



Theme #8: EMEA Reality Check

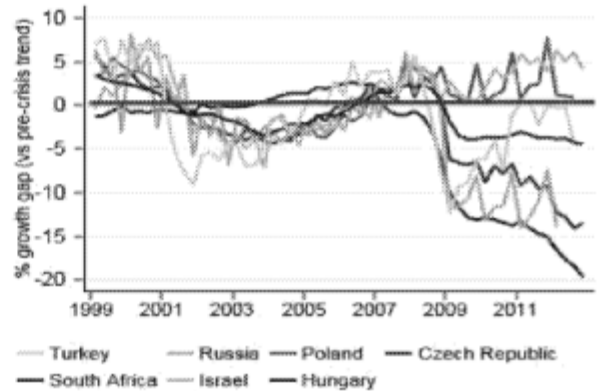
There are a number of sub-plots and potential themes currently in EMEA FX, but rather than impacting significantly on price action, they seem to have led to paralysis, with correlation patterns versus traditional drivers having converged to near zero in many cases. That is unlikely to last and over the next couple of months we are likely to see a mix of global themes and country-specific factors having much more of a significant impact on price action.

In EMEA, the impact of the external backdrop is potentially very mixed. The subdued external inflation environment means that economies with large negative output gaps will be less sensitive to currency weakness, and more inclined to continue to push through rate cuts, if not regardless of FX, at least as long as FX depreciation is orderly. Hungary's NBH have made it very clear that the focus is on growth, and that inflation is taking the back-seat for now. Consequently, the NBH rate cutting cycle continues unabated, with the Bank now having reduced the base rate down to an all-time low of 4.75% from 7.00%. The poor domestic backdrop, the need for further fiscal austerity in order to secure EDP exit and headline CPI at a record lows suggest rate reductions will continue, with the rates market currently pricing in around 100-125bps of further easing. Indeed, weak data, the non-domestic PPI running at a mere 3.2% YoY, coupled with global disinflation and relative currency strength also lower the bar for 50bp rate cuts (during all NBH easing cycles since the turn of the century the bank has at some point reduced rates by more than 25bps) and/or a more prolonged easing cycle.

Elsewhere, South Africa's SARB seems to be warming to the idea of rate cuts despite a relatively weak ZAR. Governor Marcus recently emphasized the importance of a free-floating exchange rate as a shock-absorber, and argued that a weaker currency would be crucial in dealing with the country's large trade and C/A deficits. She also pointed out that medium-term inflation expectations remain well anchored. These comments definitely appear more dovish than before, particularly with regard to the exchange rate and would suggest the Bank is ready/willing to accept a weaker currency as long as the sell-off does not become disorderly.

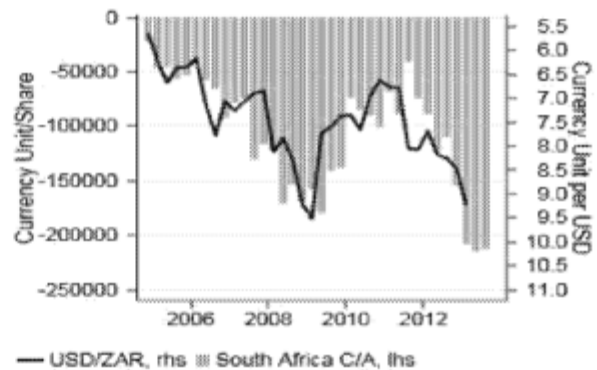
The Czech National Bank (CNB), meanwhile, falls into the category of central banks not just willing to accept but which would welcome currency weakness, in order to counter persistent disinflation. Indeed, Governor Singer recently reiterated his view that interest rates will stay near zero for a "very, very long" time, and

Figure 1: Dramatic differences wrt the 'growth gap' in EMEA (relative to pre-crisis trend)



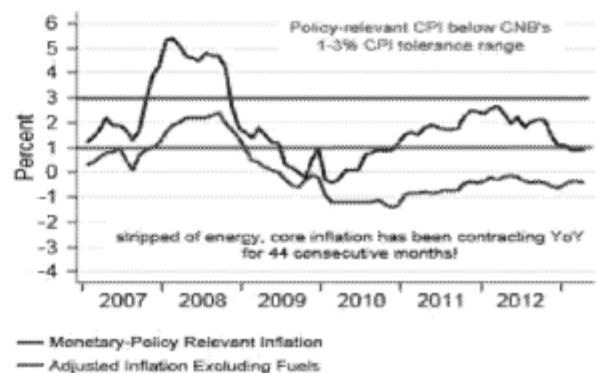
Source: Deutsche Bank

Figure 2: SA C/A deterioration to lead ZAR even lower?



Source: Deutsche Bank

Figure 3: Persistent Czech disinflation/deflation



Source: Deutsche Bank