

## CEE: Sticky inflation risks force central bankers to keep on hiking rates

Disruptions in global value chains continue to weigh on Central and Eastern Europe, and the Delta variant is blurring the outlook for the fourth quarter. Yet the activity outlook for 2022 remains sound. Record high inflation can no longer be written off as temporary. We see rates getting close to 3% across the region



### Economic activity losing steam due to supply-side disruptions

After a strong rebound in the second quarter following the lifting of pandemic restrictions, GDP growth in Hungary, Poland and Romania, the 'CEE3', moderated in the third quarter. Sequential growth (quarter-on-quarter) may suffer in the last four months of the year, at least to a certain extent. Here are the main downside risks:

- **Supply-side bottlenecks in global markets.** This is especially true for companies trying to access microprocessors and it particularly affects the automotive industry. Production of vehicles and car parts is important for all CEE3, particularly in Hungary, where carmakers have to introduce sporadic shutdowns due to the lack of spare parts. Poland is more

resilient given a much smaller share of car production in GDP terms (about half the level of Hungary) and a more diversified economy.

- **Labour market frictions due to shortages of qualified workers.** Unemployment rates in Hungary and Poland are close to, or are at, historically low levels with vacancies at a record high in Poland; firms are having difficulty recruiting qualified workers
- **Increases in global commodity prices, including energy, and maritime freight costs.** The latter has increased about four times since the middle of 2020 and is translating into higher prices for consumers, though the pass-through is about 6-9 months. The recent big jump in natural gas prices in Europe adds an additional burden as far as Europe's 'energy shock' is concerned, and prices, with regulators' consent, are also rising.
- **The Delta variant outbreak.** While increases in Covid contagion rates can be partly treated as seasonal, it is also due to relatively low vaccination rates in CEE3 when compared to Western Europe. Romania has the second lowest percentage of fully vaccinated people after Bulgaria in the EU. Just 32% of the total population were jabbed in early November (Poland - 53%, Hungary - 59%, while the EU average is 67%). Romania has suffered from a severe health crisis that triggered some softer restrictions, such as school closures. Some more restrictions are likely in Poland, especially in the Eastern regions, where vaccination rates are lower than the national average. However, we don't see wider lockdowns happening in the CEE3 in the foreseeable future.

## Prospects for 2022 growth remain quite bright but risks are tilted to the downside

Although all the factors mentioned above will remain an issue for CEE3 countries well into 2022, economies will remain in the post-pandemic economic upswing, still heavily supported by public funds and consumption spending funded from high savings and a solid labour market performance.

Currently, none of CEE3 is facing liquidity constraints as budget revenues were boosted by higher nominal GDPs, both from higher-than-budgeted economic recoveries and raised price levels.

Hungary and Poland are, however, struggling with unlocking access to advance payments from the new EU Recovery Fund due to legal disputes with the European Commission. In early December, the European Court of Justice will announce a ruling on the compliance of the conditionality mechanism with EU Treaties.

---

### *The conflict imposes a risk of delayed access to EU payments*

---

The conflict is far from over though. The debate on Poland in the European Parliament in mid-October ended with a resolution calling on the EC to put Polish access to the Next Generation EU Plan on hold. The conflict imposes a risk of delayed access to the Recovery Fund and poses a threat to other EU payments. In the short term, this risk is limited as access to the Next Generation EU plan would only add 0.5ppt to GDP in Poland.

To avoid potential delays, the Hungarian government is pre-financing investment projects which should be funded from EU money. Poland is also likely to follow suit. Hungary runs an

expansionary fiscal policy and its latest spending plan contains tax refunds, tax cuts, bonus payments for the armed forces and pensioners, public investments, and wage settlements. All this will result in elevated fiscal deficits of 7.9% of GDP this year and 5.9% in 2022, after 8% in 2020. In Poland, the fiscal side was less expansionary (general government deficit of 4% in 2021), but in 2022 we expect a positive fiscal impetus with the general government deficit at about 5% of GDP (while the economy is to grow at around 5%).

Romania's National Recovery Plan has been given the green light and the country will receive some €3.8b later this year. Its administrative capacity to implement the reforms is very limited, hence absorption will likely be disappointing going forward. The budget deficit will remain elevated as well (above 5% of GDP), mainly due to the rigidity of public expenditure.

---

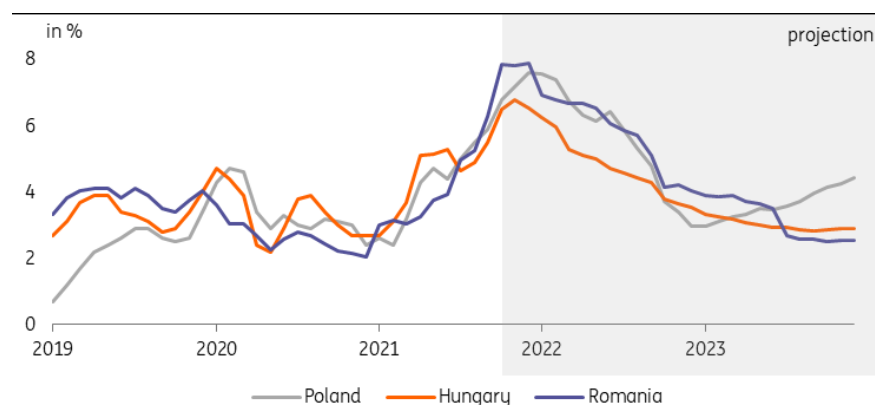
*CEE3 governments are pouring oil onto the inflationary fire*

---

Labour markets in CEE3 were tight and minimum wages were expanding even before the pandemic. That means that labour cost pressures should come to the fore in 2022 with a pro-inflationary impact. CEE3 governments are pouring oil onto the inflationary fire, not only with accommodative fiscal policy (e.g. PIT rate cuts in Poland, payroll tax cuts and tax refunds for families in Hungary, and a probable 4ppt cut in employers' social contribution rate), but also sizeable hikes in the minimum wage (e.g. by 20% in Hungary, 10% in Romania, and 7.5% in Poland).

## CPI inflation close to the peak in CEE3

Wages and demand will come to the fore in 2022



Source: Macrobond, ING

## Increased inflationary pressures, both on the supply and demand side

There is no doubt that supply-side factors have been a primary driver of accelerating inflation since the spring. But, in addition to energy and food, price increases have become generalised and visible in elevated core inflation numbers. This signals that inflation is becoming widespread and, in 2022, the contribution of demand-side pressures and wages should take a leading role in holding

core inflation at elevated levels. For example, Polish CPI accelerated to 6.8% year-on-year in October with prices rising in 70% of the CPI basket categories.

In Poland, surveys indicate that demand is becoming a lesser barrier for doing business, while anecdotal evidence shows second-round effects are just around the corner. A historically high percentage of companies are planning simultaneous employment increases and wages hikes. We hear many companies plan further rises in prices due to anticipated higher costs. In our view, labour costs are among them.

The inflation peak in the CEE3 is just ahead of us in the coming months and is set to remain elevated through the first quarter of 2022. Hungary's headline inflation should reach 6.8%YoY in November, while Poland's reading should be close to 8%; that's a level not seen since 2000.

---

### *The inflationary impact of supply shocks is not over*

---

The inflationary impact of supply shocks is not over. Consumers are facing inevitable increases in regulated prices of electricity and natural gas. In Romania, parliament capped electricity prices for households at last year's level, but it might not prevent indirect price pressure as energy bills for firms are largely determined by markets. It's a similar story in Hungary where utility prices for households are capped, but companies will shift the increase in producer prices onto consumers indirectly. In addition, Poland decided to hike excise tax rates on alcohol and tobacco products from early 2022. Some moderation of headline inflation is expected due to base effects (high prices a year before) from the second quarter of next year.

---

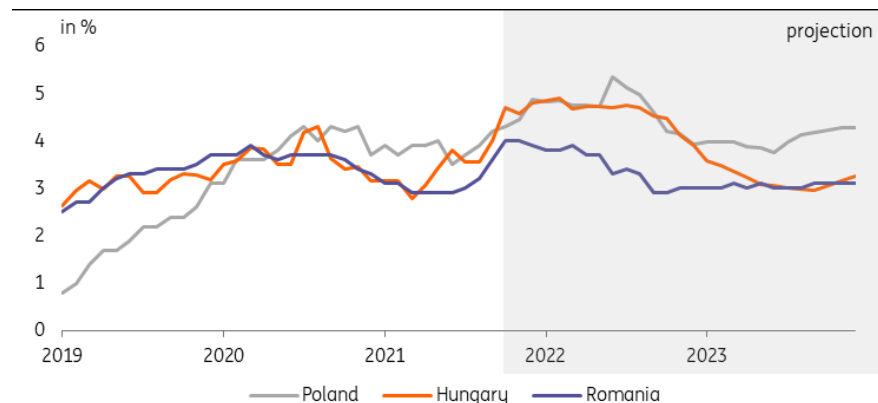
### *Labour costs and demand pressures should take a leading role in driving inflation*

---

But we strongly point out that core inflation will stay elevated even when headline CPI slows on base effects. Labour costs and demand pressures are expected to take a leading role in driving inflation in 2022-23 as opposed to 2021 when supply shocks were mainly responsible for elevated CPI. In Poland, we see core CPI peaking in 1H22, then some stabilisation towards the end of 2022, and then up again! Core inflation should relax though in Romania, as this measure was lower and the latest Covid-19 wave more elevated than in the other two countries.

Current relatively weak exchange rates in CEE3 also don't help in controlling prices, and we're looking at the importation of foreign inflation; remember, inflation was 4.5% YoY in Germany in October. That's despite the significant tightening cycle in monetary policy, initiated by the National Bank of Hungary in mid-2021 and recently joined by the central banks of Poland and Romania to a lesser extent.

## Central bankers cannot ignore persistently elevated core inflation



Source: Macrobond, ING

## Mixed reactions from CEE central banks with more rate hikes coming

The most hawkish central bank in the CEE3, the National Bank of Hungary, started with a cycle of interest rate hikes in June 2021. It raised the base rate by 120bp in five steps - from 0.6% in June to 1.8% in October. Its forward guidance remains hawkish, clearly pointing towards further rate hikes, which will continue in early 2022 with an additional 100bp. The recent forint underperformance is linked to a disappointing scale of the two most recent hikes of 15bp despite higher inflation and increasing inflation risks.

We see the terminal rate of 2.75% being reached by spring 2022 (just before the general election in April), although the latest CPI surprise increases the risk for a higher terminal rate with a more frontloaded hiking cycle approach. Later in 2022, policy-mix adjustments should see some fiscal consolidation.

One of the most dovish central banks in Central Europe, the National Bank of Poland, is catching up after making a surprise 40bp hike in October. The market surprise resulted from unclear forward guidance repeatedly provided in its communication. In early November, the NBP delivered another hike - by 75bp and again above consensus. This is due to the rising inflation risk, e.g. CPI close to 8% YoY and more visible risks of second-round effects. The new NBP projections also show average CPI in 2023 above the 3.5% upper band of the 2.5% inflation target. The tightening cycle should bring the main policy rate to 2.5 to 3.0% in 2022/23.

Romania, which has been very dovish until recently, launched a tightening cycle in October with a 25bp move. In November, the NBR raised its reference rate by 25bp, but effectively by 50bp given that the market-relevant rate is Lombard now, which was lifted by that magnitude. We expect the NBR will deliver at least 25bp rises at each of the following meetings until we reach 3%. But that depends on the NBP as well, as the interest rate differential needs to stay positive for Romania.

## Author

### **Rafal Benecki**

Chief Economist, Poland

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

### **Leszek Kasek**

Senior Economist, Poland

[leszek.kasek@ing.pl](mailto:leszek.kasek@ing.pl)

### **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)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit [www.ing.com](http://www.ing.com).