KBC Banking & Insurance

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Central European Weekly

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DEAR CLIENTS,
DUE TO A REGULAR SUMMER BREAK THE NEXT CE WEEKLY WILL BE RELEASED ON AUGUST 30TH.

Czech Republic

Cars are propelling the economy, but for how much longer?

Hungary

The Government walks away from talks with IMF/EU and it will rely on market financing

Poland

Strong retail sales point to good second quarter

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.18	0.04%	→	→
EUR/PLN	4.074	0.01%	→	→
EUR/HUF	287.5	0.04%	→	→
3M PRIBOR	1.23	0.00	→	→
3M WIBOR	3.81	0.00	→	→
3M BUBOR	0.00	0.00	→	→
10Y CZK	3.70	0.00	→	→
10Y PLN	5.82	0.00	↗	→
10Y HUF	7.25	0.00	→	→
3M EURIBOR	1.05	0.00	↗	↗
10Y EMU	2.69	0.00	→	↗

Last values from Friday 15:30 CET

Poland is moving forward with dangerously high deficits

Poland is continuing to post great figures. A strong rise in industrial output and retail sales was accompanied by a fall in unemployment and there is every indication that Q2 growth will be very strong. Czech figures look similarly good at the moment. That said, both Central European economies are primarily benefiting from the good performance of the German industry. During the crisis, the ties of both economies to Germany increased. The ties were particularly strong between Germany and the Czech Republic, from which Germany imports more than from all other Central European countries. Therefore the Czech koruna has rightly welcomed the recent surprisingly upbeat mood in German industry (IFO, PMI).

The fundamental difference between both economies lies in the risks associated with public finances. In the Czech Republic a strong centre-right coalition is at the helm, starting to implement an ambitious reform programme. It intends to cut the government deficit to less than 3% of GDP by 2013. Poland's path will be thornier. A large portion of Poland's deficit is structural (approximately 6% of GDP) and current economic growth will not eliminate this soon. In addition, a general election will be held in Poland next year and the European Football Championship in 2012. Hence it is quite possible that Polish politicians will not proceed to actual reforms until 2013.

Budgetary matters also stirred Hungary last week. A difference of opinion between Hungary and the IMF occurred with Hungary, against its rescuers' will, having decided to ease slightly the rate of its deficit reduction and to introduce a controversial banking tax. Given Hungary's current account surplus and, compared to other European countries, low deficit, the country can do without the IMF quite easily at the moment, unless any major problems occur globally, of course.

Czech Republic

Macro review

After the unprecedented drop in **car production** – as well as in other industries – production recovered in the second quarter of last year, owing to the introduction in a number of European countries of what is known as the bonus for scrapping cars. Hence the production of motor vehicles in the Czech Republic has been rising at a double-digit rate for eight consecutive months, significantly contributing to the recovery of the Czech economy. Thus far, the output of the car industry has increased by 31% since the beginning of the year, compared to a drop by more than 27% for the same period of last year. Car exports made up approximately 18% of all exports over the last year, even if we don't include the exports of the components required for car production. The surplus of foreign trade in cars has exceeded CZK 234bn on a yearly basis. However, demand for new cars in Europe was strongly supported by fiscal measures to replace older cars in several countries. These scrapping campaigns are over or will be over soon. This raises the question as to how the demand for new cars will continue to develop.

The **statistics from individual countries** confirm that those countries where the scrapping bonuses no longer apply see a significant drop in demand. Moreover, after last year's fall by 12.4%, the situation on the Czech market has probably stabilised. Without the scrapping bonus, but encouraged by the improved depreciation terms for businesses and lower prices, car sales were up by a total of 3.1% in the first half of the year. However, the support in the form of accelerated write-offs is expiring, and this may unsettle the new car market within the next few months.

While the worst is over for car production, as we can see for example from the rise in new contracts, we can still argue as to whether there is any long-term recovery of demand for new cars (not encouraged by the scrapping bonuses). Nevertheless, the performance of the Czech car production will continue to be positively influenced by Hyundai's increasing output in the wake of its production launch. Yet the second half of the year is unlikely to show a double-digit rise, as was the case in the first half, and consequently any positive output growth can be viewed as **a success.**

Currency

The **Czech koruna** went through a very solid week. With nearly no domestic impetus it got to the 25.10 EUR/CZK area. The gains were due to better global sentiment and more in particular to the excellent German Business sentiment indicators (Ifo/PMI). The predictive ability of the German index Ifo has improved during the crisis and it is reasonable to assume that the Czech economy is directly affected by the developments in Germany.
Even in the case the bears would continue to set the tone on global markets this week, the Czech koruna has proved in past to be successfully ignoring the negative development and on contrary benefit the most from the positive séances. From a technical point of view the strongest values from the year 2009 could be tested – 24.975 EUR/CZK.

EUR/CZK technical picture

(25.1900) Trying to extend below Uptrendline off low: see graph).
1st support area at 25.1100 (July 22 low), with next levels at 25.0150 (year low), ahead of 24.9750 (Sept 2009 low), where pause favored.
If wrong, next levels at 24.8750 (2nd target of hourly Head and Shoulders Top off 25.4200), ahead of 24.7900 (3rd target) and 24.5210 (76.4% 22.9250 to 29.6900): tough on 1st attempts.
Resistance area at 25.4200 (see above + break-down hourly): ideal area to stay below to keep cur-rent short term mood on CZK intact.
Failure to cap would see next levels at 25.6550 (breakdown daily), ahead of 25.8880 (June 25 high).
Inability to cap would be indication of something more serious for CZK.

DAILY CHARTS:

Fixed income

The **Czech bond market** extended its previous gains. Last week's bids in the auction of the 10Y benchmark showed that appetite for the Czech government debt remained strong.
The bid-cover ratio in the auction reached 2.71, while the Czech MiniFin sold more than CZK 9bn worth of bonds. The success in the primary market spilled over to the secondary market as the yield of the 10Y benchmark declined by an impressive 28 bps.

The domestic eco calendar for the upcoming week is empty. So the Czech bond markets will look for inspiration to other markets. In this respect, the strong koruna and neural developments in core markets might lead to stabile Czech yields – in other words the market will be able to defend its previous gains.

Hungary

Macro review

Investors' focus for **Hungary** is still centred around the sustainability of public debt without the help of the IMF/EU funding. The government initially emphasised that talks had only been suspended, but most recent comments opened the door that the government will let the IMF program expire in October and will try to finance itself completely from the market. The government has already been financing itself from the market for about a year now, but the IMF/EU loan kept a safety net behind in case a worsening of investors' sentiment would occur.

The government remained committed to this year's 3.8% of GDP deficit target, but has so far not set a firm target for 2011. The former government pledged 2.8% of GDP last year in the Convergence Program, which implies 1pp deficit reduction, but the new government would like to slow down the fiscal consolidation.

In order to see the possibilities for a higher deficit target, the Prime Minister visited the German chancellor Mrs Angela Merkel. She said that like all other EU countries, Hungary has to keep the rules of the SGP. She did not directly mention the 2.8% of GDP target, but praised the efforts of recent years, when she said that this year's 3.8% of GDP target is quiet a good performance. The government will have to lobby at other EU countries for a deficit target probably between 3.0% and 3.5% of GDP for 2011.
This doesn't look so bad, overall. Assuming a nominal growth rate of 5% (2% real, 3% inflation) a deficit below 4% would allow the public debt ratio to fall from the current level of 80% over the coming years. This would guarantee the sustainability of public debt over the long-term and may keep investors calm about this risk.
However, this seems to be a narrow, probably very narrow equilibrium until growth picks up significantly and thus sentiment may not become positive until investors see that the targeted fiscal path is achievable.

Currency

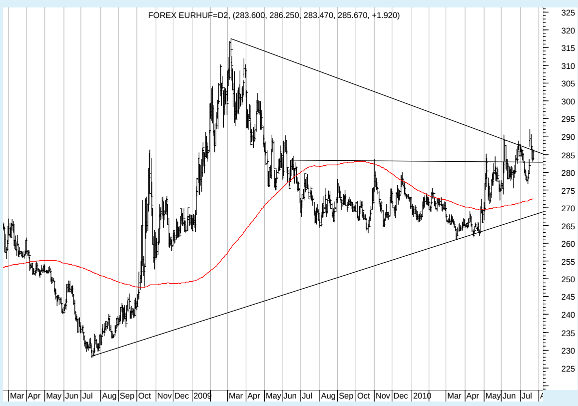
The initial negative reaction to the suspension of the IMF talks, pushed the **EUR/HUF** cross rate to this year's record low of 292.00 on Monday. However, the forint was able to recover during the week as investors calmed down and fundamentals again received priority even if the IMF program is not renewed.

The currency recovered 2% to 284.00-286.00 by the end of the week and lower intra-day volatility suggests that the market may continue to trade quietly in the summer.
Moody's announcement that it may downgrade the country's Baa1 rating if fiscal and growth risks does not abate, caused the currency into weakening again, but the move lost steam at 286.50 within hours.
We wait on the sideline until the dust settles. We see the fundamental outlook generally positive on the back of a strong fiscal performance in 2010-2011 but the market could be vulnerable over the next weeks.

EUR/HUF technical picture

(285.55): Tried to extend above long term triangle pattern and 283.60 (see graph: neckline Long Term Double Bottom).
Resistance at 288.40 (breakdown hourly).
Failure to cap would see next levels at 292.10 (July 19 high), ahead of 294.50/ 295.85 (Irregular C wave off 260.93/ 61.8% 317.45 to 260.93): tough on 1st attempts.
Support at 280.51/ 280.40 (break-up daily/ reaction lows hourly): needs to settle back below to signal return of calmer water for HUF.
If unable to hold, next levels at 277.70/ 276.70 (break-up hourly/ July 14 low), ahead of 275.50 (June 21 low) and 273.75 (June 03 low): tough on 1st attempts.

DAILY CHARTS:

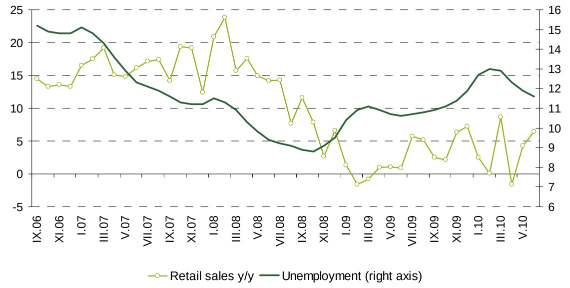


Fixed income

The **bond market** also reacted negatively to the end of the IMF program and yields rose about 30bps at the beginning of the week. However, this did not last long either and yields lowered back to the levels of the week before. The FRA market was an exception as interest rates at longer-tenors, like 6x9 and 9x12 remained about the key 6.00% level indicating that the central bank may have to hike the base rate in the coming months.

Poland

Retail sales and unemployment (%)



Currency

The **Polish zloty** gained to the 4.05 EUR/PLN neighbourhoods on solid domestic figures and improving global sentiment.
The strong results of the industry exceeded expectations (14.5% y/y). In particular, activity in the construction sector has dramatically accelerated, driven by the preparations for the football championship and supported by the inflow of money from structured funds. The manufacturing industry has done well, too, probably based on solid accomplishments by Germany.

The retail sales have risen on a yearly basis by an impressive 6.5% y/y. The number is published in nominal value and is affected by the high inflation of food prices. Nevertheless, the numbers still point to a rise of real consumption in the second quarter.

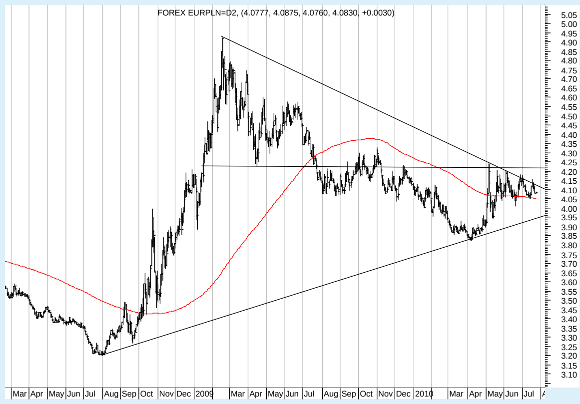
The figures support the case of the hawks in the MPC, raising the chances of increasing rates by the autumn of this year.

This week has no important events on the domestic calendar. The zloty will behave itself according to the results of the contest between the bears and the bulls on global equity markets. From a technical point of view, it is close to testing the 4.00 EUR/PLN level.

EUR/PLN technical picture

(4.0700): Currently in long term triangle pattern, but nearing apex (see graph).
1st Support area at 4.0510/ .0440 (July 14 low/ reaction low hourly), with next level at 4.0120 (June 21 low), where pause favored.
If unable to hold, next levels at 3.9700 (break-up daily May 13), ahead op 3.9400 (May 13 low + 4th wave hourly): tough on 1st attempts.
1st Resistance comes in at 4.1190 (reaction high hourly), ahead of 4.1550 (July 19 high), where pause favored.
If wrong, next levels at 4.1790 (June 29 high), ahead of 4.2060 (June 04 high): tough on 1st attempts.

DAILY CHARTS:



Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	26.7.2010	09:00	Retail sales (%)	05/2010				-3.8		-5.0
HU	28.7.2010	09:00	Unemployment rate (%)	06/2010			11.2		11.4	
HU	29.7.2010	09:00	PPI (%)	06/2010				6.7	3.8	5.5
HU	30.7.2010	09:00	Trade balance (EUR M)	05/2010 *F					428.8	
CZ	30.7.2010	11:00	Money supply M2 (%)	06/2010						4.0

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	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	*1.23*	1.15	1.22	1.35	1.60
Hungary	BUBOR	*5.32*	5.10	5.00	5.00	5.00
Poland	WIBOR	*3.81*	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.	*2.85*	3.45	3.65	3.80	3.95
Hungary	*6.81*	6.00	6.00	6.00	6.00
Poland	*5.375*	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	*25.2*	24.8	24.8	23.8	25.5
Hungary	EUR/HUF	*288*	270	265	265	260
Poland	EUR/PLN	*4.08*	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	-1.4
Hungary	1.6	0.5

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

	2009	2010
Czech Rep.	-5.9	-5.5
Hungary	-3.9	-3.8

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