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Central European Weekly

Monday, 20 January 2014

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Weekly Highlights:

- Hungary's inflation at all-time lows
- The CNB confirms again that the current FX regime will not last forever
- The NBH to cut by another 10 bps

Chart of the Week: Polish and Hungarian CPI

Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while in Hungary hit historical all-time lows.

Market's editorial

Fresh lows for Hungary's inflation impliy another rate cut

As we expected, Hungary's inflation rate hit a new all-time low (0.4% y/y) in December, and this fuelled expectations that the National Bank of Hungary would continue to cut rates. Naturally, this must have benefited Hungarian government bonds, the prices of which have increased significantly since the beginning of the year, due also to a generally positive price correction in global bond markets.

We think that on the relevant time horizon for NBH, the inflationary developments suggest that there is no need for further easing of monetary policy. But based on the statements on the Monetary Council it looks like that rate cut cycle may continue in the following months as there is no strong upward pressure on inflation, while the economic growth just started to accelerate and the lending activity is still subdued. Some members of the council also highlighted that EURHUF above 300 won't change their view and 310 level of EURHUF won't force the Monetary Council to hike the base rate. As the Council highlighted in the statement after the last rate setting meeting in December that even more cautious monetary policy has to be followed because of the starting tapering, it suggest that they may slow the speed of rate cut cycle, so we expect 10bp cut from 3% to 2.9% on the next meeting held on 21 January.

CNB's governor: the current regime will not last forever

Meanwhile, the Czech National Bank's media offensive continued even at the start of the new year, with individual CNB Board members trying to explain the purpose of the interventions against the koruna to the expert community as well as the general public. We should note the opinion by Governor Singer, who said that the CNB would not mind seeing the koruna strengthen when leaving the intervention regime. He stressed that the bank would not wish to keep the koruna weak forever, in order to provide the Czech Republic with a long-term competitive edge. This means just one thing: we should prepare for an abrupt appreciation of the Czech currency in 2015. In part, pressure for such an appreciation will be naturally curbed by an early warning about the exit, which should enable exporters to hedge their positions for a longer time ahead. Yet abrupt appreciation cannot be avoided in any event, because Czech inflation will not go up enough to offset the nominal depreciation of the koruna towards the EUR/CZK 27.0 level. This is why we predict that, after the exit, the koruna will be back close to the EUR/CZK 26.0 level at the end of next year

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	0.25%	↗	↗
EUR/HUF	302	0.95%	↗	→
EUR/PLN	4.16	0.13%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.97	-1.74	↗	↗
10Y HUF	4.99	1.63	↗	↗
10Y PLN	4.17	-0.48	↗	↗

Review of Economic Figures

The Hungarian inflation at new all-time lows

The Hungarian consumer price growth moderated from 0.9% Y/Y in November to 0.4% Y/Y in December as expected. So, the average inflation was 1.7% Y/Y in 2013. Prices dropped by 0.5% M/M in December. Despite of the falling headline figure core inflation remained at the same level as in November at 3.5% Y/Y.

The main reason behind the decreasing inflation is the effect of the public utility cost reduction of gas, electricity and district heating, which explains 0.9% Y/Y drop of CPI in November and December. Also food prices are moderating inflation thanks to the good harvest in 2013, while tradable goods prices were almost stagnating, which reflects the still relatively weak, but at least stabilizing households consumption. Fuel, market services, alcohol and tobacco prices were increasing in December.

The most worrying development of the inflation is the market services, as it stuck above 5% Y/Y level despite of the weak domestic demand, although we have to highlight that this segment was also affected heavily by government measures, like transaction tax, increase of taxi fees or higher cost of highway use fees for transportation companies etc. Without these measures market services inflation may be around 4% Y/Y.

CPI may moderate slightly further in January thanks to the VAT cut from 27% to 5% in case of pork, but as the first public utility cost reduction (was implemented beginning of 2013) will fall out from the base, inflation starts to increase substantially from February, although it may counterbalanced by a new, fourth wave of public utility cost reduction (there are plans by the government, to cut further the cost of some services before the election, but nothing was approved yet). Based on the latest available information we calculate the average inflation at 1.5% Y/Y in 2014, but CPI may already reach 3% Y/Y level in December.

The Polish inflation below 1% in 2013

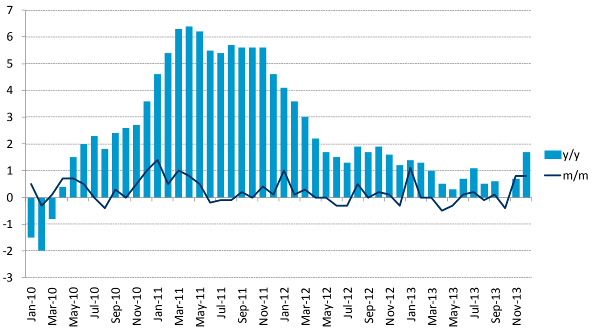
The Polish year-on-year inflation rate accelerated slightly in late 2013, having reached 0.7%, and thus the full-year average remained almost unchanged at 0.9%. This is a significant change vis-à-vis previous years, as last year's average inflation, for instance, was 3.7%. As concerns the structure of December's month-on-month rise by 0.1%, the greatest surprise to us was the fairly rapid rise in fuel prices by 0.4% (we had expected the price to fall slightly).

We believe that moderate inflation pressures should persist this year, when we expect inflation of around 1.7%. Inflation should remain low despite the very good prospects of the Polish economy, which is likely to grow in excess of 3%. The combination of reasonable growth on the one hand and low inflation on the other should enable the NBP to keep interest rates at all-time lows for the most of this year. We believe that greater pressure on the rates to go up should not occur before the late third and early fourth quarter.

The Czech PPI higher as imported priced moved higher

A clear outcome of November's forced weakening of the koruna is the rise in the producer price index in the Czech Republic. Prices in that sector went up by 0.8% m/m in both November and December. Producers have thus reacted to the increase in the prices of imported raw materials and semi-finished products, triggered by approximately the 6% depreciation of the Czech koruna. The fastest price rise in the last two months has been evident among refining product manufacturers, where exchange rates or changes in oil prices usually have the fastest effects. Prices of means of transport are rising by more than 4%, electronics by almost 3%, and metals by 2.5% now.

CZ: Industrial pruducer prices



The price rise in industry reflects the high import requirements of domestic industry; and the question is to what extent domestic producers will be able to translate their increased costs into final product prices, given the decreasing demand for their products. In foreign markets, where businesses have contracts in foreign currencies, this will be certainly easier than in the domestic market. The effect of the 'devaluation' of the koruna is growing in strength and still far from running out of steam. The weak koruna will continue to affect prices in industry early next year, while the weakened koruna is only starting to fully affect the consumer price index now.

Weekly preview

TUE 14:00	NBH base rate	
	This meeting	Last change
rate level (in %)	**2.90**	12/2013
change in bps	**-10**	-20

HU: The NBH to cut rates again to fresh lows

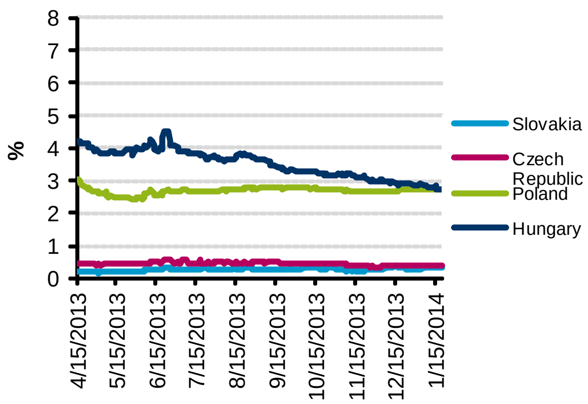
As the Monetary Council highlighted in the statement after the last rate setting meeting in December that even more cautious monetary policy has to be followed because of the starting tapering, it suggest that they may slow the speed of rate cut cycle, so we expect 10bp cut from 3% to 2.9% on the next meeting held on 21 January.

Calendar

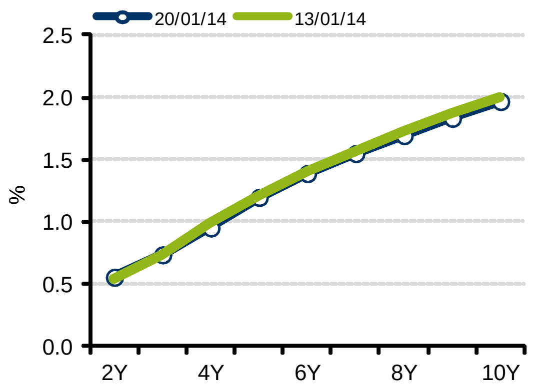
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	01/20/2014	14:00	Wages	%	12/2013			8.9	3.2	1.7	3.1
HU	01/21/2014	14:00	NBH meeting	%	01/2014	2.9		2.9		3	
CZ	01/22/2014	12:00	CZ bond auction 2013-2016, 0.50%	CZK B	01/2014						
CZ	01/22/2014	12:00	CZ bond auction floating rate/2023	CZK B	01/2014						
PL	01/22/2014	14:00	Industrial output	%	12/2013			-6.3	10.5	-6.2	2.9
PL	01/22/2014	14:00	PPI	%	12/2013			-0.2	-1.1	-0.3	-1.5
PL	01/24/2014	10:00	Retail sales	%	12/2013			19.1	7	-5.8	3.8
PL	01/24/2014	10:00	Unemployment rate	%	12/2013			13.5		13.2	

Fixed-income in Charts

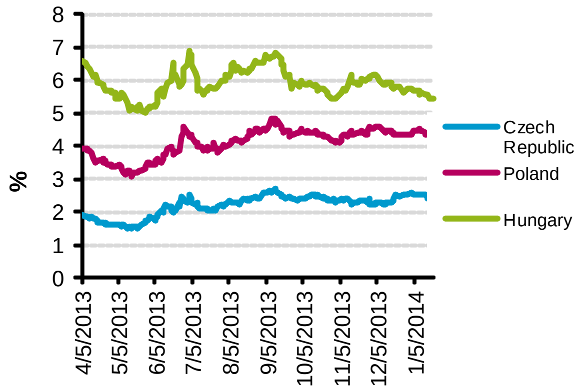
FRA 3x6



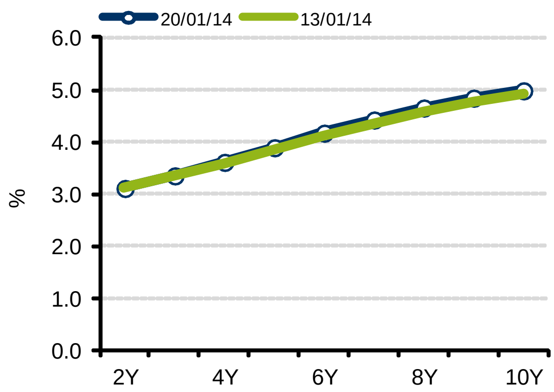
CZ IRS



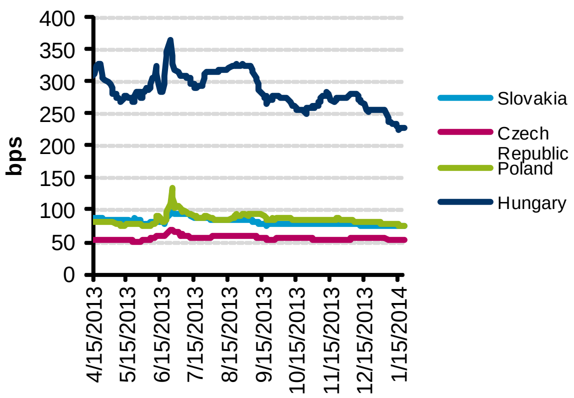
10Y GB Yields



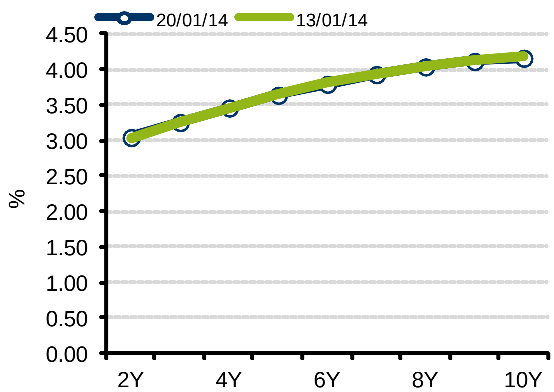
HU IRS



CDS 5Y



PL IRS



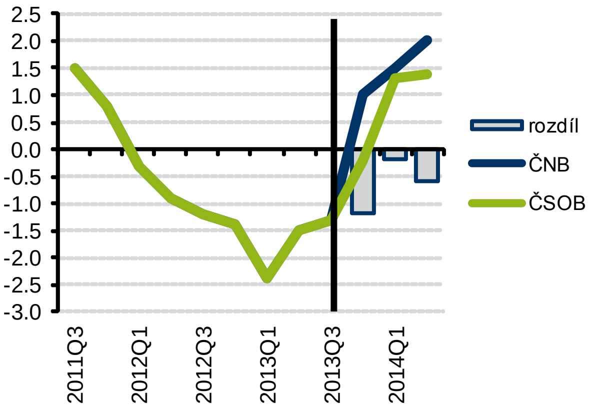
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech Republic is still led by a government that has stepped down, while the negotiations by winners of the early election have begun only recently, hence it is too soon to predict what exactly the economic policy of the future government will look like. As confirmed by production statistics, industry continues to drive the economy; however, agriculture, construction and services dragged the economy back into the red in Q3.	As elections are coming in 2014, the government may do everything to maintain the relatively good performance. The NBH's funding for lending program may boost the economy by 0.2-0.4% Y/Y in the following quarters; the net real wage growth may help the domestic consumption, while public investments are likely to continue at least till mid-2014. Additionally there were temporary stop of production in some industrial sectors end of last year, which provides very low base for this year, so we expect around 2.5% Y/Y GDP growth for 4Q13 and around 1% Y/Y average growth for 2013, which may accelerate to around 1.6% Y/Y in 2014.	The Polish economy grew by 1.9% Y/Y and 0.6% Q/Q in 2013Q3. While the growth was again mainly driven by net exports, household consumption contributed 0.6 percentage point (pp) and, maybe even more importantly, data unveiled a negligibly positive contribution of investment (+0.1pp). Figures have confirmed that growth of the Polish economy is starting to be based on more robust foundations. For this year as a whole, the Polish economy should grow by approximately 1.4%, despite its poor performance at the beginning of the year.
Outlook for official & market rates	The CNB has completely exhausted the possibility of easing its monetary policy through interest rates, and therefore it has decided to weaken the koruna and keep it close to CZK 27 per EUR. Statements from the CNB representatives indicate that the CNB would like to maintain that level for a prolonged period, until strong inflation pressures become evident in the economy. The CNB believes that the depreciation of the koruna should enable the economy to avoid deflationary pressures and boost its growth up to 2.1% next year.	We think that on the relevant time horizon for NBH, the inflationary developments suggest that there is no need for further easing of monetary policy. But based on the statements on the Monetary Council it looks like that rate cut cycle may continue in the following months as there is no strong upward pressure on inflation, while the economic growth just started to accelerate and the lending activity is still subdued. Some members of the council also highlighted that EURHUF above 300 won't change their view and 310 level of EURHUF won't force the Monetary Council to hike the base rate. As the Council highlighted in the statement after the last rate setting meeting in December that even more cautious monetary policy has to be followed because of the starting tapering, it suggest that they may slow the speed of rate cut cycle.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. Although the recent development has supported our bets on faster economic recovery in Poland (in 2014, the central bank expects 2.9% growth while we estimate 3.1% with upside risks), outlook for persistently low inflation and NBP's strong emphasis on forward guidance along with the fact that all members of the Monetary Policy Council agreed upon it, made us review our scenario and we newly expect that the first rate hike (25 bps) may come rather at the end of 2014.
Forex Outlook	The CNB has started FX interventions and we expect the koruna to stay within the regime at least till the end of 2014. Hence the currency should stay above 27.00 EUR/CZK at least in 12-month horizon. When the FX targeting regime is set to be abandoned, the CNB will have to intervene on the market much more aggressively to stop the spot koruna from appreciation. As a side effect, the forward koruna can appreciate significantly before the regime is abandoned.	While on one hand the forint could be constrained by relaxed NBH's policy, on the other it can profit from loose ECB's and Fed's policies. So, we see the EUR/HUF traded in the range and we expect low volatility. The narrow range at the moment is between 296.5 and 300, the wider range is 292 and 302. We don't expect to break out from this range for the next weeks, we would rather bet on short term on some strengthening.	Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. The Polish currency might perform particularly well in comparison with the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue. In our view, Fed's QE tapering remains the main risk for the zloty.

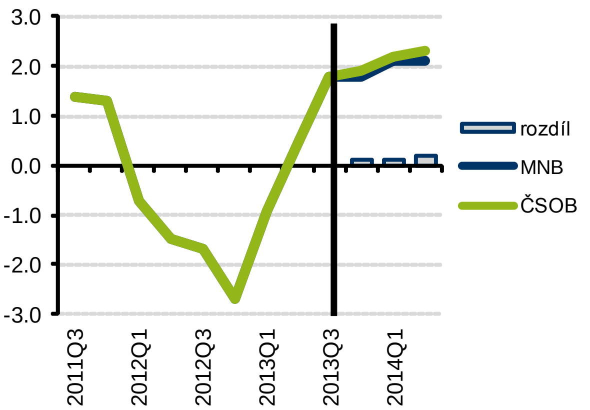
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

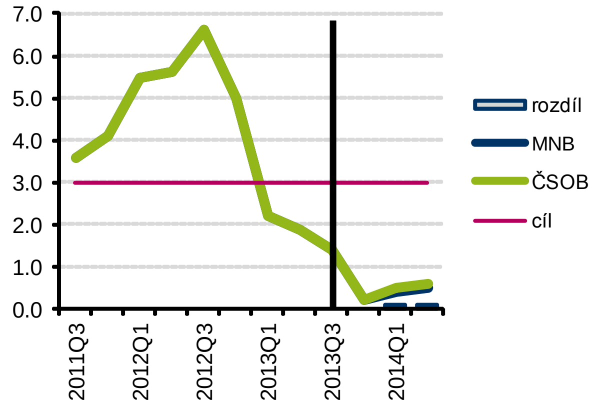


CZ: Inflation outlook (Y/Y, %)

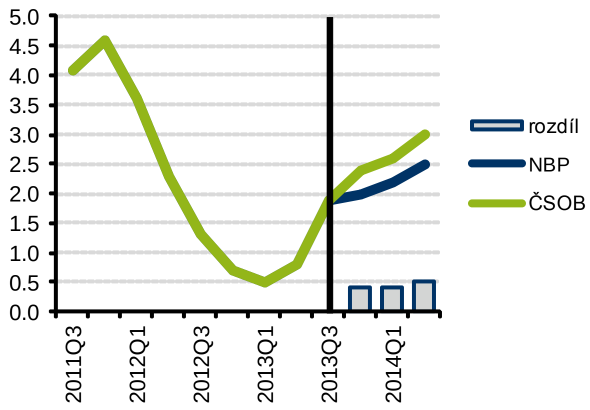
HU: GDP outlook (Y/Y, %)



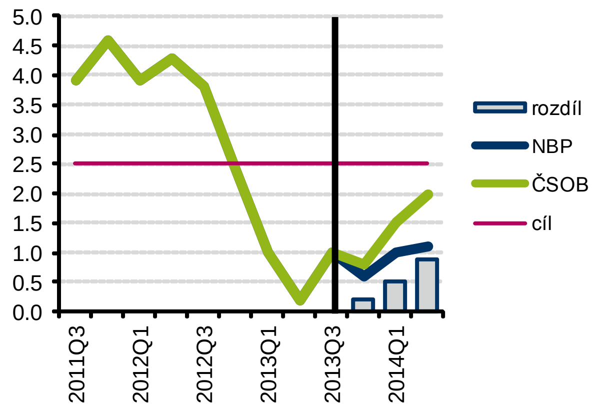
HU: Inflation outlook (Y/Y, %)



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	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	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.	*3.00*	4.25	3.60	3.00	4.00	4.50	-20 bps	12/17/2013
Poland	2W inter. rate	*2.50*	2.75	2.50	2.50	2.50	2.75	-25 bps	7/3/2013

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

		Current	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	PRIBOR	*0.37*	0.44	0.42	0.38	0.37	0.36
Hungary	BUBOR	*2.98*	4.20	3.56	2.99	3.50	3.70
Poland	WIBOR	*2.7*	2.73	2.67	2.71	2.75	3.00

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

		Current	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	CZ10Y	*1.971*	1.97	2.06	2.09	2.17	2.27
Hungary	HU10Y	*4.99*	5.84	5.17	5.25	6.10	6.20
Poland	PL10Y	*4.17*	4.14	4.24	4.25	4.05	4.35

Exchange rates (end of the period)

		Current	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	EUR/CZK	*27.4*	26.0	25.7	27.3	27.3	27.2
Hungary	EUR/HUF	*302*	295	297	297	300	300
Poland	EUR/PLN	*4.16*	4.33	4.22	4.16	4.20	4.10

GDP (y/y)

	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	-1.4	-2.4	-1.5	-1.3	-0.2	1.3	1.4
Hungary	-2.7	-0.9	0.5	1.8	1.9	2.2	2.3
Poland	0.7	0.5	0.8	1.9	2.4	2.6	3.0

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

	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	2.4	1.7	1.6	1.0	1.4	0.5	0.7
Hungary	5	2.2	1.9	1.4	0.2	0.5	0.6
Poland	2.4	1.0	0.2	1.0	0.8	1.5	2.0

Current Account

	2012	2013
Czech Rep.	-1.9	-1.1
Hungary	1.5	2.0
Poland	-3.5	-1.7

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-2.5
Hungary	-2.5	-2.7
Poland	-3.9	-4.6

Source: CSOB, Bloomberg

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