Erste Group Research
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SARS-CoV-2 to weigh on economic outlook

Spread of virus to Europe resulted in drastic reaction of markets and made major central banks react. In response to series of downward revision of global growth, we put our CEE growth forecast under revision and see it around 0.3pp lower on average.

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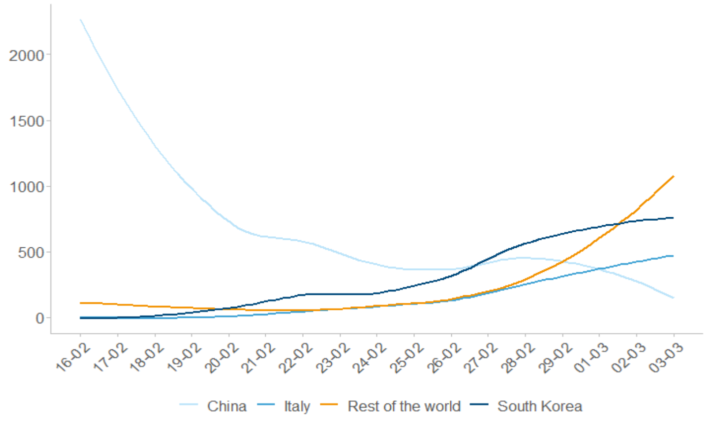
Spread of SARS-CoV-2 to Europe

Since the outbreak of the new Coronavirus in China at the end of December 2019, the situation has changed significantly. The number of infected people is tenfold compared to the SARS epidemic from 2003 and the virus has spread globally. SARS-CoV-2 began to spread rapidly in Europe at the end of February, with Italy recording the highest number of confirmed cases. Therefore, we see new downside risks to the economic outlook of the CEE region compared to our report released at the end of January.

The dynamic spread of SARS-CoV-2 globally will result in a more negative impact than earlier anticipated when the virus was assumed to be contained in China. Global growth and the persistently high levels of market fear will likely limit economic activity worldwide. Among others, the OECD cut this year's forecast for global growth by 0.5pp to 2.4% and by 0.3pp to 0.8% for the Euro Area. As a consequence, we see a downward revision of CEE growth forecasts by about 0.3pp on average in 2020. Forecasts for individual countries will be published next week. If the spread of the new Coronavirus is not contained in the foreseeable future, we could see further decreases in global economic activity that could translate into an even bigger slowdown of the growth in CEE.

In the response to the increasing number of SARS-CoV-2 infections and growing fears of slowing global growth, the FED delivered a 50bp rate cut. The FOMC decision came just after the statement of the G7 finance ministers reassuring their 'commitment to use all appropriate policy tools to achieve strong, sustainable growth and safeguard against downside risks.'

New cases in past two weeks (smoothed data)
Number of new cases, Daily update here: Corona virus data



Source: John Hopkins School of Engineering, Erste Group Research

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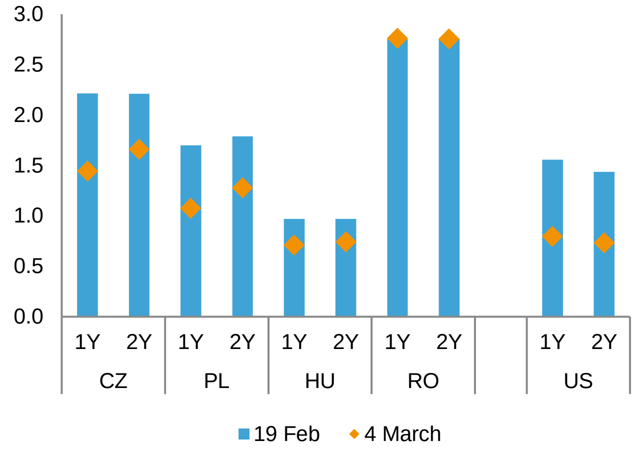
Markets are infected by Coronavirus, too

Markets started reacting very drastically to SARS-CoV-2 fears after evident signs that it is spreading in multiple places outside of China. In the final week of February and early March, stock markets were hit strongly, and the VIX index went up to levels not seen since 2015. This left its mark on CEE FXFI markets. As interest rate expectations lowered globally, regional rate outlooks followed, especially in Czechia and Poland. The move was somewhat less pronounced in Hungary, where rates are already at very low levels. They could not decline that much in Romania, due to the fiscal outlook. Global monetary easing expectations were confirmed by the 50bp emergency rate cut of the US Fed on March 3. This sent the 10Y US Treasury yield to below 1%, a level not seen since at least 1871, according to data cited by Bloomberg.

Despite the jitters, local currencies performed rather well in the emerging market universe. This is true even for the Czech koruna and Polish zloty, despite having fallen more notably within CEE in the last few weeks. Besides relatively sound economic fundamentals, this could also be reinforced by expectations of additional cuts from the US Fed, which could support local currencies. We do not feel pressured to adjust our currency forecasts, at least for the time being.

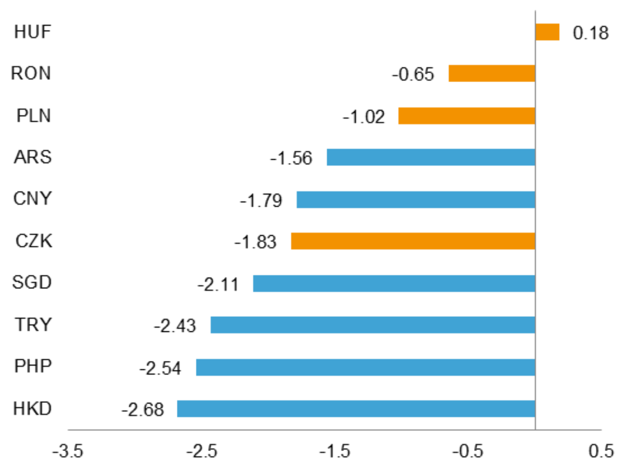
As for the rate outlook, there are conflicting forces. While markets started to price in aggressive rate easing in Poland and Czechia amid Coronavirus fears, inflation was well above the target in both countries, not to mention in Hungary. Poland kept the policy rate unchanged at 1.5% on March 4. In Czechia, the CNB might find itself under pressure to reverse the early February 25bp hike later this year. In Hungary, the last statement hinted at a possible hawkish tweak in monetary conditions in March, but chances are large (and increasing) that the MNB will not substantially tighten conditions, if at all. In Romania, fiscal risks make it difficult to ease monetary conditions, but we think that another cut in FX reserves requirements is likely.

Sharp drop in rate expectations in 1-2Y segments
Points on rate curve, %



Source: Bloomberg, Erste Group Research

Total return vs. EUR
Since 14 Feb 2020, %



Source: Bloomberg, Erste Group Research

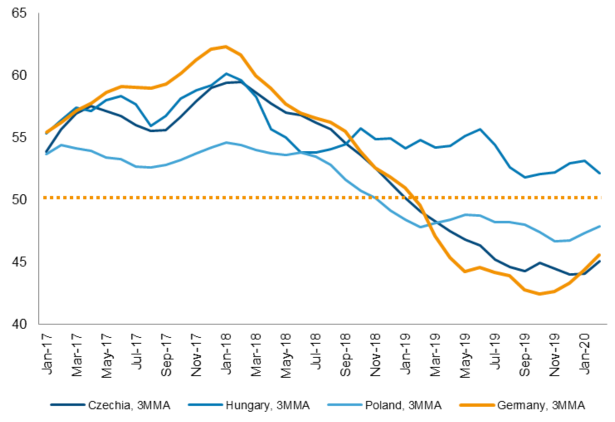
As for yields, we already cut our 10Y forecast for Poland after the recent declines. We see downward risks in Czech yields, too. In Hungary, as the HUF bond supply was rather strong at the beginning of the year to refinance FX debt, yields could not decline as much as in Poland. Nonetheless, if major market yields fail to recover, downward pressure on Hungarian yields could start to mount, too. In Romania, the uncertain fiscal outlook makes it difficult to cut the yield forecast.

Downside risks loom over CEE

With SARS-CoV-2 spreading to Europe, the downside risks have started to materialize. CEE is obviously more integrated into the European economy and exposed to spillover effects now than it was when the virus broke out only in China.

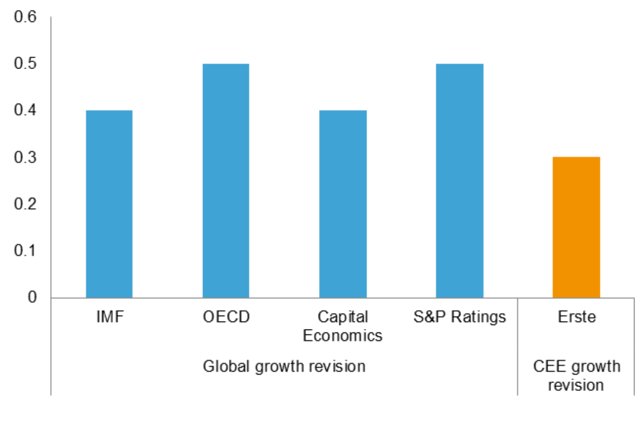
Although market sentiment and monthly economic data in Europe have not been ‘infected’ yet (PMI indices still went up in February), they are likely to catch up with reality in the coming months. The recent drop of the global PMI index due to China may be the first sign. Growing uncertainty resulted in a series of downward revisions to global and European growth. At this point, we are considering a downward revision of average CEE growth by about 0.3%, with country-specific revisions going to as much as 0.5% (Romania) or even above (Croatia). The risks remain skewed to the downside.

COVID-19 is not yet visible in European sentiment
PMI index, 3MMA



Source: Bloomberg, Erste Group Research

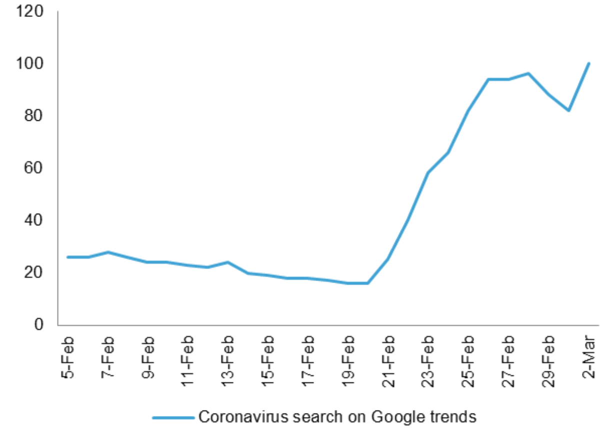
Downward revision to 2020 growth
Percentage point



Source: Bloomberg, OECD, Erste Group Research

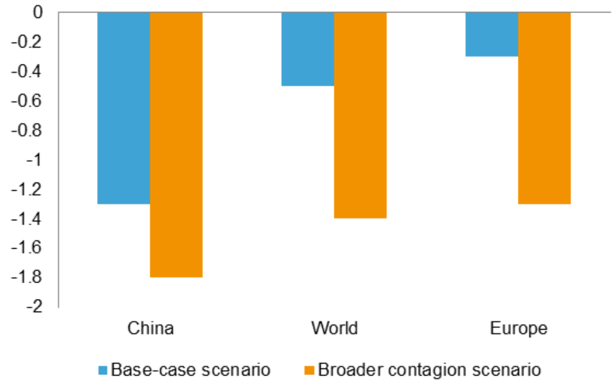
The final economic costs of the Coronavirus will strongly depend on how quickly countries manage to contain the spread of the virus and reduce the fear factor. If harsh measures, such as quarantine, closing of schools or public institutions needs to be undertaken across whole Europe, as is currently in case of Italy, materialization of OECD’s adverse scenario may become increasingly likely. Such measures could result into more severe supply as well as demand shock, with production breaks or distorted supply chains on the one hand, and consumers reducing their purchases or calling off their traveling plans on the other hand. The OECD currently estimates that broader contagion scenario could shave of as much as 1.3% meaning Europe would be in recession. In such case, it would be hard to avoid as well for some of the CEE countries.

Increasing fear limits shopping and travelling
Searches on Goolge trends



Source: Google trends, Erste Group Research

OECD adverse scenario
Percentage point

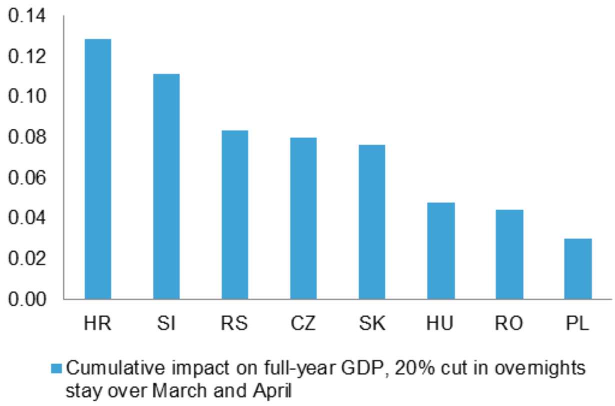


Source: OECD, Erste Group Research

Quarantine, tourism, other sectors

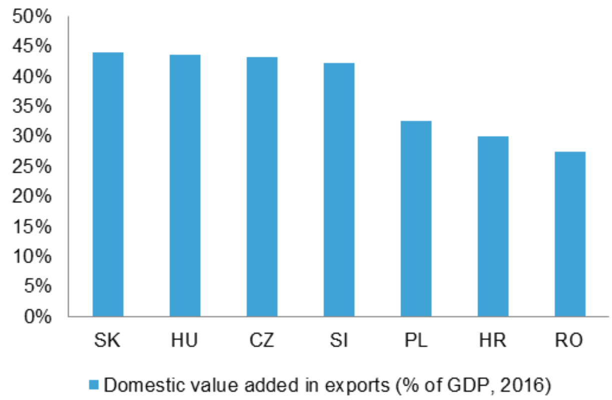
The weaker global demand will take its economic toll on CEE economies, especially the most open ones. The domestic value added in exports (that is value added of an economy in producing goods and services for export) is ranging within 27-44% for CEE countries, the highest in Slovakia, Hungary and Czechia and the lowest in Romania. The most crucial question for exporters is the uncertainty around the magnitude of the shock, potential disruptions in the supply of labor and intermediate goods caused by potential quarantine measures and their length. If the situation around the spread of SARS-CoV-2 calms down in the coming months, there are better chances for a V-shaped recovery later this year.

20% cut in overnight stays over March and April
Impact on full-year GDP, pp



Source: Eurostat, Erste Group Research

Transmission of weaker demand for CEE exports
Domestic value added in exports, % of GDP 2016



Source: OECD TiVA (2016 data), Erste Group Research

The presence of SARS-CoV-2 in Europe will certainly have its impact on domestic demand in CEE through lower investments, denting consumer confidence and potential quarantine measures, primarily hitting the sector of services. As far as the tourism sector is concerned, the impact will be determined not just by the size of the industry, but also the seasonal pattern. For instance, while Croatia’s tourism sector generates about 18% of GDP, compared to less than 3% for most CEE countries, in Croatia, the summer months take three quarters of total overnight stays. By that time, hopefully the virus will no longer be a concern for guests. If we assume a 20% decline in overnight stays due to the fear factor in March and April, the negative impact in Croatia does not differ too much from other CEE countries. However, an extra negative impact could stem from deeper price discounts for summer holidays offered in response to denting early bookings.

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