KBC Banking & Insurance

Central European Weekly

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

Czech Republic

Budget deficit on the rise, while the issuance calendar for bonds looks still relatively light

Hungary

Government officials' comments hurt the confidence, but then stick to previous targets

Poland

Are we going to see interventions around 4.20 EUR/PLN?

The Week Ahead

GDP revisions in Czech Republic and Hungary might be interesting

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.90	0.19%	↗	↘
EUR/PLN	4.161	2.19%	↗	↘
EUR/HUF	285.8	4.14%	↗	↘
3M PRIBOR	1.25	0.01	→	→
3M WIBOR	3.86	0.00	→	→
3M BUBOR	5.23	0.02	↘	↗
10Y CZK	4.30	0.12	↗	↘
10Y PLN	5.82	0.06	↗	↘
10Y HUF	7.66	0.61	↗	↘
3M EURIBOR	0.69	-0.01	↗	→
10Y EMU	2.59	-0.08	↘	→

Last values from Friday 15:30 CET

How Far is Budapest from Athens?

Risks are being reassessed on the market and, unfortunately, this also involves Central Europe. This time, Hungary is pouring oil on the flames, i.e., the new Hungarian government, with its fairly unfortunate statements that created the impression that the country might follow the example of Greece.

Although, at first glance, the revision of the government deficit in Hungary by the new government looks like the Greek story (this year's deficit has been doubled to 7.5% of GDP), there is a substantial difference between the two countries. Firstly, the revision of Hungary's deficit is mostly of an accounting nature, because the new government decided to count certain items as expenditures that the previous government had not included in public finances. Secondly, Hungary, under the IMF's supervision, has already completed much of its recovery cure, one item of evidence is that the current account has been in the black for a few consecutive quarters – and this actually makes Hungary a capital exporter in terms of its balance of payments.

Nevertheless, the current situation in Hungary also sparks concern for another reason. The new government obviously endorses the idea of a weaker forint. However, the Hungarian economy is subject to an unpleasant trade-off: the positive effect of the weaker currency on exports will be counterbalanced by negative impacts in the form of costlier payments on mortgages and consumer loans denominated in foreign currencies (notably EUR and CHF). The question now is whether the new government can steer market expectations well enough for the forint not to exceed the levels of the 'pain threshold' for indebted Hungarian households. We believe that the EUR/HUF 300 is such a level. If the forint approaches or even exceeds that level, we are likely to see verbal interventions, by which the government would stress its endorsement of fiscally responsible policy and, most probably, also the renewal of the loan programme managed by the EU and the IMF (which is scheduled to end in the autumn of this year).

Czech Republic

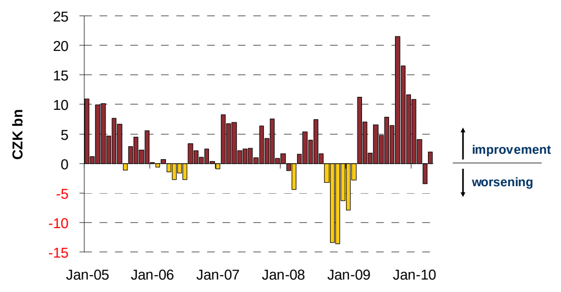
Macro review

For the first five months of this year, the state budget deficit climbed to the all-time high of CZK 95.4bn. This is more than 50% of the budget planned for 2010 as a whole. At first glance, the budget deficit is much higher than that of the same period of last year, but last year's budget was improved by the use of reserves totalling CZK 32bn. Therefore this year's budget is developing slightly better than last year's. In a year-on-year comparison, the overall tax revenue has improved slightly. Yet even this involves a risk of a decline in revenue from corporate income tax. However, what are known as insurance contributions, which constitute the largest share of the CR's budget revenue, are not very favourable; the reason is that rising unemployment and stagnating wages are reducing the assessment base for the calculation of those contributions, which are crucial for the budget. Excise duties and VAT, by contrast, are developing better, although they lag behind this year's plan.
At the moment, the chances of meeting the deficit plan of CZK 163bn seem to be decreasing. With most budget expenditures being predetermined by law, the government only has a fairly narrow margin of discretion. This increases the attention for the 2011 budget, which will be drawn up by the new government. Even so, we cannot expect next year's budget to be dramatically better than the current one. The economy will speed up somewhat, but there is no time to lose, as far as legislative changes are concerned – given the lengthy budget approval process.

While the deficit is rising faster than planned, government bond issues still lag behind this year's plan. Although the Ministry of Finance has calculated the amount of funds required to cover the deficit and maturing debt this year at CZK 280bn, it has only issued bonds for CZK 70bn since the beginning of the year (of which the Ministry itself has bought bonds for CZK 7.5bn). There are two issues left, totalling CZK 10bn, for the first half of the year. The Ministry of Finance has also released the issue schedule for the third quarter of the year, planning to issue bonds for CZK 52bn on the domestic market. By and large, it would thus gain CZK 132bn on the domestic market from January to September. Consequently, there would still be CZK 110.3 to 160.3bn left before this year's overall volume of issues, planned by the Ministry of Finance at CZK 242.3 to 292.3bn, is used; the Ministry may acquire these funds on the domestic and partly also on the foreign market. While the euro bond issue is still possible, we can speculate that the issuing of bonds on the domestic market will be stepped up even more in the second half of the year, and this will certainly influence yields on the domestic market.

The **April balance of trade** figures provided a pleasant surprise with a surplus of CZK 15.4 billion and a continuing growth in exports. This result is particularly positive in view of the higher prices of raw materials. Exports of machinery and means of transport, which dominate Czech exports, were particularly successful – mainly electronics, cars and industrial machinery. Imports to the CR also rose, and again for machinery and means of transport – and in a similar structure to exports. Overall, the foreign trade results remain very positive. They have been positively affected by growing demand from abroad, even if it is important to keep in mind that the double-digit rise in exports is based on low comparison bases from the previous year. The trend in trade will remain positive in the coming months. Although we can expect a gradual slowdown in the dynamic of both exports and imports, nevertheless the surplus for the year as a whole could still be in the order of CZK 150 billion, even in the face of more expensive oil and a strong US dollar.

Y/Y change of the monthly trade balance



The sharp fall in retail earnings of over four percent is no surprise. Car sales figures for April were sufficient to show that that month was not a good one for the vehicle segment. Earnings also fell outside the vehicle segment. People are trying to save money and are carefully considering their purchases. Only sales of electronics have risen, nevertheless we consider that the main reason for this is the very low comparison base from the year before. And we can find a similar reason for the current rise in sales posted by internet stores. The outlook for the coming months is not overly optimistic either. Economic growth will remain weak and vulnerable, unemployment relatively high and wage growth suppressed. This will tend to reduce consumption this year, which will be reflected in lower retail spending. The only positive aspect of the unfavourable development in retail earnings is perhaps that the risk of demand-pull inflation remains basically zero.

Currency

Last week was not favourable for the Czech currency. The koruna only succeeded in strengthening at the very beginning, when it opened the week at the EUR/CZK. Thus it benefited from the outcome of the weekend's general election, won by centre-right parties that are capable of forming a new government that would be ready to enforce austerity programmes. **However, the trend reversed in the days that followed, and concern that even Central European banks, including Czech ones, would need to write off larger volumes of bad loans, just like their EMU counterparts, increased the aversion to risk and weakened the koruna. Hungary's problems in maintaining an acceptable deficit also affected the Czech currency**. Given this, the koruna depreciated, and the EUR/CZK currency pair closed the week at the EUR/CZK 26.00.

From a fundamental point of view nearly all the factors should play in favour of the Czech koruna – strengthening recovery, right wing coalition and potential for rating upgrade. Nevertheless regional turmoil may weigh on the koruna for a while.

Fixed income

Czech bond prices fell last week. Their yield curve went up along the full length and flattened slightly, rising by almost 16 bps at the short end and 15 bps at the long end. Thus the bond market reacted to the budget deficit increase and to the release of a new issue schedule for the third quarter of 2010. According to this schedule, the Ministry of Finance is planning to issue bonds for CZK 52bn and treasuries for CZK 75bn. With the summer drawing near, a such a volume is no good sign, because trading during holidays is usually thinner. However, the Ministry had practically no choice, because the considered bond issue denominated in euros may not be sold at favourable prices, and therefore will be postponed.

The main event of this week will be Wednesday's auction of the 2.80%/2013 bond, in the planned amount of CZK 5bn. Short maturities are usually well in demand. Therefore we believe that the entire volume may also be subscribed this time, although the Ministry of Finance will probably have to accept a higher yield. By comparison, the average yield of the previous tranche of the same securities, of April 7, 2010, was 2.41%, while Friday's yield (June 4, 2010) is 2.436%.

EUR/CZK technical picture

(25.8500) Rebound from 25.0150 failed to regain the broken Uptrendline off low (see graph).

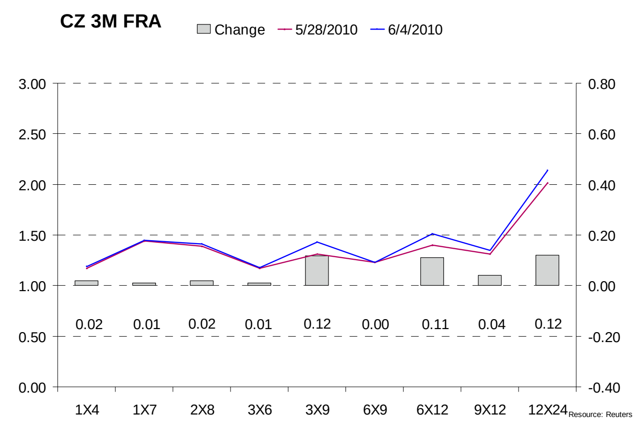
1st support area at 25.5380 (rising weekly Medium Term Moving Average), with next levels at 25.4200 (May 31 low), ahead of 25.3000 (May 12 low) and 25.2220 (April break-up daily), where pause favored.

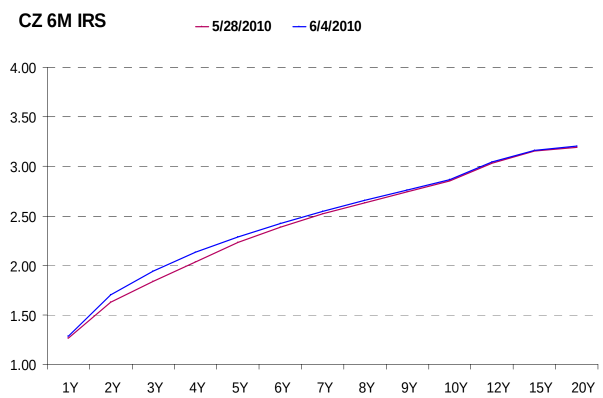
If wrong, next levels at 25.0660 (weekly Bollinger bottom), ahead of 25.0150 (current year low) and 24.9750 (Sept 2009 low): tough on 1st attempts.

Resistance area at 26.0800 (medium term breakdown hourly), where pause favored.

Failure to cap would see next levels at 26.2680/ .3000 (weekly Bollinger top/ current recovery high off 25.0150) and 26.3330 (Feb 08 high): tough on 1st attempts.

DAILY CHARTS:





Hungary

Macro review

Hungarian trading had some volatile sessions after government officials' comments hurt the confidence in the fiscal consolidation program followed by intensive communication and pledges about an action plan in order to restore credibility.

The story started last Thursday, when city mayor and leader of the ruling Fidesz party Mr Kosa said that Hungary is close to default and the situation is similar to that of Greece. Markets began to worry and fears grew quickly on Friday after the PM spokesman said that comments from Mr Kosa were right.

The forint collapsed within hours and sank to a 1-year low of 289.80/€ by early afternoon. The government started to back away from these comments shortly thereafter and they said that Hungary's default risk was mentioned in the context to last year's comment from the former Prime Minister Mr Gyurcsany.

This however did not succeed and markets remained shaky because other officials were talking about a much higher deficit path. The previous government set this year's target at 3.8% of GDP, while the new government said it could be almost twice of this, as high as 7.5% of GDP.

Beside the market pressure, the EU Commission and the IMF have tried to convince the government to maintain the current target. Hungary's last deficit revision in 2006 was almost sanctioned by freezing some EU funds, so there was probably a great risk for the government to run into something similar this time.

The government did not hesitate much and Mr Orban pledged to come out with an action plan within 72 hours.

So far, we have only hints what the plan could consist of. **First, banks will likely be taxed with a special bank tax** on top of the regular corporate income tax. Secondly, the **mandatory private pension system could be nationalised** in some form. Thirdly, **budgetary institutions may see further rationalisation and spending cuts**. These could at the end make room for tax cuts as well and the government hinted the possibility of introducing a 16% personal flat income tax rate. Tax evasion is pretty high in Hungary and some research says it is twice as high as in neighbouring Slovakia.

Without details it is quite risky to conclude here, but if the deficit is maintained at 3.8% of GDP and flat tax is introduced, the fundamental outlook gets much better.

Currency

The forint tested the 290.00/€ level twice and has established a narrow range between 286.00 and 288.00. If volatility continues to decline the forint may establish an appreciating trend and may start to get back to the 6-months average around 270.00.

EUR/HUF technical picture

(288.30): Rebound from year low puts the pair currently above 283.60 (see graph: neckline Long Term Double Bottom) and has met 2nd target of daily Double Bottom off 275.50 (290.07).

Resistance at 290.55 (current recovery high off year low), where pause favored.

Failure to cap would see next level at 294.50/ 295.85 (Irregular C wave off 260.93 + weekly Starc top/ 61.8% 317.45 to 260.93): tough on 1st attempts.

Support at 282.90/ .50 (break-up daily/ hourly + weekly envelope bottom), with next levels at 279.75/ 278.30 (reaction low hourly/ break-up hourly), where pause favored.

If wrong, next levels at 272.69 (rising weekly Long Term Moving Average), ahead of 272.00/ 271.15 (May 28 low/ May 12 low): tough on 1st attempts.

DAILY CHARTS:

Fixed income

The bond market mirrored the currency's losses and yields rose to above the key 8.00% level at the long-end. Short-end rates also moved higher and the FRA curve priced in the possibility of a 25bps hike.

The situation is pretty much the same as with the currency due to the lack of inflationary pressures and if confidence improves in the government's plan, we may see some relief rally on the bond market.

Poland

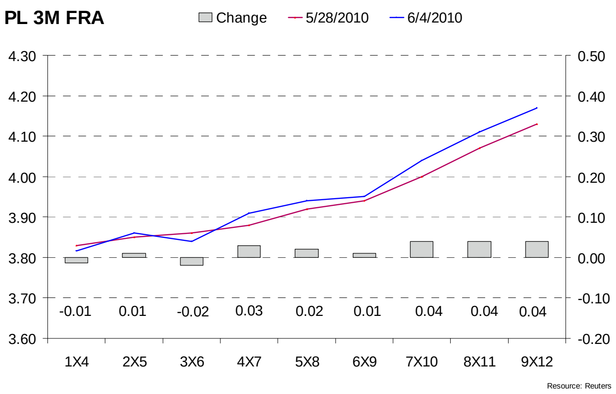
Currency

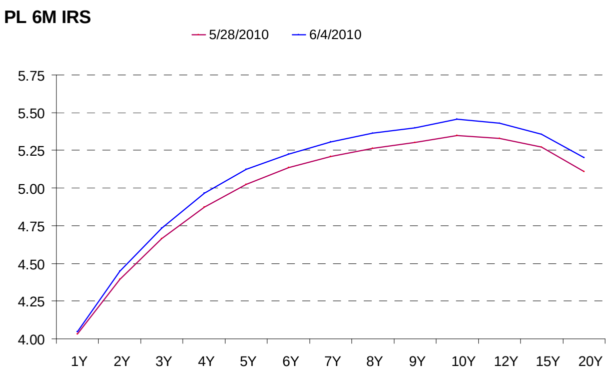
Polish zloty felt a certain relief in the middle of last week after better US housing figures and improving emerging market sentiment. The pair broke below 4.10 EUR/PLN for a while also thanks to the news about ongoing privatization plan. The government plans to sell No. 2 utility Tauron for as much as 5.2 billion zlotys by the end of the month. The privatization process (25 bilion zlotys this year) could further boost the demand for the Polish currency and thus supportive for the currency.
Nevertheless the Polish zloty came under severe pressure by the end of the week as Hungary finances deterioration and the weaker US payrolls weighed on the region. The pair shot as high as 4.2 EUR/PLN.
The week ahead is rather empty on the Polish scene. Hence further developments on global markets should be crucial for the zloty. Although bearish sentiment on the global equities may trigger more selling, we could see the finance minister to intervene in favour of the Polish currency, as we did last time around 4.20. The Polish ministry has large sums of euros due to inflow from structural funds and ongoing privatization and needs to convert it to zlotys on ongoing basis.

EUR/PLN technical picture

(4.1700): Rebound off 3.8225 sent the pair above the channel top off 4.9300 and retested the neckline of the long term Double Top (4.2250: see graph).
1st support area at 4.1350 (break-up daily), with next levels at 4.1150 (break-up hourly) and 4.1020 (weekly envelope bottom).
If unable to hold, next levels at 4.0488/ .0405 (rising weekly Long Term Moving Average/ May 28 low), ahead of 4.0166 (break-up hourly): tough on 1st attempts.
1st Resistance comes in at 4.1970 (weekly Bollinger top), where pause favored.
If wrong, next levels at 4.2050/ .2060 (May 20 high/ last week high).
4.2400./ .2455 = recovery high off 3.8225/ 38.2% 4.9300 to 3.8225): tough on 1st attempts.

DAILY CHARTS:


PL 3M FRA
Change
5/28/2010
6/4/2010
4.30
4.20
4.10
4.00
3.90
3.80
3.70
3.60
0.50
0.40
0.30
0.20
0.10
0.00
-0.10
-0.20
-0.01
0.01
-0.02
0.03
0.02
0.01
0.04
0.04
0.04
1X4
2X5
3X6
4X7
5X8
6X9
7X10
8X11
9X12
Resource: Reuters


PL 6M IRS
5/28/2010
6/4/2010
5.75
5.50
5.25
5.00
4.75
4.50
4.25
4.00
1Y
2Y
3Y
4Y
5Y
6Y
7Y
8Y
9Y
10Y
12Y
15Y
20Y

CE Weekly Preview

WED 9:00 **CZ Inflation (change in %)**

	May-10	Apr-10	May-09
CPI m/m	**0.1**	0.3	0.0
Food m/m	**-0.4**	0.4	-1.1
Housing, energy	**0.1**	0.3	0.1

CZ: Inflation Goes Up Slightly

We believe that the anticipated month-on-month rise in consumer prices was primarily due to the increased fuel prices and the continuing effect of the increased excise duties on cigarettes and alcohol. On the other hand, certain product prices, notably food prices, went down in May. Year-on-year inflation, for which the central bank sets its targets, might go up by 0.1% to 1.2%, and thus continues to be far below the Czech National Bank's target. Nevertheless, the months to come will see inflation rise towards the 2% target, although demand-pull inflation is still absolutely irrelevant.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	7.6.2010	09:00	Retail sales (%)	04/2010		-4.0		-1.8		3.9
CZ	**7.6.2010**	**09:00**	**Trade balance (CZK B)**	**04/2010**	**11.0**		**12.4**		**18.3**	
CZ	7.6.2010	09:00	Wages (%)	1Q/2010						4.8
CZ	7.6.2010	09:00	Construction output (%)	04/2010						-18.3
CZ	7.6.2010	09:00	Industrial output (%)	04/2010		8.0		10.1		10.2
HU	7.6.2010	17:00	Budget balance (HUF B)	05/2010					-637	
HU	8.6.2010	09:00	Trade balance (EUR M)	04/2010 *P			442.0		653.3	
CZ	8.6.2010	10:00	Current account (CZK B)	1Q/2010					-289.7	
CZ	9.6.2010	09:00	Unemployment rate (%)	05/2010	9.0		9.0		9.2	
CZ	**9.6.2010**	**09:00**	**GDP (%)**	**1Q/2010 *F**		**1.4**			**0.2**	**1.2**
HU	**9.6.2010**	**09:00**	**GDP (%)**	**1Q/2010 *F**					**0.9**	**0.1**
CZ	**9.6.2010**	**09:00**	**CPI (%)**	**05/2010**	**0.1**	**1.2**	**0.1**	**1.2**	**0.3**	**1.1**
CZ	**9.6.2010**	**12:00**	**CZ bond auction 2.80%/2013 (CZK B)**	**06/2010**			**5**			
HU	**11.6.2010**	**09:00**	**CPI (%)**	**05/2010**				**5.2**	**0.5**	**5.7**
HU	11.6.2010	09:00	Industrial output (%)	04/2010 *F					1.1	9.7

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	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	1.00	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*5.25*	5.25	5.25	5.25	5.25	5.25	-25 bps	2/23/2010
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	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	PRIBOR	*1.25*	1.20	1.15	1.22	1.35	1.60
Hungary	BUBOR	*5.23*	5.25	5.25	5.25	5.25	5.25
Poland	WIBOR	*3.86*	3.90	3.90	4.10	4.30	4.30

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

	Current	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	*2.9*	3.25	3.45	3.65	3.80	3.95
Hungary	*6.75*	8.00	7.75	7.50	7.25	7.00
Poland	*5.46*	5.00	5.00	5.00	5.20	5.50

Exchange rates (end of the period)

		Current	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	EUR/CZK	*25.9*	25.3	24.8	24.8	23.8	25.5
Hungary	EUR/HUF	*286*	285	280	275	270	265
Poland	EUR/PLN	*4.16*	3.90	3.80	3.60	3.90	3.30

GDP (y/y)

	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011
Czech Rep.	*1.7*	1.5	1.4	1.7	2.3	2.6
Hungary	*-1.5*	0.5	1.0	2.0	2.5	3.0

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

	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	*1.4*	2.1	2.1	2.0	1.9	1.9
Hungary	*3.8*	3.8	3.5	3.5	3.5	3.5

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-0.7
Hungary	0.5	1.0

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

	2009	2010
Czech Rep.	-5.9	-5.5
Hungary	-3.8	-2.9

Brussels Research (KBC)	
Piet Lammens	+32 2 417 59 41
Peter Wuyts	+32 2 417 32 35
Didier Hanesse	+32 2 417 59 43
Joke Mertens	+32 2 417 30 59
Dublin Research (KBC Bank Ireland)	
Austin Hughes	+353 1 6646892
Prague Research (CSOB)	
Jan Cermak	+420 2 6135 3578
Zdenek Safka	+420 2 6135 3570
Jan Bures	+420 2 6135 3574
Bratislava Research (CSOB)	
Marek Gabris	+421 2 5966 8809
Budapest Research (K&H)	
Gyorgy Barcza	+36 1 328 99 89

Global Sales Force	
Brussels	
Corporate Desk	+32 2 417 45 82
Commercial Desk	+32 2 417 53 23
Institutional Desk	+32 2 417 46 25
London	+44 207 256 4848
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
Moscow	+7 495 228 69 61

Our reports are also available on: www.kbc.be/dealingroom