Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 16 February 2015

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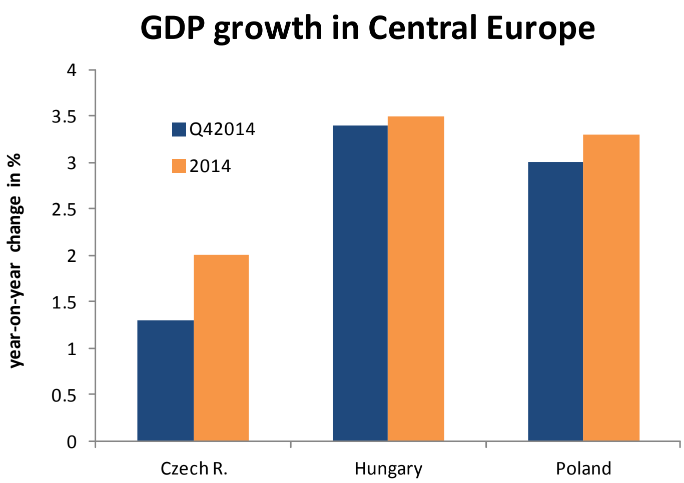
Weekly Highlights:

- Hungary becomes the top regional growth performer
- Deflation deepens in Hungary and Poland
- NBP and NBH in their way to ease again

Chart of the Week: GDP performance



Hungary beat its PEERs in GDP performance in 2014

Market's editorial

Strong GDP will not prevent rate cuts in Hungary and Poland

In addition to the facts that Central European markets have had to carefully monitor diplomatic talks between Russia and Ukraine as well as talks between Greece and the EU, they could not ignore important domestic data, specifically inflation for January and GDP for the last quarter of 2014.

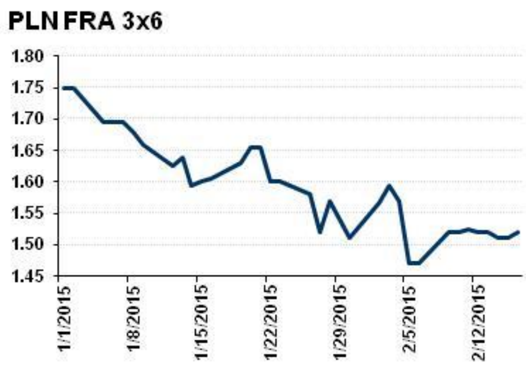
Let us begin with inflation, which surprised with its low values in both Hungary and Poland, pushing year-on-year figures even more into negative territory. As a result, markets started to even more aggressively bet on rate cuts by both the National Bank of Hungary and the National Bank of Poland. Paradoxically, such a reaction by the central banks is actually more likely after the release of very good GDP figures. The reason is that swift growth will put pressure on the forint and the zloty to continue to strengthen, and this will tighten monetary conditions in Hungary and Poland; naturally, this is an undesirable scenario amid deflation.

Thus, in contrast to last year's comments of Polish central bankers, we think that deepening deflation along with the risk of its protraction beyond previously expected limits will overshadow otherwise good news from the economy and persuade the NBP to cut interest rates in March (we see a 50 bps cut as the most likely option).

A deep rate cut in Poland might be actually a trigger for NBH easing too. While the plan of extending the NBH's funding for lending program on big corporates rather works against a rate cut, the strong forint together with deflation and rate cuts elsewhere go the other way.

Hence, the earliest rate cut in Hungary may come on 24th March as the NBH will publish the next inflationary report at that time. Based on the NBH's minutes from the last rate setting meeting – it was pub-lished yesterday afternoon – the council agreed that the Council should decide on the possibility of changing the base rate after a comprehensive assessment of the outlook for inflation and the real economy and in view of the March issue of the Inflation Report.

In this respect we should add that the appreciation of local currencies and cuts in official interest rates may lead to an even greater positive slope of yield curves in the future, and this will be all the more evident if the sell-off global bond markets (and consequently the rise in yields at the long end of the curve) accelerates in future.



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.7	-0.23%	↗	↘
EUR/HUF	307	-0.61%	↗	↘
EUR/PLN	4.18	-0.10%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0.84	9.09	↗	↗
10Y HUF	2.73	-4.55	↗	↗
10Y PLN	2.03	-4.36	↗	↗

Review of Economic Figures

Hungary as a new regional growth leader

Reading released growth statistics it's clear that Hungary has become a regional growth leader. The 3.4% y/y growth of 4Q14 GDP was well above the expectation of 2.7% y/y. It means that Hungary's economy grew by 3.5% y/y in 2014. As monthly figures showed some modest slowdown of industrial production and construction in the last quarter, the surprise factor may come from the agriculture and the services. Probably both the domestic and external demand boosted the service sector performance for example in the tourism. Also German economy's performance was better than expected which is also favourable for Hungary. Looking ahead Hungary's economy may slow down, but probably less than previously expected thanks to the improving international environment and the stable and strong domestic demand. So economy may grow around 2.5% y/y in 2015 and now we see rather positive risk in this forecast.

Although lower collection of excise taxes on cigarettes pulled the Czech economy's growth rate down, growth in production and exports remains strong.

Even though the economy only grew by 1.3% year-on-year, this weak figure is due to the high comparison base created by the strong collection of excise taxes on cigarettes at the end of 2013. Cigarette stockpiling once again played a significant role, but it was a short-term statistical effect that we should definitely not use to assess the state of the economy.

Value added in the economy actually grew by 2.4%, primarily thanks to the boom enjoyed by the automotive industry. This shows that the economy is still being driven upwards by the manufacturing industry, which is also intimated by data from industry, exports and, ultimately, also employment. It is precisely industry that is creating new jobs and thus participating in reducing unemployment and increasing the living standard of the population.

According to the initial estimate the Czech economy added 2% for the whole of 2014, and thus offset the drop experienced in the previous two years. On the demand side, growth was helped primarily by company investments, most probably also by the public sector, and without doubt also household consumption. Low inflation accompanied by growing employment has significantly contributed towards a real improvement in the financial situation of consumers.

We anticipate that this year's economic growth will be at around last year's level. On the supply side, industry will remain in charge, seconded by construction, while on the demand side growth will be taken care of by consumption and partly also investment. Cheaper oil will be a great boost to the economy, bringing billions in savings for both companies and households. This money, which under normal circumstances would head abroad as payments for this formerly expensive commodity, could now stay in the country and contribute towards growth in both consumption and investment.

As concerns the Polish economy – it grew by 3% (3.1% seasonally adjusted) in the third quarter of the year was not very surprising given the figures for last year as a whole. While details of the growth will not be available before late February, domestic demand, specifically household consumption, probably continued to be the primary growth driver in the last quarter. This had been suggested by data from the retail sector as well as by rapid wage growth for last year.

Hungary's and Poland's deflation deepened in January

Polish inflation data released on Friday, it showed that the country slipped into a deeper deflation in January than we had anticipated. Prices were down by 0.2 % M/M and 1.3 % Y/Y. While the data are still preliminary, the observed decline in transport prices of over 4 % month-on-month, primarily attributable to low oil prices, is likely to remain the greatest surprise in terms of inflation structure. In the light of January's figures, it is probable that the period of deflation in Poland may last over a year.

Like in Poland the Hungarian consumer price index showed even deeper deflation in January. The CPI was -1.4% YoY in Janury vs market expectation of -1.1 and -1.2% YoY, while it reflects a huge drop from the -0.9% YoY level in December. The core inflation moderated marginally from 0.8% YoY in December to 0.7% in January.

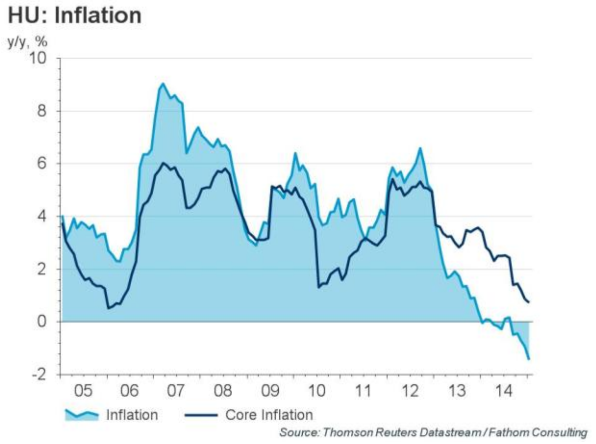
After the new historically low level of CPI the market's rate cut expectations were rather confirmed, but we think that the picture is not so obvious.

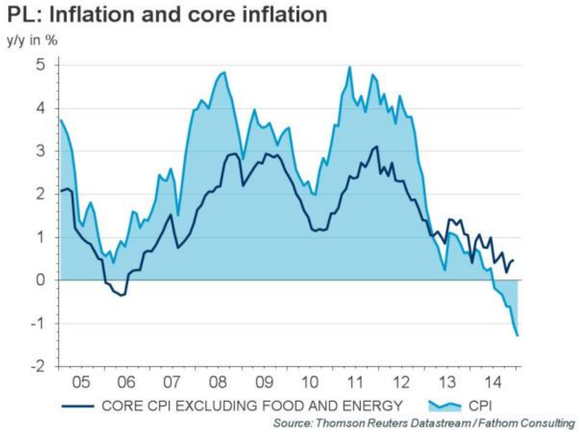
The main drop came from the fuel price fall in the last months. Excluding the direct effect of the lower fuel price inflation would be around 0.4% Y/Y in January, so fuel price caused roughly 1.8%pt drop of CPI. The food price decrease – thanks to last year's good harvest – caused additional 0.4%pt fall in inflation. There is still some regulated price cuts in the base, that pushes down inflation by 0.7%pt, so all to gather there is roughly 3%pt one off effect in the inflation currently. Without these effects CPI would be around 1.5% YoY in January. The market service inflation is running around 2.5% YoY, while tradable goods inflation is around

0% YoY. So Hungary still imports the low inflationary environment.

We also recognized in the last couple of months that exchange rate has very low effect on the inflation so NBH cannot easily accelerate the CPI with the depreciation of the currency.

We see this year's inflation around 0% YoY, but CPI may be around 2% YoY in December, which is in the tolerance range of the NBH's inflation target of 3% YoY +/- 1%pt. Fundamentally we see no reason at the moment to cut base rate, so we maintain our forecast that key rate will be kept unchanged in this year.



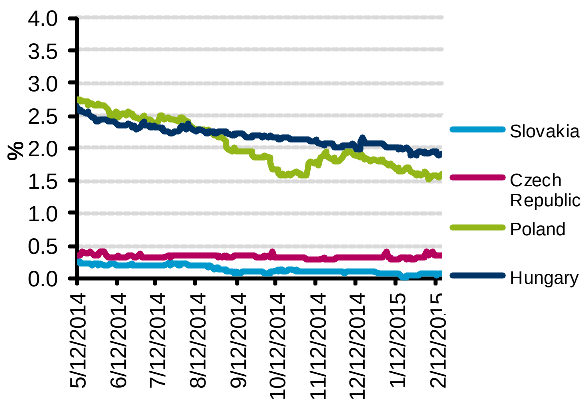


Calendar

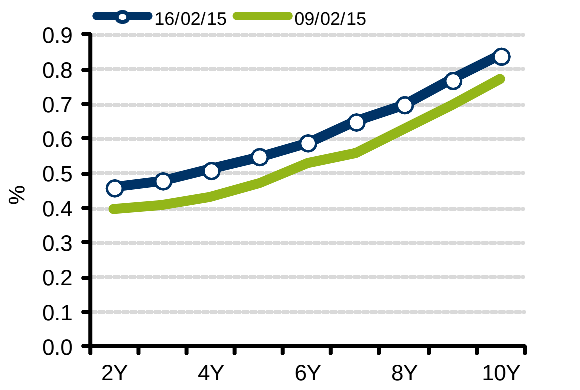
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	02/17/2015	14:00	Wages	%	01/2015			-10.2	3.3	9.4	3.7
PL	02/18/2015	14:00	Industrial output	%	01/2015			-2.8	2.4	-2.3	8.4
PL	02/18/2015	14:00	PPI	%	01/2015			-0.4	-2.9	-1	-2.5
PL	02/18/2015	14:00	Retail sales	%	01/2015			-22.2	0.9	19.6	1.8

Fixed-income in Charts

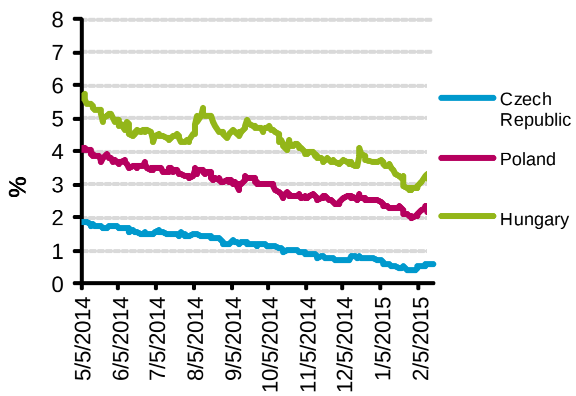
FRA 3x6



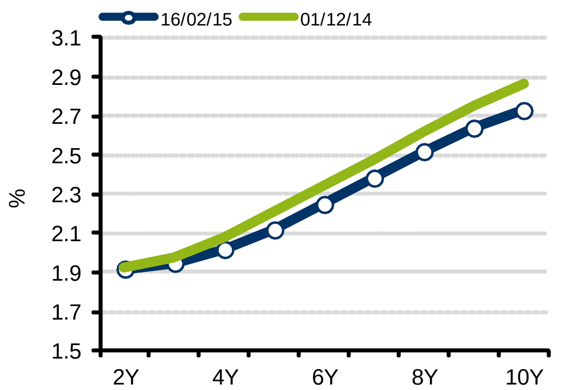
CZ IRS



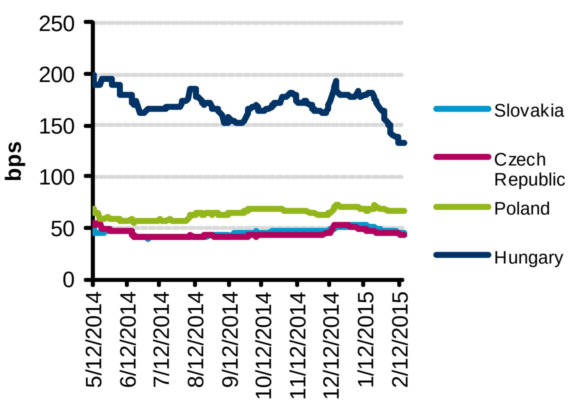
10Y GB Yields



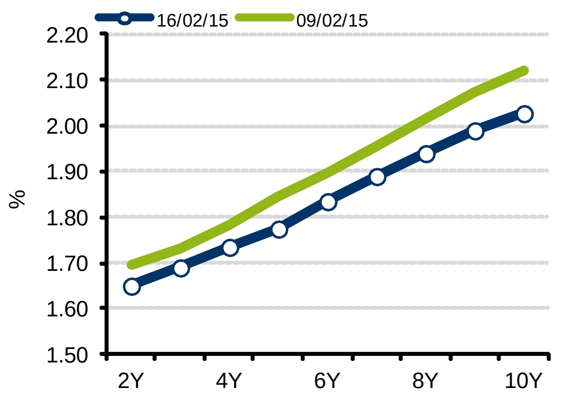
HU IRS



CDS 5Y



PL IRS



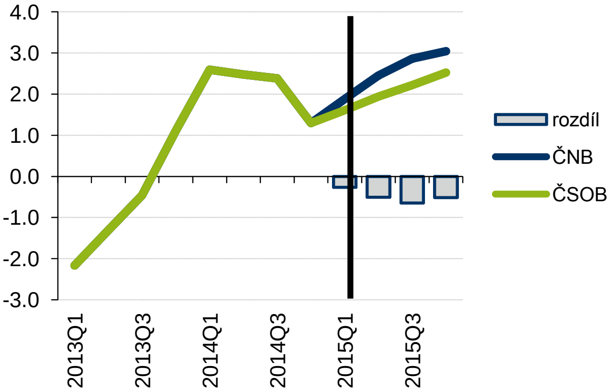
Source: Reuters

Medium-term Views & Issues

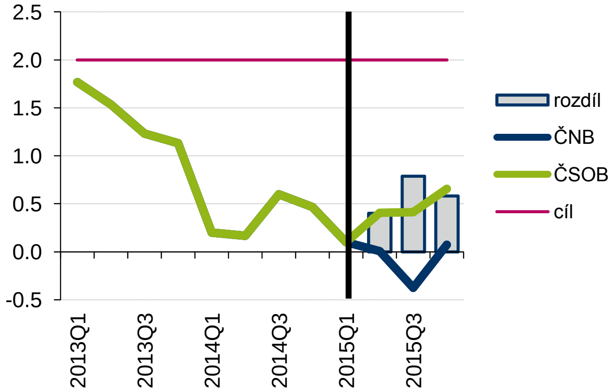
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing 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.	Hungary's economy may slow down, but probably less than previously expected thanks to the improving international environment and the stable and strong domestic demand. So economy may grow around 2.5% y/y in 2015 and now we see rather positive risk in this forecast. We recognized in the last couple of months that exchange rate has very low effect on the inflation, so the NBH cannot easily accelerate the CPI with the depreciation of the currency. We see this year's inflation around 0% Y/Y, but CPI may be around 2% Y/Y in December	According to the GUS estimates, the Polish economy grew by 3% in 2014Q4 and by 3.3% in whole year. Although the structure of growth for the last quarter has not been published yet, there are reasons to believe that domestic demand was again the key driver of economic growth. As for this year, we expect economic growth to slow down slightly below 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 2017. 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.	A deep rate cut in Poland might be actually a trigger for NBH easing too. While the plan of extending the NBH's funding for lending program on big corporates rather works against a rate cut, the strong forint together with deflation and rate cuts elsewhere go the other way. Hence, the earliest rate cut in Hungary may come on 24th March as the NBH will publish the next inflationary report at that time. Based on the NBH's minutes from the last rate setting meeting – the Council agreed that the Council should decide on the possibility of changing the base rate after a comprehensive assessment of the outlook for inflation and the real economy and in view of the March issue of the Inflation Report.	Inflation pressures in Poland remain subdued and year-on-year prices growth is still negative. 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. Though the central bank said last year it would put more emphasis on economic growth than on prices, risks of inflation persisting for longer than expected as well as recent comments of central bankers suggest that a rate cut is likely. We therefore expect one in March. The most probable option seems to be a 50 bps rate cut.
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 stay around 4.25 EUR/PLN in both 3-month and 6-month horizon.

CBs' Projections vs. Our Forecasts

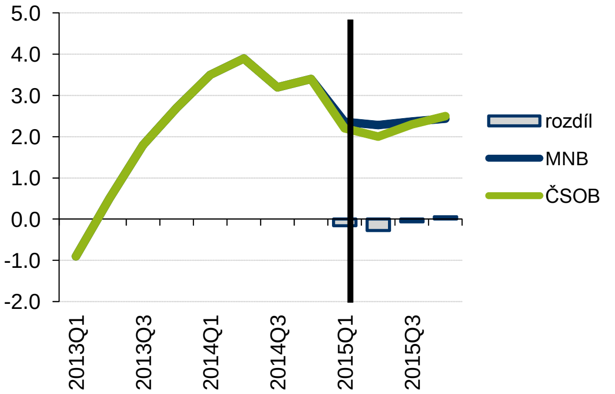
CZ: GDP outlook (Y/Y, %)



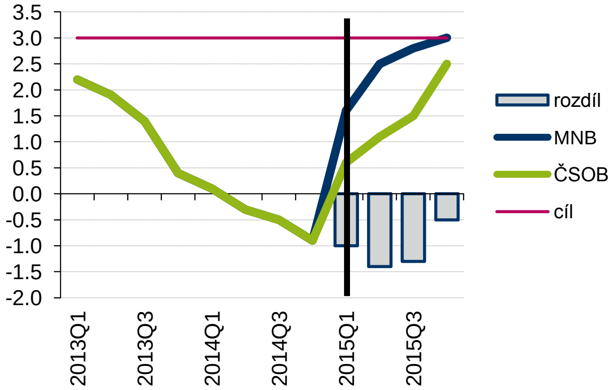
CZ: Inflation outlook (Y/Y, %)



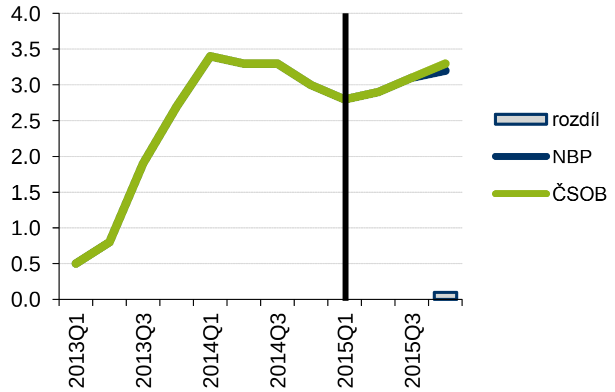
HU: GDP outlook (Y/Y, %)



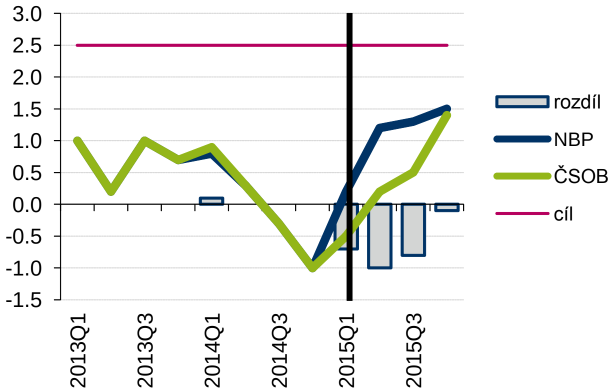
HU: Inflation outlook (Y/Y, %)



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	*1.94*	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	*0.84*	1.22	0.88	0.75	0.78	0.93
Hungary	HU10Y	*2.73*	3.92	3.25	3.50	3.50	3.65
Poland	PL10Y	*2.03*	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	*4.18*	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	1.8	1.6	1.9	2.2
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	0.5	0.4
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

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	**Brussels**	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85