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Central European Weekly

Monday, 13 June 2016

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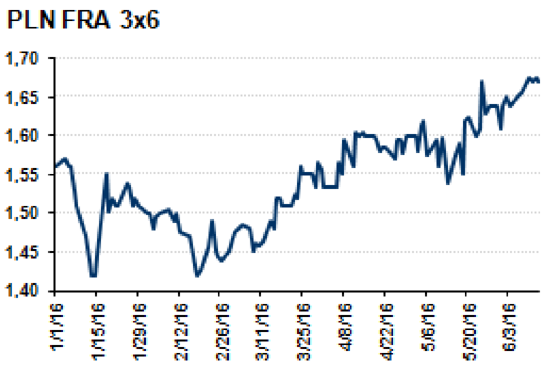
Weekly Highlights:

- NBP firmly on hold and even new governor does not change its neutral bias
- Negative inflation surprises in Hungary and the Czech republic will not alter respective monetary policies
- Regional markets await Fed and Brexit vote, but it will monitor hard Polish macro data

Chart of the Week: Rate-cut bets in Poland



PLN FRA 3x6, last 119 days. Source: Reuters

The Polish money market has completely priced-out possible rate cuts from the NBP.

Central banks & markets

The NBP keeps its neutral bias, despite ongoing deflation

Not even at his last meeting at the helm of the National Bank of Poland (NBP) did its President Belka give markets any chance of believing that the NBP was about to take any monetary action. The Monetary Policy Council (MPC) still sees deflation as a temporary phenomenon, driven by lower oil prices, with the central bank still anticipating stable GDP growth, primarily fuelled by private consumption and, in the future, also by higher investments financed from EU Funds. In addition, the NBP President Belka pointed out that the negative inflation rate was accompanied by an all-time low unemployment rate and record-breaking real wage growth. Therefore interest rate stability is preferred in this macroeconomic situation, with the NBP President again highlighting the temporary threat of the UK Brexit referendum.

Although current MPC member Glapinski will replace Mr Belka as NBP Governor next week, we believe that the NBP policy is unlikely to change in the months to come. Its policy will probably remain highly conservative; after all, this was confirmed by statements from new MPC members, who took part in the press conference. Just like Mr Belka, these members refused journalists' deliberations on an official rate cut and this is good news for the zloty, of course.

	Last	Change 1W
EUR/CZK	27.0	-0.17%
EUR/HUF	312	0.13%
EUR/PLN	4.37	0.33%

	Last	Change 1W
10Y CZK	0.57	-17.39
10Y HUF	2.25	-3.64
10Y PLN	2.43	-1.43

Review of Economic Figures

Hungarian inflation surprises heavily on downsize in May

The Hungarian consumer price index delivered surprise again in May just like in the last two months, just this time on the downside. The market expected 0.1% Y/Y inflation in May vs. 0.2% Y/Y in April, but it was -0.2% Y/Y just like in March. The core inflation moderated from 1.4% Y/Y in April to 1.3% Y/Y in May.

The main surprise came from the food and tradable goods. The prices of the former increased significantly less than a year before although the bad weather suggested the unprocessed fruits prices should accelerate. In case of the latter it looks like that the low imported inflation fully counterbalances the weaker HUF exchange rate in May. We can see some inflationary pressure coming from the strong domestic consumption only in the market service sector. Although fuel price went up by 2.7% M/M in May it was well below the last year's increase, so it pushed the annual inflation as well. Additionally the long-range travelling became cheaper as well, which on its own moderated the inflation by 0.1%pt.

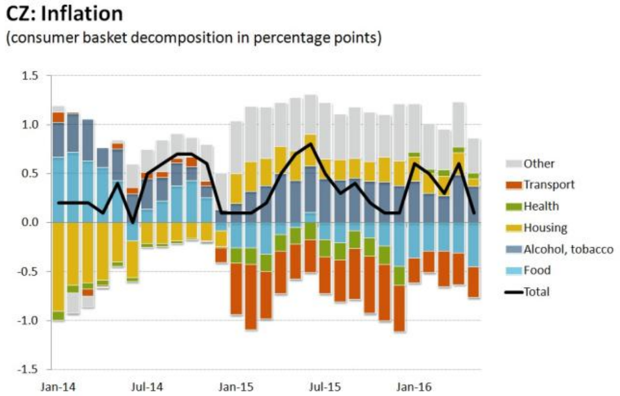
Looking ahead the consumer price index may remain around the zero level till August and we may see the first substantial jump in Hungary in September to around 1% Y/Y level, while we see year-end CPI around 2% Y/Y, which means 0.5% average inflation for 2016. The driver of the autumn increase of CPI beside the base effect is the excise duty hike of tobacco and fuel (in case of the latter only if oil remains below 50USD per barrel as in this case the tax will be increased on fuel products). As the VAT will be moderated from beginning of next year we see average inflation around 2% Y/Y in 2017.

Despite of the surprise drop in inflation back to negative territory, the most likely scenario that NBH may keep base rate unchanged in June especially that the rate setting meeting will be held on 21st of June just two days before the Brexit referendum. The statement may emphasize that the current low interest environment is planned to be maintained for an extended period, which means that no rate hike is expected in 2017.

Czech Republic without inflation again – thanks to beer...

May's inflation sprang another surprise – but different from the previous one. While April's inflation soared, May's inflation took the opposite direction, with the month-on-month consumer price index falling by 0.2%. The Statistical Office reported that the main contributors to this included cheaper food and a reduction in natural gas and beer prices. Not even rising fuel prices have been strong enough to change inflation yet. But this will certainly change with June's figures, when the greatest increase in petrol prices to date will influence the price level. Year-on-year inflation fell from 0.6% to 0.1%, thus returning to the level at the turn of the year. Compared to last year, the consumer prices of alcohol and cigarettes in particular have gone up significantly. With a few exceptions, housing costs have also increased – in particular water rates and rents – and, last but not least, this also applies to package tour prices. Food, household equipment, mobile phone and other goods are still cheaper than last year.

While inflation headed towards the vicinity of zero, this will more probably be a short episode, and will be over at the end of the summer. Rising fuel prices will start to influence inflation to a greater extent, while the effect of cheaper food is likely to peter out over time. The less the increase in fuel prices was evident in May's figures, the more it will become evident in June's data. Although inflation again stands almost at zero, this does not mean that the Czech economy is suffering from a lack of consumer demand that would compel retailers to cut their prices. Hence in the end, **the CNB can be satisfied with the price developments because inflation hit exactly the level envisaged in its last forecast**. This is why we do not expect the current figure to trigger discussions on changing the exchange rate or interest rate settings.

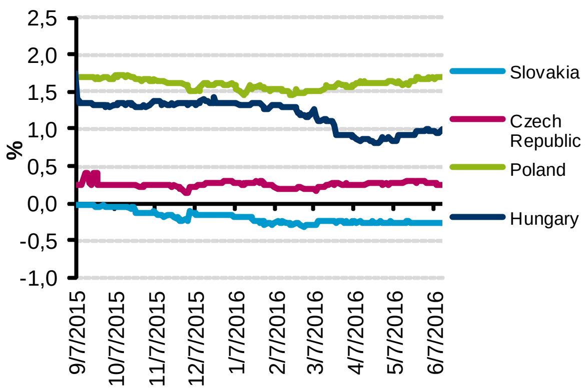


Calendar

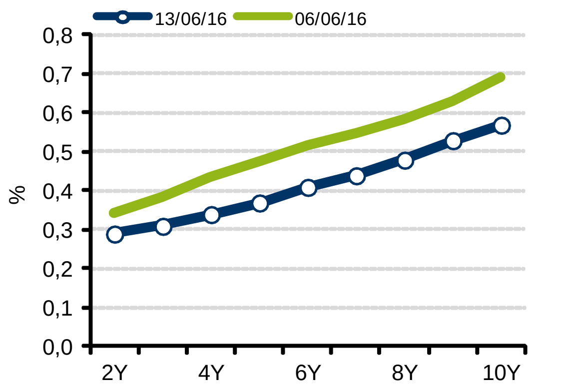
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/13/2016	10:00	Current account	CZK B	04/2016	18.3		15		32.4	
PL	06/13/2016	14:00	Current account	EUR M	04/2016			372		-103	
PL	06/13/2016	14:00	Trade balance	EUR M	04/2016			242		204	
PL	06/13/2016	14:00	CPI	%	05/2016 *F					0.1	-1
PL	06/14/2016	14:00	Money supply M3	%	05/2016			0.7	11.3	1.3	11.5
PL	06/14/2016	14:00	Core CPI	%	05/2016			0	-0.4	0.3	-0.4
CZ	06/16/2016	9:00	PPI	%	05/2016			0.3	-4.9	0.1	-4.7
PL	06/16/2016	14:00	Wages	%	05/2016			-3.1	4.7	-0.9	4.6
PL	06/17/2016	14:00	Industrial output	%	05/2016			-2.5	4.5	-3.1	6
PL	06/17/2016	14:00	PPI	%	05/2016			0.6	-1	0.3	-1.2
PL	06/17/2016	14:00	Retail sales	%	05/2016			0.3	3.8	0.3	3.2

Fixed-income in Charts

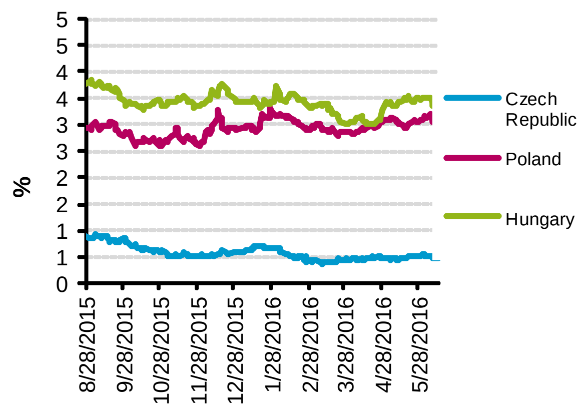
FRA 3x6



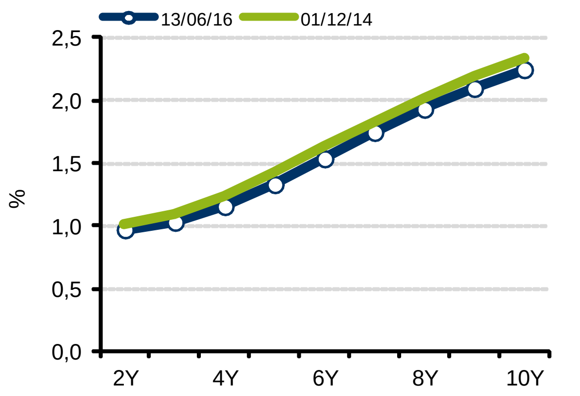
CZ IRS



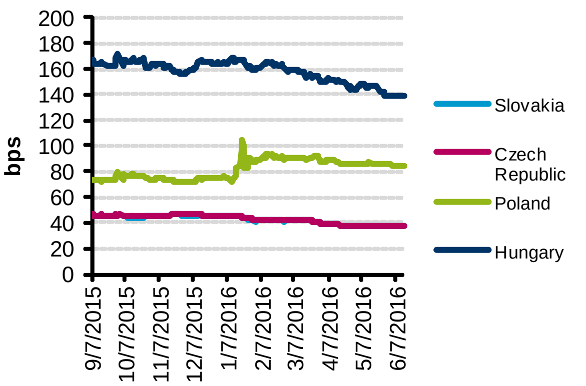
10Y GB Yields



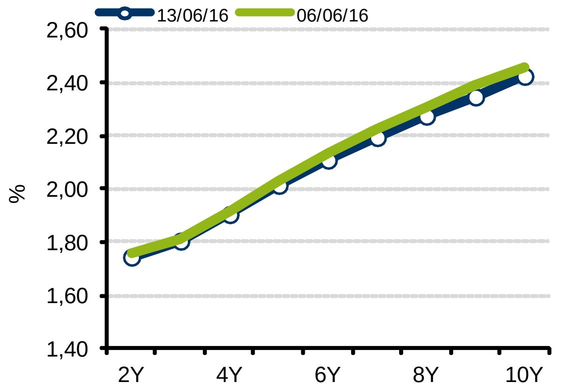
HU IRS



CDS 5Y



PL IRS



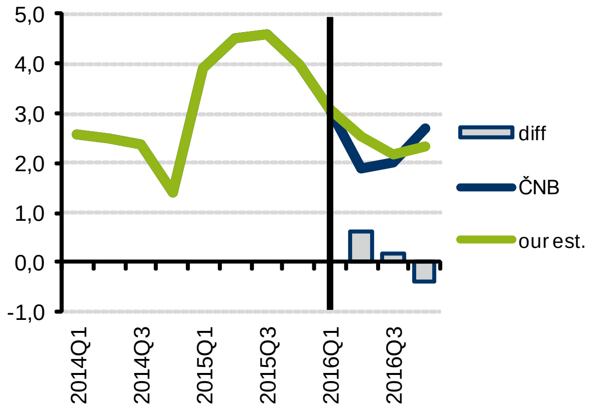
Source: Reuters

Medium-term Views & Issues

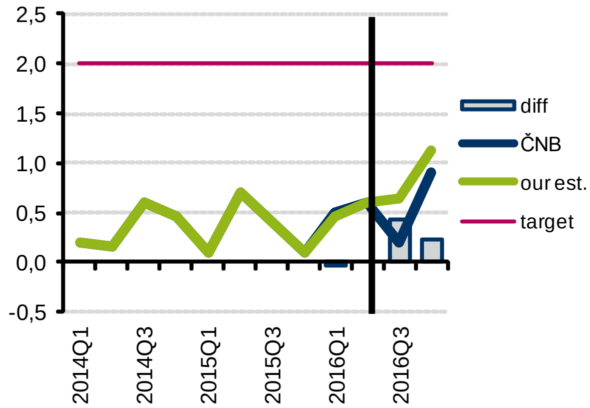
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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.	Growing net real wages and the postponed consumption since the crises (we calculate around 5% of GDP under consumption) boost the retail sales and it may be the main driver of this year's economic growth of around 2% Y/Y.	Prospects of the Polish economy remain good in our view. For the whole year 2016 we expect GDP growth may reach 3.5 - 4.0 percent. Apart from low interest rates (further cuts cannot be excluded) and a relatively weak zloty, we expect the economy to draw additional support from policy measures of the new government (stimuli for private consumption). The risks thus stem mainly from a possible deterioration in the external environment, most notably in China, Russia and other emerging markets.
Outlook for official & market rates	The latest forecast does not envisage the return of inflation to the target before early 2017, with inflation not significantly diverging from it afterwards either. The CNB has extended its exchange rate commitment until the first half of 2017. The possibility of introducing negative interest rates has been increasing, in light of the widening of the interest rate differential vis-à-vis the euro area and developments in domestic financial markets. But we still don't expect negative CNB's rates. There are two main preconditions for negative official rates: 1) significant ECB's rate cut, 2) continuing large monthly fx interventions of the CNB.	A relatively strong and continuously robust consumption is expected to push inflation gradually higher. So this figure suggests that NBH won't cut the base interest rate (0.9%) further in June despite of the surprise drop in inflation back to negative territory.	We expect the NBP to keep official rates stable, but we think that risks for of further rate cuts have increased. The main reason is the combination of the "inflow of cheap euros from the ECB", ongoing deflation and stronger currency (PLN). Hence, should the zloty get strong there could be a window of opportunity for the NBP to ease its policy in the second quarter of this year. Nevertheless this is not our main scenario yet.
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. With regard to the inflation outlook and ECB's policy, we anticipate an exit from the fx regime in the first quarter of 2017. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Current turmoil on the Chinese market poses negative risks for the Central Europe. We however think the impact on the koruna should only be limited.	Looking ahead the areas around 312.5 and 311 are strong support levels for the EUR/HU, which might stop the current rally especially in case of strong US data releases afternoon. Also the uncertainties around Brexit vote may not support further strengthening of the forint in the near-term , so we see bigger chance for some correction followed by side moves, but it will highly depend on global risk taking willingness before the Brexit vote.	We think that zloty's sell-off related to markets' fears coming from appointment of new members of the Monetary Policy Council (MPC) is over now. Nevertheless, while domestic fundamentals should be relatively supportive for the zloty, the currency should be mostly driven by sentiment in emerging markets and the ECB or the Fed policy actions respectively.

CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

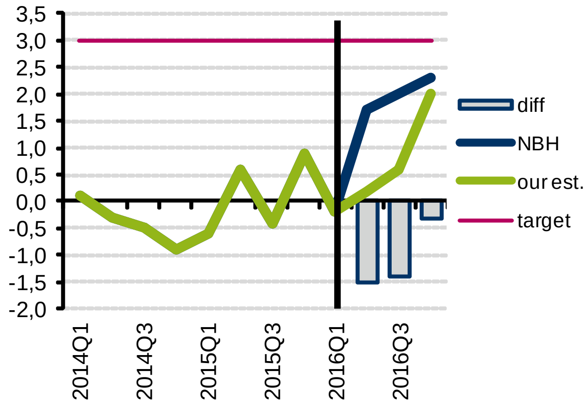


CZ: Inflation outlook (Y/Y, %)

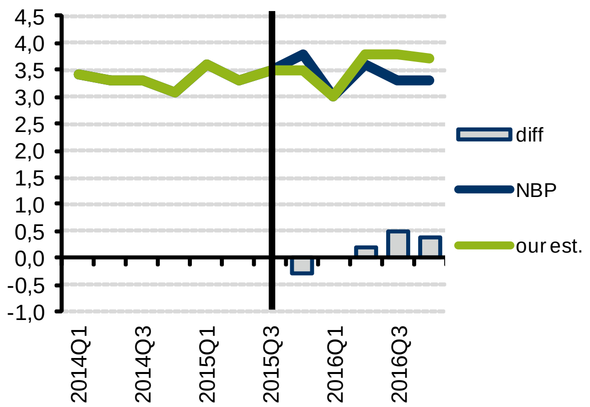


HU: GDP outlook (Y/Y, %)

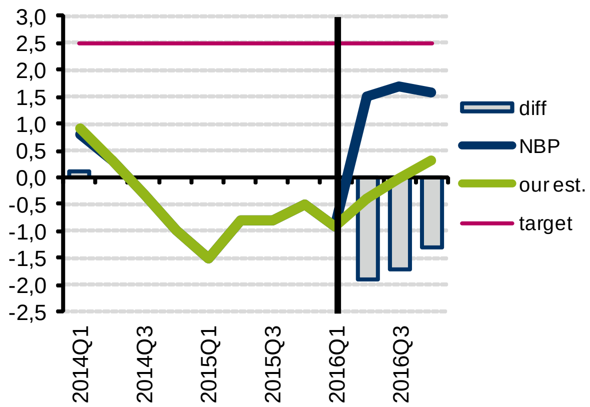
HU: Inflation outlook (Y/Y, %)



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	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3	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*	0.90	0.90	0.90	0.90	0.90	-10 bps	7/21/2015
Poland	2W inter. rate	*1.50*	1.50	1.50	1.50	1.50	1.50	-50 bps	3/5/2015

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

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	PRIBOR	*0.00*	0.28	0.28	0.27	0.28	0.28
Hungary	BUBOR	*1.00*	1.00	0.95	0.90	0.90	0.90
Poland	WIBOR	*1.68*	1.65	1.65	1.70	1.70	1.70

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

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	CZ10Y	*0.57*	0.73	0.81	1.00	1.10	1.20
Hungary	HU10Y	*2.25*	2.30	2.40	2.80	2.80	2.90
Poland	PL10Y	*2.43*	2.50	2.40	2.50	2.70	2.80

Exchange rates (end of the period)

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	EUR/CZK	*27.03*	27.02	27.02	27.00	26.50	26.20
Hungary	EUR/HUF	*312*	310	315	315	310	313
Poland	EUR/PLN	*4.37*	4.39	4.27	4.25	4.24	4.23

GDP (y/y)

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	2.5	2.2	2.3	2.3	2.3	2.2	2.3
Hungary	2.1	2.3	2.6	3.6	3.2	2.8	3.3
Poland	3.8	3.8	3.7	3.8	3.7	3.6	3.5

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

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	0.5	0.7	1.4	1.8	1.5	1.7	1.9
Hungary	0.2	0.6	2.0	2.5	2.1	2.2	2.4
Poland	-0.4	0.0	0.3	0.6	0.9	1.2	1.5

Current Account

	2016	2017
Czech Rep.	1.2	1.1
Hungary	4.1	3.5
Poland	-1.5	-1.3

Public finance balance as % of GDP

	2016	2017
Czech Rep.	-0.8	-1.1
Hungary	2.0	2.5
Poland	-2.9	-3.0

Source: KBC, Bloomberg

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