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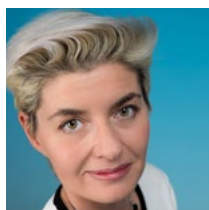
Thematic paper | CROSS ASSET Investment Strategy

November 2018

Central European countries:
Outlook to 2020

Research
& Macro
Strategy

Central European countries*: Outlook to 2020



KARINE HERVÉ
Senior Economist,
Macroeconomic Research

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The essential

Global growth resynchronised in 2017. In this particularly bullish environment, Central European countries “outperformed” with growth rates of between 4% and 6%. This year, global growth should remain at last year’s levels. However, rising political and economic tensions have generated a high level of uncertainty, which is damaging consumption and investment, and they are weighing on global trade. The most vulnerable emerging economies are always the most affected by such trends. This is not the case for Central European countries, which should fare relatively well again this year. Although we are expecting a turnaround in the growth cycle in these countries, they should continue to achieve above-potential growth between now and 2020.

Central European countries are entering the downward phase in their cycle but they are still growing

Global growth resynchronised in 2017. In this bullish environment, Central European countries outperformed with growth rates of over 4% and over 6% in Romania. Global economic growth should remain robust but is expected to flatten in 2018. A number of political and economic risks are hanging over many economies, first and foremost the emerging economies. However, Central European countries are continuing to perform well.

With the exception of Hungary, growth slowed in these countries in the first half of this year. The slowdown is set to continue in the second half and for the next two years. However, unless there is a major external shock, growth in these countries should be above potential (estimated at around 2.5%-3% in the different countries). In our core scenario, we expect a limited slowdown of 0.5 pp per year for the next two years in the Czech Republic and Romania. However, the slowdown is expected to be more marked in Hungary and Poland, at 2 pp and 1.5 pp respectively over two years. Even though these countries’ growth will remain robust, 2017-2018 will mark the turning point when they enter the downward phase in their cycle.

Several factors make these economies relatively resilient: i) their growth is driven by domestic demand, ii) inflationary pressures are growing but still controllable, iii) their public finances are overall sound, and iv) their external financing levels are stable.

*In this document, we limit our review to four countries - Hungary, Poland, the Czech Republic and Romania.

Growth will remain robust and mainly driven by domestic demand

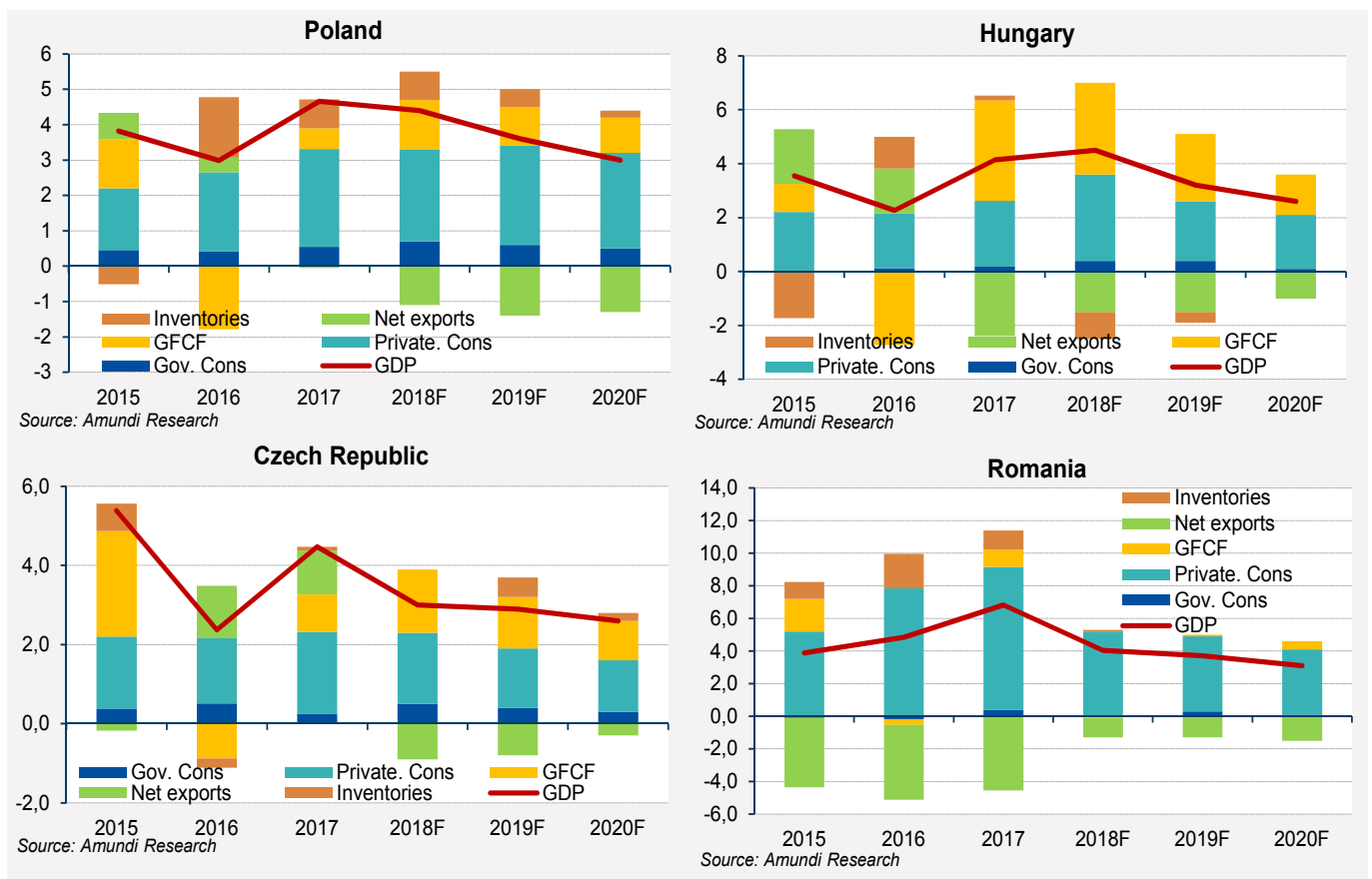
Consumer spending and private investment are these countries' main growth drivers and will remain so through to 2020, even if their rate of growth slows. (See Charts 1 GDP and components.)

“Domestic demand is strong”

In the first two quarters of 2018, consumer spending increased by 5% in all these countries. Since their unemployment rates are low, households will continue to benefit from real wage rises, which will boost consumption. However, the rise in consumer purchasing power is set to lose momentum in 2019-2020 as domestic inflation increases and nominal wage growth slows. Pressure on corporate margins (Czech Republic), reduced government support for minimum wages (Romania) and rising economic immigration (Poland) will increasingly curb nominal wage growth.

Investment increased sharply in Hungary (15%), the Czech Republic (10%) and Poland (7%) in the first half of 2018. However, in Romania, after a positive first quarter (+5%), investment declined by an equivalent amount in the second quarter. While growth seems relatively well balanced in Hungary, Poland and the Czech Republic, the same does not apply in Romania. From now to 2020, we are not expecting a significant recovery in investment in this country, and growth will be entirely driven by private consumption. One of the country's major problems seems to lie in its inability to use European Union funds for investment spending.

1/GDP and components

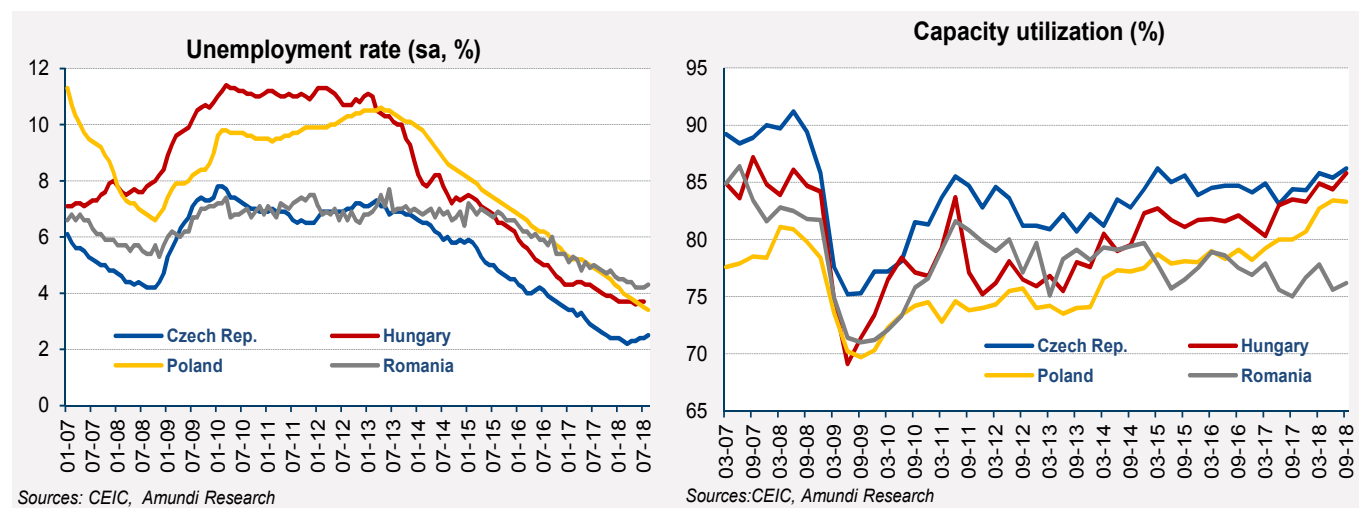


In Hungary, Poland and the Czech Republic, investment should continue to rise until 2020. Our core scenario does not expect a sharp drop in global demand, and as consumer spending is strong, supply is not likely to encounter demand constraints. In addition, some countries are likely to increase their investment as they are confronted with growing labour shortages, mainly due to the ageing population, and extremely high capacity utilisation rates. (See Charts 2: unemployment and

capacity utilisation.) This is particularly true in the Czech Republic. Investment growth will, however, be limited in some countries as public investment slows following the massive use of European funds in 2017 and 2018 (Czech Republic, Hungary), and also because of the risks in terms of foreign private investment arising from tensions with the European Union¹ (Hungary, Poland).

Net exports are expected to continue to make a low or slightly negative contribution to growth. Strong domestic demand should continue to drive imports, while exports stagnate due to the slowdown in global demand forecast in our core scenario.

2/Unemployment and capacity utilisation



Rising trade tensions between China and the United States, which have weakened global foreign trade, have only had a minor impact on Central European countries since they do little trade with either the United States² or China. Evidently, an escalation in this “trade war” to include the European Union and/or the cars industry would have a greater impact on these countries, but this is not part of our core scenario. The agreement reached between Jean-Claude Juncker and Donald Trump - even if it is only a verbal agreement at this stage - protects European Union countries at least temporarily. Moreover, it seems that the US administration’s priority is to rebalance its trade with China, with which it has a sizeable deficit, rather than with the European Union.

Similarly, although a hard Brexit would have negative consequences on trade in the European Union and in Central European countries, our core scenario expects a soft Brexit. However, if the hard Brexit scenario materialises, the negative impact on these countries’ exports could be partially offset by company relocations from the United Kingdom to these countries. Some relocations have already been seen in the past year, but their number is negligible. They seem to concern only goods manufacturing plants that are highly integrated in the European production chain, and in any case the phenomenon is limited.

The share of these countries’ exports to Turkey³ is not insignificant, and any deterioration in the Turkish economy could therefore affect these countries. In our core scenario, we expect Turkey to fall into recession in 2019, and we have factored a slowdown in exports to Turkey into our forecasts for these Central European countries.

¹ Due to these countries’ right of veto, there is little likelihood that the European Union will be able to apply the sanctions it has threatened to countries that violate the “Rule of Law.” However, problems will arise with the 2021-2027 budget, when the funding allocated to these countries could be cut by more than 20%.

² Exports to the United States account for barely 2% of their total exports. European Union countries, and in particular Germany, are these countries’ main trading partners, accounting for 80% of their exports.

³ Turkey represents 2% of these countries total exports

“Exports slow more than imports.”

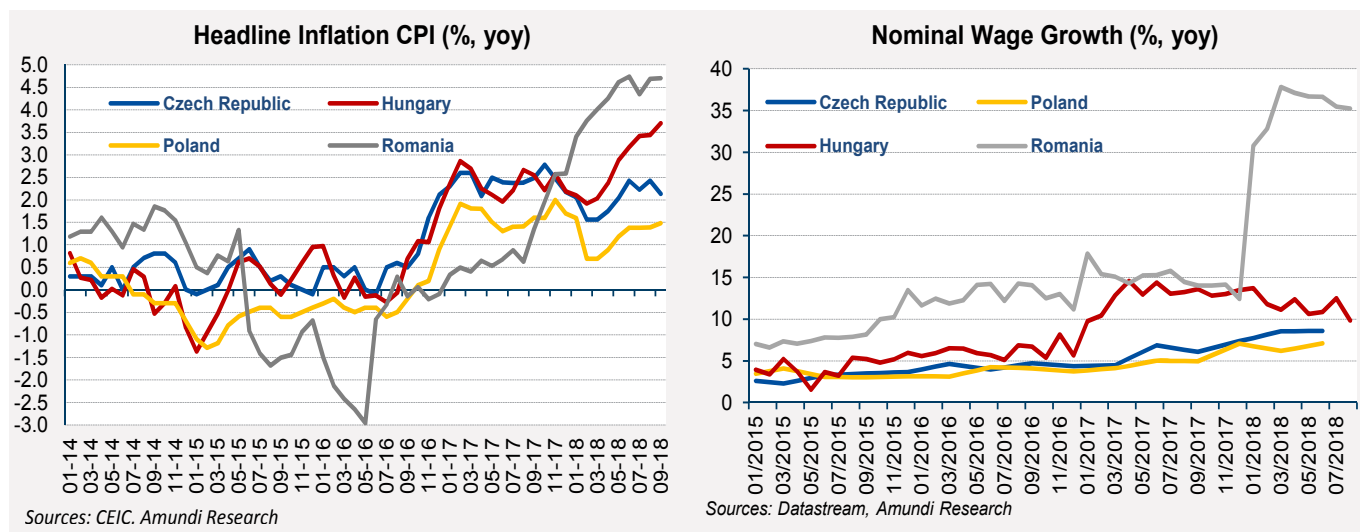
Inflationary pressure will increase but should be controllable

Inflation has risen in these countries in 2018 and should continue to climb in 2019-2020. (See Charts 3: inflation, nominal wages.) Several forces are at work both domestically (rising nominal wages due to a very tight labour market, sharp rise in property prices in some countries like the Czech Republic, and an acceleration in food prices) and externally (pressure on emerging currencies⁴ causing an exchange rate pass-through effect via imported goods and high oil prices).

As key interest rates are extremely low⁵ in these countries, their central banks could take action if necessary. In Hungary, inflation could close in on the upper limit of the central bank's target (4%), but the bank is likely to keep key interest rates unchanged. However, the Czech central bank, which has a lower target (2%) should continue to tighten monetary policy, in particular to limit the growth in home loans, which are fuelling a property market bubble. Four additional 25 bp rate hikes seem extremely plausible between now and the end of 2019. In Romania, inflation should remain above the central bank's target (3.5%) at least until the end of 2019. Therefore, although the central bank seems to have paused its monetary tightening cycle, it is unlikely to keep things on hold indefinitely⁶. We expect it to raise interest rates by 25 bp by the end of the year, and if tensions persist, it could make two additional 25 bp rate hikes in 2019. There is less inflationary pressure in Poland, and inflation should remain well below the central bank's upper limit (3.5%), meaning that the bank is not likely to adjust its key interest rate before the end of 2019.

“Very low unemployment is putting pressure on wages.”

3/Inflation and nominal wages



The risk to inflation remains on the upside. First, a policy error by the central banks that would put them behind the curve cannot be ruled out. Secondly, pressure on emerging currencies could intensify if US interest rates rise by more than expected, if the trade war between China and the United States worsens or is extended, if there is an escalation in Middle Eastern conflicts that keeps oil prices above the level set in our core scenario (USD 75/barrel, Brent), or more specifically for these countries, if discussions with European institutions go badly. Finally, in our core scenario, we do not expect the ECB to raise interest rates before the end of 2019. But if our forecast proves wrong, an interest rate hike by the ECB would doubtless be a game changer for the central banks in these countries.

“Central banks are taking action, or they could be forced to do so.”

⁴ These countries' exchange rates against the dollar have depreciated by 5% for the Czech Republic and Romania and by 10% for Hungary and Poland.

⁵ The key interest rate stands at 0.9 in Hungary, at 1.5% in Poland and the 1.75% in Czech Republic and at 2.5% in Romania.

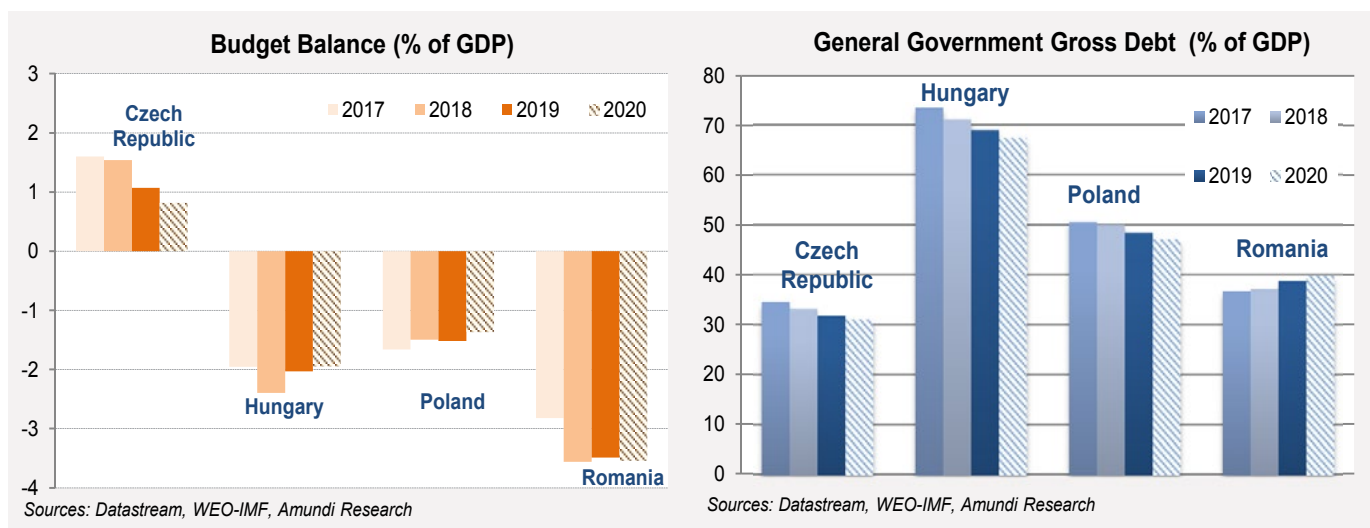
⁶ Since July, consumer prices have risen by over 4.5% per month.

Overall public finances will hold healthy but have to be monitored

The slowdown in growth is likely to reduce tax revenues. However, Hungary and Poland are not likely to exceed the public deficit target of 3% of GDP imposed by the European Union, despite the various measures already taken and to come, namely major tax cuts in Hungary and a lowering of the retirement age in Poland, combined with increasing welfare spending. The Czech Republic should continue to post a budget surplus through to 2020. However, the surplus could narrow permanently due to the decision to index public sector wages and pensions to inflation. In this sense, the IMF's forecast of a surplus of 0.8% of GDP in 2020 seems slightly optimistic. For the cost of this measure to be zero, tax revenue would have to increase by more than nominal GDP. The situation is more complex in Romania. The expansionary fiscal policy it has pursued by raising public sector wages and pensions will affect public finances. The deficit is expected to substantially exceed the limit of 3% of GDP. As elections are due to be held in 2019 and 2020, the government is unlikely to cut public spending or investment, which has already declined over the past five years. With a decline in GDP growth and no measures announced to improve tax collection, Romania's public deficit is unlikely to be eliminated in the next two years. (See Charts 4: public balances.)

“Not all countries have the same room for manoeuvre on their budgets.”

4/Public balances



In this situation, Poland and the Czech Republic, whose debt is less than 50% of GDP, have sufficient room for manoeuvre to stimulate growth if necessary. With debt levels of over 70% of GDP, Hungary's room for manoeuvre is much more limited. As for Romania, while its debt is no more than 40% of GDP, the size of its public deficit means it has no room for manoeuvre. In addition, this country could have difficulty meeting its financing requirements if investors' appetite for emerging assets dries up any more.

While these countries' public finances do not pose a major problem between now and 2020, they could become an issue if structural reforms are not made, due to the ageing population and the reduction in European Union funding⁷.

External financing levels should be stable while current accounts will deteriorate

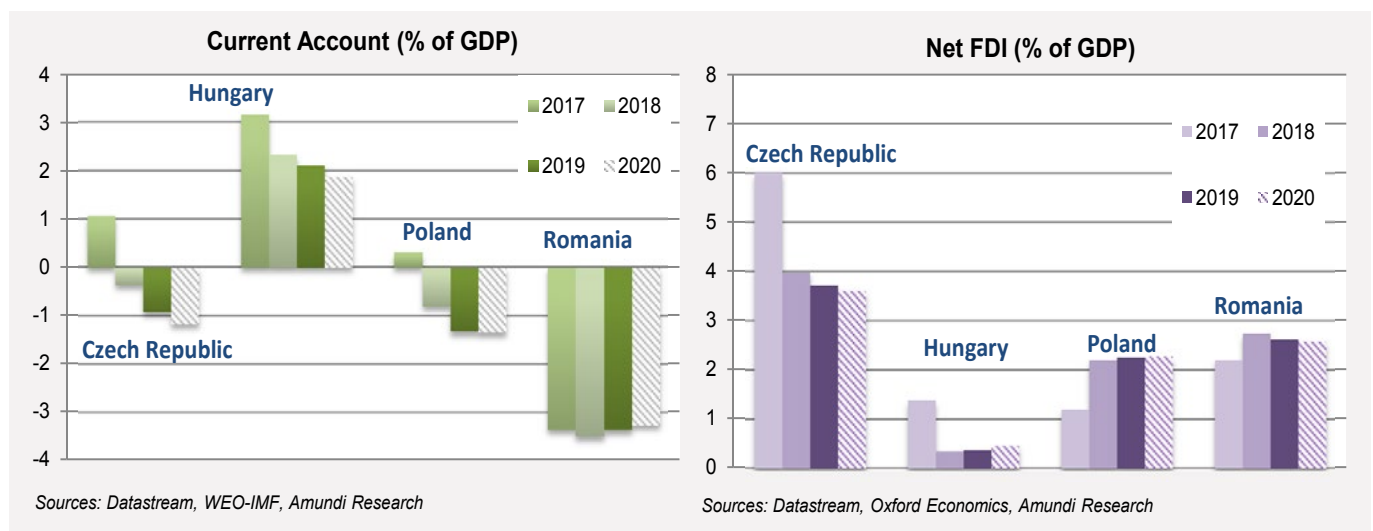
The slowdown in global trade that has begun to take hold and which is likely to continue will dampen Central European countries' exports. Their imports may slow, but not by as much, as domestic demand remains very strong. Overall, these countries are therefore expected to see a deterioration in their current accounts. (See Charts 5: Current Account Balances and FDI.)

⁷ European Union funding accounts for between 2% and 2.5% of these countries' budgets.

Their initial position will therefore be a decisive factor. As such, Hungary, which had a current account surplus of over 3% in 2017, should remain in positive territory the next two years. The IMF forecasts a current account surplus of nearly 2% for this country in 2020. In addition, although foreign direct investment (FDI) flows towards this country are relatively low - they account for less than 1% of GDP - and despite its high foreign debt (80% of GDP, though this figure has been falling for nearly 10 years), Hungary is not a high-risk country.

With relatively low current account surpluses in 2017, the Czech Republic and Poland could show a deficit as of this year, according to the IMF. However, this situation is not alarming for now, because the Czech Republic is the biggest recipient of FDI in Central Europe and Poland is the largest beneficiary of European Union funding. According to simulations using the Oxford Economics model, FDI should represent 3.5% to 4% of GDP in the Czech Republic in 2019 and 2020.

5/Current account balances and FDI



The situation is more complicated in Romania. Until now, it managed to finance part of its current account deficit with FDI (2%-3% of GDP on average depending on the year), portfolio flows (1%-1.5% of GDP) and European funds (2% of GDP). However, funding from the European Union was halved this summer (i.e. just 1% of GDP) since the Romanian government cut its infrastructure spending. In addition, in the second quarter, the current account deficit exceeded 3.5% of GDP, and nothing suggests it will improve in the short term, in particular as the harvest was poor this year. The markets may begin to worry about this situation and we could see an outflow of capital. In this case, the central bank would certainly be obliged to intervene to prop up its currency, at the risk of depleting its currency reserves. This scenario does, however, seem extreme, because although the current account deficit is widening, external debt is relatively low (40% of GDP).

“Current account balances are falling but are still funded.”

No stall in sight but in a less favourable global environment vigilance will be required

In the absence of a significant external shock, these countries should continue to grow at sustained rates by 2020, above their potential. The evolution of the public and external accounts will probably not be very favourable but should not pose any major problems either. However, in a climate of increasing uncertainty (geo) political and economic, it will be necessary to remain vigilant especially for Romania. But for the time being nothing alarming yet.

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