Emerging Europe Outlook 2020

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Emerging Europe: Diverging paths

- **Emerging Europe faced substantial headwinds in 2019, but CEE3 was relatively resilient**
- **Further modest slowdown expected for 2020 in CEE3…**
- **.. with little policy room to react to negative surprises**
- **Russia's macro fundamentals improved, but structural issues**
- **Turkey saw some recovery from downturn, helped by accommodative policies…**
- **…but remaining challenges make stability tenuous**

Emerging Europe faced substantial headwinds in 2019, but CEE3 was relatively resilient

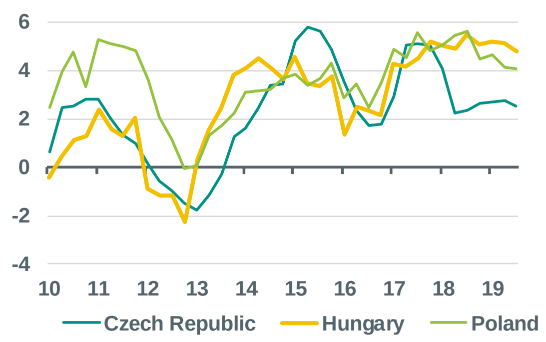
Emerging Europe faced substantial headwinds in 2019 with a sharp slowdown in major economies and global trade growth amid escalating US-China trade/tech tensions. As a result of these headwinds, the Emerging Europe region slowed down in 2019, from 3.1% in 2018 to 1.8% last year. Part of this slowdown was caused by CEE3 countries (Poland, Hungary, and Czech Republic). However, their performance was in fact, surprisingly good, given all three countries export mainly to Germany, a country which more than halved its growth rate in 2019 and where GDP only showed an uptick of 0.6% last year. CEE3 is tightly connected to the euro area via value chains, and through these value chains and via hard-hit Germany, a second order hit to CEE3 exports took place as a result of the trade conflict. But despite these headwinds, and thanks to strong domestic consumption and investment, Hungary still grew 4.8% last year, down only 0.3%p from 2018. Poland also saw robust growth of 4.2% in 2019, and Czech Republic's GDP increased a respectable 2.6%.

Further modest slowdown expected for 2020 in CEE3…

By the end of 2019, however, investment and economic growth started to slow down in CEE3. A continuation of this deterioration, at a modest pace, is expected in 2020. This is in line with our global outlook for "slower for longer" growth, in which growth is lacklustre in the first half, before picking up modestly in 2H. In this global outlook, the coronavirus depresses growth in Q1, while lifting Q2-Q3, with the net impact being modestly negative. We expect Polish real GDP growth in 2020 to stand at around 3.5%, from 4.2% in 2019. Hungary is also combining a slowdown in industrial production and trade with the mitigating effects of previous investments into a modest slowdown.

GDP growth slowing down …

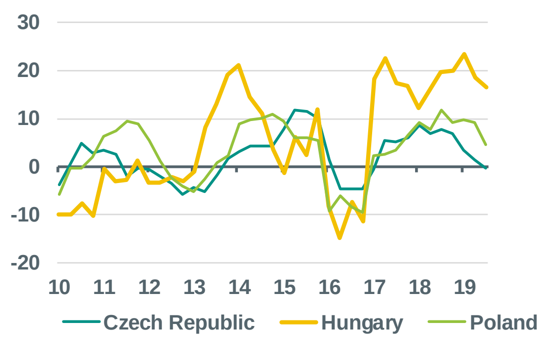
GDP growth % change YoY



Source: EIU, ABN AMRO Group Economics

… as well as investment

Fixed investment, % change YoY



Source: EIU, ABN AMRO Group Economics

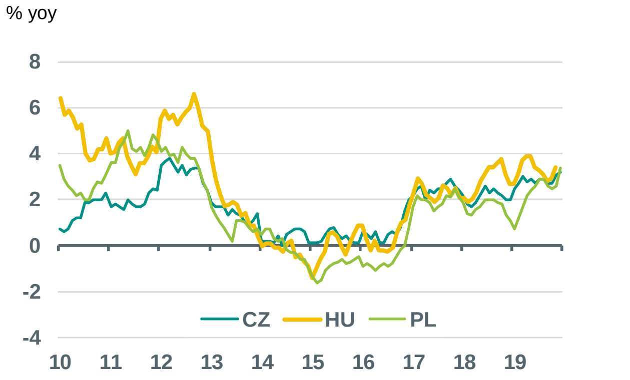
.. with little room to react to negative surprises

There is little policy room for negative surprises. Neither Poland nor Hungary have significant fiscal policy space to counter a deeper than expected downturn. Indeed, Hungary's public debt has surpassed the 60%-of-GDP Maastricht limit for many years now, and the country has been forced to maintain a tight fiscal approach in an effort to reduce imbalances. In Poland, the government has been able to offer generous social spending since 2015 without much strain on the budget thanks to rapid economic growth and by closing tax loopholes. However, this will prove more difficult going forward. As the 2020 presidential elections approach, the ruling PiS will be eager to avoid backtracking on its social spending plans. An additional challenge for Poland are the lower EU fund transfers in the next EU budget pool, which could be a drag on growth and cause a widening fiscal gap. On the positive side, Polish government debt remains low, which gives some leeway in this respect. Czech Republic is in the most favourable position in terms of fiscal space: with the government budget in surplus and government debt low and falling, the country has more room to manoeuvre in case of a larger-than-expected downturn.

Monetary policy in CEE3 has been highly accommodative

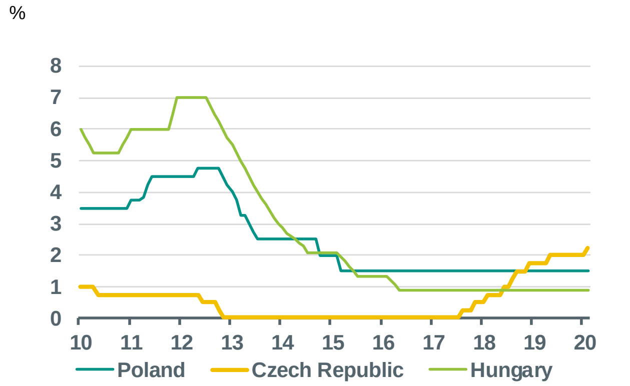
As in the fiscal area, monetary policy is also currently highly accommodative in most of CEE3. As a result, inflation has been increasing. In Hungary inflation came in at 4.7% YoY in January, at a level not seen since the end of 2012, with strong internal demand accelerating price increases. In Poland, inflation has been creeping up towards the end of the year and is expected to accelerate in the current year, with CPI YoY change expected to stand at approx. 2.5% end-20 (against 2.2% end-19). In CEE3, just like in the eurozone, real short term interest rates are negative. This is particularly the case in Hungary and Poland.

Inflation increasing in CEE3…



Source: EIU, ABN AMRO Group Economics

…while policy rates have stayed low in Hungary and Poland



Source: IHS Markit, ABN AMRO Group Economics

The monetary response to the increasing inflation has been slow in CEE3. The Polish MPC has been downplaying inflation risks and signalling it is no hurry to raise interest rates. Also the Hungarian Central Bank has remained dovish, although the latest inflation numbers were accompanied by a pledge of vigilance. As in fiscal policy, the Czech Republic is also the exception in terms of monetary policy: while its Central European counterparts are emphasising growth over inflation, the Czech National Bank has been tightening, most recently on 6 February, when it narrowly voted to raise the policy interest rate to 2.25% as inflation rose above the Central Bank's 1-3% tolerance band.

Russia's macro fundamentals improved, but structural issues

The Russian economy slowed down in 2019, after moderate expansion in 2018. The economy grew 1.3% year-on-year in 2019, following growth of 2.2% in 2018. Weaker external demand, lower oil prices and a stronger rouble since the start of the year negatively affected net exports. Ongoing international sanctions and continuing tight fiscal policy constrained public and private investment, while household consumption growth was sluggish due to declining real wage growth and tax increases. Positively, Russia's macroeconomic fundamentals improved over the last years. Fiscal and current account surpluses have been maintained despite declining oil prices, thanks to conservative macroeconomic policies. Foreign-currency reserves have been increasing. Russia had previously been tightening monetary policy in light of large capital outflows from EMs and subsequent currency instability. However, as these outflows lessened and RUB became more stable, there was room for monetary easing and the CBR has cut its policy rate by a total of 125 bps since June 2019. Lacklustre growth has been improving moderately on the back of policy support, and further fiscal stimulus is planned for the next five years. The oil price has been hit sharply since the beginning of January, shedding around 20% due to the economic and financial impact of the corona virus outbreak. While lower oil prices are obviously negative for Russia, we do expect at least part of this effect to be temporary. In addition, the National Wealth Fund is well-equipped to cushion the blow in case of an external shock.

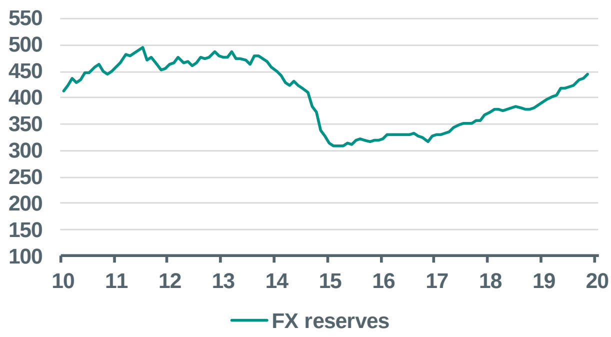
RUB more stable…

RUB per USD

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

… and FX reserves increasing

bn USD



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Improving macro fundamentals, but growth remains lacklustre

Key forecasts for the economy of Russia

	2017	2018	2019e	2020e	2021e
GDP (% yoy)	1.7	2.2	1.3	1.5	2.0
CPI inflation (% yoy)	3.7	2.9	4.5	4.5	4.0
Budget balance (% GDP)	-1.4	2.6	2.5	1.5	1.5
Current account (% GDP)	2.1	6.9	6.0	6.5	6.0

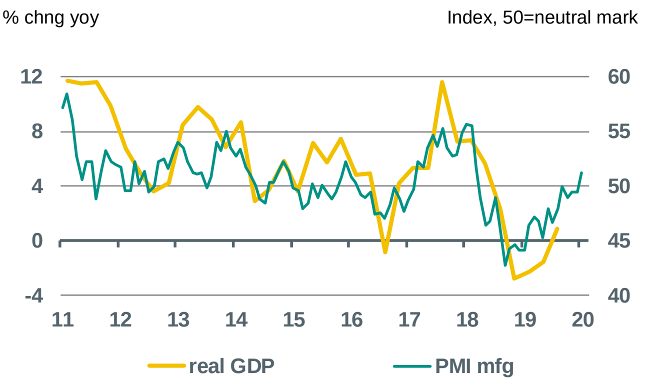
Source: EIU, ABN AMRO Group Economics. Economic growth, budget balance, current account balance for 2020 and 2021 are rounded figures

However, the economy lacks the structural ingredients for a high growth environment. The business climate remains challenging, with an overly large state role in the economy and weakness in the areas of corruption, rule of law, and regulatory quality. As an example, Russia ranks 137 out of 180 ranked countries (1 is best and 180 is worst) for corruption perception in the world (Transparency International Corruption Perception Index 2019). This compares to Turkey (91st place), Hungary (70th), and Czech Republic and Poland (44th and 41th place respectively). There appears to be little incentive from the authorities for market-oriented reforms, due to opposition from vested interests. The resignation of PM Medvedev's administration and instalment of a new government led by PM Mishuskin serve to illustrate that the power of Mr Putin, whether he is president, like now, or in any other role, is absolute and this will remain the case for the foreseeable future. In addition, there is the continuing negative impact on growth of sanctions imposed by the EU and USA, while exports are likely to be held back by the weaker global trade environment. China is Russia's largest export destination. Given the above, economic activity is expected to remain relatively weak as well as resource dependent.

Turkey saw some recovery from downturn, helped by accommodative policies…

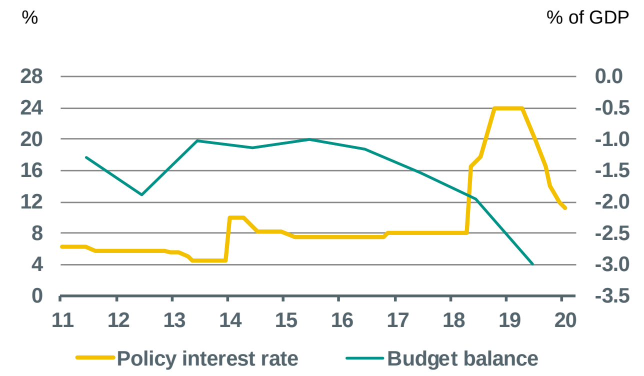
Turkey's economy contracted for three straight quarters from late 2018 but returned to a modest growth rate in the third quarter of last year, as the economy started recovering from earlier financial pressures. Inflation, which had risen to double digits due to the sharp lira fall, started to decrease slowly. The gradual improvement in domestic demand is supported by accommodative monetary policies. While the authorities were forced to tighten monetary policy previously due to political issues, capital outflows and currency instability, aggressive interest rate cuts (to stimulate domestic demand) were implemented under a newly installed central bank governor. Fiscal policies have become pro-growth as well, as waning popularity of the Erdogan administration gave the authorities an incentive for fiscal stimulus. The budget deficit increased to 3% of GDP in 2019, up from 2% in the previous year. These pro-growth policies should have ended economic losses in the fourth quarter of 2019, and the subsequent growth throughout 2020 could continue on condition that further financial market turbulence is averted. The country has become somewhat less vulnerable to market sentiment due to the dramatic improvement in the current account. Weak domestic demand has significantly cut merchandise and service imports, as a result balancing the current account, which was previously in substantial deficit. Given efforts to stimulate domestic demand, the current account will likely slip back into a slight deficit in 2020, but still the improvement in external deficit is quite dramatic and implies a decrease in dependence on capital flows from abroad.

Recovery from downturn ….



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

... helped by accomodative policies…



Source: Bloomberg, EIU, ABN AMRO Group Economics

…but remaining challenges keep stability tenuous

Despite the current account improvement, however, dependence on capital from abroad and sensitivity to international capital flows remains high due to the high external debt and external debt service burden. The external debt burden is concentrated in the private (banking and corporate) sector, making them vulnerable to lira depreciation. Non-performing loans in the banking sector jumped to 5.3% in 2019, from 3.9% the year previously, after the sharp lira depreciation in 2018 left companies unable to service their foreign-currency debt. Combined with pressure from the government to spur economic activity by lending more, this poses a challenging climate for the banking sector.

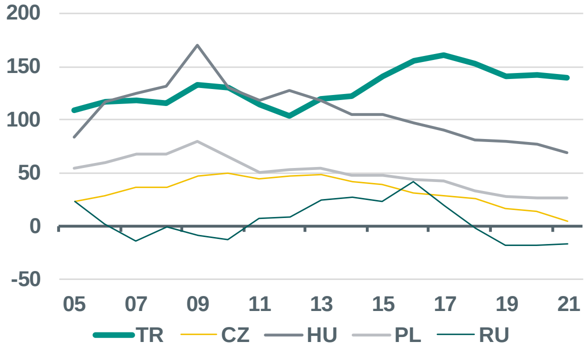
TRY currency more stable since currency crisis

TRY per USD

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

External debt burden high

% yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

The struggle in the coming period will be how to keep the lira stable and recapture capital inflows while sticking to the latest two-year plan which includes high economic growth, low inflation, tightening fiscal policy, and low interest rates. Further complicating this is the risk of sanctions by US and EU as a result of Turkey's buying weapon and defence systems from Russia, and as a result of Turkey's Northeast Syrian offensive. But even before the strain of potential international sanctions and lingering security concerns, the economic plan was difficult to reconcile. The outlook for gradual improvement in domestic demand supporting growth assumes that stability is maintained.

To conclude

After a year of slower growth across the region, we expect paths in Emerging Europe to diverge in 2020. CEE3 is expected to slow down modestly this year. Russia's macroeconomic fundamentals have improved but growth remains lacklustre. Turkey is recovering from earlier financial shocks, but stability is tenuous.

CEE3: economic growth (forecasts)

	Q4-18	Q1-19	Q2-19	Q3-19	2018	2019	2020	2021
Czech Republic	2.7	2.7	2.7	2.5	2.9	2.6	2.5	2.5
Hungary	5.1	5.2	5.2	4.8	5.1	4.8	3.0	2.5
Poland	4.5	4.7	4.1	4.1	5.1	4.2	3.5	3.5
Turkey	-2.5	-2.4	-1.7	1.0	3.0	0.1	4.0	3.5
Russia	2.9	0.5	0.8	1.8	2.2	1.3	1.5	1.5
Regional average	-	-	-	-	3.1	1.7	2.6	2.6

Source: EIU, ABN AMRO Group Economics. *Regional average includes, besides the countries mentioned in this report, Belarus, Bulgaria, Croatia, Kazakhstan, Romania, Slovak Republic, Slovenia, and Ukraine*

Main economic indicators/forecasts

GDP growth (%)	2018	2019e	2020e	2021e	Inflation (%)	2018	2019e	2020e	2021e
Emerging Asia	6,1	5,2	5,1	5,5	Emerging Asia	2,6	3,1	3,1	2,8
Emerging Europe	3,1	1,8	2,6	2,8	Emerging Europe	6,4	6,8	5,5	4,9
Latin America	0,9	-0,4	1,4	2,3	Latin America**	7,3	9,2	7,9	6,2
Emerging markets total	**4,5**	**3,5**	**4,0**	**4,4**	**Emerging markets total**	**4,3**	**5,1**	**4,7**	**3,8**
Eurozone	1,9	1,2	0,8	1,3	Eurozone	1,8	1,2	1,0	1,0
US	2,9	2,2	1,3	2,0	US	2,4	1,8	1,9	1,9

Budget balance (%GDP)	2018	2019e	2020e	2021e	Current account (%GDP)	2018	2019e	2020e	2021e
Emerging Asia	-3,4	-3,8	-4,0	-3,5	Emerging Asia	0,2	0,8	0,6	0,5
Emerging Europe	0,4	-0,3	-0,5	-0,5	Emerging Europe	1,5	2,3	2,0	1,5
Latin America	-4,9	-4,7	-4,5	-3,5	Latin America	-2,4	-1,8	-2,0	-2,0
Eurozone	-0,5	-1,1	-1,3	-1,4	Eurozone	3,8	3,3	3,2	3,1
US	-4,2	-4,5	-4,6	-4,6	US	-2,4	-2,5	-2,6	-2,5

Source: EIU, ABN AMRO Group Economics ** figures Emerging Markets regions are rounded*

***Inflation Latin America and World without Venezuela*