Written by ČSOB Prague and K&H Budapest

# Central European Weekly

**Monday, 04 April 2016**

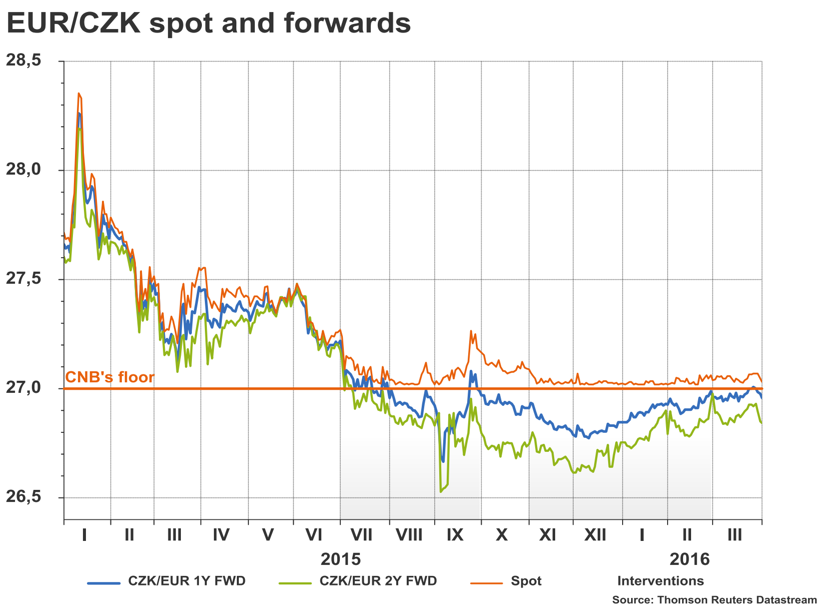
Table of contents



## Weekly Highlights:

- CNB only discussed but did not vote on negative rates
- NBH will not be afraid of forint's weakness and it will ease its policy further
- In 2015 Czech Republic's public finance recorded best results ever
- Weekly preview: watch NBP's meeting and Hungary's inflation for March

## Chart of the Week: EURCZK forwards




*EUR/CZK spot and forwards turned south after the CNB meeting as the Bank board left official rates unchanged.*

# Market's editorial

## CNB only discussed but did not vote on negative rates

At its second monetary meeting of this year, the CNB Board decided to leave rates unchanged and, as expected, did not even vote on putting negative interest rates in place. While a lengthy discussion on negative rates is said to have taken place, it did so in an economic context rather than at implementation level. The CNB Board also confirmed its exchange rate commitment and, in addition to reiterating 2017 as the earliest possible year for discontinuing its exchange rate policy, indicated that releasing the koruna was "nearer to mid-2017". Before this meeting, the discontinuation had been expected anytime during the first half of 2017, whereas now the discontinuation date has effectively narrowed to May (when another new forecast will be available, by the way). This is also the date we currently see as the most likely.

Naturally, all of this is true on condition that the economy – and notably inflation – develops more or less in line with the forecast. This means that the inflation target will be hit at the very beginning of next year, and inflation will stabilise just above this target afterwards. This is probably the greatest weakness of the outlook, as we believe that inflation may not necessarily be so willing to approach the target. One thing in the current CNB's forecast that could still be argued about is the rapid rise in short-term market interest rates. Accumulating the discontinuation of the exchange rate policy and concurrently a repo rate hike into a fairly short period – when the threat of negative rates is still hanging in the air – is quite courageous. We cannot at all rule out that the CNB will want to facilitate the discontinuation of its exchange rate policy with negative rates in order to curb the koruna. This possible strategy undermines the expectations of the forecast for 2017 even more. Therefore, we still do not expect the CNB to raise rates in 2017 at all.

The following conclusions can be drawn from Thursday's CNB Board meeting: 1) the koruna will be subject to the existing exchange rate policy for at least one more year, 2) the threat of negative rates is not gone and their likelihood remains the same as prior to the meeting (approximately 40%), 3) CNB Board members significantly different from those currently in office may gradually vote on discontinuing the exchange rate policy and on the future direction of the monetary policy (two members will see their term expire in July, and two in February), and finally 4) **the risk of a prolongation of monetary expansion (i.e., another postponement of the exit date from the current FX targeting regime in the Czech Republic is certainly not negligible.**

## Lorem ipsum dolor sit amet

As a consequence of the surprise rate cut of the National Bank of Hungary last week, the base rate expectations were modified substantially during last days. The most extremes forecast base rate at around 0.5%, while the median is now around 0.9% as the end of the recent rate cut cycle. Last time the NBH moderated to base rate in five steps from 2.1% to 1.35%, which means 75bp cut. The same speed and size would mean 60bp base rate at the end of July, so the extremist see bigger room for monetary easing than a year ago. A huge difference compared to previous year the exchange rate. At that time EUR/HUF was traded below 305 and also below 300, and only at the end of the cycle reached it today's levels. Additionally the FED didn't start the rate hike cycle, while even two rate hikes might be delivered this year. So we rather believe in a slightly smaller cutting cycle this time to around 0.8%.

The other question how sensitive the NBH is on a weak exchange rate? Is there any circumstance, which stops immediately the cutting cycle? At the moment it looks like that NBH is substantially less sensitive in that direction. Its profitability is highly depends on the short interest rate and the exchange rate level, additionally the headline inflation is on a decreasing trend. Also the household buying of government bond is booming, so the dependence on foreign funding is moderating. **As the country is substantially less sensitive on weak exchange rate (HUF) than even two years ago, a temporary weakening of the forint (EUR/HUF above 320) would rather welcomed by the NBH, which might be used for FX intervention. So we see no real threat in short term, which might stop the rate cut cycle in the next two months.**

| | Last | Change 1W |
|---|---|---|
| EUR/CZK | 27.1 | -0.34% |
| EUR/HUF | 314 | 0.00% |
| EUR/PLN | 4.24 | -0.39% |

| | Last | Change 1W |
|---|---|---|
| 10Y CZK | 0.61 | -6.15 |
| 10Y HUF | 2.03 | 2.47 |
| 10Y PLN | 2.21 | -2.32 |

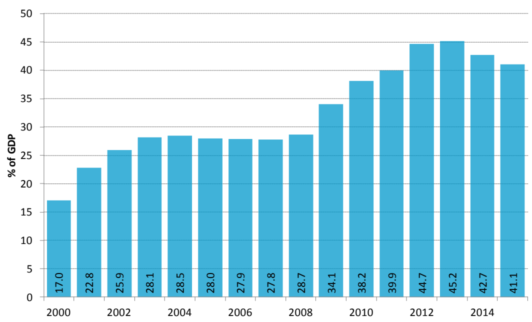
# Review of Economic Figures

## The Czech Republic's best public finance figure ever

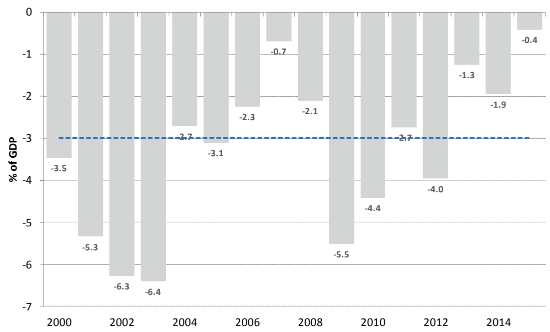
According to data released by the Statistical Office, the Czech Republic's public deficit was only 0.4% of GDP in 2015. This is the best figure ever since the reporting of these data began, i.e., since 1995. By contrast, the 2014 deficit was 2%.

The main contributor to the significant improvement of the public finances was the central government, whose deficit was much lower than in 2014. This was enabled in particular by surprisingly strong economic growth, which led to higher revenues from taxes and social security contributions on the one hand, and by the cash inflow from EU Funds on the other.

**General government debt**




**General government deficit**



# Weekly preview

WED 14:00 NBP rate (in %)

| | This | Last change |
|---|---|---|
| rate level | 1.50 | 3/2015 |
| change in bps | 0 | -50 |

## PL: MPC on hold, but with dovish comments

We believe that the rate cut by the National Bank of Hungary, the fact that Poland's inflation remains in negative territory, and the appreciation of the zloty have put serious rate cut considerations back onto the agenda in Poland. Nevertheless, our opinion is that the Monetary Policy Council (MPC) will not proceed to such a move this time, but its comment may suggest that the MPC is starting to consider this. April may see further dovish comments, which will send a clearer signal to the market as to whether the National Bank of Poland (NBP) may cut rates in early May.

THU 9:00 CZ Industry (y/y change in %)

| | Feb-16 | Jan-16 | Feb-15 |
|---|---|---|---|
| Monhtly | 4.5 | 1.0 | 4.9 |
| cummulative (YTD) | 2.8 | 1.0 | 3.8 |

## CZ: Industry still on the rise

We believe that the positive trend of domestic industry persisted in February. Industrial growth has been primarily based on the manufacturing industry, in particular the production of cars and metal products. Conversely, a decline can be expected in the energy sector and the mining industry. February's data as a whole will also be influenced by a greater number of business days in the month, which will increase the figures by approximately 2%. New orders, which may grow slightly on the strength of foreign demand, will continue to hold the spotlight.

THU 9:00 CZ Retail Sales (change in %)

| | Feb-16 | Jan-16 | Feb-15 |
|---|---|---|---|
| Sales | 6.7 | 5.5 | 7.9 |
| cummulative (YTD) | 6.1 | 5.5 | 7.4 |
| Sales (cars excl.) | 6.1 | 4.4 | 6.4 |
| cummulative (YTD) | 5.2 | 4.4 | 6.1 |

## CZ: Consumers drive retail sales upwards

We believe that real retail sales continued to grow rapidly in February. We anticipate sales increases in all retail segments, in particular the automotive one. In any event, however, e-commerce is very likely to show huge growth and we also expect fuel sales to be solid. Consumer demand remains strong – thanks to the improved financial position of households and the upbeat mood among consumers. Household consumption will be the primary driver of the Czech Republic's economic growth this year, and this will certainly continue to have a positive effect on retailer earnings.

## CZ: CNB reduced its forex activity in March

Although the Czech National Bank's FX reserves most likely continued to grow in March, this was probably not a result of the central bank's interventions against the strengthening of the koruna. Given the development of the exchange rate of the koruna, which was not very close to CZK 27 per EUR this time, and in view of the liquidity trend in the financial sector, we can assume that the CNB may have put its interventions on ice for a month. After all, the negligible willingness to put negative interest rates in place suggests that the forex market situation has calmed down over the past month.

FRI 9:00 HU Inflation (change in %)

| | Mar-16 | Feb-15 | Mar-15 |
|---|---|---|---|
| CPI y/y | 0.2 | 0.3 | -0.6 |

## HU: CNB reduced its activity in March

Consumer price index might moderate slightly in March to 0.2% Y/Y (from 0.3% Y/Y in February) due to the base effect and the low fuel prices. The main question is that what happens with the core inflation, which stuck around 1.5% Y/Y in the last couple of months. We expect that he relatively strong domestic demand may slowly push up the core CPI, but the headline consumer price index may move on the opposite direction in the following months and may return into negative territory temporary in May. We see year-end CPI at around 2% YoY, while the average inflation may be around 0.5% Y/Y in 2016.

| FRI 9:00 | CZ Unemployment Rate (in %) | | |
|---|---|---|---|
| | **Mar-16** | Feb-16 | Mar-15 |
| Rate | **6.1** | 6.3 | 7.2 |
| | **115** | 115 | 69 |

## CZ: Unemployment still recedes

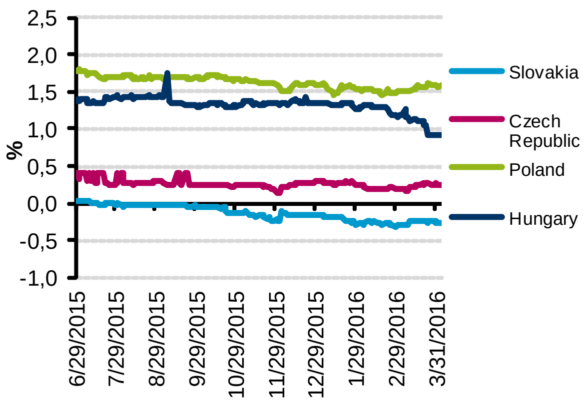
After February's fall in unemployment to 6.3%, we anticipate another decrease – to 6.1% this time. The launch of seasonal jobs will help reduce the number of unemployed to a greater extent this time and, just as in the last three years, another contributor to the unemployment reduction will be solid economic growth generating new jobs, the number of which will again be close to 115,000. Unemployment should continue to fall in the months to come – to less than 5.5% - with the unemployment rate not approaching 6% before late this year.

# Calendar

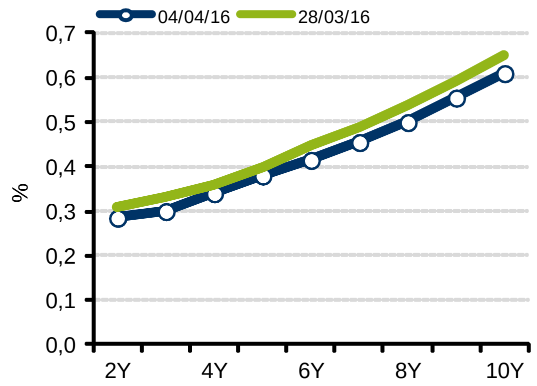
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 04/05/2016 | 9:00 | Retail sales | % | 02/2016 | | | | 4 | | 2.1 |
| CZ | 04/06/2016 | 9:00 | Trade balance (national) | CZK B | 02/2016 | 19.8 | | 19.7 | | 19.3 | |
| HU | 04/06/2016 | 9:00 | Industrial output | % | 02/2016 | | | 3.5 | 5.3 | -0.1 | 2.2 |
| PL | 04/06/2016 | 14:00 | NBP meeting | % | 04/2016 | 1.5 | | 1.5 | | 1.5 | |
| CZ | 04/07/2016 | 0:00 | Earnings VIG | CZK | 4Q/2015 | | | | | | |
| CZ | 04/07/2016 | 9:00 | Construction output | % | 02/2016 | | | | | | -10.4 |
| CZ | 04/07/2016 | 9:00 | Industrial output | % | 02/2016 | | 4.5 | | 5.3 | | 1 |
| CZ | 04/07/2016 | 9:00 | Retail sales | % | 02/2016 | | 6.7 | | 8 | | 5.5 |
| HU | 04/07/2016 | 16:00 | Budget balance | HUF B | 03/2016 | | | | | 14.8 | |
| CZ | 04/08/2016 | 9:00 | Unemployment rate | % | 03/2016 | 6.1 | | 6.1 | | 6.3 | |
| HU | 04/08/2016 | 9:00 | CPI | % | 03/2016 | | 0.2 | 0.4 | 0.1 | -0.1 | 0.3 |
| HU | 04/08/2016 | 9:00 | Trade balance | EUR M | 02/2016 *P | | | 945 | | 530 | |

# Fixed-income in Charts

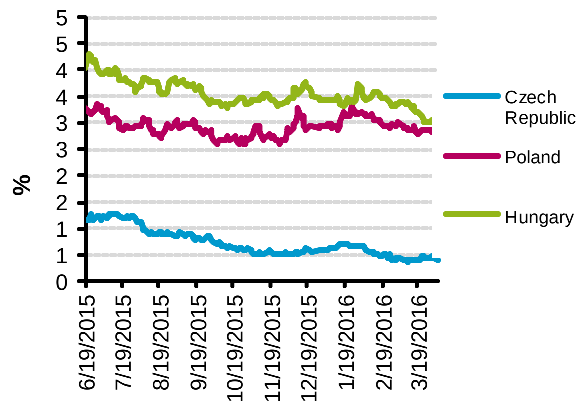
## FRA 3x6



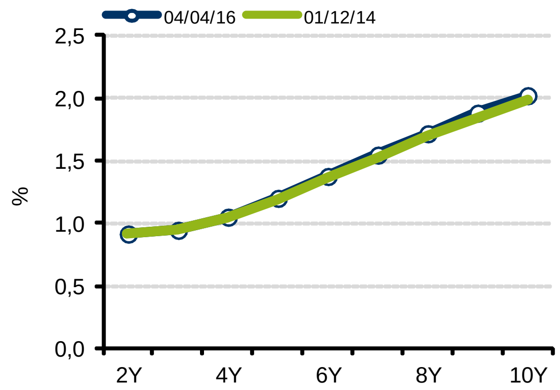

## CZ IRS



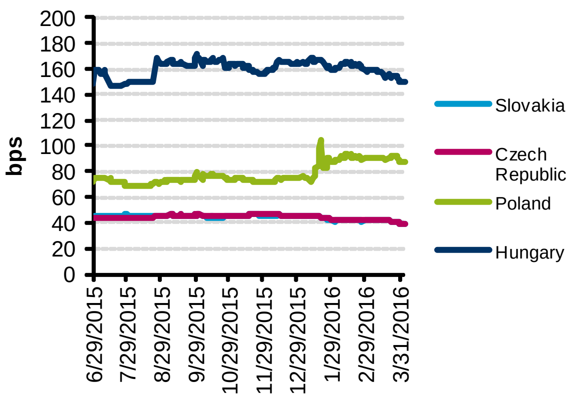

## 10Y GB Yields



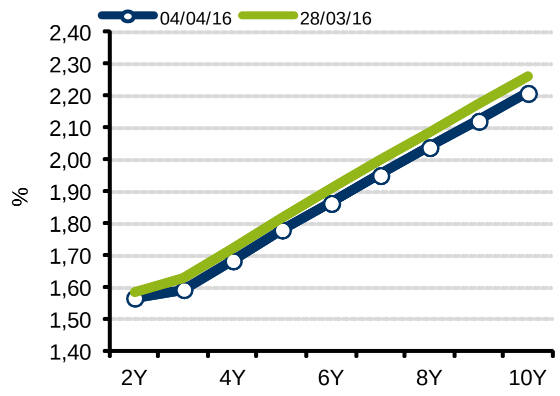

## HU IRS




## CDS 5Y




## PL IRS



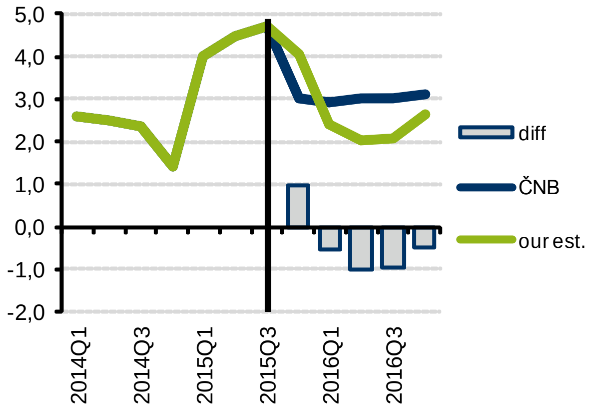

Source: Reuters

# Medium-term Views & Issues

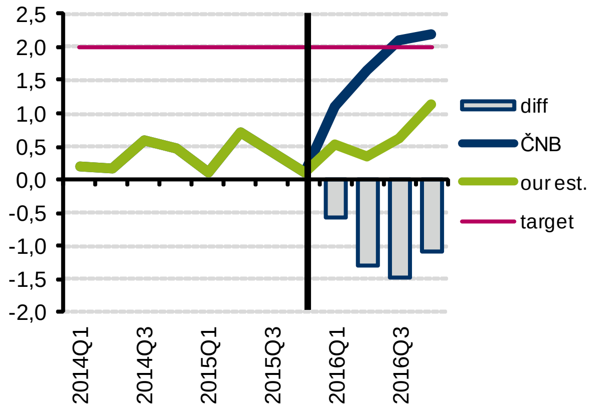
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – encouraged by growing real wages and employment – becoming a strong stimulus. At the moment, we cannot expect any fundamental economic changes or reforms, except for the abolition of the pension reform and the introduction of the electronic registration of sales. Progress in the country's preparations for joining the euro area is not expected in this electoral term either. | The 4Q15 GDP growth might bounce back closer to 3% Y/Y, as EU funds money use was accelerated, the government increased the spending and the industrial production and domestic consumption might be stronger, so the growth might be around 2.7% Y/Y in 2015. The outlook is less favorable. The investments started to fall, the EU funds money use may substantially lower in this year due to the new budgetary period. The government tries to boost the construction via new government program, which targets new homes for households. The domestic consumption may remain strong thanks to the increasing wage mass. In case there is no substantial slowdown of international growth and the agriculture provides an average harvest, the economic growth might be around 2.3% Y/Y in 2016. | Prospects of the Polish economy remain good in our view. For the whole year 2016 we expect GDP growth may reach 3.5 - 4.0 percent. Apart from low interest rates (further cuts cannot be excluded) and a relatively weak zloty, we expect the economy to draw additional support from policy measures of the new government (stimuli for private consumption). The risks thus stem mainly from a possible deterioration in the external environment, most notably in China, Russia and other emerging markets. |
| Outlook for official & market rates | The latest forecast does not envisage the return of inflation to the target before early 2017, with inflation not significantly diverging from it afterwards either. The CNB has extended its exchange rate commitment until the first half of 2017. The possibility of introducing negative interest rates has been increasing, in light of the widening of the interest rate differential vis-à-vis the euro area and developments in domestic financial markets. But we still don't expect negative CNB's rates. There are two main preconditions for negative official rates: 1) significant ECB's rate cut, 2) continuing large monthly fx interventions of the CNB. | The last NBH statement and Mr. Nagy's words full fit into our expectation. The NBH may cut the overnight deposit rate to zero or to -0.1% in March from the current level of 0.1%. The NBH also tries to push down the Bubor rates (the loans are priced with the Bubor), because they said the real rates on the secondary market are below the official Bubor levels. As concerns the base rate – a rate cut is unlikely in Mach or April. Our view that NBH may cut the key rate after Hungary is over of the heavy refinancing need of government debt in the first 5 months this year, and in case Hungary is upgrade in May or June and additionally the EUR/HUF is traded around or below 305. | We expect the NBP to keep rates at new lows (1.50%) this year, but we think that a risk for of further rate cuts have increased. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and ongoing deflation coupled with stronger currency (PLN). Hence, should the zloty remains strong there will be a window of opportunity for the NBP to ease its policy in the second quarter of this year. |
| Forex Outlook | Relatively strong economic growth, current and capital account surpluses and ongoing QE in the euro zone have been the key factors behind the recent strength of the koruna. With regard to the inflation outlook and ECB's policy, we anticipate an exit from the fx regime in the first quarter of 2017. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Current turmoil on the Chinese market poses negative risks for the Central Europe. We however think the impact on the koruna should only be limited. | We think that the NBH's commitment to the long time low interest rate may lead to short-term HUF weakening. Although compared to other emerging markets HUF looks like quite stable, the fears of Chinese hard lending scenario pushed EURHUF trading range between 313 and 318. Although the huge trade and current account balance supports HUF in medium term, the ongoing foreign sell-off of HUF denominated gov. bonds and the uncertain sentiment keeps weakening pressure on HUF, so we see bigger risk on the weak side on short term, which means that EURHUF may be pushed towards 325. | We think that zloty's sell-off related to markets' fears coming from appointment of new members of the Monetary Policy Council (MPC) is over now. Nevertheless, while domestic fundamentals should be relatively supportive for the zloty, the currency should be mostly driven by sentiment in emerging markets and the ECB or the Fed policy actions respectively. |

# CBs' Projections vs. Our Forecasts

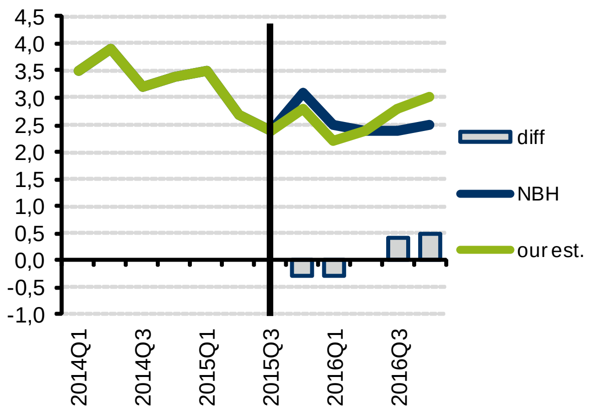
**CZ: GDP outlook** (Y/Y, %)



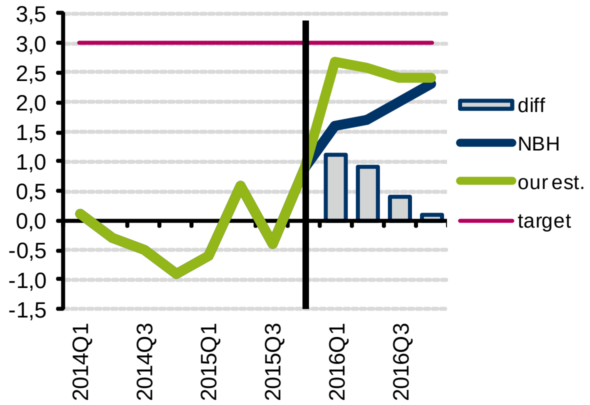

**CZ: Inflation outlook** (Y/Y, %)



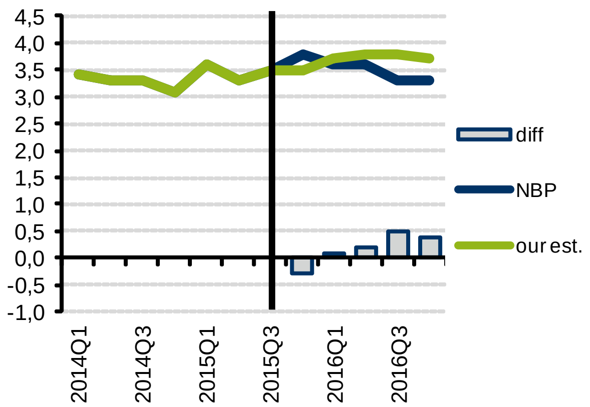

**HU: GDP outlook** (Y/Y, %)



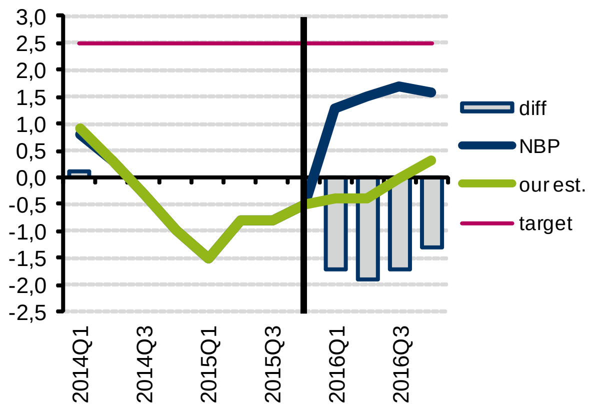

**HU: Inflation outlook** (Y/Y, %)




**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 | 2015Q4 | 2016Q1 | 2016Q2 | 2016Q3 | 2016Q4 | 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. | *1.35* | 1.35 | 2.25 | 2.50 | 2.75 | 3.00 | -10 bps | 7/21/2015 |
| **Poland** | 2W inter. rate | *1.50* | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | -50 bps | 3/5/2015 |

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

| | | Current | 2015Q4 | 2016Q1 | 2016Q2 | 2016Q3 | 2016Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | PRIBOR | *0.00* | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| **Hungary** | BUBOR | *1.20* | 1.35 | 2.40 | 2.60 | 2.90 | 3.10 |
| **Poland** | WIBOR | *1.67* | 1.72 | 1.65 | 1.65 | 1.65 | 1.65 |

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

| | | Current | 2015Q4 | 2016Q1 | 2016Q2 | 2016Q3 | 2016Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | CZ10Y | *0.61* | 1.01 | 0.60 | 0.73 | 0.87 | 1.00 |
| **Hungary** | HU10Y | *2.03* | 2.91 | 3.80 | 4.00 | 4.20 | 4.40 |
| **Poland** | PL10Y | *2.21* | 2.47 | 2.50 | 2.50 | 2.60 | 2.75 |

*Exchange rates (end of the period)*

| | | Current | 2015Q4 | 2016Q1 | 2016Q2 | 2016Q3 | 2016Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | EUR/CZK | *27.04* | 27.03 | 27.02 | 27.02 | 27.02 | 27.02 |
| **Hungary** | EUR/HUF | *313* | 316 | 310 | 308 | 305 | 300 |
| **Poland** | EUR/PLN | *4.24* | 4.27 | 4.40 | 4.30 | 4.26 | 4.25 |

*GDP (y/y)*

| | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 | 2016Q2 | 2016Q3 | 2016Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | 4.5 | 4.7 | 4.0 | 2.4 | 2.0 | 2.1 | 2.6 |
| **Hungary** | 2.7 | 2.4 | 2.8 | 2.2 | 2.4 | 2.8 | 3.0 |
| **Poland** | 3.3 | 3.5 | 3.5 | 3.7 | 3.8 | 3.8 | 3.7 |

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

| | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 | 2016Q2 | 2016Q3 | 2016Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | 0.8 | 0.4 | 0.1 | 0.6 | 0.5 | 0.7 | 1.4 |
| **Hungary** | 0.6 | -0.4 | 0.9 | 2.7 | 2.6 | 2.4 | 2.4 |
| **Poland** | -0.8 | -0.8 | -0.5 | -0.4 | -0.4 | 0.0 | 0.3 |

*Current Account*

| | 2015 | 2016 |
|---|---|---|
| **Czech Rep.** | 1.7 | 1.6 |
| **Hungary** | 6.0 | 5.1 |
| **Poland** | -1.2 | -1.5 |

*Public finance balance as % of GDP*

| | 2015 | 2016 |
|---|---|---|
| **Czech Rep.** | -1.4 | -1.3 |
| **Hungary** | -2.3 | -2.0 |
| **Poland** | -3.0 | -2.9 |

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 |

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

This non-exhaustive information is based on short-term forecasts for expected developments on the financial markets. KBC Bank cannot guarantee that these forecasts will materialize and cannot be held liable in any way for direct or consequential loss arising from any use of this document or its content. The document is not intended as personalized investment advice and does not constitute a recommendation to buy, sell or hold investments described herein. Although information has been obtained from and is based upon sources KBC believes to be reliable, KBC does not guarantee the accuracy of this information, which may be incomplete or condensed. All opinions and estimates constitute a KBC judgment as of the data of the report and are subject to change without notice.