Central European Weekly

Tuesday, 18 November 2014

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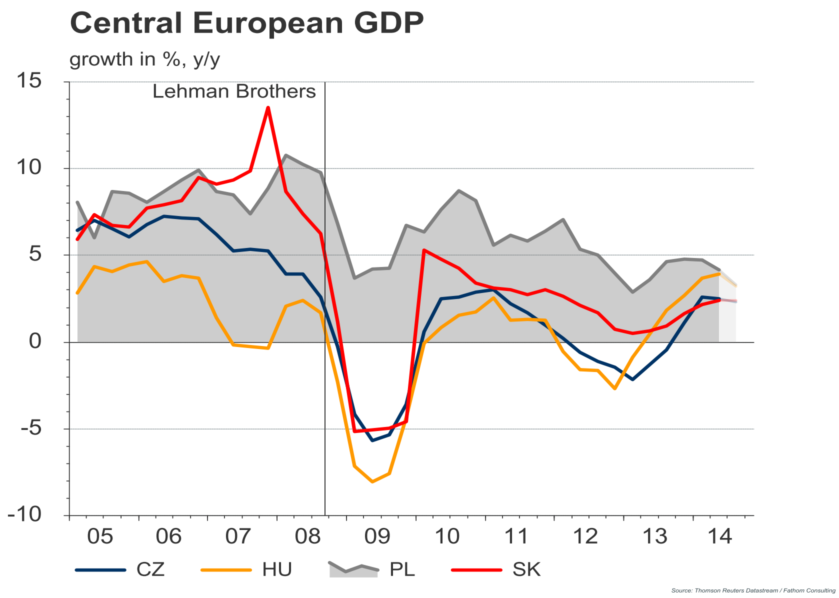
Weekly Highlights:

- Poland regains its position of the best regional growth performer, while the Czech economy is lagging again
- The Polish inflation surprised significantly on the downside in October, but the NBP should stay on hold

Chart of the Week: Growth in Central Europe



Central Europe continues to grow at solid pace in the 3rd quarter.

Market's editorial

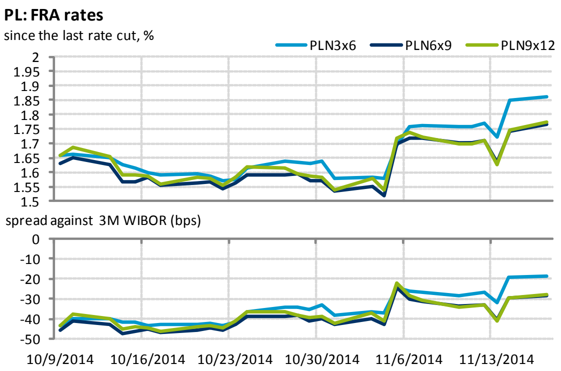
Solid regional growth v. Germany's poor performance

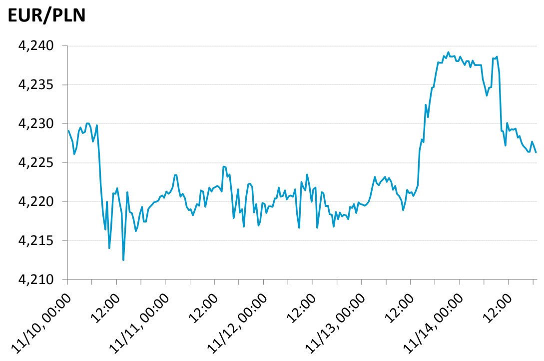
While the German economy, after its stagnation in the second quarter of the year, did not impress at all and grew by only 0.1% in the third quarter, the situation in Central Europe is more cheerful. Although the Czech economy lagged behind our expectations, it still grew by 0.3%, whereas Hungary grew by 0.5% and Poland by 0.9% q/q. The year-on-year growth rate exceeds 3% in Poland and Hungary, while Germany dropped to 1.2%.

Thus the weaker performance of Europe's largest economy has not made itself felt in Central Europe to any great extent so far. However, should the German economy stumble for a prolonged period, the aftermath will also certainly hit Central Europe – and such a scenario is fairly likely to happen. Ifo, Germany's key business mood indicator, has fallen for a sixth consecutive month, and is at its lowest levels since the end of 2012. In addition, Germany's growth rate will be curbed by the government's efforts to reach a budget surplus at any cost. Early this year, the German Ministry of Finance anticipated faster growth of around 2%, and its budget forecast for this year is based on this. Nevertheless, the economy failed to achieve such growth in the end. Therefore, given its efforts to quickly achieve a budget surplus at any cost, Europe's largest economy has had to tighten its budget at a highly unfavourable time. If Germany continues to decelerate because of this, Central European economies will also be affected soon – notably the Czech Republic and Hungary.

The NBP still on alert due to deflation, but GDP calms nerves

Regarding possible implications of the figures mentioned above we think that they should have some impact on policy-makers in Poland, especially the NBP. From the perspective of future centra bank's steps, we think that unexpectedly strong GDP in the third quarter more than offset weaker inflation (-0.6% y/y) and unless the structure of growth that will be released in the end of November (28th) reveals major surprises (or the preliminary reading is revised significantly to the downside), we think that the central bank is likely to keep interest rates stable in December. Moreover, in light of the released macro figures, the probability of further policy adjustments in the beginning of the next year seems to be lower as well.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.7	0.17%	↘	↘
EUR/HUF	306	-0.67%	➔	➔
EUR/PLN	4.22	-0.03%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.02	-5.99	➔	↗
10Y HUF	3.05	-8.41	➔	↗
10Y PLN	2.39	-1.64	➔	↗

Review of Economic Figures

Poland again growth leader, Czechs are still lagging

Last week, all regional economies released its preliminary GDP figures (without details) for 3rd quarter of 2014.

As concerns the **Czech GDP**, it increased by 0.3% quarter-on-quarter. The economy continued to grow and this is no doubt thanks to the successful automotive industry. New product lines of domestic automakers along with the renewed growth of the European market for new cars helped the Czech economy upwards. Annual growth on the other hand, slightly slowed compared with the first half. The economy is now growing only by 2.3%, while in the beginning of the year it was 2.6%. But it is still a pretty good result, which leads to the creation of new jobs and thus contributes to improving the situation on the Czech labour market. Although we do not know GDP detail structure, it is probable that help the economy up especially exports, investment and household consumption. In the rest of the year, most likely we will see a similar pace as economic growth in the third quarter, and so the Czech GDP is likely to grow by 2.4% this year.

The **Hungarian economy grew** by 3.2% Y/Y in 3Q15, exceeding the market consensus of 2.9% Y/Y. Although the figure was better than expected the main trend, namely that the economy started to slow down, is in line with our expectation. The main driver of the economic growth is was still industrial production although its contribution the GDP growth moderated substantially. Construction were also expanding dynamically thank to mainly the public investments.
The surprise factor may come from the agriculture and service sector performance. The former was highlighted by the statistical office. The growth was only 0.5% QoQ in 3Q14 down from the 0.8% Q/Q in 2Q14.
We expect that the economy may slow further in 4Q14 in the range of 2% YoY and 2.5% YoY, because the new orders in the construction sector is falling, there external demand is deteriorating, so the net external component of the growth is getting smaller. The average GDP growth may be at 3.3% YoY in 2014, while it may slow to around 2.2% YoY in 2015.

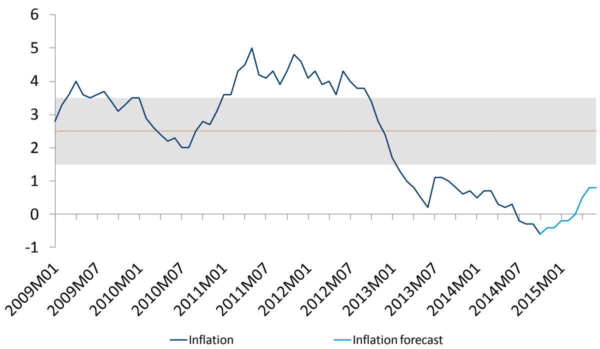
The best GDP figure came however from Poland. Its GDP growth in the third quarter remained – according to the first estimates – surprisingly robust as it remained well above 3% (more precisely, GDP grew by 3.3% Y/Y vs. market expectations of 2.7% Y/Y). Moreover, growth in quarter-on-quarter terms accelerated quite significantly (0.9% vs. 0.7% in 2014Q2). The details of GDP will be released in the end of this month. We think that households consumption probably played an important role in the third quarter though built in inventories could also have contributed significantly to the GDP growth.

Another suprise from Poland – deeper deflation in October

GDP was not the only macro surprise, which came last week from Poland. Another was very y low October's inflation. The unexpected month-on-month decline in food prices played the main role and pushed inflation to -0.6% Y/Y in October and quite naturally triggered bets on monetary policy easing in Poland, especially given the fact that one might expect decline of core inflation below 0.5% Y/Y.

PL: Inflation

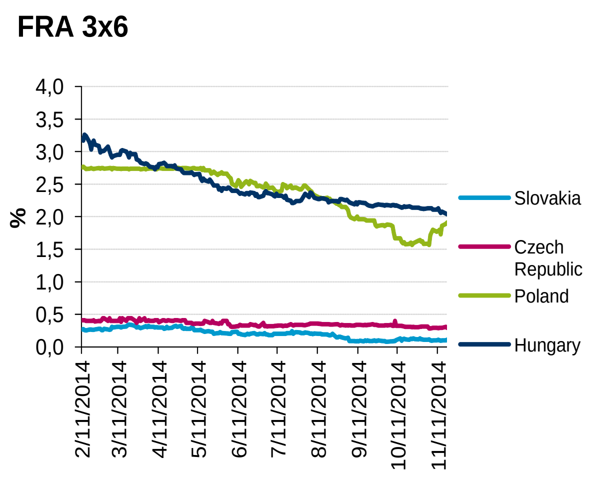
Y/Y in %; NBP tolerance band is grey, inflation target is orange dotted line

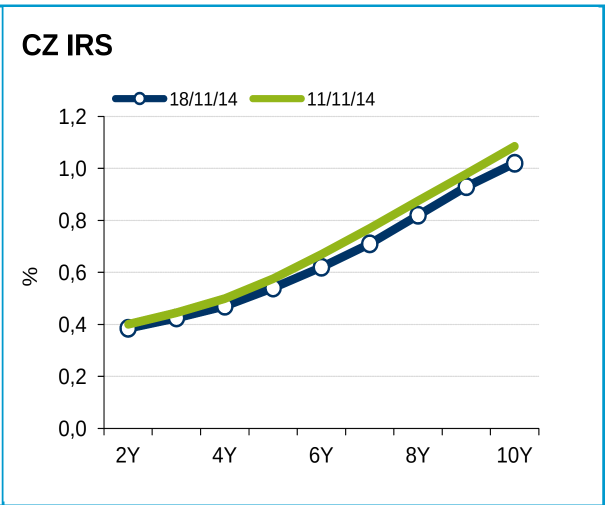


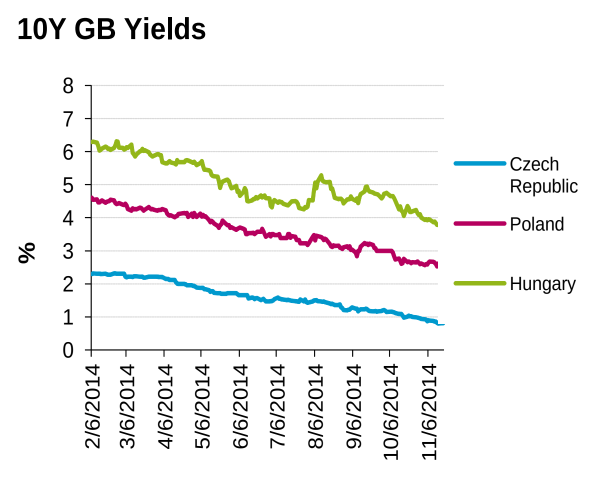
Calendar

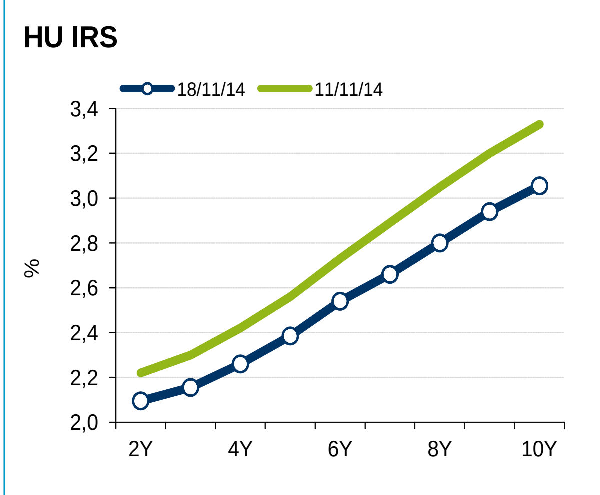
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	11/17/2014	15:00	Budget balance	PLN M	10/2014					-22373	
CZ	11/18/2014	9:00	PPI	%	10/2014	-0.2	-0.1	-0.2	-0.1	-0.3	-0.3
PL	11/19/2014	14:00	Wages	%	10/2014			1.7	3.4	0.2	3.4
PL	11/20/2014	14:00	Industrial output	%	10/2014			3.7	1.4	16.5	4.2
PL	11/20/2014	14:00	PPI	%	10/2014			-0.2	-1.2	0.1	-1.6

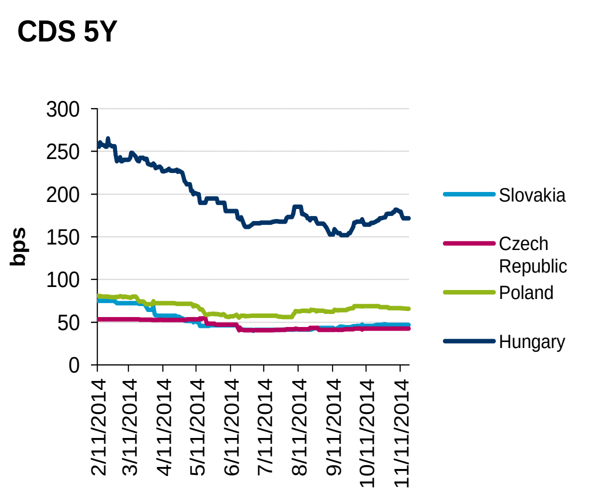
Fixed-income in Charts

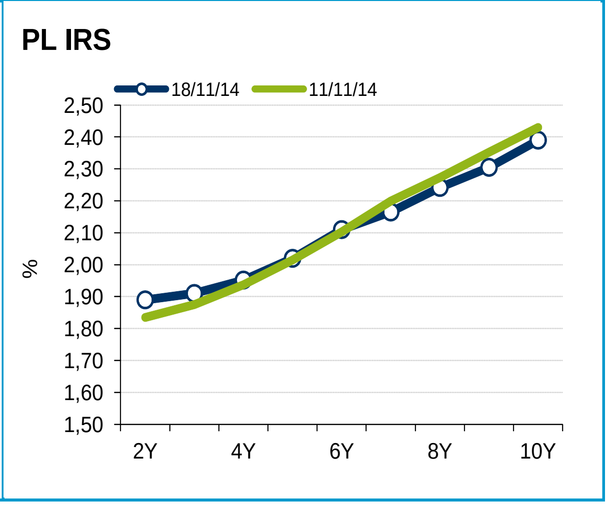












Source: Reuters

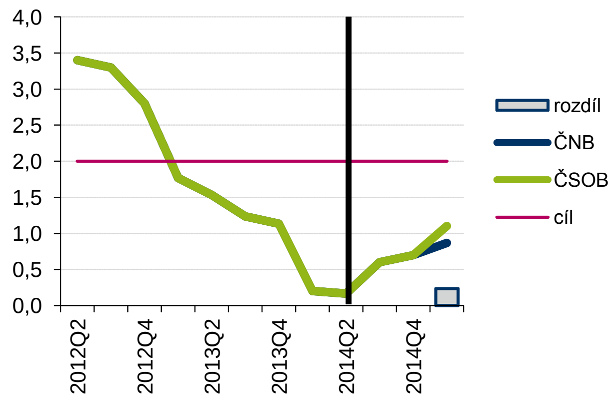
Medium-term Views & Issues

	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.	We expect that the economy may slow further in 4Q14 in the range of 2% Y/Y and 2.5% Y/Y, because the new orders in the construction sector is falling, there external demand is deteriorating, so the net external component of the growth is getting smaller. The average GDP growth may be at 3.3% Y/Y in 2014, while it may slow to around 2.2% Y/Y in 2015.	According to the GUS estimates, the Polish economy grew by 3.3% in 2014Q3. Although the structure is not known yet, we expect that the growth was again driven by domestic demand (possibly with strong contribution of inventories). Expectations of a slowdown of growth rates in the second half of the year may therefore not materialize. The recent figures suggest this year's economic growth will likely remain above 3%.
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 EUR/CZK 27. 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 (during the second half of 2016), 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. After surprising markets by cutting interest rates by 50 basis points in October, the NBP surprised in November as well, this time by leaving rates unchanged. The overall tone of the meeting was, however, dovish and we therefore not exclude additional rate cut in the beginning of the next year.
Forex Outlook	We anticipate clearly lower growth and inflation in the euro area, and therefore we also predict, on the whole, a slower rate of Czech inflation. In 2015, inflation will again be below the CNB's 2% target, and the question is how the CNB Board will react to this. The recollection of the negative response from the Czech public to the last devaluation of the currency and the fact that inflation will remain in positive territory should be the main arguments against a further targeted weakening of the currency. Yet we see an approximately 40% likelihood of this scenario, which might happen in 2015.	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.	Less optimistic economic outlook and renewed monetary policy easing should cap room for prospective strengthening of the zloty in months to come. For the rest of the year, we therefore expect a stagnation of the zloty against the euro and consider risks as skewed slightly towards possible depreciation, even though Polish assets could draw support from further easing of monetary policy conditions in the euro zone.

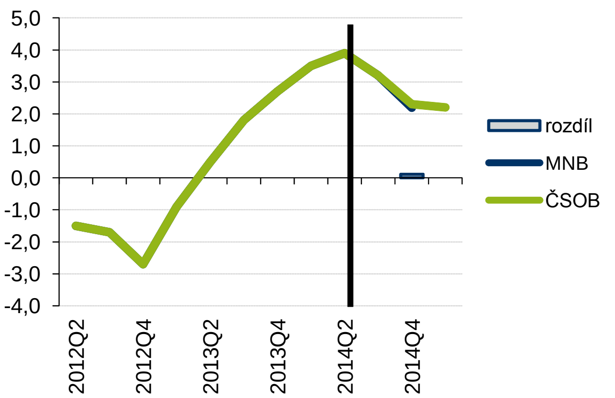
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

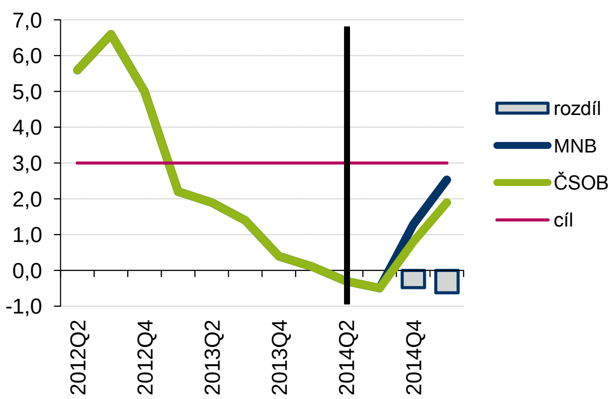
CZ: Inflation outlook (Y/Y, %)



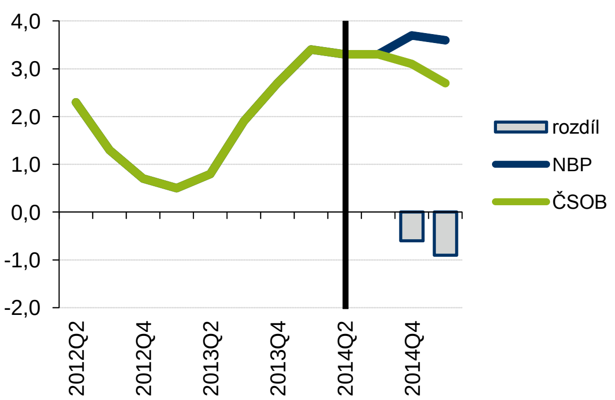
HU: GDP outlook (Y/Y, %)



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	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	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*	2.60	2.30	2.10	2.10	2.10	-10 bps	7/22/2014
Poland	2W inter. rate	*2.00*	2.50	2.50	2.50	2.00	2.00	-50 bps	10/8/2014

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

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	PRIBOR	*0.34*	0.37	0.35	0.34	0.35	0.35
Hungary	BUBOR	*2.10*	2.67	2.34	2.09	2.15	2.15
Poland	WIBOR	*2.06*	2.71	2.68	2.28	2.00	2.00

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

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	CZ10Y	*1.02*	1.84	1.34	1.22	1.15	1.20
Hungary	HU10Y	*3.05*	4.95	3.77	3.92	3.50	3.65
Poland	PL10Y	*2.39*	4.03	3.39	2.87	2.60	2.60

Exchange rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	EUR/CZK	*27.7*	27.4	27.4	27.5	27.5	27.8
Hungary	EUR/HUF	*306*	307	310	311	310	310
Poland	EUR/PLN	*4.22*	4.17	4.16	4.18	4.17	4.17

GDP (y/y)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	-0.45910147	1.1	2.6	2.5	2.3	1.7	1.5
Hungary	1.8	2.7	3.5	3.9	3.2	2.3	2.2
Poland	1.9	2.7	3.4	3.3	3.3	3.1	2.7

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

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	1	1.4	0.2	0.0	0.7	0.8	1.2
Hungary	1.4	0.4	0.1	-0.3	-0.5	0.8	1.9
Poland	1	0.7	0.9	0.3	-0.3	-0.4	0.0

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.	-1.3	-2.0
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

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