Growth in the Balkans: From zero to hero..and back?

We review below the main changes to our macroeconomic forecasts for Romania, Bulgaria, Serbia and Croatia. While the revisions are all pointing the same way, we highlight that there are notable discrepancies between the countries

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Main changes to our 2020 forecasts (2021 forecasts are left unchanged):

We believe that Serbia will be least affected due to its strong investment-driven cycle. Bulgaria and Croatia, which are more tourism dependant will fall inbetween, while Romania, due to its pro-cyclical past policies, will suffer the most. All this assumes that the disruptions caused by the Covid-19 pandemic will start to dissipate towards the end of the second quarter of 2020.

- Croatia: GDP growth is revised downwards by 1 percentage point, from 2.2% to 1.2%, inflation from 1.6% to 1.0% and the year-end EUR/HRK from 7.45 to 7.55
- Bulgaria: growth revised from 3.0% to 2.1%, annual inflation from 3.4% to 2.7%
- Serbia: GDP growth revised from 4.7% to 3.9%, annual inflation from 2.3% to 1.8%, year-end

EUR/RSD to 118.00 from 117.2
- Romania: growth is revised from 3.6% to 2.1% and annual inflation from 3.0% to 2.8%. We leave the EUR/RON forecast unchanged at 4.8500 year-end.

After the economic crisis of 2008-2009, the Balkan region experienced a prolonged economic slump, with anaemic growth rates by regional standards. However, with the help of the IMF, growth resumed in most cases by 2011-2012 and gradually picked up pace (with a few hiccups for Serbia and Croatia), pushing GDP growth to, or even above, potential in recent years. In the same vein, 2020 was shaping up to be another robust catch-up year for the Balkan economies. In 2019, Romania and Serbia exceeded expectations on GDP growth, advancing 4.1% and 4.2%, respectively, while Bulgaria's 3.7% rate and Croatia's 2.9% pace were broadly in line with our view and the consensus. And with the exception of Serbia, which we expected to accelerate this year, the growth prospects for 2020 were looking only a touch more modest compared to 2019, with Romania at 3.6%, Bulgaria towards 3.0% and Croatia at 2.2% - more in line with their long-term potential.

However, as the best laid plans of mice and men often go astray, the outbreak of Covid-19 has rapidly changed the picture, leading us to a point where the term 'recession' does not seem inappropriate. That’s not to say we are there yet and – with a bit of luck and policy wisdom – we see a good chance for the four Balkan countries to avoid such a scenario.

Croatia: Beyond the sun and the sea

In our view, Croatia is very exposed to an economic slowdown, mainly due to the very high share of tourism in the country’s GDP (close to 20% of GDP judging by travel-related revenues), but also to the weak industrial sector (quasi-flat in 2019) and the consumption-dependent growth model. Last year, out of the total 2.9% GDP growth, c.2.1ppt came from private consumption. We therefore fail to identify any catalysts that could drive the growth story further into 2020. The fixed investments advance from the first two quarters was reversed in the following two quarters, hence it’s all on the consumer to drive growth in 2020 as well.

It's worth noting that our revised 1.2% GDP growth forecast still incorporates quarterly sequential growth in three out of four quarters in 2020, with a stagnation seen in 2Q20.

On the inflation front, the lower oil price (see here the latest ING forecasts) and softer demand will undoubtedly push inflation lower. In our view, the weaker kuna will offset these developments to a very limited extent as we consider the FX passthrough to be insignificant in Croatia. Hence, our 1.0% inflation forecast for 2020 is mainly a result of incorporating the new oil price in our projection, ignoring the FX component.

Speaking of FX, the kuna looks set to be among the worst performers in our group, as the other currency which in theory could take a strong hit – the Bulgarian Lev, is under a solid peg regime. Our 7.55 year-end forecast is – we believe – relatively optimistic judging strictly from a supply/demand perspective (given that Croatia has a structural trade deficit and, starting this year, a current account deficit due to the likely fall in the export of services). However, the ample FX reserves of the Croatian National Bank (EUR19 billion as of Jan-2020) makes the case for a depreciation spiral to occur a very weak one right now.

Bulgaria: Muddling through

2020 was supposed to be the year of ERM II (Exchange Rate Mechanism) entry for Bulgaria, an important milestone and a challenge for the country. Things have slowly started to fall apart however, with Prime Minister Boyko Borisov calling for a “national consensus” before this takes place. The root cause however seems to lie with the European Central Bank's assessment of the Bulgarian banking sector, which found capital shortfalls at two banks.

Although there is no clear connection between recent Covid-19 related developments and the ERM topic, the prospect of an economic slowdown and all the implications that come with that (inclusively for the banking sector) are definitely not helping. It could also shift the attention and resources from taking the measures needed to comply with EC/ECB requirements to tackling the economic effects of the Covid-19 spread. Hence, although there is no straightforward link, we believe that the prospects of joining ERM-II in the forthcoming months look more distant now.

Turning to the growth story, the Bulgarian economy is not as reliant on the tourism sector as Croatia is - we estimate the travel-related revenues to be around 10% of GDP for Bulgaria. Moreover, the growth structure leaves some room for positive future developments, considering the relatively robust gross fixed capital formation dynamics: +2.0% in 2019 with a clear acceleration trend in the last few quarters. Having said that, there are downsides as well: the currency peg doesn’t offer any space for short-term competitiveness gains, the country needs to run balanced budgets (which is already happening, hence little room for fiscal impulses), tourism represents an important source of revenues and already sluggish consumer sentiment is likely be hit in the short term by the recent developments. This will filter through to consumption behaviour and in the end, cause more prudent spending. All things considered, we see the risks to our new 2.1% GDP growth forecast this year as being broadly balanced.

With the FX-passthrough topic not an issue in Bulgaria’s case, we expect the lower oil prices and the (forecast) change in consumer sentiment to lower the annual inflation rate to 2.7%, from our initial 3.4% estimate which was, admittedly, at the top of consensus.

Serbia: The new Balkan tiger?

The Serbian economy continues to enjoy the benefits of past and ongoing reforms, with investments boosting growth, capital inflows supporting the Serbian dinar and a benign inflation backdrop, which allowed the central bank to lower borrowing costs. In 2019, the GDP advance came in above consensus at 4.2%. The growth structure paints an optimistic picture, as investments continued to be the main growth driver, advancing by 15.6% (after 18.6% in 2018) and contributing 3.2ppt to overall growth. Bordering on double-digit territory, wage advances will keep consumption levels on the rise as we move ahead into this electoral year.

In a surprise move, on 11 March the National Bank of Serbia (NBS), lowered the key rate by 50bp to 1.75%, while narrowing the corridor of its main interest rates from ±1.25 pp to ±1 pp relative to the key policy rate. The move came explicitly as a response “to heightened uncertainty in the international environment triggered by the spread of the coronavirus (Covid-19)”. The possibility of additional easing has been also mentioned, depending on the global and domestic conditions.

However, we believe that the Serbian economy has enough momentum to move forward at a decent growth pace this year. Strong domestic demand should be able to absorb the external shocks coming from Serbia’s main trading partners – with Italy and Germany each accounting for some 12% of Serbian exports. Although not negligible, the share of tourism in GDP is not a game changer either – we estimate that travel-related revenues account for c.6.7% of GDP. Our previous 4.7% GDP growth forecast was among the highest in the market and we believe that after a fresh wave of forecast revisions, which are bound to appear, our new 3.9% GDP advance will remain one of the highest.

The already relatively low inflationary pressures will further moderate amid the impact of falling oil prices and softer demand. We see average annual inflation at 1.8% and expect headline inflation to fall below the 1.5% lower bound of the inflation target range in the coming months.

Romania: Growth resilience story to be seriously tested

We had started the year with a long-standing 2.7% GDP growth forecast, which was among the lowest in the market, but after a stellar 1.5% advance in the fourth quarter versus the previous quarter, we have revised our forecast to 3.6% for 2020 mainly due to the carry-over effect of the strong fourth quarter. However, looking at the growth structure and in view of the recent pandemic, we believe that Romania will experience a serious growth slowdown.

An unprecedented fiscal impulse in the fourth quarter (when the government spent around 2ppt of GDP in less than two months) led to an unusually large contribution from public consumption to 4Q GDP growth. At 2.6ppt, it is the highest number since the third quarter of 2008. This pace is very unlikely to be maintained and we would expect public consumption to have a neutral effect on growth in 2020. It is already well known that Romania burned through its fiscal buffers during very good economic times, which leaves the economy exposed to a downturn. Although we can hardly expect any meaningful fiscal consolidation to occur this year (due both to the Covid-19 impact and to the electoral context), there is no room for fiscal expansion either, as the -4.64% of GDP fiscal gap in 2019 has already got the attention of the European Commission (which will activate the Excessive Deficit Procedure) and the markets.

On the monetary policy front, we believe that there is some room for easing, but any serious action needs to be done in sync with credible fiscal measures. To the extent the National Bank of Romania will be comfortable with the fiscal backdrop, we can envisage the central bank doing a little bit of everything: leaving the EUR/RON to shift higher earlier in the year rather than later (we maintain our 4.85 year-end forecast), leaving some carefully monitored surplus liquidity in the market, further cuts in minimum reserve requirements and even one or two 25bp key rate cut(s) if the economic downturn deepens. As previously mentioned, we think that the central bank would initially prefer a targeted lending programme to assist businesses in need, which however requires cooperation between the NBR and political actors in order to pass the “adequate legislation”. Given the political backdrop, we think that it could take at least a couple of months for such a programme to become operational.

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