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KBC Banking & Insurance

Central European Weekly

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Czech Republic

FRA rates up, but rate hike expectations are premature

Hungary

Huge ecological catastrophe may not have significant on the economy

Poland

Parliament will discuss the draft of the public budget with deficit of 6.5 % of GDP

The Week Ahead

Czech and Polish C/A balances in significant deficits

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.48	0.19%	↗	↗
EUR/PLN	3.980	0.93%	↗	↗
EUR/HUF	276.0	0.80%	↗	↗
3M PRIBOR	1.21	-0.01	→	→
3M WIBOR	3.82	-0.02	→	↗
3M BUBOR	5.35	-0.01	↗	↗
10Y CZK	3.29	-0.01	→	→
10Y PLN	5.43	-0.03	→	↗
10Y HUF	6.59	0.09	↗	↗
3M EURIBOR	0.97	-0.03	→	↗
10Y EMU	2.26	-0.06	→	↗

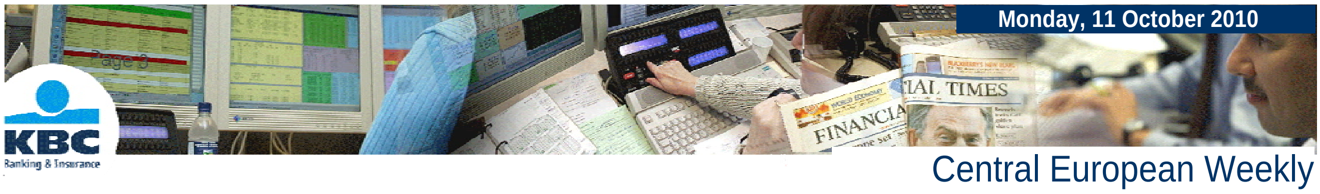
Last values from Friday 15:30 CET

Industry in Central Europe tracks strong German data

The August data on industrial output in the Czech Republic and Hungary show that the upswing in Central Europe continues. This is well in line with the outstanding performance of German industry, to which Hungarian and Czech industries are tied very closely.

In addition, a very positive phenomenon in both Central Europe and Germany is the level of new contracts that still remains very high. That's very good news as the fiscal stimuli (such as scrapping bonuses) that positively influenced the performance of Central European industry, which is very strongly oriented on exports, have run out of steam.

Nevertheless, despite the highly positive results of Central European industry in recent months, we are afraid that this won't continue necessarily given the fiscal tightening within the euro area in 2011, along with the inventory replenishment process slowly drawing to a close,. This will have a negative impact on exports and consequently on industrial growth in the region. Another argument against the optimistic expectation that industry will maintain its fast rise is associated with the fact that Hungarian and Czech industries will not be able to utilise the ever-improving demand from Asia to such a great extent as, for example, the German economy. The reason is that the exports from Central European countries to the Asian continent are negligible, representing approximately 5% of all exports.

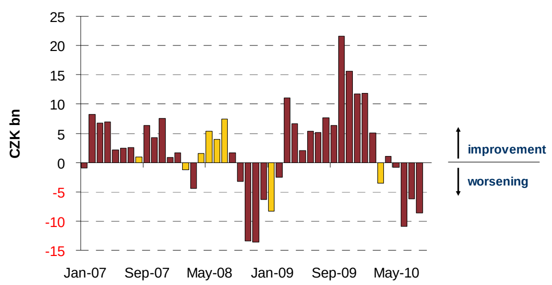


Czech Republic

Macro review

The Czech Republic's trade balance for August was much worse than expected. The trade surplus was only CZK 537m, while the market had expected a surplus in excess of CZK 5bn. The figure is CZK 8.6bn lower than last year, due to a significant increase in imports from China. These particularly consist of greatly increased imports of components for the electrical industry, which is primarily oriented on exports (the manufacture of PCs, mobile phones, LCDs, etc.). Hence the imports of those inventories should not be considered to pose a risk to the trade balance. In addition, the year-on-year rise in raw material prices, which led to the increased imports of oil and natural gas in terms of value, also had a significant impact. More importantly, we should therefore look at the export activities of domestic firms at the moment. While it becomes evident that the rate of exports lags behind that of imports, the former is still in excess of 20%. Owing to this, the trade surplus with Germany, and actually with the EU as a whole, is continuing to rise. In spite of declining car registrations in the EU, car exports to this market are still rising (+11.2%), and the rise generated by the entire group of machinery and means of transport even exceeds 20%. Contracts of industrial firms are also hopeful, showing promise of reasonable increases in exports for the months to come. Hence the predicted full-year foreign trade surplus of around CZK 150bn is realistic even still.

Y/Y change of the monthly trade balance



Fixed income

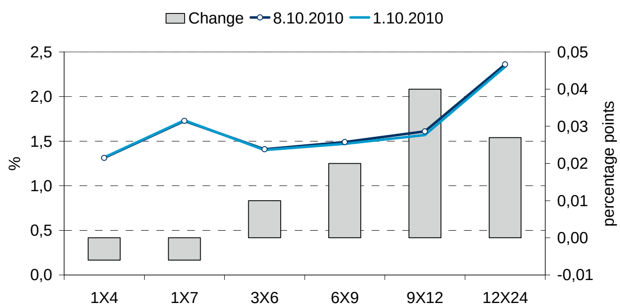
Czech FRA rates started to rise slowly, which seems to be a new phenomenon. One explanation could be the upward trend in Euribor rates, which we observed in recent weeks and it could partly spill over to the Czech money markets (respectively to FRA derivatives).
The second reason, which might be behind the price action, could be the market fear that a rate hike form the CNB would come sooner than it was previously thought. Supported by the very recent dovish comment of CNB governor Singer these bets are pre-mature, because inflation pressures will not be felt many months ahead.

EUR/CZK technical picture

(24.4400) Double Top off 25.0150 (previous year low: see graph), with new reaction low off 29.6900 being scored.
1st support area at 24.3650 (current new reaction low off 29.6900), ahead of 24.2450 (weekly modified Alpha Beta trend bottom) and 24.1980 (monthly Bollinger bottom), where pause favored.
If wrong, next levels at 24.0760/ .0630 (monthly envelope bottom/ weekly Bollinger bottom), ahead of 24.0000 (psycho + monthly modified Alpha Beta trend bottom): tough on 1st attempts.
Resistance area at 24.6110 (weekly modified Alpha Beta trend top), with next levels at 24.6500 (Sept 28 high), ahead of 24.7500/ .7700 (Sept 16 high + weekly falling Medium Term Moving Average /Sept 07 high + monthly envelope top): ideal area to stay below to keep current short term mood on CZK intact.
24.9450/ .9900 (Aug 25/ 16 highs): key area to stay below to keep current medium term mood on CZK .

DAILY CHARTS:

CZ FRA



Source: Reuters

Hungary

Macro review

Hungary came to the forefront of world news with the 'red sludge' disaster that killed five people and lead to the evacuation of a nearby village. Albeit, Hungary's biggest ever ecological catastrophe may not have significant economic impact – the budgetary impact could be below 0.05% of GDP – it has put the country into the limelight of the international media.

The short background history is that Hungary had one of the biggest bauxite resource 50-years ago and the Soviet-era regime decided to make Hungary one of the biggest aluminium producers in the world. Some of this capacity has remained alive after the transition, but it now seems that this business incurred significant risk for the environment. The final solution is not yet clear, but the government may also decide to take over the company as it also wants to rescue the 1,100 jobs besides eliminating the risks.

Beside this, the economy turned out to be in a better shape last week. Industrial output grew stronger at 14.9% Y/Y in August and trade surplus jumped back to the €400m territory with an €392m surplus in the same month on the back of 35% export growth. Export has not been expanding at this pace since early 2001, when the economy had the best days in the last 20-years. Overall, this suggests that foreign trade balance could remain at the 5% of GDP surplus, which could keep the current account in a surplus this year.

The most risky item for the last quarter could be the outcome of this year's budget, where the deficit is still standing at 125% of the full-year target. The September balance was a small deficit of Ft7bn, which is much better than last year's result of Ft145bn deficit, especially given that only Ft70bn arrived this time from the special tax on financial service providers. This implies an underlying deficit improvement of about Ft70bn, which would be enough for the last three months to meet that full-year deficit pledge of Ft900bn or 3.8% of GDP.

This week's highlight will be the September inflation data on Tuesday, which is expected at 3.9% Y/Y, up slightly from 3.7% in August. Wholesale food prices are going up sharply therefore upside risks to inflation could surprise.

Currency

The forint had one of the sharpest rallies last week, when it moved from 274 to 269.50 at the beginning of the week followed by a gradual correction towards the key 275.00 level. The latter is also the 200-day moving average, which is now being tested on the way down and this week's main question could be whether it holds on or not.

EUR/HUF technical picture

(275.40): Pair currently still below 276.70 (see graph: neckline Head And Shoulders Top) but back above Uptrendline off year low.

Resistance at 276.34/ .70 (flat weekly Long Term Moving Average/ see above): ideal area to stay below to keep current mood on HUH.

If unable to cap, next levels at 277.63 (38.2% 292.10 to 268.70), ahead of 278.85 (breakdown daily) and 280.81/ 281.20 (weekly modified Alpha Beta trend top/ weekly Bollinger midline), where pause favored.

Support at 271.50 (break-up hourly), with next levels at 268.70/ .28 (current reaction low off 292.10 + weekly modified Alpha Beta trend bottom/ 76.4% 260.93 to 292.10), were pause favored.

If unable to hold, next level at 264.70 (1st target off 276.70): tough on 1st attempts.

DAILY CHARTS:

Fixed income

The bond market rallied with the currency as usual, but demand was a bit smaller than expected and this became obvious with the smaller bid-to-cover ratios on Thursday's auctions. Yield results were however quite low at 6.41% and 6.54% for 3- and 5-year bonds, respectively. The 10-year bond was sold at 6.66% average yield and the currency's correction drove this higher to 6.75% on the next day.

Long-term forward spreads are still high at about 300bps, so there is still a lot of room to converge at the long-end, while the country's high default risk and still weak credibility may mean allow for a slow process.

Poland

Macro review

The Polish Parliament began to discuss the 2011 **public budget**, which could bring deficit 6.5% of GDP. For the years ahead, the ministry plans a deficit of 4.5% GDP for 2012 and 2.9% for 2013. **The current plan is non-ambitious, which does not mind so much with respect to low debt levels and low financing need, and lacks credibility**. It is not clear how the government plans to reduce the deficit after 2011. Furthermore the government has a poor track record even with current non-ambitious targets – the deficit may reach 8% of GDP (6.9% plan) despite the accelerating domestic economy.

Currency

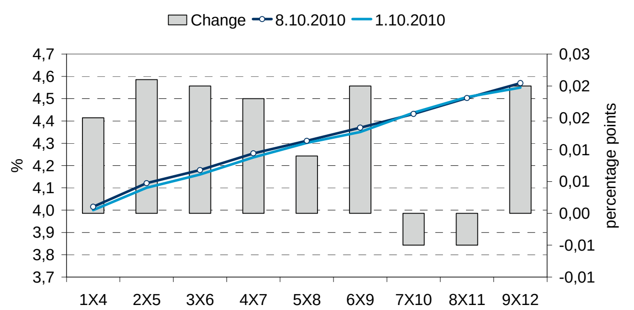
The Polish zloty continued to hover below the EUR/PLN 3.99 level in relatively tight range, while even strong forint's was not sufficient trigger for more visible price action.
This week, the zloty will eye several interesting data, which will be dominated by the September CPI (on Wednesday) and by the August C/A balance. Both reports might bring some disappointments for zloty's bulls, but the key driver of the currency will the US earnings season.

EUR/PLN technical picture

(3.9850): Currently below long term triangle pattern, but at apex (see graph).
1st Support area at 3.9450 (break-up hourly), with next levels at 3.9221/ .9177 (Oct 06 low/ current reaction low off 4.2400), ahead of 3.9020/ .9002 (1st target of daily Triple Tops off 4.0405/ rising 50 Month Moving Average), where pause favored.
If unable to hold, next levels at 3.8760/ .8750 (last targets off 4.0405 + weekly Bollinger bottom + weekly modified Alpha Beta trend bottom): tough on 1st attempts.
1st Resistance comes in at 3.9945/ 3.9980 (Sept 30/ 24 highs)
4.0180/ .0270 (Aug 31 high/ Aug 04 + 24 highs): ideal area to stay below to keep current mood on Zloty.

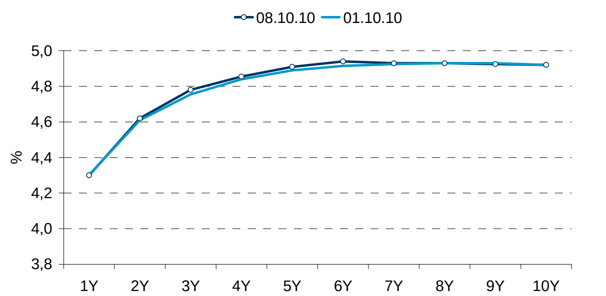
DAILY CHARTS:

PL FRA



Source: Reuters

PL IRS



Source: Reuters

CE Weekly Preview

WED 10:00 **CZ Cur. Account (CZK bn)**

	Aug-10	Jul-10	Aug-09
C/A monthly	**-20.0**	-32.5	-10.5
cummulative (YTD)	**-63.0**	-43.0	-22.3
Trade bal. monthly	**8.0**	12.8	11.3
cummulative (YTD)	**138.8**	130.8	119.0

CZ: The current account posts a double-digit deficit

The current account continued to show fairly high deficits in August. We believe that this was primarily due to the dividend outflow and the worsened balance of services. The poor foreign trade figure, which was released on Thursday, also involves uncertainty now. Even so, the current account remains within safe bounds, posing no risk to the Czech economy.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**12.10.2010**	**09:00**	**CPI (%)**	**09/2010**			**0.1**	**3.9**	**-0.6**	**3.7**
PL	12.10.2010	14:00	Current account (EUR M)	08/2010			-1 160		-1 539	
PL	12.10.2010	14:00	Trade balance (EUR M)	08/2010			-780		-865	
CZ	13.10.2010	10:00	Current account (CZK B)	08/2010	-20.0		-12.4		-32.5	
PL	**13.10.2010**	**14:00**	**CPI (%)**	**09/2010**			**0.3**	**2.3**	**-0.4**	**2.0**
HU	14.10.2010	09:00	Industrial output (%)	08/2010 *F						
PL	14.10.2010	14:00	Money supply M3 (%)	09/2010			0.5		0.8	
CZ	15.10.2010	09:00	PPI (%)	09/2010	-0.1	2.0	-0.1	2.1	-0.4	1.8

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	Sep-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	0.75	1.00	-25 bps	06/05/2010
Hungary	2W deposite r.	*5.25*	5.25	5.25	5.25	5.25	5.25	-25 bps	23/02/2010
Poland	2W inter. rate	*3.50*	3.50	3.75	3.75	4.00	4.00	-25 bps	25/06/2009

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

		Current	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	PRIBOR	*+1.21*	1.20	1.20	1.25	1.35	1.55
Hungary	BUBOR	*+5.35*	5.25	5.25	5.25	5.25	5.25
Poland	WIBOR	*+3.82*	3.90	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	Sep-11
Czech Rep.	*+2.6200*	2.65	2.75	2.90	3.05	3.15
Hungary	*+6.200*	6.50	6.50	6.25	6.00	6.00
Poland	*+4.9200*	4.95	5.00	5.60	5.60	5.80

Exchange rates (end of the period)

		Current	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	EUR/CZK	*+24.490*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*+276.100*	280	280	275	275	275
Poland	EUR/PLN	*+3.9809*	4.00	3.90	3.60	3.70	3.60

GDP (y/y)

	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Czech Rep.	2.0	1.4	1.5	1.1	2.0	3.0
Hungary	0.5	1.0	1.2	1.4	2.0	2.5

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

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	1.9	2.0	2.0	2.1	2.4	2.5
Hungary	4.2	3.5	3.4	3.2	2.8	3.2

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-1.5
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	-3.0

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