Central European Weekly

Monday, 16 March 2015

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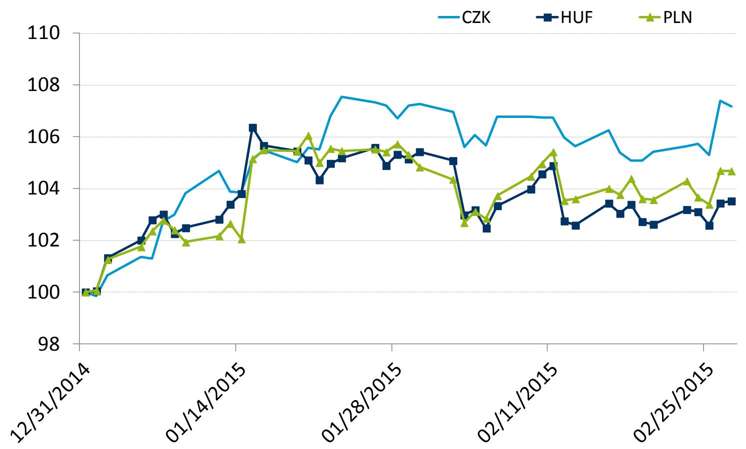
Weekly Highlights:

- **Hungary's inflation a touch higher in February, but NBH's rate cut will come anyway**
- **Will the Czech koruna test the CNB's readiness to defend the EUR/CZK floor?**

Chart of the Week: CE currencies v. USD

CE currencies against the US dollar



Loosing about 7% so far this year, the Czech koruna has weakened the most against the US dollar among the CE currencies…
(Source: Bloomberg, CSOB)

Market's editorial

Hungary's inflation higher, but NBH's rate is comming

Like the euro CE currencies have weakend significantly against the US dollar in recent weeks nad months. This might bring regional inflation higher in upcoming months, though latest inflation figures have showed that the inflation stays at all-time lows in all CE economies.

Hence, regarding the short-term monetary policy outlook we think that low inflation can still trigger an early action in Hungary. The February inflation figure (-1% y/y) confirms our view, that there is no deflation pressure in Hungary, and the strengthening domestic consumption accelerates slightly the inflation. So, based on our forecast the NBH may meet the inflation target of 3% Y/Y +/- 1%pt in 2016. So fundamentally we see no strong argument to start a rate cut cycle recently, but the international sentiment, the ECB's QE policy, Poland's rate cut may push the Council's tone towards 20bp rate cut in March and leaving open the door for further rate cuts to avoid a situation we saw on Polish market after the decision, that the end of the rate cut pushes the currency to stronger levels despite of the bigger cut than expected.

Will Czech koruna test CNB's readiness?

Regarding CE currencies we still beleive that within the next few days the Czech koruna may try to test the Czech National Bank's readiness to defend the EUR/CZK (intervention floor). If it decides to do so, what will this mean?

In fact it is clear that If the koruna weakens, the CNB's powers are essentially unlimited – theoretically the central bank can print as much new money as it likes. In practical terms, the bank can only be prevented from doing so – just as its Swiss counterpart – by pressure from the public not wanting a significant accumulation of forex reserves. Nevertheless, the CNB already got used to public pressure to a great extent last year. The balance of forex reserves in the Czech Republic is still relatively low (unlike Switzerland and Denmark) and is not a political topic in and of itself – while the weak koruna as such is. Thus the CNB in its current composition, before President Zeman has the chance to modify the CNB Board significantly, is unlikely to have a mental problem with further accumulation of forex reserves. This is also why the bank will not currently oppose the idea of overwhelming the market with new korunas (should the EUR/CZK 27.0 level be tested).

Hence we expect that any testing of the EUR/CZK 27.0 will be rather short-lived now. Moreover, while defending its intervention barrier, the CNB is also likely to step up the anti-koruna tenor of its statements. In other words, it will more actively state that it can weaken its intervention threshold of the EUR/CZK 27.0 level even more in the future. However, the question is whether markets will believe in these verbal interventions because a depreciation of the intervention exchange rate is very unlikely now for several reasons. Firstly, the Czech economy is not in a position in which it really needs a much weaker exchange rate – the beginning of 2015 has been positive, and adjusted inflation - excluding fuel prices - has grown to its highest levels since December 2008. Secondly, while the koruna has strengthened against the euro in recent weeks, due to turbulent euro-dollar developments, it has significantly weakened against the dollar as well as numerous currencies pegged to the dollar. Thirdly, if the CNB weakened the exchange rate to a greater extent, it would probably complicate the future departure from its interventions even more. By and large, the CNB may talk about the option of a further elevating of the intervention (FX) floor, but the question is how long the markets will believe in these statements by the CNB. Thus, a real intervention again the Czech currency might be neeed in the end.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27,3	0,08%	→	↘
EUR/HUF	305	-0,21%	↗	↘
EUR/PLN	4,14	0,60%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0,84	-7,22	↗	→
10Y HUF	3,02	-2,58	↗	→
10Y PLN	2,35	-0,22	↗	→

Review of Economic Figures

Czech Inflation stagnates just above zero

The Czech February inflation met expectations and remained above zero. After January's increase in spirits prices, this time the main role is attributable to cigarettes, i.e., to their increased excise duty. By contrast, the increase in winter package tour prices is typical of this period. Compared to the previous month the consumer price index rose by 0.2% while year-on-year inflation remained at 0.1%, i.e., well below the CNB's target level.

February was so far the last month when inflation was curbed by fuel prices. After the price rise in recent weeks the increase in petrol and diesel prices is also starting the influence the Czech market. However, this was not yet seen in February's inflation.

If we look at which prices have increased most this year compared to the last, we find these to be alcohol and cigarette prices, while fuel prices have decreased significantly. Something similar will be true in the months to come because even US$60 a barrel is a much lower level than last year's.

Inflation is certainly not currently and will not be a problem for the Czech economy this year and probably not even next year. Although demand is improving quite decently, prices will be curbed by competitive pressure and favourable commodity prices, not only of energy commodities but also of agricultural ones.

Hungarian inflation slightly higher

Hungarian figures showed that the consumer price index was lower 1.0% year-on-year. Meanwhile core inflation remains in positive territory as it accelerated from 0.7% Y/Y in January to 1% Y/Y in February.

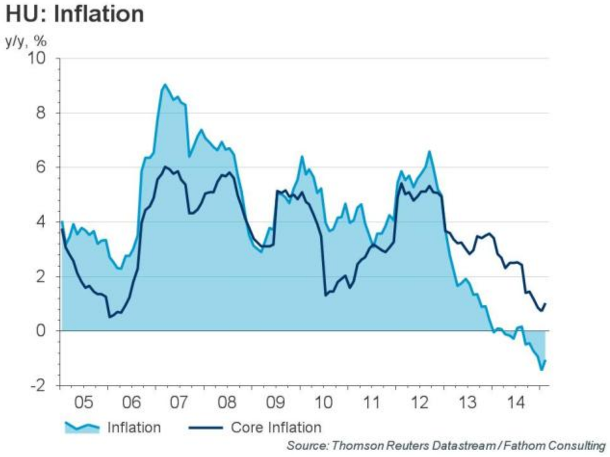
The main reasons behind the 0.5% month-on-month increase are the unprocessed foods and vegetables (6.7% M/M), durable tradable goods (up by 0.3% M/M), market services (by 0.3% M/M, mainly thanks to cinema tickets up by 1.1% M/M, healthcare by 0.8% M/M, books and newspapers by 1.1% M/M and 0.9% M/M), fuel (by 2.6% M/M) alcohol and tobacco (by 1.0% M/M).

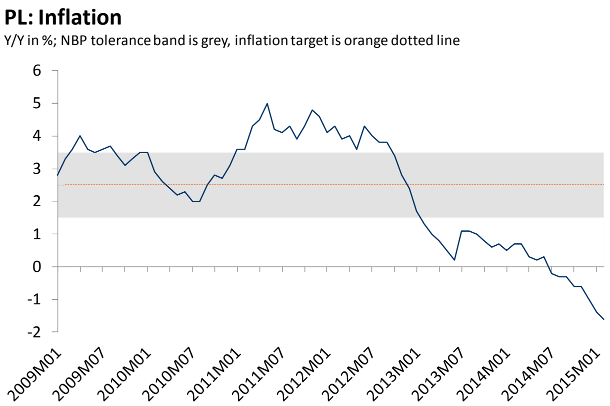
Looking ahead our forecast remains unchanged and we see inflation to move back to positive territory from September and may accelerate to around 2% Y/Y in December, while average inflation may be around 0% Y/Y in 2015, although the future development highly depends on oil price. If those expectations come through that there will be a second round of drop of oil price in 2Q15, the average inflation may move towards -0.5% Y/Y (calculating with 40 USD per barrel Brent price in 2Q15 and moving to 60+ USD per barrel in 3Q15 and 4Q15).

Poland shows record-breaking deflation

Unlike the Czech Republic and Hungary, Poland's inflation surprised markets on the downside in February. Polish prices were down by 0.1% M/M, which meant deflation of 1.6% Y/Y. The main surprise in terms of structure was the month-on-month stagnation of food prices.

Inflation probably hit bottom in February but, as a whole, this means that Polish prices may fall by more than 0.5% this year. While this is good news for consumers, the question is whether – faced with stagnating or falling prices for a second consecutive year – employees will succeed in negotiating fairly rapid wage growth this year once again.

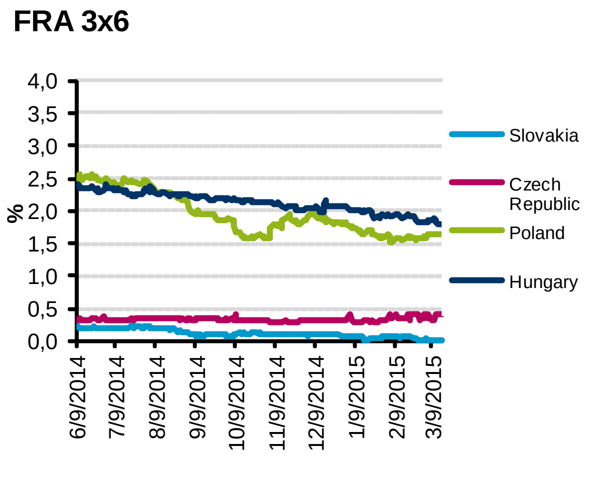


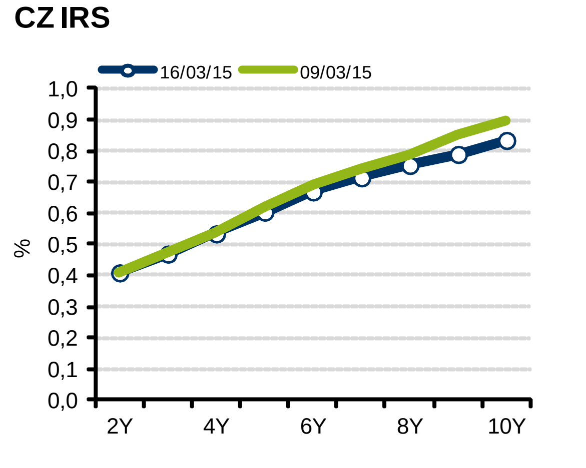


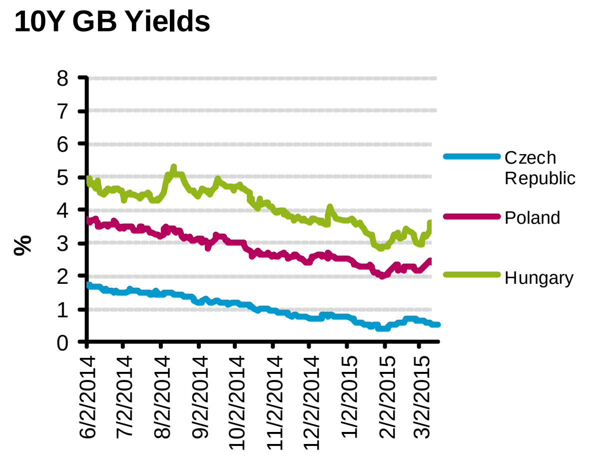
Calendar

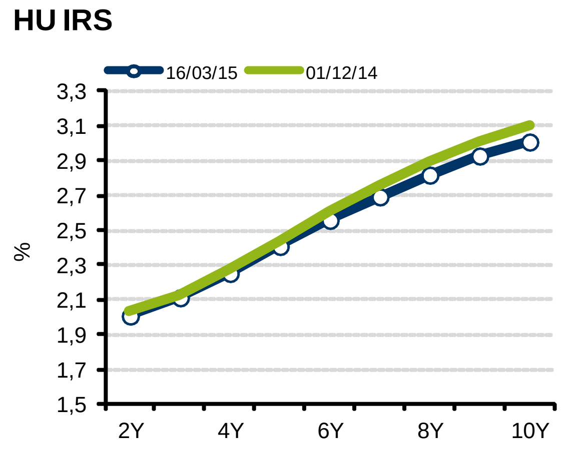
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	03/16/2015	9:00	PPI	%	02/2015	0,2	-3,3	0	-3,5	-1	-3,5
CZ	03/16/2015	10:00	Current account	CZK B	01/2015	30		28		-3,84	
PL	03/16/2015	14:00	Current account	EUR M	01/2015			-920		-1005	
PL	03/16/2015	14:00	Trade balance	EUR M	01/2015			-59		-633	
PL	03/16/2015	14:00	Core CPI	%	02/2015			0	0,5	0	0,5
PL	03/16/2015	15:00	Budget balance	PLN M	02/2015					-580	
PL	03/17/2015	14:00	Wages	%	02/2015			0,9	3,2	-10	3,6
PL	03/18/2015	14:00	Industrial output	%	02/2015			0,6	4,1	-3,1	1,7
PL	03/18/2015	14:00	PPI	%	02/2015			0,1	-2,7	-0,2	-2,9
PL	03/18/2015	14:00	Retail sales	%	02/2015			-0,7	0,2	-22,6	0,1

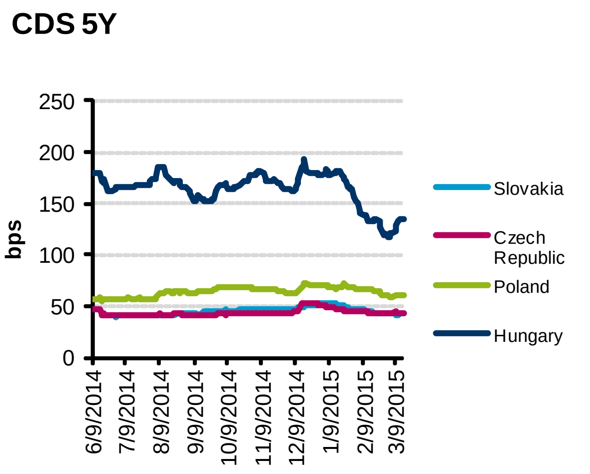
Fixed-income in Charts

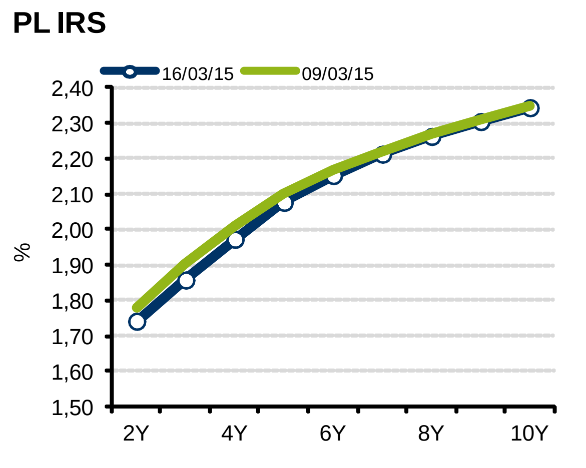












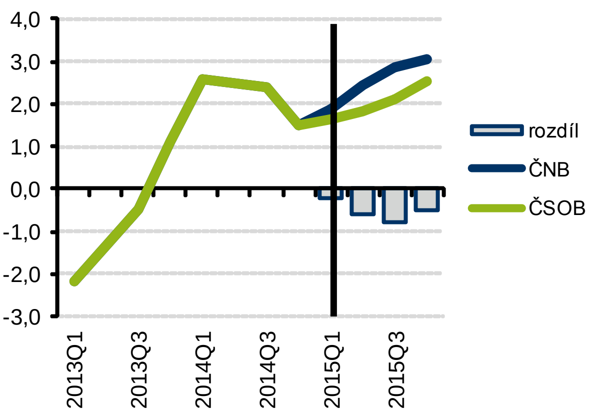
Source: Reuters

Medium-term Views & Issues

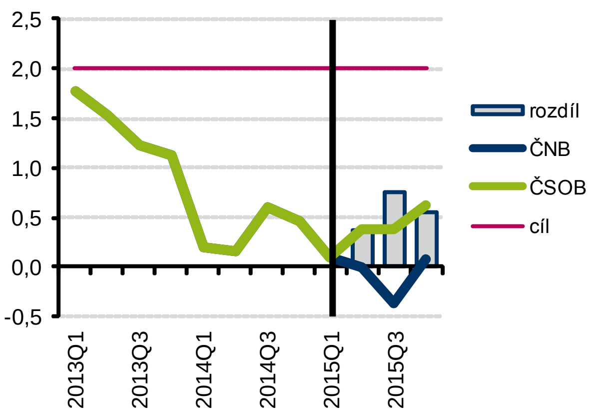
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing of the public sector, which is, however, generating no pressures on the capital market thanks to fairly low debt and reserves. The government policy has not delivered any fundamental economic changes so far, perhaps except for the planned abolition of the pension reform and partial modifications of certain taxes and social security benefits. The issue of euro adoption is still on ice in the CR.	Hungary's economy may slow down, but probably less than previously expected thanks to the improving international environment and the stable and strong domestic demand. So economy may grow around 2.5% y/y in 2015 and now we see rather positive risk in this forecast. We recognized in the last couple of months that exchange rate has very low effect on the inflation, so the NBH cannot easily accelerate the CPI with the depreciation of the currency. We see this year's inflation around 0% Y/Y, but CPI may be around 2% Y/Y in December.	According to the GUS estimates, the Polish economy grew by 3.1% in 2014Q4 and by 3.3% in whole year. As in previous quarters, economic growth was driven mainly by strong domestic demand. Particularly encouraging was a high contribution of investment to economic growth. As for this year, we expect economic growth to slow down slightly below 3%.
Outlook for official & market rates	Interest rates remain at all-time lows and, given the positive inflation outlook, the CNB is unlikely to raise its base rate before 2017. In addition, the central bank will not proceed to such a move before it abandons its current exchange rate policy, which is based on maintaining the exchange rate above the EUR/CZK floor. Moreover, the decreasing inflationary expectations may even delay these two steps. This possibility is reflected by money market rates and, in particular, by IRS and government bond yields. Our outlook for inflation as well as short-term interest rates is still below the central bank's official forecasts.	We think that low inflation can still trigger an easing action in Hungary. The February inflation figure (-1% y/y) confirms our view, that there is no deflation pressure in Hungary, and the strengthening domestic consumption accelerates slightly the inflation. So, based on our forecast the NBH may meet the inflation target of 3% Y/Y +/- 1%pt in 2016. So fundamentally we see no strong argument to start a rate cut cycle recently, but the international sentiment, the ECB's QE policy, Poland's rate cut may push the Council's tone towards 20bp rate cut in March and leaving open the door for further rate cuts to avoid a situation we saw on Polish market after the decision, that the end of the rate cut pushes the currency to stronger levels despite of the bigger cut than expected..	We expect the NBP to keep rates at new lows (1.50%) this year, but we cannot completely rule out the likelihood of further rate cuts. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year's inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected.
Forex Outlook	We believe that within the next few days the Czech koruna may try to test However, The CNB's readiness to defend the EUR/CZK (intervention floor) continues to be strong. In the case of a speculative attack on the intervention floor, we believe the CNB has enough will and power to defend the floor and effectively weaken the koruna again – either through verbal or real intervention against the Czech currency, which might significantly but only temporary weaken.	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.	We expect the zloty to gain on growing capital inflows exploiting the positive interest rate differential at the time short term yields are mostly negative in the eurozone. Given the NBP pledge to end the rate cutting cycle, the market may feel temptation to test the willingness of the central bankers to tolerate further gains of the Polish currency.

CBs' Projections vs. Our Forecasts

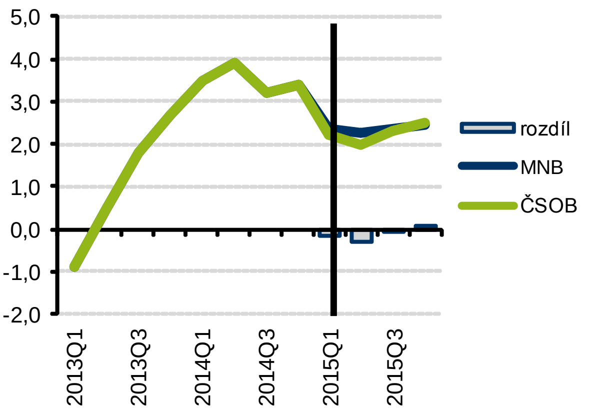
CZ: GDP outlook (Y/Y, %)



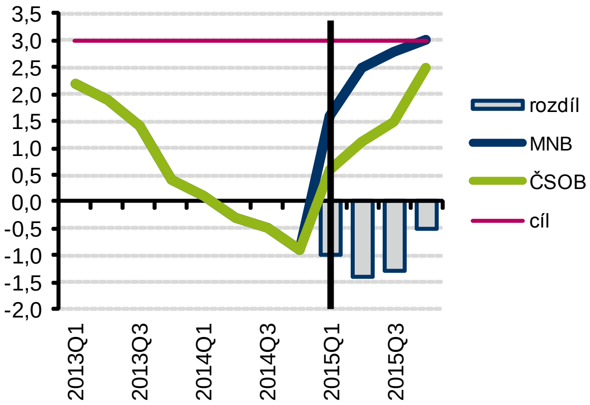
CZ: Inflation outlook (Y/Y, %)



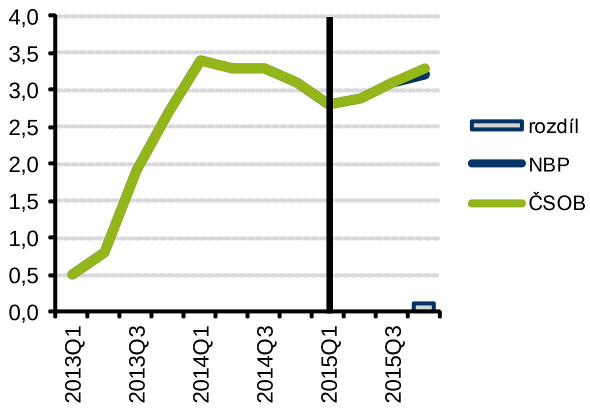
HU: GDP outlook (Y/Y, %)



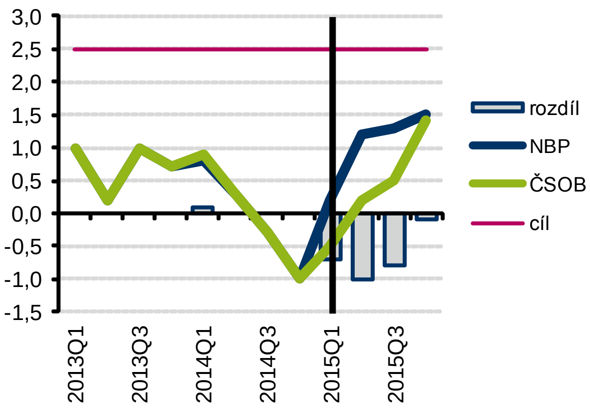
HU: Inflation outlook (Y/Y, %)



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	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	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*	2,10	2,10	2,10	2,10	2,10	-10 bps	7/22/2014
Poland	2W inter. rate	*1,50*	2,50	2,00	1,50	1,50	1,50	-50 bps	3/4/2015

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	PRIBOR	*0,33*	0,34	0,33	0,33	0,32	0,33
Hungary	BUBOR	*2,06*	2,09	2,10	2,10	2,10	2,10
Poland	WIBOR	*1,65*	2,28	2,06	2,00	2,00	2,00

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	CZ10Y	*0,835*	1,22	0,88	0,85	0,90	0,95
Hungary	HU10Y	*3,02*	3,92	3,25	3,50	3,50	3,65
Poland	PL10Y	*2,35*	2,87	2,23	2,20	2,10	2,20

Exchange rates (end of the period)

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	EUR/CZK	*27,3*	27,5	27,7	27,2	27,5	27,8
Hungary	EUR/HUF	*305*	311	316	315	315	318
Poland	EUR/PLN	*4,14*	4,18	4,28	4,25	4,22	4,20

GDP (y/y)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	2,6	2,5	2,4	1,5	1,7	1,8	2,1
Hungary	3,5	3,9	3,2	3,4	2,2	2,0	2,3
Poland	3,4	3,3	3,3	3,1	2,8	2,9	3,1

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

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	0,2	0,0	0,7	0,1	0,1	0,5	0,4
Hungary	0,1	-0,3	-0,5	-0,9	0,6	1,1	1,5
Poland	0,9	0,3	-0,3	-1,0	-0,5	0,2	0,5

Current Account

	2014	2015
Czech Rep.	0,3	1,8
Hungary	2,2	2,5
Poland	-2,5	-2,5

Public finance balance as % of GDP

	2014	2015
Czech Rep.	-2,0	-2,4
Hungary	-3,0	-3,0
Poland	-3,5	-3,0

Source: CSOB, Bloomberg

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