

Emerging Europe Outlook 2021

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Moderate recovery, large variation

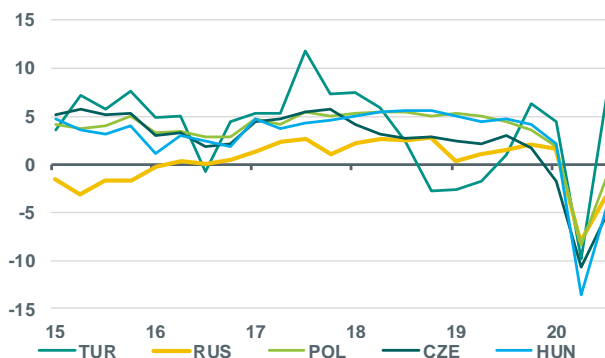
- ▶ Emerging Europe expected to be back to pre-pandemic GDP levels per end-2021 ...
- ▶ ... with large variation between countries
- ▶ Like elsewhere, unprecedented policy easing took place to counter the downturn
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Emerging Europe expected to be back to pre-pandemic GDP levels per end-2021

When the pandemic reached Europe in March 2020, countries in emerging Europe moved relatively quickly and effectively towards a lockdown in the first phase of the crisis. This resulted in sharp economic contractions in the second quarter. Some recovery followed in the third quarter, but like the rest of the world, countries in the region experienced serious flare-ups, affecting the early-stage recovery. Still, we expect emerging Europe to grow by around 3.3% this year, after a contraction of around the same magnitude in 2020. This brings the region back to around pre-Covid-19 levels by end-21. To compare, we expect the eurozone to still stand around 4% lower by that time. Within the emerging markets universe, this is middle of the road: emerging Asia's GDP is expected to stand around 6% higher than pre-pandemic, while the LatAm region is expected to stand around 5% lower.

Real GDP took a serious pandemic hit in Q2 ...

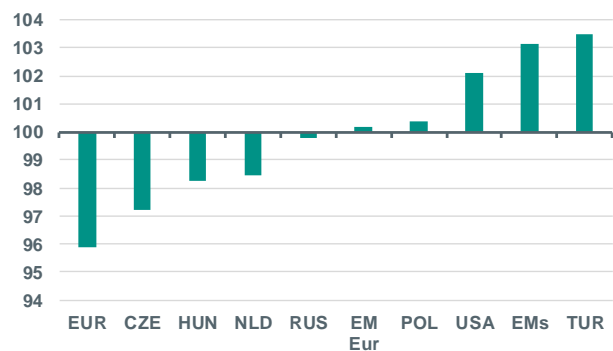
Real GDP % change yoy



Source: Bloomberg, ABN AMRO Group Economics

Distance to end-19 GDP very diverse in the region

Difference between end-21 estimate GDP and end-19 GDP



Source: EIU, ABN AMRO Group Economics

... with large variation between countries

All of CEE3, but especially small open economies Czech Republic and Hungary, were (among others) hard-hit by the collapse in demand from the eurozone. Comparing pre-pandemic levels with expected end-21 level, the Czech Republic and Hungary were hit hardest in terms of damage to GDP. Czech Republic's full year contraction of around 5.5% was the deepest on record, although still a bit better than the government and the central bank expected just a few months ago. Effects on GDP of the second lockdown were crippling to the domestic side of the economy, but contrary to the first lockdown, key export-oriented factories remained open. Poland shrank around 3% in 2020, ending nearly three decades of positive growth. This year, we expect the recovery of the eurozone and global trade to help the recovery in the region. We expect the German economy to contract in Q1 and roughly stabilise in Q2, after which acceleration will take place in the second half of the year. We expect growth of around 3% for the Czech economy for 2021 and around 4% for Hungary, leaving both countries' GDP at around 2% lower compared to pre-Covid 19 levels by the end of 2021. We expect Poland to grow around 3.5%, bringing the country back to pre-pandemic levels by end-2021.

Going forward, in the case of emerging Europe's EU members, ample access to EU funding will be important. In this context, it is positive that on 10 December, an accord was reached on the EU's upcoming 7-year financial framework and the EUR 750 bn coronavirus recovery fund. Poland and Hungary previously objected to a mechanism linking payments of EU money to adherence to the bloc's key legal principles. We estimate the allocation of EU loans and grants to add approximately 0.5-1ppt to CEE3's GDP annually in the coming years.

Turkey surprised on the upside last year in terms of growth. The economy showed a large recovery in Q3 (+6.7% yoy) and is estimated to even have avoided contraction in crisis year 2020. Still, as the country was obliged to increase interest rates sharply in response to increasing inflation and a sharply weakening lira, we anticipate 2021 growth to be somewhat restricted by the tighter monetary stance. Still, we expect growth of around 3.5%, and the economy is expected to stand at more than 3% higher at end-2021 compared to end-2019. Russia was hit hard by the oil price drop, but suffered a smaller contraction than most major economies in 2020 after the government opted not to reimpose a lockdown in the second half of the year. GDP contracted around 3% for the full year. This year, given a recovery of the oil price (+40% since the beginning of November), the economy is expected to grow by around 3%, bringing it back to pre-pandemic levels by the end of the current year.

Emerging Europe: Economic growth (forecasts)

% yoy	Q2-20	Q3-20	2019	2020	2021f	2022f
Czech Republic	-10.7	-5.3	2.3	-5.5	3.0	4.5
Hungary	-13.6	-4.6	4.6	-5.5	4.0	4.5
Poland	-8.4	-1.5	4.5	-3.0	3.5	4.5
Russia	-8	-3.4	1.3	-3.0	3.0	2.5
Turkey	-9.9	6.7	0.7	0.0	3.5	4.5
Regional average			2.0	-3.0	3.3	3.6

Source: ABN AMRO Group Economics, Bloomberg, EIU.

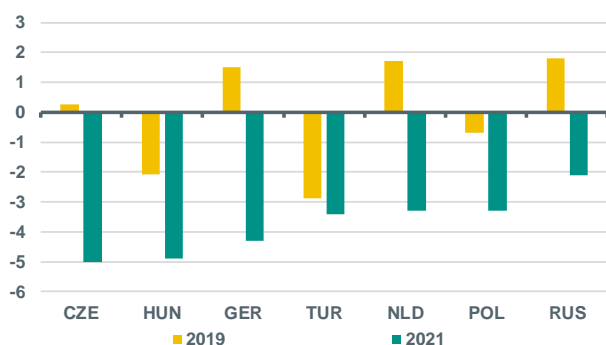
* Forecasts 2021-22 rounded

Like elsewhere, unprecedented easing took place to counter the downturn

As elsewhere, in emerging Europe the pandemic downturn was countered by large-scale fiscal and monetary stimulus. To make this possible, the European Commission loosened its rules for government finances, allowing EU members to have higher budget deficits and debt. Thus, Hungary was able to implement fiscal stimulus, despite the country's public debt surpassing the 60% of GDP Maastricht limit. Before 2020, the country had been obliged to maintain a tight fiscal approach in order to reduce imbalances. Poland, Czech Republic and Hungary saw a drastic widening of their budget deficits in 2020, and 2021 budget balances are expected to remain substantially worse compared to pre-Covid-19 levels.

Substantially wider budget deficits...

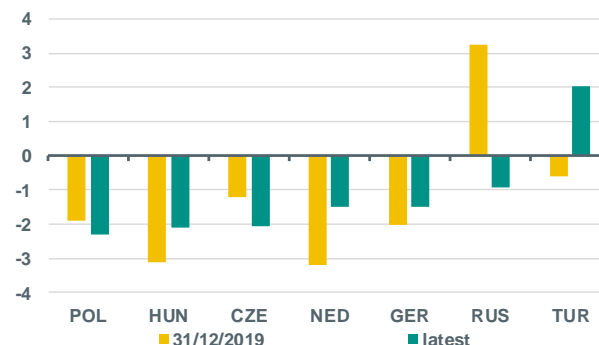
Budget deficit % GDP, Germany and Netherlands added for comparison



Source: EIU, ABN AMRO Group Economics

... made easier by accommodative monetary policies

Policy interest rate corrected for inflation, %



Source: EIU, ABN AMRO Group Economics

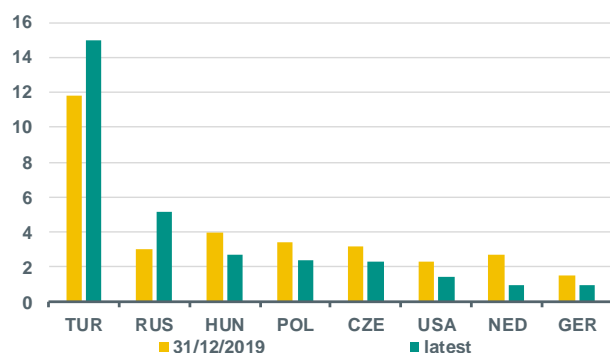
Central banks globally have effectively accommodated the fiscal expansion, as they cut interest rates aggressively to buffer the economic shock. It was possible for EMs to participate in this, as DMs' monetary accommodation led to extremely benign global liquidity conditions. Policy interest rates in CEE3 were no exception, being lowered to close to zero. In Poland, the central bank also embarked on quantitative easing, buying substantial amounts of government bonds and thus lowering bond yields and easing monetary conditions further. All CEE3 countries' policy interest rates corrected for inflation are currently significantly negative. Russia's budget deficit widened as well, accompanied with monetary loosening, but there was less pandemic support than in CEE3 or the advanced economies. In Turkey, the focus was primarily on monetary easing. The authorities stimulated the economy with ultra-low interest rates. However, the Turkish monetary stimulus came at the expense of financial stability. Sharp downward pressure on the Turkish lira and foreign-currency reserves ensued and inflation increased. The position of Central Bank governor and Finance Minister were reshuffled in November 2020. Interest rates have since increased by a cumulative 675bp, after which market confidence – and the lira – recovered.

CEE3 mostly relatively well-placed to weather the storm

While the policy easing was pretty much universal both globally and in the region, the ability of EMs to afford the easing and absorb the pandemic shock varies greatly. Many countries in emerging Europe are relatively well-placed to weather shocks, with relatively low inflation and debt levels, and good access to capital markets. For the EU members, access to EU funds is positive, while the temporary loosening of the Maastricht criteria has diminished the risk of premature tightening hampering early-stage recovery. Financial conditions should remain broadly accommodative given that central banks globally – in particular the US Fed – have signalled their intention to keep rates lower for longer. Capital flows into most EMs are likely to be more solid compared to last year, given this and a better growth outlook. However, there will be sharply higher public debt burdens going forward. Public debt in Czech Republic is expected to grow from 30% of GDP at end-2019 to 46% at end-2021, but this is still a relatively low level. Poland's increase in government debt also still leaves the government debt burden at a manageable level of 56% of GDP. Hungary was able to implement fiscal stimulus as the Maastricht criteria were loosened, but it still leaves the country with a government debt which is expected to stand at 75% of GDP by end-2021. While this is still a far cry from debt levels in some countries in the southern eurozone (Italy expected at 160% at end-21; Greece at 205%), debt interest payments on this government debt are higher than these countries. Mainly due to higher interest rate levels, interest payments take up almost 9% of fiscal revenues in Hungary, compared to 7% in Italy and only 3% in Greece. In Czech Republic and Poland interest payments on government debt take up a low 2-3% of fiscal revenues. Hungary also saw a sizeable external debt increase, while its external financing requirement for 2021 is large, making it less well-placed than the other CEE3.

Inflation high and increasing in Turkey and Russia

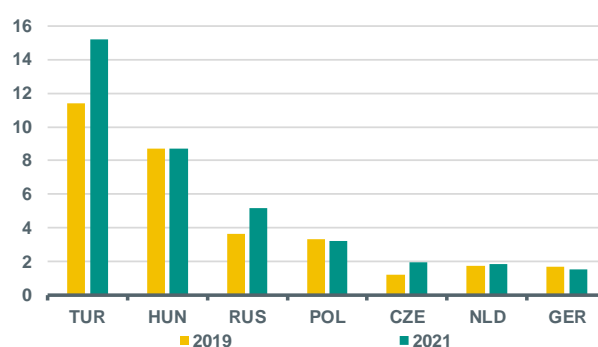
CPI, % change yoy



Source: Bloomberg, ABN AMRO Group Economics

Debt service substantial despite low interest rates

Government debt interest payments as % of fiscal revenues



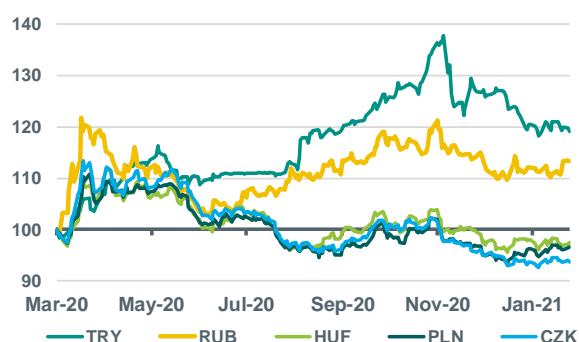
Source: EIU, ABN AMRO Group Economics

Turkey: more orthodox policies, but external finances still weak

As mentioned, Turkey was obliged to reverse the monetary loosening to counter a sharp weakening of the Turkish lira and rising inflation. Inflation stood at 15% yoy in January of this year, as a result of high credit growth, increasing food prices and cost effects due to the currency depreciation. The 675bp increase in interest rates resulted in recovery of the lira, but also made Turkey's key interest rate corrected for inflation one of the highest among major emerging markets. Partly as a result of this, and despite the fact that Turkey's public debt is low at around 35% of GDP, interest payments on government debt are expected to increase from an already substantial level to stand at an estimated 15% of fiscal revenues in the current year. The buoyant credit growth, in combination with falling exports to Europe and a sharp drop in tourism revenues, caused a sizeable current account deficit to arise in 2020 (-4.4% of GDP), after a surplus in 2019. The current account is expected to improve markedly in the current year, to almost balance, and foreign-currency reserves have increased 30% since mid-November 2020 lows. Still, however, foreign-currency reserves stand about a third lower than pre-Covid-19 levels, at a relatively weak level, and the country's high external financing requirement in relation to its foreign-currency reserves makes it vulnerable to changes in investor sentiment. The financial sector is expected to see increasing non-performing loans as sharply higher interest rates pinch businesses and households in 2021. Another risk to investor sentiment is Turkey's tense relations with a.o. the EU and the US. In December 2020, both the EU and the US imposed sanctions on Turkey, but as the sanctions imposed so far only target a very limited part of the Turkish economy, the effects on the wider economy are expected to be comparatively small for now. A risk going forward is the imposition of further sanctions by the EU, possibly in tandem with the US, at the EU Summit scheduled for March 2021.

TRY and RUB depreciated substantially

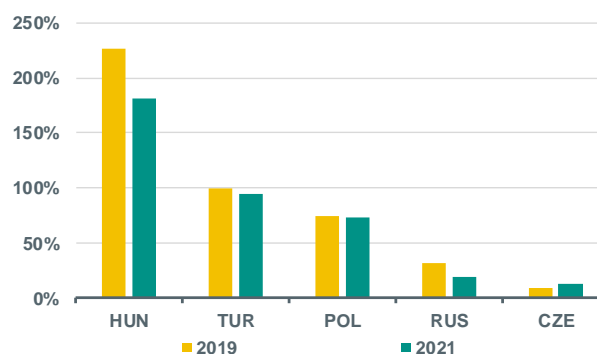
Exchange rate against USD, end-Feb 20=100



Source: Bloomberg, ABN AMRO Group Economics

Hungary and Turkey have large external obligations

Current account plus principal repayments due as % of fx reserves



Source: EIU, ABN AMRO Group Economics

Russia: substantial shock absorption capacity, but economic activity to remain relatively weak and resource-dependent

In Russia, inflation increased to a substantial level in January 2021 of 5.2% yoy, exceeding the 4% inflation target for the third month in a row. The rouble fell significantly in 2020, currently standing around 15% lower against the US dollar compared to the levels seen before the covid-19 shock. This was, among others, explained by a sharp fall in oil prices in the first half of 2020. While the country's current account surplus has fallen and crisis-battling measures have led to a budget deficit and negative interest rates corrected for inflation, the country still has a substantial shock absorption capacity due to conservative macroeconomic policies over the past few years. Government and external debt burdens are relatively low and foreign-currency liquidity is ample, especially taking into account the \$183bn (12% of GDP) National Wealth Fund.

However, the structural ingredients for a high growth environment are lacking, with an overly large state role in the economy and weakness in the areas of corruption, rule of law, and regulatory quality. There appears to be little incentive from the authorities for market-oriented reforms, due to opposition from vested interests. The protests after the arrest of opposition activist Alexei Navalny were widespread, and the heavy-handed crackdown by the Kremlin risks further escalation. The economic pain from the Covid-19 pandemic further stimulates social unrest. Given this, and constrained access to international capital markets as a result of sanctions over Russia's actions in Eastern Ukraine and the annexation of Crimea, economic activity is expected to remain relatively weak as well as resource dependent. On the plus side, the oil price has recovered most of the losses encountered in the pandemic year and currently only stands about 7% lower compared to the pre-pandemic level. Also, the economy of main export destination China is expected to grow 8.5% in 2021, providing a potential boost to export revenues.

Main economic indicators/forecasts

GDP growth (%)	2019	2020e	2021e	2022e	Inflation (%)	2019	2020e	2021e	2022e
Emerging Asia	5.0	-1.1	7.6	5.3	Emerging Asia	2.9	3.1	2.4	3.0
Emerging Europe	2.0	-3.0	3.3	3.6	Emerging Europe	6.6	5.2	5.2	5.2
Latin America	0.0	-8.0	4.1	2.8	Latin America**	9.2	7.5	8.8	6.9
Budget balance (%GDP)	2019	2020e	2021e	2022e	Current account (%GDP)	2019	2020e	2021e	2022e
Emerging Asia	-4.1	-6.0	-5.0	-4.5	Emerging Asia	1.1	2.0	1.5	1.0
Emerging Europe	-0.4	-6.0	-3.5	-2.5	Emerging Europe	1.5	0.0	0.5	0.5
Latin America	-4.1	-10.0	-5.5	-4.0	Latin America	-1.8	0.5	0.0	-1.0

Source: EIU, ABN AMRO Group Economics

**Inflation Latin America without Venezuela

* figures Emerging Markets regions are rounded

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