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Central European Weekly

Monday, 03 February 2014

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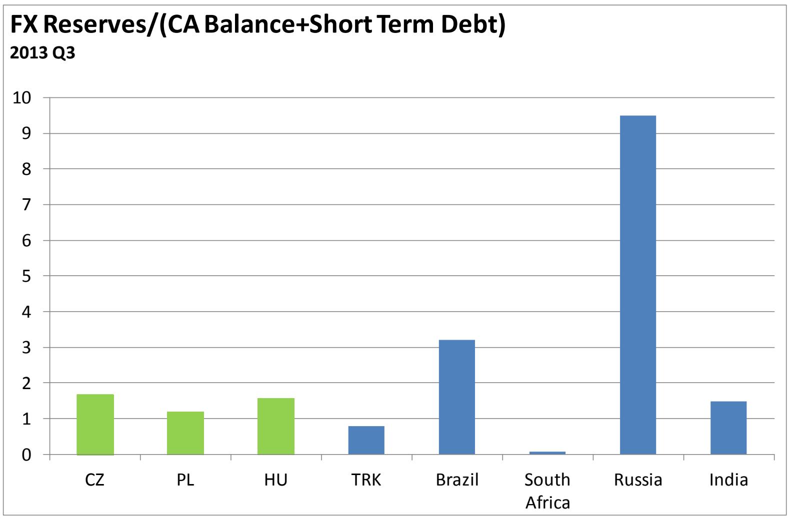
- Contagion hit Central Europe and might force the NBH to stop its easing cycle
- Regional PMIs at multi-year highs
- The CNB Bank Board will face a new macro projection

Chart of the Week: External vulnerability



Central European short term debt coverage looks better in compare with Turkey or South Africa, but lags behind Russia or Brazil

Market's editorial

Cotagion hits Central Europe – Hungary suffers the most

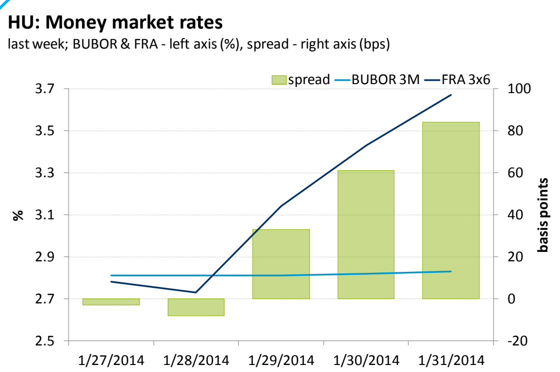
Last week showed that tension in emerging markets might significantly spill over to Central European markets, which were falling in spite of a certain stabilisation of the Turkish lira. The regional sell-off was fuelled by Wednesday's statements from the Hungarian Governor, who believes that he will be able to continue to cut rates, notwithstanding the escalated tension in the emerging world; however, markets are of a different opinion. Actually, the Hunagarian fixed-income market has already started to price in a sharp increase in official interest rates in Hungary in the three-month horizon. Is it a realistic scenario? We think that much will again depend on (as usualy) on the EUR/HUF rate.

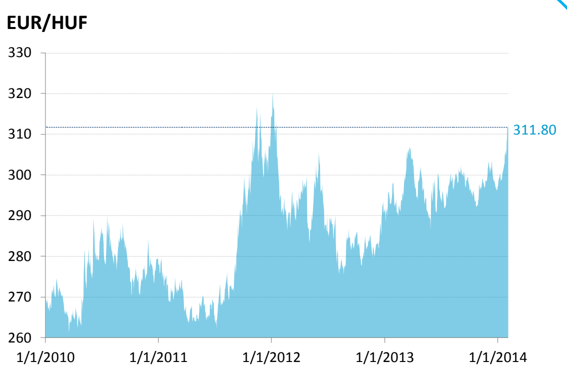
The EUR/HUF was affected by the emerging market sell off and moved suddenly above 310 levels, which is the highest read in the last two years. While there were rate hikes on other emerging markets, NBH cut base rate from 3% to 2.85% just before the sell off has been accelerated. Some MPC members (including the governor of NBH) highlighted that the monetray policy won't be changed because of HUF weakning as the central bank has no exchange rate target. As the latest comments were announced before the EUR/HUF crossed 310 level, the view of the MPC may be changed slightly. We expect that the fast and sudden movemnet of HUF and the increasing volatility may move the MPC's stance to a more cautious direction and the coucil may keep the base rate unchaged at 2.85% in January.

No inflation threat in Hungary makes the NBH more relaxed

Huge difference compared to Turkey is that there is no sudden risk of acceleration of inflation in Hungary, so the NBH can be more patient regarding of HUF movements. Rather the stability perspective can force MPC to change its monetary policy, but as the short term external debt redemption of Hungary is only half of NBH's foreign currency reserves there is only limited pressure from that side.

Technicallly, we see important EUR/HUF resistance levels at around 314, 317 and 324, while on the strong side around 310, 308 and 305.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.5	0.07%	➚	➘
EUR/HUF	312	1.94%	➚	➘
EUR/PLN	4.23	0.53%	➚	➘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.92	-0.98	➔	➔
10Y HUF	5.52	2.03	➚	➚
10Y PLN	4.45	4.83	➚	➚

Review of Economic Figures

Regional PMIs at multi-year highs

The january PMI figures have shown very good results in all three countries. The index has hit its highest level since 2011 both in Poland and in the Czech Republic, while in the case of Hungary, it nearly surpassed its seven-year high (let us recall, however, that the Hungarian index is based on a different methodology and is much more volatile). As for Poland, another good news is that the employment sub-index has shown the fastest pace of growth ever (since the survey started in the late 90th), which supports general bets on continuing economic recovery.

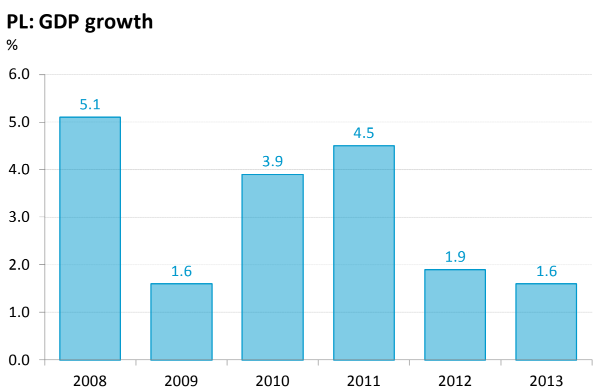
The Polish economy grew rapidly in the last quarter

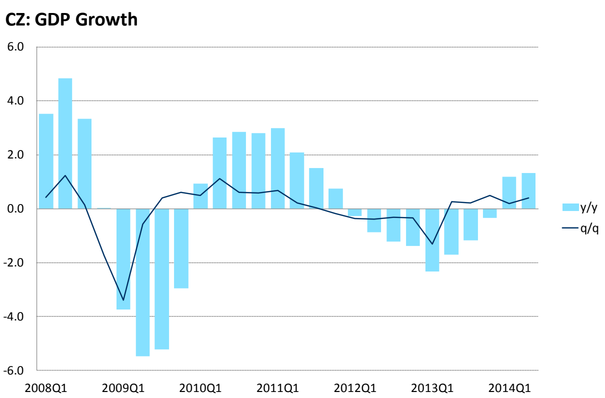
There is every indication that the Polish economy grew significantly in the last quarter of 2013. This is, at least, signalled by the preliminary growth forecasts for last year, released by the Polish Statistical Office. Unless the data for the first three quarters is revised significantly, annual growth by 1.6% is consistent with the growth rate of around 3% y/y in the fourth quarter, which was the highest figure in the last two years and also much better than we expected. Even though last year's economic growth lagged behind that of 2012, the figure can still be seen as very good, notably with regard to the very slow beginning.

For this year, we believe that economic growth should exceed 3%. Household consumption should also contribute to growth significantly this time (last year, household consumption was up by 0.8%), probably owing to the improving labour market situation as well as to low inflation (through faster real wage growth). Investment should also develop favourably, owing to the replenishment of inventories as well as to gross capital formation (the absorption of European Funds should also contribute to this). In addition, the pension system reform will enable the government to give a greater lift to the economy, owing to a one-off decline in government debt, with this also likely to be encouraged by the approaching general election and the uncertain prospects for the current ruling parties (the opposition party Law and Justice leads in current opinion polls). By contrast, the increased consumption is likely to go hand in hand with a deteriorating foreign balance, while net exports, which drove the economy in the last two and a half years, are likely to curb rather than boost growth.

Details of the Czech GDP confirms weak investments

The Czech GDP for 2013 is not yet available, but we believe that the last quarter most likely saw strong growth. Even so, the full-year GDP will remain in the red, and thus we keep our full-year downturn forecast unchanged (-1.3%). Basically, this outlook also correlates with the latest forecast by the Ministry of Finance, which envisages that the Czech economy fell by 1.4% last year, mainly because of poor investment, low household consumption, and adverse foreign trade. This year's outlook by the Ministry of Finance is also worth noting, as it predicts Czech GDP growth of 1.4% (our forecast is still 1.5%), and thus is not at all as optimistic as that of the CNB (2.1%).





Weekly preview

WED 9:00 **CZ Retail Sales (change in %)**

	Dec-13	Nov-13	Dec-12
Sales	**2.3**	6.1	-4.9
cummulative (YTD)	**0.7**	0.6	-1.1

CZ: Weaker CZK increased consumer spending

The effect of the depreciation of the koruna, which drove consumers to shops in November, is likely waning. Therefore November's extreme rise in retail sales will scarcely reoccur. This applies to the automotive segment as well as to the rest of the retail network. The faster that sales rose in the wake of the devaluation, the slower will sales rise in the months to come. We primarily attribute the predicted moderate increase in December's spending to a greater number of business days in the month.

THU 9:00 **CZ Industry (y/y change in %)**

	Dec-13	Nov-13	Dec-12
Monhtly	**9.0**	6.2	-11.4
cummulative (YTD)	**0.4**	-0.2	-0.8

CZ: Carmakers' expansion continues

As indicated in previous months, the rising trend of domestic industry is growing in strength, owing to the inflow of foreign orders. The primary role is played by carmakers, whose production is rising at a double-digit rate, machinery, and the manufacture of plastics and metal products. Steel production, which was struggling to recover from the previous recession, also seems to be picking up. Moreover, one additional business day in the last month of last year will contribute to the overall figure. We also expect very good figures from new orders, which probably continued to rise by nearly 15%.

THU 9:00 **HU Industry (change in %)**

	Dec-13	Nov-13	Dec-12
Monthly	**4.5**	5.8	-3.0

HU: Industry faces negative base effect

Industrial production started to accelerate in 2H13 mainly thanks to the car manufacturing industry. Additionally at the end of 2012 may car manufacturing companies slowed down its production, because of the unfavorable European outlook, which provided a low base for 2013 growth.

THU 13:00 **CNB base rate**

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

CZ: The CNB releases new projection

The agenda of the CNB Board's first meeting of the year will include a new inflation forecast, which may not necessarily differ significantly from the previous one (an alternative scenario with the exchange rate intervention). It will be intriguing to see the economic growth forecast for this year, now, three months after the intervention (and also after the GDP data revision). To date, the central bank has expected that Czech economic growth will double this year, owing to the weak koruna. We do not believe that even a more optimistic new forecast could make the central bank change the established exchange rate regime or interest rates.

FRI 9:00 **HU Foreign trade (EUR m)**

	Dec-13	Nov-13	Dec-12
Balance	**400.0**	825.0	140.0

HU: Another huge trade surplus

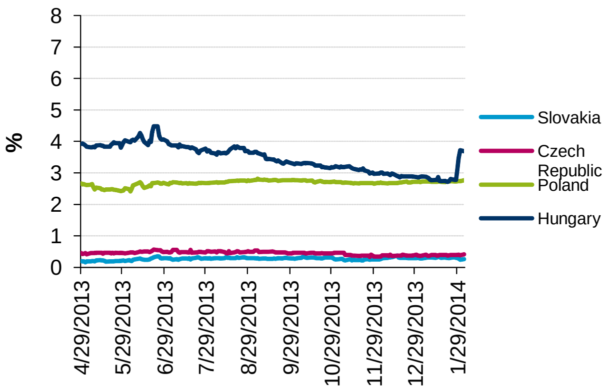
The domestic consumption started to grow in 4Q13, but the dynamic of the import was below the export level in the last months. Although we expect that the import growth might be closer to the export one, still the domestic consumption is subdued, while the export is the main driver of Hungarian GDP growth. The gap between the import and export growth increases the trade surplus.

Calendar

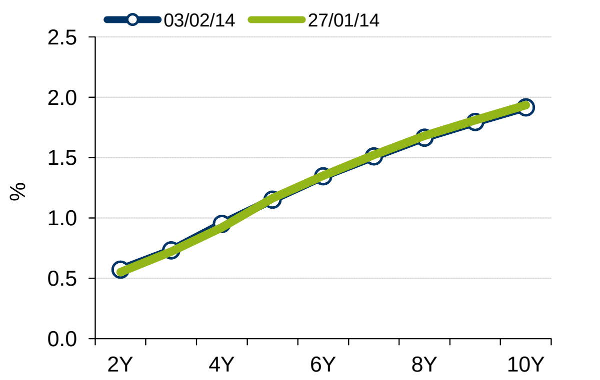
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	02/03/2014	9:00	PMI manufacturing		01/2014					53.2	
HU	02/03/2014	9:00	PMI manufacturing		01/2014					50.2	
CZ	02/03/2014	9:30	PMI manufacturing		01/2014					54.7	
CZ	02/03/2014	14:00	Budget balance	CZK B	01/2014					-80.9	
CZ	02/05/2014	9:00	Retail sales	%	12/2013		2.3		6.2		6.1
HU	02/05/2014	9:00	Retail sales	%	12/2013						4.9
PL	02/05/2014	14:00	NBP meeting	%	02/2014	2.5		2.5		2.5	
CZ	02/06/2014	9:00	Construction output	%	12/2013						-9.3
CZ	02/06/2014	9:00	Industrial output	%	12/2013		9		9		6.2
CZ	02/06/2014	9:00	Trade balance	CZK B	12/2013	10		10.9		38.7	
HU	02/06/2014	9:00	Industrial output	%	12/2013 *P		4.5		6	-0.5	5.8
CZ	02/06/2014	13:00	CNB meeting	%	02/2014	0.05		0.05		0.05	
HU	02/06/2014	17:00	Budget balance	HUF B	01/2014					-929.2	
HU	02/07/2014	9:00	Trade balance	EUR M	12/2013 *P	400				825	

Fixed-income in Charts

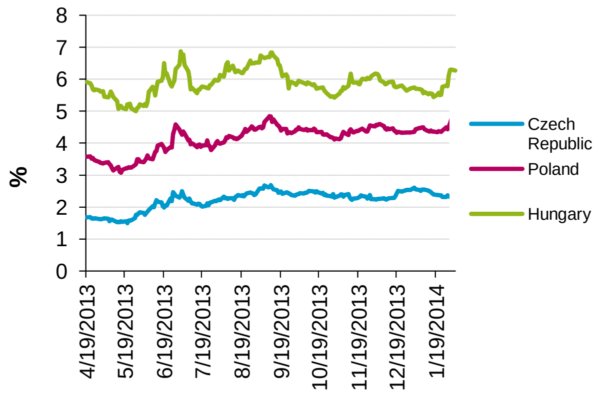
FRA 3x6



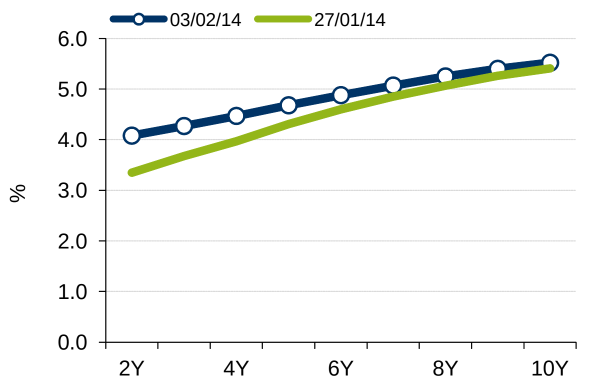
CZ IRS



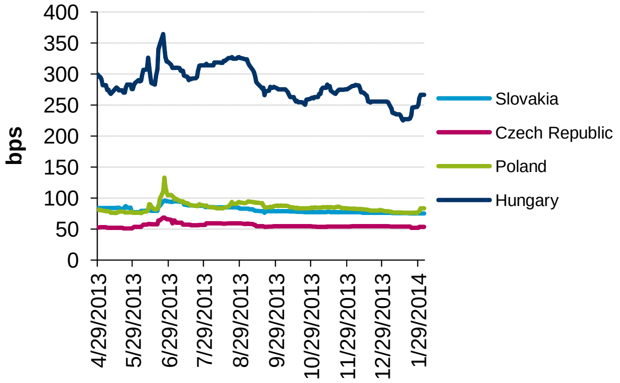
10Y GB Yields



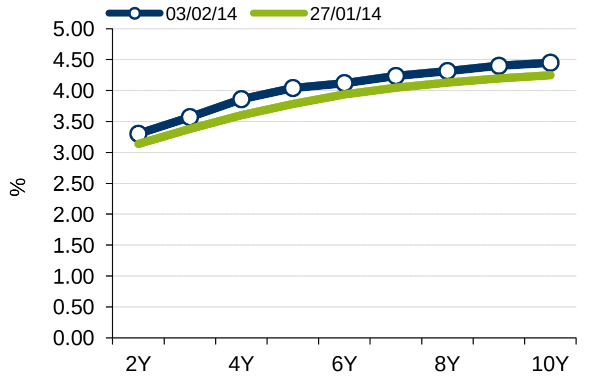
HU IRS



CDS 5Y



PL IRS



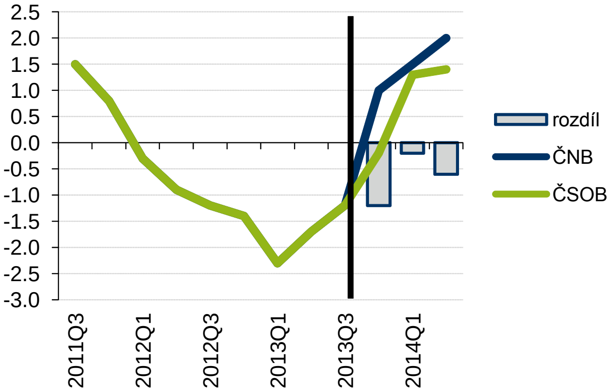
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	The president appointed a new coalition government a few months after the election. The programme of the future government is likely to be consistent with the concluded coalition agreement, which envisages keeping the government deficit below 3% of GDP throughout the government's electoral term. Statistics for the last six months confirm that the worst is over for the economy. The economy is being driven by the manufacturing industry, notably passenger car production, while construction, as well as many of services, are struggling to bottom out.	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 preliminary estimate of GDP growth in Poland (1.6%) for 2013 indicates the growth rate of around 3% y/y in the fourth quarter 2013. For this year, the growth could significantly exceed 3%. Household consumption should support growth, owing to the improving labour market situation as well as to low inflation. Investment should also develop favourably, owing to the replenishment of inventories as well as to gross capital formation In addition, lower government debt could also give a greater lift to the economy. By contrast, net exports are likely to curb rather than boost growth.
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. The CNB is very unlikely to change rates, and just as likely to maintain its intervention regime throughout this year.	310 levels, which is the highest read in the last two years. While there were rate hikes on other emerging markets, NBH cut base rate from 3% to 2.85% just before the sell off has been accelerated. Some MPC members (including the governor of NBH) highlighted that the monetary policy won't be changed because of HUF weakening as the central bank has no exchange rate target. As the latest comments were announced before the EUR/HUF crossed 310 level, the view of the MPC may be changed slightly. We expect that the fast and sudden movement of HUF and the increasing volatility may move the MPC's stance to a more cautious direction and the Council may keep the base rate unchanged at 2.85% in January.	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.	The EUR/HUF was affected by the emerging market sell-off and moved suddenly above 310 levels, which is the highest read in the last two years. Technically, we see important EUR/HUF resistance levels at around 314, 317 and 324, while on the strong side around 310, 308 and 305..	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.

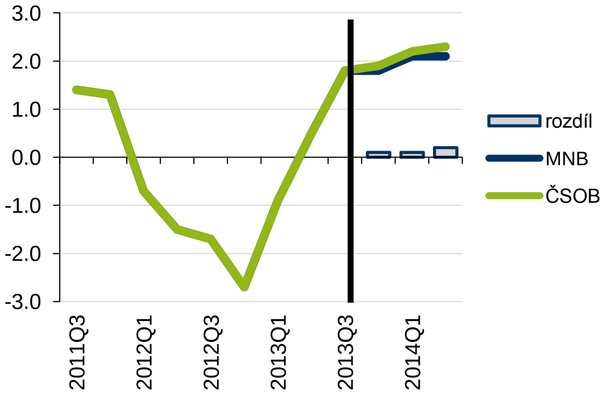
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)



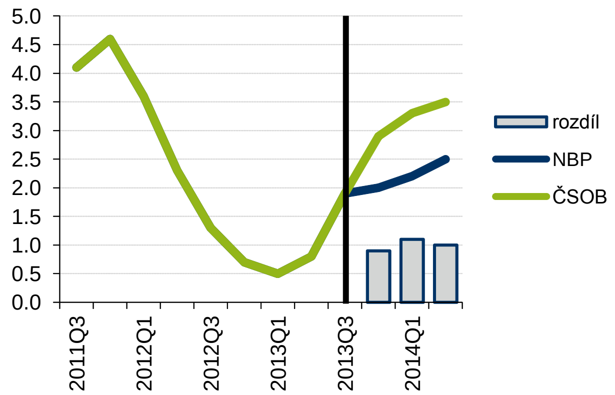
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)

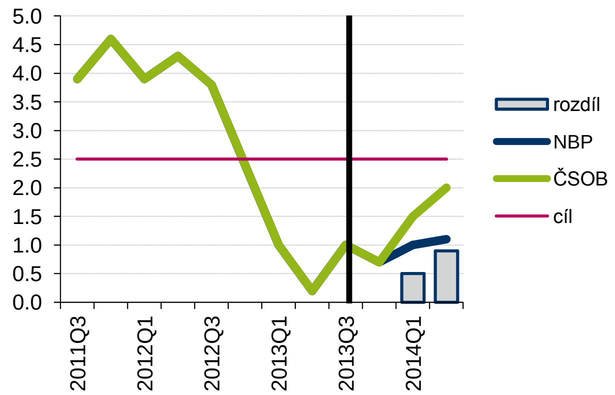


HU: Inflation outlook (Y/Y, %)

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.	*2.85*	4.25	3.60	3.00	4.00	4.50	-20 bps	1/21/2014
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	*2.85*	4.20	3.56	2.99	3.50	3.70
Poland	WIBOR	*2.71*	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	*1.916*	1.97	2.06	2.09	2.17	2.27
Hungary	HU10Y	*5.52*	5.84	5.17	5.25	6.10	6.20
Poland	PL10Y	*4.45*	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	*27.5*	26.0	25.7	27.3	27.3	27.2
Hungary	EUR/HUF	*312*	295	297	297	300	300
Poland	EUR/PLN	*4.23*	4.33	4.22	4.16	4.20	4.10

GDP (y/y)

	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	-1.4	-2.3	-1.7	-1.2	-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	2.9	3.3	3.5

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	0.4	0.5	0.6
Poland	2.4	1.0	0.2	1.0	0.7	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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