

## Central and Eastern Europe: One step further, but still not there

The general story in the region remains unchanged – more inflation means more interest rate hikes even though GDP growth is at risk. We expect the Czech Republic to reach peak rate hikes in the coming months, but other central banks are catching up fast. FX offers the potential for appreciation, but first we will need to see risk aversion subside in the market



### Poland: Double-digit central bank rate is no longer just a theoretical level

Inflation remains the main macroeconomic challenge for Poland in the near term. In April, CPI rose by 12.3% year-on-year on the back of soaring food prices and core inflation. External price shocks will continue propagating throughout the Polish economy as the current economic and policy environment facilitate it. Rising costs of energy and inputs are forcing businesses to increase their prices. Cost pressures are amplified by rising wages. Swelling household income and expansionary fiscal policy make it easy for businesses to pass on higher costs to consumers. According to the PMI survey, prices of finished goods rose for the twentieth consecutive month, reaching a new

record. We currently predict local peaks of inflation around 13-15% year-on-year in mid-2022 and at the beginning of 2023, but recent months show that the economic reality keeps surprising and we should be prepared for more negative scenarios with respect to price developments.

At the same time, companies are reporting weaker orders, both domestic and external. Companies surveyed in the PMI reported a decline in demand particularly from other EU countries, suggesting secondary effects of the war in Ukraine. Western companies are exporting less to the East and, in turn, are limiting their orders for components from Poland. This suggests that the impact of the war on exporters will be significant. In tandem with higher prices of imported resources, this suggests a high risk of further deterioration in net trade. Thankfully, Poland started 2022 on a high note (1Q22 GDP growth around 8% YoY), benefiting from domestic demand, as well as less severe supply chain disruptions. Also, in the coming months, domestic activity will be supported by spending from refugees.

The overall picture continues to point towards further monetary tightening, as confirmed by recent Monetary Policy Council comments. We may see the main policy rate at 7.5% this year. The terminal rate moves to 7.5-10%. A double-digit National Bank of Poland rate is no longer just a theoretical level. This should offer substantial support to the zloty, and we see EUR/PLN around 4.50 by year-end.

## Czech Republic: Interest rates peak within reach

The recently-released 1Q GDP result positively surprised with 4.6% year-on-year growth, reducing the risk of stagflation for the following quarter. However, we still don't have much information on the impact of the Ukrainian war on the economy and thus the risks are to the downside given that leading indicators are sending mixed signals. Early inflation numbers from the region suggest that inflation will continue to surprise on the upside. In the Czech Republic, we expect a rise from 12.7% YoY to 13.5% YoY for April and a peak in May/June at just below 15%, but inflation should remain in double-digits for at least the rest of this year.

April's state budget result showed a deficit of CZK100bn (vs our year-end forecast of CZK280bn), which is not a bad result given the additional expenditures, and we remain confident that the additional revenues caused by record-high inflation will keep the state budget close to the government's current plan, and the overall public finances will show a deficit of just above 4% this year. However, the government has promised to present a mid-year review of the state budget, which could bring additional expenditures and therefore higher Czech government bond issuance than our forecast.

On the monetary policy side, the Czech National Bank is clearly closest to the peak of interest rate hikes in the region and we expect the next central bank meetings to determine the peak in this cycle. At the same time, we do not expect the first interest rate cut before the end of the first half of next year. Thus, the base rate is expected to stall at 5.75%, but we believe that the theme of rate cuts will dominate the second half of this year. The koruna remains slightly above the upper end of our expected 25.30-25.50 band due to persistent risk aversion. We see the discussions on possible interest rate cuts as a negative factor for the koruna, although we see the reversal in EUR/USD as a positive factor. Overall, we do not expect significant moves in either direction from the koruna in the coming months.

## Hungary: Some good news in hard times

Incoming hard data suggest an unexpected acceleration in GDP growth in the first quarter. The driver is consumption fuelled by one-off transfers from the government in February and by the strong labour market. Hungary is close to full employment again and companies are facing labour shortages. This supports real wage growth, which is expected to be around 5% in 2022, despite our 10% inflation forecast. However, risks are clearly tilted to the upside when it comes to inflation, so we now see the peak at 11.5% year-on-year in September.

High inflation and ongoing upside pressure via the more positive output gap mean the central bank doesn't have time to relax. As we see the government eventually adjusting the budget by 1.5% of GDP to be able to meet the 4.9% deficit target, this could allow the National Bank of Hungary to stop the tightening cycle late in the third quarter. We expect the terminal rate at 8.25%. Hungary probably will gain more time to meet the EU's ban on Russian oil imports, reducing the pressure on the external balance in the short run. This is crucial for the forint, as it eases the systematic pressure on it and should help keep EUR/HUF around 380 in the coming weeks.

## Romania: Catching up with the regional hawks

The National Bank of Romania will hold its monetary policy meeting on 10 May and we expect another 50bp increase in the key rate to 3.50%. We see a considerable chance (say 30%) of a 100 basis point hike. More importantly, a new inflation report will be released which should show the NBR's inflation forecast revised higher compared to the February report. The latest inflation developments have been rather disturbing as prices for food items marked monthly increases which – until recently – could be seen only in a couple of years combined.

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 (and Romanian government bond curve) moved above 6.00% again. Liquidity shortages reached approximately RON10bn in March and we estimate that the system will be short liquidity for the rest of the year. Our 7% peak estimation for 10Y ROMGBs has already materialised. Reaching 8% by mid-year does not look like a risk scenario anymore but rather the next logical milestone.

Just after the Ukraine war started, we revised our 2022 GDP growth lower to 2.3% and pointed to further downside risks. Data for the first quarter points to quasi-stagnation, which is consistent with our expectations. 1Q GDP will be released on 17 May and we expect a 0.2% quarterly expansion.

## Authors

### Rafal Benecki

Chief Economist, Poland

[rafal.benecki@ing.pl](mailto:rafal.benecki@ing.pl)

### Piotr Poplawski

Senior Economist, Poland

[piotr.poplawski@ing.pl](mailto:piotr.poplawski@ing.pl)

### Frantisek Taborsky

EMEA FX & FI Strategist

[frantisek.taborsky@ing.com](mailto:frantisek.taborsky@ing.com)

### Peter Virovacz

Senior Economist, Hungary

[peter.virovacz@ing.com](mailto:peter.virovacz@ing.com)

### Valentin Tataru

Chief Economist, Romania

[valentin.tataru@ing.com](mailto:valentin.tataru@ing.com)

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