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Market Questioning CEE Policy Resilience

Forward pricing of CEE reflecting external realities

- Public spending may struggle to sustain current pace
- Manufacturing contraction will begin to affect wages and services
- Limited direct US exposures masks EU supply chain risks

CEE holdings softening as markets ponder restarting of easing

The National Bank of Hungary (MNB) held rates for the second meeting in a row on Tuesday, citing the need for “patience” and “care.” The same can be said for the policy stances of central banks in Central and Eastern European (CEE) economies, which have broadly slowed or paused policy easing. For now, these steps seem prudent due to an adverse combination of domestic and external risks. Like much of the developed world, governments are finding it difficult to sharply curtail state support for the household, even though supply risks – especially from the energy sector – are far lower compared to 2–3 years ago. The offsetting effect on financial conditions arising from fiscal loosening continues to complicate policy trajectories globally, but it is particularly acute in Europe. Secondly, since the November US presidential election, the global dollar environment has shifted. Although the EUR is struggling the most with valuations, by extension the region is going to face general pass-through risk arising from generally higher dollar-priced input costs. As such, renewed vigilance is required as smaller economies are more susceptible to pass-through.

However, markets are starting to doubt whether the current neutral stance of the region’s central banks is sustainable. As shown in Exhibit #1, the bulk of the re-pricing in forward rates took place in October as the region was almost fully synchronised in pricing out easing relative to their original baselines. Hungary even started pricing in renewed tightening, though this proved difficult to sustain. In fairness, such shifts were not isolated to the region – renewed tightening is being realised in Latin America, while Asia-Pacific central banks are also much more attuned to pass-through risks and keeping rates on hold. We also highlighted in early October, when a less dovish stance was being reflected, that the amount of inflows moving into CEE at the time would also generate significant outflow risk if rate trajectories proved unsustainable. Current evidence suggests that CEE is still expected to hold the line, but the story is probably out of central banks' hands. If the fiscal outlook and external conditions – especially indirect trade risk through the Eurozone – begin to deteriorate, easing expectations could be moved forward and quickly.

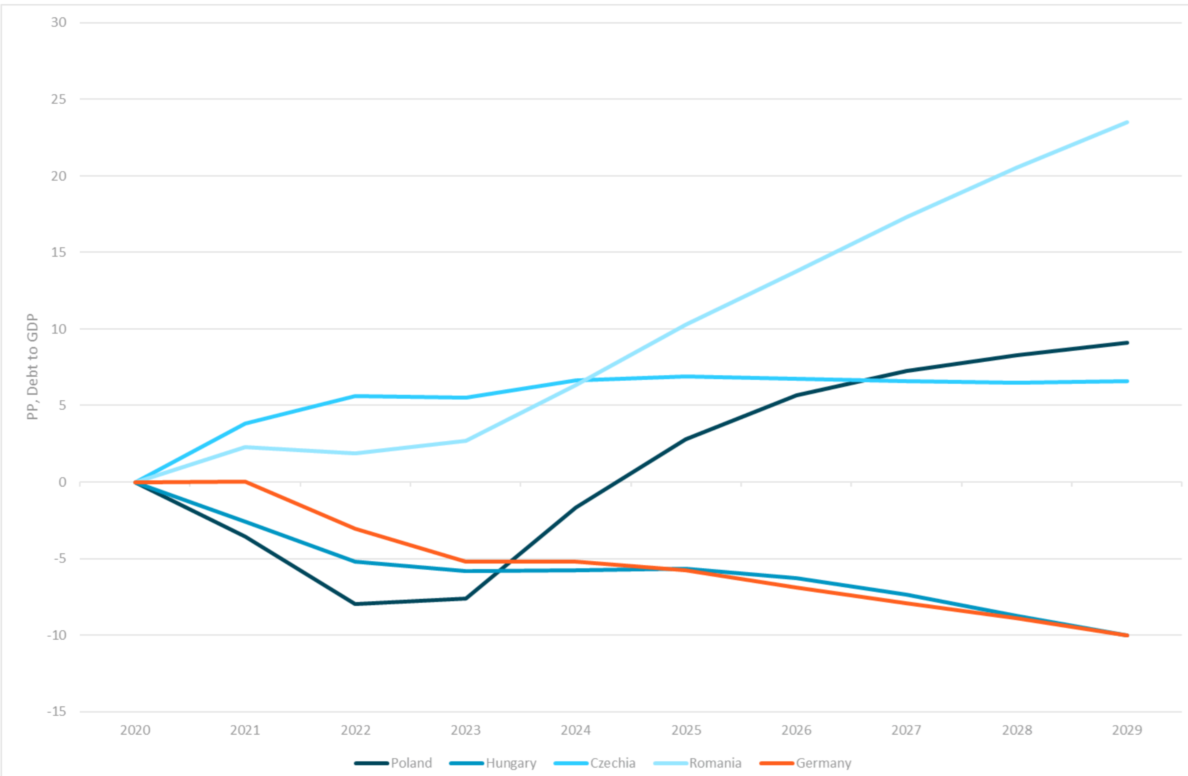
Exhibit #1: Change in CEE 1y1y Forward Rates

Source: Bloomberg, BNY

In October when we highlighted the need for CEE to maintain tight policy to sustain inflows into the economy, we lamented that "strong foreign financing flows in search of carry have not exerted as much fiscal discipline as we would usually have expected in a normal emerging market inflation spiral." Even so, this doesn't mean that governments have carte blanche to act on fiscal unless there are extenuating circumstances, and even then, we don't see the need for a repeat of the 2022 round. Based on the latest round of IMF projections (Exhibit #2), gross debt in the region – as a proxy for fiscal impulse – is still expected to rise. Only in Hungary is meaningful fiscal consolidation expected and generally aligned with Germany's, but this is for an economy which is coming from a high starting point in terms of outlays.

Furthermore, high nominal growth is also contributing to limited gains in ratios, so the true inflation impact on the ground is also masked to some extent. National Bank of Poland Governor Glapinski stressed earlier this month that less restrictive monetary policy would be easier “with fiscal tightening,” but current IMF forecasts point to an increase in total debt of 11 percentage points of GDP over the next five years. On the other hand, these factors are well in the price and if the market now believes that the balance of fiscal risks will be sharply skewed towards tightening over the forecast horizon, then the policy space as cited by Glapinski could emerge earlier than expected and have an impact on the policy path.

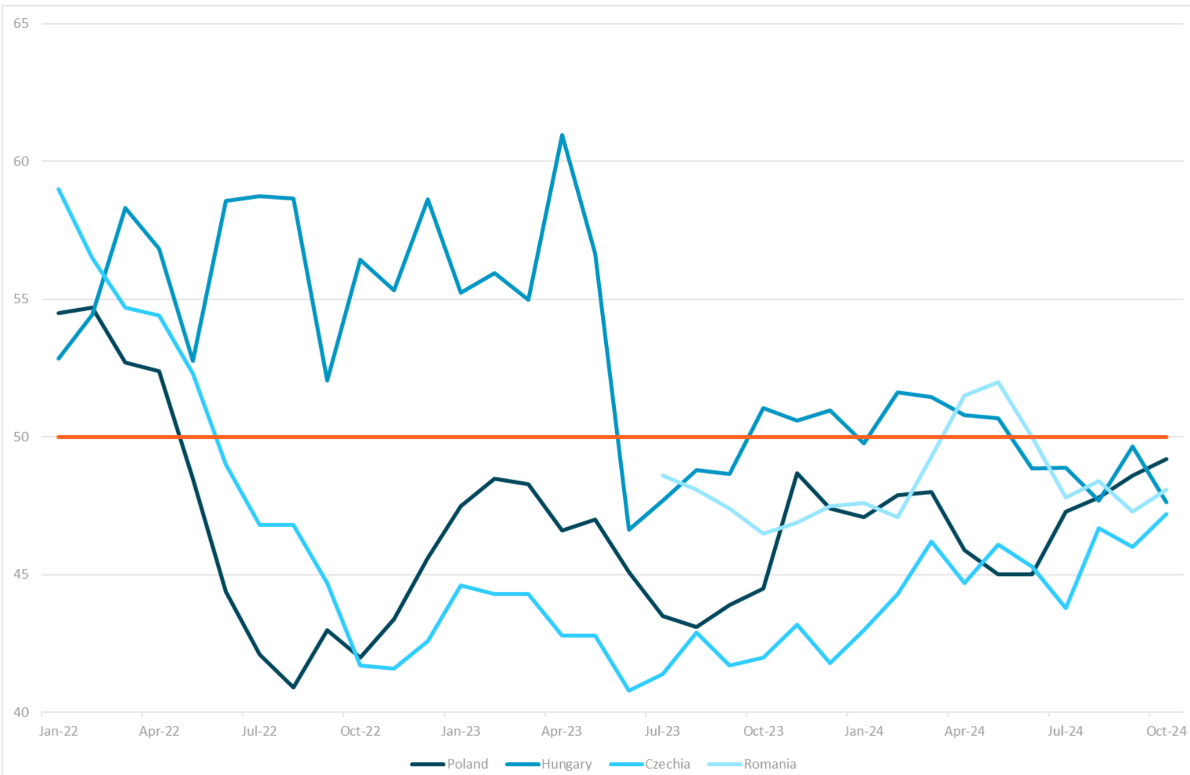
Exhibit #2: Gross Debt Change in CEE



Source: Bloomberg, BNY

The Eurozone’s growth outlook remains the biggest near-term risk to the policy path. Already, some ECB Governing Council members are pushing for a move towards “neutral rates,” and we believe there is a strong chance of a 50bp cut in December. This would immediately generate additional policy space for CEE central banks, and the recent decline in the euro has already resulted in some tightening in financial conditions via pass-through disinflation. However, as CEE central banks are mostly concerned about wage growth and labour markets in general, a decline in aggregate demand is required for the region’s policymakers to become more comfortable with the inflation outlook. As Purchasing Manager Indices (PMI) reports for the Eurozone have already hinted that manufacturing contraction is spilling into weaker services exports, a similar situation could arise in CEE, but on a more accelerated basis due to faster transmission within smaller economies. To our frustration, it has taken time for the ECB to respond to business surveys in the Eurozone and in fairness, two years' worth of contraction in the sector has not resulted in material declines in Eurozone inflation. Similarly, CEE manufacturing PMIs have been contracting for much of the year but there are tentative signs of improvement, though only insofar as the degree of contraction is no longer as severe. Given the region's importance in the general European supply chain, we find the divergence between CEE and German manufacturing PMIs surprising, though similar differences have been observed for developed Western European economies, such as renewed expansion in UK and Swedish manufacturing PMIs.

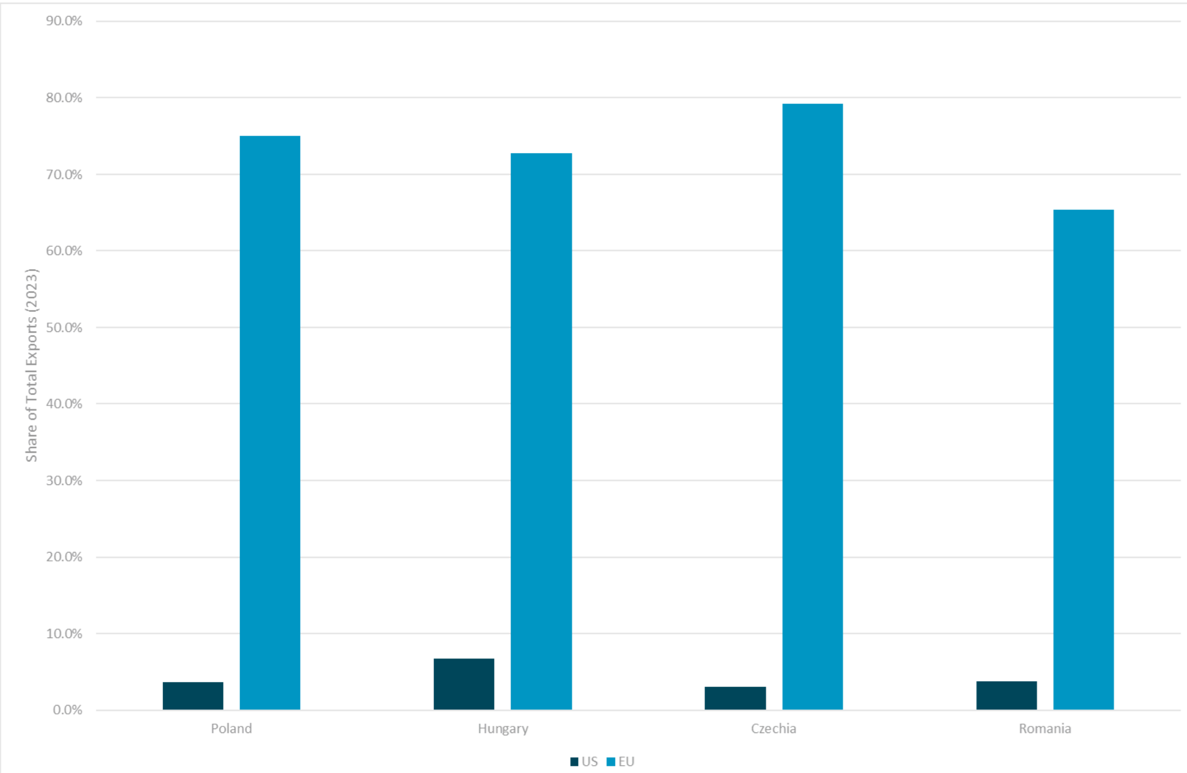
Exhibit #3: CEE Manufacturing PMIs



Source: Macrobond, Bloomberg, BNY

The final source of uncertainty is how the US election will impact the region. Geopolitics is the most obvious risk, but economic matters should not be ruled out either. While Asia-Pacific currencies and the euro have been the most affected by the result, CEE is not entirely in the clear. Headline figures suggest minimal export exposure to the US (Exhibit #4), but as CEE is part of the broader Eurozone export supply chain, tariffs on finished goods exports from the European Union to the US would heavily affect intermediate goods producers such as CEE nations. We trust that governments and central banks in the region are now assessing the real size of US demand on a look-through basis, and we trust the percentage shares will be much larger than the single-digit headline figures. Under such circumstances, having a strong fiscal stance as a starting point could prove a blessing in disguise for the economy. Even so, as general tariffs from the US would further affect EUR valuations and financial conditions, CEE central banks will need to swiftly align policy. Neutral pricing for CEE rates at present appears adequate but the risks are no longer skewed towards the upside. The MNB and its peers may find that patience is a luxury that few policymakers can afford amid uncertain times.

Exhibit #4: EU, US Share of CEE Exports



Source: Bloomberg, BNY

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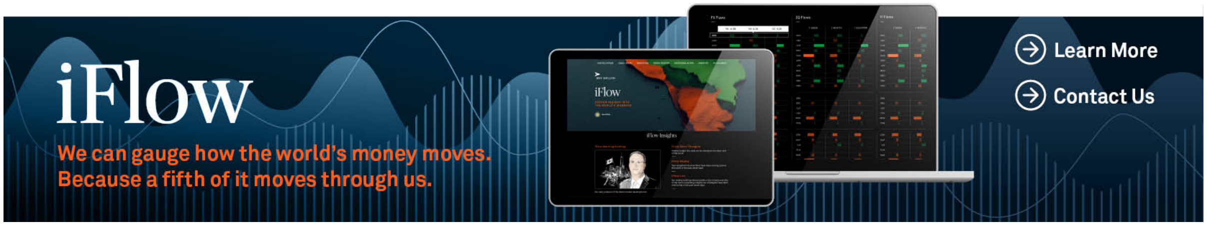

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