Emerging Europe Watch

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Resilience to a global slowdown?

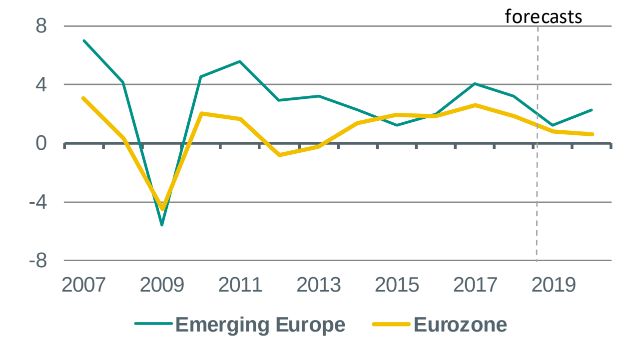
- **Growth for the CEE-3 is strong, not so for Russia and Turkey**
- **CEE-3 is vulnerable to a reversal of FDI-flows, Turkey for shifts in portfolio flows**
- **The direct impact of the US-China trade war for the region is low…**
- **… but indirect effects via eurozone imports can be substantial**
- **CEE-3 has little room for monetary stimulus; Russia and Turkey will continue easing**
- **Czech Republic and Russia still have ample room for fiscal support**

As the global cycle turns…

The relatively buoyant global economic upturn that we have seen in 2017 and the beginning of 2018 has come to an end. The downturn is reinforced by (geo)political and economic issues such as the trade war and the Brexit. The eurozone reported very weak Q2 growth figures as growth fell to 0.2% qoq compared to 0.4% qoq in the first quarter of this year. The slowdown will continue to be led by manufacturing, but increasingly, the manufacturing slowdown will begin to infect other parts of the economy. Already there are signs of this, with investment turning negative in the US and likely to do so in the eurozone, and jobs growth slowing in both economies. As a result of this, we are below consensus in expecting growth of just 0.6% next year in the eurozone (consensus: 1.1%), and 1.3% in the US (consensus: 1.8%) (Macro Weekly - Growth concerns mount, despite tariff delay). We also changed our central bank views and expect even more easing in the US and the eurozone. In this publication we assess the fallout from the turn of the global cycle for the biggest Eastern European economies (CEE-3, Russia and Turkey).

Growth in 2019 dragged down by Turkey

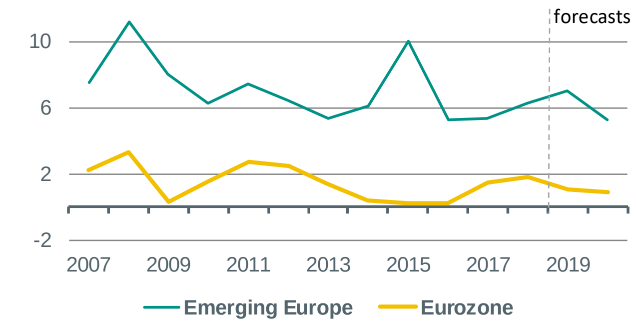
Economic growth, % yoy



Source: EIU and ABN AMRO projections

Inflation differential with eurozone substantial

CPI, % yoy



Source: EIU and ABN AMRO projections

Growth fundamentals for CEE-3 strong…,

The growth fundamentals for the CEE-3 are much better than for Turkey and Russia. Economic growth in the first half of 2019 has surprised to the upside in the CEE-3 countries. For Poland, while the growth rate has come down from levels above 5% yoy in 2018, the economy still grew by around 4.5% in the first half of 2019. For Hungary, Q1 saw a surprisingly high growth rate of 5.3% yoy, and in the first half of 2019 growth remained around 5%. In the Czech Republic, growth rates are less impressive, around 3% yoy in the first half of 2019. While Germany – the main export partner for CEE-3 – showed subdued growth rates, the region remained surprisingly strong (see for more information CEE-3 Watch: Robust but not immune to global slowdown). Rising wages steadily boosted the role of consumption, making the region less dependent on exports and therefore better protected against a global slowdown.

… while Russia and Turkey battle with low growth environments

While Russia's macroeconomic fundamentals improved over the last years (lower inflation, build-up of FX reserves and a more stable currency), growth remains lacklustre because of structural issues. In the first half of 2019, the economy grew by a disappointing 0.7% yoy. Turkey's economy is still in the doldrums, the economy declined by almost 2% yoy in the first half of 2019, although qoq growth has been positive (1.6% in Q1 and 1.2% in Q2). We only expect a very modest recovery from the current low levels (see for more information Turkey Watch: Rate cut recovery and rivalry). As CEE-3 growth rates are still strong, a negative shock will not immediately result into a recession, as will be the case in Russia and Turkey.

Emerging Europe: Key Indicators

	GDP growth 2018	GDP growth 2019*	Inward FDI as % GDP	Stock inward FDI % of GDP	Export % GDP	Terms of trade	REER ***	Fin. Requirement
Czech	2.9	2.5	3.5	74.9	47%	106.2	98.5	-22.8
Hungary	5.0	4.0	4.3	138.5	40%	90.1	88.1	-52.5
Poland	4.0	4.0	2.1	46.3	21%	111.5	90.2	-22.4
Russia	1.3	1.0	0.5	30.2	11%	164.7	86.6	64.2
Turkey	2.8	-1.5	1.7	25.3	7%	90.2	62.3	-83.3

2018 figures, unless stated otherwise * ABN AMRO forecast ** Export figures in volume terms *** figures from end-of-August 2019, Index 2010=100

Source: EIU, Bloomberg, ABN AMRO Group Economics estimates

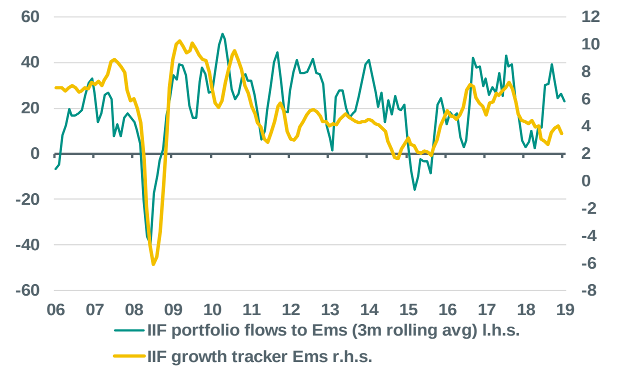
CEE-3 most dependent on FDI flows…

Normally in periods of global slowdown, FDI and portfolio flows from DMs to EMs drop or even reverse. The capacity of companies to invest weakens, as credit tightens and balance sheets deteriorate. Moreover, investors take a more cautious approach in times of global slowdown (risk-off), shying away from the more risky EMs. As you can see in the table above, especially the CEE-3 countries rely on FDI flows from abroad. The inward FDI as % of GDP in Russia is low – mainly because of the 2014 sanction framework which prohibits many Western investors to invest in Russia. Czech Republic and Hungary stand out as most vulnerable to a reversal of FDI flows, also given their high percentages of FDI stock as percentage of GDP. Hungary has a large gross external debt compared to other CEE-countries (around 86% of GDP according to the EC, albeit on a declining trend).

… Turkey remains sensitive to a withdrawal of portfolio flows

Also portfolio flows move in conjunction with risk preferences, but behave more volatile than FDI flows as they are easier to withdraw. A 'sudden stop' of portfolio flows can create external payment issues, especially for countries who are dependent on portfolio flows to finance their (large) current account deficit such as Turkey. This happened in August/September last year, when the Fed decided to tighten monetary policy and the US-China trade war escalated: a sudden reversal of portfolio flows nearly caused a balance of payments crisis in Turkey. However, the recent shift by the Fed and ECB towards easing, should be positive for portfolio flows to EMs (EM Watch: Less vulnerable but not immune). Therefore, while Turkey remains vulnerable for a shift in investor sentiment, we do not expect a repetition of the stark outflows in the Q3 and Q4 of last year.

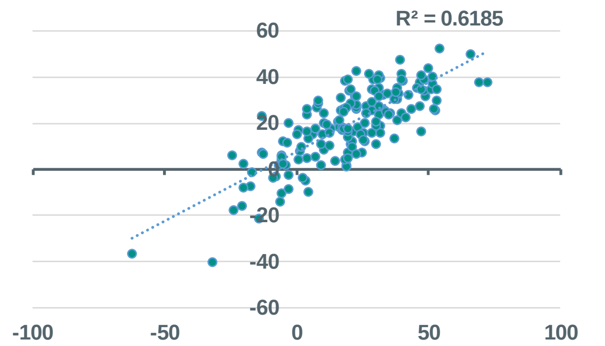
Portfolio flows to EMs move with the cycle



Source: IIF

Strong correlation port. flows and GDP

Pearson correlation (GDP growth and portfolio flows with lag of 1 month)



Source: IIF and Bloomberg, own calculations

Eastern Europe relatively shielded for an escalation of the trade war…

The combination of higher import tariffs and weaker import demand in the rest of the world is also affecting Eastern Europe. That said, the region has relatively low direct exports to China compared to other EMs in South-East Asia and LatAm. In 2018, Russia exported around 3.5% of its GDP to China, Hungary around 2.7% and Czech around 1.8%. Both Turkey and Poland export around 0.5% of their GDP to China and are therefore less sensitive to a cooling-off of the Chinese economy. Also, the direct exposure to the US is low. Around 1.5% of total exports for Russia, Turkey and

Poland is destined for the US. The Czech Republic exports around 2% of GDP to US and Hungary around 3.2%.

… but the drag in global trade does affect the region

That said, trade effects can also appear indirectly, as Germany – the most important export partner for many Eastern European countries – is being hit by the drag in global trade. Especially the CEE-3 is very reliant on global value chains, also compared to other EMs. As seen from the table above, the volume of good exports as percentage of GDP is around 47% for Czech Republic, 40% for Hungary and 21% for Poland. This is substantially higher than Russia and Turkey (11% and 7% respectively). Therefore, in a less supportive environment for global trade, CEE-3 will suffer, especially if the demand from the eurozone remains weak. More specifically, Hungary is sensitive to such a scenario as their export capacities are most concentrated in cyclically sensitive sectors such as chemicals, car manufacturing and transport. Moreover, while Russia's total exports as % of GDP is low, its exports are mainly focused in the oil and gas sector which tends to be pro-cyclical. That said, our energy economist has a flat forecast for oil prices until the end of year (USD 60/bbl for Brent) and even a slightly higher forecast end-2020 (USD 70/bbl for Brent). The trade war itself will presumably have little impact on the oil and gas trade, or may even be positive as Russia profits from the 5% tariff that China imposed on US crude oil.

Further room for stimulus?

	Keyr rate	Inflation*	Real interest rates	Budget balance % GDP	Budget balance % GDP avg 2016-2018	Public debt (% of GDP)
Czech	2.0	2.8	-0.8	0.9	1.1	32.5
Hungary	0.9	3.4	-2.5	-2.2	-2.0	71.0
Poland	1.5	2.0	-0.5	-0.4	-1.4	48.9
Russia	7.3	5.0	2.3	2.6	0.7	10.3
Turkey	19.8	18.6	1.2	-2.0	-1.6	28.9

* average over 2019

Source: EIU, Bloomberg, ABN AMRO Group Economics estimates

On the monetary front, the CEE-3 has little room for monetary stimulus…

When dark clouds gather, the umbrella's come out. We expect the Fed to cut rates further (25bp in the three remaining FOMC meetings this year). Also, we expect the ECB to cut all its policy rates by 10bp at the September meeting, followed by another 10bp step at the December meeting. Moreover, we expect the ECB to announce a EUR 70bn per month programme running for a year from October 2019 onwards. But do central banks in Emerging Europe have room to cut rates as well?

In all CEE-3 countries inflation has been close to the upper limit of the tolerance bands of the central bank. Yet, given the global slowdown, accompanied by disinflationary pressures, we do not expect inflation to structurally overshoot the targets, making tightening by central banks unlikely. As shown in the table above, real interest rates are negative in all CEE-3 countries. We expect key rates in the CEE-3 to stay constant until end-2020. We do think Hungary will continue to employ liquidity and unconventional measures of monetary policy to micromanage the economy. While it is not our base scenario, if the global slowdown is stronger than we expected and the undercurrent of global disinflationary pressures increases, also

CEE-3 may follow suit and lower interest rates accordingly. This implies that the scenario of easing has a larger probability than that of tightening.

… but Russia and Turkey are on an easing trajectory
In Russia and Turkey, over the past years, a mix of dollar tightening and idiosyncratic challenges (e.g., sanctions in Russia, political issues in Turkey) led central banks to tighten monetary policy in order to control inflation. Russia, for example, even tightened monetary policy last year in the light of the large capital outflows from EMs and the subsequent currency instability (Taper Tantrum 2.0). The Turkish central bank was forced to take bold action in the face of the sharp portfolio outflows in the second half of last year. However, today the impediments to easing have diminished and both countries are on an easing track. Going forward, we think the Turkish central bank will further cut rates by another 425bp this year (for more background on our view: Turkey Watch: Rate cut recovery and rivalry). This would bring the interest rate to 15.5% at the end of the year. While this sharp easing is growth positive, it could potentially backfire as investors may feel it is too much, too soon, turning sentiment negative again. For Russia, we expect a gradual easing trend, with a 25bp cut this Friday and another 25bp before the end of this year (bringing rates to 6.75%). In other words, Russia and Turkey have much more room to ease rates and therefore to stimulate the economy.

On the fiscal side, Poland has fired its guns and the Czech Republic and Russia still have ample fiscal room…
As seen in the table above, especially Czech Republic and Russia show strong figures on the fiscal side. Both countries have had a fiscal surplus over the last years and relatively low (and declining) government debt. In Russia it has been one of the focus areas of macro-economic policy to lower the government debt, especially debt denominated in foreign currency and therefore the country has limited financing needs. Russia also imposed a fiscal rule which requires fiscal authorities to purchase FX and hold it in the National Wealth Fund if oil prices exceed the level of 40 USD/bbl (the NWF is estimated to be around 6% of GDP). If an economic downturn sets in, both Czech Republic and Russia have ample room to stimulate the economy.

Poland shows somewhat weaker fiscal figures. The government balance has been negative for many years despite strong economic growth and low unemployment rates. Government debt to GDP stands around 50%. In May this year, the government signed off a series of fiscal measures which will likely boost growth around 0.2pp in the second half of this year and 0.4pp next year according to the IIF. The country has thus already started to fire its fiscal guns.

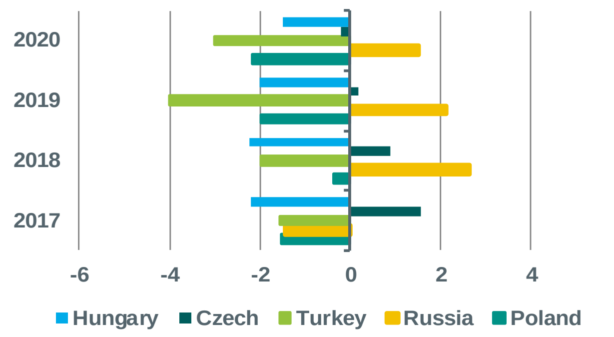
… while Hungary has little fiscal space left
Hungary's fiscal deficit is one of the highest in the European Union. Moreover, the country has a relatively high public debt (71% of GDP). In the past years, favourable economic conditions have boosted tax revenues, but the structural deficit rose by almost 2pp of GDP in 2016-2018. Therefore, in 2018 the European Council launched a significant deviation procedure against Hungary (to avoid the opening of an Excessive Deficit Procedure).

… and the political situation in Turkey will lead to more fiscal stimulus

Turkey has had a fiscal deficit for many years in a row. Even during the strong growth period after the global financial crisis, the fiscal deficit stayed between 1% and 2% of GDP. That said, the government debt is relatively moderate and has actually declined from levels of around 75% of GDP in 2001 to a current level of below 30%. In Turkey, although the economic downturn seems to be bottoming out, we may see a step-up of fiscal stimulus in the form of tax cuts and government investments in infrastructure and technology. President Erdogan has come under political pressure lately, as some of the former founding members of the AK-party have decided to launch a new political party. Hence his willingness to stimulate the economy is higher than ever.

Russia stands out in budget balance terms

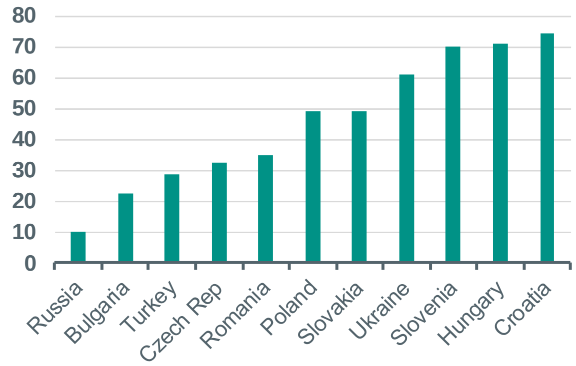
Fiscal balance, as % of GDP



Source: EIU

… and also has relatively low government debt

Government debt, as % of GDP



Source: EIU

To summarize … the fairy tale story for CEE-3 stops…

Lower global growth and further weakness on the trade front will undoubtedly have its fallout on Eastern Europe. We find that although Hungary currently has the highest economic growth levels, the country seems to be the most vulnerable to a global slowdown and an escalation of the trade war as the country is very dependent on FDI flows, has pro-cyclical exports and has little monetary and fiscal room to further support the economy. Czech Republic has been most prudent in terms of fiscal and monetary policy in the last years and although it has slightly lower growth levels than Poland and Hungary, it has a relatively stable macro environment. Poland seems to be in-between Czech and Hungary in terms of vulnerability to global conditions, but profits from relatively high economic growth rates.

… and while Russia and Turkey have more easing room, the global conditions will keep growth low…

Russia has ample room for both fiscal and monetary easing, but the economy lacks the structural ingredients for a high growth environment. We don't expect that the country will be hit by substantial lower oil prices. Moreover, the National Wealth Fund will be able to cushion the blow from an external shock. Turkey seems to be less vulnerable to global growth conditions than for example the CEE-3 countries, but deals with its own domestically economic- and political challenges (and sensitivities to shifts in market sentiment) which will continue to weigh on growth.

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