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Directional Economics EMEA

CE4 policy tools for the next downturn: Who's got the firepower?

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Summary

CE4 policy tools for the next downturn: Who's got the firepower?

The early months of 2019 have seen the global economy struggle to shake off fears of a slowdown. Global trade is slowing and two of the main engines of world growth, China and Europe, are desperate to avoid stall-speed. A sharp downturn into 2020 is not in our baseline scenario, but in this edition of *Directional Economics* our feature article analyses the stimulus tools available to CE4 authorities if a slowdown were to materialise.

Which of the CE4 authorities have the firepower to resist a downturn? We assess scope to support their economies through three policy channels: (1) conventional monetary; (2) unconventional monetary; and (3) fiscal policy.

In terms of conventional monetary policy, only Poland has real room for rate cuts – and only a 50bp easing cycle at that. Lower bound constraints and fears over a disorderly sell-off in local currencies limit the room for rate cuts elsewhere. On unconventional policy, Hungary central bankers look to have the most appetite and room to grow the balance sheet. The overly-liquid economies of Poland and Czech won't engage in QE.

When it comes to fiscal policy, the Czech Republic has the most room for stimulus, followed by Poland. The latter, however, is already engaged in aggressive fiscal stimulus and could do more later this year. Looking across all available tools, Romania has the least room to support its economy, saddled by twin deficits and a very fragile currency.

Our second article looks at the travails of the German auto sector and its fallout across the EMEA region. Domestic and external factors hit this sector and the German economy hard in late 2018. Fresh US auto tariffs look the biggest threat to this industry over the next three to six months as President Trump mulls recommendations from his advisors.

A further slowdown in the German auto sector would have a disproportionate impact across the EMEA space. Poland looks best positioned to weather this headwind given its diversified export sector and the insulation provided by the recently announced and sizable fiscal stimulus. The Czech Republic, Hungary and Romania are all very exposed to autos though, as above, of the three, Romania is the least able to offset it with stimulus.

Returning to the baseline story, we see many EMEA economies coming off the boil from some very impressive growth figures in 2017-18. However, Poland should still be able to deliver 4% growth in 2019 supported by fiscal stimulus and we see no need for the NBP to cut until late-2020. Re-balancing of the Czech economy in 2019 is probably welcome, but we are wary that crowded positioning long CZK becomes vulnerable once the CNB tightening cycle concludes this year.

Assuming none of the external risks materialise, Hungary should also be able to post 4% growth. Mixed messages from the NBH on policy normalisation and some unconventional policy, however, may create some near-term problems for the HUF. We are more concerned by Romania, where slowing growth and four election rounds over the next couple of years create scope for policy errors.

Russia and Turkey face more local challenges in how to energise growth and manage the re-balancing of the economy, respectively. A benign external environment of low core rates should provide time for local authorities to make tough policy choices.

As always, *Directional Economics* showcases ING's unique footprint and talent in the EMEA region and we encourage you to engage with our dedicated team.

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Country summaries: CE4

Czech Republic

The Czech economy slowed from 4.5% growth in 2017 to 3% in 2018. The main drag on growth was net exports as export activity slowed as a result of stretched producer capacities and weaker foreign demand while imports increased given import-intense investments. We believe this trend will continue and expect the economy to slow to 2.4% in 2019, being close to its potential growth. The labour market will remain overheated, though strong 8% wage growth will not be repeated this year due to the declining profitability of companies. Wage growth and some one-offs temporarily pushed inflation close to 3% at the beginning of 2019. The CZK is not appreciating as quickly as expected, delivering no monetary tightening, hence at least one rate hike is likely this year, if the global economy stops deteriorating.

Hungary

GDP growth accelerated to 4.9% YoY in 2018, the highest rate since data collection started in 1995. Economic activity is being driven by consumption due to an exceptionally tight labour market and double-digit wage growth, while the investment rate is the highest it has ever been at 25.5%. A positive output gap and higher costs have pushed companies to hike prices, thus core CPI rose above the 3% target and is expected to hit 3.9% YoY by mid-2019. In parallel, the NBH mildly adjusted its monetary stance, remaining dovish due to the external risks based on a gloomy global outlook. With the NBH signalling no more rate hikes as its base case and building inflation pressures, we see EUR/HUF testing 330 in 2Q19. We look for another one-off hike (15bp) at the June NBH meeting in response to soft HUF.

Poland

Pre-election spending pledges exhausted almost all fiscal space. The pledges should extend the consumption boom to 2019-20 and sustain strong GDP growth but will have limited impact on CPI (adding 0.1ppt in 2020). Given improved tax collection and a high NBP profit, net borrowing needs in 2019 should remain low (below PLN30bn). The 2020 budget is more challenging, pledges exceed the spending rule and the budget is sensitive to GDP slowdown. Also, net borrowing needs should double in 2020 (PLN50bn vs PLN22bn in 2018), so MinFin could start pre-financing 2020 now, thus widening of asset swaps and spread to Bund may continue. The stimulus excludes any monetary easing at least until end-2020. We expect money market rates to remain flat throughout 2019 and PLN to hover around 4.30.

Romania

We expect the C/A gap and budget deficit to deteriorate further. Investor sentiment has been shaken by changes in the fiscal environment. These developments have caught the eye of rating agencies. With four election rounds over the next couple of years, we see limited opportunities for fiscal consolidation or structural reforms. The appointment of a new NBR Board this year could be an additional source of concern for investors. The economy was already cooling off and regulatory changes are likely to put private investment plans on hold. Even if there is some improvement in legislation, the trust between the private sector and government is unlikely to be restored rapidly. We think that most of the burden from external imbalances will continue to fall on the central bank.

Country summaries: Other Central & Eastern Europe

Bulgaria

The economy slowed from 3.8% to 3.1% in 2018, mainly driven by contracting exports that increased the negative contribution of net exports to growth. Provided eurozone growth finds a new equilibrium, we expect the Bulgarian economy to expand at a similar speed in 2019 given that gross fixed capital formation is likely to be supported by the investment pipeline of €8.6bn in EU funds, of which €3.1bn has been spent so far. Investments are likely to offset household consumption as suggested by weakening consumer confidence over the past eight months. In the absence of a surprise after the ECB assessment of the large banks, we could see the green light for ERM-II being given in the second half of the year, which is credit positive. We expect ERM-II to exceed two years.

Croatia

The Croatian economy finished 2018 with a mild slowdown, much in line with regional developments. For 2019, we expect GDP growth to decelerate moderately, as the main growth drivers seem to be levelling off – namely consumption and export of services – while the factors that could offset them, like public investments, are yet to reach their potential. Following S&P's upgrade to BBB- in March, we consider a similar move from Fitch as likely as Croatia is ticking most of the boxes while an upgrade is also possible at Moody's. Chiefly, the fiscal position has continued to improve placing the public debt ratio on a steady downward trend, the economy remains on a growth track and a pick-up in investments should materialise in 2019 on higher expected EU funds utilisation.

Serbia

Growing by 4.4% in 2018, the Serbian economy surpassed expectations. We see economic growth moderating to 3.7% in 2019 on weaker external demand, but supported by domestic absorption, fiscal easing and relatively cheap financing costs. We believe that the benefits of past reforms and the prospects of EU membership will continue to support investments and capital inflows, allowing the National Bank of Serbia (NBS) to maintain reasonable borrowing costs while not jeopardising its inflation target. Should the government stick to its investment plans while remaining committed to lowering the public debt, we could see a rating upgrade (currently 'BB' with positive outlook) by the end of 2019.

Turkey

The change in economic policy direction and the ease of geopolitical tension triggered the recovery of Turkish financial markets. Policy determination remains critical to macro and financial performance, while cautious central banks globally have also been supportive lately. Ongoing improvement in external and internal imbalances with: (1) a sharp reduction in external deficit thanks to plunging domestic demand; (2) a deleveraging cycle with a sharp negative credit impulse, though momentum indicators provide encouraging signals on lending. Tightening policies to restore confidence have resulted in a faster rebalancing of the economy, which accelerated in 4Q18. But fiscal incentives and some stabilisation in lending could provide a buffer, while there are early signals of a bottoming in activity.

Country summaries: CIS

Russia

Russia is expected to face economic growth headwinds in 2019, increasing its dependence on external sectors amid constrained local demand following the VAT hike. The policy response so far has been through targeted support to household income and state investments, while systemic supply-side measures are still to come. By contrast, local financial markets are off to a good start this year, as global risk appetite has improved, the local CPI trend so far has allowed some easing in the CBR stance, and strong macro stability keeps local state bonds attractive for foreign investors. Potential local obstacles for a rally include a persistent risk of sanctions and structural issues in the balance of payments, favouring gradual RUB depreciation in the long term, unless productivity improves.

Ukraine

Successful disbursement of the IMF tranche at the end of 2018, followed by a rating upgrade from Moody's lifted the spirits of Ukraine's financial markets, which, combined with continuing remittances inflows (+23% YoY in 9M18), has contributed to a stronger UAH. Further sentiment will depend heavily on the outcome of the second round of Presidential elections as, following the first round on 31 March, a protest candidate and TV personality Volodymyr Zelenskiy is leading in the exit polls by a high margin (30%) versus runner-up incumbent Petro Poroshenko (16%). With little known of his economic policy views, the key watch factors would be continuity of cautious fiscal and monetary policies, that are a prerequisite for continued cooperation with the IMF.

Kazakhstan

With Nursultan Nazarbayev stepping down prematurely and Kassym-Jomart Tokayev named interim president until 2020, economic policy risks have come more into focus. Fiscal easing seems on the way, with an extra 2% of GDP pledged for social support, and the downward pressure on communal housing tariffs, which contributed to a positive CPI surprise in 2018, might require additional budget spending. Reaffirmation of the country's ratings suggests that budget risks are still remote. The key question is whether monetary policy remains cautious, as premature easing may add to the risks to KZT which is already facing headwinds due to the halt of production in key oilfields, the OPEC+ deal, and the negative spillover effects from RUB weakness and China slowdown.

ING main macroeconomic and financial forecasts

Real GDP (% YoY)

	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Bulgaria	3.2	2.9	3.4	3.9	3.4	3.4
Croatia	2.3	2.5	2.8	2.1	2.4	2.2
Czech Republic	2.6	2.5	2.4	2.0	2.4	2.6
Hungary	4.6	4.3	3.8	3.2	4.0	3.0
Kazakhstan	3.4	3.0	2.9	3.2	3.3	3.2
Poland	4.2	4.2	4.1	3.6	4.0	3.2
Romania	3.7	2.8	2.4	2.1	2.7	2.1
Russia	1.1	0.8	1.2	1.1	1.0	1.5
Serbia	3.9	3.5	3.9	3.7	3.7	3.6
Turkey	-1.8	-1.2	1.2	2.6	0.3	2.9
Ukraine	2.6	2.5	2.7	2.9	2.7	3.0
Eurozone	1.1	1.6	1.4	1.4	1.2	1.2
US	1.7	2.2	1.8	1.9	2.4	1.8

*% QoQ annualised

Source: National sources, Bloomberg, ING estimates

Exchange rate (quarterly is eop, annual is avg)

	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
EUR/BGN	1.96	1.96	1.96	1.96	1.96	1.96
EUR/HRK	7.42	7.37	7.40	7.45	7.41	7.43
EUR/CZK	25.82	25.70	25.80	26.00	25.78	26.34
EUR/HUF	321.2	330.0	325.0	325.0	324.5	325.0
USD/KZT	380	375	380	380	380	381
EUR/PLN	4.30	4.28	4.32	4.36	4.36	4.35
EUR/RON	4.75	4.77	4.80	4.85	4.78	4.88
USD/RUB	65.6	66.0	67.0	66.0	66.0	68.0
EUR/RSD	118.5	118.0	118.0	118.0	118.1	117.8
USD/TRY	5.40	5.61	5.80	6.00	5.63	6.27
USD/UAH	27.25	27.00	27.50	28.00	27.85	29.65
EUR/USD	1.12	1.10	1.15	1.20	1.14	1.26

Source: National sources, Bloomberg, ING estimates

CPI (%YoY, quarterly is eop except for US/EZ avg, annual is avg)

	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Bulgaria	3.0	2.9	3.0	3.0	3.0	3.1
Croatia	1.2	1.1	1.4	1.8	1.2	1.7
Czech Republic	2.9	2.4	2.2	2.3	2.4	1.9
Hungary	3.6	3.2	3.0	3.3	3.2	3.1
Kazakhstan	4.8	5.1	5.3	5.4	5.2	5.5
Poland	1.7	2.3	1.9	2.1	1.8	2.6
Romania	3.8	3.2	3.5	3.8	3.6	3.3
Russia	5.4	5.7	5.6	5.0	5.4	3.8
Serbia	2.5	2.4	2.1	2.4	2.2	2.2
Turkey	19.6	16.5	10.4	14.3	16.0	12.7
Ukraine	9.3	9.5	8.8	8.0	8.9	7.5
Eurozone	1.4	1.1	0.9	1.3	1.2	1.6
US	1.6	1.7	1.8	2.0	1.8	2.2

Source: National sources, Bloomberg, ING estimates

Central Bank rate (%, eop)

	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Bulgaria	0.00	0.00	0.00	0.00	0.00	0.00
Croatia	0.30	0.30	0.30	0.30	0.30	0.30
Czech Republic	1.75	2.00	2.00	2.25	2.25	2.25
Hungary	0.90	0.90	0.90	0.90	0.90	0.90
Kazakhstan	9.25	9.25	9.00	8.75	8.75	8.00
Poland	1.50	1.50	1.50	1.50	1.50	1.50
Romania	2.50	2.50	2.50	2.50	2.50	2.50
Russia	7.75	7.75	7.75	7.50	7.50	6.50
Serbia	3.00	3.00	3.00	3.00	3.00	3.00
Turkey	24.00	23.00	21.00	20.00	20.00	16.00
Ukraine	18.00	18.00	17.00	16.00	16.00	13.00
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00
US	2.25	2.25	2.25	2.25	2.25	2.25

*Lower level of 25bp range

Source: Bloomberg, ING estimates

10yr local yield (%, quarterly is eop, annual is avg)

	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Bulgaria	0.75	0.75	0.70	0.70	0.70	0.60
Croatia	2.00	1.90	1.90	1.80	1.90	1.80
Czech Republic	1.92	2.10	2.00	1.90	1.98	1.78
Hungary	2.92	3.00	2.90	2.80	2.92	2.66
Kazakhstan	n/a	n/a	n/a	n/a	n/a	n/a
Poland	2.84	2.89	2.99	3.07	2.93	3.05
Romania	4.70	4.90	4.90	4.70	4.80	4.80
Russia	8.4	8.1	7.9	7.5	7.5	6.9
Serbia	4.75	4.70	4.55	4.50	4.60	4.50
Turkey	15.14	14.76	14.93	15.15	14.98	13.27
Ukraine	n/a	n/a	n/a	n/a	n/a	n/a
Eurozone	-0.07	0.20	0.30	0.25	0.17	0.25
US	2.30	2.40	2.50	2.45	2.41	2.43

Source: National sources, Bloomberg, ING estimates

3m local rate (%, quarterly is eop, annual is avg)

	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Bulgaria	n/a	n/a	n/a	n/a	n/a	n/a
Croatia	0.50	0.50	0.50	0.50	0.50	0.50
Czech Republic	2.02	2.24	2.24	2.49	2.18	2.49
Hungary	0.18	0.38	0.38	0.38	0.29	0.38
Kazakhstan	10.25	10.25	10.00	9.75	10.10	9.35
Poland	1.73	1.73	1.73	1.73	1.73	1.73
Romania	3.10	3.20	3.20	3.10	3.20	3.00
Russia	8.3	8.3	7.9	7.5	7.5	6.5
Serbia	3.00	2.90	2.80	2.75	2.90	2.80
Turkey	23.87	23.08	20.45	21.67	22.60	19.29
Ukraine	n/a	n/a	n/a	n/a	n/a	n/a
Eurozone	-0.32	-0.30	-0.30	-0.30	-0.31	-0.30
US	2.60	2.62	2.62	2.62	2.62	2.53

Source: National sources, Bloomberg, ING estimates

CE4 policy tools in a downturn: Who's got the firepower?

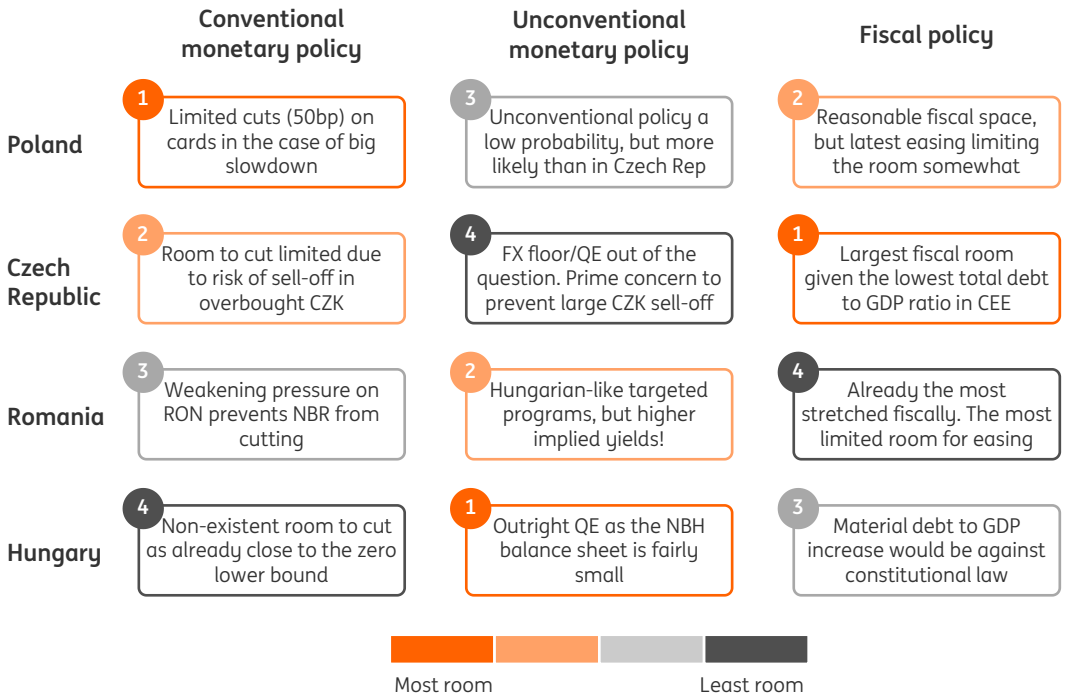
With concerns about global growth increasing, the dovish shift among major central banks and the inverted US yield curve, we consider CE4 central banks' fire power to ease should fears of a slowdown materialise. We draw three key conclusions:

1) Room for conventional easing is limited for all CE4 central banks. For the National Bank of Hungary (NBH) the key hurdle is understandably being close to the zero lower bound. Even the Czech National Bank (CNB) faces a high bar for rate cuts given the high probability of disorderly CZK weakness when the economic cycle turns. For National Bank of Romania (NBR), FX considerations will also limit the room to cut interest rates. Of the CE4 central banks, the National Bank of Poland (NBP) is, in our view, the closest to easing via monetary policy (for which the bar is nonetheless high) though an easing cycle would still be limited to 50bp.

2) In the unconventional monetary policy area, the NBH should set the trend. Here quantitative easing (QE) and balance sheet expansion would be the go-to policy in a downturn. Non-standard measures will also be imposed in Romania via liquidity management tools (which will however tighten, not ease the monetary stance). The NBP and CNB are unlikely to engage in unconventional monetary policy. This is a particularly significant U-turn for the CNB given its previous history of super unorthodox measures via large scale FX intervention. But the ballooned CNB balance sheet makes its return unlikely

3) With central banks having limited scope to ease via conventional policy and unconventional easing only being an option for some, fiscal headroom will come into focus. Here, the Czech Republic has the most room and Romania the least. Hungary should exert the highest degree of alignment between fiscal and monetary policy, while in Poland the fiscal easing is already in play.

Fig 1 CE4 policy tools in a downturn – who's got the firepower?



Source: ING

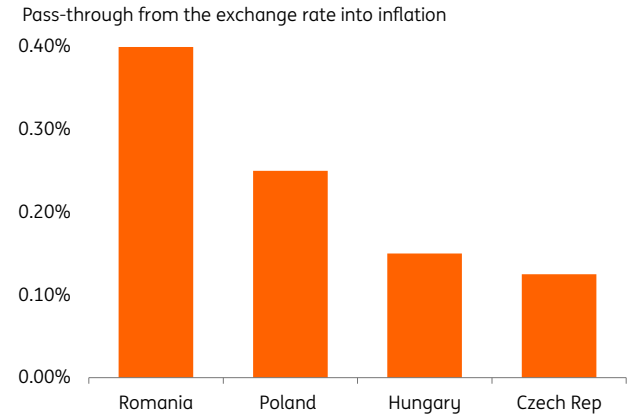
Conventional policy

Very, very limited room

In a downturn, the room for CE4 central banks to cut interest rates will be very limited. For the NBH, this is because the central bank is already at/very close to the zero lower bound. Here the deposit rate is negative (-0.05%) and the Bubor policy rate is just 0.19%. Deeply negative rates are not desirable for local policymakers.

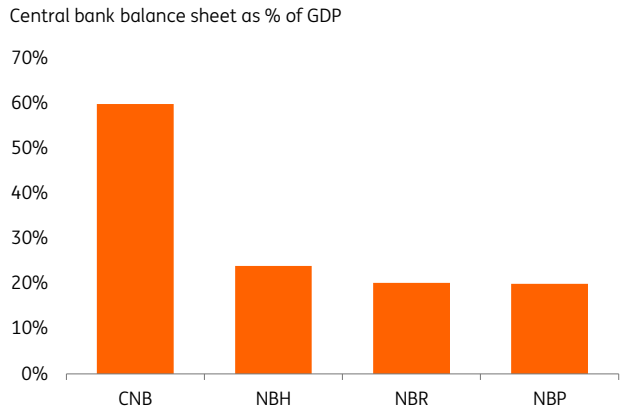
For both the CNB and the NBR, it is the currency consideration that will limit the room for either central bank to reduce policy rates. In the case of Romania, poor underlying RON fundamentals and underlying weakening pressure prevents the central bank from cutting the policy rate. It will continue to lean against an undesirable decline in the RON, where weakness exerts a very high pass-through to CPI (Figure 2).

Fig 2 RON downside constrained by high FX pass-through



Source: ING, Local CEE central banks

Fig 3 The CNB balance sheet large vs the NBH



Source: ING, Local CEE central banks

The CNB's ability to cut interest rates will be limited in the next downturn

Despite the CNB tightening aggressively over the past two years, in part to build an interest cushion for a downturn, we in fact believe the CNB's ability to cut interest rates will be limited in the next downturn.

This is due to the currency. Up until now, the ultra-hawkish CNB has been the main factor holding the CZK at current levels. Once the CNB officially stops the tightening cycle or even flirts with easing, we expect CZK to weaken given large speculative positioning.

In fact, possible CNB rate cuts risk exaggerating the CZK decline, making the koruna depreciation path potentially a disorderly one. That's why we see room for CNB cuts as limited - CZK weakness will instead deliver the bulk of the easing in monetary conditions

We view the NBP as the most likely to cut in the next downturn...

While the bar for the NBP to cut rates remains high (particularly in light of the recent fiscal stimulus and a non-negligible probability of even more after the May EU elections), we view the NBP as the most likely to cut in the downturn among the CE4 central banks.

...but we see 1.00% as the floor for the Polish policy rate

That said, and despite the interest rate being at 1.50%, we don't expect a pronounced easing cycle towards the zero lower bound but rather a more limited easing cycle of 50bp in total. We see 1.00% as a floor for the policy base rate given banking sector considerations and the impact on the co-operative banks in particular.

Unconventional policy

NBH the front runner, CNB out of the game

Along with the CNB, the NBH has been at the forefront of unconventional easing in the CE4 and we believe it will remain the trend setter (albeit alone) in the next downturn.

However, compared with the experience of prior years when the NBH preferred targeted measures (mostly concentrated on the maintenance/improvement of the monetary transmission mechanism and lending such as Funding for Growth schemes as well as the MIRS programme), this time around we would expect the NBH to engage in outright QE via buying HGBs and potentially external debt.

Indeed, with the central bank reducing its balance sheet materially over recent years (in contrast to the ballooning balance sheet of the CNB), there is clearly room to go in this direction (Figure 3). This is particularly the case when the Bubor policy rate is close to zero (as opposed to the previous slowdown when the room to cut rates was significant).

We see non-conventional measures, such as targeted programmes in Romania

Given the FX constraints on lowering interest rates in Romania, we see non-conventional measures, such as targeted programmes, as a potential option, similar to the refinancing of loans to SMEs in Hungary. Here the focus could be on financing long-term investment, conditional on a cap on the spread banks are charging and likely at a fixed rate.

Moreover, we expect the NBR to continue engaging in liquidity management operations to defend the RON. In the next downturn these are likely to be associated with a tighter/ not looser monetary policy stance on the (offshore) rates side as the need to defend the fundamentally weak currency is likely to result in higher implied yields for offshore rates.

ROMGBs look set to underperform their CE4 peers in a downturn

So while the rest of the CE4 will either run an easier or neutral monetary policy stance, the effective NBR stance may be marginally tighter, in turn suggesting ROMGBs underperforming their CE4 peers. While the front-end will underperform due to higher implied rates (associated with FX reserve depletion as the NBR is likely to defend the RON) back-end underperformance should be also driven by Romania's weakest fiscal position in the region. Domestically, however, monetary conditions would be looser (due to the unchanged ROBOR and the weaker RON).

For Poland unconventional measures are a low probability event

For Poland, unconventional measures are a low probability event, ranking after: (1) possible rate cuts; and (2) some form of conventional regulatory measures such as guarantees to improve direct credit activity or revising the repo. Only once these options are exhausted would the NBP move to QE (a low probability event at this point but, in relative terms, more likely than QE or another FX floor in the Czech Republic).

With the CNB's previous FX interventions having increased the central bank's balance sheet drastically, the case for fresh balance sheet boosting measures (such as another FX floor, QE) are low. Such measures would further increase concerns about more accounting losses on the CNB's balance sheet.

Moreover, with the CZK still being heavily overbought and the risk of a disorderly dumping of CZK longs in response to CNB easing measures, the case for non-conventional easing is low. This because: (1) the weak CZK should deliver the easing of monetary conditions; and (2) if the CNB were to ease it would do so via (conventional) interest rate cuts first before moving into the unconventional area.

Arguably the CNB will be the most constrained central bank in terms of monetary policy in the region

So quite bizarrely, while the CNB ran the most unconventional policy among the CE4 central banks during the previous downturn, this time around it will be very constrained both in terms of active conventional and unconventional measures (vs passive easing via the likely weakening CZK) - arguably the most constrained central bank in the region. Rather, the prime concern for the CNB is likely to be a potentially overly weak CZK and managing a disorderly CZK sell-off.

Fiscal policy

Czech Republic plenty of room, Romania constrained

Czech Republic has the largest fiscal headroom...

...and Romania the smallest

On the fiscal policy side, our analysis shows that the Czech Republic has the largest fiscal headroom given by its lowest total debt to GDP ratio and its total government surplus over the past three years. In contrast, Romania is already the most fiscally stretched in the CE4 space suggesting limited room for fiscal easing. Or, if it does pursue fiscal stimulus, it will lead to an even greater build-up of risk premia in ROMGBS.

The above is evident in Figure 4 which shows fiscal scenarios over the 2019-20 horizon for our baseline economic scenario, but also for two less favourable scenarios of economic slowdown.

The first slower scenario assumes GDP growth in 2019-20 lower by 1ppt for each country compared to the baseline scenario. The second scenario assumes GDP growth weaker by one standard deviation of GDP growth. This results in a 2ppt weaker GDP trajectory for Poland, 3ppt for Hungary and the Czech Republic, and 4ppt for Romania.

Fig 4 CE4 fiscal scenarios under baseline and alternative scenarios

		Baseline		Scenario 1		Scenario 2	
	2018	2019	2020	2019	2020	2019	2020
GDP growth YoY (%)							
Czech Republic	3.0	2.4	2.6	1.4	1.6	-0.6	-0.4
Hungary	4.9	4.0	3.0	3.0	2.0	1.0	0.0
Poland	5.1	4.0	3.3	3.0	2.3	2.0	1.3
Romania	4.1	2.7	2.1	1.7	1.1	0.7	0.1
Fiscal balance (% of GDP)							
Czech Republic	0.9	0.3	0.1	-0.3	-1.0	-0.9	-2.0
Hungary	-0.2	-1.8	-1.5	-2.0	-1.8	-2.5	-2.4
Poland	-0.7	-1.7	-2.3	-1.9	-2.9	-2.1	-3.7
Romania	-2.9	-3.0	-3.0	-3.3	-3.7	-3.7	-4.0
Debt-to-GDP (%)							
Czech Republic	32.7	31.9	31.3	32.7	33.4	33.4	35.0
Hungary	70.9	69.8	66.8	70.4	68.0	70.9	71.3
Poland	48.9	47.7	47.1	48.1	49.3	48.6	50.1
Romania	35.1	36.0	37.2	36.7	38.7	37.0	39.3

Source: ING

One clear fiscal constraint for EU members is the threat of the activation of excessive debt procedure (EDP) as a result of breaking the deficit threshold. Therefore the fiscal space for a particular country is lower the closer its total debt-to-GDP ratio is to the 60% threshold and its fiscal deficit to 3%.

As such, **the Czech Republic** has the greatest fiscal room given its lowest total debt to GDP ratio and total government surplus over the past three years. Also **Poland** should have relatively reasonable fiscal space, though some of that fiscal space that both countries currently possess is being partially deployed due to more expansionary social policy (enhanced child benefit, pensions, public wages).

Given the high level of debt in **Hungary**, further debt to GDP growth would be against Hungarian constitutional law. This would most likely lead to ceasing the remaining co-financed EU projects and the use of all of the net inflow from Brussels to keep the total debt-to-GDP ratio broadly constant, significantly limiting potential fiscal space.

However, it cannot be excluded that the government might try to temporarily suspend the debt reduction rule on the back of weaker economic activity - thus sending the debt-to-GDP ratio higher. This step would likely lead to a reversal in the positive sovereign credit rating action seen in recent years, however.

Romania has the least room for fiscal space, currently operating on a 3% fiscal deficit. With a potential economic slowdown ahead, the one-offs used in recent years to contain the budget deficit to within the EDP limit might not be enough.

Given Romania's heavy election calendar, raising indirect taxes with minimum impact on the voters is the likely scenario

There is a strong commitment to the 3% threshold by the authorities, but at some point this will imply a trade-off in terms of political costs. Given the heavy election calendar, raising indirect taxes with minimum impact on the voters is the likely scenario. We see the EDP being triggered by 2021 at the latest. Fiscal consolidation afterwards is likely to require external assistance (IMF/EMF).

Unlike during the upturn, the next downturn in the CE4 should see a larger synchronisation between fiscal and monetary policies as both the central bank and the government should be pushing/or intending to push in the same direction.

In our view, Hungary should exhibit the highest degree of alignment between the fiscal and monetary sides, while in Poland the fiscal easing story is already in play, front running any future potential easing from the NBP.

In both the Czech Republic and Romania, the active easing is more likely to come more via the fiscal side than the monetary side (note passive easing will be delivered in both instances via weaker domestic currencies). As per above, both central banks may be constrained in terms of monetary loosening by weakness of their respective currency.

Below we present a specific section for each CEE country and discuss the monetary policy backdrop, the tools and the most likely outcome in detail.

CE4 country focus: Monetary policy

Czech Republic

Summary: Unconventional measures are completely out of the question. Very high bar for conventional rate cuts due to the risk of the disorderly CZK sell-off

Monetary policy: new floor regime unlikely

FX-floor no more, even rate cuts are a distant possibility

Given the profound side effects of the FX floor regime on the Czech financial system and liquidity, we believe the CNB is currently the most constrained of the CE4 central banks in terms of both conventional and unconventional measures (the latter being in our view completely out of the question).

Between November 2013 and April 2017, the CNB intervened to the tune of CZK2,050bn (€76bn), equivalent to almost 45% of 2013-17-average nominal GDP, to keep CZK no stronger than 27 EUR/CZK (see Figure 3, Balance Sheet to GDP). The profound over-liquidity in the system (which was already over-liquid) has had material long-term implications for the Czech financial market. The sensitivity of CZK to interest-rate differentials is heavily muted. Thus the CNB has been able to more autonomously tighten monetary policy via interest rates independently of an ECB remaining on hold.

On the other hand, even the aggressive pace of tightening in 2H18 was not enough for CZK to strengthen versus the EUR or meaningfully outperform its peers. This less standard behaviour of CZK was a function of extreme positioning in the Czech market.

Large inflows into koruna ahead FX floor exit and subsequent saturated positioning has made CZK very vulnerable in our view

If anything, the large inflows into the koruna ahead the FX floor exit and the subsequent saturated positioning has made CZK very vulnerable in our view. Should the risk of a further EZ economic slowdown materialise and the CNB fully cease the tightening cycle, market participants might be forced to close out their long CZK positions. The koruna downfall may be even larger if the CNB entertains the idea of a pronounced easing cycle (since the hawkish CNB and its aggressive interest rate increases were the sole reason for the CZK staying largely flat against EUR last year).

With CZK weakening, monetary easing would be delivered by a softer CZK, putting less pressure on CNB to cut rates (in addition to the likely concerns that rate cuts would lead to a profound and potentially disorderly CZK sell off). This means that the 'threat' of a zero lower bound is less intense in the Czech financial sector in the years ahead, when the effect of CNB interventions will still be affecting the market. For us, this makes the case for market pricing of a pronounced CNB easing cycle (mainly next year) hard to justify.

If CZK weakens excessively, the CNB has enough firepower to use FX reserves to slow the pace of CZK depreciation

As such, deteriorating economic activity would merely stop the CNB hiking cycle and prompt stable rates for some time. Should CZK weaken too excessively, delivering too much inflationary pressure, the CNB has enough fire power to use FX reserves to slow the pace of potential CZK depreciation. While the sale of FX reserves is being vehemently resisted by the CNB at this point, the opinion of policymakers might develop in this direction were EUR/CZK to starting trading above the 27.50 area, for instance.

Introducing the FX-floor regime received a very negative public reaction, as the communication of this tool was insufficient - significantly undermining the CNB's credibility at the turn of 2013/14. Having that in mind, it might be the reason it seems unlikely the CNB would return to this tool in the foreseeable future.

Overall, given the liquidity circumstances and distortions on the market followed by the substantial intervention in 2016/17, we can hardly imagine any need for introducing the FX floor again (or going down the QE route – as we expect the NBH to do) in the next decade or so.

A possible solution for the long term, if the central bank were to return to the zero lower bound (as per above, not our base case), might be to announce FX as a new monetary policy tool instead of rates with some specified rule of thumb to be used: such as, one 25bp interest rate cut being equivalent to 1.0% FX depreciation. This might lead to a situation where the market itself pushes the currency to the target level of easing, with less intervention needed. This policy set up might be easier to exit and be less costly.

Below we set out in detail why we don't believe: (1) negative interest rates; (2) quantitative easing; or (3) other unconventional measures are likely for the CNB (should it again reach the zero lower bound).

Negative interest rates

Negative rates are not the preferred option in Czech financial markets for legal reasons

Negative interest rates are not the preferred option in Czech financial markets for legal reasons, as some penalty interest rates were derived as a multiple of the CNB deposit rate in Czech legislation. There is no clear pain threshold at which point agents would start to withdraw cash. Some slightly negative rates are possible after dealing with legal issues, but not sufficient to deliver the monetary easing needed and the CNB would soon hit lower-bound problems again. Also, negative rates in the banking sector represent a tax, since the banking sector as a whole cannot avoid it. There is also no need to intensify motivation for liquidity providing, as this is not a problem in the Czech economy. Thus we see negative interest rates as a limited tool for the CNB.

Quantitative easing

QE is not a viable option due to the shallow CZGB market

Quantitative easing is not a viable option due to the shallow CZGB market, which looks set to persist. Also, there is no need to support liquidity in the structurally over-liquid Czech banking sector, or lower the spread of CZGBs. Though price effects could work and push longer-term rates lower (thereby lowering client borrowing costs), the impact would not be sufficient as long-term rates in the Czech economy are already relatively low, influenced by German Bunds. Quantitative easing was, and is still, not applicable in the Czech economy since only some mortgage-backed securities are used for financing by Czech banks and other risky assets are negligible in banking portfolios.

Other less strong but signalling measures

Other softer actions could be considered to support CNB commitment, such as lowering the minimum reserve requirement ratio. But the real impact is limited in the over-liquid banking sector. New liquidity would end in the CNB facility anyway. The CNB could also make broader collateral accepted into the CNB repo-facility, but again, due to the structural surplus of liquidity, any real impact of the measure would be limited and therefore it would not be considered as a powerful monetary tool even in the future.

Hungary

Summary: In the next downturn, the NBH is expected to switch from targeted to non-targeted measures, with QE being the next step. Its balance sheet is still small.

Current instruments of the NBH

The current NBH monetary policy toolkit still contains some targeted unconventional instruments (even new ones), but we have seen significant changes in the conventional tools. With regards to the latter, the policy rate is still 0.90% but with the discontinuation of the three-month deposit facility, this interest rate is now paid for required reserves (the new main monetary policy instrument). Also for the preferential deposits, the NBH pays 0.90% interest overnight in connection with the FGS Fix programme and the newly introduced (as of July 2019) corporate bond buying programme. The required reserve ratio is at the EU standard level of 1%, while all the actions are communicated in advance through the forward guidance.

Regarding recent targeted unconventional instruments, the NBH is now using its FGS Fix programme (from January 2019) to push banks to place a fixed interest rate instead of variable loans. Simultaneously, the Market-Based Lending Scheme was phased out, so the preferential deposit is now linked with the FGS Fix.

To increase the liquidity of the corporate bond market, the NBH will launch the Bond Funding for Growth Scheme (BGS) on 1 July 2019

In 2019, the provided HUF1000bn-worth of 0% interest rate loan liquidity effect is to be sterilised by the NBH, using the preferential deposit. In March 2019, the NBH announced a new targeted programme to improve the monetary policy's transmission and to help the diversification of financing. To increase the liquidity of the corporate bond market, the NBH – supplementing its present set of unconventional monetary policy instruments and the FGS Fix – will launch the Bond Funding for Growth Scheme (BGS) on 1 July 2019.

Within the scope of the BGS scheme, for a facility amount of HUF300bn the central bank will purchase bonds with at least a 'B+' rating, issued by non-financial corporations as well as securities backed by corporate loans. The scheme has no effect on monetary policy conditions. The NBH intends to sterilise the excess volume of funds with the preferential deposit facility.

An asymmetric interest rate corridor (marginal lending rate equals the policy rate at 0.90%, while the deposit rate is -0.05%), negative rates and forint liquidity-providing FX swaps are also still present at a level of HUF2,000bn in the toolkit as of 1Q19. The NBH at its latest monetary policy meeting decided to start decreasing the outstanding amount of FX swaps by HUF130bn by end of 2Q19. In the meantime, the maturity structure of the FX swap stock has been changing too, but the 12-month stock still dominates with a share of 42%. The BUBOR market operates as an effective reference O/N interbank interest rate, still close to the floor of the interest rate corridor.

Possible and potential instruments in case of a crisis

We doubt the NBH will be ready to decrease its base rate or adjust the RRR in the event of a major downturn

When it comes to conventional instruments, we doubt the NBH will be ready to decrease its base rate and the RRR is expected to remain at 1% in line with EU regulations. Against this backdrop, in the case of a major downturn, the NBH will need to use unconventional tools yet again.

We see a small chance that the NBH can again deploy some measures to enhance credit activity, but only in a way that won't sterilise the HUF1tr provided via the FGS Fix programme or the HUF300bn provided via the BGS programme.

As the NBH has emphasised, FX swaps are now part of the main monetary policy instruments, so the NBH can easily increase the outstanding amount of FX swaps to flood the interbank market with extra liquidity. The NBH can again try to control the long-end of the yield curve with a new round of MIRS, or mortgage bond buying programme.

We see a traditional unconventional tool as the main option in Hungary: quantitative easing

However, we see a traditional unconventional tool as the main option: quantitative easing, where NBH buys HGBs either held by foreigners and/or taps into the HGB bond portfolio held by commercial banks (built up during the Self-financing Programme).

Moreover, as the main goal of debt management is to reduce the FX ratio of the public debt, the NBH may also start buying the REPHUNs. In our view, the highest probability scenario would be that the central bank starts to buy from the HUF4,225bn-worth of treasury bonds and bills held by foreign investors. The amount of bonds and bills sitting with the local banks will provide a roughly HUF7trn pool from which to buy.

NBH can afford a QE programme, given relatively small size of its balance sheet

The NBH balance sheet remains roughly 20% lower than its previous record high and it was HUF9,916bn on average in 2018. It is roughly equivalent to 24% of Hungarian GDP, meaning that the NBH can easily afford such a quantitative easing programme, inflating its balance sheet significantly.

Poland

Summary: The NBP the most likely among CE4 central banks to use conventional rate cuts in a downturn. Unconventional easing not on cards, but more likely than Czech.

Monetary policy: unfavourable Hungarian experiences and recently launched fiscal stimulus in Poland call for more conventional NBP policy

The NBP is pursuing perhaps the most conventional monetary policy among its CE4 peers. The MPC not only never engaged in non-standard measures, but also kept interest rates flat at the time of CPI dropping deeply below target. This has created some room to ease in the future. In our baseline scenario, we assume flat rates over the coming two years given GDP above/close to potential and CPI also near target. We worry that the MPC reaction function may be unstable in the future and subject to political issues, given the binary outcome of the October 2019 general elections.

Four arguments call for NBP monetary policy to remain conventional:

(1) lack of credit crunch or liquidity scarcity;

(2) scope for regulatory changes;

(3) reluctance to follow Hungary's experience;

(4) recently launched fiscal stimulus

In our view, there are the following four arguments calling for Polish monetary policy to stay in a conventional format over the coming two years:

(1) The starting point for the Hungarian experiment with unconventional monetary policy was the fiscal crisis and recession 10 years ago, the credit crunch (defined by the NBH 2009-13) and the lack of liquidity in the interbank market. Poland has never experienced that, which helped the NBP to sustain policy rates as a main tool. Also in the foreseeable future, we don't expect the majority of the troubles Hungary experienced, so the likelihood of entering the unconventional zone is low, in our view. (2) There are still potential regulatory decisions, which could improve the monetary policy transition and they should be explored first. (3) The NBP finds Hungarian experiences with unconventional measures unfavourable and unnecessary (we expand on this rationale over following paragraphs). (4) The recently launched fiscal stimulus (1.7% of GDP) extends the period of above-potential GDP growth by about 1-1.5 years, so monetary easing is off the agenda for a few quarters.

Very high bar for bond market intervention/quantitative easing...

Polish corporate debt market is too small for QE

The outstanding amount of Polish enterprise bonds was PLN120bn, as reported by Fitch for 2018, or 5.6% of GDP. PLN51bn of which was issued by local banks – the majority of issuance is dedicated to covered bonds, rather than actual corporate debt. Effectively the local corporate debt market is too small to allow the central bank to purchase such instruments and comply with reasonable concentration limits.

Purchases of Polish sovereign bonds by the central bank are feasible but unlikely as well. In fact, the banking tax (POLGBs are tax exempt) forced local commercial banks to become the main buyer of PLN-denominated government bonds, making NBP involvement unnecessary. The local banking sector is over-liquid and, in addition, over recent years experienced a sustainable rise in the deposit base. As a result, this group of investors has increased its share in POLGBs holding since 2013, to the extent that in January 2019 foreign holdings of PLN-denominated government bonds fell to the lowest level since 2011 (27.7%).

As long as the capacity of local banks to buy POLGBs remains solid, there is no need to engage central bank in POLGBs purchases. The recent strong acceleration of household deposits (from 6%YoY in mid-2018 to 11%YoY at the beginning of 2019) should extend the capacity of local banks to buy PLN-denominated government bonds.

The MinFin could reinvigorate the REPO markets as a means to support POLGBs

Before unconventional tools are considered (QE), there are still potential regulatory decisions, which can serve as a conventional way of supporting the POLGB market. MinFin plans to amend the banking tax in order to reinvigorate the REPO market. The idea is to exempt the borrower from the asset tax – currently both sides are taxed,

which effectively destroyed the market. If successful, REPOs may trigger some (mainly state-owned) banks to limit their holdings of taxed NBP bills and REPO excessive cash holdings to potential POLGB buyers. Effectively, there is no need to think about any form of QE before the aforementioned conventional instruments are implemented and tested.

...with direct credit activity a likely preferred next step

The starting point for the Hungarian experiment with unconventional monetary policy was the fiscal crisis and recession 10 years ago, the 2009-13 credit crunch and the lack of liquidity in the interbank market. Poland never experienced that. Currently, the Polish banking sector holds about PLN80bn of over liquidity – thus the Growth Funding Scheme tested in Hungary is not needed. Instead, Poland is facing a banking tax, which crowds outs commercial credit at the expense of government funding, but it is unlikely that it will be lifted given the current fiscal situation.

A potential instrument that may support commercial banks' appetite for corporate credit, especially for SMEs (where investments looks especially weak in this business cycle) would be a guarantee scheme. This would effectively lower the credit risk taken by banks. The programme exists (it is called de minimis) and brought encouraging results, so its scale could become larger.

On the demand side, Poland continues to see subdued demand for corporate credit in this business cycle. But corporates fund their investments from their own sources, external financing (from parent companies via cross company loans) and via withheld spending due to domestic and global uncertainty.

Liquidity support

While the overall banking sector in Poland is over liquid, some institutions tend to be forced to pay substantially higher rates for household deposits, suggesting some form of defragmentation. The central bank already has measures in its arsenal introduced in 2008. They are prepared for worst case, crisis scenarios. Measures in the package include:

- REPO operations up to 3 months,
- FX swaps,
- Currency deposits used as refinancing credit collateral,
- Extension of collateral list for the Lombard credit and decreasing the haircut.

Vulnerability of the banking sector, particularly FX exposure, has greatly decreased since. For example, the share of FX mortgage credits has more than halved since 2009. Also the capital position is very strong. Therefore it is unlikely the central bank will be forced to introduce any additional measures in the foreseeable future.

Long term swaps or other direct impact on the long-term interest rates

As an alternative to managing interest rate expectations, the central bank may attempt to directly impact long-term rates, eg, via offering long-term swaps.

We see two major factors in long-term swaps (or other direct impact on the long-term interest rates) which make them unattractive in the Polish environment. Firstly, lowering long-term borrowing costs for debtors is unlikely to translate into much stronger credit activity given that the main source of funding in Poland is still household deposits and not bank bonds. That may change together with the MREL directive but, for the time being, there is no need to test this option.

Secondly, lower long-term IRS rates would allow for lower POLGBs rates as well. However, as the Hungarian experience showed, trying to control long end yields is notoriously difficult and may not be the most efficient policy. Measures already introduced (chiefly the asset tax) or plans (chiefly reinvigorating the REPO market) should work in same direction (although less forcefully), without entering the unconventional zone in monetary policy, which the NBP seems to dislike.

Romania

Summary: Liquidity management and Hungarian style targeted programmes are the preferred option. Rate cuts are not on the table.

Monetary policy: different interpretation of conventions

NBR considers liquidity management a conventional policy tool – we think it's more unconventional

The NBR has frequently used liquidity management as a framework to influence monetary conditions without changing the key rate or rates for standing facilities. The strategy allows the central bank to change its policy stance quickly and is usually well correlated with exchange rate pressures. While the NBR considers liquidity management as a conventional policy tool, we are of the opinion that it should be treated as unconventional, due to the particular way the central bank uses and manages this tool.

Liquidity management is quite discretionary given the absence of consistent guidance and misinterpretation, which led to the decision in January 2018 to drop any reference to it from the NBR Board policy statements. Liquidity management is usually deployed as a first line of defence against FX depreciation pressures, ahead of FX interventions. Moreover, the NBR had historically unusually high spreads between the deposit and credit facilities, which translated into room for a quick and meaningful change of the policy stance via a change in liquidity management.

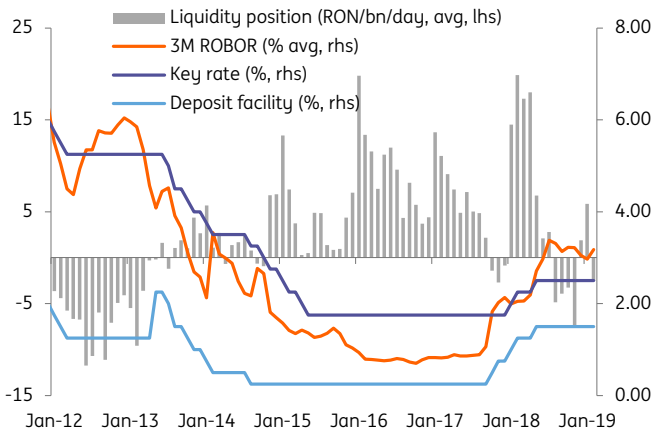
Liquidity management offers the NBR the advantage of controlling FX at a lower cost in terms of reserves depletion

The spread between the standing facilities was last narrowed in late-2017 and currently stands at 200 basis points. This, combined with no forward guidance, policy implementation unpredictability and asymmetric information as the NBR does not release daily data on the system's liquidity conditions, offers the NBR an advantage to control FX at lower cost in terms of reserves depletion.

As long as the RON is supported by fundaments (fiscal consolidation and a declining and over-financed C/A deficit) and given a benign inflation backdrop, the NBR will leave the liquidity surplus unsterilized. During a period of deflation determined by tax cuts (the largest impact from VAT) and the large liquidity surplus from EU funds, the de-facto operational instrument for monetary policy has been the deposit facility.

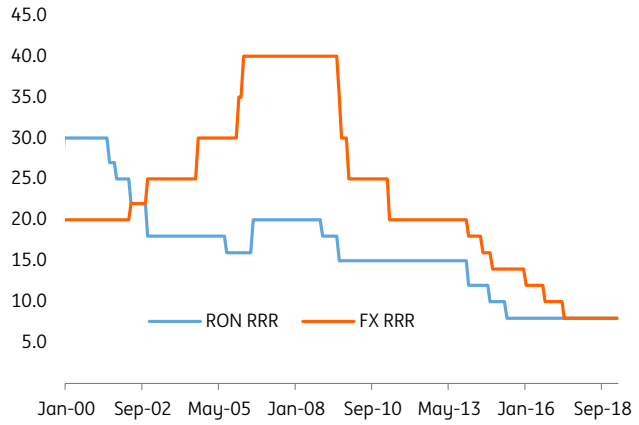
The NBR injected additional liquidity by reducing the reserve requirements ratios (RRR) during the easing cycle from the very high pre-crisis levels. In our view, the NBR was caught behind the curve by keeping its ultra-loose policy stance, while external imbalances and inflationary pressures were building up, driven by expansionary fiscal and wage policy.

Fig 5 Liquidity management: discretion rather than rules



Source: NBR, ING

Fig 6 RRR: room to ease, provided the FX is managed



Source: NBR

This led to an unintended FX-driven sharp adjustment in interest rates higher in late-2017, followed by a front-loading of the rate hikes in the first half of 2018 to regain credibility and rein in inflation. As always, the reaction was triggered by FX and the NBR is highly sensitive to it due to relatively high FX pass-through.

The next recession is likely to bring significant depreciation pressures for the RON and possible IMF involvement

The high FX pass-through very much constrains NBR's policy options in a downturn scenario, especially if this comes with weakening pressures on the RON. Given the twin deficit position, the next recession is likely to bring significant depreciation pressures for the RON and possible IMF involvement.

Hence, we see NBR easing during the next recession as a trade-off function with FX reserve depletion. In this context, even with relatively high interest rates, there is little room for the NBR to prop up the economy. Still, provided the IMF backing is secured and the fiscal house will start to be put in order, the NBR could start easing by lowering RRRs, which are relatively high at 8% for both RON and EUR liabilities versus the ECB level of 1%. Rate cuts could come only after the results of fiscal consolidation and eventual structural reforms are visible in the adjustment of the C/A shortfall.

As the government's room for stimulus is very limited, the calls for the NBR to support growth have multiplied. In the same vein came the government emergency decree in December 2018, which linked the level of the bank levy to the interbank interest rate hoping to force the NBR to ease. Eventually, the link between ROBOR and the bank tax was dropped. The government replaced ROBOR in new loan contracts for retail clients with the quarterly average interest rate for all interbank money market transactions. The latter has been most of the time lower than the 3M ROBOR index due to the steepness of the money market curve as the vast majority of the interbank trading is up to one week maturity. Furthermore, the level of the bank levy is linked to the expansion of the loan book and the decline in interest margin for each bank. This is already unconventional policy stimulus in the works. However, some of the measures might backfire, at least for short periods, as the money market curve tends to invert when the RON comes under depreciation pressure.

Recent government measures suggest that Hungary is an inspiration source for the Romanian executive

Recent government measures suggest that Hungary is a source of inspiration for the Romanian executive. In fact, the new features of the bank levy attempting to influence lending conditions are a hint that the policymakers are exploring unconventional policies to prop up economic growth.

With the current term of the NBR Board expiring in October 2019, we see a material possibility that the new Board, which will be appointed by parliament, could be even more dovish than the current one. Given the FX constraints on lowering interest rates, we see targeted programmes as a potential option, similar to the refinancing of loans to SMEs in Hungary with a focus on financing long-term investment, conditional on a cap on the spread banks are charging and likely at a fixed rate.

Still, given the fiscal position, we tend to believe that any plan to support the economy via monetary policy is likely to be viewed negatively by the markets. Furthermore, there is still plenty of room for structural reforms to boost growth.

CE4 country focus: Fiscal space

Czech Republic

Summary: The greatest room for fiscal easing among the CE4 countries due to low indebtedness and budget surpluses over recent years.

The Czech economy enjoys one of the lowest government indebtedness ratios within the EU, with total government debt to GDP below 33% in 2018. Favourable economic activity has generated higher tax revenues over recent years and, combined with improving tax collection, has seen the total fiscal balance in surplus since 2016.

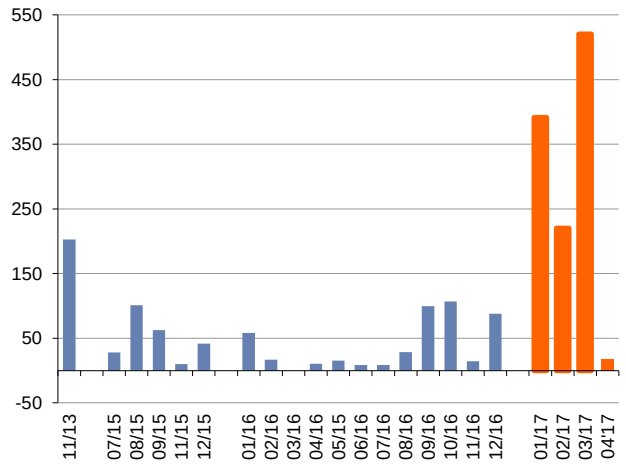
Czech total government debt to GDP has decreased from a post crisis peak of 45% to 33% in 2018

While the central government results are close to a balanced budget, the total fiscal surplus is driven by municipalities and local governments, pushing the total government balance into a surplus of around 1% of GDP for the last two years (see Figure 8). Taking into account soaring nominal GDP, total government debt to GDP has decreased from a post crisis peak of 45% to 33% in 2018. A further decline is expected in the years ahead. This means that room to provide a fiscal impulse is relatively high in the Czech economy.

On the other hand, the Czech economy suffers a very long construction approval process given inadequate legislation. As such, an urgent need to generate fiscal impulse via infrastructure investment might be hindered by a lack of construction permits. Still, there is an amendment to the current law focusing on the most important national infrastructure, which should allow building to start even when the land is not yet owned by the government. This should help transport-infrastructure investment.

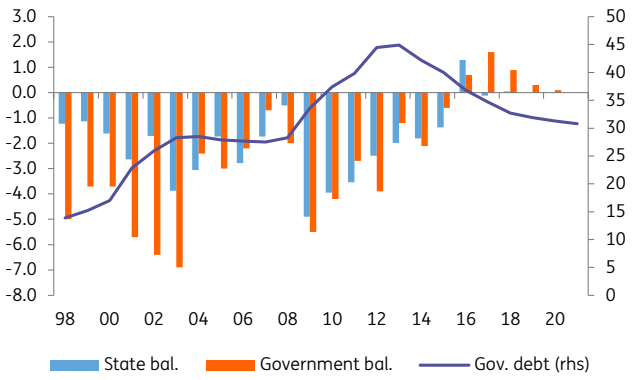
If we assume a first scenario of GDP falling by 1ppt in 2019 and 2020, this bring us to an estimate of fiscal deficit of -0.3% and -1.0% of GDP in each year, respectively. The severe scenario of 3ppt lower GDP over a two-year horizon compared to the baseline (ie, a GDP contraction of around -0.5% YoY) results in a 0.9% and 2.0% fiscal deficit in 2019 and 2020, respectively. Total debt should remain close to or below 35% of GDP - still relatively low and not triggering any concerns about fiscal sustainability. Relatively favourable results are also driven by the fact that last year's surpluses in municipalities and local governments will provide some cushion for those years assessed in our scenario horizon.

Fig 7 CNB FX interventions



Source: CNB, ING

Fig 8 Fiscal balance as a percentage of GDP and total government debt



Source: Eurostat, ING

Hungary

Summary: Some fiscal room in place, which will vanish in the case of a more pronounced downturn given the high debt to GDP and the debt rule.

Base case scenario

Fidesz-KDNP government has a good track record when it comes to the deficit-to-GDP target

The Fidesz-KDNP government has a good track record when it comes to the deficit-to-GDP target. The government plans a 1.8% of GDP general government deficit for 2019 and we see this target as plausible. This target was set by the government in mid-2018 and economic activity and revenues were all better than planned. The government thus closed 2018 with a 0.2% of GDP better deficit figure, which gives a cushion for 2019. 1.8% is our call on the 2019 budget deficit.

Debt dynamics will be also a constraint, as the base law contains a debt reduction rule

This provides 1.2% of GDP of fiscal headroom against the Maastricht criteria. Yet debt dynamics will be also a constraint, as the base law contains a debt reduction rule: the debt-to-GDP ratio needs to be cut in every year as long as the public debt is higher than 50% of GDP. The only exception regarding this need of debt reduction is an economic recession. This debt rule means that, effectively, the Hungarian government has 1.1% of GDP fiscal room, taking into consideration the expected debt reduction in 2019.

However, as the budget each and every year contains a budgetary reserve, it also provides some extra room for manoeuvre. In case of any external shock, the government has the opportunity to use budgetary reserves (HUF360bn, 0.8% of GDP) in 2019. All in all, that means almost 2% of GDP fiscal room in a downturn.

Regarding 2020, we see the deficit-to-GDP at 1.5%, matching the government's plan outlined in its latest forecast. We see the GDP growth lower, but inflation higher, and assume further improvement in the VAT gap. In this case, the fiscal room would be 1.5% of GDP and the Maastricht 3% would be the main barrier and not the debt reduction, as we expect a really significant cash flow from the EU-related projects.

Alternative scenarios

In the case of a minor economic slowdown, in which GDP growth were 1ppt less than our recent projection of 4%, it would mean that the general government budget deficit would be 0.24ppt higher in 2019. So even in this scenario, the budget deficit would be 2% of GDP (including the budgetary reserves). In this case, fiscal room decreases to roughly 1.6% of GDP this year. However, if 2020 GDP growth also proved 1ppt lower, than we see the deficit-to-GDP ratio at 1.8%, meaning the accrual based deficit won't decrease.

If real GDP growth were to slow by 1 standard deviation of GDP in both 2019 and 2020, that would mean a 3ppt drop compared to our baseline. The budget deterioration would be significant in 2019 as, in this scenario, the deficit-to-GDP would be 2.5%, but still contain the budgetary reserves, meaning 1.3% of GDP fiscal room overall. In this case there is one significant caveat: the debt-to-GDP ratio would be higher than registered in 2018, falling foul of the debt reduction law. So assuming, that the government wouldn't want to breach its own rule, we assume an unchanged debt-to-GDP ratio. It would mean that the government will stop any remaining pre-financed EU projects and use all of the net inflow from Brussels to keep debt contained.

The government could temporarily suspend the debt reduction rule during a sharp slowdown...

...risking negative rating action

Regarding 2020, in a no policy change scenario, the deficit would be 2.4%, still providing some room for the government. Overall, it seems that EU projects financed by the budget in advance will provide a significant buffer for rainy days. However, here monetary policy needs to take a lead on stimulus. As a consequence of the economy being on the verge of recession, the government could temporarily suspend the debt reduction rule. Thus we see an increasing debt-to-GDP ratio. With this step, however, the government risks a reversal in the positive sovereign credit rating action seen over the past few years.

Poland

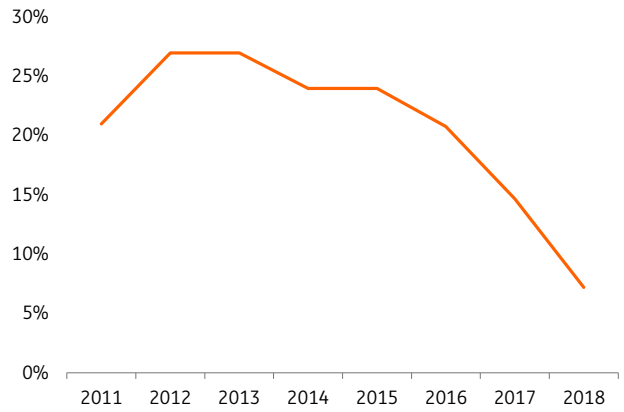
Summary: Fiscal easing is already underway. It consumes almost all fiscal space.

The fiscal policy of the current government has been twofold. On the one hand it has delivered on its campaign pledges to introduce the 500+ family support programmes (worth PLN23bn per annum) as well as lowering the retirement age (worth PLN10bn per annum). On the other hand, it has also raised new sources of public revenue (eg, a banking tax bringing PLN4bn per annum) and doubled down on tightening of the tax system. The latter has been surprisingly successful. The VAT gap fell from 24% in 2015 to about 7-10% in 2018.

We estimate that the budget has received an additional PLN33bn in revenues during 2016-18 due to tax efficiency

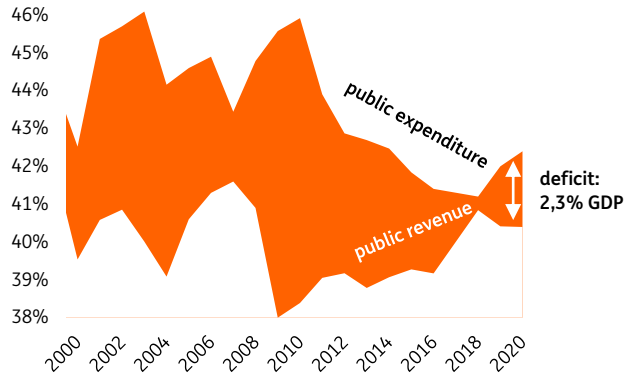
In other words, in 2015 the government collected only 76% of VAT revenues due and in 2018 as much as 90-93% of the due amount. We estimate that the budget has received an additional PLN33bn in revenues during 2016-18 due to tax tightening. This factor, together with favourable economic conditions helped lower the general government deficit from 2.6% of GDP in 2015 to c.0.4% of GDP in 2018. As a result, substantial space for fiscal easing has been created.

Fig 9 VAT gap in Poland (% of due VAT not collected)



Source: MinFin, ING

Fig 10 Build-up and use of fiscal room in Poland



Source: MinFin, ING

However, in February 2019, the government announced plans for a large fiscal impulse to be implemented in 2019 and 2020. This impulse consists mainly of social spending (enhanced child benefit, benefits for pensioners and abolition of the income limit for family benefits) and a reduction of PIT.

The combined gross cost of these measures will be PLN18bn in 2019 (0.8% of GDP) and PLN35-40bn in 2020 (1.7% of GDP cumulative). As a result, the deficit of general government should rise to 1.7% and 2.3-2.5% of GDP in 2019 and 2020, respectively, given our baseline macroeconomic scenario.

Therefore, the large amount of fiscal space that Poland currently possesses will be consumed over the next one and a half years. This will ease the GDP slowdown in Poland (we forecast GDP growth of 4.0% YoY in 2019 and 3.3% YoY in 2020).

If economic growth were to slow by more than 1ppt compared to our baseline scenario, the general government deficit would get dangerously close to 3% of GDP

However, there will be little, if any, space for further fiscal easing if the slowdown turned out to be far deeper than expected. If economic growth were to slow by more than 1ppt compared to our baseline scenario, the deficit of general government will come dangerously close to 3% of GDP, as highlighted in the table above (budget deficit calculations).

Romania

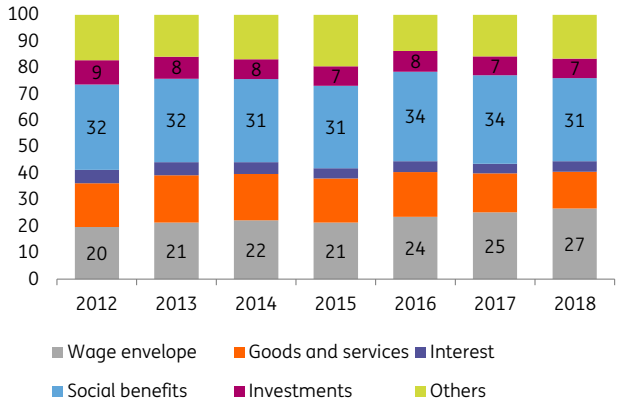
Summary: The weakest fiscal stance in the region that is running out of one-offs.

The Romanian government is entering its fourth consecutive year of budget largesse with a heavy election calendar ahead. Hence, the chance of fiscal slippage is on the rise. Still, the government seems committed to its -3% of GDP threshold.

Over the past three years, the government managed to patch budget holes by coming up with one-offs, such as special dividends, and by sharply cutting investment spending. Going forward, there is still room to switch expenditure from investments to the wage envelope and social contributions, while increasing direct taxes on voters is unlikely. Broadening the sectorial taxes on turnover to other sectors could be on the table.

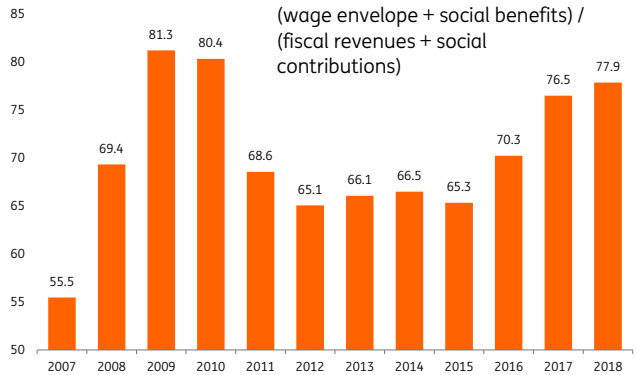
Given the relatively low level of fiscal revenues, the budget is less sensitive to economic performance. Still the ratio between quasi-permanent expenditures (wage envelope and social benefits) and cyclically sensitive revenues (fiscal revenues and social contribution) is already at levels unseen since the recession and points to very limited fiscal space to withstand even a mild economic slowdown. While there is plenty of room to improve tax collection given the high VAT gap it seems there is little political will to tackle the issue. Nevertheless, history tells us that during bad times Romanian governments tend to speed up structural reforms.

Fig 11 Weak structure for government spending



Source: MinFin, ING

Fig 12 A ticking bomb in public finances



Source: MinFin, ING

Getting the right mix

Historically when in trouble, Romanian governments have typically called the IMF. This provided a scapegoat to unpopular policies. An IMF agreement would provide NBR ammunition to deter FX weakening, lower rates and even engage in targeted growth funding schemes if such measures become more of a norm around the world – all this in exchange for structural reforms to optimise the policy mix.

Given the high home ownership ratio and high 78% share of it in total wealth, the government could also increase the guaranteed mortgage programme and the central bank could get involved in introducing incentives for banks to narrow the spread for household lending.

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German car trouble and the CEE

- **Inventory reductions knocked 0.6% QoQ off German GDP growth in 4Q18 – an outcome largely blamed on the auto sector. While it seems unlikely this sector will fare as badly this year, China, Brexit and President Trump's threat of auto tariffs add to the sense of uncertainty.**
- **With regard to the US tariff threat, the CEE's direct exposure to the US car market is relatively small. However, its indirect exposure via Germany is much larger. Were the German auto sector to face another leg lower this year, our team expect the likes of the Czech Republic, Romania and Hungary to bear the brunt of the challenge.**

Germany – how bad is it?

From fast lane to slow lane – the German economy's car problem

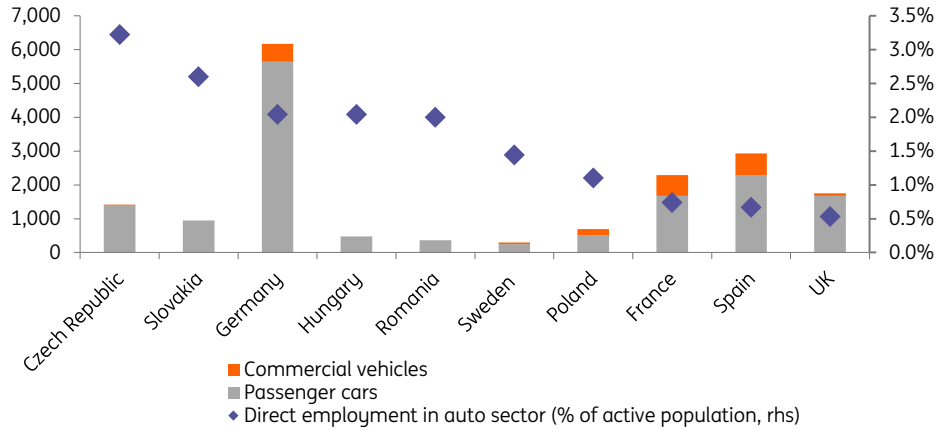
The second half of 2018 saw the German economy grind to a sudden halt. While increasing global uncertainties, looming trade wars and one-off factors like the low water levels in many of Germany's rivers also mattered, the automotive industry has probably been the most significant driver of the growth disappointment. From fast lane to slow or crawling lane within less than six months, how could this happen?

Importance of automotive sector for German economy

Adding second and third round effects between 7% and 8% of the entire German economy is linked to the auto industry

Let's start with a reminder: the German economy is not only about cars, but cars do play an important role. Currently some 2% of total employment is in the automotive industry. However, adding second and third round effects (just think of entire villages close to production plants), between 7% and 8% of the entire German economy is linked to the automotive industry. And there is more. Between 70% and 80% of automotives produced in Germany are exported making automotives one of the most important export goods. Also, one third of all investments in Research and Development in Germany stem from the automotive industry.

Fig 13 Vehicle production in the EU (000 units in 2017) and auto employment (2016)



Source: ACEA, European Automobile Manufacturers Association

What caused the current slowdown?

The slowdown in the German automotive industry started in the summer of last year with announcements of city bans for cars with older diesel engines. Some five million cars could become subject to these bans. As a result, demand for diesel cars dropped and precautionary savings of German households increased. More than half a year later, however, there are first rulings that these bans will not be implemented. A complete U-turn looks possible. Also, the introduction of a new emissions standard (WLTP, worldwide harmonised light vehicles test procedure) and delays in complying with these new standards led to severe disruptions in German automotive production and delivery.

Also, the trade war between the US and China and the subsequent slowdown of the Chinese economy have left their marks. However, these marks are still very small and nothing compared with often-heard doomsday scenarios.

In 2018 almost one quarter of all cars sold in China were German products

In 2018, total car sales in China dropped by some 4% YoY - the first decrease in twenty years. German car manufacturers, however, saw their sales increase by 2%. A slowdown, but not a contraction. In 2018, almost one quarter of all cars sold in China were German. More than one third of all cars sold by VW, BMW and Daimler went to China. VW sold almost 40% of its cars in China.

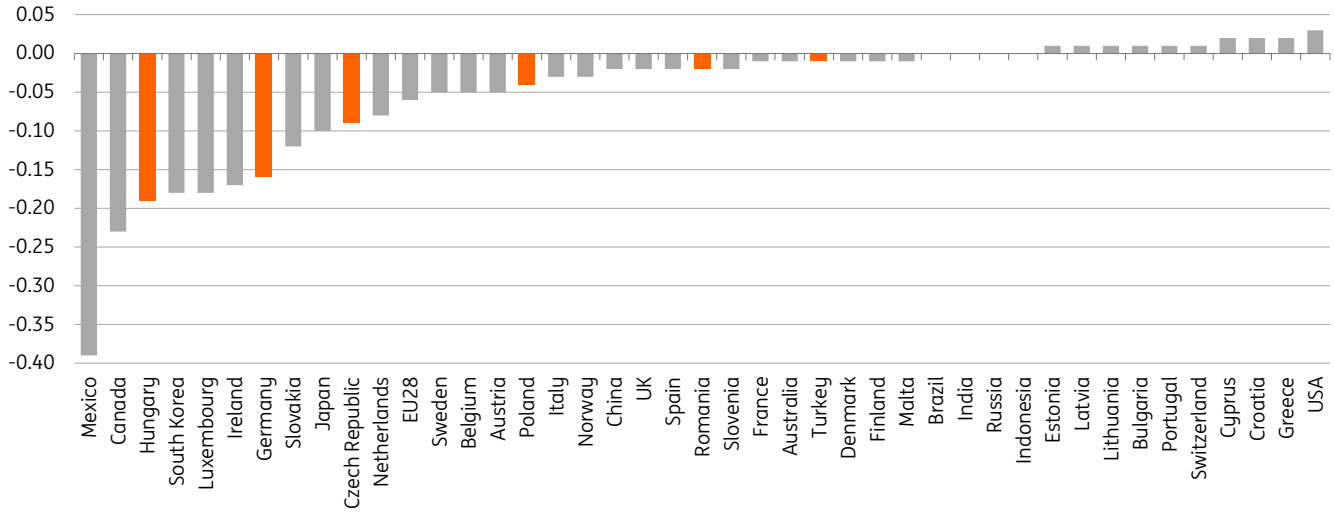
Outlook – between gloom and rebound

Contrary to the last crisis in 2008/09, the German automotive industry is currently not suffering from significant excess capacities. Nevertheless, the (German) automotive industry is facing an entire list of challenges. Some are external, like Brexit, the trade wars or a cooling of the Chinese economy; others are sector-specific, like electric mobility, CO_2 emission reductions, autonomous driving or car sharing; and some are intertwined. The current trade US-China trade war has already affected German car producers in several ways as BMW is, for example, the single largest US car exporter.

There is still ample room for growth in the Chinese auto market

The most imminent threat for the German automotive industry seems to be any Chinese slowdown - given the abovementioned importance of the Chinese markets for German car manufacturers. Here, the fact that fiscal stimulus should lead to an overall rebound of the economy as well as the fact that there is still ample room for growth in the Chinese market (currently some 14 cars per 100 inhabitants, while in Germany it is 56), both bode well for a gradual rebound.

Fig 14 Effect of US unilateral import tariffs on GDP (import tariffs of 25% on cars, % of price-adjusted GDP)



Source: IFO Institut, May 2018

As regards the two other external risks, Brexit and trade wars, the downside risks are far greater than any upside. Aside from short-term disruptions of supply chains for some German car manufacturers, a hard Brexit could lead to a drop of around 30% of German car sales in the UK (according to Deloitte).

The biggest elephant in the room is possible US tariffs on European cars. In theory, President Trump is due by mid-May to follow up on the Commerce Department's as yet unpublished findings as to whether US auto and auto-part imports are proving a national security threat.

For reference, the three largest German car manufacturers import more than half the vehicles they sell in the US from other countries (Daimler about 50%, BMW around 70% and VW more than 80%). Not all imports come from the EU, they also come from

Mexico. German car exports to the US account for between 3% and 12% of the three companies' annual sales. BMW and Daimler export around 50% of the cars produced in the US to countries outside the US.

The US administration will try to leverage the threat of tariffs on European cars for as long and as much as possible

The introduction of tariffs on European cars is therefore a very complex and complicated issue. Next to the pure sentiment effect, the actual impact of a 25% import tariff on cars would, according to the Ifo index, lead to a reduction of German GDP by 0.16%. Given the inter-linkages of German automotives and automotive suppliers, the short-term impact could be even higher. In our view, the US administration will try to leverage the threat of tariffs on European cars for as long and as much as possible. This could be done without even imposing these tariffs.

All other structural challenges the (German) automotive industry is currently facing are longer term with unclear implications currently. The only thing that is clear is that the sector will undergo further changes and shake-ups. At the current juncture, this means that cost pressures will probably mount, investment needs will increase and restructurings will occur. How far and when this will play out at the macro level is impossible to tell.

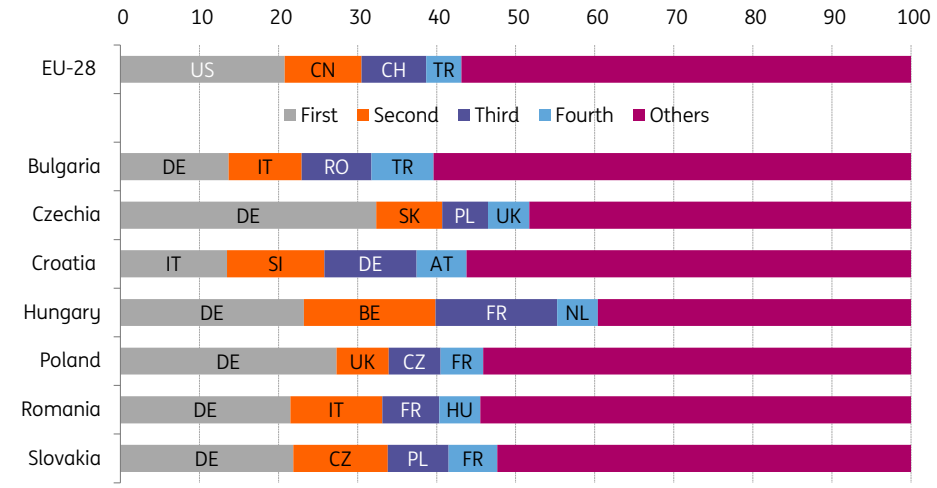
Nonetheless, we believe the German automotive industry could leave the crawling lane in the coming months as some of last year's braking factors should disappear. A quick return to the fast lane, however, looks unlikely and unexpected collisions cannot be excluded.

German cars and US tariffs – the fallout on CEE

Poland - less exposed to autos, more insulated on the fiscal side

The Polish economy, and its export structure, is one of the most diversified among the CEE economies. Also, Poland's reliance on the automotive sector is one of the lowest in the region. As a result, only limited value added (0.03% of GDP) is linked to car exports to US. We worry about the secondary effects via Poland's main trading partner, Germany, where the reliance on the US car market is much higher (up to 0.34% of German GDP is linked to value added created by cars sent to the US). Moreover, US car tariffs would hit already weak German manufacturing, which has fallen into recession.

Fig 15 Top four trading partners for exports of goods, 2016



Source: Eurostat

So far, the Polish production sector has demonstrated an impressive resilience to the slowdown in German manufacturing. We think strong domestic demand in Germany and the eurozone is probably offsetting the weakness of the markets for Western Europe's exports. Should US car tariffs (or other factors) start to impact German labour

markets and domestic demand, Polish production may start suffering and deduct from GDP growth.

Still, due to the significant fiscal stimulus announced ahead of the October 2019 general election, Poland may prove to be among the least sensitive of the CEE economies to the eurozone and German slowdown. Some CEE peers might have lower fiscal room (especially Romania) or are much more open economies (such as the Czech Republic and Hungary).

Czech Republic – in the firing line on autos

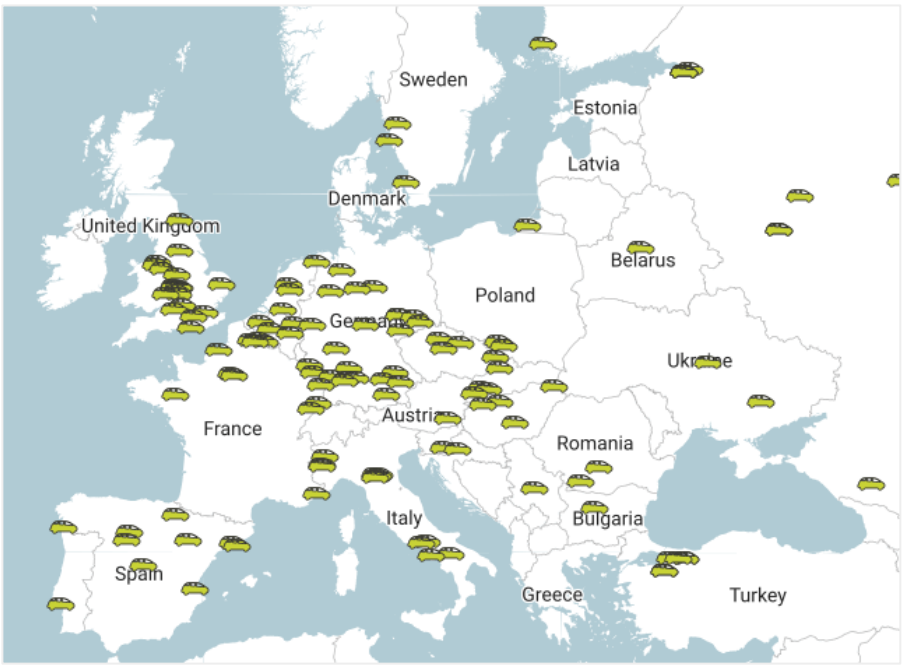
Car production represents the most important industrial and export segment in the Czech Republic, having an almost 30% share in total Czech exports. In 2018, there were 1.4 million cars produced in the Czech Republic (1.7% YoY increase), which makes it one of the countries with the highest car production per capita in the world, after Slovakia. There are three main car manufacturers, Škoda Auto (61% share), Hyundai Motor Manufacturing Czech (24% share) and Toyota Peugeot Citroën Automobile (15% share).

Due to significant supply chains in the automotive industry, the total share of the auto sector for the Czech economy represents around 9% of GDP

According to the Czech Automotive Industry Association (AIA, AutoSAP) the automotive industry employs around 150,000 people directly (3% of total workforce), but there are a further 400,000 jobs linked to the automotive industry indirectly. As such, due to the significant supply chains related to the automotive industry, the total share of the automotive sector for the Czech economy represents around 9% of GDP. Official statistics imply a weaker dependence as the car segment represents around 20% of industry, which had a 29% share in GDP last year. This equates to around 6% of GDP, but this figure does not include the abovementioned supply chains producers.

Due to the relatively limited link of the Czech automotive industry with the US market, the impact of US-EU car tariffs would not be significant, slightly below 0.1ppt, based on IFO estimates (see Figure 14).

Fig 16 Passenger car production plants across Europe



Source: ACEA, European Automobile Manufacturers Association

However, a further slowdown in global car production, mainly affecting German producers, would have greater negative implications for the Czech economy. That said, carmakers in the Czech economy were operating at stretched capacity last year, so there is no expectation of any further growth in the car industry this year anyway.

As such, some decline in demand should resettle the economy towards more balanced growth, with very limited negative consequences for the Czech economy. However, a more prolonged and severe slump in global car demand would hit the Czech economy sooner or later, as currently-solid domestic Czech demand would not be enough to compensate for a slowdown in one of the most important sectors of the economy.

Hungary – insulated by high margin brands?

There are several reasons why Hungary would be among the most affected by US tariffs and their impact on Germany

There are several reasons why Hungary would be among the most affected countries by tariff impositions and any impact on Germany. The Hungarian automobile industry produces about 5% of GDP, also it employs (on some measures) 4% of total workers in the country. Most cars and car parts are produced by German companies (VW Group and Daimler), and 90% of the production is exported. About 10% of exported cars go to the US, thus tariffs would cause a 0.2% decrease in the GDP - the highest in Europe.

On the other hand, the Hungarian economy has been more driven by domestic demand over the past couple of years. Indeed, export activity has decoupled somewhat from European and German trends. If we consider industrial production in 2017 and 2018, the growth structure is more balanced than before, meaning that the car industry is not the key driver of growth currently.

So despite being the biggest contributor to GDP, mid and lightweight manufacturing sectors are boosting growth in industry, counterbalancing the issues in car manufacturing. Also German carmakers (Audi and Mercedes and soon-to-arrive BMW) produce luxury cars, where demand is not really price-elastic – thus US tariffs would perhaps not hit the Hungarian auto market as much as it would hit mid-level car producers.

All things considered, the direct effect of higher US tariffs in the real economy would be relatively small, although it could cause a major turbulence in the FX market. Should a tit-for-tat trade war arise between the US and EU, it would have more serious consequences for the region than we see for it right now.

Romania – very much in the mix

Auto-related exports to Germany account for about 15% of Romanian exports, representing roughly 10% of Romania's GDP

Germany is the largest export partner for Romania with a 22.9% share of total exports. Around two-thirds of total exports are automotive related. Hence, automotive-related exports to Germany account for about 15% of Romanian exports, representing roughly 10% of Romania's GDP and employing approximately 90,000 people.

A slowdown in the German auto industry would have a direct negative impact on Romanian exports, planned investments by German companies and GDP growth with subsequent implications for the currency, especially considering the twin deficits are at or above warning levels.

Turkey – competitively positioned

Turkey is the leading CEE contributor to vehicle production as a large base for global original equipment manufacturers (OEMs) while it has been increasing its component exports over recent years, where Germany is now its number one export market.

As of end-2018, automotive exports to Germany stood at US$4.25 billion, having more than a quarter share in total exports to this country. Exports of motor vehicles and components are roughly balanced. These numbers show a relative sensitivity to German demand, but Turkey's cost and competitive advantages, helped by a competitive Turkish Lira as well as a quite diversified export market structure, will likely help Turkey weather any slowdown in the German automotive industry.

Russia seems more-or-less isolated from travails in the global auto sector

Russia

Russia seems more-or-less isolated from the travails in the global auto sector. According to 2018 statistics, Russia exports only 6% of light vehicles it produces locally, or 0.1 million out of 1.6 million. In USD terms, car exports total US$1.3 billion, or 0.3% of the country's total exports.

One potential channel of pass-through is via higher costs of imports and local production. Russia imports around 0.3 million new and used cars annually, worth US$7.3bn, or 3% of imports, which does not seem significant. However, it is worth mentioning that depending on the model, around 40-60% of local production requires imported investment and intermediary goods. Therefore, the global trade tensions can potentially affect at least half of Russia's US$30bn car market.

Conclusion

The German car industry faces an uncertain environment and certainly the imposition of US tariffs would be a very unwelcome headwind. Looking across the CEE space, the Czech Republic and Romania look most exposed, while Hungary will hope that its concentration in the luxury German car space will provide some insulation.

Contributors: Carsten Brzeski, Rafal Benecki, Jakub Seidler, Peter Virovácz, Ciprian Dascalu, Muhammet Mercan, Dmitry Dolgin, and Chris Turner

Countries

Bulgaria

Ciprian Dascalu, Chief Economist, Romania & Balkans

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (% YoY)*	3.2	3.2	2.9	3.4	3.9	3.4	3.4
CPI (% YoY)*	2.7	3.0	2.9	3.0	3.0	3.0	3.1
Central bank key rate (%)*	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3m interest rate (%)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a
10yr yield (%)*	0.96	0.75	0.75	0.70	0.70	0.70	0.60
USD/BGN*	1.70	1.75	1.78	1.70	1.63	1.72	1.55
EUR/BGN*	1.96	1.96	1.96	1.96	1.96	1.96	1.96

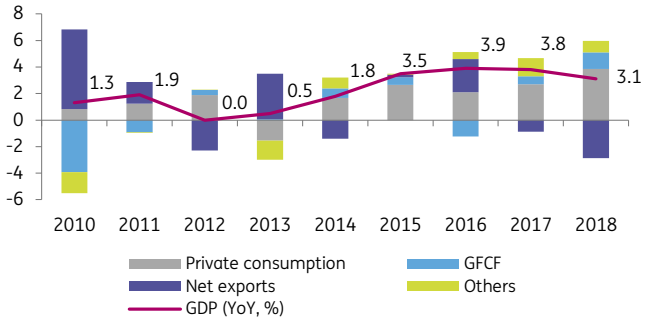
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Nov 21	S&P	BBB-	BBB-
Fiscal	Neutral	Parliamentary: Apr 21	Moody's	Baa2	Baa2
Monetary	Loose	Local: Oct 19	Fitch	BBB	BBB

*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Country strategy

The economy slowed from 3.8% to 3.1% in 2018, mainly driven by contracting exports that increased the negative contribution of net exports to growth. Provided eurozone growth finds a new equilibrium, we expect the Bulgarian economy to expand at a similar speed in 2019 given that gross fixed capital formation is likely to be supported by the investment pipeline of €8.6bn in EU funds, of which €3.1bn has been spent so far. Investments are likely to offset household consumption as suggested by weakening consumer confidence over the past eight months. In the absence of a surprise after the ECB assessment of the large banks, we could see the green light for ERM-II being given in the second half of the year, which is credit positive. We expect ERM-II to exceed two years.

Net exports dragging down GDP growth



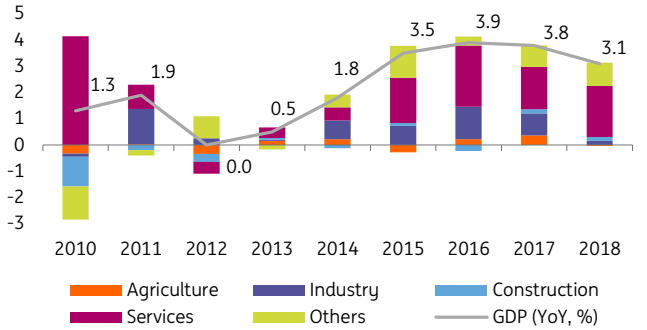
Source: NSI, ING

Investment acceleration to support growth

Despite weakness in consumer sentiment, the labour market remains robust and wages are growing at a high single digit rate in the private sector, while the state budget has allocated around 0.9ppt of GDP to increase public sector wages in 2019. The government targets a 0.5% of GDP budget deficit for 2019 versus a 0.1% surplus in 2018, the fiscal stimulus coming in addition to imported lower-for-longer rates from the ECB, which should support household demand.

Investments are likely to be the second pillar of economic expansion in 2019 after an acceleration of 6.5% YoY in 2018, from 3.2% in 2017, with 74% of EU money already available.

Industry hit by external demand



Source: NSI, ING

High frequency and soft data point to a rebound

Purchasing intentions for big ticket items (cars, houses, home improvements) jumped at the start of the year, which should keep household consumption at levels similar to 2018 when it accelerated to 6.3% YoY from 4.3% the previous year. This is a bit at odds with weaker consumer confidence and a slowdown in non-food retail sales to 4.8% YoY in January versus the average YoY growth in 2018 of 6.8%. This outlook for big ticket items could be explained by cheap loans and solid job prospects.

After the contraction in December, the manufacturing sector bounced back in January, by 2.4% YoY. Still, sentiment data from main eurozone economies doesn't show clear signs of rebound.

Bulgaria

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-3.6	1.3	1.9	0.0	0.5	1.8	3.5	3.9	3.8	3.1	3.4	3.4	2.4
Private consumption (% YoY)	-4.4	1.1	1.9	3.0	-2.2	2.6	4.2	3.7	4.5	6.5	4.3	3.8	3.4
Government consumption (% YoY)	-5.9	2.0	2.2	-2.0	0.6	0.2	1.3	2.2	3.7	3.9	5.2	4.3	5.5
Investment (% YoY)	-17.7	-17.7	-4.4	1.8	0.3	3.4	2.7	-6.6	3.2	9.0	6.8	5.2	4.5
Industrial production (% YoY)	-18.3	1.9	6.2	-0.4	0.0	2.1	2.8	2.7	3.8	0.8	0.8	1.0	0.8
Unemployment rate (year-end, %)	6.9	10.3	11.3	12.3	13.0	11.4	9.1	7.6	6.2	5.2	5.0	4.8	4.7
Nominal GDP (BGNbn)	73.0	74.8	80.8	82.0	81.9	83.8	88.6	94.1	101.0	107.4	114.1	120.8	126.7
Nominal GDP (€bn)	37	38	41	42	42	43	45	48	52	55	58	62	65
Nominal GDP (US$bn)	52	51	58	54	56	57	50	53	59	63	70	80	84
GDP per capita (US$)	7,000	6,900	7,900	7,400	7,700	7,800	6,900	7,400	8,400	9,100	10,100	11,700	12,200
Gross domestic saving (% of GDP)	20.3	19.7	21.9	18.8	20.6	20.6	21.3	23.5	23.8	22.4	22.4	22.2	21.8
Prices													
CPI (average, % YoY)	2.8	2.4	4.2	3.0	0.9	-1.4	-0.1	-0.8	2.1	2.8	3.0	3.1	2.5
CPI (year-end, % YoY)	0.6	4.5	2.8	4.3	-1.6	-0.9	-0.4	0.1	2.8	2.7	3.0	3.2	2.2
Wage rates (nominal, % YoY)	12.0	7.2	8.0	5.6	8.6	2.4	7.9	7.0	10.5	7.4	7.7	8.0	3.1
Fiscal balance (% of GDP)													
Consolidated government balance	-4.1	-3.1	-2.0	-0.3	-0.4	-5.4	-1.7	0.2	1.1	0.1	-0.5	-0.5	-1.0
Consolidated primary balance	-3.3	-2.4	-1.2	0.5	0.4	-4.6	-0.7	1.1	1.9	1.5	1.3	1.2	1.0
Total public debt	13.7	15.3	15.2	16.7	17.1	27.1	26.2	29.6	25.6	23.3	21.9	20.7	19.8
External balance													
Exports (€bn)	11.7	15.6	20.3	20.8	22.3	22.0	22.9	24.0	26.6	26.8	28.3	29.9	31.5
Imports (€bn)	16.9	19.2	23.4	25.5	25.8	26.1	26.3	26.2	30.2	32.4	34.3	36.3	38.5
Trade balance (€bn)	-5.2	-3.7	-3.1	-4.7	-3.6	-4.1	-3.5	-2.1	-3.6	-5.6	-6.0	-6.5	-7.0
Trade balance (% of GDP)	-13.9	-9.6	-7.6	-11.2	-8.5	-9.5	-7.7	-4.4	-7.0	-10.1	-10.3	-10.5	-10.8
Current account balance (€bn)	-3.1	-0.7	0.1	-0.4	0.5	0.5	0.0	1.2	3.4	2.0	1.8	2.1	2.4
Current account balance (% of GDP)	-8.3	-1.7	0.3	-0.9	1.3	1.2	0.0	2.6	6.5	3.6	3.1	3.4	3.7
Net FDI (€bn)	2.5	0.9	1.2	1.1	1.2	0.1	2.2	1.0	1.4	1.5	1.6	1.6	1.7
Net FDI (% of GDP)	6.8	2.4	2.9	2.5	3.0	0.3	4.9	1.3	2.1	2.8	2.7	2.7	2.6
Current account balance plus FDI (% of GDP)	-1.6	0.7	3.2	1.7	4.2	1.6	4.9	3.9	8.6	6.4	5.8	6.1	6.3
Foreign exchange reserves ex-gold (€bn)	11.2	10.9	11.0	13.2	12.6	14.5	18.2	21.6	21.4	22.8	26.1	29.9	34.0
Import cover (months of merchandise imports)	8.0	6.8	5.7	6.2	5.8	6.7	8.3	9.9	8.5	8.4	9.1	9.9	10.6
Debt indicators													
Gross external debt (€bn)	37.8	37.0	36.3	37.7	36.9	39.3	33.5	34.2	33.4	32.7	33.4	34.0	34.7
Gross external debt (% of GDP)	101	97	88	90	88	92	74	71	65	60	57	55	54
Gross external debt (% of exports)	323	238	179	182	166	178	146	142	126	122	118	114	110
Lending to corporates/households (% of GDP)	68.6	67.8	64.8	65.6	65.5	59.2	55.0	52.3	51.6	51.0	52.7	54.6	55.9
Interest & exchange rates													
Central bank key rate (year-end, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.00	0.00	0.00	0.00	0.00	0.15
Broad money supply (average, % YoY)	4.2	6.4	12.2	8.4	8.9	1.1	8.8	7.6	7.7	8.8	7.8	6.7	8.5
3m interest rate (Sofibor, average, %)	5.7	4.1	3.8	2.3	1.1	0.8	0.5	0.2	0.1	-0.2	n/a	n/a	n/a
3m interest rate spread over Euribor (ppt)	4.5	3.3	2.4	1.7	0.9	0.6	0.6	0.4	0.4	0.1	n/a	n/a	n/a
3yr yield (average, %)	5.7	4.7	3.7	2.7	1.5	1.4	0.9	0.4	0.1	0.0	0.1	0.2	0.2
10yr yield (average, %)	7.5	6.1	5.3	4.6	3.5	3.4	2.6	2.2	1.6	0.9	0.7	0.6	0.6
USD/BGN exchange rate (year-end)	1.40	1.46	1.40	1.52	1.47	1.48	1.78	1.86	1.63	1.70	1.63	1.50	1.50
USD/BGN exchange rate (average)	1.40	1.46	1.40	1.52	1.47	1.48	1.78	1.78	1.70	1.70	1.72	1.55	1.50
EUR/BGN exchange rate (year-end)	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
EUR/BGN exchange rate (average)	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	3.6	3.0	3.1	3.2	3.2	2.9	3.4	3.9	3.6	3.3	3.6	3.1	2.5
CPI (eop, %YoY)	2.2	3.2	3.6	2.7	3.0	2.9	3.0	3.0	3.3	3.0	2.7	3.2	2.2
Central bank key rate (eop, %)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3m interest rate (eop, %)	0.02	0.00	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
10yr yield (eop, %)	1.13	1.24	0.98	0.96	0.75	0.75	0.70	0.70	0.65	0.65	0.60	0.60	0.60
USD/BGN exchange rate (eop)	1.63	1.63	1.67	1.70	1.75	1.78	1.70	1.63	1.60	1.56	1.53	1.50	1.50
EUR/BGN exchange rate (eop)	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96

Source: National sources, ING estimates

Croatia

Valentin Tataru, Economist, Romania & Balkans

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (% YoY)*	2.3	2.3	2.5	2.8	2.1	2.4	2.2
CPI (% YoY)*	0.9	1.2	1.1	1.4	1.8	1.2	1.7
Central bank key rate (%)*	0.30	0.30	0.30	0.30	0.30	0.30	0.30
3m interest rate (%)*	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10yr yield (%)*	2.00	2.00	1.90	1.90	1.80	1.90	1.80
USD/HRK*	6.32	6.63	6.70	6.43	6.21	6.50	5.90
EUR/HRK*	7.41	7.42	7.37	7.40	7.45	7.41	7.43

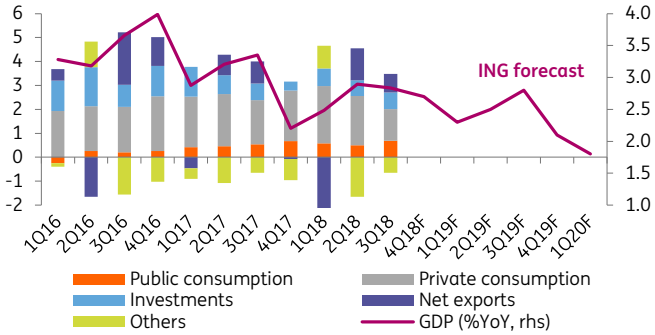
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Dec-2019	S&P	BBB-	BBB-
Fiscal	Neutral	Parliamentary: Sep-2020	Moody's	Ba2	Ba2
Monetary	Loose	Local: May-2021	Fitch	BB+	BB+

*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

Country strategy: upgraded to Investment Grade by S&P

The Croatian economy finished 2018 with a mild slowdown, much in line with regional developments. For 2019, we expect GDP growth to decelerate moderately, as the main growth drivers seem to be levelling off – namely consumption and export of services – while the factors that could offset them, like public investments, are yet to reach their potential. Following S&P's upgrade to BBB- in March, we consider a similar move from Fitch as likely as Croatia is ticking most of the boxes while an upgrade is also possible at Moody's. Chiefly, the fiscal position has continued to improve placing the public debt ratio on a steady downward trend, the economy remains on a growth track and a pick-up in investments should materialise in 2019 on higher expected EU funds utilisation.

Real GDP (%YoY) and contributions (ppt)



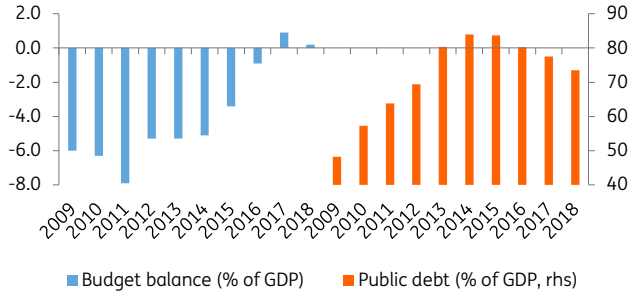
Source: Eurostat, ING

GDP growth

Economic growth remained robust in the second part of 2018. We expect 2018 GDP growth of 2.6%. Going forward, the slowdown in external demand and, to some extent, in private consumption should be offset by a pick-up in EU funds absorption and investments, particularly related to infrastructure projects. We see GDP growth at 2.4% in 2019.

Although on a downward trend, private consumption should remain robust thanks to favourable tax changes like VAT cuts for selected products and lower income tax. Furthermore, the electoral year and tightening labour market will continue to add pressure on pensions and wages.

Budget performance (% of GDP)



Source: AMECO

All good, but mind the elections

The 2018 budget balance is likely to be marginally positive (c.0.2% of GDP). For 2019 the budget bill envisages a 0.4% of GDP deficit. Unlike previous years, we tend to believe that the risk could be for an even bigger deficit, given the electoral context which typically favours an increased spending appetite. That said, the Croatian government has a good track record of containing wage and pension increases.

We estimate the 2019 budget deficit at -0.7% of GDP, including a call for a further -0.5% of GDP for shipyard guarantees. This will help bring the public debt ratio close to 70% by the end of 2019, a level that still constrains the rating outlook to some extent.

Croatia

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-7.3	-1.5	-0.3	-2.3	-0.5	-0.1	2.4	3.5	2.9	2.6	2.4	2.2	2.0
Private consumption (% YoY)	-7.5	-1.4	0.3	-3.0	-1.9	-1.6	1.0	3.4	3.6	3.8	3.3	2.9	2.6
Government consumption (% YoY)	2.1	-0.6	-0.4	-0.8	0.6	1.8	-1.0	0.7	2.7	2.7	1.8	2.0	2.2
Investment (% YoY)	-14.4	-15.2	-2.7	-3.3	1.4	-2.8	3.8	6.5	3.8	4.1	5.4	4.4	3.5
Industrial production (% YoY)	-9.0	-1.4	-1.3	-5.4	-1.6	1.1	2.5	5.1	2.1	-1.0	0.5	0.0	-1.0
Unemployment rate (year-end, %)	9.3	11.8	13.7	15.8	17.4	17.2	16.1	13.4	11.0	8.5	7.5	7.0	6.0
Nominal GDP (HRKbn)	331	329	333	331	332	332	340	351	366	380	400	420	440
Nominal GDP (€bn)	45	45	45	44	44	43	45	47	49	51	54	57	59
Nominal GDP (US$bn)	63	61	63	57	58	57	49	51	56	59	62	71	77
GDP per capita (US$)	14,700	14,100	14,700	13,300	13,700	13,500	11,700	12,300	13,600	14,300	15,000	17,800	19.700
Gross domestic saving (% of GDP)	21.4	21.0	20.2	19.7	19.9	20.7	22.4	23.6	23.2	23.4	23.6	23.8	23.9
Prices													
CPI (average, % YoY)	2.4	1.0	2.3	3.4	2.2	-0.2	-0.5	-1.1	1.1	1.6	1.2	1.7	1.1
CPI (year-end, % YoY)	1.9	1.9	2.1	4.6	0.3	-0.5	-0.6	0.2	1.2	0.9	1.8	2.1	1.5
Wage rates (nominal, % YoY)	3.0	-0.5	1.5	1.1	0.7	0.2	-3.9	1.3	3.8	4.7	4.8	4.9	5.0
Fiscal balance (% of GDP)													
Consolidated government balance	-6.0	-6.3	-7.9	-5.3	-5.3	-5.1	-3.4	-0.9	0.9	0.2	-0.5	-1.0	-1.0
Consolidated primary balance	-3.7	-3.8	-5.1	-2.1	-2.1	-1.7	0.0	2.1	3.5	2.7	2.6	1.8	1.8
Total public debt	48.3	57.3	63.8	69.4	80.4	84.0	83.7	80.2	77.5	73.5	69.9	66.5	63.5
External balance													
Exports (€bn)	7.5	8.9	9.6	9.6	9.5	10.4	11.6	12.5	14.2	15.3	16.0	16.7	17.4
Imports (€bn)	15.2	15.1	16.3	16.2	16.6	17.2	18.5	19.8	22.0	23.5	24.5	25.5	26.6
Trade balance (€bn)	-7.7	-6.2	-6.7	-6.6	-7.0	-6.8	-6.9	-7.3	-7.7	-8.2	-8.5	-8.8	-9.2
Trade balance (% of GDP)	-17.1	-13.8	-15.0	-15.0	-16.1	-15.6	-15.4	-15.7	-15.7	-16.0	-15.8	-15.6	-15.5
Current account balance (€bn)	-2.3	-0.5	-0.3	-0.1	0.4	0.9	2.0	1.2	2.0	1.4	1.1	1.0	1.0
Current account balance (% of GDP)	-5.1	-1.1	-0.7	-0.1	0.9	2.0	4.5	2.6	4.0	2.7	2.0	1.8	1.7
Net FDI (€bn)	1.3	0.8	1.1	1.2	0.8	0.7	0.2	1.9	1.2	0.6	0.6	0.6	0.7
Net FDI (% of GDP)	2.8	1.8	2.5	2.8	1.9	1.6	0.5	4.1	2.4	1.2	1.1	1.1	1.2
Current account balance plus FDI (% of GDP)	-2.2	0.7	1.8	2.7	2.9	3.6	5.1	6.7	6.4	3.9	3.2	2.9	2.8
Foreign exchange reserves ex-gold (€bn)	10.4	10.7	11.2	11.2	12.9	12.7	13.7	13.5	15.7	17.4	18.9	19.5	21.0
Import cover (months of merchandise imports)	8.2	8.5	8.2	8.3	9.3	8.9	8.9	8.2	8.6	8.9	9.3	9.2	9.5
Debt indicators													
Gross external debt (€bn)	45.6	46.9	46.4	45.3	45.8	46.4	45.4	41.7	40.1	38.4	37.9	37.3	36.7
Gross external debt (% of GDP)	101	104	104	103	105	107	102	89	82	75	70	66	62
Gross external debt (% of exports)	608	527	484	470	480	446	390	334	282	251	237	224	211
Lending to corporates/households (% of GDP)	70.3	73.3	75.6	71.5	70.6	69.2	65.5	61.1	58.3	57.1	58.5	59.8	61.0
Interest & exchange rates													
Central bank key rate (year-end, %)	6.0	6.0	6.0	6.0	6.0	6.0	0.5	0.3	0.3	0.3	0.30	0.30	0.40
Broad money supply (average, % YoY)	1.5	2.4	1.2	5.7	4.6	3.2	3.8	4.6	3.0	4.7	5.5	5.0	4.4
3m interest rate (Zibor, average, %)	9.0	2.4	3.2	3.4	1.5	1.0	1.2	0.9	0.6	0.5	0.5	0.5	0.6
3m interest rate spread over Euribor (ppt)	7.7	1.6	1.8	2.8	1.3	0.8	1.2	1.1	0.9	0.8	0.8	0.5	0.8
3yr yield (average, %)	n/a	n/a	n/a	n/a	4.0	3.5	2.5	1.6	1.1	0.4	0.4	0.4	0.6
10yr yield (average, %)	7.8	6.3	6.5	6.1	5.0	4.3	3.6	3.5	2.7	2.1	1.9	1.8	1.9
USD/HRK exchange rate (year-end)	5.21	5.51	5.38	5.86	5.73	5.80	6.94	7.20	6.20	6.45	6.21	5.73	5.73
USD/HRK exchange rate (average)	5.24	5.44	5.31	5.83	5.70	5.78	6.92	6.85	6.49	6.45	6.50	5.90	5.72
EUR/HRK exchange rate (year-end)	7.30	7.38	7.54	7.56	7.63	7.66	7.64	7.56	7.44	7.41	7.45	7.45	7.45
EUR/HRK exchange rate (average)	7.34	7.29	7.44	7.52	7.58	7.63	7.61	7.53	7.46	7.42	7.41	7.43	7.44

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	2.5	2.9	2.8	2.7	2.3	2.5	2.8	2.1	1.8	2.2	2.4	2.2	2.0
CPI (eop, %YoY)	1.0	2.4	1.4	0.9	1.2	1.1	1.4	1.8	1.8	1.6	1.5	2.1	1.5
Central bank key rate (eop, %)	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
3m interest rate (eop, %)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.55
10yr yield (eop, %)	2.20	2.20	2.00	2.00	2.00	1.90	1.90	1.80	1.80	1.80	1.80	1.80	1.85
USD/HRK exchange rate (eop)	6.19	6.31	6.03	6.32	6.63	6.70	6.43	6.21	6.08	5.92	5.80	5.73	5.71
EUR/HRK exchange rate (eop)	7.43	7.38	7.43	7.41	7.42	7.37	7.40	7.45	7.42	7.40	7.43	7.45	7.42

Source: National sources, ING estimates

Czech Republic

Jakub Seidler, Chief Economist Czech Republic

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (% YoY)	2.6	2.6	2.5	2.4	2.0	2.4	2.6
CPI (% YoY)*	2.0	2.9	2.4	2.2	2.3	2.4	1.9
Policy interest rate (eop, %)	1.75	1.75	2.00	2.00	2.25	2.25	2.25
3m interest rate (%)*	2.01	2.02	2.24	2.24	2.49	2.18	2.49
10yr yield (%)*	1.94	1.92	2.10	2.00	1.90	1.98	1.78
USD/CZK*	22.43	23.02	23.36	22.43	21.67	22.62	20.90
EUR/CZK*	25.72	25.82	25.70	25.80	26.00	25.78	26.34

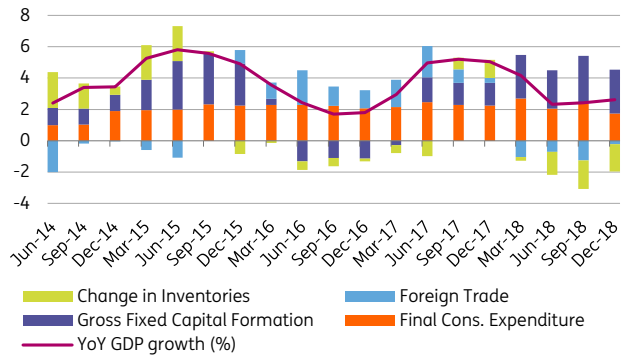
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: 2023	S&P	AA-	AA
Fiscal	Looser	Parliamentary: 2021	Moody's	A1	A1
Monetary	Tighter	Local: 2020	Fitch	AA-	AA-

*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

Country strategy

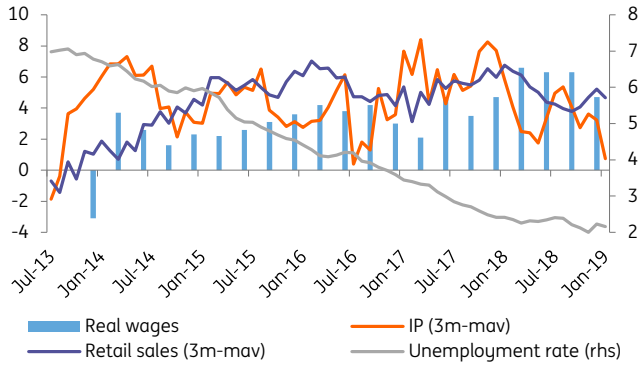
The Czech economy slowed from 4.5% growth in 2017 to 3% in 2018. The main drag on growth was net exports as export activity slowed as a result of stretched producer capacities and weaker foreign demand while imports increased given import-intense investments. We believe this trend will continue and expect the economy to slow to 2.4% in 2019, being close to its potential growth. The labour market will remain overheated, though strong 8% wage growth will not be repeated this year due to the declining profitability of companies. Wage growth and some one-offs temporarily pushed inflation close to 3% at the beginning of 2019. The CZK is not appreciating as quickly as expected, delivering no monetary tightening, hence at least one rate hike is likely this year, if the global economy stops deteriorating.

Real GDP growth structure (ppt of YoY growth, SA adj)



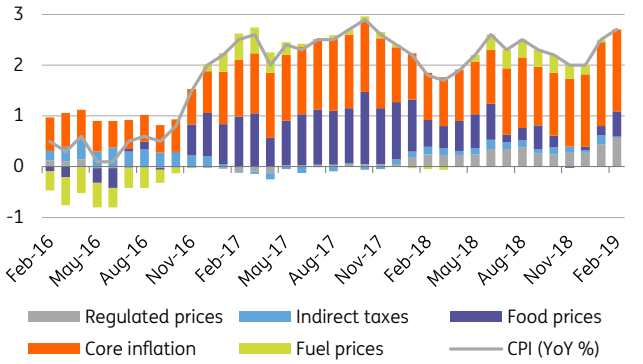
Source: CZSO

Key activity indicators (% YoY)



Source: CZSO

Structure of inflation (ppt)



Source: CZSO, CNB

Macro digest

Czech GDP growth in 4Q18 surprised on the upside at 2.6% YoY while initial market estimates were around 2.3%. The better-than-expected figures were driven mainly by a less negative contribution from net exports (-0.2ppt vs -1.2ppt seen by the CNB). In line with expectations, the most important growth factor was investments which maintained double-digit growth in 4Q18. The second most important was household consumption but, surprisingly, this slowed to just 2.2% YoY, having grown by over 3% in previous quarters. On the other hand, government consumption grew strongly by 3.6% YoY, and contributed a growth just slightly less than consumption of households (1.0ppt). GDP growth should moderate to 2.5% this year and next. This is in line with potential growth and, as such, should help to moderate increasing imbalances from previous years of above-potential growth. The labour market tightness further increased last year as the unemployment rate hit its new low in 2018 and remains the lowest in the EU. Total employment managed to increase further by 1% YoY last year and the total number employed reached an historical high. This is driven by the increasing participation of older people as the retirement age was increased a few years ago, but also through the absorption of economically less active people. Although room for a further decline in the unemployment rate is limited, strong wage growth might motivate some to exit the shadow economy, leading to a further minor decline in registered unemployment this year. Labour force scarcity, accompanied by government measures to increase public sector wages and the minimum wage resulted in strong average wage growth in 2018. It increased by 8.1% in nominal terms, the highest growth seen in the past two decades. However, the wage growth slowdown to 6.7% YoY in 4Q18 brought the first signs that 8% wage growth is hardly sustainable given the accelerating labour costs undermining the profitability of companies given the lower increase in their productivity. As such, we expect wage growth to slow to close to 5-6% YoY this year, though further minimum wage and public sector wage growth remains in place even this year. Higher household income maintained solid spending as retail sales added 5% in 2018 after 5.5% in 2017. Although the situation should remain favourable for households this year, increasing concerns related to future economic performance could see households saving more, which is likely to cause a slowdown in retail sales this year. Inflation reached 2.1% in 2018, but accelerated to close to the 3% barrier at the beginning of the year. Figures close to the CNB's upper-tolerance band should be short lived, however, and we expect inflation to slow to just slightly above 2% in the quarters ahead (see left hand chart and box on following page).

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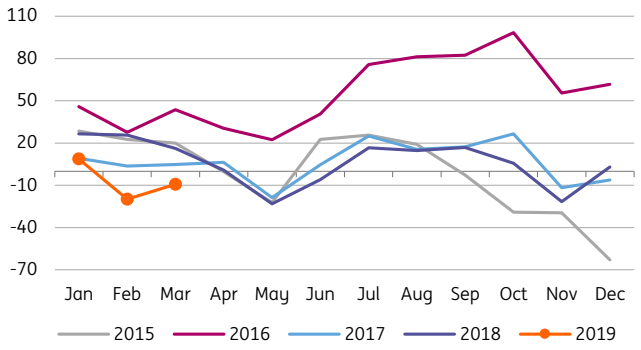
State budget (CZKbn, year-to-date balance)

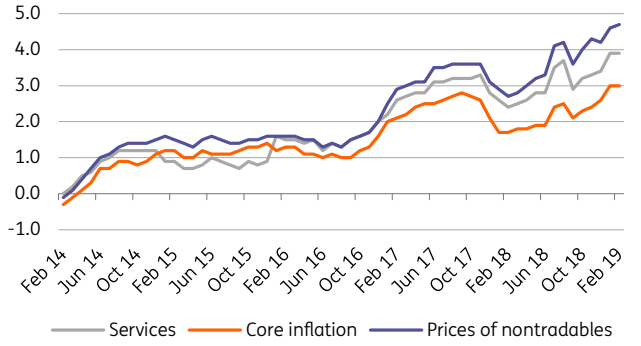


Source: MinFin

Increasing government expenditure despite weaker incomes

The state budget ended 2018 with a slight surplus of CZK3bn instead of a planned deficit of CZK50bn. As last year, however, due to a stronger surplus generated by municipalities and local government given subdued investments, the total government balance for 2018 should be close to 1.5% of GDP. This pushes total government debt to GDP below 33%, one of the weakest prints of EU countries. We expect a weaker fiscal result this year as lower economic growth generates weaker than expected income while government expenditure grows at a double-digit pace due to higher pensions and wages. A budgeted deficit close to CZK40bn is likely to be met this year. Still, local government will help return the government budget to surplus, with debt likely to drop below 32% of GDP in 2019.

Core inflation and prices of services (%)

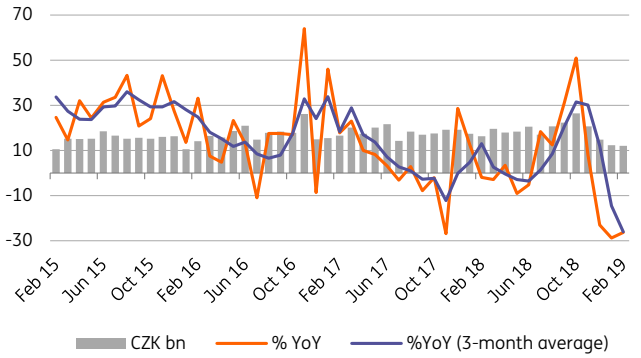


Source: CZSO, CNB, ING

Inflation temporarily accelerated to 3%

Inflation peaked at the beginning of 2019 and approached the 3% band in 1Q19. A large part of the increase is on the back of regulated prices, however, as electricity, gas and energy prices growth has increased headline CPI by 0.3ppt in at the beginning of 2019. The same contribution is provided by food price increases. Core items added 0.15ppt due to higher prices of holidays, rents, shoes and cars, but the increase in core prices was relatively broad. Core inflation itself contributed 1.6ppt to CPI YoY growth, but 0.6ppt is driven by imputed rent, which also reflects residential property prices growth. These are set to significantly decelerate this year due to CNB measures, which will impact core inflation in quarters ahead. As such, inflation should approach close to 2% again in mid-2019.

Growth in new housing loans (% YoY)

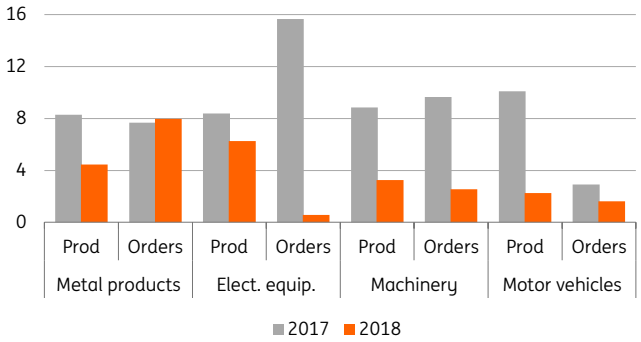


Source: CNB, ING

Housing loans weaker this year

The volume of new housing loans declined by 25% YoY in February, representing the lowest monthly volume of housing loans provided by banks in the past three years. Weak credit activity was, to a large extent, likely driven by substantial frontloading of mortgage loans in 2H18 when households were eager to obtain a loan before new, stricter CNB recommendations on income limits came into the force. Though the frontloading affect will diminish in the months ahead, it seems likely that the volume of new housing loans will be at least 10% lower this year, due to a combination of stricter CNB measures, but also higher mortgages rates and high property prices. This represents 0.4% of GDP of missing credit impulse, which will affect the residential market and stop the soaring growth of recent years.

Prod. and new orders growth in main industrial segments

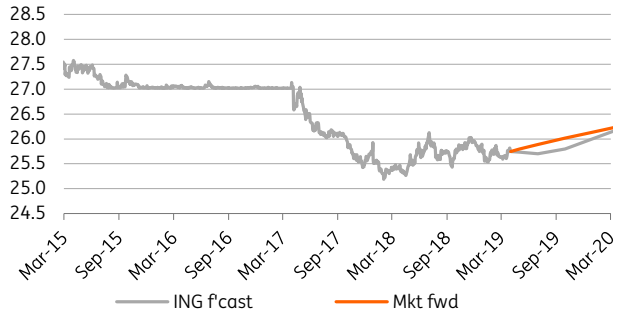


Source: CNB, ING

Industry slowing down mainly due to car segment

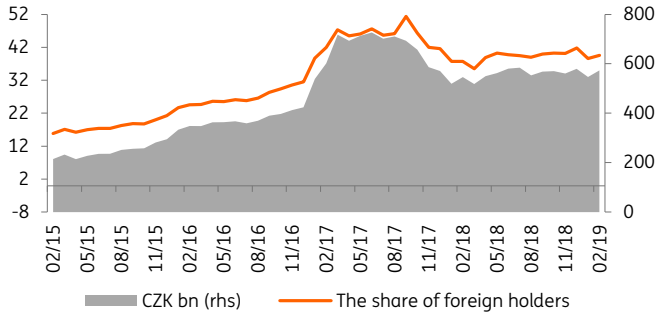
After a few years of solid industrial production dynamics, mainly driven by a strong motor vehicles segment that grew at a double-digit pace between 2014 and 2017, 2018 brought a slowdown in industrial production to 3% (after 7% in 2017). Significantly, car production decelerated from 10% in 2017 to just 2% in 2018. While other important manufacturing segments grew at a solid pace last year, though more slowly than in 2017, growth in new orders in 2018 was much weaker than a year before, suggesting that a further slowdown in industry should be expected for 2019, at least close to 2%. But risks are skewed to the downside due to the global outlook and surprisingly weak manufacturing figures and new orders at the beginning of the year in Germany.

FX – spot vs forward and INGF



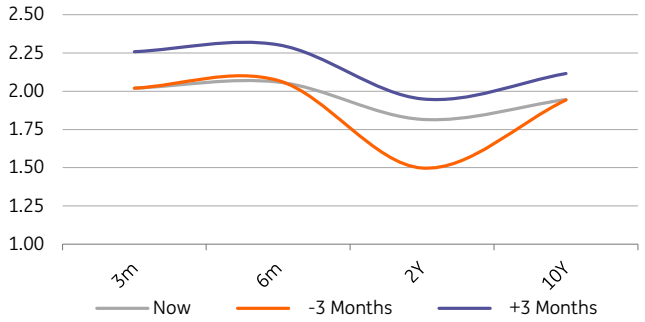
Source: Bloomberg, ING Bank

Foreign holders of CZGB (%)



Source: CZSO, ING Bank

Local curve (%)



Source: Bloomberg, ING Bank

FX strategy *(with Petr Krpata, Chief EMEA FX and IR Strategist)*

We continue to underscore our very low conviction on CZK gains given the overbought currency and the CNB getting very close to the end of the tightening cycle. We officially turn bearish on CZK as we see risks heavily skewed to the EUR/CZK upside given that the likely end to the CNB tightening cycle this year will remove one of the key supportive factors from the overbought koruna. Indeed, it took five hikes for CNB last year to keep the CZK relatively flat against EUR. As global growth slows and global central banks turn more dovish, this implies that the CNB will have less need to tighten. This will make CZK vulnerable given the still large positioning (evident on the elevated foreign holdings of CZGBs, currently at 40%). EUR/CZK to move persistently above 26.00 by the year-end.

In our view, any CNB attempt to ease (which is likely to occur in a deteriorating domestic/global growth environment - clearly not supportive for CZK) are likely to lead to pronounced CZK weakness as investors close their long positions, with risk of the stop losses being hit, exaggerating the move in CZK higher.

Czech Republic

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-4.7	2.1	1.8	-0.7	-0.5	2.7	5.4	2.4	4.6	2.9	2.4	2.6	2.5
Private consumption (% YoY)	-0.5	1.0	0.3	-1.2	0.5	1.8	3.8	3.6	4.4	3.1	2.1	2.4	2.3
Government consumption (% YoY)	2.8	0.5	-3.2	-2.0	2.5	1.1	1.9	2.7	1.3	3.9	2.4	1.3	1.2
Investment (% YoY)	-9.7	1.0	1.0	-2.9	-2.5	4.0	10.4	-3.2	4.1	10.1	3.9	3.5	3.3
Industrial production (% YoY)	-13.2	8.6	6.1	-0.7	0.1	5.0	4.3	3.6	6.5	3.3	2.0	2.2	2.5
Unemployment rate (year-end, %)	7.5	6.9	6.5	7.1	6.7	5.8	4.5	3.5	2.4	2.2	2.2	2.2	2.3
Nominal GDP (CZKbn)	3,932	3,958	4,030	4,059	4,097	4,313	4,598	4,766	5,054	5,310	5,557	5,801	6,047
Nominal GDP (€bn)	149	157	164	161	158	157	169	176	192	207	216	220	228
Nominal GDP (US$bn)	206	207	228	208	209	208	187	195	216	244	246	278	297
GDP per capita (US$)	19,741	19,809	21,719	19,730	19,916	19,745	17,715	18,464	20,375	22,964	23,097	26,089	27,887
Gross domestic saving (% of GDP)	30.4	30.2	31.0	31.2	30.6	32.0	33.1	32.5	33.2	32.9	33.0	33.4	33.7
Prices													
CPI (average, % YoY)	1.1	1.5	1.9	3.3	1.4	0.4	0.3	0.7	2.5	2.1	2.4	1.9	2.1
CPI (year-end, % YoY)	1.0	2.3	2.4	2.4	1.4	0.1	0.1	2.0	2.4	2.0	2.3	2.0	2.0
Wage rates (nominal, % YoY)	3.4	2.2	2.5	2.5	-0.1	2.9	3.2	4.5	6.2	8.1	5.8	4.5	4.0
Fiscal balance (% of GDP)													
Consolidated government balance	-5.5	-4.2	-2.7	-3.9	-1.2	-2.1	-0.6	0.7	1.5	0.9	0.3	0.1	0.0
Consolidated primary balance	-4.3	-3.1	-1.4	-2.5	0.1	-0.6	0.4	1.6	2.3	1.7	1.1	0.9	0.8
Total public debt	33.6	37.4	39.8	44.5	44.9	42.2	40.0	36.8	34.7	32.7	31.9	31.3	30.8
External balance													
Exports (€bn)	72.2	87.0	99.2	104.3	103.0	110.3	115.6	118.0	128.6	136.8	141.8	146.8	152.4
Imports (€bn)	69.7	85.5	96.1	99.3	96.6	102.3	108.7	108.9	119.5	127.4	133.0	138.1	143.3
Trade balance (€bn)	2.4	1.6	3.1	4.9	6.4	8.0	6.9	9.1	9.1	9.4	8.8	8.7	9.1
Trade balance (% of GDP)	1.6	1.0	1.9	3.0	4.1	5.1	4.1	5.1	4.7	4.5	4.1	4.0	4.0
Current account balance (€bn)	-3.5	-5.8	-3.5	-2.5	-0.8	0.3	0.4	2.7	1.9	1.5	0.8	0.4	0.4
Current account balance (% of GDP)	-2.3	-3.7	-2.1	-1.6	-0.5	0.2	0.2	1.5	1.0	0.7	0.4	0.2	0.2
Net FDI (€bn)	1.4	3.8	1.9	4.8	-0.2	2.9	-1.8	6.9	5.1	2.8	2.3	2.0	2.0
Net FDI (% of GDP)	0.9	2.4	1.1	3.0	-0.2	1.9	-1.1	3.9	2.7	1.4	1.1	0.9	0.9
Current account balance plus FDI (% of GDP)	-1.4	-1.3	-1.0	1.4	-0.7	2.0	-0.9	5.5	3.7	2.1	1.4	1.1	1.1
Foreign exchange reserves ex gold (€bn)	28.9	31.7	30.8	33.9	40.7	45.1	59.6	80.9	123.1	124.5	127.8	131.0	134.4
Import cover (months of merchandise imports)	5.0	4.4	3.8	4.1	5.1	5.3	6.6	8.9	12.4	11.7	11.5	11.4	11.2
Debt indicators													
Gross external debt (€bn)	73.9	86.4	89.6	96.8	99.7	106.3	115.4	129.4	171.2	172.0	175.0	176.0	177.0
Gross external debt (% of GDP)	50	55	55	60	63	68	68	73	89	83	81	80	78
Gross external debt (% of exports)	102	99	90	93	97	96	100	110	133	126	123	120	116
Lending to corporates/households (% of GDP)	43.8	45.7	47.7	48.5	50.0	48.8	48.8	50.2	50.4	51.3	51.1	51.0	50.8
Interest & exchange rates													
Central bank key rate (year-end, %)	1.00	0.75	0.75	0.05	0.05	0.05	0.05	0.05	0.50	1.75	2.25	2.25	2.25
Broad money supply (average, % YoY)	8.1	1.5	2.1	5.6	4.7	5.4	7.9	8.6	9.5	5.3	3.3	3.1	2.8
3m interest rate (Pribor, average, %)	2.19	1.31	1.19	1.00	0.46	0.36	0.31	0.29	0.41	1.27	2.18	2.49	2.49
3m interest rate spread over Euribor (ppt)	96.3	50.2	-20.1	42.5	23.6	14.7	32.8	55.3	73.7	159.3	248.5	279.0	273.0
2yr yield (average, %)	2.7	1.6	1.7	0.9	0.3	0.2	-0.1	-0.3	-0.2	1.1	1.9	1.8	1.7
10yr yield (average, %)	4.7	3.9	3.8	2.8	2.1	1.6	0.7	0.4	1.1	2.0	2.0	1.8	1.7
USD/CZK exchange rate (year-end)	18.47	18.69	19.74	19.01	19.89	22.86	24.87	25.70	21.29	22.43	21.67	20.38	20.38
USD/CZK exchange rate (average)	19.06	19.10	17.69	19.55	19.56	20.76	24.59	24.44	23.38	21.74	22.62	20.90	20.38
EUR/CZK exchange rate (year-end)	26.44	25.02	25.59	25.10	27.34	27.66	27.02	27.02	25.51	25.72	26.00	26.50	26.50
EUR/CZK exchange rate (average)	26.45	25.29	24.59	25.13	25.98	27.53	27.28	27.03	26.33	25.65	25.78	26.34	26.50

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (% YoY)	4.2	2.3	2.4	2.6	2.6	2.5	2.4	2.0	2.3	2.6	2.7	2.7	2.6
CPI (eop, % YoY)	1.7	2.6	2.3	2.0	2.9	2.4	2.2	2.3	1.9	1.9	1.9	2.0	2.2
Central bank key rate (eop, %)	0.75	1.00	1.50	1.75	1.75	2.00	2.00	2.25	2.25	2.25	2.25	2.25	2.25
3m interest rate (eop, %)	0.90	1.16	1.70	2.01	2.02	2.24	2.24	2.49	2.49	2.49	2.49	2.49	2.49
10yr yield (eop, %)	1.88	2.19	2.19	1.94	1.92	2.10	2.00	1.90	1.80	1.80	1.70	1.70	1.70
USD/CZK exchange rate (eop)	20.56	22.24	22.21	22.43	23.02	23.36	22.43	21.67	21.48	21.12	20.70	20.38	20.38
EUR/CZK exchange rate (eop)	25.35	25.99	25.77	25.72	25.82	25.70	25.80	26.00	26.20	26.40	26.50	26.50	26.50

Source: National sources, ING estimates

Hungary

Péter Virovácz, Senior Economist, Hungary

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)*	5.0	4.6	4.3	3.8	3.2	4.0	3.0
CPI (%YoY)*	2.7	3.6	3.2	3.0	3.3	3.2	3.1
Central bank key rate (%)*	0.90	0.90	0.90	0.90	0.90	0.90	0.90
3m interest rate (%)*	0.13	0.18	0.38	0.38	0.38	0.29	0.38
10yr yield (%)*	2.99	2.92	3.00	2.90	2.80	2.92	2.66
USD/HUF*	267.5	256.9	257.8	253.9	250.0	284.2	257.9
EUR/HUF*	321.1	321.2	330.0	325.0	325.0	324.5	325.0

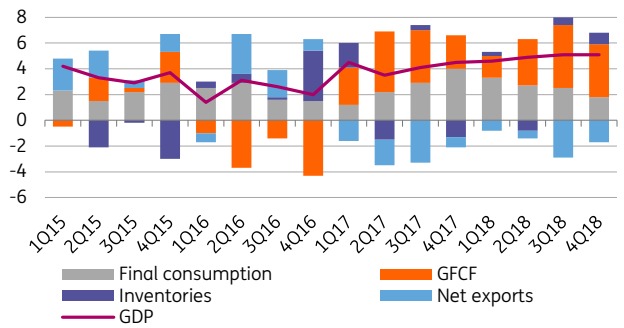
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: 2022	S&P	BBB	BBB
Fiscal	Tighter	Parliamentary: 2022	Moody's	Baa3	Baa3
Monetary	Neutral	Local: 2019	Fitch	BBB	BBB

*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Country strategy

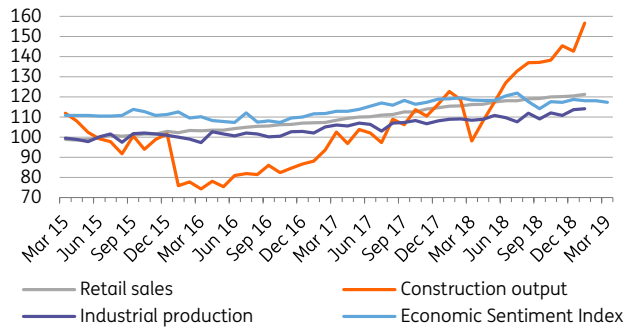
GDP growth accelerated to 4.9% YoY in 2018, the highest rate since data collection started in 1995. Economic activity is being driven by consumption due to an exceptionally tight labour market and double-digit wage growth, while the investment rate is the highest it has ever been at 25.5%. A positive output gap and higher costs have pushed companies to hike prices, thus core CPI rose above the 3% target and is expected to hit 3.9% YoY by mid-2019. In parallel, the NBH mildly adjusted its monetary stance, remaining dovish due to the external risks based on a gloomy global outlook. With the NBH signalling no more rate hikes as its base case and building inflation pressures, we see EUR/HUF testing 330 in 2Q19. We look for another one-off hike (15bp) at the June NBH meeting in response to soft HUF.

Contribution to YoY GDP growth (ppt)



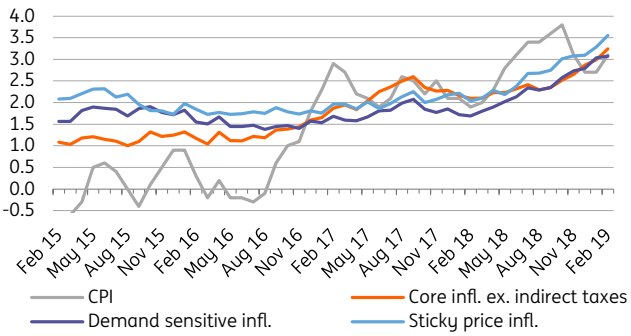
Source: Hungarian Central Statistical Office

Key activity indicators (swda; 2015 = 100%)



Source: Eurostat, Hungarian Central Statistical Office

Headline and underlying measures of inflation (% YoY)



Source: National Bank of Hungary

Macro digest

Hungarian GDP growth accelerated to 4.9% YoY in 2018, the strongest economic activity since 1995. As the fourth quarter figure (5.1% YoY) was higher than the yearly average, we expect a slight positive carry-over effect in 2019. Due to the unprecedented strength of economic activity, Hungary has become one of the top performers within the European Union.

As regards the main drivers of GDP growth on the production side, market services contributed 2.4ppt to the overall figure. Value added in construction rose by 23% YoY due to infrastructure developments co-financed by the EU, ongoing industrial capacity enhancements and a booming housing market. Against this backdrop, construction added 0.8ppt to GDP growth, higher than the contribution made by industry (0.7ppt). The effect of net taxes on products was 0.8ppt and, as this is practically the income of the government, we see this as a sign of a retreating shadow economy.

On the expenditure side, investments jumped 16.5% YoY in 2018, another strong performance, translating into a record high 3.7ppt growth contribution. The increase in final consumption decelerated somewhat, but added 2.6ppt to overall economic growth due to the high propensity to consume and the significant increase in real disposable income. Moderated industrial production combined with strong domestic demand (with its high import ratio) translated into a significant negative contribution from net exports (-1.5ppt).

In 2019, real wage growth will decelerate mainly on the back of the elevated inflation. Investment activity will decelerate as EU projects start to run out, and we also need to consider the expected global slowdown affecting external demand. However, weaker domestic demand will help to improve net exports, and new export capacities can help to bridge the external issues at least temporarily. Overall, we see GDP growth moderating to 4% in 2019.

Headline CPI came in at 3.1% YoY in February 2019, 0.7ppt higher than last year's average. Price pressure strengthened on market services and durables, while heightened duties and taxes affected the price of food, alcoholic beverages and tobacco products. Against this backdrop, core inflation jumped to 3.5% YoY in February after a 2.5% average in 2018. Other underlying measures of inflation – like core CPI excluding indirect taxes, which is the linchpin indicator for monetary policy – also jumped above the inflation target. Looking forward, headline CPI will remain relatively subdued at 3.2% YoY on average compared with the 3.7% YoY core inflation in 2019. The difference comes from the base effect in energy prices. A weaker eurozone inflation poses downside risks, while further HUF weakness and still high wage growth could push companies to raise prices.

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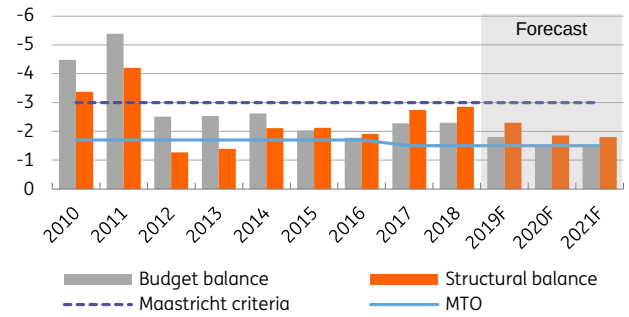
Budget and structural balance of general government (%)

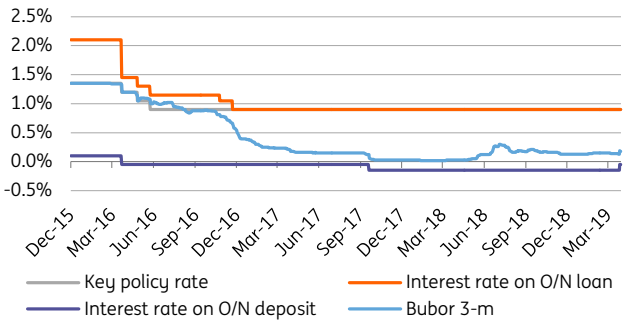


Source: AMECO, ING, National Bank of Hungary

Budget deficit to sink below 2% of GDP in 2019

Despite the moderate fiscal loosening in 2018, the government was able to keep the budget deficit at 2.3% of GDP, 0.1ppt below the planned ratio. Clearly, the stronger-than-expected economic activity helped to spur the revenue side, as both VAT and PIT overshot the planned revenue by 2.3% and 3.9%, respectively. The higher-than-expected transfer from Brussels by the year end related to the EU projects also helped. Given that the government already outlined this year's budget in the summer of 2018, we start this year with a far higher base, providing some fiscal room compared with the planned 1.8% of GDP Maastricht deficit target. So despite the new fiscal measures (demographic and economic protection action plans), we consider the deficit target to be feasible.

Benchmark policy rate and interest rate corridor

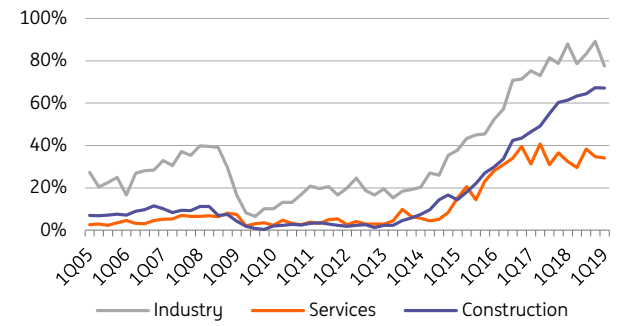


Source: Bloomberg

The NBH remains dovish after all

Mr Matolcsy, the current (and also the previous) governor of the central bank ended his first tenure with a clear dovish legacy. His next term won't be very different, at least based on the NBH's base case. At its March rate setting meeting, the central bank delivered a 10bp hike in the O/N deposit rate and the amount of liquidity to be crowded out in 2Q18 was reduced by HUF100bn. It was labelled as a "necessary and sufficient" move to keep inflation around the target over the monetary policy horizon. While we expect the NBH to retain its dovish bias, we pencil in another 'one-off' hike at the June NBH meeting in response to a weakening HUF (we expect EUR/HUF to test 330 in 2Q) and rising core CPI in this time. We see 3m Bubor increasing to around 0.35-0.40% by mid-2019.

Share of companies complaining of labour shortage

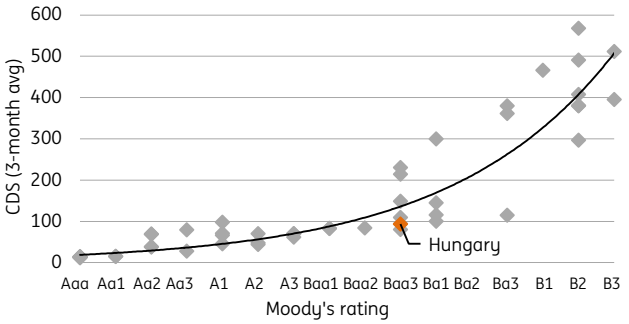


Source: Eurostat

The fight for labour drives wage growth

The number of unemployed people has hovered around 170k for nine months, equivalent to a 3.7% unemployment rate. This level is roughly consistent with full employment, in our view. The share of companies complaining of labour shortage has more-or-less stabilised. We see two reasons behind this: (1) the strong wage growth increased the supply; and (2) improved productivity thanks to capital expenditure. Automation and digitalisation might have a role too in the decreasing number of new job vacancies in the private sector which stood at 41k in 4Q18, the lowest in two years. Companies are facing tough decisions as workers are demanding far higher salaries and they are not afraid to strike. We might see at least one more year with a double-digit nominal wage growth.

Market pricing compared to the EMEA sovereign ratings



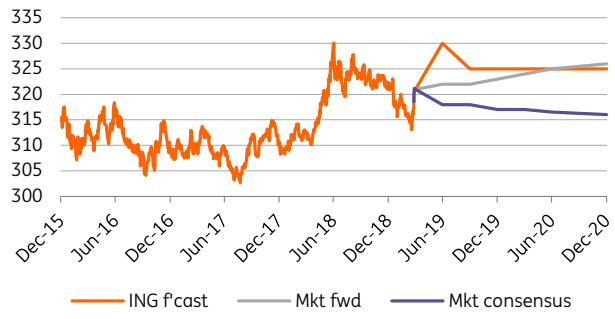
Source: Bloomberg, ING

Double 'BBB' and more to come

Hungary started 2019 on a positive note as both S&P and Fitch upgraded the country's sovereign ratings to 'BBB'. The agencies highlighted the sound growth prospects, supported by domestic demand. The strong external position, rapid deleveraging and low level of foreign currency funding also helped the positive decision. Despite admitting political risks, if Hungary maintains its positive trends and doesn't weaken the public finances, the agencies are ready to reward Hungary with further upgrades within 24 months. In the near future, we can expect a change in the outlook from stable to positive from the Big Three, with Moody's being the first in line in May. However, market pricing is still more favourable than the rating, so it's hard to see any strong market reaction on this.

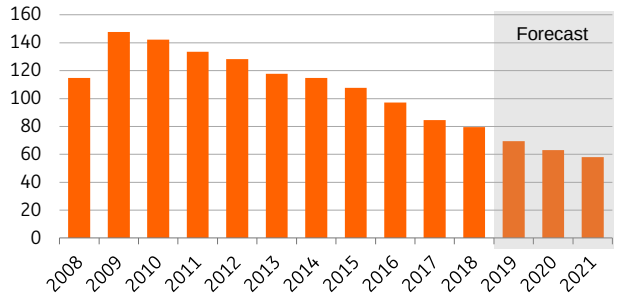
Hungary Strategy

FX – spot vs forward and INGF



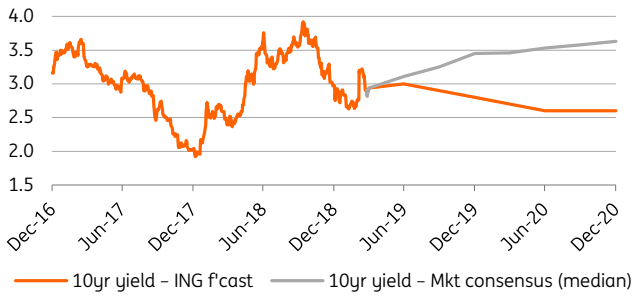
Source: Bloomberg, ING

Evolution of gross external debt (% of GDP)



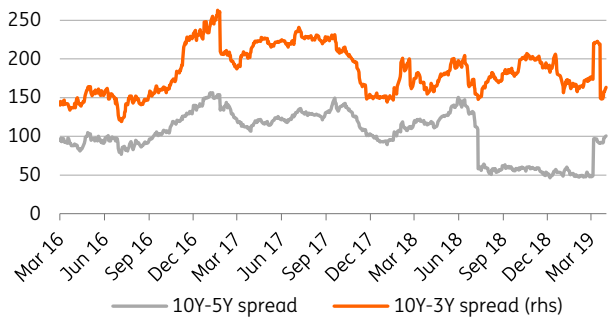
Source: Bloomberg, ING

Local curve (%)



Source: Bloomberg, ING

Steepness of the local curve (bp)



Source: Bloomberg, ING

FX strategy *(with Petr Krpata, Chief EMEA FX and IR Strategist)*

We turned bearish HUF and expect EUR/HUF to test 330 this quarter. Following the dovish NBH March meeting and its rather unclear communication, we expect markets to yet again question the NBH's credibility. This should be particularly the case in a context of rising core CPI which is likely to flirt with 4% this summer. The March CPI reading (9 April) should be the trigger point for more HUF weakness.

Rising inflation yet close to zero Bubor means a further erosion of the real rate, which is currently in deeply negative territory and one of the lowest real rates in the EM space. While the NBH might respond with verbal interventions and the threat of tighter policy in response to unwarranted HUF weakness, such verbal interventions might not be particularly effective with the NBH unwilling to commit to pronounced tightening.

Importantly, the big supportive factor for HUF in recent years (the current account surplus) has been waning. The NBH's latest forecast sees the C/A surplus at a mere 0.2% this year, not far from our forecast 0.6%. This is a large decline from prior years and means that HUF has lost the big support from the natural flow factor. In a sense, the NBH is currently running a monetary policy suited for HUF characteristics of 2015-17 but not for those now. Back in 2015-17, the strong current account exerted appreciation pressure on the HUF. This allowed the NBH to ease, with the loose policy stance leaning against HUF strength. But at this point, C/A dynamics are not supportive of HUF to the same extent, meaning the NBH is running a too loose monetary policy for HUF to remain stable.

Hungary

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-6.6	0.7	1.7	-1.6	2.1	4.2	3.5	2.3	4.1	4.9	4.0	3.0	2.5
Private consumption (% YoY)	-6.8	-2.7	0.7	-2.4	0.2	2.8	3.9	4.0	4.7	5.3	4.1	3.3	2.7
Government consumption (% YoY)	3.2	2.3	0.0	-0.2	6.6	10.0	0.0	0.9	2.0	-2.1	0.2	1.1	1.0
Investment (% YoY)	-8.3	-9.5	-1.3	-3.0	9.8	12.3	4.7	-11.7	18.2	16.5	10.2	1.5	1.9
Industrial production (% YoY)	-17.8	10.6	5.6	-1.8	1.1	7.7	7.4	0.9	4.6	3.6	4.7	6.2	4.5
Unemployment rate (year-end, %)	10.5	10.9	10.8	10.7	9.2	7.2	6.2	4.5	3.8	3.6	3.5	3.4	3.6
Nominal GDP (HUFbn)	26,425	27,225	28,305	28,781	30,248	32,583	34,379	35,474	38,355	42,073	45,953	48,755	51,482
Nominal GDP (€bn)	94	99	101	99	102	106	111	114	124	132	142	150	158
Nominal GDP (US$bn)	131	131	141	128	135	140	123	126	140	156	162	189	206
GDP per capita (US$)	13,024	13,061	14,106	12,858	13,645	14,191	12,462	12,802	14,433	16,150	16,862	19,810	21,693
Gross domestic saving (% of GDP)	19.5	20.9	21.2	21.2	24.9	24.8	25.3	25.8	25.7	25.6	25.5	25.3	25.4
Prices													
CPI (average, % YoY)	4.2	4.9	3.9	5.7	1.7	-0.2	-0.1	0.4	2.4	2.8	3.2	3.1	3.0
CPI (year-end, % YoY)	5.6	4.7	4.1	5.0	0.4	-0.9	0.9	1.8	2.1	2.7	3.3	3.0	3.0
Wage rates (nominal, % YoY)	0.6	1.3	5.2	4.7	3.4	3.0	4.3	6.1	12.9	11.3	9.5	7.0	6.5
Fiscal balance (% of GDP)													
Consolidated government balance	-4.5	-4.5	-5.4	-2.5	-2.5	-2.6	-2.0	-1.8	-2.3	-2.3	-1.8	-1.5	-1.5
Consolidated primary balance	-0.6	-0.7	-1.7	1.7	1.7	1.2	1.4	1.4	0.5	0.3	0.4	0.8	0.8
Total public debt	77.8	80.2	80.5	78.4	77.2	76.7	76.7	76.0	73.4	70.8	69.8	66.8	63.3
External balance													
Exports (€bn)	59.1	71.4	80.0	80.0	81.3	84.5	90.5	93.0	100.7	104.9	110.3	116.7	123.9
Imports (€bn)	55.4	65.9	72.9	73.3	74.7	78.2	81.9	83.3	92.6	99.3	104.7	109.7	115.4
Trade balance (€bn)	3.7	5.5	7.1	6.7	6.6	6.3	8.6	9.7	8.1	5.6	5.6	7.0	8.6
Trade balance (% of GDP)	4.0	5.6	7.0	6.7	6.4	5.9	7.7	8.5	6.5	4.2	3.9	4.6	5.4
Current account balance (€bn)	-0.8	0.3	0.8	1.8	3.9	1.6	3.1	7.0	3.5	0.6	0.5	0.9	2.0
Current account balance (% of GDP)	-0.8	0.3	0.7	1.8	3.8	1.5	2.8	6.2	2.8	0.5	0.4	0.6	1.2
Net FDI (€bn)	1.3	1.2	1.6	3.9	1.9	5.0	2.1	3.6	4.5	4.0	3.5	4.0	3.7
Net FDI (% of GDP)	1.4	1.2	1.5	4.0	1.9	4.8	1.9	3.1	3.6	3.0	2.5	2.7	2.3
Current account balance plus FDI (% of GDP)	0.6	1.5	2.3	5.7	5.7	6.3	4.7	9.3	6.4	3.5	2.8	3.3	3.6
Foreign exchange reserves ex gold (€bn)	28.5	32.3	35.1	31.8	32.6	33.7	30.0	24.0	22.6	25.8	26.0	27.0	28.4
Import cover (months of merchandise imports)	6.2	5.9	5.8	5.2	5.2	5.2	4.4	3.5	2.9	3.1	3.0	3.0	3.0
Debt indicators													
Gross external debt (€bn)	139.1	140.6	135.4	127.7	120.0	121.1	119.3	110.6	104.9	105.0	102.0	99.3	96.4
Gross external debt (% of GDP)	148	142	134	128	118	115	108	97	85	80	72	66	61
Gross external debt (% of exports)	235	197	169	160	148	143	132	119	104	100	92	85	78
Lending to corporates/households (% of GDP)	58.6	59.4	57.3	49.2	44.7	41.4	34.4	32.9	32.1	32.3	31.8	31.5	30.7
Interest & exchange rates													
Central bank key rate (year-end, %)	6.25	5.75	7.00	5.75	3.00	2.10	1.35	0.90	0.90	0.90	0.90	0.90	0.90
Broad money supply (average, % YoY)	8.8	2.8	2.5	-1.3	4.1	4.1	4.7	4.6	9.6	14.0	8.0	6.5	6.0
3m interest rate (Bubor, average, %)	8.64	5.50	6.19	7.00	4.32	2.41	1.61	0.99	0.15	0.12	0.29	0.38	0.38
3m interest rate spread over Euribor (ppt)	749	468	479	647	410	221	163	126	48	44	59	68	62
3yr yield (average, %)	9.3	6.7	7.0	7.5	4.8	3.6	2.1	1.5	0.9	1.3	1.2	1.0	0.9
10yr yield (average, %)	9.1	7.3	7.6	7.9	5.9	4.8	3.4	3.1	3.0	3.1	2.9	2.7	2.6
USD/HUF exchange rate (year-end)	188.1	208.7	240.7	220.9	215.7	259.1	286.6	293.7	258.8	279.6	270.8	250.0	250.0
USD/HUF exchange rate (average)	202.3	208.2	200.9	225.4	223.7	232.5	279.5	281.4	274.3	270.3	284.2	257.9	250.0
EUR/HUF exchange rate (year-end)	270.8	278.8	311.1	291.3	296.9	314.9	313.1	311.0	310.1	321.5	325.0	325.0	325.0
EUR/HUF exchange rate (average)	280.6	275.4	279.2	289.4	296.9	308.7	309.9	311.5	309.2	318.9	324.5	325.0	325.0

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	4.5	4.9	4.9	5.0	4.6	4.3	3.8	3.2	3.1	3.0	3.0	2.9	2.9
CPI (eop, %YoY)	2.0	3.1	3.6	2.7	3.6	3.2	3.0	3.3	3.1	3.0	3.0	3.0	3.0
Central bank key rate (eop, %)	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90
3m interest rate (eop, %)	0.03	0.26	0.17	0.13	0.18	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
10yr yield (eop, %)	2.39	3.62	3.55	2.99	2.92	3.00	2.90	2.80	2.70	2.60	2.60	2.60	2.60
USD/HUF exchange rate (eop)	260.4	281.4	281.2	279.2	286.8	300.0	282.6	270.8	266.4	260.0	253.9	250.0	250.0
EUR/HUF exchange rate (eop)	312.5	329.3	323.4	321.1	321.2	330.0	325.0	325.0	325.0	325.0	325.0	325.0	325.0

Source: National sources, ING estimates

Kazakhstan

Dmitry Dolgin, Chief Economist, Russia & CIS

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	3.5	3.4	3.0	2.9	3.2	3.3	3.2
CPI (%YoY)*	5.3	4.8	5.1	5.3	5.4	5.2	5.5
Policy interest rate (eop, %)	9.25	9.25	9.25	9.00	8.75	8.75	8.00
3m interest rate (%)*	10.25	10.25	10.25	10.00	9.75	10.10	9.35
10yr yield (%)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/KZT*	384	380	375	380	380	380	381
EUR/KZT*	439	426	413	437	456	433	480

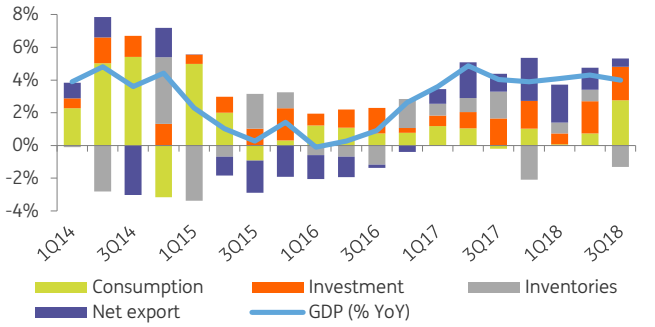
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: 2020	S&P	BBB-	BBB
Fiscal	Easing	Parliamentary: 2021	Moody's	Baa3	Baa3
Monetary	Stable	Local:	Fitch	BBB	BBB

*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Country strategy

With Nursultan Nazarbayev stepping down prematurely and Kassym-Jomart Tokayev named interim president until 2020, economic policy risks have come more into focus. Fiscal easing seems on the way, with an extra 2% of GDP pledged for social support, and the downward pressure on communal housing tariffs, which contributed to a positive CPI surprise in 2018, might require additional budget spending. Reaffirmation of the country's ratings suggests that budget risks are still remote. The key question is whether monetary policy remains cautious, as premature easing may add to the risks to KZT which is already facing headwinds due to the halt of production in key oilfields, the OPEC+ deal, and the negative spillover effects from RUB weakness and China slowdown.

GDP growth and major contributors (% YoY)

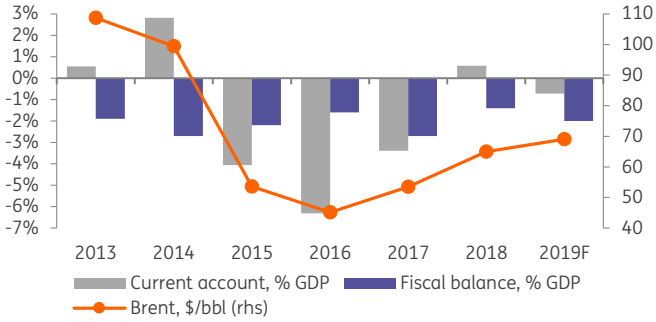


Source: CEIC, ING

GDP growth

Kazakhstan's economy managed to show 4.1% in 2018, for the second year in row, slightly exceeding our expectations thanks to higher-than-expected oil production and an expectedly solid non-oil trend. Yet for this year, the headwinds are mounting, as the three Kazakhstan oil fields accounting for 50% of national production will be closed briefly for maintenance, which is expected to lead to a decline in the annual production by approximately 5% and will negatively affect the current account, adding also to KZT risks. In addition, the external environment does not seem supportive given a likely slowdown in the growth of China and Russia, accounting for Kazakhstan's 20%+ of exports and almost 60% of imports.

CA/fiscal balance vs oil price

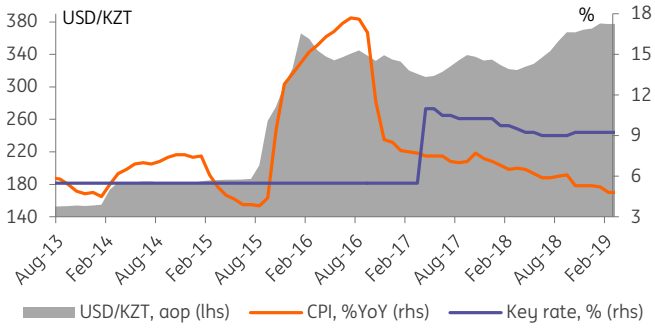


Source: CEIC, ING

Long-term fiscal risks mount due to elections

In February, now ex-President Nazarbayev sacked the government citing its inability to improve the nation's living standards. The president (elections due next year) pledged an extra social spending package of c.US$3.6bn (c.2% of GDP) of state reserves to boost consumer demand and popular support. The money will be provided mostly by the sovereign fund NFRK (c.40% of GDP), limiting the headline budget deficit, but pressuring the consolidated budget system. We see mounting fiscal risks related to increased social spending amid higher political uncertainty, however, the recent reaffirmation of the country's ratings from both S&P and Moody's suggests that those risks are at least not near term.

USD/KZT, CPI, and NBK rate (%)



Source: CEIC, ING

Still cautious on CPI and KZT for 2019

The slowdown in CPI growth to 5.3% in 2018, to the lower bound of NBK's 5-7% target range, was a positive surprise, which seems to have been driven by a decline in local gasoline prices and a downward (likely administrative) pressure on communal services prices. However, we continue to remain cautious on the CPI trend given that the 14% tenge depreciation seen in 2018 has yet to pass through into the local CPI. The balance of risks to tenge in 2019 is leaning towards moderate depreciation of the currency due to a likely deterioration of the current account and RUB-linked economy. Given these concerns, the NBK is unlikely to ease before 3Q19, though we see a risk of premature easing for electoral considerations.

Kazakhstan

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (%YoY)	1.2	7.3	7.4	4.8	6.0	4.2	1.2	1.1	4.1	4.1	3.3	3.2	3.2
Private consumption (%YoY)	0.6	11.8	12.0	10.1	10.6	1.1	1.8	1.2	1.2	3.0	3.5	3.3	1.0
Government consumption (%YoY)	1.0	2.7	11.9	13.5	1.7	9.8	2.4	2.3	1.9	2.4	2.5	3.0	2.0
Investment (%YoY)	2.9	-3.0	2.9	4.1	6.9	4.2	3.7	2.0	5.8	17.2	4.0	4.5	5.0
Industrial production (%YoY)	2.7	9.6	3.8	0.7	2.5	0.3	-1.6	-1.1	7.3	4.1	3.0	3.5	4.0
Unemployment rate (year-end, %)	6.6	5.8	5.4	5.3	5.2	5.1	4.9	5.0	4.9	5.1	5.0	5.0	4.7
Nominal GDP (KZTbn)	17,008	21,816	28,243	31,015	35,999	39,676	40,884	46,971	53,101	58,786	63,940	69,480	76,551
Nominal GDP (€bn)	78	106	143	147	181	164	96	128	145	139	148	145	152
Nominal GDP (US$bn)	114	148	191	206	234	218	127	141	159	158	169	183	198
GDP per capita (US$)	7,059	9,002	11,453	12,193	13,618	12,530	7,167	7,855	8,765	8,783	9,123	9,588	10,379
Gross domestic saving (% of GDP)	40.8	43.8	47.3	43.5	39.9	40.8	34.6	33.8	37.2	33.7	34	33	34
Prices													
CPI (average, %YoY)	7.3	7.1	8.4	5.1	5.8	6.7	6.6	14.7	7.4	6.0	5.2	5.5	5.5
CPI (year-end, %YoY)	6.2	7.8	7.4	6.0	4.8	7.4	13.6	8.5	7.1	5.3	5.4	5.4	5.0
Wage rates (nominal, %YoY)	10.7	15.3	16.0	12.5	7.8	10.9	4.1	13.4	5.5	8.0	8.0	8.0	5.0
Fiscal balance (% of GDP)													
Consolidated government balance	-2.9	-2.4	-2.0	-2.9	-1.9	-2.7	-2.2	-1.6	-2.7	-1.4	-2.0	-1.7	-1.5
Consolidated primary balance	-2.5	-2.0	-1.7	-2.1	-1.4	-2.1	-1.5	-0.8	-1.7	-0.2	-1.0	-0.7	-0.5
Total public debt	12.3	14.4	11.6	12.3	12.3	14.3	22.1	24.4	25.5	26.0	26.5	26.0	25.5
External balance													
Exports (US$bn)	43.2	60.3	84.3	86.4	84.7	79.5	46.0	36.7	48.5	61.0	58.1	62.6	63.5
Imports (US$bn)	28.4	31.1	36.9	46.4	48.8	41.3	30.6	25.4	29.6	32.5	33.4	35.2	36.7
Trade balance (US$bn)	14.8	29.1	47.4	40.1	35.9	38.2	15.4	11.4	18.9	28.4	24.7	27.4	26.8
Trade balance (% of GDP)	12.9	19.7	24.8	19.4	15.4	17.5	12.2	8.1	11.9	18.0	14.6	15.0	13.6
Current account balance (US$bn)	-4.1	1.4	10.2	1.1	1.3	6.1	-5.1	-8.9	-5.4	0.9	-1.2	-1.5	-1.0
Current account balance (% of GDP)	-3.6	0.9	5.3	0.5	0.5	2.8	-4.1	-6.3	-3.4	0.6	-0.7	-0.8	-0.5
Net FDI (US$bn)	10.1	3.7	8.6	11.9	8.0	4.6	3.1	13.4	3.7	4.1	3.2	2.5	1.8
Net FDI (% of GDP)	8.8	2.5	4.5	5.7	3.4	2.1	2.4	9.5	2.3	2.6	1.9	1.4	0.9
Current account balance plus FDI (% of GDP)	5.2	3.4	9.8	6.3	4.0	4.9	-1.6	3.2	-1.1	3.2	1.2	0.5	0.4
Foreign exchange reserves ex gold (US$bn)	20.6	25.2	25.2	22.1	19.2	21.8	20.3	20.1	18.2	16.5	16.2	15.8	16.0
Import cover (months of merchandise imports)	8.7	9.7	8.2	5.7	4.7	6.3	8.0	9.5	7.4	6.1	5.8	5.4	5.2
Debt indicators													
Gross external debt (US$bn)	112.9	118.2	125.3	136.9	150.0	157.6	153.4	163.3	167.2	175.0	180.0	185.0	190.0
Gross external debt (% of GDP)	99	80	66	66	64	72	121	116	105	111	107	101	96
Gross external debt (% of exports)	261	196	149	158	177	198	334	445	345	287	310	296	299
Lending to corporates/households (% of GDP)	44.9	34.8	31.1	32.1	31.4	30.5	31.0	27.1	24.4	25.5	25.5	25.6	26.0
Interest & exchange rates													
Central bank key rate (year-end, %)	7.00	7.00	7.50	5.50	5.50	5.50	16.00	12.00	10.25	9.25	8.75	8.00	7.75
Broad money supply (average, %YoY)	19.5	13.3	15.0	7.9	10.2	10.4	33.8	15.6	-1.7	1.5	3.0	5.0	4.0
3m interest rate (KazPrime, average, %)	8.3	4.1	1.8	2.5	6.5	7.1	10.4	15.5	11.8	10.25	10.10	9.35	8.75
3m interest rate spread over US$-Libor (ppt)	373	292	95	110	597	691	1,020	1,552	1,202	1,058	739	644	583
2yr yield (average, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
10yr yield (average, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/KZT exchange rate (year-end)	148	147	148	151	154	182	339	333	332	384	380	385	390
USD/KZT exchange rate (average)	149	147	148	150	154	182	323	334	334	372	379	381	388
EUR/KZT exchange rate (year-end)	208	211	199	196	203	250	411	363	349	461	456	501	507
EUR/KZT exchange rate (average)	219	206	198	211	199	242	426	367	367	424	432	480	504
Brent oil price (annual average, US$/bbl)	94	36	78	96	111	113	108	45	55	65	69	74	75

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	4.1	4.2	4.1	3.5	3.4	3.0	2.9	3.2	2.9	3.0	3.0	3.3	3.2
CPI (eop, %YoY)	6.6	5.9	6.1	5.3	4.8	5.1	5.3	5.4	5.6	5.5	5.4	5.4	5.6
Central bank key rate (eop, %)	9.50	9.00	9.00	9.25	9.25	9.25	9.00	8.75	8.50	8.25	8.25	8.00	8.00
3m interest rate (eop, %)	10.50	10.00	10.00	10.25	10.25	10.25	10.00	9.75	9.50	9.25	9.25	9.00	9.00
10yr yield (eop, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/KZT exchange rate (eop)	318	341	363	384	380	375	380	380	375	380	384	385	385
EUR/KZT exchange rate (eop)	392	397	421	439	426	413	437	456	458	475	491	501	485

Source: National sources, ING estimates

Poland

Rafal Benecki, Chief Economist, Poland

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	4.9	4.2	4.2	4.1	3.6	4.0	3.2
CPI (%YoY)*	1.1	1.7	2.3	1.9	2.1	1.8	2.6
Policy interest rate (eop, %)	1.50	1.50	1.50	1.50	1.50	1.50	1.50
3m interest rate (%)*	1.72	1.73	1.73	1.73	1.73	1.73	1.73
10yr yield (%)*	2.83	2.84	2.89	2.99	3.07	2.93	3.05
USD/PLN*	3.76	3.84	3.82	3.74	3.63	3.63	3.27
EUR/PLN*	4.30	4.30	4.28	4.32	4.36	4.36	4.35

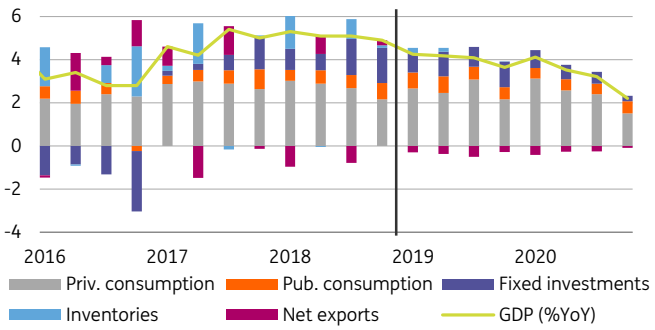
Macro trend		Political cycle	Ratings	FC	LC
Activity	▲	Presidential: 2020	S&P	BBB+	A-
Fiscal	▲	Parliamentary: 2019	Moody's	A2	A2
Monetary	▬	Local: 2018	Fitch	A-	A-

*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Country strategy

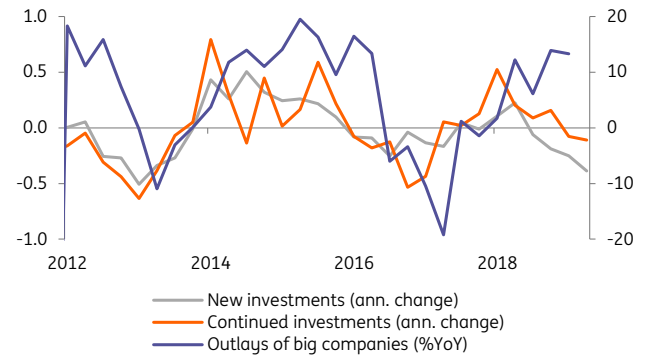
Pre-election spending pledges exhausted almost all fiscal space. The pledges should extend the consumption boom to 2019-20 and sustain strong GDP growth but will have limited impact on CPI (adding 0.1ppt in 2020). Given improved tax collection and a high NBP profit, net borrowing needs in 2019 should remain low (below PLN30bn). The 2020 budget is more challenging, pledges exceed the spending rule and the budget is sensitive to GDP slowdown. Also, net borrowing needs should double in 2020 (PLN50bn vs PLN22bn in 2018), so MinFin could start pre-financing 2020 now, thus widening of asset swaps and spread to Bund may continue. The stimulus excludes any monetary easing at least until end-2020. We expect money market rates to remain flat throughout 2019 and PLN to hover around 4.30.

GDP growth structure (%YoY)



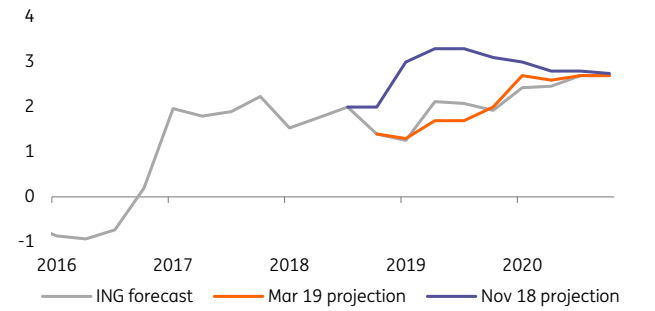
Source: GUS, ING

NBP investment survey of big companies (PLNbn)



Source: GUS

NBP CPI projection and ING forecasts



Source: NBP, GUS, ING

Macro digest

Opinion polls show weakening support for the ruling PiS, but fragmentation of the opposition and the launch of new leftist competition makes the election race very tight. Against this background, the ruling PiS decided to deliver a huge pre-election stimulus pledge, topping the 2016 programmes. We estimate the fiscal cost of the impulse at PLN18bn in 2019 and an additional PLN22bn in 2020 (altogether 1.7% of GDP). This should increase GDP growth by up to 0.5ppt in 2019 and 0.8ppt in 2020. Historical patterns suggest consumer spending is focused on domestically produced goods and services, limiting net trade deterioration. We cannot rule out further pledges, if the ruling party underperforms expectations in the May European elections.

The fiscal measures should hold 2019 GDP growth above potential, ie, at 4%, slightly below the significant 5.1% YoY result in 2018. Its structure should be suboptimal, the consumption boom is expected to be extended, while we worry about weakening of investments and external demand. Although public capital outlay should remain high in nominal terms (due to ongoing absorption of EU funds), the very strong growth of last year (when outlay grew by 70%) is unattainable due to a much higher statistical base. Moreover, the rigorous tax policy and uncertain global growth should keep private investments relatively low (as confirmed by corporate surveys).

The NBP's March statement and new projections support our call of flat rates at least until the end of 2020. Governor Glapiński expects no rate shifts during his term if NBP projections materialise. He added that nearly all MPC members exclude rate cuts in the coming months. The CPI projection for 2019 was lowered from 3.2% to 1.7% YoY (due to rationalisation of energy prices), but also lower core inflation (reflecting surprises in 4Q). The forecast for 2020 was lowered from 2.9% to 2.7% YoY. The GDP forecast was adjusted for fiscal stimulus and a less favourable external environment, both matching our earlier forecasts.

Despite the fiscal stimulus, we expect both government deficit and net borrowing needs in 2019 at low levels (1.7% of GDP and PLN30bn). This reflects past improvements in tax collection, strong GDP growth and a big NBP profit for 2018 (estimated at PLN6bn). Public finances are set to worsen next year though, as we expect much lower (if any) NBP profit and slower GDP growth. Consequently, we see public deficit rising to 2.5% GDP and net borrowing needs doubling to PLN51bn. Both numbers are close to 2016 values (2.2% and PLN57bn), but substantially worse compared to 2017-18 (0.7-1.4% and PLN22-27bn).

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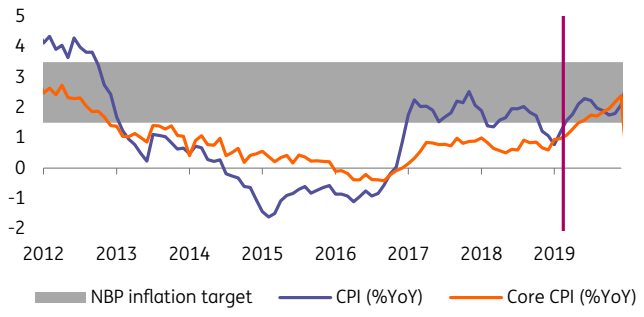
CPI and the main NBP interest rate

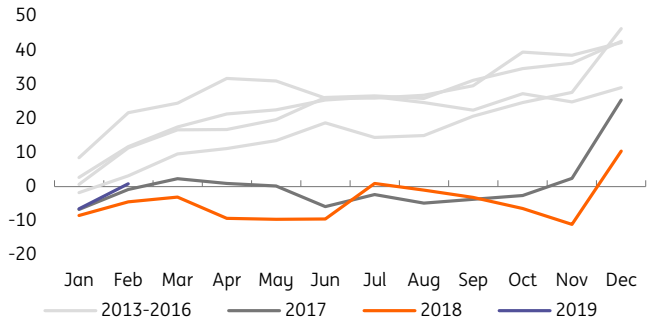


Source: NBP, GUS, ING

CPI to top in mid-2019 on core and energy prices

CPI reached a bottom in January 2019 at 0.7%, but is expected to return almost to the MPC target, peaking at 2.3% in mid-2019. The 1Q19 CPI adjustment reflects higher costs (electricity and other rising regulated prices). Nonetheless, average CPI should be subdued (1.8% YoY) unlike core inflation, which should keep rising and break 2.0% YoY by year end. This reflects strong internal demand and lagged effects of wages outpacing productivity. Still, the scope for excessive price rises is limited, given that Poland imports low inflation from the Eurozone, base effects should send fuel prices lower in 2H19, and the Ukrainian labour force holds wages in check. In tandem with GDP moderation in 2020 this supports our call for flat interest rates.

Budget deficit (PLNbn)



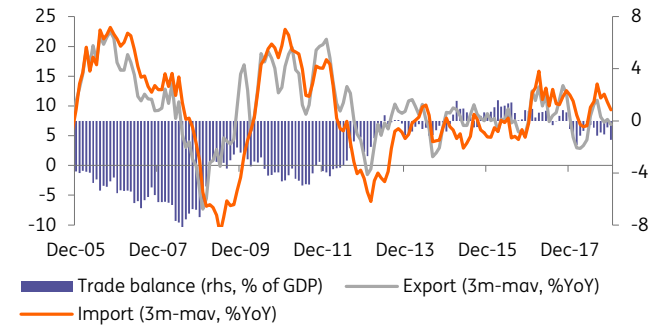
Source: Ministry of Finance

Fiscal stimulus makes 2020 budget very challenging

The Polish fiscal stance was usually a source of positive surprises, in the past two years. The period has been brought to an end after the government announced a generous fiscal spending (in Jan-19). The deficit is set to grow from 0.4%GDP in 2018 to 1.7 and 2.5% of GDP in years 2019 and 2020 (in our baseline scenario).

This might force the government to water down the spending rule or try to circumvent it via unreliable assumptions, which rating agencies should criticise. Moreover, the budget should get more sensitive to a slowdown, ie, with GDP 1.3ppt below our forecasts the deficit may hit the 3% EU threshold. The more important for POLGBs valuation is that borrowing needs (net) will grow (from c.PLN22bn in 2018 to PLN30bn and PLN51bn in 2019-20).

Trade balance (3 month moving average, % of GDP)



Source: NBP, GUS

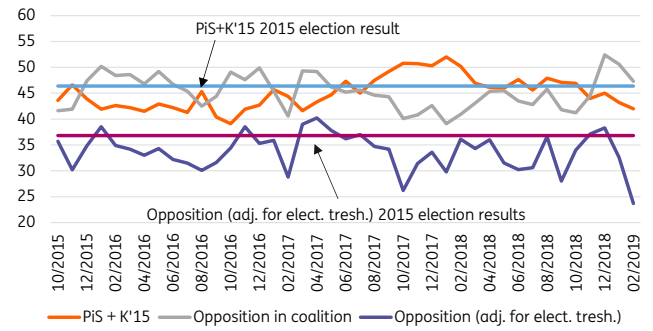
Trade balance to worsen; rising imports, uncertain exports

The 2018 current account deficit (12m rolling sum) was maintained at 0.7% of GDP, confirming the resilience of the Polish economy to the eurozone slowdown.

Experience from 2016-17 shows households tend to spend extra income on services, so the 2019 fiscal impulse should have a limited negative impact on the trade gap. Nonetheless, with slowing euro area GDP, a deterioration in the trade balance seems unavoidable, we look for -1.1% of GDP in 2019 compared to 0.7% last year.

We consider Poland relatively resilient to the fallout from US-EU trade disputes, as the share of automakers in manufacturing is half that of CEE counterparts. We worry about the indirect impact, via the German economy.

Opinion polls in February



Source: ewybory.eu

Support for PiS back at 2015-17 levels

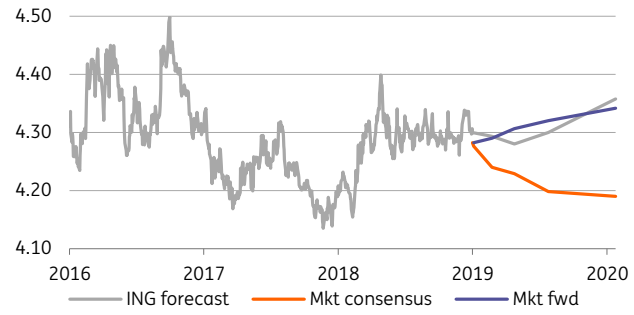
Support for the ruling PiS fell to 2015-17 levels (c.36%). The party has been hit by several public scandals. However, continued backing by the potential coalition partner K'15 suggests that PiS will retain power in the parliamentary elections in 4Q19.

Support for opposition parties has improved markedly (currently close to PiS and K'15 combined), but fragmentation is a challenge. The coalition formed for the European elections (with a premium from voters expected) is more uncertain for the general elections.

European elections will offer poor guidance for the parliamentary elections, but the results are key as they could shape the probability of the opposition holding a coalition. Also, poor support for the ruling PiS will raise the odds of spending pledges being extended.

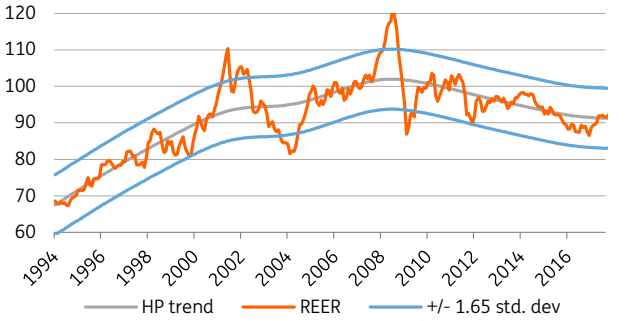
Poland Strategy

FX – spot vs forward and INGF



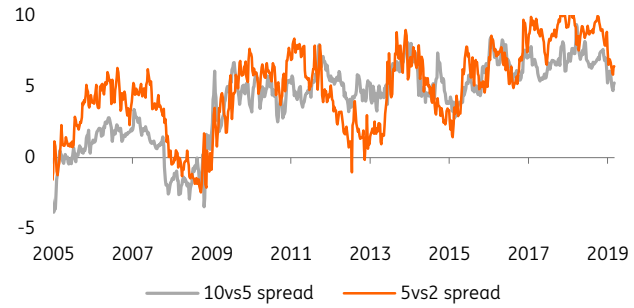
Source: Bloomberg, ING forecasts

FX – PLN REER vs HP trend



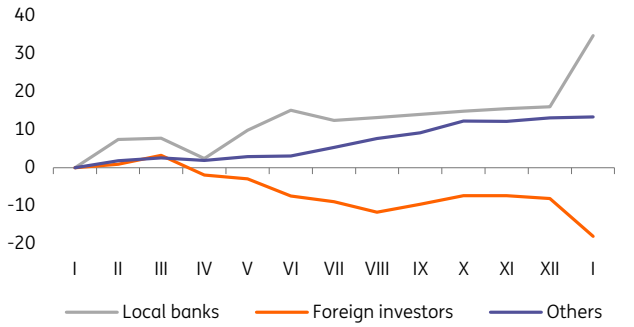
Source: Macrobond

Local curve (%)



Source: Bloomberg

Structure of POLGBs holders – change since January 2018



Source: MinFin

FX strategy

€/PLN has been on a tight horizontal trend since 3Q18, currently consolidating between 4.27 and 4.35. The lack of fundamental mispricing (€/PLN is close to our medium-term relative value model), strong GDP, sound fiscal stance, neutral MPC bias as well as a lack of non-conventional measures tested by other CEE economies, have meant the POLGBs spread to Bund has remained stable, which has also been passed on to the PLN. In 1Q19, PLN temporarily eased vs CEE FX on lowered growth expectations, but that is no longer the case given the aggressive fiscal easing announced.

€/PLN should remain within the 4.27-4.35 range throughout 2Q19. The fiscal impulse and surprisingly prolonged resilience to the eurozone slowdown has lifted consensus on growth, while any bond market correction caused by the expected higher POLGBs supply in 2020 should be limited. Poland is relatively less exposed to global trade tensions (eg, US auto tariffs). Only limited value added (0.03% of GDP) is linked to automotive exports to the US, which is much lower than for CEE counterparts, so, for example, PLN may outperform forint in periods of trade-linked market stress.

In the coming months, politics is important risk. The tight election race may force the ruling PiS to add additional pledges, which should be POLGB and PLN negative. Volatility should be mostly linked with €/US$. We downgrade the trade balance, due to fiscal impulse. Consequently, we see slightly higher €/PLN at year end (4.36). A €/PLN close to 4.30 offers no trading opportunities. We see entry levels at 4.26-4.27 (long) and 4.35 (short).

Poland

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (%YoY)	2.6	3.7	5.0	1.6	1.4	3.3	3.8	3.1	4.8	5.1	4.0	3.2	1.7
Private consumption (%YoY)	3.3	2.5	3.3	0.8	0.3	2.6	3.0	3.9	4.9	4.3	4.5	4.1	1.9
Government consumption (%YoY)	3.6	3.3	-1.8	-0.4	2.2	4.0	2.1	2.2	3.4	2.3	3.8	3.0	1.5
Investments (%YoY)	-1.9	-0.4	8.8	-1.8	-1.1	10.0	6.1	-8.2	3.9	7.3	5.7	3.0	-1.8
Industrial production (%YoY)	-3.6	11.0	7.2	1.4	2.3	3.4	4.9	3.0	6.5	4.7	3.8	3.0	1.4
Unemployment rate (year-end, %)	12.1	12.4	12.5	13.4	13.4	11.4	9.7	8.2	6.6	5.8	5.4	5.7	6.2
Nominal GDP (PLNbn)	1,362	1,445	1,567	1,629	1,657	1,720	1,800	1,861	1,989	2,116	2,241	2,364	2,450
Nominal GDP (€bn)	315	362	380	389	395	411	430	425	469	496	521	543	562
Nominal GDP (US$bn)	439	480	529	500	524	546	478	469	529	581	610	687	730
GDP per capita (US$)	11,484	12,503	13,793	13,071	13,689	14,234	12,475	12,326	13,750	15,241	16,043	18,100	18,924
Gross domestic saving (% of GDP)	16.3	14.9	16.2	17.7	20.5	20.5	23.7	23.9	24.6	24.3	24.1	23.7	23.8
Prices													
CPI (average, %YoY)	3.4	2.6	4.3	3.7	0.9	0.0	-0.9	-0.6	2.0	1.7	1.8	2.7	2.6
CPI (year-end, %YoY)	3.5	3.1	4.6	2.4	0.7	-1.0	-0.5	0.8	2.1	1.1	2.1	2.7	2.6
Wage rates (nominal, %YoY)	4.2	3.6	4.9	3.5	2.6	3.8	3.5	4.1	5.7	7.1	7.7	6.4	4.5
Fiscal balance (% of GDP)													
Consolidated government balance	-7.3	-7.3	-4.8	-3.7	-4.1	-3.7	-2.7	-2.2	-1.4	-0.4	-1.7	-2.5	-2.9
Consolidated primary balance	-4.8	-4.9	-2.3	-1.1	-1.6	-1.7	-0.9	-0.6	-0.1	0.0	-0.2	-1.0	-1.4
Total public debt	49.4	53.1	54.1	53.7	55.7	50.4	51.3	54.2	50.6	48.9	47.7	47.2	47.8
External balance													
Exports (€bn)	95.4	118.1	132.4	141.0	149.1	158.6	172.2	177.5	201.9	213.3	222.4	233.0	243.7
Imports (€bn)	103.1	129.1	145.7	149.2	149.4	161.9	170.0	174.6	200.5	216.7	228.3	241.9	251.0
Trade balance (€bn)	-7.7	-10.9	-13.3	-8.1	-0.3	-3.3	2.2	2.9	1.4	-3.4	-5.7	-8.8	-7.3
Trade balance (% of GDP)	-2.5	-3.0	-3.5	-2.1	-0.1	-0.8	0.5	0.7	0.3	-0.7	-1.1	-1.6	-1.3
Current account balance (€bn)	-12.8	-19.5	-19.7	-14.5	-5.1	-8.6	-2.4	-2.2	0.7	-3.4	-4.2	-5.4	-3.9
Current account balance (% of GDP)	-4.1	-5.4	-5.2	-3.7	-1.3	-2.1	-0.6	-0.5	0.1	-0.7	-0.8	-1.0	-0.7
Net FDI (€bn)	5.8	6.5	9.8	4.7	3.2	9.8	9.1	3.9	5.6	8.1	10.1	11.1	8.5
Net FDI (% of GDP)	1.9	1.8	2.6	1.2	0.8	2.4	2.1	0.9	1.2	1.6	1.9	2.0	1.5
Current account balance plus FDI (% of GDP)	-2.2	-3.6	-2.6	-2.5	-0.5	0.3	1.6	0.4	1.3	1.2	1.1	1.0	0.8
Foreign exchange reserves ex gold (€bn)	55.2	70.0	75.6	82.5	77.0	82.7	87.2	108.1	94.5	105.2	106.4	100.3	114.0
Import cover (months of merchandise imports)	6.4	6.5	6.2	6.6	6.2	6.1	6.2	7.4	5.7	5.8	6.5	6.5	6.5
Debt indicators													
Gross external debt (€bn)	201.2	240.8	233.0	287.0	289.2	268.5	298.4	308.2	338.6	334.5	342.5	322.1	314.2
Gross external debt (% of GDP)	64	67	61	74	73	65	69	72	72	67	66	59	56
Gross external debt (% of exports)	211	204	176	204	194	169	173	174	168	156	154	138	129
Lending to corporates/households (% of GDP)	51.2	52.5	55.0	53.6	54.6	56.0	57.2	57.8	56.0	56.5	56.1	55.3	54.9
Interest & exchange rates													
Central bank key rate (year-end, %)	3.50	3.50	4.50	4.25	2.50	2.00	1.50	1.50	1.50	1.50	1.50	1.50	1.25
Broad money supply (average, %YoY)	8.1	8.8	12.5	4.5	6.2	8.2	9.1	9.6	4.6	9.5	9.0	6.5	6.7
3m interest rate (WIBOR, average, %)	4.34	3.93	4.58	4.87	2.98	2.49	1.74	1.70	1.73	1.71	1.73	1.73	1.48
3m interest rate spread over EURIBOR (ppt)	311	312	318	430	276	228	176	197	206	203	203	203	172
2yr yield (average, %)	5.27	4.77	4.82	4.23	3.01	2.45	1.70	1.67	1.88	1.56	1.56	1.48	1.19
10yr yield (average, %)	6.13	5.80	5.98	4.94	4.09	3.46	2.69	3.08	3.46	3.20	2.93	3.04	2.98
USD/PLN exchange rate (year-end)	2.85	2.97	3.45	3.09	3.01	3.52	3.92	4.18	3.48	3.76	3.63	3.35	3.36
USD/PLN exchange rate (average)	3.10	3.01	2.96	3.25	3.16	3.15	3.77	3.97	3.76	3.64	3.78	3.45	3.35
EUR/PLN exchange rate (year-end)	4.10	3.98	4.46	4.07	4.15	4.27	4.26	4.42	4.17	4.30	4.36	4.35	4.37
EUR/PLN exchange rate (average)	4.33	3.99	4.12	4.18	4.20	4.19	4.18	4.38	4.24	4.27	4.31	4.35	4.36

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	5.3	5.1	5.1	4.9	4.2	4.2	4.1	3.6	4.1	3.5	3.2	2.2	1.7
CPI (eop, %YoY)	1.3	2.0	1.9	1.1	1.7	2.3	1.9	2.1	2.6	2.6	2.7	2.7	2.7
Central bank key rate (eop, %)	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
3m interest rate (eop, %)	1.70	1.70	1.72	1.72	1.73	1.73	1.73	1.73	1.73	1.73	1.73	1.73	1.65
10yr yield (eop, %)	3.18	3.22	3.24	2.83	2.84	2.89	2.99	3.07	3.06	3.05	3.04	3.03	3.00
USD/PLN exchange rate (eop)	3.41	3.74	3.68	3.76	3.84	3.82	3.74	3.63	3.57	3.49	3.41	3.27	3.34
EUR/PLN exchange rate (eop)	4.21	4.36	4.27	4.30	4.30	4.28	4.32	4.36	4.36	4.36	4.35	4.35	4.36

Source: National sources, ING estimates

Romania

Ciprian Dascalu, **Chief Economist Romania & Balkans**

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	4.1	3.7	2.8	2.4	2.1	2.7	2.1
CPI (%YoY)*	3.3	3.8	3.2	3.5	3.8	3.6	3.3
Policy interest rate (eop, %)	2.50	2.50	2.50	2.50	2.50	2.50	2.50
3m interest rate (%)*	3.02	3.10	3.20	3.20	3.10	3.20	3.00
10yr yield (%)*	4.80	4.70	4.90	4.90	4.70	4.80	4.80
USD/RON*	4.07	4.24	4.34	4.17	4.04	4.19	3.86
EUR/RON*	4.66	4.75	4.77	4.80	4.85	4.78	4.88

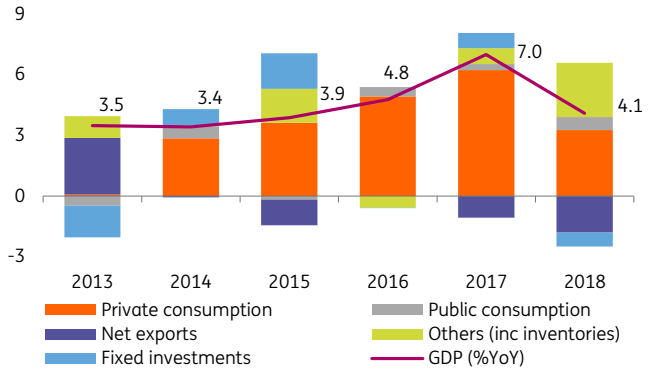
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Nov 2019	S&P	BBB-	BBB-
Fiscal	Neutral	Parliamentary: Dec 2020	Moody's	Baa3	Baa3
Monetary	Tighter	Local: Jun 2020	Fitch	BBB-	BBB-

*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

Country strategy

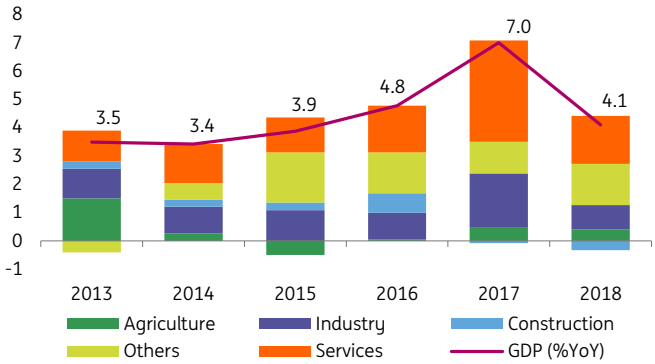
We expect the C/A gap and budget deficit to deteriorate further. Investor sentiment has been shaken by changes in the fiscal environment. These developments have caught the eye of rating agencies. With four election rounds over the next couple of years, we see limited opportunities for fiscal consolidation or structural reforms. The appointment of a new NBR Board this year could be an additional source of concern for investors. The economy was already cooling off and regulatory changes are likely to put private investment plans on hold. Even if there is some improvement in legislation, the trust between the private sector and government is unlikely to be restored rapidly. We think that most of the burden from external imbalances will continue to fall on the central bank.

Weaker consumption, higher inventories



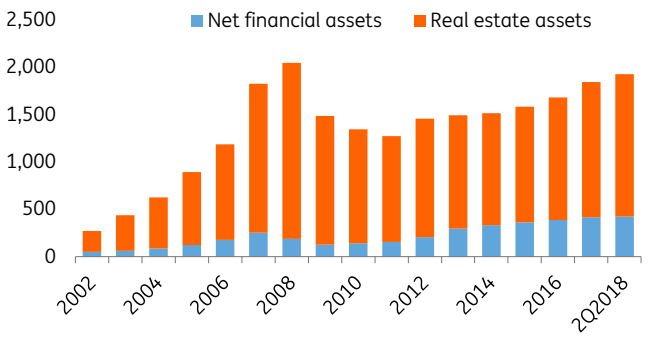
Source: NIS, ING

Broad based cooling down



Source: NIS, ING

Households net wealth: exposed to housing market



Source: NBR

Macro digest: against the wall

Romania grew 4.1% year-on-year in 2018 with a sharp slowdown in consumer spending. Consumption added just 3.3 percentage points to growth, down from a 6.2ppt contribution to the 7% growth of 2017. Inventories added 2.7ppt, investments and net exports subtracted 0.7ppt and 1.8ppt, respectively.

A sharp slowdown in household consumption was confirmed despite a third consecutive year of double-digit wage growth, with consumer confidence dented by fiscal changes, higher interest rates and a weaker currency. The cyclicality in durable goods spending was also likely to have been a factor. The data points to limitations of the consumption-driven growth model that also left deep scars in the external position, with net exports posting the largest negative contribution to growth since 2007. Unbalanced public spending is also reflected in a negative contribution of 0.7ppt to growth from investments. With most of the fiscal resources exhausted on the wage envelope and social benefits, there is little room for a fiscal impulse to support investments.

Even worse, private investment might be postponed by recent fiscal changes and general regulatory unpredictability. The large contribution from inventories might also suggest downside price pressure going forward.

On the supply side, private services made the largest contribution of 1.7ppt, followed by industry with 1.0ppt and agriculture 0.4ppt, while construction had a second consecutive year with a negative contribution, subtracting 0.3ppt from 2018 growth.

Both external and domestic growth drivers seem to point to a slowdown; the growth structure is weak and the fiscal space to prop-up growth is lacking. The absence of structural reforms in recent years is also likely to exacerbate the downturn. We forecast 2.7% GDP growth in 2019 and 2.1% in 2020, with the economy heavily exposed to a global recession.

The output gap is turning negative this year in our view, but core inflation will remain near the upper bound of 3.5% of the NBR target band over the next couple of years as currency deprecation pass-through is likely to remain high.

With little-to-no fiscal leeway to rejuvenate growth, we could see more pressure on the central bank to support growth. Depending on the structure of the new NBR Board, we could see it joining the unconventional policymakers' club. This could entail targeted measures on the housing market, which would have a significant impact on household wealth via fixed mortgage rates, and lending schemes to SMEs or priority sectors for the government, such as agriculture.

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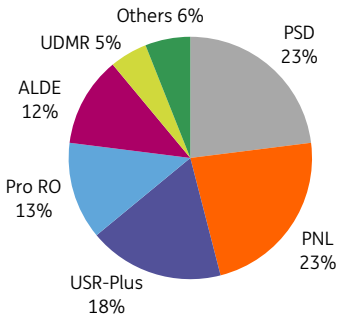
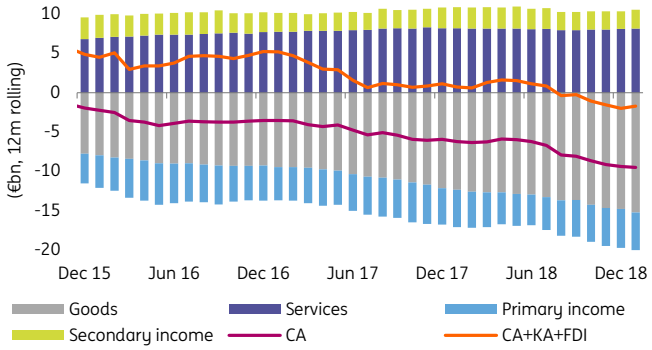
Fragmented political scene



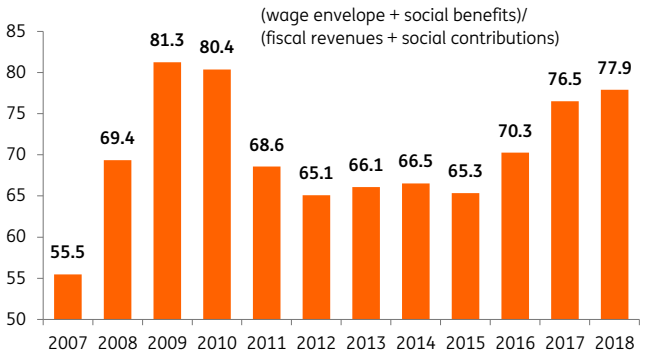
Source: IMAS, Error margin ±3ppt

External shortfall from 2018 burning into FX reserves



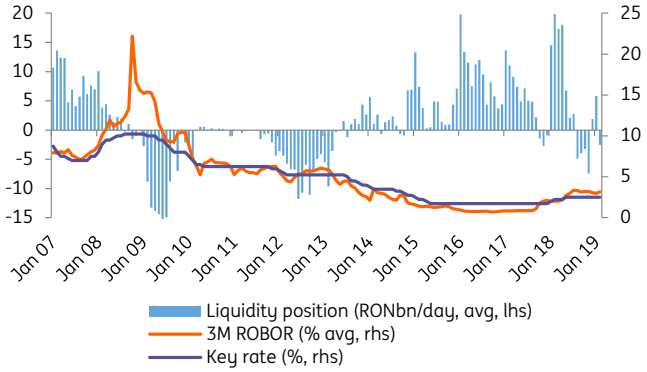
Source: NBR, ING

Fiscal constraints similar to times of recession



Source: MinFin, ING

Liquidity management: discretion prevails over rules?



Source: NBR, ING

Politics: persistent electoral noise

Opinion polls are pointing to eroded popularity of the main ruling coalition party, the PSD, but not to a clear change in the majority preference. European elections due 26 May are the first test, but can be played down due to usually low turnout. Hence, unlikely to lead to a change in government coalition despite a possibility the result could lead to more defections from PSD. Presidential elections and the outcome are likely to open the way for political negotiations. Still, we believe snap elections are unlikely this year. Fiscal policy has focused recently on buying time. Hence, whatever coalition governs after the 2020 general elections it will be faced with the unpopular choice of raising taxes and reducing the overall fiscal largesse. Good news is there is plenty of room for structural reforms.

C/A to widen further

Recent fiscal changes are continuing the objective of the government programme to redistribute national income between capital and labour remuneration in favour of the latter. This is likely to keep household demand relatively robust and raise the funding and fixed costs (utilities, communication services, labour cost) for companies, including exporters, and affect the competitiveness of the latter. A tight labour market and the absence of structural reforms and infrastructure upgrades to enhance competitiveness are weighing in. Hence, despite a quite significant slowdown in economic growth, a reversal of the current account deficit widening trend seems unlikely. Election fever over the next couple of years means an increasing probability of a hard landing.

Public finances: a ticking bomb

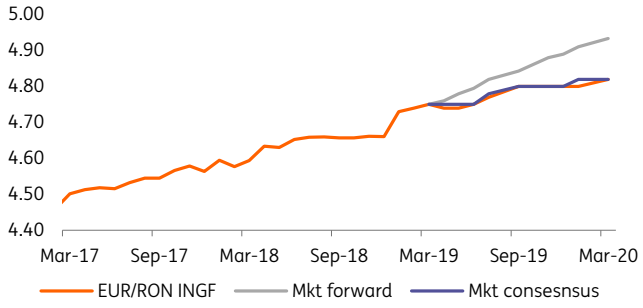
We have argued for a while that there are two outcomes to recent fiscal largesse: either an overshoot of the excessive deficit procedure (EDP) threshold, or higher taxes as lowering spending is limited by its structure of overweight on wages and social benefits, untouchable in election years. As the commitment to the 3.0% of GDP budget deficit cap seems to prevail, the government has introduced sectorial taxes to prop up the budget. Still, the budget bill envisages very optimistic macro assumptions; 5.5% real GDP growth, a 3.4% rise in employment and a 0.75ppt of GDP increase in tax collection. The deficit target is -2.76% of GDP, but we see EDP compliance unlikely under a no policy change scenario. Hence, the mid-year budget review could bring additional fiscal changes.

NBR stance: burning into FX reserves

The current central bank board ends its term in October. New appointments by parliament could be announced sooner, perhaps ahead of the European elections on 26 May. The NBR and its governor recently came under intense scrutiny from the ruling coalition; this included interference in NBR policy independence via government decree, legislative changes affecting the banking sector, a draft bill to change the NBR statute, and also suggestions that new blood was needed at the helm of the central bank. Governor Isarescu, in charge since September 1990, serving several terms, has commented that parliament will have a final say on a new mandate. In any case, the new board is likely to have a different trade-off between growth and inflation in favour of the former. Hence, FX reserves might be more intensely used.

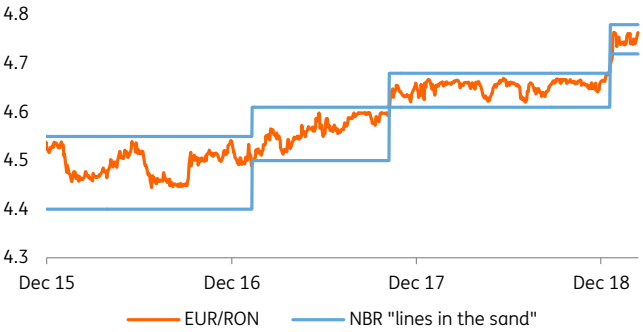
Romania Strategy

FX – spot vs forward and INGF



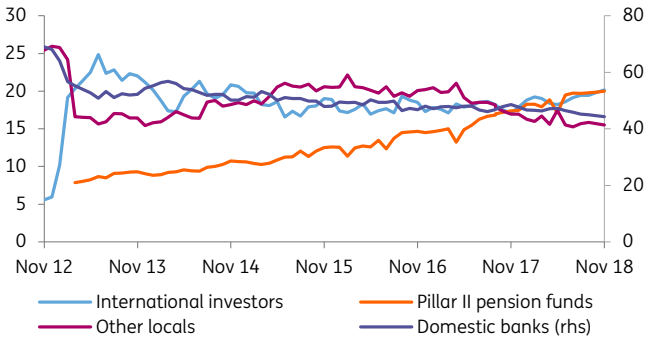
Source: Bloomberg, ING

When the next shift higher in the comfort band?



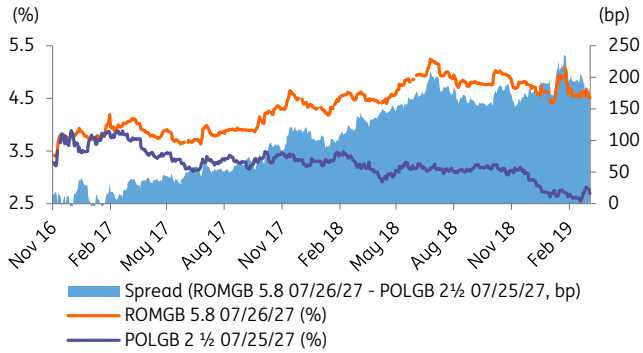
Source: NBR, ING

ROMGBs foreign ownership at four-year high



Source: MinFin, ING

Is it all priced in? NBR could become more dovish



Source: Bloomberg

FX strategy: asymmetric risks

The EUR/RON was as stable as it gets in 2018, but the trade-off between CPI and external competitiveness didn't end the year as expected for the central bank. The NBR deployed liquidity management, or squeezes to put it more bluntly, as a first line of defence and, when needed, FX interventions. Inflation declined within the NBR target band of 1.5-3.5%, though greatly helped by a fall in the oil price. The C/A closed the year at -4.7% of GDP, outside the -4% warning level. This could lead to a change in the reaction function of the central bank as fiscal consolidation and structural reforms to support the RON are unlikely during election years.

A government emergency decree, linking the size of the bank levy to the interbank interest rate indexes, thus limiting NBR flexibility to raise rates to counter RON weakening, led to a spike in EUR/RON which was quickly stopped by FX intervention from the NBR. The central bank aims to discourage sharp moves to prevent panic saving euroisation by retail clients. We still believe that central bank will allow RON depreciation within the inflation differential over 2019, so around 3%. This is anyway below the cost of carry for bets against the RON.

Clearly, the NBR can only postpone the recoupling of the RON to fundamentals. This is likely to eat up FX reserves, but expected EU fund inflows and net external debt issuance by MinFin are offering a fair degree of comfort. The risk balance to RON outlook is heavily asymmetrical as the overvaluation pressures are accumulating. A heavy election calendar is skewing the risk balance further. Hence, at the next global recession, the IMF is likely to be called upon again.

Romania

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-5.5	-3.9	2.0	2.1	3.5	3.4	3.9	4.8	7.0	4.1	2.7	2.1	1.5
Private consumption (% YoY)	-8.4	-3.4	1.3	1.9	1.2	4.5	5.8	8.0	9.9	5.6	4.6	4.0	2.0
Government consumption (% YoY)	-4.1	-1.6	-1.2	7.5	-2.9	3.5	-0.3	2.2	-0.2	1.8	1.5	1.4	1.0
Investment (% YoY)	-33.9	-2.8	6.1	3.1	-5.6	3.3	7.5	-0.2	3.5	-3.1	0.8	1.3	1.7
Industrial production (% YoY)	-5.4	4.9	8.1	3.0	7.7	6.4	2.7	3.1	8.7	5.0	4.0	2.4	2.0
Unemployment rate (year-end, %)	6.5	7.0	7.1	6.8	7.1	6.8	6.8	5.9	4.9	3.8	3.6	3.6	3.5
Nominal GDP (RONbn)	531	528	559	594	635	669	713	765	857	940	1,010	1,080	1,150
Nominal GDP (€bn)	125	125	132	133	144	150	160	170	188	202	214	224	232
Nominal GDP (US$bn)	175	168	185	172	191	199	176	187	216	232	244	282	301
GDP per capita (US$)	8,600	8,300	9,200	8,600	9,600	10,000	8,900	9,500	11,000	12,000	12,700	14,800	16,000
Gross domestic saving (% of GDP)	20.8	20.7	22.3	21.8	24.8	24.2	24.5	22.4	21.3	20.7	21.1	21.5	21.6
Prices													
CPI (average, % YoY)	5.6	6.1	5.8	3.3	4.0	1.1	-0.6	-1.6	1.3	4.7	3.6	3.3	3.4
CPI (year-end, % YoY)	4.8	8.0	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3	3.3	3.8	3.3	3.5
Wage rates (nominal, % YoY)	8.8	2.5	5.0	5.0	5.0	5.3	8.3	13.0	14.2	13.1	14.1	9.3	5.0
Fiscal balance (% of GDP)													
Consolidated government balance	-9.1	-6.9	-5.4	-3.7	-2.2	-1.3	-0.7	-2.9	-2.9	-2.9	-3.0	-3.0	-3.0
Consolidated primary balance	-7.7	-5.4	-3.8	-1.9	-0.4	0.4	0.9	-1.4	-1.5	-1.9	-2.0	-2.4	-1.8
Total public debt	22.1	29.8	34.2	37.0	37.6	39.2	37.8	37.3	35.1	35.1	36.0	37.2	37.5
External balance													
Exports (€bn)	29.1	37.4	45.3	45.0	49.6	52.5	54.6	57.4	62.6	68.4	74.8	81.8	89.4
Imports (€bn)	38.9	46.9	54.9	54.6	55.3	58.6	63.0	67.4	75.6	83.2	91.6	100.8	111.0
Trade balance (€bn)	-9.9	-9.5	-9.7	-9.6	-5.8	-6.1	-8.4	-10.0	-12.9	-14.7	-16.8	-19.1	-21.6
Trade balance (% of GDP)	-7.9	-7.5	-7.3	-7.2	-4.0	-4.0	-5.2	-5.9	-6.9	-7.3	-7.8	-8.5	-9.3
Current account balance (€bn)	-5.8	-6.4	-6.6	-6.4	-1.5	-1.0	-2.0	-3.6	-6.0	-9.4	-11.6	-12.7	-14.0
Current account balance (% of GDP)	-4.6	-5.1	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.2	-4.7	-5.4	-5.7	-6.0
Net FDI (€bn)	3.4	2.3	1.7	2.6	2.9	2.7	3.0	4.5	4.9	4.9	5.1	5.2	5.2
Net FDI (% of GDP)	2.7	1.8	1.3	1.9	2.0	1.8	1.8	2.6	2.6	2.4	2.4	2.3	2.3
Current account balance plus FDI (% of GDP)	-1.9	-3.3	-3.7	-2.9	1.0	1.1	0.6	0.6	-0.6	-1.8	-3.1	-3.4	-3.8
Foreign exchange reserves ex gold (€bn)	28.3	32.4	33.2	31.2	32.5	32.2	32.2	34.2	33.5	33.1	34.7	35.7	36.9
Import cover (months of merchandise imports)	8.7	8.3	7.2	6.9	7.1	6.6	6.1	6.1	5.3	4.8	4.5	4.2	4.0
Debt indicators													
Gross external debt (€bn)	82.3	93.6	99.9	100.9	98.1	94.7	92.1	92.9	97.4	98.5	100.5	102.5	104.5
Gross external debt (% of GDP)	66	75	76	76	68	63	57	55	52	49	47	46	45
Gross external debt (% of exports)	283	250	221	224	198	180	169	162	155	144	134	125	117
Lending to corporates/households (% of GDP)	39.2	39.2	39.5	37.9	34.3	31.7	30.5	28.9	27.2	26.7	27.4	28.0	28.4
Interest & exchange rates													
Central bank key rate (year-end %)	8.00	6.25	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.50	2.50	2.50	2.00
Broad money supply (average, % YoY)	8.2	6.2	6.2	7.9	4.1	6.8	7.8	11.4	11.1	11.1	8.3	5.3	2.3
3m interest rate (Robor, average, %)	11.7	6.7	5.8	5.3	4.2	2.5	1.4	0.9	1.1	2.8	3.2	3.0	2.7
3m interest rate spread over Euribor (ppt)	11.0	5.7	4.5	5.2	3.9	2.5	1.5	1.2	1.5	3.1	3.4	3.3	2.9
3yr yield (average, %)	11.1	7.4	7.2	6.3	4.8	3.3	1.9	1.5	1.9	3.7	3.8	3.8	3.5
10yr yield (average, %)	9.8	7.2	7.4	6.7	5.3	4.6	3.5	3.3	3.9	4.7	4.8	4.8	4.5
USD/RON exchange rate (year-end)	2.96	3.20	3.32	3.36	3.27	3.70	4.15	4.32	3.88	4.06	4.04	3.77	3.85
USD/RON exchange rate (average)	3.03	3.14	3.03	3.45	3.32	3.37	4.04	4.08	3.97	4.05	4.19	3.86	3.82
EUR/RON exchange rate (year-end)	4.23	4.28	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.66	4.85	4.90	5.00
EUR/RON exchange rate (average)	4.24	4.21	4.24	4.46	4.42	4.44	4.45	4.49	4.57	4.65	4.78	4.88	4.96

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	4.0	4.1	4.2	4.1	3.7	2.8	2.4	2.1	2.2	2.0	2.2	2.1	1.7
CPI (eop, %YoY)	4.9	5.4	5.0	3.3	3.8	3.2	3.5	3.8	3.0	3.3	3.3	3.3	2.9
Central bank key rate (eop, %)	2.25	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
3m interest rate (eop, %)	2.08	3.15	3.17	3.02	3.10	3.20	3.20	3.10	3.00	3.00	3.00	2.90	2.85
10yr yield (eop, %)	4.46	5.21	4.77	4.80	4.70	4.90	4.90	4.70	4.80	4.80	4.80	4.70	4.60
USD/RON exchange rate (eop)	3.88	3.98	4.06	4.07	4.24	4.34	4.17	4.04	3.98	3.90	3.81	3.77	3.78
EUR/RON exchange rate (eop)	4.66	4.66	4.66	4.66	4.75	4.77	4.80	4.85	4.85	4.87	4.88	4.90	4.92

Source: National sources, ING estimates

Russia

Dmitry Dolgin, Chief Economist, Russia & CIS

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	2.7	1.1	0.8	1.2	1.1	1.0	1.5
CPI (%YoY)*	4.3	5.4	5.7	5.6	5.0	5.4	3.8
Policy interest rate (eop, %)	7.75	7.75	7.75	7.75	7.50	7.50	6.50
3m interest rate (%)*	8.6	8.3	8.3	7.9	7.5	7.5	6.5
10yr yield (%)*	8.8	8.4	8.1	7.9	7.5	7.5	6.9
USD/RUB*	69.5	65.6	66.0	67.0	66.0	66.0	68.0
EUR/RUB*	79.5	73.7	77.9	80.4	82.5	82.5	87.0

Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Mar-24	S&P	BBB-	BBB
Fiscal	Stable	Parliamentary: Sep-21	Moody's	Baa3	Baa3
Monetary	Stable	Local:	Fitch	BBB-	BBB-

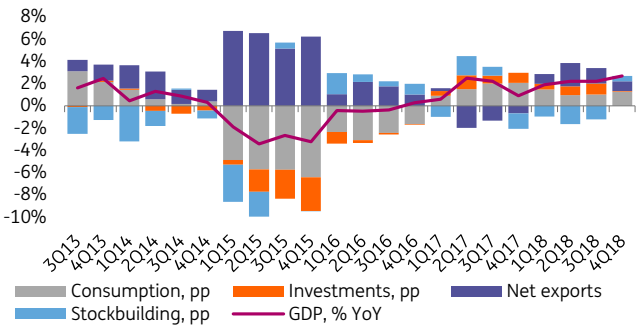
*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

Country strategy

Russia is expected to face economic growth headwinds in 2019, increasing its dependence on external sectors amid constrained local demand following the VAT hike. The policy response so far has been through targeted support to household income and state investments, while systemic supply-side measures are still to come.

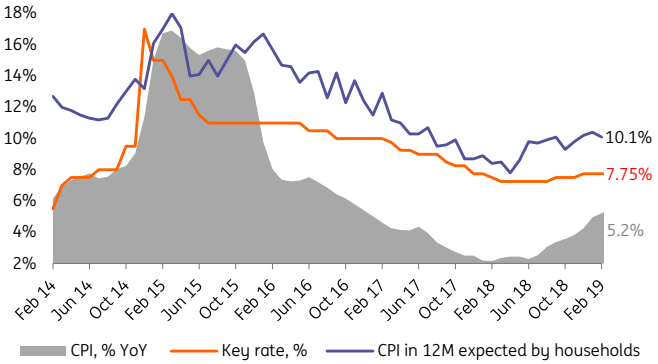
By contrast, local financial markets are off to a good start this year, as global risk appetite has improved, the local CPI trend so far has allowed some easing in the CBR stance, and strong macro stability keeps local state bonds attractive for foreign investors. Potential local obstacles for a rally include a persistent risk of sanctions and structural issues in the balance of payments, favouring gradual RUB depreciation in the long term, unless productivity improves.

GDP and key contributors (% YoY, ppt)



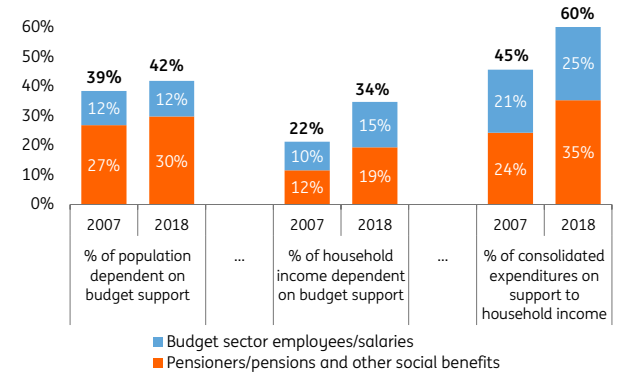
Source: Rosstat, ING

Key rate, CPI, and households' inflationary expectations



Source: Bank of Russia, ING

Social focus of the Russian budget policy



Source: Finance Ministry, Rosstat, ING

Macro digest

The acceleration of GDP growth from 1.6% in 2017 to 2.3% in 2018 outperformed expectations, but its concentration in the oil and gas sector and persistent weakness in investment growth – even after upward revisions of construction for 2017-9M18 – suggest there are few reasons to become more optimistic about 2019. Despite a number of large state-sponsored and oil-related infrastructure projects, annual real capex has barely reached 2008 levels (private consumption is 16% above 2008 level). Consumption growth showed a deceleration from 3.0% in 2017 to 1.9% in 2018, confirming weakening local demand, which is unlikely to reverse any time soon given the VAT hike and slowdown in salary growth. The only contributor to acceleration of 2018 GDP growth is net exports thanks to 17% RUB depreciation to USD and acceleration in oil and gas export volumes, which is now in doubt due to OPEC+ commitments.

At YE18, the higher-than-expected CPI of 4.3% combined with growing inflationary expectations and poor market mood triggered an additional key rate hike to 7.75%. The risk of further rate hikes has subsided with global risk appetite returning, RUB appreciation of 8% YTD, a return to OFZ inflows, an acceleration of local CPI to the lower bound of the CBR forecast, and a moderation in inflationary expectations by households and corporates. A return of the easing cycle is unlikely to take place before 4Q19 given the expiration of the local gasoline price freeze due at the end of March, the decline of the household savings rate (retail deposit growth at a 3.5-year low of 8%, retail loan growth at an almost 5-year high of 23%), seasonal BoP weakness in 2Q-3Q19, and continued uncertainty regarding global risk appetite and sanctions that are keeping mid-term risks to monetary policy at elevated levels.

Weakening economic momentum and declining popular support has triggered an expected policy response: the government has pledged to support household income through higher pension indexation and other targeted social benefits. The package so far is a modest RUB0.1tr (0.3% of total consolidated spending), which is not an immediate threat to Russia's budget stability, as the state debt is a mere 13% of GDP and sovereign funds will exceed 7% of GDP this year. At the same time, the response underscores a growing dependency on consumption of state injections. Over the past 11 years, the share of household income directly dependent on budget expenditures went up from 22% to 34%, while the share of consolidated state spending channelled to support household income increased from 45% to 60%. In order to avoid accumulation of long-term macro risks, the government could focus more on addressing productivity issues affecting quantity and quality of labour and capital.

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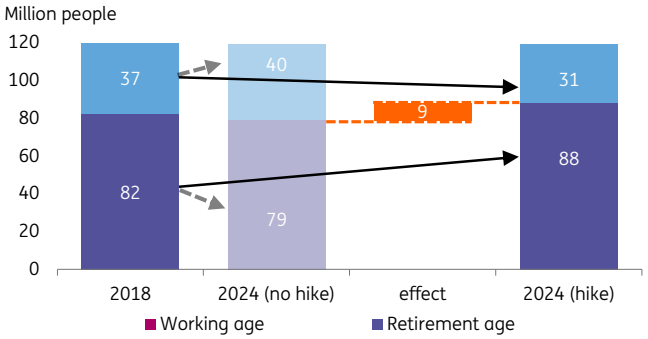
Key demographics of retirement age hike

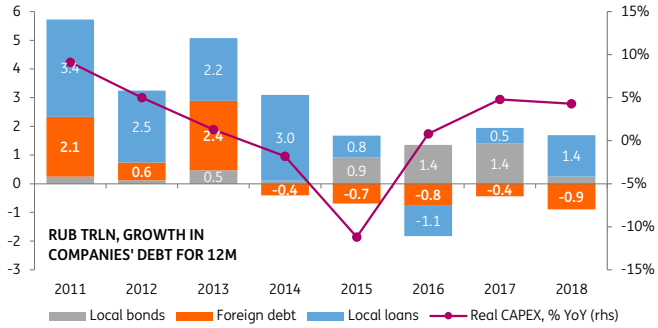


Source: Rosstat, media, ING

Retirement age hike – not a huge boost to labour force

The increase in retirement age of five years for men and women that will take place gradually over 2019-24 may seem like a way to boost labour as it shifts the formal retirement age border for 9m people vs a no age hike scenario. However, currently, around 9m above working age remain officially employed (informal employment may be higher). We suspect the retirement age hike will provide only a marginal boost to labour, mostly in the low-skilled segment, being more-or-less neutral to productivity and household income trends. Rather, this measure helps mitigate the effect of the negative demographic trend on the state finances, as now the deficit of the state pension fund (PFR) is likely to shrink from 2.5% of GDP in 2018 to 1.0% in 2024 instead of expanding to 3.2%.

Companies' capex and debt growth

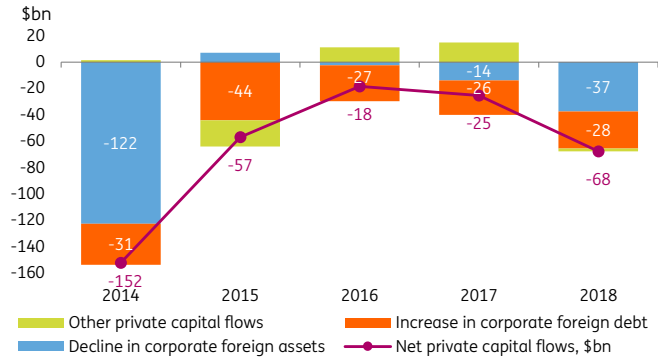


Source: Bank of Russia, Rosstat, ING

Investment demand to focus around state projects

Despite upward revisions in construction statistics and government calls to the business community, fixed investments remain weaker than desired, as the challenging business climate constrains private SME investment, while large enterprises are restrained by the risk of sanctions. Real capex growth slowed from 4.8% in 2017 to 4.3% in 2018, while nominal growth in companies' debt moderated from RUB1.5tr in 2017 to RUB0.8tr in 2018, pointing to the greater role of own and budget funds. The government has budgeted RUB13tr over the next 6 years (1.5-2.0% GDP per year) on infrastructure projects in transportation, IT and urban development. However, the two key questions are whether it can stay within spending guidelines and whether state capex will result in broader-based investment growth.

Banks' and companies' foreign debt redemption

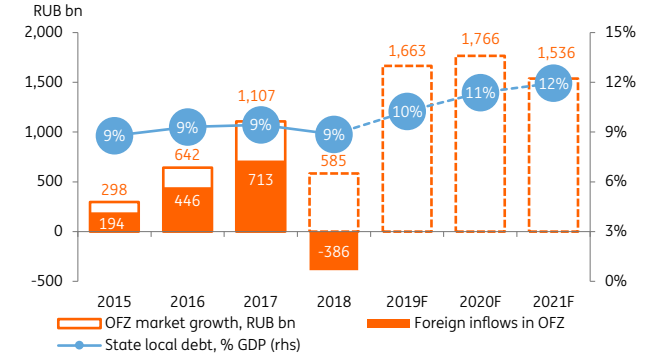


Source: Bank of Russia, ING

Corporates prefer FX assets to local investments

Limited investment demand pre-determines weakness in the capital account. The net private capital outflow increased from US$25bn in 2017 to US$68bn in 2018 as, in addition to net foreign debt redemption (which remained at a moderate US$28bn), corporates accumulated foreign assets, reflecting non-repatriation of export revenues. In 2019, net corporate foreign debt redemption is set to halve to c.US$13bn, though foreign asset accumulation remains an issue: in 2M19 it totalled nearly US$19bn, sterilising 83% of the current account surplus (vs 30-40% in 2M17-18). Low preference for corporate FX repatriation suggests that the entire US$100bn current account surplus is likely to be sterilised by US$30bn private capital outflow and US$70bn FX purchases by Minfin this year, making RUB increasingly dependent on volatile portfolio flows.

Local state debt (Finance Ministry's plan)



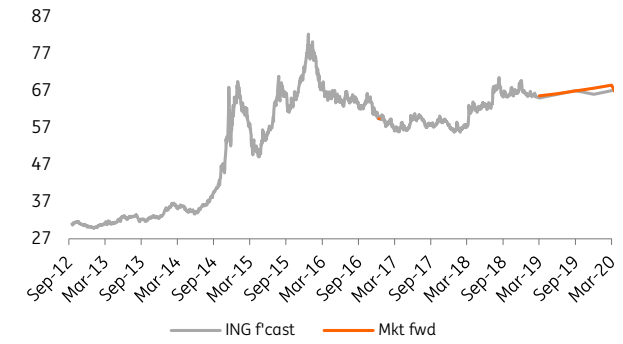
Source: Finance Ministry, Bank of Russia, ING

State to gain importance as a borrower

A logical conclusion from the state gaining importance in the economy through higher state spending amid tepid corporate activity is higher state borrowing. 2018 was a setback for Minfin's plans, as speculation on possible sanctions against Russian public debt combined with global risk-off scared away foreign investors. However, in 1Q19 the local state bond (OFZ) market could see a foreign capital inflow of RUB100-200bn, as risk-on is back. The budget rule prescribes up to RUB1.7tr net OFZ placement this year, which seems ambitious but, provided markets remain calm, it might be met with foreign and local demand given Russia's macro strengths, improvement in the rate outlook, limited competition for credit from the private sector, and ample local RUB liquidity.

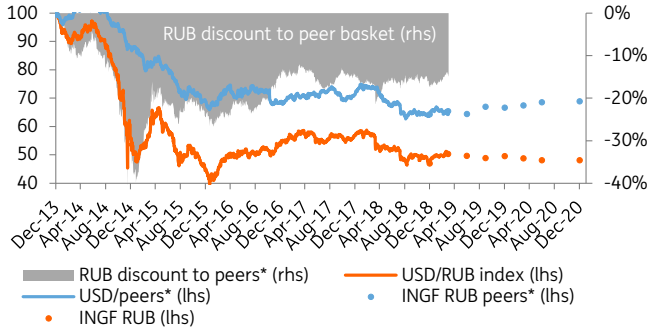
Russia Strategy

FX – spot vs forward and INGF



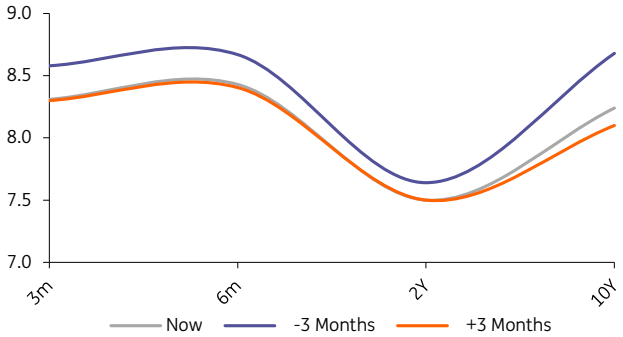
Source: Bloomberg, ING

USD/RUB performance vs its peer group*



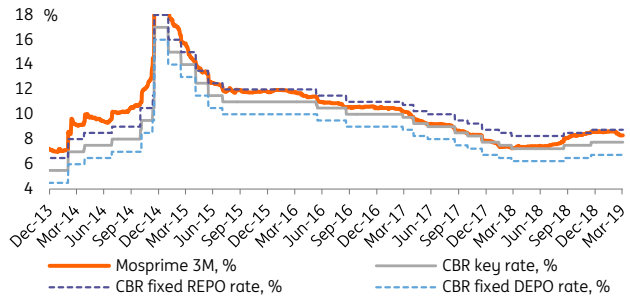
*EW FX basket of ZAR, BRL, TRL, MXN, MYR, NOK, COP; Source: Bloomberg, ING

Local curve (%)



Source: Bloomberg, ING

Russia money market indicators



Source: Bank of Russia, Bloomberg, ING

FX strategy

After a weaker-than expected end of year, RUB managed to rebound 6% against USD YTD, thanks to a strong oil price and portfolio inflows into local state bonds (OFZ) of c.US$2bn in January-February. For the short term, we maintain a positive outlook, as in 1Q and at the beginning of 2Q, Russia enjoys the strongest current account thanks to seasonality.

Meanwhile, our longer term view deteriorated because of lower corporate preference for FX revenue repatriation, which, as mentioned earlier, forced us to increase full-year net capital outflow expectations by US$10bn to US$30bn, In 2Q-3Q19, balance of risks is favouring RUB depreciation on a shrinking current account surplus amid persisting external risks. Unless the government successfully restarts investment growth, RUB is set to lag behind peers.

Local downside risks to our view still include the expansion of sanctions to ban non-resident participation in new sovereign debt. Non-residents hold c.US$30bn in local OFZ and, if there were be sanctions, 30-100% of that sum could be withdrawn. We estimate that every US$5bn outflow weakens the RUB fair value (ie, the level likely to be reached after the initial shock settles) by RUB1/USD. That gives up to RUB6/USD downside risk related to sanctions.

A second risk is related to the general EM space. As Russia's current account is routinely sterilised by either FX interventions or private capital outflows, RUB has been trading in line with portfolio flow-driven peers. Currently, our global team expect the RUB peer basket to appreciate by 4% in 2019 and by 3% in 2020. Yet the global view is subject to risks related to US-China tensions and Fed tightening.

Russia

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (%YoY)	-7.8	4.5	4.3	3.7	1.8	0.7	-2.5	0.3	1.6	2.3	1.0	1.5	1.7
Private consumption (%YoY)	-5.1	5.5	6.8	7.9	5.2	2.0	-9.4	-1.9	3.2	2.2	1.0	1.5	2.0
Government consumption (%YoY)	-0.6	-1.5	1.4	2.6	0.9	-2.1	-3.1	1.4	2.5	0.9	1.0	1.0	1.0
Investment (%YoY)	-14.4	5.9	9.1	5.0	1.3	-1.8	-11.2	0.7	5.5	2.3	1.5	3.0	3.0
Industrial production (%YoY)	-10.7	7.3	5.0	3.4	0.4	1.7	-0.8	2.2	2.1	2.9	1.5	2.5	3.0
Unemployment rate (year-end, %)	8.0	7.0	6.0	5.5	5.5	5.2	5.6	5.5	5.2	4.8	4.7	4.7	4.7
Nominal GDP (RUBbn)	38,807	46,309	60,283	68,164	73,134	79,200	83,101	86,010	92,089	103,627	110,315	116,224	122,928
Nominal GDP (€bn)	832	1,089	1,531	1,566	1,781	1,552	1,033	1,166	1,411	1,451	1,451	1,369	1,380
Nominal GDP (US$bn)	1,223	1,525	2,052	2,193	2,297	2,064	1,364	1,283	1,578	1,654	1,654	1,724	1,795
GDP per capita (US$)	8,562	10,686	14,368	15,356	16,064	14,411	9,503	8,919	10,745	11,271	11,283	11,779	12,275
Gross domestic saving (% of GDP)	21.1	26.4	29.3	27.8	24.6	25.0	26.9	26.0	26.6	27.5	27.9	27.3	27.2
Prices													
CPI (average, %YoY)	11.7	6.9	8.4	5.1	6.8	7.8	15.5	7.1	3.7	2.9	5.4	3.8	4.0
CPI (year-end, %YoY)	8.8	8.8	6.1	6.6	6.5	11.4	12.9	5.4	2.5	4.3	5.0	4.0	4.0
Wage rates (nominal, %YoY)	9.1	12.8	11.7	16.4	9.3	8.3	4.2	7.8	7.3	9.9	5.0	4.0	5.0
Fiscal balance (% of GDP)													
Consolidated government balance	-6.3	-3.4	1.4	0.4	-1.2	-1.1	-3.4	-3.7	-1.5	2.9	1.9	1.7	0.9
Consolidated primary balance	-5.6	-2.9	2.8	1.0	-0.5	-0.4	-3.0	-3.2	-0.6	3.8	2.8	2.6	1.9
Total public debt	8.3	9.0	9.4	9.8	10.6	11.8	12.5	13.3	12.6	11.7	13.4	15.2	15.6
External balance													
Exports (US$bn)	297.2	392.7	515.4	527.4	521.8	496.8	341.4	281.7	353.5	443.4	425.0	450.0	460
Imports (US$bn)	183.9	245.7	318.6	335.8	341.3	307.9	193.0	191.5	238.1	249.0	250.0	265.0	290
Trade balance (US$bn)	113	147	197	192	181	189	148	90	115	194	175	185	170
Trade balance (% of GDP)	9.3	9.6	9.6	8.7	7.9	9.2	10.9	7.0	7.3	11.8	10.6	10.7	9.5
Current account balance (US$bn)	50	67	97	71	33	58	68	25	33	76	100	115	100
Current account balance (% of GDP)	4.1	4.4	4.7	3.3	1.5	2.8	5.0	1.9	2.1	4.6	6.0	6.7	5.6
Net FDI (US$bn)	-7	-10	-12	2	-17	-35	-15	10	-8	-13	-10.0	0.0	0.0
Net FDI (% of GDP)	-0.5	-0.6	-0.6	0.1	-0.8	-1.7	-1.1	0.8	-0.5	-0.8	-0.6	0.0	0.0
Current account balance plus FDI (% of GDP)	3.6	3.8	4.2	3.3	0.7	1.1	3.9	2.7	1.6	3.8	5.4	6.7	5.6
Foreign exchange reserves ex gold (US$bn)	417	443	454	487	470	339	320	318	356	382	453	570	653
Import cover (months of merchandise imports)	27	22	17	17	17	13	20	20	18	18	22	26	27
Debt indicators													
Gross external debt (US$bn)	466	489	539	636	729	600	518	512	518	454	449	444	439
Gross external debt (% of GDP)	38.1	32.0	26.3	29.0	31.7	29.1	38.0	39.9	32.8	27.4	27.1	25.7	24.4
Gross external debt (% of exports)	157	124	105	121	140	121	152	182	147	102	106	99	95
Lending to corporates/households (% of GDP)	42	39	39	40.7	46.0	53.2	54.9	50.8	49.9	50.3	50.6	51.4	52.0
Interest & exchange rates													
Central bank key rate (year-end, %)	6.00	5.00	5.25	5.50	5.50	17.00	11.00	10.00	7.75	7.75	7.5	6.5	6.50
Broad money supply (average, %YoY)	17.7	31.1	21.0	12.2	14.7	1.5	11.3	9.2	10.5	12.0	7.0	10.0	8.0
3m interest rate (Mosprime, average, %)	11.5	4.1	5.5	7.2	6.9	10.5	13.8	11.2	9.3	7.8	8.0	6.9	6.5
3m interest rate spread over US$-Libor (ppt)	694	292	467	575	637	1028	1350	1045	814	545	531	401	358
2yr yield (average, %)	9.3	5.9	6.7	6.8	6.2	9.2	11.5	9.2	7.9	7.2	7.5	6.5	6.3
10yr yield (average, %)	11.2	7.6	8.6	8.0	7.5	9.6	11.1	8.8	7.8	8.0	8.1	7.1	6.9
USD/RUB exchange rate (year-end)	30.2	30.5	32.2	30.4	32.7	56.3	72.9	60.7	57.6	69.5	66.0	68.0	69.0
USD/RUB exchange rate (average)	31.7	30.4	29.4	31.1	31.8	38.4	60.9	67.1	58.3	62.7	66.7	67.4	68.5
EUR/RUB exchange rate (year-end)	42.3	43.6	43.1	39.5	43.2	77.1	88.2	66.1	64.6	83.4	79.2	88.4	89.7
EUR/RUB exchange rate (average)	46.7	42.5	39.4	43.5	41.1	51.0	80.4	73.8	65.3	71.4	76.0	84.9	89.1
Brent oil price (annual average, US$/bbl)	63	80	111	112	109	100	54	45	55	72	69	74	75

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	1.9	2.2	2.2	2.7	1.1	0.8	1.2	1.1	1.8	2.0	1.0	1.0	2.0
CPI (eop, %YoY)	2.3	2.3	3.4	4.3	5.4	5.7	5.6	5.0	3.6	3.2	3.4	4.0	4.0
Central bank key rate (eop, %)	7.25	7.25	7.50	7.75	7.75	7.75	7.75	7.50	7.25	6.75	6.5	6.50	6.50
3m interest rate (eop, %)	10.2	9.2	8.7	7.9	8.38	8.3	7.9	7.5	7.3	6.8	6.5	6.5	6.5
10yr yield (eop, %)	7.14	7.81	8.69	8.78	8.4	8.10	7.90	7.50	7.30	7.10	6.9	6.90	6.9
USD/RUB exchange rate (eop)	57.3	62.8	65.6	69.5	65.6	66.0	67.0	66.0	67.0	68.0	68.0	68.0	67.0
EUR/RUB exchange rate (eop)	68.7	75.3	78.7	83.4	73.7	72.6	77.1	79.2	81.7	85.0	87.0	88.4	84.4

Source: National sources, ING estimates

Serbia

Valentin Tataru, Economist, Romania & Balkans

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	3.5	3.9	3.5	3.9	3.7	3.7	3.6
CPI (%YoY)*	2.0	2.5	2.4	2.1	2.4	2.2	2.2
Policy interest rate (eop, %)	3.00	3.00	3.00	3.00	3.00	3.00	3.00
3m interest rate (%)*	3.00	3.00	2.90	2.80	2.75	2.90	2.80
10yr yield (%)*	4.75	4.75	4.70	4.55	4.50	4.60	4.50
USD/RSD*	103.0	105.8	105.4	102.6	98.3	98.4	90.6
EUR/RSD*	118.5	118.5	118.0	118.0	118.0	118.1	117.8

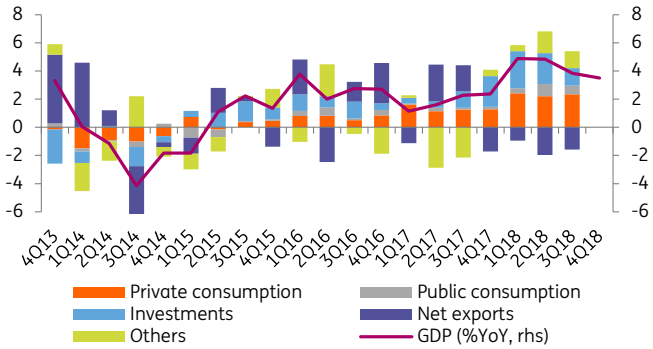
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▲	Presidential: Apr 2022	S&P	BB	BB
Fiscal	Neutral	Parliamentary: Apr 2020	Moody's	Ba3	Ba3
Monetary	Loose	Local: Mar 2022	Fitch	BB	BB

*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

Country strategy

Growing by 4.4% in 2018, the Serbian economy surpassed expectations. We see economic growth moderating to 3.7% in 2019 on weaker external demand, but supported by domestic absorption, fiscal easing and relatively cheap financing costs. We believe that the benefits of past reforms and the prospects of EU membership will continue to support investments and capital inflows, allowing the National Bank of Serbia (NBS) to maintain reasonable borrowing costs while not jeopardising its inflation target. Should the government stick to its investment plans while remaining committed to lowering the public debt, we could see a rating upgrade (currently 'BB' with positive outlook) by the end of 2019.

Real GDP (%YoY) and contributions (ppt)



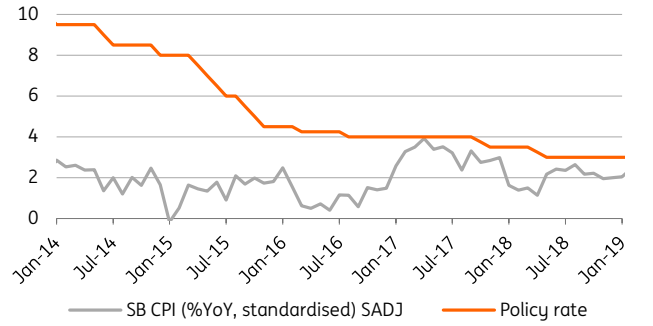
Source: Eurostat, ING

Touching the brakes

Following the positive economic surprise delivered in 2018, some cooling is expected. 2018 growth of 4.4% was driven, on the supply side, by a strong agriculture result, but weaker industry stands out. Agriculture made an almost 1ppt contribution to the overall growth, benefiting from statistical base effects as well, while the contribution by industry turned negative in the last two quarters.

We remain moderately optimistic on 2019 prospects and expect GDP growth to moderate to 3.7%, which is above most market expectations. Among others, a bit of fiscal largesse and relatively accommodative monetary conditions are coming at the right time to offset weaker demand from abroad.

CPI vs policy rate



Source: NBS, ING

Inflation is not the main concern for the NBS right now

Both year end and average 2018 inflation came out at 2.0%. CORE inflation has been even better behaved, averaging 1.0% for the year and confirming the benign inflationary environment.

Assuming quasi-constant oil prices, we see headline inflation inching marginally higher to 2.4% in the first quarter of 2019, due mainly to base effects, and then to return and hover around 2.0% for the rest of the year. CORE inflation, on the other hand, could remain on a mild upward trend as previous dinar appreciation begins to fade away.

We see no change this year to the NBS's key rate.

Serbia

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (%YoY)	-2.7	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2.0	4.4	3.7	3.6	4.0
Private consumption (%YoY)	-3.3	-0.6	1.4	-1.7	-1.7	-0.1	-0.3	1.2	1.9	3.3	3.7	3.6	4.5
Government consumption (%YoY)	-1.7	-0.1	1.6	0.4	-2.1	1.0	-3.8	1.2	3.3	3.6	3.5	3.5	3.9
Investment (%YoY)	-22.5	-6.5	4.7	13.9	-12.0	-3.4	4.9	5.3	7.0	10.1	7.4	7.3	8.2
Industrial production (%YoY)	-12.6	1.3	2.5	-2.2	5.5	-6.5	8.4	4.7	3.5	1.3	1.3	2.0	2.5
Unemployment rate (year-end, %)	17.4	20.0	24.4	23.1	22.1	19.2	17.7	15.3	13.5	12.7	9.2	7.4	6.5
Nominal GDP (RSDbn)	2,880	3,067	3,408	3,584	3,876	3,908	4,312	4,521	4,754	5,062	5,380	5,740	6,150
Nominal GDP (€bn)	30	29	33	32	34	32	33	35	37	43	46	49	52
Nominal GDP (US$bn)	43	39	47	41	46	44	37	38	42	49	52	61	68
GDP per capita (US$)	5,800	5,400	6,400	5,700	6,400	6,200	5,200	5,400	6,000	7,000	7,500	8,900	10,000
Gross domestic saving (% of GDP)	3.5	3.5	4.7	4.3	6.9	6.7	9.1	11.6	12.2	12.1	12.1	12.1	12.4
Prices													
CPI (average, %YoY)	8.1	6.1	11.1	7.3	7.7	2.1	1.4	1.1	3.1	2.0	2.4	2.8	3.0
CPI (year-end, %YoY)	6.6	10.2	7.0	12.2	2.2	1.8	1.6	1.5	3.0	2.0	2.2	2.2	3.0
Wage rates (nominal, %YoY)	-2.9	7.5	11.2	9.0	6.2	1.4	-0.2	3.7	1.5	6.5	9.0	9.6	10.2
Fiscal balance (% of GDP)													
Consolidated government balance	-4.4	-4.6	-4.8	-6.8	-5.5	-6.6	3.5	-1.2	1.1	0.4	-0.5	-0.5	-1.0
Consolidated primary balance	-3.6	-3.4	-3.4	-4.7	-3.0	-3.5	-0.5	1.7	3.6	2.7	2.7	2.4	2.0
Total public debt	32.1	40.8	47.0	58.0	61.1	71.8	70.4	68.6	60.1	53.0	50.3	47.7	45.5
External balance													
Exports (€bn)	6.0	7.4	8.5	8.8	11.1	11.1	12.0	13.4	14.7	16.1	17.6	19.3	21.1
Imports (€bn)	11.5	12.6	14.3	14.7	15.5	15.4	16.4	17.4	19.8	21.9	24.2	25.7	27.4
Trade balance (€bn)	-5.5	-5.2	-5.8	-5.9	-4.4	-4.3	-4.3	-4.0	-5.1	-5.8	-6.6	-6.4	-6.2
Trade balance (% of GDP)	-18.4	-18.0	-17.8	-18.6	-13.0	-13.2	-13.0	-11.7	-13.7	-13.6	-14.4	-13.1	-12.0
Current account balance (€bn)	-2.0	-2.0	-3.7	-4.7	-2.8	-2.6	-1.8	-1.2	-2.1	-2.1	-2.2	-2.4	-2.4
Current account balance (% of GDP)	-6.7	-6.9	-11.4	-11.7	-6.2	-6.2	-4.5	-3.2	-5.2	-5.2	-4.8	-4.9	-4.6
Net FDI (€bn)	2.1	1.1	3.3	0.8	1.3	1.2	2.0	1.9	2.4	3.2	3.3	3.4	3.6
Net FDI (% of GDP)	4.7	4.4	10.9	2.8	5.2	5.1	6.0	6.1	7.2	7.5	7.3	7.1	6.6
Current account balance plus FDI (% of GDP)	-2.0	-2.5	-0.5	-12.2	-3.0	-3.0	0.7	2.6	1.0	2.3	2.5	2.1	2.0
Foreign exchange reserves ex gold (€bn)	11.7	11.2	12.3	11.4	11.6	11.1	11.2	11.1	10.4	12.1	12.8	14.0	14.8
Import cover (months of merchandise imports)	12.2	10.7	10.4	9.3	9.0	8.6	8.2	7.6	6.3	6.6	6.4	6.36	6.5
Debt indicators													
Gross external debt (€bn)	22.5	23.8	24.1	25.6	25.6	25.7	26.2	26.5	25.6	26.5	26.8	27.0	27.3
Gross external debt (% of GDP)	75	82	74	81	76	79	79	77	68	62	59	55	52
Gross external debt (% of exports)	376	322	285	290	231	230	218	197	174	165	152	140	129
Lending to corporates/households (% of GDP)	40.0	47.2	44.8	46.5	41.0	40.8	40.6	40.9	40.3	41.5	43.0	44.6	46.4
Interest & exchange rates													
Central bank key rate (year-end, %)	9.50	11.50	9.75	11.25	9.50	8.00	4.50	4.00	3.50	3.00	3.0	3.0	3.5
Broad money supply (average, %YoY)	11.5	19.7	6.6	14.7	5.6	5.9	5.8	9.2	8.0	7.3	11.2	14.4	19.2
3m interest rate (Belibor, average, %)	14.4	10.8	12.9	11.7	10.1	8.3	6.1	3.4	3.4	3.0	2.9	2.8	3.5
3m interest rate spread over Euribor (ppt)	13.2	9.9	11.5	11.1	9.9	8.0	6.1	3.7	3.7	3.3	3.2	3.1	3.7
2yr yield (average, %)	n/a	n/a	13.2	13.5	10.8	9.2	7.8	4.8	4.5	3.4	3.2	3.3	3.6
10yr yield (average, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	4.8	4.6	4.3	4.5
USD/RSD exchange rate (year-end)	66.7	79.3	80.9	86.2	83.1	99.5	111.2	117.1	99.3	102.8	98.3	90.4	90.0
USD/RSD exchange rate (average)	67.6	78.6	73.1	88.0	84.9	89.1	109.4	111.8	105.5	103.1	103.6	93.5	90.2
EUR/RSD exchange rate (year-end)	95.9	105.5	104.6	113.7	114.6	121.0	121.6	123.5	118.5	118.2	118.0	117.5	117.0
EUR/RSD exchange rate (average)	94.1	103.5	102.0	113.6	113.1	117.4	120.8	123.1	121.4	118.2	118.1	117.8	117.3

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (%YoY)	4.9	4.8	3.8	3.5	3.9	3.5	3.9	3.7	3.9	3.5	3.6	3.6	4.0
CPI (eop, %YoY)	1.4	2.3	2.1	2.0	2.5	2.4	2.1	2.4	2.4	2.6	2.9	3.1	3.2
Central bank key rate (eop, %)	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
3m interest rate (eop, %)	2.91	2.88	2.92	3.00	3.00	2.90	2.80	2.75	2.70	2.70	2.90	3.00	3.10
10yr yield (eop, %)	5.1	4.7	4.75	4.75	4.75	4.70	4.55	4.50	4.50	4.50	4.50	4.50	4.60
USD/RSD exchange rate (eop)	98.4	100.8	102.9	103.0	105.8	105.4	102.6	98.3	96.7	94.0	91.8	90.4	90.4
EUR/RSD exchange rate (eop)	118.1	117.9	118.3	118.5	118.5	118.0	118.0	118.0	118.0	117.5	117.5	117.5	117.5

Source: National sources, ING estimates

Turkey

Muhammet Mercan, Chief Economist

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (% YoY)	-3.0	-1.8	-1.2	1.2	2.6	0.3	2.9
CPI (% YoY)*	20.3	19.6	16.5	10.4	14.3	16.0	12.7
Policy interest rate (eop, %)	24.00	24.00	23.00	21.00	20.00	20.00	16.00
3m interest rate (%)*	24.07	23.87	23.08	20.45	21.67	22.60	19.29
10yr yield (%)*	16.48	15.14	14.76	14.93	15.15	14.98	13.27
USD/TRY*	5.29	5.40	5.61	5.80	6.00	5.63	6.27
EUR/TRY*	6.05	6.05	6.17	6.67	7.20	6.75	8.15

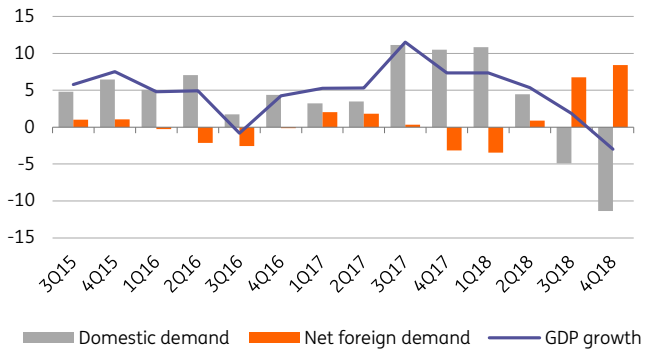
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Jun-23	S&P	B+	BB-
Fiscal	Tighter	Parliamentary: Jun-23	Moody's	Ba3	Ba3
Monetary	Tighter	Local: Mar-24	Fitch	BB	BB+

*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

Country strategy

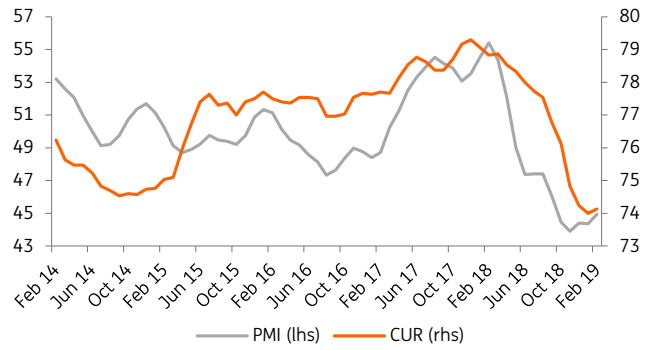
The change in economic policy direction and the ease of geopolitical tension triggered the recovery of Turkish financial markets. Policy determination remains critical to macro and financial performance, while cautious central banks globally have also been supportive lately. Ongoing improvement in external and internal imbalances with: (1) a sharp reduction in external deficit thanks to plunging domestic demand; (2) a deleveraging cycle with a sharp negative credit impulse, though momentum indicators provide encouraging signals on lending. Tightening policies to restore confidence have resulted in a faster rebalancing of the economy, which accelerated in 4Q18. But fiscal incentives and some stabilisation in lending could provide a buffer, while there are early signals of a bottoming in activity.

GDP growth (% YoY)



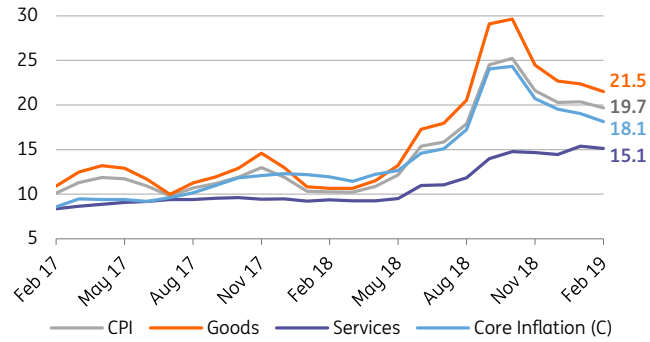
Source: TurkStat, ING Bank

PMI and CUR (seasonally adjusted, 3m-ma, % YoY)



Source: Markit, TurkStat, ING Bank

Inflation (% YoY)



Source: TurkStat, ING Bank

Macro digest

Economic growth in 4Q came out at -3.0%, translating into 2.6% in 2018, below the government's 3.8% projection. In seasonal and calendar adjusted terms (SA), GDP contracted by a significant -2.4% QoQ vs -1.6% QoQ a quarter ago, confirming that the economy has fallen into recession. In the breakdown, private consumption turned negative for the first time since the global crisis, pulling growth down by 5.4bp, while investment growth recorded another contraction and contributed -3.8bp. Public consumption, which positively contributed to the performance in early 2018, remained positive in 4Q though weakened markedly with a mere 0.1ppt lift to the headline given the efforts to get the budget deficit under control. The contribution of net exports was largely positive at 8.4ppt, the highest in the current GDP series. Lastly, inventory drawdown deducted 2.2ppt from the headline GDP growth. Overall, the strong growth in 1H18 turned into a recession in the last quarter given increased uncertainty, deteriorating sentiment, challenging external financing conditions and sharp monetary tightening that weighed on domestic demand. The government has announced a number of stimulus measures in recent months for both households and companies that should be helpful for economic recovery. But domestic demand weakness is likely to linger as unemployment continues its uptrend and credit activity remains subdued, though recent indicators on lending hint at early signals of stabilisation. We maintain our GDP growth forecast at 0.3% for 2019.

In February, CPI resumed its downtrend with a drop in annual inflation from 20.35% a month ago to 19.67%. Benign readings in food, utilities and home appliances prices, and seasonality in clothing were major drivers. Accordingly, we saw: (1) a drop in annual goods inflation from 22.4% a month ago to 21.5% with contributions from core goods, and foods, despite higher energy inflation; (2) a slight decline in annual services inflation from 15.4% to 15.1%, mainly driven by transportation services. Annual core inflation has also maintained the recovery from its peak, standing at 18.1% last month vs 19.0% in January (and 24.3% in October). This downtrend shows the impact of government actions, ie, tax cuts in consumer durables, administrative price adjustments, FX pass through running its course with sharp TRY strength since October, tight policies and weakening domestic demand. Overall, February data pulled the annual figure below the 20% threshold given weak domestic demand, a stable currency and tight CBT stance. However, the risks remain tilted to the upside in the near term given marked deterioration in pricing behaviour and inflation expectations, as well as uncertainties surrounding cost factors. We expect a pronounced drop in the second half of this year due to supportive base effects.

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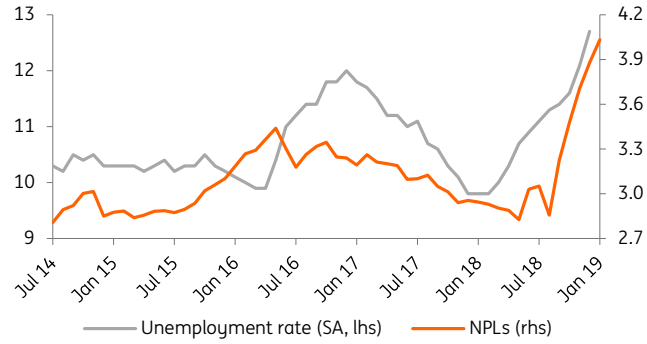
Unemployment vs NPLs (%)

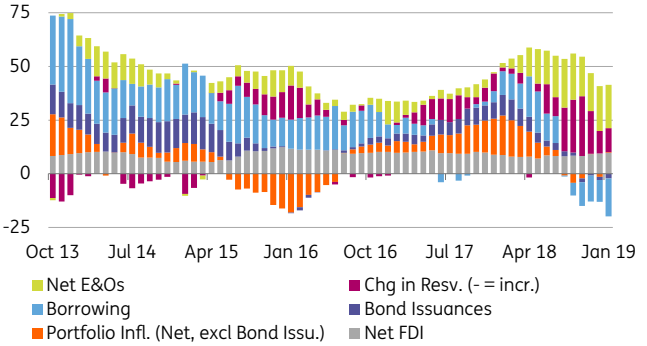


Source: TurkStat, BRSA, ING Bank

Unemployment near 10-year high

The unemployment rate continued its uptrend in December with the seasonally adjusted (SA) figure at its highest since late 2009. December also saw employment generation on an annual basis drop further into negative territory, reflecting the impact of business cycle conditions. Labour market conditions are likely to deteriorate further given the ongoing adjustment process. Employment growth in services and industry has offset losses in construction employment, but recent data shows signals of job generation weakening in these sectors too. The financial volatility leads to asset quality pressures, mainly from corporates so far. Further deterioration this year is likely to be from the retail side as unemployment inches up in a slowing economy.

Breakdown of C/A financing (12m-rolling, US$bn)

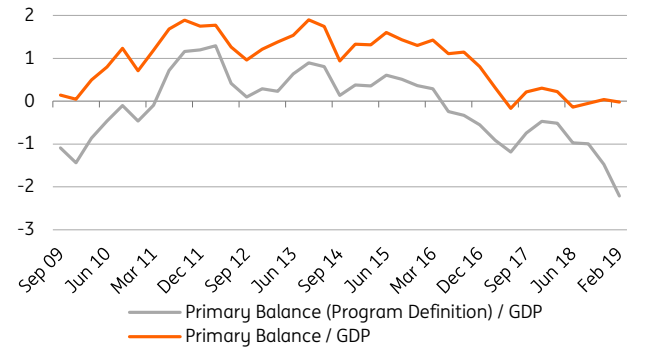


Source: CBT, ING Bank

External deficit rapidly narrowing

The 12M rolling C/A deficit, on a correction path in 2H18, stood at US$21.6bn, the lowest since 2010. Improving price competitiveness contributed to export performance, while weakening domestic demand following summer volatility with consequent tightening, has triggered a sharp improvement in external balances. Capital flow has improved recently with increasing government borrowing while a challenging picture for external financing continues with less borrowing by corporates and especially banks. Turkey is likely to remain sensitive to shifts in global risk appetite given still sizeable external financing needs, though the government's increasing external leveraging should help ease the pressure. The pace of external rebalancing is likely to slow, before rising gradually in 2H19.

Primary balance (12m-rolling, % of GDP)

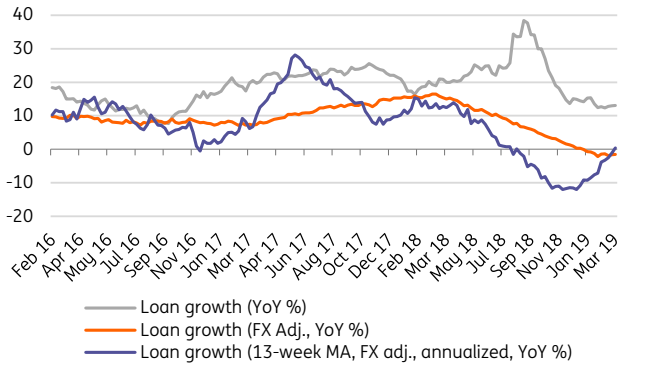


Source: Ministry of Treasury and Finance, ING Bank

Weak budget performance in the first two months

The central administration budget started the year with a deterioration in both primary and budget balances on the back of: (1) weakening tax revenue generation given the slowdown in economic activity and recent incentives introduced by the government; (2) a rapid spending pace with marked increases in all major primary expenditure items; and (3) a jump in interest expenditures on the back of elevated borrowing costs, despite a transfer of the CBT's profit to the budget in advance boosting non-tax revenues. So, a weakening in the budget performance that was also supported by recent stimulus measures is limited by large one-off revenues, while the breakdown raises concerns about the direction of fiscal policy. Given challenging 2019 budget targets, the government should tighten fiscal policies in remainder of this year.

Banking sector volume expansion



Source: BRSA, ING Bank

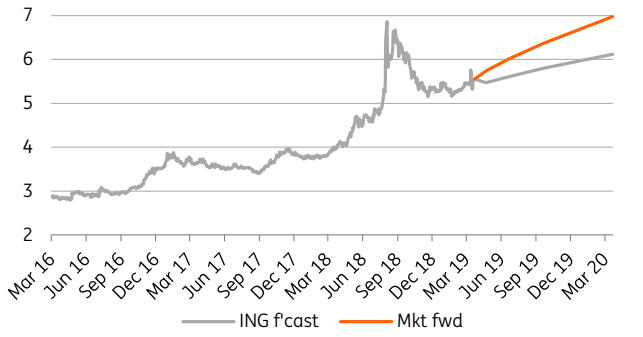
Encouraging signals on bank lending

Asset quality issues, difficulties in external financing and rising rates translate into an internal deleveraging cycle with lending, as current indicators point to a negative impulse (change in the flow of credit). Given higher inflation, real credit correction is significant with an across the board decline in lending to both consumers and corporates in recent months, while the adjustment is mainly driven by private banks despite efforts by public banks to offset part of the lending decline. However, on a positive note, recent momentum indicators (especially annualised growth in FX-adjusted lending on a 13-week moving average basis) hint at early signals of stabilisation. Despite bottoming out in lending stemming mainly from TL loans, the economic backdrop appears to still weigh on FX loan growth.

Turkey

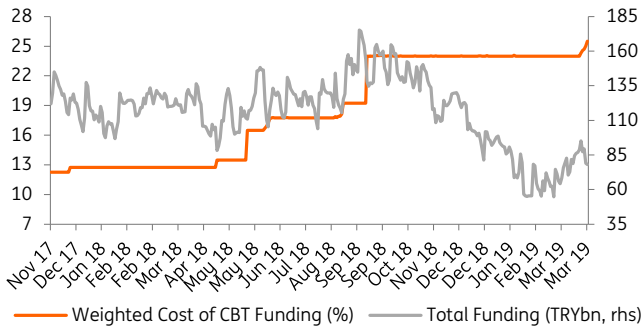
Strategy

FX – spot vs forward and INGF



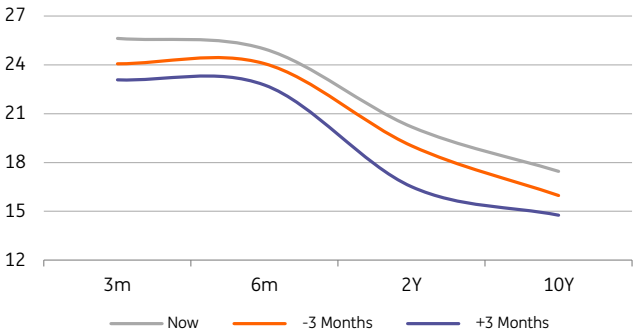
Source: Bloomberg, ING estimates

CBT funding



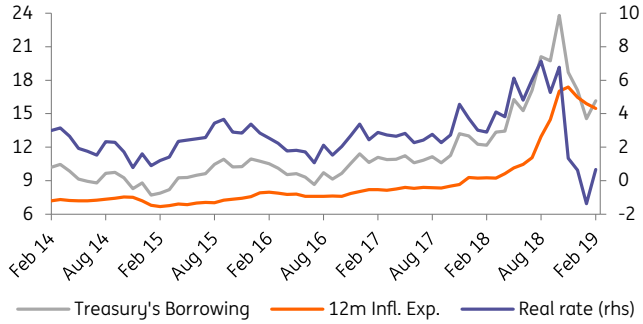
Source: CBT, ING Bank

Local curve (%)



Source: Bloomberg, ING estimates

Real interest rate (%)



Source: Treasury, CBT, ING Bank

FX strategy

In March, the CBT kept the policy rate flat despite a resumption of the downtrend in annual inflation last month. The CBT has shown no sign of complacency and uses strong wording, promising to maintain a policy that reduces inflation to single digit within the shortest possible timeframe. The bank's policy approach hints continuing sensitivity to: (1) ongoing challenges on the inflation front: the risks remain tilted to the upside in the near term given the marked deterioration in pricing behaviour and likely reversal of supportive factors; (2) the risk of TRY coming under pressure; and (3) fragile capital flows mainly driven by government re-leveraging recently. Accordingly, the CBT remained on hold again this month, while it retained a hawkish bias with a promise to deliver policy tightening if needed, until the disinflation trend becomes more pronounced. Following a pronounced TRY weakness towards the end of March, the CBT has announced a number of measures to restore stability: (1) suspended one-week repo auctions and started to provide TRY funding from the O/N lending rate, pulling average cost of funding to 25.5%; (2) cancelled FX deposits against TRY deposit auctions so as to support FX reserves. Given ultra-high TRY funding rates in offshore markets as well as the impact of the CBT actions, the currency has returned to the 5.50 area. Also, we see a normalisation in offshore rates towards onshore rates that is likely to continue in the period ahead. It should also be noted that following a 150bp adjustment to the effective cost of funding via liquidity tightening, the CBT is likely to remain cautious in the post-election period and avoid any premature easing to maintain price stability and support financial stability.

Turkey

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-4.7	8.5	11.1	4.8	8.5	5.2	6.1	3.2	7.4	2.6	0.3	2.9	3.3
Private consumption (% YoY)	-3.7	10.8	12.3	3.2	7.9	3.0	5.4	3.7	6.1	1.1	1.1	3.9	4.0
Government consumption (% YoY)	8.1	1.7	1.1	6.8	8.0	3.1	3.9	9.5	5.0	3.6	-2.1	-1.9	0.2
Investment (% YoY)	-20.5	22.5	23.8	2.7	13.8	5.1	9.3	2.2	7.8	-1.7	-3.1	4.6	3.7
Industrial production (% YoY)	-10.7	13.7	14.7	4.2	7.2	5.7	5.8	3.4	8.9	1.8	0.2	2.0	2.3
Unemployment rate (year-end, %)	13.0	11.1	9.1	8.4	9.0	9.9	10.3	10.9	10.9	10.9	12.9	12.5	11.7
Nominal GDP (TRYbn)	999	1,160	1,394	1,570	1,810	2,044	2,339	2,609	3,107	3,701	4,322	4,985	5,645
Nominal GDP (€bn)	450	575	639	666	683	770	784	820	711	666	640	612	649
Nominal GDP (US$bn)	645	770	828	878	939	932	851	861	853	763	768	796	844
GDP per capita (US$)	8,980	10,560	11,205	11,588	12,480	12,112	11,019	10,883	10,602	9,632	9,314	9,539	9,995
Gross domestic saving (% of GDP)	20.7	24.9	29.4	26.4	28.0	27.2	26.6	25.5	25.5	27.7	28.4	28.0	27.6
Prices													
CPI (average, % YoY)	6.3	8.6	6.5	8.9	7.5	8.9	7.7	7.8	11.1	16.3	16.0	12.7	10.0
CPI (year-end, % YoY)	6.5	6.4	10.4	6.2	7.4	8.2	8.8	8.5	11.9	20.3	14.3	10.6	9.4
Wage rates (nominal, % YoY)	10.1	6.1	7.3	9.5	11.3	9.9	13.7	22.0	9.0	18.6	17.0	14.9	12.8
Fiscal balance (% of GDP)													
Consolidated government balance	-5.3	-3.5	-1.3	-1.9	-1.0	-1.1	-1.0	-1.1	-1.5	-2.0	-2.1	-2.0	-1.7
Consolidated primary balance	0.0	0.7	1.8	1.2	1.7	1.3	1.3	0.8	0.3	0.0	0.7	0.8	1.0
Total public debt	43.9	40.1	36.5	32.7	31.4	28.8	27.6	28.3	28.3	32.0	31.4	30.9	30.2
External balance													
Exports (US$bn)	108.9	120.0	142.0	161.6	161.8	168.9	152.0	150.2	166.2	174.6	185.4	197.3	212.4
Imports (US$bn)	133.8	176.4	231.1	227.0	241.7	232.5	200.1	191.1	225.1	216.3	216.2	236.9	258.4
Trade balance (US$bn)	(24.9)	(56.4)	(89.1)	(65.3)	(79.9)	(63.6)	(48.1)	(40.9)	(59.0)	(41.7)	(30.8)	(39.6)	(46.0)
Trade balance (% of GDP)	-3.9	-7.3	-10.8	-7.4	-8.5	-6.8	-5.7	-4.7	-6.9	-5.5	-4.0	-5.0	-5.5
Current account balance (US$bn)	(12.2)	(45.4)	(75.1)	(48.5)	(65.0)	(43.6)	(32.1)	(33.1)	(47.3)	(27.8)	(17.4)	(26.0)	(32.4)
Current account balance (% of GDP)	-1.9	-5.9	-9.1	-5.5	-6.9	-4.7	-3.8	-3.8	-5.5	-3.6	-2.3	-3.3	-3.8
Net FDI (US$bn)	6.9	7.6	13.7	9.2	9.2	5.5	12.5	10.2	8.8	9.5	10.3	10.7	11.8
Net FDI (% of GDP)	1.1	1.0	1.7	1.0	1.0	0.6	1.5	1.2	1.0	1.2	1.3	1.3	1.4
Current account balance plus FDI (% of GDP)	-0.8	-4.9	-7.4	-4.5	-5.9	-4.1	-2.3	-2.7	-4.5	-2.4	-0.9	-1.9	-2.4
Foreign exchange reserves ex gold (US$bn)	69.6	80.7	78.3	100.3	112.0	106.3	95.7	92.1	84.1	72.0	79.1	81.7	85.2
Import cover (months of merchandise imports)	6.2	5.5	4.1	5.3	5.6	5.5	5.7	5.8	4.5	4.0	4.4	4.1	4.0
Debt indicators													
Gross external debt (US$bn)	268.8	291.7	305.3	341.9	392.4	405.7	400.3	409.3	455.1	438.8	424.7	422.4	425.6
Gross external debt (% of GDP)	42	38	37	39	42	44	47	48	53	58	55	53	50
Gross external debt (% of exports)	247	243	215	212	243	240	263	273	274	251	229	214	200
Lending to corporates/households (% of GDP)	39.3	45.3	49.0	50.6	57.9	60.7	63.5	66.5	67.5	64.7	61.2	59.9	59.8
Interest & exchange rates													
Central bank key rate (year-end, %)	6.50	6.50	5.75	5.50	4.50	8.25	7.50	8.00	8.00	24.00	20.00	16.00	13.00
Broad money supply (average, % YoY)	13.0	19.1	14.8	10.2	22.2	11.9	17.1	18.3	15.7	19.1	17.8	16.4	14.2
3m interest rate (TR Libor, average, %)	10.2	7.4	8.8	8.9	6.9	10.1	10.9	10.1	12.7	19.7	22.6	19.3	15.5
3m interest rate spread over US$-Libor(ppt)	877	718	847	836	659	989	1,062	927	1,135	1,726	1,987	1,637	1,260
2yr yield (average, %)	11.4	8.4	9.1	8.1	7.6	9.2	9.8	9.7	11.8	18.9	17.3	14.9	12.5
10yr yield (average, %)	n/a	9.8	9.6	8.5	8.3	9.3	9.4	10.1	11.0	15.9	15.0	13.3	11.5
USD/TRY exchange rate (year-end)	1.51	1.55	1.91	1.78	2.13	2.32	2.92	3.53	3.79	5.29	6.00	6.50	6.86
USD/TRY exchange rate (average)	1.55	1.51	1.68	1.79	1.93	2.19	2.75	3.03	3.64	4.85	5.63	6.27	6.69
EUR/TRY exchange rate (year-end)	2.11	2.21	2.55	2.31	2.82	3.19	3.53	3.92	4.28	6.17	6.81	8.12	8.91
EUR/TRY exchange rate (average)	2.22	2.02	2.18	2.36	2.65	2.65	2.98	3.18	4.37	5.56	6.75	8.15	8.70

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (% YoY)	7.4	5.3	1.8	-3.0	-1.8	-1.2	1.2	2.6	2.5	2.7	3.0	3.3	3.4
CPI (eop, % YoY)	10.2	15.4	24.5	20.3	19.6	16.5	10.4	14.3	14.5	12.8	11.7	10.6	10.3
Central bank key rate (eop, %)	8.00	17.75	24.00	24.00	24.00	23.00	21.00	20.00	19.00	18.00	17.00	16.00	15.25
3m interest rate (eop, %)	13.65	18.83	27.31	24.07	23.87	23.08	20.45	21.67	20.84	19.44	18.25	17.08	16.38
10yr yield (eop, %)	12.55	16.77	17.92	16.48	15.14	14.76	14.93	15.15	14.23	13.21	12.30	11.85	11.63
USD/TRY exchange rate (eop)	3.95	4.59	6.06	5.29	5.40	5.61	5.80	6.00	6.12	6.24	6.37	6.50	6.59
EUR/TRY exchange rate (eop)	4.87	5.36	7.03	6.05	6.05	6.17	6.67	7.20	7.47	7.81	8.15	8.45	8.56

Source: National sources, ING estimates

Ukraine

Dmitry Dolgin, Chief Economist, Russia & CIS

Forecast summary

	4Q18	1Q19F	2Q19F	3Q19F	4Q19	2019F	2020F
Real GDP (% YoY)	3.5	2.6	2.5	2.7	2.9	2.7	3.0
CPI (% YoY)*	9.8	9.3	9.5	8.8	8.0	8.9	7.5
Policy interest rate (eop, %)	18.00	18.00	18.00	17.00	16.00	16.00	13.00
3m interest rate (%)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a
10yr yield (%)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/UAH *	27.69	27.25	27.00	27.50	28.00	27.85	29.65
EUR/UAH*	31.71	30.57	29.70	31.63	33.60	31.75	37.36

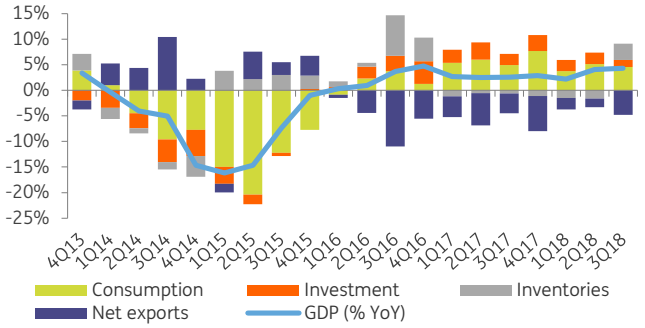
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Apr-19	S&P	B-	B-
Fiscal	Stable	Parliamentary: Oct-19	Moody's	Caa1	WR
Monetary	Stable	Local:	Fitch	B-	B-

*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Country strategy

Successful disbursement of the IMF tranche at the end of 2018, followed by a rating upgrade from Moody's lifted the spirits of Ukraine's financial markets, which, combined with continuing remittances inflows (+23% YoY in 9M18), has contributed to a stronger UAH. Further sentiment will depend heavily on the outcome of the second round of Presidential elections as, following the first round on 31 March, a protest candidate and TV personality Volodymyr Zelenskiy is leading in the exit polls by a high margin (30%) versus runner-up incumbent Petro Poroshenko (16%). With little known of his economic policy views, the key watch factors would be continuity of cautious fiscal and monetary policies, that are a prerequisite for continued cooperation with the IMF.

GDP growth and major contributors (% YoY)

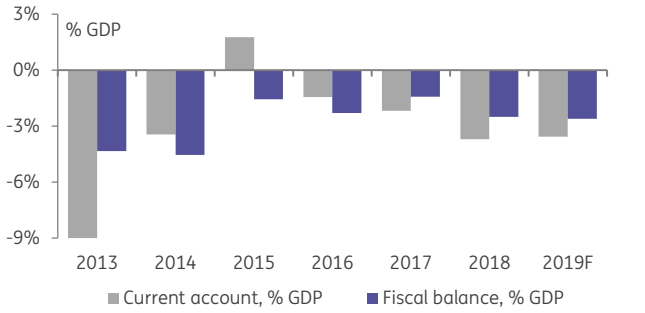


Source: CEIC, ING

Growth momentum to weaken on political uncertainty

In 2018, Ukraine's GDP growth of 3.3% slightly exceeded our expectations mainly thanks to strong domestic demand amid growing remittances. We expect domestic demand to remain the most reliable component of GDP growth going forward, yet the momentum may weaken this year, given that monetary policy needs to remain tight, while fiscal and tariff policy is unlikely to be generous on subsidies, in line with IMF requirements that the country has been keen to follow to date. Uncertainty regarding the outcome of upcoming presidential elections might come as an additional factor limiting producer confidence.

Current account/fiscal balance (% of GDP)

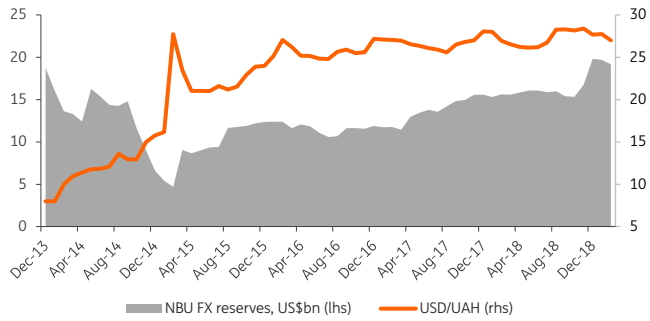


Source: CEIC, ING

Double deficit here to stay, budget risks in focus

Despite a slightly better-than-expected performance in 2018, Ukraine continues to have a double deficit of both budget (-2.2% of GDP) and current account (-3.6%), with the 2019 picture remaining challenging. A budget consolidation favoured by the IMF, does not seem realistic given the electoral cycle. On the current account side, even the strong remittances in 2018 and favourable export dynamic did not prevent expansion in the deficit. The balance of payments remains dependent on IMF disbursements, given the c.US$5bn government external debt (US$8bn total) repayments this year. The scope for monetary policy easing is limited, as CPI at 8.8% YoY is still above the NBU's 6.5%+/-2ppt target due to rising local tariffs.

USD/UAH and the NBU's FX reserves dynamics



Source: NBU

FX risks under control for now, subject to IMF relations

The local FX market seems to have positively reacted to recent relaxation of capital controls and has shrugged off the uncertainties related to upcoming elections, focusing more on the IMF's December 2018 tranche of US$1.4bn and Moody's upgrade. Ukraine now awaits a second tranche of the IMF's US$3.9bn loan, crucial to repayment of external debt in May and September (around c.US$1.5bn on each date). Cooperation with IMF is conditional on the economic policy continuity. We have improved our UAH outlook for end-2019, however the risk profile related to balance of payments seems to favour gradual depreciation of UAH vs USD, in line with other currencies in the region.

Ukraine

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-14.8	4.1	5.5	0.2	0.0	-6.6	-9.8	2.4	2.5	3.3	2.7	3.0	3.0
Private consumption (% YoY)	-14.9	7.0	15.7	8.4	6.9	-8.3	-20.7	2.1	9.5	8.9	4.0	3.5	3.6
Government consumption (% YoY)	-2.4	4.2	-2.9	4.5	-0.9	1.1	1.7	-0.5	5.2	0.3	1.5	1.2	1.3
Investment (% YoY)	-50.5	3.2	8.5	5.0	-8.4	-24.0	-9.2	20.4	16.1	14.3	7.0	6.7	6.5
Industrial production (% YoY)	-20.6	12.2	8.0	-0.7	-4.3	-10.1	-13.0	2.8	0.4	1.6	2.0	2.5	2.9
Unemployment rate (year-end, %)	9.4	8.4	8.2	8.0	7.6	10.6	9.5	9.7	9.9	9.3	9.0	8.8	8.5
Nominal GDP (UAHbn)	947	1 079	1 300	1 405	1 465	1 587	1 989	2 385	2 984	3 559	3,824	4,233	4,664
Nominal GDP (€bn)	87	102	117	137	138	101	82	84	99	111	121	113	120
Nominal GDP (US$bn)	122	136	163	176	183	134	91	93	112	131	138	143	155
GDP per capita (US$)	2 645	2 971	3 575	3 859	4 035	3 110	2 129	2 192	2 647	3 068	3,242	3,367	3,707
Gross domestic saving (% of GDP)	16.8	16.8	15.8	13.1	9.3	9.9	13.3	14.8	13.1	13.4	13.3	13.8	14.0
Prices													
CPI (average, % YoY)	16.0	9.4	8.0	0.6	-0.3	12.1	48.5	14.9	14.5	11.0	8.9	7.5	7.0
CPI (year-end, % YoY)	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	12.4	13.7	9.8	8.0	7.4	6.5
Wage rates (nominal, % YoY)	5.5	17.7	17.5	14.9	8.0	6.1	21.1	23.3	37.0	24.8	13.5	11.0	12.0
Fiscal balance (% of GDP)													
Consolidated government balance	-3.8	-6.2	-1.8	-3.6	-4.3	-4.5	-1.6	-2.3	-1.4	-2.5	-2.6	-2.2	-2.0
Consolidated primary balance	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Total public debt	34.7	40.1	36.4	36.7	39.9	69.4	79.0	80.9	71.8	62.0	61.0	60.0	62.0
External balance													
Exports (US$bn)	39.8	51.5	68.5	68.5	64.3	54.2	37.9	36.4	43.3	47.3	47.6	49.0	50.5
Imports (US$bn)	45.5	60.9	82.6	84.6	76.8	54.3	36.3	39.2	49.6	57.1	57.3	59.5	62.0
Trade balance (US$bn)	-5.7	-9.4	-14.1	-16.1	-12.4	-0.1	1.5	-2.9	-6.3	-9.8	-9.7	-10.5	-11.5
Trade balance (% of GDP)	-4.7	-6.9	-8.7	-9.2	-6.8	-0.1	1.7	-3.1	-5.6	-7.5	-7.1	-7.4	-7.4
Current account balance (US$bn)	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	1.6	-1.3	-2.4	-4.7	-4.9	-4.7	-4.5
Current account balance (% of GDP)	-1.4	-2.2	-6.3	-8.2	-9.0	-3.4	1.8	-1.4	-2.2	-3.6	-3.6	-3.3	-2.9
Net FDI (US$bn)	-4.7	-5.8	-7.0	-7.2	-4.1	-0.3	-3.0	-3.3	-2.6	2.0	1.9	2.5	3.0
Net FDI (% of GDP)	-3.8	-4.2	-4.3	-4.1	-2.2	-0.2	-3.3	-3.5	-2.3	1.5	1.4	1.8	1.9
Current account balance plus FDI (% of GDP)	-5.3	-6.5	-10.6	-12.2	-11.2	-3.7	-1.5	-4.9	-4.5	-2.0	-2.2	-1.5	-1.0
Foreign exchange reserves ex gold (US$bn)	25.6	33.3	30.4	22.7	18.8	6.6	12.4	14.6	17.7	19.8	18.0	18.5	19.0
Import cover (months of merchandise imports)	6.8	6.6	4.4	3.2	2.9	1.5	4.1	4.5	4.3	4.2	3.8	3.7	3.7
Debt indicators													
Gross external debt (US$bn)	103	117	126	135	142	125	118	113	115	115.15	123	125	130
Gross external debt (% of GDP)	85	86	77	77	78	94	129	121	103	88	89	88	84
Gross external debt (% of exports)	260	228	184	196	221	231	311	309	267	243	258	255	258
Lending to corporates/households (% of GDP)	77.0	65.8	59.8	56.5	60.4	62.4	48.4	41.3	33.7	30.5	30.0	29.0	28.0
Interest & exchange rates													
Central bank key rate (year-end, %)	10.25	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	18.00	16.0	13.0	12.0
Broad money supply (average, % YoY)	-5.5	22.7	14.7	12.8	17.6	5.3	3.9	10.9	9.6	13.2	12.0	12.0	11.2
3m interest rate (KievPrime, average, %)	21.7	10.2	11.6	20.4	11.0	17.6	24.5	20.4	18.0	n/a	n/a	n/a	n/a
3m interest rate spread over US$-Libor (ppt)	1634	563	1045	1958	960	1707	2429	2007	1730	n/a	n/a	n/a	n/a
2yr yield (average, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
10yr yield (average, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/UAH exchange rate (year-end)	7.99	7.96	7.99	7.99	7.99	15.77	24.00	27.19	28.07	27.69	28.00	30.00	30.00
USD/UAH exchange rate (average)	7.79	7.94	7.97	7.99	7.99	11.89	21.84	25.55	26.60	27.20	27.80	29.65	30.00
EUR/UAH exchange rate (year-end)	11.45	10.46	10.30	10.60	11.04	19.23	26.22	28.42	33.50	31.71	33.60	39.00	39.00
EUR/UAH exchange rate (average)	10.87	10.53	11.09	10.27	10.61	15.72	24.23	28.29	30.00	32.14	31.69	37.36	39.00

Source: National sources, ING estimates

Quarterly forecasts

	1Q18	2Q18	3Q18	4Q18	1Q19F	2Q19F	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F
Real GDP (% YoY)	3.1	3.8	2.8	3.5	2.6	2.5	2.7	2.9	3.0	2.9	3.0	3.1	3.0
CPI (eop, % YoY)	13.2	9.9	8.9	9.8	9.3	9.5	8.8	8.0	7.4	7.6	7.5	7.4	7.2
Central bank key rate (eop, %)	17.00	17.00	18.00	18.00	18.00	18.00	17.00	16.00	15.00	14.00	13.5	13.00	12.5
3m interest rate (eop, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
10yr yield (eop, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/UAH exchange rate (eop)	26.54	26.19	28.30	27.69	27.25	27.00	27.50	28.00	29.50	30.50	30.24	30.00	29.6
EUR/UAH exchange rate (eop)	32.70	30.57	33.13	31.71	30.57	29.70	31.63	33.60	35.99	38.13	38.71	39.00	37.25

Source: National sources, ING estimates

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