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Central European Weekly

Monday, 14 October 2013

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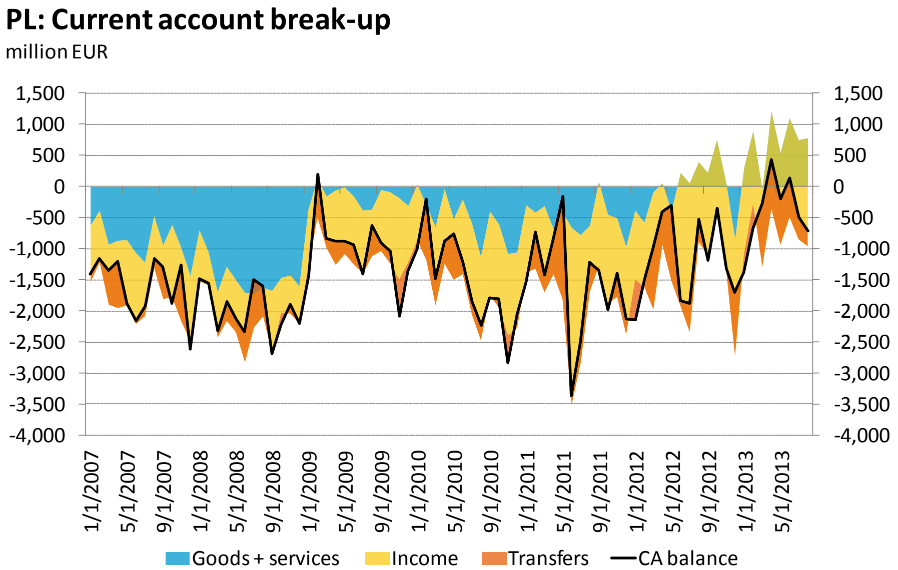
- Another inflation fall puts interventions against the Czech koruna back onto the agenda
- The European automotive market is starting to stabilize and the Czech industry feels it
- The Polish C/A starts to follow a traditional regional pattern with trade surplus and deficit on income side
- The Polish inflation flat for a third consecutive month

Chart of the Week: Polish C/A balance



Polish current account deficit increased unexpectedly in August due to counter-seasonal outflow of dividends. (Source: NBP, CSOB).

Market's editorial

The Czech inflation falls 0.4% below the CNB forecast

September has again confirmed that inflation is and will certainly not be a problem in the Czech Republic, but rather the contrary, as the consumer price index was up by only 1.0% y/y. Thus inflation was not only lower than expected by the Czech National Bank (1.4%), it even reached the lower threshold of the band where the central bank would like to see it. Moreover, inflation is likely to continue to fall in the months to come, because poor domestic demand curbs the price rise, while inflation pressures are almost not evident except for certain products. In addition, the beginning of next year should see another disinflation shock, when the prices of electricity generation will most likely go down.

Fall in inflation puts interventions against the Czech koruna back onto the agenda despite recovery in industry

The September (low) inflation figure is again likely to encourage discussion of a possible forced depreciation of the koruna by the central bank, as a new instrument for hitting the inflation target. Bear in mind that the latest forecast indicates the CNB's preferred exchange rate of approximately EUR/CZK 25.8 in the third quarter of 2013. However, a higher-than-expected PRIBOR level has pushed the exchange rate required in the model even higher – perhaps up to the EUR/CZK 26.2 (to make overall monetary conditions equal). And even though the latest data from Czech industry has improved the view of the economy, we believe that the CNB will not tolerate any strong appreciation of the koruna. Hence the central bank is likely to launch interventions after its November meeting, in order to import higher inflation to the Czech economy through the weakened local currency. In addition, the market may compel the CNB to intervene even before its next meeting, if the koruna slides below the EUR/CZK 25.40. This level would trigger verbal interventions first, likely followed by actual interventions if the former were not effective.

Do interventions make sense? Do they create inflation?

The question is whether consumers will appreciate anything like that. The CNB will hardly be reproached for its inability to push inflation to/above 2%, when it is low because of lower commodity prices as well as competition in telecommunications, where call prices have fallen significantly over the last six months.

Triggering demand-pull inflation in a small open economy such as the Czech one will always be a great challenge for the CNB. The Czech central bank has no instruments to boost poor wage growth, which is the primary factor curbing domestic private consumption. Hence the normative question for Czech economists is whether, under such conditions, the inflation increase through the CNB, the targeted depreciation of the koruna, and the subsequent import of inflation, will improve the overall utility of the Czech society. The increase in the prices of imported goods may lead to even greater frustration in the Czech Republic than temporary (and unexpected) deflation, which is, moreover, triggered by a positive supply shock.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.5	-0.06%	➔	➔
EUR/HUF	295	-0.07%	➚	➔
EUR/PLN	4.19	-0.22%	➚	➔

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.07	0.29	➚	➚
10Y HUF	5.29	1.15	➚	➚
10Y PLN	4.22	-0.82	➚	➚

Review of Economic Figures

The Czech inflation falls 0.4% below the CNB forecast

Seasonal reductions in package tour prices at the end of the season, along with the reduction of certain food prices, were responsible for the CPI decline by 0.4% (m/m). Year-on-year inflation also went down – from August's 1.3% to the current 1.0%, thus hitting the lower threshold of the CNB's tolerance band and 0.4 percentage point below the central bank forecast. Monetary relevant inflation even approached zero, as it fell to 0.2% in September. The main contributor to the current disinflation process in the CR is the favourable development of the prices of consumer goods, telecommunication services, and fuels.

Inflation is and certainly will not be a problem for the CR, but rather the contrary. Poor domestic demand curbs the price rise, while inflation pressures are essentially not evident. Moreover, low demand keeps driving the prices of numerous consumer goods downwards. Demand-pull inflation has been long ago forgotten. In addition, the months to come are likely to see another inflation fall, which should culminate early next year, when electricity generation prices should fall. Current inflation figures, along with an outlook for lower-than-predicted inflation, will again certainly encourage the discussions concerning a possible depreciation of the koruna by the central bank. The koruna has perceived the forex intervention threat essentially for a year, but, with the absence of an actual intervention, the currency tries to test the levels ever deeper below the CNB forecast from time to time. If we take into account that the latest vote on forex interventions was very close, it is just a matter of time and the courage of the koruna as to when the central bank takes action.

Hungary's inflation increases, but a cut still is in the air

The Hungarian consumer price index increased from 1.3% y/y in August to 1.4%y/y in September vs. market expectation of 1.1% y/y. Additionally core inflation jumped from 3% y/y in August to 3.5% y/y in September.

There are contrary developments in inflation process. On one hand the public utility cost reductions, the lower fuel prices compared to last year and the god harvest this year keeps CPI low, while on the other hand the increase of profit margin of tobacco, the new taxes levied on bank sector and the increased fee of high-way system pushes inflation up.

Among the food products only the unprocessed, seasonally fruit and vegetables reflects disinflationary process thanks to the good harvest, while the processed food showed an increase. What is more worrying that the tradable goods prices, where we saw deflation in the last periods and which segment looked total y non-sensitive on HUF weakening, started to increase. It looks now that the profit margins are too low and despite the still poor domestic consumption market participants started to increase the price on the first promising retail sales figures. In the last couple of months we recognized a moderate acceleration of sales.

Although in December CPI may drop below 1% y/y thanks to the next round of gas, electricity and district heating price cut of 11%, the underlying inflation looks much worse as the core inflation also reflect it. In the last couple of months market price goods and services inflation were above the headline CPI figure, so it's now clear that we cannot see disinflation process coming from the market side. Core inflation is increasing in the last 3 months from2.8% y/y to 3.5% y/y, so it confirms our view that once the one-off effect falls out from the base (most like at the end of 2014) inflation may return above 3%, so NBH may miss inflation target in 2015 again. Also it is worrying that despite of the heavy public utility cost reduction, Hungary has still one of the highest HICP figure in EU.

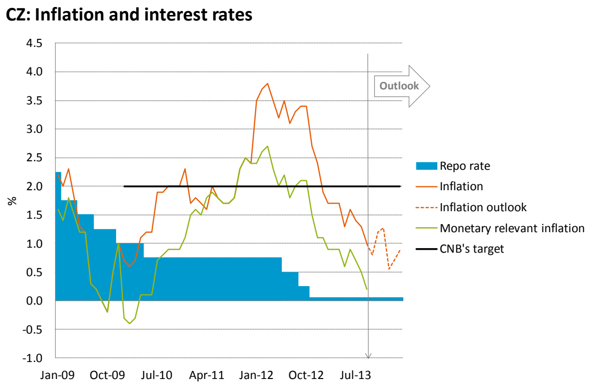
Despite of the increasing inflation, the most likely scenario that Monetary Council may focus on GDP growth and the further decrease of NBH's sterilization cost in the coming months, until the international sentiment remains supportive and EUR/HUF is traded well below 300. So for the upcoming MPC meeting, which will be held on 29 October, the most likely outcome is 20bp cut again, especially if we take it account that last time (in September) 6 members from 7 voted on 20bp cut, while only one voted for 10bp cut. In the meantime 2 new members were appointed into the council, who may have a dovish approach as well. Additionally Hungary yield curve started to flatten slightly, which opened the room for rate cut as well. So we expect 20bp cut for October.

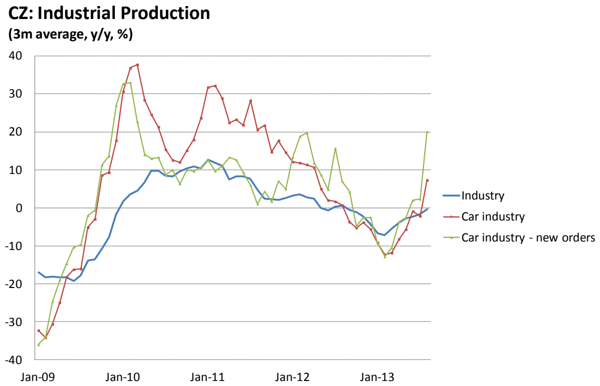
Not only rising output but particularly new orders are encouraging the optimism in the Czech automotive sector

August's industrial output was better than expected, rising by 4.2% in the largest Czech sector, after adjustment for a different number of business days in the month. Especially carmakers fared well, benefiting from a rapid rise in new orders in recent months. After all, this is also confirmed by the statistics of the Automotive Industry Association, according to which car production in the CR was up by 9.5% y/y in the third quarter. The plastics industry and the manufacture of metal products also performed well this time. By contrast, the mining industry, struggling with low commodity prices, is in the red. The rise in new industrial orders by more than 12% is particularly good news. This, along with the rising optimism of industrial businesses and the previously released purchasing managers index, holds great hopes of industry continuing to perform very decently in the months to come. Orders are again primarily fuelled by cars, encouraged by the stabilisation of the European automotive market, amongst other factors. This market has stopped falling for the first time in four years, even in countries at the overly indebted periphery. Orders also indicate that the performance of industry is primarily driven by foreign demand, while domestic demand remains weaker. Therefore we view the latest data with cautious optimism, because even the recovery of foreign demand may still be very fragile.

The Polish CA balance begins to follow a regional pattern

The Polish current account (CA) has begun to look more and more similar to its regional PEERs. The CA deficit reached 719 million euro in August while markets on average expected a milder deficit of 213 million. A wide gap between income account´s revenues and expenditures (-1 738 million euro) was a major surprise reflecting ongoing strong outflow of dividends from Poland. Although the high income deficit may prove to be a one-off event in retrospective and partial compensation of lower dividends outflow in July (see the chart), it easily surpassed August´s services and goods surplus of 779 million.





Weekly preview

TUE 14:00 PL Inflation (change in %)

	Sep-13	Aug-13	Sep-12
CPI y/y	**1.1**	1.1	3.8
Food (ex Alc.) y/y	**2.1**	2.5	5.3
Transport (including fuel)	**-1.6**	-1.4	8.0

PL: Inflation at 1.1% for a third consecutive month

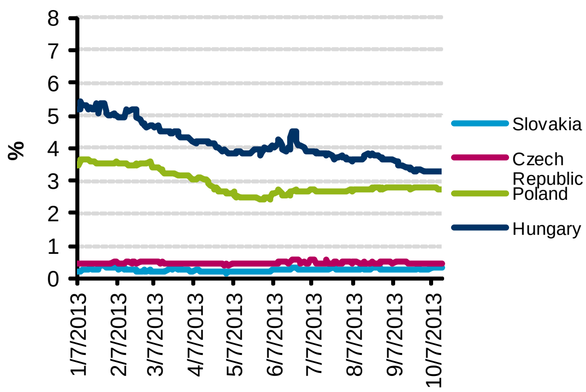
September's inflation in Poland hit 1.1% for a third consecutive month, according to our forecasts. The month-on-month price rise by 0.1% was primarily due to the increases in fuel and clothing prices. By contrast, food prices likely fell for a fourth consecutive month, this time by 0.3%, which is atypical of this season of the year.

Calendar

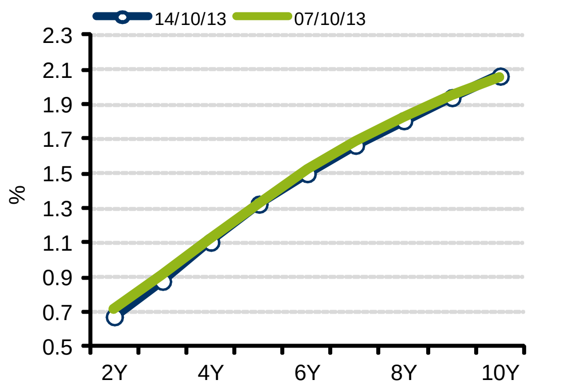
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	10/14/2013	14:00	Money supply M3	%	09/2013			0.1		0.7	
HU	10/15/2013	9:00	Industrial output	%	08/2013 *F					0.7	0.9
CZ	10/15/2013	9:00	PPI	%	09/2013	0	0.5	0	0.5	-0.1	0.5
PL	10/15/2013	14:00	CPI	%	09/2013	0.1	1.1	0.1	1.1	-0.3	1.1
PL	10/15/2013	15:00	Budget balance	PLN M	09/2013					-26784	
PL	10/16/2013	14:00	Wages	%	09/2013			-0.2	3.1	-1.8	2
PL	10/16/2013	14:00	Core CPI	%	09/2013			0.1	1.5	-0.1	1.4
PL	10/17/2013	14:00	Industrial output	%	09/2013			10.4	7.1	-4.5	2.2
PL	10/17/2013	14:00	PPI	%	09/2013			0.2	-1.4	-0.3	-1.1

Fixed-income in Charts

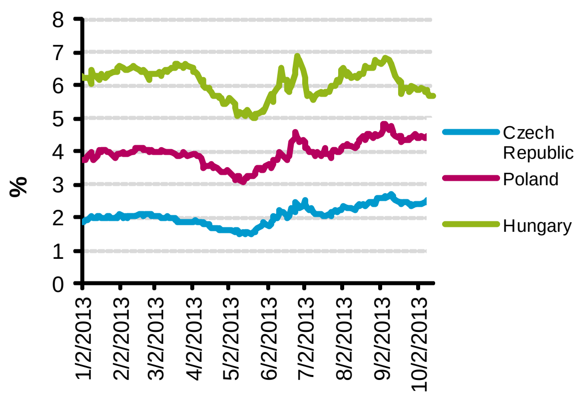
FRA 3x6



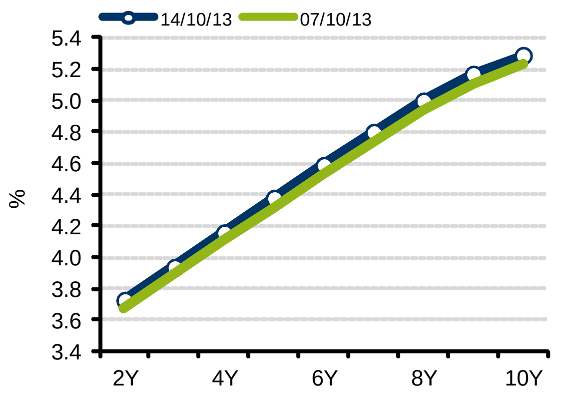
CZ IRS



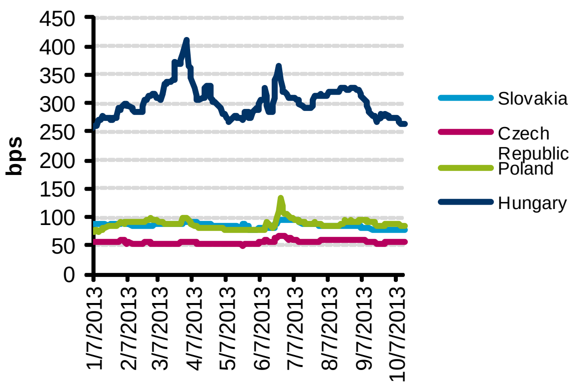
10Y GB Yields



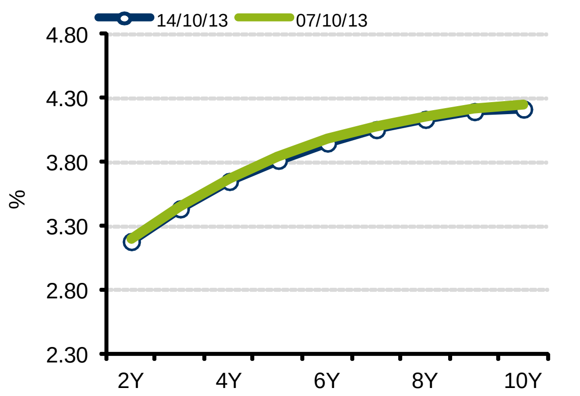
HU IRS



CDS 5Y



PL IRS



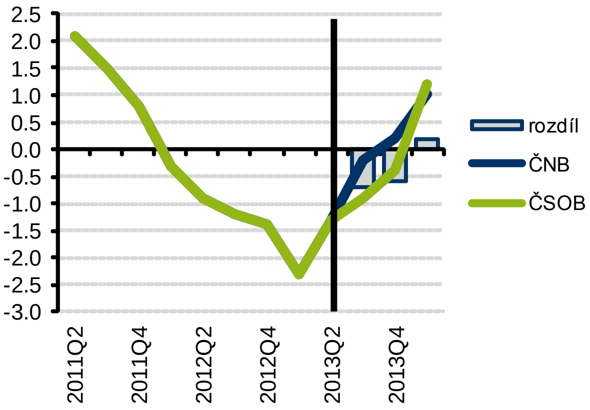
Source: Reuters

Medium-term Views & Issues

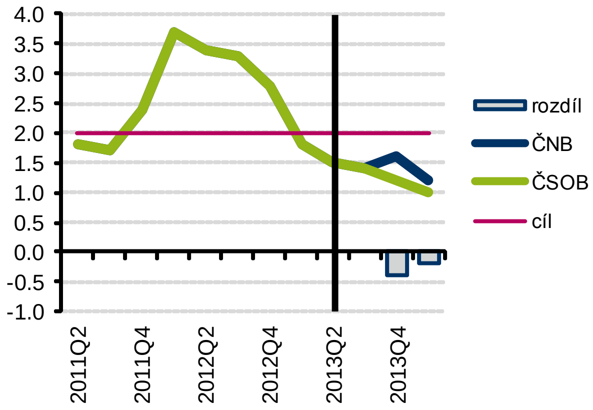
	The Czech Republic	Hungary	Poland
Growth & key issues	Three years after last elections the Prime Minister resigned and his cabined fell. With minor exceptions, the bulk of political scene in the CR refuses to call premature elections a less than year before regular parliamentary elections. Newly formed “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 25.40 (see the FX outlook).	For the upcoming NBH meeting, which will be held on 29 October, the most likely outcome is 20bp cut again, especially if we take it account that last time (in September) 6 members from 7 voted on 20bp cut, while only one voted for 10bp cut. In the meantime 2 new members were appointed into the council, who may have a dovish approach as well.	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 the NBP is probably ready to intervene above 4.35 level (the last intervention occurred at EUR/PLN 4.32).

CBs' Projections vs. Our Forecasts

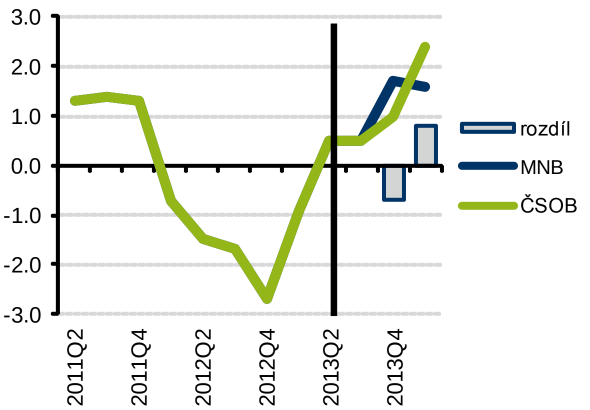
CZ: GDP outlook (Y/Y, %)



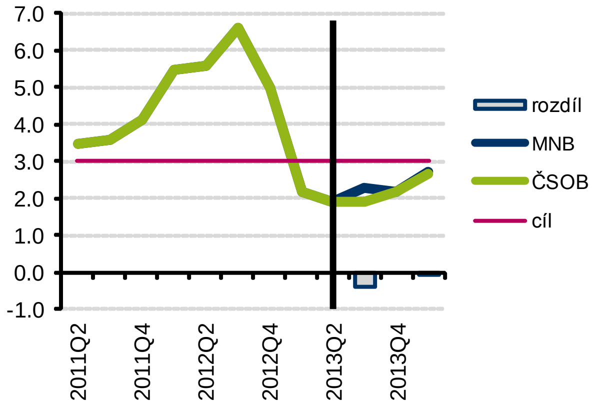
CZ: Inflation outlook (Y/Y, %)



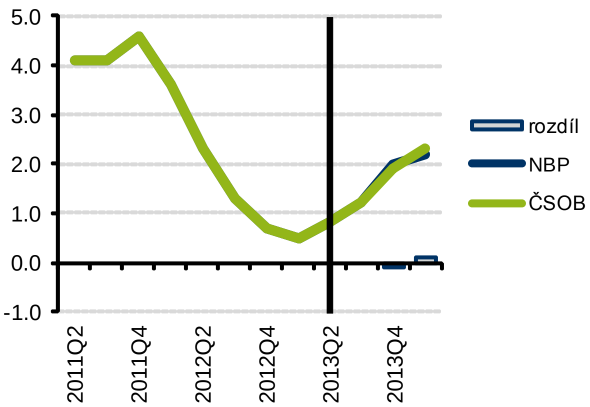
HU: GDP outlook (Y/Y, %)



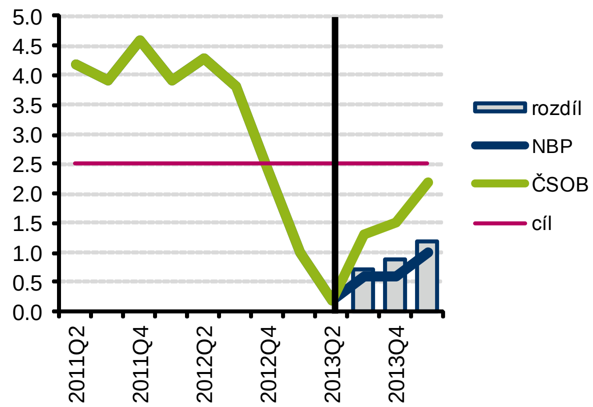
HU: Inflation outlook (Y/Y, %)



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.	*3.60*	5.75	5.00	4.25	3.60	3.75	-20 bps	9/24/2013
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	0.42	0.43
Hungary	BUBOR	*3.55*	5.75	4.90	4.20	3.56	3.50
Poland	WIBOR	*2.68*	4.11	3.39	2.73	2.67	2.75

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	*2.066*	1.37	1.31	1.97	2.06	2.15
Hungary	HU10Y	*5.29*	5.49	5.41	5.84	5.17	5.90
Poland	PL10Y	*4.22*	3.60	3.61	4.14	4.24	3.95

Exchange rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	EUR/CZK	*25.5*	25.1	25.7	26.0	25.7	25.5
Hungary	EUR/HUF	*295*	291	304	295	297	300
Poland	EUR/PLN	*4.19*	4.08	4.18	4.33	4.22	4.20

GDP (y/y)

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	-0.9	-1.2	-1.4	-2.3	-1.3	-0.9	-0.4
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	1.1	1.4
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	-1.7
Hungary	1.5	2.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-2.7
Hungary	-2.5	-2.7
Poland	-3.9	-4.0

Source: CSOB, Bloomberg

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