

Central and Eastern Europe: No deflationary threat here

Growth in the CEE region is picking up in line with the eurozone, but in contrast, inflation remains above target. Central banks are unlikely to respond as they focus on the fragile post Covid-19 recovery, while local CPIs are set to fall. CEE FX has been benefiting from rising EUR/USD and should continue to do so



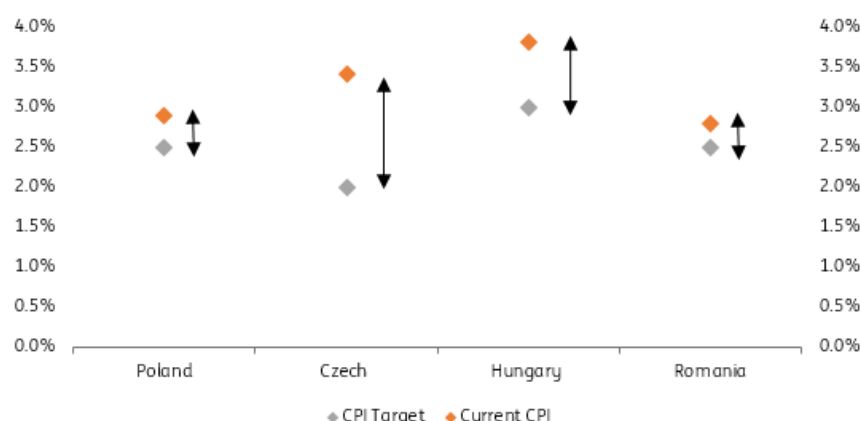
Source: Shutterstock

Growth on a recovery path (a bit like the eurozone)

The post Covid-19 recovery in central and eastern Europe continues, in line with the general eurozone trend.

The worst is behind us and in contrast to the first two quarters, the third and fourth quarters should see positive growth, with activity rebounding particularly strongly in the third quarter. Indeed, the latest bout of [CEE August Manufacturing PMIs](#) continues to point towards optimism in the manufacturing sector in the second half.

Figure 1: CEE inflation readings remain above target



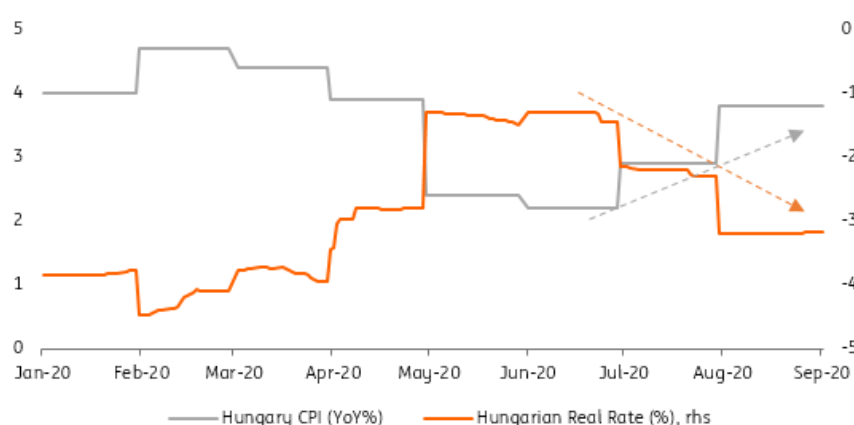
Source: ING

Inflation remains rather high, unlike in the eurozone

While the CEE economic recovery is following the trend of the eurozone, this is not the case for inflation. The eurozone CPI remains subdued and the August reading dipped into negative territory, but the CEE region has for some time faced the opposite problem – above target CPIs, as you can see in the chart above, with price pressures being particularly high in the Czech Republic and Hungary, when compared to their target.

Such a meaningful divergence vs their main trading block seems to be caused by factors such as a tight labour market and associated strong wage growth (due to retention schemes, we have not seen a meaningful rise in unemployment yet, with CEE unemployment rates remaining low) or possibly quicker and higher FX pass-through (note the meaningful depreciation, though temporary, in CE3 FX during the peak of the Covid 19 crisis).

Figure 2: HUF real rate deteriorated recently



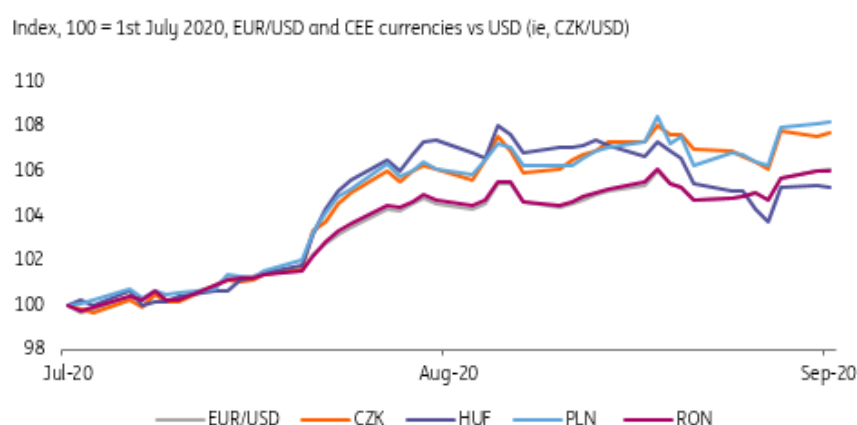
Source: ING, Bloomberg

Limited response from CEE central banks, with easing bias firmly in place

Despite the above target CPI, we don't expect local central banks to respond with tighter monetary policy, with a larger weight likely put on supporting domestic economies. Local inflation is expected to decelerate anyway into the year end (this is already underway in Poland). If anything, the easing bias of CEE central banks should remain in place.

The National Bank of Hungary increased the pace of its weekly quantitative easing purchases from HUF 15 billion to 40 billion last month and we still expect the National Bank of Poland to extend its QE into 2021. The Czech National Bank should remain firmly on hold, with unconventional easing (as has been the case in Poland and Hungary) currently being an ultra-low probability event.

Figure 3: CEE FX boosted by the rising EUR/USD



CEE FX reaping the benefits of the surging EUR/USD

Although the recent period of above-target CPI meant fairly negative real rates in the CEE region, this has not been overly negative for local FX (with the exception of HUF where we witnessed a sharp jump in CPI and fall in the real rate recently - Figure 2). As the CEE currencies are the only emerging market region benefiting from the rising EUR/USD (Figure 3), the fiscally stable CEE FX remains attractive as an EM FX overlay to bullish EUR/USD positions.

The Czech koruna remains our top pick. The gradually improving PLN real rate means there is less scope for Poland's zloty to underperform within the region. As for Hungary's forint, we expect the recent underperformance to fade as inflation has likely peaked and should move towards the 3% target by year-end. But as the real rate is now the most negative within the region, the scope for the forint to outperform its peers, as was the case in early summer, has narrowed considerably.

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