Central European Weekly

Monday, 11 January 2016

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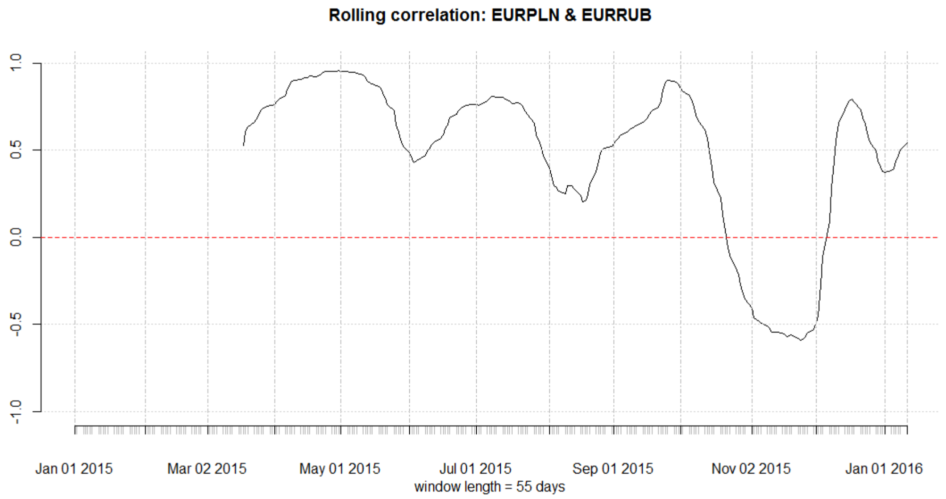
Chart of the Week: PLN and its correlations



In the recent period developments on the Polish forex market have increasingly correlated with those on more vulnerable emerging markets (like the rouble or the Turkish lira)

Market's editorial

The zloty is back in emerging markets

Global sell-off of risky assets triggered by China brought volatility to markets in Central Europe too. Not only regional equity markets but also the Polish zloty have evidently become victims of the sell-off. In the recent period, which coincidentally matches the arrival of the new government, developments on the Polish forex market have increasingly correlated with those on more vulnerable emerging markets (like the rouble or the Turkish lira).

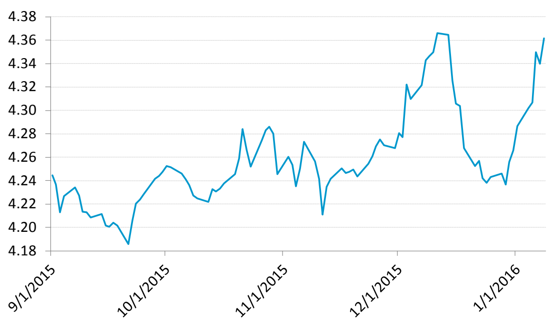
MPC personal changes watched closely

However, it is not only external events - i.e., the sentiment on risky markets – that will determine the behaviour of the zloty in the days and weeks to come. Other determinants will include domestic (Polish) information about the Polish central bank. While a meeting of the Monetary Policy Council (MPC) will be held this week, the market will be more interested in the information on personnel changes in the NBP leadership rather than in the outcome of the meeting. Until February 19th the Senate, Sejm (the Lower Chamber of the Polish Parliament) and the president will be allowed to replace 8 of the 10 MPC members, and the new government team will not miss the opportunity to fill the key positions in the NBP with people close to the policy of the PiS (Law and Justice) party. This week alone, there should three hearings of MPC nominations in the Polish Senate.

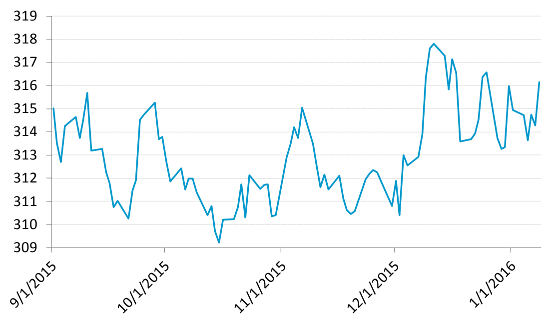
Rhetoric made by new MPC members in NBP will calm down

During January the zloty as well as Polish government bonds will thus be absorbing the new names nominated to the MPC (some have already been cited) and possible comments that the future Polish central bankers will make as part of their candidature. The uncertainty associated with the replacement of the central bank leaders may drive the zloty (and possibly bonds with longer maturities) onto the defensive, but the situation should calm down after the new names are presented. Still, we expect that rhetoric made by new central bankers will in the end be fairly cautious after they come into office at the NBP.

EURPLN



EURHUF



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*27.0*	*0.04%*	→	→
EUR/HUF	*316*	*0.36%*	↗	↗
EUR/PLN	*4.36*	*1.39%*	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*0.95*	*-4.52*	↗	↗
10Y HUF	*2.84*	*-0.53*	↗	↗
10Y PLN	*2.48*	*-0.78*	↗	↗

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Review of Economic Figures

New orders continue to develop well

The trend of strong growth in car production persisted in November and – as usual – it was the greatest contributor to the reasonable increase in industrial production as a whole. The output of this most important sector grew by 5.7% y/y, but if we disregard the one extra business day in the month the rate of industry was 'only' 3.2%. Output even fell slightly compared to October.

Overall, we can view the figure from industry positively even though it lagged behind our expectations. The main reasons for this included a lower performance by the energy sector, which was affected by temporary shutdowns of facilities, and in particular a significant reduction in the chemical industry's output.

Nevertheless, orders suggest that we can also expect favourable figures from domestic industry within the next few months. The increase in orders by 7.2% was again primarily attributable to carmakers, but engineering firms and electrical equipment manufacturers are also continuing to see demand for their products improve.

Firms face capacity limits, have to invest and raise wages

The positive developments in industry are also generating favourable expectations associated with willingness to invest and recruit new employees, whose numbers grew by approximately 3.7% in this sector over the last twelve months. Nevertheless, businesses will find it increasingly difficult to find new skilled staff in the months to come, and thus wage growth, which is not completely negligible even now, is likely to continue. Nonetheless, in comparison with the EU the Czech Republic will continue to be a very cheap country in terms of wages.

The basic trend in industry was otherwise maintained and did not actually change at the end of the year either, when carmakers were able to report a new record in passenger car production. Industry maintained its position as the main driver of the whole economy and, beyond doubt, was again responsible for the high GDP growth in late 2015.

Nevertheless, maintaining such a rate in 2016 will be very hard to achieve without huge investments in expanding production capacities. Although businesses are heavily investing under 'pressure' from growing demand and their own profitability, we tend to expect output to grow by 'only' around 3% this year.

Exports primarily driven by cars, imports down on oil

Falling oil prices and consequently cheaper imports on the one hand, and high growth in car exports on the other, were the main trends of the Czech Republic's foreign trade towards the end of last year. Thus the trade surplus rose by approximately CZK 4 bn to CZK 14.3 bn in November.

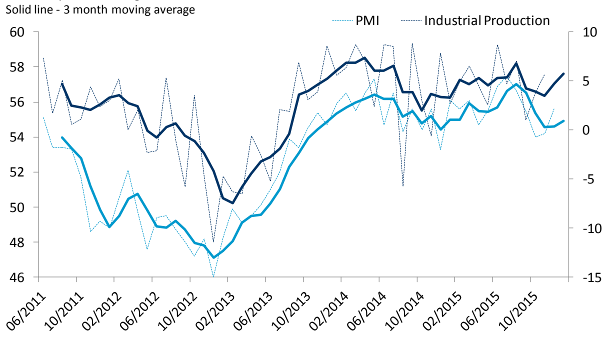
Exports are largely consistent with the performance of domestic industry, which is highly export-oriented in general. Thus the export development of cars, electrical equipment and machinery is also not a surprise. This bears out the continuing improvement in the competitive position of domestic producers, which have succeeded in gaining ground on the European market in particular.

Just as exports are reacting to improving foreign demand, imports are reflecting improving domestic demand. Therefore, improved demand for foreign cars, investment goods and finally also consumer goods in the pre-Christmas period came as no surprise.

Moreover, imports are being curbed by cheap oil and natural gas – although their volumes have decreased slightly, the low prices mean the import savings amount to billions of korunas. And this trend can also be expected to continue early this year. If oil prices remain close to their current lows, the Czech Republic – i.e., its businesses and households – may save more than CZK 20 bn this year.

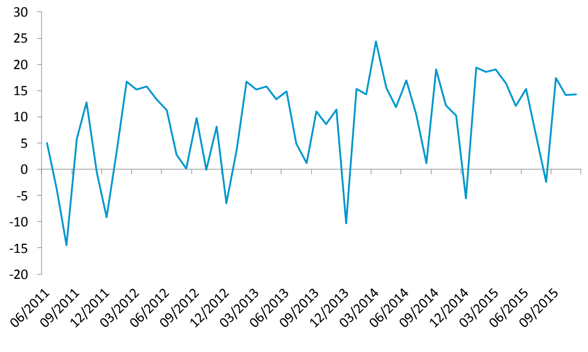
CZ: PMI vs. Industrial production

Industrial production - right axis, Y/Y in %
Solid line - 3 month moving average



CZ: trade balance

CZK bn.



In Focus: Hungary's fiscal position improves

Pubvlic gap at only 1% of GDP in 2015, debt declines

Hungary's Ministry of National Economy published the 2015 budget figure and according to its fiscal guadlines the deficit was HUF1291bn, which is HUF326bn, which is only 1% of GDP. Although it's is higher than the original proposal. The main reason behind the bigger deficit is the lagging behind EU funds money inflow of around HUF600bn, but it can be accounted based on European methodology. It means that the original deficit target of 2.4% of GDP was achieved by the government moreover it looks like that the Hungarian budget deficit was rather only around 2% of GDP and the gross public debt might moderated from 76.2% of GDP in 2014 to below 76% in 2015. These figures are in line with expectations, but the substantial government spending in the last quarter was a surprise for us. Without this massive spending the budget deficit could be also around 1.5% of GDP in 2015, but it looks like that the government did everything in order to keep Hungarian economic growth closer to 3% Y/Y, so the 4Q15 GDP growth figure might bring a positive surprise. The retail sales figure (4.4% Y/Y growth in November) also confirms our view that the domestic consumption is stable and provides a good base for Hungarian economic growth.

Budget deficit should be at around 2% of GDP in 2016

Looking ahead the budgetary developments are favorable as the revenues were substantially higher in 2015 than it was planned by the government, which provides a very good base for 2016 budget as well. The government already started to spend money, and introduced a program for households, which supports buying new homes. If it remains under control we expect that this program won't endanger the strict fiscal policy and budget balance may remain around 2% of GDP in 2016 as well. As concerns the issuance strategy, the Debt Management Agency will probably continue to try to collect as HUF financing as maximum possible. It might have an upside pressure on the Hungarian bond yields in the following weeks in case global bond yields are not dropping, but on the other the budget will be less sensitive to the exchange rate of the forint and vice versa.

Weekly preview

TUE 9:00 **CZ Inflation (change in %)**

	Dec-15	Nov-15	Dec-14
CPI m/m	**-0.2**	-0.4	-0.1
CPI y/y	**0.0**	0.1	0.1
Monetary relevant inflation y/y	**-0.1**	0.0	-0.1

THU, app. 12:00 **NBP rate (in %)**

	This meeting	Last change
rate level	**1.50**	03/2015
change in bps	**0**	-50

CZ: Inflation back to zero

Lover fuel and food prices were the main inflation drivers in December. We expect that annual inflation will legged behind the latest CNB's forecast and even the market consensus. Therefore the next central banks inflation forecast will be adjusted downwards and the current exchange rate regime will be prolonged up to 2017 officially.

PL: MPC for the last time in the current line-up

The last meeting of Poland's Monetary Policy Council (MPC) in its current composition will not result in a rate change. Bear in mind that MPC members are going to be replaced this year. The first members are leaving on January 20, with a total of 8 out of 10 members to be replaced by February 19. NBP President Belka is leaving office on June 10.

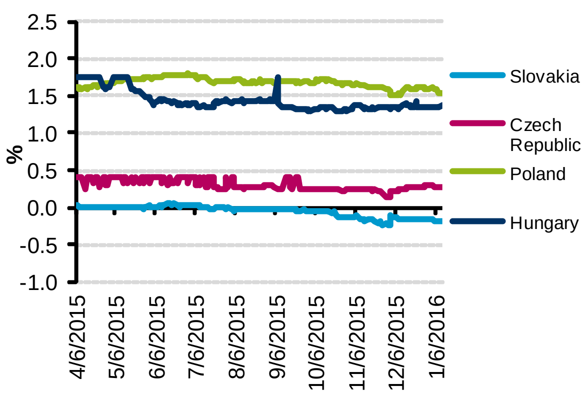
The replacement of MPC members should result in a closer coordination of economic policies, as the replacements are likely to take place completely in line with the scenario of the new ruling PiS party. In addition to efforts towards a more eased monetary policy, we cannot even rule out the introduction of some more controversial policies (TLTRO etc. …). Therefore our baseline scenario bets on the stability of official rates throughout 2016.

Calendar

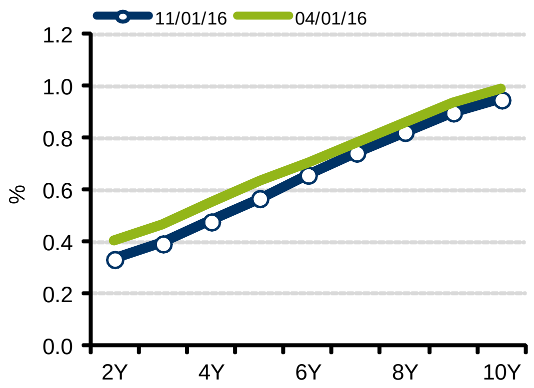
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	1/11/2016	9:00	Unemployment rate	%	12/2015		6.2	6.3		5.9	
CZ	1/12/2016	9:00	CPI	%	12/2015	-0.2	0	0	0.15	-0.4	0.1
CZ	1/12/2016	9:00	GDP	%	3Q F					0.5	4.5
CZ	1/12/2016	9:00	Retail sales	%	11/2015		8.5		8.7		7.4
CZ	1/13/2016	10:00	Current account	CZK B	11/2015			-0.6		3.12	
PL	1/13/2016	14:00	Current account	EUR M	11/2015					-113	
HU	1/14/2016	9:00	CPI	%	12/2015			-0.3	0.9	0	0.5
PL	1/14/2016	14:00	Money supply M3	%	12/2015					1.1	9.8
PL	1/14/2016		NBP meeting	%	01/2016	1.5		1.5		1.5	
PL	1/15/2016	14:00	CPI	%	12/2015 F			-0.1	-0.4	-0.2	-0.5

Fixed-income in Charts

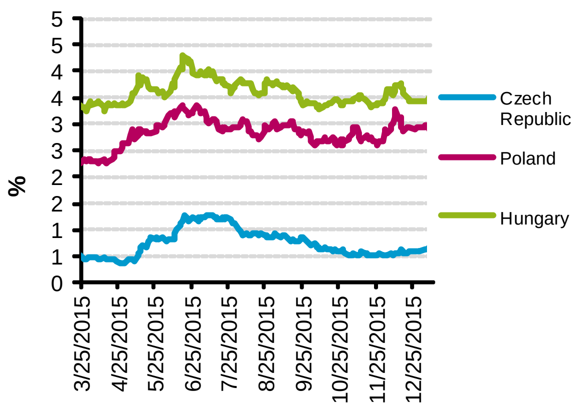
FRA 3x6



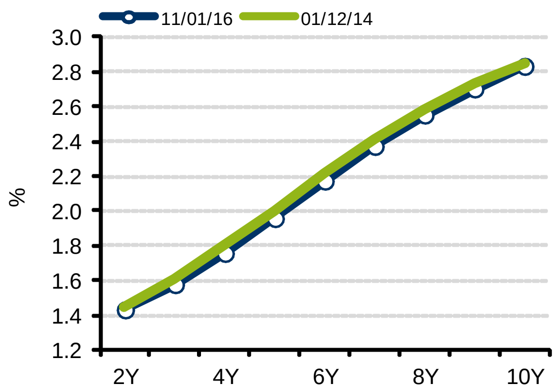
CZ IRS



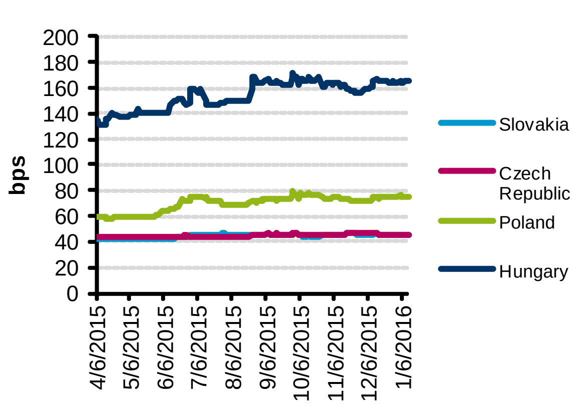
10Y GB Yields



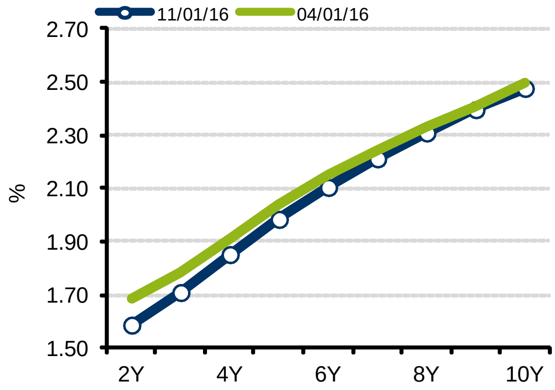
HU IRS



CDS 5Y



PL IRS



Source: Reuters

Central European Daily

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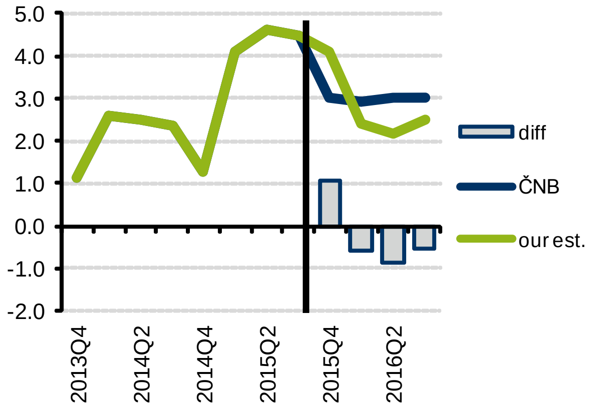
Medium-term Views & Issues

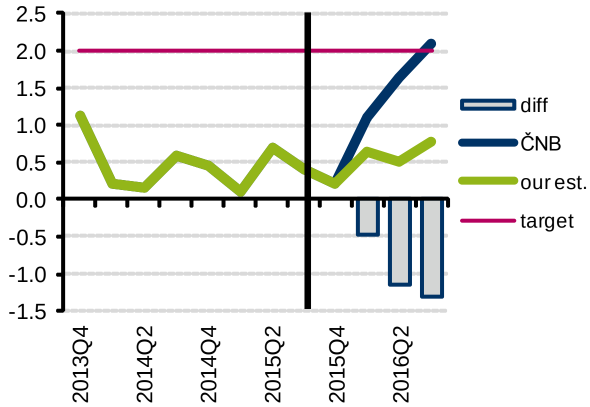
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 4Q15 GDP growth may bounce back closer to 3% Y/Y, as EU funds money use is accelerated and the industrial production and domestic consumption may be stronger this year as a year before, so the growth might be around 2.7% Y/Y in 2015. The bigger question what may happen next year, as the Q/Q figures reflects only 2% annualized economic growth for this year and the falling out EU funds money may push GDP growth below 2% Y/Y in some quarters. So GDP growth may be 2.7% Y/Y in 2015, while it may slow to around 2.2% Y/Y in 2016 because of the missing investments.	Prospects of the Polish economy remain good in our view. For the whole year 2016 we expect GDP growth may reach 3.5 - 4.0 percent. Apart from low interest rates (further cuts cannot be excluded) and a relatively weak zloty, we expect the economy to draw additional support from policy measures of the new government (stimuli for private consumption). The risks thus stem mainly from a possible deterioration in the external environment, most notably in China.
Outlook for official & market rates	The CNB has implicitly postponed the deadline for discontinuing its intervention policy until late 2016 but, unlike its previous practice, it does not want to commit itself to any clearer deadline this time. As we don't expect exit from the fx regime before Q1 2017, the first rate hike can occur in the H2 2017 or even latter. A scenario of negative rates is not on the agenda. Given the market developments, the CNB itself is even considering it to a lesser extent than it has done recently.	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. This promise will probably be hold, while we should wait how the MPC will be changed in 2016 as new President and Sejm will appoint almost all Board members.
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. With regard to the inflation outlook and ECB's policy, we anticipate an exit from the fx regime in the first quarter of 2017. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Current turmoil on the Chinese market poses negative risks for the Central Europe. We however think the impact on the koruna 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.	Although the new government may eventually turn out to be more market-friendly than had been expected, we think that pressures on zloty´s depreciation may intensify again at the beginning of 2016 when most members of the Monetary Policy Council (MPC) will be replaced and probability of further monetary easing will rises. Although Fed hikes and weaker zloty could prevent the altered MPC from cutting rates again we target the EUR/PLN peak at 4.40.

CBs' Projections vs. Our Forecasts

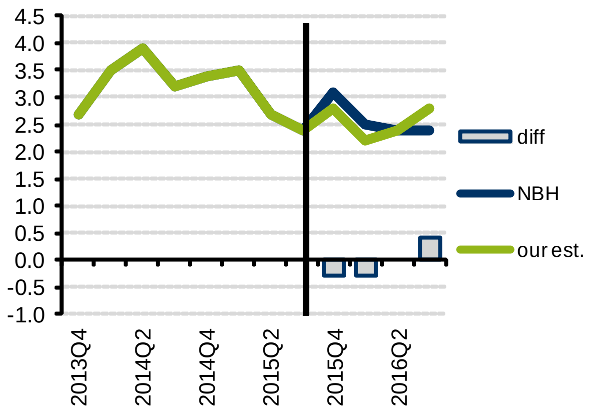
CZ: GDP outlook (Y/Y, %)



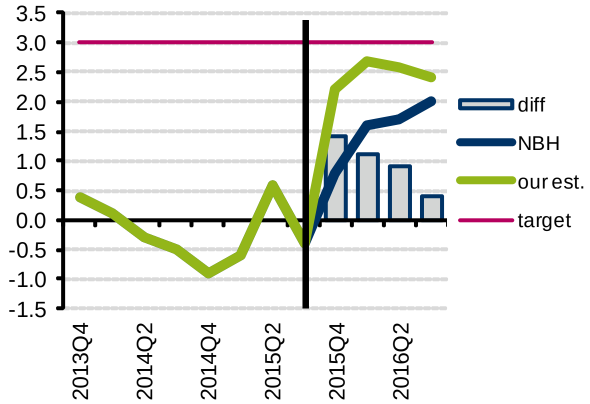
CZ: Inflation outlook (Y/Y, %)



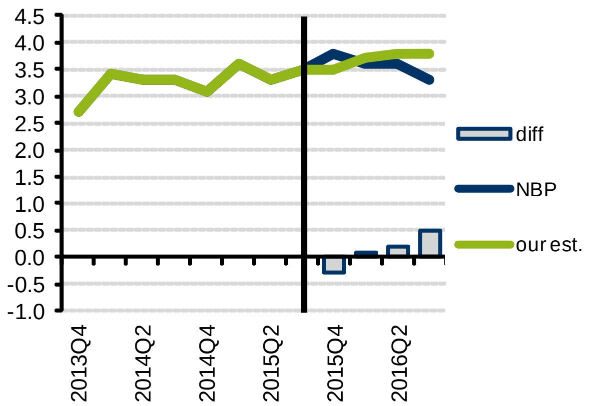
HU: GDP outlook (Y/Y, %)



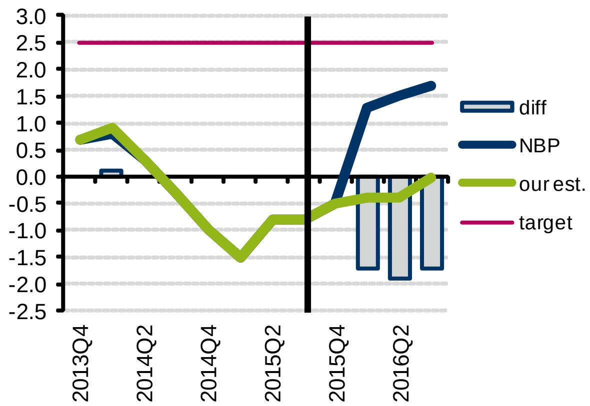
HU: Inflation outlook (Y/Y, %)



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	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	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*	1.35	1.35	2.25	2.50	2.75	-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	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	PRIBOR	*0.00*	0.26	0.25	0.28	0.28	0.28
Hungary	BUBOR	*1.35*	1.35	1.35	2.40	2.60	2.90
Poland	WIBOR	*1.72*	1.73	1.72	1.65	1.65	1.65

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

		Current	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	CZ10Y	*0.95*	0.98	1.01	1.13	1.25	1.38
Hungary	HU10Y	*2.84*	2.93	2.91	3.80	4.00	4.20
Poland	PL10Y	*2.48*	2.50	2.47	2.50	2.50	2.60

Exchange rates (end of the period)

		Current	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	EUR/CZK	*27.04*	27.19	27.03	27.00	27.00	27.00
Hungary	EUR/HUF	*316*	314	316	310	308	305
Poland	EUR/PLN	*4.36*	4.25	4.27	4.40	4.30	4.26

GDP (y/y)

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	4.1	4.6	4.5	4.1	2.4	2.2	2.5
Hungary	3.5	2.7	2.4	2.8	2.2	2.4	2.8
Poland	3.6	3.3	3.5	3.5	3.7	3.8	3.8

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

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	0.2	0.8	0.4	0.0	0.7	0.6	0.8
Hungary	-0.6	0.6	-0.4	2.2	2.7	2.6	2.4
Poland	-1.5	-0.8	-0.8	-0.5	-0.4	-0.4	0.0

Current Account

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

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.6	-1.3
Hungary	-2.3	-2.1
Poland	-3.0	-2.9

Source: KBC, Bloomberg

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