

Moment of truth for Central and Eastern Europe

January and February will be a moment of truth for Central and Eastern Europe and confirmation that the region has its own inflation story, more persistent than the global narrative. The region's economic picture is generally better than expected, but this also means stronger inflationary pressures and a problem for central banks to cut rates soon



The Polish Prime Minister, Mateusz Morawiecki

Poland: Resilient economy but persistent core CPI remains a problem

The Polish economy proved to be relatively resilient to the shocks of war, energy and aggressive rate hikes, both at home and abroad last year. In 2023 we stick to our above-consensus GDP forecast of 1%. Lower gas prices and China reopening support the eurozone and our GDP expectations for Poland. Last year's fourth-quarter GDP backdrop was disinflationary, but the labour market was still tight. According to the National Bank of Poland Beige Book, the percentage of companies planning wage hikes grew to an all-time high of 62.3% due to a tight labour market and a countercyclical hike of the minimum wage by 19.1%.

We expect CPI to rise to 18.1% in January and peak at 20% YoY in February. In the following months, CPI should drop by half to about 10% in December 2023. But the problem is the persistence of core inflation. We are not expecting rate cuts in 2023 against quite aggressive market pricing. The government covered more than 50% of borrowing needs, but given the strong sentiment in the Polish government bond (POLGBs) market, it plans for heavier supply in February.

Together with the approaching European Court of Justice ruling on 16 February, both of these factors call for tactical profit taking on the POLGBs market. The ruling of the ECJ is the second step in the Swiss franc mortgage saga. The ECJ is expected to judge whether banks can charge clients for the cost of capital, even when CHF mortgages are terminated. Should the ECJ ruling turn negative, local banks may be forced to significantly raise provisions, which should hinder their demand for POLGBs. This is an important systemic risk which needs to be tackled by policymakers. This uncertainty explains the underperformance of the zloty vs CEE FX recently and should also affect POLGBs.

Czech Republic: Recession confirmed

The flash GDP estimate confirmed the Czech economy entered recession in the second half of 2022. The Czech economy declined by -0.3% Quarter-on-Quarter, mainly due to a reduction in private spending. The good news is that the decline remained still relatively shallow compared to market expectations. The economic contraction has not been mirrored in a significant deterioration of the labour market yet. However, key local car producers have already announced they are planning to reduce their production markedly in the coming weeks due to problems with component supplies. Given the importance of the automotive sector to overall economic performance, it seems the pace of economic recovery will be postponed.

We expect inflation is likely to exceed 17% YoY in January, reflecting the increase in regulated prices and food prices. On the monetary policy side, there is no change in our view that the central bank will keep interest rates the same in February. Czech National Bank officials mostly assume that ongoing strong inflation is largely attributable to supply-side effects and should fade during the year, while the current level of rates at 7% is sufficient to tame domestic demand-pull inflationary pressures, together with a decline in consumer spending. Depending on inflation and the performance of the economy, we see the possibility of reopening the discussion on rate cuts in the middle of the year.

The Czech koruna strengthened further, which is mostly attributable to the decline in gas prices. Previous interventions by the CNB cooled market pressure on the koruna. We expect a soft correction of the currency to slightly weaker levels and volatility isn't expected to be too much of a problem.

Hungary: A glimpse of light at the end of the tunnel

This year could not have started better for a small open economy with a high dependency on energy imports like Hungary. After a rough year, the Hungarian economy is facing a non-negligible tailwind thanks to the improving external outlook on China's turnaround and the resilience of the eurozone. Internally, the biggest positive surprise is the local labour market, where companies are still trying to retain workers. However, the strength of the labour market is a double-edged sword. It leads us to revise this year's GDP growth up to 0.7% on average but poses a significant red flag from an inflationary perspective. Wage-push inflation is a real threat now. And though we see the headline inflation peaking somewhat below 26% in January-February, the deceleration will be slow

and gradual.

This possible tenacity of price increases makes us forecast an 18.5% average inflation rate in 2023. Against this backdrop and seeing the outcome of the January rate-setting meeting, we think that the monetary policy will exercise more patience than other central banks. We see the National Bank of Hungary starting its policy pivot only during the second quarter, gradually reducing the rates of the temporary, targeted tools. Our tighter-for-longer call will be complemented by more conscious fiscal spending this year. Tight fiscal and monetary policy alongside an ongoing significant voluntary energy consumption reduction will help to reduce the current account deficit. We also expect tensions to ease between the European Commission and the government as the latter will meet more milestones, translating into the flow of more EU funds. Against this backdrop, it is easy to understand why we stick to our general bullish view regarding Hungarian assets.

Romania: Strong demand in the economy but also in markets

The high-frequency data available to date suggest a rather resilient GDP growth in the fourth quarter of 2022, consistent with our current estimate of around 1.0% quarterly advance. This would take the full 2022 GDP to +5.0%, arguably one of the best outcomes one could have hoped for. Much in line with external developments, there are early signs of an accelerated cooling in the economy in January, with the Economic Sentiment Index falling for the third consecutive month, particularly on the back of lower demand in the service sector.

On the monetary policy front, the National Bank of Romania is likely done with rate hikes for the rest of the year. While not yet clearly visible, a consolidation of the downward inflationary trend should be more obvious starting in March, when we expect the headline CPI to flirt with 14.0% (from the peak of 16.8% in November). As for actual market rates, they remain somewhat decoupled from the 7.00% policy rate, being heavily influenced by the liquidity conditions in the money market.

Speaking of liquidity, January has been an outstanding month for the Ministry of Finance, which managed to issue almost RON20bn in the local bond market, thus absorbing a large chunk of the surplus liquidity created in November-December. We still think that a return to a liquidity deficit situation is unlikely, but smaller surpluses (say below RON5bn monthly) could become more usual.

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