# Central European Weekly

Monday, 14 July 2014

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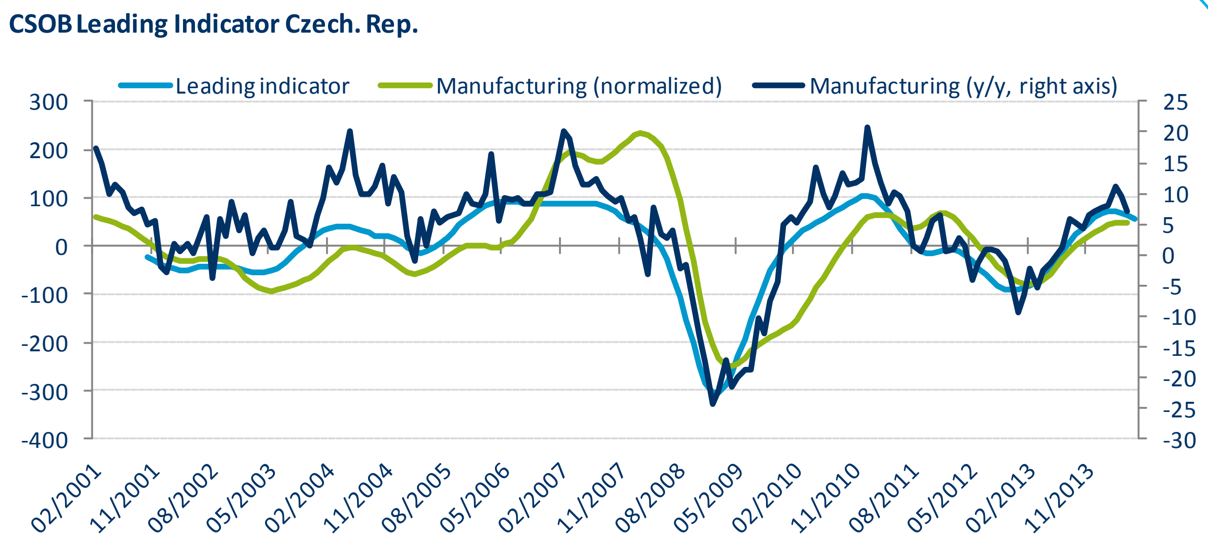
**Dear clients, the next CE Weekly will be issued on July 25th**

## Weekly Highlights:

- Potato effect drives inflation in the region even lower. What to do about that?
- A weaker June in the Czech economy
- In Focus: Hungary's FX loan bail-out update
- Watch NBP's reaction to the low June inflation!

## Chart of the Week: Czech industrial output




*The Czech Industry decelerated significantly in May. Meanwhile also our leading indicator points to weaker performace in the months ahead.*

# Market's editorial

## Potato effect drives inflation in the region even lower. What to do about that?

Too cheap potatoes were responsible for another unexpected inflation fall in the Czech Republic and Hungary in June. Moreover, potatoes quite possibly had an impact on Poland as well, and thus Poland's figure for June, to be released in a few days, may also surprise on the downside.

Although the reactions of economic policy makers, i.e., of central banks, to the seasonal inflation fall should be much the same (initially cautiously ignoring it), this may in fact not necessarily happen, and the market implications may consequently be interesting.

## While The CNB seems to be relaxed,...

The Czech National Bank responded to June's inflation fall essentially by the book, having said that it was not upset by any such thing and that there was no reason to adjust its policy.

## ...while the NBH will continue in its rate-cutting cycle

By contrast, the National Bank of Hungary is in a different position. The June figure was fully in line with the NBH's latest forecast, so it doesn't mean any change of the monetary policy. As vice-governor of NBH said in an interview, that the recent level of base rate is very close to the equilibrium level, the rate cut cycle may end above 2% base rate level. He also added that the Monetary Council will tell, when the rate cut cycle is ended, and the Council won't cut less than 10bp on a decision. It was also important information from him, that NBH is going to help in the process of FC loans conversion to HUF, but they won't cover all the need of hard currency. So it means that the FX conversion will be done partly on the market, which might cause some HUF weakening.  We think that July might by the last rate cut, so base rate might bottom at 2.2%, but the NBH might try to maintain it for an extended period, which is likely to be highlighted in the statement as well.

## Watch the NBP rhetoric after the July inflation

Probably the most interesting response to very low (or even negative) inflation can be expected from members of the Monetary Policy Council in Poland, where the variety of views on the future focus of the monetary policy is currently the most diverse. The market reaction, whether from the forex market or the bond market, to domestic inflation data, i.e., subsequent comments from the NBP, may be more pronounced than elsewhere, at the very least because Polish official interest rates are currently the highest in the whole Central European region.

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| **EUR/CZK** | *27.4* | *-0.02%* | ➔ | ➔ |
| **EUR/HUF** | *310* | *-0.24%* | ➚ | ➚ |
| **EUR/PLN** | *4.14* | *-0.17%* | ➚ | ➘ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| **10Y CZK** | *1.39* | *-0.71* | ➔ | ➔ |
| **10Y HUF** | *3.91* | *1.30* | ➔ | ➘ |
| **10Y PLN** | *3.36* | *-0.30* | ➘ | ➘ |

# Review of Economic Figures

## The Czech Industry decelerated significantly in May

Poor data from the retail sector, released on the Friday before last, was followed by further less optimistic statistics early last week. May's industrial output was the lowest in the last eight months (adjusted for a different number of business days in the month). Output was up by only 2.5% y/y, which was partly attributable to there being one less business day in the month. Adjusted for that day, output rose by 5%. Industry is again driven by carmakers. Their output is rising at a double-digit rate, just as are their new orders. On the other hand, the energy sector and mining industry are reporting lower outputs, but this is in line with their existing trends. As concerns subsequent months, good news is the persisting rise in new orders, notably from abroad, which is still decent. This applies to carmakers and electronics in particular. Unfortunately, orders in engineering, one of the largest industries in the CR, are still somewhat poor. Industry is keeping its dominant position in the economy, continuing to drive economic growth upwards. In truth, it is not that surprising that its output is not rising as rapidly as it did early this year. Maintaining such a rate for a prolonged period is very difficult, especially if it is primarily driven by a single sector – carmakers.

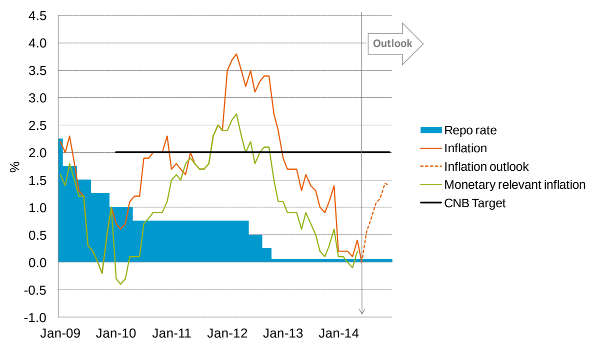
## The Czech Inflation at zero, or 0.5pps below CNB's forecast

The consumer price index remained unchanged in June, according to the latest data from the Statistical Office. The prices changed neither vis-à-vis May 2014 nor vis-à-vis June 2013. Thus year-on-year inflation fell from May's 0.4% to zero, i.e., slightly below the market consensus (0.1% y/y). On the one hand, food prices (of vegetables and especially potatoes) went down slightly last month, as did telecommunication services again; on the other hand, prices of seasonal package tours and fuel went up. Consumers will certainly appreciate that food prices started to fall for the first time in four years. In addition, prices of telecommunication services also continue to decline, albeit the effect of last year's price revolution has been largely exhausted. What households continue to feel positively and what enables them to spend their saved money elsewhere is cheaper energy. They can spend the saved thousands of crowns on something else than electricity and gas bills. Nevertheless, consumer prices are unlikely to stagnate for a long time. Inflation is likely to rise again from next month and hit 1% by the end of the year. Inflation is 0.5% below the level expected by the central bank. Given the factors that influenced the data released on Wednesday, we should see no surprising or dramatic reaction.

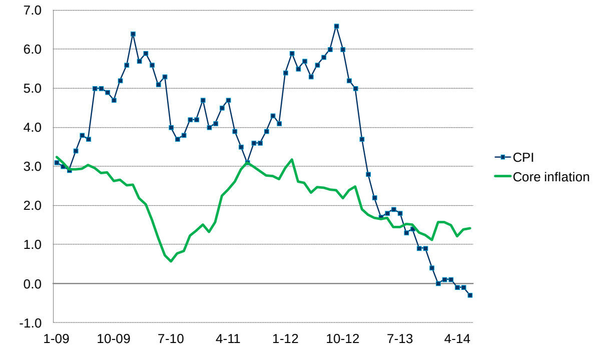
## Hungary's headline and core inflation divergence

The Hungarian consumer price index fell by 0.3% Y/Y in June, while core inflation accelerated from 2.5% Y/Y in May to 2.6% Y/Y in June. The main surprise factor came from food and tradable goods prices. In case of the former, unprocessed food price was well below 2013 level, thanks to mainly the sharp fall of potatoes' and vegetables' prices.
Just like in the previous months, the pass through effect of exchange rate is weak. Despite of the depreciation of HUF, tradable good prices decreased, which is strange especially taking in account that the domestic consumption started to accelerate. It suggests that the imported inflation is still very low, although the increasing consumer price index in German may moderate the deflationary pressure in Hungary in the coming months.
Despite the deeper headline CPI figure, Hungary is still not facing with deflation as the market services and core inflation confirm it (both suggest, that the underling CPI is 2-3 Y/Y). We expect that inflation may remain negative in July, but it may return to positive territory in August and may accelerate to around 1.5% Y/Y in December.

**CZ: Inflation and interest rates**




**HU: Inflation**



# In Focus: Hungary's FX loan bail-out update

## The Good, the Bad and the Ugly

Not only Hungarian markets paid special attention to a recently approved plan to bail out foreign currency debtors. Recall that the Hungarian parliament passed the first foreign currency loan law on last Friday, which targets the abolishment of the foreign-currency (FC) loans in the household sector.

1) The new law says that the FC loans has to be calculated based on the NBH's daily fixing rate, so the banks have to pay back the money (difference between the NBH's rate and the exchange rate they used at the disbursement and at the monthly instalments) to the households.

2) The contracts that allow the unilateral contract modifications (the banks increased the interest rate margin) are void, and the banks have to prove that these contracts were fair in other case the banks have to pay back the extra money they received from higher interest rate (both in case of FC and HUF loans).

The details – how it will be calculated – have been not set yet. The government said that the next law will be formed till September, but the money, which has to be paid back to the households, has to be calculated with interest on interest methodology using at the time valid base rate.

The government highlighted that the FC loans will be abolished till December, but the timing and the exchange rate on which the FC loans will be converted, was not decided yet. They said that they will discuss with the bank association, but it will be below the market rate.

As the details are unknown, the full effect on the bank sector cannot be calculated, but **it may cost minimum HUF400bn or 1.3% of GDP and maximum around HUF1200bn or 4% of GDP for the banking sector.**

It is quite likely the National Bank of Hungary may help in the conversion because of two main reasons: 1) without it HUF would depreciate substantially, 2) Parallel with the decrease of FC debt of the country, NBH has to keep less FC reserves and one of the targets of NBH is to decrease it because then they can moderate the sterilization cost as well.

The uncertainty of the conversion and the final loss of bank sector may keep the forint under pressure in the coming months, so it may remain relatively volatile. At the end of the conversion Hungary's dependence on foreign financing may decrease, so the stability of the country may actually improve.

Since there will be a capital transfer from the banking sector to the households, the domestic consumption may stabilize in 2014 and 2015, which is temporally supportive for economic growth.

The Hungarian banking sector may, however, require additional capital inflow (there are banks, which make huge losses) at the end of the year, which may strengthen the HUF in December. The lending activity of the banking sector may remain week in this year and it may accelerate only slowly from next year, which is on the other hand bad news for economic growth.

# Weekly preview

TUE 14:00 PL Inflation (change in %)

| | Jun-14 | May-14 | Jun-14 |
|---|---|---|---|
| CPI y/y | **0.1** | 0.2 | 0.2 |
| Food (ex Alc.) y/y | **-1.1** | -0.8 | 0.7 |
| Transport (including fuel) | **-0.4** | -0.1 | -3.5 |

## PL: Inflation at all-time lows in June

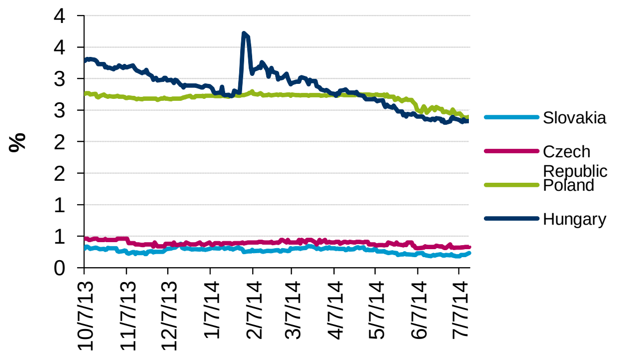
Poland's inflation fell to its all-time low of 0.1% y/y in June according to our forecasts. Just as in previous months, falling food prices were most responsible for June's decline. Poland's inflation rate is likely to continue to fall during the summer and slip into negative territory. The price rise is unlikely to recover significantly before next year, when inflation may climb back to the tolerance band of the NBP (above 1.5%) towards the end of the first half-year. Nonetheless, just like in other countries, the risks of the inflation rate remaining low for a long time also predominate in Poland.

# Calendar

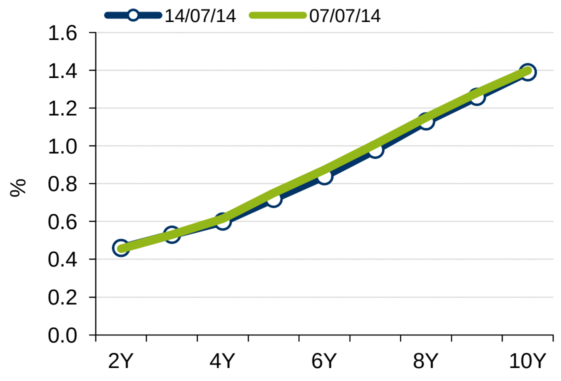
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 07/14/2014 | 9:00 | Industrial output | % | 05/2014 *F | | | | | -1 | 9.6 |
| CZ | 07/14/2014 | 10:00 | Current account | CZK B | 05/2014 | -14.8 | | -9 | | -11.42 | |
| PL | 07/14/2014 | 14:00 | Current account | EUR M | 05/2014 | | | 806 | | 1028 | |
| PL | 07/14/2014 | 14:00 | Trade balance | EUR M | 05/2014 | | | 623 | | 856 | |
| PL | 07/14/2014 | 14:00 | Money supply M3 | % | 06/2014 | | | 0.5 | 5.3 | 0.6 | 5.3 |
| PL | 07/15/2014 | 14:00 | CPI | % | 06/2014 | -0.1 | 0.1 | -0.1 | 0.2 | -0.1 | 0.2 |
| PL | 07/15/2014 | 15:00 | Budget balance | PLN M | 06/2014 | | | | | -22473 | |
| CZ | 07/16/2014 | 9:00 | PPI | % | 06/2014 | 0.1 | -0.1 | 0.2 | 0 | 0 | -0.1 |
| PL | 07/16/2014 | 14:00 | Core CPI | % | 06/2014 | | | 0 | 0.8 | 0 | 0.8 |
| PL | 07/16/2014 | 14:00 | Wages | % | 06/2014 | | | 2.1 | 4.5 | -2.5 | 4.8 |
| PL | 07/17/2014 | 14:00 | Industrial output | % | 06/2014 | | | 2 | 3.9 | -1.7 | 4.4 |
| PL | 07/17/2014 | 14:00 | PPI | % | 06/2014 | | | -0.2 | -1.8 | -0.2 | -1 |

# Fixed-income in Charts

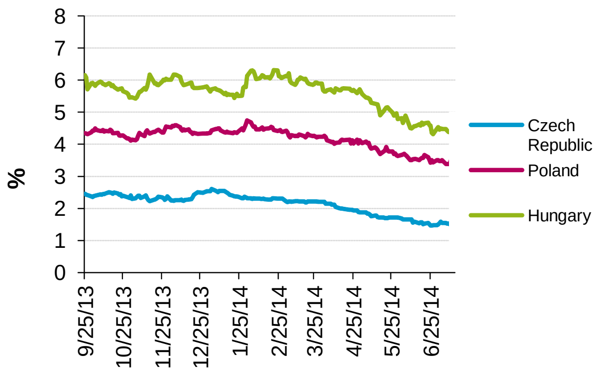
## FRA 3x6



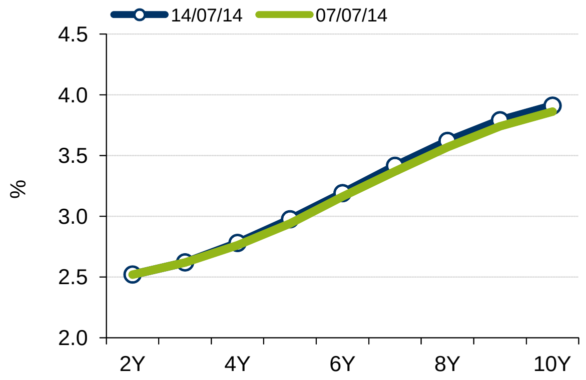

## CZ IRS



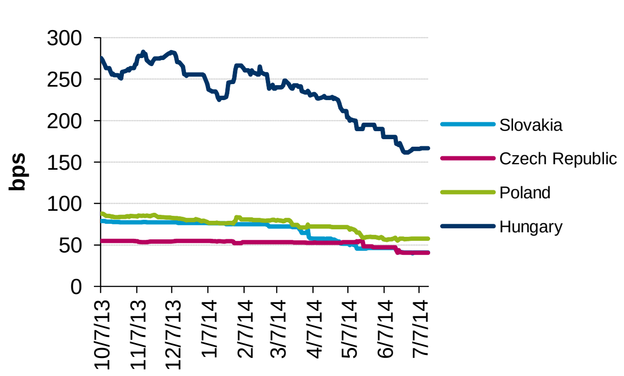

## 10Y GB Yields



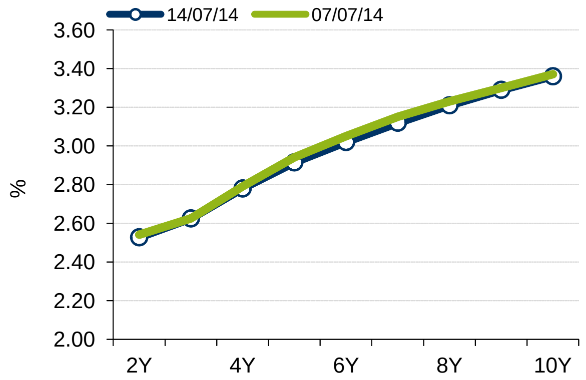

## HU IRS




## CDS 5Y




## PL IRS



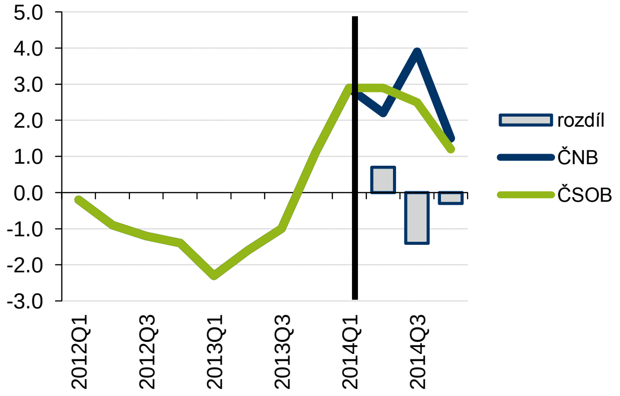

Source: Reuters

# Medium-term Views & Issues

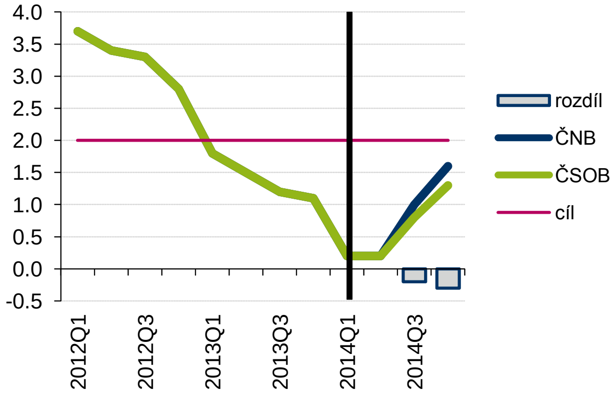
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time.<br>The new government, formed after the autumn 2013 election, is just 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 3.4% in 2014Q1. For this year, the growth should significantly exceed 3%. Household consumption should support growth, owing to the improving labor market situation as well as to low inflation. Investment should also develop favorably, owing to the replenishment of inventories as well as to gross capital formation In addition, lower government debt could also give a greater lift to the economy. By contrast, net exports are likely to curb rather than boost growth, especially in view of recent crisis in Ukraine. |
| 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 Monetary Council envisaged further cautious rate cuts considering the country's CPI outlook, risk premium, expected GDP growth and narrowing of the output gap. However the Council emphasized that the base rate is substantially close to a level that ensures the middle term inflation target (3%). Based on that, we may make new conclusions about the bottom of the rate cut cycle. The latest available figures and information suggest that the MPC might cut the base rate two more times by 10bp in which case the easing cycle ends at 2.2%.<br>We expect that the NBH may increase the base rate in 2015 after Fed fully reduces its asset purchases. Worsening of the currently high risk appetite of the markets may induce a Hungarian rate hike as well. | Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. Although the recent development has supported our bets on faster economic recovery in Poland, outlook for persistently low inflation should play in favor of stable official interest rates in the rest of this year. Although we cannot exclude possible rate cut as we forecast inflation to fall significantly below zero over the summer , the monthly data released thus far indicates similar growth for the second quarter as that for the first (3.4% y/y). And this should not be enough to cut rates. |
| 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. | Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. Albeit we expect only gradual strengthening against the euro, the Polish currency might perform well against the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue at faster pace. The main risk as regards the zloty is the ECB decision to ease MP which could further support the currency. |

# CBs' Projections vs. Our Forecasts

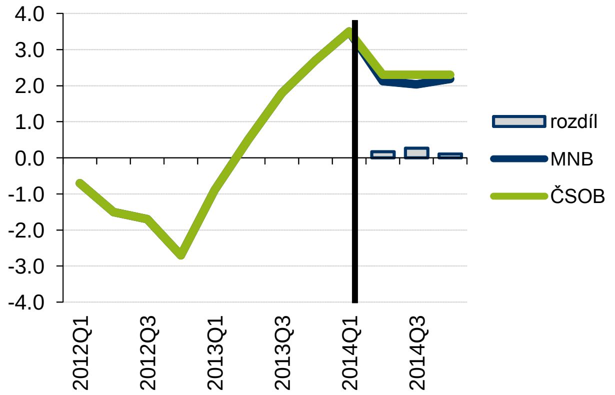
**CZ: GDP outlook** (Y/Y, %)




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

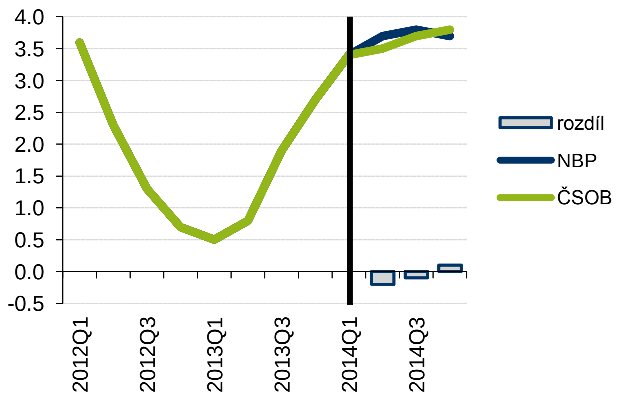



**HU: GDP outlook** (Y/Y, %)




**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* | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 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. | *2.30* | 3.00 | 2.60 | 2.30 | 2.50 | 2.50 | -10 bps | 6/24/2014 |
| **Poland** | 2W inter. rate | *2.50* | 2.50 | 2.50 | 2.50 | 2.50 | 2.75 | -25 bps | 7/3/2013 |

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

| | | *Current* | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | PRIBOR | *0.35* | 0.38 | 0.37 | 0.35 | 0.35 | 0.36 |
| **Hungary** | BUBOR | *2.30* | 2.99 | 2.67 | 2.34 | 2.50 | 2.50 |
| **Poland** | WIBOR | *2.68* | 2.71 | 2.71 | 2.68 | 2.75 | 3.00 |

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

| | | *Current* | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | CZ10Y | *1.39* | 2.09 | 1.84 | 1.34 | 1.50 | 1.70 |
| **Hungary** | HU10Y | *3.91* | 5.25 | 4.95 | 3.77 | 5.30 | 5.70 |
| **Poland** | PL10Y | *3.36* | 4.25 | 4.03 | 3.39 | 4.45 | 4.70 |

*Exchange rates (end of the period)*

| | | *Current* | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | EUR/CZK | *27.4* | 27.3 | 27.4 | 27.4 | 27.2 | 27.2 |
| **Hungary** | EUR/HUF | *310* | 297 | 307 | 310 | 298 | 295 |
| **Poland** | EUR/PLN | *4.14* | 4.16 | 4.17 | 4.16 | 4.15 | 4.09 |

*GDP (y/y)*

| | 2013Q2 | 2013Q3 | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | -1.6 | -1.0 | 1.1 | 2.9 | 2.9 | 2.5 | 1.2 |
| **Hungary** | 0.5 | 1.8 | 2.7 | 3.5 | 2.3 | 2.3 | 2.3 |
| **Poland** | 0.8 | 1.9 | 2.7 | 3.4 | 3.5 | 3.7 | 3.8 |

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

| | 2013Q2 | 2013Q3 | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | 1.6 | 1.0 | 1.4 | 0.2 | 0.0 | 1.0 | 1.4 |
| **Hungary** | 1.9 | 1.4 | 0.4 | 0.1 | 0.6 | 0.7 | 0.8 |
| **Poland** | 0.2 | 1.0 | 0.7 | 0.7 | 0.2 | -0.4 | 0.2 |

*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 | -2.5 |
| **Hungary** | -2.7 | -3.0 |
| **Poland** | -4.4 | -3.5 |

Source: CSOB, Bloomberg

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