Central European Weekly

Tuesday, 12 June 2012

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- Czech and Hungarian GDP details confirm weakness of the domestic demand
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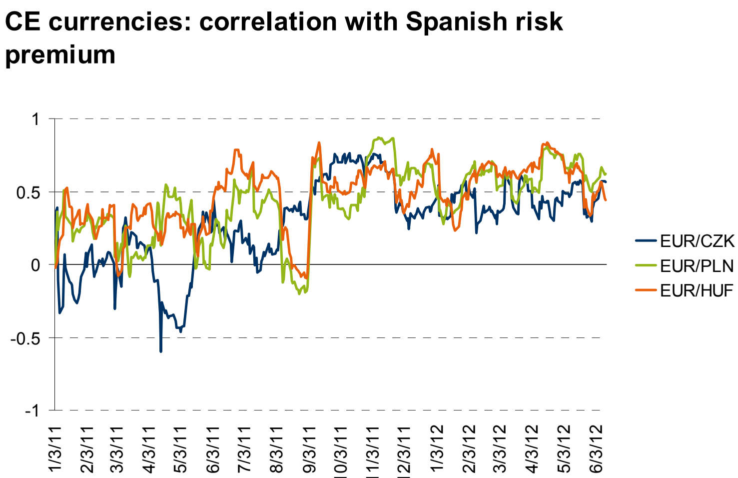
Chart of the Week



Rolling correlation (20 days) between daily changes in the spread between 10Y Spanish and German government bonds' yields and changes in Central European currencies (against euro) since 2011.

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Market's editorial

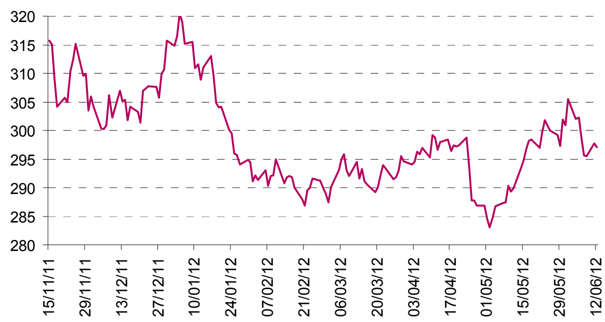
Policy makers in CE prepare for the storm

While the eurozone is busy with Spanish banks, policymakers in Central Europe want to take no chances ahead of the Greek election and are already building protective barriers against potential contagion coming from the monetary union. The Hungarian Prime Minister even wished to enhance that activity to the interstate level, having asked the other countries in the region to adopt a common region-wide position on the potential financial shock. It is not very surprising that neither the Czech Republic nor Poland endorsed Orbán's idea. While the Poles rely on their good relations with the EU, the ECB, and the IMF, which will easily supply them with adequate euro liquidity if needed, the Czech Republic rather has its usual problem of being reluctant to be lumped together with the other East European countries, because foreign-currency loans, which will be the primary generator of problems in Eastern Europe if the financial contagion occurs, are negligible in the Czech economy. If the Greek election were to pose a risk to the Czech economy, it would be through the performance of the German economy. In this respect it is worth noting the latest detailed GDP data – that has clearly shown that the Czech Republic's GDP is only being driven by exports (in fact it ca be said about the Hungarian economy).

Weaker currency is not welcome everywhere

That said, unlike Hungary and Poland, where the primary task of economic policymakers in the face of increasing contagion will include maintaining the relative stability of their local currencies and ensuring that their domestic banks have access to euro liquidity (for example, through swap lines with the ECB), the Czech Republic will need to find a way of easing its monetary conditions, i.e., a scenario consistent with the weak koruna as well as a cut in the repo rate to new all-time lows soon.

EURHUF



EURPLN

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.4	-0.92%	↗	↗
EUR/HUF	296	-2.06%	↗	↗
EUR/PLN	4.29	-1.84%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.79	5.29	↗	↗
10Y PLN	7.15	-0.83	↗	↗
10Y HUF	4.86	0.10	↗	↗

Review of Economic Figures

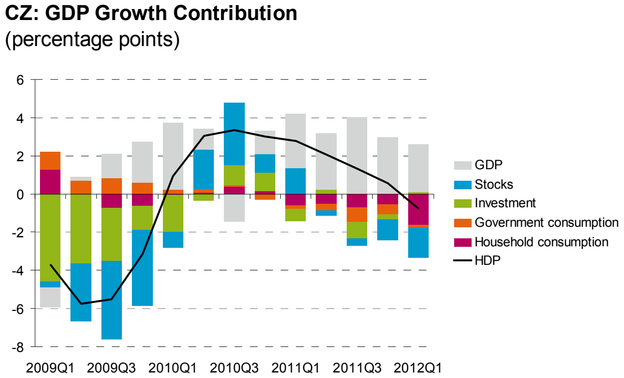
The fall of Czech demand has accelerated

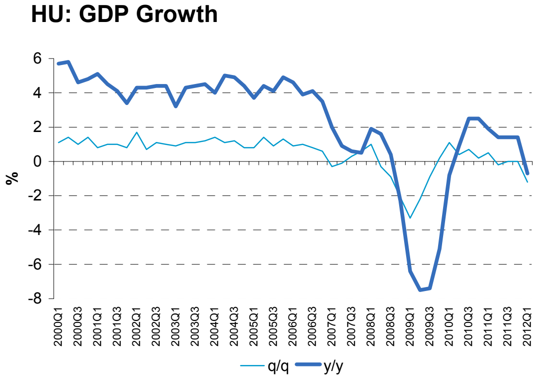
The Czech economy fell slightly less in the first quarter of the year than indicated by the Statistical Office's first forecast. Rather than a 1% drop, the updated figures indicate a GDP fall by 'only' 0.8% q/q and 0.7% y/y. The decline in household consumption accelerated significantly compared to the end of last year, while investment was also falling; by contrast, government spending rose slightly. The decline in domestic demand accelerated, while the positive figures in foreign trade curbed the fall in the entire economy. As concerns the supply side, only the manufacturing industry fared well, while construction and services were mostly in the red. Taxes, i.e., building up stocks of tobacco products ahead of the end of 2011, also contributed to the negative GDP figure in the first quarter, as it temporarily improved the GDP in the fourth quarter of last year and subsequently worsened the GDP in the first quarter of this year. The second and third quarters of this year are also very likely to see falls. Looking at industrial moods and orders, we find that industry is also losing its drive, hand in hand with the worsening economic situation in the western part of Europe. Thus the Czech economy may not get out of the recession until late this year, depending on the future development of demand in the eurozone, because Czech businesses cannot greatly rely on domestic demand.

Hungary's economy waits for new Mercedes production

Hungary's Q1 GDP was a disappointment, which was, after all, envisaged by the flash forecast. The detailed data confirmed that the drop by 1.2% q/q and 0.7% y/y was clearly based on declining domestic demand. Net exports were the only positive component that prevented the fall from actually being even greater.

We will see how the economy will perform in the second quarter, because industry obviously did not open that quarter successfully, as indicated by April's industrial figures (industry dropped by 2.4% m/m and 3.1% y/y). This sector and actually the entire economy are still waiting for the launch of a new Mercedes factory (which should produce up to 200,000 vehicles), as it might boost Hungary's exports by €5bn or 5% of GDP (1/3 of which would be added value).





Weekly preview

WED 14:00	PL Inflation (change in %)		
	May-12	Apr-12	May-11
CPI y/y	**3.9**	3.9	5.0
Food (ex Alc.) y/y	**2.2**	4.0	8.8
Transport (including fuel)	**8.9**	9.3	6.8

PL: Inflation returns below 4%

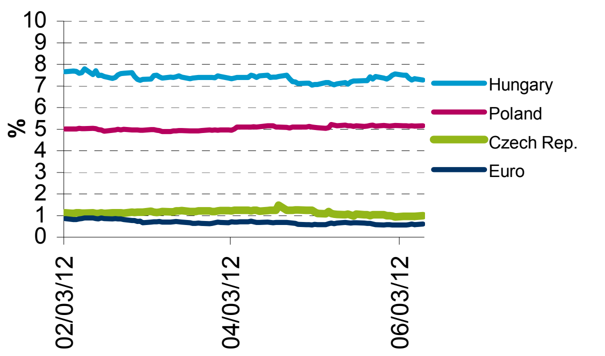
Our forecasts indicate that Poland's year-on-year inflation fell slightly to 3.9%, while month-on-month prices went up by 0.5% in May. Unlike the huge surprise of the previous month, when clothing and shoe prices were up by 3.1% m/m, the rise in these prices likely returned to less than 1% in May. Transport prices probably also rose at a slightly slower rate than usual, due in particular to a decline in oil prices, as the zloty, by contrast, weakened last month, in the wake of the worsened situation in the eurozone. For the months to come, we expect inflation to return to more than 4%, but, given the gradual deceleration of the Polish economy, this should not upset the National Bank of Poland.

Calendar

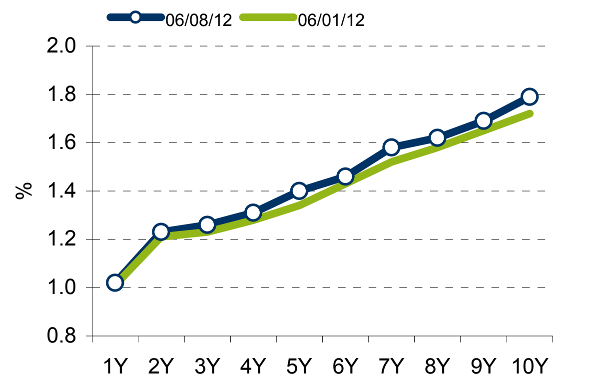
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/11/2012	9:00	CPI	%	05/2012	0.1	3.1	0.1	3.1	0	3.5
HU	06/12/2012	9:00	CPI	%	05/2012			0.2	5.7	0.8	5.7
PL	06/13/2012	14:00	CPI	%	05/2012		3.9			0.6	4
PL	06/14/2012	14:00	Money supply M3	%	05/2012					-0.5	
CZ	06/15/2012	9:00	PPI	%	05/2012	0.1	1.8	0.1	1.8	0	2.2
HU	06/15/2012	9:00	Industrial output	%	04/2012 *F					-2.4	-3.1
CZ	06/15/2012	10:00	Current account	CZK B	04/2012	-6.5		-4.1		16.83	
PL	06/15/2012	14:00	Trade balance	EUR M	04/2012					-399	
PL	06/15/2012	14:00	Current account	EUR M	04/2012					-228	
PL	06/15/2012	15:00	Budget balance	PLN M	05/2012					-24809	

Fixed-income in Charts

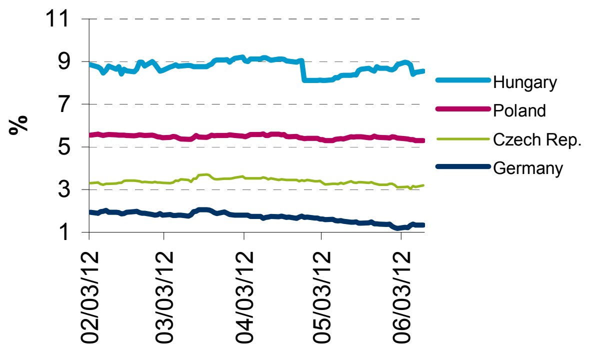
FRA 3x6



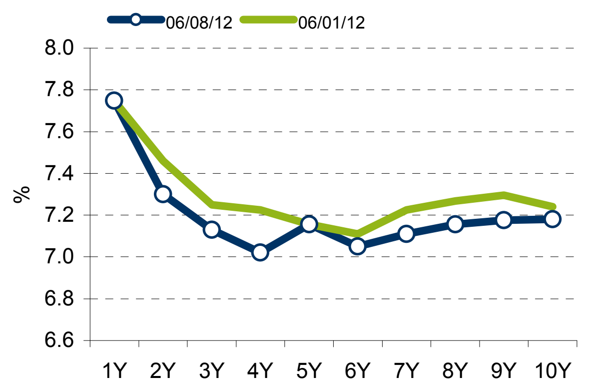
CZ IRS



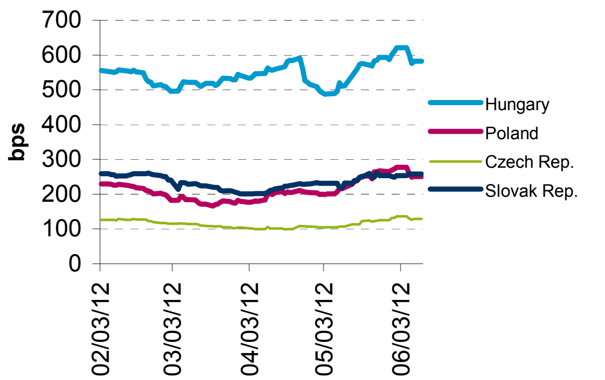
10Y GB Yields



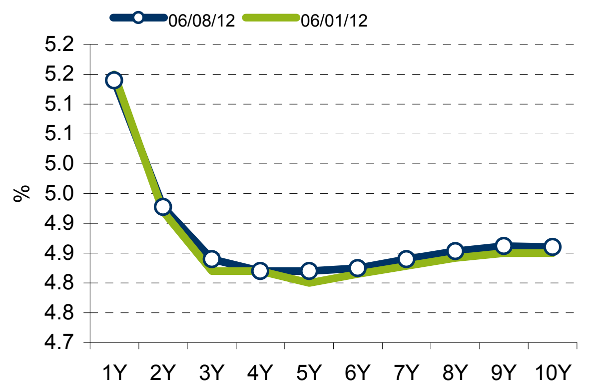
HU IRS



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.	The EU gave green light to the talks, but the IMF stated that it has also prerequisites, namely definite steps regarding the central bank's independence. They gave no further details, so the government withdrew some proposal from the central bank law's, while kept others. Currently the ball is in the IMF's court, we do not rule out that they will not accept the steps taken so far and will ask for additional changes. Of course, this will not be beneficial for the forint, but the government can take further steps before the summer break, therefore the beginning of the talks by June is not out of the question. The risk of autumn talks is that the implementation of market financing slips to the last months of the year with the risk of the market situation at that time.	According to the Polish Statistical Office, the pace of growth of the Polish economy fell to less than 4% in the first quarter of 2012. 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 continue to slow down in following quarters. 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 caused by high fuel and food prices and also by V.A.T. increase. On the other hand, weak domestic demand should counter a rise in demand-pull inflation. In spite of higher inflation the CNB still maintains its waitandsee policy. In fact there are some voices for another rate cut as two board members (incl. governor) voted for cut. So the probability of another monetary policy easening has been increasing. The first rate hike delivered by the Czech central bank is probable in 2013H2.	The April inflation in Hungary came in above expectations at 5.7% Y/Y on higher tobacco and fuel prices. This may reverse in May, when the fuel prices dropped about 5% on cheaper oil and stronger currency, but generally the trend looks to be quite negative as inflation could remain high around 5.5% and may not fall to the central bank's 3% target by the end of next year. Thus, we still believe that the next move of the MNB base rate will be down.	While the rate hike did not surprise us, owing to the well-managed communication by the NBP, we believe that it was not quite appropriate and we expect rate stability for the rest of this year. What primarily makes us believe so is the more modest rhetoric by the NBP and the expectations of the future development of the Polish economy. Its growth should decelerate significantly in the second half of the year, and this should also lead to a gradual inflation fall towards the target..
Forex Outlook	Stronger US dollar may keep further gains limited for the koruna. Also the Czech domestic factors do not look very supportive - slow continuation of real convergence and dovish CNB do not argue for dramatic gains of the Czech currency over 2012. That said, the koruna may be more vulnerable to potentially negative news from eurozone as well as to the domestic political tensions.	Leaving aside the Greek crisis, the Improved relationship with the IMF/EU should be beneficial for the forint, but the government can take further steps before the summer break, therefore the beginning of the talks by June is not out of the question. The risk of autumn talks is that the implementation of market financing slips to the last months of the year with the risk of the market situation at that time.	Zloty's fundamentals should not permit the currency perform extremely well in the short-run as the economy should slow down in second half and the rates should remain flat after the one off hike in May. During the summer we may see some renewed selling pressure after the European championship in football takes place and the Greek issue 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

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	0.50	0.50	0.50	0.50	-25 bps	5/7/2010
Hungary	2W deposit r.	*7.00*	7.00	7.00	7.00	6.50	6.25	50 bps	12/20/2011
Poland	2W inter. rate	*4.75*	4.50	4.50	4.50	4.50	4.75	25 bps	6/5/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*1.22*	1.24	1.00	1.00	1.00	1.00
Hungary	BUBOR	*7.21*	7.00	7.00	7.00	6.50	6.25
Poland	WIBOR	*5.12*	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	*1.79*	2.28	2.24	1.90	2.10	2.25
Hungary	HU10Y	*7.15*	7.10	7.50	7.75	7.50	7.25
Poland	PL10Y	*4.86*	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	*25.4*	24.8	26.0	25.2	25.0	24.5
Hungary	EUR/HUF	*296*	290	292	290	290	280
Poland	EUR/PLN	*4.29*	4.10	4.50	4.25	4.20	4.15

GDP (y/y)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	2.1	1.3	0.6	-1.0	-1.0	-0.7	0.3
Hungary	1.5	1.4	1.4	-0.7	-0.5	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	3.2	2.6	2.3

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

	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	1.8	2.4	3.8	3.3	3.3	2.8	3.0
Hungary	3.6	4.1	5.5	5.2	5.0	4.7	3.7
Poland	3.9	4.6	3.9	4.3	4.2	3.4	3.0

Current Account

	2012	2013
Czech Rep.	-2.3	-2.6
Hungary	1.5	1.0
Poland	-3.5	-3.1

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-3.3	-2.8
Hungary	-2.5	-2.2
Poland	-3.0	

Source: CSOB, Bloomberg

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