Central European Weekly

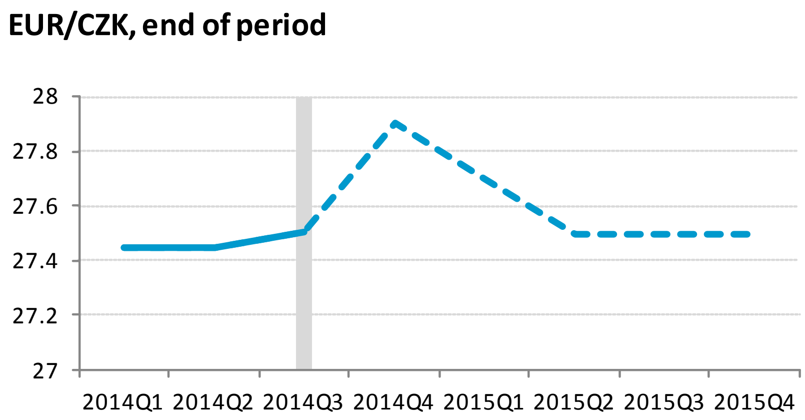
Monday, 20 October 2014

Table of contents

Weekly Highlights:

- Negative spill-over effects from global sell-off have been limited so far
- Poland still remains in deflation
- The Polish industrial output for September mitigates the disappointment of last month
- In Focus: Updated EUR/CZK outlook and its highlights

Chart of the Week: New EUR/CZK outlook



The one-year anniversary of the launch of forex interventions against the koruna, aimed at easing the monetary policy, raises the question of what the Czech National Bank will do about the Czech currency's exchange rate over the next year (and a half). We are afraid that, due to external factors (a decline in the EMU's economic growth), the CNB will again need to lower its forecast in November (2014 this time) and consequently reduce its inflation outlook for 2015. Hence even the question of further monetary easing (at least verbal) through another weakening of the koruna may be brought onto the agenda in some time.

Market's editorial

Spill-over of global sell-off has been limited so far

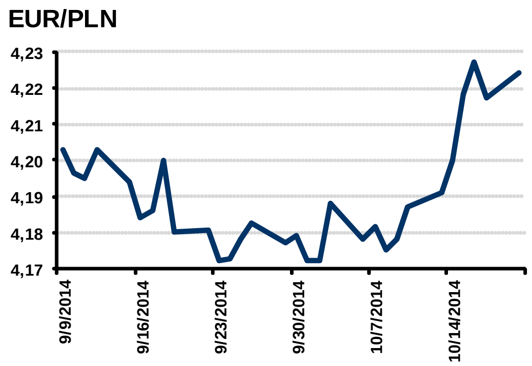
The huge sell-off in global stock and commodity markets also affected Central European markets, including but not limited to stock markets. Regional currencies and government bonds also reacted, though not in the same way.

The most visible losses were recorded by Hungarian government bonds and the Polish zloty. Neither is a great surprise. The risk profile of Hungarian government bonds is still the highest of the Central European region, due also to the fact that many of these securities are held by foreign investors. The zloty, by contrast, is affected by the National Bank of Poland having resumed its monetary easing cycle, which makes the Polish currency more vulnerable when the other emerging market currencies are weakening.

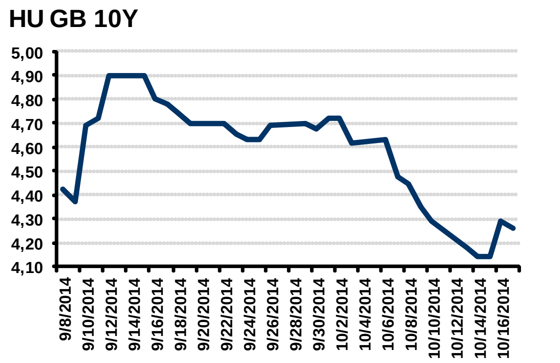
In general, the drop in commodity prices (i.e., oil prices in particular) should be seen as a positive shock, but the question in this context is to what extent the shock is (co)triggered by the drop in global demand, notably in the euro area on which Central European economies are vitally dependent. Preliminary business sentiment indices (PMIs) to be released in a few days may hint at how serious the situation in Central Europe's key tardinmg partner - the Euro-zone.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.6	0.02%	↗	↗
EUR/HUF	306	-0.17%	↗	↗
EUR/PLN	4.22	0.57%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.16	0.87	↘	↘
10Y HUF	3.40	-3.41	↗	↗
10Y PLN	2.49	-0.80	→	→



EUR/PLN, last 30 days. Source: Reuters



HU GB 10Y, last 30 days. Source: Reuters

Review of Economic Figures

The Polish industrial output for September mitigates the disappointment of last month

After the National Bank of Poland (NBP) had rapidly cut its base interest rate (by 50 bps) early this month, some market participants apparently became concerned that the impacts of the euro area's economic growth deceleration and the difficulties in Ukraine might be even stronger from the perspective of monetary policymakers than this probably seemed a few months ago. Nevertheless, the data released last week did not indicate any highly adverse scenario.

If we begin with the end of the week, September's industrial output rose more than expected. Although this surprise could be partly attributable to the equally surprising decline in August (which occurred across the region), the year-on-year rise by almost 2% and month-on-month rise by 1% (seasonally adjusted) are not at all tragic. The growth deceleration of the Polish economy in the third quarter, probably way below 3%, is evident but, on the other hand, the fact that 26 of 34 sectors grew on a year-on-year basis is still fairly encouraging.

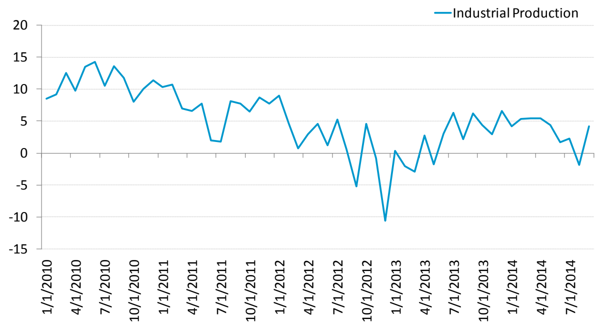
The labour market data released in the middle of the week basically met expectations. The quite robust wage growth of 3.4% is clearly good news for the rest of the year. As the inflation rate is negative, such wage growth is a solid basis for a further rise in household consumption, which should continue to be the primary growth driver for the rest of the year.

Poland still remains in deflation

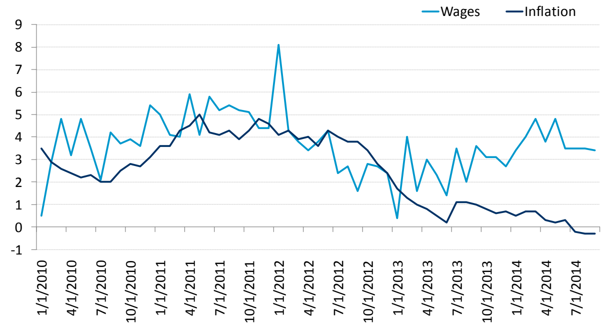
September's inflation rate was also slightly higher than expected, unlike the rest of the region. As concerns the structure, we were most surprised at a moderate rise in education prices and a slightly greater than expected rise in clothing and shoe prices. Although September's inflation rate as a whole was a little higher than we had expected, the currently observed rapid decline in oil prices is quite possibly increasing the risk of Polish inflation not turning from negative into positive values before early next year.

By and large we believe that the data released last week supported the scenario on which we are still betting – i.e., a 25 bps rate cut in November.

PL: Industrial production
Y/Y in %



PL: Nominal gross wages vs. Inflation
Y/Y in %



In Focus: Updated EUR/CZK outlook

• The one-year anniversary of the launch of forex interventions against the koruna, aimed at easing the monetary policy, raises the question of what the Czech National Bank will do about the Czech currency's exchange rate over the next year (and a half). We are afraid that, due to external factors (a decline in the EMU's economic growth), the CNB will again need to lower its forecast in November (2014 this time) and consequently reduce its inflation outlook for 2015. Hence even the question of further monetary easing (at least verbal) through another weakening of the koruna may be brought onto the agenda in time. Naturally, this is something the koruna may not like.

• We anticipate clearly lower growth and inflation in the euro area, and therefore we also predict, on the whole, a slower rate of Czech inflation. In 2015, inflation will again be below the CNB's 2% target, and the question is how the CNB Board will react to this. The recollection of the negative response from the Czech public to the last devaluation of the currency and the fact that inflation will remain in positive territory should be the main arguments against a further targeted weakening of the currency. Yet we see an approximately 40% likelihood of this scenario, which may happen in 2015. Before that, however, the strengthening downside pressures on inflation (in the euro area) might also lead to a new extension of the commitment to intervene against the koruna in the Czech Republic (beyond 2016).

• Nonetheless, we still optimistically believe that the ECB and actually the EU as a whole will eventually respond expansively enough to avert the imminent 'Japanese scenario'. In that event, the koruna might really leave its intervention regime in 2016. And what could such a departure look like? We believe that maintaining the intervention regime for a longer time would lead to a greater appreciation of the real equilibrium exchange rate, which will not be fully counterbalanced by slightly increased inflation. We predict the adequate nominal equilibrium exchange rate for the middle of 2016 to be below CZK 26.00 per EUR. Hence, if the existing exchange rate regime is ended, speculations about an abrupt appreciation of the Czech currency will hardly be avoided. Moreover, such appreciation may be encouraged by bets on the first rate hike. Nonetheless, we believe that the CNB will not allow the koruna to strengthen significantly and will strive to smoothen the exit through huge interventions. Nevertheless, we still expect the EUR/CZK exchange rate to move towards the level of CZK 26 per EUR at the end of the intervention regime (2016?).

	2014	2015	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
EUR/CZK (average)	27.55	27.60	*27.44*	*27.45*	*27.62*	27.70	27.80	27.60	27.50	27.50
EUR/CZK (end-of-period)	27.90	27.50	*27.45*	*27.45*	*27.51*	27.90	27.70	27.50	27.50	27.50

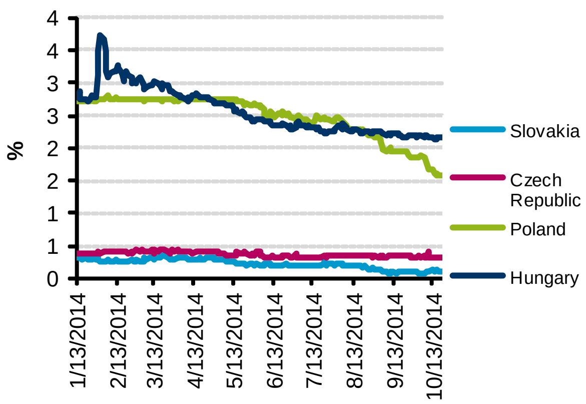
Already realized values are marked by italics and grey background. Source: CSOB, Bloomberg.

Calendar

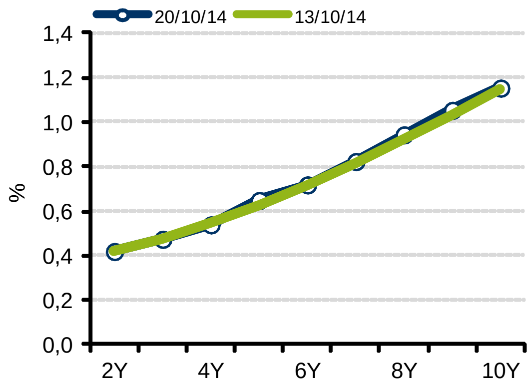
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	10/23/2014	10:00	Retail sales	%	09/2014			0	2.4	-1.1	1.7
PL	10/23/2014	10:00	Unemployment rate	%	09/2014			11.6		11.7	

Fixed-income in Charts

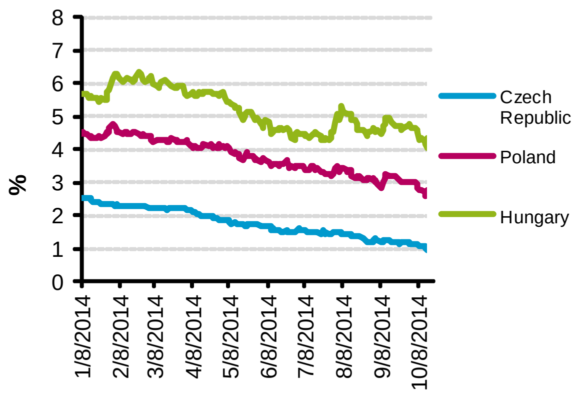
FRA 3x6



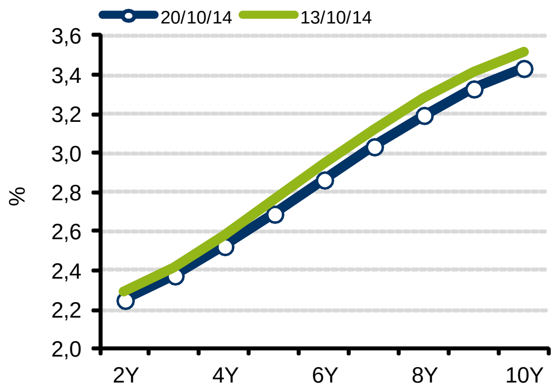
CZ IRS



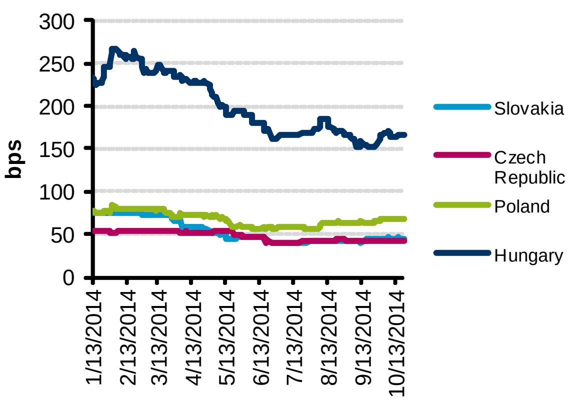
10Y GB Yields



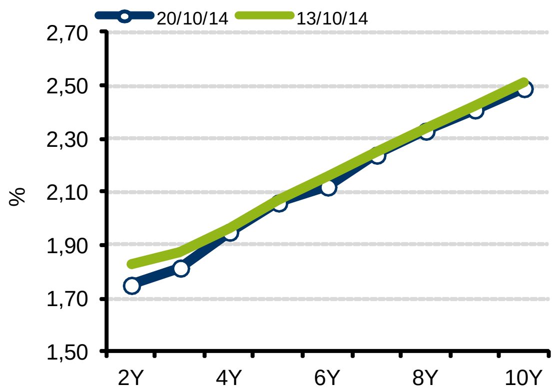
HU IRS



CDS 5Y



PL IRS



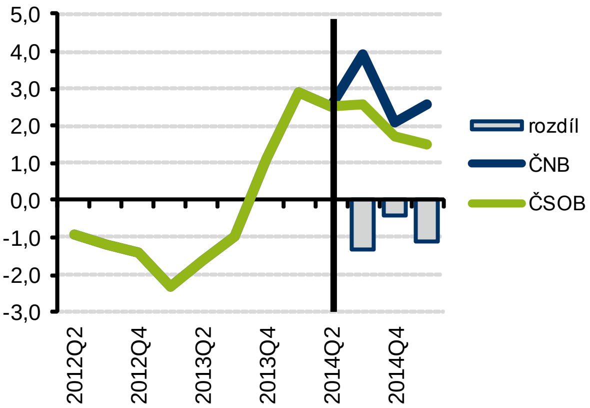
Source: Reuters

Medium-term Views & Issues

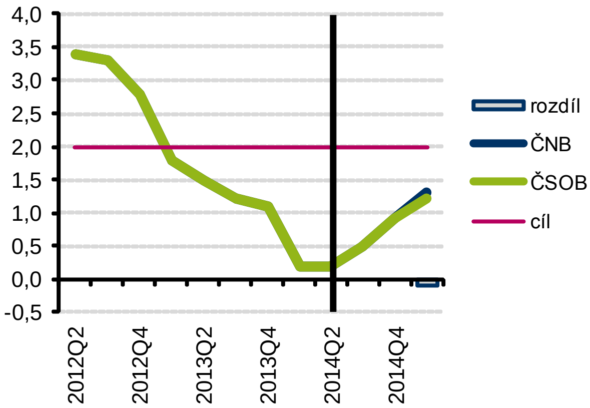
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its 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. We therefore expect a significant slowdown in economic growth in the second half of the year and in 2014 expect overall growth slightly below but close to 3%.
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. The NBP therefore decided to cut interest rates by 50 basis points in October after 15 months of their stability and did not exclude adjustments in months to come. At the time being, we expect yet-another rate cut of 25 bps in November, although an option of a more pronounced 50 bps cut probably is not off the table.
Forex Outlook	We anticipate clearly lower growth and inflation in the euro area, and therefore we also predict, on the whole, a slower rate of Czech inflation. In 2015, inflation will again be below the CNB's 2% target, and the question is how the CNB Board will react to this. The recollection of the negative response from the Czech public to the last devaluation of the currency and the fact that inflation will remain in positive territory should be the main arguments against a further targeted weakening of the currency. Yet we see an approximately 40% likelihood of this scenario, which might happen in 2015.	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

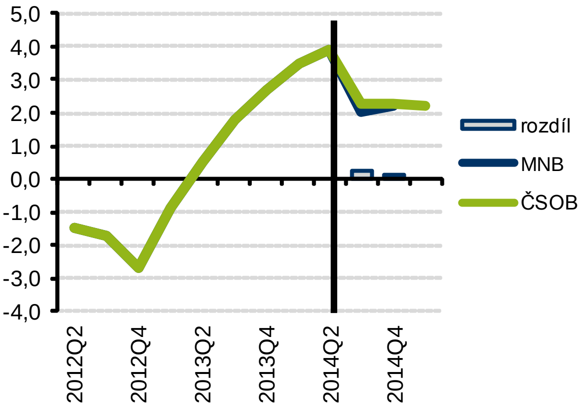
CZ: GDP outlook (Y/Y, %)



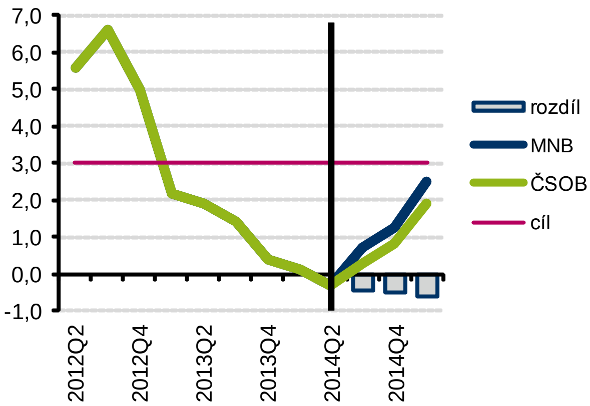
CZ: Inflation outlook (Y/Y, %)



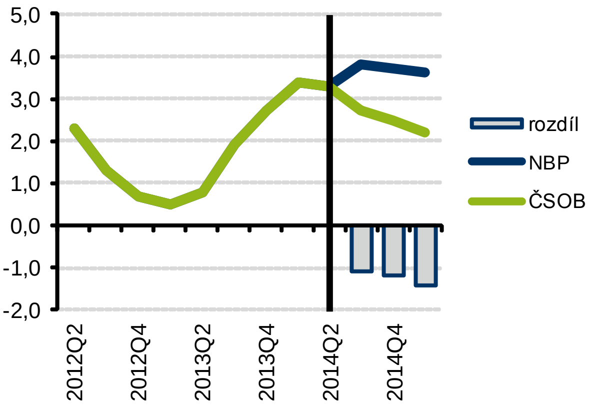
HU: GDP outlook (Y/Y, %)



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	*2.00*	2.50	2.50	2.50	1.75	1.75	-25 bps	10/8/2014

*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	*2.10*	2.67	2.34	2.09	2.15	2.15
Poland	WIBOR	*2.02*	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	*1.155*	1.84	1.34	1.22	1.25	1.30
Hungary	HU10Y	*3.40*	4.95	3.77	3.92	3.50	3.65
Poland	PL10Y	*2.49*	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	*27.6*	27.4	27.4	27.5	27.9	27.7
Hungary	EUR/HUF	*306*	307	310	311	310	310
Poland	EUR/PLN	*4.22*	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	2.6	1.7	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	2.7	2.5	2.2

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

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	1	1.4	0.2	0.0	0.7	1.0	1.3
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	-2.0
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

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