What's up in CEE?

- Domestic demand should soften the slowdown in GDP growth
- Not all CEE countries have managed to build sufficient fiscal space
- Czech and Hungarian central banks to tighten monetary conditions this year

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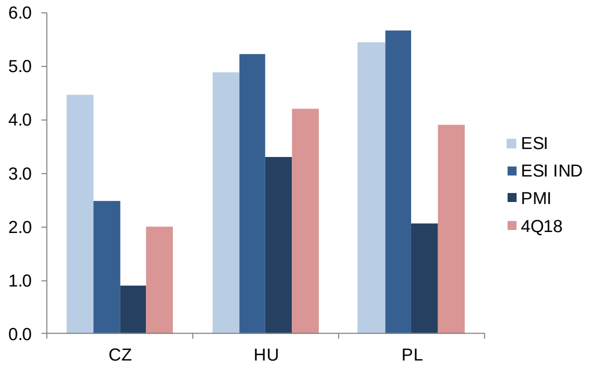
Signs of a considerable economic slowdown were undoubtedly coming in the last few months from the Euro Area. Such a development is negative for small, open and export-oriented economies such as CEE countries. So far, it has been reflected in the weakening market sentiment, as PMI in the Czech Republic and Poland went below 50. Hungary seems to be resilient to this trend.

Despite this, economic growth remained strong in 4Q18. The first monthly indicators of the year point to a relatively good start to 2019. Retail sales rebounded substantially in many CEE countries in January and industrial output also performed well (apart from Romania, where industry fell 1.6% m/m and barely managed to stay above zero in annual terms in January). Does this mean that sentiment indicators are not reliable predictors of economic performance?

While leading indicators, such as PMI, or the Economic Sentiment Indicator (ESI), can be useful in early detection of a trend change, they are among many factors determining the performance of the economy. Having said that, a simple prediction of GDP growth based on sentiment indicators suggests that, according to PMI only, the growth dynamics should already be much lower. In other words, there seems to be much more pessimism in accessing the economic situation using the PMI index compared to how the economy is really doing. On the other hand, ESI seems to overestimate the GDP growth. Looking country by country, PMI and ESI in industry seems to show the GDP trend quite accurately in the Czech Republic and underestimating it in Poland and Hungary, while ESI proves to have quite accurate estimates in the case of Hungarian GDP, while being too optimistic in the cases of the Czech Republic and Poland. All in all, sentiment indicators are worth watching as signs of possible change, but should be treated with caution.

GDP estimate based on the sentiment indicators (percent)



Source: Erste Group Research

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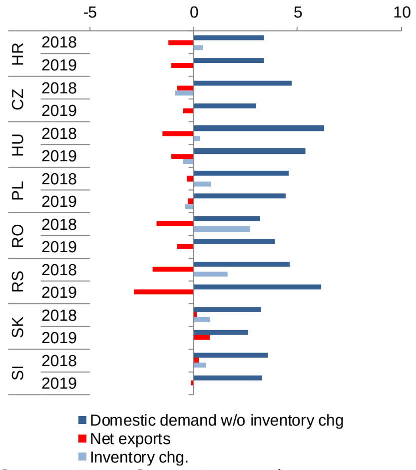
GDP growth contributions in 2018 and expectations for 2019, percentage points



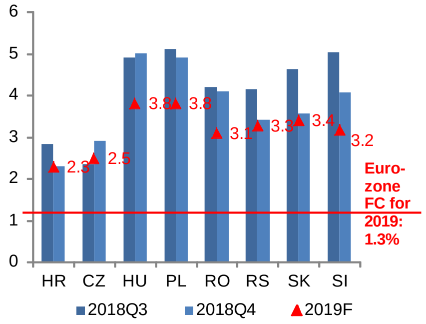
Source: Erste Group Research

Sentiment indicators are a valuable source of information, but some tend to overestimate and others to underestimate the growth. In addition (and quite importantly), domestic demand plays an important role that most manufacturing sentiment indicators likely fail to incorporate. While domestic demand was firing on all cylinders already last year, strong wage growth is expected to remain in CEE, while EU-funded investments (in most countries) should also help growth. Lending growth could also contribute to economic expansion this year, as we already discussed in our special report a few weeks ago. Overall, while domestic demand may contribute to expansion to a somewhat lesser extent, it could remain a strong contributor to growth, partly counterbalancing the export slowdown. Overall, we see GDP growth in the region to slow to 3.3% this year, still well above that of the ailing Eurozone.

Nonetheless, prospects of an economic slowdown (and upcoming elections) have prompted some CEE governments to come forth with fiscal easing. While the motive to do so is understood, the real question is the size of the fiscal buffer for any easing. Looking at just headline fiscal figures could be misleading, as economies operate above their potential in CEE, which compresses deficits. Structural shortfalls are definitely looking worse than the headline numbers would suggest. In addition, several countries are far from their medium-term fiscal objectives (which are measured by the structural balance), so further deviation from these would potentially trigger pro-cyclical fiscal consolidation. This especially applies for Hungary, Poland and Romania - three out of the four countries in CEE that started to openly flirt with fiscal relaxation.

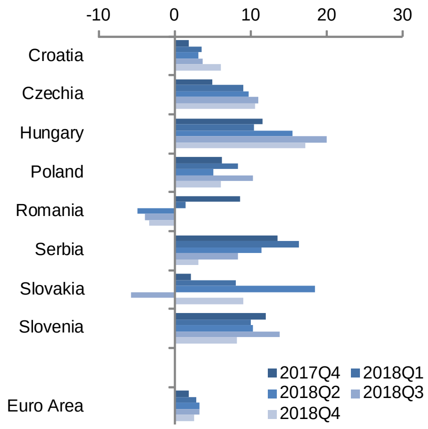
Major central banks turned more dovish in recent months. Therefore, the pressure on regional central banks to normalize monetary conditions fell compared to last year. Despite tight labor markets and robust wage growth, inflation remained relatively under control in most countries, supported by muted foreign price dynamics. That being said, inflation seems to be an issue in the Czech Republic and Hungary. Therefore, we see a further hike (or hikes) this year in the Czech Republic and the start of policy normalization in Hungary. The latter should come quite soon, but the process could remain slower than the market expects. Therefore, we see the forint weakening a little bit in the coming months, after the appreciation seen since January. In the Czech case, the CNB could still be unhappy with the relatively weak CZK, fearing that it could make already above-target inflation even harder to control. Propping it up will likely be tried by raising interest rates. In Romania, the slowdown of the economy and the inflation outlook do not warrant further hikes this year, after the already quite substantial increase in interbank rates last year. The NBR is expected to manage the RON exchange rate in the meantime. As for Croatia and Serbia, central banks could continue to tame pressures on FX markets. Central bankers could remain rather dovish in Croatia (just look at the very low inflation rate if you have any doubts about this), while Serbia is also unlikely to see policy rate changes this year. Additionally, the Croatian government may send a letter of intent, most likely in mid-2019, to join the ERM II mechanism likely sometime in 2020.

4Q18 real GDP growth and outlook for 2019, y/y, %



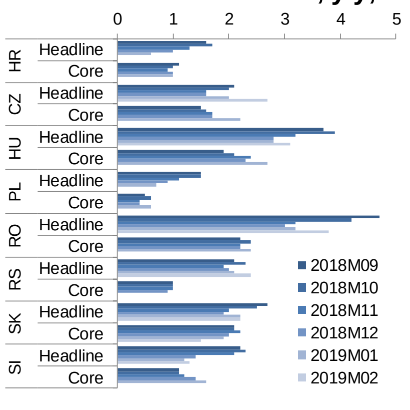
Source: Erste Group Research

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



Source: Eurostat

Headline and core* HICP, y/y, %



Source: Eurostat
** HICP ex-energy, food, alcohol and tobacco; except for SI & SK, February are CPI figures*

Real economy

CEE economies in 4Q18 mostly managed to keep up the pace of strong economic growth, despite the already upbeat 3Q18 and evident signs of a notable slowdown in the Eurozone. After Malta, Hungary was the fastest growing EU member country in 4Q18 with 5.1% y/y growth, while Poland came in fourth with just a slightly slower growth figure. Romania and Slovenia came in with 4.1% y/y, still rather strong, but Slovakia posted a slowdown that was more pronounced than expectations, at 3.6% y/y. Serbia expanded 3.4%, while the Czech Republic was the country in the CEE pack that managed to notably increase the annual speed of expansion, with 2.9% y/y. Croatia posted slower 2.3% real GDP growth in the fourth quarter.

Domestic demand seems to be able to partially counterbalance the slowdown in external demand in CEE. However, a slowdown seems inevitable for countries expanding well above their potential last year, as domestic demand was already firing on all cylinders in 2018 (courtesy of the strong wage growth and rapid expansion in employment), while the export growth performance was likely better than expected for this year. We see the CEE region expanding 3.3% this year, after the stellar 4.4% in 2018.

Inflation

Headline inflation mostly moderated, while core inflation typically stayed constant or increased, until the last few months. However, the decline of oil prices that kept a lid on headline figures reversed at the start of 2019, while food prices also started to bite, pushing price dynamics up again. Tight labor markets would also warrant an increase in prices. The external environment, however, speaks against a quickening in price increases. Recently, the ECB slashed its inflation projections for the Euro Area, cutting inflation forecasts for the first time for the upcoming one-to-two years since 2016, and seeing the 2-year-ahead inflation at just 1.7%. Courtesy of the notable growth slowdown in the Euro Area and still muted external inflation prospects, we do not expect inflation figures to notably increase this year. In fact, on average, we see CEE inflation moderating slightly this year; this includes the major decline in CPI in Romania, which brought above-5% peak values at around the middle of last year.

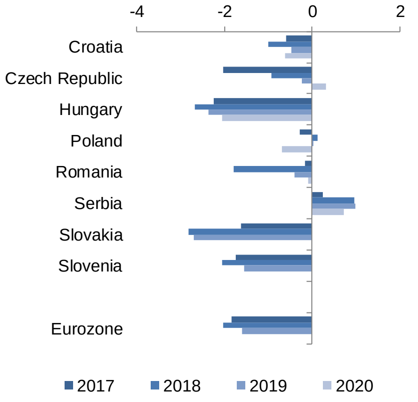
Currency outlook

Currencies were rather mixed so far this year in CEE. While the Romanian leu suffered from the news on controversial taxes, the Hungarian forint benefited from a growing expectation that the central bank might start normalizing monetary conditions soon. As for the leu, we believe that the NBR could be in position to keep it relatively stable, although news around economic policy could put some pressure on the RON, so risks are towards somewhat weaker leu levels. As for the forint, we think that the normalization of monetary policy could be very slow, and therefore, we see some room for the HUF to depreciate against the euro. The Czech koruna, on the other hand, should appreciate, in our view. Inflation is currently above the point target of the CNB, which (coupled with the very tight labor market and subsequent wage pressure) could trigger further tightening from the CNB, which could exert appreciation pressure on the CZK for the remainder of this year. In Serbia and Croatia, central banks could keep the currencies stable in the coming months. For Croatia, high dividend plans could potentially derail the kuna in the spring, but seasonal purchases could prop up the HRK later on.

Monetary assessment

Major central banks turned more dovish in recent months and thus the pressure on the region to tighten monetary conditions also lessened. Of the central banks that already tightened last year, the NBR in Romania seems able to keep rates on hold throughout the year. Besides the ECB, this is also likely possible because inflation is to remain within the target band this year. As for the CNB in the Czech Republic, however, at least one hike is expected this year. The CNB is likely unhappy with a relatively weak koruna and it is expected to try giving it a boost with a rate increase (or increases). The Hungarian central bank is also likely to carry out some slow normalization of the ultra-loose policy, but monetary conditions will remain supportive in Hungary, just to a somewhat lesser extent. Bubor rates might continuously go up this year. Poland is expected to keep rates unchanged for an extended period. While the fiscal package in Poland is growth- and inflation-positive, headline inflation numbers remain rather low, and thus, the situation does not warrant rate changes in Poland. In Serbia, rate stability is also the most likely scenario, given the muted inflation outlook, while in Croatia, inflation and FX developments also point to an ongoing dovish stance in the near term. As for the latter, the joining of the ERM II exchange rate mechanism could be in focus, as the country is aspiring to join the EMU in the foreseeable future. With regards to this, the government could send a letter of intent most likely in mid-2019, to join the ERM II mechanism likely sometime in 2020.

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

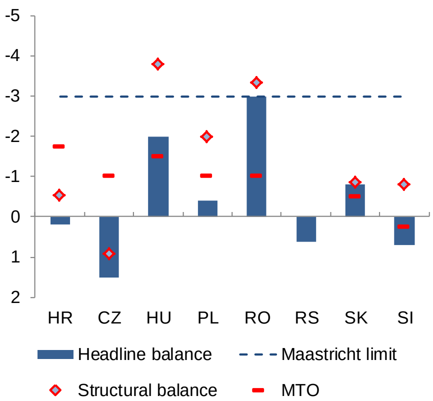


Source :Erste Group Research

Fiscal outlook

Prospects of a European growth slowdown and upcoming European and national elections triggered fiscal easing announcements in a number of countries in CEE. In Hungary, the government published its plan in early 2019 to boost the birth rate and stimulate the economy with fiscal measures, although the details of the measures were not crystal-clear at the time of the announcements, making predictions regarding the economy harder. As for Poland, the announcements were more exact: social benefits would be worth at least 0.8% of GDP this year (the cost of the PLN 500+ program and the 13th pension alone). In 2020, the total cost of all fiscal promises is estimated at around 2% of GDP. This will also include the lowering of some taxes. As for Slovakia, junior coalition party SNS also announced some easing steps. The most important measures include a proposal to cut corporate income tax from 21% to 15% and the VAT on food and print media from 20% to 10%. If carried out, the deficit could be 2pp higher next year, according to the Slovak Fiscal Council. For the whole region, we expect the fiscal deficit to increase from the 0.6% of GDP reached last year to 1.2% in 2019.

Fiscal metrics for 2018 (% of GDP)



Source: European Commission, Erste Group Research

Capital market forecasts

Government bond yields	current	2019Q2	2019Q3	2019Q4	2020Q1
Croatia 10Y	2.11	2.10	2.00	2.00	2.00
spread (bps)	204	162	141	129	123
Czech Rep. 10Y	1.87	2.24	2.29	2.34	2.44
spread (bps)	180	176	170	163	167
Hungary 10Y	3.23	3.28	3.35	3.41	3.45
spread (bps)	316	280	276	270	268
Poland 10Y	2.87	3.00	3.10	3.20	3.30
spread (bps)	280	252	251	249	253
Romania10Y	4.90	5.10	5.10	5.20	5.30
spread (bps)	483	462	451	449	453
Slovakia 10Y	0.68	0.90	1.00	1.00	1.10
spread (bps)	61	42	41	29	33
Slovenia 10Y	0.77	0.80	0.90	0.90	1.00
spread (bps)	70	32	31	19	23
Serbia 5Y	3.64	3.93	3.90	3.90	3.95
DE10Y (BBG)*	***0.07***	***0.48***	***0.59***	***0.71***	***0.77***

3M Money Market Rate	current	2019Q2	2019Q3	2019Q4	2020Q1
Croatia	0.49	0.50	0.50	0.50	0.50
Czech Republic	2.03	2.01	2.18	2.19	2.19
Hungary	0.14	0.35	0.70	0.85	0.90
Poland	1.72	1.72	1.72	1.72	1.72
Romania	3.06	2.80	2.80	2.80	2.60
Serbia	2.96	3.01	3.05	3.05	3.05
Eurozone	-0.31	-0.30	-0.30	-0.30	-

FX	current	2019Q2	2019Q3	2019Q4	2020Q1
EURHRK	7.42	7.30	7.42	7.45	7.42
forwards		7.42	7.42	7.42	7.42
EURCZK	25.67	25.30	25.10	24.80	24.65
forwards		25.69	25.69	25.69	25.69
EURHUF	314.4	320.0	322.0	322.0	322.0
forwards		317.6	317.6	317.6	317.6
EURPLN	4.30	4.31	4.32	4.29	4.29
forwards		4.30	4.30	4.30	4.30
EURRON	4.76	4.75	4.75	4.77	4.78
forwards		4.77	4.77	4.77	4.77
EURRSD	118.1	117.9	117.8	118.0	118.2
forwards		-	-	-	-
EURUSD	1.13	1.12	1.14	1.16	-

Key Interest Rate	current	2019Q2	2019Q3	2019Q4	2020Q1
Croatia	0.30	0.30	0.30	0.30	0.30
Czech Republic	1.75	1.75	2.00	2.00	2.00
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	2018f	2019f	2020f
Croatia	2.9	2.6	2.3	2.3
Czech Republic	4.5	3.0	2.5	2.8
Hungary	4.1	4.9	3.8	2.9
Poland	4.8	5.1	3.8	3.3
Romania	7.0	4.1	3.1	2.7
Serbia	2.0	4.3	3.3	2.9
Slovakia	3.2	4.1	3.4	3.6
Slovenia	4.9	4.5	3.2	3.1
CEE8 average	**4.7**	**4.4**	**3.3**	**3.0**

Average inflation (%)	2017	2018f	2019f	2020f
Croatia	1.1	1.5	1.0	1.2
Czech Republic	2.4	2.2	2.3	2.0
Hungary	2.4	2.8	2.8	3.1
Poland	2.0	1.6	1.7	2.4
Romania	1.3	4.6	3.2	2.8
Serbia	3.1	2.0	2.1	2.4
Slovakia	1.3	2.5	2.5	2.5
Slovenia	1.4	1.7	1.3	1.5
CEE8 average	**1.9**	**2.4**	**2.2**	**2.4**

Unemployment (%)	2017	2018f	2019f	2020f
Croatia	11.3	8.6	7.8	7.3
Czech Republic	2.4	2.4	2.5	3.0
Hungary	4.2	3.7	3.8	3.9
Poland	7.2	6.1	6.3	6.4
Romania	4.9	4.2	3.8	4.0
Serbia	14.1	13.3	12.6	12.1
Slovakia	8.1	6.5	6.3	5.8
Slovenia	6.6	5.1	4.2	3.7
CEE8 average	**6.2**	**5.3**	**5.2**	**5.3**

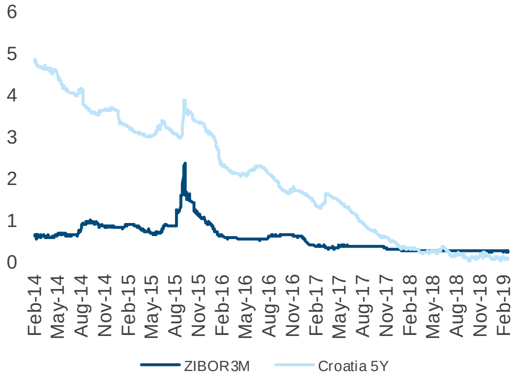
Public debt (% of GDP)	2017	2018f	2019f	2020f
Croatia	77.5	74.1	71.4	69.3
Czech Republic	34.7	33.2	32.1	31.4
Hungary	73.3	70.9	68.8	66.8
Poland	50.6	49.9	50.1	49.3
Romania	35.2	35.1	35.9	36.6
Serbia	57.9	53.8	51.5	49.4
Slovakia	50.9	49.1	48.3	46.6
Slovenia	72.4	67.0	63.8	60.8
CEE8 average	**50.2**	**48.7**	**48.1**	**47.2**

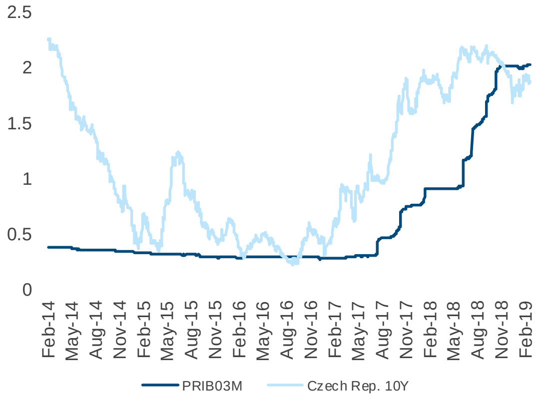
C/A (%GDP)	2017	2018f	2019f	2020f
Croatia	4.0	2.3	1.6	0.5
Czech Republic	1.1	0.6	0.5	0.6
Hungary	3.2	1.2	0.3	0.8
Poland	0.2	-0.4	-0.5	-0.7
Romania	-3.2	-4.7	-5.0	-4.8
Serbia	-5.2	-5.2	-5.5	-5.2
Slovakia	-2.0	-1.5	-0.9	0.2
Slovenia	7.2	7.3	6.5	5.8
CEE8 average	**0.2**	**-0.6**	**-0.8**	**-0.8**

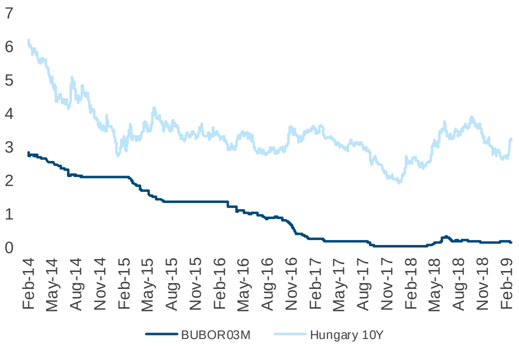
Budget Balance (%GDP)	2017	2018f	2019f	2020f
Croatia	0.8	0.2	0.0	-0.5
Czech Republic	1.5	1.5	1.1	0.9
Hungary	-2.2	-2.0	-1.8	-1.8
Poland	-1.4	-0.4	-1.8	-2.5
Romania	-2.9	-3.0	-3.0	-2.5
Serbia	1.1	0.6	-0.5	-0.5
Slovakia	-0.8	-0.8	-0.7	-0.4
Slovenia	0.0	0.0	0.50	0.3
CEE8 average	**-1.0**	**-0.6**	**-1.2**	**-1.5**

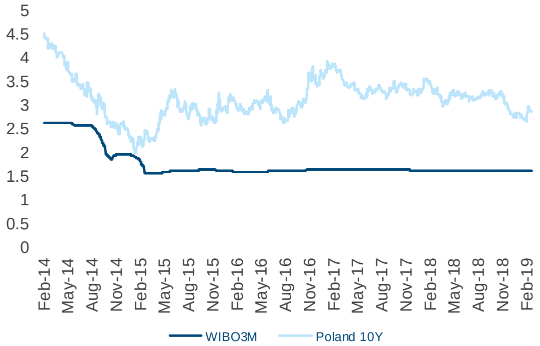
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

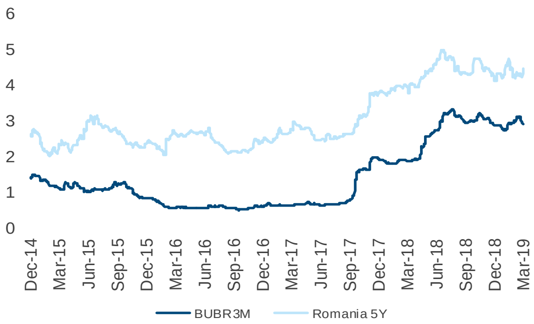
Prices as of 14 March, 2019.

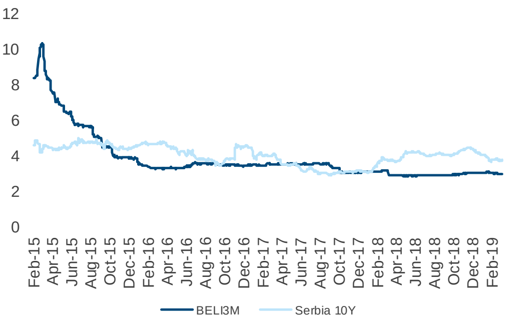


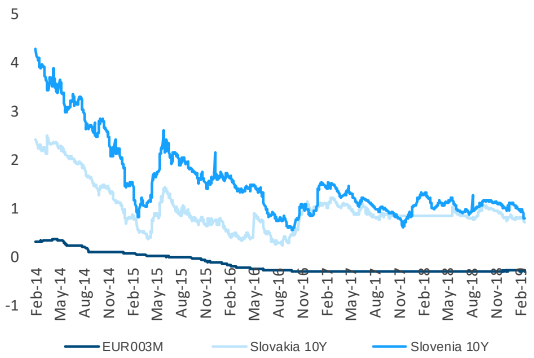












Source: Bloomberg
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