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Autumn is coming

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- **We expect a substantial slowdown in Emerging Europe, mainly driven by a recession in Turkey...**
- **... and we anticipate a marginal slowdown in growth for the CEE region from 2018, along with a 'muddling through' scenario for both Ukraine and Russia.**
- **Inflation will remain largely in check and monetary policy therefore accommodative.**
- **Both Poland and Romania must watch their public finances in light of the Excessive Deficit Procedure.**
- **The relationship between the European Union, Hungary and Poland remains problematic, although we expect a more constructive attitude from Emerging European states in light of the new EU funding round.**
- **Brexit will have little impact on Emerging Europe.**

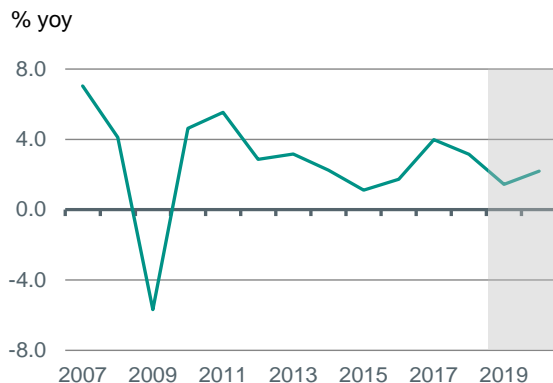
Regional growth in Emerging Europe slowed in 2018, but with strong divergence

After a strong 2017, growth in Emerging Europe¹ slowed somewhat in 2018, although with strong divergence between countries and subregions. Our regional GDP-weighted growth index dropped from 4% in 2017 to 3.2% in 2018. This was led by a slowdown across many Emerging Europe economies. Most visible was the setback in Romania and Turkey, as these economies grew far above potential in 2017. Most CEE economies² saw a loss in momentum in the third quarter of 2018 as weaker external demand, mainly reflecting a cooling of eurozone growth, pushed growth lower. The fallout from a rise in risk aversion, driven by tighter US monetary policy and escalating trade tensions, also played a role. That said, strong domestic demand partly offset these external factors. In the CEE region, private consumption was the main growth driver, underpinned by rising real wages and positive consumer sentiment. Investment remained strong, on the back of a high absorption of EU funds and brisk construction activity. Russia continued its moderate growth path with around 2% growth in 2018 (see: [Russia outlook 2019: Muddling through](#)) on the back of oil price gains. Ukraine experienced further recovery, after a deep recession in 2014-15, and posted growth figures around the long-term trend. Turkey faced difficulties throughout 2018. In the third quarter, growth dropped significantly due to external vulnerabilities and a sharp depreciation of the lira (see: [Turkey Outlook 2019: Facing contraction](#)).

¹ The Emerging Europe region includes: Belarus, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Slovenia, Turkey and Ukraine.

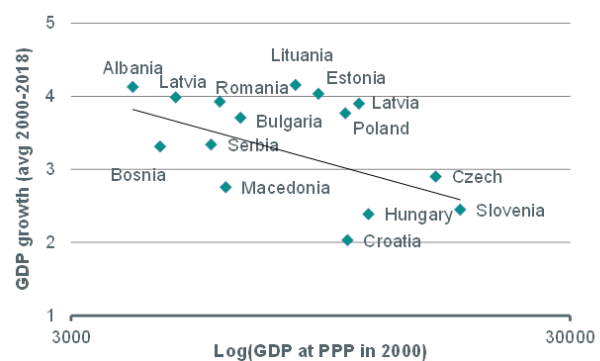
² The CEE region includes: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.

Cyclical slowdown trend in CEE region



Source: ABN AMRO Group Economics, EIU

Signs of economic convergence in CEE



Source: Bloomberg, ABN AMRO Group Economics

Economic outlook for the CEE region looks fairly bright...

Going forward, we expect growth figures for the CEE region to slow further. After a period of almost two years of growth above long-term potential, a cyclical downturn has set in.

- External environment less favourable

A less favourable external environment (see [Global Outlook 2019](#)) and our below-consensus forecast for growth in the eurozone (see [Eurozone outlook 2019](#)) will continue to dampen growth prospects for the region. Countries that are strongly integrated into regional production chains, such as Hungary and the Czech Republic, will be particularly hard hit. The forecast recession in Turkey will also add to the less favourable external environment. That said, the continuation of the trade war between China and the US is expected to only have a small impact on Emerging Europe. Trade ties with both China and the US are not significant (see: [Emerging Europe Watch - Shielded from EM turmoil](#)).

- Consumption will remain strong, slightly below 2018 levels

Low unemployment resulting in increasing wages will continue to push consumption higher, but to a lesser degree than last year. In some countries, inflation has started to take off, reducing disposable income. Moreover, in several countries (in particular Hungary and Romania), there is less room for an increase in public spending. In Poland, however, we expect consumption to be dampened by fading stimuli from earlier measures, the partial wage freeze in the public sector and higher inflation (see: [Poland Watch: Steady growth, but for how long?](#)).

- Solid investments, except for Hungary

In general, the continuation of EU funding and still-cheap borrowing costs will feed into stronger investments in 2019, partly offsetting the weaker external dynamics. Hungary is somewhat the exception to this, as the use of EU funds is set to slow given that the government already pre-financed most of the projects in the current programme period. However, this negative dynamic is partly offset by new instruments for lending to SMEs in combination with new investments in the auto industry.

All in all, while we expect a slowdown of growth in the CEE region from the high levels seen in the last years but anticipate it will still be around the long-term trend in 2019-20.

... but the story is different for Russia, Ukraine and Turkey

For Turkey, we expect a fairly pronounced recession, with three quarters of negative growth. High interest rates, in combination with high levels of inflation, will continue to slow consumption. We forecast a contraction of 1.5% in 2019 and anticipate only a modest recovery in 2020 of 2.5%. For Ukraine we foresee a moderate slowdown in growth to 3% in 2019 due to tighter monetary conditions and a recent hike in gas tariffs. We expect Russia to remain on course for expansion, but at a slow pace of around 1.5% for 2019/2020. This reflects a weak external environment due to international sanctions in combination with domestic and structural issues.

Emerging Europe: Economic growth (forecasts)							
% yoy	Q1-18	Q2-18	Q3-18	2017	2018	2019**	2020**
Bulgaria	3.5	3.4	3.1	3.3	3.8	3.0	2.5
Croatia	2.5	2.9	2.8	2.8	2.9	2.5	2.5
Czech Rep	4.1	2.4	2.3	3.5	4.5	3.0	2.5
Hungary	4.5	4.9	4.8	4.7	4.3	2.5	2.0
Poland	5.3	5.1	5.1	5.0	4.8	3.5	3.0
Romania	4.0	4.1	4.3	4.5	7.0	4.0	3.5
Russia	1.3	1.9	1.5	2.0	1.5	1.5	1.5
Slovakia	3.7	4.5	4.6	4.3	3.2	4.0	3.0
Slovenia	4.7	4.0	4.8	4.4	5.3	3.5	2.5
Turkey	7.2	5.3	1.6	3.5	7.3	-1.5	2.5
Ukraine	3.1	3.8	2.8	3.3	2.5	3.0	2.0
Regional average				1.7	4.0	3.1	1.4

Source: ABN AMRO Group Economics, Bloomberg, EIU

* Estimates 2017 (can be due to revision). ** Forecasts 2018-19 rounded

Inflationary pressures slowly built in 2018...

In 2018, regional inflation in CEE economies amounted to 2.5% on an annual basis. Rising wages only had a limited effect on inflation, because of higher saving rates and a large outflow of remittances from countries like Poland and the Czech Republic, which have a fair amount of immigrant workers from poorer Eastern European states. That said, in recent months we have seen a slight uptick in inflation, mainly because local currencies came under pressure during the emerging market turmoil in late 2018. Russia managed to lower inflation below its target of 4% for a large part of the year. Due to base effects in combination with broader price pressures, inflation broke through the target in December. In the beginning of 2018, Ukraine managed to bring inflation down from a high level of 14% yoy to around 9% in mid-2018. However, as the emerging market turmoil took hold and the hryvnia weakened against the US dollar, inflation went up in the latter half of the year to around 10% yoy end-2018. Meanwhile, Turkey faced high inflationary pressures from the sharp depreciation of the lira in August, with a peak of almost 26% yoy in October.

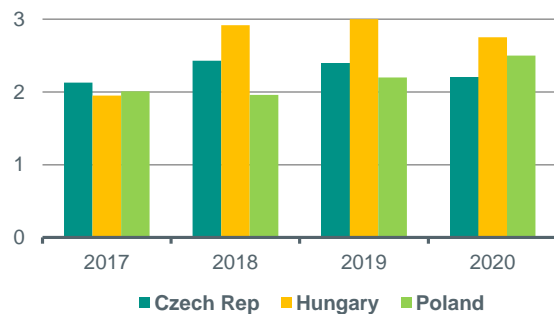
...but we do not expect an inflation run-off in 2019

For 2019/2020, we expect inflation to increase slightly in the CEE region - remaining around or slightly above many of the central bank's targets. We anticipate that Hungary will face stronger inflationary pressures. Inflation there has been gradually building up, from a low of 2% yoy at the

beginning of the year to a peak of 3.8% in October. The reluctance of the Hungarian central bank to raise rates while inflation breached its 3% target is feeding higher inflation expectations. We expect inflation in Russia to peak in the first half of 2019 at around 6% yoy before coming down to 4.5% in the second half of 2019. In Ukraine, on the back of the recent monetary tightening, inflation is expected to come down to around 8% in 2019-20. In Turkey we foresee inflation staying around 21% yoy until mid-2019, before easing to around 12% at the end of 2019 and 8% in 2020.

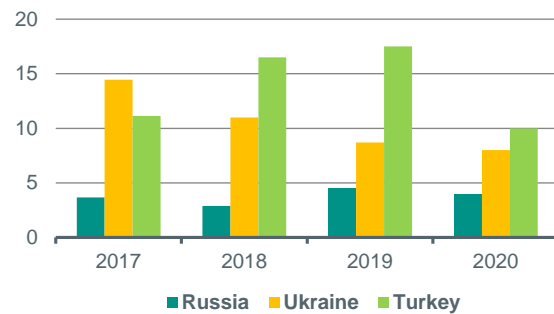
Hungary should keep a close watch on inflation

% yoy,



Source: ABN AMRO Group Economics, EIU

Turkey faces high inflation



Source: Bloomberg, ABN AMRO Group Economics

Monetary policy has remained accommodative in the CEE region...

In 2018, monetary conditions continued to be very accommodative in the CEE region. Only a handful of central banks have begun to unwind their accommodative positions. The Czech Republic raised interest rates several times in 2018, from 0.5% to a current level of 1.75%. Romania increased rates at the beginning of 2018 from a low level of 1.75% to 2.5% but has since kept rates constant. Poland and Hungary, on the other hand, have held rates steady. Facing external pressures and higher inflation, Ukraine, Turkey and Russia have been forced to increase rates in the second half of 2018. The Turkish Central Bank in particular had to implement strong tightening in order to curb the freefall of the lira; interest rates there have been at 24% since September. Although pressure on the rouble has been relatively mild, the Russian central bank has taken decisive action by increasing rates while markets expected them to hold. The National Bank of Ukraine undertook several interventions and hiked rates to 18%, thereby stabilizing the situation in the foreign exchange market.

... and will remain accommodative going forward

For 2019 we expect monetary conditions to remain relatively accommodative in the CEE region. We do not foresee runaway inflation and, given the weaker economic outlook, we anticipate central banks will hold rates in 2019. The ECB will not put pressure on Emerging Europe to increase rates, as we do not expect the ECB to start tightening until March 2020. Given the subdued macro environment, we think the risks are skewed towards even later rate hikes. Only when the ECB clearly signals a hike will some Emerging European countries consider following.

Two countries stand out in this context: Hungary and Romania. We expect that in the course of 2019, inflation will test the upper limits of the tolerance band of 3.5% in both countries. That said, both the Hungarian and Romanian central banks have clearly stated that they will only consider a rate hike if there is clear evidence of sustained above-target inflation. Apart from that, the Romanian central bank will first resort to using liquidity conditions via FX interventions and repos to temper

inflation, instead of using the interest rate mechanism. Therefore, we also expect these countries to hold rates constant.

Nor do we expect the Russian central bank to hike rates further in 2019. Our base case scenario is an unchanged rate at 7.75%, at least until the fourth quarter of 2019, and we may see a 25bp cut in that last quarter. In the case of Turkey, we foresee a gradual monetary loosening for 2019, but not until the second half. In Ukraine, as inflation has started to come back down from the high levels in mid-2018, we also expect some loosening from the current level of 18% to 15.5% end-2019.

Currencies to perform well

We anticipate that the Central and Eastern European currencies will outperform the US dollar, and in some cases the euro, in 2019 and 2020. In addition, the recovery in oil prices anticipated by our oil analyst should support the Russian rouble as well as less stringent sanctions. Moreover, we expect weaker US fundamentals and lower Treasury yields to weigh on the US dollar across the board, including versus EM FX. Last but not least, we foresee relatively constructive investor sentiment, especially towards Emerging Europe, which should support the local currencies.

Poland, Romania and, to a lesser extent Turkey, need to consolidate their public finances

For Poland and Romania, the European Commission's Excessive Debt Procedure (EDP) is looming. As both countries exited the EDP procedure only a few years ago, their budget deficits are close to the Maastricht criteria of 3% of GDP. According to the EIU, Romania's budget may even surpass the 3% level in 2019. We assume that the governments want to avoid being subject to the EDP once again and will take appropriate measures to limit the deficits to below 3%.

Both Turkey and Russia have relatively low government debts. Ukraine, on the other hand, has one of the highest government debt levels in the Emerging Europe region, although under the IMF programme it has come down substantially from 81% in 2016 to a current level below 60%. Furthermore, the IMF approved a USD 3.9bn 14-month stand-by agreement for Ukraine in December, which mitigates risks.

In August, Bulgaria adopted a detailed action plan for joining the ERM II mechanism (which precedes euro adoption) and the Banking Union. Bulgaria will be able to enter the eurozone in 2020, at the earliest, if it gains ECB approval for entering ERM II in mid-2019. Bulgaria currently adheres to the most important Maastricht criteria as the government debt-to-GDP ratio is relatively low (24%) and the government balance is in surplus (0.5%).

When play the political game of the European Union, you win or lose

Tensions have heightened between the EU and its Eastern member states due to the recent drift of Hungary, Poland and Romania from democratic norms and rule of law, together with quarrels over refugee and migrant policies. The European Commission chose a more confrontational approach last year, triggering Article 7 not only for Poland but for Hungary. Moreover, the Commission took a tougher stance on Romania, accusing it of undermining the fight against corruption. Poland has backtracked some of the judicial reforms that sparked concerns in Brussels. That said, it is not clear whether this backtracking has occurred as a result of pressures from the EU or domestic politics. This occurred just after the local elections and is likely a strategy by the incumbent party (PiS) to fend off attacks from the opposition as parliamentary elections are just around the corner.

We expect the European Commission to maintain a tougher stance towards the Eastern European states in 2019. With the start of the negotiations on the EU Cohesion Funds for 2021, we think the Eastern European states will show a more constructive attitude as they want to maintain the level of funding for the coming years. The EU is still widely popular among the population in Emerging Europe, and we do not expect any serious debate involving states wanting to leave the Union. That said, a major escalation between Poland and/or Hungary and the Commission could potentially lead to a loss of EU voting rights for the countries as well as sanctions and, in a worst case, a voluntarily or forced withdrawal from the EU treaty.

Main risks

While our base scenario only foresees a gradual slowdown of growth in 2019/2020, several risks to this outlook remain:

- **Flare-up of conflict in Eastern Ukraine.** There is a risk that the conflict will further escalate if big (military) incidents occur. This could take place in the Donbass region or, as we have seen in 2018, in the Black Sea region. This would cause the already fragile peace talks to fall apart and perhaps require international organisations such as the UN to interfere more directly in the conflict.
- **Illiberalism and (geo)political tensions with the EU.** The resurgence of authoritarianism and illiberalism in Emerging Europe, specifically in Russia and Turkey but also in Poland, Hungary and Romania, could threaten investor confidence in the region.
- **More US sanctions on Russia under the current framework, or the implementation of new sanction frameworks.** The unpredictability of further US sanctions on Russia continues to dampen investor confidence. Currently, markets expect a mild second phase of penalties, such as further restrictions on specific individuals and companies. However, more severe sanctions, such as cutting off trade or targeting sovereign debt and Russian state banks, could trigger a major shock.
- **Banking scandals.** Allegations of large-scale money laundering through the Estonian branch of Danske in 2018 point toward deeper challenges in the region's banking regulation and supervision sphere.
- **Brexit.** Uncertainty about the final outcome of Brexit is still high (see Global Daily: [What comes after the Brexit vote](#)). In trade terms, the links between Emerging Europe and the UK are small. Exports to the UK as a percentage of total Emerging Europe exports averaged around 4% in 2017. Poland is the largest trading partner, with 6.4% of total exports going to the UK, whereas Slovenia is the smallest trading partner with 2.7% of total exports going to the UK. However, this does not take into account the indirect effects on intra-EU trade as major trading countries such as Germany and the Netherlands may experience a slowdown of their exports to the UK. Furthermore, UK transfers to the EU budget will be impacted by Brexit. It is estimated that the UK attributes around EUR 15bn annually to the EU budget. Unless other member states increase their contributions, Brexit will lead to an estimated 10%-15% decline in funds available for CEE countries.

Main economic indicators/forecasts

GDP growth (%)	2017	2018e	2019e	2020e	Inflation (%)	2017	2018e	2019e	2020e
Emerging Asia	6.2	6.2	6.0	5.8	Emerging Asia	2.3	2.7	3.2	3.2
Emerging Europe	4.0	3.1	1.4	2.2	Emerging Europe	5.4	6.3	7.2	5.3
Latin America	1.0	0.8	1.9	2.4	Latin America**	7.0	7.5	8.1	5.6
Emerging markets total	4.8	4.5	4.4	4.5	Emerging markets total	3.9	4.6	5.5	4.3
Eurozone	2.5	1.8	1.1	1.3	Eurozone	1.5	1.7	1.0	1.3
US	2.3	3.0	2.7	1.7	US	2.1	2.4	1.6	2.0
World	3.8	3.6	3.4	3.3	World	3.0	3.6	3.9	3.3
Budget balance (% GDP)	2017	2018e	2019e	2020e	Current account (% GDP)	2017	2018e	2019e	2020e
Emerging Asia	-3.2	-3.4	-3.5	-3.5	Emerging Asia	1.3	0.3	0.0	0.0
Emerging Europe	-1.3	-0.3	-1.0	-1.0	Emerging Europe	-0.4	0.9	1.0	0.5
Latin America	-5.4	-5.1	-4.0	-4.0	Latin America	-1.5	-1.9	-2.0	-2.0
Eurozone	-1.0	-0.7	-1.2	-1.4	Eurozone	4.0	3.6	3.3	3.2
US	-3.5	-4.1	-5.2	-5.0	US	-2.6	-2.4	-3.0	-3.0

Source: EIU, ABN AMRO Group Economics

* figures Emerging Markets regions are rounded

**Inflation Latin America and World without Venezuela

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