CEE Viewpoint

Trip notes – no feelings of victory in CPI battle

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Short-term cuts easy, long-term cuts more challenging

The disinflation process has been faster than expected, thereby allowing swift rate cuts in the near term, though CEE central bankers are not yet claiming victory, implying market expectations of rate cuts by YE2024 are too optimistic. We keep our YE2024 forecasts unchanged and above market pricing at 4.0% for the CNB, 5.50% for the NBH, 5.75% for the NBP, and 7.0% for the NBR. Meanwhile, we see the EU funds outlook more constructive in Hungary and slightly delayed in Poland vs our previous expectations. The fiscal situation is Romania, and to a lesser extent Poland, are more concerning for investors, but in both countries, financing is well on track.

CZ: larger cuts ahead, but no appetite to go below neutral

While our Prague visit suggests the 8 February decision is a very close call between a 25bp and 50bp rate cut, we feel comfortable with our 4% YE2024 base rate call. The Board remains cautious about longer term easing, and does not see the need to go below neutral levels, which may be higher than the previous estimate of 1% real.

HU: growth prioritised, but no major stress on NBH

We returned from Brussels and Budapest feeling less worried about the underlying relationship between Hungary and the EU, and less dovish on the NBH. The NBH is still cautious with easing and mindful of the HUF, as seen in the 30 January surprise rate decision. There seems to be little pressure from the government to push the NBH policy rate below 5-6%. Rather, there could be more focus on subsidized lending later this year.

PL: politics clouds ST, still +ve LT

The political transition brings more uncertainty than expected, but our Warsaw meetings leave us still comfortable with our longer-term positive views. Our flat rates forecast of 5.75% for the NBP this year is supported by fundamentals, local consensus and the political backdrop. The budget is subject to upside, but financing looks well managed.

RO: fiscal risks prompt hawkish NBR

Our Bucharest meetings underscore the high fiscal, and thus inflation, uncertainty for the next two years, which has hawkish implications for the NBR. The hawkish stance can also be justified by sticky core CPI, longer period of positive output gap, and less favourable wage dynamics than regional peers.

Strategy: short CZKHUF, pay 1y1y in PLN vs rec in CZK

Our key convictions in the region are: 1) pay the 1y1y in Poland vs receiving the 1y1y in Czechia (current: 1.33, open: 1.21); and 2) short CZK/HUF (current: 15.58, open: 15.7). We believe too many cuts are priced in Poland vs our baseline forecast, while the 1y1y (net of roll) is likely to continue falling as the CNB eases, as was the case in all previous cycles. HUF fundamentals are improving (EU funds + hawkish NBH), which should drive appreciation.

For a list of open trade recommendations and trade recommendations closed in the last 12 months, see Global Emerging Markets Weekly: EM FX – Pain trades: A who-dunnit? 19 January 2024

Abbreviations

CNB: Czech National Bank

NBH: National Bank of Hungary

NBP: National Bank of Poland

NBH: National Bank of Hungary

RRP: Recovery and Resilience Plan

EC: European Commission

EP: European Parliament

FX: foreign exchange

ST: short term

LT: long term

PO: Civic Platform party

PiS: Law and Justice party

MPC: Monetary Policy Council

RV: relative value

Czechia: larger cuts to come, but no appetite to go below neutral

While Prague meetings suggest the 8 February decision is a close call between a 25bp and 50bp rate cut, we feel comfortable with our call for the base rate to fall to 4% by YE2024 from 6.75% currently. Beyond February, the CNB will most likely move in 50bp steps, and in 25bp steps when rates are closer to 4%. The Board has been expressing its preference for a rate profile higher than the staff forecasts, as well as a reluctance to go in at a faster pace of 75-100bp. Policymakers tend to think that neutral real rates have risen in recent years from the CNB's estimate of 1% and, at this stage, there is no strong reason to go below neutral levels. Therefore, market pricing of rate cuts to c.3-3.5% by YE2024 looks overdone.

Close call for February…

Two Board members (Frait and Holub) are likely ready to support a 50bp rate cut on 8 February, but the rest of the Board seems wedded to the January CPI outcome, to be released on 15 February after the rate decision. We think that if the cautious camp, led by Governor Michl, strongly perceives a January reading well below 3%, it will likely go for 50bp, otherwise for 25bp. This reflects these policymakers' wish to be absolutely sure inflation is back in target range before they claim victory in the inflation battle and move to faster rate cuts.

… but 50bp cuts in the pipeline anyway

Outside of the cautious camp, there is a firm acknowledgement within the central bank of the need to adjust monetary policy quickly, as inflation will soon drop to the 2±1% tolerance band and the risks to the economy are still to the downside. We think that Board members in general may be able to think about policy in a more flexible way once January CPI is out of the way. As the easing cycle progresses, there is scope for members to outvote the Governor.

Board hesitant to bring rates below 4% in 2024

The new forecast in the new Monetary Policy Report (MPR) will likely be similar to the one in November, implying the policy rate forecast will stay around 3.5% by YE2024. The downside deviation in headline CPI and GDP is largely offset by higher-than-expected energy prices and a slightly weaker-than-assumed CZK.

However, the Board's preference is to go slower in easing than the staff forecasts. There is a strong wish to rebuild the central bank's reputation as an 'inflation hawk'. The Board would not mind some undershooting of the 2% target, supporting the case for keeping rates higher for longer. Some are concerned about the core inflation outlook, particularly in services where 3m/3m momentum at 4% in December still means some discomfort. Some policymakers, including Governor Michl and Vice Governor Frait, are not in favour of sharp swings in interest rates and have strong reservations about a deep cutting cycle after a period of high inflation. Furthermore, the Bank Board is under no public pressure to cut rates faster despite the weak economy, probably given the still strong labour market and society's asymmetric preference about inflation targeting.

Views on neutral rates and CZK bring upward bias on rates

There is a debate in the CNB about whether neutral rates have risen from the central bank's long-held estimate of 1% real, or 3% nominal. While we have not heard of any precise levels, 4% nominal seems to be the first target for several members, with more assessment by the Board as we come closer to that level. The baseline thinking, including from more proactive policymakers like Holub, does not incorporate the need for policy to go below neutral. Meanwhile, Governor Michl's preference for a strong CZK may imply some caution in the easing cycle should the CZK continue to depreciate more than the CNB's assumption (EUR/CZK around 24.6-24.7 in 1H 2024).

Hungary: growth prioritised, but no major stress on NBH rates

We returned from Brussels and Budapest feeling less worried about the underlying relationship between Hungary and the EU, and less dovish about the NBH. We think a deal with the EU will be agreed eventually, which may even include some optimistic signals on the disbursement of recovery funds. Meanwhile, market pricing on NBH rate cuts looks overdone. Vice Governor Virag guides for the base rate at 6-7% by mid-year, and we do not think the authorities intend to push terminal rates much lower than that. Instead, there could be more efforts on subsidized lending later this year, once the NBH rates are back in mid-single digits.

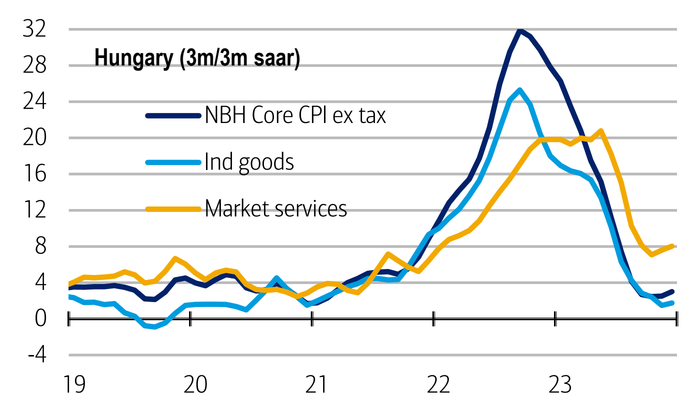
While the NBH surprised the market with a 75bp rate cut on 30 January to 10.0% vs 100bp expected, we think the MPC remains open to 100bp in the next few meetings, and then smaller steps to 6.0% by the summer, followed by less frequent moves in 2H to 5.5% by YE2024, from 10.0% currently. We thus feel less bearish about the HUF in the short term, but still expect a weakening trend in the longer term, in view of Fidesz's strong bias for growth in 2024-25, ahead of the general election in spring 2026.

NBH to accelerate cuts, but still mindful of HUF

If the NBH resumes it plans to accelerate of the pace of rate cuts to 100bp in the next few months, it is likely reflective of the central bank's more supportive view of the government's desire to bring growth to 3-4% for 2024. We still see the central bank's firm commitment to keeping real rates positive to support the HUF. The fundamentals look supportive of steep cuts from the current level of 10.0%. CPI has been falling much faster than central bank and consensus expectations, with the headline rate dropping to 5.5% yoy in December from 25.7% at the beginning of last year. The core CPI 3m annualised rate has been around 3% for several months (Exhibit 1). We see headline CPI at 4-4.5% by April, which is close to the upper bound of the target band (3%±1%).

Meanwhile, the turnaround in the current account and the partial unblocking of EU funds have reduced the HUF external vulnerability substantially, alleviating the need for the central bank to provide outsized premiums. The current account ended 2023 at nearly a 1% of GDP surplus, from an 8% deficit in 2022, thanks to lower energy prices, subdued domestic demand and a gradual recovery amid a tight fiscal stance. The basic balance (current account + non-debt creating flows) has also narrowed substantially from nearly -7% of GDP in 2022 to probably -2% to -3% in 2023 (Exhibit 2). The basic balance should be further supported by EU inflows (more below) and export capacity in the auto sector coming through in 2025-26.

Exhibit 1: Hungary – disinflation trends have been strong
Goods disinflation stronger than services



Source: NBH, Haver, BofA Global Research

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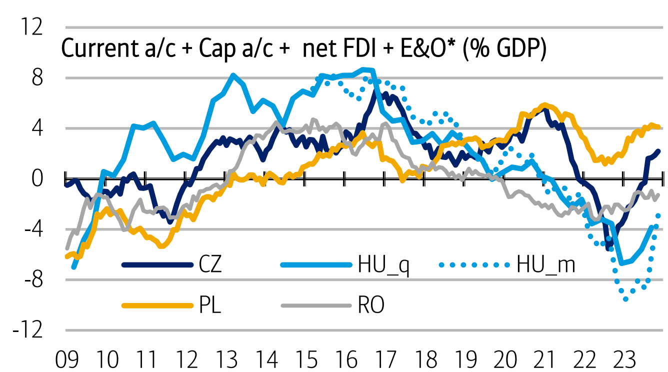
Exhibit 2: CEE – external positions
Basic balance has improved significantly in various countries, including Hungary



Source: Haver, BofA Global Research

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The central bank's stance may change from 2025, given the replacement of Governor Matolcsy, whose term expires on 4 March of that year, and also in view of elections in spring 2026. It is too early to say. Much depends on the economic backdrop next year. But if the MPC is under some influence of Economy Minister Marton Nagy, there will be more preference for a 'high pressure economy', which means less focus to anchor inflation at the 3% target and greater predilection for a weak currency.

Subsidised lending preferred over sub-neutral base rate

We perceive little pressure from the government side to push the NBH policy rate below 5-6%. Rather, there appears to be a stronger inclination to stimulate lending via intervention on loan rates to the private sector, which is a more effective way to promote the credit channel, and thus growth, while also putting less pressure on the HUF.

Indeed, commercial banks has just agreed with the government to temporarily cut their margins for new corporate lending over the next three months. In return, the government will not force through a change in the reference rate that would otherwise lead to a c.300bp margin reduction as well as higher volatility. (The Economy Ministry floated an idea last week that it could replace Bubor with T-bill yields as the reference rates for bank loans.)

The central bank will likely be encouraged by the government to restart its funding for growth schemes (FGS) or Bond Funding for Growth Scheme (BGS) later this year. In various FGS previously, which seek to support small and medium-sized enterprises, the central bank provided subsidised funding to banks to be lent on with a maximum margin (250bp in the last programme). In the previous BGS, which aimed to help large companies with financing outside of bank lending, the NBH bought high-quality bonds issued by domestic non-financial corporations.

EU funds not exactly smooth sailing but more constructive

We regard EU plans to disrupt Hungary's economy (as reported in the press), if the latter continues to block Ukraine aid, as an effort by Brussels to increase pressure on Budapest and create room for negotiations at the summit on 1 February. The EU would like unity on Ukraine aid (although the other 26 member states already have a plan B if Hungary is not on board, which means funding to Ukraine is assured). Meanwhile, we understand that Ukraine issues are not PM Orban's red lines. Budapest will thus be open to financing Ukraine from the EU budget if Hungary has signals that it will also gain more access to EU funds itself. If things unfold in this direction, we think the RRP's first payment request can be submitted by 2Q and payments probably made in the summer.

Last year, Hungary unblocked access to c.EUR10bn in cohesion funds, of which EUR5bn has been allocated to projects and reimbursement can be requested soon, with the total expected to be absorbed within the next two years. It has also received pre-financing for the RRP of EUR0.9bn (this comes without any conditions). Payment from first tranche, when approved, will bring EUR1.9bn. However, some parts of the cohesion funds may not be unfrozen, given PM Orban's red lines on LGBT and immigration issues. In addition, if the Conditionality Mechanism is not resolved by YE2024, c.15% of the blocked amount of EUR6.3bn will be lost permanently.

Fiscal target ambitious, but financing comfortable

While we think the 2024 budget deficit will be well above the current target of 2.9% of GDP, probably 4.5%-5%, down from 5.9% in 2023, Hungary is still holding a relatively tight fiscal stance considering interest payments of c.4% of GDP. The primary balance will likely be in a small deficit, probably around -0.5% of GDP in 2024 from -1.4% last year. Together with EU inflows, the fiscal financing situation looks much more comfortable this year. The debt management agency (AKK) is done with Eurobonds issuance for the year. Any further financing needs can be sourced from the domestic market, as the authorities aim to tap the large pockets of savings in the system.

Poland: politics clouds ST, still +ve LT

The political transition is much more intense, with more uncertainty than expected, but our meetings in Warsaw leave us still comfortable with our longer-term positive views for the economy and the PLN. PO's (Civic Platform party) actions seem to be supported by the electorate in view of better approval ratings, so there is no reason for PiS to trigger early elections. The biggest surprise from our meetings was the strong consensus among locals about the NBP's on-hold position this year, justified by views of higher inflation and a better growth outlook. We are of the same view and have been forecasting flat rates of 5.75% this year. This is now further supported by impressions from the trip that the tense relationship between PO and the PiS, including Governor Glapinski, seems unlikely be resolved any time soon. This means little chance to realise the easing opportunities in March-May, when inflation troughs.

Meanwhile, EU funds will likely be unfrozen with delays, probably in late 2Q/3Q, but goodwill is strong from the EU. The budget is subject to upside spending pressures, but overall financing looks well managed.

CPI trough below 3%, higher in 2H but upside uncertain

There is a general expectation locally that the inflation shields will be phased out from July, when seasonally low repricing in food and energy provides the government with the opportunity to exit. Following sharp disinflation in 1H, which could see headline CPI below 3% in March-April, it is clear that the trend is upward in 2H, but the magnitude is uncertainty, pending the government's decision on energy prices. Energy prices currently implied by the market rates mean a c.40-50% increase to end-consumer prices (adding c.4pp to headline), but the government will have to phase in gradually.

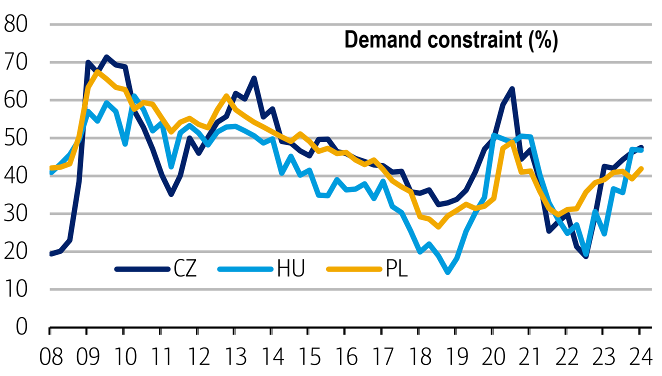
We now incorporate in our forecasts a restoration of VAT on basic food and a 10% increase in household energy prices from July, each adding c.1pp to the headline rate. Inflation will thus likely accelerate to around 6% by YE2024. Meanwhile, core CPI, after a faster disinflation in recent months, may be stuck in 2H due to economic recovery and loose fiscal policy.

NBP: fundamental and political reasons not to cut

The case for the NBP to cut rates is thus weak, both from both fundamental as well as political angles. Underlying inflation will be sustained by higher demand pressures, resulting from several rounds of wage hikes (public sector 20%, teachers 30%, minimum wage 20%) and increase in social transfers (child benefits, pensions). In fact, Poland has reported fewer adjustments in demand and labour constraints in recent quarters compared with CE3 peers (Exhibit 3-Exhibit 4). Consumer confidence in Poland is now

Exhibit 3: CE3 – factors affecting production

Demand constraints on the clear uptrend in Czechia and Hungary, less so in Poland



Source: European Commission. % balance of reporting firms.

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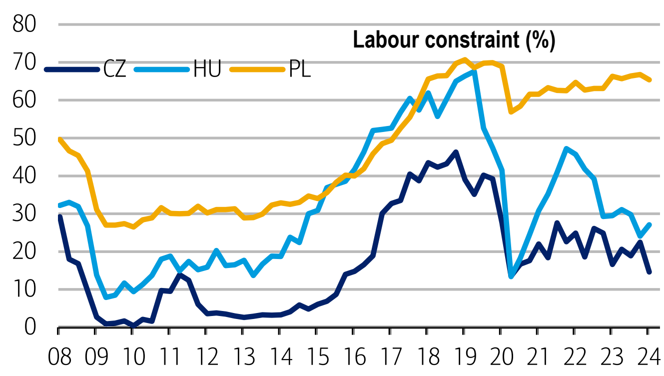
Exhibit 4: CE3 – factors affecting production

Labour constraints most elevated in Poland, softened in Hungary and to some extent in Czechia



Source: European Commission. % balance of reporting firms.

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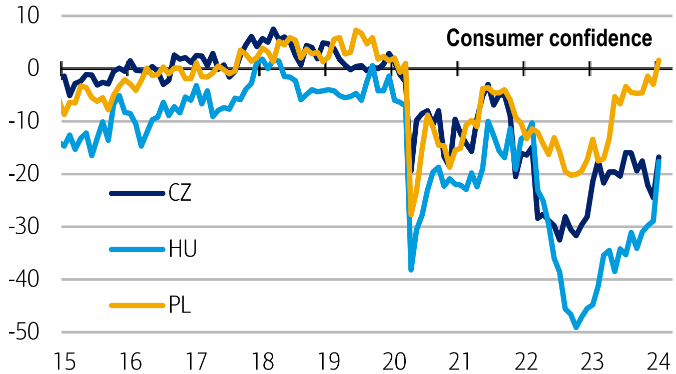
Exhibit 5: CE3 – consumer confidence

Consumer confidence most positive in Poland, followed by and Hungary



Source: European Commission. % balance of respondents.

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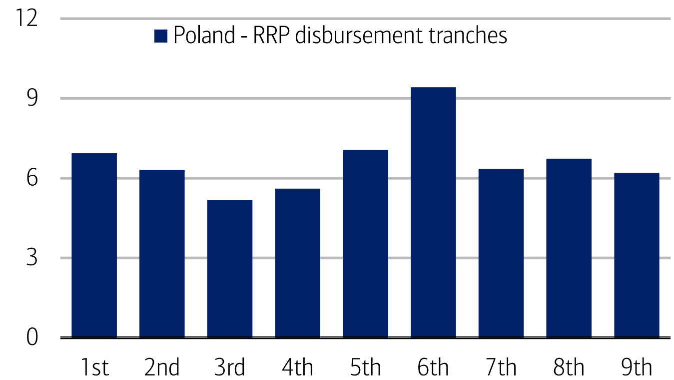
Exhibit 6: RRP planned disbursement tranches until end-2026 (EURbn)

Poland plans to submit 5 payment requests by end-2024, implying total RRP inflows of EUR33bn by 1Q 2025



Source: European Commission

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back to pre-pandemic levels (Exhibit 5). Major spending intentions also suggest that Poles are likely more inclined to consume than to save.

Meanwhile, our meetings in Warsaw suggest that the tension between PM Tusk and the PiS camp, including Governor Glapinski, seems unlikely be resolved in time for easing opportunities from March, when inflation troughs. The NBP has been in defensive mode since the end of last year, in view of the government's threat to bring Governor Glapinski to the State Tribunal. We think the central bank was trying to come to a compromise with the government, as Governor Glapinski softened his rhetoric and signalled in the December and January meetings the possibility of rate cuts.

However, the situation has turned more fluid after the recent arrest of PiS MPs from the Presidential Palace. The NBP subsequently floated the idea of rate hikes and quantitative tightening. This is likely a warning to the government against extreme action rather than a serious consideration by the NBP, but it likely reflects the high tensions. There is a small likelihood of a small easing this year if the NBP/government relationship improves, though we think Governor Glapinski is better off sticking to the fundamental reasons and not cutting – this would be the best strategy against any future investigation on him.

Budget a concern for investors, but financing comfortable

We see a small upside risk to the deficit target of 5.1% of GDP in 2024, which is manageable, but investors may stay cautious until decisions on food VAT and energy prices are made. We see a comfortable financing situation, given nearly 35% the gross borrowing covered and healthy demand from both locals and internationals. This coverage of financing does not account for c.EUR8bn in RRP loans, which Poland can use for liquidity/supply management, until it has to be lent on next year.

EU good will to ensure funding, large pipeline ahead

The EU has signalled that cohesion funds will likely be unblocked soon (c.EUR5bn planned absorption for 2024). But the recovery funds could be delayed by at least one quarter we think, due to the Presidential veto on the judiciary reform required for the 'super milestones'. The EC has signalled that a solution will be found to bypass the blockage, but no concrete proposals are available yet and it may take some time. The first payment can be approved closer to summer at the earliest.

Once Poland gets through the three 'super milestones', the funding pipeline is substantial (Exhibit 6). For 2024, the first three tranches can be paid, totalling EUR17bn. Poland also plans to submit the fourth and fifth payment request later this year, implying another EUR11.5bn by 1Q 2025. These come on top of EUR5bn prefinancing already approved at end-2023. All in for cohesion and RRP, Poland is due to get 4%+ of GDP in EU inflows in the next 15 months.

Romania: fiscal risks prompt hawkish NBR

Bucharest meetings underscore the high fiscal, and thus inflation, uncertainty for the next two years, which has hawkish implications for the NBR. We thus feel comfortable with our flat rate call this year of 7%, while we expect the central bank to tightly control the RON in the election year. The anchor for Romania's budget is the strong support from the EU, which ensures continuous flows of RRP funding. But investors may need to stay cautious on the pipeline of bonds supply until there is more visibility on the public sector wage reform and the necessary fiscal consolidation package for 2025. In addition, the 2024 deficit target of 5% of GDP look ambitious, though the better-than-expected outcome for 2023 of 5.7% of GDP brings a small relief.

RRP reforms need to be reconciled with budget room

Investors have become less concerned with the pension reform that will bring a substantial increase to budget spending (1.8% of GDP pa), as it has the EU's endorsement. But budget room is tight and the uncertainty in an election year does not help to support confidence on the fiscal front. Romania still needs to deliver on unitary wage reform in the public sector (salaries have to be raised for those underpaid) to submit the 4th RRP payment request. This was planned for 2024 with a EUR2.7bn allocation, but mostly likely delayed to 2025.

On a no policy change basis, the NBR see the deficit widening to 6.5% of GDP in 2025, implying the need for at least 1.5% of GDP in fiscal adjustments. More will be required to account for the cost of the unitary wage reform if it is carried out next year. We didn't hear any guidance on the potential impact, but there is hope that it can be done in combination with a reduction in the number of employees.

Financing on track, but supply pipeline a concern

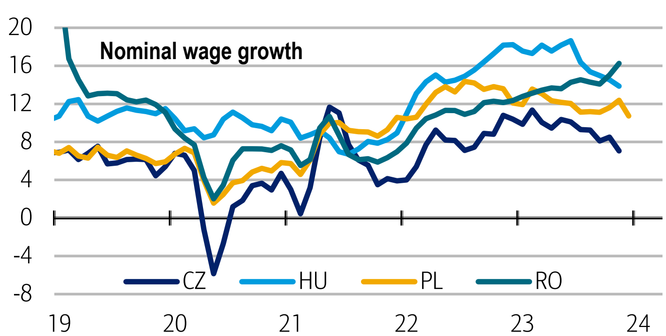
After the above-planned issuances in January and a high cash buffer, FinMin is in a relatively comfortable situation. But, given the fiscal and EU funds outlook, we see more issuance needs than the authorities' guidance (EUR8.5-9.5bn in Eurobonds). There is also a bias to protect the local curve, so supply will likely be diverted more towards the external markets, and to a smaller extent, domestic retail investors.

NBR hawkish bias means fewer rate cuts & RON stability

Sticky core inflation, loose fiscal policy keeping the output gap positive, and higher uncertainty about the tax/budget situation for 2025 justifies a more cautious stance from the NBR on easing, in our view. Romania's disinflation has been slower than peers, due to indirect tax hikes in January but also a reflection of a sooner recovery in real wages and more passthrough of inflation to wage setting. Core CPI was at 8.4% yoy in December, well above the regional average. Wage growth was on a steady upward path to 16.3% yoy in November, vs stable or downtrend elsewhere in CEE (Exhibit 7).

Exhibit 7: CEE – wage growth trends

Romania wage growth on upward path vs stable/downtrend elsewhere



Source: Haver

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Strategy: short CZKHUF; pay PLN rec CZK

Our two key convictions in the region are: 1) pay the 1y1y in Poland vs receiving the 1y1y in Czechia (current: 1.33, open: 1.21); and 2) short CZKHUF (current: 15.58, open: 15.7).

BofA Global Research Reports

Title: Subtitle	Primary Author	Date Published
EM Alpha: Fade negative headlines: short CZKHUF	Mikhail Liluashvili	29 January 2024
EM Alpha: Receive Czech vs pay Poland using 1y1y swap	Mikhail Liluashvili	24 January 2024

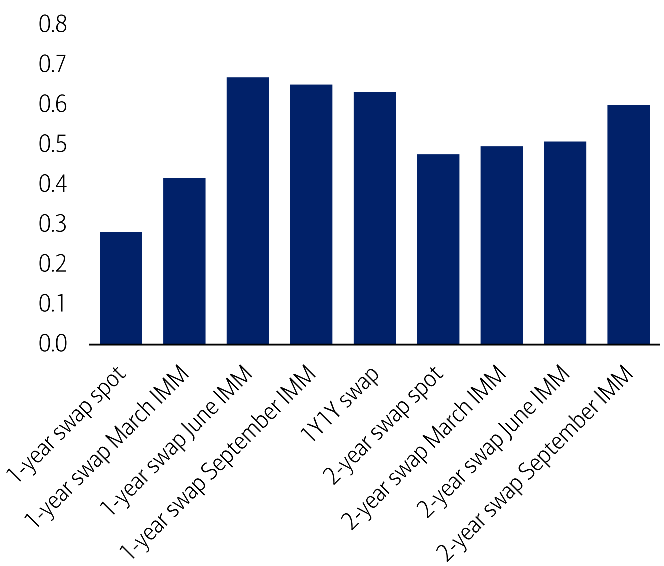
No hikes from the NBP: pay rates in PLN, receive in CZK

The market continues to price in too many cuts in Poland, in our view. Exhibit 8 shows that the market is significantly more dovish than our baseline forecast. On the other hand, it keeps pricing more cuts into the 1y1y as the CNB eases. This has historically been the case at the beginning of a cutting cycle. In all the previous easing cycles the 1y1y swap (net of carry and roll) fell as the CNB eased monetary policy (Exhibit 9). This is likely to be the case in this cycle as well.

Hawkish NBH + EU funds: short CZKHUF

The NBH surprised the market by cutting the policy rate by only 75bps (vs 100bps priced by the market) on 30 January. This clearly shows that the NBH is concerned about HUF stability. This should support the HUF going forward. Moreover, the improved relationship between the EU and Hungary as well as EU fund inflows should be positive for the forint. With the CNB easing, we believe there is room for the koruna to weaken given that the market is likely to price more cuts into the curve. Moreover, an RV expression reduces the broader USD risk compared to a short EURHUF trade.

Exhibit 8: The market is still more dovish than our baseline forecast
The chart shows BofA expectations vs market prices



Source: Bloomberg, BofA Global Research

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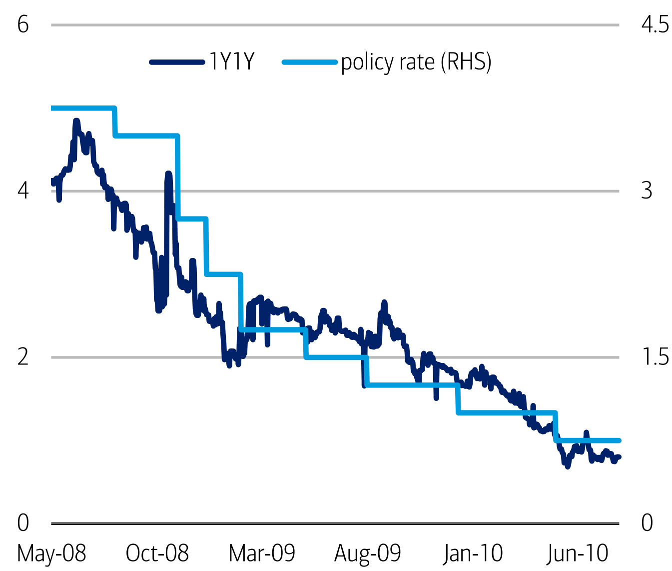
Exhibit 9: The 1y1y goes down as the CNB cuts
The chart shows the 1y1y in Czechia (net of roll) for the 2008-10 cutting cycle



Source: Bloomberg, BofA Global Research

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