



# Central European Weekly

Monday, 16 January 2017

## Table of contents

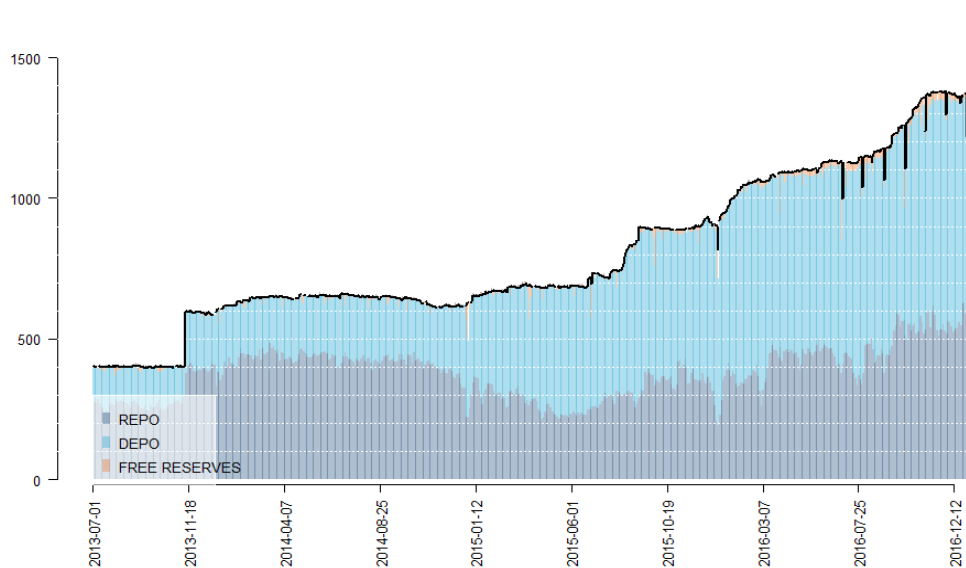
Weekly Highlights:	1
Chart of the Week: Deposits at the CNB	1
Market's editorial	2
Review of Economic Figures	3
Calendar	5
Fixed-income in Charts	6
Medium-term Views & Issues	7
CBS' Projections vs. Our Forecasts	8
Summary of Our Forecasts	9
Contacts	10

## Weekly Highlights:

- Hot money inflows intensified as higher Czech inflation brings CNB's exit closer
- Hungary's inflation also surprises on the upside, which implies no need for further easing in Hungary
- The Czech unemployment rate at eight-month lows

## Chart of the Week: Deposits at the CNB

CNB OMO: REPO & DEPO & FREE RESERVES (CZK bn)



Source: CNB, CSOB

Hot money inflows intensified as higher Czech inflation brings CNB's exit closer. The Czech central bank has to intervene heavily to defend the EUR/CZK 27.0 floor, while liquidity in the Czech banking system (sitting in the CNB accounts) has spiked in 2017.

# Market's editorial

## Hedging of Czech exporters still low

While bets that the **Czech central bank** would scrap its interventions against the CZK have been increasing and EUR/CZK forwards have been falling the fresh statistics about hedging among the Czech exporters was still at record lows at the end of 2016. Although 1-year hedging (of Czech exporters) has slightly increased to 27.6% according to the CNB's survey, after seasonal adjustment it recorded another decline to fresh record lows. Hence some of the exporters might not be "well prepared" for the end of the interventions during this year. This increases the chances of subsequent gains of the koruna. On the other hand, we have also seen that mainly foreign players built-up the speculative long positions in the CZK. Although we do not have hard data to prove it, we believe that such an inflow has accelerated at the beginning of 2017. The dramatic increase of free liquidity (in CNB's repo and depo) points to the total volume of CNB's intervention at around 6 billion euros in just 5 days at the beginning of 2017.

We believe it mostly reflects growing appetite of foreign players for the koruna. Should such a fast builds up in the CZK long positions go on, it would increase the chances of negative correction of the koruna after the interventions end. Due to higher inflation outlook, we believe the CNB is going to end interventions in Q2 2017. In our base scenario we assume high volatility afterwards (potentially in both directions) and subsequent gains of the CZK in the mid-term (6 months horizon).

## Czech MinFin sold 1Y bonds with yield minus 1.7%

Despite planning to sell 'only' CZK 8bn, the **Ministry of Finance** eventually sold CZK 12bn (about EUR 0.44 bn) of zero-coupon bonds maturing in January 2018 at a record-low average yield of -1.72 % yesterday. Demand stood at

CZK 32.3bn (about EUR 1.2 bn). / Auction results reflect rising bets on (or rising fears of) appreciation of the koruna after the exit from interventions regime which may take place already in the second quarter of 2017. Liquidity data from the **Czech National Bank** show that volume of liquidity withdrawn from the banking system has already increased by about CZK 250bn (approx. EUR 9.2bn – see the chart on the front page) in January. Although the actual volume of interventions will be released with a two-month lag (i.e. in March), the data indicate quite a strong intervention activity of the central bank in early January (in fact, it may be even stronger than at the beginning of interventions in November 2013). It is therefore likely the Ministry will take advantage of extraordinary conditions prevailing in the market and will sell more short-term bonds in the short-term (which will be in line with its debt financing strategy).

## The NBP looks quite happy with its policy

On Wednesday, **Polish central bank** (NBP) kept interest rates unchanged. NBP President Glapinski told the press conference that he saw no need to raise interest rates in 2017. / Not only interest rates but also the overall message remains the same. NBP is happy with current monetary policy settings and despite acceleration of inflation in December it sees no need to adjust interest rates. This is in line with our expectations; we also predict stable official interest rates in Poland in 2017 with the possibility of rate hike in 2018. Maybe more interesting outcome of the meeting was that Glapinski reassured markets he was in favour of a market-friendly solution to problem of FX (Swiss franc) mortgages. This has again confirmed the independence of Monetary Policy Council named by the new government.

	Last	Change 1W
EUR/CZK	27.0	-0.01%
EUR/HUF	307	-0.32%
EUR/PLN	4.38	0.03%

	Last	Change 1W
10Y CZK	0.88	-11.11
10Y HUF	2.68	-2.55
10Y PLN	2.94	-4.96

# Review of Economic Figures

## Inflation finally moves higher in Hungary

The Hungarian consumer price index jumped from 1.1% Y/Y in November to 1.8% Y/Y in December in line with expectation. The main reason is the base effect and the slightly increasing energy and oil prices. But also the domestic consumption started slowly to boost the inflation, mainly the durable goods and market services prices. It was reflected also in the increase of core inflation from 1.5% Y/Y in November to 1.7% Y/Y in December.

There is interesting price movement as the price of the egg went up more than 5% M/M in December although there was a VAT cut from 27% to 5% in January. So it is a huge question mark that what percentage point of the VAT cut will be pass through into the consumer price from January. It suggests that the demand is strong so the VAT cut may hold back the inflation less than originally expected. So we expect 2.4% Y/Y CPI for 2017, but we see more risks on the upside than on the downside at the moment.

To sum up, December's inflation means that the NBH may change the stance of their statements as in order to achieve the inflation target of 3% Y/Y, while there is still no need for further monetary loosening.

### HU: Inflation



## Inflation ride continues in the Czech Republic

December's consumer price index rose by 0.3% m/m and 2% y/y. Thus, inflation in the Czech Republic hit the Czech National Bank's target approximately half a year earlier than planned, and surpassed the central bank's latest forecast by 0.7%. **If the CNB lives up to its statements, the duration of its intervention policy is going to be much shorter and the exit from the current (intervention) regime will probably come already in the second quarter of this year.**

And what are the main contributors 'responsible' for the current inflation wave? Above all, we can see a fairly rapid rise in food prices, mainly due to the petering out of the

earlier effects of Russia's sanctions imposed on imports from the EU. Another factor is the year-on-year increase in alcohol and cigarette prices, changing because of excise duties.

The electronic records of sales also certainly played their part – not directly, but they were probably used as an opportunity to 'adjust' catering and accommodation prices upwards. Nevertheless, it is not yet possible to distinguish how much this has been a result of the electronic records of sales and how much an effect of improved demand. Moreover, rising costs of housing started to drive inflation up significantly last year. This applied not only to rent, reflecting the improving demand for housing, but also to other housing-related services. Moreover, the period of very cheap energy is over, and thus another increase is nigh. Fuel has stopped curbing inflation, because fuel prices are currently rising as a result of oil extraction restrictions agreed by OPEC.

Inflation is at the target, and is very likely to remain close to it for the majority of this year – unless oil prices dramatically fall, which seems to be improbable. In addition, inflation has been newly supported by improving consumer demand. Wage growth, along with low unemployment and a strong consumer appetite, is creating latitude for retailers to raise their prices. Moreover, our expectations for price reductions in January are not very high – these are likely to be lower than last year, and thus inflation may be well poised to continue to rise.

And how will the central bank respond? Above all, it should be satisfied with the inflation developments. The target has been met earlier than planned, and thus there is no reason to continue to extend its exchange rate commitment, which has been in place for much longer than originally intended. Furthermore, as inflation will not tend to fall and its target will be easy to maintain, the unleashing of the koruna should be just a question of proper timing after the end of the first quarter of the year.

## Czech unemployment rate at eight-years lows

The Czech unemployment (according to the method used by the Ministry of Labour and Social Affairs) reached 5.2% at the end of last year. This was one percentage point lower than in 2015, as well as the lowest unemployment rate for the past eight years. By contrast, we can already state (although data are not yet available) that record-breaking employment went hand in hand with the low unemployment.

Unemployment rose compared to November, but the rise was moderate, attributable to nothing but seasonal effects. Fixed-term employment contracts usually expire at the end of the year, but some seasonal work – for example, in services, construction, etc. – will be relaunched in the spring.

And what to expect on the labour market this year? Seasonal developments will drive unemployment up in January after those whose job contracts expired in December have registered with job centres. However, unemployment will start to fall again in February. After all, economic growth should continue to be strong enough this year to secure a positive trend on the labour market, which will make itself felt not only in a declining number of unemployed, but also in more rapid wage growth.

**Czech consumers not lacking appetite at all**

**Czech retail sales** continued to rise strongly in November last year – by 7.9% y/y, or 6.7% if adjusted for the greater number of business days in the month.

The strong consumer confidence in future economic developments is a reflection of low concern about the future and poses smaller obstacles to spending. Naturally, the primary reasons for increased consumption continue to be low unemployment (i.e. record-breaking employment) and growing real wages in most sectors.

It comes as no surprise that the greatest sales increase was experienced by e-commerce, which is still massively expanding. This time, its sales grew nearly by a third on a year-on-year basis, making it evident that more and more

consumers switched from brick-and-mortar shops to the Internet when buying Christmas presents. In this regard, improved demand for IT products, clothing and household equipment is consistent with the trend. After all, the real estate boom has also resulted in the need to equip the new dwellings.

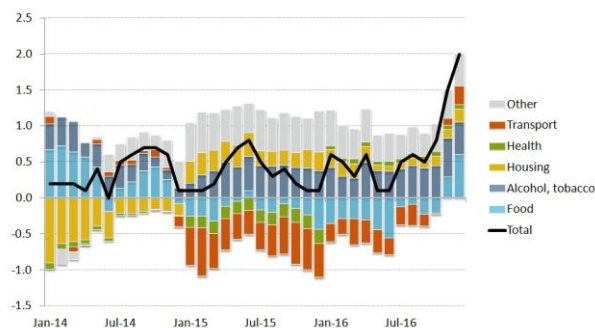
Improving consumer demand also started to influence prices, and thus retail prices began to rise again for the first time in a longer while, according to data from the Statistical Office. This primarily covered food and leisure products. Moreover, record-breaking consumer demand is curbing competition among retailers, which was a strong anti-inflationary factor over the past two years.

Nevertheless, increased retail prices cannot be explained only by record-breaking demand, but also by a more expensive dollar – the currency used to pay for consumer goods imported from Asia.

The penultimate set of retail sales figures for 2016 has again confirmed that the demand side of the Czech economy is being primarily fuelled by household consumption. We do not expect any change to this at the very end of the year. After all, even this year, when wage growth will continue to accelerate (as will inflation, however), consumption will be one of the main drivers of the Czech economy. Nonetheless, the rise in real retail sales will no longer be as strong as last year (3.8%, as opposed to approximately 6% in 2016) because of the partial saturation of demand, as well as the significantly greater price rises.

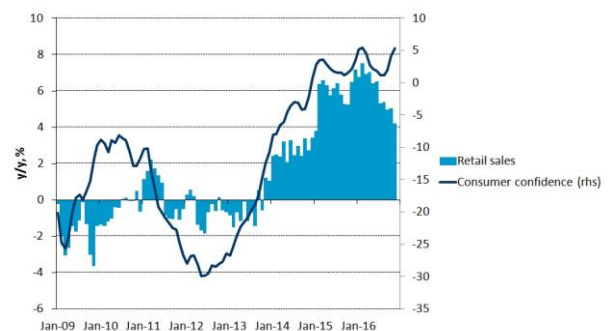
**CZ: Inflation**

(consumer basket decomposition in percentage points)



**CZ: Retail sales & Confidence**

(3m average)

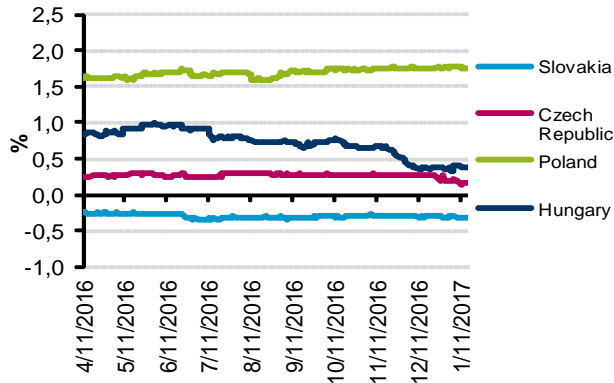


# Calendar

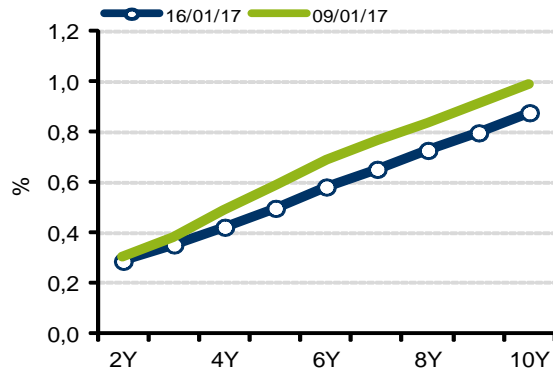
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	01/16/2017	9:00	PPI	%	12/2016			0.4	-0.5	0.1	-1.3
PL	01/16/2017	14:00	Core CPI	%	12/2016			0.1	0	0	-0.1
PL	01/18/2017	14:00	Wages	%	12/2016			8.1	4	1.7	4
PL	01/19/2017	14:00	Industrial output	%	12/2016			-5.5	1.6	1.9	3.3
PL	01/19/2017	14:00	PPI	%	12/2016			0.7	2.6	1.1	1.7
PL	01/19/2017	14:00	Retail sales	%	12/2016			21.7	6.2	-3.3	6.6
HU	01/20/2017	9:00	Wages	%, ytd.	11/2016				6.2		5.4
CZ	01/20/2017	17:00	Review rating - S&P	AA-	1. revize						

# Fixed-income in Charts

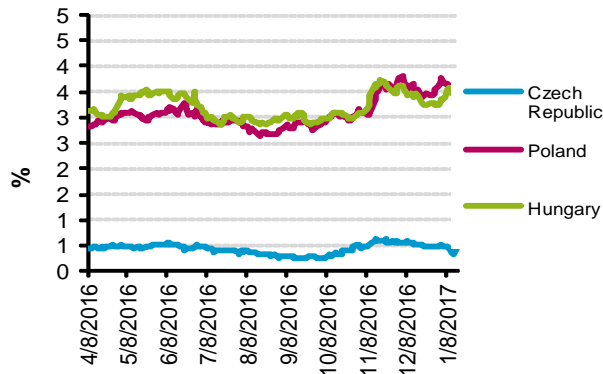
**FRA 3x6**



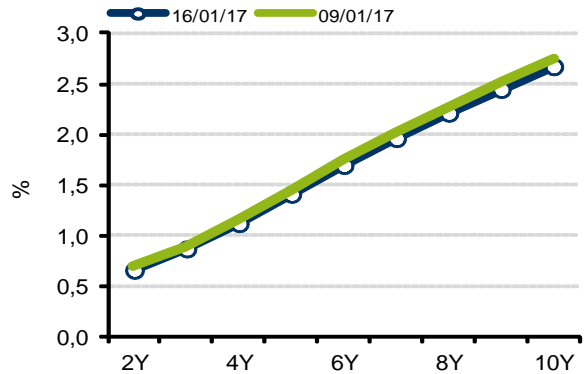
**CZ IRS**



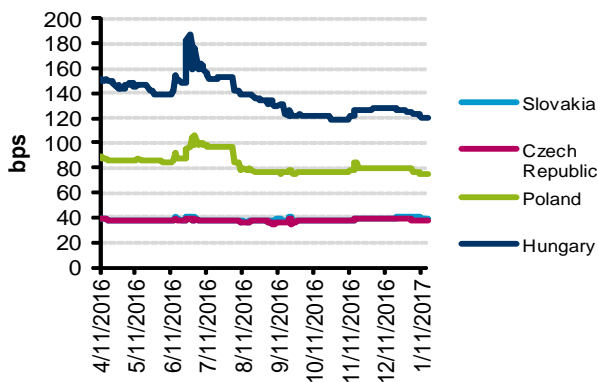
**10Y GB Yields**



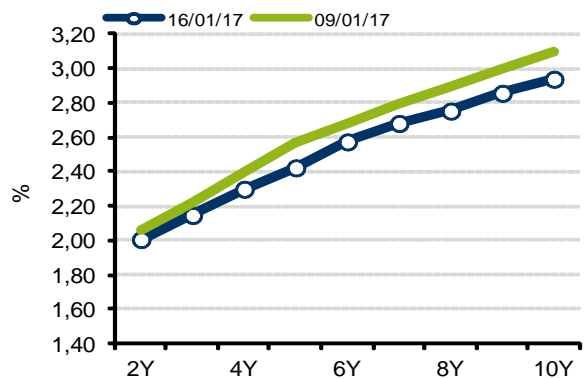
**HU IRS**



**CDS 5Y**



**PL IRS**



Source: Reuters

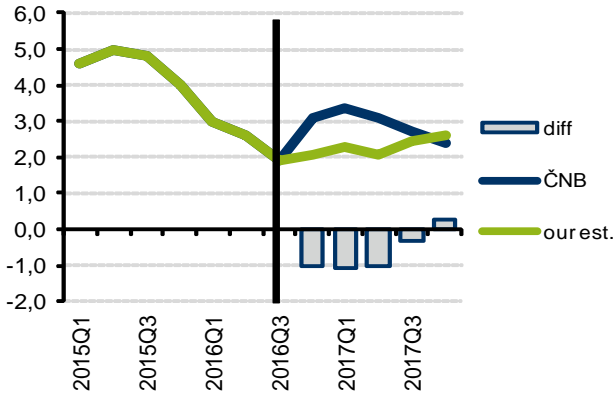


# Medium-term Views & Issues

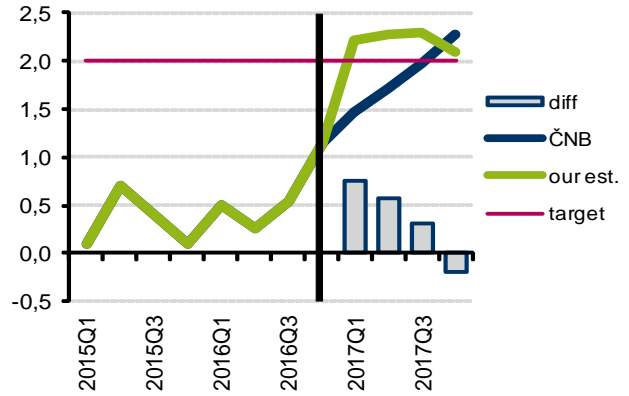
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>GDP growth remains primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see boom of consumption supported by the accelerating wages and positive consumers' expectations. 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.</p>	<p>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.</p>	<p>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.</p>
Outlook for official & market rates	<p>The CNB continues to stick to its hard commitment to intervene against the koruna till the end of Q1 2017. As the inflation reached the target about half a year earlier than the most recent CNB's forecast, we believe the end of the interventions could come already in Q2 2017. We assume the first interest rate hike to come not earlier than 6 month after the end of interventions – probably not sooner than in 2018. On the other hand CNB could theoretically adopt negative interest rates as a tactical tool to smooth the need of the interventions (although it is not preferred scenario).</p>	<p>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.</p>	<p>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.</p>
Forex Outlook	<p>As the inflation reached the target about half a year earlier than the most recent CNB's forecast, we believe the end of the interventions could come already in Q2 2017. We believe in subsequent gains of the koruna, which the CNB is probably going to limit around 26.00 EUR/CZK level. On the other hand, very strong speculative capital inflow prior the exit (similar to that one that was seen at the beginning of the January) could lead to overly optimistic bets on the koruna strengthening – these could finally end up in temporary losses of the koruna after the exchange rate regime is abolished.</p>	<p>The EURHUF moved suddenly from 304 to 315 partly parallel with polish zloty move, but it was effected also by the extra HUF liquidity pumped into the market by the NBH. 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.</p>	<p>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.</p>

# CBs' Projections vs. Our Forecasts

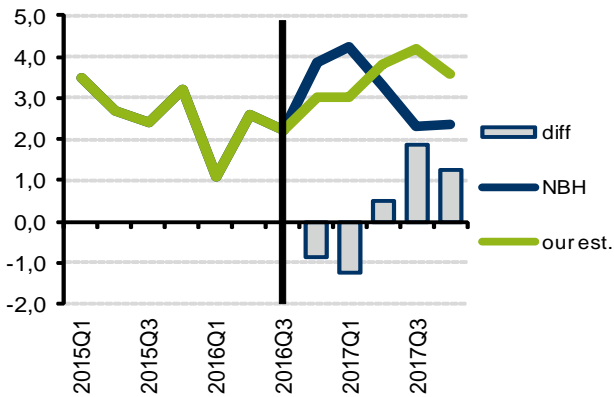
**CZ: GDP outlook (Y/Y, %)**



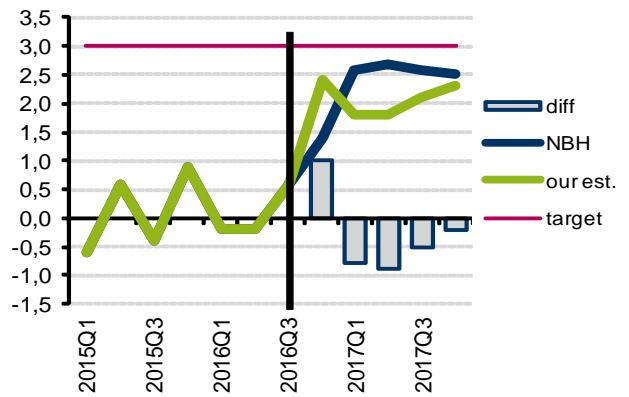
**CZ: Inflation outlook (Y/Y, %)**



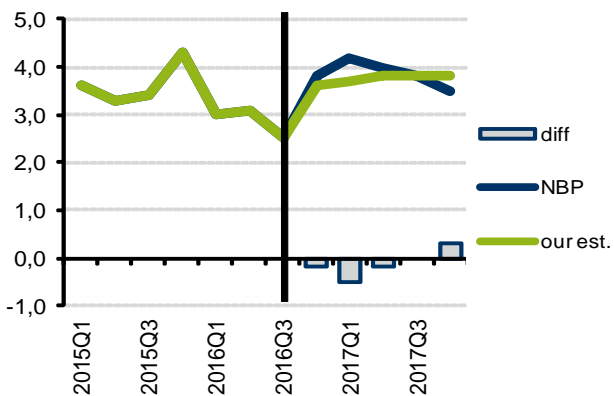
**HU: GDP outlook (Y/Y, %)**



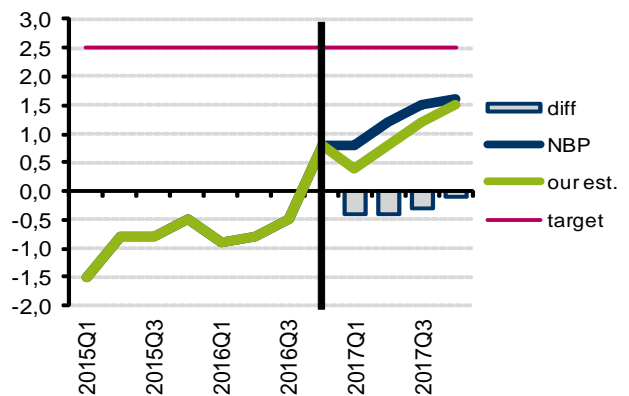
**HU: Inflation outlook (Y/Y, %)**



**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	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.	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	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	PRIBOR	0.28	0.25	0.25	0.28	0.28	0.28
Hungary	BUBOR	0.30	1.01	0.88	0.30	0.40	0.50
Poland	WIBOR	1.73	1.71	1.71	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	0.88	0.50	0.53	0.98	1.06	1.13
Hungary	HU10Y	2.68	2.18	2.00	2.50	2.60	2.80
Poland	PL10Y	2.94	2.22	2.33	2.50	2.70	2.80

**Exchange rates (end of the period)**

		Current	2016Q2	2016Q3	2017Q1	2017Q2	2017Q3
Czech Rep.	EUR/CZK	27.03	27.06	27.02	27.02	26.90	26.60
Hungary	EUR/HUF	307	315	309	315	310	303
Poland	EUR/PLN	4.38	4.37	4.30	4.39	4.28	4.27

**GDP (y/y)**

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	2.6	1.9	2.1	2.3	2.0	2.4	2.6
Hungary	2.6	2.2	3.0	3.0	3.8	4.2	3.6
Poland	3.1	2.5	3.6	3.7	3.8	3.8	3.8

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

	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Czech Rep.	0.1	0.5	2.0	2.4	2.4	2.3	2.0
Hungary	-0.2	0.6	2.4	1.8	1.8	2.1	2.3
Poland	-0.8	-0.5	0.8	0.4	0.8	1.2	1.5

**Current Account**

	2016	2017
Czech Rep.	2.0	1.9
Hungary	5.5	5.0
Poland	-1.5	-1.3

**Public finance balance as % of GDP**

	2016	2017
Czech Rep.	-0.4	-0.7
Hungary	-1.5	-2.5
Poland	-2.9	-3.0

Source: KBC, Bloomberg

## Contacts

<b>Brussels Research (KBC)</b>		<b>Global Sales Force</b>	
Piet Lammens	+32 2 417 59 41	<b>Brussels</b>	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Mathias van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
		France	+32 2 417 32 65
<b>Dublin Research</b>		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
<b>Prague Research (CSOB)</b>		<b>Prague</b>	
Jan Cermak	+420 2 6135 3578		+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
<b>Bratislava Research (CSOB)</b>		<b>Bratislava</b>	
Marek Gabris	+421 2 5966 8809		+421 2 5966 8820
<b>Budapest Research</b>		<b>Budapest</b>	
David Nemeth	+36 1 328 9989		+36 1 328 99 85

ALL OUR REPORTS ARE AVAILABLE ON [WWW.KBCCORPORATES.COM/RESEARCH](http://WWW.KBCCORPORATES.COM/RESEARCH)

This non-exhaustive information is based on short-term forecasts for expected developments on the financial markets. KBC Bank cannot guarantee that these forecasts will materialize and cannot be held liable in any way for direct or consequential loss arising from any use of this document or its content. The document is not intended as personalized investment advice and does not constitute a recommendation to buy, sell or hold investments described herein. Although information has been obtained from and is based upon sources KBC believes to be reliable, KBC does not guarantee the accuracy of this information, which may be incomplete or condensed. All opinions and estimates constitute a KBC judgment as of the data of the report and are subject to change without notice.

