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Central European Weekly

Monday, 11 April 2016

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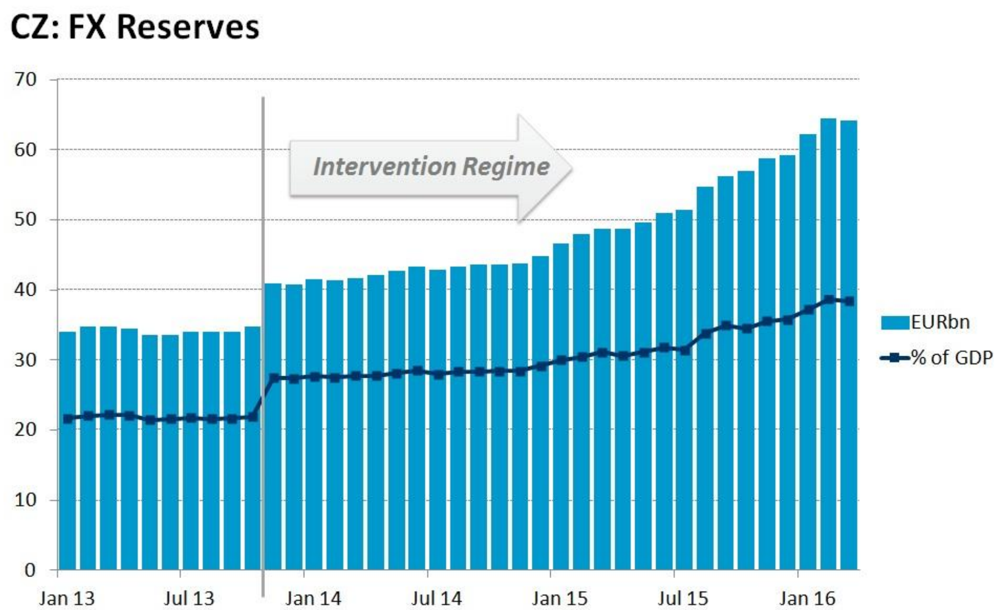
Weekly Highlights:

- The NBP firmly on hold despite ECB and NBH easing
- Czech and Hungarian inflation surprised on the downside in March
- No FX interventions from the CNB in March, but negative rates remain a tactical option

Chart of the Week: Czech FX reserves



Central Banks & Markets

The Polish deflation is not a problem even for new MPC

The recent rate cut by the ECB or the NBH did not make any substantial impression on Polish central bankers; thus the NBP is not planning to follow these easing actions and will keep its official interest rates unchanged. This is the main message from yesterday's interest-rate-setting meeting of the NBP, which was already attended by all new central bankers recently appointed by Polish President and parliament. Moreover, the Monetary Policy Council (MPC) of the NBP is not troubled by persisting deflation in Poland either because, as NBP President Belka told a press conference, this is a global phenomenon most central banks are having to face. The comment on the NBP's decision also showed that Poland's central bank is reconciled with the fact that growth consumer and producer prices will continue to be negative because it will be a result of external factors commodity prices in particular).

Let us add that President Belka explicitly highlighted one more external risk factor for the Polish economy – the UK's referendum on whether the UK should remain in the EU. Otherwise, however, both the press conference (also attended by the new MPC members) and the NBP's comment clearly indicate that the central bank considers the existing rate level to be optimal, and therefore the level should not change soon.

No FX intervention from the CNB on spot market in March

While the EUR/CZK does not look exited by recent Czech macro figures, both the development of the koruna and liquidity on the money market actually indicate that the need to intervene against the strong currency has disappeared. According to released statistics the CNB did probably not have to intervene against the koruna at all in March - FX reserves even fell slightly to €64.2bn in March, compared to €64.6bn in February. Although the Czech Republic is certainly not suffering from a lack of reserves (standing at approximately 40% of GDP, i.e., covering six months of imports of goods and services), latitude for the central bank to continue to intervene certainly exists.

After all, as the CNB has carefully suggested, the scope of interventions may be relevant for its considerations about putting negative interest rates in place. While the CNB does not regard negative rates as a road to eased monetary conditions, this may be a tactical solution for the central bank in its 'fight' on the FX market – especially when it discontinues its exchange rate policy. Therefore, the following may be true: the less the central bank needs to be active, the less willing to cut rates into negative territory the bank may be. We continue to see a 40% likelihood of negative rates in the Czech Republic.

	Last	Change 1W
EUR/CZK	27.1	-0.11%
EUR/HUF	312	-0.09%
EUR/PLN	4.29	0.94%

	Last	Change 1W
10Y CZK	0.56	-8.20
10Y HUF	1.95	-4.41
10Y PLN	2.25	0.90

Review of Economic Figures

Hungary is back in deflation territory

Hungarian consumer price index drop from 0.3% Y/Y in February to -0.2% Y/Y in March causing a huge surprise for the market. We expected that the inflation will return to negative territory, but we thought that it will be two months later. Core inflation moderated from 1.5% Y/Y in February to 1.3% Y/Y in March.

The main reasons behind the fall are 1) base effect as a year before the fuel prices went up 2) food price decrease because of the VAT cut of pork and the oversupply of milk 3) tradable goods and market services inflation started to moderate.

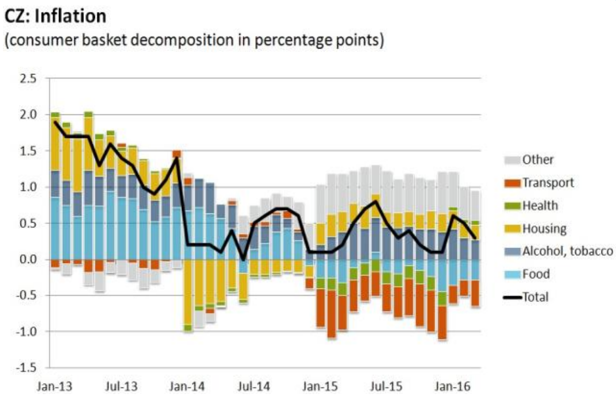
Looking ahead, without a sudden increase of oil prices, inflation is expected to fall further in the coming months below -0.5% and it is likely to remain in negative territory till August. We still see consumer price index close to 2% at the end of the year, but it calculates with an oil price increase to around 45$ / barrel in the last quarter in 2016. The average inflation may be around 0.3% Y/Y in 2016.

The inflation figure may confirm the NBH's view about the necessity of the rate cuts, so we maintain our view that the Monetary Council continues the rate cut cycle in the following months. We expect three more steps (April, May and June) and so the base rate might be moderated to 0.75%. We think that the O/N interest channel might be change asymmetric during the decision, and the O/N deposit rate might be moderated only to around -0.2% from the current level of -0.05%, while the O/N lending rate might be decreased to around 1% from the recent level of 1.45%. The last couple of days the yield curve was steepened, the long-end of the curve went up by around 20bps, but we expect that the upcoming rate cuts may push down the whole yield curve by around 20-30bps. The intention of the NBH is still to weaken the currency and it looks like that they would like to see EURHUF rather around 315 as the vice-governor of the NBH started to talk about the negative effects of strong HUF already around 312, while one and a half months ago he started the verbal intervention only below 310.

Czech inflation dow again; but the labour market is strong

The Czech inflation surprised on the downside in March as a year-on-year change of the CPI index dropped from 0.5% to 0.3%. The implied monthly fall (0.1%) of the consumer price index was caused by seasonality in vacation and food prices. At the same, it seems that the Czech consumer price index has not reacted to higher oil prices, which were already the case in March. Thus, the impact of higher gas prices should be visible in the Czech inflation in April. Still, we expect a modest decline in year-on-year inflation even next (to 0.2% y/y).

As expected, the Czech unemployment level fell again in March, declining to 6.1% this time, the lowest March level since 2009. At the same time, the number of vacancies grew again – to more than 117,000 jobs. The situation on the domestic labour market has now been significantly improving for three years. The primary contributor to the unemployment fall is economic growth, which has been continuously reducing the unemployment problem.



Weekly preview

WED 10:00	CZ Cur. Account (CZK bn)		
	Feb-16	Jan-16	Feb-15
C/A monthly	**35.0**	32.4	34.0
cummulative (YTD)	**67.4**	32.4	64.9
Trade bal. monthly	**25.8**	31.9	24.1
cummulative (YTD)	**57.7**	31.9	50.3

CZ: Current account in the black

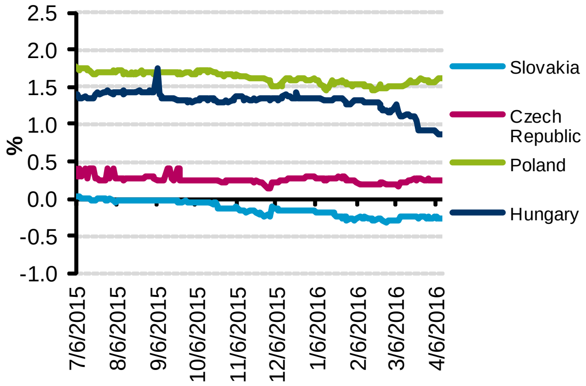
The high surplus of foreign trade in goods as well as services on the one hand, and the low dividend outflow early this year on the other, were most probably responsible for the continuation of the double-digit current account surplus in February. In addition, the data could be influenced by inflows from EU Funds, and therefore even a higher surplus should not surprise. We expect the surplus of the Czech Republic's external balance for this year as a whole to be much the same as in the previous year, i.e., just below 1% of GDP.

Calendar

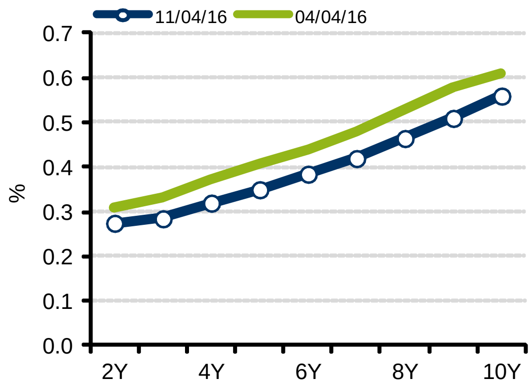
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	04/11/2016	9:00	CPI	%	03/2016	0.1	0.5	0	0.4	0.1	0.5
PL	04/11/2016	14:00	CPI	%	03/2016 *F					0.1	-0.9
PL	04/12/2016	14:00	Core CPI	%	03/2016			0.1	0	0	-0.1
CZ	04/13/2016	10:00	Current account	CZK B	02/2016	35		35		32.36	
CZ	04/13/2016	12:00	CZ bond auction 2016-18, 0.00%	CZK B	04/2016						
CZ	04/13/2016	12:00	CZ bond auction 2015-2023, 0.45%	CZK B	04/2016						
CZ	04/13/2016	12:00	CZ bond auction 2015-2026, 1.00%	CZK B	04/2016						
PL	04/13/2016	14:00	Current account	EUR M	02/2016			402		764	
PL	04/13/2016	14:00	Trade balance	EUR M	02/2016			732		576	
PL	04/14/2016	14:00	Money supply M3	%	03/2016			1.1	9.8	0.6	10
PL	04/15/2016	15:00	Budget balance	PLN M	03/2016					-3099	

Fixed-income in Charts

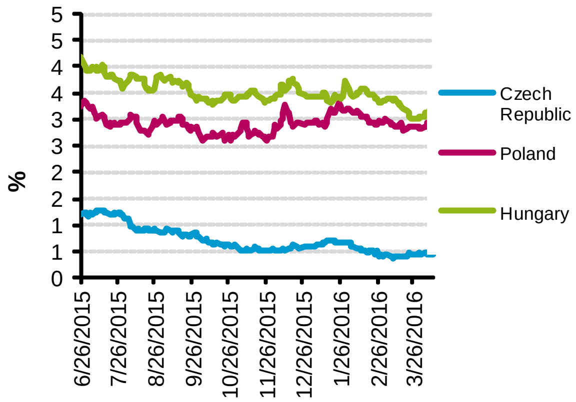
FRA 3x6



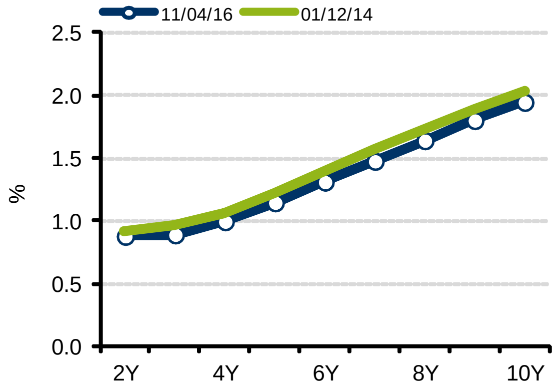
CZ IRS



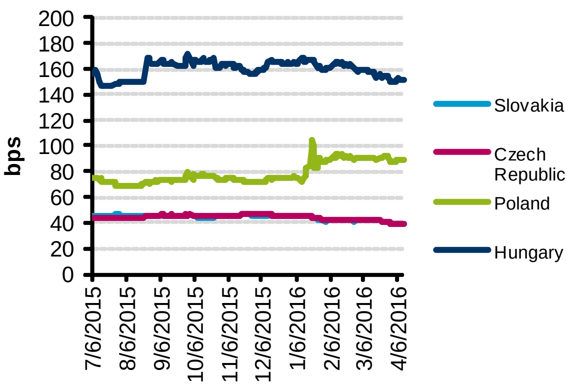
10Y GB Yields



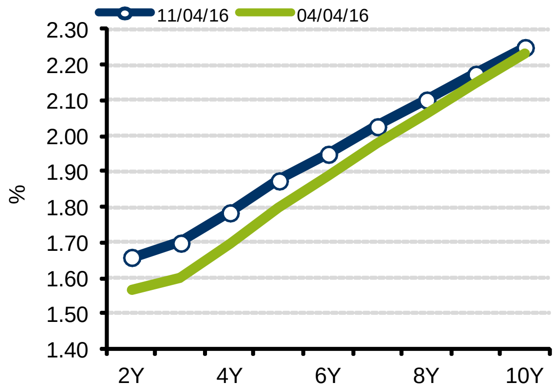
HU IRS



CDS 5Y



PL IRS



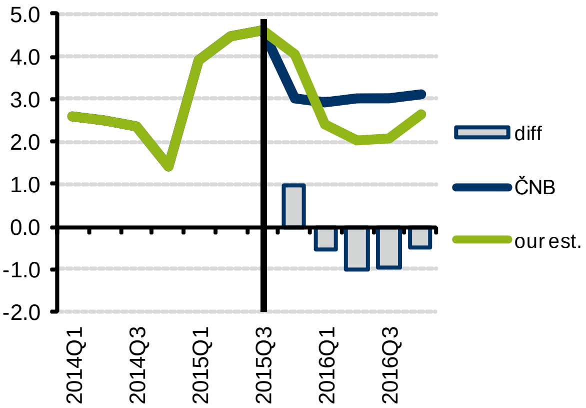
Source: Reuters

Medium-term Views & Issues

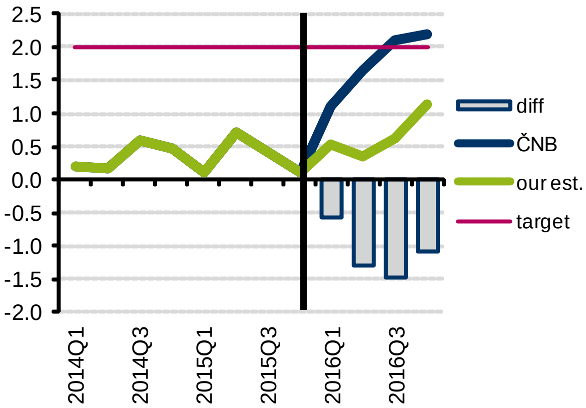
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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, Russia and other emerging markets.
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 Monetary Council continues the rate cut cycle in the following months. We expect three more steps (April, May and June) and so the base rate might be moderated to 0.75%. We think that the O/N interest channel might be change asymmetric during the decision, and the O/N deposit rate might be moderated only to around -0.2% from the current level of -0.05%, while the O/N lending rate might be decreased to around 1% from the recent level of 1.45%.	We expect the NBP to keep official rates stable, but we think that risks for of further rate cuts have increased. The main reason is the combination of the "inflow of cheap euros from the ECB", ongoing deflation and stronger currency (PLN). Hence, should the zloty get strong there could be a window of opportunity for the NBP to ease its policy in the second quarter of this year. Nevertheless this is not our main scenario yet.
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.	We think that zloty's sell-off related to markets' fears coming from appointment of new members of the Monetary Policy Council (MPC) is over now. Nevertheless, while domestic fundamentals should be relatively supportive for the zloty, the currency should be mostly driven by sentiment in emerging markets and the ECB or the Fed policy actions respectively.

CBs' Projections vs. Our Forecasts

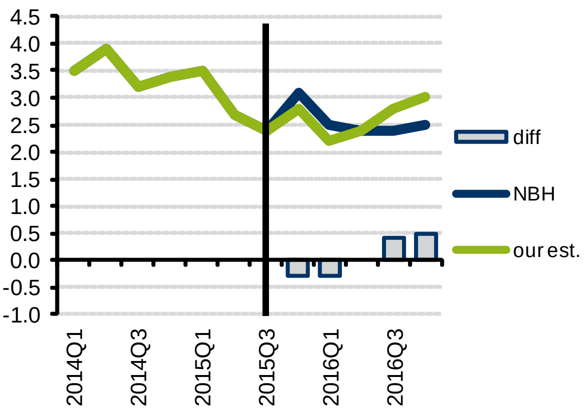
CZ: GDP outlook (Y/Y, %)



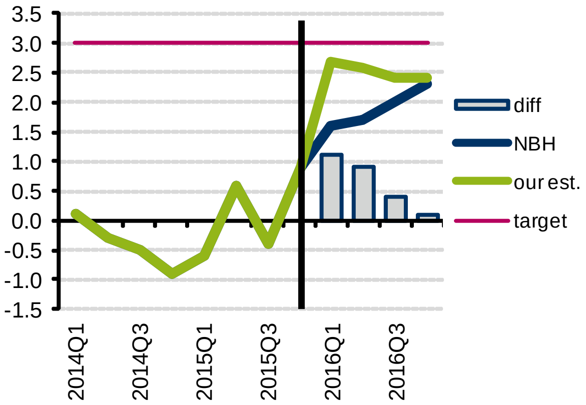
CZ: Inflation outlook (Y/Y, %)



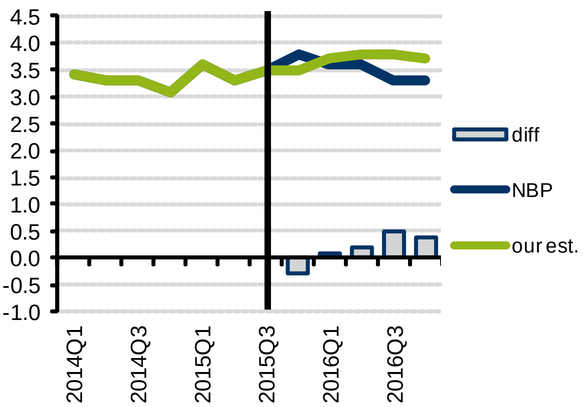
HU: GDP outlook (Y/Y, %)



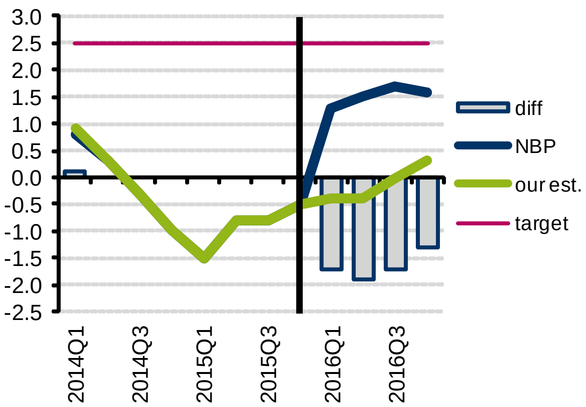
HU: Inflation outlook (Y/Y, %)



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	3/5/2015

*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	*1.20*	1.35	2.40	2.60	2.90	3.10
Poland	WIBOR	*1.67*	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	*0.56*	1.01	0.60	0.70	0.80	0.90
Hungary	HU10Y	*1.95*	2.91	3.80	4.00	4.20	4.40
Poland	PL10Y	*2.25*	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	*312*	316	310	308	305	300
Poland	EUR/PLN	*4.29*	4.27	4.40	4.30	4.26	4.25

GDP (y/y)

	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	4.5	4.6	4.0	2.4	2.0	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	0.6	0.5	0.7	1.4
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.	0.9	0.8
Hungary	6.0	5.1
Poland	-1.2	-1.5

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-0.4	-1.0
Hungary	-2.3	-2.0
Poland	-3.0	-2.9

Source: KBC, Bloomberg

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