Central European Weekly

Monday, 22 September 2014

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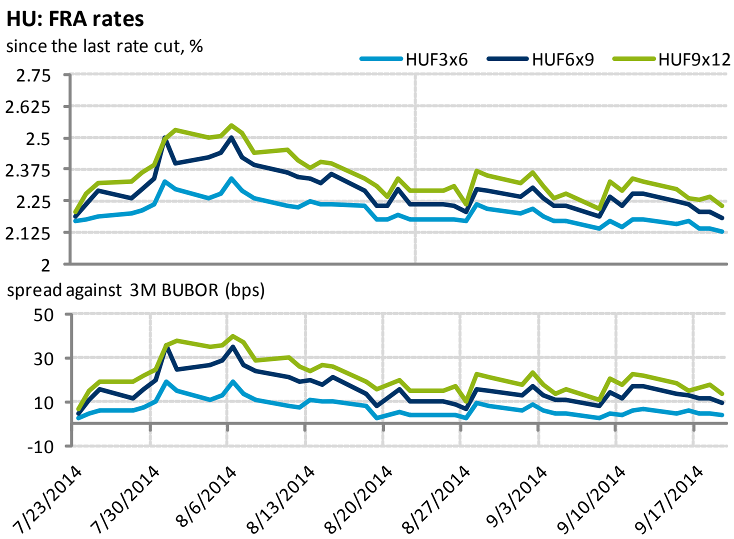
Chart of the Week



Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while the Czech inflation remain at the lowest levels.

Market's editorial

Is another wave of easing on the way in the region?

The Ukrainian crisis, the euro area's waning economic growth and, last but not least, the ECB policy, are stirring things up in the Central European region as well. Moreover, the above factors will activate central banks, which had already thought that no further expansive actions would be required. The National Bank of Poland (NBP) has essentially announced that it is going to restore its rate cut cycle, which has been dormant for longer than a year, and a similar move is not completely ruled out in Hungary (by the NBH) in the end either.

The NBH still on hold, but...

Easing in can not be ruled out in Hungary even though the NBHy stated the last time that it cut its base rate, to 2.10% in July, that interest rates had really reached bottom and would remain there for a very long time. Last time Monetary Council's decision was unanimously and the base rate was kept unchanged at 2.1%. Since the ECB cut the base rate by 10bp and the NBH's reaction was that flexibility has been increased for Hungary as well. It may suggest that they see some room for further loosening of the monetary policy. Despite of this statement we don't expect rate movement from NBH. The main reasons are that headline CPI started to accelerate slowly in the last two months. Although its level is still low (0.2% Y/Y) it is mainly because of previous public utility cost reduction, the good harvest and the low oil price. The core inflation stuck around 2.5% Y/Y in the last 4 months and projections also reflects that CPI may increase to around 3% at the end of the next year. As the inflation target of the NBH is 3% Y/Y +/- 1%, the forecasted CPI is fully in this range so no monetary policy adjustment is required.

Rate cuts in Poland – a done deal

That the NBP is in a dovish mood is beyond doubt. This was also confirmed by the minutes of the last Monetary Policy Council (MPC) meeting. They revealed that the MPC had voted on a rate cut twice – by 50 and 25 basis points respectively – but none of the votes received enough support. The minutes primarily highlighted external risks (inter alia the ECB policy), and fairly explicitly stated that rates would be cut at the next meeting (October 8), unless September's data significantly changed the MPC's view of the economic developments. In this respect August's year-on-year decline in industrial output by 1.9% and in prices by 0.3% probably can no longer be seen as positive signals.

The only area of recent stability – the Czech motetary policy

The only area of monetary stability can be find in the Czech Republic, where the central bank might be finally satisfied that September's CNB Board meeting should spring no surprises. No new forecast and likely no surprising news from the economy will be on the agenda. Inflation continues to be well below the central bank target; nevertheless, it has at least remained 0.2% above the CNB's current forecast in the last two months. Combined with very positive data from the economy, it is hard to find a reason for any urgent move by the bank.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.6	-0.09%	↗	↗
EUR/HUF	312	-0.82%	↗	↗
EUR/PLN	4.19	-0.22%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.29	4.45	→	→
10Y HUF	3.89	-0.51	→	→
10Y PLN	2.90	-1.36	→	→

In Focus: Russian-Ukrainian crisis and its impact

Russian sanctions have brought no great revolution to Central Europe thus far. Hence not even the fairly strong decline of demand from Russia has reversed the positive trend of overall exports in most European countries, and the contribution of foreign trade in the second quarter was only slightly negative in the end and was often based on a decent rate of imports.

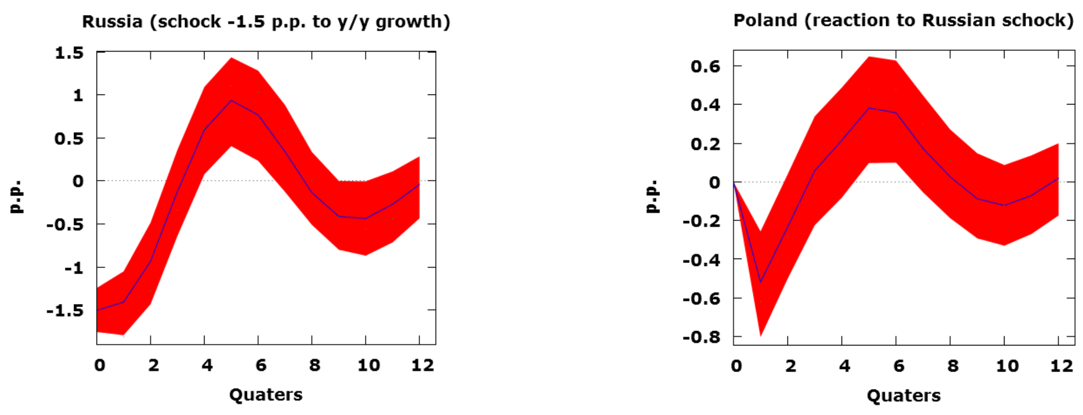
Poland is the Central European country most exposed to the existing sanctions.

On the other hand, it should be noted that the available figures do not yet reflect the latest launch of sanctions imposed by both the EU and Russia. Hence the data for August and September is likely to indicate another deterioration of exports to Russia, which will partly reflect the new sanctions and, above all, the worsened performance of the Russian economy. The Czech Republic's vulnerability to the sanctions imposed thus far is fairly small – the shares in the sectors concerned (arms, dual-use items and technologies, oil technologies, meat, dairy products, vegetables and fruit) are not high in the Czech Republic. The Central European country with the relatively worst position in this regard is Poland, which exports a great deal of fruit and vegetables to Russia – more than 7% of all of its exports to this country. Even so, this will not affect the Polish economy to a great extent. The question is what will follow? We foresee new sanctions and, in particular, another decline of the Russian economy..

The Czech economy would be most severely affected by the expansion of the Russian sanctions to include the automotive industry and a wider range of engineering products. Road vehicles make up more than a quarter of all Czech exports to Russia – over CZK 30 bn in 2013. Hungary would be most affected by restrictions on the pharmaceutical industry, which also makes up approximately a quarter of all Hungarian exports to Russia. Poland, unlike the Czech Republic and Hungary, is fortunate, because its exports to Russia are not overly concentrated in any one sector. By contrast, the weight of the Russian market for Poland is by far the greatest compared to all Polish exports – almost 9% of all of its exports go to Russia. Therefore sensitivity analyses indicate a greater vulnerability of Poland to another drop in the Russian economy.

Poland is the most susceptible to another deceleration of the Russian economy.

According to our forecasts, a shock from the Russian growth deceleration by 1.5 percentage point y/y would reduce growths of the Czech Republic and Hungary by 'only' 0.1-0.2 percentage pints in the forthcoming quarters, while Poland's growth would shrink by 0.4-0.5 p.p. Notwithstanding Poland's increased sensitivity, analyses as a whole indicate that all Central European economies should withstand Russia's moderate recession without greater problems. To threaten the Czech recovery, the Russian economy would have to fall much more. A drop in the Russian economy by approximately 8% y/y might return the Czech economy to a shallow recession (around - 0.5% y/y). Such a drop is not imminent, at least not at the moment.



Weekly preview

TUE 14:00 **NBH base rate**

	This meeting	Last change
rate level (in %)	2.10	7/2014
change in bps	0	-20

HU: The NBH on hold but it will sound dovish

Last time Monetary Council's decision was unanimously and the base rate was kept unchanged at 2.1%. Since the ECB cut the base rate by 10bp and the NBH's reaction was that flexibility has been increased for Hungary as well. It may suggest that they see some room for further loosening of the monetary policy. Despite of this statement we don't expect rate movement from NBH. The main reasons are that headline CPI started to accelerate slowly in the last two months. Although its level is still low (0.2% Y/Y) it is mainly because of previous public utility cost reduction, the good harvest and the low oil price. The core inflation stuck around 2.5% Y/Y in the last 4 months and projections also reflects that CPI may increase to around 3% at the end of the next year. As the inflation target of the NBH is 3% Y/Y +/- 1%, the forecasted CPI is fully in this range so no monetary policy adjustment is required.

THU 13:00 **CNB base rate**

	This meeting	Last change
rate level (in %)	0.05	11/2012
change in bps	0	-20

CZ: No change to the monetary policy

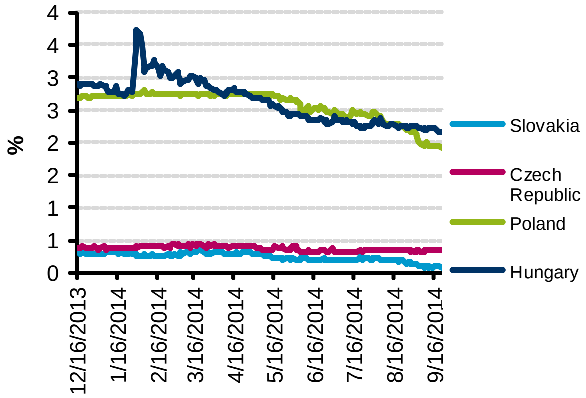
September's CNB Board meeting should spring no surprises. No new forecast and likely no surprising news from the economy will be on the agenda. Inflation continues to be well below the central bank target; nevertheless, it has at least remained 0.2% above the CNB's current forecast in the last two months. Combined with very positive data from the economy, it is hard to find a reason for any urgent move by the bank. The CNB has indicated a couple of times that its rates are at their lows, and therefore we do not expect another rate change after the fashion of the ECB, which opted for a negative deposit rate. As concerns the exchange rate, the tenor of the statement made at the last meeting is important, saying that "the Bank Board would have to find a further noticeable increase in anti-inflationary factors before moving the exchange rate commitment to a weaker level". Nothing like that is happening in the Czech Republic now. We also believe that the CNB would prepare financial markets for any further move well in advance. This is why we consider maintaining the current lower threshold of the exchange rate at CZK 27 per EUR to be the most likely scenario.

Calendar

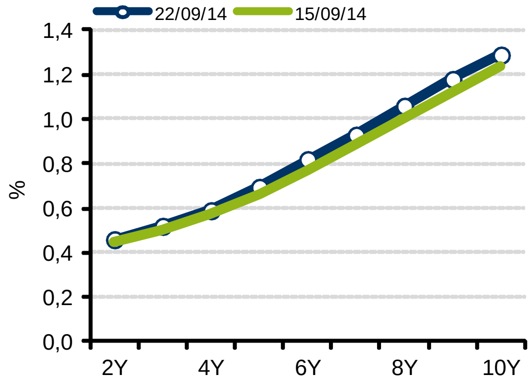
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	09/23/2014	8:30	Current account	HUF B	2Q/2014			990		984	
PL	09/23/2014	10:00	Retail sales	%	08/2014			-1.2	1.4	4.7	2.1
PL	09/23/2014	10:00	Unemployment rate	%	08/2014			11.8		11.9	
HU	09/23/2014	14:00	NBH meeting	%	09/2014	2.1		2.1		2.1	
CZ	09/25/2014	13:00	CNB meeting	%	09/2014	0.05		0.05		0.05	
HU	09/26/2014	9:00	Unemployment rate	%	08/2014					7.9	

Fixed-income in Charts

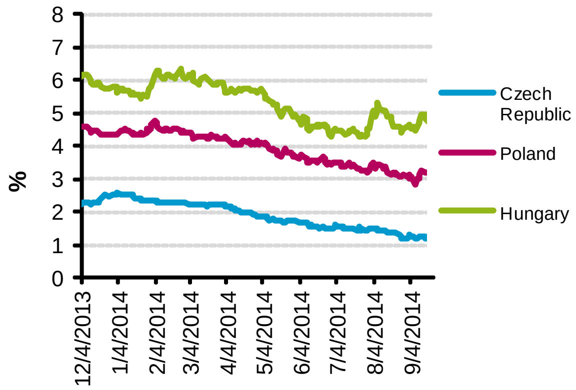
FRA 3x6



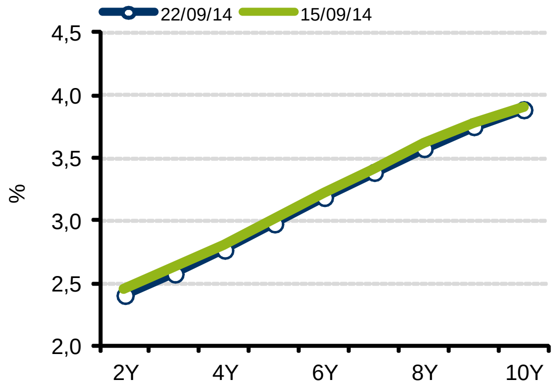
CZ IRS



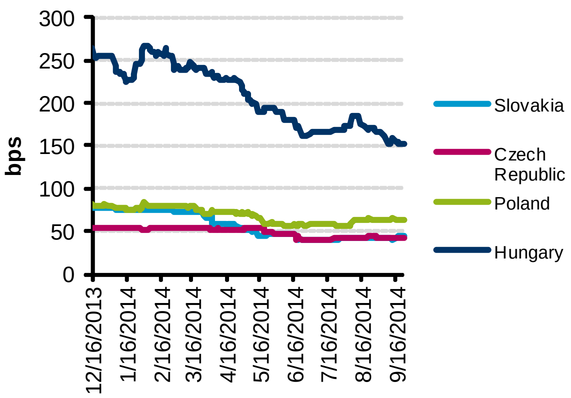
10Y GB Yields



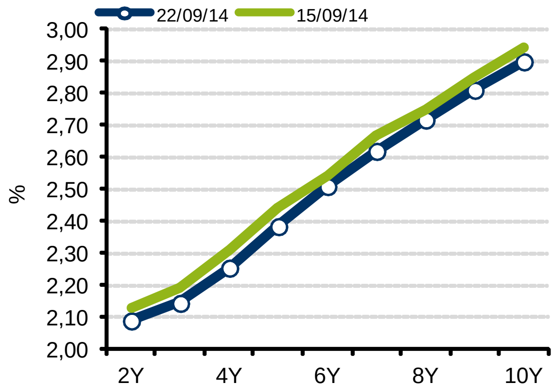
HU IRS



CDS 5Y



PL IRS



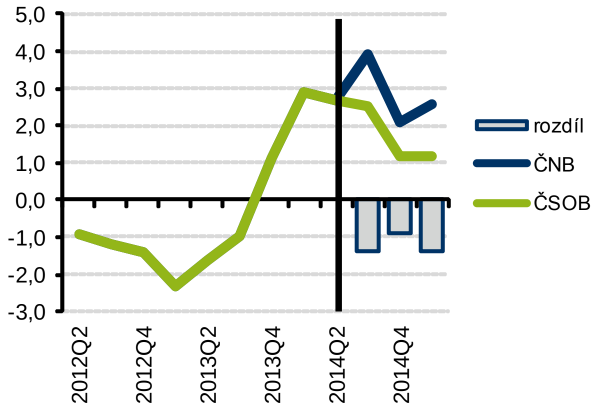
Source: Reuters

Medium-term Views & Issues

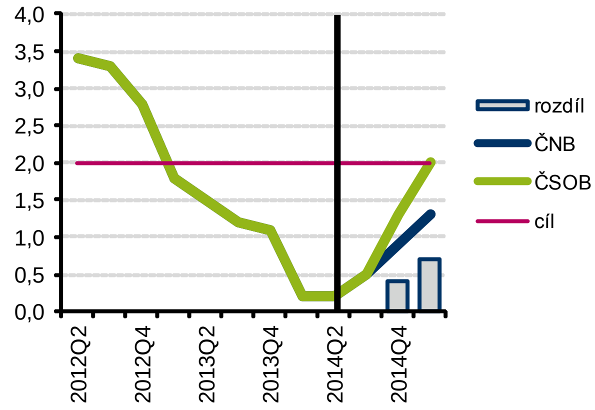
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its programme. It should include not only savings but also greater tax relief for parents with children, a new VAT rate, and likely also the termination of the new funded pension system (called the 2nd pillar), set up in the last two years.	Based on the first quarter figure and the recent trends in the economy, Hungary's GDP may grow above 2.5% Y/Y in 2014 and it cannot be excluded that the growth might be close to 3% Y/Y level. The low base supports this economic growth level in short term, but without a substantial rise of investments in the private sector this year, economy may slow down to around 2% Y/Y level in 2015. On the other hand, in spite of growing domestic demand, inflation appears well anchored and inflationary expectations stick close to 3 %. Moreover, as this year's harvest may be good, food processing industry hardly escalates price pressures in the economy.	According to the GUS estimates, the Polish economy grew by 3.3% in 2014Q2. The data unveiled a strong contribution of domestic demand but also a high contribution of in inventories which somehow blurred overall good message. On the other hand, ongoing crisis in eastern Ukraine poses clear risks for the economic growth, especially in comparison with our expectations in the beginning of the year. Still, we expect the economy to expand by more than 3% in 2014.
Outlook for official & market rates	The CNB has exhausted the possibility of easing its monetary policy through interest rates, and therefore it has decided to weaken the koruna and keep it close to CZK 27 per EUR. Statements from the CNB representatives indicate that the CNB would like to maintain that level for a prolonged period, until strong inflation pressures become evident in the economy. We believe that the exchange rate targeting will be abandoned much later (not before the second half of 2015), and that the move will certainly not be accompanied by a rise in interest rates, as suggested by the official forecast.	The NBH has finished its easing cycle in Hungary by cutting the base rate to the 2.1%. The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/- 1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy. Our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. At the same time, anti-inflationary risks stemming from Ukraine crisis and ECB recent policy easing are mounting. We therefore expect NBP to cut interest rates by 25 bps in both October and November and risks are skewed towards even more pronounced policy easing in months to come.
Forex Outlook	The CNB has started FX interventions and we expect the koruna to stay within the regime at least till the mid 2015. Hence the currency should stay above 27.00 EUR/CZK at least in 12-month horizon. When the FX targeting regime is set to be abandoned, the CNB will have to intervene on the market much more aggressively to stop the spot koruna from appreciation. As a side effect, the forward koruna can appreciate significantly before the regime is abandoned.	In a longer term perspective, HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. Taking into account the government's and NBH's statements, such a gradual depreciation of the currency is welcomed as it definitely not endangers the stability of the country. Additionally the government still wants to solve the problems of the foreign currency denominated loans in the households sector in autumn, which may give the National Bank of Hungary an even bigger room of maneuvering room.	Less optimistic economic outlook and renewed monetary policy easing should cap room for prospective strengthening of the zloty in months to come. For the rest of the year, we therefore expect a stagnation of the zloty against the euro and consider risks as skewed slightly towards possible depreciation, even though Polish assets could draw support from further easing of monetary policy conditions in the euro zone. Medium-term Views & Issues

CBs' Projections vs. Our Forecasts

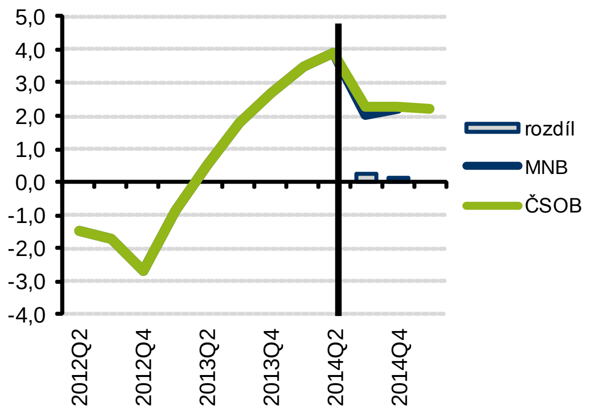
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)

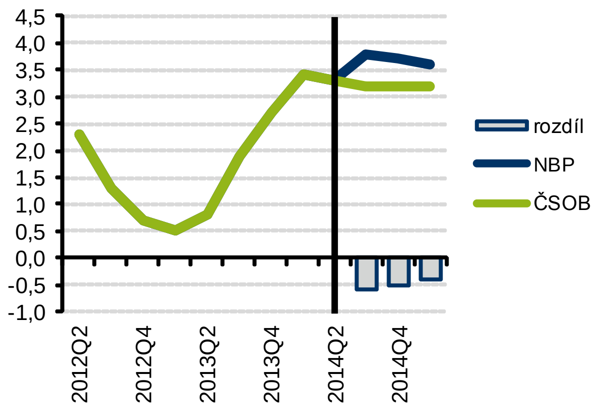


HU: GDP outlook (Y/Y, %)

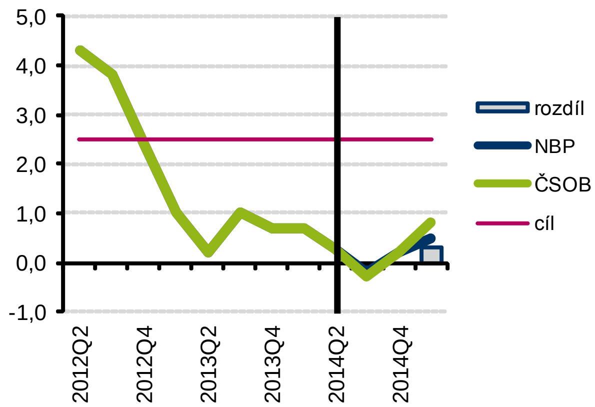


HU: Inflation outlook (Y/Y, %)

PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	Last change	
Czech Rep.	2W repo rate	*0.05*	0.05	0.05	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*2.10*	2.60	2.30	2.10	2.10	2.10	-10 bps	7/22/2014
Poland	2W inter. rate	*2.50*	2.50	2.50	2.50	2.00	2.00	-25 bps	7/3/2013

*Short-term interest rates 3M *IBOR (end of the period)*

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	PRIBOR	*0.35*	0.37	0.35	0.35	0.35	0.35
Hungary	BUBOR	*2.09*	2.67	2.34	2.15	2.15	2.15
Poland	WIBOR	*2.42*	2.71	2.68	2.45	2.20	2.20

Long-term interest rates 10Y IRS (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	CZ10Y	*1.29*	1.84	1.34	1.40	1.50	1.75
Hungary	HU10Y	*3.89*	4.95	3.77	3.50	3.50	3.65
Poland	PL10Y	*2.90*	4.03	3.39	2.75	2.60	2.60

Exchange rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	EUR/CZK	*27.6*	27.4	27.4	27.9	27.7	27.4
Hungary	EUR/HUF	*312*	307	310	310	310	310
Poland	EUR/PLN	*4.19*	4.17	4.16	4.19	4.17	4.17

GDP (y/y)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	-1	1.1	2.9	2.7	2.5	1.2	1.2
Hungary	1.8	2.7	3.5	3.9	2.3	2.3	2.2
Poland	1.9	2.7	3.4	3.3	3.2	3.2	3.2

Inflation (CPI y/y, end of the period)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	1	1.4	0.2	0.0	1.0	1.4	2.0
Hungary	1.4	0.4	0.1	-0.3	0.3	0.8	1.9
Poland	1	0.7	0.7	0.3	-0.3	0.2	0.8

Current Account

	2013	2014
Czech Rep.	-1.4	-1.4
Hungary	2.0	2.2
Poland	-1.2	-2.5

Public finance balance as % of GDP

	2013	2014
Czech Rep.	-1.5	-2.5
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

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