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Central European Weekly

Monday, 27 July 2015

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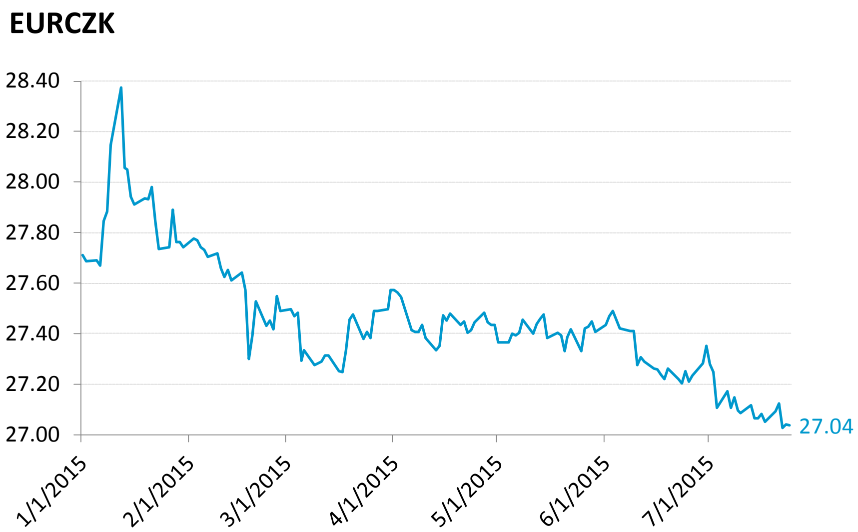
Chart of the Week



The koruna remains close to the CNB intervention threshold of EURCZK 27.0. (Source: Bloomberg, CSOB)

Market's editorial

The koruna will determine whether CNB rates will go below zero

In reaction to Thursday's contemplation by Tomáš Holub from the Czech National Bank in the Hospodářské noviny daily over the possibilities of cutting rates below zero, the yields of Czech government bonds with shorter maturities fell into clearly negative territory. Thus investors have to pay for being allowed to lend their money to the Czech government. At the moment it is just a few basis points but it is probably appropriate to ask how far this situation (which is certainly convenient for the Czech Ministry of Finance) can go.

We should look for the answer to this question on the forex market, i.e., in the exchange rate of the koruna. If pressure on the Czech currency to appreciate persists, and if the CNB has to intervene and is compelled to buy even larger foreign currency volumes to add them to its forex reserves, this will boost the natural pressure on short-term interest rates to fall. If the CNB subsequently considers a possible increase in its forex reserves to be highly inconvenient, the central bank will have to resort to introducing negative interest rates in some way unless it wants to unleash the exchange rate (and let the koruna strengthen). Everything is legislatively complicated, as the CNB should not actually be allowed to charge negative interest rates – yet Thursday's interview indicates that the CNB already knows how to circumvent even this. And how far should Czech interest rates possibly go? To alleviate pressure on the koruna at least slightly, the CNB should cut the Czech rates at which commercial banks deposit their money with the central bank to at least the level of the ECB deposit rate, i.e., -0.20%. It would probably be enough to cut the Czech rates to a few points below this rate. The Czech Republic is unlikely to need to drive its rates to the Swiss-Nordic extreme. Official rates in Switzerland and Denmark stand at -0.75%, Sweden's repo rate stands at -0.35% and its deposit rate even at -1.1%!

Naturally, there is no guarantee that negative official interest rates will really be put in place in the Czech Republic. As described above, everything depends on the koruna and the growth of forex reserves, i.e., whether there will be any objections to a possible increase in forex reserves. Thus it is partly a self-fulfilling scenario, where the market speculations alone on this happening may actually trigger such a scenario. And predicting whether or not events like this will happen in the end is hard, indeed. No matter if this or that scenario happens, short-term koruna interest rates will be really very low for some time.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*27.0*	*-0.22%*	➔	➔
EUR/HUF	*311*	*0.41%*	➚	➚
EUR/PLN	*4.15*	*0.61%*	➚	➚

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.12*	*-7.44*	➚	➚
10Y HUF	*3.10*	*-0.32*	➚	➚
10Y PLN	*2.61*	*0.00*	➚	➚

Review of Economic Figures

NBH surprisingly cuts by 15 bps and forint firms…?

Last week, the National Bank of Hungary cut base rate by 15bp from 1.5% to 1.35% vs. market consensus of 10bp cut. But the governor Mr. Matolcsy said on the press conference that this is the end of the rate cut cycle and the current level will be maintained for a very long period.

The overall decision seemed to be a small surprise, so the market reacted with HUF strengthening. We highlighted before that the inflation outlook doesn't call for further loosening, while the lending is the corporate sector is mainly driven by the NHP (funding for lending) program and the EU funds money. So the base rate cut should rather help for the households borrowing. On the other hand we also emphasized that the Hungarian yield curve is steeper than other curves in the region, which reflects that Hungary is still riskier than for example Poland, while the artificially increased domestic demand by the NBH's decision pushed down the short end of the curve.

We think that the first strengthening reaction of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture, so the start of the rate hike cycle is depending on FED's and ECB's policy. Based on the current expectation we think that NBH may hike key rate in 2Q16 the earliest.

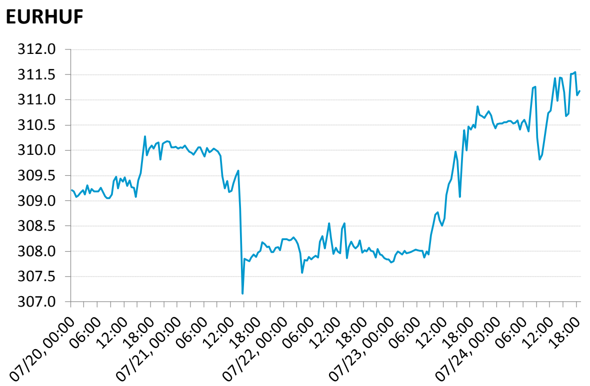
Industry in an excellent mood

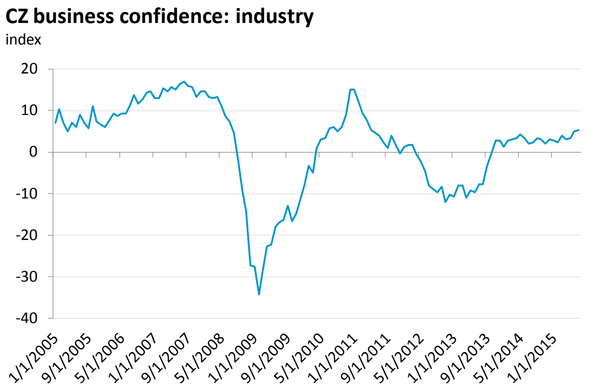
According to the latest survey conducted by the Statistical Office, the mood in Czech industry has again improved, reaching the highest level for the last four years. The latest episode in the Greek debt story did not upset businesses at all. Thus industry, thanks to its existing strong performance and new orders, is securing its position as a leader of the Czech economy, being the main contributor to this year's surprisingly strong growth of the Czech economy, and actually not only to GDP growth but also to the growing exports and employment. Successful industrial companies are those which contribute to reducing unemployment and creating a record-breaking number of new jobs.

Moreover, businesses are also still optimistic for the next six months. The utilisation of existing capacities of industrial businesses continues to be very high (85%) and, given the inflow of new orders, it is encouraging investments in production capacity expansions. This trend has also been encouraged by the improving financial performance of businesses in the last two years.

The situation in construction is slightly less optimistic at the moment. Even so, the mood among construction businesses has improved significantly thanks to orders they at last started to receive in the last one-and-a-half years after a long depression. The question is whether they will continue to see the number of new orders grow in the second half of the year. So far, new demand in construction has appeared to take a breather. Statistics for orders for the second quarter of the year will not be available for another two weeks; nevertheless, they are unlikely to head towards a new high.

The mood among consumers is also positive although their mood was even better early this year. The fear of unemployment or of a deterioration in consumers' own financial positions has largely disappeared but concerns about inflation are starting to grow. The upbeat mood is leading consumers to the shops and they are even more willing to invest in their housing. Thus consumption will continue to be one of the primary drivers of the Czech economy in the second half of the year. Nonetheless, not even such an improvement in demand is strong enough to trigger demand-pull inflation in the competitive retail environment, thus freeing the hands of the central bank, which will keep the koruna above EURCZK 27.0.



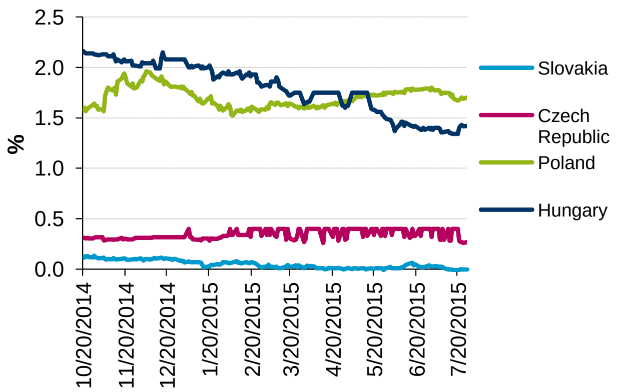


Calendar

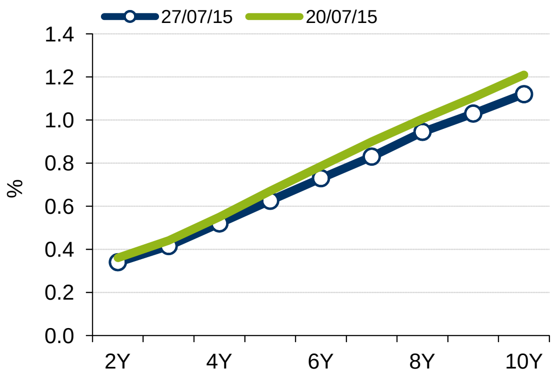
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	07/27/2015	10:00	Money supply M3	%	06/2015						5
HU	07/29/2015	9:00	Unemployment rate	%	06/2015			7		7.1	
HU	07/31/2015	9:00	PPI	%	06/2015					1.9	1
CZ	07/31/2015	10:00	Money supply M2	%	06/2015						5.3

Fixed-income in Charts

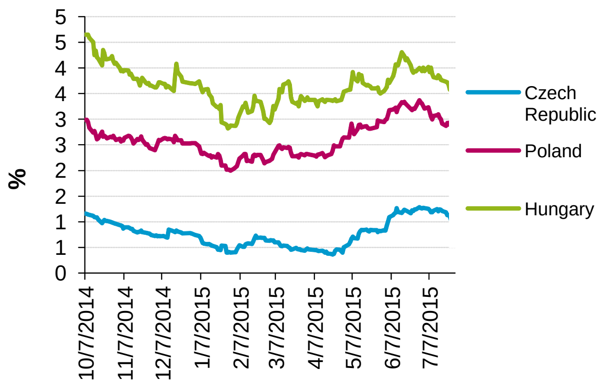
FRA 3x6



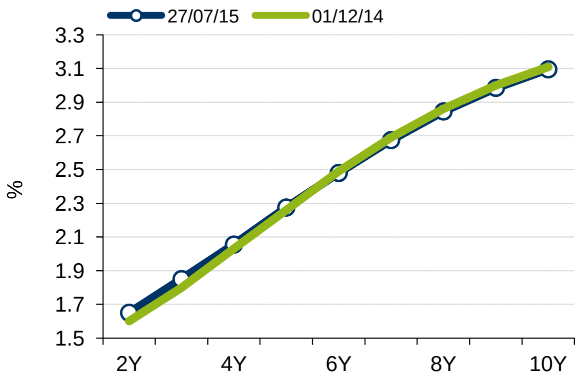
CZ IRS



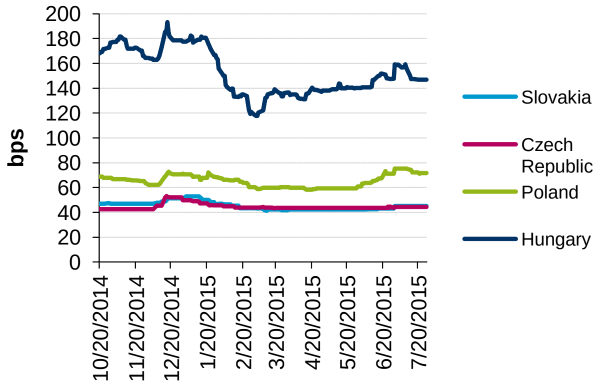
10Y GB Yields



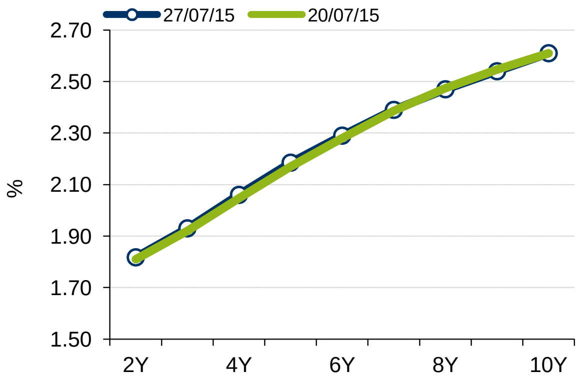
HU IRS



CDS 5Y



PL IRS



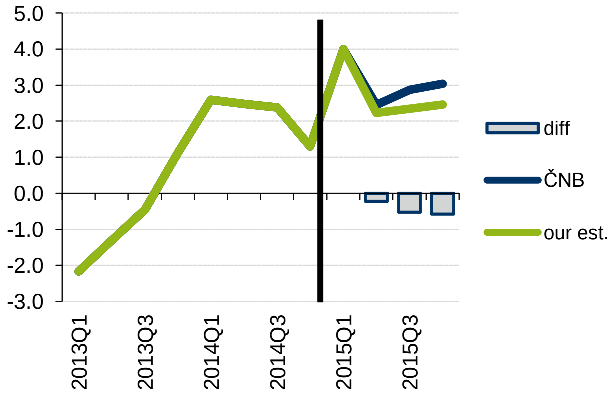
Source: Reuters

Medium-term Views & Issues

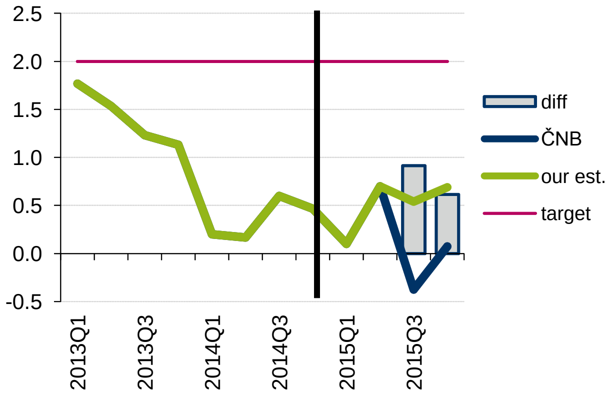
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 27.0, 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.	The MNB said in July it concluded its rate cut cycle. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture, so the start of the rate hike cycle is depending on FED's and ECB's policy. Based on the current expectation we think that NBH may hike key rate in 2Q16 the earliest.	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	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. We believe the Czech National Bank will meet its "pledge" and won't terminate its intervention regime before the second half of 2016. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Possible start of tightening of US monetary policy poses negative risks for the koruna. We however think the fallout should only be limited.	We think that the first strengthening reaction of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture.	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. Polish general elections in autumn however pose a negative risk for the zloty.

CBs' Projections vs. Our Forecasts

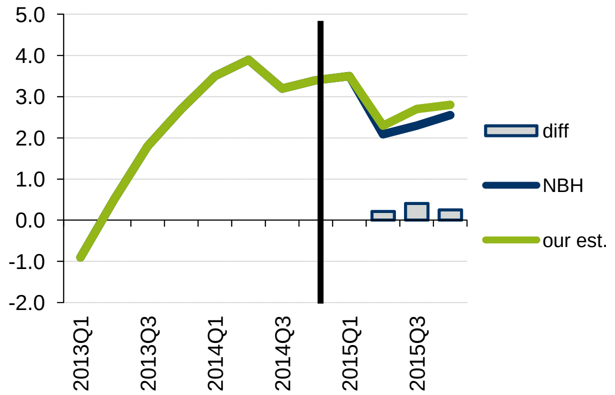
CZ: GDP outlook (Y/Y, %)



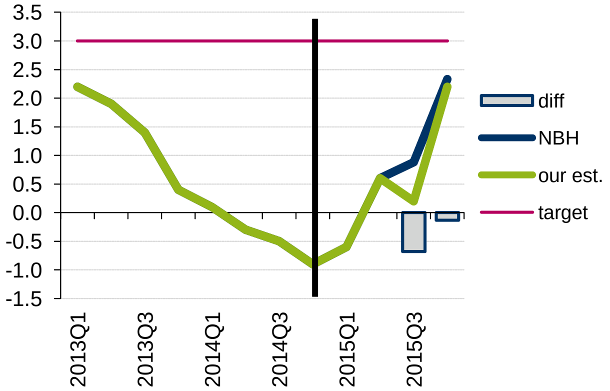
CZ: Inflation outlook (Y/Y, %)



HU: GDP outlook (Y/Y, %)

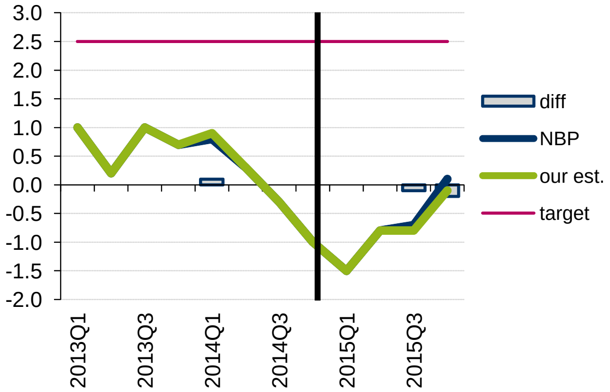


HU: Inflation outlook (Y/Y, %)



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.	*1.35*	1.95	1.50	1.35	1.35	1.35	-10 bps	7/21/2015
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	*1.36*	1.89	1.41	1.35	2.10	1.40
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	*1.12*	0.64	1.30	1.45	1.50	1.65
Hungary	HU10Y	*3.10*	2.71	3.45	3.40	3.60	3.80
Poland	PL10Y	*2.61*	2.12	3.01	2.45	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.05*	27.57	27.35	27.30	27.20	27.10
Hungary	EUR/HUF	*311*	300	315	317	315	310
Poland	EUR/PLN	*4.15*	4.07	4.19	4.20	4.15	4.10

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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