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Central European Weekly

Tuesday, 29 September 2015

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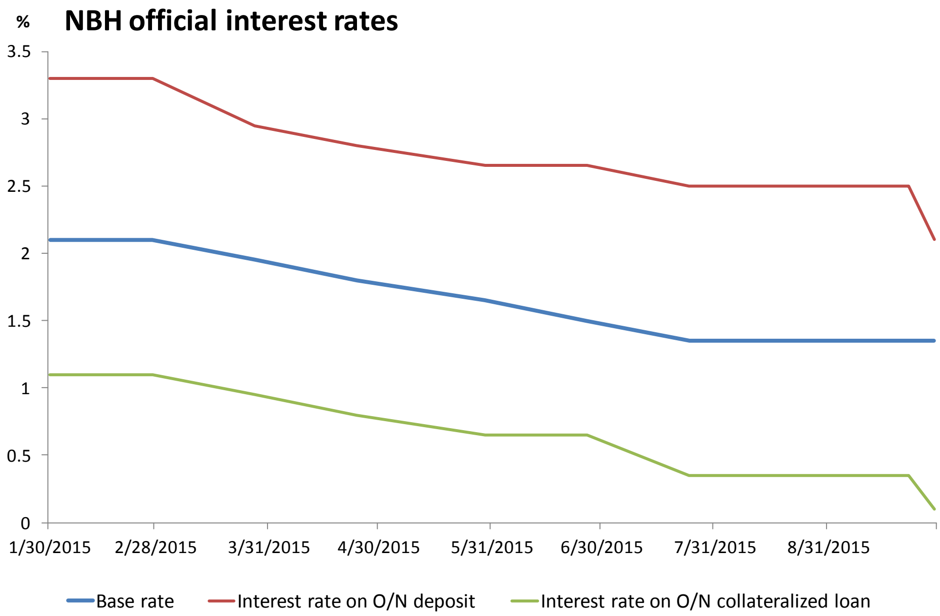
Weekly Highlights:

- The NBH surprisingly cuts interest rates paid on O/N deposit by 25 bps to the range of 0.10% and 2.10%
- The Czech koruna slips to four month lows as the CNB Bank Board discussed introduction of negative rates
- The Polish PMI in focus as the market has begun to start to bet on a rate cut

Chart of the Week: Hungary's official rates



Two days after its regular interest-rate setting meeting the NBH cuts its O/N rates.

Market's editorial

The NBH surprisingly decreased interest rates

As concern central banks - the regional eye catcher should be the CNB Bank Board meeting. However it was not the only one. The Monetary Council of the National Bank of Hungary surprised the market as it shifted the interest rate corridor of overnight (O/N) instrument by 25bp downward, so the new interest rate is 0.1% (base rate minus 125bp) for deposit and 2.1% (base rate plus 75bp) for loan. This change is part of the self financing program the NBH introduced in 2014, since the banking sector increased its Hungarian government bond holdings by HUF1400bn, so the countries dependence on external financing has decreased. The reason of this change was that in the last couple of days the 3-month treasury bills interest rate went below 0.35% (it was the O/N deposit rate before the change), so the risk increased that money may flow into O/N deposit instead of government bonds. This move means practically a 25bp rate cut and is clear the NBH is fully committed to force out money from NBH so it cannot be excluded that further steps may come in the future. After the NBH's decision the forint depreciated sharply against the euro.

In this respect, it is woth noting that the NBH already had its regular meeting last Tuesady while it had left its base rate unchanged. The NBH, however, published the new quarterly forecast for inflation and GDP growth according to the economic growth was revised only marginally for 2015 (from 3.3% Y/Y to 3.2% Y/Y), while inflation outlook was moderated more substantially (from 0.3% Y/Y to 0% Y/Y in 2015 and from 2.4% Y/Y to 1.9% Y/Y in 2016).

The Czech koruna slips to four month lows

As concern, the CNB actually met expectations and left interest rates unchanged while confirming its exchange rate commitment (defending the EUR/CZK 27.0 floor) until at least the second half of next year. In this regard, an interesting point at the press conference was the mention by Governor Singer that the CNB Board had discussed the possibility of extending its exchange rate commitment as well as the option of introducing negative interest rates. That could be a reason why some market players reduced their long positions in the CZK and the koruna weakened to four month lows.

On the monetary policy horizon the CNB expects that downside risks to inflation will be counterbalanced by improved data from the domestic economy (faster GDP and wage growth), yet the CNB still sees inflationary risks skewed towards the downside over the next few quarters. This therefore means that the discussion on possible monetary easing may be far from being over. Although the topic of the central bank's negative rates is likely to repeatedly return, we still do not believe that such rates will really be put in place in Czech conditions.

Nevertheless, we expect that inflation growth will be slower than suggested by the current forecast, and thus the appetite or need to keep the koruna weaker for a prolonged period is likely to increase. Thus it should come as no great surprise if the central bank decides not to leave its current exchange rate policy in 2016 either. This risk is constantly increasing over time, but much will on depend external factors – especially on the ECB policy.

The Polish markets bets on a rate cut – PMI in focus

Regarding the rest of this week, regional eye-catcher is a release of manufacturing PMI figures for September. The Polish index is likely to draw the most attention. Let us recall that the index fell sharply in August and hit an eleven-month low. While industrial production itself keeps relatively robust pace of growth of about 5 % year-on-year, market bets on further monetary policy easing could heighten should the index disappoint. Please note that bets on a rate cut increased in the last couple of weeks and markets see solid chance of lowering of official interest rates even in six months horizon. We, however, keep our base case and expect stable rates in the months and quarters to come.

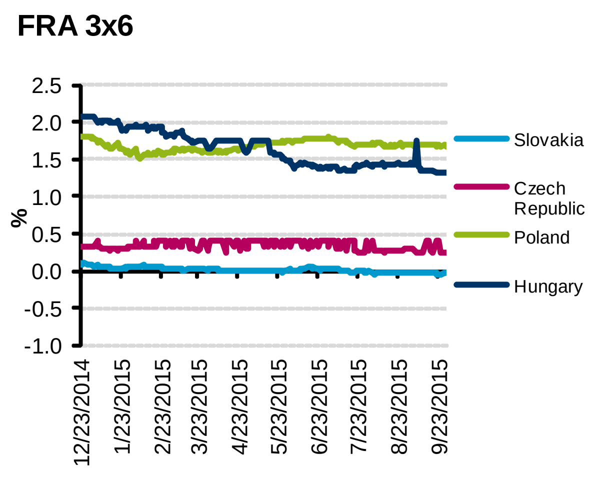
	Last	Change 1W
EUR/CZK	27.3	0.63%
EUR/HUF	315	0.94%
EUR/PLN	4.25	1.02%

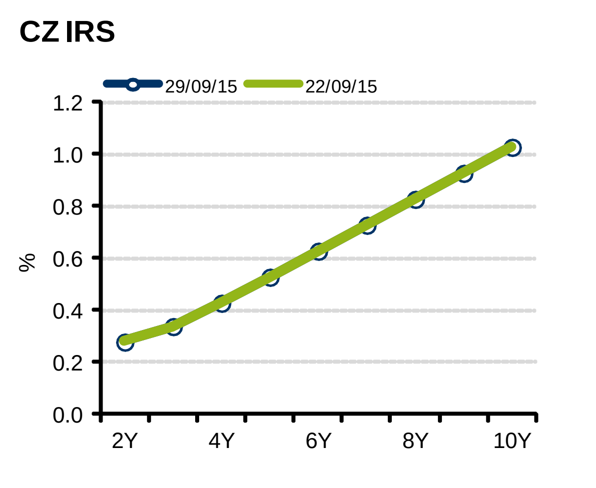
	Last	Change 1W
10Y CZK	1.03	0.00
10Y HUF	2.93	1.03
10Y PLN	2.47	1.64

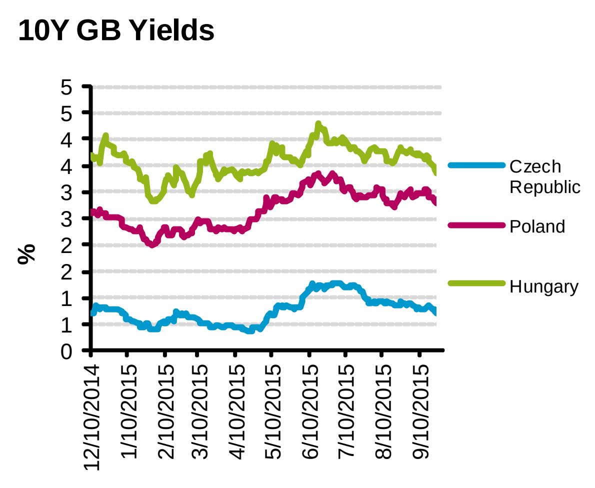
Calendar

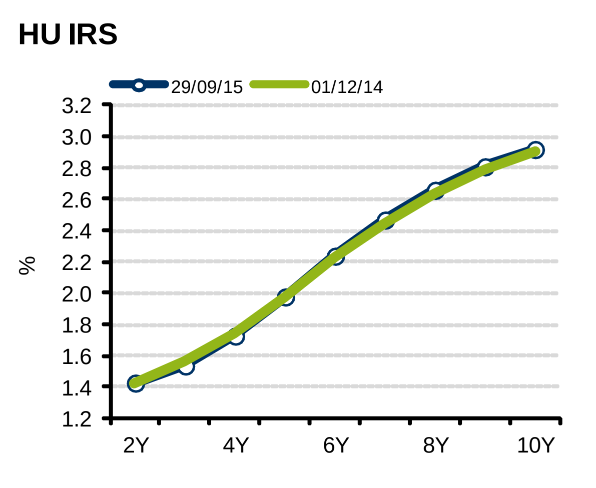
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	09/29/2015	9:00	Unemployment rate	%	08/2015			6.6		6.8	
CZ	09/30/2015	9:00	GDP	%	2Q/2015 *F			0.9	4.4	1	4.4
HU	09/30/2015	9:00	PPI	%	08/2015					-0.7	0.3
CZ	09/30/2015	10:00	Money supply M2	%	08/2015						6.5
PL	10/01/2015	9:00	PMI manufacturing		09/2015			52.2		51.1	
HU	10/01/2015	9:00	PMI manufacturing		09/2015					50.7	
CZ	10/01/2015	9:30	PMI manufacturing		09/2015			56		56.6	
CZ	10/01/2015	14:00	Budget balance	CZK B	09/2015					19	
HU	10/02/2015	9:00	Trade balance	EUR M	07/2015 *F					674	

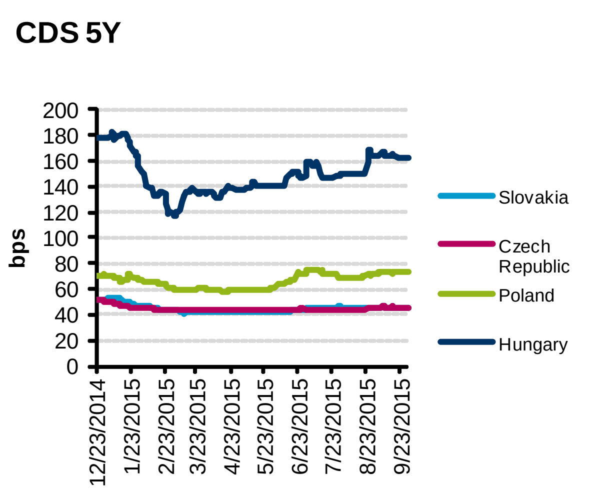
Fixed-income in Charts

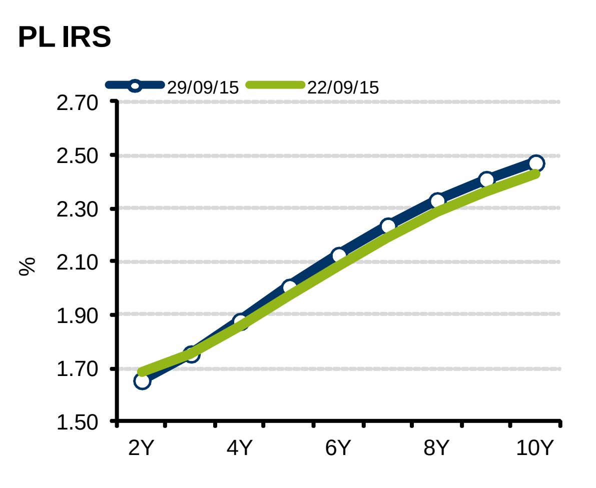












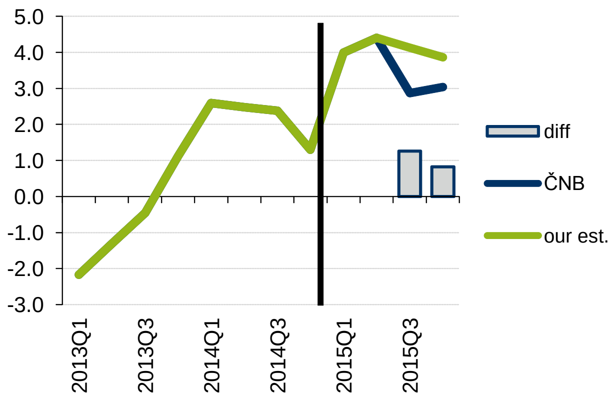
Source: Reuters

Medium-term Views & Issues

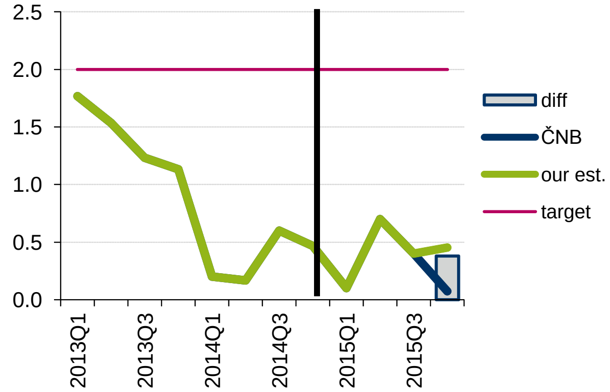
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 Hungarian economy has continued to record solid growth this year as the working day adjusted GDP grew by 3.4% Y/Y in the first quarter. Looking ahead the GDP growth might slow down slightly in the coming quarters, but the favourable European conjuncture and the increasing net real wage and employment increase might provide a stable base for the growth so we expect that Hungarian economy may grow by about 3% Y/Y in 2015.	The Polish Statistical Office kept its flash GDP forecasts for the second quarter of the year unchanged – this means growth of 3.3% y/y and 0.9% q/q. Thus the data for the second quarter fell short of expectations, but only slightly. Perhaps only the deceleration of the rate of investment may pose some issues; nevertheless, we are not overestimating this at the moment either. The overall positive economic developments in Europe and the long-term eased monetary policy should translate into growth of the Polish economy within the range of 3.5-4% this year as well as the next.
Outlook for official & market rates	The CNB's monetary policy continues to be based on record-low interest rates and the weak koruna. The exchange rate policy, not allowing the koruna to strengthen beyond (below) EUR/CZK 27.0, is most likely to remain in place at least until the second half of 2016, and low interest rates probably even longer. The reason is that inflation remains below the 2% target and will most likely remain there next year, and will only slowly approach the target.	The NBH surprised the market as it shifted the interest rate corridor of overnight (O/N) instrument by 25bp downward, so the new interest rate is 0.1% (base rate minus 125bp) for deposit and 2.1% (base rate plus 75bp) for loans. This move means practically a 25bp rate cut and is clear the NBH is fully committed to force out money from NBH so it cannot be excluded that further steps may come in the future.We think the NBH will cut further its base rate, if the ECB loosen further its monetary policy and the EUR/HUF moves closer to 300. In that case the base rate might be cut below 1%, while we think that with the previous speed, namely by 15bp per meetings.	We expect the NBP to keep rates at new lows (1.50%) this year, but we cannot completely rule out the likelihood of further rate cuts. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year's inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected.
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. We believe the Czech National Bank will meet its "pledge" and won't terminate its intervention regime before the second half of 2016. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Possible start of tightening of US monetary policy poses negative risks for the koruna. We however think the fallout should only be limited.	We think that any strengthening of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks and months. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture.	We expect the zloty to gain on growing capital inflows exploiting the positive interest rate differential at the time short term yields are mostly negative in the eurozone. Given the NBP pledge to end the rate cutting cycle, the market may feel temptation to test the willingness of the central bankers to tolerate further gains of the Polish currency. Polish general elections in autumn however pose a negative risk for the zloty.

CBs' Projections vs. Our Forecasts

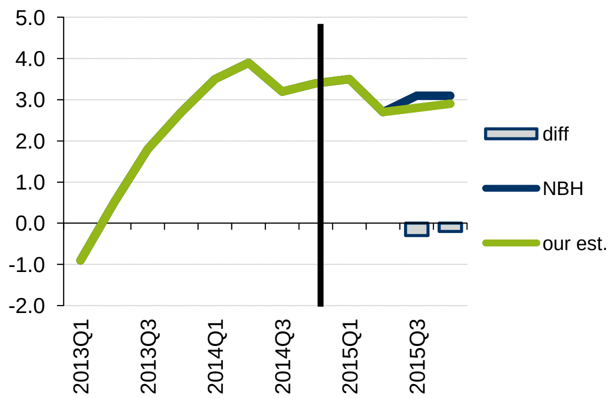
CZ: GDP outlook (Y/Y, %)



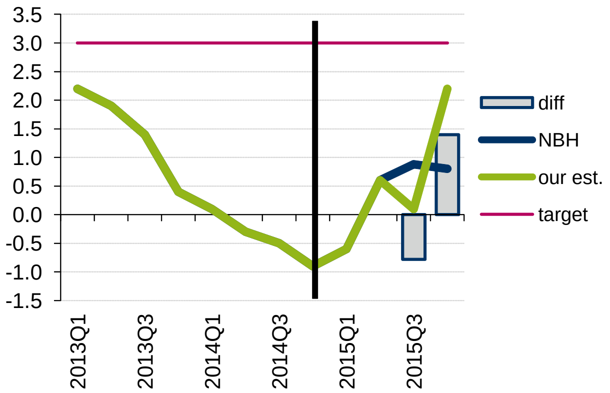
CZ: Inflation outlook (Y/Y, %)



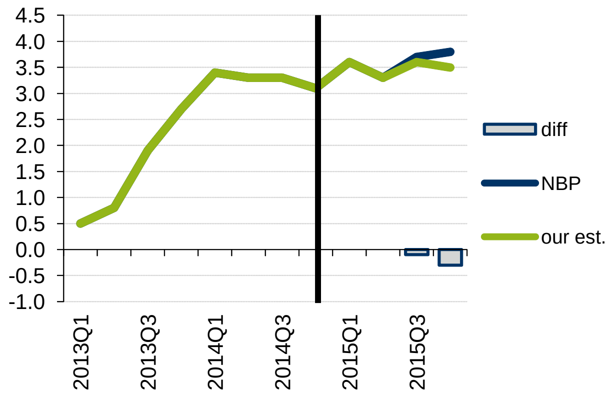
HU: GDP outlook (Y/Y, %)



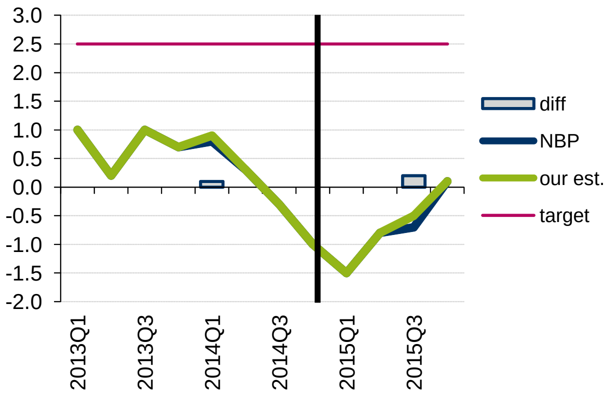
HU: Inflation outlook (Y/Y, %)



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	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	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*	1.95	1.50	1.35	1.35	1.35	-10 bps	7/21/2015
Poland	2W inter. rate	*1.50*	1.50	1.50	1.50	1.50	1.50	-50 bps	3/4/2015

*Short-term interest rates 3M *IBOR (end of the period)*

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	PRIBOR	*0.00*	0.30	0.29	0.30	0.30	0.30
Hungary	BUBOR	*1.35*	1.89	1.41	1.35	1.35	1.35
Poland	WIBOR	*1.73*	1.65	1.72	1.60	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*1.03*	0.64	1.30	1.25	1.30	1.40
Hungary	HU10Y	*2.95*	2.71	3.45	3.40	3.60	3.80
Poland	PL10Y	*2.50*	2.12	3.01	2.45	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.23*	27.57	27.35	27.10	27.05	27.00
Hungary	EUR/HUF	*314*	300	315	310	310	309
Poland	EUR/PLN	*4.24*	4.07	4.19	4.20	4.15	4.10

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.3	4.0	4.4	4.1	3.9	2.2
Hungary	3.2	3.4	3.5	2.7	2.8	2.9	2.4
Poland	3.3	3.1	3.6	3.3	3.6	3.5	3.5

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

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	0.7	0.1	0.2	0.8	0.2	0.7	1.5
Hungary	-0.5	-0.9	-0.6	0.6	0.1	2.2	2.2
Poland	-0.3	-1.0	-1.5	-0.8	-0.5	0.1	0.4

Current Account

	2015	2016
Czech Rep.	1.7	1.7
Hungary	6.0	4.5
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.6	-1.3
Hungary	-2.3	-2.1
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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