# Central European Weekly

Tuesday, 03 July 2012

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## Weekly Highlights:

- The CNB cuts its base rate to fresh all-time lows
- The koruna as a financing currency for carry trade?
- Polish PMI at 35-month lows
- The NBP will leave official rates unchanged

**Dear clients, please note that the next CE Weekly will be released on 16th July 2012.**

## Chart of the Week: Czech official rates

*Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while the Czech inflation remain at the lowest levels.*

# Market's editorial

The summer silly season is slowly approaching, evidence of which is the increased activity of economic policymakers in both Western and Central Europe, so that important matters need not be tackled during the summer holidays.

Such events include the rate cut by the Czech National Bank as well as significant progress in the implementation of legislative changes to Hungary's Central Bank Act. Bear in mind that the IMF and the ECB require the changes from the Hungarian Government, so that both institutions can approve a loan to help Hungary overcome its difficult repayment schedule.

Although both the cut in the official interest rate of the Czech Republic and the positive conclusion of the talks between the IMF and the Hungarian Government had been anticipated for a few days or even weeks, these events may have longer impacts on Central European markets; above all, the costs of financing speculative positions in Czech korunas have again fallen (the one-month PRIBOR has dropped to 0.76%) on the one hand, while, on the other hand, the good prospects for Hungary complying with the conditions for obtaining the IMF loan have substantially improved the view of the Hungarian economy in fundamental terms. In terms of market practice, this could make CZK-HUF carry trades even more attractive. The market implication of such speculative behaviour speculators, who will borrow money in the low-yielding CZK and invest it in the high-yielding forint, may be that, if the summer sentiment improves, the Czech koruna will lag behind the forint as well as the zloty. Otherwise, the correlation between the koruna and the other risky assets in the region may weaken significantly or even be negative (see the table below).

FX Correlation Matrix

| | EUR/PLN | EUR/HUF | EUR/USD | EUR/CHF |
|---|---|---|---|---|
| EUR/CZK | 0.24 | 0.28 | -0.48 | -0.29 |
| EUR/PLN | | 0.44 | -0.42 | -0.10 |
| EUR/HUF | | | -0.55 | 0.11 |
| EUR/USD | | | | 0.12 |

correlations of 30 min changes over past 5 sessions

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | *25.5* | *-1.62%* | ↘ | ↘ |
| EUR/HUF | *286* | *-0.07%* | ↘ | ↘ |
| EUR/PLN | *4.22* | *0.14%* | ↘ | ↘ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| 10Y CZK | *1.96* | *3.98* | ↘ | ↘ |
| 10Y PLN | *6.70* | *-0.89* | ↘ | ↘ |
| 10Y HUF | *4.74* | *-0.63* | ↘ | ↘ |

# Review of Economic Figures

## A new all-time low for the CNB repo rate

The Czech National Bank met expectations and cut its base interest rate by 25 basis points to a new all-time low of 0.50%. The market had anticipated this, and therefore it came as no surprise to the koruna. After all, calls for a rate cut have been increasingly heard from the CNB recently. In the end, the vote was fairly narrow, 4:3, with three members voting for rate stability.

The result of the vote confirmed the CNB forecast, which is consistent with a decline in market interest rates for the remainder of this year, followed by a rise in rates as from the second half of 2013.

In addition, at the post-meeting press conference, it was stated that the risks were skewed towards the alternative 'fiscal' scenario, which envisaged even lower rates, albeit under higher headline inflation (if the tax changes proposed are passed by Parliament). As Governor Singer pointed out multiple factors had favoured the rate cut: a lower current inflation rate, a worse development of the Czech economy, an anticipated cut in euro rates, and lower commodity prices.

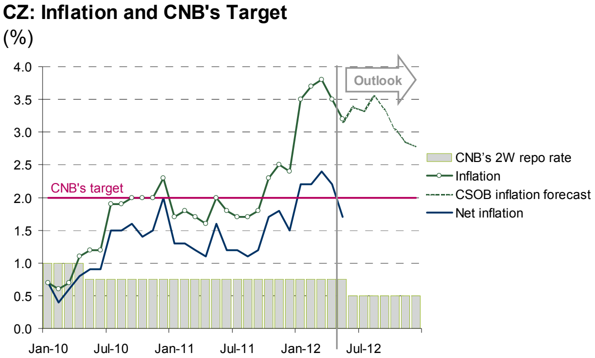
Thus, the CNB sees major risks in the fiscal consolidation (with a negative impact on demand), developments abroad, weaker domestic economic activity, and domestic price developments. By contrast, the central bank views a weaker koruna exchange rate as the major risk on the upside.

In our view, this was likely the last rate cut in this easing cycle, which might be followed by a fairly long period of stability now. That said, monetary conditions are also being eased by a weaker koruna, and thus the CNB might not opt to cut rates even closer towards zero, even if the alternative (negative) scenario were actually to happen.

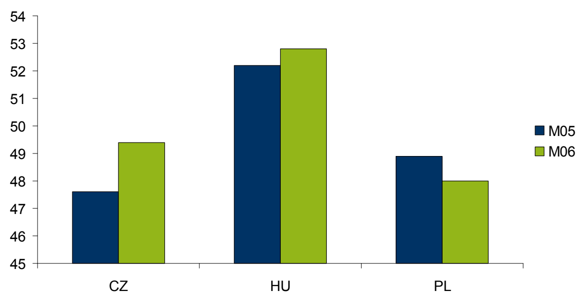
## Polish PMI hits 35-month low

Fresh PMI figures for June pointed to a deterioration of business sentiment in Poland whereas the overall index slightly improved in Hungary and the Czech Republic. However, despite the improvement, the Czech PMI still remains below the key 50 points level. In Poland, overall PMI index fell to 35-month low and unlike the Czech index surprised on the downside of expectations. Hence, it might be interesting to follow comments of Polish central bankers as well as take a closer look at the new inflation report which will be discussed at the upcoming meeting.

CZ: Inflation and CNB's Target




CE PMI



# Weekly preview

## The Czech Republic: Retail sales growth negative

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

| | May-12 | Apr-12 | May-11 |
|---|---|---|---|
| Sales | **-2.0** | -4.1 | 3.7 |
| cummulative (YTD) | **-0.6** | -0.3 | 4.5 |

May's retail sales likely remained in the red. Consumer demand continues to be weak, car sales are also decelerating, and May's sales were also reduced by the lower number of business days in the month. The consumer mood is not improving to any great extent, and thus we do not expect better figures for the months to come either.

## Poland: The NBP will leave rates unchanged

**WED, app. 13:00** **NBP rate (in %)**

| | This meeting | Last change |
|---|---|---|
| rate level | **4.75** | 05/2012 |
| change in bps | **0** | 25 bps |

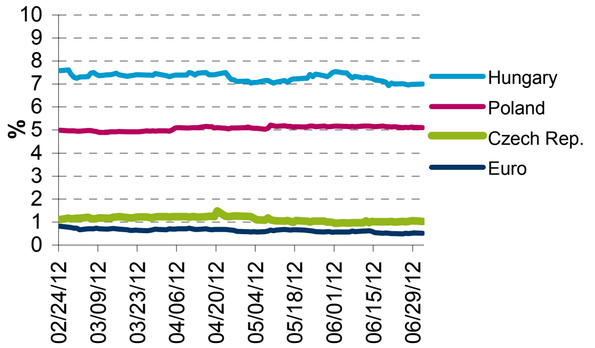
Although we expect Poland's inflation to climb to more than 4% again in the summer, in relation to the European Football Championship and a weaker zloty, May's surprising decline to just above the upper threshold of the tolerance band of the National Bank of Poland reassures us that the central bank (NBP) may not necessarily resort to a rate hike again. That said, end-of-year inflation might even fall below the upper threshold of that tolerance band, against the backdrop of significantly decelerating economic growth. These tendencies should be confirmed by a new inflation report, which will be available to the Monetary Policy Council at its Wednesday meeting.

# Calendar

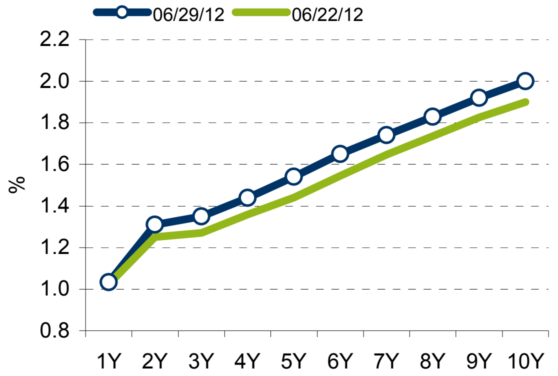
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 06/25/2012 | 9:00 | Retail sales | % | 04/2012 | | | | -0.3 | | 0.9 |
| PL | 06/26/2012 | 10:00 | Unemployment rate | % | 05/2012 | | | 12.6 | | 12.9 | |
| PL | 06/26/2012 | 10:00 | Retail sales | % | 05/2012 | | | 0.7 | 7.3 | -2.4 | 5.5 |
| HU | 06/26/2012 | 14:00 | NBH meeting | % | 06/2012 | 7 | | 7 | | 7 | |
| HU | 06/28/2012 | 9:00 | Unemployment rate | % | 05/2012 | | | 11.3 | | 11.5 | |
| CZ | 06/28/2012 | 12:30 | CNB meeting | % | 06/2012 | 0.5 | | 0.5 | | 0.75 | |
| HU | 06/29/2012 | 8:30 | Current account | HUF B | 1Q/2012 | | | 132 | | 149 | |
| HU | 06/29/2012 | 9:00 | PPI | % | 05/2012 | | | | 7.1 | 0.3 | 7.1 |
| CZ | 06/29/2012 | 11:00 | Money supply M2 | % | 05/2012 | | | | | | 6.5 |
| PL | 06/29/2012 | 14:00 | Current account | EUR M | 1Q/2012 | | | -3623 | | -4964 | |

# Fixed-income in Charts

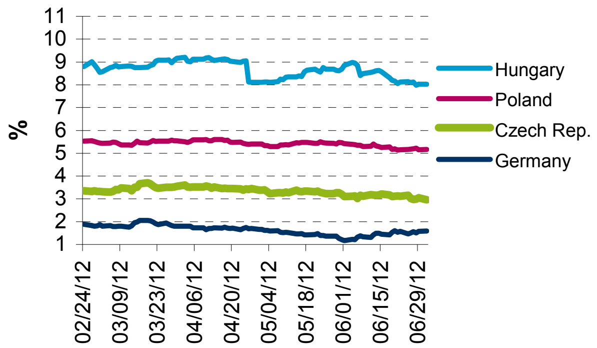
## FRA 3x6



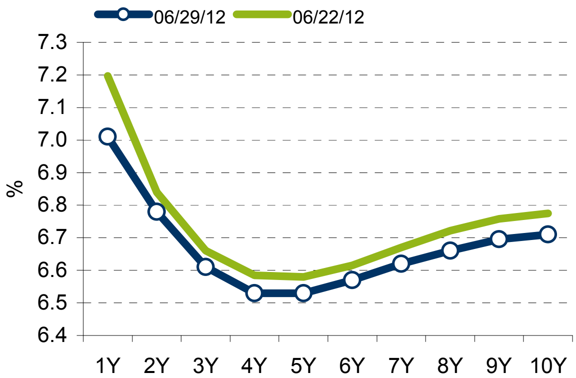

## CZ IRS



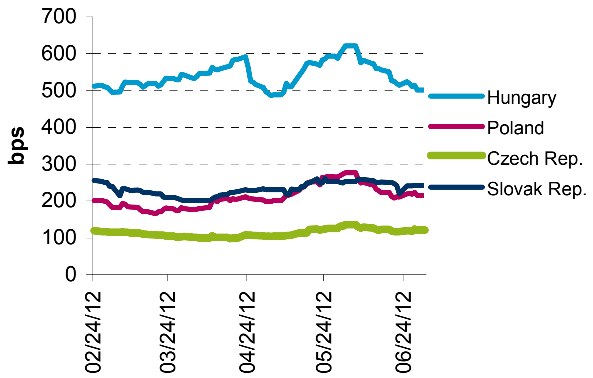

## 10Y GB Yields



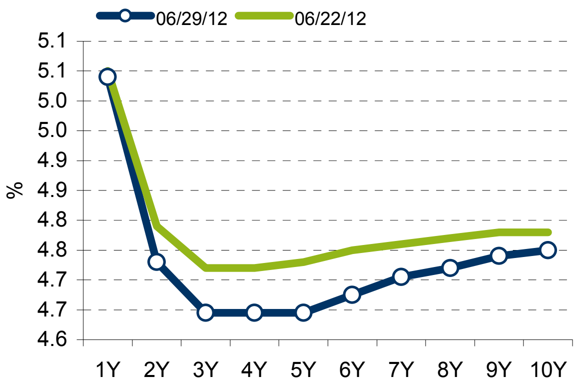

## HU IRS




## CDS 5Y




## PL IRS



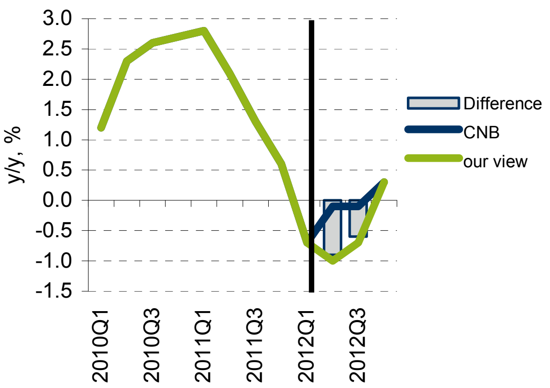

Source: Reuters

# Medium-term Views & Issues

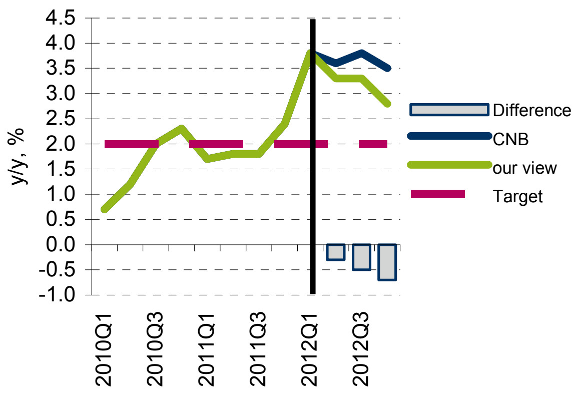
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition 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.. | The IMF accepted the most recent modification to the central bank law. This means that negotiations may start soon, according to the government around mid-July. The government said that the end date could be between mid-September and end-October.<br>The government announced new tax cuts worth Ft300bn funded 1/3rd from budgetary reserves and 2/3rd from extending the transaction tax onto the central bank and state treasury. In case of the latter, it is only a temporary funding because the state owns both institutions. Although it has not yet been communicated, it may mean that revenue side will be used in 2013 and expenditure side in 2014. | 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. | Shrinking domestic demand may keep inflationary pressures low and from this side rate cuts could come in Hungary. On the other hand foreign demand for Hungarian bonds is still important and this may go against this.<br>We think the MNB could cut around 75-100bps in aggregate, also depending on external conditions. | 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 inflation target (2.5%). |
| 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 (euro) crisis, the improved relationship with the IMF/EU should be beneficial for the forint in the medium-term. | Zloty's fundamentals should not permit the currency perform 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 might takes place.<br>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

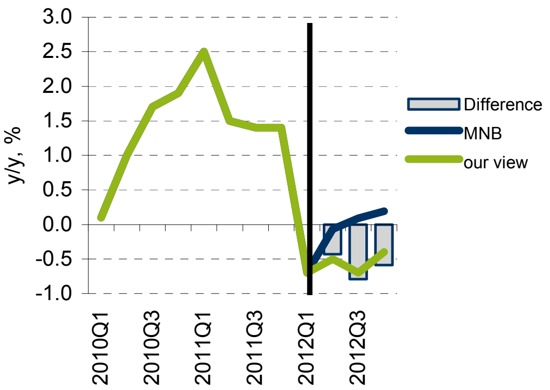
## CZ: GDP Outlook



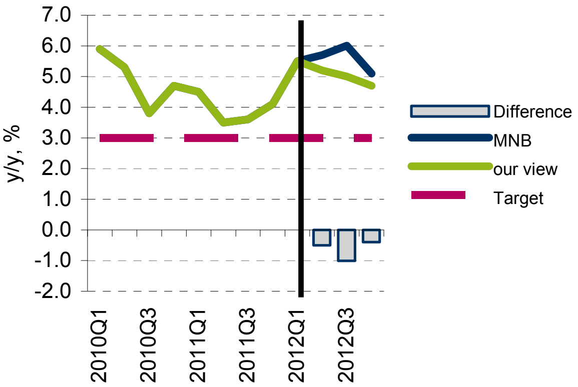

## CZ: Inflation outlook



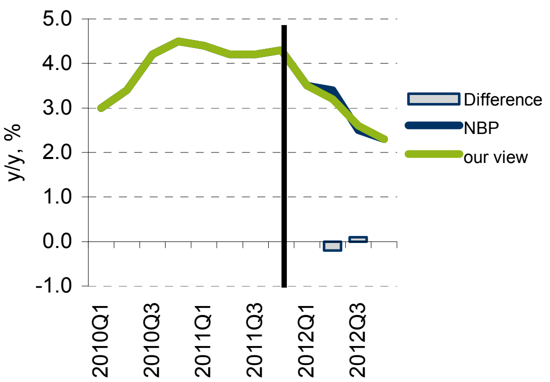

## HU: GDP Outlook



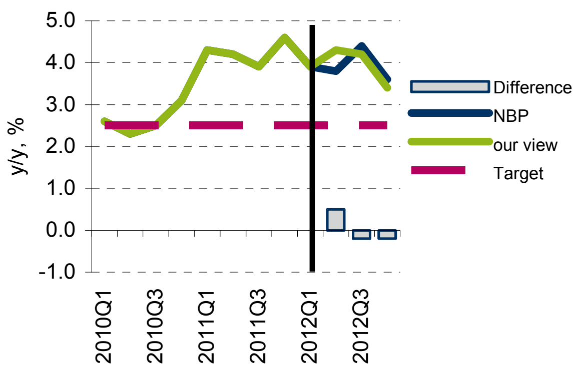

## HU: Inflation outlook




## 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 | *0.50* | 0.75 | 0.50 | 0.50 | 0.50 | 0.50 | -25 bps | 6/29/2012 |
| **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 | *1.08* | 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 | *5.13* | 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 | *1.961* | 2.28 | 2.24 | 1.90 | 2.10 | 2.25 |
| **Hungary** | HU10Y | *6.70* | 7.10 | 7.50 | 7.75 | 7.50 | 7.25 |
| **Poland** | PL10Y | *4.73* | 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 | *25.5* | 24.8 | 26.0 | 25.2 | 25.0 | 24.5 |
| **Hungary** | EUR/HUF | *286* | 290 | 292 | 290 | 290 | 280 |
| **Poland** | EUR/PLN | *4.22* | 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 | -0.7 | -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** | -4.3 | -3.7 |

*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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