Monday, January 17,

KBC
Banking & Insurance

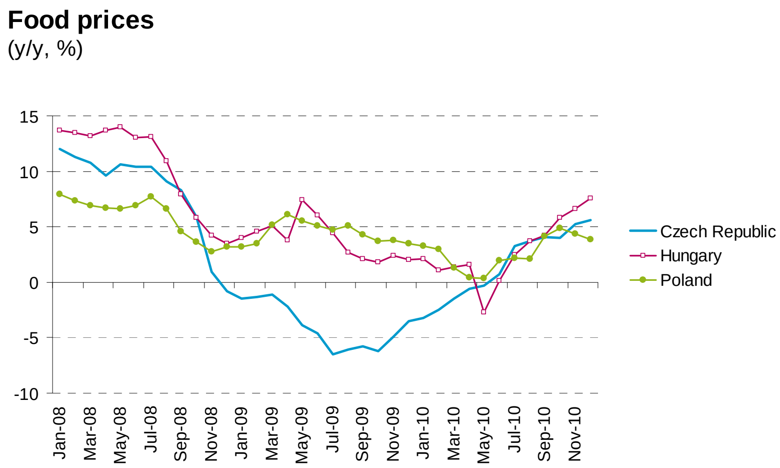
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Markets have priced in too many hikes in Poland and in the Czech Rep.
- Zloty and koruna benefit strongly from rate-hike bets
- Headline inflation higher across the whole region driven by gas and food prices
- The NBP will start a new tightening cycle

Chart of the Week: Food price inflation in Central Europe



Food prices moved sharply up in the Czech Republic and Hungary. Surprisingly, Polish food prices remained stable. We do not expect such price divergence will last too long.

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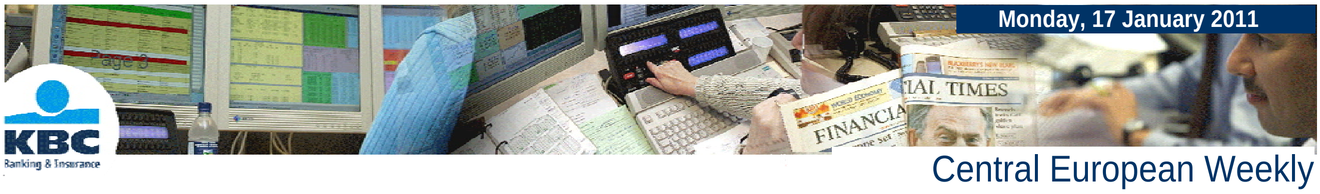


Market’s Editorial

CE fixed-income markets are confident that rate hikes will come, but…

Notwithstanding the fairly dramatic events on the euro area bond markets, Central European forex and bond markets lived lives of their own. Domestic events and their impact on the central bank policies have become the main topic for trading in the region.

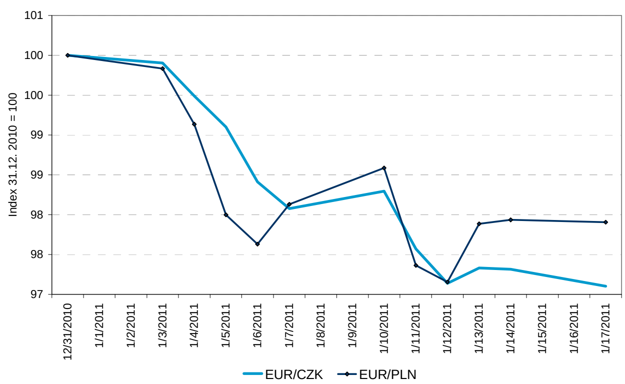
As could be anticipated, markets noticed the rise in inflation in the individual countries as well as the associated comments from central bankers. This particularly applied to the Czech Republic and Poland, where market interest rates were on the rise and the exchange rates of the relevant currencies strengthened at the same time. The constellation in Hungary was somewhat different. The minutes of the latest meeting of the NBH showed that its members were divided as to whether to continue to raise rates.

…they already might expect too much

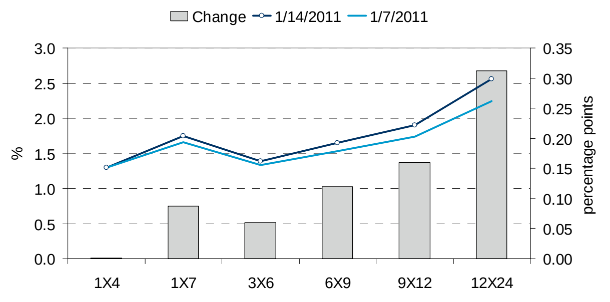
Nevertheless, the Czech and Polish yield curves, i.e., the expectations they imply, suggest that the markets are now likely running ahead of events (as, after all, could be expected, due to the approaching start of a tightening cycle). If we look at FRA rates, markets anticipate a total of 125 basis points of rate hikes this year in Poland. The Czech market has priced in almost two 25 bps hikes in the repo rate within the next six months. While we cannot rule out that markets may drive up their anticipations even higher, we consider expectations for both countries to be exaggerated. The main reason why we do not expect the official rate hikes as implied by the market will materialise has to do with the exchange rates of the zloty and the koruna. If the NBP or the CNB were really as aggressive as money markets are anticipating, the appreciation of the Polish and Czech currencies would be extreme, indeed. Both central banks don‘t want this to happen.

In this context, the meeting of the NBP logically becomes the main event of the week. We expect the NBP to raise rates by 25 bps as widely expected. However, the central bankers may somewhat ease their hawkish comments after the meeting. Most Members of the Monetary Policy Council are likely to envisage (just as we do) only a moderate tightening of the monetary policy (see Expected Data), and therefore may wish to cool the aggressive rate hike bets in Polish markets.

Koruna and Zloty against the euro (YTD)



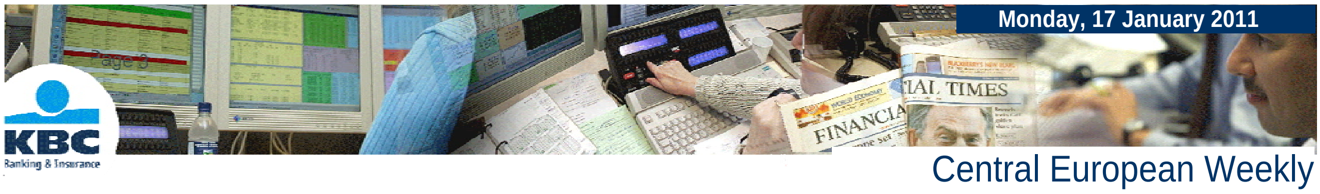
CZ FRA



Source: Reuters

	Last	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.37	→	↗
EUR/PLN	3.872	→	↗
EUR/HUF	275.8	→	↗

	Last	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.89	↗	↗
10Y PLN	6.36	↗	↗
10Y HUF	7.70	↗	↗



Review of Economic Figures

Poland's y-o-y inflation exceeds 3% and will continue to rise.

In the last month of last year, Poland's consumer price index went up, in line with our expectations, by 3.1% y/y and 0.4% m/m. Looking into the index structure more closely, we find that the further acceleration of inflation (which is thus already 0.6% above the central bank's target) was primarily due to petrol prices, which went up by a huge 5.1% m/m. Remarkably, despite the significant rise in the prices of soft commodities in December 2010 (the FAO Food Price Index went up by 4.27%), food prices stagnated in Poland over that period. In January 2011, inflation will continue to rise and might even be very close to the upper threshold of the central bank's tolerance band (3.5%), as prices will be affected by the rising VAT rates (by 1 percentage point), which should increase the state coffers' revenue by up to PLN 5bn a year, according to forecasts by the Ministry of Finance. Nonetheless, demand-pull inflation does not even exist in Poland at the moment and the price rise has been triggered by the increase in commodity prices.

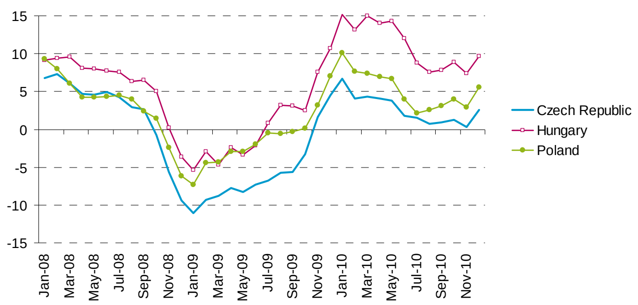
Hungary's inflation higher-than-expected too

Hungary's inflation also went up and the reasons for this were similar to those in the Czech Republic. The aggregate index was primarily driven upwards by food (0.6 % m/m) and fuel prices (+4.3% m/m). As a result, the headline year-on-year inflation rate accelerated from 4.2% to 4.7%. This is certainly no good news for the NBH, albeit core inflation was up by only 0.1% to 2.0%.

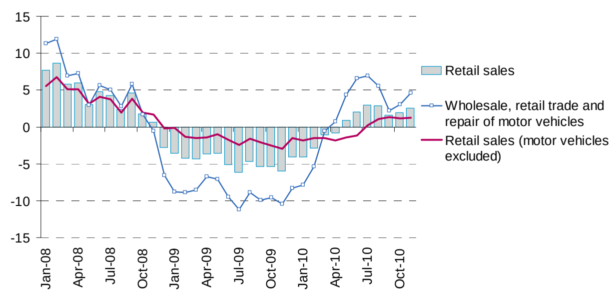
Czech consumer willingness to spend money improved in late 2010.

November's consumer shopping went up by 5% y/y and signalled that consumer appetite to spend money has, at least partly, recovered. Nevertheless, the automotive segment played a key role, while sales in the rest of the retail sector rose at a very moderate rate. We can speculate that this could be due to the massive purchases of winter tyres, which peaked at that time, while fuel sales continued to be curbed because of high fuel prices (down by 5.1% for the first eleven months). Retail sales figures were also greatly influenced by a greater number of business days and the low comparative baseline of the previous year. However, given the fundamental role of cars in November's sales, we should not overestimate the fairly rapid sales rise in the retail sector. Excluding cars and fuels, sales were up by only 2.1%, and this is certainly no evidence of a shopping boom. In addition, the data do not signal any potential demand-pull inflationary pressures whatsoever. What is more, we are also likely to draw the same conclusion from December's data. Demand is improving very slowly and inflation is only rising because of costlier fuel and food, curbing consumer spending on other goods and services. Consequently, the only sectors experiencing a genuine boom in the retail business are catalogue sales and Internet commerce. November saw these sales go up by 24% in real terms.

Consumer prices - Transport
(y/y, %)



Czech retail sales
(3m average, y/y)



CE Weekly Preview

WED	NBP base rate	
	This meeting	Last change
rate level (in %)	**3.75**	6/2009
change in bps	**+25**	-25

PL: The NBP will start a new tigthening cycle

Numerous Members of the Monetary Policy Council endorsed hawkish positions over the last fourteen days. Hence the first meeting in January is very likely to put an end to the period of record low interest rates, with the NBP to raise its base rate by 25 bps to 3.75%. At the moment, nine of the ten MPC Members (except J. Hausner) are in favour of a rate hike, according to the comments available. We consider that this is the right move. Poland grew at a reasonable rate for a second consecutive year and the labour market situation has slowly improved over the last few months. Moreover, there is no doubt that inflation is set to exceed the upper threshold of the tolerance band of the National Bank of Poland (due to fuels, VAT, and food) and the recovering labour market poses a risk that cost inflation will make itself felt in wage negotiations and inflation expectations. This is why rates ought to be normalized, and we predict that they will be gradually raised by a total of 75 bps to 4.25% this year.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	18.1.2011	09:00	Wages (%, ytd.)	11/2010		2.1				1.2
PL	**19.1.2011**	**14:00**	**NBP meeting (%)**	**01/2011**	**3.75**		**3.75**		**3.5**	
PL	19.1.2011	14:00	Wages (%)	12/2010			7.6	3.9	2.5	3.6
PL	20.1.2011	14:00	Core CPI (%)	12/2010			0.1	1.4		1.2
PL	20.1.2011	14:00	PPI (%)	12/2010			0.7	5.1	0.3	4.6
PL	**20.1.2011**	**14:00**	**Industrial output (%)**	**12/2010**			**-3.5**	**11.6**	**-1.3**	**10.1**
PL	21.1.2011	10:00	Unemployment rate (%)	12/2010			12		11.7	
PL	**21.1.2011**	**10:00**	**Retail sales (%)**	**12/2010**			**9.1**	**22.1**	**-6.7**	**8.3**

CE Forex Technicals

EUR/CZK Daily Chart:

Currently below long term Triangle bottom (see graph), with new reaction low off 29.6900 scored.

Support at 24.3150 (current reaction low off 25.3800?), ahead of 24.2030 (monthly Bollinger bottom), where pause favored. Failure to hold would see next levels at ahead of 24.1710 (weekly Bollinger bottom), ahead of 23.9490 (Irregular B off 25.3800) and 23.7300 (1st target of Double Top off 25.0150 (see graph): tough on 1st attempts.

Resistance at 24.5150 (breakdown daily), with next levels at 24.7480/ 24.8000 (falling weekly Short Term Moving Average/ breakdown daily Jan 05): ideal area to stay below to keep current mood on CZK.

Failure to cap would see next levels at 25.0350 (breakdown weekly), ahead of 25.23 (weekly Bollinger top) and 25.3800 (Dec 27 high): tough on 1st attempts.

EUR/HUF Daily Chart:

Approached 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 3.8422 (break-up hourly), with next levels at 3.8290/ .8225 (current reaction low off 4.1100?/ see above), where pause favored.

If wrong, next levels at 3.8053 (monthly + weekly modified Alpha Beta trend bottoms), ahead of 3.7851 (monthly Bollinger bottom): tough on 1st attempts.

Resistance at 3.9078/ .9120 (falling weekly Short Term Moving Average/ Jan 10 high): ideal area to stay below to keep current mood on Zloty.

Failure to cap would see next levels at 3.9340/ .9450 (breakdown hourly/ daily), ahead of 3.9550/ .9644 (falling weekly Medium Term Moving Average/ current year high) and 3.9921 (falling monthly Medium Term Moving Average), where pause favored to set in.

EUR/PLN Daily Chart:

. In Triangle pattern (see graph).

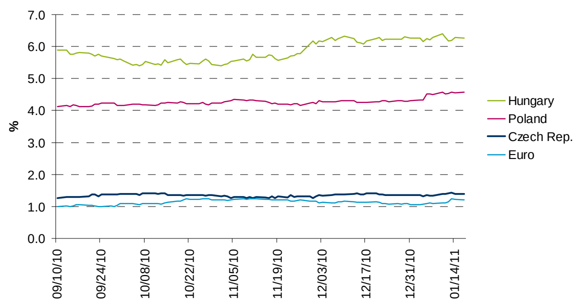
Support at 274.20 (current reaction low 280.80), with next levels at 273.75 (break-up daily), ahead of 272.25/ .11 (Dec 17 low/ weekly modified Alpha Beta trend bottom), where pause favored. Failure to hold would see next levels at 271.62 (monthly envelope bottom), ahead of 270.00 (Nov 02 low + monthly 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 277.40 (breakdown hourly), with next level at 280.80 (current year high + weekly modified Alpha Beta trend top), where pause favored.

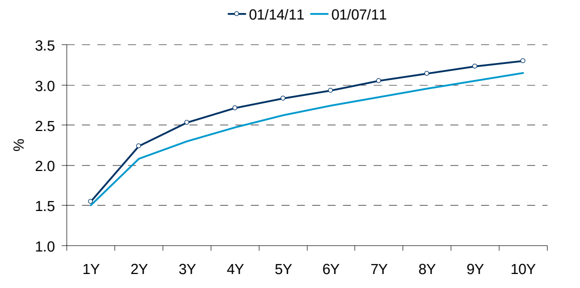
If wrong on that call, next levels at 281.15 (last month high) and 283.44/ .55 (monthly envelope top/ weekly Bollinger top): tough on 1st tests.

CE Fixed-income in Charts

FRA 3x6

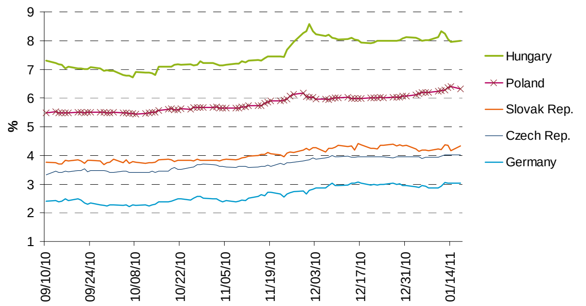


CZ IRS

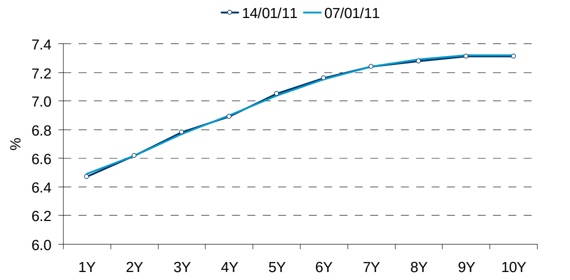


Source: Reuters

10Y GB Yields

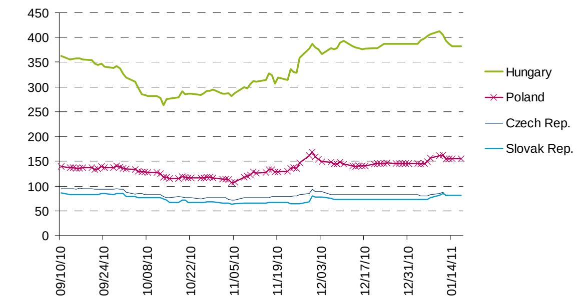


HU IRS

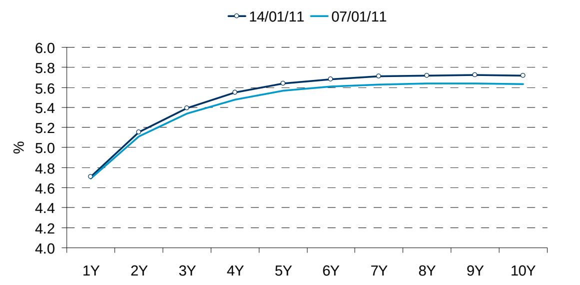


Source: Reuters

CDS 5Y



PL IRS



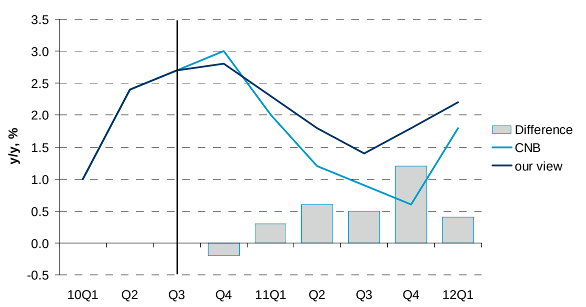
Source: Reuters

Medium-term Views & Issues

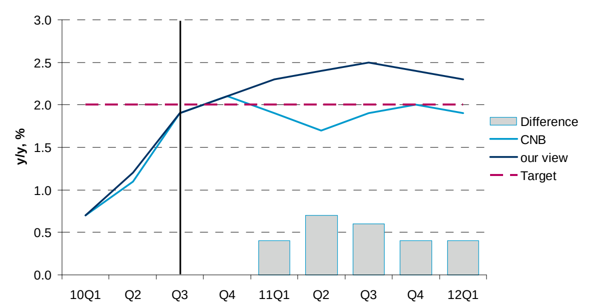
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction at a rate by less than a percentage point per year is very reasonable, without posing any huge risk to the ongoing economic recovery. Last year's budget ended with a lower than planned deficit. The general government deficit even fel below 5% of GDP in 2010.	We stick to the improving medium-term outlook on Hungary as growth has been accelerating, while balance indicators are improving. We can imagine that you will debate the issue with Portugal and probably with Spain now and depending on your assessment on those, there could be some hiccups for Hungary this year. However, there is a 2/3rd majority behind the government and the economic momentum is improving due to the tax cut (personal income tax rate lowered to 16%) and improving fiscal situation.	Latest GDP figures confirmed strong growth of 4.7% y/y (on seasonally adjusted basis). The main drivers were domestic consumption of households and of the government and rebuilding of inventories. Although we were somewhat disappointed by the 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 as it lifted the base rate to 5.50%. The MNB delivered another one in December and it will hike probably again in January. Although we think that underlying inflation trends are not that much worrying seems 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.	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. The Czech economy should outperform eurozone and the external balance should remain at reasonable levels. Beside that the Czech koruna may profit from an earlier start of the hiking cycle and growing inflow of EU funds. Nevertheless it can stay in defensive 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 could depend on the boost in productivity. 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.	Polish central bankers' rhetoric moved to a 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 the second prudential level for government debt (55% GDP) may temporary bring volatility of the PLN by the end of the 2011. .

Central Bank’s Projections versus Our Macro Forecasts

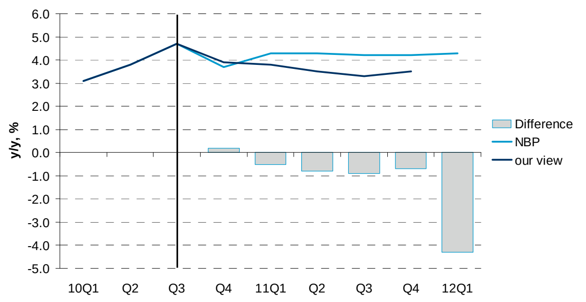
CZ: GDP Outlook



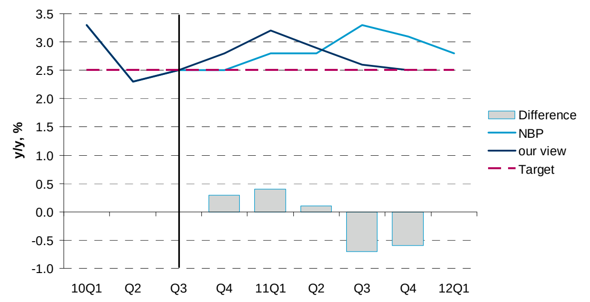
CZ: Inflation outlook



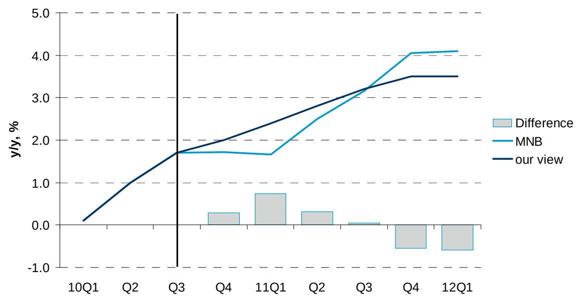
PL: GDP Outlook



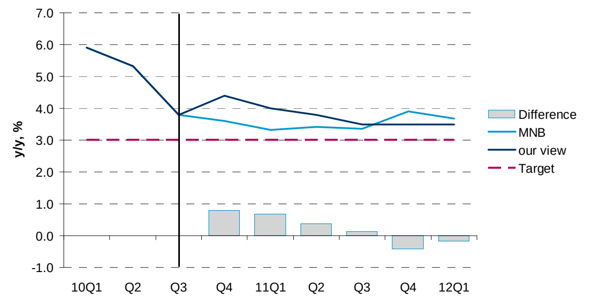
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	1.00	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*5.25*	5.75	5.75	5.75	5.75	5.75	25 bps	11/29/2010
Poland	2W inter. rate	*3.50*	3.75	4.00	4.25	4.25	4.25	-25 bps	6/25/2009

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

		Current	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	PRIBOR	*1.18*	1.20	1.22	1.26	1.45	1.60
Hungary	BUBOR	*5.85*	5.75	5.75	5.75	5.75	5.75
Poland	WIBOR	*3.97*	4.10	4.15	4.35	4.35	4.35

Long-term interest rates 10Y IRS (end of the period)

	Current	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	*3.28*	3.00	3.15	3.30	3.40	3.60
Hungary	*7.34*	8.00	7.75	7.75	7.50	7.50
Poland	*5.715*	5.80	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	EUR/CZK	*24.4*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*276*	280	280	277	273	270
Poland	EUR/PLN	*3.87*	4.00	3.90	3.60	3.70	3.60

GDP (y/y)

	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012
Czech Rep.	2.8	2.3	1.8	1.4	1.8	2.7
Hungary	2.0	2.4	2.8	3.2	3.5	3.5

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

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	2.3	2.3	2.5	2.6	2.3	2.1
Hungary	4.4	4.0	3.8	3.5	3.5	3.5

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-3.0
Hungary	0.5	1.0

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

	2009	2010
Czech Rep.	-5.9	-5.0
Hungary	-3.8	-2.9

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