CEE: Fiscal risk amid global turbulence

The region's economy continues to disappoint, although the recovery from last year is still underway. Figures for the third quarter once again show a mixed picture. The monetary easing cycle has essentially stopped and switched to a wait-and-see or fine-tuning mode

Clockwise from top left: National Bank of Hungary, The National Bank of Romania, Czech National Bank, The National Bank of Poland

Poland: Higher fiscal deficit and start of monetary easing only next year

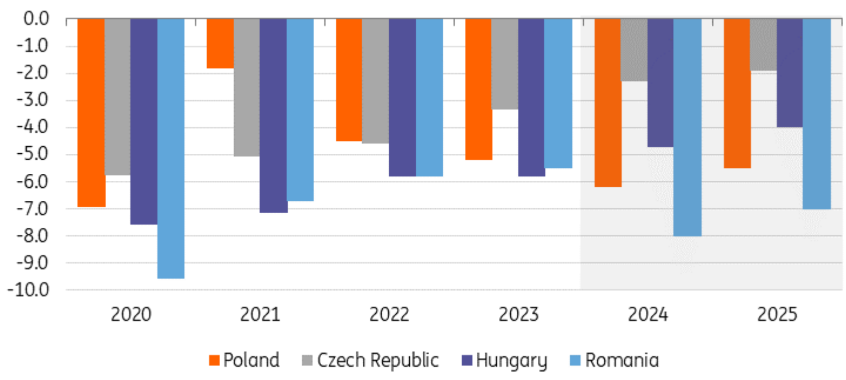
In the last days of October, market attention was focused on fiscal policy (the 2024 budget amendment) and the soft patch in GDP in the third quarter. Despite a volatile domestic backdrop, the general outlook didn't change much at November's policy meeting. Softer macro activity data for 3Q24 might suggest a less hawkish stance, but a more expansionary fiscal outlook and rising headline inflation still call for restrictive monetary policy. Most of the Council seems ready to discuss rate cuts in the first half of next year. We anticipate the first 25bp rate cut in the second quarter of next year, with a total reduction of 100bp in 2025.

September's data has confirmed that 3Q24 was softer than 2Q24, with annual GDP growth likely below 3%. We revised our 3Q24 GDP growth forecast to 2.5% year-on-year from 2.8% YoY due to weaker consumer spending. Hopefully, the sharp deterioration in consumption in September was not caused just by slower real disposable income growth (when headline CPI rebounded following energy price controls expired) but also by one-off effects like flooding in Western Poland. With easing consumption growth, declining fixed investment, and a worsening foreign trade balance, the downside risks to economic growth are increasing. But we hope this is a rather temporary soft patch, given that retail sales may recover and also that the PMI signalled a recovery for the fourth month in a row, recently matching some improvement in the structurally weak German automotive sector. Poland has other drivers of domestic demand, too, which may start in 2025, ie gradually increasing public investment due to the delayed start of the Recovery and Resilience Facility and cohesion funds. There is also significant potential for private investments, given that Poland's private debt is the second lowest in the EU. We forecast economic growth in 2024 may be close to, but below, 3%.

Headline inflation continues to rise due to less favourable base effects, energy price normalisation, and upward pressure on services prices, keeping core inflation high. High wage growth continues to drive services prices up. Headline inflation hit 5.0% YoY in September and is projected to peak around 5-6% YoY in early 2025 before moderating in the second half of the year. Our models still suggest that slower wage growth should bring inflation down in the second half of next year and 2026.

Authorities have finally embraced the fact that the 2024 revenues in the budget act were overly optimistic and in the draft budget amendment bill revised them down by PLN56bn. With spending plans unchanged, this boosted the state budget deficit and borrowing needs accordingly. The intention is to cover most of the new needs in 4Q24 from the liquidity cushion (around PLN130bn at the end of October), but it may reduce 2025 pre-financing needs. We also think the government may have shifted some of the 2025 spending to the 2024 budget. The general government deficit in 2024 may slightly exceed 6% of GDP vs the 5.7% of GDP planned a few weeks ago, making the 2025 fiscal adjustment effort even bigger than initially planned if the 5.5% of GDP target for 2025 remains unchanged.

Public finance balance (% of GDP)



Source: Macrobond, ING forecast

Czech Republic: Upper range inflation in a sub-potential economy

The Czech economy is expected to further operate below its potential, expanding by 0.9% this year and by 2% next. Private spending will remain the key driver of the economic rebound as household budgets continue to benefit from solid real wage growth. Consumption expenditure remains well below pre-pandemic levels but this gap is narrowing. Meanwhile, the industrial base is likely coming out of a protracted malaise, which would be reflected in next year's fixed investment contribution to economic performance. Indeed, the very hesitant investment approach is not good news for future growth, and Czech firms have started to realise that this will leave them at the mercy of fierce global competition, regardless of what Brussels does in terms of trade policy.

Inflation will likely increase to above 3% by the end of this year, yet announced reductions in electricity prices by large distributors are assumed to bring it back to the target early next year. In contrast, core inflation should remain elevated as price growth in the service sector remains sticky. The rebound in property demand and revival of the construction sector implies some price acceleration in the residential segment, which carries the potential to push rents higher. Despite recent job losses in the industry, the continued tightness in the labour market is set to contribute to solid nominal wage increases which should foster the appetite for spending and potentially drive price dynamics in the services and food segment.

Monetary policy conditions remain tight, as the recovery is only gradual, and the economy will likely remain below its potential over the next year or so. However, we expect rates to be reduced only gradually due to elevated core inflation, with a target level of 4% this year and 3.25% next. Such a cautious approach should support the domestic currency over the coming months and quarters, along with the foreseen economic pickup.

Hungary: Bracing for impact

Third-quarter GDP data surprised sharply to the downside, even relative to our already pessimistic view. The Hungarian economy slipped into a technical recession for the second time in three years. After a contraction of 0.2% in the second quarter, economic activity contracted by 0.7% on a quarterly basis in 3Q24. Based on the incoming data, we have lowered our GDP growth forecasts to just 0.6% in 2024 and 2.9% in 2025. The labour market deteriorated surprisingly in the third quarter, with employment falling and unemployment rising. It is too early to overreact, but it may be that companies have started to rationalise their workforce as the economic outlook deteriorates. The country's external balances have remained in positive territory, although here, too, there has been some kind of reversal as export activity has weakened. Nevertheless, we expect the current account to remain above 2% of GDP in the coming years.

After 44 months, headline inflation reached the central bank's 3% target in September. But this will be a short-lived visit as inflation will pick up in the fourth quarter due to base effects and rising fuel and food prices. We see inflation averaging around 4% next year. The National Bank of Hungary's room for manoeuvre has been severely constrained by the significant weakening of the Hungarian forint, first triggered by the market's excessive expectations of a rate cut, then by geopolitical risks and by the EM FX sell-off related to the rising chances of a Trump win and the potential for tariffs, which hit the forint hard. While the central bank kept the key rate unchanged in October and sent hawkish signals (prolonged period of unchanged rates), risk aversion continued, pushing EUR/HUF above 408.

Given the weak economic activity, the risk of significant fiscal easing is clearly increasing. This could heighten market concerns and place the forint under pressure due to potential downgrade risks from rating agencies if both GDP growth and the fiscal outlook worsen. Consequently, the market is now anticipating a rate hike from the National Bank of Hungary, instead of a rate cut. The outcome will hinge on the initial reaction following the US election.

Romania: Strong internal demand and fiscal looseness to keep upside pressures on rates

We expect domestic demand to remain robust in the third and fourth quarters. Higher pension income and public sector wages will provide a boost to disposable incomes while private sector wages will likely still grow at a robust pace. Meanwhile, net exports are set to continue to contribute negatively to growth in the coming quarters.

In other news, upward data revisions by the National Statistics Institute for the 2023 GDP growth have put additional downward pressure on our already optimistic 1.3% GDP growth projection for 2024. That said, an even larger fiscal deficit projection for this year is set to add further near-term stimulus, countering the statistical base effect to an extent.

On the monetary policy front, the National Bank of Romania left rates on hold at its October meeting, in line with our expectations. We think that the current environment will convince policymakers to hold fire once again in November, while they continue to monitor both internal and external risks. The visible fiscal slippage, vigorous wage growth and geopolitical uncertainties are key considerations favouring prudence. For 2025, we foresee a total of 100bp of rate cuts, taking the key rate to 5.50%.

On the fiscal front, the budget deficit slipped visibly to 5.5% of GDP in January-September. We continue to expect a fiscal deficit of 8.0% in 2024 and 7.0% in 2025. Meanwhile, in October, the government published its medium-term fiscal adjustment plans, which are in line with our long-held view that the deficit will only see small adjustments in the near-to-medium, as the investment cycle is in full swing. While projected adjustments do not increase significantly even after 2026-2027, they will also coincide with the next election cycle, which is so far the key source of uncertainty and upside risk to the government's target of a 2.5% deficit by 2031.

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