

Gloomy growth prospects ahead for Central and Eastern Europe

Economic activity in the first half of the year has been disappointing across Central and Eastern Europe, leading us to expect a gloomier full-year outlook. Despite this synchronised bottoming, we see a divergence in economic policy responses, driven by country-specific challenges



The economic forecast for much of the CEE region is looking a little gloomy.

Poland: A weak third quarter so far

The Polish economy started the third quarter on a soft note. All real economy figures for July underperformed, showing generally lacklustre domestic demand, while global conditions remain unfavourable. This indicates that the recovery will be slow and more visible in the fourth quarter than in the third. This suggests downside risks to our 2023 GDP forecast of 1%.

CPI inflation in July came in at 10.8% year-on-year (down from 11.5% YoY in June), largely owing to food (-0.6pp) and energy (-0.2pp) prices. Core inflation receded as well to 10.6%, but subtracted only 0.2pp from CPI. Compared to the CPI peak in February, CPI has already slowed by nearly 8pp, mainly due to fading external supply shocks. We estimate CPI will dip near 10% YoY in August, but not lower. It should decisively reach single digits in September and hover around 7% by the year-end.

We expect the Monetary Policy Council to start its easing cycle in September, even without meeting the governor's guidance on CPI reaching single digits. The recent real economy data proved lacklustre, i.e. the second quarter GDP print of -0.5% YoY came in below the July National Bank of Poland projection (-0.1% YoY), and the outlook for the second half of the year is also subject to downside risks. At the same time, inflation is on a clear path to reach single-digit levels later in the second half of the year. Still, recent MPC statements do not indicate the Council is willing to cut rates by more than 25bp at a single meeting. Consequently, we look for two or three 25bp cuts in 2023.

€/PLN remains range-bound against the euro and it's unlikely to change prior to the mid-October general elections. The zloty remains supported by the trade surplus and presumably Ministry of Finance activity, which offsets rather unsupportive emerging market sentiment. The zloty may ease after the elections, as opinion polls suggest that the political set-up may prevent prompt access to the Recovery Fund. Moreover, we see domestic demand recovering gradually in the second half, which should trim Poland's trade surplus, given limited external demand.

We expect further Polish government bond curve steepening. The 2024 budget draft presents a strong rise (by 55%) in net borrowing needs (to PLN225bn vs. PLN143bn in 2023), while local banks may cover one-third of it in 2024 vs. two-thirds in 2023, and the Ministry of Finance should rely strongly on foreign demand. Also, core market developments are generally unsupportive for the local long end, while domestic data should maintain, or even strengthen, market views on central bank easing.

Czech Republic: The first rate cut is coming

The Czech economy posted negligible quarter-on-quarter growth of 0.1% in the second quarter and the latest monthly data show moderate growth in industrial and retail sales after very weak numbers in the first half of the year. However, the picture is still mixed. Looking at the details, we see that the only real driver of the economy is the auto sector and demand from abroad. Thus, full-year growth looks like it will be weaker than we previously forecast, but we still expect a rebound in the coming months, which the early data are already suggesting.

Inflation fell to 8.8% YoY in July and was in single-digit territory for the second consecutive month and the lowest in the CEE region. Disinflation should continue in our view in the coming months but at a much slower pace. In addition, fuel prices have surprisingly risen following the excise tax hike, pushing inflation 0.3-0.4pp above our earlier forecast. Even so, inflation should be in the 7-8% YoY range in September. However, thanks to the base effect, inflation will rise back above 8% in October and remain there for the rest of the year. In January, inflation is expected to fall into the 2-3% YoY range, close to the Czech National Bank's target, due to the massive base effect and seasonality.

We continue to expect the Czech National Bank to cut rates by 25bp for the first time in November. However, there is a clear risk that the central bank will want to stay on the safe side and wait for the January inflation number. This would mean delaying the rate cut until the first quarter of 2024.

On the fiscal side, we have seen a big turn to the positive side in recent months. The government budget deficit has stabilised and there is a good chance that the government will deliver on its deficit target. Moreover, the government is continuously discussing further savings for this year. For next year, parliament has already approved a consolidation package in the first round and a continuation of the legislative package can be expected in September. Given the government's

majority in parliament, we expect approval during October.

Hungary: The worst may be over

We had high hopes going into the release of second-quarter GDP, and we were sorely disappointed. Hungary has been in a technical recession for four quarters, a new record in modern times. The silver lining remains agriculture, which we expect to pull the country out of the doldrums with a strong performance in the second half of the year. But it won't be enough to keep the economy out of a full-year recession. We now expect real GDP to contract by 0.5% in 2023, possibly the only country in CEE to record a down year.

Shrinking domestic demand (the main driver of the negative momentum) has a positive side effect: the trade balance has been in surplus for five months, while the current account posted a surplus in the second quarter based on preliminary figures. Against this background, we have significantly raised our external balance forecast and now see the current account in surplus by 0.3% of GDP in 2023.

If disinflation continues as expected on the back of weak domestic demand, we see headline inflation below 7% and single-digit core inflation by the end of the year. In this context, the National Bank of Hungary will soon succeed in creating a positive real interest rate environment, especially after the latest signal from policymakers, which warned against excessive rate cut expectations based on market pricing. This hawkish stance could translate into a higher-than-expected interest rate path, at least in the coming months. As a result, we see upside risks to our year-end policy rate forecast of 11%.

Hungary's fiscal situation remains challenging, as evidenced by budgetary developments in the first seven months of the year. So, it is hardly surprising that the finance minister has openly talked about the possibility of a budget revision in September. While it is not clear what a revision could mean in practice, we think it would be a combination of an upwardly revised deficit goal to 4.4% of GDP, accompanied by some additional budgetary measures to achieve the new target. We don't see any problems here from a debt financing perspective, as the additional supply will be raised through FX debt issuance.

Romania: Fiscal adjustments needed to contain the widening deficit

The second-quarter flash GDP print confirmed that the Romanian economy is slowing rather rapidly. GDP advanced by 1.1% in the second quarter and 1.7% in the first half of the year, visibly below our 2.3% estimate. While the detailed GDP data due on 7 September might shed a different light on the growth dynamic, we have already revised our 2023 GDP growth forecast from 2.5% to 1.5%, while maintaining 2024 at 3.7%.

From a monetary policy perspective, the lower growth is likely to offset the marginal higher inflation forecast of the National Bank of Romania and lead to a stable interest rate environment for the rest of the year. We believe that the central bank is not yet contemplating the timing for a dovish pivot, despite the more frequent dovish statements coming from other central banks in the region. We maintain our view of a first rate cut in the first quarter of 2024 with a key rate of 5.5% by the end of 2024.

Particularly relevant for future growth and the interest rates pattern is the final form of the fiscal

package which is under discussion at the moment. We are likely to see a budget deficit target of around 5.0% of GDP (up from 4.4%) but how exactly it will be achieved is important. An emphasis on taxes such as VAT (e.g. a generalised VAT hike) will likely skew the inflation profile higher while it might have a lesser impact on growth, while a more aggressive stance on increasing income taxes (e.g. by eliminating some facilities for employees in IT, constructions, agriculture) could be more growth-detrimental in the short term, but more helpful on the inflation side.

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