

CEEMEA FX Outlook 2022: Treating inflation with respect

Currencies from Central and Eastern Europe, the Middle East and Africa will struggle in the stronger dollar environment in 2022. Yet with a lot of tightening already priced in, we look for the Czech koruna and ruble to outperform steep FX forward curves. The Turkish lira and the South African rand look the most vulnerable



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More hikes coming, growth holding up

As has been the case the world over, inflation has surprised across the CEEMEA regions and most authorities have been forced to act. Russia has been the stand-out early mover looking to take rates into restrictive territory. Turkey is operating off a quite different cycle, where disinflation and currency stability no longer seem to be a priority.

In the CE4 region, all central banks should be hiking rates over coming months. Our team estimates that inflation rates should be peaking, perhaps in the 7-8% year-on-year range, into early next year. Of the four, the ever-hawkish Czech central bank should be taking rates towards the 3.50% area early next year, which should keep the CZK well supported. Our Polish team thinks the zloty is undervalued and that good interest for it emerges at EUR/4.70. Hungary faces some uncertainty from elections next spring and the forint may stay vulnerable, while the National Bank of Romania will likely require all its tools to keep EUR/RON stable.

Among the high-yielders, we favour USD/RUB continuing to trade in a 70-75 range, buoyed by impressive rates and a strong external position. While a push under USD/70 may be a stretch, the ruble should, however, outperform a steep FX forward curve. The USD/TRY forward curve is also very steep, but could get steeper as a weaker Turkish lira questions whether the Central Bank of Turkey needs to reverse its easing course. The South African rand has enjoyed strong gains in 2021, but mean-reversion in commodities and a more difficult external environment signals that USD/ZAR could be trading close to 17 by end 2022.

EUR/PLN: Re-positioning into Polish debt should help the zloty

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|------|--|------|------|------|------|------|
| EUR/PLN | 4.67 | Mildly Bearish  | 4.61 | 4.52 | 4.49 | 4.53 | 4.54 |

- NBP policy:** A long series of upside CPI surprises finally convinced the MPC that inflation is not going away anytime soon. The consumption-driven GDP structure, the strong labour market and another fiscal package (Polish Deal) etc. all hint at core inflation remaining elevated for years to come, even after the impact of energy commodities fades. We expect 2022 inflation to be even higher than this year (5.5% versus 4.9% year-on-year). The National Bank of Poland's rhetoric indicates that the central bank will continue rate hikes both in December and in 2022, reaching 2.50-3.00% in late 2022 / early 2023.
- POLGBs:** Local debt took a heavy beating in 4Q21 and 10Y yields have risen almost 150bp since August. Asset swaps have widened as well. In tandem, a weak zloty may entice foreign investors to approach the local market, especially since they are heavily underweight Polish bonds. This trend is partially under way already, as foreign holders have increased their positions since May, although at a slow rate. Increased unhedged exposure to POLGBs should help the zloty.
- The outlook:** The zloty is heavily undervalued, based on our long-term models. While Poland no longer benefits from a hefty trade surplus, unlike other CEE economies, it does not suffer from a significant deficit. The rise in interest rates offers the zloty support as well. Models point to levels around 4.50 for fair value. Many investors seem to agree, as large option positions have been opened, betting on PLN gains. In the short term, much may happen though. EM sentiment is uncertain given the situation in Asia. Poland is also at risk of further tension with the EU, as both sides await the European Court of Justice's ruling on conditionality of access to EU funds (due in early December).

EUR/HUF: Domestic policy divergence challenges the HUF

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|--------|------------------|--------|--------|--------|--------|--------|
| EUR/HUF | 365.00 | Mildly Bullish ↗ | 360.00 | 365.00 | 360.00 | 367.00 | 370.00 |

- NBH policy:** Although the National Bank of Hungary does not have an FX target, it has clearly signalled recently that it is ready to manage short-term market risks to help reach its inflation target over the monetary policy horizon. In this respect, the hawkish forward guidance, and the readiness to take immediate action should keep EUR/HUF around the 360 gravity line in the short-term. We see the NBH continuing with rate hikes through the first half of next year with a terminal rate of 3.5%. In the event of turbulent FX markets, we see the NBH calming markets with rate hike(s) in the 1-week deposit facility.
- General election:** The next Hungarian parliamentary election will be held in April 2022, which could be a really tight race between the governing Fidesz-KDNP and the six-party alliance. Such rare uncertainty in the political landscape could place the forint under extra pressure towards the end of the first quarter next year. Our base case scenario sees the reigning political force remaining in power with a small majority, which may help stabilise the HUF on the back of policy continuity. Should the opposition win the election, a power struggle could see more volatility in the currency.
- Domestic policy divergence:** The central bank is fighting an uphill battle against inflation as the government is pushing for GDP growth via fiscal easing. This easing will amount to roughly 8% of GDP during 4Q21 and 1Q22. Measures include public investment, tax refunds, tax cuts, pension bonuses and wage settlements. But the Ministry of Finance has admitted that fiscal consolidation needs to take place soon. This could mean reduced budget spending from the second half of next year. As fiscal consolidation begins, we see the NBH stopping the tightening cycle. In this respect, local policy divergence will come to an end, but international monetary divergence will create an environment where the forint is vulnerable to depreciation, which is the reason for our end '22 EUR/HUF forecast of 370.

EUR/CZK: Front-loaded CZK gains

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|-------|-----------------|-------|-------|-------|-------|-------|
| EUR/CZK | 25.20 | Neutral | 25.20 | 25.00 | 25.00 | 25.15 | 25.30 |

- Czech National Bank policy rate heading to 3.5%+:** Having hiked by 125bp to 2.75% in November, the CNB is expected to take the policy rate to the 3.50% area in early 2022 – 3.50% being the top of the CNB’s range for a neutral policy setting. It is yet to discuss restrictive settings! Driving the move is the CNB’s hawk-like focus on inflation, which is expected to hit 7% YoY by year-end. A 3.50% policy rate, dragging the 2-year CzechGB yields to the 2.75% area, would make Czech sovereign debt some of the most attractive investment grade bonds in Europe and very interesting for FX reserve managers.
- Time to let CZK do the tightening?:** The CNB’s Autumn projections forecast growth at 2% this year and 3.5% next. This assumes that 3M CZK Pribor moves up to 3.60% and that EUR/CZK heads down to 24.00 by the end of 2022. But what if EUR/CZK stays at 25.00 – would the CNB need to tighten more aggressively? One policy discussion that could emerge is whether the CNB starts selling its EUR140bn stockpile of FX reserves to drive CZK stronger. This is probably unlikely since the CNB will not want to target the currency and might struggle with a domestic PR exercise of suffering heavy losses on the FX it bought defending the 27.00 floor.
- Deficits the Achilles' Heel:** Aggressive tightening has driven the CZK higher this year and so far, weak domestic activity has not weighed on it. Yet the Czech economy is very exposed to the supply chain challenge, and auto sector production in some companies is being shut down until the end of the year. That will impact trade and leaves the CZK exposed to twin deficits into 2022. Additionally, the CNB acknowledges that the CZK is starting to trade like an EM currency, i.e. it weakens when the dollar turns bid. Given that we’re bullish on the dollar into 2022, we are therefore reluctant to forecast EUR/CZK substantially below 25.00.

EUR/RON: Many balls for the NBR to juggle

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|------|-----------------|------|------|------|------|------|
| EUR/RON | 4.94 | Neutral | 4.95 | 4.95 | 4.95 | 4.95 | 4.98 |

- Inflationary pressures:** Romanian inflation rose at an unexpectedly fast pace in 2021 as the global rise in energy prices overlapped the local market liberalisation for natural gas and electricity. This is pushing end-2021 inflation to around 8.0% and the profile will not look much better in 2022 when average inflation could well exceed 6.0%. The central bank began to tighten monetary conditions, squeezing liquidity out of the market and pushing implied yields higher by well over 100bp in less than two months starting in September. This makes long EUR/RON positions particularly expensive, and we expect to see this situation continue well into 2022.
- Local politics:** After the December 2020 general election, Romania was supposed to have four years of political tranquillity and plenty of time to do the right thing, given that no other elections are due until 2024. But the centre-right government coalition has nevertheless broken apart in less than a year and discussions now point towards a grand coalition between the liberals and socialists. This comes with important social measures to be included on the agenda for the future government, which in essence translate into increased pressure on spending. Whatever the outcome, it looks almost certain that the political scene will remain volatile, and monetary-fiscal coordination could suffer.
- Twin deficits:** While policy makers have long acknowledged the twin deficits, they've not only persisted but marginally deteriorated. We estimate both the current account deficit and the budget deficit to be around 6.5% of GDP in 2021, with the latter set to contract painfully slowly towards 3.0% of GDP – and most likely not before 2025, given that 2024 is an important election year. On the current account side, the improvements will likely be even slower due to the significant trade deficit. This represents a significant structural factor which will keep pressure on the local currency elevated, prompting constant FX intervention from the central bank. In this context, strong EU funds absorption will be key to maintaining the reserve adequacy levels within acceptable metrics.

EUR/HRK: Inflows to keep pouring in

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|------|-----------------|------|------|------|------|------|
| EUR/HRK | 7.51 | Neutral | 7.53 | 7.53 | 7.50 | 7.49 | 7.53 |

- **ERM-II:** Having entered the Exchange Rate Mechanism back in July 2020, Croatia will likely have no major issues in keeping the kuna stable around the central parity rate of 7.53 against the euro. The country is expected to have sizeable FX inflows in the coming years, the Recovery and Resilience Facility alone making the country the largest recipient of EU grants (around 11.6% of 2019 GDP). A sizeable part of these will likely end up in central bank's FX reserves.
- **Euro adoption:** With more or less transparent support from EU officials, the local policy makers continue to indicate that Croatia will be ready to join the eurozone in January 2023. Whether it will be 2023 or one to two years' later, it is becoming clear that the country has the EU support even without strictly meeting all the Maastricht criteria. Here, debt-to-GDP stands out as most divergent. Or, in the ECB's own words "Member States with government debt ratios to GDP in excess of 60% are expected to bring them down towards the reference level at a satisfactory pace".
- **Tourism & Vaccination:** The 2021 tourist season exceeded most expectations, with tourism revenues estimated at 90% of the 2019 level. However, with only around a 50% vaccination rate, Croatia is still exposed to pandemic waves and its "safe destination" status can be questioned. Thus, consolidating the economic recovery from 2021 into 2022 could be endangered if the pandemic dynamics are not firmly kept in check.

EUR/RSD: Mild policy reaction to inflation spike

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|--------|-----------------|--------|--------|--------|--------|--------|
| EUR/RSD | 117.60 | Neutral | 117.55 | 117.55 | 117.55 | 117.55 | 117.55 |

- Inflation:** Having the National Bank of Serbia (NBS) praise currency stability as a pivotal pillar of financial and price stability whenever it has the chance, the current spike in inflation will only cement the NBS's stance on FX. We see relative policy complacency against inflation reaching and likely overshooting 6.0% in 1Q22. The NBS is most likely to revert to very limited rate hikes before 2Q22 - the bulk of the policy reaction possibly being postponed until after April 2022 general elections.
- Politics:** Serbia holds general and presidential elections in April 2022. Current President Vucic and the leading SNS party will most likely win a comfortable victory. So far, the policy-making process seems to be surprisingly level-headed given the approaching elections, with the government cutting the 2021 budget deficit target to 4.9% of GDP from the previous 6.9% and already setting a 3.0% target for 2022.
- Ratings:** Despite the pandemic putting a brake on the upward rating trajectory, we believe that Serbia remains a relevant investment grade candidate. The current BB+ with a stable outlook that S&P and Fitch have on the country make the upgrade story a matter for early 2023 at best, while the Ba2 from Moody's extends this horizon even further. However, we underline our belief that the rating trend remains positive and an investment grade is in sight.

USD/RUB: Local environment largely constructive, but external constraints matter too

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|-------|-----------------|-------|-------|-------|-------|-------|
| USD/RUB | 72.80 | Neutral | 70.00 | 72.00 | 73.00 | 74.00 | 74.00 |

- Exports and fiscal rule are supportive:** The recovery in oil production, thanks to easing OPEC+ restrictions and global demand for commodities, should support Russia's current account. We expect annual export revenues for every US\$1/bbl of the price of oil to increase from US\$3.5b in 2021 to a historic high of US\$4.8-5.0b in 2022. While imports will play catch up, the current account surplus at US\$68/bbl Urals should reach US\$110-120b. The effect of high oil and gas prices will be largely sterilised by the fiscal rule. However, the planned local investment out of the sovereign fund may reduce the expected FX purchases by up to US\$12b per year – in 2022 – to US\$50b, or 42-45% of the current account.
- Private capital account remains the weak link:** Our biggest concern from the balance of payments perspective is related to the capital account. Contrary to some other observers, we do not take private capital outflows as the technical mirror image of the high current account surplus. The nature of the outflows - sustainable outward FDI by corporates, and the accumulation of cash abroad by households suggests that at least a portion of the outflows is structural (steady at US\$30-40b per year), keeping the ruble weak enough to maintain an elevated current account surplus.
- Portfolio flow is the key unknown:** In the environment of a strong current account counterbalanced by large private capital outflows, volatile portfolio flows are becoming an important factor tipping the scales for the local FX market despite its smaller volume. In Russia's case, local currency public debt (OFZ) is a key factor to watch. On the positive side, Russia's strong fiscal position and conservative monetary policy represent a competitive advantage over EM/commodity peers. However, foreign policy tension and higher inflationary concerns for the longer-term are restraining factors. And Russia is not immune to potential USD strengthening.

USD/KZT: Energy market to support tenge in the near-term, longer view remains cautious

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|--------|-----------------|--------|--------|--------|--------|--------|
| USD/KZT | 431.00 | Neutral | 425.00 | 420.00 | 425.00 | 420.00 | 430.00 |

- Energy exports are supportive:** The post-2020 recovery of the energy market is positive for the current account. We expect fuel exports to jump from \$24b in 2020 to \$31b in 2021 and \$38b in 2022. This will be thanks to the \$25/bbl price growth in 2021 and at least a 2% increase in volumes in 2022 amid an easing in the country's OPEC+ quota by 16 ths bbl/day each month till September 2022 - assuming no material oilfield maintenance. Fuel exports should help narrow the current account deficit from 3.7% GDP in 2020 to 1.9% in 2021, but the import catch-up should widen it to 2.5% GDP in 2022.
- Tighter fiscal policy may weaken state support to the tenge:** In 2022, the government is planning to tighten fiscal policy to fight inflation and to lower the consolidated budget breakeven oil price from \$100-110/bbl in 2020-21 to a more comfortable \$60-90/bbl in 2022-23. This will boost the accumulation of the state oil FX savings and limit the amount of FX the sovereign fund NFRK will transfer to finance current budget spending. Officials forecast it to decrease from \$11-12b in 2020-21 to \$7b in 2022, limiting the FX available to be spent on the local FX market.
- State capital inflows to narrow, private sector flows uncertain:** In 2020-21, Kazakhstan's capital account has been supported by the government: spending from NFRK and \$2.2b state foreign borrowing contributed to the overall net capital inflow of \$5.6b in 2020 and \$4.1b in the first nine months of 2021. For 2022, the expected fiscal tightening suggests a net increase of NFRK assets, and modest \$1.5b increase of public foreign debt, leaving the tenge vulnerable to private sector flows, which have been negative so far. In 2020 to the first half of 2021, net private capital outflows totalled \$4.7b and may narrow on a post-Covid recovery, but will remain subject to volatility.

USD/UAH: Hard to repeat the UAH gains of 2021

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|-------|-----------------|-------|-------|-------|-------|-------|
| USD/UAH | 26.40 | Neutral | 26.50 | 26.50 | 26.50 | 26.50 | 26.50 |

- NBU policy:** The National Bank of Ukraine reacted swiftly to emerging inflation risks in 2021 and raised its key policy rate from 6% in late 2020 to 8.5% in mid-2021. Because inflation stabilised around 11% in October and is expected to decline in the following months, the NBU kept its key policy rate unchanged at 8.5% at its late October decision meeting. According to NBU estimates, CPI peaked at 11% in 3Q and its macro forecast envisages that inflation will slow to 9.6% in 4Q 2021, and then to the target level of 5% at the end of 2022. At the same time, the projected policy rate is to fall to 7.5% in late 2022 and to 6.5% by end-2023, which – provided ongoing interest rate hikes in the CEE region and forthcoming Fed hikes in 2022 – will translate into a narrower interest rate differential.
- Low vaccination rates but relatively sound medium-term outlook:** Because of record high new Covid-19 cases in recent weeks, the authorities have been forced to introduce some preventive measures given that vaccination rates remains very low. In mid-November, the percentage of fully vaccinated people amounted to barely 20%, compared to 66% on average in the EU. Therefore, there is a risk that stricter lockdown measures will be introduced, constraining economic activity in 4Q this year and early next. Nonetheless, in 2021 as a whole, GDP is projected to grow at about 3% and accelerate to about 4% in 2022. This is because the economy is to become more resilient to the pandemic, and the country benefits from elevated export prices of industrial and agricultural goods.
- External flows affected by the natural gas shock in the EU:** Ukraine's current account deficit will be relatively low in 2021 on the back of a strong harvest and high export commodity prices. However, it will widen considerably next year as domestic demand recovers. Ukraine has been indirectly involved in the recent EU natural gas crisis which is translating into higher energy prices. This is due to Russia's policy to make the EU members buy natural gas from its new Nord Stream 2 pipeline, which is awaiting the green light from the European regulator, rather than use the existing pipelines in transit via Ukraine. Elsewhere, one positive for the UAH could be the inclusion of one Ukraine UAH-denominated sovereign bond in the JPM GBI-EM benchmark, effective end-March '22.

USD/TRY Policy mix leaves lira vulnerable

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|-------|-----------------|-------|-------|-------|-------|-------|
| USD/TRY | 10.20 | Bullish ↗ | 10.00 | 10.40 | 10.70 | 11.05 | 11.50 |

- Inflation Outlook:** Inflation will likely remain under pressure in the near term and at elevated levels in the first half of next year before starting to decline into year-end 2022, with the support of large base effects. We expect year-end and 2022 inflation at 19.2% and 16.5%, respectively, versus central bank projections of 18.4% and 11.8%. Given the broad-based deterioration in price dynamics due to high commodity prices, relatively high trend inflation and an increase in the FX pass-through, risks are significantly tilted to the upside for next year. This requires a restrictive policy stance.
- Monetary Policy:** Despite: i) all six core inflation indicators being above the policy rate after the focus shifted to core inflation, ii) recent sharp moves in commodity prices already impacting headline inflation and iii) significant weakness in the lira creating further cost-led pressures, the Central Bank of Turkey shifted to a more supportive stance with 300bp cuts recently. This is likely attributable to the objective of providing support to the real sector. Yet moves in the exchange rate will likely see expectations deteriorate further. This will add to already high inflationary pressures and implies that disinflation is not a policy priority currently. Unless we see a tighter stance to anchor expectations and foster price stability, the current policy setting is negative for the lira.
- Capital Flows:** Capital flows had improved since the change in CBT governorship in March. Portfolio flows had gradually returned to the bond market, issuance in the international market had increased, as had corporate rollovers. However, since the monetary policy shift (to easing) in early September, outflows from the bond market have amounted to US\$0.8b, and outflows via swap positions are at US\$8.2b, pulling the swap stock down to US\$5.4b. Going forward, external financing will likely remain a challenge given confidence issues among non-residents due to concerns about geopolitics, the grey listing of Turkey and the quality of the domestic policy framework. Vulnerability to a stronger USD and rising US real yields do not bode well for the currency outlook.

USD/ZAR: South African Reserve Bank thinks ZAR is overvalued

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|-------|-----------------|-------|-------|-------|-------|-------|
| USD/ZAR | 15.25 | Bullish ↗ | 14.75 | 15.50 | 15.75 | 16.00 | 16.50 |

- Challenging 2022 ahead:** The rand sits towards the slightly better end of EMFX performers this year. This seems to be wholly down to the Terms of Trade gains delivered by higher commodity prices. South Africa's current account surplus rose to a whopping 5.6% of GDP in 2Q21, driven by the trade surplus. This natural demand for rand from the export community has provided strong insulation to the ZAR. The problem is that the expected levelling off of commodity prices and the recovery in imports sees the South African Reserve Bank (SARB) forecasting the current account surplus dropping back to zero in 2022.
- Monetary policy looks unlikely to help:** South Africa has not suffered the kind of inflation spikes seen elsewhere in the world, meaning that the SARB has not rushed to hike interest rates. Indeed, with GDP set to slow from 5% in 2021 to 2% in 2022 and inflation looking set to remain within the SARB's 3-6% target range, the SARB may keep rates at 3.50% for longer than the market expects. Yet that puts the rand at an interest rate disadvantage to its commodity peer group and leaves the currency more exposed to the higher US rate environment in 2022.
- An over-valued ZAR:** In September, the SARB said that rand was trading above its long-term equilibrium value (USD/ZAR was around 14.50 at the time). An uncertain environment for China in 2022 (South Africa's main export market), receding help from commodity prices and a firmer dollar should all combine to drive USD/ZAR higher as 2022 unfolds. Additionally, the ANC government looks under pressure after scoring poorly in recent municipal elections, and South Africa's FX reserve defences look to be some of the weakest in the EM space. We think a weaker rand is the most likely catalyst for SARB hikes in 2022, which forewarns of a possible surge in USD/ZAR outright forwards.

USD/ILS: An interventionist Bank of Israel unlikely to change tack

| | Spot | Year ahead bias | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 |
|---------|------|------------------|------|------|------|------|------|
| USD/ILS | 3.10 | Mildly Bullish ↗ | 3.10 | 3.10 | 3.15 | 3.20 | 3.25 |

- Intervention, intervention, intervention:** In a weak dollar environment in January, the Bank of Israel (BoI) announced a new \$30b FX intervention fund when USD/ILS was trading down near 3.15. That kept USD/ILS supported up until recently when: i) the BoI announced the end to its QE plan ii) BoI 'used up' its \$30b intervention target and iii) inflation over 2% questioned whether the BoI really still needed a weaker shekel. In our experience, the BoI has been one of the most interventionist central banks around and it would be quite a shock were it to let USD/ILS crash below 3.00.
- Shekel story is a good one:** Yet the shekel story is a good one. Israel's 5%+ of GDP current account surplus is not just one driven by a temporary rise in commodity prices (even though Israel does have gas). Instead, Israel's strong position is driven by direct investment into its tech industry. Israel's economy is also expected to grow 7% this year and 5.5% next. And inflation above 2% may raise questions about whether the BoI should be lifting the base rate substantially off zero for the first time since 2015.
- Shekel as a safe haven:** In the EM hard currency bond world, Israel is known as a safe haven. A five-year sovereign CDS trading inside of 50bp and a solid investment grade rating sees Israeli assets outperform in more difficult investment environments. We suspect the stronger dollar environment will see USD/ILS trend gently higher through 2022, but we would fully expect the shekel to outperform some of the more vulnerable EM currencies such as the South African rand and the Brazilian real.

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