What's up in CEE? – 2Q19

- 1Q19 growth in CEE still looked good but slowdown could be only postponed
- Local core inflation getting higher but external inflation environment is very low
- GDP growth helps headline fiscal numbers, structural figures less favorable

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Despite the fact that we discussed in our last What's Up in CEE publication that a slowdown for this year looks very likely, courtesy of external demand headwinds, real GDP growth was surprisingly fast in several regional countries in 1Q19. Strong growth in the first quarter led us to revise real GDP expectations for the full year to 4.8% for Poland and to 4.5% for Hungary and Romania, while we slightly revised growth to the upside for Croatia and marginally for the Czech Republic as well. Countries for which we see a more notable slowdown compared to last year are Slovakia, Serbia and Slovenia, while elsewhere, growth should only be slightly lower than last year, or even higher than in 2018 (in Romania and Croatia). With the revisions above, we now see the average real GDP growth in CEE at above the 4% mark (4.1%), not much behind the 4.4% of 2018. Just three months ago, our expectation was only 3.3% on average for this year.

A quick look at growth contributors for 1Q19 reveals strong momentum of both investments and final consumption in several CEE countries. Annual growth of final consumption gained speed in all regional countries except for Poland, Serbia and Slovakia vs. 4Q18. The yearly increase of gross fixed capital formation increased everywhere apart from the Czech Republic and Slovakia.

Looking ahead to the coming quarters, domestic demand is likely to remain in high gear, but its strength could wane somewhat. Wage growth is to remain solid, given the still very tight labor market situation everywhere, but some slowdown cannot be ruled out, given the high wage dynamics recently. Inflation is also slowly going up (seen at 2.7% this year on average for CEE, from 2.4% last year), eating away an increasing share of wage growth. The increase of employment could also be lower, as unemployment rates are already at or around record lows, limiting the increase in the number of employed. As for investments, EU funds are starting to have an increasingly large impact, as we are heading towards the end of the current 2014-20 programming period and a large amount of funds were still not paid to beneficiary countries by Brussels.

As for external demand, the picture remains much less rosy. It is not just that German growth (the main export partner of many CEE countries) could remain rather slow, but new risks have started to appear on the external landscape. As for global car manufacturing, negative news and fears of a notable slowdown seem to be intensifying, mostly tied to news coming from China. In this already grim environment, tariff threats from US President Trump have further unnerved investors and increased the fears of a pronounced global growth slowdown.

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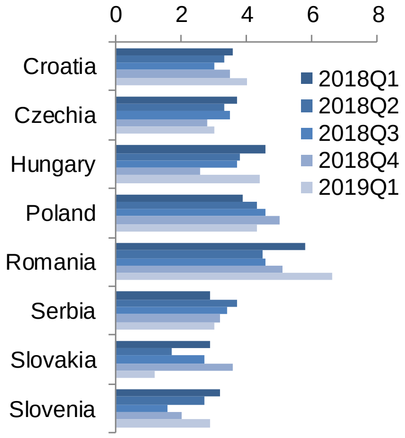
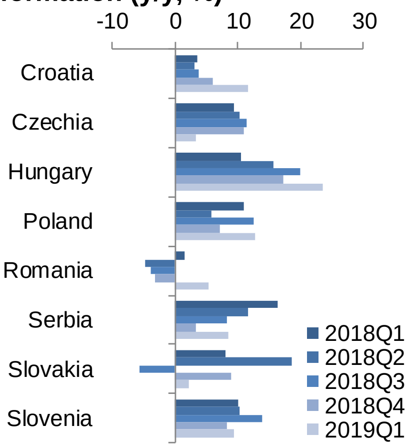
Country macro outlooks

Growth of final consumption expenditure (y/y, %)



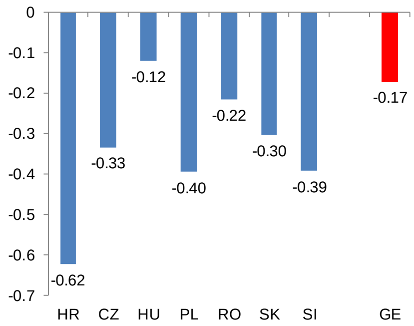
Source: Eurostat

Growth of gross fixed capital formation (y/y, %)



Source: Eurostat

Nominal 10Y yield changes in CEE and in Germany in 2Q19 (QTD, percentage points)



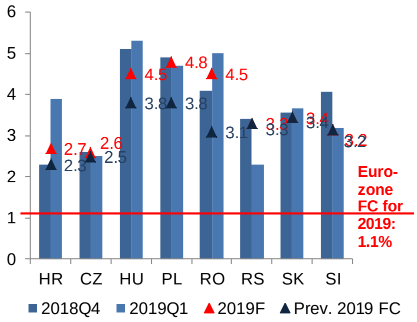
Source: Bloomberg
Prices as of 13 Jun, 2019

With regards to the outlook of car exports in case of US tariffs, we have concluded in our Special Report in late May that Hungary and Slovakia would be more exposed to an external demand shock related to the introduction of tariffs by the US than the Czech Republic. In that report, we assumed that a 20% decline of car imports from the EU to the US would reduce Hungarian and Slovak GDP by 0.2pp and Czech GDP by 0.1pp.

As for Europe, the resignation of British PM Theresa May has definitely not helped to tame fears of a hard Brexit. The exact outcome is very difficult to guess: while chances for a hard Brexit likely increased, it is not a certainty. As for Italy, the country could well be heading towards an Excessive Deficit Procedure due to its very high public debt. Even if this is avoided with fiscal austerity, the latter is still obviously negative news for growth in Italy.

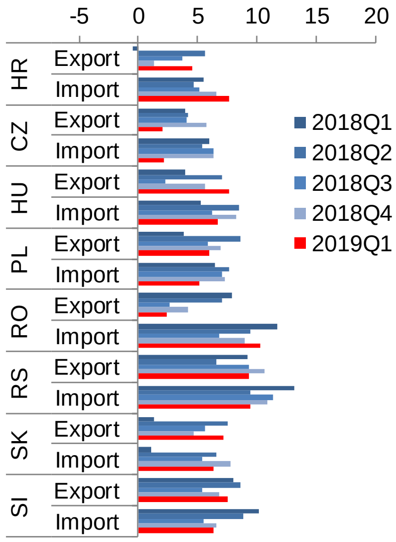
The weakened growth outlook and the newest episodes in the global trade war already had a significant impact on global markets, but so far, CEE markets managed to fare the impact rather well: yield spreads over German Bunds actually decreased, and currencies mostly appreciated, as lower global interest rate expectations increase the attractiveness of local currencies and domestic demand and tight labor markets do not leave much room for local central banks to substantially ease monetary conditions.

1Q19 real GDP growth and outlook for 2019, y/y, %



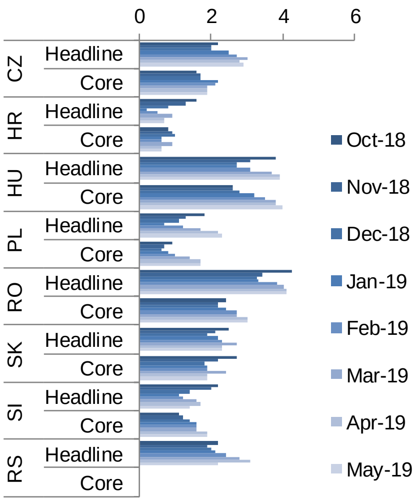
Source: Erste Group Research

Growth of exports and imports volumes, y/y, %



Source: Eurostat

Headline and core inflation (CPI, y/y, %)



Source: Bloomberg. For Slovenia, core inflation is based on HICP

Real economy

Strong growth of several CEE economies continued in 1Q19, somewhat surprisingly. On a quarterly basis, growth in the whole EU was fastest in Croatia at 1.8% q/q, followed by Poland and Hungary at 1.5% and Romania at 1.3%. On an annual basis (based on seasonally-adjusted figures), Hungary was the growth champion at 5.2% y/y, followed by Romania at 5.1% and Poland at 4.7%, also within the whole EU. In the same measurement, Croatia came in at 3.9%, while Slovakia also fared well at 3.8%, and Slovenia delivered 3.7%. The Czech Republic arrived at 2.6%, while non-EU member Serbia at 2.3% (the latter is non-adjusted). All of these numbers are considerably above the EU average of 1.5% y/y.

It is widely known that domestic demand is the helping hand for CEE in times of external market woes, but this opens the question about the export performance relative to that of imports. However, looking at 1Q19 data, annual dynamics of exports were above import growth in all countries but Croatia and Romania, while it was practically matching import growth in the Czech Republic and Serbia. Elsewhere, exports notably surpassed import dynamics, somewhat counter-intuitively. It remains to be seen, however, how long this performance can be sustained, especially if fears of an even more pronounced global economic slowdown materialize. Romania seems to be a negative outlier from the pack, as its strong consumption expansion (with a major uptick in 1Q19 to 6.6% y/y in real terms, from 5.1% in 4Q18), although boosting GDP growth, puts additional upward pressure on imports. Thus, maintaining the growth dynamics in the longer run is greatly burdened by external imbalances in Romania.

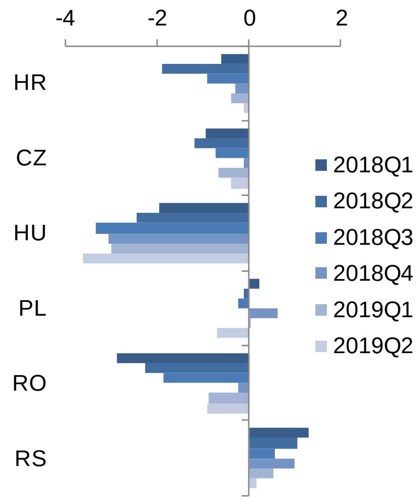
Inflation

Price dynamics increased in the last few months in CEE, but a large part of this was caused by an increase in non-core items (food, energy). All this notwithstanding, core inflation kept on creeping higher, reaching a multi-year high in Romania and a decade high in Hungary, making domestic pressures increasingly apparent. Looking ahead for the coming months, non-core items could be more forgiving. The recent decline in crude oil prices and subsequent cuts of petrol prices in the region could dampen the headline index, while food prices also have the potential to decline after fresh vegetables were first put to the market in spring. For the latter, however, some risks exist, as the very rainy weather in May and dry weather in the months before pose risks for this year's harvest. Overall, we could see a few countries (i.e. the Czech Republic, Hungary, Serbia) witnessing lower annual price dynamics in the coming few months, but core inflation is not really expected to inch much lower anywhere, owing to high domestic demand.

Currency outlook

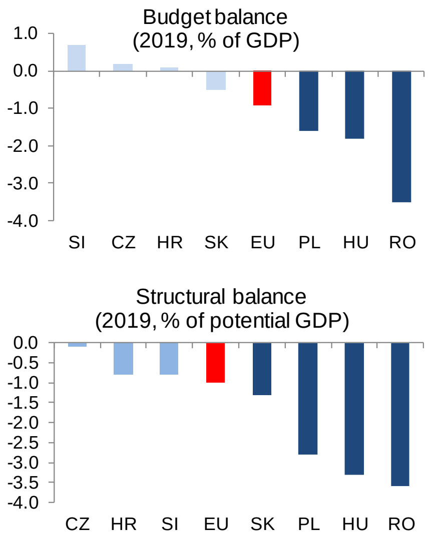
CEE currencies gained a lot in the last few weeks, as the decrease in global interest rate expectations increased inflows to the region. However, further appreciation is getting less likely, in our view. In Hungary, the central bank's dovish bias limits the appreciation of the forint, in our view. As for the Czech koruna, recent gains mean that the EURCZK pair came pretty close to our previous call for appreciation. As for the Romanian leu, the combined sizable shortfalls in the budget balance and the current account could weigh on the currency.

Real interest rates (3M interbank rates minus inflation. percent)



Source :Erste Group Research

Fiscal outlook for 2019 (% of GDP)



Source: European Commission, Erste Group Research

As for the Polish zloty, the recent appreciation could be followed by some weakening, as Polish monetary conditions could remain unchanged, while the US dollar may stay strong against the euro, which is usually negative for emerging currencies. The Croatian kuna and Serbian dinar may remain rather stable, as central banks could stay put to fend off external inflows (or outflows).

Monetary assessment

Global interest rate developments have removed some of the pressure from CEE central banks. However, domestic pressures (tight labor markets, high internal demand) remain an issue. It remains to be seen which force will be stronger on inflation - the disinflationary pressure imported from abroad, or local factors that have been pushing core inflation already high. Still, as somewhat stronger currencies are already tightening the monetary conditions, we do not see local central banks quickly increasing rates in the near future. In the Czech Republic, the next rate hike could only come in 2020, while in Romania, tight liquidity controls from the central bank already pushed interbank rates well above the policy rate, while the NBR has been communicating that it rather intends to keep the market under control by continuing with tight liquidity controls and not by increasing the policy rate further. This is also not to increase the gap between interest rates in Romania and the rest of the region. In Hungary, the central bank did not decrease extra liquidity for a few weeks in a row, while the appreciation of the forint also favors the ultra-dovish bias of the MNB, which is not expected to radically change, in our view. In Croatia and Serbia, rates could also remain relatively stable. Finally, in Poland, Governor Glapinski is of the view that there will be no need to tighten until his mandate expires in 2022, which definitely does not suggest any material change in rates in the next few quarters at least.

Fiscal outlook

In our Special Report in May, we have already compared fiscal and economic forecasts of regional governments to that of the European Commission. It is clear from the numbers that hefty economic growth hides the fact that underlying fiscal balances are not looking as good as headline numbers. Several countries do not just have their structural balances below the so-called medium-term budgetary objective (MTO), but also have them beyond the simple 3% of GDP threshold (Romania and Hungary), according to the Commission. Countries that have their structural balances not at the MTO should advance towards it. Currently, both Romania and Hungary are under the Significant Deviation Procedure at the moment due to non-compliance. However, this procedure cannot ultimately result in tangible penalties (ie. a monetary fine). This is a reason why politicians are targeting to avoid the Excessive Deficit Procedure, which is stricter, but could only be triggered if the headline deficit breaches the 3% of GDP Maastricht threshold. This latter could be helped by better than expected GDP growth, however.

Capital market forecasts

Government bond yields	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia 10Y	1.28	1.20	1.30	1.30	-
spread (bps)	154	150	140	120	-
Czech Rep. 10Y	1.59	2.00	2.15	2.25	2.36
spread (bps)	184	230	225	215	226
Hungary 10Y	2.79	2.93	2.98	3.06	3.12
spread (bps)	304	323	308	296	302
Poland 10Y	2.44	2.60	2.65	2.70	2.70
spread (bps)	269	290	275	260	260
Romania10Y	4.61	5.10	5.20	5.40	5.40
spread (bps)	487	540	530	530	530
Slovakia 10Y	0.29	0.55	0.65	0.80	-
spread (bps)	54	85	75	70	-
Slovenia 10Y	0.32	0.40	0.40	0.50	0.60
spread (bps)	58	70	50	40	50
Serbia 5Y	3.54	3.65	3.80	3.80	3.70
DE10Y*	***-0.26***	***-0.30***	***-0.10***	***0.10***	***0.10***

3M Money Market Rate	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia	0.48	0.50	0.50	0.50	-
Czech Republic	2.17	2.16	2.16	2.22	2.36
Hungary	0.18	0.22	0.25	0.35	0.45
Poland	1.72	1.72	1.72	1.72	1.72
Romania	3.25	3.70	3.60	3.50	3.50
Serbia	2.97	2.95	2.98	2.97	2.98
Eurozone	-0.32	-0.30	-0.30	-0.30	-

FX	current	2019Q3	2019Q4	2020Q1	2020Q2
EURHRK	7.41	7.42	7.42	7.42	-
forwards		7.41	7.41	7.41	-
EURCZK	25.56	25.55	25.30	25.14	24.88
forwards		25.72	25.86	25.97	26.09
EURHUF	322.1	325.0	325.0	325.0	325.0
forwards		322.6	323.1	323.7	324.5
EURPLN	4.26	4.31	4.32	4.31	4.30
forwards		4.28	4.30	4.33	4.35
EURRON	4.72	4.75	4.77	4.79	4.82
forwards		4.77	4.82	4.88	4.93
EURRSD	118.0	118.0	118.3	118.0	117.9
forwards		-	-	-	-
EURUSD	1.13	1.10	1.13	1.15	-

Key Interest Rate	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia	0.30	0.30	0.30	0.30	-
Czech Republic	2.00	2.00	2.00	2.00	2.25
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.50
Romania	2.50	2.50	2.50	2.50	2.50
Serbia	3.00	3.00	3.00	3.00	3.00
Eurozone	0.00	0.00	0.00	0.00	-

Real GDP growth (%)	2017	2018	2019f	2020f
Croatia	2.9	2.6	2.7	2.4
Czech Republic	4.5	2.9	2.6	2.8
Hungary	4.1	4.9	4.5	3.2
Poland	4.8	5.1	4.8	4.0
Romania	7.0	4.1	4.5	3.5
Serbia	2.0	4.3	3.3	3.5
Slovakia	3.2	4.1	3.4	3.3
Slovenia	4.9	4.5	3.2	3.1
CEE8 average	**4.7**	**4.4**	**4.1**	**3.5**

Average inflation (%)	2017	2018	2019f	2020f
Croatia	1.1	1.5	1.0	1.2
Czech Republic	2.5	2.1	2.6	2.2
Hungary	2.4	2.8	3.3	3.0
Poland	2.0	1.6	2.4	2.7
Romania	1.3	4.6	4.0	3.2
Serbia	3.2	2.0	2.5	1.8
Slovakia	1.3	2.5	2.5	2.5
Slovenia	1.4	1.7	1.5	1.9
CEE8 average	**1.9**	**2.4**	**2.7**	**2.6**

Unemployment (%)	2017	2018	2019f	2020f
Croatia	11.3	8.4	7.4	6.4
Czech Republic	2.9	2.3	3.0	3.3
Hungary	4.2	3.7	3.6	3.5
Poland	7.3	6.1	6.0	6.4
Romania	4.9	4.2	3.8	4.0
Serbia	13.5	12.7	10.6	9.8
Slovakia	8.1	6.5	5.8	5.7
Slovenia	6.6	5.1	4.2	3.7
CEE8 average	**6.3**	**5.2**	**5.1**	**5.2**

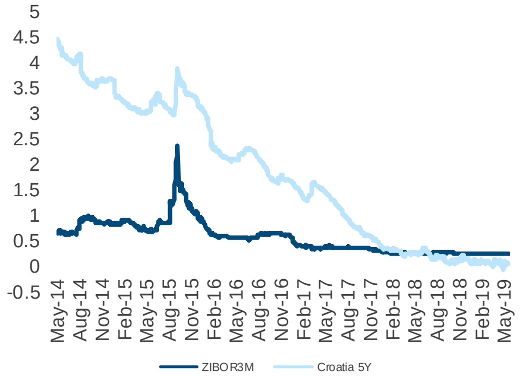
Public debt (% of GDP)	2017	2018	2019f	2020f
Croatia	77.8	74.6	71.6	69.4
Czech Republic	34.7	33.2	32.1	31.4
Hungary	73.4	70.8	68.2	66.4
Poland	50.6	48.9	50.1	49.3
Romania	35.2	35.0	35.1	35.3
Serbia	59.3	53.6	51.1	49.0
Slovakia	50.9	48.9	47.7	46.2
Slovenia	72.4	67.0	63.6	60.2
CEE8 average	**50.3**	**48.3**	**47.9**	**46.9**

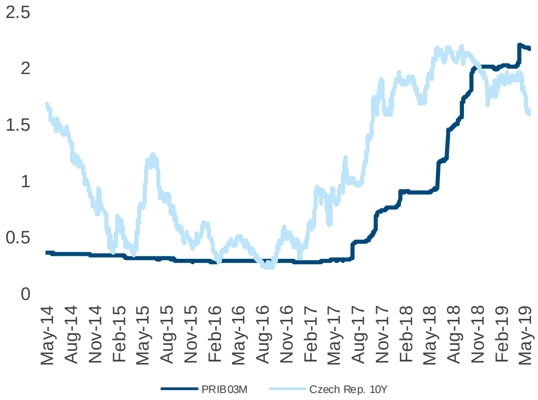
C/A (%GDP)	2017	2018	2019f	2020f
Croatia	3.7	2.6	1.5	0.6
Czech Republic	1.7	0.3	0.4	0.5
Hungary	2.8	0.5	-0.1	0.7
Poland	0.2	-0.7	-0.5	-0.7
Romania	-3.2	-4.5	-4.8	-5.2
Serbia	-5.2	-5.2	-6.3	-6.0
Slovakia	-2.0	-2.5	-2.4	-1.2
Slovenia	7.2	7.0	6.4	5.7
CEE8 average	**0.2**	**-0.9**	**-1.0**	**-1.0**

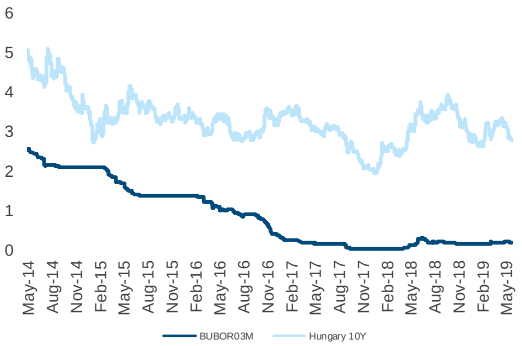
Budget Balance (%GDP)	2017	2018	2019f	2020f
Croatia	0.9	0.2	0.0	-0.5
Czech Republic	1.5	1.5	1.1	0.9
Hungary	-2.2	-2.2	-1.8	-1.5
Poland	-1.5	-0.4	-1.9	-2.6
Romania	-2.7	-3.0	-3.0	-2.5
Serbia	1.1	0.6	-0.5	-0.5
Slovakia	-0.8	-0.7	-0.7	-0.4
Slovenia	0.0	0.0	0.50	0.5
CEE8 average	**-1.0**	**-0.6**	**-1.3**	**-1.5**

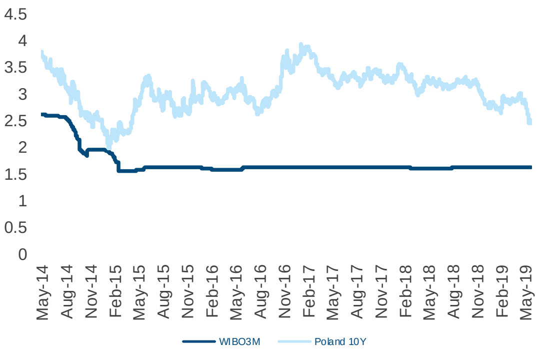
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

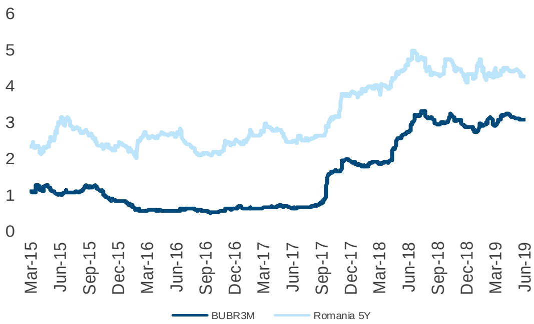
Prices as of 14 June, 2019.

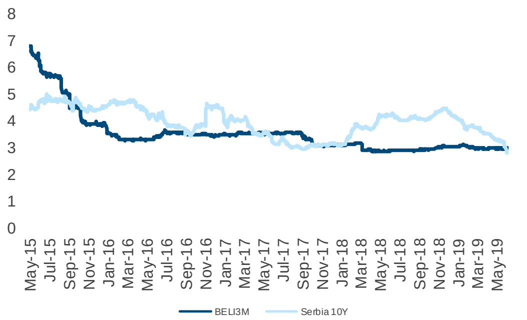


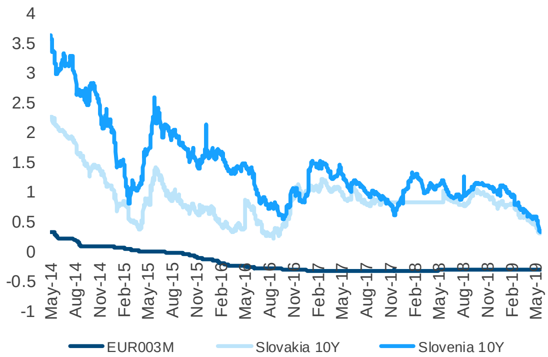












Source: Bloomberg
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