

Central and Eastern Europe has shown surprising resilience

GDP results for the first quarter were a positive surprise, signalling economic resilience in the second quarter. This makes the situation easier for central banks. Policymakers are cautious, however, given the already high level of rates. We believe a continued rise in inflation will soon restore the hawkish view



Poland: GDP posted a strong positive output gap at the beginning of 2022

In the first quarter, the Polish economy accelerated despite the Russia-Ukraine war, growing by 8.5% year-on-year and 2.5% quarter-on-quarter. But we think this is the cyclical peak. The following quarters should bring a slowdown to ca. 2% YoY in the fourth quarter. So far, manufacturing has been driven by backlogs, but the PMI shows a strong contraction in new orders. The high contribution of inventories (ca. 7ppt) is not sustainable. Investment may also suffer from uncertainty though consumption should slow only marginally given the massive fiscal stimulus (mainly spent on social transfers and tax cuts) and spending on hosting Ukrainian refugees. The high starting point implies that average annual GDP growth should be about 4.7%.

Both the robust dynamics and GDP structure make the inflation picture even worse. The positive output gap has widened. We see strong evidence that the external supply shock is causing widespread second-round effects. Companies are seeing strong demand and are passing higher commodity and energy costs on to retail prices. As a result, core inflation has grown by about 1ppt for a fifth straight month. We see CPI peaking in 4Q22 at 15-20%. Our models show that the process of passing higher costs on to retail prices may last until the end of the year. Even if GDP slows, as we predict, this should not cause unemployment to rise while the output gap will likely go from strongly positive to neutral rather than negative.

The policy mix is hardly helping inflation. The National Bank of Poland keeps raising rates but on the fiscal side, new programmes have been added, with fiscal stimulus likely reaching 3% of GDP this year. This raises the risk of persistent inflation, which the NBP should contain with further rate hikes. We see the terminal rate closer to the upper bound of our range at 5-10%. Our target is 8.5% to be reached at the end of 2022.

Czech Republic: CNB shifts to dovish tone despite rising inflation

Economic growth in 1Q surprised positively. Moreover, the second estimate brought a further upward revision to 0.9% quarter-on-quarter and 4.8% year-on-year. The surprise came mainly from the investment and inventory formation component. The overall picture is thus better than expected, reducing the risk of recession for the next two quarters. April inflation surprised on the upside again and was 0.4ppt higher than the central bank's forecast, rising to 14.2% YoY. We have thus once again raised our peak forecast to around 16% mid-year, pushing the level of inflation safely above 10% at the end of this year. Energy and fuel prices remain the main drivers, but the entire core component is also rising. On top of that, the largest energy supplier announced another price increase, signalling the start of a third round of price hikes. This assures us that the downward path of inflation will be very slow in the second half of the year.

The appointment of a new Czech National Bank governor has brought a change in stance, with the Bank shifting to a dovish tone having traditionally been the biggest hawk in the region. This signals the impending peak of the tightening cycle. [We expect](#) the June meeting to deliver the last 100bp rate hike to 6.75%. However, at the moment we still don't know the composition of the board after 1 July, which will play a key role in the future monetary policy direction. On the FX side, the CNB has been intervening in favour of the koruna since mid-May. Although no details have been published, we think the intention is to prevent the koruna from weakening above the 25.0 EUR/CZK level. This may change quickly with the new board composition, but we believe a shift to a dovish stance will require much more frequent central bank market activity if the CNB is serious about taming inflation.

Hungary: Finding the inflation peak

With positive underlying growth momentum set to keep inflation on an upward trajectory in the near future, the key question is where prices will peak. Details of the strong first-quarter GDP, mounting global challenges (oil embargo and other supply-side shocks), producer prices, and corporate surveys about pricing power are all pointing to a further acceleration in inflation. We see the peak at 11.7% year-on-year in September followed by a slow and gradual decline amid sustained labour shortages and continuing positive real wage growth.

Markets did not respond well to fiscal changes, which amount to 3% of GDP (more than enough to meet the deficit target in 2022) but contain windfall taxes for eight sectors worth 1.3% of GDP. The

forint has been stumbling on this and carries a sizeable risk premium. The National Bank of Hungary is clearly committed to tightening further but will reach the terminal rate in a gradual manner. We see the end of the tightening cycle at 8.25% in the fourth quarter, but we assign a significant chance to the terminal rate reaching roughly 9.00%, if inflation surprises on the upside again and/or HUF shows no sign of relief in the short run.

Romania: A strong economy makes the central bank's job easier

The +5.2% GDP advance from the first quarter was the second-highest quarterly advance in history and markedly improved the 2022 outlook. Assuming no significant data revisions, even a quasi-stagnant economy for the rest of the year would still bring the annual GDP advance in 2022 to at least 5.0%. Add to this average inflation of around 12.5% and the nominal GDP advance will easily exceed 15% in 2022. This will, in turn, make it a touch easier for the government to stick to its 5.8% budget deficit target in 2022. However, the pressure on 2023 budget spending is already shaping up to be massive, as increases in wages and pensions will most likely be sensibly below inflation this year and the pressure for a more rapid indexation will only grow.

The higher-than-expected GDP numbers are likely to make it easier for the National Bank of Romania to at least maintain its 75bp hiking pace at the July meeting. However, we keep unchanged our forecast for the key rate not to exceed 5.50% this year. In the context of a persistent liquidity shortage for the rest of the year, the relevant rate will in fact remain the credit facility (100bp higher than the key rate).

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