

# EMERGING EUROPE CENTRAL BANK WATCH

Nov. 2007



## Poland and Czech Rep. to hike, Hungary to cut

- ***National Bank of Poland to hike following last month's spike in inflation***
- ***Hike also possible in Czech Republic, but case is less clear-cut***
- ***Further slump in real economy could prompt 25bps cut in Hungary***

Brace yourselves for what could be an action-packed series of rate-setting meetings next week. A 25bps hike in Polish interest rates is pretty much guaranteed following the spike in inflation last month. Policymakers in the Czech Republic could also hike rates, though recent currency appreciation means that this is much less certain. Meanwhile, a cut in rates is possible in Hungary following more dire news from the real economy.

### **Hungary (26<sup>th</sup> Nov., CE Forecast: 25bps cut)**

Last month policymakers were evenly split on whether to hold interest rates at 7.5% or cut them by 25bps. In the event, Governor Simor cast the deciding vote to keep them on hold.

The minutes of the meeting revealed that the usual arguments were made both ways. Dovish Board members noted that despite rising food prices, a the slump in the real economy should mean that inflation still hits its 3% target over the key policy setting horizon of 18 months ahead. By contrast, the hawks cited ongoing wage pressures as a reason to keep rates on hold until more information became available in this month's inflation report.

Since then, the data have been something of a mixed bag. GDP growth slumped to just 1% in Q3, adding weight to the argument for further rate cuts. But the news from the labour market has been more tricky to interpret. Wage growth accelerated to 8.6% y/y in September, up from 7.4% in August. On the face of it, this points to keeping rates on hold for longer. But oddly enough it might actually support the case for further rate cuts – wage growth was expected to rise to nearly 10% on the back of unfavourable base effects.

What's more, while inflation picked up in October (from 6.4% to 6.7% y/y) this may not prevent a rate cut next week. For a start, the increase was small and driven by rising food prices rather than core pressures. But the bigger picture is that inflation is still well down on the rates seen earlier this year, as the effects of last autumn's indirect tax hikes have dropped out of the annual comparison. This has created room for rates to be cut without causing a fall in real rates and a relaxation in overall monetary conditions.

We see the case for remaining on hold this month, but on balance believe a 25bps cut to 7.25% is probably more likely. Either way it's going to be a close call. The market is currently half way to pricing in a rate cut. Further out, while higher food and oil prices mean that this month's updated inflation report will probably revise up the path of inflation, we think that it is still on track to fall to its 3% target by 2009. As such, we are sticking by our call for rates to fall to 6% by the end of next year. The market is pricing in a flatter path to 6.75% by end-2008.

### **Poland (28<sup>th</sup> Nov., CE Forecast: 25bps hike)**

As expected, the MPC kept interest rates on hold last month at 4.75%. The statement released after the decision was fairly balanced. As usual, it noted the upside risks to price stability from a tightening labour market, rising food prices and looser fiscal policy. But it also said that rapid investment growth should help ease capacity constraints and that the expected slowdown in the global economy could reduce domestic price pressures.

The Bank also published an updated inflation report, which, as expected, revised up the medium-term path of inflation. The Bank now sees

CPI rising to 3.3% by end-2008 and exceeding the 3.5% upper limit of its target range by mid-2009. Crucially, the Bank still thinks that the probability of inflation running above target is significantly higher than inflation running below target.

We would agree. While core pressures remain fairly well contained for now, they are likely to pick up over the next year as spare capacity diminishes. The labour market has continued to tighten in recent months and with wage growth now running at over 10% y/y, unit labour costs are probably increasing by 6-7% y/y. This is clearly inconsistent with an inflation target of 2.5%.

Interest rates therefore have further to rise. But recent Bank communications have suggested that the timing of future hikes will be data dependent. CPI inflation rose back above target to 3% y/y in October due to rising food prices and we think that it is likely to hover at around this rate for the foreseeable future. With inflation now well above target, a 25bps hike in rates next week looks a done deal. That is likely to be it for this year, but we are sticking to our above-consensus forecast for interest rates to rise to 5.75% by end-2008. At present the FRA market is only pricing in hikes to just under 5.5% over the same period.

#### **Czech Rep. (29<sup>th</sup> Nov., CE Forecast: 25bps hike)**

As we expected, the Czech National Bank left interest rates unchanged at 3.25% last month, with five Board members voting to keep rates on hold and two voting for a 25bps hike. An updated inflation report was also released at the same time. The Bank has revised up its forecast for inflation at the end of next year to 5.1% y/y, from 3.8% previously. The Bank sees price pressures easing from the end of next year, but inflation should still remain above its 3% target until mid-2009.

While the upward revisions to the forecast are partly due to a rise in core pressures, the main driver is the indirect tax hikes due in January. 'Monetary-policy relevant' CPI (which excludes the first round impact of planned indirect tax

hikes) is forecast to be lower, but should still average 3% in 2008.

The Board now views potential second round effects from the tax changes as the key risk to the inflation outlook. Our view is that the tight labour market and strength of demand significantly raises the risk of such second round effects.

As such, further increases in interest rates seem certain. Inflation rose sharply to 4% y/y in October, from 2.8% in September due to higher food and fuel prices. This could prompt a 25bps hike next week. But at the same time some Board members argue that the 5% rise in the koruna since the summer has already tightened monetary conditions and, as such, there is no need to rush into raising interest rates.

It's a close call, but on balance we expect the Board to hike rates to 3.5%. Further out, we had expected interest rates to rise to 4.25% by the end of next year. If the currency maintains its value over the coming months (as we expect it to), this is probably overdoing things a little. But two more hikes to 4% by mid-2008 are certainly a realistic proposition. By contrast, the market is expecting interest rates to rise to just over 3.5% over the same period.

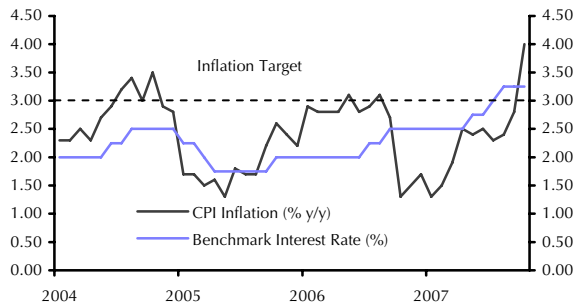
#### **Slovakia (27<sup>th</sup> Nov., CE Forecast: hold)**

The National Bank of Slovakia left interest rates on hold at 4.25% last month and once again the minutes revealed that policymakers did not even discuss the prospect of any change. But while medium-term inflation pressures are building, the near-term inflation outlook remains benign and, despite the rise to 2.4% in October, HICP inflation is likely to remain below the ceiling stipulated by the Maastricht Criteria for the time being (currently 3%). Accordingly, there is no immediate pressure to tighten policy. We continue to expect the NBS to keep interest rates on hold until the EU Commission rules on 2009 EMU entry in Q2 of next year.

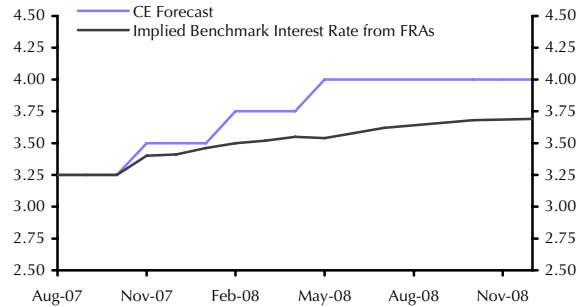
**Neil Shearing**

## Background Charts

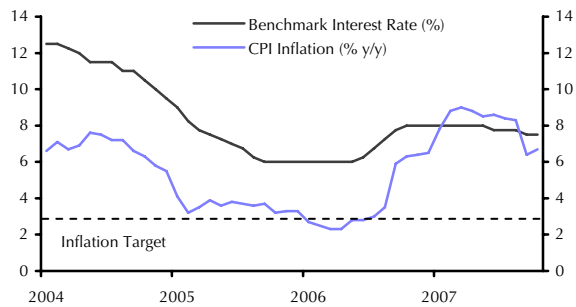
**1. Czech Republic: Inflation and Interest Rates**



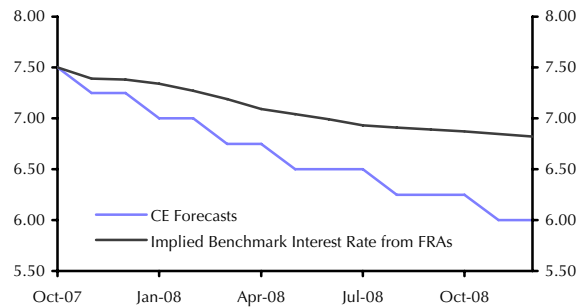
**2. Czech Republic: Interest Rate Forecast & Expectations**



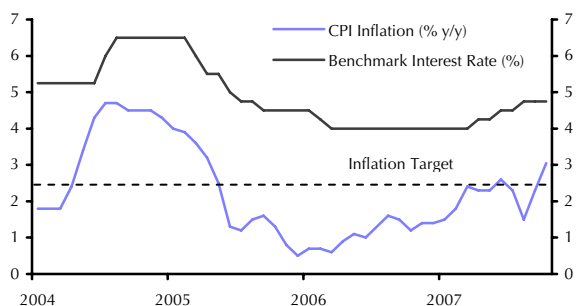
**3. Hungary: Inflation and Interest Rates**



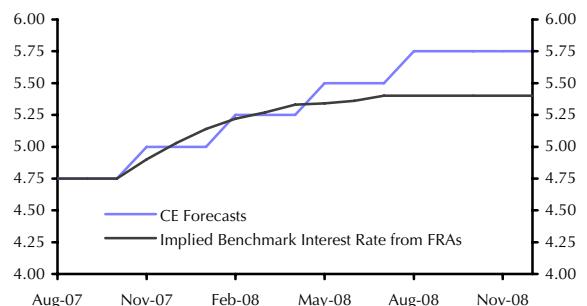
**4. Hungary: Interest Rate Forecast & Expectations**



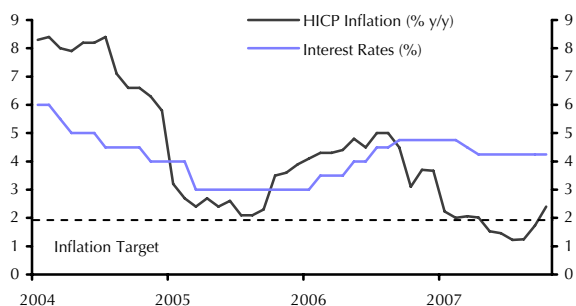
**5. Poland: Inflation and Interest Rates**



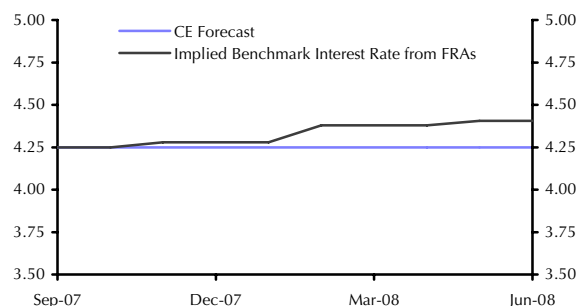
**6. Poland: Interest Rate Forecast & Expectations**



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



**8. Slovakia: Interest Rate Forecast & Expectations**



Sources – Bloomberg, Thomson Datastream, Capital Economics

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## BACKGROUND INFORMATION

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### Czech Republic

Interest Rate Meetings Meet monthly; last Thursday of every month.

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

Governor Zdenek Tuma

Interest Rate Meetings	Date	Outcome	Vote
2007	28 <sup>th</sup> June	2.75%	4-1 (Hold-Hike)
	26 <sup>th</sup> July	3.00%	6-1 (Hike-increase by 50bp)
	30 <sup>th</sup> August	3.25%	4-3 (Hike-Hold)
	27 <sup>th</sup> September	3.25%	6-0 (Hold-Hike)
	25 <sup>th</sup> October	3.25%	5-2 (Hold-Hike)

### 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
2007	25 <sup>th</sup> June	7.75%	9-1-2 (Cut by 25bp- Cut by 50bp-Hold)
	23 <sup>rd</sup> July	7.75%	9-1 (Hold-Cut by 25bp)
	27 <sup>th</sup> August	7.75%	5-5 (Hold-Cut, Governor's casting vote to hold)
	24 <sup>th</sup> September	7.50%	8-1-2 (Cut by 25bp- Cut by 50bp-Hold)
	29 <sup>th</sup> October	7.50%	6-6 (Hold-Cut, Governor's casting vote to hold)

### 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
2007	27 <sup>th</sup> June	4.50%	-
	25 <sup>th</sup> July	4.50%	-
	29 <sup>th</sup> August	4.75%	-
	26 <sup>th</sup> September	4.75%	-
	31 <sup>st</sup> October	4.75%	-

### Slovakia

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

Inflation Target 2%, and with exchange rate within ERM II bands

Governor Ivan Sramko

Interest Rate Meetings	Date	Outcome	Vote
2007	26 <sup>th</sup> June	4.25%	Unanimous
	31 <sup>st</sup> July	4.25%	Unanimous
	28 <sup>th</sup> August	4.25%	Unanimous
	25 <sup>th</sup> September	4.25%	Unanimous
	30 <sup>th</sup> October	4.25%	Unanimous

Source – National Central Banks