Central European Weekly

Monday, 29 February 2016

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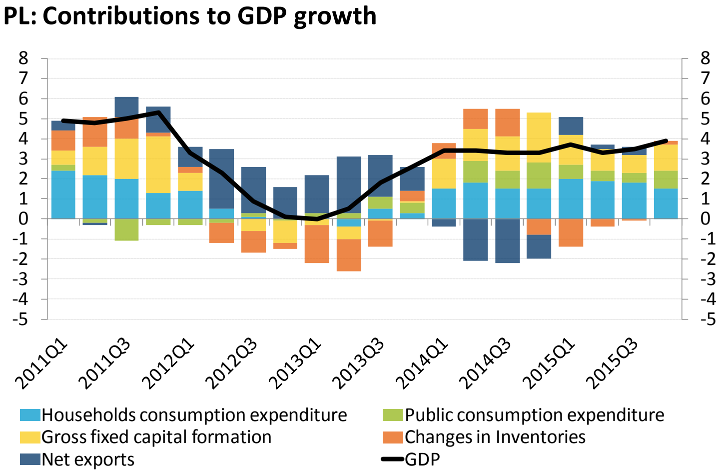
Weekly Highlights:

- German and regional PPI negative inflation readings show that deflationary climate persists in CE
- The NBH may cut o/n deposit rate to zero or to -0.1% in March
- Weekly preview: watch regional PMIs and Moody's rating action on Hungary

Chart of the Week: Polish GDP in details



The Polish economic growth continues to be driven by domestic demand...(Source: GUS, CSOB)

Market's editorial

Eurozone and regional producer prices keep falling

The return of German and EMU inflation into negative territory has reminded us that generating positive inflation in Central Europe continues to be a problem when oil prices are very low. The deflationary climate in the region persists, and – in small open economies – this is also highly evident in the regional producer price index (PPI) statistics. The PPI dropped even deeper into negative territory in January, thus fuelling the speculations – especially in the Czech Republic and Hungary – that both the Czech National Bank and the National Bank of Hungary will have to continue to easing their respective monetary policies. Nevertheless, in the end the ECB policy (i.e., its meeting on March 10) will determine whether and how much the NBH or the CNB will eventually cut their respective interest rates because both regional central banks are subject to the ECB's influence.

NBH may cut o/n deposit rate to zero or to -0.1% in March

In this respect it is wort notig the outcome of the latest NBH meeting. The NBH left base rate unchanged at 1.35% in line with the market expectation. The statement was almost the same one month before, but there was an important change at the end of the statement. Previously the Council highlighted that the base rate will be left unchanged and they will use the non-conventional tools for monetary easing. This time the last two sentences were: "The Council closely examines developments in the foreign monetary environment, particularly the measures of the European Central Bank. The Monetary Council may ease monetary conditions further in view of the March Inflation Report "

Moreover, vice Governor Mr. Nagy told to markets that the investors sentiment on Hungary improved too fast, so further monetary easing may come. But benchmark rate cut is unlikely in March or April; they will rather focus on the unconventional tools.

The Council's statement and Mr. Nagy's words full fit into our expectation. The NBH may cut the overnight deposit rate to zero or to -0.1% in March from the current level of 0.1%. The NBH also tries to push down the Bubor rates (the loans are priced with the Bubor), because they said the real rates on the secondary market are below the official Bubor levels. Additionally the Council may increase the available IRS facility by HUF300bn in March. So the NBH tries to push down the bond yields further in the coming months.

The statement by Mr. Nagy, that base rate cut is unlikely in Mach or April, confirms our view that NBH may cut the key rate after Hungary is over of the heavy refinancing need of government debt in the first 5 months this year, and in case Hungary is upgrade in in May or June and additionally the EUR/HUF is traded around or below 305 permanently. So, we still expect unchanged base rate on March decision.

Watch regional PMI's indices

Until before then, however, some important macroeconomic figures will be released in Central Europe. Beside GDP details in Poland (see the the chart on the front page) and the Czech republic Some of such these figures to be released this week include the business sentiment indices (PMI). Bear in mind that the optimism in both Czech and Hungarian industries has been high so far, and thus it will be interesting to see whether this was also true in February. As indicated by the data released last week, similar statistics in the German industry (Ifo and PMI indices) have deteriorated.

It is worth adding that at the end of the week there wil be a revision from of the Hungarian sovereign ratings from Moody's.

	Last	Change 1W
EUR/CZK	27.1	0.03%
EUR/HUF	311	1.14%
EUR/PLN	4.36	0.00%

	Last	Change 1W
10Y CZK	0.62	-1.59
10Y HUF	2.13	-6.59
10Y PLN	2.22	-3.27

Review of Economic Figures

Czech producer prices keep falling

January's producer price index clearly shows that we will have to wait for some more time to see the PPI rise. Compared to December the producer price index fell by 1.6% and its year-on-year fall again accelerated – this time to 3.4%. This is not only a result of the declining oil prices, influencing the refining prices, but also due to a significant fall in the electricity prices for businesses. At the moment, this is just a the primary outcome of January's decline in energy prices, which may be followed by a secondary effect, resulting from a decline in a significant portion of domestic business costs.

For the sake of completeness we can add that some businesses in the textile and clothing, pharmaceutical, electronics, furniture and food industries modified their price lists upwards. The latitude for raising prices is still limited by pressure from consumers as well as competition on domestic as well as foreign markets. Moreover, certain sectors are still struggling with curbed demand and growing competition from eastern imports (see, for example, metal production).

Notwithstanding the weak koruna there is no latituderoom for the Czech Republic to import PPI inflation. All EU countries that are willing to publish their PPIs indicate that their manufacturing industry prices are continueing to fall. Therefore the options of raising producer prices are still limited despite the economic recovery. Hence, given the falling producer prices, we cannot even expect CPI inflation to accelerate now. This is whyerefore we do not believe that year-on-year inflation may will significantly move away from January's 0.6%. We predict February's inflation of 0.5% – only fuelled by an increase in cigarette excise duties. Thus hitting the inflation target is still nowhere to be seenin sight, unless we expect any fundamental turnaround in energy prices, i.e., in the prices of oil and its derivatives. Therefore inflation continues to favour maintaining an extremely eased monetary policy in both the Czech Republic.

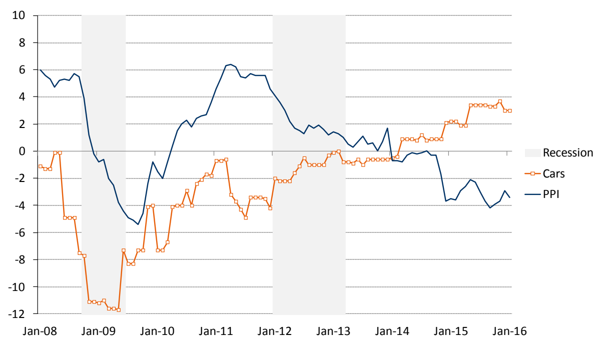
Czech business sentiment heading downwards

January's confidence in the economy was the highest infor the last eight years but February saw a moderate cooling, notably among consumers and service businesses operating in services. However, the decline in confidence was fairly small and, compared to previous years, the confidence is still very high. The decline in consumer confidence is most likelyprobably attributable to the news onf potential economic problems abroad, which may affect the Czech economy after some time. The Statistical Office reports that concern about a deterioration ofin the overall economic situation inover the next twelve months has increased.

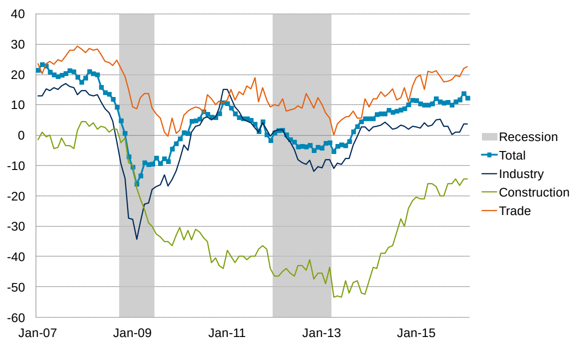
While consumer optimism decreased from its highs, the situation in industry – the largest sector of the Czech economy – diddid not change very much over the last month. Businesses expect production to grow within over the next few months and surprisingly anticipate a moderate decline in employment. So far industry has significantly helped to reduce unemployment by rapidly creating new jobs, and therefore this statement from the Statistical Office is interesting atto say the least. We believe that this is not a picture of the entire sector; more likelyprobably it is an effect of certain specific sectors affected by a long-term decline in demand. The data on confidence in the Czech economy suggests that domestic economic growth ishas been decelerating this year, and this alone comes as no surprise.

CZ: PPI

(y/y, %; Source: ČSÚ)



CZ: Business confidence



Weekly preview

FRI 9:00	CZ GDP (change in %)		
	Q4-15	Q3-15	Q4-14
GDP (q/q)	**0.0**	0.7	0.4
GDP (y/y)	**4.0**	4.7	1.3

CZ: GDP down on temporary shutdowns

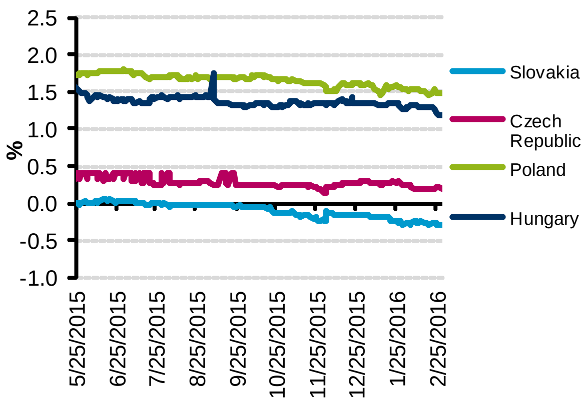
As indicated by the preliminary GDP forecast for the last quarter of last year, the economy was far from performing as well as it did in the previous quarters. However, this was primarily due to problems in the energy sector (prolongation of temporary shutdowns) and the chemical industry (accidents). Thus the lower performance could also be attributable to taxes. Overall, however, the economy performed well, as also suggested by an increased value added versus a GDP decline.

Calendar

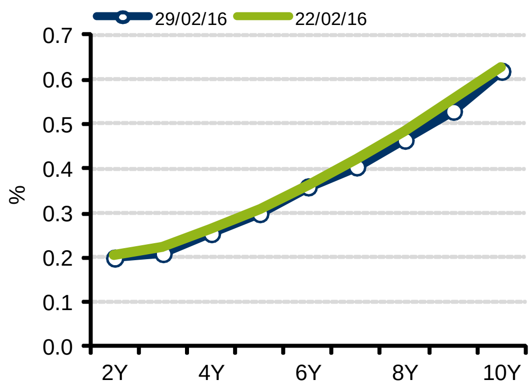
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	02/29/2016	9:00	PPI	%	01/2016					-0.5	-1.3
CZ	02/29/2016	10:00	Money supply M2	%	01/2016						6.9
PL	02/29/2016	10:00	GDP	%	4Q/2015 *F					1.1	3.9
HU	03/01/2016	9:00	PMI manufacturing		02/2016					53	
PL	03/01/2016	9:00	PMI manufacturing		02/2016			50.5		50.9	
CZ	03/01/2016	9:30	PMI manufacturing		02/2016					56.9	
CZ	03/01/2016	14:00	Budget balance	CZK B	02/2016					45.9	
HU	03/03/2016	9:00	Retail sales	%	01/2016						4.5
HU	03/03/2016	9:00	Trade balance	EUR M	12/2016 *F					643	
PL	03/04/2016	0:00	Earnings PGNiG	PLN	4Q/2015						
HU	03/04/2016	0:00	Earnings OTP Bank	HUF	4Q/2015						
CZ	03/04/2016	9:00	GDP	%	4Q/2015 *P	0	4			-0.1	3.9
PL	03/04/2016	15:00	Budget balance	PLN M	01/2016					-36129	

Fixed-income in Charts

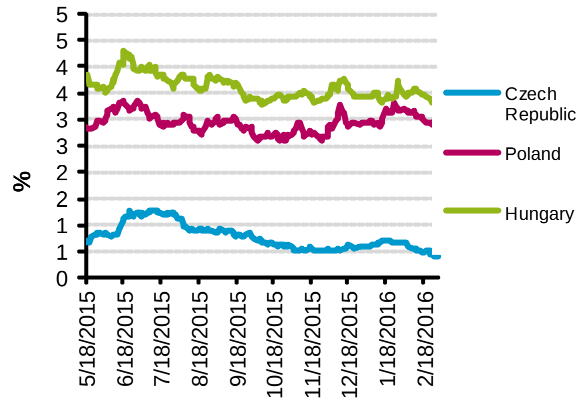
FRA 3x6



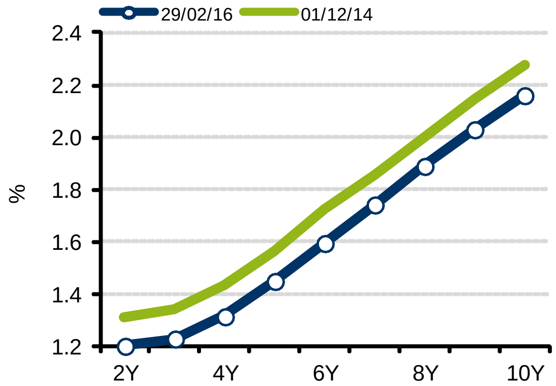
CZ IRS



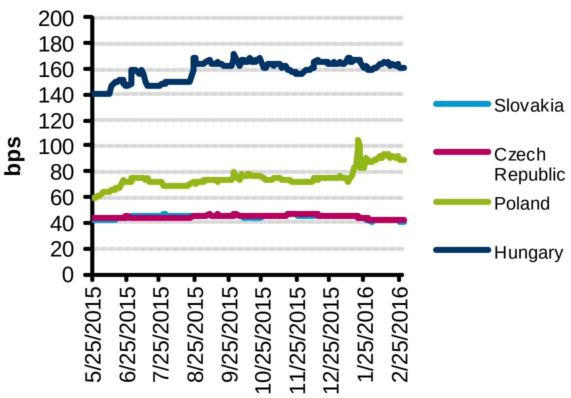
10Y GB Yields



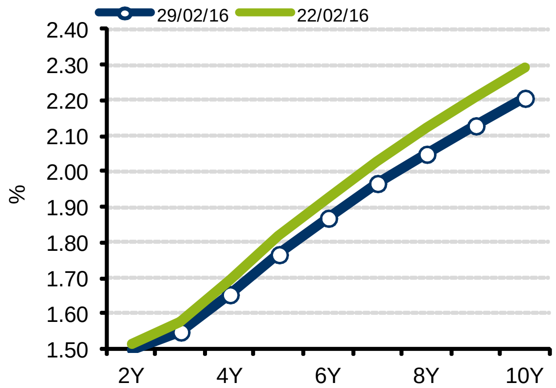
HU IRS



CDS 5Y



PL IRS



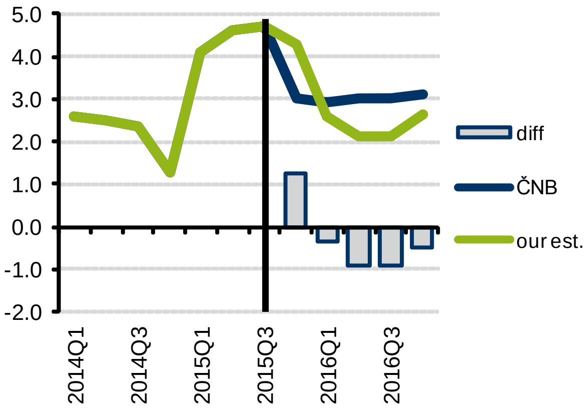
Source: Reuters

Medium-term Views & Issues

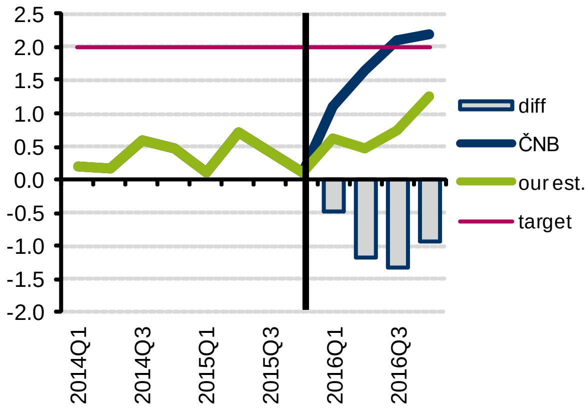
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 last NBH statement and Mr. Nagy's words full fit into our expectation. The NBH may cut the overnight deposit rate to zero or to -0.1% in March from the current level of 0.1%. The NBH also tries to push down the Bubor rates (the loans are priced with the Bubor), because they said the real rates on the secondary market are below the official Bubor levels. As concerns the base rate – a rate cut is unlikely in Mach or April. Our view that NBH may cut the key rate after Hungary is over of the heavy refinancing need of government debt in the first 5 months this year, and in case Hungary is upgrade in May or June and additionally the EUR/HUF is traded around or below 305.	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

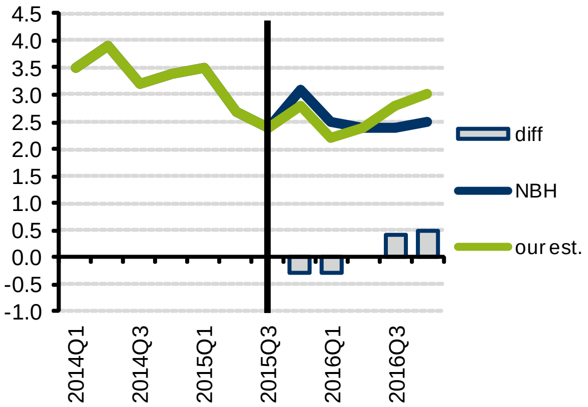
CZ: GDP outlook (Y/Y, %)



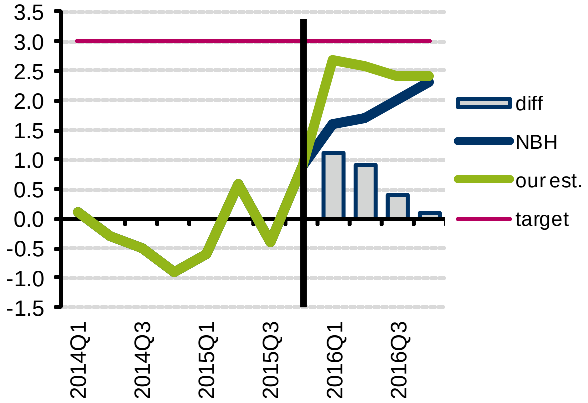
CZ: Inflation outlook (Y/Y, %)



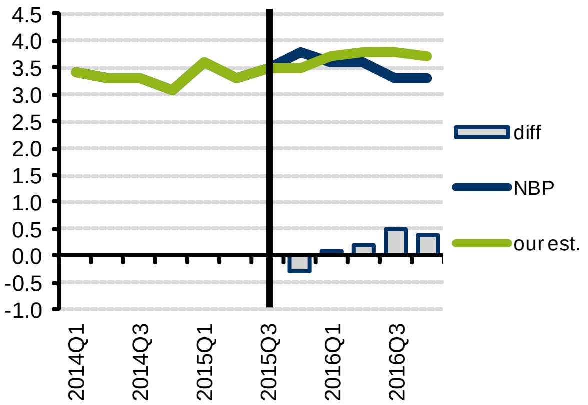
HU: GDP outlook (Y/Y, %)



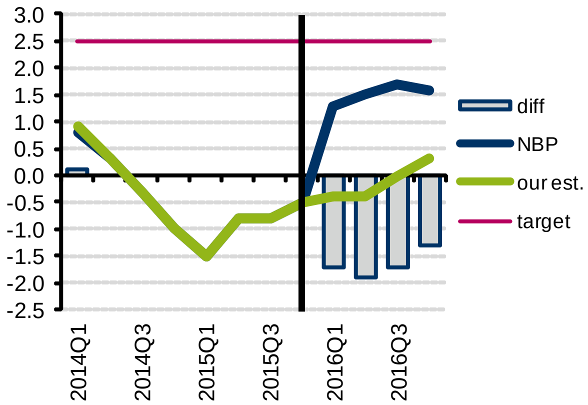
HU: Inflation outlook (Y/Y, %)



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	2.25	2.50	2.75	3.00	-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	0.25	0.25	0.25	0.25
Hungary	BUBOR	*1.35*	1.35	2.40	2.60	2.90	3.10
Poland	WIBOR	*1.68*	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	*0.62*	1.01	0.65	0.82	0.98	1.15
Hungary	HU10Y	*2.13*	2.91	3.80	4.00	4.20	4.40
Poland	PL10Y	*2.21*	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	*27.07*	27.03	27.02	27.02	27.02	27.02
Hungary	EUR/HUF	*311*	316	310	308	305	300
Poland	EUR/PLN	*4.36*	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	4.3	2.6	2.1	2.1	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	0.7	0.6	0.8	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.	1.7	1.6
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

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