Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 18 March 2013

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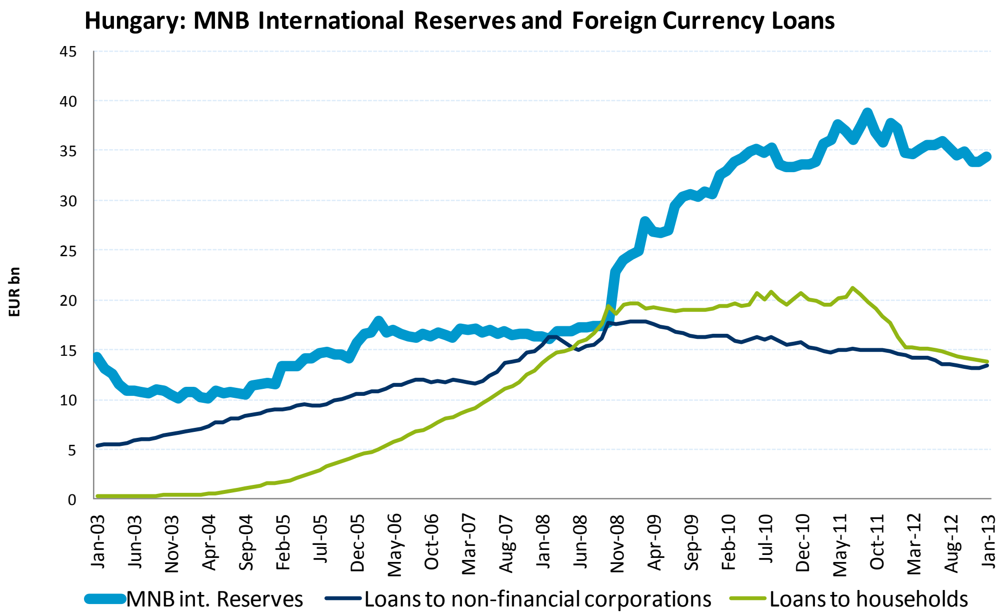


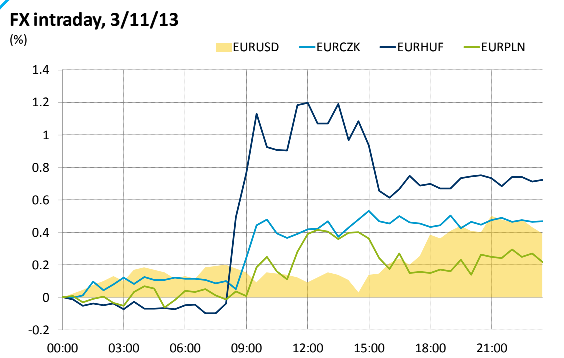
Market's editorial

Hungary's specific contribution to the currency wars

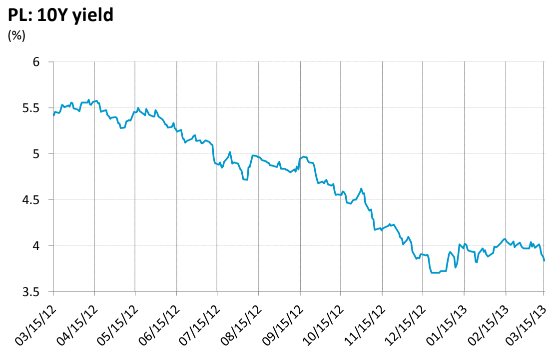
While last week we wrote here that the National Bank of Poland, by its decision to cut rates, might be trying to jump on the currency war bandwagon at the last moment, we now need to correct our opinion after the release of Poland's inflation data for February. Inflation in Poland is rapidly falling, already being well below the NBP target, and the inflation outlook continues to be very favourable. However, even after the latest rate cut, Polish interest rates are still fairly high in real terms, absolutely as well as relatively, and this (given the stability we anticipate) may, on the other hand, attract investors who are searching the world over for stable economies with higher interest rates. Hence Polish government bonds may still be in demand, and the inflow of portfolio investment may even encourage the zloty in the end.

Nevertheless, currency wars continue to be a hot topic in Central Europe – but this time because of Hungary, which is trying to get involved in those wars in its own specific manner. One day after the approval of certain controversial amendments to the Constitution, Hungarian Prime Minister Orban spoke of the necessity of continuing to reduce the foreign currency debt (notably among households and small and medium-sized enterprises). No doubt, the government believes that a potential conversion of foreign currency loans would increase its monetary policy flexibility, which could thus be used for weakening the forint without a negative impact on the balances of those sectors of the economy with open FX positions. Naturally, the reaction of the forint to "an idea of the increased exchange rate sovereignty" was negative, and the currency immediately tested its one-year lows in response to PM Orban's statement.

Now the question is how far the government, in cooperation with the National Bank of Hungary, will allow its reflections to go on using the forint for macroeconomic aims. While the central bank has large stocks of FX reserves (EUR32bn), which would easily cover the foreign currency debts incurred by households as well as the debts of SMEs, we should bear in mind that the government debt is also partly denominated in foreign currencies. It is as large as EUR29bn, while it represents 40% of the total government debt. Such an amount may not be easily covered by FX reserves, and therefore Hungary can still fear of free floating/fall of its currency and the forint will still face some kind of management.



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25,6	-0,02%	→	→
EUR/HUF	306	-0,13%	→	↘
EUR/PLN	4,15	0,21%	→	↘



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1,44	-2,70	↗	↗
10Y HUF	5,62	0,90	↗	↗
10Y PLN	3,66	-4,82	↗	↗

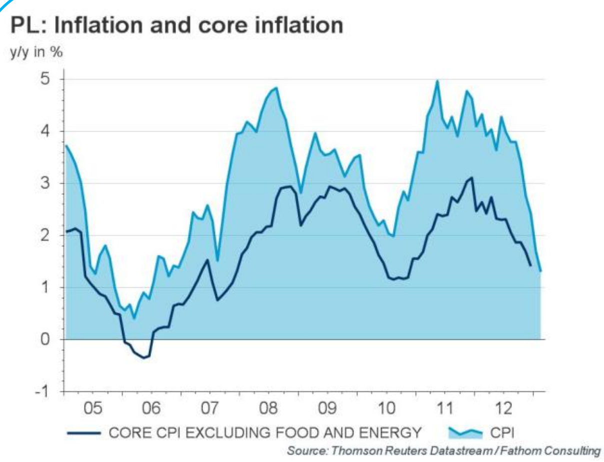
Review of Economic Figures

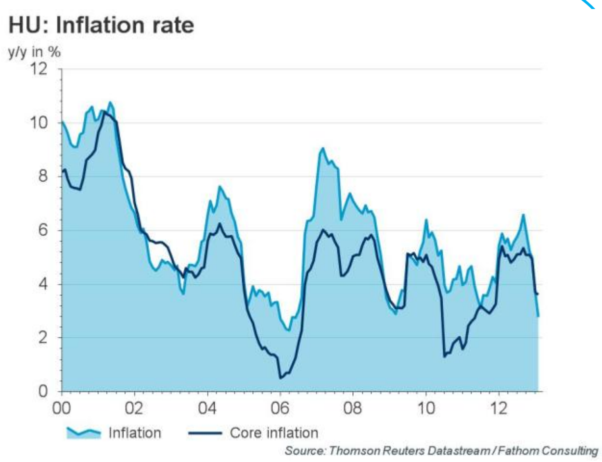
February's inflation in Poland was the lowest since Oct 2006

A week after the surprisingly aggressive 50 bps cut in its official interest rates Poland delivered another surprise, this time by its inflation data for February. The unexpected development of food prices made month-on-month inflation stagnate, and thus year-on-year inflation fell to 1.3%, the lowest level in more than six-years. Having been above the upper threshold of the tolerance band of the central bank (NBP) from the beginning of 2011 to September 2012 (i.e., for 21 consecutive months), inflation slipped below the lower threshold of the band last month. Apart from the moderate month-on-month fall in food prices, the greatest surprise came from lower communication prices (-3% M/M). Inflation should remain below that level in the months to come and, according to our forecasts, it should hit bottom approximately in the middle of this year (we cannot even rule out a fall below 1% Y/Y in June). Nevertheless, given the anticipated recovery of the Polish economy and the above-mentioned aggressive rate cut by 50 bps in early March, we believe that an inflation fall in March should be of no real concern to the NBP.

Hungary's year-on-year inflation rate falls to 2.8%, owing to a reduction in regulated prices.

Hungary's year-on-year inflation rate fell to a seven-year low (2.8%) in February, after the composite index of consumer prices went down by 0.1% m/m, owing to a reduction in certain regulated prices. The inflation fall was due not only to a 10% decline in gas and electricity prices, but also to the favourable comparative baseline, when last year's VAT increase no longer influenced inflation. From this point of view, it is hard to say whether Hungary will soon become a low-inflation economy, just as is, for example, its Czech counterpart. After all, the depreciation of the forint to one-year lows will prevent the year-on-year inflation rate from continuing to fall well below 3% (the NBH target), because prices of tradable goods may not necessarily continue to fall as they have in the last few months.





In Focus: Czech industry

Hard data from the Czech industry, not very encouraging

January's industrial output was down by 4.1% y/y. The fall was not as strong as that of December, yet the new figures as a whole do not provide reasons for optimism now.

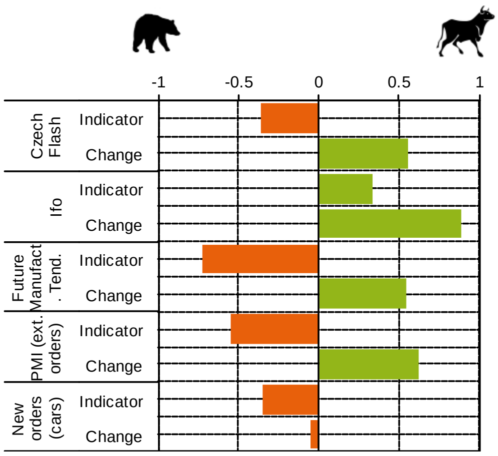
The downturn of the automotive industry, a dominant industry in the Czech Republic, was particularly strong (-8.6%). New orders, which dropped by 7.6%, due in particular to low orders in the automotive and electronics industries, also closed January with an unpleasant result.

Thus the industry, the strongest sector of the Czech economy, did not open this year very positively. As a result, the economy is heading towards another poor quarter, when the GDP is likely to fall again, and the Czech Republic's longest recession ever will continue to persist.

.., but the Czech leading indicator – the Flash continues to promise a slightly brighter future

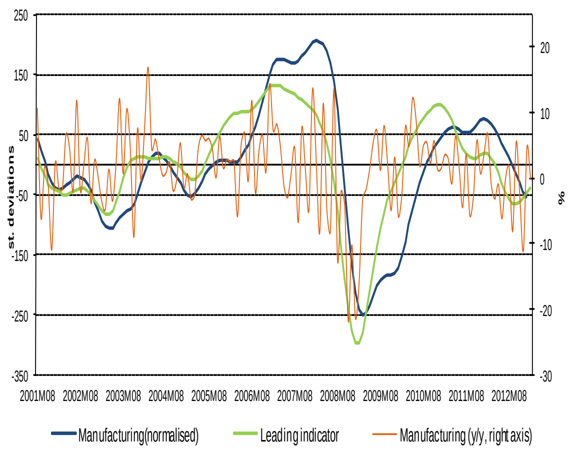
However, hopes are confirmed by soft indicators, including our Flash leading indicator. Having hit its nine-month highs in February, the Flash improved for a fourth consecutive month. Thus it indicates that the late first quarter and the early second quarter of the year may be more optimistic for industry. The PMI, the German Ifo business mood index, as well as the future expectations in industry according to the OECD have consistently improved for several consecutive months. However, the fact that new orders in the automotive industry lag behind slightly is a warning signal, as they are among the key components of our leading indicator and have not provided many reasons for optimism yet. Hence soft data should be certainly interpreted with caution at the moment and, before drawing stronger conclusions, we will await better figures on February's industry.

The Czech Flash- leading indicator



**Indicator: the level of the indicator vis-à-vis historical values*
***Change: the change in the indicator vis-à-vis historical values*
(1 = the current value is the maximum historical value; -1 = the current value is the minimum historical value)

The Czech Flash - leading indicator

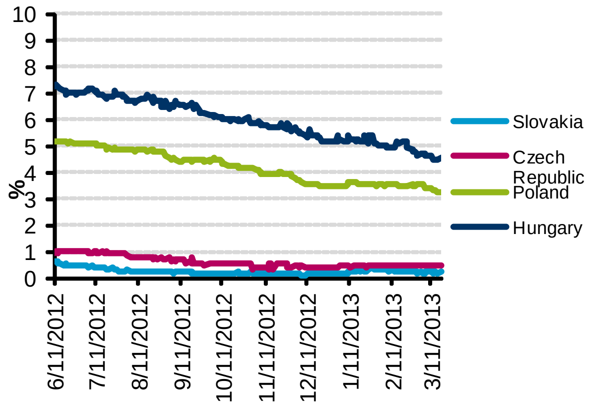


Calendar

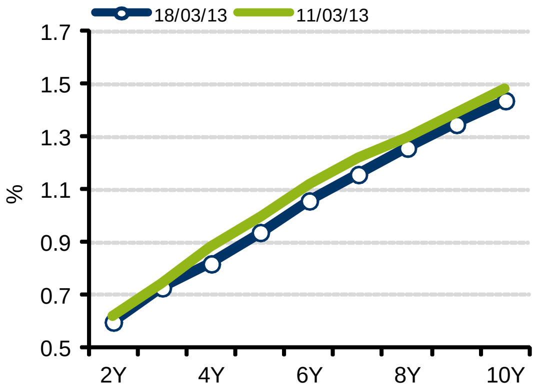
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	03/18/2013	14:00	Wages	%	02/2013			-0,4	3	-10,5	0,4
PL	03/18/2013	14:00	Core CPI	%	02/2013			0	1,1	-0,1	1,4
PL	03/19/2013	14:00	Industrial output	%	02/2013			-1,9	-1,2	5,4	0,3
PL	03/19/2013	14:00	PPI	%	02/2013			0,3	-0,5	0,1	-1,2
CZ	03/20/2013	12:00	CZ Bond auction 4.70%/2022	CZK B	03/2013			4			
CZ	03/20/2013	12:00	CZ bond auction 2013-2016, 0.50 %	CZK B	03/2013			4			
HU	03/21/2013	9:00	Wages	%, ytd.	01/2013				4,8		4,9

Fixed-income in Charts

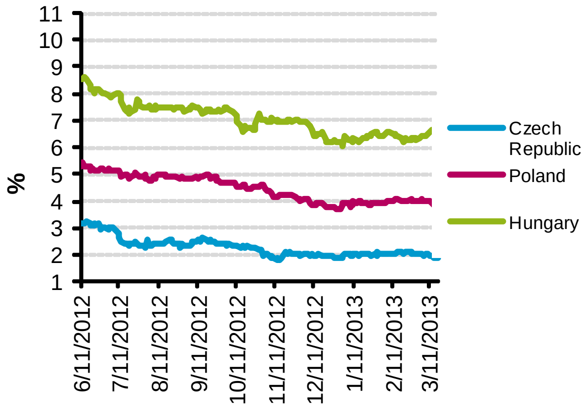
FRA 3x6



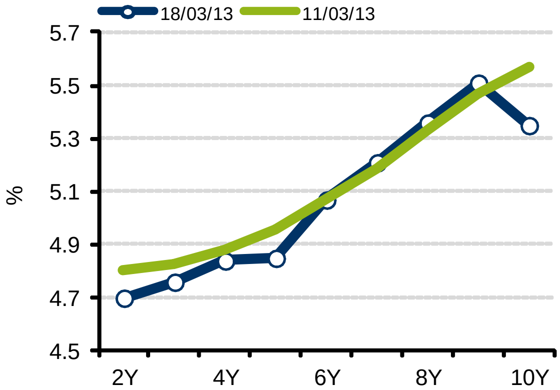
CZ IRS



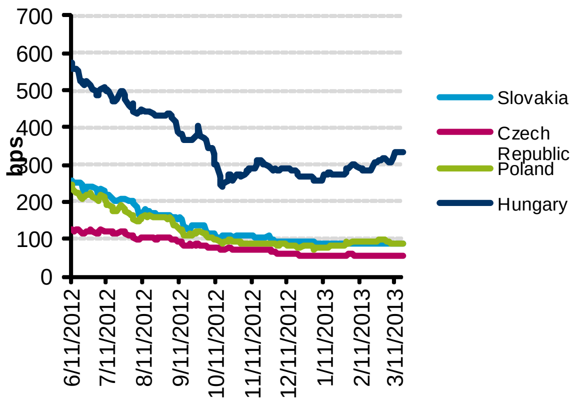
10Y GB Yields



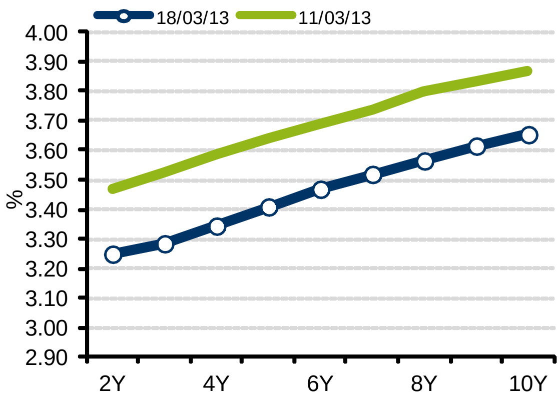
HU IRS



CDS 5Y



PL IRS



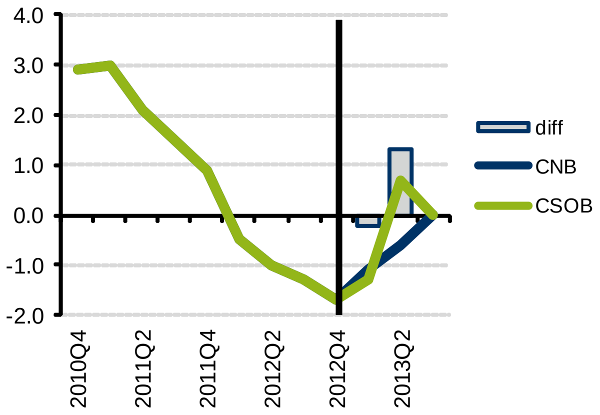
Source: Reuters

Medium-term Views & Issues

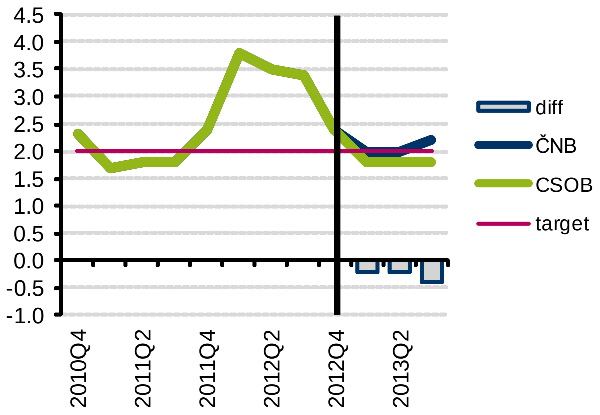
	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech economy remains in a recession, which is shallower but longer than the previous one. The latest data from industry – production as well as orders – still tend to be negative. The drop in domestic demand was followed by a decline in foreign demand. Domestic growth stimuli are still absent. Another VAT increase will again curb household consumption, while concern about the negative outlook for the European economy curbs the investment activity of domestic firms. Nevertheless, taxes should remain unchanged in the next two years.	Like the Czech economy, the Hungarian has been facing a double dip. The persistent weakness of the domestic demand cannot be compensated by improvement in (net) exports. Real recovery of the economy could be visible in 2014.	Growth of the Polish economy fell to 1.1% in the fourth quarter of 2012. Figures from the Statistical Office confirmed that the economy was only driven by net exports, which improved owing to falling imports as well as rising exports. Household consumption was down by 1% y/y, while investment also dropped on a year-on-year basis (though much less than in the third quarter). However, we expect that the recent rate cuts should help the economy to bottom out as early as in the first quarter 2013.
Outlook for official & market rates	The CNB met expectations and left its rates unchanged, while it downgraded its economic outlook for this year. The CNB expects that the economy will continue to fall this year (as opposed to its original expectation of 0.2% growth). In addition, the central bank raised its three-month PRIBOR forecast for the next quarter to 0.5% (+30bps). The central bank also mitigated concern about forex interventions as an instrument to ease monetary conditions in the economy. Only much worse than expected economic developments could make the central bank ‘diverge’ from its wait-and-see attitude.	The MNB will very likely continue to ease its policy under the new Presidency of György Matolcsy. Although the former member of the government and the Minister of the Economy toned down his dovish previous statements by labeling himself an enemy of inflation, we think the monetary easing cycle seems to be far from over.	After surprising 50 bps cut in march, the NBP cutting cycle is over. We believe in longer term stability of interest rates. Although economic recovery could argue in favor of interest rate hikes later in the 2013, we believe that further decline in inflation should prevent the bank from doing so. The inflation should stay below the target till the beginning of 2013.
Forex Outlook	The koruna should be more prone to losses after Italian elections than we initially expected. First of all because of higher uncertainty and risk aversion on the global markets. Secondly because of lower GDP growth in the eurozone. We downgraded the koruna over the whole one year horizon with 1-month target at 25.70 and 12 month at 24.80 EUR/CZK.	The forint has experienced some volatility, which has been attached to the recent appointment of a new MNB President (see the text above). However, given the improvement in Hungary’s balance of payments and global market sentiment, we believe that forint’s weakness will be rather temporary than persistent.	While the surprise by Poland’s Monetary Policy Council triggered an immediate negative reaction from the zloty, we believe this should not last for long time. The money market currently anticipates one more rate cut, which, we believe, will not occur; moreover, the market opinion on the NBP may completely turn about. Naturally, this might be grist to the mill of the zloty, which may benefit from fairly high interest rates even today.

CBs' Projections vs. Our Forecasts

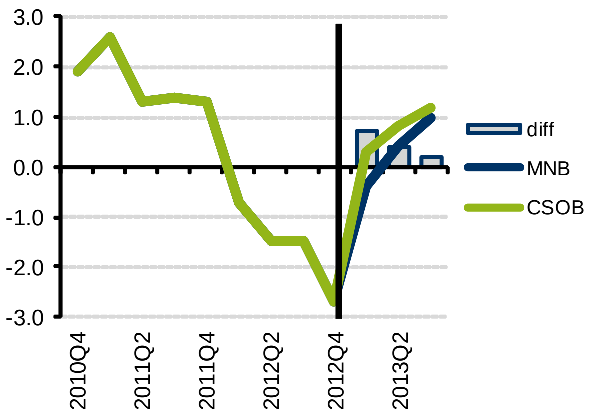
CZ: GDP outlook (Y/Y, %)



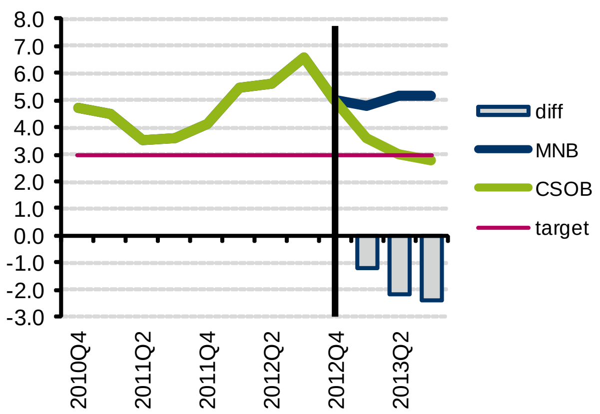
CZ: Inflation outlook (Y/Y, %)



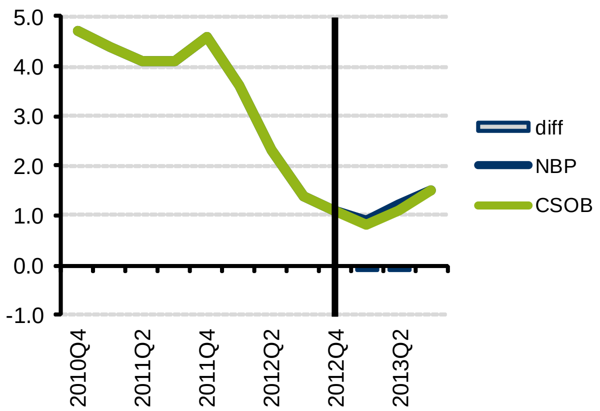
HU: GDP outlook (Y/Y, %)



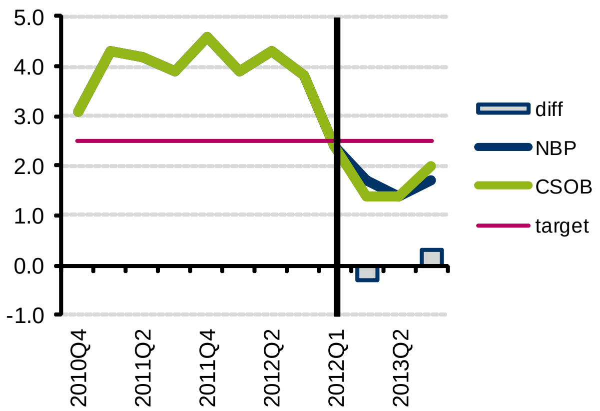
HU: Inflation outlook (Y/Y, %)



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	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	Last change	
Czech Rep.	2W repo rate	*0.05*	0,50	0,05	0,05	0,05	0,05	-20 bps	9/27/2012
Hungary	2W deposit r.	*5,25*	6,50	5,75	5,25	4,75	4,50	-25 bps	2/26/2013
Poland	2W inter. rate	*3,25*	4,75	4,25	3,25	3,25	3,25	-25 bps	3/6/2013

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

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	PRIBOR	*0,49*	0,80	0,50	0,47	0,46	0,45
Hungary	BUBOR	*5,14*	6,61	5,75	5,20	4,70	4,50
Poland	WIBOR	*3,42*	4,92	4,11	4,90	4,90	4,90

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

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	CZ10Y	*1,44*	1,61	1,37	1,43	1,58	1,78
Hungary	HU10Y	*5,62*	6,56	5,49	7,25	7,00	4,80
Poland	PL10Y	*3,66*	4,39	3,60	5,40	5,40	5,40

Exchange rates (end of the period)

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	EUR/CZK	*25,6*	25,1	25,1	25,7	25,4	25,0
Hungary	EUR/HUF	*306*	285	291	280	280	#N/A
Poland	EUR/PLN	*4,15*	4,11	4,08	4,15	4,00	4,00

GDP (y/y)

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	-0,5	-1,0	-1,3	-1,7	-1,3	0,7	0,0
Hungary	-0,7	-1,5	-1,5	-2,7	0,3	0,8	1,2
Poland	3,6	2,3	1,4	1,1	0,8	1,1	1,5

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

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	3,8	3,5	3,4	2,4	1,8	1,8	1,8
Hungary	5,5	5,6	6,6	5,0	3,6	3,0	2,8
Poland	3,9	4,3	3,8	2,4	1,4	1,4	2,0

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

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	Brussels	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Commercial Desk	+32 2 417 53 23
Mathias van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 6646892	Frankfurt	+49 69 756 19372
Prague Research (CSOB)		Paris	+33 153 89 83 15
Jan Cermak	+420 2 6135 3578	New York	+1 212 541 06 97
Jan Bures	+420 2 6135 3574	Singapore	+65 533 34 10
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)		Prague	+420 2 6135 3535
Marek Gabris	+421 2 5966 8809	Bratislava	+421 2 5966 8436
Warsaw Research		Budapest	+36 1 328 99 63
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