Central European Weekly

Monday, 23 September 2013

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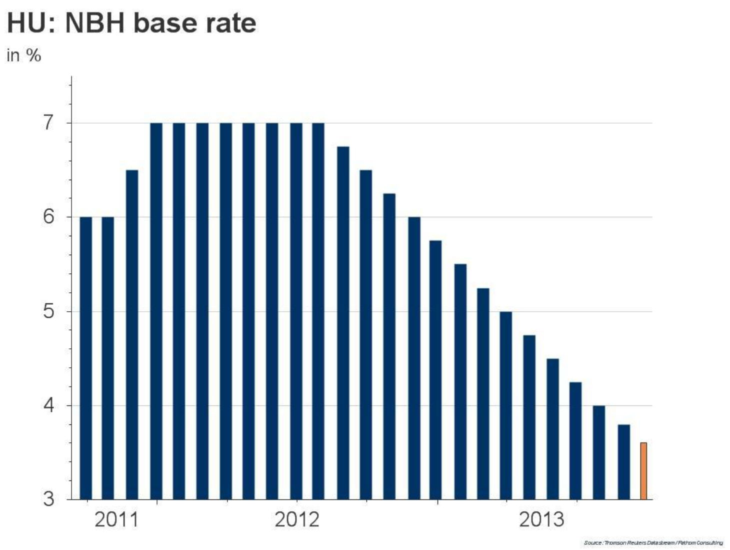


The Hungarian central bank have started to cut its base rate by unusual steps (e.g. by 20 bps).

Market's editorial

Will the CNB follow the Fed and surprise markets?

Czech central bankers surprised us by their comments last week, which indicate that interventions against the koruna are more likely than we originally thought. Surprisingly, in addition to Governor Singer, his colleague Kamil Janáček also cautiously spoke in favour interventions. Hence the CNB decision scheduled for this Thursday will be made by a very narrow margin.

Bear in mind that the August forecast basically justified the launch of interventions against the koruna. The exchange rate implied by the forecast, if adjusted for the difference between the market PRIBOR rate and the predicted PRIBOR rate, was evidently weaker than the current exchange rate (our forecast is EUR/CZK 26.2). Although the CNB has been pleasantly surprised since the last forecast by a better GDP figure for the second quarter of the year, it also turned out that the key components of domestic demand – investment and household consumption – were worse than, or at best in line with, the August forecast. In addition, the CNB is again facing lower-than-expected inflation, while real wages are also developing worse than envisaged by the August forecast. In other words, the exchange rate implied by the August forecast should not change, according to the CNB, while the actual exchange rate for the last month was stronger than the central bank forecast.

All of this together may irritate the Bank Board, even some of its hesitant members. In other words, whether actually or through the lens of the CNB's statements, the likelihood of the launch of interventions has clearly increased. Therefore we do not rule out that the CNB Board will decide to define a new scheme, which will indicate its willingness to actively prevent the koruna, by interventions, from strengthening beyond a certain explicitly set limit. We believe the existence of such a defined (binding) ceiling for the appreciation of the koruna would be conditioned by the compliance with the current macroeconomic forecast of the CNB.

The NBH should cut by another 20 bps

Consumer price index dropped substantially from 1.8% YoY in July to 1.3% YoY in August, which was a huge surprise for the markets. Beyond the last quarters' tendencies, like poor domestic demand, moderating fuel and food prices and public utility cost reductions (government cut prices of water, sewage disposal and rubbish carriage), the main surprise came from tobacco as the retail price increased only by 2%, although the retail price margin was increased to 10% from 2-3%. The government approved the next round of public utility cost reduction from 1 November, which may push consumer price index below 1% YoY at the end of the year. Although headline inflation is falling, the core inflation stuck around 3.0%, which suggest that after the one off effects fall out from the base, inflation is expected to return to NBH's inflation target of 3% YoY, but in the next 12 months CPI may remain maximum around 2% YoY, which gives maneuvering room for the National Bank of Hungary (NBH).

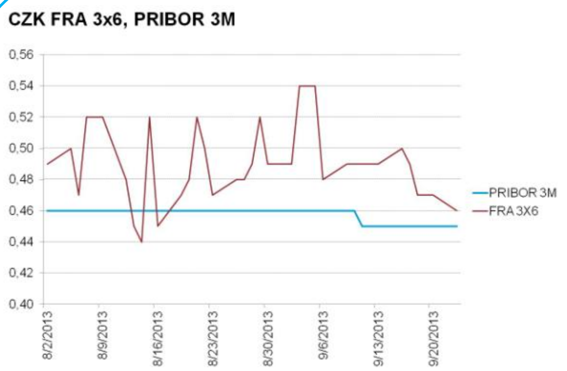
The NBH has continued the gradual and cautious rate cut cycle (started in August 2012). Base rate was moderated by 3.2%pt achieving historic low level of 3.8%. NBH changed its decision matrix from the simple inflation targeting system to a new one, which also focusing on economic growth, labour market and stability aspects. Although it is not a new phenomenon in NBH's decision method, it was never said officially. The bigger innovation is rather the change of the possible steps of the base rate modification as from August MPC can change key rate by less than 25bp in one step. This method slightly confused the market and the 20bp rate cut (delivered in August) was a big surprise for most of the market participants. Additionally the sharp drop of August inflation figure from 1.8% YoY to 1.3% YoY renewed the expectations that NBH may cut base rate even to 3%.

Most of the emerging market calmed down temporary, believing that cheap funding will remain for a longer period. On this wave Hungarian bonds' yield also moderated, but remained in the trading range of previous months. HGBs' yields along the curve moderated by 50-60bp in the first two week of September, while US and German Treasury bonds' yields decreased only by 15-20bp. We see no reason for the narrowing of the spreads from fundamental perspective as there are more risks on budget balance and the public debt also stuck close to 80% of GDP. Additionally the foreign ownership of Hungarian bonds decreased by 5% (HUF250bn) within two months, which suggests, that the confidence towards Hungary didn't improve. Hungarian 5-year CDS moved in the range of 290bp and 320bp.

The EURHUF had rather a weakening trend since mid-June and it was traded slightly above 300 in the first two weeks in September, but it couldn't break the level of 303, and it strengthened back to 297. One of the biggest risks is the new program for the abolishment of foreign currency denominated loans. If NBH is not helping for the banks in the conversion, there could be a substantial weakening pressure of HUF. We expect that EURHUF may move rather on the weaker side and it can be traded in the range of 296 and 308 in the coming months.

We can conclude from the above mentioned tendencies that inflation development may play only marginal role in

MPC's decision, while the increasing volatility and uncertain outlook of market developments are more important. The postponement of FED's QE policy may give definitely gun powder for NBH, which may lead for further rate cut. Market prices roughly 50bp rate cut within 3 months to around 3.3%, while there are research houses, who expect 3% as the bottom of rate cut cycle. Taking in account that inflation dropped substantially and EURHUF is traded below 300 we expect that NBH may decrease base rate by 20bp again to 3.6%, but further monetary policy will highly depend on FED's action and market development.



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25,9	0,44%	↗	↗
EUR/HUF	299	-0,20%	↗	↗
EUR/PLN	4,23	0,63%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2,23	1,78	↗	↗
10Y HUF	5,26	-1,22	↗	↗
10Y PLN	4,16	-1,21	↗	↗

In Focus: Update Hungary's FC loan issue

No decision yet; November 1st is the deadline for agrrement

There was no step forward rather a small step backward in the new program of the abolishment of foreign currency denominated loans in the last couple of weeks. The government and the Bank Association couldn't make a agreement after the first negotiation and the government gave a ultimatum to the banks, that they have to solve the problem till November 1st or the government will find the solution and will approve new laws to save the households.

Banks shoul bear alomost all costs

What we can see at the moment that most likely most of the foreign currency denominated may be involved into the new program, which means that roughly EUR11bn loan is involved. It also looks that the government sticks to the concept of the National Bank of Hungary. It would fix the exchange rate of the monthly installments till the redemption of the loan, which is a quite similar solution to the current ongoing program. The main difference that not only the interest payment FX risk but also the FX risk of capital of the loan would be taken by the bank sector. Also it is quite likely that the government won't participate in the program, which means that the biggest part of the lost may be levied on the bank sector. The short deadline and the hurry may come from the promise the government has given to the voters three years ago, namely they will pretend the households from the foreign currency denominated loans. The election will be held within 8 months, so the government would like to see the results of the program at the beginning of next year the latest.

The open questions are still that what would be the exchange rate of the fixation, will the program set the interest rate of the loans as well, and how it has to be accounted. The most likely scenario is that the same exchange rate will be used as in the previous program: EURCHF at 180, EURHUF at 250. The fixation would mean that banks have two options: heading the FX risk with swaps, which would substantially decrease the interest income or running the FX risks. It is not very likely that banks can leave open such a huge FX risk, so it can decrease the profitability of the banks. It is also not clear that in case of fixation of exchange rate all the lost has to be accounted front run or it can divide among the years of the duration of the loans. NBH says that only the yearly cost has to be accounted so it can be split between the years.

The forint stable supported by the dovish Fed

It seems that the negotiation stopped now, but banks highlighted that the problem of the FC denominated loans cannot be solved in such a short deadline, because it would cause to big loss for the bank sector and the EUR/HUF would weaken substantially.

EUR/HUF was extremely volatile in the last days. Although is strengthened significantly after the FED decision it looks that it was only temporary. The FC loan program, the loosening fiscal policy and the ongoing rate cut cycle suggests that HUF may weaken in the following months and may EUR/HUF may move above 300 again.

Weekly preview

TUE 14:00 **NBH base rate**

	This meeting	Last change
rate level (in %)	**3.60**	8/2013
change in bps	**-20**	-20

HU: The NBH to cut its base rate again

We can believe that (positive) inflation development may play only marginal role in MPC's decision, while the increasing volatility and uncertain outlook of market developments are more important. The postponement of FED's QE policy may give definitely gun powder for NBH, which may lead for further rate cut. Market prices roughly 50bp rate cut within 3 months to around 3.3%, while there are research houses, who expect 3% as the bottom of rate cut cycle. Taking in account that inflation dropped substantially and EURHUF is traded below 300 we expect that NBH may decrease base rate by 20bp again to 3.6%, but further monetary policy will highly depend on FED's action and market development.

THU 14:00 **CNB base rate**

	This meeting	Last change
rate level (in %)	**0.05**	11/2012
change in bps	**0**	-20

CZ: CNB interventions in the air?

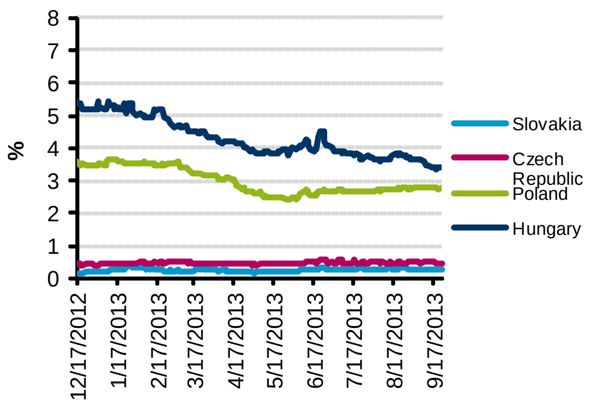
After the latest statements from the central bankers of the CNB, interventions against the koruna are more likely than we originally thought. Surprisingly, not only Governor Singer, but also his colleague Kamil Janáček, spoke cautiously in favour of interventions. Hence the decision scheduled for this Thursday will be made by a very narrow margin. The likelihood of the actual launch of interventions has clearly increased. We do not rule out that the CNB Board will decide to define a new scheme, which will indicate its willingness to actively prevent the koruna, by interventions, from strengthening beyond a certain explicitly set limit.

Calendar

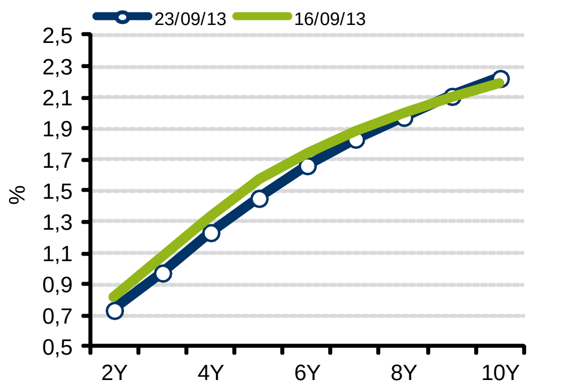
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	09/24/2013	10:00	Retail sales	%	08/2013			-1.5	2.7	3.8	4.3
PL	09/24/2013	10:00	Unemployment rate	%	08/2013			13.1		13.1	
HU	09/24/2013	14:00	NBH meeting	%	09/2013	3.6		3.6		3.8	
CZ	09/26/2013	13:00	CNB meeting	%	09/2013	0.05		0.05		0.05	
HU	09/27/2013	8:30	Current account	HUF B	2Q/2013			520		549	
HU	09/27/2013	9:00	Unemployment rate	%	08/2013			10		10.1	

Fixed-income in Charts

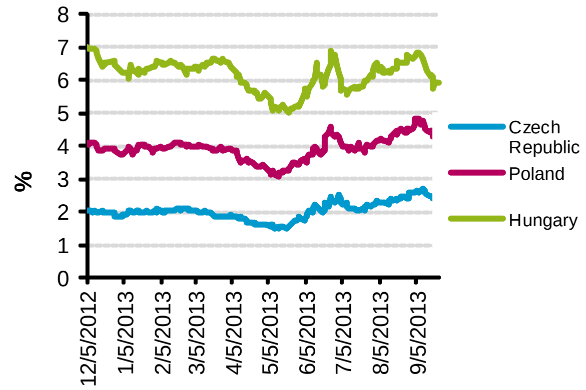
FRA 3x6



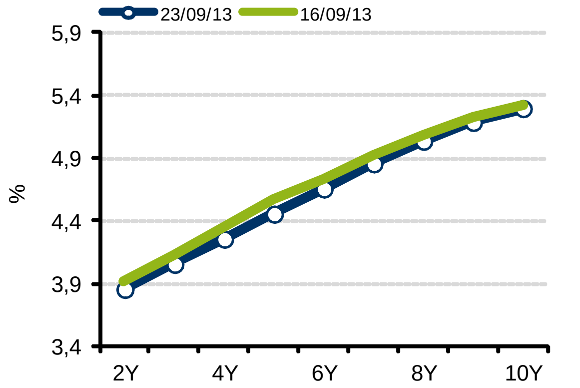
CZ IRS



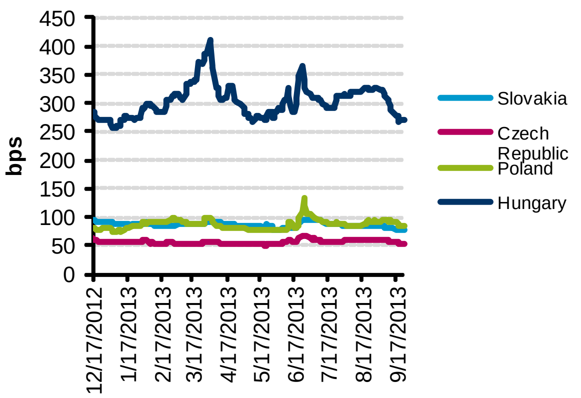
10Y GB Yields



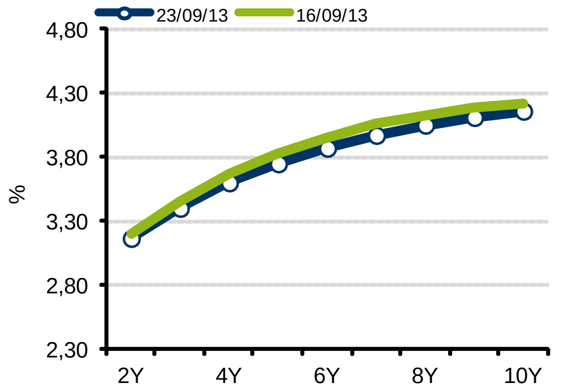
HU IRS



CDS 5Y



PL IRS



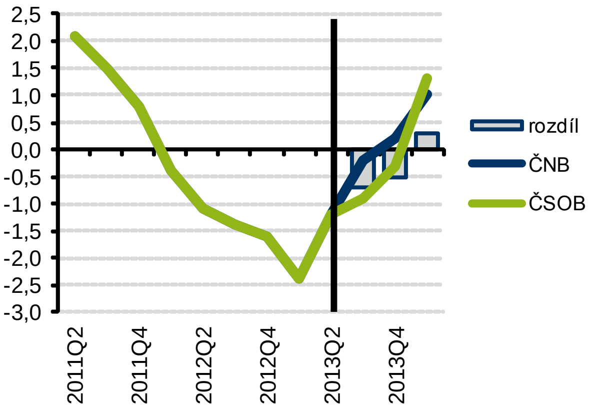
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	Three years after last elections the Prime Minister resigned and his cabined 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. The Czech Economy seems to get from the worst. After six consecutive quarters of falls the cyclical leading indicators (our Czech Flash, PMI) improve strongly and point to bottoming.	Negative signs of growth in May about second quarter economic performance. Industrial production decreased by 2.1% Y/Y. 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 Q/Q basis from the very impressive 0.7% Q/Q growth in 1Q13, but may remain in the positive territory. We expect 0.3% Y/Y growth from 2013.	Growth of the Polish economy bottomed out in the second quarter of 2013 and reached 0.8%. On the quarter-to-quarter basis, the economy grew by 0.4%. Figures from the Statistical Office confirmed that the economy was almost exclusively driven by net exports, which improved owing to falling imports as well as rising exports. On the contrary, domestic demand (except of government consumption) remained weak. However, fresh PMI figures support our view that the economy could accelerate further in the second half of the year.
Outlook for official & market rates	The CNB met expectations kept the rates at record lows and has not started FX interventions. On the other hand it downgraded its economic (and inflation) outlook for this year and openly communicated that the risk of interventions have risen. The CNB expects that the economy will continue to fall this year (-1.5%) and grow a bit faster next one (2.1 %). The rates should stay at technical zero for extended period. The interventions are probable from our point of view, if the koruna strengthens below 25.60 (see the FX outlook).	The National Bank of Hungary cut its base rate by 20bp from 4% to 3.8% in August. The statement highlighted that fundamentally there is more room for monetary easing as inflation is well anchored and GDP growth is still below its potential level, but the uncertain market sentiment calls for more cautious monetary policy. The statement suggests that the NBH may cut base rate further, but the speed may slow down if the market environment doesn’t improve in the coming month. We expect 10bp rate cut for the September meeting.	Clearly, the NBP is concerned with a sharp decline in inflation rate and unfavorable structure of GDP growth, which has lately been almost exclusively driven by net exports; traditionally strong domestic demand contributed negatively to both 2013Q1 and 2013Q2 growth. However, prospects of the Polish economy have been improving and inflation rate surged unexpectedly in July 2013. We therefore stick to our base scenario which bets on stability of official interest rates in the remainder of this year and we anticipate the NBP could start discussing possibility of interest rate hikes in the second quarter of 2014.
Forex Outlook	The new CNB forecast implies the weaker koruna and the lower rates. The implied exchange rate (adjusted for the difference between actual and foreacted PRIBOR) is currently around 26.20 EUR/CZK. Hence there is nearly no potential for gains for the koruna for now. We believe the interventions could be triggered if the koruna settles below 25.60 EUR/CZK at the time of next meeting (Sept 26th).	The HUF did not like and EURHUF broke 300 levels. There is a resistance level at 302.5 and if the HUF breaks this level than the next technical level is at around 305-306. We still see more chance for further weakening in the coming months, so we maintain our forecast that EUR/HUF may test the above mentioned levels. All in all the Forint could affected no just by rate decision, but it will face some headwinds, if situation in emerging markets deteriorates further.	The zloty has been hit by an outflow of funds related to the rise in US government bond yields after Fed announced the possibility of tapering the QE policies. Nevertheless the situation has calmed down and NBP similarly to Fed decided to end an easing cycle. Hence EUR/PLN has not much potential for further losses now. Furthermore th NBP is probably ready to intervene above 4.35 level (the last intervention occurred at EUR/PLN 4.32).

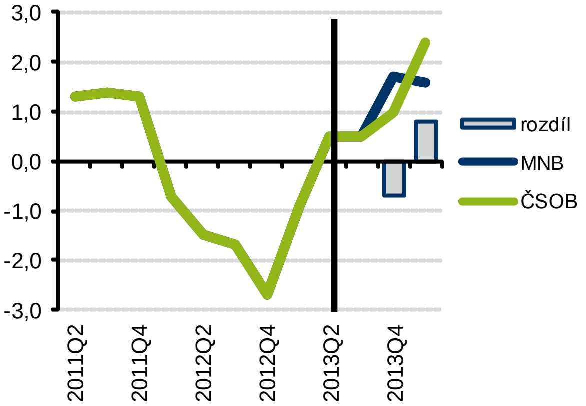
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

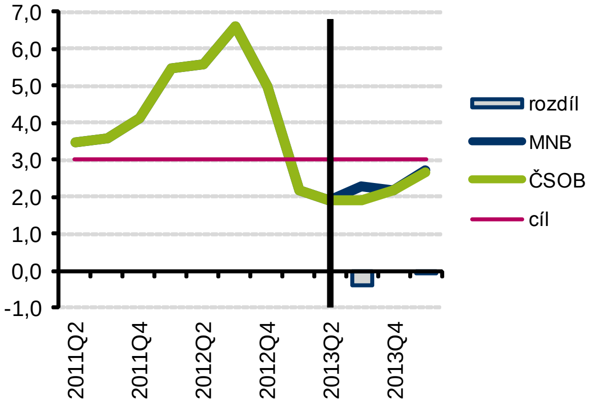


CZ: Inflation outlook (Y/Y, %)

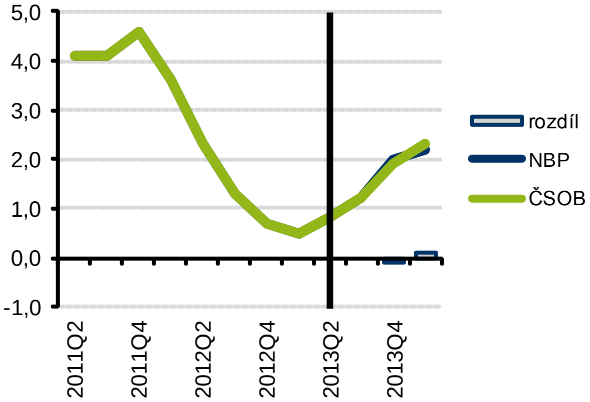
HU: GDP outlook (Y/Y, %)



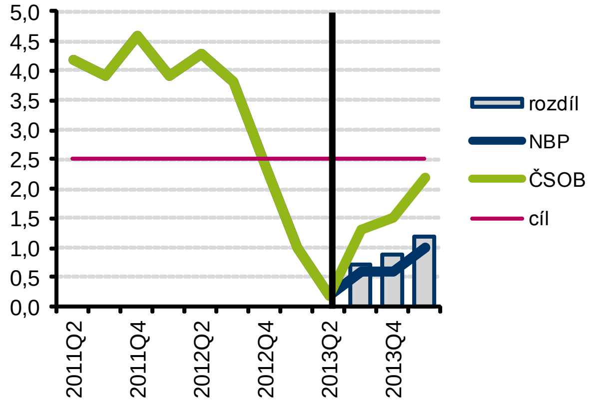
HU: Inflation outlook (Y/Y, %)



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.	*3,80*	5,75	5,00	4,25	3,75	3,75	-20 bps	8/27/2013
Poland	2W inter. rate	*2,50*	4,25	3,25	2,75	2,50	2,50	-25 bps	7/3/2013

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	PRIBOR	*0,45*	0,50	0,47	0,44	0,43	0,43
Hungary	BUBOR	*3,75*	5,75	4,90	4,20	3,80	3,90
Poland	WIBOR	*2,68*	4,11	3,39	2,73	2,70	2,75

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	*2,225*	1,37	1,31	1,97	2,05	2,30
Hungary	HU10Y	*5,26*	5,49	5,41	5,84	5,50	5,90
Poland	PL10Y	*4,16*	3,60	3,61	4,14	3,90	3,95

Exchange rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	EUR/CZK	*25,9*	25,1	25,7	26,0	26,0	25,5
Hungary	EUR/HUF	*299*	291	304	295	300	300
Poland	EUR/PLN	*4,23*	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	-2,4	-1,2	-0,9	-0,3
Hungary	-1,5	-1,7	-2,7	-0,9	0,5	0,5	1,0
Poland	2,3	1,3	0,7	0,5	0,8	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	1,6	1,5	1,6
Hungary	5,6	6,6	5,0	2,2	1,9	1,9	2,2
Poland	4,3	3,8	2,4	1,0	0,2	1,3	1,5

Current Account

	2012	2013
Czech Rep.	-1,9	-2,5
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

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