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KBC Banking & Insurance

Central European Weekly

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Czech Republic

Contrary to expectations, prices in the CR remained unchanged in June

Hungary

Forint and bonds under fire as the IMF-EU delegation has left without a financing deal

Poland

High inflation caught Poland by surprise in June

The week ahead

No change in MNB's policy setting expected

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.45	0.58%	↗	→
EUR/PLN	4.118	1.24%	↗	→
EUR/HUF	282.3	0.79%	↗	→
3M PRIBOR	1.22	-0.01	→	→
3M WIBOR	3.84	-0.01	→	→
3M BUBOR	5.26	-0.01	↗	→
10Y CZK	3.91	-0.04	→	→
10Y PLN	5.81	0.00	↗	→
10Y HUF	7.19	0.00	↗	→
3M EURIBOR	0.92	0.06	→	↗
10Y EMU	2.62	-0.01	→	↘

Last values from Friday 15:30 CET

The IMF-EU mission leaves Budapest without a new deal

The Hungarian government (and the IMF) apparently wanted to keep the boring summer season on financial markets alive as the IMF-EU delegation has suspended the review of Hungary's financing agreement. There were several disputes about policy steps, but it seems that negotiations failed because the European Commission continues to ask for a deficit target below 3% of GDP for 2011. The IMF criticised the hefty bank tax (~40% of pre-tax profit) and the setup of a state company to bail out troubled household borrowers. However, the government has continued to emphasise that it does not want to introduce austerity measures for households.

The government looks to be determined to stick to its election pledge about tax cuts and no austerity. This means that fiscal consolidation could take place only via tax on profit (bank tax) and growth.

Romania and Ukraine also had a temporary cancellation of the IMF program and talks there resumed after some months. The IMF/EU team will return in September, but that will also be before the municipality election in October.

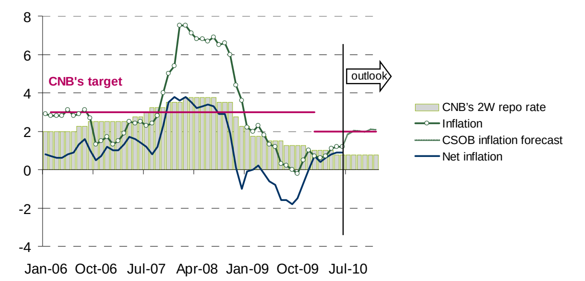
Local elections could be important politically because ruling Fidesz wants to win the mayor of Budapest position, too, but here the margin over their political rival is rather narrow. Therefore Fidesz may not want to introduce unpopular measures before the elections. Hence, we may not see more details about the 2011 budget. Next year's budget will be key in assessing the sustainability of public finances as stabilising public debt at 80% of GDP requires a budget deficit of below 4% of GDP.

Czech Republic

Macro review

Czech inflation sprang a surprise in June, when consumer prices surprisingly remained unchanged, and not even the 'time-proven' potato effect worked (the replacement of cheaper ware potatoes with costlier early potatoes in the consumer basket). Thus June saw just a moderate rise in food prices and a seasonal rise in package tour prices, while the prices of summer season products went down. Year-on-year inflation stagnates at 1.2%, i.e., 0.3% above the Czech National Bank forecast. This is primarily due to administrative measures in the form of increased excise duties and regulated prices. Increased fuel prices also had an effect, due to the rising koruna price of oil. Thus the Czech Republic continues to be a low-inflation economy. The central bank will have no problem hitting its inflation target (2%), even as inflation will begin to climb within the next few months, due to the low statistical baseline. In the short term, inflation is likely to exceed the CNB's threshold, but, given the character of the inflation, the CNB will not change rates for at least the next six months. With the restrictive nature of the budget reforms intended by the government, the rate stability period may even be much longer.

Inflation and CNB's Target
(%)



Currency

Last week, the Czech koruna weakened slightly and closed the week at CZK 25.480 per EUR. The main reasons included the aversion to risky assets and a higher current account deficit. The stagnation of consumer prices and the appointment of the new government, by contrast, were favourable factors for the koruna. The currency was also slightly encouraged by statements from the previous and current Ministers of Finance that the Ministry was prepared to issue bonds denominated in US dollars.

The global uncertainty and tensions around the Hungary-IMF deal may keep the koruna in a defensive mode. Nevertheless, the low yielding koruna may outperform the regional peers in the current climate.

EUR/CZK technical picture

(25.4300) In medium term Triangle pattern and toying with the neckline of a short term Double Top (25.4200: see graph).
1st support area at 25.2800 (July 12 low), with next levels at 25.2220 (break-up April on daily charts), ahead of 25.1500 (weekly Bollinger bottom), where pause favored.
If wrong, next levels at 25.0150 (year low) and 24.9750 (Sept 2009 low): tough on 1st attempts.
Resistance area at 25.6550 (breakdown daily), ahead of 25.8880 (June 25 high + breakdown daily + weekly Bollinger top), where pause favored.
Failure to cap would see next level at 26.0800 (June 07 high): tough on 1st attempts.

DAILY CHARTS:

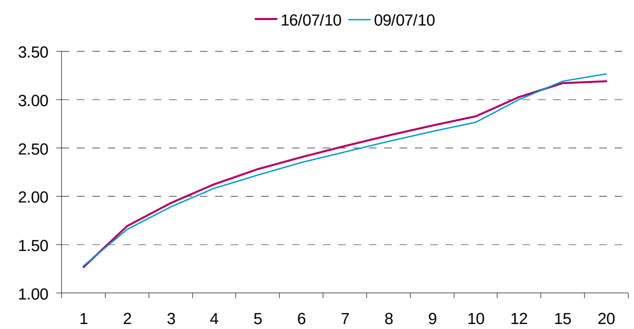
Fixed income

Czech bond prices went up last week. Yields went down along the full length and steepened, falling by 11 bps at the short end and 8 bps at the long end. Domestic bonds benefited from the appointment of the new government, which is preparing austerity programmes. However, the upbeat sentiment was somewhat affected by the high current account deficit, though mostly stemming from the transfer of dividends to foreign owners. However, demand for bonds improved at the end of the week, in the wake of remarks by outgoing Minister of Finance Janota, that the Ministry of Finance was preparing a dollar bond issue. According to earlier information, the volume of those bonds might be as high as $2bn. The new Minister of Finance hasn't also ruled out such an issue, should market conditions prove favourable.

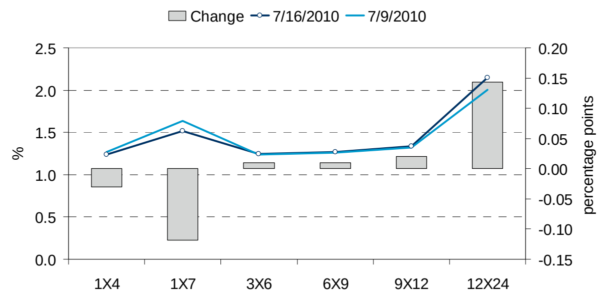
Nevertheless, the main event of the week was the auction of the 3.40%/2015 government bond, which met expectations and attracted reasonable demand. The demand exceeded the original supply of CZK 7bn 2.25 times. Bonds for CZK 7.742bn were sold in the end, but the Ministry kept 0.5bn of that volume on its book. The average yield was 3.011%. By comparison, at the previous tranche of the same securities of May 12, the demand only exceeded supply 1.29 times, but the average yield was 2.936%.

No major events are on the agenda this week. The effort to issue dollar bonds, thus reducing the supply of koruna bonds, should support demand for Czech government bonds. In addition, less favourable data from the United States should be another positive factor.

CZK IRS



CZ FRA



Source: Reuters

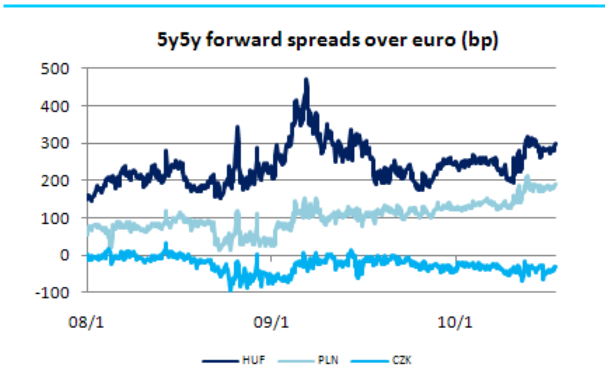
Hungary

Macro review

Last week was relatively quiet on the data front with only the June inflation release, but investors were kept busy as talks between the government and the IMF/EU team had ended without an agreement and thereby the IMF program is now suspended, at least temporarily (see the front page).
Inflation picked up to 5.3% Y/Y in June from 5.1% Y/Y due to expensive fruits and vegetables after floods ruined large areas. Core inflation however lowered to 3.5% Y/Y from 4.0% Y/Y suggesting that there is no inflationary pressure in the economy.

Currency

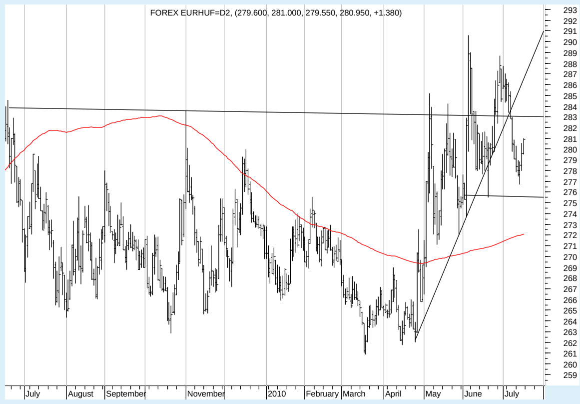
The forint lost 3% over the weekend and 4% in 1-week as it moved to 289.00 from 282.00. The level of 290.00 was this year's low in June and the currency may test this level this week.
Investors will probably wait for new targets from the government, but lack of additional measures could keep uncertainty prolonged for months, which may allow the currency to weaken further.
Given the large foreign trade surplus over 5% of GDP and positive balance in the current account, financing the external debt should be no problem for the country, but investors could start to worry about this without the IMF's help. The key issue instead could be the budget performance as the government will need all efforts to rein in the budget deficit that stood at 119% of the full-year target in June. We would recommend to stay on the sideline until the outlook gets clearer.



EUR/HUF technical picture

(281.10): Currently back below 283.60 (see graph: neckline Long Term Double Bottom) and below Uptrendline off 262.05.
Resistance at 282.80 (breakdown daily): ideal area to stay below to keep current mood on HUF.
Failure to cap would see next levels at 284.30 (breakdown hourly), ahead of 285.35 (reaction highs hourly): tough on 1st attempts.
In case of renewed major turmoil, next levels at 288.70 (June 29 high), ahead of 290.55/ 291.00 (current reaction high off year low/ weekly Bollinger top).
Support at 278.85 (break-up daily), with next levels at 277.70/ 276.70 (break-up hourly/ July 14 low), where pause favored.
If wrong, next levels at 275.50 (June 21 low), ahead of 273.75 (June 03 low) and 272.24 (61.8% 260.93 to 290.55): tough on 1st attempts.

DAILY CHARTS:



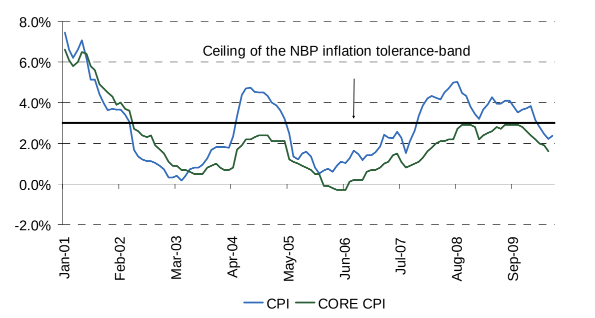
Similarly to the currency, **bonds** also weakened over the weekend and yields rose about 30 bps across the curve. The FRA market now sees chance for a series of rate hikes up to the 6.00% level from the current 5.25% rate over the next 9-months, implying three 25bps steps.
On the other hand, the forward spread at the long-end has not widened much and stayed at about the recent peak of 300bps at the 5y5y tenor.

Poland

Macro review

The effect of the high comparative baseline was outdone by the surprisingly fast rise in food prices in June. So, inflation, contrary to expectations, soared to 2.3%. Although the effects of demand-pull pressures on the inflation rise have been negligible thus far, the increased figures are unpleasant news for the central bank. The high comparative baselines will stop having an effect in August, and inflation will start to accelerate in a natural way. Hence the reasonably growing Polish economy, encumbered with high government deficits, may soon provide latitude for monetary policy tightening in the autumn. To a certain extent, this was also confirmed by the minutes of the last central bank meeting, where inflationary risks associated with high government deficits were the subject of a lively discussion. Andrzej Rzonca of the Monetary Policy Council (MPC) said that more than 18bn PLN needs to be saved in 2011 to keep the debt below 55% of GDP, and we cannot but agree with him. After the presidential election, the Cabinet announced that it was going to apply an austerity policy, but the details of the plan for 2011 are still unavailable. It will be very difficult for the government coalition to plan major savings ahead of the general election (2011) and the European Football Championship (2012). If the government fails to put public finances under control, this may soon become another argument to be used by the hawks on the MPC.

Polish inflation, y/y



Currency

The **Polish currency** benefited from shifting the argumentative balance on the side of hawks. In the first half of the week it clearly outperformed regional neighbours and more or less ignored ongoing nervousness on the global equity markets after a series of weak US figures. Nevertheless at the end of the week it was hit by the disagreement of Hungary with IMF and the pair shot up to 4.15 EUR/PLN.

This week we expect the ongoing uncertainty to weigh on the markets. The zloty thus will have a problem to erase the losses, even though we expect further nice numbers from the industry – the sentiment of the June was not at the heights of the last three years due to Germany and construction.

EUR/PLN technical picture

(4.0900): Currently below Uptrendline off year low (see graph).

1st Support area at 4.0510/ .0440 (July 14 low/ reaction low hourly), with next level at 4.0300 (broken falling weekly Long Term Moving Average), ahead of 4.0120/ 4.0067 (June 21 low/ weekly Bollinger midline), where pause favored.

If unable to hold, next levels at 3.9700 (break-up daily May 13): tough on 1st attempts.

1st Resistance comes in at 4.1100/ .1183 (reaction high hourly/ breakdown hourly), where pause favored.

If wrong, next levels at 4.1284/ .1310 (reaction highs hourly): ideal area to stay below to keep current mood on Zloty.

DAILY CHARTS:

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**19.7.2010**	**14:00**	**NBH meeting (%)**	**07/2010**	**5.25**		**5.25**		**5.25**	
PL	19.7.2010	14:00	PPI (%)	06/2010			0.8	1.7	1.6	1.5
PL	**19.7.2010**	**14:00**	**Industrial output (%)**	**06/2010**			**4.5**	**11.5**	**2.0**	**14**
PL	20.7.2010	14:00	Core CPI (%)	06/2010			0.2	1.5	0.1	1.6
CZ	21.7.2010	12:00	CZ bond auction 5.00%/2019 (CZK B)	07/2010			8			
PL	23.7.2010	10:00	Unemployment rate (%)	06/2010			11.6		11.9	
PL	**23.7.2010**	**10:00**	**Retail sales (%)**	**06/2010**			**1.8**	**4.2**	**3.1**	**4.3**

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

		Current	Sep-10	Dec-10	Mar-11	Jun-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	1.00	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*5.25*	5.00	5.00	5.00	5.00	-25 bps	2/23/2010
Poland	2W inter. rate	*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	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	PRIBOR	*1.22*	1.15	1.22	1.35	1.60
Hungary	BUBOR	*5.27*	5.10	5.00	5.00	5.00
Poland	WIBOR	*3.84*	3.90	4.10	4.30	4.30

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

	Current	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	*2.84*	3.45	3.65	3.80	3.95
Hungary	*6.51*	6.00	6.00	6.00	6.00
Poland	*5.385*	5.40	5.60	5.60	5.80

Exchange rates (end of the period)

		Current	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	EUR/CZK	*25.5*	24.8	24.8	23.8	25.5
Hungary	EUR/HUF	*282*	270	265	265	260
Poland	EUR/PLN	*4.12*	3.90	3.60	3.90	3.60

GDP (y/y)

	Q2 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011
Czech Rep.	*1.7*	1.4	1.7	2.3	2.6
Hungary	*-5.3*	-1.5	0.5	1.0	2.0

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

	Jun-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	*1.4*	2.1	2.0	1.9	1.9
Hungary	*5.9*	4.2	3.5	3.5	3.5

Current Account as % of GDP

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

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

	2009	2010
Czech Rep.	-5.9	-5.5
Hungary	-3.9	-5.5

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