Central European Weekly

Monday, 20 July 2015

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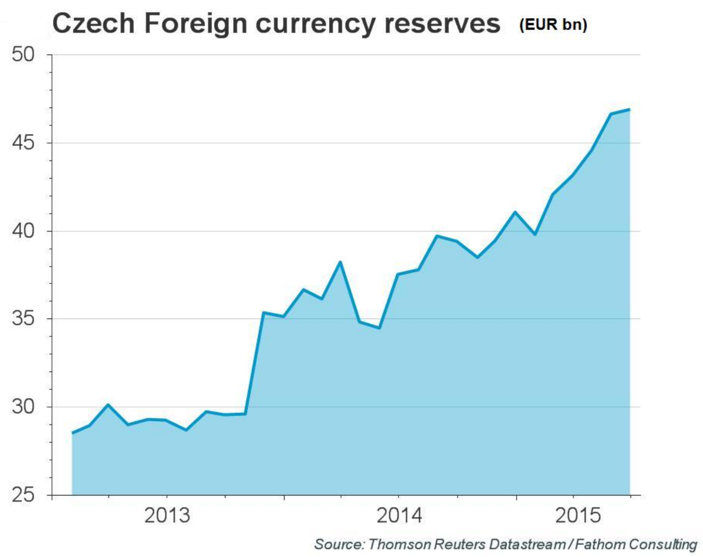
Weekly Highlights:

- Booming Czech foreign exchange reserves versus CNB's exit strategy
- Despite persisting deflation in Poland, hard monthly confirm very solid growth
- NBH will deliver last easing in this cycle

Chart of the Week: Czech FX reserves



CNB's foreign exchange reserves have been growing rapidly since the introduction of the new monetary regime in November 2013.

Market's editorial

Czech FX Reserves-to-GDP ratio at 33% and still growing…

While the lack of euros remains a significant problem in Greece, the Czech Republic has the opposite one. Ever more euros have been coming into the Czech Republic and the question now is beginning to be "what to do with them?"

This can best be seen in the growing level of foreign exchange reserves held by the Czech National Bank (CNB). These reserves stand now above 51 billion euros and they are still growing rapidly (see the first chart). Interestingly, if we ignore the impact of the CNB's post-devaluation intervention in November 2013, these reserves have grown by another EUR 10bn. Hence, the Czech FX reserves have grown by almost 50% since the end of managed-float regime (October 2013). The FX reserves are now equal to almost 1/3rd of GDP (see the second chart) - such a level isn't as high as the figure in Switzerland or Denmark but the rate of growth over the last year-and-a-half has nonetheless been very impressive.

To what does the country owe this significant growth in FX reserves? Well, in part, this can be ascribed to an acceleration of inflows from EU funds, which, along with the country's positive balance of payments (C/A surplus – see the nex page), forces the central bank to exchange euros for new koruna and these euros then accumulate to its foreign exchange reserves. The second major reason for the increase in the level of FX reserves is the fact that contrary to the past, the CNB does not sell its profits from FX reserves' holdings on the market (which would lead to CZK's appreciation), but it rather keeps to reinvesting them. So, in the end its FX holdings are increasing even faster…

Strong Czech fundamentals makes CNB's exit harder

This situation has several interesting implications. First of all, there is little the CNB can do, if it doesn't want to get into a negative interest rate regime (like the ECB, SNB, Danish and Swedish central bank). Thus, it has no other choice than to see its level of foreign exchange reserves increase as it promises to keep the EUR/CZK floor 27.0. Secondly, the large numbers of euros coming into the country (e.g. from EU funds) have to be converted into korunas, which means that the CNB's printing press works at full speed and CZK's liquidity in the Czech financial system grows rapidly. All of this supports very low markets interest rates – especially at front-end of the Czech yield curve. From a macroeconomic point of view - this should support credit growth and the Czech domestic demand.

Last, but not least the country's high level of FX reserves and its positive balance of payments has a strong medium-term implication for CNB's exit from the current monetary and FX set up (i.e. maintaining the EUR/CZK floor at 27.0). Once it decides to do so (in 2016H2?), there should be strong appreciation pressures on the CZK. To hold this down, the central bank would have to intervene against the Czech currency, so the level of the country's foreign exchange reserves will jump to even higher levels. It is worth noting that such a (eco/market) pattern was seen it in the case of the central bank of Israel, which had been leaving very similar FX regime some time ago.

The very last rate cut from the NBH?

The only regional eye-catcher of this week will be an interest-rate-setting meeting of the National Bank of Hungary. Although we see no reason to continue the monetary easing, the calm down of global sentiment is likely to lead to rate cut next Tuesday, so base rate might be moderated from 1.5% to 1.4%. As concerns a possible market reaction we believe that a 10 bps cut has already been priced in. The cut will, however, make HUF less attractive and in addition the NBH attempts to squeeze out foreign investors from the domestic bond markets which might weaken the HUF too.

	Last	Change 1W
EUR/CZK	27.1	-0.25%
EUR/HUF	309	-1.18%
EUR/PLN	4.10	-1.91%

	Last	Change 1W
10Y CZK	1.24	-3.88
10Y HUF	3.19	-0.62
10Y PLN	2.70	-2.88

Review of Economic Figures

June sees mixed macroeconomic data in Poland

June's figures from the Polish economy did not show a clear picture, mainly because of the data from Poland's labour market, which fell somewhat short of expectations. On the other hand, Friday's data from the industry and retail sector slightly surpassed expectations.

The usual statistical data releases in Poland began with June's inflation figures last week. These met market expectations, as prices fell by 0.8% y/y and stagnated on the month-on-month basis. As regards the month-on-month structure, we were most surprised by a moderate increase in food and soft drink prices, which is not usual at this time of the year. However, this was largely counterbalanced by a decline in communication prices.

Wednesday's labour market data disappointed markets in terms of wage growth as well as employment growth. Nevertheless, we are not overestimating the figure for June. By and large, the situation on the Polish labour market has developed well in the last six months, and as far as wages are concerned, we should bear in mind the rapid wage growth in March and the fact that the Polish economy has been in deflation for a year. This means that household consumption will probably continue to drive growth because the real financial position of households has been improving. We believe that a very slow price rise, which we expect in the coming quarters, will encourage this.

By contrast, industry and retailers sprang a pleasant surprise

After all, the spending appetite of Polish households was confirmed by Friday's retail sales data, which slightly surpassed market expectations. In addition, June's retail sales rose by 6.6% y/y in real terms. The sustainability of the overall positive development of the Polish economy is also suggested by the data from industry, which was also better than expected, as reflected in the latest data about the mood in the manufacturing industry. We believe that June's figures did not include any information significant for the central bank, which will most probably keep rates stable until the end of this year.

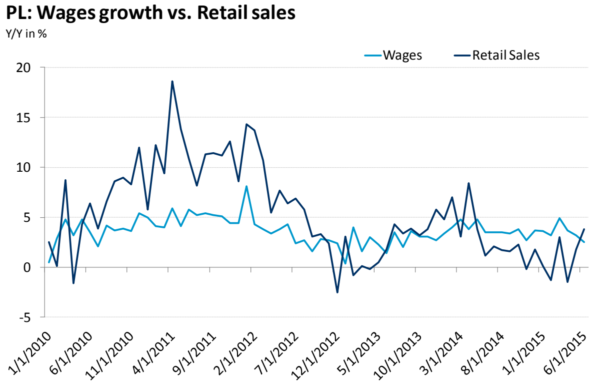
This first Czech C/A monthly deficit in 2015

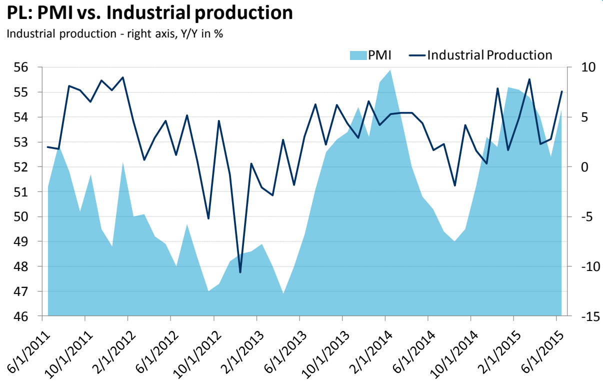
As indicated by May's current account figure, the dividend season has begun. Unlike the previous months, when the Czech Republic's external balance showed surpluses of between CZK 20 bn and almost CZK 35 bn, May's current account slipped into slightly negative territory. As expected, this was attributable to dividends, which the Czech National Bank estimated at nearly CZK 32 bn.

The wave of profit repatriation to abroad is only beginning and thus the C/A surplus for the first five months still exceeds CZK 100 bn. The surplus of foreign trade in goods and services can easily counterbalance the profit transfers to foreign countries as well as interest paid there.

We expect that the dividend payments will persist in the months to come, thus optically worsening the current account performance. In any event, the full-year current account will remain as a surplus, which may reach approximately 2% of GDP. With regard to capital inflow into the Czech economy, 2015 has not been a record-breaking year. Foreign direct investment is primarily based on reinvested (foreign) profits.

As for portfolio investment, Czech businesses as well as investors continue to be very active on foreign markets, which offer more attractive investment opportunities than the small Czech market. By contrast, the activities of foreign portfolio investors in the Czech Republic were not very impressive in May, apart from increased demand for government securities.





Weekly preview

TUE 14:00 NBH base rate

	This meeting	Last change
rate level (in %)	**1.40**	6/2015
change in bps	**-10**	-15

HU: Is this real end end of NBH' easing?

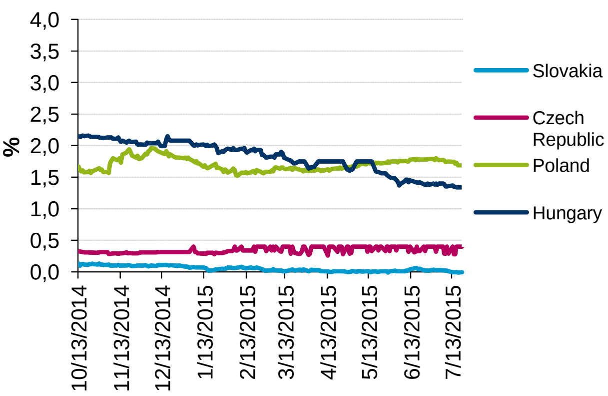
Although we see no reason to continue the monetary easing, the calm down of global sentiment is likely to lead to rate cut next Tuesday, so base rate might be moderated from 1.5% to 1.4%.

Calendar

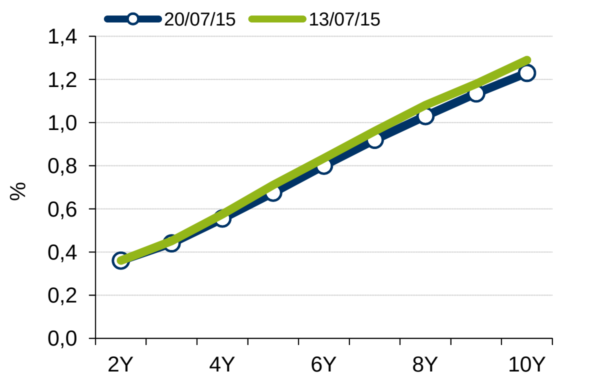
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	07/21/2015	14:00	NBH meeting	%	07/2015	1.4		1.4		1.5	
PL	07/23/2015	10:00	Unemployment rate	%	06/2015			10.4		10.8	

Fixed-income in Charts

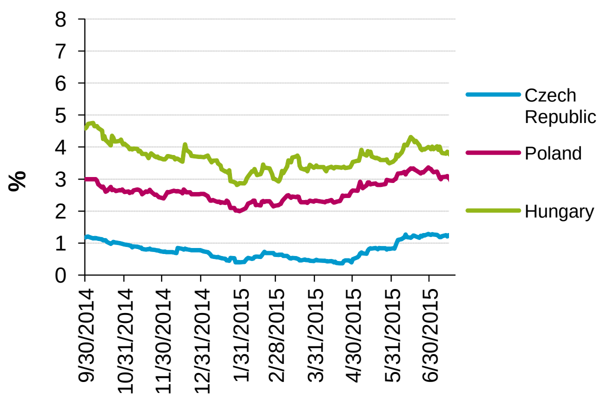
FRA 3x6



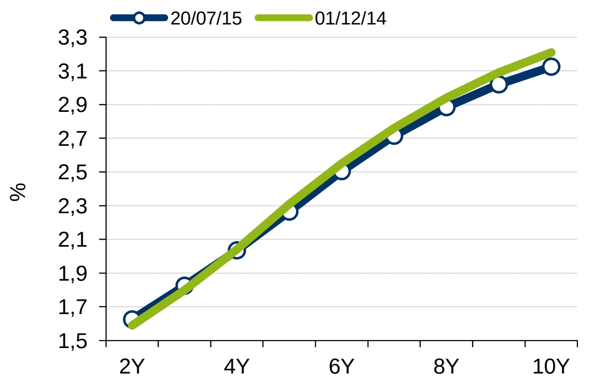
CZ IRS



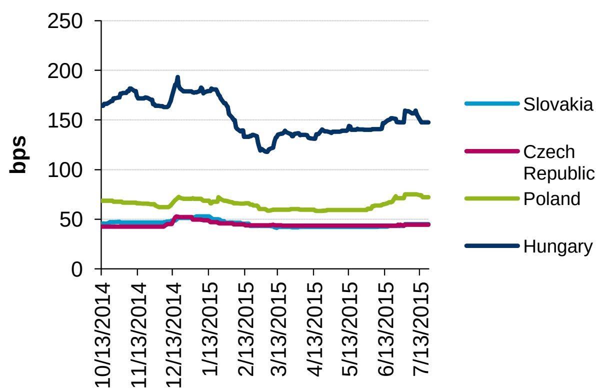
10Y GB Yields



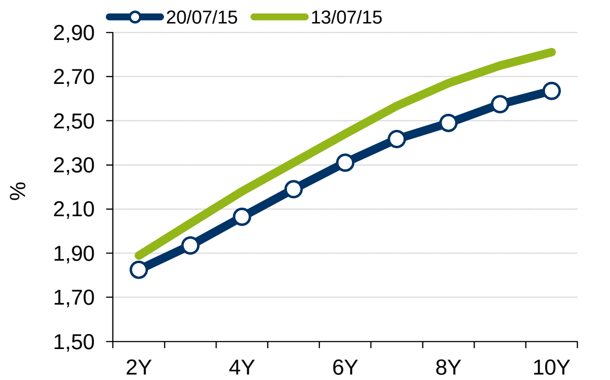
HU IRS



CDS 5Y



PL IRS



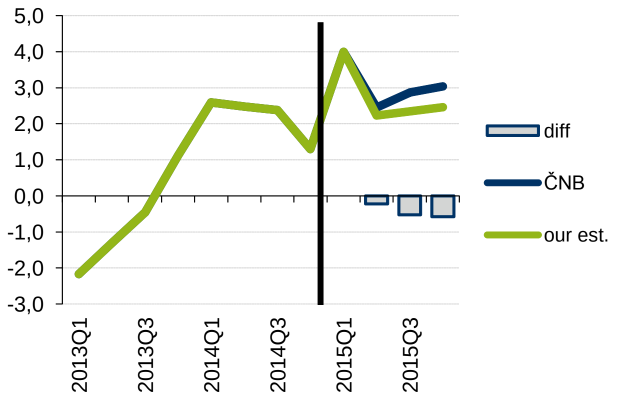
Source: Reuters

Medium-term Views & Issues

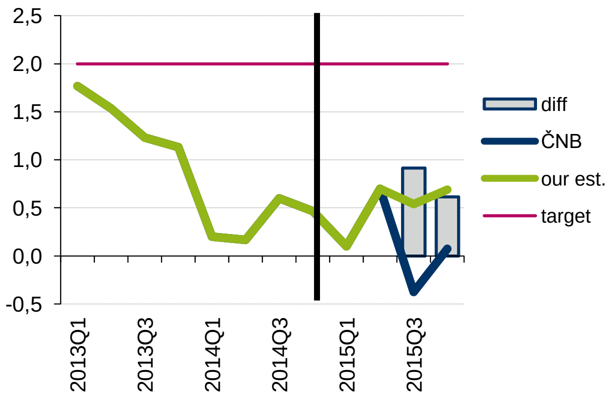
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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.	According to the GUS, the Polish economy grew by 3.6% in 2015Q1. As in previous quarters, economic growth was driven mainly by strong domestic demand. We suspect households consumption was again the key driver of economic growth in Poland. As for this year, we expect economic growth may be 3.5-4%.
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., 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. On the other hand, at least the deflationary pressures – occasionally triggered by speculation about another possible forced weakening of the koruna – have disappeared.	The Council said that the inflation may remain below the inflation target of 3% Y/Y in 2015 and 2016, and it may reach the inflation target only at the end of the forecasted period, so in late 2017. Hence, although we see no reason to continue the monetary easing, the calm down of global sentiment is likely to lead to a rate cut, so the NBH base rate might be moderated from 1.5% to 1.4% in July.	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	We believe a hike of EUR/CZK floor is still unlikely. This would require deterioration of currently positive economic outlook. On the other hand the, the more aggressive verbal interventions may keep the Czech koruna on the defensive for a while. Hence it is probable that the pair forgets about testing the 27 EUR/CZK for now. Fundamentally, the Czech currency should be more sensitive to readings of major Czech macroeconomic indicators – inflation, wages, industry and, of course, GDP. The koruna may get more nervous ahead of May's CNB Board meeting, where a new inflation forecast will be submitted.	In a longer term perspective, the HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. In a short-run, however, if the NBH says in June that they stop now the rate cut cycle than it is rather bullish for the forint as some key market players bet that the NBH may cut the base rate to even 1.2%.	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.

CBs' Projections vs. Our Forecasts

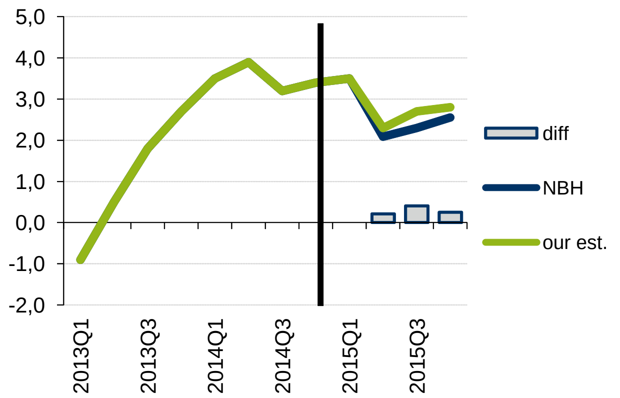
CZ: GDP outlook (Y/Y, %)



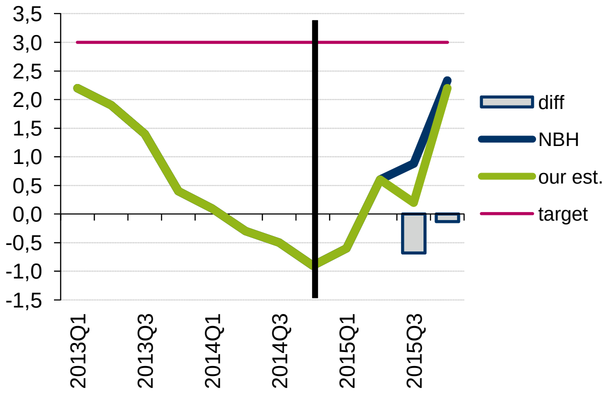
CZ: Inflation outlook (Y/Y, %)



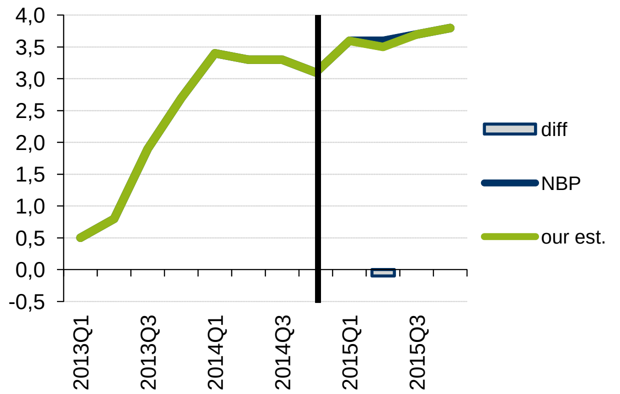
HU: GDP outlook (Y/Y, %)



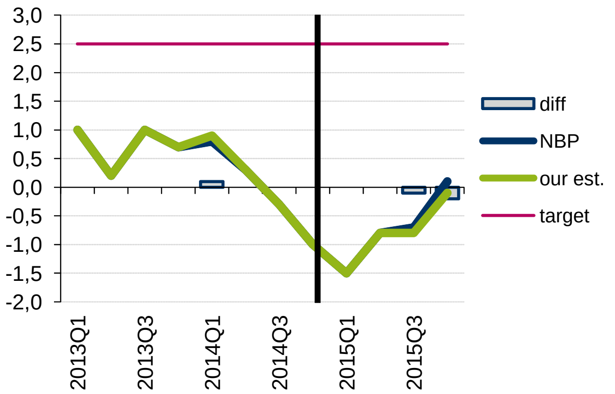
HU: Inflation outlook (Y/Y, %)



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.	*1.50*	1.95	1.50	1.70	2.00	2.25	-10 bps	6/23/2015
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	0.30	0.30	0.30
Hungary	BUBOR	*1.40*	1.89	1.41	1.70	2.10	2.40
Poland	WIBOR	*1.72*	1.65	1.72	1.60	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*1.23*	0.64	1.30	1.45	1.50	1.65
Hungary	HU10Y	*3.14*	2.71	3.45	3.40	3.60	3.80
Poland	PL10Y	*2.64*	2.12	3.01	2.20	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	27.40	27.20	27.10
Hungary	EUR/HUF	*310*	300	315	317	315	310
Poland	EUR/PLN	*4.11*	4.07	4.19	4.00	4.10	4.05

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.3	4.0	2.2	2.3	2.5	2.5
Hungary	3.2	3.4	3.5	2.3	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.5	3.7	3.8	3.8

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	0.5	1.0	1.7
Hungary	-0.5	-0.9	-0.6	0.6	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.5	-0.8	-0.8	-0.1	0.4

Current Account

	2015	2016
Czech Rep.	2.0	1.8
Hungary	4.0	3.8
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-2.4	-1.9
Hungary	-2.2	-2.0
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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