



# Central European Weekly

Monday, 27 March 2017

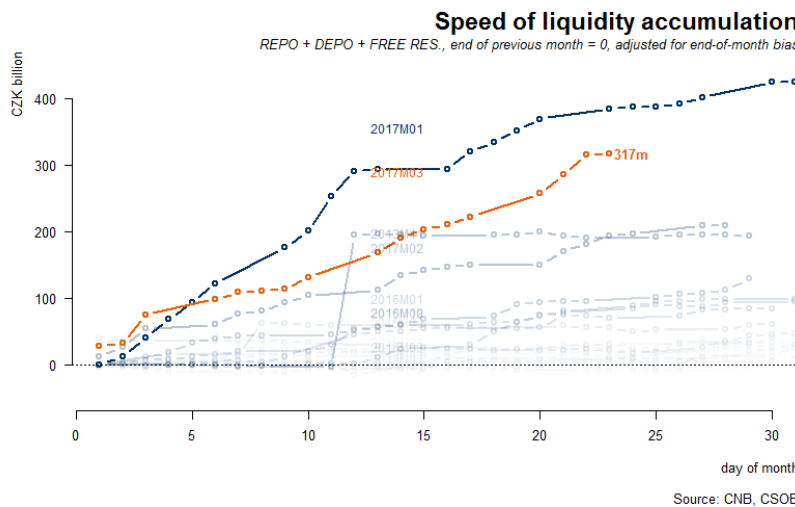
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## Weekly Highlights:

- Czech FinMin sold bonds with negative yield again
- Zloty close to an eight-month high
- In Focus: The koruna is not the Swiss franc
- Preview: CNB's exit on the horizon, the NBH on hold

## Chart of the Week: Liquidity at the CNB



CZK liquidity at CNB's accounts have been growing very quickly again, which implies that the Czech central bank must intervene heavily.

# Market's editorial

## Czech president Zeman successfully intervened

Czech President Miloš Zeman successfully intervened in the EUR/CZK forward market as he said that he met with CNB's Governor Jiří Rusnok and that it is not out of the question that the exit from the intervention regime will come sooner than we expect. As a result EUR/CZK forwards dropped visibly below the intervention level 27.0. We do not think, however, that Zeman's words changes the outlook for the CNB exit in either way. In our view the CNB will stick to its commitment that it will not discontinue the use of the exchange rate as a monetary policy instrument before 2017 Q2. Bear in mind, however, that the commitment ends next Friday (March 31st), while there will be a regular CNB Bank Board meeting next Thursday (March 30th).

## Czech FinMin sold bonds with negative yield again

Czech FinMin sold about CZK 4.1bn of 0.00%/2020 government bond in an auction and CZK 4 billion of 1.00%/2026 in an auction yesterday. / Demand for Czech government bonds remains solid despite the fact that it has somehow weakened in comparison with the beginning of the year. Still, MinFin managed to sell the former bond with a slightly negative yield. At the same time, demand for longer maturity bond has increased in comparison with its previous auction.

Relatively less favourable conditions (from the Ministry's point of view) reflect better absorption of liquidity in the

Czech banking system which is also reflected in relatively stable EUR/CZK forward rates (especially those with shorter-term maturities).

This holds despite the fact that data from the Czech National Bank (CNB) indicate that volume of interventions has probably already exceeded EUR 11bn in March. CNB however keeps its view and says that size of its balance sheet has no implications at all for timing of the exit from the intervention regime.

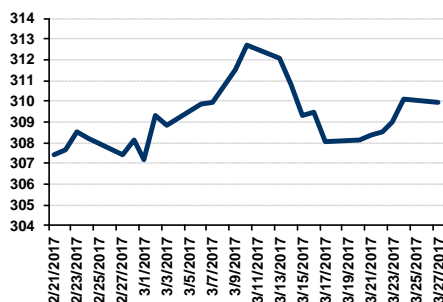
## Zloty close to an eight-month highs

The Polish zloty extends its gains and was trading close to an eight-month high against the euro. Apart from a stable ratings, good prospects of the Polish economy, rising inflation and dovish Fed hike, NBP's Minutes from the latest meeting of the Monetary Policy Council (MPC) could have supported the zloty. Although the majority of MPC still keeps its view that interest rates should remain unchanged in the following quarters, the Minutes also said that it might be justified to consider an increase in the NBP interest rates if inflation continues to surprise to the upside (in comparison with March projection). All in all, the wording remained very similar to the previous one but this time it also showed some concerns of possible impact of (low) real interest rates on asset prices in Poland.

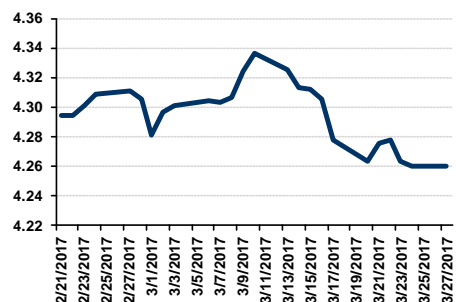
	Last	Change 1W
EUR/CZK	27.0	-0.02%
EUR/HUF	310	0.51%
EUR/PLN	4.26	-0.03%

	Last	Change 1W
10Y CZK	1.26	-3.08
10Y HUF	2.65	-8.64
10Y PLN	2.86	-6.54

EUR/HUF



EUR/PLN



# In Focus: The koruna is not the Swiss franc

We have released a flash report (<http://bit.ly/2omQAzN>), which points to increasing speculations on the CZK strengthening after CNB's exit from intervention regime.

## Speculation on CZK increases

According to the latest available figures about the free liquidity in the Czech banking sector, we believe that March new long koruna's positions (and the accumulation of CNB foreign exchange reserves) were only slightly below the record set in January. In March, the foreign exchange reserves have increased by a currently estimated additional 10.5 billion euros bringing its total since the beginning of the intervention at approximately 80 billion euros.

After making a cross-check with the Czech balance-of-payments flows (recorded from the beginning of the CNB's interventions regime) we have found about two thirds (approx. 40 billion euros) consisted of portfolio and other investments (bonds, deposits, derivative positions), which are very probably simply "bets" on a stronger koruna. These bets may reflect either speculative positions (more likely) or additional above-normal hedging of exporters (less probable according to the surveys). These "bets" on stronger koruna grew probably further over February and March - for the moment by an estimated 50-60 billion. This is several times more than the annual surpluses of the Czech external balance - the annual current account surplus in the Czech

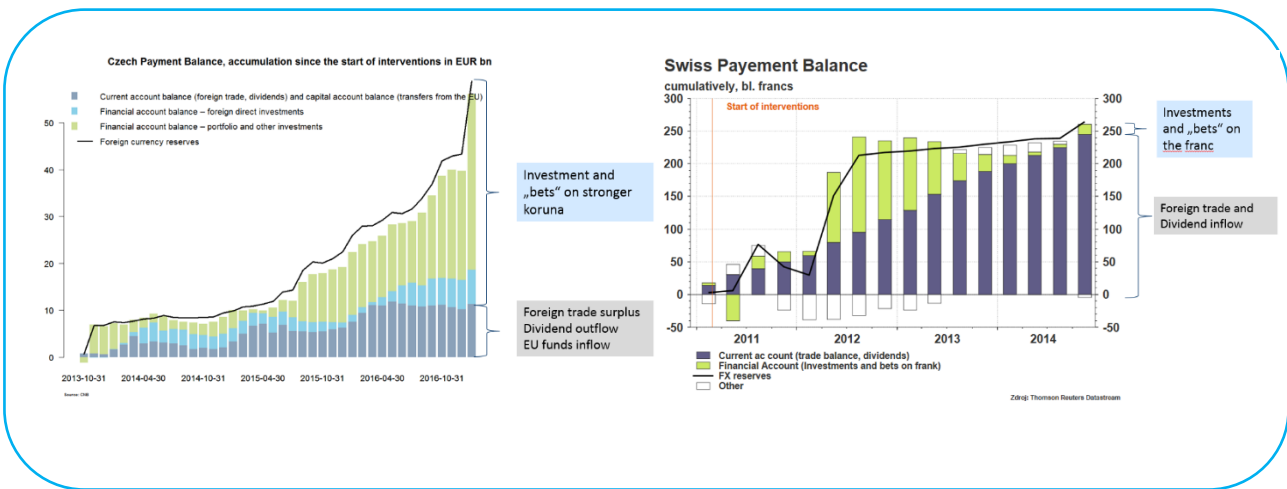
Republic is "only" about 2 billion euros with a trade surplus of about 13 billion euros.

## The current CZK is different from the CHF in 2015

The Czech koruna is often compared to the Swiss franc. But Switzerland's international position was vastly different before interventions were stopped. As the following chart shows, the growth of foreign exchange reserves in Switzerland before stopping interventions (3/2011-1/2015) was based almost exclusively on domestic fundamentals (a foreign trade surplus and the inflow of dividends). Bets on a stronger franc were basically absent as the end of the interventions was not communicated in advance and was a great surprise for vast majority of market players.

## Excessive CZK longs puts koruna's bullish play into question

From this perspective, the Czech koruna looks already overbought - if some players want to quickly liquidate their long CZK positions after the end of intervention, they may have to rely on the willingness of the CNB to sell part of its massive FX reserves. Therefore, we do not rule out that when interventions stop, it may be under pressure for a while and will only return to its naturally stronger levels after several months.



# Weekly preview

**TUE 14:00**
**NBH base rate**

	This meeting	Last change
rate level (in %)	<b>0.90</b>	5/2016
change in bps	<b>0</b>	-15

## HU: NBH to keep its slightly dovish stance

Last time, the NBH was quite dovish again. The NBH statement still emphasized that the output gap is still negative and there are unused capacities. The Council doesn't concern about the increasing inflation, they see consumer price index moving to the inflation target of 3% only for 2018. So we expect that the MPC may moderate further the cap on the 3-month depo instrument from HUF750bn to 600bn till end of June. The new inflationary report will be published also, so it will be interesting how much the CPI outlook would be modified on the figures of jumping inflation and wages at the beginning of the year. We expect that NBH may still continue still with its slightly dovish stance.

**THU 13:00**
**CNB base rate**

	This meeting	Last change
rate level (in %)	<b>0.05</b>	11/2012
change in bps	<b>0</b>	-20

## CZ: CNB's exit on the horizon

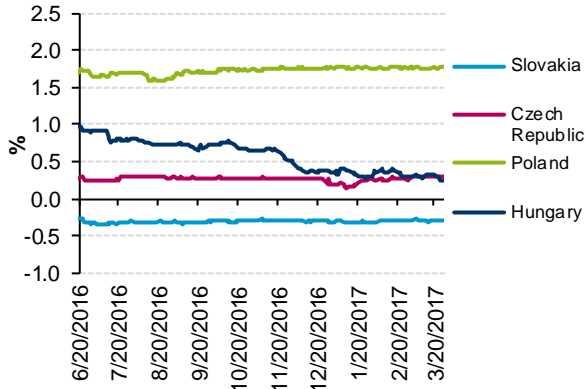
The March meeting of the CNB Bank Board will be the last with the current exchange rate commitment, under which the CNB promises to maintain the exchange rate regime (to hold the EUR/CZK above 27.00). At the same time it will be a meeting between the two forecasts, so the council will also have to deal with the fact that its existing views are not being met. Inflation is significantly higher than anticipated and the updated forecast probably confirms that the commitment to the monetary policy horizon has been met. Add to this the pressure on the crown (in March the CNB has already probably purchased an additional 12 billion). And this is certainly not a reason to delay the end of the exchange rate regime. We expect that the CNB will exit from the current (FX) policy regime at the beginning of April and will make sure that it does not differ extremely from the current exchange rate limits. However, the end of the exchange rate regime does not mean the end of foreign exchange interventions.

# Calendar

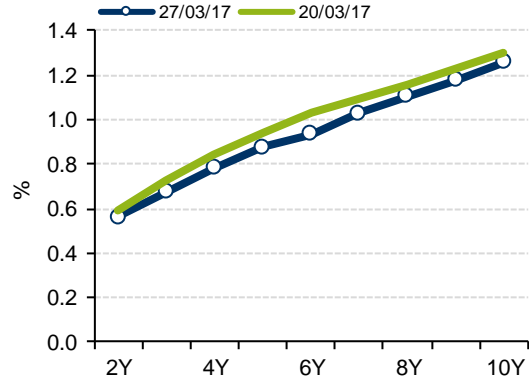
Country	Date	Time	Indicator	Unit	Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	03/28/2017	14:00	NBH meeting	%	03/2017	0.9		0.9		0.9	
HU	03/29/2017	9:00	Unemployment rate	%	02/2017					4.3	
CZ	03/30/2017	13:00	CNB meeting	%	03/2017	0.05		0.05		0.05	
HU	03/31/2017	9:00	PPI	%	02/2017					0.8	2.2
CZ	03/31/2017	9:00	GDP	%	4Q/2016 *F			0.2	1.7	0.4	1.9
CZ	03/31/2017	10:00	Money supply M2	%	02/2017						8.4
PL	03/31/2017	14:00	CPI	%	03/2017 *P				2.3	0.3	2.2

# Fixed-income in Charts

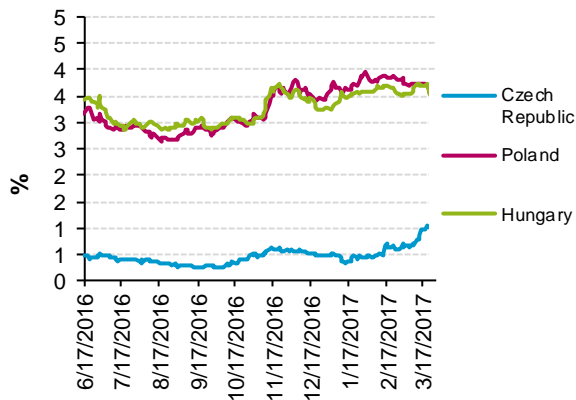
**FRA 3x6**



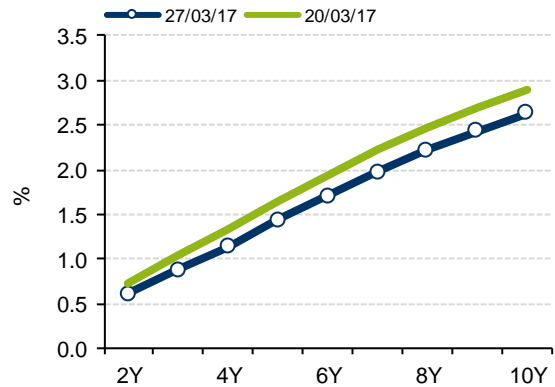
**CZ IRS**



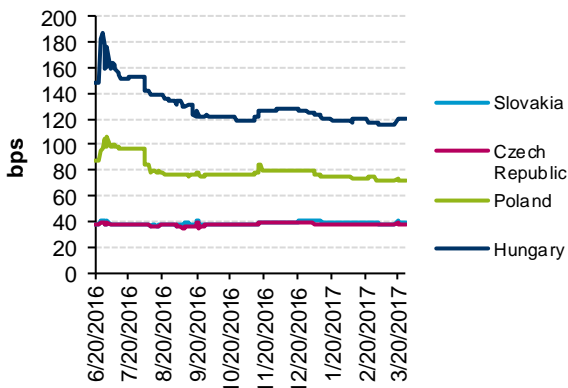
**10Y GB Yields**



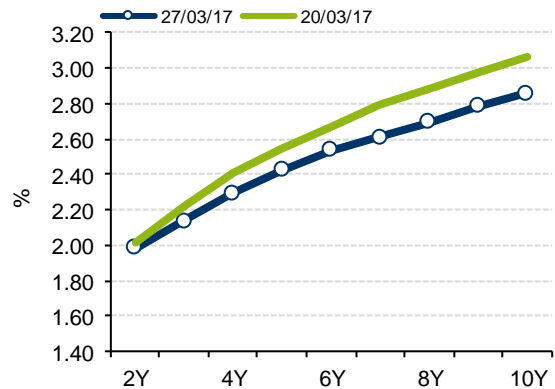
**HU IRS**



**CDS 5Y**



**PL IRS**



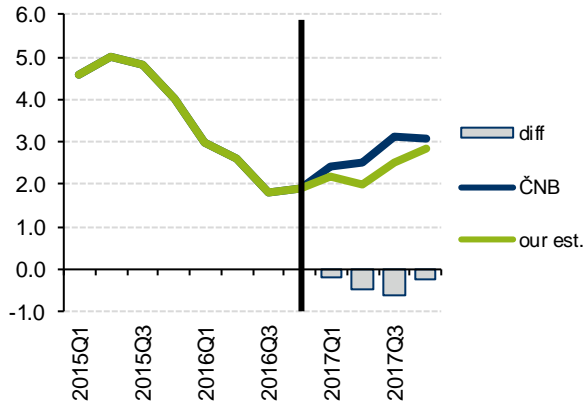
Source: Reuters

# Medium-term Views & Issues

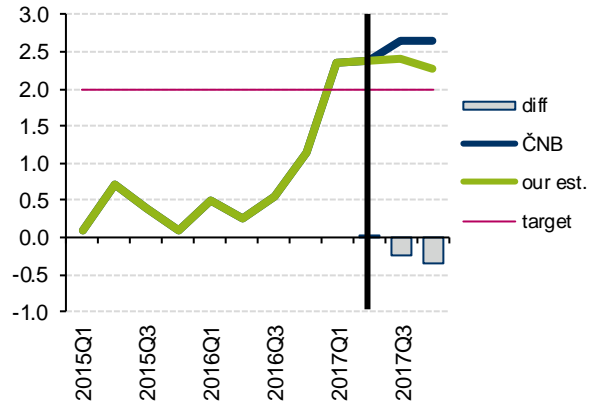
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>GDP growth remains primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see boom of consumption supported by the accelerating wages and positive consumers' expectations. 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

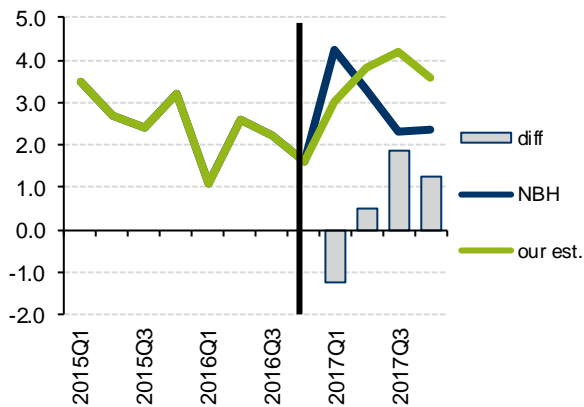
**CZ: GDP outlook (Y/Y, %)**



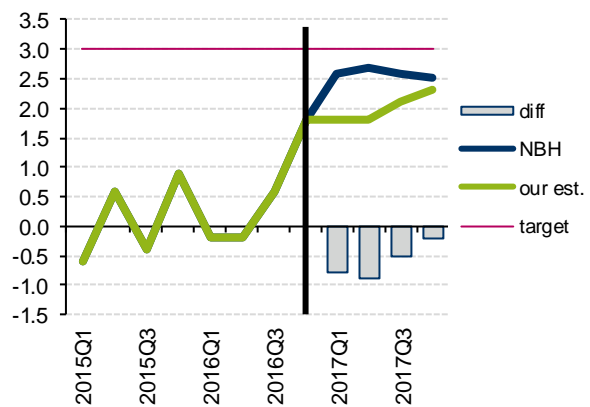
**CZ: Inflation outlook (Y/Y, %)**



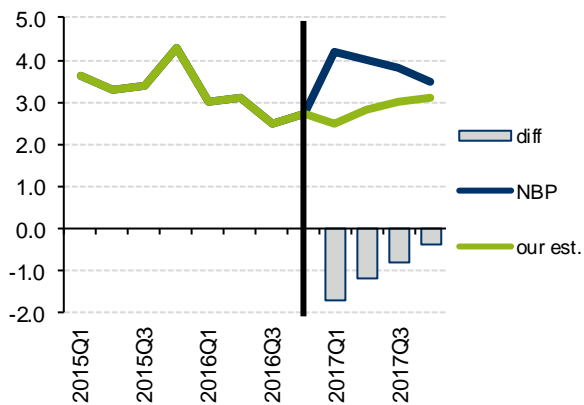
**HU: GDP outlook (Y/Y, %)**



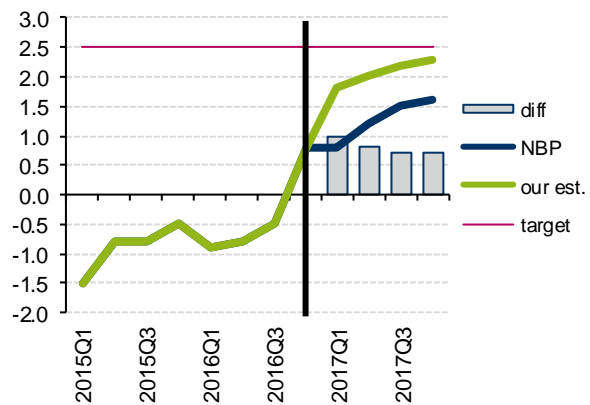
**HU: Inflation outlook (Y/Y, %)**



**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	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	0.28	0.25	0.28	0.28	0.28	0.28
Hungary	BUBOR	0.21	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	1.26	0.88	1.30	1.33	1.37	1.40
Hungary	HU10Y	2.65	2.39	2.50	2.60	2.80	3.00
Poland	PL10Y	2.86	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	27.02	27.02	27.02	26.90	26.60	26.20
Hungary	EUR/HUF	310	309	315	310	303	308
Poland	EUR/PLN	4.26	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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