover, the prospect of seeing inflation return to its target has firmed up in the most recent period. In contrast, in Japan the current low inflation is nothing new. The persistence of low inflation or even mild deflation has characterised its economy for a quarter of a century. Nowadays, the persistently weak inflation still prevails, despite a favourable economic situation and an unemployment rate at record-low.

ESTIMATED CONTRIBUTIONS TO EURO AREA INFLATION



Source: NBB.

A Phillips curve analysis helps to assess whether the link between economic activity and inflation actually still exists in the euro area, and how it compares with the situation in the United States and Japan.

The analysis shows that low inflation in the euro area can be explained mainly by remaining economic slack, slightly lower trend inflation and downward drag from relative import price inflation. In this sense, the euro area situation resembles more that of the US, where low inflation is mainly a cyclical phenomenon. In contrast, the fact that Japan's trend inflation is found to be very low confirms that subdued price dynamic is more of a chronic issue there.

The implications from these findings are the following. First, as the underutilisation of production capacity dissipates, inflation in the euro area should revert to the ECB's target, namely a rate below, but close to, 2 %. Next, to achieve that, monetary policy must continue to support the economic recovery by ensuring favourable financing conditions, but without creating an overheated economy.

How does inflation in Belgium compare to the euro area?

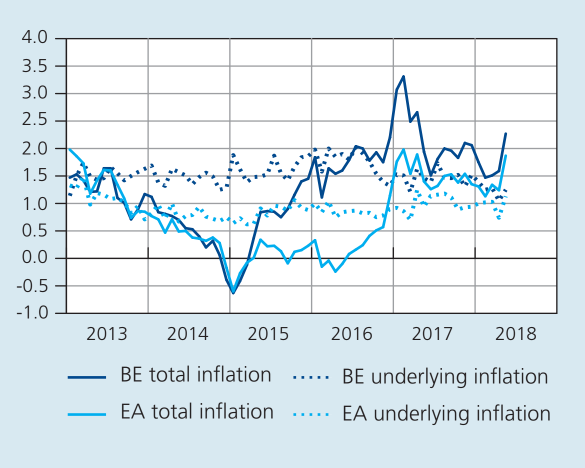
As opposed to the euro area, Belgian underlying inflation – mostly the services component – has remained quite persistent in the past years, despite strong labour cost moderations. In particular, over 2015 and 2016, underlying inflation reached 1.6 % and 1.8 % respectively in Belgium, against rates of 0.8 % and 0.9 % in the euro area. Next to the earlier observed phenomenon of incomplete pass-through of domestic costs to services prices, this is due to some specific factors[2], such as a lack of competition in the Belgian telecommunications sector that allowed operators to increase their prices more quickly, the price-setting behaviour in the 'bars and restaurants' sector, and the numerous government measures affecting services prices in Belgium. Examples of the latter factor are increasing fees for medical services as of January 2015 or the increase, in the Flemish community, of tertiary education tuition fees in October 2015. More recently, the gap has lowered somewhat, due to a tempering in Belgium and an upwards tendency in the

(1) This Special Topic is based on Cordemans, N. and Wauters (2018), "Are inflation and economic activity out of sync in the euro area?", National Bank of Belgium, Economic review, June.
(2) See also Belgian Prime News 77 (September 2017).

euro area of the underlying inflation. The gap amounted to about 0.8 percentage point on average in the period 2014-2016 ; and it fell down to 0.5 p.p. in 2017. During the first five months of 2018 it has decreased further, to 0.3 percentage point.

Total inflation, which includes the most volatile components energy and food, has also come out higher in Belgium than in the euro area since 2015. From 2017 however, the gap has decreased in line with the above-mentioned core inflation developments. It amounted to 0.6 and 1.5 p.p. in 2015 and 2016 respectively, and it declined to 0.7 p.p. in 2017 and 0.3 percentage point during the first five months of 2018. Total inflation in Belgium appears to be more volatile than in the euro area. Brent oil price movements indeed tend to have a larger impact on energy inflation in Belgium, amongst others due to the lower excise duties on heating oil, which cause crude oil price fluctuations to have a stronger impact on the final consumer price.

TOTAL AND UNDERLYING INFLATION IN BELGIUM AND THE EURO AREA



Source : EC.

FINANCIAL MARKETS AND INTEREST RATES

Lower financial market volatility, but higher sovereign risk premia in the euro area amid political tension

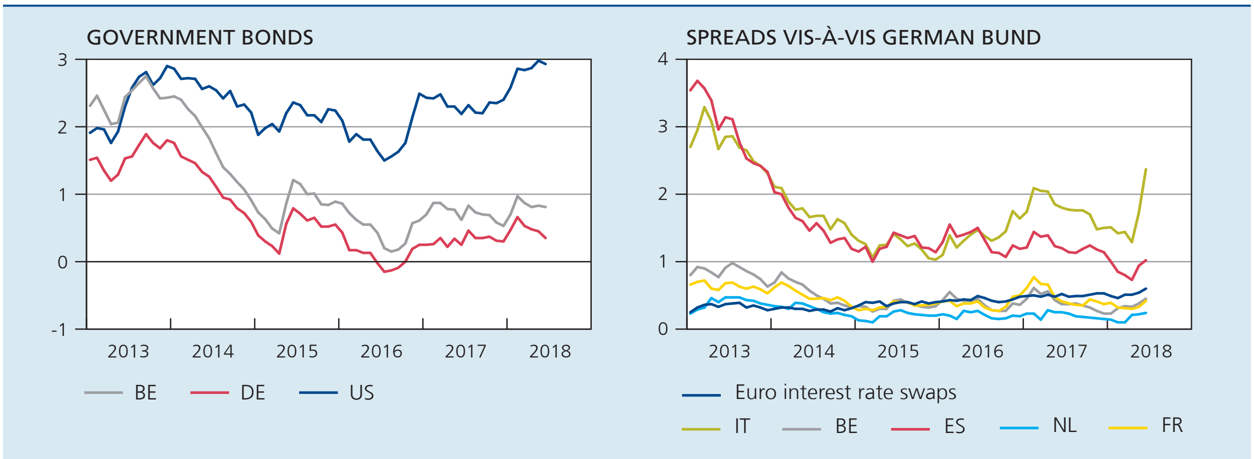
After a sudden rise in the first quarter of 2018, financial market volatility measures dropped back to lower levels during the second quarter. On the stock markets, the VIX and VSTOXX indices fell back down to mid-2017 levels. At the same time, stock prices rose throughout the second quarter in the US, while they stalled in Europe at the end of May mainly because of political tension. Redenomination risk returned, as indicated by CDS spreads on sovereign bonds. This risk was mainly priced in by financial markets for Italian debt following the results of the March 2018 elections and the subsequent negotiations on the formation of a new government in Italy. The composite indicator of systemic stress in the euro area has nevertheless remained at a low level, despite a slight increase in June. The euro tended to depreciate over the second quarter against the USD in particular, partly reflecting the different dynamics in monetary policy.

Still on the subject of monetary policy, the ECB’s Governing Council announced on 14 June its decision to reduce the monthly pace of its net asset purchases to € 15 billion until the end of December this year, and then end net purchases. Nevertheless, long-term OIS yields dropped slightly following the announcement (and shorter-term yields remained stable) given the overall dovish character of Governing Council communication on standard monetary policy measures.

Its decision also contributed to slightly lower sovereign yields. Over the second quarter of 2018, long-term sovereign bond yields tended to decline in the euro area for countries with the best ratings, while they continued to rise in the US. In Germany and Belgium for instance, ten-year yields dropped by respectively 18 and 6 basis points to reach 0.35 % and 0.81 % in June. The decline in (almost) risk-free sovereign yields in the euro area also reflected a softening in euro area economic activity (including GDP) and spillover from an intensification in trade disputes and geopolitical tension. In the US, the ten-year yield rose by 9 bp to 2.93 % in a context of further (expected) monetary policy normalisation. On 13 June, the FOMC decided to raise the target range for the federal funds rate for the seventh time since the crisis, to 1.75 % – 2 %.

Long-term sovereign yield spreads in the euro area vis-à-vis Germany have tended to widen somewhat in countries with the lowest yields. In Belgium, France and the Netherlands for instance, ten-year spreads widened over the second quarter of 2018 by respectively 11, 11 and 15 bp to 45, 42 and 24 bp. These increases mainly reflect the drop in Bund yields which possibly results from a flight-to-safety movement amid political tension in the euro area. Spread increases were significantly more pronounced in less well-rated countries and in particular those hit by political tension. The Italian ten-year spread, for instance, soared to 280 bp at the end of May (an increase of 150 bp compared to April) in the context of difficulties in forming a government after the March elections. When the government finally took office at the beginning of June, it dropped to around 220 bp by the middle of the month. Spanish sovereign spreads also widened considerably after domestic political troubles led to the dismissal of the government: the ten-year spread reached 140 bp at the end of May (while it was still about 80 bp in mid-May). It then narrowed to about 100 bp in mid-June, after a new government was formed.

10-YEAR INTEREST RATES
(percentage points, monthly averages)



Sources: BIS, Thomson Reuters.
Average over the first 22 days for June 2018.

TREASURY HIGHLIGHTS **Two-thirds of the 2018 funding plan already achieved**

The results of the two **OLO** syndications earlier this year were already published in the March issue. In addition to the launch of these new lines, two **OLO** auctions (in April and June) were held, resulting in a total of **€ 8.6 billion** of funding:

OLO AUCTIONS (€ 8.6 BILLION)

Date	OLO	NR	Issued (€ Billion)	Yield	Bid to cover
April 23	OLO 0.50 % 22/10/2024	OLO82	**0.890**	0.370 %	2.41
	OLO 0.80 % 22/06/2028	OLO85	**1.387**	0.866 %	1.78
	OLO 1.60 % 22/06/2047	OLO78	**0.775**	1.642 %	1.61
	OLO 2.25 % 22/06/2057	OLO83	**0.350**	1.824 %	1.67
Non-competitive tour			**0.977**		
Total April			**4.379**		
June 18	OLO 0.20 % 22/10/2023	OLO79	**0.580**	-0.004 %	2.33
	OLO 0.80 % 22/06/2028	OLO85	**1.520**	0.732 %	1.62
	OLO 1.00 % 22/06/2031	OLO75	**0.933**	0.996 %	1.67
	OLO 1.60 % 22/06/2047	OLO78	**0.567**	1.701 %	1.72
Non-competitive tour			**0.640**		
Total June			**4.240**		

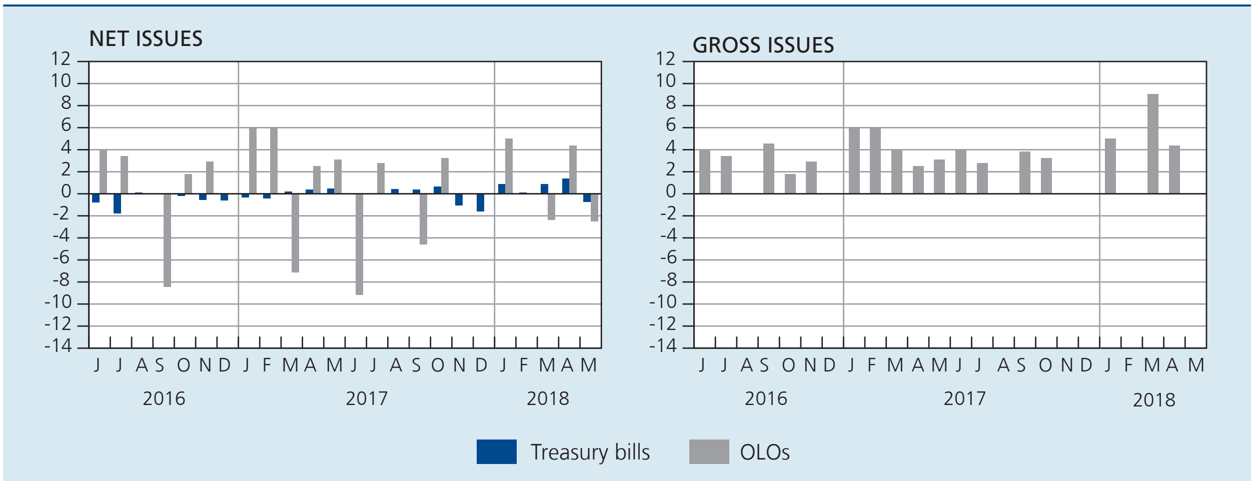
So far, there have been no EMTN or Schuldscheine issues.

Belgium has therefore already issued **€ 22.7 billion**, corresponding to 66.2 % of its **€ 34.25 billion** funding target.

In terms of portfolio structure, the average life of the portfolio is now **9.52 years** (end of May) and it has an implicit yield of **2.19 %.**

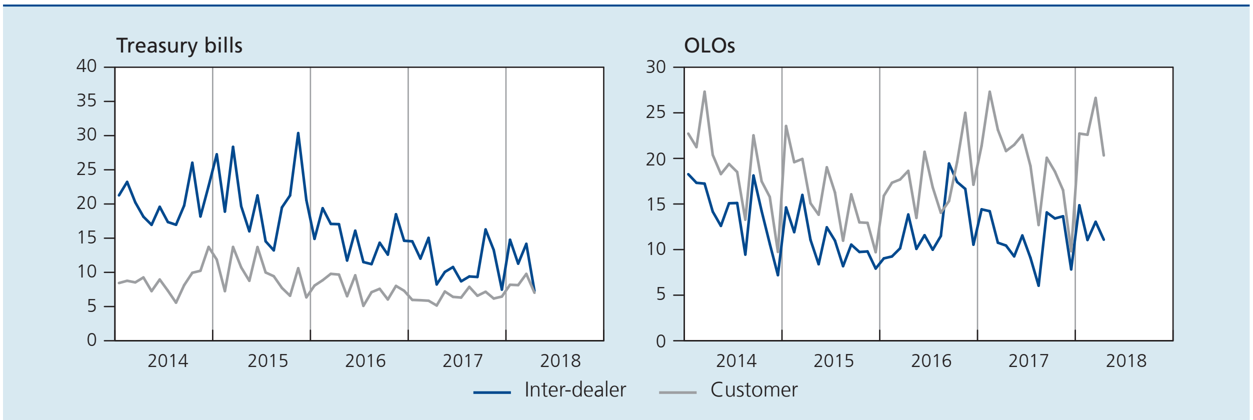
GOVERNMENT SECURITIES STATISTICS

PRIMARY MARKET
(billions of euros)



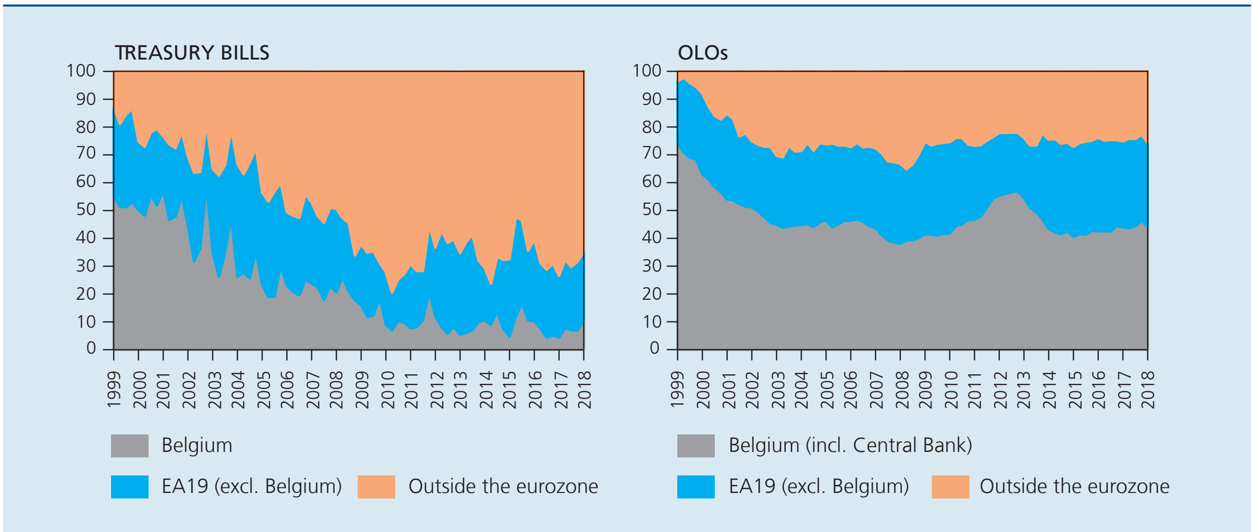
Source: Belgian Debt Agency.

SECONDARY MARKET TURNOVER
(as reported by primary and recognised dealers to the Treasury, billions of euros)



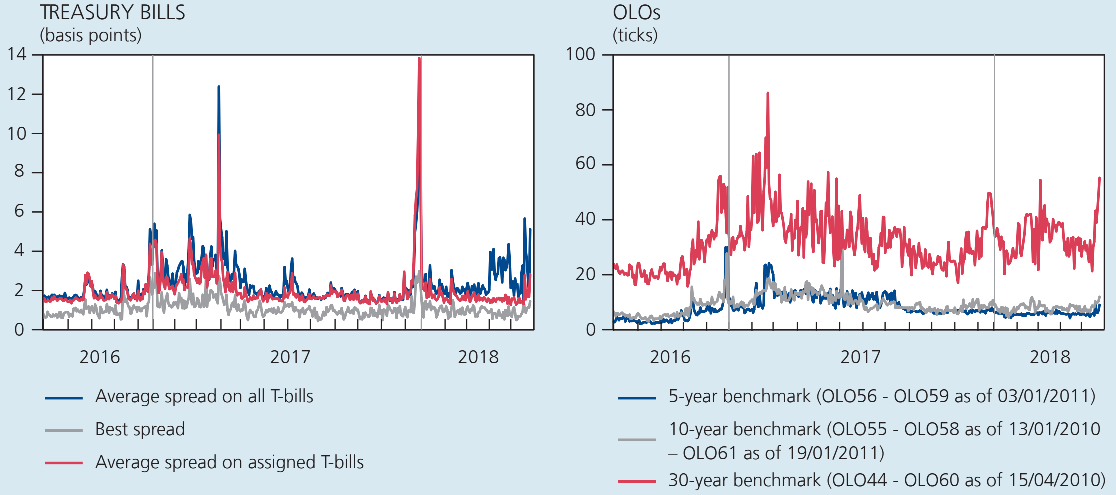
Source: Belgian Debt Agency.

HOLDERSHIP BELGIAN SECURITIES
(in %)



Source: NBB.

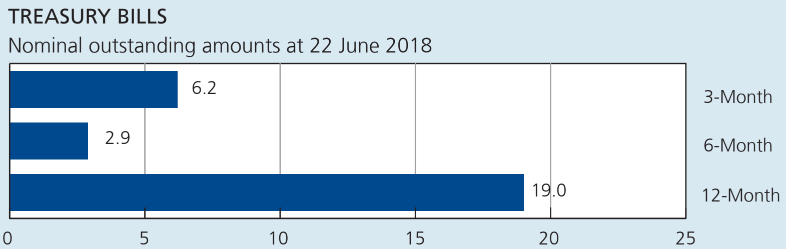
BEST BID/OFFER SPREADS [1]

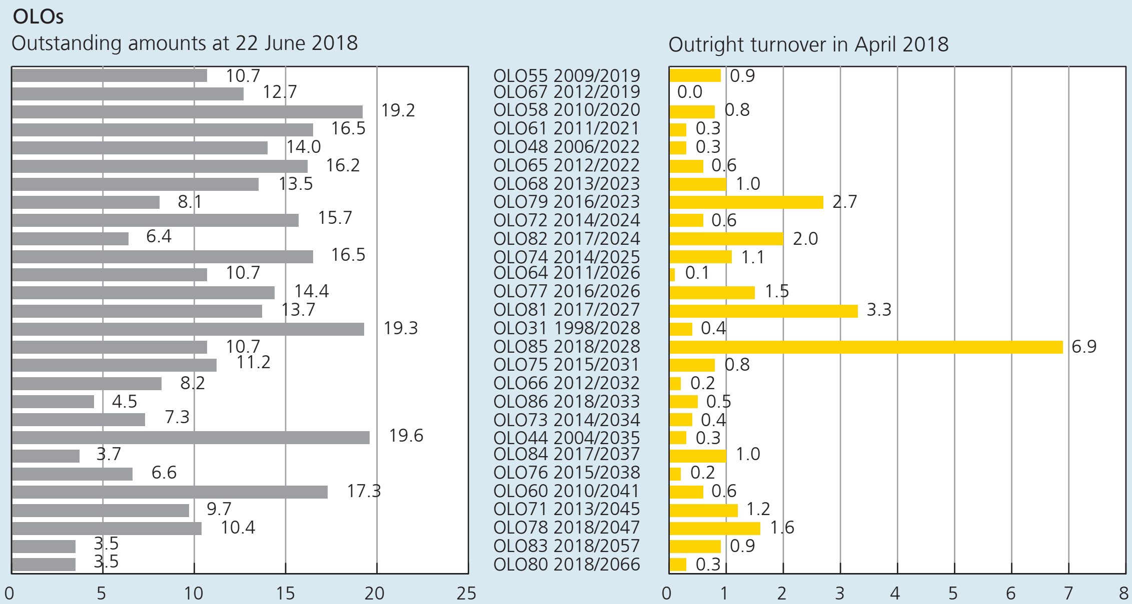


Source: Treasury.
(1) As reported by three electronic platforms (MTS, Broker Tec and BGC eSpeed).

OUTSTANDING AMOUNTS AND TURNOVER

(billions of euros)





Source: Belgian Debt Agency.

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