Economic & Financial Analysis

5 November 2019

Please note that this is the non-investment research version of Directional Economics EMEA and does not include the investment strategies contained in the Global Markets Research version of this report

Directional Economics EMEA

Remarkable Resilience: Why CEE is withstanding the European slowdown

- Azerbaijan
- Bulgaria
- Croatia
- Czech Republic
- Hungary
- Kazakhstan
- Poland
- Romania
- Russia
- Serbia
- Turkey
- Ukraine

EMEA Economics and Strategy Team

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Summary

Remarkable resilience:
Why CEE is withstanding the European slowdown

2019 growth across a large part of the Central and Eastern European region is running above potential. And that's in stark contrast to Western European countries, particularly Germany. In fact, the CEE is no longer just a cog in the German manufacturing wheel. Economies have diversified away from industry towards services. And most importantly, the CEE consumer is now a force to be reckoned with. The big question: Is a significant downturn just a matter of time, or are things fundamentally different now than they were just five or ten years ago? That's what we examine in this report.

2019 will be remembered as a year of declining trade volumes and an industrial sector under intense pressure. With its international footprint and heavy reliance on manufacturing, Germany has been at the forefront of the slowdown story. The presumption here has been that the high-beta and integrated economies of Central and Eastern Europe (CEE) will soon be suffering as well.

In fact, the CE4 economies (Czech Republic, Hungary, Poland and Romania) have been growing above potential through the first half of 2019. While these economies will clearly not be immune to the German slowdown, we think their ongoing resilience stems from better-balanced and more domestically-sourced growth.

Our feature article examines some of the reasons why growth in the CEE region is holding up well – so far. One of the biggest factors has been the decreasing reliance on net exports for growth. In a little under a decade, the region has managed to migrate to a growth model driven by domestic demand.

That domestic demand is being driven by two key factors: (1) above trend growth, tight labour markets and high wages supporting private consumption; and (2) with the support of EU-financing and generous fiscal policy, investment growth rates substantially outpacing those in Western Europe (although Poland lags the CEE in private investment).

In addition, the services sector has increasingly been contributing to growth and is one reason why the CEE's exposure to the German industrial sector is smaller than one might think. Based on our calculations, the Czech Republic is most exposed in the CEE region to the German industrial sector - but that is worth just 5% of Czech GDP.

We would be naïve to think the CEE would be completely immune to the German slowdown, however. Looking through sector exposure to Germany, where autos and the auto supply chain feature prominently, the Czech Republic and Hungary look the most exposed. And Romania's response to Germany's manufacturing slowdown looks one of the strongest based on our empirical analysis.

While acknowledging that growth will decelerate across a large part of the CEE region in 2020, our core message here is that the more diversified structure of these economies and strong domestic demand mean that CEE growth slows, but does not stall.

Looking more broadly across the CEE region, we expect Russian growth to pick up next year as infrastructure spending kicks in but, at just 1.5%, growth is hardly spectacular. And Turkey's economy should continue its rebalancing process, where lower interest rates should help to support private consumption.

As always, *Directional Economics* showcases ING's unique footprint across the EMEA region and details multi-year forecasts for activity, prices and key market variables. We are sure it will help you in your decision-making process. Enjoy!

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Country summaries: CE4

Czech Republic

Growth in the Czech economy has remained slightly below 3% over the past three quarters and, given recent weakness in the Germany economy, domestic data shows surprising resistance. This is very likely because weaker foreign data will impact the overheated Czech economy with some delay. As such, we see a slowdown to below 2% next year, especially if foreign development does not turn better, which is not our baseline for now. However, the labour market and inflation has some persistency, meaning that imminent CNB reaction and monetary easing is not likely. Moreover, in case of a slowdown, koruna is likely to weaken due to its overbought condition after the 2013-17 FX-floor regime, and deliver the monetary easing needed. As such, we do not see aggressive CNB cuts as likely.

Hungary

Following 5.1% YoY GDP growth in 2018, against all the odds the Hungarian economy maintained the same pace in 1H19. The exceptionally strong activity has been fuelled by domestic factors. Consumption is rising due to full employment and double-digit wage growth. The investment rate of 29% is the highest among all EU member states. This is the clear result of the 'high-pressure' economy run by policymakers, which has translated into above-target inflation, too. Another important effect of this is the recurrent deficit in the current account, which clearly won't support the forint. The data-driven NBH can live with EUR/HUF reaching 340 in coming months, with weaker FX set to offset disinflation from abroad as global risks are strengthening and a local slowdown is approaching.

Poland

The post-election rationalisation of the 2020 budget (adding missing spending and deducting the business unfriendly hike of pension contribution for most skilled) should cause upward revision of net borrowing needs, but from an ultra-low (PLN7bn) to low (PLN15bn) level. On the other hand, household deposits should keep outpacing credit, so local banks remain main POLGBs buyers. This favourable supply-demand condition calls for further tightening of the POLGB-Bund and asset swap spread in 2H19. In 2021, the supply-demand conditions should change. We expect the MPC to hold flat rates even if average CPI in 2020 reaches 4% YoY (not our scenario; INGF 2.8% YoY). FX wise, a twofold ruling of local courts and gradual provision building by banks spread negative pressure of CHF loans over time.

Romania

Without a clear parliamentary majority that can coalesce behind a government, Romania faces difficulty navigating a course until the next elections set for late-2020. The implementation timeline for pension and public wage bills is unlikely to be derailed. This is likely to spook markets, especially the 40% pension hike due in September 2020 that could potentially double the budget deficit under a no policy change scenario. Romania's investment grade status is dependent on measures that the new government will take and how credible and rapid the fiscal consolidation will be. This is expected to become even more difficult as the economy is set to slow down. Fiscal adjustment will offer room for the NBR to ease policy, but we do not see this happening until after general election with snap elections unlikely.

Country summaries: Other Central & Eastern Europe

Bulgaria

Strong fiscal metrics were rewarded by rating agencies and further upgrades are likely after the ERM-II announcement which has been delayed by the political changes at the head of the EU following the European elections. GDP growth has so far shrugged off weaker external demand but lagged contagion effects are likely to kick in. The budget deficit is likely to post a one-off deterioration this year due to spending on fighter jets, ending three consecutive years of surpluses. The government targets a balanced budget next year. We expect a mild deficit of -0.5% of GDP in 2020 as the government is likely to spend more to offset the economic slowdown. The economy is also benefiting from ECB stimulus as it automatically imported under the currency board FX regime.

Croatia

The regaining of its investment grade status from S&P and Fitch, an almost done deal on ERM-II admission next year, and still reasonable growth numbers have all contributed to make 2019 arguably the best post-crisis year for Croatia. Fiscal metrics remain sound and set to improve further in our view should the latest Economic and Fiscal Policy Guidelines 2020-2022 be followed. It envisages relatively balanced budgets with a small 0.2% of GDP deficit in 2020, followed by 0.2% and 0.6% surpluses in the following two years. This leaves room for additional fiscal stimulus if needed. We maintain our 2.9% GDP growth forecast for 2019 with downside risks due to Eurozone slowdown, in Germany and Italy in particular.

Serbia

On 27 September 2019, Fitch upgraded Serbia to 'BB+', just a notch below IG. With S&P and Moody's having the country on a positive outlook at 'BB' and 'Ba3' respectively, achieving IG status looks within sight. Nevertheless, we don't see this happening earlier than 2021. In our view, Serbia's ratings to date have principally been driven by economic and fiscal developments. As we approach the IG zone, qualitative factors like institutional framework, rule of law or judicial independence will start to weigh in. Until then, we see the economy growing by 3.3% this year on strong private consumption and fixed investments. Fiscal stance will remain prudent and this is needed to offset the widening C/A deficit which – albeit fully funded by FDIs – should start to raise some concerns for the policymakers.

Turkey

The policy mix is shifting towards further loosening supported by an improving global, geopolitical and political backdrop, despite not well anchored inflation expectations, dollarisation and still weak confidence along with other macro vulnerabilities. Accordingly, we see: (1) a continuing supportive fiscal stance; (2) an easing cycle driven by the dovish turn of global CBs and a favourable inflation trend; (3) lending incentives by linking required reserve ratios and remunerations to credit growth. Inflation dynamics and geopolitical backdrop have improved, making the CBT more confident on timing and extent of easing cycle also. Global CB policies, asset quality outlook, dollarisation, fiscal developments and geopolitical issues will be key for macro performance in the period ahead.

Country summaries: CIS

Azerbaijan

We believe Azerbaijan has a favourable near-term view, as new projects in the oil & gas sector support exports and overall growth, while state social spending is boosting local consumption without causing immediate threat to fiscal stability, which remains the country's key strength. Gradual de-dollarisation in the banking sector is a bonus, adding to market confidence. Meanwhile, with the government's limited track record in structural reforms, we remain cautious on the fundamental trends, with no strong signs of diversification of growth and financial flows, persisting risks to balance of payments from imports and capital outflows, and a still weak banking sector. A stable outlook on sovereign ratings despite fiscal strength underpins vulnerability to external and internal risks.

Kazakhstan

Kazakhstan continues to post a healthy 4%+ of GDP growth rate despite temporary setbacks related to oilfield maintenance. Political transition this year helped to strengthen household income and consumption but came at the cost of a higher social focus of the budget policy, with 47% of total public spending now channelled into healthcare and social payments. Fiscal stability is not a near-term concern, but will be a watch factor going forward. Meanwhile the balance of payments is under double pressure of growing imports and surging capital outflow, both linked to the political transition. Recovery in oil exports after the 5% YoY drop in 8M19 should limit tenge's downside but not remove risks entirely. This suggests that the near-term scope for monetary easing is limited.

Russia

Russian economic growth is about to accelerate modestly as National Projects investment into infrastructure, representing 3.0-3.5% of GDP pa (70% funded by the budget), gains traction by 2022-24. Confidence outside the budget-driven sectors will remain constrained unless the business climate is improved and exports are diversified. The macro picture is strong, with state savings of above 7% of GDP and growing, leaving space for fiscal easing. An externally-driven CPI slowdown to below 4% in 2019-20 creates room for at least a 50bp cut in the key rate by mid-2020, supporting attractiveness of bonds. RUB seems safe in the near-term, but a reversal in the accumulation of foreign assets by the private sector is required in order to break the long-term depreciation tendencies.

Ukraine

President Zelensky's party, 'Servant of the People', has successfully formed the new government and has proposed reforms to open the land market, launch concessions and privatisation, establish customs and facilitate tax administration. The reforms were praised by the IMF, which is expected to initiate the new US$5bn programme that will support the country's budget and balance of payments. The country's stable macro performance favours investor sentiment, and, along with continuous anti-inflationary NBU policy, keeps Ukraine's sovereign bonds under 'BUY', subject to the IMF deal and UAH stability. The key risks we see are worsening weather conditions vital for next year's grain harvest and rising imports along with the usual event risks in the political area.

ING main macroeconomic and financial forecasts

Real GDP (% YoY)

	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Azerbaijan	2.0	2.0	2.5	2.6	2.3	2.6
Bulgaria	3.5	3.3	2.8	3.1	3.4	3.0
Croatia	2.7	2.5	2.0	2.5	2.9	2.7
Czech Republic	2.7	2.2	2.0	1.7	2.6	1.9
Hungary	4.8	3.9	3.6	3.2	4.7	3.4
Kazakhstan	4.2	4.0	4.0	4.1	4.1	4.2
Poland	3.9	3.8	4.0	3.5	4.2	3.3
Romania	3.8	3.2	2.9	2.3	4.0	2.8
Russia	1.2	1.1	1.8	2.0	1.0	1.5
Serbia	3.9	3.7	3.9	3.5	3.3	3.7
Turkey	0.4	2.7	2.9	3.0	-0.1	3.0
Ukraine	2.7	2.9	3.0	2.9	3.2	3.0
Eurozone*	0.8	0.4	0.4	0.9	1.1	0.7
US*	1.9	1.5	0.6	1.3	2.3	1.4

*% QoQ annualised
Source: National sources, Bloomberg, ING estimates

Exchange rate (quarterly is eop, annual is avg)

	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
USD/AZN	1.70	1.70	1.70	1.70	1.70	1.70
EUR/BGN	1.96	1.96	1.96	1.96	1.96	1.96
EUR/HRK	7.41	7.45	7.43	7.40	7.41	7.43
EUR/CZK	25.80	25.90	26.00	26.00	25.73	25.94
EUR/HUF	335.0	335.0	340.0	340.0	325.3	337.0
USD/KZT	388	385	386	388	383	388
EUR/PLN	4.37	4.28	4.30	4.34	4.30	4.32
EUR/RON	4.75	4.80	4.82	4.82	4.76	4.83
USD/RUB	64.86	64.00	64.00	66.00	64.85	65.60
EUR/RSD	118.0	117.4	117.5	117.4	117.8	117.3
USD/TRY	5.65	6.00	6.12	6.25	5.70	6.27
USD/UAH	24.08	26.00	26.50	27.00	26.24	27.00
EUR/USD	1.10	1.10	1.10	1.12	1.11	1.13

Source: National sources, Bloomberg, ING estimates

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

	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Azerbaijan	2.6	3.0	2.8	3.00	2.6	3.0
Bulgaria	2.8	3.2	2.8	3.5	3.0	3.4
Croatia	0.8	1.2	1.1	1.2	0.9	1.4
Czech Republic	2.7	2.7	2.7	2.2	2.8	2.4
Hungary	2.8	3.6	3.4	3.3	3.3	3.3
Kazakhstan	5.3	5.6	5.6	5.5	5.3	5.5
Poland	2.5	3.0	3.6	2.6	2.2	2.8
Romania	3.5	3.8	2.8	2.4	3.8	3.1
Russia	4.0	3.4	2.5	3.0	4.5	3.1
Serbia	1.1	1.2	1.1	1.6	1.9	1.6
Turkey	9.3	12.8	12.0	11.1	15.4	10.9
Ukraine	7.5	7.2	7.0	6.8	8.4	6.7
Eurozone	0.9	1.0	1.2	1.0	1.2	1.1
US	1.8	1.8	2.2	1.9	1.8	2.1

Source: National sources, Bloomberg, ING estimates

Central Bank rate (%, eop)

	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Azerbaijan	8.00	7.75	7.50	7.25	7.75	7.25
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	2.00	2.00	2.00	2.00	2.00	1.75
Hungary	0.90	0.90	0.90	0.90	0.90	0.90
Kazakhstan	9.25	9.25	9.25	9.00	9.25	8.75
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	7.00	6.50	6.25	6.00	6.50	6.00
Serbia	2.25	2.25	2.25	2.25	2.25	2.25
Turkey	16.50	14.00	14.00	13.00	14.00	12.00
Ukraine	16.50	15.00	14.00	13.50	15.00	12.00
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00
US	1.75	1.25	1.00	1.00	1.25	1.00

*Lower level of 25bp range
Source: Bloomberg, ING estimates

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

	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Azerbaijan	n/a	n/a	n/a	n/a	n/a	n/a
Bulgaria	0.40	0.40	0.40	0.40	0.55	0.40
Croatia	0.50	0.45	0.45	0.45	0.95	0.45
Czech Republic	1.36	1.40	1.40	1.40	1.59	1.41
Hungary	1.98	1.80	1.70	1.60	2.43	1.66
Kazakhstan	n/a	n/a	n/a	n/a	n/a	n/a
Poland	2.00	1.90	1.85	1.78	2.40	1.85
Romania	4.10	4.00	4.10	4.30	4.40	3.80
Russia	7.15	6.50	6.25	6.30	6.50	6.30
Serbia	3.55	3.45	3.40	3.40	4.00	3.40
Turkey	13.58	14.08	13.79	13.46	15.83	13.47
Ukraine	n/a	n/a	n/a	n/a	n/a	n/a
Eurozone	-0.60	-0.50	-0.50	-0.40	-0.36	-0.36
US	1.70	1.40	1.40	1.50	1.85	1.63

Source: National sources, Bloomberg, ING estimates

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

	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Azerbaijan	n/a	n/a	n/a	n/a	n/a	n/a
Bulgaria	n/a	n/a	n/a	n/a	n/a	n/a
Croatia	0.45	0.45	0.45	0.45	0.45	0.45
Czech Republic	2.16	2.15	2.15	2.14	2.11	2.05
Hungary	0.20	0.20	0.20	0.20	0.20	0.20
Kazakhstan	10.25	10.25	10.25	10.00	10.20	10.05
Poland	1.72	1.73	1.73	1.73	1.72	1.73
Romania	3.09	3.00	3.00	3.00	3.10	2.90
Russia	7.21	6.70	6.45	6.20	7.77	6.35
Serbia	2.80	1.90	1.90	1.80	2.60	1.75
Turkey	15.12	15.70	15.41	14.27	20.33	14.15
Ukraine	n/a	n/a	n/a	n/a	n/a	n/a
Eurozone	-0.41	-0.40	-0.40	-0.40	-0.36	-0.40
US	2.03	1.70	1.40	1.40	2.18	1.40

Source: National sources, Bloomberg, ING estimates

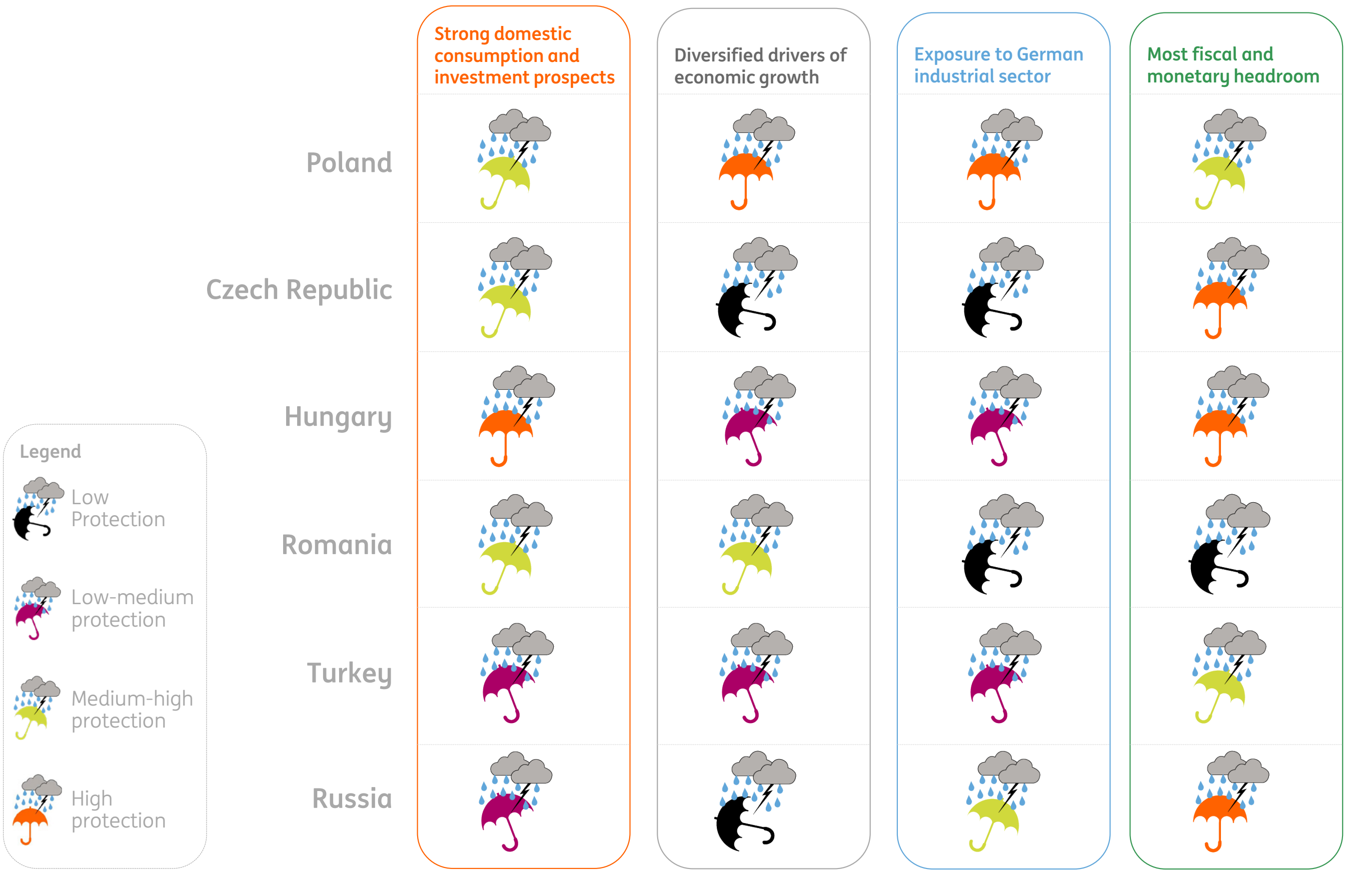
Remarkable resilience

Why CEE is withstanding the European slowdown

CEE has withstood the slowdown in Western Europe very well – this especially so since Germany looks about to go into recession. Is it just a matter of time before the German industrial collapse takes large parts of the CEE with it? Or does the region enjoy some genuine resilience? In this article our team across the CEE region present their views.

- 2019 growth across a large part of the CEE region is running above potential. That stands in stark contrast to Western Europe and in particular to Germany. Our empirical work on CEE exposure to German manufacturing suggests the likes of Romania and the Czech Republic are most exposed, typically with a 3-4 month lag.
- Here the auto sector is clearly the key sector of contagion, although we would argue that recent investment in the region and a competitive labour force provides the CEE with some protection against the challenges facing the global auto sector.
- Yet the CEE is no longer just a cog in the German manufacturing wheel. Economies have diversified away from industry towards services. And most importantly the above trend growth, tight labour markets and higher wages of recent years mean the CEE consumer is a force to be reckoned with.
- Investment growth has also been an important source of support to the region and EU co-financed should continue to play a role. Equally, most economies, apart from Romania, have fiscal headroom - with most governments prepared to use it.
- These factors should combine to deliver 2020 CEE growth rates at or above the average seen over the last decade.

Weathering the storm: Who's most protected from the European slowdown?



Source: ING

Setting the scene in Europe

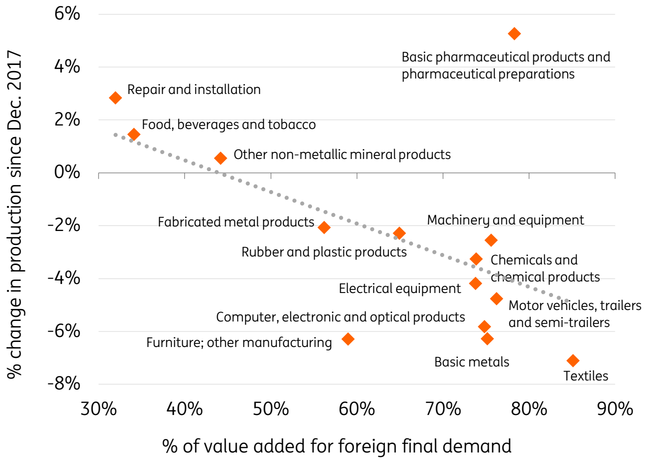
Eurozone flirts with recession

The Eurozone economy has recently shown some worrisome signs of slowing. While the exposure to the global economy has been a strength in times of weakening domestic demand, it is now proving to be a weakness. The slowdown in world trade has hit Eurozone economies more significantly than other major economies as the Eurozone is much more open than most markets. Quite a few factors have been key to the slowdown, but the trade war seems to take centre stage in explaining why global trade has started to contract.

Eurozone production peaked in December 2017

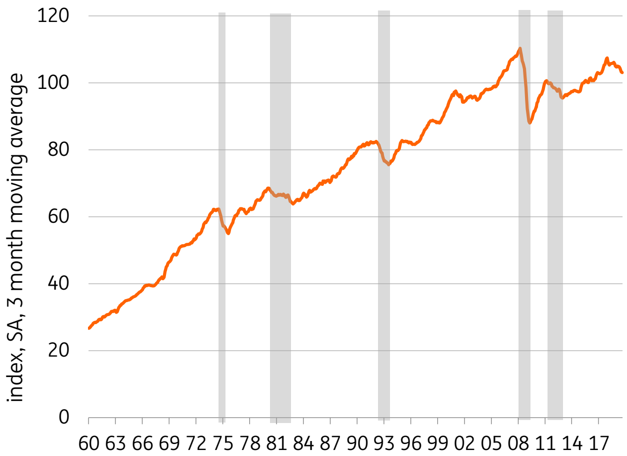
Because external demand is so vital to the slowdown that the Eurozone is experiencing at the moment, it has remained relatively contained to industry so far. But industry has been hit hard. Production peaked in December 2017 and has since declined steadily to about 4.8% below its peak. As can be seen in Figure 1, the slowdown is strongly related to foreign final demand.

Fig 1 The weakest industries are the ones that produce for foreign final demand



Source: ECB, Macrobond, ING Research

Fig 2 Production has been in recession since December 2017



Source: Eurostat, ING calculations

Why isn't the Eurozone in recession already?

Figure 2 provides a worrying picture; it shows that we have not seen industrial production decline this much without the Eurozone economy going into recession since at least the 1960s. This means that we should almost ask ourselves the question why the Eurozone isn't in recession already as opposed to whether it will go into recession at some point. The answer is twofold: (1) the downturn has hit German industry far harder than other large Eurozone countries, partly due to some specific regulatory factors; and (2) the labour market continues to perform surprisingly well.

Is it just a German problem?

To start with the first point, Germany has been struggling far more significantly than other countries. The German economy is in fact flirting with (technical) recession at the moment as it contracted in the second quarter and initial data on the third quarter suggests that it is doubtful whether contraction has been avoided. When comparing the industrial performance in Germany to that of other large economies in the world, it has shown a remarkable slowdown since the start of 2018. In fact, of all the major industrial economies, its PMI showed the strongest expansion in January 2018 and is now the weakest of all and is indicating sharp contraction.

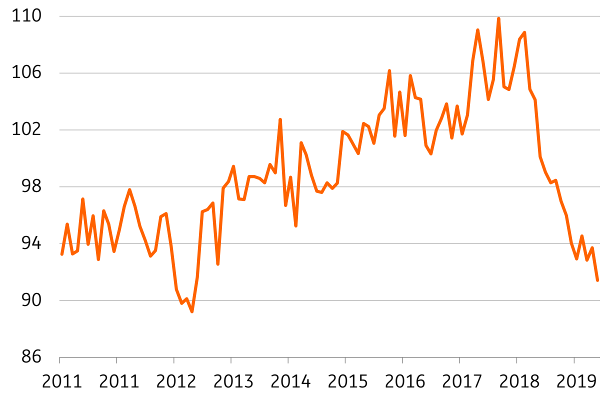
A lot of factors have contributed to German industry's turn for the worse

This is not all attributable to the US-China trade war, of course. A lot of factors contributed to German industry's turn for the worse, including low water levels in the Rhine at the end of 2018, new emission standards in the car industry, and slowing demand from large trade partners not involved in the trade war. Many of these factors can be considered one-offs, although some of the more dominant ones have yet to show signs of recovery.

It may be more than just new regulations hampering German car production

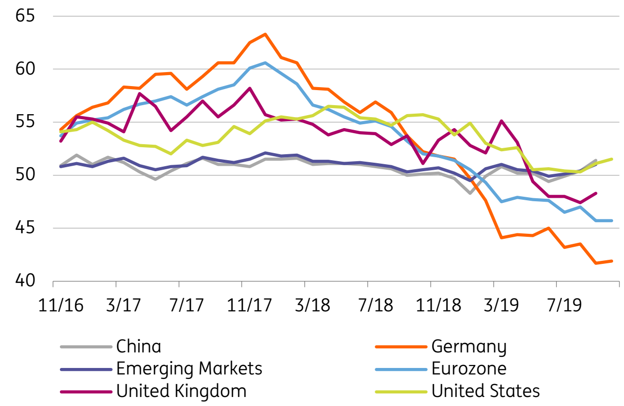
The auto sector, for example, saw production fall off a cliff in September last year when producers were not yet ready for the new emission standards, but production has hardly recovered as yet, indicating that it is more than just new regulations hampering car production. Or it may be that new emissions regulations facing the auto sector are simply more difficult to adapt to than has previously been the case.

Fig 3 German car production took a large hit in 2018 and has yet to bounce back



Source: Destatis, ING calculations

Fig 4 Germany has quickly gone from leader to laggard in terms of manufacturing over the past two years



Source: Markit, Macrobond

Slowing global demand also seems to have a disproportionate effect on Germany. Being one of the Eurozone economies most tied into the global value chain, it is hurt more significantly than others by trade disruptions.

The epicentre of this Eurozone slowdown is in German industry…

…with car production falling 10% year-to-date

The rest of the Eurozone is also suffering, but not as badly as Germany is. The latest industrial production figures show that Germany is now producing 5% less than at the same time last year (with car production falling 10% year-to-date), while Italy and France are just 1.8% down. Spain is still growing its production at 1.8% annually, indicating that the epicentre of this Eurozone slowdown is in German industry.

Job growth to the rescue!

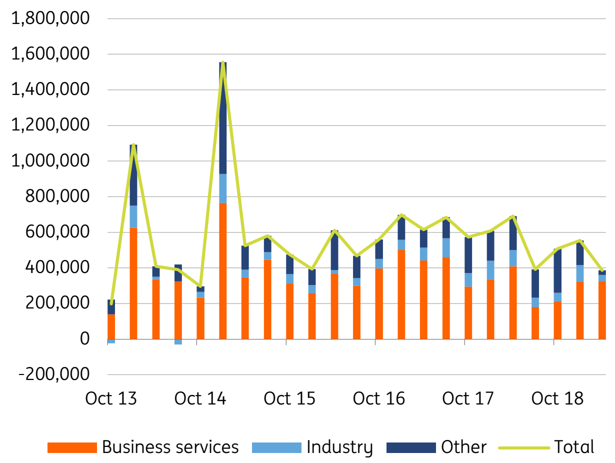
Eurozone wage growth has also picked up over recent quarters and is now back at levels seen in the mid-2000s

Even though growth has slowed down markedly, the Eurozone labour market continues to perform very well. Job growth has fallen somewhat but continues to be positive for almost all sectors at the moment. Even manufacturing continues to see increased employment despite the decline in production over the past two years.

Moreover, wage growth has also picked up over recent quarters and is now back at levels seen in the mid-2000s. Together with mild inflation, this is causing real income growth to develop favourably. This provides a strong foundation for service sector growth as this is more dependent on consumption than industry is.

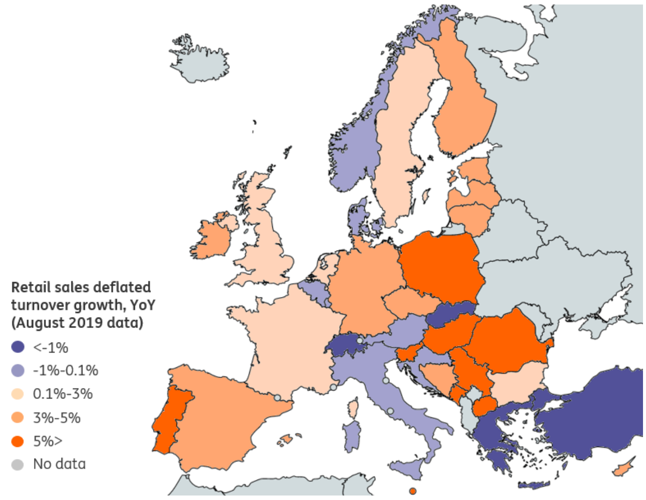
As can be seen from Figure 6, retail sales across the Eurozone continued to grow at a decent pace over the past year and are set to continue to do so as long as employment growth remains positive. Survey data indicates that this is likely going to be the case for the months ahead.

Fig 5 Job growth continues to fuel consumption (number of jobs created)



Source: Eurostat, ING Research. Number of jobs created

Fig 6 Most large economies continue to post strong sales growth



Source: Eurostat, ING Research

Labour market strength at times of an economic slowdown is unlikely to last though

Labour market strength at times of an economic slowdown is unlikely to last though, as negative spill-over effects are likely to become larger the longer this drags on. Because of that, a recession in the Eurozone remains a real concern.

Avoiding a recession seems to be dependent on relief from geopolitical developments that impact trade, like the US-China negotiations and Brexit. If, indeed, global trade picks back up during the course of 2020, this would not mean that Eurozone GDP growth will return to 2% or higher. Structural factors also impact the economic trend negatively, keeping longer term growth expectations as low as between 1% and 1.5%. Still, that is better than recession of course…

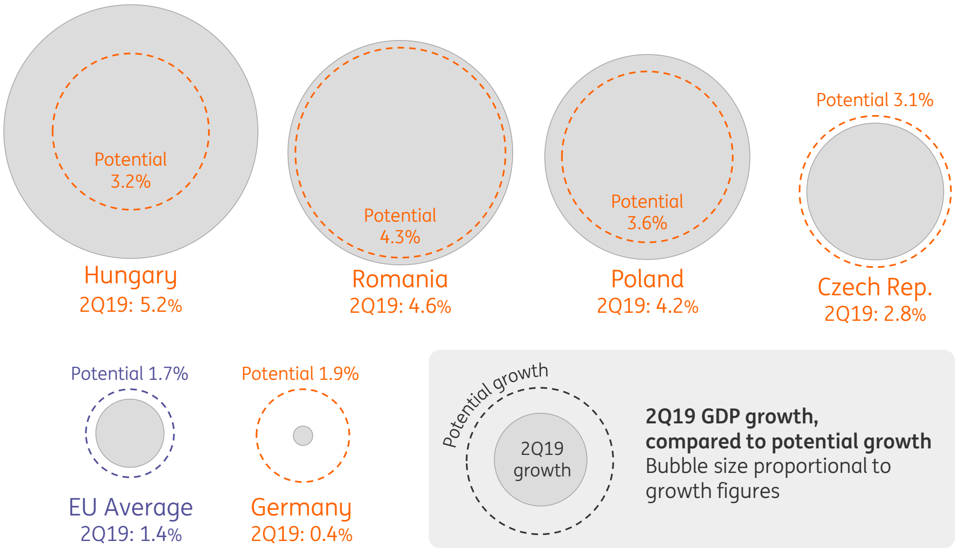
Bert Colijn Amsterdam 31 20 563 4926

Why is the CEE decoupling from the Eurozone?

As discussed above, the Eurozone economy has had a tough 2019 with decelerating GDP growth, decreasing industrial output and no sign of a turnaround. The downward trend in German industry (especially in manufacturing) is also crystal clear.

At the same time though, looking at the Central-Eastern-European (CEE) region, the story is strikingly different. Growth consistently exceeds that of the Eurozone, and the slowdown in Western countries hasn't affected the region as deeply as it once did. Within the EU, CEE members are certainly outperforming and many of those are actually growing above potential. This is a far cry from what's happening in Germany and the EU as a whole.

Fig 7 How CEE economies are performing relative to their potential



Source: Macrobond, ING

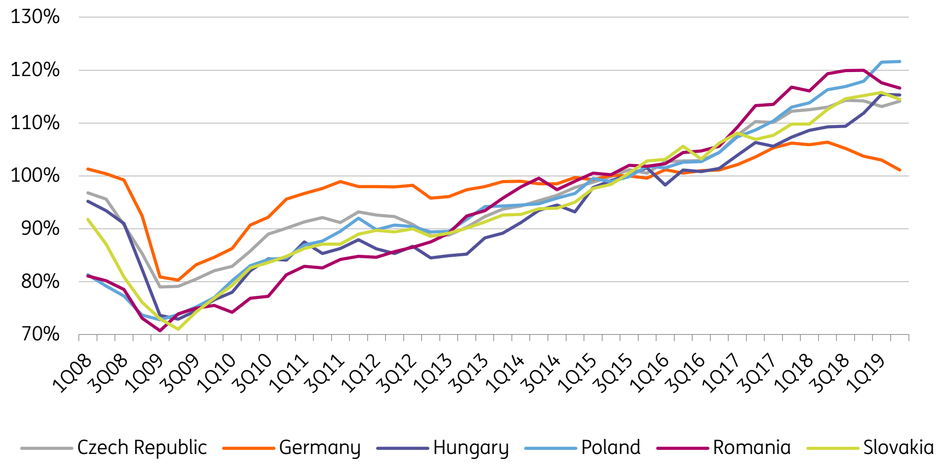
Looking in more detail into the de-coupling story, one can evaluate either "hard" industrial production (Figure 8) or the "soft" PMI indicators that essentially aim to predict the direction of sectoral performance.

Historically, manufacturing production in the CEE region typically tracks German measures pretty closely. "If Germany sneezes, the CEE catches a cold" has been a familiar adage for most countries in the CEE region. Consequently, when German industry started to fall in 2008 or in 2012, regional economies were soon to follow.

The German spill-over to the CEE region, so far, has been delayed compared to previous crisis periods

Now, however, the situation is notably different. While German (and generally Eurozone) economic performance started to deteriorate from the second quarter of 2018 onwards, CEE economies (especially Poland and Hungary) have been showing strong resilience. The spill-over to the CEE region, so far, has been delayed compared to previous crisis periods and also the effect seems to be milder.

Fig 8 Industrial output (2015=100)



Source: Eurostat

Does this represent a softening of the strong linkage between the CEE and the Eurozone, ie, a formal decoupling, or is a CEE slowdown merely a matter of time? We look at this issue both through structural changes and one-off factors.

We believe structural reasons for the decoupling mostly arise from the changing nature of the CEE's domestic economy

We believe the structural reasons for the decoupling mostly arise from the changing nature of the CEE's domestic economies (e.g., drivers of growth) and international trade dependencies (e.g., main trade partners). At the same time, we detail country-specific factors in our *Country Focus* section.

Another important driver behind this phenomenon could be the nature of the recent shock. Usually Germany is a good barometer of a slowdown in global demand. But current German weakness is more 'local' (e.g. emission norms hitting local car makers) and only partially driven by global demand (Brexit, trade uncertainties).

On the issue of decoupling, it is clear however that the CEE is not totally immune. No matter how bulletproof CEE economies are looking, local manufacturers are deeply integrated into the European value chains.

The retreat of the German economy usually spills eastwards within 6-9 months, according to research by the National Bank of Hungary

As a consequence, the weak performance of the German automotive industry may well eventually feed into CEE economic performance in the medium term through the real economy channel. According to research by the National Bank of Hungary, for example, the retreat of the German economy usually spills eastwards within 6-9 months.

Over the next sections we will focus on some of the main structural channels that could be explaining why the CEE has been so resilient, and then focus on individual country stories.

But first we take an empirical look at the relationship between the manufacturing sectors in Germany and the CEE. Using a VAR model, our team in Poland calculate what a decline/increase in German real manufacturing output means for the CEE region.

Impulse response function

A model approach: CEE response to a German manufacturing impulse

Attempting to quantify the relationship between German and EM Europe manufacturing sectors, we calculate impulse response functions (from a VAR model). For CEEs we base our analysis on Eurostat real manufacturing output indices (calendar adjusted) on a window starting from 2004. For Turkey and Russia, we use data from the local statistical office.

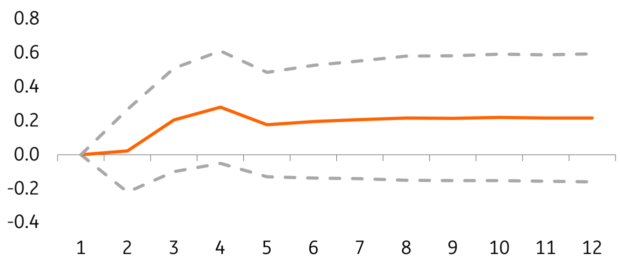
Our analysis shows that CE4 economies generally show low/moderate vulnerability to German output. On average a 1% rise/decline in German production translates to a rise/decline of just 0.2-0.3% in Polish manufacturing (with a 2-4 month lag). In other CE4 countries the effect is generally stronger (0.5%) and more immediate, but still relatively muted. This coincides with our findings on value added in manufacturing – CEE economies typically rely far more strongly on domestic demand.

Shortening the period to start from 2010 we get substantially lower vulnerability results for Hungary and the Czech Republic, but higher exposure of Poland. This is likely explained by an unusual 2008-11 factors. During that time Poland showed resilience to both global and economic activity, largely resulting from PLN weakness, tax cuts and public investments ahead of EURO 2012 held in Poland and Ukraine. Other CEE economies suffered heavily during that crisis in tandem with Germany.

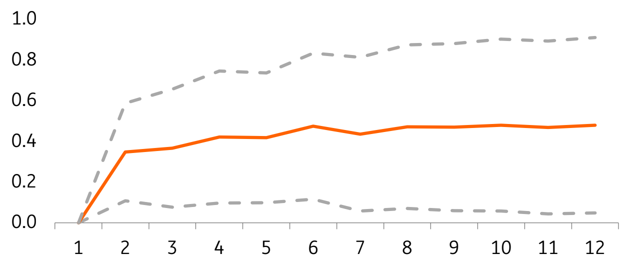
Romania seems a conundrum. Local manufacturing relies on internal demand as much as Poland, but our analysis shows that on average a 1% drop in German output equates to a 0.8-0.9% decline. Turkey's vulnerability to the German economy is also quite strong – on average a 1% decline in German output resulted in a 0.5% decrease in Turkish manufacturing. Local data from Russia relates to overall industry (including a 37% share of mining). Russia's relationship to Germany proves negligible. If manufacturing only was to be taken into account, the results would probably be slightly higher, but still low compared to CEEs.

EM Europe manufacturing vulnerability to German output – impulse response functions

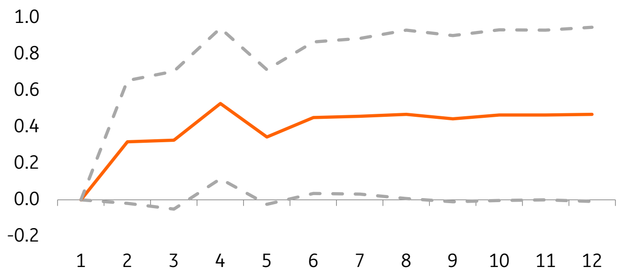
Poland



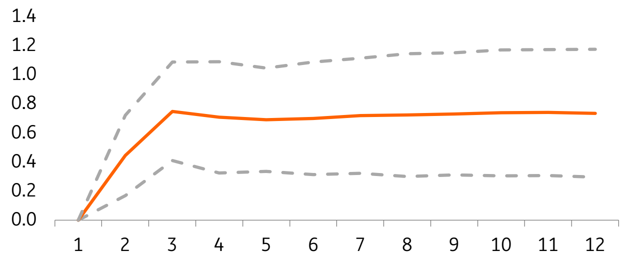
Hungary



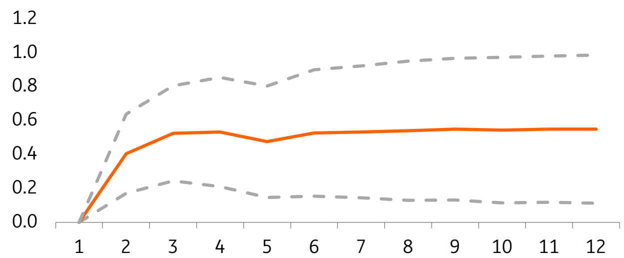
Czech Republic



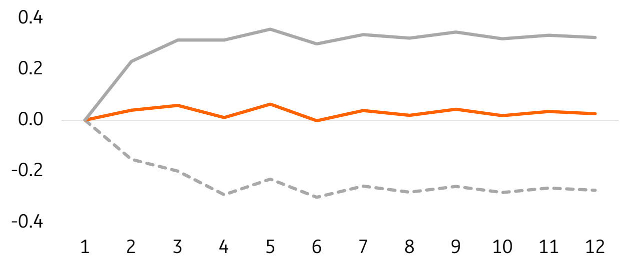
Romania



Turkey



Russia



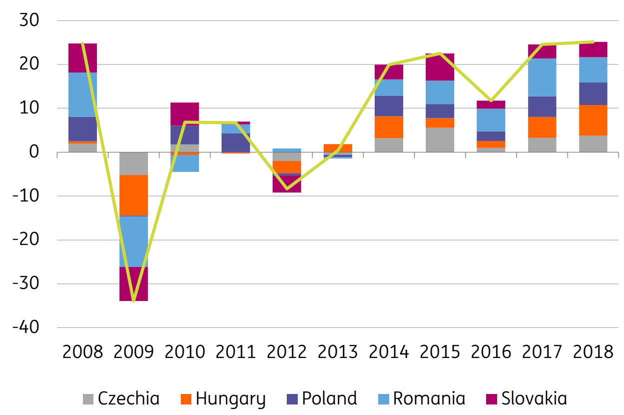
Y axis represents response to German shock, X axis = months
All sources: ING estimates

Structural factors

The growing importance of domestic demand

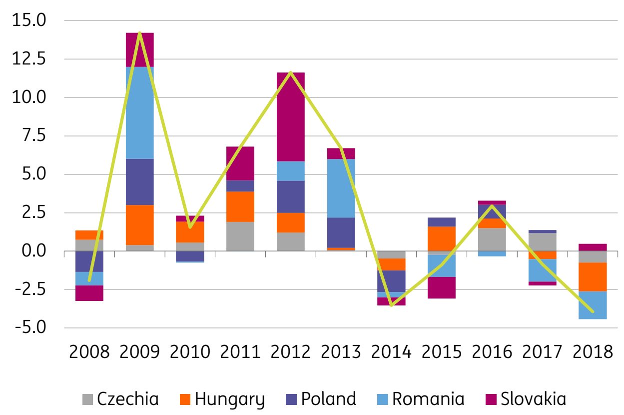
CEE economies are currently generally more domestic demand-driven than they were between 2008 and 2016. This is because the CEE labour market is much tighter and governments are not facing financing constraints - since any weakness so far has been limited to the manufacturing sector.

Fig 9 Domestic demand contribution to GDP (ppt)



Source: Eurostat, ING

Fig 10 Net export contribution to GDP (ppt)



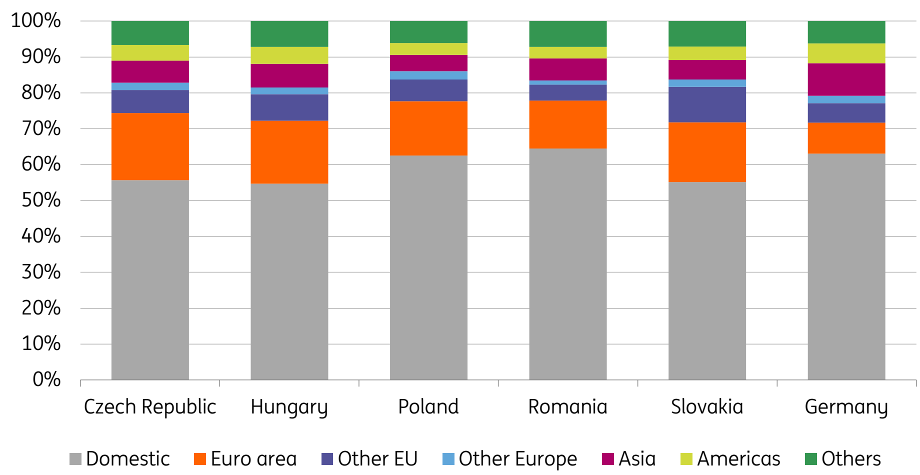
Source: Eurostat, ING

The CEE region's growth path is generally more balanced and sustainable now than it was in 2009-13

Looking at the expenditure side of GDP in CEE countries, net exports had been the strongest driver of growth between 2009 and 2013 (partly helped by weaker currencies), while now they are far less significant. In terms of domestic demand (consumption and investment) and external sources of growth (net export), the region's growth path is generally more balanced and sustainable now than it was in the 2009-2013 period.

But even on that issue of net exports, one could also argue that Germany is more exposed to final demand outside of the EU (particularly Asia) and that as long as consumption holds up within Europe, the CEE should be less affected.

Fig 11 Value added of intermediate goods by final destination



Source: OECD, ING

Focusing on consumption, the resilience is largely a result of high wage growth and rising employment in the region. Compared to 2009-13, unemployment has decreased significantly in all countries, reaching historical lows, further fuelling wage increases and consumer demand.

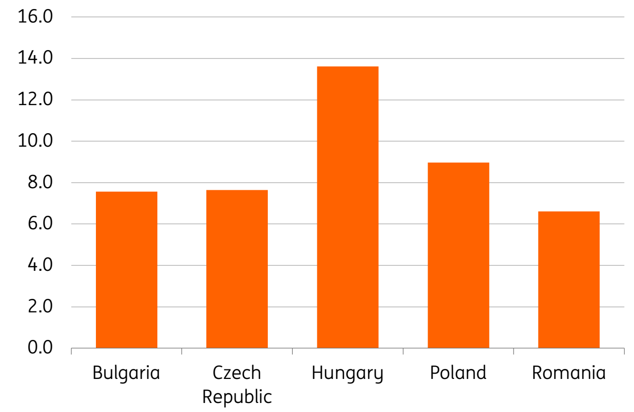
At the same time, tight labour markets and an insufficient workforce, inflows of foreign direct investment (FDI) and EU funds are all contributing to investment growth as well. The investment rate (% of GDP) in all CEE countries is currently above that of Germany and the Eurozone average.

In practice this has seen governments in the CEE region cumulatively invest anywhere between six and thirteen percent more (in GDP terms) than the Eurozone average over the past five years (Figure 12).

In theory, these investment rates could possibly slow in the 2021-27 period as part of the EU's next Multiannual Financial Framework (MFF). We discussed this in detail in the November 2018 edition of *Directional Economics*, *Brexit's impact on Central Europe*. In particular, we highlighted some potential large (20%+) real declines for the likes of the Czech Republic, Hungary and Poland.

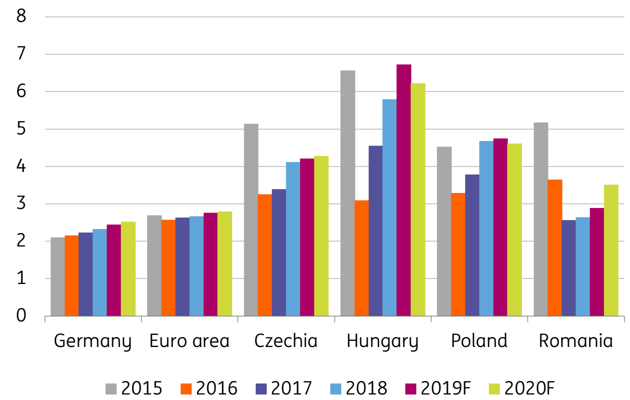
That said, the region will still be tapping funds from the current MFF round until 2023, suggesting concerns over lower EU co-financed investment activity is more a medium term concern rather than over the 2020-21 horizon. Indeed, there may be a last minute surge in investment to tap the remaining funds still available in the current MFF round – a similar pattern occurred in 2015 (Figure 13).

Fig 12 Cumulative govt. invest/GDP versus EZ (2013-18%)



Source: Eurostat ING

Fig 13 Gross government investment (% of GDP)



Source: Ameco

Decreasing role of industry, rise of service exports

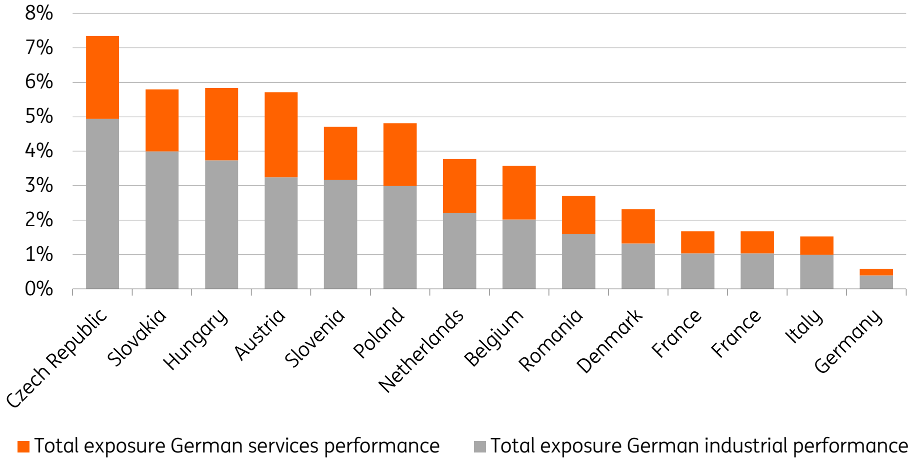
The composition of the production side has also shifted towards supporting the CEE's economic resilience. The share of services has increased within GDP over recent years, while the role of the industry has decreased in most countries.

This is a crucial factor, as a significant share of the region's industrial output (6.9%) still serves as an input for German industrial firms, thus there is a material exposure. While Slovakia and the Czech Republic have the most significant industrial dependency (close to 9% of all industrial output), the Romanian industry is much less reliant on German industrial performance (3.7%).

In GDP terms, the Czech economy is the most exposed to the German industry

In GDP terms (Figure 14), the Czech economy is the most exposed to the German industry (4.9%), followed by Slovakia (4%), Hungary (3.7%) and Poland (3%), while Romania (1.6%) is less sensitive to such shocks.

Fig 14 Exposure to German economic performance scaled to GDP

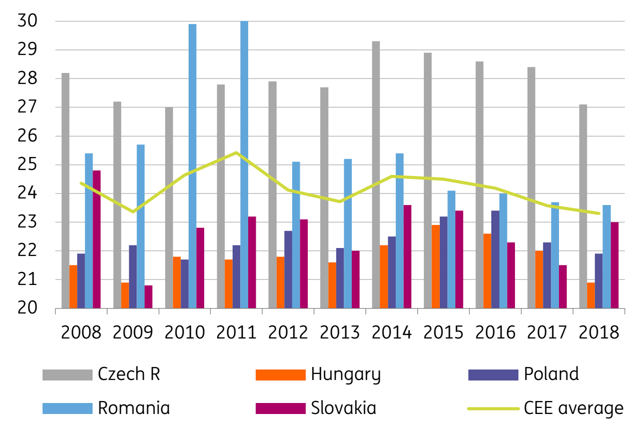


Source: OECD data, ING analysis

The CEE countries are less integrated to Germany via the services sector. According to our data based on Input-Output model calculations, regional economic dependency on the German services sector is on average 1.9%, while on German industry it is 3.5%.

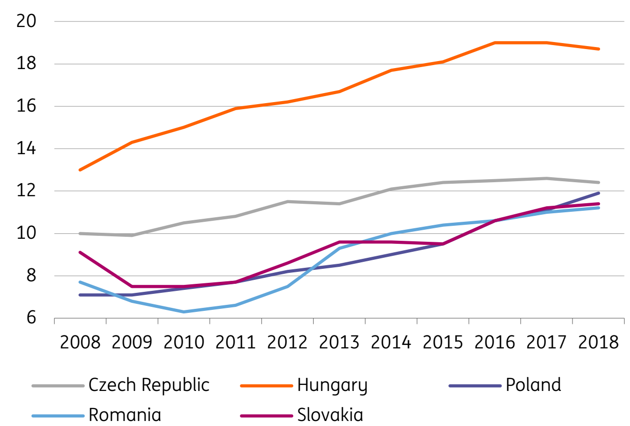
Also the share of services within exports and the share of services exports within GDP (Figure 16) has become more substantial lately (compared to 2008-10), mainly due to the ongoing regional diversification of corporates (eg, Shares Service Centres). This is good for the region's economic stability, as the gross value added of services is typically higher than that of products and can be more resilient to external shocks.

Fig 15 Share of industry (% of GDP)



Source: Eurostat

Fig 16 Share of services exports (% of GDP)



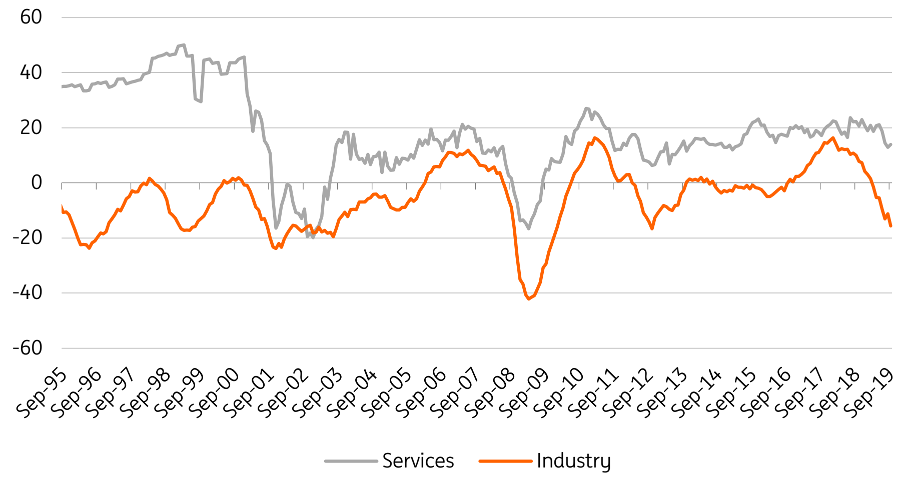
Source: Eurostat

Volatility of demand is much smaller in services than in industrial products

At the same time, the volatility of demand is much smaller in services than in industrial products. This means that an economic downturn affecting the trading partners will probably cause a bigger decrease in export demand for products (eg, cars), while only a smaller drop in services.

This relationship can be demonstrated by the time series of the more volatile manufacturing and the less volatile services measures in Germany (Figure 17).

Fig 17 German economic confidence indicators (balance)



Source: Bloomberg, European Commission

Most vulnerable CEE sectors to German industry are unsurprisingly those related to the auto industry…

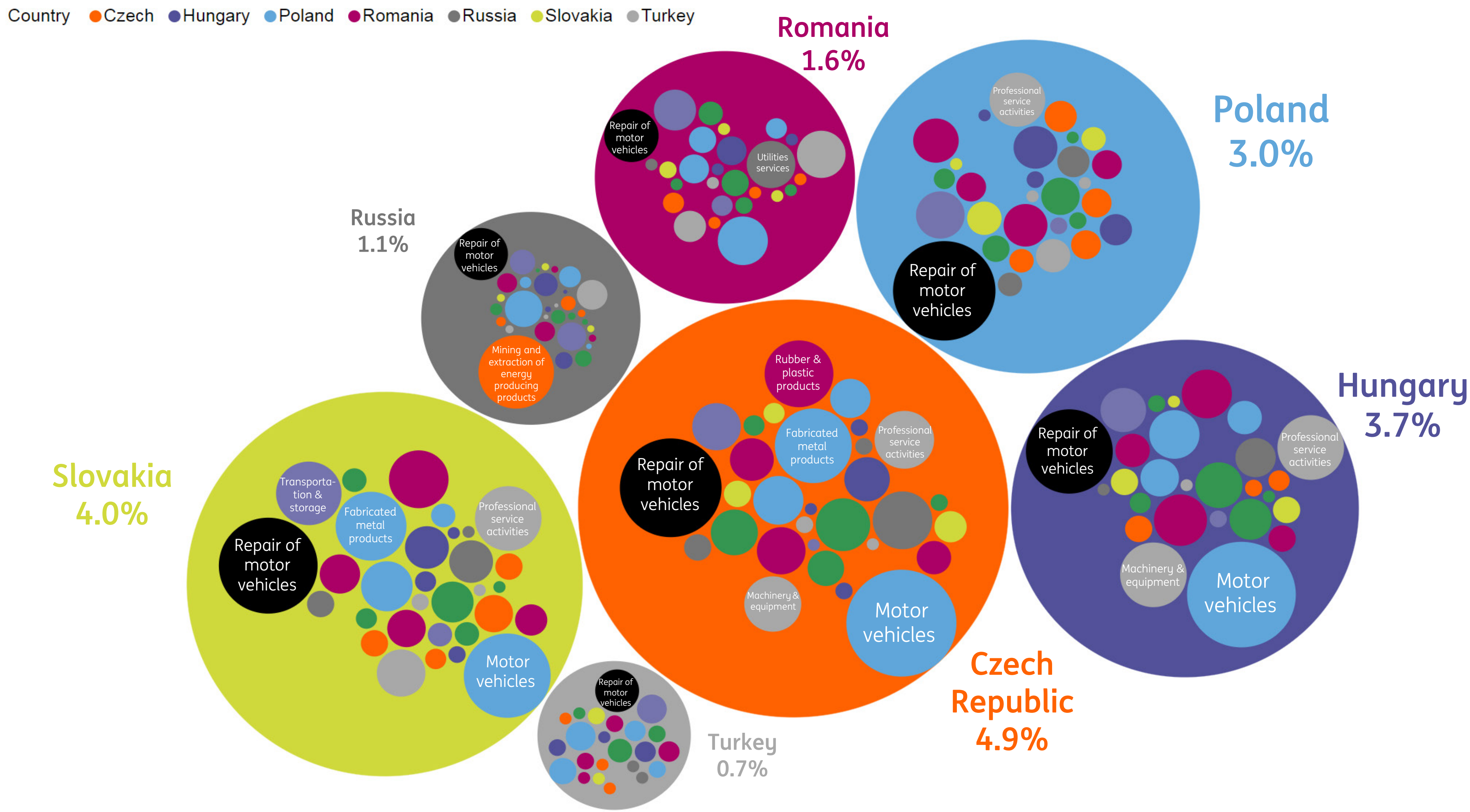
Returning to the industrial side, in our assessment of the most vulnerable sectors to German industry (Fig 23), the most important amongst the CEE countries are those related to the auto industry. (We discussed this issue in detail in our article '*German car trouble and the CEE*' published in our April 2019 version of *Directional Economics*). It hardly comes as a surprise that these sectors appear prominently across each of the analysed countries as all of them are included in the horizontal structure of the auto production chain.

…although the trade relationship between car manufacturers in CEE countries and their partners has changed remarkably over the past ten years

The export of industrial (especially manufacturing) products still has an important role in the Czech Republic, Slovakia, Romania and Hungary. However, the trade relationship between car manufacturers in CEE countries and their partners has changed remarkably over the past ten years.

Taking Hungary, for example. Despite the fact that car exports from Hungary doubled in a decade (in nominal terms), Hungary has become less reliant on one or two specific regions/countries. Specifically, Europe's share as an export destination has decreased (from 94% in 2008 to 66% in 2017), while American and Asian markets have gained importance (from 2.4% and 3.1% in 2008 to 13% and 17% in 2017, respectively).

Fig 18 CEE's exposure to German industrial demand by CEE domestic sector



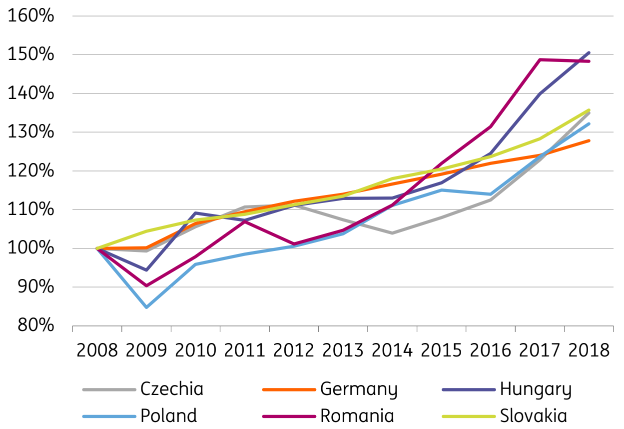
Percentage of country's total GDP related to value added exports to Germany
Source: ING's trade team, with special thanks to Timme Spakman

Differences in labour costs and competitiveness

We have noted that one of the main drivers behind the CEE's resilience is a tight labour market and high wage growth which supports domestic demand. However, some may say that this phenomenon might prove only a short-term strength and that in the long-run the strong wage growth jeopardises the cost competitiveness of the region, so can be a long-term threat. Let's break down the wage development using different layers, like net earnings and then the unit labour cost (which is more important from the corporates' point of view).

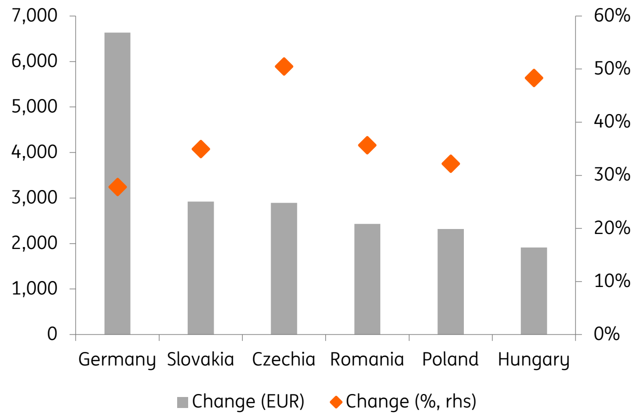
As part of economic convergence, CEE wages have typically grown at a higher pace than in more developed countries (e.g., Germany). This is true for the 2008-18 period, when net earnings (in euro terms) rose by 27.8% in Germany and 37.4% in CEE countries on average. The biggest relative net earnings growth was seen in Hungary (50.5%) and Romania (48.3%), while Slovakia (35.5%), Czech (35%) and Polish (32.2%) wages showed a touch weaker increase, partially due to a higher base in 2008.

Fig 19 Net average earnings (2008=100%)



Single person without children, 100% of average worker
Source: Eurostat, ING

Fig 20 Change in net average earnings 2008-18



Single person without children, 100% of average worker
Source: Eurostat, ING

Has the regional, especially the Hungarian and Romanian, workforce become more expensive relative to Germany?

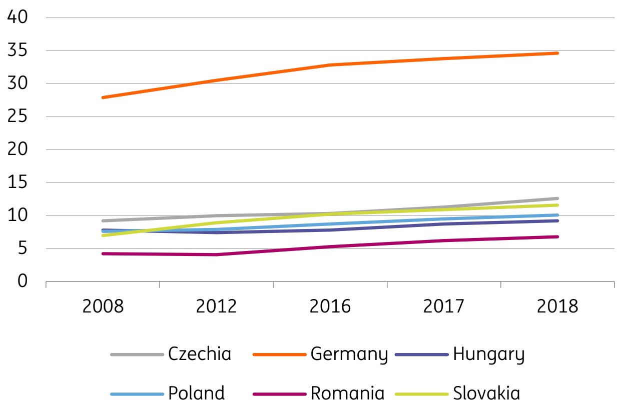
At a first sight, this would suggest that the regional, especially the Hungarian and Romanian, workforce has become significantly more expensive relative to Germany - meaning that the regional labour force is now less competitive.

Yet employers might see the situation differently. In absolute terms, German workers have seen a 2.5 times bigger wage increase (in euro terms) in a decade than their CEE peers. Even if we take into account consumer prices, an average German worker earns twice as much, in PPS terms, as peers in CEE countries and the absolute difference widened over the past 10 years. So actually the CEE is now even more competitive than it was in 2008.

Net wages (either in euro terms or in PPS) properly characterise earning opportunities in the country, but hardly tell us anything about the actual costs of labour that companies are facing. It also doesn't take into account productivity - thus we should consider other related indicators.

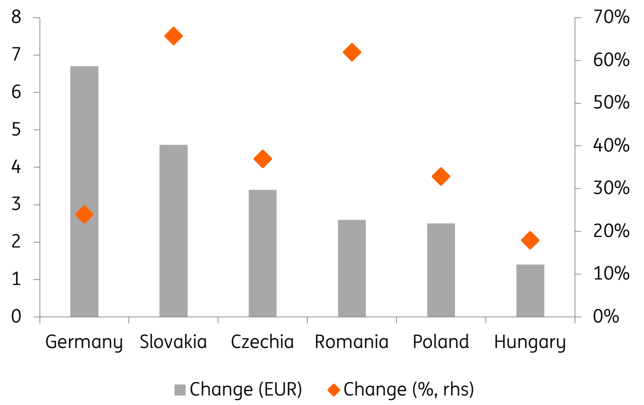
The unit labour cost index (ULC) denotes the expense of labour (in euro) related to the amount of output, so considers productivity. In relative terms, ULC in most CEE countries grew faster between 2008 and 2018, than in Germany. While labour costs have increased the most in Slovakia (65.7%) and Romania (61.9%) in a decade, in Hungary labour cost increases did not even exceed the German measure.

Fig 21 Unit labour cost (€)



Source: Eurostat, ING

Fig 22 Change in unit labour cost, 2008-18



Source: Eurostat, ING

The reason why the Hungarian net wage growth (in percentage terms) was the highest in the region, but at the same time ULC hardly increased, is mostly down to productivity growth, significant HUF depreciation against the euro and considerable tax reductions.

Similarly to net earnings, in absolute terms it turns out that German workers are not only more expensive than CEE peers, but the gap based on unit labour cost in euro terms has even widened. So despite the 'convergence' of wages within the EU, Germany is now even more expensive and thus less 'cost competitive' than regional countries.

Perhaps this has been an argument for manufacturers to cut down on expensive German production when global demand is starting to shrink. This is certainly what the German trade unions will not let happen in scale.

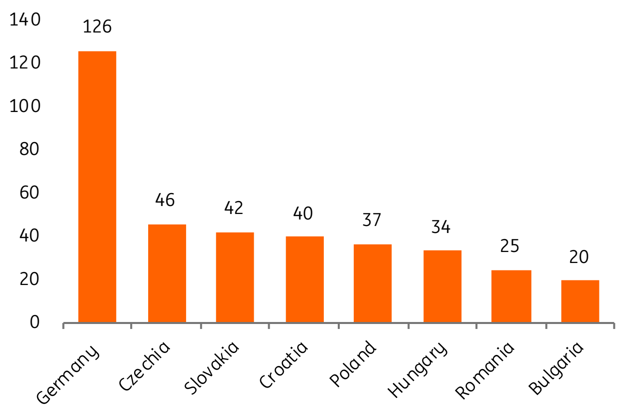
At the same time, most car models are produced in only one country, vastly limiting car manufacturers from swift optimisation of production worldwide. Instead, CEE countries can maintain or even increase manufacturing production because the models produced locally have not faced significantly decreasing demand, so far.

Despite hefty increases in recent years, labour cost in CEE is still a fraction of EU average

Despite hefty increases in recent years, driven both by tight labour markets and government policies, the labour cost in CEE is still a fraction of EU average. At the same time, productivity, despite being below EU average is not as low as the labour cost ratio.

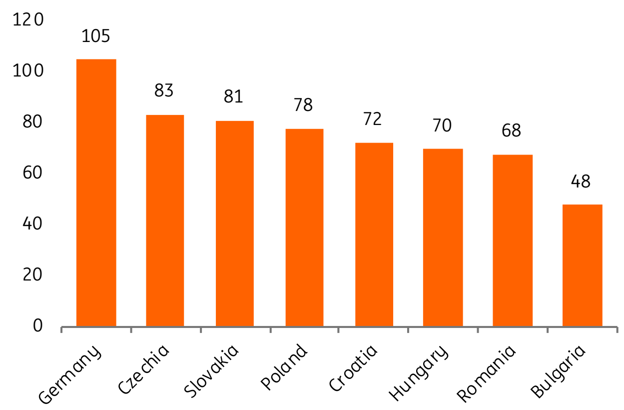
Hence, there is plenty of scope to invest in CEE as productivity outweighs labour costs, the only issue being the pace of wage growth which should be gradual and predictable enough in order to be accommodated by investments in productivity enhancement.

Fig 23 Labour costs as percentage of EU average (%)



Source: Eurostat

Fig 24 Labour productivity as percentage of EU average (%)



Source: Eurostat

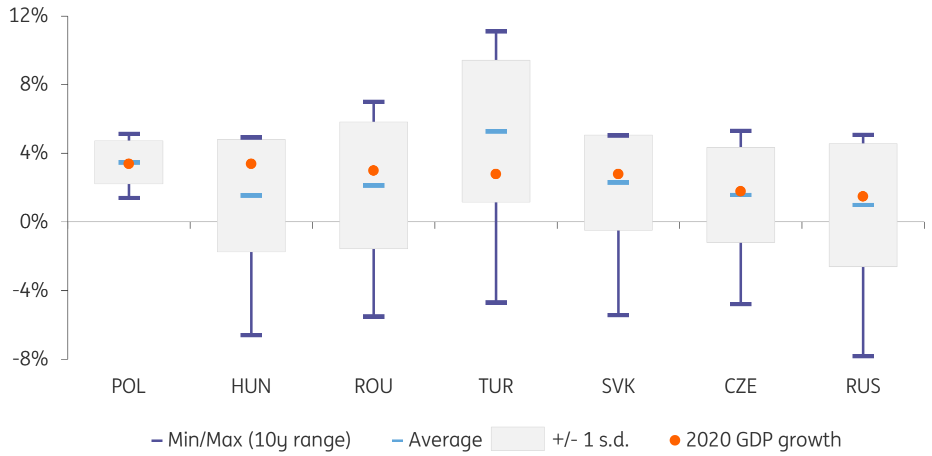
In all, based on the labour costs and labour productivity developments, the CEE has managed to maintain its price competitiveness despite the hefty wage growth. This combined with the new structure of global value chains (countries producing unique intermediate goods and consumer goods) suggests that labour market and international work-sharing can be a strength rather than a weakness in the long-run for the CEE, providing another cushion to a global slowdown.

Acknowledging the negatives, focusing on the positives

We would be naïve to think that the CEE is immune to Germany's sharp slowdown, but we do believe that strong domestic demand and the more diversified nature of CEE economies can provide strong protection from European headwinds. And the fundamental story of a competitive and productive labour force, encouraging FDI inflows remains intact.

Strong activity, tight labour markets and rising wages in the CEE over recent years has laid the groundwork for private consumption growing at rates of 2-4% YoY in 2020. This will drive full year 2020 GDP growth at rates mostly above, or at, ten year averages. Given that Germany is heading into a recession, that's not bad at all!

Fig 25 ING's 2020 GDP forecasts – mostly on or above average



Source: OECD, ING

Peter Virovacz, Piotr Poplawski, Timme Spakman, Ciprian Dascalu, Jakub Seidler, Rafal Benecki, Chris Turner, James Smith

Country Focus

Czech Republic: surviving on services

Despite weakening German economic activity over the past year, Czech economic growth remains stable with GDP just slightly below 3% YoY in the past three quarters.

Relatively firm GDP growth in a more challenging global environment has been due to solid domestic demand, where services have now become the main driver of growth instead of manufacturing. Indeed, the manufacturing industry grew by 11% YoY in 2017 and contributed by 3% percentage points to the 4.5% GDP growth in the economy that year, but has since decelerated to just 1.6% YoY in 2018 and 1% in the first half of 2019. As such its contribution has remained just slightly above zero since 2Q18.

Services has seen relatively broad based growth since 2015. Last year, the highest contribution to growth came from wholesale and retail trade, IT and transport services,

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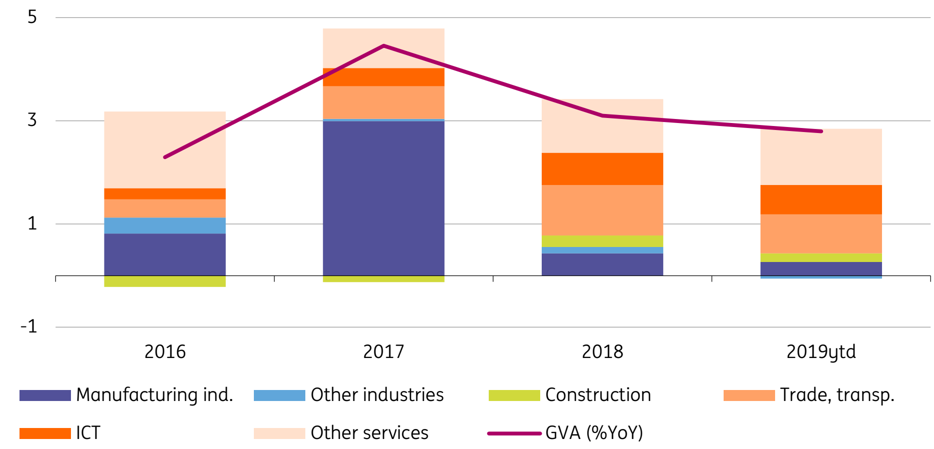
Fig 26 Contributions to Gross Value Added (percentage points)



Source: CZSO

Weaker QoQ dynamics in the manufacturing segment have generally been observable since 2018

The weakening manufacturing segment is apparent also from the QoQ dynamics as it saw a 0.3% fall in 2Q19 after negligible growth in the previous quarter. Weaker QoQ dynamics have generally been observable since 2Q18, with average QoQ growth rates since then equal to zero. That compares to average quarterly dynamics in the 2015-17 period of around 1.5%, mainly driven by the banner year of 2017.

Czech service sector has grown 4% over the past eighteen months

As such, the main driver of Czech economic growth has rotated to services, growing at around 4% over the past eighteen months, and largely driving the Czech economy since 2Q18. Last year, the highest contribution to growth came from wholesale and retail trade (5% YoY), information and telecoms services (10% YoY) and transport services (8.6% YoY). These three segments contributed 1.7 percentage points of the 3% GDP growth figure and the overall combined services delivered 2.6 percentage points of the total growth figure. This is the main reason German weakness is yet to register in the Czech GDP data.

Investment activity was strong last year, also mitigating effect of economic slowdown from abroad

Investments were also an important factor contributing to growth last year. Government investments accelerated by 28% YoY in 2018, which is the strongest growth since 2015 when investments surged by 33% YoY in a last chance to tap EU money from the previous MFF round. In 2015, investments contributed 2.7 percentage points of the 5.4% GDP growth that year, and in 2018, the contribution was similarly important at 1.8% of the 2.9% GDP growth. Driving this activity was the fact that some of the EU funds could be lost if not utilised by the end of 2018 due to a new EU rule – the so called 'n+3', meaning that money provided for a given year must be used within a three-year horizon. However, investments significantly slowed in 2Q19 to 0.9%, signalling that their contribution to growth this year will be lower.

Despite solid GDP, industrial production has stagnated this year

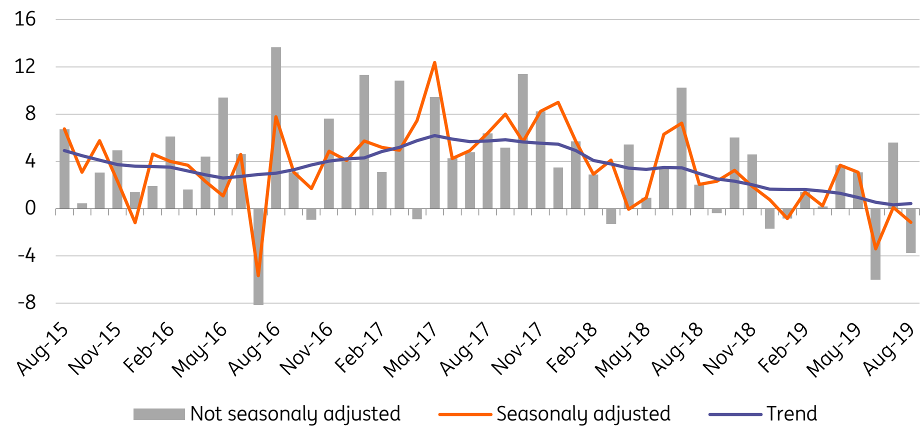
Despite the above-mentioned factors that are keeping Czech GDP growth broadly stable, signs of weakness in industry are clear. Czech industrial production grew by 6.5% in 2017 but slowed to 3% in 2018 and has stagnated year-to-date (see Figure 27). Car production represents the most important industrial and export segment in the Czech Republic, having almost a 30% share in the total Czech exports. After double-digit growth in car production in 2014-17, production slowed to 2.3% in 2018. This year growth has remained at 2.3% YTD (Jan-Aug), but in terms of units, car production has effectively been stagnant in 1Q-3Q, growing by just 0.7% YoY, according to the AIA (Czech Automotive Industry Association).

Car production has stagnated so far this year, but supply segments seem to be more affected by global slowdown

However, some sub-segments of manufacturing, usually linked to the automotive supply chain producers, are losing momentum at a faster pace. For example rubber and plastic production is stagnating for a second year in a row and metal production slightly fell - the second most important manufacturing segment beyond automotive. As such, there is a clear decelerating trend in Czech industry.

Looking at export dynamics in more detail, we see that automotive part exports are weakening more than the export of the finalised cars, suggesting that automotive supply chain producers are feeling global weakness more. Czech car manufacturers are not directly exposed to the US or Chinese car markets, where car demand may be suffering more on trade war uncertainty and weakening Chinese demand driven by the new emission norm, China 6.

Fig 27 Volume index of production in industry (2015=100%)



Source: CZSO

Services were more resilient, but confidence has started to fall

However, a more prolonged and severe slump in global car demand is bound to hit the Czech economy sooner or later, in our view, as the currently solid domestic Czech demand and services would be impacted also by negative sentiment.

Indeed, while confidence in industry hit a six-year low this year, even services confidence has started to fall recently, falling to its lowest level in three years. We see the same trend in consumer confidence, hitting its lowest levels since mid-2016. This indicates that the strong domestic demand, which has supported growth over recent quarters, cannot be relied on indefinitely.

Hungary: well shielded, temporarily

Hungary has weathered the ill-winds from Europe quite well, despite being deeply integrated in global value chains and notwithstanding the strong ties to Germany and its carmakers. The country was able not just to survive but to thrive. We see a mix of one-off and structural factors behind the resilience. The individual decisions of car manufacturers based in Hungary, the rising domestic demand, the increasing share of services, the weakening currency and the supportive fiscal stance all played a role to provide Hungary a short-term shield against the recent downturn.

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Let's break it down to the finer details of the factors that are providing Hungary a short-term shield against the ill-winds from Europe.

One-off factors

These factors are largely related to car manufacturing. And since this is the main industrial contributor to GDP (4.95%) in Hungary, it has a significant effect.

The US-China trade war will take its toll in the long run, but in the first instance, with looming car tariffs, it has given a temporary boost to the car industry globally. Here US buyers have built up inventories, preparing for a worst-case scenario. However, sometimes it is just a matter of luck and geography: German carmakers in Hungary are producing compact models that represent the lower/cheaper end of the model range. These have faced the lowest decrease in demand, so far.

According to Audi's Interim Financial Report (July 2019), in the first half of 2019, the group produced 10.2% fewer cars globally than the prior-year period. In contrast, Audi manufactured 48% more cars than a year ago in Győr (Hungary). This is mainly due to model changeovers following the end of the manufacture of older models (eg, Audi TT), readjustment of production lines and the start of production of the Q3 model.

Daimler (Mercedes-Benz) car sales fell by 5% YoY in 1H19, but unit sales of compact models were up by 4% YoY. Production volume dropped by 1% YoY globally in the first half of 2019, but Kecskemét (Hungary) has become a centrepiece of production with the start of new exclusive production lines. Besides the compact A-Class, Mercedes-Benz has also been manufacturing the compact CLA Coupé and CLA Shooting Brake models in Hungary since September. Hungary has also been producing the super-premium AMG models (AMB A, AMG CLA Coupé and AMG CLA Shooting Brake) since October.

Structural factors

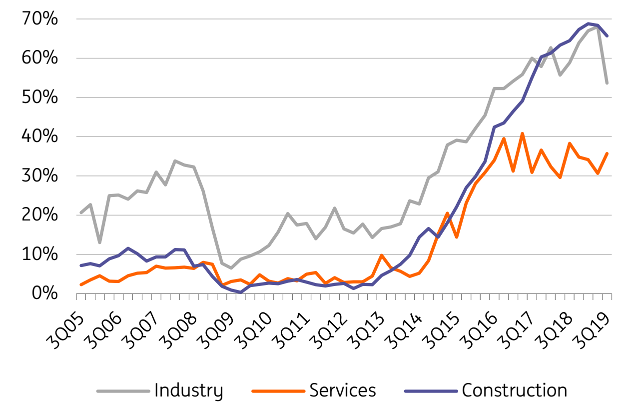
Besides the above-mentioned one-off factors, there have been structural changes in Hungary over recent years as well - improving the country's economic resilience to external shocks.

The dominance of Hungarian vehicle exports to Germany, which primarily served re-export purposes, has been replaced by direct exports to target markets. According to our estimates, only 13% of the local automotive industry is dependent on German car manufacturing. If we aggregate all of the Hungarian sectors' contributions to the German car industry and we take into consideration these sectors' importance in producing local GDP, we end up with a 1.6% share. So 1.6% of Hungarian GDP is dependent on the German car industry, a figure that is smaller than intuition suggests.

Hungarian assembly lines represent state-of-the-art facilities in Europe and produce exclusive products in the value chains. This, combined with a low cost level in general is providing a (temporary) cushion against shift cuts, lay-offs and shutdowns, which are in the pipeline in several factories in developed countries.

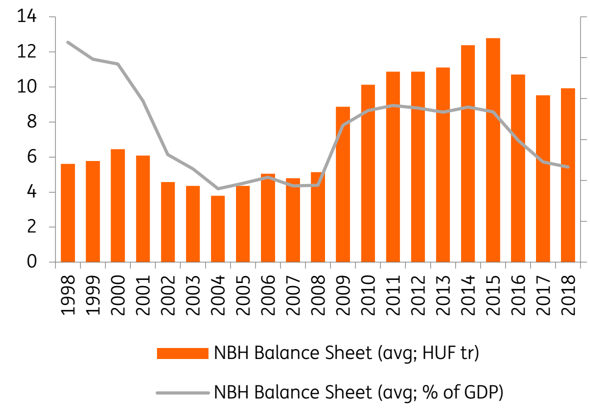
The growth structure of Hungary has changed recently. This is mostly due to the increased contribution of domestic demand. Consumption is on the rise due to double-digit wage growth (2017-19) and the record-low unemployment rate, combined with an elevated level of consumer confidence. Investments are strongly supported by EU fund related infrastructural projects. The severe labour shortage (Figure 28) has also pushed the corporate sector to invest in digitalisation and automation. Residential investment is also booming on government programmes to support the housing market.

Fig 28 Share of companies complaining of labour shortage



Source: Eurostat, ING

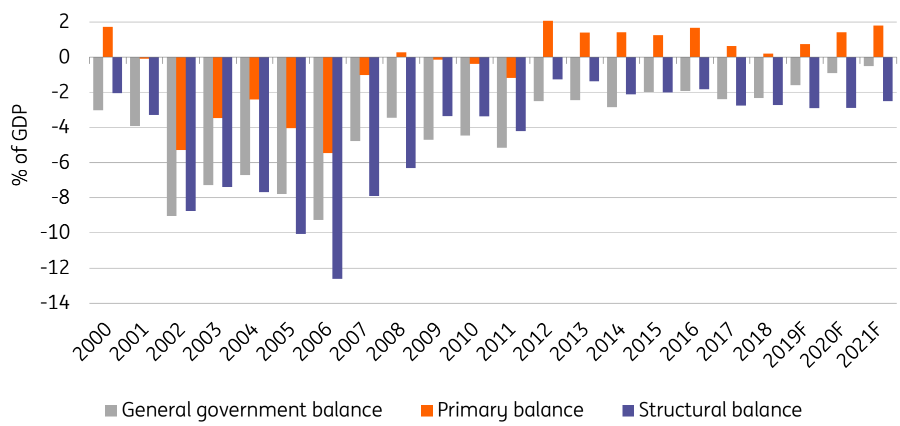
Fig 29 Balance sheet of the NBH



Source: NBH, ING

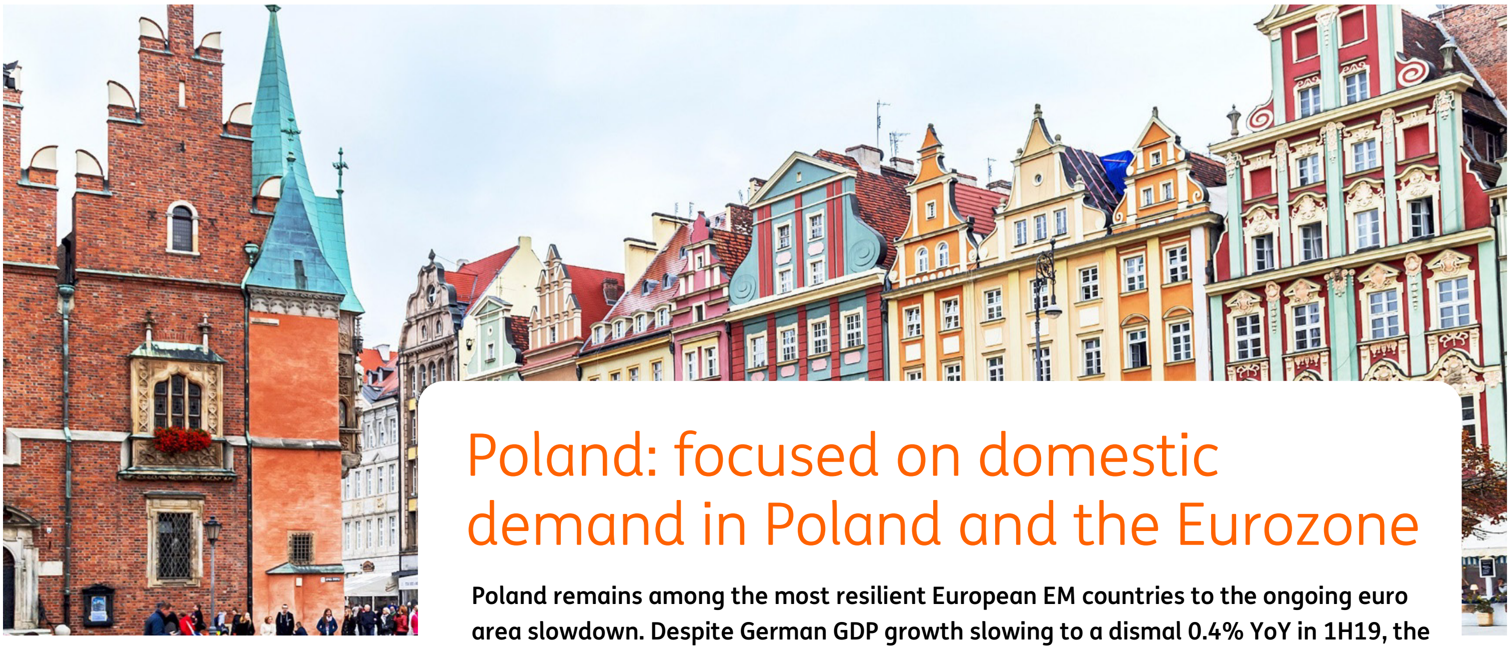
Monetary policy is also key for Hungary (and for other CEE economies). The National Bank of Hungary is equipped to deal with lower exports via using the exchange rate channel. Even though the central bank doesn't have an FX target, our intuition is that the NBH let forint weaken on global risk-off to support the price competitiveness of the economy. Moreover, when it comes to room for manoeuvre, because of the low level of balance sheet, the NBH can easily move to outright Quantitative Easing.

Fig 30 General government budget balance measures



Source: Bloomberg, ING

Fiscal policy is in play too. The government is supporting new (seven-seater) car-purchases for large families, giving out one-off vouchers for pensioners and bonuses for fostered workers. The new childbirth allowance, complementing the housing programme, also provides a boost for domestic demand. Prime Minister Viktor Orbán in his latest interview with a local TV channel has commented that additional new stimulus might come soon.



Poland: focused on domestic demand in Poland and the Eurozone

Poland remains among the most resilient European EM countries to the ongoing euro area slowdown. Despite German GDP growth slowing to a dismal 0.4% YoY in 1H19, the Polish economy expanded by 4.4%. The growth of local manufacturing continues as well despite recession for its German counterpart. We attribute this phenomenon to a mix of local factors, ranging from: (1) low reliance on non-EU export markets – which have suffered more than the EU during recent trade wars; (2) local fiscal easing; and (3) relatively strong domestic demand in Poland and in the Eurozone.

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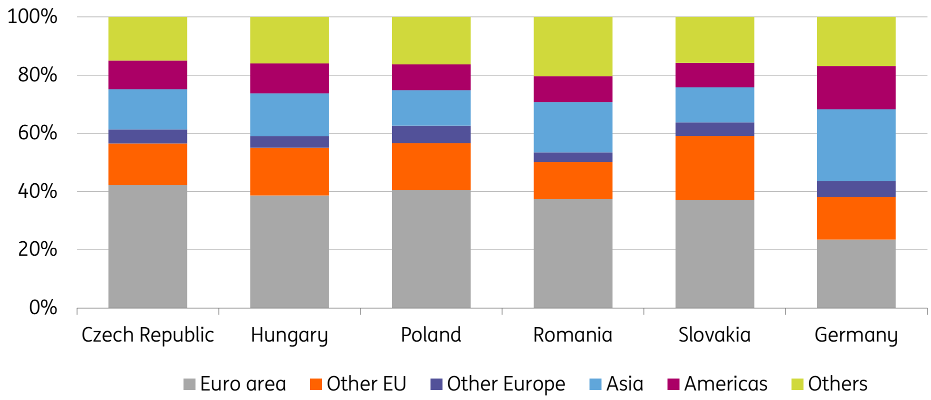
Structure of the economy

Polish manufacturing is focused on the domestic market, even more so than its CEE peers. Based on OECD data (TIVA database), over 60% of value added produced by domestic manufacturing is consumed internally, above the CEE average. Final demand accounts for over 20% (both direct and indirect exports), see Figure 31. The remaining export destinations account for c.15%, again below CEE peers, which makes the economy less sensitive to the global trade slowdown. Moreover, the dependency of Poland solely on German business performance (both directly and indirectly) is just 4.8%, among the lowest in the CEE (only Slovenia scores a bit lower at 4.7%). The average for the other CE4 countries' reliance is above 6%.

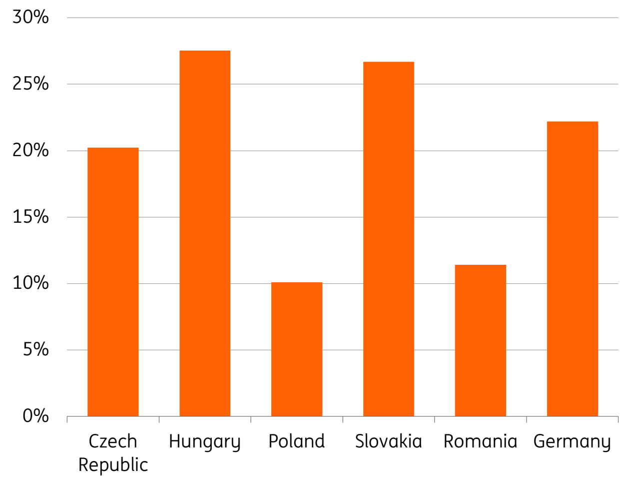
Fig 31 Value added by final destination -manufacturing



Source: OECD, ING

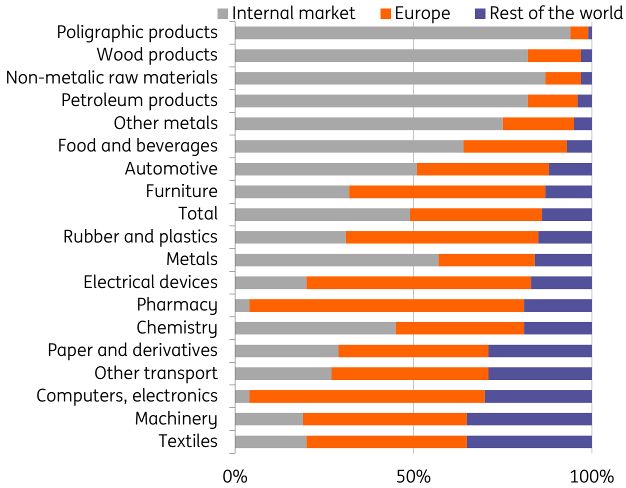
Importantly, Poland also has a far more diversified industry structure compared to CEE counterparts. Unlike other CEE economies, the low share of the automotive sector stands out. Value added of motor vehicle production constitutes just 10% of manufacturing in Poland, while the remaining CE4 average is 25%, even higher than in Germany - 22% (see Figure 32). In terms of the structure of Polish industry, based on the final destination of value added from domestic manufacturing, there are no key branches where non-European export demand is higher than demand from the EU (although it comes close for manufacturing of textiles and machinery). For a detailed list please see Figure 33 (based on University of Groningen data).

Fig 32 Share of automakers in total value add of manuf.



Source: OECD, ING

Fig 33 Final destination of Polish manufacturing products



Source: University of Groningen, ING

German and Eurozone internal demand performed substantially better than manufacturing. This in turn helped Polish industries heavily reliant on core EU markets, such as the manufacture of furniture.

Also, Polish manufacturing has a generally low exposure (both direct and indirect) to the UK compared to other CEEs, or Germany. This insulates Polish industry somewhat ahead of Brexit. However Polish exposure to UK services is among the highest in EU. This includes trade and export-oriented transport services.

In sum, a strong reliance on internal demand, both domestic and in the eurozone, as well as a diversified industry structure has largely sheltered Poland from the slump in German production so far. However, leading indicators suggest that this period may be coming to an end. Here we are concerned by the PMI leading indicator for Eurozone services, often considered a proxy for internal demand – this shows signs of weakening.

Policy mix and EU co-financed investment cycle

Domestic fiscal easing, PLN depreciation and an inflow of EU funds are also crucial factors sheltering Poland from global slowdowns in the past and also now.

Private spending growth has not fallen below 3.5% YoY since 1H16

We estimate the 2019-20 package of election social spending at about 1.5% of GDP (gross 2% of GDP, but partially offset by new revenues). The ruling PiS decided to introduce significant social benefits, which helped to maintain the longest consumption boom since Poland's accession into the EU. Private spending growth has not fallen below 3.5% YoY since 1H16 and we expect this level of growth at least until the end of 2020, which makes domestic consumption the main GDP driver.

In the past, public investments induced by EU funds usually partially coincided with periods of poor activity either in Europe or globally. Poland also undertook a massive investment programme ahead of the EURO 2012 football event hosted jointly by Poland and Ukraine. In tandem with loose fiscal policy it resulted in a significant fiscal stimulus in 2008 and 2009 (respectively 1.5% and 3% of GDP based on OECD data).

EU co-financed investment cycle started in 2018 and is already at its peak

This time around, the EU co-financed investment cycle started in 2018 and is already at its peak. We don't think that growth of EU funds will stay as high as the 70% seen in 2018. In 2019, growth should be single digit and money paid should decrease slightly in 2020, but continued high outlays are expected to last up to 2023.

That should support employment and household propensity to spend, adding to Poland's economic resilience to the Eurozone/German slowdown.

Romania: the first to sneeze?

Despite a slightly lesser degree of synchronisation with the Eurozone economy than its CEE peers, our impulse response analysis shows that Romania is most exposed to German output. This can be explained by the peripheral role on the German value chain, low bargaining power of Romanian exporters due to their size, labour intensive exports and relative real FX appreciation versus peers over recent years.

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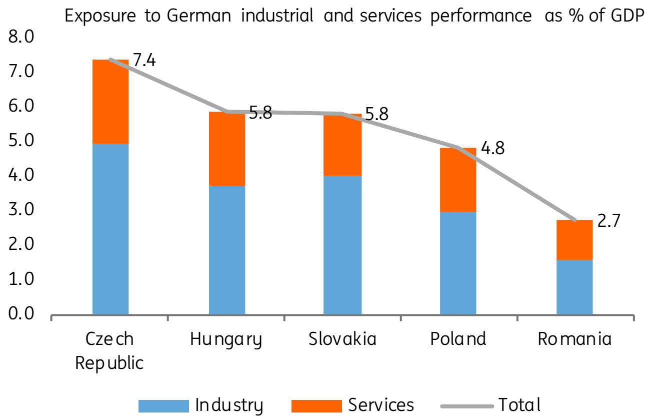
Compared to most of its CEE peers, Romania's economic integration with the Eurozone's economy has started with a lag. Romania was admitted into the European Union in 2007, three years later than the Visegrad group. After admission, it didn't really have time to enjoy the benefits right away as almost all of Europe was soon to be in the grip of the Global Financial Crisis (GFC) of 2008-09.

Nevertheless, economic integration moved ahead, and the importance of the EU for the Romanian economy has grown over the years as the country became integrated into the Continental supply chains. Looking into details, the 'German dominance' has been working for Romania as well as for the rest of the CEE countries, with the importance of the German market growing considerably in recent years. As of 2018, 23% of Romania's exports and 21% of imports were to/from Germany.

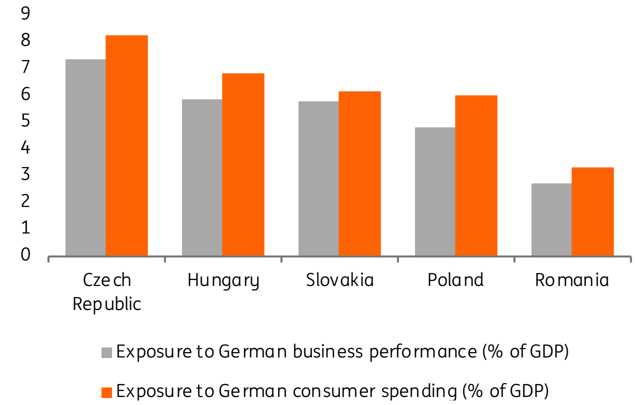
However, Romania is evidently not as much at risk as peers in terms of being Germany-dependant. According to OECD data, only 2.7% of economic output is used as an input in the German economy, far less than the 7.4% for the Czech Republic. Focusing on sector levels, Romania's position also appears to be slightly more balanced than its regional peers, as output is a touch more evenly spread between exposure to Germany's industrial performance (1.5% of GDP) and Germany's services performance (1.1% of GDP).

Fig 34 Dependency on German business performance



Source: OECD, ING calculations

Fig 35 Supply or demand side, not much of a change



Source: OECD, ING calculations

We argue however, that despite this lesser degree of direct relationship with the German economy, Romania is likely to be the country most hit by a more severe Eurozone/ Germany slowdown for reasons we explore below.

The good

One sector driving economic resilience and preventing the trade balance from widening out of control is the **auto sector**. Turnover in the sector expanded from around €7.5bn in 2007 (year before the GFC) to €28bn in 2018. Even considering the very strong nominal growth of recent years, the sector's share in GDP more than doubled during this time, to c.13% in 2018. One reason for this success is that Romania has been particularly well positioned, with Renault's low cost Dacia brand enjoying a remarkable success. From this point of view, Romania is probably best placed to face a slowdown as the elasticity of demand will likely increase, favouring lower cost cars. The other important car manufacturer, Ford, has only recently begun production of more premium vehicles so there isn't much downside potential from current production levels. All considered, Romanian OEMs will probably feel the least impact of an external slowdown compared to CEE peers. However, it is worth noting that Romania has the second highest share of automotive employment in total manufacturing from the EU. Hence it is plausible to assume that some layoffs will be faced.

"Turnover in the auto sector has expanded from around €7.5bn in 2007 to €28bn in 2018"

Consumers have remained generally optimistic, putting a greater emphasis on the double digit wage growth they've been enjoying for the past four consecutive years

Another factor of resilience is, in our view, the **consumers**. Faced with a fair amount of negative news in recent years (both internal and external), consumers have remained generally optimistic, putting a greater emphasis on the double-digit wage growth they've been enjoying for the past four consecutive years. Given the electoral context that will last until late-2020, we see a high probability for double-digit wage (and pensions) growth to continue. This will support private consumption which has been the main growth pillar for several years already. Relatively low indebtedness rates are also a mitigating factor when it comes to Romania's economic reaction in the face of a slowdown. Financial intermediation (credit/GDP) is the lowest in the EU (26% in 2018).

The bad

Romania could be far more severely hit by an external slowdown than CEE peer countries

As mentioned, we believe that Romania could be far more severely hit by an external slowdown than its CEE peers. This might come via less direct channels rather than the straightforward external demand. **Limited fiscal space** to prop the economy is at the top of our aggravating factors list. For the fourth year in a row, the Romanian government will be struggling to meet the -3.0% of GDP target in order to avoid the Excessive Deficit Procedure activation. These deficits have been built during good economic times, when in fact some fiscal buffers should have been created. The share of rigid spending (wages plus pensions) in total revenue has been reaching historical highs, which will make fiscal adjustments a complex issue for future governments.

Next to fiscal policy is the **constrained monetary policy despite relatively high interest rates**: inflation is already above target and there are limited prospects of a meaningful consolidation at lower levels. On the other hand, the Romanian leu became increasingly overvalued in relative terms while the twin deficits call for a currency depreciation. With the political scene set to remain heated in 2020 as well, the best the NBR can do is to keep things in balance and forget about stimulus for now.

Romania remains most sensitive to market sentiment and arguably has the highest rating sensitivity to deteriorating debt metrics among CEE peers

Somewhat related, **relatively high financing needs** are lengthening our negative factors list. Although the gross financing needs should remain relatively the same in 2020 compared to 2019 (c.RON78bn on the local market and c.€4bn in Eurobonds), Romania remains most sensitive to market sentiment and arguably has the highest rating sensitivity to deteriorating debt metrics among CEE peers. In addition, surpassing the 3.0% of GDP budget deficit will certainly increase the level of scrutiny it gets from investors. Hence, higher financing costs for the economy.

As history has shown, the Romanian economy tends to grow above average when the global context is favourable but also to contract abruptly when things turn negative. This is due to pro-cyclical policy behaviour. The result of impulse response function has shown higher sensitivity to German industry. This could be explained by the size, labour intensity and peripheral position on the German value chain of the Romanian exporters.

Russia: following its own path

The German/EU slowdown, provided it does not escalate into a broader global downturn, is not a big concern for Russia, because Russia's growth has decoupled since 2014, export mix is oil-heavy, trade partner geography has shifted from West to East, and the fiscal position allows room for stimulus if need be.

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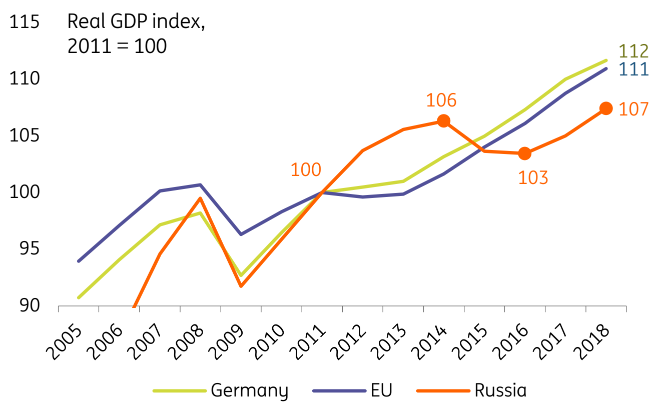
Russia's growth trend decoupled from the EU some time ago. Russia showed little response to the 2011-13 slowdown in the EU and has since posted a geopolitics driven drop in 2015-16 (forced redemption of foreign debt, currency depreciation, trade limitations) followed by a tepid recovery, which is limited, among other things, by internal structural constraints.

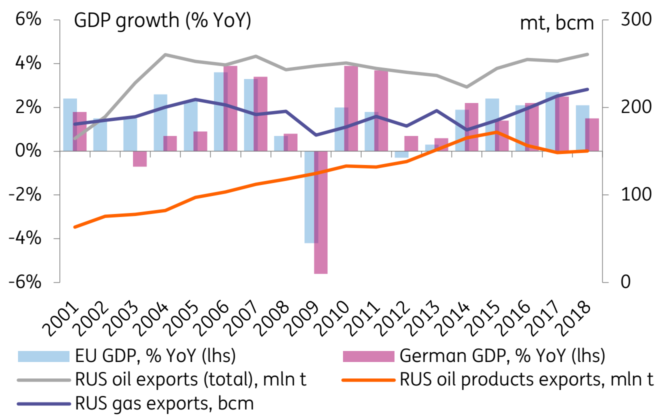
Russia's export mix is dominated by fuel (60-70%), which is resilient in terms of volumes. Oil supplies are more-or-less flat in physical volumes, while gas supplies are driven by the development of the pipeline projects. The EUR value of exports to Germany/EU fluctuates in line with oil price changes, not German/EU GDP growth.

Fig 36 Index of GDP in 2005-18, 2011=100



Source: IMF, ING

Fig 37 Russian fuel exports vs GDP growth of Germany and the Eurozone

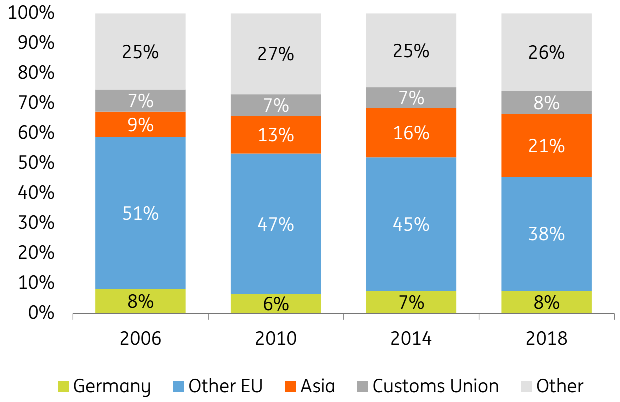


Source: IMF, Bank of Russia, ING

Russia has been diversifying its trade partner geography away from the EU in favour of Asia for quite some time now. The share of EU in Russian exports has dropped from 59% to 46% over 12 years, while the share of Asia (mainly China and South Korea) has increased from 9% to 21%.

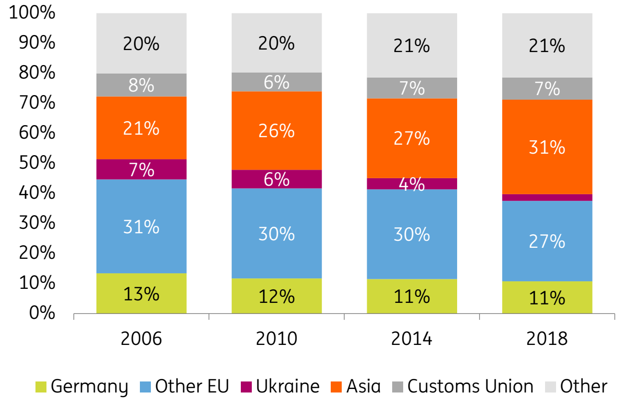
The share of EU in Russian imports dropped from 45% to 37%, mainly following the ban on food imports from the EU since 2015, while the share of Asia increased from 21% to 31%. Currently, Russia is seeking further diversification of its trade through closer cooperation with African countries, which should further limit the potential exposure to German/EU slowdown.

Fig 38 Structure of Russian exports by country



Source: IMF, ING

Fig 39 Structure of Russian imports by country



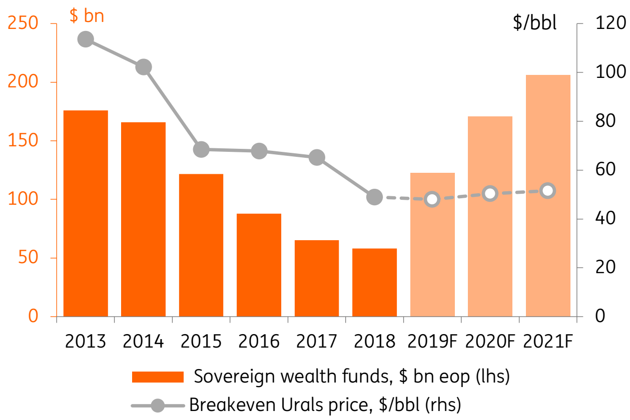
Source: IMF, Bank of Russia, ING

There is room for fiscal stimulus in Russia as a response to potential global slowdown. The budget breakeven oil price is currently around US$50/bbl, its lowest level since 2007, and is budgeted to remain close to that level for the next three years. Some modest increase in expenditures planned for 2020 is expected to be offset by an increase in non-oil revenue collection. Overall, since 2014, the budget policy has been conservative, aimed at rebuilding fiscal buffers.

Public debt is 10% of GDP (expected at 12% of GDP in three years) and state savings are 7% of GDP (expected at 13% of GDP in three years). In 2019-24, Russia is implementing its National Projects programme, representing targeted spending of 2.7-3.4% of GDP per year (70:30 public : private spending) on infrastructure : other areas in a 70:30 ratio, aimed at boosting hard infrastructure and human capital.

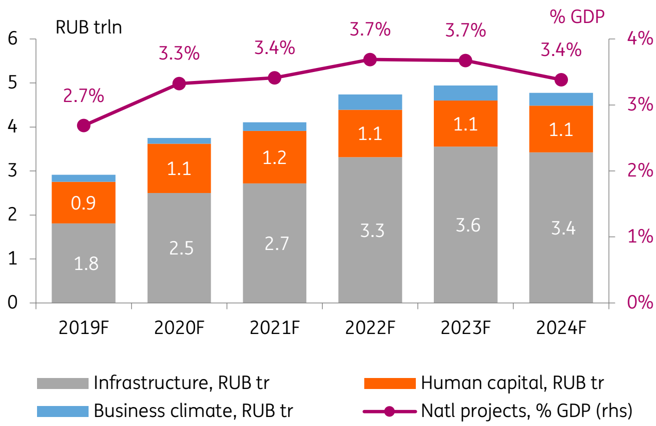
Fixed investments are planned to be increased from 22% to 25% of GDP. Additional spending/state investments are possible from the National Wealth Fund starting from 2020 to directly support local capex projects or to provide loans to Russia's export partners. The currently discussed sums are so far limited to 0.3% of GDP per year, but could be increased if needed.

Fig 40 Russian fiscal savings and oil breakeven



Source: Finance Ministry, ING

Fig 41 Timeline of the Russian 'National Projects'



Source: IMF, Finance Ministry, media, ING

Turkey: a turnaround story

After an unsurprising adjustment following the financial shock last year, we have seen a remarkable turnaround in Turkey's core trade balance this year - driven by both import compression and a better performance of exports. Accordingly, net exports have positively contributed to GDP growth in the last five quarters, while the lift to growth in 1Q19 was one of the highest in recent history. That said, this contribution from net exports to growth is slowing down.

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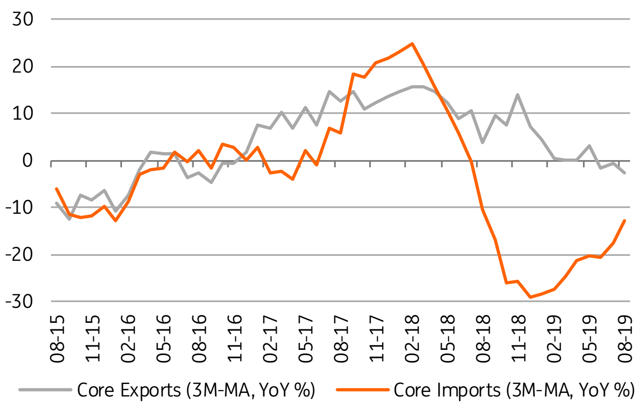
The global slowdown, especially in European economies, is likely to weigh on external demand going forward due to a relatively higher share of EU in Turkey's exports.

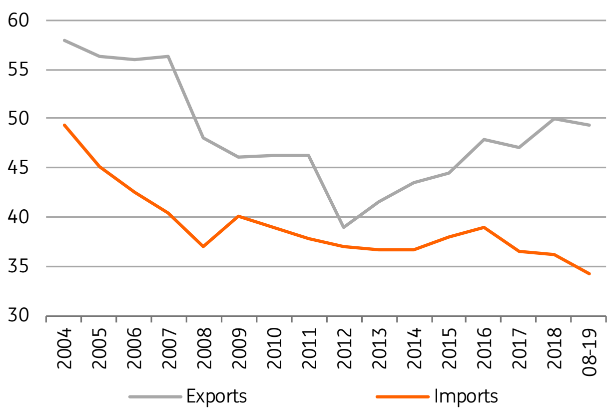
However Turkey's exposure to German weakness is to some extent limited. This is because Turkey has been intensifying its efforts to diversify its trade partners with a special focus on MENA. For example, the EU share of Turkey's exports, once close to 60%, is relatively lower now and the top three trade partners' share in manufacturing has been declining.

Fig 42 Core exports and imports



Source: TurkStat, ING

Fig 43 Trade with EU (% share in total)



Source: TurkStat, ING

Despite external rebalancing coming to an end, growth is expected to further rebound next year, led by a recovery in private consumption and investment - this thanks to the demand management policies of the government.

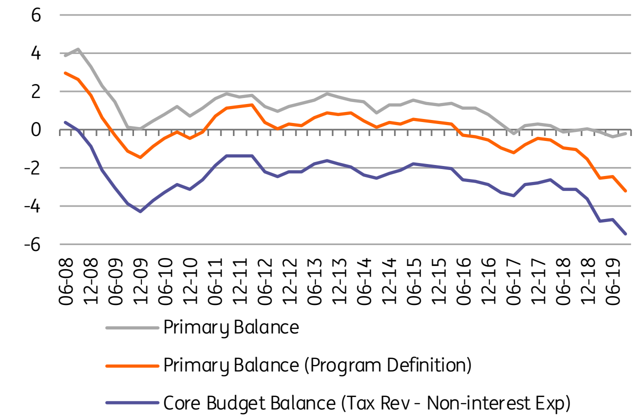
Credit growth has slowed since early 2018, driven by private banks even as public peers try to offset part of the lending crunch. However, the credit impulse will likely turn to positive in 2H19 given the lower rate environment and lending incentives by linking required reserve ratios and remunerations to credit growth.

The recent banking sector data shows signs of loan growth recovery, primarily driven by the state banks, though the private banks are also now signalling their intention to join the trend with an acceleration in consumer lending and improving appetite in local currency TRY corporate loans.

As an additional note, fiscal prudence has been one of Turkey's main policy characteristics in recent years, leading to a primary balance in surplus and the budget deficit around 1.0-1.5% of GDP range until last year.

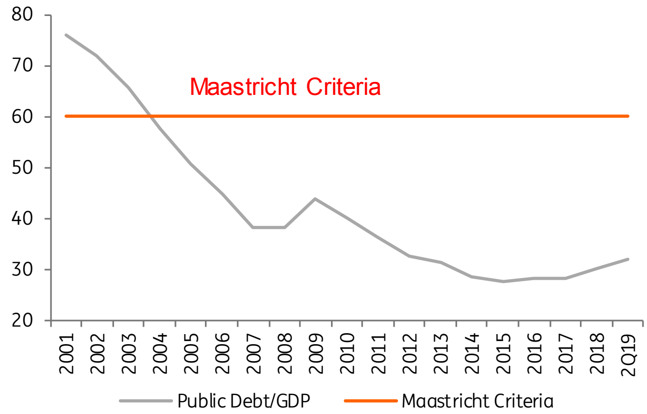
Similarly, continued fiscal discipline has led to a significant improvement in public debt dynamics with the ratio of public debt to GDP standing at 32.2% in Jun-19. This backdrop provides a fiscal space that can be utilised to support growth - as has been the case since early 2018. However, higher funding needs and likely debt rollover pressures, as well as uncertainty over the extent of contingent liabilities, should be factors which limit the available fiscal space.

Fig 44 Budget performance (as % of GDP)



Source: Ministry of Treasury and Finance, ING

Fig 45 Government debt stock*



*Defined by EU Standards
Source: Ministry of Treasury and Finance, ING

All in all, we expect a continuation of the Turkish recovery with further policy stimulus to boost demand, while policy rate cuts, already delivered by the CBT should also support growth.

Turkey is therefore a turnaround story from the significant rebalancing process after last year's financial volatility, and once again the turnaround will be driven by local factors.

CEEMEA FX valuation

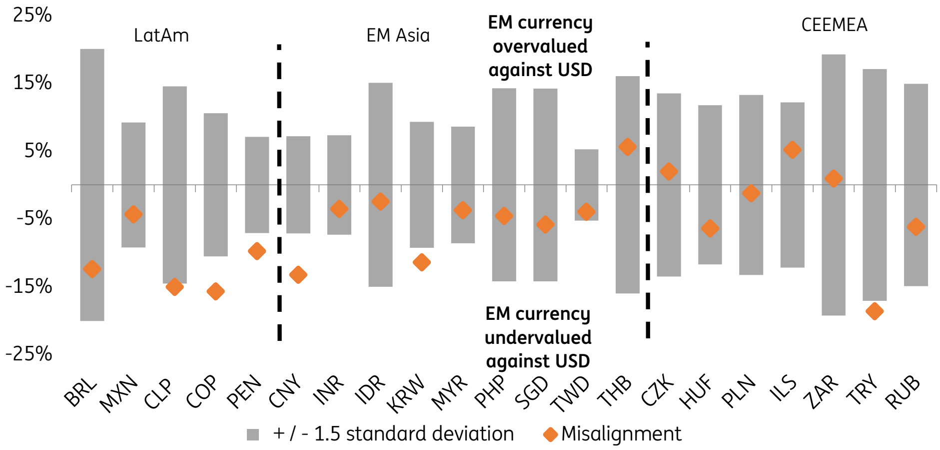
Embracing the diversity

- **Unlike Latam and EM Asia FX, the CEEMEA region offers a clear valuation diversity, hosting the most expensive (ILS) and the cheapest (TRY) EM currencies**
- **This diversity is also present within the CEE FX space. While HUF is the cheapest currency, CZK screens modestly overvalued. PLN is in the middle, modestly cheap**
- **Modest ZAR richness makes it the least attractive high yielder in the CEEMEA and wider EM space on a valuation basis. No other EM high yielder is expensive vs USD**

We find that the CEEMEA region offers the greatest valuation diversity in the EM space based on our BEER valuation framework[1]. As Figure 46 shows, while all Latam and most EM Asia currencies are undervalued vs the dollar, in the CEEMEA space only around half the currencies are cheap vs the dollar while the other half are expensive[2]. Within the CEEMEA space, the divergence is present both sub-regionally (ie, among CEE FX) and within each of the two currency type buckets (ie, high yielders and low yielders).

Fig 46 The CEEMEA region offers the biggest valuation diversity in the EM space

%, Real exchange rates misalignments (EM FX against USD) vs their BEER fair values



Source: ING

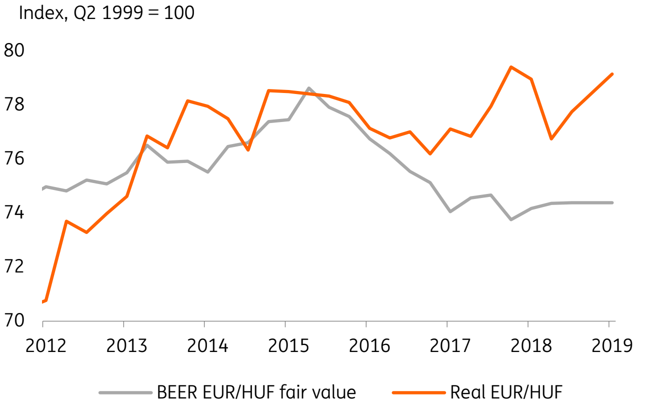
HUF: The cheapest CE3 currency

In the low yielding CEE FX space, HUF is the cheapest currency. This is both a function of the pronounced currency decline that started last year and the modest increase in the forint fair value (which was the largest among CE3 currencies over the past 3-4 years). On the latter, although the Hungarian current account dynamics deteriorated over the past few years (with the current account position turning from a meaningful surplus to a deficit) and contributed negatively to the forint fair value, the HUF fair value in fact increased (Figure 47) given the rise in labour productivity and terms of trade (vs EZ) which more than offset the negative (for HUF) current account dynamics. This is evident in Figure 48 where we show a decomposition of the drivers behind the EUR/HUF BEER fair value. Looking ahead, we expect the Hungarian labour productivity growth to slow, reflecting the lower output of the economy. This in turn suggests a lower pace of the forint fair value appreciation going forward.

[1] To gauge the medium-term valuation for the EM currencies, we employ our Behavioural Equilibrium Exchange Rate (BEER) valuation framework, where we model currency fair values based on variables such as terms of trade, productivity and current account dynamics, among other things. More details are available on request

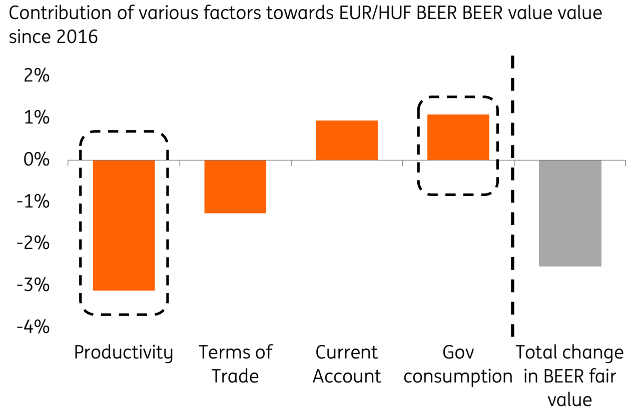
[2] In Figure 1, we show CEE FX mis-valuation vs USD (for an easier comparison vs other EM currencies). As our estimates suggest that EUR/USD is currently fairly valued (see G10 FX valuation: Why the dollar is not screamingly expensive for more details), the CEE FX mis-valuation vs USD is not dissimilar to the one vs EUR.

Fig 47 EUR/HUF has been decoupling from the HUF spot



Source: ING

Fig 48 Productivity offset the deteriorating current account

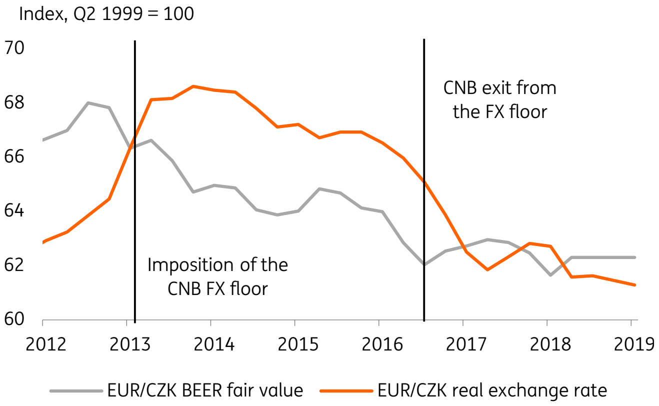


Source: ING

CZK: Modestly rich as the fair value improvement stalled after the FX floor exit

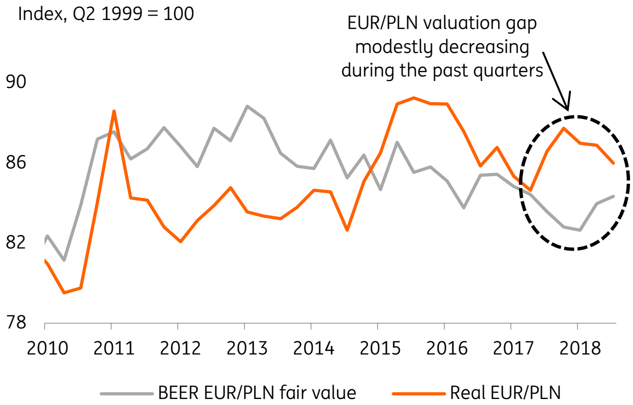
In contrast, the CZK screens as modestly expensive vs EUR, by around 1.5%. This suggests a EUR/CZK fair value at around 26.00. As Figure 49 shows, the pick-up in the koruna's fair value vs the euro (largely generated during the FX floor period and primarily driven by the improvement in the relative labour productivity) stalled after the CNB exit from the FX floor, with EUR/CZK: (1) catching up with its BEER fair value within three quarters after the FX floor exit; and (2) stabilising around its fair value since then (which in turn translated into a stable EUR/CZK trading range). The modest CZK overvaluation and the still saturated one-way positioning suggests, in our view, a limited upside to CZK. Moreover, with the transmission mechanism from the interest rate channel into the exchange rate muted/broken, the bar for an idiosyncratic/non-externally driven CZK rise remains high.

Fig 49 Rise in CZK fair value stalled since the FX floor exit



Source: ING

Fig 50 The zloty valuation gap is closing



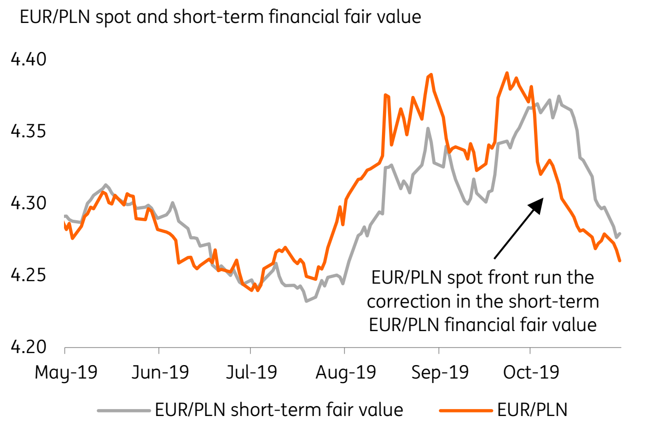
Source: ING

PLN: Not far away from the fair value with the FX mortgage risk premium vanishing

PLN remains modestly undervalued vs the euro, yet as Figure 50 shows, the level of the mis-valuation has been gradually decreasing over recent quarters as the zloty real exchange rate and its fair value converged. This was on the back of: (1) real EUR/PLN declining due in part to a modest inflation-related real PLN appreciation; and (2) modestly rising EUR/PLN fair value (that is a decline in the zloty fair value).

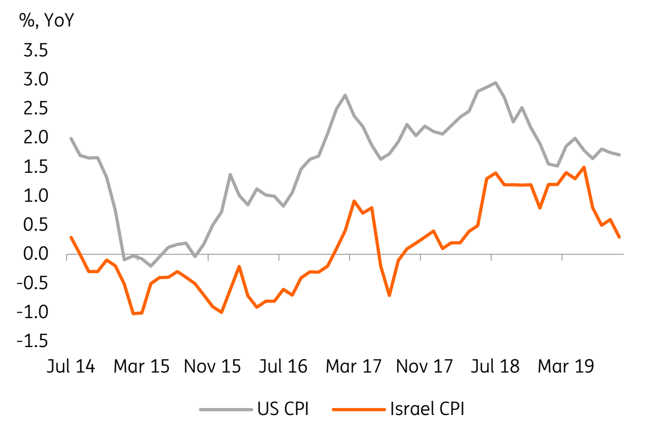
On a short-term basis, the risk premium associated with Poland's FX mortgage uncertainty all but disappeared after the PLN's rally throughout October. As Figure 51 shows, EUR/PLN currently trades modestly undervalued on a short-term valuation basis, suggesting a modest overshoot related to the PLN short squeeze after the ECJ ruling on the FX mortgage matter in early October. Indeed, as the same figure shows, the EUR/PLN spot front ran the correction in the short-term EUR/PLN financial fair value, with the latter only gradually catching up with the meaningful move in the spot.

Fig 51 Risk premium related to FX mortgage story priced out



Source: ING

Fig 52 Israel inflation persistently undershooting US CPI

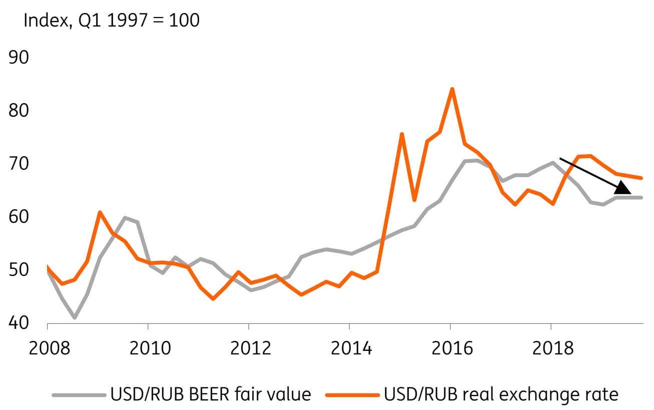


Source: ING, Bloomberg

ILS: The most expensive currency in the EM FX complex

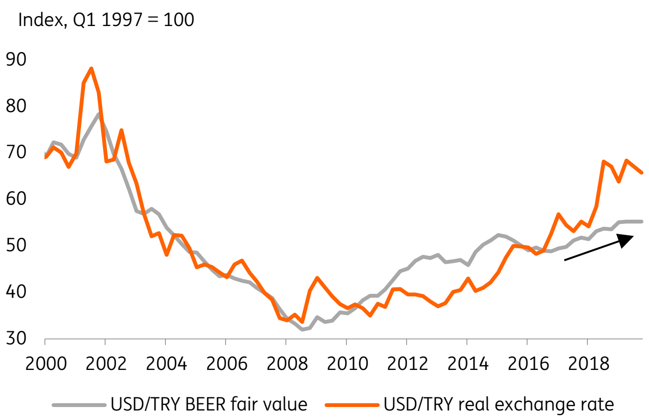
ILS is the most expensive CEEMEA currency, being overvalued by around 5% vs USD (as per Figure 1). ILS has been persistently overvalued vs the dollar since 2016, even if the low domestic inflation (vs higher US CPI) actually translated into the ILS depreciation against the dollar in real terms via the inflation channel. This is evident in Figure 52, depicting persistently lagging Israel inflation vs the US prices. Still this was not enough the offset the nominal FX appreciation (with ILS being one of the top performing currencies globally this year). With Israel inflation well below the target and the currency being overvalued (the most overvalued currency in the CEEMEA space as well as in the entire EM FX complex), the bar for the BoI to cut interest rates is rather low.

Fig 53 Terms of trade behind in the rise RUB fair value



Source: ING

Fig 54 USD/TRY BEER fair value on a constant uptrend



Source: ING

RUB: Only modestly undervalued vs the dollar

RUB screens modesty undervalued against the dollar, but the scale of undervaluation is in fact muted relative to its wide 1.5 standard deviation band (as Figure 46 shows). As Figure 53 shows, USD/RUB fair value declined since the start of 2018, primarily driven by the relative improvement in Russian terms of trade vs the US, which along with the government consumption, has been the key variable contributing to the variation in the rouble fair value over recent years (vs the fairly muted effect of the labour productivity and the current account variables).

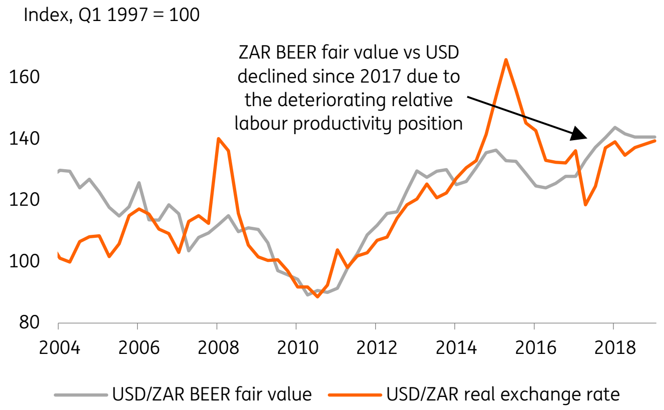
While we are modestly constructive on RUB for this year and next, the degree of overvaluation and the eventually weakening BoP dynamics should tame the rouble upside later next year. Still, from the carry prospective, RUB remains attractive.

TRY: One of the cheapest in the EM space but inflation to erode the valuation gap

TRY remains the cheapest currency in the CEEMEA region, being undervalued against USD by around 19%. While meaningfully below its fair value, we have already seen a non-negligible correction over recent quarters, with real USD/TRY declining due to the mix of the TRY rebound vs USD (in nominal terms) in late 3Q/early 4Q18 and the meaningful inflation differential translating into real lira appreciation.

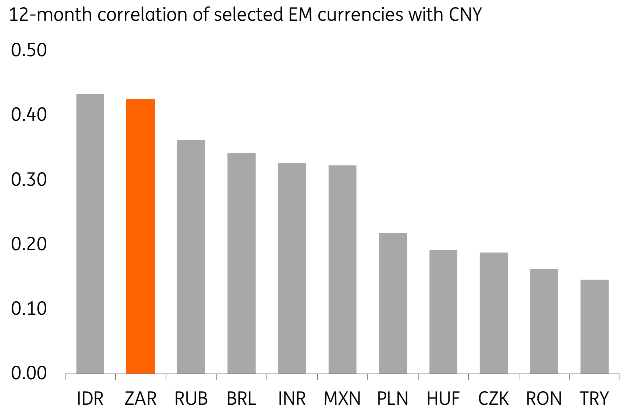
As is apparent in Figure 54, the USD/TRY BEER fair value has been on a constant uptrend (meaning that the lira equilibrium value has been falling), with its rise over the past quarters largely attributable to the relative terms of trade dynamics (in this case, improving US terms of trade and declining Turkish terms of trade). While we have seen the Turkey CPI falling sharply this year and now being below 10% YoY, we expect inflation to stabilise from here and in fact modestly rise, averaging around 11% next year.

Fig 55 Labour productivity behind fall in ZAR fair value



Source: ING

Fig 56 ZAR exerts high correlation with CNY



Source: ING, Bloomberg

This means that in the absence of nominal lira depreciation, the lira would appreciate in real terms via the inflation channel (by around 9% vs the dollar based on the projected inflation differential vs the US for the next year) and, coupled with the deteriorating lira fair value, the valuation gap would close further. This suggests that even without a nominal lira appreciation, the current valuation gap would close within two years. This, in our view, opens a scope for an ongoing lira depreciation in nominal terms as the valuation ceiling on USD/TRY will naturally decline due to the still high inflation differential that leads to the TRY appreciation in real terms.

ZAR: The least attractive high yielder globally on valuation basis

From a valuation prospective, ZAR is the least attractive high yielder in the CEEMEA space (as well as globally) as it currently screens as modestly expensive/close to the fair value vs the dollar (in contrast to cheap RUB and very cheap TRY). As Figure 55 shows, we have observed a non-negligible decline in the ZAR BEER fair value vs USD since 2017, with the deteriorating relative labour productivity position being the key driver behind the drop in the rand's fair value.

This, coupled with the recent change in Moody's credit rating outlook to negative (and possibly a downgrade next year) due to the disappointing Medium Term Budget Policy Statement, makes us cautious on ZAR, albeit the key driver for the rand in coming weeks/months will be the US-China trade situation. As Figure 56 shows, ZAR is one of the most sensitive EM currencies to the fluctuation in CNY - currently acting as a gauge for the US-China trade war dynamics.

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CEE driving factors

No longer hiding at the front-end

- **The importance of the common factor as a driver of CEE asset prices has increased sharply for local rates but dropped for FX. In line with the price action this year, investors can no longer 'hide' from global factors at the front-end of CEE curves**
- **A resolution of the trade war uncertainty is needed for correlation of front-end rates with global factors to drop. Then the local central banks can execute on their current bias, leading to a re-correlation of front-end rates with domestic factors**
- **By contrast, the importance of the common factor for CEE FX should not decrease further as FX-relevant local stories are now less pressing. A possible resolution of the US-China trade conflict would benefit all CEE currencies due to the 'risk-on'**

CEE FX has become less driven by a common factor…

The divergence amongst regional EM FX valuations discussed in the previous article is also corroborated by our Principal Component Analysis (PCA) which estimates the common drivers of assets and the importance of these drivers over time.

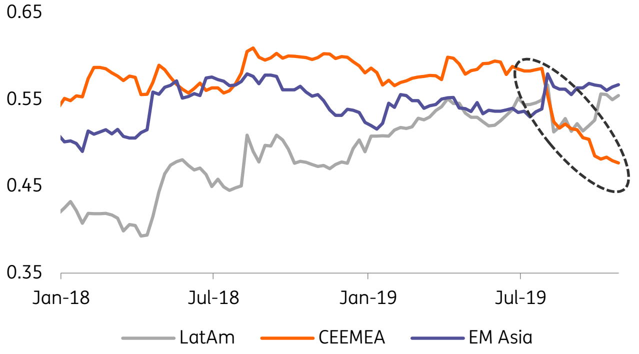
We find that while the importance of the first common factor (Principal Component 1: PC1), as a driver of regional currencies increased for Latam and Asian FX this year, the opposite has been the case for the CEEMEA region where the PC1 actually dropped (Figure 57).

The drop has been even more pronounced and more persistent (occurring since the beginning of the year) for the CEE currencies, where the decline in PC1 started earlier, as per Figure 58, and supports the notion of the diverging valuations (ie, cheap HUF, modestly expensive CZK) within the region discussed in the previous article.

Here the decreasing importance of the common factor as a driver behind CEE FX returns increases the scope for a variation in returns and thus a variation in valuation.

Fig 57 Importance of common factor dropped for CEEMEA FX

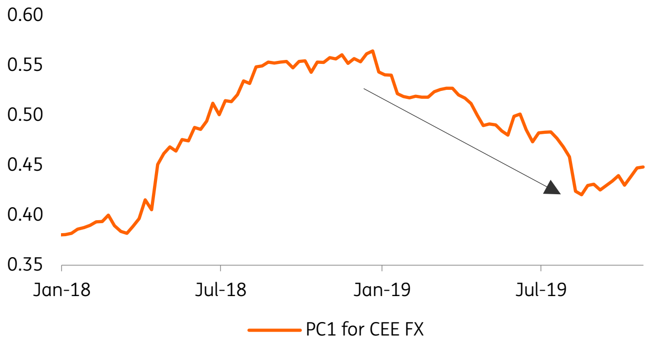
The importance of the first common factor as a driver of EM FX based on region. 1-year rolling first principal component (PC1) of weekly returns



Source: ING

Fig 58 For CEE FX the drop occurred on more persistent basis

The importance of the first common factor as a driver of CEE FX (CZK, PLN, HUF, RON). 1-year rolling first principal component (PC1) of weekly returns



Source: ING

The drop in the PC1 for CEE FX has reflected clear, FX-relevant idiosyncratic stories in the region. For example: market concerns about the central bank's stance in Hungary, the FX mortgage story in Poland and the one-way positioning in the CZK.

By contrast, the US-China trade conflict and CNY gyrations have been the clear, overriding driver for EM Asia FX, while higher beta Latam FX has been more susceptible to swings in risk appetite. Although global risk appetite was indeed an important driver of CEE FX, the strength of the domestic stories and their relevance for FX (rather than rates) have allowed for some divergence among the local currencies.

…while CEE front-end rates have become more interconnected

Interestingly, while the importance of the common factor for CEE FX has decreased, we have observed a rather meaningful increase in interconnectedness among the CEE IRS rates and across all the tenors (Figure 59).

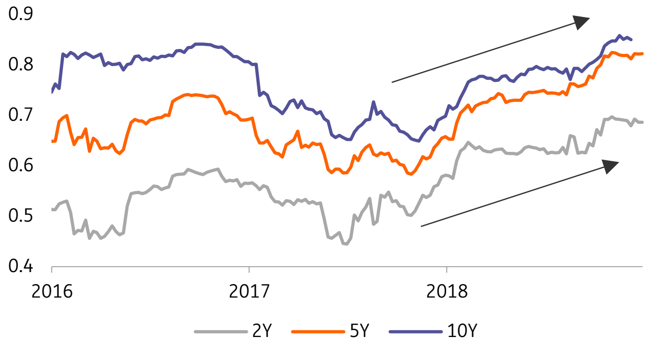
In particular, what is striking is the rise in importance of the first common factor as a driver of the short-end CEE rates (grey line in Figure 59). This implies that front-end CEE rates are no longer insulated from global drivers (which is quite rare for front-end rates - typically similar global factors tend to drive the moves in back-end rates).

As Figure 60 shows, the 2yr CEE IRS correlation with the 10yr Bund has risen sharply this year (this is particularly the case for CZK rates), being currently not far away from the levels of 10yr CEE IRS–10yr Bund correlation (Figure 61).

This is a remarkable change and is in stark contrast to the state of affairs last year when local front-end CEE rates were less driven by the common factor and showed more material intra-regional divergence.

Fig 59 Rise in interconnectedness among CEE rates

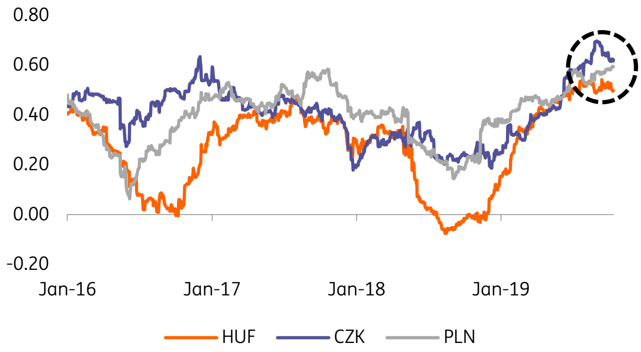
CEE IRS rates interconnectedness, 1-year rolling first principal component (PC1) of weekly returns for various tenors (2y,5y, 10y IRS)



Source: ING

Fig 60 Sharp rise in front-end CEE IRS correlation with Bund

CEE 2-year IRS 6-month rolling correlation with 10y bund



Source: ING

This shift from local to a common factor in our view reflects: (1) the top down approach investors have adopted on the back of trade war uncertainty and the (so far, ex-post incorrect) assumption that local central banks will follow global events/major central bank easing irrespective of the domestic situation. For example, the market briefly this summer priced 100bp of cuts for the CNB over a two-year time horizon, but is now focused on a November hike; and (2) lower liquidity in local markets exaggerated the moves and triggered stop-losses (ie, the collapse in CEE front end rates this August – Figure 62)

The trade war and the importance of the PC1 for CEE FX and CEE rates

As long as the overhang of trade wars (and the associated risks towards global trade and growth) remain in place, we expect the importance of the common factor (PC1) as a driver of the front-end CEE rates to remain elevated.

For their correlation with global drivers (such as 10yr Bunds) to remain high, the market will likely continue discounting local considerations (such as inflation or the central bank's bias) and rather focus on the possible spill-overs from global drivers into local monetary policy settings.

As has been very apparent so far this year, this in turn makes it more difficult to trade the front-end CEE rates on a risk adjusted basis. While one may be ex-post correct in terms of the view on the central bank, the increased inter-connectedness with global factors and the associated sharper moves increase the risk of (even a wide) stop-loss being hit. Unless we see a more meaningful improvement in the trade conflict, we expect the correlation of front-end CEE rates to global factors to remain elevated.

For CEE FX, however, we now see the scope for the importance of the common factor (PC1) to pick up again (after the reduction in recent months) and currencies to move more in tandem as, in our view, the key FX-relevant idiosyncratic stories have faded somewhat. Here the Polish FX mortgage issue seems less imminent and more protracted, while in Hungary the peak in headline CPI, and what it means for real rates, is behind us.

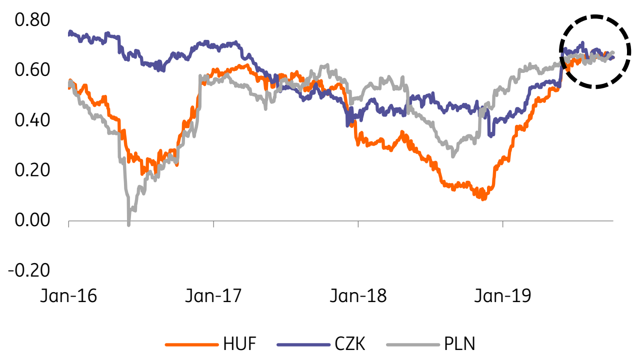
Even if the trade war situation is resolved, the importance of the common factor for CEE FX should not decrease any further (which in contrast is likely to be the case for CEE rates at the front-end) as the subsequent boost to risk appetite will benefit CEE FX across the board, keeping the importance of the first principal component elevated.

By contrast, the resolution of the trade war situation would allow for the divergence among the CEE central banks (CNB to hike, NBP not to cut and NBH not to hike provided the HUF is not depreciating).

Hence, in 2020 we look for a possible drop in the common factor as a driver of CEE front end IRS rates (allowing for differentiation) while we expect some modest increase in the common factor for local FX should we see some resolution of the US-China trade conflict.

Fig 61 10yr CEE IRS correlation with Bund near 2yr

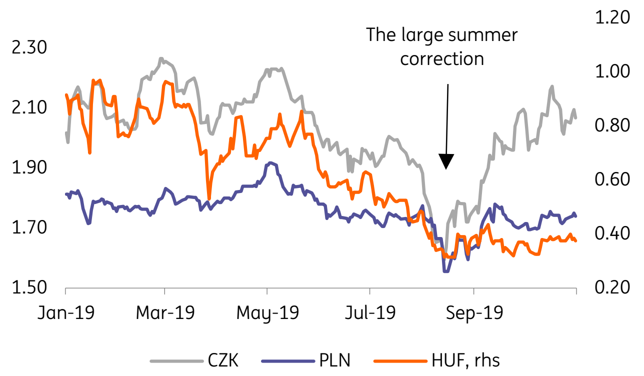
CEE 10-year IRS 6-month rolling correlation with 10y bund



Source: ING

Fig 62 Sharp moves in 2yr CEE IRS observed this summer

%, 2-year IRS for CEE countries



Source: ING, Bloomberg

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Countries

Azerbaijan

Dmitry Dolgin, Chief Economist, Russia & CIS

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	2.4	2.0	2.0	2.5	2.6	2.3	2.6
CPI (%YoY)*	3.0	2.6	3.0	2.8	3.00	2.6	3.0
Policy interest rate (eop, %)	8.50	8.00	7.75	7.50	7.25	7.75	7.25
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/AZN *	1.70	1.70	1.70	1.70	1.70	1.70	1.70
EUR/AZN *	1.93	1.85	1.82	1.87	1.90	1.89	1.92

Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▲	Presidential: 2025	S&P	BB+	BB+
Fiscal	Neutral	Parliamentary: 2020	Moody's	Ba2	-
Monetary	Neutral	Local: -	Fitch	BB+	BB+

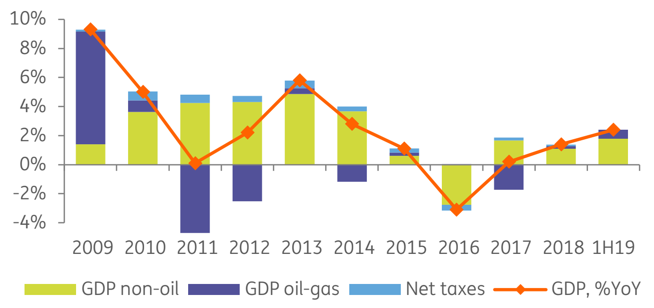
*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Country strategy

We believe Azerbaijan has a favourable near-term view, as new projects in the oil & gas sector are supporting exports and overall GDP growth, while the state's social spending is boosting local consumption without causing immediate threat to fiscal stability, which remains the country's key strength. Gradual de-dollarisation in the banking sector is a bonus, adding to market confidence.

Meanwhile, with the government's limited track record in structural reforms, we remain cautious on the fundamental trends, with no strong signs of diversification of the economic growth and financial flows, persisting risks to balance of payments from imports and capital outflows, and a still weak banking sector. A stable outlook on sovereign ratings despite fiscal strength underpins vulnerability to external and internal risks.

GDP and oil/non-oil contribution (% YoY, ppt)

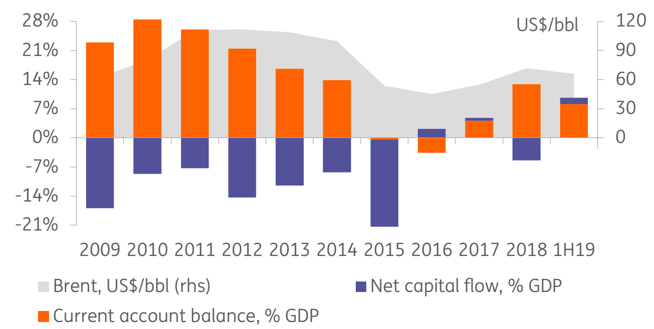


Source: CEIC, IMF, ING

GDP: growth supported by oil and social spending

GDP growth will pick up in 2019-20 thanks to oil and non-oil sectors (share in GDP is roughly 50/50). Non-oil will benefit from state social spending at 2.6% of GDP. Social spending has already led to a pick up of wage growth from 3% in 2018 to 9% YoY in 8M19, and pensions have increased 174% YoY. The near-term optimism on consumption for 2020 is supported by the 2020 parliamentary elections. Oil & gas will be boosted by gas exports from Shah Deniz-2 (37% of total exports) to Turkey via Southern Gas Corridor (up 28% YoY in 9M19). Further ramp up is expected to continue in 2020 with a subsequent slowdown given the retirement of older projects (ACG). Meanwhile, risks to the outlook are skewed to the downside due to possible delays in commissioning of new projects as well as general structural/political issues.

Balance of payments and Brent oil price (US$/bbl)

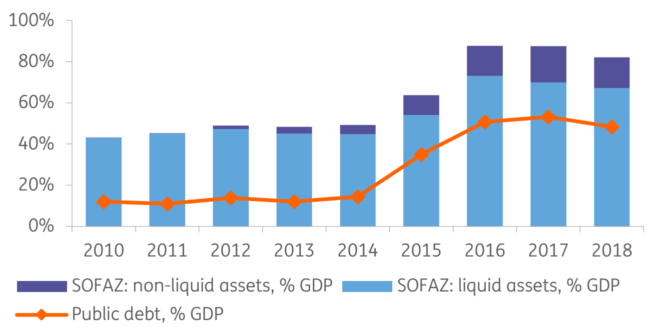


Source: CEIC, ING

Near-term risks to AZN low, may increase

With 90%+ of exports being fuel, the current account is heavily dependent on oil price. ING's view on the oil price combined with likely real growth in exports suggest a positive current account in 2019-21, however as each US$1/bbl of oil price brings c.US$0.3bn in export revenue, the vulnerability to oil price is high. Growing imports driven by consumption amid stable exchange rate is another pressure factor. Capital account, despite relatively stable FDI inflow of US$1-2bn pa, remains volatile on portfolio and corporate sides. While we see no signals for immediate AZN depreciation, FX stability beyond the two-year horizon would require diversification of exports and continued improvement in the corporate capital flows.

Key indicators of state savings and state debt



Source: CEIC, ING

Fiscal position – the key strength and a necessity

The spike in social spending is offset by a cut in other (mainly capital) expenditure, hence we have no near-term concerns regarding the fiscal position. Provided the government follows the new fiscal rule, budget breakeven will remain at around current US$50/bbl, ensuring budget surpluses and accumulation of the sovereign wealth fund (SOFAZ). Meanwhile, maintaining a tight fiscal approach is a necessity, given the high share (two-thirds) of oil revenue, low efficiency and transparency of spending, and high level of guarantees (31% of GDP) needed to maintain the banking sector. With over 70% of public debt FX-denominated, and banking sector running an open FX position, tolerance to AZN depreciation is low.

Azerbaijan

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (%YoY)	9.3	5.0	0.1	2.2	5.8	2.8	1.1	-3.1	0.1	1.4	2.3	2.6	2.3
Real oil GDP (%YoY)	14.0	1.8	-9.8	-5.1	0.9	-2.9	0.6	0.1	-5.3	0.5	1.5	2.2	2.0
Real non-oil GDP (%YoY)	3.7	7.7	9.4	9.7	9.9	7.0	1.1	-4.4	2.8	1.9	3.0	3.0	2.5
Investment (%YoY)	-18.7	21.2	27.3	18.0	15.1	-1.7	-11.1	-26.1	-2.6	-4.4	-1.0	-0.5	0.0
Industrial production (%YoY)	8.6	2.6	-5.0	-2.3	1.8	-0.7	2.4	-0.5	-3.4	1.5	2.9	2.9	2.8
Unemployment rate (year-end, %)	5.7	5.6	5.4	5.2	5.0	4.9	5.0	5.0	5.0	4.9	5.0	5.0	5.0
Nominal GDP (AZNbn)	35.6	42.5	52.1	54.7	58.2	59.0	54.4	60.4	70.1	79.8	84.0	88.8	94.4
Nominal GDP (€bn)	31.8	39.9	47.4	54.2	55.8	56.6	47.8	34.2	36.1	39.7	44.4	46.2	47.1
Nominal GDP (US$bn)	44.3	52.9	66.0	69.7	74.2	75.2	53.1	37.9	40.7	46.9	49.4	52.2	55.5
GDP per capita (US$)	4,923	5,807	7,142	7,447	7,825	7,843	5,469	3,860	4,117	4,703	4,892	5,121	5,391
Gross domestic saving (% of GDP)	46.1	49.8	52.6	50.0	47.8	43.7	30.9	28.5	31.1	36.6	33.8	31.6	30.2
Prices													
CPI (average, %YoY)	1.5	5.7	7.9	1.1	2.4	1.4	4.0	12.4	12.9	2.3	2.6	3.0	3.5
CPI (year-end, %YoY)	0.7	7.8	5.5	-0.3	3.6	-0.1	7.7	15.5	7.9	1.6	3.0	2.9	3.5
Wage rates (nominal, %YoY)	8.6	11.2	9.9	8.7	6.2	5.7	4.5	7.4	5.9	2.9	11.5	4.2	2.3
Fiscal balance (% of GDP)													
Consolidated government balance	n/a	n/a	n/a	n/a	3.1	2.9	-5.3	0.3	1.5	5.9	4.2	3.5	3.3
Consolidated primary balance	n/a	n/a	n/a	n/a	4.4	4.3	-3.8	2.4	3.8	8.7	7.0	6.1	5.9
Total public debt	n/a	n/a	n/a	n/a	n/a	14.4	35.0	50.7	53.2	48.4	48.4	46.8	42.40
External balance													
Exports (US$bn)	21.1	26.5	34.5	32.6	31.8	28.3	15.6	13.2	15.2	20.8	19.9	19.9	22.0
Imports (US$bn)	6.5	6.7	10.2	10.4	11.2	9.3	9.8	9.0	9.0	11.0	12.0	13.3	13.9
Trade balance (US$bn)	14.6	19.7	24.3	22.2	20.6	18.9	5.8	4.2	6.1	9.8	7.8	6.6	8.1
Trade balance (% of GDP)	32.9	37.3	36.9	31.9	27.8	25.2	11.0	11.1	15.0	21.0	15.8	12.7	14.5
Current account balance (US$bn)	10.2	15.0	17.1	15.0	12.2	10.2	-0.2	-1.4	1.7	6.1	3.7	2.5	3.8
Current account balance (% of GDP)	23.0	28.4	26.0	21.5	16.5	13.6	-0.4	-3.6	4.1	12.9	7.4	4.8	6.8
Net FDI (US$bn)	0.2	0.3	0.9	0.8	1.1	2.4	0.8	1.9	0.3	-0.8	2.3	2.2	2.3
Net FDI (% of GDP)	0.5	0.6	1.4	1.1	1.5	3.2	1.6	5.1	0.7	-1.7	4.6	4.3	4.2
Current account balance plus FDI (% of GDP)	23.4	29.0	27.4	22.6	18.0	16.8	1.2	1.5	4.8	11.2	12.0	9.1	11.0
Foreign exchange reserves ex gold (US$bn)	5.2	6.4	10.5	11.7	14.2	13.8	5.0	4.0	5.3	5.6	6.2	6.5	6.8
Import cover (months of merchandise imports)	9.5	11.4	12.4	13.5	15.2	17.7	6.2	5.3	7.1	6.2	6.2	5.9	5.9
Debt indicators													
Gross external debt (US$bn)	4.6	7.3	7.7	10.8	10.6	12.1	13.5	14.8	15.5	16.4	16.7	17.2	17.7
Gross external debt (% of GDP)	10.3	13.7	11.7	15.5	14.3	16.1	25.3	39.0	38.0	35.0	33.8	32.9	31.9
Gross external debt (% of exports)	21.6	27.4	22.3	33.2	33.3	42.8	86.3	111.8	102.1	79.0	84.1	86.4	80.5
Lending to corporates/households (% of GDP)	23.6	21.6	18.9	22.4	26.5	31.4	40.0	27.2	16.8	16.3	17.0	17.3	17.8
Interest & exchange rates													
Central bank key rate (year-end, %)	2.00	3.00	5.25	5.00	4.75	3.50	3.00	15.00	15.00	9.75	7.75	7.25	7.00
Broad money supply (average, %YoY)	-0.3	24.3	32.1	20.7	15.0	11.8	-1.1	-2.0	9.0	11.3	7.2	6.0	6.2
3m interest rate (Bakibor, average, %)	15.9	12.1	9.6	7.8	9.7	10.8	9.2	13.5	n/a	n/a	n/a	n/a	n/a
3m interest rate spread over US$-Libor(ppt)	1050	752	841	703	829	1027	894	1324	n/a	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/AZN exchange rate (year-end)	0.80	0.80	0.79	0.79	0.78	0.78	1.56	1.77	1.70	1.70	1.70	1.70	1.70
USD/AZN exchange rate (average)	0.80	0.80	0.79	0.79	0.78	0.78	1.02	1.60	1.72	1.70	1.70	1.70	1.70
EUR/AZN exchange rate (year-end)	1.16	1.07	1.02	1.04	1.08	0.95	1.70	1.87	2.04	1.95	1.82	1.96	2.04
EUR/AZN exchange rate (average)	1.12	1.06	1.10	1.01	1.04	1.04	1.14	1.77	1.94	2.01	1.89	1.92	2.01
Brent oil price (annual average, US$/bbl)	63	80	111	112	109	100	54	45	55	72	65	62	68

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	1.9	3.0	2.4	2.0	2.0	2.5	2.6	2.6	2.7	2.3	2.2	2.4	2.3
CPI (eop, %YoY)	1.6	2.7	3.0	2.6	3.0	2.8	3.00	3.10	2.90	2.80	2.70	2.70	2.60
Central bank key rate (eop, %)	9.75	9.00	8.50	8.00	7.75	7.50	7.25	7.25	7.25	7.00	7.00	7.00	7.00
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/AZN exchange rate (eop)	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
EUR/AZN exchange rate (eop)	1.95	1.91	1.93	1.85	1.82	1.87	1.90	1.92	1.96	1.97	1.99	2.01	2.04

Source: National sources, ING estimates

Bulgaria

Ciprian Dascalu, Chief Economist, Romania & Balkans

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	3.5	3.5	3.3	2.8	3.1	3.4	3.0
CPI (%YoY)*	2.8	2.8	3.2	2.8	3.5	3.0	3.4
Policy interest rate (eop, %)	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 (%)*	0.45	0.40	0.40	0.40	0.40	0.55	0.40
USD/BGN	1.67	1.70	1.78	1.78	1.70	1.77	1.55
EUR/BGN	1.96	1.96	1.96	1.96	1.96	1.96	1.96

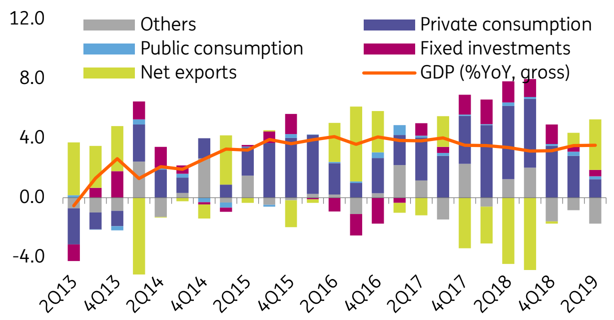
Macro Trend		Political Cycle	Ratings	FC	LC
Activity		Presidential: Nov 2021	S&P	BBB-	BBB-
Fiscal	Neutral	Parliamentary: April 2021	Moody's	Baa2	Baa2
Monetary	Loose	Local: Oct 2019	Fitch	BBB	BBB

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

Country strategy

Strong fiscal metrics were rewarded by rating agencies and further upgrades are likely after the ERM-II announcement which has been delayed by the political changes at the head of the EU following the European elections. GDP growth has so far shrugged off weaker external demand but lagged contagion effects are likely to kick in. The budget deficit is likely to post a one-off deterioration this year due to spending on fighter jets, ending three consecutive years of surpluses. The government targets a balanced budget next year. We expect a mild deficit of -0.5% of GDP in 2020 as the government is likely to spend more to offset the economic slowdown. The economy is also benefiting from ECB stimulus as it automatically imported under the currency board FX regime.

More balanced GDP growth backdrop

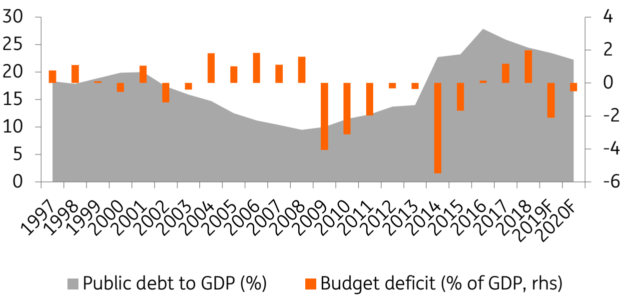


Source: NSI, ING

Economy has so far shrugged off weaker external demand

GDP expanded by 3.5% YoY in the first two quarters of the year. Details point to a more balanced structure. Household consumption expanded by 2.8% YoY in the second quarter, adding 1.2ppt to the 3.5% figure, and is no longer the main growth driver as weaker demand for imports and still solid exports turned net exports into the main contributor to GDP growth, adding 3.4ppt. Less positive is that gross fixed capital formation slowed materially to 2.2% YoY in 2Q19 vs 6.5% in 2018 and added only 0.4ppt to growth. We see a weaker growth ahead, but the contraction in the manufacturing sector is likely to be offset by higher EU funded investments and fiscal stimulus via higher wages/pensions to prop up consumption.

History of sound fiscal policy contained public debt levels



Source: AMECO

Turning to a deficit after three consecutive surplus years

Parliament approved an increase in the budget shortfall from -0.5% of GDP to -2.1% for 2019 to make room for the purchase of fighter jets. This is a one-off and is unlikely to affect medium-term sound fiscal performance. In fact, the government is likely to target a balanced budget execution for 2020. European elections back in May saw the main ruling coalition party (GERB, centre-right) posting some decline in voters' preferences versus the general elections, but its lead versus the main opposition party (BSP, left) actually widened. This should offer some comfort to the government and avoid a populist decision that could weaken the fiscal position in the coming years with general elections due in May 2021.

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	3.0	2.5
Private consumption (% YoY)	-4.4	1.1	1.9	3.0	-2.2	2.6	4.2	3.7	4.5	7.2	4.0	3.8	3.0
Government consumption (% YoY)	-5.9	2.0	2.2	-2.0	0.6	0.2	1.3	2.2	3.7	4.7	12.2	8.3	5.5
Investment (% YoY)	-17.7	-17.7	-4.4	1.8	0.3	3.4	2.7	-6.6	3.2	6.5	2.8	5.2	4.5
Industrial production (% YoY)	-18.3	1.9	6.2	-0.4	-0.1	2.1	2.8	2.7	3.9	1.1	0.8	1.0	1.8
Unemployment rate (year-end, %)	6.9	10.3	11.3	12.3	12.9	11.5	9.1	7.5	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	107.9	114.5	120.0	130.0
Nominal GDP (€bn)	37.3	38.2	41.3	41.9	41.9	42.8	45.3	48.1	51.7	55.2	58.5	61.4	66.5
Nominal GDP (US$bn)	52.2	50.5	57.8	54.1	55.7	56.5	49.8	52.9	58.9	65.1	64.4	69.3	78.4
GDP per capita (US$)	7,100	6,900	7,900	7,400	7,700	7,900	7,000	7,500	8,400	9,300	9300	10000	11400
Gross domestic saving (% of GDP)	20.3	19.7	21.9	18.8	20.6	20.6	21.3	23.5	23.8	21.6	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	3.4	3.0
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	10.0
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	1.4	1.0
Total public debt	13.7	15.3	15.2	16.7	17.1	27.1	26.2	29.6	25.6	22.6	21.3	20.4	18.8
External balance													
Exports (€bn)	11.7	15.6	20.3	20.8	22.3	22.0	22.9	24.0	27.8	28.1	28.3	28.5	28.7
Imports (€bn)	16.9	19.2	23.4	25.5	25.8	26.1	26.3	26.2	30.2	32.1	34.3	36.6	39.2
Trade balance (€bn)	-5.2	-3.7	-3.1	-4.7	-3.6	-4.1	-3.5	-2.1	-2.4	-4.0	-6.0	-8.1	-10.4
Trade balance (% of GDP)	-13.9	-9.6	-7.6	-11.2	-8.5	-9.5	-7.7	-4.4	-4.7	-7.3	-10.2	-13.3	-15.7
Current account balance (€bn)	-3.1	-0.7	0.1	-0.4	0.5	0.5	0.0	1.2	3.4	2.5	2.2	2.2	2.4
Current account balance (% of GDP)	-8.3	-1.8	0.2	-1.0	1.2	1.2	0.0	2.5	6.6	4.5	3.8	3.6	3.6
Net FDI (€bn)	2.5	0.9	1.2	1.1	1.2	0.1	1.9	0.6	1.3	0.5	0.5	0.5	0.5
Net FDI (% of GDP)	6.8	2.4	2.9	2.5	3.0	0.3	4.1	1.2	2.5	0.9	0.9	0.9	0.8
Current account balance plus FDI (% of GDP)	-1.6	0.6	3.1	1.6	4.2	1.5	4.1	3.7	9.1	5.4	4.6	4.5	4.4
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	25.5	28.2	31.2
Import cover (months of merchandise imports)	8.0	6.8	5.7	6.2	5.8	6.7	8.3	9.9	8.5	8.5	8.9	9.2	9.5
Debt indicators													
Gross external debt (€bn)	37.8	37.0	36.3	37.7	36.9	39.3	33.9	34.7	34.2	33.2	33.8	34.5	35.2
Gross external debt (% of GDP)	101	97	88	90	88	92	75	72	66	60	58	56	53
Gross external debt (% of exports)	323	238	179	182	166	178	148	144	123	118	120	121	123
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	0.00
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	6.0	6.3	6.6
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, %)	5.71	4.72	3.67	2.65	1.50	1.59	1.03	0.49	0.23	-0.05	0.00	0.00	0.00
10yr yield (average, %)	7.50	6.10	5.30	4.55	3.54	3.42	2.83	2.34	1.73	1.10	0.55	0.40	0.40
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	1.78	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	1.77	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

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	3.2	3.5	3.5	3.5	3.3	2.8	3.1	2.2	3.8	2.3	2.7	2.4	2.7
CPI (eop, %YoY)	2.7	3.6	2.8	2.8	3.2	2.8	3.5	3.8	4.3	3.3	2.4	2.7	3.0
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, %)	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, %)	0.95	0.65	0.45	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
USD/BGN exchange rate (eop)	1.63	1.63	1.67	1.70	1.78	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

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	2.4	2.7	2.5	2.0	2.5	2.9	2.7
CPI (%YoY)*	0.6	0.8	1.2	1.1	1.2	0.9	1.4
Policy interest rate (eop, %)	0.30	0.30	0.30	0.30	0.30	0.30	0.30
3m interest rate (%)*	0.48	0.45	0.45	0.45	0.45	0.45	0.45
10yr yield (%)*	1.20	0.50	0.45	0.45	0.45	0.95	0.45
USD/HRK*	6.70	6.50	6.77	6.75	6.61	6.68	6.58
EUR/HRK*	7.37	7.41	7.45	7.43	7.40	7.41	7.43

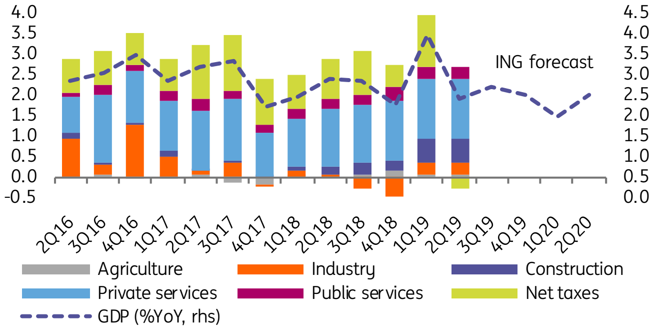
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: Dec-2019	S&P	BBB-	BBB-
Fiscal	Neutral	Parliamentary: Sep-2020	Moody's	Ba2	Ba2
Monetary	Loose	Local: May-2021	Fitch	BBB	BBB

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

Country strategy: ERM-II in sight

The regaining of its investment grade status from S&P and Fitch, an almost done deal on ERM-II admission next year, and still reasonable growth numbers have all contributed to make 2019 arguably the best post-crisis year for Croatia. Fiscal metrics remain sound and set to improve further in our view should the latest Economic and Fiscal Policy Guidelines 2020-2022 be followed. It envisages relatively balanced budgets with a small 0.2% of GDP deficit in 2020, followed by 0.2% and 0.6% surpluses in the following two years. This leaves room for additional fiscal stimulus if needed. We maintain our 2.9% GDP growth forecast for 2019 with downside risks due to Eurozone slowdown, in Germany and Italy in particular.

Real GDP (%YoY) and contributions (ppt)

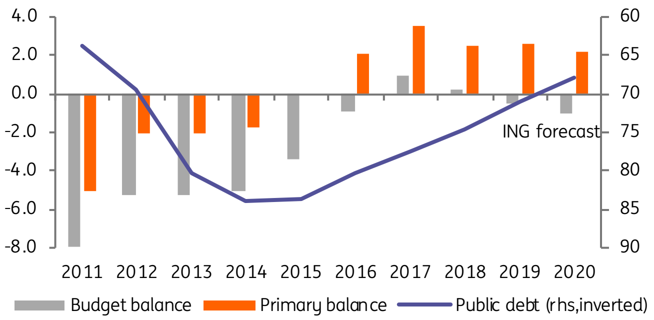


Source: Eurostat, ING

GDP growth shows resilience

Following an impressive 3.9% YoY advance in 1Q19 driven by a surge in investments (+11.5% YoY) and solid private demand, the second quarter growth saw a return towards previous cruising speed, advancing by 2.4%. On the positive side, investment growth remained robust at 8.2%YoY. The negatives come from Croatia's main trading partners which are seeing their economies contracting or stagnating. Hence, net exports subtracted 2.8ppt from 2Q GDP. That said, we believe that there are domestic resources to prop up the economy: investment activity is set to remain sound on improved EU funds absorption, recent tax reliefs should further boost consumption while monetary conditions remain loose.

Budget performance (% of GDP)



Source: AMECO

Electoral context to challenge the so far prudent stance

In mid-2019 the government presented a tax reform plan which should leave a total of HRK10 billion in the economy. More notably – though application is still uncertain – the VAT rate might be cut from 25% to 24% in 2020 and to 13% for food in the hospitality industry. Raising the income threshold subject to a profit tax of 12% (instead of the standard 18%) from HRK3m to HRK7.5m could boost consumption as firms might pass some of it to employees. We see these measures as likely credit positive but expect talks about wage hikes to be resumed as elections get near. We forecast a -0.4% of GDP budget deficit for 2019, with risks skewed again towards a balanced budget considering the 0.3% of GDP surplus at mid-year.

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	2.9	2.7	2.5
Private consumption (%YoY)	-7.5	-1.4	0.3	-3.0	-1.9	-1.6	1.0	3.4	3.6	3.5	3.5	3.2	2.8
Government consumption (%YoY)	2.1	-0.6	-0.4	-0.8	0.6	1.8	-1.0	0.7	2.7	2.9	3.0	3.0	2.5
Investment (%YoY)	-14.4	-15.2	-2.7	-3.3	1.4	-2.8	3.8	6.5	3.8	4.1	8.0	5.0	4.0
Industrial production (%YoY)	-9.0	-1.4	-1.2	-5.3	-1.6	1.1	2.4	5.1	2.0	-1.0	1.0	0.5	0.0
Unemployment rate (year-end, %)	9.3	11.8	13.7	15.8	17.4	17.2	16.1	13.3	11.0	8.3	7.0	6.5	6.0
Nominal GDP ({HRKbn)	331	329	333	331	332	332	340	351	366	382	400	420	440
Nominal GDP (€bn)	45	45	45	44	44	43	45	47	49	51	54	57	59
Nominal GDP (US$bn)	63	60	63	57	58	57	49	51	56	61	59	64	70
GDP per capita (US$)	14,700	13,900	14,700	13,300	13,700	13,500	11,700	12,300	13,500	14,800	14,500	16,000	17,400
Gross domestic saving (% of GDP)	21.4	21.0	20.2	19.7	19.9	20.7	22.4	23.6	23.2	22.8	22.9	23.0	23.1
Prices													
CPI (average, %YoY)	2.4	1.0	2.3	3.4	2.2	-0.2	-0.5	-1.1	1.1	1.5	0.9	1.4	1.9
CPI (year-end, %YoY)	1.9	1.9	2.1	4.6	0.3	-0.5	-0.6	0.2	1.2	0.9	1.2	1.8	2.1
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	6.0	5.1
Fiscal balance (% of GDP)													
Consolidated government balance	-6.0	-6.3	-7.9	-5.3	-5.3	-5.1	-3.2	-1.0	0.8	0.2	-0.4	-0.8	-1.0
Consolidated primary balance	-3.7	-3.8	-5.1	-2.1	-2.1	-1.7	0.3	2.1	3.5	2.5	2.1	1.8	1.5
Total public debt	48.3	57.3	63.9	69.5	80.4	84.0	83.7	80.5	77.8	74.6	71.2	67.8	64.7
External balance													
Exports (€bn)	7.5	8.9	9.6	9.6	9.5	10.4	11.6	12.5	14.2	14.9	15.3	15.7	16.4
Imports (€bn)	15.2	15.1	16.3	16.2	16.6	17.2	18.5	19.8	22.0	23.9	25.2	26.3	27.4
Trade balance (€bn)	-7.7	-6.2	-6.7	-6.6	-7.0	-6.8	-6.9	-7.3	-7.8	-9.0	-9.9	-10.6	-11.0
Trade balance (% of GDP)	-17.1	-13.8	-15.0	-15.0	-16.1	-15.5	-15.4	-15.7	-15.8	-17.4	-18.4	-18.8	-18.6
Current account balance (€bn)	-3.0	-1.0	-0.8	-0.8	-0.5	0.1	1.5	1.0	1.7	1.0	0.8	0.4	0.3
Current account balance (% of GDP)	-6.6	-2.2	-1.8	-1.8	-1.1	0.3	3.3	2.1	3.4	1.9	1.5	0.7	0.5
Net FDI (€bn)	1.2	0.8	0.9	1.1	0.7	0.7	0.2	2.0	1.1	0.7	0.8	0.8	0.8
Net FDI (% of GDP)	2.7	1.8	2.1	2.4	1.7	1.6	0.5	4.3	2.3	1.4	1.4	1.4	1.3
Current account balance plus FDI (% of GDP)	-3.9	-0.4	0.3	0.6	0.6	1.8	3.7	6.4	5.7	3.3	2.9	2.1	1.8
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	20.9	22.8	25.0
Import cover (months of merchandise imports)	8.2	8.5	8.2	8.3	9.3	8.9	8.9	8.2	8.6	8.7	10.0	10.4	11.0
Debt indicators													
Gross external debt (€bn)	48.2	49.4	49.1	47.6	48.5	49.1	48.2	44.7	43.7	42.7	42.2	41.6	41.0
Gross external debt (% of GDP)	106.7	109.4	109.5	108.1	110.6	113.0	108.1	95.8	89.1	82.9	78.1	73.6	69.3
Gross external debt (% of exports)	642	555	512	494	508	471	414	358	307	286	276	265	251
Lending to corporates/households (% of GDP)	70.3	73.3	75.6	71.5	70.6	69.2	65.5	61.1	58.3	56.8	58.4	60.0	61.5
Interest & exchange rates													
Central bank key rate (year-end, %)	6.00	6.00	6.00	6.00	6.00	6.00	0.50	0.30	0.30	0.30	0.30	0.30	0.30
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	4.5	4.1	3.6
3m interest rate (Zibor, average, %)	8.96	2.44	3.15	3.42	1.50	0.97	1.23	0.85	0.61	0.45	0.45	0.45	0.45
3m interest rate spread over Euribor 3m (ppt)	7.74	1.63	1.76	2.85	1.28	0.76	1.25	1.11	0.94	0.77	0.83	0.85	0.85
2yr yield (average, %)	n/a	n/a	n/a	n/a	4.00	3.50	2.50	1.60	1.10	0.40	0.17	0.05	0.05
10yr yield (average, %)	7.80	6.30	6.50	6.10	5.00	4.30	3.60	3.50	2.70	2.10	0.95	0.45	0.45
USD/HRK exchange rate (year-end)	5.11	5.55	5.79	5.72	5.57	6.33	7.00	7.20	6.26	6.45	6.77	6.48	6.21
USD/HRK exchange rate (average)	5.24	5.52	5.31	5.83	5.69	5.78	6.92	6.84	6.54	6.28	6.68	6.58	6.31
EUR/HRK exchange rate (year-end)	7.31	7.39	7.53	7.55	7.64	7.66	7.64	7.56	7.51	7.42	7.45	7.45	7.45
EUR/HRK exchange rate (average)	7.34	7.29	7.43	7.52	7.57	7.63	7.61	7.53	7.46	7.41	7.41	7.43	7.44

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	2.3	3.9	2.4	2.7	2.5	2.0	2.5	3.2	2.8	2.6	2.6	2.5	2.4
CPI (eop, %YoY)	0.9	1.0	0.6	0.8	1.2	1.1	1.2	1.8	1.8	1.9	2.0	2.0	2.1
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, %)	0.48	0.49	0.48	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45
10yr yield (eop, %)	2.00	1.65	1.20	0.50	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.40
USD/HRK exchange rate (eop)	6.45	6.63	6.70	6.50	6.77	6.75	6.61	6.58	6.48	6.41	6.32	6.30	6.21
EUR/HRK exchange rate (eop)	7.41	7.42	7.37	7.41	7.45	7.43	7.40	7.43	7.45	7.43	7.40	7.43	7.45

Source: National sources, ING estimates

Czech Republic

Jakub Seidler, Chief Economist Czech Republic

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (% YoY)	2.8	2.7	2.2	2.0	1.7	2.6	1.9
CPI (% YoY)*	2.7	2.7	2.7	2.7	2.2	2.8	2.4
Policy interest rate (eop, %)	2.00	2.00	2.00	2.00	2.00	2.00	1.75
3m interest rate (%)*	2.17	2.16	2.15	2.15	2.14	2.11	2.05
10yr yield (%)*	1.51	1.36	1.40	1.40	1.40	1.59	1.41
USD/CZK*	22.36	23.67	23.55	23.64	23.21	23.18	22.95
EUR/CZK*	25.43	25.80	25.90	26.00	26.00	25.73	25.94

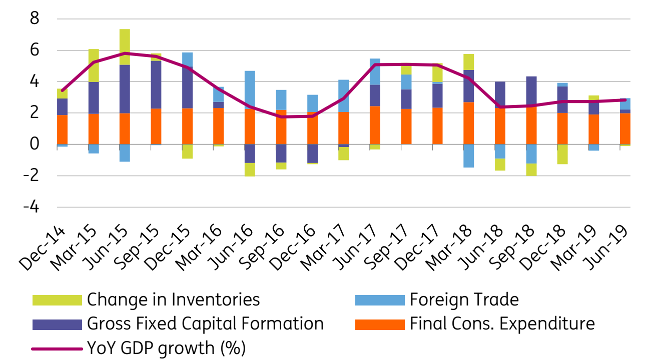
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: 2023	S&P	AA-	AA
Fiscal	Looser	Parliamentary: 2021	Moody's	Aa3	Aa3
Monetary	Tighter	Local: 2020	Fitch	AA-	AA-

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

Country strategy

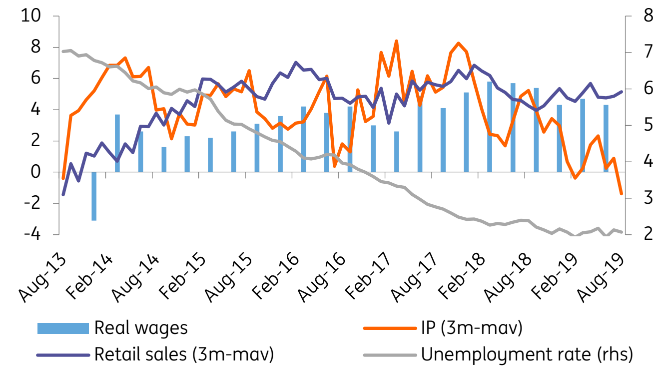
Growth in the Czech economy has remained slightly below 3% over the past three quarters and, given recent weakness in the Germany economy, domestic data shows surprising resistance. This is very likely because weaker foreign data will impact the overheated Czech economy with some delay. As such, we see a slowdown to below 2% next year, especially if foreign development does not turn better, which is not our baseline for now. However, the labour market and inflation has some persistency, meaning that imminent CNB reaction and monetary easing is not likely. Moreover, in case of a slowdown, koruna is likely to weaken due to its overboughtness after the 2013-17 FX-floor regime, and deliver the monetary easing needed. As such, we do not see aggressive CNB cuts as likely.

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



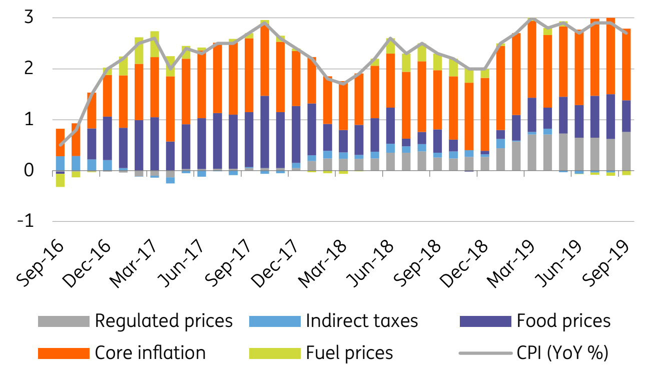
Source: CZSO

Key activity indicators (% YoY)



Source: CZSO

Structure of inflation (ppt)



Source: CZSO, CNB

Macro digest

Czech GDP growth in 2Q19 surprised on the upside at 2.8% YoY while initial market estimates were around 2.6%. Not working-day adjusted print reached 2.5% YoY. Despite being more positive than expected, the structure of GDP sent some mixed signals. Mainly investment significantly lagged expectations, slowing to 0.2% YoY vs the CNB's expectations of 3.7%. Interestingly, this was driven mainly by corporate investment, which stagnated in both YoY and QoQ terms, after growing by more than 7% in 2018. Also government investment slowed from almost 30% YoY growth in 2018 to 13% in 2Q19. As such, investment represents downside risk for this year's growth. As investment is import-intensive, a deceleration here caused imports to decline, resulting in the stronger-than-expected growth of net exports, contributing 0.7ppt to YoY growth in 2Q. Household consumption continued growing around 2.7% YoY. Though weaker than in 2015-18 YoY growth of 3-4% YoY, given the recent fall in household confidence to a 4-year low, it is solid and remains the main growth factor with a contribution of 1.3 ppt. Still, we expect the Czech economy to decelerate to slightly below 2% next year given the weakening foreign demand. Labour market tightness persisted but has reached its peak in 1H19. The unemployment rate remains at its historical lows, but employment growth ceased. In bigger industrial companies, it even fell by 1.5% YoY in August, partially through not replacing voluntarily leaving workers, but also due to some layoffs given the weaker production and new orders (see main article). Still, wage growth remains persistent (7% YoY in 2Q), pushed also by solid public wage growth at 8.6%. As such, wage growth is likely to remain strong this year, and we expect any slowdown to be delayed into the next year, though further minimum wage and public sector wage growth will keep dynamics above 5%. Due to continuing solid wage growth, retail sales growth in 1H19 was similar to previous years at 5% YoY. Car sales remain weaker, slightly falling YoY on average this year. Inflation accelerated to close to the 3% CNB upper tolerance band this year and will reach the highest average annual print since 2012. The main contribution to growth is core inflation (1.5ppt) due to the growing price of services (+3.7% year-to-date). Still, an important part of growing CPI, this year included "regulated prices" mainly electricity prices (+10%) and housing costs generally. But, due to a base effect and some economic slowdown ahead, inflation is likely to decelerate. Also growth of imputed rent (a reflection of the soaring property prices) started to decline slightly (see box on the next page). However, we expect inflation to remain around 2.5% next year, supported also by tax increases for cigarettes and alcoholic beverages (+0.7ppt in our estimates).

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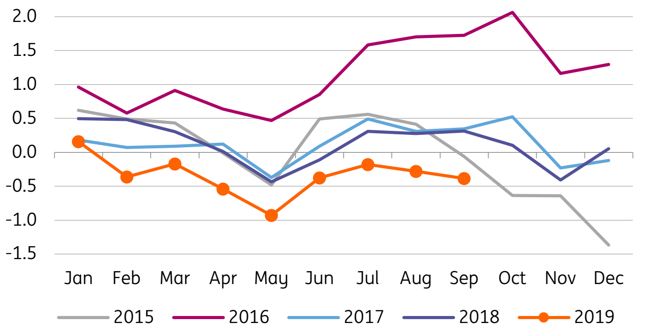
State budget (% of GDP, year-to-date balance)

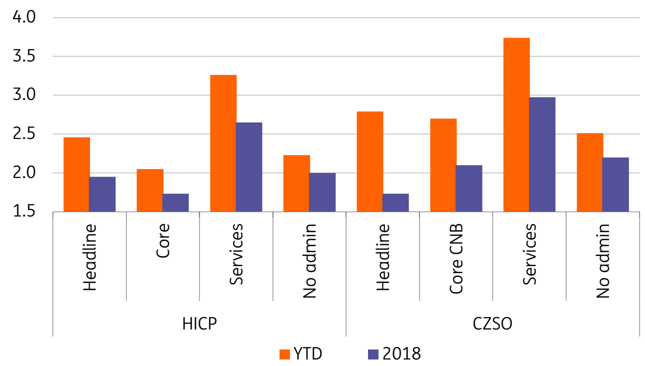


Source: MinFin

Fiscal performance is worsening

While the state budget ended 2018 with a slight surplus of CZK3bn instead of a planned deficit of CZK50bn, this year's developments will not surprise on the upside, and we expect a deficit very close to the planned figure of CZK40bn. This signals also that the cumulative state budget will remain in negative territory this year (-0.4% of GDP in October). However, due to a surplus generated by local government and the social fund, the total government balance ended in a surplus of CZK58bn last year (1.1% of GDP after revisions). In 1H19, local governments even increased their surplus by CZK10bn YoY. As such, despite worsening fiscal performance, we expect total government budget to retain a small surplus this year, with debt likely to drop below 32% of GDP. For 2020, we see a decline to 30%.

Difference between HICP and CZSO inflation (%)

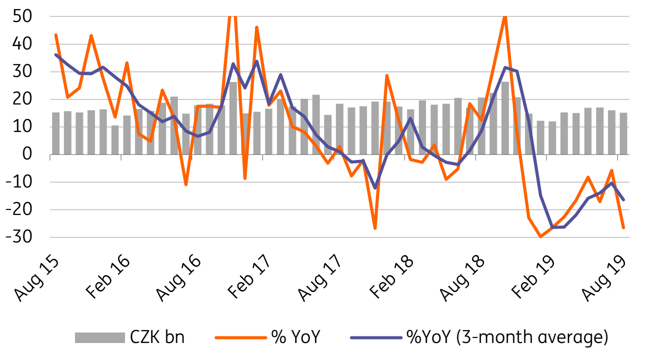


Source: CZSO, CNB, Eurostat

Inflation supported by housing price growth

The main difference between the harmonised inflation measure published by Eurostat (HICP) and the Czech Statistical Office's CPI is the item of imputed rent, reflecting hypothetical costs for owners of property. The methodology has changed in recent years, increasing the weight of new property prices, mainly for Prague, in its construction. Imputed rent has grown by 5,5% YoY on average, contributing 0.6ppt to YoY CPI this year due to its relatively high weight in the consumer basket of 10%. However, imputed rent is part of both CNB core inflation, with a weight of 19%, and services, with an even more significant weight of 27%. Thus, the difference between CZSO and HICP price growth is influenced by this item, which started a gradual deceleration from 6% in January to 4.4% in September.

Growth in new housing loans (% YoY)

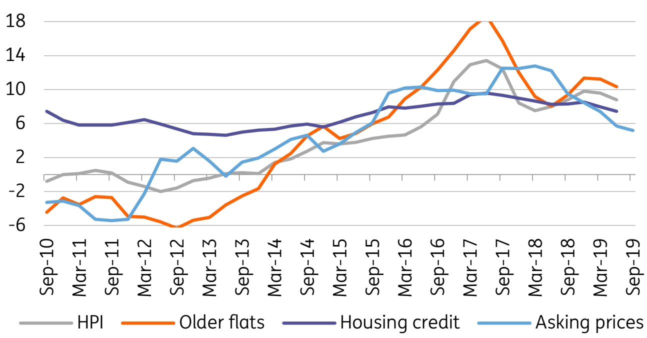


Source: CNB, ING

New housing loans weaker this year

The volume of new housing loans has been declining in 2019 as a result of stricter CNB recommendations on income limits, which came into the force in October 2018. This lowered housing loan affordability and caused substantial frontloading of mortgage loans in 2H18, leading to their 20% YoY decline in 1H19. Though the frontloading affect has gradually diminished, the high base from 2H18 will accelerate in the months ahead. As such, total volume of new housing loans will be c.20% lower this year (-CZK50bn) compared to 2018. Despite that, we do not see a significant impact on property market prices yet. This is likely to be because new mortgages were gradually withdrawn during 1H19, delaying the effect of lower housing loan dynamics in the real economy.

Housing credit and property prices (% YoY)

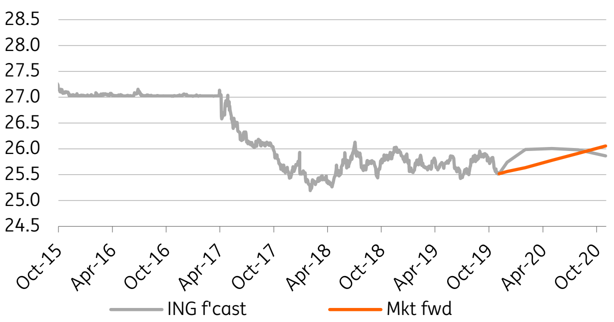


Source: CZSO, Eurostat, ING

Property market should decelerate starting 3Q19

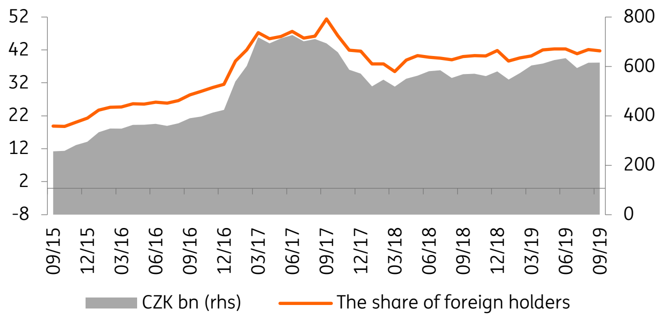
Despite the fall in new housing credit in 1H19, growth in housing loan stock remains more stable (7.7%), supporting our view of a delay between contract signing and tapping of the loan. Czech property prices have thus remained strong in 1H19 at 9.2% YoY, based on the House Price Index (HPI), which includes prices of existing and new family houses, flats and land. Older flat prices grew by 10%. However, asking prices of flats in the Czech Republic in 3Q19 further slowed to 5.2% YoY and to 3.3% YoY in Prague, signalling that real estate price growth is very likely to slow in the months/quarters ahead. A slowdown is expected given that property prices have increased by more than 40% over the past four years and could be overvalued by 20%, according CNB estimates.

FX – spot vs forward and INGF



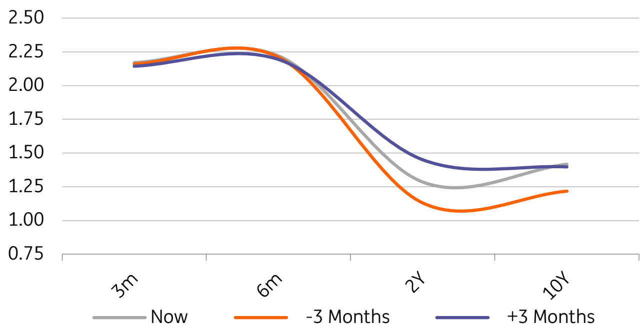
Source: Bloomberg, ING Bank

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)*

CZK benefited from the fading risk of no deal Brexit, the shift in CNB bias towards cautiously hawkish and the declining risk of US-China imminent trade war escalation. But all these news seem to be largely in the price and are now susceptible to negative re-pricing. We don't expect CNB to hike this year, the US-China negotiations beyond the "easy" Phase 1 agreement will be tricky and the ratification of the Withdrawal Agreement in the UK Parliament is now a story for early next year (in one of the positive scenarios).

With the external environment being a prime driver of CZK (koruna correlation with global risk remains high, while the transmission mechanism from CNB interest rate to the exchange rate remains muted at best) we see downside risk to CZK, particularly when the EZ / German economy should remain soft in 4Q19 and 1Q20 and the Czech economy slows. We thus expect EUR/CZK to converge back to the 26.00 level in coming months

The CZK overboughtness remains in place (as evident in the still large foreign holdings of CZGBs) but so far the positions were rather sticky despite the bouts of risk aversion this year. In our view, the stickiness is likely attributable to the nature of the holders (real money rather than fast money accounts, in our view). Due to the positioning, we still see CZK as the currency with the largest tail risk in the CEE FX space on a negative shock such as car tariffs

We expect the CNB to start the sale of profits on FX reserves next year, with the aim of market neutral impact (as was the case in previous intervention periods in 2001-02). This in our view suggest a muted impact on CZK, beyond near-term positive signalling effect.

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	-0.8	-0.5	2.7	5.4	2.4	4.6	3.0	2.6	1.9	2.4
Private consumption (% YoY)	-0.5	1.0	0.3	-1.2	0.5	1.8	3.8	3.5	4.4	3.3	2.5	2.2	2.0
Government consumption (% YoY)	2.8	0.5	-3.2	-1.9	2.5	1.1	1.9	2.7	1.3	3.9	2.9	2.2	1.2
Investment (% YoY)	-9.8	1.1	0.9	-3.0	-2.5	4.0	10.3	-3.2	4.0	7.1	1.8	3.1	3.6
Industrial production (% YoY)	-13.2	8.6	6.1	-0.7	0.1	5.0	4.3	3.6	6.5	3.1	0.9	1.1	1.1
Unemployment rate (year-end, %)	7.5	6.9	6.5	7.2	6.7	5.8	4.5	3.5	2.4	2.1	2.0	2.1	2.2
Nominal GDP (CZKbn)	3,932	3,958	4,030	4,059	4,097	4,313	4,598	4,766	5,054	5,335	5,606	5,847	6,086
Nominal GDP (€bn)	149	157	164	161	158	157	169	176	192	208	218	225	238
Nominal GDP (US$bn)	206	207	228	208	209	208	187	195	216	245	242	255	281
GDP per capita (US$)	19,668	19,710	21,706	19,751	19,931	19,741	17,738	18,460	20,415	23,094	22,703	23,852	26,202
Gross domestic saving (% of GDP)	30.4	30.2	31.0	31.2	30.6	32.0	33.1	32.5	33.2	32.8	32.7	32.5	32.9
Prices													
CPI (average, % YoY)	1.1	1.5	1.9	3.3	1.4	0.4	0.3	0.7	2.5	2.1	2.8	2.4	1.9
CPI (year-end, % YoY)	1.0	2.3	2.4	2.4	1.4	0.1	0.1	2.0	2.4	2.0	2.7	2.5	1.7
Wage rates (nominal, % YoY)	3.4	2.2	2.5	2.5	-0.1	2.9	3.2	4.5	6.7	7.6	6.7	5.5	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	1.6	1.1	0.2	0.1	0.0
Consolidated primary balance	-4.3	-3.1	-1.4	-2.5	0.1	-0.6	0.4	1.6	2.4	1.9	1.0	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	32.6	31.4	30.3	29.3
External balance													
Exports (€bn)	72.2	87.0	99.2	104.3	103.0	110.3	115.6	118.0	129.5	136.8	139.5	142.0	146.2
Imports (€bn)	69.7	85.5	96.1	99.3	96.6	102.3	108.7	108.9	119.7	128.3	130.9	134.2	137.9
Trade balance (€bn)	2.4	1.6	3.1	4.9	6.4	8.0	6.9	9.1	9.8	8.5	8.6	7.9	8.2
Trade balance (% of GDP)	1.6	1.0	1.9	3.0	4.1	5.1	4.1	5.1	5.1	4.1	4.0	3.5	3.5
Current account balance (€bn)	-3.5	-5.8	-3.5	-2.5	-0.8	0.3	0.4	2.7	3.0	0.7	0.4	0.3	0.2
Current account balance (% of GDP)	-2.3	-3.7	-2.1	-1.6	-0.5	0.2	0.2	1.5	1.6	0.3	0.2	0.1	0.1
Net FDI (€bn)	1.4	3.8	1.9	4.8	-0.2	2.9	-1.8	6.9	1.7	3.5	2.9	2.2	1.8
Net FDI (% of GDP)	0.9	2.4	1.1	3.0	-0.2	1.9	-1.1	3.9	0.9	1.7	1.3	1.0	0.8
Current account balance plus FDI (% of GDP)	-1.4	-1.3	-1.0	1.4	-0.7	2.0	-0.9	5.5	2.5	2.0	1.5	1.1	0.9
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	131.6	135.3	138.0
Import cover (months of merchandise imports)	5.0	4.4	3.8	4.1	5.1	5.3	6.6	8.9	12.3	11.6	12.1	12.1	12.0
Debt indicators													
Gross external debt (€bn)	73.9	86.4	89.6	96.8	99.7	106.3	115.4	129.4	171.1	169.3	171.3	173.3	175.3
Gross external debt (% of GDP)	50	55	55	60	63	68	68	73	89	81	79	77	74
Gross external debt (% of exports)	102	99	90	93	97	96	100	110	132	124	123	122	120
Lending to corporates/households (% of GDP)	43.8	45.7	47.7	48.5	50.0	48.8	48.8	50.2	50.4	51.0	51.5	51.3	51.2
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	2.00	1.75	1.75
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	6.7	5.8	4.9
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	2.11	2.05	1.90
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	247.2	245.5	230.0
2yr yield (average, %)	2.7	1.6	1.7	0.9	0.3	0.2	-0.1	-0.3	-0.2	1.1	1.5	1.4	1.4
10yr yield (average, %)	4.7	3.9	3.8	2.8	2.1	1.6	0.7	0.4	1.1	2.0	1.6	1.4	1.5
USD/CZK exchange rate (year-end)	18.5	18.7	19.7	19.0	19.9	22.9	24.9	25.7	21.3	22.4	23.5	22.4	21.2
USD/CZK exchange rate (average)	19.1	19.1	17.7	19.6	19.6	20.8	24.6	24.4	23.4	21.7	23.2	23.0	21.7
EUR/CZK exchange rate (year-end)	26.4	25.0	25.6	25.1	27.3	27.7	27.0	27.0	25.5	25.7	25.9	25.8	25.4
EUR/CZK exchange rate (average)	26.5	25.3	24.6	25.1	26.0	27.5	27.3	27.0	26.3	25.6	25.7	25.9	25.6

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (% YoY)	2.7	2.7	2.8	2.7*	2.2	2.0	1.7	1.9	2.1	2.3	2.4	2.4	2.4
CPI (eop, % YoY)	2.0	3.0	2.7	2.7	2.7	2.7	2.2	2.4	2.5	1.8	1.8	1.7	1.7
Central bank key rate (eop, %)	1.75	1.75	2.00	2.00	2.00	2.00	2.00	1.75	1.75	1.75	1.75	1.75	1.75
3m interest rate (eop, %)	2.01	2.02	2.17	2.16	2.15	2.15	2.14	1.90	1.90	1.90	1.90	1.90	1.90
10yr yield (eop, %)	1.94	1.92	1.51	1.36	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.60	1.60
USD/CZK exchange rate (eop)	22.43	23.02	22.36	23.67	23.55	23.64	23.21	22.92	22.43	22.16	21.88	21.61	21.17
EUR/CZK exchange rate (eop)	25.72	25.82	25.43	25.80	25.90	26.00	26.00	25.90	25.80	25.70	25.60	25.50	25.40

Note that except GDP, all data is actual for 3Q19

Source: National sources, ING estimates

Hungary

Péter Virovácz, Senior Economist, Hungary

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)*	4.9	4.8	3.9	3.6	3.2	4.7	3.4
CPI (%YoY)*	3.4	2.8	3.6	3.4	3.3	3.3	3.3
Central bank key rate (%)*	0.90	0.90	0.90	0.90	0.90	0.90	0.90
3m interest rate (%)*	0.25	0.20	0.20	0.20	0.20	0.20	0.20
10yr yield (%)*	2.61	1.98	1.80	1.70	1.60	2.43	1.66
USD/HUF*	288.5	307.3	304.5	309.1	303.6	293.1	298.2
EUR/HUF*	323.1	335.0	335.0	340.0	340.0	325.3	337.0

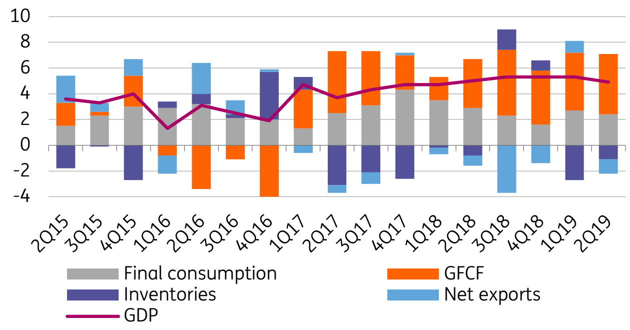
Macro Trend		Political Cycle	Ratings	FC	LC
Activity		Presidential: 2022	S&P	BBB	BBB
Fiscal	Tighter	Parliamentary: 2022	Moody's	Baa3	Baa3
Monetary	Neutral	Local: 2024	Fitch	BBB	BBB

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

Country strategy

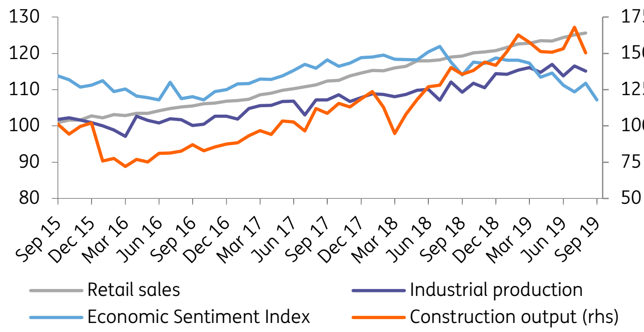
Following 5.1% YoY GDP growth in 2018, against all the odds the Hungarian economy maintained the same pace in 1H19. The exceptionally strong activity has been fuelled by domestic factors. Consumption is rising due to full employment and double-digit wage growth. The investment rate of 29% is the highest among all EU member states. This is the clear result of the 'high-pressure' economy run by policymakers, which has translated into above-target inflation, too. Another important effect of this is the recurrent deficit in the current account, which clearly won't support the forint. The data-driven NBH can live with EUR/HUF reaching 340 in coming months, with weaker FX set to offset disinflation from abroad as global risks are strengthening and a local slowdown is approaching.

Contribution to YoY GDP growth (ppt)



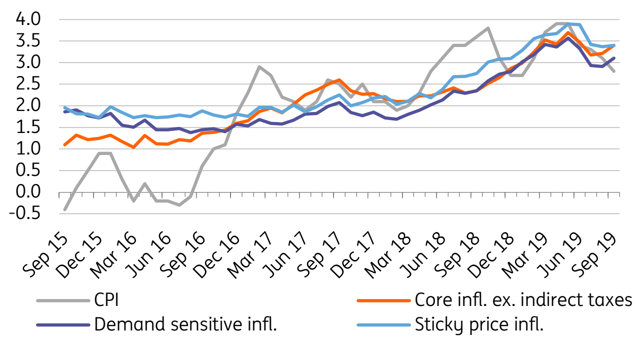
Source: Hungarian Central Statistical Office

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

GDP growth of 5.1% YoY in 2018 set a record high. Despite the gloomy global environment, Hungary maintained its exceptional economic activity in the first half of 2019. Although the economy won't be immune to external woes in the long run and the first signs of a slowdown have already become apparent, the real economy has held up remarkably well, mainly on domestic factors.

On the final use side, domestic demand has remained the main driver of growth. Household consumption is driven by full-employment, double-digit wage growth and elevated consumer confidence despite the worsening global outlook. The labour shortage and low interest rates are pushing companies to raise capital expenditures. EU projects and the housing boom are also supporting a record high investment rate. Although net exports dragged GDP growth down by 0.1ppt, this is not that bad considering the external environment.

On the production side the most important positive surprise is industry. It fared well with a 5% YoY value added increase in 1H19, but showed a significant slowdown from 1Q to 2Q. Construction has grown by 29.6% YoY so far this year, due to infrastructure developments, and residential and industrial buildings in particular. The services sector lost some ground, but remained the main contributor adding 2.2ppt to GDP growth in 1H19; a significant drop from 3.5ppt last year. It is a clear sign of the ongoing underlying slowdown. Agriculture had a neutral growth effect in 1H19.

Looking forward, we expect a deceleration due to base effects and external factors, resulting in 4.7% YoY GDP growth in 2019. The further slowdown to 3.4% YoY that we forecast for 2020 is the effect of the global downturn, combined with reducing impetus from the labour market and retreating business and household confidence. A high base in investment and an end to EU projects won't help either.

Headline CPI came in at 2.8% YoY in September 2019, pushing the year-to-date figure to 3.3% YoY, 0.5ppt higher than in 2018. Price pressure picked up on food (supply side shocks and tax increase) and services (demand-driven inflation), while heightened duties affected the price of tobacco products. This was counterbalanced by a significant retreat in fuel and energy prices. Against this backdrop, core CPI rose to 3.7% YoY in Jan-Sep after 2.5% in 2018. However, the tax effect has a lot to do with this elevated reading, which is why the linchpin indicator for monetary policy is now core CPI excluding indirect taxes. It stands at 3.3% YoY through three quarters. We see inflation remaining somewhat above the target until 2021, but showing a continuous deceleration on external and local economic slowdown even with unchanged (loose) monetary policy conditions.

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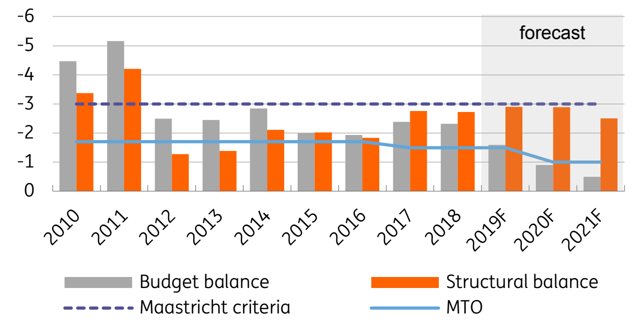
Budget and structural balance of general government (%)

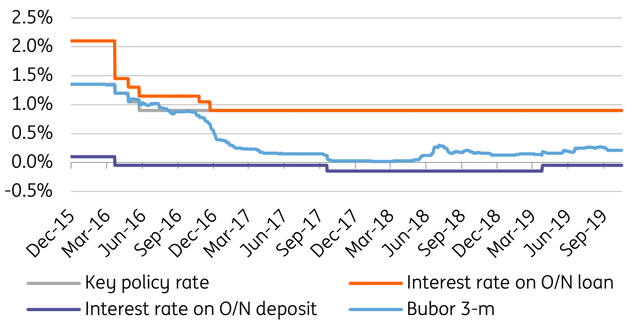


Source: AMECO, ING, National Bank of Hungary

Government on course to outperform fiscal targets

The government planned a 1.8% accrual based deficit-to-GDP and aimed to reduce the public debt to 69.2% of GDP. The budget has outperformed these targets, so far. The general government deficit was equal to 1.4% of GDP in the four quarters to 2Q19. Regarding the cash-flow based deficit, the year-to-date figure came in at 30% of the year-end target in September. Against this backdrop, we have every reason to assume the deficit-to-GDP target won't be simply achieved, but the actual figure could be even better. This strong performance is mainly driven by the better-than-expected GDP growth (government forecast was 4%) resulting in much higher revenue. The debt-to-GDP ratio stood at 68.2% at the end of 2Q19, 1ppt lower than the target. All these results provide significant scope for possible fiscal stimulus.

Benchmark policy rate and interest rate corridor

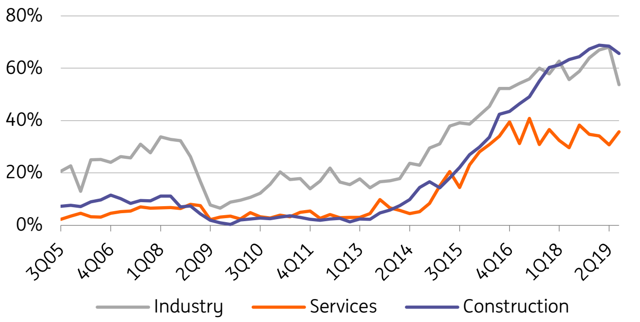


Source: Bloomberg

The NBH stands pat in turbulent times

The latest meaningful rate setting meeting in September did not bring any major change. The NBH left rates unchanged and, after a dovish sequence from major central banks, just to be safe, increased crowded out liquidity for 4Q19. We see this as a fine-tuning step and a reaction to the downside risks to the CPI outlook, which has recently been stressed several times by the NBH. We see the central bank keeping its data-driven ad-hoc approach in place maybe even through 2020, leaving loose monetary policy unchanged. With HUF being seen as a contributor to the monetary conditions set up and a weaker currency offsetting the possible disinflationary impact of imported prices from abroad, we expect the NBH to be comfortable with further HUF weakness, even if it breaches the 340 level.

Share of companies complaining of labour shortage

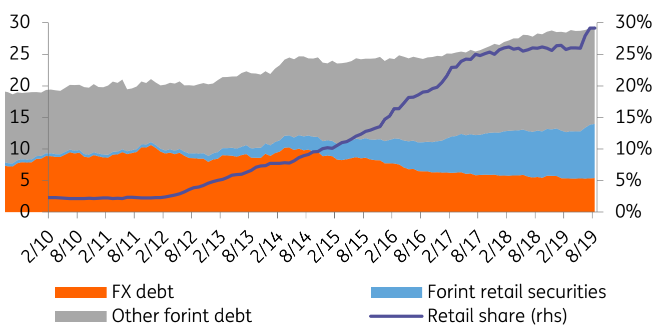


Source: Eurostat, ING

Extremely strong labour market

The unemployment rate has been moving around record low levels of 3.3-3.5% in 2019. In our view, this level is consistent with full employment. This tight labour market has pushed companies to raise wages or spend more on capital (modernisation, digitalisation). The latter might have started to affect demand for labour with the share of companies complaining of labour shortage having recently retreated from record highs. Besides productivity enhancements, this could be the first sign of a looming downturn. However, it will take a long time to see any notable spillover in the real economy, as wages will be pushed via minimum wage increases and wage settlements in the public sector. So the unusually strong labour market will provide a significant tailwind for domestic demand.

Structure of the public debt (HUF tr)



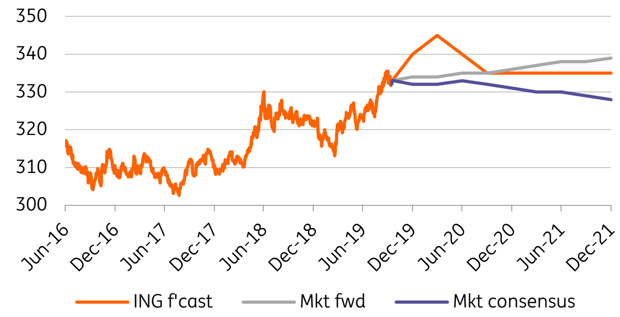
Source: ÁKK, ING

Retail bond market flourishes

Hungary's savings and self-reliance market has undergone a significant change recently with the introduction of the new five-year retail bond, the Hungarian Government Security Plus (HGS+). It is the highest risk-free fixed yield investment (4.95%) with flexible redemption, is offered at a low cost and is exempt from interest tax too. According to the latest statistics, over HUF2tr worth of HGS+ has been sold since its launch in June. Thanks to the government's retail securities, the FX share of the public debt dropped from 52% to 18% in August 2019, while the retail share jumped to 30%. It also gives the ÁKK (Government Debt Management Agency) some flexibility in the wholesale market. The strong fiscal stance and popularity of the retail bonds will translate into less supply of HGBs going forward.

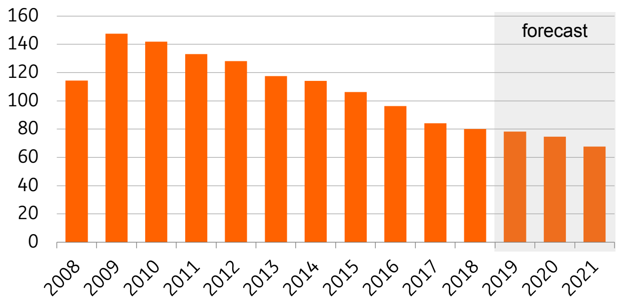
Hungary Strategy

FX – spot vs forward and INGF



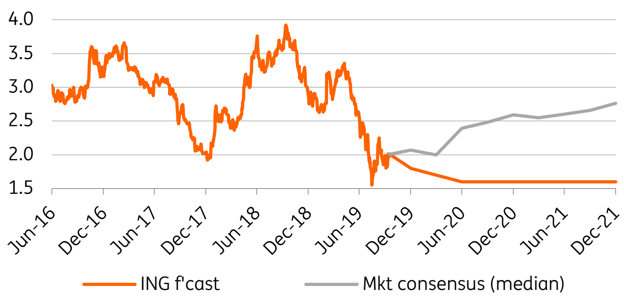
Source: Bloomberg, ING

Evolution of gross external debt (% of GDP)



Source: Bloomberg, ING

Local 10-year curve (%)



Source: Bloomberg, ING

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

We see EUR/HUF moving towards 340 level in coming months. With HUF being seen as part of monetary conditions set up and a weaker currency offsetting the possible disinflationary impact of imported prices from abroad, we expect NBH to be comfortable with further HUF weakness. Such weakness should in our view be primarily caused by global factors (soft EZ and German economy, trade war uncertainty). Coupled with low HUF funding costs and the deficit in the current account (a meaningful change from previous years when the current account was in a large surplus), this suggests a weaker forint.

We see a high bar for the NBH to become uncomfortable with HUF weakness and step in as long as the HUF decline is: (1) orderly; and (2) does not materially decouple from its CEE peers (the differing price actions of this and the last summer provide a case in point). Moreover, with the fairly muted FX pass through (1% movement in EUR/HUF translates into 0.1-0.2ppt change in inflation over a one-year horizon), this gives the NBH a lot of wriggle room before the depreciating currency leads to a more meaningful increase in inflation (as opposed to Romania where FX pass through is high).

While we see the overbought CZK as exhibiting the largest tail risk among CEE FX to the negative risk event (such as EZ car tariffs), its relatively high cost of carry makes it unattractive for wait-and-see short positions. In contrast, HUF's low cost of carry, yet also a meaningful exposure to the car industry (and Hungary being also a small open economy) makes long EUR/HUF positions more attractive from the time decay point of view, allowing investors to wait for the risk event at fairly low costs.

Hungary

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Activity													
Real GDP (% YoY)	-6.7	0.7	1.8	-1.5	2.0	4.2	3.8	2.2	4.3	5.1	4.7	3.4	3.0
Private consumption (% YoY)	-6.9	-2.8	0.6	-2.5	0.0	2.5	3.7	4.9	4.4	4.9	4.9	3.7	2.9
Government consumption (% YoY)	1.4	2.3	0.1	0.0	6.0	9.8	1.1	0.3	3.2	2.0	0.0	0.6	0.2
Investment (% YoY)	-9.1	-9.5	-1.3	-3.0	9.8	12.3	4.8	-10.6	18.7	17.1	16.7	3.9	4.5
Industrial production (% YoY)	-17.8	10.6	5.6	-1.8	1.1	7.7	7.4	0.9	4.6	3.5	5.4	3.5	4.1
Unemployment rate (year-end, %)	10.5	10.9	10.8	10.7	9.2	7.2	6.2	4.5	3.8	3.6	3.4	3.4	3.6
Nominal GDP (HUFbn)	26,458	27,269	28,371	28,848	30,290	32,694	34,785	35,896	38,835	42,662	46,677	49,953	53,047
Nominal GDP (€bn)	94	99	102	100	102	106	112	115	126	134	143	147	158
Nominal GDP (US$bn)	132	131	142	129	136	140	123	127	143	158	159	167	187
GDP per capita (US$)	13,019	13,074	14,098	12,873	13,646	14,183	12,487	12,819	14,264	15,924	16,556	17,451	19,684
Gross domestic saving (% of GDP)	19.5	20.9	21.2	21.2	24.8	24.8	25.4	26.2	25.5	27.5	29.8	31.7	32.4
Prices													
CPI (average, % YoY)	4.2	4.9	3.9	5.7	1.7	-0.2	-0.1	0.4	2.4	2.8	3.3	3.3	3.1
CPI (year-end, % YoY)	5.6	4.7	4.1	5.0	0.4	-0.9	0.9	1.8	2.1	2.7	3.6	3.2	3.1
Wage rates (nominal, % YoY)	0.6	1.3	5.2	4.7	3.4	3.0	4.3	6.1	12.9	11.3	10.5	8.0	6.5
Fiscal balance (% of GDP)													
Consolidated government balance	-4.7	-4.5	-5.2	-2.5	-2.5	-2.8	-2.0	-1.9	-2.4	-2.3	-1.6	-0.9	-0.5
Consolidated primary balance	-0.1	-0.4	-1.3	2.2	1.9	1.4	1.6	1.6	0.6	0.3	0.9	1.4	1.7
Total public debt	78.2	80.6	80.8	78.5	77.3	76.8	76.1	75.5	72.9	70.2	67.3	65.1	61.9
External balance													
Exports (€bn)	59.1	71.4	80.0	80.0	81.3	84.5	90.5	93.0	100.7	104.9	111.7	120.3	126.1
Imports (€bn)	55.4	65.9	72.9	73.3	74.7	78.2	81.9	83.3	92.6	99.3	106.4	114.1	118.4
Trade balance (€bn)	3.7	5.5	7.1	6.7	6.6	6.3	8.6	9.7	8.1	5.5	5.4	6.2	7.6
Trade balance (% of GDP)	4.0	5.6	6.9	6.7	6.4	5.9	7.7	8.4	6.4	4.1	3.7	4.2	4.8
Current account balance (€bn)	-0.7	0.3	0.6	1.6	3.6	1.3	2.6	5.2	2.8	-0.7	-0.4	0.2	0.6
Current account balance (% of GDP)	-0.7	0.3	0.6	1.6	3.5	1.2	2.4	4.5	2.3	-0.5	-0.3	0.1	0.4
Net FDI (€bn)	1.4	1.4	1.7	4.1	2.1	5.1	2.3	3.9	5.2	5.3	1.2	3.3	3.5
Net FDI (% of GDP)	1.5	1.4	1.7	4.1	2.0	4.9	2.0	3.4	4.1	4.0	0.8	2.2	2.2
Current account balance plus FDI (% of GDP)	0.8	1.6	2.3	5.7	5.5	6.1	4.4	7.9	6.4	3.4	0.6	2.3	2.6
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	26.5	28.1	29.2
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)	139.0	140.5	135.3	127.6	119.8	121.0	119.3	110.9	105.6	107.2	112.0	110.0	107.0
Gross external debt (% of GDP)	147	142	133	128	117	114	106	96	84	80	78	75	68
Gross external debt (% of exports)	235	197	169	160	147	143	132	119	105	102	100	91	85
Lending to corporates/households (% of GDP)	58.6	59.3	57.2	49.1	44.7	41.3	34.0	32.5	31.7	31.9	32.5	32.8	31.6
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	13.9	6.9	6.0	5.5
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	0.20	0.20	0.20
3m interest rate spread over Euribor (ppt)	741	469	480	643	410	220	163	126	47	44	56	60	60
3yr yield (average, %)	9.3	6.7	7.0	7.5	4.8	3.6	2.1	1.5	0.9	1.3	0.8	0.4	0.3
10yr yield (average, %)	9.1	7.3	7.6	7.9	5.9	4.8	3.4	3.1	3.0	3.1	2.4	1.7	1.6
USD/HUF exchange rate (year-end)	189.4	209.6	239.3	220.7	216.7	260.2	287.3	296.2	258.5	279.6	304.5	291.3	279.2
USD/HUF exchange rate (average)	200.4	208.6	199.4	224.4	223.2	233.8	281.7	283.1	271.2	270.2	293.1	298.2	283.9
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	335.0	335.0	335.0
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	325.3	337.0	335.0

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	5.3	5.3	4.9	4.8	3.9	3.6	3.2	3.0	3.6	3.2	3.0	2.9	2.9
CPI (eop, %YoY)	2.7	3.7	3.4	2.8	3.6	3.4	3.3	3.5	3.2	3.1	3.1	3.1	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, %)	0.13	0.18	0.25	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
10yr yield (eop, %)	2.99	2.92	2.61	1.98	1.80	1.70	1.60	1.60	1.60	1.60	1.60	1.60	1.60
USD/HUF exchange rate (eop)	281.7	286.8	288.5	307.3	304.5	309.1	303.6	296.5	291.3	288.8	286.3	283.9	279.2
EUR/HUF exchange rate (eop)	321.1	321.2	323.1	335.0	335.0	340.0	340.0	335.0	335.0	335.0	335.0	335.0	335.0

Source: National sources, ING estimates

Kazakhstan

Dmitry Dolgin, Chief Economist, Russia & CIS

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	4.3	4.2	4.0	4.0	4.1	4.1	4.2
CPI (%YoY)*	5.4	5.3	5.6	5.6	5.5	5.3	5.5
Policy interest rate (eop, %)	9.00	9.25	9.25	9.25	9.00	9.25	8.75
3m interest rate (%)*	10.00	10.25	10.25	10.25	10.00	10.20	10.05
10yr yield (%)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a
USD/KZT*	381	388	385	386	388	383	388
EUR/KZT*	433	423	424	425	434	426	438

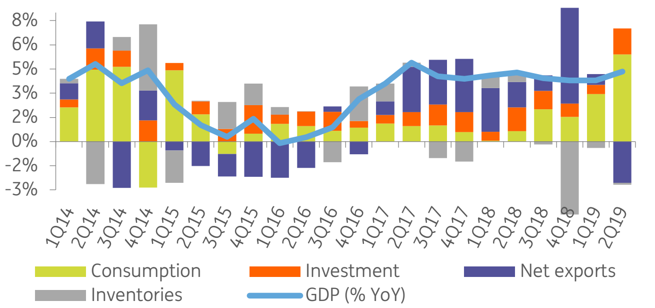
Macro Trend		Political Cycle	Ratings	FC	LC
Activity		Presidential: 2024	S&P	BBB-	BBB-
Fiscal	Easing	Parliamentary: 2021	Moody's	Baa3	Baa3
Monetary	Stable	Local:	Fitch	BBB	BBB

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

Country strategy

Kazakhstan continues to post a healthy 4%+ of GDP growth rate despite temporary setbacks related to oilfield maintenance. Political transition this year helped to strengthen household income and consumption but came at the cost of a higher social focus of the budget policy, with 47% of total public spending now channelled into healthcare and social payments. Fiscal stability is not a near-term concern, but will be a watch factor going forward. Meanwhile the balance of payments is under double pressure of growing imports and surging capital outflow, both linked to the political transition. Recovery in oil exports after the 5% YoY drop in 8M19 should limit tenge's downside but not remove risks entirely. This suggests that the near-term scope for monetary easing is limited.

GDP growth and major contributors (% YoY)

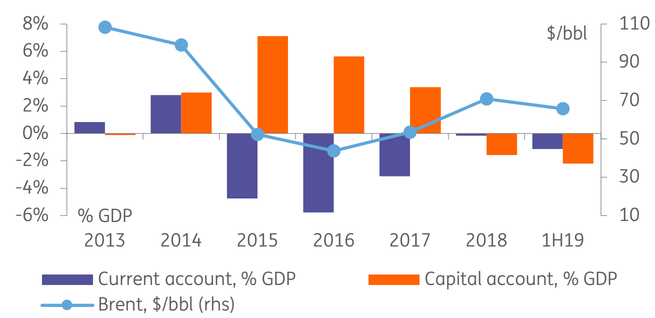


Source: CEIC, ING

GDP growth healthy, but dependence on budget grows

Kazakhstan's GDP managed 4.1% YoY growth in 1H19 as oilfield maintenance (completed in mid-October) was offset by stronger non-oil exports, 11.1% YoY growth in construction and a 7.0% YoY surge in consumption, a reaction to a social shift in the budget policy; public spending on social support was up 24% YoY in 1H19, given electioneering for a new president earlier in the year. Overall, we slightly improve our three-year GDP outlook for Kazakhstan and downgrade fiscal expectations due to the irreversible nature of the social spending increase. However, the recent upgrade of sovereign rating by Moody's to positive suggests that the budget is not a huge concern in the near term.

Balance of payments and oil price

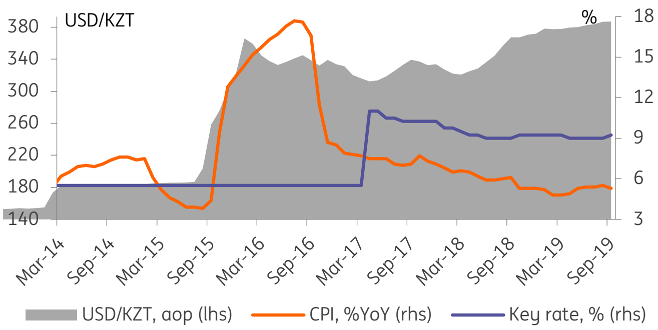


Source: CEIC, ING

BoP under pressure of growing imports, capital outflow

Acceleration of import growth from 2.7% in 1H18 to 10.5% YoY in 1H19 was the main side effect of the spike in local consumption and construction activity, which, combined with declining oil prices and oilfield maintenance, led to expansion of the current account deficit by almost 1ppt to -1.1% GDP in 1H19. Another immediate concern is the spike in net capital outflow to 2.2% GDP on accumulation of foreign assets by the private sector, coinciding with a political shift. As a result, the NBK was forced to spend US$5bn of reserves in 1H19, and risks for BoP remain for the near term, though an expected recovery of oil exports from c.-5% YoY in 8M19 should limit the tenge's downside.

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



Source: CEIC, ING

KZT and CPI risks are obstacles to monetary easing

Surging consumption alongside continued tenge depreciation raises inflationary risks, with CPI accelerating from 4.9% YoY in April 2019 to 5.3% YoY in September 2019, forcing the NBK to take a more hawkish stance. In July, it raised the key rate from 9.00% to 9.25%, reversing its April move. We continue to see KZT depreciation (though not as intense as previously) and CPI staying at the upper bound of the 4.0-6.0% target range on budget support to consumption, which limits room for monetary easing from this point. The NBK may return to the cut cycle next year, with local watch factors including re-consolidation of the fiscal policy and signs of improvement of the capital account.

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	4.1	4.2	4.2
Private consumption (%YoY)	0.6	11.8	12.0	10.1	10.6	1.1	1.8	1.2	1.2	5.3	5.0	4.0	3.0
Government consumption (%YoY)	1.0	2.7	11.9	13.5	1.7	9.8	2.4	2.3	1.9	-14.0	6.5	2.5	2.0
Investment (%YoY)	2.9	-3.0	2.9	4.1	6.9	4.2	3.7	2.0	5.8	17.5	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	4.4	2.4	3.2	3.7
Unemployment rate (year-end, %)	6.6	5.8	5.4	5.3	5.2	5.1	4.9	5.0	4.9	4.9	4.8	4.8	4.7
Nominal GDP (KZTbn)	17,008	21,816	28,243	31,015	35,999	39,676	40,884	46,971	54,379	61,820	66,209	71,042	76,228
Nominal GDP (€bn)	78	112	145	157	171	177	116	133	138	146	156	162	165
Nominal GDP (US$bn)	114	148	191	206	234	218	127	141	163	166	173	183	195
GDP per capita (US$)	6,975	8,890	11,285	11,983	13,364	12,295	7,040	7,731	8,922	8,987	9,333	9,752	10,133
Gross domestic saving (% of GDP)	7.3	7.1	8.4	5.1	5.8	6.7	6.6	14.7	7.4	33.7	33.6	33.0	34.0
Prices													
CPI (average, %YoY)	10.7	15.3	16.0	12.5	7.8	10.9	4.1	13.4	5.5	6.0	5.3	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	5.6	5.4	5.2
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	6.4	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	-2.4	-2.0
Consolidated primary balance	-2.5	-2.0	-1.7	-2.1	-1.4	-2.1	-1.5	-0.8	-1.9	-0.5	-1.0	-1.4	-1.0
Total public debt	12.3	14.4	11.6	12.3	12.3	14.3	22.1	24.4	25.5	27.2	26.5	26.3	26.1
External balance													
Exports (US$bn)	43.2	60.3	84.3	86.4	84.7	79.5	46.0	36.7	48.5	61.1	58.1	58.5	61.5
Imports (US$bn)	28.4	31.1	36.9	46.4	48.8	41.3	30.6	25.4	29.6	33.7	33.4	36.7	41.1
Trade balance (US$bn)	14.8	29.1	47.4	40.1	35.9	38.2	15.4	11.4	18.9	27.5	24.7	21.8	20.4
Trade balance (% of GDP)	12.9	19.7	24.8	19.4	15.4	17.5	12.2	8.1	11.6	16.5	14.3	11.9	10.5
Current account balance (US$bn)	-4.1	1.4	10.2	2.2	2.0	6.1	-6.0	-8.1	-5.1	-0.3	-2.0	-3.0	-4.0
Current account balance (% of GDP)	-3.6	0.9	5.3	1.1	0.8	2.8	-4.7	-5.8	-3.1	-0.2	-1.2	-1.6	-2.1
Net FDI (US$bn)	10.1	3.7	8.6	11.9	8.0	4.7	3.3	13.7	3.8	4.9	3.2	2.5	1.8
Net FDI (% of GDP)	8.8	2.5	4.5	5.7	3.4	2.1	2.6	9.8	2.3	3.0	1.9	1.4	0.9
Current account balance plus FDI (% of GDP)	5.2	3.4	9.8	6.8	4.3	4.9	-2.2	4.0	-0.8	2.8	0.7	-0.3	-1.1
Foreign exchange reserves ex gold (US$bn)	20.6	25.2	25.2	22.1	19.2	21.8	20.3	20.1	18.2	16.5	11.0	10.0	9.0
Import cover (months of merchandise imports)	8.7	9.7	8.2	5.7	4.7	6.3	8.0	9.5	7.4	5.9	4.0	3.3	2.6
Debt indicators													
Gross external debt (US$bn)	112.9	118.2	125.3	136.9	150.0	157.1	153.0	163.3	167.2	158.8	162.0	163.8	165.0
Gross external debt (% of GDP)	99	80	66	66	64	72	121	116	103	95	94	89	85
Gross external debt (% of exports)	261	196	149	158	177	198	333	445	345	260	279	280	268
Lending to corporates/households (% of GDP)	44.9	34.8	31.1	32.1	31.4	30.5	31.0	27.1	24.4	25.5	25.5	25.6	26.0
Interest & exchange rates													
Central bank key rate (year-end, %)	7.00	7.00	7.50	5.50	5.50	5.50	16.00	12.00	10.25	9.25	9.25	8.75	8.50
Broad money supply (average, %YoY)	19.5	13.3	15.0	7.9	10.2	10.4	33.8	15.6	-1.7	7.0	3.8	6.7	6.3
3m interest rate (KazPrime, average, %)	8.3	4.1	1.8	2.5	6.5	7.1	10.4	15.5	11.8	10.3	10.20	10.05	9.65
3m interest rate spread over US$-Libor (ppt)	796	373	134	223	627	681	966	1,424	944	789	852	817	965
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)	148.4	147.4	148.4	150.7	153.6	182.4	339.5	333.3	332.3	384.2	385	390	393
USD/KZT exchange rate (average)	148.7	147.4	147.9	150.4	154.0	181.8	322.8	333.7	333.7	371.8	383	388	392
EUR/KZT exchange rate (year-end)	213	195	192	199	211	222	371	352	398	439	424	449	472
EUR/KZT exchange rate (average)	218	195	195	197	211	224	351	352	395	423	426	438	462
Brent oil price (annual average, US$/bbl)	63	80	111	112	109	99	54	45	55	72	65	62	68

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	3.8	3.8	4.3	4.2	4.0	4.0	4.1	4.2	4.3	4.0	4.2	4.1	4.2
CPI (eop, %YoY)	5.3	4.8	5.4	5.3	5.6	5.6	5.5	5.4	5.4	5.6	5.6	5.5	5.2
Central bank key rate (eop, %)	9.25	9.25	9.00	9.25	9.25	9.25	9.00	9.00	8.75	8.75	8.75	8.50	8.50
3m interest rate (eop, %)	10.25	10.25	10.00	10.25	10.25	10.25	10.00	10.00	9.75	9.75	9.75	9.50	9.50
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)	384	380	381	388	385	386	388	389	390	391	392	393	393
EUR/KZT exchange rate (eop)	439	426	433	423	424	425	434	440	449	454	459	464	472

Source: National sources, ING estimates

Poland

Rafał Benecki and Piotr Poplawski, Poland

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	4.5	3.9	3.8	4.0	3.5	4.2	3.3
CPI (%YoY)*	1.7	2.5	3.0	3.6	2.6	2.2	2.8
Policy interest rate (eop, %)	1.50	1.50	1.50	1.50	1.50	1.50	1.50
3m interest rate (%)*	1.72	1.72	1.73	1.73	1.73	1.72	1.73
10yr yield (%)*	2.84	2.00	1.90	1.85	1.78	2.40	1.85
USD/PLN*	3.84	4.01	3.95	3.95	3.87	3.86	3.76
EUR/PLN*	4.30	4.37	4.28	4.30	4.34	4.30	4.32

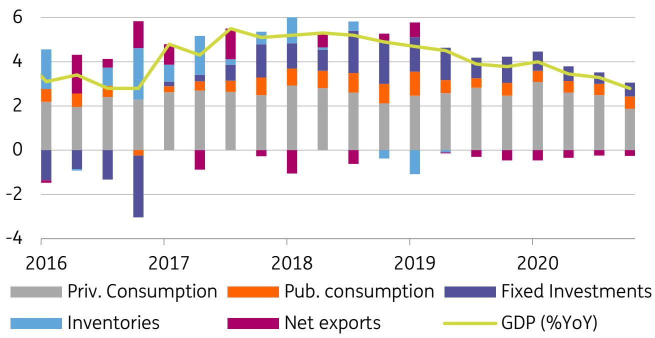
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: 2020	S&P	BBB+	A-
Fiscal	Neutral	Parliamentary: 2023	Moody's	A2	A2
Monetary	Stable	Local: 2023	Fitch	A-	A-

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

Country strategy

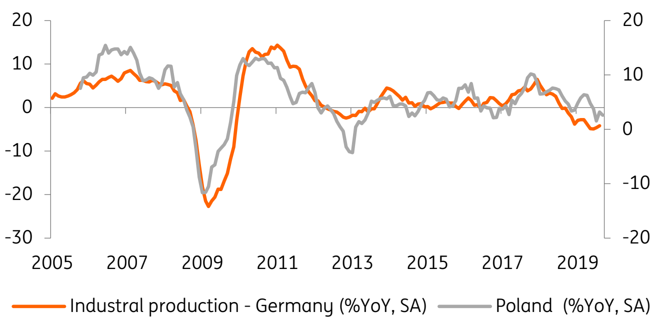
The post-election rationalisation of the 2020 budget (adding missing spending and deducting the business unfriendly hike of pension contribution for most skilled) should cause upward revision of net borrowing needs, but from an ultra-low (PLN7bn) to low (PLN15bn) level. On the other hand, household deposits should keep outpacing credit, so local banks remain main POLGBs buyers. This favourable supply-demand condition calls for further tightening of the POLGB-Bund and asset swap spread in 2H19. In 2021, the supply-demand conditions should change. We expect the MPC to hold flat rates even if average CPI in 2020 reaches 4% YoY (not our scenario; INGF 2.8% YoY). FX wise, a twofold ruling of local courts and gradual provision building by banks spread negative pressure of CHF loans over time.

GDP structure (%YoY)



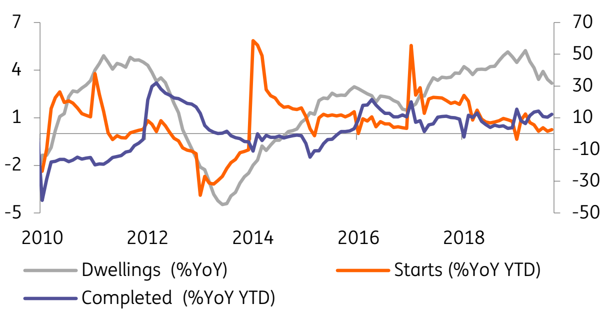
Source: GUS, ING

Industry was immune to German slowdown in 1H19



Source: GUS, Destatis

Construction activity is moderating



Source: NBP, GUS, ING

Macro digest

In the general elections, the PiS retained a single-party majority in the Lower Chamber of Parliament (235 seats), but failed to reach either a presidential majority (267, allowing rejection of a presidential veto) or a constitutional majority (at 306 votes, allowing constitutional amendments). This equates to a largely unchanged policy but, over the next three quarters, abundant social pledges from the campaign should be delivered, with the remainder of the PiS term expected to be more about initiation of large infrastructure projects. The political agenda may again become an issue as PiS may push projects like media law overhaul.

A generous rise in the minimum wage (15.6%) as of next year seems a done deal. We estimate it to increase the overall wage growth by 1.5ppt, extending the consumer spending boom. We expect consumption to grow by 4.5% YoY this year and to be just slightly slower in 2020 (4.3%).

Manufacturing activity remains resilient to the industrial slump in the euro area, largely owing to strong reliance in domestic demand in Poland and the euro zone (rather than non-European markets) – see the lead article for more detail. Investment activity has been the real failure of this government, especially in relation to private outlay. Thus, in this second term, PiS is expected to focus on public infrastructure projects and renewables, funded partially by state-governed utilities. We see 2019 investment growth at 7.9% YoY, a bit lower than in 2018 (8.8%). With EU co-financed spending at its peak in 2019 and the impulse from social benefits evaporating after 2020, the 2021 growth outlook looks particularly bleak. We see about 2% YoY GDP growth in 2021 with unchanged policy assumption, but given strong PiS determination to hold strong growth and concern about non-linear tax revenue deterioration when GDP slows, the government should deliver the new fiscal measures, with a focus on investment rather than social spending.

Temporarily rising CPI is not an issue for the MPC though. The MPC remains confident that CPI will move back to target (2.5% YoY) in 2H20 and Chairman Glapiński sees no change in monetary policy for the foreseeable future. While we see the scope for a CPI decline in 2H20 as more limited than the NBP expects (reflecting continuously rising service prices), easing by key central banks and prospects of economic slowdown domestically effectively exclude rate hikes. We see rate cuts as more likely, but no sooner than in late-2021.

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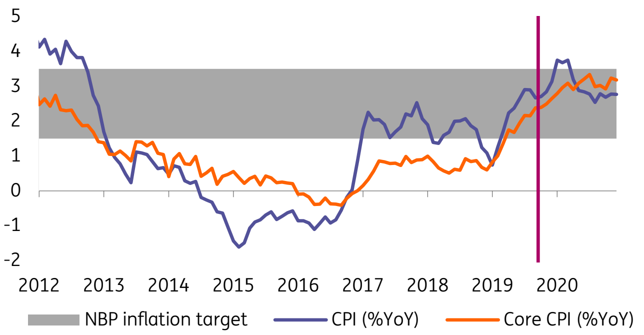
CPI and the main NBP interest rate

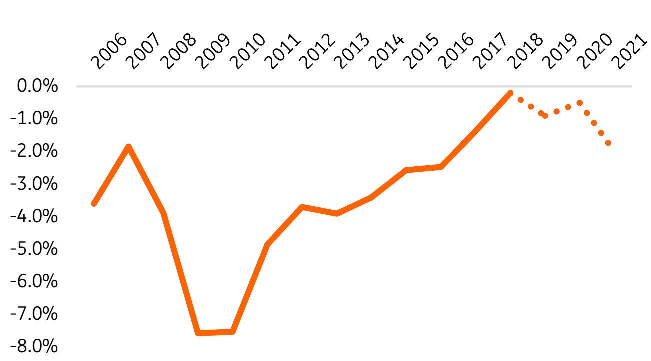


Source: NBP, GUS, ING

Further rise in the core component

We forecast inflation to flirt with the upper ceiling above the NBP's target (2.5%YoY+/-1%) in 1Q20. CPI should oscillate slightly below 3% in the later part of 2020. This mainly reflects our view on the core component. The rise of regulated prices (garbage collection), some methodological changes (better capture of clothing prices) as well as lagged effects of rising unit labour costs and strong demand pressure are main core CPI drivers in 2019. In 2020, a 15% rise in the minimum wage should add c.0.3ppt to core. On average, CPI should reach almost 3% YoY in 2020 (Bloomberg consensus at 2.8%), but another year of frozen retail electricity prices should deduct about 0.3ppt. Food prices are set to rise by 6% YoY in 1Q20, in our view, but should moderate to 2% in 4Q20.

Net result of the general government (% of GDP)

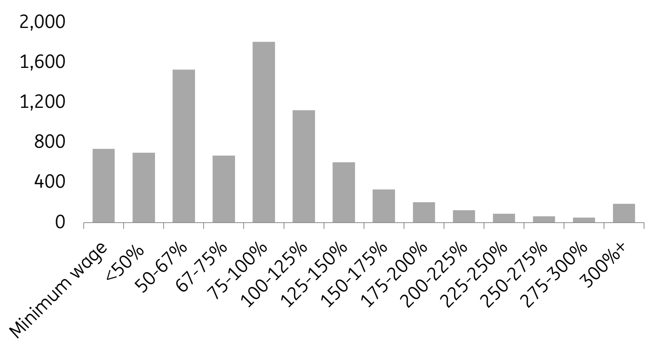


Source: Ministry of Finance, ING forecast

Fiscal stance to deteriorate in 2021

The 2019 general government deficit should be sustained at a low level of 0.9% of GDP, despite aggressive pre-election spending. The 2020 budget will be even more burdened by that, but the gap will be filled by one-off revenues, such as taxing OFE pension funds, sale of CO_2 allowances and 5G frequencies. We don't think a zero central deficit will be delivered next year due to abundant election transfers, lowering of the PIT tax and abandoning of the pension contribution rise after the elections. We forecast a PLN10bn rather than zero deficit but, nonetheless, net borrowing needs should be amended from ultra-low (PLN7bn) to low (PLN15bn). In 2020, the sector deficit should reach 0.5% of GDP but, in 2021, we expect it to rise to 2.0-2.5% of GDP after the one-off revenues deplete.

Number of workers earning % of average wage (000)

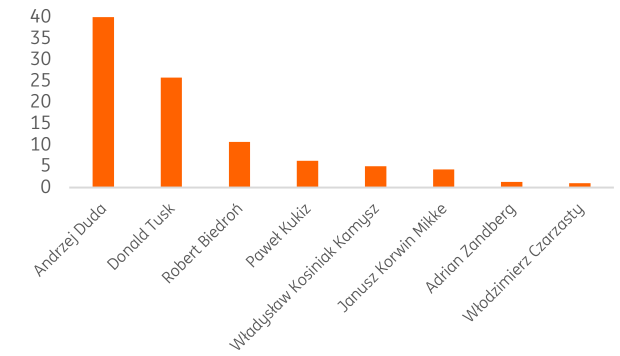


Refers to employment in the National economy. Source GUS

Why minimum wage increase is so important

The government's decision to increase the minimum wage by 15.6% YoY in 2019 is the strongest increase since 2007. If sustained, the government plans to double the minimum wage in five years. The magnitude of the 2020 minimum wage rise is double that of 2018 (7.1%). The share of workers whose salary is lower than 50% of the average wage is currently 17.4%, of which 9% work for a minimum wage, ie, higher than the EU median (6.8% in 2014). The most likely outcome of the aggressive minimum wage hike is deterioration of company profits, partially offset by inflation, and there may additionally be some layoffs, mainly in SMEs that are strongly reliant on cheap labour. Lastly, the ruling PiS could water down the planned aggressive minimum wage hike.

Top presidential candidates (polls for first round)



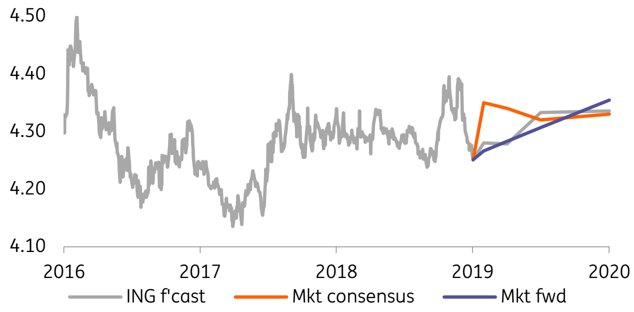
Source: Ewybory.eu

PiS failure in May 2020 presidential election is possible

The polls indicate that PiS-backed Andrzej Duda is the most trusted politician (at 65%) and would win the election. Since PiS doesn't have the majority to repeal a presidential veto, the party will back Duda heavily. In the first round many opposition candidates would participate, and their votes would be expected to pass to a single opposition leader in the second round. There are number of candidates in the running for this key role. Donald Tusk is back in play and with an anticipated 40-45% backing in the polls, he may be the main threat to Andrzej Duda. Other candidates include centrist newcomer Małgorzata Kidawa-Błońska (Civic Platform) and frontrunners of smaller parties. We see a 50/50 chance that Andrzej Duda will be defeated, which would constrain ruling PiS, due to president's veto.

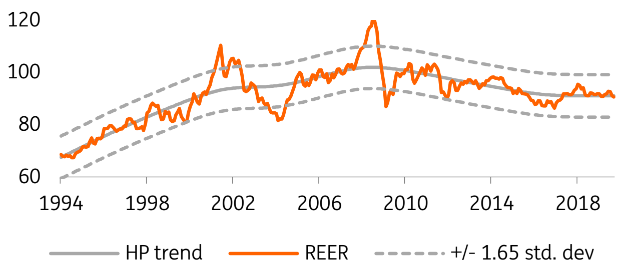
Poland Strategy

FX – spot vs forward and INGF



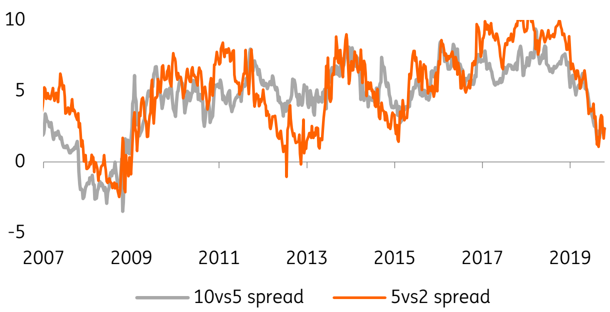
Mostly stable Bloomberg, ING forecasts

FX – PLN REER vs HP trend



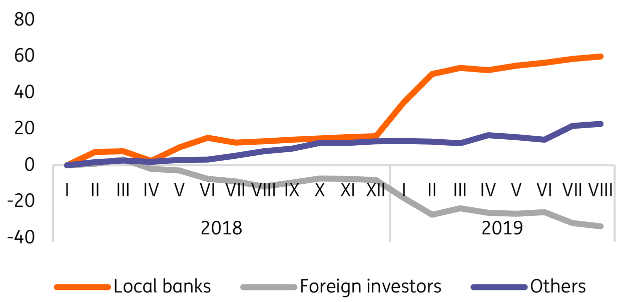
the Source: Macrobond

Local curve (%)



Source: Bloomberg

Structure of POLGBs holders – change since Jan-18



Source: MinFin

FX strategy

We see two structural factors that could keep PLN slightly undervalued over the coming quarters. First, the impact of CHF loans – this was watered down recently, but still exists. Courts have increasingly sided with debtors, but final verdicts (even after ECJ guidance) are less encouraging. The twofold ruling of local courts are likely to prevent a significant spike in new cases. Also, the prevailing provisions policy is likely to be on a case by case basis rather than all FX loans/losses being provisioned upfront. Both factors should ensure that the negative pressure of CHF loans on PLN is spread across time as the likely pre-emptive hedges of banks' CHF/PLN short should be spread over time. If the courts were to side with debtors, however, the conversion of CHF mortgages to PLN at origination rates takes place and the FX loss will burden banks.

Secondly, Commerzbank is planning to sell its controlling stake in Polish mBank. A state-governed institution may place a bid, which would involve converting about PLN15bn into a hard currency in the near future.

In the short term, better EM sentiment and possible upside risk for €/US$ should mitigate the abovementioned PLN-negative factors.

Therefore €/PLN should trade within a 4.25 and 4.35 range for the remainder of 2019 and likely close to 4.35 in 2020, in our view. This means a lasting undervaluation, as our models indicate fundamental (both short and long term) levels at 4.20-25.

If weaker PLN prevails, it is likely to be welcomed by central bank. The MPC is not only focused on the CPI target but also GDP growth.

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	4.9	5.1	4.2	3.3	2.1
Private consumption (%YoY)	3.3	2.5	3.3	0.8	0.3	2.6	3.0	3.9	4.5	4.5	4.5	4.3	2.5
Government consumption (%YoY)	3.6	3.3	-1.8	-0.4	2.2	4.0	2.1	2.2	2.8	2.3	3.7	3.0	1.6
Investment (%YoY)	-1.9	-0.4	8.8	-1.8	-1.1	10.0	6.1	-8.2	4.0	8.9	7.0	3.4	0.6
Industrial production (%YoY)	-3.6	11.0	7.2	1.4	2.3	3.4	4.9	2.9	6.5	6.0	4.2	4.3	2.6
Unemployment rate (year-end, %)	12.1	12.4	12.5	13.4	13.4	11.4	9.7	8.2	6.6	5.8	5.6	5.9	6.4
Nominal GDP ({CUR}bn)	1,362	1,445	1,567	1,629	1,657	1,720	1,800	1,861	1,989	2,116	2,257	2,400	2,484
Nominal GDP (€bn)	315	362	380	389	395	411	430	425	469	496	523	554	572
Nominal GDP (US$bn)	439	480	529	500	524	546	478	469	529	585	579	615	672
GDP per capita (US$)	11,484	12,503	13,793	13,071	13,689	14,234	12,475	12,420	13,879	15,310	15,293	16,244	17,934
Gross domestic saving (% of GDP)	16.3	14.9	16.2	17.7	20.5	20.5	23.7	23.9	24.9	24.2	24.5	23.8	23.4
Prices													
CPI (average, %YoY)	3.4	2.6	4.3	3.7	0.9	0.0	-0.9	-0.6	2.0	1.7	2.3	2.8	2.8
CPI (year-end, %YoY)	3.5	3.1	4.6	2.4	0.7	-1.0	-0.5	0.8	2.1	1.1	2.8	2.6	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	6.9	7.7	7.0
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	-0.2	-0.9	-0.5	-2.5
Consolidated primary balance	-4.8	-4.9	-2.3	-1.1	-1.6	-1.7	-0.9	-0.6	-0.1	1.3	0.6	1.0	-0.5
Total public debt	49.4	53.1	54.1	53.7	55.7	50.4	51.3	54.2	50.6	48.9	47.5	45.9	46.4
External balance													
Exports (€bn)	95.4	118.1	132.4	141.0	149.1	158.6	172.2	177.5	201.9	216.9	227.4	239.9	250.7
Imports (€bn)	103.1	129.1	145.7	149.2	149.4	161.9	170.0	174.6	200.5	221.6	231.2	246.5	255.6
Trade balance (€bn)	-7.7	-10.9	-13.3	-8.1	-0.3	-3.3	2.2	2.9	1.4	-4.8	-3.8	-6.6	-4.9
Trade balance (% of GDP)	-2.5	-3.0	-3.5	-2.1	-0.1	-0.8	0.5	0.7	0.3	-1.0	-0.7	-1.2	-0.9
Current account balance (€bn)	-12.8	-19.5	-19.7	-14.5	-5.1	-8.6	-2.4	-2.2	0.7	-2.9	-1.4	-2.5	-2.5
Current account balance (% of GDP)	-4.1	-5.4	-5.2	-3.7	-1.3	-2.1	-0.6	-0.5	0.1	-0.6	-0.3	-0.4	-0.4
Net FDI (€bn)	5.8	6.5	9.8	4.7	3.2	9.8	9.1	3.9	6.7	12.4	9.4	8.4	8.5
Net FDI (% of GDP)	1.9	1.8	2.6	1.2	0.8	2.4	2.1	0.9	1.4	2.5	1.8	1.5	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	1.6	1.9	1.5	1.1	1.0
Foreign exchange reserves ex gold (€bn)	55.2	70.0	75.6	82.5	77.0	82.7	87.2	108.1	94.5	102.3	118.1	117.0	114.4
Import cover (months of merchandise imports)	6.4	6.5	6.2	6.6	6.2	6.1	6.2	7.4	5.7	5.5	6.1	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	339.5	307.3	335.0	328.8	314.8
Gross external debt (% of GDP)	64	67	61	74	73	65	69	72	72	62	64	59	55
Gross external debt (% of exports)	211	204	176	204	194	169	173	174	168	142	147	137	126
Lending to corporates/households (% of GDP)	51.2	52.5	55.0	53.6	54.6	56.0	57.2	57.8	56.0	56.6	56.7	56.4	57.0
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	9.2	9.0	6.7	5.3
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	1.72	1.73	1.67
3m interest rate spread over EURIBOR (ppt)	364	293	322	468	269	241	187	197	206	203	207	213	207
2yr yield (average, %)	5.22	4.77	4.85	3.14	3.05	1.79	1.62	1.67	1.88	1.56	1.59	1.56	1.37
10yr yield (average, %)	6.13	5.80	5.98	4.94	4.09	3.46	2.69	3.08	3.46	3.20	2.40	1.85	2.01
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	3.86	3.76	3.63
USD/PLN exchange rate (average)	3.10	3.01	2.96	3.25	3.16	3.15	3.77	3.97	3.76	3.62	3.91	3.82	3.70
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	4.28	4.32	4.36
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	4.30	4.32	4.34

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	4.9	4.7	4.5	3.9	3.8	3.8	3.5	3.3	2.8	2.31	2.34	2.11	1.87
CPI (eop, %YoY)	1.1	1.7	2.6	2.5	2.8	3.6	2.6	2.5	2.6	2.64	2.93	2.92	2.57
Central bank key rate (eop, %)	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.50	1.50	1.50	1.50
3m interest rate (eop, %)	1.72	1.72	1.72	1.72	1.73	1.73	1.73	1.73	1.73	1.73	1.73	1.65	1.48
10yr yield (eop, %)	2.83	2.84	2.39	2.00	1.90	1.85	1.78	1.84	1.90	1.95	1.99	2.07	2.13
USD/{CUR} exchange rate (eop)	3.76	3.84	3.73	4.01	3.89	3.91	3.88	3.83	3.76	3.73	3.69	3.66	3.63
EUR/{CUR} exchange rate (eop)	4.30	4.30	4.25	4.37	4.28	4.30	4.34	4.33	4.32	4.33	4.34	4.35	4.36

Source: National sources, ING estimates

Romania

Ciprian Dascalu, Chief Economist, Romania & Balkans

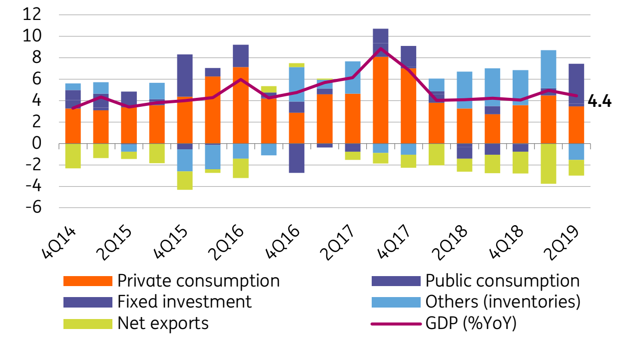
Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	4.4	3.8	3.2	2.9	2.3	4.0	2.8
CPI (%YoY)*	3.8	3.5	3.8	2.8	2.4	3.8	3.1
Policy interest rate (eop, %)	2.50	2.50	2.50	2.50	2.50	2.50	2.50
3m interest rate (%)*	3.23	3.09	3.00	3.00	3.00	3.10	2.90
10yr yield (%)*	4.60	4.10	4.00	4.10	4.30	4.40	3.80
USD/RON*	4.23	4.36	4.36	4.38	4.30	4.29	4.27
EUR/RON*	4.74	4.75	4.80	4.82	4.82	4.76	4.83

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

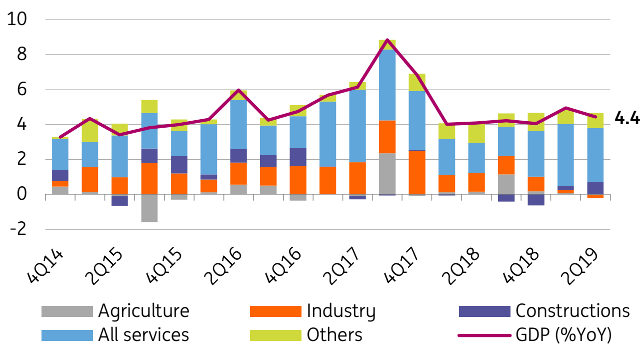
*Quarterly data is eop, annual is avg Source: National sources, ING estimates

Not the most sustainable growth model



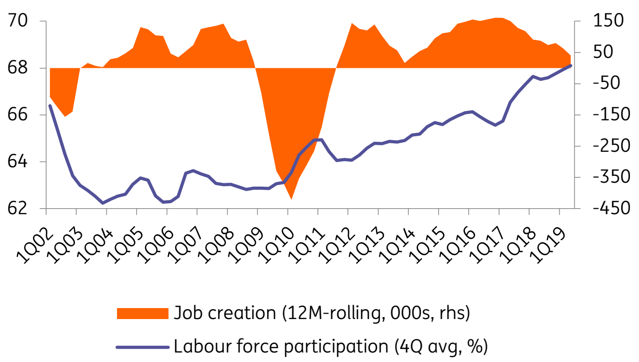
Source: NIS, ING

Industry contracts on weak external demand



Source: NIS, ING

Peak of the job creation behind us



Source: Eurostat, NIS, ING

Country strategy

Without a clear parliamentary majority that can coalesce behind a government, Romania faces difficulty navigating a course until the next elections set for late-2020. The implementation timeline for pension and public wage bills is unlikely to be derailed. This is likely to spook markets, especially the 40% pension hike due in September 2020 that could potentially double the budget deficit under a no policy change scenario. Romania's investment grade status is dependent on measures that the new government will take and how credible and rapid the fiscal consolidation will be. This is expected to become even more difficult as the economy is set to slow down. Fiscal adjustment will offer room for the NBR to ease policy, but we do not see this happening until after the general election with snap elections unlikely.

Macro digest

The economy performed relatively well in the first half of 2019 posting a 4.8% YoY GDP growth. It was supported by investment predominantly in the construction sector and private consumption as Romania is in the fourth consecutive year of double-digit wage growth. These offset the negative impact from net exports which were hit by weaker external demand visible in a negative impact from industry on the supply side.

Apart from external headwinds, there is reason to expect a year or two of weaker growth from domestic adjustment related to unavoidable fiscal consolidation. This is not only about consolidation alone, but also a rebalancing of the budget structure, which currently sees the ratio between rigid spending versus cyclically sensitive revenue at levels unseen since the economy was in recession. We see improved management of hiring and possible layoffs as more likely than wage cuts. Fiscal adjustment is likely to be triggered by concerns about the rating outlook and higher financing costs. To offset the growth impact, it is likely to be accompanied by reforms to improve tax collection, boost productivity and monetary policy easing. This will also help a narrowing of the other twin deficit, the current account deficit which is set to overshoot -5.0% of GDP this year. In the end, we believe that narrowing the external imbalance will involve a combination of fiscal consolidation, structural reforms and moderate and controlled currency depreciation.

Labour shortage and a skills mismatch are also factors behind our weaker growth outlook. Rapid wage hikes have so far failed to stave off labour force migration. 21.3% of the country's working-age population has moved abroad. In addition, public sector policies are targeting the redistribution of national income from capital to labour via minimum and public sector wage hikes. This has led to a significant tightening of the labour market in the absence of meaningful reforms to ease it by improving labour force participation through better mobility, training and tackling the grey economy.

The electoral backdrop does not offer too much political drive for deeply needed fiscal consolidation and reforms. The delay could lead to a larger cost in terms of growth later, also subject to external economic and market conditions. Depending on the mix and external conditions, we could see a loss of between one and two percentage points in terms of short-term growth. Initially, this is likely to be accompanied by higher inflation biting into real incomes. Hence, not a lot to cheer for a new government that will take office after the late-2020 general elections. Regardless of the political composition of the new executive, we believe fiscal consolidation is imminent.

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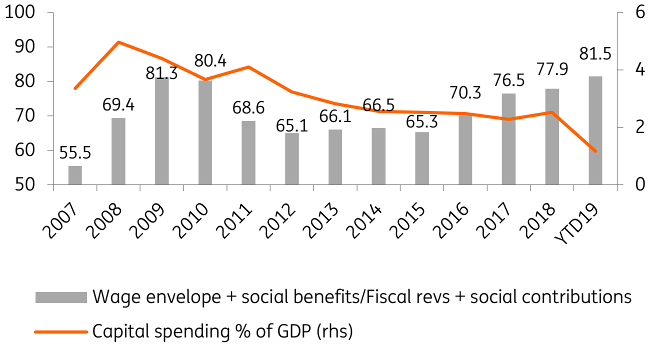
No fiscal space due to high rigid spending

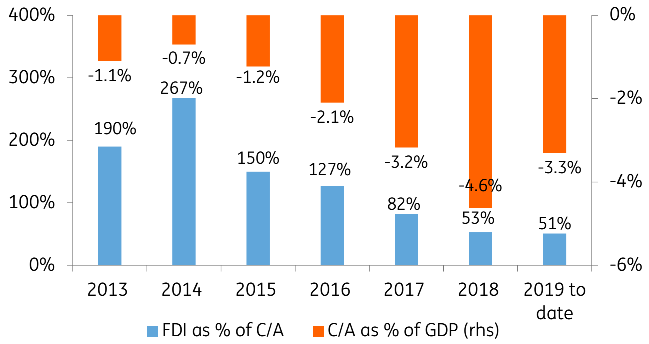


Source: MinFin, ING

Fiscal policy: A ticking time bomb

Rigid spending (wages and social benefits) is already consuming over 80% of fiscal revenues and contribution. If the economy slows and this ratio goes up, there is little room to cut from public investments. Hence, the government will face two options: raise taxes or raise the collection with VAT gap at 35.5% - the largest in the EU. The former bears some political costs, while the latter takes time to implement. In the end, it might be a combination of the two. The biggest threat to medium-term fiscal outlook is the 40% hike in pensions due September 2020, with just two months ahead of scheduled general elections. This is only partially included in the outlook of the rating agencies and not priced-in by the markets. Without snap elections ahead of Sep-20, it is hard to imagine a postponement or rescheduling of the hike.

Mind the gaps: twin deficit widening

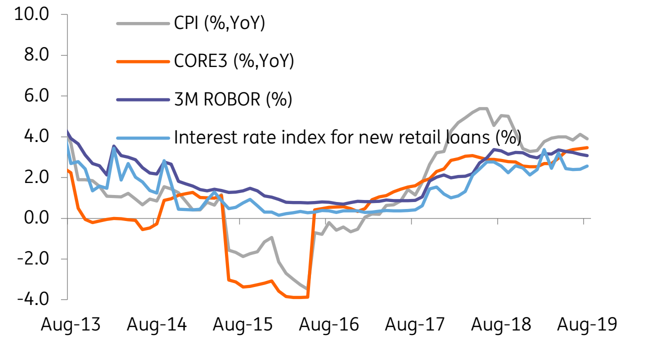


Source: NBR, NIS, ING

External shortfall: not so sound financing sources

The C/A shortfall is likely to widen to -5.4% of GDP this year as the trade balance shortfall won't be corrected without meaningful fiscal consolidation which is unlikely until after the general elections. The size of the fiscal adjustment depends on the complementary measures such as structural reforms and currency weakening. The structure of financing with FDI covering less than half of the C/A gap which forces the NBR to keep a relatively large interest rate differential to discourage RON weakening in order to keep inflation and inflationary expectations in check. Good news is that recent trade balance data points to some signs of balancing on slower import growth, negative news is that export of services are slowing as well. The longer the delays the higher the currency risks.

Policy stance loosen by the new index for retail loans

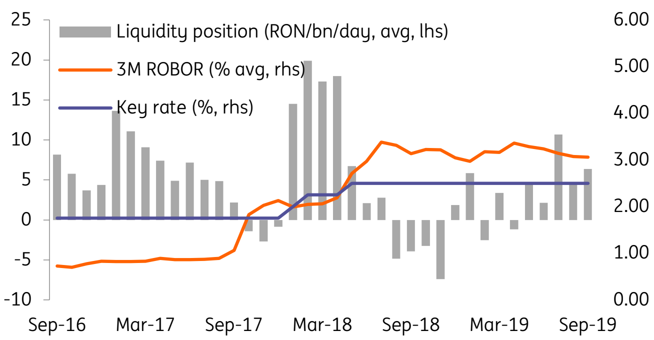


Source: NBR, NIS, ING

CPI outlook: eventually will go down

Despite expected GDP growth slow-down, inflation is expected to stay elevated in the short-term, but likely to return within the NBR target range of 1.5-3.5% at the start of 2020. The main risk to outlook is related to liberalisation of the regulated prices. Fiscal policy remains a short-term risk to inflation, but unavoidable fiscal consolidation is likely to help disinflationary process and allow the NBR to ease policy. We expect once there are reasonable prospects of fiscal consolidation, the NBR can take initial easing steps via easing liquidity control and cutting reserve requirements, This is unlikely to happen before 2021. The peak of core inflation is just a few months ahead of us. This means that NBR could get a bit more relaxed about currency weakness.

Liquidity management – NBR's favourite tool



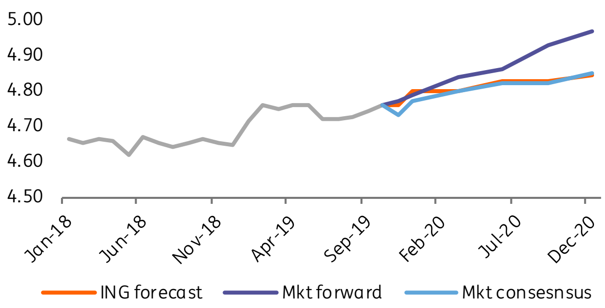
Source: NBR, ING

Monetary policy: operating under too many constrains

The NBR policy operates under many constraints. The lack of a fiscal rule linked to the phase of the economic cycle increases the monetary policy burden. The lack of coherent policy mix was partially offset by NBR via interest rate hikes, macro-prudential regulatory measures and real appreciation of the exchange rate. The latter had a cost in terms of competitiveness which came on top of high import demand and led to a trade gap widening. The NBR prefers the flexibility of controlling interest rates within the standing facilities interval of 1.5-3.5% to quickly react to exchange rate volatility. The exchange rate volatility seems determinant in NBR decision making process. Such a reaction function might lead to unnecessary tightening when the economy slows.

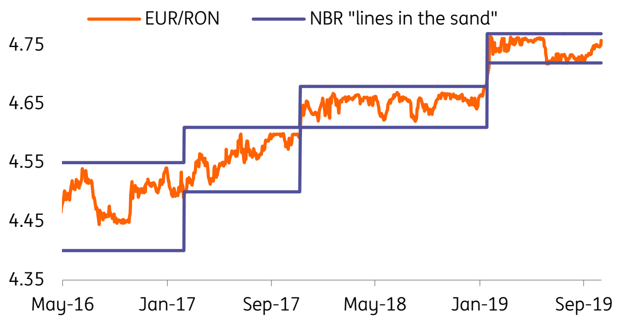
Romania Strategy

FX – spot vs forward and INGF



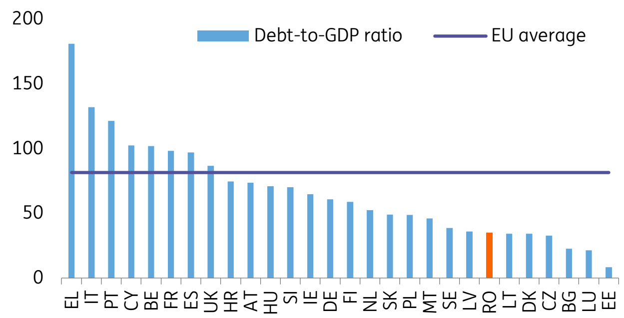
Source: Refinitiv, ING

EUR/RON range to shift higher, but timing is tricky



Source: NBR, ING

Investment grade safe on low public debt-to-GDP ratio



Source: AMECO

FX strategy

The NBR remains obsessed by a low FX volatility regime. While the current account is likely to continue to deteriorate, the RON is likely to continue to appreciate in real terms due to a high inflation differential and nominal depreciation that is narrower than the relative increase in prices. Making things worse, with EUR/RON near an all-time high and a heavy election calendar ahead, the NBR is likely to avoid negative news headlines. We look for a mild weakening of the RON, within the inflation differential over the next twelve months, given the still high FX pass-through in the context of CPI staying within the upper half of the NBR target range. Despite being fundamentally bearish on the RON, we do not recommend shortening the currency due to prohibitive cost of carry and tight NBR FX management. The timing of the adjustment higher in the EUR/RON is difficult to call. A first move higher could be after the presidential election due 10/24 November.

We believe that weaker RON will be part of the adjustment process of the external imbalances, especially as fiscal consolidation and structural reforms are likely to be delayed until after the general elections due late-2020. We think, given the imbalances built over the past few years and real appreciation of the RON over this period that there is a significant asymmetric risk towards a much larger move higher in the EUR/RON, but this depends a lot on the global context. Assuming a relatively benign external environment the NBR can easily manage the FX given the relatively high level of FX reserves versus the average turnover in the EUR/RON market. In the meantime, various measures point to RON overvaluation.

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	7.1	4.0	4.0	2.8	2.1
Private consumption (% YoY)	-6.6	-4.6	1.5	1.8	0.5	4.6	5.8	8.2	10.1	5.3	4.3	3.0	2.0
Government consumption (% YoY)	-4.1	-1.6	-1.2	7.5	-2.9	3.5	-0.3	2.2	4.2	1.5	0.5	1.4	1.0
Investment (% YoY)	-33.9	-2.8	6.1	3.1	-5.6	3.3	7.5	-0.2	2.5	-2.6	5.5	1.3	3.7
Industrial production (% YoY)	-5.4	4.9	8.1	3.0	7.7	6.4	2.7	3.1	8.7	4.4	0.0	2.4	4.0
Unemployment rate (year-end, %)	6.5	7.0	7.1	6.8	7.1	6.8	6.8	5.9	4.9	4.2	3.6	3.6	3.5
Nominal GDP (RONbn)	531	528	559	594	635	669	713	765	858	940	1,031	1,110	1,200
Nominal GDP (€bn)	125	125	132	133	144	150	160	170	188	202	216	230	246
Nominal GDP (US$bn)	175	166	185	172	191	199	176	187	214	238	238	260	290
GDP per capita (US$)	8,600	8,200	9,200	8,600	9,600	10,000	8,900	9,500	10,900	12,200	12,400	13,600	15,400
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	21.4	21.1
Prices													
CPI (average, % YoY)	5.6	6.1	5.8	3.3	4.0	1.1	-0.6	-1.6	1.3	4.6	3.8	3.1	3.3
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	3.3
Wage rates (nominal, % YoY)	8.8	2.5	5.0	5.0	5.0	5.3	8.3	13.0	14.2	13.1	14.7	10.5	9.7
Fiscal balance (% of GDP)													
Consolidated government balance	-9.1	-6.9	-5.4	-3.7	-2.2	-1.3	-0.7	-2.7	-2.7	-2.9	-3.4	-3.7	-3.0
Consolidated primary balance	-7.6	-5.4	-3.8	-1.9	-0.4	0.4	0.9	-1.2	-1.4	-1.8	-2.3	-3.4	-2.7
Total public debt	21.9	29.8	34.2	37.0	37.6	39.2	37.8	37.3	35.2	35.0	35.6	36.3	36.8
External balance													
Exports (€bn)	29.1	37.4	45.3	45.0	49.6	52.5	54.6	57.4	62.6	67.4	72.6	78.2	84.2
Imports (€bn)	38.9	46.9	54.9	54.6	55.3	58.6	63.0	67.4	75.6	82.9	90.8	99.6	109.2
Trade balance (€bn)	-9.9	-9.5	-9.7	-9.6	-5.8	-6.1	-8.4	-10.0	-13.0	-15.4	-18.2	-21.4	-25.0
Trade balance (% of GDP)	-7.9	-7.5	-7.3	-7.2	-4.0	-4.0	-5.2	-5.9	-6.9	-7.6	-8.4	-9.3	-10.2
Current account balance (€bn)	-5.8	-6.4	-6.6	-6.4	-1.5	-1.0	-2.0	-3.6	-6.0	-9.2	-11.6	-12.7	-11.0
Current account balance (% of GDP)	-4.6	-5.1	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.2	-4.5	-5.4	-5.5	-4.5
Net FDI (€bn)	3.4	2.3	1.7	2.6	2.9	2.7	3.0	4.5	4.9	5.0	5.2	5.3	5.5
Net FDI (% of GDP)	2.7	1.8	1.3	1.9	2.0	1.8	1.8	2.6	2.6	2.5	2.4	2.3	2.2
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	-2.1	-3.0	-3.2	-2.2
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	4.6	4.3	4.1
Debt indicators													
Gross external debt (€bn)	82.3	93.6	99.9	100.9	98.1	94.7	92.1	92.9	97.4	99.8	101.8	103.8	105.8
Gross external debt (% of GDP)	66	75	76	76	68	63	57	55	52	49	47	45	43
Gross external debt (% of exports)	283	250	221	224	198	180	169	162	155	148	140	133	126
Lending to corporates/households (% of GDP)	82.3	93.6	99.9	100.9	98.1	94.7	92.1	92.9	97.4	99.8	101.8	103.8	105.8
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	9.0	8.2	7.7
3m interest rate (Robor, average, %)	11.72	6.75	5.82	5.34	4.22	2.54	1.40	0.89	1.15	2.80	3.10	2.90	2.40
3m interest rate spread over Euribor (ppt)	10.5	5.9	4.4	4.8	4.0	2.3	1.4	1.2	1.5	3.1	3.5	3.0	2.7
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	3.2	3.0
10yr yield (average, %)	9.8	7.2	7.4	6.7	5.3	4.6	3.5	3.3	3.9	4.7	4.4	3.8	3.7
USD/RON exchange rate (year-end)	2.96	3.22	3.32	3.36	3.27	3.70	4.15	4.32	3.88	4.09	4.36	4.22	4.08
USD/RON exchange rate (average)	3.03	3.19	3.03	3.45	3.32	3.37	4.04	4.08	4.01	3.94	4.29	4.27	4.14
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	4.80	4.85	4.90
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	4.76	4.83	4.87

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	4.1	5.0	4.4	3.8	3.2	2.9	2.3	2.9	2.9	1.8	2.2	2.5	2.0
CPI (eop, %YoY)	3.3	3.8	3.8	3.5	3.8	2.8	2.4	2.9	3.3	3.0	3.3	3.6	3.3
Central bank key rate (eop, %)	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.25	2.00	2.00
3m interest rate (eop, %)	3.08	3.10	3.23	3.09	3.00	3.00	3.00	2.90	2.75	2.75	2.50	2.25	2.25
10yr yield (eop, %)	4.80	4.70	4.60	4.10	4.00	4.10	4.30	4.00	3.80	3.70	3.70	3.60	3.50
USD/RON exchange rate (eop)	4.09	4.25	4.23	4.36	4.36	4.38	4.30	4.27	4.22	4.18	4.16	4.13	4.08
EUR/RON exchange rate (eop)	4.66	4.76	4.74	4.75	4.80	4.82	4.82	4.83	4.85	4.85	4.87	4.87	4.90

Source: National sources, ING estimates

Russia

Dmitry Dolgin, Chief Economist, Russia & CIS

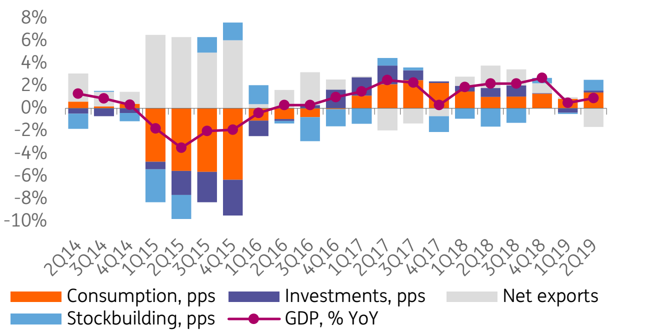
Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	0.9	1.2	1.1	1.8	2.0	1.0	1.5
CPI (%YoY)*	4.7	4.0	3.4	2.5	3.0	4.5	3.1
Policy interest rate (eop, %)	7.50	7.00	6.50	6.25	6.00	6.50	6.00
3m interest rate (%)*	8.03	7.21	6.70	6.45	6.20	7.77	6.35
10yr yield (%)*	7.49	7.15	6.50	6.25	6.30	6.50	6.30
USD/RUB*	63.21	64.86	64.00	64.00	66.00	64.85	65.60
EUR/RUB*	71.88	70.66	70.40	70.40	73.92	71.98	74.13

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-

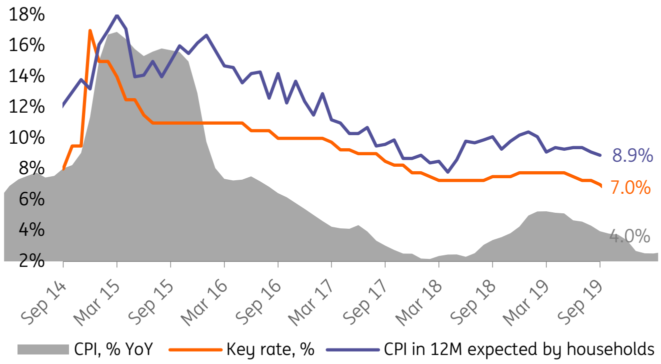
*Quarterly data is eop, annual is avg. Source: National sources, ING estimates

GDP and key contributors (% YoY, ppt)



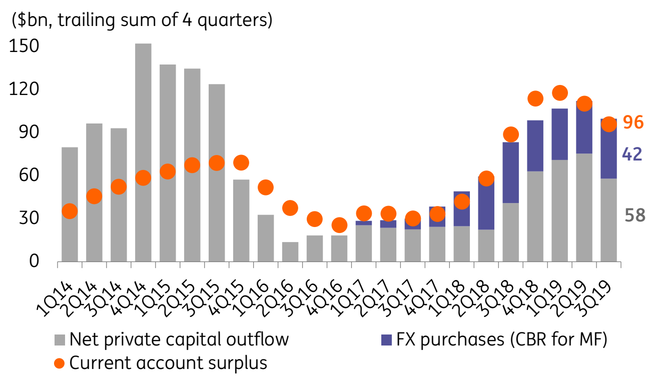
Source: Rosstat, ING

Key rate, CPI, and households' inflationary expectations



Source: Bank of Russia, Rosstat, ING

Current account surplus neutralisation



Source: Finance Ministry, Bank of Russia, Rosstat, ING

Country strategy

Russian economic growth is about to accelerate modestly as National Projects investment into infrastructure, representing 3.0-3.5% of GDP pa (70% funded by the budget), gains traction by 2022-24. Confidence outside the budget-driven sectors will remain constrained unless the business climate is improved and exports are diversified.

The macro picture is strong, with state savings of above 7% of GDP and growing, leaving space for fiscal easing. An externally-driven CPI slowdown to below 4% in 2019-20 creates room for at least a 50bp cut in the key rate by mid-2020, supporting attractiveness of bonds. RUB seems safe in the near-term, but a reversal in the accumulation of foreign assets by the private sector is required in order to break the long-term depreciation tendencies.

Macro digest

GDP growth slowed from 2.3% in 2018 to 0.7% YoY in 1H19 following a VAT rate hike, a pause in big ticket construction projects, and underexecution of state spending. Russia now appears to be heading towards recovery from 1.0% in 2019 to 1.5-1.7% in 2020-21, as budget financing of the National Projects should support industrial output and construction. The growth is constrained by a stagnating labour force and lack of confidence outside the budget-driven sectors, as reflected in the weak 7-10% corporate credit growth. Improvement may follow in the case of higher non-oil exports and promotion of SMEs (not our base case). We are not too optimistic on the consumer sector given the lack of income growth drivers and the regulatory de-stimulation of consumer lending growth, which is currently up 24% YoY and will decelerate. State support for consumption may come later in the electoral cycle (2022-24).

The biggest positive surprise is the continued underperformance of CPI growth, which decelerated from 5.3% YoY in March 2019 to below 4.0% YoY in October on the continued gasoline price freeze, favourable global grain prices, a strong rouble and tight fiscal stance. The CBR has cut the key rate by 125bp YTD to 6.50% and may cut further to 6.0% in 1H20, which we see as a mid-term floor. CPI growth, following a temporary drop to below 3% in 1Q20 on a high base effect, should start to recover, as the effects related to budget policy and global grain prices start to fade. CPI and the key rate have only just met the CBR's targets of 4.0% and 6.0-7.0%, respectively, which makes a revision unlikely any time soon. The CBR's control over non-monetary CPI drivers remains under question, and it seems unwilling to boost corporate lending growth before structural issues are addressed.

The rouble has appreciated 9% against the USD YTD (vs a 3% depreciation by RUB peers on average), as the decline in sanction risks alongside a strong local macro picture ensured a US$13bn inflow into local state bonds (OFZ) after a US$7bn outflow in 2018. RUB strength represents a catch-up with peers vs last year, when RUB lost 17% to USD vs the 10% drop by peers. Local RUB fundamentals failed to see improvement as; (1) the current account surplus is still large but under pressure of declining oil prices; (2) non-oil exports are weak; (3) any recovery in imports is routinely sterilised by FX purchases conducted by the CBR for the Finance Ministry; and (4) net private capital outflow continues. Private capital outflow is driven mostly by accumulation of foreign assets by the non-financial sector, which is a sign that there is no improvement in local private investment demand. Without sustainable repatriation of capital, RUB has no insulation against external risks related to EM flows and Russia sanctions.

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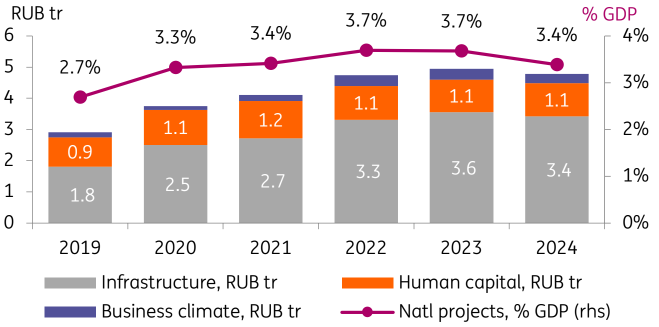
Spending on National Projects: Timeline

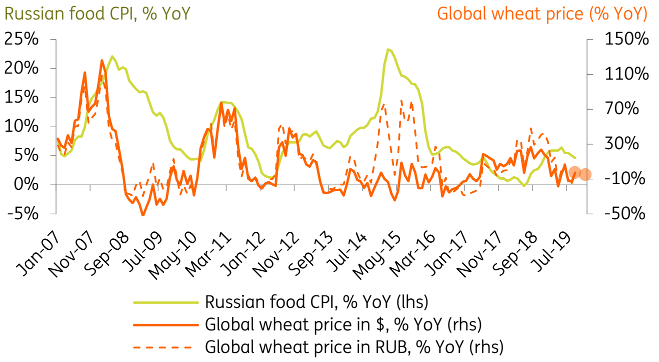


Source: Media, ING

National Projects to gain traction in 2022-24

The budget draft for 2020-22 remains tight, as a spending increase of 1.2ppt in 2020 vs 2018 is smaller than a 1.4ppt increase in non-fuel revenue (higher VAT, more efficient collection). Budget breakeven oil price is set to remain around US$50/bbl, its lowest since 2007. State spending on the National Projects (around 70% of total), which is already incorporated into the budget draft, will gain traction in 2022-24. For now, state investment into infrastructure is in preparatory stages, offering little support to construction or industrial output. Additional support may come in the form of local investment from the National Wealth Fund into local projects starting 2020. Preliminary Minfin estimates are RUB200-400bn (0.2-0.4% of GDP), but the sum might be increased later.

Russian food CPI vs global agriculture prices

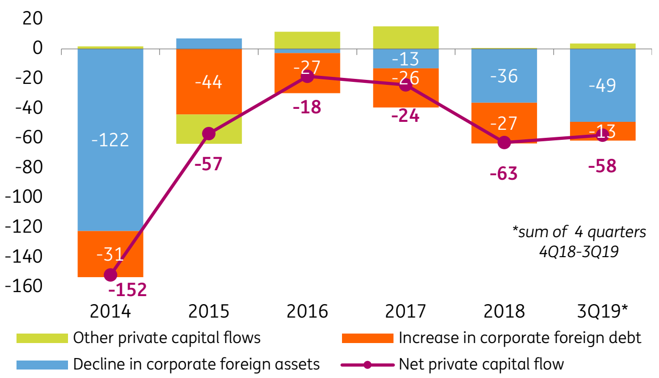


Source: Rosstat, Bloomberg, ING

Russian CPI pushed down by global agro prices

Russian CPI has decelerated from 5.3% YoY in 1Q19 to 4.0% YoY in September, underperforming expectations. The key driver of CPI volatility is the food segment (38% of the total basket), which is highly sensitive to global agri prices. A 10ppt change in global RUB grain price growth equates to a 1ppt change in Russian food CPI and 0.4ppt of total CPI. The slowdown in global wheat prices from 40% YoY to 0% through to 9M19 creates a 1.6ppt downside to overall CPI, all other things being equal. Accounting for some pro-inflationary risks related to budget and local gasoline prices, we expect local CPI to decelerate to 3.4% by year-end 2019, with the balance of risks skewed to further downward revision. CPI may temporarily drop below 3.0% YoY in 1Q20 on a high base effect.

Structure of net private capital outflow (US$bn)

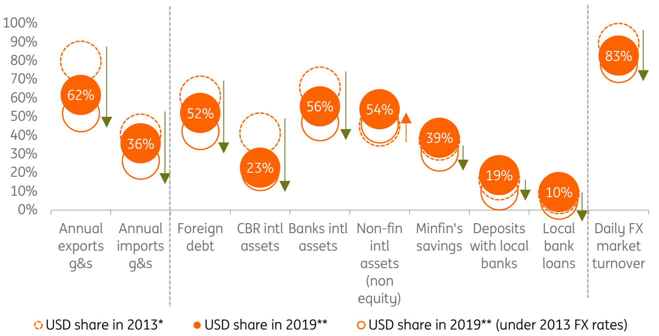


Source: Bank of Russia, ING

Corporates still prefer FX assets to local investments

The key concern regarding the investment climate and rouble is the lack of improvement in the private capital account despite the stabilisation of corporate foreign debt. While the amount of net foreign debt redemption has gradually shrunk from US$44bn in post-sanction 2015 to just US$13bn in 2019E, the net private capital outflow remains at around US$60bn pa, reflecting intensified accumulation of international assets by the corporate sector, mainly non-financial companies and households in the form of outward FDI and financial assets with international banks amid stagnating local investment and credit growth. The 2020 foreign debt redemption schedule is light, and we expect net redemption of just US$5-10bn, however further accumulation of foreign assets remains the key variable for the rouble exchange rate.

Role of USD in Russia: evolution as a share, 2013-19



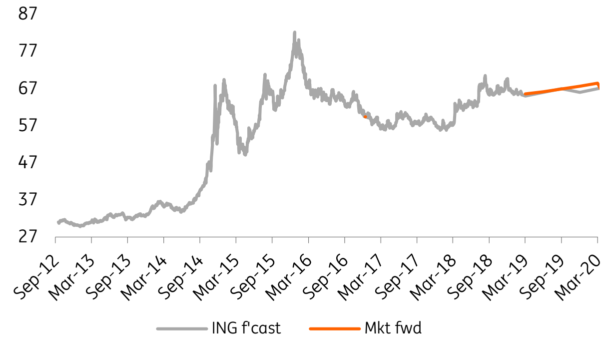
*ING estimates for 2013 intl. assets and 2013-19 local banks' balance sheets.
**Latest available data for 2019 vary from YE2018 to mid-2019
Source: Finance Ministry, Bank of Russia, Russian Customs, KUAP.RU, ING

De-dollarisation: Banks on board, others need convincing

De-dollarisation is seen in trade flows, foreign debt, international assets held by banks and the CBR, loans, and FX market turnover. De-dollarisation progress has been optically suppressed by the effects of depreciation of EUR and RUB to USD, by c.20% and 50%, respectively, since 2013. Russia still sees a huge annual net inflow of USD via the trade channel (US$190bn in 2019), which is still enough to be accumulated as international and local assets by the private sector. De-dollarisation is favoured by the banks, while companies, households and government are holding on to their US dollars that are more attractive relative to euro thanks to higher interest rates. As a result, the local FX market is still dominated by the USD/RUB pair, and the progress of EUR has been very slow, so far.

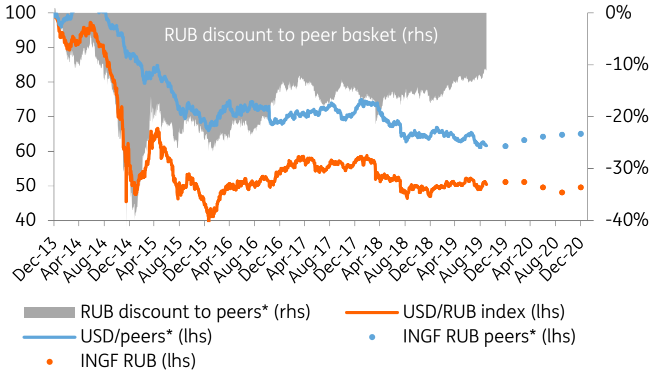
Russia Strategy

FX – spot vs forward and INGF



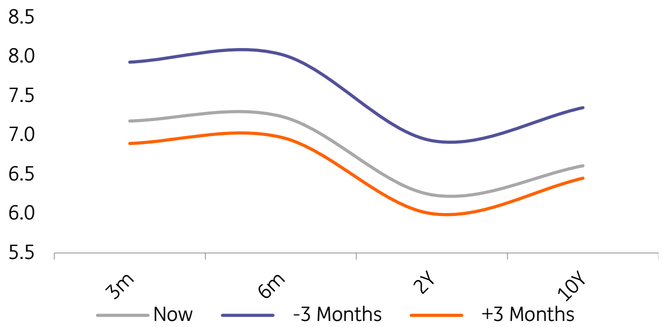
Source: Bloomberg, ING

USD/RUB performance vs its peer group*



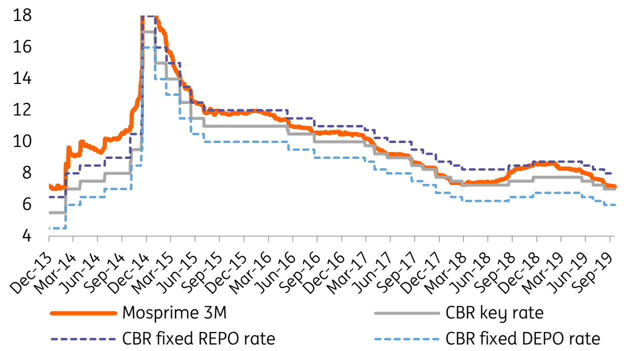
*EW FX basket of ZAR, BRL, TRL, MXN, MYR, NOK, COP; Source: Bloomberg, ING

Local curve (%)



Source: Bloomberg, ING

Russia money market indicators (%)



Source: Bank of Russia, Bloomberg, ING

FX strategy

RUB strength this year is being driven by the recovery in Russia-specific portfolio inflows, reflecting a return of investor interest along with a reduction in sanction risk perception. The Mueller report de-linked Russia and Trump, the CBW act did not affect OFZ (only US$-denominated paper), while a de-escalation of attrition between Russia and Ukraine has been observed following the election of Volodymir Zelenskiy as Ukraine President.

Easing of the budget rule (local investments of National Wealth Fund) may lower annual FX purchases by US$3-6bn, but the positive effect on RUB (c.USD/RUB 2) might be offset by higher private asset accumulation and fears of policy framework erosion.

A reversal in the foreign asset trend, which is not in our base case, could break the long-term RUB depreciation trend. This could either be through forced capital repatriation in the case of a bigger sanction scare and deeper problems within the EU banking sector, or through gradual improvement in the local business climate. The latter is preferable but also less likely in the coming year.

For 4Q19 and 1Q20, we keep a constructive view on RUB thanks to favourable BoP seasonality with only 30-40% of the current account surplus to be sterilised by FX purchases, increasing RUB's insulation against external market volatility vs 2Q-3Q. We then expect gradual depreciation to RUB/USD of 66 by end-2020, in line with weakening in the local BoP. Our forecast RUB trajectory suggests some relative weakness to EM/commodity peers in 2020, which leaves some room for improvement in our mid-term outlook if global EM risk-off and/or a return of the Russia sanctions story do not materialise.

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	1.8	2.0	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	0.5	1.0	1.5
Investment (%YoY)	-14.4	5.9	9.1	5.0	1.3	-1.8	-11.2	0.7	5.5	2.3	0.0	1.5	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	2.5	2.7	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	4.5	4.5
Nominal GDP (RUBbn)	38,807	46,309	60,283	68,164	73,134	79,200	83,101	86,010	92,089	103,627	109,741	115,620	122,289
Nominal GDP (€bn)	832	1,089	1,531	1,566	1,781	1,552	1,033	1,166	1,411	1,451	1,525	1,533	1,535
Nominal GDP (US$bn)	1,223	1,525	2,052	2,193	2,297	2,064	1,364	1,283	1,578	1,654	1,692	1,762	1,842
GDP per capita (US$)	8,562	10,686	14,368	15,356	16,064	14,411	9,503	8,919	10,745	11,271	11,544	12,039	12,580
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	-	-	-
Prices													
CPI (average, %YoY)	11.7	6.9	8.4	5.1	6.8	7.8	15.5	7.1	3.7	2.9	4.5	3.1	3.9
CPI (year-end, %YoY)	8.8	8.8	6.1	6.6	6.5	11.4	12.9	5.4	2.5	4.3	3.4	3.7	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	6.5	5.6	5.9
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	2.3	1.2	2.0
Consolidated primary balance	-5.6	-2.9	2.8	1.0	-0.5	-0.4	-3.0	-3.2	-0.6	3.8	3.2	2.1	3.0
Total public debt	8.3	9.0	9.4	9.8	10.6	11.8	12.5	13.3	12.6	11.7	26.9	26.2	25.6
External balance													
Exports (US$bn)	297.2	392.7	515.4	527.4	521.8	496.8	341.4	281.7	353.5	443.4	426.0	418.0	436.0
Imports (US$bn)	183.9	245.7	318.6	335.8	341.3	307.9	193.0	191.5	238.1	249.0	251.0	257.0	266.0
Trade balance (US$bn)	113	147	197	192	181	189	148	90	115	194	175	161	170
Trade balance (% of GDP)	9.3	9.6	9.6	8.7	7.9	9.2	10.9	7.0	7.3	11.8	10.3	9.1	9.2
Current account balance (US$bn)	50	67	97	71	33	58	68	25	33	76	90	80	85
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	5.3	4.5	4.6
Net FDI (US$bn)	-7	-10	-12	2	-17	-35	-15	10	-8	-13	0.0	0.0	0.0
Net FDI (% of GDP)	-0.5	-0.6	-0.6	0.1	-0.7	-1.7	-1.1	0.8	-0.5	-0.8	0.0	0.0	0.0
Current account balance plus FDI (% of GDP)	3.6	3.8	4.2	3.3	0.7	1.1	3.9	2.7	1.6	3.8	5.3	4.5	4.6
Foreign exchange reserves ex gold (US$bn)	417	443	454	487	470	339	320	318	356	382	429	467	514
Import cover (months of merchandise imports)	27	22	17	17	17	13	20	20	18	18	21	22	23
Debt indicators													
Gross external debt (US$bn)	466	489	539	636	729	600	518	512	518	454	456	462	471
Gross external debt (% of GDP)	38.1	32.0	26.3	29.0	31.7	29.1	38.0	39.9	32.8	27.4	26.9	26.2	25.6
Gross external debt (% of exports)	157	124	105	121	140	121	152	182	147	102	107	111	108
Lending to corporates/households (% of GDP)	41.5	39.2	38.6	40.7	46.0	53.2	54.9	50.8	49.9	50.3	50.6	51.4	52.0
Interest & exchange rates													
Central bank key rate (year-end, %)	6.00	5.00	5.25	5.50	5.50	17.00	11.00	10.00	7.75	7.75	6.50	6.00	6.00
Broad money supply (average, %YoY)	17.7	31.1	21.0	12.2	14.7	1.5	11.3	9.2	10.5	12.0	7.0	10.0	12.0
3m interest rate (Mosprime, average, %)	11.5	4.1	5.5	7.2	6.9	10.5	13.8	11.2	9.3	7.8	7.8	6.4	6.2
3m interest rate spread over US$-Libor (ppt)	1082	373	515	672	663	1027	1348	1045	814	544	541	467	432
2yr yield (average, %)	9.3	5.9	6.7	6.8	6.2	9.2	11.5	9.2	7.9	7.2	5.7	5.5	5.5
10yr yield (average, %)	11.2	7.6	8.6	8.0	7.5	9.6	11.1	8.8	7.8	8.0	6.5	6.3	6.3
USD/RUB exchange rate (year-end)	30.24	30.48	32.20	30.37	32.73	56.26	72.88	60.66	57.60	69.47	64.00	66.00	67.00
USD/RUB exchange rate (average)	31.74	30.37	29.38	31.09	31.84	38.38	60.94	67.06	58.34	62.67	64.85	65.60	66.40
EUR/RUB exchange rate (year-end)	42.34	43.58	43.14	39.48	43.20	77.07	88.19	66.12	64.63	83.36	70.40	75.90	80.40
EUR/RUB exchange rate (average)	46.66	42.51	39.37	43.52	41.07	51.04	80.44	73.76	65.26	71.44	71.98	74.13	78.35
Brent oil price (annual average, US$/bbl)	63	80	111	112	109	100	54	45	55	72	65	62	68

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	2.7	0.5	0.9	1.2	1.1	1.8	2.0	1.0	1.0	2.0	1.7	1.5	1.5
CPI (eop, %YoY)	4.3	5.3	4.7	4.0	3.4	2.5	3.0	3.6	3.7	3.9	4.0	4.0	4.0
Central bank key rate (eop, %)	7.75	7.75	7.50	7.00	6.50	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00
3m interest rate (eop, %)	8.58	8.31	8.03	7.21	6.70	6.45	6.20	6.20	6.20	6.20	6.20	6.20	6.20
10yr yield (eop, %)	8.78	8.41	7.49	7.15	6.50	6.25	6.30	6.30	6.30	6.30	6.30	6.30	6.30
USD/RUB exchange rate (eop)	69.50	65.63	63.21	64.86	64.00	64.00	66.00	68.00	66.00	66.00	66.33	66.67	67.00
EUR/RUB exchange rate (eop)	83.40	73.70	71.88	70.66	70.40	70.40	73.92	76.84	75.90	76.56	77.61	78.67	80.40

Source: National sources, ING estimates

Serbia

Valentin Tataru, Economist, Romania & Balkans

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	2.9	3.9	3.7	3.9	3.5	3.3	3.7
CPI (%YoY)*	1.5	1.1	1.2	1.1	1.6	1.9	1.6
Policy interest rate (eop, %)	3.00	2.25	2.25	2.25	2.25	2.25	2.25
3m interest rate (%)*	2.90	2.80	1.90	1.90	1.80	2.60	1.75
10yr yield (%)*	3.85	3.55	3.45	3.40	3.40	4.00	3.40
USD/RSD	103.6	107.4	106.8	106.8	104.8	106.1	103.8
EUR/RSD	118.0	118.0	117.4	117.5	117.4	117.8	117.3

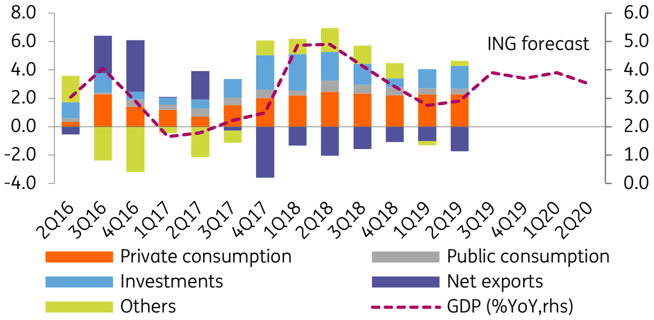
Macro Trend		Political Cycle	Ratings	FC	LC
Activity		Presidential: Apr 2022	S&P	BB+	BB+
Fiscal	Neutral	Parliamentary: Apr 2020	Moody's	Ba3	Ba3
Monetary	Neutral	Local: Mar 2022	Fitch	BB	BB

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

Country strategy: Getting closer to investment grade (IG)

On 27 September 2019, Fitch upgraded Serbia to 'BB+', just a notch below IG. With S&P and Moody's having the country on a positive outlook at 'BB' and 'Ba3' respectively, achieving IG status looks within sight. Nevertheless, we don't see this happening earlier than 2021. In our view, Serbia's ratings to date have principally been driven by economic and fiscal developments. As we approach the IG zone, qualitative factors like institutional framework, rule of law or judicial independence will start to weigh in. Until then, we see the economy growing by 3.3% this year on strong private consumption and fixed investments. Fiscal stance will remain prudent and this is needed to offset the widening C/A deficit which – albeit fully funded by FDIs – should start to raise some concerns for the policymakers.

Real GDP (%YoY) and contributions (ppt)

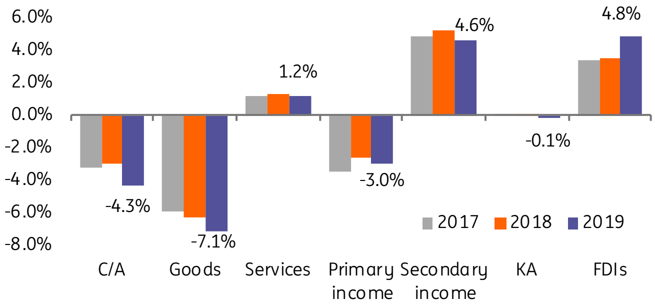


Source: Eurostat, ING

Growth slowing a bit

What appeared to be a marked deceleration in 1Q19 when GDP advanced by 2.3% has since been revised upwards twice by the Serbian Statistical Office to the latest figure of 2.7%. Along with the 2.9% growth from the second quarter, it has been a good first half for the economy in our view. Private consumption and investments remained the growth drivers adding 2.3ppt and 1.6ppt, respectively, to second quarter growth. The widening trade deficit is to blame for the 1.7ppt negative contribution of the net exports. We see growth accelerating to 3.7% in 2020 as wage pressures will continue to boost consumption, while bank lending and the investment cycle are to quicken as the business environment improves.

January-July balance of payments as % of GDP



Source: Eurostat

Current account widening

While we acknowledge that the C/A deficit is fully financed by still strong FDIs, the pace of C/A widening should raise some concern, in our view. It has seen a 55% widening in the first seven months of 2019 compared to the same period in 2018. While over half of the import growth consists of equipment and intermediate goods (which, in theory, should boost productivity and exports going forward), it looks like the consumption boost has been accommodated mainly through higher imports as well. Until the positive effects start to show up, for now we can only revise our C/A deficit forecast for 2019 to -7.0% (from -6.5% previously).

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	4.3	3.3	3.7	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	4.5	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	3.0	3.3	3.9
Investment (%YoY)	-22.5	-6.5	4.7	13.9	-12.0	-3.4	4.9	5.3	7.0	9.6	7.9	6.8	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	1.0	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	10.0	8.8	6.5
Nominal GDP (RSDbn)	3,052	3,251	3,612	3,810	4,121	4,161	4,312	4,521	4,754	5,069	5,408	5,750	6,150
Nominal GDP (€bn)	31.8	30.8	34.5	33.5	35.9	34.4	35.5	36.6	39.9	43.0	46.0	49.1	52.8
Nominal GDP (US$bn)	45.2	41.4	49.4	43.3	48.5	46.7	39.4	40.5	44.7	50.4	50.5	55.4	62.2
GDP per capita (US$)	6,200	5,700	6,900	6,000	6,800	6,600	5,600	5,800	6,400	7,200	7,300	8,000	9,000
Gross domestic saving (% of GDP)	5.3	5.4	5.5	5.5	9.2	8.5	11.6	13.1	13.0	13.2	13.2	13.3	13.4
Prices													
CPI (average, %YoY)	8.1	6.1	11.1	7.3	7.7	2.1	1.4	1.1	3.1	2.0	1.9	1.6	2.2
CPI (year-end, %YoY)	6.6	10.2	7.0	12.2	2.2	1.8	1.6	1.5	3.0	2.0	1.2	2.2	2.5
Wage rates (nominal, %YoY)	-2.9	7.5	11.2	9.0	6.2	1.4	-0.2	3.7	1.5	6.5	10.0	14.5	15.4
Fiscal balance (% of GDP)													
Consolidated government balance	-4.2	-4.3	-4.5	-6.4	-5.1	-6.2	-3.5	-1.2	1.1	0.6	-0.1	-0.5	-0.5
Consolidated primary balance	-3.6	-3.4	-3.4	-4.7	-3.0	-3.5	-0.5	1.7	3.6	2.7	2.1	1.7	1.4
Total public debt	30.3	48.9	43.5	54.3	56.7	65.4	70.7	68.6	60.1	54.5	50.5	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	16.3	17.8	19.5	21.4
Imports (€bn)	11.5	12.6	14.3	14.7	15.5	15.4	16.4	17.3	19.8	22.0	24.5	26.3	28.1
Trade balance (€bn)	-5.5	-5.2	-5.8	-5.9	-4.4	-4.3	-4.3	-3.9	-5.1	-5.8	-6.7	-6.7	-6.7
Trade balance (% of GDP)	-17.4	-17.0	-16.8	-17.5	-12.2	-12.4	-12.2	-10.6	-12.9	-13.4	-14.5	-13.7	-12.7
Current account balance (€bn)	-2.0	-2.0	-3.7	-3.7	-2.1	-2.0	-1.6	-1.2	-2.1	-2.1	-3.2	-3.3	-3.0
Current account balance (% of GDP)	-6.3	-6.5	-10.7	-11.0	-5.8	-5.8	-4.5	-3.2	-5.1	-5.0	-6.9	-6.7	-5.7
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)	6.6	3.6	9.6	2.4	3.6	3.5	5.6	5.2	6.0	7.4	7.2	7.0	6.8
Current account balance plus FDI (% of GDP)	0.3	-2.9	-1.2	-8.7	-2.2	-2.3	1.1	2.0	0.9	2.5	0.3	0.3	1.1
Foreign exchange reserves ex gold (€bn)	11.7	11.2	12.3	11.4	11.6	11.1	11.2	11.1	10.4	12.2	13.8	14.6	15.2
Import cover (months of merchandise imports)	12.2	10.7	10.4	9.3	9.0	8.6	8.2	7.7	6.3	6.6	6.8	6.7	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	26.8	27.9	28.2	28.5
Gross external debt (% of GDP)	70.6	77.2	69.9	76.5	71.3	74.7	74.0	72.4	64.1	62.5	60.6	57.3	53.9
Gross external debt (% of exports)	376	322	285	290	231	230	218	197	174	165	156	144	133
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	40.9	41.0	40.9
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	2.25	2.00	2.00
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	14.7	36.2	18.3
3m interest rate (Belibor, average, %)	14.44	10.75	12.85	11.66	10.13	8.25	6.08	3.43	3.40	2.96	2.60	1.75	1.75
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	3.0	2.2	2.2
2yr yield (average, %)	n/a	n/a	14.48	15.10	10.99	10.13	8.17	5.20	4.25	3.70	2.60	2.50	2.50
10yr yield (average, %)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	4.80	4.00	3.40	3.30
USD/RSD exchange rate (year-end)	66.7	79.3	80.9	86.2	83.1	99.5	111.2	117.1	99.3	102.6	106.8	101.7	97.1
USD/RSD exchange rate (average)	67.6	78.6	73.1	88.0	84.9	89.1	109.4	111.8	106.4	100.5	106.1	103.8	98.9
EUR/RSD exchange rate (year-end)	95.9	105.5	104.6	113.7	114.6	121.0	121.6	123.5	119.1	118.0	117.5	117.0	116.5
EUR/RSD exchange rate (average)	94.1	103.5	102.0	113.6	113.1	117.4	120.8	123.2	121.3	118.6	117.8	117.3	116.8

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	3.4	2.7	2.9	3.9	3.7	3.9	3.5	3.7	3.6	3.9	4.4	4.0	3.8
CPI (eop, %YoY)	2.0	2.8	1.5	1.1	1.2	1.1	1.6	2.1	2.2	2.1	2.1	2.1	2.5
Central bank key rate (eop, %)	3.00	3.00	3.00	2.50	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25
3m interest rate (eop, %)	3.00	3.00	2.90	2.80	1.90	1.90	1.80	1.80	1.90	2.00	2.00	2.00	2.00
10yr yield (eop, %)	4.75	4.75	3.85	3.55	3.45	3.40	3.40	3.35	3.30	3.30	3.30	3.30	3.30
USD/RSD exchange rate (eop)	103.0	105.8	103.6	107.4	106.8	106.8	104.8	103.7	101.7	101.0	100.0	99.0	97.1
EUR/RSD exchange rate (eop)	118.5	118.5	118.0	118.0	117.5	117.5	117.4	117.2	117.0	117.2	117.0	116.8	116.5

Source: National sources, ING estimates

Turkey

Muhammet Mercan, Chief Economist

Forecast summary

	2Q19	3Q19	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (% YoY)	-1.5	0.4	2.7	2.9	3.0	-0.1	3.0
CPI (% YoY)*	15.7	9.3	12.8	12.0	11.1	15.4	10.9
Policy interest rate (eop, %)	24.00	16.50	14.00	14.00	13.00	14.00	12.00
3m interest rate (%)*	24.02	15.12	15.70	15.41	14.27	20.33	14.15
10yr yield (%)*	16.73	13.58	14.08	13.79	13.46	15.83	13.47
USD/TRY*	5.79	5.65	6.00	6.12	6.25	5.70	6.27
EUR/TRY*	6.59	6.16	6.60	6.73	6.99	6.39	7.01

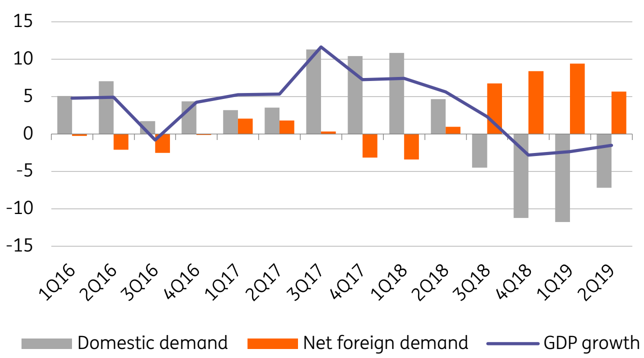
Macro Trend		Political Cycle	Ratings	FC	LC
Activity		Presidential: Jun-23	S&P	B+	BB-
Fiscal	Looser	Parliamentary: Jun-23	Moody's	B1	B1
Monetary	Looser	Local: Mar-24	Fitch	BB-	BB-

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

Country strategy

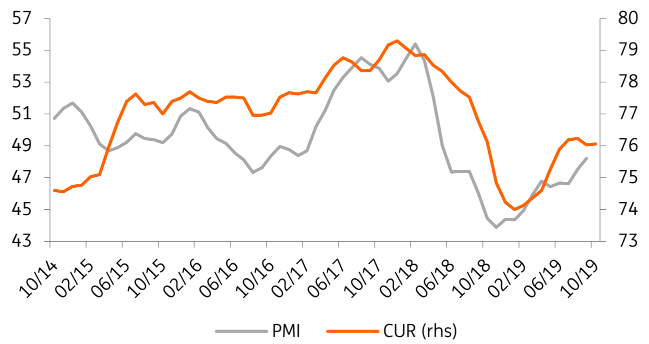
The policy mix is shifting towards further loosening supported by an improving global, geopolitical and political backdrop, despite not well anchored inflation expectations, dollarisation and still weak confidence along with other macro vulnerabilities. Accordingly, we see: (1) a continuing supportive fiscal stance; (2) an easing cycle driven by the dovish turn of global CBs and a favourable inflation trend; (3) lending incentives by linking required reserve ratios and remunerations to credit growth. Inflation dynamics and geopolitical backdrop have improved, making the CBT more confident on timing and extent of easing cycle also. Global CB policies, asset quality outlook, dollarisation, fiscal developments and geopolitical issues will be key for macro performance in the period ahead.

GDP Growth (% YoY)



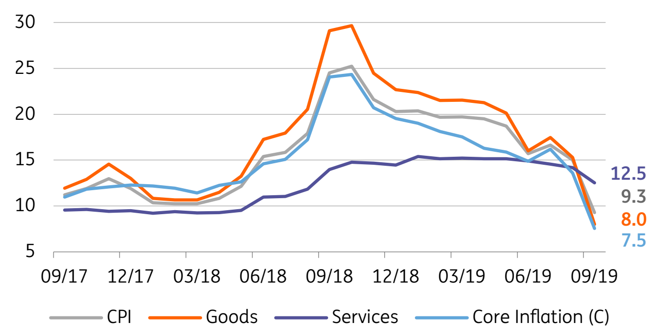
Source: TurkStat, ING Bank

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



Source: ICI, TurkStat, ING Bank

Inflation (% YoY)



Source: TurkStat, ING Bank

Macro digest

GDP in 2Q recorded -1.5% YoY growth, while in seasonal and calendar adjusted terms, growth momentum maintained a healthy pace at 1.2% QoQ, after turning positive at 1.6% QoQ a quarter ago. Looking at the spending breakdown, private consumption and investment dragged on the GDP performance again. However, contraction in private spending moderated at -1.1% YoY in comparison to a quarter ago, while investments weakened further at -22.8% YoY, the biggest drop since the global financial crisis. The more modest contraction in private consumption is attributable to government incentives and a relative recovery in sentiment in late-May and June. Public consumption that has contributed positively to growth performance continuously since the second quarter of 2017, remained so with a 3.3% YoY increase, lifting 2Q growth by 0.5ppt. Net trade also made a positive contribution at 5.7ppt as exports maintained the uptrend with an 8.1% increase thanks to improving price competitiveness, while imports contracted by 16.9% on the back of demand factors. Lastly, the contribution from inventory turned to a slight positive number, after four consecutive negative prints, meaning significant inventory depletion. In the second half, the ongoing recovery momentum and base effects should provide support to the headline figure in the second half. Normalisation in financial conditions with the CBT's easing cycle and credit impulse turning to positive again should back the growth outlook. We expect GDP growth to be -0.1% in 2019 and 3.0% in 2020.

Inflation surprised to the downside in recent months thanks to still weak domestic demand, moderating pass-through, easing cost push factors and a favourable base along with further correction in unprocessed food prices despite some administrative price hikes. Accordingly, the annual figure was sharply down in September at 9.3%, the first single digit reading since July 2017 and the lowest level in the past 32 months, from 15.0% a month ago. This shows the impact of the base-effect driven drop, along with the large correction in unprocessed food prices and easing core prices. Annual core inflation stood at 7.5% last month, its lowest since November 2016 on the back of lowering pressures with weak domestic demand and stability in the currency. As an indicator for underlying price dynamics, the diffusion index has remained below trend. The Domestic Producer Price Index (D-PPI) also fell to single digit at 2.4%, the lowest in the past three years, in a continuation of the downtrend from 46.2% a year ago, implying a sharp decline in producer-price-driven cost pressures. Going forward, inflation inertia (especially on services) and modestly stronger growth will keep inflation broadly unchanged at low double digits during most of next year, especially if administrative price adjustments continue.

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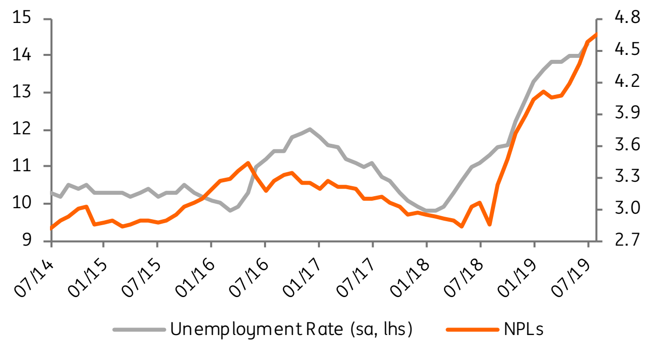
Unemployment vs NPLs (%)

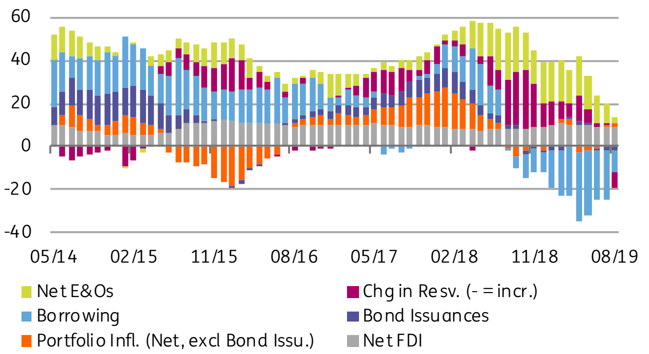


Source: TurkStat, BRSA, ING Bank

Strains in the labour market

The unemployment rate (on a seasonally adjusted basis), that has been on an uptrend since the beginning of 2018 from single digits, maintained the path and reached 14.3% as of July, the highest in the current series starting in 2005. A comparison with the 2008-09 recession reveals that the recovery that started after 12 months of uptrend following the global financial crisis, is absent currently after 17 months of continuous increase. Also, despite one of the better tourism seasons of the decade, employment in services turned negative on a 12M rolling basis. That was not the case even during the global crisis. Going forward, employment conditions should gradually improve given recovering economic activity though the process will take time and remain challenging in the near term.

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

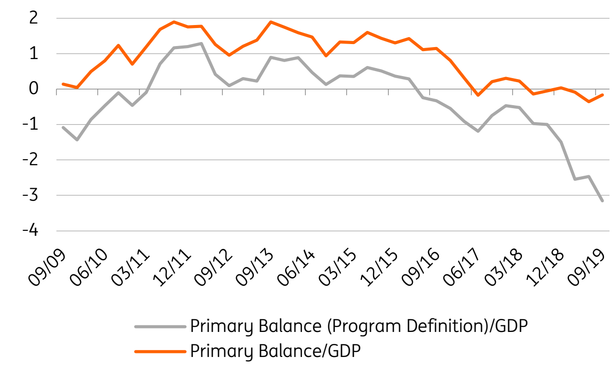


Source: CBT, ING Bank

External rebalancing is coming to an end

The 12M rolling external balance moved further into positive territory in August at US$5.1bn - the best reading since the start of the series in 1996, showing the extent of rebalancing. The recovery trend in external imbalances has stemmed from weak activity in the aftermath of financial market volatility last year weighing on import demand, while exports have been supported by increased price competitiveness. In the first eight months of 2019, registered capital flows have been barely positive. Key trends show locals maintained their acquisition of assets abroad, higher trade credits show a continuation of business relationships of Turkish companies with foreign peers, net borrowing turns negative and net errors and omissions recorded a small inflow vs large inflows in the same period of 2018.

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

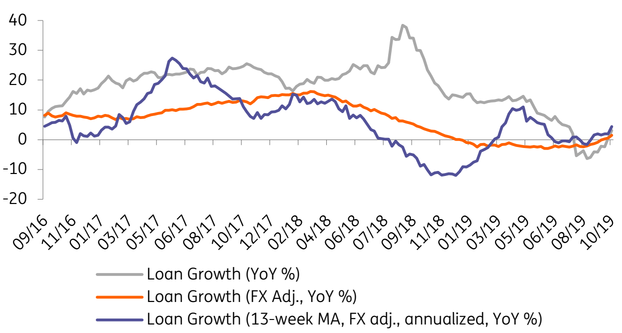


Source: Ministry of Treasury and Finance, ING Bank

Continuing supportive fiscal stance in 2019

In the first nine months, the budget deficit was TRY86bn (including the impact of TRY78.3bn CBT resources), up by 51.3% YoY (29.3% YoY in real terms). The year-end budget deficit target has already been exceeded by 26% and revised in the new economic programme to 2.9% of GDP from 1.8%. The underperformance is attributable to: (1) high interest spending with higher short-term borrowing and rising bond yields; (2) large primary spending (current and personnel expenditures responsible for an increase of more than 88% in the headline); (3) slow tax generation given growth weakness and tax cuts. Fiscal indicators in the new programme show a shift from the previous one that saw a wide range of spending and revenue measures aimed at keeping the deficit in check during the forecast period.

Banking sector volume expansion



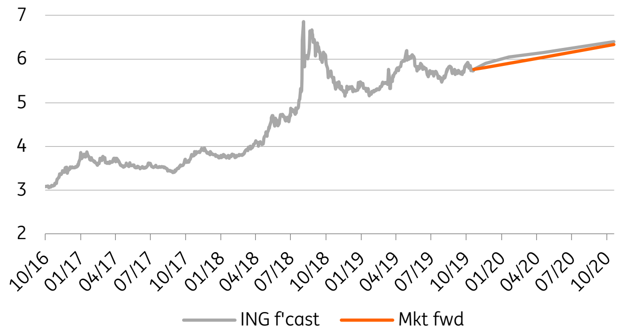
Source: BRSA, ING Bank

Policy moves supporting lending

The CBT unveiled regulatory changes on reserve requirement ratios in August. The selective drop with respect to volume growth of banks, targets to support activity through faster credit growth. The changes are to improve the weighted return of banks and support loan growth. Credit impulse was negative in 2Q though turning to positive in 2H with this move and low rate environment. Also, as a prudent step, the Banking Regulation and Supervision Agency instructed banks to writedown loans worth TRY46bn (roughly US$8bn) to provide transparency. The decision is likely to pull the NPL ratio above 6% and the impact on capital adequacy manageable. The latest banking sector data shows recovery in lending appetite again driven by state banks, while private banks also follow to some extent.

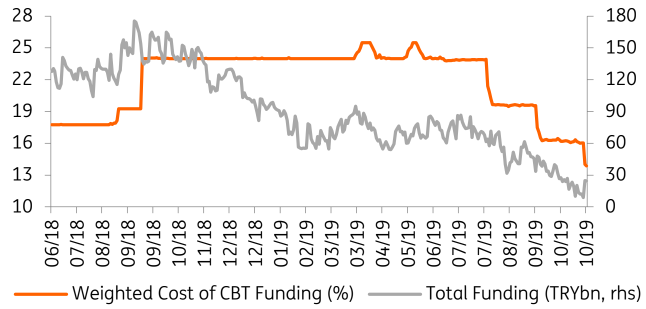
Turkey Strategy

FX – spot vs forward and INGF



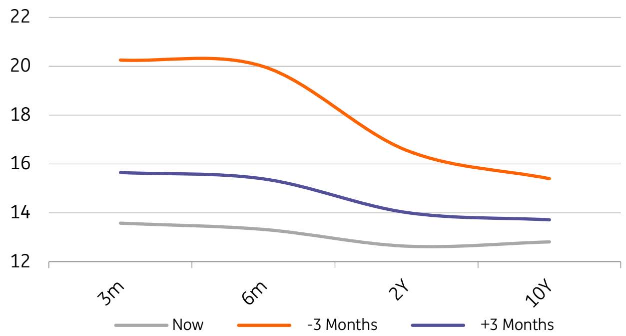
Source: Bloomberg, ING estimates

CBT funding



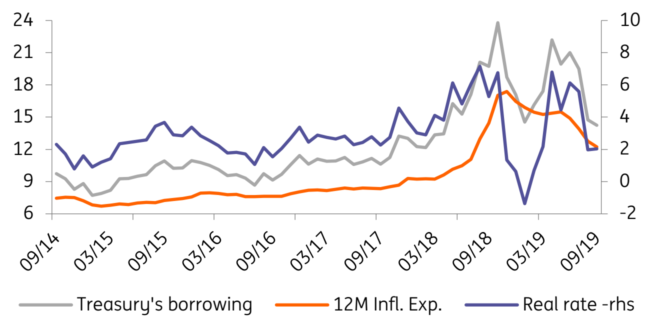
Source: CBT, ING Bank

Local curve (%)



Source: Bloomberg, ING estimates

Real interest rate (%)



Source: Treasury, CBT, ING Bank

FX strategy

In recent months, the surprisingly positive inflation releases pulled the annual figure to single-digit territory thanks to still weak domestic demand, moderating pass-through, easing cost push factors and a favourable base along with a further correction in unprocessed food prices despite some administrative price adjustments. Accordingly, the CBT felt more confident about the strength of the ongoing disinflation trend and came up with frontloaded moves in a deep easing cycle amounting to 1,000bp across the last three MPC meetings, also with the contribution of supportive global backdrop and improving geopolitics. We think inflation will probably remain in single digits in October and reverse thereafter because of unsupportive base effects, closing the year at 12.8%. Accordingly, the case for further monetary easing at the last MPC meeting in December has significantly weakened, while any move should take a more gradual pace. The CBT maintains its commitment to a sustained disinflation process that will help reduce sovereign risk, lower long-term interest rates and support a stronger economic recovery. Given the earlier signals, this commitment also includes a positive ex-post real policy rate at around the EM peers' average in the medium-to-long term. So, in future, the CBT is likely to be even more cautious at this level given still not well anchored inflation expectations and high inertia, especially as far as services inflation is concerned, along with high dollarisation and the subdued capital flow outlook. Given the decline in the real rate buffer, we should not rule out TRY volatility with any shifts in the global and geopolitical backdrop.

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	7.5	2.8	-0.1	3.0	3.7
Private consumption (% YoY)	-3.7	10.8	12.3	3.2	7.9	3.0	5.4	3.7	6.2	0.0	-0.4	4.2	4.7
Government consumption (% YoY)	8.1	1.7	1.1	6.8	8.0	3.1	3.9	9.5	5.0	6.6	6.9	-0.8	-0.7
Investment (% YoY)	-20.5	22.5	23.8	2.7	13.8	5.1	9.3	2.2	8.2	-0.6	-9.1	5.9	5.3
Industrial production (% YoY)	-10.7	13.7	14.7	4.2	7.2	5.7	5.8	3.4	9.0	1.3	-0.1	3.3	3.9
Unemployment rate (year-end, %)	13.0	11.1	9.1	8.4	9.0	9.9	10.3	10.9	10.9	11.0	13.5	12.7	11.8
Nominal GDP (TRYbn)	999	1,160	1,394	1,570	1,810	2,044	2,339	2,609	3,111	3,724	4,319	4,916	5,584
Nominal GDP (€bn)	459	537	619	679	711	677	703	774	757	658	676	701	710
Nominal GDP (US$bn)	645	770	828	878	939	932	851	861	855	767	758	784	831
GDP per capita (US$)	8,980	10,560	11,205	11,588	12,480	12,112	11,019	10,883	10,602	9,632	9,193	9,406	9,850
Gross domestic saving (% of GDP)	20.7	24.9	29.4	26.4	28.0	27.2	26.6	25.5	25.5	28.2	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	15.4	10.9	10.1
CPI (year-end, % YoY)	6.5	6.4	10.4	6.2	7.4	8.2	8.8	8.5	11.9	20.3	12.8	10.1	8.9
Wage rates (nominal, % YoY)	10.1	5.8	7.5	9.7	10.9	10.1	13.8	21.9	9.1	18.4	17.1	12.8	10.9
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	-1.9	-2.9	-2.9	-2.9
Consolidated primary balance	0.0	0.7	1.8	1.2	1.7	1.3	1.3	0.8	0.3	0.0	-0.5	-0.2	-0.1
Total public debt	43.9	40.1	36.5	32.7	31.4	28.8	27.6	28.3	28.2	30.1	32.8	33.4	33.8
External balance													
Exports (US$bn)	108.9	120.0	142.0	161.6	161.8	168.9	152.0	150.2	166.2	174.6	182.4	191.4	206.0
Imports (US$bn)	133.8	176.4	231.1	227.0	241.7	232.5	200.1	191.1	225.1	216.5	199.5	223.0	247.6
Trade balance (US$bn)	-24.9	-56.4	-89.1	-65.3	-79.9	-63.6	-48.1	-40.9	-59.0	-41.9	-17.1	-31.6	-41.6
Trade balance (% of GDP)	-3.9	-7.3	-10.8	-7.4	-8.5	-6.8	-5.7	-4.7	-6.9	-5.5	-2.3	-4.0	-5.0
Current account balance (US$bn)	-12.2	-45.4	-75.1	-48.5	-65.0	-43.6	-32.1	-33.1	-47.3	-27.0	-1.7	-15.6	-25.3
Current account balance (% of GDP)	-1.9	-5.9	-9.1	-5.5	-6.9	-4.7	-3.8	-3.8	-5.5	-3.5	-0.2	-2.0	-3.0
Net FDI (US$bn)	6.9	7.6	13.7	9.2	9.2	5.5	12.5	10.2	8.8	9.4	10.1	10.1	10.9
Net FDI (% of GDP)	1.1	1.0	1.7	1.0	1.0	0.6	1.5	1.2	1.0	1.2	1.3	1.3	1.3
Current account balance plus FDI (% of GDP)	-0.8	-4.9	-7.4	-4.5	-5.9	-4.1	-2.3	-2.7	-4.5	-2.3	1.1	-0.7	-1.7
Foreign exchange reserves ex gold (US$bn)	69.6	80.7	78.3	100.3	112.0	106.3	95.7	92.1	84.1	72.0	77.8	79.9	82.6
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	4.7	4.3	4.0
Debt indicators													
Gross external debt (US$bn)	268.9	291.9	305.5	342.4	393.0	406.0	400.5	409.8	455.1	444.6	422.7	421.8	429.5
Gross external debt (% of GDP)	42	38	37	39	42	44	47	48	53	58	56	54	52
Gross external debt (% of exports)	247	243	215	212	243	240	264	273	274	255	232	220	209
Lending to corporates/households (% of GDP)	39.3	45.3	49.0	50.6	57.9	60.7	63.5	66.5	67.5	64.3	61.1	60.1	60.0
Interest & exchange rates													
Central bank key rate (year-end, %)	6.50	6.50	5.75	5.50	4.50	8.25	7.50	8.00	8.00	24.00	14.00	12.00	11.00
Broad money supply (average, % YoY)	13.0	19.1	14.8	10.2	22.2	11.9	17.1	18.3	15.7	19.1	17.0	14.8	14.6
3m interest rate (TRLibor, average, %)	10.2	7.4	8.8	8.9	6.9	10.1	10.9	10.1	12.7	19.7	20.3	14.2	12.6
3m interest rate spread over US$-Libor(ppt)	877	718	847	836	659	989	1062	927	1135	1726	1829	1249	1070
2yr yield (average, %)	11.4	8.4	9.1	8.1	7.6	9.2	9.8	9.7	11.8	18.9	17.8	13.5	12.6
10yr yield (average, %)	n/a	9.8	9.6	8.5	8.3	9.3	9.4	10.1	11.0	15.9	15.8	13.5	12.8
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	6.90
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	5.70	6.27	6.72
EUR/TRY exchange rate (year-end)	2.16	2.07	2.47	2.35	2.93	2.81	3.17	3.70	4.55	6.05	6.60	7.48	8.28
EUR/TRY exchange rate (average)	2.18	2.16	2.25	2.31	2.54	3.02	3.33	3.37	4.11	5.66	6.39	7.01	7.87
Brent oil price (annual average, US$/bbl)	61.8	79.9	112.1	112.4	109.6	99.4	52.1	43.3	54.8	71.8	64.8	61.8	68.0

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (% YoY)	-2.8	-2.4	-1.5	0.4	2.7	2.9	3.0	3.1	3.2	3.6	3.5	3.7	3.8
CPI (eop, % YoY)	20.3	19.7	15.7	9.3	12.8	12.0	11.1	10.3	10.1	10.1	10.7	10.2	8.9
Central bank key rate (eop, %)	24.00	24.00	24.00	16.50	14.00	14.00	13.00	12.00	12.00	12.00	12.00	11.50	11.00
3m interest rate (eop, %)	24.07	25.63	24.02	15.12	15.70	15.41	14.27	13.18	13.10	12.96	12.90	12.29	11.19
10yr yield (eop, %)	16.48	17.92	16.73	13.58	14.08	13.79	13.46	13.41	13.23	13.21	13.02	12.61	11.79
USD/TRY exchange rate (eop)	5.29	5.54	5.79	5.65	6.00	6.12	6.25	6.37	6.50	6.60	6.70	6.80	6.90
EUR/TRY exchange rate (eop)	6.05	6.28	6.59	6.16	6.60	6.73	6.99	7.20	7.48	7.66	7.84	8.02	8.28

Source: National sources, ING estimates

Ukraine

Dmitry Dolgin, Chief Economist, Russia & CIS

Forecast summary

	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	2019F	2020F
Real GDP (%YoY)	4.6	2.7	2.9	3.0	2.9	3.2	3.0
CPI (%YoY)*	9.0	7.5	7.2	7.0	6.8	8.4	6.7
Policy interest rate (eop, %)	17.50	16.50	15.00	14.00	13.50	15.00	12.00
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*	26.17	24.08	26.00	26.50	27.00	26.24	27.00
EUR/UAH*	29.73	26.33	28.60	29.15	30.24	29.12	30.51

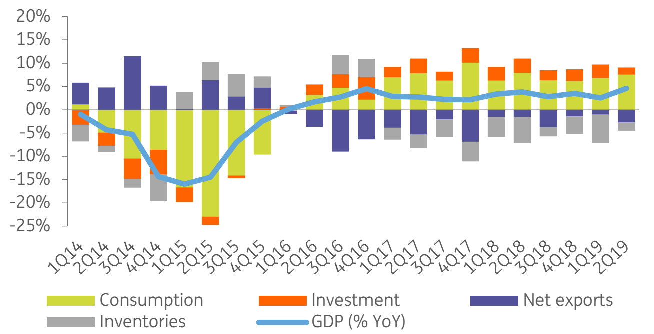
Macro Trend		Political Cycle	Ratings	FC	LC
Activity	▼	Presidential: 2024	S&P	B	B
Fiscal	Stable	Parliamentary: 2023	Moody's	Caa1	WR
Monetary	Stable	Local:	Fitch	B	B

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

Country strategy

President Zelensky's party, 'Servant of the People', has successfully formed the new government and has proposed reforms to open the land market, launch concessions and privatisation, establish customs and facilitate tax administration. The reforms were praised by the IMF, which is expected to initiate the new US$5bn programme that will support the country's budget and balance of payments. The country's stable macro performance favours investor sentiment, and, along with continuous anti-inflationary NBU policy, keeps Ukraine's sovereign bonds under 'BUY', subject to the IMF deal and UAH stability. The key risks we see are worsening weather conditions vital for next year's grain harvest and rising imports along with the usual event risks in the political area.

GDP growth and major contributors (% YoY)

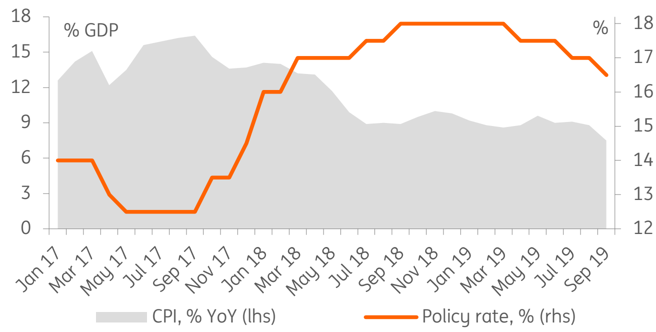


Source: CEIC, ING

Growth momentum to recover, pending local uncertainties

In 2Q19, GDP growth accelerated to 4.6% YoY after 2.5% in 1Q19, mostly due to rising consumer spending (amid higher remittances and consumer lending) and the improvement in economic sentiment following stabilisation of the domestic political situation. We expect the economy to see further recovery in 2019, and the growth will be supported by rising exports of agriculture given the good harvest this year. However, the fall in industrial production in July (-0.2% YoY) and August (-1.7% YoY), mostly because of a drop in the manufacturing sector, may limit the country's growth pace. In 2020, consumption and prospects of rising investment may support the country's performance, while negative net trade may hamper it.

Policy rate and inflation (%)

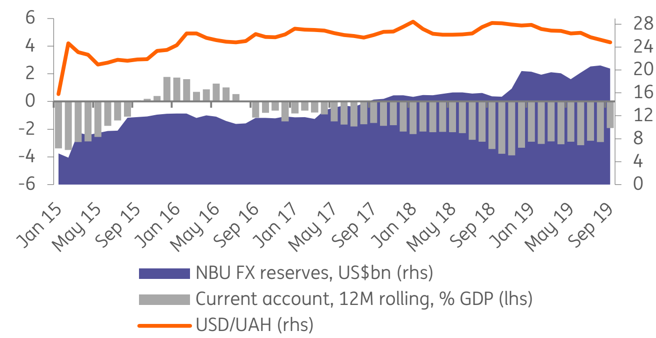


Source: CEIC, ING

New IMF deal will support the country's performance

With a continual CPI decline from 9.8% YoY at end-2018 to 7.5% in September 2019, the NBU cut its rate from 18.0% to current 15.0%. An expected further decline in CPI growth suggests further room for key rate cuts in 2019-20. The new government has proposed reforms to open the land market, launch concessions and privatisation, establish customs and facilitate tax administration. Praising these reforms and sound monetary policy, the IMF is expected to sign a new US$5bn programme, vital for Ukraine's external debt repayment (prelim. US$4.8bn in 2020), BoP and budget (its 2020 draft version is balanced at c.-2.4% of GDP amid rising expenses on defence, security, infrastructure and human development).

USD/UAH, FX reserves and current account



Source: CEIC, ING

UAH is strengthening, subject to risks

UAH/USD has strengthened by 12% in Jan-Oct 2019 on positive talks with the IMF, rating upgrades by Fitch and S&P from B- to B and political stabilisation (which improved sentiment and pushed foreign turnover in state bonds to an historical high of 12% in Aug 2019 from 1% in Jan 2019). Rising grain exports and remittances improved the C/A balance (-1.7% GDP in 9M19 vs -3.7% GDP in 9M18) and thus also favoured UAH. As a result, the NBU restored FX reserves to US$20bn in Sept 2019. This has enhanced our view on UAH and C/A for 2019-20, but we still account for risks of adverse weather conditions for next year's harvest and rising imports with strong local consumer demand that may undermine performance.

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	3.2	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	0.8	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 (KZTbn)	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	131	139	138
Nominal GDP (US$bn)	122	136	163	176	183	134	91	93	112	131	146	157	163
GDP per capita (US$)	2,645	2,971	3,575	3,859	4,035	3,110	2,129	2,192	2,647	3,068	3,435	3,716	3,893
Gross domestic saving (% of GDP)	16.8	16.8	15.8	13.1	9.3	9.9	13.3	14.8	12.3	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	8.4	6.7	5.8
CPI (year-end, %YoY)	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	12.4	13.7	9.8	7.2	6.0	5.5
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)													
State* budget balance	-3.8	-6.2	-1.8	-3.6	-4.3	-4.5	-1.6	-2.3	-1.4	-1.9	-2.6	-2.2	-2.0
State* budget 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	60.9	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	57.2	57.3	59.5	62.0
Trade balance (US$bn)	-5.7	-9.4	-14.1	-16.1	-12.4	-0.1	1.5	-2.9	-6.3	-9.9	-9.7	-10.5	-11.5
Trade balance (% of GDP)	-4.7	-6.9	-8.7	-9.2	-6.8	-0.1	1.7	-3.1	-5.6	-7.5	-6.7	-6.7	-7.1
Current account balance (US$bn)	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	1.6	-1.3	-2.4	-4.4	-4.5	-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	-3.3	-3.1	-3.0	-2.8
Net FDI (US$bn)	4.7	5.8	7.0	7.2	4.1	0.3	3.0	3.3	2.6	2.4	1.9	2.5	3.0
Net FDI (% of GDP)	3.8	4.2	4.3	4.1	2.2	0.2	3.3	3.5	2.3	1.8	1.3	1.6	1.8
Current account balance plus FDI (% of GDP)	2.4	2.0	-2.0	-4.1	-6.8	-3.2	5.1	2.1	0.1	-1.5	-1.8	-1.4	-0.9
Foreign exchange reserves ex gold (US$bn)	25.6	33.3	30.4	22.7	18.8	6.6	12.4	14.6	17.7	19.8	22.0	22.5	23.7
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	4.6	4.5	4.6
Debt indicators													
Gross external debt (US$bn)	103	117	126	135	142	125	118	113	115	115	123	125	130
Gross external debt (% of GDP)	85	86	77	77	78	94	129	121	103	88	84	80	80
Gross external debt (% of exports)	260	228	184	196	221	231	311	309	267	242	258	255	258
Lending to corporates/households (% of GDP)	77.0	65.8	59.8	56.5	60.4	62.4	48.4	41.3	33.7	30.5	30.0	29.0	28.0
Interest & exchange rates													
Central bank key rate (year-end, %)	10.25	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	18.00	15.00	12.00	10.00
Broad money supply (average, %YoY)	-5.5	22.7	14.7	12.8	17.6	5.3	3.9	10.9	9.6	5.7	12.0	12.0	11.2
3m interest rate (KievPrime, average, %)	21.7	10.2	11.6	20.4	11.0	17.6	24.5	20.4	18.0	n/a	n/a	n/a	n/a
3m interest rate spread over US$-Libor (ppt)	2,170	1,020	1,160	1,971	1,066	1,726	2,408	2,010	1,777	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	26.00	28.00	29.00
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	26.24	27.00	28.56
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	28.60	32.20	34.80
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	29.12	30.51	33.71

*State budget does not include the balance of NFRK, the state oil fund

Source: National sources, ING estimates

Quarterly forecasts

	4Q18	1Q19	2Q19	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
Real GDP (%YoY)	3.5	2.5	4.6	2.7	2.9	3.0	2.9	3.0	3.1	3.0	3.0	3.0	3.0
CPI (eop, %YoY)	9.8	8.6	9.0	7.5	7.2	7.0	6.8	6.5	6.0	6.0	5.8	5.7	5.5
Central bank key rate (eop, %)	18.00	18.00	17.50	16.50	15.00	14.00	13.50	13.00	12.00	11.50	11.00	10.50	10.00
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)	27.69	27.25	26.17	24.08	26.00	26.50	27.00	27.50	28.00	28.39	28.61	28.82	29.00
EUR/UAH exchange rate (eop)	31.71	30.57	29.73	26.33	28.60	29.15	30.24	31.08	32.20	32.93	33.47	34.01	34.80

Source: National sources, ING estimates

Disclaimer