Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 30 March 2015

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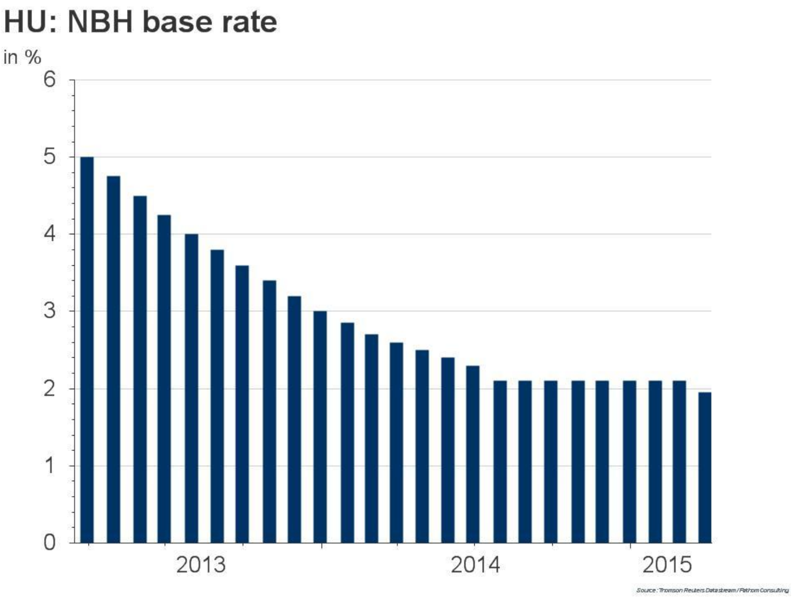
Weekly Highlights:

- NBH eases just gently, the EUR/HUF slips below 300
- CNB threatens to raise intervention floor for EUR/CZK and koruna temporary eases

Chart of the Week: NBH base rate



The NBH cut its base rates to fresh all-time lows.

Market's editorial

While the NBH cuts less-than-expected,...

The National Bank of Hungary cuts its base rate by 15 bps from 2.1% to 1.95%. The market consensus was a bit wider a 20bps cut, though the expectations were divided between 10bp and 20bp. Thus, the 15bps easing was a small surprise. The HUF reacted on the decision with strengthening and the EUR/HUF pair broke through 300 barrier.

The MPC confirmed the 3% inflation target (next decision will be in three years), but it introduced again the +/-1%-point tolerance band around the inflation target. This change gives the Council a bigger manoeuvring room. The inflation forecast was revised downside both for 2015 and 2016. The former from 0.9% Y/Y to 0% Y/Y, while the latter from 2.9% Y/Y to 2.6% Y/Y. The GDP outlook was increased from 2.3% Y/Y to 3.2% Y/Y in 2015 and from 2.1% Y/Y to 2.5% Y/Y in 2016. The inflation forecast of the NBH is nearly in line with our own expectations.

The main message of the statement is the inflationary pressure may remain moderate in the following months and the risk of second round effect of low oil price has increased, so it allows loose monetary conditions for an extended period.

Although the international sentiment is favourable, the risk premium of Hungary has decreased and the HUF strengthened against EUR, the council wants to continue with a cautious monetary policy because of the uncertain international market environment.

The council sees upside and downside risks as well. On the upside is an increasing required risk premium from Hungary and a possible HUF weakening because of the geopolitical risks, which would call for tighter monetary conditions, while on the downside is the second round effect of low oil price, the inflation expectations might move away from the target, resulting in a significantly lower path for nominal wage growth. It could lead to looser monetary policy. The statement was finished with the following sentence: "Cautious easing of monetary conditions may continue as long as it supports the achievement of the medium-term inflation target."

It confirms our view that mainly the international environment may lead the next months' decisions, and the council may move with 10bp steps in the following months. We see relatively high chance for cuts in April and May, so the base rate might be moderated to 1.75% at the end of May.

...the CNB threatens to raise floor for the EUR/CZK pair

Contrary to the NBH, an outcome of CNB's Bank Board surprised on the dovish side. We consider it another verbal intervention from CNB officials, which provoked depreciation of the Czech currency by tens of hellers this time. To be more specific - the koruna lost in response to Governor Singer's statement that risks of its weakening due to a shift of the exchange rate floor had increased since the last meeting. The statement acted as a red rag in front of the eyes of President Zeman, who did not let markets wait long for his deprecatory reaction, owing to which the koruna wiped out part of its losses.

The crucial problem now is, whether a hike of intervention floor is reasonable to expect in a foreseeable future? In our view, this scenario is unlikely for a couple of reasons.

First, the Czech economy is not in bad need a weaker exchange rate. Although CNB's optimistic bets on a rapid wage growth will not be fulfilled, other data from the beginning of 2015 look quite optimistic, including consumer inflation – core inflation ex-fuel prices has grown to its maximum since December 2008

Secondly, while the koruna has strengthened against the euro in recent weeks, the turbulent euro-dollar development means that it has significantly weakened against the US dollar as well as against other currencies pegged to the USD. In other words, the effective koruna exchange rate (reflecting currency composition of the Czech foreign trade basket) has been moving in the opposite direction to the EUR/CZK in recent months, i.e., it has been weakening.

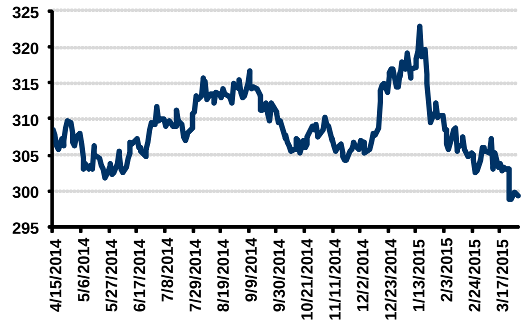
Thirdly, if the CNB significantly weakens the EUR/CZK exchange rate, it will further complicate its exit from the intervention regime. Fourthly and finally, we must not forget how (negatively) targeted weakening was adopted by the Czech public. Popular mood has been consistent with President's disapproval of koruna devaluation. And President Zeman should appoint four new members to the seven-membered CNB Board, including the new Governor, as early as next year...

To sum up, we believe the depreciation of EUR/CZK floor is unlikely for now. This would require deterioration of currently positive economic outlook. On the other hand the, the more aggressive verbal interventions may keep the Czech koruna on the defensive for a while. Hence it is probable that the pair forgets about testing the 27 EUR/CZK for now. Fundamentally, the Czech currency should be more sensitive to readings of major Czech macroeconomic indicators – inflation, wages, industry and, of course, GDP. The koruna may get more nervous ahead of May's CNB Board meeting, where a new inflation forecast will be submitted. Last, but not least we continue to believe the dovish CNB together with ECBs QE may keep the Czech yields and rates near zero or even in a negative territory (short end of the Czech bond curve, swap curve should stay above the repo rate).

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*27.5*	*0.26%*	↘	↘
EUR/HUF	*300*	*-1.25%*	↗	↗
EUR/PLN	*4.09*	*-0.39%*	↗	↗

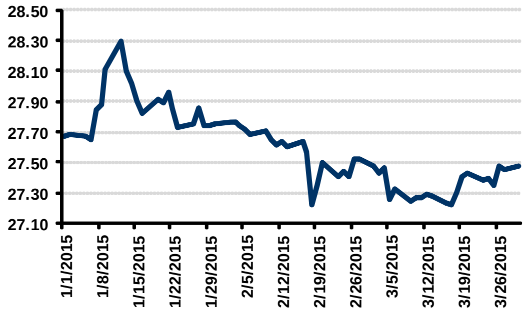
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*0.66*	*0.76*	↗	↗
10Y HUF	*2.70*	*-6.09*	↗	↗
10Y PLN	*2.13*	*0.24*	↗	↗

EUR/HUF



EUR/HUF, last 250 days. Source: Reuters

EUR/CZK



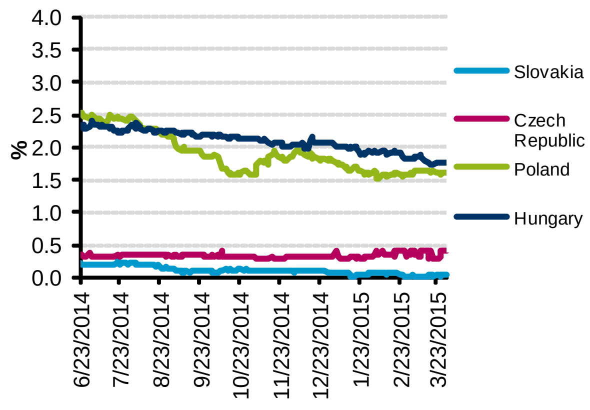
EUR/CZK, last 63 days. Source: Reuters

Calendar

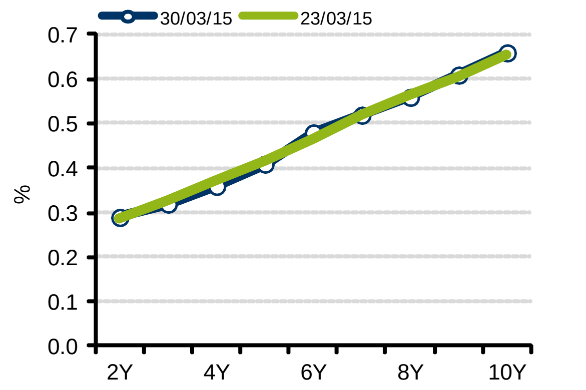
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	03/31/2015	9:00	GDP	%	4Q/2014 *F					0.4	1.5
HU	03/31/2015	9:00	PPI	%	02/2015					-0.4	-1
CZ	03/31/2015	10:00	Money supply M2	%	02/2015						4.9
PL	03/31/2015	14:00	Current account	EUR M	4Q/2014			-1332		-1777	
PL	04/01/2015	9:00	PMI manufacturing		03/2015			55.3		55.1	
HU	04/01/2015	9:00	Trade balance	EUR M	01/2015 *F					691	
HU	04/01/2015	9:00	PMI manufacturing		03/2015					54.9	
CZ	04/01/2015	9:30	PMI manufacturing		03/2015			56.5		55.6	
CZ	04/01/2015	14:00	Budget balance	CZK B	03/2015					22.6	
CZ	04/03/2015	9:00	Retail sales	%	02/2015		5		6.2		6.4

Fixed-income in Charts

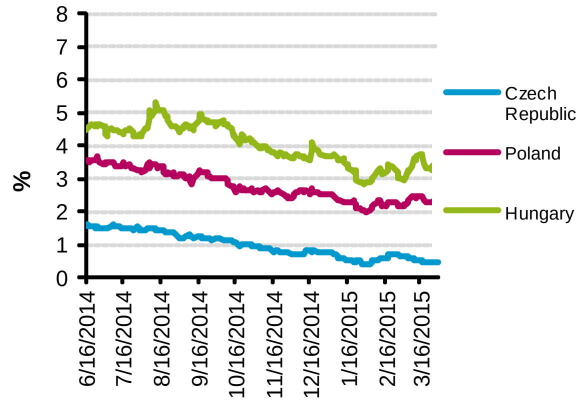
FRA 3x6



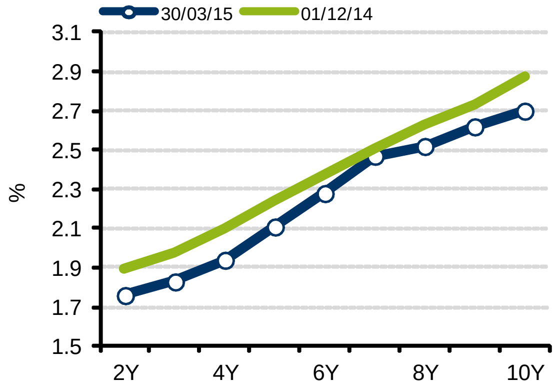
CZ IRS



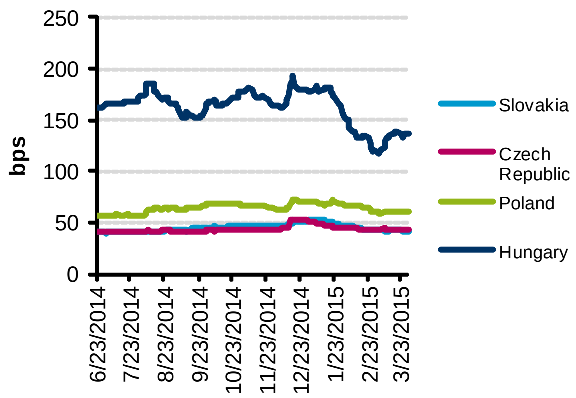
10Y GB Yields



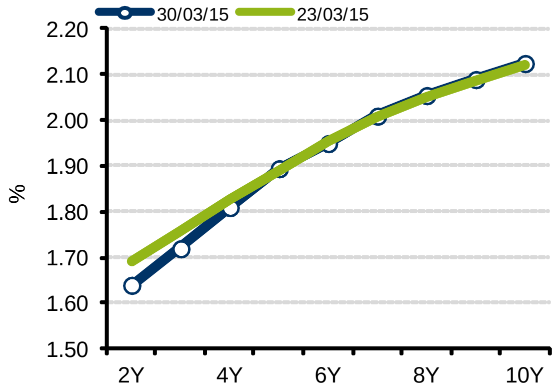
HU IRS



CDS 5Y



PL IRS



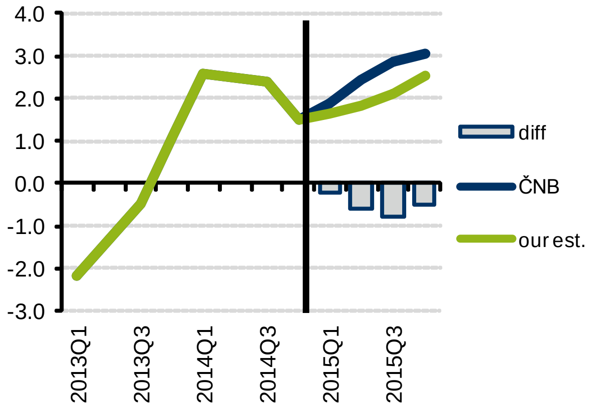
Source: Reuters

Medium-term Views & Issues

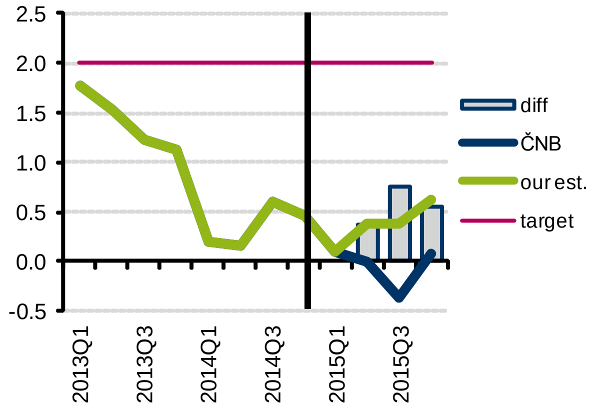
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing 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.	The march rate cut form the NBH (by 15 bps) confirms our view that mainly the international environment may lead the next months' decisions, and the council may move with 10bp steps in the following months. We see relatively high chance for cuts in April and May, so the base rate might be moderated to 1.75% at the end of May.	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 a hike of EUR/CZK floor is still unlikely.. This would require deterioration of currently positive economic outlook. On the other hand the, the more aggressive verbal interventions may keep the Czech koruna on the defensive for a while. Hence it is probable that the pair forgets about testing the 27 EUR/CZK for now. Fundamentally, the Czech currency should be more sensitive to readings of major Czech macroeconomic indicators – inflation, wages, industry and, of course, GDP. The koruna may get more nervous ahead of May's CNB Board meeting, where a new inflation forecast will be submitted.	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

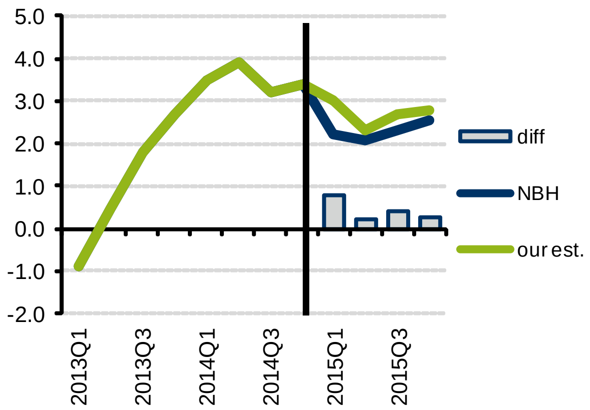
CZ: GDP outlook (Y/Y, %)



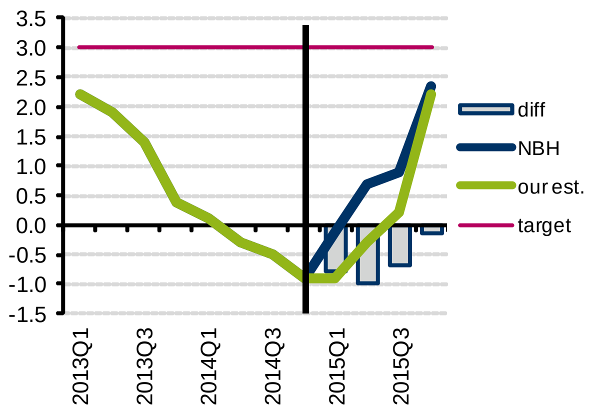
CZ: Inflation outlook (Y/Y, %)



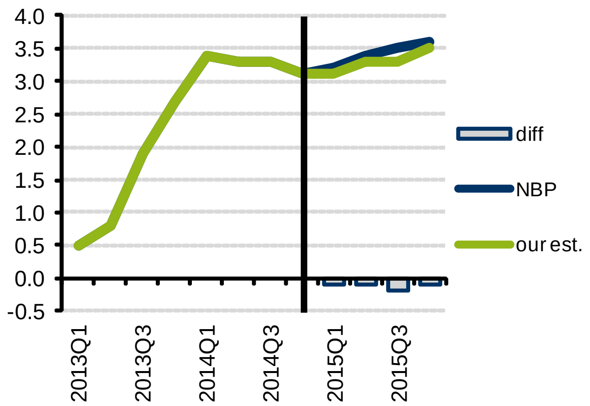
HU: GDP outlook (Y/Y, %)



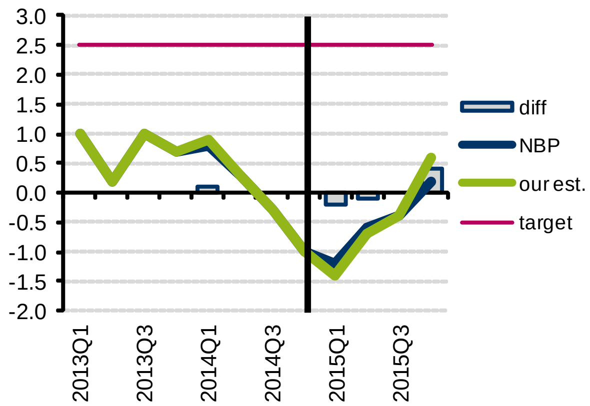
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, KBC

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	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.	*1.95*	2.00	1.70	1.70	2.00	2.25	-10 bps	3/24/2015
Poland	2W inter. rate	*1.50*	1.50	1.50	1.50	1.50	1.50	-50 bps	3/4/2015

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	PRIBOR	*0.31*	0.33	0.32	0.33	0.33	0.33
Hungary	BUBOR	*1.90*	1.90	1.70	1.70	2.10	2.40
Poland	WIBOR	*1.65*	1.60	1.55	1.60	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*0.66*	0.85	0.90	0.95	1.10	1.15
Hungary	HU10Y	*2.70*	3.00	3.20	3.40	3.60	3.80
Poland	PL10Y	*2.13*	2.20	2.10	2.20	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.48*	27.20	27.50	27.80	27.50	27.50
Hungary	EUR/HUF	*300*	305	310	317	315	310
Poland	EUR/PLN	*4.09*	4.18	4.18	4.10	4.10	4.05

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.5	1.7	1.8	2.1	2.5	2.5
Hungary	3.2	3.4	3.0	2.3	2.7	2.8	2.2
Poland	3.3	3.1	3.1	3.3	3.3	3.5	3.5

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

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	0.7	0.1	0.1	0.5	0.4	0.9	1.0
Hungary	-0.5	-0.9	-0.9	-0.3	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.4	-0.7	-0.4	0.6	1.5

Current Account

	2015	2016
Czech Rep.	1.8	1.7
Hungary	4.0	3.8
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-2.4	-2.3
Hungary	-2.2	-2.0
Poland	-3.0	-2.5

Source: KBC, 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	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
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
Budapest Research			
David Nemeth	+36 1 328 9989	Budapest	+36 1 328 99 85