Growth in the Balkans: from zero to hero again?

We review the main macroeconomic forecasts for Bulgaria, Croatia, Romania and Serbia. While the resurgence of coronavirus infections has dashed hopes for a rapid V-shaped recovery, 2021 should still be a good year. Yes, the pace of the vaccination remains key to resuming normal economic activity but we do believe that things can only get better

Our outlook for Bulgaria's economy sees growth cautiously picking up despite shaky political ground

Placed in what is traditionally perceived as a rather volatile region -a characteristic frequently attributable to the macroeconomic context as well- the four Balkan economies that we review here have navigated through the 2020 in an admirably resilient fashion. Yes, this came on the back of large fiscal deficits and monetary policy measures that just one year ago were unconceivable in emerging markets, but in the end it is the real economy response which reflects the suitability of such extraordinary measures.

And we have some reasonably good news on this front:

- Serbia reconfirmed its status as one of the most dynamic European economies, contracting by only around 1.1% in 2020 and looks on track to post one of the highest economic growth rates in 2021, which we estimate at 5.5%.
- Bulgaria and Romania have even somehow managed to avoid a technical recession in 2020

as they saw their economies contracting solely in the second quarter of 2020. Hence, GDP contraction should be in the 4.5-5.5% range for both. In 2021 the much hoped economic growth will return at an estimated 3.0%-4.0% pace.

- With an estimated 8.8% GDP contraction in 2020, Croatia might seem an outlier in this pack but remember the context: over 20% of its GDP depends on a sector which plummeted in 2020 – tourism. Hence, we believe that a single digit contraction is in fact a laudable result. In 2021 we expect a growth rebound of just over 4.0% as consumer sentiment might remain depressed for longer than currently anticipated.

Looking beyond growth, we expect less homogenous behaviour and to start seeing signs of divergence at different levels. On the fiscal front Romania could stand out as the country with the slowest budget deficit reduction, given the more structural nature of its deficits, while the other countries' deficits have been more driven by one-offs. Rating-wise, Romania looks again more pressured, given the negative outlooks placed on its rating by all agencies. We believe that Romania can maintain its investment grade rating in 2021 but risks for a downgrade will stay with us throughout the year, contingent on a credible fiscal consolidation plan. On the inflation front, things look sufficiently well-behaved in all four countries in order not to trigger policy actions from their central banks. Current account deficits will likely remain at relatively high levels in Romania and Serbia, but fully financing them from stable non-debt creating sources looks more probable only for Serbia. Finally, on the political front it will be Bulgaria's turn to face elections in 2021 – and the scene already looks quite hot.

Main macroeconomic forecasts

	Bulgaria			Croatia			Romania			Serbia		
	2020	2021	2022	2020	2021	2022	2020	2021	2022	2020	2021	2022
Real GDP (%YoY)	-4.3	3.3	3.9	-8.8	4.1	4.0	-5.5	3.7	5.0	-1.1	5.5	5.0
CPI (average, %YoY)	1.7	1.7	2.2	0.2	0.7	1.2	2.6	2.5	2.5	1.6	1.7	2.2
Budget balance (% of GDP)	-3.0	-3.0	-2.0	-8.3	-3.8	-2.8	-9.3	-7.3	-5.0	-8.5	-3.5	-2.2
Govt debt (% of GDP)	25.3	26.1	27.2	88.5	86.1	85.5	45.9	50.2	51.7	57.4	58.5	57.0
Current account (% of GDP)	1.5	2.5	3.5	-0.8	1.5	1.8	-4.5	-4.1	-3.8	-5.2	-5.4	-5.0
FX rate vs EUR (year-end)	1.96	1.96	1.96	7.53	7.53	7.53	4.87	4.92	4.95	117.6	117.6	117.5

Source: National sources, ING estimates

Bulgaria: politics in the foreground

Growth: Without standing out, the Bulgarian economy managed to muddle through 2020 in a rather resilient manner; our estimate for a 4.3% GDP contraction places the country in the better half of European economies. For 2021 and beyond, we estimate that the economy will return to its previous growth pace, with a 3.3% expansion this year and 3.9% next. Growth drivers could be tilted more towards construction and investment on the back of EU funded projects.

Inflation: For the first time in over four years, the end of 2020 and beginning of 2021 will probably bring negative inflation rates. This has come on the back of base effects, oil prices and lagging consumption. Starting with the second quarter of 2021, inflation should increase gradually towards the 1.50-2.00% area and even climb towards 3.00% in 2022. We maintain our 1.7% average inflation forecast for 2021 and 2.2% for 2022.

Fiscal: The elections due in March have likely been key to expanding the budget deficit from 0.2% in November to 3.0% in December (but still below the 4.1% initial target). For 2021, the government proposed, and parliament approved, a deficit of 3.9% of GDP. It envisages a minimum 5% rise in pensions, a minimum 10% rise in public sector wages, and other targeted support measures. GDP growth is conservatively (in our view) seen at 2.5%. Our call is for higher GDP growth (3.3%) and a lower budget deficit (-3.0%).

Politics: Opinion polls seem to point towards a complicated post-election landscape. The ruling centre-right GERB still seems to be coming first in most polls, but left-wing socialists are closing the gap. Parliamentary fragmentation will make it difficult for any winner to form a coalition as there seems to be little compatibility among the few parties which have a chance of making the 4% threshold.

Ratings (Baa1/BBB/BBB): On 9 October 2021, Moody's upgraded Bulgaria's rating to Baa1 (from Baa2) while S&P and Fitch maintained the BBB rating throughout 2020. All have a stable outlook. There is still upward rating pressure though this might not be realised until after 2021, as there is still uncertainty around the issue of euro adoption while the political scene is quite heated ahead of the March parliamentary elections. However, ratings are underpinned by the EU recovery fund, of which Bulgaria is one of the main beneficiaries, as well as the expected return to growth and supportive fiscal outcomes.

Next scheduled reviews: 19 February – Fitch; 2 April – Moody's; 28 May – S&P.

Croatia: looking for the summer

Growth: Except for the ERM-II bright spot, 2020 could be a year to forget for Croatia. The economic contraction (-8.8% ING forecast) will be one of the largest in Europe. In all fairness, it could have been worse for the economy given the dramatic contraction in tourism, but the fiscal and monetary support were quick to react. In 2021, exports of services (mostly tourism) should be the main growth driver. Nevertheless, our 4.1% growth forecast is more conservative than most estimates as we believe that personal consumption could stay subdued for longer due to the resurgent pandemic.

Fiscal: The previous years of a quasi-neutral fiscal stance have allowed Croatia to face the current crisis with a reinforced fiscal profile. Hence, a one-off expansion of the budget deficit towards 8.0% of GDP in 2020 did not ring any alarm bells for the markets. Nevertheless, Croatia's main weakness, in our view, remains its relatively high debt-to-GDP ratio which we estimate to reach 88.0% in 2020, and erasing years of painstaking efforts which brought it close to 70% in 2019. The 2021 budget plan envisages a budget deficit below 3.0% of GDP, which is overly ambitious in our view. We believe that this will be revised and expect the deficit closer to 4.0% of GDP.

Inflation and monetary policy: Inflation developments largely met expectations in 2020, with negative (but close to zero) rates for most of the year. However, the core inflation rate didn't decline as abruptly and remained around 1.00%. For 2021 we forecast a modest pick-up of inflation towards an average of 0.7% (from 0.2% in 2020) and further towards 1.2% in 2022. Essentially, this all means that inflation will remain very much under control.

All of the above will allow the Croatian National Bank to maintain its accommodative stance and use its firepower should the situation require it again. Given the better prospects for the tourist season, the seasonal pattern of the kuna could tilt more towards the appreciation zone, but the swings should be milder than in previous years.

Ratings (Ba1/BBB-/BBB-): A strong fiscal track record, the prospect of EU funds and entry into the Exchange Rate Mechanism II (ERM II) have provided ratings resilience for Croatia despite its large dependency on tourism (c.20% of GDP) and a high government debt burden (c.88% of GDP at end-2020). In November 2020, Moody's upgraded Croatia to Ba1 (from Ba2), albeit this is still a notch below S&P and Fitch (both BBB-). All ratings have a stable outlook. For Croatia to see more rating upgrades, we would need evidence for an improvement in growth and the debt profile while, similar to Bulgaria, more clarity on the timeline for euro adoption would also lead to upgrades (not a base case for 2021).

Next scheduled reviews: 19 March – S&P; 14 May – Moody's; 21 May – Fitch.

Romania: time for fiscal consolidation measures

Growth: After much temptation to adjust (sometimes for the worse, other times for the better) our -5.5% GDP growth forecast for 2020, it seems that things are now going our way. Assuming no significant data revisions, it would only take 0.3% growth in the fourth quarter of 2020 versus the previous one in order to get to our -5.5% full year forecast. Given the relatively less stringent and more targeted Covid 19-related restrictions introduced over the last months, we believe that positive growth in the last quarter is not just wishful thinking.

For 2021, growth drivers should be a touch more balanced than in the past (when almost everything was about private consumption), but consumer sentiment -strongly influenced by the pace of vaccination- will probably still dictate the trend. Our 3.7% growth forecast (revised downward from 4.1%) pushes the full recovery to pre-pandemic levels into mid-2022, when we see 5.0% GDP growth.

Inflation: Absent any major supply side shocks (e.g. oil price), this year's inflation readings should be mostly a non-event. We see headline inflation hovering around the National Bank of Romania's 2.5% central target for most of the year, with a spike towards 3.0% in the last quarter. In any case, an annual inflation rate of 2.5% (our forecast) will not constitute a headache for the central bank this year.

Somewhat more interesting could be the core inflation dynamics. Our forecasts largely match the central bank ones for the next three quarters (meaning a gradual drop towards the 2.2-2.3% area in 2Q21 and 3Q21), but start to diverge once we approach the end of 2021 and into 2022, when we see the core inflation rate ticking higher again, closer to (but below) 3.0% while the central bank expects levels closer to 2.0%. However, a divergent core inflation rate didn't seem to bother the NBR in 2020 when it averaged around 3.7%, hence it will probably not bother them in 2021 either, when we expect an average rate of 2.6%.

Monetary policy: 2021 should be a year of relative tranquility on the monetary policy front, after the unprecedented policy easing undertaken in 2020. However, in light of the benign inflation and -more importantly- other CEE central banks contemplating additional easing measures, we acknowledge that the chances for further key rate cuts are material. For now, however, we stick to our view that the central bank will try to preserve as much policy space as possible.

An eventual easing (which we think will come) could be done through looser liquidity management (with market rates closer to the 1.00% deposit facility rate rather than the 2.00% Lombard rate) and some limited FX weakness (4.92 being our year-end forecast for the EUR/RON). This setup would provide the central bank with the possibility of a rapid tightening (in case it is needed) without changes in the key rate. Further cuts for both RON and hard currency minimum reserve requirements are also likely in 2021.

Ratings (Baa3 neg/BBB- neg/BBB- neg): Downgrade risks (and with it the loss of investment grade ratings) remain prominent through 2021. Perceived risk will peak in April and October, given that all rating agencies have their review dates in those months. In 1H21 and for the first review date, the focus will be on the 2021 budget. We believe that rating agencies will again look past elevated deficits in 2020 and 2021 with more importance given to medium-term fiscal and growth prospects. This will depend on measures to reduce fiscal rigidity (notably coming from social spending) but also the uptake from the EU budget and recovery fund (NGEU), with risks skewed to the downside. Thus, in the second half of 2021 (for the second rating review date), rating agencies and investors will likely scrutinise early reform implementation and successes as well as EU fund absorption. It's a close call but we believe that Romania can dodge downgrades.

Next scheduled reviews: 16 April – Moody's, S&P; 23 April – Fitch.

Serbia: outperforming the pack

Growth: We've been constantly upbeat on Serbia's growth prospects for a while now and so far things are going our way. Possibly benefiting from the strongest growth momentum in Europe, the Serbian economy is projected to have contracted by only 1.1% in 2020 (official and ING estimates). It should also be one of the few countries to witness a full recovery to pre-pandemic levels by the end of 2021 when we forecast GDP growth of 5.5%, slightly below the 6.0% official estimates but still above most market predictions. A lot depends on the vaccination pace as currently, the campaign doesn't seem to be progressing very much in sync with other EU countries.

Fiscal: Key to the well managed economic slowdown in 2020 was the generous fiscal support, which basically equalled the budget deficit of almost 9.0% of GDP. For 2021, the authorities -in agreement with the IMF- have set a budget deficit target of 3.0% of GDP. In our view, this strikes a good balance between the need to return to fiscal prudence (given the relatively large current account balance) and preserving support for the economy. We tend to believe that the lagged effects from the second wave of infections will cause a slight overshoot of the deficit target which we forecast to close the year at 3.5% of GDP.

Inflation and monetary policy: After cutting the key rate to 1.00% in 2020, the room for additional easing by the National Bank of Serbia is very limited, in our view. We see the key rate as flat through 2021 and most of 2022. This is helped by a calm inflation profile which we forecast to average 1.7% in 2021 (from 1.6% in 2020) and 2.2% in 2022. The central bank will likely continue to provide as much liquidity as needed to the banking system and continue to promote its dinarization strategy. On the FX front, the stability of the dinar remains a central pillar of the central bank's monetary policy and in 2021 we expect more of the same in this respect.

Ratings (Ba3 pos/BB+/BB+): We remain impressed by the sovereign's fiscal prudence, with the government recently having successfully concluded a non-financing IMF programme and considering a follow-up programme (possibly another Policy Coordination Instrument). We believe that an upgrade at Moody's (Ba3 positive) is due in 1H21. Meanwhile, the sovereign remains an investment grade candidate with S&P and Fitch both rating Serbia at BB+ right now, albeit with a stable outlook. Thus, this is more of a 2022 story, but underpins the convergence narrative. Given Serbia's relatively large current account deficit (in the mid-5% of GDP area), we would also need to see stable or improving foreign direct investment and/or a decrease in external debt.

Next scheduled reviews: 19 March – Fitch; 11 June – S&P.

Author

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

Disclaimer