Monday, November 16,

Central European Weekly

Written by CSOB Prague, Kredyt Bank Warsaw and K&H Budapest

Czech Republic

GDP suggests the worst might be over for the Czech economy

Hungary

Lower inflation could make the budget target hard to achieve

Poland

Inflation on the way back to NBP comfort-zone

The Week Ahead

Polish industrial output in focus

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.55	-0.70%	→	→
EUR/PLN	4.117	-3.07%	→	→
EUR/HUF	269.7	-1.74%	↗	↗
3M PRIBOR	1.81	-0.02	→	→
3M WIBOR	4.19	0.00	→	↗
3M BUBOR	6.86	-0.03	↗	↗
10Y CZK	4.15	-0.07	→	↗
10Y PLN	6.10	-0.04	→	↗
10Y HUF	6.96	-0.24	↗	↗
3M EURIBOR	0.71	0.00	→	→
10Y EMU	3.36	0.00	→	↗

Last values from Friday 13:30 CET

The Czech and Hungarian GDPs Are Like Night and Day

The Central European economies (with the exception of Poland), like most other EU countries, presented their key inflation and growth data last week. Probably the most interesting of the indicators released were the growth data of the Czech Republic and Hungary, albeit we haven't yet the detailed structure of their GDPs.

Nevertheless, the Czech Republic's growth clearly sprang a pleasant surprise in two respects. Firstly, quarter-on-quarter growth in Q3 was higher than most expected. Secondly, the Statistical Office also revised the Q2 growth into slightly positive territory, and this actually means that the Czech economy already reached the bottom of its economic cycle in the spring.

Unlike the Czech Republic's growth, Hungary's growth sharply disappointed showing another contraction. The Hungarian economy dropped by more than 7% on the year-on-year basis, but it fell again significantly on the quarter-on-quarter basis (by 1.8%), unlike numerous EU economies. Concluding, the Hungarian economy hasn't hit bottom yet.

Thus the Czech and Hungarian economies are developing largely differently, although their respective structures are fairly similar. What differentiates these economies is obviously the extent of fiscal restriction, which is much stronger in Hungary and, in addition, augmented by the forced expenditure cuts made by indebted households. Thus the only shared light at the end of the tunnel for both economies are exports, which fared well in the third quarter of the year. The current positive signs from the German economy are signalling that the Czech and Hungarian export-oriented industries might also perform well in the final quarter of this year.

Czech Republic

Macro review

Czech inflation was down by 0.2% m/m as well as y/y, in October and thus again confirmed that inflationary pressures in this country continue to be very subdued. October's decline in prices is primarily due to food, seasonally cheaper package tours, and lower natural gas prices for households. Year-on-year inflation, which the Czech National Bank still projects to be 3% this year, is falling to its lowest level for more than six years. The year-on-year price fall in the Czech Republic is also broadly based on food and lower petrol and diesel prices. In both cases, the prices are falling because of the rapid decline in global commodity prices – in both the agricultural and energy sectors. Consumers may rejoice the lower retail prices, but their considerations are still predominantly influenced by unemployment concerns, and therefore consumers are postponing costlier purchases, thus putting more pressure on the prices of consumer goods to go down. Evidence of the lack of shopping demand has been the 12-month fall in retail sales, last time by 7.6% in September.
Thus inflation again diverged from the central bank target, which is set at 3% for this year, and 2% for next year. However, the inflation outlook remains favourable. Although year-on-year inflation will start to rise again in the months to come, this will only be due to the low comparative baseline of the previous year. As a matter of fact, inflation will not return to positive territory until 2010, and the rise will be primarily based on administrative moves, i.e., the increased regulated prices and increased indirect taxes. Nevertheless, monetary-policy inflation will most likely remain below the CNB's new target.

According to the latest forecasts released by the Statistical Office, the Czech Republic's GDP was up by 0.8% q/q in the third quarter of the year, following an already positive (up revised) figure for the second quarter. It confirmed that the worst is over for the Czech economy. Hence the economic downturn only lasted for half a year, yet it was incredibly deep, and year-on-year data, which usually attracts more attention, will continue to show the downturn. According to statisticians, consumption contributed to economic growth in the third quarter of the year, while investment and foreign trade weighted on growth. In addition, we suspect that inventories also played a significant role this time. However, a more detailed view of the GDP structure will not be available until updated figures are out, due to be released by the Statistical Office on December 9. We should also bear in mind that the previous results of the Czech Republic's GDP were also significantly updated. The drop in GDP for the first half of the year is slightly lower, from today's point of view, than that indicated by the previous data, yet the full-year economic downturn will be beyond 4%. The last quarter of the year should, in our opinion, also show quarter-on-quarter economic growth, as should the beginning of next year. Nonetheless, the W-shaped scenario is still possible, encouraged by the diminishing effect of stimulation measures in the economy and the lack of private demand, curbed by rising unemployment and stagnating real wages.

Currency

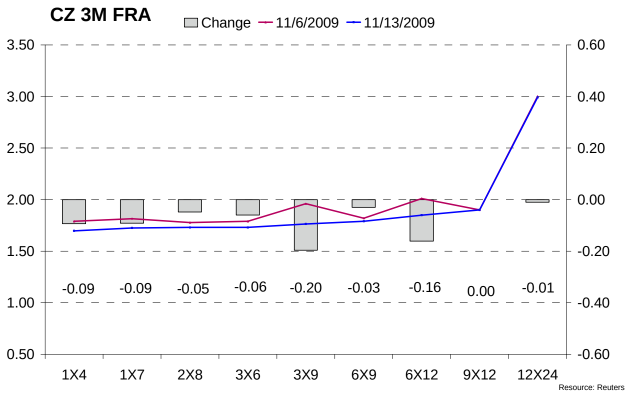
The koruna strengthened last week. While at the beginning of the week, the EUR/CZK currency pair stood at CZK 25.74 per EUR, it slipped to CZK 25.48 per EUR over the following business days, and even temporarily broke through CZK 25.40 per EUR on Thursday. Throughout the week, the development of the currency pair was thus consistent with the depreciation of the dollar and the decreasing aversion to risk. Only at the very end of the week was the global trend reversed; in addition, the koruna was bolstered by the favourable Czech GDP data, and this enabled the currency pair to return to CZK 25.55 per EUR.

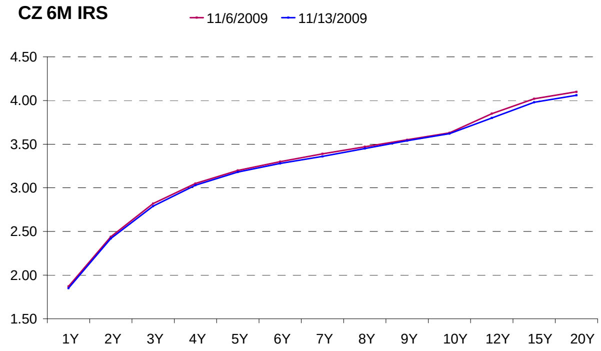
Fixed income

Czech bonds fared well last week; the yield curve fell along its full length and slightly flattened. The main stimuli were probably the decline in consumer prices and particularly the strengthening koruna. The political squabble surrounding the selection of the Czech EU Commissioner had no effect on the market. Only at the very end of the week, when the quarter-on-quarter GDP growth data was released, was some of the rise in the domestic bond prices offset. We should also mention that at the end of the week Parliament approved the request by the Minister of Finance that this year's budget deficit be additionally raised by CZK 14 bn and covered by a bond issue.

During the week, the Ministry of Finance supplied another tranche of the 5.00%/2019 government bonds in its auction. Demand was CZK 8.43 bn, at the expected issue volume of CZK 5 bn. The Ministry subsequently raised the volume to CZK 7.675 bn, but kept bonds for CZK 2 bn of that amount in its book. The average yield was 4.180% this time; for your information, the average yield in the previous tranche of early September was 5.111%. This is the only November auction.

This week is virtually free of new eco data, as Monday's producer price index will scarcely have any effect. In addition, Tuesday's bank holiday is likely to reduce the market activity for the week as a whole. The favourable GDP figure and the partial depreciation of the koruna should offset at least some of the last week's price rise.

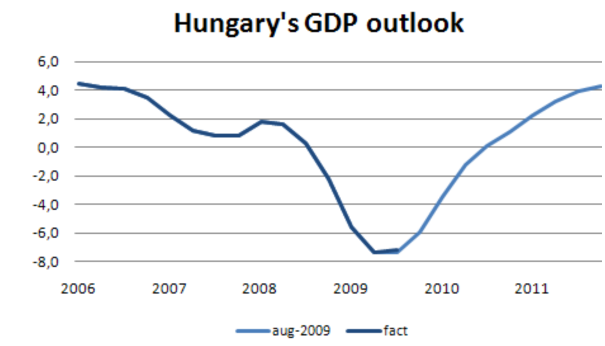

CZ 3M FRA
Change
11/6/2009
11/13/2009
-0.09
-0.09
-0.05
-0.06
-0.20
-0.03
-0.16
0.00
-0.01
1X4
1X7
2X8
3X6
3X9
6X9
6X12
9X12
12X24
Resource: Reuters


CZ 6M IRS
11/6/2009
11/13/2009
1Y
2Y
3Y
4Y
5Y
6Y
7Y
8Y
9Y
10Y
12Y
15Y
20Y

Hungary

Macro review

Last week's macro data reinforced expectations about the recession path of Hungary. Inflation data was again better in October at 4.7% Y/Y, down from 4.9% Y/Y in September, but this time core inflation also slowed by the same 20bps to 4.9% Y/Y due to services. It seems that weak domestic demand has a greater disinflationary effect than expected and inflation could undershoot the expected path.
This is good news for the markets, but less so for the budget, which has already seen lower revenues due to falling consumption. Lower inflation could really make the 2009 deficit target of 3.8% of GDP difficult to achieve, hence it was no surprising that both the IMF and the EU Commission expect an overshoot of the deficit now.



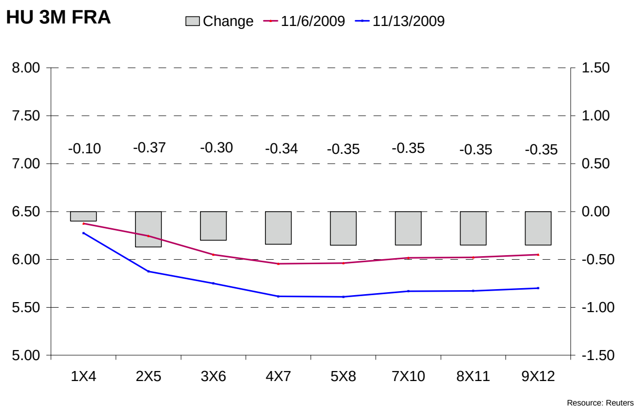
Together with the opposition's recent announcement that next year's budget deficit could be as high as 7.5% of GDP, the fiscal outlook has become a concern again. So far, this has not yet affected markets, probably because there is no firm evidence available at the moment about the slippage, while there is some probability of an 'on target' scenario.
Meanwhile, actual data suggests that Hungary is broadly tracking the expected slow recovery path. Third quarter data was -7.2% Y/Y, worse than market expectation for -6.5% Y/Y reading, but tad better than central bank's August projection of -7.3% Y/Y.
This week's macro calendar consists of only the wage data, which is not that important. More interesting will be the following week's central bank meeting on the 23rd, where another 50bps rate cut is possible.

Currency

The forint continued its appreciation trend last week and the pair reached the 268.00 level. Conforming news about the global economy helped carry-trade currencies around the world and the forint was able to join this trend. The current level is however close to the recent high of 265.00 and upcoming rate decision may also trigger profit-taking among investors. Therefore, we would look for an exit around the 265.00 level. The main risk for the currency is now stemming from the budget and the pair may be hurt if the deficit target is missed in December.

Fixed income

The bond market recovered almost fully during the week. Long-term yields narrowed the key 7.00% level again, while shorter-dated papers lowered to 6.30%. The FRA market has started to digest the possibility of a sub-6% base rate scenario with interest rates lowering to 5.70% at the 3x6 and longer tenors.
The outlook is similar to the currency's, except if the central bank adopts a more dovish tone next week. Naturally, that would help the short-end at the expense of a weaker currency.


HU 3M FRA
Change
11/6/2009
11/13/2009
-0.10
-0.37
-0.30
-0.34
-0.35
-0.35
-0.35
-0.35
8.00
7.50
7.00
6.50
6.00
5.50
5.00
1.50
1.00
0.50
0.00
-0.50
-1.00
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1X4
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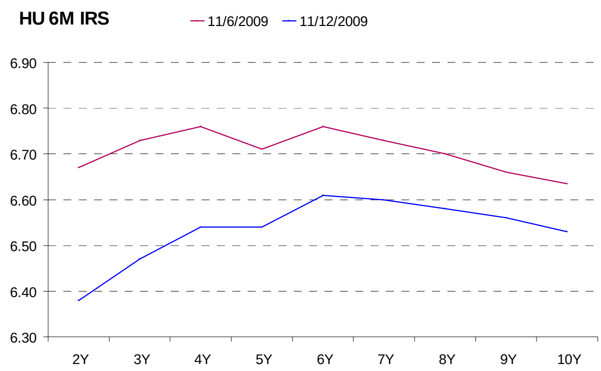
9X12
Resource: Reuters


HU 6M IRS
11/6/2009
11/12/2009
6.90
6.80
6.70
6.60
6.50
6.40
6.30
2Y
3Y
4Y
5Y
6Y
7Y
8Y
9Y
10Y

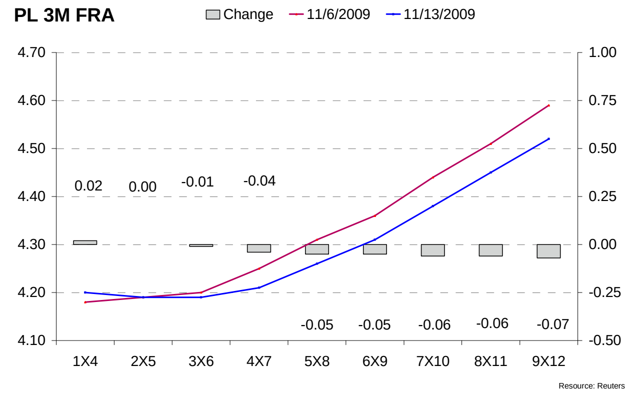
Poland

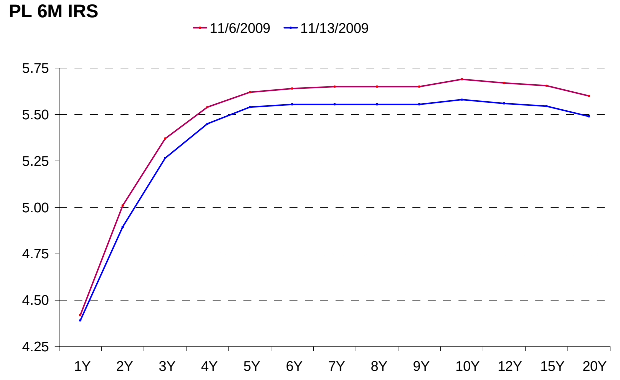
Macro review

Poland's inflation is slowly returning to the tolerance band of the National Bank of Poland. It fell for a second consecutive month, to 3.1% y/y in October, because of the gradual easing of the rise in food and energy prices, which should persist until the end of this year. If the falling inflation trend is borne out, the NBP will not be in any haste to change the settings of its monetary policy, and we believe that the first tightening will not come before the second quarter of 2010.

Currency

The zloty more or less ignored domestic figures and strengthened sharply during the week. The polish currency was without any doubt the leader of the regional gains driven mostly by the renewed optimism on the Wall Street. The zloty strengthened by more than 3% and broke below 4.10 EUR/PLN during a week.
This week the industrial output figures as well as wages should be in focus. The industry should accelerate on month to month basis, but probably remain weak year to year. Construction should continue to develop positively on the other hand manufacturing should lag behind and we do not bet on any sharp rebound. Nevertheless the zloty should stay more or less directly linked to the sentiment on the global markets. If the positive sentiment prevails, the pair may test 2009 lows at 4.066 EUR/PLN.





Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	11/16/2009	09:00	PPI (%)	10/2009		-5.1	-0.2	-4.5	-0.4	-5.4
PL	11/16/2009	15:00	Budget balance (PLN M)	10/2009					-5.827.4	
HU	11/17/2009	09:00	Wages (%, ytd.)	09/2009						0.6
PL	11/18/2009	14:00	Wages (%)	11/2009			1.7	2.6	0.4	3.3
PL	11/18/2009	14:00	Wages (%)	10/2009					0.4	3.3
PL	11/19/2009	14:00	PPI (%)	10/2009			0.1	1.7	-0.2	1.6
PL	**11/19/2009**	**14:00**	**Industrial output (%)**	**10/2009**			**1.1**	**-2.1**	**15**	**-1.3**
PL	11/20/2009	14:00	Core CPI (%)	10/2009					0.2	2.9

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

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Commercial Desk	+32 2 417 53 23
Institutional Desk	+32 2 417 46 25
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Frankfurt	+49 69 756 19372
Paris	+33 153 89 83 15
New York	+1 212 541 06 97
Singapore	+65 533 34 10
Prague	+420 2 6135 3535
Bratislava	+421 2 5966 8436
Budapest	+36 1 328 99 63
Warsaw	+48 22 634 5210
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Our forecast

Official interest rates (end of the period)

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Last change	
Czech Rep.	2W repo rate	*1.25*	1.25	1.25	1.25	1.25	1.25	-25 bps	8/6/2009
Hungary	2W deposite r.	*7.00*	6.50	6.00	6.00	6.00	6.00	-50 bps	20/10/200
Poland	2W inter. rate	*3.50*	3.50	3.50	3.50	3.75	4.00	-25 bps	6/25/2009

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

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.	PRIBOR	*1.81*	1.80	1.70	1.70	1.80	1.85
Hungary	BUBOR	*6.86*	6.50	6.00	6.00	6.00	6.00

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

	Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.	*3.66*	3.70	3.70	3.80	3.80	3.90
Hungary	*6.63*	7.25	7.00	7.00	6.75	6.75

Exchange rates (end of the period)

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.	EUR/CZK	*25.6*	25.3	26.0	24.8	24.8	25.5
Hungary	EUR/HUF	*270*	270	270	275	270	270
Poland	EUR/PLN	*4.12*	4.10	4.30	3.60	3.90	3.30

GDP (y/y)

	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Czech Rep.	*-4.8*	-3.1	1.5	1.4	0.5	0.7
Hungary	*-7.3*	-6.1	-2.4	-1.6	0.9	0.0

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

	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.	*0.0*	0.8	0.9	1.1	2.0	1.9
Hungary	*3.7*	5.0	4.5	3.8	3.8	3.5

Current Account as % of GDP

	2008	2009
Czech Rep.	-3.1	-2.5
Hungary	-6.0	-3.0

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

	2008	2009
Czech Rep.	-1.6	-5.8
Hungary	-3.9	-4.5