Economic Perspectives

February 2025

Highlights

- Donald Trump fired his first salvos in the new trade war. He imposed 10 percentage points extra tariffs on Chinese imports, causing China to retaliate. Canada and Mexico were threatened with 25% tariffs, but were offered a one month reprieve. Trump also made several tariff threats towards the EU. Most recently he imposed 25% tariffs on steel and aluminum imports. We haven't materially changed our working assumption of the US imposing a 10% blanket tariff on all imports and a 60% blanket tariff on Chinese imports, but now assume the initial phase of the trade war to be focused on China and his North-American neighbours, while assuming the EU tariffs to be implemented in a later phase. These working assumptions are likely to be adjusted as the trade war develops.

- Oil prices increased mildly last month to 76 USD per barrel. Harsh winter conditions in the US and President Biden's extra sanctions on the Russian energy sector pushed oil prices up in early January. However, this price increase was partly compensated by President Trump's declaration of a national emergency. European natural gas prices also rose to 53 EUR per MWh last month, due to weather conditions, strong Asian demand and significant declines in EU gas reserves. Gas futures indicate lower prices in the medium term, however.

- Euro area inflation rose again in December from 2.4% to 2.5%. The rise was primarily caused by an increase in food and energy inflation. Core inflation remained stable at 2.7% as core goods inflation remained unchanged, while services inflation slightly declined. Favourable wage evolutions and productivity gains are expected to reduce domestic price pressures. Furthermore, as we now assume the US-EU trade war to start later, we reduce our 2025 inflation forecast from 2.6% to 2.5%, while increasing our 2026 forecast from 2.3% to 2.5%.

- US inflation is accelerating. In January, headline inflation increased from 2.9% to 3,0%, while core inflation increased from 3.2% to 3.3%. Energy prices made another big jump, and also food, core goods, shelter and core services inflation accelerated. Wage data moved in an unfavourable direction as well. Furthermore, consumers' inflation expectations jumped to new highs. The impact of the intensification of the trade war is expected to put additional upward pressure on inflation going forward. We thus upgrade our 2025 forecast from 2.7% to 3.3%, while slightly downgrading our 2026 forecast from 3.1% to 3,0%.

- Macroeconomic divergence between the US and the euro area is also resulting in divergence in monetary policy. The Fed kept its policy stable at 4.375% in January, possibly in anticipation of tariff-induced inflation and elevated economic uncertainty. We now expect only two rate cuts this year. Interest rates are thus likely to remain in restrictive territory in the near term. In contrast, in support of a slow-growing economy, the ECB cut its policy rate in January by 25 basis points. We expect the ECB to cut rates three more times this year. The elevated (and increasing) interest rate differential and continued trade-related uncertainty is likely to keep the US dollar strong in the short term.

- The euro area economy stagnated in the fourth quarter of 2024. The disappointing figure was partly caused by a big decline in Ireland. However, France and Germany also posted negative growth figures. In contrast, Spain and Portugal grew rapidly. Sentiment indicators show a continued and painstakingly gradual recovery. However, the labour market is easing, particularly in the manufacturing sector, and the European economy is exposed to US trade shocks. We thus maintain our forecast of low 0.7% growth this year and a gradual recovery pushing 2026 growth to 1,0%.

- Strong consumer spending keeps the US economy in shape. Its economy grew by 0.6% in the fourth quarter as a strong consumption contribution compensated for negative contributions in inventories, net exports and non-residential investments. We expect this strong growth momentum to be maintained in the first half of the year, thanks to decent consumer spending and a rebound in inventory growth. In later quarters, we expect tariffs and lower migration to keep growth below potential. Some signs of weakening can be noted in consumer sentiment and the labour market. We increase our 2025 growth forecast from 1.9% to 2.3%, while maintaining our 1.8% 2026 growth forecast.

- Chinese GDP growth reached the government's 5% target last year, thanks to strong growth in the fourth quarter. Exports and manufacturing were the main growth contributors. The real estate crisis is holding consumption down, however. This is despite increased government support. The US-China trade war is likely to weigh on growth in the coming years. Given the strong Q4 GDP growth, we upgrade our growth forecast from 4.5% to 4.7% in 2025, while expecting 3.9% growth in 2026.

Global Economy

Our economic forecasts are clouded by trade uncertainty. Two weeks into his presidency, Donald Trump fired first salvos in the new trade war. On 4 February, the US hit China with a 10 percentage point tariff increase versus current levels. China retaliated in a moderate and targeted way. For now, as we expect further escalation in this trade conflict, we maintain our working assumption of an average 60% tariff on all Chinese imports. That said, if China were to make concessions on e.g. fentanyl trade or a TikTok divestment, we might have to revise scope and intensity of these working assumptions on tariffs downwards.

Donald Trump had also announced 25% tariffs on Mexican and Canadian imports (to also go into effect on 4 February). However, as both countries' leaders vowed to support the US in limiting the flow of migrants and fentanyl, both countries were offered a one month reprieve. Though we don't expect the 25% tariffs to be fully implemented next month, we still assume a meaningful increase in tariffs on the US neighbours to be put in place. Indeed, both countries are unlikely to make sufficient progress in limiting the flow of fentanyl or migration in a month time. Especially Mexico is at risk of US tariffs being raised.

The EU has so far been spared in the first phase of the trade war. That said, Donald Trump still vows to slap tariffs on the EU later because of the large US trade deficit towards the EU. We still assume tariffs to be lifted to (on average) 10% over the course of Trump's presidency.

Most recently, Donald Trump also announced 25% tariffs on all aluminum and steel imports into the US. The US imports 25% of its steel, mostly from Canada, Brazil, Mexico and the EU. It imports 70% of its aluminum needs, primarily from Canada.

Overall, we have not materially changed our working assumption of a 10% blanket tariff on all US imports and a 60% blanket tariff on US imports from China. We have changed the timing of the trade shock, however. We initially assumed the tariffs would be implemented gradually over the course of his term. We now changed that assumption and assume full implementation of the tariffs on US neighbours in the first half of 2025. We assume full roll-out of the 60% tariffs on Chinese imports in the first two years of Trump's term. The tariffs on the EU are assumed to be implemented in a later phase (gradual implementation from Q2 onwards).

Needless to say, these working assumptions are subject to elevated uncertainty. We will review them in every forecasting round and, if necessary, update them if new trade-related developments occur.

The trade war is expected to cause a stagflationary shock. Especially in the US, inflation is likely to rebound as (universal) tariffs lift import prices. This explains why the Fed has kept its policy rates unchanged in January. In contrast, tariffs may delay the euro area's recovery even further. The ECB is expected to respond by further cutting its policy rates, at the cost of a strong US dollar. China's growth is also likely to be hit by tariffs. However, the government will partly compensate the growth impact by further expanding government stimulus.

Sanctions and winter weather drive up energy prices

Oil prices slightly increased in January, reaching 76,4 USD per barrel. Aside from harsh US weather conditions, the increase was primarily driven by tighter sanctions on Russia. In early January, the Biden administration imposed sanctions on 183 Russian vessels, bringing the total number of vessels under sanctions to 451. Sanctions were also imposed on Gazprom Neft and Surgutneftegaz, two major state-owned oil and gas companies, as well as on two oil tanker insurance providers. Given the scope and strength of the sanctions, oil prices surpassed 80 USD per barrel in early January. However, in his inauguration week, Donald Trump declared an energy emergency and signed multiple energy-related executive orders, hoping to encourage energy exploration and production on US federal lands and waters. This put downward pressure on oil prices.

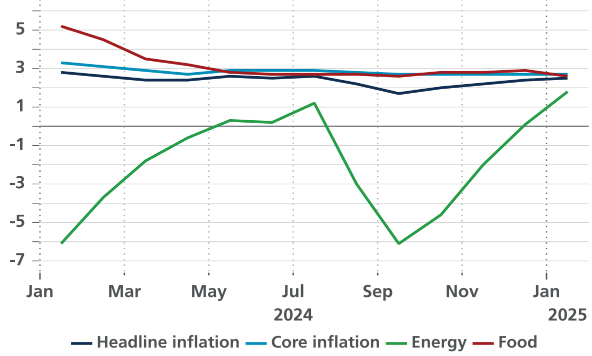
European gas prices also increased January. They reached 53 EUR per MWh, 6.7% higher than in December. The rise was a result of elevated global natural gas demand. In the US in particular, a cold polar vortex drove up demand for heating. Asian demand for natural gas also continues to rise rapidly. Approximately 45% of incremental gas demand in 2024 came from the Asia Pacific region. Meanwhile, European gas reserves are shrinking rapidly, implying large re-stocking demand going forward. They are now half empty, which is somewhat below historic averages at this time of the year. Though the natural gas market is expected to remain tight this year, futures markets expect prices to decline gradually in the coming years, halving from current levels by 2029. Indeed, President Trump's decision to reverse Biden's pause on permits for new LNG projects will boost the US supply of LNG on the market in the medium term.

Euro area inflation again slightly higher

Euro area inflation increased by 0.1 percentage points to 2.5% in January (see figure 1). The increase in the rate of energy price growth (caused by base effects and higher gas prices) from 0.1% in December to 1.8% in January was mainly responsible for this. Food price inflation fell from 2.6% to 2.3%, while core inflation (the rise in prices excluding energy and food prices) stabilised for the fifth month in a row at 2.7%.

In particular, the cooling of the services component in core inflation appears to be stalling. Nevertheless, the easing of wage growth pressures, implied by the most recent wage agreements, and accelerating cyclical productivity growth support the expectation that wage cost pressures will ease further during 2025. To what

Figure 1 - Inflation in the euro area
year-on-year percentage change of harmonised consumer price index



Source: KBC Economics based on Eurostat

extent this will lead to an effective decline in core inflation depends on the size and impact of potential retaliatory measures taken by the EU should the trade conflict with the US escalate and the strength of the US dollar. For the time being, we maintain our assumption that these will prevent a sustainable decline in (core) inflation in the coming period, although the effects are likely to appear somewhat later than initially expected.

As a result, we have slightly lowered our forecast for average inflation in the euro area for 2025 from 2.6% to 2.5%, but raised it for 2026 from 2.3% to also 2.5%. This adjustment also reflects expectations that the recent increase in the price of natural gas will keep energy price inflation in 2025 slightly higher than estimated last month.

US inflationary pressures accelerate in January

US inflation surprised to the upside in January, increasing from 2.9% to 3,0% year-on-year and 0.5% month-on-month. Core inflation also increased from 3.2% to 3.3%. Inflation pressures were elevated across all major components.

Energy prices jumped 1.1% last month, thanks to large increases in gasoline and especially fuel oil prices. Food prices also accelerated (0.4% month-on-month), especially in the food at home component. Within food prices, the bird flu impact was visible as egg prices increased by 15.2% last month.

Despite a notable decline in apparel prices, core goods inflation also accelerated (0.3% month-on-month). The increase was driven by a large increase in prescription drug prices as well as used cars and trucks prices. The latter was unexpected as forward-looking indicators were hinting at a decline here. Some moderation can thus be expected in this component in the next months.

Shelter prices also accelerated (0.5% month-on-month). This increase was caused by a big uptick in hotel prices, but also by accelerating rents of primary residence. Owner-equivalent rents remained under control. Forward-looking indicators point to a softening in this major category. Especially the drop in new tenant rent prices is encouraging (see figure 2). Services ex. shelter also accelerated (0.5% month-on-month), due to big increases in recreation and transportation services.

Wage developments were also unfavourable last month as average hourly earnings increased by 0.5%. Furthermore, productivity slowed down last quarter (particularly in durable manufacturing). This productivity slowdown drove overall unit labour costs up by 0.75% in Q4. It remains to be seen whether this is a one-off or the start of a new trend.

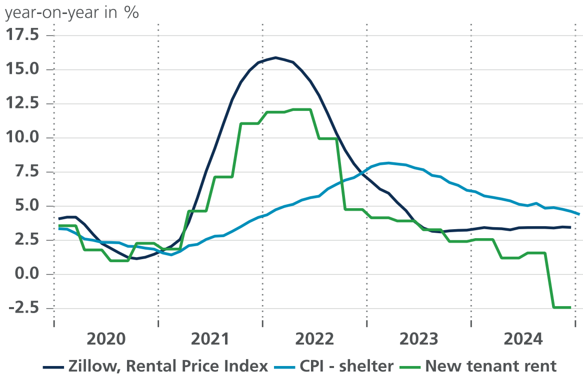
Also worrying are consumer inflation expectations which continue to rise rapidly. They now stand at 4.3% for the year ahead, 1.7 percentage points higher than in November. For the next 5 years, consumer inflation expectations are at 3.3%, a level not seen since 2008.

Tariffs will also have a major impact on US inflation (especially for goods). As the trade war is heating up more rapidly than we anticipated (especially towards USMCA countries), we expect a bigger impact this year and a slightly smaller one next year. Given all these unfavourable developments, we made a big upside adjustment to our 2025 forecast (from 2.7% to 3.3%). For 2026, we lower our forecast slightly from 3.1% to 3,0%.

Fed in wait-and-see mode, ECB continues easing cycle

At its policy meeting at the end of January, the Fed left its policy rate unchanged at 4.375%. We now expect the Fed to maintain a wait-and-see stance throughout the first half of the year. We expect two rate cuts of 25 basis points each in the second half of 2025 (while we previously expected three cuts in 2025). Our adjusted expectations are also in line with current market expectations. The Fed's more cautious stance is driven by the combination of elevated policy uncertainty, increasing upside inflation

Figure 2 - Shelter CPI vs market rents



Source: KBC Economics based on Zillow, BLS risks (and expectations) and the political discussion between the US government and the Fed on the independence of the US central bank.

Unlike the Fed, the ECB did continue its easing cycle in January. It cut its deposit rate by 25 basis points to 2.75%. It is likely to cut its policy rate by 25 basis points at the next three policy meetings as well. As a result, the deposit rate will reach its cyclical bottom of 2%. This is also in line with market expectations.

We assume that this 2% interest rate level (corresponding to a real interest rate of only 0%) is mildly accommodative. This is a precautionary policy move by the ECB to help support the European recovery in the context of large geopolitical risks. A (nominal) neutral interest rate near, or slightly higher than, 2% is also consistent with the estimates published by ECB economists on 7 February. While the overall tenor of the ECB economists was non-committal, the message was that neutral interest rates may have fallen slightly from the post-pandemic levels. In line with that analysis, we expect that the ECB will need to raise its deposit rate only marginally to 2.25% in 2026 (compared to our earlier expectation of 2.50%) to return to a roughly neutral level.

Dollar strength here to stay

The combination of a wait-and-see Fed and an ECB staying on easing course means that the short-term interest rate differential will continue to play in the dollar's favour in the coming months. We therefore expect that the euro could still weaken against the dollar to around USD 1.02 per EUR. The euro may only regain some limited ground in the second half of 2025, when the ECB deposit rate has bottomed out and the Fed resumes its easing cycle. However, that recovery of the euro will be limited, meaning that the period of general dollar strength will continue for some time.

Volatile bond yields

Bond yields in both the US and Germany have been volatile, macro-sensitive and data-dependent recently, especially regarding the likely trade conflict with the US. It is notable, however, that both bond yields have fallen on balance since the beginning of this year, reversing a (limited) part of the strong rise since autumn 2024. This is also reflected in the fall of real bond yields since the start of this year. One possible interpretation for this is that bond markets are starting to price in downside growth risks, next to upside inflation risks; due to both the effectively decided new US policy, as well as the high policy uncertainty associated with it.

Against the background of only limited adjustment to our Fed expectations for 2025 (policy rates are still likely to bottom out at 3.625% in 2026), we also keep the projections of the US 10-year rates unchanged. This is also the case for German 10-year rates, despite our slightly lower expectation for the ECB deposit rate for the end of 2026. The reason is that German 10-year rates are still trading below their 'fair value' and will still be on their upward normalisation path during 2026. The pace of that upward correction is unlikely to be slowed by the slightly more moderate deposit rate at the end of 2026.

Intra-EMU spreads remain under control

Our view on euro area government bond yield spreads remains unchanged. We are arguably at, or even over, the peak of spreads against German yields. In some countries, there is even a slight decline, such as in France where a budget for 2025 was reached. The formation of a federal government in Belgium, and the prospect of a budget that works towards consolidating public finances, are also positive developments in this context. In addition, the mere existence of the ECB's TPI continues to play a stabilising role in European bond markets.

No Q4 growth in euro area

According to Eurostat's preliminary flash estimate, the euro area economy didn't grow in the fourth quarter of 2024. This disappointing result – we had expected a slight 0.1% growth in real GDP compared to the previous quarter – was mainly due to the weak German and French economies. These experienced a contraction of 0.2% and 0.1%, respectively. With zero growth, Italy also fell short of expectations. Once again, Spain was the star performer, with real GDP 0.8% higher in the fourth quarter than in the previous three-month period.

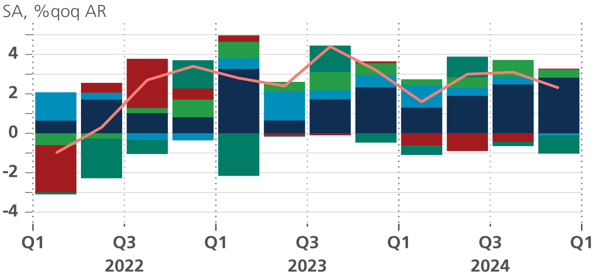
According to the breakdown of growth by spending components, household consumption and, to a lesser extent, government consumption made a positive contribution to growth in both France and Spain. No figures are yet available for Germany in this regard, but comments from Destatis, the German statistics agency, suggest that German consumption also made a positive

Figure 3 - Consumption dynamics in the euro area

Source: KBC Economics based on Eurostat, DG ECFIN

Figure 4 - US real GDP growth contributions

SA, %qoq AR



Source: KBC Economics based on BEA

growth contribution. In Spain, growth received an additional boost from business investment. In France, on the other hand, there was a negative impact reversing the Q3 growth impulse of the Olympics. Both in France, Spain and Germany, but not in Italy, net exports have made a negative growth contribution.

Looking ahead, private consumption should become the driver of the long-awaited economic recovery. And, at the level of the euro area, it seems that this accelerated consumption growth, which manifested itself clearly in Q3, consolidated in the fourth quarter. It is difficult to gauge how durable this consumption momentum is for now. Retail sales declined during the fourth quarter. And while consumer confidence surveys show that at the start of 2025 consumers had become slightly more optimistic about the general economic and financial situation in the year ahead, they also indicated that consumers still plan to scale back major purchases (see figure 3). This suggests that the consumption recovery may be rather moderate. Elevated uncertainty and some loosening labour market conditions – although still tight - may contribute to households preferring to build up and/or maintain their high savings buffers.

The still weak business confidence in January also suggests that a strong economic recovery is not yet immediately at hand. Although there was some improvement on that front. The Composite Purchasing Managers' Confidence Index (PMI) improved in January for the second consecutive month. It is now just above the 50 threshold, including in Germany, where – thanks to the services sector – it is even slightly higher than in France and Italy. Spain also remains the outperformer on this measure. All this suggests that while the euro area economy is not recovering strongly, it is not slipping into a recession either. In this respect, it is somewhat encouraging that confidence also improved slightly in the manufacturing sector in January, albeit from a very low level.

However, many indicators on German industry, such as the evolution of production and orders, and expectations for the next six months, remain very weak. Both the uncertain domestic political situation and the prospect of a trade war are undoubtedly contributing factors. For now, only on the domestic political front is there any hope of improvement after the parliamentary elections at the end of February. Although it remains to be seen whether the election results will provide a strong mandate to tackle Germany's numerous structural economic challenges in the near term.

We therefore maintain our expectation that the euro area economy will continue to drag on at a mediocre growth rate of less than 1% for a long time. We only expect an – overall limited – pick-up in growth towards the end of the year and in the course of 2026. This will translate into euro area real GDP growth of 0.7% in 2025, the same as in 2024, and 1.0% in 2026.

Consumers power the US economy

The US economy grew by a healthy 0.6% quarter-on-quarter in Q4 (see figure 4). Consumer spending made by far the biggest contribution to US growth (0.7 percentage points quarter-on-quarter). Durable goods spending made a big jump, in particular on motor vehicles. This might be partially front-loaded spending, in anticipation of an end to electric vehicle tax credits and higher tariffs (which will hit the car industry disproportionately). Other positive GDP contributions came from government spending and residential investments. Net exports made a negligible contribution, while there were big negative contributions coming from inventories and fixed investments. Within fixed investment, the large drop in equipment spending (a leading indicator of overall investments) is a cause for concern.

Though lower January auto sales and declining consumer sentiment suggest consumer spending will slow down somewhat, we still expect it to be the main driver of economic growth in 2025. Indeed, continued growth in real disposable income will continue to fuel consumption growth in the first half of the year. Furthermore, we expect inventories to bounce back following two quarters of negative growth, thus making important positive contributions in H1 2025.

The labour market remains in decent shape (though it is cooling gradually). Notwithstanding forest fires in Los Angeles and exceptionally cold winter weather, non-farm payrolls increased by a decent 143k in January. There were also upward revisions for the prior two months of 100k jobs. The unemployment rate declined from 4.1% to 4,0% in January. There were some warning signs in labour market data, however. Productivity growth slowed down notably in Q4 (from 0.6% to 0.3% quarter-on-quarter). Especially in manufacturing, productivity growth has been slow lately. Productivity data can be volatile, so it remains to be seen how durable this decline is. Furthermore, average weekly hours worked declined for the second month in a row (to 34.1), though this could be partly weather-related. The decline in December job openings also points to some softening in the labour market. That said, we expect this softening to be gradual and contained.

For later quarters (from Q3 2025 onwards), we continue to expect the trade war and migration shock to pull down growth below potential. Furthermore, we lowered our assumption on growth-supportive deficit spending. Indeed, given Trump's narrow majority in the House of Representatives, we expect fiscal conservatives to limit Trump's tax plans. We now assume Trump's 2018 tax cuts to be extended, but expect other tax cuts (such as lower corporate taxes) to be compensated by spending cuts. Given the continued growth momentum in H1 2025, we increase our 2025 growth forecast from 1.9% to 2.3%, while maintaining our 1.8% 2026 growth forecast.

Strong Q4 in China but a full-scale trade war looms

The Chinese economy ended the year stronger than expected with real GDP growth of 5.4% (year-on-year) in Q4. This figure brings the annual growth rate for 2024 to exactly 5%, which is the Chinese government's growth target. As in previous quarters, the main growth contribution in the fourth quarter came from manufacturing and exports. In contrast, consumption remained remarkably weak and this despite government support measures to boost consumption. Consumer restraint is mainly related to the ailing real estate sector, which contains a very large portion of Chinese citizens' wealth. There are first signs that the real estate crisis is bottoming out but uncertainty remains high and thus consumer confidence remains under pressure. As a result of the strong fourth quarter, we mechanically raise our growth forecast for 2025 to 4.7% and for 2026 we expect growth of 3.9%.

The Chinese authorities did not yet publish an official growth target for 2025, but sources within the government indicate that the Chinese government has decided to maintain the 5% growth target. This is an ambitious target in the context of weak domestic demand and increasing trade protectionism. The official announcement will happen during the Two Sessions, the annual plenary meetings of the country's two main political bodies, which takes place in early March. If the economic environment changes significantly in the coming weeks, the growth target might still be adjusted.

An important factor for growth in 2025 will undoubtedly be US trade policy. US President Trump imposed additional trade tariffs of 10% on all imports from China in the first weeks of his presidency. In retaliation, the Chinese government announced import tariffs of 15% on certain types of coal and liquefied natural gas and 10% on crude oil, agricultural machinery, some large-engine cars and pickup trucks. The country also filed a complaint with the World Trade Organization and imposed export restrictions on some metals and related products, including tungsten and indium, which are essential for the production of green technologies and for the defence industry, among others. China also announced an antitrust investigation into Google and Illumina, and it blacklisted the holding company of US clothing brands Calvin Klein and Tommy

Hilfiger. China's reaction is considered as relatively muted, probably because the Chinese government wants to avoid adding fuel to Trump's fire. After all, for now, the import tariffs imposed by Trump are still relatively low compared to the 60% he threatened with during the election campaign.

The current tariffs are unlikely to be final. In the short term, tariffs could be weakened or temporarily paused. Trump has indicated that he is willing to negotiate on tariffs, as he did with Canada and Mexico. In exchange for concessions from China, for example on the export of products for the production of fentanyl, a temporary relaxation in trade tensions could be possible. For now, however, no talks have been scheduled. Trump did pause the ending of the tariff exemption for cheap shipments from China but this was due to logistical problems, namely the rapid accumulation of millions of packages arriving in the US every day.

In the medium term, import tariffs could further increase. Upon taking office, Trump ordered an investigation into the US trade relationships. The conclusion of this investigation is expected on April 1, 2025, an important date thus for the further course of the trade war.

If trade tariffs increase further, this will put upward pressure on inflation in China. This is probably not the biggest concern for the Chinese government at the moment as consumer price inflation has been floating around zero for almost two years now. There was a tentative rise in consumer price inflation to 0.5% year-on-year in January, but this increase is likely due to the early timing of the Chinese New Year. For the second month in a row, the producer price index fell by 2.3% year-on-year in January. Because of continued weakness in the Chinese economy, we are keeping our inflation outlook at 0.7% for 2025 and 1.7% for 2026 for now.

Belgium

The flash estimate of Belgian growth in the final quarter of 2024 came out at 0.2% qoq. The figure was in line with what we had expected and signalled a slight deceleration from the stable 0.3% growth recorded in the previous four quarters. Q4 growth was above the euro area figure (0%) and driven by activity in both services (0.2%) and construction (0.7%). Industry continued to record negative growth (-0.1%). For the full year 2024, Belgian real GDP growth slowed to 1.0%, from 1.3% in 2023. The Q4 component breakdown has not yet been published, but details for the first three quarters already indicate that 2024 growth was underpinned by final domestic demand, while net exports and especially inventory change were a drag. Despite the slowdown in annual growth, Belgium continued to outperform the euro area, where annual growth in 2024 was at 0.7%. Having realised three years of stronger growth in a row compared to the euro area, Belgium's performance has been quite good in relative terms. Looked at from a longer perspective, economic activity in Belgium in Q4 2024 was 7.1% higher than its pre-pandemic level (Q4 2019), as against only 5.2% higher in the euro area.

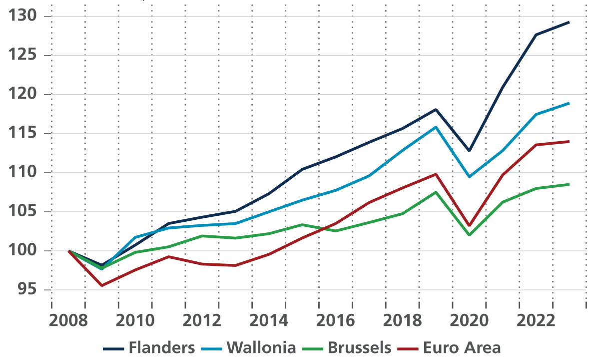
Regional growth figures in Belgium lag behind the publication of the national GDP figures, meaning that it is unclear for now to what extent activity grew differently in the regions in 2024. Flanders having a relatively bigger manufacturing sector and a more open economy than Wallonia and Brussels, the region likely was affected more by the downturn in industry and the weak external environment. The latter does not necessarily mean that 2024 growth for the economy as a whole was lower in Flanders than in Wallonia and Brussels. In 2023, for which regional data have recently been published, growth in Flanders was already significantly affected by a sluggish industry, mainly due to a slump in the chemicals sector. Still, Flanders recorded growth of 1.3% that year, compared to 1.2% and 0.5% in Wallonia and Brussels, respectively. Growth slowed noticeably in 2023 in all three regions, mainly as a result of post-pandemic normalisation. Flanders' growth in 2021 (+7.2%) and 2022 (+5.5%) had reached record highs, driven partly by the production of vaccines in the pharmaceutical industry (see figure BE1).

Trade uncertainty

For now, Europe has been spared by US tariffs but president Trump signalled that the EU is also set to be targeted. If effectively implemented, US tariffs could weigh on Belgian economic growth, given Belgium's strong dependence on foreign trade. The potential hit to businesses would be another negative shock to the manufacturing sector, at a time when its activity is already subdued. For 2024 as a whole, value added in Belgian industry fell by 1.0% according to the preliminary estimate. Given high trade uncertainty, we decided to stick to our more cautious stance on Belgian growth and to not make major changes to the forecast at present. The scenario still assumes that ultimately tariffs on the EU will be applied.

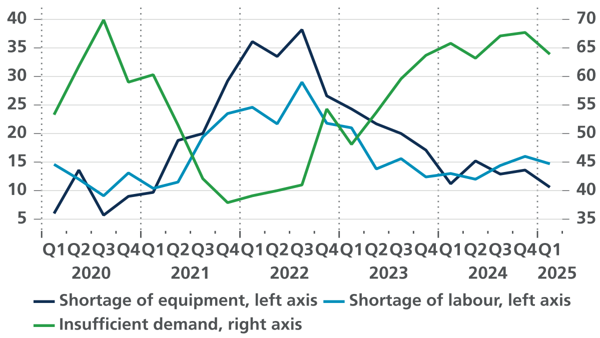
We nevertheless upgraded the 2025 growth outlook slightly from 0.6% to 0.7%. First, as Europe was not included in the first round of US tariffs, there is no immediate impact, in contrast to what we had expected. Second, amid all tariff-buzz seen over the recent weeks, there were also some small bright spots to highlight for the Belgian economy. The NBB business survey showed a slight improvement of producer confidence and capacity utilisation in industry in January. Also, in the Q1 EC confidence indicator, insufficient demand is seen somewhat less as a factor limiting industrial production in Belgium (see figure BE2). Last but not least, a coalition deal was reached on 31 January to form a new federal government, after more than seven months of negotiations. This reduced the prevailing uncertainty on the political situation and avoided Belgium falling in a protracted political crisis.

Figure BE1 - Economic activity in the regions 2008-2023
index 2008 = 100, value added in volume terms



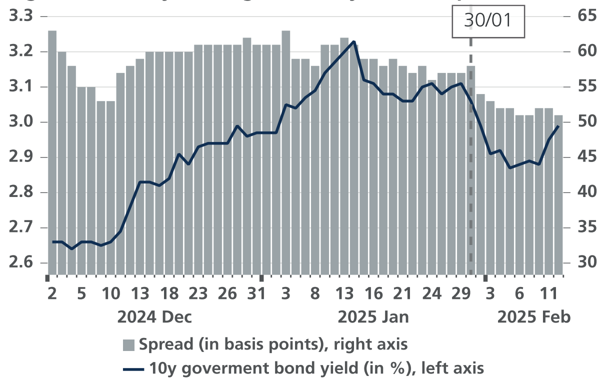
Source: KBC Economics based on NBB (Institute National Accounts)

Figure BE2 - Factors limiting industrial production
Industrial Confidence Indicator, SA



Source: KBC Economics based on DG ECFIN

Figure BE3 - 10 year Belgian bond yield and spread



Source: KBC Economics based on Macrobond

The latter will likely be recognised by the European Commission, rating agencies and financial markets. Between 30 January, the day before the coalition deal was reached, and 12 February, when we finalised this publication, the Belgian-Germany 10y bond spread fell by 7 basis points (see figure BE3). The impact of the many ambitious (but some still vague) reforms on the budget balance and possibly on long-term economic growth should be positive, but its extent remains highly uncertain. A particular weak spot in the budget exercise are the expected payback-effects and receipts from fight against fraud. These are budgeted for a total of 9 bn EUR but may well end up being smaller than expected. There is also a risk of a gap between the intentions of the agreement and the actual reforms carried out. The difficulty of reaching the agreement illustrates that the views of the five governing parties remain very different, possibly resulting in political conflict. Despite the risk of not fully delivering on the planned budget consolidation, the main good news is that Belgium finally has an government in full power, capable of taking long-due structural decisions.

Drop in core inflation

Belgian HICP inflation for January came in at 4.4%, unchanged from the December figure. Core inflation fell sharply, though, from 2.6% in December to 1.4% in January. Surprisingly, the month-on-month decline in core goods prices, traditionally caused by the January winter sales, was relatively big this time (-7.1%, as against only -3.3% in January 2024 and -5.0% on average in the month of January in 2000-2024). In contrast, the year-on-year inflation for the other HICP categories (energy, food, services) was up in January, fully compensating the sharp drop in core goods inflation. These categories are still important drivers of Belgian inflation, with energy and food inflation currently much higher than in the euro area as a whole. In our scenario, we continue to expect Belgian inflation to average 2.8% this year and marginally changed the inflation outlook for 2026 from 2.2% to 2.1%.

Central and Eastern Europe

Fiscal consolidation in CEE: diverging trends

The COVID-19 pandemic and subsequent economic shocks have significantly impacted public finances across Central and Eastern Europe (CEE). Countries in the region implemented extensive fiscal support measures to combat the pandemic's effects and address the energy crisis, resulting in substantial increases in budget deficits and government debt levels. As these extraordinary circumstances have mostly subsided, regional economies are now facing the challenge of fiscal consolidation.

Czechia: the regional champion

The Czech Republic stands out as a fiscal consolidation superstar in the region. The government budget deficit has narrowed from 5.6% of GDP in 2020 to 2.8% of GDP in 2024 (see figure CEE1), moderately below the Maastricht limit of 3%. This consolidation effort has been supported by the expiration of energy-related measures and the government fiscal package. These elements should consolidate the budget towards a deficit of 2% of GDP in 2025 and 2026, through a mix of revenue-side measures (two-third share) and spending cuts (one-third share).

This has not only helped to bring the budget deficit back below the Maastricht limit, but also stabilised government debt at around 43% of GDP (see figure CEE2). As such, Czechia's government debt remains one of the lowest in the EU, although the COVID-related surge from 29% of GDP to the current levels was significant. Looking forward, we maintain our view of a gradually improving budget balance and stabilising government debt around 45% of GDP, backed by higher GDP growth and a relative prudent fiscal policy. According to the recent analysis by the Czech Fiscal Council, the breach of the national debt brake of 55% of GDP has been postponed from 2028 to 2038, signaling a moderately improving fiscal outlook.

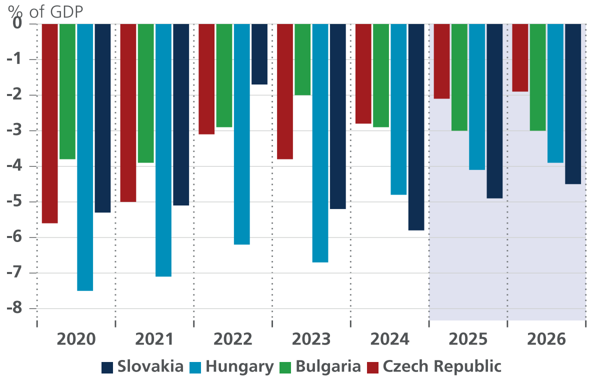
We nonetheless see risks to our fiscal outlook, as Czechia heads to autumn parliamentary elections. The risks are twofold. First, we see a risk of a possible fiscal slippage in the 2025 election year due to higher expenditures. This would increase the budget deficit above the current expectations of 2.1% of GDP. Second, we see a risk of post-election deterioration under a possibly new higher-debt tolerant government, led by a populist ANO-led coalition.

Slovakia: heading the other way

Slovakia has been a regional laggard in terms of fiscal consolidation. The country's deficit has remained elevated for some time, having deteriorated last year to 5.8% of GDP from 5.2% of GDP a year earlier. Also, government debt has shown an upward trend, rising from 48% of GDP in 2019 to 58.2% of GDP in 2024, moving closer to the Maastricht limit of 60%.

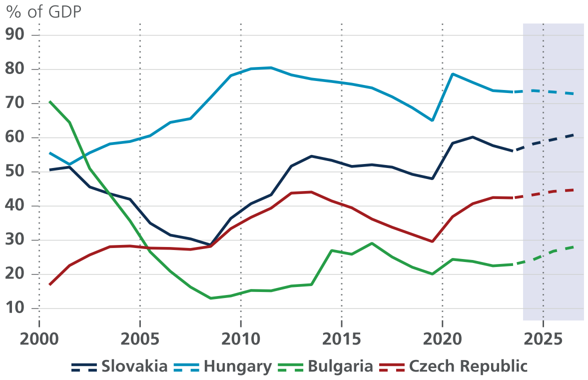
The Fico's government has embarked on a consolidation path, implementing several measures in January 2025, yet with uncertain impact on public finances. Key changes include raising the VAT rate to 23% and introducing a 24% income tax rate for companies with turnover above EUR 5 million. On the expenditure side, the Slovak

Figure CEE1 - Government budget balance



Source: KBC Economics

Figure CEE2 - General government debt



Source: KBC Economics based on

government is targeting some savings in areas such as social expenditures and the wage bill. However, the heavy reliance on tax increases comes at the expense of addressing public spending inefficiencies. At the same time, higher taxes could potentially hamper economic growth and consumer spending this year.

As a result, we expect only moderate consolidation of Slovak public finances going ahead. Our baseline scenario assumes a deficit above 4.5% of GDP in both 2025 and 2026. While the Slovak government debt is set to remain well below the euro average, it is projected to rise above the Maastricht limit of 60% of GDP in 2026. Against the backdrop of political turbulence, the public debt trajectory requires attention to ensure long-term sustainability.

Hungary: bumpy path ahead

Hungary's budget balance improved in 2024, with the deficit narrowing from 6.7% of GDP to a still sizable 4.8% of GDP. Public finances continue to feel pressure from the extension of some of the government support measures introduced in 2022, as well as an increase in pensions and the rise in debt interest payments. Last year, the Orban government introduced a fiscal consolidation package as part of its broader economic action plan. The outcome is uncertain.

The plan aims to balance fiscal consolidation with social support and growth targets. On the one hand, consolidation efforts include revenue measures including an adjustment to bank taxation and a prolongation of windfall taxes on the energy and retail sectors. On the other hand, the overall plan focuses on boosting social support and economic growth by doubling the child tax allowance, implementing a three-year minimum wage agreement, and introducing subsidised lending programs for housing and SMEs.

As a result, we forecast a moderate reduction of the budget deficit to 4.1% of GDP this year and a further moderation to 3.9% in 2026, relying largely on the assumption of higher GDP growth. The risks are, however, skewed to a more limited consolidation path, if any. This is mainly due to the parliamentary elections in the spring of 2026, historically implying additional expenditures. After all, Prime Minister Orban has already suggested a loose fiscal stance. Should the growth outlook deteriorate, for example due to higher US tariffs, the fiscal easing might be even more pronounced.

Bulgaria: stable but unconvincing

Bulgaria's public finances came under strain last year, with the budget deficit widening from 2.0% of GDP to 2.9% of GDP. Higher public spending from 2022's pension and salary increases continued to affect the budget in 2024. As a result, the developments on the expenditure side outweighed revenue growth from social contributions and direct taxes driven by the strong labour market.

The 2025 outlook expects a stable deficit at 3.0% of GDP, aligning with the Maastricht reference value. The efforts to improve revenue collection and contain expenditure pressures have begun, but key challenges remain. In addition, politically, Bulgaria has been experiencing significant turbulence, which complicates the implementation of fiscal policies and necessary structural reforms. The country has held seven parliamentary elections since 2021, reflecting deep political instability and fragmentation.

Bulgaria maintains the lowest public debt ratio in the CEE region, providing it with more fiscal space compared to its regional peers. The debt ratio has nonetheless gradually increased in the post-pandemic period from 20.1% of GDP to 24.3% of GDP. We forecast government debt to reach a still modest 28% of GDP in 2026.

Several challenges and risks ahead

All in all, fiscal consolidation in the CEE region has seen diverging paths, highlighting several challenges and risks. The potential slowdown in economic growth – amid risks from higher US tariffs and/or prolonged weakness in Germany – could make deficit reduction more difficult. At the same time, fiscal risks related to parliamentary elections (Czechia and Hungary) and political instability (Bulgaria) are pronounced and tilted towards less fiscal consolidation.

In addition, the short- to medium-term risks are coupled with long-term fiscal challenges. These are very similar across the regional economies, including aging populations and associated pension and healthcare costs. In the long term, the success of fiscal consolidation efforts will largely depend on governments' ability to implement structural reforms while maintaining social cohesion and political stability. Last but not least, the efficient absorption of EU structural funds will play a crucial role in meeting investments needs to boost potential growth.

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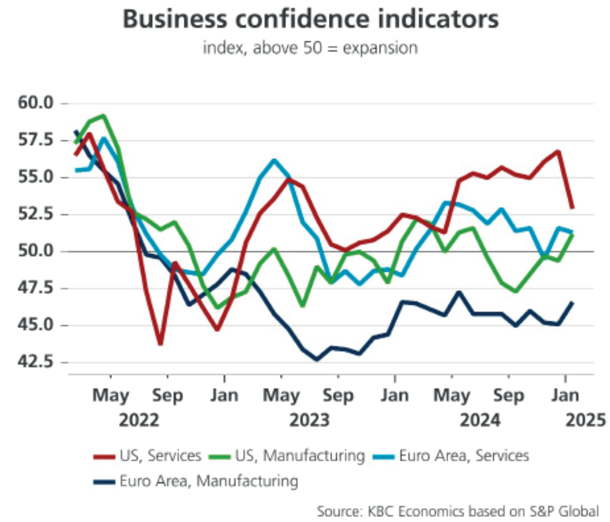
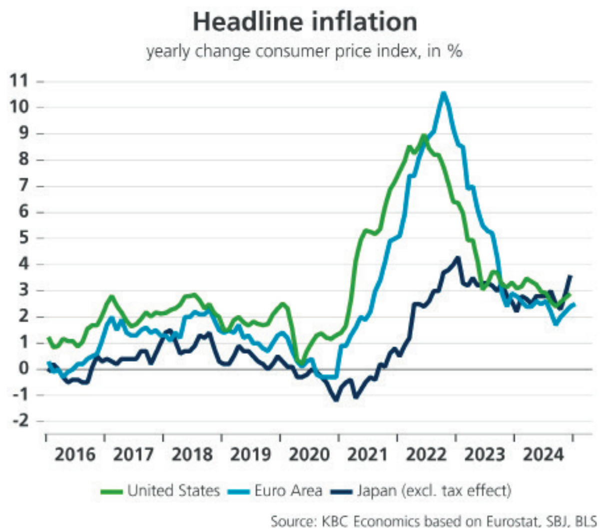
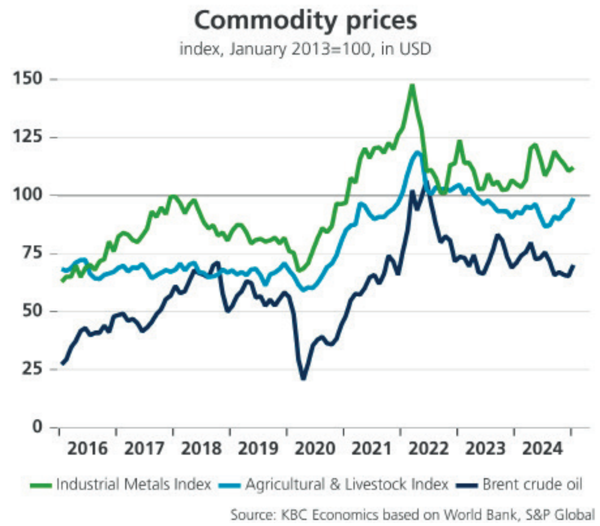
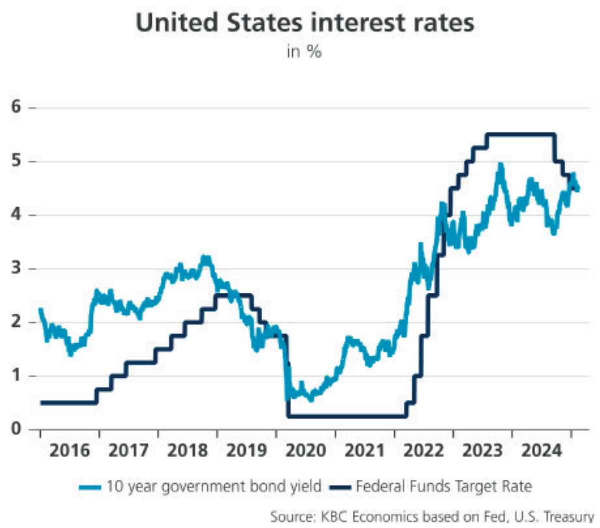
Figures

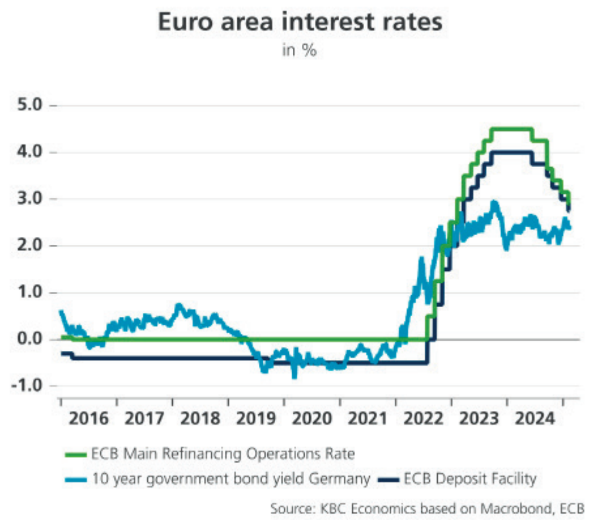

Real GDP
yearly change in %
Euro Area, lhs
United States, lhs
China, rhs
Source: KBC Economics based on Eurostat, BEA, NBS


Business confidence indicators
index, above 50 = expansion
US, Services
US, Manufacturing
Euro Area, Services
Euro Area, Manufacturing
Source: KBC Economics based on S&P Global


Headline inflation
yearly change consumer price index, in %
United States
Euro Area
Japan (excl. tax effect)
Source: KBC Economics based on Eurostat, SBJ, BLS

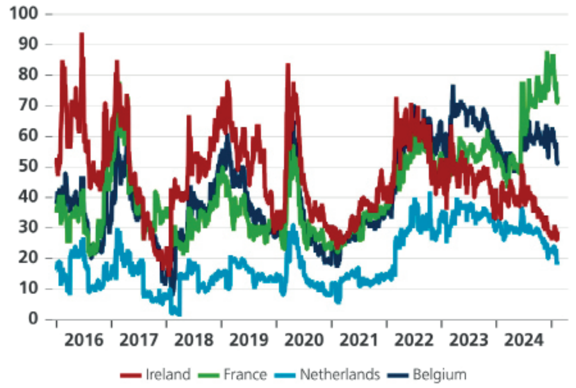

Commodity prices
index, January 2013=100, in USD
Industrial Metals Index
Agricultural & Livestock Index
Brent crude oil
Source: KBC Economics based on World Bank, S&P Global


United States interest rates
in %
10 year government bond yield
Federal Funds Target Rate
Source: KBC Economics based on Fed, U.S. Treasury


Euro area interest rates
in %
ECB Main Refinancing Operations Rate
10 year government bond yield Germany
ECB Deposit Facility
Source: KBC Economics based on Macrobond, ECB

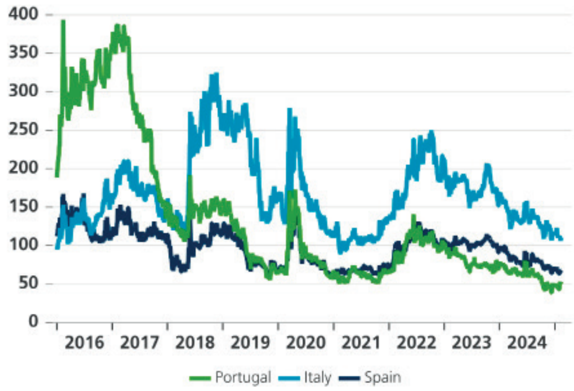
Figures

10 year government bond yield spreads to Germany
in basis points



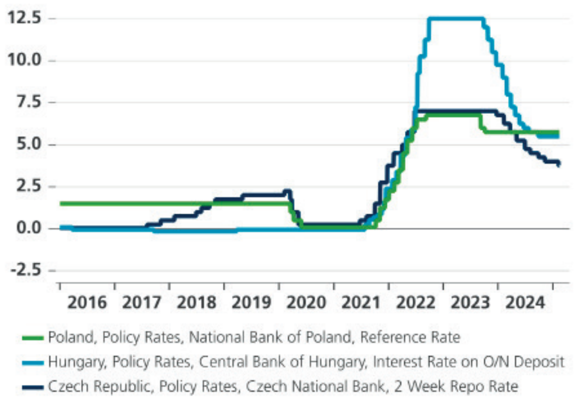
Source: KBC Economics based on Macrobond

10 year government bond yield spreads to Germany
in basis points



Source: KBC Economics based on Macrobond

Monetary policy rates Central Europe
in %

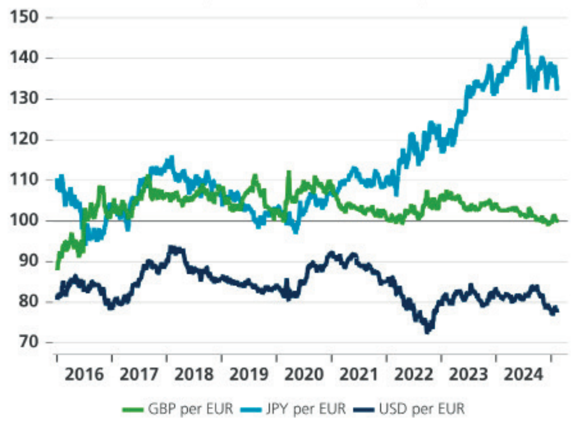


Source: KBC Economics based on CNB, MNB, NBP

10 year government bond yield spreads to Germany
in basis points

Source: KBC Economics based on Macrobond, AKK, Eurostat

Exchange rates
index, January 2013=100, increase = stronger EUR



Source: KBC Economics based on Macrobond

Exchange rates
index, January 2013=100, increase = stronger EUR

Source: KBC Economics based on Macrobond

Outlook main economies in the world

		Real GDP growth (period average, based on quarterly figures, in %) 2024	2025	2026	Inflation (period average, in %) 2024	2025	2026
Euro area	Euro area	0.7	0.7	1.0	2.4	2.5	2.5
	Germany	-0.2	0.1	0.9	2.5	2.8	2.7
	France	1.1	0.5	1.0	2.3	2.0	2.3
	Italy	0.5	0.3	0.5	1.2	1.9	2.1
	Spain	3.2	2.2	1.8	2.9	2.5	2.3
	Netherlands	0.9	1.4	1.0	3.2	3.6	3.4
	Belgium	1.0	0.7	0.9	4.3	2.8	2.1
	Ireland	0.3	4.2	4.5	1.4	1.7	2.0
	Slovakia	2.1	1.9	2.5	3.2	4.1	3.0
Central and Eastern Europe	Czech Republic	1.0	2.1	2.3	2.7	2.4	2.4
	Hungary	0.6	2.3	3.9	3.7	4.1	3.6
	Bulgaria	2.2	2.1	2.4	2.6	2.9	3.0
	Poland	2.9	3.1	3.2	3.6	4.1	2.7
	Romania	1.0	2.3	2.9	5.8	4.4	3.5
Rest of Europe	United Kingdom	0.8	1.2	1.4	2.3	2.6	2.3
	Sweden	0.6	1.8	2.4	2.0	1.0	1.7
	Norway (mainland)	0.9	1.5	1.7	2.9	2.5	2.1
	Switzerland	1.3	1.3	1.6	0.9	0.6	0.8
Emerging markets	China	5.0	4.7	3.9	0.2	0.7	1.7
	India*	6.4	6.5	6.5	4.8	4.3	4.6
	South Africa	0.5	1.6	1.7	4.4	4.1	4.5
	Russia	Temporarily no forecast due to extreme uncertainty					
	Turkey	2.9	2.5	3.5	58.5	31.5	19.7
	Brazil	3.5	2.2	2.3	4.4	5.1	4.4
Other advanced economies	United States	2.8	2.3	1.8	3.0	3.3	3.0
	Japan	-0.1	1.2	0.9	2.7	2.3	1.8
	Australia	1.0	2.0	2.4	3.2	2.8	2.5
	New Zealand	-0.4	1.2	2.6	2.9	2.1	2.0
	Canada	1.3	1.7	1.7	2.3	2.0	2.1
*** fiscal year from April-March**						7/2/2025	

Policy rates (end of period, in %)		7/2/2025	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Euro area	Euro area (refi rate)	2.90	2.65	2.15	2.15	2.15
	Euro area (depo rate)	2.75	2.50	2.00	2.00	2.00
Central and Eastern Europe	Czech Republic	3.75	3.75	3.50	3.50	3.50
	Hungary	6.50	6.50	6.25	6.00	5.75
	Bulgaria	-				
	Poland	5.75	5.75	5.75	5.50	4.75
	Romania	6.50	6.50	6.25	6.00	5.75
Rest of Europe	United Kingdom	4.50	4.50	4.25	4.00	4.00
	Sweden	2.25	2.25	2.25	2.25	2.25
	Norway	4.50	4.25	4.00	3.75	3.75
	Switzerland	0.50	0.25	0.25	0.25	0.25
Emerging markets	China (7-day r. repo)	1.50	1.50	1.40	1.30	1.20
	India	6.25	6.25	6.00	6.00	5.75
	South Africa	7.50	7.50	7.50	7.25	7.25
	Russia	Temporarily no forecast due to extreme uncertainty				
	Turkey	45.00	42.50	37.50	32.50	29.75
	Brazil	13.25	14.25	15.00	15.50	15.50
Other advanced economies	United States (mid-target range)	4.375	4.375	4.375	4.125	3.875
	Japan	0.50	0.50	0.50	0.75	0.75
	Australia	4.35	4.10	3.85	3.85	3.85
	New Zealand	4.25	3.75	3.25	3.25	3.25
	Canada	3.00	3.00	3.00	2.75	2.75

Outlook main economies in the world

10 year government bond yields (end of period, in %)		7/2/2025	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Euro area	Germany	2.36	2.45	2.45	2.45	2.50
	France	3.07	3.20	3.20	3.19	3.23
	Italy	3.43	3.55	3.55	3.53	3.56
	Spain	3.02	3.15	3.15	3.14	3.18
	Netherlands	2.55	2.65	2.65	2.65	2.70
	Belgium	2.94	3.05	3.05	3.04	3.08
	Ireland	2.63	2.75	2.75	2.75	2.80
	Slovakia	3.05	3.25	3.25	3.25	3.30
Central and Eastern Europe	Czech Republic	3.87	4.20	4.20	4.20	4.20
	Hungary	6.60	6.70	6.50	6.30	6.10
	Bulgaria*	3.85	3.85	3.85	3.80	3.80
	Poland	5.79	5.80	5.70	5.10	4.80
	Romania	7.59	7.70	7.70	7.70	7.75
Rest of Europe	United Kingdom	4.47	4.50	4.50	4.50	4.55
	Sweden	2.23	2.30	2.30	2.30	2.35
	Norway	3.80	3.90	3.90	3.90	3.95
	Switzerland	0.39	0.40	0.40	0.40	0.45
Emerging markets	China	1.61	1.80	1.80	1.70	1.70
	India	6.70	6.70	6.70	6.60	6.60
	South Africa	10.42	10.60	10.60	10.50	10.50
	Russia	15.13	Temporarily no forecast due to extreme uncertainty			
	Turkey	26.00	26.00	24.00	24.00	22.50
	Brazil	14.81	14.90	14.90	14.80	14.80
Other advanced economies	United States	4.43	4.60	4.60	4.50	4.50
	Japan	1.30	1.30	1.30	1.30	1.30
	Australia	4.35	4.50	4.50	4.40	4.40
	New Zealand	4.58	4.70	4.70	4.60	4.60
	Canada	2.96	3.10	3.10	3.00	3.00

***Caution: very illiquid market**

Exchange rates (end of period)	7/2/2025	Q1 2025	Q2 2025	Q3 2025	Q4 2025
USD per EUR	1.04	1.02	1.02	1.04	1.04
CZK per EUR	25.07	25.30	25.20	25.10	25.10
HUF per EUR	404.27	404.00	406.00	408.00	413.00
PLN per EUR	4.19	4.22	4.25	4.20	4.20
BGN per EUR	1.96	1.96	1.96	1.96	1.96
RON per EUR	4.97	5.00	5.05	5.05	5.05
GBP per EUR	0.83	0.84	0.85	0.86	0.87
SEK per EUR	11.30	11.30	11.25	11.25	11.25
NOK per EUR	11.65	11.65	11.65	11.65	11.65
CHF per EUR	0.94	0.94	0.94	0.93	0.93
BRL per USD	5.76	5.90	6.00	6.25	6.25
INR per USD	87.40	88.00	88.50	88.75	88.75
ZAR per USD	18.41	18.71	19.00	19.50	19.50
RUB per USD	97.10	Temporarily no forecast due to extreme uncertainty			
TRY per USD	35.98	36.87	38.64	39.81	40.70
RMB per USD	7.29	7.34	7.36	7.40	7.40
JPY per USD	151.76	150.00	150.00	147.00	145.00
USD per AUD	0.63	0.61	0.61	0.62	0.63
USD per NZD	0.57	0.55	0.54	0.54	0.54
CAD per USD	1.43	1.43	1.43	1.43	1.43

Outlook KBC markets - Central and Eastern Europe

	Czech Republic			Slovakia		
	2024	2025	2026	2024	2025	2026
Real GDP (average yearly change, based on quarterly figures, in %)	1.0	2.1	2.3	2.1	1.9	2.5
Inflation (average yearly change, harmonised CPI, in %)	2.7	2.4	2.4	3.2	4.1	3.0
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	2.6	3.2	3.1	5.3	5.5	5.5
Government budget balance (in % of GDP)	-2.8	-2.1	-1.9	-5.8	-4.9	-4.5
Gross public debt (in % of GDP)	43.3	44.3	44.7	58.2	59.5	60.8
Current account balance (in % of GDP)	0.7	0.3	0.5	-2.0	-2.8	-2.5
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	4.5	5.4	3.5	3.0	3.0	3.5

	Hungary			Bulgaria		
	2024	2025	2026	2024	2025	2026
Real GDP (average yearly change, based on quarterly figures, in %)	0.6	2.3	3.9	2.2	2.1	2.4
Inflation (average yearly change, harmonised CPI, in %)	3.7	4.1	3.6	2.6	2.9	3.0
Unemployment rate (Eurostat definition) (in % of the labour force, end of year)	4.3	4.3	3.9	3.8	3.9	3.8
Government budget balance (in % of GDP)	-4.8	-4.1	-3.9	-2.9	-3.0	-3.0
Gross public debt (in % of GDP)	73.8	73.4	72.9	24.3	26.8	28.0
Current account balance (in % of GDP)	1.5	1.3	1.0	-0.7	-0.9	-1.0
House prices (Eurostat definition) (average yearly change in %, existing and new dwellings)	12.6	5.5	4.0	15.1	5.0	3.5

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Outlook KBC markets - Belgium

National accounts (real yearly change, in %)	2024	2025	2026
Private consumption	1.9	1.5	1.6
Public consumption	3.5	0.9	0.5
Investment in fixed capital	1.2	1.7	2.4
Corporate investment	1.7	1.9	2.6
Public investment	7.4	2.3	2.0
Residential building investment	-4.2	0.7	1.7
Final domestic demand (excl. changes in inventories)	2.1	1.4	1.5
Change in inventories (contribution to growth)	-0.9	0.3	0.0
Exports of goods and services	-4.5	-2.5	0.3
Imports of goods and services	-4.4	-1.3	1.1
Gross domestic product (GDP), based on quarterly figures	1.0	0.7	0.9
Household disposable income	1.4	1.6	1.3
Household savings rate (% of disposable income)	14.2	14.4	14.2

Equilibrium indicators	2024	2025	2026
Inflation (average yearly change, in %)			
Consumer prices (harmonised CPI)	4.3	2.8	2.1
Health index (national CPI)	3.3	3.1	2.0
Labour market			
Domestic employment (yearly change, in '000, year end)	6.6	15.0	30.0
Unemployment rate (in % of labour force, end of year, Eurostat definition)	5.8	6.0	5.9
Public finances (in % of GDP, on unchanged policy)			
Overall balance	-4.3	-4.7	-4.4
Public debt	104.0	106.3	107.5
Current account balance (in % of GDP)	-0.5	-1.2	-1.3
House prices (average yearly change in %, existing and new dwellings, Eurostat definition)	3.1	3.0	3.0

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