

Central and Eastern Europe in 2021: Bracing for the post winter rebound

Once winter has passed, the CEE region should brace itself for a meaningful economic rebound from 2Q21 onwards but the prospects of a reflation narrative are limited as deflation has never been an issue. We expect some central banks to ease but this is unlikely to derail the rebound in local FX which should experience a benign and less volatile year in 2021



Source: Shutterstock

Three main themes for CEE in 2021

1. After the cold winter months, the region should brace itself for a meaningful economic rebound from 2Q21 onwards
2. The wider reflation narrative is, in isolation, less relevant for CEE as low inflation has never been an issue
3. Local central banks may ease more, but this won't derail a rebound in local FX. We prefer the Czech koruna and Turkish lira

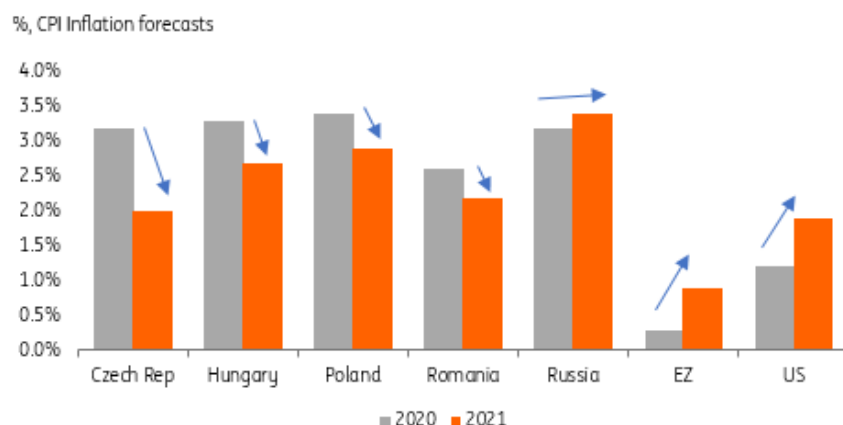
Second dip now, but a strong recovery from 2Q21 onwards

The double-dip recession the region will experience is now certain as the second wave of the pandemic and related restrictions in Europe weigh both on domestic demand as well as exports. All CEE countries will experience negative quarter-on-quarter growth and shallow activity in the first quarter of 2021.

The rebound is expected to come in the second quarter next year once we pass the tough winter months and that should be in line with the expected recovery path of the eurozone economy. With the prospects of a successful vaccine in place, this (a) reduces downside risks to the growth outlook for the second half of next year (i.e, a low probability of the winter lockdown in late 2021); (b) the brighter outlook for global trade should benefit open CEE economies.

Moreover, new EU funds should provide further cushion to the regional growth outlook, though the front-loaded investments within the seven-year EU budget are more likely to materialise in 2022 rather than next year.

Differing EMEA inflation dynamics to Eurozone and the US



Source: ING

2 External, internal reflation theme narrative

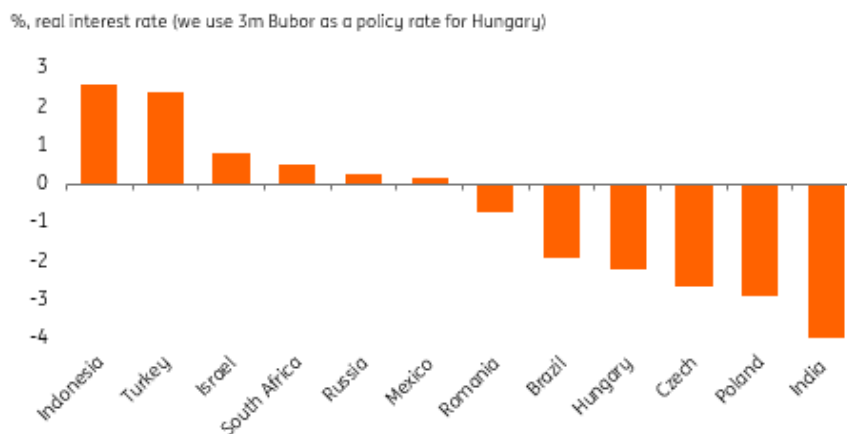
In isolation, the prospects of the reflation narrative are limited in Eastern Europe, with the local inflation dynamics being vastly different from developed Europe.

As the chart above shows, inflation should on average be lower in the region in 2021, not higher. The deflation threat isn't really present here this year given the cushion the tight labour market provided to domestic prices. All CEE countries started the year with above-target inflation and now we see a normalisation towards the target, which is also likely to continue next year (mainly in Q1) as the Covid-19 related one-offs and the labour market shortage ease.

Any reflation theme for the CEE region next year will be more about the pick-up in local economic growth

From this perspective, any reflation theme for the region next year will be more about the pick-up in local economic growth rather than domestic price pressures, as these will decelerate rather than accelerate compared with 2020. That increase in local growth should reduce the easing bias of some local banks despite above-target CPI and higher long-end core rates, which reflects the re-rating of the economic outlook and inflation expectations in the developed world.

Preference for higher real rates



Source: ING, Bloomberg

3 Modest easing ahead, but EMEA FX should do well nonetheless

Despite the brighter outlook for 2021 and limited deflation risks, the near-term bias remains towards more easing among regional central banks, albeit for different reasons.

In Hungary, the central bank is likely to reverse its 15 basis points FX stabilising hike in September. In Poland, the Bank may cut reference rate by 10bp (and/or explore other measures) should the currency continue appreciating, while in Russia the benign inflation outlook points to more rate cuts.

In contrast to this year, EMEA FX should experience a more benign and less volatile year in 2021

For the easing prone Poland and Hungarian central bank, in particular, the bar is high for a move towards less accommodative policy in 2021, pointing to steeper local curves. However, the Czech central bank should be the outlier in the region, with a non-negligible probability of the Bank delivering a hike at the end of 2021, suggesting higher front-end CZK rates vs PLN.

In contrast to this year, EMEA FX should experience a more benign and less volatile year in 2021. The more supportive global backdrop (due to more predictable US international relations policy and the Covid-19 vaccine), the sharp pick up in CEE growth from 2021 onwards and gradually rising EUR/USD should be beneficial for CEE FX.

We heavily favour CZK to PLN and HUF, given the inherent dovish bias of Poland and Hungarian central banks versus the Czech national bank. The benign global environment and lower volatility should favour carry. Within the high yielding EMEA space, TRY outlook for upcoming months looks the most attractive as the central bank is likely to deliver meaningful tightening, in turn cementing its superior carry and real rate position within the emerging market space.

This should also further compress some of the still profound risk premia and help the lira.