CEE: Inflation set to rebound with cautious economic recoveries

Inflation in Central and Eastern Europe has reached this year's lows and we are likely to see a rebound in some countries. Here, the challenge will be to distinguish between one-off effects and persistent inflationary pressures. It is clear that the battle with inflation is not over, which will complicate further rate cuts in the region

Poland: A weaker start to 2024, but expected CPI rebound to keep rates unchanged

The beginning of 2024 surprised to the downside and weak industrial output and construction data has prompted us to revise our first quarter economic growth forecast down from 2.1% year-on-year to 1.5%. With construction output down by some 8% YoY in the first quarter, we may even see a decline in fixed investment in annual terms. At the same time, we still believe in a consumption-led recovery and 3% GDP growth in 2024. Even though corporate profits narrowed (less robust mixed income), lower inflation and buoyant wage growth should allow for solid private consumption growth despite a higher propensity to save.

CPI inflation increased to 2.4% YoY in April on the back of the return of VAT on food and is expected to continue trending upwards as the disinflationary impact of the high reference base stemming from the earlier energy shock fades away. The partial withdrawal of the energy shield could lead to exceptional uncertainty in inflation in the second half of 2024 as the scale of the potential jump in electricity and gas prices is difficult to estimate. At the same time, core inflation is projected to remain persistently elevated amid a tight labour market and double-digit wage growth that is keeping services inflation high.

In the face of the upward trend in headline inflation, high core inflation and uncertainty surrounding the inflation outlook (partial withdrawal of energy shields), the National Bank of Poland (NBP) is expected to maintain a cautious approach and stick to a hawkish policy bias. We still believe the Monetary Policy Council will keep policy rates unchanged by the end of 2024 and start to discuss potential cuts later this year. In 2025 we forecast 75-100bp cuts in NBP rates.

Czech Republic: A cyclical upswing driven by household spending keeps the central bank on alert

The Czech economy continued its expansion at the beginning of this year, with growth of 0.5% quarter-on-quarter being a positive surprise. At the same time, real GDP has not yet risen above pre-pandemic levels. High inflation in recent years has put household budgets under significant pressure, with real wages falling a cumulative 18% from their 2021 peak. The recent return of consumer inflation to the Czech National Bank's (CNB) 2% target will ultimately be reflected in a return of real wage dynamics to positive territory, boosting households' appetite for spending.

The continuous improvement in consumer confidence since the beginning of the year suggests that economic activity is finally rebounding from two years of stagnation. However, this cyclical upturn will continue to be constrained by medium-term structural weaknesses such as high levels of regulation, insufficient support for innovation, and increasing Chinese competition in the auto industry. The Czech economy is thus likely to expand by 1.2% this year, with real growth accelerating to 2.2% next year.

Headline inflation had been tamed, but price growth in the service sector has remained strong, even amid a lacklustre economic performance. At the same time, labour market conditions are still tight despite some easing recently. Overall, wage-driven inflationary pressures could accumulate over the medium term, with the unemployment rate expected to hover only around 3% and nominal wage growth continuing at around 7% YoY. Therefore, we expect renewed strength in domestic demand to keep inflation in the upper tier of the CNB's tolerance band. The Board will likely be cautious about further cuts in the key interest rate. In our view, monetary policy will remain restrictive as the policy rate is expected to gradually fall to 4% by year-end.

The Ministry of Finance assumes the public deficit will fall to 2.1% of GDP this year as part of a consolidation package. As a consequence, government consumption is about to hamper economic growth this year, while the impact is expected to be neutral next year.

Hungary: An uncertain recovery

The Hungarian economy has started to emerge from stagnation, according to preliminary GDP data for the first quarter. However, high-frequency data still paints a rather mixed picture, so we haven't seen a general upswing yet, just some green shoots here and there. The very tight labour market has eased recently, so we expect the pace of wage growth to moderate gradually in the second half of this year. While this is good news from an inflation point of view (lack of wage-push inflation), a pick-up in domestic demand may be more challenging. The large trade surplus comes as declining export activity meets subdued import needs. The former is due to constrained external demand and the latter is due to lower energy costs and weak domestic activity. Coming back to price pressures, disinflation is about to end, with services and fuel inflation heating up. Base effects will take over and push inflation towards 5.5-6.0% by the end of the year. Given all the risks (inflation and money market), the central bank slowed the pace of easing in April and delivered a hawkish message. As a result, we are raising our mid-cycle terminal rate to 7.00%.

The government has officially raised the ESA-based deficit target for 2024 to 4.5% of GDP. However, we still see a risk of around 0.5-1.0ppt even for the updated target. We see pro-inflationary risks if the fiscal adjustment is implemented in the second half of the year. S&P also expects these measures to be carried out after the local and EU elections and in anticipation of this, affirmed Hungary's 'BBB-' rating with a stable outlook. However, we are concerned about the risk of a downgrade by Fitch given its latest comments. As a result, the forint is entering a complicated period with fiscal risks and a further narrowing of the interest rate differential. We expect EUR/HUF to return to the 395-400 range. The IRS curve should invert again. Hungarian government bonds continue to benefit from strong auction demand, but fiscal risk and a rebound in inflation may keep yields higher for longer.

Romania: Strong consumer activity and early fiscal slippage complicate the easing cycle

After slowing in 2023 to 2.1%, economic growth in Romania is set to pick up this year on the back of stronger momentum in private consumption. Early signs are already pointing in that direction. In January-February, retail sales were very strong and wage growth remained comfortably in double digits. Fixed investment growth, the key component which kept the economy afloat last year, is set to remain high but slow nevertheless, partly due to some delays in project execution and EU financing absorption. On exports, the recent improvement in German activity only make the outlook slightly less cloudy. Overall, we expect growth to accelerate to 2.8% in 2024.

On the monetary policy front, we think that the National Bank of Romania is preparing the ground for a cautious easing cycle ahead. Our call for a first rate cut of 25bp at the May meeting is still in place, although the most recent communication from the Bank made the situation less certain. We now expect a total of only 50bp of rate cuts by the year-end, with a terminal rate of 6.5%, driven by the fiscal slippage, high wage growth and stronger-than-expected private consumption early in the year.

On the fiscal front, the budget deficit slipped visibly to 2.06% of GDP in the first quarter (2024 official target: 5.0% of GDP). At this stage, we pushed up our 2024 deficit forecast from 5.5% to 6.0%, with upside risks still in play. The key factors to watch ahead are the outcome of the negotiations with the European Commission (EC) in June and the growing debates on whether military spending should be exempt from the metrics. Getting to -3.0% of GDP looks out of sight until 2027-2028 at the earliest.

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