BNY
iFlow
MACRO MORNING BRIEFING

October 2, 2024

Favorable Rates Required to Sustain CEE

Cross-asset positioning in the region looking stretched

- External inflows into debt markets at multi-year highs
- ECB easing may not open up sufficient policy space
- Private and public consumption expected to stay high in 2025

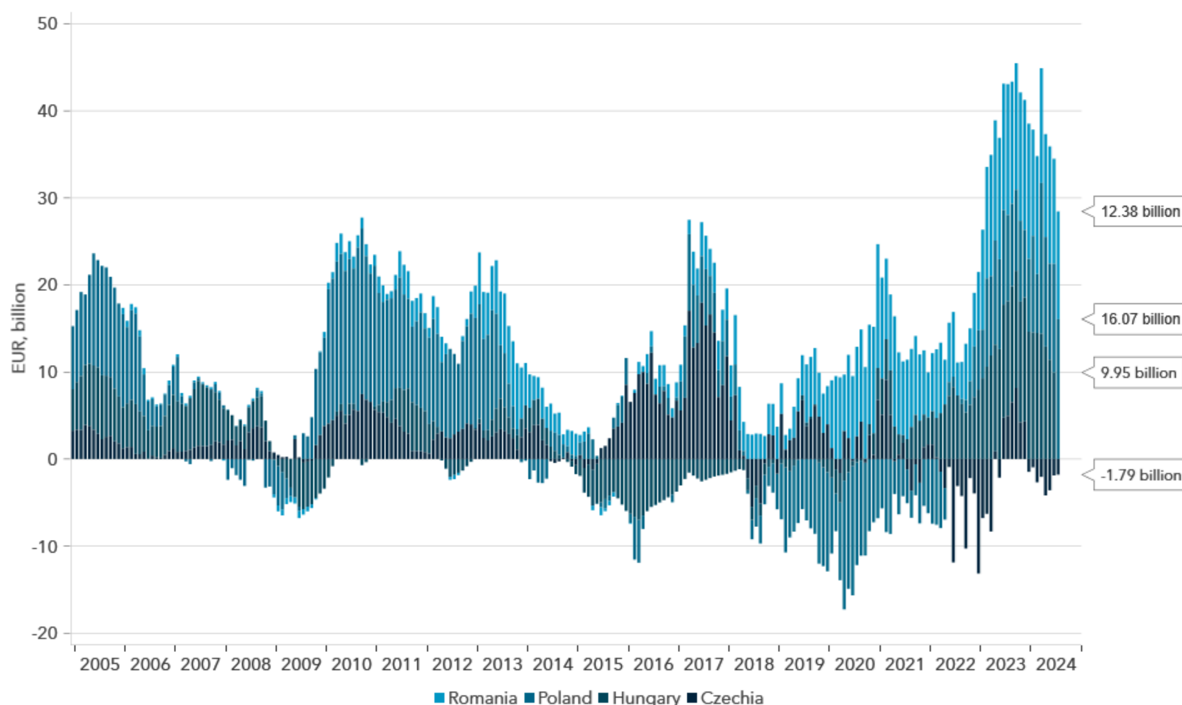
Labor market and public spending to inhibit rate cuts

Barring any major surprises, National Bank of Poland (NBP) and National Bank of Romania (NBR) are expected to keep their policy rates on hold this week. In doing so, it would be a sign to the market that even within the Central and Eastern Europe (CEE4) economies, notwithstanding their exposures to broader Eurozone conditions, divergence is taking place in policy and there is no guarantee that where the European Central Bank (ECB) leads, the rest of the region will follow. This mirrors some of the divergence seen elsewhere, for example, in Latin America, where the Central Bank of Brazil has started rate hikes despite the surprise 50bp cut by the Fed.

Such divergences underscore the challenges of optimizing monetary policy where the bulk of inflationary impulse is driven by supply issues, especially labor supply and wage formation. CEE4 economies were arguably among the earliest to respond to such pressures, as tightening had already been forthcoming well before the pandemic began. Post-reopening supply pressures only amplified such trends, and the region was seen as a paragon of credible monetary policy response, as policy was tightened aggressively and early. Even now as easing cycles have commenced for all four economies, to different degrees, markets expect the region to hold on to strong real rates, and this has supported inflows in what remains a carry favorable environment. As Exhibit #1 shows, external inflows into debt

markets in CEE4 on a 12-month rolling sum basis have surged over the past two years in pursuit of real rates. Only flows into the Czech debt market are negative on a 1-year rolling sum basis. As the ECB continues to cut rates with the risk of more easing than currently priced or communicated, these flows will likely remain strong even with more limited hedge ratios due to the additional interest rate pick-up. However, given positioning is already so extended, and faced with growing external and internal risks, keeping flows within the country and preventing a disorderly exit of external funding will be a challenge.

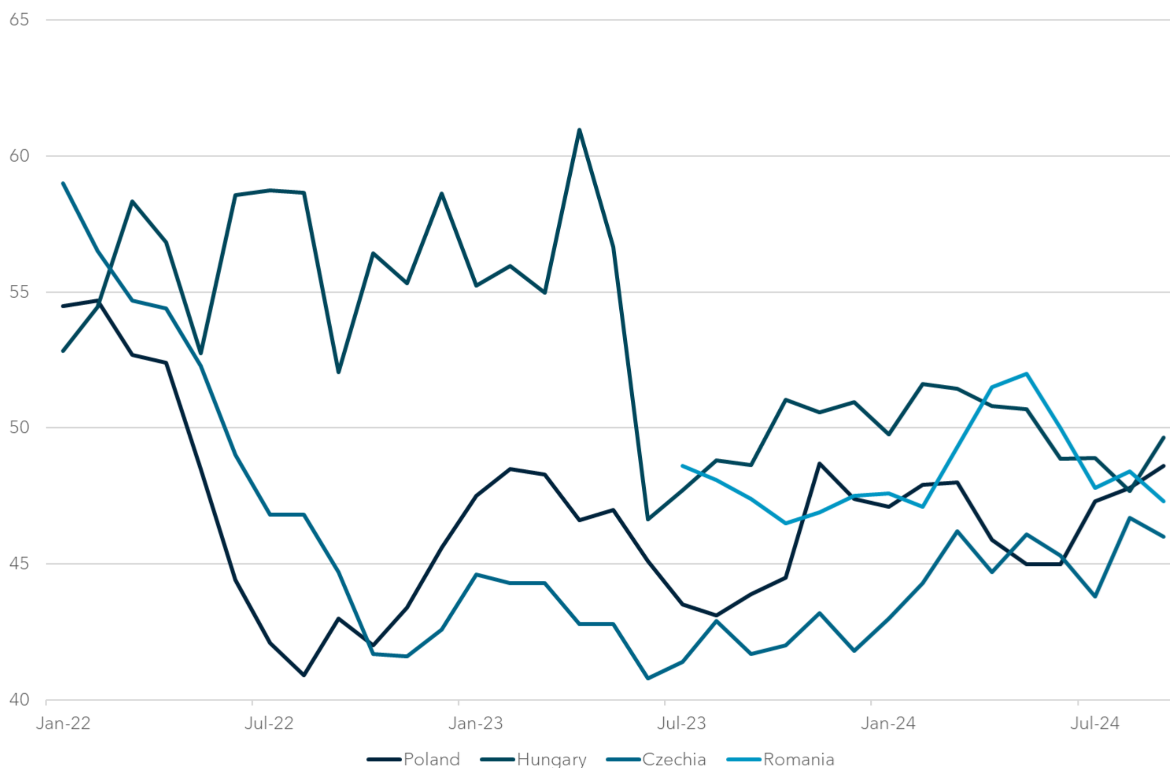
Exhibit #1: Debt Inflows into CEE4



Source: Macrobond, BNY

Given the economic exposures of all four economies, the risk of a material slowdown in the Eurozone is obvious. In comments made earlier this week, ECB President Lagarde noted that the "increased confidence" of the ECB in meeting their 2% inflation target needs to be taken "into account in October." Compared to previous guidance, this is evidently a signal that October is a live meeting. The revisions to German economic performance for the rest of the year – to which much of the CEE4's manufacturing based is exposed – have clearly changed the equation as well. Whether this means that the CEE4 central banks will automatically follow remains to be seen. The ECB's general reluctance to ease stems from the failure of manufacturing declines to spill over into services. The September German Purchasing Managers Index (PMI) report indicated that spillover is finally taking place, but only after over two years of contraction in manufacturing itself. Exhibit #2 shows that as of September, all CEE4 economies' manufacturing PMIs are below 50 and showing contraction, but the trend is

uncertain. Romania and Hungary were back in expansion earlier this year, while Czech and Polish PMIs largely track the German output trends, even though the Czech National Bank (CNB) and NBP are very much divergent in their policy outlook.

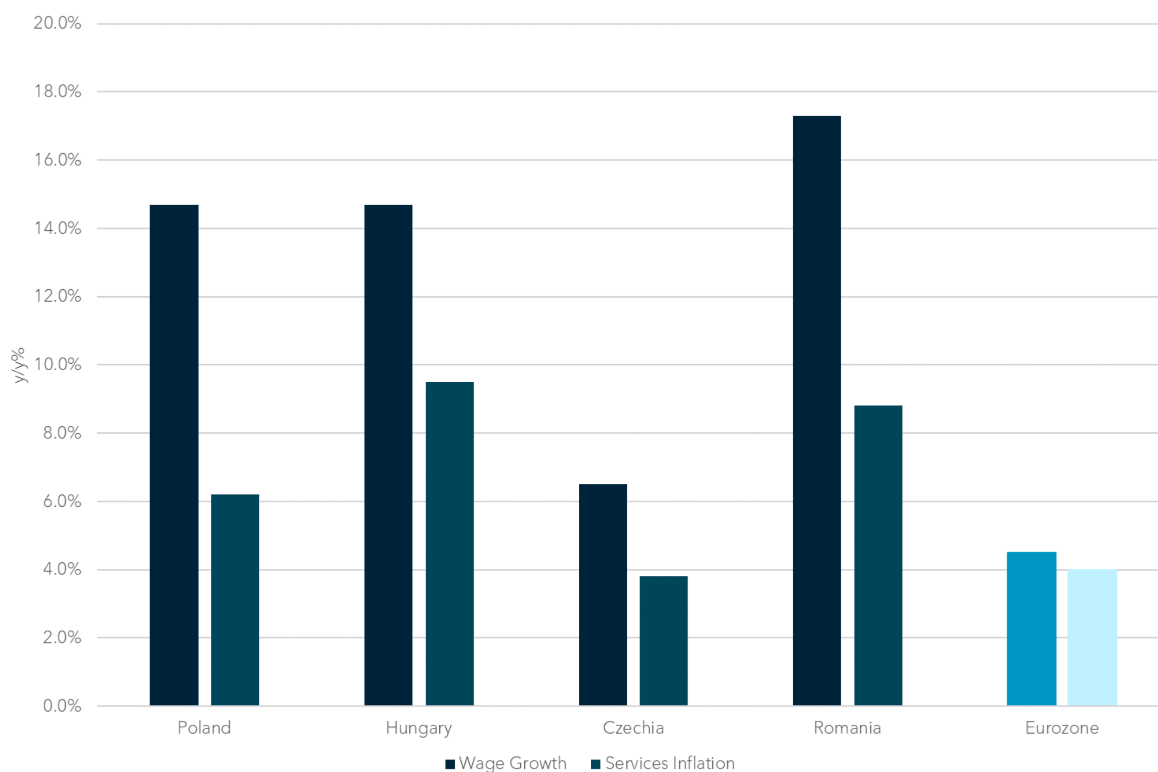


Source: Bloomberg, BNY

If we hold the view that Europe's general manufacturing struggles are a given and long "in the price," then it will be domestic conditions which will cause a policy pivot. As we highlighted recently in comparing ECB policy with regional peers, services sector inflation risks, mostly arising from labor market tightness, are still the most important factor inhibiting a more dovish approach. Lagarde also highlighted in her testimony this week that the Eurozone labor market was "resilient," and the latest wage and services inflation figures – both holding above 4%y/y – support the hawks' case for caution. However, for the CEE4 economies, only Czech services inflation is broadly in line with the Eurozone's, whereas all other equivalents are far above their own policy targets. Even though the numbers are softening from very elevated levels, they are still far too high for comfort, as inflation expectations tend to be difficult to anchor when running above policy targets. Consequently, to maintain policy credibility and foreign investment flows, all CEE4 central banks will need to maintain restrictive conditions until there is clear evidence of loosening wage pressures.

As is the case with the Eurozone, one of the key drivers of wage support in CEE4 is also arising from public spending. Central banks are still dealing with the fallout from strong fiscal support during the pandemic, and CEE4 economies faced particularly high exposures in 2022 and 2023 due to the energy crisis. Over the past 18 months, fiscal restraint has become accepted wisdom, but this does not imply more aggressive budgetary tightening. If anything, 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.

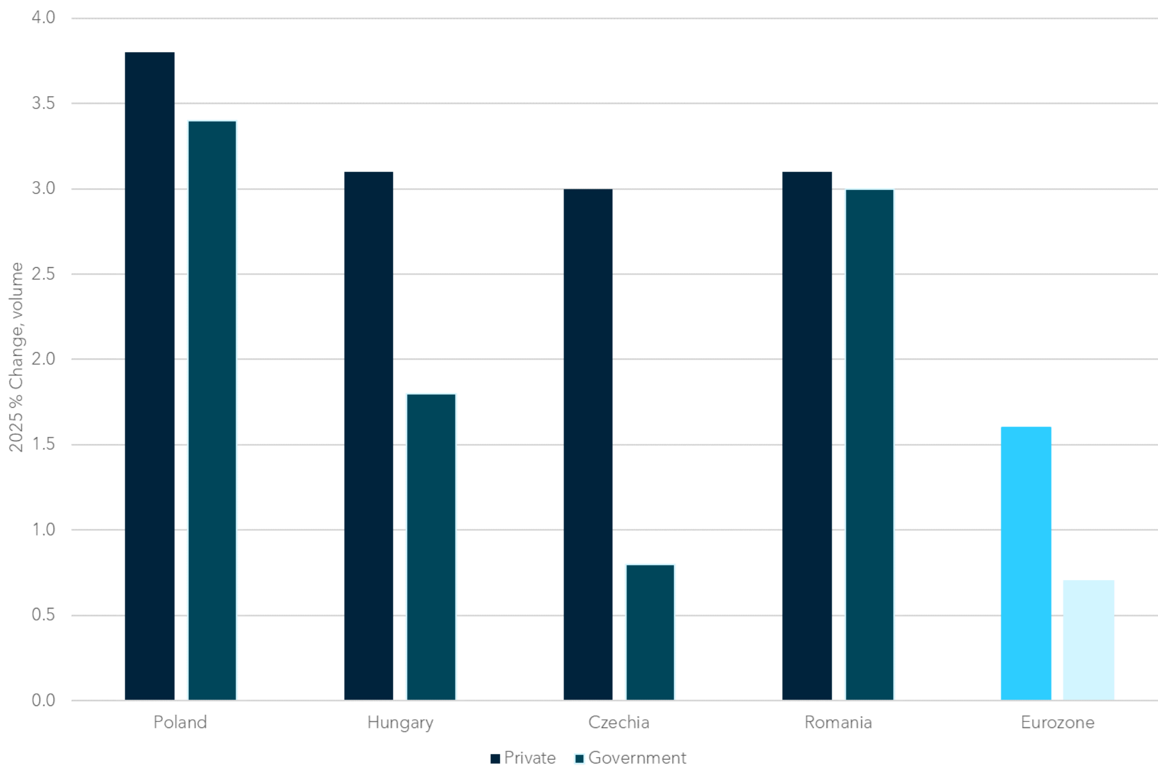
Exhibit #3: CEE4 Wage Growth and Services Inflation



Source: Macrobond, BNY

Based on the most recent OECD Economic Outlook (Exhibit #4), private consumption growth in real terms is expected to remain robust, at 3%y/y, in all CEE4 economies next year, undoubtedly helped by robust wage growth. In contrast, Eurozone households are only expected to increase spending by around half that level. However, while public consumption growth is expected to fall well below 1% in 2025 in the Eurozone, Poland and Romania are both expected to register growth rates of above 3%, Hungary just below 2%. Only Czech government outlays are expected to match the relative restraint in the Eurozone. Governments in the region will hope for ongoing external financing to help sustain such investment levels, but given the downside risk to real rates due to sustained inflation pressures, nominal rates will have to stay high to compensate.

Exhibit #4: 2025 CEE4 Public, Private Consumption Growth



Source: OECD, BNY

The struggle of central banks to convince their governments to exercise spending restraint is an unfortunate necessity globally, but without any changes in fiscal direction CEE4 central banks will need to oblige. Moving more aggressively with rate cuts risks causing outflows that, apart from their impact on financial conditions, generates currency weakness that would reintroduce risks to achieving the inflation target, which ultimately is the cornerstone of the central banks' mandates.

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

Can't see the email? View online

We take our data protection and privacy responsibilities seriously and our privacy notice explains how we collect, use, and share personal information in the course of our business activities. It can be accessed here.

This email was sent to WeeKhoon.Chong@bnymellon.com, and was sent by The Bank of New York Mellon 240 Greenwich Street, New York NY 10286.

Your privacy is important to us. You can opt out from receiving future Newsletters by unsubscribing via this link at any time. You can also select the topics that you want to receive by managing your preferences.

This message was sent from an unmonitored email box. Please do not reply to this message.

Contact Us | iflow@bnymellon.com

© 2024 The Bank of New York Mellon Corporation. All rights reserved.

This message was sent from an unmonitored email box. Please do not reply to this message.

.