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Central European Weekly

Monday, 10 April 2017

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Weekly Highlights:

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- Hungary's industrial production remains strong
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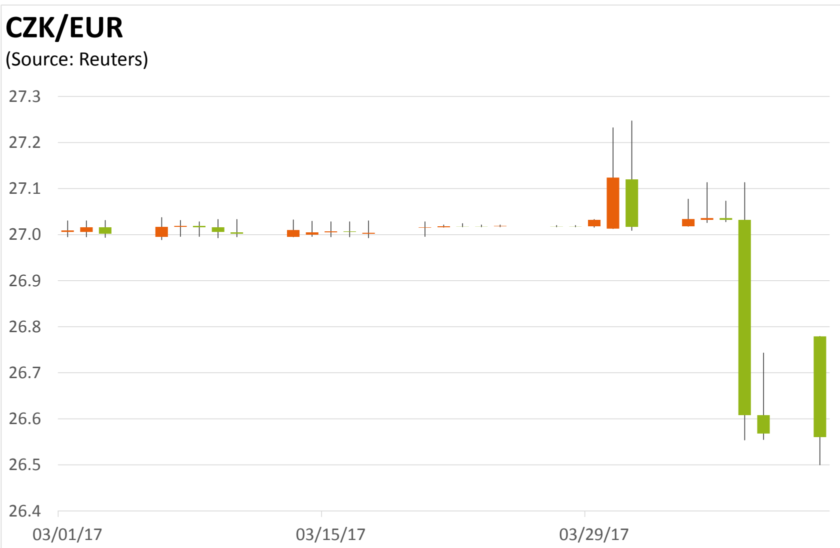
Chart of the Week: CNB's exit & koruna



The Czech central bank exited from its intervention regime last Thursday. The koruna has stabilized around 2% below the previous EUR/CZK floor 27.00.

Market's editorial

The CNB lets the koruna float again

The Czech national Bank finally ended its FX intervention regime at 27.00 EUR/CZK and let the koruna float again. Initially, the koruna was quite volatile, but at the end of day it recorded some small gains (1-2%). Furthermore the spread between spot and forwards narrowed a bit and short term government yields moved higher.

What next? We assume there might be a period of excessive volatility on the Czech forex market in both directions in the upcoming weeks, potentially months. Lot of long CZK positions had been built prior to the end of the interventions (we estimate up to EUR 50bn). If part of the long players close their positions at certain levels, it may be challenging for them to find the counterparts on the market - the yearly current account surplus of the Czech economy is "only" EUR 2bn. Hence in the upcoming weeks/months we can imagine the koruna trading in both directions.

In the mid to long term (after post-intervention volatility calms down), however, we believe the koruna should be stronger. Our fundamental exchange rate model estimate is roughly 10% stronger from the intervention level - around 25.00 EUR/CZK. Nevertheless we do not believe the CNB would let the koruna appreciate to this level in the foreseeable future, as CNB's governor Rusnok reiterated willingness to limit excessive volatility. On the other hand the CNB board is willing to leave the koruna find its new equilibrium value and will probably try to avoid being in the forex market too soon.

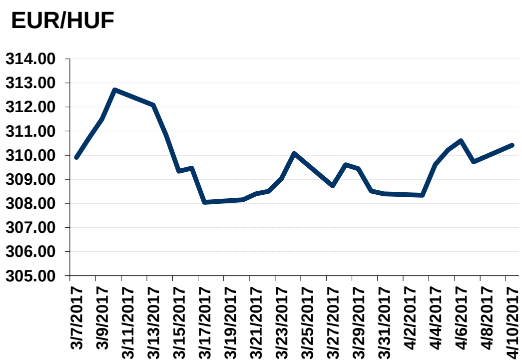
We also believe the short-term government bond yields might go further up, mainly as a result of correction of their excessive fall ahead of the exit. However, the CNB might want to wait till the post-intervention volatility calms down before it starts the hiking cycle. Hence we assume the first interest rate hike to come significantly later than projected by the current CNB forecast (forecast assumes Q3 2017). Furthermore one cannot still rule out even negative interest rates scenario - in case higher bond yields attract additional speculative capital inflow in the future. Nevertheless this scenario currently has a low probability.

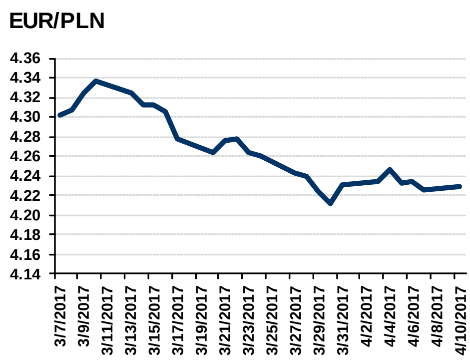
The NBP leaves its policy unchanged

As expected the National Bank of Poland left its policy unchanged at its MPC meeting yesterday. In our view, the NBP statement sounds neutral to slightly dovish as the MPC thinks that 'inflation will stabilise at a moderate level over the following quarters. The stabilisation of price growth in the coming quarters will result from fading effects of the past increase in global commodity prices, with only a gradual rise in domestic inflationary pressure stemming from improving domestic economic conditions. In consequence, the risk of inflation running persistently above the target in the medium term is limited'.

	Last	Change 1W
EUR/CZK	*26.6*	*-1.79%*
EUR/HUF	*311*	*0.66%*
EUR/PLN	*4.23*	*-0.13%*

	Last	Change 1W
10Y CZK	*1.23*	*16.04*
10Y HUF	*2.61*	*0.00*
10Y PLN	*2.88*	*1.78*





Review of Economic Figures

The Hungarian industry grew in February

The Hungarian industrial production jumped in February as it increased by 3.4% M/M. The soft figures (like sentiment index) suggested the acceleration of industrial production, which is drive by manufacture industry. We expect that Industry might remain strong, which is boosted also by some new production of car tires.

The dynamic of foreign trade is substantially higher than a year ago, which reflects the accelerating economy. But the trade balance started to deteriorate slowly, which is in line with our expectation. The reason is the increasing domestic consumption, which boost the import. Also the higher usage of EU funds money may bring higher import in the coming quarters. It means only that the extraordinary high trade surplus may narrow.

Hungarian retail sales slowed down considerably

The Hungarian retail sales rose only by 1.2% YoY, which is definitely a negative surprise, but we think that is too early to draw conclusion that the domestic consumption may collapse. The reason is the last year's figure were distorted by the whitening effect, so the base is very high, and also the correlation between domestic consumption and retail sales are not too strong. So we expect that the high net real wage dynamic (around 7% YoY) may boost consumption.

So all in all the above mentioned figures rather strengthens our view that 1Q17 GDP growth figure might be above 3% YoY.

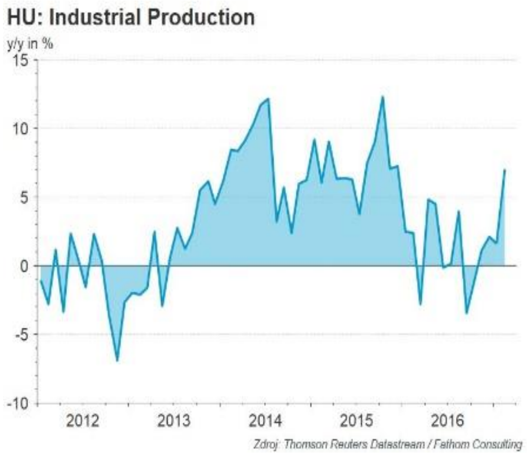
Czech Industry slightly slower, but it is not revolutionary

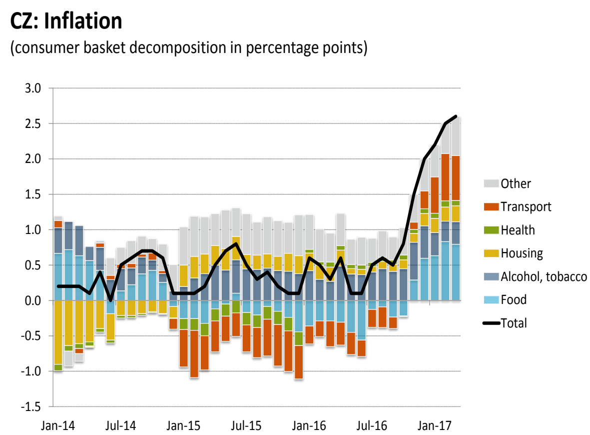
In February **Czech industry** stepped on the brakes slightly. Adjusted for the number of working days year on year it grew by 2.7% compared to 10.3% in January. Nothing untoward is happening to the backbone of the Czech economy and our prospects for 2017 remain "reasonably" optimistic (GDP growth of 2.3%), because the monthly fluctuations in the pace of industrial production in the Czech Republic are high and in the background we can constantly see a healthy growth trend - the three-month average annual growth in industry is above 5%. Moreover, despite a slight slowdown the dynamic of new orders also remains solid (+ 7%) and the strongest workhorse of Czech industry - the car industry - continued to lead the way (+ 7.5% yoy). In addition, at the beginning of 2017 business sentiment in industry according to the PMI climbed to its highest level for two years. We therefore believe that industry will continue to grow slightly faster than the economy as a whole. This is mainly due to faster domestic demand, which is building on faster wage and investment growth. This is underscored by slowly accelerating new domestic orders.

Czech inflation flat in March

The Czech consumer prices stagnated in March. In year-on-year terms (+2.6 %), all items in the consumer basket except for household equipment got more costly.

What development of inflation can we expect next? In our opinion, inflation is set to stay above the CNB´s inflation target by the end of the year, in line with central bankers´ expectations and hence not inciting them to any change in the current policy setting. While the CNB inflation forecast will still envisage a soon interest rate hike, there will be no real scope for monetary policy tightening due to possible negative consequences of a widening interest rate differential on the koruna exchange rate. In this respect we do not believe comments coming from CNB's Governor Jiri Rusnok, who said hiking cycle may start by late 2017 or early 2018.





Weekly preview

TUE 9:00 **HU Inflation (change in %)**

	Mar-17	Feb-17	Mar-16
CPI y/y	**3.0**	2.9	-0.2

HU: Hungarian inflation driven by oil in March

The Hungarian headline inflation might remain around 3% Y/Y in March. The main driver of inflation is still base effect (oil price), but the markets services price increase started to accelerate. As the gross wages are rising by 10% YoY the domestic demand may remain strong in this year. Although the headline inflation may decrease in April (mainly due to the change of excise duty of fuel), we still think that inflation pressure is increasing. We see this year's average CPI at 2.6% Y/Y, which might accelerate above 3% YoY in 2018.

THU 10:00 **CZ Cur. Account (CZK bn)**

	Feb-17	Jan-17	Feb-16
C/A monthly	**20.0**	29.4	42.4
cummulative (YTD)	**49.4**	29.4	76.2
Trade bal. monthly	**24.0**	26.5	26.8
cummulative (YTD)	**50.5**	26.5	55.4

CZ: Current account back in black

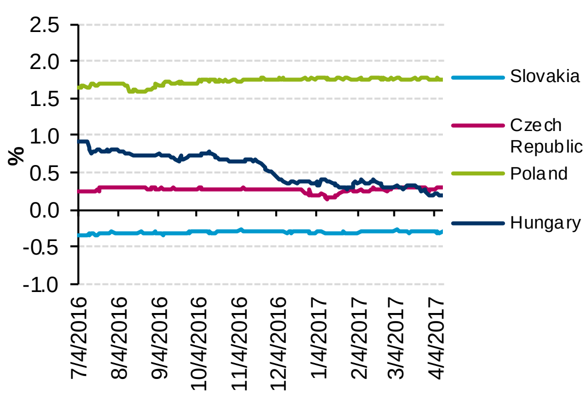
The balance of payments current account probably ended February with a high surplus, which is mainly due to the positive development of foreign trade in goods and services and the low outflow of dividends. Profits are repatriated in the later months, so the development of the current account so far looks very favourable. We expect the current account to maintain a surplus corresponding to about 1.2% of GDP for the whole year. However, there remains the risk of higher dividend outflows after the expected strengthening of the Czech crown.

Calendar

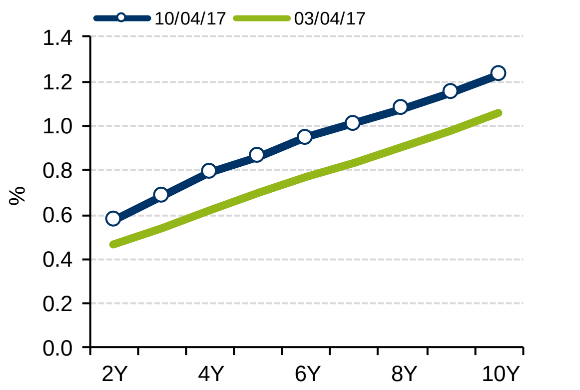
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	04/10/2017	9:00	CPI	%	03/2017	0	2.6	0	2.6	0.4	2.5
CZ	04/10/2017	9:00	Unemployment rate 15-64	%	03/2017	4.8		4.9		5.1	
HU	04/11/2017	9:00	CPI	%	03/2017		3	0.3	3.1	0.4	2.9
PL	04/11/2017	14:00	CPI	%	03/2017 *F					-0.1	2
CZ	04/12/2017	12:00	CZ bond auction 2017-20, 0.00%	CZK B	04/2017			5			
CZ	04/12/2017	12:00	CZ bond auction 2015-2023, 0.45%	CZK B	04/2017			4			
CZ	04/12/2017	12:00	CZ bond auction 2017-27, 0.25%	CZK B	04/2017			4			
PL	04/12/2017	14:00	Core CPI	%	03/2017			0.2	0.5	0.1	0.3
CZ	04/13/2017	10:00	Current account	CZK B	02/2017	20		32.85		29.4	
PL	04/13/2017	14:00	Current account	EUR M	02/2017			-100		2457	
PL	04/13/2017	14:00	Trade balance	EUR M	02/2017			-29		22.5	
PL	04/14/2017	14:00	Money supply M3	%	03/2017			0.9	8.7	0.3	8.2

Fixed-income in Charts

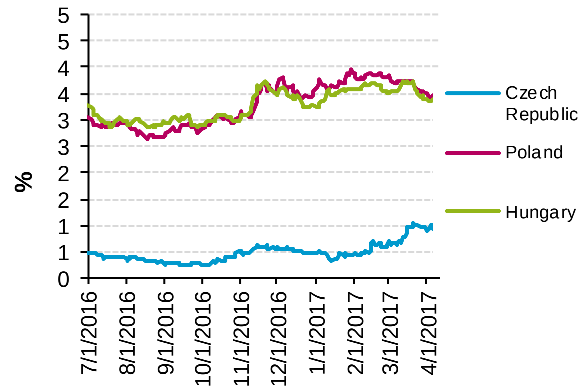
FRA 3x6



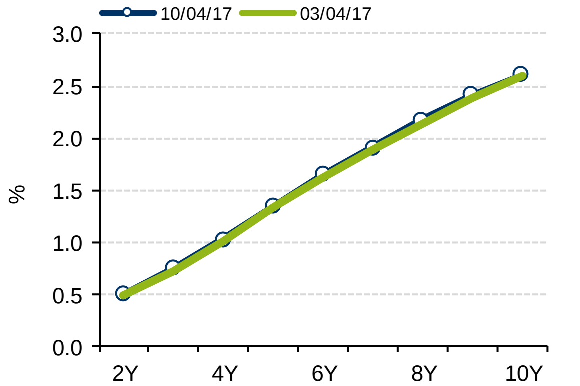
CZ IRS



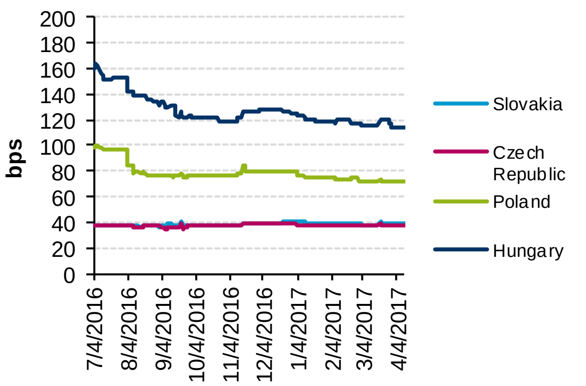
10Y GB Yields



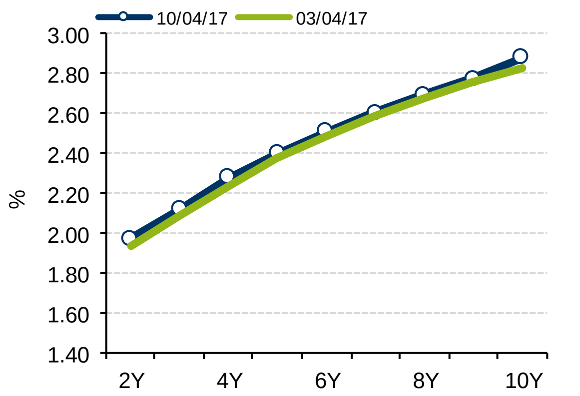
HU IRS



CDS 5Y



PL IRS



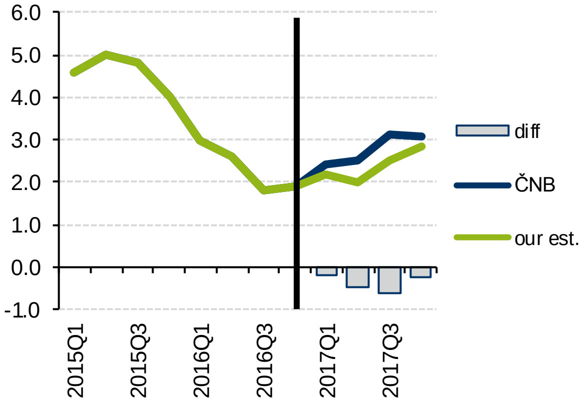
Source: Reuters

Medium-term Views & Issues

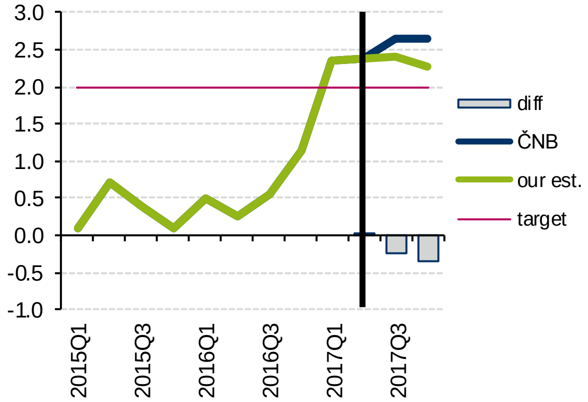
	The Czech Republic	Hungary	Poland
Growth & key issues	GDP growth remains primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see boom of consumption supported by the accelerating wages and positive consumers' expectations. At the moment, we cannot expect any fundamental economic changes or reforms because of the Autumn Parliamentary elections. Progress in the country's preparations for joining the euro area is not expected in this (as well next) electoral term either.	The Hungarian economy slowed down substantially in 2016, due to the lower use of EU funds money and lack of investment. The main driver of the growth was domestic consumption, which might still boost the economy in 2017. The household consumption is supported by massive wage increase and some government measures like moderation of VAT, social contribution fee, while investment may be supported by the new EU funds inflows and corporate income tax cut in 2017. We expect above 3.5% Y/Y growth for 2017 up from around 2% Y/Y growth in 2016.	The Polish economy slightly decelerated because the absorption of EU Structural Funds is not optimal, and investment is slowing down as a result. Thus, the economy should be driven by private consumption – thanks to persisting fiscal stimuli (increased child benefits) as well as decently growing wages.
Outlook for official & market rates	As the CNB abandoned the exchange rate intervention regime the monetary conditions in the Czech Republic tightened. So there is no reason to hike CNB's interest rates soon as the central bank can be afraid of fast appreciation of the koruna due to the interest rate differential widening. We therefore assume the first interest rate hike to come in the 2nd half of 2018.	The National Bank of Hungary kept base rate unchanged at 0.9%, but it continued to use the unconventional tools. The cap of 3-month deposit at HUF900bn was introduced as the end of 2016, while the ON lending rate was moderated to 0.9%. Although we don't expect any cut of base rate for the coming months, the NBH may moderate further the maximum amount can be placed in 3-month deposit in 1Q17, which means that the effective benchmark interest rate may be moderated further, which is already around 0.5%. The NBH actions may keep the short-end of the curve at the current low level, while we see some risk on the upside on the long-end of the curve at the beginning of 2017, so we expect some modest steepening.	The official interest rates of the National Bank of Poland should remain unchanged throughout the year, even though inflation will rise this year. Nevertheless, inflation is very unlikely to reach even the NBP's inflation target (2.5%). However, market interest rates with longer maturities may be very volatile during the year, especially if interest rates on key markets continue to rise.
Forex Outlook	We believe the Czech koruna should post gains in the mid to long-term after the end of the interventions seeing it in 1Y horizon about 5% stronger (slightly below 26.00 EUR/CZK). Nevertheless in the short-run, which can last up till several months, we believe the koruna might be volatile in both directions as we might see speculative part of the market closing its long positions at certain levels.	Although fundamentally we see some pressure on real appreciation of the currency, the NBH may try to keep the exchange rate in the range of 307 and 315 in the coming months. The inflation is expected to accelerate to around 2% Y/Y, which is higher than in the Eurozone, which also means some real appreciation of the currency if it remain nominally unchanged around the current level.	While dollar market rates, driven by expectations of a rate hike by the Fed, may keep the zloty on the defensive, the ECB's eased policy may counterbalance such pressure. Moreover, Poland's continuing upturn and the NBP's very conservative monetary policy are fundamentally positive for the zloty from the medium-term perspective. Of the Polish macroeconomic fundamentals that should not allow the zloty to weaken significantly, we should mention the very well developing balance of payments and growing FX reserves.

CBs' Projections vs. Our Forecasts

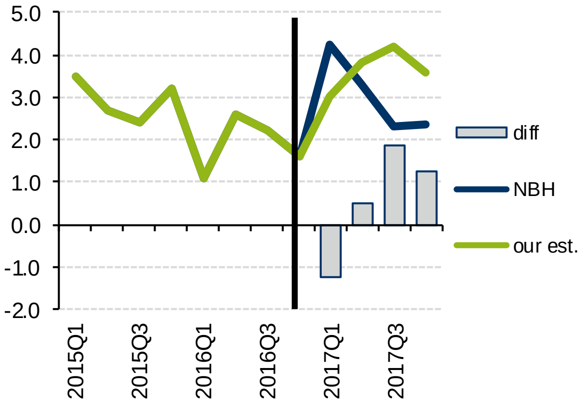
CZ: GDP outlook (Y/Y, %)



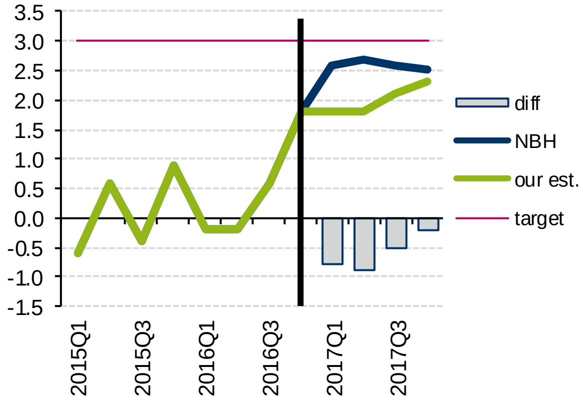
CZ: Inflation outlook (Y/Y, %)



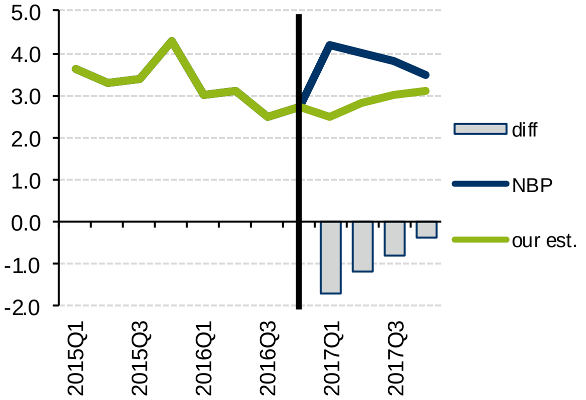
HU: GDP outlook (Y/Y, %)



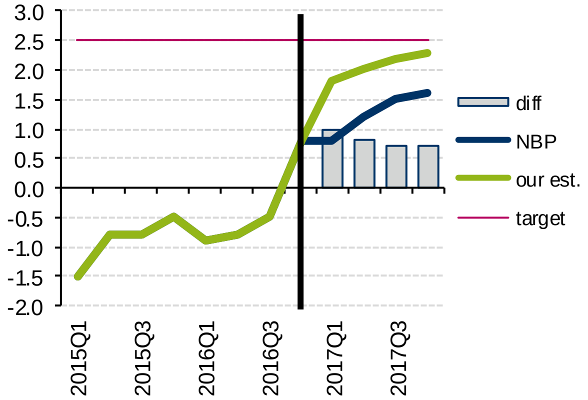
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Source: CNB, NBP, NBH, KBC

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	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.	*0.90*	0.90	0.90	0.90	0.90	0.90	-10 bps	5/24/2016
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	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	PRIBOR	*0.29*	0.25	0.28	0.28	0.28	0.28
Hungary	BUBOR	*0.17*	0.37	0.30	0.40	0.50	0.70
Poland	WIBOR	*1.73*	1.73	1.75	1.75	1.80	2.70

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

		Current	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	CZ10Y	*1.23*	0.88	1.30	1.33	1.37	1.40
Hungary	HU10Y	*2.61*	2.39	2.50	2.60	2.80	3.00
Poland	PL10Y	*2.88*	3.00	3.10	3.20	3.30	3.50

Exchange rates (end of the period)

		Current	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	EUR/CZK	*26.59*	27.02	27.02	26.90	26.60	26.20
Hungary	EUR/HUF	*311*	309	315	310	303	308
Poland	EUR/PLN	*4.23*	4.40	4.39	4.28	4.27	4.25

GDP (y/y)

	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2
Czech Rep.	1.9	2.2	2.0	2.5	2.8	#N/A	#N/A
Hungary	1.6	3.0	3.8	4.2	3.6	#N/A	#N/A
Poland	2.7	2.5	2.8	3.0	3.1	#N/A	#N/A

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

	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2
Czech Rep.	2.0	2.5	2.5	2.5	2.1	#N/A	#N/A
Hungary	1.8	1.8	1.8	2.1	2.3	#N/A	#N/A
Poland	0.8	1.8	2.0	2.2	2.3	#N/A	#N/A

Current Account

	2016	2017
Czech Rep.	1.6	1.8
Hungary	5.5	5.0
Poland	-1.5	-1.3

Public finance balance as % of GDP

	2016	2017
Czech Rep.	0.3	-0.7
Hungary	-1.5	-2.5
Poland	-2.9	-3.0

Source: KBC, Bloomberg

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