Visegrad– Strong growth momentum leading into 2019, but real GDP growth set to ease

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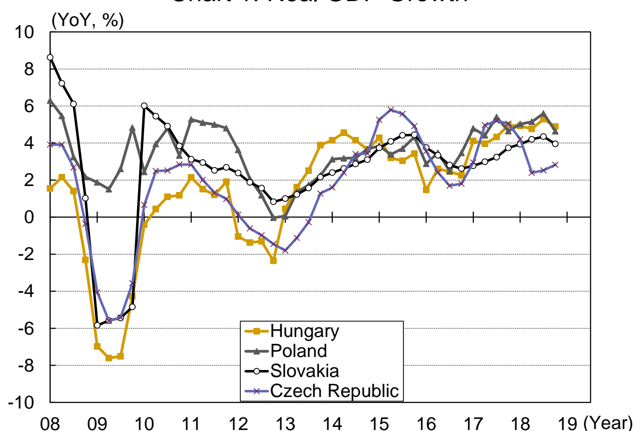
1. Introduction

Strong real GDP growth in the Visegrad (Czech Republic, Hungary, Poland and Slovakia), underpinned by an increase in employment and a rise in wages, has led to an improvement in public finances and a decline in government debt ratios (% of GDP). For now, latest quarterly real GDP growth data remains solid, but risks are to the downside. Strains have appeared in the Visegrad labour markets and will persist. Real GDP growth is set to ease in 2019 with a weaker global backdrop amid trade uncertainties weighing on confidence.

2. Real GDP Growth

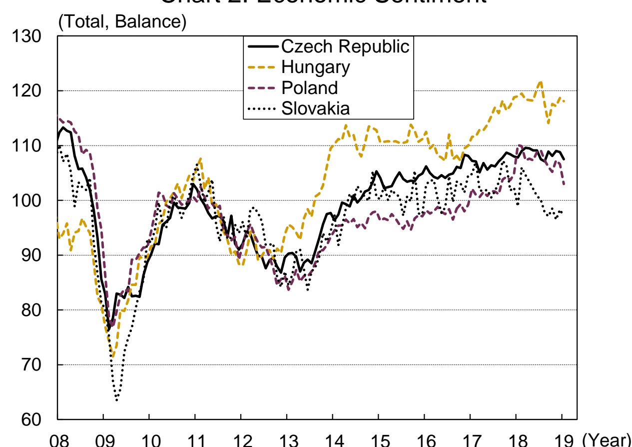
Recent quarterly real GDP growth rates (Chart 1) suggest strong growth momentum in the Visegrad group despite weaker economic sentiment indicators (Chart 2). The latest real GDP data in Q4 2018 show a YoY increase of 4.9% in Hungary, 4.6% in Poland, 4.0% in Slovakia and 2.8% in Czech Republic. Strong consumption and investment trends have been the main drivers, with the former driven by a rise in wages, and the latter supported by EU expenditures as part of the 2014-2020 "Multiannual Financial Framework" (MFF).

Chart 1: Real GDP Growth



Source: National Statistical Offices, Eurostat, MUFG Bank Economic Research Office

Chart 2: Economic Sentiment



Source: DG ECFIN, MUFG Bank Economic Research Office

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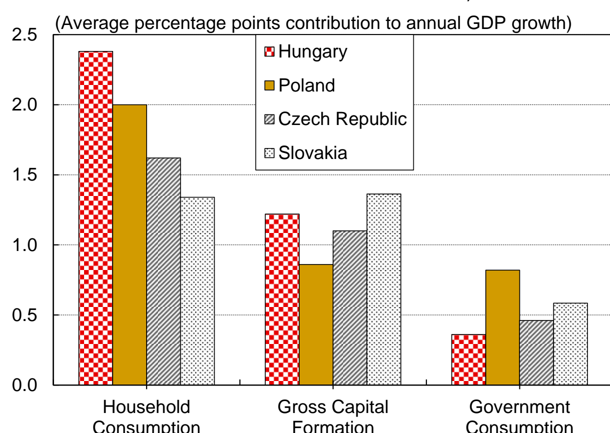
(1) Household consumption

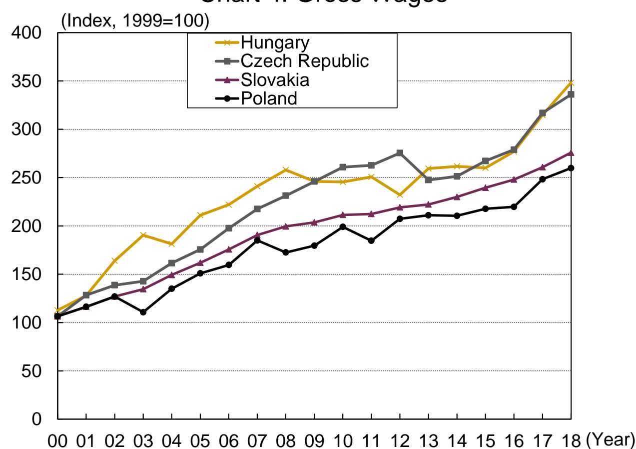
Over the last five years, household consumption has been the main driver of real GDP growth in the Visegrad (Chart 3). This has been due to tighter labour markets as evidenced by the upward momentum of gross wages in the Visegrad countries (Chart 4) and the fall of unemployment. The rise in gross wages has also been due to increased labour productivity. Taken together, these three factors have underpinned household consumption. However, tighter labour markets have also created negative pressures as well. For example, hiring difficulties are increasingly being cited by businesses as a factor that limits production. Furthermore, firms are finding it harder to find appropriately-skilled workers and there are concerns over international competitiveness.

Chart 3: Main Real GDP Contributors, 2014-2018



Source: National Statistical Offices, MUFG Bank Economic Research Office

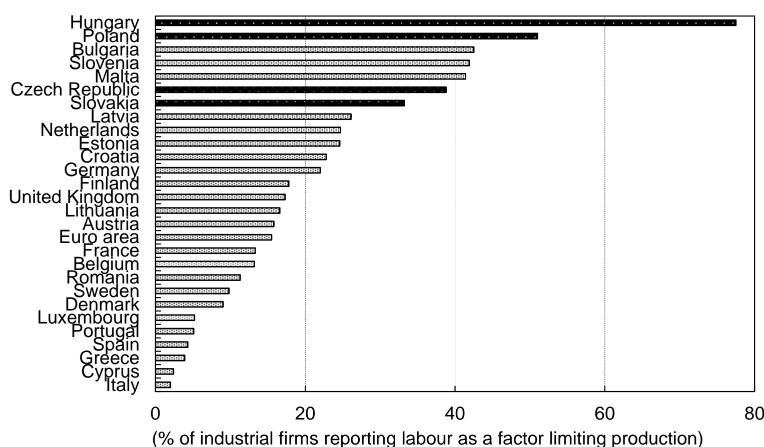
Chart 4: Gross Wages



Source: National Statistical Offices, MUFG Bank Economic Research Office

Recent Eurostat data reflects this, particularly in Hungary, where 77.5% of firms report labour as a factor that limits production, and in Poland, where 51% of firms were affected (Chart 5). These pressures are not only acute in Hungary and Poland. Czech Republic and Slovakia are also in the top ten. This suggests that there may be some strains on current economic models that rely on an inexpensive but skilled labour force to produce manufactures for export.

Chart 5: Labour Shortages 1Q 2019



Source: Eurostat, MUFG Bank Economic Research Office

Despite wage pressures, the consensus view is that competitiveness (which is important to attract foreign investment) has not been harmed by tight labour markets. There are a few

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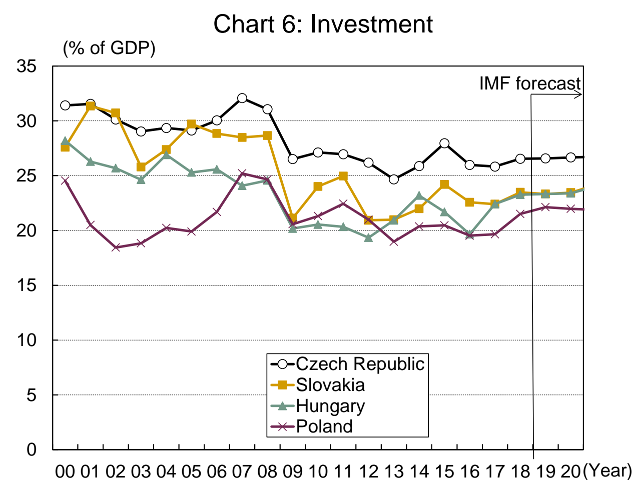
possible explanations for this. First, wage increases could be part of wider regional trends. Second, corporate profits have been robust, which could act as a shield for companies from the rise in wages. Third, it could also be attributed to increased labour productivity (discussed below). On balance, we think that although there are strong reasons why competitiveness has not been harmed so far, further labour shortages over 2019 could have a negative effect on real GDP growth at a time of weaker global momentum.

(2) Investment

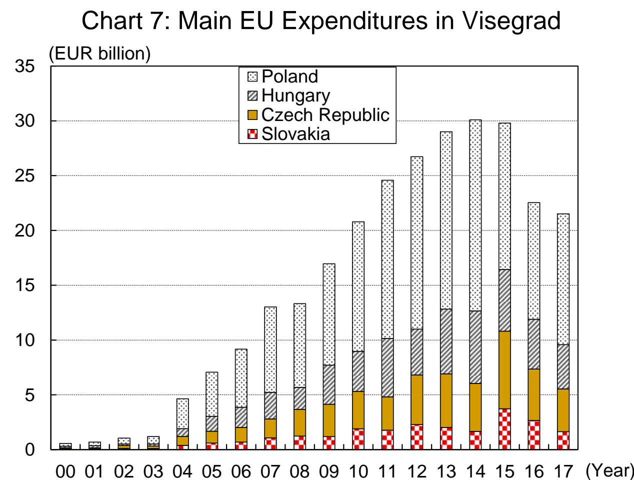
Investment has also supported real GDP growth. Despite some fluctuations, investment (% of GDP) in the four Visegrad countries has been fairly stable since 2008 (Chart 6). EU expenditures have been an important factor. For instance, in Slovakia, the rise in investment levels to 24.0% of GDP in 2015 from 22.0% of GDP in 2014 occurred as EU disbursement increased to EUR 3.7 billion in 2015 from 1.7 billion in 2014. The peak of the overall EU funds disbursement took place in 2014, as the 2007 to 2013 MFF reached its final stage (Chart 7). Despite a drop in EU expenditures in 2016 and 2017, these are expected to continue to support real GDP growth in 2019 and 2020.

Chart 6: Investment



Source: IMF, MUFG Bank Economic Research Office

Chart 7: Main EU Expenditures in Visegrad



Source: European Commission, MUFG Bank Economic Research Office

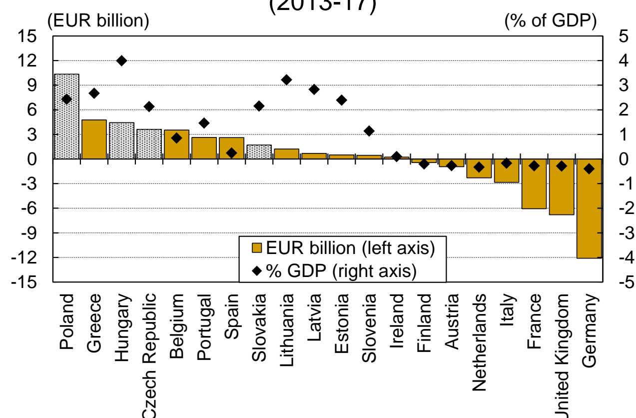
Under the 2014 to 2020 MFF there are six main headings. The 'Smart and Inclusive Growth' category accounts for 47.2% of total commitment appropriations and is aimed at the improvement of competitiveness for growth and jobs. The other five include, 'Sustainable Growth', 38.7%, 'Security and Citizenship', 1.6%, 'Global Europe', 6.1%, 'Administration', 6.4%, and 'Compensations' with a total of around EUR 1 trillion available to be invested across EU countries over this period.

Regions with smaller GDP and lower GDP per capita receive more funds as seen in Chart 8. Consequently, Visegrad countries have been some of the biggest beneficiaries of the EU budget and are expected to remain so. For example, Hungary received 4% of its GDP per annum in funds from 2013 to 2017, the highest level among all beneficiaries, and in absolute terms, Poland was the largest net beneficiary, when it received an average of EUR 10.3 billion per annum over the same time period. As part of the latest 2014 to 2020 MFF and in particular the 'Smart and inclusive growth' heading, structural funds are allocated based on GDP as a per cent of the EU average. Furthermore, the cohesion fund (worth EUR 63.4 billion) is aimed at member states whose gross national income (GNI) per inhabitant is less than 90% of the EU

average. From this, we can continue to expect the Visegrad countries to continue to benefit from higher levels of EU funds versus other EU members.

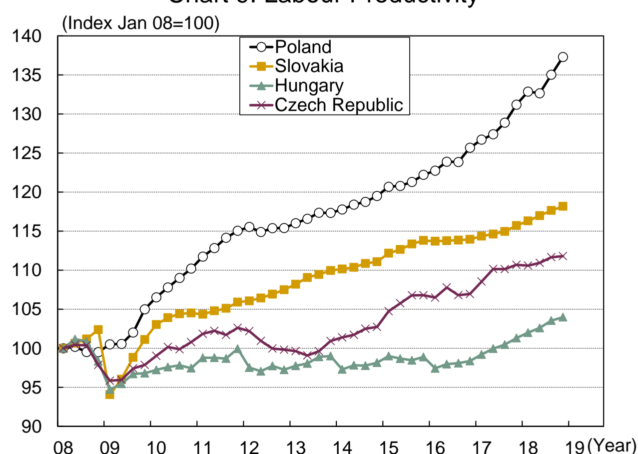
EU expenditures have also contributed to labour productivity (Chart 9), which has fed into the rise in wages and private consumption (mentioned in 2.(1)). Labour productivity is important as it affects the link between the rise in wages and international competiveness. For instance, if wages rise faster than productivity then competitiveness will be reduced. This will be important for the future economic performance of the group. We expect these positive trends in labour productivity to continue over the course of the latter part of the current MFF. The 'Smart and Inclusive Growth' expenditure category will support this. The category focusses on 'smart, sustainable and inclusive growth' to overcome structural weaknesses and improve competitiveness and productivity, according to the European Commission. It targets employment levels of 75% of people aged 20-64 to be in work, research and development levels (R&D) of 3% of the EU's GDP, as well as targets for education levels and the eradication of poverty and social exclusion.

Chart 8: Average Annual Net Receipts from EU Budget (2013-17)



Source: Eurostat, European Commission, MUFG Bank Economic Research Office

Chart 9: Labour Productivity



Source: ECB, MUFG Bank Economic Research Office

(3) Exports

Historically, exports have been a launch pad for real GDP growth in the Visegrad, and have also contributed to the decline of current account deficits, which were a previous source of vulnerability (Chart 10). However, since Q1 2018, export growth has been in decline in terms of YoY. Latest export data from January 2019 shows the continuance of this decline in Hungary and Czech Republic, but, in Poland, data has been stable and, in Slovakia, there has been a pick-up of export growth. As a whole, risks will remain to the downside over 2019. Hungary's current account (% of GDP) is forecast to remain in surplus, although it will drop slightly due to a decline in the trade balance surplus. A similar trajectory, although with a small deficit, is also expected in both Czech Republic and Poland, as strong consumption trends and EU investment maintain demand for imports (Chart 11). In Slovakia, the current account deficit trajectory is forecast to improve due to car exports from a new Jaguar Land Rover (JLR) factory.

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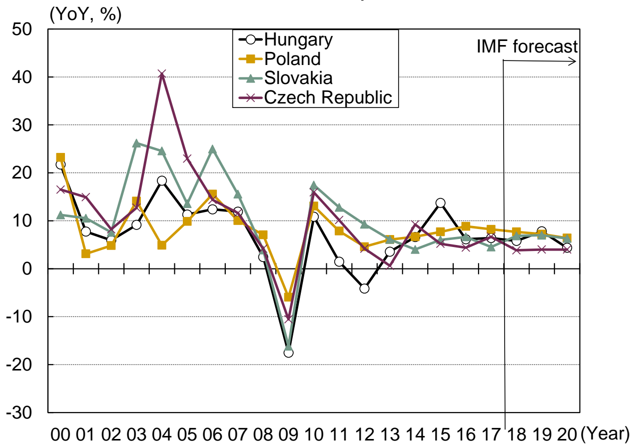
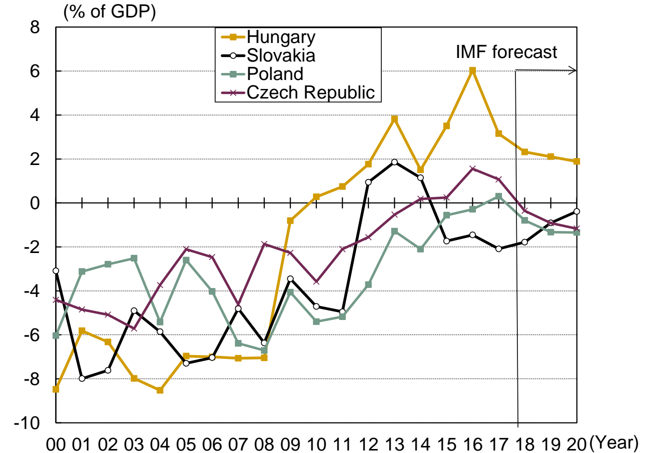
Chart 10: Exports



Source: IMF, MUFG Bank Economic Research Office

Chart 11: Current Account Balances

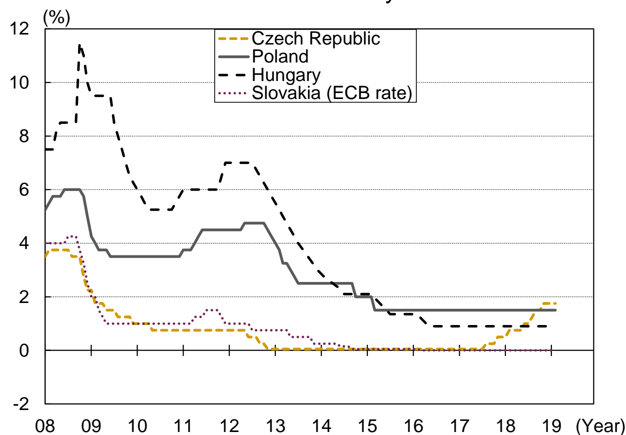


Source: IMF, MUFG Bank Economic Research Office

(4) Monetary policy

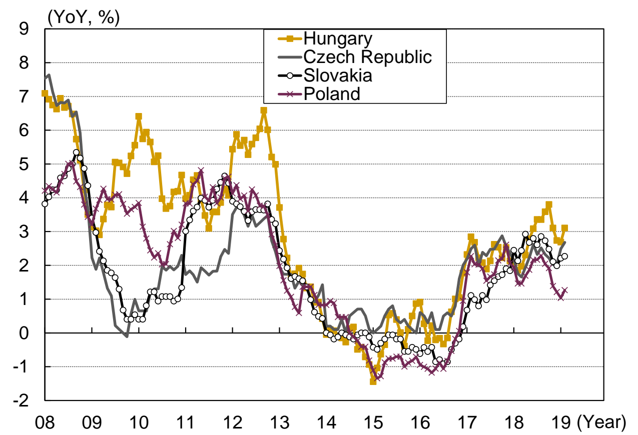
The main policy rates of the Visegrad countries have fallen significantly since the Global Financial Crisis (GFC), and have acted as a key support to economic growth (Chart 12). However, since 2017, subdued inflationary pressures have risen. In 2018, the Czech National Bank (CNB) increased the main policy rate by 125 basis points as a result of inflation at the top end of the 2%+/-1% target of the CNB. More recently, the consumer price index (CPI) has shown a pick-up in the Visegrad countries, but has remained subdued in Poland (Chart 13). In Czech Republic and Hungary, the recent pick-up and volatility have been as a result of developments in fuel and unprocessed food prices. The Czech Republic has also been affected by depreciation of the Koruna against the euro which has fed into the rise of inflation. Despite the pick-up in Hungary and Slovakia, CPI remains close to target rates of inflation at 3% in Hungary, and 2% in Slovakia. In contrast, CPI has been weaker in Poland due to more moderate domestic demand pressures and weakening in domestic food and energy price growth.

Chart 12: Main Policy Rates



Note: Slovakia acceded to the Euro area in 2009
Source: Macrobond, MUFG Bank Economic Research Office

Chart 13: Consumer Price Index



Source: National Central Banks, Macrobond
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(5) Growth outlook

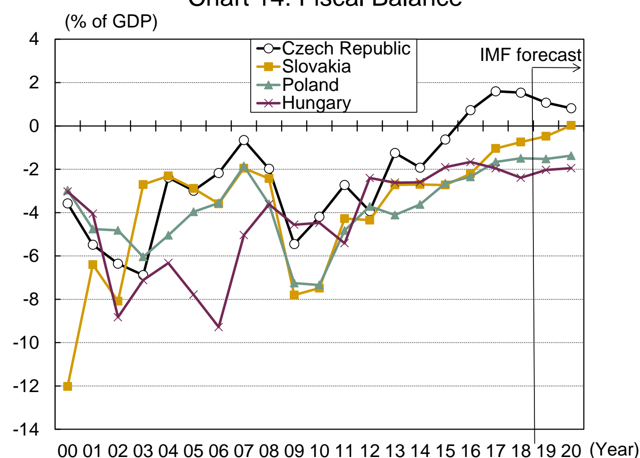
Real GDP growth is forecast to remain strong although it will slow in 2019. According to the latest 'Consensus Forecasts', in Hungary growth will ease to 3.5% YoY in 2019 from 4.8% in 2018, in Poland to 3.8% YoY in 2019 from 5.1% in 2018, in Slovakia to 3.7% YoY in 2019 from 4.2% in 2018 and in Czech Republic to 2.7% YoY in 2019 from 2.9% in 2018 . The main drivers of growth will continue to be household consumption driven by rising wages and low unemployment, and investment, supported by EU expenditures. However, labour shortages could be a constraint on higher real GDP growth across the Visegrad. The global backdrop will also be weaker amid trade uncertainties weighing on confidence.

Risks to growth stem from the rise in uncertainty as a result of global protectionism concerns, slowing Chinese growth momentum and Brexit. The Visegrad is vulnerable to slowing external demand through its exports channels as well as business investment via confidence channels. Highlighting the risks, recent weaker sentiment has shown up in the decline of purchasing managers indexes in Poland, Czech Republic and Hungary, with recent figures in contraction territory. This suggests a further slowdown in exports, on top of the decline in exports across the region since Q1 2018.

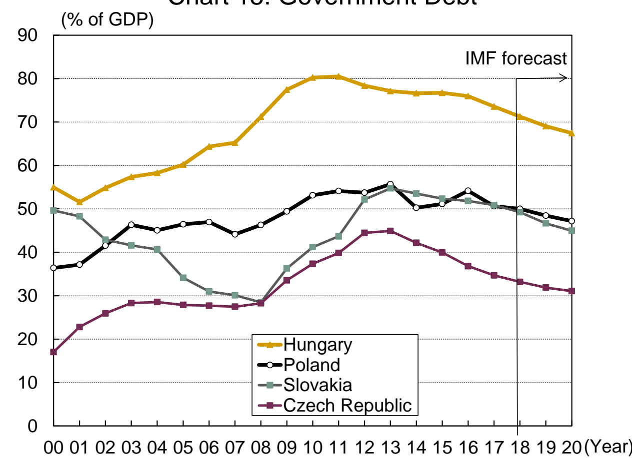
In the long term, one of the main challenges that the Visegrad faces is the potential decline of their populations. United Nations' projections highlight the potential demographic difficulties. The forecasts show a combined population drop to 55.6 million by 2050 from 64 million people in 2017, a decline of 13%. These pressures are likely to add to the pre-existing labour market stresses. Potential policies to alleviate pressures may include allowing higher immigration, as we have seen in Poland (1.7 million short-term work registrations issued to Ukrainians in 2017), or policies to encourage fertility rates, such as in Hungary, where child benefits are generous.

3. Stronger Public Finances

Strong growth has supported the decline of government fiscal deficits across the Visegrad, which have improved significantly since the GFC, shown in Chart 14. From 2008 to 2012, fiscal deficits averaged 5.3% of GDP in both Poland and Slovakia, 4.1% of GDP in Hungary, and 3.7% of GDP in Czech Republic. These have since narrowed with the 5-year average deficits from 2013 to 2017 improving to 0.3% of GDP in Czech Republic, 2.1% of GDP in Hungary, 2.3% of GDP in Slovakia and 2.9% of GDP in Poland. Strong growth has also supported the decline of government debts (% of GDP) from their post-GFC peaks (Chart 15). Fiscal policy is well-anchored by national fiscal rules as well as more broadly by the EU's 'Stability and Growth Pact' (SGP). The SGP entails debt limits of no more than 60% of GDP, as well as fiscal deficit limits of 3% of GDP.



Source: IMF, MUFG Bank Economic Research Office



Source: IMF, MUFG Bank Economic Research Office

4. Conclusion

Strong real GDP growth across the Visegrad has been underpinned by solid consumption and investment trends, with the former driven by a rise in wages, and the latter supported by EU expenditures as part of the 2014-2020 “Multiannual Financial Framework” (MFF). At the same time, this has also led to strains in the labour markets of the Visegrad countries. For example, hiring difficulties are increasingly being cited by businesses as a factor that limits production. Furthermore, firms are finding it harder to find appropriately-skilled workers and there are concerns over international competitiveness. These strains are expected to persist. Further labour shortages over 2019 could have a negative effect on real GDP growth.

Regardless, real GDP growth is forecast to remain strong although it will slow in 2019, with a weaker global backdrop amid trade uncertainties weighing on confidence. There is the potential for trade uncertainties to affect exports – as seen in the recent decline of purchasing managers indexes in Poland, Czech Republic and Hungary, with recent figures in contraction territory. The main drivers of growth will continue to be household consumption driven by rising wages and low unemployment, and investment supported by EU expenditures. Despite a drop in EU expenditures in 2016 and 2017, these are expected to continue to support real GDP growth in 2019 and 2020.

In the long term, one of the main challenges that the Visegrad faces is the potential decline of their populations. These pressures are likely to add to the pre-existing labour market constraints. Recent measures to alleviate pressures have included higher immigration and pro-fertility policies. If further pro-fertility measures are needed, strengthened public finances, including lower levels of government debt, will be a key support.

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