Recession now expected in larger CEE countries and Russia in 2020

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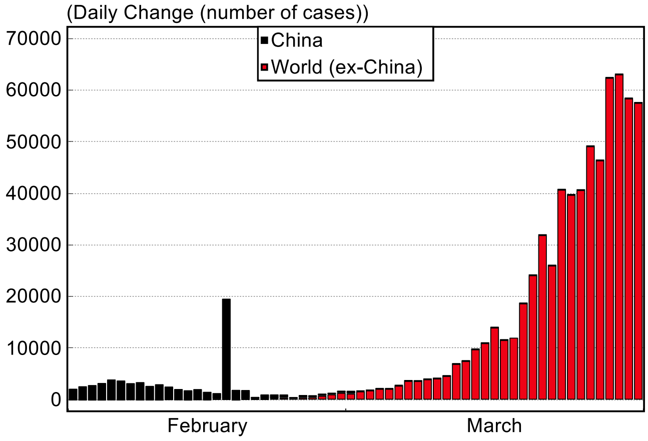
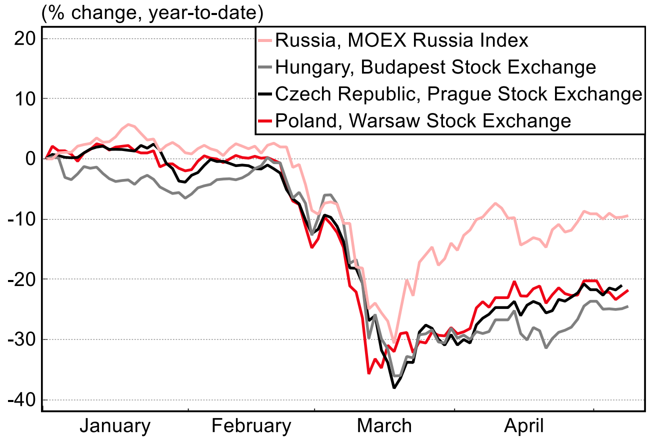
1. Introduction

The outbreak of COVID-19 has led to severe disruptions to global supply chains across the globe in the first quarter of this year with a significant negative demand shock now expected in the second and third quarters of 2020. We have downgraded our forecasts for all major economies and world real GDP growth in 2020.

The global backdrop is a challenging environment for developing markets, and the development of the coronavirus still remains highly uncertain. Financial markets in CEE remain weak after dropping significantly while currencies have been under pressure.



Source: Macrobond, MUFG Bank Economic Research Office



Source: Macrobond, MUFG Bank Economic Research Office

The typical policy response in the largest CEE (Central and Eastern Europe) economies and Russia has focused on lockdowns, travel bans and social distancing measures in an attempt to slow the transmission of the virus. While major central banks have reduced policy rates and introduced liquidity measures, asset purchases programs (quantitative easing (QE)) have also been introduced for the first time in some CEE countries, and fiscal packages introduced by national governments. The policy response will be important to the speed of recovery, but *it is unlikely to prevent a collapse in real GDP.*

All-in-all, real GDP growth in the largest CEE economies will be adversely affected by the impacts of coronavirus, with risks expected to remain elevated in 2020.

Table 1: Policy Response

Country	Fiscal response	Monetary response
Poland	Deferral of social security payments. Income support scheme for employees and self-employed w orkers. Financial support for firms. Credit guarantees and micro- loans (for entrepreneurs)	Further rate cuts by 50 basis points w ith the main rate at 0.5%, after previous 50bps rate cut (depo at 0% and Lombard at 1%).QE programme to buy unspecified amount of Polish government bonds from commercial banks.
Czech Republic	Tax delays, no-interest loans, income support scheme for those employees ordered into quarantine. Support program for employers	Further main policy rate cut to 0.25% from 1.0% on 7th May (after cut from 1.75% to 1.0% on 26th March). Countercyclical capital buffer rate reduced from 1.75% to 1.0% (effective from April).
Hungary	Business tax exemptions. Suspension of all loan payments due by all private borrowers and companies till end of year. Increased healthcare spending. Deferral of SSC contributions	Policy rate unchanged at 0.9%. Introduction of a long-term (3-6-12m and 3-5y) collateralised lending facility. QE program to buy government debt bonds on secondary market also announced.
Russia	Tax breaks for tourism companies and airlines, sick leave benefits for individuals under quarantine, subsidized and guaranteed loans for SMEs, retailers, and distributors.	Main policy rate cut by 50 bps to 5.5%. Servicing conditions for loans to individuals infected w ith the coronavirus eased, financing to SMEs eased and low er loan quality requirements for some mortgage segments.

2. Poland, Czech Republic & Hungary

Outlook: Recession now expected in 2020

Real GDP growth in Poland, Czech Republic and Hungary, will be negative this year, due to the effects of the coronavirus outbreak on supply chains and exports (both supply and demand side driven); and the subsequent effects of containment measures weighing on private consumption and investment.

In response to the coronavirus crisis, containment measures have been rolled out, while a series of fiscal and monetary measures are now being implemented. Given the fact containment measures such as lockdowns, travel bans and enforced closures will heavily weigh on spending and productivity, in the near term, the main objective of economic measures is to minimise the economic fallout and thus lay the ground work for the recovery once containment measures are lifted.

Poland and the Czech Republic have announced direct fiscal measures worth around 3% and 2% of GDP respectively to mitigate the economic shock. Additional loan guarantee measures have also been announced. Direct fiscal injections in Hungary are notably smaller, but the mandated suspension of loan payments by companies and individuals may help to minimise permanent damage from bankruptcies.

Fiscal measures have been complemented by cuts to the main policy rates in both Poland and Czech Republic. The National Bank of Poland (NBP) has also introduced a programme to buy an unspecified amount of Polish government bonds from the secondary government bond market, a fairly significant move and the first of its kind in Poland. Quantitative easing has also been announced in Hungary too.

Are there constraints to further policy measures?

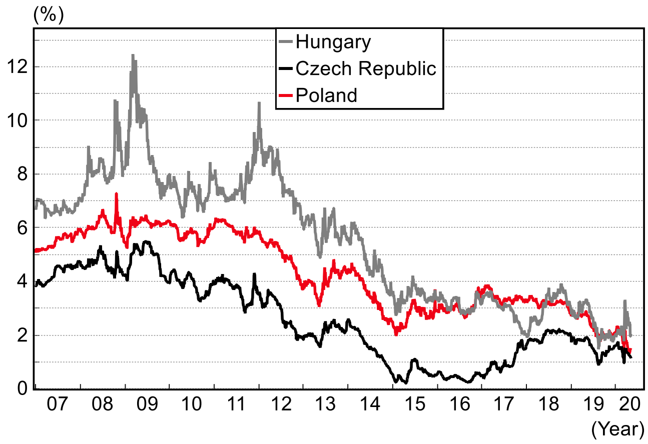
After a fairly comprehensive policy response, further measures should they be needed, may face tougher constraints.

In terms of fiscal policy, while there may indeed be further scope to increase government debt levels, especially given the explicit support of the European Union, which has suspended all budget rules, the amount of fiscal space may be limited. This is, in the most part, due to the ability of governments to fund larger fiscal deficits, and to a lesser extent, the higher interest payments associated with greater government debt levels.

Given the huge global surge of government bond debt issuance (to fund higher government fiscal deficits worldwide) and the wider selloff of riskier assets, the ability of governments to fund larger fiscal deficits could be an issue. While we expect QE to soak up excess government bonds not bought by the market, there may be limits due to the potential effects of QE policies on exchange rates. The NBP and Central Bank of Hungary (MNB) have been cautious so far and QE programs have been kept unspecified in terms of total asset purchases. Altogether, QE policies are likely to remain on a small scale (versus developed markets), and could limit the ability of governments to fund higher fiscal deficits.

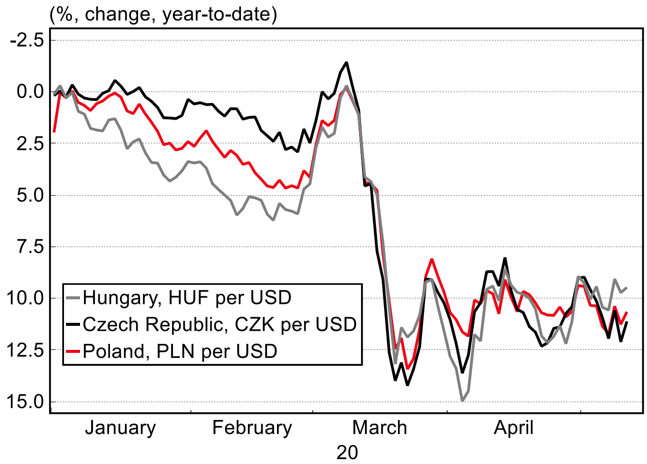
Notwithstanding other factors, government benchmark bond yields and FX spot rates could be key signposts for potential market concerns over further policy measures.

Government Benchmarks, 10 Year Yields



Source: Eurostat, Macrobond, MUFG Bank Economic Research Office

Weaker FX Spot Rates



Source: Macrobond, MUFG Bank Economic Research Office

We also note, with regards to government debt levels, whereas in Czech Republic and Poland, government debt levels of 31.6% of GDP and 47.8% of GDP in 2019 compare favourably against European peers, Hungary had higher government debt of 67.5% of GDP in 2019. Naturally, interest payments were higher at 5.1% as a percent of total government revenues in Hungary last year. Given that higher interest payments and government debt levels could limit the flexibility of future fiscal policy, this will be a further consideration and policy trade-off.

Real GDP growth rates to decline in 2020

Overall, we expect all three countries will slip into a sharp recession in H1 this year with quarterly real GDP growth expected to bottom out and recover in the latter part of 2020. Manufacturing PMIs have declined across the board and are consistent with large declines in quarterly real GDP growth. These are expected to take a further hit in Q2 2020, when we see the full extent of effects from the lockdown measures on the domestic economy.

Our baseline assumes a high degree of uncertainty regarding the development of the virus with the scenario hinging on the return of supply chains and loosening of containment measures from H2 2020, although we note this could be later. With this in mind, in 2020, real GDP could contract up to 6.5% YoY in Czech Republic, 4.6% in Poland, and 3.1% in Hungary, according to the IMF's latest world economic outlook. Risks are expected to remain firmly to the downside in 2020.

Source: IHS Markit, HALPIM, MUFG Bank Economic Research Office

3. Russia

Outlook: Recession now expected, as oil price sinks and coronavirus hits

The Central bank of Russia (CBR) expects real GDP growth to weaken over the next few quarters due to the coronavirus outbreak. All this comes after a weak 2019 when Russia faced a number of headwinds, including the rise of the VAT rate and relatively tight monetary policy in the earlier part of 2019, both of which weakened disposable income dynamics and in turn weakened private consumption (the main driver of real GDP growth).

The outbreak of coronavirus will have a strong impact on real GDP growth, while this year, global oil prices have registered their lowest since 2003. Since the start of the year, Brent crude oil price has fallen by 55.4%, and now stands at USD 29.4 per barrel (from USD 65.9 per barrel) due to the breakdown of the former OPEC + oil production limits, and then latterly the effects of coronavirus on oil demand. Given these events, Russia's real GDP growth drivers will now be significantly hit. Importantly, we note the forecast is subject to a great degree of uncertainty at the moment (as with the other emerging Europe countries).

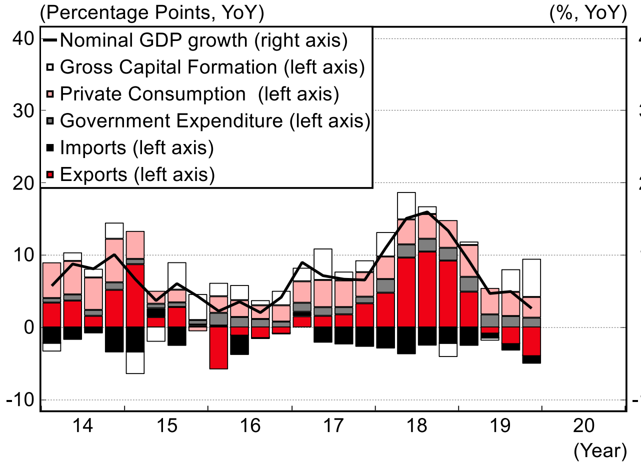
Main real GDP growth drivers to be hit by coronavirus impacts

Private consumption was expected to be the main contributor to real GDP growth in 2020 with a slight contribution to real GDP growth from national projects (as part of investment) which were expected to contribute 'about 0.1 percentage points (pp) to GDP growth in 2020 and about 0.2-0.3 pp in 2021' according to the World Bank.

However, the spread of coronavirus and containment measures will now have a strong negative impact on the main real GDP growth drivers. Across Russia, travel and entry restrictions, federal-wide lockdowns, ban on non-essential outings, school closures have been imposed. In Moscow, a full lockdown is now in progress, with citizens only allowed to leave homes for essential items.

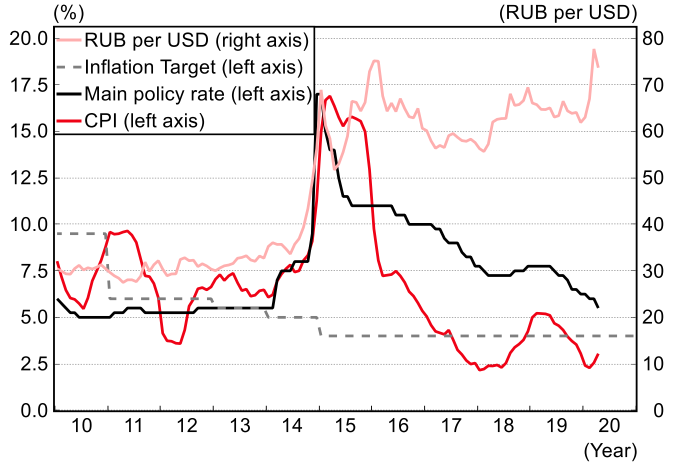
The Russian rouble has fallen by 19.2% against the USD since the start of the year, which could push inflation back up to the 4% YoY target over coming months, and have a negative impact on real disposable income. In addition, the expected contribution to real GDP growth from national projects is unlikely to materialise as construction projects will now be more difficult to undertake.

Contributions to Nominal GDP Growth



Source: Macrobond, MUFG Bank Economic Research Office

Exchange Rate, Inflation and Monetary Policy



Source: CBRF, Rosstat, MUFG Bank Economic Research Office

Policy response

The Central Bank of Russia (CBR) has cut the main policy rate by 50 basis points to 5.5%, while measures have been introduced to ease financing conditions for private individuals and small and medium sized enterprises.

The tougher global economic backdrop will remain a key consideration for the CBR in 2020, given the need to support the rouble and maintain the inflation target. The local OFZ government debt market (and capital inflows/outflows) will also be a consideration. The CBR will continue to monitor global economic developments, as well as the effects of coronavirus containment measures on the domestic economy.

Meanwhile, the government has announced a set of fiscal measures (up to an estimated 3.0% of GDP), such as tax breaks for companies and benefits for those unable to work. We note, fiscal buffers could be used to support the expected government fiscal deficit in 2020. Government debt, which stood at an estimated 14.9% of GDP in 2019, is also low and may rise if needed to support additional fiscal policy measures.

However the policy response is unlikely to prevent a major decline in real GDP growth over the coming quarters, in tandem with most of the developed and developing world. As already stated, the main priority of the policy response will be to provide the essential pre-conditions for the recovery. Necessary containment measures will clearly have a negative effect on most major economic activities in the short-run. That is, until the containment phase is over, the economy will remain weak.

Furthermore, we believe the recovery will be gradual. This will still depend, to an extent, on capex and the degree to which this can be ramped-up, in addition to the speed with which containment measures are lifted and how private consumption responds.

As noted the government had issues with capex under execution in 2019. While there has been a slight improvement in fiscal figures for January 2020, 8.8% of the government's annual spending plan was fulfilled in January from 6.1% last year- further positive outcomes will be needed for a change to our baseline. Granted, a larger fiscal package and faster government expenditures would be beneficial for real GDP growth, but this will have to remain monitored for now.

Real GDP growth rate to decline in 2020

All-in-all, we expect real GDP growth to fall to -2.0% or below YoY in 2020, and could fall by up to -5.5% according to the IMF. The authorities have taken a number of measures so far to contain the spread of the virus, while the economic policy response has been more limited. Further economic policy measures (both fiscal and monetary) might be introduced down the line, although we note, given the headwinds faced in 2020, it will be difficult this time around to stimulate private consumption, which is expected to take the brunt of the hit. Risks are expected to remain to the downside in 2020.