KBC Banking & Insurance

Monday, October 18,

Central European Weekly

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

Czech Republic

The current account is heading for a worse figure this year

Hungary

Introduction of new taxes on energy, telecoms and retail companies brings mixed reaction

Poland

The September inflation surprised strongly on the upside

The Week Ahead

Polish industrial output and Czech bond auction might grab some attention

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.54	0.41%	↗	→
EUR/PLN	3.907	-0.95%	↗	→
EUR/HUF	274.6	0.27%	↗	→
3M PRIBOR	1.20	-0.02	→	→
3M WIBOR	3.82	-0.02	→	↗
3M BUBOR	5.35	0.00	↗	→
10Y CZK	3.33	0.03	→	↗
10Y PLN	5.51	0.04	→	↗
10Y HUF	6.80	0.30	↗	→
3M EURIBOR	1.09	0.09	→	↘
10Y EMU	2.35	0.03	→	↘

Last values from Friday 15:30 CET

Markets start to bet on hikes in the Czech R. and Poland

The market expectations of a possible hike in the official interest rates in the Czech Republic and Poland are slowly increasing. The rise in Polish and Czech FRA rates is related not only to a possible contagion from the euro market, where short-term interest rates are obviously rising. However, domestic factors are also fuelling concerns that the relevant central banks will need to react to the risk of future inflation sooner or later.

The ammunition for an increase in market expectations in the Czech Republic was primarily supplied by central bankers and the latest inflation figure was largely irrelevant in this respect. Exact the opposite was true for Poland. Its inflation rate for September surprisingly rose by 0.6% m/m and although it was primarily driven by increased food prices, it encouraged the view that a rate hike cycle would be launched soon.

We agree that official rates in the Czech Republic and particularly in Poland will go up in the end (in the middle of 2011 and late 2010 respectively). However, we doubt whether the current pricing of the start of the hiking cycle is correct. At the moment, markets have priced in that the official interest rate may go up by 25 basis points in the Czech Republic and even 50 bps in Poland before the end of the first quarter of 2011. We would consider such a move to be highly aggressive and, beyond any doubt, it would trigger a sharp appreciation of the domestic currency. And having a strong currency is not popular macroeconomic strategy in the age of a global currency wars.

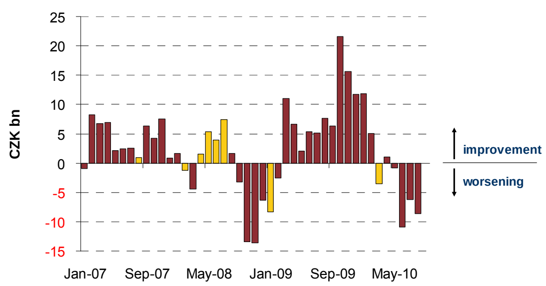
Czech Republic

Macro review

The Czech Republic's current account did not surprise, but it posted a significant deficit of slightly above CZK 18bn in August. The trade balance surplus for that month has been the poorest trade balance figure of this year. Even so, as we noted the last time, this was primarily due to a significant increase in the imports of components for the electrical industry, rather than due to domestic demand from end users. Just like in previous months, the balance of services remained well in the red, because of the inclusion of what is known as 'branding'. This year's current account has also been affected by the increased dividends paid out by enterprises under foreign control.

By and large, the current account is heading towards worse figures this year. The deficit is approximately 2.1% of GDP at the moment, but we do not believe that the figure will deteriorate significantly until the end of this year. By contrast, we see a positive trend in the inflow of foreign direct investment, which has reached almost CZK 119bn for the first eight months of the year, with nearly half that amount being the reinvested profits of businesses under foreign control. The positive developments in the FDI and actually in the entire financial account create favourable preconditions to cover this year's current account deficit.

Y/Y change of the monthly trade balance

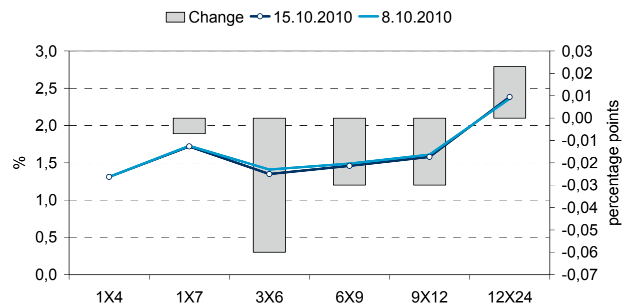


Fixed income

The Czech fixed income market remained quite calm last and it seems that even rate-hike bets have taken a pause these days.

The most interesting domestic item for the fixed income market point be an auction of a 15Y benchmark on Wednesday. The current right-wing ruling coalition lost in the local elections (held during the last weekend) and this might complicate an application of the austerity programme. Nevertheless, we think the demand for bonds will be again solid.

CZ FRA



Source: Reuters

EUR/CZK technical picture

(24.4700) Double Top off 25.0150 (previous year low: see graph), with new reaction low off 29.6900 having been scored.

1st support area at 24.3650 (current new reaction low off 29.6900), ahead of 24.2240 (weekly modified Alpha Beta trend bottom + monthly Bollinger bottom), where pause favored.

If wrong, next levels at 24.0760 (monthly envelope bottom), ahead of 24.0000 (psycho + weekly Bollinger bottom + monthly modified Alpha Beta trend bottom): tough on 1st attempts.

Resistance area at 24.5320/ .5500 (weekly modified Alpha Beta trend top/ Oct 11 high), with next levels at 24.6300/ .6500 (weekly falling Medium Term Moving Average/Sept 28 high): 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:

Hungary

Macro review

The government's second action plan had a mixed reaction on markets as the government did not announce deep spending cuts, but rather decided to introduce special taxes on energy, telecommunication and retail companies. This would generate additional Ft160bn (0.6% of GDP) income for the budget beside the existing tax on financial service companies.
The government will also redirect some Ft360bn (1.3% of GDP) contribution from mandatory private pension funds to the state pension fund in 2011, which will also temporarily boost the state coffers. This measure looks to be a kind of cheap financing of the budget deficit in 2011, like a zero-cost bond rather than a real revenue measure, but the government also kept the door open for private pension fund members to return to the state budget. This step looks to buy time for the government to see some results on growth from the tax reduction on labour, mainly the introduction of a flat, 16% personal income tax rate combined with tax allowance for children.
The flat tax will leave about Ft400bn (1.5% of GDP) in the pockets of the people, which could boost domestic demand, but may also help savings.
Lower tax burden on labour could also improve the supply side of the labour market, which than may help growth without adverse effects. The overall impact of the tax package is cloudy, but we think given Hungary's low employment ratio – the second lowest after Malta – the supply-side effect will also be positive.
On the data front, inflation was a tad better – again – in September at 3.8% Y/Y, while core inflation remained low at 1.5% Y/Y. Inflation seems to be running below the central bank's inflation forecast from August.
This week could confirm that wage growth remained moderate in August, just like retail trade.

Currency

The **forint** extended its rally to a 6-month high of 269.50/€ at the beginning of last week followed by a correction to the 277.00 level at the end of the week as the government plans together with risk aversion on global markets established a weakening trend of the forint.
Market's negative attitude toward the government decisions could keep the sentiment bearish for the time being and there could be some improvement only later if this year's budget deficit target will get closer.

EUR/HUF technical picture

(274.90): Pair currently still below 276.70 (see graph: neckline Head And Shoulders Top) but back above Uptrendline off year low.
Resistance at 276.24/ .70 (flat weekly Long Term Moving Average + Oct 08 high/ 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/ 279.26 (break-down daily Sept 23/ falling weekly Medium Term Moving Average↓), where pause favored.
Support at 269.80/ .49 (break-up hourly/ weekly modified Alpha Beta trend bottom), with next levels at 268.70/ .28 (current reaction low off 292.10/ 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

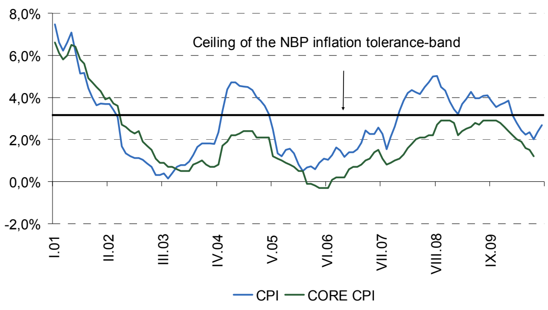
The **bond market** had a sharper correction and long-term yields rose back to the key 7.00% level. The 5y5y forward spread also widened to above 300bps, while short-end rates priced in some 50bps rate hikes for the next 6-months.
Investors became concerned especially by the pension system changes as they fear that half of the flow (Ft180bn or 0.6% of GDP) could be missing for the bond market on the demand side. On the other hand, we assume that the lower deficit and lower redemptions mean lower gross issuance and the overall weekly bond supply could remain around the current level.

Poland

Macro & interest rate review

September's development of Poland's inflation was fairly surprising. The **consumer price index** went up by 0.6% m/m, while markets had expected half that figure, i.e., 0.3% m/m. Year-on-year inflation hit exactly the 2.5% inflation target of the National Bank of Poland (NBP). A more detailed look into the index structure reveals that the main reason for prices to go up compared to August were food, including soft drinks (1.8% m/m), clothing and shoes (2.6% m/m). The Monetary Policy Council of the NBP responded quite quickly. One member, Andrzej Bratkowski, made a hawkish comment in reaction to the released data and called for quick hikes in the reference rate, with his main argument being the anticipated increase in the inflation expectations, which are largely influenced by food prices. The initial reaction of markets was also fairly clear: the Polish zloty strengthened and FRA rates went up. However, should we really be afraid that the start of a rate hike cycle is on the horizon in Poland? Note that core inflation is still low and unlikely to rise until next year. Moreover, the rise will be due to administrative measures taken by the government (a VAT increase). In addition, the dilemma of the Polish monetary policy is even more complicated by the fact that a rate hike would probably mean another appreciation of the zloty. This is not desirable at all in the current situation, the hallmark of which is a rise in current account deficit. **Nevertheless, we expect the fear of inflation to be predominant at the NBP, and the reference rate will consequently be raised from the current all-time low by 0.25%, to 3.75%, before the end of 2010.**

Polish inflation, y/y



Poland's current account is starting to deteriorate gradually and almost unnoticeably. Although its cumulative deficit for the first eight months of the year is even lower than a year ago, it has evidently deteriorated in recent months. This has been primarily due not only to the worsened balance of foreign trade but also due to the balance of services, which has deteriorated for more than a year (i.e., the rate of increase in the exports of services is lower than the rate of increase in service imports). That said, the balance of services kept posting high surpluses over the last few years, while now there is a risk that it may even slip into a deficit in early 2011.

Thus we can see that the combination of high budget deficits, a fairly strong currency, and the swift improvement in private demand is starting to affect the external balance of the Polish economy. In addition, the current account deficit may continue to deteriorate in the months to come, thus attracting more investor attention. The ultra-low 2009 deficit of 1.6% will certainly not reoccur within the next few years.

Currency

EUR/PLN technical picture

(3.9125): New reaction low off 4.2400 has met 1st target of daily Triple Top off 4.0405 (see graph).

1st Support area at 3.8900 (current new reaction lo off 4.2400), with next levels at 3.8760/ .8750 (last targets off 4.0405), where pause favored.

If unable to hold, next levels at 3.8598 (weekly modified Alpha Beta trend bottom), ahead of 3.8489 (monthly envelope bottom) and 3.8450/ .8409 (last Central Bank foray/ weekly Bollinger bottom): tough on 1st attempts.

1st Resistance comes in at 3.9915 (breakdown daily + weekly falling Medium term Moving Average↓): ideal area to stay below to keep current mood on Zloty.

Failure to cap would see renewed risk towards 3.9980/ 4.0107 (Sept high/ weekly Bollinger midline): tough on 1st attempts.

DAILY CHARTS:

CE Weekly Preview

CZ: Another easy auction of Czech bonds

The issue of the 15Y government bonds denominated in koruna's will be the only one in this quarter of the year, and its volume will be relatively small. Hence the auction demand is likely to be very strong, due also to the fact that global liquidity conditions have been greatly eased abroad, and foreign investors are buying practically anything on emerging markets.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
PL	18.10.2010	14:00	Wages (%)	09/2010			0.3	4.0	-0.8	4.2
HU	19.10.2010	09:00	Wages (%, ytd.)	08/2010				1.7		0.3
PL	19.10.2010	14:00	PPI (%)	09/2010			-0.1	4.2	-0.2	4.1
PL	**19.10.2010**	**14:00**	**Industrial output (%)**	**09/2010**			**12.4**	**11.2**	**-1.8**	**13.5**
CZ	**20.10.2010**	**12:00**	**CZ bond auction 5.70%/2024 (CZK B)**	**10/2010**			**6**			
PL	20.10.2010	14:00	Core CPI (%)	09/2010			0.2	1.2	-0.1	1.2
PL	20.10.2010	15:00	Budget balance (PLN M)	09/2010					-2 047.9	
HU	21.10.2010	09:00	Retail sales (%)	08/2010				0.7		1.7

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	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	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	3.75	3.75	4.00	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	Sep-11
Czech Rep.	PRIBOR	*1.20*	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.	*2.65*	2.65	2.75	2.90	3.05	3.15
Hungary	*6.345*	6.50	6.50	6.25	6.00	6.00
Poland	*5.138*	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	*24.5*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*275*	280	280	275	275	275
Poland	EUR/PLN	*3.91*	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	-2.4
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

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41		
Peter Wuyts	+32 2 417 32 35	Brussels	
Didier Hanesse	+32 2 417 59 43	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Commercial Desk	+32 2 417 53 23
		Institutional Desk	+32 2 417 46 25
Dublin Research (KBC Bank Ireland)			
Austin Hughes	+353 1 6646892	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Jan Bures	+420 2 6135 3574	New York	+1 212 541 06 97
		Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	Prague	+420 2 6135 3535
		Bratislava	+421 2 5966 8436
Budapest Research (K&H)		Budapest	+36 1 328 99 63
Gyorgy Barcza	+36 1 328 99 89	Warsaw	+48 22 634 5210
		Moscow	+7 495 228 69 61

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