Central European Weekly

Monday, 08 April 2013

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- The NBH has announced new growth-supporting measures, which seems to have a limited impact
- The Czech industry disappoints as expected
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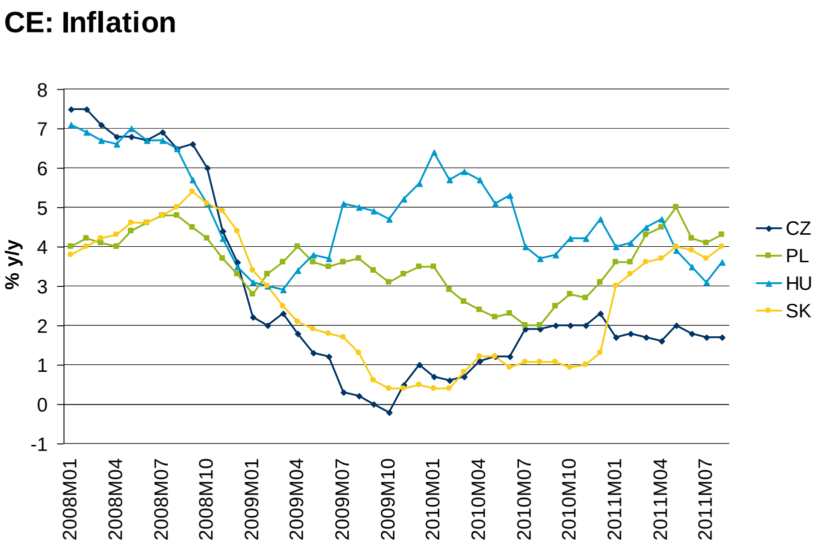
- The NBP on hold this time, but it might sound dovish

Chart of the Week



Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while the Czech inflation remain at the lowest levels.

Market's editorial

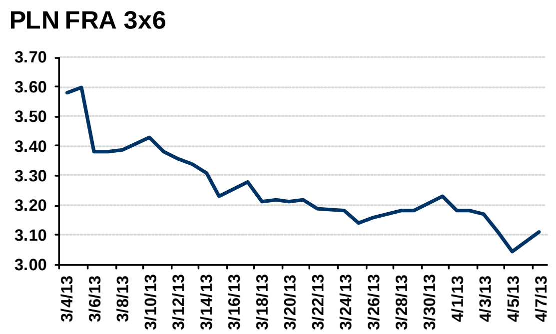
The NBH just softly unorthodox

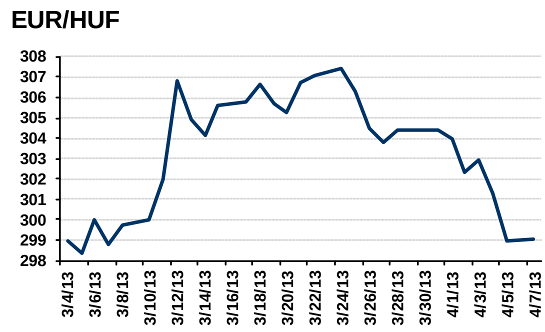
Hungary, or rather its central bank (the National Bank of Hungary), grabbed the greatest share of the spotlight that shone on the Central European region after the Easter holidays. Late Wednesday evening, the bank sprang a surprise by convening an extraordinary meeting and a press conference about new growth-stimulating actions for the next day. The news unsettled markets, because concerns over possible unconventional central bank policies, led by György Matolcsy, a new NBH President, were primarily responsible for the March depreciation of the forint to nine-month lows.

Nevertheless, no such wild scenario arose. In the end, the NBH, in line with its previous suggestions, decided to take actions to support loans for small and medium-sized enterprises and early repayments of loans denominated in foreign currencies taken by enterprises. The loans for enterprises will be subject to a 2% interest rate, i.e., far below the official interest rate (5%), and the NBH will lend banks the funds for the loans at zero interest. The total amount of the loans thus granted will be up to HUF 500 bn (approximately 2% of Hungary's GDP). As concerns foreign-currency loans, they will be converted back into forints at market exchange rates (unlike household mortgages),so the impact on forex reserves will not be significant (not just according to central bank forecasts).

The NBP on hold this time, though it might sound dovish

This week, it could be another regional central bank – the National Bank of Poland -which can bring new headlines to traders' screens. After its surprisingly strong rate cut by 50 basis points in March, the NBP has made it clear that this marked the end of its monetary easing cycle, started in November last year. The data, which have been released since the last MPC meeting, should not trigger another change (cut), so we believe that the base interest rate will remain at its all-time low of 3.25%. Nevertheless, NBP's Governor Belka might bring some fresh dovish signals, which will please bulls in the Polisjh bond market. On the other hand, the market has already priced in more than two additional (25) cuts, so it will be very hard to bring Polish yileds even lower.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.8	-0.26%	→	→
EUR/HUF	297	-1.67%	↗	↗
EUR/PLN	4.15	-0.96%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.25	-6.02	→	→
10Y HUF	4.94	-8.52	→	→
10Y PLN	3.33	-7.51	→	→

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Review of Economic Figures

February's drop in the Czech industry is no surprise

Remarkably, one less business day in February this year reduced the overall figure by 4 percentage points. Adjusted for this effect, industry only fell by 1.6%, and month-on-month industrial output even rose by 1.6%.

Cars drove the decline again, with car production having shrunk by 10.4%. While in the first half of last year, cars kept Czech industry afloat, now they are driving industry down.

As signalled by new orders, the months to come will be no great reason to rejoice either. The drop by 10.2%, due to poor domestic as well as foreign demand, has likely delayed the return into the black until the second half of the year. Carmakers also play the crucial role in the decline of orders, and thus the bad times for this strongest industry of the Czech Republic are still far from being over.

Czech exports go down hand in hand with the industry

While the trade balance again showed a promising double-digit surplus, the Czech Republic's exports as well as imports plummeted again.

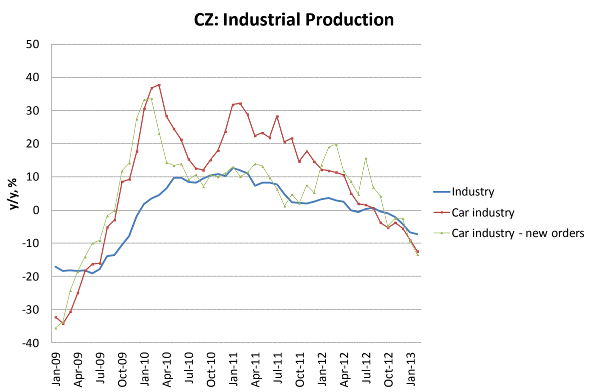
Exports primarily indicate the poor performance of the most important items in which the Czech Republic trades – i.e. cars and machinery. The drop in exports to Germany is no good sign either, as the German economy is performing decently and demand in its market is improving. By contrast, lower exports to the rest of the eurozone, which has been going through a lengthy recession of its overly indebted countries, is not that surprising.

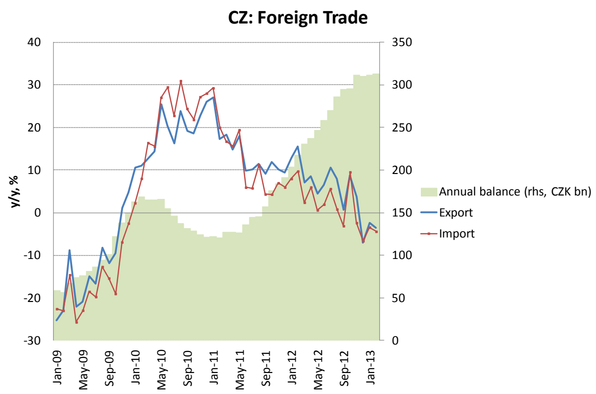
By contrast, imports are going down because of poor domestic demand, which lacks any stimulus. This is yet more evidence that cars are not much in demand this year on the Czech market either, and their imports are consequently falling.

Foreign trade reflects a not quite good condition of the European economy, to which the Czech economy is closely tied. This is why we anticipate poor figures from industry and exports in the months to come, as any stimulus to turn the Czech economy back into the black is still nowhere to be seen.

Thus, no surprise that the CNB still sounds dovish

When we look into the last minutes of the Czech National Bank, we find that the central is still flirting with the idea of futhre easing. While the latest situation report sees the risks of the forecast as very slightly on the downside and "tilted towards slightly easier monetary conditions", the CNB does not yet seem to be set for forex interventions. According to the minutes of the meeting, the CNB is weighing whether a depreciation of the koruna would activate consumers, who would stop deferring consumption; moreover, owing to the 'substitution channel', they would prefer domestic goods. Nonetheless, this construct seems to involve more cons than pros to be used now.





In Focus: Hungary is the most dependent on trade with the PIIGS

Hungary proves to be the most vulnerable in a comparison of dependence on the foreign demand from PIIGS.

Central European economies, including the largest one, Poland, are substantially dependent on foreign trade. Foreign trade alone strongly contributes to the GDP. In addition, foreign demand works as a driver that propels new investment and job creation. In doing so, it actually pre-sets the bounds for the domestic demand in Central European economies to a great extent.

As the global economy is going through a greater divergence in growth, it is quite important to know the export markets to which Central European countries are most exposed. In 2013, the U.S. economy is likely to continue to grow decently, China's growth will accelerate, while the eurozone is about to go through its second consecutive year of recession. This is why we are trying to compare Central European economies in terms of their total exposures to foreign trade, as well as in terms of their exposures to specific territories. We primarily distinguish the overall exposure to demand from the eurozone and from PIIGS (Portugal, Ireland, Italy, Spain, and Greece), which may be the most risky in 2013. In this regard, Hungary remains the most vulnerable: firstly, it is the most dependent on foreign demand; and secondly, it has the greatest exposure to the eurozone as a whole as well as to PIIGS.

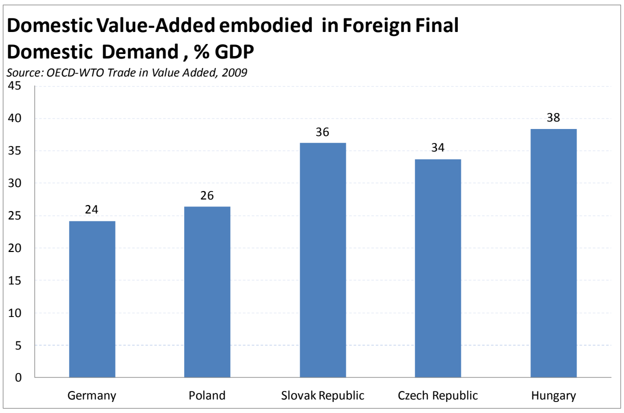
We use Domestic Value-Added embodied in Foreign Final Domestic Demand, compiled by OECD, to measure accuratelly the exposure.

In comparing export structures, we use the OECD database that monitors the use of exports by final consumers. Thus, if Czech exporters export intermediate products to Germany, but the products are intended for the manufacture of vehicles for the Indian market, the OECD statistics will show a greater exposure of the Czech Economy to the Indian than to Germany (the final consumption is the crucial criterion). The indicator that the OECD has designed is referred to as the Domestic Value Added embodied in Foreign Final Domestic Demand – DVAFFD. The advantage of using the DVAFFD is fairly clear. The importance of transnational customer-supplier chains has increased quite significantly over recent years. Hence a simple territorial comparison of net exports may not reveal much about to which consumer basket the specific economy is most sensitive. With its focus on final demand, the DVAFFD addresses this shortcoming. Its disadvantage is a significant delay in data releases – at the moment, the latest data from OECD dates back to 2009. Nevertheless, if we want to evaluate the structure of the economy rather than its dynamics, a greater delay may not do much harm.

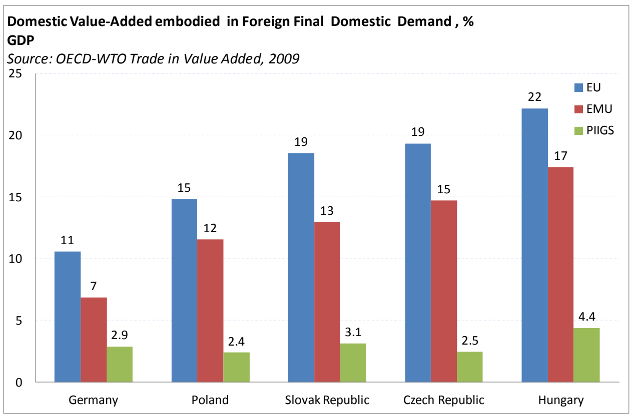
Compared to Germany, all Central European economies show greater exposures to foreign demand in general as well as to foreign demand from eurozone countries..

The comparison indicates that, in Central Europe (see the graphs below), Hungary is the most exposed to foreign trade – DVAFFD comprises 38% of its GDP. However, Slovakia lags behind only slightly (36% of GDP), as does the Czech Republic (34% of GDP). Even the largest Central European economy, Poland, is more dependent on foreign demand than Germany, the export driver of the eurozone.

If we compare exposures to the European Union and the eurozone, we find that Hungary is again the leader (22% and



Domestic Value-Added embodied in Foreign Final Domestic Demand , % GDP
Source: OECD-WTO Trade in Value Added, 2009



Domestic Value-Added embodied in Foreign Final Domestic Demand , % GDP
Source: OECD-WTO Trade in Value Added, 2009

17% of GDP respectively), and is also clearly the most exposed to PIIGS (4.4% of GDP), due in particular to its strong dependence on demand from Italy.

A comparison between the Czech Republic and Slovakia is interesting. While the Czech Republic's dependence on PIIGS is fairly low (2.5% of GDP), the country is more dependent on the overall eurozone demand than its eastern neighbour. This is really due in particular to the Czech Republic's very strong dependence on final German demand (6% of GDP in the Czech Republic, as opposed to 4% of GDP in Slovakia). There is every indication that Slovak exporters, by contrast, have much stronger direct or indirect links with the Russian market (0.9% of GDP in the Czech Republic; 2.5% of GDP in Slovakia).

All countries including Poland are more dependent on demand from their EU neighbours than is Germany. For Germany, the final demand from the United States is the most crucial, and the U.S. is also the final destination of numerous articles initially exported to China as intermediate products or comprehensive sets of equipment. In Central European economies, the final demand from the U.S. is of greater importance to the Czech Republic only (the U.S. is the second-most important economy after Germany for the Czech Republic).

Weekly preview

TUE 9:00 **CZ Inflation (change in %)**

	Mar-13	Feb-13	Mar-12
CPI m/m	**0.1**	0.1	0.2
CPI y/y	**1.7**	1.7	3.8

CZ: Inflation recedes

The disinflation trend persisted in February. Thus year-on-year inflation remained below the CNB target, notwithstanding the January increase in both VAT rates. The lack of demand-pull inflation makes the central bank adopt a wait-and-see attitude, extend the period of low interest rates, and consider forex interventions. This will also be true of the months to come, with inflation continuing to be below the target.

THU 9:00 **CZ Retail sales (y/y change in %)**

	Feb-13	Jan-13	Feb-12
Monhtly	**-2.8**	-0.5	1.7
cummulative (YTD)	**-1.7**	-0.5	2.0

CZ: Bad weather delays seasonal jobs

Although seasonal jobs usually start in March, with the number of unemployed falling, this year's worse weather delayed the recruitment of seasonal staff. Moreover, the economy remains in a recession, which leads to a falling number of vacancies. Even though seasonal jobs will certainly have an effect in the months to come, the labour market situation will not improve yet.

WED 14:00 **NBP rate (in %)**

	This	Last change
rate level	**3.25**	3/2013
change in bps	**0**	-50

PL: The NBP on hold this time

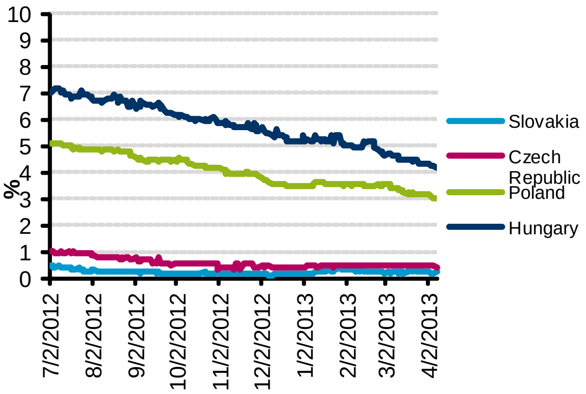
After its surprisingly strong rate cut by 50 basis points in March, the National Bank of Poland (NBP) has made it clear that this marked the end of its monetary easing cycle, started in November last year. The data to be released this month should not change the decision by the NBP at all, and therefore we believe that the base interest rate will remain at its all-time low of 3.25%.

Calendar

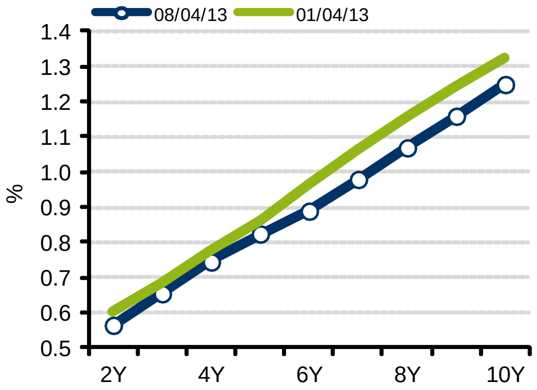
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	04/08/2013	9:00	Trade balance	EUR M	02/2013 *P			720		316.2	
CZ	04/08/2013	9:00	Construction output	%	02/2013						-9.3
CZ	04/08/2013	9:00	Industrial output	%	02/2013		-5		-5		-4.1
CZ	04/08/2013	9:00	Trade balance	CZK B	02/2013	25.6		28.8		31.5	
HU	04/08/2013	17:00	Budget balance	HUF B	03/2013					-339.5	
CZ	04/09/2013	9:00	CPI	%	03/2013	0.1	1.7	0.1	1.7	0.1	1.7
CZ	04/09/2013	9:00	Unemployment rate 15-64	%	03/2013	8.2		8		8.1	
PL	04/10/2013	14:00	NBP meeting	%	04/2013	3.25		3.25		3.25	
HU	04/11/2013	9:00	CPI	%	03/2013			0.6	2.6	-0.1	2.8
HU	04/12/2013	9:00	Industrial output	%	02/2013 *F					0.3	-1.1
PL	04/12/2013	14:00	Money supply M3	%	03/2013			0.6		0.8	

Fixed-income in Charts

FRA 3x6

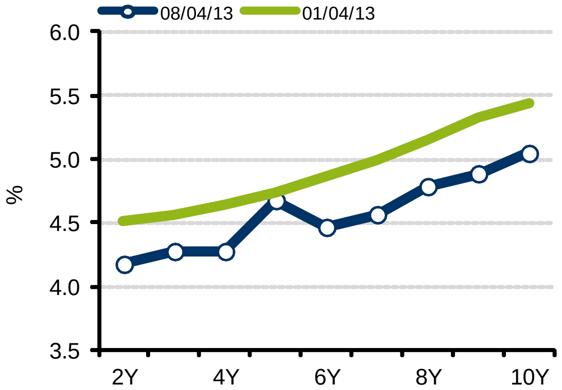


CZ IRS

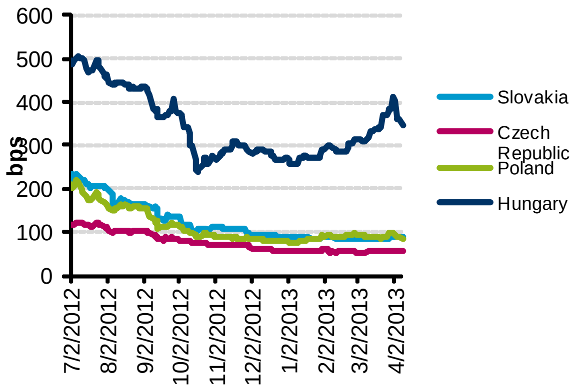


10Y GB Yields

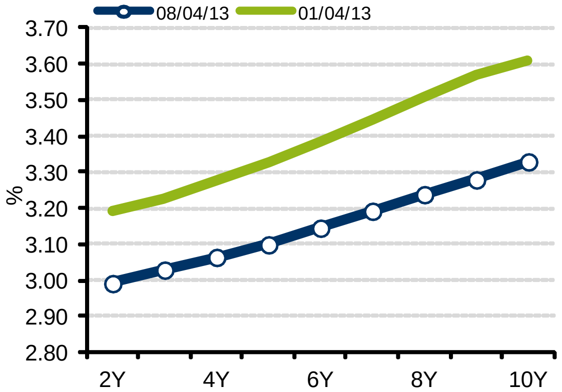
HU IRS



CDS 5Y



PL IRS



Source: Reuters

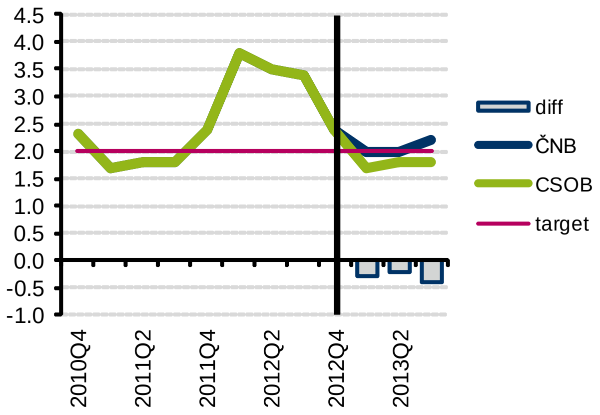
Medium-term Views & Issues

	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.	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.	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 does not have much space to weaken further above 26.00 EUR/CZK. We believe in near term stability and lower volatility in a range 25.20-26.00 EUR/CZK.	The forint has experienced some volatility, which has been attached to the recent appointment of a new NBH 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.

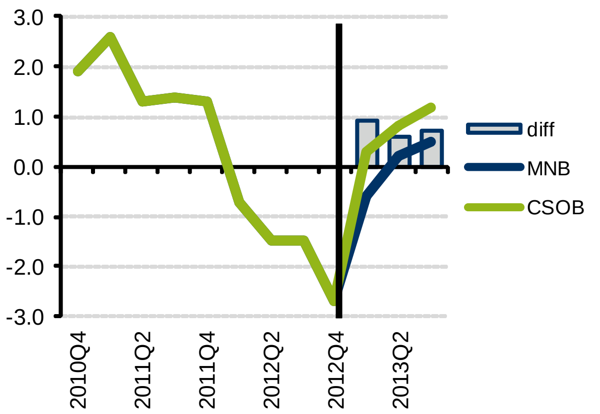
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

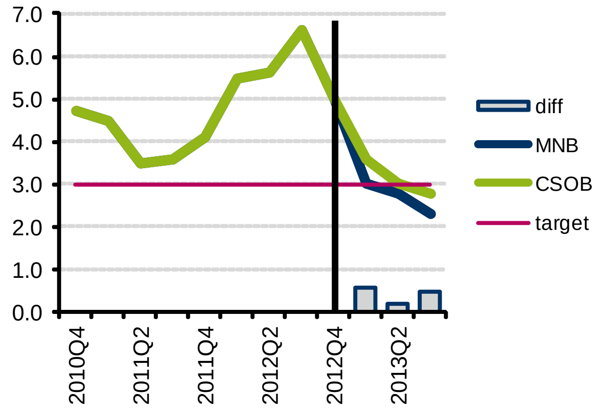
CZ: Inflation outlook (Y/Y, %)



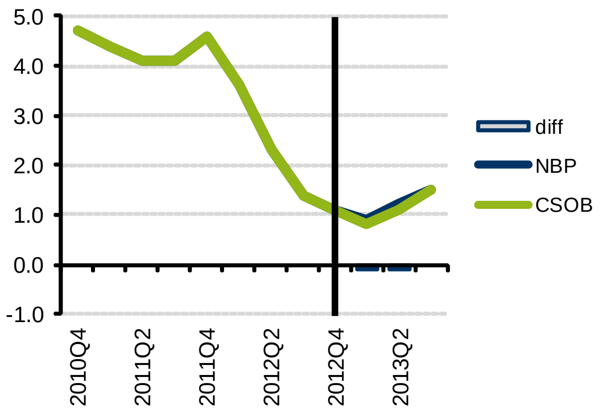
HU: GDP outlook (Y/Y, %)



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.	*5.00*	6.50	5.75	5.25	4.75	4.50	-25 bps	3/26/2013
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	*0.47*	0.80	0.50	0.47	0.46	0.45
Hungary	BUBOR	*4.88*	6.61	5.75	5.20	4.70	4.50
Poland	WIBOR	*3.37*	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	*1.25*	1.61	1.37	1.43	1.58	1.78
Hungary	HU10Y	*4.94*	6.56	5.49	7.25	7.00	4.80
Poland	PL10Y	*3.33*	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	*25.8*	25.1	25.1	25.7	25.4	25.0
Hungary	EUR/HUF	*297*	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	1.7	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
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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
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