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Central European Weekly

Monday, 14 September 2015

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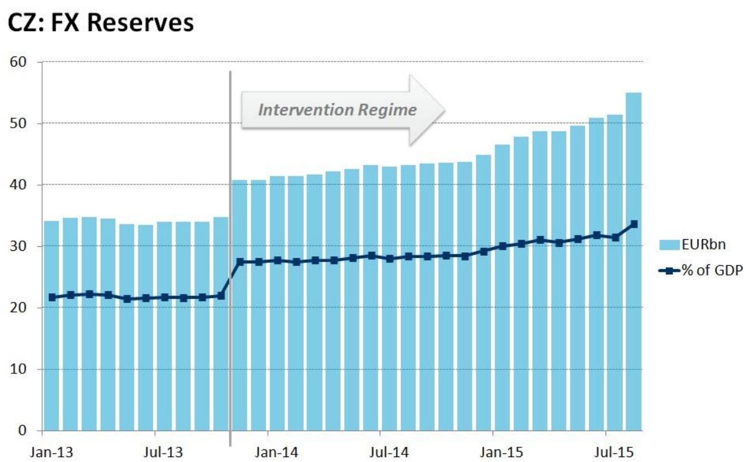
Weekly Highlights:

- The CNB has to defend EUR/CZK with interventions, which flooded the market by CZK liquidation
- …as a result Czech short government bond yields fall into negative territory
- Czech and Hungarian inflation are falling again
- Cheap petrol kept Polish annual inflation deeply negative in August

Chart of the Week: Czech FX reserves



Czech International reserves has increased by 60% since the introduction of CNB's new FX regime with the EUR/CZK floor at 27.0.

Market's editorial

Lorem ipsum dolor sit amet

The long awaited Czech statistics that nobody has paid much attention - the actual amount of foreign exchange reserves and especially statistics of the CNB's FX transactions – is finally out.

And the latest figure is definitely worth of market attention. Just in August, FX reserves increased by another EUR 3.6 billion. At the moment, we cannot say how much of the latest increase is due to the intervention and to what extent the increase in reserves due converting euros coming from EU. However, it is quite likely that more than half of that figure is directly attached to interventions against the strong koruna.

On the other hand, it is already clear that CNB purchased EUR 1 billion on the market in July. It is worth noting that July was the first month when the central bank had to step in the foreign exchange market against the koruna since the introduction of new FX (Swiss) foreign exchange regime in November 2013. We believe that CNB has been defending the floor even in September as it had to take another CZK 30 billion into its repo and depo operations.

Despite the fact that foreign exchange reserves are growing rapidly and their value already corresponds to about 34% of GDP, we do not think that the CNB will give up the current regime sooner than it is promising (2nd half of 2016). The biggest argument against 'the Swiss surprise' from the CNB is the fact nobody among Czech politicians (and even among economists) currently cares about the 'fair' level of Czech FX reserves and its implications for the economy and wealth of the Czech population. Moreover, the Czech Republic has much lower level of FX reserves compared to Switzerland, when it was forced to scrap its intervention regime (34% versus 85% of GDP).

Czech short-term bond yields deeply negative

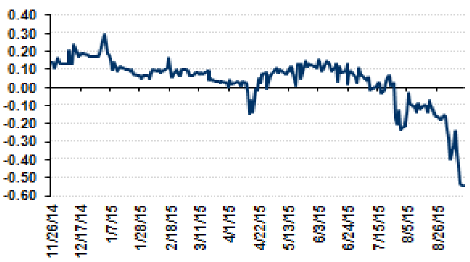
However huge amounts of freshly printed korunas flooded the Czech fixed-income with CZK liquidity, so it has been hungry for any yield. In such environment Czech government bond auction drew the most attention last week. Despite the fact that the ministry of finance raised the volume of a new zero-coupon bond (due to 2017) it was offering, the demand easily outpaced supply and average yield fell to -0.21%. Clearly, a pass-through of deeply negative implicit interest rates (that is a consequence of rising volume of liquidity in the Czech banking system) into market interest rates continues.

Regarding news, CNB governor Singer reiterated that he remains rather sceptical about the possibility of introduction of negative interest rates, even if it was for a brief period of time. This is in line with our expectations – we do not expect CNB cutting interest rates below zero.

	Last	Change 1W
EUR/CZK	27.1	0.21%
EUR/HUF	313	-0.44%
EUR/PLN	4.21	-0.73%

	Last	Change 1W
10Y CZK	1.04	-2.35
10Y HUF	3.13	-3.69
10Y PLN	2.60	-1.14

CZ GB 2Y



CZ GB 2Y, last 200 days. Source: Reuters

EUR/CZK

EUR/CZK, last 110 days. Source: Reuters

Review of Economic Figures

Czech inflation falls again and drops below CNB's projection

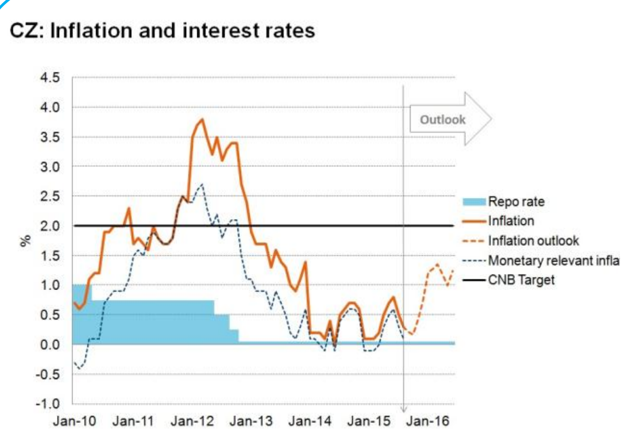
In line with expectations, inflationary pressures have once again started to disappear from the Czech economy. Year-on-year inflation fell from the previous 0.5% to 0.3% in August, and thus again moved away from the central bank's inflation forecast. In August alone the consumer price index declined by 0.2% m/m, mainly because of cheaper food, fuel, alcohol and seasonal sales. While inflation is still positive compared to last year (the above-mentioned 0.3%), prices of numerous items in the consumer basket keep falling. The greatest savings are currently available in fuels, thanks to drops in oil and petrol prices on global markets. Food prices have also declined as a result of the falling prices of agricultural producers, influenced, inter alia, by the high supply of milk in Europe. There is probably no need to elaborate on the argument of the persisting fall in the prices of electronics, including mobile phones, either.

Which prices are currently higher than last year? Mainly imported clothing and shoes, and cigarettes, while package tours and housing are also slightly more expensive. The Czech economy is essentially free of inflation, which is also unlikely to return any time soon. We expect price rises to continue to decelerate and approach zero in the months to come. Low inflation is being imported to the Czech Republic despite the weak koruna.

No wonder that the current gap between the central bank's forecast and reality has widened to 0.4%. As this is attributable to diesel and petrol prices, we do not expect that the central bank will need to react to such developments dramatically. After all, the CNB itself is using the argument of adjusted inflation, excluding fuel, which remained at 1.1% and is definitely not suggesting any deflation in the economy. Hence leaving the monetary policy unchanged currently appears to be the most probable scenario – despite pressure on the forex market (see the editorial). Therefore, if there is any real uncertainty, it is the timing of the departure from the current exchange rate system and whether the announced second half of next year is not too early.

Hungarian annual inflation back to zero

The Hungarian consumer price index dropped from 0.4% Y/Y in July to 0% Y/Y in August. The fuel price decreased by more than 5% MoM, so it was the main driver of the inflation drop. The core inflation remained almost unchanged at 1.2% Y/Y. Although the headline inflation is extremely low, we see that the domestic driven inflation is slowly picking up. While in previous years the weakening HUF had almost no effect on tradeable goods, recent months the slightly weaker HUF started to push up slowly these products prices, which reflect the relatively stable and strengthening demand. Looking ahead the inflation may increase from October as the last year's energy price cut and fast oil price drop will fall out from the base. The year-end CPI might be above 2% Y/Y, but the exact level highly depends on the next months' oil price development. Next year the average inflation may be between 2.5% Y/Y and 3% Y/Y.



Weekly preview

TUE 14:00 PL Inflation (change in %)

	Aug-15	Jul-15	Aug-14
CPI y/y	**-0.7**	-0.7	-0.3
Food (ex Alc.) y/y	**-1.3**	-1.7	-2.1
Transport (including fuel)	**-7.5**	-7.0	-1.5

PL: Cheap petrol keeps inflation deeply negative

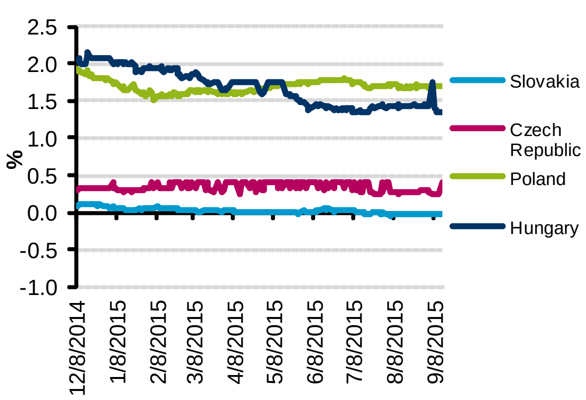
Poland's inflation rate remained at -0.7% in August according to our forecasts. We believe that prices fell by 0.4% m/m. The main reasons for the month-on-month decline include seasonally falling clothing prices and in particular lower food and fuel prices. If our forecast is borne out, the Polish economy may not return to positive price growth before the very end of this year.

Calendar

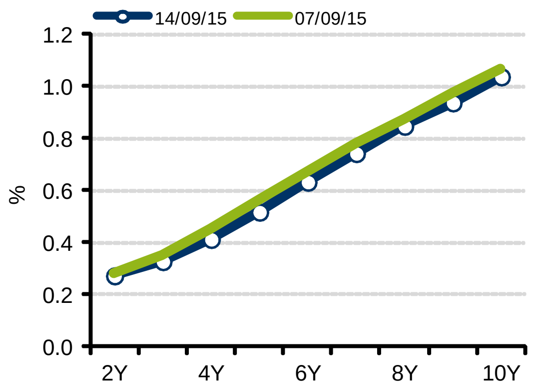
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	09/14/2015	10:00	Current account	CZK B	07/2015	-4		0.7		13.26	
PL	09/14/2015	14:00	Money supply M3	%	08/2015			1.2	8	0.9	8.6
PL	09/14/2015	14:00	Current account	EUR M	07/2015			-527		-849	
PL	09/14/2015	14:00	Trade balance	EUR M	07/2015			107		56	
PL	09/15/2015	14:00	CPI	%	08/2015			-0.4	-0.7	-0.1	-0.7
PL	09/15/2015	15:00	Budget balance	PLN M	08/2015					-26592	
CZ	09/16/2015	9:00	PPI	%	08/2015			-0.4	-3.4	-0.4	-3
PL	09/16/2015	14:00	Core CPI	%	08/2015			-0.1	0.4	0.2	0.4
PL	09/16/2015	14:00	Wages	%	08/2015			-1.6	3.5	1.4	3.3
PL	09/17/2015	14:00	Industrial output	%	08/2015			-6.1	6.4	-1.3	3.8
PL	09/17/2015	14:00	PPI	%	08/2015			-0.3	-2.4	-0.4	-1.7
PL	09/17/2015	14:00	Retail sales	%	08/2015			-1	1.5	2.1	1.2

Fixed-income in Charts

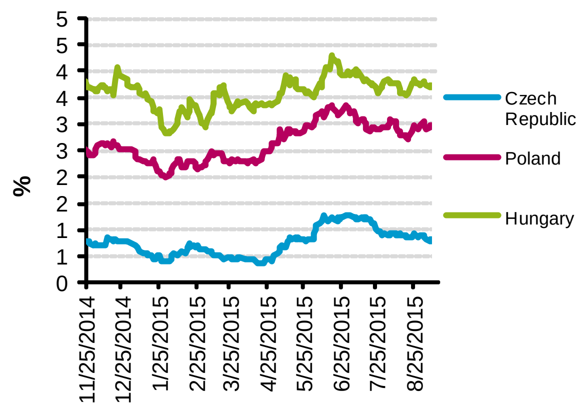
FRA 3x6



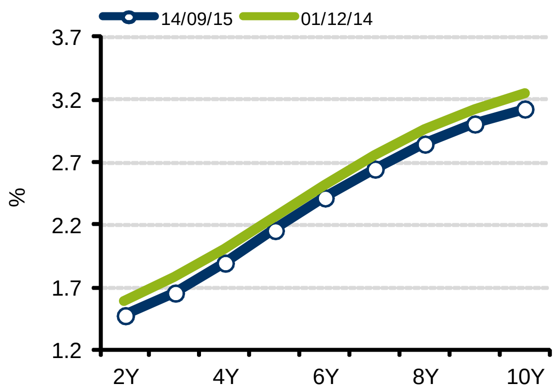
CZ IRS



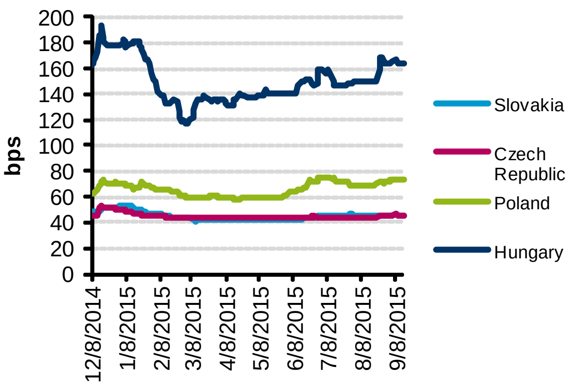
10Y GB Yields



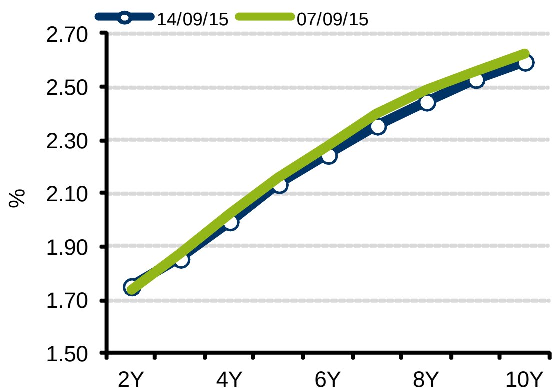
HU IRS



CDS 5Y



PL IRS



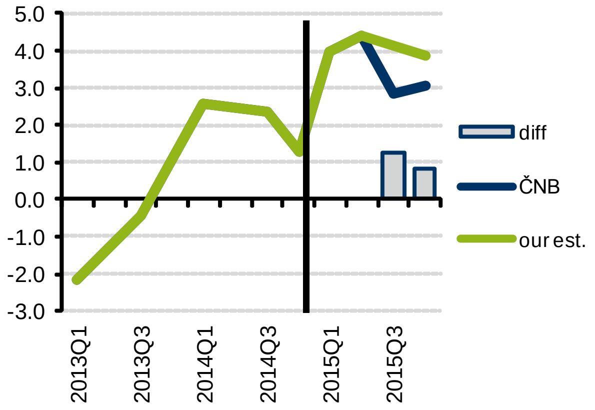
Source: Reuters

Medium-term Views & Issues

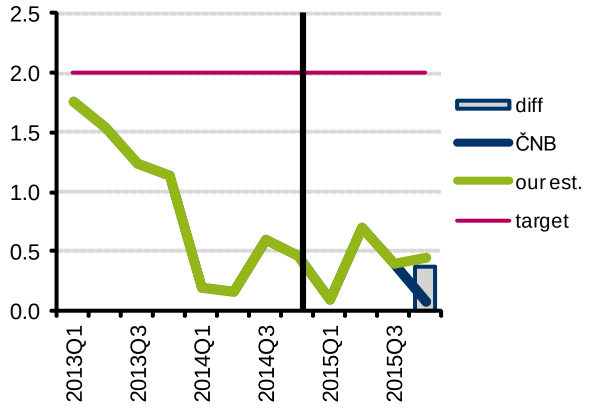
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – encouraged by growing real wages and employment – becoming a strong stimulus. At the moment, we cannot expect any fundamental economic changes or reforms, except for the abolition of the pension reform and the introduction of the electronic registration of sales. Progress in the country's preparations for joining the euro area is not expected in this electoral term either.	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.	The Polish Statistical Office kept its flash GDP forecasts for the second quarter of the year unchanged – this means growth of 3.3% y/y and 0.9% q/q. Thus the data for the second quarter fell short of expectations, but only slightly. Perhaps only the deceleration of the rate of investment may pose some issues; nevertheless, we are not overestimating this at the moment either. The overall positive economic developments in Europe and the long-term eased monetary policy should translate into growth of the Polish economy within the range of 3.5-4% this year as well as the next.
Outlook for official & market rates	The CNB's monetary policy continues to be based on record-low interest rates and the weak koruna. The exchange rate policy, not allowing the koruna to strengthen beyond (below) EUR/CZK 27.0, is most likely to remain in place at least until the second half of 2016, and low interest rates probably even longer. The reason is that inflation remains below the 2% target and will most likely remain there next year, and will only slowly approach the target.	The MNB said in July it concluded its rate cut cycle. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture, so the start of the rate hike cycle is depending on FED's and ECB's policy. Based on the current expectation we think that NBH may hike key rate in 2Q16 the earliest.	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	Relatively strong economic growth, current and capital account surpluses and ongoing QE in the euro zone have been the key factors behind the recent strength of the koruna. We believe the Czech National Bank will meet its "pledge" and won't terminate its intervention regime before the second half of 2016. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Possible start of tightening of US monetary policy poses negative risks for the koruna. We however think the fallout should only be limited.	We think that the first strengthening reaction of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture.	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. Polish general elections in autumn however pose a negative risk for the zloty.

CBs' Projections vs. Our Forecasts

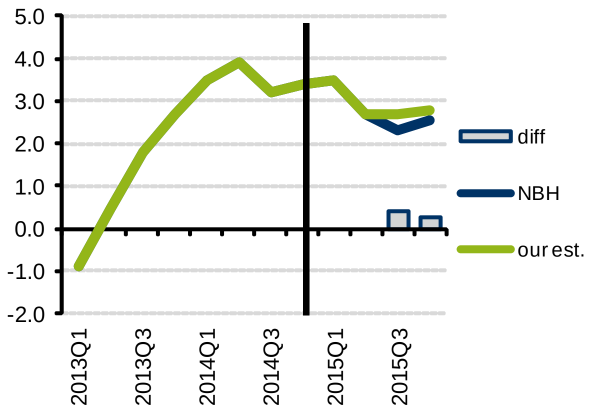
CZ: GDP outlook (Y/Y, %)



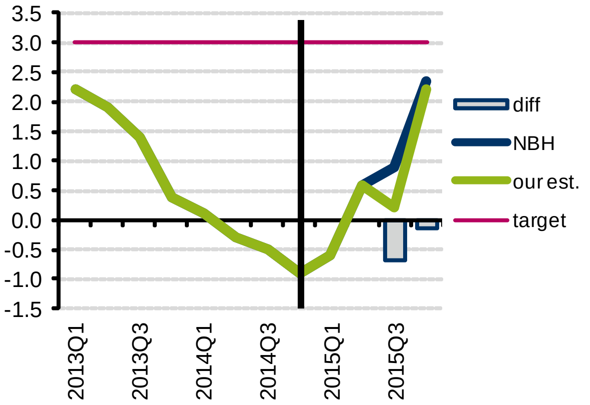
CZ: Inflation outlook (Y/Y, %)



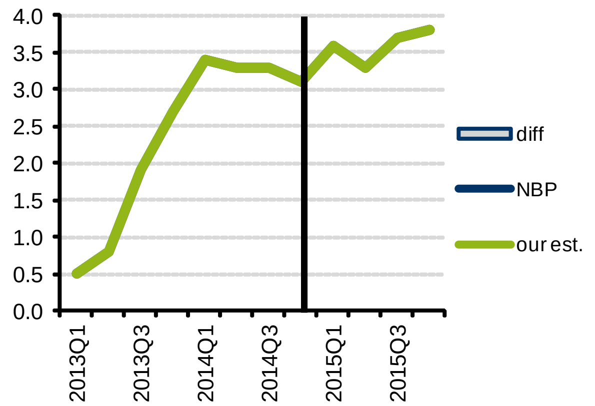
HU: GDP outlook (Y/Y, %)



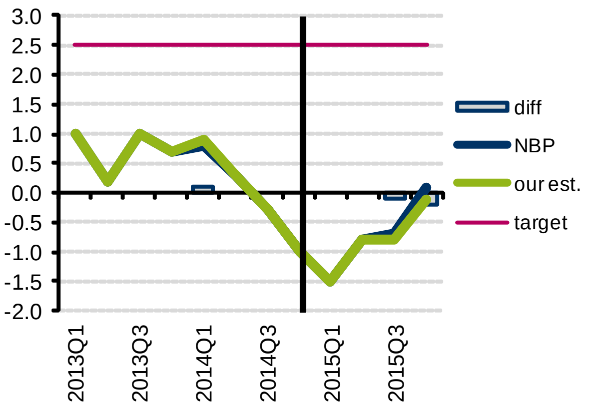
HU: Inflation outlook (Y/Y, %)



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.	*1.35*	1.95	1.50	1.70	2.00	2.25	-10 bps	7/21/2015
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	*0.00*	0.30	0.29	0.30	0.30	0.30
Hungary	BUBOR	*1.36*	1.89	1.41	1.70	2.10	2.40
Poland	WIBOR	*1.72*	1.65	1.72	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	*1.04*	0.64	1.30	1.25	1.30	1.40
Hungary	HU10Y	*3.13*	2.71	3.45	3.40	3.60	3.80
Poland	PL10Y	*2.60*	2.12	3.01	2.45	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.12*	27.57	27.35	27.10	27.05	27.00
Hungary	EUR/HUF	*313*	300	315	317	315	310
Poland	EUR/PLN	*4.21*	4.07	4.19	4.20	4.15	4.10

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.3	4.0	4.4	4.1	3.9	2.2
Hungary	3.2	3.4	3.5	2.7	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.3	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	0.2	0.7	1.5
Hungary	-0.5	-0.9	-0.6	0.6	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.5	-0.8	-0.8	-0.1	0.4

Current Account

	2015	2016
Czech Rep.	1.7	1.7
Hungary	4.0	3.8
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.6	-1.3
Hungary	-2.2	-2.0
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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