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# Central European Weekly

Monday, 15 September 2014

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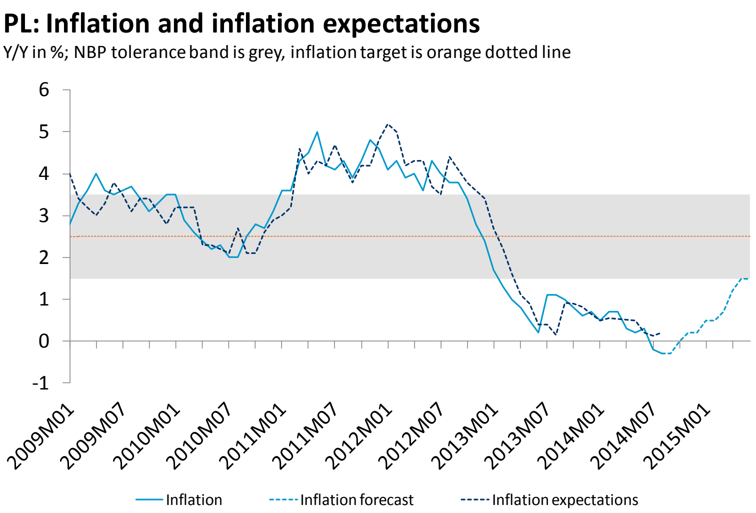
## Weekly Highlights:

- Central Europe eyes Russia's counter-action to new sanctions imposed by the EU
- The Czech inflation ticks higher and in year-on-year terms stay above CNB's forecast
- Hungarian and Polish inflation in line with market expectations

## Chart of the Week: Polish inflation




*The Polish inflation remained below zero in August and is likely to do so in September as well... (Source: NBP, CSOB).*

# Market's editorial

## Central Europe and new sanctions against Russia

The European Union has decided to launch another round of sanctions against Russia. Above all, the new sanctions against the country again impede Russian companies' access to funds from abroad. Trade in new equity and debt (with a maturity exceeding thirty days) issued by the five major Russian state-controlled banks and three major defence and energy companies will be prohibited in the EU. Other sanctions apply to the provision of services in the exploration of new oil and gas deposits and to the exports of arms.

The composition of the sanctions is no surprise to markets; however, in the wake of the hesitation at the end of the week before last, some investors might have counted on the EU just keeping its sanctions 'on standby' in the event that the agreed ceasefire were to be breached. In the end, European politicians showed their willingness to proceed against Russia slightly more actively (likely in response to the curbed gas supply to Poland).

## Awaiting Russia's counter-move

From Central Europe's perspective, it will be important to monitor Russia's counter-move. The first wave of the Russian sanctions hit Poland in particular, where the exports of fruit and vegetables make up more than 7% of all of its exports to Russia. According to the press, Russia is currently considering a number of actions, including car import restrictions. This would have the greatest impact on Czech industry. Road vehicle exports make up more than a quarter of all Czech exports to Russia, as opposed to 7-9% for exports from Hungary and Poland. However, the particular formulation of the sanctions would also matter. If they were to be only imposed on used vehicles, the impact on Central European manufacturers may not necessarily be significant.

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | 27.6 | -0.12% | ↗ | ↗ |
| EUR/HUF | 315 | -0.07% | ↗ | ↗ |
| EUR/PLN | 4.20 | 0.50% | ↗ | ↗ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| 10Y CZK | 1.26 | 6.36 | ↗ | ↗ |
| 10Y HUF | 3.98 | 10.25 | ↗ | ↗ |
| 10Y PLN | 2.94 | 8.29 | ↗ | ↗ |

# Review of Economic Figures

## The Czech inflation above the CNB's prognosis

The Czech consumer price index fell slightly less vis-à-vis July than we had expected (-0.1% as opposed to the predicted -0.2%), which led to the year-on-year inflation rise from 0.5% to 0.6% in August. However, the year-on-year price developments and, in particular, their direction are more important than their month-on-month developments. Year-on-year inflation, monitored by the central bank, moved away from the previously hit 0.5% and reached 0.6%. Although this is still well below the inflation target, this year's low inflation continues to be due to cheaper energy, influenced by the shale revolution in the United States and the green revolution in Europe.

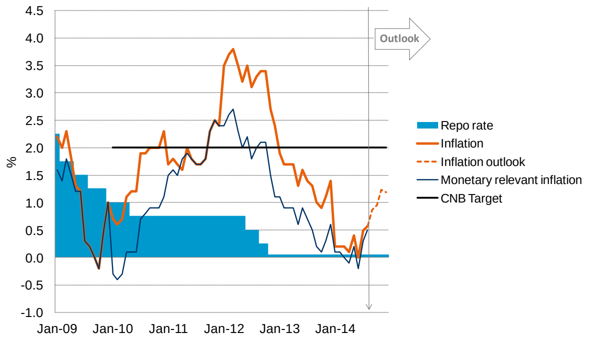
The central bank can also be satisfied with inflation, because the latest figure was again 0.2 percentage point above its latest forecast. Inflation is also influenced by the weak koruna, the impact of which is primarily evident in clothing and shoes imported to the Czech Republic, and the currency also curbs the long-term decline in the prices of electronics. Even so, as is evident from the figures released by the Statistical Office, mobile phone prices are still falling by almost 20%. The competition in the electronics segment is strong and the cycles of individual products are ever shorter. Inflation seems to have rebounded at last and is slowly heading upwards. It will be no dramatic rise, as inflation will only climb to very slightly above 1% late this year. This will also be boosted by increased excise duties on cigarettes, which have a long delay in influencing tobacco prices, because of tobacco stockpiling. However, there is still a long way to go to reach the inflation target, and therefore the outlook for rates and for the departure from the existing exchange rate regime remains unchanged. Hence 2016 continues to be the nearest possible date in this regard.

## Hungarian and Polish inflation in line with expectations

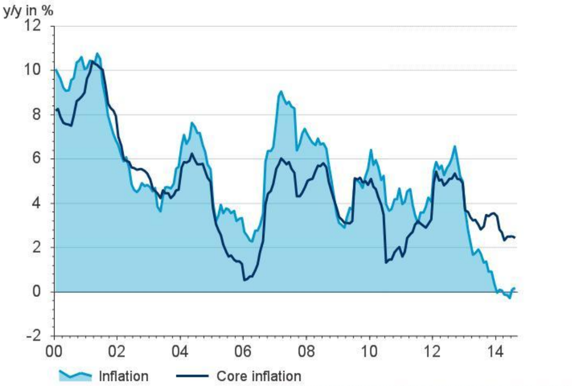
The Hungarian headline inflation increased slightly from 0.1% Y/Y in July to 0.2% Y/Y in August in line with the expectation. The fuel price was down by 1.8% M/M, which decreased the headline CPI by 0.1%point. The subgroups reflect that inflation may accelerate gradually as the public utility cost reductions are falling out from the base. Also core inflation confirms this view as it stuck around 2.5% Y/Y level in the last four months. It is still a question how the weaker HUF exchange rate may affect CPI, but August figure suggest rather that it started to pass through in the consumer prices.

As for the fresh inflation figures from Poland, prices fell by 0.3% Y/Y and 0.4% Y/Y in August, and results were therefore in line with both our and market expectations. Regarding the structure, the main surprise was 1.3% M/M growth in prices of communications which, however had only a small impact on headline inflation (given its small weight in the consumers' basket). To sum up, August inflation has no impact on our expectations of NBP cutting official interest rates by 25 bps in both October and November.

CZ: Inflation and interest rates




HU: Inflation rate



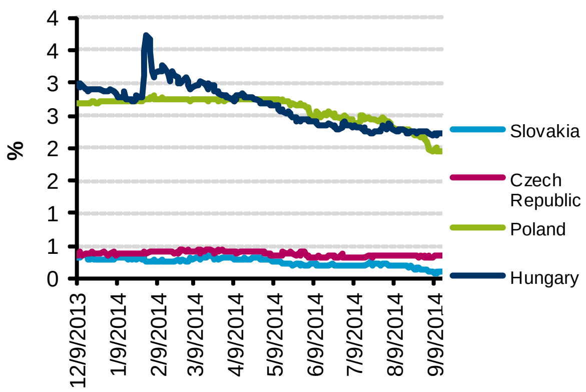

Source: Thomson Reuters Datastream / Fathom Consulting

# Calendar

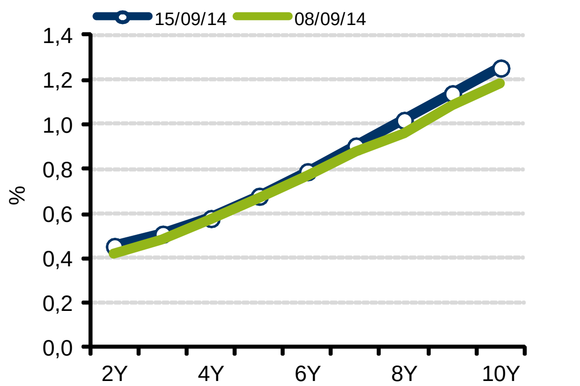
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| CZ | 09/15/2014 | 10:00 | Current account | CZK B | 07/2014 | -6.5 | | -4.5 | | -0.25 | |
| PL | 09/15/2014 | 14:00 | Trade balance | EUR M | 07/2014 | | | 194 | | 333 | |
| PL | 09/15/2014 | 14:00 | CPI | % | 08/2014 | -0.4 | -0.3 | -0.4 | -0.3 | -0.2 | -0.2 |
| PL | 09/15/2014 | 14:00 | Current account | EUR M | 07/2014 | | | -518 | | -391 | |
| PL | 09/15/2014 | 15:00 | Budget balance | PLN M | 08/2014 | | | | | -26351 | |
| CZ | 09/16/2014 | 9:00 | PPI | % | 08/2014 | 0.1 | 0.1 | 0 | 0 | 0.3 | -0.1 |
| PL | 09/16/2014 | 14:00 | Core CPI | % | 08/2014 | | | -0.1 | 0.4 | 0 | 0.4 |
| PL | 09/16/2014 | 14:00 | Wages | % | 08/2014 | | | -1.5 | 3.8 | 0.6 | 3.5 |
| CZ | 09/17/2014 | 12:00 | CZ bond auction 2014-18, 0.85% | CZK B | 09/2014 | | | | | | |
| CZ | 09/17/2014 | 12:00 | CZ bond auction 2014-2027, floating rate | CZK B | 09/2014 | | | | | | |
| PL | 09/17/2014 | 14:00 | Industrial output | % | 08/2014 | | | -5.8 | 0.3 | 2 | 2.3 |
| PL | 09/17/2014 | 14:00 | PPI | % | 08/2014 | | | 0.1 | -1.7 | 0 | -2 |

# Fixed-income in Charts

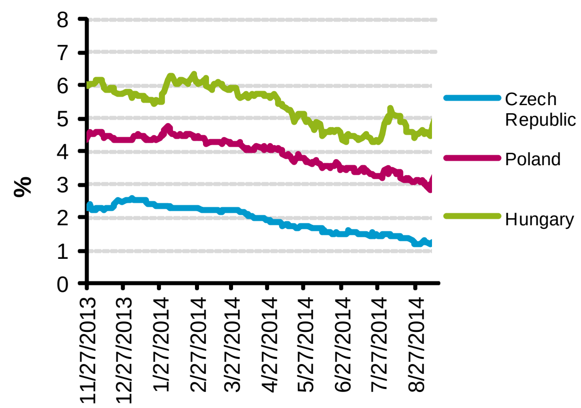
## FRA 3x6



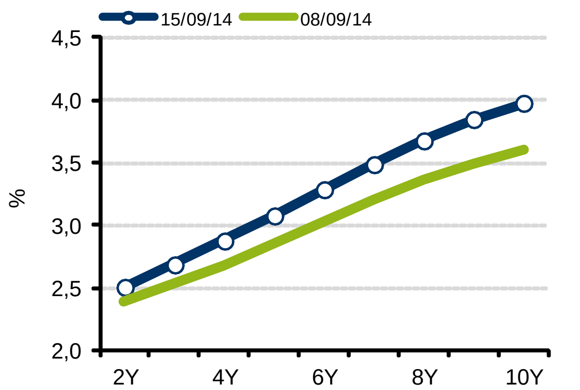

## CZ IRS



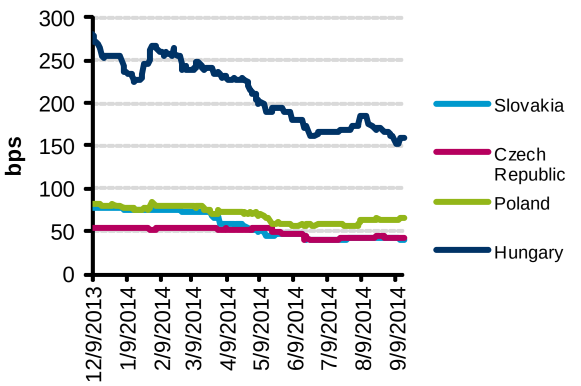

## 10Y GB Yields



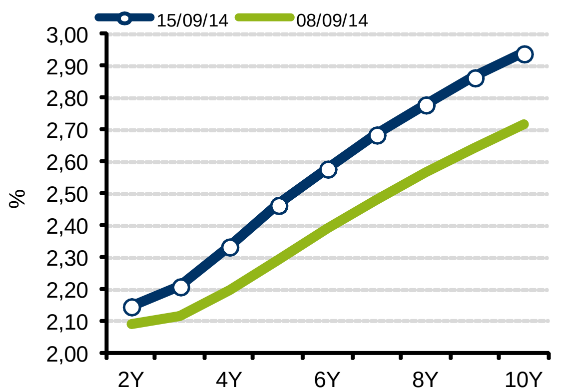

## HU IRS




## CDS 5Y




## PL IRS



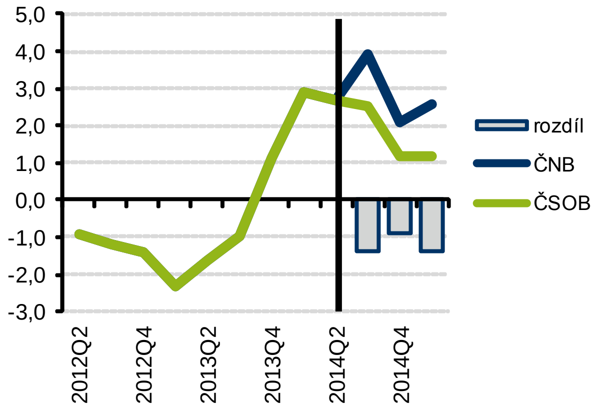

Source: Reuters

# Medium-term Views & Issues

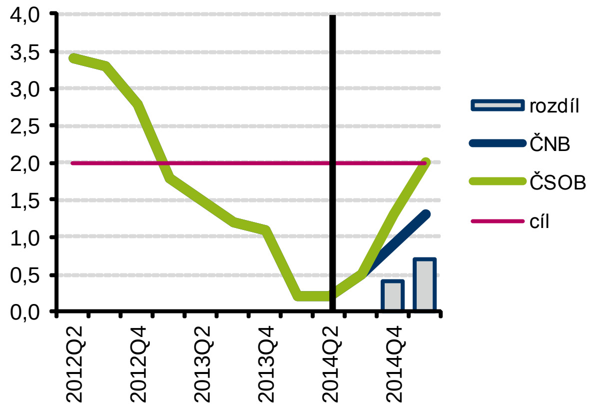
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time.<br>The new government, formed after the autumn 2013 election, is just 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 3.3% in 2014Q2. The data unveiled a strong contribution of domestic demand but also a high contribution of in inventories which somehow blurred overall good message. On the other hand, ongoing crisis in eastern Ukraine poses clear risks for the economic growth, especially in comparison with our expectations in the beginning of the year. Still, we expect the economy to expand by more than 3% in 2014. |
| 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 has finished its easing cycle in Hungary by cutting the base rate to the 2.1%.<br>The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/-1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy.<br>Our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015. | Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. At the same time, anti-inflationary risks stemming from Ukraine crisis and ECB recent policy easing are mounting. We therefore expect NBP to cut interest rates by 25 bps in both October and November and risks are skewed towards even more pronounced policy easing in months to come. |
| 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. | Less optimistic economic outlook and renewed monetary policy easing should cap room for prospective strengthening of the zloty in months to come. For the rest of the year, we therefore expect a stagnation of the zloty against the euro and consider risks as skewed slightly towards possible depreciation, even though Polish assets could draw support from further easing of monetary policy conditions in the euro zone. |

# CBs' Projections vs. Our Forecasts

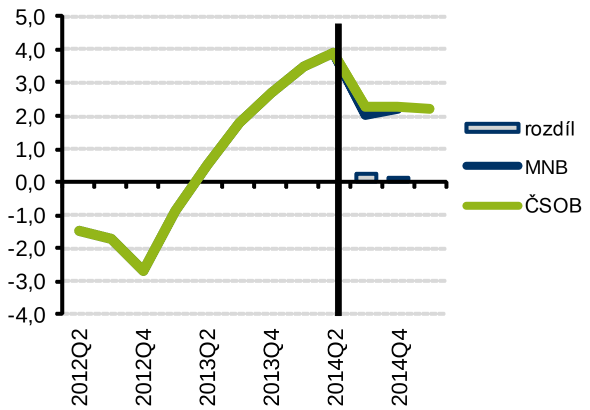
**CZ: GDP outlook** (Y/Y, %)



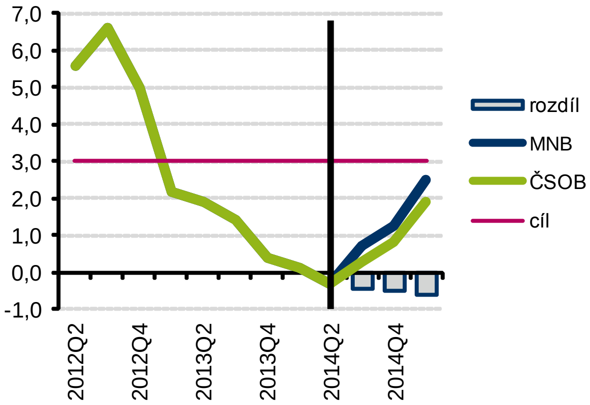

**CZ: Inflation outlook** (Y/Y, %)



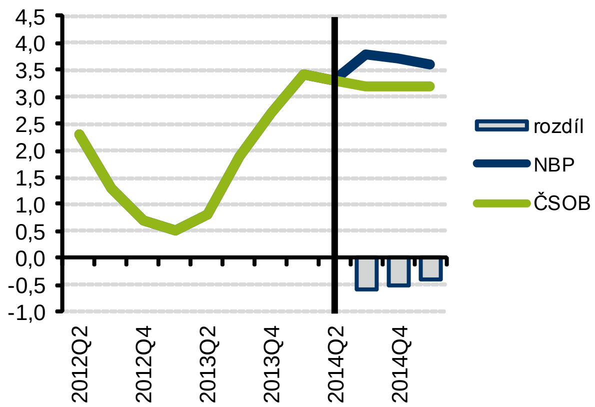

**HU: GDP outlook** (Y/Y, %)



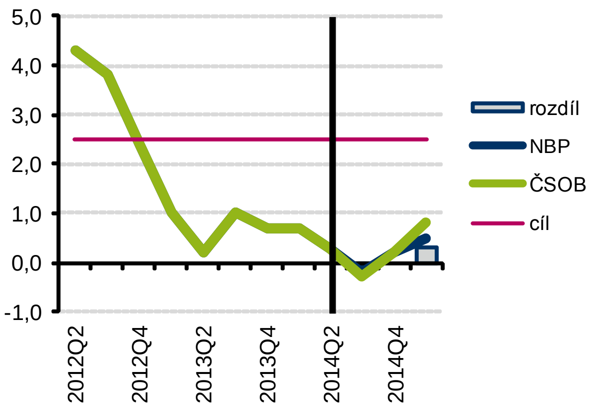

**HU: Inflation outlook** (Y/Y, %)




**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* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 | 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* | 2.60 | 2.30 | 2.10 | 2.10 | 2.10 | -10 bps | 7/22/2014 |
| **Poland** | 2W inter. rate | *2.50* | 2.50 | 2.50 | 2.50 | 2.00 | 2.00 | -25 bps | 7/3/2013 |

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

| | | *Current* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | PRIBOR | *0.35* | 0.37 | 0.35 | 0.35 | 0.35 | 0.35 |
| **Hungary** | BUBOR | *2.11* | 2.67 | 2.34 | 2.15 | 2.15 | 2.15 |
| **Poland** | WIBOR | *2.48* | 2.71 | 2.68 | 2.45 | 2.20 | 2.20 |

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

| | | *Current* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | CZ10Y | *1.255* | 1.84 | 1.34 | 1.40 | 1.50 | 1.75 |
| **Hungary** | HU10Y | *3.98* | 4.95 | 3.77 | 3.50 | 3.50 | 3.65 |
| **Poland** | PL10Y | *2.94* | 4.03 | 3.39 | 2.75 | 2.60 | 2.60 |

*Exchange rates (end of the period)*

| | | *Current* | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | EUR/CZK | *27.6* | 27.4 | 27.4 | 27.9 | 27.7 | 27.4 |
| **Hungary** | EUR/HUF | *315* | 307 | 310 | 310 | 310 | 310 |
| **Poland** | EUR/PLN | *4.20* | 4.17 | 4.16 | 4.19 | 4.17 | 4.17 |

*GDP (y/y)*

| | 2013Q3 | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | -1 | 1.1 | 2.9 | 2.7 | 2.5 | 1.2 | 1.2 |
| **Hungary** | 1.8 | 2.7 | 3.5 | 3.9 | 2.3 | 2.3 | 2.2 |
| **Poland** | 1.9 | 2.7 | 3.4 | 3.3 | 3.2 | 3.2 | 3.2 |

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

| | 2013Q3 | 2013Q4 | 2014Q1 | 2014Q2 | 2014Q3 | 2014Q4 | 2015Q1 |
|---|---|---|---|---|---|---|---|
| **Czech Rep.** | 1 | 1.4 | 0.2 | 0.0 | 1.0 | 1.4 | 2.0 |
| **Hungary** | 1.4 | 0.4 | 0.1 | -0.3 | 0.3 | 0.8 | 1.9 |
| **Poland** | 1 | 0.7 | 0.7 | 0.3 | -0.3 | 0.2 | 0.8 |

*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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