Monday, January 10,

KBC Banking & Insurance

Central European Weekly

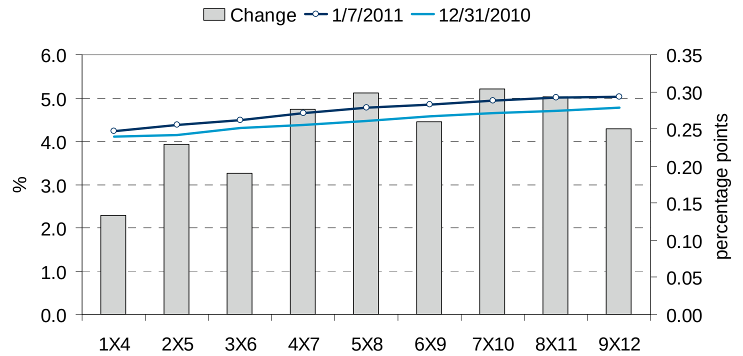
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- The NBP Governor Belka prepares the market for January's rate hike
- Czech inflation surprises on the upside due to higher food prices
- Czech and Hungarian industry continue to expand strongly
- Correlation of the Polish zloty with the Czech koruna re-strengthens
- Week ahead: Not only Czech inflation moves up, but the Polish too

Chart of the Week: Polish FRA Rates

PL FRA



Source: Reuters

Polish money market rates have started to price a tightening cycle

Table of Contents:

Market’s Editorial

The NBP Governor turns suddenly hawkish,

The relaxed holiday mood on Central European markets was over very soon. The only reason for this was the National Bank of Poland, that is to say its Governor Belka. Before Christmas, he seemed to have persuaded his colleagues on the Monetary Policy Council (MPC) out of raising interest rates; but, once the new-year began, he changed his mind and suggested that rates needed to be raised. Paradoxically, the zloty was again used as the main argument with the Governor stating that the currency strength alone could no longer curb inflationary pressures.

As not only did the Governor change his mind, but also three other followers of the dovish policy on the MPC, the market reaction was straightforward: money markets and bond markets immediately priced in January’s 25 basis point hike in the official rate, and the Polish zloty strengthened significantly. Let us add that the Czech koruna followed suit, jumping on the bandwagon of Poland’s bullish mood, and easily offset the losses it accumulated over the last two months of 2010.

While our bet on December’s hike in the official rate was fairly courageous, the latest comments from MPC members indicate that the start of a monetary tightening cycle may start his month. In addition, the market expectations may be encouraged by the upcoming inflation data, which is likely to confirm Governor Belka’s assumption that not even the strong zloty is any longer able to prevent a rise in inflation, driven by the currently high commodity prices, i.e., food and petrol prices.

…but be careful how many hikes have been already priced in…

On the other hand, we need to be much more cautious in predicting how far the NBP may go in tightening its monetary policy this year. As indicated by MPC members in recent days, rates may go up very slowly. Moreover, our opinion is that the rates may not at all be raised as much as markets believe. At the beginning of a monetary tightening cycle, markets usually tend to aim too high, which is what is happening now. Polish FRA’s currently envisage this year’s increase in the official rate as being more than 100 basis points. Nevertheless, we believe that the concurrently appreciating zloty will not allow the NBP to raise its base interest rate by more than 3x25 basis points in 2011.

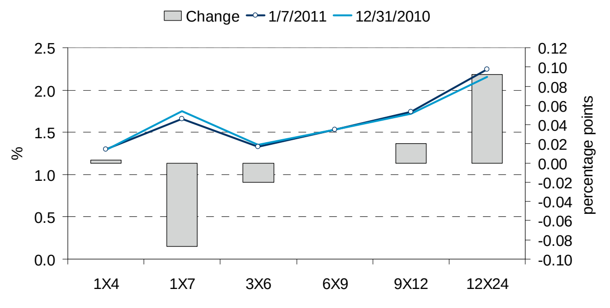
MPC board division

Hawks	Doves
A. Bratkowski	***M. Belka***
Z. Gilowska	***E. Chojna-Duch***
A. Glapinski	*J. Hausner*
A. Rzonca	***A. Kazmierczak***
A. Zielinska-Glebocka	***J. Winiecki***

Names in red turned to hawkish camp

Now there is a strong majority, which favors a rate hike in the Polish MPC

CZ FRA



Source: Reuters

While Polish rates move strongly up, the Czech money market remained calm.

Review of Economic Figures

Food and fuel are mainly responsible for driving Czech inflation up.

Inflation is above the Czech National Bank target, but the main reasons are outside its control. The Czech market is not suffering demand inflation, but it is a matter of commodities. Food is 5.6 % more expensive in a year-on-year comparison; and do not expect the situation to turn around quickly. Inflation will remain higher than the central bank's target. January will be a crucial period, when so-called deregulation will be projected in inflation. However, the latest figure lends itself to raising rates sooner than the central bank had expected until now.

Czech unemployment comes as a major surprise.

Seasonal factors have played a part here, as has the extraordinary influence of changes in the provision of support during unemployment and evidently the restriction of numbers of public servants. People signed on at the unemployment office sooner so as not to be affected by the new conditions coming in at the beginning of January. Therefore we can expect unemployment to rise more slowly than usual in January. The great unknown is with what sort of zeal the public sector has set about making redundancies as a result of savings. This we will obviously learn at a later date. There are more and more people without work and less and less available positions. A record low, in fact. There have not been as few available jobs here in the past eleven years. We are now seeing an average of 18 applicants per job, the same negative result as at the beginning of last year, when the situation on the labour market came to a head.

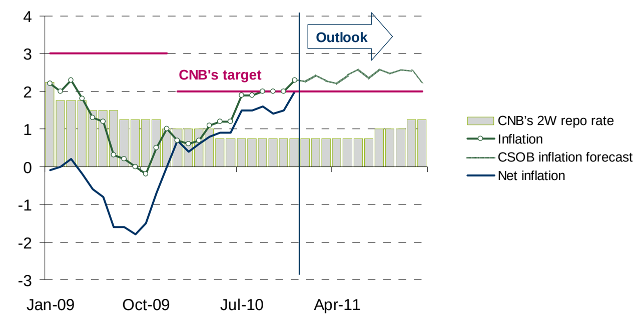
Czech and Hungarian industrial production grows rapidly

November's rise in industrial output was almost 16% y/y and 2% m/m. Industry was driven by its strongest components – cars, machinery and metals, i.e., sectors primarily oriented on exports and riding the wave of improving foreign demand. Refineries, furniture manufacturers, and the textile industry remained in the red this time. The current data from industry was also influenced by one more business day in the month, even though the rise was very strong, even when adjusted for this effect (+13%). Figures from Czech industry look very positive and, owing to high contracts (+14.2% y/y), they also provide good prospects for the months to come. The primary drivers again include carmakers (+16.3%), metal producers (+50.6%) and PC manufacturing (+17.9%); however, one more fact is certainly worth noting: the rising employment rate in industry. Although the number of people working in industry has declined on the year-on-year basis, we can see an increase by almost 19,000 employees compared to the first quarter of the year.

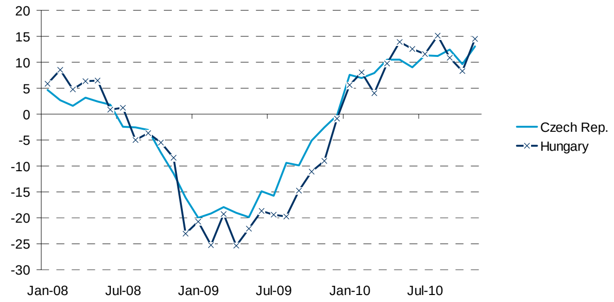
Hungary's industrial output also accelerated, when October's moderate month-on-month decline was followed by a surprisingly strong rise (4.3%). Industrial output thus accelerated to 14.5% y/y. Hence the last quarter of the year, owing to the strong orientation of industry on a high-performing Germany, will be the strongest quarter of 2010, while production in that year likely went up at a double-digit rate.

November's figures from industry in the Czech Republic and Hungary (along with the foreign trade data) indicate that the end of the year also saw very decent economic growth, which might be even slightly higher than our forecasts for the last quarter of the year.

CZ: Inflation and CNB's Target
(%)



CZ, HU: Industrial production
(y/y, working days adjusted)



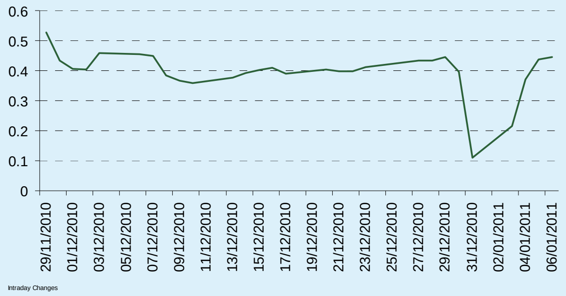
In Focus: Correlation of zloty with koruna re-strengthens

We believe the correlation of the koruna and zloty to become closer again and both currencies to remain more immune to global shocks

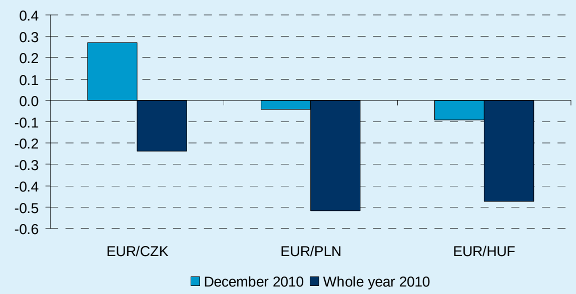
Long-established correlations once again started to ease in Central Europe in late 2010, and particularly the strong alliance of the Czech koruna and the Polish zloty. The relationship of the koruna to the zloty, as indicated by the development of the rolling monthly correlation, weakened significantly at the end of the year. One of the possible explanations was the persisting dovish tenor from the Czech National Bank (CNB), which started to contrast with the increasing strength of hawks on the Monetary Policy Council of the National Bank of Poland. This gave rise to the increasing speculations that the Czech koruna might again serve, to a greater extent, as a currency suitable for funding regional carry trades. Nonetheless, these speculations vanished at the very beginning of 2011. The relationship of the koruna to the zloty again started to increase, and the koruna was able to profit from the bets on a rate hike in Poland, hand in hand with its Polish neighbour. **Thus decrease in correlation at the end of the year was probably caused by low liquidity rather than a launch of carry trades. The continuing good performance of the Czech economy and the increasing risk of the first rate hike should continue to prevent the launch of regional carry trades in the subsequent months of 2011.**

In December we also saw the relationship of Central European currencies to global markets decrease significantly. The correlations (of daily changes) of all Central European currencies with regard to the S&P 500, EUR/USD, as well as the 10Y U.S. yield diminished significantly (compared to the 2010 average)**. In the case of EUR/PLN, the weaker relationship to global markets – particularly to the development of the aversion to risk (S&P 500) – may persist for some time.** The beginning of a rate hike cycle is ahead of us, and this may largely protect the zloty from the increasing tension at the peripheries of the euro area. The Czech koruna may also benefit from this to a certain extent, because its relationship to the Polish zloty is again increasing and a rate hike may soon be on the agenda in the Czech Republic this year**. Therefore particularly the Hungarian forint may again become more linked to the global markets. Foreign investors' low confidence in the Hungarian government may, in times of increasing tension on the eurozone peripheries, drive the forint into a strong defensive posture and above all increase the relationship to EUR/USD and S&P 500.**

Monthly correlation EUR/CZK and EUR/PLN



Correlation of intrady changes with S&P 500



Correlation of intraday changes, whole year 2010	EUR/CZK	EUR/PLN	EURHUF	EUR/USD	S&P 500	10Y US
EUR/CZK	1	0.6	0.5	-0.3	-0.2	-0.1
EUR/PLN	0.6	1	0.7	-0.4	-0.5	-0.3
EUR/HUF	0.5	0.5	1	-0.4	-0.5	-0.3
EUR/USD	-0.3	-0.4	-0.4	1	0.4	0.1
S&P 500	-0.2	-0.5	-0.5	0.4	1	0.5
10Y US	-0.1	-0.3	-0.3	0.1	0.5	1

Correlation of intraday changes, December 2010	EUR/CZK	EUR/PLN	EURHUF	EUR/USD	S&P 500	10Y US
EUR/CZK	1	0.4	0.1	0.1	0.3	0.1
EUR/PLN	0.4	1	0.4	-0.1	0.0	0.1
EUR/HUF	0.1	0.1	1.0	-0.2	-0.1	-0.2
EUR/USD	0.1	-0.1	-0.2	1.0	0.1	-0.1
S&P 500	0.3	0.0	-0.1	0.1	1.0	0.1
10Y US	0.1	0.1	-0.2	-0.1	0.1	1.0

CE Weekly Preview

TUE 9:00 — **CZ Retail Sales (change in %)**

	Nov-10	Oct-10	Nov-09
Sales	**2.5**	-0.7	-5.4
cummulative (YTD)	**0.9**	0.8	-5.0

CZ: Retail sales show a surplus this time

We believe that retail sales rose slightly in November, primarily driven by the sales of new cars. Neither food sales, as this sector has been affected by a rapid price rise in recent months, nor lower fuel sales are likely to spring any surprises. Thus the year-on-year surplus of the overall sales is likely to be primarily based on there being a low comparative baseline and one more business day in the month. By and large, retail sales should go up by less than 1% over the first eleven months. That said, sales clearly show that consumer demand remains very modest, and demand-pull inflationary pressures are out of sight.

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

	Nov-10	Oct-10	Nov-09
C/A monthly	**-2.0**	0.6	-1.0
cummulative (YTD)	**-92.2**	-90.2	-20.2
Trade bal. monthly	**19.0**	22.4	18.2
cummulative (YTD)	**193.7**	174.7	175.3

CZ: Current account shows a low deficit

November's current account might post a deficit of around CZK 2bn. This fairly positive figure is primarily based on a high trade balance surplus and, given the end of the dividend season, just a moderate outflow of earnings to foreign countries. However, the current account deficit has increased very quickly since the beginning of the year and has already exceeded CZK 90bn. This is largely due to a change in the reporting of what is known as branding, which turned the balance of services deep into the red. Nevertheless, the overall current account deficit for this year as a whole should not exceed 3%.

PL: Inflation above the target; a rate hike on the horizon

THU 14:00 — PL Inflation (m/m change in %)

	Dec-10	Nov-10	Dec-09
CPI m/m	**0.4**	0.1	0.0

We believe that the rise in Poland's consumer price index accelerated in December and should reach 3.1% y/y and 0.4% m/m in that month. The main reasons for the rise should include commodity prices (the price of a barrel of Brent oil went up by 10% during December, while the average rise in the prices of sugar, wheat, and maize was even 19%). The potential further rise in the price level also influenced the comments by Poland's monetary policy makers. Certain members from among doves, i.e., the group which had been more or less stubborn until recently, (Governor Belka, Chojna-Duch, Winiecki, Kazmierczak) have admitted that it is time to tighten the monetary policy. In addition, a good argument for a rate hike is the fact that, given the administrative moves in 2011, inflation will probably continue to rise.

FRI 9:00 — HU Inflation (m/m change in %)

	Dec-10	Nov-10	Dec-09
CPI m/m	**0.2**	0.3	0.0

HU: Some inflation releif after strong November?

After a strong rise in November, the headline inflation probably slowed, although food and petrol prices pose some upside risks.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	11/01/2011	09:00	Retail sales (%)	11/2010		2.5		3		-0.7
CZ	13/01/2011	10:00	Current account (CZK B)	11/2010	-2		-1.75		0.62	
PL	13/01/2011	14:00	Trade balance (EUR M)	11/2010					-702	
PL	13/01/2011	14:00	Current account (EUR M)	11/2010					-1.155	
PL	**13/01/2011**	**14:00**	**CPI (%)**	**12/2010**	**0.4**	**3.1**			**0.1**	**2.7**
HU	14/01/2011	09:00	Industrial output (%)	11/2010 *F					4.3	14.5
HU	**14/01/2011**	**09:00**	**CPI (%)**	**12/2010**	**0.2**	**4.3**	**0.3**	**4.3**	**0.3**	**4.2**
PL	14/01/2011	14:00	Money supply M3 (%)	12/2010					0.9	

CE Forex Technicals

EUR/CZK Daily Chart:

Approaching long term Triangle bottom (see graph).
Support at 24.5850/ 5800 (current reaction low off 25.3800?/ Nov 17 low + see graph: Triangle bottom), where pause favored.
Failure to hold would see next levels at 24.4010/ .3950 (broken monthly/ weekly Downtrendlines off 29.6900), ahead of 24.3450 (2010 low) and 24.2510 (monthly Bollinger bottom).

Resistance at 24.8000 (breakdown daily), with next levels at 24.9750 (idem + falling weekly Short Term Moving Average): ideal area to stay below to keep current mood on CZK.
Failure to cap would see next levels at 25.1550 (breakdown weekly), ahead of 25.2320 (weekly Bollinger top) and 25.3800 (current recovery high off 24.3450): tough on 1st attempts.

EUR/HUF Daily Chart:

In Triangle pattern (see graph).
Support at 275.10 (current reaction low 280.30), with next levels at 273.75 (break-up daily + weekly modified Alpha Beta trend bottom), ahead of 272.25 (Dec 17 low), where pause favored.
Failure to hold would see next levels at 271.62 (monthly envelope bottom), ahead of 270.00 (Nov 02 low + monthly modified Alpha Beta trend bottom) and 268.70/ .28 (Oct 06 low/ 76.4% 260.93 to 292.10): tough on 1st attempts.

Resistance at 277.70 (breakdown hourly), with next levels at 278.85/ 279.38 (current year high/ broken rising weekly Long Term Moving Average) and 280.30/ .73 (Dec 30 high/ weekly modified Alpha Beta trend top), where pause favored.
If wrong on that call, next levels at 281.15 (last month high) and 283.44 (monthly envelope top) and 284.61 (weekly Bollinger top): tough on 1st tests.

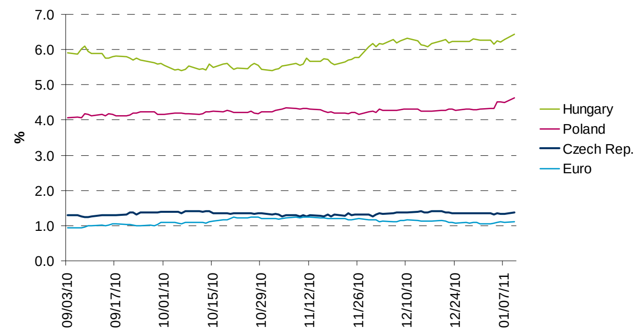
EUR/PLN Daily Chart:

Approaching key Support area (see graph) at 3.8225 (2010 low + neckline long term Double Top) and in return action towards broken Downtrendline off 4.9300.
Support at 3.8490/ .8410 (current reaction low off 4.1100?/ last target of daily Triple Tops off 3.9755), with next level at 3.8225 (see above), where pause favored.
If wrong, next levels at 3.8053 (monthly modified Alpha Beta trend bottom), ahead of 3.7851 (monthly Bollinger bottom + weekly Starc bottom): tough on 1st attempts.

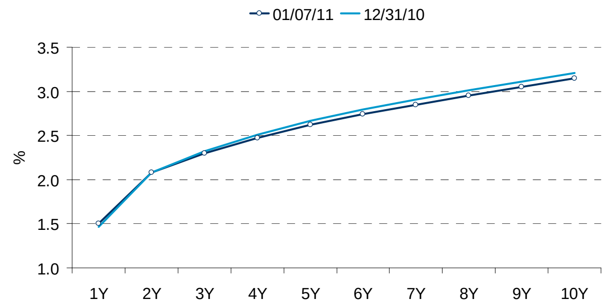
Resistance at 3.8760 (previous reaction low), with next levels at 3.9340/ .9450 (breakdown hourly/ daily): ideal area to stay below to keep current mood on Zloty.
Failure to cap would see next levels at 3.9644 (current year high), ahead of 3.9921 (falling monthly Medium Term Moving Average), where pause favored to set in.

CE Fixed-income in Charts

FRA 3x6

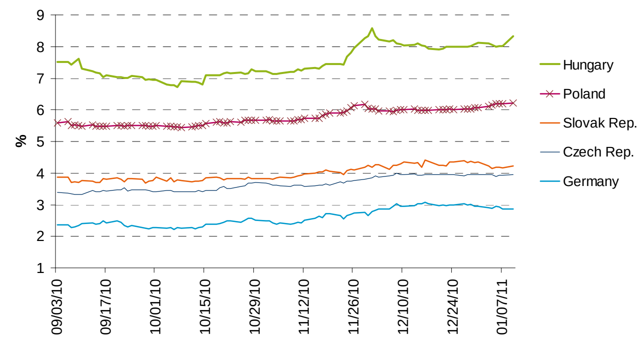


CZ IRS

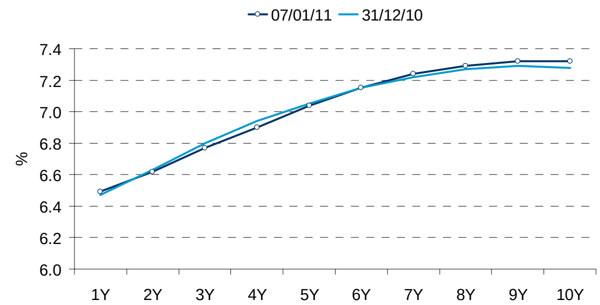


Source: Reuters

10Y GB Yields

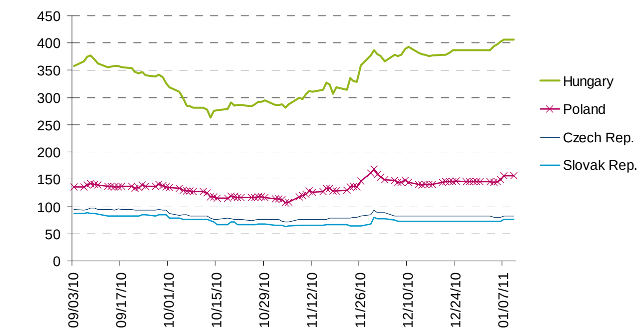


HU IRS

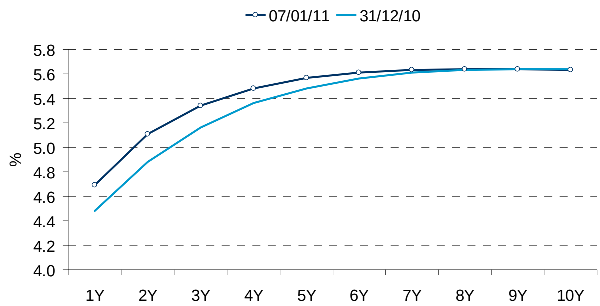


Source: Reuters

CDS 5Y



PL IRS



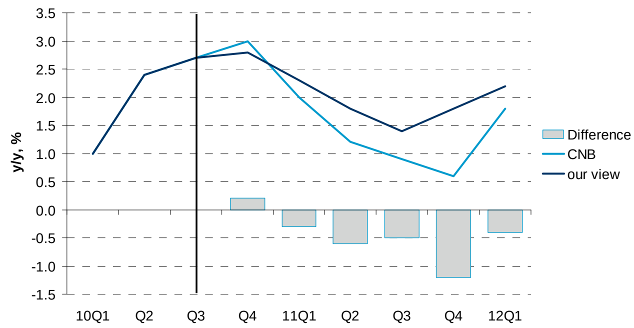
Source: Reuters

Medium-term Views & Issues

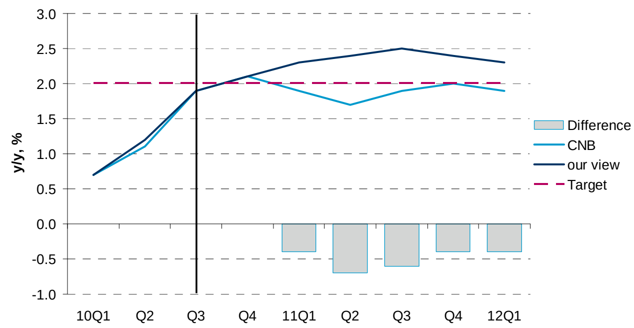
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction at the rate by less than a percentage point per year is very reasonable, without posing any huge risk to the ongoing economic recovery. Already last year's budget ended with a lower than planned deficit. The general government deficit even felt below 5% of GDP in 2010.	Debate about Hungary remained centred on the medium-term fiscal outlook as one-off revenue measures (special taxes on the financial, energy, retail and telecom sectors) will expire in 2013 implying a risk of higher budget deficit. Moody's downgraded its credit rating of Hungary by two notches from Baa1 to Baa3 with a negative outlook. It cited sustainability concerns of the fiscal outlook due to heavy reliance on temporary revenue measures offsetting tax cuts. Fitch could announce its assessment in the coming weeks.	Latest GDP figures confirmed strong growth 4.7% y/y (on seasonally adjusted basis) The main drivers were domestic consumption of household and government and rebuilding of inventories. Although we were somewhat disappointed by low contribution of core investments (ex-inventories), which stayed more or less flat in Q3, we expect the preparation for European football championship should accelerate and boost core investment through 2011. Moreover, given our assumption of positive labour market trends and relatively mild fiscal tightening we bet on solid overall domestic demand
Outlook for official & market rates	Inflation climbs above the central bank's target due to higher fuel and foodstuffs' prices and to administrative measures, i.e. the VAT and excise duty increases carried during last year. Fuel prices, which shadow oil and petrol price developments in global markets, continue to pose a risk to inflation. On the other hand, weak demand should counteract the rise in inflation. We still think that the CNB will hike its rates sooner than its prognosis announced (2012 Q1). We expect the first rate hike in the mid of 2011.	. The central bank surprised us with a 25bps rate hike in November and lifted the base rate to 5.50%. It seems that the central bank became worried about markets' confidence and decided on a pre-emptive hike before the forint weakens too much or yields go too far at the long-end. Although we think that underlying inflation trends are not that much worrying another hike will be delivered in December. Future moves could thus depend on the market (forint) volatility.	Given solid growth prospects for the second year in a row supported by positive labour market developments we believe it is the right moment the normalisa-tion of interest rates, which have been sitting at record lows (first rate hike in January 2011). Our view is supported by the fact that inflation should grow further above central bank's target (2.5 %) in upcoming months. Nevertheless due to persisting global uncertainties we bet only on gradual tightening. In year horizon we continue to see the interest at 4.25 (75 bps higher). .
Forex Outlook	Fundamentals behind the Czech currency continue to be very strong. Czech economy should outperform the eurozone and the external balance should remain at reasonable levels. Beside that the Czech koruna may profit from earlier start of hiking cycle and growing inflow of EU funds. Nevertheless it can stay in defensive mode due to eurozone crisis in the short term. Beside that the end of the 2011 could be used for profit taking due to Polish elections.	The (government) program's effect on the exchange rate is neutral over the short-term, while the longer-term positive impact depends on the productivity boost. Slower growth in the EU due to fiscal tightening measures may play a role behind the future weakening as Hungary's recovery is depending on export. Should however global markets come out of the woods, the forint may also get closer to its pre-crisis equilibrium rate.	Since calls for the stronger zloty had fallen on deaf ears, the Polish central bankers' rhetoric moved forward to more hawkish mode. Tighter monetary conditions should further support the Polish currency. We bet on strong gains especially after the euro crisis is resolved – 6 month target at 3.55 EUR/PLN. Nevertheless the parliamentary elections in autumn 2011 and the risk of breaching second prudential level for government debt (55% GDP) may bring temporary volatility of the PLN by the end of the 2011. .

Central Bank's Projections versus Our Macro Forecasts

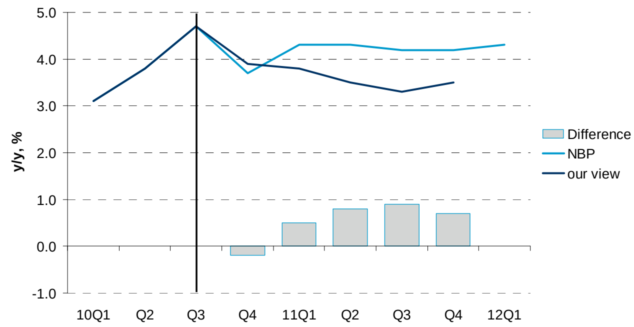
CZ: GDP Outlook



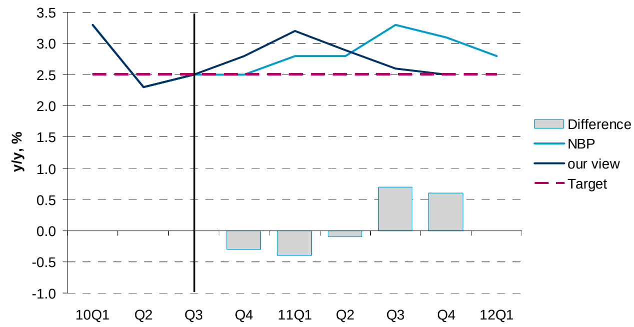
CZ: Inflation outlook



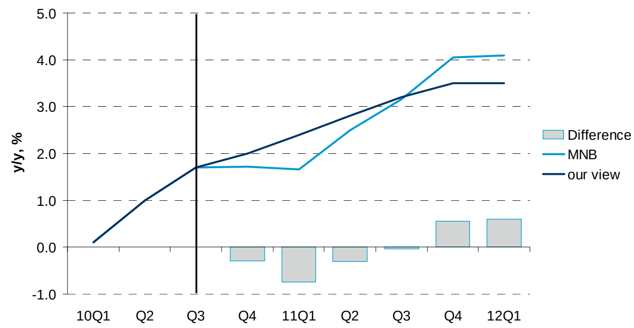
PL: GDP Outlook



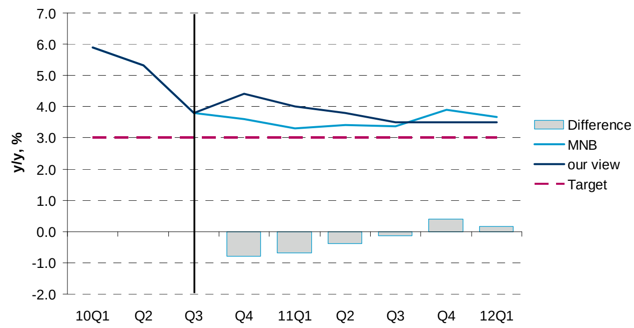
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

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