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Central European Weekly

Monday, 28 January 2013

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Table of the Week: The CNB Bank Board

Role	Name	Mandate Expiration
governor	Miroslav Singer	Jul-16
vice-governor	Mojmir Hampl	Dec-18
vice-governor	Vladimir Tomsik	Dec-18
member	Kamil Janacek	Jul-16
member	Lubomir Lizal	Feb-17
member	Pavel Rezabek	Feb-17
member	Eva Zamrazilova	Mar-14

See the above composition of the Czech National Bank Board and expirations of mandates of its members. Newly elected Czech President Milos Zeman will be able to replace five of seven Board Members.

Market's editorial

Poor Polish Data Counterbalanced by German Optimism

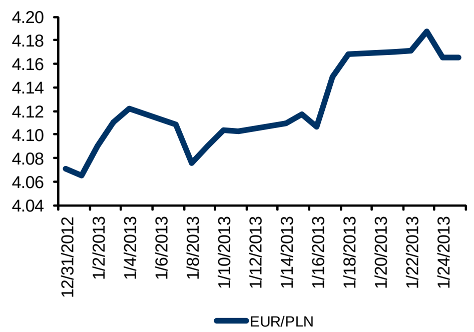
A look at the latest macroeconomic data from Poland is frightening, indeed. No matter whether we look at industry or retail sales – virtually any hard figure from the Polish economy is evidence that the last quarter was truly bad. Indeed, according to our forecasts, the year-on-year GDP growth rate in the fourth quarter of 2012 decelerated to 0.6%, the worst figure since the beginning of 2009, when the global financial crisis was escalating abroad.

Fortunately, the gloomy macroeconomic data from Central Europe's largest economy is counterbalanced by a much more optimistic picture of the German economy. Although the driver of Europe, just like Poland, performed poorly in the last quarter of 2012, its key business mood indices (Ifo and PMI) show that the start of the new year of 2013 might be more joyful. The mood in German industry, to which Central European industry is linked very closely, improved for a third consecutive month, and this might indicate a that there will soon be positive turnaround in the cycle of not only German but also Central European economies. After all, we should note that even our leading indicators for Czech and Polish industries ('Flashes') slightly improved in the last two months. However, the question still is whether the improvement in the industry-oriented exports will be able to offset poor consumption in the Czech Republic and Hungary and a decline in public procurement contracts, i.e., investment activity, in Poland.

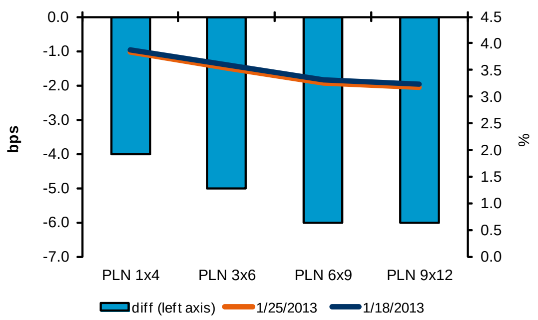
Newly elected Czech President might change the CNB Board

Regarding the Czech presidential election, although the president has only limited powers as regards the economy, he still can have some impact as he names all members of the Czech National Bank's board (which, in turn, drives the Czech monetary policy). Recall that during Milos Zeman's term, mandates of five (out of seven) central bankers are due to expire. Only two vice-governors, Mr. Tomsik and Mr. Hampl, will remain members of the board. Zeman already said he would prefer a "more balanced composition" of the board and already mentioned several names which would, in his view, contribute to such a goal. Apart from former Minister of Finance (during Zeman's Prime Minister mandate) Jiri Rusnok or academic economist Jan Svejnar, he also mentioned labor union economists such as Mr. Fasmann and Mr. Ungermann.

Exchange rate against the euro



FRA, weekly change



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.7	0.38%	↗	→
EUR/HUF	299	0.49%	→	→
EUR/PLN	4.21	0.68%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.43	-0.69	↗	↗
10Y HUF	5.86	7.82	↗	↗
10Y PLN	3.74	0.54	→	↗

Review of Economic Figures

Even Prime Minister Tusk assaults the central bank…

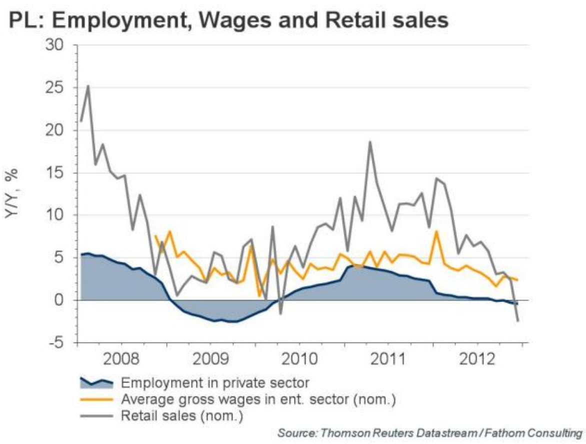
The atmosphere in Poland is continuing to deteriorate. Following on the heels of the Minister of Finance, Prime Minister Tusk has newly assaulted the central bank, criticising certain members of the Monetary Policy Council (MPC) for their sluggish attitude to rate cuts. The Prime Minister believes that the central bank's approach does not significantly help the Polish economy, the year-on-year growth rate of which likely decelerated far below 1% in late 2012.

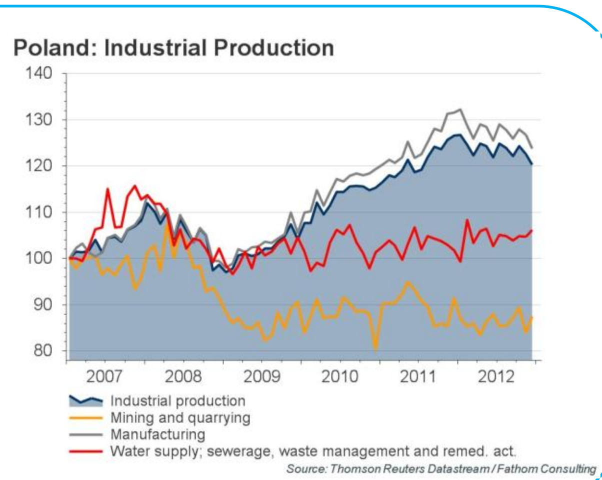
…because last year the economy grew at the slowest rate since the 'crisis' year 2009.

The last major figures, which complemented the set of data for the last quarter, which was unfortunately not very favourable, were released last week. On Thursday, the Statistical Office announced a fall in December's retail sales by 2.5% y/y, the worst figure since April 2005. Thus the figures from the retail sector confirmed the poor performance of the economy, by Polish standards, in late 2012 – adjusted for inflation, year-on-year retail sales declined in real terms in the fourth quarter. This was due to adverse labour market developments – December's unemployment rate hit 11-month highs, while real wages declined slightly. If we take account of year-on-year drops in industrial output, the Polish GDP likely grew by only 0.6% y/y at the end of last year.

But the prospects are improving, and thus central bankers should remain relatively calm.

Nevertheless, as we have reported several times, we are not advocates of pessimistic scenarios that would subsequently trigger a dramatic response in the central bank policy in Poland. Obviously, the MPC's opinion on further steps is divided, and certain members would like to 'comply with the wish' of Prime Minister Tusk. According to the newly released minutes of the meeting, rate cuts by a huge 125 bps and 50 bps were put to a vote in January. On the other hand, the MPC includes numerous members who tend to favour a tighter monetary policy. These members are encouraged by the improving prospects for the Polish economy, which we also anticipate in our scenario. Our bets on a reversal of the cycle within the next three to four months were also borne out by the latest business mood surveys. Central European economies may be particularly pleased with the positive expectations of German businesspeople. The Ifo business mood index, released on Friday, was a shade better than expected, due in particular to the expectation sub-index. This is why we believe that the market expectations of rate cuts by 75 basis points in Poland within the next six months are exaggerated.





In Focus:CNB interventions: A real threat?

Czech National Bank Governor Miroslav Singer repeated that the Central Bank may intervene on the FX markets to weaken the koruna. We examine the possibility of such policy in this research note. We conclude that, given a de facto zero official base rate, the CNB may upgrade its inflation targeting mechanism with a 'more binding opinion on the exchange rate'. However, we don't expect the CNB will set a fixed target for the EUR/CZK (such as a bottom or a ceiling) like other central banks (e.g. Swiss central bank). The koruna is currently already weak enough. Therefore, we expect that intervention threats might only become real when the koruna strengthens significantly or when the economic outlook would worsen beyond what the CNB expects currently

Why interventions against the koruna?

Why does the CNB wish to weaken eventually the exchange rate? Inflation forecasts suggests that market interest rates should be lower than they are currently, given the poor performance of the economy and the positive outlook for inflation. However, the CNB's base interest rate (the 2-week repo) is technically at zero and cannot anymore be lowered (if one excludes the possibility of negative rates). Therefore, the Czech National Bank considers alternative strategies of easing the monetary conditions in the economy, and the use of the exchange rate is one of the options.

How does a weaker FX rate help the economy?

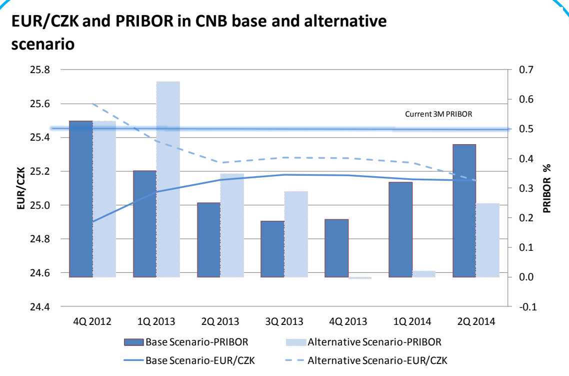
Firstly, it improves the position of export firms, via increased sales as their competiveness increases vis-à-vis their competitors. However, the advantages should not be overrated if, as is the case currently, the foreign markets for their products stabilize or even shrink. In recent years the Czech exporters had no problems because of an overvalued koruna. So, a depreciation of the koruna by CZK 0.20-0.30 may not in the end necessarily change very much on the outlook regarding the demand for their products. Therefore, they have little incentives to invest or expand staff.

Secondly, a weaker koruna may encourage Czech households to start shopping, due to expectations on future price rise. Prices excluding fuel, food and regulated prices (approximately half the consumer basket) have been falling for three consecutive years in the Czech Republic. People have become accustomed to the fall in the prices of costlier durable goods such as cars, refrigerators, washing machines, vacuum cleaners or TV sets. Besides the stagnation of real income, deflation is another reason for postponing purchases. There is room for a decline in the savings rate, and if a weaker koruna would raise expectations of higher prices of durable goods, it might, but is far from sure, encourage conservative households to start shopping. Indeed, the price increases should preferably not affect energy, petrol and food prices, because these would only reduce households' real income. Unfortunately, the CNB cannot fine-tune the effect of a weaker currency to exempt energy prices

Concluding, a weakening of the koruna is no panacea with only positive effects on the Czech economy. Therefore, we don't expect the CNB to put forward an FX target, besides its inflation target, but eventually will use the FX as a means to achieve its inflation target.

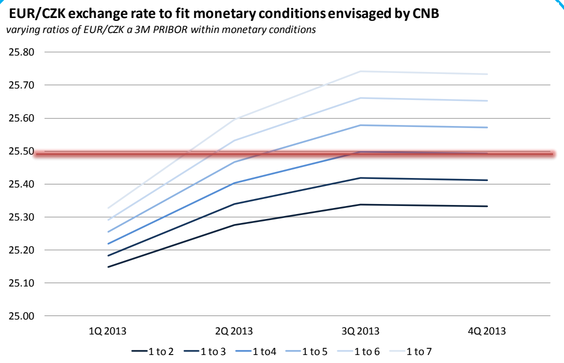
How can the interventions against the exchange rate be made, and at which levels are they likely?

The most likely scenario is that the CNB will use the exchange rate to make up for exactly what it has not accomplished through interest rates. Although the base rate is at its technical zero, the market rate (three-month PRIBOR) stands at 0.5% and doesn't show a tendency to decline further. For inflation not to be below the CNB target in 2014, the central bank would like to see the PRIBOR market rate lower – at around 0.2%. According to the CNB's sensitivity scenario, a depreciation of the Czech koruna from CZK 25.20 per EUR (an exchange rate anticipated by the forecast) to around CZK 25.60 per EUR would be consistent with such an additional decline in interest rates. The particular dynamics of the exchange rate and the PRIBOR in the alternative scenario is shown in the following graph.



CNB December Forecast View: Recent weakening of the Czech koruna to the 25.50 EUR/CZK should compensate for the inability of 3M PRIBOR to fall below 0.50%.

However, if we abandon the CNB's model and consider that the CNB views the economy through the lens of monetary conditions, our conclusion is not completely different. Considering that a change in PRIBOR rates can be substituted by approximately a double percentage change in the exchange rate, the "target" exchange rate would be slightly above the EUR/CZK 25.30 level. Even with a significantly reduced weight of the exchange rate in the monetary conditions – see the graph below – the exchange rate should not be above the EUR/CZK 25.70 even if the ratio were 1:7.



Even if we assume extreme composition of monetary conditions index (1:7; EUR/CZK to 3M PRIBOR), current CNB forecast would hardly envisage the koruna above 25.70 EUR/CZK.

What to expect from the CNB in February (and later)?

- The CNB Board is likely to upgrade its inflation targeting with a ‘more binding opinion’ on the exchange rate at its February meeting. However, it won’t be a fixed FX target; it will be a sliding opinion on the exchange rate, which will change with every forecast. In addition, the CNB is unlikely to set, a priori, any boundaries for the fluctuations around those forecasted exchange rate values.

- For the conservative CNB Board to decide to intervene, the koruna would have to strengthen at least to below CZK 25.00 per EUR now....

- ...or the December’s forecast would have to worsen significantly. This is unlikely.

The current composition of the CNB Board does not favour a switch from verbal to actual interventions against the koruna either. The Board is composed of numerous conservative members and advocates of traditional monetary policy instruments. We also believe that even the dovish and activist group of CNB Board members will not want any extraordinary measures (such as forex interventions) to be approved by just a narrow margin of votes, all the more so because an accumulation of forex reserves was not seen as desirable in the past.

Coincidentally, the koruna traded at those levels in early January. In other words, there are no compelling reasons for the CNB to intervene at current CZK levels, unless the koruna strengthen substantially or the CNB downgrades its 2013/14 eco forecasts significantly (at the Feb. meeting).

Is the current inflation forecast too optimistic?

Taking account of our baseline scenario and recent eco data, we consider a significant deterioration of the CNB’s macroeconomic forecast to be unlikely. Our 2013 GDP forecast is only slightly worse, while leading indicators for the Czech economy (such as ČSOB Flash) are stabilizing.

December CNB Forecast of CNB, versus CSOB Estimate				
	2013		2014	
	CNB	CSOB	CNB	CSOB
Inflation	2.3	2.60	1.60	2.00
Monetary Policy Inflation	1.4	1.40	1.50	1.70
GDP	0.2	0.00	1.90	2.00

By and large, we see the latitude for interventions against the koruna as very limited in the context of the forecast

Weekly preview

HU: The MNB is going to cut again

Another fall in headline inflation and poor retail sales as an indication of still weak domestic consumption will bring another 25 bps rate cut. The market is, however, much more concerned by an issue of the upcoming replacement of the current MNB President Simor, who is the only hawk in the Monetary Council.

PL: Just 2% GDP Growth Last Year

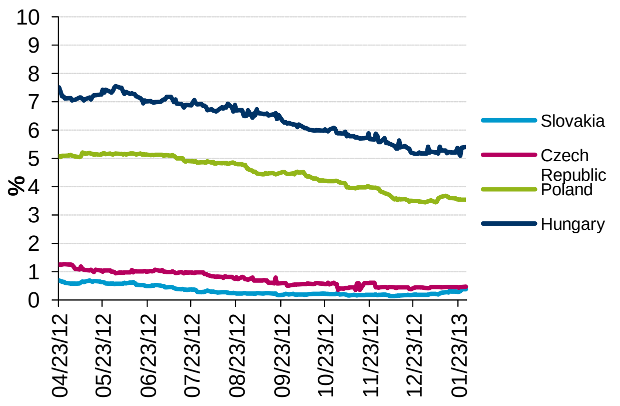
According to our forecasts, the Polish economy grew just 2% last year, the worst figure since the crisis year of 2009. The deceleration is greatly attributable to the deterioration of conditions in the fourth quarter, when the GDP grew by ‘only’ 0.6% y/y. Both external and internal conditions – Q4 retail sales declined in real terms, as did industrial output – likely contributed to the further growth deceleration in late 2012. Poland’s economic growth is likely to continue to decelerate this year, but the economy may bottom out as early as in the first quarter.

Calendar

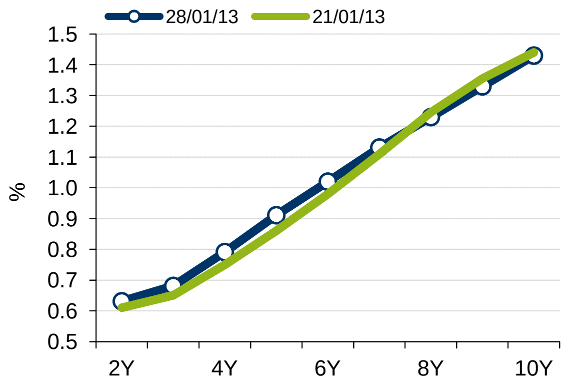
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	01/29/2013	9:00	Unemployment rate	%	12/2012						
PL	01/29/2013	10:00	GDP	%	2012FY		2		2		4.3
SK	01/29/2013	10:00	Current account	EUR B	11/2012					308	
HU	01/29/2013	14:00	NBH meeting	%	01/2013					5.75	
HU	01/31/2013	9:00	PPI	%	12/2012						
PL	01/31/2013	10:00	GDP	%	12/2012 *A						4.3
CZ	01/31/2013	11:00	Money supply M2	%	12/2012						

Fixed-income in Charts

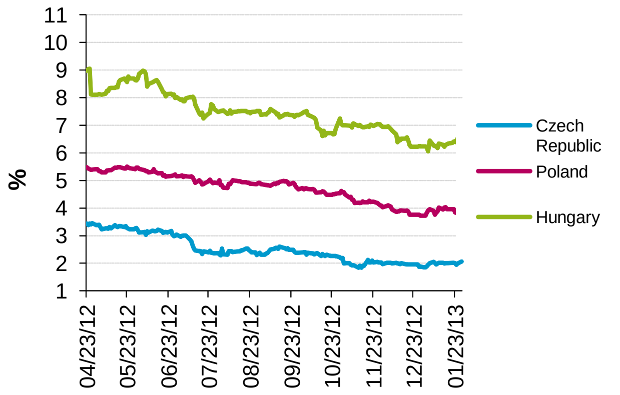
FRA 3x6



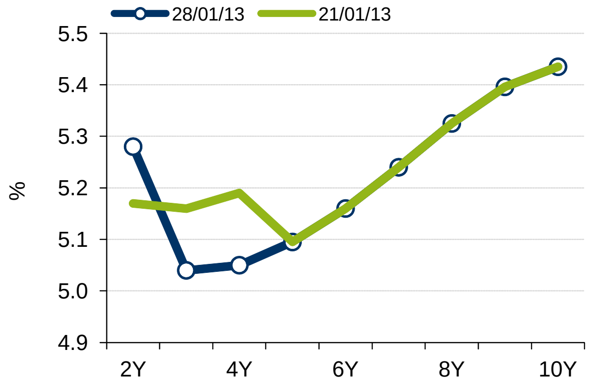
CZ IRS



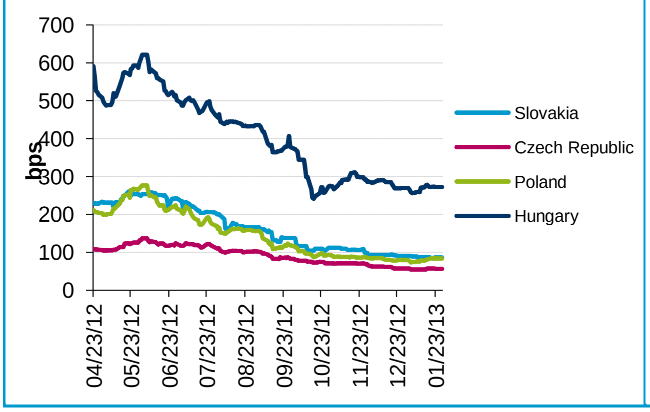
10Y GB Yields



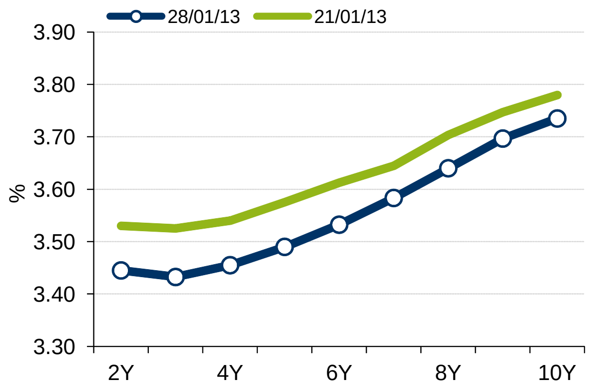
HU IRS



CDS 5Y



PL IRS



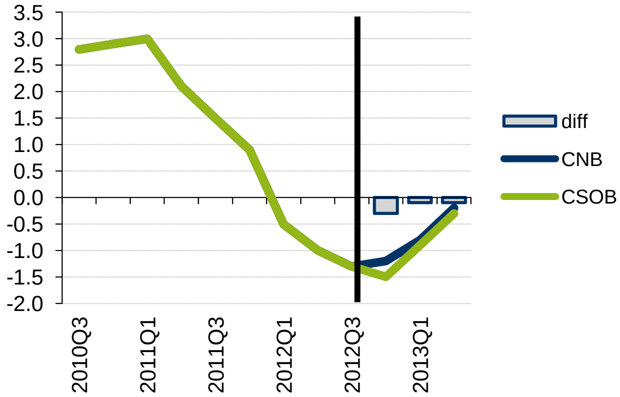
Source: Reuters

Medium-term Views & Issues

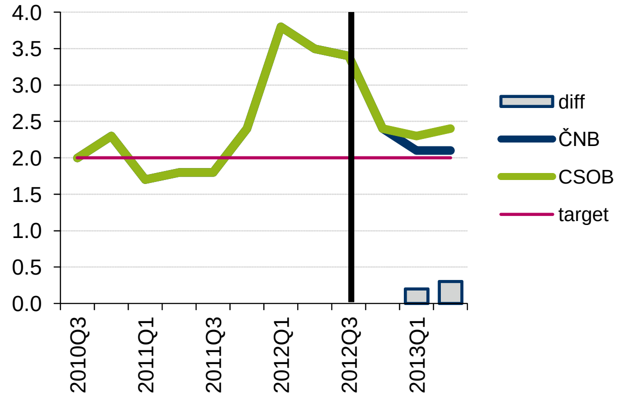
	The Czech Republic	Hungary	Poland
Growth & key issues	September's rapid drop in industrial output (-7.1% y/y) is primarily due to a lower number of business days and to weakening demand. This time, the greatest decline was generated by carmakers (-11.1%), which had been up until now the primary drivers of industry as a whole, exports and also GDP. The figures from industry are not pleasant, even if we look at the statistics of new orders, which fell by 5.2%.	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 probably to 0.6% in the fourth quarter of 2012. Clearly, factors that kept the Polish economy growing during the World Financial Crisis have stepped 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 2.0% in 2012.
Outlook for official & market rates	At its last meeting, the Czech National Bank (CNB) Board again decided to cut its interest rates. Thus the central bank's base rate hit a new all-time low of 0.05% and the CNB made a commitment to keep it there until it sees a significant inflationary pressure. In our view, these will not be visible until the second half of 2014.	The NBH will probably continue to gradually ease its policy. Year-on-year inflation already fell to 5.0 percent and is expected to ease further due to a substantial government subsidies of energy prices. Moreover, the term of central bank governor and his two deputies, who were the only members of the monetary policy council who consistently opposed recent cuts, is coming to an end.	The data confirms the declining performance of the Polish economy, while pointing out a slightly faster inflation fall towards the target than expected. In a response, the National Bank of Poland decreased its interest rates by another 25 basis points in December. We believe that further weakness in the Economy warrants further monetary easing by another 25 or 50 bps at the beginning of 2013.
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 new year. Bottoming out of the recession should help the koruna in the second quarter of 2013.	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, or if the naming of the new governor undermines market confidence.	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 continue in monetary easing cycle. Nevertheless bottoming out in the first quarter should help the zloty to regain the positive momentum in 2013.

CBs' Projections vs. Our Forecasts

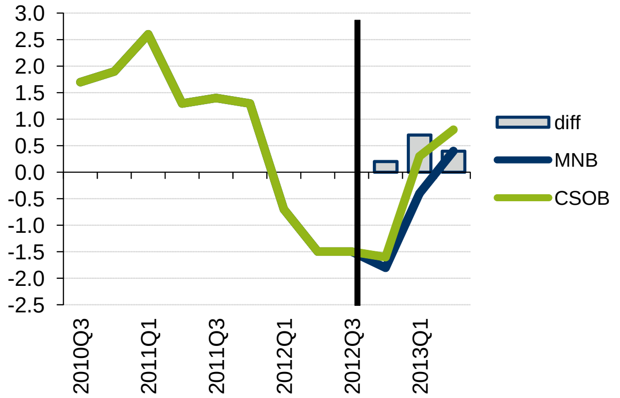
CZ: GDP outlook (Y/Y, %)



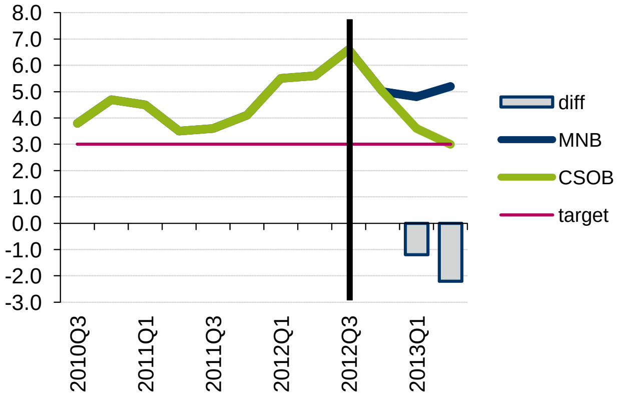
CZ: Inflation outlook (Y/Y, %)



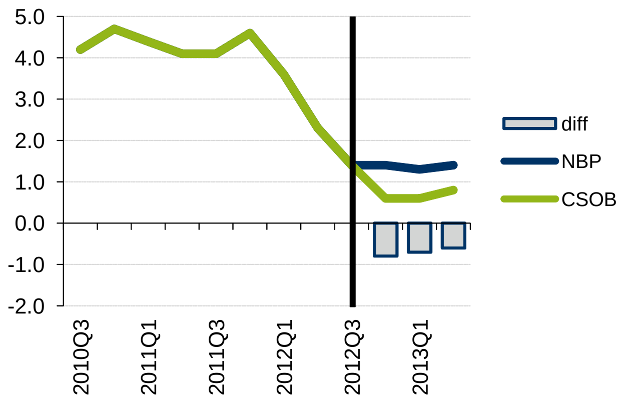
HU: GDP outlook (Y/Y, %)



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	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	Last change	
Czech Rep.	2W repo rate	*0.05*	0.50	0.50	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*5.75*	7.00	6.50	5.75	5.25	4.75	-25 bps	12/18/2012
Poland	2W inter. rate	*4.00*	4.75	4.75	4.25	3.75	3.75	-25 bps	1/9/2013

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

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	PRIBOR	*0.50*	1.03	0.80	0.50	0.50	0.45
Hungary	BUBOR	*5.70*	7.20	6.61	5.75	5.20	4.70
Poland	WIBOR	*3.99*	5.13	4.92	4.11	4.90	4.90

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

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	CZ10Y	*1.43*	2.02	1.61	1.37	1.45	1.50
Hungary	HU10Y	*5.86*	6.71	6.56	5.49	7.25	7.00
Poland	PL10Y	*3.74*	4.74	4.39	3.60	5.40	5.40

Exchange rates (end of the period)

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	EUR/CZK	*25.7*	25.5	25.1	25.1	25.1	24.7
Hungary	EUR/HUF	*299*	286	285	291	280	280
Poland	EUR/PLN	*4.21*	4.22	4.11	4.08	4.15	4.00

GDP (y/y)

	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	0.9	-0.5	-1.0	-1.3	-1.5	-0.9	-0.3
Hungary	1.3	-0.7	-1.5	-1.5	-1.6	0.3	0.8
Poland	4.6	3.6	2.3	1.4	0.6	0.6	0.8

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

	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	2.4	3.8	3.5	3.4	2.4	2.3	2.4
Hungary	4.1	5.5	5.6	6.6	5.0	3.6	3.0
Poland	4.6	3.9	4.3	3.8	2.4	2.3	2.3

Current Account

	2012	2013
Czech Rep.	-1.7	-1.9
Hungary	1.5	1.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-5.0	-3.0
Hungary	-2.5	-2.2
Poland	-3.5	-4.0

Source: CSOB, Bloomberg

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