

# EMERGING EUROPE CENTRAL BANK WATCH

June 2009



## Market still underestimating scope for rate cuts

- *Further cuts in Turkey and Czech Rep, although rates nearing trough*
- *Meanwhile, pace of cuts in Hungary and Romania will be slow*
- *But rate hikes currently priced in for next year are unlikely to materialise*

Aggressive cuts earlier this year mean that interest rates are nearing their trough in Turkey and the Czech Republic, while concerns over financial stability mean that the pace of easing in Hungary and Romania will be slow. Nonetheless, with a sustained recovery in the real economy still some way off, and likely to disappoint when it does arrive, the path of interest rates currently priced into the market appears too high.

### **Czech Rep. (25<sup>th</sup> June, CE Forecast: 25bps cut)**

The Czech National Bank cut interest rates by 25bps to a record low of 1.5% in early May, but recent comments from policymakers suggest that they may now be nearing their bottom. In a recent interview, Vice-Governor Miroslav Singer said that 'the next move is hard to predict', although he did go on to note that 'a lowering of rates can't be excluded'. With this in mind, we believe the CNB still has a bias for further easing.

GDP shrank by 3.4% y/y in the first quarter of this year. While this was in line with our own forecast for a contraction of 5% over the year as a whole, it will have surprised the CNB, who are still forecasting a contraction of just 2.4% in 2009.

More recent data have continued to paint a grim picture. Industrial production contracted by 22% in April, from -12.2% in March, although both were distorted by the timing of Easter. (There were fewer working days in April this year, and more in March.) The bigger picture is that, while the aggressive run down of stocks seen in the first quarter of this year appears to have eased, a sustained recovery in industry is still contingent on a pick-up in demand in Western Europe. This, in turn, is unlikely much before the start of next year. Forward looking indicators, such as the

manufacturing PMI remain consistent with a further contraction in output (albeit at a slower pace). Meanwhile, other key sectors of the economy – notably retailing – have continued to slump.

With huge amounts of spare capacity set to open up, inflation is yesterday's story. Headline CPI fell to just 1.3% in May – well below this year's 3% target and next year's 2% target. With producer price inflation now firmly in negative territory (-3.8% y/y in May), CPI looks set to fall further over the coming months.

Accordingly, further interest rate cuts are likely and we are sticking to our below-consensus forecast for rates to hit 1% by the end of this year. By contrast, the market is pricing in no further cuts this year. More importantly, while the market believes that rates could start to rise again by mid-2010, we expect them to remain at record lows throughout next year as the recovery in the real economy disappoints.

### **Hungary (22<sup>nd</sup> Jun., CE Forecast: no change)**

As expected, the National Bank of Hungary kept interest rates on hold at 9.5% last month. Seven members of the Monetary Council voted to keep rates unchanged, while two voted for a 50bps cut.

Since then, inflation data have continued to disappoint. Headline CPI rose to 3.8% in May, from 3.4% in April, on the back of rising food prices. Core inflation, however, edged down slightly to 3.1%, from 3.2% the previous month. Nonetheless, inflation is likely to rise even further over the coming months in response to indirect tax hikes. A planned 5% rise in VAT could add around 2.5%-pts to inflation, meaning the headline rate

could top 6.5% later this year. According to the latest inflation report, released late last month, the Bank now expects inflation to average 4.5% next year – well above its 3% target.

Nonetheless, policymakers are likely to view this as a temporary phenomenon. With the economy mired in recession, inflation is likely to fall sharply next year as the effects of the VAT hikes drop out of the annual comparison. Indeed, the Bank expects inflation to average just 1.9% in 2011.

What's more, the bigger picture is that maintaining financial stability, rather than tackling inflation, is the MPC's overriding priority. Given the heavy burden of fx-denominated debt, this essentially translates into maintaining the value of the forint. In this regard, we continue to believe that *hiking* interest rates (as some have argued for) would achieve little – fluctuations in global risk appetite rather than relative interest rate differentials remain the key driver of currency movements. There have been some welcome developments on this front. Indeed, the minutes of last month's rate-setting meeting noted that there were 'a number of signs that financial market sentiment may have turned around'. However, the fragility of sentiment also warranted a 'cautious and robust policy stance'. Governor Simor later reinforced this point, suggesting that at this juncture rate cuts would be 'very risky'.

We continue to expect the next move in interest rates to be down. But the pace of easing will be slow. **We expect rates to hit 7.5%, with the first 50bps cut coming in Q3. This is around 100bps below what is currently priced into the market.**

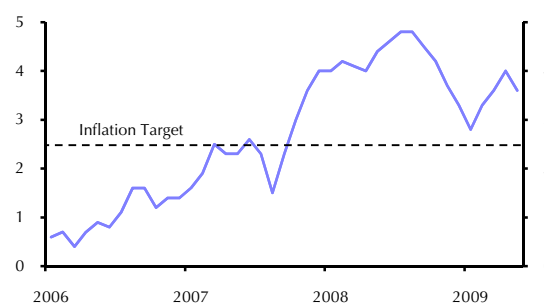
**Poland (24<sup>th</sup> June, CE Forecast: 25bps cut)**

The National Bank of Poland kept interest rates on hold at 3.75% last month, in line with both our forecast and that of the consensus. Since then, Q1 GDP data have reinforced the widely held (and largely justified) view that Poland is better placed to weather the global turmoil than anywhere else in the region. Output grew by 0.8% y/y in the first quarter – the only country in Emerging Europe to record an annual gain.

But we would caution against getting to carried away just yet. Growth in the first quarter was driven in large part by private consumption, which has proved to be surprisingly resilient. We doubt it will last – with unemployment set to rise further, real incomes are likely to fall outright this year. And while optimists would argue that retail sales have accelerated in the past two months, this is largely due to a pick-up in fuel prices (data are reported in values terms.) Poland may be better insulated from the global slump, but it is not immune – we expect GDP to fall by 1.5% this year, and any recovery in 2010 will be extremely weak.

Meanwhile, there are signs that inflation pressures are easing. Following a brief pick-up in March and April, headline CPI dropped to 3.6% in May. (See Chart.) While the drop in inflation was broad-based, weaker food and electricity price growth played an important role.

**CHART: POLAND – CONSUMER PRICES (% Y/Y)**



Source – Capital Economics

What's more, with huge amounts of spare capacity set to open up, inflation should remain below the MPC's 3% target of the key policy-setting horizon of one year ahead. Accordingly, interest rates have further to fall and are likely to remain low for some time. **We have penciled in a 25bps cut this month and are sticking to our forecast for rates to fall to 3% by the end of the year.** By contrast, the market currently expects no further cuts in rates in this cycle.

### **Romania (30<sup>th</sup> June, CE Forecast: 50bps cut)**

The National Bank of Romania resumed its easing cycle last month, cutting interest rates by 50bps to 9.5%. With the real economy in dire straits, further cuts are likely. GDP fell by 6.4% y/y in Q1 and is likely to fall further over the course of this year. While Romania's current account deficit has narrowed recently, the adjustment has further to run. This, in turn, will require domestic demand to fall further. This process will be helped by the fiscal tightening prescribed under the conditions of Romania's IMF programme.

Crucially, however, the leu has stabilised in recent weeks in line with a general improvement in global risk appetite. As we have argued before, currency fluctuations have a much greater influence on monetary policy in Romania compared to the rest of the region. For a start, high levels of foreign-currency denominated borrowing mean that a weaker currency hits the balance sheets of household and firms. What's more, there is a more mechanistic pass through from a weaker exchange rate to higher inflation in Romania than elsewhere in the region.

The combination of a stable leu and a collapse in domestic demand caused inflation to fall to 6% in May, from 6.5% in April. Further falls are likely. The National Bank now expects headline CPI to fall to 3.2% by the turn of the year and to 2.8% by end-10 – well below its 3.5% target. Accordingly, further cuts in interest rates are likely. But the pace of easing will be dictated by developments in currency markets. This in turn, will be influenced by fluctuations in global risk appetite and the success of the recent IMF programme. (Romania has a long track record of failed agreements with the Fund.) **Either way, the pace of rate cuts in Romania will not match that seen elsewhere in the region.** We have penciled in a further 150bps of cuts this year, taking rates to 8% by December, starting with another 50bps cut next month.

### **Turkey (16<sup>th</sup> July, CE Forecast: 25bps cut)**

The Central Bank of Turkey cut interest rates by 50bps to 8.75% this month, in line with our

forecast but more than the 25bps the market was expecting. In its communiqué, the Bank said it would now 'consider a deceleration in the pace of cuts or a pause', but only if 'signs of improvement in economic activity turn into a robust recovery'.

We think rates have further to fall. There are certainly signs that conditions in the real economy are stabilising. Consumer confidence has risen and, more significantly, the manufacturing PMI rebounded to over 50 in May – the crucial dividing line between contraction and expansion.

All of this reinforces our view that Turkey is likely to be one of the first economies in the region to recover. But we would caution against getting too carried away just yet. For a start, while we have edged up our growth forecasts for key export markets in recent weeks, any recovery will be extremely weak. Meanwhile, all is far from well on the domestic front. Nervous banks do not appear to be passing cuts in official interest rates on to borrowers and although unemployment edged down in April, this was driven by seasonal factors.

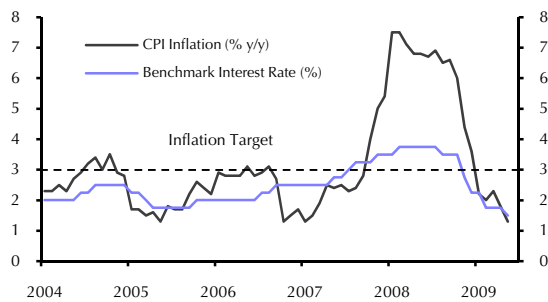
More importantly, however, there is an urgent need to tighten fiscal policy following a pre-election spending splurge earlier this year. May's public finance data hinted at some signs of expenditure restraint, while the Finance Ministry has announced that this March's cut in car sales tax from 37% to 18% would be partly reversed next month. Further retrenchment is needed. Indeed, **with inflation set to remain below target for the foreseeable future, fiscal policy is likely to be the key driver of monetary policy.**

If the government restores fiscal discipline, we think that rates are likely to fall further and, more importantly, stay low throughout 2010. We have penciled in a 25bps cut next months and are sticking to our long-held forecast for rates to hit 8% by the end of the year. On the other hand, if the government fails to tackle its rising deficit, the markets could force the CBRT into reversing some of its recent cuts by the end of the year.

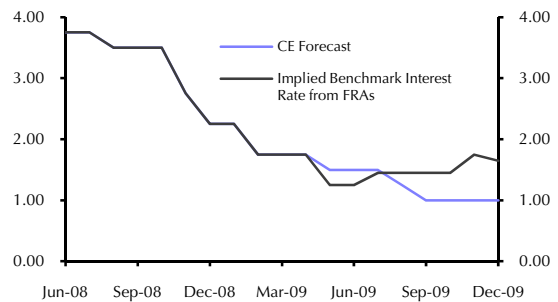
**Neil Shearing**

## Background Charts

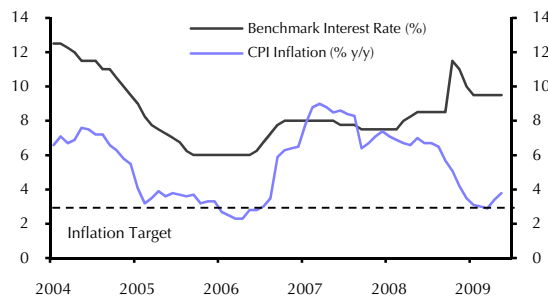
**1. Czech Republic: Inflation and Interest Rates**



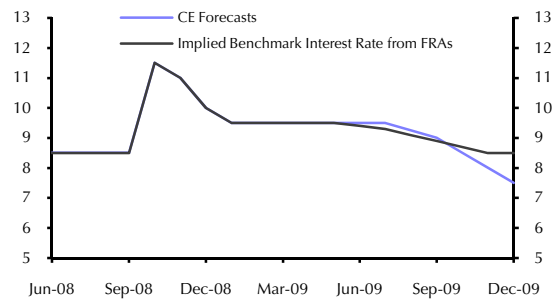
**2. Czech Republic: Interest Rate Forecast & Expectations**



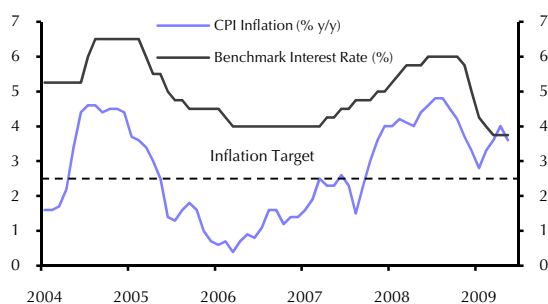
**3. Hungary: Inflation and Interest Rates**



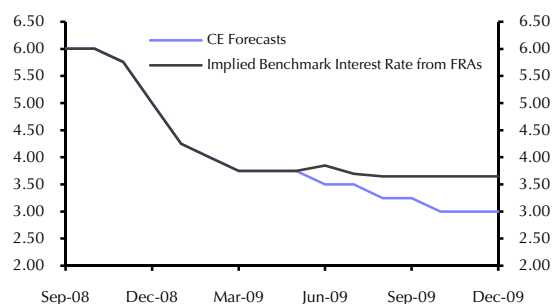
**4. Hungary: Interest Rate Forecast & Expectations**



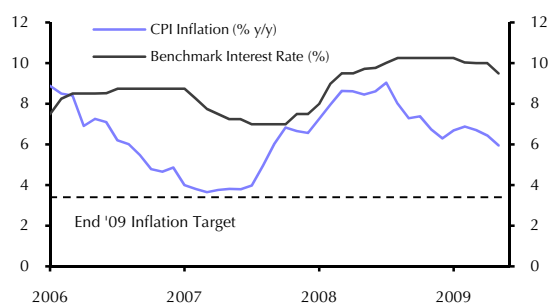
**5. Poland: Inflation and Interest Rates**



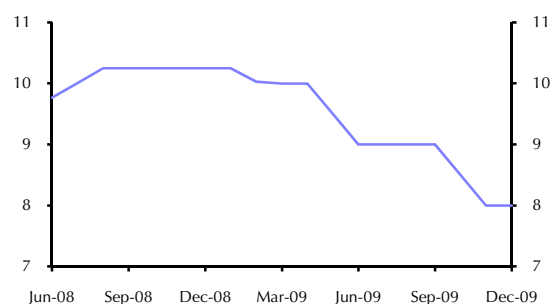
**6. Poland: Interest Rate Forecast & Expectations**



**7. Romania: Inflation and Interest Rates**

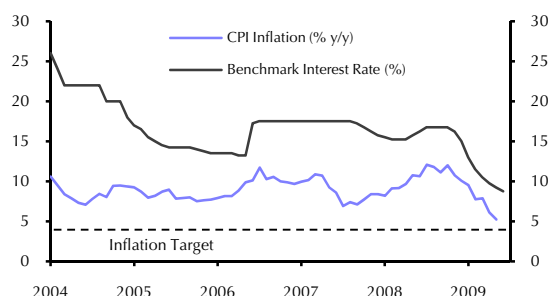


**8. Romania: Interest Rate Forecast**

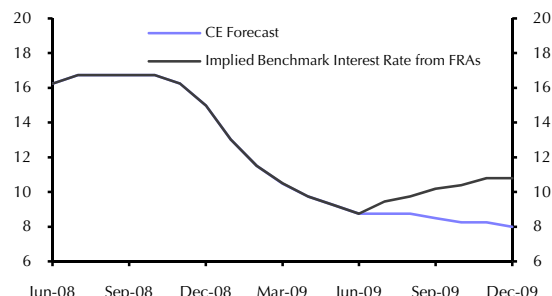


Sources – Bloomberg, Thomson Datastream, Capital Economics

**9. Turkey: Inflation and Interest Rates**



**10. Turkey: Interest Rate Forecast & Expectations**



Sources – Bloomberg, Thomson Datastream, Capital Economics

## BACKGROUND INFORMATION

### Czech Republic

Interest Rate Meetings 8 Meetings in 2009.

Inflation Target 3%, with +/- 1% tolerance range.

Governor Zdenek Tuma

Interest Rate Meetings	Date	Outcome	Vote
	25 <sup>th</sup> September 2008	3.50%	4-2 (Hold-Cut by 25bps)
	6 <sup>th</sup> November 2008	2.75%	4-1 (Cut by 75bps-Cut by 50bps)
	17 <sup>th</sup> December 2008	2.25%	4-1-1 (Cut by 50bps-Cut by 75bps-Cut by 100bps)
	5 <sup>th</sup> February 2009	1.75%	1-4-1 (Cut by 25bps-Cut by 50bps-Cut by 75bps)
	26 <sup>th</sup> March 2009	1.75%	Unanimous
	7 <sup>th</sup> May 2009	1.50%	5-2 (Cut by 25bps-Hold)

### Hungary

Interest Rate Meetings Meet monthly; last Monday of the month.

Inflation Target 3%, with +/- 1% tolerance range.

Governor András Simor

Interest Rate Meetings	Date	Outcome	Vote
	22 <sup>nd</sup> December 2008	10.00%	5-2-3 (Cut by 50bps-Cut by 75bps-Cut by 100bps)
	19 <sup>th</sup> January 2009	9.50%	5-2-2 (Cut by 50bps-Cut by 75bps-Cut by 100bps)
	23 <sup>rd</sup> February 2009	9.50%	Unanimous
	23 <sup>rd</sup> March 2009	9.50%	6-3 (Hold-Hike by 100bps)
	20 <sup>th</sup> April 2009	9.50%	Unanimous
	25 <sup>th</sup> May 2009	9.50%	7-2 (Hold-Cut by 50bps)

---

**BACKGROUND INFORMATION (CONTINUED)**

**Poland**

Interest Rate Meetings	Meet monthly; last Wednesday of every month.		
Inflation Target	1.5% - 3.5%		
Governor	Slawomir Skrzypek		
Interest Rate Meetings	Date	Outcome	Vote
	23 <sup>rd</sup> December 2008	5.00%	5-5 (Cut by 75bps, For-Against)
	27 <sup>th</sup> January 2009	4.25%	Voting breakdown released in Q1 Inflation Report
	25 <sup>th</sup> February 2009	4.00%	Voting breakdown released in Q1 Inflation Report
	25 <sup>th</sup> March 2009	3.75%	Voting breakdown released in Q1 Inflation Report
	29 <sup>th</sup> April 2009	3.75%	Voting breakdown released in Q2 Inflation Report
	27 <sup>th</sup> May 2009	3.75%	Voting breakdown released in Q2 Inflation Report

**Romania**

Interest Rate Meetings	8 Meetings in 2009.		
Inflation Target	3.8%, with +/- 1% tolerance range.		
Governor	Mugur Isarescu		
Interest Rate Meetings	Date	Outcome	Vote
	25 <sup>th</sup> September 2008	10.25%	
	30 <sup>th</sup> October 2008	10.25%	
	6 <sup>th</sup> January 2009	10.25%	
	4 <sup>th</sup> February 2009	10.00%	Voting breakdown unavailable
	31 <sup>st</sup> March 2009	10.00%	
	6 <sup>th</sup> May 2009	9.50%	

**Turkey**

Interest Rate Meetings	Once a month.		
Inflation Target	4% with +/- 2% tolerance range.		
Governor	Durmus Yılmaz		
Interest Rate Meetings	Date	Outcome	Vote
	15 <sup>th</sup> January 2009	13.00%	
	19 <sup>th</sup> February 2009	11.50%	
	19 <sup>th</sup> March 2009	10.50%	
	16 <sup>th</sup> April 2009	9.75%	Voting breakdown unavailable
	14 <sup>th</sup> May 2009	9.25%	
	16 <sup>th</sup> June 2009	8.75%	

---

Source – National Central Banks