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Central European Weekly

Monday, 17 June 2013

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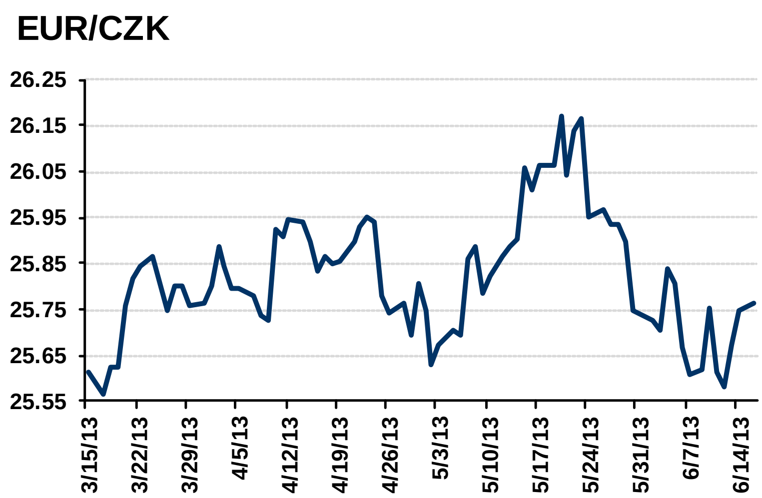
Weekly Highlights:

- The Czech PM Nečas resigns, so fresh political uncertainty looms. Still, Czech markets stay stable
- Inflation falls across the board in Central Europe

Chart of the Week: The Czech koruna



The Czech koruna has showed almost no reaction to a new political crisis, which led to to the resignation of the Czech PM .

KBC Central European Daily

Market's editorial

The Czech PM and cabinet resign, so what next?

The Czech Republic has respected a rule over the past few years which state the following: whenever we find ourselves in the eye of the leading global financial dailies such as the Wall Street Journal or Financial Times, the consequences are always on the whole negative. Things are no different this morning, when the WSJ informs us that the Czech Prime Minister Nečas is resigning in reaction to a scandal surrounding Nagyová the chief of staff in the office of the government.

The whole affair leading to the resignation of the prime minister is certainly a tasty media titbit, but we will reduce it down to three questions, the answers to which should be of interest to us. Firstly, what at the other alternatives for government; secondly, will the government's economic policy be changing in any way in the foreseeable future and thirdly, with a view to the above, can we expect any reaction on the part of the Czech financial markets - i.e. primarily the koruna and government bonds?

As far as the answer to question number one is concerned – three alternatives of a government cabinet, which could take up the reigns after the Nečas government, present themselves. Firstly, this could be a cabinet built on the pattern of the current centre-right coalition. However, a solution like this has several drawbacks – the collation will for example have to, not only alone, but also with the President, agree on a new Prime Minister, whereas the new government needs the support of 101 votes (out of 200) in the Chamber of Deputies, which again means placing their bets on (currently) independent deputies. Secondly, we have the alternative of early elections, which the opposition (Soc-Dem and Communists) of course look for. But there would have to be even greater agreement on this, as 120 (out of 200) votes are required for early dissolution of the Chamber of Deputies. And finally, we have the alternative of a caretaker government created by new President Zeman.

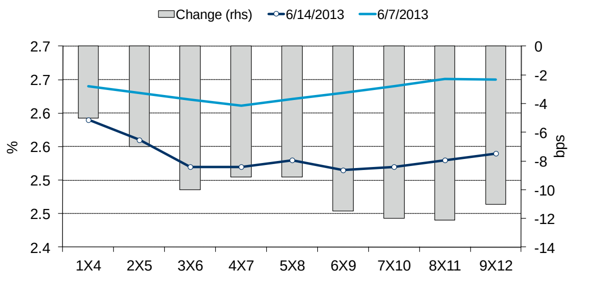
Political crisis will have only a limited impact on markets

It is difficult at this moment in time to say which of the alternatives is most likely. Nevertheless, whatever solution is chosen, it is on the whole clear that a change in government will exhibit itself at least over the short term with regards to economic policy. For example, the opposition wants the current government to follow through work in the area of flood damage. The situation is similar with regards to the state budget for 2014 – the framework of which must be set within a matter of weeks, which means that it will be the same budget with the signature of the outgoing Nečas government. This is one of the reasons why the Czech markets should remain calm and focus (as is almost always the case) on events on core markets or on Wednesday's FOMC meeting respectively.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.7	0.50%	→	→
EUR/HUF	291	-2.12%	↗	↘
EUR/PLN	4.23	-1.16%	↗	↘

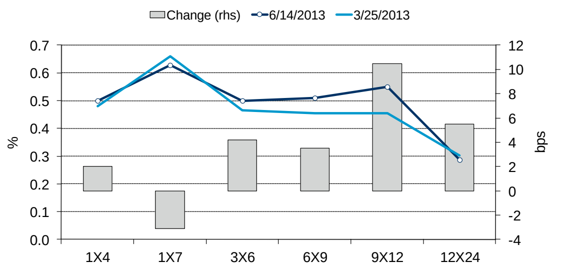
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.66	-5.68	↗	↘
10Y HUF	5.25	-6.75	↗	↘
10Y PLN	3.59	-6.75	↗	↘

PL FRA



Source: Reuters

CZ FRA



Source: Reuters

Review of Economic Figures

Lower inflation frees the Hungarian central bank's hands

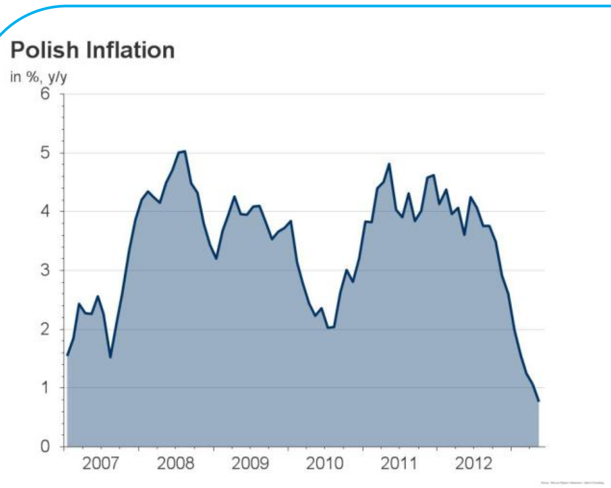
Hungarian inflation sprang a pleasant surprise in May, with prices having increased by only 1.8% y/y (and even fallen by 0.1% m/m). Low inflation was primarily due to the reduction of energy and gas prices (-8.5% y/y) and fuel prices (-5.1% y/y). By contrast, food prices, notably seasonal ones, went up (3.7% y/y), as did the prices of services (4.1%). Inflationary pressures remain subdued in the Hungarian economy. Domestic demand is still fairly weak, while further planned administrative price cuts will continue to keep inflation low. Thus inflation should continue to be below the 3% target of the NBH next year. Hence it seems that that the NBH might continue to ease its monetary policy, but the forint, which remains highly volatile, is troubling the central bank in this regard.

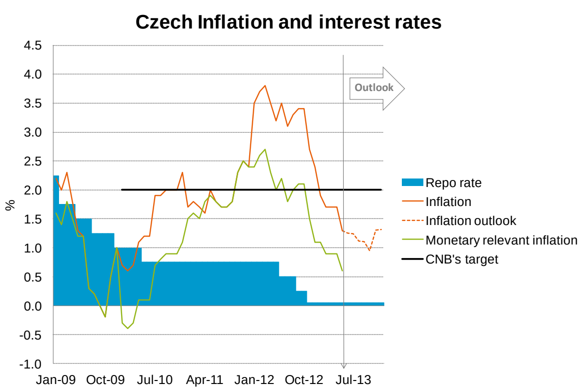
The May inflation in Poland falls close to the all-time lows

May's inflation in Poland lagged behind expectations, thus following the example of its Czech counterpart. The year-on-year price rise decelerated to 0.5%, thus ending up only 0.2% above the all-time low of April 2003. Month-on-month prices were down by 0.1%. As far as the structure is concerned, a significant decline in the transport index (-2.3% m/m), which includes petrol prices, surprised us most. Last month, inflation thus continued to go down below the central bank target and provided the doves on the Monetary Policy Council with more trumps ahead of the July meeting, where a new forecast will also be available. The main risks to the decision on another rate cut continue to be the developments in key global markets, which have recently led to the significant depreciation of the zloty, making the central bank intervene in favour of the Polish currency for the first time in eighteen months.

Czech inflation falls sharply below CNB's expecations.

May's consumer prices fell by 0.2% vis-à-vis April. Year-on-year inflation, monitored by the central bank, continued to approach the lower threshold of its tolerance band, having fallen from April's 1.7% to May's 1.3%. Better inflation developments again confirm that the economy is certainly not affected by inflation pressures. The contrary is more likely. Poor demand is curbing the latitude for raising the prices of goods and making retailers as well as manufacturers curb their prices. The Czech National Bank Governor sees low inflation (according to wire reports) as an unpleasant surprise, causing him great concern. While the new forecast will not be available to the CNB Board before its August meeting, the possibility of forex interventions will likely be again accentuated as early as at the June meeting of the CNB.



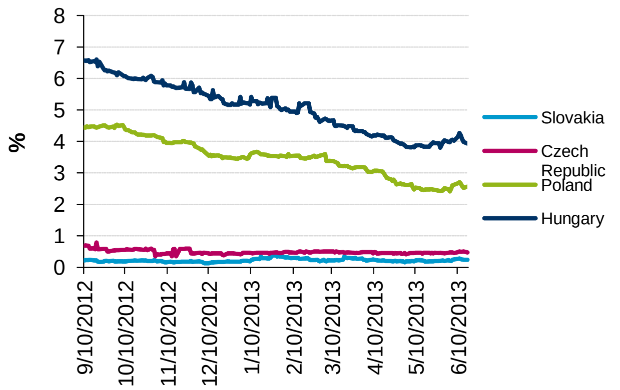


Calendar

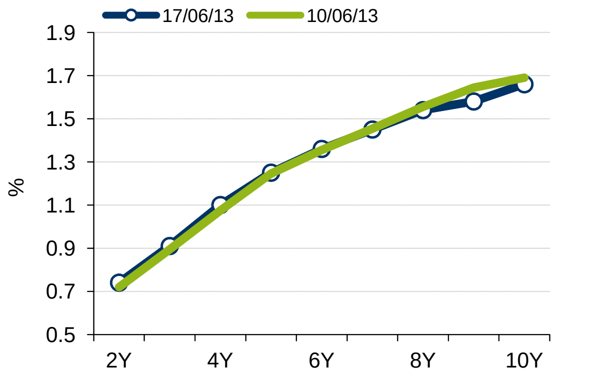
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/17/2013	9:00	PPI	%	05/2013	-0.1	0.4	-0.1	0.4	-0.5	0.5
CZ	06/17/2013	10:00	Current account	CZK B	04/2013	-3.2		3.75		-35.8	
PL	06/17/2013	14:00	Current account	EUR M	04/2013			-150		-200	
PL	06/17/2013	14:00	Trade balance	EUR M	04/2013			69		-273	
PL	06/17/2013	15:00	Budget balance	PLN M	05/2013					-31746	
HU	06/18/2013	9:00	Wages	%, ytd.	04/2013				3		3.2
PL	06/18/2013	14:00	Wages	%	05/2013			-3	2.7	-0.1	3
PL	06/19/2013	14:00	Industrial output	%	05/2013			-0.3	-1.9	-2.3	2.7
PL	06/19/2013	14:00	PPI	%	05/2013			0	-2.5	-0.6	-2

Fixed-income in Charts

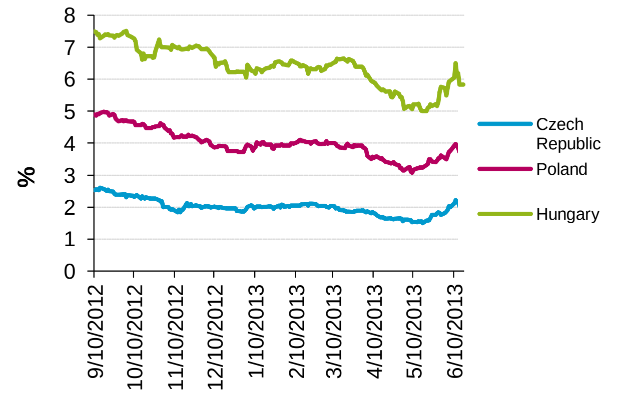
FRA 3x6



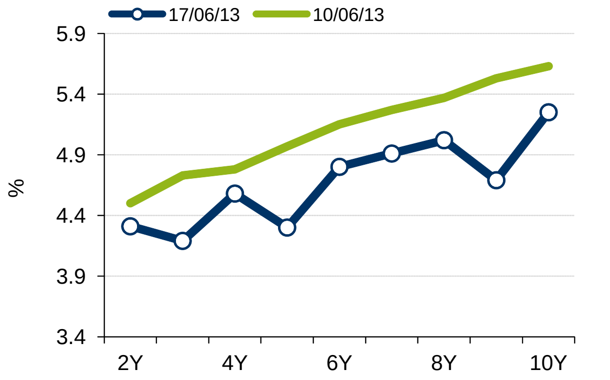
CZ IRS



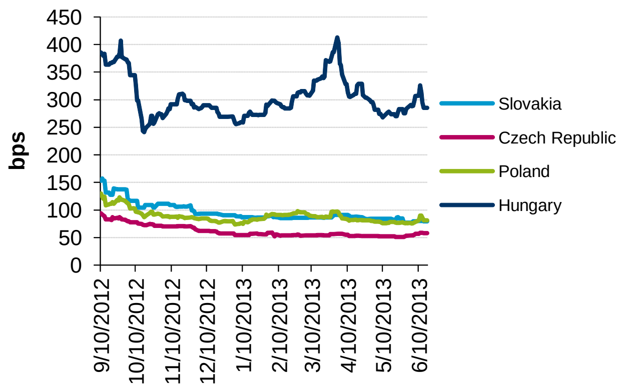
10Y GB Yields



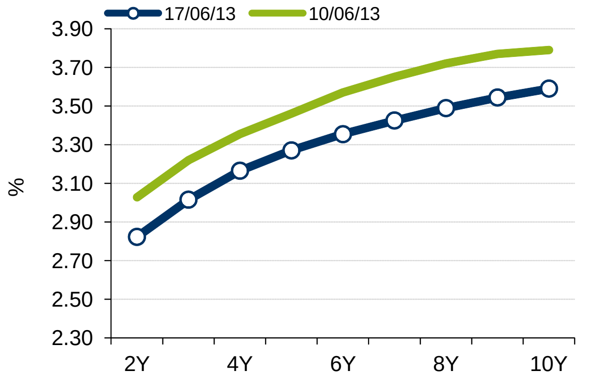
HU IRS



CDS 5Y



PL IRS



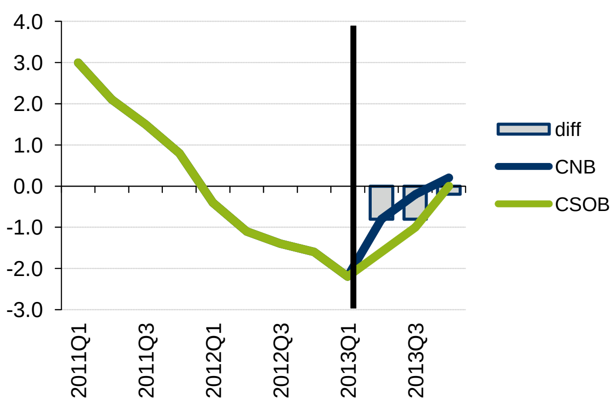
Source: Reuters

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 the NBH rate at 4.0%, while the downside risk to our forecast is high.	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 rise in rates and yields in core markets. However, given the improvement in Hungary's balance of payments and global market sentiment, we believe that any 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.

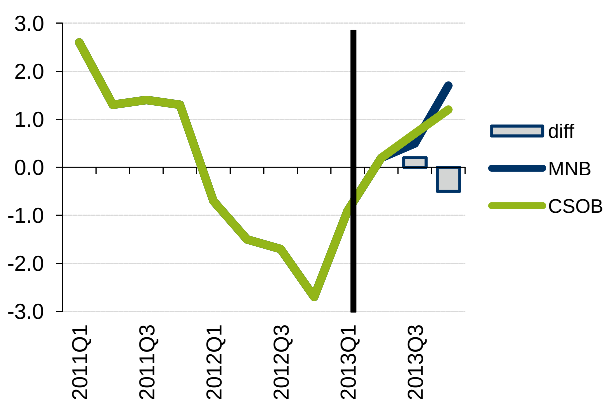
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)



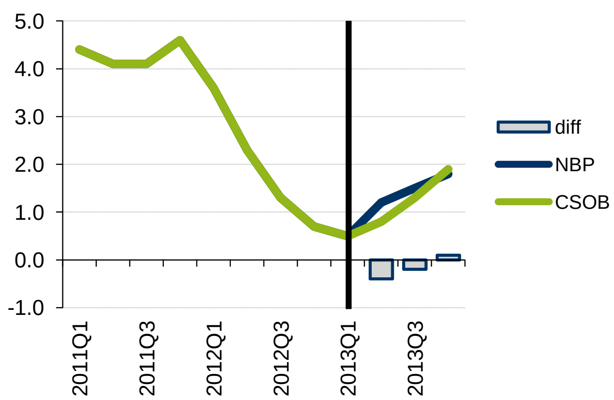
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)

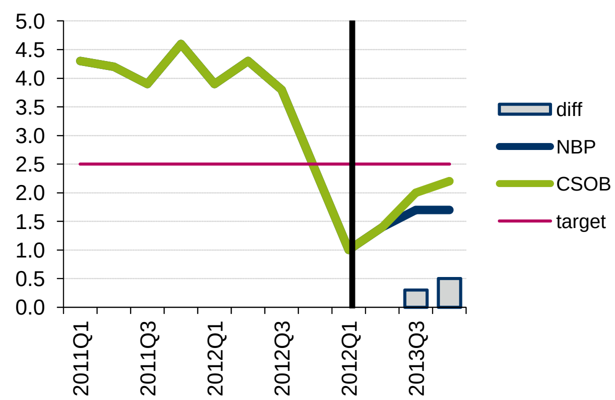


HU: Inflation outlook (Y/Y, %)

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	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	Last change	
Czech Rep.	2W repo rate	*0.05*	0.05	0.05	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*4.50*	5.75	5.00	4.25	4.00	3.75	-25 bps	5/28/2013
Poland	2W inter. rate	*2.75*	4.25	3.25	2.75	2.75	2.75	-25 bps	6/5/2013

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	PRIBOR	*0.47*	0.50	0.47	0.45	0.43	0.43
Hungary	BUBOR	*4.38*	5.75	4.90	4.50	4.25	4.00
Poland	WIBOR	*2.75*	4.11	3.39	2.60	2.60	2.65

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	*1.66*	1.37	1.31	1.70	1.70	1.85
Hungary	HU10Y	*5.25*	5.49	5.41	5.70	5.50	5.00
Poland	PL10Y	*3.59*	3.60	3.61	3.55	3.55	3.65

Exchange rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	EUR/CZK	*25.7*	25.1	25.7	25.7	25.5	25.2
Hungary	EUR/HUF	*291*	291	304	290	300	300
Poland	EUR/PLN	*4.23*	4.08	4.18	4.00	4.00	3.90

GDP (y/y)

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	-1.1	-1.4	-1.6	-2.2	-1.6	-1.0	0.0
Hungary	-1.5	-1.7	-2.7	-0.9	0.2	0.7	1.2
Poland	2.3	1.3	0.7	0.5	0.8	1.3	1.9

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

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	3.5	3.4	2.4	1.7	1.3	1.3	1.8
Hungary	5.6	6.6	5.0	2.2	2.0	2.2	2.8
Poland	4.3	3.8	2.4	1.0	1.4	2.0	2.2

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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