CEEMEA Regional Report
Monetary Policy to Support Growth

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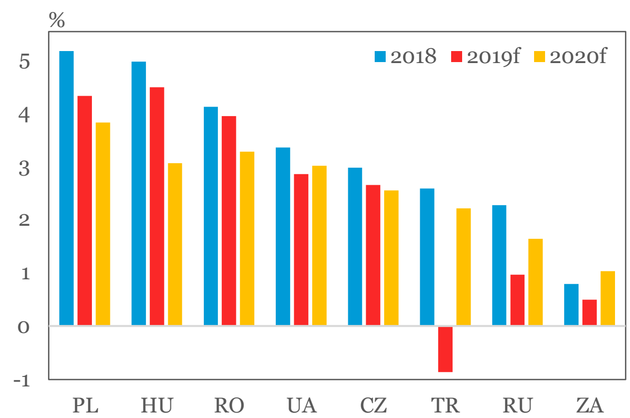
- Labor shortages and fragile investor confidence will constrain output growth.
- Policies will likely become more accommodative, thanks to a dovish ECB and Fed.
- The external financing and inflation outlook will remain challenging for some.
- Slow progress in addressing structural problems will intensify vulnerabilities.

Against the background of weaker domestic spending and a less supportive external environment, we project aggregate real GDP growth for the CEEMEA region to slow down from 2.9% in 2018 to 1.5% in 2019, before rebounding modestly to 2.2% in 2020. With escalating trade tensions and slowing global demand having adverse effects on the performance of the Euro Area (EA) and, particularly, exporters such as Germany, output growth in the EU4 (**Czech Republic**, **Hungary**, **Poland**, and **Romania**) – an important hub supplying manufacturers in Western Europe – will likely weaken in 2019. Output growth in other CEEMEA countries (**Russia**, **South Africa**, and **Ukraine**) looks set to slow down as well. **Turkey** is the only country in the region where output is projected to decline in 2019 (Exhibit 1).

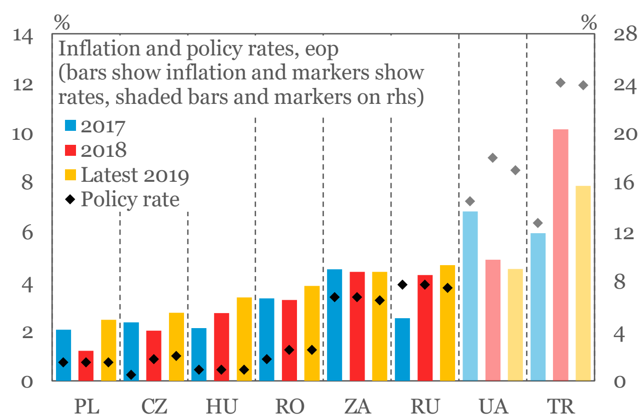
Exhibit 1. Growth in EU4 and Ukraine remains strong.



Source: Haver, IIF

GDP in the EU4 grew much faster than in other CEEMEA countries in recent years. Private consumption, supported by stronger employment and higher wages, has been the key engine of growth in these four countries since 2016. Higher absorption of EU funds has also boosted investment's contribution to growth. Intensifying labor shortages will likely weigh on production capacities in the EU4 while adding more to underlying price pressures over the medium-term. Tight labor market conditions have, indeed, already led to strong wage increases in recent years.

Exhibit 2. Likely no further interest rate hikes in 2019.



Source: Haver, IIF

Some central banks in the CEEMEA region have tightened their stances markedly since 2017 to alleviate the inflationary effects of high wage growth (**Czech Republic**, **Hungary**, and **Romania**) or exchange rate depreciation (**Ukraine** and **Turkey**). Weakening activity will likely keep central banks in the region from delivering more monetary tightening, as evidenced by decisions across the region in recent months to keep interest rates on hold or lower them (Exhibit 2).

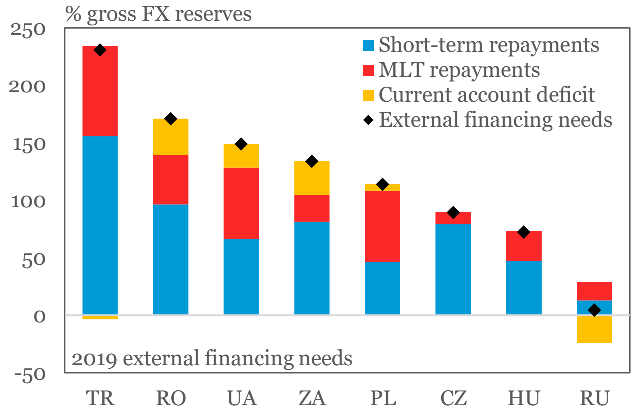
With the growth outlook for the EA having turned gloomier, the ECB will likely ease its stance markedly through 2020. Similarly, the Fed looks set to cut its key policy interest rate as well. Looser monetary policy in developed markets should help capital inflows to EM pick up, allowing central banks in the CEEMEA region to become more accommodative. Even so, sizable external financing needs relative to FX reserves (**Turkey**, **Romania** and **Ukraine**) will leave currencies vulnerable to shifts in market sentiment, requiring authorities to follow prudent policies (Exhibit 3).

The size of external financing needs will also determine how much fiscal space will be available to CEEMEA countries to stimulate domestic spending and growth. Countries with low government deficits and/or debt levels will likely depend on expansionary fiscal policy more than countries in which public finances are under stress (**Romania** and **South Africa**). Any measures to support the economy will depend on sufficiently positive market perception to allow countries to raise the funding needed for fiscal easing. Considering their relatively low external financing needs, as well as low government deficit and debt levels, the **Czech Republic**, **Poland**, and **Russia** appear to be better positioned compared to other countries in the region (Exhibit 4).

Fiscal easing and looser financial conditions would give support to investment and thereby boost productivity and potential growth. However, persistent geopolitical uncertainties (**Russia** and **Turkey**), slow progress in addressing structural problems (**South Africa** and **Turkey**), as well as concerns about the predictability of policymaking (**Romania**) will continue to weigh on investor confidence, keeping additional policy stimulus from translating into higher investment and thus stronger potential growth. Moves to improve investor sentiment would reduce the risk of additional policy stimulus solely boosting consumption with little or no effect on long-term growth prospects. Consequently, they would lower the risk of stimulus measures intensifying demand pressures and external vulnerabilities.

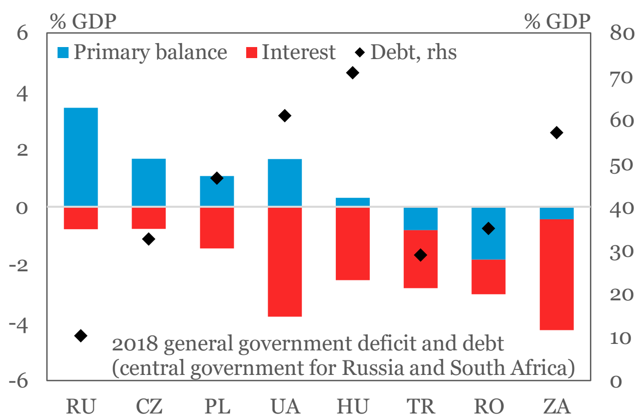
A sharp decline in investor confidence led net inflows of non-resident capital to the CEEMEA region to drop from 5% of regional GDP in 2017 to 2% in 2018. Higher interest rates (**Romania** and **Turkey**) as well as improved market sentiment (**Russia**) helped net inflows to the region pick up in early 2019. Assuming that the recent marginal improvement in market sentiment is sustained, such inflows of non-resident capital look set to increase modestly during the remainder of 2019 and in 2020, thanks in part to smaller outflows from **Russia**. Even so, net inflows this year and next will likely remain substantially below their 2017 levels (Exhibit 5). Most of the increase in capital inflows to the CEEMEA region later this year and in 2020 is likely to reflect short-term flows and portfolio capital, attracted by still-wide interest rate differentials (**Turkey**, **South Africa**, and **Ukraine**). Inflows are likely to be supported by larger direct equity investment to **Russia** in 2020 as the slightly improved growth outlook translates into stronger investment by non-resident enterprises.

Exhibit 3. External financing needs are large for some.



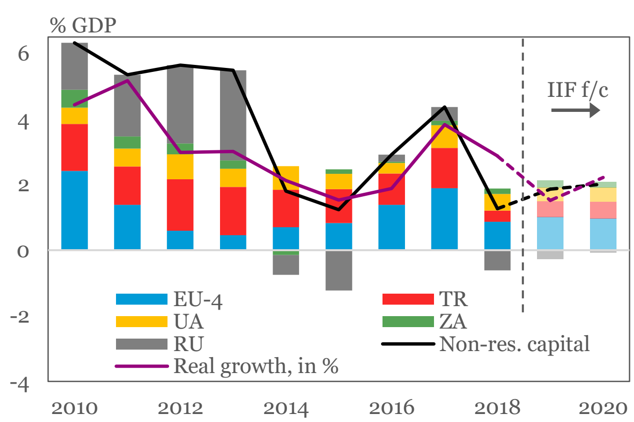
Source: Haver, IIF

Exhibit 4. Most countries have very little fiscal space.



Source: Haver, IIF

Exhibit 5. Capital inflows will improve only modestly.



Source: Haver, IIF

Czech Republic

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LABOR SHORTAGES CONSTRAIN GROWTH

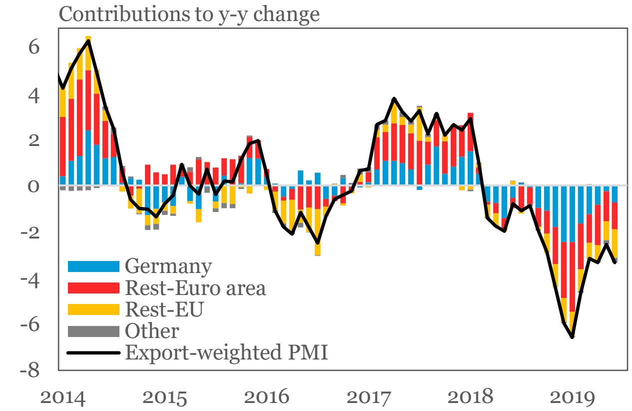
Seasonally adjusted real GDP growth slowed to 0.6% q/q in 2019Q1 from 0.9% q/q in 2018Q4. The Czech Republic's manufacturing sector depends heavily on the production processes of the German auto industry, which continues to struggle. As a result, slower growth mainly reflects weaker external demand from Germany, which accounts for around 30% of the Czech Republic's total exports. A trade-weighted PMI illustrates the challenges for the economy, particularly in light of the fact that recent readings of high-frequency indicators for Germany surprised to the downside once more (Exhibit 1). We project output growth of 2.6% and 2.5% in 2019 and 2020, respectively, which, in the context of weak growth in the rest of the EU, will allow for convergence to continue.

While the external environment represents the most significant short-term risk factor, medium- and long-term growth prospects appear relatively weak compared to the recent past in the face of growing labor shortages (Exhibit 2). A shrinking population, together with record-high labor force participation and a historically low unemployment rate (around 2%) have reduced the number of non-working individuals by close to 1.4 million since 2010. The shrinking labor reserves prompted the government to somewhat ease its restrictive immigration policies. In early 2019, it doubled the number of work visas available to Ukrainians to 40,000, after increasing them by around 10,000 in 2018. Even so, tight labor market conditions continued, leading to high nominal wage growth (around 7.5% y/y on average over the last two years). With unit labor costs rising, the Czech economy's competitiveness has been eroding.

Aside from continued significant nominal wage increases, strong increases in food and alcohol prices pushed up 12-month headline inflation toward the upper end of the central bank (CNB) target range of 2%±1, with headline inflation above 2.7% since February (Exhibit 3). After the CNB increased its key policy rate by a cumulative 90bps since mid-2018 (to 1%), inflationary pressures appear to have eased, with 12-month core inflation below its January peak of 3%. In response to a deteriorating growth outlook and easing inflationary pressures, the central bank did not continue with its hiking cycle at the last MPC meeting in June. With inflation expectations remaining well-anchored around the midpoint of the inflation target band, the central bank looks unlikely to raise its key policy interest rate further in the near-term, barring a significant CZK depreciation.

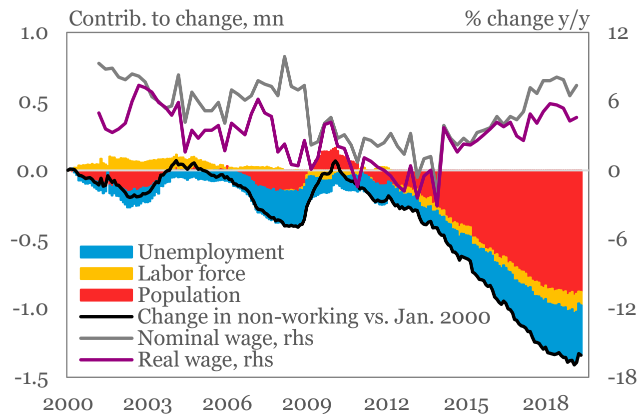
The near-term outlook is clouded by potential political instability. Ongoing protests against Prime Minister Babiš over alleged misallocation of EU funds and self-enrichment, as well as attacks on the judiciary, have eroded support in the ANO-CSSD coalition. It appears possible that early elections could be held if the government loses its parliamentary majority.

Exhibit 1. Trade-weighted PMI has bottomed out.



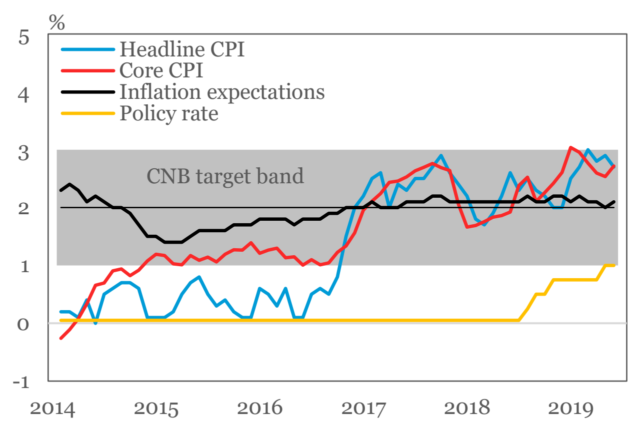
Source: Haver, IIF

Exhibit 2. Tight labor market drives wage growth.



Source: Haver, IIF

Exhibit 3. Inflation remains elevated.



Source: Haver, IIF

Hungary

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GROWTH REMAINS ROBUST

Output growth picked up in early 2019 – from 4.9% y/y in 2018Q4 to 5.3% y/y in 2019Q1 – fueled mainly by stronger investment and private consumption (Exhibit 1). Investment was supported by a positive credit impulse and larger EU funds disbursements, while consumption benefited from increases in employment and real wages. Nevertheless, slowing activity in the Euro area and weaker investment growth will likely lead real GDP growth to decline from 4.9% in 2018 to 4.5% this year and decrease further to 3% in 2020. Cuts to EU structural funds in the 2021-27 budget and a shift in the allocation toward Mediterranean and less-developed CEE countries will constrain investment, thereby making it more difficult to sustain robust growth over the medium term (Box 1).

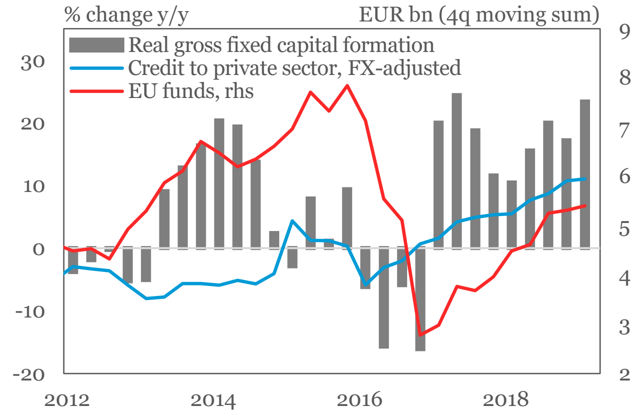
Hungary's unemployment rate has remained below 4% since late 2017 and currently stands at 3.5%. Despite record-high labor force participation (above 72%), labor shortages have intensified in the absence of significant inflows of foreign workers. As a result, nominal wage growth remains in double-digit territory, leaving growth in real wages outpacing that in productivity. With domestic demand strengthening and unit labor costs rising, inflationary pressures have increased, and imports have picked up.

Demand pressures and cost-push factors drove headline inflation from 2.7% y/y in January to 3.9% y/y in May. In June, it eased to 3.4%. Tax-adjusted core inflation increased significantly as well over January-June, from 2.5% y/y to 3.6% y/y. The rise in inflation has started to deteriorate inflation expectations, which poses a risk to the near-term inflation outlook (Exhibit 2). 12-month headline inflation looks likely to pick up to 4% by December 2019 before easing to 3.2% by December 2020 (thanks mainly to base effects and a slowing economy).

In response to the recent increase in inflation, the central bank (MNB) has tightened its stance since March by cutting the amount of liquidity provided through FX swap auctions. The MNB has also shortened the average maturity of FX swaps, which should provide more flexibility to better address volatility in liquidity conditions (Exhibit 3). (For more details, see CEEMEA Views: Hungary – Growth Remains Robust) Despite signs of overheating, weaker foreign demand and the recent shift of the ECB toward a more dovish stance will likely allow the MNB to maintain a largely accommodative policy stance through 2020.

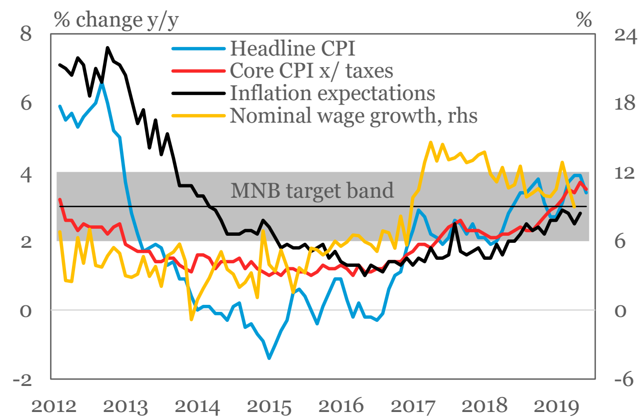
Strong imports growth has resulted in a deterioration of the current account surplus from the recent peak of 6.2% of GDP in 2016 to 1% of GDP in early 2019. Even so, the current account is likely to remain in small surpluses this year and next. Reduced disbursements of EU funds and a continued shortage of skilled labor will be the main challenges facing Hungary in the medium term.

Exhibit 1. Growth is mainly driven by strong investment.



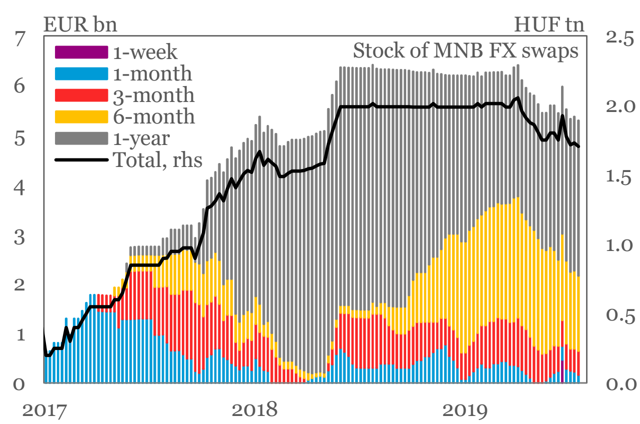
Source: Haver, IIF

Exhibit 2. Inflation continues to rise.



Source: Haver, IIF

Exhibit 3. MNB is tightening liquidity conditions.



Source: Haver, IIF

Poland

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PROCYCLICAL FISCAL POLICY

Contrary to expectations of a slowdown to around 4%, seasonally adjusted real GDP growth surprised to the upside in 2019Q1, picking up to 4.7% y/y from 4.5% y/y in 2018Q4 (Exhibit 1). Continued strength of exports points to a somewhat surprising decoupling from the growth slowdown in Germany. High-frequency indicators such as export orders, retail sales, and industrial production suggest no substantial loss of growth momentum in 2019Q2. Strong domestic spending as a result of increasing disposable incomes should partially offset weaker foreign demand during the remainder of 2019. Even so, we project that real GDP growth will slow from 5.1% in 2018 to 4.3% this year and further to 3.8% in 2020.

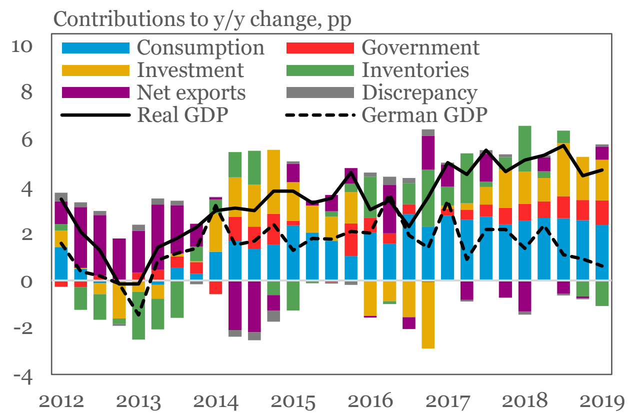
Ahead of the European elections in May, the PiS government announced a fiscal package that included additional spending on social benefits (childcare and pensions) as well as tax cuts for persons under 26 and low-income groups. These measures were announced against the backdrop of a smaller-than-targeted general government deficit of 0.4% of GDP in 2018 (Exhibit 2). The government is planning to finance additional expenditures by one-off revenues, which are dominated by a sizable levy through changes in the pension system but also include proceeds from auctions of 5G mobile network licenses and unused CO_2 certificates. We expect the general government deficit to widen to 1.5% of GDP this year before declining to 0.5% of GDP next year. (For more details, see CEEMEA Views: Poland – Procyclical Fiscal Policy)

Rising disposable incomes have not only boosted private consumption but also led to a deterioration of the current account, which turned to a 0.6% of GDP deficit in 2018 from a small surplus in 2017. We project this development to continue given persistent robust wage growth and the deficit to reach 1.0% and 1.2% of GDP in 2019-20, respectively.

Poland's labor market is in a somewhat different place compared to regional peers. While the headline unemployment rate is very low (3.8% in May), the influx of Ukrainian workers has somewhat alleviated labor shortages. As a result, wage growth has been strong but lagged behind other CEE countries, and CPI inflation remains around the mid-point of the central bank's (NBP) 2.5%±1 target band. However, it has increased sharply in recent months, from 0.7% y/y in January to 2.6% y/y in June. Core inflation has also increased significantly, from 0.6% y/y at the end of 2018, to 1.9% y/y in June. We project headline inflation to reach 2.2% in 2019 (from 1.8% last year), before accelerating further to 2.7% in 2020.

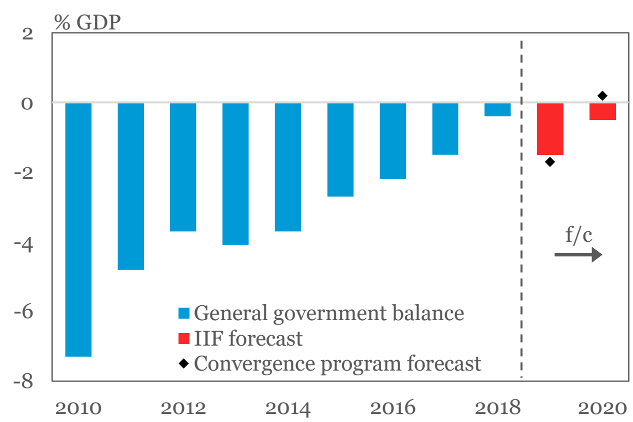
The growth slowdown in Germany remains the key short-term risk to Poland's outlook as the decoupling will likely be only temporary. In the medium term, growing shortages of skilled labor will restrict growth prospects. If other European countries open their labor markets further to Ukrainian workers, labor shortages would intensify and inflation pressures grow.

Exhibit 1. GDP growth remains strong.



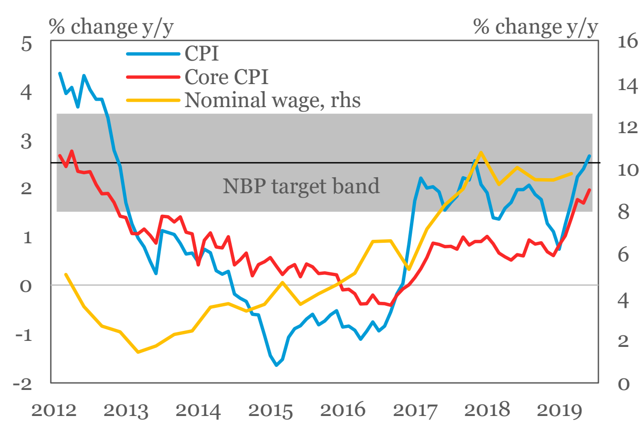
Source: Haver, IIF

Exhibit 2. Government deficit will rise in 2019.



Source: Haver, IIF

Exhibit 3. Wage growth and inflation have picked up.



Source: Haver, IIF

Romania

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GROWING IMBALANCES

Populist policies focused on raising wages and pensions have led to growing twin deficits, as well as rising inflation (Exhibit 1). Despite these policies, the governing PSD-ALDE coalition suffered substantial losses in the European elections in May. This appears to reflect a strong desire by the electorate to reverse a series of measures geared toward weakening judicial independence and the rule of law.

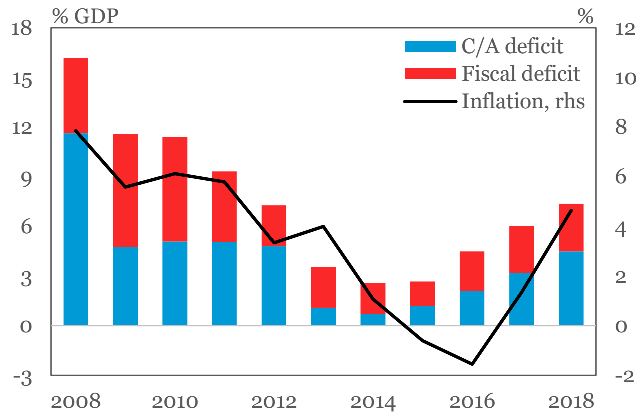
A sharp deterioration in the fiscal deficit prompted the government to introduce ad-hoc taxes on banks as well as energy and telecommunications companies in December 2018. The extensive nature of the measures caught markets by surprise. The RON subsequently came under significant depreciation pressure, and rating agencies issued downgrade warnings (Exhibit 2). Market reaction led the government to amend the bank tax legislation, markedly reducing the burden on banks. Together with frequent legislative changes and unpredictable policymaking, attempts to decriminalize corruption have eroded investor confidence, undermining growth prospects.

A violation of the 3% EU deficit limit in 2018 was avoided only through a slew of one-off measures, including substantial cuts to capital spending, a delay of VAT refunds to 2019, retroactive EU funds disbursements, and higher dividend payments to the budget by SOEs. We forecast that cyclical revenue weakness and the 15% pension hike in the fall of 2019 will widen the deficit to 3.5% of GDP in 2019 and 4.1% in 2020 (Exhibit 3). (For more details, see CEEMEA Views: Romania – Growing Imbalances)

Contrary to our expectations, parliament passed legislation to increase pensions by an additional 40% in September 2020. In the absence of corrective measures, next year's fiscal deficit will likely exceed our forecast. As a result, Romania could be placed once again under the Excessive Deficit Procedure (EDP). With output growth slowing and the external environment deteriorating, fiscal adjustment will thus have to take place in a less favorable context. The composition of government expenditures will likely require painful cuts to social benefits or tax increases.

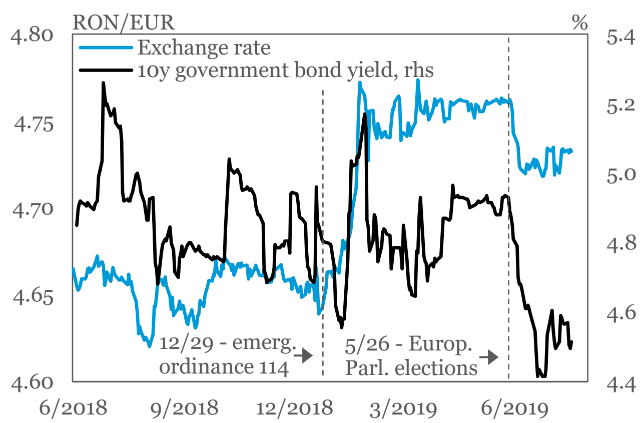
Double-digit wage growth over a period of more than three years has led to both rising inflation and growing external imbalances. Headline inflation remains above the upper end of the central bank's 2.5%±1 target band (3.8% y/y in June). We project headline inflation to reach 4.7% y/y by the end of 2019 and average annual inflation to remain above 4% in both 2019 and 2020. Rising disposable incomes have also driven up imports, leading to a significant deterioration of the current account balance. The external deficit has widened from 0.7% of GDP in 2014 to 4.7% in 2018, and we expect it to reach 5.0% in 2019 before falling slightly to 4.8% in 2020. Policy uncertainty, together with widening twin deficits and rising inflation, represents the key risk to Romania's outlook.

Exhibit 1. Domestic and external imbalances have risen.



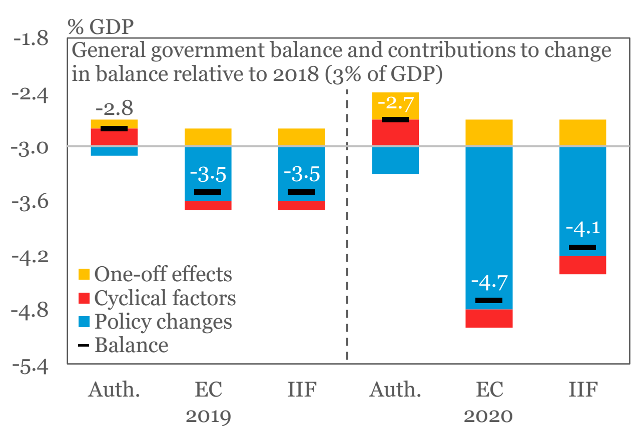
Source: Haver, IIF

Exhibit 2. Ad-hoc measures weigh on investor confidence.



Source: Haver, IIF

Exhibit 3. Deficit limit likely to be breached in 2019-20.



Source: Haver, IIF

BOX 1. EU STRUCTURAL FUNDS BOOST GROWTH AND CONVERGENCE IN CEE

CEE countries in the EU have seen strong real GDP growth since 2010. Annual average growth between 2010-18 reached 2.9%, and growth was even higher in PPP per capita GDP terms. During this period, these countries received significant funding from the EU through the European Regional Development Fund (ERDF), Cohesion Fund (CF), and European Social Fund (ESF) – which, combined, equaled €168 bn in the 2007-13 budget and €188 bn in the 2014-20 budget.

We look at how EU funds disbursements have benefited growth across these countries, taking into account first-round effects through investment, second-round effects through increased consumption, and spillover effects to imports. For future disbursements, we assume that remaining funds from the 2014-20 budget will peak in 2019 and gradually taper off by 2023, similar to the disbursement pattern of the 2007-13 budget. We then apply the 2014-20 disbursement pattern to the proposed 2021-27 budget, in which the Commission allocates a total of €192 bn to CEE countries through ERDF, CF, and ESF. Our estimates show EU funds' contributions to annual output growth ranging from 0.4pp (Slovenia) to 1.2pp (Poland) between 2007 and 2018 (excluding Croatia, which joined the EU in 2013). Going forward, we expect contributions to range from 0.2-0.8pp over 2019-24, and from 0.2-0.7pp over 2025-30 due to budget cuts. (Exhibit 1) The proposed cuts to cohesion funding will affect long-term growth significantly. However, cliff-edge effects are unlikely, as disbursements from the current budget will continue past the formal budget period.

Due to their contribution to growth, EU funds disbursements also had a large effect on per capita GDP in PPP terms relative to the rest of the EU, i.e. convergence (Exhibit 2). We illustrate this point by showing two scenarios for the eleven-country group: one in which EU funds were disbursed and will be disbursed going forward, and one in which EU funds were never made available. We find that funds decreased the time needed for a full recovery from the global financial crisis by roughly two years, and that median convergence would have been approximately 5pp weaker by 2018. Looking forward, convergence would slow down considerably in the no-funds scenario, and median relative PPP per capita GDP would fall another 4.6pp behind the baseline by 2030

A similar pattern emerges for individual countries. Under the baseline scenario, some CEE countries – such as the Czech Republic, Lithuania, and the Slovak Republic– will come close to parity with the remaining EU members by 2030, while others – such as Bulgaria, Croatia, and Romania – will still lag substantially. Under the no-funds scenario, some countries suffer greater losses than others. Poland and Lithuania would have been particularly hard hit in the period since their EU accession in 2004, with convergence levels 7-9pp lower than in the baseline scenario. These countries, together with Croatia and Latvia, would also face the highest risk going forward, as funds are estimated to further reduce the income gap around 6-7pp by 2030. (For more details, see [CEEMEA Views: EU Structural Funds Boost Growth in CEE])

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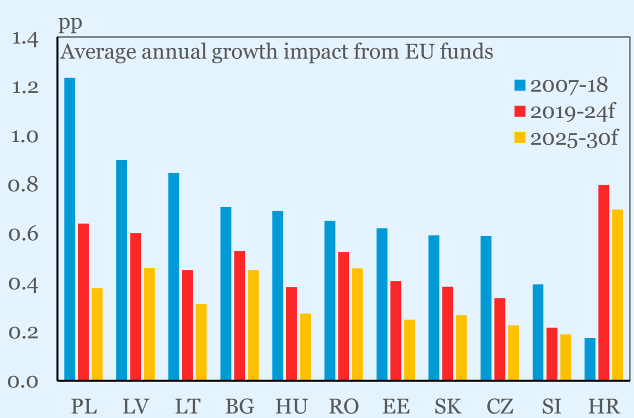
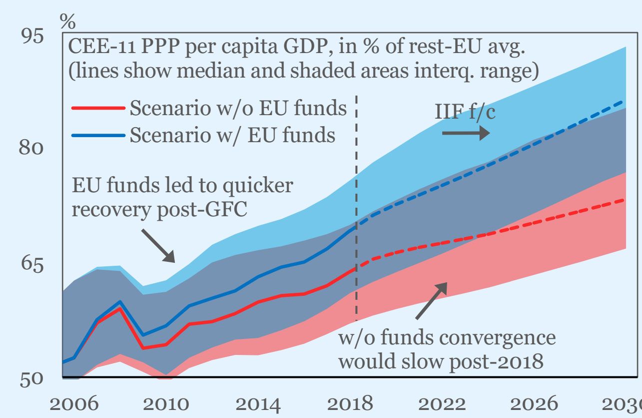
Exhibit 1. Contributions to growth are large, ...



Source: Haver, IIF

Exhibit 2. ... supporting income convergence.



Source: Haver, IIF

Russia

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SLOW GROWTH BUT LOW VULNERABILITIES

We expect growth to come in at around 1% in 2019. It surprised on the upside in 2018 at 2.3%, the highest reading in seven years, following an extraordinarily strong Q4 (2.9% y/y). However, this was mainly a result of the fact that Rosstat included a number of investment projects in its 2018Q4 numbers that had been completed over the past few years. We expect the statistics agency to revise and smoothen its GDP numbers in the coming months. Output growth came in substantially weaker in 2019Q1, at -0.7% q/q (sa) and 0.5% y/y (Exhibit 1). While private consumption remained robust, gross fixed capital formation declined sharply, -2.1% relative to 2018Q4 and -3.2% relative to 2018Q1.

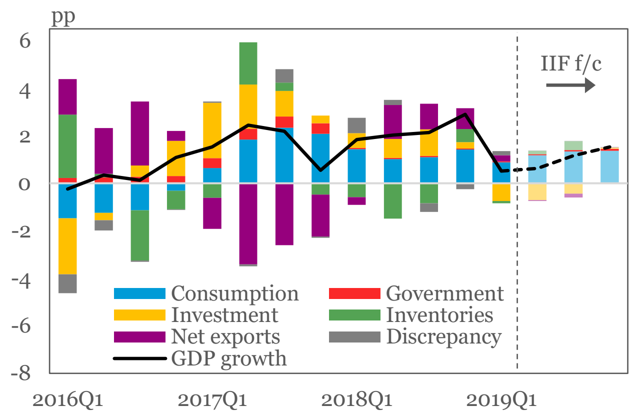
High-frequency indicators appear to show that challenges persist in 2019Q2. While industrial production growth continues to recover from stagnation at the beginning of last year, non-food retail sales and market services volumes are growing at slower rates compared to mid-2018, and car sales have been declining in recent months. We project the economy to recover in the second half of 2019, but output growth for the whole year will likely be weak before recovering modestly to 1.6% in 2020.

Inflation will average around 4.9% in 2019 and approach the central bank's (CBR) 4% target by the end of the year according to our forecast. After an extended period of declining price pressures, inflation began to rise again in early-2018 (Exhibit 2). In response, the CBR raised its policy rate twice in 2018 for a total of 50bps. Nevertheless, inflation moved above the target in December, likely related to an increase in the VAT rate from 18% to 20% in January. It fell below 5% for the first time this year in June. Inflation expectations also increased sharply in January but declined to 5% last month, thereby limiting the risk of persistent inflation pressures. We expect the central bank to further loosen monetary conditions by 75-100bps in 2019-20 and reach the neutral rate (~6.50%) by mid-2020.

Domestic and external vulnerabilities are low. The current account surplus reached a record-high USD114 bn in 2018 (or 6.9% of GDP) on the back of recovering oil prices. We project the surplus to remain sizable in 2019-20 at 5.5% and 4.2% of GDP, respectively. At the same time, and as the result of expenditure restraint as well as substantially higher energy revenues, the consolidated government balance reached a surplus in 2019Q1 and is expected to remain in surplus territory over the near term (Exhibit 3). Additionally, external debt in GDP terms has been declining from its peak in early-2016 and currently lies below 30% of GDP.

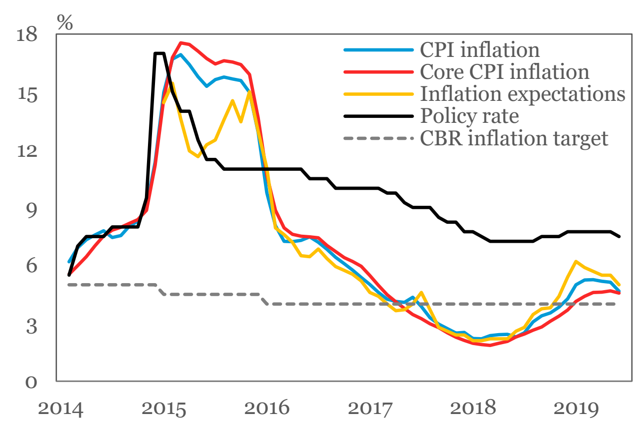
Finally, according to the fiscal rule, excess energy revenues are used to add to FX reserves, which are then transferred to the National Welfare Fund (NWF). We project the fund to grow to around RUB10.5 tn by end-2020, thereby further protecting the economy from external shocks.

Exhibit 1. Growth is expected to remain weak.



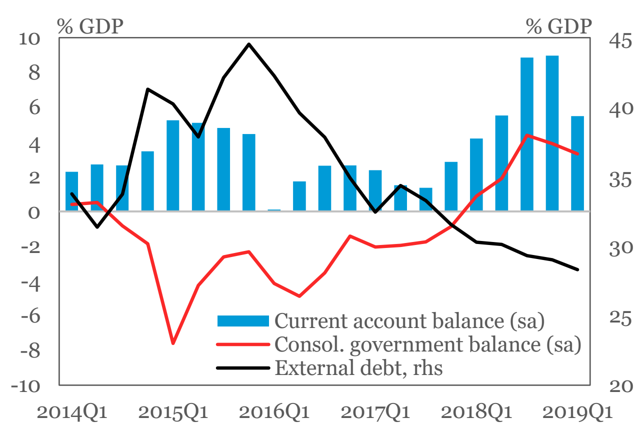
Source: Haver, IIF

Exhibit 2. Inflation is returning to the target.



Source: Haver, IIF

Exhibit 3. Domestic and external vulnerabilities are low.



Source: Haver, IIF

South Africa

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CHALLENGING FISCAL OUTLOOK

A combination of power cuts, low business confidence, and political uncertainty ahead of the May 8 parliamentary elections led to a continued decline in investment, bringing y/y output growth to a halt in 2019Q1 (Exhibit 1). Weaker y/y increases in private consumption and exports also contributed to the dismal growth performance in early 2019. High-frequency indicators such as manufacturing and mining production suggest that growth picked up modestly in 2019Q2. With growth likely to remain subdued in 2019H2, real GDP growth looks set to slow down from 0.8% in 2018 to 0.5% this year before picking up only marginally to 1% in 2020.

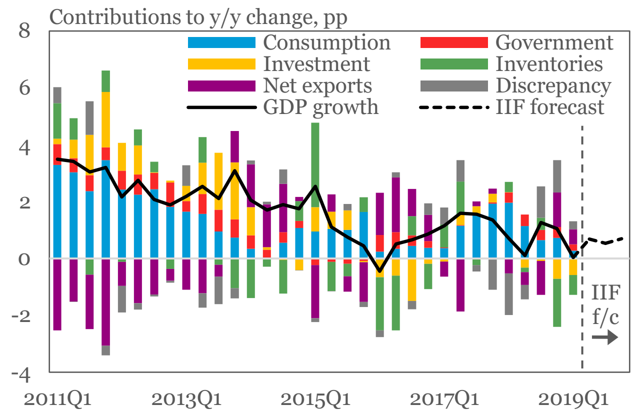
Weak activity was accompanied by low inflation, leaving the increase in nominal incomes much weaker than the government's forecast. Nominal GDP growth is likely to significantly undershoot the government's expectation of 6.9% for this fiscal year. Together with cyclical revenue weakness, the frontloading of financial support to Eskom will likely widen the fiscal deficit to nearly 6% of GDP in 2019, much larger than the government's 4.5% of GDP target for the 2019/20 fiscal year. The structure of Eskom support (capital injection, debt transfer, or some combination thereof) will determine the extent of the deterioration of government deficit and debt (Exhibit 2).

With the government unlikely to be able to introduce meaningful corrective measures to stop the deterioration in the fiscal deficit and public debt ahead of the next Moody's rating review scheduled for November 1, the risk of a credit rating downgrade to non-investment grade has risen. This would result in net outflows of non-resident portfolio debt and equity from investors with holdings subject to investment grade credit rating requirements. Against the backdrop of South Africa's relatively large current account deficit and external financing needs, any sizable net outflows of non-resident capital could lead to a substantial ZAR depreciation.

The central bank seeks to anchor inflation expectations at 4.5%, the mid-point of the 3%-6% target range. Driven mainly by higher food prices, 12-month headline inflation rose to 4.5% in May, up from 4% in January. 12-month core inflation, meanwhile, eased to 4.3% from 4.6% over the same period. With monetary policy responsive to inflation expectations as well as other variables such as changes in output and unemployment, weak economic activity prompted the central bank to cut its key policy rate by 25bps to 6.5% in July, even though one-year ahead inflation expectations remain above 5%.

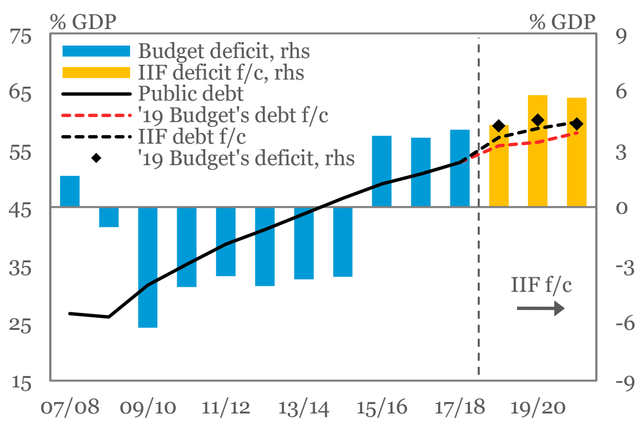
The main near-term risk is a credit rating downgrade by Moody's, as it would increase South Africa's already high external vulnerability. Any sustained ZAR weakness would have an adverse impact on inflation and inflation expectations and therefore constrain the central bank's ability to adopt a more accommodative stance to support activity (Exhibit 3).

Exhibit 1. Growth is expected to disappoint.



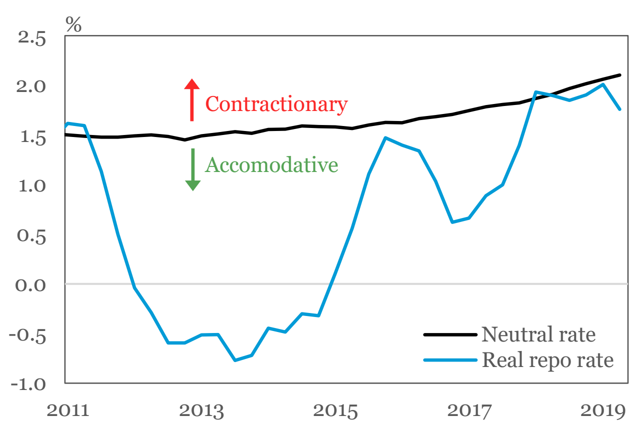
Source: Haver, IIF

Exhibit 2. Eskom frontloading should worsen outlook.



Source: Haver, IIF

Exhibit 3. Monetary policy turns more accommodative.



Source: SARB, Haver, IIF
Note: Real repo rate equals nominal repo rate deflated by 4q average of y/y headline inflation. Neutral rate estimated by SARB.

Turkey

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IDIOSYNCRATIC RISKS WEIGH ON OUTLOOK

Aside from global uncertainties weighing on market sentiment toward EM assets, Turkish assets have underperformed their peers in early 2019 due to heightened idiosyncratic risks to Turkey's near-term macro outlook (Exhibit 1). Those risks initially centered around uncertainty about policymaking in the aftermath of the rerun of local government elections in Istanbul. Further risks stem from Turkey's acquisition of Russian S400 air missile defense systems. Uncertainty about the Unites States' response to the S400 deliveries still weighs on the TRY exchange rate. However, the current exchange rate level reflects optimism that the relationship between presidents Erdogan and Trump will prevent harsh sanctions.

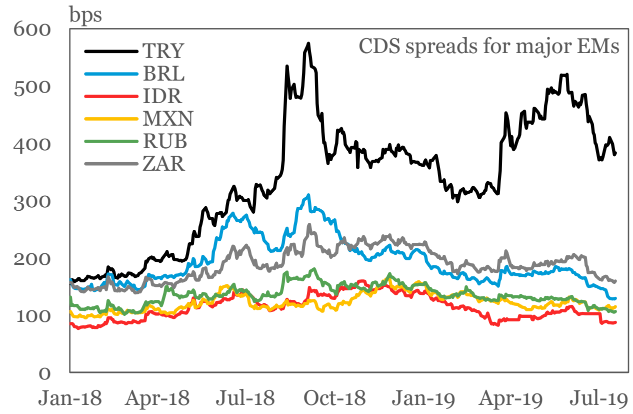
Other Turkey-specific uncertainties include questions about the sustainability of the country's credit-driven output recovery in early 2019. Additionally, Turkey's external financing position and fiscal outlook present challenges. Moreover, the government's willingness to implement structural reforms and the central bank's ability to support growth amid ongoing dollarization remains in question.

The market interprets the replacement of former governor Murat Çetinkaya as a sign for larger interest rate cuts in the short term. With headline inflation likely to ease from 15.7% y/y in June to 9.2% y/y in October, thanks mainly to base effects and weak demand, the market is pricing as much as 300bps in interest rate cuts in the short term (Exhibit 2). Cuts beyond market pricing would bring the TRY under renewed depreciation pressure.

Import compression, driven by the reversal of the positive credit impulse that had boosted domestic spending and imports in 2019Q1, supported the shift of the current account to a small surplus in May. The deficit narrowed to USD3.1 bn during January-May from USD28 bn a year before. A weaker TRY will likely continue to keep exports and tourism revenues strong during the remainder of 2019, which should lead to a full-year current account surplus of 0.3% of GDP compared to a 3.5% of GDP deficit in 2018. The shift to a small surplus notwithstanding, Turkey's USD175 bn liabilities to non-residents, which are due to mature over the next 12 months, will leave the TRY vulnerable to shifts in market sentiment.

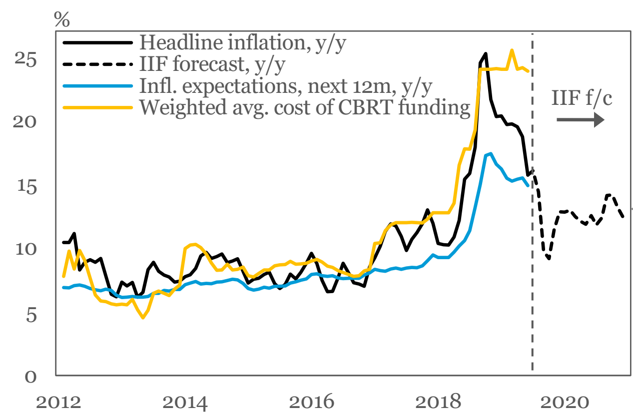
Combined with cyclical revenue weakness, pre-election spending widened the IMF-defined annualized noninterest fiscal deficit from 1.5% of GDP in 2018 to 2.8% of GDP during the first half of 2019. This raised concerns about the government's pledge to curb inflation and reduce the current account deficit by maintaining fiscal discipline (Exhibit 3). The main near-term risk for Turkey is the authorities' desire to boost growth via lower interest rates and credit expansion, which could jeopardize the stability of the TRY, as policy stimulus widens the current account deficit and requires more external funding.

Exhibit 1. Risk premium remains high.



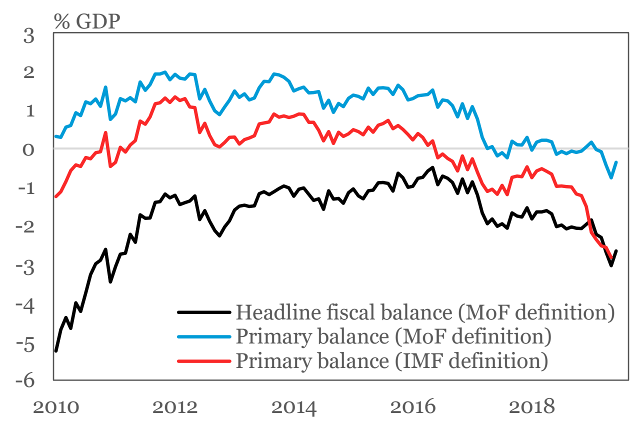
Source: Haver, IIF

Exhibit 2. CBRT is expected to ease its stance.



Source: Haver, IIF

Exhibit 3. Pre-election spending widened deficit.



Source: Haver, IIF

Ukraine

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IN NEED OF A NEW IMF PROGRAM

We project real GDP growth to slow down from 3.3% last year to 2.8% in 2019, before picking up to 2.9% in 2020. Growth in 2019Q1 slowed, to 2.5% y/y and 0.0% q/q. However, despite a worsening external environment given Euro area weakness, exports performed well in Q1 and industrial production has strengthened after negative growth y/y in late-2018 and early-2019. Growth is supported by strong private consumption as a result of a tight labor market and robust wage growth. Rising disposable incomes will allow for private consumption growth of around 7% in 2019-20.

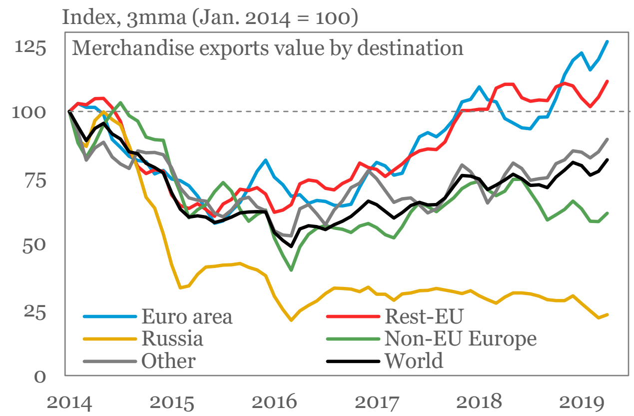
We expect Ukraine's external balance to improve over the near term, with the current account deficit contracting from 3.3% in 2018 to 3.1% and 3.0% in 2019-20, respectively. Export reorientation toward the European Union, together with higher transfers from abroad, will support the current account, while imports increase in line with robust domestic demand (Exhibit 1). The reorientation of exports toward the West has been crucial given the loss of access to the Russian market after 2014. However, it also exposes Ukraine to the current weakening of activity in Europe. (For more details, see Macro Notes: Positive Shift in Ukraine's Current Account)

Ukraine is facing heightened external financing needs over the next couple of years due to repayments to the IMF as well as Eurobond amortization. Despite the improving current account, stable FDI and a moderate increase in portfolio inflows will not be enough to cover the gap. Under the assumption of broadly stable capital flows and the issuance of Eurobonds of USD1.5 bn, we estimate a financing gap of USD2 bn (Exhibit 2). As a result, a new IMF program will need to be negotiated following this month's parliamentary elections. (For more details, see Macro Notes: Ukraine Will Need the IMF in 2020)

While the external financing picture remains a challenge, public finances appear to be in decent shape. Ukraine achieved a primary surplus over the last four years and a broadly stable exchange rate. Together with a modest growth rebound, this has led to a more than 20pp decline in the debt-to-GDP ratio to below 60%. We project debt to stabilize around 55% over 2019-22 and stress tests demonstrate that it would take significant shocks to throw debt sustainability off track (Exhibit 3).

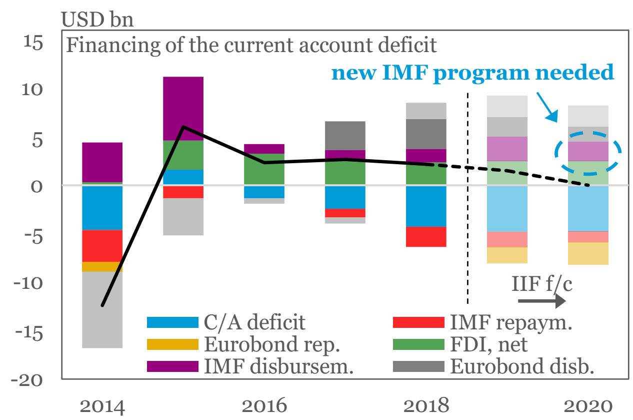
Even under the assumption of a growth collapse in line with the 2014-15 episode, the debt-to-GDP ratio is unlikely to rise to crisis levels. The debt picture is, however, more sensitive to exchange rate volatility. A repeat of the UAH depreciation of 2014-17 would result in debt levels in excess of 100% of GDP. In order to minimize foreign exchange rate risks, Ukrainian authorities have opened up local government bond markets to foreign investors. As a result, the share of foreign investor ownership of domestic government bonds has increased sharply in recent months to just under 8%, its highest level since late-2010.

Exhibit 1. Export reorientation continues.



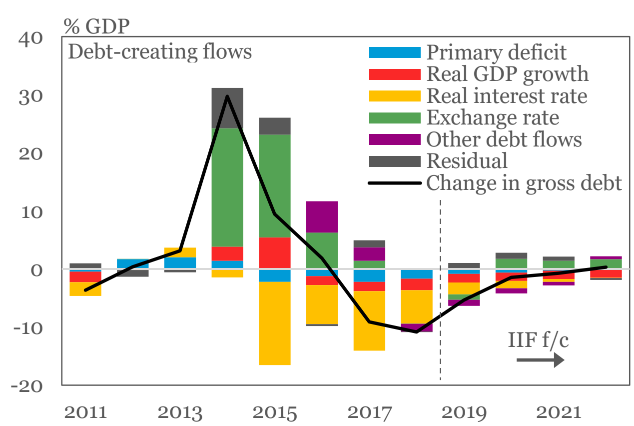
Source: Haver, IIF

Exhibit 2. A new IMF program will be needed in 2020.



Source: Haver, IIF

Exhibit 3. Public debt to stabilize around 55% of GDP.



Source: Haver, IIF

Appendix: CEEMEA outlook at a glance

	2010	2011	2012	2013	2014	2015	2016	2017	2018	**2019f**	**2020f**
Czech Republic											
Growth (%, y/y)	2.3	1.8	-0.8	-0.5	2.7	5.3	2.5	4.4	3.0	**2.6**	**2.5**
Inflation (% y/y, avg)	1.5	1.9	3.3	1.4	0.3	0.3	0.7	2.5	2.1	**2.7**	**2.1**
Current account balance (% GDP)	-3.7	-2.1	-1.6	-0.6	0.3	0.1	1.6	1.5	0.3	**0.2**	**0.3**
Gen. gov. balance (% GDP)	-4.2	-2.7	-3.9	-1.2	-2.1	-0.6	0.7	1.6	0.9	**0.3**	**-0.2**
Hungary											
Growth (%, y/y)	0.7	1.7	-1.6	2.1	4.2	3.5	2.3	4.1	4.9	**4.5**	**3.0**
Inflation (% y/y, avg)	4.9	3.8	5.6	1.6	-0.3	-0.1	0.5	2.5	2.9	**3.9**	**3.4**
Current account balance (% GDP)	0.3	0.7	1.8	3.8	1.5	2.8	6.2	2.8	0.4	**0.1**	**0.4**
Gen. gov. balance (% GDP)	-4.5	-5.4	-2.4	-2.6	-2.6	-1.9	-1.6	-2.2	-2.2	**-2.0**	**-1.5**
Poland											
Growth (%, y/y)	3.7	5.0	1.6	1.4	3.2	3.8	3.1	4.9	5.1	**4.3**	**3.8**
Inflation (% y/y, avg)	2.7	4.2	3.7	1.2	0.2	-0.9	-0.7	2.0	1.8	**2.2**	**2.7**
Current account balance (% GDP)	-5.4	-5.2	-3.7	-1.3	-2.1	-0.6	-0.5	0.1	-0.6	**-1.0**	**-1.2**
Gen. gov. balance (% GDP)	-7.4	-4.8	-3.7	-4.1	-3.7	-2.7	-2.2	-1.5	-0.4	**-1.5**	**-0.5**
Romania											
Growth (%, y/y)	-3.9	2.0	2.1	3.5	3.4	3.9	4.8	7.0	4.1	**3.9**	**3.3**
Inflation (% y/y, avg)	6.1	5.8	3.3	4.0	1.1	-0.6	-1.6	1.3	4.6	**4.2**	**4.2**
Current account balance (% GDP)	-5.1	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.2	-4.7	**-5.0**	**-4.8**
Gen. gov. balance (% GDP)	-6.9	-5.4	-3.7	-2.2	-1.3	-0.7	-2.7	-2.7	-3.0	**-3.5**	**-4.1**
Russia											
Growth (%, y/y)	4.5	4.1	3.6	1.8	0.7	-2.3	0.3	1.6	2.3	**1.0**	**1.6**
Inflation (% y/y, avg)	6.8	8.4	5.1	6.8	7.8	15.5	7.0	3.7	2.9	**4.9**	**3.9**
Current account balance (% GDP)	4.1	4.7	3.3	1.5	2.8	5.0	1.9	2.1	6.9	**5.5**	**4.2**
Gen. gov. balance (% GDP)	-3.2	1.4	0.4	-1.2	-1.1	-3.4	-3.7	-1.5	2.9	**2.1**	**1.4**
Turkey											
Growth (%, y/y)	8.5	11.1	4.8	8.5	5.2	6.1	3.2	7.4	2.6	**-0.9**	**2.2**
Inflation (% y/y, avg)	8.6	6.5	8.9	7.5	8.9	7.7	7.8	11.1	16.3	**15.3**	**12.7**
Current account balance (% GDP)	-5.8	-9.0	-5.5	-6.7	-4.7	-3.7	-3.8	-5.6	-3.5	**0.3**	**-0.8**
Gen. gov. balance (% GDP)	-3.2	-0.6	-1.8	-1.2	-0.8	-1.0	-1.7	-2.0	-2.8	**-3.8**	**-4.1**
Ukraine											
Growth (%, y/y)	3.8	5.5	0.2	0.0	-6.6	-9.8	2.4	2.5	3.3	**2.8**	**2.9**
Inflation (% y/y, avg)	9.4	8.0	0.6	-0.3	12.1	48.7	13.9	14.4	10.9	**8.5**	**6.8**
Current account balance (% GDP)	-2.2	-6.3	-8.2	-9.0	-3.4	1.8	-1.4	-2.2	-3.3	**-3.1**	**-3.0**
Gen. gov. balance (% GDP)	-5.8	-2.8	-4.3	-4.8	-4.5	-1.2	-2.2	-2.2	-2.1	**-2.4**	**-2.3**
South Africa											
Growth (%, y/y)	3.0	3.3	2.2	2.5	1.8	1.2	0.4	1.4	0.8	**0.5**	**1.0**
Inflation (% y/y, avg)	4.3	5.0	5.6	5.8	6.1	4.6	6.3	5.3	4.6	**4.5**	**4.7**
Current account balance (% GDP)	-1.5	-2.2	-5.1	-5.8	-5.1	-4.6	-2.9	-2.5	-3.5	**-3.6**	**-3.7**
Central gov. balance (% GDP)	-4.1	-3.6	-4.1	-3.7	-3.6	-3.7	-3.6	-4.0	-4.3	**-5.8**	**-5.6**

Source: IIF