Central European Weekly

Monday, 15 February 2016

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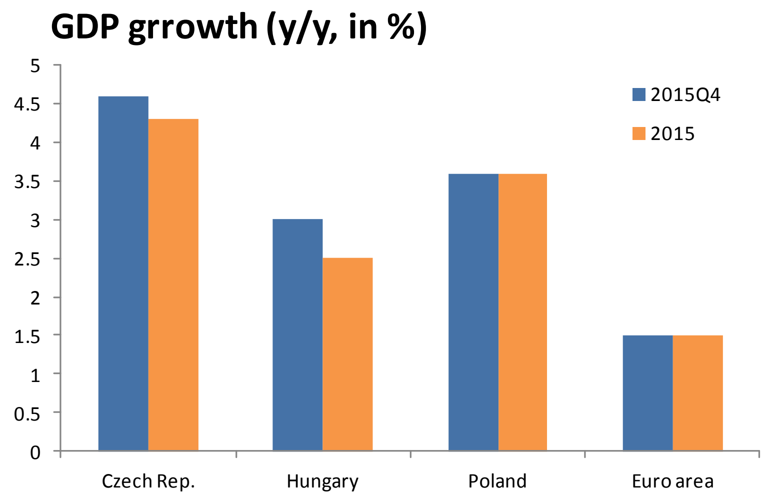
Weekly Highlights:

- GDP growth in 2015Q4: the region keeps momentum
- January's inflation readings still across the region
- Czech current account in historical surplus in 2015
- Weekly pre-view: strong Czech GDP figure expected

Chart of the Week: Growth in Central Europe



Economic performance in Central Europe looked very solid in 2015.

Market's editorial

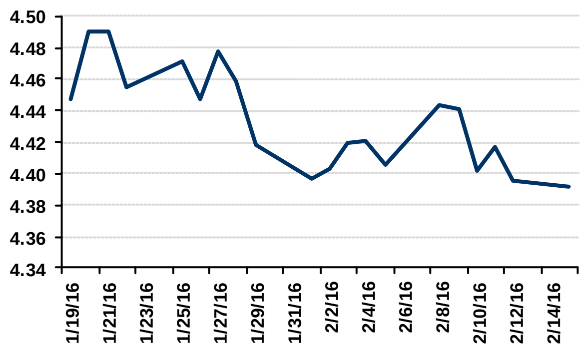
Central Europeean economies still in a good shape,...

The GDP data released in Poland and Hungary last week confirmed that growth in the region continued to be very solid in late 2015, and that the process of what is known as real convergence has been reactivated. This feeling may be further augmented after the release of the Czech GDP data this Tuesday (we predict 4.6% y/y growth). After this figure is released, it will be evident that Central European economies are growing by 3-4%, as opposed to only approximately half that rate in the more developed euro area. This is what the situation looked like in 2015 at least. Although this year's growth difference will not be that huge – unless the euro area slips into a recession (which is not our scenario) – the growth differential should remain positive in favour of the Central European region.

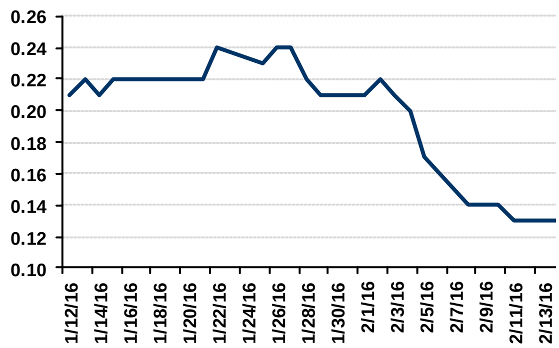
...but should it help regional currencies?

In fundamental terms such growth figures should be good news for Central European currencies and should thus make it possible for them to strengthen. This conclusion is certainly true for the medium-term horizon, while in the short term we can also see them move in the opposite direction too. Although the global sentiment on risky asset markets has improved, it is still uncertain and it is a common threat to all regional currencies. Moreover, the Polish zloty still has a problem with low inflation which, as indicated by January's data, is again surprisingly falling deeper into negative values (-0.7% y/y). Hence, the modified Monetary Policy Council of the NBP, where doves will be much more represented now, may be concerned about such developments and consequently seek ways to continue to ease the Polish monetary policy. Regarding the Czech koruna, it cannot appreciate by definition because of the CNB's intervention policy. On the other hand, the koruna is exposed to the risk that the Czech central bank will put negative interest rates in place after the fashion of numerous Western European countries. This may not necessarily happen in the end, but even the fear of something like this may slightly affect the koruna (ahead of the next Board meeting).

EUR/PLN



CZK FRA 3x6



	Last	Change 1W
EUR/CZK	*27.1*	*0.14%*
EUR/HUF	*309*	*-0.36%*
EUR/PLN	*4.40*	*0.13%*

	Last	Change 1W
10Y CZK	*0.83*	*12.16*
10Y HUF	*2.48*	*3.61*
10Y PLN	*2.33*	*-2.72*

Review of Economic Figures

Hungarian GDP surprisesslightly on the upside

The Hungarian GDP increased by 3.2% y/y in 4Q15 and it surprised slightly on the upside. We assume that with exception of the agriculture and construction all sectors rose in the last quarter. Although the detailed figure will be published only 3-weeks later, we think that domestic consumption accelerated further and EU funds money use pushed up investment level. The trade balance suggests that the net export contribution to the GDP was also higher in 4Q15 than in 3Q15. The full year growth of 2.9% Y/Y was fully in line with our expectation. The Hungarian economy is likely to slow in the following quarters to around 2% Y/Y, but the second half of the year GDP may accelerate slightly so we expect 2.3% Y/Y growth for 2016.

Low inflation readings for January in Hungary

In January, the Hungarian consumer price index remained at the same level as it was in December (0.9% Y/Y), and so it was below the expectation of 1.1% Y/Y. The core inflation increased from 1.4% Y/Y in December to 1.5% YY in January, but it reflects rather a stagnation of around 1.5% Y/Y.

The fuel price was again one of the main factors which were pulling back the CPI figure in January as it dropped by 4.2% M/M. The food price increase was smaller than a year before because of the VAT cut of pork (from 27% to 5%). One surprise is the moderating inflation of market services. The domestic demand is quite stable and strong so we expected that services price starts to accelerate slowly.

Looking ahead inflation is expected to moderate in the coming months and likely to return temporary into negative territory in May. In case oil price remains around the current level till the end of the year headline inflation in Hungary may accelerate only to 1.7% Y/Y in December and so the average inflation may be around 0.6% Y/Y in 2016. We still expect some increase of oil price for 2H16 (between 45 and 50$/barrel till the end of the year), which may push year-end inflation to around 2.5% Y/Y, but the average inflation may remain still well below 1% Y/Y in 2016.

The last inflation figure confirms that the NBH may keep monetary policy loose in 2016. We don't expect rate or any monetary policy change for February. March is more interesting and it may highly depend on the decisions of the ECB and the FED, but our base case that no rate cut is expected until the EUR/HUF is not traded below 305 permanently.

Costlier food, alcohol and cigarettes helped Czech CPI rise

The rise in the Czech consumer price index accelerated in January in line with expectations, with prices going up by 0.6% m/m as well as y/y. Especially food and drink prices rose against December. This rise is partly attributable to seasonal effects, hand in hand with waning pre-Christmas price cuts, and partly to new price lists for this year. Cigarette prices also grew – as a result of an increase in excise duties. Nor can we forget about costlier package tours sold during the winter season. An interesting and somewhat unexpected phenomenon is an increase in electricity prices, which contrasts to the general and long-term fall in the prices of electricity on the European market.

On the other hand, post-Christmas price reductions worked well with shoes and clothing – as a result of retailers' efforts to free up space for new collections. And, of course, the decline in prices also applied to fuel, the prices of which are quickly falling due to the falling prices of oil and petroleum products on global markets.

Year-on-year inflation sprang no surprises this time, having jumped from December's 0.1% to 0.6%. Nevertheless, this does not mean that we are now facing a genuine inflation trend because inflation will hardly move away from this level in the months to come, and thus there will still be a very long way to go until the CNB's inflation target is reached. Inflation was fairly good compared to the latest inflation forecast, and the central bank can essentially be satisfied. The divergence from the CNB's expectations is only -0.1%.

Despite solid economic growth, Czech inflation remains very low. Consumers can thus enjoy favourable price developments, influenced by strong competition among retailers as well as the producers themselves. Inflation will also continue to be favourably 'driven' by the falling oil prices for a while yet. This year's primary inflation factors will continue to include, in particular, increased prices of tobacco products and certain services. If we discount the likelihood of an oil shock, inflation may climb above 1% during the autumn.

Czech Republic's external balance improves rapidly

The high foreign trade surplus and the balance of services on the one hand, and almost no dividends on the other, are the main reasons why the current account posted a high surplus in December. Thus, for last year as a whole, the current account surplus even reached nearly CZK 75 bn, as opposed to only CZK 26 bn a year ago. This is the Czech

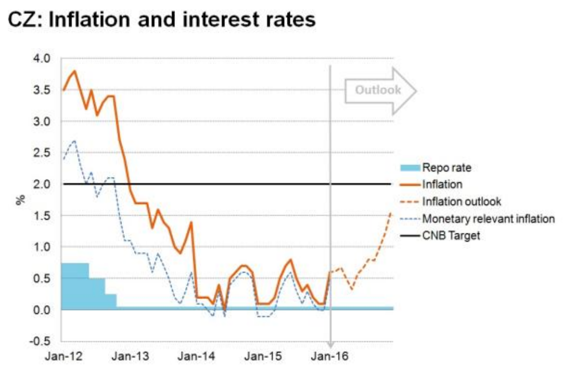
Republic's best ever figure, not only in absolute terms but also as a share of GDP (1.7%).

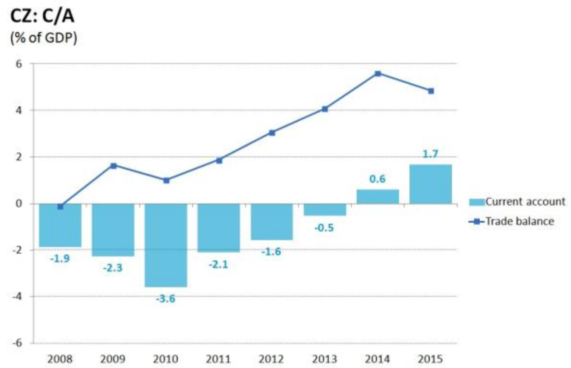
The current account developments clearly reflect the strong export orientation of the Czech Republic as a small open economy successfully improving its competitiveness on foreign markets. However, we should also bear in mind the positive effect of cheaper oil, which is causing reductions in the value of raw material imports to the CR of tens of billions of crowns. In any event, however, despite dividend outflows to foreign countries during the year, the Czech Republic can achieve a surplus in the balance of payments, which would encourage appreciation of the koruna under differing circumstances.

While the current account maintained its favourable trend and its surplus grew, the financial account position is somewhat different. Foreign direct investors' interest in the Czech market is far from being as breath-taking as we used to see in the past. Today, most FDI is composed of reinvested earnings, which foreign businesses keep in the Czech Republic for their further expansion or keep it there as retained earnings for their future dividend payments.

Regarding portfolio investments, Czech investors still love buying foreign securities – and therefore they have been the most active investors in the region over the long term. On the other hand, foreign demand for domestic securities, notably government bonds, is no longer negligible either. Given the forex interventions and negative market rates, government bonds have become attractive assets for foreign investors, who actually do not know what to do with their purchased korunas. In addition, according to the CNB, banks – in an effort to optimise their contributions to what is known as the resolution fund – influenced portfolio investments in late 2015.

For this year, we do not expect any significant changes in the current account. While cheaper oil will curb the koruna value of imports to the CR, the improving domestic demand will stimulate it. Therefore, we expect the current account surplus to remain more or less at last year's level.





Weekly preview

TUE 9:00	CZ GDP (change in %)		
	Q4-15	Q3-15	Q4-14
GDP (q/q)	**0.3**	0.7	0.4
GDP (y/y)	**4.6**	4.7	1.3

CZ: GDP above 4% again

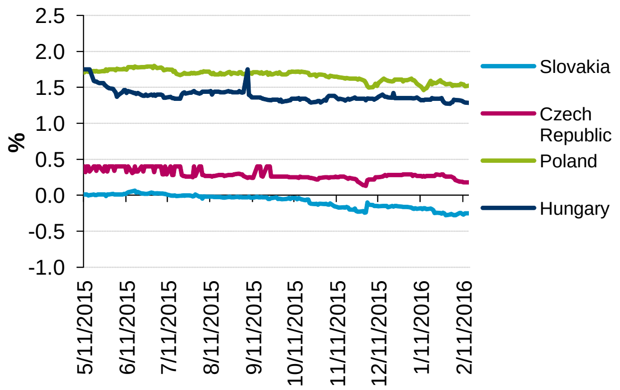
We expect the GDP growth slowed down (to 0.3% q/q) in the 4th quarter of the last year as the industrial production – as the main driver – showed worse figures as a result of outages in electricity generation and chemical industry. On the other hand, household consumption also accelerated and drove imports to the Czech Republic. Compared to the same period of the previous year the GDP increased by 4.6%.

Calendar

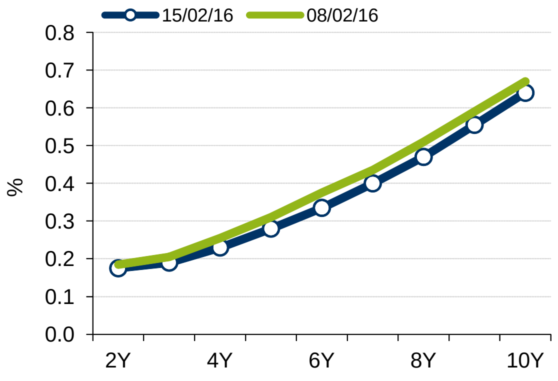
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	2/16/2016	9:00	GDP	%	2015 4Q A		4.6	4.5		4.7	
PL	2/16/2016	14:00	Wages	%	01/2016				3.4		3.1
PL	2/16/2016	14:00	Employment	%	01/2016			0.6	1.5	0.2	1.4
PL	2/17/2016	14:00	Industrial output	%	01/2016			-6.7	2.9	-3.6	6.7
PL	2/17/2016	14:00	PPI	%	01/2016			-0.05	-0.7	-0.2	-0.8
PL	2/17/2016	14:00	Retail sales	%	01/2016			-23.9	2.9	21.5	4.9

Fixed-income in Charts

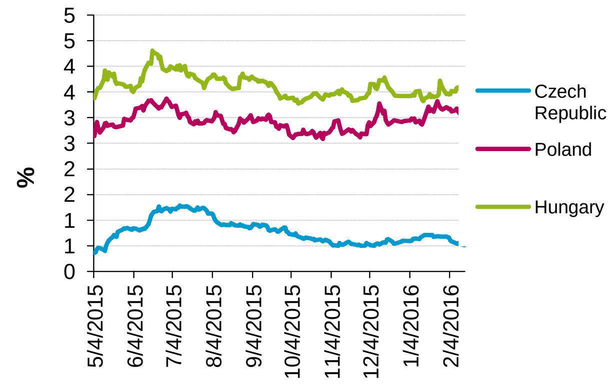
FRA 3x6



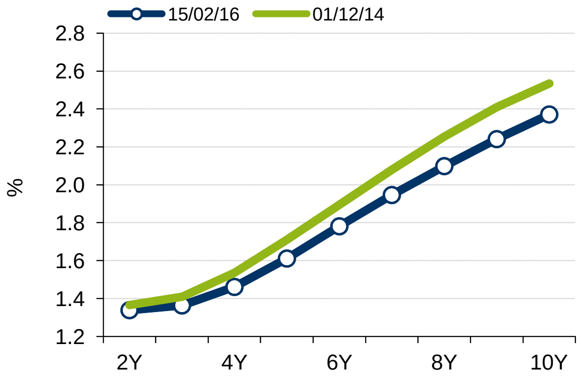
CZ IRS



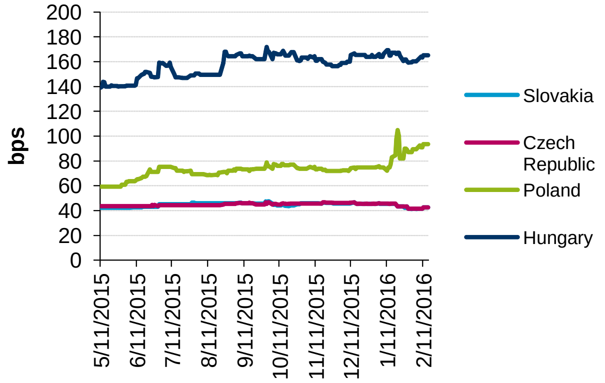
10Y GB Yields



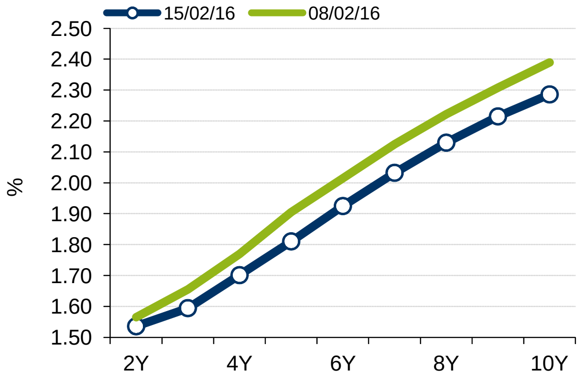
HU IRS



CDS 5Y



PL IRS



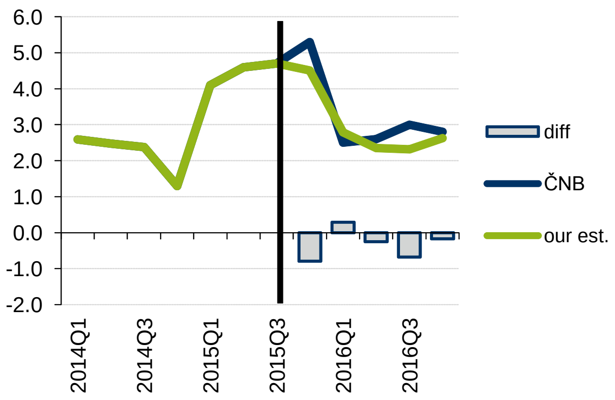
Source: Reuters

Medium-term Views & Issues

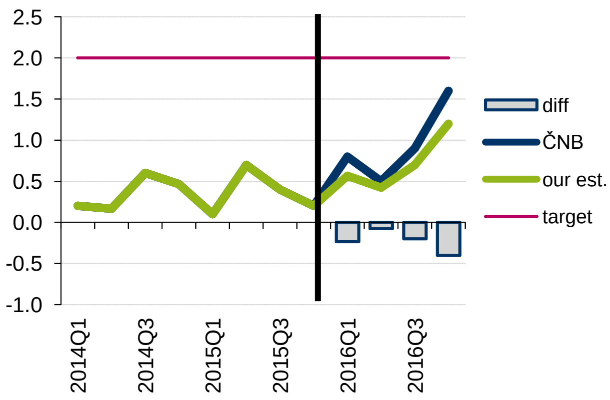
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 4Q15 GDP growth might bounce back closer to 3% Y/Y, as EU funds money use was accelerated, the government increased the spending and the industrial production and domestic consumption might be stronger, so the growth might be around 2.7% Y/Y in 2015. The outlook is less favorable. The investments started to fall, the EU funds money use may substantially lower in this year due to the new budgetary period. The government tries to boost the construction via new government program, which targets new homes for households. The domestic consumption may remain strong thanks to the increasing wage mass. In case there is no substantial slowdown of international growth and the agriculture provides an average harvest, the economic growth might be around 2.3% Y/Y in 2016.	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 latest forecast does not envisage the return of inflation to the target before early 2017, with inflation not significantly diverging from it afterwards either. The CNB has extended its exchange rate commitment until the first half of 2017. The possibility of introducing negative interest rates has been increasing, in light of the widening of the interest rate differential vis-à-vis the euro area and developments in domestic financial markets. But we still don't expect negative CNB's rates. There are two main preconditions for negative official rates: 1) significant ECB's rate cut, 2) continuing large monthly fx interventions of the CNB.	The NBH plans to keep base rate unchanged at 1.35% till the end of its forecasting period, which is 4Q17. It is more or less in synchrony with the ECB's monetary policy forward guidance. The main attention of NBH is decreasing FX reserve and the amount of money placed at the NBH. So the Council may change rather the monetary tools first, but in case HUF strengthens to around 300 base rate cut cannot be excluded either, although this is not our base case. We expect first rate hike only for 2017, as with the conversion of households' FC loans to HUF ones, the tolerance level of a weaker HUF jumped substantially.	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 the NBH's commitment to the long time low interest rate may lead to short-term HUF weakening. Although compared to other emerging markets HUF looks like quite stable, the fears of Chinese hard lending scenario pushed EURHUF trading range between 313 and 318. Although the huge trade and current account balance supports HUF in medium term, the ongoing foreign sell-off of HUF denominated gov. bonds and the uncertain sentiment keeps weakening pressure on HUF, so we see bigger risk on the weak side on short term, which means that EURHUF may be pushed towards 325.	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

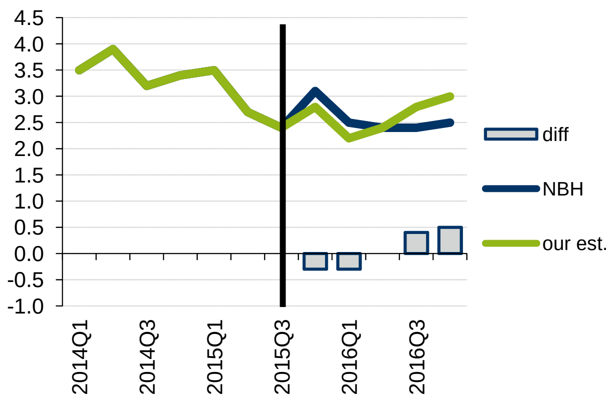
CZ: GDP outlook (Y/Y, %)



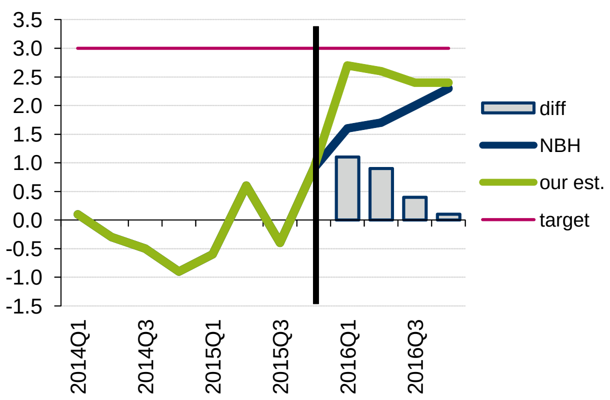
CZ: Inflation outlook (Y/Y, %)



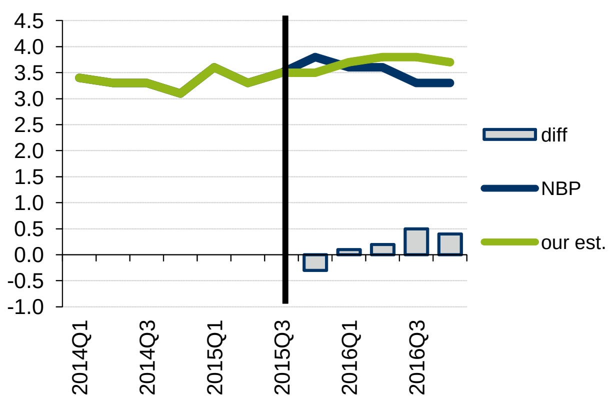
HU: GDP outlook (Y/Y, %)



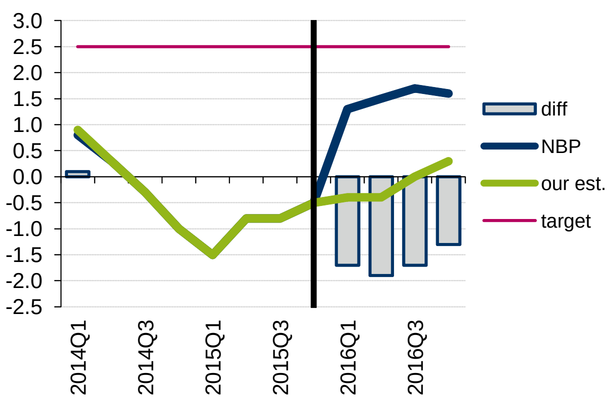
HU: Inflation outlook (Y/Y, %)



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	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	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	1.35	1.35	1.35	-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	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	PRIBOR	*0.00*	0.25	0.24	0.25	0.25	0.25
Hungary	BUBOR	*1.35*	1.35	1.35	1.35	1.35	1.35
Poland	WIBOR	*1.69*	1.72	1.65	1.65	1.65	1.65

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

		Current	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	CZ10Y	*0.64*	1.01	1.08	1.15	1.23	1.30
Hungary	HU10Y	*2.33*	2.91	2.50	2.60	2.80	3.00
Poland	PL10Y	*2.29*	2.47	2.50	2.50	2.60	2.75

Exchange rates (end of the period)

		Current	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	EUR/CZK	*27.05*	27.03	27.02	27.02	27.02	27.02
Hungary	EUR/HUF	*309*	316	310	308	305	300
Poland	EUR/PLN	*4.39*	4.27	4.40	4.30	4.26	4.25

GDP (y/y)

	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	4.6	4.7	4.5	2.8	2.3	2.3	2.6
Hungary	2.7	2.4	2.8	2.2	2.4	2.8	3.0
Poland	3.3	3.5	3.5	3.7	3.8	3.8	3.7

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

	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	0.8	0.4	0.1	0.6	0.5	0.7	1.5
Hungary	0.6	-0.4	0.9	2.7	2.6	2.4	2.4
Poland	-0.8	-0.8	-0.5	-0.4	-0.4	0.0	0.3

Current Account

	2015	2016
Czech Rep.	1.5	1.5
Hungary	6.0	5.1
Poland	-1.2	-1.5

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.4	-1.3
Hungary	-2.3	-2.0
Poland	-3.0	-2.9

Source: KBC, Bloomberg

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