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Central European Weekly

Monday, 12 October 2015

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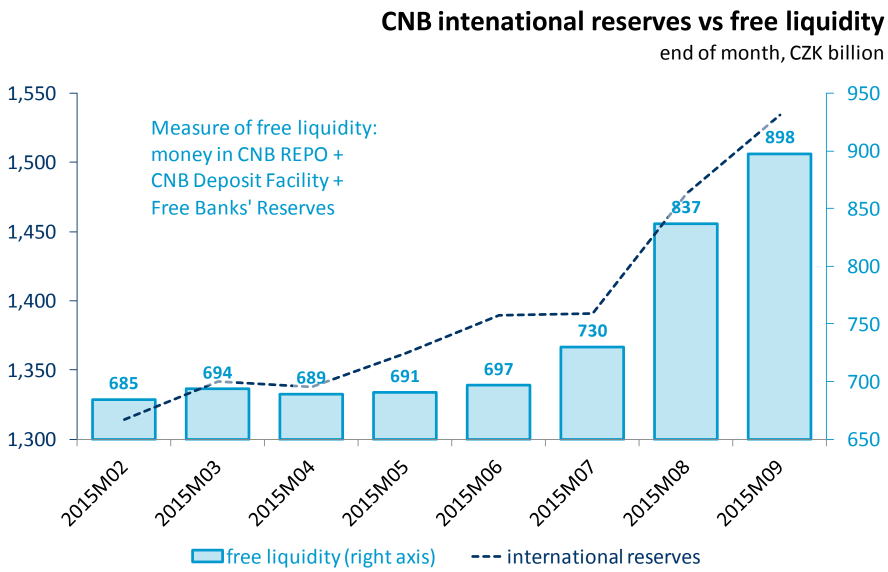
Weekly Highlights:

- Industry performed well before the VW affair, inflation remains depressed by oil prices
- CNB's forex interventions reached EUR 3.7bn in August as CNB's reserves reaches 35% of GDP
- Polish markets might start to eye upcoming elections

Chart of the Week: CNB's forex reserves



Due to huge summer FX interventions CNB's FX reserves jumped to 35% of GDP.

Market's editorial

Hard data OK ahead of VW scandal, inflation down on oil

A quick look at hard monthly data in the region shows that industry, as the most important driver of growth, performed well before the affair, while inflation remained at very low levels because of the fall in fuel prices. This view may change in a month's time because industrial output data may, at least in part, be adversely impacted by VW's diesel scandal and inflation may also climb. Here we should realise that VW has large production facilities in the Czech Republic as well as Hungary (Škoda and Audi respectively) and that the drop in petrol prices will certainly not reoccur in October. In addition, the positive base-effect related to a sudden fall in oil prices late last year will slowly (and positively) start to influence year-on-year inflation in months to come.

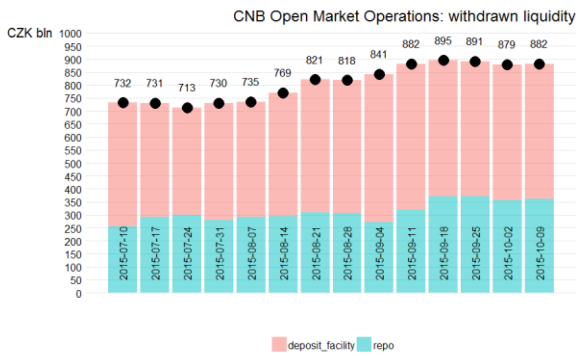
CNB's FX increase and credit growth accelerates

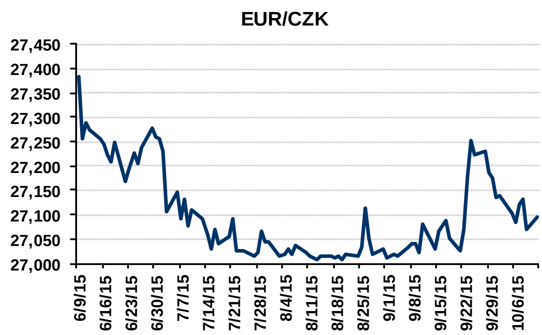
Meanwhile just released CNB's detail statistics of its forex activity showed that the central bank made huge interventions in August as it bought EUR 3.7bn in August. Moreover as the headline figure for the CNB forex reserves show interventions continued in September too. The level of CNB forex reserves stood at EUR 61bn, which represents 35% of GDP.

Interestingly, it seems that the CNB is aware of growing liquidity in the system, which leads to stronger credit growth. According to CNB's vice-governor Tomšík a policy reaction could rather be a decision to force banks to raise capital (apply a countercyclical capital buffer). Recall that the current rate of (CNB's) countercyclical capital buffer is zero, while it might reach up to 2.5% (of banks´ risk-weighted assets). The next time when the CNB might change (increase) a rate of countercyclical capital buffer will be in December 2015. If the new buffer is introduced (**not our scenario**), all Czech commercial banks will have fulfill new capital criteria in approx one-year horizon (at the beginning of 2017).

Polish markets might start to eye upcoming elections

In the days to come, however, the regional events that will interest markets will include politics rather than macroeconomic data. Parliamentary elections will be held in Poland in two weeks' time, and the current liberal government, which has been very popular with the markets, can become an opposition party. A possible change of the government could make Polish financial markets volatile, all the more so because certain programme items promoted by the conservative opposition (PiS), which is the favourite in the upcoming elections according to opinion polls, are not quite market-friendly. Nevertheless, unlike similar episodes in the past, we do not expect contagion to spread to the rest of the region if sell-off of (Polish) assets were to occur ahead/after the elections.





	Last	Change 1W
EUR/CZK	27.1	-0.12%
EUR/HUF	312	-0.41%
EUR/PLN	4.22	-0.65%

	Last	Change 1W
10Y CZK	0.96	3.78
10Y HUF	2.75	-0.90
10Y PLN	2.39	3.69

Review of Economic Figures

Inflation remains at bottom despite the weak Czech koruna

September saw another decline in the consumer price index. The Czech consumer prices were down by 0.2% compared to August, with this being primarily attributable to a reduction in package tour prices after the season and, of course, to falling fuel prices. Year-on-year inflation, monitored by the central bank, continues to be very low. Although it grew by 0.1% (to 0.4%), it is still far from the inflation target and in the end also remained below the CNB's latest forecast.

Inflation will not grow until the turn of the year, but there will not be any dramatic jump as consumers can still look forward to a reduction in electricity prices, which will continue to curb inflation next year. Thus the return to the inflation target will still take some time. We believe that inflation will not climb to the 2% level before 2017, and thus the central bank can maintain its current policy of a weak koruna and almost zero rates.

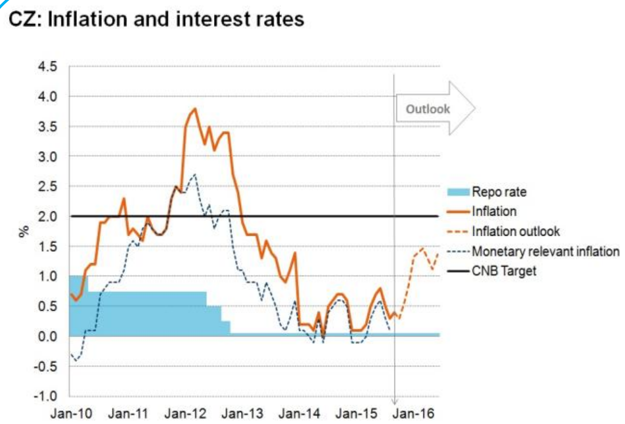
Hungary's inflation negative, but could it be positive next?

The Hungarian inflation dropped due to the decreasing fuel prices in September, while core inflation increased slitghly from 1.2% Y/Y in August to 1.3% Y/Y in September. So it suggests that there is still no secondary effect of the continuously low oil prices in the Hungarian inflation, while the stable domestic demand rather has some modest inflationary effect. The consumer price index might jump back into positive territory in October, thanks to base effect (regulated price cut last year), but inflation may remain below 2% YoY at the end of the year. Average inflation may remain well below the inflation target of 3% YoY in next year, so the monetary council can maintain a loose monetary policy in the next 12 months. The underlying inflation development hasn't changed, so there is no need for monetary policy adjustment, but in case HUF starts to strenghten to around 300 against euro, base rate cut can not be ruled out for the first half of next year.

Czech and Hungarian industry 'OK' before the VW affair

Just a month ahead of the VW diesel scandal regional industries were doing quite well as the Czech and Hungarian industrial production grew by more than 6% year-on-year in August.

Regarding specifically the Hungarian industrial production the speed of the growth was in line with our expectation. The month-on-month figure showed 2% fall in August and although it is normal in this period of the year as many of the industrial companies keeps holiday in August, it raises some concerns about the future development of the sector that statistical office released a decrease of the sector on month-on-month basis also in July and May. Additionally the VW crisis might have also some effect on Audi's engine production, which has a huge factory in Hungary as well, so in case the production has to be moderated in the VW holding company it might force the Audi Hungary factory to cut back the production as well. There are some calculations about what the worst case would mean for Hungarian economic growth, according to the negative effect might be between 0.3 and 0.6%point on growth. On the other hand the base of the next months will be low as last year the Suzuki started to replace one of its old model due to the factory work with a lower capacity.



Weekly preview

WED 10:00	CZ Cur. Account (CZK bn)		
	Aug-15	Jul-15	Aug-14
C/A monthly	**-6.0**	-21.5	-10.4
cummulative (YTD)	**68.3**	74.3	38.4
Trade bal. monthly	**6.0**	14.7	7.7
cummulative (YTD)	**162.9**	156.9	171.1

CZ: Current account slightly in the red

The dividend season, along with a poorer foreign trade figure, is probably responsible for August's anticipated current account deficit. Hence its negative figure should not surprise, especially if it does not even mean a change to the existing positive trend of the current account – this will only slightly reduce its existing accumulated surplus. Despite some extraordinary dividends, we still expect the full-year current account surplus to grow to approximately 1.5% of GDP.

PL: Inflation still below the target in September

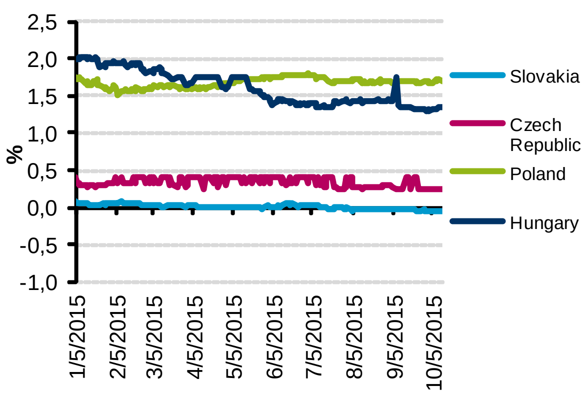
A revision of the flash forecast for Poland's inflation for September (–0.2 m/m, -0.8 y/y) will probably show that price growth did not approach the NBP's target last month. Just as in other countries of the region, inflation was probably curbed by transport prices in particular, the decline of which reflects the fall in global oil prices. If the final forecast confirms the flash forecast (this fact alone is worth paying attention to), it means that Poland's inflation will probably remain below zero for this year as a whole.

Calendar

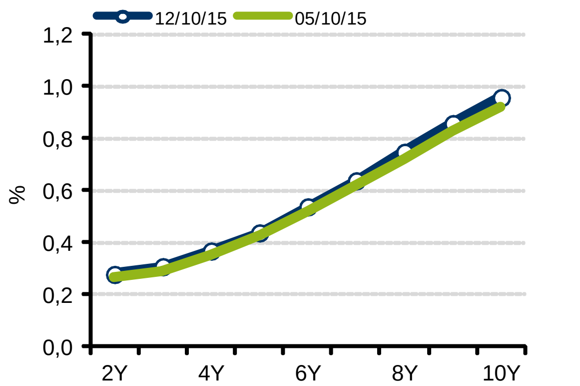
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	10/14/2015	10:00	Current account	CZK B	08/2015	-6		-8.6		-21.53	
CZ	10/14/2015	12:00	CZ bond auction 2015-2017, 0.00%	CZK B	10/2015						
CZ	10/14/2015	12:00	CZ bond auction 2015-2023, x.xx%	CZK B	10/2015						
CZ	10/14/2015	12:00	CZ bond auction 2013-2028, 2.50%	CZK B	10/2015						
PL	10/14/2015	14:00	Money supply M3	%	09/2015			0.4	7.7	0.7	7.3
PL	10/14/2015	14:00	Current account	EUR M	08/2015			-1026		-1660	
PL	10/14/2015	14:00	Trade balance	EUR M	08/2015			-491		-1071	
PL	10/15/2015	14:00	CPI	%	09/2015 *F					-0.2	-0.8
PL	10/15/2015	15:00	Budget balance	PLN M	09/2015					-25860	
CZ	10/16/2015	9:00	PPI	%	09/2015			-0.3	-3.8	-0.8	-3.7
PL	10/16/2015	14:00	Core CPI	%	09/2015			0	0.4	-0.1	0.4
PL	10/16/2015	14:00	Wages	%	09/2015			0.3	3.5	-1.7	3.4

Fixed-income in Charts

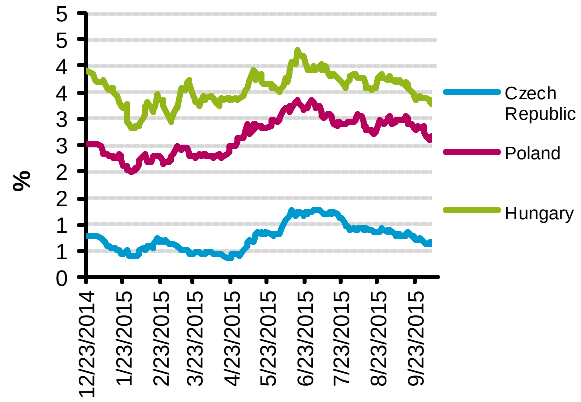
FRA 3x6



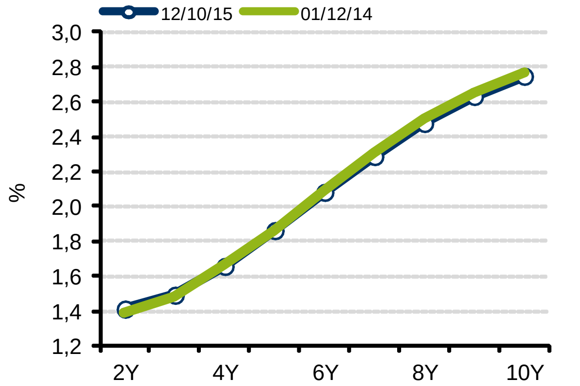
CZ IRS



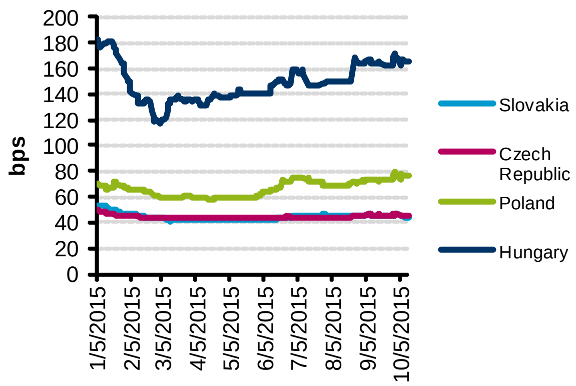
10Y GB Yields



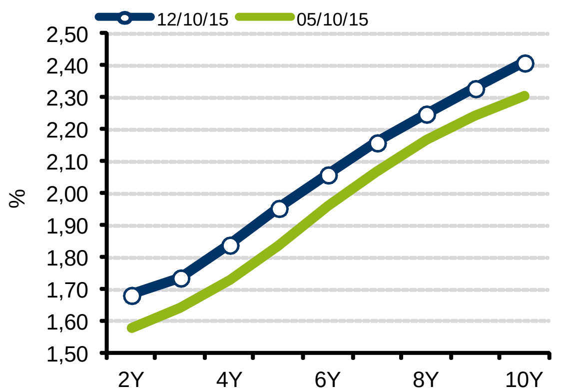
HU IRS



CDS 5Y



PL IRS



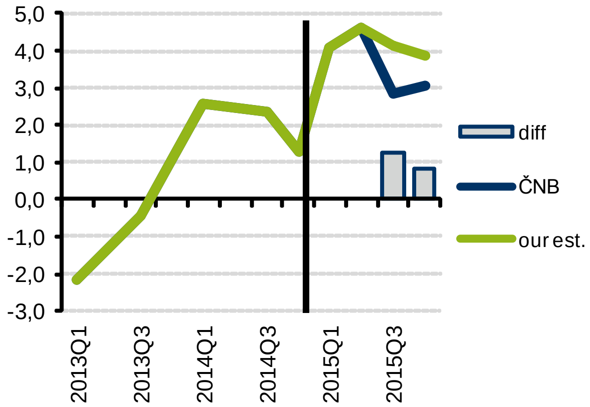
Source: Reuters

Medium-term Views & Issues

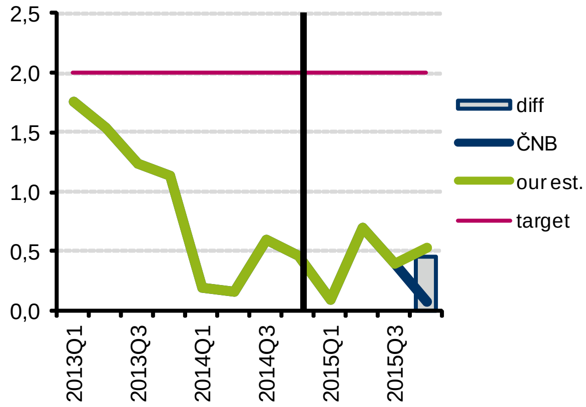
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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.	The Polish Statistical Office kept its flash GDP forecasts for the second quarter of the year unchanged – this means growth of 3.3% y/y and 0.9% q/q. Thus the data for the second quarter fell short of expectations, but only slightly. Perhaps only the deceleration of the rate of investment may pose some issues; nevertheless, we are not overestimating this at the moment either. The overall positive economic developments in Europe and the long-term eased monetary policy should translate into growth of the Polish economy within the range of 3.5-4% this year as well as the next.
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 27.0, 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.	The NBH surprised the market as it shifted the interest rate corridor of overnight (O/N) instrument by 25bp downward, so the new interest rate is 0.1% (base rate minus 125bp) for deposit and 2.1% (base rate plus 75bp) for loans. This move means practically a 25bp rate cut and is clear the NBH is fully committed to force out money from NBH so it cannot be excluded that further steps may come in the future. We think the NBH will cut further its base rate, if the ECB loosen further its monetary policy and the EUR/HUF moves closer to 300. In that case the base rate might be cut below 1%, while we think that with the previous speed, namely by 15bp per meetings.	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	Relatively strong economic growth, current and capital account surpluses and ongoing QE in the euro zone have been the key factors behind the recent strength of the koruna. We believe the Czech National Bank will meet its "pledge" and won't terminate its intervention regime before the second half of 2016. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Possible start of tightening of US monetary policy poses negative risks for the koruna. We however think the fallout should only be limited.	We think that any strengthening of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks and months. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture.	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. Polish general elections in autumn however pose a negative risk for the zloty.

CBs' Projections vs. Our Forecasts

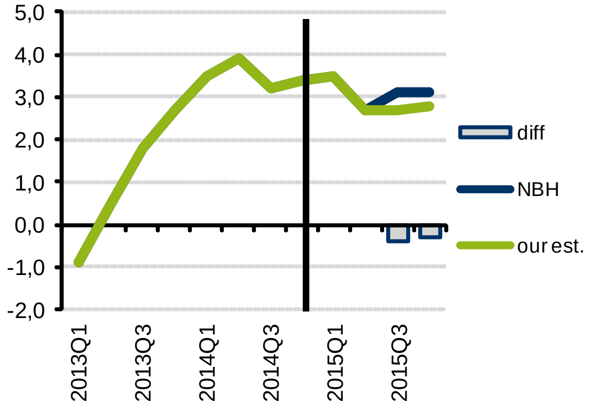
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)

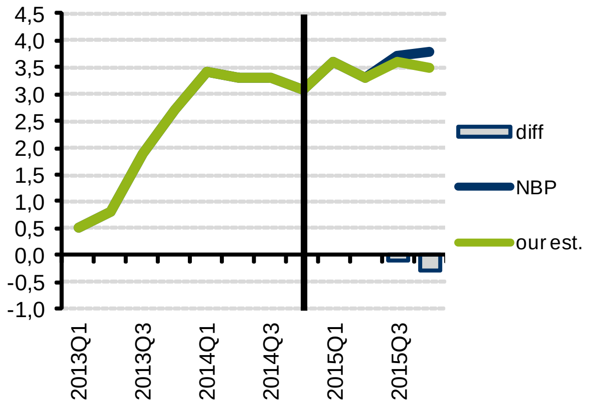


HU: GDP outlook (Y/Y, %)

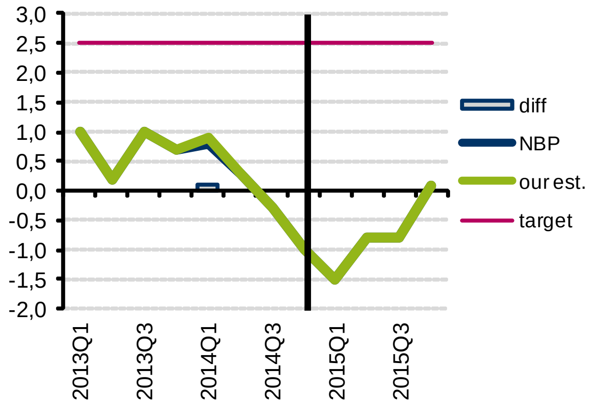


HU: Inflation outlook (Y/Y, %)

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.	*1.35*	1.95	1.50	1.35	2.00	2.25	-10 bps	7/21/2015
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	*0.00*	0.30	0.29	0.26	0.30	0.30
Hungary	BUBOR	*1.35*	1.89	1.41	1.35	2.10	2.40
Poland	WIBOR	*1.73*	1.65	1.72	1.73	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*0.96*	0.64	1.30	0.98	1.30	1.40
Hungary	HU10Y	*2.75*	2.71	3.45	2.93	3.60	3.80
Poland	PL10Y	*2.41*	2.12	3.01	2.50	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.13*	27.57	27.35	27.19	27.05	27.00
Hungary	EUR/HUF	*312*	300	315	314	315	310
Poland	EUR/PLN	*4.22*	4.07	4.19	4.25	4.15	4.10

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.3	4.1	4.6	4.1	3.9	2.2
Hungary	3.2	3.4	3.5	2.7	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.3	3.6	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	0.8	0.3	0.8	1.4
Hungary	-0.5	-0.9	-0.6	0.6	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.5	-0.8	-0.8	0.1	0.4

Current Account

	2015	2016
Czech Rep.	1.5	1.5
Hungary	6.0	4.5
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.6	-1.3
Hungary	-2.3	-2.1
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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