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Central European Weekly

Monday, 02 February 2015

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- Regional inflation indices to stay in deep deflationary territory and to challenge central banks' policies
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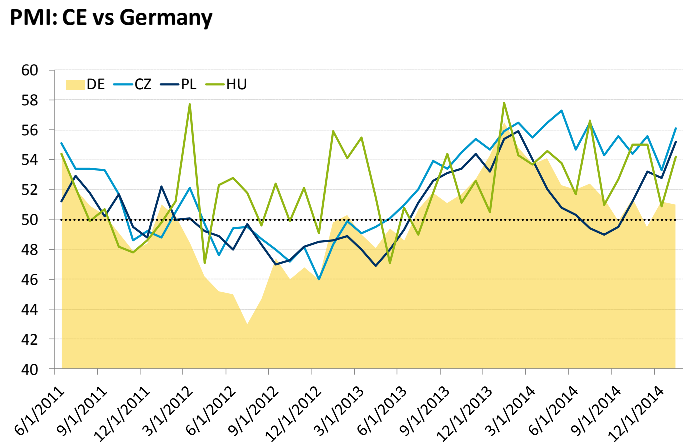
- The NBP will stay still on hold, but voices for a rate cut might be heard
- The CNB might extend its FX commitment for the EUR/CZK floor until the end of 2016

Chart of the Week: Regional PMIs up!



Unlike at the end of the last year, regional Purchasing Managers' Indices (PMIs) surprised positively in January. A sharp surge in the Polish index which hit the highest level since February last year. Similarly, the Czech PMI hit a six-month high (56.1) while the traditionally more volatile Hungarian index exceeded 54 points

Market's editorial

Regional PMIs look goo, but January's CPI will be a challange

Although the just released regional PMI's look still very good, a slump in January's inflation (to -0.5 %) in Germany and subsequently also in the euro area as a whole reminds us why the ECB launched a new wave of massive monetary easing. Negative inflationary pressures inevitably spill over to Central Europe, where inflation will be likely pulled down into negative territory too. In such circumstances, markets´ attention has been naturally attracted by upcoming meetings of two regional central banks – the Czech National Bank and the National Bank of Poland. Consumer inflation has been deep below their respective targets for a long time, with the CNB having addressed the unwelcome development by a targeted devaluation of the koruna and the NBP by cutting its rates to their all-time lows. Although we do not think that either the NBP or the CNB were ready to step up their pro-inflationary efforts this week, the meetings and subsequent press conferences may well provide markets with useful hints and clues.

The NBP on hold, but a rate cut is in the cards

Nevertheless, we still expect the NBP to again leave rates unchanged at this meeting. Although inflation fell even faster than expected by the market, figures from the real economy are not bad. Nominal wages grew by almost 4% y/y (at 1% deflation). Such strong wage growth creates good preconditions for solid performance by domestic demand, which has driven the Polish economy upwards over the past year. Yet we believe that super-low inflation, combined with the ECB's monetary expansion, will eventually make the Polish central bank cut rates again – by 50 bps by this summer.

Will The CNB to extend its FX commitment?

Although we expect that the Czech January's CPI figures will show the number minus 0.3% y/y, the main reason why the it has been driven so deep into negative territory is primarily cheap oil. Thus, no wonder that CNB representatives have talked about a positive supply shock and that they consider its exchange rate policy as appropriately fine-tuned. So deflation does not trouble the CNB at the moment, because the Czech economy and demand are growing. Hence we do not expect a change to its policy in the remainder of this year either. On the other hand we thing that the Bank Board might extend the existing exchange rate commitment beyond the previously announced threshold of early next year. Thus, given the outlook for inflation, the exchange rate of the koruna is not likely to be relaxed until the end of 2016 or the begining of 2017.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.8	-0.06%	↗	→
EUR/HUF	311	-0.03%	→	↗
EUR/PLN	4.17	-1.12%	→	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0.72	-1.37	→	↗
10Y HUF	2.61	0.77	→	↗
10Y PLN	1.83	-1.83	→	↗

In Focus: How weak is the Czech koruna?

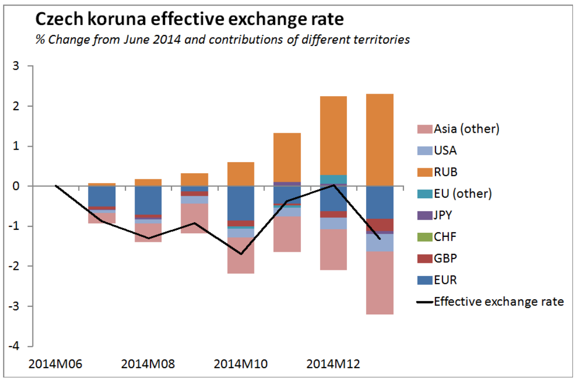
The EMU inflation slumped to -0.6% y/y in January. This reminds us why the ECB decided to massively print new money. Negative inflationary pressures are also filtering through into the Czech Republic. We expect that Czech inflation may even be negative for the first time since 2009 – specifically at -0.3% (y/y) in January. Both the European Central Bank and the Czech National Bank believe that monetary expansion and, in particular, weaker currencies, will help to stabilize inflation. However, is the koruna weak enough to have any material impact on inflation in 2015?

The Czech koruna weakened against the US dollar by almost 17% y/y, mostly due to the (anticipated) monetary expansion of the ECB. Nevertheless, the Czech Republic's share of foreign trade with the United States is relatively small (approximately 2.5%). On the other hand, the Czech koruna also depreciated versus numerous Asian currencies (Chinese yuan, Korean won), which are more or less tied to the US dollar. China and Korea have a larger share in Czech foreign trade (almost 10%). Even so the effective exchange rate of the koruna (which uses foreign trade weightings) is just 1% weaker year-on-year.

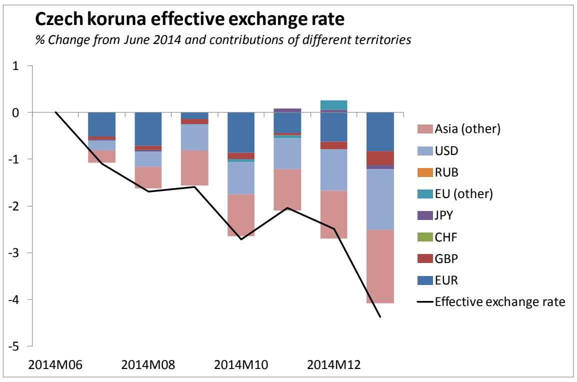
However, this picture is distorted by one important factor – the Russian rouble (see the picture). The Czech koruna has strengthened significantly (by 65%) against the Russian rouble (trade with Russia counts for about 5%) over the last twelve months because of the Russian crisis. We believe that the effective exchange rate of the CZK overstates the impact of a weaker rouble.

Many imports from Russia are denominated in dollar rather than rouble (oil, natural gas). Moreover, with the start of the Russian crisis, numerous Czech exporters have probably started to push for dollar pricing. With this effect included, the Czech koruna weakened by an estimated 3-4% year-on-year.

We expect ongoing weakness in CZK exchange rate to support the economy further. It should also partly offset the effect of falling oil and food prices and contribute to a moderate rise in inflation later in 2015. We expect Czech inflation, after falling into negative territory in the first quarter, to reach 0.8% by the end of this year. The Czech National Bank should be comfortable with that development and keep the exchange rate floor unchanged.



Effective exchange rate: Foreign trade with Russia in roubles



Effective exchange rate: Foreign trade with Russia in USD

Weekly preview

WED 9:00 **CZ Retail Sales (change in %)**

	Dec-14	Nov-14	Dec-13
Sales	**4.0**	0.8	5.6
cummulative (YTD)	**5.2**	5.3	1.2

CZ: Trade still driven by cars

Predicted growth in December's retail sales is again primarily based on strong sales of new passenger cars on the Czech market (although some of them still end up abroad). For the remaining larger part of the retail sector we do not expect any dramatic year-on-year increases. The existing trends may not necessarily change either, i.e., e-commerce expansion and growing demand for electronics, the prices of which have continued to fall despite the weak koruna. This year, however, the situation should gradually change towards a more sustainable rate of retail sales, including the automotive segment. This time cheaper fuel will be a great stimulus, resulting in significant family budget savings; nevertheless, a record-breaking increase in new car sales is unlikely to reoccur.

WED 14:00 **NBP rate (in %)**

	This	Last change
rate level	**2.00**	10/2014
change in bps	**0**	-50

PL: The NBP on hold, but a rate cut is in the cards

We expect the National Bank of Poland to again leave rates unchanged at this meeting. Although inflation fell even faster than expected by the market, figures from the real economy are not bad. Nominal wages grew by almost 4% y/y (at 1% deflation). Such strong wage growth creates good preconditions for solid performance by domestic demand, which has driven the Polish economy upwards over the past year. Yet we believe that super-low inflation, combined with the ECB's monetary expansion, will eventually make the Polish central bank cut rates again – by 50 bps by this summer.

THU 13:00 **CNB base rate**

	This meeting	Last change
rate level (in %)	**0.05**	11/2012
change in bps	**0**	-20

CZ: Will The CNB to extend its FX commitment?

While inflation lags behind the Czech National Bank's latest forecast and has probably been in negative territory since January, the central bank will not change its policy this time either. Hence we expect neither a change to its interest rates, nor a change to its exchange rate policy. The reason is that inflation has been driven into negative territory primarily by cheap oil, i.e., falling fuel prices on the domestic market, and CNB representatives have talked about a positive supply shock and that they consider its exchange rate policy is appropriately configured a couple of times. Deflation does not trouble the CNB, as the Czech economy and demand are growing. We do not expect a change to its policy in the remainder of this year either. The only thing we currently see as likely is an extension of the existing exchange rate commitment beyond the previously announced threshold of early next year. Thus, given the outlook for inflation, the exchange rate of the koruna is not likely to be relaxed until 2017.

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

	Dec-14	Nov-14	Dec-13
Monhtly	**3.5**	-0.4	8.6
cummulative (YTD)	**4.5**	4.6	-0.1

CZ: Positive end of the year for industrial sector

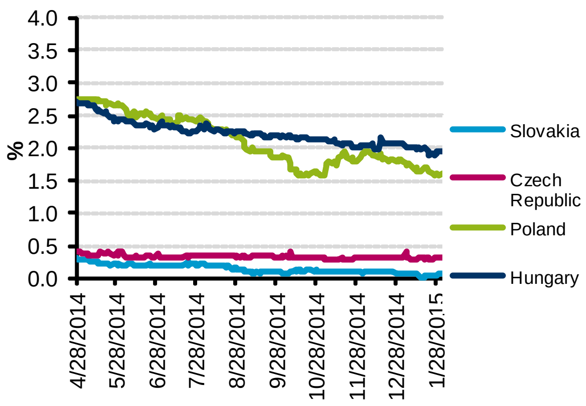
We expect the last data for 2014 from industry to be positive; whether from the perspective of growing production, or orders and employment. Car production continued to grow, yet we anticipate faster rates from the manufacturers of electrical products, electric equipment, and metal products. By contrast, the mining and quarrying industry probably fell again. New orders also grew decently in December, albeit probably not at a double-digit rate any more. Nevertheless, given their previous increase, the figure should still be very positive, ensuring that the trend of Czech industry will continue to be favourable in the first months of 2015.

Calendar

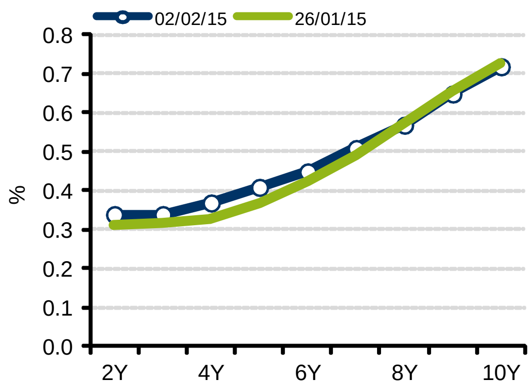
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	02/02/2015	9:00	PMI manufacturing		01/2015			53.1		52.8	
HU	02/02/2015	9:00	PMI manufacturing		01/2015					50.7	
HU	02/02/2015	9:00	Trade balance	EUR M	11/2014 *F					831.8	
CZ	02/02/2015	9:30	PMI manufacturing		01/2015			53.5		53.3	
CZ	02/02/2015	14:00	Budget balance	CZK B	01/2015					-77.8	
CZ	02/04/2015	9:00	Retail sales	%	12/2014		4		4.6		0.8
HU	02/04/2015	9:00	Retail sales	%	12/2014						5.2
PL	02/04/2015	14:00	NBP meeting	%	02/2015	2		2		2	
CZ	02/05/2015	13:00	CNB meeting	%	02/2015	0.05		0.05		0.05	
HU	02/05/2015	17:00	Budget balance	HUF B	01/2015					-825.7	
HU	02/06/2015	9:00	Industrial output	%	12/2014 *P					3.3	5.8
CZ	02/06/2015	9:00	Trade balance (national)	CZK B	12/2014	-1.5		-7.8		13.1	
CZ	02/06/2015	9:00	Industrial output	%	12/2014		3.5		6.7		-0.4
CZ	02/06/2015	9:00	Construction output	%	12/2014						2

Fixed-income in Charts

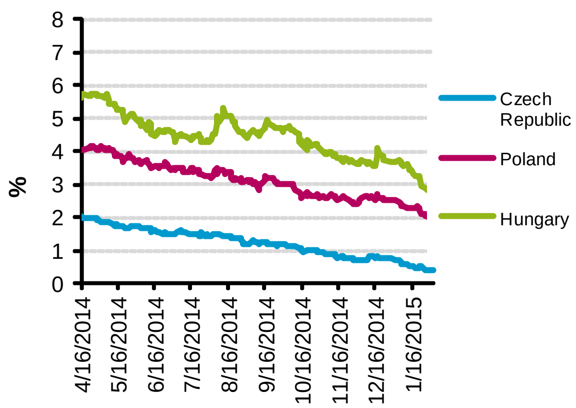
FRA 3x6



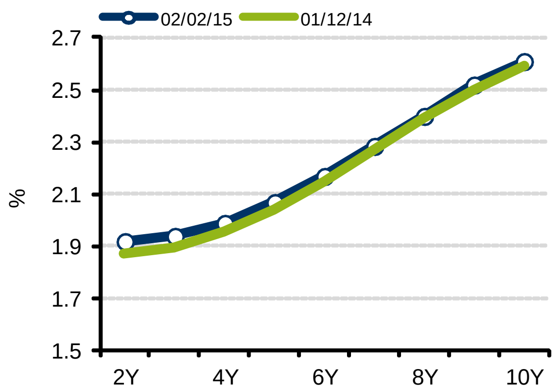
CZ IRS



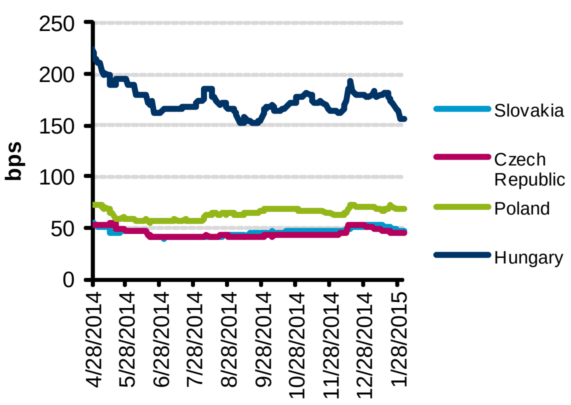
10Y GB Yields



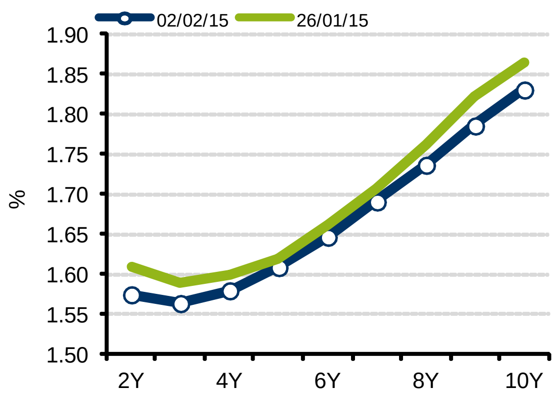
HU IRS



CDS 5Y



PL IRS



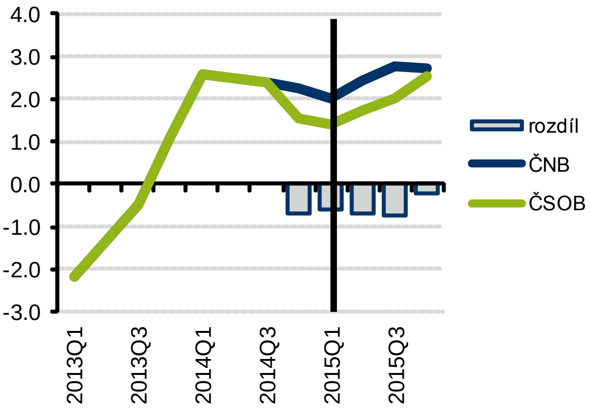
Source: Reuters

Medium-term Views & Issues

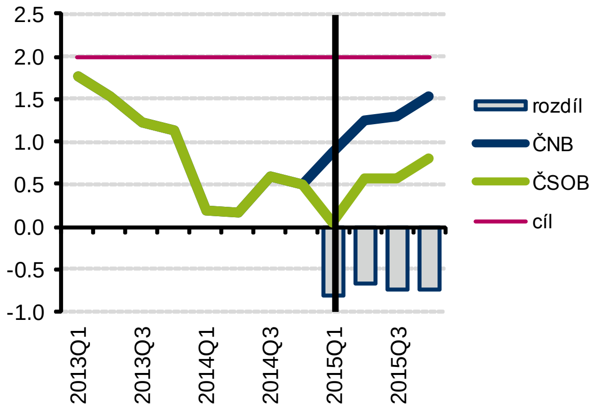
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing of the public sector, which is, however, generating no pressures on the capital market thanks to fairly low debt and reserves. The government policy has not delivered any fundamental economic changes so far, perhaps except for the planned abolition of the pension reform and partial modifications of certain taxes and social security benefits. The issue of euro adoption is still on ice in the CR.	We expect that the economy may slow further in 4Q14 in the range of 2% Y/Y and 2.5% Y/Y, because the new orders in the construction sector is falling, there external demand is deteriorating, so the net external component of the growth is getting smaller. The average GDP growth may be at 3.3% Y/Y in 2014, while it may slow to around 2.2% Y/Y in 2015. In light of the 2014 final data and the sharply falling oil prices, the new outlook is around 0.2% for average CPI in 2015. This means that CPI may remain in the negative territory for the following months and a figure above 1% is expected only around by the end of the year.	According to the GUS estimates, the Polish economy grew by 3.3% in 2014Q3. Moreover, the structure of growth was robust – it was driven by strong households' consumption and investment. Expectations of a slowdown of growth rates in the second half of the year may therefore not materialize. The recent figures suggest this year's economic growth will therefore almost certainly remain well above 3%.
Outlook for official & market rates	Interest rates remain at all-time lows and, given the positive inflation outlook, the CNB is unlikely to raise its base rate before late 2016. In addition, the central bank will not proceed to such a move before it abandons its current exchange rate policy, which is based on maintaining the exchange rate above the EUR/CZK floor. Moreover, the decreasing inflationary expectations may even delay these two steps. This possibility is reflected by money market rates and, in particular, by IRS and government bond yields. Our outlook for inflation as well as short-term interest rates is still below the central bank's official forecasts.	Following ECB's 'bazuka' our view fresh view on Hungary's monetary policy is that the NBH would like to see the inflation figure for the January and how the ECB's decision influenced Hungarian markets. Thus, we think that a fresh rate cut may come in February, if the market environment remains supportive. In that case the NBH may re-start an easing cycle with a 20bps rate (rather than just 10 bps). So, the end of the re-started easing cycle might be around 1.6-1.7%.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. After surprising markets by cutting interest rates by 50 basis points in October, the NBP surprised in November as well, this time by leaving rates unchanged. The overall tone of the meeting was, however, dovish and we therefore not exclude additional rate cut during 2015.
Forex Outlook	We expect that the Czech central bank will not come up with any revolutionary changes at its eagerly expected February meeting. Nonetheless, the koruna will likely be weakening before the meeting. How far can the pair EUR/CZK weaken in the upcoming weeks? Markets remember that the November 2013 intervention pushed the EUR/CZK pair higher by about 5-6 %. It would not be surprising then, if we see the short-term peak in the EUR/CZK 28.7-29 territory (i.e. a roughly 5% devaluation against the 2014 average). After the February (5th) meeting, the crown should start trimming the loss.	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.	The Polish zloty came under pressure at the end of the year in the low liquid trading. Although some of the losses were trimmed recently, the zloty continues to trade on the defensive side Market players seem to realize that inflation is to stay extremely low for considerable time and that NBP board can withsand weaker currency. The pair can sty around 4.25 EUR/PLN in both 3-month and 6-month horizon.

CBs' Projections vs. Our Forecasts

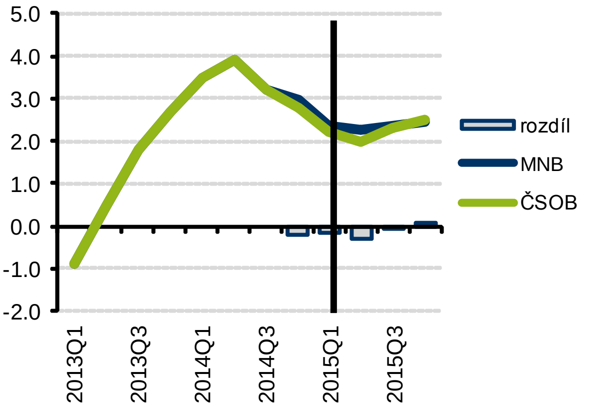
CZ: GDP outlook (Y/Y, %)



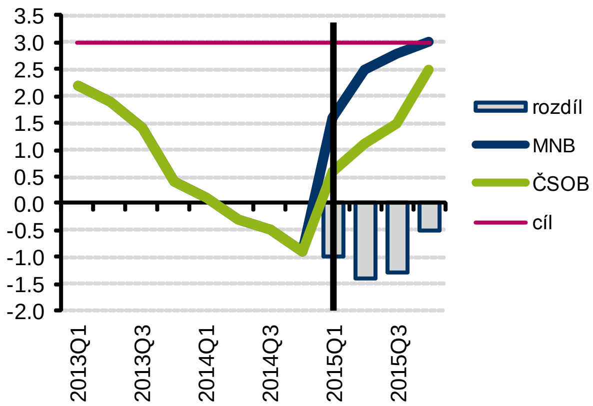
CZ: Inflation outlook (Y/Y, %)



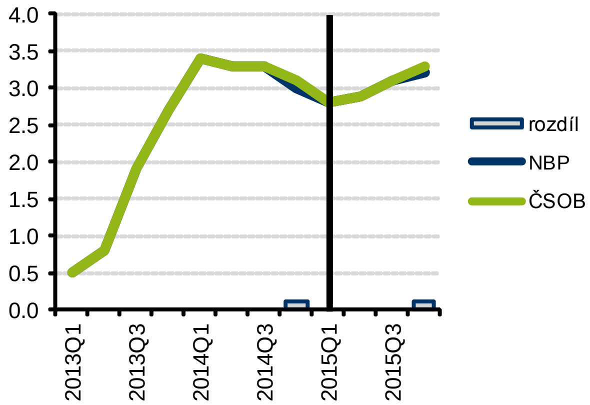
HU: GDP outlook (Y/Y, %)



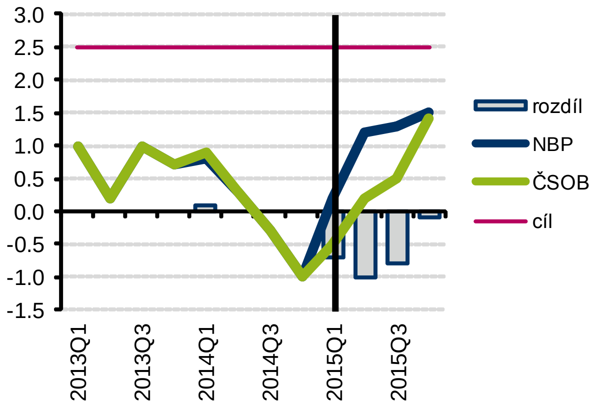
HU: Inflation outlook (Y/Y, %)



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	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	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*	2.10	2.10	2.10	2.10	2.10	-10 bps	7/22/2014
Poland	2W inter. rate	*2.00*	2.50	2.00	2.00	2.00	2.00	-50 bps	10/8/2014

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	PRIBOR	*0.33*	0.34	0.33	0.33	0.32	0.33
Hungary	BUBOR	*2.10*	2.09	2.10	2.10	2.10	2.10
Poland	WIBOR	*2*	2.28	2.06	2.00	2.00	2.00

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	CZ10Y	*0.72*	1.22	0.88	0.75	0.78	0.93
Hungary	HU10Y	*2.61*	3.92	3.25	3.50	3.50	3.65
Poland	PL10Y	*1.83*	2.87	2.23	2.20	2.10	2.20

Exchange rates (end of the period)

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	EUR/CZK	*27.8*	27.5	27.7	28.0	27.7	28.1
Hungary	EUR/HUF	*311*	311	316	315	315	318
Poland	EUR/PLN	*4.17*	4.18	4.28	4.25	4.22	4.20

GDP (y/y)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	2.6	2.5	2.4	1.6	1.4	1.7	2.0
Hungary	3.5	3.9	3.2	2.8	2.2	2.0	2.3
Poland	3.4	3.3	3.3	3.1	2.8	2.9	3.1

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

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	0.2	0.0	0.7	0.1	0.2	0.7	0.6
Hungary	0.1	-0.3	-0.5	-0.9	0.6	1.1	1.5
Poland	0.9	0.3	-0.3	-1.0	-0.5	0.2	0.5

Current Account

	2014	2015
Czech Rep.	0.0	1.8
Hungary	2.2	2.5
Poland	-2.5	-2.5

Public finance balance as % of GDP

	2014	2015
Czech Rep.	-2.0	-2.4
Hungary	-3.0	-3.0
Poland	-3.5	-3.0

Source: CSOB, Bloomberg

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