



Central European Weekly

Monday, 22 July 2013

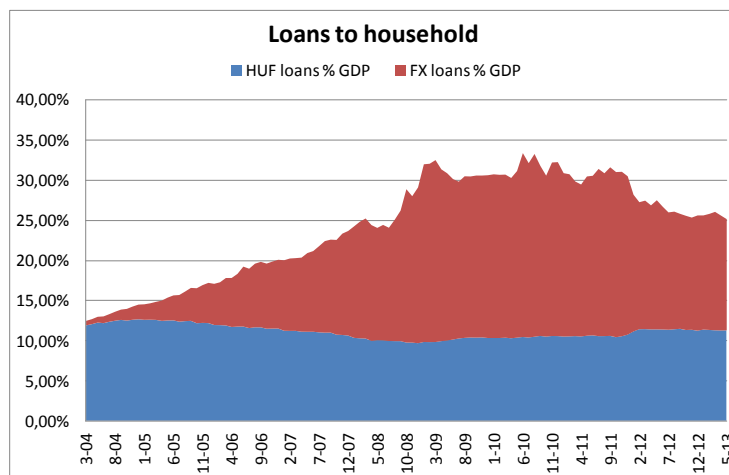
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Weekly Highlights:

- **New FX loans conversion plans of the Hungarian government worry markets**
- **Polish industry improves, but inflation still falls**
- **The NBH base rate slips to fresh lows at 4.0%**

Chart of the Week: Hungary's FX debt trap



FX loans of Hungarian households currently total to almost 14% of GDP..

Market's editorial

New FX loans conversion plans worry Hungarian markets

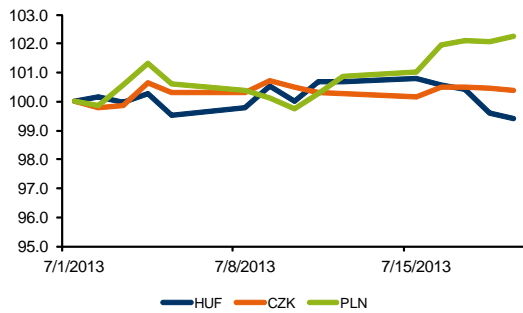
Despite of the positive international market sentiment HUF has weakened against the major currencies last week. The main reason is most likely that Minister of Justice said in a TV interview that the government is working on a new program, which helps the households who have foreign currency denominated loans and who cannot pay the monthly instalments, because of the substantial weakening of HUF.

Recall that already in 2011, the government tried to help households with conversion of their FX loans, but fixing of the exchange rate CHF/EUR at 180 was not attractive enough and only around 15% of the total amount of FX loans was converted. Total FX loans amounted to 4769bn HUF at the beginning of 2012, which corresponded to 14% of GDP. The overall negative impact on the banking sector was weak. However this time, with parliamentary elections

to be held next year, things may look different. The government is scheduled to discuss the topic on its meeting on July 24 and to calculate potential cost of the planned measure now would be premature.

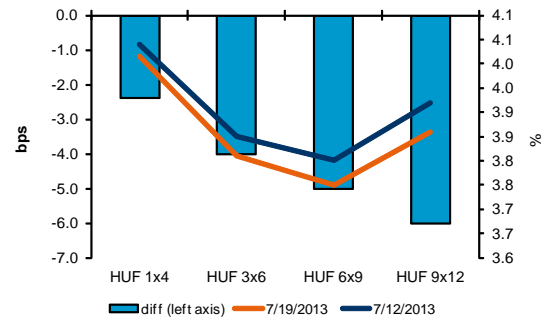
Although details were not published yet, the market started to price in the conversion of foreign currency denominated loans to HUF ones. Estimates range from a negligible impact to several percent of GDP. The intended fixing of the exchange rate is rumoured to be even at around 155 CHF/HUF. Given that CHF/HUF exchange rate oscillates around 240, close to values seen in the second half of 2011 when households had the first opportunity to convert their loans at fixed rate), the current offer promises to be much more favourable for borrowers. No wonder that banks in Hungary carefully monitor any signal the government may send regarding this issue.

CE currencies against the euro



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	26.0	-0.09%	→	→
EUR/HUF	294	0.74%	↗	↘
EUR/PLN	4.22	-1.60%	→	→

FRA, weekly change



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.87	-2.60	→	↗
10Y HUF	5.41	1.41	→	↗
10Y PLN	3.65	-3.83	↘	↗

Review of Economic Figures

Polish industry improves, but inflation still falls

Last week's most interesting macroeconomic events in Central Europe likely took place in Poland. We mean the release of domestic figures, i.e., the inflation and industrial output for June. While industrial output sprang a pleasant surprise – it was up by 3% Y/Y, i.e., twice as fast as expected – inflation met our expectations and fell to 0.2% Y/Y.

Monthly figures indicate that Poland's GDP continued to grow slowly in the second quarter

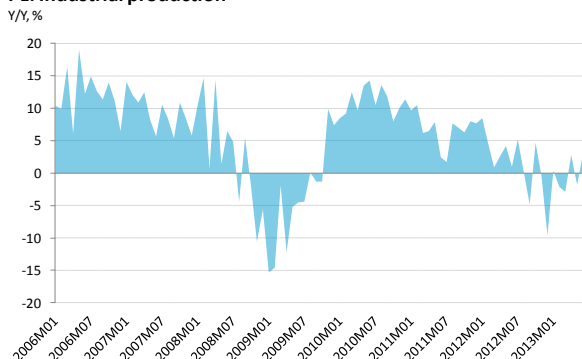
The industrial output figure is good all the more so because its seasonal adjustment revealed its rise by 4.5% Y/Y and 3.1% M/M. Despite the good overall figure and the improvement in certain sectors, such as the production of motor-vehicles (+7.7% Y/Y), Polish industry was still subdued in the first half of this year and, compared to the same period of last year, fell by 0.4%. The fact that Poland's economic growth is unlikely to be anything huge in the second quarter of the year is also confirmed by the data on construction, which was down by approximately 20% Y/Y in the first half of the year. These signals, along with just a negligible rise in retail sales in April and May, suggest that the GDP figure may be somewhere around the Q1 figure (+0.5% Y/Y). Worse figures from the economy and lower growth this year triggered a reaction by the Ministry of Finance, which revised its deficit forecast for this year. The deficit may reach 4% of GDP. Nevertheless, according to

information from the Ministry, even if growth is lower (than 1% this year), the debt should remain below 55% of GDP, a level that would by law trigger austerity measures if exceeded. Bear in mind that a modification of the pension system is also being discussed in Poland, in an effort to cut the debt by 11% of GDP, and this would continue to free the hands of the Ministry and the Government for encouraging the suffering economy.

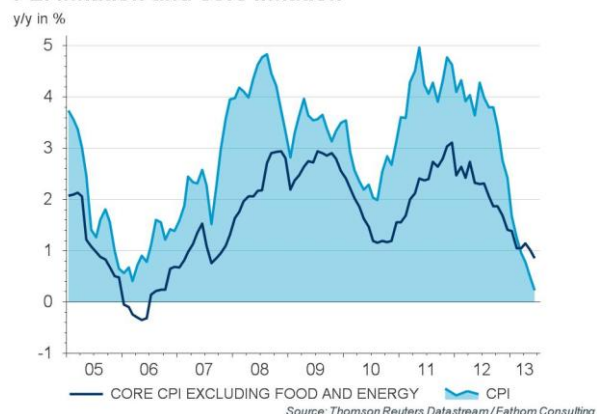
Poor demand and falling commodity prices push inflation to all-time lows

Poor domestic demand and falling commodity prices also affected June's inflation. After having hovered around multi-year lows in recent months, inflation has even dropped to all-time lows (over the post-communist era). On the other hand, month-on-month prices stagnated. Probably the greatest surprise to us, as concerns the structure, was the month-on-month rise in the transport sub-index, where we, by contrast, had anticipated a moderate decline. Although inflation likely hit this year's low in June, it is likely to remain at very low levels in the months to come, due to the announced administrative reduction of energy prices for households.

PL: Industrial production



PL: Inflation and core inflation



Weekly preview

TUE 14:00

NBH base rate

	This meeting	Last change
rate level (in %)	4.00	6/2013
change in bps	-25	-25

The NBH base rate slips to fresh lows

The National Bank of Hungary keeps rate setting meeting on 23 July. On the previous meeting (held on 25 June) Monetary Council moderated base rate by 25bp from 4.5% to 4.25% in line with the expectations. Based on the minutes (published on 10 July) all seven members voted on the 25bp rate cut. The council sees the inflationary development in line with the NBH's projections. The council sees inflation target of 3% YoY achievable on the relevant time horizon (6-8 quarters ahead). They highlighted that the latest government decisions (like increase of high way fee or widen the retail profit margin of tobacco, bank transaction tax etc.) has upward pressure on inflation, but as the domestic demand is still very weak in Hungary they expect that the price shock will be only marginally rolled over on the consumers. The council expects that Hungary's economic performance may accelerate in the following quarters, but they see the speed of the growth below the potential level. It means that from both perspective – inflation and GDP growth – the council sees more room for monetary easing.

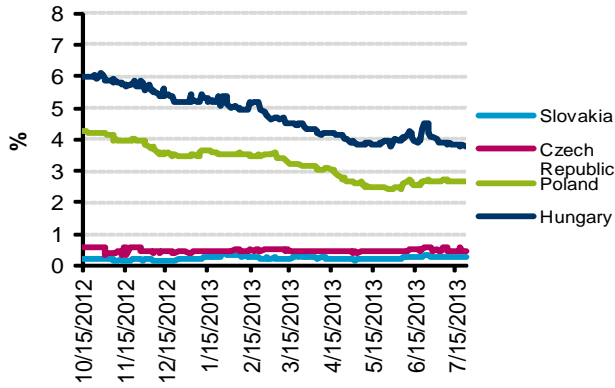
Regarding the market stability the Council highlighted that they have to focus on the development of developed markets' monetary policy, especially on FED's policy as it may cause turbulences on the HUF market as well. So the statement was ended with the sentence that the Council judged that as long as the outlook for inflation and the real economy justified it, interest rate could be reduced further; however, increased caution was warranted in the volatile and fast-changing global environment.

Calendar

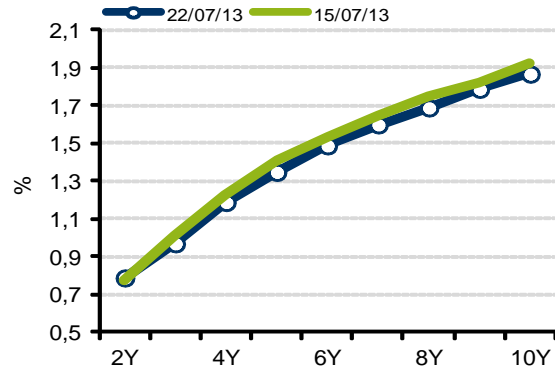
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	07/23/2013	10:00	Retail sales	%	06/2013			1.1	1.2	1.6	0.5
PL	07/23/2013	10:00	Unemployment rate	%	06/2013			13.2		13.5	
HU	07/23/2013	14:00	NBH meeting	%	07/2013	4		4		4.25	
CZ	07/24/2013	12:00	CZ bond auction 2013-2019, 1.50%		CZK B						
CZ	07/24/2013	12:00	CZ bond auction 2013-2028, 2.50%		CZK B						

Fixed-income in Charts

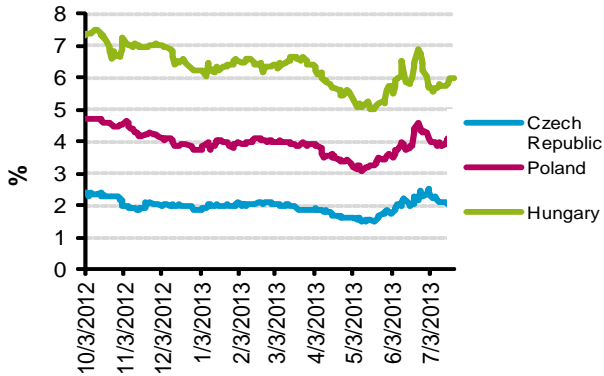
FRA 3x6



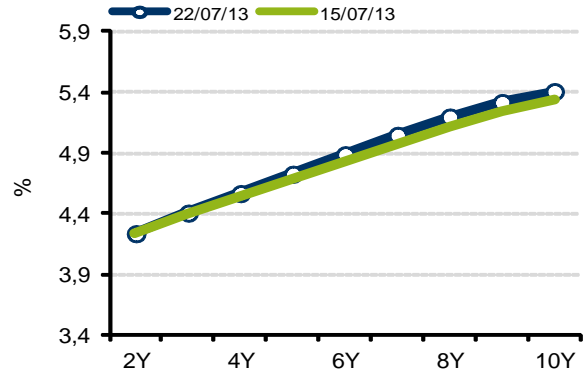
CZ IRS



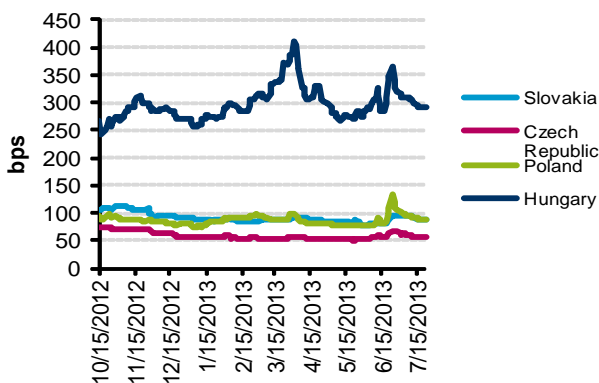
10Y GB Yields



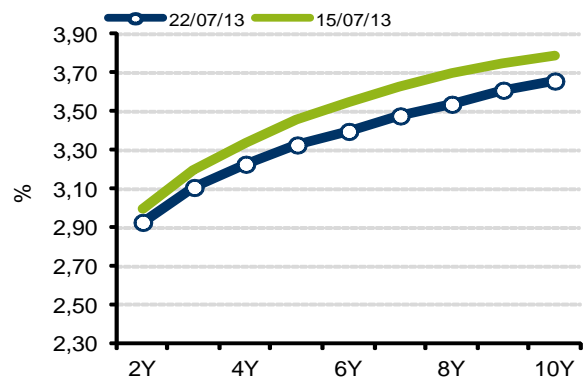
HU IRS



CDS 5Y



PL IRS



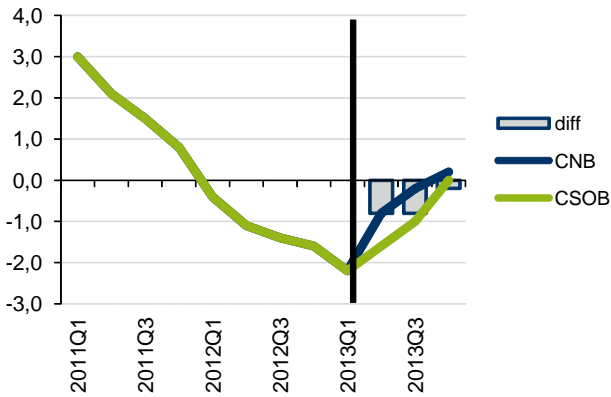
Source: Reuters

Medium-term Views & Issues

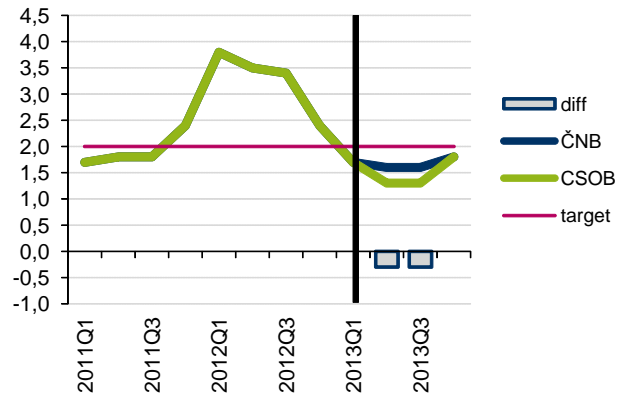
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>Three years after last elections the Prime Minister resigned and his cabinet fell. With minor exceptions, the bulk of political scene in the CR refuses to call premature elections a less than year before regular parliamentary elections. Newly formed “independent” caretaker government has to ask the Parliament for confidence and start to prepare the 2014 state budget. Prior to that, the Parliament will vote on its dissolution that is on premature elections.</p>	<p>Negative signs of growth in May about second quarter economic performance. Industrial production decreased by 2.1% YoY. The ongoing fall of electronic devices were standing behind the bad May figure, while car manufacturing companies are still helping industrial production. It looks that in 2Q13 Hungary’s GDP may slow down on QoQ basis from the very impressive 0.7% QoQ growth in 1Q13, but may remain in the positive territory. We expect 0.3% YoY growth from 2013.</p>	<p>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.</p>
Outlook for official & market rates	<p>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.</p>	<p>The NBH feels comfortable itself with the latest consumer price index development and sees inflation target of 3% achievable on relevant time horizon. In the mean time economic performance is still subdued so they see further room for rate cut. The possible slowdown of FED’s QE policy calls for more cautious monetary policy in the future, so NBH will monitor market development very closely. Until the international sentiment remains favorable monetary council may continue rate cut cycle, so we expect that base rate may be moderated from 4.25% to 4% on 23 July.</p>	<p>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, the central bank decided recently to cut interest rates to a new all-time low at 2.5%. Although inflation is seen markedly below the target (and is expected to stay there in the rest of this year), we expect the NBP to keep rates unchanged.</p>
Forex Outlook	<p>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.</p>	<p>The EURHUF remained relatively sensitive on international developments but it was traded mainly in a range of 290 and 300. As a narrower range we can name 292 and 297 which is between the 100 and 200 days moving average. The recent wide range is acceptable for the NBH, and we see that NBH may tolerate around 305 and 310 levels for a couple of weeks as well without any active intervention. We expect that in the positive market sentiment the above mentioned trading range may remain in the following weeks.</p>	<p>The zloty has been hit by an outflow of funds related to the rise in US government bond yields. Sharp depreciation of the zloty spurred the NBP to intervene in favor of the Polish currency. We believe that the central bank might decide to step in again if the zloty remained persistently above EUR/PLN 4.30 level (the last intervention occurred at EUR/PLN 4.32).</p>

CBs' Projections vs. Our Forecasts

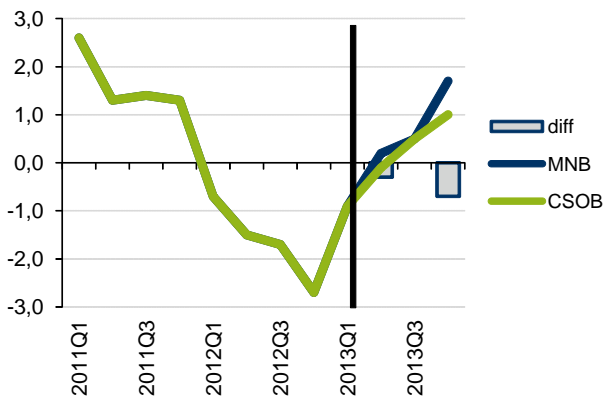
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)



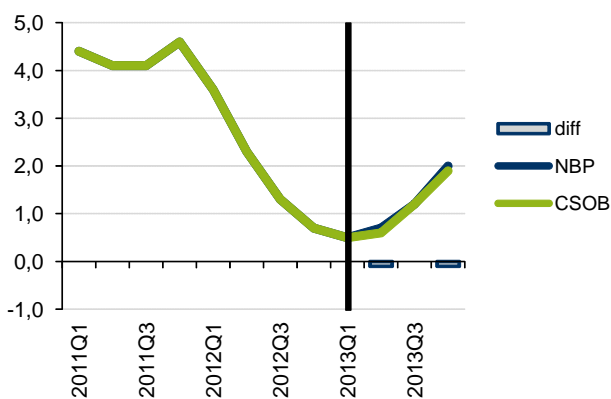
HU: GDP outlook (Y/Y, %)



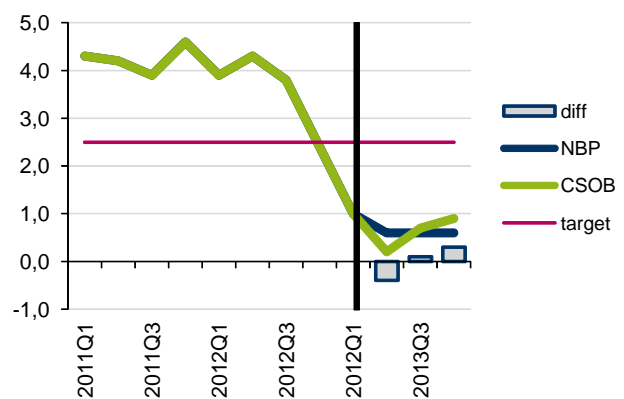
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (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.	4.25	5.75	5.00	4.25	3.75	3.75	-25 bps	6/25/2013
Poland	2W inter. rate	2.50	4.25	3.25	2.75	2.75	2.75	-25 bps	7/3/2013

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	PRIBOR	0.46	0.50	0.47	0.44	0.43	0.43
Hungary	BUBOR	4.19	5.75	4.90	4.20	3.80	3.90
Poland	WIBOR	2.69	4.11	3.39	2.73	2.60	2.65

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	1.87	1.37	1.31	1.97	1.90	2.00
Hungary	HU10Y	5.41	5.49	5.41	5.84	5.80	6.20
Poland	PL10Y	3.65	3.60	3.61	4.14	3.55	3.65

Exchange rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	EUR/CZK	26.0	25.1	25.7	26.0	25.9	25.5
Hungary	EUR/HUF	294	291	304	295	300	300
Poland	EUR/PLN	4.22	4.08	4.18	4.33	4.25	4.20

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	-0.1	0.5	1.0
Poland	2.3	1.3	0.7	0.5	0.6	1.2	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	1.9	2.2
Poland	4.3	3.8	2.4	1.0	0.2	0.7	0.9

Current Account

	2012	2013
Czech Rep.	-1.9	-1.9
Hungary	1.5	2.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-3.0
Hungary	-2.5	-2.7
Poland	-3.9	-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			
Austin Hughes	+353 1 664 6889	London	+44 207 256 4848
Shawn Britton	+353 1 664 6892	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
Budapest Research			
David Nemeth	+36 1 328 9989		

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