

CEE-3 Watch

Group Economics
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Robust but not immune to global slowdown

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- **Growth surprised to the upside in the first quarter of 2019**
- **Apparent decoupling from the German economy**
- **We have revised our growth forecast upwards for Hungary and Poland and downwards for the Czech Republic**
- **Rising wages are increasingly feeding into higher inflation...**
- **... but we foresee no policy hikes by the central banks**
- **Currencies are expected to remain resilient**

Growth in the first quarter of 2019 has surprised to the upside in CEE-3. Looking ahead, we expect a gradual slowdown from the strong Q1 figures, as the CEE-3 region is robust but not immune to the global slowdown. High growth rates are reflected by higher inflation, which is around the central banks' upper target bands. That said, we expect inflation to only temporarily overshoot before coming down and in light of our dovish change in the base case scenario for the ECB, we expect CEE-3 central banks to keep rates constant.

Growth remains surprisingly strong

GDP growth was surprisingly strong in Q1 2019 in the CEE-3 (Czech Republic, Hungary and Poland). Growth in both Hungary and Poland stood at 1.5% qoq in the first quarter, compared to 1.1% qoq and 0.5% qoq, respectively, in the fourth quarter of last year. Growth in the Czech Republic was 0.6% qoq. This strong growth in the CEE-3 came on the back of robust domestic demand underpinned by rising real wages. Furthermore, investments remained strong, benefitting from sustained EU funding and low interest rates.

CEE-3: Economic growth (forecasts)

% yoy	Q3-18	Q4-18	Q1-19	2017	2018	2019*	2020*
Czech Rep	2.5	3.0	2.6	4.5	2.9	3.0	2.5
Hungary	5.1	5.1	5.3	4.4	5.0	4.0	3.0
Poland	5.2	4.9	4.7	4.8	5.1	4.0	3.0

Source: ABN AMRO Group Economics, Bloomberg, EIU

* Forecasts 2019-20 rounded

Decoupling from Germany as exports remains strong...

There seems to be a (temporary) decoupling from the growth slowdown in the German economy, which slackened from an annual growth rate of around 2% yoy in the first half of 2018 to an average of 0.9% in the second half. The first quarter of this year also showed a subdued growth rate (0.7%). As Germany is the CEE-3's most important export partner – with around 30% of exports destined for Germany – the region is normally very sensitive to a slowdown in the German economy. However, exports from CEE-3 have remained relatively strong. In the Czech Republic, exports increased by an average of 6.5% on an annual basis in the first four months of 2019, compared to an average of 3.8% in 2018. For Hungary, average annual exports grew by 5.2% in the first four months of this year compared to an average of 4.5% last year. And Poland's exports increased by 7.8% in the first quarter of this year (April figures are not yet available), compared to an average of 6.6% in 2018.

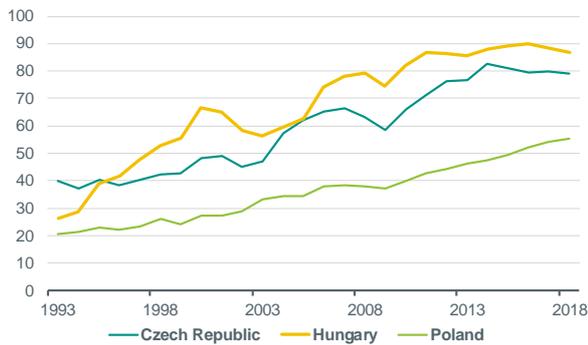
There are a few reasons for the strong export figures. Firstly, compared to a decade ago industry in the CEE-region has become more diversified and less dependent on the German auto industry production chains. For example, while around 42% of the Czech Republic's total exports went to Germany in 2000, this has now declined by around 10pp to 32%. For Hungary and Poland, the dependence on Germany has fallen by around 10pp and 7pp, respectively, since 2000. Secondly, CEE-3, and most specifically Poland, has managed to increase its value-added exports and now produces more final products than intermediary products. While German industry is underperforming, consumption has remained relatively strong, bolstering the import of consumption goods from, amongst others, the CEE-3.

... and growth becomes more broad-based

Moreover, the CEE-3 is moving up the development ladder and is becoming less dependent on exports in general as the economies become more driven by domestic consumption. High wage growth has boosted spending, offsetting some of the weakness in exports. In addition, EU funds – which peaked in 2018/2019 - are an important driver of investment. In 2016, when the CEE-3 was in between two EU funding cycles and the flow dried up, GDP growth nearly halved. Hungary, which has a high absorption rate and is frontloading funds to stimulate the economy, will be particularly hard-hit by a withdrawal of EU funds. Moreover, Hungary has a relatively loose monetary policy and enjoyed brisk fiscal stimuli in 2018 and early 2019.

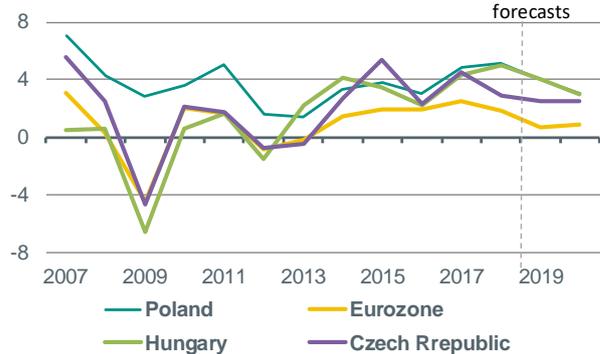
Exports as % of GDP is declining

Exports as % of GDP



Source: EIU

Growth in CEE-3 above that of the eurozone



Source: EIU and EIU projections

Modest slowdown expected

Despite increasing trade tensions and slower global growth ([EM Watch - Less vulnerable but not immune](#)), we expect growth to stay slightly above trend in 2019 and around trend in 2020. Our forecast is based on the following assumptions:

1. Growth in the CEE-3 will continue to be driven by high household demand, mainly supported by continuing wage increases. Leading indicators, such as retail sales, point towards resilient household spending.
2. The peak of EU funds (2014-20 budget period disbursements) has been reached, and the total amount of funds available to CEE-3 will likely decrease over the coming years. This will feed into lower investments.
3. The contribution of net exports will decline given the ongoing global economic slowdown – specifically weak eurozone growth figures – and uncertainties related to the trade wars (see also [Global daily: changes to our base case](#)). We anticipate subdued growth in the eurozone: 0.7% for 2019 and 0.9% in 2020.
4. We expect Hungary and Poland to continue their accommodative fiscal stance. Poland announced a fiscal package which should contribute to growth in the coming years.

Looking ahead to the remainder of 2019, we foresee a gradual slowdown of growth from the strong Q1 figures. We have slightly lowered the growth outlook for the Czech Republic from 3% to 2.5% in 2019 and maintain our forecast of 2.5% for 2020. For Hungary we have raised our annual growth forecast from 3% to 4% in 2019 on the back of continuing strong consumption. However, that still means that during the year, Hungary will experience a substantial growth slowdown from the Q1 figure of 5.3% yoy. The country has very little monetary or fiscal room to further stimulate the economy and as EU funds gradually come to a halt, we foresee Q4 2019 growth at around 3%. For 2020, we expect growth to stay around 3%. We have also raised our growth forecast for Poland, from 3.5% to 4% in 2019, due to the announcement of the fiscal stimuli packages and stronger-than-expected Q1 figures. Our 2020 forecast remains unchanged at 3%.

Our main risk to the growth outlook is a further escalation of the trade war. The CEE-3 is very reliant on global value chains, also compared to other EMs. The value of exports as a percentage of GDP may have declined slightly, but it is still substantially higher than

other EMs such as Brazil, Russia and South Africa (see [Emerging Europe Watch: CEE-3 shielded from EM turmoil](#)). Therefore, in a less supportive environment for global trade, CEE-3 will suffer as well, especially if the eurozone – the region’s key export destination – suffers from such trade conflicts.

CEE-3: Key indicators 2018 and 2019 (estimate)

	Inflation (%)		Govt Balance (% GDP)		CA balance (% GDP)		Debt (% GDP)	
	2018	2019	2018	2019	2018	2019	2018	2019
Czech Republic	2.2	2.3	0.9	0.5	0.4	0.2	32.7	31.8
Hungary	2.4	2.9	-2.2	-2.0	0.5	1.8	71.0	69.8
Poland	1.5	2.0	-0.4	-2.4	-0.7	-0.5	48.9	47.8

Source: ABN AMRO Group Economics, Bloomberg.

CEE is facing labour shortages...

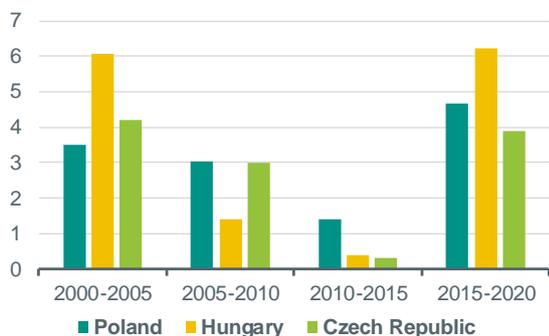
The CEE region is facing increasing labour shortages. According to Eurostat data, the working-age population will decline by around 30% by 2050. Unemployment level in the Czech Republic, which is currently below 2%, is the lowest in the EU-28. In Poland and Hungary, unemployment rates are around 3.5%. In addition, business surveys conducted by the European Commission show the need for more workers in the CEE-3, as many employers flag labour shortages as one of the most pressing constraints for increasing production. Labour shortages are slightly less severe in Poland, partly because of a large inflow of workers from neighbouring Ukraine on work permits that are relatively easy to obtain. It is estimated that currently around 2 million workers from Ukraine are working in Poland.

.... resulting in sharp wage increases

The labour shortages in CEE are mirrored by large wage increases, as firms boost salary bids to continue to attract workers. In 2018, the average real wage growth (% change pa) was around 5.5% in Poland, 6.2% in the Czech Republic and 8% in Hungary.

Catch-up growth in wages in CEE region

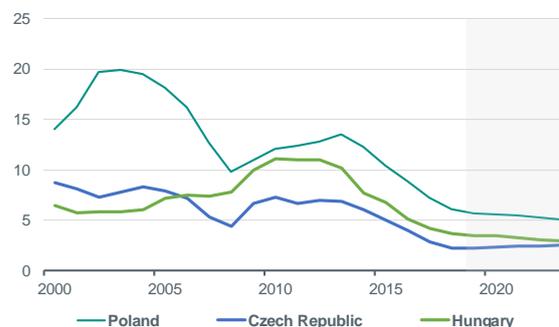
Average real wage growth (% change pa), 2019 and 2020 are forecasts



Source: EIU

Unemployment levels have converged

Unemployment rates (%)



Source: EIU and EIU projections

Inflation is trending upwards

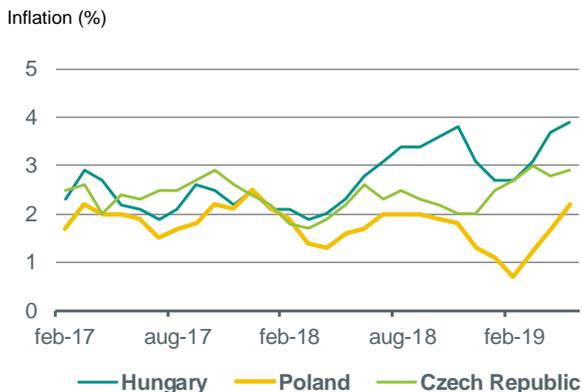
Inflation in the CEE-3 has been on the rise due to brisk wage growth resulting in strong consumption. However, while inflation has been rising in Poland, it has remained below

the 2.5% mid-point of the inflation target band of the National Bank of Poland (NBP) (target is 2.5% with a fluctuation band of +/- 1 percentage point). A number of factors are curbing inflationary pressures. First, wage growth has been mirrored by a surge in productivity growth. Moreover, strong competition in the retail sector and the rise of e-commerce have kept retail prices down. That said, the pick-up in inflation resulting from higher wages may also be somewhat delayed and the strong rise in core inflation points to increasing price pressures. We expect inflation to rise further in the second half of 2019, reaching 3% by year-end.

Meanwhile, Hungary has experienced an inflation run-off. Inflation accelerated from 2.7% in the beginning of 2019 to 3.9% in May. Core inflation also reached 4% in May, suggesting that the inflationary pressures are broad-based. The central bank's most closely watched measure, which strips core inflation of the impact from indirect taxes, accelerated to 3.7%, the highest level in more than a decade. Momentum remains strong as the economy is accelerating and private sector wage growth is one of the highest in the region. Therefore, we expect inflation to remain high, reaching 4% at the end of 2019.

In the Czech Republic, inflation stood at 2.9% in May, on the higher end of the Czech central bank (CNB) tolerance band (2 percent target +/- 1 percentage point tolerance). However, core inflation is substantially lower at around 2% in March and April this year. In addition to higher wages, the recent surge in inflation has been driven by an unexpected growth in food prices, mainly due to a poor harvest. We expect inflation to trend back to around 2.5% at the end of this year.

Inflation has been on the rise



Source: Bloomberg

Core CPI rising in Hungary and Poland



Source: Bloomberg

Central banks will remain accommodative

Our conviction that CEE-3 central banks will keep rates constant has been strengthened by the latest change in our ECB view ([Global Daily](#)). Indeed, we now expect a 20bp rate cut as well as QE. The relatively high inflation rates will prevent CEE-3 central banks from cutting rates further. In Poland, most MPC members have remained dovish and we think we will need to see more sustained higher inflation above 3.5% before the NBP will consider tightening monetary policy. Furthermore, the NBP will be hesitant to hike rates before the elections, which are scheduled to take place in the second half of 2019.

In Hungary, the National Bank of Hungary (NBH) decided in March to tighten monetary conditions by delivering a 10bp hike in the O/N deposit rate to -0.05% (targeted rate managing tool). The NBH is also slowly reducing the outstanding FX swaps, tightening HUF liquidity. Despite the fact that the central bank's measure of inflation will most likely temporarily overshoot the upper target band, we do not expect tightening of the key policy rate. So far, the NBH has been extremely dovish, using liquidity and unconventional measures of monetary policy instead of outright tightening to micromanage the economy. We believe they will continue to do so, as this policy has been largely successful in the past few years.

In the Czech Republic, the CNB decided to lift the two-week repo rate by 25bp (to 2%) on 2 May. The CNB communicated a pause in the gradual tightening that started in 2017 as they see inflation coming down to 2% end-2020 (slightly lower than our forecast of 2.5%). In our base case scenario we also assume rates will remain constant, however the risks are tilted to the upside. If inflation remains at or above the 3% upper-target tolerance band, we think the CNB may deliver another rate hike at the end of this year.

Resilient currencies

The Polish zloty, Hungarian forint and the Czech Koruna have been very resilient since the trade tensions re-escalated. This is because the domestic economy continues to do well despite weakness in the eurozone economy. Moreover, their central banks will be accommodative, but it is unlikely they will ease monetary policy as we expect the ECB to do. However, we anticipate that investor sentiment will remain jittery because of the trade tensions and tensions in the Middle East. Although these countries are not very sensitive to such developments, an overall deterioration in investor sentiment is likely to weigh on these currencies versus the US dollar and the euro. This is reflected in our currency forecasts.

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