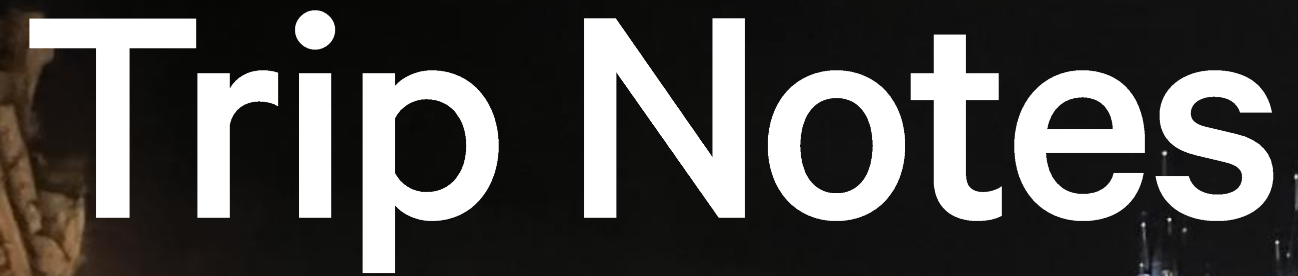

Trip Notes

CE3 November 2024

Aktia

View from Czech Republic, Prague

Trip Notes: CE3 Countries

- We recently travelled to Czech Republic, Hungary, and Poland to get the latest on-the-ground insights, current state and direction of the economies. During the three days we with policymakers, local banks, other financial institutions, economists, and journalists.
- In CE3, growth is expected to improve going into next year, with the main driver being private consumption as wage development is supportive for households. Poland is expected to show the strongest growth, with a consensus above 3.5% for 2025. Hungary is seen to grow about 3%, while the Czech Republic is expected to land at around 2.5%.
- However, a new risk has emerged after the US elections in the form of potential trade tariffs by the US on EU. This topic was among the main discussions in many meetings, showing that it is one of the main concerns for the investors as Czech Republic, Hungary and Poland are small open economies. In CE3, the direct export exposure to the US is low, but the additional burden to German growth (which is already sluggish) would very likely have negative growth spillovers to the countries.
- On the monetary policy side, CE3 central banks have now adopted cautious stance. While the underlying reason for the hawkishness varies from country to country, especially in Hungary the external environment has been a driving force to keep rates unchanged.
- When it comes to fiscal policy, the Czech Republic stands out positively. In Poland, however, budget deficits are going to the stay elevated driven by defense spending, and consolidation is expected to take place no earlier than 2026. In Hungary, the political environment adds uncertainty regarding the fiscal outlook as the ruling party Fidesz has recently lost its peak position in polls and growth momentum has lost steam.

View from Poland, Warsaw

Czech Republic

Fiscal in check, cautious central bank

Growth is expected to improve going into next year (to above 2% from 1%), led by private consumption. Real income growth is expected to continue above historical averages in 2025, which is certainly a supportive factor for household spending. Also, if consumer confidence continues to recover, private consumption could receive an additional boost from excessive savings being spent. However, in the meetings it was pointed out that the savings rate has already been surprisingly sticky at elevated levels, dragging down consumption, suggesting that precautionary saving might have some structural elements owing to (global) uncertainties.

Many seem to expect lower interest rates to support private investments over the coming quarters, while public investments are seen to remain accommodated by the EU funds. The view that stronger private investments will be driven by lower rates is now being challenged, as the central bank has turned hawkish. The main question now is if the cautiousness is only temporary. Some believe that there is a high probability that the central bank will pause its cutting cycle in December. The central bank board is divided with some board members putting more weight on growth risks, while others think upside risks to inflation dominates the big picture. The latter group is concerned about food inflation and elevated service price inflation. The latest central bank forecasts included a substantial upward revision to inflation, with annual consumer price growth expected to exceed 3% at the end of the year and remain elevated throughout 2025.

Overall, we got the impression that for the central bank the risks of low or below-target inflation are not very high, and as a result, a possible EU recession (e.g. due to trade tariffs) wouldn't trigger the central bank to act in an extremely pre-emptive manner. The monetary policy stance is still restrictive with the real policy rate high in historical terms. Also, the central bank seems to think that the recent dovish pricing for the ECB shouldn't be seen as a road map for the Czech monetary policy. In fact, even the most dovish members of the board argue that as inflation has been above the target since 2016 and there could be some unidentified structural factor in play, it doesn't make sense be very reactive driven solely by the ECB. The potential FX strength (or stability) due to policy divergence would be seen as beneficial for the inflation outlook.

We got the impression that for the central bank the risks of low or below-target inflation are not very high

Czech Republic

The 2026 elections may shape the fiscal outlook, but the general expectation is that the fiscal path is going to stay sustainable irrespective of the outcome, despite some populistic election promises having already been made. Budget tightening is on track, with on the back consolidation package for 2024–2025 amounts to 1.8% of GDP. The ministry of finance targets budget deficits of 2.8% of GDP and 2.3% for 2024 and 2025, respectively, with the public debt ratio expected to peak at 45% of GDP in 2026. Unlike other CE3s, the Czech Republic is safe from an Excessive deficit procedure (EDP) by the EU, and overall, the discussions regarding the fiscal stance were not at the forefront of the meetings.

The automotive sector is very important for the Czech economy, accounting for around 10% of GDP, and with car production per capita among the highest in the world. While the sector is doing well now, some believe that it may face challenges over the medium-term. For example, the green transition and the shift towards EVs may prove to be difficult for the country unless the production structure is adjusted to meet new demand, as around 90% of all production involves cars with internal combustion engines. Also, Chinese car makers are shaping the playing field, adding (cost) competition. In addition, Volkswagen is in the progress of shutting down several factories in Germany due to overcapacity, and these measures could be extended to the Czech Republic, too.

Our view and positioning: In our EM local currency strategy, the Czech Republic has the highest weight in our CEE allocation at close to 7% weight. The market is stable compared to other EMs, offering diversification, downside protection and steady carry to portfolio. The FX is expensive in our view, but hawkish central bank coupled with ample reserves protect the currency. In rates, we think the outlook is supported by improvement in fiscal and inflation that is under control as the central bank has high credibility.

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Hungary

All the Fidesz need is growth

Hungary's growth momentum has recently lost some steam as weak Q3 GDP put the economy into a technical recession and on a clearly weaker path than the government had expected. GDP contracted by 0.8% from the previous quarter, while the government anticipated zero growth. The Ministry of Finance has an optimistic outlook, penciling in 3.4% growth for 2025 versus the consensus forecast of +3.1%. The central bank is in the process of updating its growth forecasts and is likely to land in the +2.5–3% area, i.e. revising the outlook downward. Overall, the narrative for the new year is quite similar to that of other CE3s: Growth is seen as recovering on the back of private consumption supported by a strong labour market and income gains. Indeed, employment is at a record high, and companies continue to express hiring intentions. A large amount of EU money is still blocked for Hungary, undermining the country's growth outlook. Exports remain a question mark considering weak EU growth and downside risks from the potential trade tariffs, but large FDI projects coming online could positively impact export figures in the latter part of the year or during 2026.

The central bank has struck a hawkish tone as it believes that the market environment has changed significantly since mid-September. More specifically, pressure on the currency is a concern as the FX transmission channel is important for price dynamics. Amid an unstable external environment, the central bank aims to provide stability by keeping rates on hold, and widening policy rate spread against DM central banks would be welcome in the current situation. Inflation is anticipated to increase towards 4% in the coming months, but the central bank thinks this is mostly transitory, and its focus is now on maintaining FX stability. Some argue that the EURHUF below 400 could be a possible trigger for the central bank to cut back its hawkishness and resume easing. We got the impression that the weaker domestic growth momentum is not a huge concern for the central bank in terms of keeping rates on hold, as the underlying reasons for the lower activity are beyond the control of monetary policy. Also, a lot of faith has been placed on the continued recovery of domestic consumption.

Amid an unstable external environment, the central bank aims to provide stability by keeping rates on hold, and widening policy rate spread against DM central banks would be welcome in the current situation

Hungary

The central bank leadership change is one factor that has created uncertainty in the Hungarian markets. The new governor will take over in March 2025, when after György Matolcsy's term expires.. Finance minister Mihály Varga was expected to be the main candidate for the post, and we has appointed after trip at the end of November. While Varga is expected to have conservative approach to monetary policy some see there is a risk for a broader reshuffle in the MPC which could have implications for the rate outlook and central bank credibility. After all, the Fidesz party needs growth to pick up in order to stay in power, so there could be a bias toward having a more dovish central bank.

The government is on a fiscal consolidation path with draft budget for targeting a deficit of 3.7% of GDP (goal for 2024 at 4.5%). Under the medium-term economic framework, the deficit is aimed to brought down to 1.5% of GDP by 2028. However, already the 2025 target could prove to be challenging, given general elections in April 2026. In the meetings, it was mentioned that the economy ministry has pressure to create growth, the debt trajectory necessarily does not rank very high on the priority list. On expenditure side, new measures have been announced within the new economic plan, including goals such as improving real incomes, providing affordable housing, and supporting SMEs.

The ruling Fidesz party as lost popularity, which may have implications for the fiscal policy outlook, especially regarding the expenditure side and the government's commitment to remain within the 3.7% target. The ruling party Fidesz has been challenged by Péter Magyar's Tisza party who has recently reached peak positions in polls. Also, PM Orbán is not the most popular politician in Fidesz, at least for the time being. In the meetings, it was noted that the government has made changes to electoral laws, which could imply a possibility of early elections, a rare occurrence in Hungary. However, many think that early elections wouldn't make sense at this point, given the weak growth momentum. Hungary is a small open economy, so tariffs would be a drag to growth, possibly causing headwinds for the government, but some see Orbán may have a real chance to able to negotiate with the Trump administration something beneficial for Hungary. On the other hand, many think that Orbán is merely engaging in a PR stunt, as pictures with global leaders are enough to boost his popularity.

Our view and positioning: Hungary is designated as red in our country selection model, meaning we don't invest in government bonds. In the EM local currency strategy, we have an underweight position in Hungary. In our view, the market is the most politically driven in CE3 and given the Fidesz is now challenged the risks for market-negative policies is increasing. We see central banks FX sensitive approach as positive, and overall think that the central bank has good credibility. However, the coming changes in the central bank leadership is a risk factor, despite Varga is seen to have prudent approach to monetary policy.

Poland

The central bank running excuses not to cut

Poland is expected to have the strongest growth next year among the CE3 countries. The consensus forecast for 2025 GDP growth currently stands at 3.6%, while the Ministry of Finance sees the growth at 3.9% and the central bank at 3.4%. As is the case in the region, private consumption is expected to be the main growth engine on the back of nominal and real wage increases, despite moderation is expected going into next year. Wage growth has been very strong this year on the back of a 18% minimum wage hike in January (policy by the previous government) and a 20–30% increase for civil servants and teachers (policy by the current government). The labour market is seen as tight, keeping upward pressure on wages. Recently, there has been speculation that during the year Ukrainian refugees may have started to move from Poland to other countries, which could materialise as a large negative shock to the labour market, increasing labour shortages and adding to wages pressures. However, at present, at least the registered employment has remained stable, not giving support to the claim.

In contrast to other CE3 countries, the central bank communication has shifted to be less hawkish during the past few months. Governor Adam Glapinski has suggested the March meeting could be possible for discussing a rate cut as staff inflation forecasts are updated. Overall, the central bank's stance is seen as politically driven with Adam Glapinski and several other MPC members are appointed by the Law and Justice (PiS) party. Many think that central bank's communication and rationale for the rate outlook are inconsistent. Indeed, after the PiS lost elections, the central bank has taken very hawkish tone. Officially the central bank's reluctance to cut rates is argued to be based on inflation risks due to high wage growth, loose fiscal policy, and regulated prices (e.g. cigarette and alcohol excise tax hikes) adding inflation uncertainty. However, at the same, time the so-called super core inflation (which strips out administrative prices) is moving in the right direction, and the central bank assesses the output gap to be negative.

The central bank's reluctance to cut rates is argued to be based on inflation risks due to high wage growth, loose fiscal policy, and regulated prices

Poland

Headline inflation has been trending upward, rising to 5.0% YoY, with the central bank anticipating the peak in Q1 next year. The recent rise is mainly due to the partial phase-out of the anti-inflation measures in July for power and gas, a low base, and higher food prices. That being said, the government's decision to extend energy price caps will decrease a lot of inflation uncertainty perceived by the central bank. Due to the caps, energy prices are not going to jump in January, and the energy component will have a negative contribution to inflation in July due to the high base from the current year. Some central bank members argue that the weak activity data in Q3 (especially the retail sales disappointment) should not be used as an argument to lean more to the dovish side as the risk for below 3% growth is thought to be unlikely. In addition, some MPC member believe that potential US trade tariffs and their indirect downside risks to Poland's economy are not imminent. If the risks are to realise, the impact could be felt maybe in late 2025 or in 2026, rather than over the short term. Overall, the central bank's easing will most likely be gradual, with some members seeing the cumulative upper limit for rate cuts at 100bps over the next year.

Regarding the fiscal outlook, Poland stands out negatively compared to its CE3 peers as fiscal consolidation is in practice postponed to 2026. While the public debt level is still relatively modest, the deficit target for this year is very high (5.7% of GDP) with only marginal tightening (5.5%) expected to take place in 2025, a year for presidential elections. For the Civic Coalition (KO)-led government a win in the presidential elections would be highly welcome as the incumbent president Andrzej Duda (PiS) has been blocking the government's policies.

Poland is under the EU's EDP, and it aims to meet the criteria in four years (with a below 3% budged deficit target in 2028), but the timeframe could be extended to seven years. Elevated budget deficits owe to an increase in defence spending (4.7% of GDP in 2025), which is among the highest in the EU. Another big spending item in the budget is healthcare (5.6%). In the meeting some pointed out that the fiscal consolidation plan lacks credibility as a set of measures to achieve the targets has yet to be identified. That being said, the litmus test for the government's commitment for fiscal consolidation will be later next year when the 2026 budget draft is presented. Overall, there is a risk that the four-year plan to reduce the budget deficit to below 3% is too ambitious, given general elections are scheduled to take place in 2028.

Our view and positioning: In our local currency strategy, we have an underweight position in Poland. The market has benefitted from better EU relations with ample funding after the government change. Interest rates are still above the long-term averages, but inconsistent central bank may add volatility, especially in the short end of the curve. The longer end of the curve could be pressured by the loose fiscal position, especially if growth disappoints. In the Hard currency strategy, Poland adds diversification in the high rated IG segment, in which some countries have exposure to geopolitical tensions in the Middle East.

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