Central and Eastern Europe: Growth still set to top pre-pandemic rates despite tough near-term outlook

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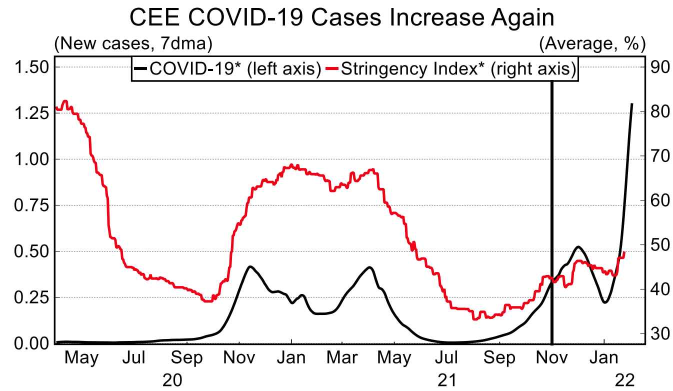
09 FEBRUARY 2022

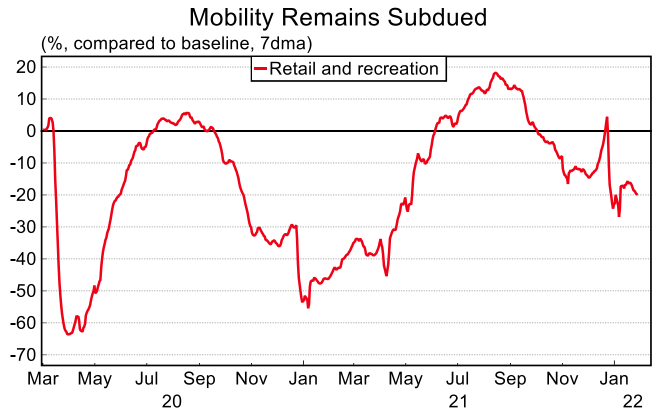
Retail footfall likely to remain subdued in near-term

The emergence of the Omicron variant has led to a rapid increase of COVID-19 cases across Central and Eastern Europe (CEE). Over the week, 24th to 31st January alone, COVID-19 cases surged by 1.25 million. Poland, Czech Republic and Romania have seen the largest increases by absolute numbers, and account for 62.2% of the overall surge, nonetheless excluding Albania, cases have risen everywhere.

Before Christmas, governments across the region had re-introduced restrictions ranging from national lockdowns, to the cancelling of shows or events, as well as more testing, and the mandatory wearing of masks. Czech Republic introduced a 30-day state of emergency on 26 November 2021, banning all Christmas markets and the drinking of alcohol in public places. Meanwhile, Slovakia went even further and introduced a 90-day state of emergency from 25 November 2021 on top of a two week lockdown. This said governments may need to go further given the recent surge of COVID-19 cases. Restrictions have not been as stringent as previous COVID-19 waves, and there are added risks as vaccination coverage is lower in the CEE versus western European counterparts.



*Countries included Albania, Bulgaria, Czech Rep, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovakia and Slovenia
Source: WHO, Oxford University, Macrobond, MUFG Bank Economic Research Office



Countries included Albania, Bulgaria, Czech Rep, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovakia and Slovenia
Source: Google, Macrobond, MUFG Bank Economic Research Office

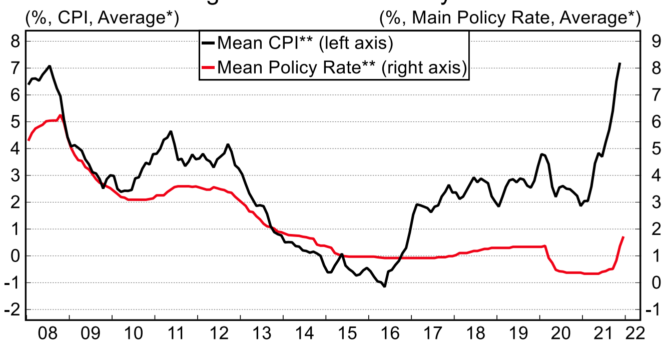
Regardless, the effect of rising cases will have an effect on mobility over Q1. Consumers remain reluctant to return to shops and other recreational activities. After previous COVID-19 waves, it has taken a few months at least for shopper numbers to recover back to their former levels. As a result, we expect the recent COVID-19 wave to have an effect on private consumption and weigh on real GDP momentum over Q1 2022.

Rising energy prices a major headwind

There are also other headwinds for private consumption. The average rate of inflation across the CEE (weighted by 2021 USD GDP) is now the highest it has been since 2009. Several central banks raised rates multiple times over the course of 2021. However, there are no signs yet that inflation has peaked. Further still, despite recent increases, policy rates remain low against strong inflationary pressures and as a result are likely to need to be increased further.

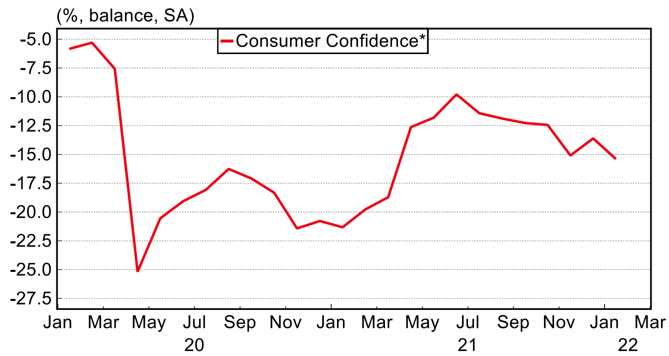
The causes of higher prices have been broad-based, but there has been a well-noted contribution from supply and demand imbalances. Restricted by lockdown measures, consumers have substituted consumption on services and recreation towards consumer goods. Meanwhile, supply has struggled to keep up as a result of COVID-19 related domestic distortions (such as a shortage of skilled labour) and global supply-side disruptions. Energy prices have also surged for similar reasons over 2021. There has been both strong global demand for natural gas, but also some COVID-19 related supply side disruptions.

Average Inflation and Policy Rates



*Weights have been calculated by using 2021 GDP in USD terms
**Countries included: Bulgaria, Czech Rep, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovakia and Slovenia.
Source: National Central Banks, Macrobond, MUFG Bank Economic Research Office

Consumer Confidence Holds Up Despite Inflation Concerns



*Countries included: Albania, Bulgaria, Czech Rep, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovakia and Slovenia
Source: DG ECFIN, Macrobond, MUFG Bank Economic Research Office

More recently, there have also been increasing financial market concerns that tensions between Russia and Ukraine could affect Russian gas supply to Europe (a large net importer of natural gas). The front-month contract for Dutch TTF[1], a European natural gas benchmark initially leapt back up to EUR/MWh 93.6, 341% higher than a year ago, although it has declined over recent weeks.

[1] As noted in our most recent Visegrad report, front-month contract for Dutch TTF saw a huge increase in 2021. Visegrad: Growth set to moderate, as concerns about inflation and higher interest rates rise (published 11th November 2021). Link here: https://www.bk.mufg.jp/report/ecoeu2021e/MUFG-Economic-Brief-20211111.pdf

Fortunately strong real wage growth for the most part shielded consumers' disposable income in CEE from higher prices at supermarkets and petrol stations over 2021, while manufacturing remained resilient. Despite a recent drop, consumer confidence has also remained steady.

We still expect strong real wage growth this year given robust demand for labour in the face of labour shortages in some sectors (such as leisure and retail). However, rising prices are set to take a greater proportion of household disposable incomes in 2022. A number of national regulators approved higher energy tariff prices at the end of 2021 which came into effect from 1 January 2022. The Energy Regulatory Office (ERO) of Czech Republic approved an average price increase of 3.7% for electricity and 2.4% for gas. Yet, this was on the lower end of the spectrum of regulated price increases across CEE for 2022. Indeed, the Energy Regulation Office of Poland forecasts energy prices to surge by 24.0% to 40.0% in 2022.

Given the extent of energy price increases and its potential significant socio-economic implications, several governments across the region enacted measures at the end of 2021 to reduce pressures on households. Poland was among one of the first as it introduced a 0.3% of GDP (EUR 2 billion) package of tax breaks and contributions to help the most vulnerable households. Meanwhile, the Czech Republic exempted electricity and gas from the value-added-tax (VAT) system, and introduced a set of fiscal measures to help households and entrepreneurs. In Estonia, the government introduced discounted energy prices for vulnerable households from September 2021 to March 2022, as part of a wider package of measures that could amount to 0.35% of GDP (EUR 100 million).

Against the effect of rising energy prices on consumer balance sheets, however, we think that these measures will have a minimal effect. Granted, some of the more severe effects of rising prices on the most vulnerable households will be alleviated. But these measures are unlikely to counter-balance the broader effect of higher prices on households. At the same time, CEE households spend a larger proportion of their incomes on energy costs versus the EU average.

Rising geopolitical tensions have also add to near-term pressures

Over recent weeks, there have also been added pressures from rising geopolitical tensions. The build-up of more than 100,000 Russian military personnel near the Ukrainian border, is spurring fears that Russia could launch an invasion of Ukraine.

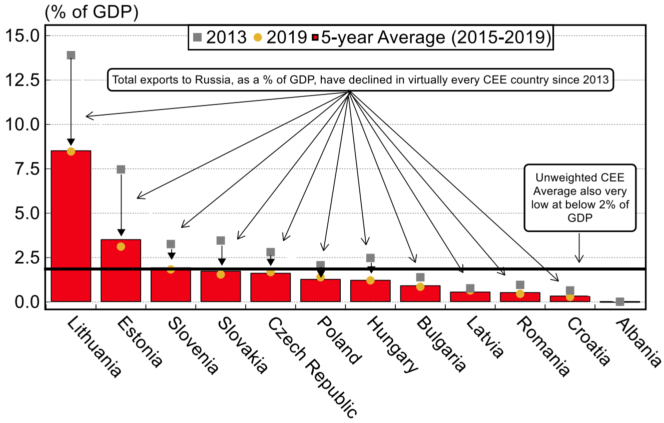
The main effect of rising geopolitical tensions has been on energy markets so far. On top of the aforementioned increase of gas prices, the Brent oil price benchmark surged to 90 USD per barrel, over fears that a Russian invasion could affect global oil supplies. Meanwhile, there has also been a modest effect on CEE currencies and stock indices. This said, in comparison to the 2014 Crimea crisis, the overall effects of rising tensions have been far less severe up to this point, although we note there are plenty of downside risks.

Our central scenario remains that a diplomatic solution is found with a likelihood of 60%. We note, in the event of full scale invasion, Russia would face severe economic sanctions. Indeed, the European Commission President has warned that the European Union would hit Russia with "massive economic and financial sanctions" should it invade Ukraine. Meanwhile, Russia is likely to be dis-incentivised as a result of the effects of previous sanctions on the Russian economy which are well noted. Post-2014, there was a large decline in foreign investment in Russia, while exports were severely affected impacting real GDP growth.

Even so, the longer tensions persist for, the greater the downside risks. Although not our central scenario, if current geopolitical tensions were to escalate, there could be additional upward pressures on energy prices and in turn inflation, and far more profound effects on the CEE macroeconomic outlook. Indeed, in the aftermath of the imposition of sanctions from 2014 on Russia, the European Parliament estimated that sanctions reduced European exports to Russia by 11%, although the actual effect on EU value added, estimated at -0.2%, and employment, was far lower. Given the hit to exports, we note that this time around, CEE is broadly far less exposed through direct trade channels to Russia. Since 2013, there has been a massive reduction in exports, as a percent of GDP, to Russia. While the overall unweighted CEE export average to Russia, is low (under 2% of GDP).

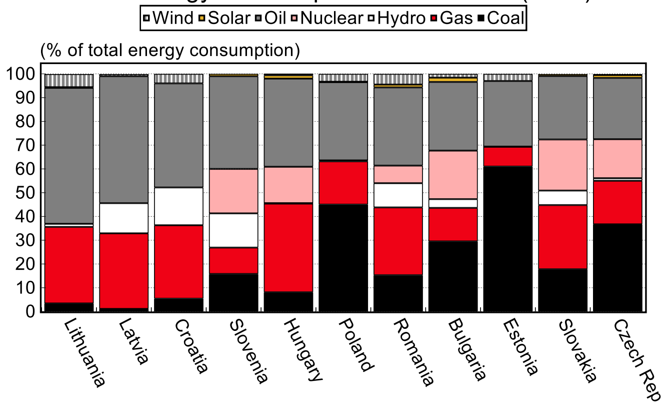
Consequently, assuming that there is no further escalation of tensions, our main concern is the recent effect of higher oil and gas prices on CEE households. In terms of energy consumption, oil and gas are the main energy sources across the CEE, accounting for nearly 60% of total energy consumption. The recent increase of geopolitical tensions could lead to more persistent pressures on CPI over the near-term, which would weigh on real GDP growth.

CEE Trade Exports to Russia Generally Low



Source: IMF, Macrobond, MUFG Bank Economic Research Office

CEE Energy Consumption Breakdowns (2019)



Source: BP Statistical Review of World Energy, Macrobond, MUFG Bank Economic Research Office

Near-term pressures a major concern, but growth should still top pre-pandemic rates

As a result, we expect downside risks to remain elevated in the near-term against a backdrop of elevated geopolitical tensions, rising COVID-19 caseloads, and higher CPI. We note, inflation headwinds should start to ease from H2 2022, as positive base effects start to fade out of inflation readings after the surge in prices from H2 2021, while households' energy usage should decline due to warmer weather. Nonetheless, in the interim and perhaps longer-term too, the inflation outlook is set to remain subject to a number of upside risks, which will continue to weigh on the outlook. Certainly, CPI is set to remain elevated, and supply-chain pressures could persist while recent geopolitical tensions have added to recent pressures.

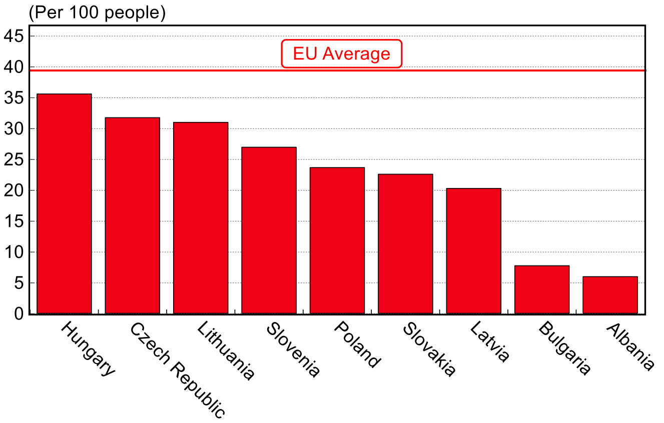
Despite this, we still expect activity to remain resilient. Real GDP growth has been resilient to previous COVID-19 waves, while governments are unlikely to increase lockdown measures to the extent that they harm growth too much. Indeed, real GDP has recovered back to pre-pandemic levels in all CEE countries, despite the headwinds of recent years and multiple COVID-19 waves.

Furthermore, strong real wage growth is set to continue to support households over the near-term, and once inflation pressures decline from H2 2022, household balance sheets should strengthen. Meanwhile, the continued roll-out of booster jabs and warmer spring weather should help to ease COVID-19 caseloads over the next few months. Hungary remains furthest ahead with its booster jab rollout, after starting earlier than others, but the rest will eventually catch-up given faster trajectories. Granted, some countries are likely to remain more vulnerable than others, in particular, Albania and Bulgaria, which remain some way behind others. Nevertheless, the wider rollout across the CEE should be closer to the EU rate by Q2 2022. This should help private consumption, which we expect to be the main driver of real GDP growth in 2022.

Meanwhile, there will also be a moderate contribution from investment as EU Next Generation funds are rolled out. Our baseline still remains that all EU Next Generation fund plans should eventually be approved at some point despite some of the more country specific issues over recent months (such as rule of law concerns in Poland and Hungary). EU funds should provide a large boost to real GDP over the next five years, and improvements to productive capacity could be supportive over an even longer horizon. Also, against a backdrop of fairly strong global demand, easing global supply chain issues should also help exports.

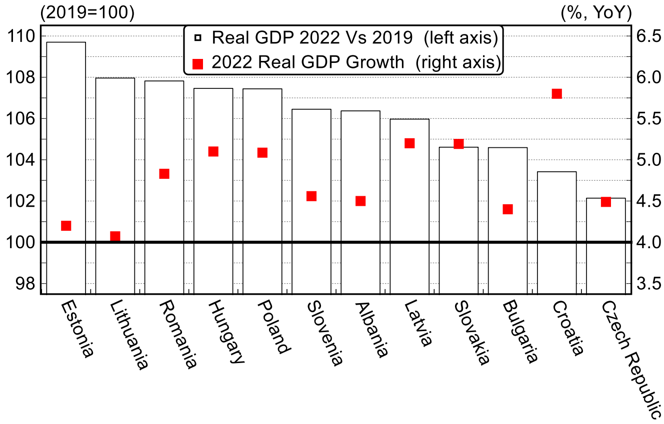
Consequently, we still expect strong real GDP growth in 2022, which is set to top pre-pandemic rates. Resilient underlying economic drivers, together with EU Next Generation Funds, should support activity against a backdrop of raised near-term risks. This said, there will clearly be a risk that some of these near-term pressures prove longer lasting. In the event of further COVID-19 related setbacks, or higher than expected inflation or geopolitical risks, we note, real GDP forecasts for 2022 would be subject to downside revisions. But for now, we expect these pressures to decline from H2 2022, and activity to remain resilient.

Booster Jab Rollout Latest Figures



Source: Our World in Data, Macrobond, MUFG Bank Economic Research Office

Real GDP 2022



Source: IMF, Macrobond, MUFG Bank Economic Research Office