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Our 3 calls for Central and Eastern Europe

After an unprecedented wave of monetary tightening in Central and Eastern Europe, we expect the region to start normalising monetary conditions. Although headline inflation will slow, core inflation is proving more persistent, and that poses a major dilemma for central banks

Who'll win the race to start cutting rates in the CEE region? Pictured: A woman rides a charging bike to light a Christmas tree in Budapest

1 The timing of central bank interest rate cuts

Central banks in the CEE region were essentially the first globally to start a rate hiking cycle and have delivered massive monetary tightening this year, often also through the FX channel. So the number one question next year will be how long central banks are willing to hold interest rates at record high levels and when we can expect the first rate cuts and the end of extraordinary measures. You can divide the CEE region into two camps. First, the race for the first interest rate cut, which we see between the Czech National Bank and the National Bank of Hungary, which we believe will take place in the second quarter.

On the one hand, the CNB was the first central bank to raise rates, so it may be the first to cut them. On the other, NBH has been forced to raise interest rates well above its regional peers, so it has the most room to normalise monetary policy. In the second camp are the National Bank of Poland and the National Bank of Romania. In both cases, the question is whether we will see additional rate hikes next year, but our baseline assumes that the hiking cycle is over. The NBR could well come up with the first rate cut at the end of the year, while we think the NBP will hold rates at current levels for longer.

2 Persistence of core inflation despite slowdown in headline numbers

Although the theme of high inflation is a global one, CEE is leading the way for two reasons. Firstly, while inflation in the eurozone has touched 10% Year-on-Year, we're talking about levels in the range of 16-23% in CEE. Secondly, the inflation story is not just focused on energy prices but affects the overall consumer basket. While core inflation in the eurozone is half the headline number, in Central and Eastern Europe, core is only slightly slower than the headline in most cases. That's due partly to the record-tight labour market, the convergence of economies and the differing composition of the consumer basket.

The second big question for us is: how fast will inflation slow? It is core inflation that has shown a surprise to the upside in recent months and that remains our baseline scenario for next year. It will be very difficult for central banks to find a way through this minefield of seemingly slowing headline inflation with resistant core inflation hiding the inflationary essence of the CEE region, which was here with us even before the energy crisis and even before the Covid years.

3 Tight labour market despite recession

For next year, our baseline scenario is a shallow recession or, at best, economic stagnation across the region. However, we also expect the unemployment rate to rise only symbolically while wage growth remains in double digits in most cases, but of course, it's still negative in real terms. Labour shortages are one of the main barriers to growth in the region, and the migration crisis, which has boosted labour supply in Poland and the Czech Republic, in particular, has not changed this.

In addition, governments across the region are playing a strong role here, still actively supporting households in the midst of the energy crisis. One channel is the minimum wage hikes we see across the region supporting the mentioned strong wage growth, which is one of the reasons for the persistence of core inflation and underlines the dilemma central banks will face in 2023.

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