Monday, November 08,

Central European Weekly

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

Czech Republic

CNB anticipates a much later start of its tightening cycle

Hungary

Hungary budget proposal disappoints

Poland

The MPC turns more hawkish

The Week Ahead

Czech and Hungarian economy grew in the 3rd quarter, but not spectacularly

Overview

CE currencies might diverge for some time

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.58	-0.13%	→	↗
EUR/PLN	3.901	-1.67%	→	↘
EUR/HUF	273.7	0.67%	→	→
3M PRIBOR	1.22	0.02	→	→
3M WIBOR	3.85	0.00	↗	↗
3M BUBOR	5.35	0.00	↗	↗
10Y CZK	3.43	-0.18	↗	↗
10Y PLN	5.66	0.02	↗	↗
10Y HUF	6.89	0.01	↗	↗
3M EURIBOR	1.13	0.05	↗	↗
10Y EMU	2.39	-0.13	↗	↗

Last values from Friday 15:30 CET

Only rarely does the correlation among Central European currencies decrease as significantly as it did last week. Naturally, the reason for this must be specific domestic factors, owing to which each currency to some extent goes its own way. What has been responsible for this?
Let us begin with the Polish zloty, which is obviously benefiting from the increasing expectations that the National Bank of Poland will raise rates soon. The fact that of those members of the Monetary Policy Council who position themselves neutrally, two voted for a rate hike as long ago as in August, indicates that the hawks on the NBP are starting to predominate. Therefore the expectations that the NBP would raise its official interest rate in November or December (which is our basic scenario) have begun to strengthen, as has the Polish currency.
One of the factors in the fluctuation of the Czech currency is the Czech National Bank – albeit the other way round, compared to Poland; the tone of the CNB Board meeting was surprisingly dovish, and thus the koruna responded negatively, because the market had somewhat bet on the CNB following the example of its Polish counterpart. However, this does not seem likely, now that fairly pessimistic macroeconomic forecasts have been released.
Finally, the forint is to some extent starting to live its own life, due to the fact that markets are increasingly upset by the latest fiscal measures taken by the government, which appear to be fiscally efficient in the short term, but pose numerous questions in the long term.
The divergence of Central European currency pairs might persist for some time. Indeed, the particular stories of the individual Central European economies really look quite divergent at the moment. In addition, this divergence may still become more pronounced when the assumption of stable rates (in the Czech Republic) on the one hand, and the anticipated start of the monetary tightening in Poland, on the other hand, would trigger regional carry trades.

Czech Republic

Macro review

The Czech National Bank left its rates unchanged at Thursday's meeting, by a 5-to-1 majority. The dissented voted for a rate hike by 25 basis points. The CNB Board also discussed a new CNB forecast, which, compared to the previous forecast, envisages a much better performance from the economy in 2010 and a much worse performance in 2011. The overall tenor of the forecast is even more dovish than that of the previous forecast. The CNB anticipates inflation very close to the target over the monetary policy horizon; nevertheless, it also envisages a significant deceleration of economic growth in 2011, to as low as 1.2%. The economic growth of the Czech Republic should be nearly twice as slow as that of the euro area. By and large, the forecast favours slower rate hikes next year. Looking into the CNB presentation, we can cite the following conclusion: "*Consistent with the forecast is stability of market interest rates close to their current levels initially, followed by a gradual rise in rates at the longer end of the forecast.*"

Prognosis		new	previous	change
GDP	2010	**2.3**	1.6	⬆
GDP	2011	**1.2**	1.8	⬇
Inflation	2011Q4	**2.0**	1.9	⬆
Monetary-relevant inflation	2011Q4	**2.0**	1.9	⬆
PRIBOR 3M	2011	**1.3**	1.4	⬇
EUR/CZK	2011	**24.3**	24.3	➡
External assumptions		**new**	**previous**	**change**
GDP-EMU	2011	**2.0**	1.9	⬆
Inflation-EMU	2011	**1.7**	1.7	➡
EURIBOR 3M	2011	**1.2**	1.2	➡
Brent	2011	**86.4**	78.6	⬆
USD/EUR	2011	**1.32**	1.20	⬆

The CNB perceives one moderate upside risk to inflation: higher world commodity and domestic agricultural producer prices. Also, there is one moderate downside risk to inflation: higher-than-expected anti-inflationary effects of fiscal consolidation, internationally. That said, the CNB Governor considers the uncertainties stemming from these risks to be greater than in the past. With the new inflation forecast, the central bank makes it clear that it will not at all be hasten to raise rates, anticipating a rate hike as coming at an even later date than it did in the previous months. The new inflation forecast appears to be fairly optimistic, given the anticipated development of food prices and regulated prices. This is why we rather expect inflation to rise temporarily above the target level, as early as at the beginning of next year. The extent of the deregulation and further administrative moves, which are only being discussed at the moment, continues to be an inflation uncertainty. Another uncertainty stems from the development of food prices, which have not stopped rising yet. Thus, next year's actual situation could make the central bank raise rates sooner rather than later. **Hence we believe that the CNB will raise rates as early as in the middle of next year, i.e., sooner than reported in the one-year or one-and-a-half-year horizon released last week**. Naturally, the primary determinant, as usual, will be the latest figures from the economy, which are highly uncertain at the moment.

Currency

The Czech koruna was similarly to us surprised by the dovish comments made after the CNB meeting and unexpectedly pessimistic outlook for growth in 2011. Hence the pair moved higher after touching 24.35 EUR/CZK and ended week in its favourable range around 24.50.

EUR/CZK technical picture

(24.6000) Double Top off 25.0150 (previous year low: see graph), with new reaction low off 29.6900 having been scored.
1st support area at 24.3450 (current new reaction low off 29.6900?), with next level at 24.3200 (weekly modified Alpha Beta trend bottom), where pause favored.
If unable to hold, next levels at 24.1960/ .1900 (monthly envelope bottom/ monthly Bollinger bottom), ahead of 24.0910 (weekly Bollinger bottom) and 24.0240/ .0000 (monthly modified Alpha Beta trend bottom/ psycho): tough on 1st attempts.
Resistance area at 24.7000/.7100 (Oct 24/ .22 highs) and 24.7500/ .7700 (Sept 16 high + monthly envelope top/ Sept 07 high): ideal area to stay below to keep current short term mood on CZK.
24.9450/ .9900 = Aug 25/ 16 highs: key area to stay below to keep medium term mood on CZK.

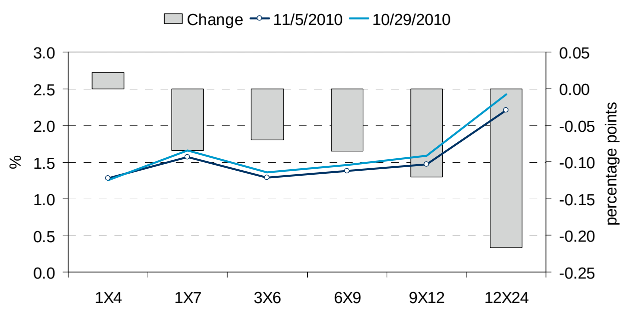
DAILY CHARTS:

At the beginning of the week the Czech koruna shrugged of rather favourable outcome of domestic figures (retail sales, foreign trade, industrial output) We are slightly below consensus in terms of GDP estimate. That could keep the koruna in defensive mode giving rather cautious CNB more arguments to stay in wait and see mode.

Fixed income

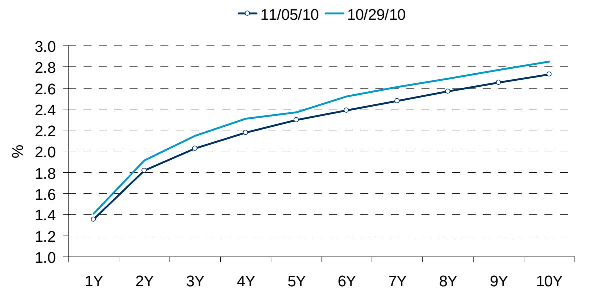
The dovish forecast had an impact not only on the exchange rate of the koruna, but particularly on the short end of the yield curve, where bets on an early hike in official interest rates have been largely eliminated. Consequently, FRA rates, as well as short swap rates, went down by around 10 basis points.
The prospects for a later hike in the Czech National Bank's repo rate are likely to encourage demand for the 3Y bond to be supplied by the government in this week's auction. Nevertheless, if the sale of bonds on leading markets persists after the decent report from the U.S. labour market, this will also have a negative impact on the end of the Czech yield curve.

CZ FRA



Source: Reuters

CZ IRS

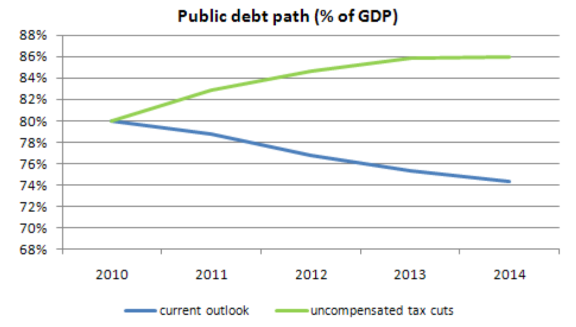


Source: Reuters

Hungary

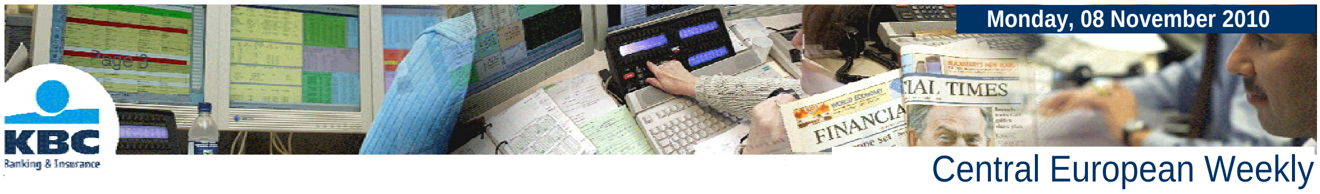
Macro review

The government submitted the draft 2011 budget proposal to the Parliament last week, which contains the key figures for next year. **Disappointingly, the government kept on to its earlier promises and did not introduce deep spending reduction, but just kept the overall spending level at an un-changed in real terms**. This reflects it policy strategy to outgrow the large spending and debt burden of the country, which could start already in 2011 with the projected 3% growth rate.
For the budget deficit, the good news is that it will lower from this year's 4% of GDP level to 2.94% of GDP, so just exactly to the level that is below the required 3% threshold. This year's 4% target is higher than the 3.8% official target, but the former is a cash-based figure, while the later is an ESA one, so there could be some difference, but this is something to be clarified.
Special taxes on the financial, energy, retail and telecom sectors amounting to 1.3% of GDP will be used to lower the deficit.
Beside this, the government also had to find compensation of the tax reduction. Personal and corporate income taxes would lower by about Ft600bn due to the lower tax rates (16% for PIT and 10% for CIT) and this will be offset by revenues from the cancellation of the second pension pillar.
The changes to the pension system have two key implications. One is that employees will pay their 8% contribution to the state system instead of private pension funds, which will mean Ft360bn or 1.3% of GDP additional budget revenue.
Secondly, employees may (not necessarily) decide on transferring their accumulated savings from the pension fund to the state. Total savings on these accounts amount to Ft 2,800bn or 10% of GDP. The budget assumes that Ft450bn or 16% of this could be transferred to the state next year, which will also be additional revenue.
Technically, there will be an intermediate state fund, which will likely take over the wealth from pension funds and may sell assets on the market and pay these proceedings into the budget.
Overall, these two revenues are planned at 810bn or 2.8% of GDP, more than enough to cover the cost of tax cuts.
The rest will offset the nominal growth of expenditures as overall expenditures are planned at 3% growth, close to the forecasted inflation of 3.5%, implying unchanged spending level in real terms.
The government's strategy seems to aim at faster growth of the economy, which would over time generate enough additional tax revenues to fill in the gap. Special taxes and pension wealth transfer will expire by 2013-2014, so the key question is whether this will happen by then or not.
Currently, the government's primary expenditures amount to 57.5% of GDP, which would lower by 1.5pp a year if it is maintained at an unchanged level in real terms. This would equal to 52.5% by 2014. Primary revenues are at 57.7% of GDP and would fall to 52.5% of GDP with the tax cuts. If the mandatory private system is cancelled permanently, pension contributions would raise this to 53.2% of GDP, if maintained, this would be enough to keep the primary balance in a surplus in 2014.
The implication of these changes onto the public debt path is quite significant as the current outlook with assumptions of a 3% real growth rate and a 3% inflation lowers public debt ratio to 74% from the current 80% by 2014. This is without reduction of public debt from pension fund transfers, which may also take place and that would lower it further



Currency

After reaching the key 270/€ level for the second time in October and therefore forming a 'W' shape pattern at the end of the autumn rally, the forint began to weaken and by the end of the week it reached the key 275/€ level.
This is the 200-day moving average and it could be important for the mid-term outlook. If this support level does not hold, the 50-day average of 278/€ could come into the picture.
Central bank's market flow data suggests that the forint's autumn rally was basically due to the position closing of earlier HUF-bearish positions, which were built during the summer. This short covering flow seems to have ended with the 'W' and thus the market may now try to find a new equilibrium, probably around 275-280/€ in our view.



EUR/HUF technical picture

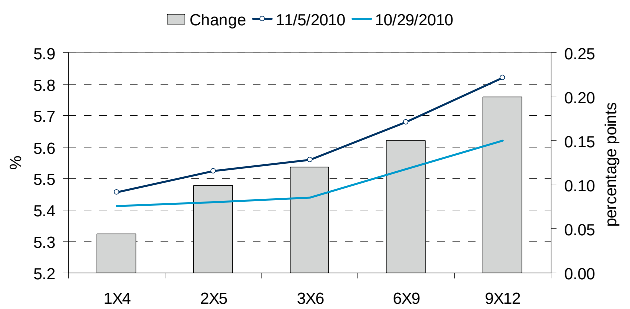
(274.55): Pair currently still below 276.70 (see graph: neckline Head And Shoulders Top) but back above Uptrendline off year low.
Resistance at 276.15 (Oct 27 high), with next levels at 277.31/ .60 (falling weekly Medium Term Moving Average/ monthly envelope top) and 278.40/ 278.85 (Oct 20 high/breakdown daily Sept 23), where pause favored.
If unable to cap, next levels at 280.40/ .65 (50% 292.10 to 268.70/ breakdown weekly): tough on 1st attempts.
Support at 271.55 (break-up daily), with next levels at 270.00/ 269.80 (Nov 02 low/ break-up hourly), where pause favored.
If wrong, next levels at 269.40 (weekly Bollinger bottom), ahead of 268.70 (current reaction low off 292.10) and 268.28 (weekly modified Alpha Beta trend bottom + 76.4% 260.93 to 292.10): tough on 1st attempts.

DAILY CHARTS:

Fixed income

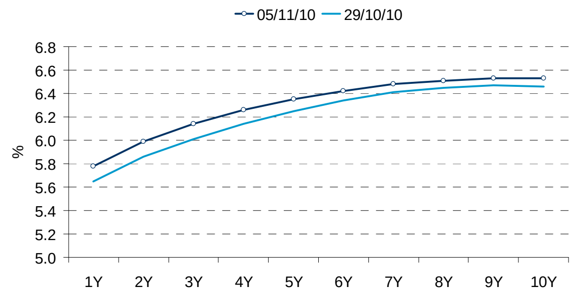
The bond market became very resilient as neither domestic nor foreign news were able to generate a major flow to the market.
Yields at the long-end rose slightly above the key 7.00% level, while short-term rates stabilised at 5.50-5.75% as some probability of a rate hike is still priced in, but the market is less sure about this then it was some weeks ago. Given the risk in the medium-term budget outlook, as was noted by S&P, which kept the negative outlook and maintained Hungary's BBB- rating, the bond market could left with relatively wide long-term spreads as it is now and we may need to see faster growth and effectiveness of spending control as these could be the Achilles heel of the government's program.

HU FRA



Source: Reuters

HU IRS



Source: Reuters

Poland

Macro & currency review

The Polish zloty came back to the 3.90 EUR/PLN. Partly thanks to favourable development on the core markets, partly due to growing hawkishness among MPC members. MPC member Winiecki said the interest rate hike should be considered by the end of the year. Beside that also A. Zielenska-Glebocka seemed to have turned more to the hawkish side. That is interesting as these two members are the swing voters that joined the dovish camp in recent months (see table below). Their shifting preferences therefore support our view of first interest rate hike by the end of the year and play in favour of the zloty. Although we expect only 25 bps hike – a compromise between governor Belka and the hawks – first interest rate is typically followed by more aggressive pricing on the yield curve and the appreciation of the currency

MPC Voting (August) 50 bps hike	
For	**Against**
A. Bratowski	*M. Belka*
Z. Gilowska	*E. Chojna-Duch*
A. Glapinski	*J. Hausner*
A. Rzonca	*A. Kazmierczak*
	J. Winiecki
	A. Zielinska-Glebocka

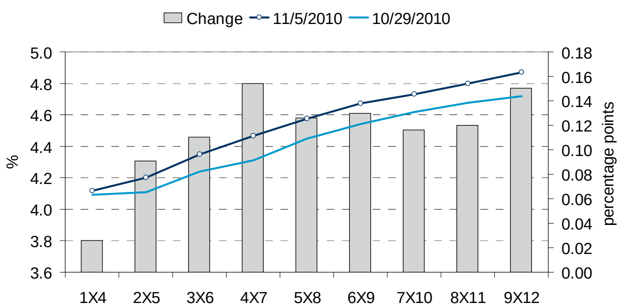
The domestic scene is rather empty for the week ahead. Although a moderate correction after the rally on the global markets in recent days is possible, we remain bullish on the zloty in the mid-term due to our interest rate outlook.

EUR/PLN technical picture

(3.9250): 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 (Oct 14 low + Nov 04 low), where pause favored.
If unable to hold, next levels at 3.8803 (monthly envelope bottom), ahead of 3.8760/ .8750 (last targets off 4.0405) and 3.8618 (weekly modified Alpha Beta trend bottom): tough on 1st attempts.
1st Resistance comes in at 3.9425/ .9457 (breakdown daily/ falling weekly Medium Term Moving Average): ideal area to stay below to keep current mood on Zloty.
Failure to cap would see next levels at 3.9677 (weekly modified Alpha Beta trend top), ahead of 4.0005 (Oct 29 high), where pause favored.

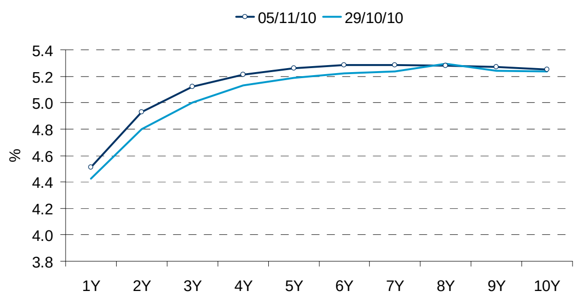
DAILY CHARTS:

PL FRA



Source: Reuters

PL IRS



Source: Reuters

CE Weekly Preview

TUE 9:00	CZ Inflation (change in %)		
	Oct-10	Sep-10	Oct-09
CPI m/m	**0.1**	-0.3	-0.2
Food m/m	**0.2**	0.1	-0.4
Housing, energy	**0.0**	0.0	-0.2

CZ: Prices changed only slightly

We believe that consumer prices only changed slightly in October. Prices of fuels and package tours went down, while those of seasonal clothing and footwear likely went up. Food prices rose slightly, and will increasingly reflect the rising agricultural commodity prices. The months to come may not necessarily spring any great inflation surprises either. The extent of deregulation and administrative moves in respect of prices is still uncertain; nevertheless, inflation is unlikely to be far above 2% for any long time. Inflation will continue to be curbed by poor consumer demand, which often provides no latitude for price increases. In addition, Internet competitors are not sitting still either, also curbing the price increases by land-based retailers. Hence inflation is not and will not be a problem of the Czech economy.

FRI 9:00	CZ GDP (change in %)		
	Q3-10	Q2-10	Q3-09
GDP (y/y)	**2.2**	2.4	-4.4
GDP (q/q)	**0.3**	0.9	0.5

CZ: The economy maintains its steady growth rate

The first GDP forecast is likely to indicate that, in light of the conditions, economic growth remains above 2%. Of course, we cannot rule out an upward surprise, but we still bear in mind that this is just the first forecast without any further details of its structure. More accurate data on the GDP developments in the third quarter of the year will not be available until December.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	**9.11.2010**	**09:00**	**CPI (%)**	**10/2010**	**0.1**	**2.2**	**0.1**	**2.2**	**-0.3**	**2.0**
HU	9.11.2010	09:00	Trade balance (EUR M)	09/2010 *P			500		392	
CZ	**10.11.2010**	**12:00**	**CZ bond auction 2.80%/2013 (CZK B)**	**11/2010**			**6**			
PL	10.11.2010	14:00	Trade balance (EUR M)	09/2010					-786	
PL	10.11.2010	14:00	Current account (EUR M)	09/2010					-1 129	
HU	**11.11.2010**	**09:00**	**CPI (%)**	**10/2010**			**0.2**	**4.0**	**-0.1**	**3.8**
CZ	**12.11.2010**	**09:00**	**GDP (%)**	**3Q/2010 *P**	**0.3**	**2.2**	**0.6**	**2.5**	**0.9**	**2.4**
HU	**12.11.2010**	**09:00**	**GDP (%)**	**3Q/2010 *P**				**1.3**		**1.0**
HU	12.11.2010	09:00	Industrial output (%)	09/2010 *F					0.5	10.9
CZ	12.11.2010	10:00	Current account (CZK B)	09/2010	-16.0		-14.5		-18.1	
PL	12.11.2010	14:00	Money supply M3 (%)	10/2010					0.4	

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	1.00	1.25	-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	*1.22*	1.20	1.25	1.30	1.50	1.65
Hungary	BUBOR	*5.35*	5.25	5.25	5.25	5.25	5.25
Poland	WIBOR	*3.85*	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.	*2.72*	2.65	2.75	2.90	3.05	3.15
Hungary	*6.53*	6.50	6.50	6.25	6.00	6.00
Poland	*5.25*	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	*24.6*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*274*	280	280	275	275	275
Poland	EUR/PLN	*3.90*	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.	2.2	1.6	1.7	1.2	1.8	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	2.1	2.3	2.5	2.5	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	-2.2
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
Mathias Van der Jeugt	+32 2 417 51 94	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