Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 04 July 2016

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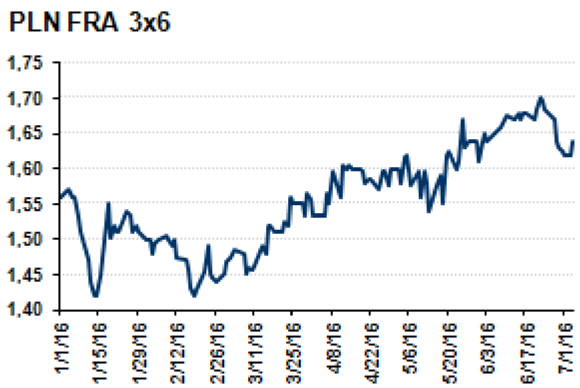
Dear clients, please note the next CE Weekly will be released on July 18th.

Weekly Highlights:

- The CNB firmly on hold – watching the Brexit impact
- Regional business sentiment indices had deteriorated already ahead the Brexit vote
- The Hungarian labour market heats up
- New NBP's President is going to present a more pessimistic inflation report

Chart of the Week: Polish rate-cut bets



PLN FRA 3x6, last 134 days. Source: Reuters

The upcoming meeting of the Polish MPC will bring a new inflation report, which will see project even lower inflation in future. This could fuel rate-cut bets in Poland and bring the short-end of the curve even lower.

Central Banks & Markets

The CNB firmly on hold

The CNB Board again left its monetary policy unchanged at its last meeting. Thus its interest rates remain where they were, and its exchange rate policy has not changed either. Not even the timing of the probable termination of its intervention policy has changed, with the CNB Board still expecting to unleash the koruna in the middle of next year (as the most probable date). The forecast cites 2017 in general.

The forecast tends to envisage sustainable fulfilment of the inflation target in the second half of 2017. In addition, inflation risks to the forecast are still on the downside. This means that the risk of extending the intervention policy beyond the middle of next year definitely exists. By contrast, the scenario of further 'devaluation' is certainly not very likely, particularly if there is accelerating wage growth in the business sector, which the CNB sees as an important factor of inflation expectations. After all, so far the economy has also been developing better than anticipated by the central bank, wage growth is higher, and inflation is at the forecast level.

The CNB considers the Brexit as uncertainty surrounding the forecast, but the governor was not very willing to elaborate on this milestone at the press conference. Perhaps we can add that the Brexit has increased the risk of extension of the quantitative easing policy in the euro area, and consequently the exchange rate policy in the Czech Republic. For the sake of completeness, we can just add that the scenario of negative interest rates is still on ice and we believe that the CNB may only resort to it if there are long-term attacks on the intervention threshold. Otherwise, negative rates were probably not discussed at all this time.

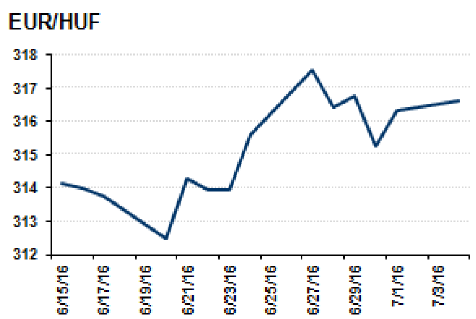
The CNB Board will hold its next meeting, where a new forecast is going to be discussed, with slightly different members. Nevertheless, we do not expect any fundamental change from the new composition of the Board.

The Polish MPC meeting with a new NBP's President

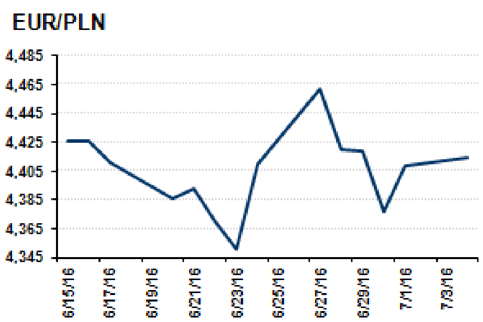
Although the new NBP governor Adam Glapiński will have his first opportunity to defend the policy of the National Bank of Poland at a press conference, we do not expect any great changes in the NBP's communication. Nevertheless, a new inflation forecast may draw more attention, as it is likely to be changed significantly – due in part to the negative shock from the Brexit. We believe that in particular the optimistic outlook for 2017, envisaging GDP growth of 3.8%, will be reduced. At the same time, we can anticipate a reduction of the inflation outlook for 2017 especially. In addition, there is the risk that the new forecast will indicate that inflation will remain below the lower threshold of the target inflation band (1-3%) for the most of next year.

	Last	Change 1W
EUR/CZK	27.1	-0.31%
EUR/HUF	317	-0.64%
EUR/PLN	4.42	-1.10%

	Last	Change 1W
10Y CZK	0.50	-6.60
10Y HUF	2.11	-4.84
10Y PLN	2.17	-8.25



EUR/HUF, last 14 days. Source: Reuters



EUR/PLN, last 14 days. Source: Reuters

Central European Daily

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Review of Economic Figures

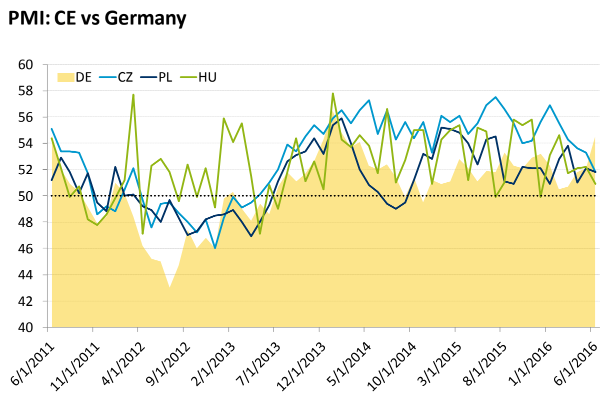
Regional PMI indices weaker already ahead of the Brexit

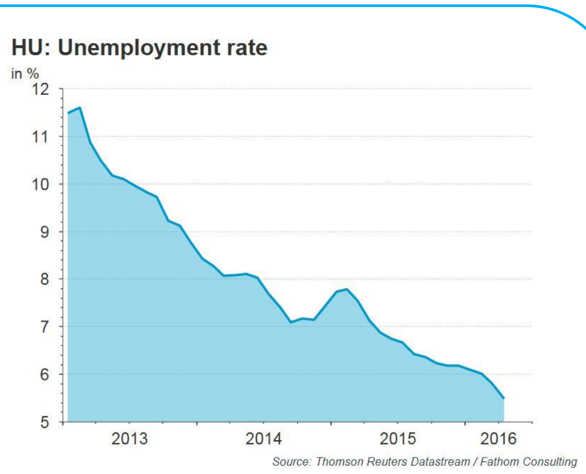
Business sentiment in Central Europe surprisingly deteriorated just before the Brexit vote. While Hungary's PMI dropped to the year´s bottom value, its Czech counterpart declined even deeper, to the three-year low. In contrast to Czech and Hungarian PMIs, a bad omen in the form of a drop in the sub-index of new orders has not been present in Poland. Irrespective of country differences, all CEE´s PMI indices are still standing above the breakeven level of 50 points. Let´s wait if they stay there also in July, when the result of the Brexit referendum will influence business mood across Europe for the first time.

Hungary's labour market continues to improve

The Hungarian labour market improved further in the period of March and May. The number of employed people increased by 149 thousand in a year time from which 116 thousand more people works on the domestic primary labour market. The public forced work program absorbed 25 thousand more people, while there are 8 thousand more workers abroad in the age group between 15 and 74 years. The activity rate went up to 60.8% (it is 0.1%pt higher compared to previous month and 1.3%pt higher than a year ago). The unemployment rate in Hungary is down to 5.5% vs. 5.8% in April and 7.1% a year ago.

It means that the Hungarian labour market is getting very tight and the business may have difficulties to find new worker from Hungary. Although there is still room to increase further the participation rate of the population, it might be a longer process as the currently inactive people skills are out of date, which could be solved only with education. On the other hand the tight labour market may keep wage increase at high level (around 6-7% Y/Y), so the domestic consumption may remain strong in the coming 2 years and it may give a stabile base for Hungarian economic growth. Hence, despite of the Brexit vote we expect that the Hungarian GDP may increase around 3% Y/Y in 2017 as the government may introduce some fiscal loosening during the autumn.





Weekly preview

THU 9:00 **CZ Foreign trade (CZK bn)**

	May-16	Apr-16	May-15
Balance (national)	**25.0**	23.6	10.6
cummulative (YTD)	**117.0**	92.0	78.7
Balance	43.7	56.0	29.3
cummulative (YTD)	**250.0**	206.4	187.5

CZ: Trade surplus on the rise

Just as in previous months, two basic tendencies can be seen as being responsible for another rise in the foreign trade surplus: the boom in the export-oriented automotive industry on the export side, and the effect of the year-on-year decline in raw material prices on the import side. The figure was also boosted by three additional business days in the month, and thus we can expect much more rapid rates of imports and exports than in previous months, driven by improving domestic demand, including record-breaking passenger car sales. The overall foreign trade trend can still be seen as favourable and we can also anticipate a new record-breaking trade balance surplus this year.

WED 14:00 **NBP rate (in %)**

	This	Last change
rate level	**1.50**	3/2015
change in bps	**0**	-50

PL: New governor to present a new forecast

Although the new NBP governor Adam Glapiński will have his first opportunity to defend the policy of the National Bank of Poland at a press conference, we do not expect any great changes in the NBP's communication. Nevertheless, a new inflation forecast may draw more attention, as it is likely to be changed significantly – due in part to the negative shock from the Brexit. We believe that in particular the optimistic outlook for 2017, envisaging GDP growth of 3.8%, will be reduced. At the same time, we can anticipate a reduction of the inflation outlook for 2017 especially. In addition, there is the risk that the new forecast will indicate that inflation will remain below the lower threshold of the target inflation band (1-3%) for the most of next year.

FRI 9:00 **CZ Retail Sales (change in %)**

	May-16	Apr-16	May-15
Sales	**13.5**	8.5	8.2
cummulative (YTD)	**9.0**	7.8	7.9
Sales (cars excl.)	**9.2**	4.9	5.7
cummulative (YTD)	**6.9**	6.3	6.3

CZ: Shopping boom is not over

As attention is usually focused on unadjusted data, we can expect that May's retail sales figures were also influenced by the significantly higher number of business days in the month. Retail - excluding the automotive segment - most likely saw an improvement of demand in all groups of goods, in particular household equipment, food and fuel. A double-digit rise in e-commerce should be no surprise. In addition to a significant rise in retail sales, May also saw a significant sales increase in the automotive segment. After all, this was already suggested by the year-on-year rise in car registrations (+35%). Overall, this year's retail sales are clearly heading towards a new all-time high.

FRI 9:00 **CZ Industry (y/y change in %)**

	May-16	Apr-16	May-15
Monhtly	**8.5**	4.2	3.0
cummulative (YTD)	**4.2**	3.2	4.7

CZ: Industry at the mercy of carmakers

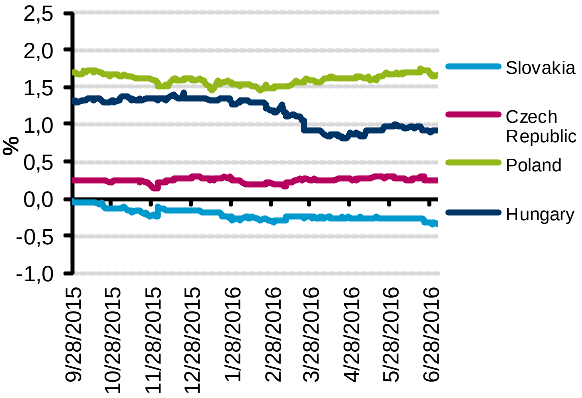
A strong rise in the manufacturing industry on the one hand and lower figures from the energy sector, and especially mining and quarrying, on the other – this is what can probably be expected from May's industrial output. Just as with other statistics, the overall figure will be influenced by the much larger number of business days in the month and, just like in previous months, carmakers again played the primary role. Therefore, a double-digit rise in output should be no surprise. However, the statistics for new orders should draw even greater attention than the rate of output. The last increase in orders - by almost 37% - for carmakers is unlikely to reoccur, yet the overall data on orders should be positive.

Calendar

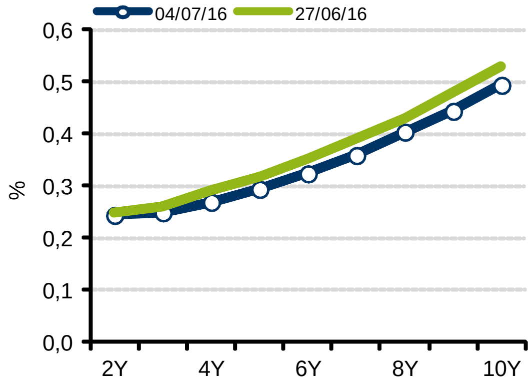
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	07/05/2016	9:00	Retail sales	%	05/2016				5.9		6.4
PL	07/06/2016	14:00	NBP meeting	%	07/2016	1.5		1.5		1.5	
CZ	07/07/2016	9:00	Trade balance (national)	CZK B	05/2016	25		15.3		23.6	
HU	07/07/2016	9:00	Industrial output	%	05/2016				5.2	5.4	5.3
HU	07/07/2016	11:00	Budget balance	HUF B	06/2016					-13.2	
CZ	07/08/2016	9:00	Construction output	%	05/2016						-13.7
CZ	07/08/2016	9:00	Industrial output	%	05/2016		8.5		8.2		4.2
HU	07/08/2016	9:00	CPI	%	06/2016			0.2	-0.1	0.3	-0.2
HU	07/08/2016	9:00	Trade balance	EUR M	05/2016 *P			702		989	
CZ	07/08/2016	9:00	Retail sales	%	05/2016		9.6		10.7		8.5

Fixed-income in Charts

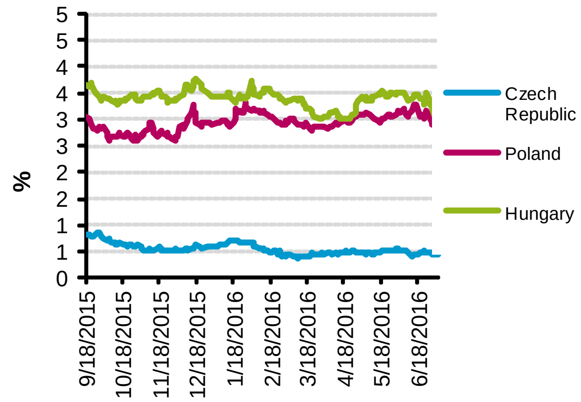
FRA 3x6



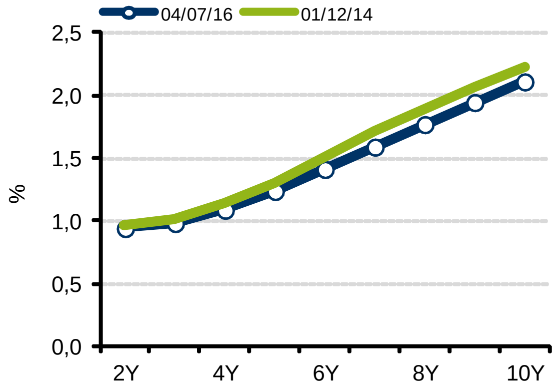
CZ IRS



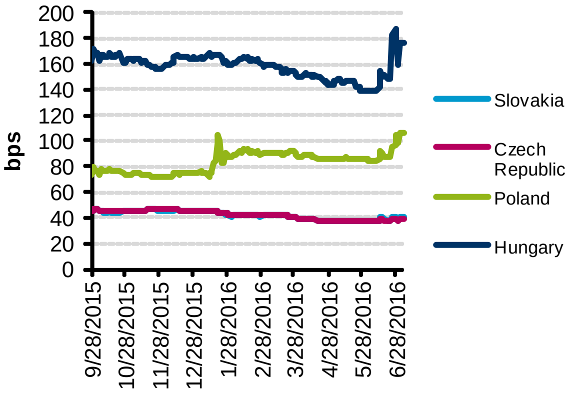
10Y GB Yields



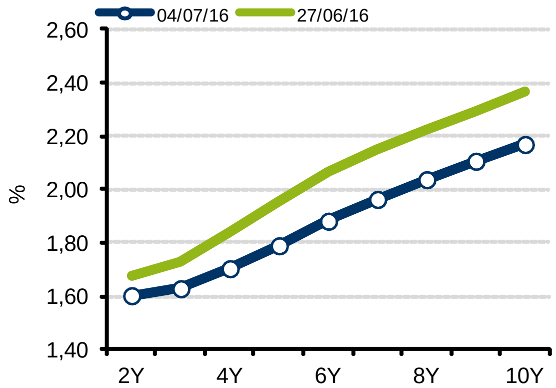
HU IRS



CDS 5Y



PL IRS



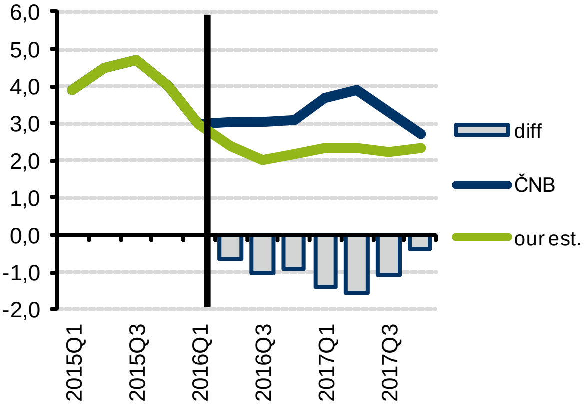
Source: Reuters

Medium-term Views & Issues

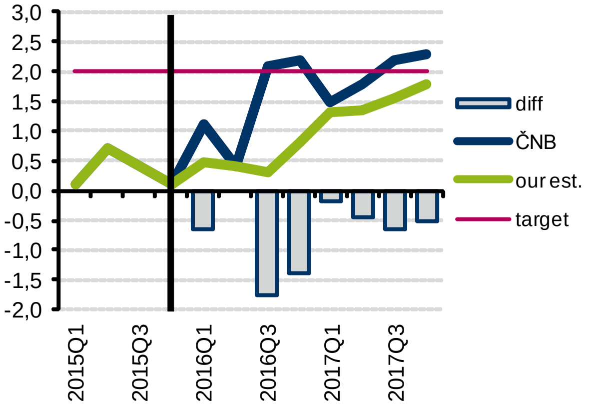
	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech economy entered a stage of moderately decelerating growth, at the mercy of household consumption and exports. Inflation remains subdued despite the anticipated solid GDP rate, and will unlikely approach the CNB's inflation target before 2017, thus enabling the central bank to continue its exchange rate policy. 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.	Growing net real wages and the postponed consumption since the crises (we calculate around 5% of GDP under consumption) boost the retail sales and it may be the main driver of this year's economic growth of around 2% Y/Y.	Prospects of the Polish economy remain good in our view. For the whole year 2016 we expect GDP growth may reach 3.5 - 4.0 percent. Apart from low interest rates (further cuts cannot be excluded) and a relatively weak zloty, we expect the economy to draw additional support from policy measures of the new government (stimuli for private consumption). The risks thus stem mainly from a possible deterioration in the external environment, most notably in China, Russia and other emerging markets.
Outlook for official & market rates	The latest forecast does not envisage the return of inflation to the target before early 2017, with inflation not significantly diverging from it afterwards either. The CNB has extended its exchange rate commitment until the first half of 2017. The possibility of introducing negative interest rates has been increasing, in light of the widening of the interest rate differential vis-à-vis the euro area and developments in domestic financial markets. But we still don't expect negative CNB's rates. There are two main preconditions for negative official rates: 1) significant ECB's rate cut, 2) continuing large monthly fx interventions of the CNB.	A relatively strong and continuously robust consumption is expected to push inflation gradually higher. So this figure suggests that NBH won't cut the base interest rate (0.9%) further in June despite of the surprise drop in inflation back to negative territory.	We expect the NBP to keep official rates stable, but we think that risks for of further rate cuts have increased. The main reason is the combination of the "inflow of cheap euros from the ECB", ongoing deflation and stronger currency (PLN). Hence, should the zloty get strong there could be a window of opportunity for the NBP to ease its policy in the second quarter of this year. Nevertheless this is not our main scenario yet.
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. With regard to the inflation outlook and ECB's policy, we anticipate an exit from the fx regime in the first quarter of 2017. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Current turmoil on the Chinese market poses negative risks for the Central Europe. We however think the impact on the koruna should only be limited.	Looking ahead the areas around 312.5 and 311 are strong support levels for the EUR/HU, which might stop the current rally especially in case of strong US data releases afternoon. Also the uncertainties around Brexit vote may not support further strengthening of the forint in the near-term , so we see bigger chance for some correction followed by side moves, but it will highly depend on global risk taking willingness before the Brexit vote.	We think that zloty's sell-off related to markets' fears coming from appointment of new members of the Monetary Policy Council (MPC) is over now. Nevertheless, while domestic fundamentals should be relatively supportive for the zloty, the currency should be mostly driven by sentiment in emerging markets and the ECB or the Fed policy actions respectively.

CBs' Projections vs. Our Forecasts

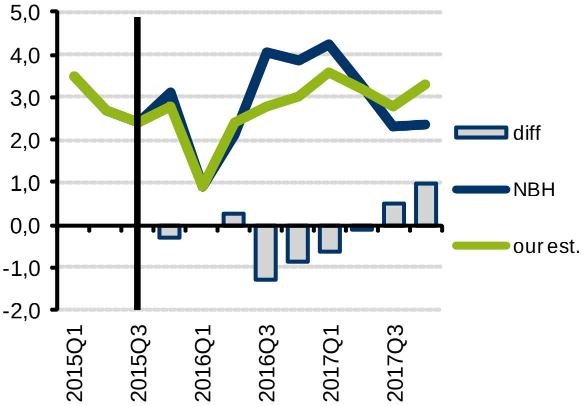
CZ: GDP outlook (Y/Y, %)



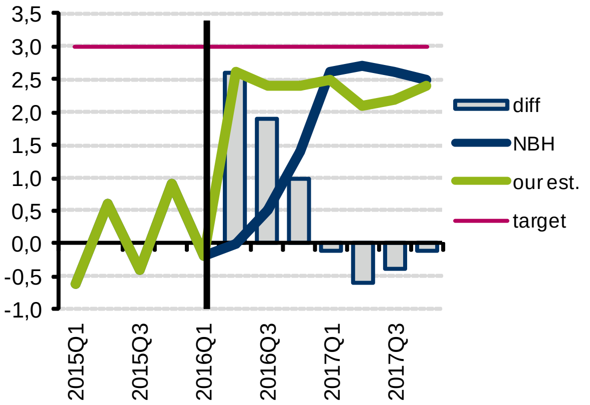
CZ: Inflation outlook (Y/Y, %)



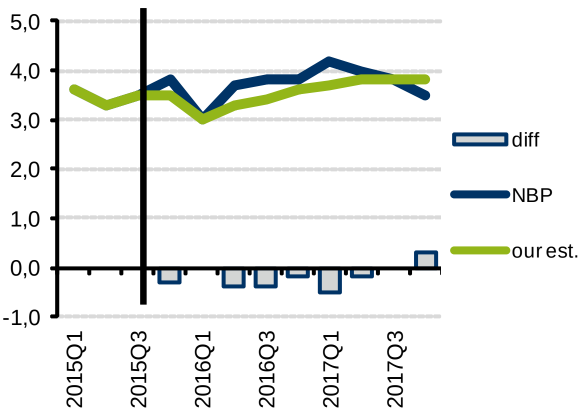
HU: GDP outlook (Y/Y, %)



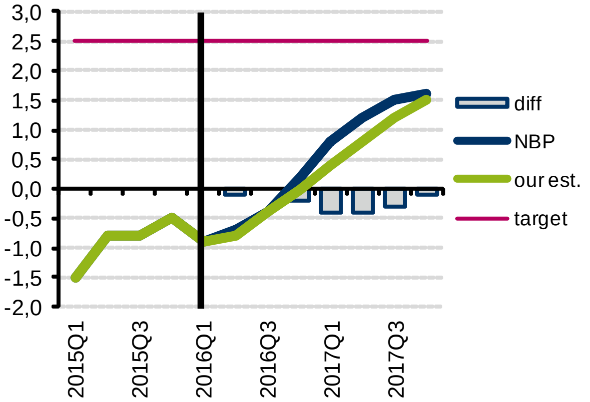
HU: Inflation outlook (Y/Y, %)



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	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3	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*	2.50	2.75	0.90	0.90	0.90	-10 bps	7/21/2015
Poland	2W inter. rate	*1.50*	1.50	1.50	1.50	1.50	1.50	-50 bps	3/5/2015

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

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	PRIBOR	*0.00*	0.29	0.29	0.28	0.28	0.28
Hungary	BUBOR	*1.02*	2.60	2.90	0.90	0.90	0.90
Poland	WIBOR	*1.71*	1.65	1.65	1.70	1.70	1.70

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

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	CZ10Y	*0.50*	0.54	0.62	0.80	0.90	1.00
Hungary	HU10Y	*2.11*	4.00	4.20	2.80	2.80	2.90
Poland	PL10Y	*2.17*	2.50	2.40	2.50	2.70	2.80

Exchange rates (end of the period)

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	EUR/CZK	*27.10*	27.02	27.15	27.05	26.70	26.20
Hungary	EUR/HUF	*317*	308	305	315	310	313
Poland	EUR/PLN	*4.42*	4.39	4.27	4.25	4.24	4.23

GDP (y/y)

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	2.4	2.0	2.2	2.3	2.3	2.2	2.3
Hungary	2.4	2.8	3.0	3.6	3.2	2.8	3.3
Poland	3.3	3.4	3.6	3.7	3.8	3.8	3.8

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

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	0.2	0.4	1.1	1.5	1.5	1.6	1.8
Hungary	2.6	2.4	2.4	2.5	2.1	2.2	2.4
Poland	-0.8	-0.4	0.0	0.4	0.8	1.2	1.5

Current Account

	2016	2017
Czech Rep.	1.2	1.1
Hungary	4.1	3.5
Poland	-1.5	-1.3

Public finance balance as % of GDP

	2016	2017
Czech Rep.	-0.8	-1.1
Hungary	2.0	2.5
Poland	-2.9	-3.0

Source: KBC, Bloomberg

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