CENTRAL EUROPE

THE REGION IS STILL ATTRACTIVE DESPITE WEAK GROWTH

In Central Europe, economic activity slowed in Q3 2024. Over the first three quarters, the Polish economy performed better than its neighbours. In the region, inflation has picked up again and a return to the inflation target is not expected until 2026. With the exception of the Czech Republic, all Central European countries are under excessive deficit procedure. Moreover, several countries have tapped international capital markets. This is accompanied by a higher currency risk, but generally, Central European countries have adopted a cautious management of foreign currency debt. Meanwhile, capital flows rebounded in Q3. The region remains an attractive destination for short- and medium-term capital flows.

SLOWDOWN IN ECONOMIC ACTIVITY

OIn the first half of this year, household consumption recovered in all Central European countries, thanks to the strength of real wages. The improvement was particularly marked in Romania, Poland and Hungary. On the other hand, investment and external demand have slowed down significantly for all countries in the region since the end of 2023.

In Q3, growth slowed to 2.3% y/y after 3.6% in Q2 in all Central European countries (Poland, Hungary, Romania, Czech Republic, Slovakia and Bulgaria). More importantly, Hungary entered a technical recession with a decline in GDP for two consecutive quarters (Q2: -0.2%, Q3: -0.7%). In the Czech Republic and Slovakia, economic activity proved resilient with relatively similar growth compared to the previous quarter. In Q4, growth is likely to remain weak, reflecting the effects of the floods faced by all Central European countries in September.

Over the year as a whole, however, Poland could be one of the region's best performing economies despite headwinds. The carry over already amounts to 2.5% in Q3. In comparison, Hungary and Romania are likely to lag behind in 2024 with a carry over of 0.6% and 0.7% respectively in Q3.

Growth prospects for the region remain well-oriented for 2025. Monetary policy is likely to become more accommodative again next year, and fiscal policy is unlikely to tighten. Although moderate, the improvement in external demand should also provide support. However, risks are tilted to the downside due to a very likely increase in protectionist measures by the Trump administration, which could weaken the European economy, the main export destination of Central European countries.

NO RETURN TO INFLATION TARGET BEFORE 2026

In the region, inflation rose again in October. One of the reasons for this is the rise in food prices. Specifically in Hungary, the Financial Transaction Tax introduced last August also contributed to the increase. For Poland, the rise in inflation is temporary as it is the result of the increase in the cap on electricity and gas prices in the second half of this year. Inflation is expected to peak in Q1 2025 in Poland. However, the common denominator in several of these countries (Hungary, Poland and Romania) is a return to moderate disinflation in 2025 as wage pressures remain high and core inflation is therefore higher than headline inflation. Slovakia, meanwhile, is expected to see a more marked acceleration due to the removal of energy-related support measures and the increase in the VAT rate from 20% to 23% from 1st January 2025. A return to the Central Bank inflation target is not expected until 2026 for most Central European countries including Poland, Hungary, Romania and Slovakia.

REAL GDP

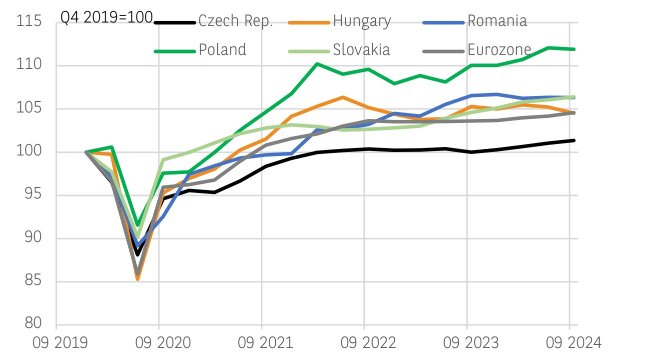

CHART 1 SOURCE: EUROSTAT, BNPPARIBAS

CENTRAL EUROPE: CONSUMPTION GROWTH IN VOLUME

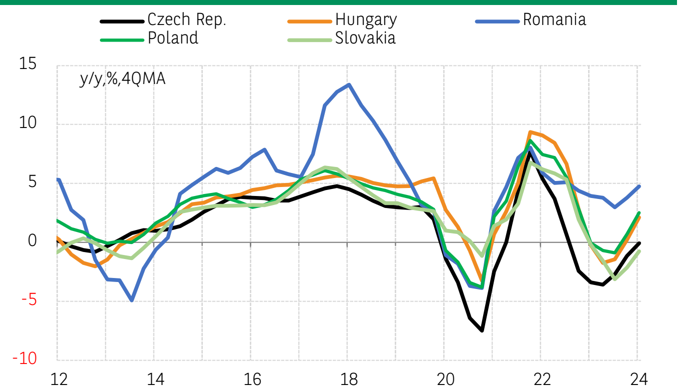

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

ACCOMMODATIVE MONETARY POLICY

The significant drop in inflation since the peak observed at the beginning of 2023 facilitated the adoption of monetary easing in most countries in the region in late 2023, but the extent of such easing differs from country to country. The central banks of the Czech Republic and Romania opted for relatively moderate easing with a cumulative drop of 225 bps and 25 bps, respectively. In Hungary, the key rate cut was more aggressive at 650 bps cumulatively, although this stemmed from a more aggressive tightening a year earlier. Poland, which had lowered its key rate twice in September and October 2023, has maintained a monetary status quo since then (key rate unchanged at 5.75%). This caution can be explained by expectations of a rise in inflation from mid-2024 onwards.

In the short term, a change of course in monetary policy is expected for both Hungary and Poland. Monetary easing in Poland is expected by the end of Q1 2025 at best, based on recent comments from the Central Bank. At the end of 2025, Poland's key rate could reach 4.00%. In Hungary, the monetary authorities have recently shifted towards a pause, probably until March 2025, which is when the mandate of the current Central Bank Governor comes to an end. After that, easing should not be ruled out.

TAPPING INTERNATIONAL BOND MARKETS

Four countries in Central Europe have been placed under excessive deficit procedure by the European Union. Poland, Hungary and Slovakia are concerned since this summer. Romania has been under this status for a much longer period (since early 2020). In Poland, the budget deficit of 5.3% of GDP in 2023 is expected to worsen in 2024. In Central Europe, the widening fiscal deficit and the resulting increase in public funding requirements have prompted governments to raise more funds from international bond markets since 2023. This momentum intensified in 2024 and is also expected to be sustained in 2025. According to Bloomberg, before 2023, the amount for all Central European countries was barely USD 10 billion per year. This amount was over USD 30 billion in 2023 and is expected to largely exceed USD 40 billion in 2024. Poland, Hungary and Romania have raised external funds several times this year. In 2025, Poland is also planning to do so.

Central European countries have highly developed domestic bond markets, therefore raising debt on the international bond markets may initially seem surprising. The explanation is twofold. Firstly, the cost of borrowing in eurobond markets is much lower than the cost of borrowing in domestic markets, despite the monetary easing that has already begun in some countries. Secondly, making use of external financing helps limit a crowding out effect of private companies on the domestic market in competition with the State.

The increase in bond issues in foreign currency obviously comes with a higher currency risk for the sovereign. This risk remains manageable at present, taking into account prudent management of public debt in Hungary and Poland. The limit of public debt in foreign currency is 30% in Hungary and 25% in Poland The limit of public debt in foreign currencies is 30% in Hungary and 25% in Poland (with temporary overruns possible in the case of Poland). For both countries, the ratios are close to their limit but have not gone beyond that limit. In Romania, on the other hand, the ratio is very high at 51.8% in 2023. Given that the majority of foreign currency debt is in euros, currency risk remains contained, since the country has adopted a managed currency regime,

CENTRAL EUROPE: POLICY RATE

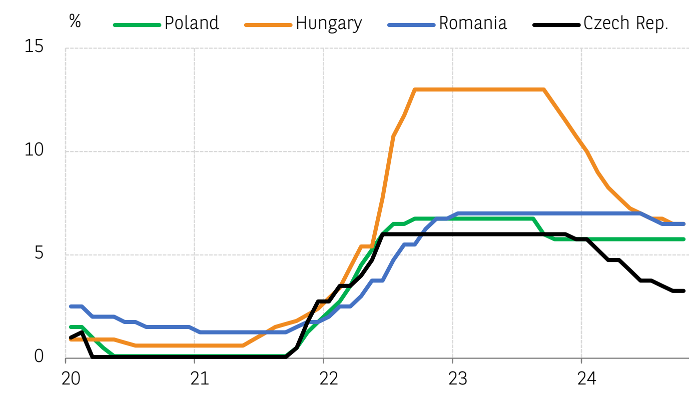

CHART 3

SOURCE: CENTRAL BANKS, BNP PARIBAS

which maintains relative stability of the Romanian currency against the euro.

REBOUND IN CAPITAL FLOWS IN Q3

Foreign currency reserves in Central European countries reached EUR 467 billion at the end of October 2004, that is, an increase of EUR 39.5 billion over the first 10 months of the year. This figure is already higher compared to 2023. Poland alone contributed 50% to this increase, followed to a lesser extent by Hungary and Romania.

The more marked increase in foreign currency reserves since 2023 can be explained in part by the return of the current surplus in Hungary, Poland and the Czech Republic. In addition, the importance of foreign capital flows in the region also supports this. In particular, 2021 and 2022 were marked by a strong return of foreign direct investment (FDI) and portfolio flows. These slowed down in 2023 but remain close to the average of pre-COVID-19 years. This year, net capital flows remained strong, even though there was a decline in Q2 2024. The preliminary estimates for some countries in Q3 show a rebound that has largely offset the decline in the previous quarter.

Poland, Hungary and Romania have captured most of the net FDI flows over the past three years. Importantly, Romania has also become a key destination for net portfolio flows since 2020 (1.7% GDP in 2021, 2.4% in 2022, 6.5% in 2023). Meanwhile, reforms have been put in place to obtain the emerging country status (currently in the frontier markets category) and to be included in the MSCI Emerging Markets Index. Romania's attractiveness for capital flows should be enhanced if this objective was to be achieved quickly.
In the short and medium term, the region remains an attractive destination for capital flows due to the reorganisation of the production activity of developed countries, in response to the supply shocks experienced during the COVID-19 crisis and to the rise of protectionism. Meanwhile, Hungary has also benefited from Chinese FDI since 2022.

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