Central European Weekly

Tuesday, 04 March 2014

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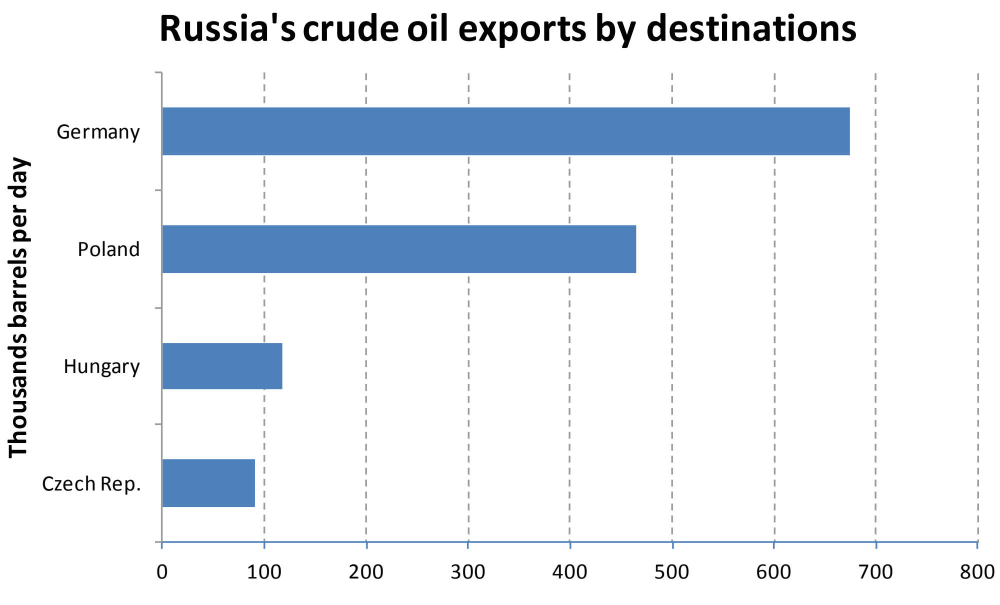
Weekly Highlights:

- CE markets' reaction to the Ukraine crisis has been clam so far. This might change however.
- Czech and Polish PMIs look still strong
- In focus: our update for the EUR/CZK outlook
- The NBP will stay on hold again

Chart of the Week: Exposure to Russia's oil



sources: Global Trade Atlas, US Energy Information Administration, Czech Statistical Office

Market's editorial

The Ukrainian crisis met with calm in Central Europe,...

Last week Central European currencies remained fairly immune to the increased geopolitical tension in relation to the Ukrainian crisis. After a week, the forint and the koruna are slightly stronger, while the zloty closed the week without significant changes. Central Europe was not even upset by the political crisis in Romania, one which did however remind the Ukrainians of how politically difficult it is to sustain the International Monetary Fund's hard cleansing cure.

Interestingly, the Czech koruna has virtually completely ignored the external events beyond its borders in recent weeks. Its moderate appreciation was exlusively driven by better figures from the real economy. Nevertheless, in our new outlook for the koruna (sees the focus), we argue that the CNB's last forecast is still too optimistic, and therefore the koruna may not necessarily soon return towards the EUR/CZK 27.00 floor set by the central bank last November.

..., but the Russian attack brings threat of contagion higher

Nevertheless, the situation has changed a bit as Russian troops invaded the Crimea peninsula. As a result the Russian ruble plunged to an all-time low against the central bank's basket and Russia's central bank had raised its key interest rate by 1.5 percentage point to 7% in order to regain financial stability. Thus, the possibility that the contagion spreads is not off the table, especially if tensions grew into a bloody conflict. In addition, although the bilateral trade of the Czech Republic, Poland as well as Hungary with Ukraine is only marginal, possible sanctions from European Union against Russia due to violation of international agreement would undoubtedly affect international trade of CEE Europe, especially of Poland. We, however, do not think sanctions are very likely...

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	-0.07%	➔	➚
EUR/HUF	313	0.81%	➔	➘
EUR/PLN	4.19	0.75%	➔	➘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.84	-3.41	➔	➚
10Y HUF	5.52	0.00	➔	➚
10Y PLN	4.15	0.37	➔	➚

Review of Economic Figures

Bussines sentiment remains at high levels in Central Europe

Bussines sentiment remains generally bullish in Central Europe, which have been confirmed by February's PMI figures.

In Poland, PMI beat the forecast as it increased from 55.4 in January to 55.9 in February and signals that economic recovery is gaining momentum. Also the rise of the Czech PMI to 56.5 (the highest level in almost three years) was a positive surprise. Hungarian PMI felt to 54.3; nevertheless, it is compounded by different methodology and traditionally suffers from high volatility. February's PMI still represents result above average of the past three years.

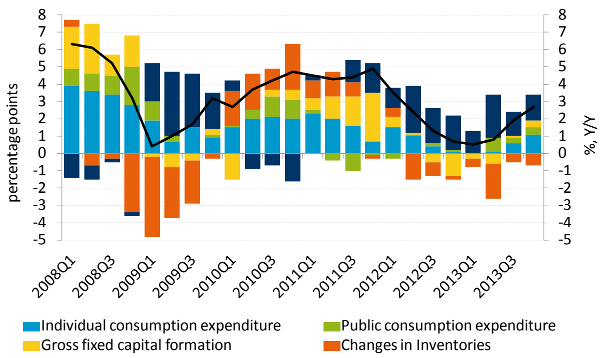
The March PMI fuigures will be probably chalenged by fears how the current conflict bewteen Ukraine and Russia can influience regional economies. So far, the real impact seems to be negligible, while it might definitely change, if tensions escalate further.

The Polish economy – steady as she goes

The Polish Statistical Office released the economic growth structure for the last quarter of 2013. In addition to confirming its flash forecast released in the middle of the month (+2.7% y/y), it also confirmed our expectations concerning a more balanced growth structure. While growth was still driven by net exports in particular (1.5%), domestic components of demand did not significantly lag behind this time (1.2%). Compared to the previous quarter, there was, in particular, a strong year-on-year increase in private consumption by 2.1% (as opposed to 1.2% in the previous period) while investment activity also continued to recover, contributing 0.4% to growth. The only component that curbed economic growth was a change in inventory, just as in the previous quarter. On the supply side, a good sign is the persisting stabilisation of construction, which declined by only 1.5% y/y in the last quarter of 2013.

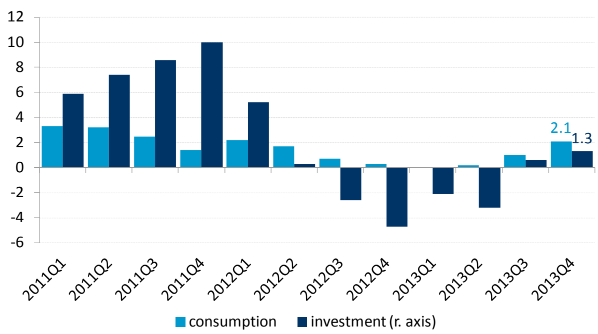
The more robust foundations of growth promise continued positive economic developments this year, when we expect the economy to accelerate from last year's 1.6% to 3.4%. Domestic consumption, encouraged by the improving situation in the labour market and low inflation, should again contribute to this, through accelerated real wage growth. According to our forecasts, inflation should remain below 1.5%, notwithstanding the economic acceleration, and this will subsequently enable the National Bank of Poland to maintain stable interest rates for the most of this year. Investment should continue to develop favourably, encouraged, inter alia, by the absorption of European funds. Inventory, which has been falling for a long time, might also increase this time. In addition, the pension system reform will enable the government to boost the economy to a greater extent owing to a one-off decline in government debt, with the approaching election and uncertain prospects for the parties currently in power likely to favour such a scenario. By contrast, increased consumption will probably go hand in hand with trade balance deterioration. Net exports, which have driven the economy in the last two and a half years, will likely tend to curb Polish economic growth.

PL: Contributions to GDP growth



PL: consumption and investment

year-on year in %



In Focus: Our new outlook for EUR/CZK

We update our EUR/CZK medium term outlook

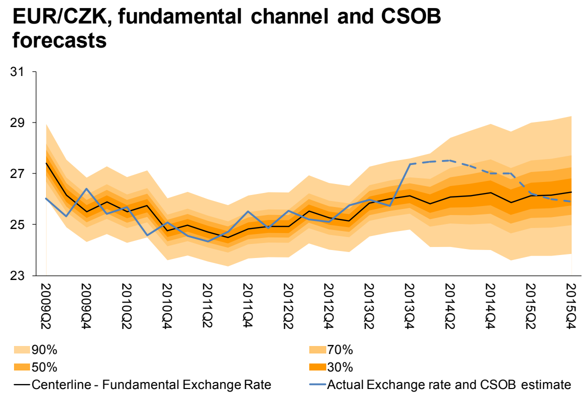
The Czech National Bank awaits the effects of its interventions. What most interests the central bank is not an immediate increase in import prices; the bank would like to see a positive spill-over effect of the interventions in domestic demand – through accelerated investment, recruitment of new staff, and wage growth. We are still afraid that the assumptions of the February forecast are too optimistic in this regard. Hence the May or August forecast may be somewhat more sober.

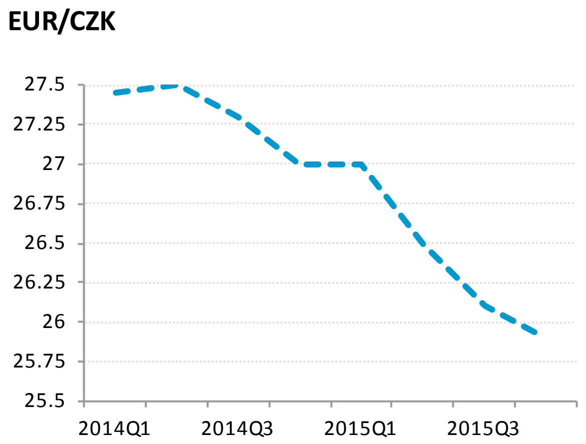
The question is what the implications of this sobering up will be. Probably, there will 'only' be a postponement of the exit from the intervention regime, from the first quarter of 2015 to the middle of that year.

We do not see another weakening of the intervention exchange rate as being very likely. The central bank will probably prefer benefits stemming from long-term exchange rate stability; however, the threat of a weaker koruna hanging in the air may continue to keep the currency pair well above CZK 27.00 per EUR.

By and large, however, we expect little volatility in the exchange rate throughout the intervention regime against the koruna. The forward exchange rate may catch the eye when markets start to speculate on the departure from the intervention regime. At that moment, the CNB will be compelled to raise its intervention volumes, which will overwhelm the market with koruna liquidity, and this may drive the forward exchange rate of EUR/CZK below the spot exchange rate – i.e., way below CZK 27.00 per EUR.

The last questions are what will the exit from the intervention regime look like and how far may the koruna strengthen? Upon the exit from the existing exchange rate regime, speculations on an abrupt appreciation of the Czech currency will hardly be avoided – towards CZK 26.10-26.20 per EUR, according to our forecasts. Moreover, such appreciation may be encouraged by bets on a first rate hike. The CNB may only succeed in seamlessly switching to the 'old' regime of floating exchange rate by means of huge interventions.





Weekly preview

WED 14:00	NBP rate (in %)	
	This	Last change
rate level	2.50	7/2013
change in bps	0	-25

PL: NBP rates again on hold

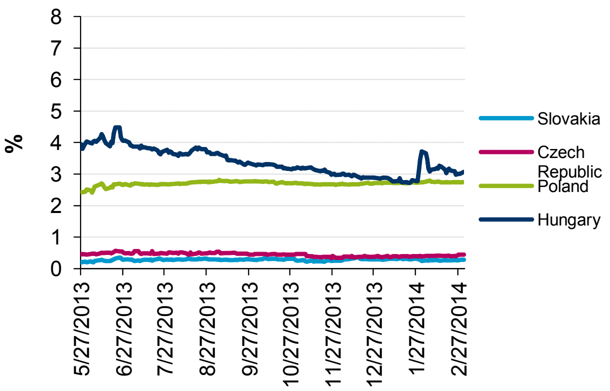
The National Bank of Poland is likely to keep interest rates unchanged at its Wednesday meeting. Inflation still remains well below the central bank's target (January's inflation was only 0.7% y/y according to preliminary forecasts) while the economy successfully continues to grow, with the growth structure also developing favourably. We believe that the combination of low inflation and recovering growth will allow for keeping interest rates unchanged for the most of this year.

Calendar

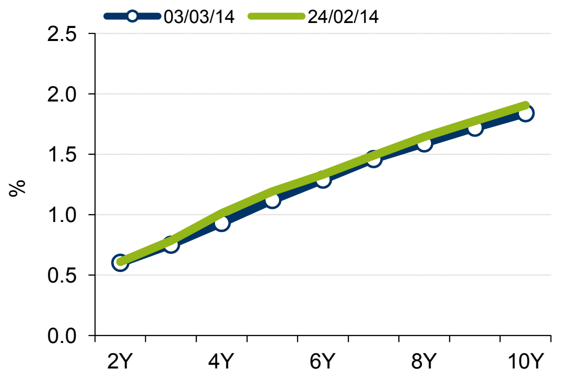
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	03/03/2014	9:00	PMI manufacturing		02/2014					55.4	
HU	03/03/2014	9:00	PMI manufacturing		02/2014					57.9	
CZ	03/03/2014	9:30	PMI manufacturing		02/2014					55.9	
CZ	03/03/2014	14:00	Budget balance	CZK B	02/2014					45	
HU	03/05/2014	9:00	Trade balance	EUR M	12/2013 *F					289.8	
HU	03/05/2014	9:00	Retail sales	%	01/2014						1.8
HU	03/05/2014	9:00	GDP	%	4Q/2013 *F					0.6	2.7
PL	03/05/2014	14:00	NBP meeting	%	03/2014	2.5		2.5		2.5	
CZ	03/06/2014	9:00	GDP	%	4Q/2013 *P					1.6	0.8
HU	03/06/2014	9:00	Industrial output	%	01/2014 *P					-1.9	4.4

Fixed-income in Charts

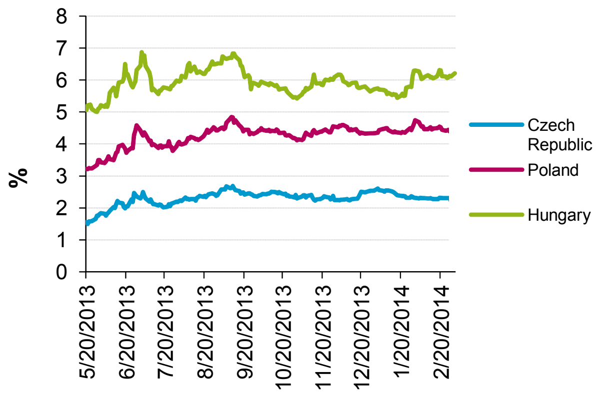
FRA 3x6



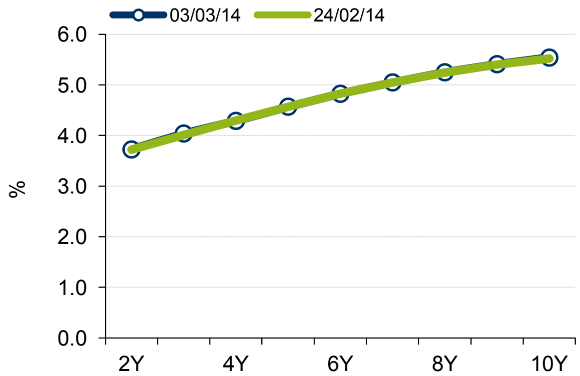
CZ IRS



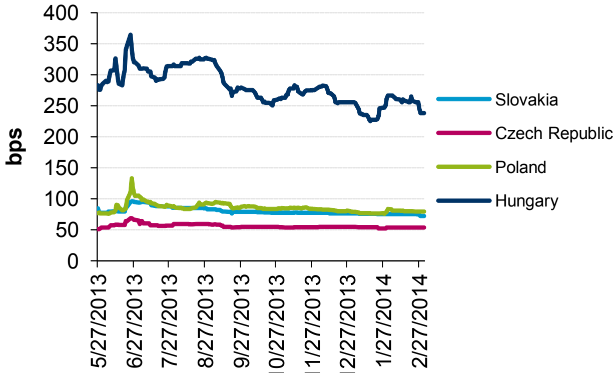
10Y GB Yields



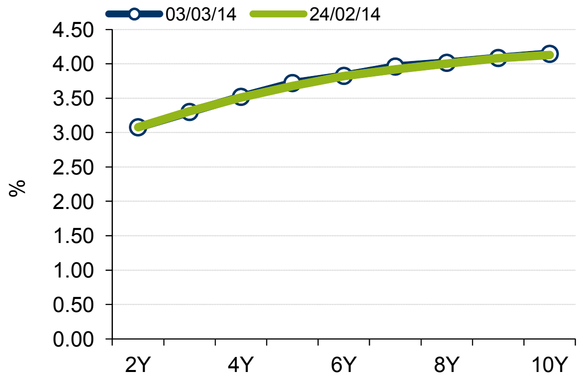
HU IRS



CDS 5Y



PL IRS



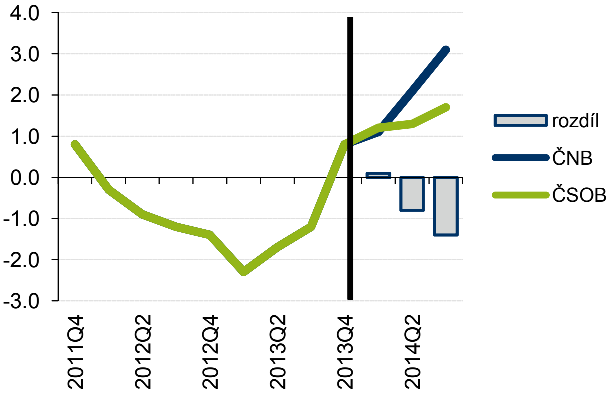
Source: Reuters

Medium-term Views & Issues

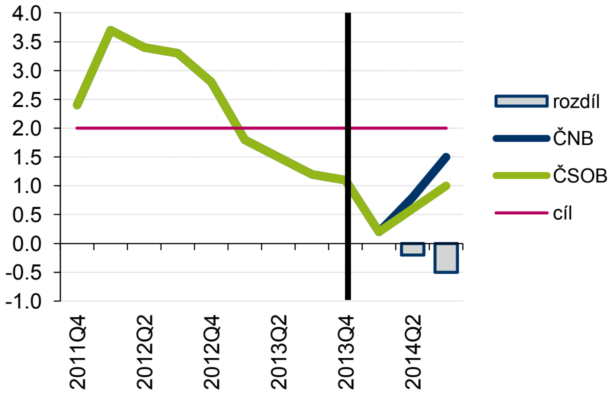
	The Czech Republic	Hungary	Poland
Growth & key issues	The president appointed a new coalition government a few months after the election. The programme of the future government is likely to be consistent with the concluded coalition agreement, which envisages keeping the government deficit below 3% of 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 mid 2015. 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

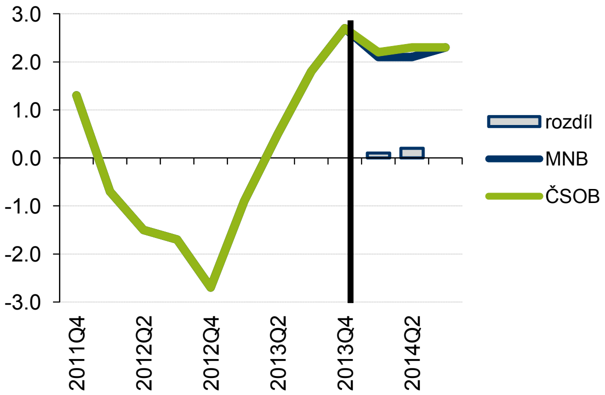
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)

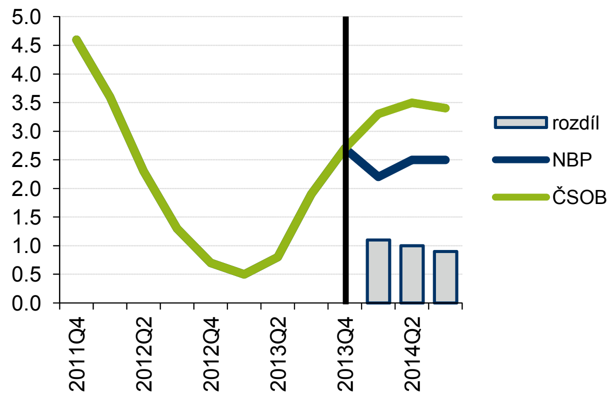


HU: GDP outlook (Y/Y, %)

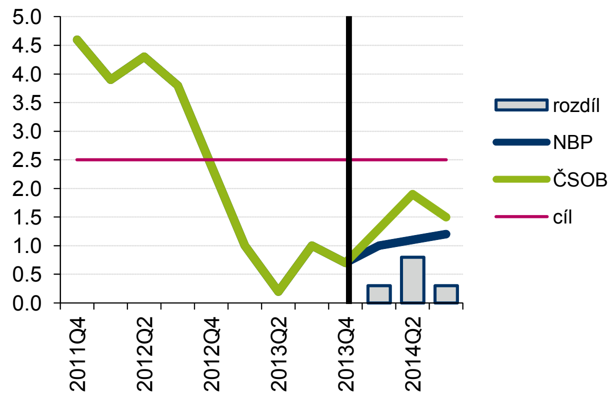


HU: Inflation outlook (Y/Y, %)

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	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	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*	3.60	3.00	2.60	2.50	2.50	-15 bps	2/18/2014
Poland	2W inter. rate	*2.50*	2.50	2.50	2.50	2.50	2.50	-25 bps	7/3/2013

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

		Current	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3
Czech Rep.	PRIBOR	*0.37*	0.42	0.38	0.37	0.36	0.36
Hungary	BUBOR	*2.75*	3.56	2.99	2.70	2.50	2.50
Poland	WIBOR	*2.71*	2.67	2.71	2.75	2.75	2.75

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

		Current	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3
Czech Rep.	CZ10Y	*1.84*	2.06	2.09	1.95	2.15	2.30
Hungary	HU10Y	*5.52*	5.17	5.25	5.40	5.00	5.30
Poland	PL10Y	*4.15*	4.24	4.25	4.10	4.10	4.45

Exchange rates (end of the period)

		Current	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3
Czech Rep.	EUR/CZK	*27.4*	25.7	27.3	27.4	27.2	27.2
Hungary	EUR/HUF	*313*	297	297	300	300	300
Poland	EUR/PLN	*4.19*	4.22	4.16	4.20	4.10	4.00

GDP (y/y)

	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3
Czech Rep.	-2.3	-1.7	-1.2	0.8	1.2	1.3	1.7
Hungary	-0.9	0.5	1.8	2.7	2.2	2.3	2.3
Poland	0.5	0.8	1.9	2.7	3.3	3.5	3.4

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

	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3
Czech Rep.	1.7	1.6	1.0	1.4	0.5	0.7	1.1
Hungary	2.2	1.9	1.4	0.4	0.5	0.6	0.7
Poland	1	0.2	1.0	0.7	1.3	1.9	1.5

Current Account

	2013	2014
Czech Rep.	-1.1	-1.2
Hungary	2.0	2.2
Poland	-1.6	-1.6

Public finance balance as % of GDP

	2013	2014
Czech Rep.	-2.5	-2.7
Hungary	-2.7	-3.0
Poland	-4.4	4.5

Source: CSOB, Bloomberg

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