Central and Eastern Europe (CEE): Back on the EM Radar

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Higher Funding Needs Due To Elevated Post-Pandemic Fiscal Imbalances

Pre-pandemic European Union (EU) CEE sovereigns were not on the radar for most external Emerging Markets (EM) investors. CEE4 (Poland, Hungary, Romania and Czechia) did not fit the 'investable EM universe' due to their closer links with Developed Markets (DM) via their EU membership and prominent trade links. The investment-grade status of CEE4, their geographical proximity to DM and sporadic-at-best issuance in USD also meant little to no investment opportunity for the yield-searching EM investor. The COVID-19 pandemic, however, was a blow to economies in the region; a big drop in government income as industry slowed coincided with significant hikes in government spending to deal with the economic and health crisis. The war in Ukraine also added to government spending via the energy and military expense channel. All of this resulted in swelling budget deficits and higher gross financing needs for CEE sovereigns, which became more prolific issuers of hard currency external debt.

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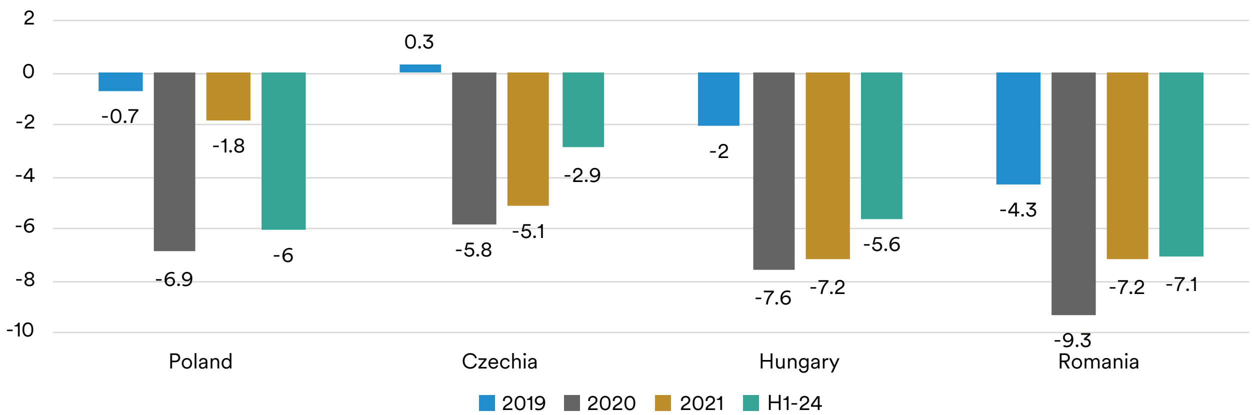
We expect CEE countries to embark on fiscal consolidation paths, albeit at a slow pace, which will require multiple years of fiscal adjustment. All of these countries may face some ratings pressure but will we believe maintain their investment grade status throughout this transition period. Meanwhile, we view elevated issuance as a rare opportunity for investors to gain exposure to the CEE region and across the respective sovereign curves.

Figure 1 | Budget Balance as % of GDP

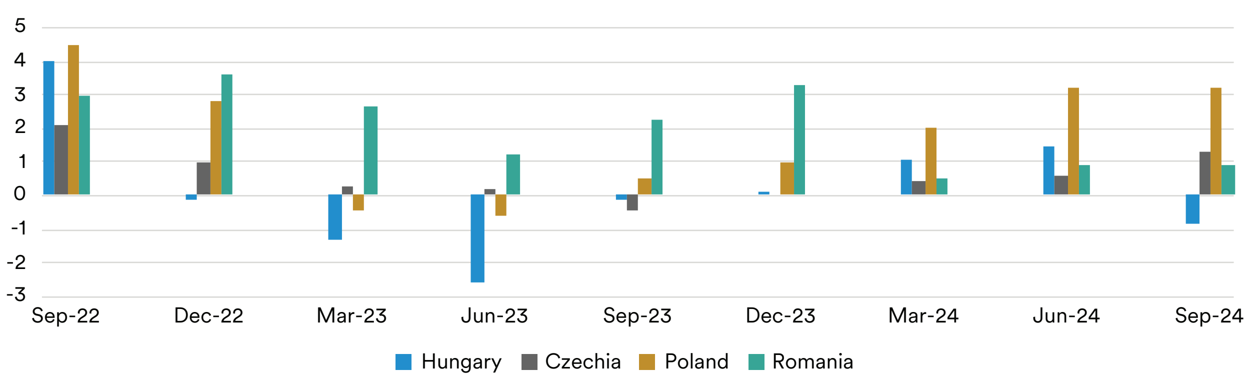


Sources: European Commission, Haver as of June 30, 2024

Slower Growth Due To Weak Exports, but Poland Is a Standout

Private consumption remains the primary driver of growth across the region. High real wages, tight labor markets and continuing disinflationary trends have been supportive factors for domestic demand. Investments are also an important driver of growth, but they will be more significant in 2025 when public investment will pick up due to the disbursement of EU (RRF) funds. Poland is particularly well positioned to benefit in 2025, while Hungary's investment levels are currently very weak, and no significant pickup is expected in 2025. Weak external demand is the biggest detractor from growth in the region due to sluggish activity in the Eurozone. Czechia and Hungary are the most exposed to the automotive sector, as their share of exports to Germany is close to 30%. Poland's exports to Germany are also close to 30% but are better diversified across sectors. With respect to growth in 2024, Poland is a clear standout (3.1% year-over-year GDP growth estimated by Ministry of Finance), while Hungary is a laggard (1.4% year-over-year GDP growth estimated by The National Bank of Hungary).

Figure 2 | Real GDP, % Y/Y

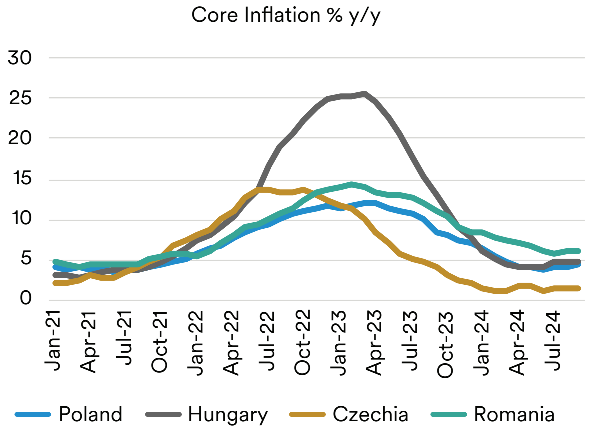


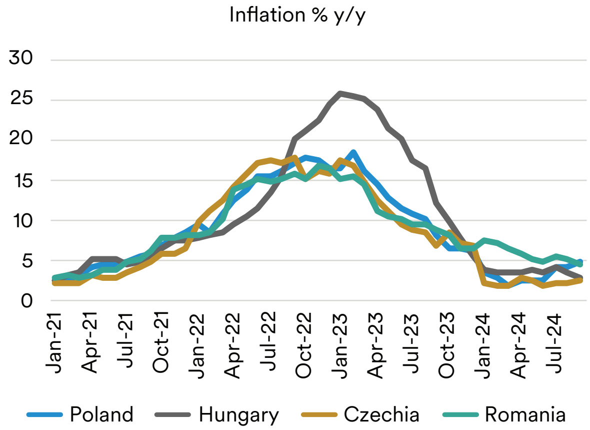
Source: Bloomberg LP as of September 30, 2024

Disinflation Trends Will Continue, but Core Pressure Warrants Caution

The CEE region has seen strong disinflation trends in the last two years on the back of restrictive monetary policy. Over the summer, the disinflation trend slowed, while core inflation (especially services) remained stubborn and above target levels across the region. On the positive side, lower core market rates have allowed CEE Central Banks to continue cutting rates without disrupting their own currencies. Further cuts are dependent on both data and sentiment (especially in Hungary), while Central Banks are adopting a cautious stance due to possible inflationary pressures from a loose fiscal stance (particularly in Romania, Poland and Hungary). National Bank of Poland (NBP) stands out as the most hawkish among its peer group, as it has kept its key rate on hold for eleven consecutive months. Pressure to cut rates, however, has mounted, and NBP is expected to start a cutting cycle in mid-2025 at the latest. National Bank of Romania is likely to remain on hold for the remainder of the year due to significant fiscal uncertainty, while further rate cuts in Hungary will be severely constrained by the recent pressure on the forint.

Figures 3 and 4 | Inflation Metrics



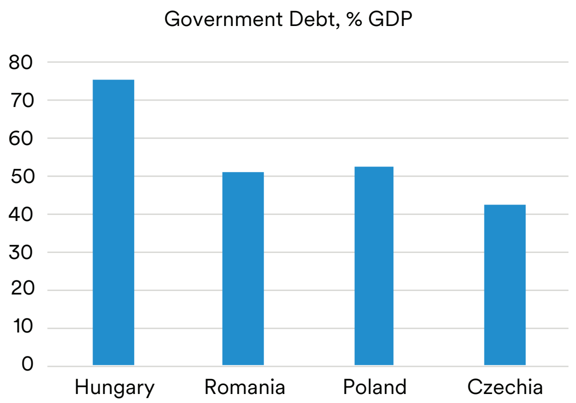


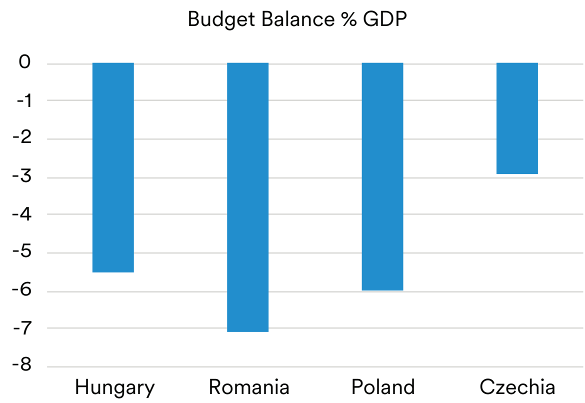
Source: Haver as of September 30, 2024

Large Fiscal Deficits Require Fiscal Consolidation in Post-Election Cycles

CEE sovereigns (except Czechia) are running large and expansionary deficits, which have fueled domestic demand in 2024. Budget deficits are expected to expand in 2024 in Poland and Romania, as governments have been reluctant to cut populist spending before elections. In Hungary, there is a risk of loose fiscal policy in 2025, ahead of the 2026 parliamentary elections. Poland, Hungary and Romania are all subject to the excessive deficit procedure (EDP) by the European Commission and need to start fiscal consolidation in 2025 or risk delay of EU funding and rating downgrades.

Figures 5 and 6 | Fiscal Metrics





Source: Bloomberg LP as of September 30, 2024

Romania has the highest fiscal deficit in the CEE and one of the highest in Europe. In a super election year such as 2024, the government is not committed to deliver a much-needed fiscal adjustment, which means the fiscal gap could reach 8% of GDP by year-end. However, the importance of its investment-grade credit rating, the conditionality of the EU funds and market pressures have pushed Romania into a slow budget consolidation over a seven-year period through to 2031. The more popular budget consolidating options that are expected to save at least 1.1% of GDP, as per the fiscal plan, include raising the flat tax from 10% to 16%, increasing property taxes and hiking the VAT from 19% to 21%. Despite the high fiscal deficit, Romania's investment-grade rating is anchored on a modest debt/GDP, and there is capacity to add more debt versus its peer group in the same rating category.

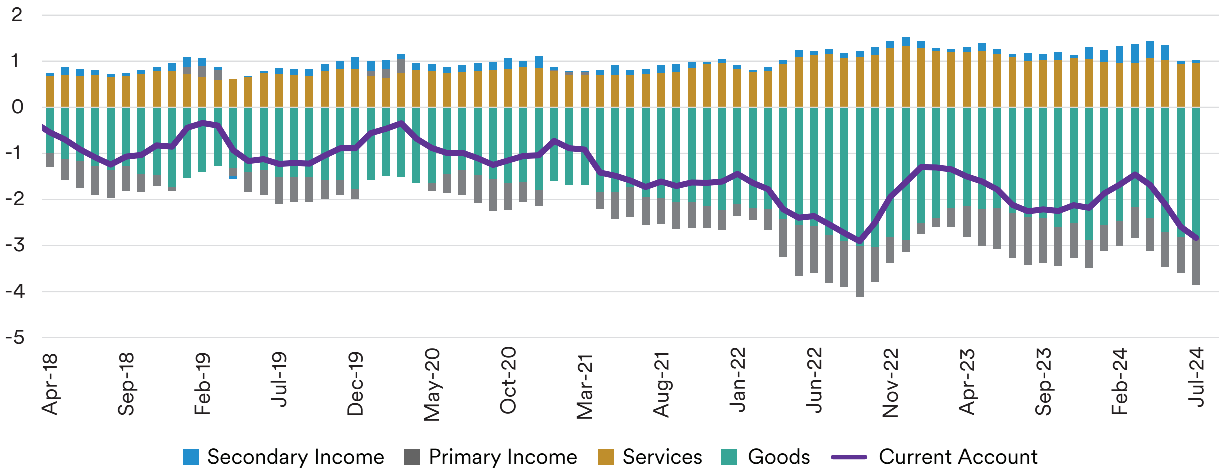
Poland's fiscal slippage in 2024 is explained with high social and military spending, as PM Tusk is delivering on his pre-electoral promises, while also eyeing the upcoming presidential elections in 2025. The proposed 2025 budget was disappointing, as it showed a marginal decrease in the deficit to 5.5% in 2025, despite expectations that 2025 will be a high growth year. Poland's efforts to reign in the deficit will be focused more on fostering growth rather than cutting spending, and the deficit is expected to fall below 3% of GDP in 2028 (five-year fiscal adjustment plan).

In Hungary, the government is targeting fiscal deficits of 4.5% and 3.7% in 2024 and 2025, respectively. The reduction in 2025 will come from a lower interest bill as expensive CPI-linked retail bonds will reprice. There is the risk, however, that in 2025, the primary deficit will widen ahead of the parliamentary elections in 2026 and due to the poor growth outlook. Hungary's fiscal space is limited due to an already higher debt/GDP than its similarly rated peer group.

EU Funds Provide a Backstop to a Large Current Account Deficit in Romania

Romania has a structural current account deficit that is largely driven by strong domestic demand fueled by a large fiscal deficit. While exports remain weak and demand for imported goods persists, almost 60% of the current account deficit is covered by non-debt-creating inflows such as EU transfers and net foreign direct investment (FDI), while the rest of the gap is mostly funded by long-term external borrowing. The wide current account deficit is less concerning and will naturally shrink when Romania tackles its fiscal imbalances.

Figure 7 | Romania Current Account Components (EUR bn)



Source: Bloomberg LP as of September 30, 2024

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