Written by ČSOB Prague and K&H Budapest

# Central European Weekly

Monday, 18 June 2012

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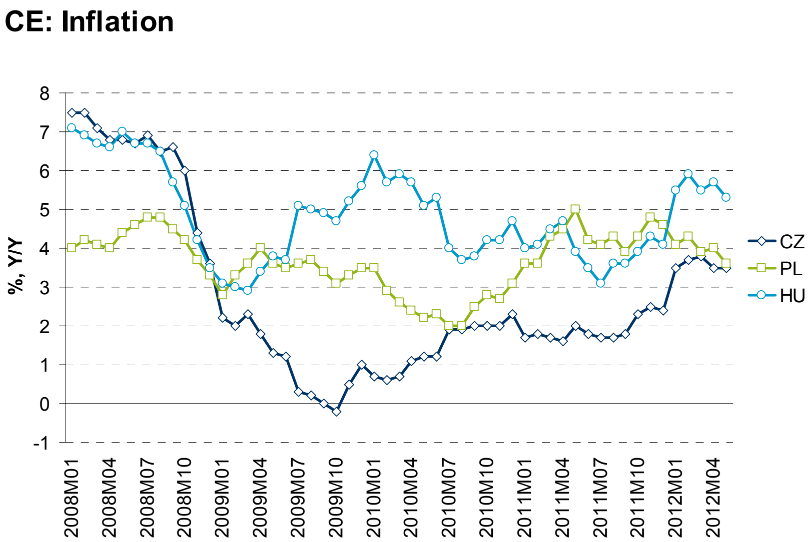
## Weekly Highlights:

- Central Europe cautiously watch developments in the eurozone after the Greek vote
- Hungary closer to a loan from the IMF
- Inflation in Hungary and Poland ease
- The MNB will stay on hold again

## Chart of the Week



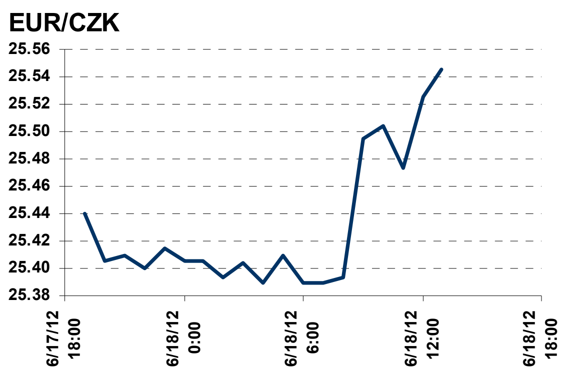

*In May, year-on-year inflation in Poland and Hungary slowed down markedly.*

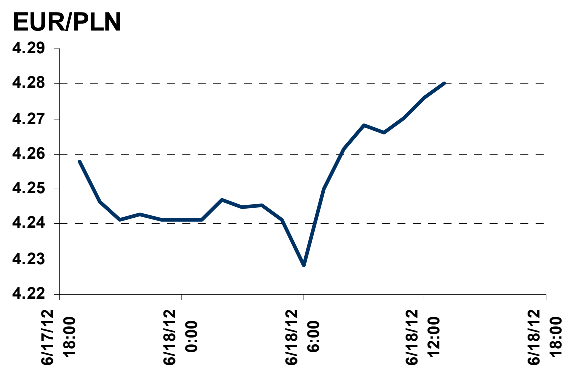
# Market's editorial

CE markets feel some short-term relief, but sentiment remains fragile. Hungary can enjoy progress in IMF talks.

Like core markets, CE markets had been waiting for results of the Greek election. Fortunately for Central Europe and other emerging markets, the results make a near-term exit of Greece unlikely. On the other hand the longer term outlook regarding euro participation (in case of Greece) is still uncertain. It is hard to see how the country may satisfy the bail-out targets (even when giving some extra time) and thus the prospect of a delayed exit won't fade rapidly. We suspect that the idea of some market participants that by giving Greece more time, the EMU is just giving itself more time to prepare for a Greek exit won't die. Also for Spain and Italy, the Greek election results are no game changer.

That is why, we still remain cautious in terms of regional markets too. Although CE currencies and partly credit markets have already felt some relief, this could easily prove just temporary, if vulnerable bond markets in the EMU do not recover. The only exception could be (to some extent) Hungarian markets as the Minister responsible for the IMF talks said that there is 99% chance to reach an agreement. He also said that the government will submit new proposal about the central bank law this week, which means that it could be approved at the end of June or aerly July.  The IMF may assess it then and if its positive, Hungary may finally start negotiations.




| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | 25.4 | -1.21% | ↗ | ↗ |
| EUR/HUF | 292 | -1.81% | ↗ | ↗ |
| EUR/PLN | 4.25 | -1.79% | ↗ | ↗ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| 10Y CZK | 1.91 | 7.61 | ↗ | ↗ |
| 10Y PLN | 6.93 | -1.56 | ↗ | ↗ |
| 10Y HUF | 4.84 | -0.82 | ↗ | ↗ |

# Review of Economic Figures

## Inflation eases in Hungary and Poland in April

Poland, just like Hungary, saw May's prices go up at a slower rate than expected, with May's inflation having decelerated to 3.6% y/y, thus hitting the lowest level since February 2011. Regarding the structure, we saw the greatest surprise in the decline of transport prices, which is, seasonally, very unusual for May. Likewise, housing prices, which rose at a slower rate than we expected, also contributed to the fall.

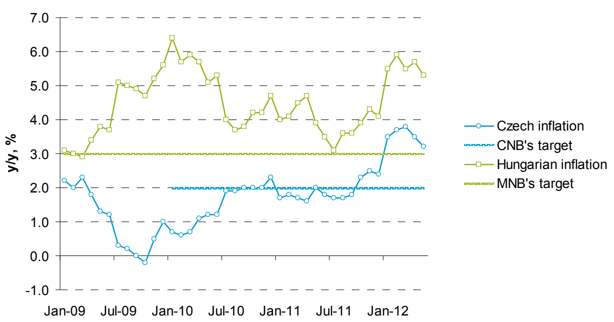
After April's greatest rise ever (+3.1% m/m), clothing prices fell slightly this time, thus also contributing to the somewhat surprising overall CPI figure. Although we believe that Poland's inflation will rise again to more than 4% in the summer, due to the football championship and the weaker zloty, the latest figure reassures us that the central bank (NBP) might not necessarily resort to rate hikes again, because end-of-year inflation may even fall below the upper threshold of the tolerance band of the NBP, against the backdrop of significantly decelerating economic growth.

Hungary's May inflation data came in well below expectations and the previous month's data as the consumer price index dropped to 5.3% Y/Y from 5.7% Y/Y and core inflation also lowered to 4.8% Y/Y. Fuel and energy prices are still pushing the inflation higher, but the same effect from food prices are slowly fading and this time they increased just 4.1% Y/Y, which is an important effect due to the relatively high share in the basket. Durable good prices lowered a bit during the month, which could be attributed to the stronger forint.

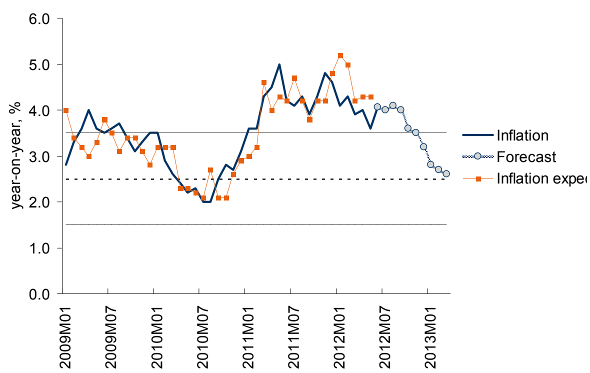
Regarding the outlook, the oil company has just announced 1-2% lower prices in June, which may help the overall index to lower further. Stripping off the effect of the higher taxes, inflation would have been 3.1%, very close to the 3% target, which may allow the central bank to keep its wait-and-see mode.

The May inflation in the Czech Republic slightly exceeded market expectations, with the consumer price index (CPI) going up by 0.2% y/y. The main contributors to this price rise included food, followed by tobacco products, although, with the latter lagging significantly behind the former. By contrast, given the decline in oil prices on global markets, fuel prices began declining for the first time in over six months. Year-on-year inflation fell from April's 3.5% to the current 3.2%, thus standing 0.2% below the CNB forecast. Monetary policy inflation returned to the central bank's 2% target level. We believe that although headline inflation will remain above 3% in the months to come, it is likely to develop slightly better than indicated by the latest CNB forecast. This, along with a worse-than-expected performance of the Czech economy, encourages the calls for a rate cut by the central bank, which is why the two-week repo rate is likely to be cut by 0.25% as early as at the June meeting of the CNB Board (June 28) for the first time in two years..

**CZ, HU: Annual Inflation**




**PL: Inflation**



# Weekly preview

| TUE 14:00 | MNB base rate | |
|---|---|---|
| | **This meeting** | Last change |
| rate level (in %) | **6.00** | 1/2011 |
| change in bps | **0** | 25 |

## The MNB still waits for the end of IMF's talks

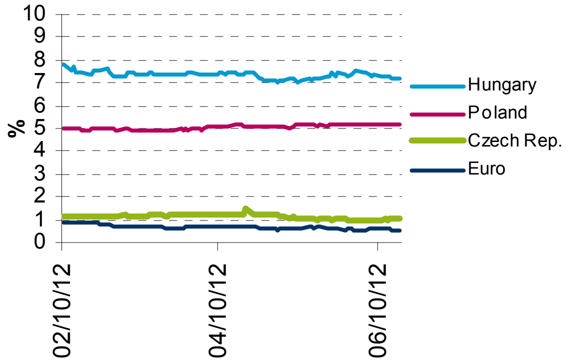
Although the May inflation surprised on the downside the MNB base is expected to remain unchanged, because the forint is still quite weak and demand for bonds and other assets are volatile. We think the first cut could come next month if the negotiations with the IMF get close after the government submits a new modification about the central bank law in two weeks.

# Calendar

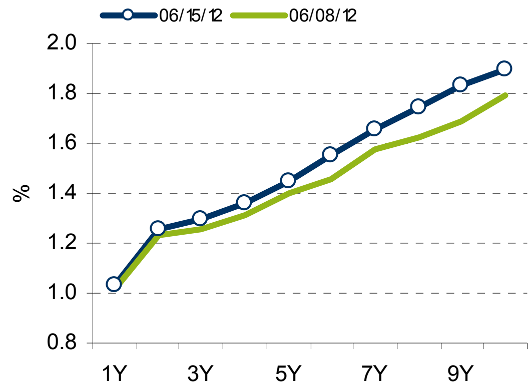
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 06/19/2012 | 9:00 | Wages | %, ytd. | 04/2012 | | | | 4 | | 2.7 |
| PL | 06/19/2012 | 14:00 | Wages | % | 05/2012 | | | -2.5 | 4.1 | -1.3 | 3.4 |
| PL | 06/20/2012 | 14:00 | Core CPI | % | 05/2012 | | | 0.3 | 2.7 | 0.5 | 2.7 |
| PL | 06/20/2012 | 14:00 | Industrial output | % | 05/2012 | | | 2.9 | 2.5 | -7.5 | 2.9 |
| PL | 06/20/2012 | 14:00 | PPI | % | 05/2012 | | | 0.5 | 5 | 0.6 | 4.3 |

# Fixed-income in Charts

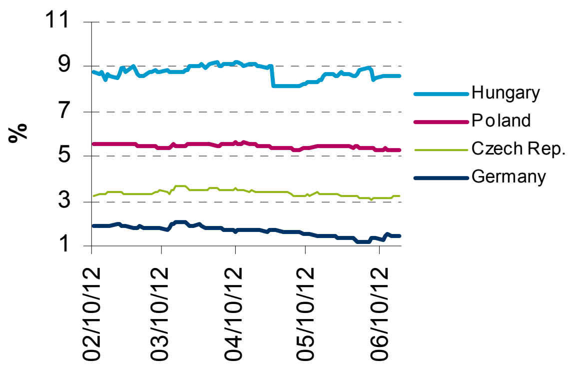
## FRA 3x6



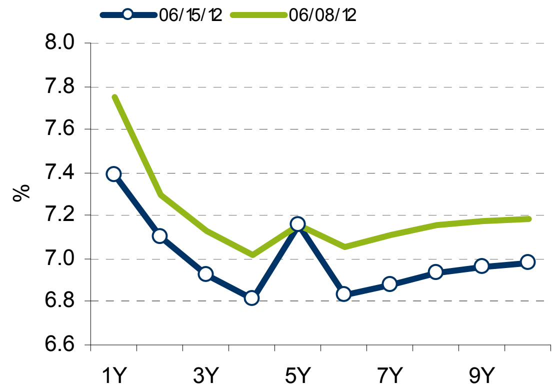

## CZ IRS



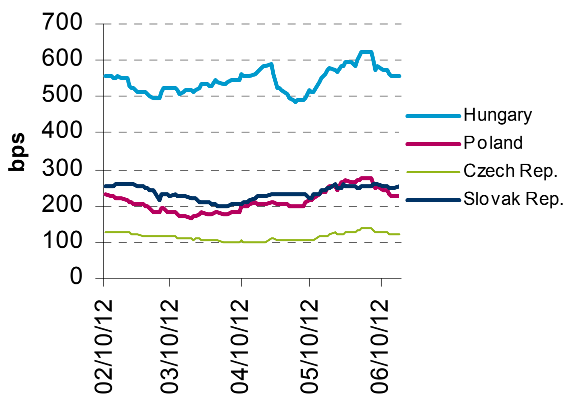

## 10Y GB Yields



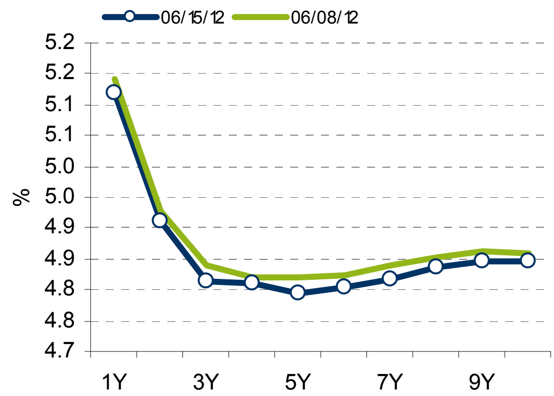

## HU IRS




## CDS 5Y




## PL IRS



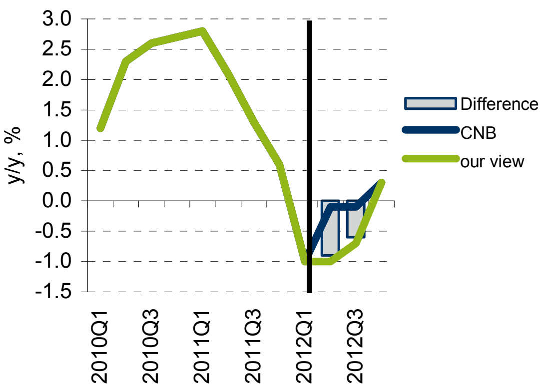

Source: Reuters

# Medium-term Views & Issues

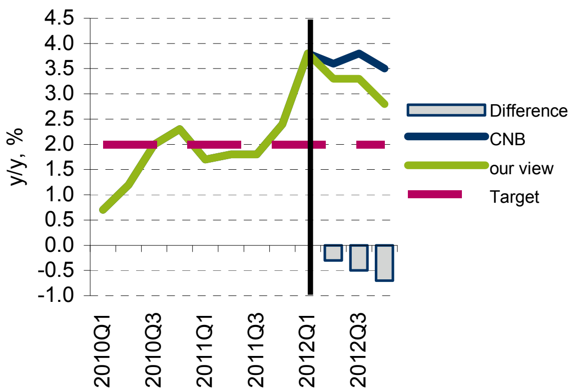
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition 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

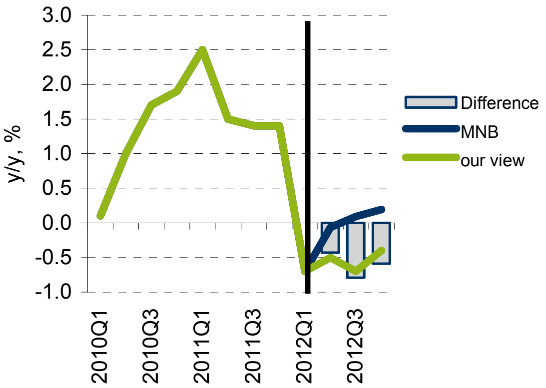
## CZ: GDP Outlook



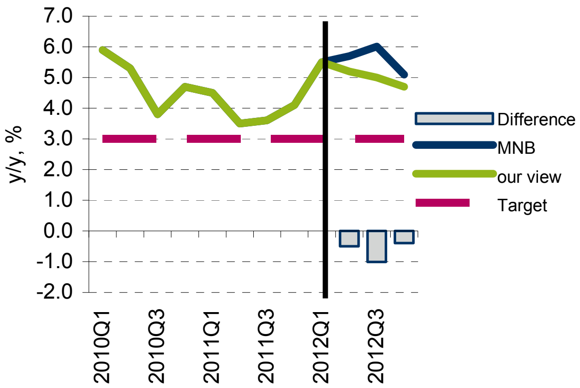

## CZ: Inflation outlook



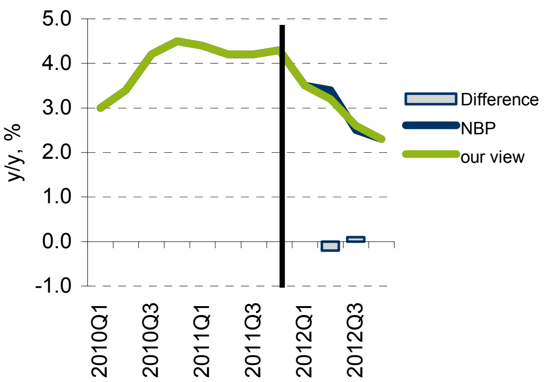

## HU: GDP Outlook



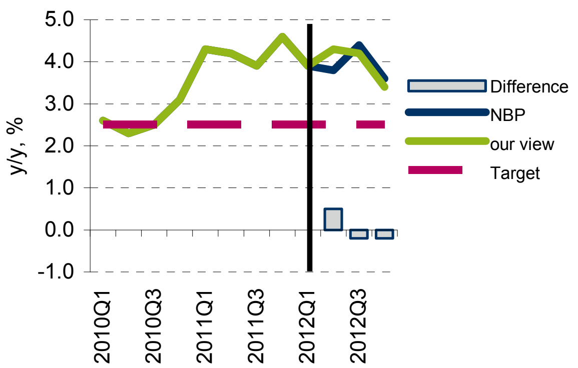

## HU: Inflation outlook




## 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 | 0.50 | 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 | *7.20* | 7.00 | 7.00 | 7.00 | 6.50 | 6.25 |
| **Poland** | WIBOR | *5.11* | 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 | *1.91* | 2.28 | 2.24 | 1.90 | 2.10 | 2.25 |
| **Hungary** | HU10Y | *6.93* | 7.10 | 7.50 | 7.75 | 7.50 | 7.25 |
| **Poland** | PL10Y | *4.84* | 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 | *292* | 290 | 292 | 290 | 290 | 280 |
| **Poland** | EUR/PLN | *4.25* | 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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