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# Central European Weekly

Monday, 13 October 2014

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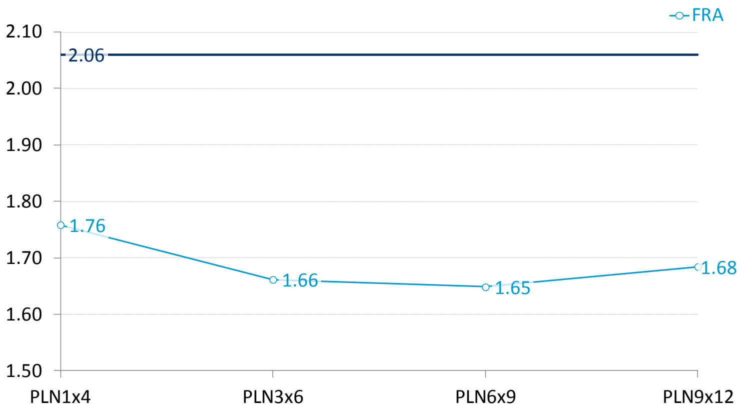
## Weekly Highlights:

- The NBP cut its rate by 50bps. More to come - the question is how aggressive the MPC will be?
- The Czech and Hungarian inflation surprise again on the downside in September
- Watch Polish inflation figures for guidance for next NBP's policy step

## Chart of the Week: Rate-cut bets in Poland




*Rate cut bets on further easing remain quite high in Poland...(Source: Bloomberg, CSOB)*

Central European Daily



# Market's editorial

### Inflation suprises again on the downside

Last week, a series of major events in the Central European region brought various surprises that point in one direction – to low inflationary pressures (see the next page).

This conclusion has been implied not only by the recent Czech and Hungarian inflation data for September, which was clearly lower than expected, but also by industrial output figures for August. These were much lower in both the Czech Republic and Hungary, thus even further augmenting the queries surrounding the situation in the euro area, which may be worse than expected in terms of its upswing. In the future, this may also imply lower inflationary pressures in the euro area, with Central European economies partly importing that inflation. In other words, if disinflation pressures in the euro area increase, the one-off/continuous generation of inflation in the region will also be more difficult.

### The NBP cut its base rate by 50bp and more to come

In this context, the latest decision by the National Bank of Poland (NBP), which surprised most of the market by cutting interest rates by 50 basis points on Wednesday, does not at all look extreme. The main reason for the rate cut is the low inflation rate and the deteriorating prospects for maintaining the fast rate of economic growth. The NBP believes that these prospects are increasing the risk of inflation remaining below target (2.5%) even in the medium term. Let us add that October's move may not necessarily mark the end of the monetary easing cycle. The NBP leaves the door open in this regard, albeit the NBP President's comment on the decision was rather cautious during his press confernce after the Monetary Policy Council (MPC).

Nevertheless there was a follow up of the Polish easing story on Friday and weekend, several interesting comments came from members of the Polish MPC. Maybe the most important was the one of NBP's President Marek Belka, who said that MPC would complete rates adjustment by the end of this year. Belka therefore echoed his previous comments that there was an agreement among those MPC members who backed the 50 bps cut last week that rate adjustments should be concentrated in time. Meanwhile, comments of two of the most dovish members of the MPC (Bratkowski, Chojna-Duch) suggest that a 25 bps rate cut scenario seems to be more likely option, at least for the time being. From this point of view, this week's data on inflation and industrial production could play an important role in determining the likelihood of yet another 50 bps cut in November.

### Can the NBP inspire the NBH?

Facing the NBP rate cut and very low inflation figures some market participants started to expect that the NBH might follow suit. The NBH's inflation target is 3% Y/Y +/-1 %point and based on the latest quarter inflationary report and also our expectation suggest that central bank may keep base rate unchanged on the coming months. This debate may strengthen in the Monetary Council especially if following months represents further downside surprise. But we still evaluate the recent developments meaning that the chance that the NBH may keep base rate unchanged at 2.1% till the last quarter of next year has increased. No doubt that the NBH is now in a safer position from inflationary outlook pint of view and the main danger might come from external factors.

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | 27.5 | 0.17% | ↗ | ↗ |
| EUR/HUF | 306 | -0.81% | ↗ | ↗ |
| EUR/PLN | 4.19 | 0.25% | ↗ | ↗ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| 10Y CZK | 1.15 | -8.03 | ↘ | ↘ |
| 10Y HUF | 3.61 | -5.25 | → | → |
| 10Y PLN | 2.57 | -7.23 | ↘ | ↘ |

# Review of Economic Figures

## The Czech industry in the red for the first time in a year

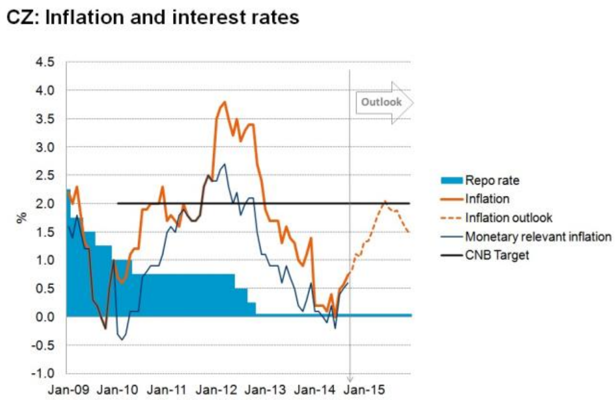
At first glance, the August data from industry is certainly no reason to rejoice. Industrial output fell by 5.2% y/y, but this is partly attributable there having been one less business day in the month. Adjusted for this calendar effect, the drop is slightly less dramatic, by 3.6%. The reasons for the figures being unfavourable at first glance are suggested by the report from the Statistical Office. The primary factor is the production of passenger cars, which diverges in the summer as a result of factory-wide workforce leaves. This time, the movements of these leaves proved to have increased the industrial output figure in July and cut it back in August. Something similar will apply to orders received by carmakers. Hence we do not dramatically overestimate their rate or the overall poor rise in orders (+1.4%). The August figures from industry are certainly no reason to rejoice, but they need to be viewed in the context of the previous month, which was abnormally strong. This is why we do not at all consider the current figures to be extremely unfavourable and do believe that industry returned to its normal level in September. After all, even soft confidence indicators, including the purchasing managers index, do not indicate a longer fall in industry, but rather the contrary. Therefore industry will not lose its dominant role as the driver of the Czech economy after the release of the August data either.

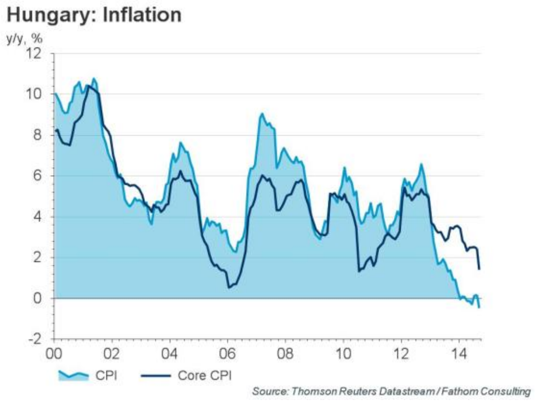
## Hungary’s annual inflation remains in negative territory

The Hungarian consumer price index surprisingly dropped from 0.2% Y/Y in August to -0.5% Y/Y in September. Although the decrease was expected the level of the headline figure was a huge surprise. The main reasons behind the low figure are the high base of last year (taxi fee hike, banking transaction tax, tobacco etc.), the price decrease of long-distance travel, fall of textbooks' price, domestic holidays and the low imported inflation. The September figure pushed down our average inflation expectation from 0.2% Y/Y to 0% Y/Y in 2014 and from 2.2% Y/Y below 2% Y/Y in 2015, but we still expect that CPI may accelerate in the coming months and it may close 3% Y/Y at the end of 2015.

## The Czech inflation tick up only marginally in September

The Czech Year-on-year inflation has been rising progressively but slowly. While it hit 0.6% in August, it added 0.1% to reach 0.7% in September. This is slightly less than we expected, but the figure is still 0.2% above the Czech National Bank’s latest forecast. Prices were down by 0.2% m/m (we expected a 0.1% fall), due in particular to a seasonal decline in package tour prices. Fuel and household equipment also helped to improve the price developments. The latest figures confirm that inflation is slowly on the rise, yet it still remains far behind the CNB’s target. The reasons include the reduction of energy prices at the beginning of the year as well as mobile operators’ persisting fight for customers. Consumers will also slightly save in healthcare expenditure. The months to come will see another inflation rise, which will be encouraged by the previously approved increase in excise duty on tobacco. Hence inflation may rise to slightly above 1% by the end of the year. Nevertheless, its return to the CNB’s target of 2% will not be that easy next year either. Another reduction in electricity prices may hang in the air and another reduced VAT rate on medicines as well as the elimination of healthcare fees are going to be put in place. However, these are administrative moves, which the central bank should essentially ignore.



# Weekly preview

**WED 14:00** **PL Inflation (change in %)**

| | Sep-14 | Aug-14 | Sep-13 |
|---|---|---|---|
| CPI y/y | **-0.4** | -0.3 | 1.0 |
| Food (ex Alc.) y/y | **-1.9** | -2.1 | 2.4 |
| Transport (including fuel) | **-2.3** | -1.5 | -1.5 |

## PL: The deflation period continues

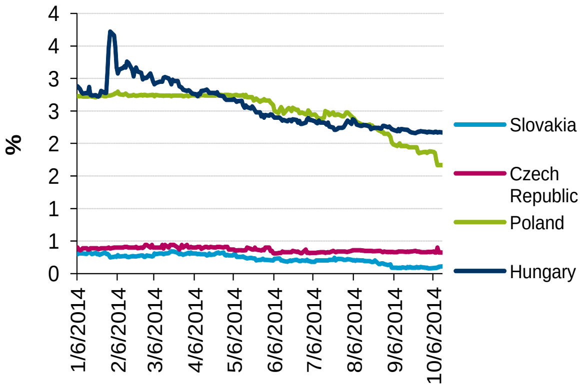
The price rise in Poland continued to be negative in August, according to our forecasts. Month-on-month prices likely stagnated, due to a slower than usual rise in food and soft drink prices on the one hand, and probably due to a decline in transport prices on the other. Not even the rest of the year looks very promising for a return to the target soon. Downside risks to inflation are on the rise, and thus the price rise may not even necessarily leave the deflation band before next year.

# Calendar

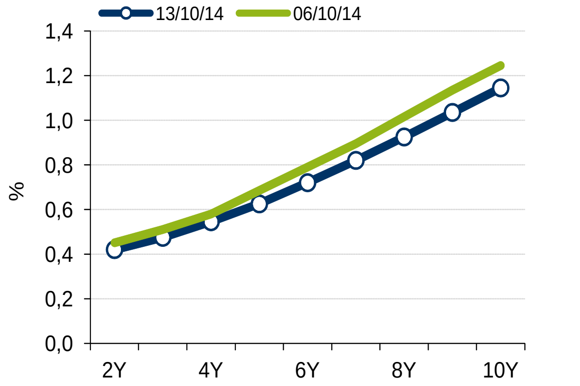
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 10/14/2014 | 9:00 | Industrial output | % | 08/2014 *F | | | | | -5.7 | 2.9 |
| CZ | 10/14/2014 | 10:00 | Current account | CZK B | 08/2014 | -9.7 | | -17.6 | | -14.31 | |
| PL | 10/14/2014 | 14:00 | Current account | EUR M | 08/2014 | | | -340 | | -173 | |
| PL | 10/14/2014 | 14:00 | Trade balance | EUR M | 08/2014 | | | 309 | | 393 | |
| PL | 10/14/2014 | 14:00 | Money supply M3 | % | 09/2014 | | | 0.3 | 7.7 | 1.8 | 7.4 |
| HU | 10/15/2014 | 8:30 | Current account | HUF B | 08/2014 | | | | | | |
| PL | 10/15/2014 | 14:00 | CPI | % | 09/2014 | 0 | -0.4 | -0.1 | -0.4 | -0.4 | -0.3 |
| PL | 10/15/2014 | 15:00 | Budget balance | PLN M | 09/2014 | | | | | -24636 | |
| CZ | 10/16/2014 | 9:00 | PPI | % | 09/2014 | 0.1 | 0 | 0 | -0.1 | 0 | 0 |
| PL | 10/16/2014 | 14:00 | Core CPI | % | 09/2014 | | | 0 | 0.6 | 0 | 0.5 |
| PL | 10/16/2014 | 14:00 | Wages | % | 09/2014 | | | 0.3 | 3.6 | -1.8 | 3.5 |
| PL | 10/17/2014 | 14:00 | Industrial output | % | 09/2014 | | | 14.7 | 3.1 | -8.5 | -1.9 |
| PL | 10/17/2014 | 14:00 | PPI | % | 09/2014 | | | 0.1 | -1.5 | 0.3 | -1.5 |

# Fixed-income in Charts

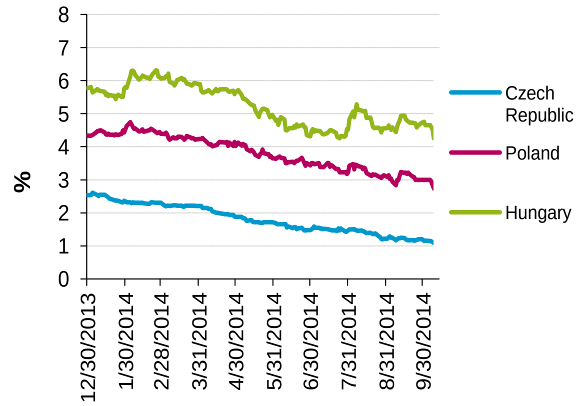
## FRA 3x6



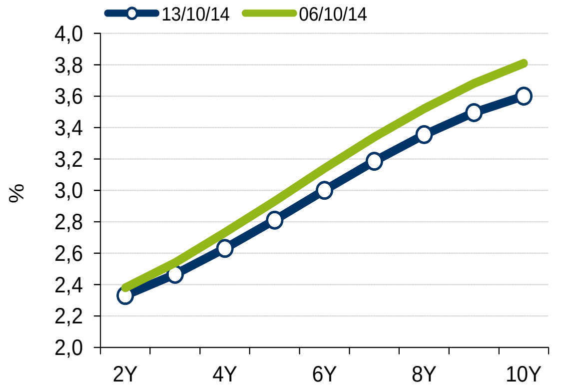

## CZ IRS



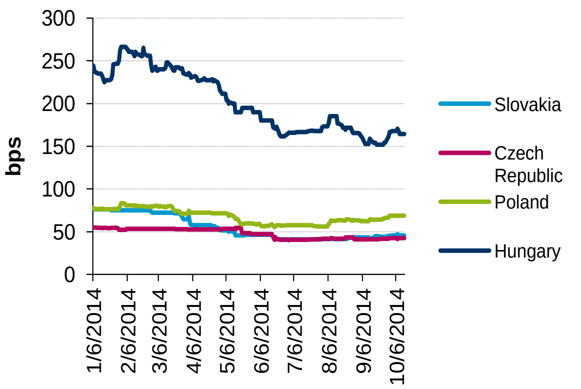

## 10Y GB Yields



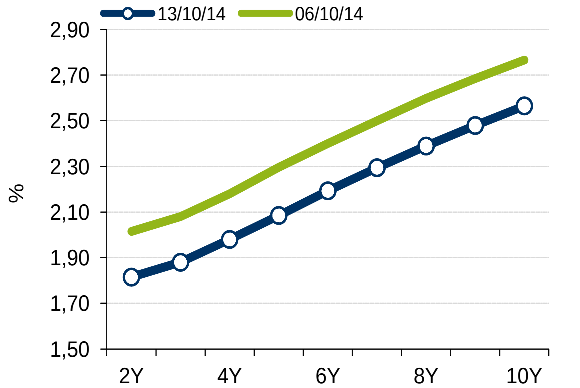

## HU IRS




## CDS 5Y




## PL IRS



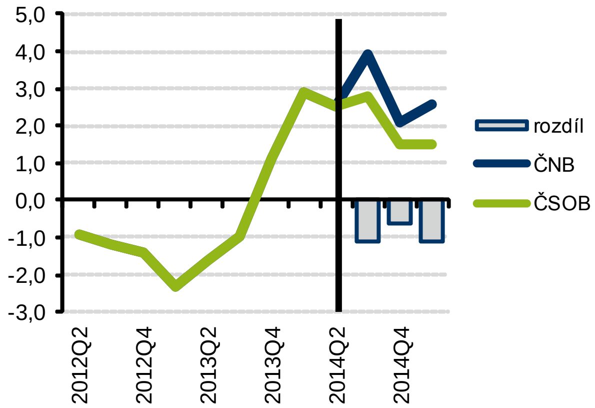

Source: Reuters

# Medium-term Views & Issues

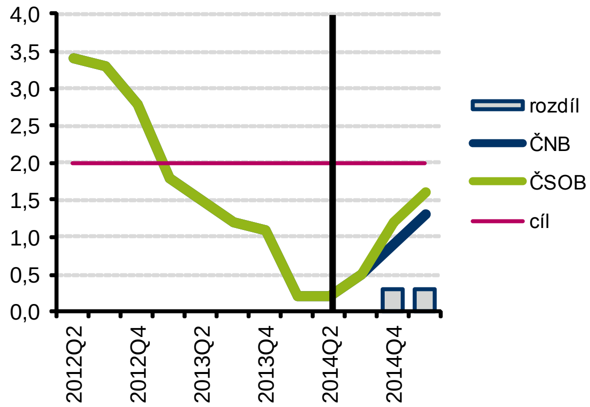
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time.<br>The new government, formed after the autumn 2013 election, is just gradually starting to carry out its programme. It should include not only savings but also greater tax relief for parents with children, a new VAT rate, and likely also the termination of the new funded pension system (called the 2nd pillar), set up in the last two years. | 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.<br>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. | According to the GUS estimates, the Polish economy grew by 3.3% in 2014Q2. The data unveiled a strong contribution of domestic demand but also a high contribution of in inventories which somehow blurred overall good message. On the other hand, ongoing crisis in eastern Ukraine poses clear risks for the economic growth, especially in comparison with our expectations in the beginning of the year. We therefore expect a significant slowdown in economic growth in the second half of the year and in 2014 expect overall growth slightly below but close to 3%. |
| Outlook for official & market rates | 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.<br>We believe that the exchange rate targeting will be abandoned much later (not before the second half of 2015), and that the move will certainly not be accompanied by a rise in interest rates, as suggested by the official forecast. | The NBH has finished its easing cycle in Hungary by cutting the base rate to the 2.1%.<br>The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/-1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy.<br>Our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015. | Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. At the same time, anti-inflationary risks stemming from Ukraine crisis and ECB recent policy easing are mounting. The NBP therefore decided to cut interest rates by 50 basis points in October after 15 months of their stability and did not exclude adjustments in months to come. At the time being, we expect yet-another rate cut of 25 bps in November, although an option of a more pronounced 50 bps cut probably is not off the table. |
| 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. | In a longer term perspective, HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. Taking into account the government's and NBH's statements, such a gradual depreciation of the currency is welcomed as it definitely not endangers the stability of the country. Additionally the government still wants to solve the problems of the foreign currency denominated loans in the households sector in autumn, which may give the National Bank of Hungary an even bigger room of maneuvering room. | Less optimistic economic outlook and renewed monetary policy easing should cap room for prospective strengthening of the zloty in months to come. For the rest of the year, we therefore expect a stagnation of the zloty against the euro and consider risks as skewed slightly towards possible depreciation, even though Polish assets could draw support from further easing of monetary policy conditions in the euro zone. |

# CBs' Projections vs. Our Forecasts

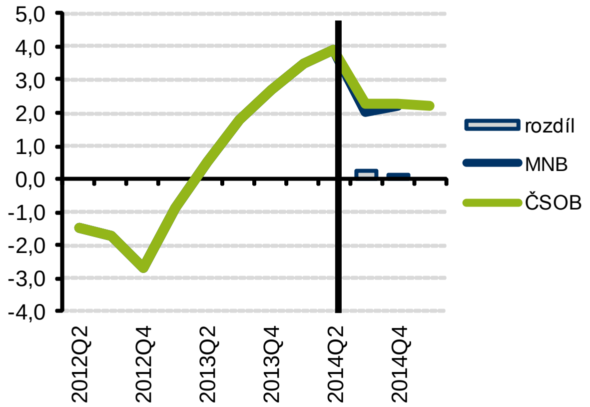
**CZ: GDP outlook** (Y/Y, %)



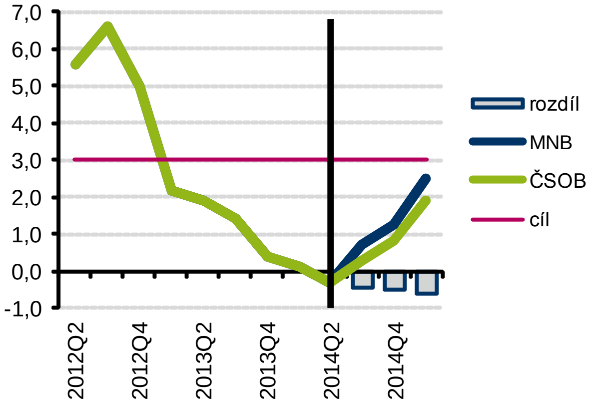

**CZ: Inflation outlook** (Y/Y, %)



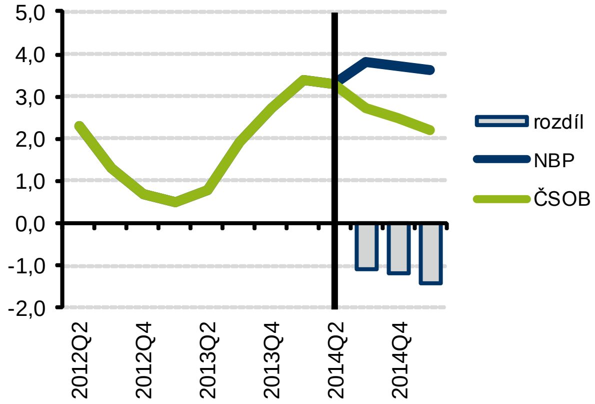

**HU: GDP outlook** (Y/Y, %)



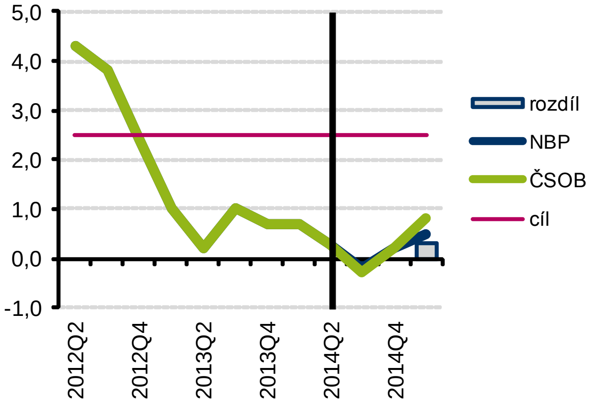

**HU: Inflation outlook** (Y/Y, %)




**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* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 | 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. | *2.10* | 2.60 | 2.30 | 2.10 | 2.10 | 2.10 | -10 bps | 7/22/2014 |
| **Poland** | 2W inter. rate | *2.00* | 2.50 | 2.50 | 2.50 | 2.00 | 2.00 | -25 bps | 10/8/2014 |

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

| | | *Current* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | PRIBOR | *0.35* | 0.37 | 0.35 | 0.34 | 0.35 | 0.35 |
| **Hungary** | BUBOR | *2.10* | 2.67 | 2.34 | 2.09 | 2.15 | 2.15 |
| **Poland** | WIBOR | *2.05* | 2.71 | 2.68 | 2.28 | 2.20 | 2.20 |

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

| | | *Current* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | CZ10Y | *1.145* | 1.84 | 1.34 | 1.22 | 1.50 | 1.61 |
| **Hungary** | HU10Y | *3.61* | 4.95 | 3.77 | 3.92 | 3.50 | 3.65 |
| **Poland** | PL10Y | *2.57* | 4.03 | 3.39 | 2.87 | 2.60 | 2.60 |

*Exchange rates (end of the period)*

| | | *Current* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | EUR/CZK | *27.5* | 27.4 | 27.4 | 27.5 | 27.7 | 27.4 |
| **Hungary** | EUR/HUF | *306* | 307 | 310 | 311 | 310 | 310 |
| **Poland** | EUR/PLN | *4.19* | 4.17 | 4.16 | 4.18 | 4.17 | 4.17 |

*GDP (y/y)*

| | 2013Q3 | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | -1 | 1.1 | 2.9 | 2.5 | 2.8 | 1.5 | 1.5 |
| **Hungary** | 1.8 | 2.7 | 3.5 | 3.9 | 2.3 | 2.3 | 2.2 |
| **Poland** | 1.9 | 2.7 | 3.4 | 3.3 | 2.7 | 2.5 | 2.2 |

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

| | 2013Q3 | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | 1 | 1.4 | 0.2 | 0.0 | 0.9 | 1.3 | 1.7 |
| **Hungary** | 1.4 | 0.4 | 0.1 | -0.3 | 0.3 | 0.8 | 1.9 |
| **Poland** | 1 | 0.7 | 0.7 | 0.3 | -0.3 | 0.2 | 0.8 |

*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 | -2.1 |
| **Hungary** | -2.7 | -3.0 |
| **Poland** | -4.4 | -3.5 |

Source: CSOB, Bloomberg

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