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Executive Summary

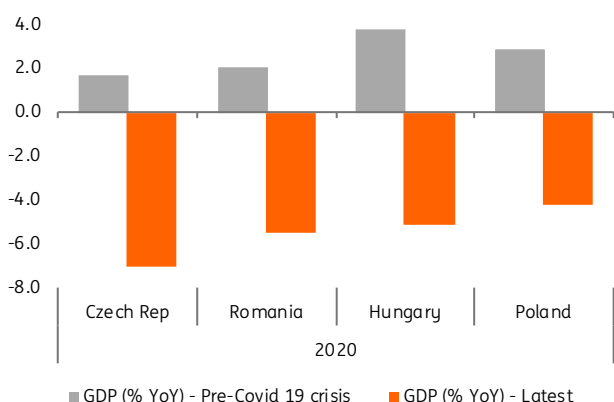
We provide ING’s CEE regional economic update with the latest forecasts. We believe the CEE economies are through the worst and a gradual recovery lies ahead. The small open Czech economy should suffer the most in 2020 in terms of the GDP fall. Despite the sharp fall in growth, deflationary pressures are not present in the region as CEE economies ran hot prior to the crisis. This should translate into more limited monetary easing ahead and only on some individual country level (NBP and NBH). The NBP appears the most dovish central bank in the region. In FX, we like CZK and dislike PLN.

Economic growth to gradually recover

Despite the high degree of uncertainty, the worst seems to be behind the CEE region. Significantly downward revisions to growth have been made vs the pre-Covid-19 (Figure 1), but 2Q looks to be the bottom and the second half of the year should offer a gradual recovery. Still, local economies are unlikely to reach pre Covid-19 levels until very late 2021 or 2022.

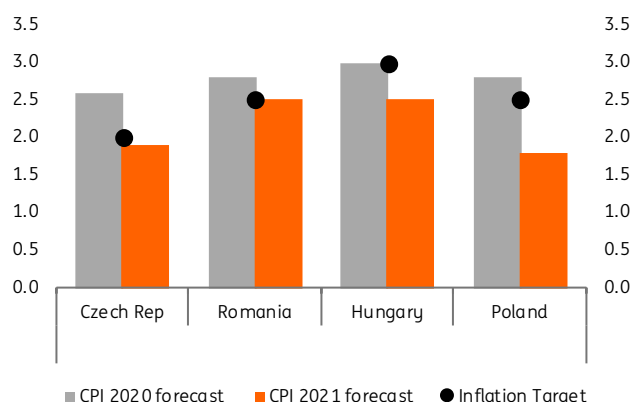
The Czech economy is to see the most negative growth in the region this year (-7.0%) though in terms of the scale of the outlook downgrades vs the pre Covid-19 situation, the almost 9% downward revision to Czech growth (+1.7% pre-crisis vs -7.0% now) is equal to the one in Hungary and larger than in Poland and Romania. This partly reflects the mix of the large openness of these two CEE economies (as very evident in Figure 3) as well as their exposure to the cyclical auto industry (particularly when compared to Poland). See [CEE automotive industry](#) for more on the CEE auto sector. The CEE growth recovery should stem from a mix of improving foreign demand and stabilising domestic demand, both underscored by the low base, generating solid YoY figures. The 2021 growth should range around 4% for Czech, Poland and Hungary, while around 7% in Romania (page 10).

Fig 1 Large drop in the GDP outlook due to Covid-19



Source: ING

Fig 2 No urgent CEE deflation risks on the horizon



Source: ING

Declining CPI from above target levels means no deflation risks

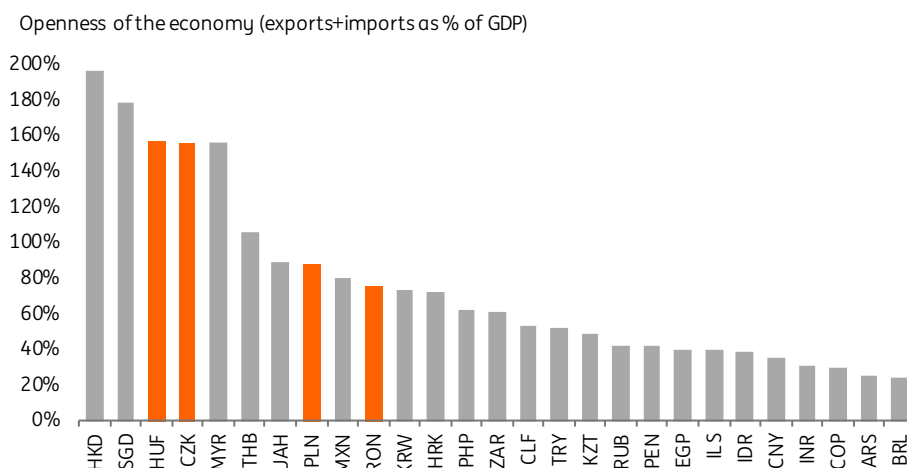
As for the inflation outlook, the trend into the year-end is largely similar across the region. That is declining CPI (with the exception of stable inflation in Romania) from the rather high, well above the inflation target level starting points. The decline is to be mainly driven by the lacklustre demand. Still, any talk of deflation is premature and the regional inflation outlook for the next year points to either at-the-target CPI (Czech and Romania) or modestly below the target CPI (Hungary and Poland) – Figure 2. As the pre Covid-19 starting point for CEE inflation dynamics was rather high vs the rest of the Europe (due to most CEE economies running above their potential growth, solid labour

market and high wage growth prior the crisis), the subsequent decline is not strong enough to cause deflation concerns.

Bulk of the easing is done, with only some central banks continuing

As the worst seems to be over, there is a gradual recovery ahead and no imminent deflation pressures, this also means the bulk of the across-the-board aggressive monetary policy easing is behind us. Note that the National Bank of Poland (NBP) delivered one of the largest QE programmes globally while the cumulative 200bp worth of Czech National Bank (CNB) cuts was one of the largest conventional easings). We see both the CNB and the National Bank of Romania as(NBR) largely done. In Hungary, the National Bank of Hungary (NBH) started the process of reversing the previous FX stabilising hikes, but additional easing should be only modest (one last 15bp cut and we don't see 3m Buber below 0.60% this year) while the central bank has paused its QE programme. In this respect, the NBP should be the leader on the policy loosening front and we expect QE in Poland to be extended into 2021.

Fig 3 Czech and Hungarian economies particularly opened



Source: OECD

FX: CZK to outperform, PLN to underperform

The dominant driver of CEE crosses will remain the market expectations about the shape of the post Covid-19 global recovery. Indeed, the global growth optimism was behind the sharp rebound in CEE FX in May, while the recent CEE FX weakness was caused by the rise in Covid-19 cases in the US and its implications for the global economic outlook. Our view for a gradual U-shaped recovery suggest stable / lower EUR/CEE crosses.

The dovish bias of the NBP is the key idiosyncratic CEE story. In the FX space, this should translate into the PLN underperformance as the NBP is likely to extend QE beyond this year. Moreover, we also see NBP as the most likely CEE central bank (after NBR, where the management of RON is a business-as-usual) to lean against currency strength. Indeed, the surprising rate cut in May occurred in an environment of appreciating PLN while the recent NBP statement mentioned the zloty (strength) as a potential obstacle to the pace of economic recovery. With inflation still high and rates at the zero lower bound, PLN currently suffers from one of the most negative real rates in EM space (Figure 4).

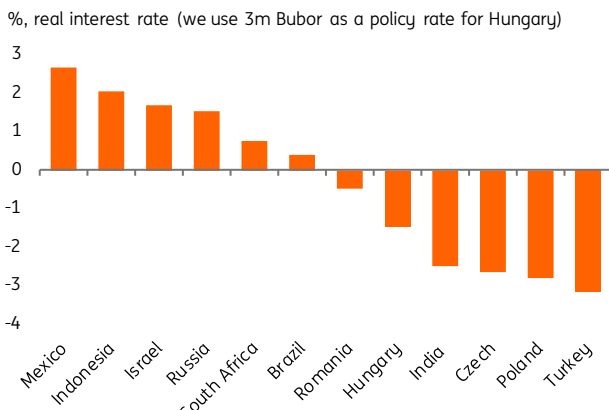
While HUF weakened noticeably in recent days (following the surprising June NBH cut), we don't see this as long lasting. Not only was the 15bp cut modest, but the latest NBH guidance suggest that only one additional 15bp cut will be delivered and the base rate is to stay at 0.60% - which is higher than in Czech Rep and Poland. The risk of HUF weakness should keep NBH cautious and prevent it from aggressive easing, in our view. Indeed, the overriding importance of the NBH stance for the HUF price action has been neatly

reflected in the decoupling HUF correlation from risk (both in absolute terms and relative to CZK and PLN – Figure 5) Compared to PLN, HUF now exerts higher real rates.

CZK is our preferred CEE currency given limited scope for further CNB easing (even one last rate cut to bring interest rates to the zero lower bound looks questionable now), the solid fiscal position and the low odds of the CNB leaning against CZK strength (due to the low risk of deflation – vs the clear deflation risks in 2013 ahead of the start of FX interventions). We see EUR/CZK at 26.00 by the year-end.

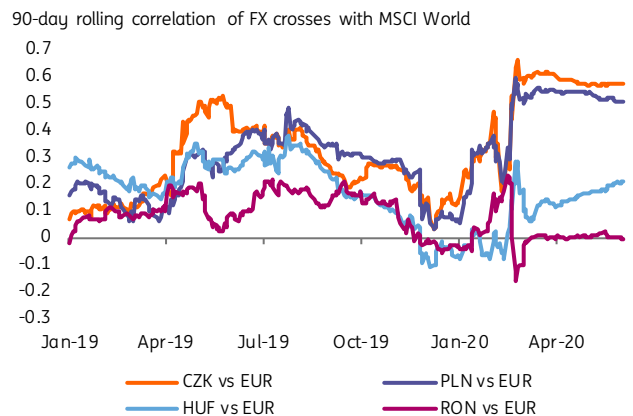
In terms of allocation / preferences, we like to be Overweight CZK, Neutral HUF and RON and Underweight PLN. As for RON, the tightly managed nature of the EUR/RON cross and steep FX forward curve suggest that any attempts to short RON remains a futile battle. On the other hand, in times of stress, the RON should be the outperformer in the CEE space – as was the case during the first part of March and the peak of the Covid-19 crisis.

Fig 4 PLN suffers from one of the lowest real rates



Source: Bloomberg, ING

Fig 5 HUF risk sensitivity decoupled from its peers



Source: Bloomberg, ING

Petr Krpata

Country Detail

Czech Republic

Growth: The Czech economy contracted by 3.3% QoQ in 1Q GDP, which is equivalent to a 2% YoY fall. The GDP decline was driven mainly by investment, which fell by 15% QoQ, while fixed investment contracted by 10%. Household consumption was hit less, falling by 2% QoQ and stagnating in YoY terms. Exports fell by 2.6% while imports declined more, by 3.5%, as investments are import-intensive. This meant that net exports contributed slightly to QoQ growth. However, the most significant pro-growth factor was the government consumption, which increased by 5% and contributed by 1.15 percentage points to the quarterly growth. For the whole year, we keep our forecast of a 7% YoY GDP decline. This currently is close to the median analysts estimate across surveys, which range from -5 to -11% fall this year.

Inflation: The May CPI decelerated to 2.9% YoY, slightly less than the market expected. The deceleration was driven by a high base effect as prices relatively soared in May 2019, mainly food prices. Therefore, the YoY dynamics of food prices slowed down to 6.3% after 7.8% YoY in April, despite growing by 0.6% MoM. The base effect was apparent also in prices related to housing. On the other hand, MoM price growth was driven mainly by alcoholic beverages and tobacco, where a higher excise tax played a role. Still, prices of services are not decelerating as quickly as feared. In fact, they increased in MoM terms (0.3%) and remained stable at 3.3% YoY. Core inflation in the CNB definition accelerated from 2.7% to 3.3% YoY, mainly due to a lower VAT being introduced in May, which is being cleaned out in the CNB core measure. Although we expect prices to gradually slow down due to the current crisis, average inflation should stay around 2.5% this year. Hence, deflationary fears, which could motivate the CNB to act, are premature in our view.

Fiscal policy: The Czech government announced a plan to amend the 2020 budget deficit from CZK300bn to CZK500bn this year. This has to be approved by the Chamber of Deputies, but it was already approved in the first reading. KSČM (communist party) - silently supporting the coalition of ANO and CSSD (social democrats) - signalled some concerns at the beginning, but finally supported the budget. The new budget pencils in CZK63bn lower revenues due to measures that lower tax income, but also higher expenditures (by CZK136bn), where broadly one-half of that is not described in a concrete way. It seems the government wants to get some buffer for unexpected expenditures in 2H20 without being pushed to search for a new approval. The opposition parties fear that this will be used as a pre-election spending. We believe the CZK500bn deficit budget will be approved, but investments will not be spent due to the time constraints, leading to a slightly lower final deficit around CZK450bn (8.5% of GDP) this year.

Central bank: As expected, the CNB did not surprise during the June meeting and kept the rate unchanged at 0.25%. This might be the bottom for some time, unless we see deteriorating economic activity beyond the baseline scenario. Unless we see the Czech economy heading towards the CNB's adverse scenario, the CNB using unconventional tools seems very unlikely, in our view.

FX: Among low yielding CEE FX, CZK remains our top pick. Despite a higher fiscal deficit, total indebtedness will remain below 40% of GDP and the central bank is unlikely to enter unconventional monetary measures that would mitigate the possible currency appreciation. We see EUR/CZK at 26.00 by the year end.

Jakub Seidler

Hungary

Growth: Hungarian GDP growth came in at 2.2% YoY in 1Q20, one of the best across the EU, but still lower than our forecast. The April data showed a historical collapse in industry (-37% YoY) and retail sales (-10% YoY), while construction held up well (-2% YoY). A recovery is on the way, according to the confidence indicators and big data (such as Google mobility data and local data from online cash registers, electricity usage, air and road traffic, etc). The pent-up demand will support the economy in May-June, in our view. After that, however, the plummeting order levels, uncertainty driven savings, cost cutting in the private sector and labour market deterioration will show up in activity. Against this backdrop, we downgraded our 2020 GDP outlook from -4.2% to -5.1% YoY, followed by a 3.7% YoY recovery in 2021.

Inflation: Our inflation outlook has been shaped by two opposite effects lately. On the one hand, we see strengthening disinflationary pressure due to the ease of imported inflation, which fits the bill as the ECB cut its inflation forecast. Moreover, surveys showed easing inflation pressure in services due to the lack of demand. On the other hand, this impact on core inflation will be counterbalanced by the increasing non-core price pressure on oil prices and on supply side shocks in agriculture. We thus maintain our 3% year-on-year 2020 CPI outlook, but expect high volatility in the coming months. In 2021, we see a 2.5% inflation rate on average.

Fiscal policy: The government has filled up its budget and FX reserves lately with foreign currency denominated debt issuances (including the first ever green bond). Despite the flashy headlines on the economy protection programme, we still see the fiscal impulse to be around zero, as most of the measures are being financed from restructuring the budget rather than from additional debt. The government's 3.8% deficit-to-GDP forecast is too optimistic in our view, based on the differing macro forecasts. We rather see the deficit to come in around 6% of GDP in 2020. This would mean increasing local bond supply, which will be supported by the National Bank of Hungary's government bond buying programme.

Central bank: Three months ago, we envisioned a QE, which became a reality. Lately we were talking about a reversal of the FX stabilising hikes. Albeit we missed on the timing, [the central bank hugely surprised markets](#) cutting both the base rate and the 1-week deposit rate by 15bp to 0.75% already in June. We expect one additional 15bp cut as soon as in July, but as per Vice Governor Virag's comments, the NBH does not seem willing to bring the base rate below the 0.60% level. With this fine-tuning, the NBH wants to react on the disinflationary effect of Covid-19, as well as show that it has room and willingness to support growth. The reduction of the base rate follows through on the NBH's significant outlook downgrade. However, the central bank remains the most optimistic forecaster, as it sees economic growth in the 0.3-2.0% range in 2020.

FX: While the surprising monetary easing sent EUR/HUF through the 350 level, the not so dovish nature of the NBH statement / the press conference and the cautious forward guidance from NBH officials on only one last 15bp cut (to keep the base rate at, but not below, 0.60%) should stabilise EUR/HUF and reduce the forint's imminent downside potential. The expected cumulative 30bp cut to the base rate is not overly aggressive, no cap on 1-week depo facility was / is likely to be introduced and QE is in the paused mode, albeit without any guidance (but being seen as a financial stability mechanism). Even if we pencil in the one last 15bp cut in July, HUF retains a higher real rate than PLN and CZK. We see the HUF fall after the June NBH rate cut as a one-off adjustment rather than the start of a strong HUF bearish trend.

Peter Virovacz

Poland

Growth: The post-lockdown rebound was uneven in May. Retail sales showed a substantially stronger improvement than high frequency indicators (ie, google mobility reports) suggested. Households reduced the number of visits to shops but increased the average value of purchases. The new pattern of consumption likely reflects pent-up demand. On the other hand, industrial activity and construction output was lacklustre. Leading indicators suggest only a gradual recovery in these sectors. Electricity consumption declined in June in YoY terms, signalling still low capacity utilisation in manufacturing. The Covid-19 outbreak in the Southern Poland will also substantially affect mining activity. Moreover, the pent-up demand fuelling relatively high retail sales will fade over time. This underscores our call for a sharp GDP decline in 2Q20 (-8.5% YoY). Nonetheless, external demand from the euro area should shore up domestic activity in 3Q20.

Inflation: CPI slowed in May from 3.4% to 2.9% YoY, largely reflecting a drop in food and fuel prices. Core inflation remained relatively high, as GUS is imputing costs of goods and services unavailable during the lockdown. Prices in those categories should align with the post-pandemic reality in June-July, most likely trending lower. Lacklustre demand is expected to pull CPI down in the following months as well. We estimate CPI to reach the NBP target (2.5% YoY) already in July and undershoot it in the year-end (1.2% YoY). All in all, 2020 CPI should average 2.8% YoY. CPI should bottom in 1Q21 given strong base effects from this year.

Fiscal policy: Tax revenues have fallen by 18% YoY in May, most notably in the case of VAT (down by 33% YoY) and excise (22% YoY). CIT revenues were up by 51% compared to May-19 but this was mainly due to the extension of the annual tax settlement deadline this year (from April to May). Public expenditure did officially not grow, as Covid-19 expenses were pushed outside of the budget. All in all, the data support our forecast of the 2020 deficit reaching 11% of GDP, mainly due to unprecedented fiscal easing.

Central bank: Remarks from the central bank confirmed our suspicion that PLN appreciation was a major factor behind an aggressive rate cut in May. The MPC also signalled it is unwilling to cut rates into negative territory, so the rate easing cycle is completed. Given only a gradual economic recovery ahead and low CPI we expect the MPC to keep rates unchanged at least until 2022. The Council should rely on bond purchases as a major policy tool. We expect the central bank to acquire assets worth the equivalent of 8-10% of GDP this year. Given a high budget deficit next year we expect the central bank to extend the QE programme into 2021.

FX: Arbitral Tribunal in Stockholm ruled Gazprom should pay the Polish natural gas operator PGNiG US\$1.5bn by the end of the month. This could be a major PLN mover. If the payment is converted via the market into PLN this could result in EUR/PLN moving below 4.40, as liquidity is reportedly low. However, Gazprom did not confirm the transfer yet. In July EUR/PLN should trade around 4.40. Potential for appreciation of the zloty is largely limited by NBP policy. Poland not only has the lowest real rates in the CEE space, but also the central bank continues to conduct aggressive QE. Moreover, the monetary authorities seem to be concerned of the zloty's appreciation and should continue verbal interventions. The Presidential elections are largely ignored by markets, despite polls showing a tight race between incumbent PiS-backed A.Duda and opposition candidate R.Trzaskowski.

Piotr Popławski

Romania

Growth: The 0.3% quarterly GDP advance in 1Q was quite a positive surprise but the details are weak. On the demand side, the advance came entirely from an already famous category named “others” (usually inventories). All the other items – public and private consumption, fixed investments, net exports – had negative contributions to growth in 1Q. So not a great story here, except for the headline. Hence, we maintain our -5.5% GDP forecast for 2020 and a well above market forecast for 2021 at 7.1%, though admittedly, the later starts to look a bit out of the landscape.

Inflation: Despite the relatively high risks and large swings of particular items, the overall inflation profile looks remarkably stable. The drop in fuel price overlapped an eye-catching increase in food prices. Fresh fruits and vegetables were particularly hit so far this year, with the former posting price increases unseen in the last 9 years. We expect these trends to soften as the fuel price should pick-up slightly while seasonality will kick-in for some food items, particularly for vegetables, which should see some price decreases. At 2.3% YoY the May inflation might have seen this year's low point, but that doesn't mean that we see inflation much higher going forward. We maintain our forecast of 2.8% annual inflation this year.

Fiscal policy: After avoiding a rating downgrade from S&P earlier this month (more [here](#)) the government will probably need to deliver on the single important measure that S&P assumes for this year, which is a pension hike of around 10% instead of the scheduled 40%. This 10% increase is in line with our view as well. Apart from this, we don't expect much fiscal consolidation measures this year. At best, doubling the child allowances will be postponed again but in general we believe that more things can go wrong rather than go well on the fiscal side due to the populist parliamentary initiatives likely to be pushed in the upcoming period. Hence, we remain comfortable with our 8.6% budget deficit for this year and expect the bulk of fiscal consolidation measures to be postponed for the next year.

Central bank: We think that the 1.75% key rate is likely the terminal key rate of this rate cut cycle. We have 3 reasons to believe this: (1) the NBR sees inflation rebounding slightly higher in the second half of 2020; (2) preserving an attractive interest rate differential – in Poland, Czech Republic and Hungary rates have been essentially cut to zero, so any further cut from the NBR would narrow this differential. Worth remembering that after the first four months of 2020 the foreign direct investment balance is negative, hence maintaining the attractiveness of Romania's interest rates is important to ensure some financing (albeit a volatile one) of the C/A deficit; and (3) we think the NBR wants to preserve its policy response space and not waste all its bullets at once.

Regarding its bond-buying activity, the NBR has made it clearer lately that this is linked with its role of lender of last resort, therefore the purchases should presumably be made only when a structural liquidity deficit exists. We therefore lower our already modest estimation for bond purchases this year from 1.5% of GDP to 0.8-1.0% (c. RON 10-12bn).

FX: We marginally update our year-end EUR/RON forecast from 4.8800 to 4.8700 as the NBR's firm grip on the currency makes even a tiny 0.8% depreciation from current levels look increasingly improbable. Reinforcing our view, the NBR anticipates in its latest inflation report that the real effective exchange rate will appreciate “throughout the quasi-totality of the forecast horizon” under the impact of the inflation differential between Romania and its trading partners. This of course doesn't exclude nominal depreciation still occurring, but it does limit the potential.

Valentin Tataru

CEE Economic Forecasts

Fig 6 CEE Economic Forecasts

	2020F					2021F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
Poland										
GDP (YoY%)	2.0	-8.5	-6.5	-3.7	-4.2	-1.9	8.0	6.2	3.7	4.0
GDP (QoQ%)	-0.4	-8.3	2.4	2.9		1.5	1.0	0.7	0.4	
CPI headline (YoY%)	4.5	2.9	2.2	1.6	2.8	0.7	1.7	2.2	2.6	1.8
Policy Rate (% eop)	1.00	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-month interest rate (% eop)	1.17	0.30	0.31	0.33	0.33	0.33	0.33	0.33	0.33	0.33
EUR/PLN (eop) ¹	4.55	4.48	4.45	4.40	4.40	4.43	4.43	4.41	4.40	4.40
Czech Republic										
GDP (YoY%)	-2.0	-11.4	-8.3	-5.9	-7.0	-1.3	9.5	5.7	3.0	4.2
GDP (QoQ%)	-3.3	-9.2	4	3		1.5	0.7	0.4	0.4	
CPI headline (YoY%)	3.40	2.2	2.5	2.1	2.6	1.3	2.3	2.0	2.0	1.9
Policy Rate (% eop)	1.00	0.25	0.05	0.05	0.05	0.05	0.05	0.25	0.25	0.25
3-month interest rate (% eop)	1.03	0.35	0.15	0.15	0.15	0.15	0.15	0.35	0.40	0.40
EUR/CZK (eop)	27.4	26.5	26.2	26.1	26.3	25.8	25.7	25.6	25.5	25.7
Hungary										
GDP (YoY%)	2.2	-7.2	-9.0	-6.6	-5.1	-4.8	5.9	7.9	5.6	3.7
GDP (QoQ%)	-0.4	-8.3	-1.0	3.0		2.2	1.5	1.0	0.6	
CPI headline (YoY%)	4.3	2.3	2.8	2.4	3.0	1.6	2.8	2.8	3.0	2.5
Policy Rate (% eop)	0.90	0.75	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
3-month interest rate (% eop)	0.55	0.75	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
EUR/HUF (eop)	361	355	355	355	355	360	360	365	365	365
Romania										
GDP (YoY%)	2.4	-18.1	-4.6	-1.6	-5.5	-1.3	23.6	6.5	2.7	7.1
GDP (QoQ%)	0.3	-19.7	17.0	4.4		0.6	0.6	0.8	0.7	
CPI headline (YoY%)	3.2	2.5	2.6	2.5	2.8	2.6	2.3	2.6	2.5	2.5
Policy Rate (% eop)	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-month interest rate (% eop)	2.50	2.15	2.00	2.00	2.00	2.00	2.00	2.00	2.25	2.25
EUR/RON (eop)	4.85	4.85	4.86	4.87	4.87	4.87	4.89	4.92	4.92	4.92

Source: ING estimates

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