



Central European Weekly

Monday, 18 May 2015

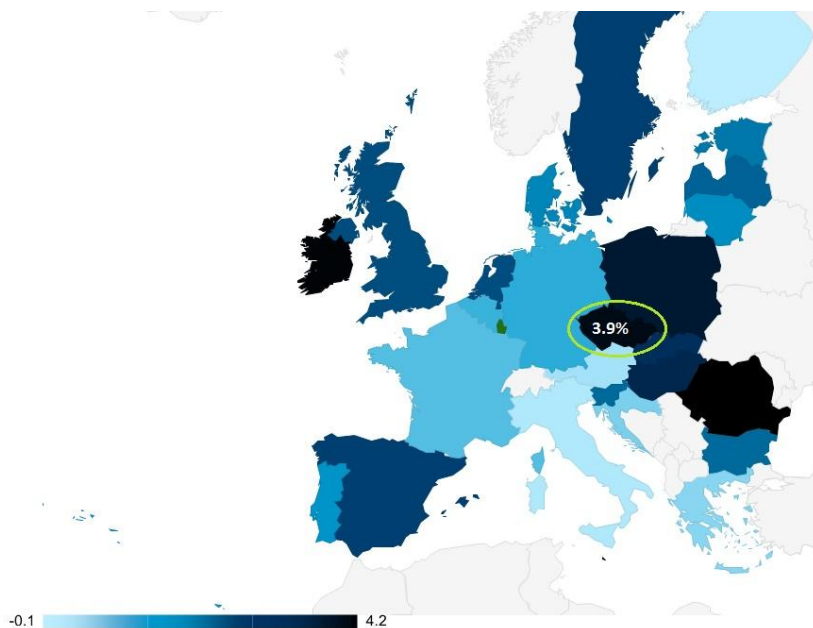
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Weekly Highlights:

- Czech GDP growth reaches almost 4% as industry drives economy up
- Hungary and Poland holds solid growth
- Second round of Polish presidential elections in focus

Chart of the Week: GDP growth in EU in Q1



Compared to the other EU countries, the Czech growth performance is excellent (No.2 in among EU states).

Market's editorial

Convergence story back on agenda in Central Europe?

The Central European economies are growing very swiftly – this is the rather expected message from last week. However, what was not expected and what is also evident from the appreciation of the Czech koruna is the very high growth rate of the Czech economy – almost 4% y/y in the first quarter, a rate which the other Central European countries have lagged behind in early 2015. Admittedly, certain specific factors, such as (cigarette) stockpiling, contributed to the excellent growth of the Czech economy, yet the figure is outstanding.

The robust growth of the Central European economies, exceeding 3%, evokes memories of the convergence story experienced by the region until the global financial crisis. At that time, Central Europe was visibly growing faster than the euro area, and therefore the regional economies and markets were very attractive to investors. If average growth in Central Europe in the quarters to come clearly outpaces that of the euro area – which is our baseline scenario – we can expect that the convergence story will be increasingly

cited on markets, and regional assets may ‘outperform’ their counterparts (emerging markets).

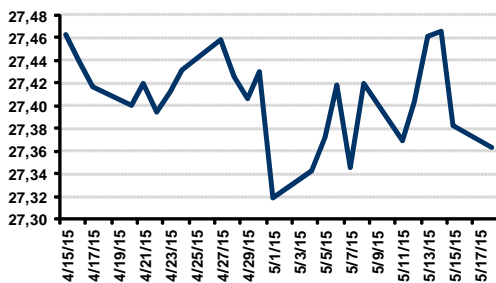
The Polish presidential elections in focus now

However, this week will be about politics rather than macroeconomic data – specifically about the second round of the presidential election in Poland. After the surprising result of the first round, the candidate (Andrzej Duda) for the opposition Law and Justice (PiS) party has continued gaining in popularity. His victory may be unpleasant for the zloty for two reasons. Firstly, it would significantly increase the likelihood that the less market-friendly conservative PiS will also win the more important election to the lower house of the Polish parliament (Sejm) scheduled for the autumn. In addition, it would threaten the possible re-election of M. Belka as governor of the NBP. Recall that his term expires next year. Hence, Duda as the eventual president would probably propose to the Sejm a new NBP governor whose opinions are closer to those of the PiS.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	-0.31%	↘	→
EUR/HUF	306	0.34%	↘	→
EUR/PLN	4.04	-0.97%	↘	→

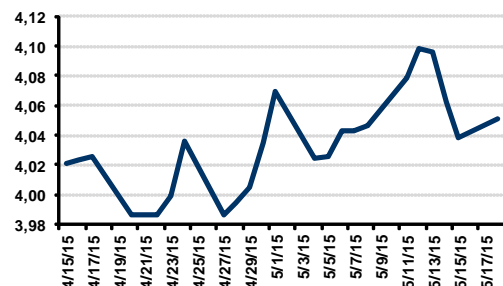
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.05	14.75	↗	↘
10Y HUF	3.28	-0.15	↗	↘
10Y PLN	2.68	3.68	↗	↘

EUR/CZK



EUR/CZK, last 24 days. Source: Reuters

EUR/PLN



EUR/PLN, last 24 days. Source: Reuters

Review of Economic Figures

Industry drives the Czech economy rapidly upwards

The preliminary GDP forecast for the Czech Republic for the first quarter of this year looks incredibly good. The fact that the economy grew rapidly, primarily fuelled by the manufacturing industry, could have been anticipated but the GDP jump of nearly 4% y/y is almost incredible.

In addition, the GDP was fuelled not only by the manufacturing industry, i.e., carmakers, but also by other sectors that have grown decently this year. Although these are still just forecasts, the growth was also probably encouraged by construction and market services.

On the demand side, the economy has been primarily driven upwards by household consumption and investment. Consumer optimism, encouraged by falling unemployment, and improvements in the consumers' financial situation, have led to higher expenditure on consumer goods as well as greater courage in housing investment.

Part of the economic growth is attributable to excise duties on tobacco products. With retailers' stockpiling ahead of changes in these duties, the GDP growth in individual quarters varies. While in late 2014 this had a negative effect on growth, now it is positive again. Hence we believe that the Q2 figure will not be as great at first glance as the current figure (+2.8% q/q).

The Hungarian economy holds its solid growth rate

The Hungarian economy has continued to record solid growth this year. According to the Hungarian statistical office – the working day adjusted GDP grew by 3.4% Y/Y in the first quarter, which reflects a moderate acceleration from the 4Q14 level of 3.2% Y/Y. But the seasonally and working day adjusted Q/Q figure showed a slowdown from 0.9% Q/Q in 4Q14 to 0.6% Q/Q in 1Q15.

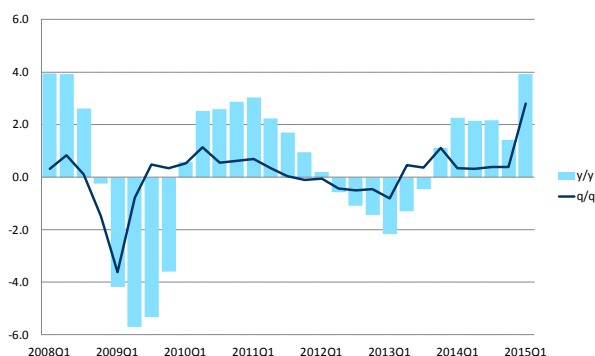
As it was only a preliminary figure the details were not published, but the statistical office said that the main driver of the growth was the industrial production, which is in line with the monthly figure. The construction was also strong in the first quarter although it might slow down from the previous months, while in case of the agriculture the statistical office might use a conservative estimation, because the last year's harvest was quite good. So it looks like that the service sector might perform less dynamically and it might slow down from the previous quarter, so the domestic demand might be slightly weaker than expected. It means that the households are still cautious and they maintain partly their saving attitude. It is partly reflected in the increasing trade balance surplus.

Looking ahead the GDP growth might slow down slightly in the coming quarters, but the favourable European conjuncture and the increasing net real wage and employment increase might provide a stable base for the growth so we expect that Hungarian economy may grow by about 3% Y/Y in this year.

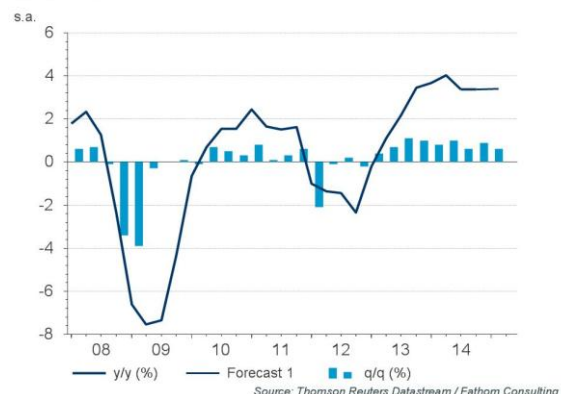
The Polish economy still in a good shape

The development of the Polish economy also continues to be very positive, with GDP growing by 3.5% y/y and 1% q/q in the first quarter of the year. While the growth structure is unknown, the data released during the first quarter suggest that the growth was primarily based on domestic demand. In spite of deep deflation, wages continued to grow very rapidly (by approximately 4% in nominal terms), which is a positive development for household consumption. Investment probably encouraged growth again while foreign trade is expected to have slowed it.

CZ: GDP Growth



HU: GDP



Weekly preview

PL: Second round of presidential elections

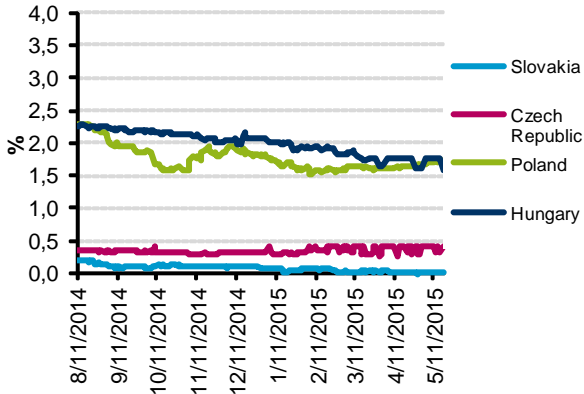
On Sunday, Poland's presidential election is set for a run off between the conservative opposition (Law and Justice party or PiS) candidate Andrzej Duda and current president Bronislaw Komorowski, supported by the center-right Civic Platform party that has ruled Poland for nearly eight years. Andrzej Duda suprisingly won the first round.

Calendar

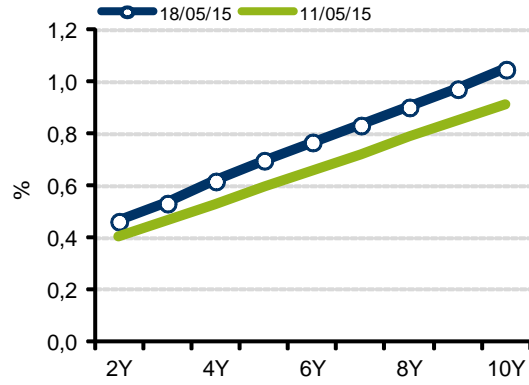
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	05/19/2015	9:00	PPI	%	04/2015	0.2	-2.7	0.3	-2.6	0.5	-2.9
PL	05/19/2015	14:00	Wages	%	04/2015			-1.9	3.9	5.8	4.9
PL	05/20/2015	14:00	Industrial output	%	04/2015			-4.9	5.5	13.4	8.8
PL	05/20/2015	14:00	PPI	%	04/2015			0	-2.2	0.2	-2.4
PL	05/20/2015	14:00	Retail sales	%	04/2015			0.3	1	17.4	3

Fixed-income in Charts

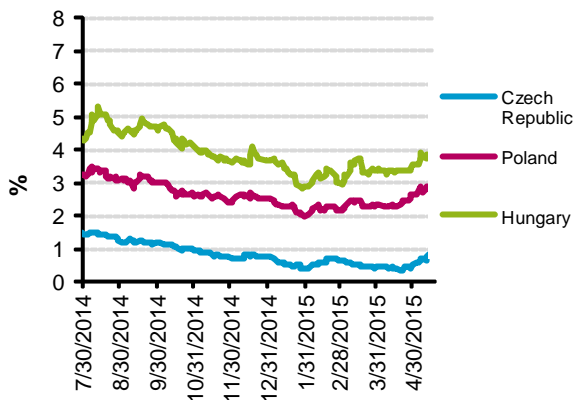
FRA 3x6



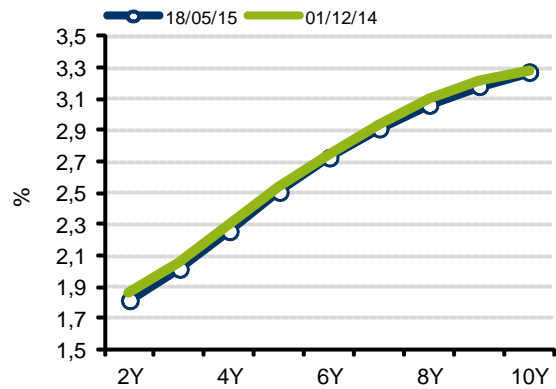
CZ IRS



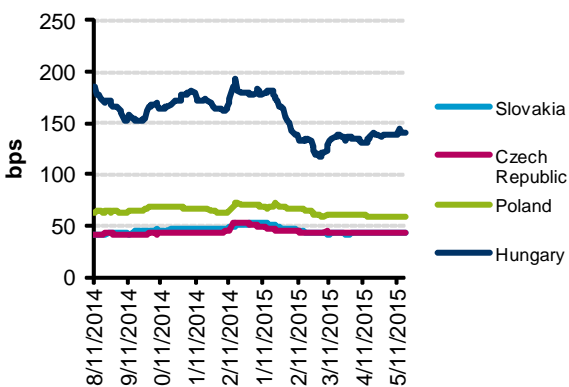
10Y GB Yields



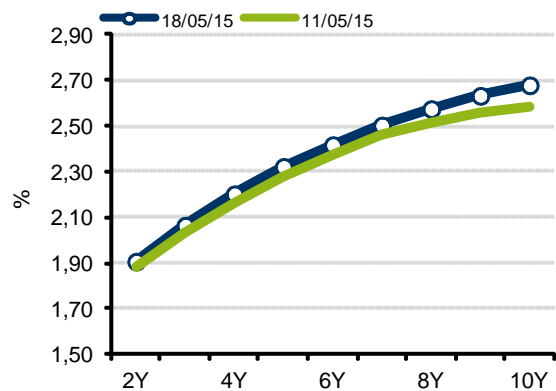
HU IRS



CDS 5Y



PL IRS



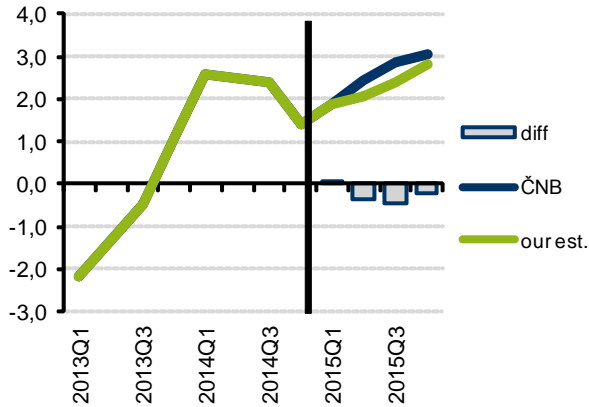
Source: Reuters

Medium-term Views & Issues

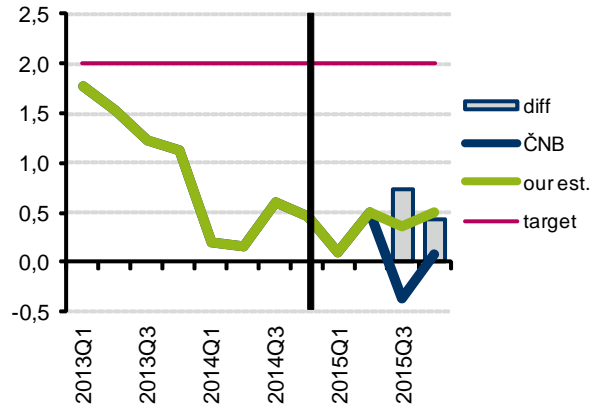
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing 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.</p>	<p>The Hungarian economy has continued to record solid growth this year as the working day adjusted GDP grew by 3.4% Y/Y in the first quarter. Looking ahead the GDP growth might slow down slightly in the coming quarters, but the favourable European conjuncture and the increasing net real wage and employment increase might provide a stable base for the growth so we expect that Hungarian economy may grow by about 3% Y/Y in 2015.</p>	<p>According to the GUS estimates, the Polish economy grew by 3.5% in 2015Q1. As in previous quarters, economic growth was driven mainly by strong domestic demand. We suspect households consumption was again the key driver of economic growth in Poland. As for this year, we expect economic growth will likely surpass 3 %.</p>
Outlook for official & market rates	<p>Interest rates remain at all-time lows and, given the positive inflation outlook, the CNB is unlikely to raise its base rate before 2017. 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 longer term outlook for inflation is still below the central bank's official forecasts.</p>	<p>The march rate cut from the NBH (by 15 bps) confirms our view that mainly the international environment may lead the next months' decisions, and the council may move with 10bp steps in the following months. We see relatively high chance for cuts in April and May, so the base rate might be moderated to 1.75% at the end of May.</p>	<p>We expect the NBP to keep rates at new lows (1.50%) this year, but we cannot completely rule out the likelihood of further rate cuts. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year's inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected.</p>
Forex Outlook	<p>We believe a hike of EUR/CZK floor is still unlikely. This would require deterioration of currently positive economic outlook. On the other hand the, the more aggressive verbal interventions may keep the Czech koruna on the defensive for a while. Hence it is probable that the pair forgets about testing the 27 EUR/CZK for now. Fundamentally, the Czech currency should be more sensitive to readings of major Czech macroeconomic indicators – inflation, wages, industry and, of course, GDP. The koruna may get more nervous ahead of May's CNB Board meeting, where a new inflation forecast will be submitted.</p>	<p>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.</p>	<p>We expect the zloty to gain on growing capital inflows exploiting the positive interest rate differential at the time short term yields are mostly negative in the eurozone. Given the NBP pledge to end the rate cutting cycle, the market may feel temptation to test the willingness of the central bankers to tolerate further gains of the Polish currency.</p>

CBs' Projections vs. Our Forecasts

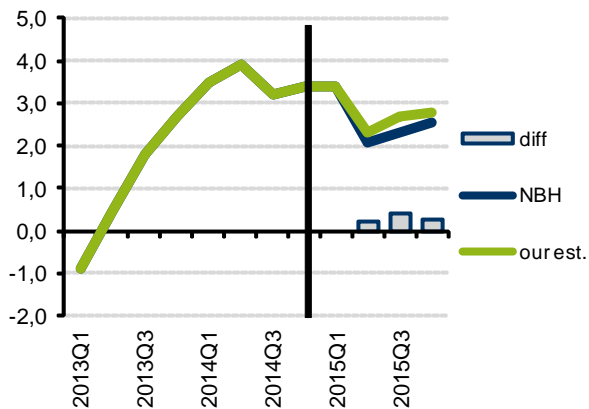
CZ: GDP outlook (Y/Y, %)



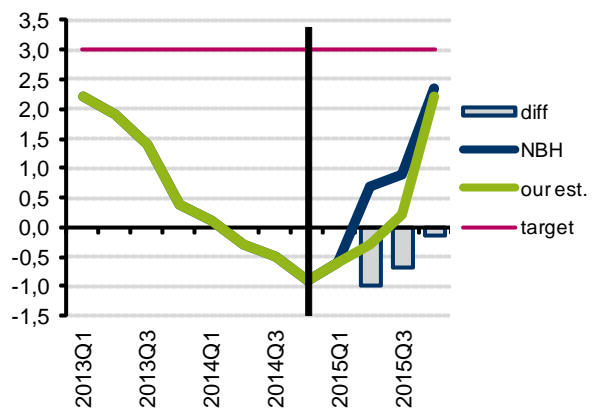
CZ: Inflation outlook (Y/Y, %)



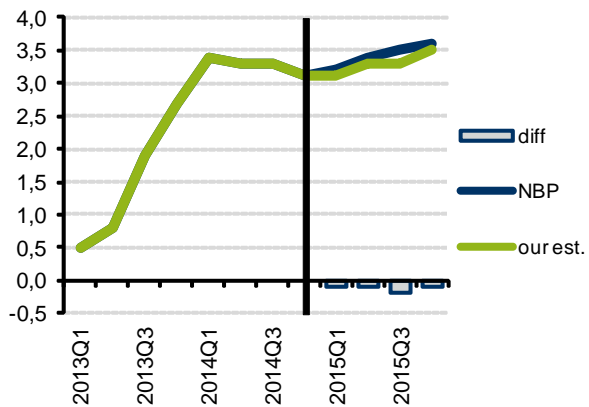
HU: GDP outlook (Y/Y, %)



HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Source: CNB, NBP, MNB, KBC

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	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.	1.80	1.95	1.70	1.70	2.00	2.25	-10 bps	4/21/2015
Poland	2W inter. rate	1.50	1.50	1.50	1.50	1.50	1.50	-50 bps	3/4/2015

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	PRIBOR	0.31	0.30	0.30	0.30	0.30	0.30
Hungary	BUBOR	1.69	1.89	1.70	1.70	2.10	2.40
Poland	WIBOR	1.67	1.65	1.55	1.60	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	1.05	0.64	0.80	0.75	0.80	0.80
Hungary	HU10Y	3.26	2.71	3.20	3.40	3.60	3.80
Poland	PL10Y	2.68	2.12	2.10	2.20	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	27.38	27.57	27.30	27.60	27.30	27.30
Hungary	EUR/HUF	307	300	310	317	315	310
Poland	EUR/PLN	4.05	4.07	4.05	4.00	4.10	4.05

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.4	3.9	2.1	2.4	2.8	2.5
Hungary	3.2	3.4	3.4	2.3	2.7	2.8	2.2
Poland	3.3	3.1	3.5	3.3	3.3	3.5	3.5

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

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	0.7	0.1	0.2	0.6	0.3	0.8	1.5
Hungary	-0.5	-0.9	-0.6	-0.3	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.5	-1.1	-0.8	-0.1	0.4

Current Account

	2015	2016
Czech Rep.	1.6	1.5
Hungary	4.0	3.8
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-2.4	-1.9
Hungary	-2.2	-2.0
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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