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Central European Weekly

Monday, 19 October 2015

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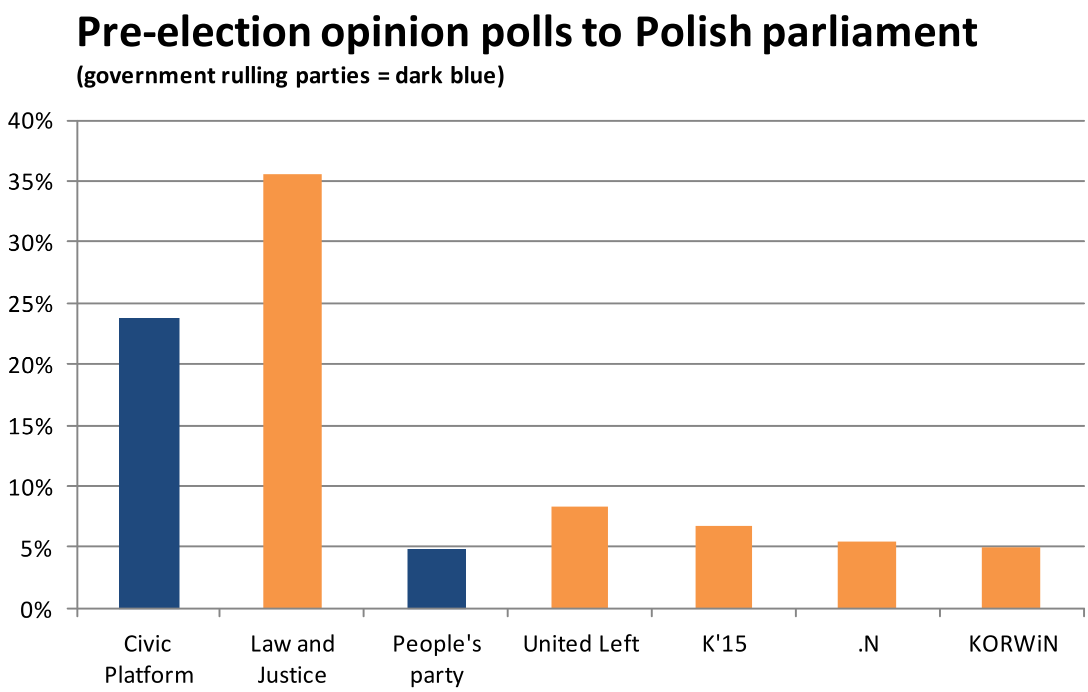
Weekly Highlights:

- Dovish ECB could bring CNB's closer to an extension of its FX intervention regime
- Deteriorating economic outlook starts to worry Hungarian authorities
- Upcoming NBH's meeting: on hold, but dovish
- Watch the outcome of the Polish elections – they might change not only government and the NBP too

Chart of the Week: Polish pre-elections polls



Market's editorial

After the caustios FOMC, watch the dovish ECB...

The Fed's decision to stay on hold (for some time) and the ECB dovish stance is putting pressure on regional central banks that might be forced to ease their policy further. Although we don't expect the ECB to take yet additional measures this week, Mr. Draghi may lay the groundwork for additional easing at the December meeting.

The CNB will be the most sensitive to ECB's easing

ECB's step should grab attention of the Czech central bank in particular as it accommodates ECB's expansive policy through a quasi-fixed FX regime. In this respect, it is worth noting that the CNB starts to talk slowly but loudly about extending its exchange rate policy. Recall that the policy (to defend the EUR/CZK 27.0 floor) is currently expected to last until at least the second half of next year, but in view of how inflation is lagging behind the central bank's target and is set to do so for some time, a moment to announce the extension of the FX regime may be approaching. The question is whether it could happen already in November. On the one hand, the CNB Bank Board will have a new inflation projection. On the other, the ECB (further easing) action may still be missing. Nevertheless, a transparent and timely announcement on extending the exchange rate interventions may in the end appear to be the simplest and the best CNB's move.

The NBH on hold, but more dovish

The other regional central bank, which should watch ECB's policy steps closely, is the National Bank of Hungary which it holds its policy meeting tomorrow afternoon. We believe that the NBH may deliver a more dovish statement which will stem not only from ongoing domestic deflation but also from Fed/ECB dovish stance.

The NBP in wait-and-see mode ahead weekend elections

Last but not least there is the Polish central bank. In this case we do not expect any policy impact (from the ECB). The NBP will rather stay in a wait-and-see mode for some time and it will have to digest implications, which will arise from the Polish parliamentary elections scheduled for this weekend. This could bring not only a change of the government but also significant personal changes in the composition of the Monetary Policy Council (a rate-setting body in the NBP) later on. Recall that **the Polish new parliament will appoint six of the nine MPC's members in early in early 2016, plus it will have to confirm NBP's governor in mid of 2016. Current NBP Governor Marek Belka will not be probably re-appointed by conservative president Duda, while his successor has to be confirmed by Sejm's majority.**

Still, the NBP meeting scheduled for early November may be of interest too. A new forecast will be available to the central bank, which is likely to revise its inflation outlook significantly downwards. But it was mentioned above - we do not expect any significant modifications of the NBP policy before the replacement of (some) MPCl members early next year.

	Last	Change 1W
EUR/CZK	27.1	-0.01%
EUR/HUF	309	-0.32%
EUR/PLN	4.24	0.22%

	Last	Change 1W
10Y CZK	0.91	-4.21
10Y HUF	2.80	2.19
10Y PLN	2.41	-0.04

Review of Economic Figures

Worse outlook starts to worry Hungarian authorities

More statistical figures show that Hungarian economy is slowing. The previous drives of the economy are not able to boost the economy, while the new ones are in late. Construction figures (fall of 6.1% YoY in August) reflect the best the recent problem of growth: the civil engineering works (using EU and state money) are decreasing massively, while the construction of building is still missing. The EU funds money usage reached its maximum level in the last 12 months and expected to fall back substantially from January. The government's investment into infrastructure is also around its peak level, while the lending activity in the private sector is still weak. The result of it that the new contracts are falling by 10.6% Y/Y, while the volume of the stock contracts are down by 48% Y/Y.

The deteriorating economic outlook worries the government and the NBH as well. So, while it is clear that the main focus moved away from the inflation to the economic performance for the NBH. Although the phrase of cemtral bank's communication is still the inflationary developments, the decisions are influenced more by the economic developments.

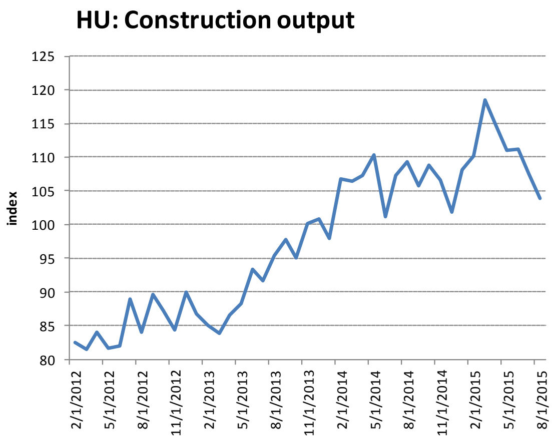
Poland's consumer prices continue to fall

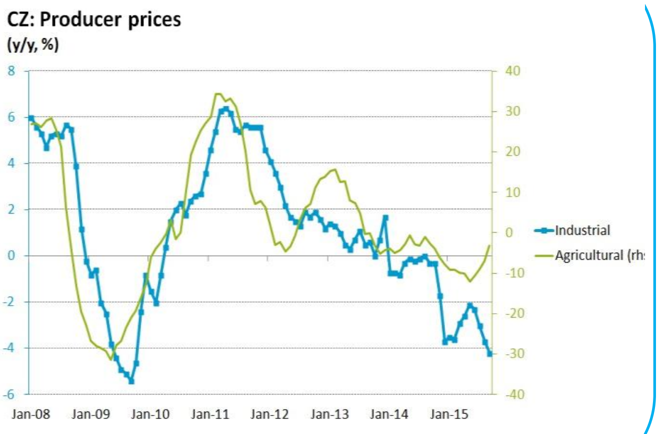
A revision of the flash forecast for Poland's inflation for September sprang no significant surprises. The year-on-year price rise remained at -0.8%, while the month-on-month change was only revised slightly downwards (from 0.2% to -0.3%). The data sprang no surprises in terms of their structure either. September's figures from the other countries signalled that the originally unexpected deepening of deflation had probably been attributable to a greater decline in fuel prices than was actually confirmed. In addition, the fastest month-on-month rise in food prices since April and a surprisingly strong fall in package tour prices are also worth mentioning.

Czech producer inflation will not occur any time soon

Cheap oil and consequently cheaper petrol and diesel are driving the producer price index (PPI) even deeper into negative territory. The PPI was down by 0.7% m/m, mainly because of a reduction in refining product prices, but prices were also cut in the food industry. On a year-on-year basis, the fall in the PPI even accelerated to -4.2%. Not only refineries but also chemical factories and manufacturers of metals and fabricated metal products are benefiting from the low prices.

It is remarkable to see that even the currently most successful industry – the automotive industry – is continuing to cut the prices of its products. These are almost 1% y/y lower than a year ago. Thus the effect of devaluation has gradually petered out because the last time that prices in this industry grew was last year. Now they have already been falling again for four consecutive months. Cheap oil, i.e., lower fuel prices, is reducing companies' costs in industry as a whole, thus also curbing the latitude for any price increase that could possibly please the central bank. However, it is evident that the Czech Republic is not the only country affected by this, as PPI 'deflation' also persists in Europe. Therefore, PPI inflation will not occur any time soon. Perhaps a turnaround might occur in the first half of next year, when the comparative baseline takes effect, the positive effect of cheap oil is exhausted, and perhaps prices of food products also go up. Nevertheless, this will certainly not return inflation to the 2% target in the Czech Republic.





Weekly preview

TUE 14:00	NBH base rate	
	This meeting	Last change
rate level (in %)	1.35	7/2015
change in bps	0	-15

HU: NBH on hold, but dovish

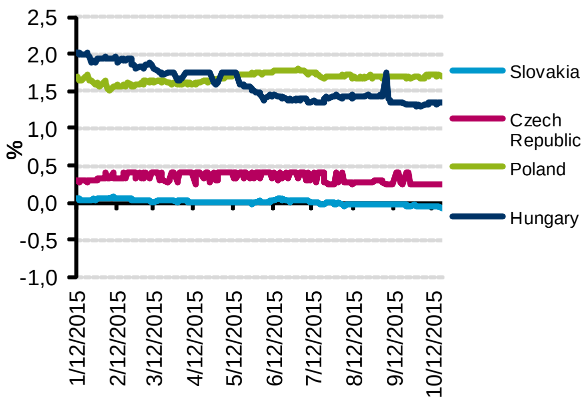
We believe that the NBH may deliver a more dovish statement after the rate setting meeting on Tuesday afternoon, where the base rate may be kept unchanged at 1.35%. Additionally the strengthening HUF is also not supportive for Hungarian export, so the chance of a rate hike in 2016 is disappearing. On the other hand, a rate cut is rather a risk at the beginning of next year.

Calendar

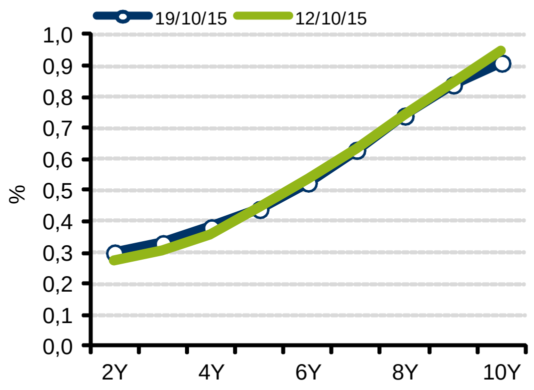
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	10/19/2015	14:00	Industrial output	%	09/2015			15	4	-7.1	5.3
PL	10/19/2015	14:00	PPI	%	09/2015			-0.2	-2.8	-0.7	-2.7
PL	10/19/2015	14:00	Retail sales	%	09/2015			0.8	1.3	-2.6	-0.3
HU	10/20/2015	14:00	NBH meeting	%	10/2015			1.35		1.35	
PL	10/23/2015	10:00	Unemployment rate	%	09/2015			9.9		10	
PL	10/25/2015	0:00	Parliamentary elections		10/2015						

Fixed-income in Charts

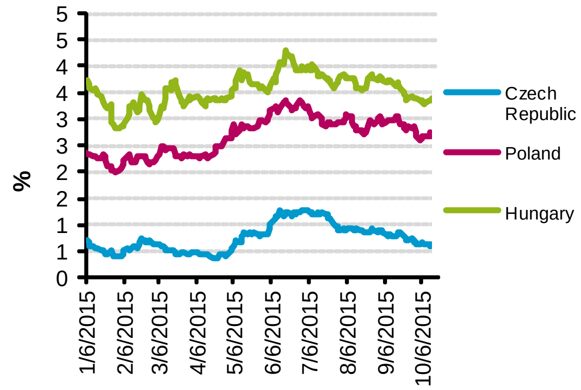
FRA 3x6



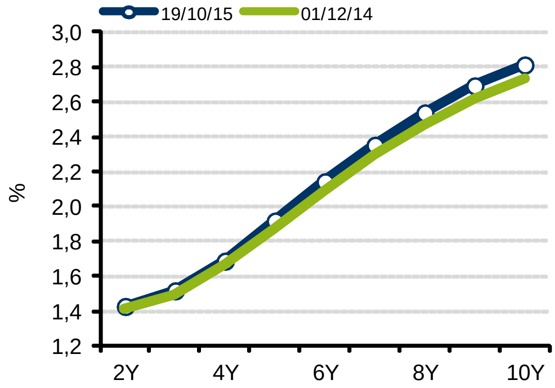
CZ IRS



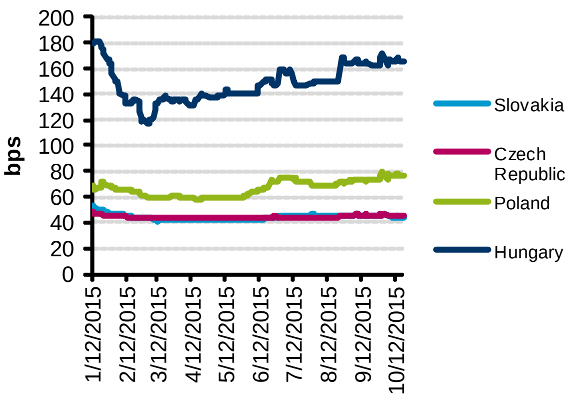
10Y GB Yields



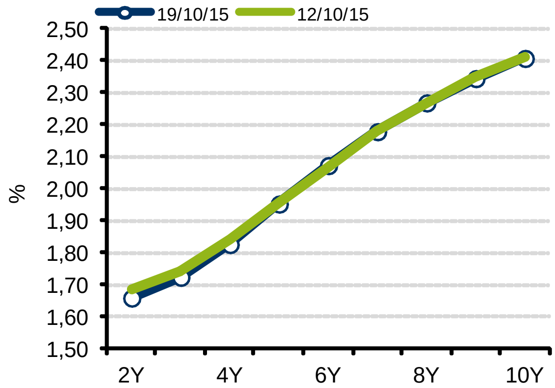
HU IRS



CDS 5Y



PL IRS



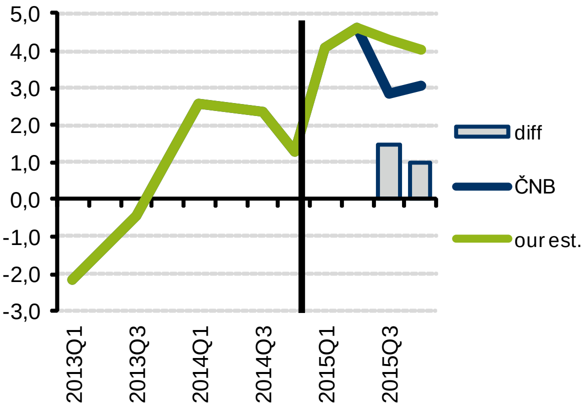
Source: Reuters

Medium-term Views & Issues

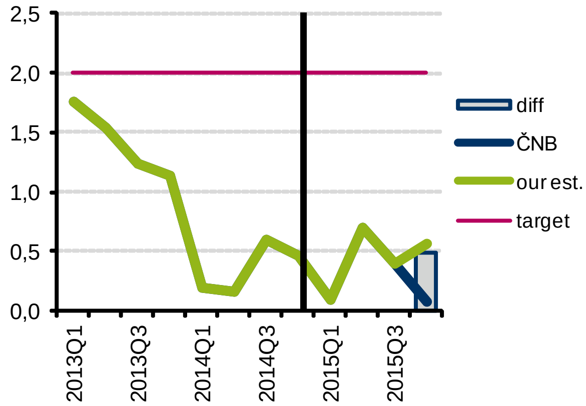
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 NBH surprised the market as it shifted the interest rate corridor of overnight (O/N) instrument by 25bp downward, so the new interest rate is 0.1% (base rate minus 125bp) for deposit and 2.1% (base rate plus 75bp) for loans. This move means practically a 25bp rate cut and is clear the NBH is fully committed to force out money from NBH so it cannot be excluded that further steps may come in the future. We think the NBH will cut further its base rate, if the ECB loosen further its monetary policy and the EUR/HUF moves closer to 300. In that case the base rate might be cut below 1%, while we think that with the previous speed, namely by 15bp per meetings.	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 any strengthening 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 and months. 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

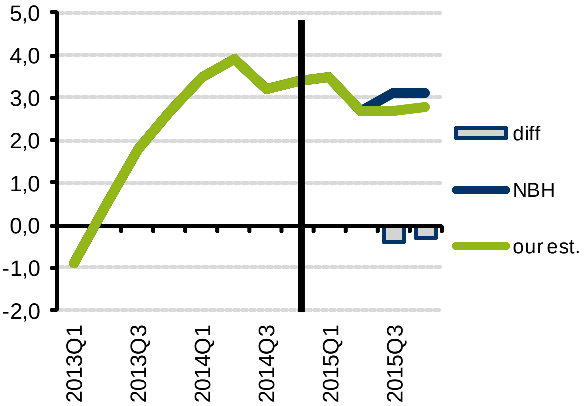
CZ: GDP outlook (Y/Y, %)



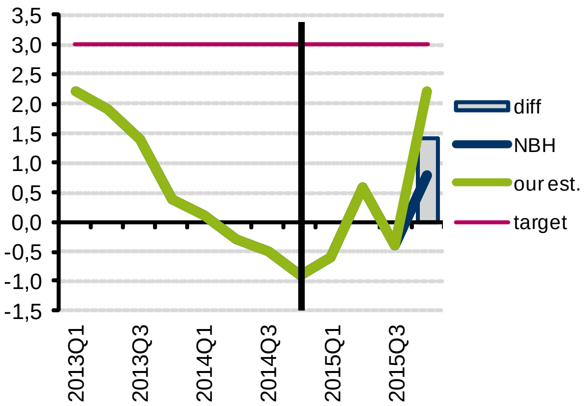
CZ: Inflation outlook (Y/Y, %)



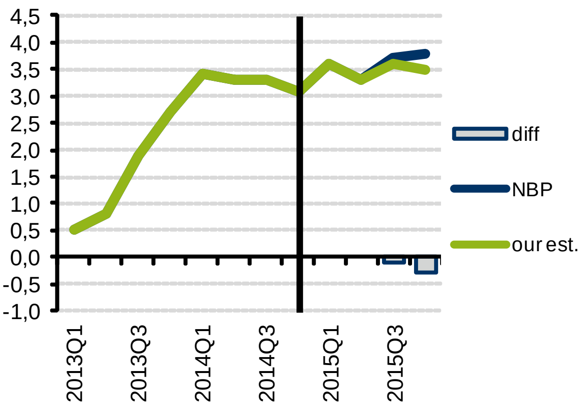
HU: GDP outlook (Y/Y, %)



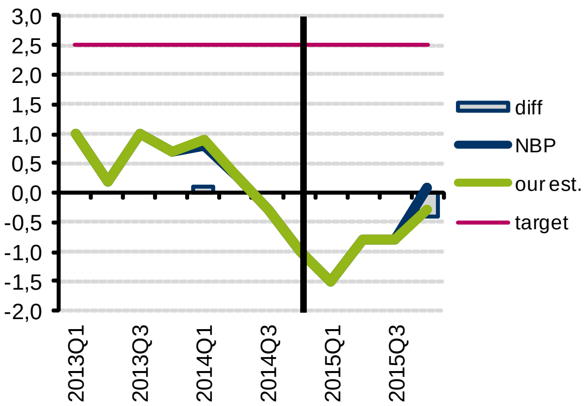
HU: Inflation outlook (Y/Y, %)



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	1.35	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	0.26	0.28	0.28
Hungary	BUBOR	*1.35*	1.89	1.41	1.35	2.10	2.40
Poland	WIBOR	*1.73*	1.65	1.72	1.73	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*0.91*	0.64	1.30	0.98	1.15	1.20
Hungary	HU10Y	*2.80*	2.71	3.45	2.93	3.60	3.80
Poland	PL10Y	*2.41*	2.12	3.01	2.50	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.06*	27.57	27.35	27.19	27.05	27.00
Hungary	EUR/HUF	*309*	300	315	314	315	310
Poland	EUR/PLN	*4.24*	4.07	4.19	4.25	4.15	4.10

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.3	4.1	4.6	4.3	4.1	2.3
Hungary	3.2	3.4	3.5	2.7	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.3	3.6	3.5	3.5

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	0.4	0.9	1.5
Hungary	-0.5	-0.9	-0.6	0.6	-0.4	2.2	2.7
Poland	-0.3	-1.0	-1.5	-0.8	-0.8	-0.3	0.2

Current Account

	2015	2016
Czech Rep.	1.5	1.5
Hungary	6.0	4.5
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.6	-1.3
Hungary	-2.3	-2.1
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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