Economics

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Central Europe Macro View

Trip Notes: Living in A Weak Growth World

- The deteriorating growth outlook is likely to put additional pressure on the fiscal positions of Central European governments. Hungarian authorities have already acknowledged such risk and come up with additional tightening measures. However, the commitment to keep ambitious fiscal targets, although aiming to support the government's credibility, creates a risk of a deepening economic slowdown in Hungary.

- The Polish government downplays fiscal risks related to slowing GDP and probably won't show any tightening measures in the election period. We expect the Polish Ministry to eventually revise its growth forecasts substantially lower, albeit only when the depth of the slowdown becomes more evident.

- In the Czech Republic, the central government budget is based on optimistic assumptions, but this is likely to be manageable and probably won't reverse the recent S&P rating upgrade as the government has been successful in approving its consolidation measures and long-term fiscal and structural reforms. Czech central government debt management is unlikely to face financing issues (unless we see a severe change in confidence in Czech assets) and the Eurobond issuance is still likely this year (to make a prefunding for next year), if we see better pricing.

- Despite economic slowdown, the Hungarian central bank is unlikely to cut interest rates anytime soon as this could increase HUF depreciation pressure thus raising the debt burden on households with FX mortgages. In the Czech Republic, we believe that the CNB is a bit behind the curve, but we do not expect a cut in policy rate; but we assume a weaker koruna compared to CNB's forecast and consensus.

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With thanks to
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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Trip Notes: Living in A Weak Growth World

Between 7 and 9 September, we held a series of meetings with central bank and government officials, local fund managers, political analysts and IMF economists in Czech Republic, Hungary and Poland. This note presents key conclusions regarding monetary and fiscal policy in Central Europe.

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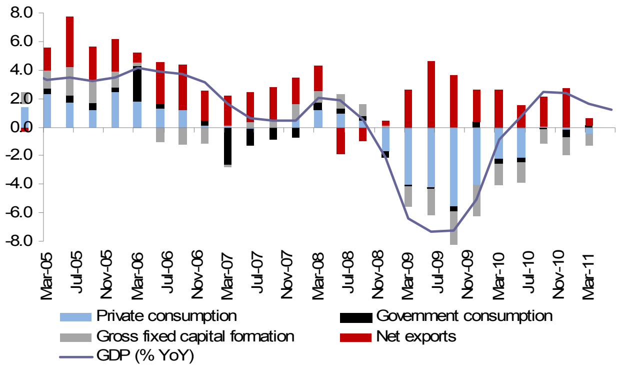
Hungary

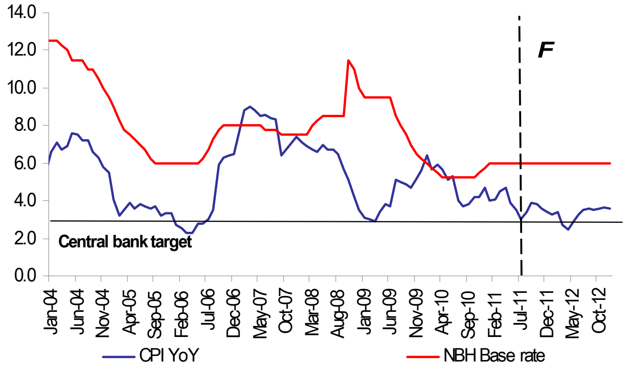
After a trip to Budapest, we maintain our view that interest rate cuts are not imminent in Hungary[1]. The common theme from our meetings with the central bank is that economic growth is likely to be much weaker than previously expected, while the output gap is currently negative and is not showing signs of narrowing. This view is partly based on second-quarter GDP data that showed continued weakness of domestic demand as well as the recent intensification of the euro area sovereign debt crisis. Taking this into account, the central bankers we met with feel quite confident the inflation rate will converge towards the CPI target in the coming months. Given this backdrop, we were a bit surprised by the cautiously hawkish tone of Hungarian policymakers. Despite a relatively gloomy economic growth scenario, NBH officials do not appear in any hurry to consider rate cuts anytime soon. In their opinion, due to the substantial share of FX loans in banks' balance sheets, the monetary transmission mechanism in Hungary is much more complicated than the textbooks would suggest. In particular, a rate cut could actually lead to tightening of monetary conditions via HUF weakening and thus a higher loan repayment burden. Also, according to a senior central banker, the elevated risk premium implies higher (real) equilibrium interest rates. Since such views are shared by internal, as well as (recently appointed) external, MPC members, we stick to our view that interest rates will remain on hold in the coming months and any changes – either up or down – will be dependent on the evolution of Hungarian risk premium. In other words, in our opinion, rate cuts would be possible if the situation in financial markets stabilises and the forint starts appreciating substantially, something we don't envisage this year.

Figure 1. Slowdown is driven by continued weakness of domestic demand



Source: HCSO, Citi Investment Research and Analysis

Figure 2. Inflation is likely to fluctuate around 3% target in the coming months



Source: HCSO, Citi Investment Research and Analysis

[1] We were in Budapest on 8 September and talked to the State Debt Management Agency (AKK), Economy Ministry, deputy NBH governor, two new MPC members, the IMF as well as local fund managers.

Another common theme of almost all our meetings in Budapest was the fiscal shortfall resulting from weaker-than-expected growth. The Economy Ministry lowered its GDP forecasts to 1.9%YoY in 2011 and 2% in 2012 from approximately 3% for both years, with substantial weakness coming from private consumption. The Ministry was open about a HUF100bn shortfall in the 2011 budget caused by growth underperformance but wasn't ready yet to share its estimates of the 2012 shortfall. Although government officials admitted this number could be at least twice as large as 2011, we estimate the actual gap could easily exceed HUF 350bn. This would imply that the 2012 general government deficit could reach 3.8% of GDP, well above the 2.5% government target.

The Hungarian government is committed to keeping the budget deficit under control and is planning to tighten fiscal policy to offset revenue underperformance. Economy Ministry officials said this year's shortfall will be tackled with a mix of higher excise taxes (on tobacco, fuels, alcohol, gambling), better VAT collection, higher dividends and public procurement freeze (Figure 3). This should plug the HUF 100bn hole in this year's budget but will create only HUF 60bn of revenues for 2012. Ministry officials didn't want to elaborate on planned fiscal tightening measures for 2012 as our meetings took place before the government took final decisions on the fiscal adjustment programme.

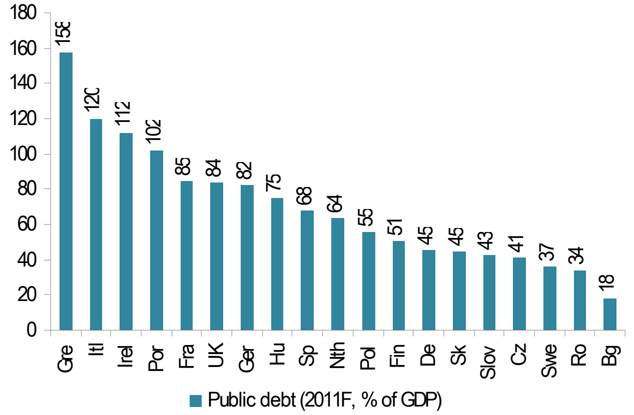
Figure 3. Additional fiscal measures planned for 2011-2012

	2011	2012
Excise duties	10	60
Improved VAT collection	40	-
Dividends	10	-
Public procurement	40	-
Total	**100**	**60**

Source: Finance Ministry of Hungary, Citi Investment Research and Analysis

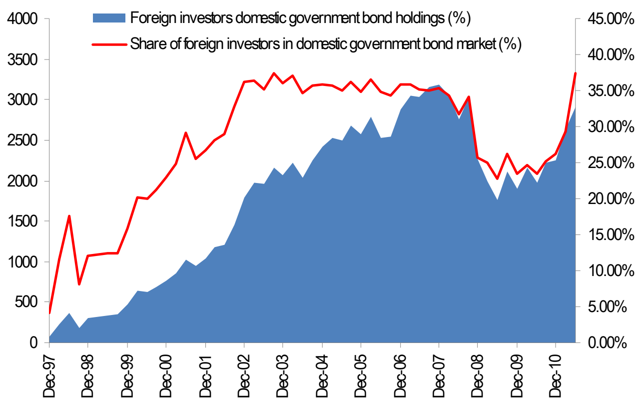
Although fiscal tightening plans aim to reassure bondholders and avoid a sell-off on the bond market, they are also likely to weigh on economic growth in the coming quarters. This is all the more so that they come on top of earlier tightening included in the so-called Széll Kálmán plan. The weaker economic performance will make deficit reduction more difficult as it creates a risk of a vicious circle of tighter policy, weaker growth and underperforming budget revenues. Taking into account the unfavourable external environment, we doubt that such fiscal tightening efforts could lead to improvements in private sector confidence sufficient to create non-Keynesian effects (i.e. to contribute to stronger economic activity as a result of tighter fiscal policy). This suggests the government would need to strike a balance between keeping the deficit under control and allowing for at least moderate economic growth. Having said this, we believe the government's forecast of around 2% GDP growth in 2012 is overly optimistic. Our forecast assumes next year's growth will reach 1.6%YoY but we believe the implementation of fiscal tightening measures could push it even lower, perhaps towards 1%.

Figure 4. Debt reduction has been one of the key priorities of the Hungarian government



Source: Eurostat, Citi Investment Research and Analysis

Figure 5. Foreign investors' holdings of HUF bonds are rising



Source: NBH, Citi Investment Research and Analysis

According to the state debt management agency (AKK), thanks to keeping the budget deficit under control, next year's domestic market issuances are likely to fall slightly compared to 2011. As far as external debt markets are concerned, Hungary is not planning any additional issuances this year and wants to sell bonds worth EUR 4bn in 2012 which would imply zero net issuances on external markets. However, given unfavourable market conditions, even such limited supply of external debt could be difficult to place on the market, in our view. Interestingly, the AKK is not considering an option to prefund 2012 borrowing needs as this might be against the government's commitment to keep public debt on a consistently downward path. Similar to Polish policymakers, Hungarian officials don't see any easy solution to a substantial increase in foreign investors' holdings of local government bonds (Figure 5). The AKK believes the share of foreign investors in the domestic debt market is already in the "discomfort zone", especially given a risk of simultaneous position reduction of investors in case of unfavourable external shocks. However, since the Hungarian debt manager lacks any tools to control foreign investors holdings, we don't expect the AKK to take any actions to change recent trends.

Poland

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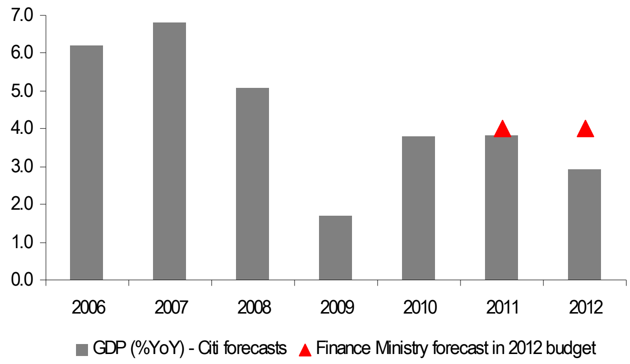
Compared to Hungary, the Polish Finance Ministry still seems in a denial phase, downplaying fiscal risks related to economic slowdown[2]. The Ministry is retaining its 4%YoY GDP forecast in 2012 and apparently believes the slowdown in the euro area and in particular in Germany will be less harsh than widely believed. Taking into account these macroeconomic assumptions, the Polish government maintains its ambitious forecast of the general government deficit falling to only 3% of GDP next year from 7.9% in 2010. Although this year's budget performance is quite strong and could lead to substantial undershooting of the state budget deficit, we don't share the Ministry's optimism regarding 2012. Given approaching parliamentary elections (9 October), it is not surprising the government is not vocal about potential fiscal threats, but we expect the topic will come to the fore later this year or early in 2012 when it is likely to become more evident that

[2] We were in Poland on 9 September and met with central bank officials, debt management and economic analysis teams in Finance Ministry, the IMF and a political analyst.

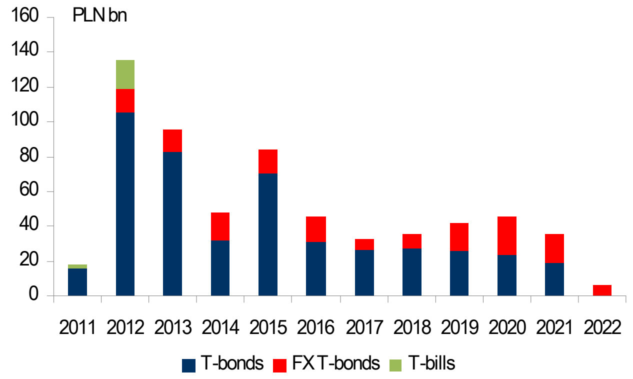
next year's fiscal target is overly optimistic. According to our estimates, the general government deficit will reach 4.0-4.5% in 2012 and this forecast assumes weaker domestic demand growth, lack of spending rules for local governments and possible small fiscal slippage. According to our calculations, assuming the EUR/PLN rate at around 4.30, this would result in public debt rising to 53.5-54.0% of GDP by the end of 2012. Although such debt level would be still lower than the 55% of GDP threshold written in Polish public finance law (the breaching of which would trigger painful fiscal tightening), it seems pretty tight, especially given a risk of potential further weakening of the local currency. Taking this into account, we expect after elections the government will eventually come up with additional tightening measures equivalent to around 1% of GDP.

Figure 6. The Finance Ministry seems overly optimistic in its GDP growth forecasts



Source: Finance Ministry, Citi Investment Research and Analysis

Figure 7. Government debt redemptions

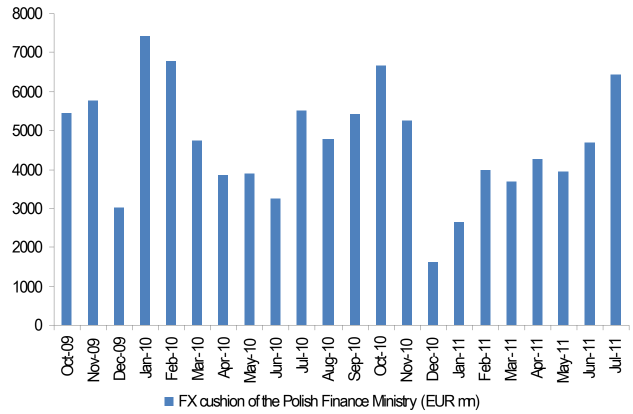


Source: Bloomberg, Citi Investment Research and Analysis

As argued in our earlier notes, we believe the lack of fiscal space is one of reasons why Poland is unlikely to repeat its stellar outperformance from 2009 (see *Not so resilient anymore* dated 25 July 2011). Although two years ago Poland was able to use counter-cyclical fiscal policy to offset the impact of external shocks and thus avoided recession, this time room for such fiscal stimulus doesn't exist. Actually it seems to us this time fiscal policy will become pro-cyclical and will additionally depress economic activity. Having said this, our current forecast assumes 2012 economic growth will slow below 3%YoY and will be than 1% point lower than the Finance Ministry is projecting. We believe also that risks to our forecast are skewed asymmetrically to the downside.

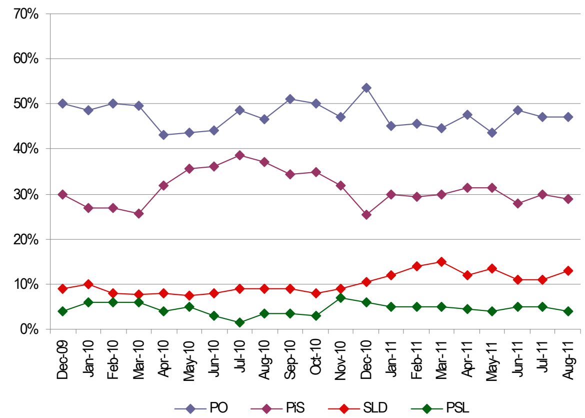
On the positive side, the Finance Ministry has secured funding for almost its entire borrowing needs for 2011. Additionally next year's gross issuances are likely to be lower than initially expected. Instead of PLN 185bn gross borrowing needs, the Finance Ministry is now targeting PLN 164bn, as smaller supply of T-bills this year and planned switch auctions in the coming months should reduce next year's redemptions by PLN 11bn and PLN10bn respectively. This implies issuances in 2012 are likely to be somewhat smaller than previously thought partly reducing pressure on yields. However, if the market situation doesn't stabilise in the coming months, we expect even selling PLN 164bn of bonds could prove difficult.

Figure 8. Foreign currency cushion at Finance Ministry's disposal



Source: Finance Ministry, Citi Investment Research and Analysis

Figure 9. Opinion polls suggest ruling party PO is a clear leader in the election race



Source: Reuters, TVN24, PAP, CIRA. Note: Opinion poll conducted by GfK Polonia (30 August 2011)

The government continues its policy of selling foreign currency directly on the market and thus smoothing fluctuations of the PLN. Foreign currency comes either from external bond issuances or from EU funds that are regularly transferred to Poland to finance infrastructure projects. The Ministry said it usually has at its disposal EUR 2-3bn of EU funds and additionally around EUR 3.5bn of other FX funds while foreign exchange is gradually exchanged on the market depending on needs of EU fund beneficiaries. Given seasonal patterns in infrastructure projects and the fact the Finance Ministry wants to keep end-of-year PLN rate at a strong level[3], we expect an intensification of the Finance Ministry's operations in the FX market in last 1-2 months of the year. Finance Ministry officials admitted – and we agree with this view – such FX operations could help stabilise the PLN in relatively calm periods but could be insufficient in more volatile periods. Interestingly, the government has put a lot of emphasis on good co-operation with the central bank that has at its disposal a much larger pile of FX reserves (EUR 64.4bn). Although this looked to us like a suggestion the central bank might act in any moment, we still believe the central bank will not be in a hurry to intervene and it may need to see a much weaker PLN to enter the market.

One important topic in our discussions was the approaching parliamentary election (9 October). Opinion polls suggest the ruling party PO is the clear leader in the election race but there is much more uncertainty about its possible coalition partners after the results. According to a political analyst we talked to, a coalition of opposition parties PiS and SLD seems unlikely due to fundamental differences in the programmes of both parties. The continuation of incumbent coalition (PO-PSL) appears to be the most likely scenario (at least from opinion polls' point of view) and this could provide some stability in terms of economic policy. However, given more balanced rhetoric of the PO than during previous elections and less ambitious policy priorities in their programme, it is uncertain what reforms could be expected after the 9 October vote (for our recent comment on Polish politics, see Poland Macro View).

[3] These are end-of-year PLN rates that are used to calculate the value of public debt to GDP. Therefore they have impact on whether Poland breaches or not the 55% of GDP public debt threshold which shows the Finance Ministry has a preference for stronger zloty in December.

Czech Republic[4]

Growth to ease below official forecast

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We expect GDP growth to average 1.5%YoY over the next one and half year – a view that is below the expectations of the CNB and MoF. The August CNB forecast looks for 2.2%YoY growth in 2012 driven by private consumption and investment activity, while the July MoF's forecast sees even stronger GDP growth of 2.5%YoY in 2012 also driven by private consumption and investment activity but also by net foreign trade. We expect both institutions to revise downwards their forecast, particularly reflecting a weaker outlook for foreign demand as the upward revision of the consensus forecast of euro area and German GDP peaked around the time the CNB and MoF numbers were being forecast.

Monthly indicators confirm that we are on an easing path. Industrial production growth eased to 6.8%YoY (wda) in July from 7.9% in June and while we expect a stronger MoM outturn in August, industrial production is likely to ease in September falling to 2%YoY on the back of a regular temporary stoppage at a refinery industry. We expect industry will grow 4-5%YoY in 2012, beating the 1.1% expected for the euro area. The main downside risks to our forecasts are the flagging export activity. Domestic demand has remained weak with retail sales still in contraction in July, although 2Q wage data improved while the unemployment rate also improved in August. However, both positive factors did not prevent a lower-than-expected CPI growth outturn again in August.

All in all, the economic policies, which we discuss below, are likely to result in (at least) less tighter monetary policy and tighter fiscal policy.

CNB likely to keep its policy rate unchanged, if MCI eases

We expect CPI inflation to undershoot the CNB forecast on the monetary-policy horizon. Although we expect CPI inflation to accelerate to 2%YoY in 4Q11 from 1.7% in August, it is unlikely to undershoot the CNB's 2.3% forecast. However, as we forecast sluggish private consumption growth in 2012, we think profit margins will remain under pressure and our forecast of milder koruna appreciation is likely to pass through later – here we see an upside risk to our forecast. Hence, we look for adjusted core CPI to also contract next year. This, accompanied by a lower oil price, is likely to partly offset any upside impact of the hike in the lower VAT rate in January 2012 (which is likely to be around 1% points). Hence, we forecast headline CPI inflation will be above the CNB target, but within the tolerance band and below the CNB's forecast of 3.2% in 2012 – that is unless we see any upside price shock to agriculture commodities re-emerge.

While price expectations remained elevated, the labour market data are decisive and likely plausible for the CNB to sound in dovish tone. Households' price expectations for next year have eased somewhat in recent months, but remain above the current assessment of the price growth that actually increased in August despite the actual CPI surprising the CNB and consensus on the downside. In addition, the labour market has not been inflationary. The weakness in the labour market – where there is around 12 people unemployed for one vacancy – has kept wage growth (also only in the business sector) behind the previous surge in households' price expectations. Our meetings with CNB officials support our view that better 2Q wage data will be downplayed. And as we expect GDP growth to be below its potential, in fact we actually expect the negative output gap to widen, we

[4] During our trip to Prague last week (7 September), we met with officials from the CNB and Ministry of Finance

feel the CNB could be more negative on the unemployment rate (which will be lowered by the demographic effect) as long as it revises downwards its GDP growth forecast in October, more below its potential growth, which we understand is probably 2.0-2.5%YoY.

The monetary conditions index is likely to ease due to higher CPI and weaker koruna; if not, the CNB is likely to sound more dovish. The current CNB forecast is accompanied by both disinflationary risk (particularly lower foreign interest rates) and inflationary risk (weaker koruna). Hence, we understand that the Bank Board will watch the monetary condition index (MCI) to asses its policy. Our estimate of the MCI suggests a mild tightening of monetary policy through 2011 compared to 2010. However, it has stabilised as the koruna has traded in the 50 haler range since the beginning of 2011 and real rates remained virtually unchanged after they eased owing to the CPI acceleration in middle of 2010. Our MCI forecast suggests its mild easing for months ahead reflecting higher CPI growth as well as weaker koruna and a return to current levels around 1Q13.

Alternative shocks – 'Swiss koruna', no thanks. Although the koruna is currently viewed as a mild inflationary risk, some market participants see potential to show a strong appreciation as was the case in 2H07-1H08 due to being a relative safe haven, particularly after the S&P upgraded Czech foreign rating by two notches and the Swiss franc has a protected barrier to appreciate below 1.20 against the euro. If this materialises, the MCI would become tighter and the CNB would likely react through interest rates. However, the size of this move would be limited given its policy rate currently stands at 0.75%. Hence, intervention would become more likely – firstly verbal and potentially followed by intervention in the FX market (this has not been done since 2002). Such a step would have a higher chance of success as it is consistent with the interest rate policy. We understand that the CNB still distinguishes between potential intervention to weaken the koruna (monetary policy) and daily sale of its yields from FX reserves (FX reserves management).

All in all, we expect the CNB to keep the main policy rate unchanged at 0.75% until around the middle of 2012. Therefore, we expect the CNB to sound dovish on 22 September. This suggests the Bank Board is likely to reiterate the downside risks, which are likely to postpone the first hike in the policy rate to a later period than the CNB August forecast suggests (which was pointing to the end of 2011). As usual, there is unlikely to be an update on the indication of timing, but the newly published GRIP chart should provide an indication of the possible size of an adjustment. The market has started to speculate on a possible cut in the CNB's policy rate. We think this may be premature and our forecasts do not point to this. However, Citi expects the ECB to put in place extra non-standard measures. If this materialises on 6 October, it would support additional dovish expectations before the CNB November meeting (3 November, together with the ECB).

Fiscal policy likely to face manageable challenges

The economic slowdown and prospect for tighter fiscal policy are likely to exacerbate coalition tensions. The central government deficit has been negatively influenced by tax collection and the wider deficit in August is challenging. The 12-month rolling deficit widened to CZK165bn in August. This expansion of the deficit could be a challenge for the government to narrow the 2011 deficit to CZK135bn. Hence, unless we see greater revenues in September, the government will likely remain prudent on the expenditure side. However, the lower interest rates are likely to help to meet the deficit target, as was the case in 2010. Moreover, the tensions have been already apparent after the discussion about the draft of 2012 central government budget that plan to narrow the deficit to CZK105bn. Particularly the

junior coalition centrist party Public Affairs (VV) asked for additional expenditures. As the economic slowdown – our 2012 GDP forecast at 1.5%YoY is below the MoF's 2.5% – suggests a shortfall of CZK10-15bn and the government committed to expenditure ceilings and a deficit target, we do not see much room to meet VV's requests, unless the government cuts expenditures in other areas. We see the proposal of the Prime Minister Petr Necas (ODS) to unify the VAT at 19% in 2012 (instead of gradually unification at 17.5% in 2013) as part of bargaining with the VV. However, we expect the unification of VAT rates at 19% in 2013.

Factors for bonds markets – larger 4Q issuance, rating upgrade, issuance for households, pension reform and still possible eurobond. As we reported recently, the MoF plans to do a larger issuance of local bonds at CZK50bn and T-bills of CZK54bn in 4Q11. Taking into account current lower sales at non-competitive auction, the total issuance of bonds point to around CZK176bn – in the lower range of planned issuance for this year at CZK174-194bn. The Ministry of Finance plans to issue the first auction of bonds for households (both resident and non-resident) of around CZK10bn. This would become regular supplementary source of funding and also it would increase the interest of citizens over Czech fiscal sustainability. Also the approved pension reform is a positive supply/demand factor for local bond market. However, likely not in a full size of contributions into the 2nd pillar as the 2/5 of these contributions are additional savings that are likely to be partly taken from other investments (partly including also Czech government bonds).

The larger local bonds issuance in 4Q11 and wider spread between Czech local yields and Czech eurobonds suggests a later issuance. But we understand that the Ministry of Finance has not ruled out the possibility of doing the issuance this year, as prefunding for the next year, as the MoF is likely to have similar borrowing needs as in 2011 (strategy for 2012 is likely to be published on 12 December). There is still a valid the agreement between the government and the CNB about hedging of foreign issuance against FX risk, but we feel that there are various strategies that can be used to meet this requirement. Therefore, we would expect that the possible issuance would be a positive factor for the Czech koruna. The Ministry of Finance also expects the share of foreigners in local bond market to increase gradually from 16% in July 2011, particularly after the S&P rating upgrade and after two new foreign banks have recently became primary dealers.

The government has been recently successful in approving its reforms in September. The Parliament approved the social reforms, which were necessary as the Constitutional Court requested their re-approval this year, as the approval process in late 2010 was not in line with the Constitution – hence, it is only a mild positive factor. Also the reform of the healthcare system has been approved, but this is likely to be attacked by opposition at the Constitutional Court. Moreover, the government is likely to set the **"Above Standard Acts"** (the standard operations should be covered by insurance, the above standard from cash) – a key part of this reform – for 2013. The amendment of the Labour market law was approved, which is likely to increase the flexibility of the labour market. Finally, the pension reform – introduction of the 2nd pillar – was approved in first reading. The government expects up to 50% of employees to join the system and the opt-out transition costs are estimated around CZK18-20bn per year. Opt-out costs reflect a 3% points transfer from pension social contribution of total 28% of gross wage. These costs should be covered by the hike in the VAT and depends how many employees participate as the 2nd pillar will be voluntary and savers have to add 2-3% transferred from the PAYG. This would be negative for long-term fiscal sustainability, if there is a low participation.

Appendix A-1

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