Polish Economic Institute

2/2022

CEE Economic Monthly

May 2022

NO RISK OF TWIN DEFICITS IN THE VISEGARD COUNTRIES

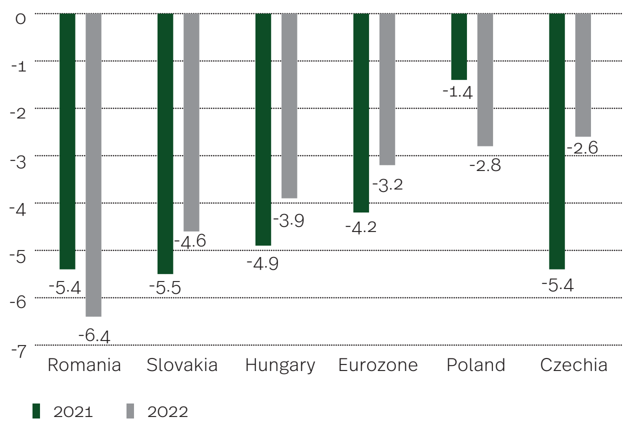
→ Russia's invasion of Ukraine destabilised the CEE countries' trade with both those countries and increased inflation worldwide. Governments in the region responded with VAT cuts and new transfers to less affluent households, which has limited fiscal consolidation (Figure 1). Central banks raised interest rates, increasing debt servicing costs (Figure 2). This issue of the CEE Monitor is therefore dedicated to the risk of twin deficits – a simultaneous decrease in the external balance and the deterioration of public finances.

→ The recent increase in energy prices caused the CEE states' external balance to deteriorate. All the countries should record a deficit in 2022. Still, its scale is rather moderate, usually hovering around 2-2.5% of GDP. We present the detailed outlook in the section *A moderate trade deficit in the CEE region*.

→ The war is leading to a swift increase in the fiscal deficit in most CEE countries. The IMF expects a large increase in net lending in 2022 and stabilisation in subsequent years. The deterioration of fiscal conditions will mainly be caused by programmes shielding the economy from an energy crisis and by the increase in military spending. Nevertheless, we do not expect fiscal dominance, as most CEE countries have fully sustainable debt levels. We provide more details in the section *Fiscal policy on the verge of crisis*.

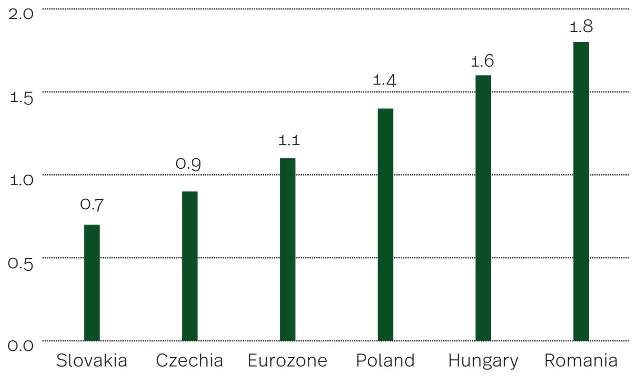
→ The CEE currencies weakened against the euro after the start of the war in Ukraine. Polish złoty (PLN) and Hungarian forint (HUF) are undervalued compared to the economic fundamentals. However, we do not expect them to appreciate imminently given the countries' proximity to Ukraine. Economic fundamentals suggest that the Czech koruna (CZK) is more likely to depreciate. The outlook is presented in the section *CEE currencies dependent on global issues*.

General government primary net lending
(% of GDP) – IMF forecasts



Source: IMF.

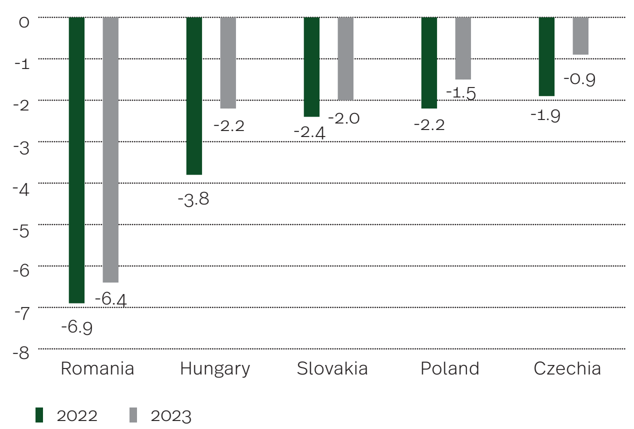
General government debt servicing costs in 2023
(% of GDP) – IMF forecasts



Source: IMF.

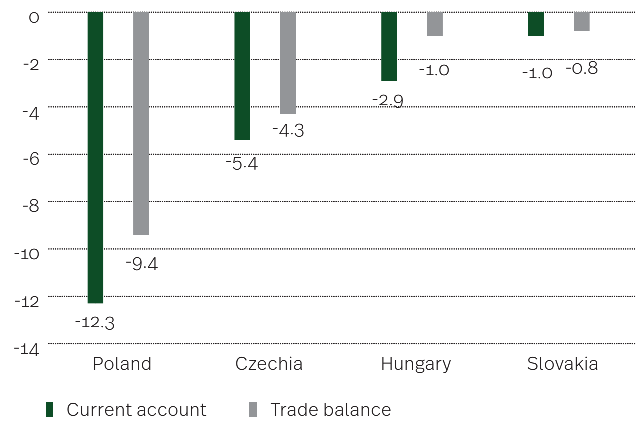
A MODERATE TRADE DEFICIT IN THE CEE REGION

Forecasts – current account balance (% GDP)



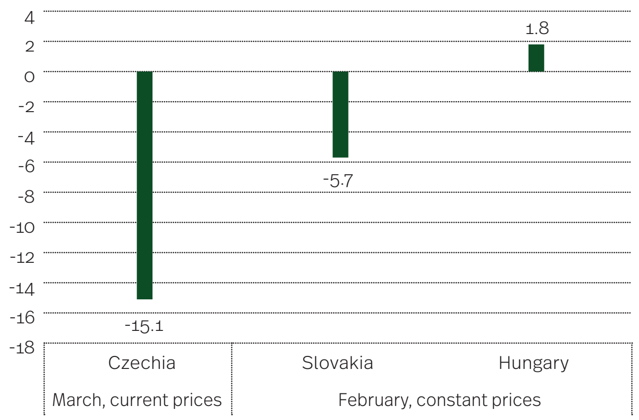
Source: Focus Economics.

Revisions of current account and trade balance forecasts since February (billions of EUR)



Source: Focus Economics.

New orders in automotive sector – latest data (%YoY)



Source: Macrobond.

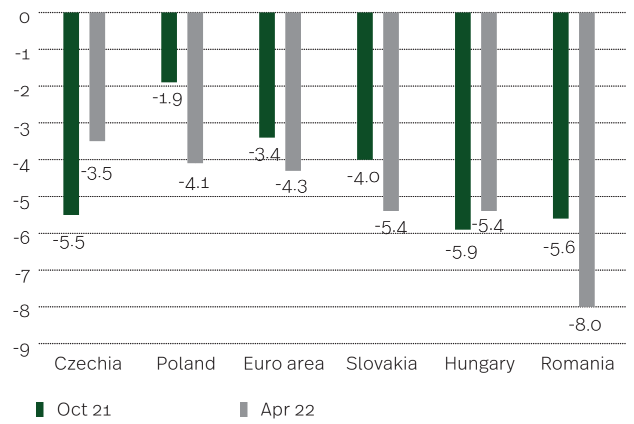
The Russian invasion of Ukraine deteriorated the CEE states' external balance – all the countries should record a deficit in 2022 (Figure 1). The scale of the deficit is moderate; it usually hovers around 2-2.5% of GDP. The deficit is slightly higher in Hungary, oscillating close to 4%. An imbalance is only present in Romania, where the deficit equals 6% of GDP and is unlikely to narrow significantly in the coming years.

The biggest downward revisions of the current account balance were made in Poland and Czechia. According to the Focus Economics poll, forecasts for 2022 in each case have been lowered by more than 1.5% of GDP since February. Still, **both countries have recorded the lowest deficit in the region. The deterioration should be short-lived:** the current account balance in all the CEE states is projected to improve in 2023. Czechia and Poland should maintain a small deficit next year.

The trade deficit has widened as commodity prices have increased. The magnitude is greatest in Poland: nearly 75% of current account deterioration is related to the higher cost of importing energy commodities. Poland imports approximately 14 million barrels of crude oil per month. With this level of demand, the recent price increase widens the deficit by EUR 600 million per month and approximately EUR 7.2 billion per year. Energy commodity imports are also set to deteriorate in Czechia; additional costs related to oil imports amount to EUR 2 billion, nearly 40% of the forecast deficit increase in the current account balance. Slovakia and Hungary's expenses should amount to approximately EUR 1.6 billion and 1.8 billion. Given that loss, analysts are likely to underestimate the fallout from the war in those countries – in both cases, revisions of the current account balance were small.

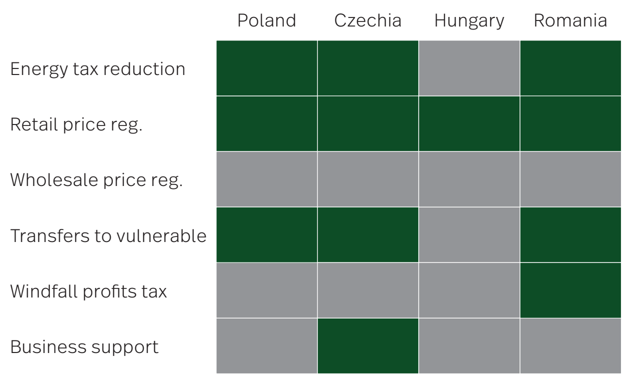
Czechia and Slovakia should also suffer from weak automotive performance. The volume of new orders is declining across the CEE countries. The biggest decrease was recorded in Czechia; in March, their nominal value fell by 15%. The fall of output is greater – high inflation increases the nominal value of orders. According to OEC data, transport accounted for 19.9% of the value of exports. Slovakia recorded a 5.7% drop in February – similar to Czechia that month. Automotive performance worsened in March, like in Czechia. However, this sector's impact on overall economic performance is greater in Slovakia, where transport accounts for 36.5% of exports. The only country still reporting an increase is Hungary; Poland is not providing data.

General government net lending in 2022 (% GDP)



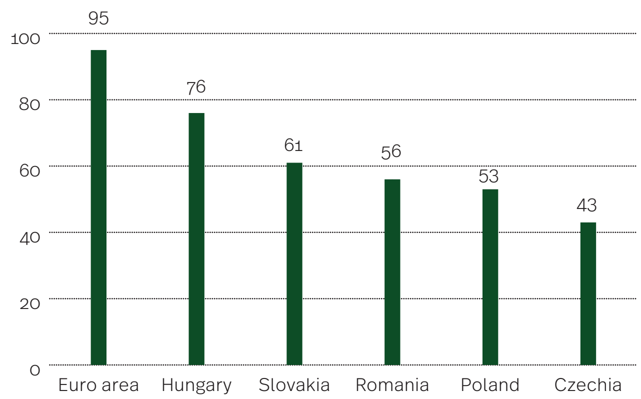
Source: IMF WEO forecasts.

Policies in response to the energy crisis



Source: Bruegel.

General government debt in 2022 (% GDP)



Source: IMF WEO April 2022.

The International Monetary Fund (IMF) forecasts that the CEE countries' fiscal deficits will increase in 2022. The deficit in Poland and Czechia should be slightly lower than in the Eurozone; 4.1% and 3.5% respectively, compared to 4.3% in the Euro area. The IMF forecasts a slightly higher deficit in Slovakia and Hungary; it should amount to 5.4%. An imbalance is seen in Romania, where the deficit is likely to exceed as much as 8.0%.

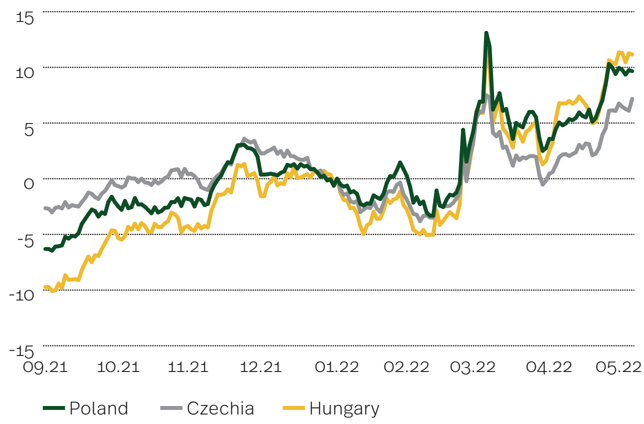
Fiscal conditions should improve in the next year. The biggest reduction is expected in Slovakia (2.3 pp). Poland and Romania are expected to lower the deficit by 1.2 pp. As a result, Poland will have the lowest fiscal deficit in 2023; it will be the only country that complies with the Excessive Deficit Procedure, with net lending at -2,9%. Slightly higher results are expected in Czechia. The other countries should exceed the -3.0% threshold.

Government spending is directly focused on preventing a fallout from energy prices after the Russian invasion. The scale of the interventions in the CEE states is comparable to other European countries. Governments have adopted a number of policies to shield consumers from rising prices. These mostly consist of price regulation for households, reducing VAT on energy, and transfers to vulnerable groups.

Simultaneously, military spending is increasing. Poland and Slovakia have pledged to increase theirs to 3% of GDP. Czechia and Romania are planning to increase their military spending, too. We expect this spending to have a limited effect on inflation. A large share of modern military equipment is likely to be imported. This spending will mostly weigh on countries' current account balance and will not boost demand at home much.

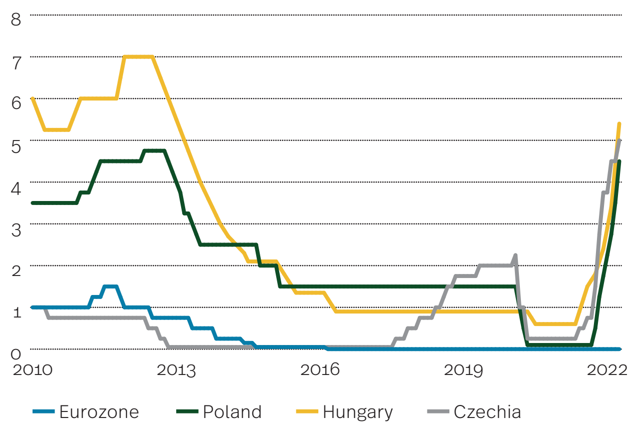
Debt will not weigh heavily on the CEE countries' economies. The CEE countries have less debt than the Eurozone. Hungary is the only Visegrad country with debt significantly above the 60% of GDP limit. Moreover, the IMF expects debt to remain stable or even fall, partly due to the high inflation, which is increasing budget revenue. Hence we expect that rising debt servicing costs will not weigh on central banks' decisions. The opposite can be expected in the Eurozone, as some ECB policymakers are already arguing against rate (link).

Euro exchange rate (EUR/CEE currencies)



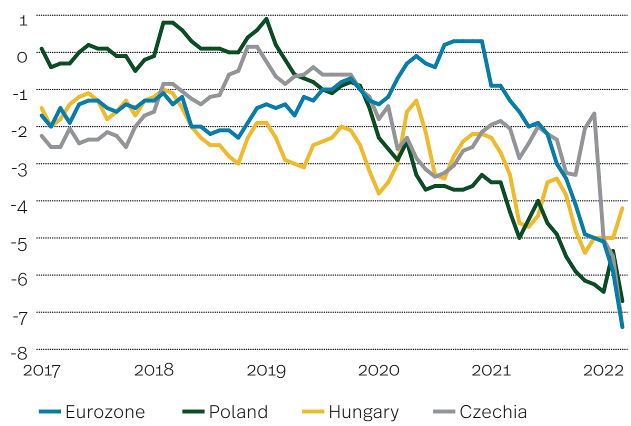
Source: Macrobond.

Central banks interest rates
in the CEE region vs Eurozone (%)



Source: Macrobond.

Central banks rates corrected for inflation (%)



Source: Macrobond.

The CEE currencies weakened against the euro after the start of the war in Ukraine. The Czech koruna (CZK) was the most stable of the CEE currencies and has already returned to its pre-war level (EUR/CZK at 24.4). The Polish złoty (PLN) and Hungarian forint (HUF) depreciated after the Russian invasion. The złoty and forint are undervalued, compared to the economic fundamentals. However, we do not expect them to appreciate imminently given the countries' proximity to Ukraine. The Czech Koruna is depreciating with the appointment of a new, dovish governor; our fundamental model points to an exchange rate of CZK 25 per euro.

So far, the sharp rate hikes have had a limited impact on the CEE currencies. The National Bank of Poland increased rates by 100bp in April and by 75bp in May. While the first decision exceeded market expectations by 50bp, the złoty failed to appreciate. The latter was below the market consensus (100bp), but did not have a meaningful impact on the złoty, either. Domestic issues, such as the government's assistance for borrowers, should therefore have a limited impact on the exchange rate. Rather, increased volatility is more likely to be triggered by the geopolitical situation amid the war in Ukraine or energy security.

The spread between the EURIBOR and CEE rates is currently the highest since 2002, but is expected to decrease in 2023. The Czech Republic is currently the frontrunner, with the rates at 5.75%, but is expected to conclude its cycle soon. Hungary and Poland have slightly lower rates, at 5.4% and 5.25% respectively. However, the recent consensus and market pricing suggest that interest rates should peak at 7% this summer. Theoretically, the CZK should be more vulnerable to ECB tightening than the HUF and PLN. Still we expect CEE currencies reaction on the ECB hike to be moderate, given slow pace of tightening in the Eurozone.

Higher real interest rates will strengthen the CEE currencies next year. Thanks to the rate hikes, real interest rates in the region are currently higher than in the Eurozone. We expect the real rates to increase further next year with falling inflation. CPI forecasts suggest that it will fall to 5.6%. Given the pace of tightening in CEE, inflation could fall even faster, which should translate into the appreciation of the Visegrad currencies. Still, the effects are more likely to be seen next year.

Authors: Konrad Bochniarz, Marcin Klucznik, Jakub Rybacki

The Polish Economic Institute

The Polish Economic Institute is a public economic think tank dating back to 1928. Its research primarily spans macroeconomics, energy and climate, foreign trade, economic foresight, the digital economy and behavioural economics. The Institute provides reports, analyses and recommendations for key areas of the economy and social life in Poland, taking into account the international situation.

Polish Economic Institute

Contact

Jakub Rybacki
Deputy Head of the Macroeconomics Team
jakub.rybacki@pie.net.pl
phone: 48 512 275 365