Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 27 June 2016

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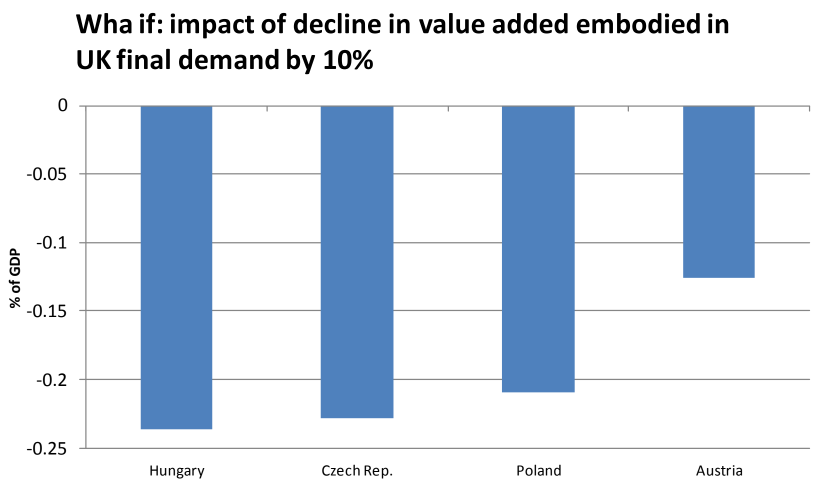
Chart of the Week: A drop in UK exports…



Our stress test was done on OECD data : Domestic value added in foreign final demand, share of UK

Market's editorial

Central European markets and the Brexit storm

The surprise result of the UK referendum sent shock-waves to all markets including Central Europe. Beside equity markets the reaction was quite pronounced in forex markets as the zloty and forint weakened by 2% and 1% respectively. As for the Czech koruna, even though the currency has shown a restrained response to the Brexit it actually weakened just 0.2% against the euro, still the EUR/CZK hit the 9-months high on Friday afternoon.

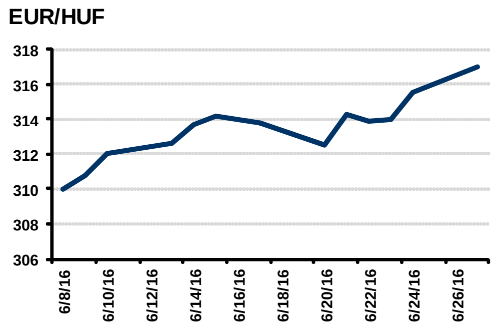
Regarding regional fixed-income markets, market reaction was asymmetric – while Czech government bond yields moved lower (though not as aggressively as did Bund yields), Hungarian and Polish bond yields jumped up by some 25 basis points.

Zloty and Polish bonds in focus as usual

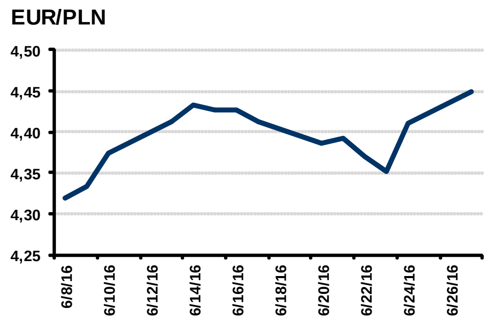
Although volatility in core and regional markets has declined, we are afraid that risk aversion will remain in place as there is also a lot of uncertainty on the tactics that both the UK and the EU follow to manage the post-Brexit cooperation. In this environment all CE currencies (including the Czech koruna) might stay under pressure. In this respect, should the zloty extend its losses (the EUR/PLN is traded above 4.50) the market has to be ready for eventual forex interventions from the Polish authorities. We should also add that especially Polish government bonds will be vulnerable to further capital outflows related to euro-scepticism triggered by the Brexit. Currently, non-residents hold around 40% of Polish government bonds, while in the Hungarian and Czech cases the share of non-resident holdings stand 'just' around 25%. Moreover, although the Hungarian debt is definitely more vulnerable the Debt Management Agency is well ahead of its financing need in this year (something like 1% of GDP reserve), which means that even without any issuance in the following months Hungary would have no problem of financing. The stability of the Hungarian fixed-income market could be supported also by the NBH policy, which had indicated (already ahead the UK vote) that the current level of its based rate would be maintained for an extended period.

	Last	Change 1W
EUR/CZK	27.1	0.10%
EUR/HUF	318	1.28%
EUR/PLN	4.45	1.15%

	Last	Change 1W
10Y CZK	0.56	-8.20
10Y HUF	2.23	-1.55
10Y PLN	2.44	1.88



EUR/HUF, last 14 days. Source: Reuters



EUR/PLN, last 14 days. Source: Reuters

Review of Economic Figures

Czech Republic's foreign debt keeps growing rapidly

The Czech Republic's foreign indebtedness is on the rise. At the end of the first quarter of this year, it reached almost CZK 3,200bn, i.e., 70.4% of GDP. Thus assets held by non-residents in the CR have increased by approximately CZK 220bn over the last 12 months. Just for the sake of completeness, we should add that this is not primarily public sector debt, because foreign debt also includes private sector liabilities to non-residents.

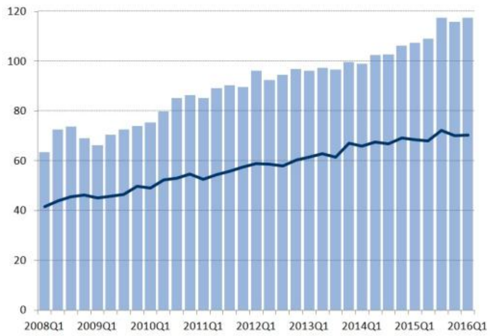
At first glance, the rise in debt seems to be bad news, but this is primarily a result of the central bank carrying out its exchange rate policy, because foreign investors' deposits with domestic banks or their purchases on the Czech bond market also automatically become debt. The rise in foreign indebtedness over the last 12 months is primarily attributable to the two reasons above. The first is the inflow of speculative capital, which once bet on an early departure of the koruna from the intervention policy. The second is foreign investors' increased demand for Czech government bonds – whether because these are more attractive to speculating investors than interbank market deposits at negative interest rates or because their yields are higher than bond yields, say, in Germany.

Foreign investors' activity on the domestic bond market is rising hand in hand with the extension of the period of quasi-fixation of the Czech currency. While Czech government bonds were previously almost unattractive to investors, now investors hold approximately 25% of koruna bonds (25.6% at the end of April). Nevertheless, this is far less than in Poland or Hungary, and therefore the Czech market is unlikely to be so sensitive to any fierce flight of investors. While the liabilities of banks and the state to foreign creditors are rising in this way, the business sector has lowered its debt. Yet the business debt to foreign creditors (including liabilities to their parent companies) makes up the largest part of the CR's indebtedness.

Confidence in the Czech economy again declines

The short improvement in the Czech economic mood has been followed by another moderate deterioration. Even so, the mood in the Czech economy is at a similarly high level as last year. Thus the extreme flash of optimism that emerged late last year only proved to be temporary. After all, even if the moods could not yet reflect the uncertainties arising from the Brexit voted for in the UK, they suggested that the growth rate of the Czech economy was starting to decelerate. Business moods reflect not only the development of employment but also business orders in individual sectors. Hence it is no surprise at all to see the decent performance of industry, riding the wave of booming European demand for cars on the one hand, and construction, plagued by a lack of new projects, on the other. The incredibly upbeat mood among consumers has also receded from its highs, as consumers are increasingly afraid of a possible deterioration of their economic position in the coming year. On the other hand, they are not afraid of unemployment or any possible adverse impact from weaker economic growth on their budgets. We consider the current moderate mood deterioration to be nothing dramatic; we see it as just a reflection of the actually ongoing and, moreover, anticipated deceleration of the CR's economic growth to 2.5%.

CZ: Gross foreign debt



CZ: Business and consumer confidence

In Focus: Brexit – some initial thoughts

Czech Republic: short-term impact low, CNB's exit later?

We believe in negligible short-term impact of Brexit on the Czech economy. A more precise degree, in which changes will happen in behaviour of consumers and businesses in the UK as well as in Germany and other large EU members, can be fairly assessed only after some time.

Nevertheless probability of a later than expected exit of the CNB from the current exchange rate regime increases because of growing probability of extended ECB's QE. As concerns market reactions, we think that hedging activity of Czech exporters will keep the EUR/CZK pair relatively close to the current CNB's intervention floor (27.0)

Hungary: the government to accelerate using of EU funds

Although perceived as rather euro-sceptic the Hungarian government also supported the Bremain vote, which was important from that perspective that Hungary was still committed towards the EU. The Hungarian government knows very well that it should keep warm relations with Brussels as the country receives huge amount of EU funds money. Actually the government accelerated the write of projects using the EU funds, so it still looks like that the majority of the EU budget (for the 2014 and 2020 period) might be used already in the next two years. Additionally households' disposable income is increasing substantially which boosts the domestic consumption and it gives a strong base for the economic growth.

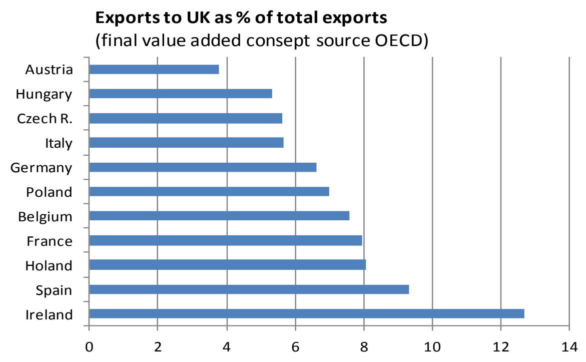
As concern the Hungarian trade activity with UK, it has already moderated since 2010 (less than 4% of export and less than 2% of import is done with UK). Hence, we don't expect any sudden drop from the part either, which means that the country's huge trade balance surplus will last.

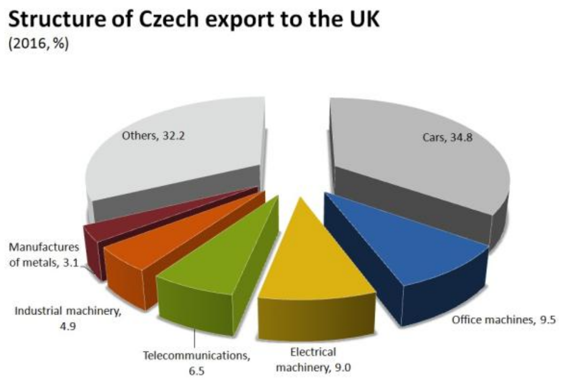
Poland: mind the migrants in the UK and CHF mortgages

The Polish economy less opened economy that the Czech and Hungarian one, so the negative impact from trade disruptions related to the Brexit would be smaller. Nevertheless, concerns related to Brexit's impact on the Polish economy are probably richer than in the cases of the Czech Republic and Hungary. Beside the fact that the UK is significant trading partner and the country is heavy recipient of EU funds, there are the two other issues, which should be taken into account: the Polish migration to the UK and CHF mortgages of Polish households.

Regarding the Polish migration to the UK – it's been significant since the fall of the Iron curtain and the Brexit vote can make lives of Poles working in Great Britain harder – especially, if the EU decide to play a hard ball against the UK. In such a case it is crucial to answer the question whether Poles will actually remain in the UK or (some of them) decide to return to their native country. All in all, it is a mid-term issue, which will not influence balance the economy this or next year.

As concerns the CHF mortgages issue, it becomes more painful as the Swiss franc stands strong after the Brexit. Should the CHF strengthened further the Polish authorities will be motivated to help indebted domestic households by a quick implementation of the CHF mortgage bill (with the burden put on the Polish banking sector).





Weekly preview

THU 13:00	CNB base rate	
	This meeting	Last change
rate level (in %)	**0.05**	11/2012
change in bps	**0**	-20

CZ: CNB not to change its policy despite Brexit

We expect no fundamental move from June's CNB Board meeting. The risk of further 'devaluation' has been averted by rapidly growing wages, and the time for negative interest rates has not yet come. Therefore, we believe that the CNB will express its satisfaction with the development of the Czech economy and its comment will only cite increased risks from developments in the European economy. We cannot rule out that the CNB Board will mention a possible extension of its exchange rate commitment beyond the currently presented mid-2017.

FRI 14:00	PL Inflation (change in %)		
	Jun-16	May-16	Jun-15
CPI y/y	**-0.8**	-0.9	-0.8
Food (ex Alc.) y/y	**0.7**	0.8	-1.7
Transport (including fuel)	**-5.9**	-6.8	-7.3

PL: Deflation at the level of a year ago

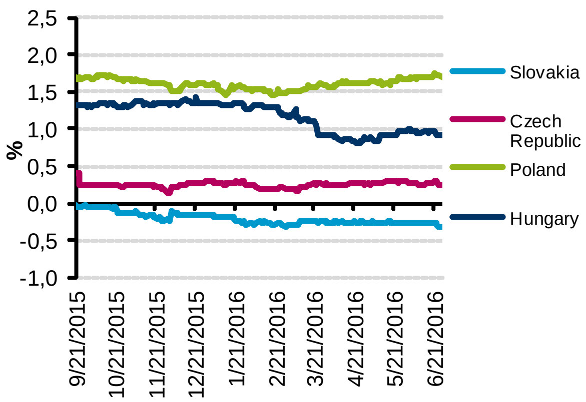
According to our forecasts, prices in Poland fell at the same rate in June 2016 as in June 2015, i.e., by 0.8%. Prices probably rose slightly compared to last month – due in particular to rising oil prices. However, the Polish economy as a whole has been in deflation for nearly two years. Nonetheless, the central bank is not worried very much given in particular the positive labour market developments.

Calendar

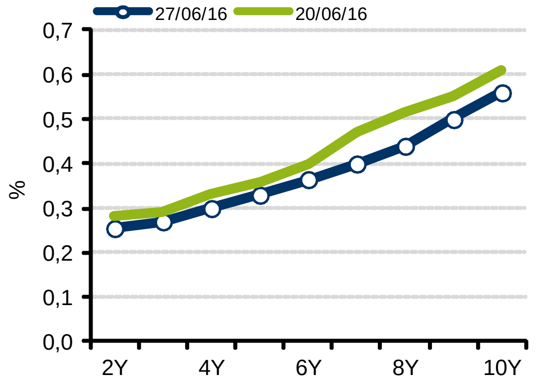
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	06/28/2016	9:00	Unemployment rate	%	05/2016			5.7		5.8	
PL	06/28/2016	15:00	Budget balance	PLN M	05/2016					-11125	
HU	06/30/2016	9:00	PPI	%	05/2016					0.1	-1.4
HU	06/30/2016	9:00	Trade balance	EUR M	04/2016 *F					959	
CZ	06/30/2016	10:00	Money supply M2	%	05/2016						9.1
CZ	06/30/2016	13:00	CNB meeting	%	06/2016	0.05		0.05		0.05	
HU	07/01/2016	9:00	PMI manufacturing		06/2016					52.3	
PL	07/01/2016	9:00	PMI manufacturing		06/2016					52.1	
CZ	07/01/2016	9:00	GDP	%	1Q/2016 *F					0.4	3
CZ	07/01/2016	9:30	PMI manufacturing		06/2016					53.3	
PL	07/01/2016	14:00	CPI	%	06/2016 *P	0.1	-0.8			0.1	-0.9
CZ	07/01/2016	14:00	Budget balance	CZK B	06/2016					22.4	

Fixed-income in Charts

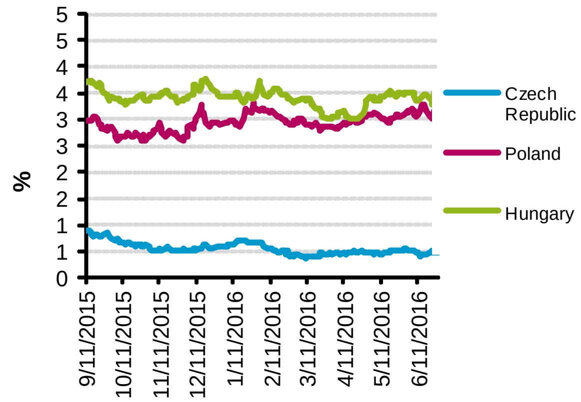
FRA 3x6



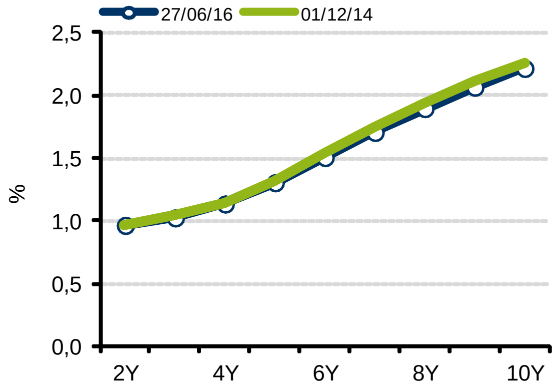
CZ IRS



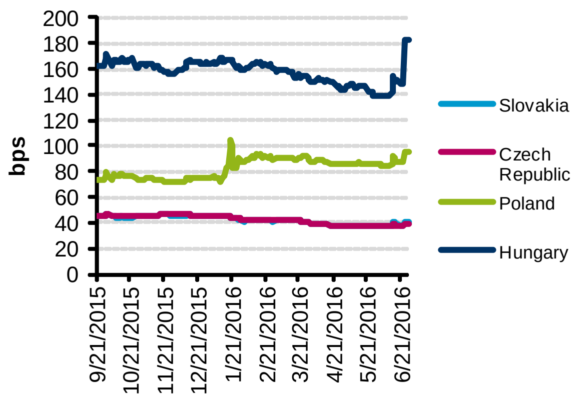
10Y GB Yields



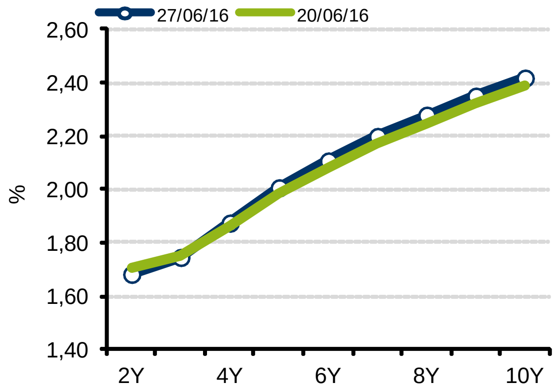
HU IRS



CDS 5Y



PL IRS



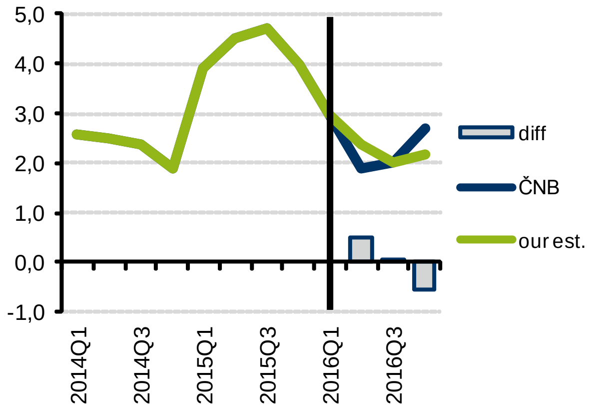
Source: Reuters

Medium-term Views & Issues

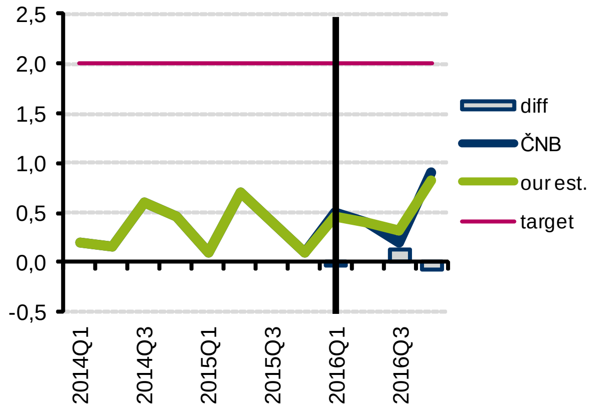
	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech economy entered a stage of moderately decelerating growth, at the mercy of household consumption and exports. Inflation remains subdued despite the anticipated solid GDP rate, and will unlikely approach the CNB's inflation target before 2017, thus enabling the central bank to continue its exchange rate policy. 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.	Growing net real wages and the postponed consumption since the crises (we calculate around 5% of GDP under consumption) boost the retail sales and it may be the main driver of this year's economic growth of around 2% Y/Y.	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.	A relatively strong and continuously robust consumption is expected to push inflation gradually higher. So this figure suggests that NBH won't cut the base interest rate (0.9%) further in June despite of the surprise drop in inflation back to negative territory.	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.	Looking ahead the areas around 312.5 and 311 are strong support levels for the EUR/HU, which might stop the current rally especially in case of strong US data releases afternoon. Also the uncertainties around Brexit vote may not support further strengthening of the forint in the near-term , so we see bigger chance for some correction followed by side moves, but it will highly depend on global risk taking willingness before the Brexit vote.	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

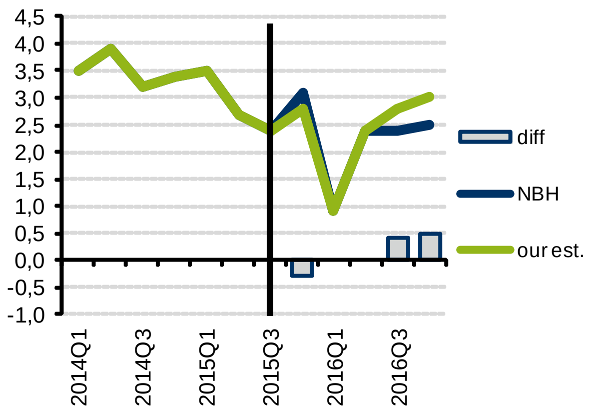
CZ: GDP outlook (Y/Y, %)



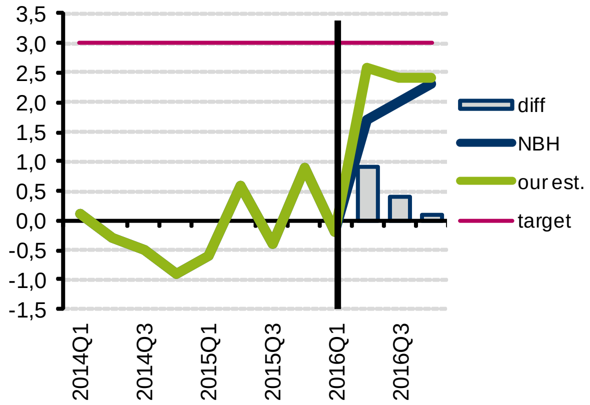
CZ: Inflation outlook (Y/Y, %)



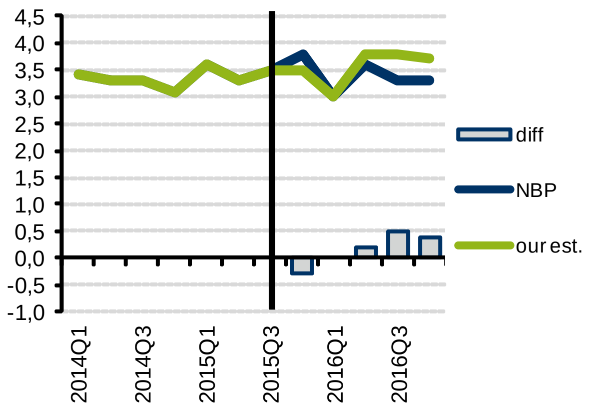
HU: GDP outlook (Y/Y, %)



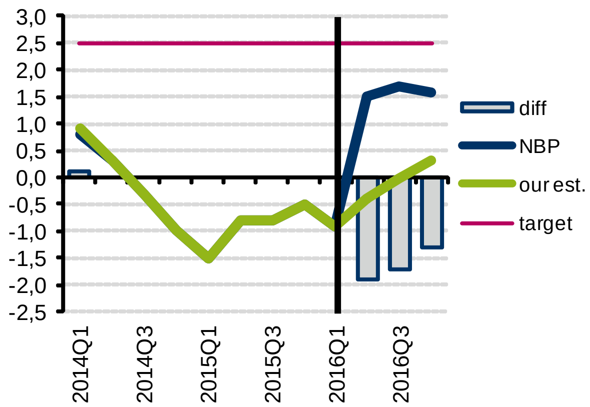
HU: Inflation outlook (Y/Y, %)



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	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3	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*	2.50	2.75	0.90	0.90	0.90	-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	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	PRIBOR	*0.00*	0.28	0.28	0.27	0.28	0.28
Hungary	BUBOR	*1.02*	2.60	2.90	0.90	0.90	0.90
Poland	WIBOR	*1.71*	1.65	1.65	1.70	1.70	1.70

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

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	CZ10Y	*0.56*	0.60	0.69	1.03	1.15	1.28
Hungary	HU10Y	*2.23*	4.00	4.20	2.80	2.80	2.90
Poland	PL10Y	*2.42*	2.50	2.40	2.50	2.70	2.80

Exchange rates (end of the period)

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	EUR/CZK	*27.09*	27.02	27.02	27.00	26.50	26.20
Hungary	EUR/HUF	*318*	308	305	315	310	313
Poland	EUR/PLN	*4.45*	4.39	4.27	4.25	4.24	4.23

GDP (y/y)

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	2.4	2.0	2.2	2.3	2.3	2.2	2.3
Hungary	2.4	2.8	3.0	3.6	3.2	2.8	3.3
Poland	3.8	3.8	3.7	3.8	3.7	3.6	3.5

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

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	0.2	0.4	1.1	1.5	1.5	1.6	1.8
Hungary	2.6	2.4	2.4	2.5	2.1	2.2	2.4
Poland	-0.4	0.0	0.3	0.6	0.9	1.2	1.5

Current Account

	2016	2017
Czech Rep.	1.2	1.1
Hungary	4.1	3.5
Poland	-1.5	-1.3

Public finance balance as % of GDP

	2016	2017
Czech Rep.	-0.8	-1.1
Hungary	2.0	2.5
Poland	-2.9	-3.0

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

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