Monday, January 24,

Banking & Insurance

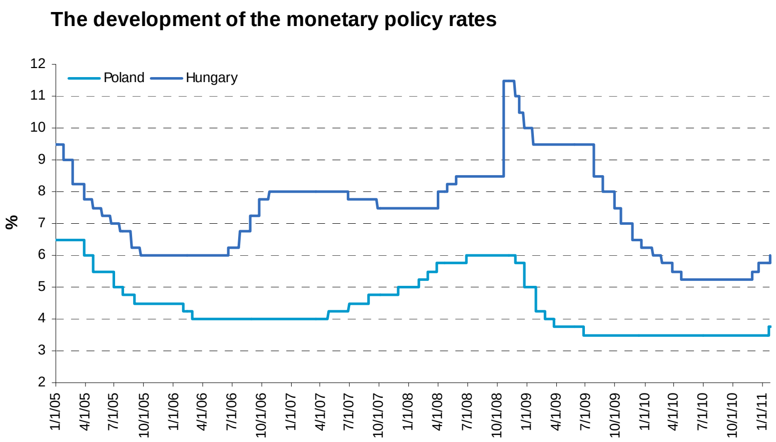
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Polish NBP starts hiking cycle, governor remains hawkish
- We expect Polish headline inflation to climb further towards 4 %
- ..but we continue to expect only a moderate monetary tightening as the zloty should help
- CNB's board members in focus as central bank meeting approaches
- NBH should strike again. Another 25 bps rate hike is on the agenda

Chart of the Week: NBP and NBH base rates on their way up



The NBP has just started its tightening cycle, the NBH has already been hiking since the end of November.

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Market's Editorial

Rising headline inflation is bringing the central bankers into the spotlight

Given rising inflation in Central Europe, the markets increasingly need to monitor the behaviour of the respective central banks. These banks have to cope with the unpleasant fact that headline inflation is hitting (or is about to hit within the next few months) the upper threshold of the their inflation bands/targets.

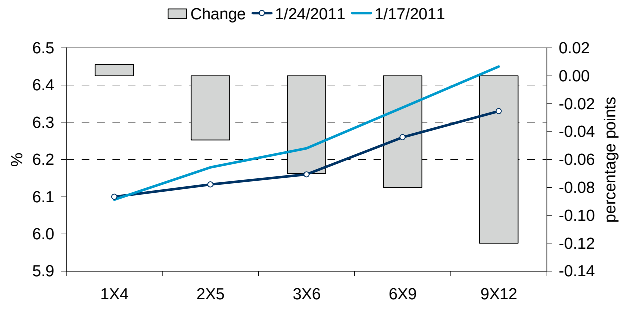
The meeting of the National Bank of Poland (NBP) last week was the eye catcher as the NBP started monetary tightening. The NBP raised rates by 25 basis points and NBP Governor Belka warned after the meeting that the rate hike would not be a one-off event. Somewhat paradoxically, the market expectations regarding rate hikes have cooled slightly and are now closer to our opinion that Poland may see two additional rate hikes this year. In other words, the base rate of the NBP might be 'only' 4.25% in December.
Nevertheless, it is quite possible that markets will again expect more from the NBP as early as in February. Poland's year-on-year inflation will rise, due also to a VAT increase, to slightly below 4% during the first quarter of the year (see page 3 for details). This might fuel speculation on the need to raise rates even more. However, in the end, rates may not necessarily hit the level that the market bet on, because, firstly, inflation has been partly driven by factors out of central bank's control and, secondly, just like Governor Belka, we expect the strengthening of the zloty will contribute to the monetary tightening significantly.

NBH should follow NBP. Czech central bankers might deliver some interesting comments

The next central bank to come into the spotlight after the NBP is its Hungarian counterpart. The NBH should raise its base rate by 25 basis points on Monday. Being aware of increased inflation, the market anticipates this. However, given some slightly dovish signals from the NBH Monetary Council and the fairly strong forint, the market is not as certain this time as it was last month. We think that the Council, ahead of its re-composition scheduled for March (three new Members will join the Board), will use one of its last opportunities in its existing composition to raise rates.

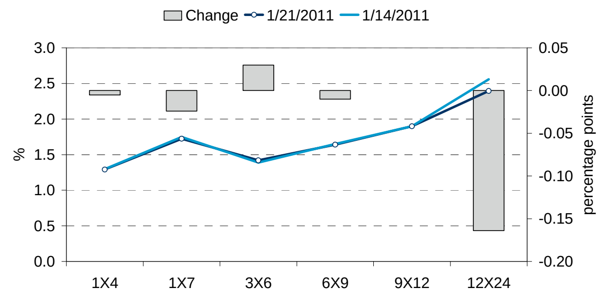
Finally, both the Czech forex and fixed-income markets should be ready to catch eventual comments from CNB Board members this week. The interest rate meeting is scheduled for February 3. Hence CNB Board Members will have the chance to comment on monetary policy till Thursday when the seven-day black-out period ahead of the meeting starts. It is quite possible that some of the CNB Board Members will feel the need to comment on the current monetary policy settings at the last moment. Especially, Czech markets should be on the lookout if Governor Singer were to share his views, as his position within the CNB Board is exclusive.

HU FRA



Source: Reuters

CZ FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.29	-0.33%	↘	↘
EUR/PLN	3.870	-0.04%	↘	↘
EUR/HUF	274.2	-0.56%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.90	0.01	→	→
10Y PLN	6.31	-0.04	→	↗
10Y HUF	7.46	-0.24	→	→

Review of Economic Figures

The NBP hikes rates as expected

The Polish central bank (NBP) started to normalise record low interest rates. The base rate rose from 3.5% to 3.75% and the comments after the meeting continued to point to a further monetary tightening. This is a right step in our view and we have been arguing for such move for some time (see our December flash). The latest macro figures, including strong GDP growth of 4.7% Y/Y (on seasonally adjusted basis), point towards a sustainable recovery. In 2011, core investments (ex inventories) and domestic consumption (enhanced by positive labour market trends) should enable similarly strong growth as in 2010. Putting this together with rising headline inflation and growing risk of spill over effects on wage negotiations, the situation clearly calls for a certain interest rate normalisation. Beside that, it is clear that the Polish zloty remained rather weak in the second half of 2010 and did not help to tighten monetary policy.

Governor Belka said in a comment after the meeting that he would not interpret the current hike as a one-time adjustment. On the other hand he also expected a stronger zloty, which should prevent the NBP from aggressive tightening.

Although the majority is hawkish now, we continue to bet on a gradual tightening

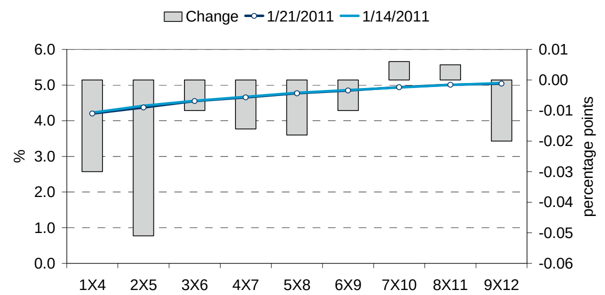
The upcoming development of Polish headline inflation could be quite nasty, but we are no fan of aggressive monetary tightening. In our view there are a few important reasons to be cautious. One must take into account that inflation, although it accelerates above the target, is now purely cost/supply driven and the NBP cannot do much about it. The main drivers are fuel and food prices and the administrative changes from the beginning of 2011 (see inflation projection on the next page). At this stage, a moderate monetary tightening should be enough to prevent any spill-over on the wage negotiations. We also believe that monetary tightening does not necessarily need too many interest hikes if the Polish zloty continues to appreciate as it will tighten overall monetary conditions further. Beside that, the current favourable growth forecast of the NBP must still take into account global uncertainties, especially in light of persisting tensions in the euro zone peripheries.

Hence in one year horizon we continue to see the base interest rate at 4.25% (+25 bps in March and +25 bps in Q2 2011), which is less than is currently priced in, in the market.

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 probably turned to hawkish camp

PL FRA



Source: Reuters

In Focus: Polish headline inflation to climb to 4 %

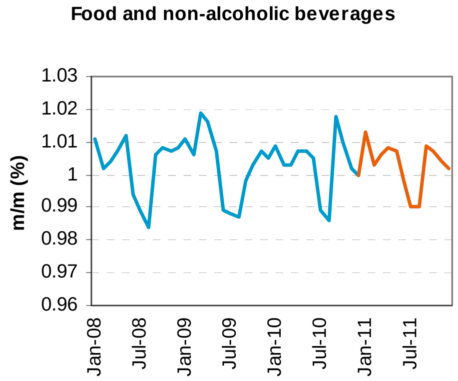
Polish inflation might approach even 4% y/y

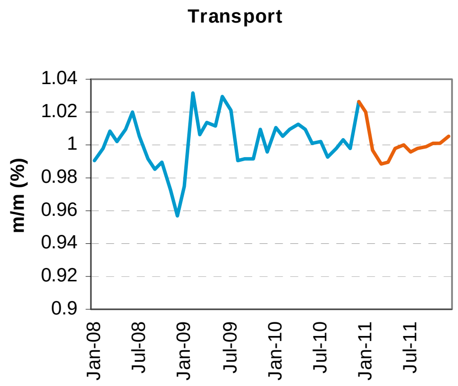
In the last month of last year, Poland's consumer price index was up by more than 3% y/y, and thus inflation went up even further above the target of the central bank (NBP). The reaction, i.e., the monetary tightening, came soon and put an end to the period of record low interest rates in the country. If we look more closely into the index structure, we find that petrol prices, which were up by a huge 5.1% m/m, were evidently the main contributor to the acceleration of inflation. Remarkably, in spite of the significant global increase in food prices in December 2010, the sub-index of food and non alcoholic beverages prices stagnated over that period.

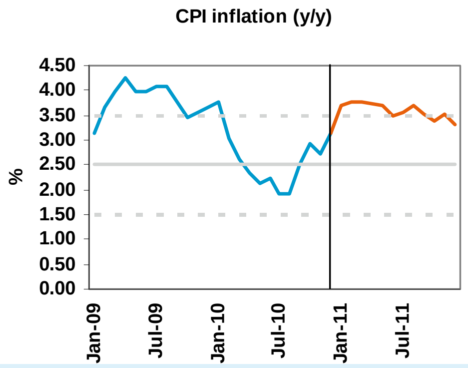
We expect that Poland's inflation will continue to accelerate within the next few months, due in particular to a 1% increase in VAT rates, even above the upper threshold of the NBP (3.5%) for some time. Even with a fairly conservative scenario (a rapid rate of appreciation of the Polish zloty; a fairly strong drop in oil prices by almost US$12 compared to the current prices during the first quarter of the year; and, except for January 2011, only seasonal factors of food prices taken into account), our model indicate that the overall rate of year-on-year inflation in Poland will exceed 3.5% as early as in the first month of this year and might reach approximately 3.8% in February and March. Inflation should be primarily driven by food prices and the VAT increase. The sub-index of food and soft drink prices, adjusted for the VAT increase, might go up by more than 1% m/m in January. The shock in the form of the increased VAT rates might contribute approximately 0.5% to January's inflation figure.

That said, Polish central bankers find themselves at the start of challenging times, as we do not believe that inflation will fall significantly – to less than the upper threshold of the tolerance band of the NBP – until autumn, when last year's comparative baseline will increase.

BOX: Detail inflation outlook for coming months







CE Weekly Preview

Mon 14:00	MNB base rate	
	This meeting	Last change
rate level (in %)	**6.00**	12/2010
change in bps	**+25**	**+25**

HU: NBH strikes again with a 25 bps rate hike

December's surprisingly high inflation is likely to make the NBH raise its base rate for the third consecutive time. Nevertheless, the NBH Board's opinion is evenly divided between doves and hawks, and therefore the outcome of the vote may be fairly narrow.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**1/24/2011**	**14:00**	**NBH meeting (%)**	**01/2011**	**6.0**		**6.0**		**5.75**	
HU	1/25/2011	09:00	Retail sales (%)	11/2010						-0.7
HU	1/28/2011	09:00	Unemployment rate (%)	12/2010						
PL	1/28/2011	10:00	Unemployment rate (%)	12/2010			12		11.7	
PL	**1/28/2011**	**10:00**	**Retail sales (%)**	**12/2010**			**9.1**	**22.1**	**-6.7**	**8.3**

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

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 24.1800/ .1780 (current reaction low off 25.3800/ monthly Bollinger bottom), where pause favored.
Failure to hold would see next levels at ahead of 24.1000/ .0960 (1st Irregular B off 25.3800/ weekly Bollinger bottom), ahead of 23.9490 (2nd 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/ .5230 (breakdown daily/ falling weekly Short Term Moving Average): ideal area to stay below to keep current mood on CZK.
Failure to cap would see ext levels at 24.7460/ 24.8000 (falling weekly Medium Term Moving Average/ breakdown daily Jan 05), ahead of 24.9750/ 25.0350 (breakdown daily/ weekly): tough on 1st attempts.

EUR/HUF Daily Chart:

Currently back Triangle pattern and back above 272.25 (see graph: neckline Double Top).
Support at 273.50 (break-up hourly), with next levels at 271.62/ .60 (monthly envelope bottom/ current reaction low 280.80), where pause favored.
Failure to hold would see next levels at 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 276.10/ 277.40 (weekly Bollinger midline/ breakdown hourly): ideal area to stay below to keep current mood on HUF.
Failure to cap would see next level at 279.81 (weekly modified Alpha Beta trend top), ahead of 280.80/ 281.15 (current year high/ last month high) and 281.77 (weekly Bollinger top): tough on 1st tests.

EUR/PLN Daily Chart:

.Approached key **Support** area (see graph) at 3.8225 (2010 low + neckline long term Double Top) and currently back above the 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 + weekly modified Alpha Beta trend bottom), where pause favored.
If wrong, next levels at 3.8053 (monthly modified Alpha Beta trend bottom), ahead of 3.7851 (monthly Bollinger bottom): tough on 1st attempts.

Resistance at 3.9160 (current reaction high off 3.8290?): ideal area to stay below to keep current mood on Zloty.
Failure to cap would see next levels at 3.9340/ .9450 (breakdown hourly/ breakdown daily + falling weekly Medium Term Moving Average), ahead of 3.9519 (weekly modified Alpha Beta trend top), where pause favored to set in.

CE Fixed-income in Charts

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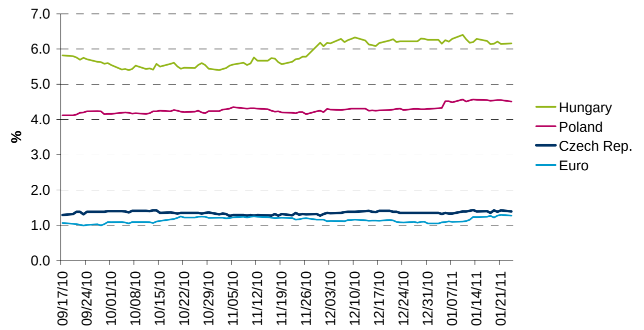
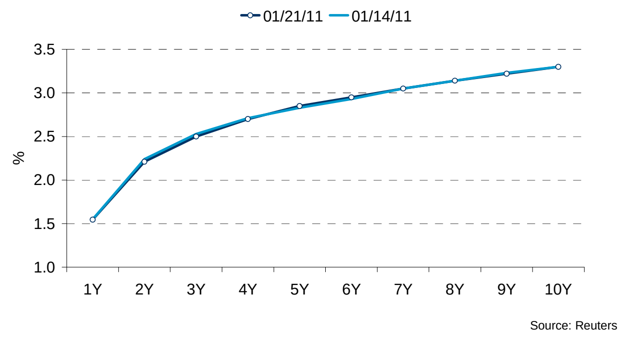
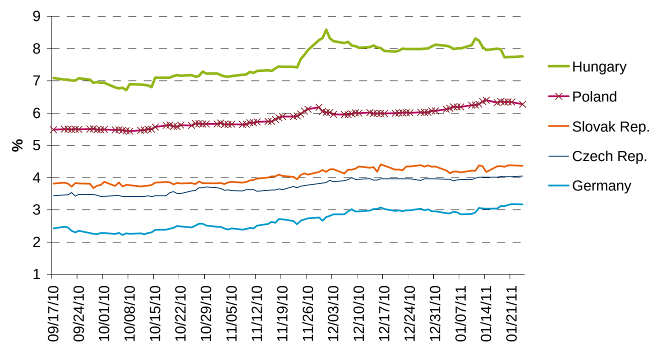


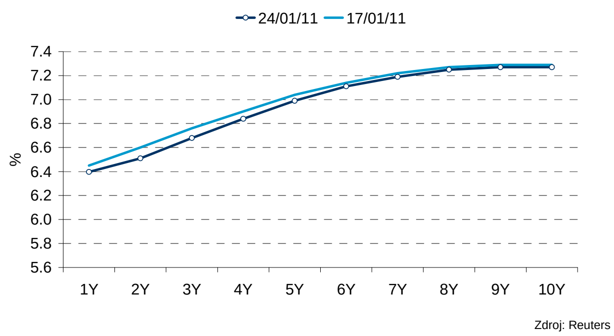
CZ IRS



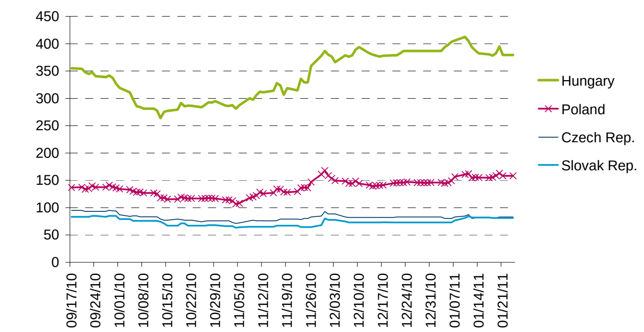
10Y GB Yields



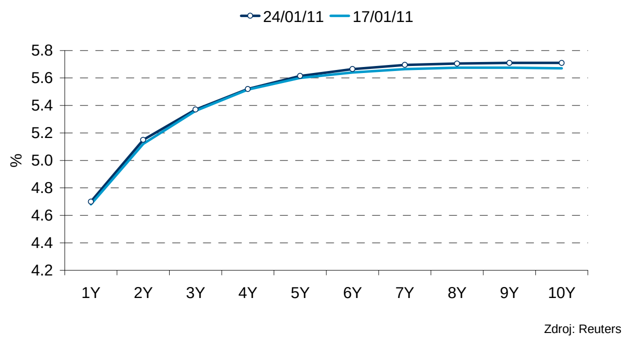
HU IRS

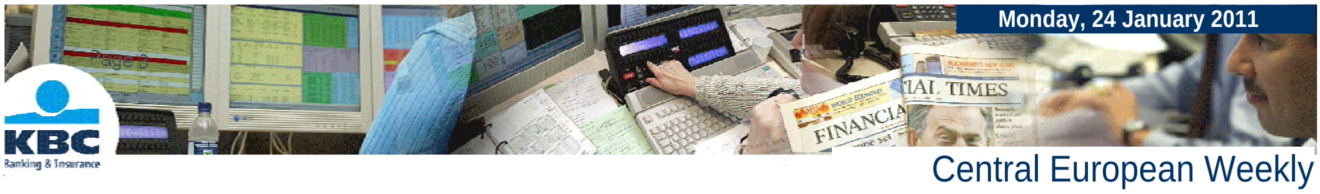


CDS 5Y



PL IRS



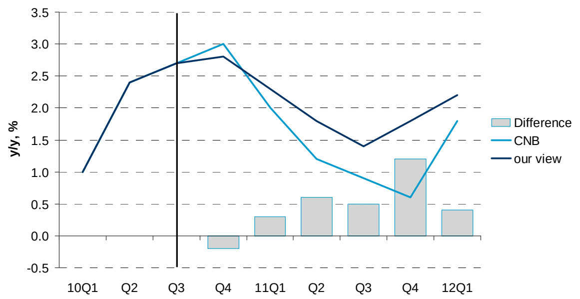


Medium-term Views & Issues

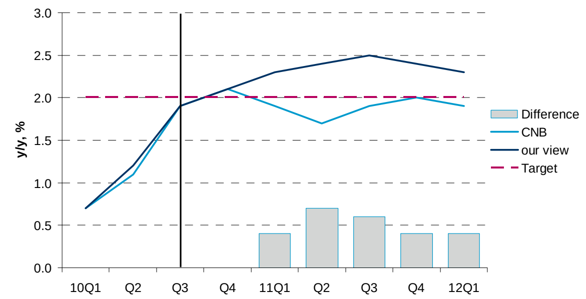
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction at the rate by less than a 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 fell 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, economic momentum is gaining momentum due to the tax cut (personal income tax rate lowered to 16%) and the fiscal situation is improving.	Latest GDP figures confirmed strong growth (4.7% y/y on a seasonally adjusted basis) The main drivers were domestic consumption of households and 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, it 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 consider it to be the right moment the normalisation 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 expect only a gradual tightening. In a one-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 euro-zone and the external balance should remain at reasonable levels. Beside that the Czech koruna may profit from an earlier start of hiking cycle and growing inflow of EU funds. Nevertheless the CZK can stay in defensive due to euro-zone 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 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 exports. 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 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 bring temporary volatility of the PLN by the end of the 2011.

Central Bank’s Projections versus Our Macro Forecasts

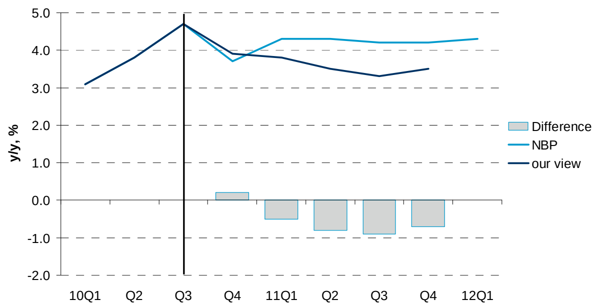
CZ: GDP Outlook



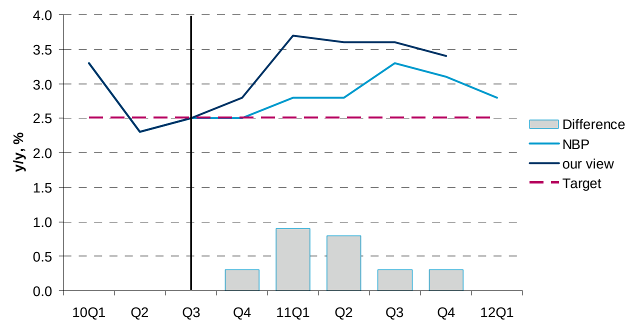
CZ: Inflation outlook



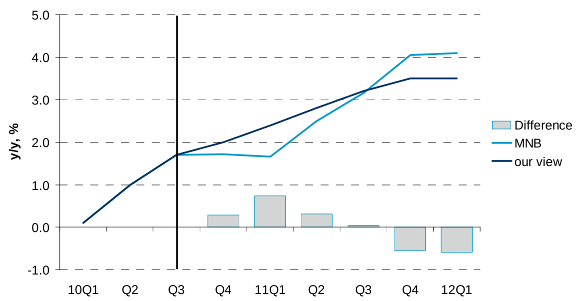
PL: GDP Outlook



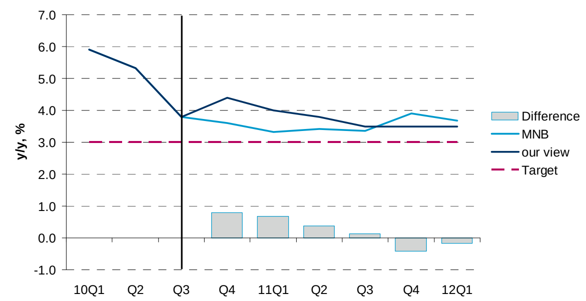
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	1.00	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.00	6.00	25 bps	1/24/2010
Poland	2W inter. rate	*3.75*	4.00	4.25	4.25	4.25	25 bps	1/19/2011

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

		Current	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	PRIBOR	*1.18*	1.22	1.26	1.45	1.60
Hungary	BUBOR	*5.84*	6.05	6.05	6.00	5.90
Poland	WIBOR	*4.08*	4.15	4.35	4.35	4.35

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

	Current	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	*3.31*	3.15	3.30	3.40	3.60
Hungary	*7.31*	7.75	7.75	7.50	7.50
Poland	*5.765*	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	EUR/CZK	*24.3*	24.7	23.7	24.0	25.5
Hungary	EUR/HUF	*276*	273	277	273	270
Poland	EUR/PLN	*3.89*	3.70	3.55	3.60	3.80

GDP (y/y)

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

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

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

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