Written by ČSOB Prague and K&H Budapest

Central European Weekly

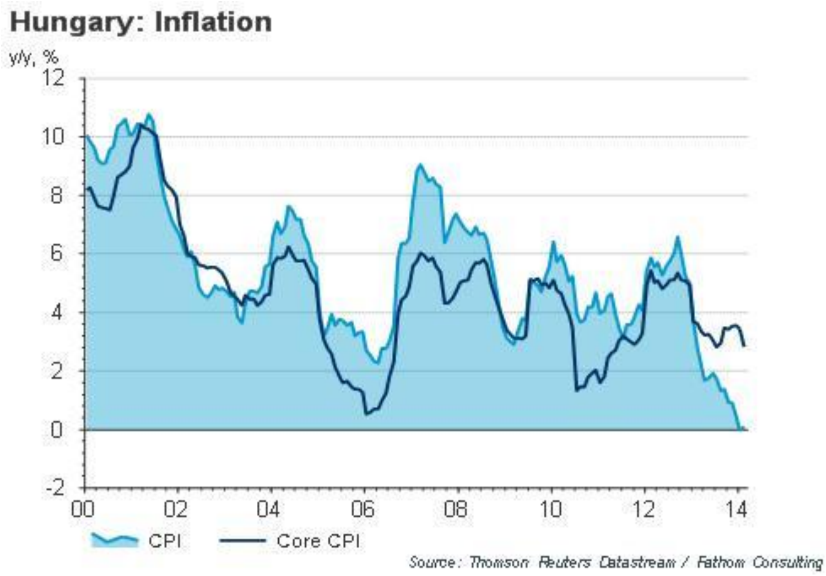
Monday, 17 March 2014

Table of contents

Weekly Highlights:

- Low Hungarian inflation readings trigger rate cut hopes despite relatively weak forint
- Strong Czech retail sales pleased the CNB
- Mild winter mild push Czech construction sector up

Chart of the Week: Hungarian inflation



While the Hungarian headline inflation hit almost zero, core inflation remains significantly in year-on-year terms.

Market's editorial

Low Hungarian inflation trigger new rate cut hopes

Another consecutive month again saw low inflation figures across the region. For the Czech and Polish economies, the figures basically met expectations; however, data from Hungary caught the eye, because its year-on-year inflation surprisingly fell to 0.1%. The market interpretation was that such a figure stood the mostly dovish central bank in good stead.

No surprise that the Hungarian forint still trades in a slightly bearish mode despite some supportive statements coming from NBH's key figures. Recall that vice-governor Balog recently highlighted that the Monetary Council had to re-think the rate policy in the recent market environment, but he still emphasized that the inflation outlook still allows rate cut. The market thought this statement as a possible stop of rate cut cycle. It was important statement as Mr. Balog is the right hand of the NBH's governor, Mr Matolcsy, so the market saw in this statement that Mr Matolcsy's view might be changed also. In the meantime another MPC member, Mr Pleschinger talked about the exponentially increasing risk of further rate cut, but it was not a surprise as he was one of the two members who voted last time on no change of the NBH base rate.

The bank's meeting is scheduled for March 25, and the NBH has signalled recently that it does not see the weak forint as much of a problem. The bond market may view this in the same way, evidently expecting that the NBH will again cut rates even though the forint is weaker. Remarkably, Hungary's government bond market is not concerned about the weakened forint either, and this is a change vis-à-vis the past, when a weaker forint implied lower bond prices; however, this may easily change – notably if the forint begins to strengthen really rapidly.

Czech strong retail sales pleased again the CNB

As concerns other macroeconomic data, fairly strong retail sales in the Czech Republic caught the eye. The Czech National Bank welcomed the strong sales rise gratefully, with Governor Singer stating in his blog that this figure disproves the myth that November's increased purchases will be counterbalanced by declines in retail sales in subsequent months. We are still cautious about this, as the sales were primarily driven by a volatile element like car sales. In any event, we acknowledge the Governor's satisfaction with the performance of the economy, which somewhat makes it easier to forget about very low inflation figures. The message to the market is that the existing regime will really not change soon (at least within a year).

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	-0.03%	➔	➔
EUR/HUF	313	0.04%	➚	➚
EUR/PLN	4.23	0.42%	➚	➚

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.83	-4.50	➔	➚
10Y HUF	5.34	-0.93	➚	➚
10Y PLN	4.10	0.37	➚	➚

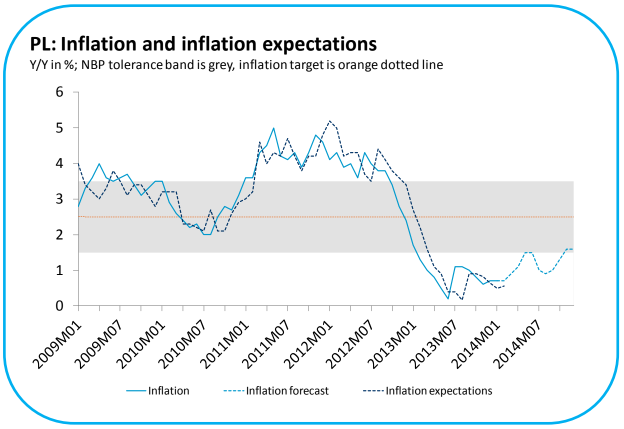
Review of Economic Figures

Inflation pressures in the Central Europe remain subdued

After the fall of the **Czech inflation** to the vicinity of zero in January, owing to a significant reduction in electricity and natural gas prices for households, inflation has stabilised at 0.2% y/y. Thus the Czech Republic is one of the EU countries with the lowest inflation, primarily due to cheapened energy, telecommunication services, and mobile phones. By contrast, food prices, which were up by 4.2% y/y, saw their fastest year-on-year increase. The present inflation developments are no reason for the CNB to change its current exchange rate regime. Owing to low inflation, the central bank can maintain the lower threshold of CZK 27 per EUR until something like the middle of next year. The CNB's interest rate forecast, which still envisages a rapid rise in three-month PRIBOR by almost 70 bps within the next 12 months, seems to be similarly unlikely.

The **Hungarian headline inflation** surprisingly rose by a meager 0.1 % on annual basis in February. The core inflation fell to 2.8 % y/y from 3.4 % y/y in the previous month. CPI acceleration was expected because of a base effect brought about by the public utility cost reduction program launched a year ago. Several elements counterbalanced pressures on a CPI increase, though. Energy, fuel and tobacco prices grew slower than in 2013. The price of market services dropped by 0.6 % m/m, mirroring weak domestic demand that keeps inflation expectations anchored. Tradables also delivered a huge surprise as their prices increased by 0.1 % m/m only, despite a weak HUF. Hungary is facing no inflationary pressures, either from outside, or from inside. As a result, the NBH may continue its rate cut cycle without imminent risks to financial stability of the country. Although we have to highlight that there is definitely no deflationary risk in Hungary as there are still many one-off effects, that push inflation to the recent low levels (there were more public utility cost cuts in 2013) and the core inflation may return to around 3% y/y on the relevant time horizon (6Q and 8Q ahead).

Pressure on **consumer prices in Poland** to rise remains highly subdued in early 2014, just as in the other countries of the region. February's inflation rate was 0.7% y/y and the data for January was even cut to 0.5% (the Statistical Office regularly revises the consumer basket in February). On the month-on-month basis, prices went up by 0.1%, mainly because of the increase in the prices of alcoholic drinks and tobacco products by 1.4%; nevertheless, weak inflation pressures evidently persist in Poland, despite the fairly strong acceleration of its economy in the last quarter of 2013. Inflation should remain below the target virtually all the year round, and this should make the central bank keep rates at all-time lows until at least the end of this year. After all, comments of the NBP governor Marek Belka from today's morning support this scenario. Apart from saying that interest rates may remain stable in 2014, Belka added that if the economy evolved in line with the recent forecast (to which, as far as GDP growth is concerned, he sees rather upside risks), the central bankers would surely need to think about rate hikes in 2015.

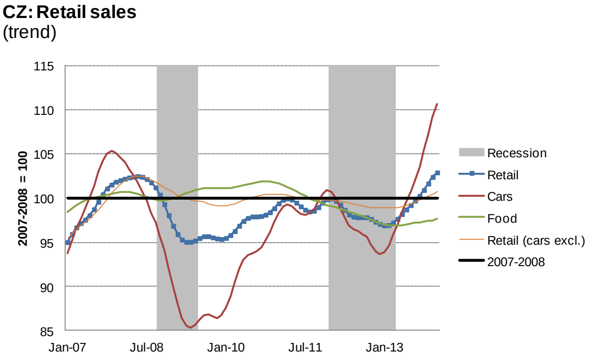


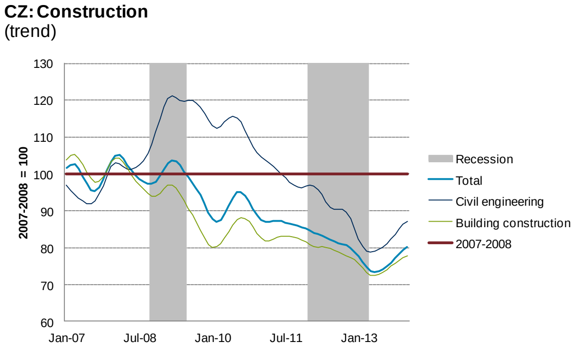
Bullish hard figures from the Czech economy in January

Altough Czech January's industrial output was slightly lower than December's (-0.5%), it came much higher than that of early 2013 (+5.5%). In line with expectations, notably carmakers fared well, with their production rising by 15% this time. Energy production and mining performed worse. The very good performance of industry is consistent with the previous development of orders, which were again positive. Orders at industrial firms were up by 12.6% y/y, with foreign demand again being the primary factor. New orders at carmakers even look amazing, being more than 25% above the January 2013 level. Industry has performed very well in recent months, with production as well as orders on the rise, and businesses even having started to recruit new staff in the end. These figures – albeit only for the first month of this year – suggest that industry will continue to drive the Czech economy this year.

Not only industry but also construction may also boast favourable performance. Construction output for January this year rose at the fastest rate in almost the last three years (+5% y/y). It primarily benefited from the very mild winter and eventually also from the low comparative baseline of last year. Even so, we can say that the situation in construction is slowly starting to stabilise for the first time in five years. Construction will hardly offset its previous decline. After all, not even the decline in the number of building permits and the continuous layoffs indicate an optimistic view of the future among construction firms. Not even th in e construction statistics of new dwellings (+32.6%) should be overestimated now, as they are again based on a very low comparative baseline of January last year. Construction still lacks a sufficiently strong stimulus from new orders, notably from the public sector, where the preparation of such orders takes years. Hence the sector will still need to wait a while for its true upswing.

And thirdly, positive data also came from the retail sector on Friday. Retail sales continued to rise significantly (+6.4% y/y), owing to the Czech National Bank's intervention against the weak koruna, in particular. Especially car dealers see a rapid improvement of demand, and thus the sales in the automotive segment went up by nearly a fifth. This is likely attributable to carmakers' innovated supply in the market and clearly also to concern about a possible price increase due to the weak koruna. The performance of the retail sector excluding cars is not that impressive. Sales were up by only 1.5%, primarily fuelled by e-commerce, sales of electronics and clothing. The question is how long this strong spending 'spree' will last. In any event, the retail sector stands a good chance of performing decently throughout this year, albeit 6% rates will not occur very often. Improved mood among consumers and, in particular, their increased purchasing power should encourage this. The reduction of electricity and gas prices, which will slightly free people's hands for spending their money in shops, will also contribute to this.



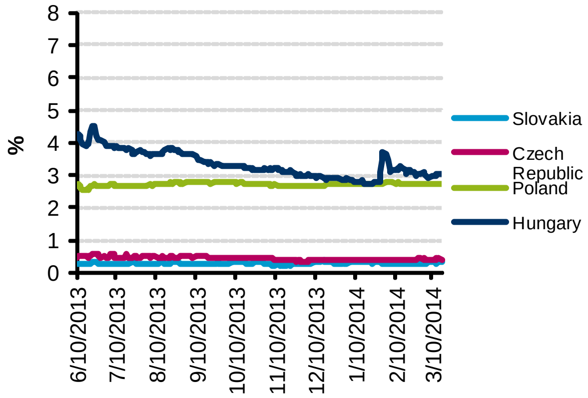


Calendar

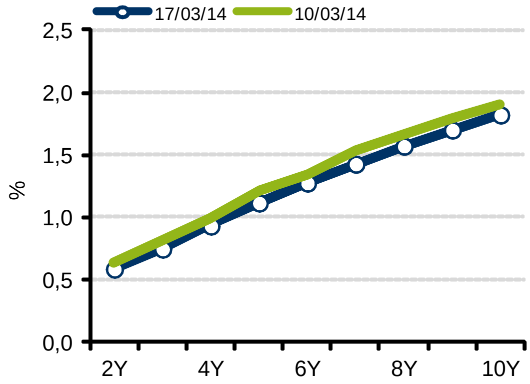
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	03/17/2014	9:00	PPI	%	02/2014	0.2	-0.5	0	-0.6	-1.3	-0.7
CZ	03/17/2014	10:00	Current account	CZK B	01/2014	18.5		16		-9.44	
PL	03/17/2014	14:00	Core CPI	%	02/2014			0	1		
PL	03/17/2014	14:00	Current account	EUR M	01/2014			-795		-843	
PL	03/17/2014	14:00	Trade balance	EUR M	01/2014			337		-232	
PL	03/17/2014	15:00	Budget balance	PLN M	02/2014					-2644	
PL	03/18/2014	14:00	Wages	%	02/2014			0.5	3.1	-9.9	3.4
PL	03/19/2014	14:00	Industrial output	%	02/2014			-1	6.1	2.9	4.1
PL	03/19/2014	14:00	PPI	%	02/2014			0.1	-1.1	0.1	-0.9

Fixed-income in Charts

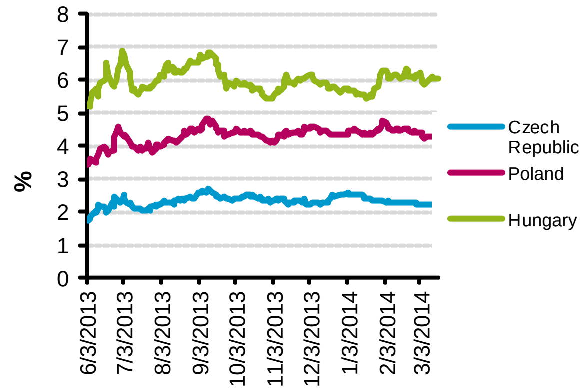
FRA 3x6



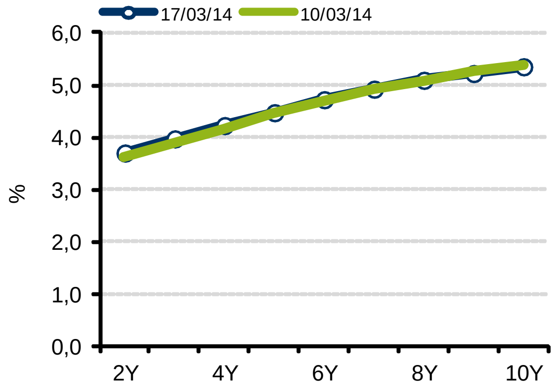
CZ IRS



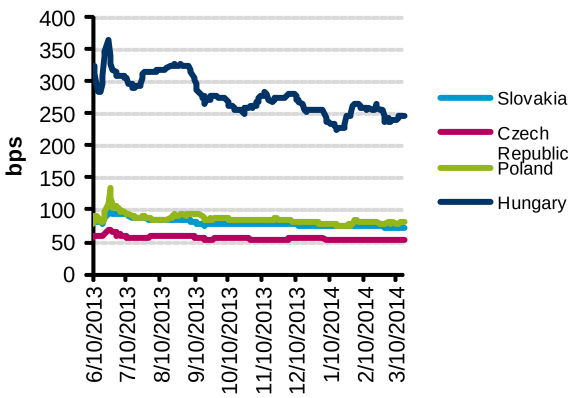
10Y GB Yields



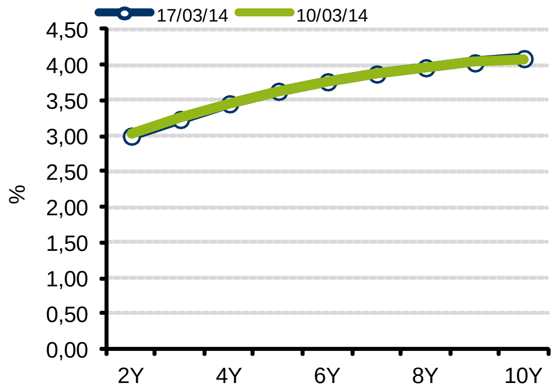
HU IRS



CDS 5Y



PL IRS



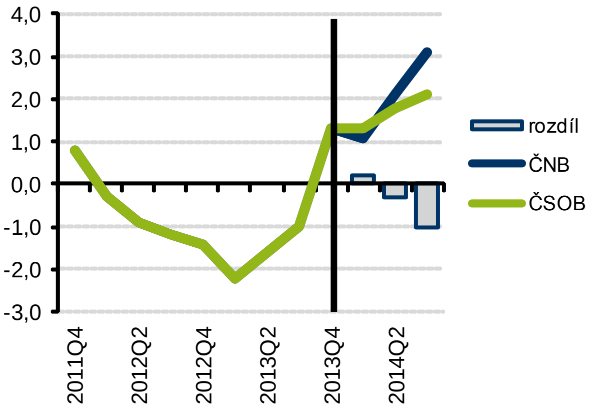
Source: Reuters

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 should 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 next interest-rate-setting meeting will be held on 25 March. In a case of the EUR/HUF remains close to 310 we expect a rate cut may be delivered, but if it breaks out from the range of the weak side it may lead to a stop of the rate cut cycle. Interestingly, although the forint is under pressure, the long-end of the yield curve remained relatively stable and e.g. 10-year bond is around 30bp lower than it was in mid-February, when the EUR/HUF was traded around 314. Additionally the yield curve is also flatter than it was 3 weeks ago especially the 3-15 year spread. So, we expect that in a case of the EUR/HUF breaks out from the above mentioned range it may cause a sudden sell-off on the long-end of the bond curve and the curve may steepen significantly.	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 3.6% growth while we estimate 3.4% 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 at the end of 2014 at earliest.
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 fast and sudden weakening of the HUF and the fact, that in the last 6 weeks HUF was able to strengthen less and less, increase the chance the EUR/HUF may break out from the range of 308 and 314 upward. The next resistance levels are around 317, 320 and 324.	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 as well as to development in Ukraine.

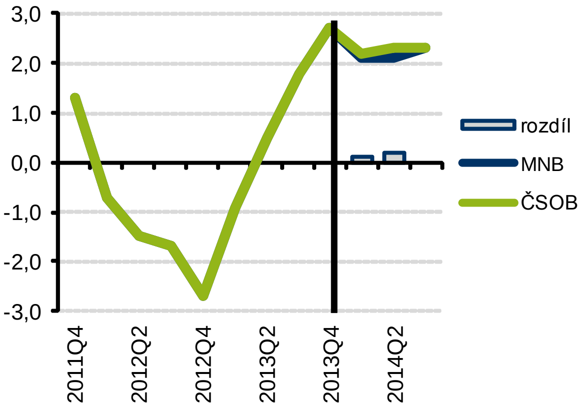
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

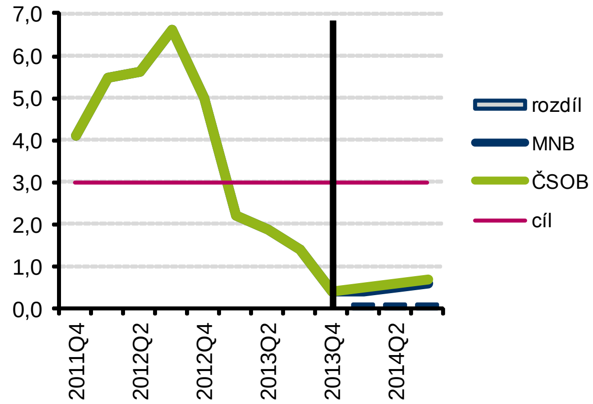


CZ: Inflation outlook (Y/Y, %)

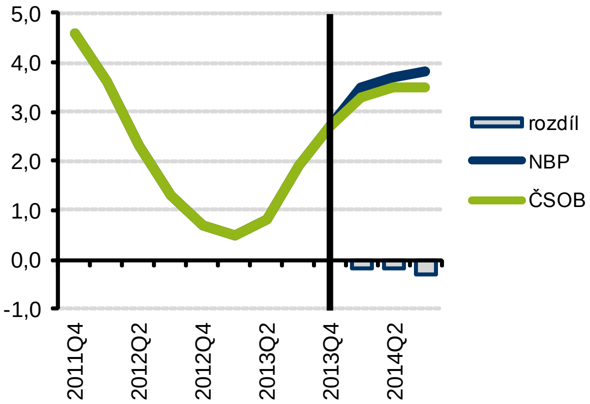
HU: GDP outlook (Y/Y, %)



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	*1.825*	2.06	2.09	1.90	2.10	2.30
Hungary	HU10Y	*5.34*	5.17	5.25	5.40	5.00	5.30
Poland	PL10Y	*4.10*	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	*4.23*	4.22	4.16	4.20	4.10	4.00

GDP (y/y)

	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3
Czech Rep.	-2.2	-1.6	-1.0	1.3	1.3	1.8	2.1
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	0.3	0.6	1.2
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

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	Brussels	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94		
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Frankfurt	+49 69 756 19372
Shawn Britton	+353 1 664 6892	Singapore	+65 533 34 10
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	Prague	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	Bratislava	+421 2 5966 8820
Warsaw Research			
Budapest Research			
David Nemeth	+36 1 328 9989	Budapest	+36 1 328 99 85

ALL OUR REPORTS ARE AVAILABLE ON WWW.KBCCORPORATES.COM/RESEARCH