Central European Weekly

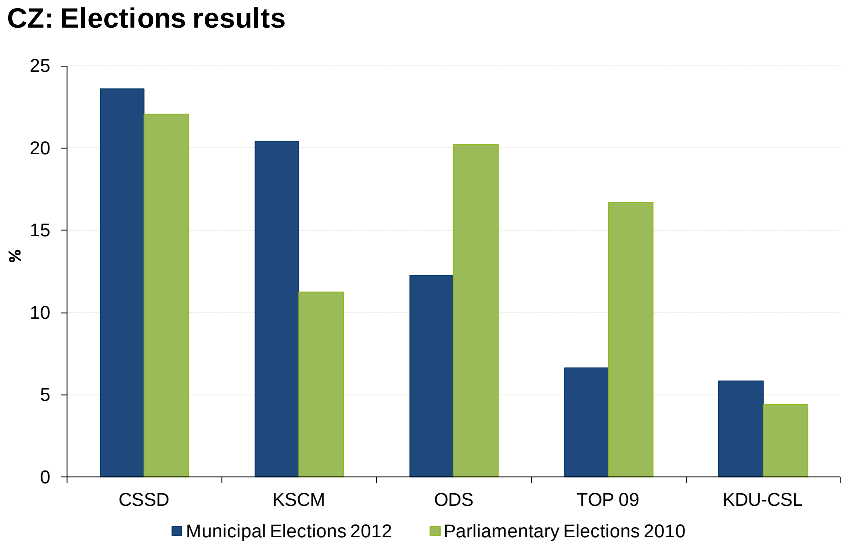
Tuesday, 16 October 2012

Table of contents

Weekly Highlights:

- While Czech mainstream parties saw big losses in regional elections, the CZK and bonds remain stable
- The NBP starts to play a catch-up game with its PEER's
- The Hungarian inflation extends its divergence from the NBH target

Chart of the Week



The communist party (KSCM) obtained the most votes since the Velvet Revolution.

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Market's editorial

While Czech mainstream parties saw big losses in regional elections, the koruna and bonds remain stable so far...

The Czech elections (regional and first round of Senate) brought unpleasant surprise to the ruling center-right coalition. Leftist Social Democrats (CSSD) was the outright winner, with 23.6% of the vote and victories in nine of the 13 regions, but it lost 75 seats in the regional assemblies, to 205. The Communists were the big winners in the regional elections. They took 20.4% of the total vote and increased their seats in the regional assemblies by 68, to 182. Meanwhile, the governing coalition won only one region.

The election results clearly strengthened the rebels in the largest coalition party (ODS). According to the Czech daily Pravo the rebels may be willing to bring down the government ahead of Presidential elections to help outgoing president Vaclav Klaus to reinstall its influence in ODS. Although it is only a speculation, the risk of early elections clearly grows in the Czech Republic.

The crucial test for the government comes at the end of the month, when the Parliament should vote once again on the controversial tax package. The government has decided to combine with the vote on the tax package the vote of confidence. Few days later there is the election congress of ODS, where the position of Prime Minister Petr Necas is going to be questioned.

The Czech koruna is typically not very susceptible to domestic political tension. At present, however, investors focus their attention, much more than in the past, on budgetary discipline, and an escalation of political tension (early elections) would certainly take the wind out of the sails of Czech bonds as well as the koruna.

The NBP plays a catch up game with its PEER's

As expected, the NBP is quickly starting to ease what has been its fairly hawkish position, compared to the central banks in other countries in the region (including the ECB). Although, at the press conference held after the NBP's last meeting, NBP Governor Belka stood by the decision to leave interest rates unchanged, stating that the central bank wished to wait for new data, this has evidently not happened. Even the hawks in Poland's Monetary Policy Council are quickly calling for a cut in the official interest rate at the next meeting, and some even proposed the rates may be cut by more than the usual 25 basis points. Nevertheless, we believe that such an aggressive move cannot be expected from the NBP for numerous reasons, one of which is the fact that the NBP insists on real interest rates remaining positive; given the inflation rate and its expectations at 4%, this rules out any rapid cuts in the base interest rate.

While Poland's campaign for monetary easing has just started, it is already in full swing in the Czech Republic and Hungary. Bear in mind that even after the rate cut to 0.25% in the Czech Republic, the CNB has not stopped making dovish statements, still threatening to intervene against the koruna. In Hungary, by contrast, the monetary conditions are being eased through the falling real interest rates, while the NBH is still only watching inflation diverge from its target.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.0	-0.10%	→	↘
EUR/HUF	279	-1.58%	↘	↘
EUR/PLN	4.09	0.30%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.61	-3.01	→	↗
10Y HUF	6.25	-3.70	→	↗
10Y PLN	4.34	-2.03	→	→

Review of Economic Figures

Further signs of recession in the Czech economy

The August decline in the production of the Czech economy's largest sector was surprisingly dramatic, as it dropped by 3.1% in real terms, albeit orders in the previous months had looked quite promising. Car production, which has fuelled industry thus far, also fell this time. The question is how much this was due to holidays, production changes, or a strong comparative baseline, and to what extent this represents a new trend that would topple the Czech economy in the second half of the year. New orders were also poor – both domestic and foreign. Moreover, the greatest decline in orders also hit carmakers, but their orders had increased by almost 42% a month earlier, followed by metal producers, and the engineering sector. As indicated by the latest figures, the Czech economy is likely losing its last certainty, i.e., its growing export-oriented industry. As domestic demand is still strongly subdued, the data in the months to come is unlikely to be very encouraging.

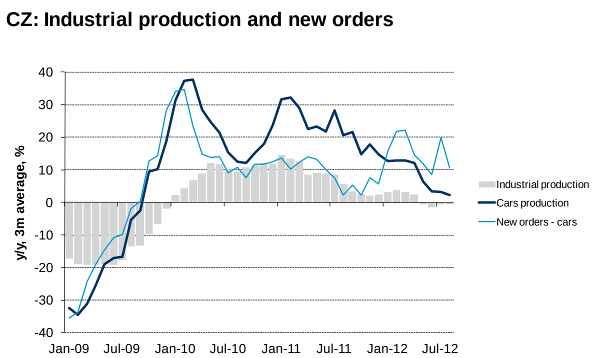
Although at first glance the rise in the trade balance surplus (to CZK 287 bn annually), along with rapidly rising exports (+7.9%), would not seem to be indicating any hitch in foreign demand, certain signals, in addition to the above-mentioned worsened industrial orders, are evident. These primarily include a month-on-month decline in exports and the fact that the latest figures are partly overvalued (in accounting terms) by the weakened koruna. Moreover, exports are continuing to develop depending on the success of carmakers, which are succeeding in extending their positions in the declining European and the growing Asian markets. Nevertheless, the future development of the Czech economy's strongest sector – industry – will not be clearer until the data on new orders is released at the beginning of next month.

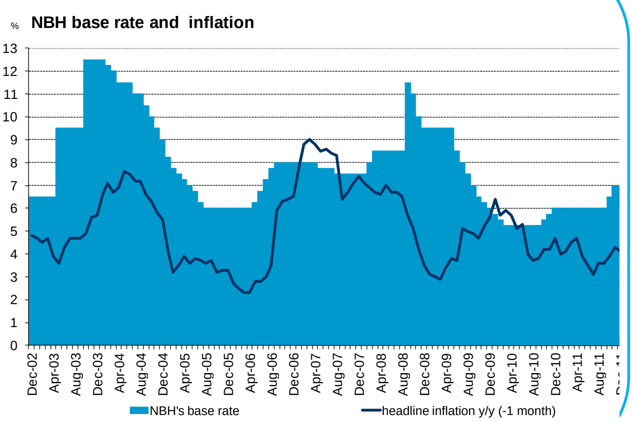
The economic recession is also triggering layoffs, as signalled by the 1% decline in industrial employment, a 5% drop in the number of employees in construction, as well as the rising unemployment rate in the whole economy, which increased to 8.4% last month and is already 0.4% higher than in the same month of last year. The unemployment increase is partly attributable to school-leavers, the number of whom was almost 10,000 this time, and partly due to the cyclical deceleration of the economy. Concern about unemployment, also fuelled by the currently rising number of those who are unemployed, along with this year's drop in real income, are worsening consumer confidence, curbing consumption, and continuing to deepen the cyclical depression of the economy. In addition, unemployment is most likely to continue to rise in late 2012, when it may climb to 9%.

Hungary's inflation extend its divergence from the target

The inflation rate in Hungary is continuing to accelerate. September's year-on-year inflation already hit 6.6%, with month-on-month prices (an increase by 0.4%) being primarily fuelled by the increased food and petrol prices. Nonetheless, core inflation also went up, and has already climbed to 5.3% (y/y).

Although the inflation rate continues to diverge from the long-term target of the National Bank of Hungary (3.0%), the mostly dovish Monetary Council is unlikely to be upset by this – due also to the fact that the last inflation forecast basically anticipated such an increase. As usual the NBH may be discouraged from its intention to cut rates again by the rapid depreciation of the forint rather than by high inflation.



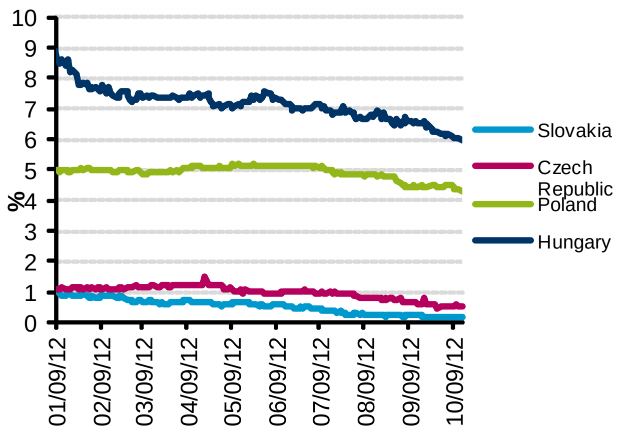


Calendar

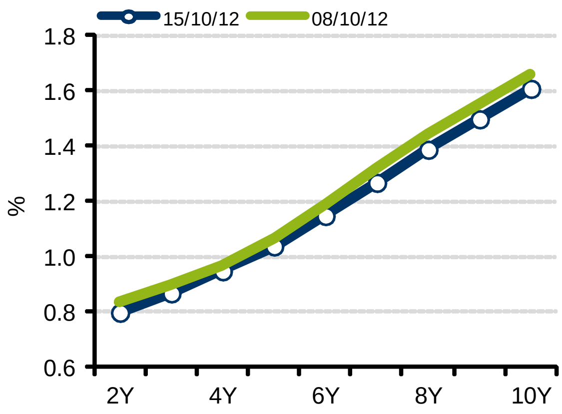
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	10/15/2012	9:00	PPI	%	09/2012	0.4	2.1	0.3	2	0.5	1.9
CZ	10/15/2012	10:00	Current account	CZK B	08/2012	-22		-18.5		-11.5	
PL	10/15/2012	14:00	CPI	%	09/2012	0.3	4	0.2	3.9	-0.3	3.8
PL	10/15/2012	14:00	Current account	EUR M	08/2012			-1050		-1027	
PL	10/15/2012	14:00	Trade balance	EUR M	08/2012			-445		-314	
PL	10/15/2012	15:00	Budget balance	PLN M	09/2012					-22935	
PL	10/16/2012	14:00	Wages	%	09/2012			-0.1	2.7	-0.4	2.7
PL	10/17/2012	14:00	Industrial output	%	09/2012			7.8	-3.7	-0.8	0.5
PL	10/17/2012	14:00	PPI	%	09/2012			0.3	1.7	0.1	3.1
HU	10/18/2012	9:00	Wages	%, ytd.	08/2012				4.9		7.1

Fixed-income in Charts

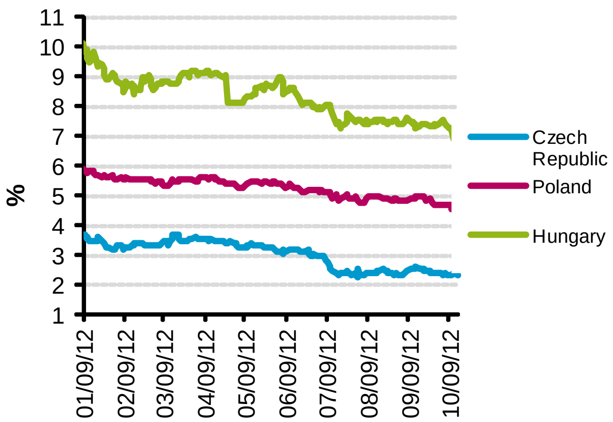
FRA 3x6



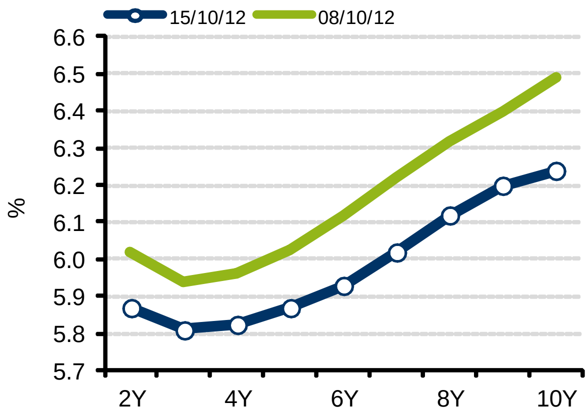
CZ IRS



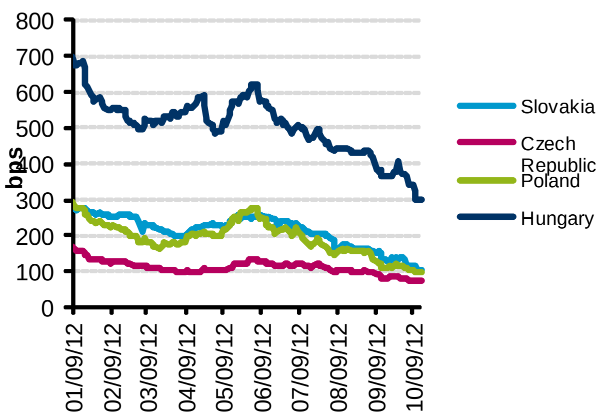
10Y GB Yields



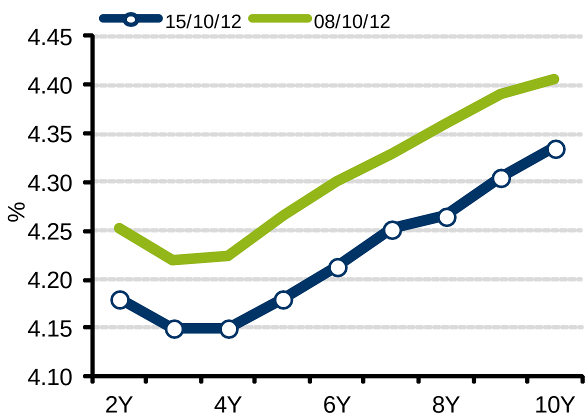
HU IRS



CDS 5Y



PL IRS



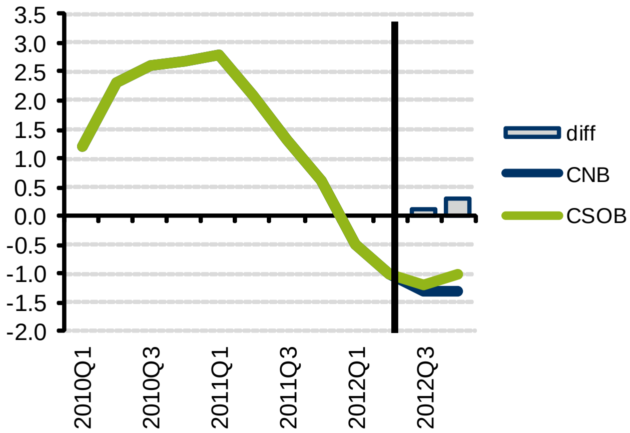
Source: Reuters

Medium-term Views & Issues

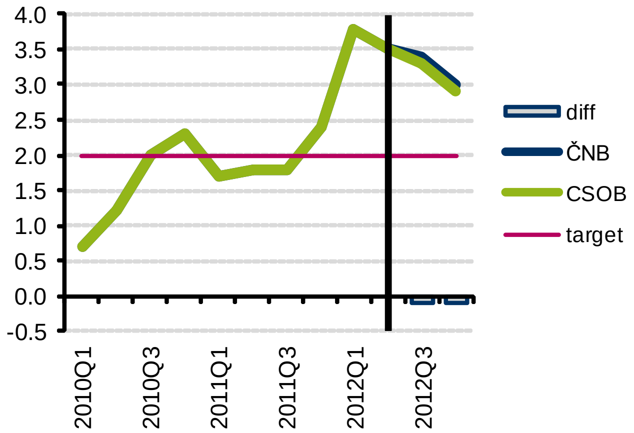
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion 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 Outlook for official & market rates 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 a new all-time low of 0.25% in September.	The MNB cut its base rate twice by 25 bps in two months so the base rate stands at 6.5%, although the headline inflation is back above 6%. We think the last decision was too risky and market expectation for a gradual rate easing of 25bps every second month would have been a better strategy. Further weakening of the currency however may trigger substantial increase of short-term rates and thus could act as a defence, especially if council members indicate that the easing cycle could stop.	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	CNB willingness to intervene against the koruna should play against the currency in the near term. Also the Czech domestic factors do not look very supportive - slow continuation of real convergence That said, the koruna may be more vulnerable to potentially negative news from euro zone at the beginning of the autumn and may go further 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 slow 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

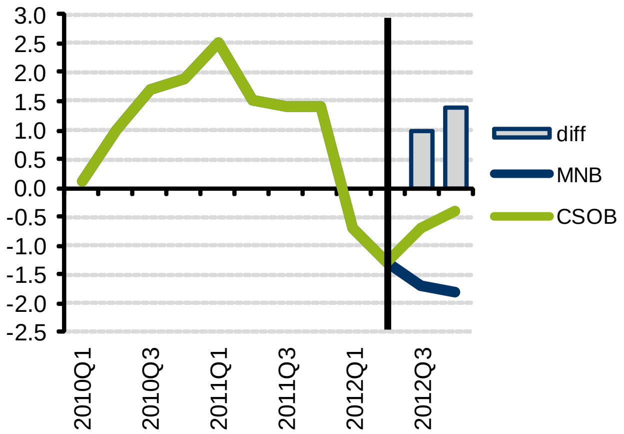
CZ: GDP outlook (Y/Y, %)



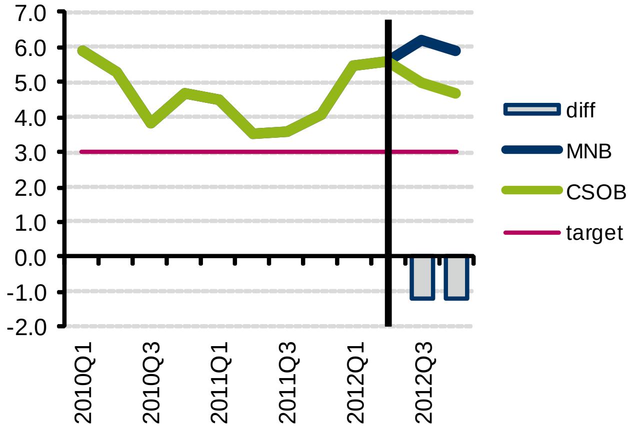
CZ: Inflation outlook (Y/Y, %)



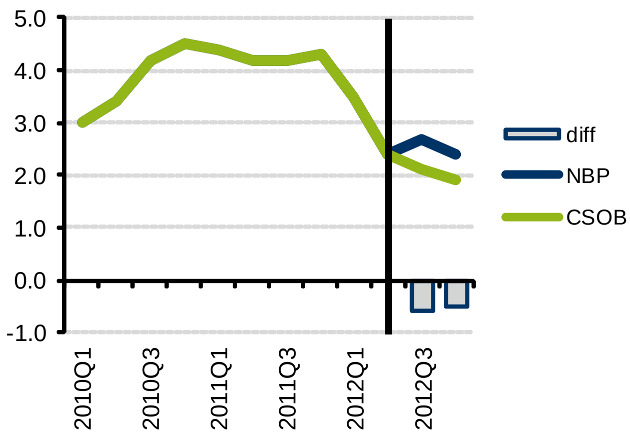
HU: GDP outlook (Y/Y, %)



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	*0.25*	0.75	0.50	0.50	0.25	0.25	-25 bps	9/27/2012
Hungary	2W deposit r.	*6.50*	7.00	7.00	6.50	6.50	6.50	-25 bps	9/25/2012
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	*0.71*	1.28	1.03	0.80	0.70	0.70
Hungary	BUBOR	*6.57*	7.25	7.20	6.61	6.50	6.40
Poland	WIBOR	*4.8*	4.94	5.13	4.92	4.80	4.90

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	CZ10Y	*1.61*	2.25	2.02	1.61	1.70	1.80
Hungary	HU10Y	*6.25*	7.36	6.71	6.56	7.50	7.25
Poland	PL10Y	*4.34*	4.95	4.74	4.39	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*25.0*	24.8	25.5	25.1	24.9	24.5
Hungary	EUR/HUF	*279*	294	286	285	290	280
Poland	EUR/PLN	*4.09*	4.14	4.22	4.11	4.30	4.15

GDP (y/y)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	2.1	1.3	0.6	-0.5	-1.0	-1.2	-1.0
Hungary	1.5	1.4	1.4	-0.7	-1.3	-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	3.7	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.	-3.3	-2.8
Hungary	-2.5	-2.2
Poland	-3.5	-4.0

Source: CSOB, Bloomberg

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