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Central European Weekly

Monday, 22 October 2012

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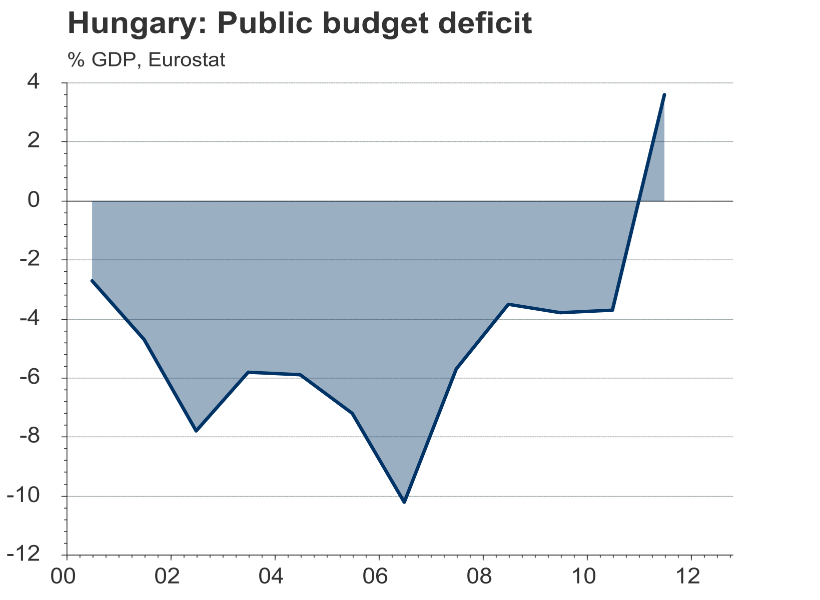
Weekly Highlights:

- The Czech left won constitutional majority in the Senate. Will the ruling coalition survive?
- The Hungarian government unveil fresh fiscal tightening to keep the deficit below 3% of GDP
- The Polish economy continues to decelerate
- In focus: The New Polish leading indicator

Chart of the Week



Just in two weeks time the Hungarian government announced HUF 764 billion of fiscal measures. It shows that government's commitment too keep the budget deficit under 3% in 2013 seems to be firm

Market's editorial

The Czech left won constitutional majority in the Senate

The second round of the Czech Senate elections confirmed the victory of the Left. Together three leftist parties won a constitutional majority of 60% in 81-seat Senate. Although it does not change much for now – as the main coalition party ODS has already needed an agreement with leftist CSSD to push through constitutional changes – the majority in the Senate will give the Left the power to decide on the appointment of eight judges to the 15-seat Constitutional court.

As early as this Wednesday, the Czech government may face a confidence vote as a condition attached to the second vote on controversial tax package. After the lost elections, the position of the Prime Minister Necas seems to be weaker. He has not yet succeeded in persuading the rebels within his own party (ODS), who seem to be playing tactical games ahead of the ODS summit scheduled for November. Although we believe, the government can survive this week, the vote is going to be narrow.

The Hungarian cabinet unveil fresh budget cuts

The European Commission said that the previous package announced 2 weeks ago is not enough to meet the deficit target for 2013. Because of this the Ministry for National Economy implements HUF 367 billion of new fiscal measures, and in the calculations they don't include the favorable effects of an EU/IMF agreement. Overall in two weeks time the government announced HUF 764 billion of fiscal measures. Market reaction was mixed to the news. On one side the government's commitment to keep the budget deficit under 3% seems to be firm, which is definitely positive and the forint reacted with intensive strengthening. At the same time the stock exchange began to fall. The contents of the package can divide the EU and the IMF, as the government chooses from the alternative solutions additional taxes providing only a temporary solution instead of structural re-forms. In the prevailing dual economy structure there is still no emphasis on supporting Hungarian companies which create higher added value. It seems to be clear that the rush with the 2013 budget during the summer was hardly a success as the government wanted to get some commendation for it but the budget did not prove to be reliable. It raises more concerns that the budget needs to be amended from time to time. One reason for this could be that economic growth is much worse than the government thought. The Ministry for National Economy expected 0.1% GDP growth for this year in September, which they revised down to -1.2% in the last 2 weeks. Worse economic performance gives less budget income, which makes more and more fiscal measures necessary. The deficit target for this year had to be raised from 2.5% to 2.7%. The Ministry's recent forecast expects 0.9% growth in 2013 and 2% in 2014. It is hard to assess the inflationary impact of the package, but upward risks strengthened and it remains to be seen whether these growth forecasts can be sustainable.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.9	0.29%	↗	↗
EUR/HUF	279	0.12%	↗	↗
EUR/PLN	4.10	0.45%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.68	3.00	↗	↗
10Y HUF	6.24	1.96	↘	↘
10Y PLN	4.34	-0.80	↗	↗

Review of Economic Figures

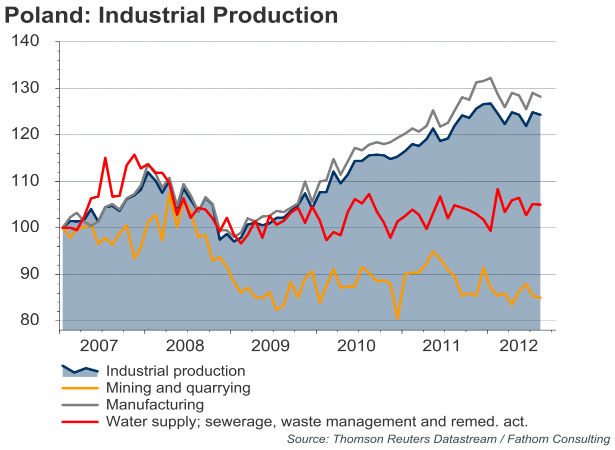
The Polish economy decelerates; a rate cut is on the horizon

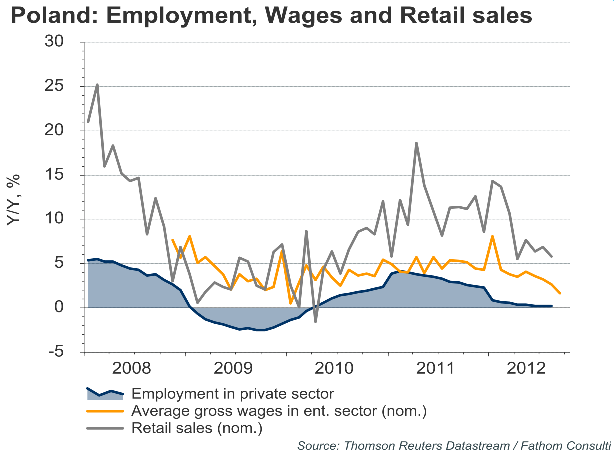
The data released in Poland last week left no one in any doubt that a rate cut is on the horizon. The Statistical Office confirmed that the inflation rate was falling, while the industrial output and average wage data indicated a lower (or a potentially lower) performance of the real economy.

Inflation stagnated at 3.8% Y/Y in September, which was a moderately pleasant surprise. The main reason for the slower than expected price rise was food, the prices of which fell slightly compared to August (unlike in the Czech Republic and Hungary, where food prices went up). Bear in mind that, according to the minutes of the last meeting, released on Thursday, falling inflation, along with the persistence of reduced economic activity, justifies a rate cut. And we believe that the data from the real economy, namely from industry, construction and the labour market, suggest that economic growth may fall to less than 2% in the last quarter of this year.

The reason is that September's industrial output fell surprisingly rapidly (by 5.2% Y/Y), and this basically confirmed the previous figures. Only a few of the major sectors of Polish industry have fared well in recent months – e.g., plastics production – however, even this sector is decelerating, according to the latest data from the Statistical Office (by 6.1% Y/Y in September). In addition, as opposed to the past, growth is unlikely to be significantly boosted by construction, while the developments in employment and wages (September's wages grew at a slower year-on-year rate than in any month of the 'post-Lehman' year 2009) have recently signalled that not even the contribution of household consumption to growth will be anything huge in the following quarters.

We believe that even the impatiently anticipated new inflation forecast by the National Bank of Poland (NBP) will confirm our outlooks and make the Members of the Monetary Policy Council cut rates. Our scenario currently envisages a rate cut by 25 basis points in November of this year and January of next year; in other words, we still see the market bets on a total rate cut by 100 bps over the next twelve months as exaggerated.





In Focus: The Polish leading indicator

Indicators that can provide early signals of turning points in the economic cycle are often more important to markets than the current information on the performance of economies, because markets are most susceptible to such turning points. For the best possible detection of turning points in the economic cycle, we have decided to create a set of Central European leading indicators – the "ČSOB Flash". At the beginning of this year, we presented the Czech leading indicator, and now we are presenting the Polish Flash. It comprises three components and, on average, is more than 3 months ahead of the economic cycle. Since 2000, the success of our index in detecting turning points has been 89%.

In designing our leading indicator, we followed the methodology used by the OECD , which is described in detail in the paper on the Czech leading. We used the economic cycle based on the monthly developments in the manufacturing industry as the basis. Given its greater frequency, this is more appropriate than quarterly GDP statistics. Of the 19 possible pre-identified variables, we finally narrowed our choice to three components of the leading indicator – the German business sentiment index Ifo (a weight of 25%), the Polish PMI index (a weight of 25%) and the production sub-index of the Polish PMI (a weight of 50%). Candidates for membership in the index were evaluated by two main criteria: the success in detecting turning points and the stability of the lead. The variables which were most successful in detecting turning points and which predicted the turning points with the greatest stability (lowest volatility) of the lead were selected. Apart from the finally selected variables, new orders in Polish industry and future production tendency according to the OECD also had good properties. However, none of the variables could improve the predictive capabilities of the Flash as a whole.

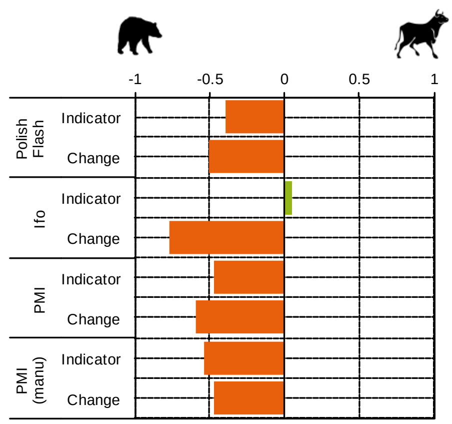
We present the final index (Flash) graphically, along with normalised industry and with the year-on-year growth rate of industry. We also present the index structure graphically. For the individual components in the structure, we show the level and the change in the last month. Both the level and the change are shown as percentiles of previous values (-1=minimum previous value, +1=maximum previous value).

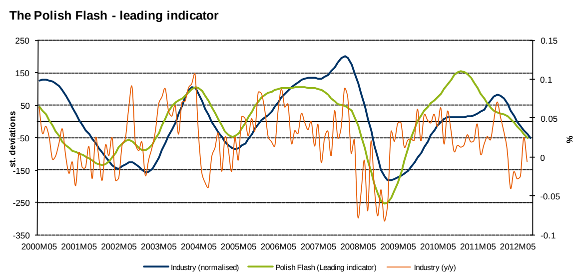
The resulting indicator (Flash) is ahead of the developments in industry by 3.3 months on average (a standard deviation of 3.3) and, since 2000, its success in detecting turning points has been 89%. The success of the Polish PMI index in detecting turning points for that period is similar to that of the Flash. However, the standard deviation in the length of its lead is greater (3.6), suggesting a less stable indication of turning points.

For the entire period of 2000-2012/08, the Flash failed to predict just one cycle peak, in April 2004. However, it predicts the fundamental peaks and troughs reliably; for example, it predicted Polish industry bottoming out after the fall of Lehman Brothers, two months before it actually happened.

At the moment, the Polish Flash has been falling for a twentieth consecutive month, with all of its components deteriorating in September. The overall low values of the production sub-index under the PMI spark particular concern. By and large, this is thus consistent with the further deterioration of the Polish economy, whose growth should drop to less than 2% y/y in late 2012.

The Polish Flash- leading indicator



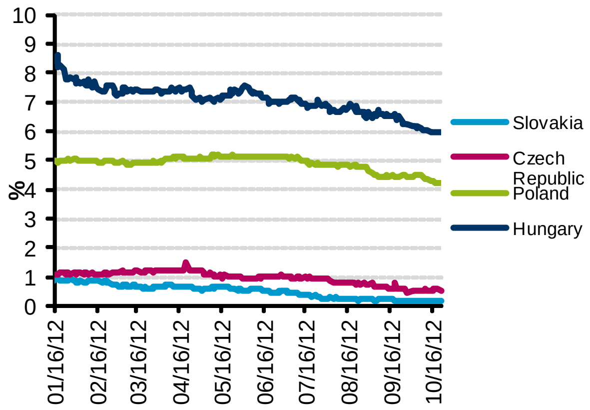


Calendar

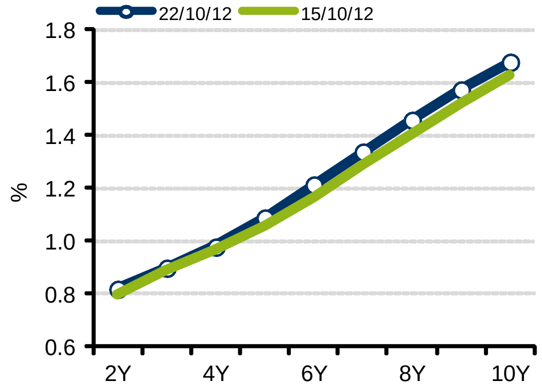
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	10/22/2012	14:00	Core CPI	%	09/2012			0	1.9	-0.1	2.1
PL	10/23/2012	10:00	Retail sales	%	09/2012			0.3	4.5	0.1	5.8
PL	10/23/2012	10:00	Unemployment rate	%	09/2012			12.5		12.4	
HU	10/25/2012	9:00	Retail sales	%	08/2012				-2.3		-2.6

Fixed-income in Charts

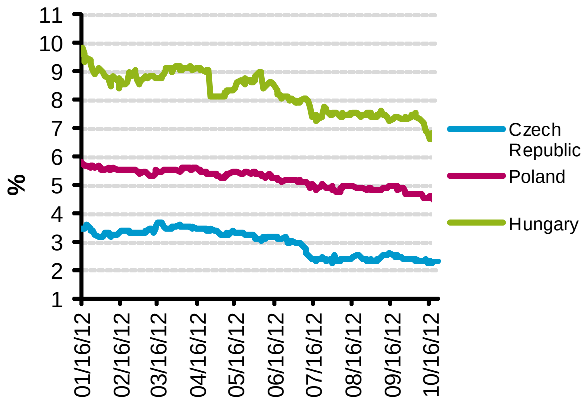
FRA 3x6



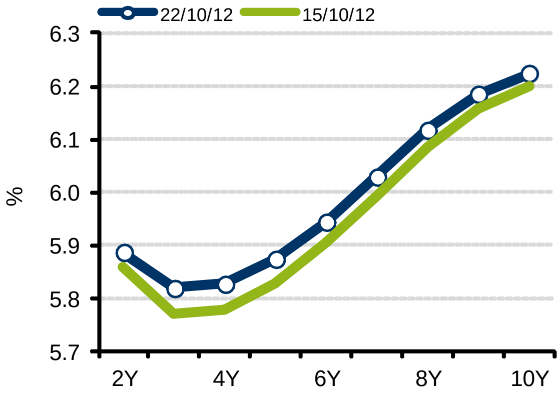
CZ IRS



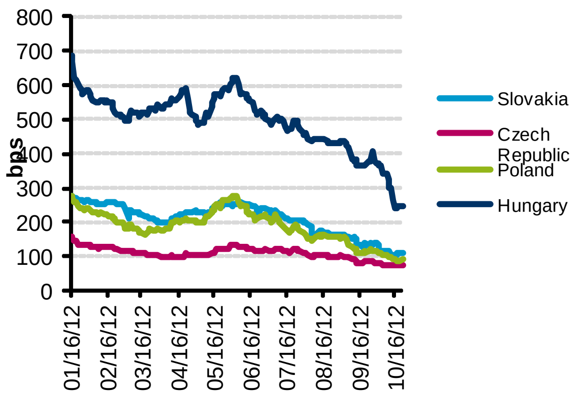
10Y GB Yields



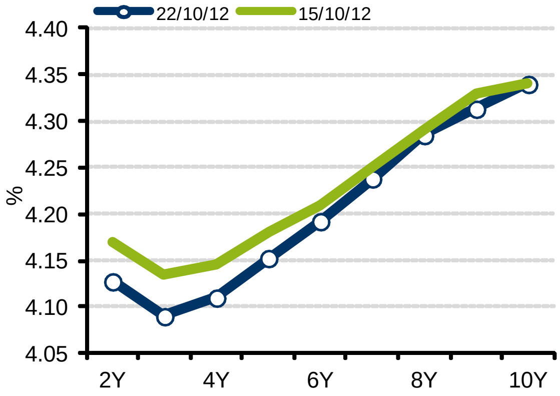
HU IRS



CDS 5Y



PL IRS



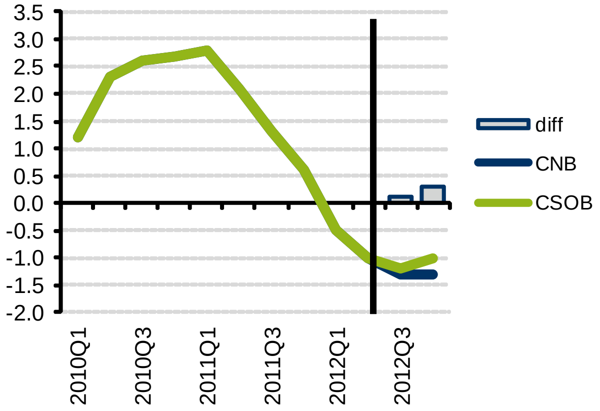
Source: Reuters

Medium-term Views & Issues

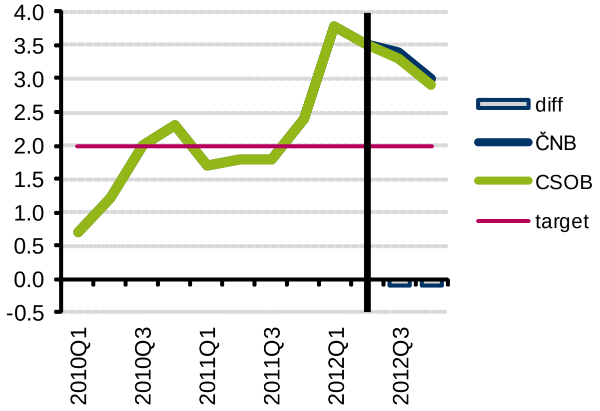
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic Growth & key issues growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, 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 government announced HUF 764 billion (2.5% of GDP) of fiscal measures. On one side the government's commitment to keep the budget deficit under 3% seems to be firm. On the other hand, it is fairly evident that the government is likely to be able to keep its deficit below the Maastricht level only at the cost of sharply reduced economic growth.	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 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 NBH will probably continue to gradually ease its policy despite unfavorable inflation readings. Recall that the year-on-year inflation has already reached 6.6%, while it is far from certain whether it will be decline back to the NBH's target (3.0%).	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 Forex Outlook 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.	The forint has been able to withstand both NBH's rate cuts and worsened relationship with the IMF. The exchange rate might not be stable forever, especially if the NBH continue to ease its policy.	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

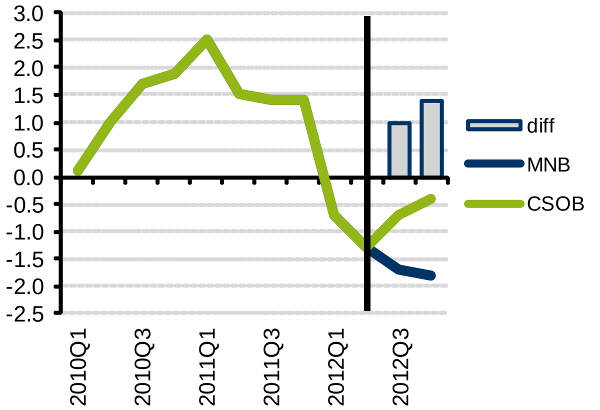
CZ: GDP outlook (Y/Y, %)



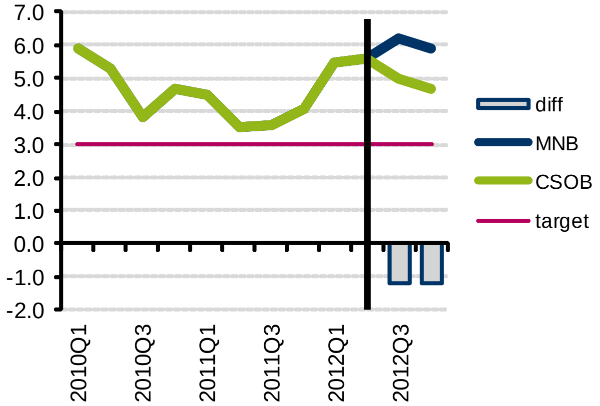
CZ: Inflation outlook (Y/Y, %)



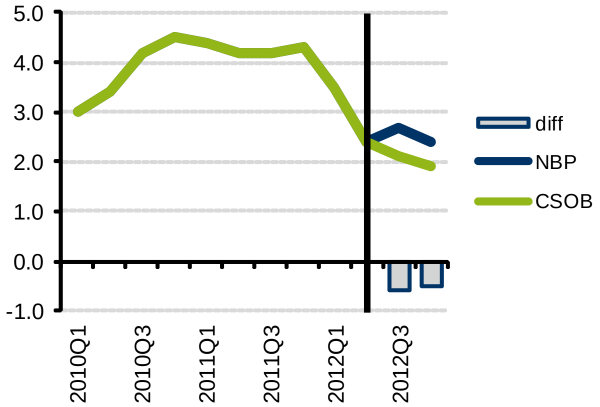
HU: GDP outlook (Y/Y, %)



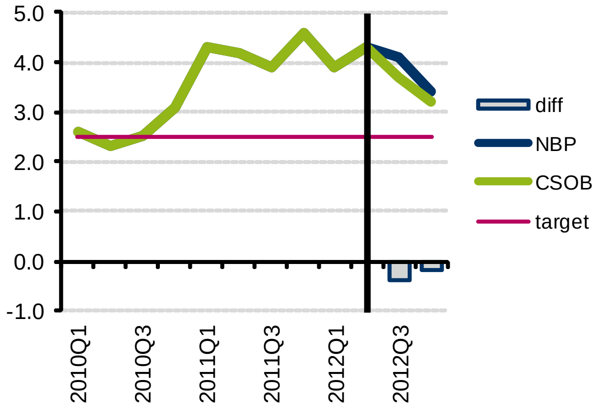
HU: Inflation outlook (Y/Y, %)



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	*6.55*	7.25	7.20	6.61	6.50	6.40
Poland	WIBOR	*4.78*	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	*1.68*	2.25	2.02	1.61	1.70	1.80
Hungary	HU10Y	*6.24*	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	*24.9*	24.8	25.5	25.1	24.9	24.5
Hungary	EUR/HUF	*279*	294	286	285	290	280
Poland	EUR/PLN	*4.10*	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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