CEE economies switching to higher gear

Recovery to be stronger than previously anticipated. CEE economies to grow by 5.1% in 2021 and 4.8% in 2022. RRF to affect growth mostly after 2022. Czechia, Hungary and Poland to start hiking interest rates already this year in order to tame inflation expectations.

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Macro Outlooks:
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Central banks prepare for first rate hikes

Given better than expected 1Q21 GDP growth data, stronger global economic outlook and the brisk reopening of CEE economies stemming from the improved epidemiological situation, we have raised our 2021 GDP growth forecast to 5.1% from 3.8% a quarter ago. So far, the recovery has been mostly driven by industrial output, exports of goods and government consumption, while household consumption was depressed by restrictive measures and uncertainty. This is going to change in the coming quarters, as we expect a strong recovery in household spending. Moreover, some countries have been receiving a strong boost from public investments. In our view, CEE economies could reach their pre-COVID GDP levels in the next few quarters, with most of them achieving that in the second half of the year.

Although there are still risks associated with another pandemic wave in the autumn or winter, this time may be different. Two key indicators may help in assessing the necessity of restrictive measures and may render them regional rather than nationwide: the number of hospitalizations and the vaccine uptake. The larger the latter, the more contained may be the former. Progress in vaccination and the availability of full spectrum of disposable vaccines by then should significantly reduce both health and economic costs compared to previous waves. The most tangible risk to our forecasts at this moment is seen on the supply side, where industrial production can be limited by shortages of intermediary products (i.e. semiconductors) and increases in input prices.

Many of the strong readings that we observe these days (i.e. 60% y/y growth of industrial output in April or inflation overshooting the target) have been strongly determined by the base effect and well-anticipated a couple of months before (see our previous WUCEE report). On top of that, we can see that the supply side needs some extra time to adjust in order to satisfy the abrupt increase of demand after inventories and investments were kept at lower levels due to uncertainty around the pandemic and the speed of recovery. In the meantime, price inelastic pent-up demand will allow some spillover of higher producer prices into consumer prices. Once the supply side adjusts, pent-up demand is met and governments start to phase out their fiscal support, the economic environment should be less inflationary.

We expect inflation to remain above its target in many CEE countries both this year and next. Thus, Czech, Hungarian and Polish central banks will deliver their first rate hikes already this year to signal their preparedness to tighten monetary policy and contain rising inflation expectations. We pencil in the most aggressive tightening in Czechia, as the CNB should hike interest rates at least twice this year and two times in 1H22, bringing the key rate up to 1.25% by June 2022. The MNB should increase its key rate in several steps towards 1.20% by the year-end and push the rate to 1.35% by June 2022. The Polish central bank will try to delay its first 15bp rate hike to 4Q21 and raise the key rate to 0.5% by June 2022. The NBP, conversely to the MNB, intends to stop its asset purchases before starting to lift interest rates.

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Faster than expected recovery

When looking at the seasonally- and calendar-adjusted real GDP compared to the pre-pandemic quarter of 4Q19, most countries have experienced brisk rebounds since 3Q20. Croatia, which was hit the most in 2Q20, embarked on a gradual rebound and reached 98.5% of its pre-pandemic level. Most CEE countries were still around 1.5-5% below their 4Q19 levels, with Czechia and Slovakia at the further end of the range. Slovakia marked a brisk recovery in 3-4Q20, but departed from its recovery path in another visible dip in 1Q21, whereas the recovery in the second half of 2020 as well as the 1Q21 diversion were both milder in Czechia. Romania and Serbia have already reached their pre-COVID levels of GDP and were 0.8% above them in 1Q21.

An even more interesting and varied insight can be seen when looking at the components of GDP. Whereas government expenditure hardly displays any signs of COVID-related wear-and-tear, household consumption remains subdued in the whole of CEE. Some countries, such as Czechia and Slovenia were below 95% of their pre-pandemic levels of household consumption in 1Q21, whereas Romania and Serbia were nearing 98%. The most diverse outcome can be observed with respect to investments. Gross fixed investment exceeded its pre-pandemic level in Croatia, Poland, Romania and Slovenia, whereas it remained visibly muted elsewhere. Slovakia is a particular outlier, as gross fixed capital formation has thus far only recovered towards 78.4% of the 4Q19 level. Exports and imports of goods and services have mostly recovered exceedingly well, aided by the supportive external development and strong performance of the industry. Croatia, on the other hand, is lagging behind due to its large share of services in its exports, but the country should receive a helping hand from the upcoming summer tourism season.

Returned to pre-COVID 19 level yet?
Index level as of 1Q21, 4Q19 = 100, SA

	Real GDP	Government expenditure	Household consumption	Gross fixed capital formation	Exports of goods and services	Imports of goods and services
Czechia	95	103	92	89	102	104
Croatia	99	104	97	106	98	94
Hungary	98	101	97	96	102	100
Poland	98	105	98	101	107	110
Romania	101	98	97	109	98	105
Slovenia	97	103	95	108	100	100
Slovakia	96	99	95	78	107	105
Serbia	101	106	98	95	105	99

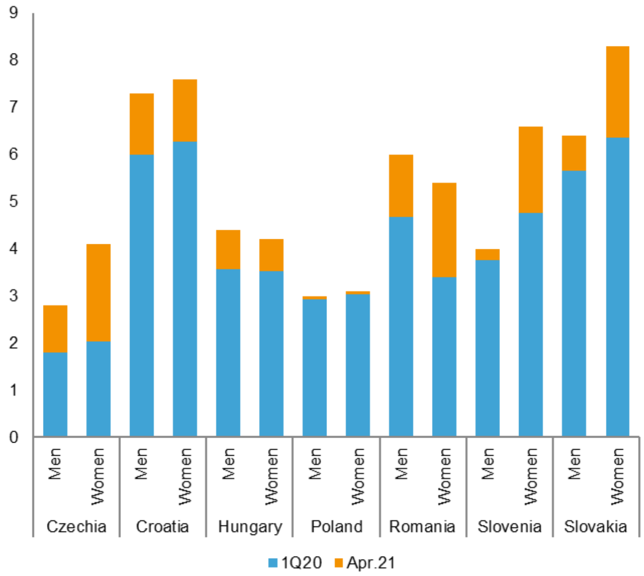
Source: Eurostat, Erste Group Research

Given the ongoing improvements in the epidemiological situation, vaccinations and loosening of restrictions at home and abroad, we can expect CEE economies to reach their pre-COVID GDP levels in the next few quarters, with most of them achieving that in the second half of the year. The budding economic recovery will be particularly visible in the y/y growth rates for 2Q21, exaggerated by the very low base from last year that will shift GDP growth visibly upwards. Household consumption should receive a boost as pent-up demand is gradually released into the economy, on the back of lower uncertainty, which should also bode well for the investment outlook.

Labor market needs more time to recover

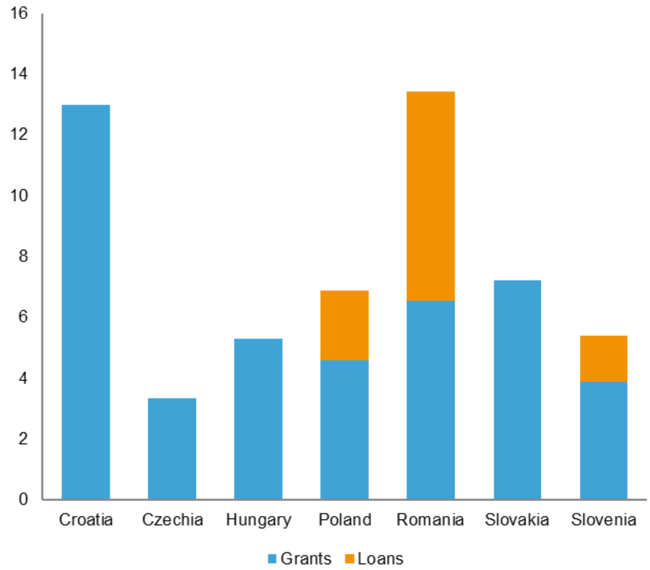
Local labor markets have remained relatively resilient, aided by state measures to protect jobs as well as the recent improvement in economic outlook and ongoing easing of restrictions. Yet, women have been affected disproportionately more than men, as evidenced by the latest April unemployment rates. Whereas Polish unemployment rates rose only marginally by 0.1pp since 1Q20 for both men and women, and both sexes were affected the same in Croatia (+1.3pp since 1Q20), the difference between female and male unemployment rates was much more pronounced in the rest of the region. Women saw a steeper increase in their unemployment rate since 1Q20 in Czechia, Romania, Slovenia and Slovakia. Slovenia stood out in particular, as the male unemployment rate rose by just 0.2pp since early 2020, whereas women saw their unemployment rate increase by 1.8pp in the same time frame. Hungary proved an intriguing outlier, as the only CEE country where women have been affected slightly less than men. Even though the resumption of economic activity should lead to a quick return of GDP to its pre-crisis levels, the labor market may need a bit more time to revert to its old state – particularly so for women, as the disparity has been more pronounced for them. Moreover, some hidden wounds could be revealed once furlough and other government support schemes are phased out.

Women were disproportionately more affected by the pandemic than men
Unemployment rate by sex, %



Source: Eurostat, Erste Group Research

Requested grants and loans within RRF
% of GDP



Source: Bruegel, Erste Group Research

RRF to boost investments in years beyond 2022

The EU's flagship recovery plan, worth EUR 750bn in grants and loans, known as the 'Next Generation EU' program, will be a key factor shaping economic performance in CEE in the next few years. Almost all member states have submitted national plans that describe planned reforms and public investments to Brussels by now and the rest will do so as soon as possible.

The CEE grant allocation under the RRF totals EUR 67bn and ranges between 3.3% of 2020 GDP in Czechia to 12.8% of 2020 GDP in Croatia. If the countries wanted to utilize both grants and loans to the full extent possible, this range would be shifted up to 10% and 20.3% of the Czech and Croatian 2020 GDP, respectively. All CEE countries have requested the estimated full amount of grants or slightly more (such as Croatia, Romania and Slovakia) – in such cases, the amount over the maximum possible will be financed by the individual member state. Only Romania requested the full amount of the loans available to it, whereas Poland and Slovenia requested just 35% and 22% of their loan allocations, respectively.

Brussels-given guidelines for RRF require that overall shares of green and digital components need to account for at least 37% and 20% of total expenditure, respectively. Based on the submitted national plans, we can see that most CEE countries meet these criteria, except Slovenia, which falls short of both and Romania, which fails to meet the digital criterion. Romania is planning to spend the largest proportion of its total RRF funds on green expenditure, an astonishing 65%, whereas it only allocated 15% of the total to digital-related outlays. Slovenia has, on the other hand, planned for only 7% and 30% of its RRF request to be labelled digital and green, respectively. The largest digital allocations can be found in the Czech and Hungarian plans (both at 23% of the total).

Comparing and assessing the impact of RRF national plans is challenging as they are not in a uniform structure and some investments could easily tick a number of boxes – green, social as well as growth-enhancing or aimed at the next generation. Moreover, in order to assess their impact more precisely, additionality of spending plans would have to be done to distinguish new expenditure from spending that will now be covered by the RRF funds instead of national budgets. Nevertheless, it is clear that the recovery funds will offer a significant uplift to economic growth in the next few years (mostly from 2022 onwards), with countries drawing loans on top of their grant allowance (Romania, Poland, Slovenia) getting a more pronounced boost.

Average inflation points to tightening in Czechia and Hungary

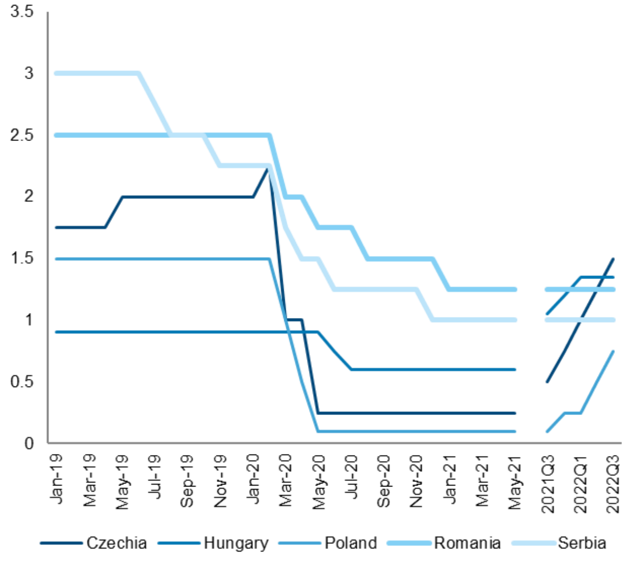
Inflation has been on the rise across the globe as a mismatch between supply and demand following re-opening of the economies has been driving prices up. Moreover, the base effect from last year's slump in commodity prices, especially in fuel costs, has been pushing headline CPI upwards. Similar development has been observed across the CEE region, where base effects have been amplified by tight labor market and one-off factors. Upside surprises in headline CPI, which have been observed since the beginning of the year, resulted in a visible upward revision of CEE8 average inflation forecast for this year. We expect CEE8 inflation to reach 3.4% this year (up from 2.3% in January 2021) with CPI staying outside of the central bank's tolerance band in Czechia, Hungary, Poland and Romania.

Given surging inflation, the expected strong economic rebound and tight labor markets, the Czech and Hungarian central banks will likely begin policy normalization as early as June 2021. We expect the Czech National Bank to deliver 2-3 quarter point hikes this year and follow with further tightening next year such that its key rate reaches 1.25% by mid-2022. On the other hand, the Hungarian central bank is expected to merge the base rate (0.6%) and the 1-week depo rate (0.75%) at a higher level. We expect the MNB to enter a tightening cycle and to increase the key rate to 1.35% by June 2022. The National Bank of Poland remains more hesitant, but we think that the NBP will also have to react given elevated inflation. We expect the NBP to deliver a 15bp hike in 4Q21 and follow with a 25bp hike in 1Q22, bringing the key rate to 0.5% by June 2022.

In other CEE countries, inflation will be broadly under control in the upcoming quarters. Thus, central banks are expected to remain on hold. In Romania, the interest rate outlook will strongly depend on developments in other CEE economies, especially in Poland. All in all, the National Bank of Romania will likely focus on tighter liquidity management, reflecting the weaker RON. In Serbia, the central bank is expected to remain on hold as long as inflation expectations remain anchored and the exchange rate is stable.

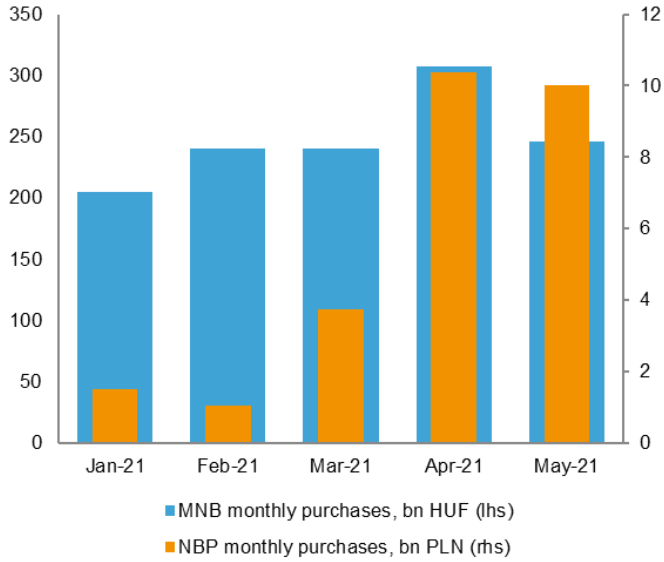
Recently, the Fed delivered a significant change in its policy as it switched from flexible inflation targeting into flexible average inflation targeting. Thus, the Fed promised to allow inflation to overshoot the target in order to compensate for the periods of undershooting. Average inflation targeting would provide more flexibility to the central bank to pursue its goals in the current low interest rate environment. What would 5Y average inflation targeting imply for regional central banks?

Interest rate hikes to begin soon in CEE
Target rate, %



Source: Erste Group Research

MNB keeps steady pace of purchases, NBP intensified them in April-May
Monthly purchases, LCY bn



Source: MNB, NBP, Erste Group Research

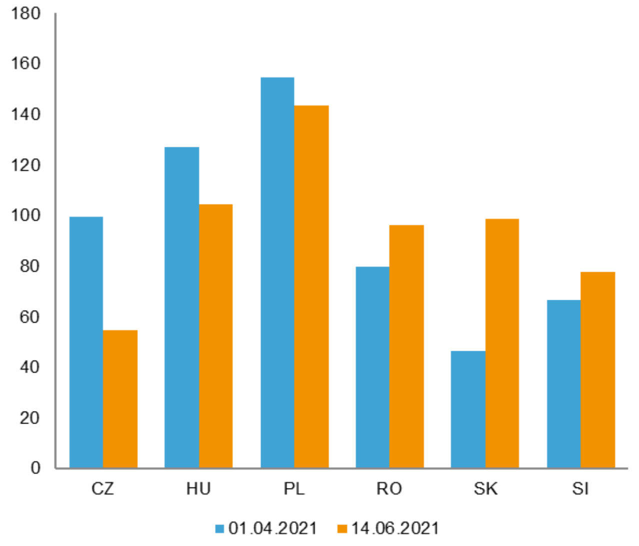
If inflation is kept flat at the current level (May 2021) until the end of 2022, 5Y inflation average would justify interest rate hikes as soon as possible in Czechia, sometime in 3Q21 in Hungary and in 4Q21 in Poland. The situation seems the most complicated in Czechia, as both 5Y average headline and core CPI have already reached the central bank's target. Average headline inflation is expected to hit the target in Hungary in August 2021 and in September 2021 in Poland. Moreover, the balance between the number of months of inflation under- and overshooting the target has already been positive in Czechia since 4Q19. It will only turn positive in 4Q21 and 1Q22 in Hungary and Poland, respectively (see Appendix I).

Yields mostly to stay stable in CEE

While global yield increases and surging inflation pushed LCY yields visibly up in 1Q21, the upward move was less pronounced in the second quarter. Curves flattened further in Czechia, Hungary and Poland, as monetary tightening has been priced in. In other CEE countries we could observe the curve steepening.

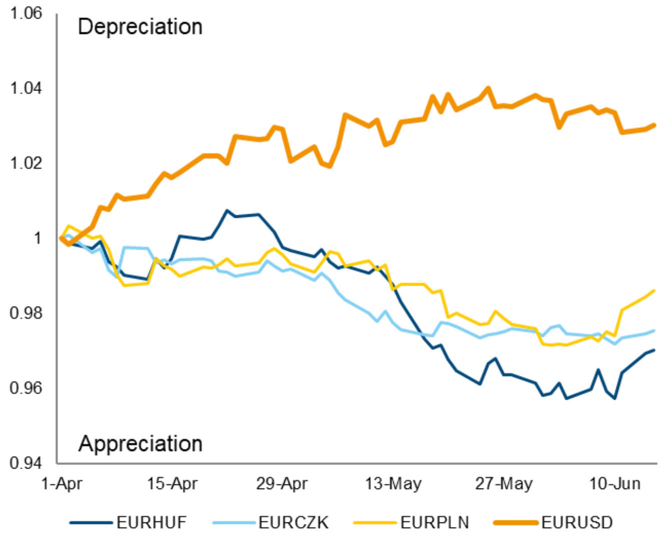
The presence of the central banks on the market likely limited the upward pressure on the long end in Hungary and Poland, as both central banks are the most active ones in the region. The National Bank of Hungary has bought HUF 1352bn thus far in 2021, while the total amount of central bank's bond purchases reached HUF 2342bn (4.4% of GDP). On the other hand, the National Bank of Poland bought securities worth almost PLN 27bn YTD, while since the start of the QE program in March 2020 it purchased close to PLN 134bn in Treasuries and state-guaranteed papers (5.3% of GDP). After not being present on the bond market since August 2020, the National Bank of Romania stepped in and bought RON 247mn this year. However, the lack of a predictable and consistent presence of the NBR weighed on ROMGBs.

Curve flattened, where tightening is expected soon
10Y-2Y spread, bp (10Y-3Y spread for HU and RO)



Source: Bloomberg, Erste Group Research

CEE currencies benefited from weaker USD
FX performance, Index (April 1st = 1.00)



Source: Bloomberg, Erste Group Research

The central bank's operations should provide further support to the long end of the curve in Hungary, as the MNB plans to phase out the bond-buying program only gradually. We suppose it will be a longer-lasting process, which will likely take place in parallel with the ECB's steps. On the other hand, the NBP communicated that its asset purchases program needs to end ahead of interest rate hikes. We expect the tapering to begin during the summer months.

Tightening to support CEE FX

CEE currencies appreciated throughout 2Q21 on the back of the weaker US dollar, easing of pandemic restrictions and surging inflation. Expected tightening of the monetary conditions was especially positive for the Czech koruna and Hungarian forint. The current level of the EURCZK around 25.40 already contains the first hike in June and, overall, three interest rate increases during this year. Thus, we see koruna appreciating at a slower pace in 2H21.

We believe that the central bank will tolerate a stronger forint amid inflation risks pointing to the upside. We see the EURHUF hovering around 350 until the end of the year. The Polish zloty should benefit from expected tightening as well and move toward 4.40 vs. the EUR by year-end. While the CZK, HUF and PLN are to remain stable or to get stronger by the end of the year, the Romanian leu will likely weaken due to the widening of the CA deficit.

The Serbian dinar has been locked around 117.6 vs. the EUR since the beginning of the year, as the National Bank of Serbia remains active on the market. Given the NBS's high level of FX reserves as well as the additional precautionary EUR 1bn repo line with the ECB at its disposal, it seems all but certain that the EUR/RSD will remain steady around current levels. In Croatia, two dates of euro adoption are being discussed – 2023 and 2024. The ongoing suspension of fiscal rules until 2022 also provides more maneuvering space, as Croatia has not been put under the EDP (together with other countries) and thus formally has not breached the fiscal criteria on euro adoption.

Forecasts

Government bond yields

	current	2021Q3	2021Q4	2022Q1	2022Q2
Croatia 10Y	0.5	0.5	0.5	0.6	0.6
spread (bps)	77	62	52	63	59
Czechia 10Y	1.6	1.8	1.9	2.0	2.1
spread (bps)	187	193	193	205	211
Hungary 10Y	2.8	2.9	2.9	3.0	3.1
spread (bps)	309	300	292	303	308
Poland 10Y	1.7	2.00	2.20	2.30	2.40
spread (bps)	197	212	222	233	239
Romania10Y	3.3	3.5	3.5	3.5	3.6
spread (bps)	350	357	347	353	354
Slovakia 10Y	0.1	0.2	0.3	0.4	0.5
spread (bps)	39	27	32	38	49
Slovenia 10Y	0.12	0.15	0.15	0.25	0.35
spread (bps)	36	27	17	28	34
Serbia 5Y	2.4	2.3	2.2	2.1	2.1
spread (bps)	263	242	222	213	209
DE10Y*	-0.2	-0.1	0.0	0.0	0.0

* Spreads based on Bloomberg consensus forecast

FX

	current	2021Q3	2021Q4	2022Q1	2022Q2
EURHRK	7.49	7.53	7.53	7.53	7.48
EURCZK	25.46	25.35	25.25	25.14	24.98
EURHUF	352.03	350.00	350.00	350.00	350.00
EURPLN	4.52	4.48	4.42	4.38	4.35
EURRON	4.92	4.96	4.98	4.99	5.03
EURRSD	117.56	117.50	117.60	117.55	117.50
EURUSD	1.21	1.18	1.20	1.20	1.22

3M Money Market Rate

	current	2021Q3	2021Q4	2022Q1	2022Q2
Czechia	0.42	0.59	0.86	1.13	1.39
Hungary	0.93	1.05	1.20	1.35	1.35
Poland	0.21	0.21	0.35	0.35	0.60
Romania	1.49	1.60	1.60	1.65	1.65
Serbia	0.87	0.85	0.83	0.83	0.83
Eurozone	-0.54	-0.54	-0.54	-0.54	-0.54

Key Interest Rate

	current	2021Q3	2021Q4	2022Q1	2022Q2
Croatia	0.05	0.05	0.05	0.05	0.05
Czechia	0.25	0.50	0.75	1.00	1.25
Hungary	0.60	1.05	1.20	1.35	1.35
Poland	0.10	0.10	0.25	0.25	0.50
Romania	1.25	1.25	1.25	1.25	1.25
Serbia	1.00	1.00	1.00	1.00	1.00
Eurozone	0.00	0.00	0.00	0.00	0.00

Real GDP growth (%)

	2019	2020	2021f	2022f
Croatia	2.9	-8.0	5.0	5.5
Czechia	2.2	-5.6	3.7	4.3
Hungary	4.6	-5.0	6.9	4.1
Poland	4.7	-2.7	4.8	5.4
Romania	4.1	-3.9	6.7	4.5
Serbia	4.2	-1.0	6.0	4.0
Slovakia	2.5	-4.8	4.0	4.8
Slovenia	3.2	-5.5	5.0	4.8
CEE8 avg	3.9	-4.0	5.1	4.8

Average inflation (%)

	2019	2020	2021f	2022f
Croatia	0.8	0.1	1.7	1.6
Czechia	2.8	3.2	3.1	2.4
Hungary	3.4	3.3	4.2	3.2
Poland	2.3	3.4	4.0	3.5
Romania	3.8	2.7	3.7	3.0
Serbia	1.9	1.6	2.5	2.7
Slovakia	2.7	1.9	1.6	1.8
Slovenia	1.6	0.0	1.3	1.5
CEE8 avg	2.7	2.8	3.4	2.9

Unemployment (%)

	2019	2020	2021f	2022f
Croatia	6.6	7.5	7.5	6.7
Czechia	2.0	2.6	3.3	2.7
Hungary	3.4	4.2	4.2	3.8
Poland	5.4	5.9	6.2	5.9
Romania	3.9	4.9	5.9	6.1
Serbia	10.4	9.0	8.9	8.5
Slovakia	5.8	6.7	7.0	6.0
Slovenia	4.4	5.0	5.0	4.8
CEE8 avg	4.6	5.2	5.6	5.3

Public debt (% of GDP)

	2019	2020	2021f	2022f
Croatia	72.8	88.7	87.2	84.3
Czechia	31.2	38.1	44.4	46.8
Hungary	65.5	80.4	77.5	75.9
Poland	45.6	57.5	57.0	55.0
Romania	35.3	47.3	49.6	50.8
Serbia	52.1	57.4	59.1	58.4
Slovakia	48.2	60.3	63.5	63.5
Slovenia	65.6	80.8	79.7	76.3
CEE8 avg	45.9	57.4	58.3	57.7

C/A (%GDP)

	2019	2020	2021f	2022f
Croatia	2.8	-0.8	0.6	0.4
Czechia	-0.3	3.2	0.7	0.3
Hungary	-0.5	0.1	-0.2	-0.1
Poland	0.5	3.5	2.1	1.2
Romania	-4.9	-5.2	-5.9	-5.4
Serbia	-6.9	-4.3	-3.5	-3.6
Slovakia	-2.7	-2.7	-1.6	-0.9
Slovenia	5.6	7.1	6.3	5.5
CEE8 avg	-0.8	0.9	0.0	-0.4

Budget Balance (%GDP)

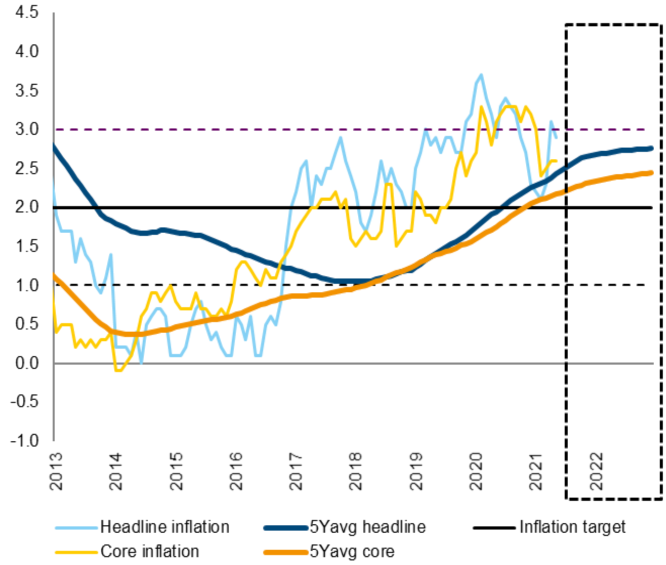
	2019	2020	2021f	2022f
Croatia	0.3	-7.4	-4.2	-3.0
Czechia	0.3	-6.2	-7.2	-3.5
Hungary	-2.1	-8.1	-7.1	-5.5
Poland	-0.7	-7.0	-4.5	-3.2
Romania	-4.4	-9.2	-7.8	-5.4
Serbia	-0.2	-8.0	-6.5	-3.0
Slovakia	-1.3	-6.1	-6.0	-4.0
Slovenia	0.5	-8.4	-7.0	-4.5
CEE8 avg	-1.2	-7.4	-6.0	-3.9

Source: Bloomberg (prices as of 15th June), Erste Group Research

Appendix I

5Y inflation averages point to tightening in Czechia

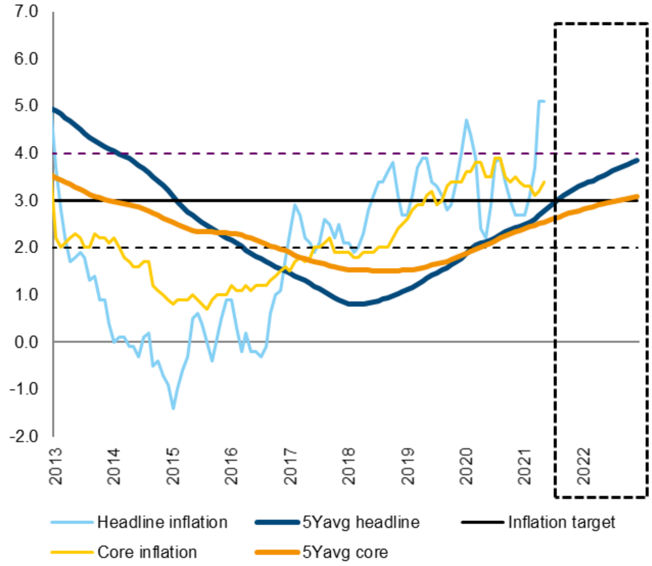
Headline and core inflation, spot and 5Y avg, %



Source: Erste Group Research

In Hungary, 5Y inflation average to hit target in August 2021

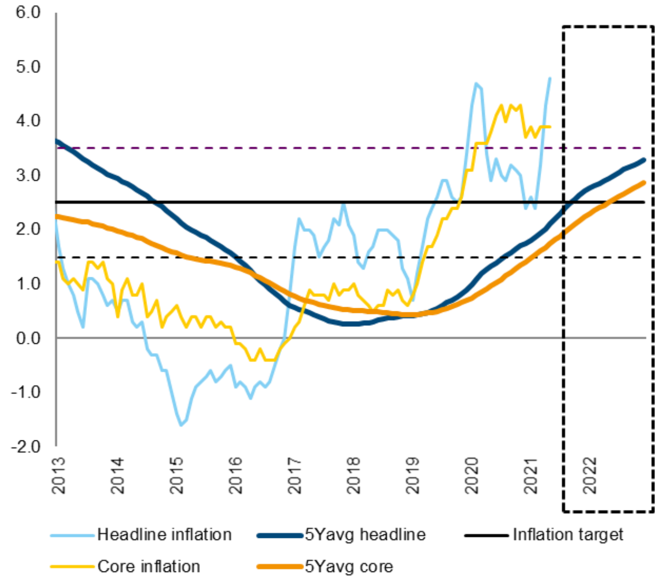
Headline and core inflation, spot and 5Y avg, %



Source: Erste Group Research

5Y inflation average to reach target in September 2021 in Poland

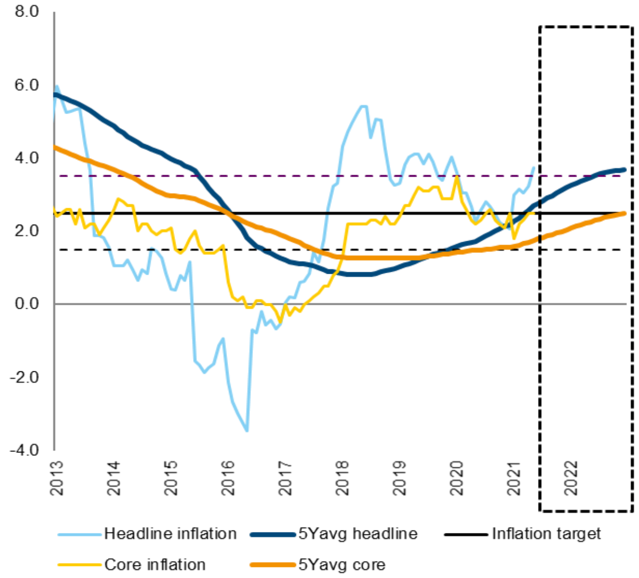
Headline and core inflation, spot and 5Y avg, %



Source: Erste Group Research

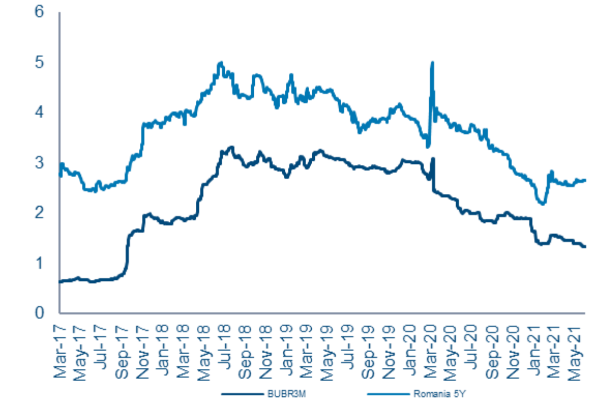
While 5Y inflation average to hit target in September 2021, Romanian central bank to remain on hold

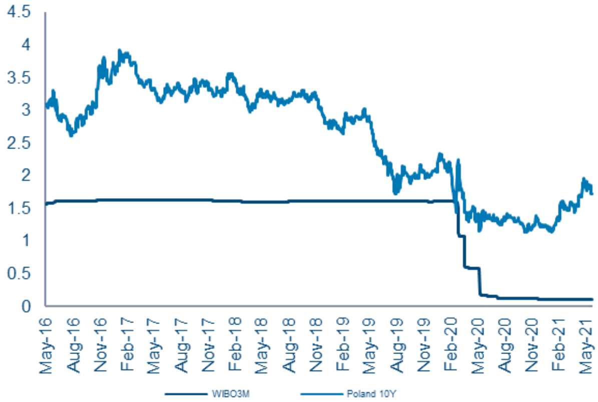
Headline and core inflation, spot and 5Y avg, %

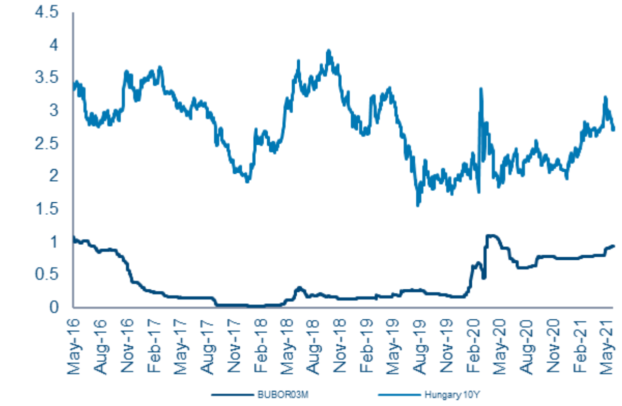


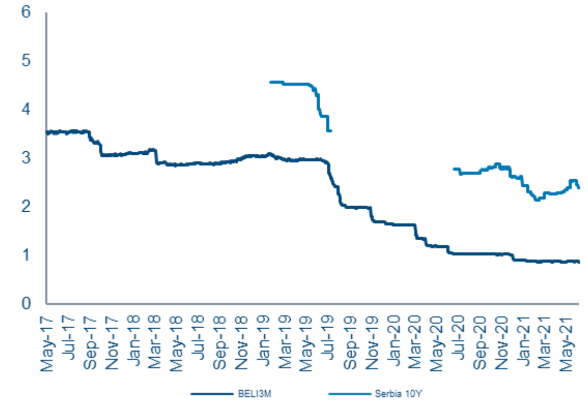
Source: Erste Group Research

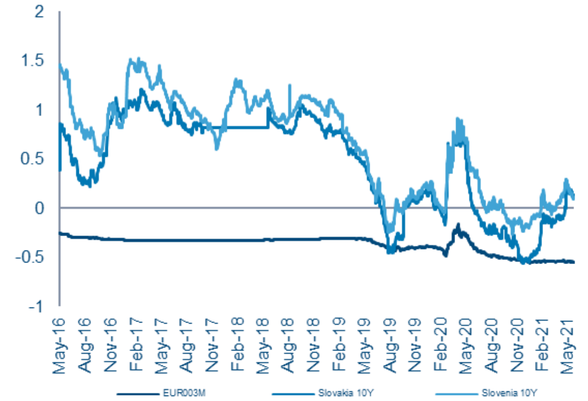
Appendix II











Source: Bloomberg, Erste Group Research

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