

## CEE: Reflation theme intact despite more lockdown measures

Despite prolonged lockdowns, the reflation theme is intact. CPI will be running above target, but some are more willing than others to tolerate it. The Czech Republic is set to tighten later in the year but Hungary might be the first to hike, forced by FX. Look for steeper CEE curves. Steepening pressure on high yielders Turkey and Russia should be limited



Capital City of Prague,  
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Source: Shutterstock

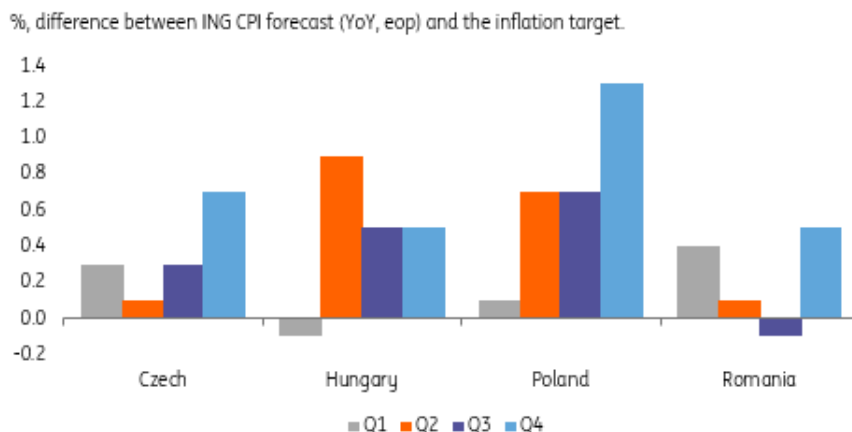
### More lockdowns, but reflation theme intact

Despite the extension of lockdown measures across Central and Eastern Europe, the reflation theme remains intact. Inflation readings have been surprising on the upside across the region and headline CPIs are set to rise further. The recent inflation overshoots were, in large part, driven by volatile factors (food prices in the Czech Republic and Poland, energy prices in Romania) but the core inflation measures have also remained elevated (Poland and Hungary providing a case in point, with core prices around 4% in January).

For now, local central banks should take a Fed-like approach, tolerating the inflation overshoot

with no imminent desire to hike rates, particularly given that domestic economies are struggling with the extension of lockdowns. For some, however, the tolerance for inflation overshoots is larger than it is for others.

## Figure 1: CEE CPIs to persistently overshoot the inflation targets



Source: ING

## Some are more willing than others to tolerate the CPI overshoot

We continue to see two Czech National Bank rate hikes delivered this year, with the tightening being backloaded into the latter part of the year, due in part to the current (and regionally most pressing) Covid situation. The National Bank of Romania should take the second most hawkish (ex ante) approach, with another rate cut now being out of the question. The upside risks to Romanian CPI point to more stability in the managed EUR/RON, with limited upside potential to the cross (as Romania has relatively high FX pass-through).

While the National Bank of Hungary's ex ante approach is less hawkish than that of the CNB and NBR (unlike these two central banks, the NBH still engages into quantitative easing), ex post there is a high probability that it will be the first central bank to tighten in the low yielding CEE space. The expected sharp acceleration in Hungarian CPI inflation in April and May (above 4% year-on-year) may reinstate selling pressure on the forint and in turn lead to emergency hikes. At least one 15bp hike in the 1-week depo rate in the second quarter is now our base.

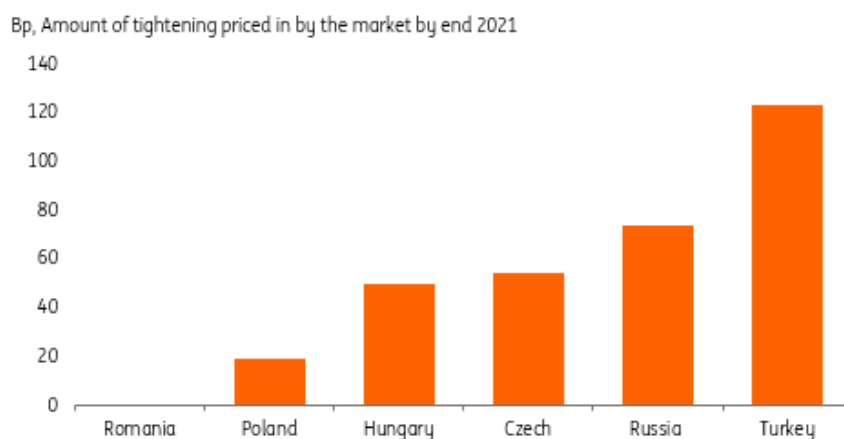
The dovish CEE spectrum is dominated by the National Bank of Poland, which is likely to look through the consistently above-target CPI this year, keeping rates unchanged and signalling little need for tight monetary policy. With the zloty less vulnerable than the forint given the vastly different current account positions (surplus in Poland vs deficit in Hungary), the odds of FX stabilising hikes in Poland are meaningfully lower than in Hungary. If anything, the NBP continues to verbally fight the zloty's strength.

## Steeper curve for CEE low yielders...

The low probability of imminent tightening among most of the CEE central banks beyond and above what is already priced in (Fig 2), the inflation premium being built into the back end of domestic curves (mainly the case for Poland and Hungary) and rising US Treasury yields (our developed markets rates team targets 2.0% on the 10y UST by 3Q) all suggest further steepening

of local curves in coming weeks. Eventually, the steepening pressure on CZK rates should fade as we get into 2Q and the post-Covid recovery brings us closer to the first hike, while the steepening trend should remain intact for PLN given the NBP's dovish bias. The HUF curve is likely to continue steepening for now, but should the forint come under pressure in the second quarter and the NBH is forced into emergency rate hikes, the curve should re-flatten. However, we are still some time away from this.

## Figure 2: Market is already pricing a meaningful tightening for most central banks



Source: ING, Refinitiv

### ... limited room for steepening among the EMEA high yielders

In contrast, we see more limited room for curve steepening in Turkey and Russia. In Turkey, the challenging inflation outlook over the coming months (not helped by rising commodity prices) keeps the possibility of additional central bank rate hikes in place. Also, should the risk of a further UST sell off materialise (which would in turn add pressure to long-end TURGBs) the associated currency weakness would also increase the case for hikes and limit the curve steepening potential. In Russia, bonds and rates sold off meaningfully, but with the vigilant central bank (which, due to a deteriorating CPI outlook, ruled out rate cuts and might be inclined to hike if CPI continues to surprise on the upside) and higher commodity prices, local bonds should show some resilience from here.