Central European Weekly

Tuesday, 13 January 2015

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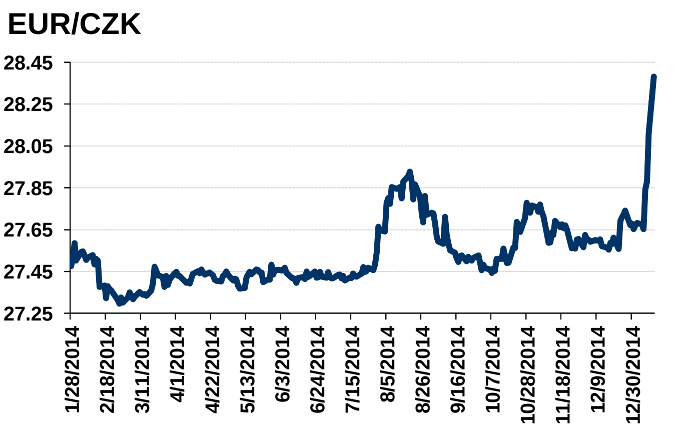
- The koruna hostage to fear of further devaluation – weakness will prevail to CNB's meeting in February
- Czech inflation is close to zero again
- Hard data from Czech and Hungarian industries still solid
- The NBP to sit out deflation, though it deepens

Chart of the Week: The Czech koruna



EUR/CZK, last 250 days. Source: Reuters

The EUR/CZK continues to spike ahead of the CNB meeting scheduled for February 5th.

Market's editorial

The Czech koruna weakens on CNB's dovish talk

The Czech koruna has started the new year on weak footing as it has hit the lowest level since March 2009. Clearly the forex market has started to bet on further monetary easing, or a shift of intervention level the CNB had set for the crown-euro exchange rate in November 2013. recall that there were two triggers for the CZK bearish move: low CPI inflation in December (see the next page) and dovish comments by CNB's Vice-Governor Tomšík. He warned against strong deflationary pressures. He wrote in Czech Business Daily that 'falling producer prices drag down the fragile growth in foreign demand, hat may have a negative impact on domestic real demand and the CNB will be again facing a decision on how to meet its inflation target, stabilize inflationary expectations and support the domestic real economy'.

Czech inflation back at zero but inflation expectations stable

The question is, how real the threat of new EUR/CZK floor-hike is real and how it can impact the koruna in the course of upcoming weeks and months. As a matter of fact, CNBs November inflation forecast that had envisaged annual price growth returning to its target level (2 % y/y) by the end of 2016 is effectively dead. Inflation will stay close to zero at the beginning of this year and only slowly climb up later while still staying below 1 % by the end of 2015. Inflation has been muted largely owing to falling oil prices. So far, the CNB board has interpreted declining oil prices as a positive supply shock helping rather than hurting the economy. This way of interpretation did not provide arguments for further devaluations. However, according to the latest minutes from the CNB board meeting, central bankers may change their positive view of the cheap oil if deflation in the euro zone would have strong negative spill-over effects on domestic demand or longer-term inflation expectations (which has not been the case so far).

The koruna to remain weak ahead of CNB's meeting

What's our view? We expect that the Czech central bank will not come up with any revolutionary changes at its eagerly expected February meeting. Nonetheless, the crown will likely be weakening before the meeting. How far can the pair EUR/CZK weaken in the upcoming weeks? Markets remember that the November 2013 intervention pushed the EUR/CZK pair higher by about 5-6 %. It would not be surprising then, if we see the short-term peak in the EUR/CZK 28.7-29 territory (i.e. a roughly 5% devaluation against the 2014 average). After the February (5th) meeting, the crown should start trimming the loss.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	28.5	2.75%	↗	↘
EUR/HUF	319	0.18%	↗	↘
EUR/PLN	4.28	-0.21%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0.81	-9.50	↘	↗
10Y HUF	2.98	-5.56	↗	↘
10Y PLN	2.08	-2.12	↗	↘

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Review of Economic Figures

Czech inflation is again close to zero

Falling oil prices on global markets are responsible for low inflation. For the CR, as a net importer of raw materials, the slump in oil prices is a positive cost shock, which will have a positive impact on the financial position of businesses as well as households. The consumer price index was down by 0.1% m/m in December, due in particular to falling fuel prices. Year-on-year inflation dropped to 0.1%, in line with expectations, and significantly lags behind the CNB's forecast and target. Full-year inflation hit 0.4% in December. Thus inflation alone also implies a reduced stimulus to wage growth this year. The inflation outlook for this year is more than moderate. Inflation will hardly rise from today's nearly zero level and will not approach 1% before the second half of the year.

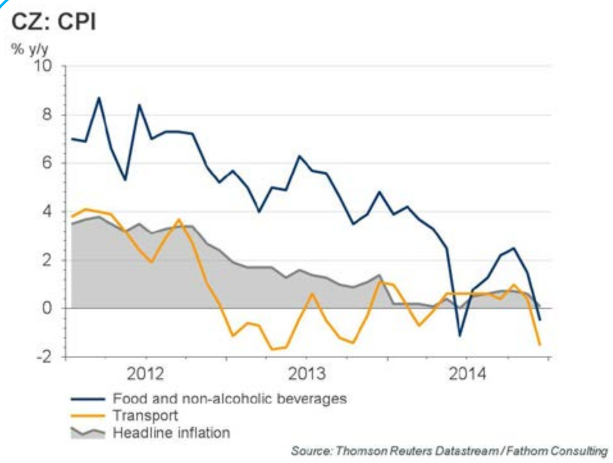
November's industrial output fell on a year-on-year basis in November but this was only due to there being two less business days in the month. Adjusted for this effect, the pace of industrial output was still close to 5%. While November's industrial output fell short of expectations, it still remains very reasonable given the number of business days in the month, and industry continues to be the dominant sector of the whole economy. Industry continued to maintain its dominant position not only as the driver of the economy but also as the creator of new jobs. Although industry remained slightly in the red in November, orders are still on the rise.

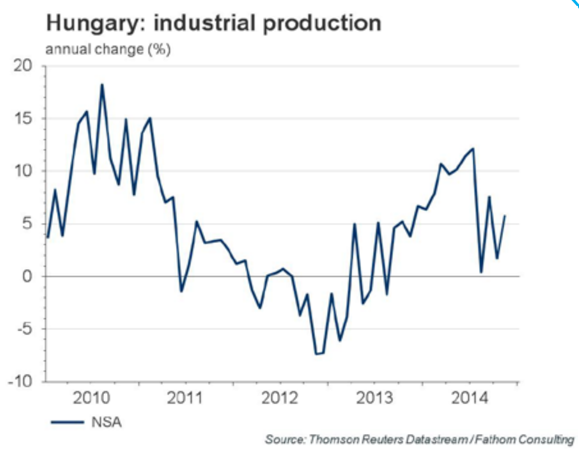
Hard Hungarian macro figures very solid in November

Latest figures from Hungary's statistical office point to better macro performance than markets expected in November.

The Hungarian retail sales increased by 5.2% Y/Y in November vs. market expectation of 4.3% Y/Y growth. It confirms our view that domestic consumption may partly counterbalance the deteriorating external environment as in the September and November period the retail sales grew by around 5% Y/Y. The main driver of the increase is fuel consumption (8.5% Y/Y growth, thanks to the falling fuel price), but non-food product consumption has been accelerating as well (from around 3% Y/Y in the summer to around 6% in September and November period). As the inflation may remain extremely low in the coming months, while the wages are increasing by 2-3% Y/Y, it means that households consumption power may be strong in the following months as well, so we expect that retail sales and domestic consumption may remain relatively strong and may play one of the most important role in GDP growth in 1H15.

The Hungarian industrial production growth jumped back from 1.7% Y/Y in October to 5.8% Y/Y in November, but exceeded the market consensus of 2.4% Y/Y. As the detailed figure will be published only next week, we don't know that which sectors are still strong within industrial production, but based on the previous months' figures electronic devices production may increase above 10% Y/Y. Vehicle productions slowed down and it is quite volatile also because models change in Suzuki factory from beginning of this year. We also saw in previous months' figures that the gap between domestic and export sales of industrial production get closer, but unfortunately the way that export sales slowed down. Manufacturing PMI figure suggest that the sector may slow down in the coming months, so industrial production may be weak in the first half of this year and may start to accelerate in 2H15. We expect that the industrial production may increase by around 5% Y/Y in 2015.





Weekly preview

WED 9:00 — HU Inflation (change in %)

	Dec-14	Nov-14	Dec-13
CPI y/y	**-0.5**	-0.7	0.4

HU: Is there deflation of tradable goods

Oil, food and low international inflation may keep inflation low despite of the depreciation of HUF. The consumer price index may fall by 0.5% Y/Y in December slightly up from the -0.7% Y/Y November level. The main reason of the slight increase is the base effect of the regulated prices as the government left the electricity and gas price unchanged in December 2014, while there was 10% cut a year before. The deflation of food prices are mainly because of the good harvest. The main question is whether there are any signs of inflation among the tradable good and market services due to the HUF weakening and increasing domestic consumption? The full year average inflation might be -0.2% Y/Y in 2014, while it may accelerate between 0.5% and 1% Y/Y in 2015. Despite of the low headline inflation we don't expect rate cut in January.

WED 14:00 — NBP rate (in %)

	This	Last change
rate level	**2.00**	10/2014
change in bps	**0**	-50

PL: Central bank to sit out deflation

Things will not be exactly easy for the National Bank of Poland (NBP) early this year, but we believe that the bank will leave rates unchanged. Although there are several factors favouring a rate cut, notably fairly deep year-on-year fall in prices, the latest votes indicated restraint to further rate cuts. Thus, once again, it will be interesting to watch the press conference, where questions about the weaker macroeconomic figures released in late 2014 may arise. The NBP may be more susceptible to them than to falling prices in the end. By and large, the situation in Poland as concerns the return of inflation to its target has become complicated recently, and the likelihood of a rate cut later this year is on the rise.

THU 14:00 — PL Inflation (change in %)

	Dec-14	Nov-14	Dec-13
CPI y/y	**-0.9**	-0.6	0.7
Food (ex Alc.) y/y	**-3.1**	-2.5	1.5
Transport (including fuel)	**-6.0**	-3.7	-0.9

PL: Deflation deepens in late 2014

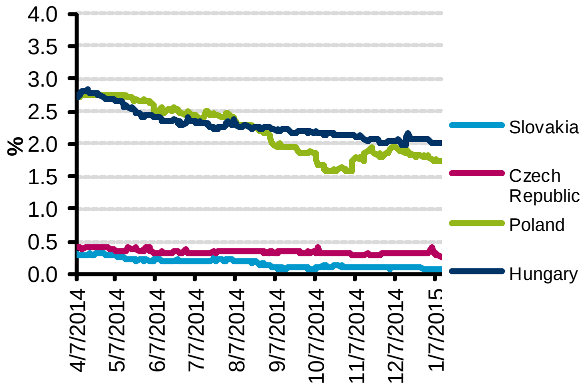
Rapidly falling oil prices on global markets and a good harvest were responsible, according to our forecasts, for the deepening of Poland’s deflation in late 2014. Inflation probably fell by up to 0.9% y/y and by 0.2% m/m. We should also note that the prices of many of the other items in the consumer basket rose slowly last year. Thus the return of Poland’s inflation to positive values has been postponed again, and this could easily be of concern to the central bankers.

Calendar

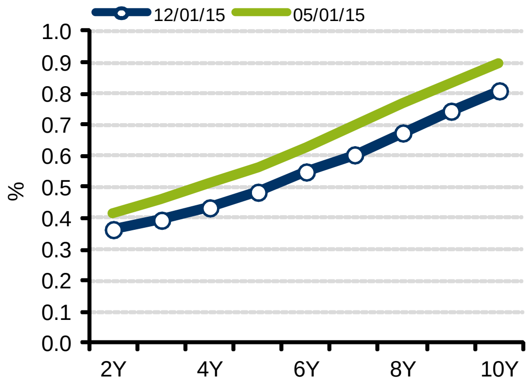
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	01/12/2015	9:00	Retail sales	%	11/2014		3.3		1.9		7.5
CZ	01/13/2015	10:00	Current account	CZK B	11/2014	3		3		5.15	
PL	01/13/2015	14:00	Current account	EUR M	11/2014			-347		-435	
PL	01/13/2015	14:00	Trade balance	EUR M	11/2014			100		56	
HU	01/14/2015	9:00	CPI	%	12/2014			-0.3	-0.4	-0.4	-0.7
HU	01/14/2015	9:00	Industrial output	%	11/2014 *F					3.3	5.8
PL	01/14/2015	14:00	Money supply M3	%	12/2014			2.5	8.2	0.4	8.4
PL	01/14/2015	14:00	NBP meeting	%	01/2015	2		2		2	
PL	01/15/2015	14:00	CPI	%	12/2014	-0.2	-0.9	-0.2	-0.9	-0.2	-0.6
CZ	01/16/2015	9:00	PPI	%	12/2014	-0.6	-3	-0.6	-3	-0.6	-1.7
PL	01/16/2015	14:00	Core CPI	%	12/2014			0	0.5	-0.1	0.4

Fixed-income in Charts

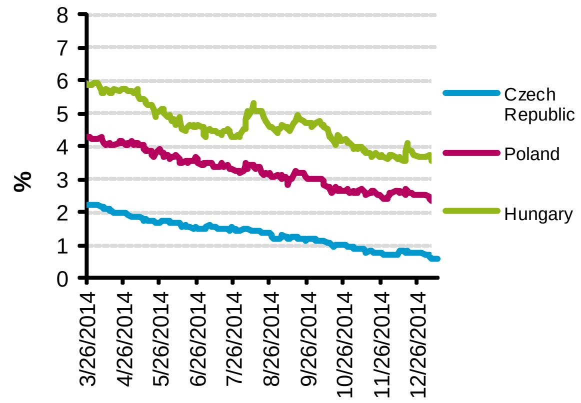
FRA 3x6



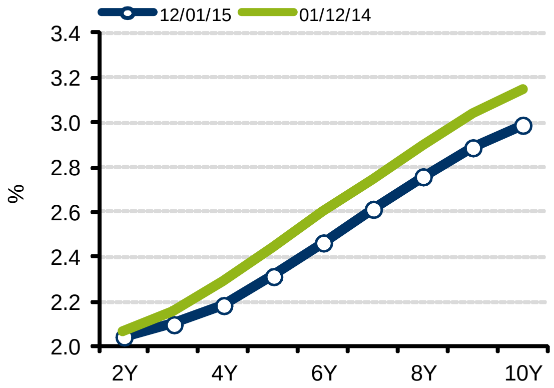
CZ IRS



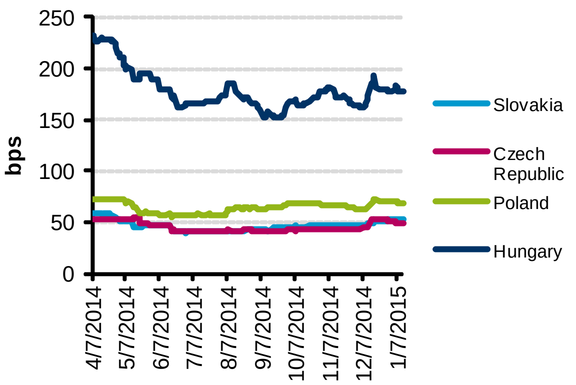
10Y GB Yields



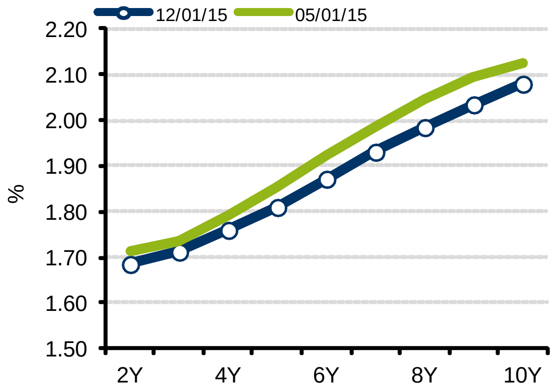
HU IRS



CDS 5Y



PL IRS



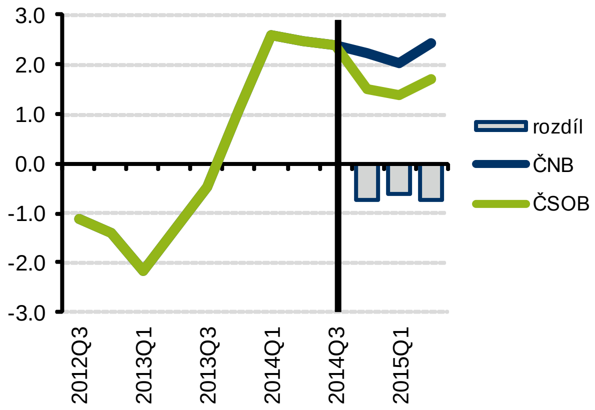
Source: Reuters

Medium-term Views & Issues

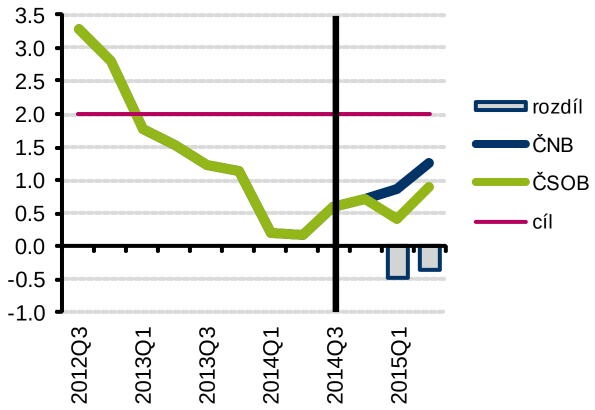
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its programme. 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. Moreover, the structure of growth was robust – it was driven by strong households' consumption and investment. 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 therefore almost certainly remain well 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 during 2015.
Forex Outlook	We expect that the Czech central bank will not come up with any revolutionary changes at its eagerly expected February meeting. Nonetheless, the koruna will likely be weakening before the meeting. How far can the pair EUR/CZK weaken in the upcoming weeks? Markets remember that the November 2013 intervention pushed the EUR/CZK pair higher by about 5-6 %. It would not be surprising then, if we see the short-term peak in the EUR/CZK 28.7-29 territory (i.e. a roughly 5% devaluation against the 2014 average). After the February (5th) meeting, the crown should start trimming the loss..	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.	The Polish zloty came under pressure at the end of the year in the low liquid trading. Although some of the losses were trimmed recently, the zloty continues to trade on the defensive side Market players seem to realize that inflation is to stay extremely low for considerable time and that NBP board can withsand weaker currency. The pair can sty around 4.25 EUR/PLN in both 3-month and 6-month horizon. .

CBs' Projections vs. Our Forecasts

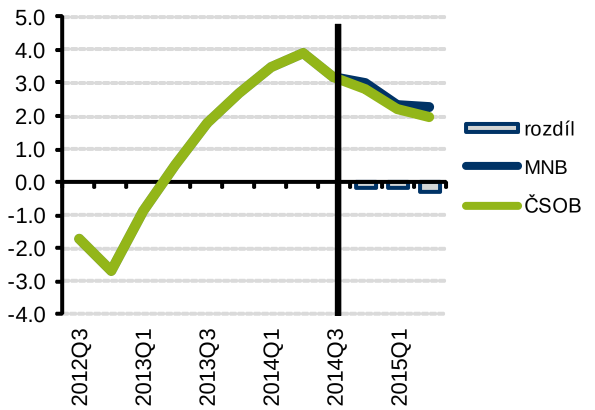
CZ: GDP outlook (Y/Y, %)



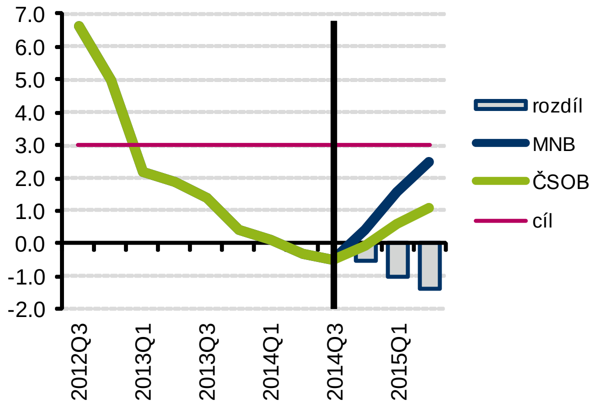
CZ: Inflation outlook (Y/Y, %)



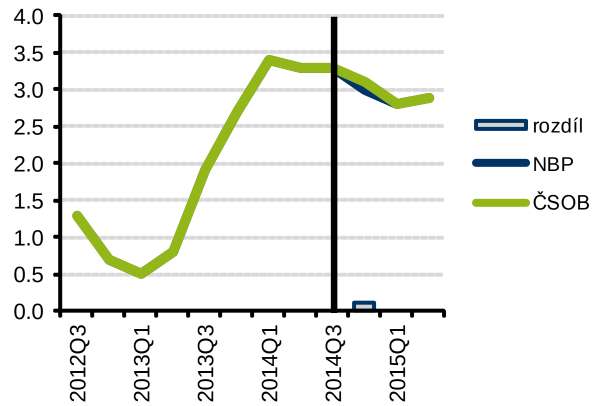
HU: GDP outlook (Y/Y, %)



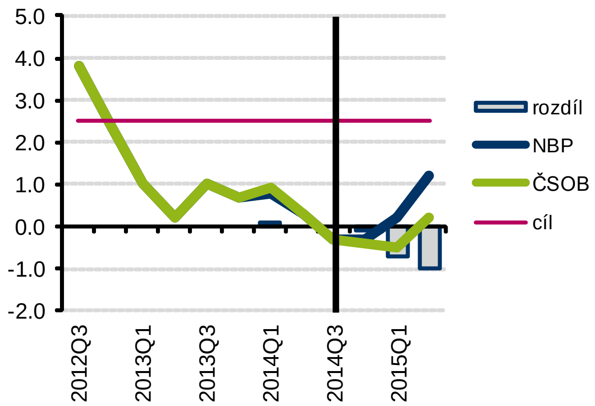
HU: Inflation outlook (Y/Y, %)



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

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	PRIBOR	*0.34*	0.34	0.33	0.33	0.32	0.33
Hungary	BUBOR	*2.10*	2.09	2.10	2.10	2.10	2.10
Poland	WIBOR	*2.05*	2.28	2.06	2.00	2.00	2.00

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	CZ10Y	*0.81*	1.22	0.88	1.05	1.15	1.35
Hungary	HU10Y	*2.98*	3.92	3.25	3.50	3.50	3.65
Poland	PL10Y	*2.08*	2.87	2.23	2.20	2.10	2.20

Exchange rates (end of the period)

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	EUR/CZK	*28.5*	27.5	27.7	27.8	27.6	27.5
Hungary	EUR/HUF	*319*	311	316	315	315	318
Poland	EUR/PLN	*4.28*	4.18	4.28	4.25	4.22	4.20

GDP (y/y)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	2.6	2.5	2.4	1.5	1.4	1.7	2.0
Hungary	3.5	3.9	3.2	2.8	2.2	2.0	2.3
Poland	3.4	3.3	3.3	3.1	2.8	2.9	3.1

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

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	0.2	0.0	0.7	0.1	0.5	1.1	0.9
Hungary	0.1	-0.3	-0.5	-0.1	0.6	1.1	1.5
Poland	0.9	0.3	-0.3	-0.4	-0.5	0.2	0.5

Current Account

	2014	2015
Czech Rep.	-0.1	1.7
Hungary	2.2	2.5
Poland	-2.5	-2.5

Public finance balance as % of GDP

	2014	2015
Czech Rep.	-2.0	-2.4
Hungary	-3.0	-3.0
Poland	-3.5	-3.0

Source: CSOB, Bloomberg

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