Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 06 October 2014

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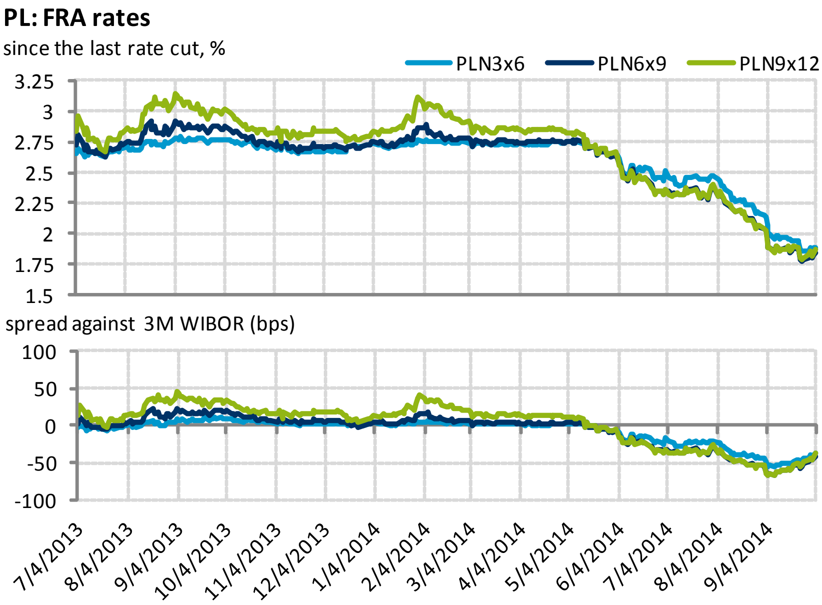
- The Czech inflation should move closer to 1% in September

Chart of the Week: NBP rate-cut bets



Markets expect nearly three 25 bps rate cuts in Poland including this week's easing which has already been priced in (a 25 bps cut).

Market's editorial

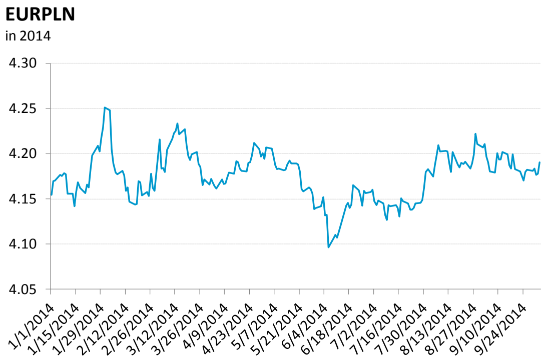
Czech and Hungarian macro data might be interesting, but...

For the first time in a long while, this may be an interesting week from a purely regional perspective, for not only will there be major macroeconomic data on inflation and industrial output from the Czech Republic and Hungary, but also a key meeting of the National Bank of Poland (NBP). While Czech and Hungarian inflation important figures for September are going to be released this week, the NBP will not wait for such data any longer and will proceed to take action for the first time in quite some time.

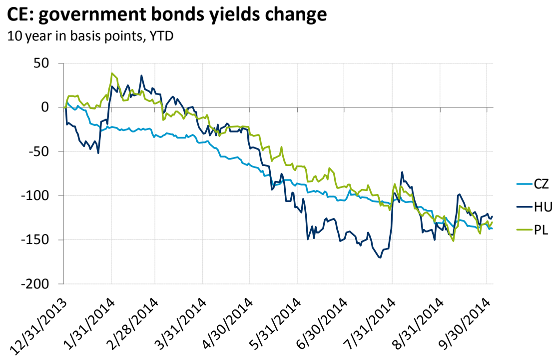
NBP's meeeng and a rate cut should be the highlight

We believe that on Wednesday, the NBP, after more than a year, is likely to resume its monetary easing cycle and cut rates by 25 basis points. Although the Polish economy grew by more than 3% in the first half of the year, inflation dropped into negative territory in the summer, and a combination of external adverse factors, with the Ukrainian crisis being the primary one, will lead to a growth rate deceleration in the second half of the year. This factor will curb a faster return of inflation to its target. Even though we cannot completely rule out a greater rate cut, by 50 bps, we believe that the economic situation is not serious enough for the NBP to proceed to such a move. This is why we expect a rate cut by 25 bps in October, accompanied by the same move in November. Moreover, risks are diverged towards an even greater monetary easing.

With most of the market endorsing our view on how much the rates will be cut (just 25 bps), this outcome of the NBP meeting should not come as a great surprise; nevertheless, those in the market who expect a greater rate cut may use such cautious progress by the NBP as a pretext for an appreciation of the zloty. Nonetheless, much will depend on the outcome of the press conference by NBP President Belka.



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.5	-0.23%	↘	↗
EUR/HUF	309	-0.99%	→	→
EUR/PLN	4.19	0.11%	↘	→



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.19	-4.03	↗	↗
10Y HUF	3.83	-3.89	↗	↗
10Y PLN	2.78	-2.80	↗	↗

In Focus:

The Czech Republic's GDP is CZK 200 bn higher after a new calculation. The new set of methods does not change the trends of the Czech economy, but its size.

Europe is switching to a new set of methods for calculating its GDP, with this change also having an impact on the Czech Republic. Thus the Statistical Office released new GDP data last week, which more or less confirmed the previous trend of the economy; however, it did lead to certain changes that caught the eye. Above all, the overall GDP figure increased by approximately CZK 200 bn in the last three years due to updated data and changes in reporting. Thus the GDP in current prices exceeded CZK 4 trillion for three consecutive years, and this will clearly have impacts on carefully monitored indicators such as public budget figures, debt or current account deficit. Owing to a higher denominator (GDP), these relative indicators have improved by a few tenths of percent, albeit this is certainly not a dramatic alteration that would change the view of the reality.

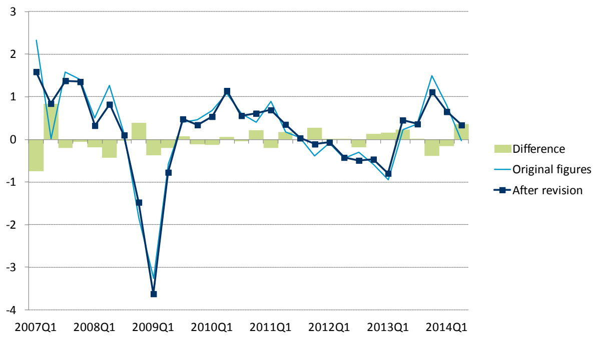
The new calculation method also influenced this year's reported economic growth. While, in early 2014, the economy was supposed to grow by almost 3%, the latest data indicates 2.6%, and 2.5% in the second quarter. The view of the quarter-on-quarter development of the economy has also changed. While originally the economy was supposed to stagnate in the second quarter, now the data suggests growth by 0.3%, owing to consumption and investment, with foreign trade lagging behind the former two this time. Particularly the rise in investment is pleasant, being focused on purchases of not only means transport but also machinery, the construction of commercial real property, and now even housing construction. As concerns GDP creation, the economy is still driven by the manufacturing industry, with other contributors currently being construction, IT services, and to a slight extent even the real estate market this time. This is no great surprise, except for construction, albeit in this case it was just a question of time as to when the increasing orders would at last become evident in the performance of the overall sector.

The change in methods should not trigger a change in the monetary policy.

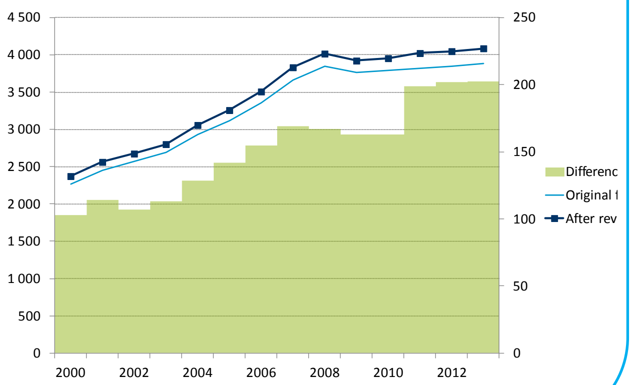
We do not expect the current change to the GDP calculation method to have an impact on, for example, central bank decision-making, despite the fact that currently reported growth clearly lags behind the Czech National Bank's latest forecast. The reason is that the trends of the economy have not changed; only the calculation methods have been revised or changed, with this having, inter alia, slightly improved the picture of the previous two years, thus having raised the comparative baseline. Therefore we should take all of the existing forecasts at a discount. However, we believe that the new forecast, on which the CNB will decide in November, may not necessarily lead to any substantial change in its policy.

Regarding our view of economic developments, we are not now going to change the economic growth forecasts for this year and the next (2.5%) because of the revision. Only the GDP structure and the absolute GDP amount are likely to change slightly.

CZ: GDP Growth
(y/y, %)



CZ: GDP
(CZK bn)



Weekly preview

CZ: Will holidays influence industrial output?

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

	Aug-14	Jul-17	Aug-13
Monhtly	4.7	8.6	1.9
cummulative (YTD)	6.3	6.6	-2.8

Soft data as well as orders still suggest that industrial output should continue to be very strong for a few more months, owing, in particular, to the automotive industry, which should maintain a double-digit rate, due to innovations and positive developments in the overall European trend. However, factory-wide workforce leaves at large businesses, which take place in the summer of every year, pose a risk to the August forecast. Even a shift between July and August can make the figure for the manufacturing industry fairly misleading. Hence we will also subsequently evaluate data on production as well as new orders from this perspective. In any event, industry continued to be the primary driver of the Czech economy in the third quarter.

HU: Growth in industrial prodution still strong

TUE 9:00 HU Industry (y/y change in %)

	Aug-14	Jul-17	Aug-13
Monhtly	12.0	12.3	0.5

Industrial production was strong in the previous months, increasing aove 10% YoY. Although the confidence indicies were decreasing previous months, and also the European economies slowed down, the new orders and the new capacities in the industrial sector (for example car manufacturing) suggest that industry might increase by about 12% YoY in August. But it may gradually slow in the following months.

PL: Central bank resumes its rate cut cycle

WED around 12:00 NBP base rate

	This meeting	Last change
rate level (in %)	2.25	7/2013
change in bps	-25	-25

The National Bank of Poland is likely to resume its monetary easing cycle and cut rates by 25 bps on Wednesday, after more than a year. Although the economy grew by more than 3% in the first half of the year, inflation dropped into negative territory in the summer, and a combination of external adverse factors, with the Ukrainian crisis being the primary one, will lead to a growth rate deceleration in the second half of the year. This factor will curb a faster return of inflation to its target. Even though we cannot completely rule out a greater rate cut, by 50 bps, we believe that the economic situation is not serious enough for the NBP to proceed to such a move. This is why we expect a rate cut by 25 bps in October, accompanied by the same move in November. Moreover, risks are diverged towards an even greater monetary easing.

CZ: Inflation slightly on the rise

THU 9:00 CZ Inflation (change in %)

	Sep-14	Aug-14	Sep-13
CPI m/m	-0.1	-0.1	-0.4
CPI y/y	0.9	0.6	1.0
Monetary relevant inflation y/y	0.8	0.5	0.2

We believe that the late summer saw a moderate inflation rise. Specifically, September's price developments were primarily influenced by seasonally cheaper package tours, on the one hand, and by higher prices of seasonal goods on the other. Food prices, in particular, pose uncertainty, as they usually – but not always – rise in this period. A downside inflationary factor that is 'waiting to materialise' continues to be the excise duty on tobacco products, which has not fully influenced market prices thus far. Inflation will tend to rise at a moderate rate for the rest of the year, but the CNB's target value is still far from being reached.

HU: Inflation back at zero

FRI 9:00	HU Inflation (change in %)		
	Sep-14	Aug-14	Sep-13
CPI y/y	**0.0**	0.2	1.4

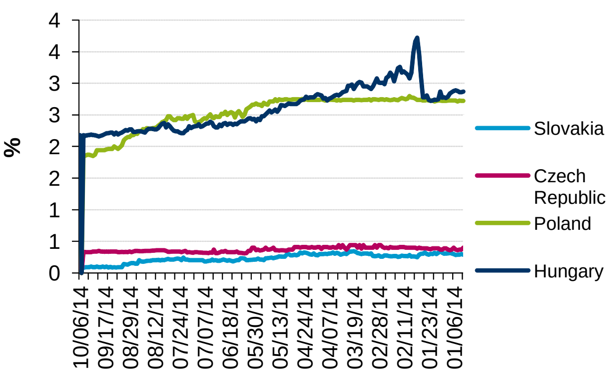
Inflation is expected to return below 0% in September because of base effect. The consensus is 0.3% YoY drop of CPI and stagnation on month on month basis. While the base pushes inflation down in September, it will have countrary effect in the following months, so CPI is expected to accelerate to 1% YoY at the end of the year.

Calendar

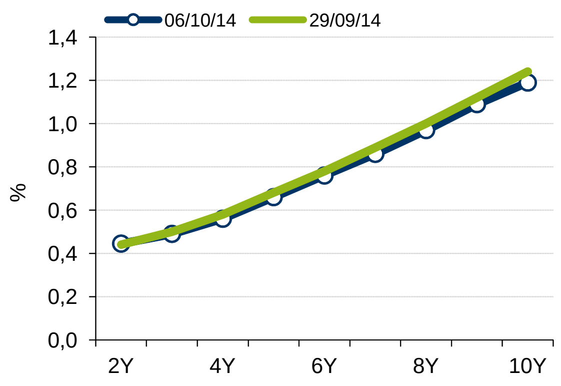
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	10/06/2014	9:00	Retail sales	%	08/2014		3.8		3.2		6.2
HU	10/07/2014	9:00	Industrial output	%	08/2014 *P				12.5	1.6	12.3
CZ	10/07/2014	9:00	Trade balance (national)	CZK B	08/2014	7.5		5.6		11.5	
CZ	10/07/2014	9:00	Industrial output	%	08/2014		4.7		0.7		8.6
CZ	10/07/2014	9:00	Construction output	%	08/2014						-3.7
HU	10/07/2014	16:00	Budget balance	HUF B	09/2014					-858.8	
CZ	10/08/2014	9:00	Unemployment rate 15-64	%	09/2014	7.4		7.3		7.4	
CZ	10/08/2014	12:00	CZ bond auction 2014-25, 2.40%	CZK B	10/2014						
CZ	10/08/2014	12:00	CZ bond auction 2014-2020, floating rate	CZK B	10/2014						
PL	10/08/2014	14:00	NBP meeting	%	10/2014	2.25		2.25		2.5	
CZ	10/09/2014	9:00	CPI	%	09/2014	-0.1	0.9	-0.1	0.9	-0.1	0.6
HU	10/09/2014	9:00	Trade balance	EUR M	08/2014 *P			530		481.8	
HU	10/10/2014	9:00	CPI	%	09/2014				-0.3	-0.2	0.2

Fixed-income in Charts

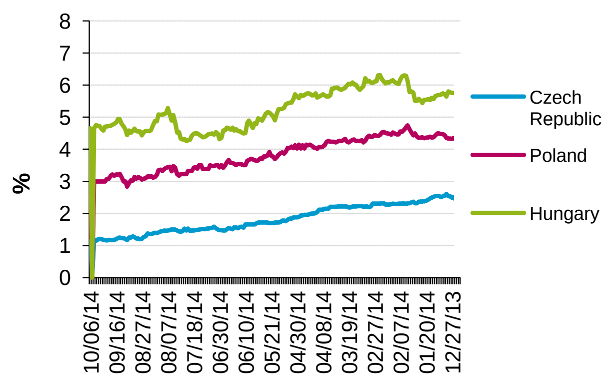
FRA 3x6



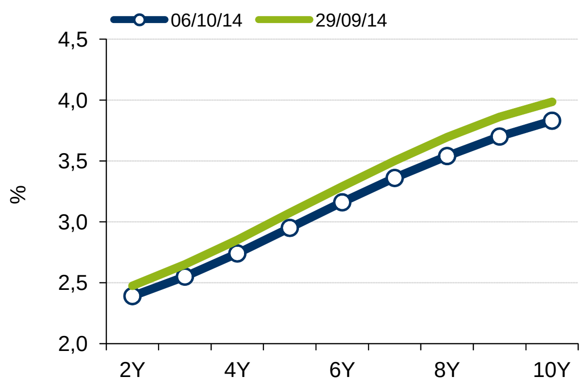
CZ IRS



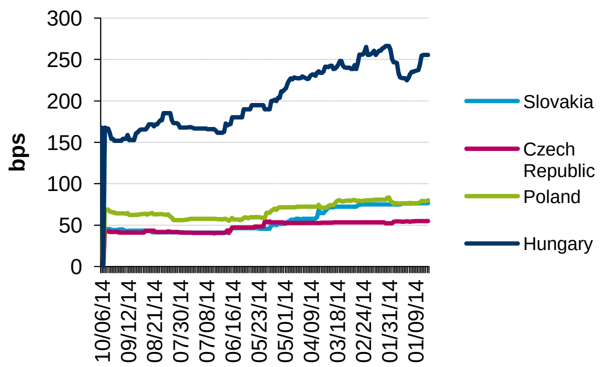
10Y GB Yields



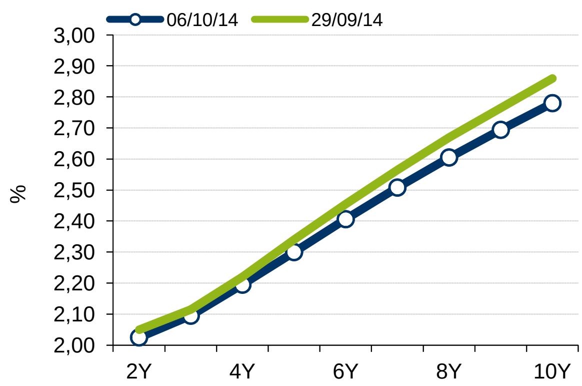
HU IRS



CDS 5Y



PL IRS



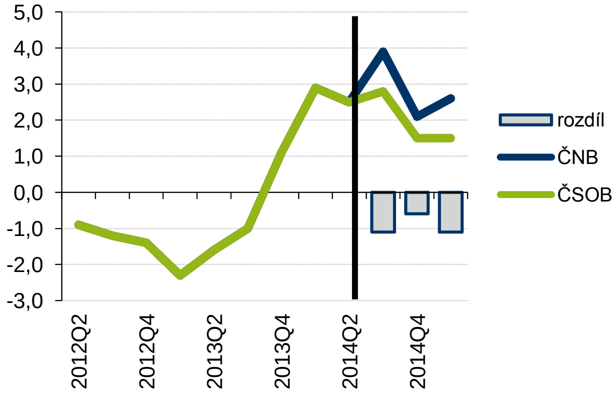
Source: Reuters

Medium-term Views & Issues

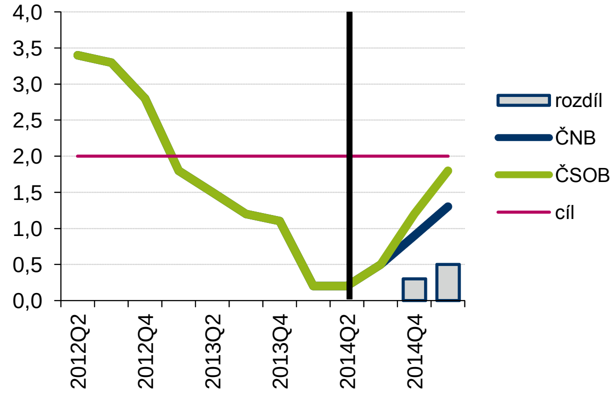
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its 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. 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. 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%. 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. 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

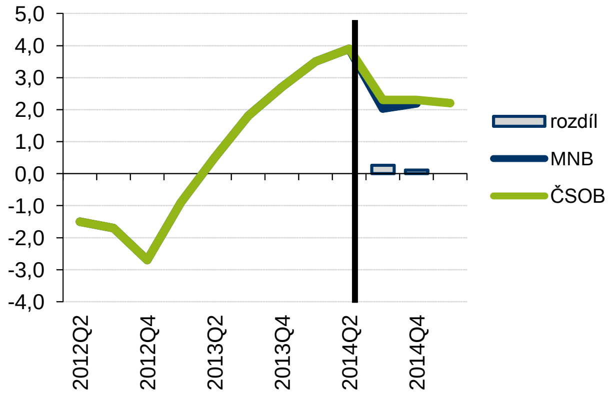
CZ: GDP outlook (Y/Y, %)



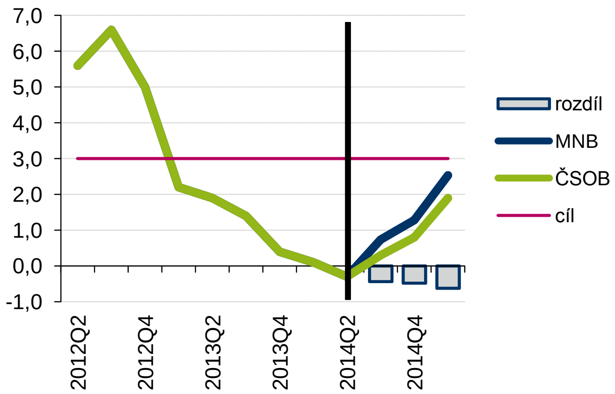
CZ: Inflation outlook (Y/Y, %)



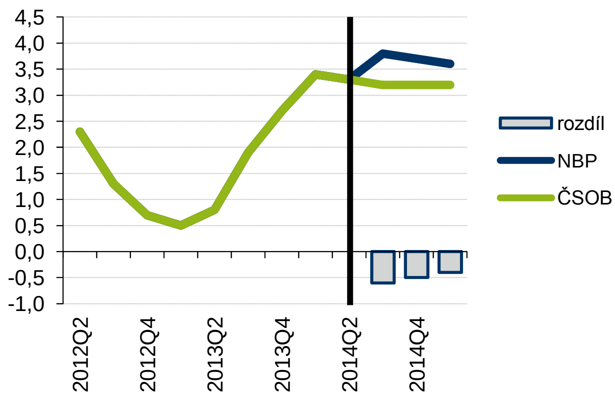
HU: GDP outlook (Y/Y, %)



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	0.34	0.35	0.35
Hungary	BUBOR	*2.09*	2.67	2.34	2.09	2.15	2.15
Poland	WIBOR	*2.24*	2.71	2.68	2.28	2.20	2.20

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

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	CZ10Y	*1.19*	1.84	1.34	1.22	1.50	1.61
Hungary	HU10Y	*3.83*	4.95	3.77	3.92	3.50	3.65
Poland	PL10Y	*2.78*	4.03	3.39	2.87	2.60	2.60

Exchange rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	EUR/CZK	*27.5*	27.4	27.4	27.5	27.7	27.4
Hungary	EUR/HUF	*309*	307	310	311	310	310
Poland	EUR/PLN	*4.19*	4.17	4.16	4.18	4.17	4.17

GDP (y/y)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	-1	1.1	2.9	2.5	2.8	1.5	1.5
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	0.9	1.4	1.9
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	-2.1
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, 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	Frankfurt	+49 69 756 19372
Shawn Britton	+353 1 664 6892	Singapore	+65 533 34 10
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