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Central European Weekly

Monday, 24 February 2014

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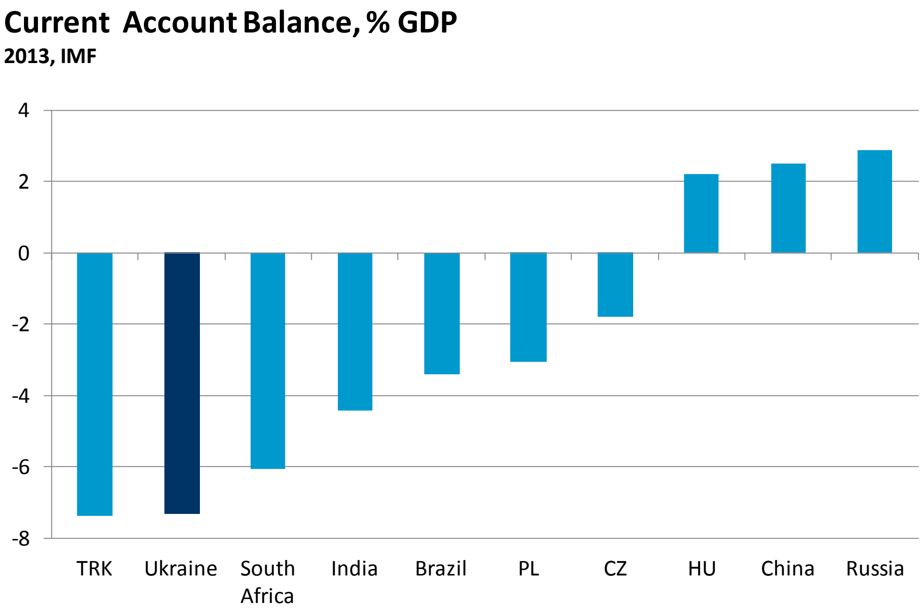
Chart of the Week



Ukraine current account balance in much worse shapethan in Central Europe

Market's editorial

To what extent should we fear Ukrainian contagion?

Eastern Europe again grabbed investors' attention for the first time in a while, due to dramatic events in Ukraine. Ukraine has found itself on the brink of civil war, and this will naturally have an adverse impact on the economy of this large country. Central European markets have not been upset by the situation in Kiev and other West-Ukrainian cities thus far, and this may suggest that concern about Ukrainian contagion is still very small at the moment.

And who is most at risk of Ukrainian contagion? Contagion may occur in its usual way, either through foreign trade or through high financial interlinks. In both events, the links of most countries (inside as well as outside the EU) to Ukraine are not strong. Ukraine as an export destination is most important for Belarus (whose exports to Ukraine make up 8% of GDP). Poland, Hungary, as well as Russia 'only' export approximately 1% of their respective GDPs to Ukraine. Data about the exposure of banking sectors is not easily available. The banking sector's exposure to Ukraine is likely greatest in Russia. Banks in the European Union have greater exposures to Ukraine in three countries – Greece, Austria and Hungary. Even so, the exposures are not significant, according to the European Banking Authority (EBA). If therefore tension in Ukraine escalates, the Hungarian forint, in particular, may come under certain pressure.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	-0.13%	➔	➚
EUR/HUF	310	0.60%	➘	➘
EUR/PLN	4.16	0.34%	➘	➘

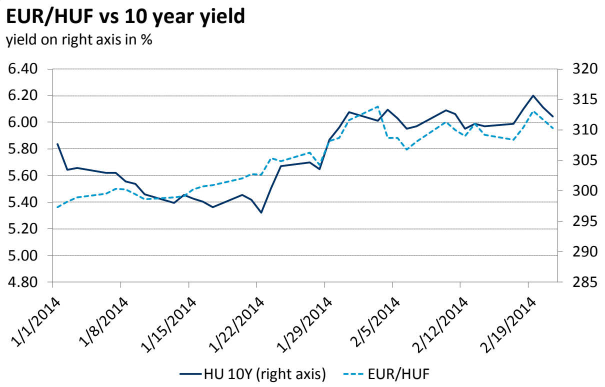
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.91	0.79	➔	➚
10Y HUF	5.53	3.36	➔	➘
10Y PLN	4.15	-0.96	➔	➚

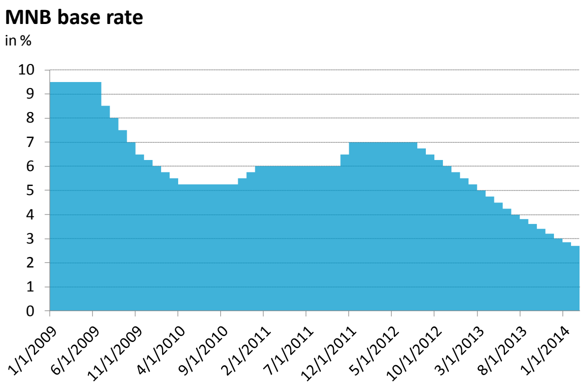
Review of Economic Figures

Hungarian central bank cut rates more than expected

The National Bank of Hungary (NBH) surprised with its aggressiveness on Tuesday. Although a rate cut was generally anticipated in the wake of recent emerging market sales that also significantly affected the Hungarian currency, the general anticipation was that the NBH would adjust its rate cut pace from January's 15 basis points to 10 bps. Nevertheless, the NBH again proceeded to a 15 bps rate cut, pushing its base rate to a new all-time low of 2.7%. The NBH's rate-cut arguments did not significantly differ from those used before. In its accompanying press statement the bank stresses that, although the economy shows signs of recovery, growth remains below its potential. Inflation is still very low (having dropped to zero in January) and, despite certain wage growth, the NBH believes that poor domestic demand and low inflation in other countries will continue to have downside effects on inflation. The NBH started its monetary easing cycle as long ago as in August 2012 and has not interrupted it yet; it has only reduced the pace of its monetary expansion. Tuesday's meeting included one new item: central bankers no longer included the sentence on further rate cuts in their press statement accompanying the decision on rates. In response to the surprising decision, the forint immediately weakened to two-year lows, and Thursday's auction of Hungarian government bonds was tensely awaited.

The auction surpassed expectations in the end, encouraging the Hungarian currency at least temporarily. On the other hand, we need to add that, although the Hungarian government bond auction attracted such demand that the Hungarian Government Debt Management Agency (AKK) even raised the originally supplied volume in the end, Hungary's debt is becoming more expensive. Yields went up quite significantly compared to the auction held two weeks ago – by 30 basis points, to an average accepted yield of 5.06% for 3Y bonds, and by 22 basis points to 6.17% for 10Y bonds. If therefore tension in Ukraine escalates, the Hungarian forint, in particular, may come under certain pressure.





Central European Daily

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In Focus: Risk of Ukrainian contagion

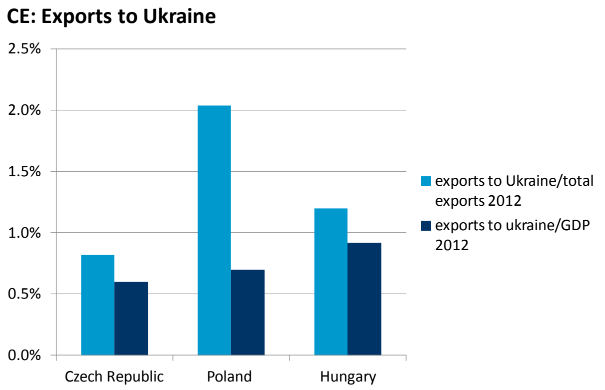
Risk of Ukrainian contagion

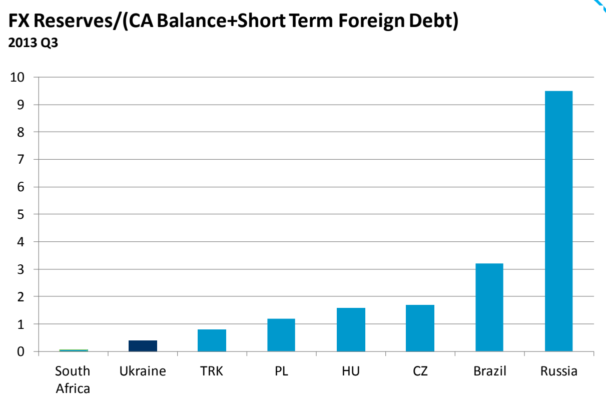
Ukraine´s development gained momentum during the past weekend. President Yanukovich was blamed for recent violence in the Parliament, ousted and temporarily replaced by Oleksandr Turchynov (former right-hand man of Yulia Tymoshenko, just released from prison). In the capital, life has started to return to normal but the country faces many urgent political and economic problems to be addressed soon.

Due to its numerous structural problems, Ukraine has a long-term need to borrow abroad to finance the normal operation of its economy, and it also has deep current account deficits and high short-term debt. In combination with fairly low forex reserves, this forever drives the Ukrainian government into talks on foreign assistance, whether with the IMF/EU tandem or with Russia. Within a year, Ukraine will probably need more than approximately US$50bn to cover its due foreign debt and current account deficit. However, its forex reserves are only less than US$18bn. Without an agreement with either party, there is a real risk of Ukraine's inability to repay its foreign liabilities.

As the Russians are probably not willing to continue with the 15 bln USD rescue package , the negotiations with the EU and the IMF are going to of crucial importance. Nevertheless any deal bofore the presidential election (scheduled fo the end of May) is going to be difficult. Hence the default continues to be the real option.

And who is most at risk of Ukrainian contagion? Contagion may occur in its usual way, either through foreign trade or through high financial interlinks. In both events, the links of most countries (inside as well as outside the EU) to Ukraine are not strong. Ukraine as an export destination is most important for Belarus (whose exports to Ukraine make up 8% of GDP). Poland, Hungary, as well as Russia 'only' export approximately 1% of their respective GDPs to Ukraine. Data about the exposure of banking sectors is not easily available. The banking sector's exposure to Ukraine is likely greatest in Russia. Banks in the European Union have greater exposures to Ukraine in three countries – Greece, Austria and Hungary. Even so, the exposures are not significant, according to the European Banking Authority (EBA).



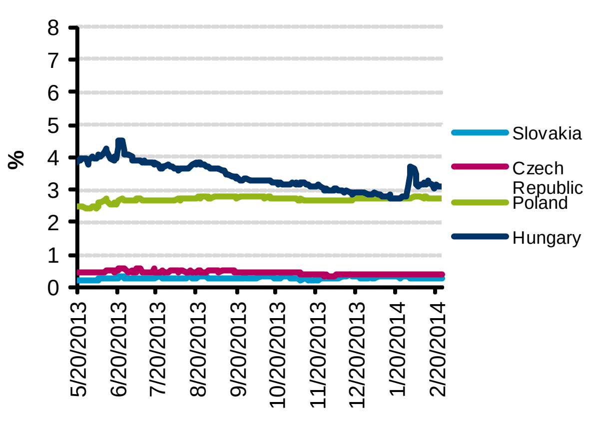


Calendar

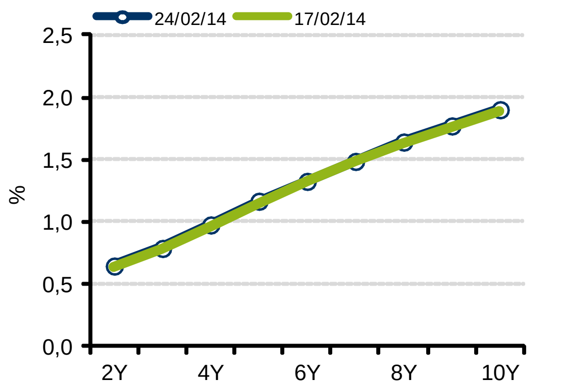
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	02/24/2014	9:00	PPI	%	01/2014	1	1.6	0.1	0.7	0.8	1.7
PL	02/24/2014	10:00	Retail sales	%	01/2014			-21.4	4.7	17.3	5.8
PL	02/24/2014	10:00	Unemployment rate	%	01/2014			14		13.4	
HU	02/26/2014	9:00	Unemployment rate	%	01/2014			9.3		9.1	
CZ	02/26/2014	12:00	CZ bond auction 3.85%/2021	CZK B	02/2014						
CZ	02/26/2014	12:00	CZ bond auction 2013-2028, 2.50%	CZK B	02/2014						
HU	02/28/2014	9:00	PPI	%	01/2014			-0.3		0.5	0.5
PL	02/28/2014	10:00	GDP	%	4Q/2013					0.5	2.7
CZ	02/28/2014	10:00	Money supply M2	%	01/2014						4.7

Fixed-income in Charts

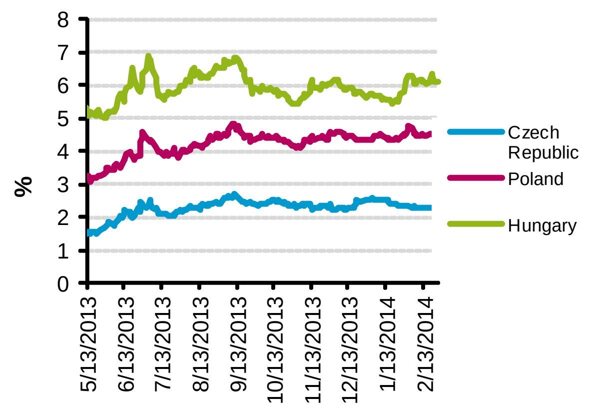
FRA 3x6



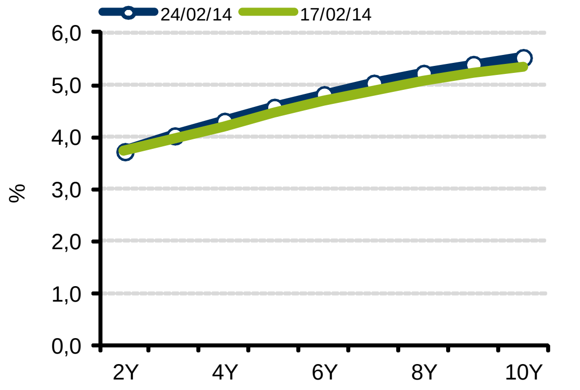
CZ IRS



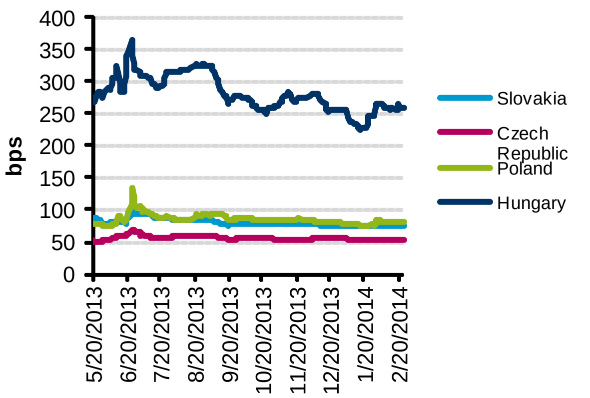
10Y GB Yields



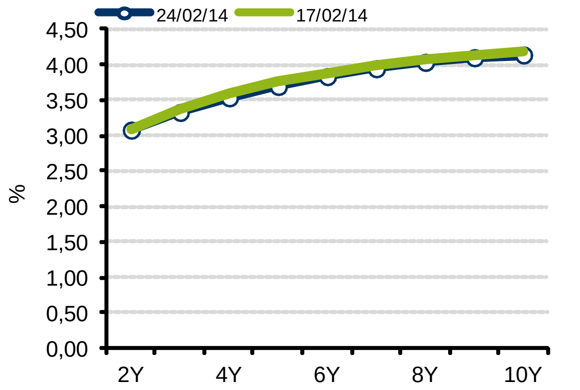
HU IRS



CDS 5Y



PL IRS



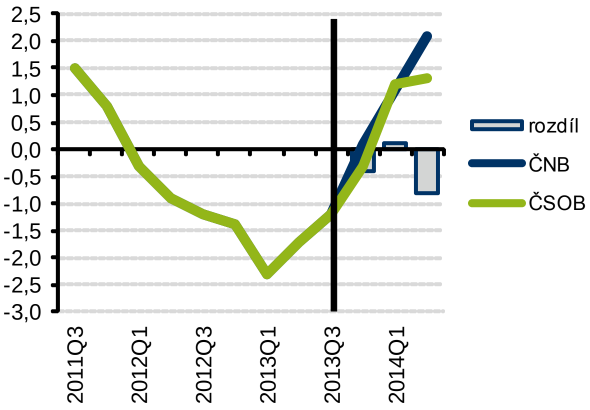
Source: Reuters

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. as GDP growth accelerated on quarter-on-quarter basis in Hungary's main trading partners and also in the CEE region – that Hungary's economic growth slowed (from 0.8% Q/Q in 3Q13 to 0.6% Q/Q in 4Q13) less than expected. It confirms our view that economy may grow by 2% Y/Y in 2014.	According to the preliminary estimates the Polish economy grew by 2.7% in 2013Q4. For this year, the growth could significantly exceed 3%. Household consumption should support growth, owing to the improving labor market situation as well as to low inflation. Investment should also develop favorably, 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 2.2% this year. The CNB is very unlikely to change rates, and just as likely to maintain its intervention regime throughout this year.	The NBH emphasized in the last statements that headline inflation will remain below the inflation target in the next 6 quarters, which allows further rate cut. This situation hasn't changed, so it suggests that monetary easing may continue. The main question that the two hawkish members can convince at least three members about the clear fact, that the underlying inflation is around or rather slightly above 3% Y/Y, and the unreasonable rate cut increases Hungary's vulnerability and adds less to the economic growth. The last statements of the dovish members emphasized that EURHUF around 307 won't change the monetary policy, but they don't like the high volatility the HUF. So the chance for anther 10bp cut is there.	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. The Zloty is also more vulnerable to the emerging markets sell offs due to higher CA deficit and lower FX reserves.

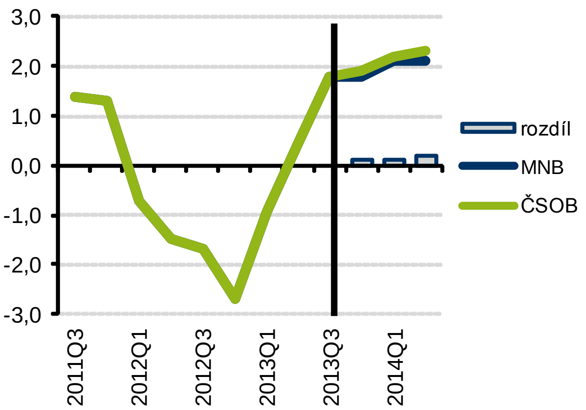
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

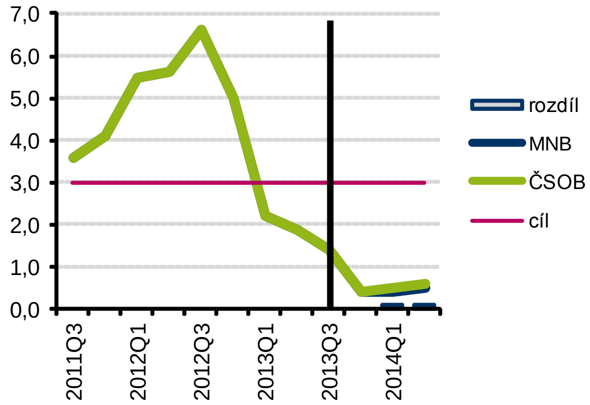


CZ: Inflation outlook (Y/Y, %)

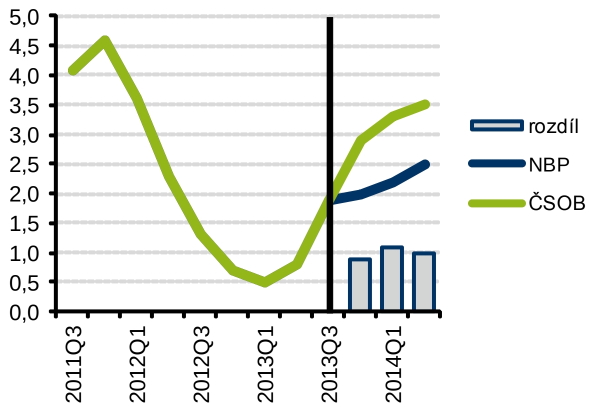
HU: GDP outlook (Y/Y, %)



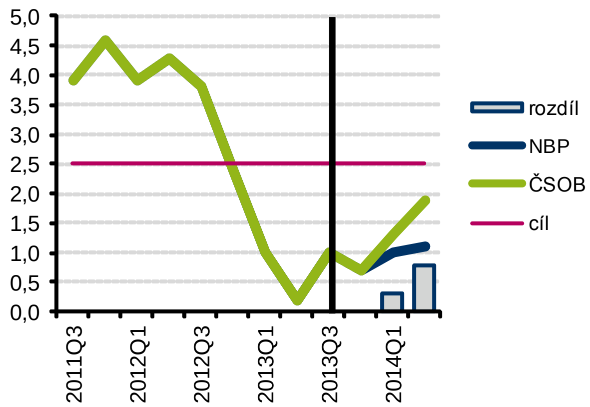
HU: Inflation outlook (Y/Y, %)



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.	*2.70*	4.25	3.60	3.00	4.00	4.50	-20 bps	2/18/2014
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	*2.74*	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	*1.905*	1.97	2.06	2.09	1.95	2.15
Hungary	HU10Y	*5.53*	5.84	5.17	5.25	6.10	6.20
Poland	PL10Y	*4.13*	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	27.4	27.2
Hungary	EUR/HUF	*310*	295	297	297	300	300
Poland	EUR/PLN	*4.15*	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	0.8	1.2	1.3
Hungary	-2.7	-0.9	0.5	1.8	2.7	2.2	2.3
Poland	0.7	0.5	0.8	1.9	2.7	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	1.3	1.9

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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