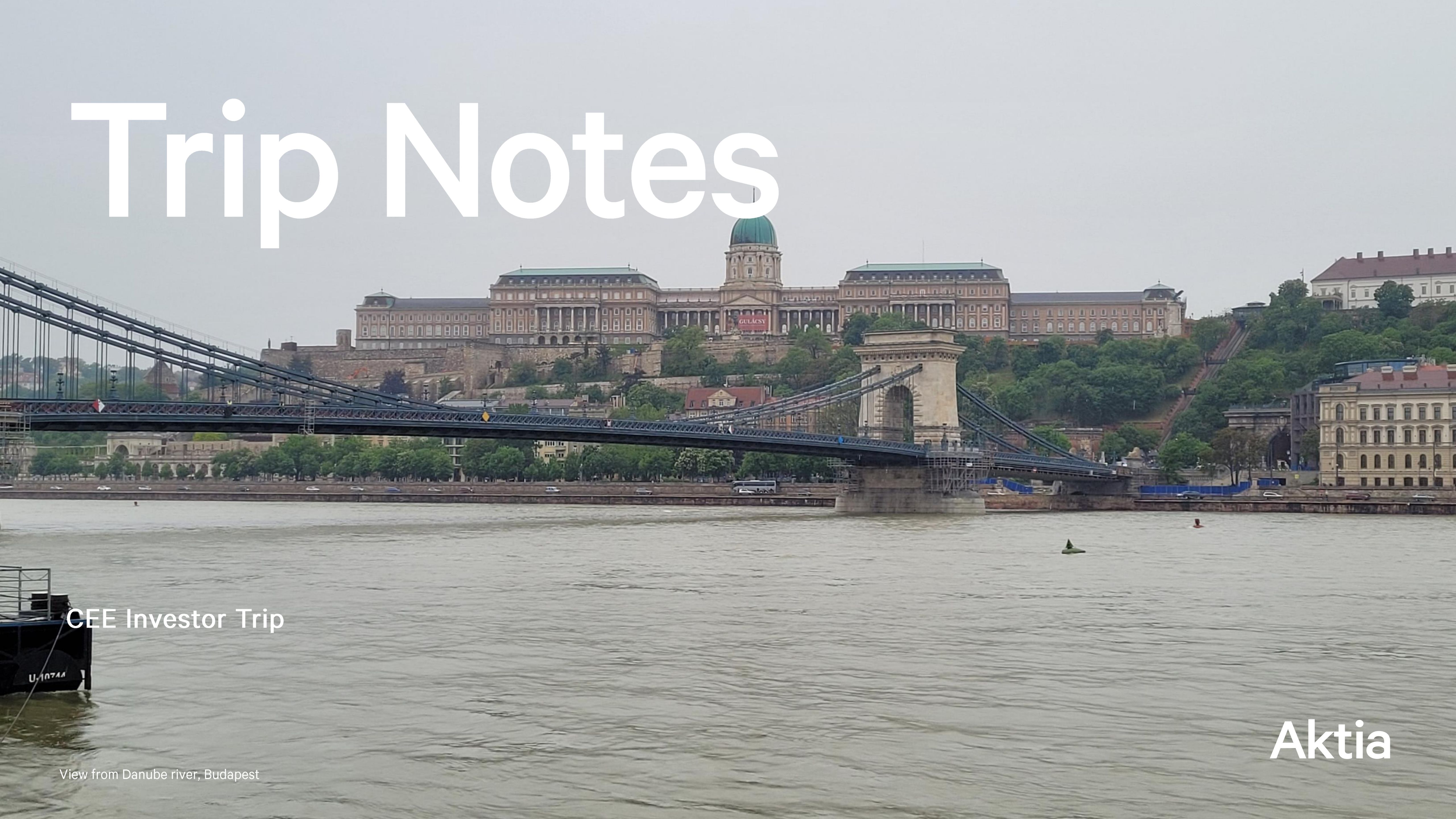
Trip Notes

CEE Investor Trip



View from Danube river, Budapest

Aktia

Political Turbulence in CEE

- During our visit to Central Eastern Europe (CEE) countries Hungary, Romania and Poland, we had numerous meetings with policymakers, economic experts, and political analysts. Overall, the CEE countries we visited are confronted with various economic and political challenges, including inflation, fiscal deficits, rule of law issues, and upcoming elections.

- Hungary is currently grappling with two significant challenges. Firstly, it faces the highest inflation rate within the EU, but also among EM. Secondly, Hungary is experiencing disagreements with the European Commission regarding rule of law issues.

- In Romania, the main concern revolves around a high structural current account deficit, which is primarily financed through Foreign Direct Investment (FDI) and EU funds. Politically Romania is enjoying a stable period

- Poland is dealing with both high and persistent inflation, primarily due to a tight labor market and substantial fiscal spending. Additionally, the country is facing rule of law challenges with the European Commission. Parliamentary elections are set for the autumn, and three more elections are scheduled for 2024.

Picture of the Central Bank of Poland. The billboard states that inflation is due to two reasons, Russias aggresion on Ukraine and the pandemic

Overview

Central Eastern European countries are currently grappling with several common challenges. One prominent issue is the persistently high inflation, with an unfavorable outlook. Core inflation especially has shown stickiness. Factors such as labor dynamics and extensive fiscal spending contribute to inflation remaining above central bank target bands especially in Hungary and Poland. This has led to high interest rates and shrinking household consumption in the countries we visited.

The European Union's Recovery and Resilience Facility which is designated to aid countries in recovering from the impact of the Covid-19 shock. The primary objective of this program is to provide affordable financing to enhance green infrastructure. The funds are disbursed in installments, referred to as tranches, with each country's program being allocated either five or ten tranches. To access the funds, specific milestones (reforms) and targets must be achieved. In cases where certain goals are not met, partial payments can be made. For some countries, notably Hungary there are super milestones that must be completed to unlock any funding at all.

One significant challenge faced by many countries is the strict deadline of 2026. By this year, projects must be completed to receive funding. Given the inherently sluggish nature of infrastructure projects, there is a risk that some projects may not be completed in time. This would render a country ineligible to request payments from the Recovery and Resilience Fund tranches, as the funds can only be allocated upon the completion of investments.

Furthermore, upcoming elections will play a crucial role in the coming years. Romania is expected to have four elections in 2024, while Poland will hold parliamentary elections in the autumn, alongside three other elections in 2024. Hungary, on the other hand, has only upcoming EU elections in 2024. The increase in election spending is likely to exacerbate fiscal issues, while politicians prioritize appealing to their voters rather than focusing on necessary reforms. Poland and Hungary also face the challenge of EU politicians attempting to demonstrate a tough stance towards them, which may complicate matters concerning the rule of law conditionality procedure. If these issues persist and hinder their access to EU funding, the prospects of fully utilizing the allocated funds from the Recovery and Resilience Fund will diminish. While the European Commission serves as the primary decision-making body, the parliament does possess the power to hold the commission accountable to enforce EU principles.

Hungary

Hungary has demonstrated robust economic growth despite the challenges posed by the COVID-19 pandemic. After experiencing a decline of -4.6% in 2020, the country swiftly rebounded with a growth rate of 7.1% in 2021, followed by a solid 4.9% growth in 2022. This growth has been mainly driven by investments, which is the highest rate of investment in the European Union (EU). The authorities highlight a mix of foreign direct investment (FDI) and public and private investments. Asian investors, particularly Chinese companies involved in electric vehicle (EV) manufacturing, have been active, acquiring large logistics fields and establishing a presence close to car production centers in Hungary.

However, the most pressing economic challenge in Hungary is inflation, which currently ranks the highest in the EU. Inflation peaked at over 25% YoY at the beginning of the year and has only moderately decreased to around 21%. Disinflation is expected to accelerate due to base effects. Hungary implemented measures to combat inflation in 2022, causing the inflation peak to occur later compared to other CEE countries. The central bank's inflation target of 3% suggests the likelihood of higher interest rates for an extended period but cuts to the basic rate is to be expected already this year. Low unemployment rates and unfavorable demographics hinder disinflation, making wage negotiations difficult. Wage growth is projected to remain above 7%. Given these factors, the central bank does not foresee a return to pre-COVID monetary policy conditions.

In May, the central bank indicated its intention to lower interest rates and implemented a 100 basis points cut to the overnight deposit rate. The central bank plans to gradually reduce the deposit rate until it reaches the basic rate, after which the two rates will start to move in tandem. The deposit rate is expected to equal the basic rate sometime in autumn. The decision on cuts to the basic rate is still pending and subject to ongoing data assessment. Pressure from other institutions has urged the central bank to lower rates, but it emphasizes its independence and commitment to its own strategy. The primary focus remains on curbing inflation, which has already affected domestic demand, resulting in a decline of over 10% earlier this year. Consequently, the Hungarian economy experienced a technical recession. The central bank aims to offer the highest carry in the region, as there is a significant amount of hot money in the economy. Additionally, maintaining a strong foreign exchange rate would aid in reducing inflation. The appropriate level of real carry is still under discussion, with considerations around 3%.

The relationship between Hungary and the European Union (EU) has been complex and challenging, primarily due to disagreements regarding rule of law issues. The EU has suspended the disbursement of EU funds to Hungary as a result. Hungarian authorities anticipate that the funds will be unlocked once the new judicial reform is passed into law. However, there is no guarantee that the solution will meet the European Commission's requirements. Despite the challenges, Hungarian authorities remain hopeful, considering the technical assistance provided by the EU throughout the reform process.

Hungary

The disbursement of the first tranche of the Recovery and Resilience Funds in addition to cohesion funds is contingent on the completion of 27 super milestones, which are more stringent than regular milestones. These milestones must be achieved before any cohesion funds or funds within the framework of the RRF plan can be released. There is a risk that Hungary may not be able to utilize the entire allocated amount of RRF funds by the 2026 deadline. To address this concern, Hungary has taken proactive measures by initiating the financing of projects ahead of schedule, recognizing that RRF funds are intended for completed projects. Currently, approximately 22 billion euros are blocked due to judicial reforms, while an additional 9 billion euros are tied to issues such as academic freedom, LGBT rights, and migrant-related matters. The specific allocation of funds varies for each topic.

In 2022, Hungary faced significant challenges related to its reliance on gas. However, by negotiating a special exemption to use Russian gas within the EU, the country managed to avoid a major shock. Currently, gas storages are at satisfactory levels. Full gas storages would provide energy reserves for approximately two-thirds of the year, with winter being the critical period. Authorities had implemented measures to address energy prices, including price caps and windfall taxes, while also enacting laws to manage consumption. New energy projects, such as the construction of gas pipelines, are underway, and Hungary has established pipeline connections with six out of seven neighboring countries. Additionally, private companies and households have made substantial investments in solar energy. However, the existing energy grid in Hungary is not equipped to handle peak energy production, highlighting the need for

Hungarian Parliament entrance

Hungary

infrastructure upgrades. Updating the energy infrastructure is one of the main focuses of EU funding programs such as the RRF, RePowerEU, and Fitfor55. It is worth noting that a controversial nuclear power plant project, with Russian company Rosatom as the main contractor, has raised questions about a potential EU intervention, which could potentially cause a delay of at least five years if a new contractor would be required.

The political climate in Hungary is currently in an interesting phase. The ruling party, Fidesz, holds a super majority in parliament, which can facilitate reforms, for better or worse. However, it is notable that the government has developed closer ties with Russia and China. There have been rumors and media discussions regarding a potential Hungarian exit from the EU. The likelihood of this scenario has increased due to Hungary's growing interest in securing financing from China and the Middle East. Such an outcome would have a significant impact on the Hungarian economy, considering that almost 80% of all exports are destined for EU countries.

To diversify its sources of financing away from the EU, the Hungarian government is increasing the issuance of retail bonds, available exclusively to households. EU funds do play a significant role in the fiscal budget and if EU funds remain blocked throughout the year, it would necessitate issuing new bonds equivalent to 2% of GDP. Hungarian authorities are currently finalizing their new green bond framework as part of their efforts to explore alternative financing options.

View: Hungary is defined as red in our country selection framework i.e. we are we are not willing to finance the government mostly due to governance issues. We acknowledge the risk regarding EU funding still exists, but at the same time Hungary's external environment has become more benign for the currency on the back of improving terms of trade. Hungary's nominal carry in the short end of the curve is very good, and we expect the central bank to be cautious with monetary policy easing and focusing on keeping the currency in check. However, we see the current valuation challenging and have reduced our Hungary exposure.

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Romania

Romania experienced robust economic growth during the Covid pandemic. After a dip in 2020 with a contraction of -3.7%, the economy rebounded strongly, achieving a growth rate of 5.9% in 2021 and 4.5% in 2022. This growth has been driven by strong domestic consumption and public investments. While growth is expected to remain strong in 2023, there are signs of it starting to weaken, likely due to the impact of high inflation on consumption. The following year is also expected to see weaker growth, but it should help to moderate inflation and alleviate current account issues due to less strong imports.

Romania faces systematic current account issues, as the current account deficit (CAD) reached over 9% in 2022, primarily driven by higher energy and food prices. The CAD is projected to narrow down to 7% in 2023 and gradually moderate in the coming years. However, the deficit is likely to persist due to high fiscal expenditure and relatively high domestic consumption, resulting in a negative trade balance. A 1% reduction in fiscal spending over two years would decrease the CAD by 0.5%. Fortunately, the CAD is financed by foreign direct investment and substantial EU funding, which is one of the largest in proportion to GDP in the European Union.

Inflation peaked at 17% YoY last year and has already started to moderate, reaching 11.5% in April of this year. The decrease in inflation has been driven mainly by base effects and reduced fuel prices. Core inflation reached a turning point in the spring and started to moderate in April, although it remains high at 14%. The central bank expects inflation to slow to single digits in the third quarter of this year. Their inflation model indicates a CPI of around 7% by the end ofthe year, with core inflation at 9.3%. The most significant deceleration is anticipated in the prices of processed foods. For 2024, the central bank forecasts CPI of 4.2% and core inflation of 4.8%, setting the stage for achieving their inflation target range in 2025. Given the persistently high inflation, the central bank will continue to maintain its policy rate at 7%, especially since there have been no issues in the banking sector, according to the central bank. Interestingly, the central bank entered the market and purchased 1 billion euros worth of Romanian government bonds during the US banking stress episodes, although the central bank denied it was to support a local bank, as speculated by most investors, but instead referred to keeping volatility down in the market. One concern for the central bank is the euroization of the economy, particularly as smaller companies have started to take out euro-denominated loans due to the interest rate differential. It is expected that euroization will slow down as the European Central Bank raises rates; otherwise, the central bank will implement prudential measures aimed to reduce euroization.

Romania benefits from significant EU funding, which is one of the highest proportions to GDP in the European Union. Much of the discussion revolves around unlocking the next tranche of funds from the Recovery and Resilience Facility (RRF). One major obstacle is the special pension reform, where government officials and workers receive special pensions, which can amount to up to 10 thousand euros per month. Since the law must be accepted at all levels, including the constitutional court, this can cause issues and delays as receivers of this special pensions must accept the amendment to the law. It is not considered very realistic to implement the reform in its entirety. Romania will likely opt for a partial payment to access the next tranche and hope to negotiate modifications to the special pension system. Interestingly, in the fourth tranche, one of the major reforms is centered around the entire pension system, including special pensions, so the issue will continue to persist.

Romania

Politically, Romania is seen as one of the most stable countries in the region. The ruling government plans to change the prime minister between the two largest parties at the end of May, but this is not expected to cause a significant shift in government plans or create divisions between the parties. However, the political climate is expected to become more challenging as 2024 will bring four elections: EU, presidential, parliamentary, and local elections. This may pose challenges for implementing RRF reforms in the economy. Romania is predominantly dominated by two parties, with no strong opposition to challenge either. However, a new right-wing party Alliance for the Union of Romanians (AUR) has emerged to shake up the political landscape.

View: Rating agency Fitch has recently revised Romania's outlook to stable from negative and affirmed the rating BBB-. Stabilization of public debt, gradual fiscal consolidation and greater political stability were key drivers for the decision. Inflation has peaked in Romania but the central bank re-opened door for tightening due to worsening global risk sentiment and slow and uncertain disinflation process. Romania is supported by its energy independence and EU transfers of around 4-5% of GDP per year. The current yield level offers pick up to the Czech and Poland government bonds and the managed floating exchange regime reduces short term fx-volatility. We have recently added to our holdings in Romania. We hold also EUR and USD denominated bonds in our Hard Currency strategy and it is one of our higher conviction positions in BBB category.

Picture of the Romanian Parliament building

Poland

Poland experienced a rapid rebound from the effects of the Covid pandemic. The country achieved a growth rate of 6.9% in 2021 and 4.9% in 2022. However, growth has already started to slow down, and is expected to slow to 0.9% for this year. The slowdown in growth in 2023 can be attributed to both internal and external factors. Nonetheless, growth is expected to pick up in 2024, particularly due to strong foreign direct investment. Poland has benefited from the trend of nearshoring, as it possesses higher quality infrastructure compared to other Central and Eastern European countries and relatively lower wages compared to Germany, for example. Furthermore, foreign companies have been constructing logistics centers in southern Poland in preparation for the eventual rebuilding of Ukraine.

Inflation has been running high in Poland and has displayed signs of being persistent. Forecasts indicate that inflation will not even reach the central bank's target band by 2025 due to labour markets being tight and high fiscal expenditure. However, there are already positive signs, as peak inflation was reached in February, and it is believed that inflation will reach single digits in 2024. Food and energy prices have been major contributors to inflation, but core inflation has also remained strong. The unemployment rate in Poland is one of the lowest in the EU, and there are indications that it will continue to fall. Efforts are being made to activate individuals outside the workforce, such as women on parental leave who face challenges in reentering the workforce.

The fiscal deficit in Poland has remained high, particularly as election spending is in full swing for the upcoming elections in autumn 2023. Both the opposition and the government have recently announced new fiscal policies, including free pharmacy drugs and increased child support. It is surprising that the opposition, previously known for its fiscal conservatism, is also engaging in election spending. This situation resembles a poker game where each party raises the stakes. Fiscal consolidation is expected to begin in 2025, once the election cycle has ended. However, the focus is likely to be more on the revenue side. Military spending in Poland is among the highest in the EU, accounting for 2.2% of GDP and putting significant strain on the budget. The issue is that both the EU's fiscal spending framework limits are broken and Poland's government debt ceiling is creeping closer. It is probable that Poland will raise its debt ceiling and attempt to negotiate with the EU to exclude military spending from the excessive deficit procedure. The views on the probability of the EU approving military spending outside the fiscal budget are mixed.

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Poland

The Monetary Policy Committee (MPC) consists of 10 members, three of whom are chosen by the president, three by the parliament, three by the senate, and the governor is the head of the central bank. As a result, the MPC is heavily politicized and may not necessarily consist of the most competent monetary policy individuals. The MPC has not indicated any intention to cut interest rates yet, but there is a belief that if the ruling party, Law and Justice (PiS), were to lose ground, a rate cut might be implemented. This move could potentially appease voters and signal a stronger economic situation before the elections. Rumors suggest that the governor, Adam Glapinski, largely determines the monetary policy.

Poland is currently embroiled in a dispute with the EU regarding the rule of law procedure, which has led to the blocking of the first tranche of funding from the Recovery and Resilience Facility (RRF). Additionally, Poland's new local laws concerning LGBT rights has continued to strain the relationship with the European Commission, increasing the likelihood that even cohesion funds will be blocked. A rule of law reform has been passed through the parliament to address the issue surrounding the RRF funding. However, President Duda decided to refer it to the judicial tribunal slowing the process. Some judges are boycotting the tribunal due to judicial system reforms and the leader of the tribunal. As long as this boycott persists, the law cannot be approved, and the RRF funding remains locked. Authorities signaled that this situation will persist until the elections are completed in autumn, at which point a solution will be sought. However, the deadline for RRF projects is approaching, and to mitigate the issue, the Polish Development Bank has started to prefinance many projects.

There is uncertainty around the banking system in Poland. The European Court of Justice is set to issue its final ruling on foreign currency mortgages, primarily those denominated in Swiss francs, on June 15th. The base case scenario is that the court will rule in favor of banks having to repay all accumulated interest to clients. The worst-case scenario for banks is that the contracts are deemed abusive, and banks are not even entitled to recoup the principal, with clients receiving the principal, interest, and the property. In this scenario, banks would need to double their estimated provisions, and some banks could face difficulties. The underlying message is that these banks would either be acquired by other banks or by a government entity, thereby avoiding a full-blown banking crisis. However, the risks of widespread systematic issues are heightened.

View: Poland’s growth has disappointed to the downside and there has been renewed uncertainty over unlocking the EU fund. In addition to the political risks, we think that the underperformance for the Polish zloty may be driven by the central bank which could change its stance to more dovish in order to support growth. The fx valuation is rich and the bond yield levels are low compared to the risks, especially the real rate will stay low. We have reduced our holdings in Polish zloty. We have a position also in our Hard Currency strategy. However, we don’t view it as one our core positions, but it has worked quite well as a defensive play since we opened it Q4/2022.

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