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Central European Weekly

Tuesday, 21 May 2013

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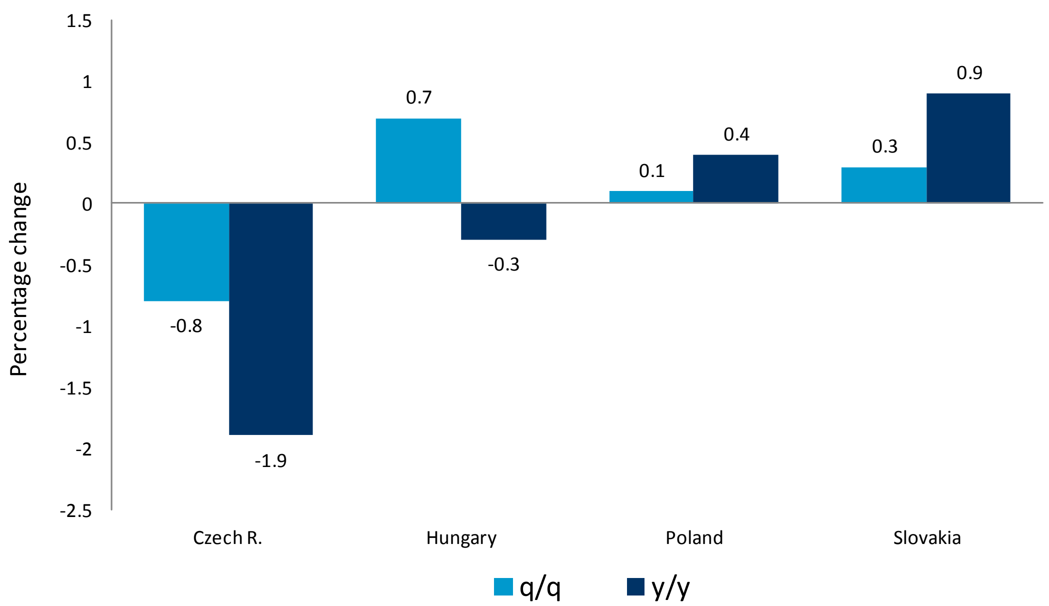
Chart of the Week: GDP in Q1 of 2013



The Czech economy has become to underperform its regional PEERs.

Market's editorial

The koruna's underperformance has intesified

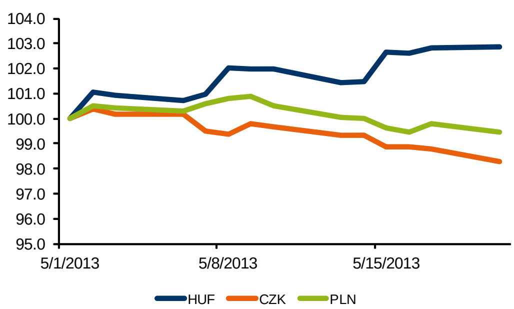
The result of the Czech economy for the first quarter of this year was a cold shower for all – analysts, official authorities, led by the Government and the CNB, and last but not least the market. As a result the decoupling of the Czech currency from the rest of the region has begun to intensify and the EUR/CZK pair broke above the 26.0 level. Both technically and findamentally more koruna's losses could be in the cards.

The performance of Czech GDP is alarming, not only because the actual performance is much worse than expected, but especially when looked at in relative terms: above all, this Czech recession has been the longest recession since the market economy was restored in this country, and the comparison to the Czech Republic's neighbours in the region is not favourable either. In a way, we are already used to seeing Germany, Slovakia, or Poland outperform the Czech Republic, but the fact that the over-indebted Hungarian economy is starting to recover faster than its Czech counterpart is a completely new phenomenon.

The question now is whether anything can be changed quickly about such a poor relative performance of the economy (whether in the historical or territorial comparison). A weaker koruna and zero interest rates may slightly help the economy, but these instruments alone will hardly lead to an economic wonder in a small open economy. Nor should we even expect any structural conversion of the economy into an economic tiger at any time soon, albeit the breath of competition in certain oligopolistic structures is a positive signal. Thus fiscal policy continues to be the only effective instrument of domestic economic policy for fighting recession. However, the experience of recent years does not give much cause for optimism either – at the moment, the imagination seems to end with shifting a VAT rate and reconstructing a single motorway.

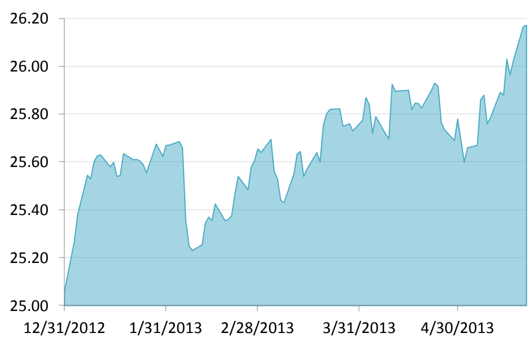
By and large: a bet on any positive domestic stimuli driving the Czech economy out of its recession seems to be hopeless in a short-run. As always, the Czech economy and koruna can can only bet on the stronger performance of Germany. At the same time the falling commodity prices, which will hopefully boost the weakened disposable income of Czech households, might also be a certain (external) benefit.

CE currencies agains the euro



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	26.2	0.50%	→	→
EUR/HUF	290	-0.68%	→	↘
EUR/PLN	4.18	0.03%	→	→

EUR/CZK, year-to-date performance



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.36	1.88	→	↗
10Y HUF	4.58	1.89	→	→
10Y PLN	3.18	2.58	↘	→

Review of Economic Figures

The Hungarian economy is picking up (at last)

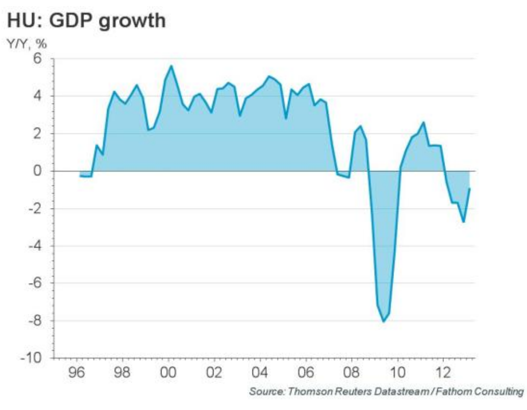
The Hungarian Central Statistical Office (KSH) released preliminary economic figures for the first quarter of this year, which sprang a pleasant surprise. According to the preliminary data, the Hungarian economy grew by 0.7% q/q while it declined on the year-on-year basis, but only by 0.9%, and by as little as 0.3% when adjusted for calendar effects.

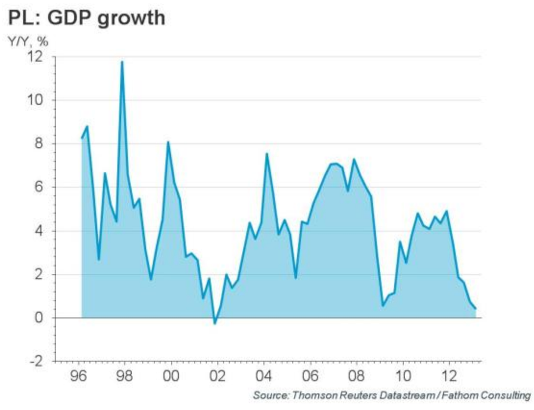
The overall growth structure will be unveiled on June 6, but the KSH states that construction, along with agriculture, is responsible for the favourable figures. This is no surprise, in view of last year's crop failure. In addition, the data is preliminary and the agricultural output figures are based on estimates, which may differ from the reality. We should also bear in mind that quarter-on-quarter growth is partly attributable to a low comparative baseline, while poor figures from Germany raise doubts about growth sustainability. On the other hand, Hungary's prospects may not be quite bad. Low inflation (notably the reduction in energy prices), along with the increase in the minimum wage, might theoretically boost domestic demand. We need to wait for the detailed data to see whether this really happened or whether households saved their disposable funds. Government expenditure might also contribute to growth; however, the Government is going to curb its expenditure in order to be able to extract itself from the excessive deficit procedure. The situation in industry is not that bad either. While industry is still falling on the year-on-year basis, month-on-month data has indicated a change in the trend since the beginning of the year. It seems that the promising acceleration of the automotive industry might especially contribute to improving the performance of the Hungarian economy. The announced growth programme of the National Bank of Hungary might also boost the economic recovery somewhat, although the amount of loans planned for small and medium-sized enterprises does not seem to be large enough to become a driver of the economy. We need to wait for the final data to draw any strong conclusions, yet the economic decline in the last quarter of last year seems to be a one-off phenomenon rather than a beginning of a deeper recession.

Polish GDP disappoints, inflation falls below 1% so the case for another NBP's rate cut in June is well in place

Just like the other Central European statistical offices, the Polish one (GUS) decided to release a flash GDP growth forecast for the first quarter of this year, making it first time that the forecast was released only a month and a half after the end of the period concerned. Just like in the Czech Republic, the figure was not very positive. While the forecast shows that the Polish economy grew by 0.4% y/y, which is an outstanding figure in the Central European context, it was Poland's slowest growth in the last four years. Just as in previous quarters, net exports likely continued to be the primary driver of growth in early 2013, as also suggested by a significant Q1 surplus in the positive balance of goods and services, registered in the balance of payments statistics of the NBP. By contrast, a rapid drop in imports suggests persisting poor domestic demand, in addition to falling commodity prices (see "In Focus").

Although GUS may revise the GDP figure slightly upwards in late May, slow economic growth, and notably its adverse structure, are likely to trigger a reaction from the central bank (NBP), as doves on the Monetary Policy Council (MPC) have received another argument for the discussion – another (albeit anticipated) decline in the inflation rate, which hit seven-year lows in April (0.8% y/y). Finally, a rate cut as early as at the June meeting (originally, we expected another cut in July) is also signalled by the latest statements from those central bankers who have tended to be slightly hawkish in the MPC context for a long time. The question still is how much the rates will be cut. Although a rate cut by 50 basis points (bps) cannot be ruled out, we believe that a 25 bps rate cut is more likely. The above-mentioned release of the GDP growth structure, scheduled for late May, can provide additional information in this regard.





In Focus: GDP and terms-of-trade in Q1

The Q1 Czech and German GDP releases disappointed many observers, who had expected a better number. Germany grew by only 0.1% q/q (consensus: +0.5%) while the Czech economy even fell by 0.8% (consensus -0.2%). However, in both the Czech and the German economy, the industrial output, retail sales and, after all, even from foreign trade data showed (quarter-on-quarter) improvements. What went wrong?

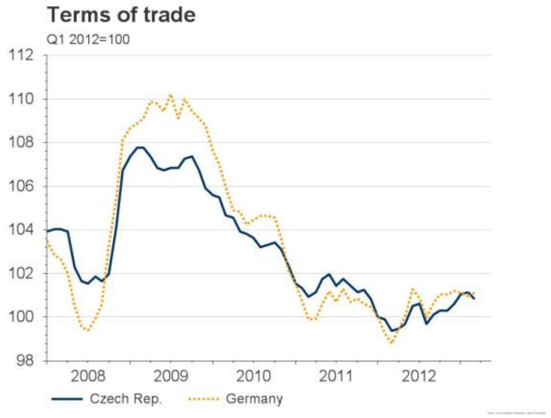
Preliminary observation, no detailed information about the structure of GDP is available, i.e., the currently released figures are simply preliminary forecasts, which may be significantly revised. Yet interesting information can already be drawn from comments by the respective Statistical Offices. The comments in the Czech Republic and Germany are very similar. According to Czech Statistical Office, net foreign trade (real terms) was the greatest burden on growth and according to German Statistisches Bundesamt the balance of exports and imports had almost no impact, even as the balance of foreign trade in both economies improved in Q1. The seasonally adjusted nominal trade balance increased by 3% q/q in the Czech Republic, and by a huge 9% q/q in Germany.

The paradox between net trade making a negative contribution to (real) GDP growth and the sharp increase in the (nominal) trade balance might be explained by the terms of trade, in other words the ratio between export and import prices. Indeed when export prices rise more than import prices, the nominal trade balance may improve, without a net change in the quantities imported or exported and thus having no impact on GDP growth. This is certainly not ruled out, because prices in commodity markets have fallen in recent months, thus pushing import prices across Europe down. A simple comparison of monthly import and export prices indicates that the terms of trade in both economies are improving this year (see the graph), but not to the extent of the negative contribution of net trade to Q1 GDP suggests. Only the detailed GDP structure, to be released later on, will make sure whether our explanation of the terms of trade is correct. Please note that the export and import deflators used to calculate the contribution of net exports to GDP are volatile and may sometimes be changed considerable as more information becomes available. If the preliminary GDP figures are confirmed and the change in the terms of trade explains our paradox, it would not really change the interpretation of the GDP, notably that Q1 was a very bad quarter for the economy. Let us add that another possible reason that might have driven net foreign trade negative is services, the surplus of which declined in the Czech Republic on a quarter-onquarter basis, according to the Czech National Bank data.

Concluding, while Q1 GDP report was disappointing and suggest a very weak environment, especially in the Czech economy, **it might not be as gloomy as suggested by most commentaries after the GDP release**. The same may also be true of Germany. While the real deterioration of net exports (and investment) is indeed bad news, it follows last year's strong increase in exports. Moreover, Q1 exports might have been diverged by the **strong winter** or, in the Czech Republic, by the **production interruptions** at ŠKODA AUTO. In addition, the automotive industry and industry as a whole are reporting fairly high capacity utilization rates, which might indicate that a turnaround in the negative investment trend is nearby. The drop in real GDP accompanied by the improvement of the terms of trade on account of lower commodity prices, is **good news for the future of both highly open economies**.For example, unlike the CNB, we believe that the lower (import) prices may lead to **a further stabilisation of real disposable income**, laying the foundation for the recovery of (real) household consumption and for domestic demand as a whole.

Quarter-on-quarter change in Q1 2013 (s.a.)

	Czech R.	Germany
Real GDP (%)	-0.8	+0.1
Industrial Output (%)	+1.2	+0.3
Retail sales (%)	-0.5	+1.5
Foreign trade - goods (bn)	+2.1*	+4.1**
	* in CZK	** in EUR

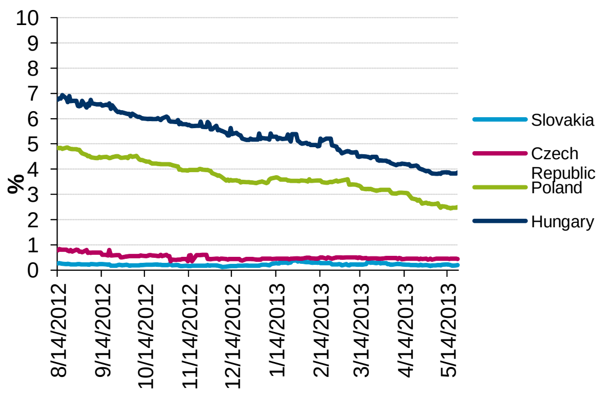


Calendar

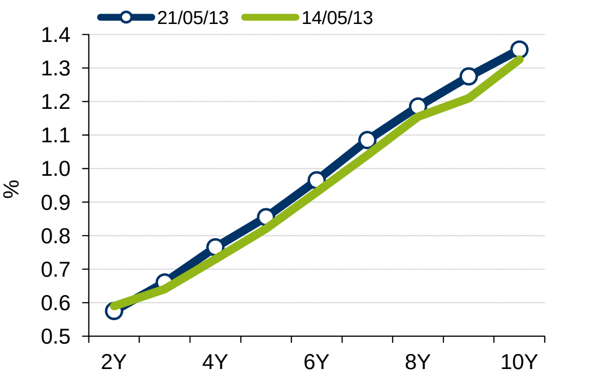
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	05/20/2013	14:00	Wages	%	04/2013			-0.9	2.2	3.3	1.6
PL	05/21/2013	14:00	Industrial output	%	04/2013			-1.7	3.1	9.2	-2.9
PL	05/21/2013	14:00	PPI	%	04/2013			-0.2	-1.5	-0.2	-0.6
HU	05/22/2013	9:00	Wages	%, ytd.	03/2013				3.1		2.7
PL	05/24/2013	10:00	Retail sales	%	04/2013			-1	1.2	16.8	0.1
PL	05/24/2013	10:00	Unemployment rate	%	04/2013			13.9		14.3	

Fixed-income in Charts

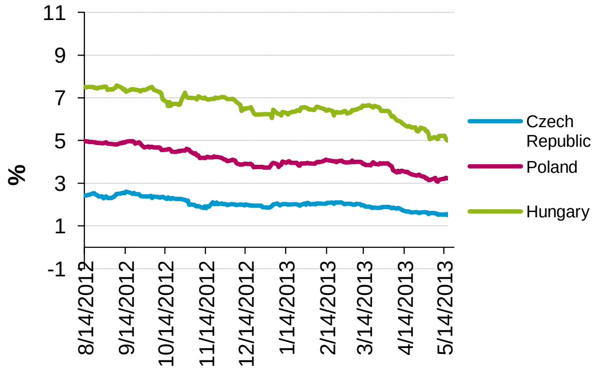
FRA 3x6



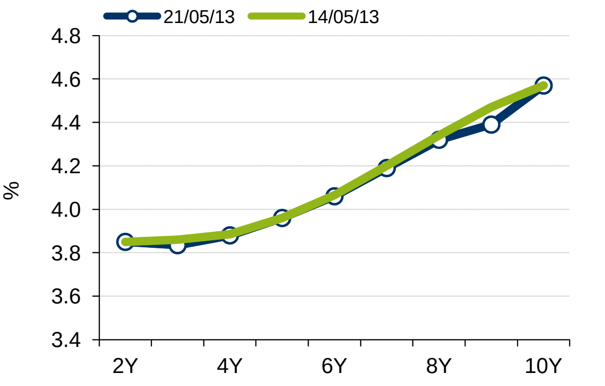
CZ IRS



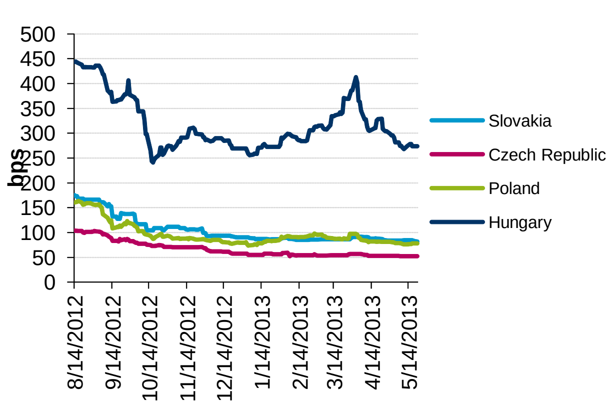
10Y GB Yields



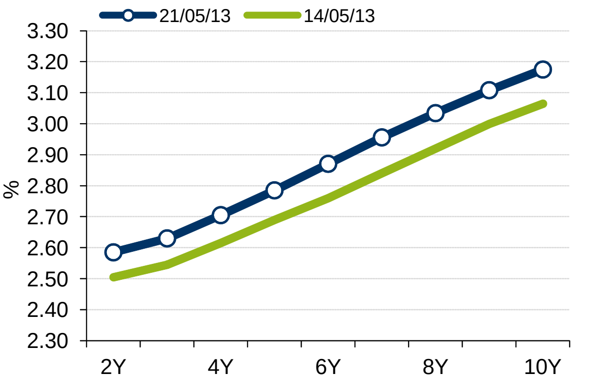
HU IRS



CDS 5Y



PL IRS



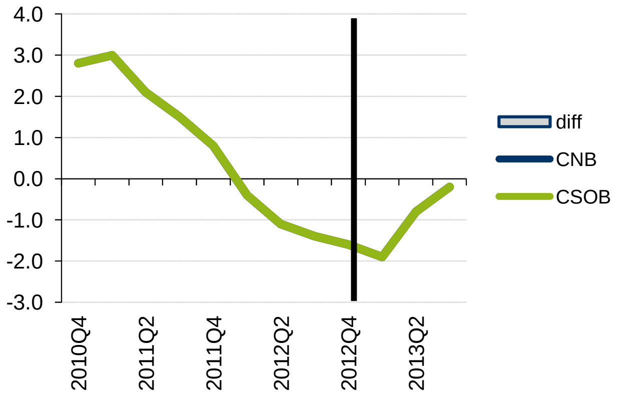
Source: Reuters

Medium-term Views & Issues

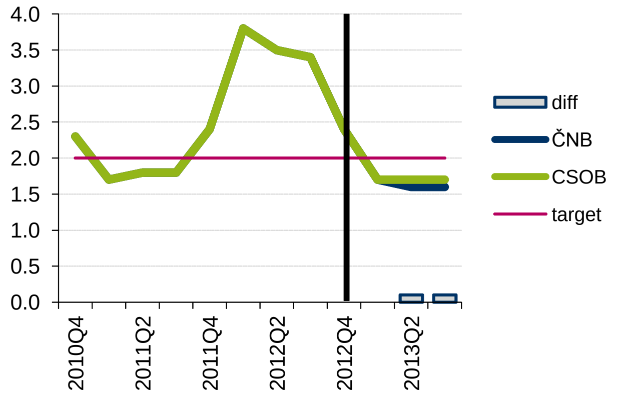
	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech economy remains in a recession, which is shallower but longer than the previous one. The latest data from industry – production as well as orders – still tend to be negative. The drop in domestic demand was followed by a decline in foreign 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 0.7% in the fourth quarter of 2012 (after revision). 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 in the second half of 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 (-0.5%). 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 development or rapidly firming koruna 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.	Clearly, the NBP is concerned with a sharp decline in inflation rate and unfavourable structure of GDP growth, which has lately been almost exclusively driven by net exports; traditionally strong domestic consumption and investment even contributed negatively to the 2012Q4 growth. Although signs of relative underperformance of the Polish economy (in comparison with the previous decade) have been present for some time, we thought the MPC would be reluctant to undertake more aggressive easing policies. Recent decisions of the Council, however, have undermined this view. Therefore, we have revised our outlook and newly expect the reference rate to stay unchanged in June and to be lowered by additional 25 bps in July along with the release of a new Inflation report.
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 25.40-26.00 EUR/CZK. We believe that rather than risks of outright interventions (against CZK), the CNB policy sets a threshold for eventual (fast) strengthening of the koruna. Therefore, we think that the koruna is heading for the period of lower volatility and relative decoupling from global and regional markets.	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, %)



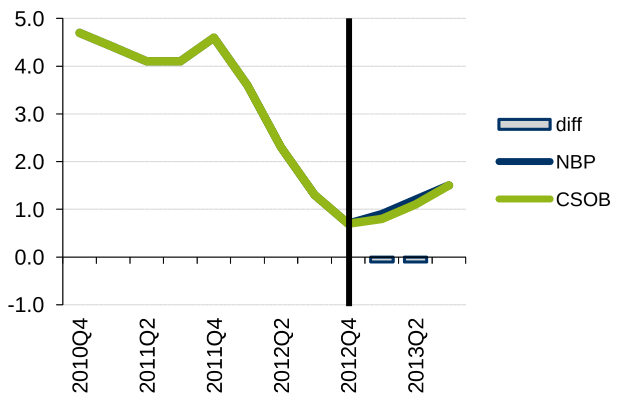
CZ: Inflation outlook (Y/Y, %)



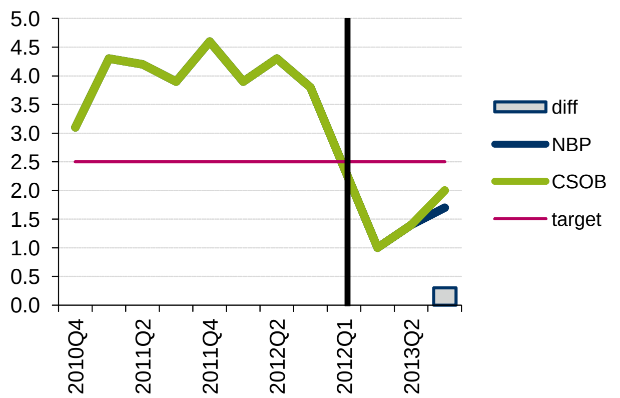
HU: GDP outlook (Y/Y, %)

HU: Inflation outlook (Y/Y, %)

PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, CSOB

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.	*4.75*	6.50	5.75	5.00	4.75	4.50	-25 bps	4/23/2013
Poland	2W inter. rate	*3.00*	4.75	4.25	3.25	3.25	3.25	-25 bps	5/8/2013

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

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	PRIBOR	*0.46*	0.80	0.50	0.47	0.45	0.43
Hungary	BUBOR	*4.56*	6.61	5.75	4.90	4.70	4.50
Poland	WIBOR	*2.81*	4.92	4.11	3.39	4.90	4.90

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

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	CZ10Y	*1.355*	1.61	1.37	1.31	1.40	1.50
Hungary	HU10Y	*4.58*	6.56	5.49	5.41	5.20	4.80
Poland	PL10Y	*3.18*	4.39	3.60	3.61	5.40	5.40

Exchange rates (end of the period)

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	EUR/CZK	*26.2*	25.1	25.1	25.7	25.7	25.5
Hungary	EUR/HUF	*290*	285	291	304	290	300
Poland	EUR/PLN	*4.18*	4.11	4.08	4.18	4.00	4.00

GDP (y/y)

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	-0.4	-1.1	-1.4	-1.6	-1.9	-0.8	-0.2
Hungary	-0.7	-1.5	-1.7	-2.7	-0.9	0.2	0.7
Poland	3.6	2.3	1.3	0.7	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	1.7	1.7
Hungary	5.5	5.6	6.6	5.0	2.2	2.2	2.2
Poland	3.9	4.3	3.8	2.4	1.0	1.4	2.0

Current Account

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

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-3.0
Hungary	-2.5	-2.2
Poland	-3.9	-4.0

Source: CSOB, Bloomberg

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