



# Central European Weekly

Monday, 16 June 2014

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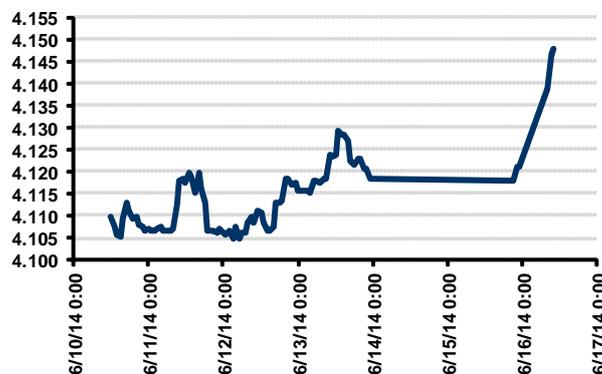
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## Weekly Highlights:

- Regional inflation remains low and calls for relaxed monetary policies
- NBP's affair hurts the zloty as it questions central bank's credibility

## Chart of the Week: PLN and Belka's affair

EUR/PLN



EUR/PLN, last 90 hours. Source: Reuters

*The zloty weakens sharply on Belka's affair.*

# Market's editorial

## Regional inflation remains low and calls for low rates

Inflation across Central Europe remains low. While Hungary's inflation is negative, that of the Czech Republic and Poland is slightly above zero. Something similar also applies to the euro area, where May's inflation fell to 0.5%, a 4.5-year low. Although the inflation story is much the same in all of the countries, not all central banks are responding in quite the same way. And this has substantial implications for markets.

It began to be more evident after the ECB set up a negative deposit rate and adopted a package of measures focused on a further monetary easing. While this, along with low inflation, is likely to open the door to another rate cut in Hungary, no significant changes are on the way in Poland. While doves have dominated the Board of the National Bank of Hungary in recent years and are likely to keep cutting rates as long as markets allow them to do so, the opinions within the National Bank of Poland are distributed much more evenly, with the likelihood of a rate cut being much lower there. The currency pairs have sensed this, with the zloty and the forint being close to all-time highs. Money market participants are slightly more cautious, having priced in and, in today's prices, having started to bet on a rate cut even in Poland. However, unless the central bankers change the tenor of their statements in the wake of low inflation, the bets may quickly wane again.

## Polish macro picture overshadowed NBP's Belka affair

Macroeconomic arguments can be, however, overshadowed by the recent affair, which is related the conversation between central bank's (NBP) head Marek Belka and Interior Minister Sienkiewicz published during last week Saturday by Polish weekly "Wprost".

The conversation which took place back in July last year seriously undermines credibility and puts into question independence of the NBP. Its transcript unveils that the Minister and the Governor discussed possible support of the central bank to the government ahead of elections and, in effect, constituted an attempt to prevent opposition parties from winning the vote. In return, Marek Belka had asked the Interior Minister to replace the then Minister of Finance Jacek Rostowski with a nonpartisan person which indeed happened in November last year. In addition to the topics outlined above, Mr. Belka has also made a couple of discourteous comments on the Monetary Policy Council (MPC) in general and his MPC colleague Jerzy Hausner in particular.

The affair has been a hot issue nowadays when the central bank considers further interest rate cuts which can be henceforth interpreted by opposition as politically-motivated. No matter that inflation is likely to fall below zero during this summer and the controversial conversation focused on possibility of government bond purchases by the NBP (in order to avoid breaching debt ceilings) rather than on interest rate manipulation.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	-0.12%	↘	→
EUR/HUF	308	1.39%	↘	→
EUR/PLN	4.14	0.87%	↘	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.50	0.00	→	→
10Y HUF	4.11	-0.24	→	→
10Y PLN	3.59	2.14	→	→

# Review of Economic Figures

## The Czech inflation remains slightly above zero

May's consumer price index rose by 0.1% vis-à-vis April, primarily driven by alcohol and pharmaceuticals. Year-on-year inflation has climbed to this year's high of 0.4%. Inflation monitored by the central bank continues to be well below its target, but this is still mainly a result of January's reduction in energy prices and the long-term decline in mobile telecommunication prices. Nevertheless, it is already evident that the effect that last year's price 'revolution' in mobile services has had on inflation is starting to wane over time. Although the Czech National Bank's forecast envisaged an inflation rise to 0.6%, we regard the current figure as very positive, given Europe's disinflation trend, which suggested the possibility of a greater fall in food prices. The central bank might still be satisfied with the price developments, and the speculation as to a further weakening of the koruna might not necessarily occur. The curbed inflation trend will not change significantly in the coming months either. Inflation may gradually climb to more than 1%, but not before the autumn; firstly, there will be the effect of the low comparative baseline and secondly, prices should also be affected by the increased excise duties on cigarettes.

## Hungary's inflation still negative, due to regulated prices

The Hungarian consumer price index keeps falling, albeit we need to admit that, unlike the neighbouring countries of the region, Hungarian inflation adjusted for the effect of the volatile food, fuel and energy prices remains clearly above zero; core inflation is still 2.5% y/y, while headline inflation remained slightly negative in May (-0.1%). This divergence is primarily a result of cuts in the regulated prices of gas, heat, and electricity (this category alone fell by 2.5% m/m in May).

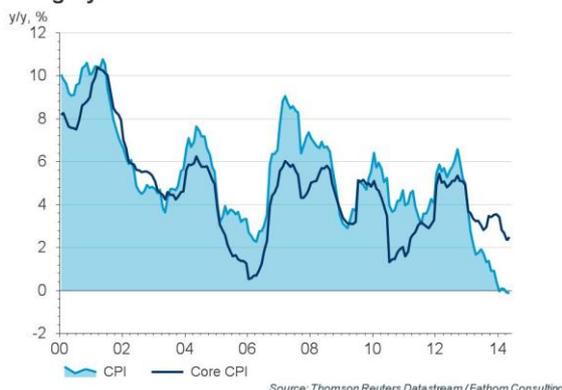
Although the Hungarian economy is, in effect, not (much) at risk of deflationary pressures, the contrary is true, i.e., headline inflation will continue to be low for some time yet – until July at least. The first inflation rise can be expected in August and then in the 4th quarter, when the previous cuts in regulated prices (carried out before the end of last year) no longer influence year-on-year data.

## The Polish inflation continued to fall in May

Poland's inflation slowed down unexpectedly in May to 0.2% y/y, with month-on-month prices falling by 0.1%. This was an unpleasant surprise to markets, which had anticipated a year-on-year price rise by 0.5%. The main reason for the price rise deceleration was another unexpected fall in food and non-alcoholic drink prices (-0.4% m/m), which, in comparison to our forecasts, more than counterbalanced slightly faster price increases in some other items.

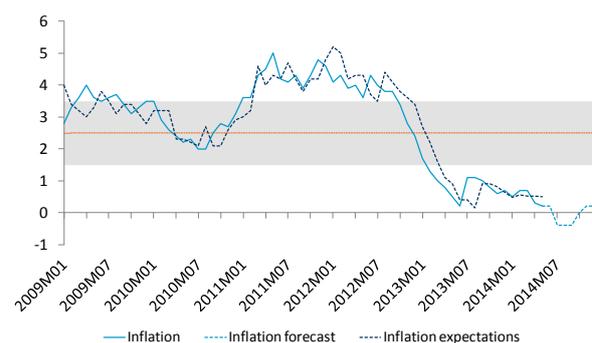
We will see how another inflation deceleration will influence comments to be made by central bankers. The NBP, unlike most of its counterparts, has a room to cut rates further, if necessary. An inflation fall below zero, which will very likely occur during the summer, will be probably stronger than expected, given May's inflation. This may continue to upset the NBP, but we believe that the bank will not proceed to any resolute step, such as a rate cut, unless a tangible corroboration of a significant cooling of economic growth is available to the bank. Hence important milestones will include the monetary policy meeting of early July, when a new economic forecast will be available to the Monetary Policy Council, and notably the release of GDP data for the second quarter of the year, scheduled for late August. Meanwhile, markets are likely to show greater susceptibility to monthly statistics (industry, wages, construction, etc.) and to comments from central bankers, than was the case in previous months.

Hungary: Inflation



PL: Inflation and inflation expectations

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

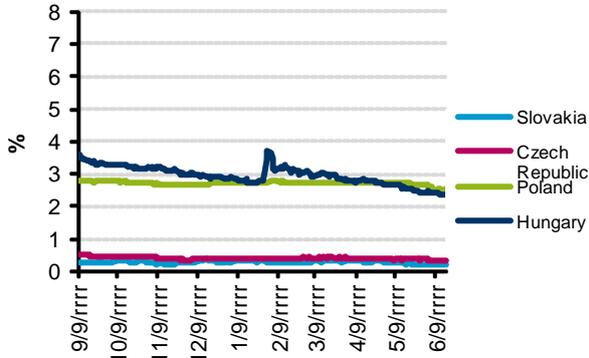


# Calendar

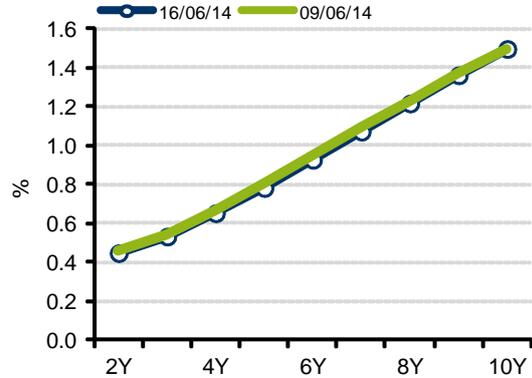
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/16/2014	9:00	PPI	%	05/2014	0.1	0	0.1	0	0	-0.3
PL	06/16/2014	14:00	Core CPI	%	05/2014			0	0.9	0.3	0.8
PL	06/16/2014	15:00	Budget balance	PLN M	05/2014					-21306	
PL	06/17/2014	14:00	Wages	%	05/2014			-3	4.3	-1	3.8
PL	06/18/2014	14:00	Industrial output	%	05/2014			0.4	5.9	-2.3	5.4
PL	06/18/2014	14:00	PPI	%	05/2014			0.1	-0.7	-0.1	-0.7

# Fixed-income in Charts

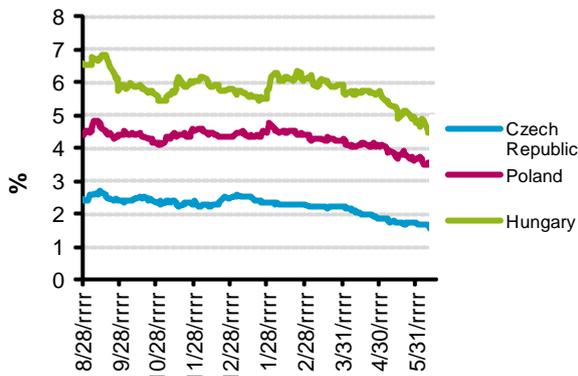
**FRA 3x6**



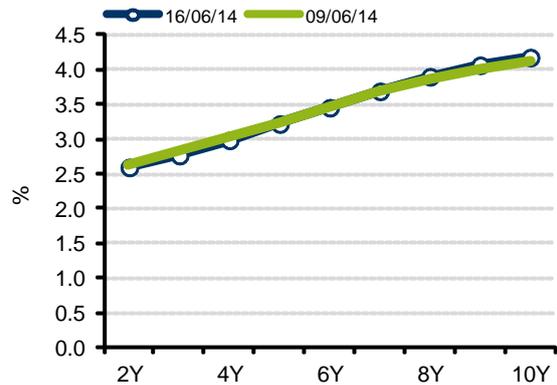
**CZ IRS**



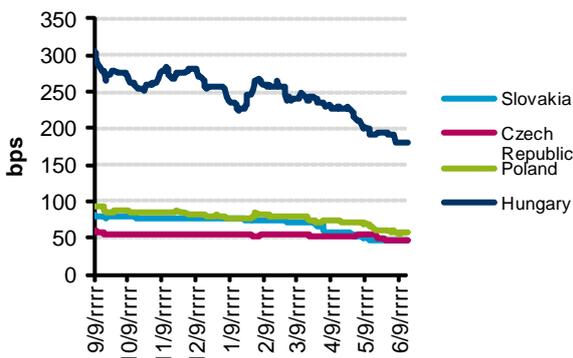
**10Y GB Yields**



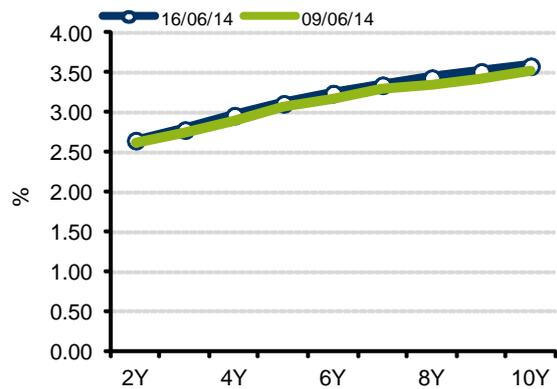
**HU IRS**



**CDS 5Y**



**PL IRS**



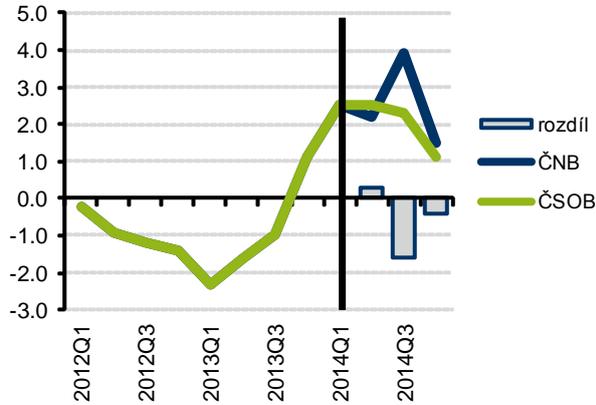
Source: Reuters

# Medium-term Views & Issues

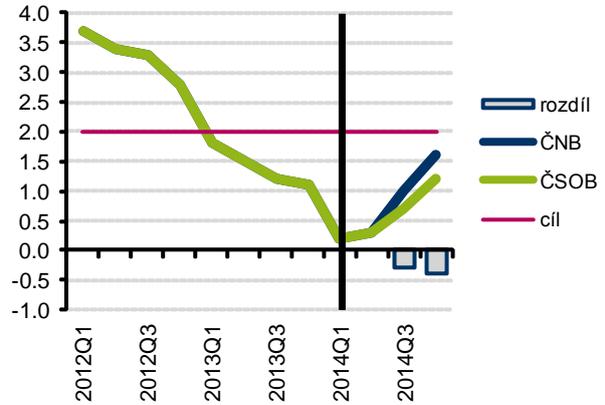
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>The president appointed a new coalition government a few months after the election. The programme of the future government is likely to be consistent with the concluded coalition agreement, which envisages keeping the government deficit below 3% 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.</p>	<p>Based on the first quarter figure and the recent trends in the economy, Hungary's GDP may grow above 2.5% Y/Y in 2014 and it cannot be excluded that the growth might be close to 3% Y/Y level. The low base supports this economic growth level in short term, but without a substantial rise of investments in the private sector this year, economy may slow down to around 2% Y/Y level in 2015. On the other hand, in spite of growing domestic demand, inflation appears well anchored and inflationary expectations stick close to 3%. Moreover, as this year's harvest may be good, food processing industry hardly escalates price pressures in the economy.</p>	<p>According to the GUS estimates the Polish economy grew by 3.4% in 2014Q1. 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, especially in view of recent crisis in Ukraine.</p>
Outlook for official & market rates	<p>The CNB has 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 2.6% this year. The CNB is very unlikely to change rates, and just as likely to maintain its intervention regime throughout this year.</p>	<p>Given the low headline inflation figures (-0.2% y/y) in May the NBH may continue its monetary policy and the rate-cutting cycle in June.</p>	<p>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, outlook for persistently low inflation should play in favor of stable official interest rates in the rest of this year. The main risk in this regard stems from the ECB MP easing and its possible impact on the zloty exchange rate. If the zloty continued to strengthen, it would not be welcome news for the NBP, especially with inflation hovering well-below the target and risk of slower growth due to Ukraine.</p>
Forex Outlook	<p>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.</p>	<p>The NBH ongoing easing cycle might be also a reason, why HUF was hit more aggressive in this sell-off than its regional peers. It has also a message that Hungary is still more sensitive on international sentiment than its regional PEERS.</p>	<p>Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. Albeit we expect only gradual strengthening against the euro, the Polish currency might perform well against the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue at faster pace. The main risk as regards the zloty is the ECB decision to ease MP which could further support the currency.</p>

# CBs' Projections vs. Our Forecasts

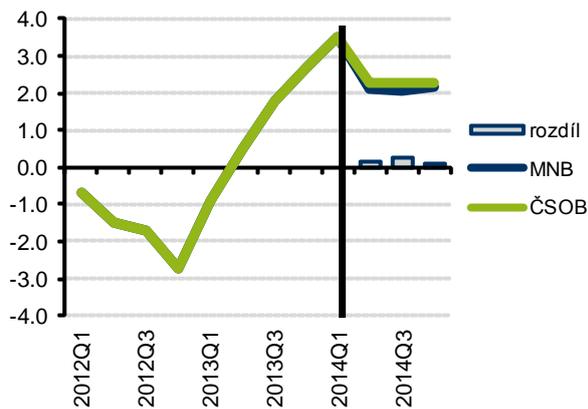
**CZ: GDP outlook (Y/Y, %)**



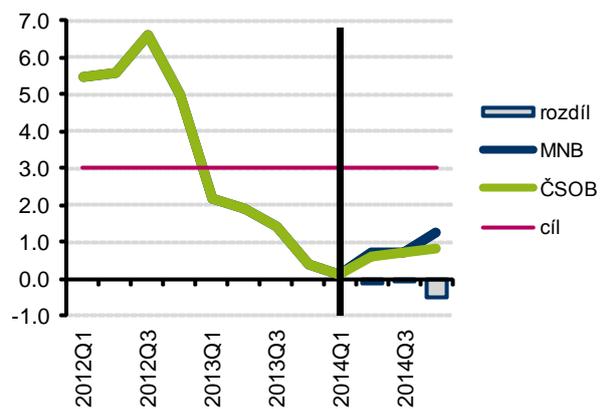
**CZ: Inflation outlook (Y/Y, %)**



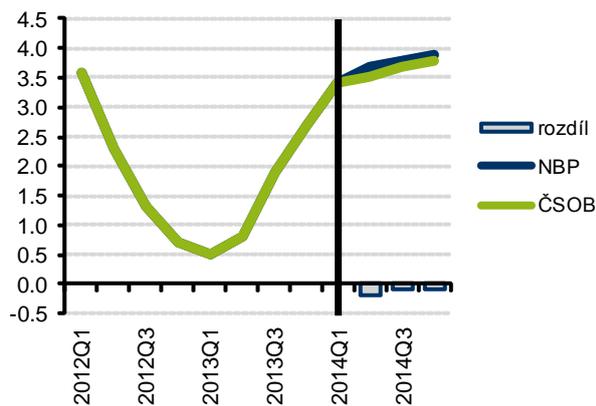
**HU: GDP outlook (Y/Y, %)**



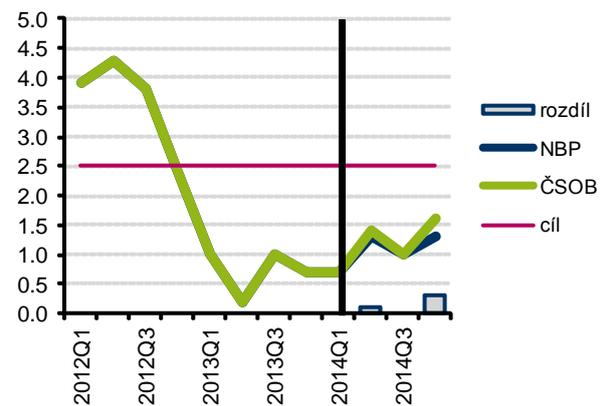
**HU: Inflation outlook (Y/Y, %)**



**PL: GDP outlook (Y/Y, %)**



**PL: Inflation outlook (Y/Y, %)**



Source: CNB, NBP, MNB, CSOB

# Summary of Our Forecasts

## Official interest rates (end of the period)

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	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.	2.40	3.00	2.60	2.50	2.50	2.50	-15 bps	5/27/2014
Poland	2W inter. rate	2.50	2.50	2.50	2.50	2.50	2.75	-25 bps	7/3/2013

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	PRIBOR	0.36	0.38	0.37	0.36	0.36	0.36
Hungary	BUBOR	2.42	2.99	2.67	2.50	2.50	2.50
Poland	WIBOR	2.68	2.71	2.71	2.75	2.75	3.00

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	CZ10Y	1.5	2.09	1.84	1.55	1.70	1.85
Hungary	HU10Y	4.11	5.25	4.95	5.00	5.30	5.70
Poland	PL10Y	3.59	4.25	4.03	4.10	4.45	4.70

## Exchange rates (end of the period)

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	EUR/CZK	27.4	27.3	27.4	27.2	27.2	27.2
Hungary	EUR/HUF	308	297	307	305	298	295
Poland	EUR/PLN	4.14	4.16	4.17	4.16	4.15	4.09

## GDP (y/y)

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	-1.6	-1.0	1.1	2.5	2.5	2.3	1.1
Hungary	0.5	1.8	2.7	3.5	2.3	2.3	2.3
Poland	0.8	1.9	2.7	3.4	3.5	3.7	3.8

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

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	1.6	1.0	1.4	0.2	0.2	0.9	1.5
Hungary	1.9	1.4	0.4	0.1	0.6	0.7	0.8
Poland	0.2	1.0	0.7	0.7	1.4	1.0	1.6

## Current Account

	2013	2014
Czech Rep.	-1.4	-1.4
Hungary	2.0	2.2
Poland	-1.2	-2.5

## Public finance balance as % of GDP

	2013	2014
Czech Rep.	-1.5	-2.5
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

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