Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 15 April 2013

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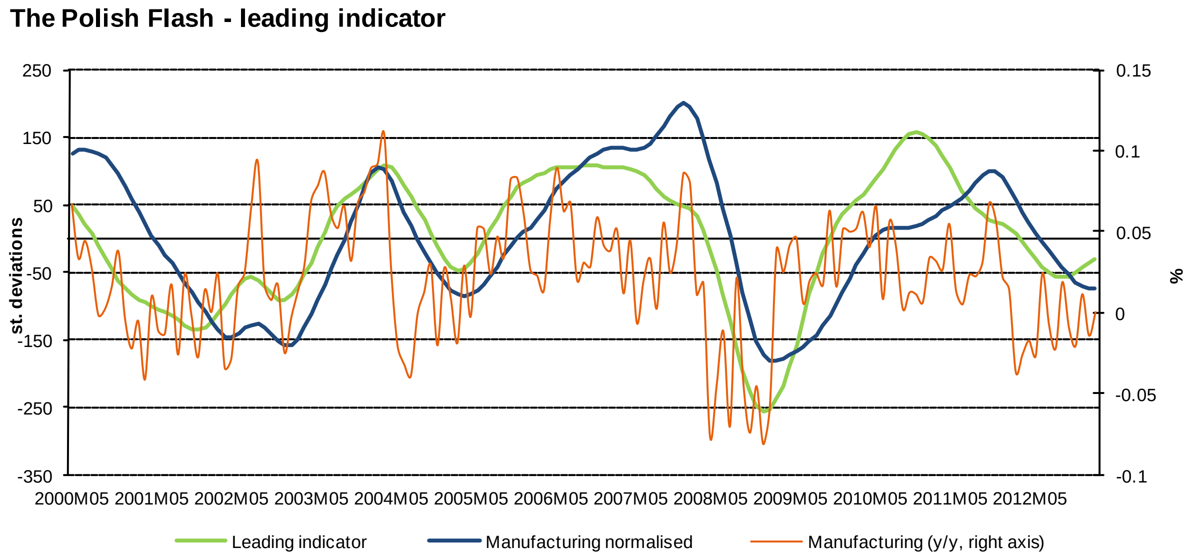
Weekly Highlights:

- Positive real interest rates make the zloty and Polish government bonds attractive
- Hungary's inflation fell to new all-time lows
- Inflation is not and will not be, for a long time, a problem of the Czech economy
- Leading indicators for industry continue to improve, but the rate of improvement unfortunately decelerates

Chart of the Week: The Polish Flash



The Polish flash (leading indicator) has improved further, but the momentum has surprisingly deteriorated

Market's editorial

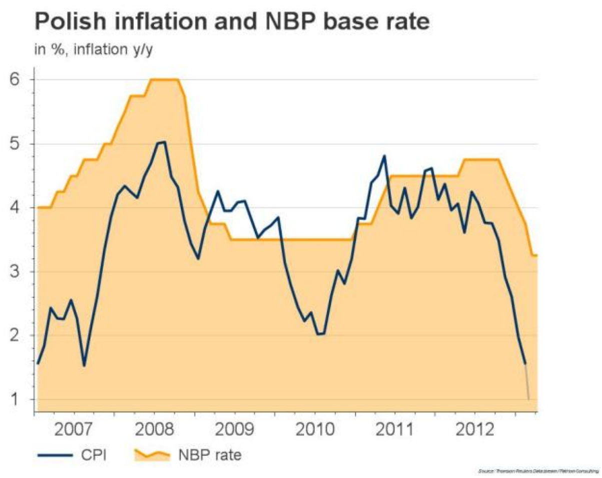
Positive real interest rates make the zloty and Polish government bonds attractive

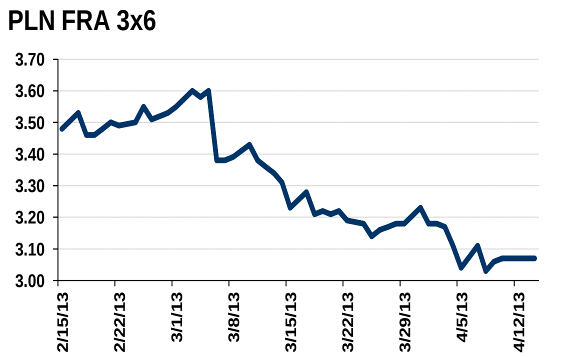
The National Bank of Poland (NBP) matched expecations and left its interest rate at the all-time low of 3.25%. As this had been generally anticipated, markets focused their attention on the press conference in particular. The tenor of the conference evidently disappointed some market participants. Since the last surprising rate cut by 50 basis points (bps), the market has built up bets on further rate cuts by a total of 50 bps within six months. Nevertheless, NBP President Belka warned against bets on rate cuts in May and even expressed concern about possible adverse impacts of unconventional monetary policies. Bear in mind that Poland is one of the few countries where interest rates are significantly positive if adjusted for inflation, and thus the NBP is far from employing an unconventional policy. This impression has been underlined by the March inflation figures as the headline rate decelerated even further (the year-on-rate fell to 1.0% - see the Chart below).

Hence Belka's statement, along with the NBP's bets on the bottoming out of the Polish economy in the second quarter, can be seen as a curb on further rate cuts. Nonetheless, we currently view positive real rates as the greatest risk to further decisions by the NBP, because the increasing attractiveness of Polish bonds to foreign investors led to increased cash flow from foreign countries to Poland last week (partly due also to the fresh stimuli from the Bank of Japan), and resulted in a strong appreciation of the zloty (by 1.4% in a week). If this trend were to persist, the strengthened zloty, all other circumstances remaining constant, would push the inflation rate downwards, and this might potentially convince the NBP of having to cut rates again; however, such a scenario is not relevant at the moment, and therefore we still bet on NBP rate stability – at least until another inflation forecast by the central bank is released in July.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*25.9*	*0.84%*	↘	↘
EUR/HUF	*295*	*-0.93%*	→	↘
EUR/PLN	*4.11*	*-0.18%*	→	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.30*	*1.25*	→	↗
10Y HUF	*4.82*	*-4.55*	→	→
10Y PLN	*3.40*	*-0.29*	→	→





PLN FRA 3x6, last 50 days. Source: Reuters

Review of Economic Figures

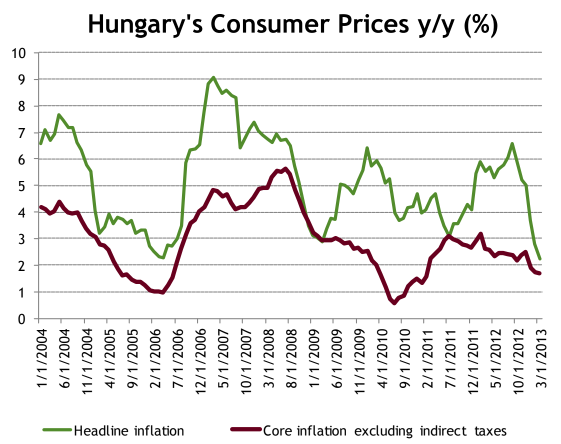
Hungary's inflation fell to new all-time lows

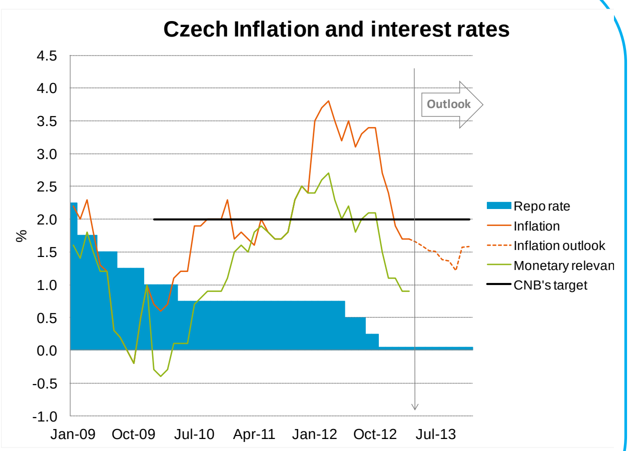
Hungary's year-on-year inflation rate continued to fall to as low as 2.2% in March, the lowest inflation level since the fall of communism in that country. While an administrative order to cut electricity prices contributed to a fall in February's inflation rate, the actual stagnation of food prices and the drop in fuel prices contributed to a very moderate month-on-month increase of 0.3% in March. Of course, permanently poor domestic demand has contributed to the very favourable inflation developments, as the year-on-year core inflation rate, adjusted for the effect of indirect taxes, has already fallen to 1.7%. This is also one of the key reasons why we believe that the National Bank of Hungary will continue to cut its base rate.

Despite VAT hike the Czech inflation remain below the central bank target

Inflation, just like the whole economy, is highly subdued. With the consumer price index up by 0.1% last month, it was just a very moderate change, stemming from increases in certain food prices. Compared to March 2012, the CPI was up by 1.7%, just like in February. Compared to last year, the CPI rose the most in the food category (+4%), where prices have been rising quite rapidly for almost a third consecutive year. By contrast, consumer prices of household equipment and notably electronics have fallen.

Inflation is not and will not be a problem of the Czech economy. Consumer prices are rising at a slower rate than the Czech National Bank target, in spite of this year's increase in both VAT rates. Poor consumer demand, which has not yet recovered from last year's record-breaking fall, does not enable retailers to raise the prices of their goods and services to any great extent, and thus curbs inflation. Hence the Czech Republic remains a low-inflation economy, and this will also be true of the rest of this year. Thus low inflation is enabling the CNB to keep interest rates at record-low levels for a prolonged period. Concurrently, however, this fosters a debate about a further possible monetary easing, for which the central bank may only use forex interventions against the koruna now.





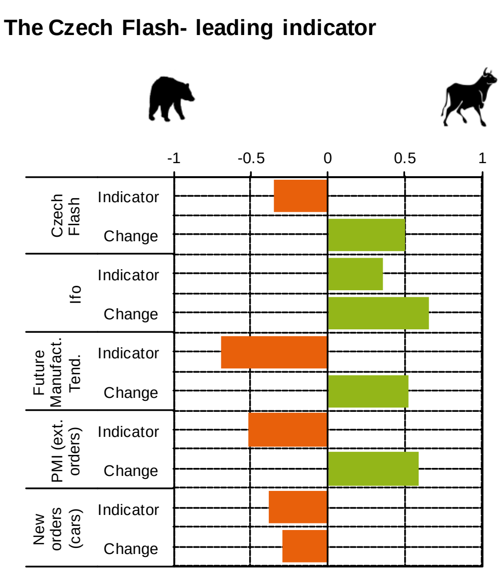
In Focus

Leading indicators in Central Europe continue to improve, but the momentum is lacking, which raises the questions about the sustainability of the recovery

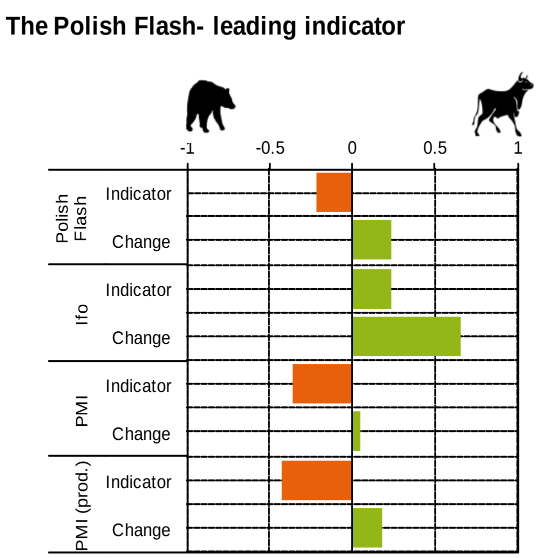
The Czech Flash rose for the fifth consecutive time in March and hit the highest levels since June 2012. In addition, normalised industry improved in February, for the first time in twelve months, following two seasonally adjusted month-on-month increases. At first glance, this confirms our main scenario of a recovery in industry by the middle of 2013; however, there are some BUTs!.

With the advance of a more stable recovery, the Flash usually boosts its positive momentum from month to month. Unfortunately, the positive momentum has declined across all the positive sub-categories in March. Another and more serious warning continues to be the development of new orders in the automotive industry – one of the key components of the Czech Flash- that has not yet started to improve at all, and deteriorated for the thirteenth consecutive time in March. Thus the initial post-crisis driver of the Czech industry may turn into an undesirable curb in 2013. Putting it together, the uneven development of sub-categories and losing momentum of the Flash are warning signals – the upbeat sentiment might disappear as rapidly as happened in late 2011..

Just like the Czech Flash, the Polish Flash improved for the fifth consecutive time in March and, just like its Czech counterpart, it hit the highest levels since June 2012. Unfortunately, the Polish Flash is also losing its positive momentum, which is disturbing especially at these relatively low levels. Although all components of the Polish Flash improved in March, the positive momentum of all of them (Ifo, PMI, PMI-production) decelerated vis-à-vis February. This is not a good signal for the strength of any recovery in industry. Moreover, the Polish industry (normalised timeline), unlike its Czech counterpart, did not see its long-expected bottoming out in February yet..



*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)*



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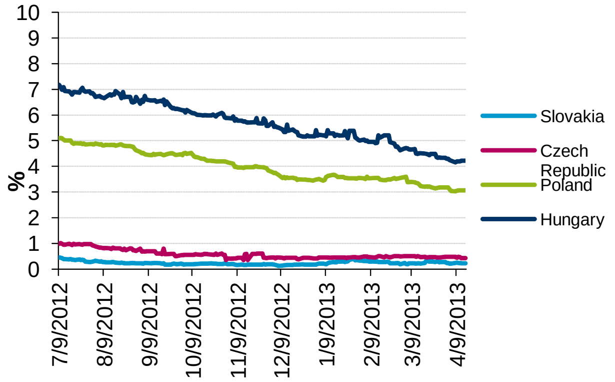
**Change: the change in the indicator vis-à-vis historical values
(1 = the current value is the maximum historical value; -1 = the current is the minimum historical value)*

Calendar

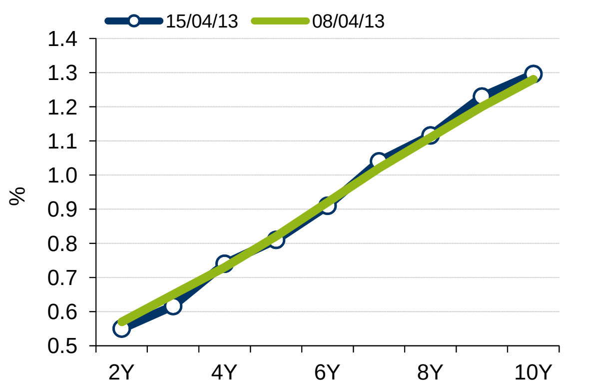
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	04/15/2013	9:00	PPI	%	03/2013	0.1	1.1	0.1	1.1	0	1.3
CZ	04/15/2013	10:00	Current account	CZK B	02/2013	10		4.25		6	
PL	04/15/2013	14:00	Current account	EUR M	02/2013			-1507		-1546	
PL	04/15/2013	14:00	Trade balance	EUR M	02/2013			-241		5	
PL	04/15/2013	14:00	CPI	%	03/2013		1.2	0.3	1.1	0	1.3
PL	04/15/2013	15:00	Budget balance	PLN M	03/2013					-21655	
PL	04/16/2013	14:00	Core CPI	%	03/2013			0.2	1	-0.1	1.1
PL	04/17/2013	14:00	Wages	%	03/2013			4.3	2.6	0.8	4
HU	04/18/2013	9:00	Wages	%, ytd.	02/2013				3.3		2.5
PL	04/18/2013	14:00	Industrial output	%	03/2013			10.2	-2.2	-2.8	-2.1
PL	04/18/2013	14:00	PPI	%	03/2013			0	-0.4	0.3	-0.4

Fixed-income in Charts

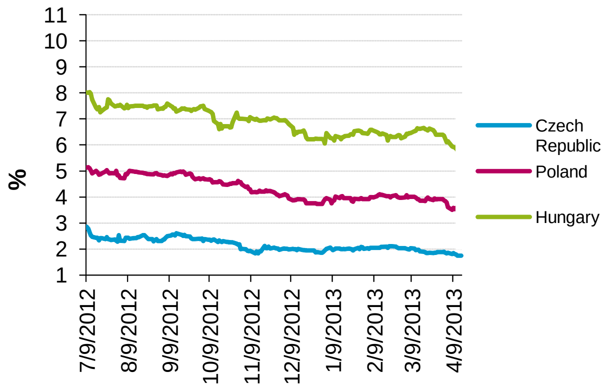
FRA 3x6



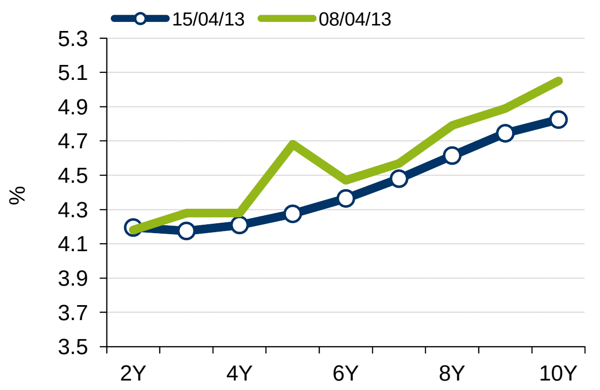
CZ IRS



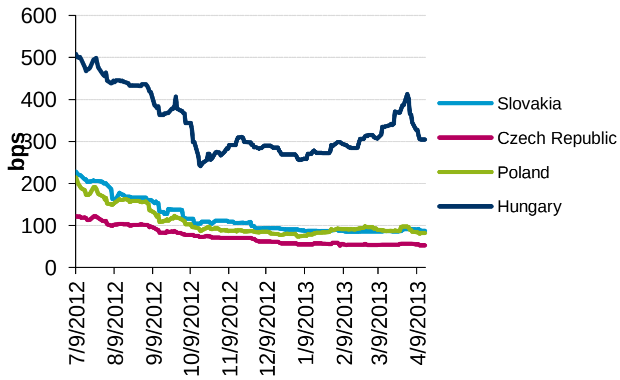
10Y GB Yields



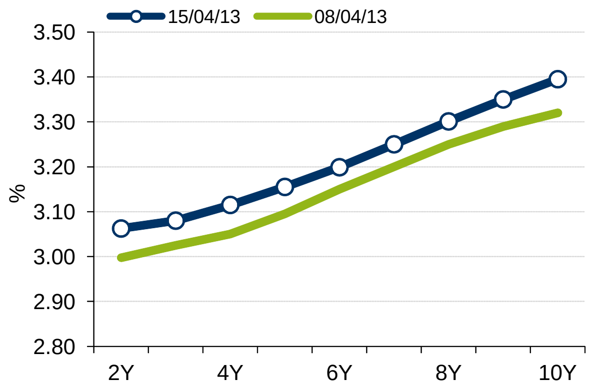
HU IRS



CDS 5Y



PL IRS



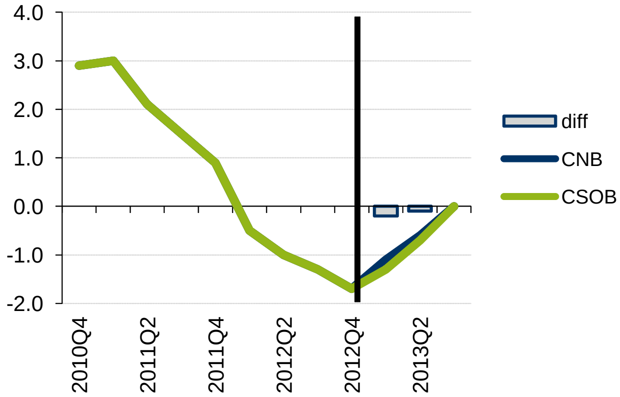
Source: Reuters

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 again has curbed 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 rather visible in 2015.	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.	With newly appointed governor of the NBH György Matolcsy and his deputies, the doves have overwhelming majority in the central bank. The tendency for further monetary easing will be mainly supported by the inflation, which decelerated below the central bank target and the domestic demand which stays very low. On the other hand monetary easing is limited by the forint, which is very vulnerable and its weaker levels would hurt FX debtors. We thus believe that NBH will cut rates gradually further. We see the lowest levels of NBH rate at 4.5%, while the downside risk to our forecast is high due to current low transparency of the NBH. .	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

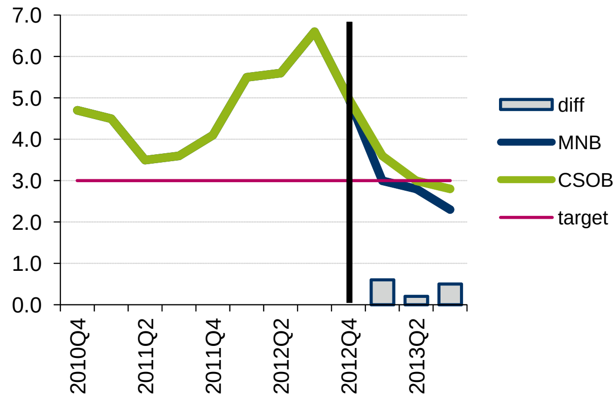
CZ: GDP outlook (Y/Y, %)



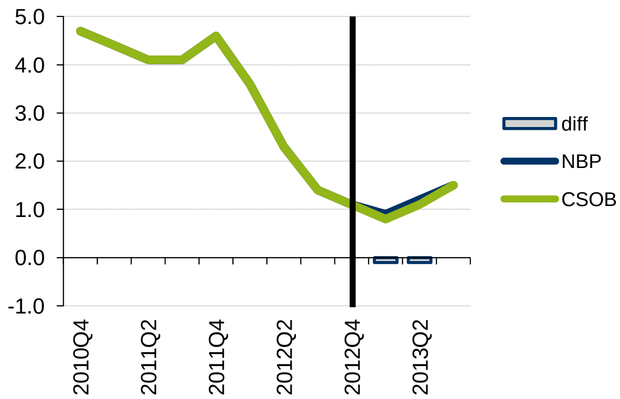
CZ: Inflation outlook (Y/Y, %)

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	*4.89*	6.61	5.75	5.20	4.70	4.50
Poland	WIBOR	*3.35*	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	*1.296*	1.61	1.37	1.43	1.40	1.55
Hungary	HU10Y	*4.82*	6.56	5.49	7.25	7.00	4.80
Poland	PL10Y	*3.40*	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	*25.9*	25.1	25.1	25.7	25.4	25.0
Hungary	EUR/HUF	*295*	285	291	280	280	#N/A
Poland	EUR/PLN	*4.11*	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

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