

EMERGING EUROPE CENTRAL BANK WATCH

Nov. 2011



Euro-crisis takes centre stage

- *Parts of region flirting with recession, but scope for monetary easing limited*
- *In Poland, rate cuts could come in Q1 2012; but in Hungary fragile banks...*
- *...and threat of sovereign downgrade makes defensive rate hikes likely.*

It goes without saying that the deepening crisis in the euro-zone has led (as we had always expected) to a marked deterioration in the growth outlook for Emerging Europe. But the crisis in Western Europe will bring a range of different responses by central banks in the East.

At one extreme, perennial concerns about the health of the Hungarian banking system, coupled with the increasing likelihood of a sovereign downgrade, have taken the forint to levels that, in the past, have triggered defensive interest rate *hikes*. In the absence of a marked turnaround in investor risk appetite an emergency hike of perhaps 100-200bps or so seems more likely than not over the next couple of months. Likewise, monetary tightening appears to have put a floor under the Turkish lira, and suggests that the CBRT will have to keep market interest rates in double-digit territory to mitigate balance of payments concerns.

Only in Poland (where the growth outlook is comparatively bright) and the Czech Republic is there scope for policy easing – and even here there is less room for manoeuvre than in the 2008-09 downturn. In Poland, we have pencilled in 50bps of rate cuts, starting in Q1 next year. This would take the benchmark rate to a below-consensus

4.0%, although we wouldn't rule out the possibility of further cuts to 3.5% or below (the trough reached in 2009) given the severity of the euro-crisis. In the Czech Republic, a rate cut could come as soon as next month.

Czech Rep. (21st Dec, CE Forecast: 25bp cut)

With the Czech economy already slowing on the back of weaker growth in its key export markets, the case for policy stimulus is mounting. **In the first instance, we expect a 25bp interest rate cut, probably before the end of this year, followed perhaps by intervention in the FX market to weaken the koruna.**

Over the past month, the tone of Czech rate-setters has become markedly more dovish. And while interest rates were kept on hold at the last monetary policy meeting of the Czech National Bank (CNB), one board member voted for a 25bp rate cut, the first such vote since May 2010. (See Chart 1 over the page.)

The change of tone has been spurred by the rapidly deteriorating growth outlook. In seasonally adjusted terms, industrial production has barely risen at all over the past six months. What's more, forthcoming data are likely to show that GDP stagnated in q/q terms in the third quarter. With recession looming in the euro-zone,

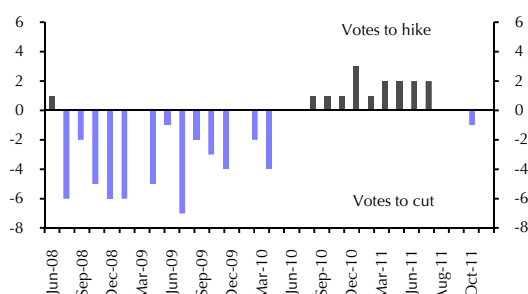
TABLE 1: EMERGING EUROPE INTEREST RATE FORECASTS

	Current interest rate (%)	Latest Inflation rate (%)	Central Bank inf. target (%)	Next meeting date	CE forecast next meeting (bps)	Consensus forecast next meeting (bps)	CE forecast end '12 rate (%)	Market implied end '12 rate (%)
Czech Rep.	0.75	2.3	2.0 +/- 1.0	21 st Dec	25bp cut	TBC	0.50	0.75
Hungary	6.00	3.9	3.0 +/- 1.0	29 th Nov	100bp hike	No change	6.50	6.50
Poland	4.50	3.9	2.5 +/- 1.0	7 th Dec	No change	TBC	4.00	4.25
Romania	6.00	3.6	3.0 +/- 1.0	5 th Jan	25bp cut	TBC	5.75	N/A
Turkey	5.75	7.7	5.5% (end '11)	23 rd Nov	No change	TBC	5.75	5.75

Sources – Thomson Datastream, Bloomberg, Capital Economics

we have pencilled in (below-consensus) GDP growth of only 0.7% in the Czech Republic next year, although it would clearly be premature to rule out the possibility of a recession. **Against this backdrop, inflationary pressures remain subdued.** Indeed, although inflation rose to an above-target 2.3% y/y in October (from 1.8% y/y in September), it was driven by food inflation rather than domestic demand.

CHART 1: CZECH MPC VOTING RECORD (NUMBER)



Source – CNB

All of this argues in favour of looser policy. In this respect, the Czech Republic is fortunate compared with other economies in Emerging Europe in that it is not being forced to *tighten* policy. For a start, a weak currency is not a concern since Czech households are not burdened by FX debt. Accordingly, unlike in Hungary, defensive rate hikes are not on the cards.

But equally so, there are fewer options to loosen policy than in 2008/09. Interest rates are already at a record low of 0.75% so there is now little room for significant monetary stimulus. In spite of this, **we think the first move will be to cut rates by 25bps, probably before the end of the year**, bringing the benchmark rate to 0.50% (below what the market is currently pricing in).

Nevertheless, with recession a real threat, more unorthodox policy measures will probably also be considered. The CNB is one of the few emerging market central banks with the credibility to undertake quantitative easing should it so wish. But given the already high levels of liquidity in the domestic banking system, combined with the

CNB’s institutional conservatism, we don’t think there will be much argument in favour of such a move.

A more likely scenario is that the CNB intervenes in the FX market to weaken the koruna. At first this would probably come via verbal intervention, but the CNB would have to be prepared to match statements with actions. Admittedly, previous attempts by the CNB to weaken the currency in the early 2000s met with little success. However, with few prospects of re-igniting domestic demand, improving the competitiveness of the export sector (even when external demand is weak) would appear to be the best growth strategy.

Hungary (29th Nov, CE Forecast: 100bp hike)

The National Bank of Hungary (NBH) is in a bind between supporting growth and propping up the currency. **But with investor sentiment evaporating, the forint reaching record lows against the euro, and Hungarian government debt on the cusp of being downgraded to junk rating, we think that a defensive rate hike is more likely than not within the next couple of months.**

Over the past month, the Hungarian growth outlook has taken a turn for the worse. Industry appears to be stagnating and the manufacturing PMI points to worse to come. Moreover, data released this week are likely to show that GDP grew by only around 0.5% y/y in Q3, down from 1.5% y/y in Q2. And as the euro-zone appears to be heading towards a recession next year, we expect Hungarian GDP to contract by 0.5% in 2012.

In spite of this, **looser monetary policy is definitely off the cards and defensive rate hikes look more likely.** For a start, it is worth noting that at its last MPC meeting, the NBH justified its “wait and see” stance on the basis of the risks to inflation and financial stability. In addition, it stated that the best way it can contribute to growth is “by preserving the stability of prices and the financial system”.

Since that meeting, **inflation, which was already above target, has accelerated.** Headline CPI

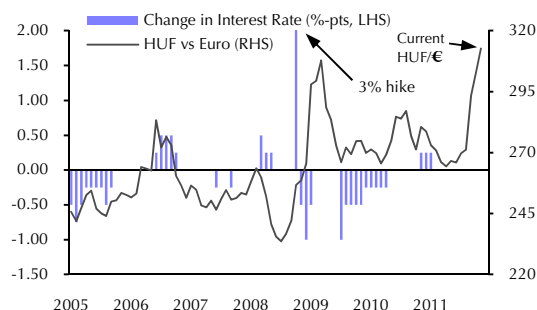
inflation increased to 3.9% y/y in October, up from 3.6% y/y in September, and should rise further on the back of excise tax hikes this month and a VAT hike due in January. That being said, underlying inflationary pressures are still muted. Domestic demand and labour market conditions are weak, while October's jump in the headline rate was driven by higher-than-expected energy inflation due to the elimination of government subsidies. Looking further ahead, we still expect inflation to fall comfortably below the NBH's 3% target by 2013.

Of more importance for rate-setting decisions though, concerns about evaporating investor confidence are reaching a critical level. First of all, since Hungarian households and corporates are burdened by high levels of FX debt, the NBH, more than other central banks in the region, has to make monetary policy decisions with a careful eye on the exchange rate. The forint has been hit harder than most emerging market currencies by waning investor risk appetite, and is currently trading below 315/€ (a record low against the euro and a 15% fall since the beginning of August). This means that households face higher debt servicing costs, while banks face the prospect both of rising non-performing loans and incurring higher losses via the Home Protection Plan (a government policy which obliges banks to allow households to pay back FX mortgage loans at preferable exchange rates).

In addition, **deteriorating investor sentiment is likely to make it increasingly difficult for banks and the government to roll over debt**, as attested by two consecutive failed government bond auctions in early November.

Overall then, we think that the NBH cannot afford to "wait and see" for much longer. The forint is firmly in the territory for defensive rate hikes. Indeed, it is now weaker against the euro than in October 2008, when the NBH hiked interest rates by 300bps. (See Chart 2.)

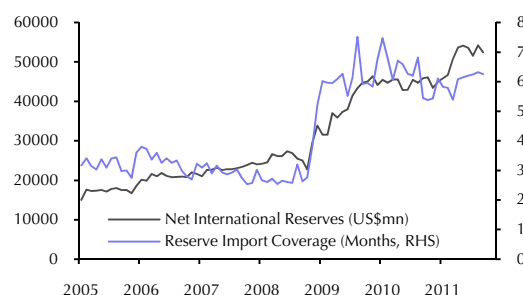
CHART 2: HUNGARY – INTEREST RATE CHANGES VS. HUF



Sources – CSO, Capital Economics

Admittedly, unlike in 2008, FX reserves now provide significantly more coverage, equivalent to around 6 months of imports (compared with 2.5 months in 2008). (See Chart 3.) **In the first instance, therefore, the NBH may turn to FX intervention to try and strengthen the forint. Nevertheless, if the forint persistently trades in the 315-325/€ range, we think defensive rate hikes will be on the cards.**

CHART 3: HUNGARY – FX RESERVES & IMPORT COVERAGE



Sources – Thomson Datastream, Capital Economics

Of course, much depends on the exchange rate so forecasting the exact timing for rate movements is tricky. If investor risk appetite picks up on the back of the apparent stabilisation of the Italian political situation and the forint strengthens, then rates will probably be left on hold at the next MPC meeting. But even this seems like wishful thinking at present. Meanwhile, the backdrop of accelerating inflation provides a convenient cover to tighten monetary policy.

As such, **we think defensive rate hikes are more likely than not within the next couple of months.**

For the time being, we have pencilled in a 100bp rate hike at the next MPC meeting, although we would not rule out a move as large as 200bps.

When rates were hiked in 2008, the move was quickly reversed with the backing of an IMF programme. Now, there are serious political hurdles to re-establishing ties with the IMF, but even this may not be as insurmountable as some commentators suggest. Hence, there may be scope to lower rates from Q2 or Q3 next year, probably by around 50bps, bringing the benchmark interest rate to 6.5% by end-2012.

Poland (7th Dec, CE Forecast: unchanged)

The National Bank of Poland (NBP) kept the benchmark interest rate unchanged at 4.5% at its last meeting on 9th November, as expected. In the accompanying statement the Board pointed out that the recent activity data had remained strong, suggesting that GDP continued to grow solidly in Q3. However, survey data suggest a marked deterioration in the outlook. **This points to a looming slowdown in economic activity, which we think will be sharper than most expect, prompting interest rate cuts early next year.**

The Polish economy has held up pretty well so far. Industrial production grew by a solid 7.8% y/y in September. Meanwhile, consumer spending remains strong on the back of rising gross wages and slowing inflation; retail sales grew by a healthy 10.3% y/y in September. However, survey data have been weakening for several months now suggesting that these improvements are likely to prove temporary. Confidence in both the consumer and industrial sectors is rapidly deteriorating, pointing to a looming slowdown in activity.

What's more, we think that the Polish economy is more vulnerable to a renewed slump in global demand now than it was in 2008. The key factor that helped Poland escape recession back then was a large fiscal boost, equivalent to almost 2.5% of GDP. With public debt now close to constitutional limits that would force a fiscal *tightening*, there is now little scope for a repeat of

this. Meanwhile, the potential monetary boost is limited too. Interest rates are now at 4.5% compared with 6.0% in October 2008. **All told, growth is likely to drop sharply next year and we have pencilled in below-consensus GDP growth of only 1.5% in 2012 (from 4% this year).**

For now though, much of the focus remains on inflation, which is still well above the NBP's 2.5% target. The headline rate did edge down to 3.9% y/y in September from 4.3% y/y in August, but households' inflation expectations have shifted upwards. In fact, October's MPC meeting minutes show that some Board members see the possibility of rate hikes as more likely than cuts in the coming quarters if inflation "remains above the target for a period longer than currently anticipated". What's more, at the last meeting the Board revised up its projections for GDP growth and inflation for this year and next.

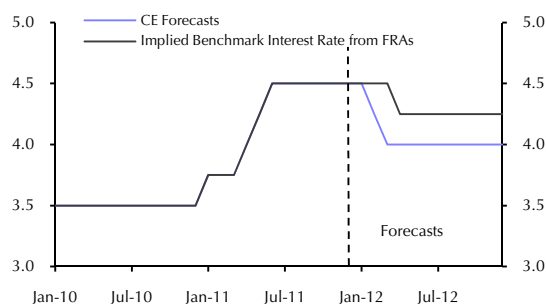
Nevertheless, we think that fears of inflation are overstated for at least three reasons. First, as the impacts of January's hike in VAT and last year's global commodity shock drop out of the annual comparison, the headline rate will fall early next year. Secondly, imported inflation from the weaker zloty is unlikely to have a significant impact on the headline rate, as the link between fluctuations in the exchange rate and domestic prices has not been particularly strong in the recent past. And finally, as the global economic outlook deteriorates, weaker external demand will weigh on Polish economic activity, thus easing inflationary pressures.

While we do not think that the weaker zloty poses a substantial threat to inflation, the bigger concern is that Polish households are burdened with reasonably high levels of FX debt. This means that currency depreciation increases debt servicing costs and weakens domestic demand. Of course, the Polish situation is not as bad as in Hungary and Romania. Moreover, the pegging of the Swiss franc to the euro has alleviated some exchange rate pressure. **But even so, concerns over the zloty**

mean that it would be premature to talk of rate cuts at the moment.

Nevertheless, as the outlook for inflation improves, it seems likely that policymakers will shift their attention to concerns over weakening growth. Accordingly, **we expect the NBP to start easing policy next year and have pencilled in 50bps of rate cuts starting in Q1, which will bring the benchmark rate to 4.0%.** This is well below the profile for rates priced into the market. (See Chart 4.)

CHART 4: POLAND INTEREST RATES (%)



Sources – Bloomberg, Capital Economics

Romania (5th Jan, CE Forecast: 25bp cut)

The decision by the National Bank of Romania (NBR) to cut interest rates by 25bps to 6.00% at its last meeting came as a surprise, despite mounting evidence that the economy is slipping back into recession. We (and the consensus) had expected rates to be kept on hold, as concerns over the currency outweighed worries over the outlook for growth.

Nevertheless, markets seem to have taken the Board's decision in their stride – the leu has held up well so far. Indeed, the leu has avoided the worst of the recent sell-off seen in other emerging market currencies, and is down by only 2% against the euro on the start of the year (most other currencies in the region have fallen by around 10%). (See Chart 5.)

CHART 5: ROMANIA – EXCHANGE RATE (VS. EURO, INVERTED)



Source – NBR

Maintaining the stability of the currency is crucial since **high levels of FX debt mean that currency weakness poses a substantial threat to Romania's financial stability.** Over 60% of total household loans are FX-denominated (mainly in euros). If the leu weakens, rising payments on FX-debt will squeeze consumers' real incomes that have only recently started to recover. This may, in turn, increase non-performing loans and have a detrimental effect on the already fragile banking sector. **Indeed, the NBR's decision to cut rates was unexpected for this very reason.**

Nevertheless, rate cuts came against the backdrop of a sharply deteriorating growth outlook. Domestic demand remains perilously weak. And although real wage growth has picked up on the back of falling inflation, retail sales slipped further into negative territory, contracting by 5.0% y/y in September. Looking ahead, since consumer confidence remains fragile, spending is unlikely to pick up in the near-term.

Industry has held up better so far, thanks largely to strengthening export demand. However, as the crisis in the euro-zone intensifies, the prospects for Romania's export-led industry look grim, given that 70% of its total exports go to Europe. This is particularly worrying as weak domestic demand will not be able to pick up the slack.

Meanwhile, inflationary pressures remain subdued. Although headline CPI inflation edged up slightly to 3.6% y/y in October, from 3.5% y/y in September, it remains comfortably within the

NBR's target of $3\pm 1\%$. Falling food inflation, coupled with weak economic activity and large amount of spare capacity in the economy, should keep inflation within the NBR's target this year, before it falls to 2.5% in 2012.

Against all this, however, we think there is only limited scope for policymakers to cut rates further. Although a \$7.4bn precautionary credit line with the IMF and the EC provides some support for the currency, given Romania's fragile banking system and close financial ties to the euro-zone's southern periphery (especially Greece), the leu is likely to come under further pressure as the euro-crisis intensifies. **We've pencilled in an end-year target of 4.40/€, versus 4.35/€ at present.**

All told, we think further rate cuts are likely next year. But the key point is that this month's move is unlikely to mark the start of an aggressive easing cycle. **Indeed, with the crisis in the euro-zone set to deepen, there is a risk that the authorities may ultimately be forced to hike rates once again before too long.** For now we expect that concerns over growth will remain the priority for the NBR, prompting a 25bps interest rate cut to 5.75% at its January meeting.

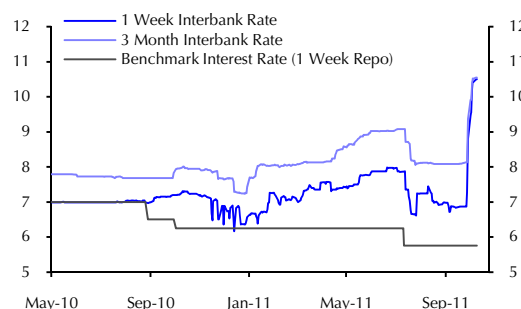
Turkey (23rd Nov, CE Forecast: unchanged)

Having pursued a low interest rate policy for the past year, firstly to deter speculative capital inflows and then to counter the deteriorating growth outlook, **the Turkish Central Bank (CBRT) has finally relented to growing pressure on the currency by raising interest rates, albeit via the backdoor.** Although this comes at a time when the economy is slowing, we think it is unlikely that there will be any change in policy over the next 6 months.

To tighten monetary policy, the CBRT is limiting liquidity provision via its 1-week repo auctions, the benchmark monetary policy instrument with an interest rate of 5.75%. Instead, more liquidity is being provided via overnight repo auctions, with an interest rate of between 12.0% and 12.5%. The result is that interbank borrowing rates have shot

up from around 7-8% in October to almost 11% in November. (See Chart 6.)

CHART 6: TURKEY – INTEREST RATES (%)



Source – Thomson Datastream

The CBRT has justified tighter monetary policy as necessary to tackle above-target inflation. Indeed, the headline inflation rate surprised in October, rising to 7.7% y/y, up from 6.2% y/y in September (a 3.2% m/m increase). However, this was driven by tax hikes, rather than underlying inflationary pressures.

Instead, the crux of the problem lies in Turkey's gaping current account deficit, which we expect to average 10% of GDP this year. This means that the Turkish economy is highly dependent on foreign capital inflows to fund its domestic demand. But with capital inflows harder to come by against the backdrop of financial market volatility in recent months, the lira has come under sustained pressure, falling below 1.90/US\$ at its trough in October. By tightening monetary policy, the CBRT is attempting to shore up the lira and prevent a disorderly balance of payments adjustment, with some success – the lira has traded at around 1.75-1.80/US\$ over the past couple of weeks.

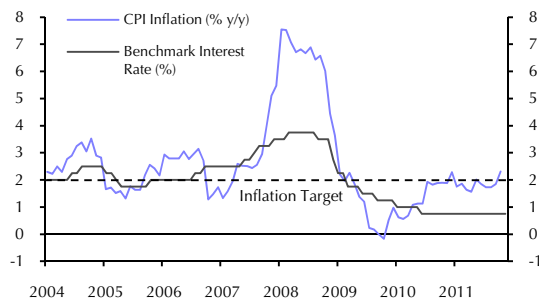
Of course, balance of payments adjustment entails a severe hit for domestic demand and the past month's monetary tightening add weight to our below-consensus view that **the Turkish economy will slip into a recession next year. But given the relative success the CBRT has had so far in stabilising the lira, we think policymakers are likely to leave interest rates on hold for the time**

being. That being said, it remains a clear possibility that the lira comes under renewed pressure, in which case policymakers may use other measures to tighten policy. One such step would be to raise the overnight borrowing (deposit) rate, by up to 50bps, from its current level of 5.0%.

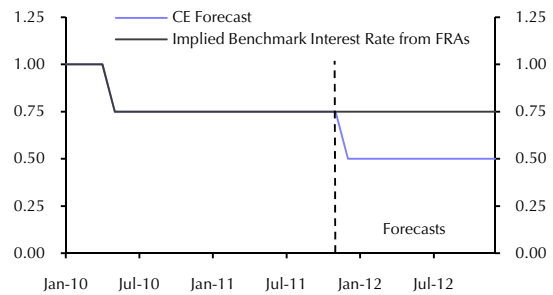
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Background Charts

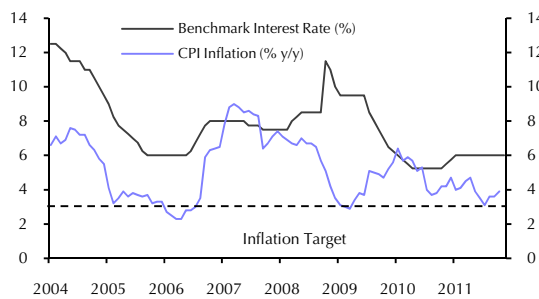
1. Czech Republic: Inflation and Interest Rates



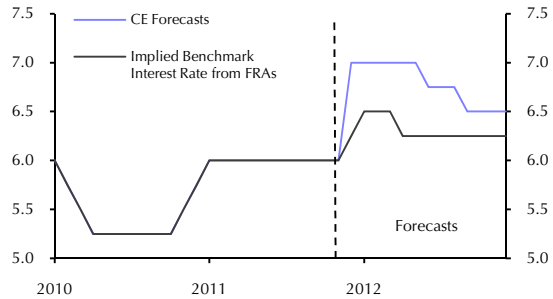
2. Czech Republic: Interest Rate Forecast & Expectations



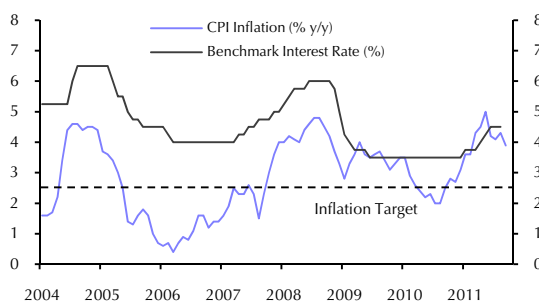
3. Hungary: Inflation and Interest Rates



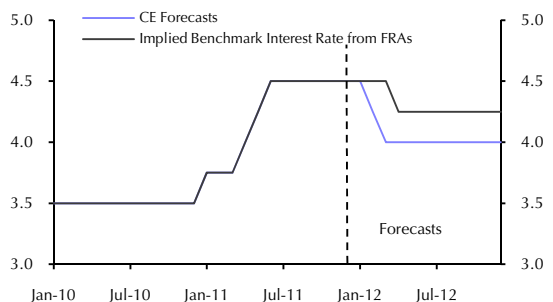
4. Hungary: Interest Rate Forecast & Expectations



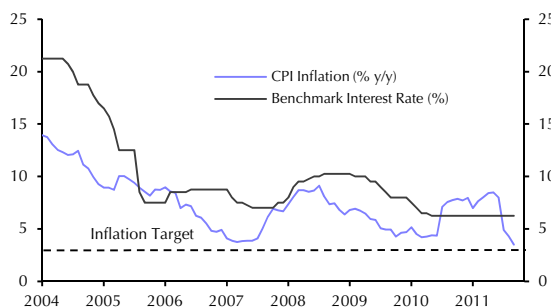
5. Poland: Inflation and Interest Rates



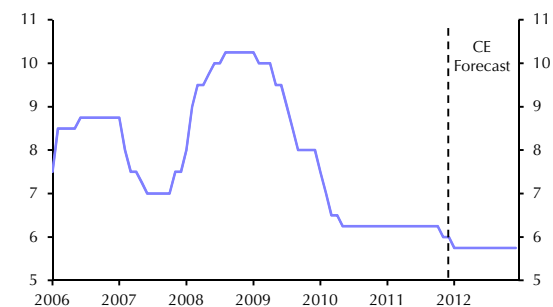
6. Poland: Interest Rate Forecast & Expectations



7. Romania: Inflation and Interest Rates

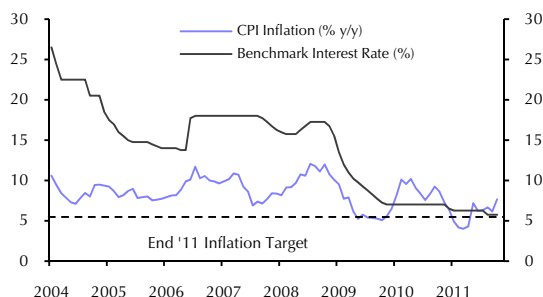


8. Romania: Interest Rate Forecast

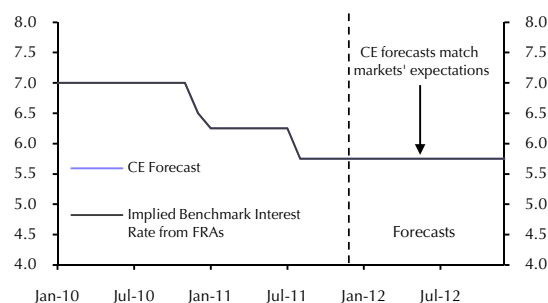


Sources – Bloomberg, Thomson Datastream, Capital Economics

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 2011.

Inflation Target 2%, with +/- 1% tolerance range.

Governor Miroslav Singer.

Interest Rate Meetings	Date	Outcome	Vote
	3 rd February 2011	0.75%	4-3 (Hold-Hike by 25bps)
	24 th March 2011	0.75%	5-1 (Hold-Hike by 25bps)
	5 th May 2011	0.75%	5-2 (Hold-Hike by 25bps)
	23 rd June 2011	0.75%	5-2 (Hold-Hike by 25bps)
	4 th August 2011	0.75%	5-2 (Hold-Hike by 25bps)
	22 nd September 2011	0.75%	Unanimous
	3 rd November 2011	0.75%	5-1 (Hold-Cut by 25bps)

Hungary

Interest Rate Meetings Meet monthly.

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

Governor András Simor.

Interest Rate Meetings	Date	Outcome	Vote
	18 th April 2011	6.00%	Unanimous
	16 th May 2011	6.00%	Unanimous
	20 th June 2011	6.00%	Unanimous
	26 th July 2011	6.00%	Unanimous
	23 rd August 2011	6.00%	Unanimous
	20 th September 2011	6.00%	6-1 (Hold-Hike by 25bp)
	25 th October 2011	6.00%	To be released on 16 th November

BACKGROUND INFORMATION (CONTINUED)

Poland

Interest Rate Meetings	Meet monthly.		
Inflation Target	2.5%, with +/- 1% tolerance range.		
President	Marek Belka (who has the decisive vote in the event of a tie, marked with an asterisk below).		
Interest Rate Meetings	Date	Outcome	Vote
	5 th April 2011	4.00%	9-1 (Hike by 25bps-Hold)
	11 th May 2011	4.25%	8-2 (Hike by 25bps-Hold)
	8 th June 2011	4.50%	9-1 (Hike by 25bps-Hold)
	6 th July 2011	4.50%	9-1 (Hold-Hike by 25bps)
	7 th September 2011	4.50%	9-1 (Hold-Hike by 25bps)
	5 th October 2011	4.50%	Details released in November Inflation Report
	9 th November 2011	4.50%	Details released in November Inflation Report

Romania

Interest Rate Meetings	8 Meetings in 2011.		
Inflation Target	3%, with +/- 1% tolerance range; 2.5%, with +/- 1% tolerance range from Jan. 2013.		
Governor	Mugur Isarescu.		
Interest Rate Meetings	Date	Outcome	Vote
	3 rd February 2011	6.25%	
	29 th March 2011	6.25%	
	3 rd May 2011	6.25%	
	29 th June 2011	6.25%	Voting breakdown unavailable
	3 rd August 2011	6.25%	
	29 th September 2011	6.25%	
	2 nd November 2011	6.00%	

Turkey

Interest Rate Meetings	Meet monthly.		
Inflation Target	5.5% at end-2011; 5.0% at end-2012.		
Governor	Erdem Basci		
Interest Rate Meetings	Date	Outcome	Vote
	23 rd March 2011	6.25%	
	21 st April 2011	6.25%	
	25 th May 2011	6.25%	
	23 rd June 2011	6.25%	Voting breakdown unavailable
	4 th August 2011	5.75%	
	20 th September 2011	5.75%	
	20 th October	5.75%	

Source – National Central Banks