Central European Weekly

Monday, 13 July 2015

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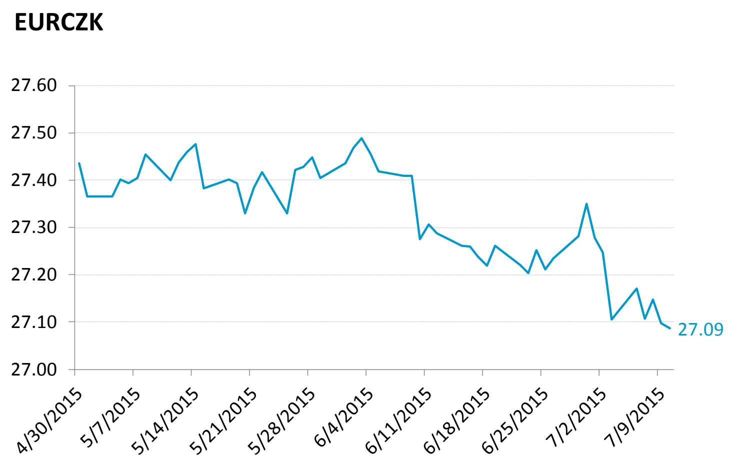
Weekly Highlights:

- EUR/CZK pair test CNB's nerves as it hovers just above 27.0 intervention level
- Hungarian and Czech inflation moved higher – in latter case only temporally
- NBH keeps pushing funding and speculative foreign capital out of Hungary
- Polish inflation readings in focus

Chart of the Week: EUR/CZK and its floor



Following some better news from the Czech economy and more bullish CNB's Minutes the EUR/CZK dropped below the 27 level.

Market's editorial

CZK keeps flirting with intervention floor set by CNB

While the Polish zloty and the Hungarian forint have been under pressure almost since the beginning of May because of the escalation of tension in Greece, the Czech koruna seems to have been untouched. Moreover, the Czech currency strengthened to the vicinity of EUR/CZK 27.00 in the wake of the fairly optimistic tenor of the last CNB Board meeting. So what to expect going forwards?

If an agreement between Greece and its creditors is eventually achieved, there may theoretically be room for appreciation of both the zloty and the forint. After all, we saw the first signs of this during Friday's trading. Moreover, today in early trading, the zloty is being supported even further and hits a ten-day high as the Polish central bank revised its inflation forecast for 2016 significantly to the upside (vis-a-vis the previous one).

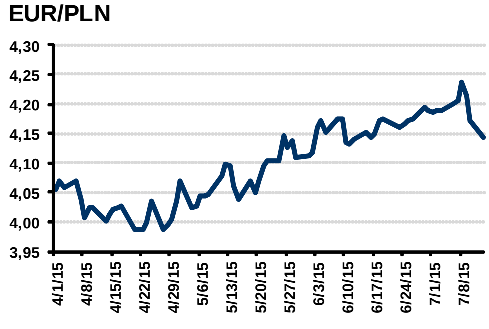
As for the koruna, in conditions like that, it might eventually try to test the intervention threshold of EUR/CZK 27.00. What would follow after that? The Czech National Bank has an almost unlimited arsenal in hand to protect the weak koruna in such an event. In effect, defence of the intervention threshold would probably lead to overwhelming the market with new korunas and to a temporary abrupt depreciation of the exchange rate – by approximately CZK 0.30-0.50 according to our forecasts. Given the positive figures from the Czech economy, little chance of a further devaluation and growing external balance surpluses, the possible losses of the koruna triggered by actual interventions should only be temporary.

NBH keeps pushing foreign capital out of Hungary

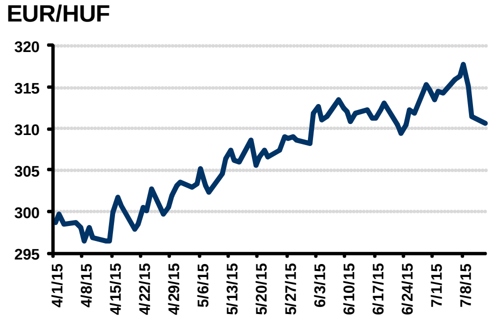
The NBH is still working on pushing out foreign funding and speculative money from Hungary. These measures target to decrease the vulnerability of Hungary and the banking sector. Yesterday's decisions were (effective from January 2016) the following: the tightening of the FFAR (foreign exchange funding adequacy ratio), outstanding swaps can no longer be included in the ratio and the required level of the FFAR will be raised to 100 per cent. The new FECR (foreign exchange coverage ratio) regulation will limit the on-balance sheet currency mismatch at 15 per cent of the balance sheet total, thereby reducing banks' excessive reliance on the swap market. As an effect of the new regulations, the banking sector's short-term external debt may fall by as much as EUR 2–3 billion to EUR 6–7 billion by the end of the 2016, which is equal to 6 per cent of the balance sheet total. Additionally the NBH is introducing an interest rate swap (IRS) facility with ten-year maturity (from September 2015), in addition to the three and five-year maturities already applied. The current outstanding amount of swaps used by the majority of banks is nearly HUF 550 billion. It targets to increase further the banks' holdings of government bonds also in longer tenors. These measures have rather weakening effect on the HUF in short-term, but in long turn it increases the financial stability of the country.

	Last	Change 1W
EUR/CZK	27.1	-0.31%
EUR/HUF	310	-2.01%
EUR/PLN	4.15	-1.19%

	Last	Change 1W
10Y CZK	1.29	-4.44
10Y HUF	3.17	-8.65
10Y PLN	2.78	-6.24



EUR/PLN, last 74 days. Source: Reuters



EUR/HUF, last 74 days. Source: Reuters

Review of Economic Figures

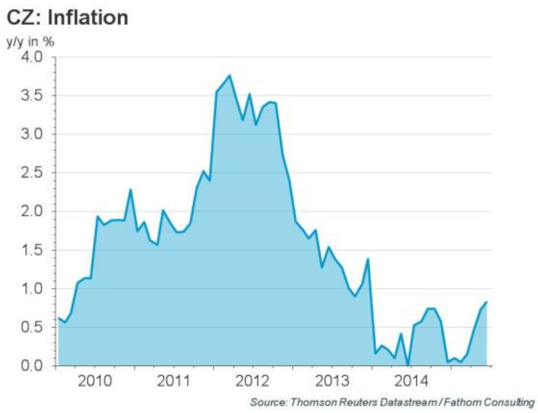
Hungary's inflation keeps moving up

The Hungarian headline inflation accelerated from 0.5% Y/Y in May to 0.6% Y/Y in June in line with market expectations. Compared to the previous month the CPI was 0.2%. Core inflation decreased slightly from 1.3% Y/Y in May to 1.2% Y/Y in June.
The main reason behind the core inflation moderation is the surprise drop of unprocessed foods, but we still expect that the previous months' unprocessed food price increase may spill-over into the processed ones. The tradeable products price rise may reflect the weakening HUF and the increasing domestic demand.
Looking ahead we maintain our expectation that inflation may accelerate to around 3% Y/Y already at the end of the year due to base effect (regulated price cut and low fuel price a year ago), the increasing domestic consumption and weaker HUF. Additionally we see next year's average inflation also close to 3% Y/Y, which is the inflation target of the NBH.

Czech inflation is gaining momentum, but this will not last long. Additionally, the visible increase in prices only applies to the marginal parts of the consumer basket, focusing primarily on cigarettes, alcohol and shoes. Although the costs of living are also increasing, they are compensated for, at least in part, by cheaper electricity.
Annual inflation, which is being closely followed by the central bank, has climbed to 0.8%, while it was still flirting with zero at the beginning of this year. What might be pleasing to the CNB is that, for the moment at least, inflation is four tenths above its current prognosis. For consumers, the good news is that the price rises for food have calmed down. In addition, despite the short-term increase in the price of fuels, we are still paying significantly less for them this year than last, while telephone calls and electronics are also costing us less. Even though consumer demand in the economy is growing significantly this year, it is fortunately not making itself felt too much thanks to competition, especially on the Internet.
The inflation outlook suggests that the current trend of growth in consumer prices will be short-lived. Inflation will begin to fall again as soon as in the third quarter and will only catch its breath at the end of the year. We think it hit two percent next year, but it will only slowly approach this target and at a slower rate than the central bank expects.

Slightly worse figures from Czech industry

May's data from Czech industry fell slightly short of expectations. Output grew by only 2%, or 4.6% if adjusted for the lower number of business days in the month. Although the figures are less favourable at first glance, these were corrections of the previous steep increases rather than an indication that the largest Czech sector is running out of steam. As usual, industry has been driven upwards by passenger car production, which is set to break new records, followed by electrical equipment and plastics manufacturers. Low orders slightly contrast the excellent mood in industry – whether as concerns confidence indicators or purchasing manager indices. They were up by only 1.4% y/y, with foreign orders even having dropped. Orders in the automotive industry were surprisingly in the red (-1% y/y). Does this mean that demand for new vehicles manufactured in the Czech Republic is starting to wane? We do not think so, given the improving demand for new cars in Europe as well as the determination of consumers in most EU countries to buy a new vehicle during the year.



Weekly preview

TUE 10:00	CZ Cur. Account (CZK bn)		
	May-15	Apr-15	May-14
C/A monthly	**0.0**	20.5	13.1
cummulative (YTD)	**112.1**	112.1	60.7
Trade bal. monthly	**22.8**	31.8	25.7
cummulative (YTD)	**123.0**	105.1	121.3

CZ: Start of the dividend season?

May's current account figures were already probably affected by the delayed start of the dividend season. Thus the outflow of profits most likely completely counterbalanced otherwise very decent surpluses in foreign trade and the balance of services. Naturally, the absorption of European funds, which was already evident from the development of forex reserves, has sparked uncertainty about the forecast. By contrast, even though current account figures may not be as impressive as in the previous months, the trend of this account will continue to be highly positive. We still expect the full-year current account surplus to reach approximately 2% of GDP.

WED 14:00	PL Inflation (change in %)		
	Jun-15	May-15	Jun-14
CPI y/y	**-0.9**	-0.9	0.3
Food (ex Alc.) y/y	**-2.1**	-2.2	-0.8
Transport (including fuel)	**-7.4**	-8.0	-0.1

PL: Deflationary period persists

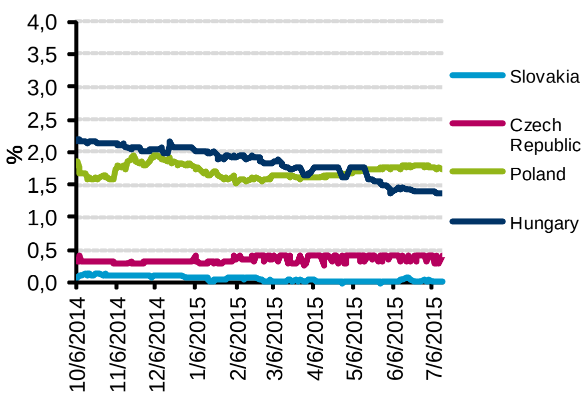
Poland's inflation remained at -0.9% y/y in July according to our forecasts. Month-on-month prices probably stagnated, and we believe that not even food and soft drink prices (whose month-on-month fall was probably only slightly smaller than usual) or transport prices changed significantly this time. We still expect the Polish economy to be unlikely to emerge from deflation until November, and we cannot even rule out an extension of the deflationary period until the very end of this year.

Calendar

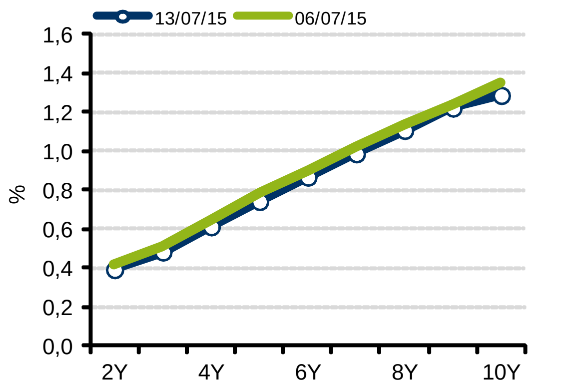
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	07/14/2015	10:00	Current account	CZK B	05/2015	0		1		20.55	
PL	07/14/2015	14:00	Money supply M3	%	06/2015			0.7	7.6	0.9	7.7
PL	07/14/2015	14:00	Current account	EUR M	05/2015			482		1138	
PL	07/14/2015	14:00	Trade balance	EUR M	05/2015			22		127	
CZ	07/15/2015	12:00	CZ bond auction 2014-2027, floating rate	CZK B	07/2015						
CZ	07/15/2015	12:00	CZ bond auction 2015-30, 0.95%	CZK B	07/2015						
PL	07/15/2015	14:00	CPI	%	06/2015		-0.9	0.1	-0.8	0	-0.9
PL	07/15/2015	15:00	Budget balance	PLN M	06/2015					-19638	
PL	07/16/2015	14:00	Core CPI	%	06/2015			0.1	0.3	0	0.4
PL	07/16/2015	14:00	Wages	%	06/2015			2.6	4.5	-2.9	3.2
CZ	07/17/2015	9:00	PPI	%	06/2015	0.2	-1.9	0.1	-2	0.4	-2.1
PL	07/17/2015	10:00	Retail sales	%	06/2015			1.1	4.1	0.5	1.8
PL	07/17/2015	14:00	Industrial output	%	06/2015			3.9	6.9	-1.3	2.8
PL	07/17/2015	14:00	PPI	%	06/2015			0.3	-1.9	0.3	-2.2

Fixed-income in Charts

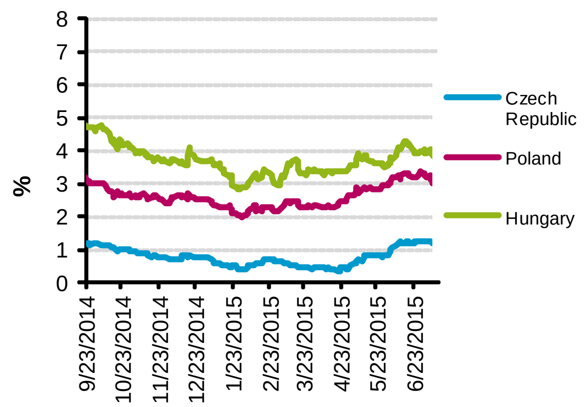
FRA 3x6



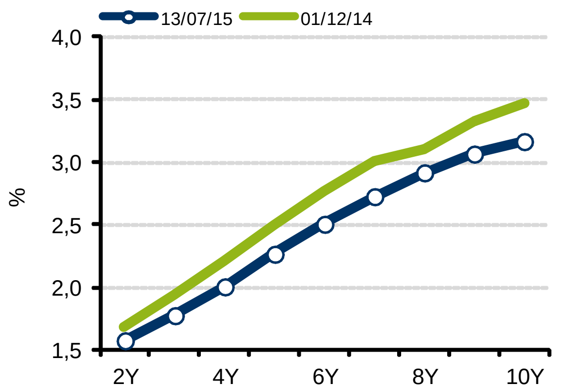
CZ IRS



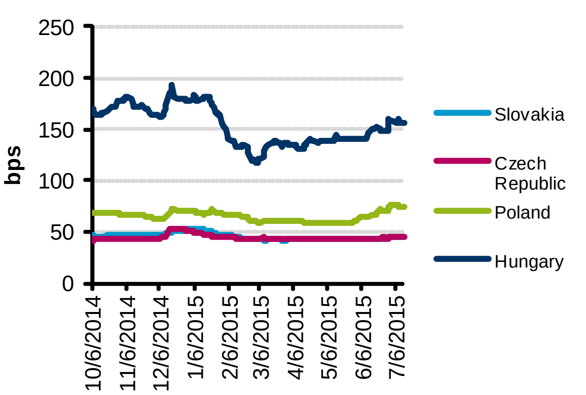
10Y GB Yields



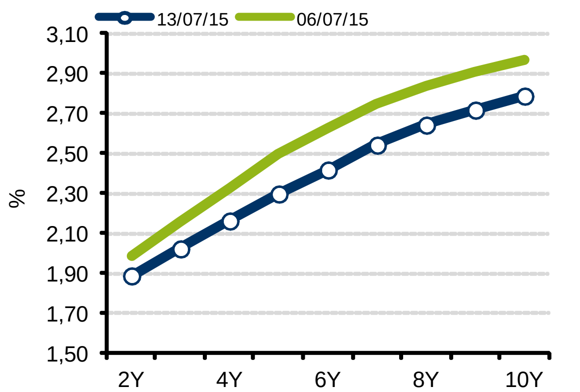
HU IRS



CDS 5Y



PL IRS



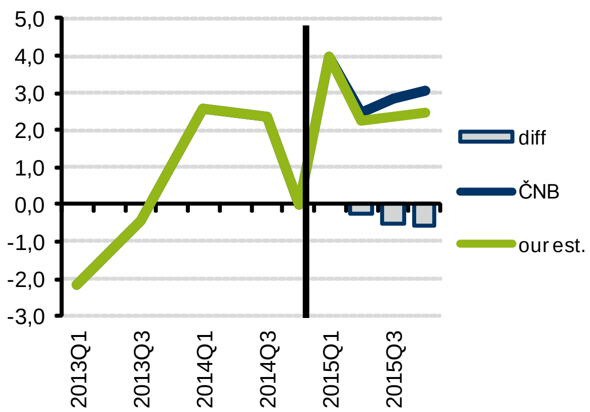
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – encouraged by growing real wages and employment – becoming a strong stimulus. At the moment, we cannot expect any fundamental economic changes or reforms, except for the abolition of the pension reform and the introduction of the electronic registration of sales. Progress in the country's preparations for joining the euro area is not expected in this electoral term either.	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.	According to the GUS, the Polish economy grew by 3.6% 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 may be 3.5-4%.
Outlook for official & market rates	The CNB's monetary policy continues to be based on record-low interest rates and the weak koruna. The exchange rate policy, not allowing the koruna to strengthen beyond (below) EUR/CZK 27., is most likely to remain in place at least until the second half of 2016, and low interest rates probably even longer. The reason is that inflation remains below the 2% target and will most likely remain there next year, and will only slowly approach the target. On the other hand, at least the deflationary pressures – occasionally triggered by speculation about another possible forced weakening of the koruna – have disappeared.	The National Bank of Hungary cut base rate by 15bp from 1.65% to 1.5% in June. The Council said that the inflation may remain below the inflation target of 3% Y/Y in 2015 and 2016, and it may reach the inflation target only at the end of the forecasted period, so in late 2017. So based on the lasts statement, the Council's clear intention to maintain the illusion of continuing of rate cut cycle (which became more and more an expected scenario on the markets) and main message of the statement that the next step might be 10bp rate cut in July.	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.
Forex Outlook	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.	In a longer term perspective, the HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. In a short-run, however, if the NBH says in June that they stop now the rate cut cycle than it is rather bullish for the forint as some key market players bet that the NBH may cut the base rate to even 1.2%.	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.

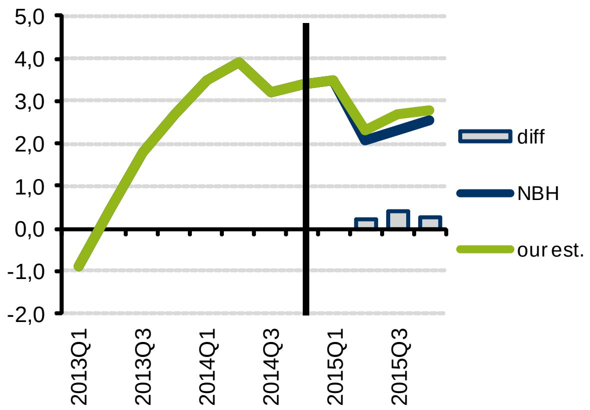
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)



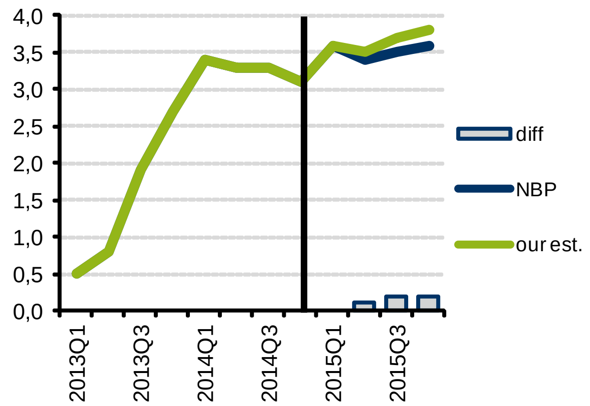
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)



HU: Inflation outlook (Y/Y, %)

PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)

Source: CNB, NBP, MNB, 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.	*1.50*	1.95	1.70	1.70	2.00	2.25	-10 bps	6/23/2015
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	*0.00*	0.30	0.30	0.30	0.30	0.30
Hungary	BUBOR	*1.41*	1.89	1.70	1.70	2.10	2.40
Poland	WIBOR	*1.72*	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	*1.29*	0.64	1.35	1.45	1.55	1.50
Hungary	HU10Y	*3.17*	2.71	3.20	3.40	3.60	3.80
Poland	PL10Y	*2.79*	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	*27.11*	27.57	27.30	27.40	27.20	27.10
Hungary	EUR/HUF	*311*	300	310	317	315	310
Poland	EUR/PLN	*4.15*	4.07	4.05	4.00	4.10	4.05

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	0.0	4.0	2.2	2.3	2.5	2.5
Hungary	3.2	3.4	3.5	2.3	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.5	3.7	3.8	3.8

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

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	0.7	0.1	0.2	0.8	0.5	1.0	1.7
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.	2.0	1.8
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

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	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
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

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