Monday, November 24,

Central European Weekly

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Czech Republic

Czech inflation beats a quick retreat

Hungary

Falling domestic demand could help to mitigate the effect on inflation of a weaker forint

Poland

MPC will wait with the cut for the Q4 GDP data and the inflation projection in February

Slovakia

ARDAL plans Eurobond issue in Q1 09

The Week Ahead

The Hungarian and Polish central bank are expected to stay on hold this month

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.72	2.07%	↗	→
EUR/PLN	3.872	4.45%	→	↘
EUR/HUF	267.1	-0.81%	→	↘
EUR/SKK	30.43	0.18%	→	→
3M PRIBOR	3.75	-0.13	→	→
3M WIBOR	6.51	-0.05	↘	↘
3M BUBOR	0.00	-11.70	→	↘
3M BRIBOR	3.10	-0.17	↘	↘
10Y CZK	4.47	-0.15	→	→
10Y PLN	6.39	0.01	→	→
10Y HUF	9.38	-0.42	→	→
3M EURIBOR	4.02	-0.14	↘	↘
10Y EMU	3.40	-0.31	→	↘

Last values from Friday 16:30 CET

NBP waits for a missing agreement on the euro entry

The upcoming week in Central Europe will be particularly interesting for Hungary and Poland, where **meetings** of their respective **central banks** will be held. Unlike the Czech Republic, where official interest rates are low and will continue to go down aggressively (see our new revised outlook for the CNB), we do not expect the NBH and the NBP to follow this example. However, the reasons why the NBH and NBP will not cut rates at their forthcoming meetings are quite different. The situation in **Hungary** is somewhat simpler: the central bank will come up with an Inflation Report, which is going to be more favourable in terms of inflation, but the economy, which 'flirted' with the currency and banking crisis and is currently under the guidance of the IMF, cannot afford a cut in official interest rates. On the contrary, the NBH will need to keep domestic interest rates high, to support the forint, and keep capital in the economy in these turbulent times. **The Polish story** is absolutely different. Poland's macroeconomic situation, which is far better than that of Hungary, would strongly encourage the NBP to cut rates rapidly. Given the falling commodity prices and significantly decelerating domestic demand, Poland's inflation outlook has also improved greatly, and inflation is very likely to fall back to the target value (2.5%) in 2009. Nonetheless, a limiting factor, which does not allow Poland's Monetary Policy Council to start the cycle soon, is not only the weak local currency but particularly the fact that the central bank is not certain about the eventual date of accession to the Euro zone. January 2012, which implies meeting the inflation criterion in 2010, is still possible, and this means that the bank should maintain a tighter monetary policy rather than running the risk that the failure to comply with the criterion will eventually become an obstacle to quick accession to the Eurozone.

Czech Republic

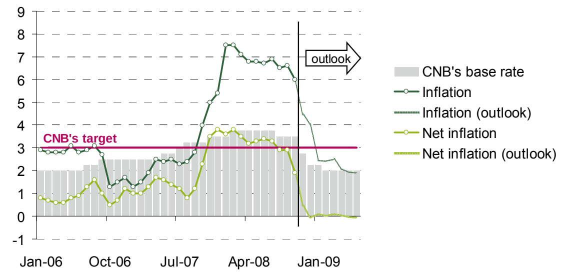
Macro review

The current situation in foreign oil and petrol markets, along with falling agricultural commodity prices and decelerating economic growth favours a faster decline in **inflation** than originally expected. The significantly lower inflation rate which will be apparent in the November's inflation figures and will persist in the CR in the months to come. Inflation will thus develop better than the CNB anticipated in its latest forecast. Latitude for another rate cut is reopening.

Inflation was already better than expected in October, when it declined from 6.6% to a precise 6%. We are likely to see inflation fall again in November, probably as low as 4.5%. This is primarily due to cheaper raw materials and the high comparative baseline of the previous year, when food prices went up rapidly, because of a VAT increase and a rapid rise in the prices of agricultural commodities. In recent months, inflation has been strongly pushed downwards by falling fuel prices. This will be particularly obvious in November, but we should also bear this factor in mind in the months to come, as there is still significant latitude for a further decline in petrol as well as diesel prices in the market. A similar situation applies to food prices, which are going down slightly; however, the rapidly falling agricultural commodity prices have not made themselves fully clear in retail prices so far. End-of-year inflation has a good chance of falling back to 4.0%.

Using the CNB's language, we can say that the significant risks to inflation are on the downside. Since the last forecast, inflation has developed better than the central bank had anticipated. The latest inflation figure (October's) lagged behind the CNB forecast by 0.4 percentage points and the difference may extend to as much as 1 percentage point by the end of the year. Inflation is expected to drop again in early 2009, to 3%. In addition, it will be largely driven by administrative moves (energy, rent), and thus net inflation, adjusted for these effects, may even hit zero. Hence there is more latitude for the CNB to cut rates again, after the latest rate cut at its October meeting, when the bank cut rates by 75bps. The central bank might lower rates again at the next **CNB Board meeting** (December 17), by 0.5% this time. The CNB meeting will be preceded by a meeting of the ECB, which will probably cut rates to the same extent. Regarding the koruna, nothing has changed. As far as the money market is concerned, another rate cut, along with the central bank increasing its refinancing operations by additional repo transactions, the CNB's rate cut might trigger the convergence of market rates towards central bank rates. In the first quarter of next year, the CNB's base rate might subsequently go down to as low as 2%.

Inflation
(y/y, %)



Currency

EUR/CZK technical picture

(25.6700): Drop from 26.2450 retested 23.8500 but could not extend below it (see graph).
1st support area at 25.4600/ .4300 (break-up daily/ hourly), with next levels at 25.1190 (Nov 14 low), ahead of 24.8580 (rising weekly Medium Term Moving Average): needs to settle back below to put CZK on better footing.
1st Resistance area at 25.8770 (Nov 19 high), with next level at 25.9200 (weekly Bollinger top), where a pause is favoured.
Failure to cap would see next levels at 26.2450 (current recovery high off low): tough on 1st attempts.
In case of move to new recovery ground, next levels at 26.5270 (weekly Starc top), ahead of 26.5540 (50% 28.7970 to 22.9250), where pause favoured.

DAILY CHARTS:

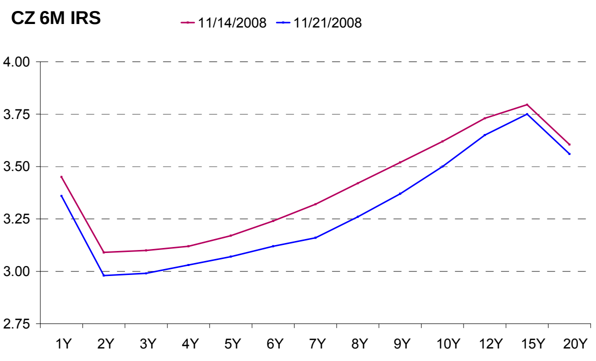
The **Czech koruna** weakened further to near 25.85 EUR/CZK as sentiment on global markets remained nervous (the dollar strong and the regional peers weak). The koruna continued to ignore more or less favourable domestic statistics (after a surprising acceleration of GDP also better than expected retail sales).

We believe that although the Czech currency remains vulnerable to further selling it may not be as drastic in the upcoming sessions. We see strong resistances at 26.25 EUR/CZK

Fixed income

The **Czech yields** shifted downwards especially on the short end of the curve. This was mainly thanks to the favourable core market sentiment and slightly higher demand. Also the auction of an 8-year floater came out surprisingly stronger. The new repo-operation that should provide liquidity for 3-months was widely ignored and the situation on the money market remains tight.

The scenario for next week is very much the same. Yields on the short end of the curve remain attractive. If positive sentiment on core markets prevails we see further space for a bullish steepening.



Hungary

Macro review

The **IMF** published its staff report on Hungary's balance of the credit crisis. It gives a comprehensive assessment about the refinancing risk of the external debt and possible sources of its replacement. Generally, the Report seems to assume (our estimation, not stated) an exchange rate of EUR/HUF 290 and continuous capital withdrawal from equities and debt. It concludes that the full €20bn financing could be used to ease liquidity constraints, but says that investors' confidence could improve in the second half of 2009, well before the program finishes in March 2010.

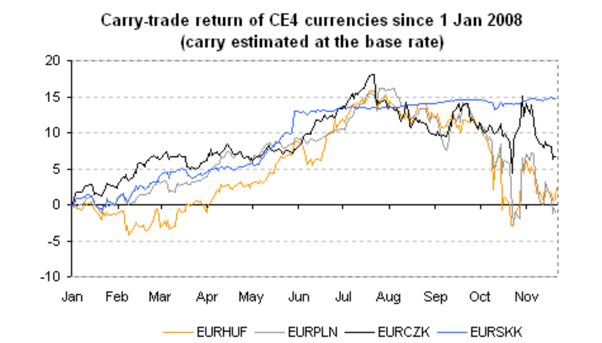
The likelihood of a **recession** intensified last week by the September industrial production data showing a 5.3% Y/Y decline, while third quarter GDP data were also below expectations. The preliminary GDP release showed a mere 0.8% growth over a year-ago, well below the consensus forecast of 1.2%. This has reinforced expectations about a recession in 2009 and even the risk of a deeper, 2-3% contraction of the economy should not be ruled out completely. As we wrote last week, falling domestic demand could help to mitigate the effect of a weaker exchange rate on inflation as the relatively strong pass-through between the exchange rate and inflation makes instability one of the biggest risk for achieving the 3% inflation target.

The **Central bank meeting** therefore will be an important event as the new Inflation Report will be thoroughly examined by market participants in order to look for additional information about the new inflation path. Council members however have emphasised recently that inflation is still the key medium-term goal, but safeguarding stability of financial markets is the top priority for now. This could mean that albeit inflation may not be significantly higher than what was outlined in the August report, tight monetary conditions could be maintained.

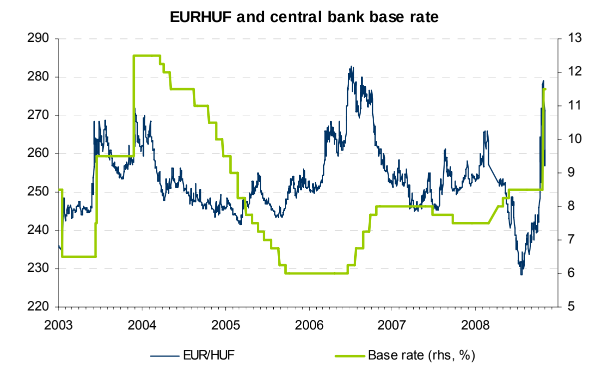
Currency

The currency weakened on the fragile growth prospects and hit the key level of 272.60 on Thursday. This was followed by a quick recovery to around 265-268 on Friday as other emerging market currencies recovered.

The **forint's** relative performance has clearly improved after the 300 bps emergency rate hike on 22 October and it has slightly outperformed the zloty and the (Czech) koruna if the carry differential is also taken into account. Whether there will be similarities with the 2003 (December) and the 2006 forint crises is an interesting question. In both earlier cases, the forint had a massive weakening first followed by gradual and slow stabilisation. This stabilisation period lasted for some 2-3 months with recurring market volatility. However, the range of second and forthcoming waves narrowed and therefore the market was trying to draw a triangle with an upward sloping resistance level and a downward sloping support one. The new recovery trend started after these two crosses each other.



Now we could be in the second wave thus volatility may stay with us for some more weeks, but relatively calmer trading during the year-end period could eventually mean lower volatility, which later on could yield some more support to the high-yielder forint. This would mean a range of 260-275 in November and probably for some time in December, followed by a period with a narrower range and more stable trading later. In 2009, the chance is probably for at least some recovery towards 250-260 if investors' confidence improves and the double-digit interest rate environment attracts at least some portfolio investment.



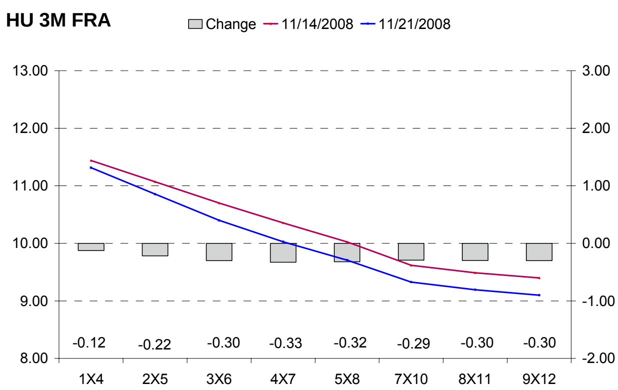
Fixed income

The **bond market** has basically hibernated as volume fell to low levels, but this is far from the freeze we saw in October and could therefore be seen as an overall improvement. Asset swap spreads are still wide and very few investors take up the risk of buying in the current situation, while foreign investors' capital flight has softened. They sold some Ft700bn during the crisis as their bond holdings fell from Ft3300bn to Ft2600bn, where it has been stable in the last week. This stability could however help volatility to decrease, which in turn may make bonds more attractive.

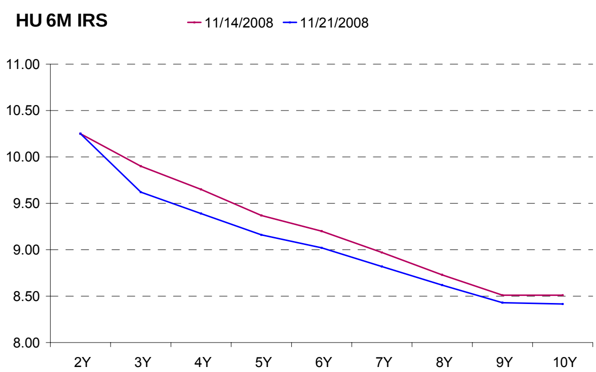
EUR/HUF technical picture

(266.50):1st Resistance area at 273.25/ .50 (Nov 20 high/ 61.8% 286.30 to 252.79), where pause favoured to set in.
If wrong, risk towards 278.39/ 279.00 (76.4% 286.30 to 252.79/ long term reaction high hourly + (weekly Bollinger top): tough on 1st tests.
Support at 264.00 (break-up daily Nov 06), with next level at 260.15 (reaction low hourly).
256.50 = rising weekly Medium Term Moving average: favored as range bottom.

DAILY CHARTS:



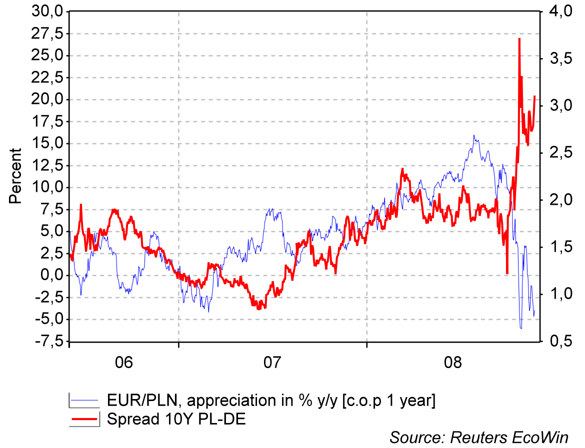
Resource: Reuters



Poland

Macro review

The vote arithmetic suggests the **MPC is on the verge of cutting rates**, with either moderate Jan Czekaj or dovish Stanisław Nieckarz likely to be the median voter. Interestingly, Czekaj has been quite dovish in the last weeks, while declared-dove Nieckarz indicated he would support the motion to stay on hold until early next year. Our baseline scenario is that the motion will eventually fail to get the necessary majority by the smallest of margins as the Council remains wary that a tougher policy stance might be warranted in case the government sticks to its ambitious euro zone entry plans. The meeting of the Prime Minister with the MPC and NBP board members last week failed to produce spectacular results, although it did signal that the central bank would be cooperating very closely with the government so that Poland is able to meet all necessary procedural and economic obligations within the desired (i.e. ambitious) timeframe. While we are sceptical on the chances for a political agreement on the **2012 accession date**, the PM's wording is a signal to markets that plans of the quick entry have not been altogether abandoned. In a wild bid to rationalize the strong wording from the PM (given the obvious hurdles along the way), one might speculate that the government is merely putting on a brave face ahead of the (tough) negotiations with the parliamentary opposition on the timing of entry, and that the decision to postpone entry by a year has already been made. If so, this would open the road to rate cuts al-ready this week. We do not go so far at this stage though. Our baseline scenario is that the MPC will hold on to its guns for two-three months as all the remaining (political) considerations are eventually resolved, before starting to cut rates in Q1 2009. The weak zloty is a point of concern for some (mostly hawkish) rate setters, who seem to fear that without the interest rate support the currency would be even more vulnerable, making it harder to contain inflation next year. While we think the MPC will stay on hold, it will be difficult for them to avoid mentioning the ongoing deterioration in growth perspectives and the softening inflation risks associated with it. This means the Council might switch from neutral mode to an outright dovish policy stance already this week in a bid to prepare markets for the imminent cuts already on the table in the months to come. Lowering rates in December would be seen as a panic move though, given that the MPC will have little new information before then and the fact that the Council has never moved rates at the Christmas meeting. A reduction in January is likely if market tensions remain elevated, but our baseline scenario remains that the MPC will wait with the cut for the Q4 GDP data and the inflation projection in February. The depth of the cycle will depend on the severity of the economic slowdown in 2009-2010, with 150 bps of fairly fast easing a likely bet in case of our baseline 3.0% y/y 2009 growth scenario. Needless to say the risks for growth, inflation and hence nominal rates are skewed the downside. Our risk scenario is that growth will moderate to 1.5% y/y next year, which could put the economy on the verge of recession at the break of 2009/2010 and would entail cuts of 200 bps or more next year.



Source: Reuters EcoWin

Risk aversion weighs on the zloty... Bonds spreads widen in extremely tight liquidity conditions...

Currency

The **FX market** seems to have entered calmer waters despite the ongoing turbulence in global equity and credit markets. Liquidity remains low and risks that we will continue to witness spikes in volatility. The EUR/PLN 3.80 - 3.90 range seems firmly in place though and while we could see some signs of recovery if the MPC stays on hold as we expect it to on Wednesday, the range is likely to hold. A softer policy statement should leave no doubt that cuts will eventually follow in the months to come. On the other hand, if the Council decides to reduce rates already this week, the PLN's reaction should be slim to none. The market is already pricing in a 70% chance of a cut and, most importantly, control of risk exposure rather than the search for capital gains is driving markets at this stage. In such an environment changes in the interest rate spread are hardly a market driver.

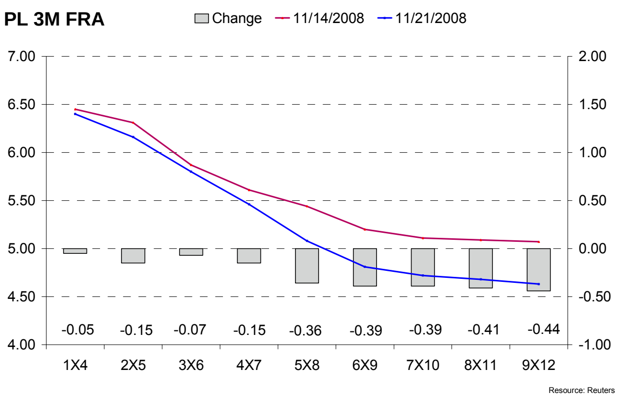
EUR/PLN technical picture

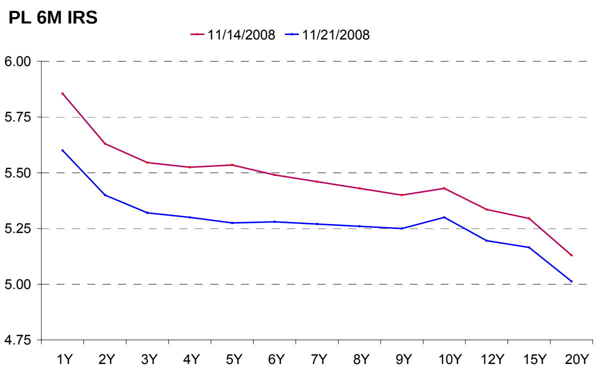
(3.8000): Sharp correction from 3.9950 retested 3.4915 (see graph: neckline Double Bottom), but could not sustain below it.
1st support area at 3.7485/ .7251 (rising Weekly Short Term Moving Average/ break-up hourly), ahead of 3.6700 (Nov 14 low): needs to settle back below to put Zloty on better footing.
Risk would then extend towards 3.5631 (rising Weekly Medium Term Moving Average), ahead of 3.5400 (break-up daily Nov 05), where pause favored.
1st Resistance comes in at 3.8692/ .8800 (weekly Bollinger top/ Nov 19 high), favored as range top.
If wrong, next level at 3.9494 (1st C wave off 3.4595): tough on 1st attempts.

DAILY CHARTS:

Fixed income

In the **Polish bond market** we have seen a slight recovery in terms of turnover, although tight liquidity constraints in interbank trading have kept the market dangerously close to the deadlock. We keep to our long-standing view that the short end of the (flat) curve offers more value as rate cut expectations intensify ahead of the start of the easing cycle. The 2Y bond yield at 6.40% stands bluntly in contrast with the expectations that official rates will drop to an average of at most 5.0% in 2009 and 4.5% in 2010. At the same time we remain extremely cautious to advise building longs in the current market conditions given the liquidity issues at stake. Nevertheless, a no-cut rate decision on Wednesday could push yields temporarily higher at the short end of the curve providing opportunity to play a steeper curve.





Slovakia

Currency

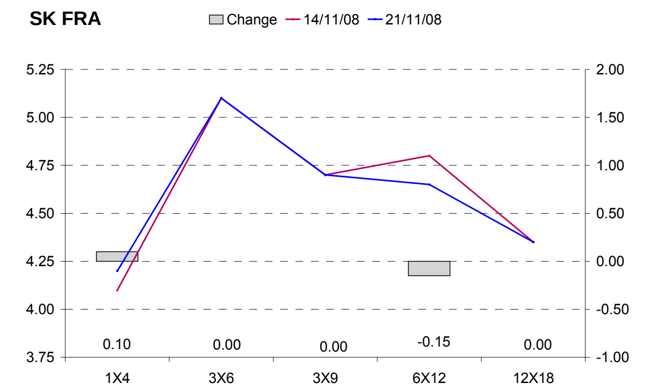
Nothing important happened on the Slovak markets last week. The eco calendar was empty and there were no other important events scheduled. The **Slovak koruna** oscillated within a tight range of EUR/SKK 30.38-30.48 lacking any impulses. With the end of the year coming closer, the exchange rate should move closer to the conversion rate at EUR/SKK 30.126. Until then, the unit should only move along the borders determined by interest rate differential.

The main event of this week is certainly **the central bank meeting.** The NBS is expected to leave the key repo rate unchanged at 3.25%. Surprisingly, the bank eased its monetary policy shortly after the ECB at the beginning of November. This decision was probably motivated by the need to keep interest rates in line with those in EMU. Therefore we do not expect any change this time. Moreover, the accompanying statement should not bring any novelties and thus the impact on the market will be neutral.

Fixed income

Liquidity on the **bond market** is very low and sentiment mainly depends on global risk aversion. Domestic data or events have no real impact on trading. For better liquidity it is better to look at the IRS curve which went down by approximately 15 bps along the whole curve. The 10Y benchmark now trades at around 130 bps over Bunds which we consider cheap at the moment.

The head of the Slovak Debt Agency (ARDAL) Mr. Bytcanek said last week that they aim to continue issuing Eurobonds in 2009 after the situation on the global markets will be more favourable. The first issue in the volume of EUR 1.0-1.5 bn should be done in the first quarter of 2009; the next one will be in the second half of the year. The maturity should be 5 years. On the domestic market, ARDAL plans to sell bonds worth of EUR 1-1.5 bn through the opening of the existing issues and adding two new issues. The maturity should be up to 3 years. He added that the agency is also considering issuing a bond denominated in yen.



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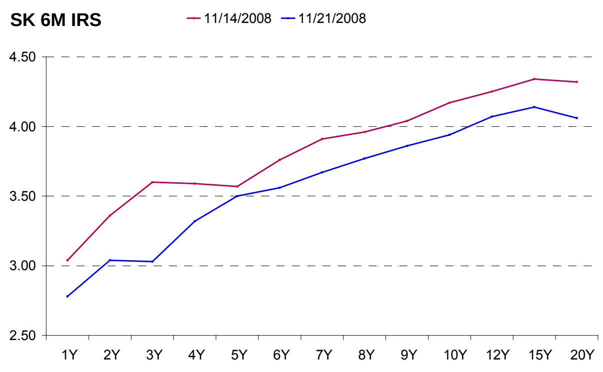

CE Weekly Preview

MON 14:00 **MNB base rate**

	This meeting	Last change
rate level (in %)	**11.50**	2008/10/22
change in bps	**0**	300

HU: New Inflation Report does not bring a change in rates

Central bank is expected to keep the base rate unchanged. Some think a 50 bps cut is possible, but the risk would be to trigger another selling wave for the currency with such a move and derail the recently started stabilisation period.

WED 10:00 **PL Retail sales (%)**

	Oct 08	Sept 08	Oct 07
y/y	9.50	11.60	19.4

PL: Sales to have slowed due mainly to calendar effects

Annual sales growth is expected to have slowed marginally due mainly to calendar effects. The sales dynamics remain the most robust element of the economic picture as labor market conditions remain strong due to the inertia of wage setting processes. A reading in the 10% range should help convince the MPC to stay on hold this month.

WED 14:00 **NBP rate (in %)**

	This meeting	Last change
rate level	**6.00**	June
change in bps	**0**	+25

PL: NBP on hold, but it switches to a dovish mode

Our baseline scenario is that the motion will eventually fail to get the necessary majority by the smallest of margins as the Council re-mains wary that a tougher policy stance might be warranted in case the government sticks to its ambitious euro zone entry plans.

FRI 10:00 **PL GDP (y/y change in %)**

	Q3-08	Q2-08	Q3-07
GDP	**4.70**	5.80	6.50
Fixed Investment	**12.5**	15.2	16.7
Consumption	**5.40**	5.50	4.80

PL: GDP growth moderately weaker

Growth is expected to have moderated further in the third quarter, but all-in-all remained relatively robust as domestic demand held up reasonably well due to consumption growth underpinned by the strong labor market conditions. Further out, tighter credit conditions will adversely impact both investments and consumption. Along with the weaker zloty, this should start to curb the demand for imports. At the same however, the fallout in EU demand will weigh heavily on exports. We are looking for growth to drop below 4.0% in Q4 and to head further south in H1 2009.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	24.11.2008	09:00	Retail sales (%)	09/2008		-1.0		-1.1		-1.4
SK	24.11.2008	09:00	Wages (%)	Q3/2008 *P		9.1				9.5
HU	**24.11.2008**	**14:00**	**NBH meeting (%)**	**11/2008**	**11.5**		**11.5**		**11.5**	
SK	25.11.2008	09:00	Current account (SKK B)	09/2008					-82.6	
SK	**25.11.2008**	**12:00**	**NBS meeting (%)**	**11/2008**	**3.25**				**3.75**	
PL	26.11.2008	10:00	Retail sales (%)	10/2008		9.5		9.1		11.6
PL	**26.11.2008**	**14:00**	**NBP meeting (%)**	**11/2008**	**6.00**				**6.00**	
HU	27.11.2008	09:00	Unemployment rate (%)	10/2008		7.9				7.7
SK	28.11.2008	09:00	PPI (%)	10/2008	0.1	6.6			0.6	6.8
HU	28.11.2008	09:00	PPI (%)	10/2008		-2.0				4.7
PL	**28.11.2008**	**10:00**	**GDP (%)**	**11/2008 *A**		**4,7**				**5.8**
CZ	28.11.2008	11:00	Money supply M2 (%)	10/2008						8.1

m/m - monthly change; y/y - yearly change; s.a. - seasonally adjusted; n.s.a. - non-seasonally adjusted; P - preliminary; F - final
EMU, USA, UK, JPY - figures seasonally adjusted, if not stated otherwise; Central Europe - figures seasonally non-adjusted, if not stated otherwise
Government Bond Auction: period = auction settlement date; m/m = total bids; y/y = supply

Our forecast

Official interest rates (end of the period)

		Current	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Last change	
Czech Rep.	2W repo rate	*2.75*	2.25	2.25	2.00	2.00	2.00	-75 bps	11/6/2008
Hungary	2W deposite r.	*11.50*	11.50	10.50	9.50	8.50	8.50	300 bps	5/31/2008
Poland	2W inter. rate	*6.00*	6.00	5.75	5.25	5.00	5.00	25 bps	6/26/2008
Slovakia	2W repo rate	*3.25*	2.75	x	x	x		-50 bps	10/28/2008

*Short-term interest rates 3M *IBOR (end of the period)*

		Current	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
Czech Rep.	PRIBOR	*4.13*	3.70	3.20	2.75	2.45	2.45
Hungary	BUBOR	*11.66*	11.50	10.50	9.50	8.50	8.50
Poland	WIBOR	*6.71*	6.70	6.30	5.80	5.50	5.45
Slovakia	BRIBOR	*3.45*	4.35	x	x	x	

Long-term interest rates 10Y IRS (end of the period)

	Current	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
Czech Rep.	*3.55*	3.70	3.60	3.50	3.50	3.50
Hungary	*8.4*	9.00	8.50	8.00	7.50	7.00
Poland	*5.27*	5.50	5.40	5.30	5.30	5.20
Slovakia	*4*	4.65	x	x	x	

Exchange rates (end of the period)

		Current	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
Czech Rep.	EUR/CZK	*25.8*	25.2	23.9	22.7	24.1	24.3
Hungary	EUR/HUF	*268*	270	265	260	255	250
Poland	EUR/PLN	*3.87*	3.55	3.50	3.45	3.45	3.40
Slovakia	EUR/SKK	*30.4*	30.1	x	x	x	

GDP (y/y)

	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009
Czech Rep.	*4.7*	4.0	3.2	2.9	2.7	2.8
Hungary	*0.8*	0.1	-0.5	-1.0	-1.3	-1.2
Poland	*4.7*	4.1	3.5	4.0	4.1	3.6
Slovakia	*7.1*	6.4	5.0	5.5	4.9	4.6

Inflation (CPI y/y, end of the period)

	Oct-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
Czech Rep.	*6.0*	*4.0*	2.6	2.0	1.8	2.2
Hungary	*5.1*	*5.7*	5.0	4.3	4.0	3.7
Poland	*4.2*	3.8	3.9	3.6	3.2	3.0
Slovakia	*5.1*	3.4	4.4	4.2	4.0	3.9

Current Account as % of GDP

	2007	2008
Czech Rep.	-3.3	-2.6
Hungary	-5.9	-5.0
Poland	-4.0	-5.5
Slovakia	-5.3	-2.9

Public finance balance as % of GDP (in ESA95 standards)

	2007	2008
Czech Rep.	-1.6	-2.3
Hungary	-5.8	-2.9
Poland	-2.0	-2.5
Slovakia	-2.2	-2.1

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