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Central European Weekly

Monday, 28 July 2014

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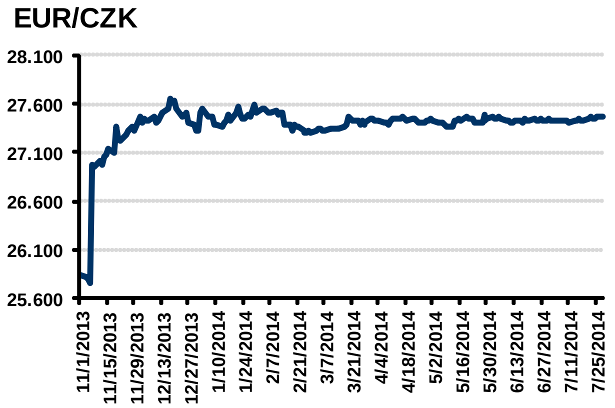
- The NBH finishes easing cycle in Hungary, the first rate hike may come in the third quarter of 2015
- The CNB: later exit from the current FX regime will be officially confirmed by a new macro projection

Dear readers, the new CE Weekly will be released after a summer-break on September 1st.

Chart of the Week: CZK – intervention phase



EUR/CZK, last 192 days. Source: Reuters

The Czech koruna has been amazingly stable sin the introduction of a new (FX targeting) regime in November 2013.

Market's editorial

In Central Europe, the central banks are still in central stage

Last week, it was the National Bank of Hungary that surprisingly cut rates by 20 basis points to a new all-time low of 2.1%. With this move, the NBH has likely put an end to a nearly 2-year cycle of continuous monetary easing. The aggressiveness of the rate cut can be explained by the central bank's plan to eliminate 2-week treasuries. The bank used those treasuries to withdraw liquidity and, from August 1, it will replace them with 2-week deposits, which will not be traded in the secondary market. This move has recently led to strong demand for short-term government bonds and a decline in short-term rates. This market climate enabled the NBH to cut its base rate to a greater extent.

Hungary: a flat base are for feresenable future?

Is Hungary thus heading for a long period of rate stability? According to Governor Matolcsy, rates might remain unchanged until the end of 2015; nevertheless, time will tell whether the NBH will really be able to keep its base rate low for such a long time, especially if the Fed tightens its monetary policy. Our base case is that the first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015.

The CNB: later exit from the current FX regime will be officialy confirmed by a new projection

The last day of July will be the date of this year's fifth CNB Board meeting to discuss monetary policy. The agenda will also include a new forecast, which is likely to postpone the departure from the existing exchange rate regime to a later period. The currently applicable forecast envisages that the koruna will remain close to CZK 27 per EUR 'until' early next year (only). Nonetheless, any postponement to a later period (in view of low/zero inflation) should come as no great surprise – particularly if the summer of 2015 is going to be the new departure period.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.5	-0.06%	↗	→
EUR/HUF	309	-0.43%	↗	→
EUR/PLN	4.15	0.01%	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.33	-1.12	↗	↗
10Y HUF	3.91	1.03	↗	↗
10Y PLN	3.20	-4.05	↗	↗

Review of Economic Figures

The end of easing cycle in Hungary, the first rate hike may come in the third quarter of 2015

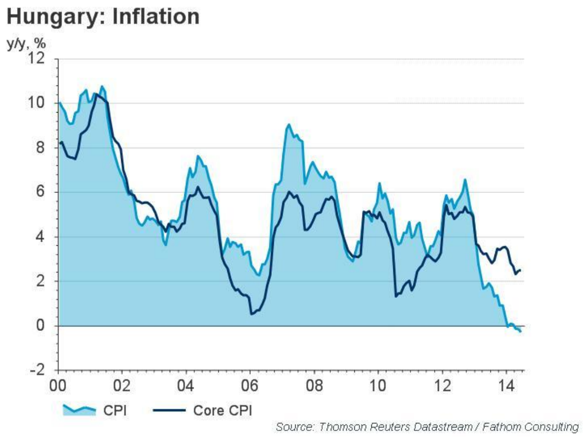
The National Bank of Hungary cut base rate by 20bp from 2.3% to 2.1%, which was a surprise for the market. Additionally the governor of NBH, Mr. Matolcsy said that this is the end of the rate cut cycle and they would like to maintain the current base rate level till end-2015.

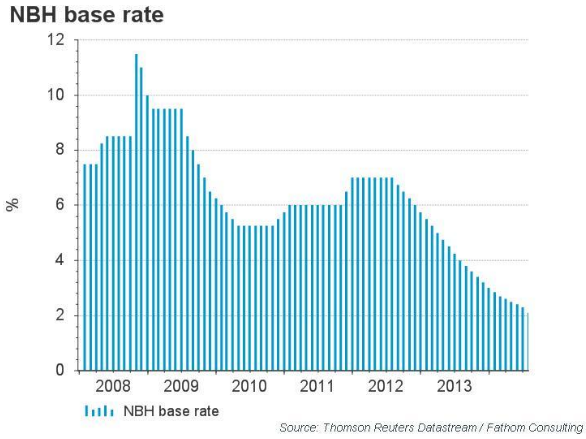
The decision is a little bit strange, as the NBH had moderated its base rate rate by 10bps month by month, so it was interesting why they speed up the end of the cycle. Probably one explanation might be, that the 2-weeks NBH bond will be abolished from 1st August and will be replaced by 2-weeks deposit instrument. It caused heavy interest in the short government bonds (especially for 3-months T-bills) which pushed the short yields to extremely low levels. The NBH could use this market environment for a bigger cut.

The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/- 1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy.

It was not a surprise that the NBH would like to maintain the current historically low level for an extended period, and the statement confirmed our view that NBH's tolerance zone might be quite wide, also in case of exchange rate level and also in case of inflation. It suggests for us that in a case of fast and substantially movement of the EUR/HUF pair, The NBH might use first the tools of verbal and foreign currency market intervention. We are slightly less optimistic than the NBH, as the start of FED and BOE rate hike cycle might force Hungary also to increase the base rate, although we expect that there might be couple of months postponement of the movement. So our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015.

The HUF reacted on the bigger than expected cut by weakening, but it started to strengthen on the news that the rate cut cycle is ended and reached the 100-days moving average. As the possible end of the rate cut cycle was already communicated by the leaders of the central in the last weeks, and it was also mentioned that base rate might keep above 2%, we think that it was mostly priced into the market. Additionally the strong forward guidance that base rate may remain at 2.1% till end-2015 means rather a loose monetary policy. So we didn't change our exchange rate forecast, which means that EURHUF may continue the range trading (303 and 315), but the volatility of it might increase (and chance of extreme values in case of market turbulence) thanks to the NBH's wide tolerance zone.





Weekly preview

THU 13:00	CNB base rate	
	This meeting	Last change
rate level (in %)	**0.05**	11/2012
change in bps	**0**	-20

CZ: CNB and its new forecast

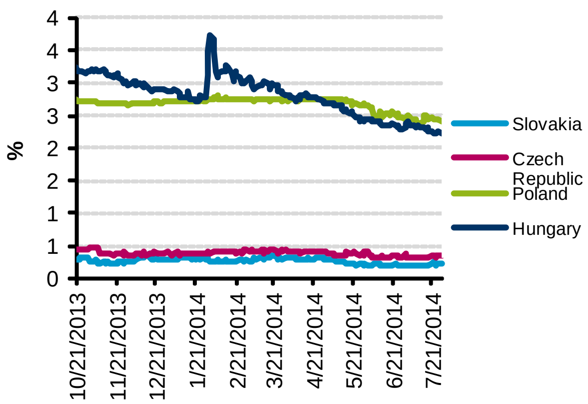
The last day of July will be the date of this year's fifth CNB Board meeting to discuss monetary policy. The agenda will also include a new forecast, which is likely to postpone the departure from the existing exchange rate regime to a later period. The currently applicable forecast envisages that the koruna will remain close to CZK 27 per EUR 'until' early next year (only). However, subsequent comments from the Czech National Bank favoured the second quarter of next year, albeit any postponement to a later period should not come as a great surprise either. We believe that another likely change to the forecast may be a reduction of the inflation outlook for late this year and for 2015, as may be a downwards adjustment of the predicted 3-month PRIBOR, which would actually mean a postponement of the predicted timing of the first rate hike from the first quarter of next year to further into the future. From this perspective, the new forecast should be closer to the market view as well as to our expectations of a later departure from the exchange rate regime and even a later commencement of monetary tightening. As concerns the speculations about weakening the koruna, we do not believe that the CNB Board will take any step.

Calendar

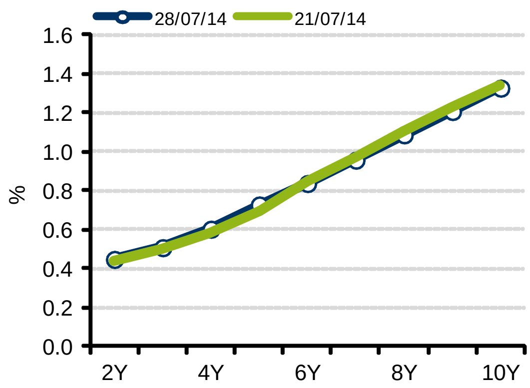
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	07/30/2014	9:00	Unemployment rate	%	06/2014					8	
HU	07/31/2014	9:00	PPI	%	06/2014				-0.7	-0.8	-1.1
CZ	07/31/2014	10:00	Money supply M2	%	06/2014						5
CZ	07/31/2014	13:00	CNB meeting	%	07/2014	0.05		0.05		0.05	
HU	08/01/2014	9:00	PMI manufacturing		07/2014					51.5	
HU	08/01/2014	9:00	Trade balance	EUR M	05/2014 *F					419.2	
PL	08/01/2014	9:00	PMI manufacturing		07/2014			50.5		50.3	
CZ	08/01/2014	9:30	PMI manufacturing		07/2014					54.7	
CZ	08/01/2014	14:00	Budget balance	CZK B	07/2014					1.5	

Fixed-income in Charts

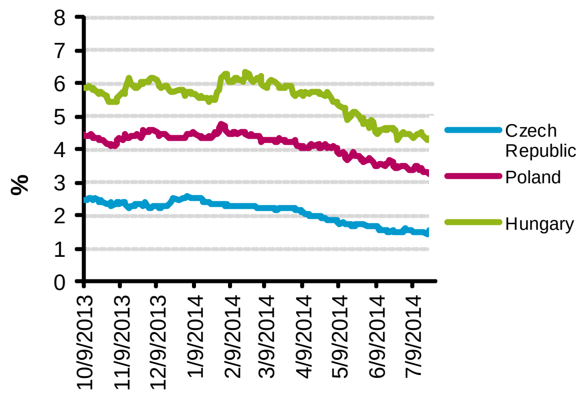
FRA 3x6



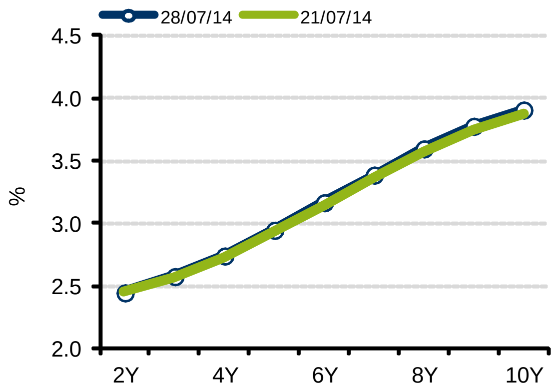
CZ IRS



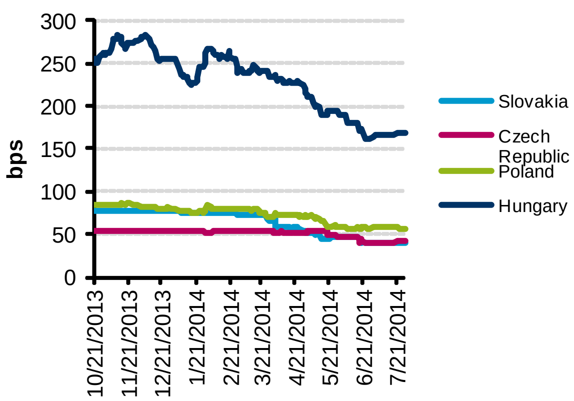
10Y GB Yields



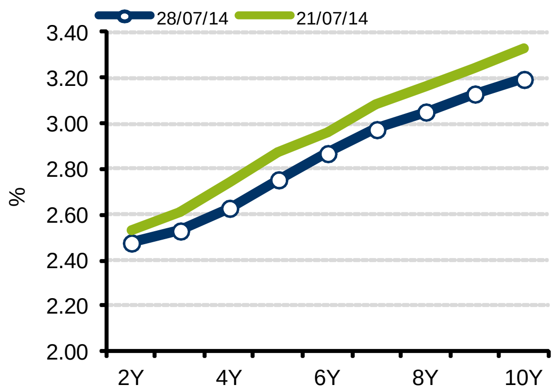
HU IRS



CDS 5Y



PL IRS



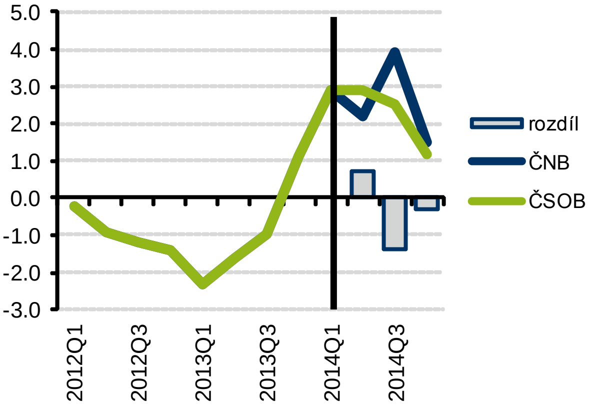
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its programme. It should include not only savings but also greater tax relief for parents with children, a new VAT rate, and likely also the termination of the new funded pension system (called the 2nd pillar), set up in the last two years.	Based on the first quarter figure and the recent trends in the economy, Hungary's GDP may grow above 2.5% Y/Y in 2014 and it cannot be excluded that the growth might be close to 3% Y/Y level. The low base supports this economic growth level in short term, but without a substantial rise of investments in the private sector this year, economy may slow down to around 2% Y/Y level in 2015. On the other hand, in spite of growing domestic demand, inflation appears well anchored and inflationary expectations stick close to 3 %. Moreover, as this year's harvest may be good, food processing industry hardly escalates price pressures in the economy.	According to the GUS estimates the Polish economy grew by 3.4% in 2014Q1. For this year, the growth should significantly exceed 3%. Household consumption should support growth, owing to the improving labor market situation as well as to low inflation. Investment should also develop favorably, owing to the replenishment of inventories as well as to gross capital formation In addition, lower government debt could also give a greater lift to the economy. By contrast, net exports are likely to curb rather than boost growth, especially in view of recent crisis in Ukraine.
Outlook for official & market rates	The CNB has exhausted the possibility of easing its monetary policy through interest rates, and therefore it has decided to weaken the koruna and keep it close to CZK 27 per EUR. Statements from the CNB representatives indicate that the CNB would like to maintain that level for a prolonged period, until strong inflation pressures become evident in the economy. We believe that the exchange rate targeting will be abandoned much later (not before the second half of 2015), and that the move will certainly not be accompanied by a rise in interest rates, as suggested by the official forecast.	The NBH has finished its easing cycle in Hungary by cutting the base rate to the 2.1%. The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/-1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy. Our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. Although the recent development has supported our bets on faster economic recovery in Poland, outlook for persistently low inflation should play in favor of stable official interest rates in the rest of this year. Although we cannot exclude possible rate cut as we forecast inflation to fall significantly below zero over the summer , the monthly data released thus far indicates similar growth for the second quarter as that for the first (3.4% y/y). And this should not be enough to cut rates.
Forex Outlook	The CNB has started FX interventions and we expect the koruna to stay within the regime at least till the mid 2015. Hence the currency should stay above 27.00 EUR/CZK at least in 12-month horizon. When the FX targeting regime is set to be abandoned, the CNB will have to intervene on the market much more aggressively to stop the spot koruna from appreciation. As a side effect, the forward koruna can appreciate significantly before the regime is abandoned.	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.	Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. Albeit we expect only gradual strengthening against the euro, the Polish currency might perform well against the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue at faster pace. The main risk as regards the zloty is the ECB decision to ease MP which could further support the currency.

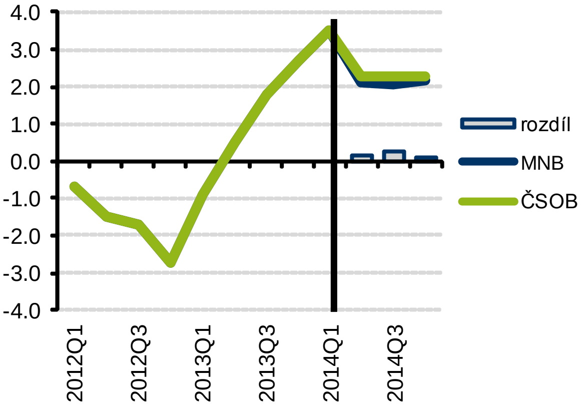
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)



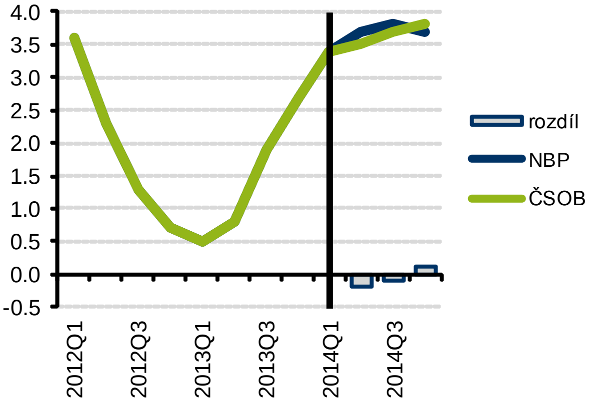
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)



HU: Inflation outlook (Y/Y, %)

PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)

Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	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*	3.00	2.60	2.30	2.50	2.50	-10 bps	7/22/2014
Poland	2W inter. rate	*2.50*	2.50	2.50	2.50	2.50	2.75	-25 bps	7/3/2013

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	PRIBOR	*0.35*	0.38	0.37	0.35	0.35	0.36
Hungary	BUBOR	*2.13*	2.99	2.67	2.34	2.50	2.50
Poland	WIBOR	*2.67*	2.71	2.71	2.68	2.75	3.00

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	CZ10Y	*1.33*	2.09	1.84	1.34	1.50	1.70
Hungary	HU10Y	*3.91*	5.25	4.95	3.77	5.30	5.70
Poland	PL10Y	*3.20*	4.25	4.03	3.39	4.45	4.70

Exchange rates (end of the period)

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	EUR/CZK	*27.5*	27.3	27.4	27.4	27.4	27.4
Hungary	EUR/HUF	*309*	297	307	310	298	295
Poland	EUR/PLN	*4.15*	4.16	4.17	4.16	4.15	4.09

GDP (y/y)

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	-1.6	-1.0	1.1	2.9	2.9	2.5	1.2
Hungary	0.5	1.8	2.7	3.5	2.3	2.3	2.3
Poland	0.8	1.9	2.7	3.4	3.5	3.7	3.8

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

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	1.6	1.0	1.4	0.2	0.0	1.0	1.4
Hungary	1.9	1.4	0.4	0.1	0.6	0.7	0.8
Poland	0.2	1.0	0.7	0.7	0.2	-0.4	0.2

Current Account

	2013	2014
Czech Rep.	-1.4	-1.4
Hungary	2.0	2.2
Poland	-1.2	-2.5

Public finance balance as % of GDP

	2013	2014
Czech Rep.	-1.5	-2.5
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

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