Central European Weekly

Tuesday, 17 April 2012

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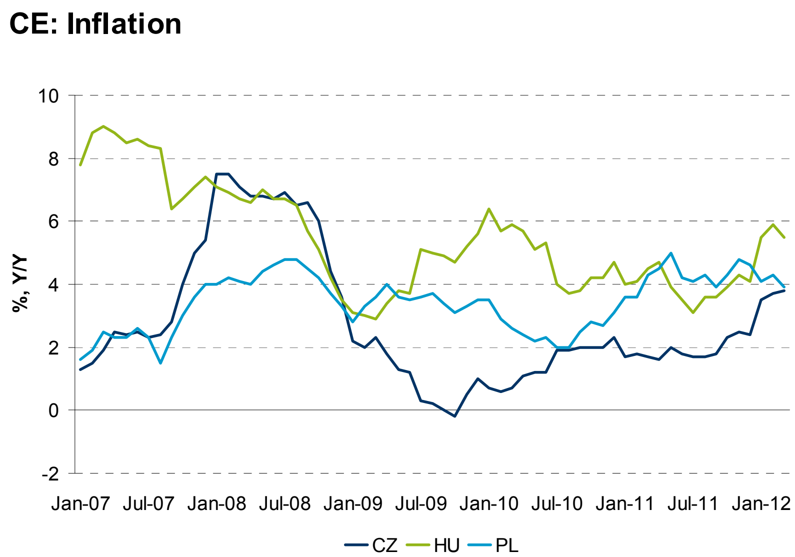
- The Czech ruling coalition goes on, but with further austerity measures
- Is the Polish central bank ready for a rate hike?
- The inflation wave in the Czech Republic and Hungary might be over this year

Chart of the Week



Year-on-year inflation rates in Central Europe.

Market's editorial

The Czech government opts for more austerity

Although the Czech government did not accede to the new fiscal compact at the latest EU summit, it fully observes the established German strategy: saving, saving, saving. This was evident when the government coalition crisis was warded off owing to an agreement on a further fiscal restriction, which should ensure that the Maastricht budgetary target, i.e., a deficit below 3% of GDP, is being met in the medium term.

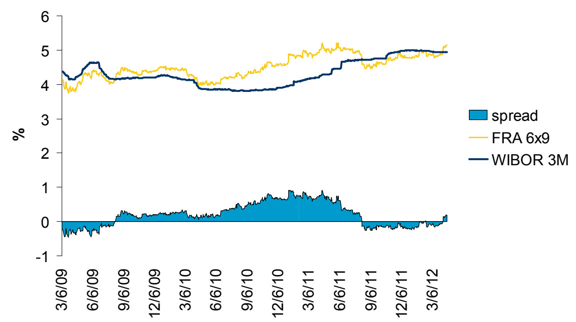
No doubt the budgetary tightening will be appreciated by the market in Czech bonds, the supply of which will in no way be great in the years to come, and thus the risk margins to be paid by the Czech government may remain at very reasonable levels. Nonetheless, from the macroeconomic point of view, we must notice a trick so frequently used by U.S. legislators: the planned budgetary restriction should not culminate before the general election (the State should save more than CZK 140 bn in 2015, and nearly CZK 95 bn in 2014, but 'only' CZK 57 bn next year). In other words, unless this government survives the next 'regular' election, half the planned savings may not necessarily take place at all…

Another question is the effect of the government's new austerity strategy on the Czech National Bank's policy. The increased indirect taxes (VAT; wine, tobacco, and carbon taxes) should accelerate inflation; however, the CNB 'disregards' inflation driven by taxes, and will not pay attention to it until it makes itself felt in long-term inflation expectations and wage negotiations. By contrast, the bank may be interested in the impact of government measures on real domestic demand and economic growth. For 2013 and 2014, the fiscal restriction should reach more than 4% of GDP in total. This should continue to curb domestic demand-pull inflation pressures and enable the CNB to keep rates at record-low levels for a prolonged period. Thus, notwithstanding the increased inflation rate, the tougher fiscal restriction may, in the end, open up space for a longer monetary expansion, and this may not be good news for the Czech koruna.

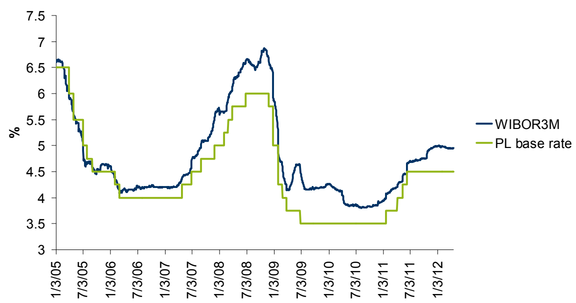
Is the NBP ready for a 25 rate hike?

The developments in neighbouring Poland, where the central bank (NBP) has basically announced that it will raise rates at its May meeting, are interesting too. Still, we view such a move by the NBP rather as a token gesture – because the price rise, just like in other countries across the globe, is being primarily driven by commodity prices. However, the NBP, led by Governor Belka, likely wishes to indicate to markets that inflation is an actual priority for the central bank, and does not want to open up space for any discussions about this. The hawkish conclusions from the latest meeting have on their own basically eliminated the previously evident bets on a rate cut at the end of this year, and the act of a rate hike itself should reassure markets of the NBP credibility.

PL: FRA vs WIBOR



PL: Base rate vs WIBOR 3M



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.8	-0.27%	↗	↗
EUR/HUF	299	-0.23%	↗	↗
EUR/PLN	4.19	-0.33%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.22	0.00	→	→
10Y PLN	7.56	-0.40	↗	↗
10Y HUF	5.09	0.00	↗	↗

Review of Economic Figures

The Polish headline inflation falls back below 4%

The last to release its inflation data for March was Poland's Statistical Office. Its figures indicate that last month's prices were up by 3.9% y/y – i.e., inflation fell to less than 4% for the first time since September 2011. Compared to our forecast (we had anticipated 4%), the greatest surprise was the increase in the transport sub-index (0.8% m/m) twice as fast as was expected. Food prices went up slightly faster (1.2% m/m) than indicated by leading indicators. By contrast, prices of alcohol and tobacco products went up slower than we had anticipated (0.5% m/m). We believe that Poland's inflation may remain near its current levels for the next two months; however, in the summer, we expect it to return to more than 4%.

Hungary's CPI stays high due to high food and energy prices

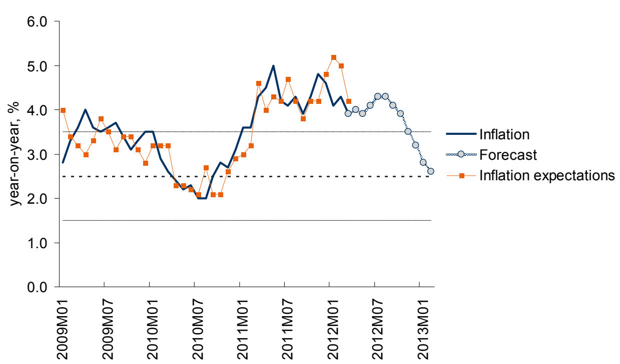
Hungary's inflation was quite a significant surprise in August, when its year-on-year rate accelerated to 3.6%. The accelerated rise is more or less due to external factors, such as the noticeably increased petrol prices and a smaller (seasonal) decline in food prices. By and large, this means that core inflation decelerated (to 3.1% y/y), unlike headline inflation.

Hungary's inflation outlook remains mixed, as the price rise may be slightly boosted by the weakened forint and by the increase in certain excise duties. In both events, the contribution to the inflation rise should be 0.1-0.2%. By contrast, the outlook for 2012 continues to be fairly good, when poor demand should make (year-on-year) inflation go down slightly, towards 3%.

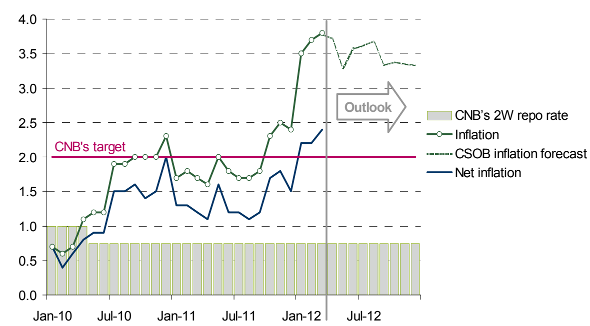
The Czech inflation has peaked in y-o-y terms this year

The Czech Republic's inflation for March was slightly better than expected. This time the consumer price index went up by 0.2%, due primarily to an increase in food prices – specifically eggs. March also saw a moderate increase in seasonal clothing and shoe prices. Consumers also had to pay more for fuel, the price of which again hit new highs. Year-on-year inflation rose by 0.1% to 3.8%. Thus the consumer basket is 3.8% costlier than in the same period last year. Healthcare costs rose at the fastest rate, albeit their role in consumer expenditure is not dominant. The increases in food prices (+8.7%) and housing prices (+5.6%) are affecting people much more. We can say that inflation is already peaking, and thus should not continue to rise to any great extent. Even so, the price rise is unusually fast, and we have not seen prices go up so rapidly for a long time. Nevertheless, the main reasons for these price increases include administrative moves, i.e., increased taxes (VAT and excise duties) and what is known as deregulation, rather than demand. This year's inflation is likely to remain above 3% throughout the year, thus being the highest over the last three years; however, given the poor performance of the economy, the CNB is unlikely to raise rates this year either.

PL: Inflation



CZ: Inflation and CNB's Target (%)



In Focus: Czech fresh austerity measures

The Czech coalition government warded off its dispute that had posed a risk of an early general election, and agreed to continue their joint rule. The right-wing coalition also agreed on moves to improve the performance of public budgets, the deficit of which still exceeds 3% of GDP, thus increasing the public debt, whether nominally or as a share of GDP.

The agreed measures are primarily based on expenditure cuts, supplemented with selected tax increases. The expenditure cuts should be made in the ordinary operations of the State (approximately CZK 12 bn) and in trimming certain social security expenditures; these particularly include a change in the pension adjustment scheme, which thus far has been based on the pension increases being tied to inflation plus one-third of real wage growth. The new calculation should only reflect one-third of inflation and real wage growth alike. This should ultimately 'save' more than half the money earmarked for the annual pension adjustments.

However, the government has also taken steps to raise budget revenue, which should be primarily boosted by an increase in both VAT rates by one percentage point. The VAT increase will be accompanied by the introduction of an excise duty on wine (CZK 10 per litre) and an increase in taxes on selected tobacco. The 'carbon' tax has also been addressed, and will severely impact on the end users of natural gas and coal. The calculation of personal income tax is also going to change; its rate is currently 15 % and the taxable amount also includes health insurance and social security contributions paid by both the employee and the employer. The new rate should be 20%, and will only be calculated from what is known as the gross wage excluding insurance contributions. The cap on health insurance contributions will be abolished, and an increased tax rate will be temporarily levied on taxpayers with income in excess of CZK 100,000.

While households in general will save a bit on income tax, they will spend more on VAT, excise duties, and environmental taxes. In an ordinary household where both parents are employees, approximately two-thirds of the tax increase will be offset by an income tax reduction. The impact on pensioners will be tougher, because the pension adjustment compensation will cover less than half the increase in the cost of living.

Changes will also affect entrepreneurs who use what are known as flat-rate expenditures. While entrepreneurs will not be eligible for tax credit refunds in respect of their spouses and children, the expenditure flat rates of 30-80% will remain in force. Likewise, the position of entrepreneurs within the social security system, which places them at significant advantage vis-à-vis employees, will not change either.

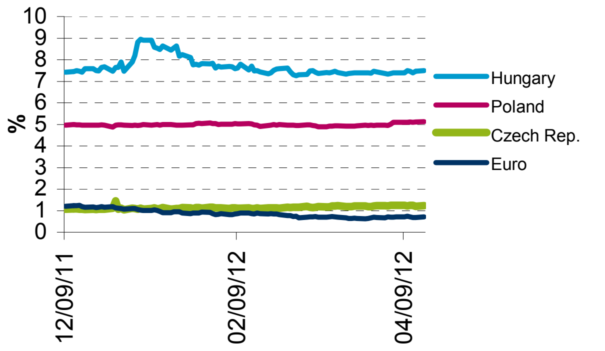
By and large, **the government's steps are intended to cut public deficits to less than 3% of GDP as early as in 2013; however, the government is doing this in order to remedy public budgets rather than to accelerate the adoption of the euro. The euro is not on the agenda**, and the current government is definitely not going to set any timetable or even prepare for the euro. Not only is the euro out of favour with the current government officials, but voter support for the euro is basically at its lowest level in the last few years..

Calendar

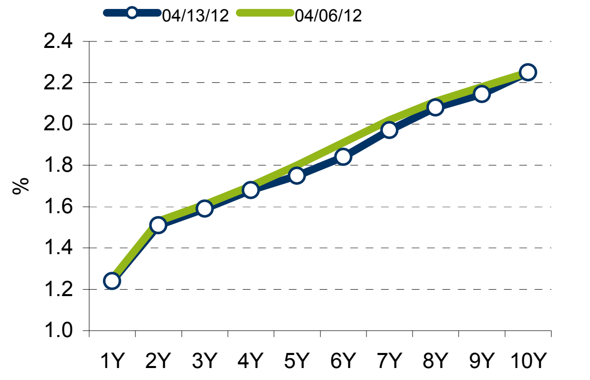
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	04/16/2012	9:00	PPI	%	03/2012	0.2	2.9	0.2	2.9	0.1	3.6
CZ	04/18/2012	12:00	CZ bond auction floating rate/2023	CZK B	04/2012						
CZ	04/18/2012	12:00	CZ bond auction 4.60%/2018	CZK B	04/2012						
PL	04/18/2012	14:00	Wages	%	03/2012			5.3	3.8	-2.7	4.3
PL	04/18/2012	15:00	Budget balance	PLN M	03/2012					-16372	
HU	04/19/2012	9:00	Wages	%, ytd.	02/2012				6		4.3
PL	04/19/2012	14:00	Industrial output	%	03/2012			14.6	4.4	-1	4.6
PL	04/19/2012	14:00	PPI	%	03/2012			0.1	4.8	-0.3	6.3
PL	04/20/2012	14:00	Core CPI	%	03/2012			0.3	2.5	0.3	2.6

Fixed-income in Charts

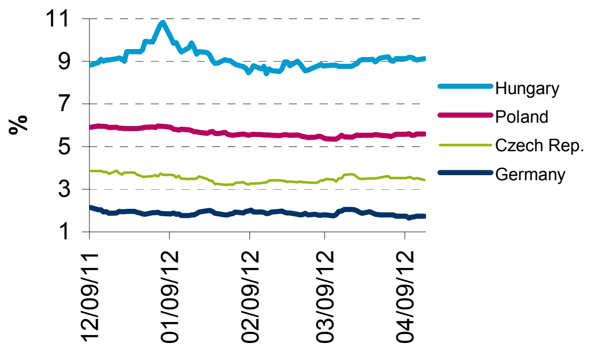
FRA 3x6



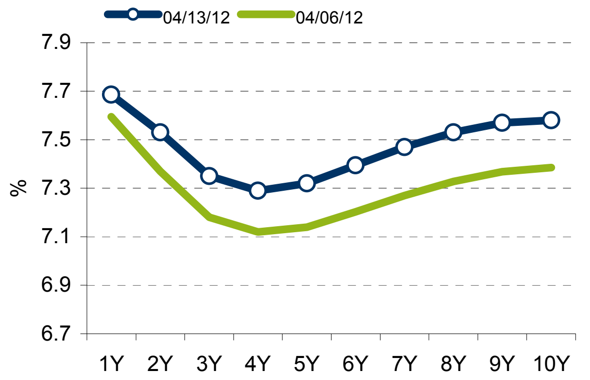
CZ IRS



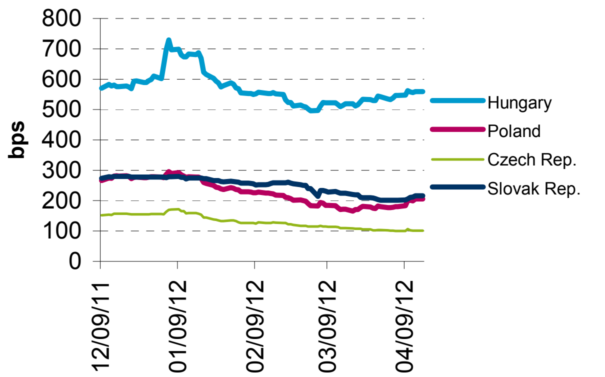
10Y GB Yields



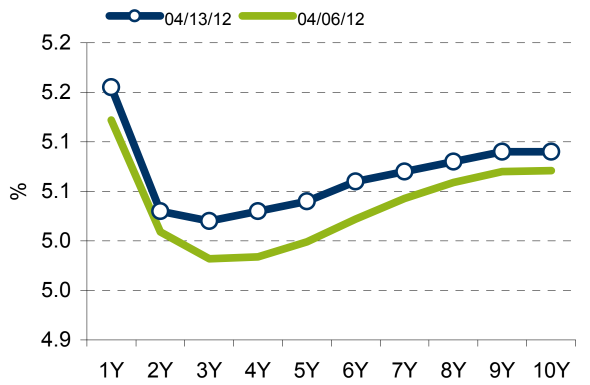
HU IRS



CDS 5Y



PL IRS



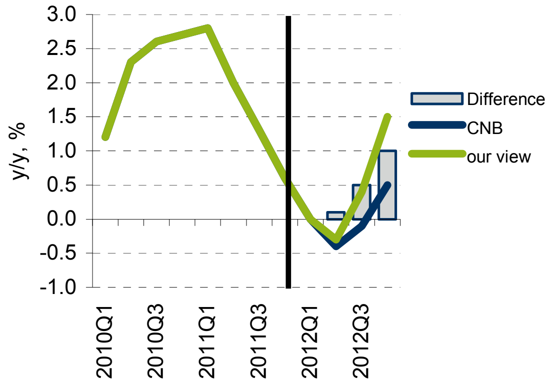
Source: Reuters

Medium-term Views & Issues

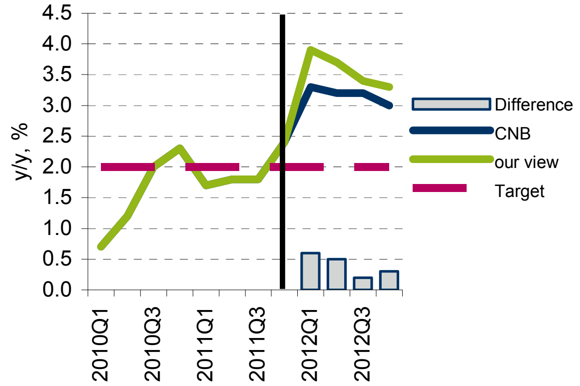
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion of tax increases may be considered. It can not therefore exclude the growing tensions in the government coalition. The government does not intend to set a target date for the euro adoption in the Czech Republic. On the other hand, CR will lend more money to the IMF to address the debt crisis in the Euro-zone.	In the Hungarian outlook the IMF agreement will evidently have a crucial role. The EU/IMF talks have been ongoing in the background and the government sent its reply to the Commission, where it stand up to its demand about the oath of the central bank leaders and the retirement age of judges. We think it would be unlikely if Hungary does not get the loan facility because of these issues and the loan agreement could come in May- June.	According to preliminary estimates, the Polish economy grew by 4.3% last year. Nevertheless, we expect that factors that kept the Polish economy growing during the World Financial Crisis will gradually step aside and we estimate that the economy will grow at a slower pace next year. More specifically, a room for relatively loose fiscal policy seems to have diminished and higher interest rates should, in our view, contribute to a slowdown in both households' consumption as well as private and public investment.
Outlook for official & market rates	Inflation increased above the central bank's target in October driven by food and fuel prices. Fuel prices as well as prices of agricultural commodities continue to pose a risk for future inflation. In January the inflation will jump above the 3% as a result of V.A.T. increase. On the other hand, weak domestic demand should counter a rise in inflation. We expect the CNB to maintain its wait-and-see policy at least until the end of the next year. The first rate hike delivered by the Czech central bank is probable in 2013H1.	The MNB announced three new measures to boost forint credit in the banking system. Overall, I could help somewhat in the current deleveraging world, but the central bank also admits that current situation is more of the case of lack of willingness, where these may not help much. Meanwhile, the headline inflation accelerated to above 5% Y/Y on VAT hike. Further tightening does not look needed now, but definitely the VAT hike does not seem to pass on smoothly. Overall, cautious monetary policy is warranted, ie. the MNB may stay in a wait-and-see mode.	Although the inflation should somewhat decelerate and growth slow down in 2012, we do not believe in monetary easing. The inflation should still remain above the target for the whole year and the volatility of the zloty could have impact on inflationary expectations, if the NBP started with easing once again. On the other hand pretty low job creation should keep also the hawks on hold. Hence we bet on interest rate stability over the whole year 2012.
Forex Outlook	The Czech koruna has strengthened on the second Greek bailout deal and may extend gains in reaction to the global optimism On the other hand stronger US dollar may keep further gains limited. Also the Czech domestic factors do not look very supportive - slow continuation of real convergence does not argue for dramatic gains of the Czech currency over 2012. That said, at levels near 24.00 EUR/CZK, the koruna may be more vulnerable to potentially negative news from eurozone We see the koruna in 12-month horizon near current levels at 24.50 EUR/CZK.	EURHUF stays around 290 levels. As we have a look at the situation of EU countries in crisis, HUF strengthening in the past few weeks is remarkable. It is important to be aware of the international trends and investors' sentiment as the volatility of bond yields would not drop in the near future.	The Polish zloty has strengthened on Greek hope. Similarly to the koruna, the Greek deal may help to ensure further gains. Nevertheless the fundamentals should not permit gains below 4.00 EUR/PLN – the economy should slow down in second half and the rates remain flat. During the summer we may see some renewed selling pressure after the European championship in football takes place and the Greek/Portugal issue potentially comes back to the table. The motivation by official authorities to defend the zloty may be weaker this time due to changed methodology of debt/GDP calculation and lower sensitivity to FX volatility...

Cent. Banks' Projections vs. Our Forecasts

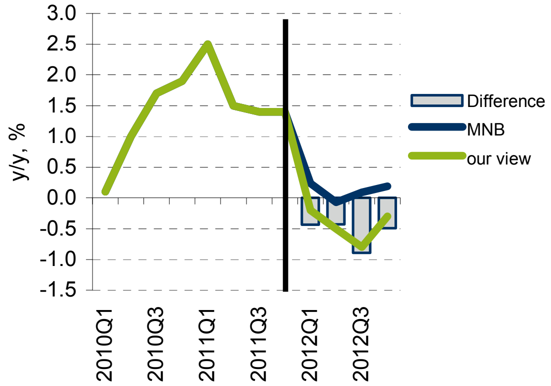
CZ: GDP Outlook



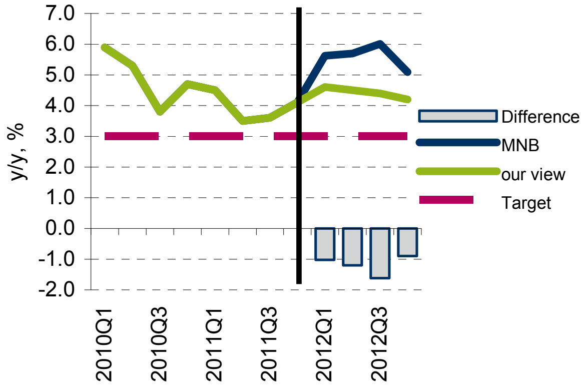
CZ: Inflation outlook



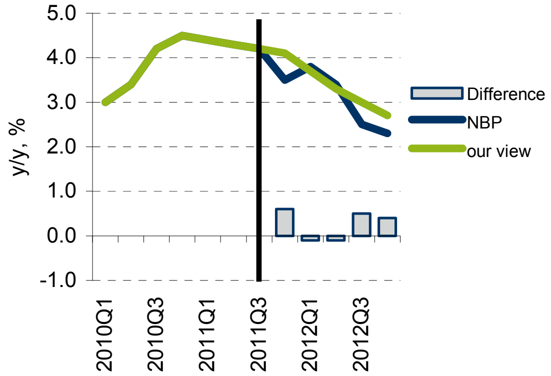
HU: GDP Outlook



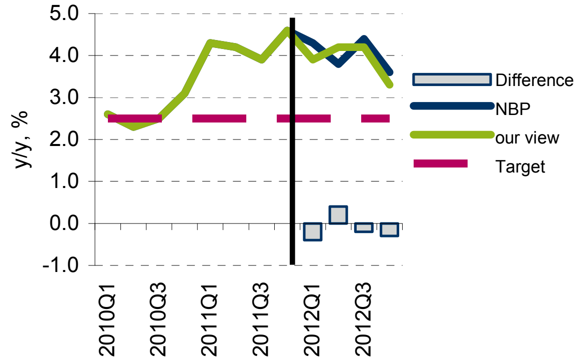
HU: Inflation outlook



PL: GDP Outlook



PL: Inflation outlook



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	0.75	0.75	-25 bps	5/7/10
Hungary	2W deposit r.	*7.00*	7.00	7.00	7.00	7.00	6.75	50 bps	12/20/11
Poland	2W inter. rate	*4.50*	4.50	4.50	4.50	4.50	4.75	25 bps	6/9/11

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*1.25*	1.24	1.18	1.20	1.22	1.28
Hungary	BUBOR	*7.24*	7.00	7.00	7.00	7.00	6.75
Poland	WIBOR	*4.95*	4.60	4.75	4.80	4.80	4.90

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

		Current	2012Q1	2011Q4	2012Q3	2012Q4	2013Q1
Czech Rep.	CZ10Y	*2.22*	2.23	2.24	2.60	2.85	3.15
Hungary	HU10Y	*7.56*	7.10	7.50	7.20	7.20	7.00
Poland	PL10Y	*5.09*	5.00	5.00	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*24.8*	24.8	24.5	25.0	25.0	24.5
Hungary	EUR/HUF	*299*	290	290	290	290	290
Poland	EUR/PLN	*4.19*	4.10	4.00	4.30	4.20	4.15

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	2.8	2.0	1.3	0.6	0.0	-0.3	0.4
Hungary	2.5	1.5	1.4	1.4	-0.2	-0.5	-0.8
Poland	4.4	4.3	4.2	4.1	3.7	3.3	3.0

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

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	1.8	1.8	2.4	3.9	3.7	3.4	3.3
Hungary	3.5	3.6	4.1	4.6	4.5	4.4	4.2
Poland	4.2	3.9	4.6	3.9	4.2	4.2	3.3

Current Account

	2010	2011
Czech Rep.	-3.9	-2.9
Hungary	0.5	2.9
Poland	-2.1	-5.0

Public finance balance as % of GDP

	2010	2011
Czech Rep.	-4.8	-3.1
Hungary	-3.8	-2.9
Poland	-7.1	-6.9

Source: CSOB, Bloomberg

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