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Central European Weekly

Monday, 22 June 2015

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Weekly Highlights:

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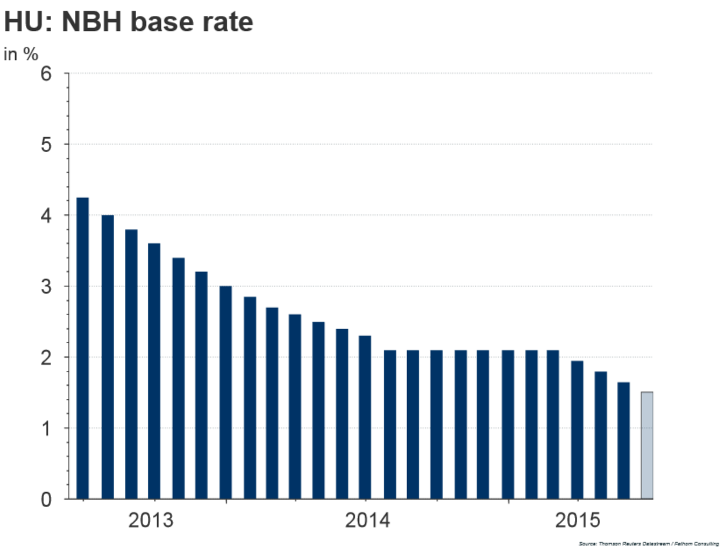
- Czech C/A showed another high surplus in April, it should reach 2% of GDP in 2015
- Data from Polish industry disappoints, but only at first glance
- Weak ahead: NBH will delivers last rate cut in this easing cycle, CNB will be boring as usual

Chart of the Week: Hungary's official rate



On Tuesday, the NBH will deliver probably the last rate cut of its base rate in this easing cycle.

Market's editorial

What if Greek capital controls are introduced...?

Although there are some interesting items on regional eco calendar (like the NBH or the CNB meetings) this week, it might happen that markets on Central Europe could be primarily driven by core (European) markets' developments.

Global and regional markets have not played the game about the risk of default and Grexit very much so far – may be except for Greek government bonds. However contagion may be triggered by the moment when Greece is compelled to impose capital controls, just as Cyprus had to do in early 2013. At that moment the Greek game could start in full, and the contagion may feature numerous well-known features of the recent euro-crisis episodes. How would CE forex and bond markets react?

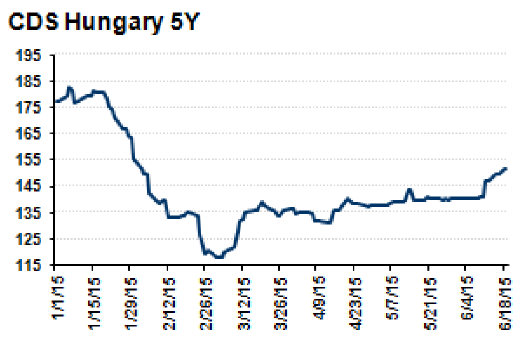
We believe that in a case of eventual financial contagion the spreads for Polish and Hungarian bonds against German Bunds would certainly widen but this may not necessarily be the case for Czech bonds, as their yields may go down even deeper, along with German PEERs, as was the case during the Cypriot crisis in March 2013. With regard to currencies, while the koruna may only weaken slightly, other currencies in the region (PLN, HUF, RON) will certainly be more vulnerable. If the contagion spread, tomorrow's rate cut by the NBH may not play into the hands of the forint either.

NBH's last rate cut in this easing cycle

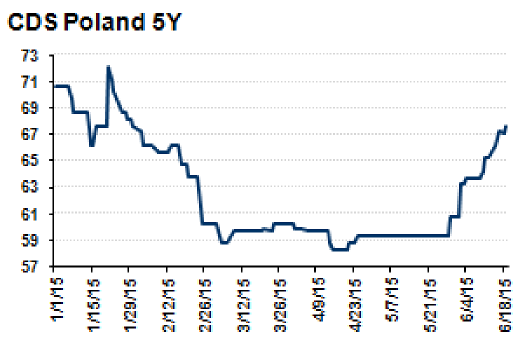
Regarding NBH's meeting – it might be quite an interesting event after the last month's 'boring' meeting (when everybody expected 15bp rate cut and a dovish comment). The market and we also expect 15bp rate cut from 1.65% to 1.5% as the Monetary council gave strong guidance to that direction on its last meeting. But the question is that will be the rate cut cycle continued (which would mean below Polish key rate level) or this is the end of it. We think that NBH may stop the rate cut cycle on Tuesday, but they may emphasize that the monetary policy remains supportive for economic growth and if they see it necessary new rate cut may come in the future.

	Last	Change 1W
EUR/CZK	27.2	-0.11%
EUR/HUF	312	-0.09%
EUR/PLN	4.17	0.41%

	Last	Change 1W
10Y CZK	1.31	-0.38
10Y HUF	3.51	-4.10
10Y PLN	3.04	-2.78



CDS Hungary 5Y, last 122 days. Source: Reuters



CDS Poland 5Y, last 122 days. Source: Reuters

Review of Economic Figures

Czech current account showed another high surplus in April

Czech current account showed another high surplus in April. This time the surplus exceeded CZK 20bn, thanks to the high surpluses of the trade balance and balance of services. Unlike last year, the latest figures have not yet started to reflect dividends paid out by businesses under foreign control, and thus the current account showed a surplus of CZK 112 bn for the first four months. On an annual basis this is clearly the best figure ever, reflecting the strong export performance of domestic businesses on foreign markets.

The Czech Republic is also likely to post current account surpluses in the years to come. This is very likely notwithstanding the growing outflow of dividends abroad. These will certainly cut the current account in the months to come but its trend as a whole will continue to be very positive. **We expect that its CA surplus will climb to 2% of GDP this year**.

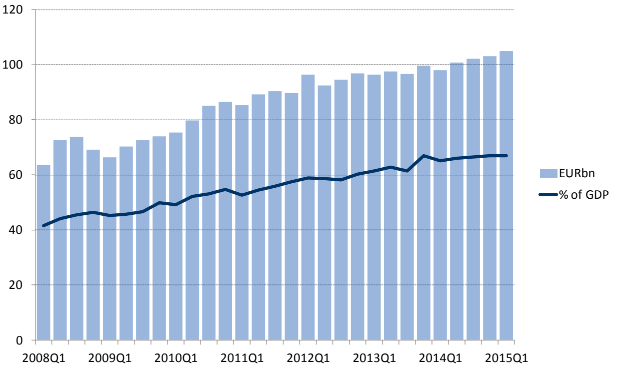
Although capital inflow to the CR is certainly not breaking any records this year, the trend in the financial account of the balance of payments remains positive. It is evident that foreign firms are reinvesting some of their profits in this country, there are financial loans from Czech subsidiaries to their foreign parents, and domestic investors are still interested in foreign securities. Nevertheless, no fundamental or risky trends in capital movement are evident.

Despite a huge trade surplus, the Czech foreign debt rising

The Czech economy's debt to foreign countries soared to nearly EUR 105bn in late March, with this corresponding to almost 67% of GDP. Naturally, this is not public debt – these are liabilities of domestic businesses, banks (including the central bank) and the government to foreign countries. The CR's debt grew by almost EUR 7 bn over the last year, due to growing deposits by foreign entities in domestic banks. The question is why.

What is so attractive about the CR that makes it worthwhile for them to deposit their money in this country? There may be several explanations, or rather speculations. One of them (without any ranking) may be the increasing activity by businesses of foreign 'origin' on the Czech market. With businesses formally changing their registered offices to foreign countries, they become non-residents. Thus their deposits are actually being converted into foreign liabilities. Another reason may be the attractiveness of extremely cheap euros abroad as a source of financing in the Czech Republic. Gaining euros at a negative rate and realising them on the Czech market may certainly be an attractive opportunity for banks as well as businesses. Liabilities of other entities to foreign countries only changed negligibly over the last year.

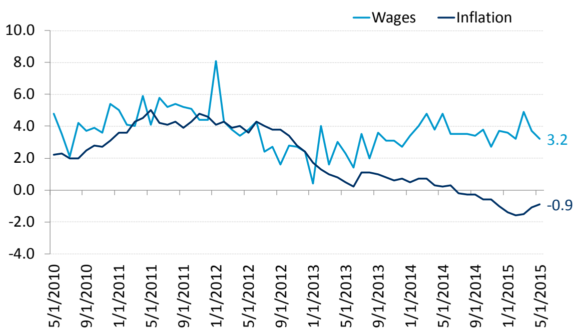
CZ: Gross foreign debt



Poland: Data from industry disappoints at first glance only

The data released last week confirmed that the Polish economy continued to perform well in the second quarter of the year. The statistical figure that provided reasons for greater doubts at first glance was industrial output. While May's industrial output fell short of expectations, its seasonally adjusted rise (by 5.3% y/y, 0.9% m/m) gave a shade more positive picture. Thus only construction data might have disappointed to a greater extent, although we do not overestimate the news at all, given the high volatility of these data.

PL: Nominal gross wages vs. Inflation
Y/Y in %



Wage growth in the corporate sector was also slightly lower than expected. Nevertheless, we should take into account that the Polish economy has been going through an 11-month deflation period (May's inflation was -0.9% y/y), which may persist until October, according to our forecasts. From this perspective, approximately 4% real wage growth remains very decent. By contrast, retail sales performed slightly better, suggesting that the improving situation on the labour market is likely to continue to boost economic growth significantly through solid wage growth and employment growth.

Overall, our evaluation of May's data is that economic growth should be around 3.5% y/y in the second quarter. We believe that the data are neutral from the perspective of the NBP policy, and this means that we have not changed our outlook for the stability of official interest rates for the rest of the year either.

Weekly preview

TUE 14:00 NBH base rate

	This meeting	Last change
rate level (in %)	**1.50**	5/2015
change in bps	**-15**	-15

HU: NHB's last rate cut in this easing cycle

After the last month's 'boring' meeting (when everybody expected 15bp rate cut and a dovish comment), this one might be quite interesting. The market and we also expect 15bp rate cut from 1.65% to 1.5% as the Monetary council gave strong guidance to that direction on its last meeting. But the question is that will be the rate cut cycle continued (which would mean below Polish key rate level) or this is the end of it.

The NBH will publish its quarterly inflationary report on Thursday, but the new GDP and inflation forecast will be published already on Tuesday. As the consumer price index was picking up faster than the NBH forecasted it in its March inflationary report, it is very likely that they will revise upwards the inflation orbit. They communicated previously that the inflation may accelerate to the inflation target only at the end of 2017, but our calculation shows that CPI might be around 3% YoY already at the end of this year. We think that NBH might be more conservative, but they may have to bring closer the meeting of inflation target somewhere to the end of next year. It means that from inflationary perspective there is no need for further monetary easing.

The increasing geopolitical risk might be also a reason for having a more cautious attitude this time especially if we look on the extremely steep Hungarian yield curve. 2-10-year spread is 250bp in Hungary while 130bp in Poland so the Hungarian yield curve is 120bp steeper than the Polish one. The reason behind is the National Bank's new monetary policy tools, which forces the banks to hold more Hungarian government bonds, and the banks are buying rather the short-end of the curve. But it also reflects that Hungary is still risker than Poland so cutting the base rate too deep might be quite dangerous. Additionally the EUR/HUF moved in the range of 310 and 315, which is comfortable for the NBH.

We think that NBH may stop the rate cut cycle, but it may emphasize that the monetary policy remains supportive for economic growth and if they see it necessary new rate cut may come in the future.

THU 13:00 CNB base rate

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

CZ: CNB meeting - no surprise this summer

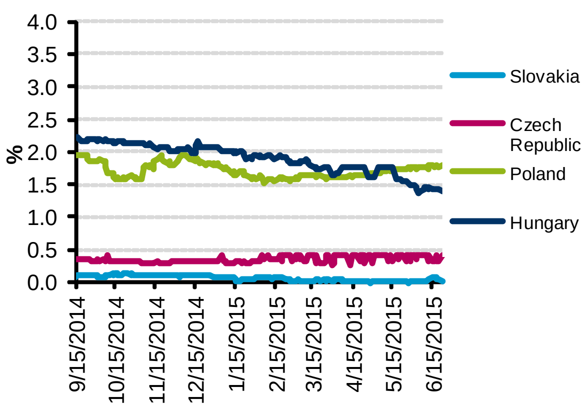
This year's fourth CNB Board meeting, from which we expect no substantial monetary policy changes, is held on Thursday. The forecast was on the agenda last time, and thus the central bank will tend to pay attention to divergences of current economic developments from outlooks currently in force. Both inflation and economic growth have proved to surpass expectations so far; on the other hand, slow wage growth sparks questions. Thus the CNB may be more or less satisfied and continue to pursue its policy of low rates and its existing exchange rate arrangement. We expect the central bank to reaffirm the second half of 2016 as the nearest possible date for unleashing the koruna.

Calendar

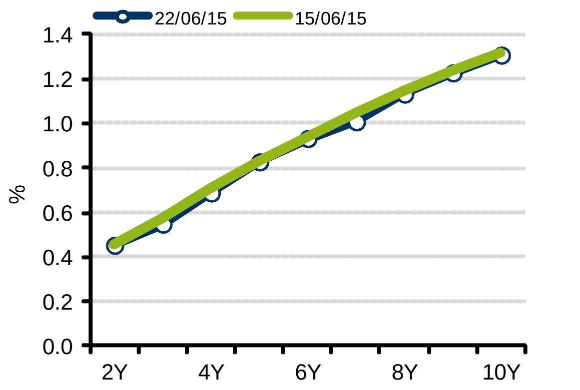
Country	Date	Time	Indicator		Period	Forecast m/m	Forecast y/y	Consensus m/m	Consensus y/y	Previous m/m	Previous y/y
HU	06/23/2015	14:00	NBH meeting	%	06/2015	1.5		1.5		1.65	
HU	06/24/2015	8:30	Current account	HUF B	1Q/2015			2000		892	
PL	06/24/2015	10:00	Unemployment rate	%	05/2015			10.8		11.2	
CZ	06/24/2015	12:00	CZ bond auction 2014-18, 0.85%	CZK B	06/2015						
CZ	06/24/2015	12:00	CZ bond auction 2015-26, x.xx%	CZK B	06/2015						
CZ	06/25/2015	13:00	CNB meeting	%	06/2015	0.05		0.05		0.05	
HU	06/26/2015	9:00	Unemployment rate	%	05/2015			7.5		7.6	

Fixed-income in Charts

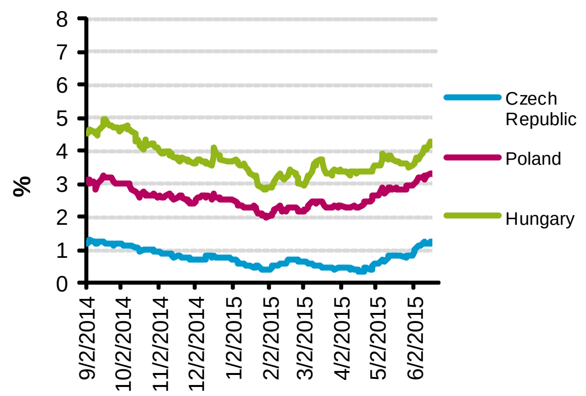
FRA 3x6



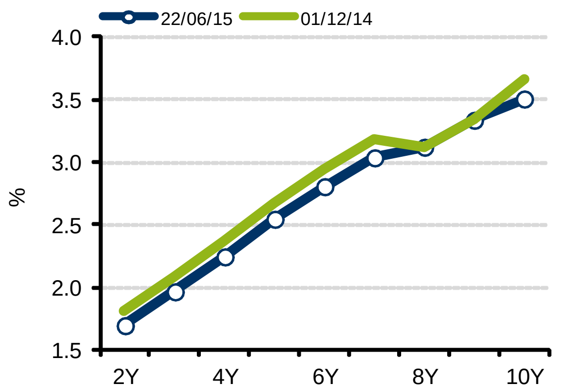
CZ IRS



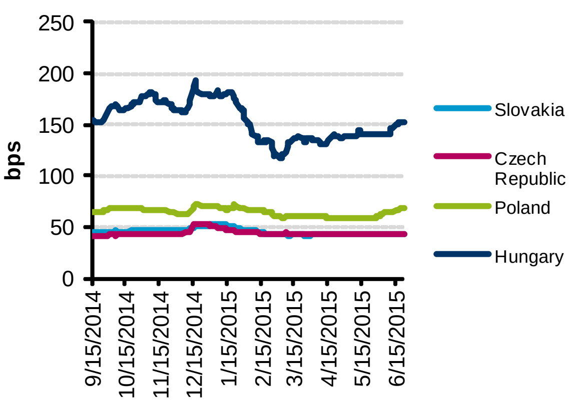
10Y GB Yields



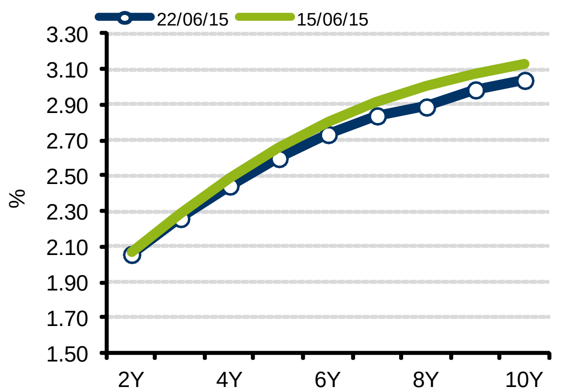
HU IRS



CDS 5Y



PL IRS



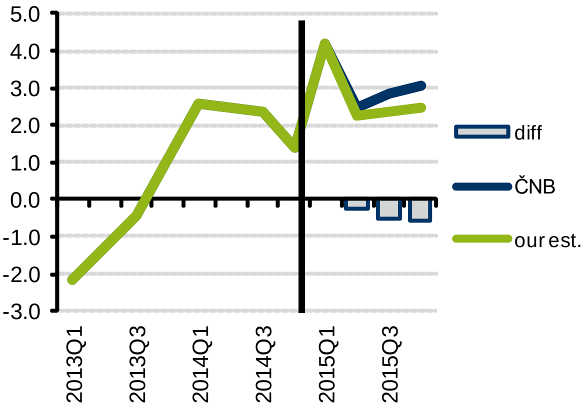
Source: Reuters

Medium-term Views & Issues

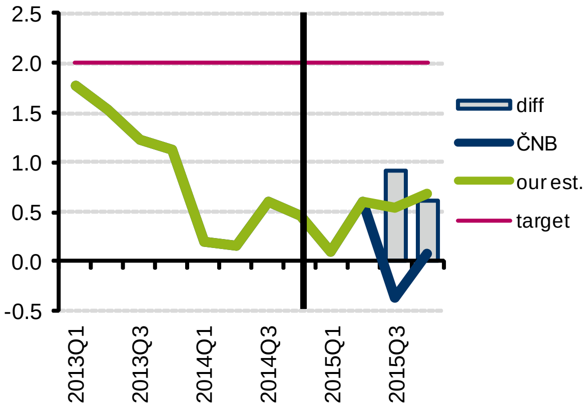
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing 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.	The Hungarian economy has continued to record solid growth this year as the working day adjusted GDP grew by 3.4% Y/Y in the first quarter. Looking ahead the GDP growth might slow down slightly in the coming quarters, but the favourable European conjuncture and the increasing net real wage and employment increase might provide a stable base for the growth so we expect that Hungarian economy may grow by about 3% Y/Y in 2015.	According to the GUS, the Polish economy grew by 3.6% in 2015Q1. As in previous quarters, economic growth was driven mainly by strong domestic demand. We suspect households consumption was again the key driver of economic growth in Poland. As for this year, we expect economic growth may be 3.5-4%.
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 longer term outlook for inflation is still below the central bank's official forecasts.	The National Bank of Hungary cut base rate by 15bp from 1.8% to 1.65%. Although the statement mentioned these changes, it doesn't give main importance to it. In our view the last sentence: 'Cautious easing of the policy rate may continue as long as it supports the achievement of the medium-term inflation target' confirms that the NBH is determined to moderate the base rate to the Polish level of 1.5%, which is likely to be achieved already in June. We expect that it might be the end of the rate cut cycle as fundamentally we see less and less reasons to continue the cycle, while the stability risk aspect is increasing.	We expect the NBP to keep rates at new lows (1.50%) this year, but we cannot completely rule out the likelihood of further rate cuts. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year's inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected.
Forex Outlook	We believe a hike of EUR/CZK floor is still unlikely. This would require deterioration of currently positive economic outlook. On the other hand the, the more aggressive verbal interventions may keep the Czech koruna on the defensive for a while. Hence it is probable that the pair forgets about testing the 27 EUR/CZK for now. Fundamentally, the Czech currency should be more sensitive to readings of major Czech macroeconomic indicators – inflation, wages, industry and, of course, GDP. The koruna may get more nervous ahead of May's CNB Board meeting, where a new inflation forecast will be submitted.	In a longer term perspective, the HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. In a short-run, however, if the NBH says in June that they stop now the rate cut cycle than it is rather bullish for the forint as some key market players bet that the NBH may cut the base rate to even 1.2%.	We expect the zloty to gain on growing capital inflows exploiting the positive interest rate differential at the time short term yields are mostly negative in the eurozone. Given the NBP pledge to end the rate cutting cycle, the market may feel temptation to test the willingness of the central bankers to tolerate further gains of the Polish currency.

CBs' Projections vs. Our Forecasts

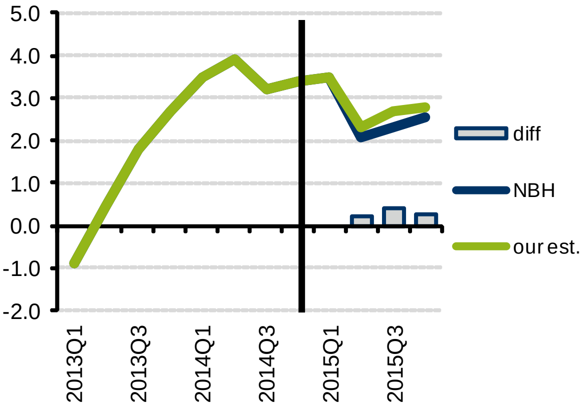
CZ: GDP outlook (Y/Y, %)



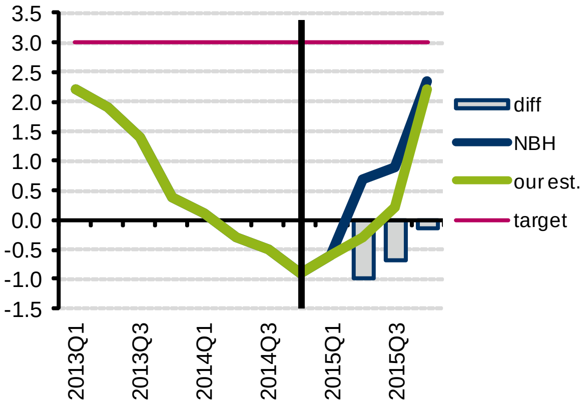
CZ: Inflation outlook (Y/Y, %)



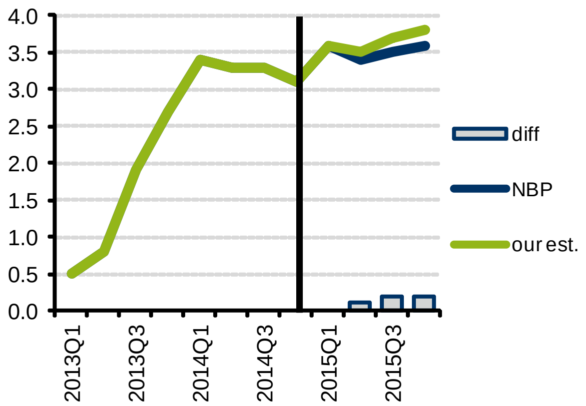
HU: GDP outlook (Y/Y, %)



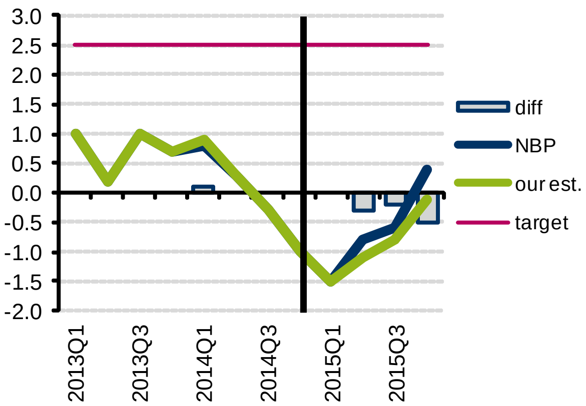
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, KBC

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	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.	*1.65*	1.95	1.70	1.70	2.00	2.25	-10 bps	5/26/2015
Poland	2W inter. rate	*1.50*	1.50	1.50	1.50	1.50	1.50	-50 bps	3/4/2015

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	PRIBOR	*0.31*	0.30	0.30	0.30	0.30	0.30
Hungary	BUBOR	*1.50*	1.89	1.70	1.70	2.10	2.40
Poland	WIBOR	*1.72*	1.65	1.55	1.60	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*1.31*	0.64	1.35	1.45	1.55	1.50
Hungary	HU10Y	*3.51*	2.71	3.20	3.40	3.60	3.80
Poland	PL10Y	*3.04*	2.12	2.10	2.20	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.26*	27.57	27.30	27.60	27.30	27.30
Hungary	EUR/HUF	*312*	300	310	317	315	310
Poland	EUR/PLN	*4.17*	4.07	4.05	4.00	4.10	4.05

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.4	4.2	2.2	2.3	2.5	2.5
Hungary	3.2	3.4	3.5	2.3	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.5	3.7	3.8	3.8

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

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	0.7	0.1	0.2	0.8	0.5	1.0	1.7
Hungary	-0.5	-0.9	-0.6	-0.3	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.5	-1.1	-0.8	-0.1	0.4

Current Account

	2015	2016
Czech Rep.	2.0	1.8
Hungary	4.0	3.8
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-2.4	-1.9
Hungary	-2.2	-2.0
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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