

High inflation in Central and Eastern Europe calls for higher rates despite slowing economies

Despite the downgrade in GDP growth forecasts across the region, in our view, additional inflationary pressures and the need for higher interest rates should prevail



Poland: unusual economic slowdown

We keep our revised GDP forecast for 2022 at 3.2% unchanged. The downside risk to our forecast comes from further downside revisions for the eurozone, but the upside risk comes from very strong data in January and February – before the war in Ukraine started – which calls for first-quarter economic growth of around 7% year-on-year. Also, the government keeps delivering new spending. So far measures announced for 2022 have reached 3% of GDP (the anti-inflation shield 1.0 and 2.0, plus the extension for the second half of 2022; the cut of direct taxes, ie, Polish Deal 1.0 and 2.0). That should significantly cushion the negative impact of the inflation shock on disposable income. Still, Poland is facing an unusual economic slowdown this year, as the spending on the hosting of refugees should reach about 0.7-1.4% of GDP and keep consumption robust despite the inflation shock. The main hit to GDP should come from net exports and weaker investment.

The strong consumption should facilitate second-round effects and pass-through from higher commodity prices to CPI. Given that, we revised up our CPI forecast for 2022 to 10.5% on average and 8.4% year-on-year in 2022. The Monetary Policy Council (MPC) changed its stance and is targetting CPI and a stronger zloty, while the fiscal side should take care of GDP dynamics. This is still a policy mix, which doesn't address the long-term inflation risk. The National Bank of Poland (NBP) sent hawkish signals in March. Our analysis of the MPC reaction function indicates that with our GDP and CPI forecasts for 2022-23, and the MPC bias getting similar to that of the Council in 2010-16, rates should reach about 7.5%. We see NBP rates at 6.5% in 2022 and 7.5% in 2023 with risks to the upside.

Czech Republic: despite the risk of stagflation, the CNB's hawkish tone prevails

Although January's numbers showed a solid start, we believe that the Czech Republic is the most vulnerable country in the region in terms of stagflation. GDP growth projections for this year are heading towards the 1-2% range, while inflation continues to rise. We think it will peak in May/June at around 14% year-on-year, and although we expect a slowdown in the second half of 2022, we expect 10% for the end of the year. This pushes the inflation story into next year, and thus we believe the Czech National Bank (CNB) will maintain its hawkish tone. The terminal rate has moved to 5.75% in our forecast, and we see the first possible rate cut only in the second half of the year. On the fiscal side, the Chamber of Deputies has approved a new state budget for this year with a deficit of CZK280bn (4.6% of GDP), however, the Ukraine conflict will likely require an increase in spending. For the time being, however, the government has not introduced changes that would significantly alter the fiscal restriction narrative. Thus, we expect a public finance deficit of around 4% of GDP for this year.

The Czech koruna (CZK) has seen the fastest recovery in the region, returning almost to pre-Ukraine conflict levels, supported by the CNB's hawkish tone and announcement of its readiness to intervene in favour of the CZK. However, central bank liquidity data suggests that the koruna has strengthened with little or no intervention from the central bank side. Overall, we expect the CZK to strengthen further given the record rate differential and further CNB rate hikes, however, reaching pre-Ukraine conflict levels will be a bumpy road in our view.

Hungary: inflation and twin deficit is top of the to-do list for policymakers

Early indicators are showing a strong first quarter in Hungary despite the Ukraine war, with major downsides materialising in the second quarter related to supply chain disruptions. We see 4-5% GDP growth in 2022, although there are significant negative risks. We continue to believe that Hungary will be able to avoid stagflation. The development in the Hungarian forint (HUF) market as well as in commodities and global value chains point to further upside risks in inflation. Our call is sitting at 9.1% year-on-year in 2022, while the year-end headline CPI print could be around 8%. In our view, inflation will only reach the central bank's target in early 2024.

To anchor inflation expectations and mitigate the risks of second-round effects, we expect the central bank to continue its tightening up to an 8.00-8.25% terminal rate. With that, we see a positive real interest rate at the year-end and an inverted yield curve is also in striking distance. The latest opinion polls are favouring the Fidesz-KDNP political alliance to remain in power after the

3 April general election. After that, the focus must shift to improving fiscal and external balances, so we expect some budgetary adjustments to reduce the depth of the twin deficit.

Romania: higher rates to keep the FX stable

The high-frequency data available so far point to a rather solid economic activity in the first quarter of 2022 with industrial production and construction starting the year on a strong footing. When available, the March data might look on the weaker side, but this is unlikely to materially change the picture. As it stands, we anticipate a +0.2% quarterly expansion in the first quarter of 2022, which means that Romania should narrowly avoid a technical recession.

We have maintained our 8.8% average inflation forecast for 2022 after the government decided to extend caps on energy prices for consumers. However, risks are still clearly skewed to the upside given the latest surge in global commodities prices. The anticipated economic slowdown could offset some of the price pressures, but upside risks still dominate. We now see the central bank increasing the key rate to a minimum of 4.50% this year. This will keep the real rates deep into negative territory in 2022 and most likely 2023 as well.

FX wise, we maintain our view for a stable EUR/RON rate close to 4.95. [As anticipated](#), the liquidity context is providing a helping hand, as the entire FX swap yield curve has moved above 6.00%.

Authors

Rafal Benecki

Chief Economist, Poland
rafal.benecki@ing.pl

Frantisek Taborsky

EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Peter Virovacz

Senior Economist, Hungary
peter.virovacz@ing.com

Valentin Tataru

Chief Economist, Romania
valentin.tataru@ing.com

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