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Central European Weekly

Tuesday, 25 September 2012

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Weekly Highlights:

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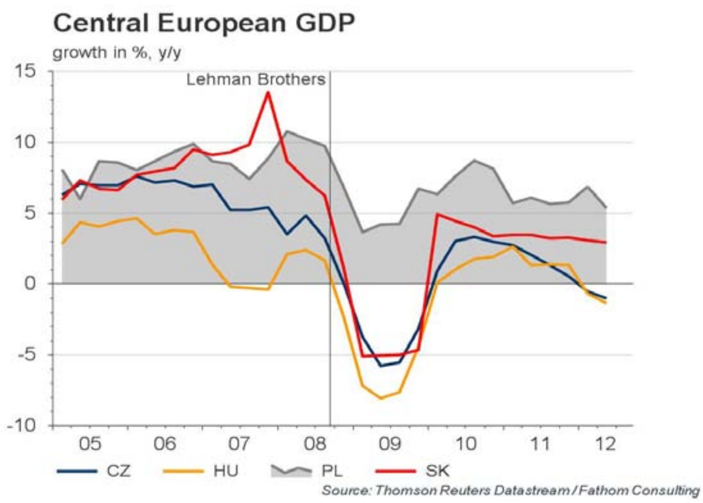
Chart of the Week



Despite GDP slowdown. Poland still by far outperforms its regional neighbours

Market's editorial

The Hungarian parliament and the CNB in focus

Events in Central European markets are usually determined by the behaviour of the core markets; nevertheless, from time to time, economic policy makers in Central Europe are temporarily able to influence the behaviour of the regional markets. This may happen in the coming week, with Czech National Bank set to have a very interesting meeting (Thursday) and another major event being the session of the Hungarian Parliament, which will today start to discuss legislation related to the 2003 budget bill.

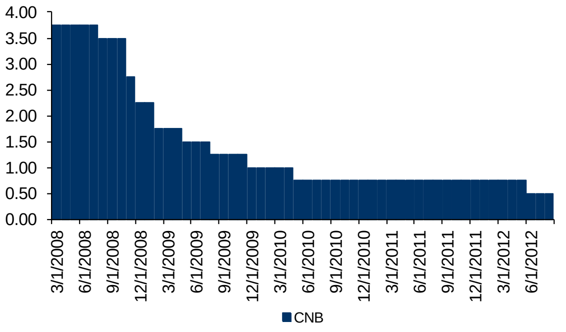
As concerns the CNB, the tension ahead of its Board meeting was heightened by Governor Singer himself, who gave what amounted to a public endorsement of the idea of the Czech Republic getting involved in global monetary wars. These have been going on for some time among the central banks of developed countries, in an effort to add more inflation to their respective economies (in order to eliminate part of their debts) and to weaken their respective local currencies (in order to encourage exports and consequently the economy as a whole). At a time of virtually zero official interest rates, central bankers even resort to non-standard monetary instruments to attain the above aims. These include interventions against their own currency, purchases of bonds to be added to the central bank's balance, promises to keep rates low for a long time and, finally, easing the conditions for holding the collateral in repo operations. CNB Governor Singer has made it clear that he is not opposed to the use of such non-standard ammunition. He as well as the CNB Board is well aware that, in the case of the Czech Republic, certain instruments will be more effective, while others less so. Should such measures be taken in the end, even after a repo rate cut to a record-low of 0.25% (which our base-line scenario), we believe that they would most likely include an expansively impacting intervention against the koruna, or CNB gives some stronger forward guidance to keep interest rates low for a prolonged period (or strongly stick to the Inflation report implies such a scenario). On the other hand, given very low consensus in the Bank Board in these kind of issues, we see very little likelihood that non-standard steps would employed at the moment.

In Hungary, the focus will be on Parliament as the 2013 budget law might be modified to incorporate the governments 'employment defence program' that will cost about 1% of GDP. The controversial financial transaction tax is planned to cover this additional expense, but taxing the central bank will not be supported by the ECB and thus may have to be replaced by other measures. Still there is a good chance that the ruling party might risk a negative market reaction and the transaction tax against the MNB will be confirmed.

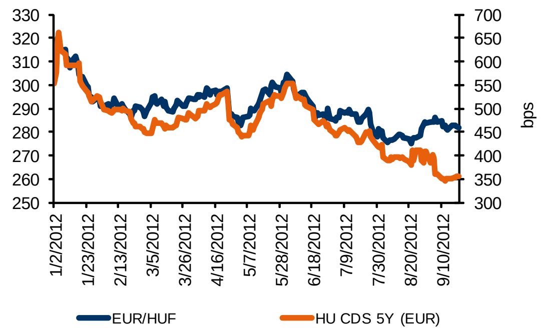
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.9	0.23%	↗	→
EUR/HUF	283	0.11%	↗	→
EUR/PLN	4.15	0.83%	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.71	-2.29	↘	↘
10Y HUF	6.53	-0.99	↗	→
10Y PLN	4.48	-0.55	↘	↘

Official interest rate



CDS vs. exchange rate against the euro



In Focus

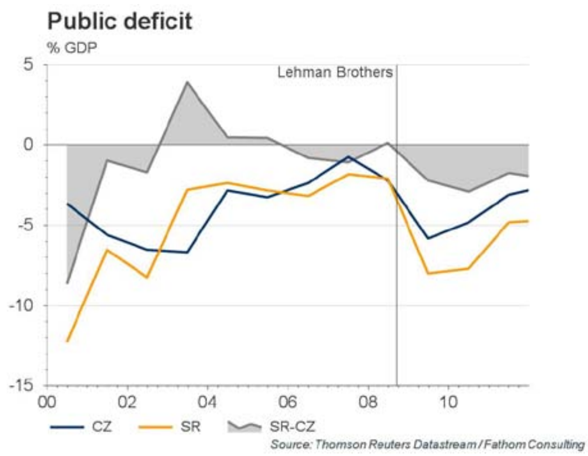
The Czech-Slovak decoupling?

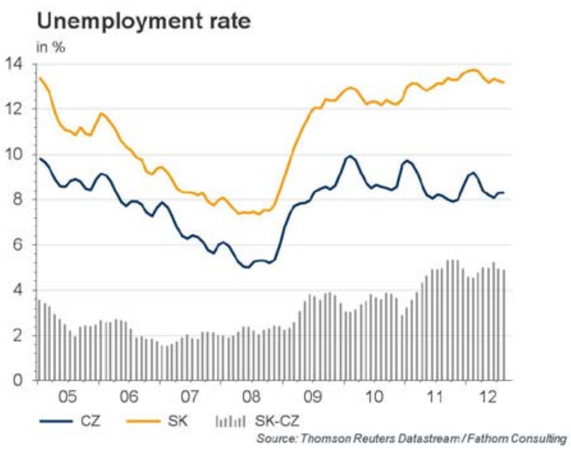
The poor performance of the Czech economy at this point is hardly attributable to the euro-crisis. Czech exports are faring extremely well, whereas Czech households are experiencing the greatest decline in consumption in modern history. Such a rapid cut in household consumption did not even occur after the fall of Lehman Brothers, when the global economy survived its 'clinical death'.

At first glance, the Slovak economy is faring much better; however, regional comparisons are not always quite fair. While the Slovak economy is growing much more rapidly, this is due to its even better export performance and the greater weight of foreign trade in its overall GDP, rather than only due to domestic demand. The rate of Slovak exports is almost double, while household consumption, just like in the Czech Republic, is also falling (albeit much less).

Also, Slovakia's unemployment rose higher during the crisis and remains higher (around 13%) than that of the Czech Republic. The difference between Czech unemployment and Slovak unemployment is close to eight-year highs, and there is evidently little left out of Slovakia's export-driven growth for Slovak consumers. Retail sales in the Czech Republic are falling even more rapidly than in Slovakia, because of a more rapid consolidation of Czech public budgets; however, Slovakia will also need to tackle its budget consolidation in the end.

Thus, from this point of view, there are no major differences between the Czech and Slovak economies. The question to ask is not whether or not Czechs or Slovaks would deserve to grow faster. It is now much more about the quality of reforms and their mid-term benefits that financial markets are calling for.





Weekly preview

TUE 14:00 MNB base rate

	This meeting	Last change
rate level (in %)	6.75	8/2012
change in bps	0	-25

The MNB will not go against the market this time

The central bank will again face a difficult decision about the base rate on Tuesday. The new Inflation Report - due a day later - will likely see higher inflation and lower growth for 2013-2014, hence there will be strong arguments on both sides. The interest rate curve has not changed much sinve the August decision, so the market is looking for a rate cut every two months implying the next one in October. The IMF/EU talks are still uncertain and this makes a quick rate cut risky. Overall, we think decision and accompanying statement will broadly meet market expectations.

THU 13:00 CNB base rate

	This meeting	Last change
rate level (in %)	0.25	6/2012
change in bps	-25	-25

The CNB will cut its repo rate to fresh all-time lows

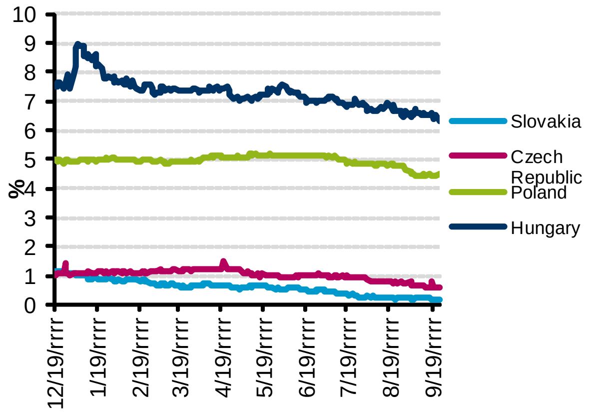
At its September meeting, the CNB Board is likely to cut its two-week repo rate again, to a new all-time low of 0.25%. The fact that the debate on a possible rate cut is not yet over is indicated by the outcome of the CNB Board's last vote, when two out of six members were in favour of a rate cut. Meanwhile, additional unfavourable figures came from the economy, indicating a faster drop in GDP and consumption in the second quarter of the year and slightly lower inflation. Hence dovish calls to signal another rate cut started to be heard from the CNB. Not only the weaker performance of the economy but also the deterioration of the outlook for the euro area and the development of the Euribor favour a rate cut. Even the possible use of non-standard instruments, of which the CNB Governor has spoken in general in the media recently, may be discussed at the forthcoming CNB Board meeting. Nevertheless, we see very little likelihood that non-standard steps would be not only discussed but also employed at the moment.

Calendar

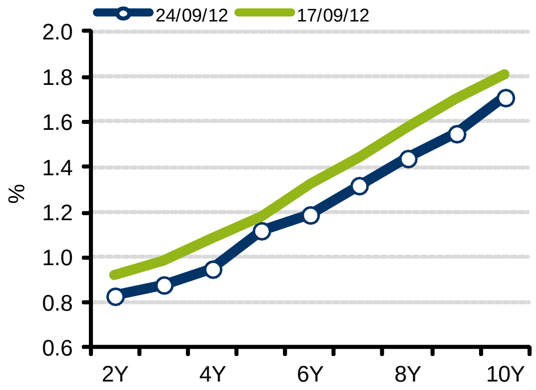
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	09/24/2012	9:00	Retail sales	%	07/2012				-1.9		-1.7
PL	09/25/2012	10:00	Unemployment rate	%	08/2012			12.3		12.3	
PL	09/25/2012	10:00	Retail sales	%	08/2012			0.1	5.5	1.3	6.9
HU	09/25/2012	14:00	NBH meeting	%	09/2012	6.75		6.75		6.75	
CZ	09/27/2012	11:00	Money supply M2	%	08/2012						6.3
CZ	09/27/2012	12:30	CNB meeting	%	09/2012	0.25		0.25		0.5	
HU	09/28/2012	8:30	Current account	HUF B	2Q/2012			550		186	
HU	09/28/2012	9:00	PPI	%	08/2012				5.1	-0.4	6.2
HU	09/28/2012	9:00	Unemployment rate	%	08/2012			10.5		10.5	
PL	09/28/2012	14:00	Current account	EUR M	2Q/2012			-2700		-4344	

Fixed-income in Charts

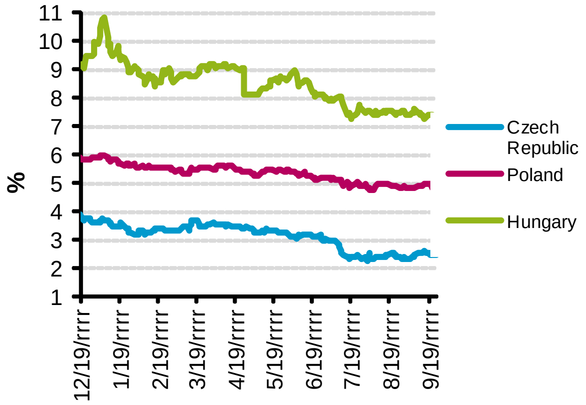
FRA 3x6



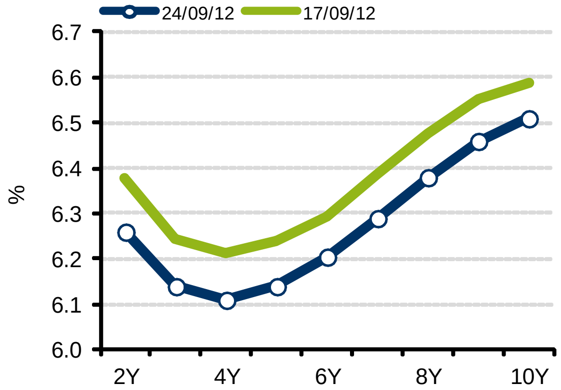
CZ IRS



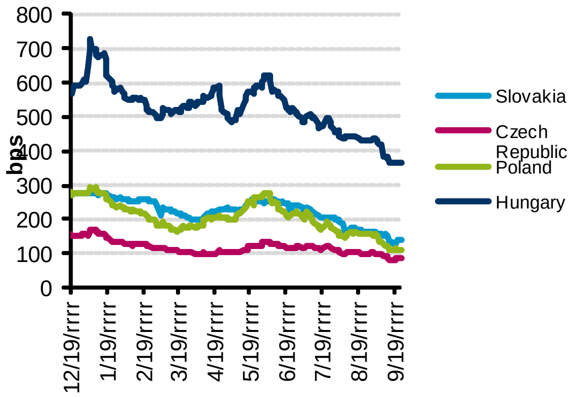
10Y GB Yields



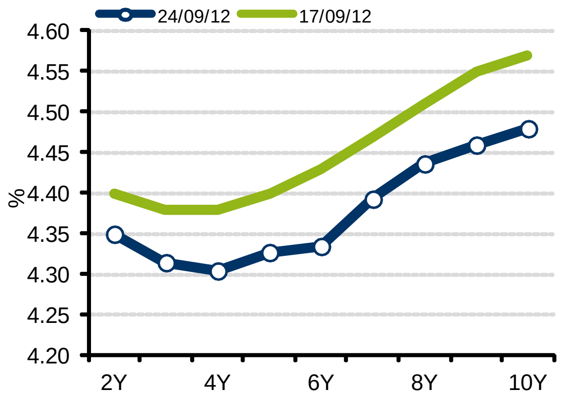
HU IRS



CDS 5Y



PL IRS



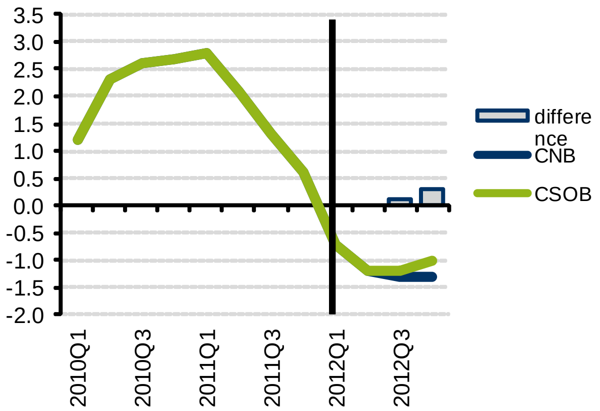
Source: Reuters

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. 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 2.4% in the second 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, although at a more moderate pace. 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. Therefore, we expect that the Polish economy might grow by about 2.5% in 2012.
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 cut its base rate to 0.5% in June. Another rate cut can be expected in Autumn as the GDP as well as inflation have been falling faster than the CNB expected.	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. For now we continue to see the space for one more 25 bps cut by the end of the year and 50bps more in 2013.	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. For now the deteriorating macro-figures start to argue for a rate cut. However this might not come till November when inflation expectations cool down and new forecast is on the table.
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 euro zone at the beginning of the autumn and may come back above 25.00 EUR/CZK.	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 slows down and the Central bank is about to change its course. At the beginning of the autumn we may see some renewed selling pressure as uncertainties around ECB intervention on the secondary markets and Greek package may weigh on CE currencies.

CBs' Projections vs. Our Forecasts

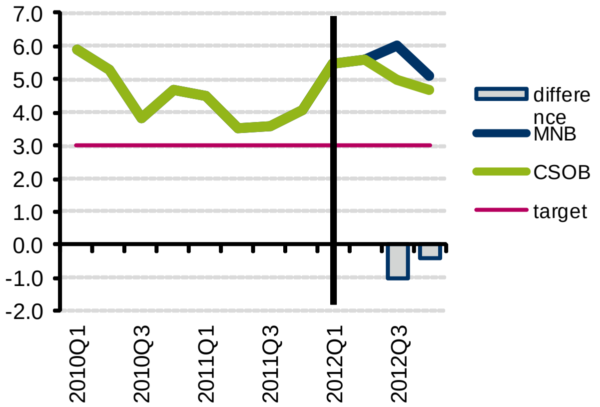
CZ: GDP outlook (Y/Y, %)



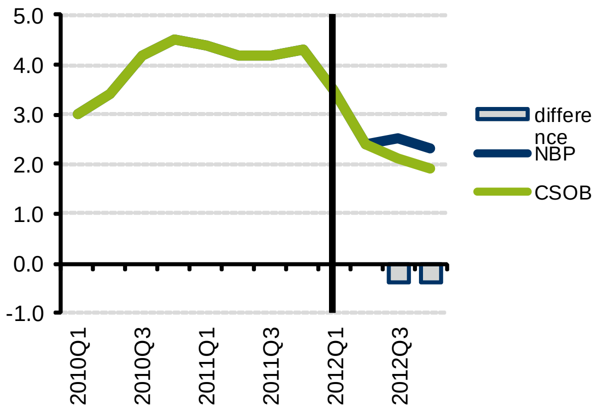
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)

HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)

Zdroj: ČNB, NBP, MNB, ČSOB

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	0.25	0.25	0.25	-25 bps	6/29/2012
Hungary	2W deposit r.	*6.75*	7.00	7.00	6.75	6.50	6.50	-25 bps	8/28/2012
Poland	2W inter. rate	*4.75*	4.50	4.75	4.75	4.50	4.50	25 bps	6/5/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*0.84*	1.28	1.03	0.70	0.70	0.70
Hungary	BUBOR	*6.86*	7.25	7.20	6.70	6.50	6.40
Poland	WIBOR	*4.94*	4.94	5.13	4.80	4.80	4.90

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	CZ10Y	*1.71*	2.25	2.02	1.60	1.70	1.80
Hungary	HU10Y	*6.53*	7.36	6.71	6.75	7.50	7.25
Poland	PL10Y	*4.48*	4.95	4.74	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*24.9*	24.8	25.5	24.2	24.9	24.5
Hungary	EUR/HUF	*283*	294	286	290	290	280
Poland	EUR/PLN	*4.15*	4.14	4.22	4.10	4.30	4.15

GDP (y/y)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	2.1	1.3	0.6	-0.7	-1.2	-1.2	-1.0
Hungary	1.5	1.4	1.4	-0.7	-1.2	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	2.4	2.1	1.9

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

	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	1.8	2.4	3.8	3.5	3.3	2.9	2.9
Hungary	3.6	4.1	5.5	5.6	5.0	4.7	3.7
Poland	3.9	4.6	3.9	4.3	4.0	3.2	2.7

Current Account

	2012	2013
Czech Rep.	-2.2	-1.9
Hungary	1.5	1.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-3.0	-3.8
Hungary	-2.5	-2.2
Poland	-3.5	-4.0

Source: CSOB, Bloomberg

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