Central European Weekly

Monday, 09 February 2015

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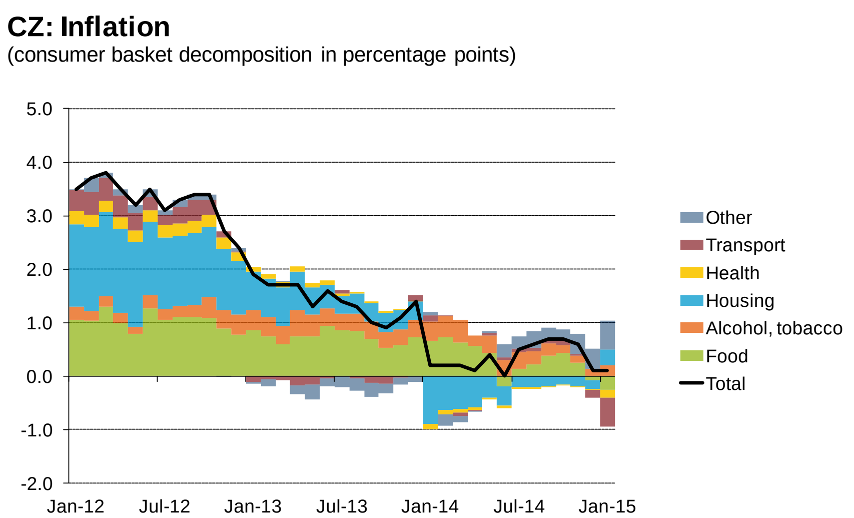
Weekly Highlights:

- The CNB looks satisfied, but extends its exchange rate commitment to the second half of 2016
- Czech hard macro data strong again, the January inflation surprises on the upside
- Is the NBP ready for a 50 bps rate cut?
- January's inflation and GDP flash estimates for 4th quarter of 2014 in regional focus

Chart of the Week: January's inflation



The Czech year-on-year inflation stays in positive territory despite sharp drop in fuel prices.

Market's editorial

The new CNB's projection and its satifaction

The Czech National Bank has again slightly lowered its inflation outlook but this does not seem to be currently troubling the central bank overmuch. According to most indications, the economy is set for another year of growth above 2%. Inflation is also low, mainly because of low fuel and food prices. Adjusted inflation excluding fuel prices accelerated throughout 2014. Yet the CNB is keeping the door open for a possible further depreciation of the exchange rate, but its preferable policy is to rather extend its exchage rate commitment (like this time when the promise to defend the EUR/CZK floor was extended to 2016H2). Nevertheless, according to governor Singer, this would only happen if inflation expectations systematically decreased and if re-established deflationary pressures started to threaten private demand. This is not the case now. Thus, the central bank is ready to tolerate even slightly negative inflation this year.

In this respect lates inflation data are very important, because it might make the CNB even more satistfied. Recall the January inflation surprised significantly on the upside as consumer prices rose compared with December 2014 by 0.1%. Thus, we should not affraid of negative inflation figures, which could eventually activate dovish responses from some CNB's Board members. Actually, it seems the CNB might be satisfied that inflation stands actually higher than it expected, so there is no need for a weaker currency – especially when other 'hard' data from the economy point to ongoing recovery. In this respect, it is worth noting today's release of (un)employment figures, which were again better-than-expected (the rate of unemployment dropped to 7.7%).

A 50bps rate-cut from the NBP in the pipeline in March?

Nevertheles by contrast, the National Bank of Poland, according to comments after its last MPC meeting, is still ready to continue to ease its monetary policy in reaction to negative inflation, notwithstanding solid growth in domestic demand. Unlike the CNB, the NBP still has conventional instruments at hand – i.e., interest rates – through which it can fine tune its policy. Not even the NBP has the exchange rate under control, with the Polish zloty having started to strengthen significantly in reaction to the ECB's huge monetary expansion. In this respect, Polish figures released this might be very important – especially the January inflation. Hence, because we predict again a very negative inflation figure we expect a 50 bps rate cut at the March meeting.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.7	-0.52%	↗	→
EUR/HUF	307	-1.31%	↗	↗
EUR/PLN	4.17	-0.42%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0.78	6.85	↗	↗
10Y HUF	2.84	9.86	↗	↗
10Y PLN	2.10	13.05	↗	↗

Review of Economic Figures

The Czech industry and exports gains ground...

Carmakers are driving production to new record-breaking levels and speeding up the Czech Republic's economic growth. Thanks to their positive figures, industrial enterprises are the greatest contributors to the creation of new jobs and the reduction of unemployment.

Figures from industry did not even disappoint in late 2014, when production by this largest sector of the Czech economy grew by 7.3%, primarily thanks to the automotive industry once again. The success of domestic carmakers is primarily attributable to innovations supporting their competitiveness, and to re-established growth of European demand for new cars. With slight exaggeration, we could say that carmakers are reaping the rewards for their innovation efforts that were even maintained during the poorer years.

For 2014 as a whole, industry grew by almost 5% and pushed output to new all-time highs. Thus output has grown by 10% since 2010 and even by a third for carmakers. Prospects for industry are also hopeful in the first half of this year because both the business mood and orders among businesses are very decent. This primarily applies to new cars again, followed by electrical engineering and assembly of computers.

Industry is responsible for the acceleration of economic growth as well as for the unemployment reduction. Moreover, we also anticipate a similar trend this year, although it will not be at all easy to maintain the established high rate anymore, due to last year's high comparative baseline. A solid outlook for the European economy will also contribute to a positive outlook for industry, albeit things may continue to become more complicated for certain sectors as a result of the growing recession of the Russian economy.

Late 2014 already saw a significant positive effect from cheap oil, with this leading to a decline in the koruna value of imported oil and petroleum products. Thus the Czech Republic is directly saving in these raw materials, with these savings starting to gradually spread across the economy. They will translate into tens of billions of korunas that businesses and households will not have to pay for fuel and will be able to spend on something else.

In national statistics, December's deficit reached CZK 3 bn, a great improvement compared to December 2013. After all, nothing other than a deficit could be anticipated for December because of the seasonal effects. Not only the above-mentioned oil but, in particular, cars, with their record-breaking exports to the European market, are responsible for the positive foreign trade figures.

For 2014 as a whole the foreign trade surplus hit a new all-time high (CZK 157 bn), an improvement of more than 50%. This improvement is only partly attributable to oil. The main driving force of exports, and consequently of the growing trade surplus, is carmakers, which are showing strong increases in output as well as new orders.

Given the positive figures for new orders in industry as well as current oil prices, this year's foreign trade surplus is very likely to break a new record – CZK 200 bn this time.

...so the Czech unemployment is visibly falling

Although unemployment grew to 7.7% in January, this seasonal jump changes absolutely nothing in terms of the positive trend on the Czech labour market. Unemployment is one percentage point lower than last January, which means a fall of several tens of thousands in the numbers of unemployed. We can unequivocally say that the economic growth, even if not dazzling, is actually creating new jobs and thus improving the situation on the labour market.

We anticipate the situation on the labour market to improve again in the coming months and unemployment will soon fall under seven percent. There are more and more jobs available, with more than 62,000 in January alone, meaning 25,000 more than last year. A similar number of job opportunities was last seen in 2009.

The engine for the improving situation on the labour market is unequivocally the manufacturing industry, which is creating the most jobs. As there are positive developments in terms of orders for industrial concerns, we can anticipate that new jobs will continue to appear. What is more, we also see positive developments in the construction industry, which after a period of depression lasting six years is winning more and more new orders and will soon be needing more employees.

Expensive alcohol "saves" Czech Republic from deflation

The expectation that significantly cheaper fuels would push inflation into negative territory was not fulfilled. The reason why inflation remained positive was a significant rise in the price of alcohol, something that we had definitely not anticipated. With a certain amount of exaggeration, we can say that alcohol saved the Czech Republic from deflation.

Consumer prices rose by 0.1% in January both month-on-month and also year-on-year. In addition to the already mentioned significant price rise for alcohol, slight price rises for foodstuffs, holidays and some housing costs were all reflected in inflation. On the other hand, inflation was pushed down by significantly cheaper fuels, the cancellation of health-service fees and the post-Christmas sales of footwear and clothing.

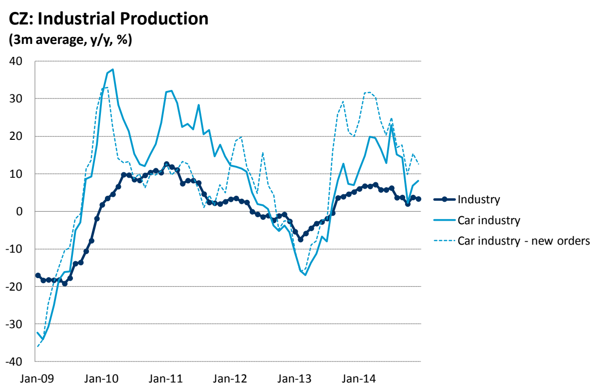
Inflation developed in accordance with the CNB prognosis in January and thus the central bank has no reason at this time to adjust the exchange rate regime established in November 2013. What is more, the economy is very healthy from both the supply and demand sides and there are definitely no deflationary expectations visible that might depress domestic demand.

So what to expect now as regards inflation? Inflation will remain at very low levels in the coming months. It might of course flirt with the possibility of falling into negative territory, nevertheless it is oil that will have the final say. This latter has for now reversed its trend and is drawing optimism from every report indicating a reduction in production from shale in the USA.

The Hungarian industry still in a good shape

The Hungarian industrial production increased by 7.1% YoY in December, which means that industry was up by 7.6% YoY in 2014 compared to 2013. The working day adjusted figure was less attractive as it rose by 4.6% YoY in December, additionally the seasonally and working day adjusted figure showed 1.7% MoM drop in December.

The reasons behind the slowing industrial production are the increasing base effect, the slowing European economy, Russian sanctions and some model change in the car industry sector. Looking forward we expect that industry may grow by around 5-6% YoY in 2015, which is roughly the speed of the last 4-5 months' growth level. The risks are coming mainly from the Eurozone performance, the possible additional Russian sanctions. We expect that the role of production for domestic use may increase in 2015, which may partly counterbalance the less favourable market environment.



Weekly preview

WED 9:00 HU Inflation (change in %)

	Jan-15	Dec-14	Jan-14
CPI y/y	**-1.2**	-0.9	0.0

HU: Food and fuel drive inflation even lower

Stat office will publish consumer price index for January on Wednesday (11 Feb). The marker expects further drop of inflation from -0.9% Y/Y in December to -1.2% Y1Y in January. We are slightly less pessimistic as we projects only -1.1% Y/Y CPI for January and we think that it may be the bottom of the inflation. The reasons behind the drop are the falling fuel price (it started to increase in February) and food price (due to the good harvest). We forecast around 0% average inflation for 2015, but slightly above 2% Y/Y CPI for December, so we still don't have fear about a durable deflation in Hungary.

FRI 9:00 CZ GDP (change in %)

	Q4-14	Q3-14	Q4-13
GDP (q/q)	**0.5**	0.4	1.1
GDP (y/y)	**1.8**	2.4	1.1

CZ: GDP growth driven by carmakers

The preliminary GDP forecast for the last quarter of 2014 should confirm the positive direction of the Czech economy. We believe that its growth is being driven by the manufacturing industry on the one hand, combined with investment and consumption on the other. Naturally, we need to take into account that this will be a preliminary and incomplete forecast, to be updated and revised several times.

FRI 9:00 HU GDP (change in %)

	2014Q4	2014Q3	2013Q4
GDP (y/y)	**2.8**	3.2	3.2

HU: Only modest slowdown in GDP growth rate

GDP growth may slow down slightly from 3.2% Y/Y in 3Q14 to 2.8% Y/Y in 4Q14. The main reason from the supply side is the slowing industrial production in the last quarter, while on the demand side the investment and the next export may be less favorable compared to previous quarter. The domestic consumption may play a more important role in the economic growth. It means that the full year economic growth may be around 3.4% Y/Y in 2014.

FRI 14:00 PL Inflation (change in %)

	Jan-15	Dec-14	Jan-14
CPI y/y	**-1.1**	-1.0	0.5
Food (ex Alc.) y/y	**-3.8**	-1.8	2.0
Transport (including fuel)	**-7.9**	-7.5	-1.5

PL: Deflation continues to deepen in January

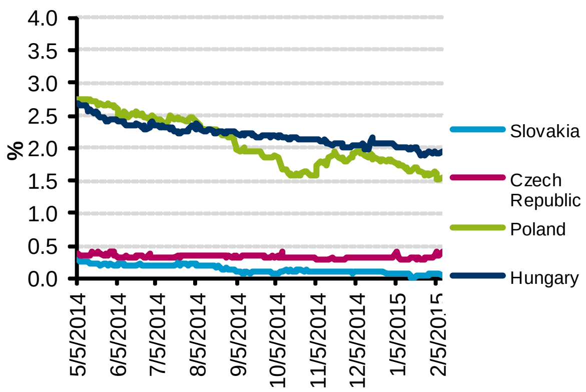
Poland's inflation went even deeper into negative territory in January according to our forecasts, hitting -1.1%. The main reason for the further decline was fuel prices, which continued to fall because of declining oil prices. The price of oil fell well below US$50 a barrel in January. As concerns the other components of the consumer basket, we believe that food prices also grew more slowly than usual. By and large, another year-on-year fall in inflation means that the period of deflation will probably persist until the second half of this year in Poland.

Calendar

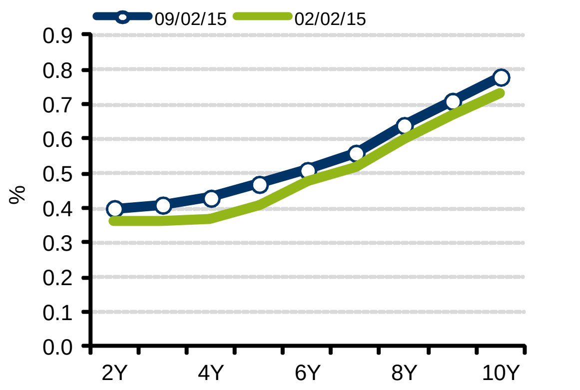
Country	Date	Time	Indicator		Period	Forecast m/m	Forecast y/y	Consensus m/m	Consensus y/y	Previous m/m	Previous y/y
CZ	02/09/2015	9:00	CPI	%	01/2015	-0.3	-0.3	-0.2	-0.2	-0.1	0.1
CZ	02/09/2015	9:00	Unemployment rate 15-64	%	01/2015	7.9		7.8		7.5	
HU	02/09/2015	9:00	Trade balance	EUR M	12/2014 *P			279.5		843.1	
HU	02/11/2015	9:00	CPI	%	01/2015		-1.2	0.1	-1.1	-0.7	-0.9
CZ	02/11/2015	12:00	CZ bond auction 2014-18, 0.85%	CZK B	02/2015						
CZ	02/11/2015	12:00	CZ bond auction 2013-2028, 2.50%	CZK B	02/2015						
HU	02/12/2015	9:00	Industrial output	%	12/2014 *F					-1.7	4.6
CZ	02/13/2015	9:00	GDP	%	4Q/2014 *P	0.5	1.8	0.6	1.8	0.4	2.4
HU	02/13/2015	9:00	GDP	%	4Q/2014 *P		2.8	0.4	2.7	0.5	3.2
CZ	02/13/2015	10:00	Current account	CZK B	12/2014	-10		-15		-6.72	
PL	02/13/2015	10:00	GDP	%	4Q/2014 *P			0.5	3.1	0.9	3.3
PL	02/13/2015	14:00	Money supply M3	%	01/2015			-1	9	2.7	8.4
PL	02/13/2015	14:00	Current account	EUR M	12/2014			-406		-268	
PL	02/13/2015	14:00	Trade balance	EUR M	12/2014			-293		-96	
PL	02/13/2015	14:00	CPI	%	01/2015	0	-1.1	-0.1	-1.2	-0.3	-1

Fixed-income in Charts

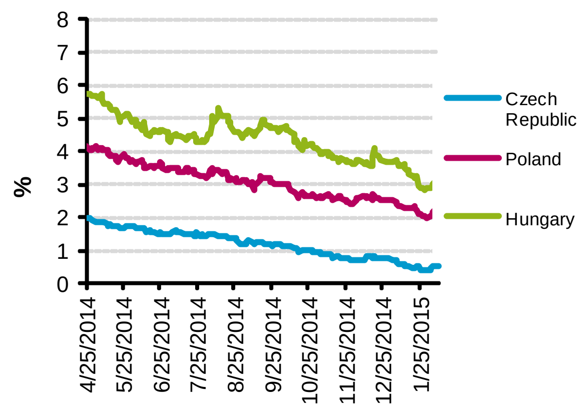
FRA 3x6



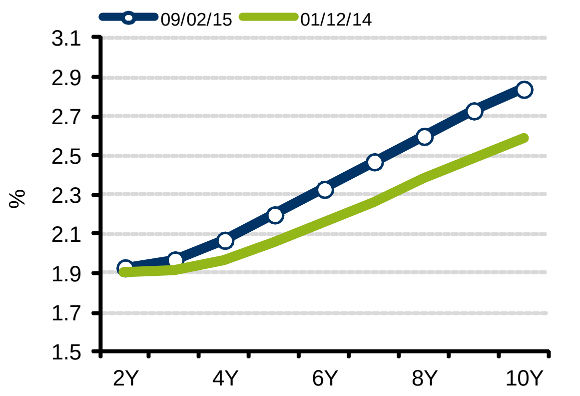
CZ IRS



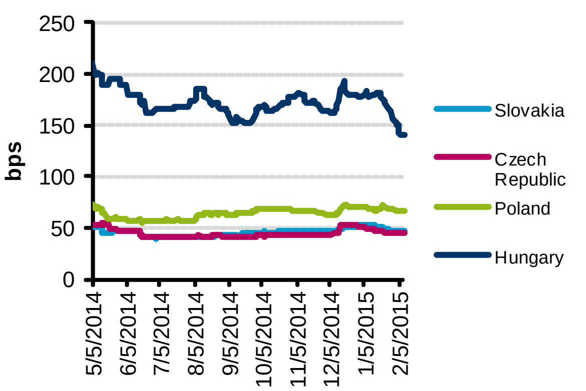
10Y GB Yields



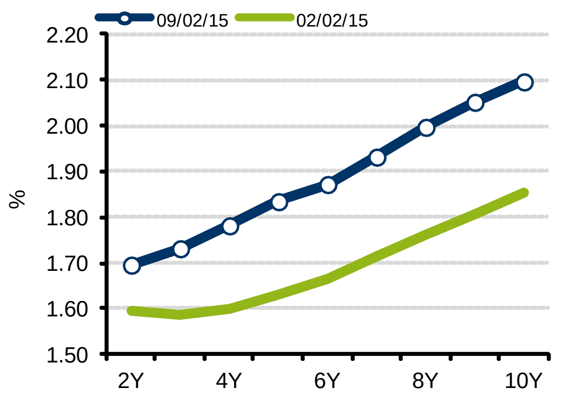
HU IRS



CDS 5Y



PL IRS



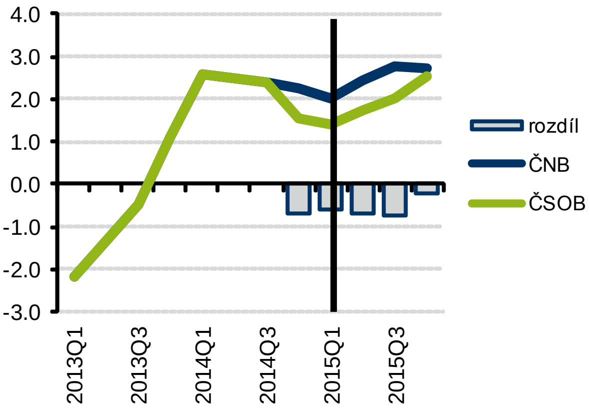
Source: Reuters

Medium-term Views & Issues

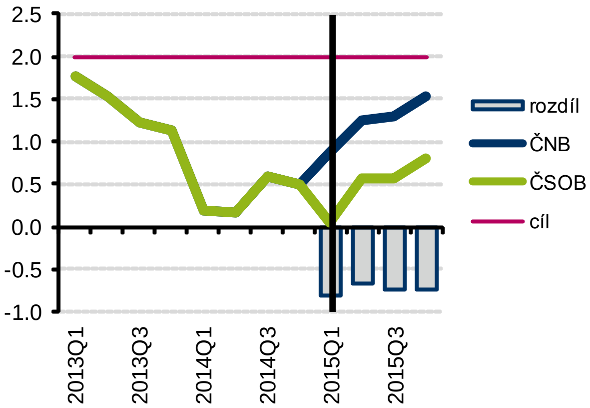
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing of the public sector, which is, however, generating no pressures on the capital market thanks to fairly low debt and reserves. The government policy has not delivered any fundamental economic changes so far, perhaps except for the planned abolition of the pension reform and partial modifications of certain taxes and social security benefits. The issue of euro adoption is still on ice in the CR.	We expect that the economy may slow further in 4Q14 in the range of 2% Y/Y and 2.5% Y/Y, because the new orders in the construction sector is falling, there external demand is deteriorating, so the net external component of the growth is getting smaller. The average GDP growth may be at 3.3% Y/Y in 2014, while it may slow to around 2.2% Y/Y in 2015. In light of the 2014 final data and the sharply falling oil prices, the new outlook is around 0.2% for average CPI in 2015. This means that CPI may remain in the negative territory for the following months and a figure above 1% is expected only around by the end of the year.	According to the GUS estimates, the Polish economy grew by 3.3% in 2014Q3. Moreover, the structure of growth was robust – it was driven by strong households' consumption and investment. Expectations of a slowdown of growth rates in the second half of the year may therefore not materialize. The recent figures suggest this year's economic growth will therefore almost certainly remain well above 3%.
Outlook for official & market rates	Interest rates remain at all-time lows and, given the positive inflation outlook, the CNB is unlikely to raise its base rate before late 2016. In addition, the central bank will not proceed to such a move before it abandons its current exchange rate policy, which is based on maintaining the exchange rate above the EUR/CZK floor. Moreover, the decreasing inflationary expectations may even delay these two steps. This possibility is reflected by money market rates and, in particular, by IRS and government bond yields. Our outlook for inflation as well as short-term interest rates is still below the central bank's official forecasts.	Following ECB's 'bazuka' our view fresh view on Hungary's monetary policy is that the NBH would like to see the inflation figure for the January and how the ECB's decision influenced Hungarian markets. Thus, we think that a fresh rate cut may come in February, if the market environment remains supportive. In that case the NBH may re-start an easing cycle with a 20bps rate (rather than just 10 bps). So, the end of the re-started easing cycle might be around 1.6-1.7%.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. After surprising markets by cutting interest rates by 50 basis points in October, the NBP surprised in November as well, this time by leaving rates unchanged. The overall tone of the meeting was, however, dovish and we therefore not exclude additional rate cut during 2015.
Forex Outlook	We expect that the Czech central bank will not come up with any revolutionary changes at its eagerly expected February meeting. Nonetheless, the koruna will likely be weakening before the meeting. How far can the pair EUR/CZK weaken in the upcoming weeks? Markets remember that the November 2013 intervention pushed the EUR/CZK pair higher by about 5-6 %. It would not be surprising then, if we see the short-term peak in the EUR/CZK 28.7-29 territory (i.e. a roughly 5% devaluation against the 2014 average). After the February (5th) meeting, the crown should start trimming the loss.	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.	The Polish zloty came under pressure at the end of the year in the low liquid trading. Although some of the losses were trimmed recently, the zloty continues to trade on the defensive side Market players seem to realize that inflation is to stay extremely low for considerable time and that NBP board can withsand weaker currency. The pair can sty around 4.25 EUR/PLN in both 3-month and 6-month horizon.

CBs' Projections vs. Our Forecasts

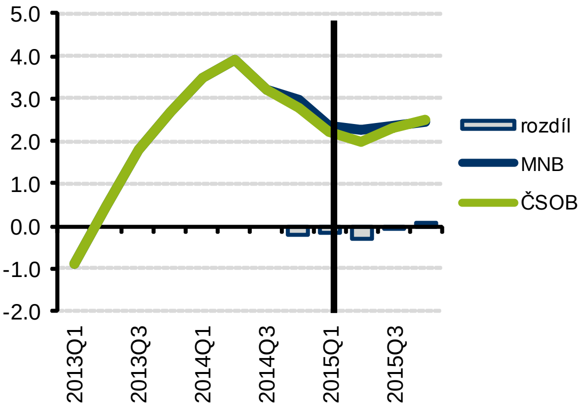
CZ: GDP outlook (Y/Y, %)



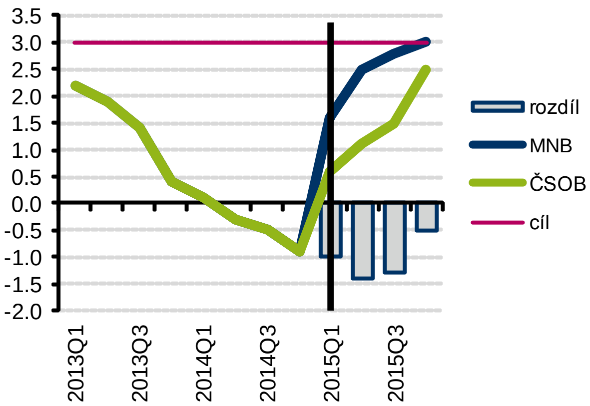
CZ: Inflation outlook (Y/Y, %)



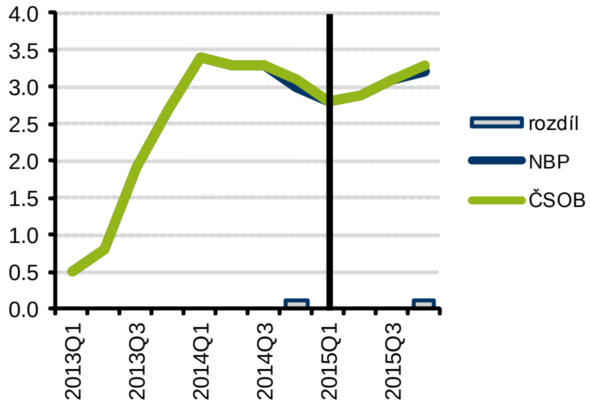
HU: GDP outlook (Y/Y, %)



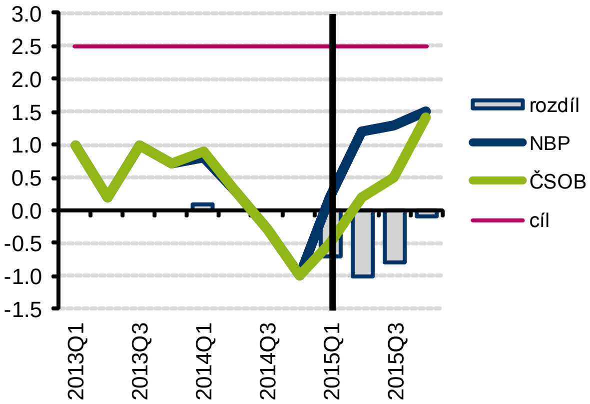
HU: Inflation outlook (Y/Y, %)



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	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	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*	2.10	2.10	2.10	2.10	2.10	-10 bps	7/22/2014
Poland	2W inter. rate	*2.00*	2.50	2.00	2.00	2.00	2.00	-50 bps	10/8/2014

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	PRIBOR	*0.33*	0.34	0.33	0.33	0.32	0.33
Hungary	BUBOR	*2.10*	2.09	2.10	2.10	2.10	2.10
Poland	WIBOR	*1.97*	2.28	2.06	2.00	2.00	2.00

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	CZ10Y	*0.78*	1.22	0.88	0.75	0.78	0.93
Hungary	HU10Y	*2.84*	3.92	3.25	3.50	3.50	3.65
Poland	PL10Y	*2.10*	2.87	2.23	2.20	2.10	2.20

Exchange rates (end of the period)

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	EUR/CZK	*27.7*	27.5	27.7	28.0	27.7	28.1
Hungary	EUR/HUF	*307*	311	316	315	315	318
Poland	EUR/PLN	*4.17*	4.18	4.28	4.25	4.22	4.20

GDP (y/y)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	2.6	2.5	2.4	1.6	1.4	1.7	2.0
Hungary	3.5	3.9	3.2	2.8	2.2	2.0	2.3
Poland	3.4	3.3	3.3	3.1	2.8	2.9	3.1

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

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	0.2	0.0	0.7	0.1	0.2	0.7	0.6
Hungary	0.1	-0.3	-0.5	-0.9	0.6	1.1	1.5
Poland	0.9	0.3	-0.3	-1.0	-0.5	0.2	0.5

Current Account

	2014	2015
Czech Rep.	0.0	1.8
Hungary	2.2	2.5
Poland	-2.5	-2.5

Public finance balance as % of GDP

	2014	2015
Czech Rep.	-2.0	-2.4
Hungary	-3.0	-3.0
Poland	-3.5	-3.0

Source: CSOB, Bloomberg

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