Written by ČSOB Prague and K&H Budapest

Central European Weekly

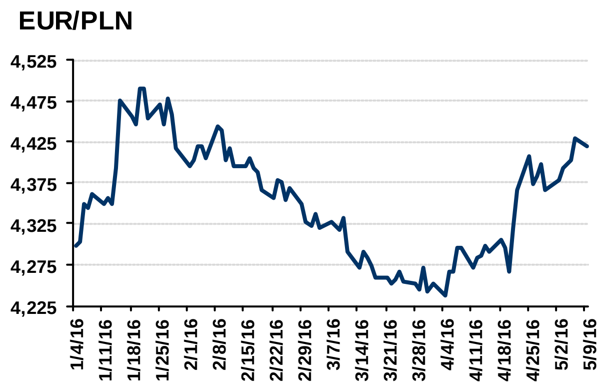
Monday, 09 May 2016

Table of contents

Weekly Highlights:

- Czech and Polish central bankers keep their neutral policy bias
- Czech and Hungarian industrial performance disappoints in March
- In Focus: regional leading indicators look weaker
- Weekly preview: watch low inflation readings in the Czech republic and Hungary plus Moody's in Poland

Chart of the Week: PLN eyes another downgrade?



The zloty nervously eyes Moody's rating decision as the S&P's downgrade caused a huge EUR/PLN spike in January.

Central Banks and Markets

The CNB 'threatens' to weaken the koruna, nobody cares

The outcome of Thursday's CNB Board meeting can be summarised into the following sentence: rates remain unchanged, as does the exchange rate commitment for the moment. The CNB has reduced its inflation outlook and sees inflation risks to the forecast on the downside. What has changed is the timing of the discontinuation of its existing exchange rate commitment. While February's forecast had envisaged that the exchange rate would be used as a monetary policy instrument until the end of this year, now the forecast cites the end of the first half of next year. This puts the forecast in line with the CNB Board's view, which has been known since the last meeting, i.e., that mid-2017 still appears to be the probable date of the discontinuation.

In its statement the CNB 'threatens' to weaken the koruna even more, but only if there were to be "a systematic decrease in inflation expectations manifesting itself in nominal variables, especially wages". Nevertheless, we see the fact that the CNB is talking of the possibility of further 'devaluation' as a possible scenario, as meaning that it may materialise under certain conditions. At the moment, however, we do not consider it to be very likely; moreover, the press conference did not even indicate that the CNB would be about to do anything like that soon. Therefore, we still believe that the CNB will not move the exchange rate of the koruna; nevertheless, the market should pay all the more attention to wage statistics, the first of which will not be available before June 6.

A change was made – as we had anticipated, after all – to the inflation forecast, which the CNB again lowered. This applies to both this year's inflation and inflation anticipated for the first half of 2017. Thus the central bank expects to hit the inflation target in the second half of next year rather that at the beginning of it, as suggested by the most recent (February) forecast. The CNB does not even rule out that inflation may temporarily fall into negative territory. Nonetheless, the central bank will also continue to view inflation developments with regard to the option of using what is known as inflation exemptions. This means that it would not react to the primary consequences of falling fuel or food prices. Their possible spill-over into other prices, i.e., into the economy as a whole, would be more important.

However, the CNB reduced not only its inflation outlook but also the expected economic growth of the Czech Republic. Thus the central bank believes that the Czech economy will grow by only 2.3% this year, i.e., 0.4% less than predicted in February. In contrast, economic growth should again slightly accelerate up to 3% next year. At the same time the central bank made its view of market interest rate developments at least slightly more realistic, and no longer expects that they might soar as early as at the beginning of next year.

In conclusion, we cannot omit negative interest rates. The CNB Board discussed them again, but definitely did not vote on them. We still regard the chances of putting negative rates in place as less likely. If the central bank really put them in place in the end, it would more likely be a temporary instrument used when it discontinued the interventions and only limited to the inflow of speculative liquidity. Overall, we can summarise Thursday's CNB Board meeting as interesting in terms of its outcomes as well as the forecast, but it has not yet substantially changed our expectations of the timing of the discontinuation of interventions or our expectations of interest rate developments.

The NBH on hold as expected, markets eye Moody's action

The National Bank of Poland met expectations and left the official interest rates unchanged. It did so even though it still expects a decline in consumer prices and despite the absence of inflationary pressures. In addition, the NBP President Belka told the press conference that, so far, the Monetary Policy Council had not basically changed its opinion to such an extent that would result in a change in the view of the monetary policy (i.e. a change that would result in monetary easing). Such a change was indicated, inter alia, by the detailed minutes of April's NBP meeting. In other words, the NBP policy still remains in a neutral bias and, notwithstanding the deterioration of the latest business cycle data, the bank is not going to abandon it. The NBP leaders still believe that Poland's deflation is temporary and consequently they do not see the need for a rate cut.

Whatever the outcome of Friday's NBP meeting the zloty will remain under selling pressure this week. The market is probably afraid of Moody's revising Poland's rating, scheduled for Friday. Bear in mind that S&P's shock downgrade of Poland's rating in the middle of January led to a rapid depreciation up to EUR/PLN 4.50. We should add that Moody's still rates Poland two notches higher than S&P (A2 or A, as opposed to BBB+), and thus a downgrade can be anticipated. Interestingly, the possible reaction of the zloty was even discussed at the press conference of the NBP Governor, with Mr Belka not even ruling out interventions in favour of the Polish currency. However, we believe that there will probably not be interventions – at least not by the NBP.

Review of Economic Figures

Czech and Hungarian industruies weaker in March

Both the Czech and Hungarian industrial production disappointed slightly in March, which was in line with suggestions coming from our regional leading indicators (**see the next page 'In Focus'**).

As concerns, the Czech industry – the output grew by 0.6%. However, when we take into account the different number of working days, the result was still much better (+ 3.6%). The industry continues to drag up mainly automakers, whose production is destined for further historical record.

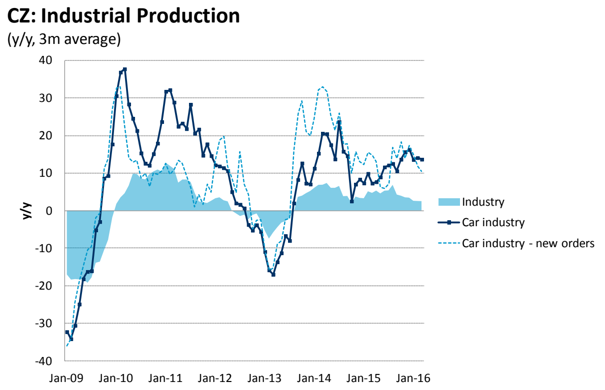
The March results of the industry were rather mixed also taking into account developments of new orders. In their case a decline of 1.4% was borne by both weak domestic and foreign demand. Unsurprisingly, the poor result is related also to metals production, which has been suffering under the pressure of imports from Asia. Nevertheless less encouraging was also performance of the manufacturing and the chemical industry.

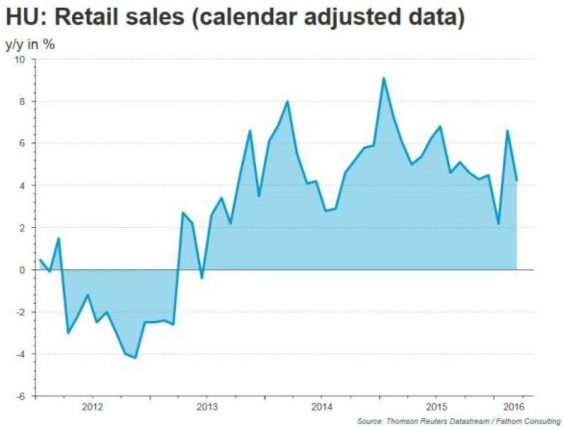
Regarding the weaker performance of the Hungarian industry in March we guess only that the vehicle, chemical and textile productions were worse, partly because of the very high base, partly because of weaker export.

Hungarian retail sales a bit weaker

Hungarian retail sales rose by 5.5% Y/Y in March slightly down from the 6.7% Y/Y in February (according to calendar adjusted data - the volume growth was 4.2% y/y). The main driver of the growth was the non-food products, which were up by 7.6% Y/Y. The food sales were up by 1.9% Y/Y, while the fuel consumption rose by 5% Y/Y. The first quarter retail sales figures confirms our view that the households consumption fuelled by the net real wage growth boosts the economy and it may remain one of the main components of GDP growth in the following quarters as well, because the relative level of the households consumption is still well below the equilibrium level compared to the real income.

The main question is that the quite strong domestic consumption pushes up the inflation in the following months or not. The headline figure is likely to remain in negative territory till August – the bottom might be in July around -0.8% Y/Y – mainly due to base effect, VAT cut and low energy prices. The April CPI might remain around the March level of -0.2% Y/Y, so we have to focus on tradable products and market services inflation and on the core inflation adjusted by the tax changes to have a clearer picture about inflationary orbit.





In Focus: Leading indicators weaker in CE

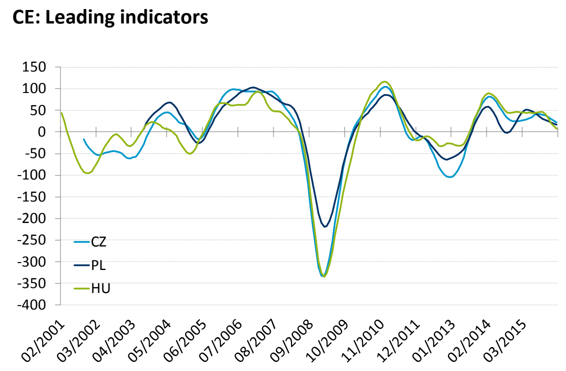
Our forward-looking indicators for Central Europe – the "Flashes" – are gradually deteriorating across all Central European economies in early 2016. While the decline is moderate and the levels remain fairly high, the Flashes indicate a gradual deceleration of industrial output. This is partly why we expect further monetary easing in Hungary, with a rate cut not theoretically ruled out in Poland either.

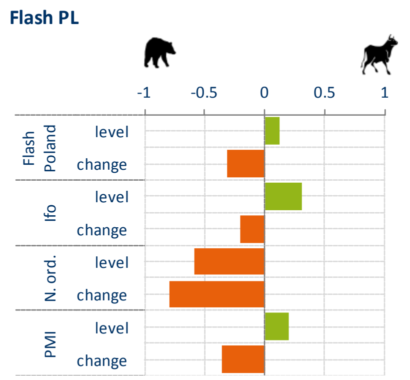
The Czech Flash is the best performer at the moment – it declined in April mainly because of a fall in the PMI index (business moods). Other components of the Czech Flash fell to a much lesser extent (IFO, new orders received by carmakers) or even slightly improved (OECD's expectation index).

In contrast, the Polish Flash has been falling for a prolonged period (9 months), thus hitting slightly lower levels. The Polish Flash structure also looks worse – in particular, new orders have been falling for a longer time and much more rapidly. The level of the Hungarian Flash is relatively the lowest now, but the Flash for this country is more volatile and has not been falling for such a long time as its Polish counterpart. Hence its signal may not necessarily be that strong in the end.

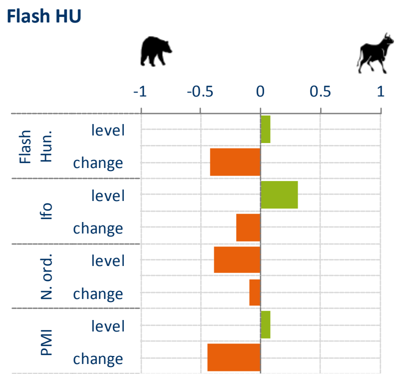
Although the forward-looking indicators are deteriorating, their decline has not been very dramatic so far. Therefore, we believe that they foreshadow an economic growth deceleration across Central Europe rather than a recession on the horizon. After all, we are anticipating such a deceleration in both the Czech Republic and Hungary (this has been partly confirmed by the March industrial production data). The deceleration in the Czech Republic should not surprise the Czech National Bank and, with growth of around 2.5%, we do not expect any response from the central bank.

Conversely, the National Bank of Hungary may respond to the growth deceleration by continuing to cut its interest rates. The situation in Poland is slightly more complicated – worse figures from industry (indicated by the Flash) in a more closed and less industrial-based economy may be counterbalanced by faster domestic consumption and fiscal expansion. Nevertheless, if we see the Polish economy as a whole curb its performance, a rate cut may also come onto the agenda in this country.Lorem ipsum dolor sit amet.

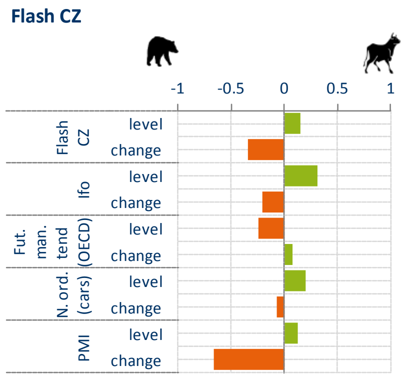




Notes: level: the level of the indicator vis-à-vis historical values; change: the change in the indicator vis-à-vis historical values; (1 = the current value is the maximum historical value; -1 = the current value is the minimum historical value)



Notes: level: the level of the indicator vis-à-vis historical values; change: the change in the indicator vis-à-vis historical values; (1 = the current value is the maximum historical value; -1 = the current value is the minimum historical value)



Notes: level: the level of the indicator vis-à-vis historical values; change: the change in the indicator vis-à-vis historical values; (1 = the current value is the maximum historical value; -1 = the current value is the minimum historical value)

Weekly data preview

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

	Mar-16	Feb-16	Mar-15
Monhtly	**2.5**	5.6	6.5
cummulative (YTD)	**3.1**	3.5	4.8

HU: Negative inflation despite higher fuel prices

The annual inflation may remain at -0.2% Y/Y in April. The fuel price might have increased in the last months but it is still well below the 2015's level. The VAT cut of pork pushed food inflation down, but the fruit harvest might be weak because of the bad weather conditions in previous weeks. The tradable and market services inflation might accelerate slightly just like the core inflation - back to around 1.5% Y/Y - thanks to relatively strong household consumption. Inflation may remain in negative territory till August, but CPI may accelerate substantially from September thanks to base effect and the planned excise duty hike of tobacco.

TUE 9:00 **CZ Inflation (change in %)**

	Apr-16	Mar-16	Apr-15
CPI m/m	**0.3**	-0.1	0.3
CPI y/y	**0.3**	0.3	0.5
Monetary relevant inflation y/y	**0.3**	0.1	0.3

CZ: Stable and low inflation persist

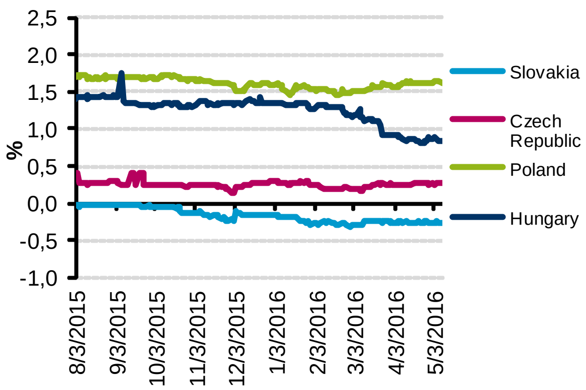
The April inflation probably remained at its previous (year-on-year) level, mainly because of the changing trend in fuel prices. The recent increase in the prices of oil and oil derivatives has been gradually reflected in the prices at petrol pumps and is currently becoming an important inflationary factor. In spite of this we do not currently anticipate any significant change in the inflation outlook. We expect that inflation will remain at its very low level in both the second and third quarters of the year, and should not return to more than 1% before late this year – for the first time in a long while.

Calendar

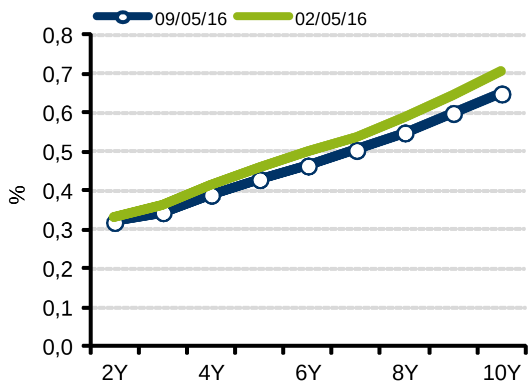
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	05/09/2016	0:00	Earnings PGNiG	PLN	1Q/2016						
PL	05/09/2016	0:00	Earnings PKO Bank Polski	PLN	1Q/2016						
CZ	05/09/2016	9:00	Trade balance (national)	CZK B	03/2016	20		21.4		22	
CZ	05/09/2016	9:00	Construction output	%	03/2016						-2.3
CZ	05/09/2016	9:00	Industrial output	%	03/2016		2.5		1.4		5.6
CZ	05/09/2016	9:00	Unemployment rate	%	04/2016	5.6		5.7		6.1	
HU	05/09/2016	16:00	Budget balance	HUF B	04/2016					-125.8	
CZ	05/10/2016	0:00	Earnings CEZ	CZK	1Q/2016						
PL	05/10/2016	0:00	Earnings Bank Pekao	PLN	1Q/2016						
PL	05/10/2016	0:00	Earnings PGE	PLN	1Q/2016						
HU	05/10/2016	9:00	CPI	%	04/2016			0.5	-0.1	0.1	-0.2
CZ	05/10/2016	9:00	CPI	%	04/2016	0.3	0.3	0.3	0.3	-0.1	0.3
PL	05/11/2016	0:00	Earnings Tauron Polska	PLN	1Q/2016						
PL	05/11/2016	0:00	Earnings Energa	PLN	1Q/2016						
PL	05/12/2016	0:00	Earnings PZU	PLN	1Q/2016						
PL	05/12/2016	14:00	CPI	%	04/2016 *F					0.3	-1.1
HU	05/13/2016	0:00	Earnings OTP Bank	HUF	1Q/2016						
HU	05/13/2016	9:00	GDP	%	1Q/2016 *P					1	3.2
PL	05/13/2016	10:00	GDP	%	1Q/2016 *P			0.6	3.4	1.1	3.9

Fixed-income in Charts

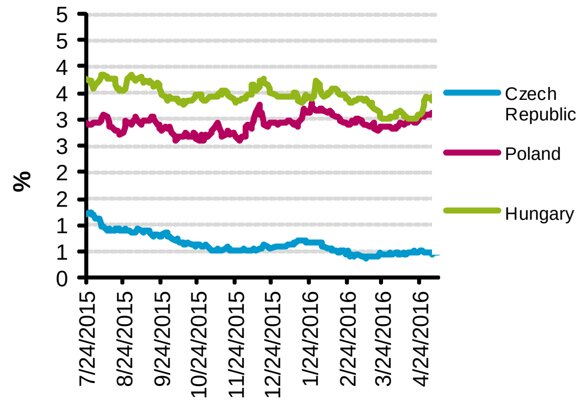
FRA 3x6



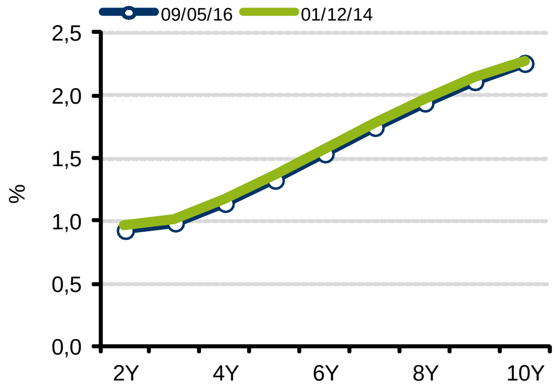
CZ IRS



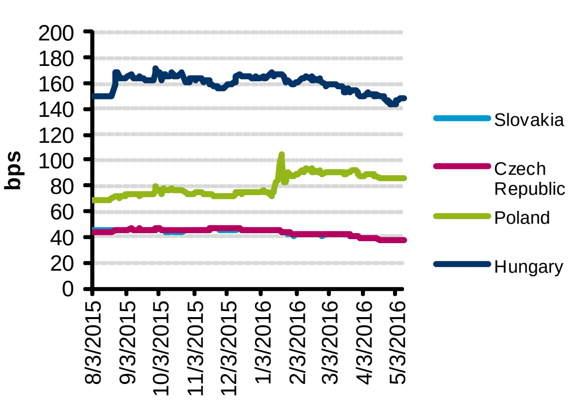
10Y GB Yields



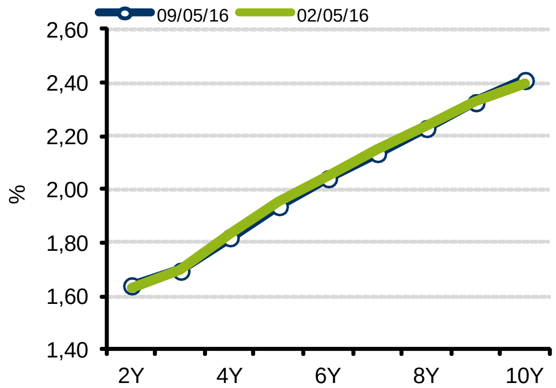
HU IRS



CDS 5Y



PL IRS



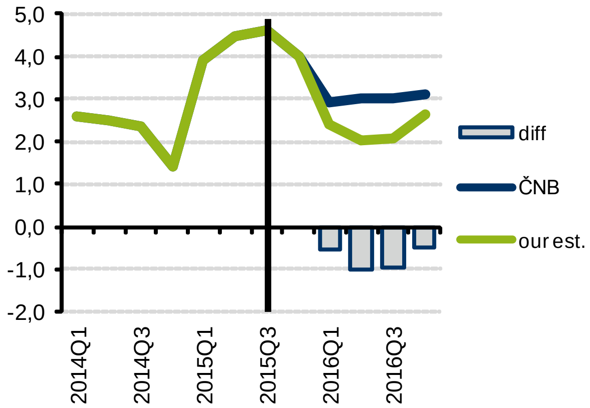
Source: Reuters

Medium-term Views & Issues

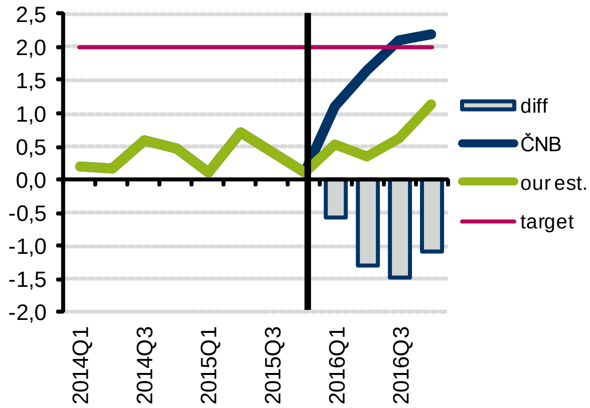
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 Monetary Council continues the rate cut cycle in the following months. We believe that the easing cycle may be continued at least till June, when the next inflationary report will be published. The latest inflation figure (falling from 0.3% Y/Y in February to -0.2% in March) also gives gunpowder for monetary easing, so we expect 15bp cut on 26th April, which might be followed with two more steps in May and June down to 0.75% from the current level of 1.2%..	We expect the NBP to keep official rates stable, but we think that risks for of further rate cuts have increased. The main reason is the combination of the "inflow of cheap euros from the ECB", ongoing deflation and stronger currency (PLN). Hence, should the zloty get strong there could be a window of opportunity for the NBP to ease its policy in the second quarter of this year. Nevertheless this is not our main scenario yet.
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

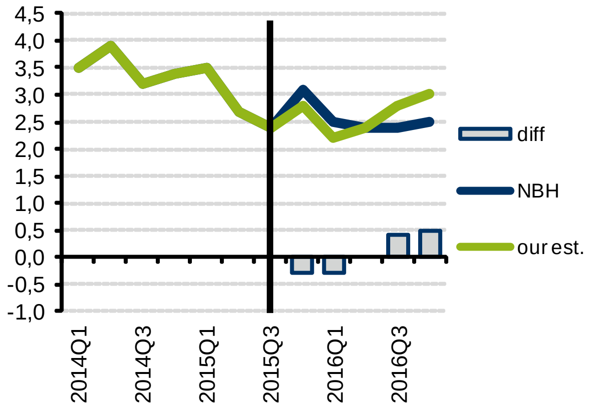
CZ: GDP outlook (Y/Y, %)



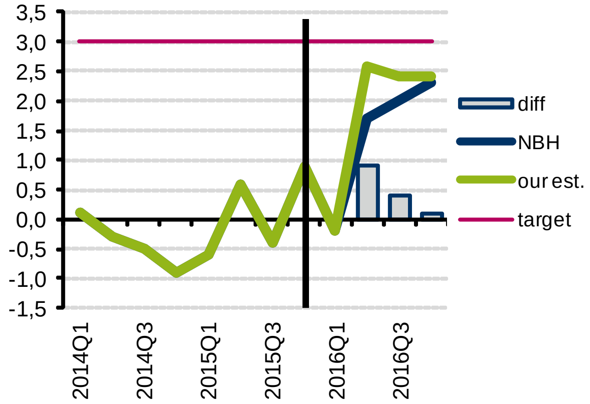
CZ: Inflation outlook (Y/Y, %)



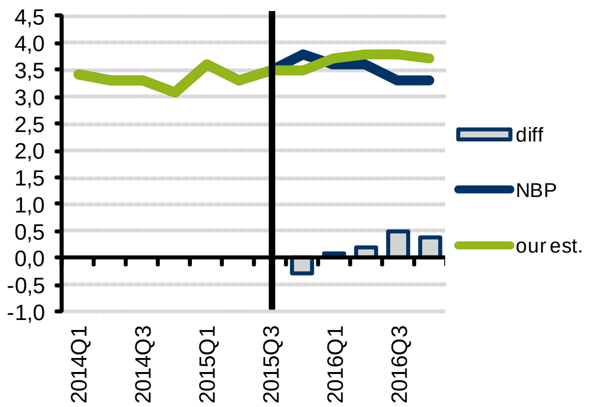
HU: GDP outlook (Y/Y, %)



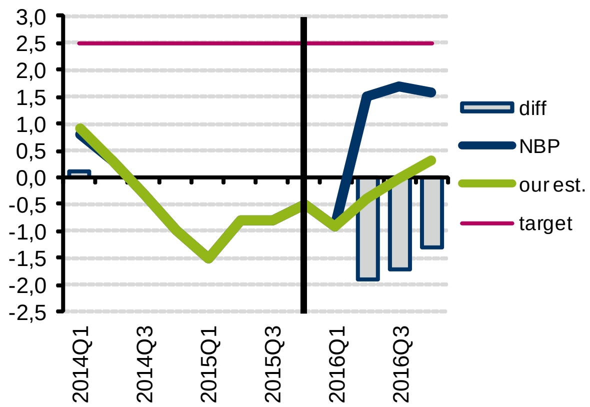
HU: Inflation outlook (Y/Y, %)



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	1.20	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	0.24	0.25	0.25
Hungary	BUBOR	*1.10*	1.35	1.20	2.60	2.90	3.10
Poland	WIBOR	*1.67*	1.72	1.67	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	*0.65*	1.01	0.63	0.73	0.81	0.90
Hungary	HU10Y	*2.27*	2.91	2.07	4.00	4.20	4.40
Poland	PL10Y	*2.41*	2.47	2.23	2.50	2.60	2.75

Exchange rates (end of the period)

		Current	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	EUR/CZK	*27.06*	27.03	27.05	27.02	27.02	27.02
Hungary	EUR/HUF	*315*	316	314	308	305	300
Poland	EUR/PLN	*4.42*	4.27	4.25	4.39	4.27	4.25

GDP (y/y)

	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	4.5	4.6	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	0.3	0.5	0.7	1.4
Hungary	0.6	-0.4	0.9	-0.2	2.6	2.4	2.4
Poland	-0.8	-0.8	-0.5	-0.9	-0.4	0.0	0.3

Current Account

	2015	2016
Czech Rep.	0.9	0.8
Hungary	6.0	5.1
Poland	-1.2	-1.5

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-0.4	-1.0
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