Central European Weekly

Monday, 10 March 2014

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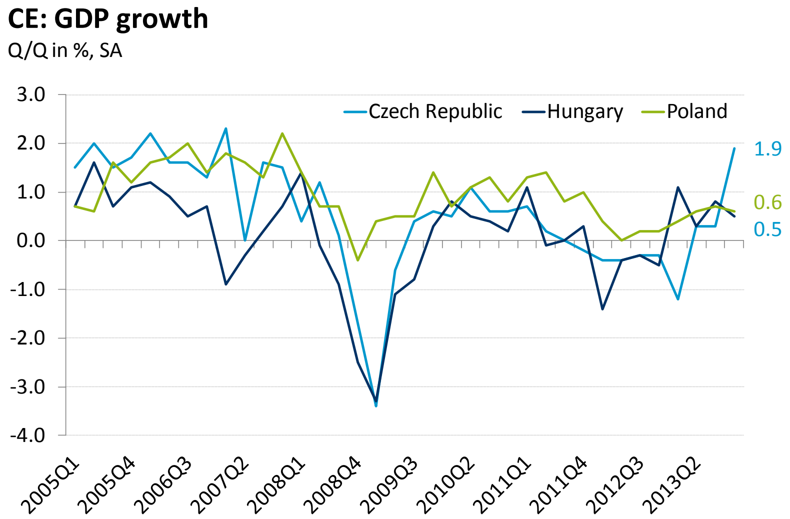
Chart of the Week



Czech economy outperformed its peers in the last quarter of 2013.

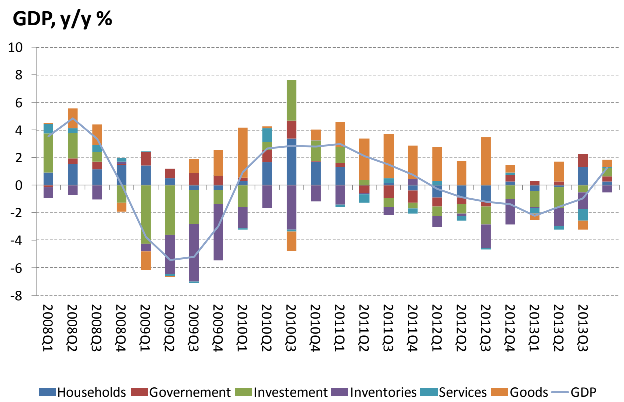
Market's editorial

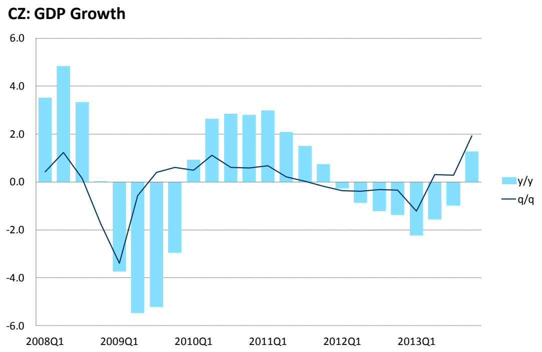
Czech and Hungarian economies on track to grow at last

With the Ukrainian crisis having gone off of investors' radar, attention is being refocused more onto the fundamentals of the individual economies. After all, this also applies to Central Europe. The view of both the GDP details and the National Bank of Poland's new forecast, including the related report by the Monetary Policy Council, caught the eye, because the latter indicated to markets that the NBP would keep its official rates unchanged until at least the end of the third quarter of this year, and Polish government bonds appreciated this greatly.

As concerns macroeconomic data, the Czech Republic reported its GDP details, which furnished even stronger evidence that its late 2013 growth was really much higher than was originally expected. Even though the figure is clearly positive, it should not be overestimated significantly for the moment, as it was influenced by one-off factors such as the stockpiling of cigarettes and, for example, the increased sales of cars and electronics (out of fear of price increases in the wake of the devaluation of the koruna). Hungary's data was similarly positive, not only showing that the country's late 2013 economic growth was the highest in the last eight years (2.7% y/y), but that it was at last also encouraged by domestic demand. Good news from Hungary was not limited to GDP details alone. The first hard data of this year, retail sales and industrial output for January, also showed very decent increases.

In any event, for both the Czech and Hungarian economies, we can finally easily state that the recession has already hit bottom (in 2013) and both economies are on track to moderate growth.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*27.4*	*-0.10%*	↗	↗
EUR/HUF	*313*	*-0.35%*	↗	↗
EUR/PLN	*4.20*	*-0.51%*	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.92*	*1.05*	→	↗
10Y HUF	*5.35*	*-3.78*	↗	↗
10Y PLN	*4.07*	*-2.52*	↗	↗

Review of Economic Figures

Czech GDP – the first impression alone is not enough

In the end, the Czech economy grew even faster in late 2013 than signalled by the flash forecast. Compared to the third quarter, the GDP grew by nearly 2% (+1.9%), and by 1.3% y/y.

In late 2013, the economy was driven upwards by investment, exports, and eventually also by household consumption. Nevertheless, the greatest contributor to GDP growth in that period was inventory. This is fairly evident between the rise in added value and overall GDP growth. The added value generated in the economy in late 2013 was up by only 0.6%, i.e., half the GDP growth figure. Excise duties on cigarettes were responsible for the rest.

Therefore, given the strong effect of taxes (and inventory), we should not overly rejoice at nearly 2% growth in the fourth quarter. It is certainly good that the economy emerged from the recession, as is the fact that consumption and investment are no longer falling; however, the last quarter is largely exceptional, due to extraordinary factors.

As far as individual sectors are concerned, particularly the manufacturing industry fared well, followed by construction, which may be seen as a surprise. Nonetheless, we cannot forget about the exceptional weather, which, unlike previous years, made it possible to continue construction work even at times when construction work is not usually in progress.

Not even three quarters of growth counterbalanced the previous economic downturn, and the economy fell by 0.9% for 2013 as a whole; nevertheless, the Czech economy's longest recession has ended and the economy has resumed growing, owing to exports, i.e., the successful manufacturing industry.

Czech CPI grew 0.2 % y/y in February

The Czech CPI published earlier today shows that prices rose by meager 0.2 both month-on-month and year-on-year in February. The growth rates were no surprise for markets. The annual price increase ranks among the lowest in the EU, mainly due to dropping energy and communication prices. Food prices, on the contrary, rose relatively fast (+4.2 % y/y). Today´s figures show that inflation pressures have remained subdued in the Czech economy; on the other hand, the risk of deflation seems to be averted as well due to rising food prices and higher prices of imported goods brought about by CNB´s FX intervention in 2013Q4.

Nor the Czech foreign trade balance for January brought a surprise when it showed - in line with our expectations - a rising surplus of CZK 44.6bn. Double-digit growth of exports reflects favorable conditions prevailing in machinery and in the car production in particular. We believe that comfortable trade balance results will arrive also in the coming months owing to strengthening European demand.

The NBP extends its rate stability period

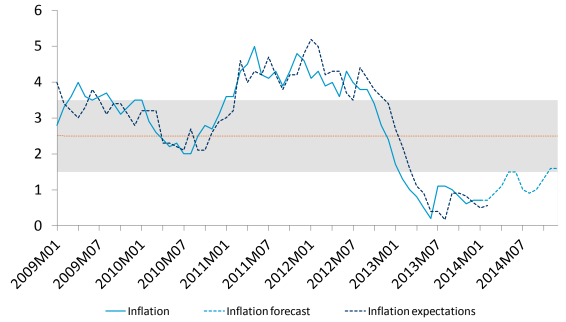
The National Bank of Poland (NBP) met expectations and left interest rates unchanged at its Wednesday meeting. Hence, as has been the case in recent months, attention was focused on the official statement and the subsequent press conference. The main output of both events was the extension of the period for which the NBP expects interest rate stability, by one quarter. Thus the NBP newly expects to leave its official interest rates at all-time lows (2.5%) until at least the end of the third quarter of 2014. In addition, at the meeting with journalists, NBP President Belka complemented his official statement with dovish comments, as he stated that the market should not interpret the statement in such a way as to mean that the end of the said period would automatically imply a rate hike. Moreover, the dovish mood on the Monetary Policy Council was also illustrated by the remark that the Council had agreed on extending the rate stability period unanimously.

The main reason to extend the period was that a new economic development forecast was available to the NBP. Compared to the previous forecast, this one envisages faster economic growth and lower inflation pressures. The NBP newly expects this year's GDP growth to be around 3.5%, and inflation to be around 1.1%, which is basically in line with our forecasts (3.4% and 1.2%). We believe that, although the combination of low inflation and fairly robust economic growth means a comfortable situation for the NBP, the bank might resort to its first rate hike in late 2014 (although the risks of a later move by the NBP are increasing).

Although the new forecast was changed more or less in line with expectations vis-à-vis the November prediction, the extension of the outlook for stable rates and the accompanying dovish comments had a strong impact on markets. In addition to a moderate depreciation of the zloty, this primarily influenced bond yields, which dropped along the full length of the curve (notably, their decline at the longer end of the curve was huge). Moreover, the market has reduced its bets on a rate hike within the next nine months by 5 basis points (at the moment, the difference between the FRA9x12 rate and the three-month WIBOR is 13 basis points).

PL: Inflation and inflation expectations

Y/Y in %; NBP tolerance band is grey, inflation target is orange dotted line



IF: What if Russia shuts its pipes off?

The Ukrainian crisis is still not over, with threats of sanctions being imposed on Russia and of Russia's possible retaliatory measures still hanging in the air. We cannot even completely rule out an escalation of tension between Ukraine and Russia such as would result in an armed conflict.

Although the likelihood of both scenarios is fairly remote, we have decided, as a precaution, to have a look at the countries, i.e., economies that would be immediately and most affected if the Ukrainian crisis were to escalate into a partial or even complete interruption of Russian supply of the strategic commodities of natural gas and oil to Europe. For numerous European economies, such an interruption might have unpleasant consequences, as Russian imports cover a great majority of their natural gas and oil consumption. Our simple analysis indicates that, of EU countries, Central European countries are most exposed to the risk of the Russian gas and oil pipes being (temporarily) shut off.

Russia as a great superpower in commodities

As an introduction, we should mention that Russia really is a major producer of strategically important commodities, which the country exports to the EU in large volumes. Russia is the world's second largest natural gas producer (after the United States) and the third largest producer of liquid fuel (after Saudi Arabia and the United States), with this including oil in particular. Moreover, in both cases, Russia is a net exporter, and it is Europe that is particularly dependent on its oil and natural gas, as Europe is the destination of 84% of Russia's oil exports and 81% of its natural gas exports. From the European perspective, nearly a third of its oil and natural gas imports come from Russia, with this share being more than double in Central Europe.

Dependence on Russian oil

In 2012, a total of 31% of all crude oil imports to European countries came from Russia. Given the share of imports from Russia in total crude oil imports, any halt of supply would most adversely affect Eastern European and Central European countries – Bulgaria, Hungary, Latvia and Slovakia import 100% of their oil from Russia. Poland is also almost completely dependent on Russian oil. However, a large share of imports from Russia also applied, for example, to the Czech Republic (65%), Finland, and Sweden. Germany, which imported the largest volume of Russian oil expressed in absolute numbers (one-fifth of total imports to European countries), imported nearly a half of its oil from Russia. The Netherlands, the second largest importer of Russian oil in absolute numbers (approximately 10% of European imports), imports approximately one-third of its oil from Russia.

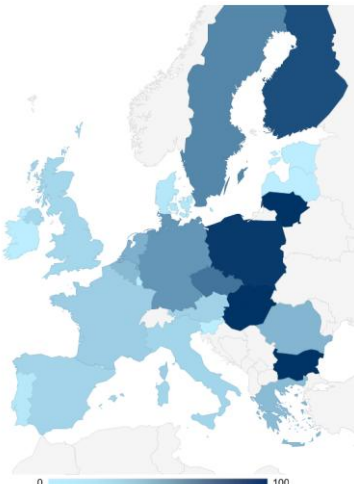
Dependence on Russian natural gas

As concerns natural gas, European countries are again largely dependent on Russian production. The largest volume of Russian natural gas expressed in absolute numbers was imported by Germany in 2012 (more than a fifth of total European imports). However, this is again more attributable to the size of the economy, because German imports from Russia made up approximately one-third of its total natural gas imports. Regarding the relative dependence, the comparison again turns out to be most adverse for Eastern European countries and, perhaps surprisingly, also for countries in the north of Europe – Sweden and Finland, which are completely dependent on Russian gas. The Central European countries most dependent on Russian gas include the Czech Republic and Slovakia, where the share of Russian imports exceeded 70% of both countries' consumption in 2012.

Summing up:

As is clear from the above text, the exposure of the Czech Republic, Slovakia and their neighbours vis-a-vis the threat of shutting off the Russian gas and oil pipes is relatively significant, as we could saw during the 2009 crisis in the end. At that time, Ukraine's unpaid debt to Gazprom led to a reduction of gas supply to Slovakia and Bulgaria in particular. On the other hand, we do not expect a total escalation of the crisis, which would lead to such halt of Russian oil and natural gas exports that could not be covered by reserves of the individual countries (several months of consumption, i.e., imports). We should note that such a move would also affect Russia itself, as oil and natural gas exports generate half its federal budget revenue.

Share of oil imports from Russia in total oil imports (%)



Weekly preview

TUE 9:00 — CZ Wages (y/y change in %)

	Q4-13	Q3-13	Q4-12
Nominal wages	**-2.0**	1.3	3.5
Real wages	-3.2	0.1	0.7

CZ: Real wages fall rapidly

The anticipated year-on-year drop in wages in both nominal and real terms was primarily due to the effect of the high comparative baseline. The last quarter of 2012 saw an extra strong increase in the average wages of most sectors of the Czech economy as a result of the approved introduction of what is known as the solidary tax, in force since the beginning of 2013. Thus businesses paid out their bonuses in advance to avoid this measure, at least in its first year of being in force. Nothing like that reoccurred in the last quarter of 2013, and thus we see the expected drop in the wage growth rate as a return to the statistically standard level.

TUE 9:00 — HU Inflation (change in %)

	II.14	I.14	II.13
CPI y/y	**0.5**	0.0	2.8

HU: Inflation may jump

Inflation may jump to 0.5% YoY in February. The main reason behind is the base effect, as the first public utility cost reduction (gas, electricity and district heating prices) was done by the government at the beginning of 2013. Also the weak currency (average EURHUF was 302 in January, while 310 in February) may push slightly the tradable goods prices slitgthly up and there are signs of acceleration of retail sales, which may increase the pass trough effect of the exchange rate trasnmission chanel.

FRI 9:00 — CZ Retail sales (y/y change in %)

	Jan-14	Dec-13	Jan-13
Monhtly	**3.0**	5.2	-0.4
cummulative (YTD)	**3.0**	1.0	-0.4

CZ: Retail sector still under the influence of cars

The anticipated rise in January's retail sales, rather than reflecting steadily improving domestic demand, primarily reflects the persisting demand for the purchases of new passenger cars, in order to take advantage of their favourable prices before they are fully affected by the 'devaluation'. The retail sector, excluding the automotive segment, continued to perform poorly, with the continuing exception of E-commerce and electronics retailers. By contrast, other retail segments cannot rely on an increase in real sales very much. Consumer appetite is still curbed by the unimproved financial position of households and their concern as to future developments.

FRI 9:00 — CZ Industry (y/y change in %)

	Jan-14	Dec-13	Jan-13
Monhtly	**6.5**	9.3	-4.2
cummulative (YTD)	**6.5**	0.5	-4.2

CZ: Industrial output goes up rapidly, driven by carmakers

Domestic industry most likely continued in its reasonable growth in early 2014, in line with the indications given by the previous statistics of new orders as well as soft indicators, i.e., the PMI and business opinion survey by the Statistical Office. By far the greatest contributor to the rise in the entire sector was the production of passenger cars, followed by the engineering sector, and the production of metal and chemical products. We also expect reasonable figures from new orders, which are likely to continue to rise at a double-digit rate in early 2014. Thus industry still remains the primary and, in a way, lonely driver of the Czech economy.

FRI 14:00 — PL Inflation (change in %)

	Feb-14	Jan-14	Feb-13
CPI y/y	**0.7**	0.7	1.3
Food (ex Alc.) y/y	**1.8**	2.1	2.7
Transport (including fuel)	**-2.5**	-1.2	-0.6

PL: Inflation still below 1%

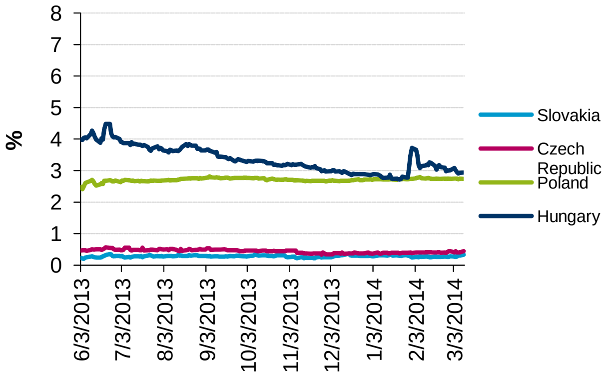
Poland's inflation was 0.7% y/y in January, according to our forecasts. The main contributors to the month-on-month price stagnation included, on the one hand, the rising food prices, which were, on the other hand, offset by the moderate decline in transport prices and by seasonally falling clothing and shoe prices. Just like the central bank, we also expect low inflation until the end of this year (we believe that its average level may be 1.2%). Let us add that, along with the figure for February, the Statistical Office will also release a new consumer basket structure and a complete inflation structure for January.

Calendar

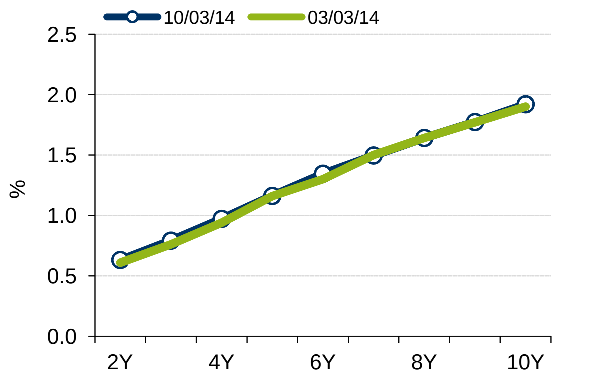
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	03/10/2014	9:00	Trade balance	CZK B	01/2014	41.8		34.8		9.6	
CZ	03/10/2014	9:00	CPI	%	02/2014	0.1	0.2	0.1	0.2	0.1	0.2
CZ	03/10/2014	9:00	Unemployment rate 15-64	%	02/2014	8.7		8.6		8.6	
CZ	03/11/2014	9:00	Real wages	%	4Q/2013		-3.2		-1.5		0.1
HU	03/11/2014	9:00	CPI	%	02/2014		0.5	0.3	0.4	0.3	0
HU	03/12/2014	9:00	Industrial output	%	01/2014 *F					3.1	6.1
HU	03/12/2014	9:00	Trade balance	EUR M	01/2014 *P			383.7		303.2	
CZ	03/12/2014	12:00	CZ bond auction 2014-18, x.xx%	CZK B	03/2014						
CZ	03/12/2014	12:00	CZ bond auction 2014-25, x.xx%	CZK B	03/2014						
CZ	03/14/2014	9:00	Industrial output	%	01/2014		6.5		6.7		9.3
CZ	03/14/2014	9:00	Construction output	%	01/2014						1.4
CZ	03/14/2014	9:00	Retail sales	%	01/2014		3		2.8		5.2
CZ	03/14/2014	10:00	Current account	CZK B	4Q/2013			-310.5		-1127.4	
PL	03/14/2014	14:00	Money supply M3	%	02/2014			0.6	5.3	-1.6	5.5
PL	03/14/2014	14:00	CPI	%	02/2014	0	0.7	0.1	0.8	0.1	0.7

Fixed-income in Charts

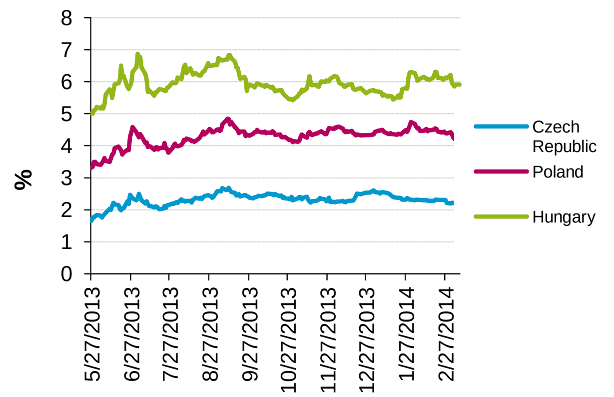
FRA 3x6



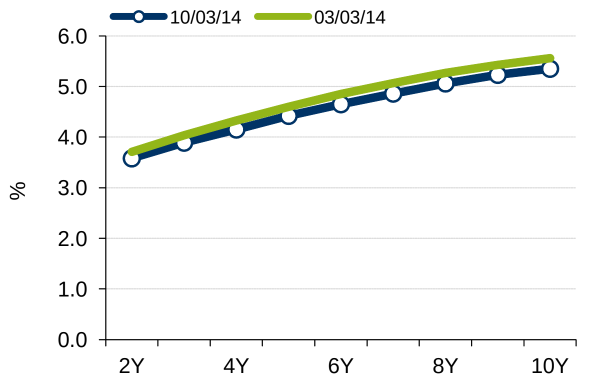
CZ IRS



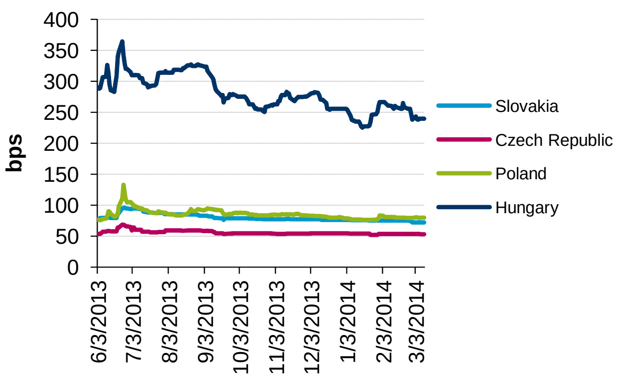
10Y GB Yields



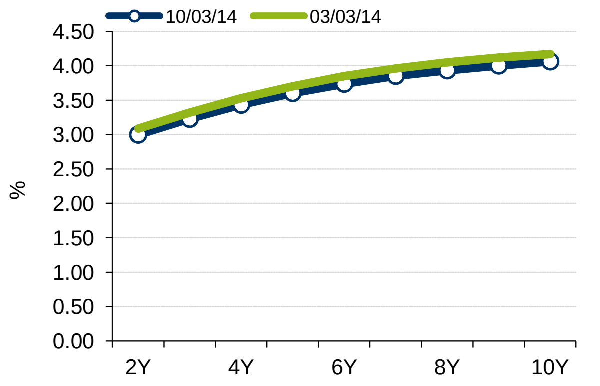
HU IRS



CDS 5Y



PL IRS



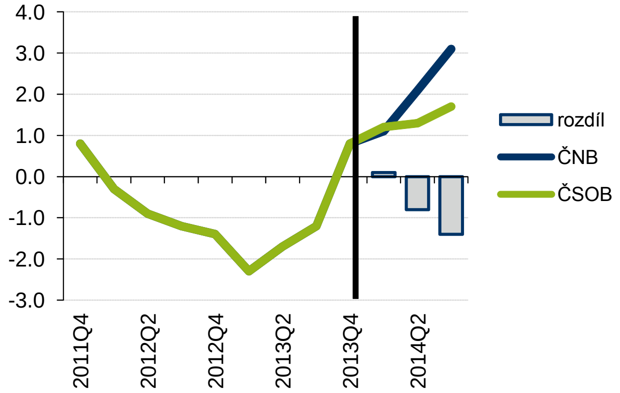
Source: Reuters

Medium-term Views & Issues

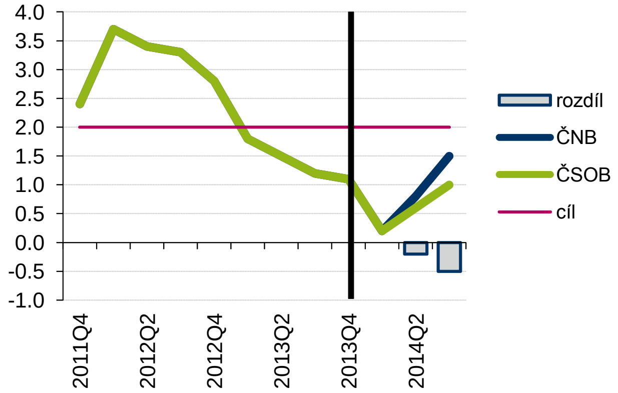
	The Czech Republic	Hungary	Poland
Growth & key issues	The president appointed a new coalition government a few months after the election. The programme of the future government is likely to be consistent with the concluded coalition agreement, which envisages keeping the government deficit below 3% of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

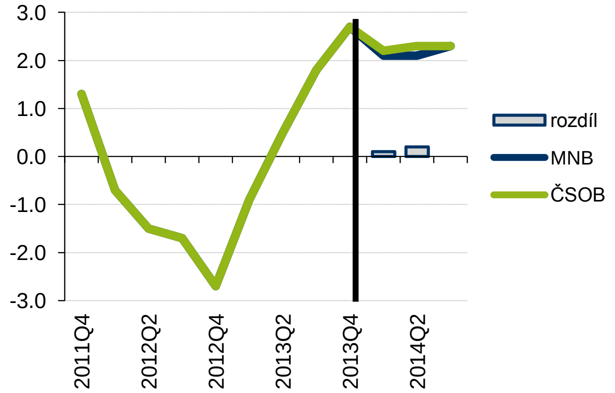
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)

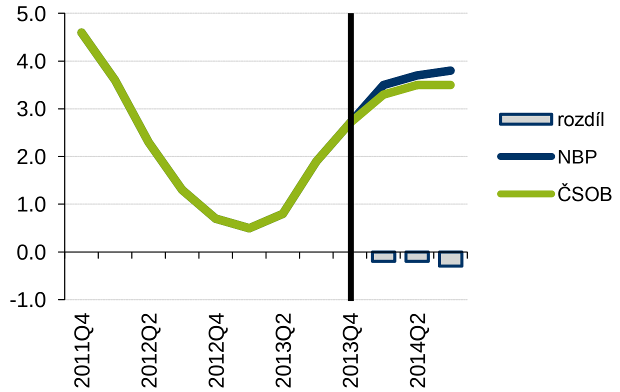


HU: GDP outlook (Y/Y, %)



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	*2.74*	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	*1.92*	2.06	2.09	1.95	2.15	2.30
Hungary	HU10Y	*5.35*	5.17	5.25	5.40	5.00	5.30
Poland	PL10Y	*4.07*	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	*4.20*	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	3.5

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	0.9	1.4	1.0

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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