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Central European Weekly

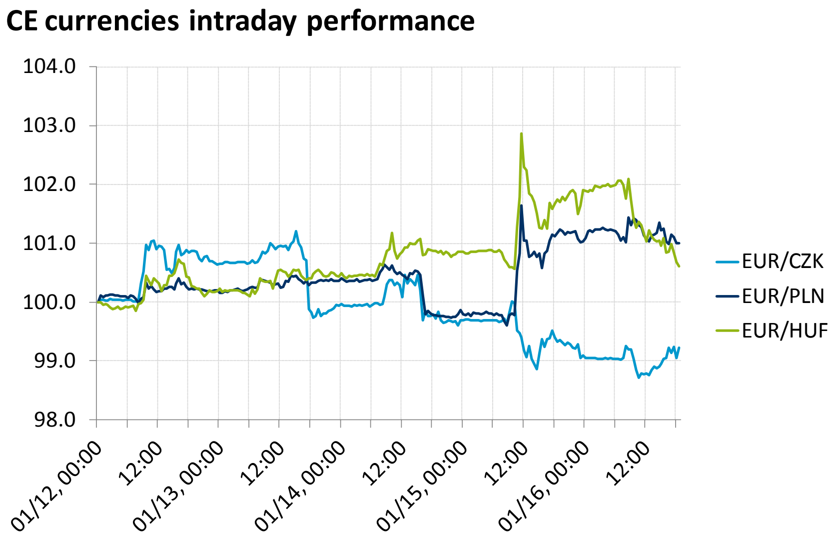
Monday, 19 January 2015

Table of contents

Weekly Highlights:

- Swiss shocking departure from its intervention policy triggers abrupt volatility to regional FX markets
- Deflation in Hungary and Poland deepens
- In Focus: Expensive CHF: A problem for Poland rather than Hungary

Chart of the Week: FX reaction CHF floating



The Polish zloty fell against the euro after the Swiss National Bank surprised markets last week...
(Source: Bloomberg, CSOB)

Market's editorial

Expensive CHF? Short the zloty against the forint

While the Czech actually koruna firmed, the forint and the zloty were hit by international environment mainly especially the abolishment of Swiss franc intervention floor. Regional forex markets speculated that, because of the expensive franc, Hungarian and Polish households could be in difficulties because a significant portion of their loans (notably mortgages) are denominated in the Swiss currency. Neverthelss, as we show later in this report (see In Focus) we beleive that the Swiss franc is a problem for the Hungarian and Polish economy, so it woul make sence to short the forint against the zloty.

The Hungarian loans in CHF decreased substantially in the last two months, thanks to the action done by NBH at the beginning of December. At that time the foreign currency denominated mortgage loans' exchange risk was hedged fully in the banking sector, which gave roughly 90% of the FC denominated loans in the household sector. So in the region Hungary's overall exposure in Swiss franc is quite moderate, it is around 1-1.5% of GDP. So, the Swiss decision and expensive frank should not be a problem for the forint. As concerns other implications recall that before the decision of the SNB the market started to price in base rate cut for the coming months due to the low inflation figure, which might have a negative effect on HUF as well. Although headline CPI was extremely low in December (-0.9% Y/Y, but excluding the last three months fuel drop CPI would be 0.2% Y/Y in December), we think that inflation may accelerate on the relevant time horizon for NBH (to around 2% Y/Y). Thus, we see no reason for NBH's rate cut rather keep it stable for an extended period.

For Poland, the situation is less optimistic but thanks to the National Bank of Poland's ban on granting foreign-currency mortgages (imposed a few years ago), it is not that dramatic. The situation will also improve over time. Like in Hungary, mortgages in the Swiss currency were very popular in the past, climbing to slightly less than 12% of GDP in 2009. Currently, outstanding CHF loans amount 8% of GDP. Fundamentally, the Swiss exit is therefore a much greater problem for the zloty and the Polish economy than for Hungary and the forint. Hence the rapid appreciation of CHF (if maintained) poses a risk for the zloty. That risk is even bigger because of Poland's extremely low inflation (-1.0% y/y for December) which raises the likelihood of another rate cut by the NBP and makes the Polish currency less attractive (see more on the next page).

The Swiss exit – a discouraging markest lesson for the CNB

Aside from the global aspects of Thursday's move by the SNB, we cannot ignore the message that the shocking appreciation of the franc sent to the Czech Republic. It indicates how difficult it may be to abandon a non-standard expansive policy – for example through targeted interventions against the local currency. Above all, Thursday's fluctuation of the franc is a warning sign for Czech exporters because the CNB is currently using a policy very similar to that pursued by the SNB until Wednesday. CNB Board members still naively believe and, in particular, declare wherever they go that the departure from this monetary strategy will be essentially smooth. The contrary is true, and the market made it clear to everyone on Thursday. However, those Czech exporters (whose exposure to currency risk is not hedged) who still (just like Swiss exporters on Thursday morning) believe in the soothing 'stories' from domestic central bankers should be in particular aware that the exit from the intervention policy may be very painful.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.9	-1.64%	→	↗
EUR/HUF	318	0.08%	→	↗
EUR/PLN	4.31	0.79%	→	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0.74	-6.92	→	↗
10Y HUF	2.76	-5.15	→	↗
10Y PLN	1.99	-1.24	→	↗

Review of Economic Figures

Poland's prices down by a huge 1% y/y

The Polish inflation also surprised on the downside, although not as much as Hungarian inflation by far. Prices were down by -0.3% m/m and -1% y/y. The main surprise to us as concerns the structure (overall, we had expected price growth to be 0.1% faster) was the greater fall in fuel prices than we had anticipated. A smaller deflationary surprise also came from clothing and footwear prices.

By and large, December's figure means that the period of deflation in Poland will be longer. If we take account of the risk stemming from the further possible decline in oil prices, Poland may even remain in deflation for the majority of this year.

Hungary's CPI closed 2014 with a negative figure

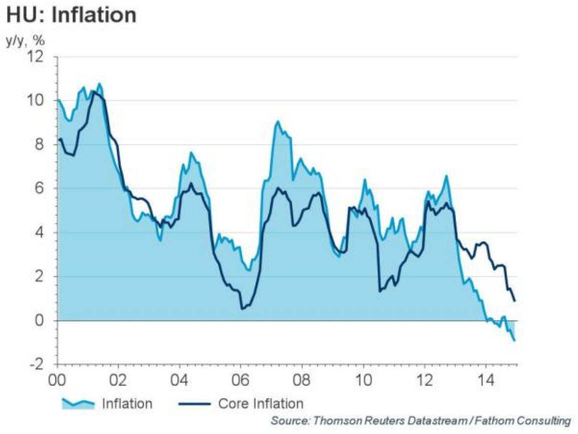
In December, Hungarian consumer prices decreased by 0.9% compared to the same period 2013 according to Hungarian Central Statistical Office. In 2014 the average price decrease amounted to 0.2% compared to year 2013.

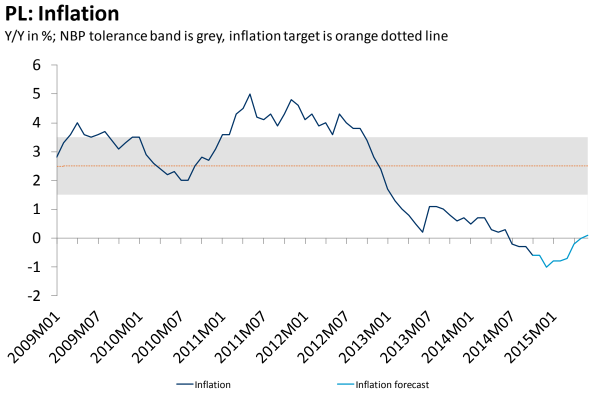
Thus, Hungary's December CPI surprised markets with a minus 0.9% figure as analysts expected the price index around minus 0.5-0.7 %.

December was the 4th consecutive month that posted a negative figure. Fuel prices played a huge role: without that factor, CPI would have been around minus 0.4 % (Y/Y). Compared to the prior month, both energy and alcohol prices declined. It was more surprise that also food prices dropped by 0.7% MoM and 0.6% YoY.

Core Inflation (that does not contain unprocessed food prices, energy and regulated prices) amounted to 0.8% Y/Y. This means also slowdown versus prior data that printed 1.2% Y/Y. Decline of this factor was due to a drop in processed food prices.

The above mentioned data rewrites market expectations for this year. Previously the consensus was 1% for average CPI in 2015. In light of the recent 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.





In Focus? Expensive CHF: A problem for PLN rather than HUF

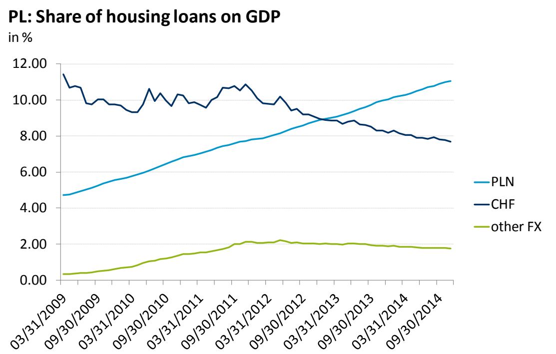
Switzerland's shocking departure from its intervention policy (EUR/CHF floor 1.20) immediately triggered an abrupt appreciation of the Swiss franc but also pushed two Central European currencies in the defensive – the Polish zloty and the Hungarian forint. Regional forex markets speculated that, because of the expensive franc, Hungarian and Polish households could be in difficulties because a significant portion of their loans (notably mortgages) are denominated in the Swiss currency.

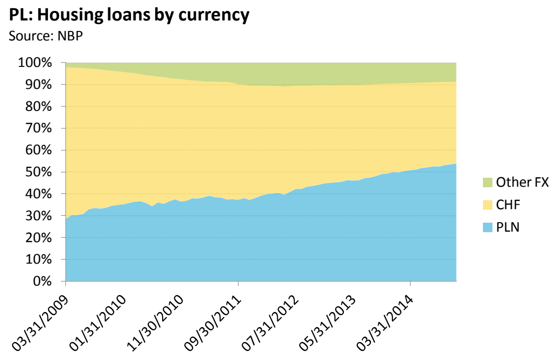
Is this really true and is the depreciation of the forint and the zloty (not only against the franc but, in particular, against the euro and consequently the koruna) therefore well-founded?

We don't think so for the forint. The zloty is more at risk.

Let's start with Hungary. Thanks to government measures, the biggest part of the foreign currency households loans (all mortgage loans and free use mortgage loans) were fixed and covered by the banks from the 1st of January. The remaining part is only around HUF230bn or EUR0.7bn, which is 0.7% of GDP. So the Swiss National Bank's decision has only a marginal effect on Hungarian loans and banks. Only consumer loans and car (FX) loans are affected by the decision (around 0.3% of GDP).

For Poland, the situation is less optimistic but thanks to the National Bank of Poland's ban on granting foreign-currency mortgages (imposed a few years ago), it is not that dramatic. The situation will also improve over time. Like in Hungary, mortgages in the Swiss currency were very popular in the past, climbing to slightly less than 12% of GDP in 2009 (see graph). Currently, outstanding CHF loans amount 8% of GDP. Fundamentally, the Swiss exit is therefore a much greater problem for the zloty and the Polish economy than for Hungary and the forint. Hence the rapid appreciation of CHF (if maintained) poses a risk for the zloty. That risk is even bigger because of Poland's extremely low inflation (-1.0% y/y for December) which raises the likelihood of another rate cut by the NBP and makes the Polish currency less attractive.



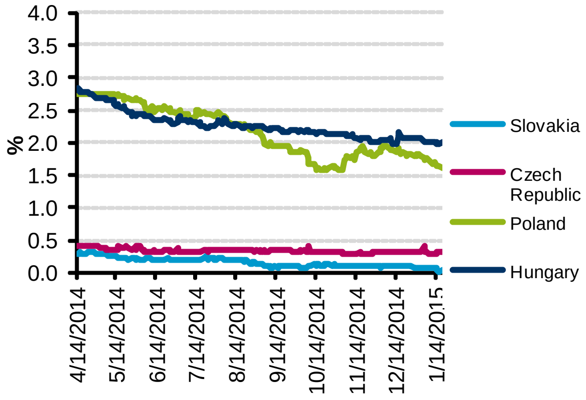


Calendar

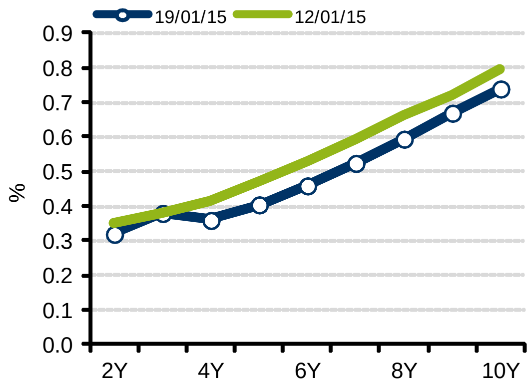
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	01/20/2015	14:00	Wages	%	12/2014			8.8	3.1	0.6	2.7
PL	01/21/2015	14:00	Industrial output	%	12/2014			-5.3	4.9	-7.5	0.3
PL	01/21/2015	14:00	PPI	%	12/2014			-0.5	-2.1	-0.5	-1.6

Fixed-income in Charts

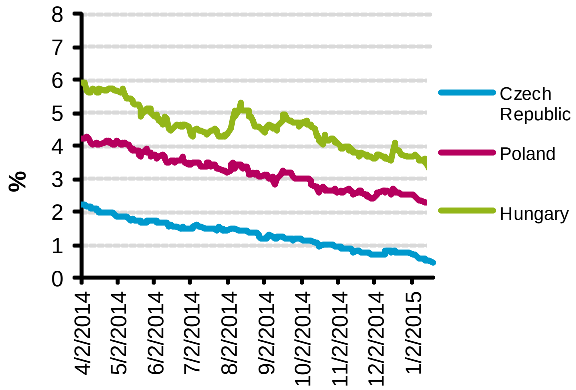
FRA 3x6



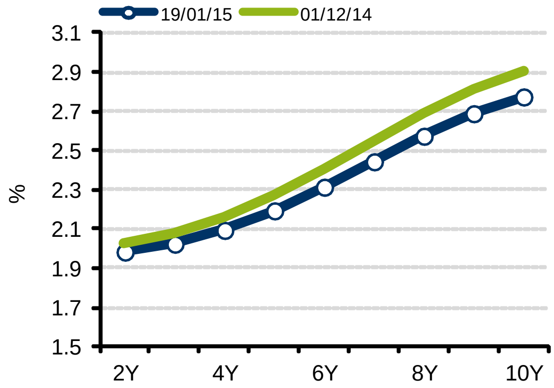
CZ IRS



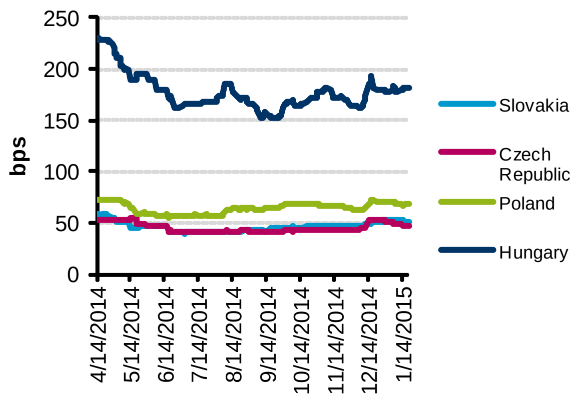
10Y GB Yields



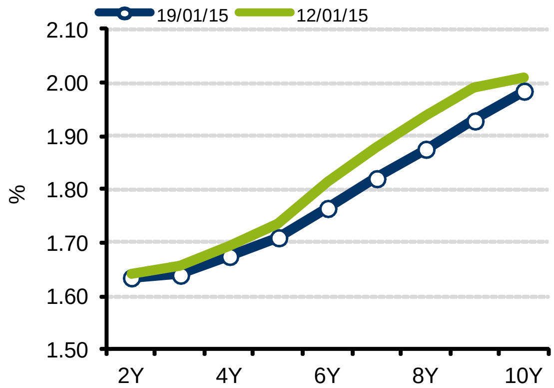
HU IRS



CDS 5Y



PL IRS



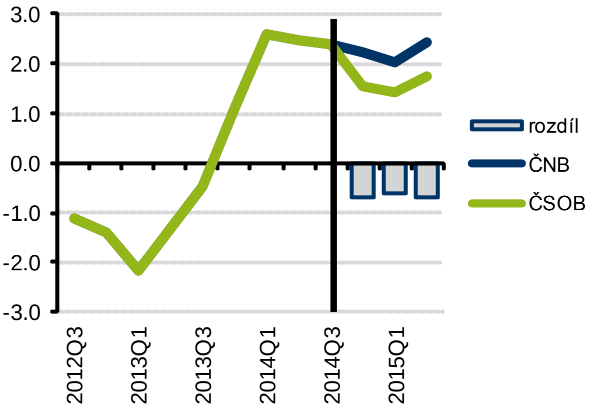
Source: Reuters

Medium-term Views & Issues

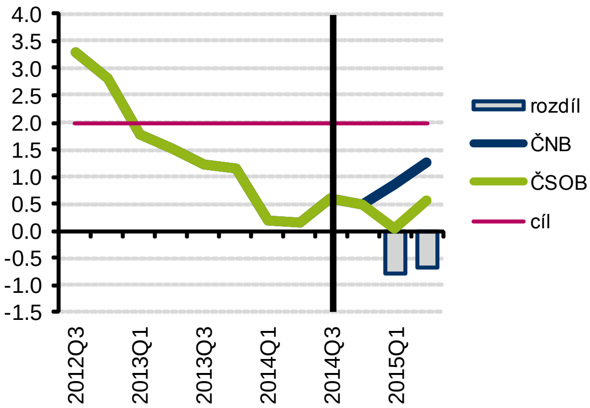
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing 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.	The NBH has finished its easing cycle in Hungary by cutting the base rate to the 2.1%. The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/-1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy. Our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015.	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

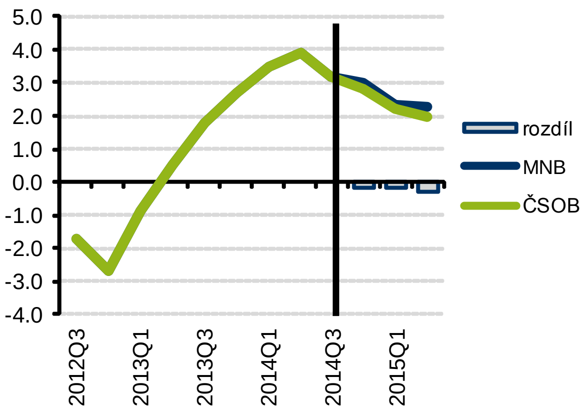
CZ: GDP outlook (Y/Y, %)



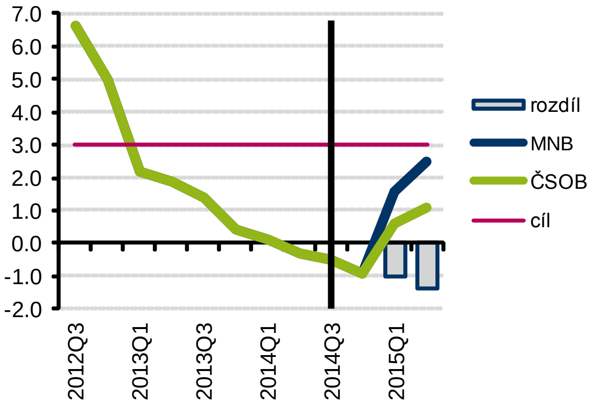
CZ: Inflation outlook (Y/Y, %)



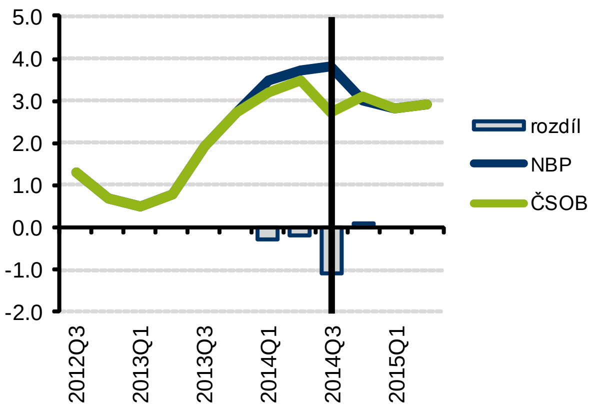
HU: GDP outlook (Y/Y, %)



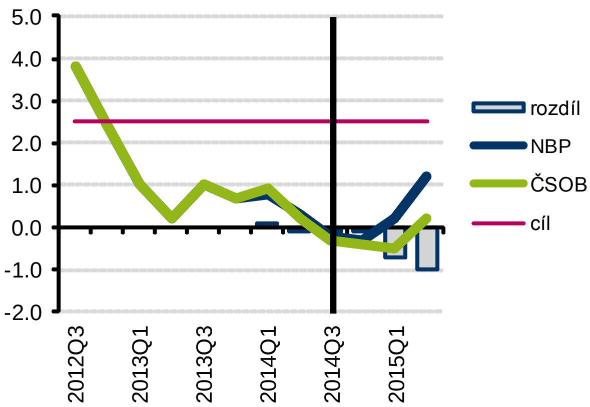
HU: Inflation outlook (Y/Y, %)



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	*2.03*	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	*0.74*	1.22	0.88	0.74	0.78	0.93
Hungary	HU10Y	*2.76*	3.92	3.25	3.50	3.50	3.65
Poland	PL10Y	*1.99*	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	*27.9*	27.5	27.7	28.0	27.7	28.1
Hungary	EUR/HUF	*318*	311	316	315	315	318
Poland	EUR/PLN	*4.31*	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	3.2	3.5	2.7	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	0.2	-0.3	-0.4	-0.5	0.2	#N/A

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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